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Reforms aimed at external stabilisation: A progress update

The list of necessary reforms in Ukraine is long. Since not all reforms can be tackled at the same time, there is a need to define priorities. In our view, reforms aimed at external stabilisation should be given priority. In this context, we identify five reform areas.

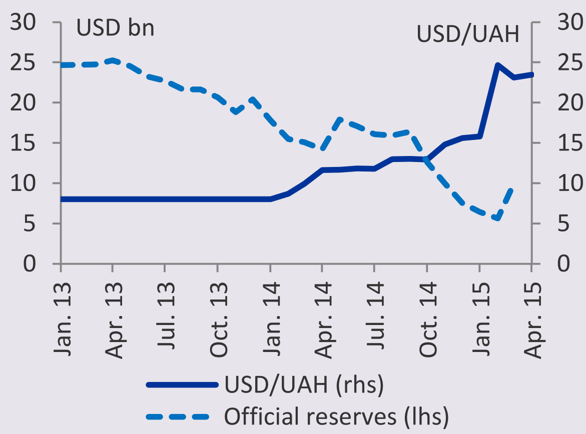
Cleaning up the <u>banking sector</u> is crucial for reducing the internal capital flight, which is a major source of instability. The National Bank made much progress in this area, in particular by the resolution of 48 banks. But also the high level of <u>energy imports</u> weakens the external situation. The hike in energy tariffs for the population was a crucial step for reducing energy imports in the future. <u>FDI attraction</u> would help to stabilise the situation. Further improving the investment climate and a clearer focus of FDI attraction on light industry are necessary for convincing investors to enter Ukraine. <u>Strengthening exports</u> is also a crucial factor. A swift implementation of the DCFTA would help to re-orientate exports to non-Customs Union countries. But also instruments of export promotion need to be developed. Lastly, Ukraine should make progress in the attraction of donor funds for <u>project finance</u>. Current procedures are dysfunctional and hinder the inflow of donors' money.

To sum up, good progress has been achieved in some reform areas, while other areas clearly need to pick up.

Urgent need for external stabilisation

Ukraine's policymakers face vast economic challenges. A top priority area is macroeconomic stabilisation, and here in particular external stabilisation. The well-known adverse exchange-rate dynamics and the low level of official reserves are proof of that challenge.

Exchange rate and official foreign reserves



Source: National Bank of Ukraine

In order to restore external stability, not only appropriate macro (monetary and fiscal) policies are required, but also supportive economic reforms at the micro level, since part of the problem is structural in nature. This raises the immediate question how far Ukraine has already progressed in addressing these problems via economic reforms.

A suitable structural framework to analyse this issue is Ukraine's balance of payments for 2014. In the following sections, we will highlight a number of respective areas and assess the reform progress.

Internal capital flight

The general lack of confidence in the banking sector can be seen from the USD 2.7 bn of net FX purchases and withdrawals over 2014. Liquidity and solvency problems at many institutions trouble the sector and undermine its financial intermediation function.

At the same time, the National Bank of Ukraine is making significant efforts to clean-up the problematic banking sector and regain confidence. The resolution of 48 banks since early 2014 (equivalent to 20% of system assets) shows a completely different, tougher approach in comparison to the financial crisis 2008/09. Legislation that introduced unlimited liability of bank owners and managers on losses arising from related-party loans is a further case in point. These advances in the regulatory framework are met with strong resistance from vested interest groups, but move on.

Energy and gas imports

The main import category of Ukraine is energy, with a share of about 25% in total imports. These imports amounted in 2014 to USD 16 bn, which is a 28% decrease over 2013. Gas imports reduced by 30% due to lower consumption and lower gas storage. While gas imports from Russia declined by 44%, imports from the EU ("reverse flows") increased by 135%. Thus, a shift in the regional import structure is underway.

The main reason for the still high imports, the low residential tariffs for gas and heat, are now being addressed. According to the IMF programme, full cost coverage shall be achieved by 2017. This is a crucial first step that will help to attract investments in order to reduce energy consumption and imports further.

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Foreign direct investment (FDI)

Net FDI inflows in Ukraine in 2014 where only at USD 0.3 bn (0.2% of GDP), which is an extremely disappointing figure, given the enormous potential of the country. Reasons for this poor performance, apart from the military conflict in the East, are also the poor investment climate, and the lack of clear focus in FDI attraction.

Policymakers have achieved some success in their deregulation agenda, even though business is currently not fully feeling the impact yet. However, these efforts need to be complemented by a focused strategy of FDI attraction, especially in the light industry. Here, the extremely competitive labour costs (the monthly average wage in Ukraine is only about a fifth of the respective level in Poland) make a strong case for investments in labour-intensive production.

Export promotion

Exports dropped by 17% (USD 13 bn) in 2014, despite the strong depreciation of the Hryvnia. The main reason was the decline in exports to the Russian-led Customs Union, which accounted for more than two-thirds of this drop.

As the situation won't probably improve in the short term, export re-orientation is required. For this to happen it is crucial to improve the quality of many Ukrainian goods; a swift implementation of the DCFTA would certainly contribute to higher quality standards, thus facilitating exports to the EU and to third countries. Furthermore an effective policy of export promotion is necessary; so far, only very few instruments of export promotion are available.

Official loans and project finance

While Ukraine attracted (net) official loans of USD 5.1 bn in 2014, most of these funds were earmarked for balance of payments or budget support purposes. Project finance to the public sector (e.g. for infrastructure investments) was relatively small. Reasons for this disappointing performance are very complicated and bureaucratic procedures, which delay the process.

Discussions with key donors on the simplification of these procedures have only started, with little tangible progress. This is rather disappointing; as such a reform could be implemented rather quickly, with a high impact (more project finance) and virtually no costs.

Conclusions

The focus of this analysis was to assess the progress that has been achieved to restore external stability, which is crucial for Ukraine's economy. The following table provides a summary:

Reform area	Progress assessment
Stabilising the banking sector	Good progress
Reduction energy imports	Crucial first steps
FDI attraction	Some progress on deregulation
Export promotion	Limited progress so far
Project finance	Still lot to do

The overall impression is that reforms are well underway, even though more time is necessary for business to feel their full impact. Policymakers should now focus on some areas that still need to catch up with more advanced reforms.

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Note:
An extensive analysis of the subject can be found in the Policy Briefing PB/05/2015 "Economic reforms aimed at external stabilisation. A structural framework"

Download: www.beratergruppe-ukraine.de

German Advisory Group
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