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RETURN TO SUSTAINABLE GROWTH OF UKRAINE'S ECONOMY AND RISKS OF FINANCIAL DESTABILIZATION

Abstract

The article presents a systematic analysis of the risks of the Ukrainian financial system and offers suggestions that encompass a set of structural reforms aimed at expanding its role in returning the country to sustainable development. It is shown that the national economy has not managed to achieve an outstripping pace of development like most «post-planned» economies of Eastern Europe. The main reason for this has always been a lack of strong and independent governmental institutes and, consequently, structural reforms. Reforms in the real economy have been substantiated in the scope of the energy sector in view of the transition to market rules and use of anti-monopoly measures. Considering the financial system, the author justifies a higher degree of operational independence for the National Bank of Ukraine as a regulator, its broader authority to regulate non-banking institutions, transition to commercial and state banks using standardized principles of deposit insurance, and mandatory calculation of borrower's credit rating when approving loans. In view of the sizable state budget deficit, improvements to the pension system are examined. It is argued that its improvement must focus mostly on eliminating privileges, revision of the retirement age for some population categories, creation of non-state pension funds and their introduction to the financial markets.

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Key words:

macroeconomic stabilization; inflation targeting; structural reforms in Ukraine; macroeconomic and macrofinancial risks for Ukraine; public debt; international reserves; programme with the IMF.

JEL: E6, E66, F3, F33.

5 figures, 15 references.

Introduction

In the last five years since the crisis of 2014-2015, the Ukrainian authorities have managed to achieve macroeconomic stabilization. Inflation has been reduced to a single-digit level due to the change in monetary policy from de facto pegging to the dollar in the previous pre-crisis period to inflation targeting. Public debt to GDP ratio began to decline again, foreign exchange reserves grew steadily and as of mid-May 2021 reached 28 billion hryvnias, or more than 4.3 months of future imports.

The resumption of macroeconomic stabilization after the crisis of 2014-2015 was accompanied by a number of stabilization programmes supported by the International Monetary Fund. Since 2016, Ukraine has seen a return to economic growth. However, the bar for this growth was very low after the fall during 2014-2015 and, furthermore, it was not based on completed fundamental structural reforms. Most likely, such growth can be considered extensive, i.e. not accompanied by a significant increase in fixed capital investment. Although some reforms have been launched and yielded some results, the lack of progress in the judicial reform and opposition to the newly established anti-corruption bodies have resulted in high levels of corruption and an unattractive investment climate when compared to neighbouring Eastern European countries. This situation continues to affect the outflow of foreign direct investment and makes business in Ukraine difficult and risky. Additionally, the lack of widespread privatization of state-owned enterprises and the slowdown in the land market make the economy less competitive and less efficient.

Literature Review and Problem Statement

Scientific publications focus on the analysis of economic and monetary policy of Ukraine and its unresolved issues. At the same time, attempts are being made to develop proposals for policies aimed at preventing financial destabilization and ensuring sustainable economic growth. In particular, V. Heyets (2016) has proved that the transformations in the economy of Ukraine over the course of its independence have had mixed results. On the one hand, in 2006 the global community recognized Ukraine as a country with a market economy, institutionally enshrined private property and other attributes of the modern economy. On the other hand, it was noted that the country was moving towards deindustrialization and the living standards were declining.

V. Shevchuk and N. Cherkas (2019) have investigated the problems of ensuring growth and stimulation of export-oriented industries. They have argued that competitive participation in global value chains (GVC) primarily involves increasing the technological complexity of exports (although using productive links within the national economy is also a possibility), integrating into production chains of lower technological modes, and substituting imports of technological goods. They have emphasized that the preconditions for the integration of certain export sectors into competitive value chains are based on the development of labour-intensive production under conditions of dynamic wage growth.

The concept of inclusive development in Ukraine has been substantiated by Adamyk and Lebid (2019). The authors have ascertained that Ukraine's economic policy should not be limited to growth, but should also include aspects of equitable distribution, as inclusive development is defined as the progressive improvement of each person's financial situation.

Kuznyetsova L. I. (2019) has examined the problems of economic reform and stimulating economic development in the context of avoiding macroeconomic imbalances. The paper presents forecasting and analytical tools for preventing potential macroeconomic imbalances in Ukraine, taking into account the experience of the European Union. Particular importance has been attached to preventing the accumulation of major imbalances in the budget and public debt, as well as in the balance of payments. O. Petryk (2019b) has determined the indicators and factors influencing economic growth based on the analysis of the main internal and external macroeconomic imbalances of the Ukrainian economy and ways of eliminating them. Shvets S. M. (2020) has modelled the relationship between the level of public debt and the rate of economic growth. The model has made it possible to prove that in order to accelerate economic growth, it is necessary to focus policy on limiting the debt burden.

A number of publications highlight and analyse the possible risks for the Ukrainian economy in the short and medium term and possible ways of preventing them (Alsund, 2021; National Bank of Ukraine, 2021a, 2021b; Ari & Pula, 2021; Petryk & Deisan, 2018; International Monetary Fund, 2020; Petryk & Magdaliuk, 2018; Petryk, 2019a). In particular, Aslund (2021) and inflation reports of the National Bank of Ukraine (2021a, 2021b) have determined the main risks of the macroeconomic forecast, namely the slowing momentum of structural reforms and, as a result, the lack of funding from the IMF and other international partners; low level of foreign direct investment; continuation of the armed conflict in eastern Ukraine; and dependence of Ukraine's economy on commodity prices on world markets. A. Ari and G. Pula (2021) have emphasized the importance of continuing structural reforms to prevent threats of financial instability. Petryk and Deisan (2018) have focused on the National Bank continuing to maintain price stability and anchoring inflation expectations. The Memorandum of Cooperation within the framework of the Stand-by Program signed between Ukraine and the IMF in 2020 (International Monetary Fund, 2020) outlines the main issues of economic development in the post-crisis period and the agreed-upon structural reforms for economic recovery.

The researchers have also turned their attention towards investigations of the macroprudential policies of central banks. This approach has been covered in terms of insufficiently stable economies, a group to which Ukraine can be included (Petryk & Kuznyetsova, 2020).

In general, the analysis of scientific publications allows us to draw a conclusion about a sufficiently systematic study of sustainable economic development in the Ukrainian context. However, it is considered mainly without considering the risks of financial destabilization, which have an extensive range in Ukraine. Ultimately, this hinders the development of a successful sustainable development policy based on stable financial security.

The aim of this article is to determine the main macroeconomic and macrofinancial risks of the Ukrainian economy and substantiate the methods of mitigating these risks in the context of structural reforms and the resumption of cooperation with the International Monetary Fund.

Methodology of Research

The paper uses methods of theoretical and empirical analysis to determine the main macroeconomic imbalances and risks in the economy of Ukraine, as well as methods of comparative and graphical analysis to study the dynamics of major macroeconomic trends to develop general recommendations for implementing structural reforms in Ukraine.

Research Results

Current crisis and the need for structural reforms

The new humanitarian and economic crisis associated with the 2020 pandemic and related quarantine measures, falling global demand and world trade have created new obstacles to sustainable economic growth and exacerbated the need for structural reforms that would give new impetus to sustainable inclusive growth. The deteriorating demographics associated with rapid population aging, low birth rates, and mass labour migration, as well as Russia's military aggression are additional factors contributing to economic stagnation and very slow growth, even in times when external conditions are favourable.

After the fall of real GDP by 4 percent in the crisis-laden 2020, estimates of growth of the Ukrainian economy have improved significantly. For instance, according to the forecasts of the Ukrainian authorities, the IMF, the World Bank and other international organizations, real GDP growth may be in the range of 3.8-4.1%. However, even if the forecasts come true, Ukraine's GDP may be only 94% of 2013 levels due to the economic downturn in 2014-2015 and ensuing moderate recovery in 2016-2019. In particular, the estimate of Ukraine's potential GDP in 2021 provided by the NBU decreased significantly over 2020 from the 3.5-4 percent previously projected in 2018-2019 to 2-2.5 percent. This indicates that the growth potential of the Ukrainian economy is limited without radical structural reforms, and it will gradually be exhausted, impeding the ability of Ukrainian's economy to return to sustainable economic growth. In fact, the economy is gradually losing the potential of high value-added production and is becoming an economy with a focus on production of commodities or goods and products with low value added.

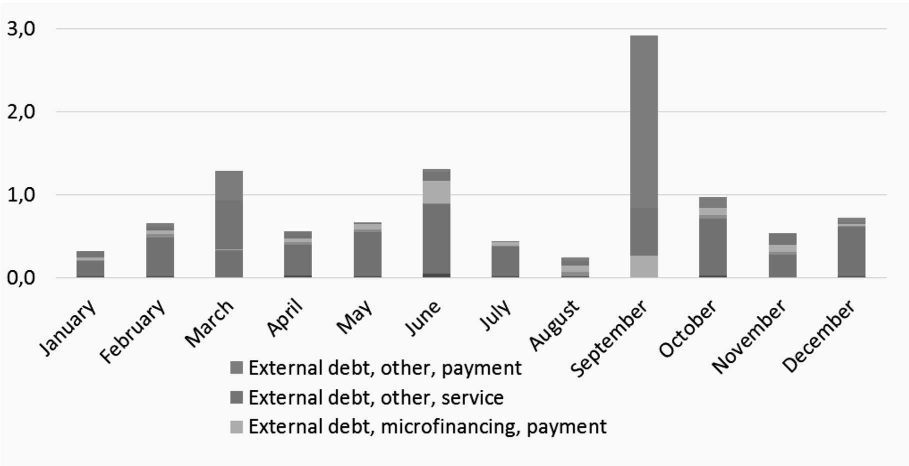
However, ill-considered fiscal policy, which is rather the result of unfinished major structural reforms, is one of the biggest risks to financial stability and at the same time a burden on economic recovery. It exacerbates the potential disruption of price stability by increasing public debt and, consequently, diverting financial resources from development to financing and servicing accumulated debt. The solution to this issue lies in the implementation of pension and administrative reforms, privatization of a number of unprofitable state-owned enterprises, as well as education and healthcare reforms and reduction of corruption.

Risks of external vulnerability in the context of peak payments in 2021

As of the beginning of May, the total amount of payments on the government's debts denominated in foreign currency during May-December 2021 will amount to about 7.8 billion US dollars, and more than a third of these payments (2.9 billion US dollars) will be due in September 2021 (Fig. 1).

Figure 1

Payments on public debt in foreign currency in 2021 in billion USD as of May 1, 2021



Source: created using the data of the Ministry of Finance of Ukraine.

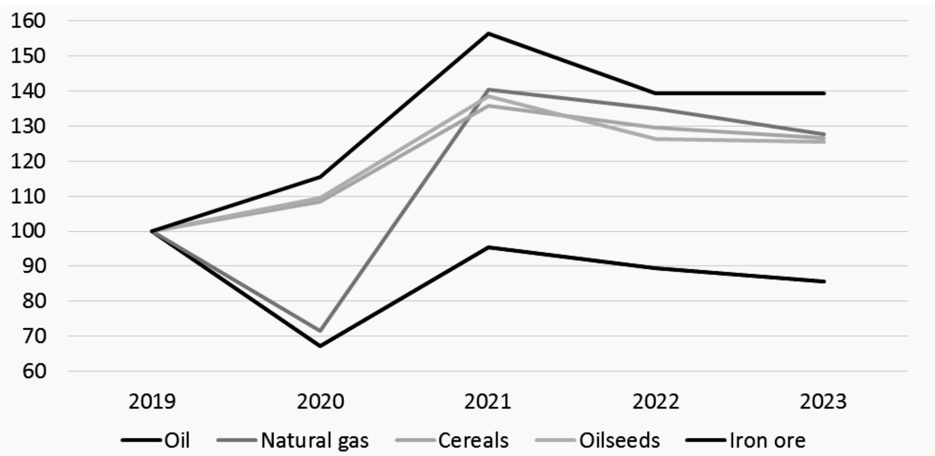
About 2 billion USD of the September payments are due to the repayment of Eurobonds (including 1 billion USD Eurobonds of Ukraine guaranteed by the US government in 2016).

Terms of trade and risks of deterioration of the current account of the balance of payments

Unlike previous crises, the crisis caused by the COVID-19 pandemic was not accompanied by a sharp deterioration in the pricing for the main goods of Ukrainian exports; on the contrary, in 2020 their prices continued to rise (Fig. 2). Therefore, we can be quite optimistic about the future dynamics of prices for basic commodities in the first half of 2021. This is explained by the gradual recovery of the world economy, the weakening of the US dollar and the extremely soft monetary and fiscal policies of most countries, which support the demand for commodities through infrastructure projects and household consumption.

Figure 2

Price indices for certain commodities, 2019 = 100

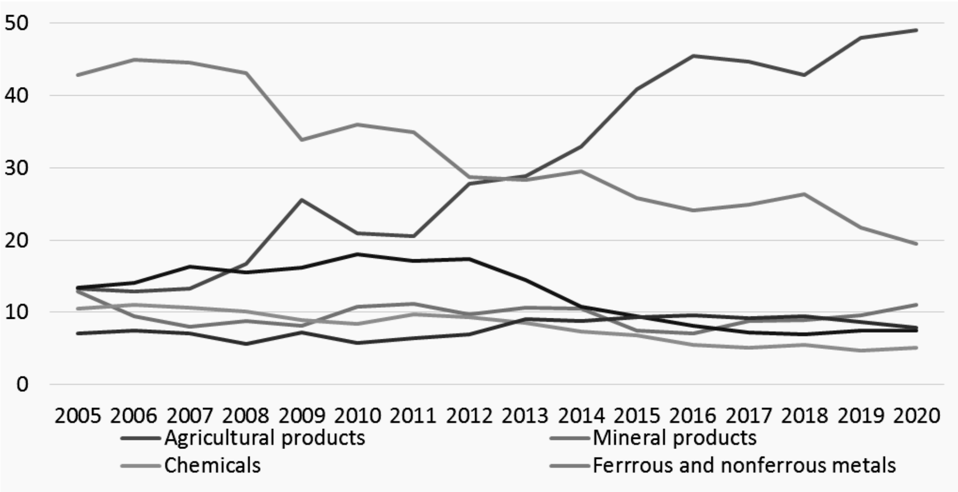


Source: created using the data of IMF WEO, April 2021.

At the same time, the structure of Ukraine's exports continues to worsen from year to year and the share of low value-added goods such as grain, foodstuffs and raw materials continues to grow. This increases the risks for Ukraine in terms of foreign currency supply depending on changes in pricing in world commodity markets (Fig. 3).

Figure 3

Structure of Ukrainian exports, percentage



Source: created using the data of the National Bank of Ukraine.

Capital flows and changing conditions in global financial markets

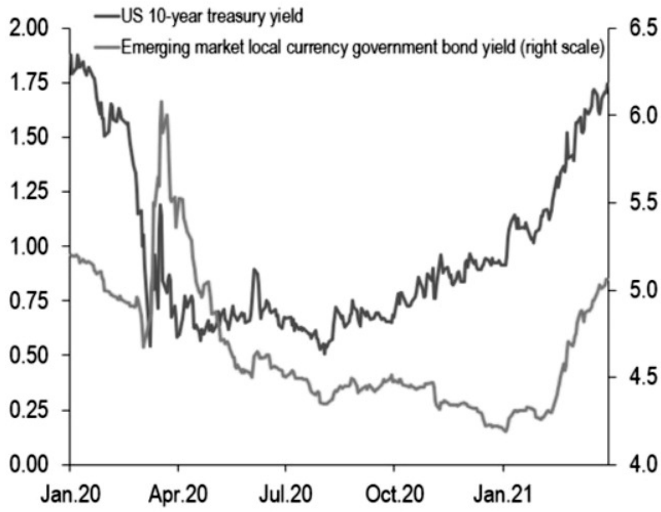
Due to unprecedented measures taken by central banks and governments of developed countries in response to the global crisis in 2020, interest rates in global financial markets remain at historically low levels. At the same time, the yields on long-term US treasury bonds started to slowly grow in the second half of 2020 and accelerated in early 2021 (Fig. 4).

On the one hand, this is happening as a large-scale vaccination program is underway and forecasts for economic growth in the United States are improving. On the other hand, the Fed's fiscal stimulus and asset repurchase programs have already reached over 5 trillion USD since the beginning of 2020, which will result in inflation in the US and the devaluation of the dollar. This also leads to rising premiums for inflation risks and fears that the Fed's monetary policy will tighten in the short term. Under such circumstances, investors may begin selling the assets of developing countries *en masse* in search of «safer» assets with acceptable returns (assets in developed countries). This is exactly the trend that can already be observed in Ukraine. «Imported inflation» is an additional risk.

According to the World Bank, food prices have risen by a third over the past year and continue to rise, which is also precipitated by the devaluation of the dollar and the policy of quantitative easing of the world's leading central banks.

Figure 4

Yields on government securities, percentage



Source: Adrian, T. (2021). *An asynchronous and divergent recovery may put financial stability at risk*. IMFBlog. https://blogs.imf.org/2021/04/06/an-asynchronous-and-divergent-recovery-may-put-financial-stability-at-risk/?utm_medium=email&utm_source=govdelivery

Taking into account all these factors, in the absence of programs of cooperation with the IMF and inhibition of structural reforms, foreign investors assess even the medium-term risks for Ukraine as very high. As a result, the net outflow of foreign direct investment in 2020 amounted to about 1 billion US dollars and continued in 2021 (over the 1st quarter the outflow amounted to 300 million US dollars). The time of capital outflows and, as a consequence, obstructed access to international capital markets for developing countries may coincide with the peak payments of Ukraine on foreign currency-denominated debt, which will put significant pressure on foreign exchange reserves and lower the resilience to external shocks.

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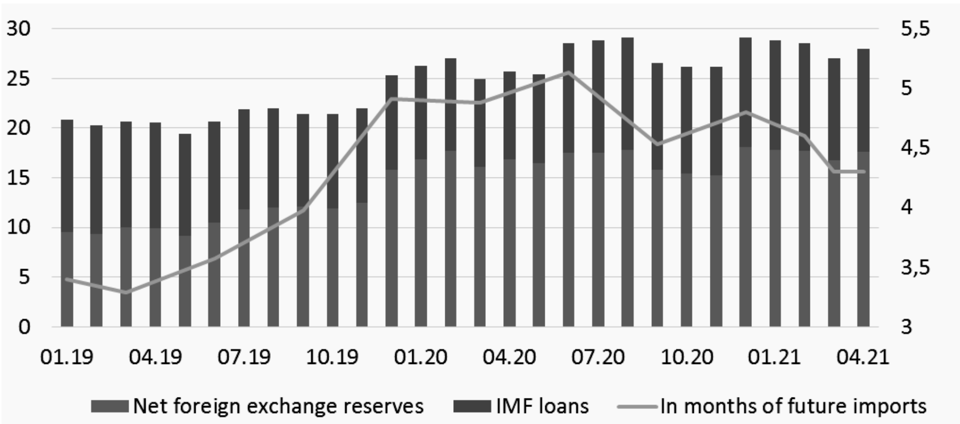
Refinancing of existing debt and sufficiency of foreign exchange reserves

Given the significant liquidity of the banking system (including in foreign currency), the government is likely to manage refinancing existing debt on foreign currency government bonds (about 3.7 billion US dollars). Refinancing of Eurobonds issued under the guarantee of the US government is possible providing appropriate agreements are reached with the US Government, but the likelihood of this is quite low without progress in negotiations with the IMF. Refinancing other Eurobonds on market terms without reaching an agreement with the IMF is highly likely to increase the debt burden due to worse conditions of new loans. Thus, the total amount of net payments (including refinancing of foreign currency government bonds) by the end of the year will be about 4.7 billion USD (of which $2.9 billion is due in September 2021).

As of the end of April, Ukraine's foreign exchange reserves amounted to 28 billion USD, covering 4.3 months of future imports (Fig. 5).

Figure 5

Ukraine's foreign exchange reserves, billion USD



Source: created using the data of the National Bank of Ukraine.

In the absence of external loans to refinance existing debts, and given the potential exit of non-residents from Ukraine's government bonds market, the size of foreign exchange reserves as of the end of September may decrease by 17% to 23.5 billion US dollars (which is about 3.5 months of future imports). Although the size of reserves will remain sufficient, such changes will lead to an increase in devaluation and inflation expectations and will have a negative impact on inflation by the end of 2021.

Directions of structural reforms in the economy

Structural reforms must be implemented and the effectiveness of fiscal policy must be strengthened in order for Ukraine to ensure macrofinancial stability and return to sustainable economic growth. A significant budget deficit primarily requires adequate financing, which directs the liquidity of the banking system and private investors to purchase government securities, instead of financing the real sector of the economy (crowding out effect) and leads to an increase in public debt.

At the same time, structural reforms should focus on reducing budget expenditures to finance pension funds, unprofitable state-owned enterprises, and a relatively large state apparatus. In Ukraine, the improvement of the pension system should focus mainly on the elimination of privileges, revision of the retirement age for certain categories of the population, creation of private pension funds under state control and regulation, and the introduction of such pension funds to financial markets.

Structural changes in the real economy of Ukraine should focus on improving the efficiency of the energy sector and the operation of state-owned enterprises. For now, the reforms have focused on improving the operation of the largest oil and gas monopoly on the Ukrainian market – *Naftogaz*. The measures concentrated on transitioning the company to market methods of setting tariffs with the simultaneous introduction of a system of subsidies for the poor. This made *Naftogaz* a break-even company. The next step in reforming the energy sector should be the implementation of antitrust measures in transportation and distribution of gas and electricity with the abolition of «manual» management practices. This will create a competitive environment in energy markets and should lead to lower energy prices for households and businesses.

Restoring sustainable economic growth requires reforms that can prevent and address the risks associated with the imperfections of certain parts of the financial system. This primarily concerns the National Bank of Ukraine. Analytical work carried out by the NBU Board and the IMF highlighted the need for amendments to the law on the National Bank of Ukraine aimed at strengthening its operational independence as a regulator, expanding its powers to regulate non-banking institutions, formulating the powers of the NBU Board and enshrining in law its non-interference in the operational activities of the Management Board. Secondly, the rules of engagement between the NBU and the Deposit Guarantee Fund must be established, while the pricing procedure for the assets of bankrupt banks should be improved. Other key areas of improvement in the banking system of Ukraine include: adoption of uniform principles for insuring deposits of commercial and state banks; acceleration of bank capitalization; introduction of a procedure for the mandatory calculation of the borrower's credit rating when they seek out bank loans.

Conclusions

In 2021, Ukraine will be able to finance payments on debt denominated in foreign currency, even in the absence of regular tranches from the IMF and lack of access to foreign capital markets, however this will result in increased public debt and the cost of its servicing. Additionally, if this negative scenario comes to pass, foreign exchange reserves will dwindle almost to the levels of 2019 and amount to 23.5 billion USD or 3.5 months of future imports in September 2021. Although the size of reserves will remain sufficient, such changes will lead to an increase in devaluation and inflation expectations and have a negative impact on inflation by the end of 2021. The implementation of such a scenario will also require budget sequestration or underfunding of unprotected items of state budget expenditures. The risks of a sharp deterioration in trade conditions and a sharp decline in export earnings to the foreign exchange market in August-October 2021 are deemed minimal, although there are significant risks of financial destabilization in the medium term.

The risk of capital outflow from Ukraine due to changes in conditions in global financial markets can be assessed as moderate (average). Quantitative assessment of this risk is 600-700 million US dollars of additional demand in the foreign exchange market in September 2021 (about +10% to the monthly purchase of currency by bank customers for the month).

Therefore, in order to prevent the negative scenario, Ukraine must adhere to the conditions of the Memorandum under the current Stand-by programme, and thus ensure the continuation of financial support from the Fund and, accordingly, other international creditors. This will allow Ukraine to prevent the negative scenario of financial destabilization in the near future and lay the foundations for sustainable economic growth.

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