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BASIC DETERMINANTS OF CRISIS RESPONSE ECONOMIC POLICY OF UKRAINE

Annotation *This paper is aimed at anti-crisis economic policy peculiarities' formation of Ukraine. The relevance is the analysis of macroeconomic development of the country, fiscal and monetary policy, banking regulation, structural reforms and pillars of crisis resolution.*

Key words: determinants, anti-crisis policy, Ukraine.

Анотація *Ця стаття присвячена особливостям формування антикризової економічної політики України. Актуальність полягає в аналізі макроекономічного розвитку країни, фіскальної і монетарної політики, банківського регулювання, структурних реформ і стратегічних шляхів виходу із кризової ситуації.*

Ключові слова: детермінанти, антикризова полiтика, Україна.

Аннотация *Эта статья посвящена особенностям формирования антикризисной экономической политики Украины. Актуальность состоит в анализе макроэкономического развития страны, фискальной и монетарной политики, банковского регулирования, структурных реформ и стратегических путей выхода из кризисной ситуации.*

Ключевые слова: детерминанты, антикризисная политика, Украина.

Introduction

Ukraine is one of a number of emerging markets to have experienced increased financial market stress in recent years, though local factors, notably corporate governance concerns, the rise in the gas price, presidential elections 2010 grew in importance. Net private capital inflows have receded, the value of equity collateral has fallen and confidence in counterparties has weakened, causing interbank rates to jump. Deterioration of economic situation in Ukraine was in some sort a result of global liquidity fall and deceleration of economic development in the majority of countries. It limited the access of the real sector enterprises and banks to foreign lending on the one hand, and, on the other hand, there was reduction of demand for the traditional Ukrainian export goods due to the unfavourable situation.

The core of this article is practical recommendations of macroeconomic policy optimizations of Ukraine as a factor of stabilization and development of structural reforms in the country. The fundamental scientific contribution into investigation of general theoretical and special problems of crisis-response policy of Ukraine is made by the following scholars and economists as: A. Åslund, M. Balston, B. Danylyshyn, A. Kapteyn, V. Korneev, Y. Lissovolik, O. Paskhaver, O. Pogarska, E. Segura. N. Shvets', T. Vakhnenko and others. Despite their basis, the author of the article thoroughly investigates pre-crisis and post-crisis macroeconomic development of the

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country, fiscal and monetary policy, banking regulation, structural reforms and pillars of crisis resolution.

1. Pre-crisis macroeconomic development and structural reforms

During the years of 2000-2007, Ukraine enjoyed high economic growth and reasonable stability. An upward rating trajectory was interrupted by the "Orange Revolution" of late 2004 and subsequent political and economic disappointments in 2005. However, the evidence of growing stability of the democratic regime, supplemented by more balanced macroeconomic growth, the country's accession to the WTO in May 2008, and various factors that combine to stimulate much-needed microeconomic restructuring and energy-efficiency measures, prompted a strong growth of the country.

For the past eight years (with the exception of 2004), Ukraine ran either a consolidated budget surplus or else a small deficit. The final deficit for 2007 was only 1.1% gross domestic product (GDP). Taxes provided for over 73% of all revenues. Starting in 2004, successive governments have increased social expenditures and public sector wages in an effort to raise living standards and gain political support. Social transfers including pensions rose from 15% GDP (2002-2003) to 20% GDP (2005-2007). Budget deficits remained contained because increased social transfers have been countered by cuts in capital expenditures. Also, it has not proved possible to lower various tax rates as much as had been envisaged by various governments, due to populist social welfare expenditure trends [Schiffer J. 2008, p. 5].

Ukrainian authorities are usually fiscally conservative with the level of budget deficit. Ukraine's technical default in 2000, which stemmed from carelessly loose fiscal policies in the 1990s, made policy-makers cautious about public debt and budget deficits. Only in 2004 fiscal authorities broke the 2.5% ceiling of GDP for deficit level. However, on the heels of aggravating economic problems the government attempts to resurrect the poor practice of an unsustainable budget deficit (-1.5% of GDP in 2008).

Although the deficit by itself was not a problem in 2008, public finances suffered extremely high levels of recurrent expenditures. On-going outlays account for more than 80% of the annual budget leaving very little funds to invest. The problem stems from Soviet privileges and the continued social policy by the authorities. In fact more than 60% of recurrent spending was public sector wages and social transfers. Although there was a positive tendency to reduce the recurrent outlays beginning in 2006 through 2008, the result was not a real improvement. Broadly speaking, the authorities just cut the excessive social outlays which increased during the 'post-revolutionary' period of 2004-2005. For significant reductions in recurrent spending the government needs to address social privileges reform and pension reform; however, little progress had been observed in these areas for many years.

Ukraine has exhibited a strong improvement in terms of its external vulnerability ratio – which has dropped from 593% (2000) to 76% (2007), due to a sharp growth of foreign currency reserves. However, its ratio was still above the median for B1 – C category rating peers (63%) [Schiffer J. 2008, p. 2]. Net foreign direct investment (FDI) grew robustly in 2007, totalling over USD 9 billion. Cyprus, representing recycled Ukrainian assets, and Germany were the largest country sources of foreign investment. Both have total stocks of FDI of almost USD 6 billion out of a net FDI total stock of USD 33.5 billion at end-2007.

Growing diversification in production and exports was matched by growing diversification in export markets. During the years of 2000-2007 the main export market shares were the CIS – 38%, EU – 30%, Asia – 21%. Russia took 26% of all exports, Turkey – 7.3%, Germany – 3.4%, Poland – 3.4%, Kazakhstan – 2.9%, Hungary – 2.5%.Ukraine's trade balance deteriorated significantly in 2007 growing by 71% year-on-year. Imports (up 29% yoy) outpaced ex-

ports (up 25% yoy) (see chart 1), due to surging domestic demand (retail trade grew at an annual rate of 29%; disposable household income grew 13%).

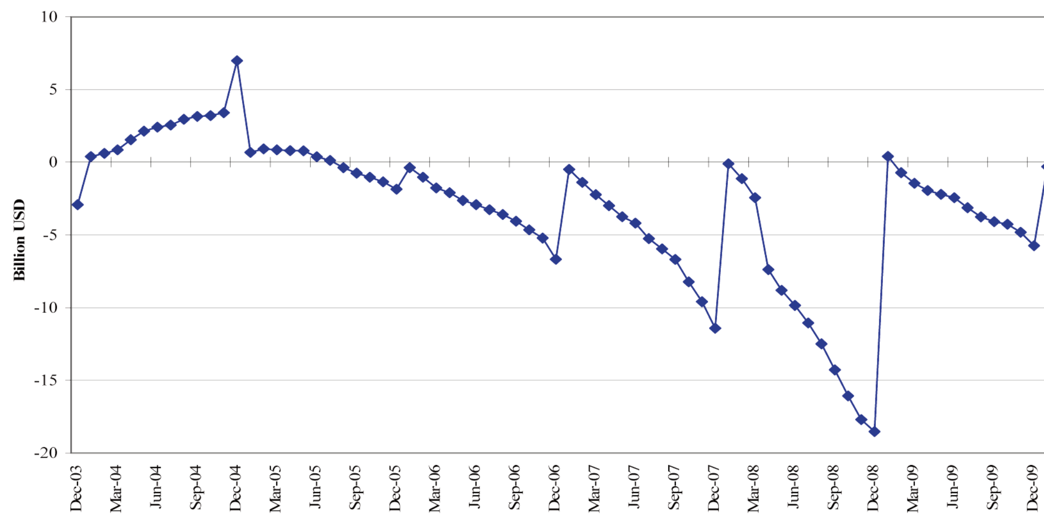

Chart 1 Foreign trade Balance of Ukraine
Source: State Statistics Committee of Ukraine

Much of import growth was prompted by serious industrial restructuring (machinery imports were up 48% yoy), as well as a substantial rise in the price of imported gas from Russia. Russian gas giant Gazprom raised the price of gas 37%, to USD 130/1000 cubic meters. This made the gas import bill USD 6.6 billion in 2007 as opposed to USD 4.9 billion in 2006. The service balance was in surplus, rising to over USD 4 billion in 2007. Large increases in imports of services provided by non-residents were registered in financial services (up over 100%) and transportation services (up over 40%), both indicating greater involvement by Ukrainian companies in international trade-related services. Export services continued to be dominated by pipeline transportation, which yielded over 25% of overall service exports. The transit price charged by Naftogaz has risen from USD 1.09/1000 cubic meters/100 kilometers in 2005 to USD 1.70 in 2008.

Strengthening the banking sector's capacity and share of bank claims on long-term credits has constantly grown since 2000 and constituted almost 70% of bank credit portfolios as of July 2008, whereas the share of long-term liabilities has grown at a substantially lower rate reaching 45%. At the same time, between 2000-2008 (and, especially, 2006-2008) bank credits grew at higher rates than borrowed funds implying growing liquidity risks and lack of effort by banks to address the issue. The very rapid growth of credit portfolio (174% in 2007 compared to 2006) was a concern by itself. Usually a high growth implied deterioration of credit quality unless accompanied by a more stringent screening process of potential borrowers, which raised substantial concerns about the future level of non-performing bank loans.

For many years Ukraine pegged its exchange rate to the US dollar. The original purpose of the peg was to have a nominal anchor to contain inflation. However, from 2003 to 2008 inflation rose gradually, eventually reaching a very high rate. In effect, Ukraine was importing inflation in terms of rising food and energy prices through its dollar peg. According to the World Bank's Government Effectiveness Index – that rates governments from -2.50 to +2.50, Ukraine (-0.57 in 2006).

All along, the Ukrainian public kept a large share of its savings in dollars and as the exchange rate remained stable it felt no need for a switch into Hryvnia (UAH). At the same time, bank loans denominated in dollars were cheaper than those in Hryvnia, as they carried consid-

erably lower interest rates. Households and enterprises did not fear a rise in the dollar as the exchange rate of the Hryvnia had remained unchanged for years. As a consequence, the Ukrainian economy was highly dollarized with the public insisting on maintaining a fixed exchange rate.

From 2000 until 2008, Ukraine went through a tremendous monetization. The volume of money (M3) rose from 15% to 54% of GDP at the end of 2008 (see chart 2). Most of this was bank lending from private banks to Ukrainian corporations and consumers. This big credit boom was the one of the drivers of Ukraine's high economic growth years. It has been especially strong in the past four years, with real GDP increasing by an average of 7.4%. Thanks to strong income growth, private households have reached a level of solvency that has allowed them to apply for bank loans and an increased level of savings has helped banks to expand their deposit bases. Similarly, banks have benefited from increased corporate income and deposits.

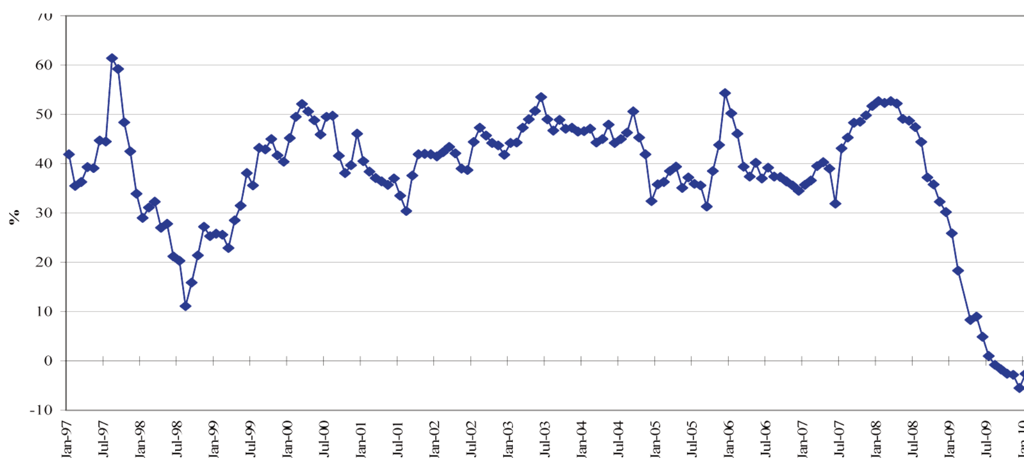

Chart 2 Money Supply M3 of Ukraine (YoY)
Source: National Bank of Ukraine

The degree of banking system penetration has been steadily growing, as reflected by significant deposit and credit expansion. Banking assets represented 84% of GDP at year-end 2007 compared with 63% in 2006 and 48% in 2005. However, this is still a considerably lower ratio than the average for Central and Eastern Europe, excluding Russia, of approximately 100%, according to Moody's estimates. The share of banks' income generated from retail and SME lending is increasing. This is expected to bring more stability to their earnings. The share of retail loans in total loans granted to the private sector rose to 36% in October 2008 from 13% in 2003. Moreover, retail deposits increased faster than corporate deposits in 2008. According to the National Bank of Ukraine (NBU), between January and October 2008, retail deposits increased by 19.2% while corporate deposits increased by 16.6%. Income from retail banking was relatively stable compared with income from wholesale banking where banks were often exposed to developments affecting large corporate customers [Robeck K. et al. 2009, p. 6-8].

High interest rates on Hryvnia deposits combined with the fixed exchange rate fuelled an increase in exchange rate risks throughout 2008. The relative proportion of Hryvnia-denominated liabilities was steadily rising, as were interest rates on deposits in Hryvnia. At the same time, in the structure of credit portfolio one observed Hryvnia denominated loans being replaced by loans issued in foreign currencies (primarily, US dollar) and stable, sometimes falling, credit interest rates. Given the fixed exchange rate or appreciation of the domestic currency vis-à-vis the US dollar in the mid of 2008, the described currency compositions of credits and deposits implied increasing liability coupled with the same or decreasing assets.

The external debt of the state and finance metrics were much improved, thanks to several years of large current account surpluses and prudent fiscal policy, previous debt restructuring, and continued inflows of foreign capital that have raised foreign currency reserves and improved liquidity ratios substantially. However, these indicators compared unfavourably to rating peers because of heavy external borrowing by the private sector.

The booming Ukrainian economy has attracted substantial foreign investment in the banking sector. As of October 2008, 50 Ukrainian banks were at least partly foreign-owned and 18 banks were 100% foreign-owned. Between January 2007 and October 2008, the share of foreign capital in total registered capital rose to 38% from 28%. The share of foreign currency liabilities on banks' balance sheets was 29.5% in September 2008, according to the NBU data.

Foreign-owned banks were in a comparatively good position as they could pick up market shares from privately owned banks. During the past few years of robust economic growth in the EU, a number of foreign owned banks in Ukraine have benefited from earnings that parent banks had generated at home and invested in their subsidiaries. Given that capital markets were relatively underdeveloped in Ukraine with significantly lower stock market capitalisation, parent capital has been a vital source of growth for banks.

To sum up, despite a political turbulence the Ukrainian economy continued to demonstrate remarkable performance during the years of 2000-2007. From 2003 to 2007 Ukraine had one of the fastest growing economies among other CIS countries. This growth was supported by booming domestic demand and strong exports. From January to September 2008, Ukraine continued to enjoy good economic results, such as: real GDP grew by 6.3%, inflation decreased, the fiscal budget was in surplus, public debt declined, exports grew by 50%, the current account deficit was being met by capital inflows, international reserves reached USD 37 billion (see chart 3). Ukraine has a market-based economy, in which total government expenditure, including consumption and transfer payments, was high. Ukraine promoted foreign investment with national treatment, except in select sectors.

2. The crisis impact on the Ukrainian economy

Ukraine has been one of the countries in the world most severely hit by the crisis. In 2008 there was the collapse of macroeconomic stability in the country. The steadily rising inflation peaked out, while the current account deficit became excessive, rendering a large depreciation of the currency necessary. In late September 2008, global liquidity froze, and Ukraine was completely excluded from global finance. Several industries – construction, metallurgy, mining, and machine-building – saw their output falling momentarily by about half. Only agriculture escaped the crisis, especially grain sector.

Ukraine suffered badly during the crisis for several reasons. The fundamental problem was Ukraine's exchange rate policy. The country had maintained a fixed exchange rate to the US dollar for years. By 2008 the persistently high inflation and even higher wage increases, left Ukraine with a very high cost level, making it difficult for the country to compete on the international market, as reflected in a widening gap between imports and exports. When international credit dried up on account of the global financial crisis, Ukraine's large current account deficit could no longer be financed. This left no choice but to devalue the overvalued currency. Being the only sensible solution, the need for a lower exchange rate was incorporated in Ukraine's letter of intent containing its request for a credit from the International Monetary Fund (IMF)

Therefore, currency inflows increased the money supply excessively (see chart 2), resulting in inflation. Ukraine had experienced double-digit inflation from 2004, and in May 2008 in-

flation peaked practically at 31% year over year. As a consequence, Ukraine priced itself out of the market. Imports rose more than exports (see chart 1), and the current account deficit expanded to 7% of GDP in 2008. At the same time Ukraine's foreign debt rapidly accumulated to USD 103 billion or 57% of GDP in 2008, adding to the country's vulnerability.

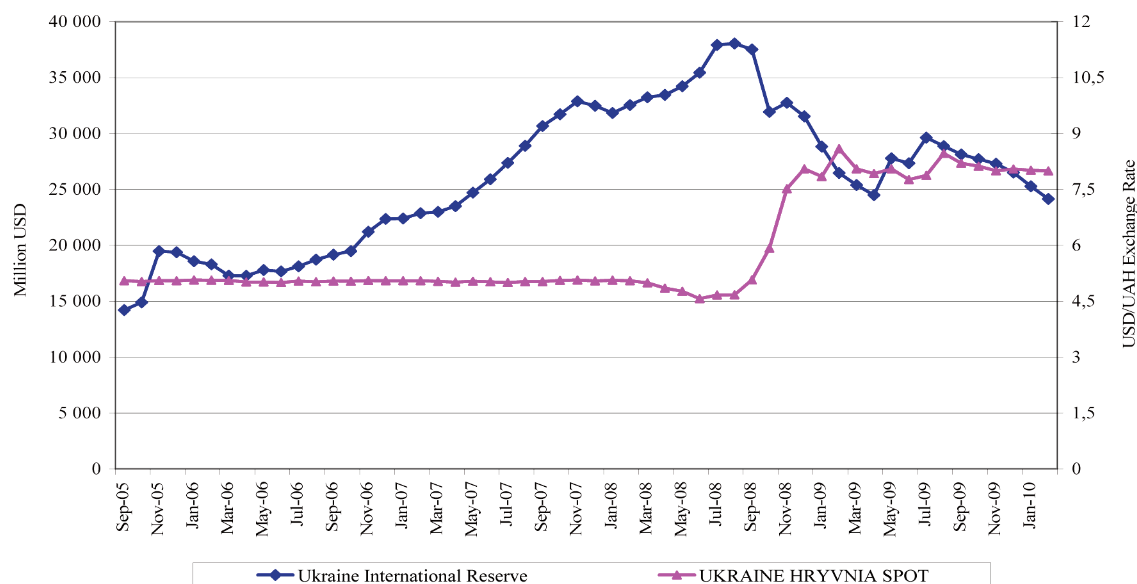

Chart 3 International Reserve Level of Ukraine vs USD/UAH Exchange Rate
Source: National Bank of Ukraine

In Q4 2008 the reduction of long-term capital inflow and outflow of short-term capital resulted in the negative aggregate balance of payments (USD 3.1 billion). Consumer Price Index made 122.3%, as a result of both global increase in the world prices (in particular, food prices) and internal factors, such as: macroeconomic imbalances, deterioration of inflationary expectations of households [Council of NBU, 2009]. The macroeconomic conditions for implementation of the monetary policy became rather complicated with regard to the risks of unfolding recession processes in the real sector due to forecasted deceleration of the world economy development and reduction of domestic demand, as well as to complicated access to external and internal sources of financing.

In the real sector of the economy, the industrial production of Ukraine fell down in November 2008 and reached the worst situation in January 2008 (see chart 4). Ukraine witnessed a notable improvement in the dynamics of industrial production in October 2009, which declined by 6.2% yoy, with month-on-month growth reaching 5%. Overall, in January-October 2009 industrial production declined by 26.4% yoy. A decline in investor sentiment towards emerging market, political uncertainty and a

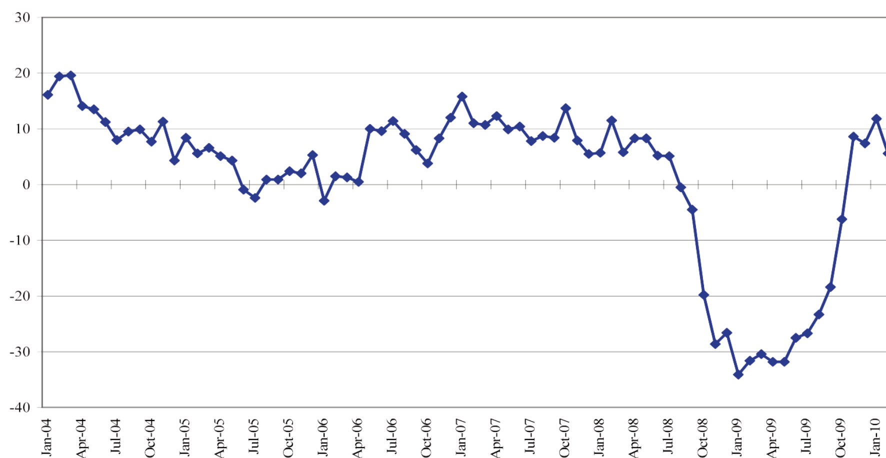

Chart 4 Industrial Production of Ukraine (YoY)
Source: State Statistics Committee of Ukraine

fall in steel prices led to the depreciation of the Hryvnia with adverse affects for inflation, debt servicing, and the asset quality of the banking system as the majority of foreign currency borrowings are on-lent in foreign currency-denominated loans.

To sum up, there were three main channels of the financial crisis influence, more deeply-felt by the Ukrainian economy [Danylyshyn, B. 2008]. The first channel was foreign trade. Widespread financial problems have already undermined demand in the international markets. Recession in the world's leading economies was accompanied by the decreasing investment demand in the metallurgy and machine building products. Since the Ukrainian economy was highly dependent on exports making up more than 47% of the country's GDP, the above trends in the global markets were harmful for the development of export-oriented sectors, with subsequent repercussions on industries relying on exports directly and indirectly.

In 2008, exports grew fast at 33%, but imports grew even faster at 39%. As a result, the current account deficit reached around USD 13 billion in 2008, or 7.2% of GDP. Although the net inflow of foreign direct investment (FDI) comprised a substantial USD 9.7 billion, it did not cover the current account deficit. To absorb the gap, Ukraine used reserves and depreciated the Hryvnia.

The second channel was the banking system. The financial sector was one of the national leaders in attracting foreign direct investments (19% of total accumulated foreign capital). Given the large share of transnational financial corporations on the Ukrainian banking sector, the global financial crisis had an indirect adverse impact if mother companies suffered great losses or had liquidity problems. In this context, the investments and development of Ukrainian manufacturing companies hinge more on lending than on the stock market: 16% of investments in fixed assets were funded from loans. The most credit-dependent sectors were agriculture, construction, processing industries, including the chemical and petrochemical industry, the food industry, coke production and oil refining.

Over the last several years, the banking sector had been experiencing an extraordinary, albeit unsustainable, expansion, as bank lending grew by over 70% per year. This growth was supported by better access to global capital markets, the entrance of many foreign owned banks and loose domestic monetary policy. However, the global financial crisis closed the main source of this expansion Ukrainian banks' access to international credit markets. As a result, local banks faced elevated liquidity and credit risks, as rollover of maturing foreign debt became hard to obtain, while the volume of nonperforming loans (NPLs) started to grow.

According to the NBU, the share of doubtful and loss loans grew from 2.5% at the beginning of 2008 to almost 9% at the end of June 2009. Including substandard loans, the share of NPLs stood at 14.5% in 2008, much higher than in other peer countries. Moreover, with more than half of all outstanding loans in the Ukrainian banking system denominated in foreign currencies, both borrowers and commercial banks were exposed to currency risks. This combination of increasing risks in the banking sector stoked fears of banks' insolvencies, which led to an erosion of public confidence in the banking system and runs on bank deposits. As a result, the banking sector lost almost 25% of its deposits from October 2008 to April 2009, making it even more difficult for banks to roll over foreign short term debt and causing an abrupt halt in credit activity.

The third channel of influence was debt. In June 2008, gross foreign debt made up 59.9% of GDP at USD 100.06 billion. Almost 85% of this debt was that of the private sector. Deteriorating liquidity in global financial markets slowed up lending to the Ukrainian economy. As a result, Ukrainian borrowers had difficulty refinancing their credit liabilities in external markets. During the years 2006-2008, Ukraine's total external debt doubled, growing from USD 53 billion to USD 103 billion by the end of 2008. Amounting to 60% of the country's GDP, Ukraine's

external debt ranked above the median value for similar countries. In the last quarter of 2008, net external debt outflow from Ukraine amounted to USD 6.6 billion and was among the main sources of Hryvnia depreciation pressures.

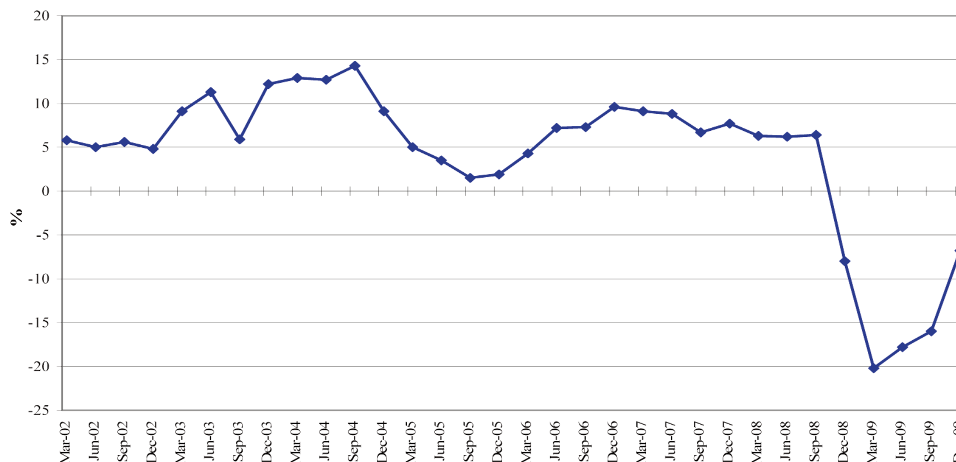

Chart 5 GDP of Ukraine (Real, YoY)
Source: State Statistics Committee of Ukraine

In Q3 2009 GDP dynamics started improving. The decline in the economy reached 15.9% yoy, compared to declines of 20.3% yoy and 17.8% yoy in Q1 2009 and Q2 2009 respectively (see chart 5). The official forecast of the government is for a fall of 12% in 2010, while the IMF projects a 14% fall [Balston et al. 2009, p. 120]. The recovery is expected to be slow in 2010 and next year, with base effects accounting for a significant part of the improvement in growth dynamics. Fitch downgraded Ukraine to 'B-'/Negative in January 2010, Moody's – to 'B1'/Negative, S&P – to 'CCC+'/Positive.

In February 2010 an industry growth achieved 5.6% comparing to the respective period in previous year. Increase of the production output was observed almost in all branches of the industrial activity. The total export volume in January 2010 was USD 376.5 mln. and grew by 23.6% comparing to the respective period in 2009. The total volume of import in January 2010 was USD 415.0 mln. and grew by 63% % comparing to the respective period in 2009. Consumer price index (CPI) in February 2010 was 101.9%, since the beginning of 2010 – 103.7%. Production price index (PPI) was 101.9%, since the beginning of 2010 – 103.8%.

Economic policy of Ukraine in the short run should be based on a clear understanding that the pre-crisis achieved stability and early signs of economic recovery remain fragile. Monitoring of national economic developments needs to be reinforced to detect and identify problems early on, making it possible for the authorities to react appropriately to them. For the same reason, economic policy should be based on realistic forecasts of no more than a moderate economic recovery in Ukraine, implying severe limitations on the country's ability to meet its financing needs.

3. Post-crisis macroeconomic development and reaction of authorities

In 2010 Ukrainian economy has appeared to be slowly rebounding but significant political uncertainty, the remaining restructuring in the banking sector, and the lengthy delay in bringing the IMF program back on track all cloud the outlook. The government was virtually out of cash raising the risk of arrears, an interruption in gas payments and monetization of the deficit that increased pressure on the Hryvnia.

The reaction of Ukrainian authorities to the crisis should not be restricted to launching measures to improve its current economic situation but should also include reforms to secure the

foundations for sustainable long-term growth. These policies should take into account elements such as a major rethinking of the role of the state in the economy, the appropriate degree and format of state regulation, and forms of state support for specific industries. The present circumstances are very challenging for the authorities, but at the same time they provide an all-important opportunity for implementing a set of reforms that could lastingly improve Ukraine's economic position.

3.1 Fiscal policy

Current Ukrainian fiscal policy is characterized by short-term planning and spontaneous changes to revenues and spending plans. Special Fund and earmarking specific revenues for some specific needs (mainly social) serves to protect selected spending during stormy political times. In 2010 presidential elections made it harder to implement austerity measures in Ukraine. This was fertile territory for political shocks. Officially, Ukraine ended 2009 with a relatively small consolidated budget deficit of UAH 21.6 billion, which was equivalent to 2.3% of estimated 2009 GDP. A relatively small budget deficit was achieved amid a 15% yoy contraction in real GDP and virtually unchanged consolidated budget expenditures. Indeed, consolidated budget expenditures amounted to UAH 307.3 billion in 2009, which was only 0.6% lower in nominal terms than in 2008. Moreover, the decline was achieved mainly on account of a 50% yoy reduction in capital spending, while current expenditures (wages to public sector employees, social transfers) actually grew by 7% yoy.

Officially, consolidated budget revenues fell by only 3% yoy in nominal terms and stood at UAH 289.5 billion. To some extent, such a relatively small decline in budget revenues was the result of an increase in excises on tobacco and alcohol and an introduction of a 13% temporary import duty mark-up. In addition, the degree of budget revenue deterioration was veiled by advanced collection of taxes and charges to the budget, accumulation of VAT arrears, and extensive reliance on one-off receipts.

The overall fiscal deficit, however, was estimated at about 11% of GDP as a number of expenditures were not included in the official statistics. Thus, government spending on bank recapitalization and the Naftogaz capital injection accounted for an additional 5.2% of GDP. Furthermore, Ukraine's Pension Fund looked alarmingly unbalanced. According to Ukrainian legislation, the pension fund deficit is covered by the state budget funds. The 2009 State Budget Law envisaged a Pension Fund deficit at about UAH 14 billion, or 1.5% of GDP. However, the actual deficit turned out to be twice as high. To cover the expenditures, the Pension Fund received credits from the unified Treasury account, equivalent to about 1.8% of GDP. Increasing pension expenditures, which reached about 18% of GDP in 2009, amid a rapidly aging society became the heavy burden on public finances, urging for radical and comprehensive pension sector reform [Pogarska et al. 2010, p. 3-4].

Obtaining sufficient budget deficit financing is likely to remain a difficult task in 2010. For Ukraine reliant on IMF-led programmes for fiscal and external financing and for underpinning economic confidence, failure to stick to programme conditions poses additional risks to macroeconomic stability.

Ukraine concluded its stabilization program with the IMF in October 2008 because the crisis was dire. Initially, the IMF posed its standard demand of a balanced state budget, but over time it has accepted a consolidated state budget deficit of as much as 6% of GDP in 2009. The second IMF demand was a realistic exchange rate, which meant that the exchange rate would float and the Hryvnia thus be depreciated. In effect, the NBU did so in November. The third key condition was bank restructuring and bank recapitalization. In return, the IMF committed a very large amount of $16.4 billion in financing over two years, and this financing was heavily front-

loaded and made available at very low interest rate. By extending large loans and pressing for fiscal reforms the IMF became the external anchor for the stabilization of the Ukrainian economy. Ukraine has been able to draw three tranches of a total of nearly USD 11 billion by the end of 2009.

One of the key issues in Ukraine after the elections was the fiscal situation, which was crucial for the resumption of IMF financing. At that stage the government was out of cash (in December 2009 cash balances dropped below USD 200 million). Otherwise, the fourth tranche of the IMF was discussed to be given for the state in June 2010. The IMF gave Ukraine quite clear requirements. Firstly, the adoption of the budget that was in April 2010, secondly – putting things in order in the banking system on the principles agreed between the NBU and the IMF (further capitalization of banks, the use of government bonds exclusively for banks, but for state monopolies).

At the same time with Yanukovich's victory there was a greater possibility of Russia's financial support to Ukraine, including possibly via the Eurasian anti-crisis fund facility. Ukraine signed with Russia a new gas contract in April 2010 that allowed reducing the gas price for 30%. At the same time Ukraine resumed talks with the EU about creating Free trade area and visa abolishing for Ukrainians to the European zone towards the end of 2010.

The negative effects of the financial and economic crisis in Ukraine are expected to gradually diminish in 2011. Following the stabilisation of the economic environment the operating revenue of local and regional governments (LRGs) will recover slowly. However, due to the crisis they will have higher, albeit still moderate, debt and much weaker liquidity positions. The problem of refinancing remains and increasing debt servicing will increase expenditure pressure as most new debt has much higher interest rates than in the past. Ad hoc financial aid from the state budget will be less expected, so regions will rely more on their own resources. Prudent public financing policies remain crucial for the regions. The credit quality is expected to be sustained by those regions that maintain a positive balance between the budget's current revenue and expenses, and avoid deterioration of operating performance.

The most urgent fiscal task is to close the budget deficit in the next 2011-2012 by cutting unjustified and wasteful public expenditures. Three groups of public expenditures stand out. One is the price subsidies for gas, electricity, and coal, which are aggravating Ukraine's energy dependence, wastage of energy, and corruption. The second one is the large public pension expenditures of 16% of GDP. A third is enterprise subsidies that are unjustified. Ukraine has no room for larger social expenditures, and any attempt to raise them will only reduce economic welfare.

Another important fiscal task is to improve the tax administration for corporations as a matter of improved governance. Ukraine should adopt the draft Tax Code that will bring clarity and stability to the tax system and facilitate tax administration. The number of tax payments must be radically reduced and simplified. It should be possible to do tax returns as well as pay taxes electronically. The government should further expand the tax base by reducing tax privileges, especially for agricultural producers and wealthy individual entrepreneurs. In particular, the new unified social tax should also apply to these subjects.

3.2 Monetary policy

In light of the escalating global financial crisis, the government and the NBU have taken a number of measures allowing for the reduction of the risk of its profound destructive influence. They included a package of anti-inflation initiatives, steps to enhance banking sector stability and to minimize the impact of the global financial crisis on Ukraine's economy. In early 2008,

the NBU passed a resolution toughening requirements to calculating the banks' regulatory capital adequacy (long-term asset transactions with time of floatation exceeding the time of funding should be additionally risk adjusted at 50% rate and so on), which enabled banks to adjust and improve their position

The fundamental cause of Ukraine's financial crisis was that the NBU of Ukraine kept the Hryvnia de facto pegged to the US dollar under circumstances that called for a change in the exchange rate regime. Ukraine was caught in the "impossible trinity" of trying to combine a fixed exchange rate, free capital flows and an independent monetary policy. But if the exchange rate is fixed and capital moves relatively freely, a country cannot pursue an independent monetary policy, because a tightening of monetary policy by raising interest rates will attract capital inflows, rather than cooling the economy. An example may illustrate this process. Commercial banks in Ukraine could borrow at 6% in euros, while they could charge interest of over 50% for certain consumer loans in Hryvnia, thanks to a fixed exchange rate. Moreover, the NBU maintained a negative real refinancing rate which further stimulated monetary expansion.

In the conditions of tensed situation in the money market in 2008 there was a deceleration trend of money supply and base money growth, which reflected a discreet character of monetary policy. The base money increased by 31.5%, money supply – by 29.9%, while in 2007 they showed an increase by 46% and 51.7% respectively [Council of NBU, 2009].

International reserve level of Ukraine reached a peak level in May 2008 due to the stable financial situation in the country. But USD/UAH exchange rate changed and Hryvnia extremely devaluated in November 2008 (see chart 3). The absence of funding for the government was increasing pressure on the NBU to monetize the deficit that led to renewed FX reserve losses and pressure on the Hryvnia. Abolishing the foreign exchange transaction tax can help deepen the foreign exchange market. As a consequence, foreign exchange transaction tax was decreased from 1% to 0.5% in February 2008 as determined in the Law "On the State Budget for the Year 2008." [BRAAC 2009, p. 48-51].

In accordance with the agreement with the IMF, the NBU allowed the exchange rate to fall from 5.1 Hryvnia to 8.4 Hryvnia per dollar in 2008. In an attempt to avoid a too rapid depreciation, the NBU continued to intervene by buying the Hryvnia for dollars from its currency reserves. The free market exchange rate touched 10 Hryvnia per dollar in January 2009, but the rate recovered gradually and stabilized at around 8 Hryvnia, without the NBU having to intervene [Korneev V. 2009, p. 30-31]. The depreciation was sufficient to restore Ukraine's competitiveness following which the current account turned around swiftly and was almost eliminated. But the depreciation also involved substantial costs. Ukraine's debt in foreign currencies rose sharply in the Hryvnia and many Ukrainian companies defaulted on their foreign debts.

Since Q1 2010, spot USD/UAH has moved from 8.10 to 7.90 and the NDF was moving to the left as well (3m contracts shifting from 8.60 to the current 8.25). This compares with 5y CDS spreads. From a medium-term perspective, there are some key technical factors that are helpful to the Hryvnia: external debt rollover ratios have surprisingly held up. According to the NBU, during the first nine months of 2009 external debt stock levels rose modestly implying high debt rollover ratios. The private sector in Ukraine has already built up substantial long FX positions ahead of the presidential elections and if these flows dissipate, the drain on FX reserves should ease as well.

Regular NBU interventions on the interbank market to support Hryvnia exchange rate (USD 10.4 billion in 2009), tightening of commercial banks' formation of credit provisions, active use of the NBU deposit certificates as well as sizable placements of domestic T-bills resulted in monetary base growth easing to just 4% yoy in 2009, compared to a 32% yoy increase in 2008.

Money supply fell by about 5% yoy in 2009, reflecting the decline in credit activities of the commercial banks. The NBU continued to sell international reserves to support the Hryvnia, extract liquidity from the banking system through its certificate of deposits facility (UAH 16.6 billion in January 2010) and provide limited refinancing resources (UAH 1.4 billion) causing the monetary base to decline by 2.8% mom in January 2010. As a result, the stock of commercial banks' credit fell by 2% mom over the period [Pogarska et al. 2010, p. 4-5].

Despite the election campaign, the Ukrainian foreign exchange market was calm during Q1 2010. Over the period, the exchange rate was virtually stable at about UAH 8.0 per USD. The stability was the result of tight liquidity in the banking sector, continuing NBU support, but mainly due to an improving current account balance and easing external debt financing needs. The strained situation with public finances and limited sources of fiscal deficit financing were the largest risks for exchange rate and inflation developments in 2010. However, assuming the IMF program is back on track in mid-2010, these risks were likely to be successfully controlled. According to the NBU, in March 2010 Ukraine's total foreign debt (state and corporate) has reached UAH 912.563 billion (93.5% of the GDP).

The main objective of the monetary policy in the following years is to remain, in accordance with the Constitution of Ukraine, securement of the national monetary unit stability, being the basis for balanced economic development, promotion of population employment and real income of households. In making the monetary decisions the NBU should be guided by forecasts of development of the real economy sector, balance of payments and financial market based on careful analysis of a wide spectrum of macroeconomic, fiscal and monetary indicators, their interrelation and impact on the Hryvnia stability with taking into account probable changes in the future.

3.3 Banking regulation

Ukrainian banks were successful in attracting deposits between January and October 2008, liquidity indicators have deteriorated in the final months of the year. Banking system liquidity has fallen and interest rates in the money market have risen significantly [Shvets' N. 2009, p. 35]. The average weighted interest rate in the interbank market rose to 30.1% in November 2008 from 15.4% in June 2008 and 4.6% in December 2007.

The National Bank of Ukraine and the government have taken a number of measures to support liquidity specifically during the recent financial market turbulence. But these for the most part benefit the country's larger banks and liquidity might not always flow through to help smaller institutions. Some of the latter have faced severe liquidity constraints and have failed to become subject to state-supported takeovers.

The resolution of the NBU No 319 "On Additional Measures in Respect of Banking Activities" was a quick reaction to a rapidly deteriorating macroeconomic environment and a bad liquidity situation in the banking system. The resolution intended to neutralize the impact of the global financial crisis and minimize the possibility for domestic bank runs and a potential liquidity crisis. The follow-up Law No. 639-VI "On Priority Measures to Prevent Negative Impacts of Financial Crises and Changes to Selected Legislation", the so called "anti-crisis package", substantially expanded the possibilities for the Ukrainian government to intervene into the economy and markets. Most of the law provisions were quite controversial and created easy possibilities for abuse of power and manual steering of the banking system.

Despite the discretionary nature of the provisions, the Law did not stipulate the conditions under which the government and the NBU could implement those measures or their restrictions in such an administration. Also, the Law created loopholes allowing government interference

with the NBU mandate, which might poorly impact the bank's operational independence. On the other hand, the preliminary steps specified in resolution No 319 and undertaken by the Ukrainian government to address the growing uncertainty and liquidity crises were quite adequate, including the temporary freeze on before-term deposit withdrawals helped to avoid massive bank runs and panic. Other measures in the resolution proved less appropriate and, possibly, detrimental for the long-run development of the domestic financial sector [BRAAC 2009, p. 55-57].

Rapid lending growth in Ukraine has long been highlighted as a concern, and this has remained relatively strong in 2008 to end-July notwithstanding the reduced availability of capital market funding. However, loan growth was likely to slow significantly in Q4 2008 and into 2010 in light of a further tightening of funding constraints and – at least in the near term – banks' focus on protecting their liquidity. In this environment, the main threat to asset quality was the tighter liquidity position of much of the corporate sector, which had already manifested itself in several defaults of smaller issuers on the domestic bond market, rather than banks continuing to add risk to their books at a rapid pace. Most Ukrainian banks had little direct exposure to the equity market, although indirect exposure through credit facilities secured by shares is considerable in some cases and could be a source of losses.

Confidence in the Ukrainian banking system declined after the imposition of a six-month suspension by the NBU on the early withdrawal of household term deposits from the commercial banking system on 13 October 2008. The NBU's action was taken to prevent a full-scale bank run after depositors withdrew more than USD 1.3 billion from their accounts in less than two weeks.

Devaluation of Hryvnia comprised a number of risks to the Ukrainian banking sector. First, asset quality deterioration and write-downs were likely as unhedged corporate and retail customers that have borrowed in foreign currency faced a relative increase in the amount of their debt, while economic growth was slowing at the same time. Second, borrowers chose to withdraw local currency savings to transfer them into more stable foreign currency, which reduced the funding base of Ukrainian banks. Finally, the capital ratio of banks with large foreign currency exposure fell as a consequence of currency devaluation-related losses. Approximately 53% of loans by Ukrainian banks rated by Moody's and 47% of their liabilities were denominated in foreign currencies [Robeck K. et al. 2009, p. 4].

The NBU has also taken preventive measures against speculative transactions against the Hryvnia in case of further significant devaluation. Banks were only allowed to buy foreign currency, firstly, to balance their open currency positions to meet the regulator's requirements and, secondly, to settle foreign currency denominated obligations that become due. The new measures came into force on 26 October 2008, except for some provisions concerning foreign currency loans to Ukrainian banks, which came into force on 1 January 2009. Finally, the NBU decided to ease its reserve requirements for banks on 26 November 2008. Mandatory reserves for raising funds in the national currency have been cancelled and the reserves for foreign currency have been reduced to 3% from 4% for call deposits and to 4% from 5% for term deposits. The new reserve requirements came into effect on 5 December 2008 [Robeck K. et al. 2009, p. 12].

In Q4 2008, total national currency deposits reduced by 13.7%, and foreign currency deposits (in dollar equivalent) – by 8%. During this period, the official exchange rate of the Hryvnia against US dollar decreased by 58.4% and by 52.5% from the year start [Council of NBU, 2009]. Actions of the NBU were, first of all, aimed at ensuring timely execution of settlements by banks, preventing funds outflow from the banking system and stabilizing the situation in the market foreign exchange segment. The implemented additional measures were as follows: support of banks' liquidity; limits on certain transactions of banks with the assets in foreign currency;

prevention of outflow of clients' funds from the banking system; continuous execution of payments; temporary limitation of deviations between the buying and selling prices of foreign exchange in cash; mitigation of terms and conditions in use of the foreign currency loans received from non-residents. The above mentioned actions facilitated reduction of pressure in the money market, which was reflected in a gradual decrease of money outflow from the banking system, increase of banking system liquidity, ensuring continuous execution of settlements.

In order to stabilize the situation in the foreign exchange market segment, as well as to consolidate positive trends of stabilization in the banking system the NBU moved to the second stage of stabilization measures at the beginning of December, which provided, inter alia, for the following: limitation of banks' liquidity support, growth of the national currency value, adjustment of the requirements to creation of the mandatory reserves, strengthening of some prudential requirements. In order to reduce the foreign exchange deficit and devaluation pressure on Hryvnia, active interventions were performed by selling of foreign currency, the amount whereof reached USD 10.3 billion in Q 4 2008. The net negative balance of foreign currency interventions made USD 3.9 billion in 2008 [Korneev V. 2009, p. 27-28]).

Indeed, severe deposit runs during October 2008-April 2009 reduced the resource base of the commercial banks. Although the withdrawal of deposits ceased in mid-2009, commercial banks saw rather shallow 3% growth in the stock of deposits in the second half of the year. Overall, the stock of commercial bank deposits fell by 8.4% yoy in 2009. High external indebtedness of commercial banks and a rising share of non-performing loans also undermined credit creation. The total stock of bank loans to the economy of Ukraine declined by only 2% yoy in 2009 compared to an average growth of about 70% over the last five years. An abrupt reduction in credit was one of the main reasons for Ukraine's hard lending in 2009 [Pogarska et al. 2010, p. 4-5].

In 2009 there were only three establishments extending mortgage credits for clients. It was possible to get a credit under 21-41% annual and under condition of making an advance payment amounting to 30-50% for 1 year, 4, 5, 10, 15, 20 and 25 years. At the same time, the latter term was only proposed by Pravex-Bank. In Q 2010 credits for purchase of housing on the secondary market was issued by BTA Bank, Folksbank, Universal Bank, Kredobank, Index-Bank, BM Bank, Ukrsotsbank, Forum, Pivdennyi, Pravex-Bank, Ukreximbank, Bank of Cyprus and the All-Ukrainian Bank of Development.

The Supreme Council of Ukraine amended the law of Ukraine "On financial services and state regulation of financial services markets", with Law No. 1822-VI dated 21 January 2010, pursuant to which financial institutions are prohibited from unilaterally increasing interest rates or other costs under facility agreements or debt repayment schedules. Financial institutions are also prohibited from requiring early repayment of outstanding debt and from unilaterally terminating facility agreements if the borrower does not agree to the financial institution's increase in interest rates or other costs under the facility agreement or debt repayment schedule.

Monetary sector data for Q1 2010 demonstrated a slow renovation of credit activity in the Ukrainian banking sector. Affected by political instability, the stock of deposits fell by 1% month-over-month in January 2010. Moreover, by placing domestic debt securities for relatively short-term and high yields (though lower than in October-December 2009), the government kept crowding out commercial banks' credit to the economy.

The NBU reacted promptly to the financial crisis by introducing new regulatory requirements that render the banking sector more stable. However, significant room for further improvement remains. Recently nationalized banks should be privatized. The Ukrainian state became the owner of Ukrhazbank (84.21% after investing UAH 3.2 billion), Rodovid Bank

(99.97% after investing UAH 2.809 billion) and Bank Kyiv (99.93% after investing UAH 3.563 billion) early June 2009 [UNA, 2009].

Subsided political tensions after the presidential elections should have positive impact on inflow of foreign investments, and, consequently, on the national payment balance. Despite the fact that in Q1 2010 the regulator continued to withdraw free resources from the banking system, the amount of funds on the banks' correspondent accounts remained stable. The cost of inter-bank resources remained low too, which was prompted by absence of necessity for their urgent substitution. In January 2010 the trend of gradual return of population's funds withdrawn earlier, has retained. The growth in the amount of deposits was fuelled by the national currency which was prompted by higher rates by this type of deposits and stabilization of Hryvnia's exchange rate.

In the midst of the crisis, the state banks have assisted the government in various rescue operations. This should not remain a practice after the crisis has abated, and the authorities should wind down these emergency measures and let the two old state banks, Oshchadbank and Ukreximbank, revert to their old roles of being specialized state banks. The government should restructure the banks that have been de facto nationalized because of default and prepare them for early privatization after the crisis.

Much remains to be done to move the legal framework closer to standards in more developed countries, especially as regards: transparency; consolidated supervision, the domination of financial industrial groups in the economy and significant related-party lending; and the perception of a high level of bureaucratic obstacles and corruption. Until these difficulties are largely removed, the financial strength and deposit ratings of Ukrainian banks are expected to remain at lower levels than those of banks in the CIS.

Stabilization of the resource base of Ukrainian banking system and strengthening of the monetary market control should be facilitated by the measures to develop cashless settlements, extended use of special payment tools, introduction of new technologies and extension of the range of operations, coordination of banks' efforts to create a unified infrastructure, widen the sphere of application of multifunctional banking smart-cards and realization of accompanying projects in the social sphere.

4. Exit strategies

The beginning of post-crisis recovery growth in Q4 2009 underlined Ukrainian economy adjusted to the open market economy at a low-tech level. It is an economy of low productivity, with little diversification, high energy consumption, and dependent on external energy monopolies. To overcome these dangerous trends Ukraine needs to build an economic system that is capable of delivering fast economic growth. The state budget is overloaded with paternalist functions of the unreformed Soviet state, most of all social expenditures but also direct support of the traditional industrial and agrarian sectors (coal mining, metallurgy, and agriculture) and natural monopolies in exchange for prices administratively set below the market level.

Critically weak links in state capacity need to be strengthened: improvement of the legislative, executive, and judicial branches of government, not least to improve the institutional ability to combat pervasive corruption. To accomplish this, the country requires reform of the gas sector; a sensible exchange rate policy; reform of budget and tax policies; comprehensive market deregulation; administrative and judicial reform; reinforcement of market competition and a fundamental improvement of governance; completion of privatization; improved efficiency in the social sector; and further integration with the European Union. Taken together the reforms aim to improve the standard of living of Ukrainians and utilize their human capital, thus unleashing the country's potential of self-development [Åslund et al. 2010, p.12-16].

For improving fiscal policy in Ukraine, first of all, it is necessary gradually eliminate revenues earmarking, and over time, integrate General and Special Funds into the budget. These steps would increase budget management efficiency and improve the implementation of public investment programs. Second, improve local government borrowing, consistent with good international practice. In particular, incorporate local government debt in public debt statistics. Third, design and implement a medium-term department management strategy, based on a systematic approach under different economic and financial assumptions, to reduce risk exposure and debt servicing costs, provide medium-term fiscal planning to make the best use of fiscal space. It is also necessary to tighten a fiscal stance; reduce wage and transfer increases, reduce subsidies, concentrate income support where most needed; gradually reduce the ratio of recurrent spending to GDP.

The fiscal framework also needs strengthening. Further improving macro-fiscal analysis would clarify the macroeconomic impact of fiscal policy, and integrating it into the budget process would help to prevent the procyclical stance that has characterized fiscal policy in recent years. A multi-year fiscal framework, including spending ceilings, would facilitate monetary-fiscal coordination and help to guide budgets toward medium-term fiscal goals (for example, gradually reducing the size of government, or implementing pension reform). Broader fiscal coverage and closer monitoring of public enterprises would identify and contain fiscal risks. Reducing the use of administered prices would improve the fiscal position and economic efficiency. In particular, gas price increases should be passed through fully to final users, with vulnerable groups protected by better targeted social programs.

The Ukrainian government should provide the NBU with a clear mandate to pursue price stability as its primary objective, as well as with operational independence to attain this objective; enhance macroeconomic forecasting capacity and prepare statistical sources; strengthen operational and political independence of the National Bank, approve changes to legislation to increase the governor's term and immunity to political pressures; reform the NBU council transforming it into a narrower technical body; fully abolish the foreign exchange transaction tax; elaborate the long-term vision defining the government's role in the domestic securities markets as the market regulator and a market participant [BRAAC 2009, p. 53].

The IMF welcomes recent NBU policies to tighten monetary conditions, including by stepping up sterilization and broadening reserve requirements. Until inflationary pressures ease, the NBU should continue such efforts to the extent feasible. As this will be costly, the government should accept profit transfers from the NBU that deviate from budget targets. However, at some point short-term capital inflows and strains on financial institutions will limit the scope for further tightening in the current policy framework.

Ukraine must not peg its exchange rate again. The only sensible exchange rate regime for Ukraine appears to be inflation targeting, that is, the exchange rate will float and monetary policy will aim at keeping inflation low and stable. The NBU can undertake limited currency interventions to smoothen fluctuations, but it must not target one specific exchange rate any longer. The dollarization of the Ukrainian economy should be reduced by the NBU through a combination of a floating exchange rate, an inflation target and an adequate regulation and supervision of banks. This has been done successfully in many other post-communist economies. Poland, the only European country of significant size maintaining economic growth in 2009, provides a good example of a successful monetary and exchange rate policy, combining a floating exchange rate with inflation targeting managed by a fully independent central bank. A precondition for inflation targeting is that the NBU be truly independent from daily political vagaries.

The NBU, with the government support, should as a first step establish and fully use an exchange rate band that allows more scope for active monetary policy. The 2010-2011 monetary

policy guidelines should indicate that the band will be progressively widened as circumstances permit and policy needs require, without specifying bands or timing in advance. The NBU should continue its welcome efforts to strengthen its analytical capacity and integrate macroeconomic analysis into its policy decisions. Communication with the public and the markets needs to be improved, including through publication of inflation reports and regular, transparent announcements of policy intentions and actions.

In view of actual and possible strains, the NBU should continue to intensify its supervision of banks. Key measures are consolidated supervision, increased transparency of bank ownership, encouragement to banks to enhance their risk management capabilities, strong guidance regarding stress testing, and intensified on-site examinations. Bank secrecy provisions should be brought into line with Basel II standards. Prudential measures might include, in addition to the recent welcome increase in minimum statutory capital, greater risk weights for assets that pose higher credit risk (notably unhedged foreign currency denominated lending) and stronger prudential requirements for banks with deteriorating liquidity positions. Finally, nonbank supervisors should be strengthened, which would also foster the development of insurance and capital markets.

The greater attention should be paid to bank resolution and crisis management. On the former, problem banks need to be identified earlier and bank exit options expanded to include rapid resolution mechanisms, notably by increasing incentives of owners of weak banks to agree to mergers. On the latter, contingency planning should be further developed and refined, to ensure an effective response in the event of unforeseen turbulence.

For improving the banking sector a government has to amend the banking law to require the identification of ultimate bank owners and to allow the NBU to assess the suitability of direct and indirect bank shareholders; strengthen banking supervision in order to eliminate opaque and risky lending and deposit practices; strengthen prudential and supervisory norms by introducing prudential limits for banks on loan-to-value and debt-service-to-income ratios for mortgage loans; increase the political and financial independence of the State Commission for Regulation of Financial Services Markets (SCRFSM) and the State Securities and Capital Market Commission (SSCMC); provide capacity of the regulator needed for carrying out risk based supervision of the NBF institutions; improve the NBF institutions' regulation on activities related to attracting financial assets and deposits in order to reduce risks and prevent illegal operation in credit unions, investment funds, and building societies; develop a sustainable Credit Guarantee Fund facilitating access of small and medium-size enterprises to loans.

The new wave of institutional reforms should remove these lingering contradictions. Strategic reforms are needed to fundamentally improve the quality of the state and economy. The development of society, as well as the current economic and political dynamics, appears to have created favourable preconditions for a new wave of institutional reforms. It should also help improving the business climate and attract more domestic and foreign investment.

5. Conclusions

In order to ensure accomplishment of the tasks elucidated above the Ukrainian government should make use of available institutional mechanisms and operation levers, securing consistency and transparency of the policy, combining in an organized way its independence in exercise of the main constitutional duty with coordination of its actions with the macroeconomic and financial measures of all authorities. With these factors in mind, the resolution of the crisis in Ukraine on the successful implementation comprises of the following measures: establishing strong organizational arrangements to confront the crisis, securing substantial foreign financial

assistance, implementing a comprehensive program for troubled banks and their borrowers, implementing a macroeconomic stabilization program and structural reforms to revive economic and export growth of the state.

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