December 2008

Banking Crisis in Ukraine: Origins, Remedies and Consequences

by Edilberto Segura, Olga Pogarska, Oleg Ustenko, Sergey Kasyanenko

1. The Origins of the Banking Crisis in Ukraine

Since the beginning of 2008, Ukraine has been going through unprecedented volatility on its currency market. In the first half of the year, the Hryvnia exchange rate appreciated from 5.05 UAH/US$ at the beginning of the year to 4.6 UAH/US$ in July. This appreciation was supported by significant foreign capital inflows and loose monetary and fiscal policies. However, since mid-August 2008 depreciation pressures emerged, partially driven by the migration of global investors to safer US$ denominated assets. As a result, Ukraine found itself on the brink of a full-scale currency crisis. During October-December, the Hryvnia lost more than 50% of its value against the US$.

The international liquidity crisis has been the main factor behind the financial crises that have affected many emerging economies, including Ukraine. However, Ukraine has been more vulnerable than most other countries due to a combination of a large current account deficit, significant external short-term debt obligations of Ukraine's private commercial banks and companies and a weak banking system.

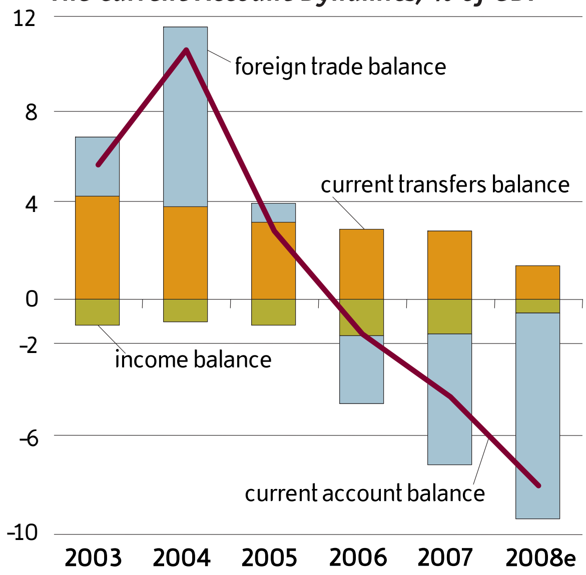
1. 1. External Trade and Current Account Deficits

The Ukrainian economy is highly dependent on exports of a narrow range of industrial commodities, particularly steel, chemicals, and machinery which are sold to a limited number of countries, including Russia, Turkey, Germany and Italy. On the import side, the country requires energy resources and raw materials that are supplied principally by CIS countries. All this makes Ukraine particularly vulnerable to price fluctuations of global commodities. Moreover, the relatively high geographic concentration of Ukraine's external trade makes it excessively reliant on the economic performance of a few countries such as Russia, Turkey and Germany. In the past, the favorable economic trends in these markets allowed Ukraine to generate significant external trade surpluses. In fact, in 2006 and 2007, Ukraine's exports of goods in dollar terms grew at a high rate of 20% per year. Moreover, during the first nine months of 2008, exports expanded by a robust 50.1% yoy. However, since 2005, imports grew even at a faster pace than exports. This acceleration of imports was due to buoyant consumer and investment demand, stimulated by expansionary fiscal and monetary policies, as well as rising raw material and energy prices. During 2006-2007, import of goods grew by 30% per year and accelerated to 60% yoy in the first ten months of 2008. As a result, Ukraine's foreign trade balance shifted into a deficit in 2005, rapidly widening thereafter. High foreign trade deficits were the major reasons of the deteriorating current account balances, which are expected to reach $13 billion in 2008, or about 7% of GDP.

Current account deficits would not be problematic if they can be covered by foreign direct investments (FDI) or long-term lending. However, the 2008 current account deficit will not be fully covered by FDIs, despite the fact that Ukraine will receive about $9 billion of FDIs. This means that Ukraine will have to rely more on external debt financing to cover the current account gap. Foreign financing, however, has become more difficult to obtain considering the tightening of global credit markets, the deteriorating macroeconomic conditions of Ukraine and a sizable volume of external debts accumulated by the Ukrainian private sector.

At present, the 2009 current account outlook does not look favorable, despite falling world crude oil prices and a possible deceleration of imports (due to a weaker national currency, only a moderate potential increase of natural gas prices, a slower growth of consumer demand and depressed industrial sector).

The Current Account Dynamics, % of GDP



Source: NBU, The Bleyzer Foundation

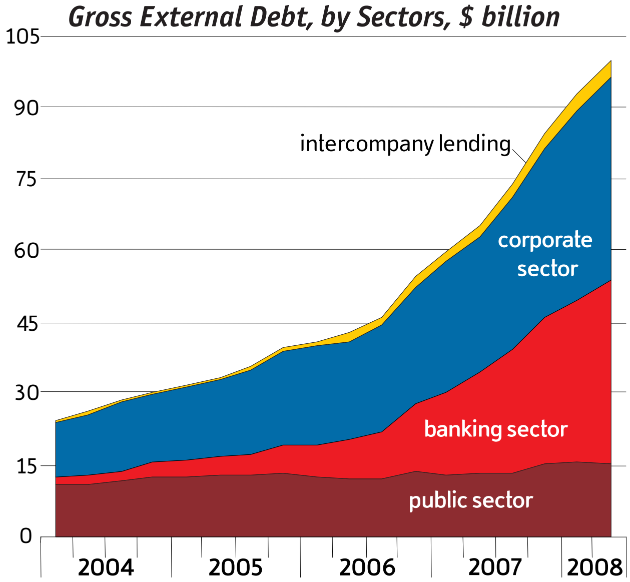
In fact, Ukraine's export revenues are likely to decline due to lower commodity prices (steel and chemicals), the deepening economic recession in developed countries and a sharp slowdown in emerging economies (including Russia). In addition, the falling output in the EU countries and a sharp slowdown of the CIS region will significantly depress workers' remittances to Ukraine. Furthermore, the income account deficit will remain large on the back of interest and principle payments on Ukraine's external liabilities.

Thus, even though the current account deficit will peak in 2008 and is likely to narrow in the coming year, Ukraine will still face the current account gap in 2009. This gap may be manageable even if FDI inflows decrease to $4 billion next year. However, the sizable repayments of the external debt maturing in 2009 will continue to put a considerable pressure on the external financing needs. In this environment, even a moderate current account deficit may emerge as a formidable economic challenge.

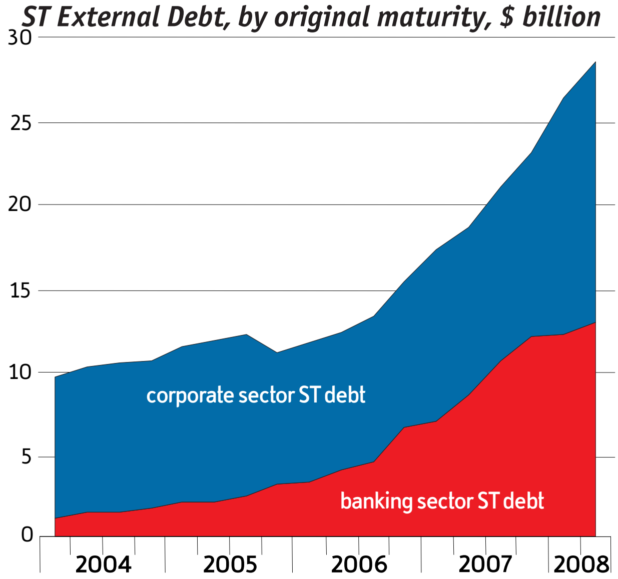
1.2. External Debt and Financing Needs

During the last two years, total external debt grew by 45% per year and exceeded $100 billion in December 2008. Out of this amount, $28.2 billion was classified as short-term debt maturing in less than one year. But the actual amount of external obligations to be repaid by the private sector during 2009 may be substantially higher. This is because the NBU reports the level of the external debt by original maturity only. The official NBU documents do not include the short-term component of the long-term debt. Thus, if the short-term portion of long-term debt is included, the

Gross External Debt, by Sectors, $ billion



ST External Debt, by original maturity, $ billion



Source: NBU, The Bleyzer Foundation

total amount of external debt refinancing needs in 2009 may be as high as $45 billion. We estimate that about a half of this amount is likely be refinanced as it constitutes trade-related obligations and commercial banks' borrowings from their parent foreign-owned banks. As a result, the external financing gap could amount to about $20-25 billion in 2009. This amount would need to be financed. Otherwise, the pressure on the exchange rate would be heavy.

1.3. Weaknesses in the Banking Sector

Over the last few years, commercial banks have aggressively expanded their credit portfolios thanks to improved access to external financing as well as loose domestic monetary policy. In the last three years, bank credit grew by more than 65% per annum. Moreover, more than 50% of all loans were issued in foreign currency. As a result, both commercial banks' borrowers and commercial banks have become considerably exposed to currency risks. In addition, booming domestic credit has been exerting a toll on the banks' asset quality. Indeed, many international studies offer ample evidence that unsustainably high rates of credit growth frequently cause the share of non-performing loans to soar. According to the NBU, the share of non-performing loans (defined as sub-standard, doubtful and loss loans) remained rather high at 13.2% in 2007. Moreover, the level of non-performing assets at the end of 2008 is likely to be much higher, due to the credit expansion of 2008 and the deteriorating economic conditions of the last few months. Furthermore, likely increases in unemployment and corporate bankruptcies and sharp depreciation of the Hryvnia exchange rate will certainly impair the creditworthiness of the banks' borrowers. This means that the solvency risks in the national banking system will intensify in the near-term.

Some additional signals of banking sector stress have emerged. In mid-September 2008, the six-largest Ukrainian bank suffered a flight of deposits. Though the National Bank of Ukraine responded quickly by providing UAH 5 billion (about $1 billion) of emergency refinancing and later taking control over this bank, this undermined public confidence into the banking system. Depositors rushed to withdraw funds from their deposit accounts in other banks, which cost the banking system about UAH 24 billion ($4.7 billion) in October and UAH 12.5 billion ($1.8 billion) in November. Increasing risks of defaults to and of the Ukrainian banks further undermine foreign creditors' confidence in Ukraine.

Selected indicators of Ukrainian banking sector

	Commercial banks external debt, $ billion	% yoy	Credits, total, UAH billion	% yoy	FX-denominated credits, % of total	FX-denominated credits, % yoy
2003	1.7		67.8	64.4	41.7	60.9
2004	2.7	52.5	88.6	30.6	42.2	32.2
2005	6.1	129.6	143.4	61.9	43.3	66.3
2006	14.1	130.5	245.2	71.0	49.5	95.4
2007	31.0	119.8	426.9	74.1	49.9	75.4
2008*	38.5	81.3	565.9	54.1	51.4	53.4

** 1H 2008 for external debt, 9 months otherwise*

Given a recent intensification of the global financial turmoil and the economic downturn in developed economies, the access of Ukraine to external financial resources is likely to remain limited in 2009. This means that Ukraine will remain vulnerable to adverse macroeconomic shocks. Furthermore, the current political instability has eroded investors' confidence on the country's near-term prospects, which does not help to slow the withdrawal of foreign capital from Ukraine. The lion share of the 2008 FDI was received during the first eight months of 2008 and, according to the NBU data, FDI inflows were very small in the last quarter of 2008. Portfolio investments also declined sharply from $3.3 billion in the first half of 2007 to just $350 million in the first half of 2008. These developments further amplified a downward correction of the equity prices of the Ukrainian publicly traded companies, prompting a 75% decline of the PFTS index since the beginning of the year. As a result, if investors' confidence does not recover, or if Ukraine is not able to secure official financing from international agencies, the country may face serious difficulties in covering its external financing gap in 2009.

The recently-approved IMF Stand-by loan of $16.5 billion as well as an additional support from other International Financial Institutions (the World Bank, EBRD, EIB) may help to reduce the external financing needs to about $10 billion. If the NBU's international reserves stay at about $27 billion at the end of 2008, this $10 billion gap implies that Ukraine may witness further erosion of its forex reserves and a deeper depreciation of the national currency. At the same time, the forex market may gradually stabilize on the back of improved transparency and functionality.

2. Four Steps to Resolve the Crisis

The past economic expansion in Ukraine was driven by large inflows of foreign credit and by a cyclically high global demand for industrial metals. Both factors have been rapidly weakening since the onset of the global financial crisis. As a result, the economy is already experiencing a radical correction, while a transition toward more resilient and stable growth may be more prolonged. This means that the role of the government in managing this transition is fundamental to minimize social and fiscal costs and ensure balanced economic recovery.

The economic and financial stabilization in Ukraine calls for an urgent, comprehensive and integral policy program. This policy program must include four **key measures:** (i) recapitalize weak banks; (ii) reduce the current account deficit to reduce foreign financing requirements; (iii) implement a comprehensive program of economic reforms to stabilize the economy and improve the investment climate to re-establish growth.; and (iv) implement a program of coordinate and facilitate the renegotiation and rescheduling of short term foreign debt by corporations and banks that may be defaulting.

2.1. Banking Sector Recapitalization

The severity of the risks in the banking sector calls for coordinated and effective policy measures. First, the functionality of the banking sector, i.e. the ability of banks to perform financial intermediation, must be restored. For this, the Ukrainian authorities plan to implement a recapitalization program of weak commercial banks to prevent failure of systemically important financial institutions. This program is expected to be based on the following key principles: (1) primacy of the private sector-led solutions, (2) minimization of costs to taxpayers and depositors, (3) fair punishment of shareholders and managers who indulged in reckless risk-taking practices, (4) competent, independent and transparent assessment of banks' needs for capital injections and (5) clear, reasonable and politically neutral conditions on banks receiving public money. The banks are also expected to focus on clearing their balance sheets. If these remedies are structured through sound institutional arrangements, the banking sector should stabilize.

2.2. Reduce Foreign Financing Requirements by reducing the Current Account Deficit

Second, the requirements for additional foreign financing of the current account deficit should be minimized through adequate macroeconomic management. In fact, the reduction of the current account deficit should occupy the top spots on government's economic agenda. Indeed, the widening current account gap is not consistent with macroeconomic stabilization. If local and foreign investors continue to observe little improvement of the country's macroeconomic stability, they will hardly expect to see a cloudless picture of the Ukrainian economy in the future.

In order to reduce the current account deficit, aggregate demand must be curbed. The ongoing Hryvnia devaluation will help to reduce import demand. A necessary second element of this process is to reduce the fiscal budget deficit, because a failure to maintain a balanced budget leads to excessive domestic consumption and excessive imports. It erodes investors' confidence and is the first indication of the inconsistent and unsustainable macroeconomic management.

2.3. Support Economic Stabilization and Growth by Improving the Business Climate

A wise and prudent macroeconomic management is essential to gain back the trust of foreign investors. Although, Ukraine's proper compliance with the conditions of the recently approved IMF Stand-by loan will be a big step forward, it is not sufficient. Indeed, these requirements need to be complemented by other actions to achieve a meaningful correction of existing macroeconomic distortions. Ukraine needs to implement policy adjustment that both enable the fulfillment of the IMF requirements and ensures a revival of economic growth. This stronger and resolute commitment to critical economic reforms will send a clear signal to foreign investors and creditors that Ukraine's creditworthiness will remain strong in the future. Otherwise, it will be practically impossible to refinance and restructure outstanding private external liabilities, while funding pressures on the local banking system will intensify.

In fact, the IMF's proposed fiscal budget measures and other macroeconomic stabilization policies are bound to have a negative impact on economic growth. For this reason, measures must be taken to revive the economy. It is now more important than ever to take measures to improve the business environment and attract increasing amounts of foreign direct investments and also domestic investments. This will also restore and enhance investors' confidence. The government must establish a comprehensive policy dialog on key structural reforms and decisively introduce all necessary changes. Many of these policy changes do not require large budget spending but do require strong political will. For example, liberalization and deregulation of the business environment will substantially boost returns on private capital and will encourage investments. In the long-term, this will help to expand local supply, reduce the dependence on imports, encourage exports and restrain the growth of prices. After all, Ukraine can only maintain confidence in its economic prospects if the government implements reforms creating fertile environment for private sector-led growth.

Ukraine has an enormous potential to create wealth and prosperity through wise and ingenious management of its national resources. However, the government should play a fundamental role in creating the political and economic environment to enable the private sector to achieve this objective. Regrettably, in the past Ukrainian public governance relied on institutions and practices which were consistently unfit to handle this task. As a result, many of the crucial reforms are long overdue. Recent global economic and financial developments offer a golden opportunity for Ukraine to consolidate efforts on policy transformations that ensure bright economic future.

2.4 Programs to Coordinate and Facilitate the Refinancing of Foreign Debt

The Government should also consider a mechanism to help corporations and banks that may default on their foreign debt to refinance this foreign debt. There is a need to obtain solid information about monthly maturities of this debt and help debtors to develop contingency and restructuring schemes of this foreign debt.

3. Economic and Crisis Resolution Outlook

Potential social tensions triggered by tighter fiscal policy and economic slowdown can be significantly eased with more precise and effective targeting of social benefits to unprotected groups of the population. Furthermore, Ukraine is notorious for the scope and scale of inefficiencies parasitizing its public sector. Thus, the government has to consider options for more economical and prudent utilization of budget funds.

Many uncertainties continue to cloud the 2009 outlook for Ukraine's economy and financial system. Yet, in 2009 the economy is increasingly likely to go through an unparalleled correction, which, among other developments, will entail a real contraction of the GDP. The seriousness of many risks will depend on how strong is the country's resilience to the ongoing financial crisis, deepening economic recession and potential social instability.

All this makes government response critical to country's economic outlook. Building investors' confidence remains the most fundamental factor, which will determine two possible scenarios of economic and financial developments in 2009 – 2010.

Key developments to watch	Scenario I: Confidence has been restored successfully	Scenario II: Ineffective results in regaining investors' confidence
1. A possibility to roll over foreign debt	Major portion of foreign debts may be refinanced. Opportunities to find addition foreign funding might appear.	Very little portion of outstanding debts will be rolled over. External credit markets remain closed to the Ukrainian private.
2. Currency devaluation	Smooth and moderate devaluation of Hryvna to UAH/$ 8-10 at the end of 2009.	Significant devaluation of Hryvna with a possible overshooting to UAH/$ 15.
3. Real sector response	Mild recession in 2009 with a recovery in 2010. A bearable increase in unemployment.	Deep recession in 2009-2010. Significant increase in unemployment rate, which may overstretch the country's social security system.
4. Non-performing loans	Moderate increase, major systemic banks are cleaned and consolidated.	Substantial increase, elevated insolvency risks in the banking sector.
5. Banking sector resolution	Fiscal costs of bank resolution program are acceptable with some bankruptcies in the banking sector.	High fiscal costs with a significant number of bankruptcies in the banking sector.
6. Living standards	Moderate deterioration in living standards. Some decrease in household savings. Decrease in consumption. Light social tensions.	Sharp deterioration in living standards. Significant decrease in savings. Substantial decrease in real consumption. Major social unrests with riots on the streets. Threat to the country's national security.