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THE GLOBAL CRISIS AND ITS IMPACT ON THE UKRAINIAN'S FINANCIAL SECTOR

There are many aspects which are caused by today's global financial crisis. But we'd like to draw your attention to the most important of them according to our point of view: on the one hand, its boom and bust in the housing market and its impact on the financial market. The crisis began with the bursting of the United States housing bubble which peaked in 2005-2006 approximately. Let's discuss two vicious cycles at the heart of the subprime mortgage crisis. The first cycle is within the housing market. Voluntary or involuntary foreclosures increase the supply of homes, which lowers home prices creating further negative equity. By September 2008, average U.S. housing prices had declined by over 20 % from their mid-2006 peak. This major and unexpected decline in house prices means that many borrowers have zero or negative equity in their homes, meaning their homes were worth less than their mortgages. As of March 2008, an estimated 8,8 million borrowers – 10,8 % of all homeowners – had negative equity in their homes, a number that is believed to have risen to 12 million by November 2008. In this situation borrowers have an incentive to “walk away” from their mortgages and abandon their homes, even though doing so will damage their credit rating for a number of years. The reason is that unlike what is the case in most other countries, American residential mortgages are non-recourse loans; once the creditor has regained the property purchased with a mortgage in default, he has no further claim against the defaulting borrower's income or assets. As more borrowers stop paying their mortgage payments, foreclosures and the supply of homes for sale increase. This places downward pressure on housing prices, which further lowers homeowners' equity. The decline in mortgage payments also reduces the value of mortgage-backed securities, which erodes the net worth and financial health of banks. This vicious cycle is at the heart of the crisis. The second cycle shows that foreclosures reduce the cash flowing into banks and the value of mortgage-backed securities (MBS) widely held by banks. Banks incur losses and require additional funds (“recapitalization”). If banks are not capitalized sufficiently to lend, economic activity slows and unemployment increases, which further increases foreclosures.

On the other hand, as one of the main causes of the crisis we outline financial institution debt levels and incentives. In other words, many financial institutions, investment banks in particular, issued large amounts of debt during 2004-2007, and invested the proceeds in mortgage-backed securities (MBS), essentially betting that house prices would continue to rise, and that households would continue to make their mortgage payments. Borrowing at a lower interest rate and investing the proceeds at a higher interest rate is a form of financial leverage. This is analogous

process to an individual taking out a second mortgage on his residence to invest in the stock market. This strategy proved profitable during the housing boom, but resulted in large losses when house prices began to decline and mortgages began to default. Beginning in 2007, financial institutions and individual investors holding MBS also suffered significant losses from mortgage payment defaults and the resulting decline in the value of MBS. Banks faced increasing liquidity needs due to commitments arising from the relationship entered into with the issuers of the ABS/MBS/CDO's programs. The result was a dramatic liquidity problem for a number of banks, that you can see on the slide.

All in all, during a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, pace keeping with financial innovation, or taking into account the systemic ramifications of domestic regulatory actions.

Now let me turn to the second part of our report. In the context of the global financial crisis the results for Ukraine were as follow:

- Ukraine is vulnerable due to *a combination* of large short term debt repayments, high current account deficits, and banking weaknesses due to non-performing loans and high foreign currency bank liabilities;
- separately, each of the above factors looks manageable, but their confluence amid a deteriorating world economy, easing of steel prices, imminent energy price increase, and turbulent domestic politics have notably affected investors risk assessment of Ukraine;
- reflecting these risks, since mid-2008 the premiums for Ukrainian Credit Default Swaps have risen to over 2,600 basis points in the mid-October;
- high risk perceptions of emerging markets translated into a decline in portfolio capital inflows to Ukraine: the inflow of portfolio capital declined from US\$3.3 billion in the first half of 2007 to only \$ 350 million in the same period of 2008;
- partly as a result, the PFTS index has declined by more than 75 % year-to-date (as of October 22, 2008), one of the largest declines in the world.

So the most important task for Ukraine is to work out a long-term policy with the purpose of preventing inflation growth and current balance deficit, optimizing state budget expenses, and improving state investment policy.

And now – lessons to be learnt. In other words, what can government, the NBU and business do. Concluding all above information, we'd like to give some advices.

What can the government do? As to the given risks of reductions in export-oriented production due to weakening global demand and problems with payments under export transactions, the government should work to stimulate domestic

demand for the group of export goods and, thus, enhance the role of domestic production. It can start with launching a new infrastructure and residential construction projects funded from the state budget. The government should prevent a sharp decline in grain prices by urging the Agrarian Fund to purchase grain of this year's harvest. It will provide agricultural producers with sufficient resources to prepare and carry out the sowing campaign. It will also support, directly and indirectly, the development of metallurgy, coke production, the mining industry, oil refining, the chemical industry, the food processing industry, trade and transport.

In order to manage the financial instability risk, it is strongly advisable to revise the draft 2009 budget so as to increase capital expenditures, including in construction, without increasing the budget deficit. It is also important to set up a Stabilization Fund that will cover all governmental guarantees, which will gain more confidence in the governmental commitment to pursue a well-balanced and sound budget policy.

During the financial crisis, the government's strategy is to encourage investments into the real sector of the economy. Consequently, alongside with accelerating the implementation of projects related to Euro-2012, we should unblock privatization processes. The government cannot do that alone, we need support from the Verkhovna Rada to get the State Privatization Program adopted. The Parliament should also pass a package of laws drafted by the government and geared towards boosting Ukraine's investment attractiveness.

What can NBU do? In order to prevent a banking crisis, NBU should establish principles of refinancing commercial banks that have short-term liquidity problems for the period of financial crisis. A currency crisis can be averted with a series of measures precluding the exchange rate destabilization by speculators. NBU should continue to pursue the policy of increasing the rate volatility in order to reduce risks to the balance of payments.

What can businesses and investors do? Given the limited financial resources inside the country and shrinking access to foreign loans, businesses face a difficult choice: either to suspend production and lose markets, maintaining high prices in expectation of better times, or to reduce prices trying to restore demand and keep consumers. The later option is for those manufacturers who care about their future, expansion and economy of scale; the former is for profiteers who make large money quickly and drop the production.