Ukraine on its way to EU- risks and opportunities for small open economy

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2nd panel : Financial globalisation and the evolution of global and regional cooperation agreements

European Aspiration

- EU integration aspirations proclaimed at the time of the Revolution of Dignity in 2014 fostered demand of the public and business for new, transparent and uniform operating EU standards.

- The central bank proclaimed its vision to create an open, modern and independent central bank enjoying the public trust and integrated into the European community of national central banks.

- Ukraine-EU Association Agreement entered into force on 1th of September 2017, but we had started our reforms three years before.

- The Agreement resembles the plans that Eastern European countries adopted entering the EU. So, Ukraine was not reinventing Ukrainian bicycle but started to implement European principles and standards.

The Comprehensive Program for the Development of the Financial Sector 2020

- We have started our reforms with the implementation of The Comprehensive Program for the Development of the Financial Sector 2020. Compliance with EU Financial directives was a cornerstone for us.

- Central Bank, Ministry of Finance, State Securities Commission, State Non-banking regulator, Deposit Guaranty Fund, Banking Associations, leaders of parliament fractions and civil society are instrumental parts of this Program.

- But central bank as a “white knight” started reforms first to preserve macro-financial stability of the country. Proper fulfilment of the central bank’s functions to secure price and financial stability is a prerequisite for the development of financial system and economic growth in any country.

Perfect storm

- More to that, Ukraine faced a “perfect storm” in 2014. We lost circa 20% of our GDP and 15% of our territory due to the annexation of Crimea and occupation of Eastern part of our country. Because of the real war, some top enterprises had stopped their production while regional infrastructure was completely destroyed. The balance of payment was “torn to pieces” and exchange rate, which is the mirror of the balance of payments, responded accordingly.

- All of that let alone with persistent, unsustainable imbalances in all sectors of the domestic economy and the banking system that had been accumulated over twenty years of absence of reforms.

- Thanks to international community IMF, WB, EBRD, European Union and US government and dedicated team of reformers in Ukraine we survived and stabilized the macroeconomic situation in the middle of 2015. It was not only the merit of the central bank but also the reform in a public sector and energy sector reforms.

How did the central bank achieve that?

We have started three pillars of our reform in parallel:

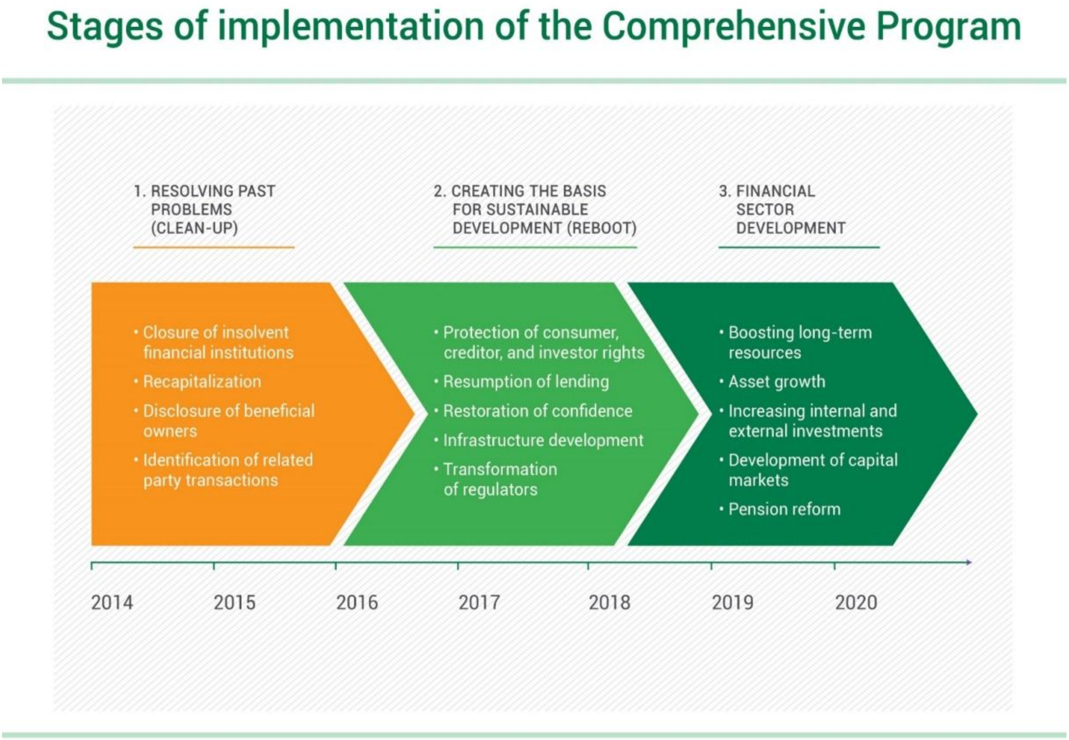
- We moved to a flexible exchange rate regime and implemented the new monetary policy of inflation targeting.

- We have cleaned up the banking system from insolvent banks and enhanced its resilience.

- Furthermore, we have transformed the NBU completely, rebuilt all internal processes and turn into a powerful modern institution. We did not only a thoroughly revised “The Law on the National Bank of Ukraine”, which enshrines the central bank’s independence, but we completely reorganized internal structure and hierarchy.

- We ensured high quality of decision-making process through fully functioning supervisory, credit, financial stability, monetary policy, and process management committees.

As of today the central bank has completed two stages of comprehensive reform and embarked on the final stage, which is aimed at ensuring the sustainable development of the domestic banking system.



Strategic goals of the Central Bank 2018-2020

1. Low and Steady Inflation (price stability, inflation target 5%)
2. Stable, Transparent and Efficient Banking System and up-to-date banking supervision
3. Resumption of Lending (handling of NPL, the increase of lending volumes that support economic growth while posing no risk to the financial stability)
4. Free Flow of Capital (lifting anti-crisis FX restrictions with no threat to financial stability cleared the way for implementing free flow of capital)
5. Efficient Regulation of Financial Sector (non-banking and FinTech regulation, infrastructure development and capital market tools)
6. Financial Inclusion (individuals are getting more involved in using financial services).
7. Implementation of cashless economy concept

<u>If we do our homework properly the financial sector of Ukraine will be completely compliant with the EU standards and fully operational in 2020.</u>

Global challenges for the financial sector

- Recent attempts to reverse globalization and to fall into protectionism alarm all Central Banks.

- After decades of setting rules, implementing banking prudential norms and supervision rules, we are moving to opposite direction. You remember of US criticism of Basel III principles, which Ukraine has been implementing since 2015.

- After decades of international cooperation and open markets we are moving to a confrontation at all fronts: endless Brexit consultations, new USD trade policy, Russian hybrid wars, nationalistic movements across Europe and populistic attacks everywhere.

- More to that, we are not properly prepared for a new era of FinTech development, we have no decent regulations on a global level, which could be implemented locally.

- And the main headache for central bankers is a risk of rising inflation. As we know, globalization contributed a lot to the low cost of production through Global Value Chains. But what will we do if the cost of production is skyrocketing?

What can small open economies do?

1. Being the small open economies and survive in global turmoil we need to continue our independent monetary policy. I do not see any alternative for small open economies but flexible exchange rate and inflation targeting monetary regime.

2. We need to continue our internal preparation for EU integration and be in line with European financial directives as well as MiFID and Deposit guarantee schemes.

3. We have to fully implement Base III principles to strengthen our supervisory regulation (minimal capital requirements, leverage ratios, liquidity requirements) and risk management as well as create buffer capital for possible financial stress.

4. We need to start active cooperation in the area of banking supervision. We have to create an efficient framework with EU Banking Union and ECB and with Non-EU regulators. More to that we need to strengthen bilateral cooperation, exchange of supervisory information and inspections.

5. We need to enhance cooperation in cyber security and AML/CFT fields.

6. We need to accelerate implementation of BEPS principles (as minimum as 5 of 15).

7. We need to enhance cooperation in the area of innovation development and development of FinTech-conductive regulatory environment.

8. SWAP agreements for trade-finance acceleration.

Our region continues to be highly sensitive to both regional and global shocks. Small open economies need to pay close attention to global and regional economic developments in their policy planning.

<u>So, prudent independent monetary policy, proper macro-prudential regulation, creation of adequate buffers in FCY reserves and banking sector's capital have to be our response to serious challenges that lie ahead.</u>