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A Historical Outlook on the Financial Sector and the Perspective on Achievable Progress of Ukraine

The assessment of the financial sector of Ukraine at the beginning of the reformation period and the prospects for the future development has been disclosed. A comparative characteristic and the methodology for general actions and main issues of the development have been analysed.
financial sector, reformation, prospects for the development, methodology, banking transition

The article provides an assessment of the situation in Ukraine's financial sector for the last 10 years and defines a policy agenda for the next stages of reform.

The perspective of reforms which this article presents is of most importance for further development of the financial sector of Ukraine. The successful implementation the reforms will face a variety of political questioning and opposition. So it is important to define some progress markers to provide a starting point of the advantages and disadvantages. It provides a forward looking perspective of what might realistically be expected by way of new financing for the economy through the period to the end of 2006 in the event that a sustained reform effort is now adopted. It does this by comparing Ukraine's performance so far with that of other transition economies in the Former Soviet Union and Central Europe where financial sector performance has so far been more impressive.

The analysis of the volumes of new finance for the productive sectors of the economy that could be realised in case of successful completion of the reform for the sector. The target year of 2006. The methodology used is a careful examination of what has been achieved in countries with transition economies which have achieved greater progress in financial sector development. Most other Former Soviet Union (FSU) countries and a few Eastern European countries faced the post-Soviet period with apparently similar problems to Ukraine. Several have dealt with these with greater success as far as financial sector development is concerned. This is true of all three Baltic states, to a lesser extent of Russia and to some degree of Poland. So these are among the comparators that can be used for our analysis.

It is important to analyse Ukraine in the wider context of banking transition. There is growing evidence that the transition from a socialist banking system to a market-oriented one comes in three major phases:

- catastrophic dislocation from hyperinflation. In this phase, there is no confidence in any form of money – cash or deposit based. This phase for Ukraine was prolonged until end-1966 with the delayed introduction of the Hryvna (UAHr);
- sound cash money is established. This usually occurs through currency reform. However, in this phase, the population is not yet confident enough of banks to use deposits. This means the banking system remains suppressed below its natural level relative to GDP and the ratio of cash in circulation remains high. It is the end of this phase that Ukraine now appears to have reached – it is the last European transition economy to do so;
- the third phase is when the rebuilding of the banking sector can really begin as an integral part of the new market economy. This happens principally by reducing relative reliance on cash and by increasing deposits as both the platform for economic transactions and as one of the prime savings instruments. It is this phase that Ukraine seems about to enter provided that the improvements of the past year are sustained.

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- Since the third phase is the most immediately relevant to Ukraine, it can be sectioned out into three distinct sub-stages as follows:

- the first sub-stage is to bring down the very high cash to deposit ratio typical of the end of phase-2, so that non-cash transfers via banks start to take over from cash transactions and other alternatives to banking such as barter. It has the merit of being sufficiently far in the future to allow complex reforms to realise their beneficial results in full. It is also sufficiently close as to remain relevant to the political and election calendar.

Other transition countries at this stage are some Central Asian and all three trans-Caucasian States (Armenia has already virtually completed it);

• the second sub-stage involves a mix of a further reduction of the cash to deposit ratio but more important is the beginnings of a genuine mobilisation of new savings into banks. This is the stage that the three Baltic States, Russia and the two largest South-European transition economies (Bulgaria and Romania) currently occupy;

• the third sub-stage involves deposit growth in banks predominantly via new savings mobilisation. At this stage too the cash:deposit ratio achieves near the EU levels. Countries in this phase include almost all the first wave of Central European candidates for accession to the EU.

From 1989 to 2000 Ukraine had extraordinarily weak progress through 1998 and the beginnings of significantly more positive movements in 1999 and 2000. More specifically, in 1999 there were first registered falls in the cash to deposit ratio since transition began. This in turn contributed to a 2.5 percentage points rise in the ratio of deposits to GDP. This was five times the net change achieved in the previous four years and was sufficient to allow the banking system to grow at a compound 20 percentage points faster than nominal GDP. This represents a widening of the differential growth rate from the previous two years even though the 1999/2000 period actually includes the impact of the 1998 Russian crisis [1].

In spite of this the propositions advanced in the previous two sections – for the moment Ukraine still does not have a banking sector of any real significance to the economy and it still lags most other FSU and Central European economies. Looking into the future, it is extremely unlikely that Ukraine can return to the level of monetisation seen towards the end of the Soviet era. The highest ratio of deposits to GDP Ukraine might achieve is unlikely to exceed 45~50% – 5 times the present level. According to the forecast of "Ukraine: the financial sector and the economy" even this could take a decade or more to attain. The practical question is what is realistically possible by 2006? Experience from other FSU countries shows that the first stage of recovery as defined above need not take more than three to four years to complete. This alone would be enough to put Ukraine in 2007 where Lithuania is now.

This simple comparison can be improved by looking at what the progression from the 1989 starting point has meant for financial savings across a larger number of transition economies. The peer-group taken for this purpose is a selection of the European former Soviet States for which comparable data are available. Table 3 below compares current and pre-reform levels of PPP-adjusted per capita GDP, broad money and deposits measured in US dollars.

Table 1 shows that all countries have experienced larger declines in their financial sectors than in their levels of GDP. Ukraine has suffered a similar decline in financial savings (broad money or deposits) to Russia and Armenia, even though its per capita GDP has fallen by less than in those two countries. This evidence suggests that today's limited depth of the Ukrainian banking system cannot be explained by its sustained economic recession alone. There are other forces at work.

Additional explanations are suggested by the Baltic States, which suffered similar peak-to-trough declines in per-capita GDP to Ukraine but have progressed far better in recovering lost per capita income and financial savings (Table 1). Closer study has shown that recovery in those cases bears a direct relation with the degree of banking system

consolidation that has been achieved in the past five years [2]. The clearest example of this is Estonia, where GDP per capita is now 50% above the pre-reform levels and where all of the 1989 level of broad money per capita has been recovered (compared to only 18% in the case of Ukraine), but this time on a voluntary basis.

Table 1. Impact to Date of Transition on Incomes and Financial Savings

All figures PPP-adjusted US$	Ukraine	Russia	Armenia	Estonia	Latvia	Lithuania
Pre-reform levels (1989):						
- GDP per capita	3314	5871	5058	4914	5094	5505
- Deposits per capita	2114	4042	2112	2227	2210	3620
- Broad money per capita	2484	4750	2746	2800	2950	4306
Most recent levels (2000):						
- GDP per capita	2875	4400	2525	7425	6850	6900
- Deposits per capita	250	650	200	2250	1300	1075
- Broad money per capita	450	850	300	2800	1975	1500
Percent change (1989~2000):						
- GDP per capita	**-13%**	-25%	-50%	+51%	+34%	+25%
- Deposits per capita	**-88%**	-84%	-91%	+1%	-41%	-70%
- Broad money per capita	**-82%**	-83%	-89%	0%	-33%	-65%
Trough year(s) / peak declines	1996	1999	93-96	1993	92/93	93/94
- GDP per capita	-36%	-44%	-63%	-23%	-40%	-38%
- Deposits per capita	-94%	-87%	-97%	-81%	-81%	-89%
- Broad money per capita	-92%	-86%	-95%	-74%	-82%	-89%

To our mind there are two possible paths for Ukraine to take. The comparison of how different countries have progressed through the transition process described above offers some interesting insights about how much progress Ukraine can aspire to by the end of 2006. There seem to be clear, good and bad paths. We can illustrate these by comparing banking transition for Estonia (a strong performer) and Russia (a weak performer). Estonia has followed an aggressive reform path, with no protection for weak banks from failure. In the early 1990s, banks accounting for around 40% of total banking system assets failed with no compensation for depositors. This cost the economy the equivalent of 11% of GDP in lost real savings, but within five years this had all been recovered. Estonia now boasts two of the three largest banks in the Baltic States (despite being the smallest of the three economies). Both of these now have strong strategic investors and are expanding abroad. Recovery of the banking sector survived the twin shocks of the Asian and Russian crises and now appears to be accelerating again. This is despite further bank failures in 1998 and 1999.

Cumulatively the banking system has grown substantially in terms of deposits but has shrunk in terms of numbers of banks from around fifty banks in 1993 to just five now. Overall domestic deposits stand now at 30% of GDP and over the last five years (1996~2000 inclusive) the equivalent of 10% of GDP annually has been injected into the economy by way of new credit, more than half of which has been domestically funded. In contrast Russian reform has been at best sporadic, with a large degree of politicisation of the banking system and both overt favouring of selected banks as well as protection for both depositors and shareholders from the consequences of failure. Even the Bank Rehabilitation Agency established in the wake of the 1998 crisis has been blocked by political pressures (particularly at regional level) from closing banks that have been weakened to a point where a return to solvency and viability is impossible. In short the Russian banking system has been treated in a similar way to the Ukrainian banking sector.

Russia has never suffered a single banking crisis of the same magnitude as the Estonian one in 1993, but equally it has not witnessed such a strong and sustained recovery.

Moreover every few years, what progress there had been was reversed. Over the last five years its banking system has injected less than 4% of GDP on average annually by way of new domestic finance and less than half of this has gone to the non-bank non–government sector (NBNGS) to fund potentially growth-supporting investment. Russia has done marginally better than Ukraine but suffers from most of the same structural problems – its record on banking development is clearly not one for Ukraine to seek to emulate.

Lithuania is an interesting example of a country that appears to have switched modes. Up until 1997, the authorities there took various steps to avoid the consequences of large bank failures. In some cases this involved depositing public funds with banks approaching crisis and after the inevitable failures attempting to mitigate the consequences of failure with transfers of deposits to the state savings bank. The identifiable costs of these unstructured efforts were equivalent to several percentage points of GDP (at a time when total deposits in the banking system only amounted to 14% of GDP). Then in 1997 a properly constituted deposit insurance fund was established with publicly subscribed capital of barely 0.1% of GDP. This fund has since had to pay out on two further bank failures but without any interruption to the remonetization process.

Within two years of establishing the fund, total deposits recovered all the ground lost relative to GDP during the crisis and household deposits relative to GDP surpassed pre-crisis levels. The establishment of a strong, well-funded deposit insurance system was accompanied by concerted moves to restructure, properly privatise and seek significant foreign strategic investors for the two remaining large state banks – agricultural and savings – as well as the merger of the two largest private banks. In part the switch of emphasis in Lithuania was part a stark choice between muddling on as before, or having any realistic chance of joining the EU alongside other Central European States.

There are clear parallels here with the choice facing Ukraine – to embrace consolidation and maintain the impressive remonetization dynamic established over the last two years, or try to avoid it, lose growth momentum in the banking system and ultimately increase the cost of bank failure to the public purse. Obviously the recommendation of this review is to follow the Estonian/Lithuanian model rather than the Russian one.

In the year 2000, the greater public confidence in the government and the achievement of positive growth stimulated a significant rise in deposits in the banks on the part of both enterprises and households. We can surmise that this rise may also have been helped by factors such as the governments far more disciplined attitude to non-payment (especially in the energy sector); improved NBU supervisory performance that resulted in better information about and differentiation between good and bad banks and the first pay-outs under the deposit insurance scheme. But a competing hypothesis is that the surge in deposits is the passive consequence of higher payments balances associated with the impressive GDP growth – itself a consequence of the temporary oil-driven gains in Russia. Either way it is too early to say whether 2000 marks the start of a promising new trend or merely a one off blip around the old and disappointing trend.

The conclusion we draw is that the Ukrainian authorities should use all their efforts to sustain the good performance of 2000. In particular, the improved supervisory capacity should be used to accelerate the delayed consolidation of the banking sector thereby enabling a pattern of future development closer to that of Estonia and other Baltic states. This has the prospect of directly and quickly improving the average costs in Ukrainian banking. It is an approach that must allow the failure of those banks that can no longer operate at reasonable margins. If the authorities reject this possibility and instead persist with a more protectionist approach, the 2000 performance will likely be shown to have been one blip around the old trend and the sector will likely face a pattern of future development closer to that of Russia. In this case, the medium term future to 2006 will see a moribund banking system that is failing (as until very recently) both to mobilise domestic savings and to provide new credit to the domestic economy in significant volumes. Obviously the bolder of these two alternatives may

itself seem very risky but the lessons from other transition economies are definitely encouraging.

The analysis presented here suggests that this turn-around cannot happen unless Ukraine adopts the structural reforms of the more successful of the FSU reforming countries. The crucial ones – consistent with the framework proposed below are:

- measures to encourage the strengthening and accelerated restructuring of the banking sector;
- further actions to improve bank regulation and supervision and especially enforcement;
- a systematic campaign to reduce the costs on banks that are caused directly by government policies;
- general actions including de-regulation to encourage a far more favourable environment for bank clients and especially small and medium enterprises.
- measures to lay better foundations for the gradual emergence and growth of a more significant non-bank financial institutions sub-sector.
- allow a significant number of today's higher-cost bank to disappear – including some of the top-7 currently subject to rehabilitation – and allow banking activities to concentrate around the lower cost base of the remaining banks;
- for the larger and politically sensitive banks, the focus should be on more directly
- distinguishing the potentially efficient from the clearly defunct. This should then be allowed to form the basis for a managed consolidation of the larger banks;
- for most banks the NBU needs to be more consistent in the application of its policies as well as transparent and expeditious in enforcing liquidations (including mergers) on banks which are indisputably unable to meet its own capital and other prudential requirements.

The new agenda may also need to include selective and limited actions to create new financial institutions – the pronouncements of the authorities frequently refer to the need for this. But past experience in Ukraine readily confirms that this approach is not a priority. It must be subordinated to the more fundamental reforms listed in the six bullet points above. In the current environment it is extraordinarily difficult to create successful and self-sustaining new institutions. In the absence of basic reforms, new financial institutions – especially those owned and controlled by the state – will be irrelevant to Ukraine's problems.

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В статті розкриваються деякі аспекти оцінки фінансового сектору України на початку періоду реформування та перспективи подальшого розвитку. Проаналізована порівняльна характеристика та методологія загальних дій та основних питань розвитку фінансового сектору України.

В статье раскрываются некоторые аспекты оценки финансового сектора Украины в начале периода реформирования и перспективы последующего развития. Проанализирована сравнительная характеристика и методология общих действий и основных вопросов развития финансового сектора Украины.