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NEWSLETTER

German Economic Team

UKRAINE

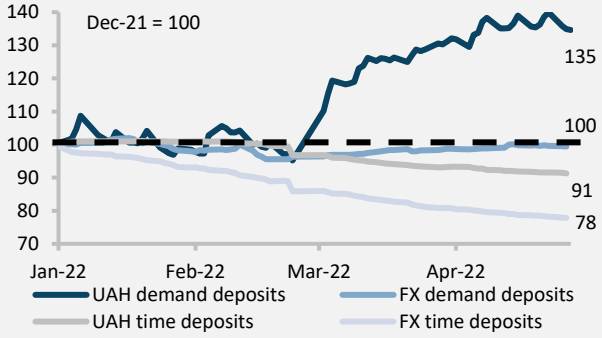
The banking sector during war: challenges and outlook

While all attention is rightfully focused on the human, social and economic damage and destruction caused by the Russian invasion of Ukraine, there are also encouraging signs of resilience and adequate policy making even under such difficult circumstances. The continuing functioning of Ukraine's banking system is a case in point, which supports the economy and the population with the provision of financial services. Specifically, no bank-runs or panic have been observed. The reasons for that are manifold, but prompt and comprehensive anti-crisis emergency regulation by the National Bank (NBU) was probably a key factor. Still, many new challenges are already appearing, e.g. the emergence of bad loans in the future, and the authorities must get ready to deal with them. In addition, the current emergency regulations are a right response in times of war, but need to be gradually removed once peace is restored. Taking a positive perspective, the well-regulated sector entered this war in a rather good shape, and many similar challenges to the ones ahead have been already tackled successfully after 2014.

Current situation

Russia`s invasion has caused an extraordinary pressure on Ukraine`s banking sector stability; still, all 69 banks – two Russian banks were closed in February – continue to operate currently. Demand deposits in Hryvnia have even increased while demand deposits in FX and time deposits in Hryvnia remained relatively constant. Only time deposits in FX declined strongly by 22% compared to December 2021. It is important to underscore that no major bank-runs on deposits have occurred.

Development of retail deposits



Source: NBU

The growth of demand deposits in Hryvnia reveals trust in the domestic currency as well as resilience of the sector. On the asset side, net assets in the sector have declined by 4% compared to the end of 2021, while both corporate and retail loans in Hryvnia remained relatively stable with some growth tendencies. Furthermore, the sector`s profitability was hit hard as financial losses of UAH 10 bn were recorded in March 2021, driven by a spike in provisions on expected losses.

Despite the hit, the sector shows its resilience

Nevertheless, financial stability has been maintained so far which is an important sign for the sector`s resilience. We see three main reasons as crucial.

1) Important anti-crisis emergency measures

As the invasion started, the NBU quickly introduced new rules for the banking system and FX market under martial law, including a shift to a fixed exchange rate regime (pre-war rate of UAH/USD 29.25), temporary cash withdrawal limits and started limited monetary budget financing via direct government bond purchases. Capital controls on FX transactions are still needed due to FX inflow shortages caused by massive export declines. As currently, a fiscal gap of USD 5 bn per month is estimated, international experts basically support the monetary budget financing so far, though some discussion is ongoing on its extent. Overall, the NBU has announced all its measures and subsequent adjustments in a transparent way, which contributes to stability within the sector.

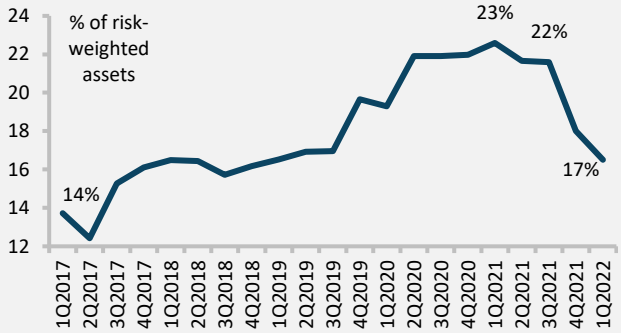
2) Digitalisation and COVID-related practices

Before Russia`s full-scale invasion, the demand for contactless card and NFC payments has increased driven by Ukraine`s dynamic IT-sector. NFC technology via Apple Pay for example was offered by 44 banks in Ukraine, 9 more than in Poland and both contactless card and NFC payments exceeded transactions with physical cards in 2021. This dynamic has been accelerated by the COVID pandemic as remote job opportunities began playing an important role. As a result, Ukrainians forced to leave the country, keep operating and receiving payments using digital way of bank communications and transactions.

3) The legacy of previous NBU banking sector reforms

The banking sector clean-up started in 2014 resulted in a halving of the number of banks to 71 in December 2021 compared to January 2015. Thus, Ukraine`s banking sector is quite small, but well capitalised.

Capital adequacy ratio (CAR) in Ukraine`s banking sector



Source: NBU

While Ukraine`s sector`s net assets accounted for just 38% of GDP (Poland: 97%) in 2021, the CAR was 23% (Poland:

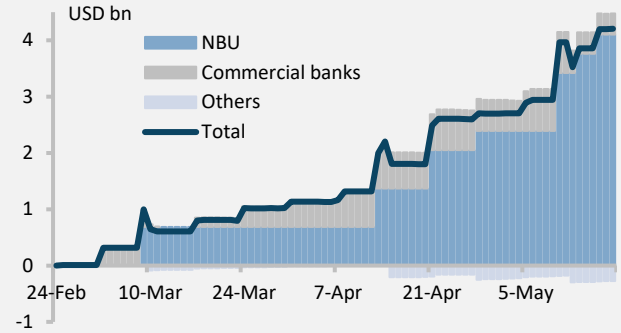
21%) in March 2021. Strong reduction of (still high) non-performing loans and increased competition from private banks were further results of the reform effort. A declining share of FX deposits opened the room for manoeuvre in case of sudden FX outflows. Finally, the role of supervisory boards and collegial decision-making processes in state banks were strengthened. All in all, the NBU was seen as a trustworthy independent monetary policy authority and regulator in the domestic market and abroad.

Further challenges to come as delayed shock

Even under a positive scenario of a quick end to this terrible war, there will be several major challenges that Ukraine`s banking system and the regulator will face.

Monetary budget financing and FX market controls were inevitable steps to absorb the first shocks to the economy from the budget revenue freefall, exports slippage and currency outflow. But in the medium to longer run, the sizeable monetary emission carries inflationary risks, while FX controls prevent the economy from readjusting to the new equilibrium. Thus, fiscal measures on both the revenue and expenditure sides might need to be taken to decrease the budget gap. And once the economy finds a new equilibrium, including its external trade, FX controls should be gradually relaxed, at least for current account transactions, while financial account transactions will probably need to stay longer in place.

NBU government bonds purchases since 24 February



Source: NBU

The deterioration of the asset quality of Ukrainian banks could be realistically evaluated just within 3-6 months after a sustainable cessation of hostilities. The NBU will have to gradually return to macroprudential policies aimed at the sector's resilience, which means the banks will have to deal with the losses and capitalisation challenges. This should happen in a controlled manner and under strict supervision. There will be a need for extensive, banking system-wide stress tests like the ones performed after 2014 to reveal the true situation. Then, the injections of new capital, which could be delivered by IFIs, could become a further form of international support.

New lending promotion will be the next challenging task. It should support the post-war recovery but will be impeded by the huge security risks associated with Ukraine's geopolitical position and de-facto limited access to credit. The revival of lending must closely follow the structure of Ukraine's post-war economy, and in the first stage, the provision of trade finance for exports would be paramount. Risk sharing models between commercial banks, government, and IFIs/donors must be further developed via new instruments (e.g. guarantees and international insurance schemes).

Conclusion

Ukraine's banking sector has remained surprisingly resilient so far during wartimes. This is an important achievement, as it helps to support economic activity and the well-being of the population, which continues to have access to basic banking services at home and abroad. Still, many challenges are already appearing, which will shape the sector in the years to come. This relates to the gradual removal of NBU emergency regulations and the return to inflation targeting once a stable ceasefire exists. As Ukraine has already gained experience with the gradual removal of FX controls in the past, this challenge should be manageable. The expected decline in asset quality will probably require additional recapitalisation funds. As the sector is relatively small, this looks possible from a macroeconomic point of view, especially if foreign partners get involved. Finally, new lending will need a boost to support the economic recovery and rebuilding of Ukraine after the war.

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This newsletter is based on the Policy Paper: The banking sector in times of war: current situation and challenges

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**Advisory activities in Belarus are currently suspended.*