78th East Jour Fixe: Ukraine – Progress of reforms and challenges ahead[1]

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Ukraine, which has received extensive political and economic attention over the last two years, was the topic of the 78th East Jour Fixe held at the Oesterreichische Nationalbank on February 26, 2016. The country now stands at a delicate crossroads between a gathering recovery and further instability. On the plus side, Ukraine shows fragile economic stabilization tendencies on the heels of a profound depression. Also, some first reforms are beginning to bear fruit. Nevertheless, much remains to be done.

In her welcome address and introductory statement, *Doris Ritzberger-Grünwald,* Director of the OeNB's Economic Analysis and Research Department, pointed out that, in contrast to many other countries, the catching-up process has not worked well in Ukraine. Possible explanations include the following: First, Ukraine has not benefited from its position between the EU and Russia. Second, Ukraine's elites have not managed to build up a well-functioning state to underpin a prospering economy. On the other hand, a vigilant civil society has developed and there is a higher degree of political competition than in other states of the former Soviet Union. While in 2014 and early 2015, the country had plunged into a deep recession alongside a war in parts of eastern Ukraine, in the course of last year some degree of macroeconomic stabilization was reached through a painful adjustment process in the framework of an IMF program. Achievements include energy sector reforms and the restructuring of privately-held external sovereign debt. However, more recently, signs have emerged that the program is no longer running smoothly. To turn the tentative stabilization into a more sustainable recovery, it is necessary, in Ritzberger-Grünwald's view, to settle the conflict in the east, and for the authorities to further intensify their reform efforts.

The first session chaired by *Ritzberger-Grünwald,* was devoted to the current macroeconomic and fiscal situation in Ukraine and the policies exercised in the framework of the IMF's Extended Fund Facility (EFF). *Dmytro Sologub,* Deputy Governor of the National Bank of Ukraine (NBU), expressed his view on the challenges for monetary policy and financial stability amid a difficult political environment. Notwithstanding a recent current account adjustment and some tepid bottoming-out of the economy, Ukraine's deteriorated terms of trade along with persistent upward pressure on inflation remain major challenges. Therefore, the NBU is putting a lot of effort into reaching its 12% inflation target in 2016. By conducting foreign exchange interventions, the monetary authority aims at managing pass-through effects from the exchange rate to prices. Moreover, Sologub underlined improvements the NBU has already achieved regarding the supervisory, monetary policy and communications frameworks. However, he also pointed to the challenges the central bank has yet to tackle to overhaul the financial sector: e.g. establishing a resolution mechanism for nonperforming loans (NPLs), developing and implementing macroprudential supervision tools, and ensuring adequate capitalization of the banking system.

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Jerome Vacher, IMF Resident Representative in Ukraine, touched upon the major reform areas under the four-year IMF EFF program that is strongly focused on structural reforms. With respect to the overhaul of monetary policy, he outlined the importance of fostering the accumulation of reserves. Although fiscal imbalances have recently started to narrow and some reforms on both the revenue (e.g. tax administration) and expenditure (e.g. pension reform) sides have been initiated, Vacher stressed that especially putting public debt on a downward path remains a major challenge. In addition, for the energy sector, which is another key reform area, the EFF program aims at gradually raising gas and heating tariffs toward cost recovery. This should be accompanied, however, by enhanced and sustainable social assistance measures to mitigate the impact on the poorest segments of society. Overall, risks to the program are seen to be tilted to the downside and depend heavily on the authorities' commitment (policy slippage risk), the global environment and the further evolution of geopolitical and trade tensions. It is safe to assume that the return to growth will be slow at any rate.

Vasily Astrov, economist and country expert on Ukraine at the Vienna Institute for International Economic Studies (wiiw), commented on reforms in the fiscal area and referred to the exchange rate policy under the current IMF program. He pointed out that the importance of exchange rate stability in Ukraine is substantial – not least due to the direct impact it has on banking sector stability and the burden of public debt. On account of sizeable pass-through effects to inflation, which, among other things, have heavily eroded households' purchasing power, Astrov advocated a (further) buildup of foreign exchange reserves to allow for some degree of exchange rate fixation. As to fiscal imbalances, he pointed out that they were not at the root of the current crisis. Hence, he criticized demands placed on the Ukrainian authorities to take fiscal policy measures that have pro-cyclical effects and affect socially weak segments in society. Therefore, he proposed that an alternative set of fiscal adjustment reforms encompassing less austerity and more ambitious debt restructuring be pursued.

In the ensuing discussion, the panelists argued that a de-dollarization of the Ukrainian economy will remain a major challenge, although there have recently been some signs of a recovery of lending in local currency to the corporate sector. Furthermore, in order to reinvigorate economic growth, the importance of quickly reining in corruption, improving the business climate, stepping up deregulation and reforming state-owned enterprises was highlighted.

The second session, chaired by *Peter Backé,* Deputy Head of the OeNB's Foreign Research Division, revealed interesting details about the implementation of the Minsk II process, on the one hand, and the pervasive extent of, and current actions against, corruption in Ukraine, on the other. Ambassador *Martin Sajdik,* Special Representative of the OSCE Chairperson-in-Office in Ukraine, pointed to some recent improvements for the OSCE mission in the country: even though there are still problems of access to the Russian-Ukrainian border in the separatist territories, monitoring conditions have somewhat improved. With the daily human toll having declined significantly, some confidence has returned to the local population. He emphasized that the goal of the Minsk II Agreement, signed in February 2015, is the reunification of Ukraine. At the same time, he highlighted the weak legal status of this political document, given the lack of an official mandate from either Russia or Ukraine. Yet, the political authority of the "Normandy format" powers Germany, France, Russia and Ukraine as well as the implicit support of the U.S.A. explain the relative success of its implementation. Sajdik concluded by listing recent achievements of the two working groups focusing on economic and political issues, including reconstruction of basic infrastructure, resumption of pension payments and clarification of open questions related to local elections in the rebel-held areas. The discussion dealt, inter alia, with reforms of Ukraine's constitution that have yet to be carried out (decentralization and autonomy amendments) and with the question whether the armed conflict has already led to a separation of nationalities. Ambassador Sajdik appealed to all the parties involved not to place too much emphasis on the issue of people's nationality, but rather to focus on the issue of internally displaced persons and refugees in neighboring countries.

The second part of the session was devoted to one of the most prevalent challenges for Ukraine: the fight against endemic corruption. *Olena Bilan,* Chief Economist at Dragon Capital (a Ukrainian investment bank) and member of the editorial board of VoxUkraine (a non-government organization), emphasized that everything needs reform in Ukraine, so the question is where to start. Yet, she also identified areas in which reforms have been successfully implemented recently, such as the banking sector (transparency has increased sharply), the energy sector (external dependency has been reduced), e-procurement (which had started as a pilot project and has reduced the cost of tenders by 80%) and the new patrol police. The most pressing challenges are to reform the judicial system and the prosecutor's office, to change the attitudes and competencies of civil servants and to tackle the issue of vested interests in state-owned enterprises. In the discussion, Bilan emphasized the supportive role of the IMF in achieving progress and the pivotal role of civil service reform.

Daria Kaleniuk, Executive Director of the Anti-Corruption Action Centre (AntAC, a Ukrainian civil society organization), stated that corruption is the rule rather than the exception in Ukraine. In light of the high degree of openness of the country's economy, the high and pervasive level of corruption is surprising. In order to break the vicious circle of corruption, she advised vesting the National Anti-Corruption Bureau established in 2015 with full power to investigate high-level persons. While many legal steps have been taken – e.g. an asset recovery agency has been created, progress has been achieved in raising the transparency of public procurement, a law on the funding of political parties has been passed –, the implementation of these steps is still lagging. Besides conviction and confiscation as a strategy to fight corruption, she also advocated the buildup of high reputational risks through open state registries and transparent public spending. Kaleniuk then presented a database of politically exposed persons in Ukraine. In the discussion, *Sologub* pointed to business areas in Ukraine where corruption is far less of a problem. He ascribed this success especially to EU influence, but also referred to the transparent recruiting process at the National Bank of Ukraine.

Session 3, which was chaired by *Michael Landesmann,* Director of Research of wiiw, was dedicated to two key economic factors for Ukraine: foreign trade and banking activities. *Amat Adarov,* wiiw Economist, and *Peter Havlik,* wiiw Senior Economist, highlighted Ukraine's position in external trade in the light of the country's Deep and Comprehensive Free Trade Area (DCFTA) agreement with the EU. While the European Union had been granting Ukraine autonomous preferences for its exports from April 2014, the full implementation (including the opening of the Ukrainian market) of the DCFTA did not start before January 2016. On the other hand, Russia suspended Ukraine's free trade with the Commonwealth of Independent States Free Trade Area (CIS FTA) also in January 2016, and imposed a special restrictive transit regime for Ukrainian products moving via Russia to Kazakhstan. Moreover, Ukraine and Russia have imposed embargos on parts of each other's bilateral agricultural exports. These negative effects are exacerbated by the continuing geopolitical conflict in the east of Ukraine, both countries' recessions, and soft global commodity prices. As one of the results, Ukrainian exports of machinery and equipment to Russia have all but collapsed. Overall, Ukrainian exports have shrunk by 29% from 2013 to 2015, and Ukrainian imports have dropped 44%. Adarov and Havlik concluded that it will be very difficult for Ukraine to reorient exports to the EU without substantially upgrading its productive structures.

The final presentation, which dealt with Ukraine's struggling banking sector, was delivered by *Stephan Barisitz,* Senior Economist at the OeNB's Foreign Research Division. He pointed out that the Ukrainian economy's depression and the plunge of the hryvnia, as well as geopolitical tensions and political uncertainty, had in 2014 and 2015 contributed to pushing the banking sector deeply into the red. However, IMF and international support continue to provide a major policy anchor also for the banking sphere. Notwithstanding the collapse of lending, the government's and the NBU's macrostabilization policies have, at least for the time being, shored up depositors' expectations. The monetary authority has also successfully intervened to remove many smaller problematic credit institutions. And some larger players have been at least partly recapitalized. Among the main shortcomings or risks plaguing the sector are high credit risk (with NPLs accounting for at least a quarter of total loans and growing further), a persisting lack of profitability (the sector may only reach the break-even point in 2018), exchange rate risk, weak rule of law, and endemic corruption. Given this state of affairs, recapitalization needs will continue to be substantial, and the recovery of the banking sector will probably lag behind that of the real sector.

The discussion focused on the impact the continuing geopolitical conflict and frictions with Russia have been having on Ukrainian export capacities and the development of banking. *Havlik* pointed to Ukraine's efforts in reorienting its trade toward its western neighbors, which have to date been only modestly successful notwithstanding the substantial devaluation of the hryvnia. He arrived at the sober assessment that investment necessary to modernize export-oriented industrial structures may not be forthcoming as long as tensions in the region remain as high as they are. In reply to a question on the effect of Russia's annexation of Crimea and the war in Donbas on Ukrainian banks' performance, *Barisitz* conceded that these events, particularly the hostilities in the east, had indeed contributed to weakening outcomes.

Wrapping up the event, *Landesmann* pointed out that one could compare contemporary Ukraine with a hiker at the beginning of a very steep climb. Against this backdrop, it was important for the European Union "to keep Ukraine on the map in terms of EU policy" and to keep supporting reforms in this country.