Financial Sector and the Effect of the Global Financial Crisis

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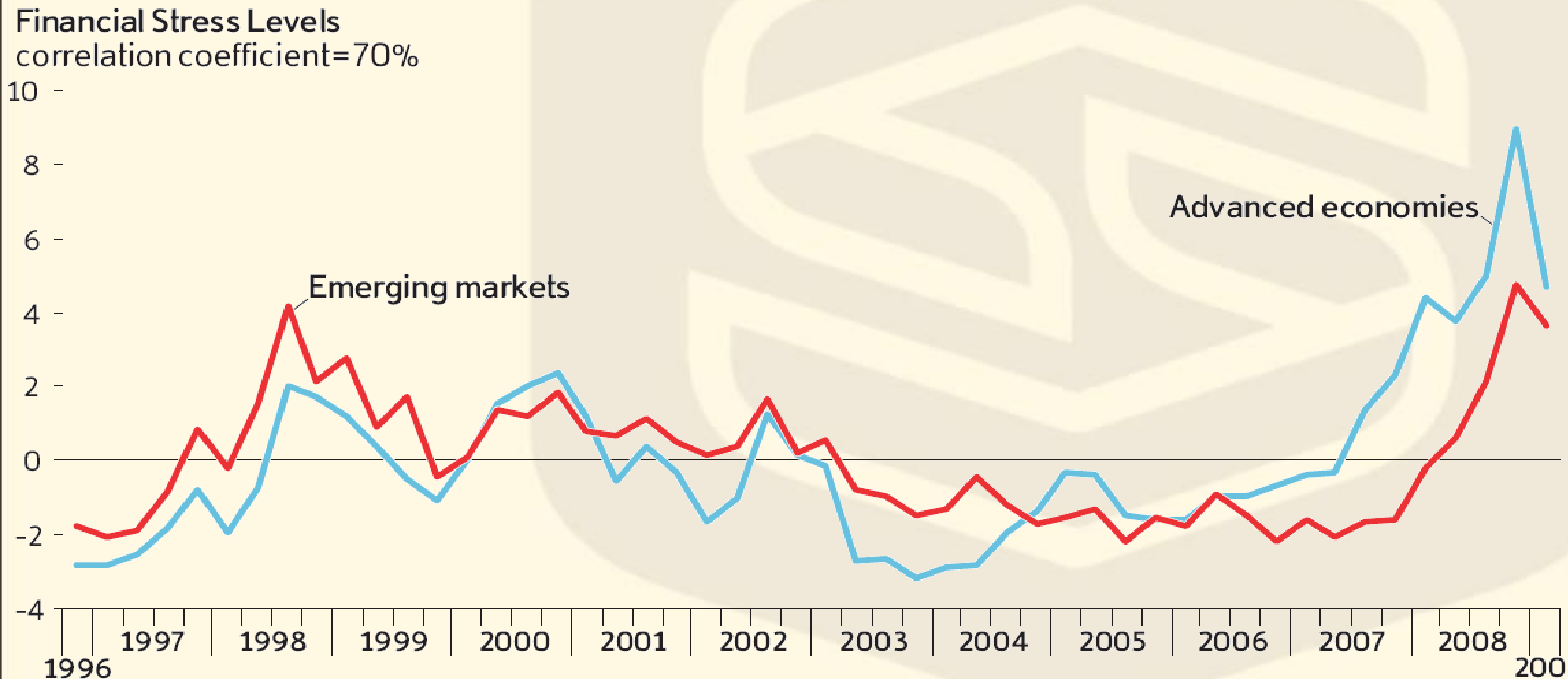
Financial Stress Contagion to Emerging Markets

- Financial stress in developed and emerging markets are **closely linked**:

Index of Financial Stress: Volatility in the Banking Sector and in Stocks, Bonds, and Exchange Rates



Source: IMF, World Economic Outlook, April 2009

Financial Stress – Channels of Contagion to EMs

- The transmission of financial shocks across countries involves two major channels:
  - **Common factors** (financial and real sector), that have a similar impact across all or a group of emerging economies.
  - **Country-specific factors**, which shape the impact of financial crisis on individual economies.
- Common factors: Initially, EMs felt immune to the global crisis due to their limited investments in toxic assets. But linkages through the real sector (lower exports) and financial (lower capital inflows) hit them hard.
- Country-specific factors determine the severity, duration and speed of contagion of financial stress to emerging markets.
- These country-specific sources of vulnerability are rooted in the country's degree of trade and financial integration to the global economy and the country's structural economic weaknesses (i.e, fiscal and CA imbalances).
- The country's capacity to resolve the crisis through fiscal and monetary policies is a function of the country-specific conditions. **Weak capacities implies faster contagion and slower recovery.**

Financial Stress – Channels of Contagion to EMs

Financial Stress in the Advanced Economies

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Propagation Channels

Common Factors:
- Investor Sentiments
- Global Liquidity Conditions
- Global Interest Rates
- Commodity Prices
- World Economic Growth
- Common Foreign Lender/Investor

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Country-Specific Factors

1. Financial and Trade Integration
   - Openness and diversification
   - **Financial sector development and liberalization**
   - Private sector external indebtedness
2. Structural Vulnerabilities
   - **Macroeconomic stability (CA, fiscal deficit, inflation)**
   - Quality of institutions
   - Business climate
   - Financial stability (quality of banking supervision, composition of capital inflows, exchange rate policies, forex reserves, etc.)

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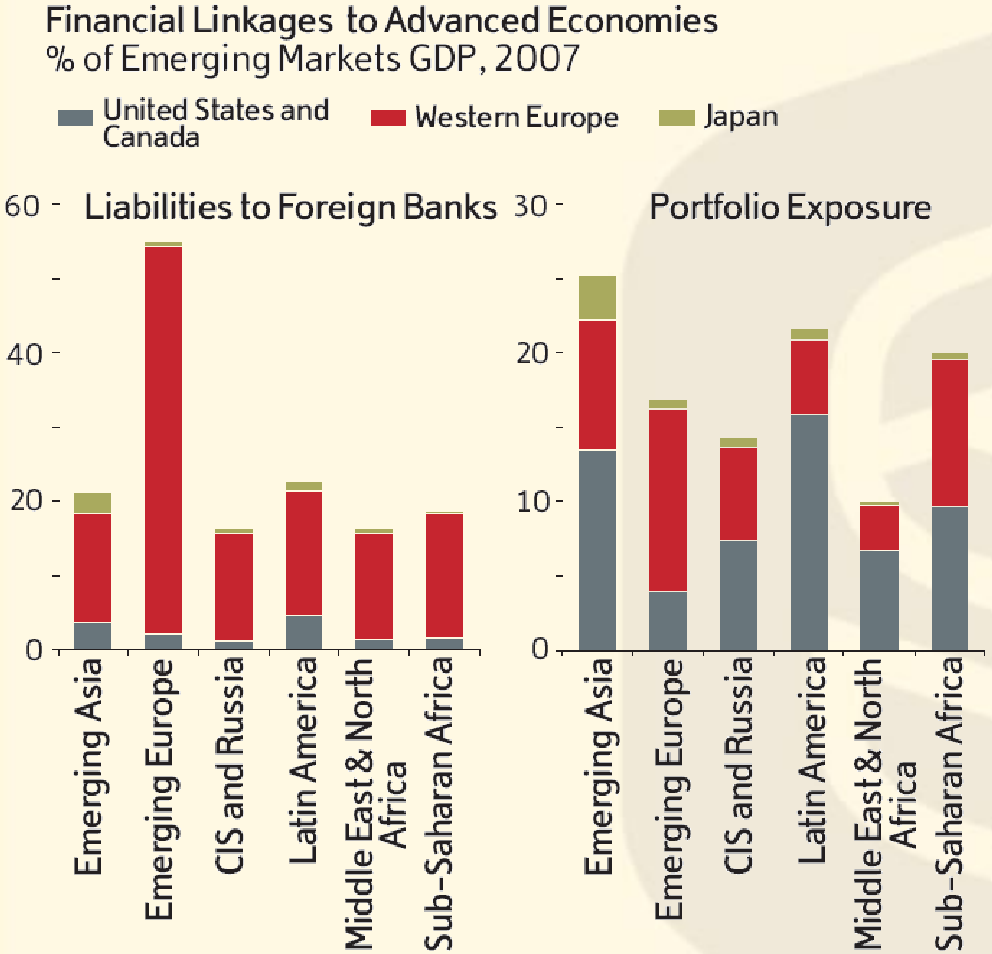
Financial Stress in the Emerging Economies

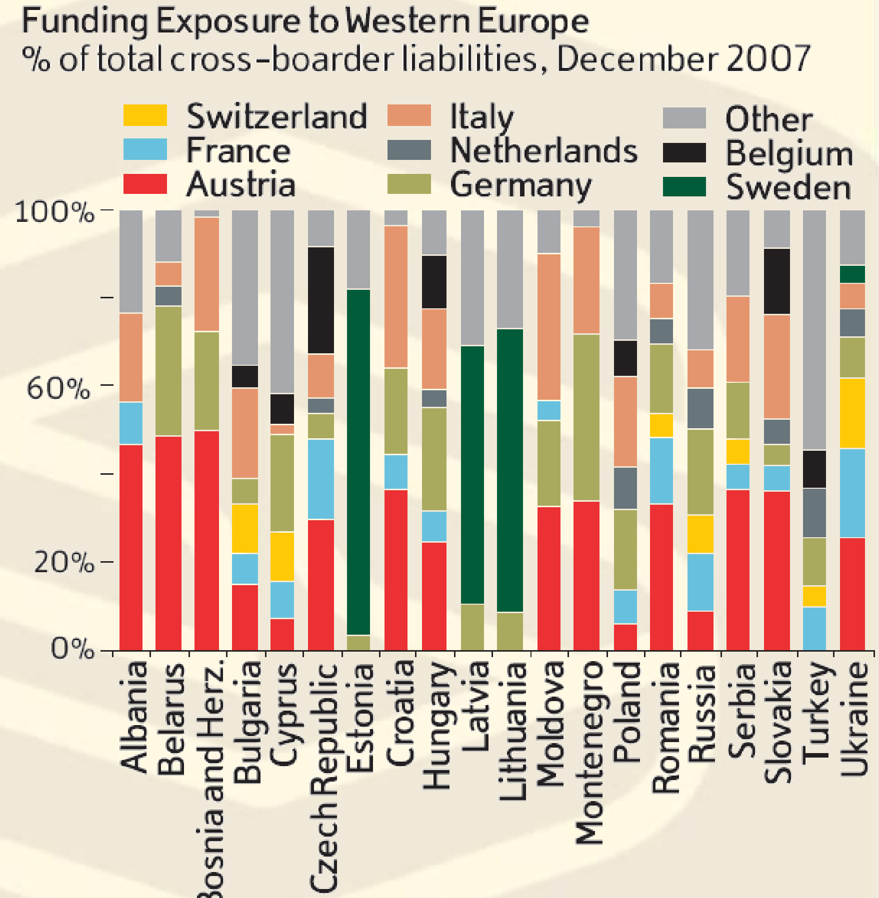
- A sever global financial stress has a large impact on all emerging markets, regardless of the initial country-specific conditions.
- However, sound economic preconditions will help to limit the implications of the crisis and accelerate recovery.

Financial Sector Development – Stylized Facts

- During 2003-2007, many emerging markets took advantage of ample global liquidity and financial openness to attract sizable capital inflows, boosting economic growth and improving population welfare.
- But this deeper financial integration increased the risk of a sudden reversal of foreign capital flows in the event of a systemic shock to the supply of international funds.
- **Financial links emerged as a main channel of transmission of the financial stress to emerging markets.** Countries with larger external liabilities (especially in the banking sector) will suffer more from the stress at the global financial markets.
- **More financial openness may lower capital volatility only if financial integration is strengthened by the institutional sophistication and credibility of the local financial sector.**
- The quality of the local financial market, friendliness of the business environment and robustness of the regulatory policies **greatly reduces the risk of capital flow reversals or sudden stops.**
- Regional patterns of financial integration and the composition of capital flows are vital components of the financial stress transmission to emerging markets. A concentration of the external funding sources and an excessive reliance on debt flows increase exposure to disturbances in international (and regional) financial markets.

Financial Sector Vulnerabilities in the EMs





Source: IMF, World Economic Outlook, Global Financial Stability Report, April 2009

- Eastern European countries are exposed to financial stress through links to the banking sector of Western Europe and significant foreign indebtedness.

Five Steps to Address a Financial Crisis

Based on extensive international experience, to resolve successfully a financial crisis, the following five "pillars" should be implemented:

I. Establish strong Organizational Arrangements to confront the crisis

II. Secure Substantial Foreign Financial Assistance

III. Implement a comprehensive program for Troubled Banks and their borrowers

IV. Implement a Macroeconomic Stabilization Program

V. Implement Structural Reforms for to revive economic and export growth.

Ukraine's Structural Vulnerabilities

The international liquidity crisis - that gained momentum since mid-2008 - affected all emerging countries. However, Ukraine suffered more than other countries:

- The Ukrainian Hryvnia depreciated by about 60% with respect to the US Dollar in 2008;
- The PFTS stock index declined by more than 74% in 2008, one of the largest declines in the world;
- Ukraine's industrial production declined by about 25% yoy in the last quarter of 2008 and 34% yoy in January 2009.

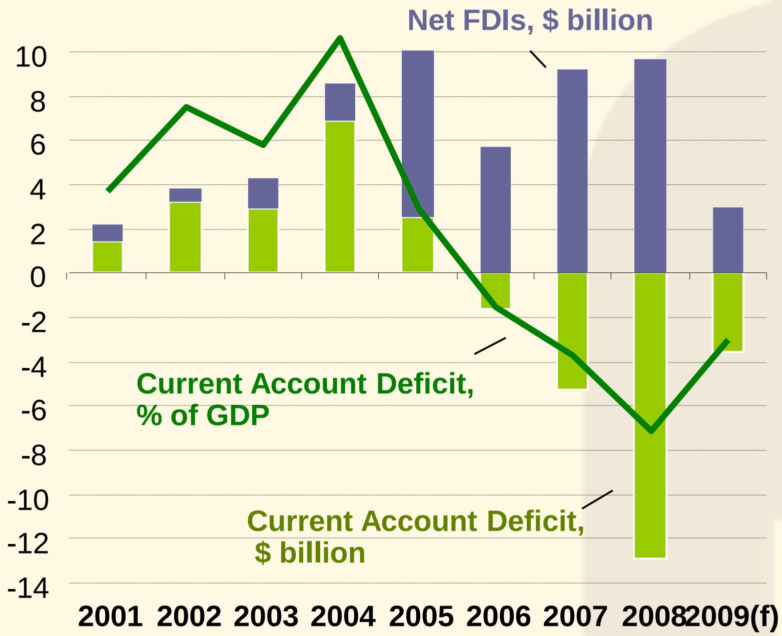
Ukraine was more vulnerable to the crisis due to a combination of:

1. Large Current Account Deficits
2. Large External Debt Burden
3. Banking Sector Weaknesses

These three serious threats to macroeconomic and financial stability were significantly amplified by the poor quality of public institutions and weak investment climate.

1. Large Current Account Deficits

The Current Account Balance, $ billion and % of GDP, and net FDI Inflows, $ billion



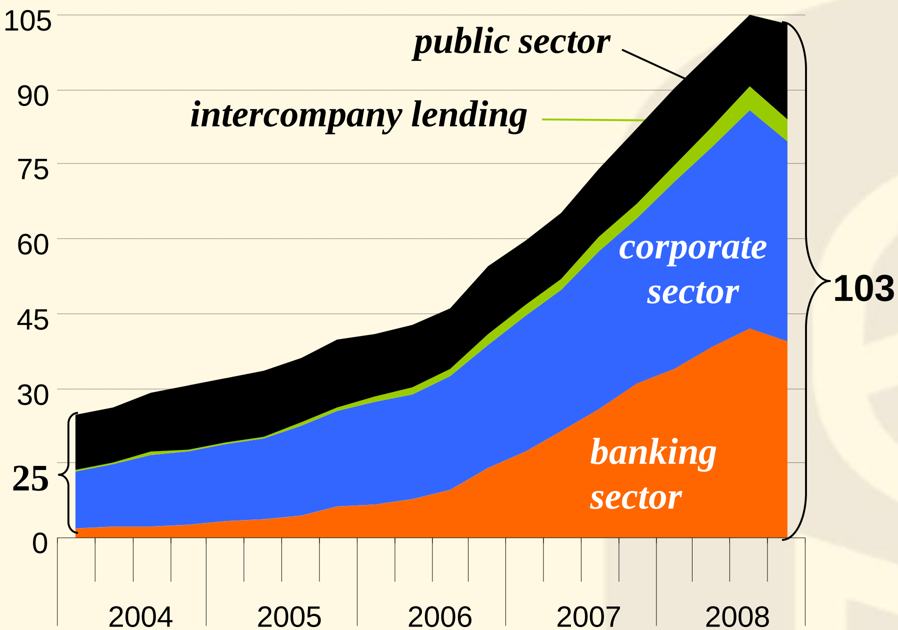
Source: NBU, The Bleyzer Foundation

- In 2008, exports grew fast at 36% pa, but imports grew even faster at 41% pa.
- As a result, the CA deficit reached around $13 bn in 2008, or 7.2% of GDP.
- With limited foreign financing, Ukraine absorbed the gap by reducing reserves and depreciating the Hryvnia.
- The BoP statistics for Jan-Mar 2009 are encouraging: due to a sharp decline in imports (almost 50% yoy) current account deficit of $0.9 billion was almost 4 times lower than a year before.

- In 2009, the current account gap could be reduced to $3.6 billion (3.0% of GDP), due to lower domestic demand (caused by lower real income, less credit and Hryvnia depreciation).
- Therefore, for 2009, the Current Account should no longer be a major source of foreign exchange strain.

2. External Debt Burden

Gross External Debt, by Sectors, $ billion



Source: NBU, The Bleyzer Foundation

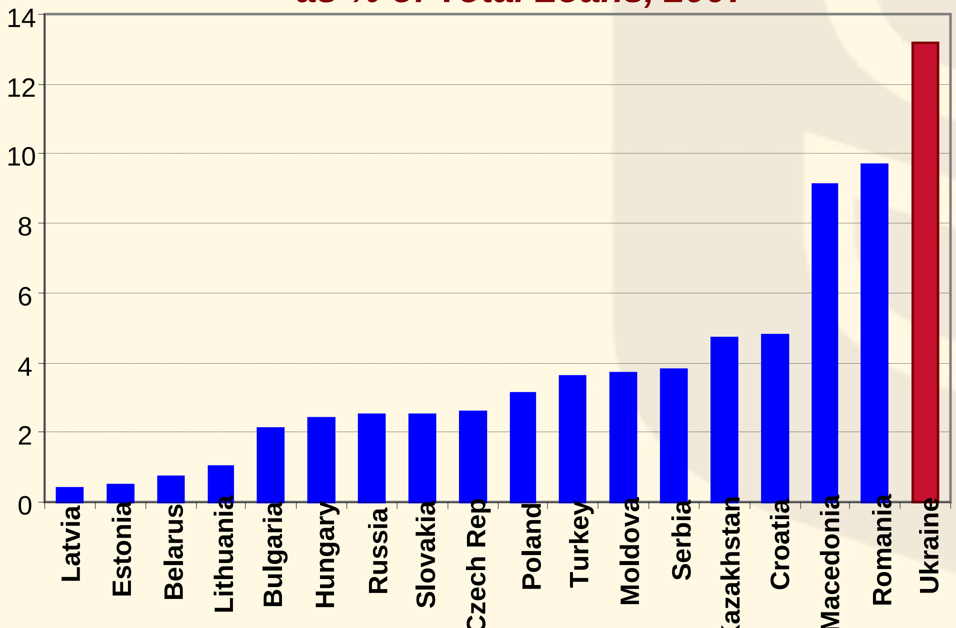
- In the last two years, total external debt doubled from $53 billion to $103 billion by end of 2008 (about $36 billion was short-term private debt).
- The global financial crisis made more difficult for banks and corporates to roll-over foreign short term debt: in the last quarter of 2008, net external debt outflows amounted to $6.6 billion, and were among the main sources of Hryvnia depreciation.

- Some of the future debt repayments represent trade credit and obligations to parent banks that can be rolled-over.
- The $16 billion loan from the IMF will go a long way of ensuring that the remaining debt service obligations are met in 2009.
- If the IMF program is fully disbursed in 2009, this second source of foreign exchange pressure would be mitigated.

3. Banking Sector Weaknesses

- During 2006-2008, bank credit grew by 70% pa, supported by increases in money supply and borrowings from abroad.
- As in many other countries, these high rates of credit growth led to high levels of non-performing assets (sub-standard, doubtful and loss loans - NPLs).
- According to the NBU, the share of doubtful and loss loans grew from 2.5% at the beginning of 2008 to almost 6.1% at the end of March 2009.

Non-performing Loans in Emerging Markets as % of Total Loans, 2007



Source: IMF GFS Report, Oct. 2008; Kazakh Agency on Regulation and Supervision of Financial Markets

- Including sub-standard loans, the share of NPLs is high.
- A run on deposits started in Sep-2008 and about $13 billion have flew out of the banking system.
- Bank weaknesses and loss of confidence represent the greatest source of risk for the country today.
- The government has initiated a re-capitalization program with support from the IMF, IBRD and EBRD.

Prospects for the Future

- The successful implementation the IMF program would address Ukraine's vulnerabilities as follows:

  (i) Current Account Deficits. The current account deficit would be contained by the control of aggregate demand through tight fiscal policies (fiscal deficit consistent with non-monetary financing) and tight monetary policies (control of money supply and credit) as well as by the current devaluation. Thus, the current account deficit should be about $3.6 billion, a manageable amount.

  (ii) High short term foreign debt service in 2009. The repayment of this short-term foreign debt would be feasible with the IMF disbursement of $10 billion and likely financing available from other international institutions. Thus, this vulnerability could also be under control.

  (iii) Weak Banks. The banking sector problems are being handled relatively well. If the current recapitalization plans are successful, systemic issues may be under control, though a number of medium and small banks may fail.
- Under this scenario, the crisis would be contained during 2009. The exchange rate would stabilize and GDP recovery could take place in 2010, following the recovery of the world economy.
- But to sustain growth, Ukraine will need to take strong measures to attract investments by improving its business environment.

Improving the Business Environment to Revive Growth

- Short-term measures should include:
  - Use a regulatory sunset scheme to curtail business regulations by a deadline.
  - Get rid of corruption in custom administration by transferring custom management to a reputable foreign agency.
  - Improve transparency in the judiciary by mandating that court decisions are immediately published in the internet and subjected to review and scrutiny by an independent entity.
  - Implement Inflation Targeting and free the foreign exchange system.
  - Promptly enter into an Enhanced Free Trade Agreement with the EU.
  - Remove the moratorium for land sale.
- Medium term measures should include:
  - Reduce the cost of doing business by reducing and consolidating taxes/duties to competitive levels and improve tax administration and VAT refunds.
  - Improve public governance by implementing a drastic public administration reform that would reduce overlapping functions, improve transparency and decision-making, and reduce administrative corruption.
  - Implement a comprehensive reform of the judiciary system
  - Improve fiscal sustainability by eliminating privileges and reforming the Pension System.