Ukraine – Economic Growth and Financial Infrastructure

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UKRAINE: Economic Highlights

- Few non-oil producing countries in the world can show the following combination of economic achievements over the last three to five years:
  - High average rate of economic growth of about 9% pa
  - Low average annual inflation rate of less than 7% pa
  - Low average fiscal deficit of about 1% of GDP
  - High current account surplus of more than 8% of GDP
  - Fairly stable foreign exchange rate
  - High international reserves (currently $9.5 billion) in excess of three months of imports
  - Very low ratio of external debt to GDP of 23%
# Economic Performance

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
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</thead>
<tbody>
<tr>
<td>Real GDP Growth</td>
<td>6.0%</td>
<td>9.2%</td>
<td>4.8%</td>
<td>9.4%</td>
<td>12.1%</td>
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<tr>
<td>Fiscal Balance (% GDP)</td>
<td>0.6%</td>
<td>-0.3%</td>
<td>0.7%</td>
<td>-0.5%</td>
<td>-3.3%</td>
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<tr>
<td>Inflation</td>
<td>25.8%</td>
<td>6.1%</td>
<td>-0.6%</td>
<td>8.2%</td>
<td>12.3%</td>
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<tr>
<td>Exchange Rate (Hr/$)</td>
<td>5.4</td>
<td>5.4</td>
<td>5.3</td>
<td>5.3</td>
<td>5.3</td>
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<tr>
<td>Current Account ($bn)</td>
<td>1.2</td>
<td>1.4</td>
<td>3.2</td>
<td>2.9</td>
<td>7.0</td>
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<tr>
<td>(as % of GDP)</td>
<td>3.7%</td>
<td>3.7%</td>
<td>7.7%</td>
<td>6.3%</td>
<td>11.0%</td>
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<tr>
<td>International Reserves ($bn)</td>
<td>1.6</td>
<td>1.7</td>
<td>4.4</td>
<td>6.9</td>
<td>9.5</td>
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<tr>
<td>Foreign Debt/GDP</td>
<td>32%</td>
<td>27%</td>
<td>24%</td>
<td>22%</td>
<td>23%</td>
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Source: National Bank of Ukraine, State Statistics Committee
Real GDP Growth (%) in Ukraine Compares well with other Transition Economies

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<tr>
<th></th>
<th>Ukraine</th>
<th>Russia</th>
<th>Romania</th>
<th>Hungary</th>
<th>Bulgaria</th>
<th>Czech Republic</th>
<th>Poland</th>
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<tbody>
<tr>
<td>2000</td>
<td>9.8</td>
<td>4.3</td>
<td>8.5</td>
<td>7.4</td>
<td>5.2</td>
<td>2.4</td>
<td>10</td>
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<tr>
<td>2001</td>
<td>9.5</td>
<td>4.2</td>
<td>7.8</td>
<td>6.3</td>
<td>4.8</td>
<td>2.6</td>
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<td>2002</td>
<td>9.2</td>
<td>4.0</td>
<td>7.5</td>
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<td>2.8</td>
<td>10.2</td>
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<td>9.0</td>
<td>3.8</td>
<td>7.3</td>
<td>5.7</td>
<td>4.3</td>
<td>2.6</td>
<td>10.0</td>
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<tr>
<td>2004(e)</td>
<td>8.8</td>
<td>3.6</td>
<td>7.1</td>
<td>5.5</td>
<td>4.1</td>
<td>2.4</td>
<td>10.0</td>
</tr>
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</table>

Source: WIIW, State Statistics Committee
Ukraine's Economic Success is not an accident

- Since 1999, when Mr. Yushchenko was Prime Minister, a number of crucial reforms were implemented, including:
  - Tightening of financial budget discipline, including elimination of arrears
  - Restricting barter or non-monetary transactions in the energy sector
  - Accelerating privatization
  - Liberalizing monetary and exchange rate policy
  - Progressing with land privatization by allowing transfer of agricultural land to individual farmers
  - Initiating administrative reform
  - Improving the banking system

- External factors also favorable
  - Ukraine's exports were helped by the hryvnia devaluation of 1998
  - Increased demand and prices for Ukrainian goods, particularly metal products
Possible Risks to Future Economic Growth

- Inflationary pressures are emerging in 2005 as a result of:
  - Substantial fiscal loosening approved in 2004 (as a result of the increase in pensions approved in September 2004)
  - Spending of privatization receipts for current, non-investment purposes
- Lack of exchange rate flexibility
- Rapid credit expansion and low quality of credit portfolio
- External shocks (Ukrainian growth is, to a great extent, export-led)

If tight fiscal and monetary policies are not implemented by the new government, inflation may reach double digit levels in 2005, discouraging investments and growth
Policy Actions for Ukraine

- President Yushchenko is aware that to ensure sustainable economic growth over the medium term, sound monetary and fiscal policies must be maintained and must be complemented by policies facilitating sustainable investment activity or “investment drivers”

  1. Macroeconomic stability
  2. Business liberalization and de-regulation policies
  3. Stable and predictable legal environment
  4. Corporate and public governance
  5. Foreign trade liberalization and international capital movements
  6. Healthy financial sector
  7. Eliminating Corruption
  8. Reducing Political uncertainties
  9. Country promotion and image
Mr. Yushchenko's Presidency

- The following reforms and changes are being taken by Mr. Yushchenko:
  - On March 25, 2005, an amended Fiscal Budget for 2005 was approved by Rada, eliminating most tax privileges and exemptions, introducing moratorium on the creation of new free economic zones, and increasing excise taxes.
  - De-regulation and virtual elimination of the use of government institutions to intimidate the private sector
  - Friendlier approach by Government to small and medium size businesses
  - Reducing the size of the shadow economy
  - Fairer government and legal systems
  - Stronger working relationship between Ukraine and the West
  - Increased interest and support from international institutions

- Yushchenko’s track record as both Chairman of the National Bank and Prime Minister set the basis for Ukraine’s recent economic performance, and bode well for Ukraine’s future
Financial Sector Overview

- Ukraine's excellent economic performance was supported by significant progress made in improving its financial infrastructure.
- Significant growth in financial assets took place, expanding by about 44% per year during the last five years.

Source: National Bank of Ukraine, State Statistics Committee
Financial Sector Overview

- Financial sector growth in Ukraine on average has exceeded growth in other comparable countries.
- Banking asset growth in Ukraine decelerated in 2004 due to political uncertainties during the Presidential elections.

Source: IMF
Despite this growth, Ukraine's financial sector is still small relative to the size of its economy, with financial assets at 46% of GDP, below Central Europe and developed countries.

But Ukraine's financial sector should continue to grow due to strong GDP growth, increased demand for financing, and better regulations.
The banking sector dominates with a share of 89% in total financial assets. It is followed by Insurance with 10%, and Credit Unions with 0.7%.

Source: National Bank of Ukraine, State Securities and Stock Market Commission
As is the case in other countries, as Ukraine further develops, the share of non-banking activities should increase significantly.

Source: IMF
Improvements in Banking Infrastructure

- The following improvements in banking infrastructure have helped to increase confidence in the sector:
  - A new Banking Law gave the NBU better governance and banking regulations
  - The implementation of a modern electronic payments system reduced settlement times
  - The liberalization in the opening of bank accounts permitted firms to have more than one account
  - The elimination of old regulations terminated the past practice of confiscation of deposits by tax authorities
  - The strengthening of the supervisory capacity of the NBU helped to identify problem banks early
The Banking Sector  -- Overview

- A better banking sector infrastructure facilitated the expansion of bank assets, which increased four-fold from $6 billion in 2000 to $26 billion in 2004.
- But the size of the banking sector is still small (at 40% of GDP – 25% including informal GDP), below the world average of 60% and the below the developed counties (Germany, 220%; Japan, 150%, and the US, 60% - which has a large non-banking sector).
- Banks’ ability to fund lending was boosted by strong increases in banking liabilities, particularly bank deposits.
- Bank deposits and money supply in general expanded as a result of the purchases of dollars by the NBU in the inter-bank market, as it had to issue more hryvnias to buy dollars.
- Increased confidence in the hryvnia and in banks contributed to rapid bank deposit growth.
The Banking Sector – Credit and Deposit Growth

- Up to October 2004, Credit and Deposit growth was similar to previous years (as marked by black lines).
- However, the political uncertainties in November/December led to a sharp decline of deposits and credits. The situation was stabilized by February 2005 thanks to temporary measures taken by the NBU (credit ceilings, band for foreign exchange rates, and limitation on early withdrawals).

Source: National Bank of Ukraine
The Banking Sector – Credit to GDP Ratio

• Bank credit to GDP in Ukraine reached 25% in 2003 and 26% in 2004.
• It compares well with other Central/Eastern European transition economies, whose ratios for 2003 were: Bulgaria 25.8%, Romania 9.5%, Poland 17.8%, Czech Republic 17.9%, Hungary 42.3%, Slovakia 25.0%.

Source: National Bank of Ukraine, State Statistics Committee
The Banking Sector -- Ownership

- The banking system is mostly privately-owned
- Of a total of 160 licensed banks, only 2 are state-owned banks (the government also owns minority stakes in few other banks)
- Seven banks are 100% foreign-owned, and 12 banks have foreign participation in equity
- Foreign banks account for about 10% of total paid-in capital
- The banking sector is led by strong national banks (PrivatBank, Prominvestbank, Aval, UkrSibbank, First Ukrainian Int.) as well as subsidiaries of well-known international banks (Calyon, Raiffeisen, ING, HVB, Citibank, Alfa)
- The sector is concentrated, with 15% of the banks (25 banks) accounting for 75% of bank assets, as noted below
The Banking Sector – Sector Concentration

Ukraine's Banking Sector Concentration

Source: IMF
The Banking Sector -- Lending

- Lending to the real sector amounts to 62% of total banking sector assets
- Bank lending is concentrated on a few very large industrial clients, with few resources going to medium and small firms
- Consumer loans represent only 10% of banking assets and 4% of GDP

Banking System Assets Structure in 2004

- Commercial loans: 51.5%
- Consumer loans: 25.5%
- Securities: 5.8%
- Other assets: 10.3%

Source: National Bank of Ukraine
The Banking Sector - Lending Structure

- Consumer loans are also under-represented in other regional countries, at less than 10%
- In some Western countries consumer loans to GDP exceed 100%

Source: EBRD Transition Report
The Banking Sector - Issues

- The IMF estimates the share of non-performing assets in total assets at **28%**, much higher than the **3.4%** reported by the NBU.
- The NBU uses loan classifications different from internationally recognized ones: the NBU includes only past-due loans as non-performing debts, whereas the international practice is to include also sub-standard loans as non-performing (which amount to **21%** of assets in Ukraine).
- The NBU also give undue weight to collateral valuations.
- Furthermore, the bad practice of just extending the maturity of past-due loans, to avoid charges to Provisions, is used extensively.
- Mandatory Provisioning against these non-performing assets is also inadequate at **6%** of total assets.
- The rapid and indiscriminate growth of lending was probably the main reason for the poor "quality" of banks' portfolios.
- Ukraine's level of non-performing assets, compares unfavorably with other countries.
Non-Performing Loans and Provisioning

Non-Performing Loans and Provisions, 2003

Source: IMF Global Financial Stability Report
Capital Adequacy is another problem area, despite the increase in the minimum Capital Adequacy ratio to 10% since March 2004. This is because, contrary to international Basel standards, banks include as "real" capital such "non-tier I capital" items as loan loss reserves, fixed assets revaluation reserves, and current earnings. Furthermore, given rapid credit growth, capitalization is not sufficient and market risk is relatively high. In addition, minimum equity size is small: depending on specialization and location, the capital requirements for a bank vary from EUR 1.3 million to EUR 6 million. Compared to other countries, the profitability of Ukrainian banks is low, as noted below.
The Banking Sector - Profitability

Banking System Profitability in 2003, %

- Return on Equity - left scale
- Return on Assets - right scale

Source: IMF
Areas for Improvement: Banking Sector

- Rules for Loan Classification and Provisioning must be made consistent with international standards
- Capital adequacy requirements must be increased and better enforced
- Ownership of banks must be disclosed
- Rules on related-party lending must be tightened
- NBU’s Resolution 482 must be repealed as it requires special bank accounts for capital inflows that lead to multiple foreign exchange conversions at additional cost and delays
- Bank consolidation must be encouraged
- Greater participation of foreign banks should be encouraged
- Related legal framework should be improved by enacting the Joint Stock Companies Law, removing inconsistencies between Civil and commercial codes, and improving the judiciary and its enforcement
Non-Banking Financial Institutions: Exchanges

- Non-banking financial institutions are even less developed than banks, accounting for about 10% of all financial assets.
- Ukraine's stock market capitalization at 8.7% of GDP compared poorly with Central Europe (about 25%) and developed countries (US-110%, Canada-80%, Japan-65%, Western Europe-60%).

**Market Capitalization in Selected Transition Economies in 2003, % of GDP**

- Ukraine
- Czech Republic
- Poland
- Hungary
- Russia

Source: PFTS, EBRD
Non-Banking Financial Institutions: Exchanges

- Stock exchanges are underdeveloped in part because many stock market transactions take place outside formal markets.
- In the last two years, corporate bond issues have increased rapidly, with a threefold increase in 2003 and a twofold increase in 2004.
- Corporate bonds now represent 5% of bank assets and account for 60% of the transactions in the official securities exchange.
- Bonds are issued by few large companies, some of them not fully creditworthy.
Non-Banking Financial Institutions: Exchanges

The stock exchange index increased substantially last year, given good macroeconomic performance and positive expectations about the future.

Source: PFTS
PFTS and SB50 Indices

- PFTS – includes 10 stocks. Uses an odd methodology (doesn’t include trades outside bid-ask spread, uses average spread on days when no trades, etc.)
- SB50 – more representative broader index including 50 stocks. More transparent (rules modeled on S&P/FTSE)
To sustain further growth, the following improvements in security exchanges are needed:

- Upgrading the capacity of regulatory agencies
- Improve the operations of depositaries
- Improve clearance and settlement systems
- Further develop credit rating agencies
- Improve stock market regulations to encourage greater transparency and accountability
Non-Banking Financial Institutions: Insurance

- Insurance is the most rapidly growing non-banking financial sector, with premiums reaching $3.5 billion in 2004

Ukraine's Insurance Sector Development

* 9 months of 2004
Source: Ukrainian Insurance Association, State Securities and Stock Market Commission
Non-Banking Financial Institutions: Insurance

- New insurance products have been introduced, including agriculture risk insurance, life insurance, mandatory car insurance.
- Ukraine's ratio of premium-to-GDP in 2003 was 3.5%, comparable to the ratio for emerging countries (3.8%) but below the Western European average (8.3%).
- In 2004, this ratio in Ukraine increased to 5.7% of GDP.

### Premiums - 2003

<table>
<thead>
<tr>
<th>Country</th>
<th>Premiums (US$ million)</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Romania</td>
<td>795</td>
<td>1.45</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>387</td>
<td>1.90</td>
</tr>
<tr>
<td><strong>Ukraine</strong></td>
<td><strong>1,712</strong></td>
<td><strong>3.54</strong></td>
</tr>
<tr>
<td>Hungary</td>
<td>2,454</td>
<td>3.01</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>3,714</td>
<td>4.48</td>
</tr>
<tr>
<td>Poland</td>
<td>6,258</td>
<td>3.02</td>
</tr>
<tr>
<td>Turkey</td>
<td>3,242</td>
<td>1.35</td>
</tr>
<tr>
<td>Greece</td>
<td>3,668</td>
<td>2.10</td>
</tr>
<tr>
<td>Portugal</td>
<td>10,810</td>
<td>7.31</td>
</tr>
<tr>
<td>Spain</td>
<td>47,014</td>
<td>5.58</td>
</tr>
<tr>
<td>EU25</td>
<td>947,509</td>
<td>8.35</td>
</tr>
</tbody>
</table>

Source: Swiss RE, CEA
Non-Banking Financial Institutions: Insurance

On a premium-per-capita basis, however, Ukraine has one of the lowest ratios of premiums per-capita to GDP, at US$35 in 2003 and $57 in 2004.

Source: Swiss RE, CEA
Non-Banking Financial Institutions: Insurance

- The number of insurance companies have also increased in the last years, reaching 378 companies in 2004
- The government holds stakes (one controlling and two blocking) in three insurance companies only
- Approximately 50% of the Total Insurance Premiums have been paid to re-insurers, including US$345 million to non-resident
- In 2003, 65% of insurers in Ukraine were profitable, and 2/3rd of these reported profitability levels exceeding 60%

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<thead>
<tr>
<th></th>
<th>2003</th>
<th>9M 2004</th>
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<tbody>
<tr>
<td>Total Insurance Companies</td>
<td>327</td>
<td>378</td>
</tr>
<tr>
<td>Including Life Insurers</td>
<td>30</td>
<td>41</td>
</tr>
<tr>
<td>Total Insurance Brokers</td>
<td>n/a</td>
<td>72</td>
</tr>
</tbody>
</table>

Non-Banking Financial Institutions: Insurance

- However, market penetration rates (total premiums/ GDP) and insurance density rates (total premiums/ capita) are over-estimated in Ukraine due to the large pseudo-insurance activity in Ukraine.

- A large portion of insurance transactions do not reflect real insurance activities: Commercial banks that own insurance companies find it attractive (for tax purposes) to transfer some operations to their insurance subsidiaries. Insurance premiums are also inflated to export capital overseas through reinsurance.

- Nevertheless, in Ukraine there is room for growth in the insurance sector as coverage of estimated insurable risk is only 5% (compared to 90% in developed countries).

- Future growth of the sector will require changes in the Insurance Law to better regulate the sector, improve governance, improve capitalization, improve creditworthiness, and eliminate discrimination against foreign insurance companies.
Non-Banking Financial Institutions: Leasing

- The amendment to the Leasing Law in late 2003 was expected to stimulate leasing operations:
  - It reduced the number of required provisions in leasing contracts from 14 to 3, making them more transparent
  - It also eliminated inconsistencies between Civil and Commercial codes on leasing

- But leasing operations are still limited: the Ukrainian Leasing Association reports that 50 leasing companies have so far generated limited leasing services so far

- Following recently approved related leasing legislation (tax and depreciation treatments), leasing has become more viable

- But improvements are needed in the law on state registration of property rights and in mechanisms for enforcements of contracts
Non-Banking Financial Institutions: Pensions

- A three-pillar pension system was introduced in Ukraine in January 2004: the new legislation foresees the rationalization of the existing government’s pay-as-you-go system (pillar I), and the introduction of a compulsory (pillar II) and voluntary (pillar III) accumulation capitalized systems.

- The major rationalization of the pay-as-you-go system (pillar I) relates to the benefit formula – pensions are now calculated based on “covered service period” (number of years during which an individual paid pension contributions) and the wage on which pension contributions were paid. Earlier a person could choose either any of 60 months in a row or last 24 months of service to calculate pension benefits.

- The second pillar will be introduced after establishing a State Pension Accumulation (Capitalization) Fund, which is expected to start operating in 2007.
Non-Banking Financial Institutions: Pensions

- The non-government pension component (pillar III) is managed by Non-State Pension Funds (NPFs), insurance companies and banks.
- Participation in the third pillar is voluntary but encouraged by a number of tax privileges for both employers and employees.
- Currently the sub-sector infrastructure is being built up; there are 26 Non-state Pension Funds registered in the country and 33 Asset Management Companies have been licensed or applied for a license to manage the pension funds’ assets.
- The sub-sector activity is in its initial phase: NPFs’ assets are estimated to be only 0.01%-0.02% of GDP.
- Future growth will also require the resolution of a number of legal and regulatory issues for Pillar III, including more satisfactory standards for capital adequacy, liquidity, asset allocation, portfolio diversification, and currency matching for assets and liabilities.
Conclusions

- Ukraine's excellent economic performance in recent years was supported by a rapidly growing financial sector.
- So far, the financial sector has avoided major crises despite the relatively high level of non-performing assets.
- But its future stability and support to further economic growth will depend on substantial improvements in Ukraine's financial infrastructure, as discussed in this presentation.