Formation, Function and Development of the Banking System of Ukraine

by

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A Master's Thesis

Submitted in partial fulfilment of the requirements
for the award of

Master of Philosophy

of Loughborough University

April 2002

Loughborough University

ABSTRACT

Financial sector reform has proved to be one of the greatest challenges facing the members of the former Soviet Union in their transition to a market economy. Their central banks have played a vital role in this reform - mainly shaping developments, but also being shaped by them. The Ukrainian experience is by no means unique.

Banking was given priority in the reform process in Ukraine. By granting loans on the basis of profitability criteria, strengthened, sound banks are to encourage companies to operate according to free-market principles and to assist the economic recovery process.

After independence in 1991 Ukraine begin to develop its own banking system. There has not yet been a comprehensive study dealing with formation and function of the banking system of Ukraine and this thesis aims to remedy this omission.

The major objective of this thesis is to examine and analyse the development of the banking system of Ukraine, its operation and its implications for a market economy. It also focuses upon the transformation process necessary to bring about the required changes.

The thesis presents an overview of the Ukrainian economy and its underlying principles; these are the corner-stone for transformation to a market economy. Subsequent chapters focus on Ukrainian banking and the experience of other post-communist states. A major part of the thesis is the unique access to and interviews with a substantial number of senior Ukrainian bankers.

The research shows that Ukrainian banks developed despite the burden of Soviet structures, inept monetary control and managements unprepared for market based banking. The ultimate decline of the "system" banks and the rise of commercial banks is highlighted and the expectations as Ukrainian banking begins the new millennium are outlined.

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CHAPTER ONE

INTRODUCTION AND BACKGROUND

Introduction

In the early 1990s the history of financial world development changed dramatically as the break up of the communist-based model of social-economy in Eastern and central Europe accelerated.

From the commencement of USSR President Gorbachev's *"glasnost"* (openness) and *"perestroika"* (restructuring) processes the old systems of the socialist centralized economy showed signs of halting or reversing development. The bad management of national resources aggravated this process. Despite the overall bureaucracy and corruption, however, post-communist countries have been going through the painful process of transforming their financial sector structures into a model close to that of a free-market economy.

Each Eastern European country was to choose its own way of development and integration in the economic-political world. One of the main challenges in the transmission process of East and Central Europe to the market economy was the substitution of a centralized credit system with decentralised financial discipline.

Typically the first step in this process was a tightening of monetary policy in order to control inflation (Bruno, 1992; Coricelli and Milesi-Ferretti, 1992). This also had the effect of inducing enterprises to substitute internal centralised financing for bank credit. The response to the credit tightening was disappointing. State enterprises responded by circumventing the liquidity ratios by accumulating trade debt to each other (Blejer and Gelb, 1993). These claims soon became overdue (for instance, trade arrears in Russia increased from 34 million to over 3 billion roubles in the first half of 1992 (Litwak, 1994)). Arrears on bank, tax and wage obligations rose as well. In some countries the government resisted the pressure to provide financial relief to companies. As a result, output first fell sharply, but over some time the problem receded.

In some other countries (including Ukraine, Russia and Romania) the governments decided to clear the massive amount of trade arrears by expanding credit. These governments were induced to act not only out of concern for the volume of arrears but also for the large number of companies involved.

Following the "bailout" the level of arrears began to grow again while inflation rose quickly. Several countries including Russia, Ukraine and others fell into a repetitive cycle of credit tightening with mounting arrears, following by reflationary "bailouts" and high inflation. In contrast, countries such as Latvia, Estonia, Poland and the Czech republic, which resisted a bailout, succeeded in controlling inflation.

The demise of several communist-led governments in Central and Eastern Europe has given way to an economic transformation of these nations that promised to be as important to the people who live there as the political transformation has been.

These countries are trying to reduce the use of central planning and rely more on the behavior of firms and households operating in open markets to improve economic decision-making and resource allocation. However the transformation has not progressed as quickly or as smoothly as originally hoped. Moreover, basic policy disagreement continues over the pace of privatization, and the conditions under which foreign firms should be allowed to enter a national market or buy its existing companies.

Focus on Ukraine

To understand better the difficulties policy makers face in reforming these economies this thesis focuses on economic transition and banking reform in Ukraine.

Ukraine, the second largest republic of the former Soviet Union, was one of the most important producers of heavy-industry goods and food supplier for the USSR. After the break up of the USSR Ukraine experienced very tough changes in the economy, caused by the destruction of very important links between suppliers and consumers within the former Soviet Union. Separating from Russia was the most serious and painful step in the transition to an independent economy.

The economies of Ukraine and Russia are very intertwined, and separating them is a lot harder than just drawing borders. During the Soviet era Russia was Ukraine's principal market and the main supplier of oil and natural gas. Lacking that old guaranteed market and short of hard currency Ukraine's economy was in poor health in the early days of independence (Klebnicov, 1996). Lost markets could not, easily, be replaced since the EU does not need Ukrainian wheat, and the world is already awash with steel - Ukraine's key exports.

Ukraine lags far behind Russia in abandoning socialism. This is largely because of opposition from both former communists and many nationalists who still have widespread popular support. Privatization in Ukraine, therefore, is proceeding at a very slow pace. Some of the country's most attractive enterprises are still government-owned.

Since the proclamation of independence and separation from the rest of the Soviet Union, Ukraine decided to develop the national economy by supporting state enterprises through an expansionary monetary policy. Establishment of a market economy in Ukraine indicated that a new banking system was required.

The old banking system was under government control of central planning and the state directed the distribution of funds throughout the economy with no regard for their most productive use. The institutional infrastructure and incentive necessary for decentralised credit allocation decisions based on rational economic criteria was not developed during Soviet rule.

The issues Ukraine has faced in reforming its banking system are similar to those confronting other transition economies. The banking system emerged from the communist ruled world with low capital, a large portfolio of non-performing loans, no meaningful system of accounting and reporting, little recourse for lenders in case of default, little technological development and inadequately trained staff.

Ukrainian banking problems also bear similarities to those of developed economies. Even though Ukraine has been making the transition toward a market economy for several years, the majority of its banking assets are still controlled by the state. Thus, deciding how and when to privatize commercial banks is a very important issue. However, some of Ukraine's largest banks are undercapitalised and have inadequate resources to address their non-performing loan problems.

The very first stage of banking system formation in Ukraine was characterised by the restructuring of Soviet banks in Kiev. These newly restructured banks were given the key role in supplying government enterprises with required loan funds. Most of the government-owned companies were showing signs of problems since the Russian market became more selective and the volumes of supplies from Ukraine were greatly reduced. In order to support unprofitable enterprises and avoid budget deficit problems the government kept on expanding overall direct credit volume. These factors along with import pressure were causing a sharp devaluation of the national currency. This situation ended up with a huge uncontrolled cycle of hyperinflation in 1992-1994 until the government decided to work to eliminate the financing of budget expenditures by printing money. Instead it started to attract funds from international financial institutions.

Many problems have retarded the improvement processes in Ukrainian banking. There is still unclear and unstable tax regulation in the economy and continuing uncertainty over the government policy of budget deficit management. The credit rating of Ukrainian institutions and doubt about the Ukrainian government combine to prevent Ukrainian banks from entering the international markets. High inflation expectations and the poor financial condition of many national enterprises along with the strict requirements of the National Bank of Ukraine (NBU) makes credit provision less profitable and more risky than inter-bank market operations.

Development of Ukrainian banks

This thesis seeks to shed light on the pressures and processes that have shaped the development of Ukrainian banking since 1991. The thesis draws on banking development literature and the limited literature on Ukraine's economy and on the banking system and on a unique series of interviews conducted especially for this research. The interviews, with senior Ukrainian bankers from Kiev and other regions, were undertaken between 1998 and 1999 and provide a valuable qualitative resource that supports the analysis of secondary data.

The thesis itself is divided into six major chapters and is supported by a number of appendices:

Chapter	**Description**
1	Introduction and background. Here the rationale for the study is explained and a broad description of the environment within which this research and the development of Ukrainian banking itself have been undertaken.
2	The Ukraine. This chapter develops a general description of the Ukrainian political and economic environment. This chapter describes the foundation for the modern Ukrainian banking system.
3	This chapter reviews literature on banking development in the UK, as an example of Western banking development. The Ukrainian banking System is compared with this development. This chapter describes the banking system in Ukraine in more detail and concentrates on the role and function of the National bank of Ukraine. The analysis is supported by a commentary on published financial data on major Ukrainian banks.
4	Development in other post communist states. This chapter studies the economic environments of former communist states outside the Ukraine. It describes the main directions of market development and aims to compare and contrast banking system developments.
5	Research methodology and findings. Here the methodology of the research is explained and the key findings from the research interviews displayed, interpreted and analysed.
6	Conclusions. In this final chapter the key pressures and processes are highlighted and comments made about the future direction of Ukrainian banking.

Banking Development and Crisis

The framework against which bank development in Ukraine is reviewed in this thesis comes from the literature concerning banking crises in developing economies. Banking crises have become increasingly common – especially in the developing world in the period since 1980. Over this period at least two-thirds of IMF member countries experienced significant banking sector problems.

There are two reasons why banking problems in the emerging economies merit particular attention: first, the serious consequences for the local economies and, secondly, the fallout on other countries as international financial markets have become more integrated. Banking crises in developing countries have been far more severe during the past 15 years than those in industrial countries.

Bank difficulties or failures are presumed to generate more serious negative externalities for the rest of the economy than those affecting either other kinds of financial firms or non-financial firms. Serious banking problems also create difficulties for monetary policy. They may not only distort the normal relationships between monetary instruments and the intermediate and final targets of monetary policy, but they also compromise the overall stance of monetary policy.

Banking crises in emerging economies can also be costly for industrial countries, particularly as the importance of emerging countries in the world economy and international financial markets has grown. Developing countries nowadays purchase about one quarter of industrial country exports.

It would be convenient for both diagnosis and prediction if banking crisis and banking risk in emerging markets could be attributed to just one or two factors. But research on the origins of banking crises strongly suggests that it is not the case.

Key risks

In any economy banks face common risks relating to their core business and their position as financial intermediaries. Key risks applicable to all banks, to international lending and to banks in emerging economies are summarised in Figure 1.1:

Figure 1.1 Banking Risks Summary

BANK RISKS[1]	INTERNATIONAL RISKS[2]	EMERGING ECONOMY RISKS[3]
• Credit Risk	• Credit Risk	• Credit Risk / Fraud
• Liquidity Risk	• Liquidity Risk	• Maturity mismatch
• Market Risk	• Interest rate/Currency Risk	• Exchange Rate Risk
• Operating Risk		• Weak management, distorted incentives and accounting weaknesses
• Reputation Risk		
• Legal Risk		
	• Regulatory Risk	• Government control
	• Country Risk	• Macroeconomic volatility

Notes: 1. Federal Reserve Board Recognised Risks (Koch & MacDonald, 2000)
2. Lewis & Davis (1987)
3. Goldstein & Turner, (1996)

The three "models" of risk have some striking similarities but also highlight important differences, especially since the risks facing developing economies, as reported to the BIS (Goldstein & Turner, 1996), show the key relationship between the regulator, the government and the banking industry.

The main risks summarised in Figure 1.1 are now expanded upon and discussed with reference especially to Ukraine:

Credit Risk

This relates to the quality of assets and can be influenced by general economic conditions, especially where loans are made into the consumer and commercial sectors. Government securities are generally less risky. For the purposes of this analysis the risk of default on commercial loans is assumed to be mainly dependent on the state of the Ukrainian economy. Added complexity is injected by the poor functioning of the legal system with respect to insolvency and bankruptcy. Ukraine does have a bankruptcy law, passed in 1992, but it is not often used in the resolution of insolvency situations.

Credit risk can be reduced by the use of a number of strategies including the use of an efficient credit assessment system, experience of historic loan losses, portfolio lending and even syndication of larger loans.

In Ukraine macroeconomic activity over the period 1991 to 1999 made credit risk assessment less accurate. This research also indicates that the legacy of bad debt inherited by privatised commercial banks, the lack of portfolio strategies, the dearth of good quality data and the weakness of management in this area also contributed to a heightened level of credit risk.

Ukraine saw much "connected lending", loans extended to banks' owners or managers and to their related businesses. The risks inherent in this are primarily ones of lack of objectivity (sometimes even fraud) in credit assessment and undue concentration of credit risk. The failure of a few large related borrowers, or a collapse of a particular sector of the economy, can wipe out a bank's capital.

Liquidity Risk

The main risk here comes through the mismatching of maturities of assets and the liabilities that fund them. This too can be affected by macroeconomic conditions as the real value of deposits reduces and the availability of "secure" core deposits is minimal.

When domestic interest rates are high, the temptation for the banking system and bank customers to denominate debt in foreign currency can be particularly strong. For instance, banks may have recourse to short-term, foreign-currency-denominated borrowing in the interbank market to fund longer-term bank loans. Such strategies can come badly unstuck when devaluation occurs.

A large unhedged debtor position in foreign exchange not only makes banks and their customers more vulnerable but also makes it harder to deal with a banking crisis once it occurs.

Similarly, the risks of maturity mismatches are typically higher for banks in the emerging markets because the have less access to longer-term sources of funding (on the liability side). Typically they receive less assistance from securities markets in increasing liquidity and in spreading risks (on the asset side) than do banks in the industrial world.

There are strategies that can be used to reduce the impact of liquidity risk such as good liability management and credit control. In Ukraine banks have fought hard to gain customer trust and acceptance in order to attract core deposits, since this is cheaper than borrowing from the central bank (NBU). This has resulted in a volatile reliance on short-term funding.

Currency devaluation, inflation and the continuing use of non-bank alternatives for deposits make this risk very real for a number of Ukrainian institutions. The absence of securitisation of assets and syndication of lending in the Ukrainian market also limits the banks' abilities to reduce this risk.

Market Risk

Market risk refers to the actual and potential risk to earnings through shifts in interest rates and securities prices. The key risks considered under this heading are:

- Security Price Risk
- Interest Rate Risk
- Currency / Exchange Rate Risk

Banks are vulnerable on a number of fronts depending on the terms and conditions applied to loans and deposits and the proportion held in local or foreign currencies.

Ukrainian banks are heavily dependent on the NBU for funding as it channels State Savings bank deposits to the commercial sector through the medium of the discount or re-financing rate. These rates have proved to be volatile themselves and dependent on the stability of Ukraine's currency. Interbank funding is particularly susceptible to the same movements.

From 1991 to 1999 Ukraine saw the value of its temporary "coupon" and replacement "hrivna" currencies fall dramatically. This had severe implications for those banks with foreign currency exposures.

The exchange rate regime can affect vulnerability to speculative attack, it can also affect the way in which the real value of impaired bank assets is adjusted downwards and the ability of the central bank to act as lender of last resort to illiquid but solvent banks.

Fixed exchange rate regimes have also been criticized for increasing the fragility of the banking system to external adverse shocks; it will lead to a balance-of payments deficit, a decline in the money supply and higher domestic interest rates. With a fixed exchange rate, the central bank must ensure that any liquidity it injects into the system to provide temporary assistance to illiquid but solvent banks does not undermine its exchange rate obligations.

There are several possible policy measures that can significantly reduce the incidence of each of these factors underlying banking crises. Close monitoring of lending by weakly capitalized banks would similarly limit vulnerability to lending booms, asset price collapses and surges of capital inflows. Adopting a cautious attitude towards short-term, foreign-currency-denominated borrowing can limit banks' liquidity of currency mismatches and discourage runs on both bank and government liabilities.

Several countries are going through a difficult period of banking sector restructuring, and are attempting to address the consequences of earlier failures of prudential oversight. These failures, and the lessons learnt from banking difficulties worldwide, have naturally prompted national authorities almost everywhere to take a good look at their safeguards against banking crises and other systemic financial problems.

Reforms need to be more widely shared and deeply rooted than was the case in the past. Fixing the problems of the banking sector will require a sustained commitment. The ways that international co-operation, in several guises, can encourage or sustain this commitment is clearly an issue that requires urgent consideration.

Operating Risks

This is the risk that costs will exceed revenues with a consequent implication for profit and net worth. This will affect differently capitalised banks differently but a system of crisis prevention can be expected to operate well only if the main actors face the proper incentives to control costs, to discourage excessive risk-taking and to take corrective action at an early stage.

At least three factors affect the incentives faced by bank owners: bank capital, their share in the costs of any bank restructuring, and the franchise value of the bank.

Ensuring that banks maintain good credit and internal risk management systems is the job of bank managers and directors: poor management has often been singled out as the leading cause of bank failures.

The potential contribution of bank depositors to market discipline in emerging economies is limited by the quality of accounting systems and by the extent of public disclosure.

Ukraine's largest banks work under the disadvantage of the legacy of wide branch networks and untrained staff, with few opportunities to train or re-train them in market disciplines. Bricks and mortar investment and maintenance is costly and cost / income ratios have taken a long time to come under control (see Chapter 3).

In Ukraine the former Soviet accounting systems were replaced by International Accounting Standards in 1998. For much of the period of this research, therefore, the ability of banks to hide high costs and bad loans was significant.

To the extent that the institutional structure in which banks carry out their businesses is weak, their performance will be adversely affected. In many countries, the accounting conventions for classifying bank assets as impaired or non-performing are not tight enough to prevent banks from making bad loans look good by lending more money to troubled borrowers ("evergreening").

Added to these more common banking risks are two areas of particular importance to emerging economies:

- The degree of regulatory / government control
- Macroeconomic volatility

Bank Regulation

As most former Soviet republics Ukraine was unprepared for financial liberalisation in 1991. Financial market reforms inevitably present banks with new risks, which, without the proper precautions, can increase the danger of a banking crisis. When interest rates were liberalised, banks lost the protection they previously enjoyed from a regulated term structure of interest rates that kept short-term rates below long-term rates. Lifting restrictions on bank lending often releases pent-up demand for credit in the liberalised sectors. Lowering reserve requirements permits banks to accommodate increased loan demand, as does the inflow of foreign capital, often attracted by reforming economies.

Political influence, resulting in too tight or too loose regulation, also has a part to play in banking crises too. Both tight and loose regulation factors have played an important role in the generation of banking crises because they allow the political objectives of governments or the personal interests of bank insiders (owners and directors) to intrude on almost all aspects of bank operations. This can lead to damage for bank profitability and efficiency. Despite increased privatization, state-owned banks still retain a significant and sometimes even dominant role. This is especially true in

Ukraine. Government involvement in (or implicit taxation of) the banking sector extends well beyond the operation of state-owned banks.

Even when banks are privately owned, government may still influence the allocation of credit to particular sectors, extend favourable loan discounting privileges to certain borrowers and prevent private banks from engaging in certain profitable banking activities. They may also require banks to hold government bonds at below market interest rates, impose high reserve requirements or taxes on banks, and direct banks to borrow in foreign currencies and assume the currency risk.

Finally, there is the old argument that the political and legal background may encourage bank regulators to delay the closure of an insolvent bank or the imposition of corrective measures. Given the greater government involvement in banking in emerging economies and the extent of banking or industrial connections, pressures on bank supervisors for regulatory forbearance may well be greater than they are in industrial countries.

Macroeconomic Volatility

The very nature of banks makes them vulnerable to large relative price changes and to losses of confidence. Volatility in emerging markets derives from several sources – both external and domestic.

Volatility in international interest rates, and the induced effect on private capital flows, is another important external factor. Not only do fluctuations in international interest rates affect the cost of borrowing for emerging markets, but they also alter the relative attractiveness of investing in emerging markets. Incompletely sterilized capital flows boost bank deposits and tempt banks to increase lending even at the expense of lower credit quality. Because economic forces in those countries drive creditor-country interest rates themselves, some of the volatility of private capital flows facing emerging markets is beyond their control.

Real exchange rate volatility can cause difficulties for banks either directly (when there is a currency or maturity mismatch between bank liabilities and assets) or indirectly (when exchange rate volatility creates large losses for bank borrowers).

Sharp real exchange rate appreciation typically precedes a banking crisis. One reason for this may be the adverse effect on the profitability of the tradables sector. Another may be that the high real domestic interest rates often associated with real exchange rate appreciation or with disinflation encourage residents to denominate their borrowing in foreign currencies, thus exposing themselves to large foreign exchange rate risks.

On the domestic side, both growth and inflation rates are often highly volatile. Assessing credit risk becomes harder when growth and inflation rates fluctuate widely. Volatility of growth and inflation rates was on a rising trend over the 1990–1994 period for countries experiencing systematic banking crisis over the period, while no such trend was evident for countries experiencing less severe or no banking difficulties.

According to one school of thought, excessive credit creation and unsound financing during the expansion phase of the business cycle cause banking crises. Both bank lending booms and declines in equity prices have often preceded banking crises.

Conclusion

Change has proved to be painful in Ukraine and this thesis chronicles the growing pains of this independent state's commercial banking sector.

The commercial banking sector has been bedevilled by political stalemate, lack of reform, a legacy of inappropriate Soviet systems and an underlying economy in need of urgent resuscitation.

Of the risks inherent in banking credit and liquidity risks added to market risks in the 1990's. Only through a combination of central support and, ultimately, good economic management by the NBU has the Ukrainian banking sector emerged into the 21st century with the potential to develop further.

This thesis looks closely at the development of the banks in Ukraine during the 1990's and places the successes and failures of the sector in clear perspective.

CHAPTER TWO

UKRAINE

Introduction

The first decade of Ukraine's independence has been overshadowed by the legacy of former Soviet times. An overwhelmingly conservative electorate watched the "roller coaster" of independence as the euphoria of 1991 evaporated and the grim realities of political stagnation and economic decline took hold.

A particular problem was that Ukraine was not prepared for independence in 1991 since 70 years of control from Moscow had robbed it of the vital central mechanisms for the formation and implementation of economic policy (Frydman, *et al*, 1993). Moscow, as the centre of Soviet activity, had subordinated Ukrainian development to that of the Union as it had with so many other aspects of Ukrainian life, including the unique Ukrainian language.

This chapter reviews the political and economic environment of the independent Ukraine. An understanding of these important factors is necessary for underpinning the development of the Ukrainian banking system. This chapter also provides a valuable background to the empirical study conducted as part of this research. The timing of interviews with senior bankers is important to note since it followed an economic and currency crisis and political stalemate, which were about to be put to public reckoning by Parliamentary elections in May 1998 and a Presidential election in 1999.

Set at the "cross-roads" of Europe and Asia Ukraine maintains strategic and economic importance for that region. Torn and divided by Russian immigration, Soviet centralisation and internal cultural differences Ukraine has struggled in its first decade of independence but now stands at a "cross-roads" of its own.

The map on the following page shows Ukraine's key cities and neighbours.

Figure 2.1 Map of Ukraine

The Politics of Independence

1991-1994 New beginnings

Following the attempted coup d'état in Moscow on August 19, 1991 and acting in pursuance of the Declaration of State Sovereignty of Ukraine, the Verkhovna Rada of the Ukrainian Soviet Socialist Republic proclaimed the independence of Ukraine on 24 August 1991. By the end of 1991 the newly independent Ukrainian state was recognised by 152 countries. Diplomatic relations were established with 138 states and 54 embassies and 6 separate international organisations were accredited in Ukraine.

The territory of Ukraine had became indivisible and inviolable. Henceforth only the Constitution of Ukraine and laws of Ukraine would have had legal strength in the territory of Ukraine.

On December 1, 1991, a referendum took place, involving 84% of the Ukrainian population, of which 90 % supported the Independence Act of August 24. The accompanying Presidential election saw 61.6 % of the votes elect Leonid Kravchuk as the first President of Ukraine.

At a summit meeting in Belovezhskaya Pustcha from December 7-8, 1991 leaders of the States of Belarus, Russia and Ukraine signed a Treaty on the formation of the Commonwealth of Independent States (CIS), thus putting an end to the USSR. Ukraine had been doing its utmost to increase its voice within the CIS and express the autonomous nature of its interests. Although the country was a founder member of the CIS in 1991, it has now reduced its status to that of an associate member (Mellow, 1994).

Ukraine only participates in joint activities that it regards as serving its interests. For example, Ukraine has not signed the collective security treaty for the CIS - in line with the principles of neutrality. It was also a key player in the adjournment of a decision on joint peace-making military units and protection of common borders (Pearce, 1995). In 1992 Ukraine gained membership of the European Conference on

Security and Co-operation, the International Monetary Fund and the European Bank for Reconstruction and Development. Ukraine is also one of the founding members of the Organisation for Black Sea Economic Co-operation.

With a focus on its own security Ukraine joined the Working Group of the North Atlantic Council and in 1993, became a member of the Council. In 1994 Ukraine joined NATO's Partnership for Peace Program.

Over a short period a new system of state administration was created, along with the National Armed Forces, the Security Service and law enforcement authorities. New, broader horizons opened for political freedoms; practically all restrictions on the spiritual progress of the Ukrainian and other nations were lifted. The Ukrainian state had entered the international community as an equal partner.

However, as in all other post-Communist states, the process of social reforms in Ukraine took a winding and thorny path, in conditions of a pitched battle between the old and the new. Among the aggravating factors were the differences between the legislative and executive branches of government. The legislature was dominated by old style communists and agrarian reformers, who associated themselves with the communists. The executive had a more reformist stance but failed consistently to bring reforms into being. Fortunately, a democratic way out of the resultant political crisis was found as Parliamentary and Presidential elections were held in 1994 (Economist, 1994a-g, Euromoney, 1998, Cowley, 1994, Jones 1994).

1995-1999 - Stalemate

Leonid Kuchma, a reforming former military factory boss with roots in the industrial east of Ukraine became the new President in 1994, winning 52.14 % of the vote in the second round of polling. Ukraine had entered a new phase of its development, when strenuous efforts were made to create an effective economic system, along with advancing the institutions of democracy, and raising the country's prestige in the international arena (Gianzero, 1994).

By voluntarily rejecting its recent status as the world's third nuclear power, Ukraine took the first historic step toward a nuclear-free, peaceful future, showing a new way to strengthen international confidence and co-operation, bringing mankind closer to the long-cherished goal, total nuclear disarmament. In December 1994 the President of Ukraine signed the START I treaty once security guarantees had been given by the USA, Russia, Britain and France. Verkhovna Rada ratified the Treaty (Jones, 1995a,b).

An agreement on Partnership with the European Union in Luxembourg was signed in 1995 and Ukraine began to look outwards from its 42 embassies, 4 permanent representations, and 8 consulates general. Ukraine's prestige increased considerably after it acceded to the nuclear non-proliferation Treaty.

Kuchma's "honeymoon" was long enough to secure sweeping new Presidential powers from the communist dominated legislature. Ukraine announced huge reforms but there were doubts whether Kuchma would use his special powers or whether Parliament would water down the reforms (Economist, 1995c,d). Whilst Kuchma maintained his position as president his administration saw a steady succession of Prime Ministers and deputy Prime Ministers, all of whom, at some stage, were blamed for failures and ousted (Economist, 1995a,b).

The panacea, it seemed at the time, was privatisation. In this way the burden of state owned industry, most of which was insolvent, badly run, underfunded and rife with labour problems, could be lifted (Takla, 1995). In 1995 privatisation of 8,000 state firms was announced but the pick of Ukrainian industry had already been sold to workers in the first tranche of privatisation (including the banks). Other "strategic" industries were protected by the parliament, lest they should fall into foreign hands. In this way the reforms were stifled and foreign investment halted.

By 1996 the slow pace of reform, the brewing economic crisis (see later) and the tolerance and involvement in corruption at the highest levels of the administration resulted in political stalemate. Some western observers called this "The wild, wild east" (Economist, 1996c, Euromoney 1996c). Kuchma presided over a country where political assassination was rife, corruption endemic, intrigue abundant and regional frictions threatening to undermine the fragile independence.

At the same time Kuchma had done enough to woo the IMF and had persuaded the USA that Ukrainian independence was necessary to prevent the re-union of the Soviet bloc (Economist, 1996a,b).

Things had come full circle by the time of Parliamentary elections in 1998. The administration wanted reform but the legislature was overwhelmingly conservative and now seemed to have more support from the population who had seen savings vanish and no economic miracle. The elections in 1998 showed that Ukraine was being pulled in many directions at once. No one party gained an overall majority, although the communists were the largest. Instead one in four seats went to independents. Reformers lost out as the population indicated that it had had enough and re-unification with Russia was once again on the agenda (Economist, 1998b).

Perhaps the 1999 presidential elections would break the stalemate? In the period leading to the October 1999 elections Kuchma trod a delicate tightrope between the nationalist west and the Slavic east of Ukraine that largely wanted the "good old days" to return. Kuchma's main success, in foreign policy, was scorned by the communists but a Kuchma-controlled media meant that his small advantage was enough to secure a further four year Presidential term (Economist, 1999).

Having secured a further presidential term Kuchma promised much but his record on delivery has failed to support his statements. One positive move according to observers, was the appointment of Viktor Yuschenko as Prime Minister in May 2000. Yuschenko, former National Bank of Ukraine chairman and largely credited with the successful introduction of the hryvna in 1994 and the management of inflation, has won parliamentary support for his long-term plans of privatisation and other reforms (Economist, 2000).

The overwhelming picture of Ukrainian politics since independence in 1991 is very foggy. No clear mandate has ever been given for reform and corruption and "cronyism" have sullied the image of privatisation considerably. The communists should have a considerable power base yet cannot secure administrative power. Whilst reform is slow observers consider that Ukraine has done enough to gain external support and to give itself a breathing space so that economic recovery can occur.

Many observers have pointed out that a strong Ukraine is Western Europe's best guarantee that this former Soviet Republic will not fall, once again, into the orbit of influence of Russia.

Economic background

Historically the two factors that determined the development of Ukrainian lands were the presence of fertile chernozem soils (Ukraine boasts approximately a quarter of the globe's black topsoil) and its remarkably convenient geographic location on the cross-roads of international trade routes.

The Ukrainian agrarian "gubernias" began to transform as agrarian-industrial regions only in the second half of the 19th century. The Donetsk Coal basin (Donbas) and the Kryvyi Rih Iron Ore basin became Russia's leading industrial venues. In 1890, Ukraine extracted 70% of the Empire's pit coal and produced 52% of its cast iron. In the early 20th c. all of Russia's grain export came from Ukraine.

Many Russians live in this region. Russia has promised to defend the interests of ethnic Russians wherever they live (Cowley, 1994). So political activity in this region is the highest in Ukraine

<u>Industrial structure</u>

Ukrainian industry has a strong bias to basic materials and heavy industry such as coal mining, iron and steel while the consumer goods industry is little developed. Aircraft manufacture and rocket technologies are also important. Besides meeting local demand, capacities were formerly geared to the needs of the other Soviet republics, which procured raw materials and semi-manufactures from Ukraine. Finished products accounted for only 20% of this trade. Many of the metal-operating plants

Table 2.1 Ukraine's Nuclear Power Stations

Location	Number of Units
Zaporozhye	5
Pivdennoukrainsk	3
Rovno	3
Chernobyl	2
Khmelnitsky	1

Fuel elements and parts for these stations have to be imported from Russia. Payment problems from the Ukrainian side hold up this supply. In 1994 a large number of reactor faults were discovered in Zaporozhye and Khmelnitsky. A major hazard is posed by the use of the units in Chernobyl in the immediate vicinity of the reactor where the disaster took place. The whole complex urgently needs to be closed down.

In March 1996 Ukraine announced that power had been cut to 7,000 factories, and more than 40,000 businesses. Unpaid bills amounted to almost $ 1 billion dollars. At varying speeds today and over the next few years, foreign investment in private power is currently accepted in several CIS countries as the most favourable way to emerge from this difficult transition period (Krikorian, 1996).

Ukraine's ecological situation is critical. It has the biggest environmental problems of the former Soviet republics. Most of its nuclear power plants are considered unsafe. 12% of the area in agricultural use was polluted by radioactive fallout from the Chernobyl disaster in 1986. Large areas of farmland remain contaminated by pesticides, nitrates and other pollutants.

The Donets-Dniper industrial region is one of the worst areas of air and water pollution in Europe. This is due to obsolete iron and steel-making plants, power generating plants and neglect of environmental protection measures.

Agriculture

Agriculture is Ukraine's traditional mainstay. Natural conditions are ideal for efficient and wide-ranging production. Roughly two-thirds of the country are covered by extremely fertile black-earth soils. As a result of this and the favourable climatic conditions Ukraine came to be known as the Soviet Union's "granary".

All the typical livestock and crops of the Northern Hemisphere are produced. The main crops, besides grain. are: potatoes, sugar beet and linseed. In the south it is possible to grow grapes and, to small extent, citrus fruits.

Ukraine's agricultural sector was once the most efficient of the former Soviet Union but was still far less productive than North America's and Western Europe's. Productivity had declined in recent years at the still mostly collective or state-owned farms.

The present economic crisis has also spread to the agricultural sector. Output of some products declined at double-digit rates in recent years. In 1994 meat production sank by 12%, milk production by 6% and egg production by 23%. Ukraine, formerly an exporter of foodstuffs, is threatened with becoming a food importer.

However, private farms, though still not numerous, increased their meat production by 42%, milk production by 40% and egg production by 54% in 1994. So far private farms only account for about 1.5% of the total area in agriculture use. The subsidisation of state owned farms throughout the 1990's was to have severe economic consequences and would damage the agroindustrial bank - Bank Ukraina.

Capacities for processing farm products are limited. Vegetable oil and sugar are major industries and important export products. Farming areas occupy 41.9 million hectares of Ukraine's more than 60 mln h of dry land of which the arable soils cover 33,3 mln h. Statistically, every family has a farming plot of 4.5 hectares. Upward of 4 million persons are employed in the agrarian sector.

Crop production is the most important farming branch (e.g., rye, wheat, corn, sugar beet, sunflower, leguminous plants, tobacco, fibre flax, fruit, vegetables, etc.). Animal husbandry is the second (e.g., cattle, pigs, sheep, goats, horses, et.).

Ukraine's agriculture remains dominated, however, by illiquid and unprofitable collective farms, bolstered by government but still offering a poor investment environment (Gregory, 1999). Structural, transportation and investment issues all need to be addressed before Ukrainian agriculture can attract outside investment.

Construction

This industrial branch plays an important role in creating the Gross National Product (GNP), placed third, in terms of manpower, after the heavy industries and agriculture. The technological base is quite strong, even though somewhat outdated. There are 84 housing construction complexes, plants and large panel construction workshops with a total output capacity of 9,6 mln sq. m of living space per year, and 537 ferro-concrete manufacturing enterprises. The construction network includes 2,900 independent construction organisations. At present, separate building enterprises are being reconstructed and new modern construction technologies introduced. At the end of 1994 the Ukrainian Cabinet of Ministers adopted the State Concept of Housing Policy envisaging basic reforms in this sphere of the economy. Apartment construction is to become a top priority in the national socio-economic policy, a factor to help stabilise the country's economy.

Transport and communications

Ukraine operates every type of modern transport - railway, air, motor, sea, river, pipeline and subway. In 1994 a total number of 939 million tonnes of cargo units were carried using all means of transport. The passenger turnover was 119 billion passengers/km.

Ukraine's transportation system is geared primarily to goods traffic. The rail and road networks are centred on the capital of Kiev. The need for modernisation is tremendous. Railways are the principal link in the transport chain. Their total operational length is 22,800 km. There are 265,000 km of roads, most of which are hard surfaced. Ukraine is traversed by international highways (Kyiv - Moscow; Moscow - Kharkiv - Simferopol; Odessa -Kyiv - St. Peterburg and Kyiv - Lviv - Warsaw).

Special attention is paid to the reconstruction and building of hard roads, particularly modern motorways, along with increasing the modern motor pool. However, maintenance to the high standards required by modern motors is not always carried out.

Ukraine is a big coastal state. Ukraine's shorelines total 2.000 km, and the Black Sea and the Sea of Azov play an important role in coastal and international traffic. The major seaports are Odessa, Illichivsk, Mykolaiv, Mariupol, Feodosia and Izmail.

Air transport requires modernisation, in terms of reconstruction of airports and adding new aircraft models. The biggest airports are Kyiv, Simferopol, Kharkiv, Odessa, Donetsk and Lviv.

Ukraine operates a well developed system of pipeline transportation. Ukraine is traversed by capacious transcontinental pipelines (e.g. "Soyuz", from the Urals to Europe; Urengoi-Pomary-Uzhgorod, from Western Siberia to Europe).

Trade and consumer services

These important national economic branches are making their first tentative steps. Over half of them still fail to meet consumer needs in retail trade enterprises and consumer service facilities, and the available ones do not meet modern technological and aesthetic standards. Over the past several years the retail trade and paid consumer service turnovers have registered a noticeable decline.

Most of these enterprises and facilities are corporate entities, but the process of privatisation is far too slow and the administrative and legal barriers to business start-ups mean that few new corporations are created.

As a measure of confidence emerges in the Ukrainian economy foreign investments have increased. The larger cities in Ukraine now boast modern western-type stores, restaurants and cafes.

Foreign economic activities

External trade is of outstanding importance for the Ukrainian economy. Up to 1991, approximately one third of gross domestic product (GDP) was generated by deliveries to other Soviet republics and abroad. Traditionally, merchandise trade with the former Soviet republics was dominant. Only a relatively small proportion of exports went to other markets. The collapse of the USSR brought a far-reaching change in this situation. Procurement and sales relations were no longer by Moscow centre but were now increasingly subject to market forces.

Trade with the CIS states still dominates, and Russia is the largest trade partner. Apart from the fact that former customers have turned more to other markets, the main reason for this was the basic change in the terms of trade. The jump in import prices for energy sources to the world market level within a relatively short period of time had put an enormous strain on the current account.

Ukraine's enterprises conduct business transactions with partners in 137 countries. Major export items are: metals, ores, coal, electricity, nitrogenous and phosphate fertiliser, soda, cement, glass, construction materials, machines, equipment, sugar, vegetable oil.

Major import items are: oil, gas, timber, non-ferrous metals, cars, machines and equipment, knitted wear and garments, top quality foodstuffs, medications.

Exports to states other than CIS account for only a small part of the total. So far, Ukraine has succeeded in only very few instances in expanding its range of competitive products for sale on western markets. Export to these countries continues to be dominated by raw materials and semi-manufactured goods products. In 1994, the EU concluded partnership agreements with Ukraine to normalise trade relations (Enders and Wonnacott, 1996).

Ukraine's leading partners are: Russia, Germany, the USA (Bergquist, 1995), Italy, China, Turkey, the Czech Republic, Belarus, Turkestan, Kazakhstan, Lithuania, Latvia, Poland and Bulgaria. Barter deals and export under federal contracts make up some 43% of the foreign trade turnover.

In 1993, external trade suffered particularly from the fact that, alongside the market exchange rate, a so-called official exchange rate had initially been introduced for the carbovanets (temporary currency) against the US$. This was then declared the sole valid exchange rate from November 1993 and its level was fixed by the authorities. Exporters, who were obliged to sell a fixed percentage of their foreign exchange revenues (1992: 70%, 1993 - 1995: 50%) to the state, received as equivalent an amount which was converted at a rate well below the market rate. This contributed to an increase in capital flight, avoidance of formal declarations of income and unofficial exchange bureaux. According to Ukrainian estimates, between US$10 bn and US$15 bn in Ukrainian funds were held on accounts abroad at the end of 1994. The lack of investment within the Ukraine suggests that capital is still fleeing the ungenerous tax regime.

From October 1994 all export contracts were to be registered because of the need to monitor adherence to import quotas to the EU. In the future, Ukraine, which is applying for WTO membership, plans to regulate its external trade exclusively via tariffs. The WTO membership will help to avoid antidumping duties which foreign countries apply to protect the market against unfair competition (Laurenson, 1994).

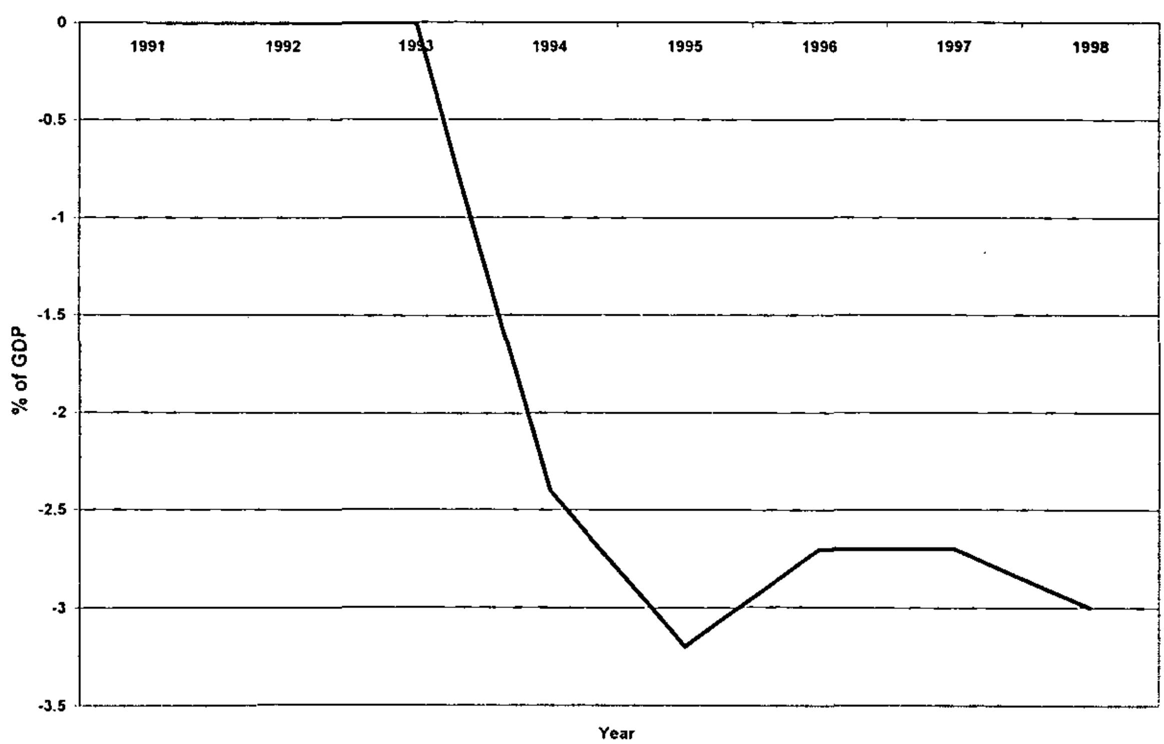
The increased incidence of barter trade has developed into an acute problem. Above all, the acute shortage of foreign exchange but also the desire to avoid taxes and controls is encouraging more and more traders to conclude barter trades. In 1994, barter trade still accounted for only roughly 40% of total exports, but in 1995 and 1996 the figure threatened to pass the 60% mark. To curb barter trade, a presidential decree dated February 1, 1995 obliges exporters to hedge their imports by acquiring so-called import custody accounts at authorised banks.

Balance of Payments

The difficult economic situation of Ukraine has been exacerbated by a huge balance of payments deficit and a growing external debt. The basic shift in the terms of trade had worsened Ukraine's balance of payments with the other former Soviet republics, reversing the surplus position at the end of 1991. The trade balance showed a deficit of US$ 2 bn in 1994 (2.4% of GDP). The largest deficit had arisen in trade with Russia and Turkmenistan, which supply natural gas. These two countries are now, also because of unsettled invoices from previous years, among the largest creditors of Ukraine. Relations between Russia and Ukraine were often strained by the unpaid energy bills (Cowley, 1994).

High import requirements and rising debt service obligations on loans taken up previously pushed the amount needed to square the payments balance in 1995 to more than US$ 5 bn. (3.2% of GDP) (See also Chart 2.1).

Chart 2.1 Ukraine's Balance of Payments deficit (% of GDP)



Source: NBU

Ukraine remains heavily dependent on financial help from abroad to close the gap in its payments balance. Apart from IMF credits in a total volume of roughly US$ 1.9 bn, further income of a World Bank credit with a total volume of US$500 m are to be used and possibly recourse to World Bank loans. Furthermore, Ukraine is hoping for bilateral loans granted by the EU and western governments.

IMF, World Bank and EU loans and credits come, however, with conditions attached. The IMF wants to see greater progress on reforms before tranches of credit are released whilst the EU wants to see Chernobyl closed down completely. Neither is an easy task for the Ukrainian government.

At the beginning of 1995, Ukraine's total external debt came to close on US$ 7.5 bn. The lion's share comprised claims by Russia totalling approximately US$ 4 bn (of which more than US$ 2.7 bn for petroleum and natural gas) and by Turkmenistan totalling roughly US$ 900 m. Agreement in principle has been reached on a debt rescheduling with both Turkmenistan and Russia and also with the Russian gas conglomerate Gasprom.

Repayment of loans is also an expected outcome for the international lenders and failure to adhere to this basic condition has not only delayed IMF credits but also further World Bank loans that are triggered by IMF covenants (Economist, 1998a).

Foreign investments

The largest investors in Ukraine include the USA (Forbes, 1994) with an investment volume of more than US$ 65 m, Germany - more than US$ 55 m and the United Kingdom - more than US$ 20 m, followed by Cyprus and Switzerland. By far the biggest investor within the group of CIS states is Russia.

The West must keep trying to locate and encourage Ukrainian individuals and business concerns with good prospects for developing sustainable free-market enterprise (Jaicks, 1994; Washio, 1995). Uncertain political conditions, the poor economic situation as well as contradictory legal conditions subject to frequent change have so far - in international comparison - meant that Ukraine has not been very attractive as an investment location for foreign investors. Although Ukraine could still boast fairly generous rules governing foreign investment in 1992 compared to other CIS republics, numerous amendments, which also resulted from a temporary disinterest in stronger opening, have watered down the country's original advantages (European Focus, 1998).

This situation was also caused by some amendments to the still valid "Decree on the regulation of foreign investments" dated May 1993, which replaced the corresponding laws from 1992. It was, for example, stipulated that companies are only considered foreign investments from a foreign equity stake of at least 20% or US$ 50,000 (for banks US$ 100,000) and receive preferential treatment accordingly. At the same time, however, the possibility was granted to extend the exemption from taxes on profit for five years. Additionally, at the start of 1994 the "Act governing the state programme to promote foreign investments in Ukraine" came into force; the act was an attempt to steer foreign investment into sectors considered on particular importance.

Since the end of 1994, there has been growing recognition in Ukraine that foreign direct investment brings positive effects with respect to modernisation and the transfer of know-how (Aviation Week, 1994, Rosenbaum, 1995). Foreign nationals can already purchase title to buildings and plant. They are, however, still prohibited from purchasing land and real estate.

There is still a great need for investment in Ukraine. Ukrainian industry needs capital and management expertise to make it competitive (Euromoney, 1996a). A sustained upturn in foreign direct investment is, however, probably contingent on stabilisation of the economic situation. Then, however, there should be very attractive possibilities, above all in the field of energy conservation and conversion, agriculture and food processing as well as transportation and telecommunications. The steps towards the stabilisation and new reform that were taken by President Kuchma have considerably increased the interest of potential investors in Ukraine as an investment location.

Total direct foreign investment, estimated at just over US$ 750 million by the end of 1995, is a trickle compared with the US$ 40 billion or more that the Ukraine says it needs for economic reconstruction (The Banker, 1996).

Economic policy since independence

The collapse of Ukraine's traditional economic ties with the former Soviet republics so shortly after the Soviet Union's sudden disintegration left little time for Ukraine to detach itself as smoothly as possible and build a national economy of its own. The surge in energy prices since mid-1992 came as a further shock for the Ukrainian economy, from which it has not yet recovered. Production was declining, state industries remained unsold, and investors were largely kept away (Mroz and Pavliuk 1996). The only way Ukrainians could prevent a collapse from coming was by deciding that they wanted to live in an independent country. (Cowley, 1994).

There was no alternative to the type of comprehensive reform program that emphasised three pillars of stabilisation, privatisation and liberalisation. Without these three components, socialist economies would have not made the transition to the market. Ukraine needed only to look to the experience of Russia, Poland, Chile and Taiwan to see what it could expect from different approaches to reform. Stabilisation, privatisation and liberalisation were not only separate aspects of an overall reform strategy, they were indeed mutually interdependent and cannot be applied in isolation (Tedstrom, 1995)

Taxation

Ukraine's economic situation would probably present a brighter picture if the results achieved in the fast-growing private sector and the "underground" economy, which did not find adequate reflection in the official statistics, were taken into account. It was estimated that, if included, this sector would increase the official GDP figure by over half. The shadow economy had became so rampant in recent years not only owing to bureaucratic obstacles to free enterprise but also because of a stifling tax policy (Cowley, 1994).

The previous tax system strongly resembled confiscation. It was based on extremely high corporate taxation in comparison with other countries, which consisted mainly of a tax based on a company's total gross earnings from the sale of goods and services, from VAT and the Chernobyl levy. At the same time, though, it provided for numerous exceptions for certain sectors and companies. Since many entrepreneurs considered this tax policy unfair, it contributed to the massive exodus of small and medium-sized businesses to the underground economy.

The government therefore decided to introduce a tax structure which promoted economic activity. On January 1, 1995 the previous corporate tax system was replaced by a tax on profits. At the core was the establishment of lower tax rates and the simultaneous widening of the tax base, above all by abolishing the numerous exceptions. The new rate for companies and banks was set at 30%, regardless of the form of business organisation. A higher rate applied to agency work and gaming.

The taxation of incomes and wages was relatively insignificant, accounting for approx. 6% of total revenues. Salaries and wages were taxed progressively, with a 10% starting rate for monthly wages of more than UAK 1.4 million. The top rate was 40%.

The rate for VAT, which will likely remain the most important source of revenue, was reduced from 28% to 20%. New sources of revenue were tapped by, for example, introducing royalties on the extraction of natural gas and oil, imposing a property tax for industrial companies and a stabilisation tax (3% of a company's gross turnover). The new tax policy would probably result in a decline in overall revenues amounting to approx. 10% of GDP for fiscal 1995 versus 1994.

When the budget for 1995 was drafted the government had also changed its approach to financing the deficit. Plans now called for only 55% of the deficit, estimated at close to 7% of GDP, to be financed via central bank loans. Some 40% were to be covered by funds from abroad, and roughly 5% of domestic savings. The government's plans to issue state bonds in this connection had been delayed, however, so in the first quarter of 1995 it again had to borrow more heavily from the National Bank.

Resuming the process of price liberalisation was a prerequisite for cutting subsidies to the corporate and agricultural sector (Sundakov *et al*, 1994).

In mid-November 1994 controls on prices, except for bread, which are to be raised only gradually, were lifted. The prices of natural gas, oil and petroleum products, coal and electricity for industrial users were allowed to converge with the international level. Higher prices for natural gas, coal and electricity also took effect for private consumers at the end of 1994 and in early 1995; these used to be subsidised partly through the budget and partly by companies. Moreover, the first stage of the planned increase in rents, district heating and water fees as well as public transport fares came into force on February 1, 1995 for private consumers. These prices were to be raised gradually during 1995 to the point where they covered costs. Price liberalisation was flanked by salary and wage hikes. However, these failed to offset the increase in household expenditure. It was therefore decided to index the pay of public-sector employees to a maximum of 80% of the price hikes; companies were left to decide themselves on the extent of pay adjustments in accordance with their own situation. The state plans were to introduce a system of social services for lower-income brackets to alleviate social hardship.

Price liberalisation was one of the reasons for the renewed inflation surge at the end of 1994 and the beginning of 1995. An absence of competition, delays by companies in adjusting to changed demand structures and substantial side-effects were prolonging the development of fair market prices (Moodgal, 1996).

Stability-oriented monetary policy

The National Bank of Ukraine flanked the stabilisation efforts of the government with a policy of tight money. It limited lending to the government to finance the deficit as well as on the permissible cash deficit. The central bank is discontinuing the practice of issuing loans to the state corporations and agriculture (Bofinger, 1996). To support attempts to attain the inflation target it plans to keep monetary growth far below the nominal increase of gross domestic product (Patterson, 1994). The rise in the money supply is to be confined to 80% (nominal GDP + 130%) in the first half of each year and to about 35% (nominal GDP + 50%) in the second half. Real interest rates are to remain positive. Forecasting money supply and velocity is, however, very difficult and inconsistent in Ukraine (Ihor and King, 1998)

The commercial banks' ability to refinance themselves with the central bank was to be geared more strongly to the market. This meant that they could no longer distribute credit resources, but they would be able to obtain them in future at central bank auctions. Another way for the commercial banks to refinance themselves is by discounting first-class paper (including government debt papers).

Exchange rate policy to battle inflation

Exchange rate policy was also geared to battling inflation. A big step in this direction was the programme started in summer 1994 to gradually achieve the convergence of the official exchange rate (for non-cash transactions) with the more market-related auction rate. This was followed in October 1994 by unifying the exchange rates for foreign currencies. The concurrent re-opening of the Kiev foreign exchange market helped in the process.

The National Bank of Ukraine was committed to a floating exchange rate policy for the time being. An account of the pressures on this policy as a result of a currency crisis in 1998 are covered in Chapter 3.

Privatisation

The privatisation process made little headway up to 1994. Between the start of privatisation in 1992 and the first quarter of 1994 a total of 1857 businesses were turned over to the private sector - only 3% of the 68,000 earmarked. 80% of these privatised businesses were smaller companies with a book value of up to UAK 700 m as at August 1, 1993 (McCollum and Gentle-Marsh, 1995). Only 50% of citizens have redeemed their privatisation vouchers (Gordon-Walker, 1996).

One factor curbing privatisation were the privileges granted to a company's workforce: 65% of the plants privatised so far have gone to the staff members, 29% were auctioned off and only 6% changed owners via tender. As a rule, businesses acquired by the workforce operate rather inefficiently after privatisation, and their owners tend to complain about liquidity difficulties more than outside buyers who have acquired their businesses by auction.

In December 1994, parliament had approved a list of more than 6000 companies to be excluded from privatisation. These were primarily companies which represent national interests in the military/industrial complex as well as oil and energy. On the other hand, the government felt that only few companies including nuclear power stations, railways and some military factories should remain in state ownership. Parliament also wanted to hand over 4,270 agribusinesses to directors of collective-farms (Jenkins, 1995; Economist, 1995e).

A law was also passed granting privatisation certificates (similar to vouchers) to Ukrainian citizens from January 1995. These certificates were to replace the unwieldy owner-related privatisation accounts with savings banks previously used, thus making Ukrainian participation in privatisation more transparent. The new certificates enabled Ukrainians to obtain corporate stakes via investment funds or trusts.

A presidential decree triggered the resumption of the privatisation process at the end of January 1995. Plans called for the privatisation of approximately 8 000 medium to large businesses in 1995, with more than 6 000 already named. The World Bank had set ambitious targets for Kuchma's privatisation program, tying the release of each transfer of $ 310 million enterprise development loan to the results of privatisation auctions (Jones, 1995a).

The legal framework

The Ukrainian parliament had passed three laws to lay the groundwork for the privatisation of state operations by March 1992:

1. **National law on the privatisation of the assets of state-run businesses (privatisation of large businesses)**

This law was applied to the privatisation of enterprises with total assets of over 20 million roubles as of May 1992 as well as monopolies, military and industrial plant, and properties to be sold to non-residents. It was Ukraine's general privatisation law.

2. **National law on the privatisation of small state-run businesses.**

This applied to businesses with total assets of less than 20 million rubles as of May 1992. Ukraine's small privatisation law was conceived as special legislation with respect to the disposal of assets via tender and auction.

3. **National law on privatisation certificates.**

In addition, parliament had to debate and pass a new state privatisation programme annually. To prepare an object of sale for privatisation the competent institution had formed a commission whose chief task was to work out a privatisation plan. The plan provided for

- the method of privatisation;
- the starting price for negotiations;
- the percentage of the purchase price (to be covered by privatisation certificates)

The process could commence once the plan had been approved by the competent state property fund, i.e. sales to those with pre-emptive rights, as well as tenders and auctions. Unlike the privatisation of "large" operations, no privatisation plan is required for "small" businesses.

The State Property Fund and its regional branches and representatives serve the state by conducting the privatisation of state-run companies. The Fund is put under control of the parliament, with officials reporting directly to it. Municipal businesses are privatised via local bodies.

The prerequisite for privatising a company was to submit a relevant application to the competent institution. To speed the process of privatisation the network of regional centres was created at the beginning of 1995 to conduct the auctions. The new privatisation round was opened in January 1995 in the regional centre Zhitomir with representatives of the EU and the World Bank in attendance.

Any resident or non-resident (natural or legal person) can participate in Ukrainian privatisation. However, the conditions relating the foreign investors have not been advantageous. For example, the price of stakes acquired up to autumn 1994 was calculated using a special exchange rate of UAK 420\US$. In practice this unfavourable rate substantially curbed foreign participation in the privatisation process.

Economic Performance 1991-1999

Chapter 2 ends with a summary of Ukrainian economic performance from 1991 to 1999. The data is drawn from NBU data to ensure as much consistency as possible although it does need to be noted that this period saw a failure to collect data and the existence of a large and unmeasured "black economy".

Commentary on the changes in major macroeconomic indicators is contained within chapters 2 and 3 of the thesis. In reviewing the data the parlous state of the economy under centralised control from Moscow must be remembered together with the inability of successive administrations to convert ideals into practical reforms.

Table 2.2 summarises the NBU data available.

<u>Inflation</u>

The Consumer and producer price inflation figures for Ukraine are shown clearly in Graph 2.1. The enormous surge in producer prices in 1992 was magnified by Consumer Price inflation in the following year. Fuelled by the standard "Soviet" response in monetary terms - to print money, the inflation rate reached 4,738% in 1993 and helped to damage the temporary "coupon" currency fatally.

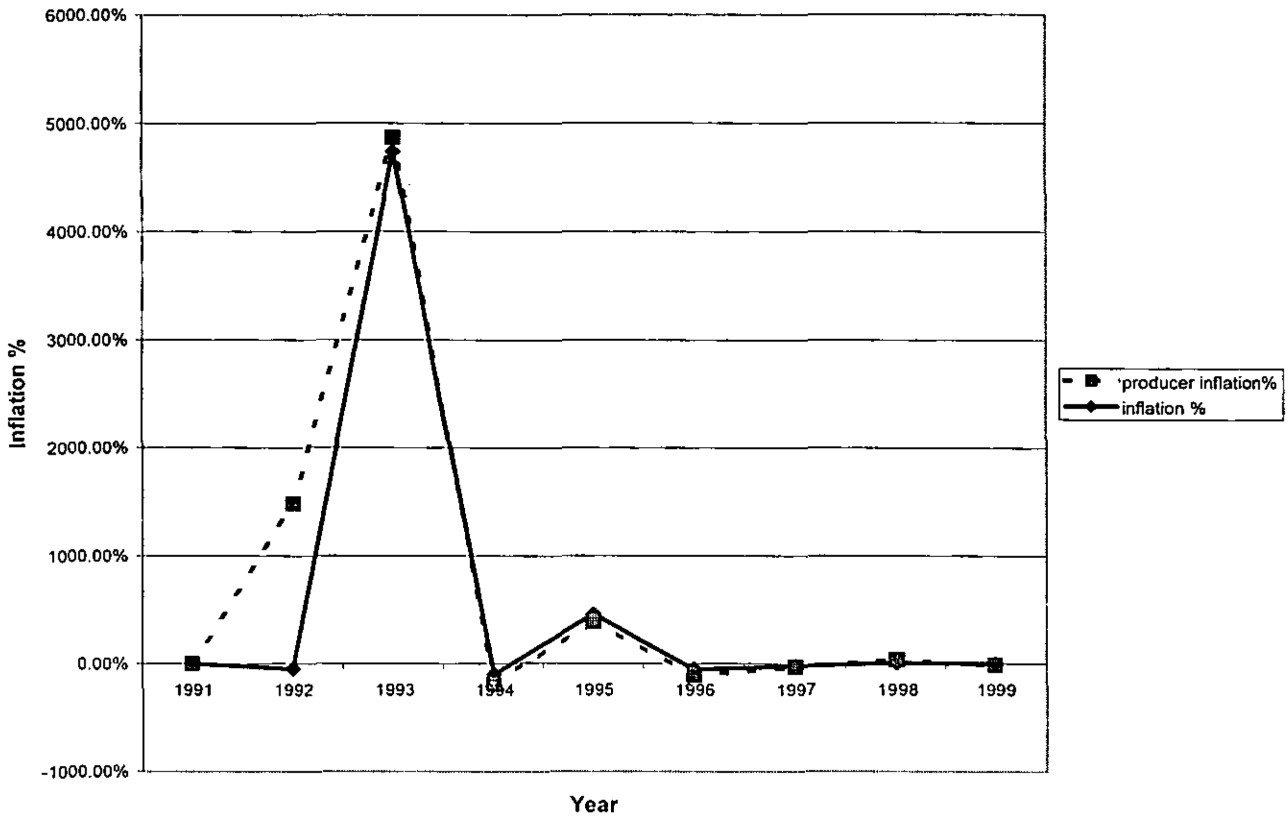
A failure to police currency exchange effectively meant that consumers staged a flight from Ukrainian currency and into hard currencies (the US dollar being the favourite).

Table 2.2: Ukraine Macroeconomic Indicators 1991 - 1999

	1991	1992	1993	1994	1995	1996	1997	1998	1999
GDP (UAH ml.)	0.3	5	148.3	1203.8	5451.6	81519	93365	102593	127126
growth rate		1566.67%	2866.00%	711.73%	352.87%	1395.32%	14.53%	9.88%	23.91%
real growth		-4933.33%	-3362.60%	-81760.34%	126.43%	-2791.58%	-145.47%	-111.10%	-124.78%
Consumer Prices Index	390	210	10160	50	280	139.7	110.1	120	119.2
inflation %		-46.15%	4738.10%	-99.51%	460.00%	-50.11%	-21.19%	8.99%	-0.67%
Production Price Index	260	4230	9770	870	270	117.3	105	135.3	115.7
producer inflation%		1526.92%	130.97%	-91.10%	-68.97%	-56.56%	-10.49%	28.86%	-14.49%
Unemployment at 31 Dec (%)		0.03	0.25	0.3	0.29	1.27	2.33	3.69	4.3
State Budget deficit (% of GDP)		13.8	5.1	8.9	6.6	4.9	6.6	2.2	1.5
Balance of Payments (% of GDP)				-2.4	-3.2	-2.7	-2.7	-3	

Source: NBU

Graph 2.1: Ukrainian Inflation 1991-1999



The picture after 1993 shows greater stability, leading to greater confidence and the successful launch of the new hryvna currency. The NBU has learned to use other methods to try to control prices although the effect on exchange rates, especially against the strong US dollar is not always helpful as Ukraine relies so much on imported goods.

Gross Domestic Product

Nominal GDP shows consistent and sometimes spectacular growth since 1991 yet the caveat on data integrity must be remembered.

Starting GDP growth in real terms reveals a real decline in this key indicator over the period of independence. Ukrainian industry began the decade in a poor state and Ukraine lacked manufacturing capacity for many of her basic needs. This legacy of central control and a wartime exodus of production capacity eastwards to avoid the

German advance, that was not reversed once victory was obtained, will only be reversed once confidence returns to the economy and bureaucratic and fiscal barriers to enterprise are reduced. Privatisation is one means of achieving this but foreign investment is also necessary.

Against this background, therefore, any comparison of Ukrainian economic progress with Western European countries becomes meaningless. Graph 2.2 simply states the nominal and real growth of GDP whilst Graph 2.3 plots the relationship between inflation and nominal GDP growth for 1995 for Ukraine and many of her neighbours and former Soviet republics. There is a negative relationship between inflation and growth although in one country with growth above 100% (Armenia) GDP increased.

Research has shown that the general level of inflation compatible with GDP growth (rather than decline) is 120% and that price stability and reform will play a major part in helping GDP to grow in the long-term (Petryk and King, 1998).

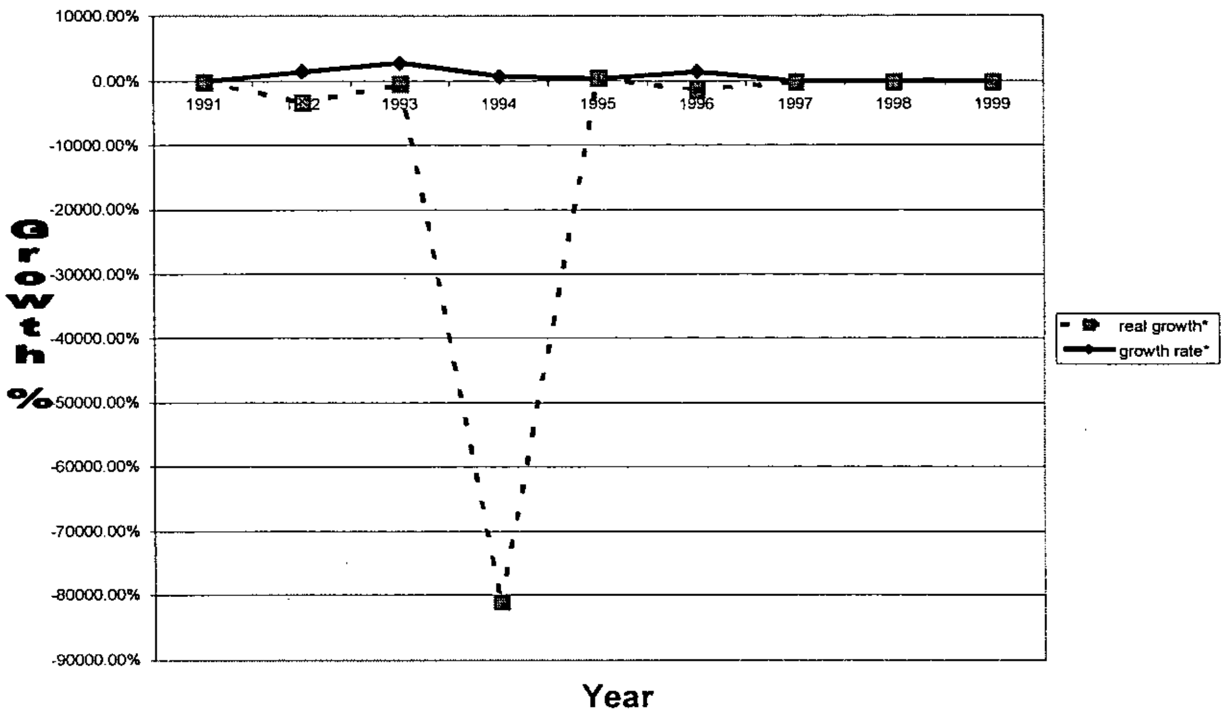
Unemployment

Unemployment is one of the most acute problems in Ukraine, largely due to the failure to achieve real economic growth. Always a visible and emotive statistic the unemployment rate has been blamed on many individuals and institutions, including the monetary and credit sector (Mortikov and Volonkin, 1999). This is logical, in part, but it is the overall failure of government and the NBU to create conditions whereby commercial banks can be used as a conduit for credit to encourage enterprise that is really to blame.

Table 2.2 shows that unemployment has increased over the 1990's. Against a background of no official unemployment under central control this is a serious decline in expectations and standards.

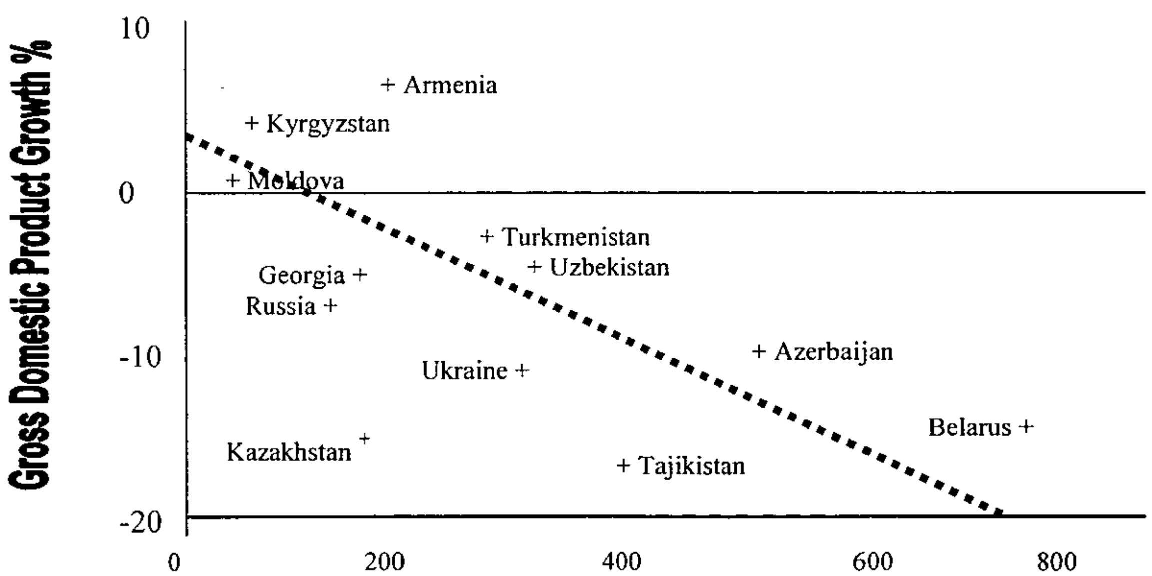
As mentioned above the government must create conditions of stability and encourage investment in new jobs -rather than in the old and inefficient industries that held the country to ransom in the past. Encouragement of enterprise is possible and it can be seen that Russia is well ahead of Ukraine in this regard (Filatochev *et al*, 1999).

Graph 2.2: Nominal and Real GDP growth 1991-1999



Source: NBU

Graph 2.3: GDP growth and inflation in Transition economies



Source: Petryk and King (1998)

Conclusion

In the year 2000 Ukraine can look back at a decade of turbulence, stagnation, inaction, muddle, frustration and some minor successes.

Ukraine is now enjoying a political honeymoon with its new Prime Minister and re-elected President but the ability to stifle reform is ever-present. Reform, however, is the path chosen by Ukraine and on it relies not only the short-term benefit of IMF and World Bank credits but also the longer-term stability and economic growth.

CHAPTER THREE

THE UKRAINIAN BANKING SYSTEM

Introduction

In this chapter the focus shifts to the development of the Ukrainian banking sector. Since this sector of the national economy was given the role of the country's "Lighthouse" in the development of a market economy, the priority of the economy's development and the biggest hopes of the major authorities rest with this sector.

The chapter opens with a brief overview of bank development in the UK. This is provided as an example of western bank development and a useful backdrop against which the development of Ukrainian banks can be reviewed. In this chapter the key variables that have influenced banking development and banking crises (as outlined in Chapter 1) are developed.

The chapter goes on to review the five distinct stages of Ukrainian bank development from 1990 to 2000.

The chapter also looks, in detail, at the role of the National Bank of Ukraine (NBU) and the control mechanisms it has put into place. It is a significant feature of the NBU that it has remained relatively immune to political influence and, as such, can be viewed as an independent regulator.

The Russian banking crisis of 1998 is reviewed in detail and the chapter concludes with a review of the key financial ratios of Ukrainian commercial banks. The data on which the analysis is based is probably as comprehensive as any published information on Ukrainian banks since most banks did not begin to report results in International Accounting Standard format until 1997/98.

An Overview of UK Banking Developments

UK banks have had a long and unhurried development over the centuries. They have developed from small local goldsmiths to global financial institutions. A brief appreciation of the stages of development is provided in Figure 3.1:

Figure 3.1 The development of UK Banking 1400 - 2000

Institutions	Goldsmiths	Local banks	Regional banks	National banks	Clearing bank oligopoly	Global banks
Transactions	Gold	Paper Money	Cheques	Cheques	Plastic cards	Electronic
Functions		Credit creation	Intermediation	Intermediation	Intermediation	Intermediation
Products		Business loans	Loans	Loans	Personal and business credit Broking services	Equities Wholesale Retail Insurance Etc.
	1400 - 1600	**1600 - 1800**	**1800-1900**	**1900 - 1950**	**1950 - 1980**	**1980 - 2000**
			Time	⇨		

(Distilled from Pond & Lipscombe, 1999)

Banking in the UK began with the goldsmiths who facilitated trade transactions locally. This developed into the use of receipts, paper money and cheques in the 1600s. Since much trade was local or regional so too was banking and numerous small banks arose to facilitate trade in their locality.

By the 18th century bankers realised that they could create credit by the prudent lending of deposits, since depositors did not want all of their funds back at once. Whilst this was a risky business banks protected themselves by inter-bank borrowing and lending (there being no "lender of last resort" at this time). As this business developed mergers between banks and take-overs of weaker banks took place to strengthen capital positions and make credit creation a profitable core business.

Banking products in the 18th century were rudimentary as the demand from customers was unsophisticated. Bank failures and the occasional "run on the bank" fuelled mergers between banks and the forerunners of today's large institutions came into being. These bigger banks were better managed and better capitalised and more able to meet the requirements of an industrial society as it expanded.

As intermediaries the larger regional and national banks were more able than smaller local banks to carry out their functions:

- Aggregation
- Maturity Transformation (short term loans were the norm.)
- Risk transformation (secured lending was the norm.)
- Geographic spread

(Brighouse and Hontoir, 2002)

It was in the late 19th and early 20th centuries that bank mergers reached a peak. The increasing demands of increasingly sophisticated customers meant that sound capitalisation of banking institutions was crucial to their survival. Communication had also improved and the larger banks (mainly London based) established branch networks both to garner deposits and to facilitate money transmission.

Bank growth and bank mergers were a direct result of the competition and funding needs brought about by the four broad sets of forces identified by Llewellyn:

1. Changes in the level of demand for financial intermediation services.
2. Evolving portfolio preferences of the users of the banking system and its components.
3. Changes in the market environment to which financial institutions and markets respond and
4. Changes in the objectives and portfolio behaviour of financial institutions.

(Llewellyn, 1985)

The changing demand for services

Increasing trade, increasing economic activity and wealth and the growing needs of personal and business customers have all acted to increase demand for financial intermediation services in the 20th century. This has accelerated in the late 20th century as communication, educational factors and banking technology have improved.

Evolving portfolio preferences

By the end of the 20th century large numbers of individuals had quite sophisticated demand for financial intermediation services and products. Life Assurance, pensions, Investments and savings have all been encouraged by tax concessions. Home ownership and house mortgages have also been incentivised although this is no longer the case. For business customers the awareness of risk and the need to manage and hedge risk has developed too. Competitive forces in industry have put pressure on costs and profits causing businesses to utilise their assets more efficiently. In this way the demand for asset finance, in particular, has developed. Businesses also seek longer - term finance, equity funding and bond finance. In some cases corporate finance raising can by-pass banks altogether (dis-intermediation).

The changing market environment

Within the UK the steady move towards de-regulation has had dramatic effects on the activities undertaken by banks. Banking is now only part of the portfolio of enlarged financial institutions that trace their origins back to the goldsmiths.

De-regulation in the 1960's and 70's caused instalment credit companies to be absorbed by banks (The London Clearing Banks, 1977) and in the 1980's share-dealing, insurance, investment services, house mortgages etc. were added. In 2000 around half of all profit earned by banks such as Barclays, Royal Bank of Scotland and Lloyds related to lending. The remainder was generated by non-lending products and services.

Greater capital requirements and market share advantages led to a further round of mergers amongst former building societies and banks, leaving a small number of huge institutions dominating the banking scene at the end of the century.

Externally the move towards floating exchange rates led to opportunities in international banking. Banks had always used correspondent networks abroad bur now saw the need to acquire banks in other countries including the U.S and Asia. Global presence also helped competition since the large U.S. banks already had a global reach.

Changes in bank objectives

Some banks in the late 20th century compete globally whilst others concentrate on domestic markets. The global banks, such as HSBC, can offer sophisticated international services to increasingly sophisticated customers. They can enjoy economies of scale and improved efficiency in the use of their capital.

In overview the development of UK banking has accelerated, especially in the latter half of the 20th century. The key drivers of change were economic growth, de-regulation and technology. Information costs have been reduced as information availability has increased. Competition has increased in some areas, causing larger banks to focus externally.

An Overview of Ukrainian Banking Development 1988-1998

The establishment of a market economy in Ukraine ordained the appearance of commercial banks. Before Ukrainian independence the banking sector was amongst those heavily influenced by the centralised administrative-bureaucratic system.

Overcoming the economic difficulties of inflation and decreasing levels of production inherited from the former regime would depend on the effective activity of the commercial banks. As with all other market economies the Ukrainian economy required (and still requires) the maintenance of effective payment systems, investment in enterprise and the proliferation of banking services. Commercial banks would be the vehicles to deliver innovation and improve the quality of wealth creating projects.

By 1998, however, the Ukrainian economy was still unstable and showed continued decline in the industrial sector, especially in consumer goods production. Whilst the establishment and development of a modern Ukrainian banking system may have avoided the worst aspects of this crisis the resultant situation cannot be blamed on banks alone. Bank development in the 1990's was carried out in conditions of social-political crisis, legislative instability, low levels of trust, high inflation and a division of cash and transfer money.

An analysis of the key elements of banking activity between 1988 and 1998 can determine five separate stages of Ukrainian banking system development (See also Sochan, 1998).

First stage (1988-1990)

The first stage is characterised by a restructuring of the Soviet banking system in Kiev into the following functional sectors:

- **Ministry or structural banks** (over 15 banks) Minmontage, Derzhpostach, Minboodmat and others.
- **Mixed banks**, different government and co-operative institutions (over 20 banks) Ukrinbank, Gradobank, Percombank and others.
- **Moscow banks' branches**: Incombank, Skhidinvestbank and others.
- **Government equity banks**: Prominvestbank, Ukraina, Ukrsotsbank, Oschadbank, and Ukreximbank.

This was really an extension and rationalisation of the central planning system. Banks in the Ministry sector concentrated mainly on execution of the national budget. Banks in the Government equity sector, which dominated the "commercial" side of the industry, concentrated their lending and customer base in specific industry sectors. Prominvestbank catered for heavy industry and Ukraina for the agricultural sector. Oschadbank, one of the Ukraine's oldest and largest banks had a more balanced portfolio, a particular strength in the years to come.

As a basis for market - oriented banking this functional approach was both impractical and potentially de-stabilising as the revenues and stability of individual banks relied on the success of their designated industry sector. As mentioned in Chapter 2, independence would have severe consequences for traditional markets for Ukrainian goods and these industry based banks would need to seek diversity.

Second stage (1991-1992)

After 2nd of October 1991 all banks had to be re-registered in the new Ukrainian Banks' Register. In this second stage of banking system development in Ukraine privatisation of Government owned banks took place (according to the Decree of Cabinet of Ministers "About transfer of ministries' equities to Ministry of finances"). The ownership of banks switched from Government to equity holders with bank staff and major clients making the bulk of the investments. Banks such as Prominvestbank, Ukraina, and Ukrsotsbank became commercial banks. This early privatisation came before the main privatisations of 1992-93 when ordinary resident citizens would be encouraged to convert savings into equity in enterprises. Banking equity, therefore, remained in a limited number of hands, experienced in the old structures but with huge new challenges ahead.

The two-tier system of banking was created with the foundation of the National Bank of Ukraine (NBU) in 1991. A number of decrees established its authority over the commercial banks (Sochan, 1998).
Examples of larger banks are given in case studies in Appendix 2. Of these Ukraina and Prominvest are typical. By 1997 the early dominance of individual shareholders created in 1991 was still apparent with the following proportions being held:

Table 3.1 Shareholdings in large Ukrainian banks

	Prominvest	Ukraina	
Individuals	92%	70%	(21.8% employees)
Firms	8%	27.5%	(0.9% government)
Bought back		2.5%	

At this time also other banking institutions separated from the Soviet structures and an independent central bank for Ukraine (NBU) was created (see later in this chapter).

A necessary part of the banking system, the interbank loan market, was also established at this time. The new commercial banks required a speedy accumulation of credit resources. From the beginning, however, the interbank market was dominated by government policy enacted by the NBU to support insolvent state enterprises.

Third stage (1992-1993)

With independence established and key structures in place the extension of privatisation brought about the establishment of "new wave banks". These banks attracted private capital, new government and non-government funds. Modern looking banks such as Aval, Inko, and Transbank appeared.

During this period the macroeconomy was characterised by hyperinflation and high interest rates and margins. This assisted the creation of a lot of small "pocket" banks. By the end of 1993 over 100 commercial banks had been registered and hundreds more were to follow. Most of these new banks had attracted private capital although many with sufficient capital to only cover creation expenses (creation expenses of such banks estimated as equivalent to purchasing a 3-room apartment). Many of these banks subsequently failed through under-capitalisation.

In 1993 the Ukrainian Interbank Currency Exchange (UICE) was formed. The UICE is one of a number of formal structures created to facilitate interbank transactions. In this case transactions in foreign currency would have implications for the setting of the UAH/$ exchange rates too. The UICE remains a principal NBU policy tool where abrupt exchange rate fluctuations can be recognised and remedied.

The interbank market was used in this period to divert huge credit resources to the non-effective sector of bankrupt state-run firms. This affected the liquidity of new wave banks seriously as they struggled to find adequate funding.

Fourth stage (1994-1996)

This stage is characterised by the successful reduction in inflationary processes by the National Bank and the establishment of effective regulation procedures. As interest rates and margins fell and the national currency was placed on a surer footing the "new wave" banks and "pocket" banks were found lacking.

Many under-capitalised and poorly managed banks were exposed and failed, the NBU no longer willing (or able) to support individual banks with problems. This caused a crisis in the banking sector and the collapse of many commercial banks. In 1994 twelve banks failed and in 1995 a further 20 banks, including the biggest commercial banks Inko, Vidrodzhennya, Econombank and Leasbank. In 1996 45 banks entered bankruptcy and a further 60 banks were technically insolvent.

Subsequent investigation of banks such as Inko would reveal huge mismanagement, corruption and fraud. Poor credit decisions and the false picture of profitability painted by traditional Ukrainian accounting in a period of super-inflation and high interest rates were also blamed for the collapse (Pond, 1998).

During 1994-95 the volume of US$ trading through the UICE grew from US$71m to US$ 981m, establishing the market as a key tool of monetary policy. During 1995 over US$8 billions were traded as the foreign exchange market was further liberalised.

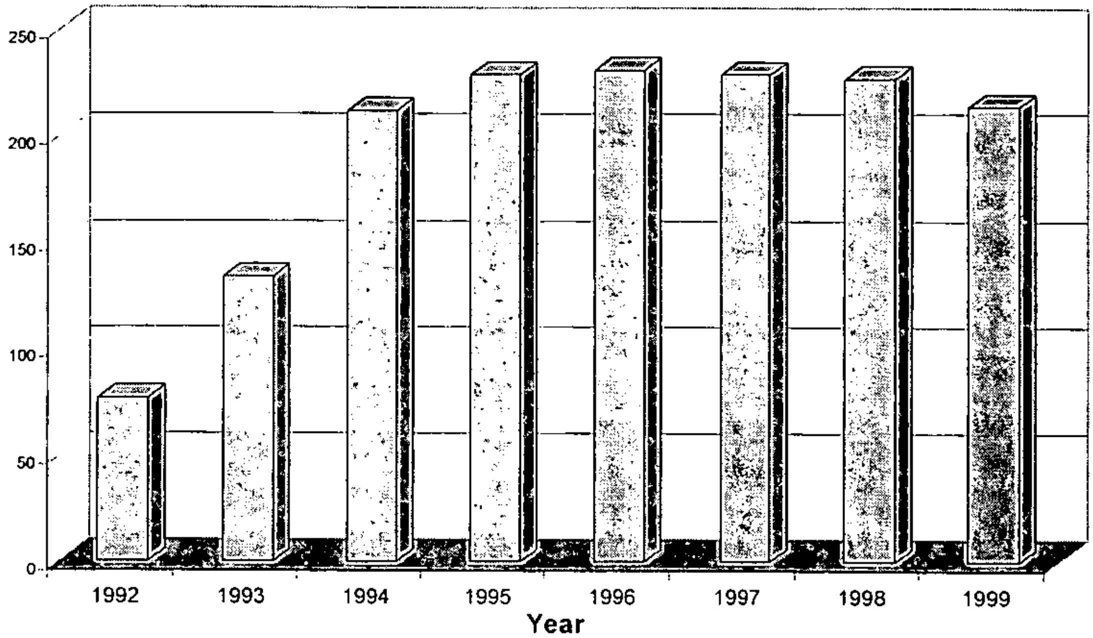
Balance Sheets and Income Statements for the UICE are shown in Appendix 2.

A fall in reserve requirements from 25% to 15% in 1994 led to a decrease in interbank loan activity. Lower reserve requirements still were allowed for those lending to agriculture.

Late 1994 saw a reversal in demand for interbank loans as a credit ceiling was imposed by the NBU. No new credit was allowed and so banks with liquidity needs turned again to the market. At the same time profit tax increased from 35% to 55%, causing further reductions in credit availability.

Strict funding limits of twice issued capital were imposed on interbank loans in 1995. The NBU supported a number of commercial banks in crisis but for some the "roller coaster" of regulation and government policy had taken a severe toll.

Chart 3.1 Commercial banks registered in Ukraine 1992 – 1999
Source: NBU



Fifth stage (1996-1998)

Once macroeconomic stability had been re-established and inward investment laws enacted there began a period of registration of many foreign bank branches and banks with foreign capital. Only three new banks registered in 1998, all of them with 100% foreign capital.

The largest foreign owned banks in Ukraine now include:

- Credit Lyonnais Ukraine (France)
- Societe Generale Ukraine (France)
- ING Barings Ukraine (Netherlands)
- Kreditanstalt (Austria)
- Raiffeisenbank Ukraine (Austria)
- Depositowo-Kreditovy bank (Poland)
- Incombank Ukraine (Russia)
- BNP Dresdener bank (France/Germany)
- Citibank Ukraine (USA)

This stage also saw the restructuring, combining and selling of commercial banks and their branches (almost 70) and registration of new commercial banks (only 5).

The UICE celebrated its 5th anniversary in 1998 but the improvement in interbank transactions and the licensing of commercial banks for currency trading operations saw its share of currency trading fall from 38.2% of the total in 1995 to 9.3% by the end of 1997. Diversification led to UICE having a broader range of products, including stocks and futures.

Having partly created the crisis in 1994/95 the NBU began to liberalise the interbank loan market in 1996 and 1997 in order to allow financially sound banks to expand again. REPO operations were introduced in 1997 and the requirement of fixing commercial bank rates by reference to the refinancing rate was abandoned. This made the sector more liquid and interest rates more flexible. However, there were further storms to weather.

The period 1988 to 1998, therefore, was characterised by opportunities being opened up by economic liberalisation in a system ill prepared to cope with market forces. Opportunities were also presented by the poor state of macroeconomic variables, especially inflationary pressures, and this influenced bank registrations too. As the government and NBU stabilised the economy so the banking "bubble" burst and consolidation took place (see Chart 3.1). It was at this time that well prepared foreign banks saw that conditions were favourable enough to enter the market.

The forces shaping commercial banks in this period were largely government policy created. As different instruments of monetary policy were enacted and crises remedied the commercial sector rocked and reeled. Only the strongest banks survived and the interbank markets were discredited.

Ukrainian and UK banking development compared

No meaningful comparison can be made of the physical development of Ukrainian and UK banking. The latter happened over centuries against the backdrop of market forces, growing economic wealth and capitalist objectives. The former has happened over a 10-year period. Change in Ukraine has been rapid and pragmatic. The backdrop has been a stagnant economy, government control and the market distortion of "privatised" banks, thinly disguised "system" banks of the Soviet era. To a smaller extent poor communication and poor financial education have also influenced development in Ukraine.

Instead the comparison between the systems will use Llewellyn's "four forces" model from 1985:

1. Changes in the level of demand for financial intermediation services.
2. Evolving portfolio preferences of the users of the banking system and its components.
3. Changes in the market environment to which financial institutions and markets respond and
4. Changes in the objectives and portfolio behaviour of financial institutions.

(Llewellyn, 1985)

The changing demand for services and evolving portfolio preferences

In 10 years there has been little change in the domestic market in Ukraine. Short-term lending and short-term deposits continue to dominate the credit market. The intermediary function of aggregation is well developed but maturity transformation less so. Inter-bank lending increased as central control and funding loosened. Banks have also sought to develop other market instruments (especially in the currency markets) but the market has proved to be very narrow and prone to instability.

For most banks the portfolio choices of customers have been limited. Large "lame duck" industries feature amongst the largest borrowers, other customers are unsophisticated in their requirements. The credit market is not innovative and where credit cards have been introduced issue has normally been against cash deposits.

The changing market environment

This is by far the major area for discussion. The Ukrainian banking system has been dominated by governmental and central bank (NBU) decree. At times the banking system has represented that in Soviet times.

Since its creation in 1991 the NBU has regulated the banks very strongly. The NBU record is sound over the 10 years in its management of the economy via monetary policy but has shown signs of weakness in the day-to-day regulation of the banks. The rapid incorporation of new banks in 1992/93, followed by their equally rapid demise in 1994/95 was not a success story for the regulator. Shortcomings in reporting were exposed, leading partly to the introduction of International Accounting Standards in 1998.

The Ukrainian economy, largely flat but no longer in decline, was troubled with hyper-inflation in the mid 1990's. Those that lost their savings would take time to trust banks again with their funds. As the economy (especially inflation) came under greater control after 1995, the banks began to stabilise and most withstood the shift to IAS in 1998. A healthier economy also aided expansion into currency related products and increased activity in the UICE.

Soon competitive pressures will be a priority for banks. Already a small number of foreign banks have established a presence in Kiev (see also chapter 5).

<u>The changing objectives of banks</u>

Over the period under consideration the key objective has been survival. The large former "system" banks have managed this well, dominating their chosen market sector and benefiting from the huge "endowment" effect of holding government and local government budgets.

The really big change in objectives came in 1991 when the "system" banks were privatised. No longer would they serve the state but they would focus on profit for shareholders. But old habits die hard and it is not until 1998/9 that economic recovery and clearer regulation combined to allow opportunities to meet the changed objectives.

In overview the Ukrainian banking system has hardly developed at all. It has survived the 1990's intact and has learned what it can and cannot do. A stronger economy will, however, allow the demand side of the equation to be developed.

The Banking Crisis in 1998-99

The macroeconomic situation in Ukraine in 1998 did nothing to advance the development of Ukrainian banks or for production and the financial-economical sector in general. The banking system of Ukraine, being a part of the financial-economical sector, weathered severe storms as 1998 progressed. Much of the work of consolidation over the period 1991 to 1997 counted for nothing as the sector was plunged into further crisis.

The severe problems faced by banks were:

- Interest rate instability
- Currency devaluation
- Poor credit portfolio quality

At the same time commercial banks were working hard to modernise their systems, investing in new computer hardware and software and were introducing corporate reporting under International Accounting Standards for the first time.

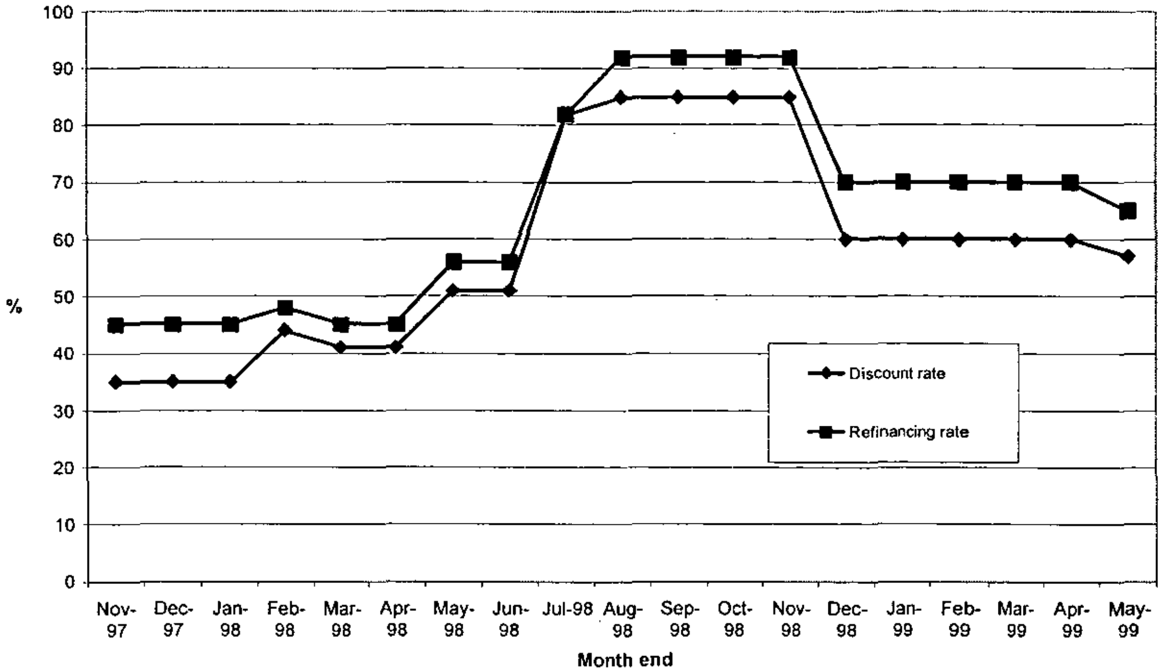
Interest rate instability

The main negative influences on the financial markets in 1998 were produced by price instability of financial instruments. This was made worse by movements in the government bond market. The currency crisis (see later) had caused withdrawals from the value of free resources. Liquidity losses from conversion of government OVDP bonds[1] to KOVDP (hryvna denominated) were estimated by the NBU at 700 million hryfsvnas (US$ 233m).

The discount rate fluctuated within the range of 35-82 % between November 1997 and May 1999 as shown in Graph 3.1. The highest point was reached in August 1998 when the discount rate topped 82 % and the refinancing rate 92 % (rate of refinancing of commercial banks under government bonds' pledge).

[1] OVDP = Internal Government Obligatory Bond (OVDP uses the Ukrainian acronym).

Graph 3.1 NBU Discount rate 11/97 - 5/99



Source: NBU

Explanations for these movements can be seen in the next chapter on currency devaluation. The devaluation had serious effects on the quality of credit portfolios too.

Practical effects of these movements were significant for banks and commercial borrowers. Interest rate rises were swiftly reflected in rates charged to customers since many loans were covered by funds attracted from the interbank market. Interest rates for borrowers became more flexible thus shifting the interest risk from banks to borrowers.

Some banks used a high-risk strategy in order to gain profits at this time and, as can be expected a number suffered losses as a consequence. The high-risk strategy was to place long term interbank loans (2-3 months is long term in the Ukrainian market) and to match these with short term (2-4 week) liabilities. Successful forecasting of rates was essential for profits to be made.

Currency devaluation

The continuing pattern of foreign investors repatriating capital and the continuing budget deficit forced the NBU to engage in OVDP purchasing. By the end of February 1998 the NBU faced the necessity of a serious hryvna devaluation in order to avoid depleting the currency reserves. As a result, the hryvna official rate started collapsing under the strict control of the NBU. From its stable rate of 1.899 hryvnas/dollars since the launch of the currency it slumped to 2.13 hryvnas/dollars in mid-August.

The decline was strictly controlled by the NBU and was supported by the establishment of a "Currency Corridor". The government set the “corridor” within the range 1.8 – 2.25 hryvnas/dollar (the planned devaluation was approximately 21 %).

However, the remainder of 1998 saw further decline following the crash of the Russian financial system in August. Within the following 2 months the hryvna collapsed a further 60 %. This situation had only been seen before during the hyperinflation of 1993-1994.

The quickening of hryvna devaluation in September-October 1998 led to a serious danger of market instability. The NBU had to review its policy of spending US dollar reserves for stabilisation of the national currency within the previously established “currency corridor” range and close the interbank exchange market. The whole market was under big pressure of administrative restrictions, especially the system of anti-crisis procedures which brought stricter reserve requirements, economical ratios, ratios of bank's capitalisation and tighter control over currency positions. The new currency corridor was announced at that time was to be 2.5-3.5 hryvnas/dollar.

In this situation the risk management experience of commercial banks (their ability to control currency and interest-based risks) played a very big role. Almost every bank had incorporated into the bank's structure a special department in order to provide adequate control and detailed analysis over currency positions. These departments also recommended the optimal balance of currencies and financial instruments.

Constant monitoring of the resource market helped to diversify commercial banks' assets in time and avoid or minimise losses from their activities.

Banks began to use more OVDP instruments on the interbank market. These were attractive as holdings of government bonds are considered in calculating the cash holding reserve. There was also an increase in foreign currency (largely US$) activity in this period. Although this depressed the amount of credit available it did shield banks from currency risks as the hryvna devalued.

Poor credit portfolio quality

The main principles of the credit-investment activity of the Ukrainian banking sector were traditionally based on asset quality and liquidity. However, the problem of credit portfolio quality had appeared in the banking sector whilst the currency and interbank market crisis was progressing. The value of overdue loans increased to 349 million hryvnas (US$ 116m) in September (29 % of the total outstanding), including overdue interbank loans of 38 million hryvnas (US$12.7m).

In September – October 1998 the interbank market was barely functioning. It functioned only within very limited range. The key reason for this was a lack of trust of counteragents. In addition the number of participants was quite small, and resource supply was limited as well. The main facilities available were in the "super-short" category (loans up to 3 days). The hard currency deficit produced a situation such that only national currency was available for dealing by the end of the year. Hryvna supply had exceeded all predictable levels by December 1998 and the commercial banks' rates dropped under discounted rate of National Bank of Ukraine (60 %) by 1.5 – 2.5 times to attract demand for hryvna denominated credits. In fact the NBU discount rate began to bear much less commonality with market rates, being determined by government policy and not by actual supply and demand considerations.

During the year special attention was paid to increasing the range and quality of banking services and improving the existing procedures of credit granting, finding new ways to service clients' credit including bills and export financing on the basis of bank guarantees.

A group of Ukrainian banks (including "AGIO", "AVAL", Privatbank) created special departments of micro-crediting, long-term crediting of small and medium-sized enterprises (under international programs featuring Federal Government of Germany and the European Bank of Reconstruction and Development).

Whilst loan conditions were getting stricter (see the NBU decree on loan loss reserves in appendix 2 and summarised later in this chapter) the banking system did not reduce the value of issued loans in total for the year. In the second half of 1998 granting of credits denominated in foreign currency grew as a response to the inflation expectations in Ukraine. In total this segment showed slow growth of interest rates to levels 15-30% above NBU discount rates. The pressure on the hryvna was growing.

The market crisis forced commercial banks to move away from interest income as a source of corporate profit and more towards commission and fees. This made commercial banks work more to upgrade their client bases in 1998. This meant further improvement of services, installing of new communication technologies and informational systems. Many commercial banks began to introduce new clearing products in order to attract deposits. Cheques, plastic cards and even Internet banking were offered.

In 1998 some problems of the commercial banks' operation in Ukraine became more serious and negative tendencies began to appear. These tendencies can be seen in many banking crises around the world as weaker banks revealed capitalization problems. The crisis did noting to aid the resumption of trust in banks from ordinary citizens and the poor quality of some banks' credit portfolios was exposed. This was made clearer by the implementation of the NBU decree on provisions and reserves for loan losses. By the end of 1998 almost one third of all commercial banks were among the "problem" category.

International Accounting Standards

At the beginning of 1998 there was a real challenge for the whole banking system. The main problem besides balancing and auditing of the year's results was changing the accounting principles in the banking sector to international standards. Some "pilot" banks had started practising this system since autumn 1997 but even so the change produced a lot of problems for most of commercial banks. The problems were mainly because of poorly functioning software. This paralysed the whole functioning of the banking system for a considerable time. Along with the cessation of transactions some commercial banks could not initialise their accounting packages in the first days of operation.

The Ukrainian bank data presented in appendix 2 illustrates the impact of IAS on the largest banks, the missing data showing the small number of "pilot" banks before 1998.

The major difference between Ukrainian and IAS accounts is the publication of a loan loss reserve and provisions for bad and doubtful debts. Under the Soviet system risk in lending was not apparent since all funds were generated by the state and returned to the state via the banks. Commercial banks such as Inko were flattered by the use of Ukrainian accounting since this did not reveal the extent of loss or poor lending. Inko subsequently failed as mentioned earlier in this chapter.

The NBU decree at appendix 2 is included not only as an example of NBU law making but as the definitive statement of loan loss reserve calculation. The salient points of the decree dated 27 March 1998 were as follows:

- Commercial banks had to form a loan loss reserve covering all credit activity with immediate effect.
- Quarterly reporting of reserves and accounting entries based on reserve volume was initiated.
- Reserves have to be calculated according to NBU rules (basically prudential/due diligence review of the borrower's financial position) and comparison with key ratios (for corporate clients):

Total liquidity ratio above 2.0 – 2.5

Acid Test ratio above 0.2 – 0.25

Gearing ratio under 1.0

Net long term liabilities ratio above 0.5

- Borrowers have to be categorised from "A" to "E" according to NBU rules (summarised in Figure 3.2) and supporting records retained for 3 years.
- Reserve levels for different categories have to be adhered to.
- Rules regarding use of reserves must also be obeyed.
- NBU can impose fines and order corrective action where loan loss reserves do not comply with the decree.

Figure 3.2 Loan categorisation

Interest recovery / Financial position	Good	Poor	Very bad
A	Standard	under control	substandard
B	Under control	substandard	doubtful
C	Substandard	doubtful	non-recoverable
D	Doubtful	non-recoverable	non-recoverable
E	Non-recoverable	non-recoverable	non-recoverable

In this context class "A" borrowers indicate a very good and sustainable financial position, "B" indicates good condition with possible future problems whilst "C" and "D" indicate average or poor financial positions. Class "E" indicates non-recovery of capital and interest.

The classes are further subdivided into "good", "poor" and "very bad" according to the likelihood of interest payment and capital repayment with "good" representing complete repayment (only one refinancing allowed) within 90 days. Anything less than this stringent standard is classed as "poor" or worse.

The reserves required for each category of loan are:

Category	Reserve level (risk)
Standard credits	2 %
Credits under control	5 %
Substandard credits	20 %
Doubtful credits	50 %
Non- recoverable credits	100 %

<u>After-effects of crisis</u>

The reactions to crisis of the NBU and the government have had some far-reaching effects in 1999. As the commercial banks reacted to change their structures and to develop expertise in risk management so the NBU has acted to change the environment in which commercial banks operate.

In early 1999 the Exchange market was liberalised, a lot of administrative restrictions were cancelled, and Interbank Exchange Market was opened. The procedure of US dollar rate formation was liberalised. Currency dealings on Ukrainian and Crimean interbank exchange markets were stopped for some time.

After the August 1998 crisis and default on repayment of government bonds the market in government bonds had practically perished by February 1999. This situation forced commercial banks to concentrate even more on commission income. This produced serious competition for good quality and solvent clients in 1999.

The NBU's main focus in 1999 was to support hryvna stabilisation and to slow down inflation. It was hoped that this could be achieved by budget balancing and foreign creditors' support. Otherwise this will cause currency reserves loss and uncontrolled devaluation.

In 1998 the National Bank of Ukraine was introducing a weighted monetary policy, holding the speed of money supply growth in real terms. The real monetary base increased by 2 % in 1998 and the real value of "wide" money by approximately 5 %.

A big budget deficit without real resources to cover meant that the NBU extended lending to the government in 1998. Thus the NBU increases its inside net assets faster than any other monetary aggregate in real time. These assets had grown by 80 % within just one year. 1999 would see much stricter monetary control.

Recently the National Bank of Ukraine has been using the "pulsing" money supply procedure: for 1 – 2 months it is monetary narrowing policy and after, in the end of a quarter period it is monetary expansion policy – to provide successful payment of debts, accumulated in this period. Table 3.2 shows the various monetary aggregates and the effects (in early 1999) of NBU action.

Table 3.2 Monetary aggregates 1997–1999 (hrv.mn.)

Money aggregates	1997	1998	Jan 1999	Feb 1999	Mar 1999
M 0	6132	7158	6705	6747	6714
Risk speed ratio, %	152	109	94	100.6	99.5
M 1	9050	10133	9838	9872	---
Risk speed ratio, %	143	108	95	100.3	---
M 2	12448	15432	14880	15090	---
Risk speed ratio, %	138	106	96	101	---
M 3	12541	15718	15185	15366	15940
Risk speed ratio, %	134	106	97	101.2	103.7

From the middle of 1996, real money supply volume has been constantly increasing in spite of production decline. Financing of government expenditure and support of insolvent enterprises had withdrawn all the resources from banking sector that could be spent on effective companies' needs. If budget deficit in 1999 reaches 1 % of GDP it would be possible to supply good clients with credits worth 2 billion hryvnas (US$ 667m) (from 3 billion (US$ 1bn.) of planned "wide" money growth).

In 1998 commercial banks were keeping a stable level of lending in real terms, especially oriented on insured (secured) clients. Credit volume for small and average enterprises was limited because of the high interest rates and unwillingness of banks to increase their credit risk within a crisis period.

At the end of 1998, because of devaluation and increased inflation, the deposit base started to shrink. Despite the high speed of devaluation, most citizens started to withdraw their money from banks and invest it into US dollars or other hard currencies. This sharp decrease of deposit value during the crisis period, compared to huge amount of cash turnover, reflects a continuing lack of trust in the banking sector.

Ukrainian banking in 2000

The 1990's have seen the need for commercial banks to function in conditions where government institutions no longer support certain economic sectors and the private sector is growing. Commercial banks are, therefore, required to provide a sound financial-economic base for all businesses. More detail on the specific plans of individual banks is shown in the research findings chapter (Chapter 5)

Some commercial banks are also expanding by opening new branches, a sure sign of confidence. At the same time other banks are closing down or selling their branches because of management problems. In a market economy the bureaucratic management style of the Soviet era is no longer sufficient protection against the pressures of business.

Most commercial banks are also trying to improve the quality of their operations. Modern commercial banks are becoming a part of international clearing systems, signing up as agents of the international plastic card institutions and absorbing world banking experience, especially in the field of staff training and management. The introduction of new technologies and modern software is also evident.

Current payment procedures (especially advance payment) are not ideal and are slowing down the development of market activity. Commercial banks and enterprises are at the forefront of distributing new methods of payments.

The banks also have to cope with non-bank competition in core services as non-banking organisations (different funds, financial companies, financial–industrial associations and others) can attract and distribute money. Basically, they provide the same services that commercial banks do, but without licenses.

Competition with deposit and non-deposit financial institutions produces new products and opens new market sectors. Competition pushes commercial banks' management to more effective planning. It also makes bank management more innovative.

One key factor apparent in 2000 and related to future growth of Ukrainian banking is that Ukrainian banks do not enjoy the trust of the population. Although commercial banks have strengthened their position in the face of economic adversity they lack the essential ingredient for growth based on increasing consumer deposits (Sochan, 1998).

In Soviet times banks were mere conduits of government policy, an executive branch of the central Bank. This perception is no longer valid, especially as the NBU has enacted monetary policy without the concurrence of banks. Indeed, commercial banks have largely survived due to their ability to avoid the strictures of NBU control. The perception of commercial banks being an arm of central policy still persists, however. It is strengthened by the feeling that the banks were the perpetrators of hyper-inflation (Sochan, 1998), since many pre - 1991 savings and deposits became worthless at that time.

A legacy of stricter control

The NBU now apply especially strict control procedures to the solvency of the banking system because of the crisis in 1998. The procedures of liquidity support are provided only for commercial banks with a satisfactory solvency ratio (and in some cases – for former state banks, that lose their liquidity temporarily). Following this policy will insure the whole banking sector against loss of liquidity or bankruptcy risk. The big role of the NBU in the future is to provide restructuring of the banking sector in order to gain early warning of bank insolvency. The main problems that require solving are:

- which banks have to be closed down;
- which banks need assistance for improving;
- which banks can be allowed to combine;
- what procedures are to be applied for improving the economy;

The current situation in the Ukrainian banking sector is that of the 275 banks registered since 1991 only 217 remained registered by April 1999. Out of this amount only 171 bank have licenses (158 have licenses on operation with foreign currencies).

Table 3.3 summarises the structure of Ukrainian banking in 1999:

Table 3.3 Ukrainian banks in April 1999

Group	Group criterion	No. of banks	Share of GBA*
1	Assets over I billion hrv (US$ 333m) (System banks).	7	52%
2	Assets over 100 million hrv (US$ 33m).	27	25.6%
3	Assets under 100 million hrv (US$ 33m).	99	15%
4	Assets under 10 million hrv (US$ 3.3m).	23	0.7%
5	Problem banks**	61	6.7%
	totals	217	100.00%

* Total gross banking assets

** 17 “Problem banks” account for 6.3% of GBA. Of the 61 banks 20 were in the process of financial improvement, 5 had lost their licences and 36 were being liquidated.

<u>The future for Ukraine</u>

The program "Ukraine 2010" was elaborated by the Cabinet of Ministers in 2000. It stipulates the main topics of Ukrainian banking sector economic improvement being contemplated by government:

Over the next few years Ukrainian banks should see:

- Improvements in the existing system of bank registration and issuing of licenses for banking operations;
- The provision of an effective currency policy;
- The further development of banking transfer services;
- The restoration of liquidity in the banking market.
- Better laws relating to the liquidation of banks and the bankruptcy of firms.

Whilst it is encouraging to see a focus maintained on this important area of economic activity the lessons of the recent past must be learned and the firm control of the NBU maintained alongside relaxations to encourage the sector to expand.

Government regulation of commercial banks' activity

The effectiveness of the commercial banking system in Ukraine depends on effective and efficient government regulation. As a newly independent state of the former Soviet Union, Ukraine needed a "proprietary" banking system. This was launched in March 1991, with the enacting of the Law of Ukraine " About Banks and Banking Activity ". The law was provided for two-tier banking system composed of the National Bank and commercial banks of all forms of ownership. A brief history of the NBU and the major changes it has undergone is shown in Figure 3.3.

Functions of the National Bank of Ukraine

The NBU is hugely influential and powerful. It performs many of the normal central bank functions together with the responsibility for issuing decrees and regulations.

The NBU Governor is responsible directly to the Verkhovnaya Rada (Parliament). The term of Governor's service is 5 years unless any external circumstances take place. The Parliament can replace the Governor by special decree. The Governor manages the National Bank of Ukraine via the Banks Council.

Figure 3.3 A brief history of the National Bank of Ukraine

Date	Event
March 1991	Foundation
October	Re-registering of commercial banks that were registered by former USSR State bank.
Jan 1992	"temporary" coupon currency introduced
August	Establishing of NBU Currency Stock Market
September	Ukraine's entry to the IMF and World Bank
October	Ukraine's entry to the EBRD
Feb 1993	Approval of the NBU as leading monetary institution
June	Establishment the Central Clearing Department of the NBU
July	Restructuring of the NBU Stock Exchange to Ukrainian Interbank Stock Exchange
November	Establishment of electronic reporting system
Jan 1994	Implementation of the National Clearing System using electronic inter-bank clearings
April	Application of the daily reporting procedure for commercial banks and whole banking system
Feb 1995	Approval of the cash operation procedures
March	Approval of thc agricultural households credit granting procedures
June	Installation of commercial banks' cash operation procedures
September	Introduction of the commercial banks' licensing procedures
March 1996	Approval of accounting and reporting procedures for Ukrainian banks. Interbank Clearing Procedures Decree is approved. Implementation of the new Ukrainian currency - hryvna
May	Approval of new procedures for national and foreign currency accounts in commercial banks.
1997 – 98	Introduction of numerous procedures to regulate commercial banks' activity
1999	The Law of Ukraine about the NBU is approved

Being one of the most important financial institutions of independent Ukraine, the National Bank of Ukraine (NBU) is the direct successor to the republican branch of the former State Bank of the USSR. According to the Law "About Banks and Banking Activity", the NBU is Ukraine's central bank whose main function is to pursue the integral state policy in the money circulation and lending area, and to ensure the stability of the national currency. The NBU maintains the Republican register of banks, currency exchanges and other financial and lending institutions.

As a money emission centre, the NBU also enjoys a monopoly right to issue money and to provide cash for the national economy. In this role it masterminded the establishment of the Ukrainian hryvna in 1996 which replaced the temporary "coupon" currency used since independence. Currency printing and coin production is also a profit making initiative with international orders being received.

The NBU is a state currency agency that exercises currency policy within the overall framework of the economic policy of the country using currency asset reserves retained at the National Bank. The NBU is empowered to define the means for setting, pegging and using foreign currency exchange rates in terms of the currency of Ukraine, and to monitor the enforcement of currency legislation.

The NBU also carries out the banking supervision function, and it is responsible to the society at large for the banking system operation; in addition, the NBU co-ordinates and controls commercial bank compliance with banking regulations. To support the banking system stability, the NBU refinances commercial banks performing the role of the bankers' bank and "lender of last resort".

As a state bank, the NBU organises and carries out the cash execution of the State budget of Ukraine via authorised commercial banks. It also organises inter-bank settlement arrangements.

Under the Constitution of Ukraine, the NBU enjoys the right to initiate laws and regulations (an example of such a law is reproduced in appendix 2).

This hugely powerful and influential state agency also compiles two macroeconomic data systems: monetary and banking statistics and the balance-of-payment statistics.

Development of a banking control system in Ukrainee

Banking control is a part of NBU's statutory role. The Banking Control Department carries out its control functions according to Ukrainian legislation and is in charge of depositors' and creditors' protection and maintenance of confidence in the financial-banking system.

The key methods of control used by NBU are:

- Registration and licensing;
- Inspection and topical checking;
- Establishment and checking of prudential and liquidity ratios;
- Punishing commercial banks for violating banking legislation.

The NBU has set up systems and procedures to support its work:

- Early warning procedures for failing banks.
- Reporting of economic ratios of commercial banks;
- "CAMELS" rating system of commercial banks' activity.

CAMELS stands for:

Capital adequacy
Asset quality
Management quality
Earnings
Liquidity
Sensitivity to market risk

The NBU also acts to improve the financial condition of commercial banks by managing restructuring and mergers of banks.

The NBU carries out control over observance of banking legislation and NBU regulations by commercial banks and is authorised to decide the procedures that should be applied to commercial banks. It has the power to increase the ratio of obligatory reserve of cash holdings, to cancel licenses for some (or all) banking operations, to dismiss a bank's management, to apply to the arbitration court with charges against banks in case of violations and to apply other procedures according to Ukrainian legislation.

The obligatory reserve (cash holdings) requirement is an affective instrument of money volume regulation. It is established by NBU and formed by requiring banks to keep some money on corresponding account and in cash. If a commercial bank does not maintain the required volume of cash holdings it is penalised by the total of the interest income received from the amount of the cash holdings that were missing. This cash reserve obligation was relaxed in July 1999 by decree number 332.

Analysis of major Ukrainian banks

Comparative statistics on all Ukrainian banks are both incomplete and subject to bias introduced by the providers of data and of thc annual reports of the banks from which the data are derived. This latter bias should diminish from 1998 onwards as Ukrainian banks adopted International Accounting Standards (IAS) during 1997.

This chapter analyses Ukrainian bank data contained in the Bankscope database (Bureau van Dijk, 1999). This database contains information of 10,000 commercial banks from all over the world, including Ukrainian commercial banks, it is used within Ukrainian banks to analyze the financial condition of commercial banks both as potential borrowers and as correspondents for international trade finance.

The Bankscope database contains information based on IAS only. Since Ukrainian commercial banks changed to IAS in 1998, most of the data, provided here for 1997, 1996, 1995 is not complete. The development of the Ukrainian banking system is analysed on a base of the 23 largest banks by asset value. These banks have been dominant in establishing and developing the Ukrainian banking system. These banks also form the core of the Ukrainian banking system. The data is reported in appendix 2.

The following analysis looks at key measures of bank performance encapsulated in parts of the CAMELS system. The analysis focuses mainly on the vital areas of liquidity, capital adequacy and profitability. Detailed data are not available to analyse asset quality or management quality and so these aspects must be implied from financial ratios alone. In addition the data do not allow for comparison with prudential ratios found in similarly sized Western banks or under the Basle agreement. In particular, the breakdown of assets for risk weighting is not possible since the data is aggregated before it is reported into the database. However, the progress or problems of individual banks is highlighted using their own published accounts, press releases and detail from the interviews conducted as part of this research.

Liquidity measures

Assets

The total absolute volume of Ukrainian commercial banks' assets has been growing since 1995. In general this means that the stability and activity of the banking sector has been improving over the period.

Within the data the volatile nature of banking assets in Ukraine can be determined. Changes in total asset values of over 50% in one year are not uncommon. Individual banks show dramatic growth, dramatic decline or dramatic reversals of fortune in the space of one year.

The dominance of former state owned banks (Ukraina, Prominvestbank, Ukrsotsbank) has been threatened by the dynamic asset accumulation seen in a number of banks. Among these are: Oschadbank, Aval, Privatbank, Credit Lyonnais Ukraine, Ukrgazprombank and VaBank. Smoother asset growth is seen in Praveks, Ukraine, ZUKB, Perkombank, Kiev, Grant and Pivdenny.

Despite these dramatic changes of size the dominance of the 7 "System" banks has not been interrupted as they still account for over 50% of all assets. The strengths of individual banks within "Group 1" have altered, however. Individual banks can be highlighted to illustrate this:

Oschadbank has seen very dramatic growth of assets since 1995. Customer and short-term funding volume has been increasing since 1996 - as a result of growing trust amongst citizens and customers. The bank has been showing a steady decrease in Net Loans/Total Assets ratio. In 1996 its ratio was well above average at 38.52 (av. 27.93). By 1998 this had reduced to well below average at 21.78 (av. 35.16).

Oschadbank's growth and the attraction of customer funds have been brought about by two separate factors: growth in the branch network and a cautious lending policy.

The latter (whilst not supported by data on profitability available in the database) is felt to encourage the attraction of funds, especially when consumers compare its record with the failure (and loss of customer funds) of similarly sized banks.

Bank Ukraina had been showing asset decline until 1997 and then rapid recovery and growth. The lending performance had been more prudent up to 1997 and based on its core agricultural customers but in 1998 the bank started to expand its credit portfolio dramatically. The effects of this expansion are seen in the sharp net income decline in 1998 (10% of 1996 levels), largely due to the halving of net interest margins between 1997 and 1998 in order to attract funds and attract borrowers. In addition the risk profile of the bank has worsened as Net Loans/Total Assets ratio is constantly increasing. In 1998 this ratio reached level of 50.12 %, which greatly exceeded the national average.

Prominvestbank has seen assets decreasing since 1995. At the same time the Net Loans/Total Assets ratio has been growing rapidly. The ratio reached 64.83 % in 1998, which exceeded the average level almost twice. The data indicate that the credit policy of the bank worsened the risk profile of the institution but no data is available on loan loss reserves for 1997 and 1998 to corroborate this. The bank mainly suffered from bad lending to old industries that were in decline. This lending took huge amounts of resources and worsened the bank's capital adequacy position.

Liabilities - Customer & Short Term Funding

According to the data provided it is clear that the total volume of Ukrainian commercial banks' Customer & Short Term Funding has been increasing since 1995. Almost all commercial banks show this tendency. The sharpest increase is seen in Ukrgazprombank and Perkombank, although this was from a relatively low base. The largest volumes of deposits and short-term funds are seen in the former state owned banks. These banks benefit from having the most developed net of branches all over the country. These are: Ukraina, Oschadbank, Aval and Ukrsotsbank. Clearly availability of branches is important in the garnering of deposits and from analysis of the research interviews it comes as no surprise to find smaller banks planning to expand domestic coverage as an important part of their growth.

Some banks' Customer & Short Term Funding has fallen since 1995 as customers avoid riskier investments. The banks worst affected are: First Ukrainian International Bank, AGIO and Bank Kiev. This decline eliminated lending funding and was one of the causes for the dramatic reduction in assets over the same period.

Chart 3.2 reflects NBU data on activity in the interbank market showing a slowing of interbank lending as a proportion of funds sources between 1992 and 1998. The data also reflect the growing importance of household deposits. This shows some return of trust in the banking system by the general population.

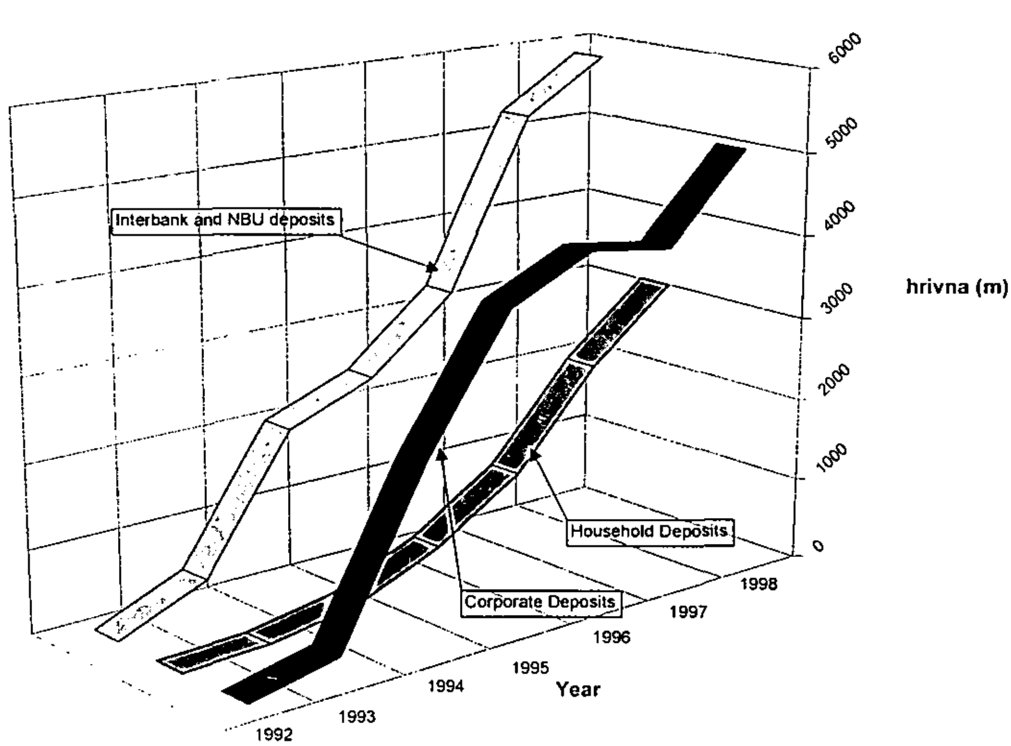
A different picture is painted when the Capital Funds/Liabilities ratio is reviewed. Here Prominvestbank, First Ukrainian International Bank and Agio show comfortable ratio levels whilst Ukraina, Oschadbank and Ukrsotsbank show very low capital cover.

Most of the larger banks appear to be reliant on short term rather than long term funding – a situation that cannot be allowed to continue unchecked by the NBU.

<u>Net Loans/Total Assets</u>

The total average volume of this ratio has been growing steadily since 1995. This shows that the credit portfolios in reviewed commercial banks have been growing, since most banks also show increasing assets. The credit risk profile of the banks has also changed. There has been more active lending in the Ukrainian banking sector since 1995 although this brings with it some negative aspects. Along with the increasing volume of this ratio we can expect a worsening of credit portfolio quality in the future since Ukraine's economic situation fails to improve.

Chart 3.2 Sources of Ukrainian Commercial Bank funding 1992 - 1998



hrv. millions	***1992***	***1993***	***1994***	***1995***	***1996***	***1997***	***1998***
Corporate Deposits	17	244	2208	3729	4197	4050	5061
Household Deposits	3	30	214	642	1289	2400	3217
Interbank and NBU Deposits	8	460	2018	2424	3261	5261	5864
TOTAL	28	734	4440	6795	8747	11711	14142

%	*%*	*%*	*%*	*%*	*%*	*%*	*%*
Corporate Deposits	60.7%	33.2%	49.7%	54.9%	48.0%	34.6%	35.8%
Household Deposits	10.7%	4.1%	4.8%	9.4%	14.7%	20.5%	22.7%
Interbank and NBU Deposits	28.6%	62.7%	45.5%	35.7%	37.3%	44.9%	41.5%

growth	***92-93***	***93-94***	***94-95***	***95-96***	***96-97***	***97-98***
Corporate Deposits	1335%	805%	69%	13%	-4%	25%
Household Deposits	900%	613%	200%	101%	86%	34%
Interbank and NBU Deposits	5650%	339%	20%	35%	61%	11%
OVERALL	2521%	505%	53%	29%	34%	21%

A growing Net Loans/Total Assets ratio is seen in: Bank Ukraine, Grant Bank, Credit Lyonnais, Prominvestbank, Ukrsotsbank and Privatbank. The NBU is sure to keep a watchful eye on the categorisation of their loans. Some banks have managed to reduce the level of this ratio. Among these Ukrinbank and Bank Kiev have decreased the size of their of loan portfolio volume. Alone, Oschadbank has affected the ratio by increasing its assets too.

Net Loans/Customer & Short Term Funding

The finer focus afforded by this ratio indicates that this key measure of risk is impacted more by short term than long term funding. It shows that the dependency of the Ukrainian banks' credit policy on Customer & Short Term Funding is becoming more serious.

Only a few banks have chosen a policy to decrease this ratio (Oschadbank in particular mainly by a sharp increase of funding volume, Ukrin Bank, on the other hand, by a decline of credit activity). The other commercial banks show the tendency of loan volume accumulation despite the slower increase of Customer & Short-Term Funding volume.

As reported above, Prominvesbank's decline in Customer & Short Term Funding was one of the main reasons for their ratio increase. Privatbank and Credit Lyonnais, on the other hand, have been increasing lending activity. Bank Ukraina has increased both its Short Term Funding and its lending portfolio quite dramatically.

Loan Loss Reserve/Gross Loans

Governed by IAS criteria and the NBU decree of March 1998 regarding loan categorisation and the creation of loan loss reserves, this is a broad ratio of asset quality. The former Ukrainian accounting system failed to provide for potential loss in this way and, therefore flattered banks with poor lending records.

The data provided are sparse and cover only 9 of the 23 banks reported (four of the seven group 1 banks, four group two banks and one group three bank). Of the Group 1 banks (Assets over hrv. 1 billion (US$333m)) Bank Ukraina, Bank Kiev and Ukrsotsbank all show improving asset quality whilst Privatbank shows a worsening picture. Of the four Group 1 banks Bank Ukraina alone carries reserves over 20% of gross loans (a legacy of its connections with agriculture). Ukrinbank shows the poorest lending record with a reserve ratio of 45.12% in 1998, due largely to the specialised nature of its lending.

In the future this ratio will become an important benchmark for asset quality but now serves to underline the irrelevance of comparison with similarly sized Western banks that enjoy growing economies and significantly smaller loan loss reserves.

Capital adequacy

Equity

Considering the fact that most data are not available for 1995 and 1996, the total tendency of Ukrainian banks' in equity capital since 1995 is clear. Reversal and slowing of this growth in 1998 is mainly explained by the national currency crisis and, as a result, equity depreciation. Among commercial banks this situation is not the same. Some banks display pretty rapid equity accumulation (Ukrsotsbank, Aval, Ukraina, Credit Lyonnais, Perkombank, and Ukrgazprombank). Others have show less tendency to increase equity. A few banks decreased their equity by 1998 (Prominvestbank Agio), Ukrinbank had even decreased its equity to negative US$3,545,000.

Prominvestbank has seen equity levels rise substantially in 1997, caused by share distribution among staff and other buyers, and then fall again in 1998. The bank's ROAE ratio has shown a decreasing tendency over the past 4 years and the level of Net Interest Margin has been decreasing as well. These figures show that the decline in equity was caused by other factors in addition to the currency devaluation in 1998. These factors included: trading losses in the face of competition, poor credit portfolio quality and huge expenditures on a substantial network of branches – largely without the desired objective of branches to garner deposits. The Capital Funds/Liabilities ratio of this bank was upset by the surge in equity formation in 1997 but re-established its downward trend by 1998.

Oschadbank has been constantly decreasing its equity since 1995. Despite success in attracting deposits and short-term funds its lending has been cautious. Soviet-era management has shown its ineffectiveness in a modern banking sector. Overstaffed branches (most of them non-profitable) have lowered the bank's flexibility and prospects for earnings. Overall the bank shows its low competitive abilities and this is reflected in low investor confidence.

Privatbank has been increasing its equity over the past 4 years despite the currency crisis of 1998. Even though that bank's ROAE ratio was declining along with other commercial banks, it still remains at quite high level and well above the average figure. Privatbank has been very competitive in maintaining a low net interest margin. Net Income has been growing over this period due to a combination of higher than average lending against short term funds, a lower bad debt ratio and evidence of some degree of cost control. This paints a picture of a bank with increasing turnover, more active operations and assets growth.

The banks are under pressure from the equity requirements of the National Bank of Ukraine. In order to meet required levels of cover all commercial banks will push their businesses towards the capitalization of reserves and increase in equity. This, of course, assumes profitability, which, as can be seen, cannot be certain.

The average value of the Equity/Average Assets ratio has been increasing steadily among Ukrainian banks: since total assets and equity have both been growing, with equity growing faster. This is largely due to the equity requirements of the National Bank of Ukraine.

Total Capital Ratio

Compared to the international standards the average total capital ratio of Ukraine's banks is quite high, which explains the investment attractiveness of Ukrainian banking sector to foreign capital. The whole picture is not quite clear, however, because of the lack of data for most commercial banks.

Profitability

Net income

The total income of Ukrainian commercial banks has been decreasing over the period 1995 to 1998. Profitability of the banking sector in Ukraine has been falling too. As a result of the reduction in inflation and stricter NBU regulations the banking business in Ukraine has, however, been getting less risky.

Some efforts have been made to reduce cost/income ratios but ineffective management, a large network of non-profit-making branches along with the poor quality of credit portfolios caused sharp income declines in the former state-owned and some commercial banks as shown in the following summary:

Table 3.4 Net income in key Ukrainian banks 1995 to 1998

Bank	1995 (US$)	1998 (US$)	Change
Prominvestbank	153,177,000	17,975,000	-88%
Ukraina	25,400,000	4,500,000	-82%
First Ukrainian International Bank	10,500,000	700,000	-93%
IAS Bank	(11,270,000)	3,846,000*	-
*Overall average***	*198,622,000*	*127,834,000*	*-36%*

**1996 figure used, 1995 not available in IAS format.*

**All reported banks*

Net interest margin

Almost every Ukrainian commercial bank has been moving towards reducing their net interest margins. From the time that the overall economic situation had been improving and stabilizing, mainly through the reduction in inflation, most commercial banks started to cut their net interest margins.

The reduction has resulted in a short-term decline in profitability and has contributed to the weakening of the former Soviet banks' oligopoly and market dominance. This measure shows that, overall, competition between banks in providing better services and cheaper rates is increasing. But still this ratio is quite high compared to foreign banks.

Return on Average Assets (ROAA)

The average volume of this ratio has been constantly falling (from 8.38 in 1995 down to 6.28 in 1998). Former state-owned banks again support the suggestion that their management is poor by returning very low ROAA ratios between 0 and 2.8, which is under the average volume of ROAA for Ukrainian banks. The best result in 1998 so far was in Ukrgazprombank, which had raised this ratio from 11.04 in previous year to 30.70 in 1998. The Return on Average Assets ratio is very high compared to international requirements. This explains both profitability and the associated high level of risks in the Ukrainian banking sector.

Return on Average Equity (ROAE)

As the average ROAA volume, this ratio had greatly dropped since 1996 (from 120.26 down to 31.60). All this shows is that profits of commercial banks are down. Some banks, such as Ukrgazprombank, Ukrsotsbank and Bank Kiev have shown a sharp increase in this ratio. It is felt that this indicates an improvement in the quality of management. At the same time many commercial banks, including Privatbank, Perkombank and Ukraina saw a decline in this ratio. Despite the whole picture of pessimistic decline of return on average equity situation, this ratio remains very high compared to international standards.

Cost to Income Ratio

The overall average cost/income ratio had been increasing until 1997 but in 1998 it fell by 6 %. Decreasing of net interest margin and the lower resultant incomes mainly caused the decline.

Higher costs are seen in Ukrinbank, Ukraina, Privatbank, Pravex and Ukrsotsbank – mainly the banks with big market shares and can be explained by a set of related factors:

- Most of these banks have wide net of branches and as a result very costly operation.
- Large numbers of staff makes it hard to reduce costs.
- Bad management and low qualification of staff increases operational costs.

Of the commercial banks Bank Kiev and Credit Lyonnais have shown constant and stable improvement in Cost-Income balance. The total picture shows that commercial banks are beginning to control their expenses.

Conclusion

The Ukrainian experience has shown that commercial banks can develop and function in unstable economic conditions and social-political and psychological crises. Since banking reform started in 1991 most of commercial banks have focused their interest on the more effective functioning of the banking system. It is still too early to talk about a developed banking system that can be related to a real market economy, but, despite instability in political-economic and social-psychology sphere, the foundation is good and signs of successful banking system development are apparent.

The key to the successful introduction of commercial banks is the creation of a competitive environment. This encourages the growth of commercial banks and other financial organisations. According to this situation it is important for both large and small banks to concentrate their efforts in certain sectors of the financial market and provide flexible and competitive services. It is also important to provide personal services for some clients. Further growth of commercial banks will also cause a decline in the market influence of former state banks in this sector.

The brief history of Ukrainian banking has shown that market reforms and effective competition have been delayed by the dominance of former state banks. These banks display ill preparedness for competition, the legacy of poor management and moribund assets. Once macroeconomic conditions recovered the frailties of these banks were exposed and more able banks began to grow and increase their market shares.

All businesses are interested in the development of commercial banks. The principle that a stable business relationship with a commercial bank will lead to profit for both enterprise and bank is well understood.

Another legacy of the centrist policies of the former times is that larger banks are concentrated in and around the capital, Kiev. Smaller banks tend to "fill the gaps" in the regions where the larger bank networks fail to provide adequate cover. The smaller banks tend to finance small and middle-sized enterprises and usually treat every client in a personal way. These banks are closer to businesses and families and it makes positive prospects for their future development.

To attract Ukrainian investment and to stabilise the Ukrainian economy the NBU has moved increasingly towards tighter prudential and regulatory control. A principal pressure on commercial banks, in particular, is the increased capital requirements. Measures are also in place to ensure the increasing of solvency, stability, efficiency and competitive ability of commercial banks and, by implication, the return of investors' trust. It is likely that this will lead to the combination and selling of smaller and weaker banks.

The creation of commercial banks is a direct result of transforming the administrative – centralised system to a market economy. The banking sector requires change in the structural and functional spheres too. In a market economy banks operate in an open, free environment, without bureaucracy and corruption. This state of affairs is yet to be found in Ukraine. Accordingly the quality of the commercial banks' management is very important in this situation.

Perhaps the major external constraint on the development of a commercial banking system in Ukraine during the 1990's was the country's monetary policy, chosen as the main lever in stabilising the economy in Ukraine. It was planned to achieve the economic improvement only by monetary methods through the banking system without using other important mechanisms. This situation caused the following complications:

- Lending to loss making sectors of the economy by Government and commercial banks (this was supported by policy of the National Bank of Ukraine);
- The transfer of capital into loss making enterprises and, as a result, a lack of investments for other sectors;
- An inflation boost was mainly caused by uncontrolled monetary policy; this had implications for credit quality and interest margins – both of which declined.
- The diminution of citizens' trust in the national banking system and government;
- Aggravation of bureaucracy and corruption in government administrations;

Ignoring the other methods of non-monetary influence caused the most dangerous changes in the Ukrainian economy: killing off consumer and industrial as well as agricultural production by high taxation, corruption and unstable legislation.

In 1998 Ukrainian banks weathered their worst storms so far. At a time when the exposure of bad debt losses, through the introduction of IAS accounting, influenced profitability and investor confidence commercial banks acted strategically to make full use of the short-term capital available.

Whilst assets grew in 1998 this was because of short-term deposits rather than long term investment. Those banks with efficient, low cost and well-positioned branch networks fared better than most.

As the Ukrainian commercial banking sector enters the new millennium it faces a new set of challenges that will allow it to cast off the historic and restrictive influence of former times. These challenges come from within and outside the industry:

- Finding ways to improve capital positions and to raise equity finance in order to meet NBU requirements. Capital growth is the key measure of success cited by interview respondents (see chapter 5).
- Finding ways to recover problem banks, through take-over, merger or recapitalisation. This is a longer-term problem too as the professional training of bank staff and the recruitment of good quality management is also needed to maintain recovered banks.
- Re-establishing stock markets and financial markets following the devastation of currency and macroeconomic instability.
- Developing consumer trust in commercial banks.
- Developing commercial banks as an integral part of monetary policy transmission.

CHAPTER FOUR

DEVELOPMENT IN OTHER POST-COMMUNIST STATES

Introduction and rationale

In 1991 Ukraine was not alone in embarking on the transition from central control to market economy. Most eastern European states had begun reforms either before or at the same time as Ukraine.

This chapter reviews the experiences of post-communist regimes after 1991, drawing comparisons between selected states and areas and Ukraine in order to contextualise development in the political and economic environments and in the banking markets. The states focused on in particular are selected to illustrate the dichotomised experiences of the area and can be categorised into "early" and "late" market reformers as shown in Figure 4.1:

Figure 4.1 Selected post-communist states

	States
Early Reformers	Czech Republic Hungary Poland Baltic States (Estonia, Latvia and Lithuania)
Late reformers	Belarus Russian Federation

Comparative data for Ukraine is also included. The conclusion of Chapter 2 of this thesis puts Ukraine firmly in the "Late" reformers camp.

Categorisation by bank reform progress shows Ukraine having made "some progress" as with many CIS states. "Substantial progress" is seen in Eastern Europe and the Baltic states. No former communist regime (by 1996) had what The Banker described as "Well functioning systems" (The Banker, 1996). Figure 4.2 shows the full listings provided by The Banker:

Figure 4.2 Bank reform progress

Well functioning systems (1)	Substantial progress (2)	Some progress (3)	Little progress (4)
	Croatia	Albania	Tajikistan
	Czech Republic	Bulgaria	Turkmenistan
	Hungary	Belarus	
	Macedonia	Armenia	
N	Poland	Azerbaijan	
O	Romania	Kazakhstan	
N	Slovakia	Moldova	
E	Slovenia	Russia	
	Estonia	Ukraine	
	Latvia	Uzbekistan	
	Lithuania	Kyrgystan	
		Georgia	

Key:

1 Substantial deepening of financial markets; well functioning competition; nearing BIS standards of prudential regulation & supervision.
2 Full interest rate liberalisation; significant presence of private banks & lending to private firms; substantial progress in establishing prudential regulation & supervision.
3 Interest rates significantly influencing credit allocation.
4 Little progress beyond establishing two-tier banking system.

The similarities and differences between "early" and "late" reformers and between other states and Ukraine will be highlighted in this chapter. A note of caution must be made, however. Comparing progress since1989 is not to assume that all communist regimes were similar prior to this date. Reform in areas outside the former Soviet Union was already underway in 1989. In addition, the imposition of centrist policies dated back to the end of the Great Patriotic War (1941-1945) in westernmost areas rather than back to the communist revolution of 1917.

An interesting but un-researched difference is also apparent in the religious schism apparent between the western "Roman Catholic" countries and the eastern "Orthodox" ones (Hill, 1999).

The Political environment

The political environment and the speed to reform are major factors in understanding the economic progress of post-communist states. In addition to the differing initial economic conditions in 1989 three key political factors can be identified (Gaworzewska, 2000). These three factors are inter-linked and, in some ways, inseparable:

- Limited external aid
- Differing political conditions
- Diverse reform strategies

External aid

Post-communist states soon realised that Western encouragement to seek independence was not to be backed up by substantial financial aid. Sources of aid were limited and instead the European Union, The European Bank for Reconstruction and Development (EBRD), International Monetary Fund (IMF) and World Bank, among others, offered technical and knowledge-based aid alongside limited financial assistance.

Aid was often linked to the reform process (as seen in Ukraine) and some debt re-structuring was seen. Again there was a divide in Europe with earlier reformers benefiting more from aid. Of the early beneficiaries of EU "Phare" assistance (Eastern Europe and the Baltic states) most have now applied for membership of the enlarged EU. None of the "Tacis" states (former Soviet Union) has thus far applied to join. Both "Phare" and "Tacis" funding have been targeted at structural, environmental, energy and infrastructure assistance together with cross-border co-operation issues. The EU "Tempus" funding was specifically earmarked for Higher Education. An example of this is detailed in Chapter 2 where a ECU900,000 three year programme to improve the Banking faculty at Kiev State University of Trade and Economics was undertaken with UK and French Higher Education support.

It is, however, doubtful that additional aid would have improved economic performance in a marked way. The infrastructure problems and transition from centrist to market based policies meant that transition was always going to be a slow process. It must also be questioned whether transition economies could successfully absorb large-scale resources in the way envisaged (Gaworzewska, 2000).

The EBRD, founded in 1992 with the purpose of assisting transition economies in eastern and central Europe, had provided in excess of ECU 19 billions by the end of 1999 in a mixture of loans, guarantees and equity participation. Projects have been funded up to 100% with average participation around 25 - 35%. Table 4.1 details the investments made in the transition states highlighted in this chapter.

Table 4.1 EBRD funding in transition economies 1994-1999

ECU million	**To 1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**Total**
Poland	711	107	207	264	272	272	1833
Hungary	657	406	133	100	41	108	1445
Czech Republic	352	100	50	405	67	227	1201
Baltic States	242	142	119	124	134	146	907
Belarus	141	21	0	11	0	0	173
Russian Federation	906	811	882	1054	272	222	4147
Ukraine	155	148	115	232	141	281	1072
Sub-total	*3164*	*1735*	*1506*	*2190*	*927*	*1256*	*10778*
Others	1834	1120	1321	1824	1076	1292	8467
TOTALS	4998	2855	2827	4014	2003	2458	19245

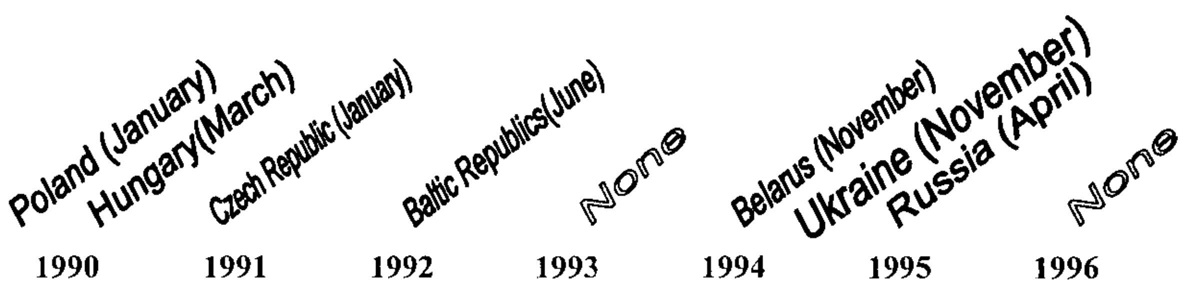
Source: EBRD Annual reports 1995 to 1999.

EBRD support has been a key factor in economic reform in many states with an average 42% of funding annually going to the banking and financial sector. A major example of this was the 1997 equity funding of GE Capital Bank Prague at ECU 359 million. In other states loans and equity financing have funded credit provision, including consumer credit (Jenkins, 1996). A further 24% of EBRD funding goes on infrastructure projects (transport and telecoms) whilst primary industries and energy generation get around 18%.

Political conditions and reform strategies

Experience appears to show that the earlier and more committed the reformers in the transition states the more successful they have been, in economic terms, in the last decade. Whilst the next chapter deals with the economic performance of the transition states selected in this study a clear divide can be seen between Poland, Hungary and the Czech Republic in Figure 4.3 and Russia, Belarus and Ukraine. The Baltic states were early reformers but suffered through their closeness to Russia and their links with the Russian economy.

Figure 4.3 Stabilisation programme implementation dates



Source: EBRD Transition Report 1999

Poland and Hungary were amongst the earliest reformers but their approach was different. Poland favoured the "Big Bang" fast reform approach whilst Hungary wished to avoid the potential disruptive effects of this by adopting a more gradual approach.

Numerous research studies indicate that "Big Bang" reformers have fared better than "Gradualist" ones over the decade (Fischer and Sahay, 2000). "Big Bang" took advantage of the changed political environment to enact a series of fundamental reforms simultaneously whilst "gradualists" felt that reforms had to be correctly sequenced. In states that delayed reform the job was made more difficult by the additional time given to entrenched and reactionary groups to gain parliamentary or commercial power in order to distort markets and reforms to their own advantage.

In both Russia and Ukraine the persistence of corruption is in no small measure due to the political lethargy following independence.

There are exceptions to the general observations about fast and gradual reformers and early and late reformers. Belarus began its reforms very late (November 1994) but benefited from reasonably favourable economic conditions in the earlier years of the decade. The cost of the lateness of reforms is now to be seen as growth slows.

Overall many observers would agree with the EBRD's conclusion that:

> *"The political process has shown robustness in the face of crises and hardship. Strong commitment to market reform and democratic processes has been shown across the political spectrum and has been maintained across changes of government. There is little likelihood of a return to the old political structures."*
>
> (EBRD, 2000)

The economic environment

The former communist states have taken very different economic journeys during the last decade. The following diagrams (Graph 4.1 through 4.4) illustrate the trends in key macroeconomic indicators.

Graph 4.1 shows that only Poland, from amongst the selected states in this chapter, enjoys a higher real GDP level than in 1989. Like its neighbours it saw GDP decline in the early 1990's as the transition to a market economy emerged. As an early reformer and a state with clear economic advantages in geographic location and natural resources quickly saw its wealth rise and continue on an upward trajectory.

Eastern Europe, as a whole, has recovered more strongly in the latter half of the last decade than its neighbours in the former Soviet Union. Russia and Ukraine have both deteriorated sharply (along with the rest of the CIS).

Although GDP has not improved in the CIS states it has, at least, stopped falling in real terms. Only political will to push through reforms will help to sustain and improve on this position.

Graph 4.2 plots the inflation rate of Ukraine (see also Chapter 2) against those in other states. Ukraine certainly suffered the worst effects of inflation but was by no means alone in having problems in 1992-1994. The knock-on effects of Russian inflation on the Ukrainian economy is clear to see and the link to Belarus from Ukraine's problems evident.

Inflation is now largely under control in all transition states, a feature that adds considerably to the picture of stability.

Current account balances in Graph 4.3 show a divergent position between selected states too. Russia's 1998 crisis can be seen clearly, with its recovery equally clear. On the whole eastern Europe has seen substantial capital outflows, this not being as marked in the CIS states since much of their trade is between themselves.

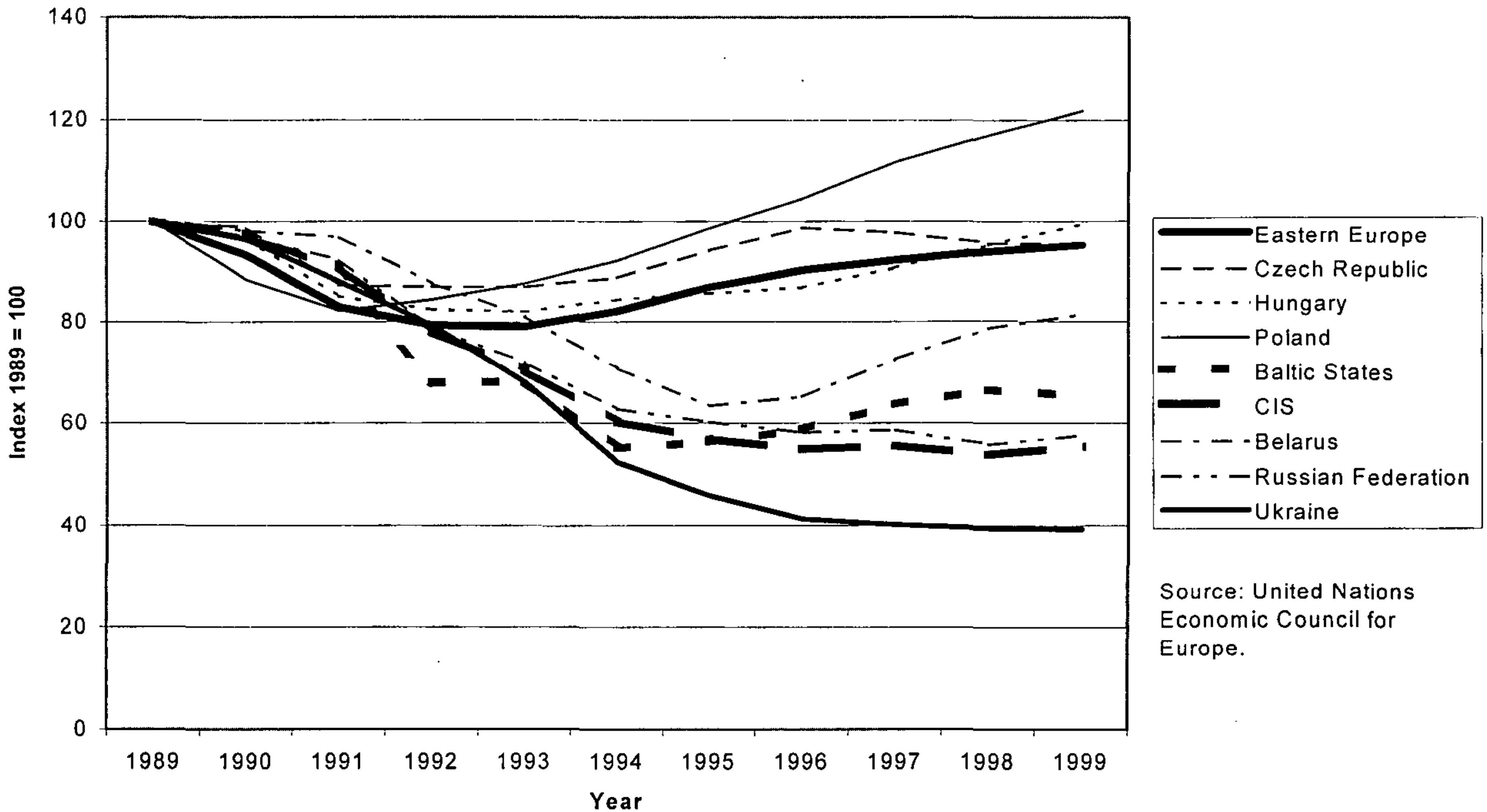
This picture is supported by the final Graph 4.4 where Russian, Ukrainian and Belarussian positions on capital formation are typified by capital flight and a reluctance of foreign investors to invest. Polish capital formation has been boosted tremendously by German and other foreign investment.

Poland

In 1993 the Polish Government implemented an economic program called Strategy for Poland, a macroeconomic blueprint for the period between 1994 and 1996. The principle aims for the government's policy were, and continue to be:

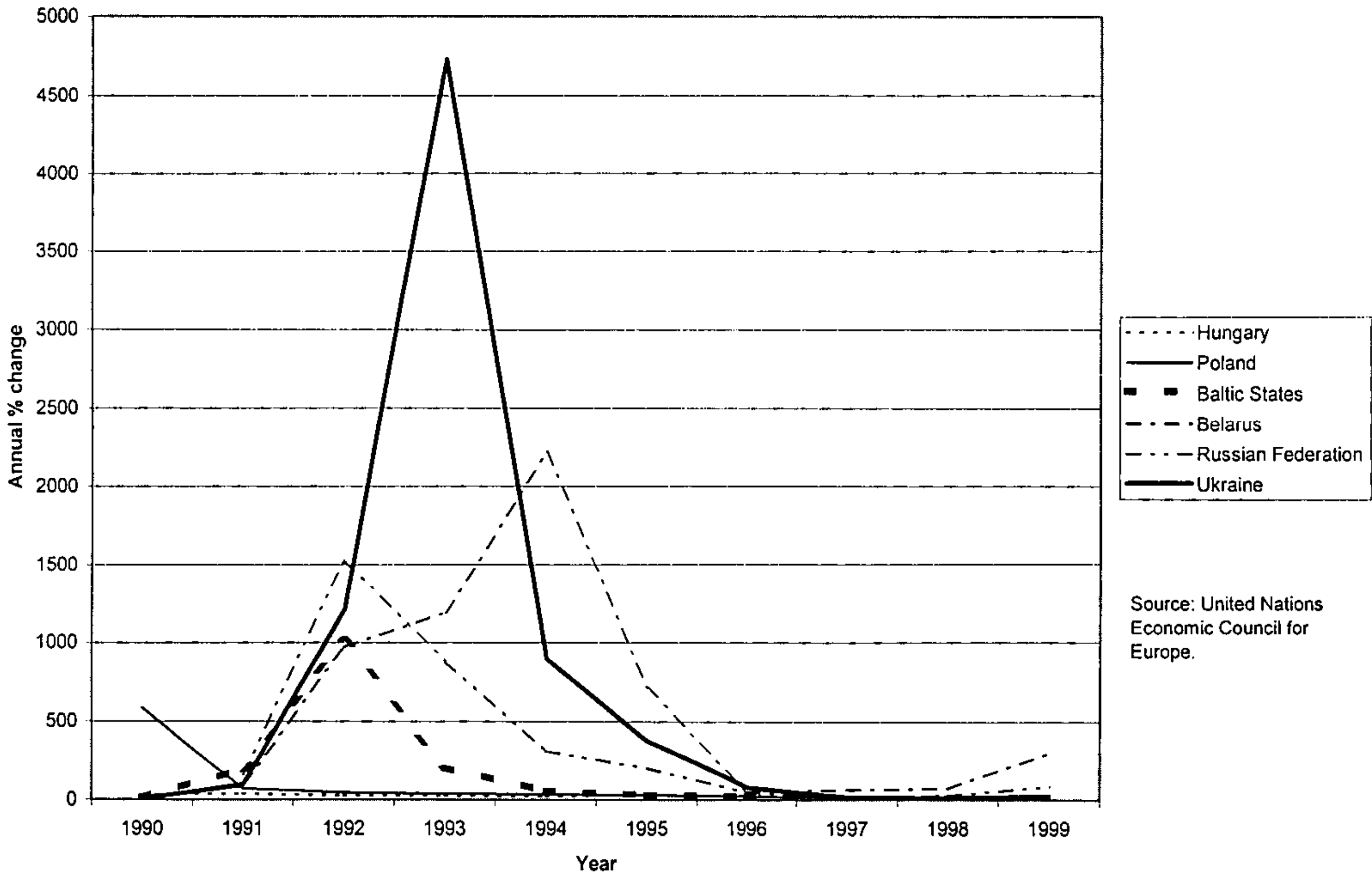
- to ensure the conditions for a high GDP growth rate
- to reduce inflation
- to reduce budgetary imbalance to a budget deficit not higher than 2.5% of GDP and to a level of public debt not higher than 60% of GDP for the coming years
- to improve people's living standards, including an increase in real wages, and to reduce unemployment.

Graph 4.1 Real GDP/NMP in selected ECE transition economies 1989-1999



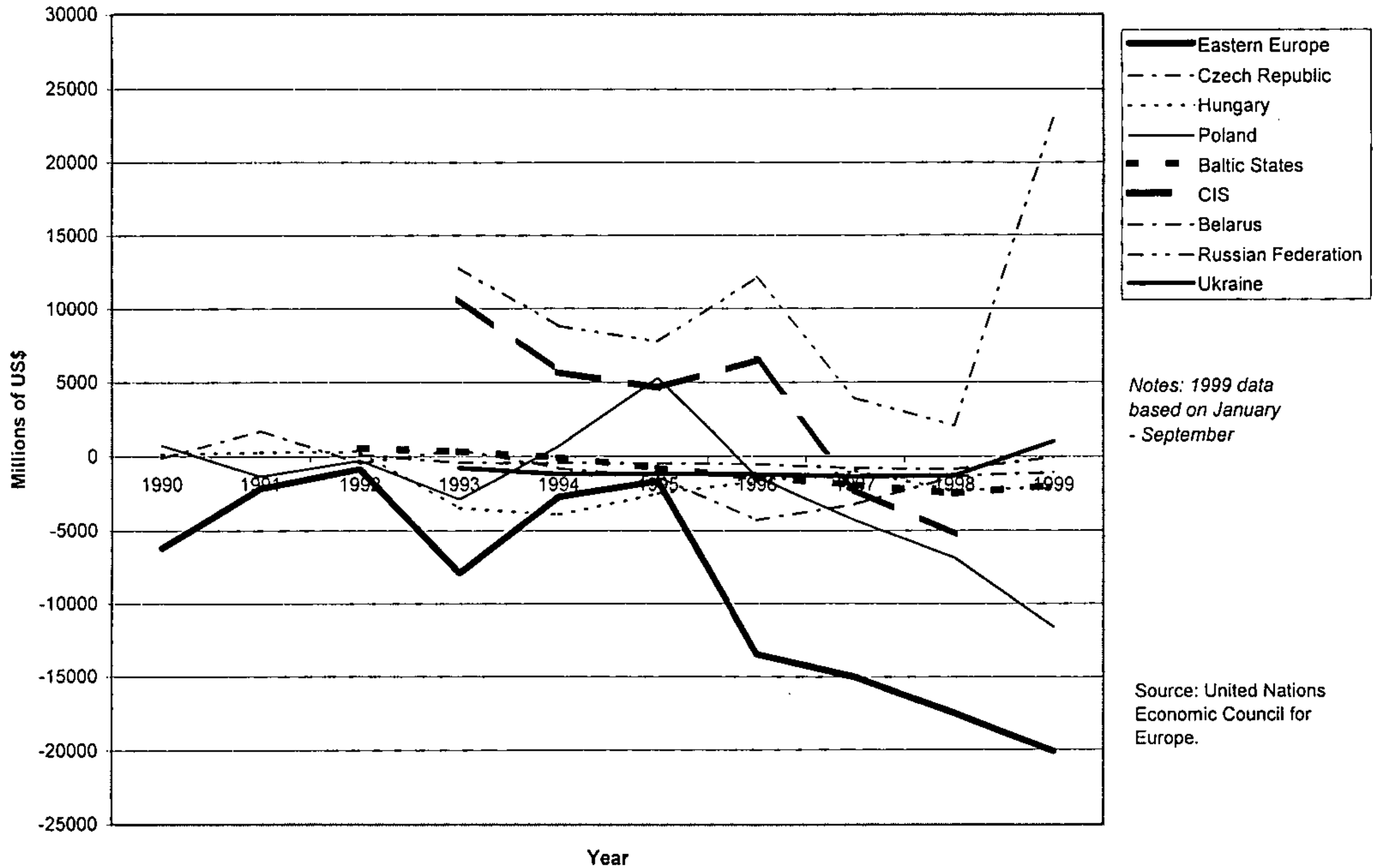
Source: United Nations Economic Council for Europe.

Graph 4.2 Consumer Price Inflation (annual rate) in selected ECE transition economies 1990-1999



Source: United Nations Economic Council for Europe.

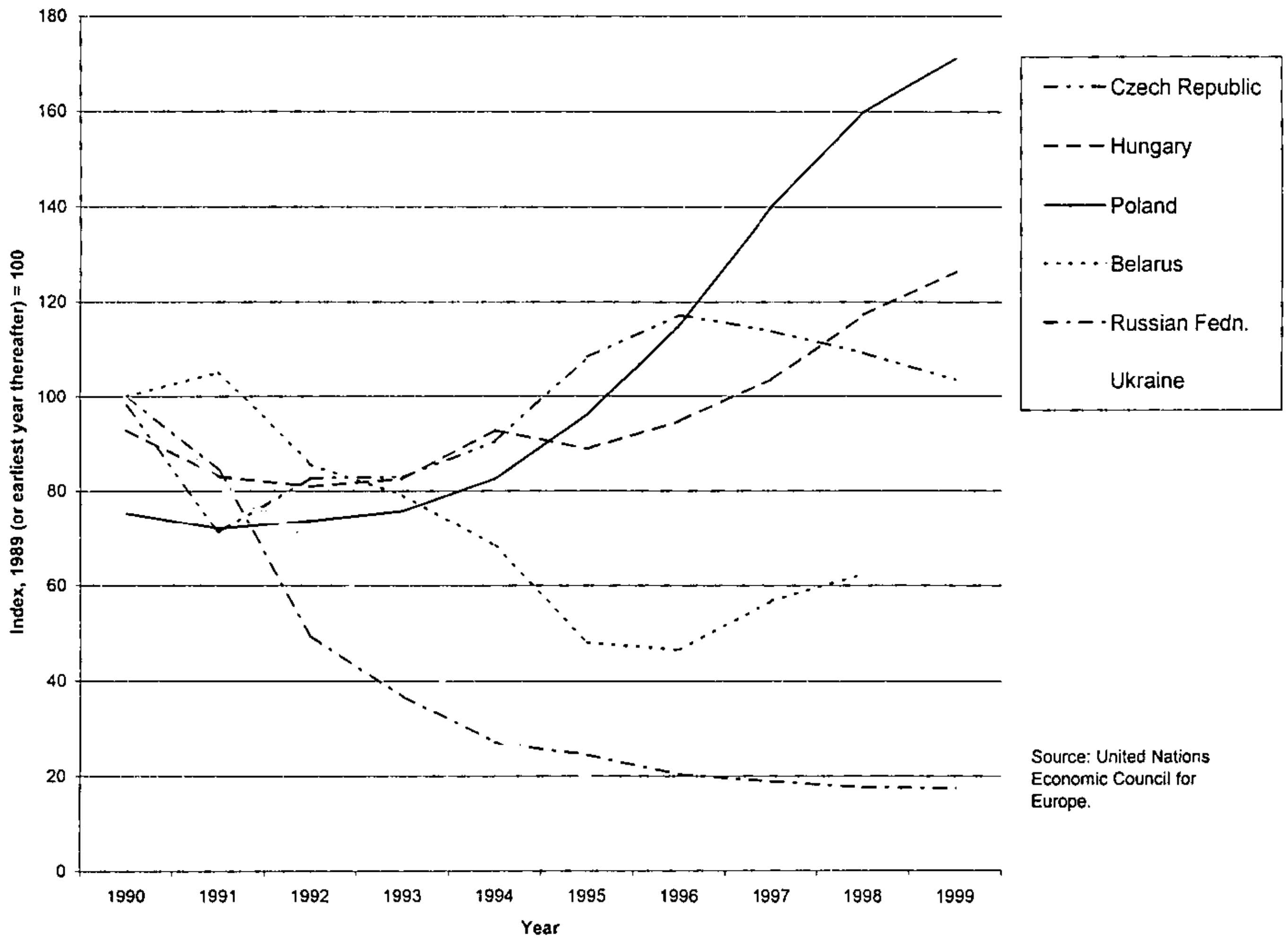
Graph 4.3 Current Account balances in selected ECE transition economies 1990 - 1999



Notes: 1999 data based on January - September

Source: United Nations Economic Council for Europe.

Graph 4.4 Real Gross Fixed Capital Formation in selected ECE transition economies 1990 - 1999



Source: United Nations Economic Council for Europe.

The combination of a massive one-off devaluation in 1989 with subsequent constant gradual devaluation and strong productivity gains has allowed a substantial undervaluation of the zloty to persist.

In 1996 the currency was still about 3% firmer than the central parity rate, so the National Bank of Poland (NBP) initiated a policy of consecutive intervention against its own currency. Interventions had a strong comeback during the summer of 1996 and since then a level of roughly 3% under parity has been accepted as the tolerance limit of the NBP. Overall, the zloty lost roughly 12.4% versus the dollar and 6.3% versus the Deutschmark during 1996. Considering that the managed devaluation alone should account for roughly 12.7% in the same period, the zloty has performed rather well and, in the light of the continuing surge of both direct and indirect foreign investment, is expected to continue doing so. The extraordinary growth of the NBP's official currency reserves is a good illustration of this.

In terms of both exchange rate and monetary policy, the NBP has proved and continuously defended its independence, as laid down in the Central Bank Act of 1989. Notwithstanding increasingly vociferous demands for export-oriented devaluation in the face of nominal balance of trade problems, the Central Bank has stuck to its guns and thereby strongly assisted the growing community of foreign investors. In terms of interest rate and money supply management, the NBP relies mostly on the frequent issue of its own bills, the more or less regular offer of repo transactions and recently the outright sale of Treasury bonds from its portfolio.

Given the quantity of underperforming assets on the books of most domestic banks, the market has been rather risk-averse over the last years. The result has been a strong preference to invest liquid funds in government and NBP securities and the interbank deposit market rather than to lend to corporate customers. As a consequence, the domestic money market has tended towards a state of constant excess liquidity, with the exception of the dates at which minimum reserves are calculated. On those days, the whole market is regularly caught scrambling for funds. So far, the NBP has been honing its skills in mopping up excess liquidity in an environment of high nominal interest rates, but it remains to be seen how it would cope with a prolonged scarcity of funds.

Hungary

Hungary has achieved a spectacular progress in transition since the beginning. After establishing the institutional framework of a market economy, a stabilization-cum-reform policy program was introduced in March 1995.

As a result of policy efforts, the rate of growth was forecasted to achieve 3.5 – 4 % in 1997 and remained around 4 - 5 % in the coming years. This growth had been generated by the private sector, which accounted for 75 % of total GDP. The acceleration of economic activity had been led by the improving export performance of Hungary and increasing investments of the business sector. The most sizable increases in production and exports have been recorded in the high value-added industries.

One of the most important elements of the transition of process in Hungary was the change of the microstructure of the economy due to liberalization and privatization. As a consequence of a well-designed privatization program focusing on finding strategic investors, Hungary became an attractive destination for foreign capital.

Fiscal adjustment resulted in a significant drop of government deficit from 9.6% of GDP in 1994 to a forecast 4 % of GDP in 1997. The fiscal reform had implemented changes in the financing and settlement system of the government and restructuring of expenditures. In 1996-97, the total amount of government deficit was financed exclusively from the market. Tight fiscal policy and the declining deficit caused growing confidence of investors, which was reflected in declining interest rate both on domestic and foreign state debt.

The credibility of present economic policy has been bolstered by consistent monetary policy. This concentrated on sustainable cut of inflation as a final target. The exchange rate regime aimed at supporting the fight against inflation and creating a predictable environment for economic activity.

Concerning interest rate policy, monetary policy had to meet multiple requirements. While the existing exchange rate regime and the goals of policy in stabilization determined the level of domestic interest rates, the NBH strove to stimulate domestic savings and at the same time to prevent the excessive inflow of speculative capital.

As a result of the development of the Hungarian economy and the financial sector, Hungarian money markets became highly liquid. They provide a wide range of information for policy purposes and allow the NBH to use indirect instruments of monetary policy.

The improving economic conditions and strengthening of the corporate sector were reflected in the worldwide notable performance of the Hungarian capital markets. The Budapest Stock Exchange (BSE) experienced a 53 % increase of prices in dollar terms and this growth was fundamental in nature.

Czech Republic

Efficiency in Czech enterprises has not improved to the same extent as in Poland or Hungary. Two key reasons for this are the implications of voucher privatisation and high wages.

The privatisation process of the Czech economy was driven by voucher privatisation, which resulted in a diluted shareholder structure and problems concerning corporate governance. Without strict bankruptcy laws in place and applied, the threat of closing down companies was modest. The relatively low unemployment rate is partly a result of this policy and must also be seen in this context.

The productivity of Czech companies is also hampered by high wage increases. After an increase of 9.8% in the first half of 1996, real wages for the first time reached the level of 1989. Over the period from 1993 to 1996, the increase in wages was faster than that in labour productivity. Moreover, the rapid wage increases have stimulated overall demand and consumption growth, including imports; and added to inflationary pressures.

To strengthen competitiveness, the restructuring process needed moved ahead. The government intended to support the macroeconomic reforms, and to propose modest wage increase. This process could result in higher unemployment and bankruptcies and could temporarily slow down economic growth. In the longer run, however, stable growth rates can only be achieved through continued reforms at the corporate level, which cannot always ensure a socially soft landing.

The Baltics

Estonia, Latvia and Lithuania, together, The Baltic Republics, held similar economic positions in 1991 but have trodden different paths over the last decade.

The fall in Estonian GDP to an index level of 78 in 1999 (1989 = 100) is actually healthier than the falls to 59 and 64 of Latvia and Lithuania respectively. Estonian inflation has stabilised after a hyperinflationary episode in 1992/93 but at a higher level than that seen in the other two republics.

Lithuania is typical of the three states and illustrates the caution and care with which economic transition has been engineered. Since 1992 the reformist Slezevicius government has presided with considerable success over Lithuania's economic transformation and recovery from the post-Soviet shake-out. Fiscal discipline has been commendably tight, with the budget deficit kept to less than 2% of GDP. Privatisation, including voucher privatisation, had been pushed ahead after a slow start.

Despite huge expenditure cuts, the government had to concede more than a doubling of its budget deficit target for 1995 to the equivalent of 3.2% of GDP, compared with a 1.7% deficit in 1994 and a 1% surplus in 1993. The country's short-lived economic recovery was also stalled. GDP fell by 0.35% in 1995, disappointing follow-ups to the 2% increase recorded in 1994. However, in the five years to 1999 GDP has staged a steady recovery in real terms and inflation in consumer prices has almost disappeared (0.8% in 1999).

All three Baltic states have applied to become EU members, showing their confidence in the reforms and economic transition over the last 10 years.

Belarus

Ukraine still remains one of the most important business partners for Belarus. The total value of turnover between Ukraine and Belarus is second only to Russia.

Ukraine's trade policy towards NIS countries has affected this situation. Ukraine started to integrate into European and other international markets outside NIS. Ukraine's turnover with NIS countries besides Russia had increased by 38.8 %, export – by 17.6 %, import – by 58.2 % (11 % - with Belarus). As a result, export to Ukraine had decreased from 20.7 % in 1995 down to 7.6 % in 1996.

Analysis of the Ukrainian goods import structure to Belarus shows that 1998 supply was mainly oriented to the real sector of economy demand and was financed by enterprises, not by direct budget funds. Most of the import value from Ukraine is oriented on intermediate goods - 67 % (power supply, seeds, medicals, non-treasure metals) and investment products - 24 %. Consumer goods import from Ukraine in 1998 was 9 %.

Russian Federation

The Russian Federation is an impressive country. Not only it is the largest country in the world, with 17 million square kilometres, it also brings together completely contradictory climatic conditions within one country, with arctic conditions in the north and hot, dry, steppes in the south. The Russian Federation also has marked regional cultural, ethnic, political, and economic variations, which only became clear with the dissolution of the former USSR at the end of 1991, and which put an end to the image maintained for decades of one large political and economic unit in the east.

Today, this territorial diversity of Russia is not only one of the problems, but it is also an essential strength, for, in spite of the overall decline in the national economy, there are definitely regions which can be regarded as "regions of hope" and which could in future develop into flourishing economic centres. Such centres would enable Russia to make appropriate use of its wealth of natural resources and its considerable economic potential within the foreseeable future.

The political and economic disintegration of the former USSR in 1991 and the attendant breakdown of economic relationships between the individual republics, in addition to the difficulties in implementing the policy of reform, have meant significant declines in economic output in Russia.

The liberalisation of prices in January 1992, together with an expansion of the money supply, the increase in loans granted and growing budget deficits, initially led to an enormous increase in price levels. The inflation rate in 1992 was about 1500% and was therefore at hyperinflation levels. Since then the rate of inflation has fallen continuously up to financial crisis of 1998.

The privatisation process, which has been implemented primarily in Russia so far, has been mass privatisation in the form of employee privatisation. However, the efficiency of companies has not significantly improved as a result of privatisation, due to the absence of new capital and new management. The second stage of privatisation, which began in mid-1994, therefore made increased use of tender procedures, auctions and direct sales. In autumn 1995 there was a new development in the Russian privatisation process. It became possible for share packages of specific companies to be mortgaged by the state in return for the acceptance of loans.

Banking markets

In the command economy there were no securities markets and banking was purely a passive instrument of the central plan. The household savings circuit was kept separate from the credit allocation circuit. Interest rates were nominal and credit assessment did not exist. Cost and profit were irrelevant. Bankers were book-keepers not financial assessors and disciplinarians.

When the command system collapsed, commercial and central banking functions had to be separated in a two-tier banking system. This meant that a legal, regulatory and supervisory framework had to be enacted and bedded in. In addition banking and supervisory management and staff had to be recruited and trained and equipment, systems, and premises updated. For the infrastructure national payments and money transfer systems had to be installed and markets in money, foreign exchange and government paper opened up.

These were only the first steps, however. More difficult to resolve without undermining the slowly emerging disciplines of prudential banking in a market environment was the problem of dealing with non-performing bank credits inherited from the command system. This problem was worsened by the additional bad loans that the new post-reform commercial banks had themselves subsequently incurred, plus the lengthening chains of unpaid inter-firm bills. Various methods have been used in different countries to clear up this overhang, and the related problems of restructuring loss-making firms, re-capitalising the banks with poor quality loan portfolios, and then privatising them.

Polish banking

Poland benefited from early reform to a two-tier banking system and a buoyant economy that allowed banks to grow their capital through profits. Banks were very attractive to foreign investors.

The key factor determining the health of the Polish banking system, apart from the general economy, is that fact that over 70% of Polish banks are owned by foreigners. Germany has the largest share. Foreign banks are attracted by good economic potential as well as proximity to western Europe.

Only about 25% of Poles have bank accounts, giving huge growth potential in domestic markets. Deutsche Bank is particularly interested in exploiting internet and direct banking in this market. Polish corporate business is sluggish, however. Polish companies have generally weak capital positions and are unable to make long-term commitments.

The privatisation of the state savings bank PKO will be the next major change in the banking market. It is doubtful if this can take place without foreign involvement and banks are queuing up to look it over. PKO has about 30% of the credit card market and dominance in other financial products too.

Hungarian banking

The Hungarian financial sector has undergone rapid change and development in recent years. Changes that commenced in the 1980s continued into the 1990s, establishing a multifaceted, broad-based industry regulated by legislation aimed at harmonising the Hungarian financial sector with that of the EU.

The financial sector counted some 44 retail, commercial and consumer finance banks, over 80 investment companies and brokerage houses and 30 or more representative offices of foreign banks and financial institutions in 1997. Recent years have seen substantial growth in the industry, with banks expanding their range of services and networks. Foreign banks have been strong in establishing themselves in the market either through joint ventures or by buying into the market through the privatisation process.

The lending business has been generally short-term in nature - both as regards forint loans and foreign currency loans. However, margins continue to fall along with forint base rates. A syndicated bank loan market has been subject to rapid growth, despite aggressive pricing, and many facilities have been oversubscribed, with European and Asian banks keen to book Hungarian business. Project and structured finance is becoming more common and not yet subject to lower margins and lower return on equity.

Banks have heavily promoted electronic payments services and systems in an attempt to bind corporate customers and establish client loyalty. Such services continue to be developed to cater for additional client needs such as concentration accounts, electronic statements and cash pooling.

With the development and installation of electronic banking services at the customer end, banks are able to generate new business and to win over new clients throughout the country, without the need to establish costly branch networks to cover corporate clients. Even so, a substantial amount of business - both domestic and international - is still undertaken on a cash basis and this is likely to continue for the foreseeable future. International payment systems are equally advanced - with certain institutions offering same-day processing and same-day value. This is surely a service area, that will continue to be developed with banks investing heavily in new systems and up-to-date technology.

Given the geographic location of Hungary, its existing business links to other central and eastern European nations and the advanced state of the financial sector, Hungary is becoming a hub for business-between Western Europe and the east. Existing businesses that have been trading with eastern European partners for decades often serve as counterparts for east-west trade, and maintain a different risk perception to their western counterparts. Eastern European political risk may be more easily absorbed by the corporate sector and the commercial banks in Hungary than by their west European counterparts.

The competition between banks has become tougher, with joint venture banks and large privatised banks seeking to establish market share in one of central and eastern Europe's smaller and yet more advanced regions. Regulatory changes - which are ongoing - have forced the sector to respond with new strategies, products and services. The question arises as to whether the market is large enough to sustain the number of financial institutions in Hungary. No doubt some will adjust their strategies, others may establish alliances and some may fall by the wayside.

One thing seems certain - lending business at low margins cannot generate the growth needed to expand and develop in the Hungarian market. Product and service innovation and development - in treasury, trade finance, investment banking and other areas - may be the key. EU membership will bring with it changes in the banking sector and at the same time contribute to greater competition.

Czech banking

The explosive growth of leasing in the Czech Republic, Hungary, and other countries in central and east Europe, is helping to bridge the acute shortage of external investment finance, particularly for small and medium-sized firms. These are shunned by risk-averse local banks virtually throughout the region. Western manufactures' finance arms, such as Ford Credit, GMAC, VW, GE Capital, and AT&T Capital are entering the region in force, in some cases (GE Capital and Ford Credit for example) taking over small local banks so as to quicken their way into the local vehicle and consumer finance markets.

For the larger, robust local companies, another option which has been opening up lately, as credit ratings improve and more countries attain current account convertibility under the International Monetary Fund's article VIII, is the GDR (global depository receipts) and ADR (American depository receipts) routes into tapping the global debt markets. In this and other ways the situation is easing for some. But it is the basic development of longer-term local-currency financing sources that is needed, and in most parts of the region that prospect remains hostage to inflation fears. The time it is taking to build up well functioning banking and financial markets in these countries is not surprising.

None of the 27 countries has yet reached the end of the road on this matter (Appendix 5.14), not even the Czech Republic, where bank balance sheets have been cleaned up but industrial restructuring was largely left to be tackled until after privatisation had been substantially completed. Another tricky task on which different countries have come up with different solutions has been that of framing a policy on the licensing of new banks which balanced the objectives of promoting competition while maintaining the stability of the financial system. In the Czech Republic, for instance, stability was at first given primacy on the reasoned grounds that a stable banking system was vital while so much else in the economy was being changed. But there, and in Poland, Bulgaria, Slovenia, the three Baltic states, the Russian Federation and many other former Soviet republics, the granting of new banking licences became quite liberal, excessively so in some cases. As a result, much effort has had to be put into rescuing, merging, or closing failed banks, some of them quite large in relation to the local market, and into pursuing formal bank consolidation schemes. Minimum capital thresholds and capital adequacy standards have been progressively raised in most countries as part of a general tightening of regulatory and supervisory requirements. These are all essentially problems of transition.

The next stage is to deepen banking and financial markets. On the corporate side, this means banks catering for medium-sized and even smaller companies as well as the big "blue chip" companies. At the top end of the corporate banking market, margins are already shrinking as competition intensifies. In the retail market, it means more banks spending heavily on electronic systems and improved customer services so as to garner their own retail deposits as a cheaper funding source than interbank and other wholesale funding markets.

Foreign bank competition will become a progressively stronger driving force, especially in those countries that aspire to European Union membership and are committed to further banking and financial liberalisation under their EU association agreements. Western banks like Citibank, ING, ABN-Amro, and Creditanstalt, which have already become major players in the region, are looking for ways to descend the corporate ladder below the blue chip level, and not only in investment banking services. Many are also aiming to have a retail presence. Citibank, for example, now has a retail network in Hungary, Poland and the Czech Republic, providing high quality services and targeting the better-off customers. Potential market size is also becoming a factor in determining future strategy.

The Czech Republic has been outshone by only two other post-communist countries, Poland and Slovenia, in the speed and extent to which its economy has bounced back from the recession which engulfed the region after the collapse of the central planning system at the beginning of the decade.

In many ways Czech banking is the most advanced in east and central Europe. Because inflation is relatively low, Czech banks are prepared to lend longer than elsewhere; and market penetration, in terms of total bank deposits and total banking lending as percentages of GDP, is well up to west European levels. But a total of 12 bank failures in recent years have raised concern. They were all small banks, involving less than 4% of total banking assets (before the Agrobanka affair (Economist (1996d). But in retrospect it is clear that too many new banks were licensed in the early days of market reforms before banking regulation and supervision had been developed to the point where they could reasonably cope. The system has now been considerably tightened up, and capital adequacy thresholds have been raised. The potential for shocks persists however (Economist, 1997b). After selling part of Investicni Postovni Banka (IPB) to Nomura in 1997 emergency measures saw a government appointed administrator in charge in late 2000 (Euromoney, 2000). Bad loans consistently covered up by complex financial reporting caused a run on the bank.

Admittedly, the Czech Republic is not the only Central European country with rickety banks. All three Baltic states also have in recent years experienced banking crises triggered, in part, by fraud. In 1995 four big banks toppled in Latvia alone. The mess was resolved by letting the troubled banks collapse, without government compensation for depositors. Upon learning the Czech problems, the governor of Latvia's central bank, Einars Repse, offered this advice: "If dishonest or poor financial strategies are involved, there's no use in helping any bank because it will only consume taxpayers' money" (Economist, 1996b).

After sending interest rates skywards and blowing around $ 3 billion on efforts to keep the koruna within its trading band against a USD/DM basket, the central bank abandoned its semi-fixed exchange rate and let the koruna float freely. Since early 1996 the Czech economy, once considered the region's sprinting hare, had shown serious sights of stress. 1996 current account deficit, at 8.6 % of GDP, was among the world's biggest, driven by a trade deficit of $ 6 billion.

Hungary had then what the Czechs did not have a finance minister, Lajos Bokros, hell-bent on austerity. He introduced an 8 % import surcharge, backed by tax hikes and deep spending cuts. Real wages fell by 15 %, but the package worked. Government spending fell from 61 % of GDP in 1994 to about 50 % in 1996, and the budget and current account deficit was swiftly narrowed.

Another big difference between the Czech Republic and its neighbors lies in their approaches to industrial restructuring and institutional reform. Hungary had killed off over 30,000 companies. In Poland, too, banks had been made to liquidate or restructure ailing clients. In the Czech Republic there has not been a single major bankruptcy since communism collapsed. Hungary's wave on bankruptcies crippled its banks. The government reacted by privatizing them quickly and inviting in foreigners, thus speeding modernization: some 40 % of Hungary's banking capital is now in foreign hands. In Poland, too, financial prudence and sophistication had been imported. Several state-owned banks were sold.

Only a third of Czech problem loans were thought to be covered by provisions. The hidebound nature of Czech banking had stymied industrial restructuring. Some of this was because of the form Czech privatization had taken. The big banks set up investment fund arms during the voucher-for-shares mass privatization programme of 1992–94, which transferred stakes in some 1,600 companies to the public.

Hungary's approach to privatization was different. It sold state companies for cash, often to foreigners, rather than handing out shares to citizens. (Economist, 1997a).

Banking in the Baltics

The Baltic countries inherited the Soviet monobank system under which specialised state banks serviced specific branches of the economy. All three countries moved quickly to establish a two-tier banking system with the central bank at the core. None of the Baltic countries had personnel skilled in modern banking practices or an appropriate legal, regulatory, and supervisory framework. Moreover, a strategy had to be devised to handle the remnant of the Soviet banking system. At the same time, the Baltic countries had to face the twin challenges of encouraging the new private banking sector while ensuring that its growth took place in a prudent manner.

Initially, the three countries took different approaches. In Estonia and Lithuania, the specialised Soviet-era banks were reconstituted as state banks and then gradually or partially privatised. In Latvia, in contrast, the Savings Bank was reconstituted as a state bank but the branches of the remaining Soviet-era banks were privatised. Remaining banks were merged, rehabilitated, and then offered for privatisation.

All three countries have had extremely liberal policies toward the licensing of new commercial banks. A large number of banks, it was thought, would quickly generate the competition needed to drive down deposit and lending rates and provide the lending needed to support the emerging private sector. Many new private banks were established by enterprises to gain access to a preferential and much cheaper source of funding than was available from existing banking institutions. Little thought was given initially to the implications of this policy for bank soundness and supervision.

When a leading bank collapses the fall-out can be substantial, even in large countries. When a big bank collapses in countries the size of the three Baltic republics, whose populations range from 1.6 million in Estonia to 3.7 million in Lithuania, the knock-on effects can be traumatic.

In Latvia the knock-on effects of the Banka Baltija collapse have certainly been felt. One out of five Latvians held a deposit at the bank, of which they had seen back only the maximum of Lats 200 (370$) which the government undertook to cover in the case of personal deposits. Corporate and other depositors were not so lucky. The sharp liquidity crunch which ensued led to a sharp drop in corporate tax payments and a drying up of demand for Treasury bills, the government's principal financing instrument.

Estonian banks are today regarded as being among the region's best. The Estonian economy has also been moving strongly ahead, giving the republic the best record among the three Baltic states, with real growth averaging around 6 % a year since 1994, a modest current account deficit, relatively low external debt, substantial investment inflows, and a strong currency which remains pegged to the Deutschmark. Inflation, though declining, has remained stubbornly high.

Economic recovery will eventually quicken in both Latvia and Lithuania, too. Their banking systems will also, like Estonia's, emerge in stronger fettle. Capital requirements are being raised substantially in all three republics. In Lithuania, where the minimum capital threshold had once been the equivalent of a mere $30,000, the threshold has recently been doubled to Lits 10 million ($2.5 million). In Latvia it is rather higher at Lats 2 million, which was raised to Lats 3 million in 1998; while in Estonia the minimum target for equity capital is being raised in stages to Kroon 35 million ($3.1 million) by April 1997 and for Tier One capital (equity plus reserves as defined by the Basle committee of bank supervisors) to Kroon 75 million ($6.7 million) by January 1998.

The Baltic Republics of Estonia, Latvia and Lithuania are in the vanguard of the transition economies. The first fruits of their reform programs are now being seen in the revival of growth. But there are a number of factors that have threatened to derail the fledgling recovery. All three republics have experienced serious banking crises, which have set in train a process of structural change in their banking systems, and have, in some instances, had adverse political and economic repercussions.

The transition from central planning to a market - based system also exposed the structural deficiencies in the banking sector and the regulatory environment. The very tight macroeconomic policy framework pursued in all three countries created an environment that was not propitious for an emerging banking system. Banks, their customers, and bank supervisors were unable to monitor and control the risks inherent in the new policy environment.

A number of conclusions can be drawn from the Baltic countries' experiences. They may have implications for banking reform in other countries of the former Soviet Union, especially smaller ones. However, owing to the very specific nature of banking sector distress in transition economies, these conclusions should not be seen as having across-the-board validity for banking crises in more developed economies. Banking distress is inevitable in countries that have had no recent experience of market-based banking. This comes from the confluence of risk factors that put pressure on the fledgling banking sector. However, it also arises from the structural features of the emerging banking systems in the countries of the former Soviet Union. In particular, the existence of a plethora of poorly capitalised banks that are vulnerable because their capital is small and that, because of their size, have not reaped the benefits of portfolio diversification. Also, new banks are often too small to afford the investment in infrastructure that is needed to offer modern services. State-owned banks are invariably overstaffed, and this drives up their operating costs when their salary levels adjust to the higher levels in the private banking sector. These factors and the high-risk nature of bank lending in these countries have fostered high intermediation margins, and the high lending rates this has generated have further added to borrowers' debt-servicing difficulties.

Banking distress is likely to be a feature of transition in the countries of the former Soviet Union for some time to come. Governments in these countries should prepare themselves now - by strengthening their supervisory capacity and readying themselves for tough implementation decisions - to deal with the inevitable. Even if banking crises do materialise, they likely will not have such severe effects on the economy as a crisis of similar proportions might have in a more developed, traditionally market- based economy (Fleming and Chu,1997).

Belarussian banks

The banking system of the republic of Belarus is a two-tier one: the National Bank of Belarus and commercial banks.

The National Bank is authorised to control credit relationship, money turnover and has the only right for emission of money. Its functions, targets in financial-crediting system, legislative base of functioning are carried out in accordance to the Law of Belarus "About National Bank of Belarus Republic".

There are 27 commercial banks in Belarus with 10 of them having overseas share ownership, 1 foreign branch (Russian "Mossbusinessbank"). Commercial banks have 550 branches on the territory of Belarus.

The banking system has already passed its busiest level of development, when there were 10 and more banks registering every year. In 1995 the number of banks functioned in Belarus reached 50. But eventually, since most of them did not have strong financial and managerial-technical potential, many were liquidated, restructured or combined with other banks.

There is a strong core of main commercial banks in Belarus, so-called "The Big Six": Belpromstroibank, Belvniesheconombank, Belagroprombank, Belarussbank, Priorbank and Belbusinessbank. These banks are highly developed with strong potential, wide net of branches and correspondent relationships.

The National Bank has neglected its policy of direct credits to different spheres of national economy. This function is more effectively performed by commercial banks. The National Bank of Belarus keeps on working on further improving the banking system, providing a stable and predictable exchange rate and a positive level of interest rates.

Russian banks

The development of capital markets and commercial banking presents some of the most difficult policy challenges for countries in transition to a market economy. The growth of commercial banking in the Russian Federation in the 1990s has been dynamic. Russia began economic transition without even the semblance of a banking sector as exists in a market economy. By the mid-1990s, over 2,500 commercial banks were operating throughout the country, most of which were newly created and private. In the last few years, a very strong dichotomy has emerged between a handful of rapidly growing large Moscow banks and the rest of the banking sector, most of which has been experiencing increasing financial distress. The government formed in March 1997 announced goals of reducing or eliminating special privileges for these large banks.

In 1998, after the first decade of development, an absolutely new banking system was formed in Russia in the aftermath of crisis. At its core are commercial banks technically equipped with newest informational systems and software. The crisis of the Russian banking system in 1998 was played out against the backdrop of an economy in recession. The main factors that determined the crisis situation in Russia in August, 1998 were as follows:

- A worsening GDP level
- A currency crisis
  Foreign debt rose in volume and the worsening "flight of capital" was augmented by capital outflow to repay debt.
- Inability to service foreign debts
  Russia had very low foreign currency reserves, which shrunk from $ 24.5 billion to $14.6 billion in 1998. This led to an aggravation of the stable relationship with the IMF and uncertainty of further systematic financing by the IMF.
- Political instability
  Boris Yeltsin's "illness" and the rapid turnover of Prime Ministers, as well as the strong showing of Nationalists in elections gave the impression of weakness and instability at the highest level. This in turn led to destabilization of the domestic financial market.

During the first week of crisis the government and Central Bank applied set of procedures in order to stabilize the situation.

Strict foreign currency control was enacted with moratoria on repayment of foreign loans announced on 17th August. Other measures included prohibitions on investments with a maturity over 1 year, backed by issues of short-term government bonds in an attempt to fund the budget deficit.

This period also saw the Central Bank provided tight monetary policy. From 24th August the refinancing rate was increased to 60 %, liquidity of commercial banks lowered to a level of 20-30 % compared to the beginning of the year. The overnight credit rate was increased to 150 %, and 50 biggest commercial banks were to provide the Central Bank with currency position report and to close it daily.

Unfortunately these actions were not as effective and could not avoid ruble exchange rate crash.

During the Central Bank interventions from 17th till 26th of August 1998, the exchange rate fell from 6.29 to 7.86 RUR/USD (down 25 %). The RCB reserves fell by $ 5.9 billion. After intervention was stopped – from 26th of August till 2nd of September the exchange rate was administratively kept on 7.86 (there were no operations on the Moscow exchanges during this period) then evenly decreased to 9.3301 RUR/USD – still within announced corridor. After that the corridor was cancelled and free rate flotation was established. So, the exchange rate devaluated to 20.825 RUR/USD (by 9th.September 1998), and the total devaluation since the start of the crisis was 331 %.

The main reasons of Russian crisis are still present – whole economic crisis and production decline, serious budget deficit, and internal governmental debt. Some of these problems have been aggravated. One of the main reasons was sharp devaluation of the ruble during first 1½ months of the crisis period, which caused serious panic in the banking system.

The August crisis damaged citizens' trust of Russian banks. The volume of ruble deposits (excluding Russian Savings Bank's figures) were decreased from August 1998 till February 1999 by 45 % (from 33.6 billion rubles to 18 billion rubles), foreign currency deposits decreased from 2.9 to 1.7 billion USD, or down 56 %.

As a fact, after the default in Russia on August 17 1998, the same situation of related stock jobbing demand for USD appeared in Ukraine. Fortunately, a set of proper procedures, eliminating the arbitrage dealings with foreign currency and enabling the faster establishing of proper rate evaluating mechanism than it was in Russia, helped Ukraine to avoid such serious losses than in Russia. Thus the stabilisation on Ukrainian exchange and financial markets was more fortunate and successful, but the problems in Ukraine are still serious and their solution, as in Russia, is impossible by monetary or exchange policies alone.

Conclusion

The parlous state of the Ukrainian political environment and the knock-on effect on the economy are thrown into clear relief when viewed against the progress made by other former communist states in the region.

Belarus alone, from the selected states, has been later and less willing to reform to create open markets. Of all the key measures available Ukraine appears to have the lowest base from which to improve. In real GDP terms National Income has fallen lower than the average for the CIS and considerably lower than Eastern Europe. Inflation in 1992/93 was worst in Ukraine although, to balance this, it shows no signs of re-emergence, unlike Russia and Belarus. A persistent problem is the legal and illegal capital flight from Ukraine, not replaced by foreign direct investment. Market reforms are still not advanced enough to stem this outward flow and the low level of capital formation goes some way to explaining the avenues for profit that Ukrainian banks have sought.

Banking development has kept pace, more or less, with economic progress as seen in this chapter. Foreign investment can be seen as a significant indicator of economic and legal reform processes. Poland, in particular, benefits hugely from German interest whilst Ukraine banking is still in the hands of Ukrainian capital.

CHAPTER FIVE

RESEARCH METHODOLOGY AND FINDINGS

Introduction

The key objective of this research is to uncover the major forces that have shaped the development of Ukrainian banking between independence in 1991 and the new millennium. Good research design suggests that if the objective is clear the appropriate methodology follows logically (Miles and Huberman, 1984). Miles and Huberman made this suggestion, however, against a US economic and social background in which information and data are readily available, survey questionnaires are commonplace and cultural norms expect transparency from public institutions. Unfortunately, for the researcher in Ukraine, certain obstacles and barriers have to be overcome before "normal" methods can be adopted. Specific instances of this are detailed later.

This chapter looks at the combination of research methods used in the research together with a brief summary of those methods considered but discarded, largely because they were unlikely to have worked in the Ukrainian setting. The chapter goes on to introduce the key primary research tool used and to discuss the design of the interview questions used. Findings from the primary research are displayed in the last part of this chapter.

Primary research findings are used in this research to underpin and amplify interpretation from secondary data sources. Although 31 interviews were carried out over the period of the research there are no claims that these form a representative sample of Ukrainian banks and bankers. Sample design has, however, been influenced by the need to gain views from as wide a selection of banks and bankers as possible.

Research methods used

Three methods of research and data collection form the heart of this thesis. These are: a literature search, interpretation of secondary data on bank performance and survey interviews with senior bankers. Each of these methods is dealt with in turn:

Literature Search

Very early in this research it became clear that no other specific academic study was being undertaken in this area. Whilst some general papers on post-communist transition appeared few mentioned Ukraine and fewer still centred on Ukrainian banking. Where applicable key papers are highlighted and used but the bulk of written information specific to Ukraine is provided from publications such as The Economist, The Banker and Euromoney. Where possible data provided in these publications has been verified and supported by reference to data from the National Bank of Ukraine.

General literature has been helpful in writing Chapters 2 and 4 of this thesis as they rely on factual information in the public domain to build a picture of the economic, political and social background.

Access to literature in Ukraine is limited and this aspect of the research was largely undertaken by using search facilities provided at Loughborough University. Most literature accessed has been written by Western observers and in English, factors that may help to explain the critical viewpoint often taken. In addition the economic scene in Ukraine changed rapidly during the period under consideration which meant that emphasis on journalism and news rather than scholarly papers was necessary.

Secondary data

Secondary data on the performance of the Ukrainian economy and that of Ukrainian banks forms the basis of Chapter 3 of this thesis. As with the literature survey the difficulty was finding consistent, credible data. For the sake of consistency, however, National Bank of Ukraine Economic data is used in Chapter 2. The caveats surrounding this are many and are detailed in Chapter 2. The key problem with using any official governmental data is that it is incomplete and subject to poor data gathering, especially in the years to 1996. The existence of a large unofficial economy (black market), caused, in part, by repressive taxation regimes affecting legitimate enterprises, also helps to cloud the real levels of GDP and inflation. Chapter 2 chronicles the NBU fight against inflation and the legacy of its former policy of monetary expansion to stimulate the economy. Once again, the extreme levels of inflation in 1993 and 1994 serve to affect other economic factors for some years afterwards.

The use of secondary data in Chapter 3 is also affected by incompleteness of information. Chapter 3 relies on a commercial database, Bankscope, which records Ukrainian bank reported accounts. A major change in audit systems (to international standards of transparency) in 1996 means that data prior to this date may be suspect, since it relates only to the less transparent Ukrainian accounting system. Accordingly the analysis in this thesis relates to the period since 1996 only.

As major organs and conduits of state policy in former times, the larger banks (including Prominvestbank, Ukrsotsbank and the Oschadbank) retain a tradition of conservatism and secrecy. Available data must, therefore, be viewed in this light. Lastly, whilst data on individual banks may be consistent, data on all banks is subject to the changes in the structural environment brought about by successive bank failures.

Primary data and survey research

Primary data, in the context of this research includes original NBU documents, regulations promulgated to banks and internal bank information obtained in the ordinary course of the author's work. Primary data also includes the survey research, conducted amongst senior bankers.

In order to obtain a fairly representative sample of senior bankers to respond to the survey questions it was necessary to review alternative methods of access. It was also necessary to ensure that response rates were maintained at a high level.

Of the three possible methods available, postal or telephone survey and face to face interview the latter was chosen for the reasons given below. Although postal and telephoned surveys presented themselves as ways in which larger and more representative samples could be gained, the practical and cultural difficulties that would have been encountered were insurmountable. Regrettably both postal and telephone systems in Ukraine fail to reach the standards of Western Europe. Delays encountered and uncertainty of contact combine to make these methods risky for the researcher.

In addition to this the culture of written or telephoned questionnaires is virtually unknown in Ukraine and it was judged that potential respondents would have been hostile to such impersonal methods.

Although face to face interviews were likely to be the most time consuming survey method they did have the advantage over other methods of allowing more open questions and discussion. Having said this, the survey design did use some considerable prior instrumentation in order to retain focus and to make best use of the limited time made available by respondents (see Research design chapter below).

One key component of the decision to use an interview methodology was the author's unique access to senior bankers by virtue of his own senior position in Bank Ukraina. Prior personal and professional knowledge of the bankers interviewed resulted in very few refusals. The author's position also added considerable credibility to requests for interview.

In all 31 interviews were undertaken ranging across both Kiev and regional banks, large and small banks, former state and new commercial organisations (see research findings). It should be noted that the institutional relationship between Bank Ukraina and the banks interviewed may impose some bias in the responses but this is not considered to be a serious flaw. Questions on macroeconomic and political influences are unlikely to have been affected in this way. More sensitive information on future plans and strategy may have been coloured, however. For the most part respondents restricted themselves to information that was already in the public domain through financial reporting, NBU reporting or publicity material.

Research design

Following Miles and Huberman (1984) the detailed design of the research sample, the research questionnaire focused on the key drivers of change and development in the banking market suggested by the basic PEST conceptual model and the emphasis apparent from the review of literature reported in Chapters 2 and 3. Questions naturally concentrated on more recent events but some of the responses show that past experience has coloured current strategies. Time allocated by respondents to each interview was limited, due to the nature of their jobs.

Interview design

The structured questionnaire used as an interview template is displayed at Appendix 4; Figure 5.1 provides a summary of the areas covered:

Figure 5.1 Summary of interview topics

Topic	**Question numbers**	**Question types**
Political situation	1,2	Open ended
Legal framework	3,4	Open ended
Economic situation	5	Closed
Impact of IAS	6	Open ended
Individual bank development (internal)	7 to 13 and 18,19	Open ended and closed questions
Banking competition	14	Open ended
Staffing issues	15,16	Open ended
Technology	17	Open ended

Most of the questions were designed as "Open–ended" in order to extract more qualitative and descriptive detail from respondents. The questioning strategy was to pose the question and to be ready to prompt in order to open up the response further.

The Ukrainian character, whilst hospitable, frank and honest is not voluble and so mechanisms needed to be adopted to explore and clarify some brief answers. These mechanisms were not always successful, however, due to the short time often allocated to the survey by respondents. Interviews typically followed business meetings with the author.

Sample selection

The greatest concentration of bank head offices is, naturally, in Kiev. All of the "System" banks are based there along with a good number of small and medium sized institutions. In selecting banks to approach it was felt necessary to include all of the largest banks, since their nation-wide presence and economic influence would be significant. It was also felt necessary to approach a selection of banks outside Kiev. Tables 5.1 and 5.2 summarise the size criteria and location of all respondents. These show a reasonably good spread of respondents both geographically and by size of institution, a feature indicative of responses being representative of the population of banks as a whole.

The focus of the research required access to banks at a high level of management, commensurate with an understanding of the environmental factors affecting Ukrainian banks and the strategic development of individual institutions. Board level respondents would appear to comply with these criteria. Table 5.3 summarises the job titles of the 31 respondents, confirming that 97% were Board members, with 55% holding leading board posts.

All interviews were carried out in the Russian or Ukrainian language and responses recorded manually. Use of tape recording would, it was judged, have reduced the level of candour shown by respondents. Transcripts were translated to English by the author.

Table 5.1 Ukrainian banks in study sample

Size	Size criterion	Sample banks**	Total banks	%
Big	Assets over 40 million hrv*	12	18	66%
Small	Assets under 40 million hrv*	19	199	10%
	totals	31	217	14.2%

* Based on 1998 Asset values (see appendix 2)

** A full listing of respondents is given in Appendix 4

Table 5.2 Location of banks in study sample*

Region	City	Large banks	Small banks	Total banks	% of respondents
Central/North	Kiev	9	11	20	64.5%
	Chernigov		2	2	6.5%
East	Donetsk		1	1	3.2%
	Dnepropetrovsk	1		1	3.2%
	Charkov		1	1	3.2%
	Zaporozye		3	3	10.0%
South (including Crimea)	Simferopol		1	1	3.2%
	Odessa	1		1	3.2%
West	Lvov	1		1	3.2%
totals		12	19	31	100%

* A full listing of respondents is given in Appendix 4

Table 5.3 Job titles of respondents

Job Title	Sample banks*	% of respondents
Chairman of the Board	7	22.6%
Deputy Chairman of the Board	10	32.3%
Member of the Board	13	41.9%
Other executive	1	3.2%
totals	31	100%

* A full listing of respondents is given in Appendix 4

<u>Interpretation of responses</u>

The interview responses were written at the time of the interview or immediately afterwards in all cases. As the interviews were carried out in Ukrainian or Russian language translation to English was undertaken by the author.

Interpretation of the transcripts was a basic and simple process. Most answers were easily classified into "positive", "negative" or "no influence", where applicable. More textual or freeform responses were classified post-hoc by the author in the terms displayed in the following tables.

In some cases the interview questions were forwarded to respondents in advance so that answers could be prepared. In all cases prompts were designed to allow a selection of answers to be chosen although the option to give a response not on the selection list was given too.

Research findings

Presentation of the survey findings follows the structure of the interview template displayed in Figure 5.1. The template itself is displayed at Appendix 4 but questions are summarised here too. In each chapter of the findings the intention is to present the summary responses of senior bankers, categorised under the size and location criteria discussed earlier. No significance is intimated by displaying the responses in this way although some commonalties and differences in viewpoint can be highlighted.

The political environment

All interviews opened with two questions about Ukraine's political situation in 1998. The May 1998 parliamentary elections had not resolved the political stalemate and President Kuchma could look forward to little co-operation and little progress of his reforms. Presidential elections were still six months away, at least, adding to the atmosphere of uncertainty.

Responses to the questions on the effects on banks of the political situation, generally (Table 5.4) and the May 1998 elections in particular (Table 5.5) show that 58% of big banks and 47% of smaller banks were affected by the situation. The remainder felt there to be no influence at all. One banker suggested that his bank (a large Kiev based institution) was "apolitical", a strange claim, given the institution's history as an organ of Soviet policy.

It is noted that impact of the political situation was felt more in Kiev (55%) than in regions (45%) with most of the effects being positive in nature. The importance of Kiev in Ukrainian politics is not underestimated in this regard.

The larger banks reported more negative effects due to the requirement of them to continue to fund former state industries that could not repay loans (mainly former state banks). Additionally government policy was for greater amounts of debt to be financed by these institutions. Such demands reduced liquidity, threatened capital adequacy and prevented larger banks from demonstrating a more commercial outlook.

The overall effects of this were also felt to include a slowing of growth and dampened demand for bank services, especially amongst personal customers. Political and country risk heightened and this made for higher risk premia on Ukrainian Financial Instruments in international markets.

This table reports the answers to question 1.

Table 5.4 The influence of the political situation in 1998/99 on banks

	Negative	Positive	No influence	**Total**	**% of resp. n=31**
Big banks	6 (50%)	1 (8%)	5 (42%)	**12**	**39%**
Smaller banks	6 (32%)	3 (16%)	10 (52%)	**19**	**61%**
TOTAL	**12**	**4**	**15**	**31**	**100%**
% of resp. n=31	**39%**	**13%**	**48%**	**100%**	

	Negative	Positive	No influence	**Total**	**% of resp. n=31**
Kiev-based	8 (40%)	3 (15%)	9 (45%)	**20**	**65%**
Regional	4 (36%)	1 (9%)	6 (55%)	**11**	**35%**
TOTAL	**12**	**4**	**15**	**31**	**100%**
% of resp. n=31	**39%**	**13%**	**48%**	**100%**	

Around 33% of big banks and 42% of small banks reported a negative impact of the 1998 elections on their business activity. A further 58% and 37% respectively felt that it had no influence at all. The impact was felt equally in Kiev and the regions.

Of the larger banks more (55%) reported "no influence" from the 1998 elections than they did on the political situation before the elections (45%). At the same time fewer (33%) reported a negative impact than before (50%). Whilst this represents the responses of a small number of banks these are amongst the largest in the country and the most influential. It also indicates a better political atmosphere post 1998 for the larger banks. In contrast more smaller banks (42%) reported a negative influence than before (32%).

Amongst those banks detecting a positive impact on their business activity were those that had successfully fielded their own "independent" parliamentary candidates. Frustrated by the lack of reform the banks had acted to place their own people in positions of influence.

Table 5.5 reports the answers to question 2.

Table 5.5 The impact of parliamentary elections on the business of banks

	Negative	Positive	No influence	**Total**	**% of resp. n=31**
Big banks	4 (33%)	1 (8%)	7 (58%)	**12**	**39%**
Smaller banks	8 (42%)	4 (21%)	7 (37%)	**19**	**61%**
TOTAL	**12**	**5**	**14**	**31**	**100%**
% of resp. n=31	**39%**	**16%**	**45%**	**100%**	

	Negative	Positive	No influence	**Total**	**% of resp. n=31**
Kiev-based	7 (35%)	4 (20%)	9 (45%)	**20**	**65%**
Regional	5 (45%)	1 (9%)	5 (45%)	**11**	**35%**
TOTAL	**12**	**5**	**14**	**31**	**100%**
% of resp. n=31	**39%**	**16%**	**45%**	**100%**	

The shift of opinions following the 1998 elections, however, might be explained by the euphoria of parliamentary success rather than the realistic expectation of political change.

Legal framework

Amongst the many reforms called for in Ukraine liberalisation of the tax laws is considered to be one of the key changes needed to encourage enterprise and growth. Income tax and profit taxes combine with Value Added Tax to limit legitimate enterprise and to encourage a culture of tax avoidance. Few new enterprises emerge since combined taxes can drain away up to 75% of earnings when declared. This is, of course, following large start-up fees.

There are also specific taxes on banks and high duties on imports as the government tries to raise revenue wherever it can.

Respondents agreed unanimously that tax law liberalisation would be one key measure that would affect their own and their customers' businesses positively. There was less agreement, however, on the specific taxes that needed to be changed, as seen in Table 5.6.

This table reports the answers to question 4.

Table 5.6 Tax changes sought by respondent banks

Taxation changes sought	**No. of responses***	**% of respondents (n.= 31)**
Simpler tax structures	22	71%
Lower bank taxes	16	52%
Simpler import/export procedures	12	39%
Lower specific taxes **	11	35%
Universal tax code in Ukraine	5	16%
Simplify bank tax laws	2	6%
Liberalise taxes (no specific feature)	2	6%
Lower business taxes	1	3%
Total:	71	

* *Banks made multiple responses.*

** *Including lower currency dealing tax (4) and removal of tax on transfer of assets by pension funds (6).*

The clear indication from this research is that banks and their customers seek reform with reduced layers of complexity and fewer instances of double taxation. Whilst these elements are part of government policy (and a substantial part of the presidential manifesto in 1998) the reality of reform is somewhat different. Government is constrained by increasing central expenditure but low levels of declared economic activity on which to impose taxes.

Ukrainian bankers have their own shorter-term interests at heart as 52% called for lower bank taxes yet only 1 called for lower business taxes - a feature that would stimulate the economy through fiscal means and stimulate demand for bank services. The short-termism is clear from discussions and underlines the way in which banks have survived during the 1990's. Banks specialising in trade finance had specific regard to the draconian customs duties and time consuming procedures.

It is noted that during the discussion of reform banks offered no views on privatisation. Banks, of course, were privatised at an early stage after independence, yet still display many of the characteristics of state banks by virtue of the heavy regulation placed upon them.

<u>The economic situation</u>

The parlous state of Ukraine's economy for much of the 1990's is described fully in Chapter 2. When asked about the state of the economy in 1998, however, responses were made against a background of improving inflationary control, abandonment of monetary expansion as a tool of policy and a currency crisis. The Russian financial crisis was also fresh in the minds of bankers.

Unsurprisingly all of the larger banks and most of the smaller banks (58%) reported negative effects of the economic troubles on their businesses. Some smaller banks (32%), however, reported some positive effects as shown in Table 5.7. Mainly these banks are located in Kiev, and their new management teams could successfully work in those difficult economical conditions by taking advantage of opportunities more swiftly than regional counterparts.

The dichotomised findings shown in Table 5.7 can be explained by the fact that most of big banks are system banks, oriented to servicing big corporate clients, usually government owned or government supported. These banks were often obliged to lend to failing industry sectors, against all prudential considerations. Negative consequences were also caused by big holdings of OVDP (Government bonds) in their asset structure at the time of the currency and financial crisis.

Table 5.7reports the answers to question 5.

Table 5.7 Responses on the impact of the economy on bank activities

	Worse	Better	**Total**	**% of resp. n=31**
Big banks	12 (100%)	0	**12**	**39%**
Smaller banks	13 (58%)	6 (32%)	**19**	**61%**
TOTAL	**25**	**6**	**31**	**100%**
% of resp. n=31	**81%**	**19%**	**100%**	

	Worse	Better	**Total**	**% of resp. n=31**
Kiev-based	15 (75%)	5 (25%)	**20**	**65%**
Regional	10 (91%)	1 (9%)	**11**	**35%**
TOTAL	**25**	**6**	**31**	**100%**
% of resp. n=31	**81%**	**19%**	**100%**	

Smaller banks were more careful with OVDP purchase and had no pressure from the government to fund "lame ducks"". Thus 32% of smaller banks questioned reported that they had improved their activity since the crisis. These comprised mainly banks that focused on servicing exporters and those which had shown their solvency and stability in daily clearings during the crisis.

Bank stability in the time of crisis caused an inflow of clients from less stable banks. Thus, Kiev based small and medium sized banks (as in Russia) were the only ones that had shown high-class management skills, flexibility and had taken a good advantage of the crisis. Smaller regional banks were cushioned from the demands of government but were in a less favorable position to benefit from niche markets.

The impact of International Auditing and Accounting Standards (IAS)

International pressures from the World Bank and the IMF and the desire to expand beyond Ukrainian borders encouraged Ukrainian banks to convert to International Accounting Standards in 1996. The key difference between Western and Ukrainian accounting practices was in the treatment of bad and doubtful debts. Under Ukrainian procedures bad debts were not shown clearly and certainly not judged to be "bad" sufficiently.

This table reports the answers to question 6.

Table 5.8 The impact of conversion to International Accounting Standards

	No. of responses*	% of respondents (n.= 31)
Greater transparency for investors/creditors	13	42%
Easier to trade with international institutions	19	61%
Easier to trade on interbank market	5	16%
Worsening financial ratios	1	3%
No difference**	2	6%

* *Banks made multiple responses*
** *Societe Generale and Credit Lyonnais used IAS before.*

For banks, reliant on good quality assets in order to maintain prudential ratios, the switch to IAS was potentially hazardous. Many of the larger banks had inherited former state industries as customers and had been obliged to continue to lend to them.

As a result of changing the accounting system in banking sector to the IAS most of the commercial banks have noticed that some banking activity ratios became worse. Overwhelmingly, however, the change was welcomed, as Table 5.8 shows. Most banks considered that balance sheet data became more clear and transparent for management as well as for creditors. This was seen as a very positive effect. The simplified procedures of international audit also helped to improve relationships with foreign financial institutions. Another positive point mentioned was the reduction of risks on the domestic market due to a better understanding of the banks' own operations.

An example of the impact of IAS on the accounts of Bank Ukraina is given at Appendix 4.2. Here the re-stated assets for 1995 showed a decline of 17.7% to $811 millions as bad debts were provided for. His had the inevitable knock-on effect on profits. These fell almost $100m to $25m.

The Marketplace

Perhaps the most important aspects of this wide-ranging survey were the questions relating to each bank's orientation to the market. The questions in this chapter cover deposit attraction, products, foreign and domestic expansion and the threat posed by Western and Russian banks entering the Ukrainian market.

Deposit attraction should be an important part of the expansion of any bank and Ukrainian banks are not unaware of this "cheap" source of funding. However, since the National Bank of Ukraine implemented reserve requirements on citizens' deposits at 17% some commercial banks stopped paying serious attention to this source of funds (some of them even gave up their licenses). The majority of banks, however, keep on attracting deposits as shown in Table 5.9, underlining the importance placed on this by creating a special department at head office to attract deposits.

A contrast should be made here with the low credit ratings of Ukrainian banks making external wholesale deposit attraction relatively difficult. The poor record in wholesale deposit attraction would also limit the ability of Ukrainian banks to expand their product portfolios. Financial innovation based on widening the scope of maturity transformation would only come with better access to wholesale funds (see Chapter 3).

Unfortunately few banks detailed the methods used by their "special department" and had not, perhaps understood the question correctly. Commercial sensitivity to deposit attraction plans may also have coloured responses here. Mostly, however, the banks concentrate on the attraction of larger deposits from individual organisations, other banks and institutions. Mainly funds attraction was better in such cities as Kiev, Zaporozye, Charkov, Dnepropetrovsk.

Table 5.9 reports the answers to question 7.

Table 5.9 Mechanisms for attraction of private deposits*

	Big banks		**Small banks**		
Figures in brackets show % of bank type	**Reg.**	**Kiev**	**Reg.**	**Kiev**	**% of resp.**
"Special department" plus top management and shareholders	3 (100)	8 (88)	7 (87)	8 (73)	84%
Advertising	0	1 (11)	0	4 (36)	16%
Competitive interest rates	0	2 (22)	0	4 (36)	19%
Deposits not important	0	1 (11)	0	3 (27)	13%
No licence held	0	0	0	1 (9)	3%
Totals*	3	12	7	20	
Number of banks	*3*	*9*	*8*	*11*	

* *Banks made multiple responses*

Interestingly, the smaller banks, including the western owned ones, use consumer advertising (banks are amongst the largest TV and Press advertisers in Ukraine) and competitive interest rates to attract deposits.

It is interesting to note that it is the smaller banks that perceive a more competitive marketplace than the larger banks. The smaller banks also adopt competitive strategies based on price (interest rates) and non-price (advertising) than their larger rivals.

The impact of inflation and wide variances in official rates, however, makes the interest rate a difficult tool to use. Data are difficult to obtain on advertising expenditures but budgets of 300,000 to 400,000 UAH (US$ 100,000) are expected for banks with gross assets of 100 million UAH or above. Prominvestbank also provides sponsorship for Ukraine's top football team - Dynamo Kiev as part of its advertising strategy.

Two questions were asked about the development of new products as a way to measure the markets to which banks are addressing themselves. All banks questioned declared interest in developing new products. The range of products available in Soviet times was very limited and following independence the aggravation of the general economic and political situation, uncertainty, high risk loan business most commercial bank moved towards expansion of their services.

Expansion of products and services is also caused by bank clients' demand for new products. In 1999 these factors conditioned the appearance of the products shown in Table 5.10 amongst respondents in the Ukrainian banking sector.

Plastic cards and entry to the international card networks, Visa and Mastercard, are prominent products for many commercial banks. Prior to full currency convertibility in Ukraine cash deposits were required to support card applications. The banks are moving in the direction of credit provision to individuals but this is still limited to the most affluent individuals.

Most product development has been in the bank-to-bank market with clearing and settlement products and systems featuring. This underlines the emphasis placed by commercial banks on institutional lending and securities markets rather than commercial and consumer credit markets.

This table reports the answers to question 9.

Table 5.10 New products offered by respondent banks*

	Big banks		Small banks		
Figures in brackets show % of bank type	**Reg.**	**Kiev**	**Reg.**	**Kiev**	**% of resp.**
New management systems	0	5 (55)	1 (12)	0	19%
Security operation services	0	2 (22)	4 (50)	1 (9)	22%
New operation software systems	0	4 (44)	0	1 (9)	16%
Plastic card services	0	5 (55)	5 (63)	2 (18)	39%
Settlement products	0	2 (22)	0	2 (18)	13%
Other	3 (100)	2 (22)	3 (37)	3 (27)	35%
totals	3	20	13	9	
Number of banks	*3*	*9*	*8*	*11*	

* *Banks made multiple responses*

Examples of "new operation software" abound. PUMB and Raiffeisen Bank (not in the study sample) have installed MIDOS software whilst Bank Ukraina uses ABRAXSYS software. Both MIDOS and ABRAXSYS have been developed for activity analysis and the control of risk and dealing.

In its annual report for 1995 First Ukrainian International Bank lists its achievements in advancing technology since foundation in 1991. The poor state of Ukrainian telecoms, it says, has been responsible for a decision to use satellite communication channels, as they seem to be the "most economically reasonable and most rapid solution" (First Ukrainian International Bank, 1996). The report goes on to announce the intention to install satellite stations in branch offices and at head office in 1996, linking them to a hub station outside Ukraine to ensure good links to international telephone, fax and data transmission lines.

Despite the small sample size a clear picture emerges among respondent banks. The picture is that loan activity is the priority in Ukrainian banking at the moment. Table 5.11 shows that 74% out of all questioned banks consider credit one of the most important (or the only important) products offered. Both big and smaller banks seem to be equally active in this area. Regional banks seem to place more importance on loan based business than Kiev based ones (91% against 65%). The loans provided for clients are in national currency – hryvna and foreign (according with currency legislation) – mainly in US dollars. The interest rate in US dollars is still quite high –

18% -22% per year. A number of big banks attract funding at the international markets and provided loans to national companies.

Following loan activity bank managers pay significant attention to settlement procedures (58%). Settlement products and services are offered equally by large and small banks although the larger banks dominate the inter-bank market. During the currency crisis situation, daily "in-time" settlement between partners is very important for maintaining the confidence of clients. The better service a bank provides, the more chances that clients will chose this particular bank.

Table 5.11 shows that 66% of big banks, and 53% of smaller banks consider clearing services a very important product of their activity. Kiev based banks are more concerned about their clearing products than banks, based in regional centres (65% against 45%).

As for inter-bank crediting, 35% of all questioned banks cited this as a key operation. 50% of big and 26% of smaller banks are quite active in this sector, the activity is seen equally in Kiev and regional sector. The more active behaviour of bigger banks can be explained by larger turnovers at the money market. Larger banks are significant market players in a small market. Their inter-bank activities can influence the whole market quite markedly.

Table 5.11 Key banking products*

Figures in brackets show % of bank type

	Interbank operations	Settlement products	Security operation	Currency operation	Loan facilities	No. of responses	No. of banks
Big banks	6 (50%)	8 (66%)	1 (8%)	1 (8%)	9 (75%)	25	12
Smaller banks	5 (26%)	10 (53%)	3 (16%)	5 (26%)	14 (74%)	37	19
TOTAL	**11**	**18**	**4**	**6**	**23**	**62**	**31**
% of resp. n=31	**35%**	**58%**	**13%**	**19%**	**74%**		
Kiev based	7 (35%)	13 (65%)	1 (5%)	1 (5%)	13 (65%)	35	20
Regional	4 (15%)	5 (45%)	3 (27%)	5 (45%)	10 (91%)	27	11
TOTAL	**11**	**18**	**4**	**6**	**23**	**62**	**31**
% of resp. n=31	**35%**	**58%**	**13%**	**19%**	**74%**		

** Banks made multiple responses*

One traditional way for banks to garner more deposits is to expand branch networks (see Chapter 3). Although this method is in decline in Western Europe the lack of networks of branches in Ukraine makes this a viable strategy. Against this background, the poor availability of qualified staff and the uncertainty still apparent in the economy mean that only 29% (9) of respondents are planning to expand branch networks in Ukraine. Table 5.12 shows the breakdown of respondents planning to expand domestically.

This table reports the answers to question 11.

Table 5.12 Respondents with domestic branch expansion plans

	Big banks	Smaller banks	Kiev based	Regional	TOTAL
No.	2	7	4	5	**9**
% of bank type	*17%*	*37%*	*20%*	*45%*	***29%***

From this response it is apparent that the smaller and regionally based banks seek expansion in the retail sector through branch networks more then the Kiev based and larger banks. As the responses showed earlier the ability of smaller, regional banks to compete in the inter-bank market and the wholesale sector is limited by capital and communication problems. The network expansion strategy, therefore, is a logical one and builds on the growth opportunities offered by a largely un-banked population.

Most banks showed a desire to expand abroad, although only one (Prominvestbank) indicated that it would be opening branches abroad. The remainder would seek to expand by opening correspondent accounts with established banks.

This more cautious approach is, again, a logical and consistent one. It accords with the Western Banking development model outlined in Chapter 3 and with the capital constraints of Ukrainian banks at the time of the research. A correspondent network strategy is likely to promote awareness of Ukrainian markets and to build trust both internally and externally.

Caution and a domestic focus still appear to be the bedrock of decision making amongst respondents.

A final question in this chapter concerned the threat of competition from Western and Russian banks. Only Bank Ukraina (with its close working relationship with overseas banks) recognised the longer-term threat from US and European banks. No banks considered the crisis-ridden Russian banks as a problem.

The key reason for this appeared to be that only Ukrainian banks were willing and able to offer lending facilities in Ukraine and the Western banks that had opened offices in Kiev offered only a limited range of products and services. Of course the foreign banks will become a more dangerous threat as economic and political stability emerge but at the moment Ukrainian banks do not consider them to be a threat. Again, this displays the short-termism that Ukrainian banks have become accustomed to. Few interview respondents suggested that there existed a longer-term strategy that planned for expansion beyond a 2-year horizon. Clearly there is scope for more strategic thinking in the institutions visited although in times of economic and political uncertainty it is difficult to see how matters could be otherwise.

Personnel matters

In an economy with high unemployment staff retention does not appear to be a problem for banks. Unfortunately, however, the better, more qualified and experienced staff shows greater signs of mobility.

Most bankers find that qualified staff are quite hard to find in Ukraine. This is due, in part, to the newness of the banking system and the high demand for banking specialists. The old (Soviet-era) staff do not have the right qualifications and skills for management in market economy. Unfortunately, however, newly qualified graduate specialists do not have enough practical experience.

Banks are trying to remedy this by forging relationships with Ukrainian Universities and sponsoring banking qualifications. The University of Trade and Economics, in Kiev, began a banking degree in 1993 and saw its first graduates in 1998. All graduates found employment immediately. From its earliest days the Banking Faculty of the University had been sponsored by Inko Bank (a commercial bank that failed in 1996) and supported by an EU grant.

Technology

Due to their dependence on state funding and their purely domestic focus in Soviet times Ukrainian banks did not keep pace with technological advance before independence. The importance of secure communications internally and with other international institutions is vital for the achievement of Ukrainian bank goals of growth and foreign expansion.

Respondents were asked, therefore, what were the main problems for integration of Ukrainian banks into the international financial market. Their responses are shown in Table 5.13. At the time of the interviews the Millennium bug problem was a considerable threat but in the event no serious harm was done by a failure to be Y2K compliant.

The main technical problems of bankers' concern are old PC hardware; old software and the millennium bug (29%). This problem seems to appear more marked in smaller banks (32%) than in big ones (25%).

The total picture is quite positive with 46% of questioned banks not having technical problems in their operations. Predictably more of the larger banks (58%) report "no problems" than smaller ones (37%). Kiev-based banks seem to have better situation compared to regional based banks. 50% of Kiev based banks reported "no problems" against 36% of regional ones.

This table reports the answers to question 17.

Table 5.13 Technical problems of Ukrainian banks

	PC, software	Funding source	Size of a bank	Staff experience	No serious problems	**No. of banks**
Big banks	3 (25%)	2 (17%)	-	-	7 (58%)	**12**
Smaller	6 (32%)	-	4 (21%)	2 (10%)	7 (37%)	**19**
TOTAL	**9**	**2**	**4**	**2**	**14**	**31**
% of resp. n=31	**29%**	**6%**	**13%**	**6%**	**46%**	

	PC, software	Funding source	Size of a bank	Staff experience	No serious problems	**No. of banks**
Kiev-based	7 (35%)	1 (5%)	1 (5%)	1 (5%)	10 (50%)	**20**
Regional	2 (18%)	1 (9%)	3 (27%)	1 (9%)	4 (36%)	**11**
TOTAL	**9**	**2**	**4**	**2**	**14**	
% of resp. n=31	**29%**	**6%**	**13%**	**6%**	**46%**	

Figures in brackets show % of bank type

Smaller banks are likely to have invested later in upgrading their computer installations. The bigger banks certainly concentrated on this aspect of their operations from an early time. Bank size and staff experience were cited exclusively by smaller banks (more regional based than Kiev) as barriers to technical advancement.

Future success

The final questions in this interview schedule related to the future plans of the respondent banks. In order to sum up the strategy employed by the bank in question respondents were asked what the most important aspect of development of their bank was and how they would best measure success.

Tables 5.14 and 5.15 detail the responses obtained and show that 45% of banks of all sizes strive for greater market share and a further 29% are working towards improved quality and improved products. One specialist bank is included in the "market share" total as it aims to maintain its monopoly position in operating interbank settlements. Only 2 respondents considered that the economic and political environment in Ukraine was the most important driver of development.

This table reports the answers to question 18 according with questionnaire.

Figure 5.14 Key aspects of bank development

	Big banks		Small banks		
Figures in brackets show % of bank type Banks made multiple responses.	**Reg.**	**Kiev**	**Reg.**	**Kiev**	**% of resp. (n=31)**
Market share/better client base	0	4 (44%)	3 (38%)	7 (64%)	45%
Improved quality and products	2 (67%)	2 (22%)	4 (50%)	1 (9%)	29%
Better credit portfolio	0	2 (22%)	0	0	6%
IT improvements	0	1 (11%)	0	0	3%
Investment banking	0	1 (11%)	0	0	3%
Management/planning	1 (33%)	0	1 (12%)	1 (9%)	3%
Better settlement system	0	1 (11%)	0	1 (9%)	6%
Political and economic stability	0	0	0	2 (18%)	6%
totals	3	11	8	12	
Number of banks	3	9	8	11	31

Three banks claim that their management lacks the skills to operate in a market environment and so improving management and strategy will be a primary aim.

It is interesting to note that no large regional banks cited "market share" as a driver, reserving this status for "improved quality". Of the smaller banks more of the Kiev based ones sought market expansion (58%) than their regional counterparts (38%). Again, as for the larger banks "improved quality" was the key for smaller regional banks. Short-termism is very apparent in the responses given.

This question was left "open" in order to allow respondents to prioritise their key strategic drivers. It is interesting to note that the majority does not feel held back by the environment of instability in the region.

This table reports the answers to question 13.

Figure 5.15 Key measures of success

	Big banks		Small banks		
Figures in brackets show % of bank type Banks made multiple responses.	**Reg.**	**Kiev**	**Reg.**	**Kiev**	**% of resp. (n=31)**
Capital growth	3 (100%)	7 (78%)	5 (62%)	8 (73%)	74%
Asset growth	0	1 (11%)	3 (38%)	1 (9%)	16%
Market share	0	3 (33%)	2 (25%)	4 (36%)	29%
Improved liquidity	0	1 (11%)	4 (50%)	2 (18%)	22%
Profit growth	0	0	1 (13%)	2 (18%)	10%
totals	3	12	15	17	
Number of banks	3	9	8	11	31

It is clear that Ukrainian banks see capital growth as a key measure of success. Under NBU regulatory rules and IAS accounting standards any bank showing capital growth will have shown an ability to overcome the Soviet legacy of bad debt. The mechanisms for improving the capital position are very logical and include better client bases, larger market shares and better quality products.

Conclusion

The primary research has added considerable detail to the picture of Ukrainian banking that is developing. Simple PEST analysis would suggest that Ukraine's political and economic instability in the last decade would have had a major effect on Ukrainian banks but that strategies have been developed to lessen the individual banks' sensitivity to these factors.

The interview based methodology for empirical work proved to be an excellent tool for collecting data. Cultural resistance to questionnaires was overcome although the individual approach could have led to bias in some cases.

The respondents in this research are all senior bankers who experienced the turmoil of the 1990's first-hand. The quality of the data is, therefore, assured. The sample size and the wide-ranging nature of questions, together with the candour displayed by respondents all help to add credibility to the research findings.

The findings, themselves, indicate that amongst respondents political uncertainty affected only a minority and although all could see the need for reform most were able to work within the strictures imposed by high taxes and close supervision. Interestingly, banks would rather the government lowered bank taxes as a priority rather than taxes on their clients.

Political impact was felt mainly in Kiev, rather than the regions and in larger, rather than smaller, banks. The influence of state policy, enacted through former "system" banks, was still felt keenly in late 1998. Larger, Kiev based banks felt positive about the 1998 elections due to the success of their own candidates.

Tax reform is high on the political agenda but little movement is seen in this regard. Banks lobby for tax liberalisation both for their own businesses and for those of their clients.

Larger banks tended to suffer more from government economic policy, especially in the purchase of government debt and the directives to support inefficient industries. Smaller banks suffered less and were more able to service niche markets rather than the mainstream business lending market. Higher quality management in larger banks (especially in Kiev) also helped flexibility and responsiveness.

Perhaps the biggest potential impact on banks came in 1997 when accounting systems switched to IAS. Although many balance sheets suffered through this most bankers saw the move in a positive light.

Marketing is still in its infancy in Ukraine and the attraction of consumer deposits is not seen as crucial. This is underlined by the small number of banks planning domestic branch network expansion. Most banks prefer to concentrate on corporate deposits and facilities for high net worth individuals as well as inter-bank and settlement products.

The dominance of lending in the banks' portfolios is both a legacy from Soviet times and a useful barrier to entry for foreign banks. Only the lack of qualified staff and overcoming minor technological problems appear to have the potential to hold the banks back from their short-term aims of growth and market share expansion.

For the future (although Ukrainian banks tend only to consider the short-term future) smaller banks strive for market share whilst larger ones work towards improved quality and products. This is borne out as nearly all respondents see capital growth as a key measure of success.

CHAPTER SIX

CONCLUSIONS

In this thesis I have analysed the establishment of the Ukrainian commercial banking sector, outlining its development and function since independence. This research has indicated that the banking sector has played a major role in the process of economic reform in Ukraine from 1991 to 2000.

No meaningful comparison can be made of the physical development of Ukrainian and UK banking. The latter happened over centuries against the backdrop of market forces, growing economic wealth and capitalist objectives. The former has happened over a 10-year period. Change in Ukraine has been rapid and pragmatic. The backdrop has been a stagnant economy, government control and the market distortion of "privatised" banks, thinly disguised "system" banks of the soviet era. To a smaller extent poor communication and poor financial education have also influenced development in Ukraine.

There were, however, some similarities of banking systems development in surrounding countries of post-Communism regime in Eastern Europe. Almost every banking sector in these countries has experienced certain problems that were slowing the process of development of banks:

- Macroeconomic trends;
- Low capital;
- Large portfolios of non-performing loans;
- Old principles of accounting;
- Little to encourage for lenders in event of default;
- Untrained personnel;
- Old technology.

The Ukrainian banking system has gone through several stages of formation. Starting from restructuring of former Soviet Union banks the banking sector has been developing towards a growing and stabilizing market. Transition to a free-market economy brought about the appearance of commercial banks, the main principle of which became profit.

The overall monitoring and controlling functions of the National Bank of Ukraine have been improving over the past years. Besides, the NBU became the main protector of Ukrainian commercial banks.

I have discovered that as the Ukrainian banking sector has been growing and improving, the number and quality of banking services has been increasing as well. In addition, the technology used by Ukrainian commercial banks has reached a level seen in many developed countries. Growing professionalism and experience of banking staff makes mismanagement less meaningful in Ukrainian banking. Government influence on banking decision-making and strategy-planning processes is also getting weaker in Ukraine.

The primary research has added considerable detail to the picture of Ukrainian banking that is developing. Simple PEST analysis would suggest that Ukraine's political and economic instability in the last decade would have had a major effect on Ukrainian banks but that strategies have been developed to lessen the individual banks' sensitivity to these factors.

The findings, themselves, indicate that amongst respondents political uncertainty affected only a minority of banks and although all could see the need for reform most were able to work within the strictures imposed by high taxes and close supervision. Political impact was felt mainly in Kiev, rather than the regions and in larger, rather than smaller, banks. The influence of state policy, enacted through former "system" banks, was still felt keenly in late 1998. Larger, Kiev based banks felt positive about the 1998 elections due partly to the success of their own candidates.

Larger banks tended to suffer more from government economic policy, especially in the purchase of government debt and the directives to support inefficient industries. Smaller banks suffered less and were more able to service niche markets rather than the mainstream business lending market. Higher quality management in larger banks (especially in Kiev) also helped flexibility and responsiveness.

Perhaps the biggest potential impact on banks came in 1997 when accounting systems switched to IAS. Although many balance sheets suffered through this most bankers saw the move in a positive light.

Marketing is still in its infancy in Ukraine and the attraction of consumer deposits is not seen as crucial. This is underlined by the small number of banks planning domestic branch network expansion. Most banks prefer to concentrate on corporate deposits and facilities for high net worth individuals as well as inter-bank and settlement products.

The dominance of lending in the banks' portfolios is both a legacy from soviet times and a useful barrier to entry for foreign banks. Only the lack of qualified staff and overcoming minor technological problems appear to have the potential to hold the banks back from their short-term aims of growth and market share expansion.

For the future (although Ukrainian banks tend only to consider the short-term future) smaller banks strive for market share whilst larger ones work towards improved quality and products. This is borne out as nearly all respondents see capital growth as a key measure of success.

Analysing the Ukrainian banking system development helps us to forecast future tendencies in the banking sector for 3-5 years ahead. Analysis based on the Bankscope database and interviews shows that the banking sector has been successfully developing in Ukraine according to all normal accounting measures. Future development of middle-sized banks and eliminating of overall number of commercial banks may now be seen in Ukraine as NBU restrictions decrease.

The oligopoly of former Soviet-era (Oschadbank and others) and new wave banks (Aval, Privatbank) has been decreasing during past few years and their influence will fall in future as foreign banks invest in Ukraine and provide effective competition.

The banking business will remain profitable in the future and the level ROAA, ROAE ratios (based on the Bankscope database analysis) will be much higher than in developed countries. As a result, since stabilization of political situation and after V.Yuschenko became a Prime Minister, foreign capital will be more actively entering the Ukrainian banking sector. This inflow probably will be rather arranged through purchasing of local banks' shares.

Still, there are a lot of problems that slow the process of national banking sector development:

- Low living standards of Ukrainian citizens slows the accumulation of deposit-base funds for banking operations;
- Uncertain bankruptcy procedures prevents the market from getting rid of "dead" enterprises, including government-owned Soviet-era factories;
- Slow privatization speed eliminates the potential for economic improvement. There are still a lot of commercial banks having large equity stakes held by the government.
- Unstable government regulation of banking activity along with bureaucracy and corruption in all levels of government administrations provides an unpredictable environment for the banking sector to act in;
- Poor credit rating of most national enterprises along with high reserve requirements of the NBU (which makes the level of hryvna funds supply very low) makes real sector crediting less attractive than interbank operations. This prohibits economic growth through industry.

Further research of this topic should certainly attempt the role of reforming processes that need to be introduced in banking sector and the Ukrainian economy in general. Another important aspect of Ukrainian banking sector development and function is preventing the potential banking system crisis, which have been experienced in many emerging countries (including the most recent Russian crisis in 1998).

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APPENDIX 1 UKRAINE - GENERAL DATA

1.1 Ukrainians outside the Ukraine

Ukrainians in the European countries bordering on Ukraine belong to the autochthonous population. In Poland, there are Boikivshchyna, Lemkivshchyna, Nadsiannya, Pidliashya and Kholmshchyna - ethnic territories where their forefathers had lived since the immemorial. After WWII, most were deported, either to the USSR or to Northeast Poland. There they were subjected to intensive pressures of assimilation. At present, official Polish statistics recognises 150,000 ethnic Ukrainians. By contrast, Ukrainian organisations in Poland say the number is close to 500,000.

In Romania, Ukrainians mostly inhabit the provinces of Sucava, Maramures, Banat, and Dobruja. Again, different sources cite different numbers of ethnic Ukrainians: from 50,000 to 600,000.

In the Slovak Republic, the number is up to 40,000 mostly near Presov.

In other European countries, Ukrainians are registered as immigrants. The largest Ukrainian communities are found in former Yugoslavia (up to 5,000), France (up to 30,000), Germany (some 20,000), and Great Britain (up to 30,000).

In North America, the Ukrainian ethnic community at large formed as the result of three waves of emigration - at the turn of the 20th c., between WWI and WWII, and after the war. In the USA, they number over a million; in Canada, the 1991 census showed 530,000 ethnic Ukrainians. Most of them (up to 90%) were born in their countries of residence.

There are ethnic Ukrainian communities in Latin America, mainly in Argentina (up to 160,000) and Brazil (some 100,000). Most of them came in between the world wars from Poland and Romania.

Historically the youngest ethnic Ukrainian community is in Australia (some 34,000), formed after 1948, and, for the most part, of former Dps - immigrates of displaced persons camps in Western Europe.

1.2 Act of proclamation of Ukraine's independence

Considering the deadly threat to Ukraine, in conjunction with the coup d'etat in the USSR, on August 19, 1991

- Continuing the age-old tradition of state construction in Ukraine,
- Proceeding from the right to self-determination, provided for by the UN Charter, and by other international legal documents,
- Acting in pursuance of the Declaration of State Sovereignty of Ukraine, the Verkhovna Rada of the Ukrainian Soviet Socialist Republic hereby solemnly

  PROCLAIMS INDEPENCE OF UKRAINE

  and the creation of an independent Ukrainian state, *UKRAINE.* The territory of Ukraine had become indivisible and inviolable. Henceforth only the Constitution of Ukraine and laws of Ukraine would have had legal strength in the territory of Ukraine.

This Act became effective instantly following its approval. In August 24, 1991 by *VERKHOVNA RADA OF UKRAINE.*

On December1, 1991, a referendum took place in Ukraine, involving 84,18 percent of the population, of which 90,32 % seconded the Independence Act of August 24. Winning 61,6 % of the votes, Leonid Kravchuk was elected a President of Ukraine.

Later Kravchuk had been criticised for a number of things, including the nuclear-disarmament deal he signed with Russia and the disastrous economy (Anonymous, 20).

At a summit meeting in Belovezhskaya Pustcha (December 7-8, 1991) leaders of the States of Belarus, Russia and Ukraine signed a Treaty on the formation of the Commonwealth of Independent States (CIS), thus putting an end to the USSR. Ukraine had been doing its utmost to increase the voice within the Commonwealth of

Independent States and expressing the autonomous nature of its interests. Although the country was a founder member of the CIS in 1991, it has reduced its status to that of an associate member (Mellow, 1994).

Ukraine only participates in joint activities which it regards as serving its interests. For example, Ukraine has not signed the collective security treaty for the CIS - in line with the principles of neutrality. It was also a key player in the adjournment of a decision on joint peace-making military units and protection of common borders (Pearce, 1995). Over a short period a new system of state administration was created, along with the National Armed Forces, the Security Service and law enforcement authorities. New, broader horizons opened for political freedoms; practically all restrictions on the spiritual progress of the Ukrainian and other nations were lifted. The Ukrainian state had entered the international community as an equal partner.

1.3 Ukraine's resources

Present-day independent Ukraine has a considerable potential to quickly develop its economy - and this is explained not only by the favourable natural conditions, but also by the convenient geographic position in terms of international trade exchanges.

Ukraine's iron and manganese ore deposits are considered the richest in the world - primarily in the Kryvyi Rih Basin (up to 62% of pure iron) and the Nikopol Basin. There are also considerable reserves of titanium, nickel, chrome, mercury and other rare metals.

The non-ore deposits are quite variegated (e.g., sulphur, phosphorites, potash salts, refractors, flux, granite, marble, porcelain clay, chalk, et.)

Still, the oil and gas deposits of Sub-Carpathia (Prykarpattya) and Left-Bank Ukraine cannot satisfy their own needs in these energy resources.

Ukraine's energy balance had been hit not only by the decline in coal output but for some years also by falling petroleum and natural gas production, making the country more dependent on imports. The exploration and development of domestic oil and gas reserves was neglected during the Soviet era. Oil production contracted from 12.8 m tpy in 1975 to around 4.1 m tpy in 1994, while gas production fell from 56.7 bn cubic metres in 1980 to only just over 20 bn cubic metres in 1994. Needs had therefore been met increasingly by imports. At present some 80% of the country's natural gas and almost the same percentage of its oil is imported , above all from Russia and Turkmenistan.

However, Ukraine has good chances of improving its energy self-sufficiency by exploiting own resources more intensively. Production of around 45 bn cubic metres of natural gas per annum is considered a realistic target, although estimates of proven natural gas reserves range, according to the technology applied, between 1.2 tr. and 7 tr. cubic metres. Oil production could be hiked to around 9 mil. tpy - given estimated reserves of 240 m tonnes - if the country presses ahead with investment in developing the fields in southern Ukraine, the Black Sea and the Sea of Azov.

Ukraine's labour pool amounts to 29.6 million persons, of whom 22.4 million are employed in the national economy, including 6.4 million in the industries, 4.6 million in agriculture and forestry, 1.7 million in construction, 1.6 million in transport and communications, and 6.6 million in the communal sphere, medicine, and public education.

1.4 Relations with international financial institutions

Ukraine became a member of the International Monetary Fund (IMF) and the World Bank in September 1992. Ukraine's IMF quota is SDR 997,3 million. Relations with these two financial organisations have improved substantially since President Kuchma took office at mid-1994 (Economist, 1994g). The first key stabilisation measures have been implemented, and a tough 1995 budget has been pushed through parliament. Internally, the president had set about building up his position vis-à-vis the hard-liners still entrenched in the state administration, in state industries, and in a parliament dominated by a left-wing ex-communist faction hostile to economic reform (Jones, 1995a). Virtually his first act on reaching the presidency in July 1994 was to telephone International Monetary Fund managing director Michel Camdessus to invite the Fund's help in preparing an economic plan.

To financially underpin the reform process, the IMF had approved in October 1994 the disbursement of the first trench of the equivalent of roughly USD 370 m of a credit granted under the Systemic Transformation Facility [STF], (Economist 1994f). Back in November 1994, negotiations began on a standby agreement for the equivalent of roughly USD 1.5 bn. It was based on an economic programme that include curbing inflation, bringing down the budget deficit, increasing exports to reduce the current account deficit, further price deregulation and the introduction of structural reforms (Economist 1995b,d).

After 18 months since Ukraine's President Leonid Kuchma had announced a set of radical reforms, things had been tricky. The government had its first row with the IMF earlier this year. Ukraine failed to pay its import bill at the end of December. The budget deficit turned out much bigger than planned. An angry parliament had forced the usually strict central bank to print more money. Hence the IMF's decision to freeze a standby loan worth $ 1.5 billion (Economist, 1996b).

The World Bank had also recognised the resumption of the reform policy by granting a credit totalling USD 500 m. The first part was already disbursed before the end of 1994 and was used primarily to pay for urgently needed imports and to stabilise the foreign exchange market.

The World Bank held out the prospect of further support especially to promote specific projects in agriculture, food processing, energy supply, the modernisation of refineries and the security of nuclear power plants. Furthermore, the World Bank is advising the country on the creation of a social network.

Ukraine's relations with the European Union had been systematically expanded. In 1993, a "partnership agreement" was concluded between Ukraine and the EU. It provided comprehensive co-operation above all in trade, economic and financial co-operation as well as the promotion of political and cultural dialogue. In December 1994, the EU provided balance of payments aid totalling ECU 85 m. Disbursement of the credit was made contingent on - among other things - Ukraine taking steps to close the Chernobyl nuclear power plant.

Under the EU's TACIS Programme, Ukraine receives diverse support, for example the implementation of reforms in the agricultural field and food processing, creation of the legal, economic and technical foundations in this field and the compilation of statistics. Farmers receive start-up aid via a special promotion programme. The programme also includes the creation of an agricultural pilot project to demonstrate the conversion of an agricultural-industrial complex.

Ukraine became a member of the European Bank for Reconstruction and Development (EBRD). Following the granting of a technical credit for USD 27 m, which was agreed at mid-1994, the Eastern European Bank increased its total exposure in Ukraine to USD 200 m at the beginning of 1995. Furthermore, the Bank had also proposed Ukrainian Government some programs concerning establishing of the financial system, privatisation as well as the conversion of agriculture, the energy and transport sectors (Jenkins, 1996).

1.5 The privatisation procedure

Choice of privatisation method

At the auction sale, the property went to the highest bidder. In a public tender, the successful bidder was the one who pledged to fulfil stipulations such as investment commitments or job guarantees and also submitted the best offer. Finally, an enterprise could have also been privatised by share subscription.

Valuation

The valuation method for privatisation assets dated from September 8, 1992 calculated the value of the enterprise to be sold on the basis of the replacement cost. The valuation covered full inventories.

Form of payment

The respective privatisation programme determined the extent to which the selling price had been covered by privatisation certificates.

Besides paying cash, employees of a company which was to be privatised, as well as other parties, could obtain company shares by using the privatisation certificates allotted to them. This right applied to all privatisation methods.

Privatisation certificates create no direct ownership of a particular property. Instead they are to be exchanged first for a participation certificate in either an investment fund or a specific company.

Pre-emptive purchasing rights

The privatisation process in Ukraine was characterised by many pre-emptive rights. The pre-emptive right enjoyed by the workforce was limited to one and a half times the nominal value of a privatisation certificate. Every employee could turn in his certificate and pay for another half in cash, with the company stakes offered to him at face value. Beyond the normal pre-emptive right, employees of both food-processing operations and their suppliers enjoy even more incentives for taking over their businesses.

1.6 Treasury Bills

Primary Market

Treasury Bills were first issued in March 1995 and they had been playing an increasing role in monetary policy till the financial crisis of 1998. The Ukrainian Ministry of Finance with the NBU acting as general agent were issuing bills. Investors had access to T-Bills through domestic commercial banks, which could participate in T-Bill auctions as the only primary dealers.

All T-Bills auctioned before April 1996 were paying quarterly coupon. As of May 1996, T-Bills were issued as a discount instruments only. Also, the nominal value of a T-Bill was reduced to UAH 100 ($54) from UAH 1000 in order to make the T-Bill market accessible to domestic retail investors.

Auctions

T-bills of all maturity were traded twice a week on Tuesdays and Thursdays. Due to high demand, it was usual to see three and six month T-Bills issued on Wednesday or Friday at the weighted average price of the last auction.

Primary dealers submitted their bids and received executions through the NBU's electronic interbank payment system. Dealers could submit bids either at limit price or request execution at the weighted average of the successful limit prices. Results were announced in the afternoon and successfully subscribed T-Bills were then credited to the securities accounts of investors at the National Bank of Ukraine. Registration of bills was through electronic book-entry form.

A secondary market in T-Bills was opened on January 11, 1996 at the Ukrainian Interbank Currency Exchange (UICE) and was organised weekly. Six domestic banks were registered to trade government securities. The most liquid were T-Bills with 1 to 2 months remaining until maturity. However, the average volume per session in the most liquid issues was only 30 to 200 bills ($1500 - 11000). Through May the total sum of T-Bills sales on the secondary market reached more than UAH 2.23 bln ($ 118,000,000). A seller was liable for 30% taxation on any realised capital gain (not paid if held until maturity). Sale on the secondary market was less attractive than holding to maturity since accrued interest is taxed as a capital gain.

Repatriation

According to the Act on Foreign Investments, repatriated UAH profits of non-resident investors were subject to 15% capital gains tax. Investors from countries that do have a double-taxation treaty with Ukraine (UK, USA, Cyprus, EU countries, Czech Republic, Switzerland and others) could avoid this tax.

APPENDIX 2 UKRAINIAN BANKING SYSTEM AND UKRAINIAN BANKS

2.1 Key NBU Decree

# 122 from	Registered in Legislative
03/27/98, Kiev	Department of the NBU
	4/3/1998, # 538

Validation of new amendment Regulation Act of loan loss reserve forming and spending procedures for commercial banks.

In order to make all rules and regulations of the National Bank of Ukraine suitable to International Standards of Accounting and Reporting requirements, the Management of National Bank of Ukraine had enacted the following PROCEDURES:

1. To introduce changes into Regulation Act of loan loss reserve formation and spending procedures for commercial banks approved by Management of the National Bank of Ukraine (Decree # 323 from 09/29/97).
2. For Crimean, Central, regional and Kiev's branches of the National Bank of Ukraine to assure the observance of Decree's requirements of creditor debts evaluation, loan loss reserve formation and spending procedures by commercial banks.
3. For Control and Economical Departments to proceed changes into standards of statistic reports.

   For Control Department and Informational Department, the necessary accounting software needed no be installed by 03/31/98.
4. Vice governor of the National Bank of Ukraine; banking control department and heads of regional management's of the National Bank of Ukraine are to be responsible for observance of Decree.
5. Decree has taken effect from the date of its approval.

Governor V. A. Yuschenko.

Approved by Decree # 122 from 3/27/98 (code # 538 from 4/3/98) by Management of the National Bank of Ukraine.

Regulation Act of loan loss reserve forming and spending procedures for commercial banks.

In order to ensure safety and stability of banking sector, to protect bank's creditors and depositors, according to Clause 24 of the Law of Ukraine "About banks and banking activity" (872-12) the National Bank of Ukraine establishes procedures of loan loss reserve forming and spending for commercial banks (further – reserve).

1. Main procedures

1.1. Commercial banks are to form reserve for compensation for possible losses from credit activity.

1.2. Commercial banks are to form reserve for covering possible losses from debts (without interests and commissions), for all kinds of credits in national and foreign currency including interbank loans and deposits, overdraft, discounted bills, leasing, factoring, guarantees and pledges.

Reserve fund formation is not necessary for government loans, credits and deposits between branches within commercial bank's structure.

1.3. Reserve is to be spent on covering from not-recoverable loans of banking credit activity.

1.4. The volume of reserve is established according to total volume of credits fixed with an allowance for extend of risk and risk ratios.

1.5. Reserve can be specified as total and special. Total reserve is formed for standard credits, special – for specific credits (credits under control, substandard credits, doubtful credits and not-recoverable loans, which is mentioned in part 2.7. of this Decree.

1.6. Each quarter commercial banks are to specify the volume of reserve according to total credits and deposits volume fixed with extend of risk.

1.7. Accounting entries are to be made during following period after reporting because of changes in reserve volume.

1.8. The total reserve volume is used in calculation of bank's capital and other economical ratios established by NBU.

2. Credit specification and determination of reserve volume

2.1. In order to accumulate reserve volume commercial bank needs to make specification for issued loans and deposits by following criteria:

- evaluation of financial position of company;
- repayment of debt and interest.

2.2. Choosing criteria's of evaluation of financial position of debtor-company is commercial bank's priority according to requirements of the Decree and recommendations of the National Bank of Ukraine, approved by Management 09/29/97 (#323).

Procedures of evaluation of financial position of company are specified by decree of commercial bank.

Commercial bank evaluates the commercial position of company-debtor and ensures of debt repayment once before approving the loan, after that – every quarter of the year.

2.2.1. For proper evaluation of the company's financial position commercial bank needs to consider the following ratios and information of the company:

- gross income;
- profit and loss;
- gross margin;
- liquidity; cash flow;
- structure of accounts receivable and payable;
- product cost.

Other factors are also can be considered:

- management effectiveness;
- market strategy of the customer and its depending on seasonal variations and other factors;
- government support or government orders;
- repayment of payables in the past;
- professional Management.

Commercial bank should consider the following ratios for evaluation of financial position of company:

- total liquidity ratio (LR1) shows the ability to repay current liabilities with gross assets of the company

$$LR1 = \frac{\text{Division II (assets)} - \text{future spending} + \text{Division II (assets)}}{\text{Division II (liabilities)} - \text{overdue loans} + \text{Division III (liabilities)}}$$

Theoretical volume of LR1 should not be under 2.0 – 2.5;

- absolute liquidity (acid test) ratio (LR2) shows the ability to repay short term liabilities with short term (liquid) assets (including securities):

$$LR2 = \frac{\text{Cash Resources} + \text{Current Account} + \text{Other Accounts} + \text{S T Deposits}}{\text{Division (liabilities)}}$$

Theoretical volume of LR2 should not be under 0.2 – 0.25;

- ratio of capital base and borrowed capital:

$$RB = \frac{\text{Division II (liabilities)} + \text{Division III (liabilities)}}{\text{Division I (liabilities)}}$$

Theoretical volume of RB should not exceed 1.0;

- equity capital mobility ratio (RM):

$$RM = \frac{\text{Division I (liabilities)} - \text{Division I (assets)}}{\text{Division I (liabilities)}}$$

The volume of RM should not be less than 0.5.

2.2.2. Evaluation of economical position of commercial bank, receiving a loan should be proceeded on the base of following factors:

- observance of economical ratios and indexes of functioning, required by the National Bank of Ukraine;
- profit and loss analysis;

- assets and liabilities structure quality;
- reserve formation;
- recovery of debt in the past;
- banking management quality.

2.2.3. Evaluation of economical position of non-corporate client should be carried out on the base of following factors:

- social stability (family status, real estate, stable job);
- real pledgery;
- age and health of the client;
- financial situation of the client, its income and spending;
- recovery of debts and interests in the past, using interbank services;
- client's relationship within business world.

2.3. According to evaluation of economical position and chances of borrower's development, credits are specified by following categories:

- class "A" - financial position is very good and ensures the repayment of debt and interest in time. It is possible that financial activity will remain at the same high level;
- class "B" - financial position is good or very good but it is complicated to remain at the same level of financial stability;
- class "C" - financial position is average but there is a tendency for becoming worse;
- class "D" - financial position is poor and it is determined for short periods of time;
- class "E" - financial position shows losses and it is seen than neither loan no interest will be possibly returned.

2.4. Loan and interest recovery can be:

- good – if loan and interest is repaid in time, or by refinanced loan (only once) no longer than 90 days;
- poor – if loan and interest are overdue no longer than 90 days, or loans refinanced for over 90 days with interest repayable.

- very bad – if loan and interest are overdue for over 90 days, or loans refinanced for over 90 days without interest repayable.

2.5. Determining reserve value the volume of loan per each customer should be decreased by the volume of:

- guarantees (Cabinet of Ministry of Ukraine guarantees, guarantees of bank, registered in countries of A-rating);
- pledges (current accounts, deposits in bank-creditor, property, or property ownership).

2.6. Price of pledged property, or property ownership should be determined as real (market price), according to possible complications and losses in case of not recoverable debt and sale of pledge. Agreement of pledge should be settled in accordance to the Law of Ukraine "About Pledge" (2654-12).

Determining the volume of reserve, the value of property pledged (property ownership), except government bonds, is to be considered with the ratio of 50 % from the value, mentioned in pledge agreement. The value of government bonds pledge can be taken with full value mentioned in pledge agreement.

Commercial bank should re-evaluate the pledge value at least once a year or in case of debt refinancing.

By non-recoverable credits the following procedures are to be carried out while determining the volume of reserve:

- credit's pledge is taken with ratio of 25 % (or less) in case of refinancing or overdue for the term of 180 – 360 days.
- in case of credit overdue and refinancing term is over 360 days, the whole value of debt is considered in evaluating the reserve volume without counting pledge value.

2.7. According to criteria's above, credit portfolio of banks are divided into following groups:

Financial position (class) \ Interest recovery	Good	Poor	Very bad
A	Standard	under control	substandard
B	Under control	substandard	doubtful
C	Substandard	doubtful	non-recoverable
D	Doubtful	non-recoverable	non-recoverable
E	Non-recoverable	non-recoverable	non-recoverable

During classification by extend of risk and determining the groups of discounted bills, factoring, guarantees for reserve calculation, only overdue debts are to be in calculations:

- standard debt – debt, which is not overdue;
- doubtful – protested bills (no longer than 30 days), factoring operations debt and bank guarantee repayment (no later than 90 days from agreement date);
- non-recoverable debt – protested bills (overdue for over 30 days), factoring operations debt and bank guarantee repayment (over 90 days from agreement date);

2.8. On the base of classification of loans, commercial bank is to accumulate reserve in accordance to each specific credit group. Reserve needs to be formed full amount in accordance to real credit volumes by extend of risk, established by reserve requirements.

Credit group	Reserve level (risk rate)
- Standard credits	2 %
- Credits under control	5 %
- Substandard credits	20 %
- Doubtful credits	50 %
- Non- recoverable credits	100 %

2.9. Total reserve for standard credits is to be accumulated by commercial bank every quarter in full-required volume from last year profit. This money is accumulated on account # 5929 "Total reserve", within Group # 502 "Funds and total reserves".

The following entries need to be made:

Debit – account # 5030 "Last period profit"

Credit – account # 5020 "Total reserves"

In case of non-sufficiency of resources for accumulating the required volume of total reserves during the year, commerčial bank needs to make the following entry for the sum that reserve fund is short of during profit distributing:

Debit – account # 5040 "Last period profit that needs to be approved"

Credit – account # 5020 "Total reserves"

2.10. Commercial bank accumulates special reserve in whole - required volume for credits "under control", "substandard", "doubtful" and "non-recoverable" credits. This reserve needs to be formed from withdrawn funds, account group # 770 "Withdrawals to reserves". Special reserve funds are to be accumulated on: balance accounts of :

Interbank operations: # 1590 "Reserve for interbank's debt";

client's operations # 2400 "Client's credit reserve".

Total debt on credits, guarantees and pledges is accumulated on

balance accounts # # 1510-1517, 1520-1527, 1581, 1582, 1589, 2000, 2010, 2020, 2027, 2030, 2037, 2040, 2045-2547, 2050, 2055-2057, 2061, 2062, 2065-2067, 2070-2077, 2090-2099, 2100-2107, 2110-2117, 2190, 2191, 2198, 2199, 2200-2207, 2210-2217, 2290, 2291, 2299, 9000, 9002, 9020, 9090, 9091.

Special reserve needs to be formed in accordance to credit portfolio evaluation (fixed on 7/1/98) by 7/1/99 by following schedule:

- Non-recoverable credit reserve needed to be formed in whole-required volume by 1/1/98. After that date special reserve for non-recoverable credits is to be formed next period (quarter) after determining a credit as "non-recoverable".

- Special reserve for credits "under control", "substandard" and "doubtful" must be accumulated no later than 7/1/99 by equal parts (no less than 12.5 % each quarter).

S = 12.5 % x N x C, where
12.5 % - per cent rate of reserve forming (12.5 x 8 quarters = 100 %);
N – amount of periods (quarters) starting from beginning of reserve forming (7/1/97).
Class – reserve value, calculated on a certain date of period.
Special reserve for credits, issued by commercial bank after 7/1/97 and for banks, registered after 7/1/97 is to be formed during quarter, following after issuing credit.
The entries below are to be made:
For commercial bank spending:
Interbank operations:
Debit – account # 7701 "Withdrawals to reserve on interbank debt",
Credit – account # 1590 "Reserve on interbank debt".
During client's operation:
Debit – account # 7702 "Withdrawals to reserve on client's credit debt";
Credit – account # 2400 "Reserve on client's credit debt"

2.11. In case of total reserve volume decreasing, compared to previous period, commercial bank is to make the following entry:
Debit – account # 5020 "Total reserve"
Credit – account # 5030 "Profit for previous period".

2.12. In case of special reserve required volume decreasing, compared to previous period, commercial bank needs to transfer the overage sum for income increasing and make following entries:

- By interbank operations:
  Debit – account # 1590 "Reserve on interbank debt";
  Credit – account # 6701 "Decreasing of reserve on interbank debt";
- by client's operations:

Debit – account # 2400 "Reserve on client's credit debt"
Credit – account # 6702 "Decreasing of reserve on client's credit debt".

2.13. Reserve is to be formed by head bank and its branches according to procedures above (1.2. of Decree). Total reserve is accumulated on central bank's balance. Special reserve is accumulated on branches' balance. Central bank is fully responsible for sufficiency of formed reserves.

3. Reserve spending

3.1. Commercial bank can spend reserve funds for covering losses from not-recoverable loans, among "doubtful loans" on balance accounts.

3.2. Not-recoverable loans can be reimbursed from special reserve in condition, that commercial bank follows procedures mentioned in clause 12 of the Law of Ukraine "About changes introduced in the Law of Ukraine "About profit tax collection procedures".

3.2.1. If bill has been protested and not repaid for over 30 days after protesting and drawer of bill has applied to Arbitrage court about bankruptcy procedure of bill's debtor, this debt on not-repaid bill is to be covered from special reserve. The following entries are to be made in this case:

Debit – account # 2400 "Reserve on client's credit debt"
Credit – account # 2092 "Doubtful debt on client's discounted bills" Non-recoverable debt of a client that has gone through bankruptcy legislative procedure is to be covered by special reserve funds, but only after approving by Arbitrage court the fact of debtor's bankruptcy.

Money returned by commercial bank from debtor's pledge and property selling is to be considered as gross income and calculated in the period of income.

In case of issuing loan for client that was on the bankruptcy procedure before the loan contract approving and information about bankruptcy process was available, non-recoverable loan is to be covered by total reserve of commercial bank.

3.2.2. Loans, secured with pledges are to be recovered according to procedures of the Law of Ukraine "About pledge". If pledge selling by commercial bank did not provide full covering of debt and any legislative procedures of taking additional property did not succeed, non-recovered debt sum is to be covered by special reserve. Selling of pledge should be held in auctions, public sales if other procedures are not mentioned in pledge agreement according to the Ukrainian legislation.

3.2.3. Not-recovered credit debt that happened because of force - major circumstances and as a result – insolvency of debtor can be covered from special reserve if any of the following documents are present:

- approving by Chamber of Commerce and Industry the fact of force-major at the territory of Ukraine or approving by other country's authorities, legalized by Ukrainian Councilor Institutions, the fact of force-major at the territory of other country;
- decision of President of Ukraine about implementation of emergency economical situation in certain areas of Ukraine, approved by Verkhovna Rada of Ukraine, or decision of Cabinet of Ministry of Ukraine about considering specific areas of Ukraine suffered from fire, flood's and other disasters that caused losses of agricultural harvest in the volume, exceeding more than 30 % of average harvest for last 5 years.

In case of covering debt by special reserve, but after reviewing the information about force-major by authorities it is found that force-major circumstances are temporary natured and do non influence debtor's sufficiency to pay debt after force-major is over, commercial bank is to apply to Arbitrage court and client is to repay the debt no later than 30 days after force-major is over.

In case of not applying to the Arbitrage court by commercial bank about turning debt under terms, introduced in Ukrainian legislation, bank's income increases by the sum of debt and special reserve is to be recovered. These credits are to be covered from total reserve.

3.2.4. Overdue loans of companies, organizations and different institutions that do not have any property for sale to recover debt, can be covered from special reserve of commercial bank according to Ukrainian Legislation, unless this debt was covered by government, municipal or other funds within 30 days from loan expiring.

This stipulates that commercial bank applies to Arbitrage court about covering of losses from this crediting.

If commercial bank does not apply to Arbitrage court in terms according to Ukrainian Legislation or if Arbitrage court does not satisfy the application, commercial bank will cover the losses from total reserve.

3.2.6. Overdue loans of non-corporate clients that are dead or disappeared is to be covered from special reserve only if decision of the court about proving their death or disappearance was approved after date of credit agreement.

3.2.7. Overdue loans of non-corporate clients that are under criminal search are to be covered from special reserve unless criminal is found within `180 days from the beginning of search.

3.2.8. Overdue loans of corporate clients that have directors under criminal search are to be covered from special reserve unless criminal is found within `180 days from the beginning of search.

3.2.9. Overdue loan by agreement or its parts that became invalid after decision of Arbitrage court because of debtor's fault, is to be covered from special reserve of commercial bank, if debtor does not pay the debt within 30 days after decision of Arbitrage court.

If higher level institutions of Arbitrage court cancel decision of lower level institutions about invalidating the agreement of contract by debtor's fault and commercial bank does not appeal against this canceling in terms, stipulated in Ukrainian Legislation, it will increase its gross income by the sum, previously included in gross spending, or covered from special reserve. In this case the sum is to be covered from total reserve.

3.2.10. Overdue loan by agreement or its parts that became invalid after decision of Arbitrage court because of commercial bank's or both-sized fault is to be covered by total reserve within 30 days unless debtor pays credit debt.

3.2.11. Commercial bank is authorized to cover losses from credit activity with total reserve in accordance with decision of Management, approved by required document of Management, but no later than last day of a year, when the loan has been specified as non-recovered.

Covering of the credit loss from special reserve, formed with increasing the value of gross spending, is possible to be carried out by decision of commercial bank's Management according to Ukrainian Legislation.

3.2.12. In case of covering the debt loss from special reserve the following entries are to be made:

a) by interbank operations:

Debit – account # 1590 "Reserve on interbank debt";

Credit – account ## 1581, 1582, 1589

The same time interests not paid are also covered.

b) by client's operations:

Debit – account # 2400 "Reserve on client's credit debt";

Credit – account # 2027, 2090, 2091, 2092, 2093, 2094, 2095, 2096, 2097, 2099, 2190, 2191, 2290. 2291, 2199, 2299.

The same time interests not paid are also covered.

3.2.13. In case of covering credit debt from total reserve the additional reserve is to be formed for this sum and calculated on separate analytical (balance) accounts # # 1590, 2400. This procedure stipulates the following entries:

a) by interbank operations:

Debit – account # 7701 "Withdrawals to reserve on interbank debt";

Credit – account # 1590 "Reserve on interbank debt";

Debit – account # 1590 "Reserve on interbank debt";

Credit – account # # 1581, 1582, 1589

b) by client's operations:

Debit – account # 7701 "Withdrawals to reserve on client's debt";

Credit – account # 2400 "Reserve on client's credit debt";

Debit – account # 2400 "Reserve on client's credit debt";

Credit – account # # 2090, 2091, 2092, 2093, 2094, 2095, 2096, 2097, 2099, 2190, 2191, 2290. 2291, 2199, 2299.

The same time while covering interbank and client's credit debt the following entries are to be proceeded:

Debit – account # 5020 "Total reserve";

Credit – account # 5030, 5031.

3.2.14. Amount, written off a credit account with total and special reserves is to be fixed on off-balanced accounts # # 9610, 9611 of Division # 961 "Debts written off to losses" of commercial bank. Interest for overdue loan volume calculated but not received are to be reflected on off-balanced accounts # 9600, 9601 of Division # 960 "Debts, not paid in time". Commercial banks need to continue the procedures of debt return for no less than 3 years.

3.2.15. If after 3 year period commercial bank does non manage to return not-recovered debt, it will be considered totally not-recovered and written of balance accounts # # 9610, 9611, while interests will be written off from off-balanced accounts # # 9600, 9601.

3.2.16. If debtor recovers partly or full debt that has been covered from reserves, commercial bank will increase its gross income by the volume of returned sum. In this case the following entries are to be made:

Debit – current account of debtor;

Credit – account # 6800 "Unforeseen income".

Interests, paid for such loan are to be written on unforeseen income account. Paid credit debt and interest will be written off off-balanced accounts # # 9600, 9601, 9610, 9611.

3.2.17. In case of insufficiency of total reserve for covering losses from credit activity, commercial bank will cover current year's losses by reducing its funds, not distributed profit from previous year, that form additional reserve.

4. Procedures of conclusion

4.1. Commercial bank (commercial bank's branches) needs to review credit portfolio structure in order to evaluate credit risk every 1st of each quarter.

4.2. Commercial bank is to organize credit committee (for branches and departments – credit commissions), that will keep records and information about evaluating of credit portfolio and forming of reserves up to three years.

4.3. Credit specification, reserve accumulation and spending reports are to be provided: by branches – to central bank and regional department of National Bank of Ukraine, Central bank – to regional department of National Bank of Ukraine quarterly according to procedures of National Bank of Ukraine about statistic reports providing.

"Credits classification according to ownership" and "Evaluation of reserve for possible losses from credit activity by commercial banks" statements are to be prepared on the basis of commercial bank's credit committee decision about credit specifications with an allowance of risk and level of reserving for next quarter.

"Changing in reserve structure" and "Written off not-recovered debt" statements are prepared on a basis of accounting information for last period.

4.4. Banking Control Department of the National Bank of Ukraine always checks commercial bank's and its branches' reports for proper classification of credit portfolios and following the procedures of reserves accumulation and spending.

If these procedures show the difference between commercial bank's statements and information of Banking Control Department of National Bank of Ukraine, commercial bank will correct the differences and reserve volume if required.

4.5. In case of insufficiency of money for reserve forming or violations of its accumulation and spending special fines are pressed against commercial banks according to Clause 48 of the Law of Ukraine "About banks and banking activity".

2.2 Discount rates 1997–1999

Date of rate change	Discount rate, %	Refinancing rate for commercial banks under government bonds' pledge, %
11/24/97	35	45
02/06/98	44	48
03/18/98	41	45
05/21/98	45	50
05/29/98	51	56
07/07/98	82	82
08/18/98	85	92
12/21/60	60	70
04/5/99	57	65

2.3 Bank profiles

Ukraina

Bank 'Ukraina' was established in 1990 on the base of the former Agroindustrial bank of the USSR. Regarding to the rating list published by the Information and Analysis Centre of the Association of Ukrainian Banks (AUB) in 1996 Bank Ukraina was the first by the amount of Capital and the second by the Share capital. The number of the Bank's employees was 26,450 (as on 1.01.1997).

The bank was founded as open joint-stock company and now has 290,900 shareholders (276,700 - individuals, 14,200 - entities). The main shareholders are listed below with their share accordingly:

- 'InterAgro' association	- 2,18%
- 'UkrAgroBusiness' JSC	- 1,07%
- 'Jadkivskiy' sovhoz	- 0,55%
- 'UkrSotsTrust' company	- 0,43%.

The Bank's shareholders equity as on 1.01.97 is divided accordingly:

- Individuals including:	- 70%
- Bank's employees	- 21,8%
- Legal entities including:	- 27,5%
- state-owned	- 0,9%
- non-state owned	- 26,6%
Shares bought - back	- 2,5%

Bank 'Ukraina' has the biggest branch network among the Ukrainian commercial banks with 576 branches located in all regional and district capitals. Bank provides the complete range of banking services and carries out all types of transactions in local and foreign currencies to more than 217,000 corporate and 1,200,000 individual customers. Bank 'Ukraina' has mainly customers in the agroindustrial and farming sector. The involvement in the conduit of governmental funds to the agricultural sector gives the Bank a strong position in the Ukrainian agroindustrial complex. The Bank services about 90% of centralised state capital investments into agroindustrial complex and almost 20% of capital investments into other fields of economy.

Since 1994 Bank 'Ukraina' had been audited by Arthur Andersen according to International Accounting Standards. In order to approach the quality of its services to the high international level and to optimise its effectiveness Bank 'Ukraina' together with Arthur Andersen has worked out the Business plan of the Bank's development for years 1997-2000. Bank 'Ukraina' was the first commercial bank in Ukraine to deal internationally with correspondent banks after receiving the International General License from the National Bank of Ukraine and now has the correspondent relations with more than 300 well-known commercial banks abroad.

Since 1992 when Bank 'Ukraina' became one of the founders and key shareholders of the Ukrainian Stock Exchange (USE) it actively operates on the securities market. In 1996 the Bank became one of the main authorised dealers on the Ukrainian State Domestic Loan Bonds market for residential and non-residential clients. Bank 'Ukraina' works with privatisation papers as well.

Bank Ukraina co-operates with international financial institutions in particular with the World Bank and the EBRD. Co-operation with the EBRD includes the following projects:

Twinning Programme (carried out together by the World Bank and the EBRD). Bank 'Ukraina' is the only Ukrainian bank which gained the access to this programme. The main objective of this project is to assist Bank Ukraina to successfully achieve its institutional goal of transforming itself into a modern competitive and profitable commercial bank. Our twinning partners are Credit Agricole (France) and Rabobank (Niderland Bank). Bank 'Ukraina' met all the eligible criteria and in November 1996 was qualified to participate in the ECU 100 Mio EBRD loan facility focusing on small and medium-sized businesses. In terms of presented projects to be financed under this line Bank 'Ukraina' is considered as the most successful participant among other Ukrainian banks. In 1996 KIB with a capital of ECU 5 Mio was set up in Kiev. The founders and the main shareholders of this bank are:

the EBRD	- 35%,
Kreditbank	- 13,5%,
Bank 'Ukraina'	- 16,5%,
Ukrainian Financial Group	- 35%.

Prominvestbank

Ukrainian Joint-Stock Commercial Industrial-Investment Bank (Prominvestbank) is the largest commercial bank of Ukraine, that is recognized as the bank having considerable experience in providing complex services to the leading branches of industry in Ukraine. Approximately one fifth of total banking capital in Ukraine is concentrated in Prominvestbank of Ukraine. During 1995 year the Bank's ownership capital has increased by 3.3 times in current prices and the authorised fund has increased by 5.5. The total number of enterprises and organisations that the Bank serves increased from 116,000 to 125,000. They can be categorised as follows: state enterprises - 15.2%, private - 33.4%, collective 48.8%, enterprises of common property - 2.6%. The volume of Prominvestbank of Ukraine credit portfolio is twice as large as the portfolio of Bank "Ukraina", the second largest bank in Ukraine.

Under the conditions of the reduction in industrial production of 11.5%, inflation of 281,7% and a decrease in the gross domestic product of 11.8% during 1995, Prominvestbank kept stable indices of it's development.

Prominvestbank proved credit support to those industries which to a large extent influence the conservation of industrial potential of the country including: machine building, power engineering, metallurgy, oil and gas, coal-mining, chemical, construction, transportation and in particular to those enterprises that are importers. The Bank also serves more than 1.2 million private clients. Approximately two thirds of short-term credits in Ukrainian carboranets totalling UKR 194.6 trillion were directed to support state and collective enterprises.

Organisation structure:

Prominvestbank of Ukraine has branches in 182 towns in Ukraine and representation in Moscow. The Bank is structured in 6 head regional branches, 12 regional branches, 7 head local branches, 242 local branches, 544 offices for deposits from population and 617 offices for hard currencies exchange. The biggest branches operate in Donetsk, Dnepropetrovsk, Kharkiv, Kyiv, Odesa, Lviv and other regions of Ukraine.
Prominvestbank is a closed joint-stock company. 92% of the Bank's authorised capital is formed at the account of shares sold to physical persons. The highest

authority of the Bank is the Meeting of Shareholders. 9 persons are members of the Bank Council and 5 persons of the Audit Commission. The Bank Board consists of 8 persons and they govern the Bank's day to day activity. The Bank's central office consists of 17 structural subdivisions.

The Bank financed and credited capital investments in machine-building, shipbuilding, aircraft construction, energetic and other industrial segments. At the end of 1995 the Bank entered the state debentures market and became a participant of the National Bank of Ukraine closed auctions for investing the bonds of state domestic loan. When the Bank is accepted into the fund sector of Ukrainian interbank currency exchange, they provide for clients services relating to state bonds on the secondary market.

Investment funds and companies that were formed with the Bank participation began their activity in Donetsk, Odessa, Dnepropetrovsk and Kharkiv for acquiring and investing of private property certificates. The funds purchased the portfolio of such big industrial giants as Dnepropetrovsk plant for heavy presses, Pavlograd plant of chemical machine building, "Electrodvigun", "Dniproazot", Dergachiov turbo-compressor plant, Lviv experimental oil plant and others. Prominvestbank also participated in the capital formation of 12 insurance companies with authorised funds totalling UKR 100 billion. In addition, the Bank is a shareholder in 75 different enterprises and organisations including the first Russian-Ukrainian Creditimpex Bank.

Oschadbank

Oschadbank, the Savings Bank of Ukraine, is one of Ukraine's largest and oldest banks, tracing its origins back more than 150 years to the days of Tsarist Russia. It has enjoyed a special status since 1991, the year that Ukraine became independent. Oschadbank is wholly state owned and has 650 district branches and 13000 outlets. This gives the Bank a presence throughout the country and allows it to offer services to the population. The breadth of its branch network gives the Bank enormous potential for future development.

Recent years have witnessed major changes in Ukrainian society and Oschadbank has had to change accordingly. The emergence of competition has eroded its share of the savings market over the past four years. Its market share decreased from 99.4% in 1991 to 75% at the end of 1995, but has since stabilised at that level. Oschadbank still operates more than 80 million accounts. In addition to its traditional business, the position of Oschadbank in Ukraine is expanding rapidly as the process of privatisation gathers momentum. Its role in privatisation is unique, since it acts as an official agent for the government by operating privatisation accounts for each citizen. In response to the forthcoming total privatisation and small business development in Ukraine, the bank is conscious of its role as a Bank actively facilitating each citizen's, being a private owner and an entrepreneur.

The Bank has long-lasting and locally tailed relations with its depositors, maintained through generations. So it is quite natural for the Bank to grant credits and render all other kinds of financial assistance primarily to its clients who are starting to run business of their own, such as private stores, restaurants, work-shops, filling stations, farms, etc. In 1995, such credits were granted by Oschadbank to the amount of 6884 bil. Krb. Of them 525 firms and enterprises were Oschadbank's customers. Taking into account the importance of loan activity in generating revenues, the Bank's loan policy is targeted at achieving the greatest effectiveness at acceptable risk level.

The Bank's balanced asset portfolio was one of the factors that helped ensure its successful performance during past years.

Oschadbank of Ukraine has the largest nation-wide branch network of all commercial banks of the country. This enables the Bank to redistribute financial resources within its system, concentrate funds and efforts on key lines of its business and benefit from fluctuations on regional markets. At the beginning of 1996, the Bank's network comprised 13454 institutions, of them: 26 regional branches, 646 district branches and 12781 outlets. Oschadbank of Ukraine is a large enterprise with over 60,000 employees - nearly half of all staff working in the entire Ukrainian banking system. For that reason, the Bank not only serves society with its banking products, but also forms part of society itself. It acknowledges that it has a position of responsibility and actively supports the state in its efforts to create economic stability.

The state export-import bank (Ukreximbank)

State export-import Bank of Ukraine was formed on January 3RD 1992 by Presidential Decree. The Government of Ukraine wholly owns it. The Bank possesses a general banking license from the National Bank of Ukraine, granted on 23rd January 1992, and also a license for hard currency operations, granted on 17th July 1992. The general banking license, which includes a license for hard currency operations, was re-registered by the National Bank of Ukraine on 25th December 1995.

Ukreximbank is one of the few Ukrainian banks, which are able to preserve stable growth indices in such a complicated economic environment. The reasons for the Bank's success are closely related to its development strategy and operations, and to the ranking Ukreximbank occupies amongst the banks of Ukraine. Ukreximbank is the only Ukrainian bank , which acts as an agent of the Government in the attraction and allocation of interbank and intergovernmental hard currency loans.

A letter from the Cabinet of Ministers of the Ukraine was received, dated 4th August 1995, confirming that the responsibility of the State export-import Bank of Ukraine is to act as an agent of the Ukrainian Government for the above described activities and thereby the loan obligations and related risks belong to the Ukrainian Government. Today, the Bank services lines of credit in the amount of approximately USD 3 billion. In addition, in 1995 new lines of credit with international financial organisations and financial institutions in developed countries around the world were initiated. In the near future, the realisation of these projects will promote the development of export capabilities of Ukrainian enterprises and a diversification of the country's trade flows.

The growing international stature of Ukreximbank can be verified by the increase in the number and amounts of L/C and guarantee confirmation lines, and currency conversion operation lines which were opened by major western banks including Credit Swiss, Zurich; Deutche Bank, Frankfurt/Main; Dresdner Bank and others. Strong compliance with international standards in effecting these operations gave the Bank a reputation of a reliable partner and promoted the development of strong mutually profitable relations with the world's leading banks many of which have provided the Bank with foreign exchange lines.

The total number of Bank's employees is 1,322, the Bank's main office is located in Kyiv, it had 24 branches throughout the Ukraine.

2.4 BALANCE SHEET AND INCOME STATEMENT OF THE UKRAINIAN INTERNATIONAL CURRENCY EXCHANGE

BALANCE SHEETS AS OF 31 DECEMBER 1995 and 1994 (USD TH)

Assets	**1995**	**1994**
Cash and cash equivalents	29047	23989
Balances at the NBU	3146	6335
Amounts due from other banks, net	13000	4988
Tangible fixed assets, net	1513	485
Other assets, net	1466	1062
Total assets	48172	36859
Liabilities		
Vostro accounts with other banks	27254	10427
Amounts owed to trading customers	3325	19550
Other liabilities	828	912
Total liabilities	31407	30889
Contingencies		
Shareholders' funds		
Authorised capital	1896	437
Retained earnings	14869	5533
Total shareholders' funds	16765	5970
Total liabilities and shareholders' funds	48172	36859

UICE STATEMENT OF OPERATIONS FOR THE YEARS ENDED 31 DECEMBER 1995 and 1994 (USD TH)

	1995	**1994**
REVENUES		
Commissions revenues	15059	6375
Interest income	5545	2507
Other income	93	165
Total revenues	20697	9047
OPERATING EXPENSES		
General and administrative	(2087)	(445)
Salaries and employment benefits	(295)	(220)
Provisions for doubtful accounts and losses	(1125)	(238)
Depreciation	(279)	(95)
Exchange differences	(1024)	(609)
Total operating expenses	(4810)	(1607)
Operating income	15887	7440
Taxation	(5809)	(2388)
Net income	10078	5052

UICE STATEMENT OF CASH FLOWS FOR THE YEARS EHDED 31 DECEMBER 1995 and 1994 (USD TH)

	1995	1994
Cash flows from operating activities		
Net income before taxation	15887	7440
Depreciation	279	95
Interest income	(5545)	(2507)
Operating profit before changes in operating assets and liabilities	10621	5028
Changes in operating assets & liabilities		
Increase amounts due from other banks	(8012)	(4824)
(Decrease)/increase balances at the National Bank of Ukraine	3189	(4347)
Increase in other assets	(539)	(459)
Increase in Vostro accounts with other banks	16827	9455
(Decrease)/increase in amounts owed to trading customers	(16225)	6275
Increase in other liabilities	540	85
Net cash flow from operating activities before income taxes paid and interest received	6401	11213
Income taxes paid	(6433)	(1669)
Interest received	5701	2066
Net cash flow from operating activities	5669	11610
Cash flows from investing activities		
Tangible fixed assets, net	(1307)	(348)
Loans advanced, net	(21)	(24)
Net cash flow from operating activities	(1328)	(372)
Cash flows from financing activities		
Statutory contributions, net	717	0
Net cash flow from financing activities	717	0
Change in cash and cash equivalents	5058	11238
Cash and cash equivalents at beginning of the year	23989	12751
Cash and cash equivalents at end of the year	29047	23989

2.5 BANK SCOPE DATA

Total Capital Ratio 1995 - 1998

Bank Name	1998	change	1997	change	1996	change	1995
Prominvestbank of Ukraine-Ukrainian Joint-Stock Commercial Industrial-Investment Bank	29.89		n.a.		n.a.		n.a.
East-Ukrainian Stock Exchange Bank Grant - Grant Bank	25.82		n.a.		n.a.		n.a.
Republican Commercial Bank for Social Development - Ukrostsbank	17.00	78.95%	9.50		n.a.		n.a.
State Export-Import Bank of Ukraine - Ukreximbank	11.00	0.00%	11.00	-8.33%	12.00		n.a.
Privatbank Commercial Bank	9.10	-9.90%	10.10		n.a.		n.a.
Bank Ukraina	8.25	-14.95%	9.70	31.26%	7.39		n.a.
Credit Dnepr Joint Stock Bank	n.a.		n.a.		n.a.		n.a.
AGIO Bank (UAS)	n.a.		n.a.		n.a.		n.a.
Pivdenniy Joint-Stock Bank	n.a.		n.a.		n.a.		n.a.
Percombank	n.a.		n.a.		n.a.		n.a.
Aval Bank	n.a.		n.a.		n.a.		n.a.
Oschadny Bank Ukrainy	n.a.		n.a.		n.a.		n.a.
Pravex Bank	n.a.		n.a.		n.a.		n.a.
Bank Kyiv - Joint Stock Commercial Bank Kiev	n.a.		18.84		n.a.		n.a.
Transbank	n.a.		n.a.		n.a.		n.a.
Bank Depozytowo-Kredytowy (Ukraina) Ltd in Lutsk-Deposit Credit Bank (Ukraine) Ltd in Lutsk	n.a.		n.a.		n.a.		n.a.
Ukrgazprombank	n.a.		n.a.		n.a.		n.a.
West-Ukrainian Commercial Bank (UAS)	n.a.		n.a.		n.a.		n.a.
Joint Stock Bank Etalon	n.a.		n.a.		n.a.		n.a.
VABANK - All-Ukrainian Joint-Stock Bank	n.a.		45.00	-2.17%	46.00	91.67%	24.00
First Ukrainian International Bank	n.a.		n.a.		53.79	11.21%	48.37
Ukrainian Innovation Bank - Ukrinbank (IAS)	n.a.		n.a.		n.a.		n.a.
Credit Lyonnais Ukraine	n.a.		n.a.		n.a.		n.a.
Average							

Net loans / Total assets 1995 - 1998

Bank Name (alpha order)	1998	change	1997	change	1996	change	1995
AGIO Bank (UAS)	23.28	50.38%	15.48		n.a.		n.a.
Aval Bank	32.77	-26.91%	44.84		n.a.		n.a.
Bank Depozytowo-Kredytowy (Ukraina) Ltd in Lutsk-Deposit Credit Bank (Ukraine) Ltd in Lutsk	3.95		n.a.		n.a.		n.a.
Bank Kyiv - Joint Stock Commercial Bank Kiev	45.34	-17.83%	55.18		n.a.		n.a.
Bank Ukraina	50.12	28.71%	38.94	6.98%	36.40	69.01%	21.54
Credit Dnepr Joint Stock Bank	31.57		n.a.		n.a.		n.a.
Credit Lyonnais Ukraine	62.10	53.08%	40.57	137.96%	17.05		n.a.
East-Ukrainian Stock Exchange Bank Grant - Grant Bank	40.18		n.a.		n.a.		n.a.
First Ukrainian International Bank	32.66	54.88%	21.09	-43.31%	37.20	-12.72%	42.62
Joint Stock Bank Etalon	32.98	8.36%	30.44	718.37%	3.72		n.a.
Oschadny Bank Ukrainy	21.78	-20.57%	27.42	-28.81%	38.52		n.a.
Percombank	23.97	16.58%	20.56	737.86%	2.45	-80.37%	12.50
Pivdenniy Joint-Stock Bank	23.46		n.a.		n.a.		n.a.
Pravex Bank	32.99		n.a.		n.a.		n.a.
Privatbank Commercial Bank	51.68	12.06%	46.12	10.24%	41.83	63.51%	25.58
Prominvestbank of Ukraine-Ukrainian Joint-Stock Commercial Industrial-Investment Bank	64.83	6.13%	61.08	3.04%	59.28	25.45%	47.25
Republican Commercial Bank for Social Development - Ukrostsbank	66.54	8.74%	61.19		n.a.		n.a.
State Export-Import Bank of Ukraine - Ukreximbank	43.70	3.22%	42.34	187.23%	14.74	47.32%	10.01
Transbank	37.23	12.71%	33.03		n.a.		n.a.
Ukrainian Innovation Bank - Ukrinbank (IAS)	33.06	-33.87%	50.00	-2.16%	51.11		n.a.
Ukrgazprombank	5.00	92.53%	2.60		n.a.		n.a.
VABANK - All-Ukrainian Joint-Stock Bank	17.80	436.44%	3.32	-32.93%	4.95	-78.97%	23.53
West-Ukrainian Commercial Bank (UAS)	31.64	3.66%	30.52		n.a.		n.a.
Average	**35.16**	1.30%	**34.71**	24.25%	**27.93**	6.82%	**26.15**

Cost to income ratios 1995 - 1998

Bank Name	1998	change	1997	change	1996	change	1995
Ukrainian Innovation Bank - Ukrinbank (IAS)	99.29	-6.27%	105.93	148.82%	42.57		n.a.
Pravex Bank	76.88		n.a.		n.a.		n.a.
Bank Ukraina	75.80	-7.59%	82.02	24.19%	66.05	106.06%	32.05
Republican Commercial Bank for Social Development - Ukrostsbank	64.46	8.42%	59.45		n.a.		n.a.
First Ukrainian International Bank	62.50	10.12%	56.76	33.07%	42.65	3.08%	41.38
Privatbank Commercial Bank	52.98	-12.17%	60.33	19.20%	50.61		n.a.
VABANK - All-Ukrainian Joint-Stock Bank	51.58		n.a.		n.a.		n.a.
Percombank	51.25	15.31%	44.44	33.33%	33.33	0.00%	33.33
East-Ukrainian Stock Exchange Bank Grant - Grant Bank	50.00		n.a.		n.a.		n.a.
Bank Depozytowo-Kredytowy (Ukraina) Ltd in Lutsk-Deposit Credit Bank (Ukraine) Ltd in Lutsk	50.00		n.a.		n.a.		n.a.
AGIO Bank (UAS)	46.84		n.a.		n.a.		n.a.
Bank Kyiv - Joint Stock Commercial Bank Kiev	41.94	-26.33%	56.92		n.a.		n.a.
State Export-Import Bank of Ukraine - Ukreximbank	39.41	4.75%	37.63	1.15%	37.20	116.51%	17.18
West-Ukrainian Commercial Bank (UAS)	38.65	12.32%	34.41		n.a.		n.a.
Transbank	36.67	6.07%	34.57		n.a.		n.a.
Credit Lyonnais Ukraine	36.26	-12.31%	41.35	-49.19%	81.40		n.a.
Ukrgazprombank	19.90	-38.09%	32.14		n.a.		n.a.
Prominvestbank of Ukraine-Ukrainian Joint-Stock Commercial Industrial-Investment Bank	7.65	-85.35%	52.18	20.92%	43.15	70.19%	25.35
Credit Dnepr Joint Stock Bank	n.a.		n.a.		n.a.		n.a.
Pivdenniy Joint-Stock Bank	n.a.		n.a.		n.a.		n.a.
Aval Bank	n.a.		n.a.		n.a.		n.a.
Oschadny Bank Ukrainy	n.a.		n.a.		n.a.		n.a.
Joint Stock Bank Etalon	n.a.		n.a.		n.a.		n.a.
Average	**50.11**	-6.68%	**53.70**	8.23%	**49.62**	66.18%	**29.86**

Return on Average Equity 1995 - 1998

Bank Name	1998	change	1997	change	1996	change	1995
Aval Bank	84.17	39.59%	60.30		n.a.		n.a.
Ukrgazprombank	83.66	337.99%	19.10		n.a.		n.a.
Joint Stock Bank Etalon	65.75	-28.61%	92.11	33.97%	68.75		n.a.
Republican Commercial Bank for Social Development - Ukrostsbank	59.25	285.97%	15.35		n.a.		n.a.
Credit Lyonnais Ukraine	42.05	-42.25%	72.82	400.63%	14.55		n.a.
Privatbank Commercial Bank	40.78	-35.22%	62.95	-11.21%	70.90		n.a.
VABANK - All-Ukrainian Joint-Stock Bank	38.17	18.28%	32.27	-68.30%	101.82	69.70%	60.00
Bank Kyiv - Joint Stock Commercial Bank Kiev	36.62	107.50%	17.65		n.a.		n.a.
Transbank	34.55	23.38%	28.00		n.a.		n.a.
West-Ukrainian Commercial Bank (UAS)	32.02	15.36%	27.75		n.a.		n.a.
East-Ukrainian Stock Exchange Bank Grant - Grant Bank	28.38		n.a.		n.a.		n.a.
AGIO Bank (UAS)	23.60	-1.49%	23.96		n.a.		n.a.
Pravex Bank	15.75		n.a.		n.a.		n.a.
Percombank	12.75	-70.57%	43.30	15.46%	37.50	-25.00%	50.00
Bank Ukraina	10.39	-83.25%	62.06	-92.00%	775.61	-628.27%	-146.82
Prominvestbank of Ukraine-Ukrainian Joint-Stock Commercial Industrial-Investment Bank	8.91	-43.57%	15.79	38.34%	11.41	-95.55%	256.46
Pivdenniy Joint-Stock Bank	7.30		n.a.		n.a.		n.a.
State Export-Import Bank of Ukraine - Ukreximbank	5.98	-77.10%	26.12	-15.72%	30.99	16.43%	26.61
First Ukrainian International Bank	1.52	-93.36%	22.95	-50.72%	46.57	-31.38%	67.87
Bank Depozytowo-Kredytowy (Ukraina) Ltd in Lutsk-Deposit Credit Bank (Ukraine) Ltd in Lutsk	0.42		n.a.		n.a.		n.a.
Ukrainian Innovation Bank - Ukrinbank (IAS)	n.a.		n.a.		44.52		n.a.
Credit Dnepr Joint Stock Bank	n.a.		n.a.		n.a.		n.a.
Oschadny Bank Ukrainy	n.a.		n.a.		n.a.		n.a.
Average	**31.60**	-18.77%	**38.90**	-67.65%	**120.26**	129.71%	**52.35**

Return on Average Assets 1995 - 1998

Bank Name	1998	change	1997	change	1996	change	1995
Ukrgazprombank	30.70	178.06%	11.04		n.a.		n.a.
Transbank	15.45	20.27%	12.84		n.a.		n.a.
Joint Stock Bank Etalon	11.78	-1.22%	11.93	162.38%	4.55		n.a.
AGIO Bank (UAS)	9.65	-8.63%	10.57		n.a.		n.a.
VABANK - All-Ukrainian Joint-Stock Bank	7.92	-4.53%	8.29	-67.91%	25.84	156.21%	10.08
East-Ukrainian Stock Exchange Bank Grant - Grant Bank	6.39		n.a.		n.a.		n.a.
West-Ukrainian Commercial Bank (UAS)	6.27	-13.98%	7.28		n.a.		n.a.
Republican Commercial Bank for Social Development - Ukrostsbank	6.15	516.85%	1.00		n.a.		n.a.
Aval Bank	5.62	61.84%	3.47		n.a.		n.a.
Bank Kyiv - Joint Stock Commercial Bank Kiev	5.46	151.59%	2.17		n.a.		n.a.
Credit Lyonnais Ukraine	5.07	-26.42%	6.88	617.08%	0.96		n.a.
Percombank	3.40	-60.82%	8.68	158.89%	3.35	-46.37%	6.25
Prominvestbank of Ukraine-Ukrainian Joint-Stock Commercial Industrial-Investment Bank	2.88	-22.99%	3.74	307.86%	0.92	-94.44%	16.48
Privatbank Commercial Bank	2.70	-35.50%	4.19	-12.98%	4.82		n.a.
Pravex Bank	2.36		n.a.		n.a.		n.a.
Pivdenniy Joint-Stock Bank	1.71		n.a.		n.a.		n.a.
State Export-Import Bank of Ukraine - Ukreximbank	0.71	-73.10%	2.65	46.06%	1.82	71.90%	1.06
Bank Ukraina	0.67	-83.59%	4.05	-43.49%	7.17	129.06%	3.13
Bank Depozytowo-Kredytowy (Ukraina) Ltd in Lutsk-Deposit Credit Bank (Ukraine) Ltd in Lutsk	0.40		n.a.		n.a.		n.a.
First Ukrainian International Bank	0.33	-93.16%	4.75	-59.50%	11.73	-11.79%	13.29
Ukrainian Innovation Bank - Ukrinbank (IAS)	n.a.		n.a.		3.64		n.a.
Credit Dnepr Joint Stock Bank	n.a.		n.a.		n.a.		n.a.
Oschadny Bank Ukrainy	n.a.		n.a.		n.a.		n.a.
Average	**6.28**	-2.95%	**6.47**	-0.11%	**6.48**	-22.73%	**8.38**

Net Interest Margin 1995 - 1998

Mark	Bank Name	1998	change	1997	change	1996	change	1995
1	Transbank	36.12	-15.72%	42.86		n.a.		n.a.
2	AGIO Bank (UAS)	30.19		n.a.		n.a.		n.a.
3	Ukrgazprombank	24.97	101.13%	12.41		n.a.		n.a.
4	Republican Commercial Bank for Social Development - Ukrostsbank	23.26	-28.54%	32.54		n.a.		n.a.
5	Bank Ukraina	21.76	-48.43%	42.20	-40.92%	71.43	-58.74%	173.12
6	East-Ukrainian Stock Exchange Bank Grant - Grant Bank	21.57		n.a.		n.a.		n.a.
7	First Ukrainian International Bank	19.49	63.12%	11.95	10.92%	10.77	-61.28%	27.82
8	Prominvestbank of Ukraine-Ukrainian Joint-Stock Commercial Industrial-Investment Bank	15.17	-31.34%	22.09	-25.89%	29.81	-44.72%	53.92
9	Bank Kyiv - Joint Stock Commercial Bank Kiev	11.61	-2.35%	11.89		n.a.		n.a.
10	State Export-Import Bank of Ukraine - Ukreximbank	10.80	1.04%	10.69	-0.69%	10.76	-40.04%	17.95
11	West-Ukrainian Commercial Bank (UAS)	10.06	-49.73%	20.00		n.a.		n.a.
12	Privatbank Commercial Bank	6.51	-47.68%	12.43	-24.42%	16.45		n.a.
13	Credit Lyonnais Ukraine	5.34	-0.34%	5.36	87.68%	2.86		n.a.
14	Bank Depozytowo-Kredytowy (Ukraina) Ltd in Lutsk-Deposit Credit Bank (Ukraine) Ltd in Lutsk	4.87		n.a.		n.a.		n.a.
15	Pravex Bank	2.94		n.a.		n.a.		n.a.
16	Ukrainian Innovation Bank - Ukrinbank (IAS)	2.07	669.52%	0.27	-97.26%	9.84		n.a.
17	Percombank	0.69	-117.16%	-4.03	-215.93%	3.48	-54.78%	7.69
18	VABANK - All-Ukrainian Joint-Stock Bank	-10.17		n.a.		n.a.		n.a.
19	Credit Dnepr Joint Stock Bank	n.a.		n.a.		n.a.		n.a.
20	Pivdenniy Joint-Stock Bank	n.a.		n.a.		n.a.		n.a.
21	Aval Bank	n.a.		n.a.		n.a.		n.a.
22	Oschadny Bank Ukrainy	n.a.		n.a.		n.a.		n.a.
23	Joint Stock Bank Etalon	n.a.		n.a.		n.a.		n.a.
	Average	**13.18**	-22.35%	**16.97**	-12.61%	**19.42**	-65.38%	**56.10**

Capital Funds / Liabilities 1995 - 1998

Bank Name (alpha order)	1998	change	1997	change	1996	change	1995
AGIO Bank (UAS)	61.20	-22.43%	78.90		n.a.		n.a.
Aval Bank	n.a.		n.a.		n.a.		n.a.
Bank Depozytowo-Kredytowy (Ukraina) Ltd in Lutsk-Deposit Credit Bank (Ukraine) Ltd in Lutsk	n.a.		n.a.		n.a.		n.a.
Bank Kyiv - Joint Stock Commercial Bank Kiev	n.a.		n.a.		n.a.		n.a.
Bank Ukraina	6.16	-22.45%	7.94		n.a.		n.a.
Credit Dnepr Joint Stock Bank	33.62		n.a.		n.a.		n.a.
Credit Lyonnais Ukraine	n.a.		n.a.		n.a.		n.a.
East-Ukrainian Stock Exchange Bank Grant - Grant Bank	29.08		n.a.		n.a.		n.a.
First Ukrainian International Bank	45.49	120.37%	20.64	-47.91%	39.62	48.76%	26.64
Joint Stock Bank Etalon	22.40	6.38%	21.05	197.36%	7.08		n.a.
Oschadny Bank Ukrainy	3.71		n.a.		n.a.		n.a.
Percombank	n.a.		n.a.		n.a.		n.a.
Pivdenniy Joint-Stock Bank	n.a.		n.a.		n.a.		n.a.
Pravex Bank	17.62		n.a.		n.a.		n.a.
Privatbank Commercial Bank	6.94	-5.52%	7.35	8.86%	6.75	-23.00%	8.77
Prominvestbank of Ukraine-Ukrainian Joint-Stock Commercial Industrial-Investment Bank	45.89	-7.51%	49.61	392.40%	10.08	26.41%	7.97
Republican Commercial Bank for Social Development - Ukrostsbank	15.42	121.96%	6.95		n.a.		n.a.
State Export-Import Bank of Ukraine - Ukreximbank	n.a.		n.a.		n.a.		n.a.
Transbank	n.a.		n.a.		n.a.		n.a.
Ukrainian Innovation Bank - Ukrinbank (IAS)	-3.72	-137.04%	10.05	12.99%	8.89		n.a.
Ukrgazprombank	46.87	-65.77%	136.92		n.a.		n.a.
VABANK - All-Ukrainian Joint-Stock Bank	22.56	-32.23%	33.29	-8.78%	36.50	80.66%	20.20
West-Ukrainian Commercial Bank (UAS)	n.a.		n.a.		n.a.		n.a.
Average	**25.23**	-32.31%	**37.27**	105.31%	**18.15**	14.21%	**15.89**

Equity / Total Assets 1995 - 1998

Bank Name	1998	change	1997	change	1996	change	1995
Bank Depozytowo-Kredytowy (Ukraina) Ltd in Lutsk-Deposit Credit Bank (Ukraine) Ltd in Lutsk	94.86		n.a.		n.a.		n.a.
Transbank	43.80	-4.53%	45.87		n.a.		n.a.
AGIO Bank (UAS)	37.97	-13.92%	44.10		n.a.		n.a.
Ukrgazprombank	31.91	-44.78%	57.79		n.a.		n.a.
Prominvestbank of Ukraine-Ukrainian Joint-Stock Commercial Industrial-Investment Bank	31.45	-5.15%	33.16	262.26%	9.15	23.99%	7.38
First Ukrainian International Bank	31.27	82.74%	17.11	-39.71%	28.38	34.92%	21.03
Percombank	27.00	4.41%	25.86	201.05%	8.59	-31.29%	12.50
Credit Dnepr Joint Stock Bank	25.16		n.a.		n.a.		n.a.
Pivdenniy Joint-Stock Bank	23.46		n.a.		n.a.		n.a.
East-Ukrainian Stock Exchange Bank Grant - Grant Bank	22.53		n.a.		n.a.		n.a.
VABANK - All-Ukrainian Joint-Stock Bank	18.41	-26.30%	24.98	-6.59%	26.74	59.09%	16.81
Joint Stock Bank Etalon	18.30	5.22%	17.39	163.02%	6.61		n.a.
Bank Kyiv - Joint Stock Commercial Bank Kiev	17.63	43.48%	12.29		n.a.		n.a.
West-Ukrainian Commercial Bank (UAS)	15.95	-39.24%	26.24		n.a.		n.a.
Pravex Bank	14.98		n.a.		n.a.		n.a.
Republican Commercial Bank for Social Development - Ukrostsbank	13.36	105.67%	6.49		n.a.		n.a.
Credit Lyonnais Ukraine	12.59	12.19%	11.22	69.89%	6.60		n.a.
State Export-Import Bank of Ukraine - Ukreximbank	11.38	-9.72%	12.60	53.38%	8.22	99.10%	4.13
Aval Bank	7.29	26.68%	5.76		n.a.		n.a.
Privatbank Commercial Bank	6.49	-5.17%	6.85	8.25%	6.32	-21.55%	8.06
Bank Ukraina	5.80	-21.14%	7.36	28.97%	5.70	-367.37%	-2.13
Oschadny Bank Ukrainy	3.57	-51.98%	7.44	-45.52%	13.66		n.a.
Ukrainian Innovation Bank - Ukrinbank (IAS)	-3.87	-142.34%	9.13	11.81%	8.17		n.a.
Average	**22.23**	7.67%	**20.65**	77.24%	**11.65**	20.31%	**9.68**

Loan Loss Reserve / Gross Loans 1995 - 1998

Bank Name (alpha order)	1998	change	1997	change	1996	change	1995
AGIO Bank (UAS)	n.a.		n.a.		n.a.		n.a.
Aval Bank	n.a.		n.a.		n.a.		n.a.
Bank Depozytowo-Kredytowy (Ukraina) Ltd in Lutsk-Deposit Credit Bank (Ukraine) Ltd in Lutsk	0.0		n.a.		n.a.		n.a.
Bank Kyiv - Joint Stock Commercial Bank Kiev	5.26	-63.02%	14.23		n.a.		n.a.
Bank Ukraina	21.56	-31.85%	31.64	-15.84%	37.60	0.26%	37.50
Credit Dnepr Joint Stock Bank	n.a.		n.a.		n.a.		n.a.
Credit Lyonnais Ukraine	n.a.		n.a.		n.a.		n.a.
East-Ukrainian Stock Exchange Bank Grant - Grant Bank	n.a.		n.a.		n.a.		n.a.
First Ukrainian International Bank	16.30	78.30%	9.14	17.82%	7.76	19.79%	6.48
Joint Stock Bank Etalon	n.a.		n.a.		n.a.		n.a.
Oschadny Bank Ukrainy	n.a.		n.a.		n.a.		n.a.
Percombank	n.a.		n.a.		n.a.		n.a.
Pivdenniy Joint-Stock Bank	n.a.		n.a.		n.a.		n.a.
Pravex Bank	n.a.		n.a.		n.a.		n.a.
Privatbank Commercial Bank	15.64	50.31%	10.41	32.40%	7.86	19.64%	6.57
Prominvestbank of Ukraine-Ukrainian Joint-Stock Commercial Industrial-Investment Bank	n.a.		n.a.		26.82		n.a.
Republican Commercial Bank for Social Development - Ukrostsbank	12.59	-21.84%	16.11		n.a.		n.a.
State Export-Import Bank of Ukraine - Ukreximbank	17.85	-6.22%	19.03	-43.73%	33.83	0.52%	33.65
Transbank	15.00	-1.92%	15.29		n.a.		n.a.
Ukrainian Innovation Bank - Ukrinbank (IAS)	45.12	105.99%	21.90		n.a.		n.a.
Ukrgazprombank	8.11	-59.46%	20.00		n.a.		n.a.
VABANK - All-Ukrainian Joint-Stock Bank	n.a.		n.a.		n.a.		n.a.
West-Ukrainian Commercial Bank (UAS)	n.a.		n.a.		n.a.		n.a.
Average	**17.49**	-0.21%	**17.53**	-23.03%	**22.77**	8.19%	**21.05**

Net Income US$000's 1995 - 1998

Bank Name	1998%	1998 cum %	1998	change	1997	change	1996	change	1995
Aval Bank	27.07%	27.07%	34603	88.1%	18400		n.a.		n.a.
Republican Commercial Bank for Social Development - Ukrostsbank	20.61%	47.68%	26349	611.1%	3706		n.a.		n.a.
Prominvestbank of Ukraine-Ukrainian Joint-Stock Commercial Industrial-Investment Bank	14.06%	61.74%	17975	-47.5%	34206	275.7%	9105	-94.1%	153177
Privatbank Commercial Bank	10.43%	72.17%	13333	6.3%	12546	68.0%	7469		n.a.
Ukrgazprombank	5.30%	77.47%	6772	652.5%	900		n.a.		n.a.
VABANK - All-Ukrainian Joint-Stock Bank	5.01%	82.48%	6402	48.8%	4303	-31.1%	6243	442.1%	1152
Credit Lyonnais Ukraine	3.56%	86.04%	4550	14.6%	3970	790.4%	446		n.a.
Bank Ukraina	3.52%	89.56%	4500	-78.7%	21100	-55.8%	47700	87.8%	25400
West-Ukrainian Commercial Bank (UAS)	3.19%	92.74%	4074	14.2%	3567		n.a.		n.a.
State Export-Import Bank of Ukraine - Ukreximbank	2.50%	95.25%	3200	-74.0%	12300	11.8%	11000	61.8%	6800
Joint Stock Bank Etalon	1.99%	97.23%	2540	28.2%	1982	223.2%	613		n.a.
Pravex Bank	1.90%	99.14%	2434		n.a.		n.a.		n.a.
Bank Kyiv - Joint Stock Commercial Bank Kiev	1.88%	101.02%	2400	166.7%	900		n.a.		n.a.
AGIO Bank (UAS)	1.87%	102.89%	2393	-47.4%	4550		n.a.		n.a.
East-Ukrainian Stock Exchange Bank Grant - Grant Bank	1.74%	104.63%	2222		n.a.		n.a.		n.a.
Percombank	1.61%	106.24%	2063	76.3%	1171	306.6%	288	-63.7%	793
Transbank	1.57%	107.81%	2011	35.6%	1482		n.a.		n.a.
First Ukrainian International Bank	0.55%	108.36%	700	-93.3%	10500	-28.1%	14600	29.2%	11300
Pivdenniy Joint-Stock Bank	0.41%	108.77%	529		n.a.		n.a.		n.a.
Bank Depozytowo-Kredytowy (Ukraina) Ltd in Lutsk-Deposit Credit Bank (Ukraine) Ltd in Lutsk	0.04%	108.82%	53		n.a.		n.a.		n.a.
Ukrainian Innovation Bank - Ukrinbank (IAS)	-8.82%	100.00%	-11270	56.5%	-7200	-287.2%	3846		n.a.
Credit Dnepr Joint Stock Bank			n.a.		n.a.		n.a.		n.a.
Oschadny Bank Ukrainy			n.a.		n.a.		n.a.		n.a.
Total			**127834**	-0.4%	**128383**	26.7%	**101311**	-49.0%	**198622**

Equity US$000's 1995 - 1998

Bank Name	1998%	1998 cum %	1998	change	1997	change	1996	change	1995
Prominvestbank of Ukraine-Ukrainian Joint-Stock Commercial Industrial-Investment Bank	29.14%	29.14%	201050	-45.2%	366931	452.8%	66371	-32.3%	98105
Republican Commercial Bank for Social Development - Ukrostsbank	9.39%	38.53%	64815	168.5%	24140		n.a.		n.a.
State Export-Import Bank of Ukraine - Ukreximbank	7.99%	46.52%	55100	6.2%	51900	22.7%	42300	47.4%	28700
Aval Bank	7.78%	54.30%	53704	76.0%	30516		n.a.		n.a.
Bank Ukraina	6.99%	61.29%	48200	25.5%	38400	29.7%	29600	-271.1%	-17300
First Ukrainian International Bank	5.84%	67.13%	40300	-21.9%	51600	29.3%	39900	75.0%	22800
Privatbank Commercial Bank	5.67%	72.80%	39153	49.1%	26257	83.3%	14326	23.4%	11612
Oschadny Bank Ukrainy	5.24%	78.04%	36138	-20.8%	45652	-14.6%	53455		n.a.
VABANK - All-Ukrainian Joint-Stock Bank	2.78%	80.82%	19206	25.2%	15343	37.6%	11148	480.8%	1919
Pravex Bank	2.24%	83.06%	15450		n.a.		n.a.		n.a.
Credit Dnepr Joint Stock Bank	2.11%	85.17%	14550		n.a.		n.a.		n.a.
Credit Lyonnais Ukraine	1.98%	87.15%	13651	70.8%	7994	160.7%	3066		n.a.
West-Ukrainian Commercial Bank (UAS)	1.95%	89.10%	13439	4.6%	12852		n.a.		n.a.
Bank Depozytowo-Kredytowy (Ukraina) Ltd in Lutsk-Deposit Credit Bank (Ukraine) Ltd in Lutsk	1.84%	90.94%	12698		n.a.		n.a.		n.a.
Percombank	1.71%	92.65%	11799	155.0%	4627	244.3%	1344	-15.3%	1586
Ukrgazprombank	1.66%	94.31%	11481	143.7%	4711		n.a.		n.a.
AGIO Bank (UAS)	1.42%	95.73%	9804	-48.4%	18995		n.a.		n.a.
East-Ukrainian Stock Exchange Bank Grant - Grant Bank	1.13%	96.87%	7831		n.a.		n.a.		n.a.
Pivdenniy Joint-Stock Bank	1.05%	97.92%	7249		n.a.		n.a.		n.a.
Bank Kyiv - Joint Stock Commercial Bank Kiev	1.01%	98.93%	7000	37.3%	5100		n.a.		n.a.
Transbank	0.92%	99.85%	6349	19.9%	5294		n.a.		n.a.
Joint Stock Bank Etalon	0.66%	100.51%	4550	34.0%	3397	280.9%	892		n.a.
Ukrainian Innovation Bank - Ukrinbank (IAS)	-0.51%	100.00%	-3545	-139.9%	8894	2.9%	8640		n.a.
Total			**689973**	-4.5%	**722601**	166.6%	**271041**	83.9%	**147423**

Customer & Short Term Funding US$000's 1995 - 1998

Bank Name	1998%	1998 cum %	1998	change	1997	change	1996	change on year	1995
Bank Ukraina	19.49%	19.49%	759000	65.3%	459100	17.2%	391800	-21.9%	501500
Privatbank Commercial Bank	14.04%	33.53%	546825	61.1%	339439	71.5%	197938	54.8%	127831
Oschadny Bank Ukrainy	11.94%	45.47%	464921	89.8%	244983	80.3%	135893		n.a.
Aval Bank	11.60%	57.07%	451746	30.2%	346940		n.a.		n.a.
Republican Commercial Bank for Social Development - Ukrostsbank	10.65%	67.72%	414868	23.6%	335786		n.a.		n.a.
Prominvestbank of Ukraine-Ukrainian Joint-Stock Commercial Industrial-Investment Bank	10.54%	78.26%	410388	-41.3%	698995	13.6%	615088	-9.1%	676472
State Export-Import Bank of Ukraine - Ukreximbank	7.53%	85.80%	293400	26.3%	232300	-30.3%	333200	-46.5%	623000
Credit Lyonnais Ukraine	2.41%	88.20%	93704	49.4%	62732	46.2%	42921		n.a.
Ukrainian Innovation Bank - Ukrinbank (IAS)	2.35%	90.55%	91481	4.4%	87612	-8.9%	96154		n.a.
First Ukrainian International Bank	1.64%	92.19%	63800	-73.4%	239600	164.5%	90600	10.5%	82000
VABANK - All-Ukrainian Joint-Stock Bank	1.18%	93.37%	45926	19.5%	38442	113.5%	18004	103.9%	8829
Pravex Bank	1.10%	94.47%	42910		n.a.		n.a.		n.a.
West-Ukrainian Commercial Bank (UAS)	0.93%	95.40%	36032	71.1%	21061		n.a.		n.a.
Credit Dnepr Joint Stock Bank	0.73%	96.13%	28466		n.a.		n.a.		n.a.
East-Ukrainian Stock Exchange Bank Grant - Grant Bank	0.68%	96.81%	26667		n.a.		n.a.		n.a.
Bank Kyiv - Joint Stock Commercial Bank Kiev	0.68%	97.49%	26500	-24.9%	35300		n.a.		n.a.
Ukrgazprombank	0.61%	98.11%	23810	602.8%	3388		n.a.		n.a.
Pivdenniy Joint-Stock Bank	0.49%	98.59%	18995		n.a.		n.a.		n.a.
Joint Stock Bank Etalon	0.44%	99.03%	17143	21.1%	14154	17.6%	12040		n.a.
Percombank	0.40%	99.43%	15556	138.5%	6522	-11.7%	7390	55.3%	4758
AGIO Bank (UAS)	0.37%	99.80%	14269	-20.9%	18042		n.a.		n.a.
Transbank	0.20%	100.00%	7778	36.0%	5717		n.a.		n.a.
Bank Depozytowo-Kredytowy (Ukraina) Ltd in Lutsk-Deposit Credit Bank (Ukraine) Ltd in Lutsk	0.00%	100.00%	53		n.a.		n.a.		n.a.
Total			**3894235**	22.1%	**3190113**	64.4%	**1941027**	-4.1%	**2024390**

Total Assets US$000's 1995 - 1998

Bank Name	1998%	1998 cum %	1998	change	1997	change	1996	change	1995
Oschadny Bank Ukrainy	17.64%	17.64%	1,011,164	64.8%	613,434	56.7%	391,363		n.a.
Bank Ukraina	14.50%	32.13%	831,000	59.2%	522,100	0.6%	519,000	-36.0%	811,200
Aval Bank	12.84%	44.98%	736,296	38.9%	529,978		n.a.		n.a.
Prominvestbank of Ukraine-Ukrainian Joint-Stock Commercial Industrial-Investment Bank	11.15%	56.13%	639,189	-42.2%	1,106,508	52.6%	725,084	-45.4%	1,328,846
Privatbank Commercial Bank	10.52%	66.65%	603,069	57.2%	383,536	69.3%	226,533	57.3%	144,050
Republican Commercial Bank for Social Development - Ukrostsbank	8.47%	75.11%	485,291	30.5%	371,731		n.a.		n.a.
State Export-Import Bank of Ukraine - Ukreximbank	8.45%	83.56%	484,400	17.6%	411,900	-20.0%	514,900	-26.0%	695,600
First Ukrainian International Bank	2.25%	85.81%	128,900	-57.3%	301,600	114.5%	140,600	29.7%	108,400
Credit Lyonnais Ukraine	1.89%	87.70%	108,466	52.2%	71,255	53.5%	46,433		n.a.
VABANK - All-Ukrainian Joint-Stock Bank	1.82%	89.52%	104,339	69.9%	61,428	47.3%	41,695	265.1%	11,420
Pravex Bank	1.80%	91.32%	103,122		n.a.		n.a.		n.a.
Ukrainian Innovation Bank - Ukrinbank (IAS)	1.60%	92.92%	91,693	-5.9%	97,406	-7.9%	105,797		n.a.
West-Ukrainian Commercial Bank (UAS)	1.47%	94.39%	84,286	72.1%	48,972		n.a.		n.a.
Credit Dnepr Joint Stock Bank	1.01%	95.40%	57,831		n.a.		n.a.		n.a.
Percombank	0.76%	96.16%	43,704	144.3%	17,893	14.4%	15,643	23.3%	12,688
Bank Kyiv - Joint Stock Commercial Bank Kiev	0.69%	96.86%	39,700	-4.3%	41,500		n.a.		n.a.
Ukrgazprombank	0.63%	97.48%	35,979	341.3%	8,152		n.a.		n.a.
East-Ukrainian Stock Exchange Bank Grant - Grant Bank	0.61%	98.09%	34,762		n.a.		n.a.		n.a.
Pivdenniy Joint-Stock Bank	0.54%	98.63%	30,899		n.a.		n.a.		n.a.
AGIO Bank (UAS)	0.45%	99.08%	25,824	-40.0%	43,069		n.a.		n.a.
Joint Stock Bank Etalon	0.43%	99.51%	24,868	27.3%	19,532	44.8%	13,489		n.a.
Transbank	0.25%	99.77%	14,497	25.6%	11,540		n.a.		n.a.
Bank Depozytowo-Kredytowy (Ukraina) Ltd in Lutsk-Deposit Credit Bank (Ukraine) Ltd in Lutsk	0.23%	100.00%	13,386		n.a.		n.a.		n.a.
Total			**5,732,664**	23.0%	**4,661,535**	70.1%	**2,740,536**	-11.9%	**3,112,205**

APPENDIX 3 POST-COMMUNIST STATES DATA

3.1 Real GDP/NMP in the ECE Transition Economies 1989-1999

(Index 1989 = 100)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Eastern Europe	100	93.2	82.9	79.3	79	82.1	86.9	90.3	92.2	93.9	95.2
Czech Republic	100	98.8	87.3	86.9	86.9	88.8	94.1	98.7	97.7	95.5	95.3
Hungary	100	96.5	85	82.4	81.9	84.4	85.6	86.8	90.7	95.2	99.4
Poland	100	88.4	82.2	84.4	87.6	92.1	98.6	104.5	111.7	117.1	121.8
Baltic States	100	97.8	89.9	67.9	68.2	55.2	56.4	58.8	63.7	66.6	65.4
CIS	100	96.8	90.9	78	70.4	60.3	56.9	55	55.6	53.9	55.5
Belarus	100	98.1	96.9	87.6	81	70.8	63.4	65.2	72.6	78.7	81.4
Russian Federation	100	97	92.2	78.8	71.9	62.8	60.2	58.2	58.7	55.8	57.6
Ukraine	100	96.4	88	79.2	68	52.4	46	41.4	40.2	39.5	39.3

Source: UNECE (2000)

3.2 Consumer Prices in the ECE Transition Economies 1990-1999

Annual average % change over previous year

	1990	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**
Czech Republic	9.9	56.7	11.1	20.8	10	9.1	8.9	8.4	10.6	2.1
Hungary	28.9	35	23	22.6	19.1	28.5	23.6	18.4	14.2	10.1
Poland	585.8	70.3	45.3	36.9	33.2	28.1	19.8	15.1	11.7	7.4
Estonia	*18*	*202*	*1078.2*	*89.6*	*47.9*	*28.9*	*23.1*	*11.1*	*10.6*	*3.5*
Latvia	*10.9*	*172.2*	*951.2*	*109.1*	*35.7*	*25*	*17.7*	*8.5*	*4.7*	*2.4*
Lithuania	*9.1*	*216.4*	*1020.5*	*410.1*	*72*	*39.5*	*24.7*	*8.8*	*5.1*	*0.8*
Baltic States	12.7	196.9	1016.6	202.9	51.9	31.1	21.8	9.5	6.8	2.2
Belarus	4.7	94.1	971.2	1190.9	2219.6	709.3	52.7	63.9	73.2	293.7
Russian Federation		160	1528.7	875	309	197.4	47.8	14.7	27.8	85.9
Ukraine	5.4	94	1209.6	4734.9	891.2	376.7	80.2	15.9	10.6	22.7

Source: UNECE (2000)

3.3 Current Account Balances in selected ECE transition economies 1990 - 1999

(Million US$)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Eastern Europe	-6188	-2146	-857	-7914	-2705	-1655	-13498	-15021	-17468	-20122
Czech Republic	-122	1708	-456	456	-787	-1369	-4292	-3211	-1336	-1058
Hungary	127	267	324	-3455	-3911	-2480	-1678	-981	-2298	-2076
Poland	716	-1359	-269	-2868	677	5310	-1371	-4312	-6858	-11628
Baltic States			548	353	-59	-788	-1400	-1890	-2489	-1925
CIS				10669	5699	4655	6497	-2233	-5273	
Belarus			131	-435	-444	-458	-516	-788	-862	-40
Russian Federation				12792	8846	7736	12116	3924	2056	23000
Ukraine				-765	-1163	-1152	-1184	-1335	-1296	1022

Source: UNECE (2000)

3.4 Capital Formation in the ECE Transition Economies 1990-1999

(Index 1989 (or earliest year available thereafter = 100)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Czech Republic	97.9	71.1	82.8	83	90.5	108.5	117.3	113.9	109.4	103.4
Hungary	92.9	83.1	81	82.6	92.9	88.9	94.8	103.6	117.3	126.4
Poland	75.2	71.9	73.6	75.7	82.6	96.2	115.2	140.1	160	171.1
Estonia				*100*	*106.2*	*110.5*	*123.1*	*144.6*	*156.3*	
Latvia	*100*	*36.1*	*25.7*	*21.6*	*21.8*	*23.7*	*29*	*35*	*38.9*	
Lithuania						*100*	*110.9*	*133.2*	*147.8*	
Baltic States	100.0	36.1	25.7	60.8	64.0	78.1	87.7	104.3	114.3	
Belarus	100	105.3	85.6	79.1	68.3	48.1	46.6	56.7	62.5	
Russian Fedn.	100	84.5	49.4	36.7	27.1	24.6	20.4	18.9	17.7	17.4
Ukraine	100	81.6	69.3	48.2	28.4	19.7	15.2	15.5	16	

Source: UNECE (2000)

3.5 Background on Poland

The exchange rate policy in Poland

The combination of a massive one-off devaluation in 1989 with subsequent constant gradual devaluation and strong productivity gains has allowed a substantial undervaluation of the zloty to persist. This point has not only been argued through the calculation of purchasing power parities but has also been strongly supported by the zloty's continuous push towards the lower boundary of its floating band. At the height of this push the zloty gained up to 6% versus central parity before the NBP decided to readjust the rate and actually revalue the zloty by the same amount in December 1995.

In the event, the currency still pushed about 3% firmer than the central parity rate, so the NBP initiated a policy of consecutive intervention against its own currency. Interventions had a strong comeback during the summer of 1996 and since then a level of roughly 3% under parity has been accepted as the tolerance limit of the NBP. Overall, the zloty has lost roughly 12.4% versus the dollar and 6.3% versus the Deutschmark in the 12 months since the end of October 1995. Considering that the managed devaluation alone should account for roughly 12.7% in the same period, the zloty has performed rather well and, in the light of the continuing surge of both direct and indirect foreign investment, is expected to continue doing so. The extraordinary growth of the NBP's official currency reserves is a good illustration of this.

Monetary policy in Poland

In terms of both exchange rate and monetary policy, the NBP has proved and continuously defended its independence, as laid down in the Central Bank Act of 1989. Notwithstanding increasingly vociferous demands for export-oriented devaluation in the face of nominal balance of trade problems, the Central Bank has stuck to its guns and thereby strongly assisted the growing community of foreign investors. In terms of interest rate and money supply management, the NBP relies mostly on the frequent issue of its own bills, the more ore less regular offer of repo transactions and recently the outright sale of Treasury bonds from its portfolio.

Given the quantity of underperforming assets on the books of most domestic banks, the market has been rather risk-averse over the last years. The result has been a strong preference to invest liquid funds in government and NBP securities and the interbank deposit market rather than to lend to corporate customers. As a consequence, the domestic money market has tended towards a state of constant excess liquidity, with the exception of the dates at which minimum reserves are calculated. on those days, the whole market is regularly caught scrambling for funds which frequently drives the short end of the curve up to the Lombard level. So far, the NBP has been honing its skills in mopping up excess liquidity in an environment of high nominal interest rates, but it remains to be seen how it would cope with a prolonged scarcity of funds.

Polish monetary market securities

Polish money market securities presently comprise Treasury bills (issued by the Ministry of Finance), NBP bills (issued by the Central Bank), certificates of deposit (issued by the local banks) and commercial paper (issued by major corporate). The lion's share of zloty-denominated market investment, Z24 billion ($8.5 billion) out of an overall market volume of roughly Z50 billion, is transacted in Treasury bills. This paper is auctioned regularly on Mondays and comes in volumes ranging from Z200 million to Z1 billion. However, this market is not restricted to banks and a lot of individual and institutional investors also participate via licensed securities brokers. As a complement to the Treasury bills, the NBP started to issue its own paper and has now reached at outstanding market volume of Z12 billion (as of June 30,1996). The central bank sells this paper by way of irregular auctions of several hundred million zloty in five maturity terms (one, three, six, nine and 12 months). Interestingly enough, NBP bills have consistently offered a yield premium over T-bills during 1995. This can be seen as part of the reason for reduced demand in the latter, although NBP bills, unlike T-bills, are not available to foreign or retail investors.

Treasury bills have been a steady feature of the market for quite some time, far outweighing the long end of the zloty-denominated capital market (as would be expected in a situation of a strongly inverted yield curve). In contrast, the commercial paper market is a relatively young segment with present market volume of roughly Z900 million, dispersed among a dozen domestic issuers which tend to be either large domestic trading conglomerates (for instance Elektrim and Universal) or subsidiaries of foreign multinationals (such as Unilever and FIAT). Zloty-CP tends to pay only a marginal premium over Treasury bills and is therefore a financial method of growing interest ina market that has been rather cautious with new lending activity. There are, however, certain legal snags involved.

The market is divided as to whether to treat CP as promissory notes or as proper securities. Under the first definition, issue of CP would fall under the law governing bills of exchange (1936) with all the entailing legal definitions as to transfer of ownership and legal recourse in case of default. Most running programmes have come explicitly under the first approach but the most prominent issue has been explicitly defined as a security under the second approach. For the moment, both viewpoints have their local champions and the ongoing debate has yet to produce a final legal ruling. In general, all fungible segments of the zloty money markets (NBP bills, T-bills and commercial paper) suffer from a severe lack of secondary market liquidity, as investors tend to follow a buy-and-hold strategy. Recently, lending activity seems to be picking up dramatically, so that the emergence of a liquid Polish commercial paper market might be a foregone conclusion. Support for this view comes from the gradual decline of interest rates over the 1995, preparing the way for more of a longer-term capital markets approach to corporate finance. The recent return to zero or even negative real rates of interest after a one-year period of positive returns has already inspired considerable activity in this regard.

Warsaw Stock Exchange

The Warsaw Stock Exchange had a capitalisation of $8 billion. There were 83 stocks listed on it, and average daily turnover in 1996 was $35 million. Poland became an OECD member in the summer of 1996. Per capita GDP equalled $3,000 according to current exchange rates, and $5,500 according to purchasing power parity. The rise in GDP was mainly due to improved productivity, as employment had remained practically unchanged. Trading securities in Poland could be conducted only through brokerages, and is concentrated mainly on the WSE. For investors on the WSE, 1996 was a good year. The WIG Index gained 86% during 1996. Factors that played the greatest role in attracting investors to the stock market in 1996 include the undervaluation of stocks in 1995, the favourable perception of Poland's economy, growth affirms' profits in real terms, and major agencies rating Poland at investment grade. (Euromoney, 1997).

3.6 Background on Hungary

The National Bank of Hungary

The National Bank of Hungary (NBH), Hungary's central bank, was established in 1924. Its primary responsibility is to maintain the internal and external purchasing power of the Hungarian currency. The NBH is regulated by the Central Bank Act of 1991 and since the start of the reforms has gradually been divested of its non-central-bank functions and granted an increased level of independence. The most recent amendment to the Central Bank Act, in force since January 1 1997, has brought the regulation of the NBH into line with the principles laid down in the Maastricht Treaty. This amendment prohibits the NBH from financing the central government. Determining the exchange rate system remains the responsibility of the government in agreement with the NBH. As a consequence of comprehensive stabilisation-cum-reform policy programme launched in March 1995, the Hungarian economy has moved decisively towards macroeconomic balance and sustainable economic growth. The growth rate has reached 3% in 1997, led by exports and private investment. From $3.9 billion in 1994, the current account deficit had fallen to $1.7 billion in 1996. As a result, the net foreign debt of the country has declined by $6 billion since the end of 1994. In order to build on these developments, monetary policy is focused on maintaining a stable environment for economic activity.

The NBH's goal is a reduction of inflation to single digits within the next few years while maintaining the momentum for growth. One important objective of the monetary authorities is to break through the public's inertia towards inflationary expectations by improving the credibility of their policies. To this end, since March 1995, a pre-announced crawling band exchange rate regime has been adopted to serve as a nominal anchor. The rate of crawl has been 1% per month since August 15 1997. The market rate can fluctuate within a +-2.25% band around the central rate, but with the exception of very short periods the exchange rate has remained at the lowest edge of the band since the introduction of the system. This is an indication of the confidence of the markets in the economic policy. Close co-ordination of fiscal and monetary policies is a precondition for the sustainability of such an exchange rate regime. The NBH has implemented a cautious interest rate policy, with the aim of guiding the market to establish a level of domestic interest rates which stimulates private savings and channels the funds to the most productive investments without encouraging an excessive inflow of speculative capital. The NBH intends to maintain this prudent policy in order to provide a stable and predictable environment conducive to sustained economic growth.

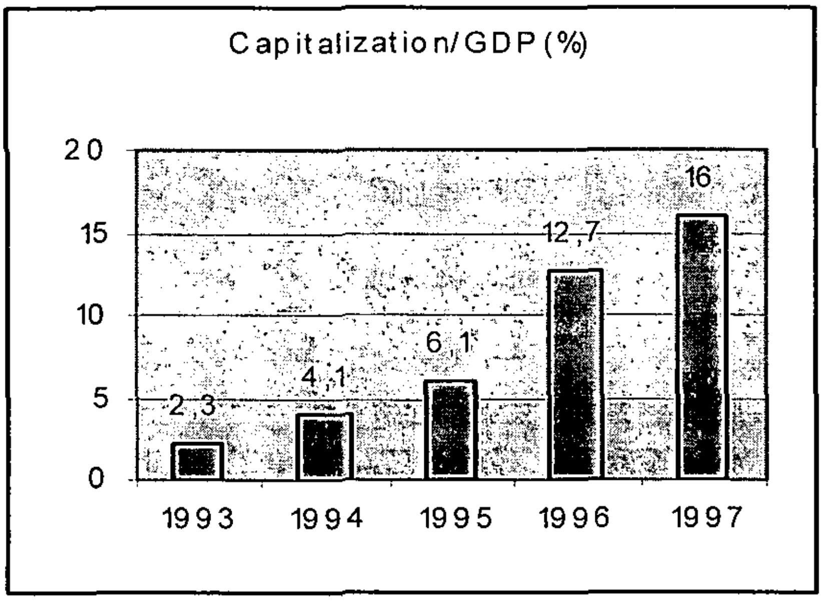
The NBH has played a dominant role in establishing and developing the financial markets during the years of transition. These markets have achieved a remarkable level of development - allowing the NBH to use indirect instruments of monetary control and providing policy-makers with information previously not available. The monetary policy instruments used by the NBH are very similar to those, which will be used by the future European central bank. The most important instruments are open-market operations, repo and reverse REPO transactions, short-term swaps and reserve requirements. The NBH focuses on the short-term market, but the fight against inflation and the need to develop the longer-term market have made it necessary for the NBH to intervene here as well. Thus, reverse repo is available for one month and - due to a lack of marketable government securities in its portfolio - the NBH issued its own one-year bond in June 1997.

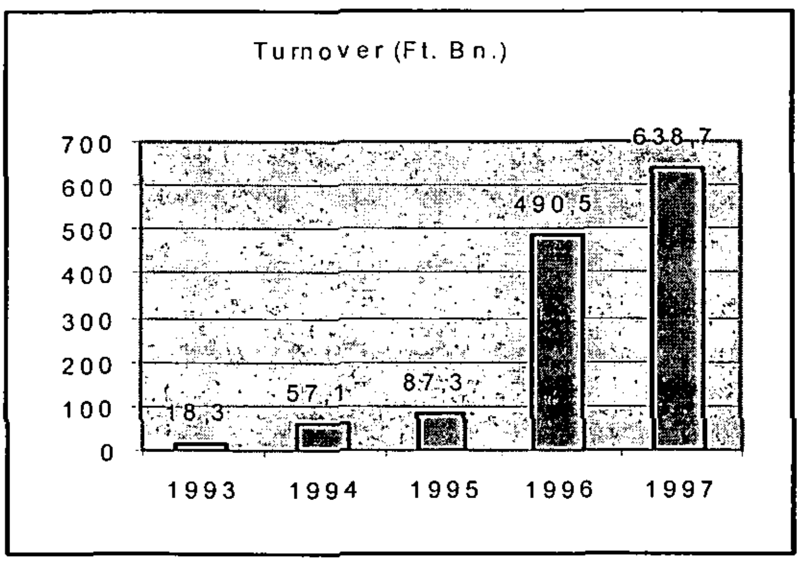
Equities

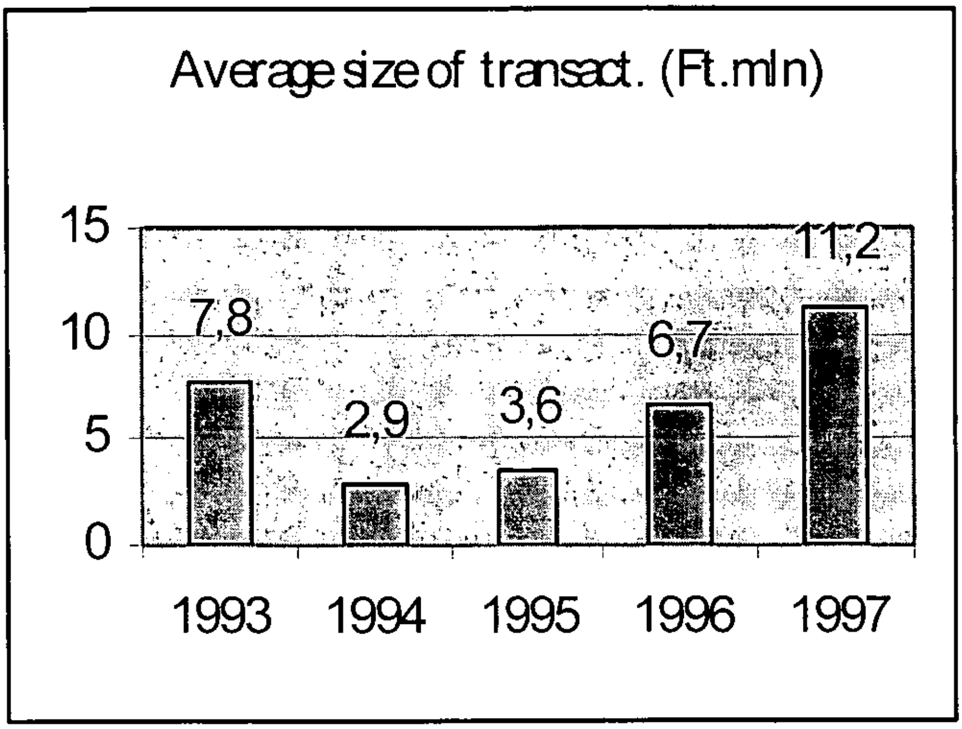
The Budapest Stock Exchange has undergone a unique and spectacular transformation. Despite the bold, decisive reforms of the early 1990s, which contributed radically to increasing the efficiency and profitability of businesses, the macroeconomic imbalances prevented the success of these developments. Whilst net profits of companies listed on the stock exchange shot up by 166% between 1993 and 1995, the stock index actually dropped by 12% (both measured in dollars), which clearly illustrates investors' uncertainty in this period. However, the Hungarian austerity package of 1995 turned the situation around, ushering in a new era of confidence in the economy and, by the end of 1996, the remarkable progress of Hungarian companies finally came to be recognised in their share price.

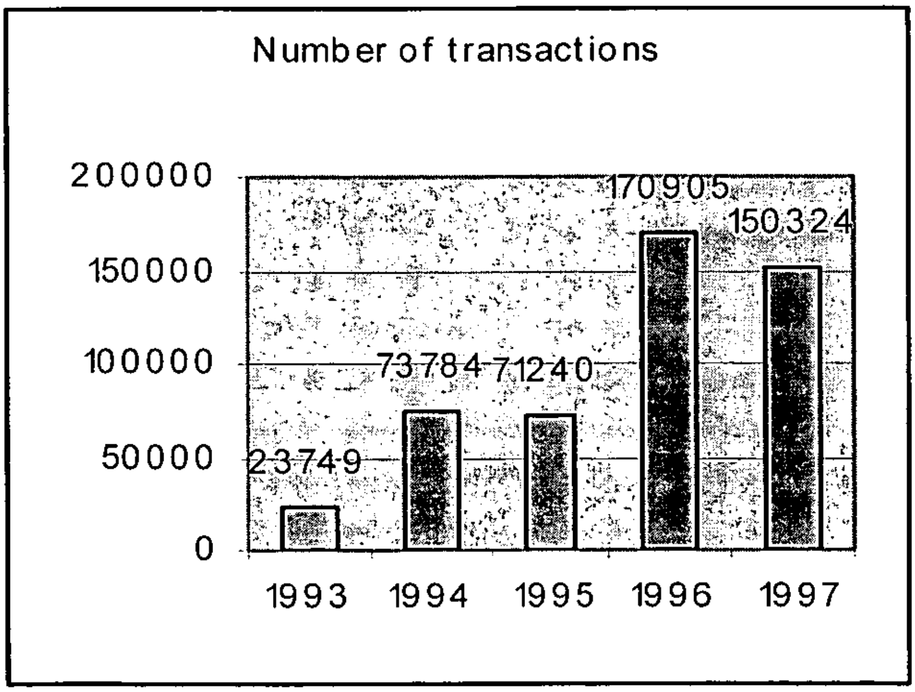
Fundamental to the progress made has been the tight rein kept on inflation, 1997 end target was 18%, down from 19.8% from previous year. Moreover there has been the improvement in the current account balance, 5.7% in 1995 and 4% in 1997 as a percentage of GDP. Another notable achievement in monetary policy has been to maintain the stability of the crawling peg currency devaluation system since the spring of 1995. This has contributed considerably in reassuring investors that inflation will remain under control. The monthly crawling peg started at 1.9% in April 1995 and it will be reduced to 1% from August 1997. Interest rates are falling, especially long-term rates, a fact which also reflects market participants' confidence in the prevailing monetary policy. However large real wage increases and slowing savings make it likely that export- driven growth will spread to other sectors of the economy, which should result in increasing consumption towards the end of the year. This in itself will obviously stimulate economic activity further, giving a boost to the banking sector in particular. It should be noted however that mainly because of the relative immaturity of the long-term savings sector, e.g. pension funds, insurance and investment funds, the availability of long-term resources is still limited.

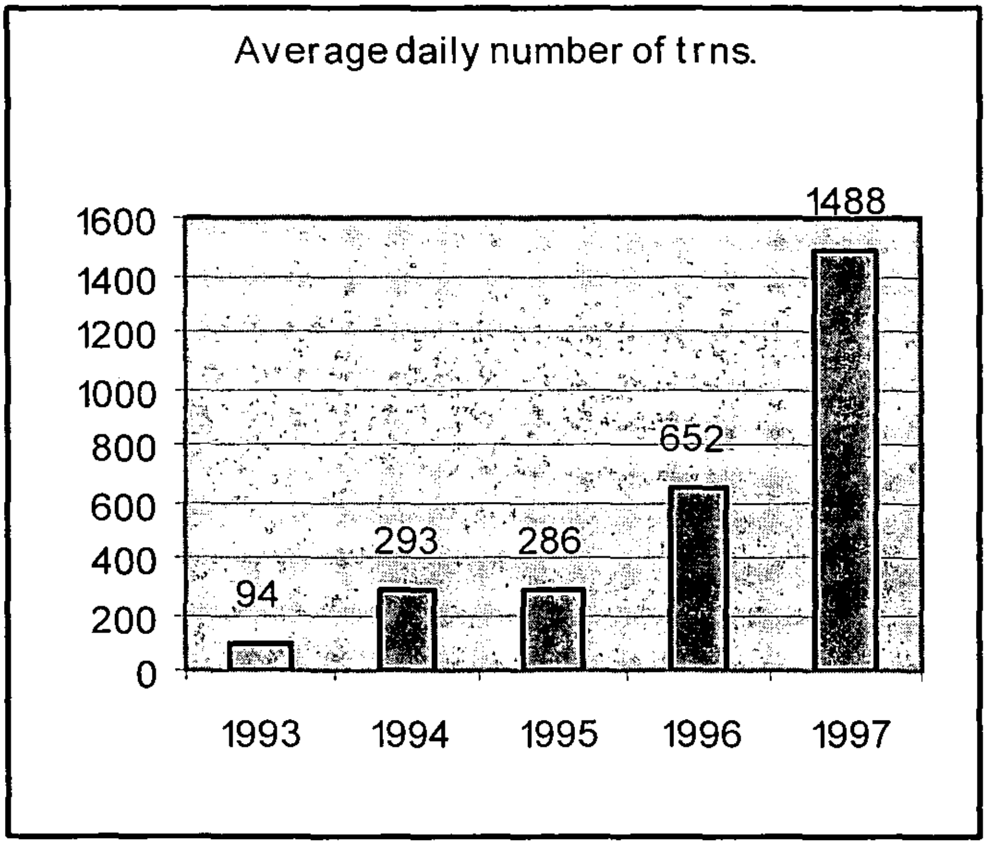
The development of BSE's trading section

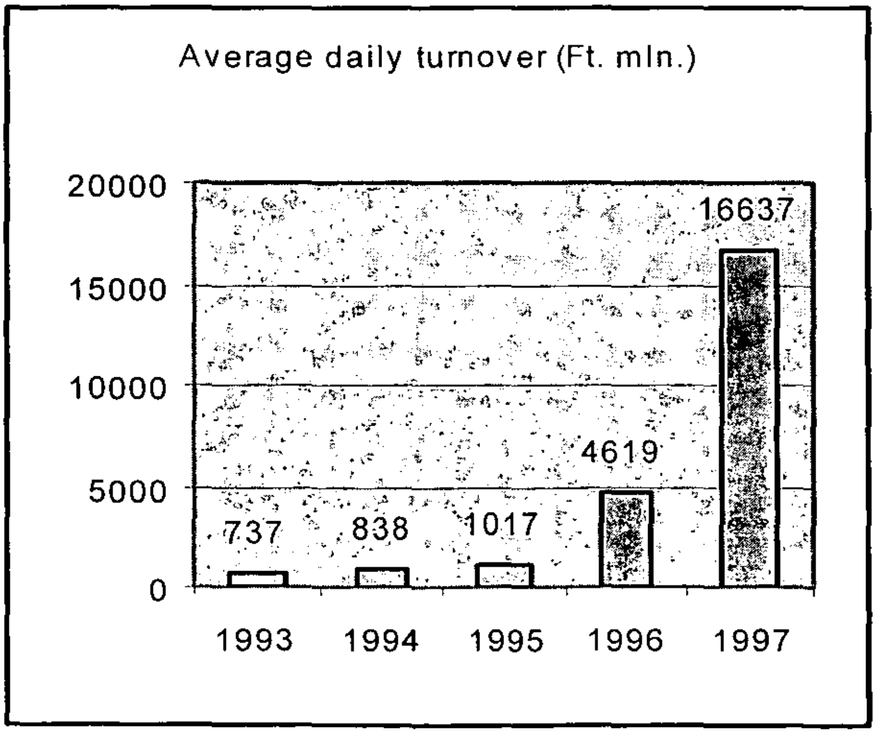


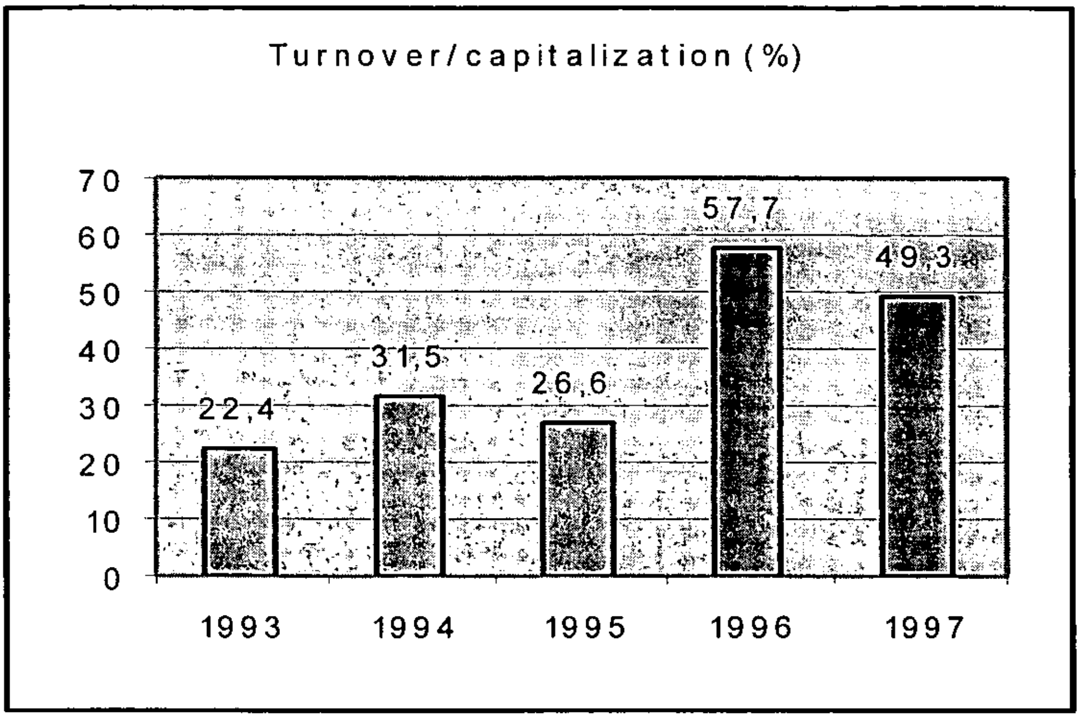


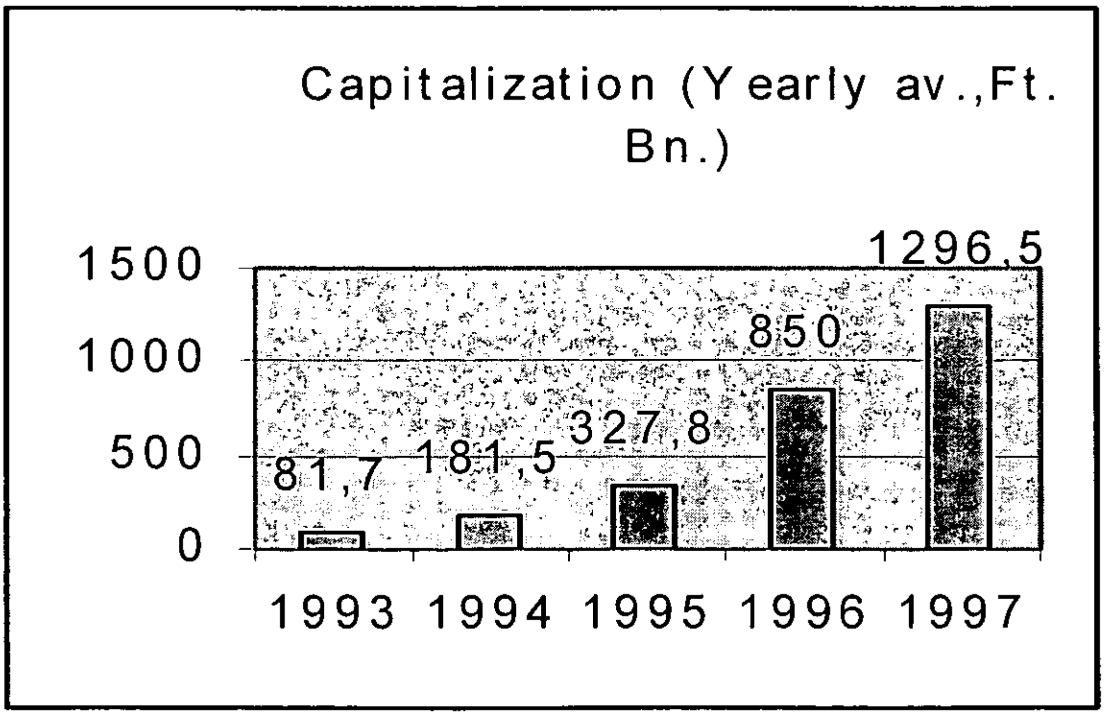

Average size of transact. (Ft.mln)
15
10
5
0
7,8
2,9
3,6
6,7
11,2
1993
1994
1995
1996
1997

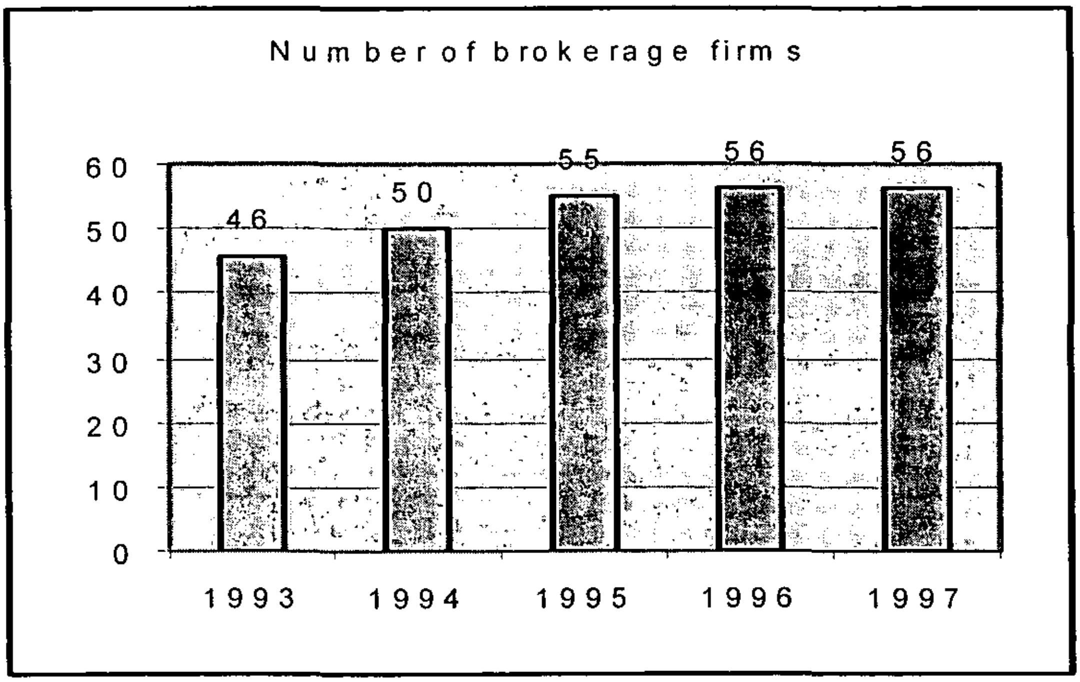

Number of transactions
200000
150000
100000
50000
0
23749
73784
71240
170905
150324
1993
1994
1995
1996
1997

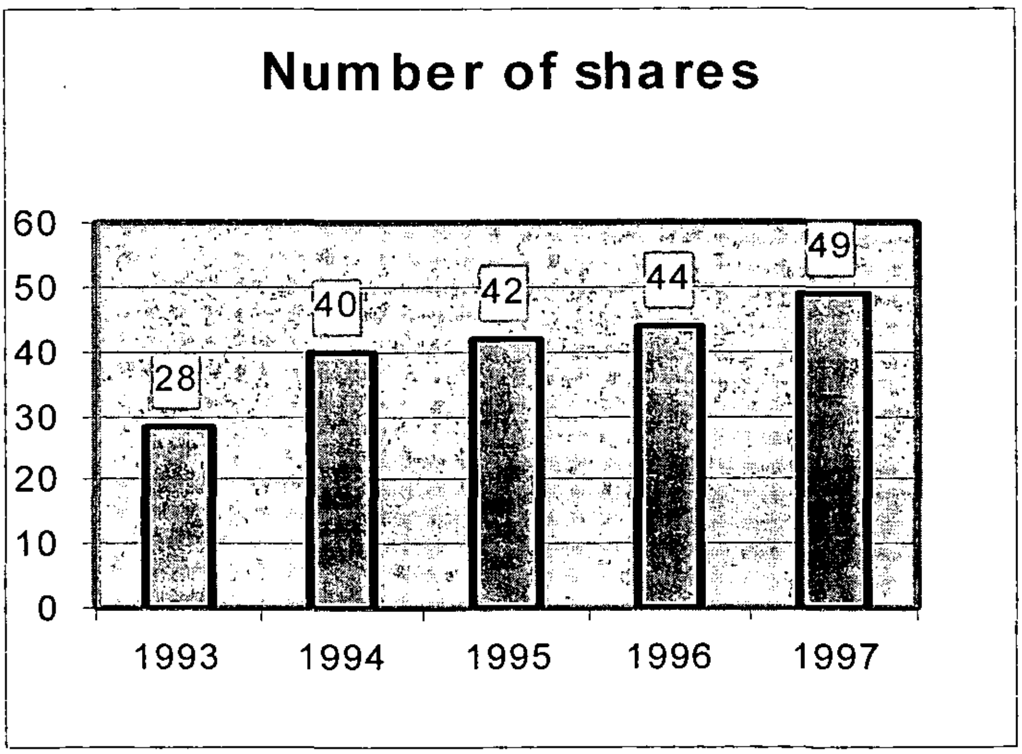

Average daily number of trns.
1600
1400
1200
1000
800
600
400
200
0
94
293
286
652
1488
1993
1994
1995
1996
1997


Average daily turnover (Ft. mln.)
20000
15000
10000
5000
0
737
838
1017
4619
16637
1993
1994
1995
1996
1997


Turnover/capitalization (%)
70
60
50
40
30
20
10
0
22,4
31,5
26,6
57,7
49,3
1993
1994
1995
1996
1997


Capitalization (Yearly av.,Ft. Bn.)
1500
1000
500
0
81,7
181,5
327,8
850
1296,5
1993
1994
1995
1996
1997





Source: Budapest Stock Exchange, 1998

3.7 BACKGROUND ON THE CZECH REPUBLIC

Budget deficit

In 1995 the current account deficit widened considerably. In 1995, the deficit was fully financed by foreign capital inflows. In 1996, the overall balance of payments for the first half registered a deficit exceeding $730m. For the first time since the creation of the Czech Republic in 1993, net capital inflows have not been sufficient to cover the current account deficit. The main factor in the deficit on the current account is the development of the trade balance. Fast economic growth and an even faster growth of investment caused an increase in demand for imports which resulted in a surging trade deficit. The gap between imports and exports significantly widened in 1996. Imports continue to grow more rapidly than exports, but the structure of imports is changing. Imports of machinery and investment goods form the most dynamic part.

These goods are used for the restructuring of the industry and infrastructure and are therefore an imperative component in the structure of imports. The composition of exports is shifting as well, and higher value-added goods like machines, transport equipment and consumer goods are growing faster than the average of all sectors. In 1995, roughly two-thirds of the trade deficit was compensated for by income from services and transfers, while in the first half of 1996, services and transfers accounted for less than half the trade deficit. High inflows of foreign capital covered the remaining current account deficit in 1995, and, on top of that, permitted a further increase in foreign exchange reserves. Capital totalling $8.4bn flowed into the country in 1995, $2.5bn of which as foreign direct investment (FDI), $3bn as lending by foreign banks to Czech companies or joint ventures in the Czech Republic, and $1.6bn in portfolio investment and speculative inflows. Capital inflows so far in 1996 were not sufficient to cover the remaining deficit.

The Czech capital market

As the Czech capital market is still developing, it might seem to be difficult for foreign investors to become familiar with possible opportunities and changes which could occur. Considering these facts, the following overview could be helpful to potential investors. There are two securities markets in the Czech Republic. The major market for foreign investors is the Prague stock exchange (PSE). In addition, there is the RM-System, an order-based electronic exchange for equities, established primarily for Czech retail investors.

The Prague stock exchange

The PSE began trading in June 1993 under the conditions stipulated by the 1991 Stock Exchange Act. At December 31 1996 the Prague stock exchange had 109 members, 33 of which were bank-type members and 77 broker-type companies. About a fourth of the membership has foreign capital participation. Trading sessions are held daily. In 1996, the organisation of the PSE was changed by dividing into three markets - main, secondary and free. In the main market there are only Czech «blue chips». The committee can either admit or reject any application for admission subjectively, provided that the following basic requirement has been met: for securities issued by corporations and banks, public offering amounts to Kr200 million, and for investment funds and unit trust funds, the minimum registered capital amounts to Kr500 million. In 1996 a new liquidity criterion was imposed to the main market at the amount of Kr300,000. Once issuers have been admitted to the main market, they are obliged to provide the stock exchange, on a quarterly basis, with economic information and on a continuous basis and with any information, which may have an impact on the price of their securities. The secondary market has the same characteristics as the main market. The basic requirement to be met for the admission to the secondary market is a public offering amount set at Kr100 million for securities issued by corporations and banks, and minimum registered capital of Kr500 million for investment funds and unit trust funds. The issuers are obliged to provide the stock exchange, semi-annually, with economic information as well as with any information, which may have an impact on the price of their securities. The free market can be filled by some of the existing exchange members.

Selling of Investicni Postovni Banka (IPB) and Komercni Banka

In July 1997 the Czech Republic's finance minister persuaded to sell the state 36% stake in Investicni a Postovni Banka (IPB), the third largest bank in Czech Republic, to Nomura, a Japanese securities house. And on August 20th, the government had accepted his arguments in favor of unloading the state's holdings in Komercni, Ceska Sporitelna and CSOB, three other big banks with cabinet assets of almost 1 trillion koruna ($29 billion).

At the turn of 1997 35% of all Czech bank loans were non-performing, the highest ratio in Central Europe. The Central Bank's futile attempt to defend the koruna in May caused interest rates to skyrocket and the interbank money market to dry up, and set off a run on deposits. In July the freak floods did an estimated 30 billion koruna-worth of damage to Czech industry, with obvious consequences for big lenders.

All of this had fuelled rumors in Prague that the Czechs, like the neighboring Poles and Hungarians before them, will have to spend billions propping up wobbly banks. The cabinet's decision to sell IPB to Nomura was driven by fears that the bank had only about two months to function before running into deep trouble.

With the banks in such a mass partners had to be lured with public money to write off their bad debts. (Economist, 1997b).

In November 1997 the new government of Czech Republic had put the privatization project of Komercni Banka in doubt. Komercni, with assets of 456 billion koruna ($12.7 bn.) is Central Europe's biggest bank. As of September provisions did not cover a fifth of Komercni's loan-book, or 55 billion koruna – a sum greater than the bank's equity.

Komercni's disclosure came on top of new troubles at two other banks that were on privatization block: Investicni a Postovni Banka (IPB), the third biggest bank and Agrobanka. These cases made a mockery of claims from Czech bankers that their loan books were not as bad as they looked. Their reports showed that nearly a third of all outstanding loans were delinquent, and that provisions and collateral were woefully insufficient. (Economist, 1998a).

3.7 BACKGROUND ON THE BALTICS

Regulations of commercial bank's activity in Latvia

Since Latvia's independence, its government has been trying to achieve macro-economic stability and establish structure reforms in order to make an effective market economical system along with stable banking system.

Fortune financial policy displayed constant improving of economy, national currency stabilization, constant and lasting decreasing of inflation rate, and as a result – development of banking system in Latvia.

Macro-economic characteristics and Russian crisis influence on Latvian economy:
1997 and first half of 1998 showed impetuous growing of economy, fast development of financial sector, increasing of export value and positive balance of government budget.

Because of outside factors influence in 1998, the speed of economical grow had slowed down. Russian crisis, ruble devaluation, problems of Russian banking system had decreased the growing speed of production and export in Latvia.

Thus, export reducing speed was higher than import decreasing and as a result – 11% trade deficit of GDP.

GDP increasing rate slowed down as well. In 1998 GDP increased by 3.6%, compared to 1997 – 8.6%. It is predicted that this rate in 1999 will be 3%.

Inflation rate continued to decrease and was 4.7% in 1998 (in 1997 – 8.4%). Inflation in March 1999 compared to March 1998 was 2.8%.

Deficit of current balance yet had been covered by foreign investments.

Main resources of investment attractions are direct foreign investments and long-term loans. Private capital was being supported by legislative base, which provided favorable conditions for foreign investors.

In 1998 the volume of direct investments inflow was 4.3% of GDP. Foreign currency reserves of Bank of Latvia increased in 1998. Clear reserves (gold and foreign currency) were covering total value of cash resources and commercial banks' balances on corresponding accounts of Bank of Latvia for over 100%.

Since banking system remains stable, complete and developing, it is expected to further inflow of long-term foreign capital.

Banking system condition

Banking system was one of the first sectors effected by Russian crisis influence, since government bonds of CIS countries were ones of the most profitable short-term instruments.

As a result of the crisis 2 banks ("Kapital-bank" and "Viktorija") which had 1.2% of whole banking system turnover, had lost their licenses for banking activity and one bank was under control of Administrator, nominated by court.

According to auditing of year balance reports, losses of banking sector for 1998 were 53 million lats, and 9 banks alone ended up with 4 million profit. Losses came from revaluation of Russian Government bonds. These savings' volume was 95% of total Russian securities purchasing and 20 – 60% of investments' volume into securities, denominated in US dollars. Ukrainian Government bonds were also reevaluated so the balance values did not exceed 70-80% of nominal value.

Despite all losses of 1998, the capital adequacy ratio, calculated according to Basely Committee requirements (minimum volume, established by "Law of credit institutions" is 10%), still remained on high level at the beginning of 1999 and exceeded 17%.

In 1998 banks' deposit volume decreased by 3.5%. Deposit structure had also changed. Decreasing of non-resident's deposits(-15.7%) was partly compensated with increasing of resident's deposits (+5.7%). Per cent value of non-residents' deposits, sensitive to changes of market conditions had decreased from 43% to 38%. Tendencies of deposit account volume increasing were seen. In 1998 the volume of saving deposits had decreased from 83% to 75%.

Investment risk growing in Russia pushed all the banks to reducing of these investment portfolios and direct free resources to domestic crediting.

During 1998 the value of gross credits had increased by 46% and came to volume of 43% of all assets structure of banking sector (in 1997 – corresponding 74.4% and 30%).

Growing of credits' value was attended by changing of its structure. Per cent value of middle- and long-term credits (over 1 year) had increased from 45% to 65% of total credit value.

Credit portfolio quality remained at the same high level. Proportion of standard, non-problem credits had increased from 90% in 1997 to 93% in 1998, the proportion of not functioned loans had decreased.

Increasing of market interest rates and slight increasing of credit risk by the end of 1998 came to increasing of weighted average rates for long-term (up to 15.3%) and short-term credits (up to 16.4%) in national currency and by 11.1% and 13.9% (corresponding) in currencies of OESR countries.

Russian crisis effected liquidity of Latvian financial market and increased profitability of Latvian Government bonds. At the end of 1998 coupon rate on these bands came to 11.8% (for 1 year) and 14.9% - for bonds, maturing in 2 years. But already in February-March of 1999 the process of interest rates decreasing was seen.

Moving of priorities and concentration on domestic market – the main positive result of Russian crisis. Loss of high profitable and – high risky investment possibilities on eastern market made banks to pay more attention to financing of domestic economy.

Growing of domestic market competition, from another side, makes premises for banking sector consolidation, which contained very big amount of commercial banks compared to market volume.

Present time there are 25 banks functioning in Latvia, 7 savings banks, Riga's branch of Societe Generale (France) and branch of Dresden Bank (Germany). 10 biggest banks control 80% of whole market.

Increasing of bank's capital volume requirement also push banks to consolidation.

According to "The law of credit institutions" by 31/12/99 bank's equity capital and capital base must not be under 5 million EUR (approximately 3.5 million Lates).

Increasing of foreign capital share in Latvian banks (by 67.7%) was a very typical thing in the end of 1998. Foreign capital contain 24 banks, 15 of them have over 50% of foreign capital.

Government share of banking sector is still decreasing (now–4.9%) and now government controls only one middle-sized bank that deals mainly with mortgage loans.

The following factors are considered as main in banking system developing in the future:

- Attraction of foreign and domestic investments;
- Restoring and development of banking profitability;
- Combining of small banks and purchasing of small banks by bigger ones.

It is expected that the process of combining will speed up in 1999. Thus, at least 11 small and middle sized banks will have to make an attempt of accumulating their capital base volumes.

(Armande Hteinberge, Chief of Banks Credit Institutions' Department control in Latvia).

Upgrading of banking control in Latvia

Latvia Bank has been working on improving of banking activity regulation requirements and their accordance with EU banking directives and main principles of effective banking control, that were established by Basely committee of banking control.

In May 1998 there was a Decree of Latvia approved (actually functioning from 1/1/99), it introduced changes to the Law of Latvia "About credit institutions". It underlined certain commercial banks that require consolidate control. Special legislative-based procedures were elaborated in order to Bank of Latvia cooperation with Latvia's and foreign control institutions.

Some changes those stipulate procedures of banks' liquidation and regulate procedures of insolvency, restructuring, bankruptcy and point out Administrator's actions in these situations were introduced in legislative base. Bank of Latvia is authorized to control liquidation's procedure. There is legislative base elaborated for establishing the Register of credit institution's debtors.

06/01/1998 "The Law of criminal resources' legalization preventing" was enrolled. It's main role – preventing from using Latvian financial system to legalize criminal resources. In situations, stipulated by this law, credit, financial institutions, their authorities are to provide by demand of control department any information about "unusual" financial dealings.

The law "About citizen's deposits security" (acting since 01/01/98) stipulates that commercial banks are to make transfers to special Insurance Fund of non-corporate clients' deposits, which stipulates receiving by depositors, in case of bank's bankruptcy, the sum of deposit, but not more than 500 lates. The Law also stipulates that this value will be constantly growing and will reach 13,000 lates by 2008.

"The Mortgage Bond Law" (introduced from 01/29/98) that regulates procedure of public mortgage bonds' emission is a good aid in mortgage crediting development.

In order to control investment limitation in non-financial sector and investments in movable property and real estate the Latvian bank had elaborated the "Procedures of big enterprises' proper reporting".

In the beginning of 1999 the Bank of Latvia had introduced "Procedures of consolidate banking control" that describes proper group report providing procedures, and reports of meeting the requirements (capital adequacy, investment and risky activity) by a group.

In order to supply creditors, owners and others with financial reports and activity results the Latvian Bank had elaborated "Procedures of consolidate year reports of commercial banks" (active since 05/01/99).

The "Procedures of credit institutions' licensing" was enrolled from 01/01/1999. Since introducing of consolidate banking control procedures there were corrected and added requirements of credit institutions' owner and founders identification, and providing the information about financial condition of owners and their valuable equity investments.

The "Procedures of trust operations" was elaborated and enacted on 01/01/1999. This document establishes minimum requirements in order to avoid conflict between investor and bank, and also regulations according accounting principles of trust operations using devising to investor's money resources and securities.

Aggravation of economic situation in B-group countries and Russian crisis pushed the Bank of Latvia to change risk ratio of B-countries government bonds, denominated in national currencies. From now these assets will be fixed with 50% of risk ratio for calculating the value of Capital (earlier – 0%).

In order to eliminate risks of B – group countries' dealings there are limits established by Latvia Bank. The total value of dealings with B-countries, including their governments, must not exceed 2 times the bank's capital.

Since IMF mission of technical aid by Latvia's request had evaluated procedures of banking activity regulation and control, it approved the positive result in this sphere and pointed out that out of 25 procedures, elaborated by Basely Committee, only 3 need to be enacted (2 of them – about regulation of market risks, one – about regulation and monitoring of countries' risks). Elaboration of new regulation documents is already started.

(by Voyevoda Ludmila Methodology Department head manager of Latvia Bank).

Collapse of Lithuanian banks

In 1995 nine small banks were closed and two larger ones needed government support. In December 1995 the Central Bank was obliged to suspend operations at the two largest banks, Innovation Bank and Litimpeks, after it was discovered that they were being run into the ground as a result of mismanagement, bad lending decisions, and fraud. The banks, privately owned and about to merge, were key players in the country's banking system, holding between them about 23% of all bank deposits.

Perhaps learning from Latvia's experience in May 1995, when the Riga government reacted hesitantly to the collapse of Banka Baltija, the biggest Latvian bank, dragging down about 40% of the sector, the Lithuanian authorities' response was swift and decisive.

Innovation Bank and Litimpeks Bank were both closed. The 52,000 individual depositors were compensated up to a government-imposed limit of Litas 1,000 ($250) each. The two banks were nationalised and then merged with Vakaru Bank, which closed in 1995, into a new institution, called United Bank. After recapitalisation, United Bank was reopen for business. The speed of response, which is being financed by the issue of five-year interest-bearing government bonds, earned praise from the International Monetary Fund and the World Bank, which lent their technical help, and from many other observes. There were no runs on other banks: any threat of systemic risk did not materialise. But the affair cost Kazys Ratkevicius, governor of the central bank, his job after Lithuanian president Algirdas Brazauskas demanded his resignation for exercising "insufficient control" over the commercial banking system.

The position of Adolfas Slezevicius had been severely undermined by reports that he had withdrawn personal deposits worth the equivalent of $30,000 from a fixed-term account just two days before Innovation Bank was suspended. Lithuania's general prosecutor also wanted to know why the prime minister had been receiving a specially high interest rate on his deposit account. Interior minister Romasis Vaitekunas also resigned. He had enjoyed the same rate of interest - and in December in a widely publicised move had despatched armed anti-terrorist police to besiege Innovation Bank's headquarters and arrest its chairman, Arturas Balkevicius. It was this action in particular that threatened to start a run on deposits. Mindaugas Stankevicius, another former communist, is now prime minister. He faces fresh parliamentary elections in October. He is a former technocrat, like Reinoldijus Sarkinas, who has moved from being finance minister to the central bank governorship. Together, the two men have to deal with the wider economic effects of the Innovation/Litimpeks failures.

Banking crises in Baltic States

Banking crises, mainly involving private banks, surfaced in Estonia in 1992, in Latvia in early 1995, and in Lithuania in late 1995. There were many causes, some of which - systemic in nature - had been eating away at the fabric of these banking systems for some time. For example, falling inflation was a prominent factor in all three countries, which helped make borrower distress more apparent while simultaneously squeezing banks' intermediation margins. But in each country, different events led to the crises and different triggers brought them to a head.

In Estonia, the proximate causes of the crisis were the freezing of the assets in Moscow of two important Estonian banks, and the drying up of cheap credit from the central bank, which had previously provided Estonian banks with significant profits and liquidity. In Latvia, the waning of highly profitable trade-financing opportunities, as well as general mismanagement and corruption, set the stage for the crisis. It was set off by the central bank's requirement that banks be properly audited using International Audit Standards (IAS) principles. Bank profits in Lithuania were also compressed owing to the contraction of lucrative trade financing opportunities. Moreover, the government pressed some banks (both state-owned and private) to lend to the public sector to finance quasi-fiscal expenditures. Leaks of the result of on-site examinations of two banks, showing deep insolvency, led to runs on those banks and liquidity shortages.

Broadly, there were four systemic factors underlying the crises: poor regulation and supervision, poor accounting and excessive taxation, an inadequate legal infrastructure for lending, and pervasive corruption coupled with weak banking skills and mismanagement. The stresses and strains of the economic transition and stabilization also exposed the bank's underlying weaknesses. To some extent these factors are interrelated. For instance, the transition environment has unleashed profit-seeking in many segments of society, including the banking industry. While much of it reflected enterpreneurialest, some of it spilled over into illegal and unscrupulous activities. In some instances, weaknesses in bank regulation and supervision created incentives for corruption.

Bank regulation and supervision

A contributory factor to all three banking crises was the failure of banking regulation and supervision. In Latvia, deficiencies in the regulatory framework itself contributed to the crises, although there were also some weaknesses in implementation. In Lithuania, the culprit was deficiencies in the implementation of regulations - even when bank supervisors had identified problems, they were not acted upon. In Estonia, the legal, regulatory, and supervisory framework was very underdeveloped at the time of the crisis, but it was less important as a cause of crisis than in the other two countries. The licensing and regulatory regimes in the three countries did not discourage the entry of foreign banks. The Lithuanian central bank may nonetheless have discouraged foreign banks from entering the local market. Arguably in Estonia - where nine foreign banks have entered the market in recent years - banking discipline may have been more quickly embedded in the system.

Accounting and taxation

Initially, banks in the Baltics continued to use the old Soviet Gosbank chart of accounts. In Estonia, banks were required to use IAS for the first time in 1995, although the better banks had begun doing so in 1993. In Latvia, the introduction of IAS accounting and reporting requirements began in 1994 - indeed, this requirement precipitated the country's banking crisis. In Lithuania, a number of changes in bank accounting and prudential rules have been introduced gradually over the last three years, but full IAS compliance was expected only as of January 1, 1997. The initial absence of and unfamiliarity with IAS - based accounting systems in the Baltics has made it more difficult for bank managers, shareholders, and supervisors alike to accurately gauge the solvency and liquidity problems building up in individual banks. Even though most of the Baltic banks were quick to have international auditors undertake IAS audits, these audits have not served as the early warning signals they were intended to be and often have been ignored altogether by the supervisors.

Legal infrastructure

In the Baltic countries, there was initially no legal framework to support bank lending. There was no appropriate legislation relating to bankruptcy and collateral; well - functioning property title, mortgage and pledge registers; or, more generally, a market for land and real estate. Another important omission was corporate governance and accountability provisions for banks that specified the duties and responsibilities of bank shareholders, supervisory board members, and managers. This allowed shareholders to manipulate supervisory board members and, through them, managers to serve their own interests. All of this factors - most of which have been or are being addressed - contributed to the riskiness of bank lending.

Corruption and weak management

In all three Baltic countries, some banks were created as captive funding mechanisms by groups of enterprises and individuals - raising funds directly from the public was cheaper than borrowing from banks. In other cases, owners and managers tried to make quick profits by making high-risk loans or by assuming large open foreign exchange positions. This behavior was encouraged by the knowledge that the supervisory authority was inexperienced and understaffed, and lacked effective enforcement powers. The lack of skills among bank managers and other staff also led to poor decision making.

3.8 BACKGROUND ON BELARUS

Regulation of banking activity in Belarus

Banking Control Department is to regulate and determine the following risks of banking system:

- Insolvency risk (capital adequacy ratio, minimum volume – 10%).
- Liquidity risk (current liquidity ratio – 100%).
- Credit risk (limit of loan to one customer–fewer than 20% of Capital).
- Investment risk (total investment value must not exceed 15% of commercial bank's equity capital).

* Currency risk (open currency position limit – under 10% of Equity capital in hard currencies and 5% - in soft currencies).
* In-banking control and audit regulate operation risk).

Special regulation norms were introduced in order to more effective controlling over banking stability.

The NB supports policy of foreign investment attractions in commercial banks' equity.

Since the world financial crisis, the banking system of Belaruss has been trying to prevent its negative influence by improving of some documents (solvency, liquidity, big risk norms). Since all residents' and non-residents' (not members of Organization of Economical Union and Development) loan repayment risk ratio had risen from 50 to 70%. For government loans (not members of OEUD) the risk ratio is 20% (up from 0%).

The National Bank of Belaruss and Russian Central Bank had set an agreement about cooperation in commercial banks' control activity.

By 01/01/1999 only 6.5% of foreign currency assets was accumulated in Russian banks. 35.2% of assets accumulated in Russian banks were set on corresponding accounts of Belarussian banks, 17% - Russian government bonds.

Banking control procedures show the tendency of banking system operation quality improving. This is mainly due to requirement standards increasing level of National Bank of Belarus to banks' staff – necessary testing of banks' staff by National Bank's authorities.

The future development of banking activity control and regulation system will be carried out in accordance to Basely Committee Principles. The 1999-year will change the system of capital evaluation. The new method stipulates dividing bank's capital into two levels; this will show more realistic picture of banks' capital, its stability and structure.

(Grigorovich V. N., Head of Banking Control Department of the National Bank of Belarussian Republic).

Export-import structure in Belarus

The main reasons of import volume increasing in Belarus:

* establishing by Russia in August 1996 the Value Added Tax for goods, imported from Ukraine, Belarussian government approved VAT only in February 1997. This caused big attraction for goods importing to Belaruss and further re-export to Russia, especially tires (their supply in 1996 had increased by 2.3 times compared to 1995), liquid pumps (import increased by 2 times), busses (6.8 times), black metals (1.8 times), and products from them (1.4 times);
* increasing of wheat (by $52.7 million or 32 times) and barley supply (by $19 million or 15 times) from Ukraine for alcohol production and its export to

Russia. This caused growing of ethyl alcohol export to Russia in 1996 by $79 million, and strong spirits – by $24 million;

- re-orientation of supply for Belarussian industry from Russia to Ukraine. For example, the value of flat metal sheets and nickel steel import had decreased in 1996 from Russia by 49%, increased by 23% from Ukraine; black metal pipes import from Russia had reduced by 5%, from Ukraine – increased by 27%; cable production – by 10.7% (decreased from Russia) and by 2.7 times - increased from Ukraine.

Because of VAT differences between Russia and Belarus the system "import from Ukraine – re-export to Russia" kept on working in 1997 for some groups of goods. For example, busses import had increased by 2.2 times or $15.8 million (VAT rate in Russia was 20% for this group, in Belarus – zero). The same situation was with liquid pumps (import increasing from Ukraine was 46%).

Procedures enrolled in 1998 (import limitations for Belarussian rubles and barter operations) leaded to rationalization of import from Ukraine and as a result – it's decreasing by 24%.

Export

The following groups of goods predominate over Belarussian export structure to Ukraine: vehicles; textile, and textile products; machinery, equipment and mechanisms; plastic, rubber, caoutchouc and products – corresponding to 22, 17.2, 16.5 and 10.5%. Most of these goods show decreasing of supply volumes. During last period heavy trucks supply was reduced by 20.8% ($7 million), agricultural machinery - $98.9 million, bearings - $7.1 million, refrigerators and freezers - $1.8 million and other goods. Potash fertilizers' supply had sharply decreased: from 112 tons in 1996 down to 20 tons in last year.

Most of the government institutions in present financial situation avoid shrinking of export value. For example, "Belnyeftekhim" corporation increased its export by $21.3 million and decreased import by $14 million. "Bellegprom" had increased shoe export value by 3.7 times, clothes – 2.3 times, textile clothes – 1.5 times. Quite a big amount of light industry products is being imported to Ukraine by "chelnocks" (private persons, dealing at the market). Legalization of chelnocks' trading by developing of chelnocks' supply net would greatly increase export and improve trading balance of Belarus.

Export-import regulation procedures of export support, enrolled by the Government helped to slow down export decreasing in 1998 in Belarus.

3.9 BACKGROUND ON RUSSIA

Production Decline in Russia

Between 1989 and 1995 real GDP fell by an average of 8% per annum. In 1996 Russia's economic performance recorded a further, albeit smaller drop of 6% in real terms in comparison to the preceding years. The first indications that the situation is beginning to stabilise are therefore evident. Estimates are already suggesting moderate growth in real ODP of 1% for 1997, and this could certainly increase in the coming years. However, in overall real economic terms, the indicators still showed declines in 1996. Recently industrial production fell by 5% in real terms. Measured against the pre-reform level of 1989, Russian industrial production declined to just under 50%. The greatest weakness of Russian industry is its obsolete machinery arid equipment, which is main reason for inefficiency and low labour productivity, above all in the predominant capital-intensive heavy industrial sectors. A boost in investment activity would therefore be needed to initiate the necessary structural changes within industry. In addition, the expansion of infrastructure, which in some regions of Russia is still completely inadequate, presents the economy with the problem of enormous capital investment requirements. In fact, the Russian economy is characterised by a drastic lack of investment. Gross fixed capital formation has fallen continuously since the beginning of the reforms and today it is just one quarter of pre-reform level. This indicator recently again fell by 15% in 1996, and together with the recent downturns in private consumption it was the main reason for the continued deterioration of the economic situation in Russia.

Foreign trade in Russia

The integration of the Russian economy into the international division of labour is making progress. In the meantime, more than one half of Russia's foreign trade is conducted with the West. The majority of this is with the EU. In June 1994 a partnership and co-operation agreement was signed with the EU. In 1996 the balance of trade surplus achieved was about $35 billion and the balance on current account ran a surplus of $10 billion. Raw materials still represent a large proportion of goods which are exported. In fact minerals and fuels amount to more than 40% of all Russian exports, and metals and metal products approximately 20%. Since the beginning of the reforms, Russian industry has increasingly developed in the direction of raw and basic materials. Declines in production were less than average in view of the steady and strong domestic demand and the realisation of the great potential for exports. Furthermore, the focus for foreign investment is the raw materials sector.

Tax regulation of banking activity in Russia

Banking activity – is an area of extreme attention of tax administrations of Russian Federation. This problem is conditioned by difficult financial condition of many commercial banks and as a result – not transferring of tax payments to budget.

It is known that banking sector keeps around 20 billion of tax payments. Figures, showing that this situation is getting more complicated, push administrative department to tighten control functions:

- applying to Central Bank of Russia about canceling of some licenses for banking activity;
- unquestionable withdrawals of arrested amounts of taxes from corresponding accounts;
- keeping a record of insolvent banks in order to reaching this information by other tax administration departments.

There were some changes introduced in tax legislation in order to increase banks' effectiveness. These changes are mostly related to evaluation of profit tax for 1998.

They stipulate not including the profit from devaluating of ruble in August 1998. Besides, in 1999, there was a decrease in profit tax rate from 43 down to 38%. It is also planned to cancel profit tax for investment credits (for over 1 year) that are directed to production development.

It is also being suggested to provide commercial banks that deal with treasure stones and metals, with tax privileges, in order to support gold-mining industry.

It has been slightly developing and installing the policy of declining the tax pressure on commercial bank.

Another topic of conversation – is about taxation of commercial bank's income by road tax, housing fund and cultural objects fund (total rate – 4%). It is quite clear that collection of these taxes without considering each bank's specification brings to serious critics by commercial banks. But any suggestions about these taxes' canceling has not been implemented yet in 1999.

According to tax codex of Russian Federation, commercial banks are to pay 11 taxes. From total value of tax income in Russia in 1998 banks' portion was 4.2%. Most of it was profit tax (from 8 billion of income there was 5.9 billion – from profit tax or 79%).

Delay in tax payments by commercial banks show bad financial conditions of many commercial banks. In 1998 this sum raised by 2 times and came up to 1.9 billion rubles or 10% from total income to budget from banking system.

Russian Government together with Russian Bank are implementing complex procedures of banking system restructuring and orientation of its functioning in real sector of economy. Ministry of Russian Federation Tax Collection plans to take part in this process and has some constructive suggestions about banks' restructuring process:

- to accept proposal of restructuring a certain commercial bank only after Ministry of Russian Federation Tax Collection approves program of banks tax debts restructuring;
- to tight requirements to problem banks (license canceling, bankruptcy) that will have restructuring expenses exceeding potential profit from restructuring;
- to support strong banks that have wide net of branches and experience of dealing on real sector of economy and ability to increase the tax volume transfers after restructuring;
- determining the "bearing" banks in regions is to be carried out after approval by Ministry of Russian Federation Tax Collection the fact of in-time transferring of commercial bank's and clients' taxes.

Actions of Russian government during crisis in 1998

- on August 17th, 1998 the Russian government had announced moratorium for 90 days for Russian residents repayments on loans, received from not-residents for the term over 180 days, on securities-pledged loans;
- non-residents were prohibited to invest in Russian assets in rubles for over 1 year of maturity;

- the announcement "About conditions of some securities repayment" was issued about technical re-registering GDKO-OFP;
- stopping of GDKO-OFP sales with maturity dates under 31st of December, 1999;
- in order to finance the budget deficit and provide the liquid market for commercial banks, the Russian government started issuing short-term bonds 1-2 weeks maturity;
- there were mobile groups of enterprises' functioning control in order to meet the tax legislation requirements;
- the Russian Central Bank had established a new currency exchange range – 6-9.5 RUR/USD;
- the Russian Central Bank had established limited spread on foreign currency cash operation – 15%;
- Moscow Interbank Currency Exchange started operations on USD dealing for DM;
- in order to overcome the crisis of payment system it was suggested to establish the block of 12 Russian banks (Sberbank, Vneshtorgbank, Uneximbank, "Menatep", Most-Bank, Incombank, Bank of Moscow, "SBS-Agro", Russian Credit). Conditions of these banks' loans supply by Central Bank – GDKO and controlled stake of shares pledge;
- the Central Bank announced about providing 100% guarantee on non-corporate clients' accounts in credit institutions, opened before 08.01.1998.

Model of two axes

Since financial crisis in August 1998 hardly damaged financial and production sector, previous organised structure of economic cash flows, the total volume of savings and investments greatly decreased. In this situation the only source of "blood" for economy is credit emission of Russian Central Bank. The required volume of this emission for Russia in 1999 is 190-210 billion of rubles. According to allowed controlled inflation (under 45%) the limit of emission is 45-55 billion.

Creation of certain institutional structures and procedures of emission cash flow direction will keep this amount under control and prevent transferring of emission money to exchange market. It can possibly increase the value of production that has potential on domestic and international markets.

Institutional structures should be elaborated by three directions:

1. Creation of big production-financial corporations with government participation. These corporations should take the main responsibility for tax payments', debt repayments between enterprises, credits repayments, maintenance of required liquidity ratio.
2. Restructuring of big important banks and forming of stable institutional connections with big industrial corporations. Establishing of these banks under governmental control will produce control over centralised resources' spending. The big banks could also work as clearing centres.
3. Forming of wide net of base regional banks that will be under control of Central Bank by equity participation. This will save the stability of financial

environment and payment system of the country, to attract resources and make channels for regional programs financing.

So, it is suggested to build up two structural axes: centre – federal and corporate banks-big industrial corporations and centre – regional banks-regions.

Lost billions

Loss of value, profitability, stability, total bankruptcy, appearance of new leaders in banking sector were caused by terrifying financial crisis.

Total gross assets of commercial banks in Russia reduced since crisis from 88.7 to 43.2 $billion. Stability loss was even worse: total capital reduced by 5 times in foreign currency evaluation – from 16.1 to 3.1 billion dollars (except Sherbank). Most of the banks have completely lost their capital, including the biggest banks: five banks from top-thirty rating by net assets came down to negative value of their capital (Inkombank, Imperial, Tokobank, Promstroibank, Mezhkombank).

It total banking system ratio capital/assets declined in half a year from 19.4 down to 8.5%. Russian Central Bank cancelled the requirement of capital adequacy till July 1, but it seems that this date will be prolonged, since there are no sources for capital accumulation.

Problems that caused profit and capital loss seem to be hardly related to government bonds default and had occurred long before August 17th. During first half of 1998 most of the banks started to show losses. Total net losses for 1st half of 1998 were 3.3 billion rubles, while profit was only 1.5 billion rubles. Despite the fact that profit of commercial banks increased in 4th quarter, total losses of banking system in Russia were 42.3 billion rupbles, while profit was 5.1 billion rubles.

Idea that main problem of the crisis was GKO default is far from reality. Portion of government bonds in net-assets structure by middle of 1998 was only 13% or 70 billion rubles (except Sherbank and Vnesheconombank). By August most of the banks reduced this amount to 7-10% and 2/3 of commercial bank had under 2% of GKO from net-assets structure.

Of course, bonds' default had a negative influence on liquidity aggravation and lead to total withdrawals of deposits from banking sector.

But one of the central problems, caused the crisis were currency risks of commercial banks. Ruble interest rate was much higher than in foreign currency. Here banks had huge interest margin: attracting liabilities in foreign currency and selling these resources in rubles. In 1997 commercial banks were seriously increasing their foreign currency liabilities. Since open currency position rate came to 30% (limit of Russian central Bank for this ratio), devaluation by 300% caused total evaporation of banks capitals.

Foreign liabilities of Russian biggest banks by October 1st 1998 (million Dollars)

Bank	Short-term liability	Syndicate loans	Bonds in foreign currency	Forward contracts
"SBS – AGRO"	631	113	-	84
"Menatep"	515	80	-	100
"Uneximbank"	353	70	300	1900
Vneshtorgbank	356	120	-	608
Inkombank	274	140	-	1884
"Russian credit"	118	229	200	70
Alfa-bank	214	77	175	-
NRB	208	42	-	268
Most-Bank	129	-	-	-
Avtobank	108	47	-	380
Sherbank	100	225	-	325
MFK	97	-	51	-
Vozrozhdfsenie	51	-	-	-
Bank of Moscow	15	20	-	-

Since beginning of 1999 banks were trying to improve their currency situation and started to accumulate assets in currency, this produced serious pressure on exchange market and ruble.

On August 1st foreign liabilities exceeded assets by 4.2 billion dollars. Statistics show that the main problem of banking crisis in developing countries is usually caused by big value of foreign liabilities compared to gold-currency reserves of the country and total assets of banking system.

Banks with big portion of non-corporate deposits were seriously effected: Inkombank, SBS-AGRO, Promstroibank, Russian credit, Most-bank, Menatep, Agrobank and others (32.1 billion of rubles, or 22.5%).

Enterprises were seriously influenced not just by frozen deposits, but by bad transferring procedures.

Talking about small and average banks it is important to say that after last year's results small banks have a right to exist. Banks with total gross assets volume under 500 million rubles recommended themselves the best way. Group of banks with assets under 100 million is the only one that could make profit in 1998 and increase the capital value. These banks did not have currency risk and barely worked with government bonds.

The worst situation was in big banks with assets value over 2 billion rubles. In first half of 1998 losses in this group exceeded profit. After past year results this group's losses came to 23 billion rubles out of total 42 billion. These banks took the most responsibility for currency risk, coming from non-residents. They also had bad quality of credit portfolio and the most serious deposits' withdraw.

Debts of Russian banks to foreign creditors	
Bank	Debt on July 1998 ($thousand)
SBS AGRO	1 196 706
Inkombank	820 405
"Russian credit"	648 098
UNEXIMBANK	557 896
Gazprombank	549 982
Vneshtorgbank	474 089
MENATEP	419 073
Imperial	388 858
Sherbank	355 875
NRB	276 682

(Oleg Solntsev (Scientific staff of Macroeconomic Analyses and Forecast Centre)).

Commercial banks' improving scenario

There are 441 problem Russian banks out of 1473 by CB figures. 44 of them need urgent aid of the Government, according to their significance in financial sector. These banks keep over 50% of banking assets and 45% of citizens' deposits.

The Central Bank of Russia has proposed 2 ways of new banking structure:

1. Stipulates involvement of big Moscow multy-profile banks into sphere of government interests. This means providing of structural credit policy of the government through wide net of banks' branches throughout the country. This will require 25 billion rubles for restructuring of big banks and 15 billion for maintenance of current liquidity. Since CORA has only 10 billion there is 2nd way, more realistic.
2. Restructuring of base regional banks (by Central Banks figures – 79 banks in 67 regions). Re-capitalisation of regional banks will require about 5 billion RUR and maintenance of liquidity – 6 billion.

Approving of 2nd way of restructuring, regional banks will be paid more attention because they will be in charge of distributing the Government money.

Financial situation of commercial bank except Sherbank

Group of banks	Amount	Resources needed for		Total capital volume		Total volume of gross assets		Total volume of citizens' deposits	
		re-capitali-zation	liquidity maintenance	billion rubles	% part to all banking system	billion rubles	% part to all banking system	billion rubles	% part to all banking system
Banks that do not need financial support of the Government									
Large	5	-	-	14.1	22	139.7	13.5	3.5	6.6
Base	53	-	-	3.6	5.7	25.2	2.4	2.7	5.2
other	974	-	-	39.6	61.5	157	15.2	12	23.1
Total	1032	-	-	57.3	89.2	321.9	31.1	18.2	34.9
Banks that need financial support of the Government									
With many branches	4	25	15	12.8	19.9	145.7	14.1	8	15.4
Large	14	45	15	14.5	22.6	328.1	31.7	12.7	24.2
Base	26	5	6	3.3	5.2	29.8	2.9	2.8	5.4
Banks with no sense to restructure	397	55	11	1.9	2.9	208.8	20.2	10.5	20.1
Total	441	130	47	6.9	10.8	712.1	68.9	34	65.1
Total foe banking system	1473	130	47	64.2	100	1034.3	100	52.2	100

In the beginning of May, 1999 the Bank of Russia has chosen 85 base banks in 60 regions to be restored and reconstructed by Government funds in order to create the new core of post-crisis period.

This process will not be easy because of resources lack, unpredictable tendencies and other problems.

These procedures are going to decentralise banking capital and transfer necessary resources to regions, where they are urgently needed. Of course, this plan is not common for modern market system, but forced transfer of capital and strict control over its spending by Government's words seems to be the only way in today's situation.

Moscow Interbank Stock Exchange

Stages of MISE development

"Swimming" ruble exchange rate (1992 – July 1996)	Controlled exchange rate (July 1996 – September 1998)	Uncontrolled exchange rate (since September 1998)
• Ruble devaluation and serious ruble deflections; • Predomination of operations on stock exchange; • Concentration of foreign operations in Moscow. Forming of regional stock exchanges	• Stabilisation of ruble exchange rate. It plays a role of economy "anchor"; • decreasing of stock exchange and increasing of interbank currency exchange function; • Adding of Russia to VIII clause of IMF Charter	• Shifting to "swimming" exchange rate after 200% devaluation of ruble; • Decreasing of interbank currency exchange and increasing of stock exchange function; • Elimination of speculative possibilities of commercial banks on interbank currency exchange;
• MISE organises trades on $US, DEN, Ukrainian karbovanyets; • MISE initiates creation of Russian Regional stock exchanges in order to co-ordinate development of regional currency exchanges.	• Increasing of MISE competitiveness by cost decreasing, improving of clearing and guarantee systems; • Increasing the amount of traded currencies; • SELT system operation; Organising currency trading..	• Stopping of trades, using fixing procedure; • Transferring all foreign currencies operations to SELT system; • Establishing special trade session on $US trade for Russian rubles in SELT; • Starting EURO trades for rubles and $US.

Changing of main parameters of Russian stock exchange

Official rate RUR/USD establishing	Obligatory selling of foreign currency	Pre-lodgement on MISE trades	Establishing of rate deflection limits for USD on MISE
• Since 07/03/1992 till 05/16/19 official exchange rate was figured out after each trade with established fixing of MISE; • From 05/16/19 till 09/01/1998 there is a system of official rate establishing according to banks' supply-demand situation on stock exchange and interbank currency exchange; • Since 09/01/1998 Bank of Russia establishes official ruble rate according to special trade session on MISE.	• Since 07/03/92 it is established to obligatory selling of export earnings on stock exchange • Since 06/28/93 this ratio came up to 50%; • From 06/27/95 exporters can choose either to sell 50% of foreign currency on stock exchange or interbank currency exchange; • 10/06/98 – selling of 50% on stock exchange; • 01/11/99 – obligatory selling of foreign currency came up to 75%.	• From 11/10/94 it is a rule of obligatory depositing of ruble sources for $US purchasing on MISE; • 19/08/96 – cancelling of obligatory depositing; • 08/17/98 – introducing of 100% ruble depositing; • 10/06/98 obligatory depositing both the USD and RUR for trading on special sessions of MISE.	• 01/01/95 – established allowed rate deflection (10%) compared to last trade with fixing establishing; • 11/26/97 – this rate is 5%; • Since 10/06/98 the limit of rate deflection on special trade session compared to average volume of last trade – 15%.

Trade volumes on MISE (1992-1998)

Financial instrument		1992	1993	1994	1995	1996	1997	1998*
Exchange market total	bln. RUR	739.0	13475.0	54152.3	114169.0	28423.4	37076.0	373. 740
Stock market total	bln. RUR	-	283.2	27266.0	269120.2	1082692	1276374.25	699.451
GKO/OFZ	bln. RUR	-	283.2	27263.8	269120.2	1081374	1265901.16	699.451
Corporate bonds	bln. RUR	-	-	-	-	1318.4	1492.24	1.407
OBR	bln. RUR	-	-	-	-	-	-	6.823
Russian enterprises bonds	bln. RUR	-	-	-	-	-	404.98	0.311
Agro-bonds	bln. RUR	-	-	-	-	-	2942.42	0.637
Shares	bln. RUR	-	-	-	-	-	5733.44	15.142
REPO-market	bln. RUR	-	-	-	-	-	137374.10	122730
Short-term instruments market	bln. RUR	-	-	-	-	609.470	35766.48	48.97
MISE turnober total	bln. USD	2.788	13.265	36.706	83.131	223.029	253.832	127.315
	trln. RUR	0.739	13.759	813421	383.29	1111.73	1486.57	1.244

* In 1998 the trade volume was figured in denominator (1000 non-denominated rubles = 1 denominated ruble)

Since August 17, 1998 the following changes were made on stock exchange:

1. Stopping of trades with fixing procedure since 08.27.98 and carrying out trades within SELT system;
2. Increasing of operation volumes and growing of stock exchange importance by:
   - Obligatory selling of foreign currency on stock exchange;
   - Decreasing of trade volume on interbank currency exchange. Stock exchange trade volume portion increased to 90%.
3. Banking operations on servicing the international trade clients dominate on stock exchange;
4. Establishing of special trade session;
5. Increasing of stock exchange participants (over 500 banks);
6. Starting from September,1997 it has been calculated first and only stock index of MISE.

Risk management system on MISE

Dependability and reliability of technical processes on trading-clearance system proved itself during destabilised period. Current system of risk management is carried out by following mechanisms:

- strict criteria's and requirements to financial condition of market participants;
- 100% depositing on special trading session operation;
- establishing of USD trading limits on net-operations according to participants' resources;
- establishing of limits on rate deflection compared to previous trades;
- following the principle "delivery against payment" during trade;
- supplying corresponding banks by MISE with overdrafts;
- forming of insurance reserve in RUR by MISE;
- forming by participants of MISE the operation risk and other losses reserve on USD trades – $20.000.

APPENDIX 4
RESEARCH QUESTIONS, METHODOLOGY AND EXAMPLES

4.1 OUTLINE QUESTIONNAIRE

1. How does the current political situation influence the development of your bank?
2. How does the result of the election impact on the business activity of your bank? (Banking system in generally?)
3. How will the liberalisation of the tax law influence the development your business:
   - effect on the bank?
   - effect on the customers?
4. How would you like to see the changes in the tax laws?
   - for your bank?
   - for customers?
5. Is the current economical situation better or worse for the activities of your bank?
6. What is the result of reforming the financial and statistical reporting pursuant to the IAS requirements on the business activity of your bank?
7. How do you attract customers to deposit funds in your bank?
8. Are you interested in providing new types of products for customers?
9. Which new products have you provided this year?
10. Are you going to increase the number of branches?
11. Is it your strategy to expand abroad?
12. How will you expand your strategy abroad:
    - by opening branches?
    - by developing correspondent banking?
13. What is the measure of success for developing of your bank? (capital growth, assets growth, lending growth, profit growth, improving liquidity, market share etc.)
14. How do you see the competition of your bank with the entry of western and Russian banks into the Ukrainian economy? Why?
15. What can you tell me about the recruitment and retention of your staff?
16. How often do your employees leave the bank?
17. From a technical point of view what are the main problems for integration of Ukrainian banks into the international financial market?
18. What is the most important aspect of the development of your bank?
19. What are the key products of your bank? Why?

Translated from the original Ukrainian by Alexsey Bagriy

4.2 STUDY RESPONDENTS

	Bank	Location	Size	Name of respondent	Title of respondent
1	Ukrsotsbank	Kiev	Large	Vasily Slutch	First Deputy Chairman of the Board
2	Commercial bank "Finance & Credit"	Kiev	Large	Kirill Schevchenko	Deputy Chairman of the Board
3	Commercial bank "Metalurg"	Zaporozye	Small	Sergei Kosa	Head of Treasury, member of the Board
4	Commercial bank "Aviatek"	Kiev	Small	Igor Petrov	Deputy Chairman of the Board
5	Commercial bank "RZB - Ukraine"	Kiev	Small	Sergei Manocha	Head of Treasury, member of the Board
6	Commercial bank "Industrial"	Zaporozye	Small	Artem Laznya	Head of Treasury, member of the Board
7	Commercial bank "Privatbank"	Dnepropetrovsk	Large	Vladimir Yaczenko	Deputy Chairman of the Board
8	Commercial bank "Forum"	Kiev	Small	Victor Polovinko	Head of Treasury, member of the Board
9	Commercial bank "Mriya"	Kiev	Small	Vladimir Sich	Deputy Chairman of the Board
10	Commercial bank "Donbirzbank"	Donetsk	Small	Yan Lesin	Head of Treasury, Member of the Board
11	Commercial bank "Legbank"	Kiev	Small	Edvard Popov	Deputy Chairman of the Board
12	Commercial bank "Syntez"	Kiev	Small	Victor Boyko	Member of the Board
13	Commercial bank "Ukraina"	Kiev	Large	Dmitry Gridzuk	Chairman of the Board
14	Commercial bank "Avtozazbank"	Zaporozye	Small	Sergei Kravchuk	Member of the Board
15	Commercial bank "Societe Generale Ukraina"	Kiev	Small	Valeria Gontareva	Deputy Chairman of the Board
16	Commercial bank "Credi Lione Ukraina"	Kiev	Large	John Petit	Deputy Chairman of the Board
17	Commercial bank "Demark"	Chernigov	Small	Victor Roslyi	Deputy Chairman of the Board
18	Commercial bank "Aval"	Kiev	Large	Arseniy Yaczeniuk	Member of the Board
19	Commercial bank "Interbank "	Kiev	Small	Artyr Krikliy	Chairman of the Board
20	Commercial bank "Kiev - Privat"	Kiev	Small	Alla Gromova	Member of the Board
21	Commercial bank "Clearing House"	Kiev	Small	Valentina Yur	Member of the Board
22	Commercial bank "Chernigovbank"	Chernigov	Small	Tatyana Petrenko	Member of the Board
23	State commercial bank "State saving bank of Ukraine"	Kiev	Large	Victor Gribkov	Chairman of the Board
24	Commercial bank "United commercial bank"	Simferopol	Small	Roman Nefred	Chairman of the Board
25	"Megabank"	Charkov	Small	Svetlana Gura	Member of the Board
26	Commercial bank "West-Ukrainian commercial bank"	Lvov	Large	Yuriy Malyk	Chief dealer
27	Commercial bank "Ukrinbank "	Kiev	Large	Vladimir Lavrenchuk	Chairman of the Board
28	Commercial bank "Vabank"	Kiev	Large	Vitaliy Serov	Deputy Chairman of the Board
29	Commercial bank "Morskoi transportnyi bank"	Odessa	Large	Aleksey Kosmyn	Chairman of the Board
30	Commercial bank "Energobank"	Kiev	Small	Evgeniy Patrushev	Chairman of the Board
31	Commercial bank "Prominvestbank"	Kiev	Large	Dmitriy Goncharuk	Member of the Board

4.3 IMPACT OF IAS ON BANK UKRAINA

Bank Ukraina Balance Sheet as at 1 January 1996
(Drawn up under the Law of Ukraine "On Auditing Activity")

US$000's (converted at krb 179,400 = US$1)

Item	US$000's	%	IAS re-statement*
ASSETS			
Cash and NBU accounts	123,756	12.5%	
Debtors	50,232	5%	
Loan credits	311,506	31.5%	
Interbank credits	26,685	3%	
Securities purchased	20,738	2%	
Physical assets	80,260	8%	
Other assets	373,268	38%	
TOTAL ASSETS	986,445	100.00%	811,200
LIABILITIES			
Capital and Reserves	28,169	3%	
Profit for the year	123,518	12.5%	25,400
Other funds	107,972	11%	
Current accounts	294,883	30%	
Customer deposits	73,827	7.5%	
Correspondent bank balances	11,503	1%	
Loans	7,632	0.5%	
Creditors	43,836	4.5%	
Other liabilities	295,105	30%	
TOTAL LIABILITIES	986,445	100.00%	811,200

* IAS re-statement based on Bankscope data (Appendix 2)

Source: Bank Ukraina Accounts 1995 (Bank Ukraina, 1996)

Bank Ukraina Profit & Loss account for year ended 1 January 1996
(Drawn up under the Law of Ukraine "On Auditing Activity")

US$000's (converted at krb 179,400 = US$1)

Item	US$000's	%	IAS re-statement*
INCOME			
Interest	207,230	*78%*	
Commissions	50,546	*19%*	
Income from Securities and other sources	8,094	*3%*	
TOTAL INCOME	265,870	*100.00%*	
EXPENDITURE			
Interest Paid	53,723	*37%*	
Commissions Paid	1,514	*1%*	
Securities and other expenses	21,496	*15%*	
Staff and overhead costs	67,455	*47%*	
TOTAL EXPENDITURE	144,188	*100.00%*	
NET PROFIT	121,682		
Profits from other operations	1,153		
Compensation	683		
PROFIT FROM ALL OPERATIONS	123,518		25,400

* IAS re-statement based on Bankscope data (Appendix 2)

Source: Bank Ukraina Accounts 1995 (Bank Ukraina, 1996)