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The impact of the European debt crisis on the economy of Ukraine

1. Introduction

In the face of globalization and the gradual integration of Ukraine into the world economic community, the stability of economic conditions worldwide is a key to active investment and innovation processes, dynamic economic growth and, consequently, to higher living standards of citizens of the country.

However, as practical experience indicates, the crisis in the financial sector of European countries has a significant impact on economy-wide status of our country in particular, the result of the crisis in European states is a drop in foreign trade and foreign direct investment in Ukraine, the formation of negative tendencies of enterprises real sector of economy and the suspension of economic growth.

On the current stage of development the problem of the impact of external economic factors on the national economy and its integration into the world economy is becoming more urgent. Ukraine has entered the world economy on the economic and organizational base of market relations and this fact has brought not only mutual advantages in cooperation, but also an array of problems of the world economy.

Leading economists, scientists and practitioners are expecting the premises of the second stage of global recession. The reasons are the world-wide tendencies of the most important global markets which almost resemble the world economic situation from 2008. The global financial system is a footstep away from a new crisis which can outgrow the effects of the previous one in 2008–2009. Although the previous time there were the US private loans that catalyzed the crisis phenomena, this time the problem lies in the national debt of the European countries.

The world-wide known economists have warned about the destructive consequences of globalization and the probability of the global financial crisis. Among them such personalities as M. Allais, P. Herst and G. Thompson, D. Held and

E. McGrew, J. Soros, J. Stiglitz, A. Anikin, etc. should be mentioned.[1] Due to these experts' criticism, the positive impact of globalization processes is highly doubtful and the measures should be taken to overcome their destructive consequences and create effective methods of crisis exclusion.

2. Causes of the debt crisis in Europe

The crisis phenomena which were spreading among the Euro-regions, especially Greece, Ireland, Italy, Spain and Portugal, can now be traced in those EU countries that are off the euro circulation. The fact that Iceland has suffered the crisis more temperately than in 2008, when the whole banking system of the country has collapsed, is partially bound to the decision to default on the debt to the foreign banks.

In those EU countries that conducted large-scale financial inflows into the banking system to its rescue, debt burden on the state budget grew frantic rates and led to a significant increase in the gap between profitability on bonds and the cost of insurance risk bankruptcy by credit default swaps, hence its turn resulted in deterioration of solvency, that is, restricting the opportunities of finance to pay timely interest and loan body without further borrowing.

The problem of several EU member countries resulted in a systemic crisis of the entire eurozone. In May 2011, the Greek government debt was in the spotlight of the world.[2] Greek society has rejected any proposals that were designed to save public funds, and expressed their dissatisfaction with the situation through aggressive street protest actions. European Union leaders have confirmed the possibility of granting assistance to Greece. Thus at the end of June 2011 the Greek government was forced to apply new austerity measures. Bills were proposed to the Parliament that provided cost-cutting budget of 28 billion euros (about 314 billion UAH) over five years. In case of passing the proposed amendments, the Greeks were to be given 12 billion from the European funds. Without this cash infusion the Greek government would have been forced to declare a default in mid-July 2011.[3]

Reduction of the overall investment activity resulted in the dissemination of information about the growing government indebtedness around the world, along

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[1] *EU leaders pledge to do what is needed to help Greece*, BBC, 23 June 2011, http://www.bbc.co.uk/news/world-europe-13886099; *EU ministers offer 750bn-euro plan to support currency*, BBC News, 10 May 2010, http://news.bbc.co.uk/2/hi/business/8671632.stm; *Condition of foreign economic relations with EU countries in 2010*, Express release, State Statistics Committee, 18 March 2011, no. 62, sec. 1–3.

[2] I. Traynor, *Greek debt crisis: Eurozone ministers meet amid deepening gloom*, 19 June 2011, http://www.guardian.co.uk/business/2011/jun/19/greek-debt-crisis-eurozone-ministers?intcmp=239.

[3] *EU leaders pledge...*

with a shower of rating loss of EU countries. On 9 May 2010 the Council of EU finance ministers approved the formation of the special reserve fund in the amount of €750 billion, the main target direction is to ensure financial stability in Europe — the European Financial Stability Fund (European Financial Stability Facility — EFSF).[4]

In terms of the ratio of public debt to GDP among the EU countries at the beginning of 2011, the highest indicators are marked in Greek (145%) and Italian (118.4%) economies. The largest state budget deficit in relation to GDP is observed in the Republic of Ireland (–31.3%) and Greece (–10.6%). Thus 14 out of 27 EU member states and 12 of the 17 Euro-regions exceed the convergence criteria set forth by the Maastricht Treaty on the ratio of public debt to GDP, and 19 from 27 and 14 from 17, respectively — the criterion of the public deficit ratio to GDP. In particular, it is Germany and France, who were among the founders of the European Union, which first raised the ratio of public debt to GDP in 2002 and 2003, respectively, at the EU summit in 2005 they initiated changes to the previously concluded Stability Pact between EU member states and proposed the increase of non-use penalties for violating the Maastricht criteria for economic growth. Among those, Belgium, Greece and Italy, at the time an agreement has not reached the limit values of the public debt, could not get closer to the convergence criteria in subsequent years. Greece — the only country that was added to the "euro" as a double failure to comply with convergence criteria (including the permanent excess of a three percent budget deficit).

Financing of the budget deficit through borrowed funds increases the debt load on the EU and, consequently, leads the investors to overestimate the risk of investments in government securities. For example, as of November 3, 2011 profitability of 10-year bonds of Greece almost doubled in the last four months and reached 31%, Portugal — 12.1%, Ireland — 8.33%, Italy — 6.24%, Spain — 5.53%. Today on the international bond market the bonds of developed countries are the most profitable, and the countries that issue Visa have recently been having major problems with servicing their debt obligations.

The yield of government bonds also increased spreads on sovereign credit default swaps (CDS) — financial instruments of protection against credit risk. As a consequence, the rate increases PD on debt obligations (CPD). In the case of five-year CDS price covering default risk on $1 million. U.S. ambassador to the CDS spread at 10 points is 1 thousand USD.

On 2 May 2010 eurozone countries and the IMF reached agreement on the €110 billion loan to Greece. Immediately an €85 billion rescue package for Ireland has been granted as well as a €78 billion plan to redeem the Portuguese government

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[4] *EU ministers offer...*

debt securities. These steps have been directed to restrain the crisis process that began in Greece and spread to countries across the continent.

In October 2011 leaders of the eurozone member states approved the package of measures that had to stop "suicidal spiral" of increasing public debt. The decision was made on the cancellation of 50% of debts of Greece, along with the increase in EFSF to €1 trillion. (about 11 trillion UAH) and requirements for European banks to raise equity share to 9% of the total value of their assets. But in November 2011 eurozone leaders Sarkozy and Merkel made an ultimatum and a declaration addressed to Greece.[5]

Taking into account the analogous situation in Greece it can be asserted that organizing the Euro-2012 may negatively affect the Ukrainian economy, due to the implication of the the wide range of shady schemes that misuse the funds mobilized by taxes, credits from the IMF and that are accumulated from the sale of state property. Since 2008 the NBU has been printing government obligations which appeared due to the chronic deficit of the National Joint Stock Company "Naftogaz Ukrainy" and the Pension Fund of Ukraine.

Leaders of the world's leading countries are not interested in spreading pessimistic expectations. Note that the cause of emerging crisis is pouring billions of euros into Greece and Portugal. The United States developed the most extensive program of economic recovery, but cannot change the negative trends in its development. The most important indicator of global financial stability is the situation in the stock markets.

A number of analysts called the collapse of stock indexes the first sign that European economy is facing a crisis, confirming that the economies of Italy and Spain, Greece, Portugal, Ireland, Iceland as well as the US are experiencing serious problems and almost facing the default due to lower global ratings of their securities. In future, difficulties may arise in China, because a strong decline in purchasing power in the US and EU market will mean crisis for China and the entire global economy.

3. Impact of the European debt crisis on the economy of Ukraine

Ukrainian stock market traditionally follows trends in American and European stock exchanges. Since the level of domestic stock market is significantly lower compared with European and American markets, the fall of indexes abroad almost minimizes the volume of stock trading in our country. As a result many companies that operate in this area face a prospect of shutting down their activities.

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[5] Ch. Forelle, D. Gauthier-Villars and M. Walker, *Europe gives Greece an ultimatum*, "Wall Street Journal" 3 November 2011, http://online.wsj.com/article/SB10001424052970203804204577014371119242492.html?mod=WSJ_hp_LEFTTopStories%7Ctitle=Europe.

Note that on Monday 8 August 2011 on Wall Street decline was registered in most essential quotes from the end of 2008. Negative expectations of investors literally provoked the collapse of stock indexes in Asia. Russian exchanges also experienced a record decline since 2008. The fall index USE exceeded 10% and thus set an annual record.[6]

As for Ukraine, within the main directions of the negative impact of the European debt crisis in the financial and economic situation is the narrowing of opportunities for growth in foreign trade, foreign trade balance deterioration of the country. Thus, due to a decrease in consumption in Europe, which is characterized by the annual amount of public debt and the possible devaluation of currency at the same time, there is a reduction of exports of goods and services.

According to J. Sachs, the economic success of any nation in the world is based on foreign trade, because no country has managed to create a healthy economy, insulated from the global economic system. Ukraine is gradually integrating into the global economy so it cannot remain aloof from the processes taking place in the world. An important indicator of the country's foreign economic activity is the ratio of exports and imports. Note that the most profitable for the country are the prevailing knowledge-based export of finished products, and imports — raw product group.

According to analytical data of the Ministry of Foreign Affairs of Ukraine, in the first half of 2011, exports of goods from Ukraine to EU countries amounted to 9 billion 458.6 million. In comparison with the corresponding period of the previous year, the US has increased its export to 65.6%, and import is correspondingly about 11 billion 299.3 million dollars and increased to 42.1% (Fig. 1). The negative balance was 1 billion 840.7 million dollars (2 billion 236.5 million dollars in the first half of 2010). Export–import coverage ratio was 0.84 (in the first half of 2010 — 0.72). In total, export share of EU countries accounted for 28.8%, imports — 29.5% (in the first half of 2010, respectively 24.8% and 31.3%). The main export–import partners are Italy (respectively 1772.3 and 850.2 million dollars), Poland (1 billion 411 million dollars) and the US (1 billion 409 million dollars), Germany (3 billion and 17.2 million dollars), Hungary (602.9 and 609 million dollars) and Romania (508.2 and 515.7 million dollars).[7]

European financial crisis, and particularly the likely default of Greece (the possibility of default is about 90%) are the reasons for the further devaluation of the euro. In this regard, decreasing the competitiveness of countries with export-oriented European market means declining attractiveness of purchasing European goods and in the value of sent remittances from the EU to Ukraine. Note

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[6] *The second wave of crisis. How will the global economic downturn affect Ukraine?*, "Money-News" 12 August 2011, http://money-news.te.ua/2011/08/12/druha-hvylya-kryzy-yak-svitovyj-ekonomichnyj-spad-vplyne-na-ukrajinu/.

[7] *Needs assessment of Ukraine...*; official website of the Ministry of Foreign Affairs of Ukraine.

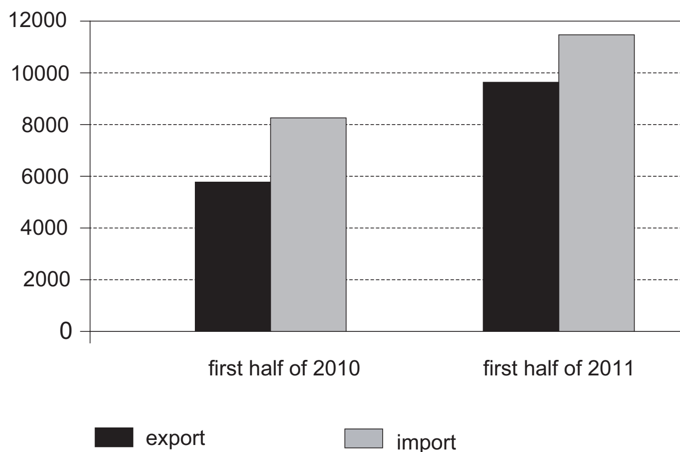

Fig. 1. Structure of export and import of Ukraine to EU countries for the 1st half of 2010–2011 (bn USD)

Source: *Needs assessment of Ukraine in promoting international trade*, UNDP Regional Bureau for Europe and CIS, Kyiv 2011; official website of the Ministry of Foreign Affairs of Ukraine.

that for stability of the ECB and the European Central Bank currency eurozone countries direct a significant portion of international reserves to purchase “troubled” bonds and a stabilization fund. In addition, under these conditions the countries that joined the EU in 2004, 2007 (including Bulgaria, Latvia, Lithuania, Poland and Romania) and are not in the eurozone suffer significant financial losses associated with the action currency risks. Moreover, the countries whose national currencies pegged to the euro and have a fixed rate (Bulgaria, Latvia and Lithuania), suffer greater financial losses in comparison with countries that adhere to a floating rate of national currency (Hungary, Poland, Romania and the Czech Republic). Therefore, we can predict that export of domestic goods to the European market will shrink. The probability of recession in Europe is currently estimated by experts at 40%, of the global recession — 35–38%. Naturally, this leads to a decrease in commodity prices and currency revenue decline in Ukraine. For the Ukrainian economy the dynamics of steel prices is an extremely important indicator. It is the main export product which significantly affects the stability and exchange rate (Fig. 2). Due to decreasing demand for Ukrainian products abroad, customs revenue will be reduced, and the account deficit in its turn will lead to the fact that the domestic currency will be under pressure. That is why investors seeking to minimize their risks will be forced to leave the unstable Ukrainian market.

We can forecast that in times of crisis the course of Ukrainian currency will be unstable. In view of the problems in the financial sector of the US and the EU, we

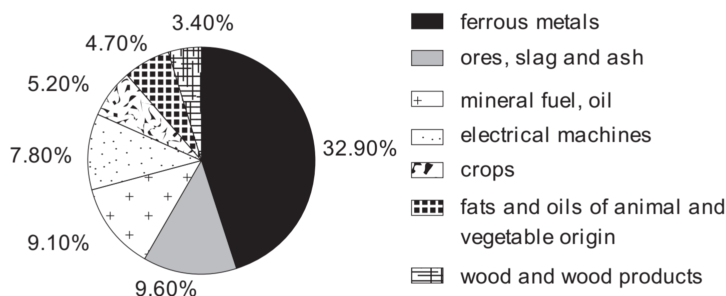

Fig. 2. Structure of export and import of Ukraine to EU countries
Source: official website of the State Statistics Committee.

can speak about the high volatility of the currency pair euro/dollar, according to which the rate will fluctuate with the value of these currencies. Stability of the course will depend on the resources and methods used to keep NBU rate within the approved fiscal year on the amplitude. Although the EU is a major trade partner of Ukraine, the future of the euro will have significant, but not decisive, consequences for the development of domestic economy, with Ukrainian currency, the hryvnia, unofficially pegged to the dollar.

As for the dollar, in case of the crisis in the global economy the demand for US currency in Ukraine will increase dramatically, leading to an increase in its value. It also means the growth of the euro in Ukraine.

As for investment from the European Union, the major portion of investments in Ukraine are investments from the EU only. The volume of direct investment in Ukraine with the EU as of January 1, 2011 amounted to 35.2 billion dollars which constitutes 78.8% of total investment in Ukraine (January 1, 2010 — 31.6 billion, 78.9%). The main countries-investors, which account for over 82% of total investments from the EU are Cyprus, Germany, the Netherlands, Austria and France (Fig. 3).

Practice shows that investment in Ukraine was risky even prior to the beginning of the crisis in the European Union. But now that the EU itself is going through hard times, it is unlikely investors will be risking their funds and invest them in the economy of our state. The reduction of foreign investment will lead to slower economic growth, which in turn will lead to lower living standards in the country.

It is worth noting that the volume of investments in real sector of Ukrainian economy is directly related to the stability of domestic banking sector. High dependence on foreign capital, a considerable amount of bad loans at a level of 35% and high risk loan portfolios place Ukrainian banks among the most vulnerable to the effects of banking crises in Europe.

There was a significant decrease in the activity of European banking institutions in Ukraine, which is caused by the debt crisis in Europe. But this is not the only

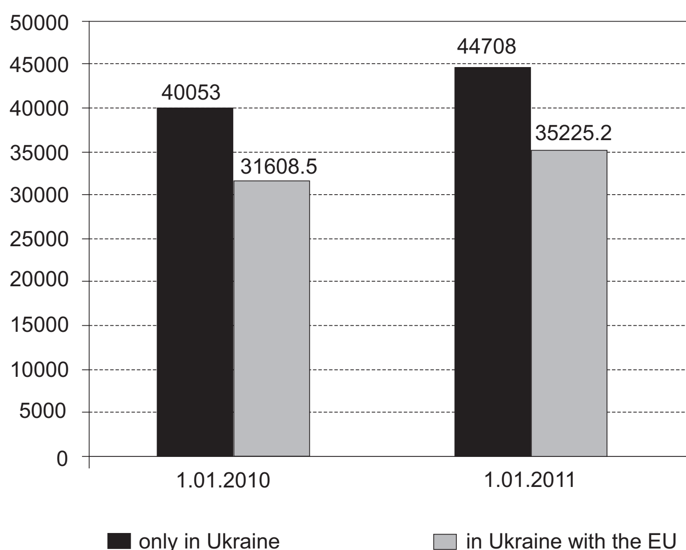

Fig. 3. Direct investment in Ukraine (bn USD)

Source: *Condition of foreign economic relations with EU countries in 2010*, Express release, State Statistics Committee, 18 March 2011, no. 62, sec. 1–3.

cause of reducing their presence in the domestic banking sector. Significant losses "earned" in Ukraine, questionable prospects of the economy, ambiguous regulatory environment, corruption in the judicial system quicken "migration" of powerful financial institutions in Ukraine.

According to the National Bank of Ukraine, today there are 55 foreign banks (22 — 100% foreign capital). The concentration of foreign bank capital is high, foreign partners control about half of banking system assets. As of November 1, 2011 the share of foreign equity investors in the authorized capital of Ukrainian banks amounted to 41.6% (January 1, 2011 — 40.6%). The largest foreign investors in the banking sector, as in the real sector, are Russia, Cyprus, Austria, France, Germany.[8]

Note that the experts estimate the value of different presence in the banking sector by foreign banks to the economy of Ukraine. On the one hand, their functioning in Ukraine improves the quality of life through active consumer and mortgage lending, moreover, the banking institutions before the crisis were the driving force behind the implementation of international standards in the domestic banking sector and helped expand the financial capacity of financial and economic system of the state.

[8] Official website of the National Bank of Ukraine.

During the crisis of 2009–2010 the presence of foreign capital was one of the key factors in stabilizing the banking system: none of the foreign banks was under the administration. In 2010 about 50% of foreign direct investment in Ukraine — 4.7 billion dollars — came from the banking sector.

However, there are critics of the expansion of foreign banks in Ukraine. The excessive expansion of foreign banks, which adversely affects the trade balance, is distinguished among the key factors of deterioration. This is reflected in the increase of consumer imports, growth of property prices and the dollarization of the economy (through active granting of foreign currency loans). In contrast to the previous years when banks were one of the most important sources of foreign exchange, at present these financial institutions are one of the main channels of capital flight. During the last three quarters of 2011 banks have extinguished 2.9 billion dollars of external debt which is more than was attracted. They are obliged to pay off the debt before January 7, 2012 in the amount of 13.4 billion US dollars.[9]

According to analysts, the collapse of the banking business by foreigners in Ukraine will negatively affect the balance of payments of the state and prospects for lending to the economy in general. Actually, this process has already started: since 2009, when the Dutch ING left the Ukrainian market, the liquidation of representative offices of foreign banks in the country has begun. At the same time, the German Dresdner Bank agency was liquidated. In 2010, the British HSBC, and Polish Pekao also went this way. And in 2011, Home Credit Bank, Czech PPF Group and the Dutch-Israeli groups TBIF Financial Services BV — VAB Bank were sold. Ukrainian subsidiaries eliminated the Bank of Georgia (80%) and Russia's Renaissance Capital. The Ukrainian offices of the German Bayerische Landesbank and South Korean Kookmin Bank have also been liquidated.

The major tendencies peculiar to the banking system, called the output from the Ukrainian market of foreign banks, showed in particular Kredobank, Folskbank, BM Bank and SEB Bank. UkrSibbank put up for sale a mortgage portfolio of $1 billion and some offices. In September 2011, a group of Swedbank announced the release of the retail business segment and focus on corporate clients. The owners of Commerzbank announced the possible sale of Forum.

It must be admitted that the activity of Western banks is reduced not only in Ukraine. The Russian market was maintained, they also kept Spanish Santander, Dutch Rabobank, Belgian KBC, Swedish Handelsbanken and Swedbank, British Barclays (leaves investment subdivision) and HSBC (focusing only on corporate clients), US Morgan Stanley and GE Money Bank (owned by General Electric).

[9] Ibid.

French BNP Paribas closes many departments and focuses on the project POS-loans from Sberbank.[10]

In summer 2011, the attention of analysts was focused on the long-awaited results of stress testing of 90 largest banks held by European Banking Authority. Target capital ratio is defined first order — (core tier 1 capital ratio), reflecting the bank's ability to withstand the crisis. According to the results analyzed, eight financial institutions are not ready in the target capital adequacy of the first order of 5%. The Austrian group Volksbanken (represented in Ukraine by Volksbank) in the case of a negative scenario will receive critical indicator of capital adequacy of the first order at 4.5%, therefore to compensate for this risk it requires immediate capital infusion in the amount of 160 million.

Another financial institution which failed to pass the stress test was the Greek holding EFG Eurobank Ergasias — 4.9%, which controls Ukraine in an extensive network of bank branches Universal Bank. In order to achieve the required minimum capital, Greeks should fill in the amount of 58 million euros.

In addition, 16 European credit institutions showed results between 5% and 6%, of which present in Ukraine are Greek Piraeus Bank (5.3%) and Cyprus Marfin Popular Bank (5.3%), which in 2006–2007 purchased domestic banks.[11]

Experts called the performed stress-test rather mild, due to the not too "pessimistic" scenario of the movement — eurozone GDP has fallen by 0.5% in 2011 and the stock market collapsed by 15%. One of the main claims has also disregarded the possible consequences of default for troubled countries sovereign obligations in adequate amounts. Although representatives of the EVA recommended banks to find only 2.5 billion to replenish capital, S&P agency in their own stress tests counted needs for additional capital amounting to 250 billion euros.

Following the announcement of the results of stress tests, downward trends prevailed at the stock markets, usually falling quotes of banks that failed the stress test and decreased in value stocks of credit institutions with a low, close to the boundary — 5–7% core tier 1 capital ratio.[12]

In case of the second wave of crisis there is a risk that the parent company of Ukrainian banks may reconsider their strategy from a position out of the Ukrainian market. The defining "internal" condition to view this is a high-profitability of foreign banks, primarily because of the need provisioning for NPLs.

In 2010–2011, part of the financial institutions with foreign capital managed to slightly reduce the negative financial result. However, many of them still continue

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[10] *Correction banking strategies in terms of the European debt crisis and its impact on the financial system of Ukraine (information-analytical materials)*, League of Financial Development, http://www.lfr.org.ua/ru/analytics/328-2011-11-15-10-45-13.html.

[11] R. Kornylyuk, *Foreign banks recovered from stress*, "Economic Truth" 20 July 2011, http://www.epravda.com.ua/publications/2011/07/20/292399/.

[12] Ibid.

to carry huge loss or balance on the brink of loss, showing minimal gains. It should be taken into consideration that although foreign banks in the majority are more responsibly suited for the formation of provisions for non-standard debt (currently formed reserves on average 20–30% of the loan portfolio) than the domestic financial institutions, the situation may be complicated due to the probable second wave of crisis, when it is possible that the solvency of borrowers will fall again. According to Fitch, by the end of the first half of 2011, 50% of bank loans (mostly foreign) that are rated by agencies were potentially problematic (20% of loans with instalments 90 days, 30% — restructured).

A negative on the financial position of foreign banks displayed the current requirement to form the reserves for foreign currency loans only in the rate (in case of depreciation of even only 1 kopeck damages arising millions). In the present context one of the key sources of income for banks with foreign capital are consumer credits, however they also may be limited (draft appropriate NBU regulations already presented, recently the government approved the "Action Plan to overcome the negative balance in foreign trade," which is provisions for the prevention of rising consumer lending). For foreign banks the opportunity to generate profits on currency transactions is constrained by reduced standard of open currency positions to 5% (20%).[13]

Reduction in the non-government securities portfolio (which has decreased by half from the middle of July to early November 2011 — from 9 billion to 4.5 billion), appointed withdrawal of foreign investors took place primarily because of the problems in Europe.

In order to attract foreign investors, the government issued foreign currency bonds. The National Bank plans to issue coins and investment securities indexed on the rate of gold.

Conclusions

The effects of debt crisis on economic cooperation between Ukraine and the EU can cause several generalizations. Firstly, the sharp decline in economic activity in partner countries will trigger a sharp decline in trade. Secondly, fluctuations of dollar and euro exchange rates will influence hryvnya rate. Thirdly, reducing the number of banks with foreign capital will cause the outflow of investments from Ukraine. The crisis has certainly affected the economic cooperation between Ukraine and the EU, yet still the co-operation will continue.

Thus, one could argue that the crisis certainly affects the economic situation in Ukraine and the volume of trade transactions with EU countries. Ukraine integrates gradually into the global economic system, therefore the world stability is a pre-

[13] *Correction banking strategies...*

requisite for Ukrainian effective development. Possible decline in foreign trade and investment in our country would lead to a negative trend and the suspension of the economy as a whole, and this primarily affects the living standards of citizens.

The main factors that led to the emergence of the European debt crisis were investigated. The results of its influence on economic relationship between Ukraine and the EU were analyzed. The author investigated the main factors that led to the emergence of the financial crisis in the European Union, and also analyzed the impact of the crisis in Europe on the amount of investment in Ukraine's economy and prospects of the banking system.

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However, as practical experience indicates, the crisis in the financial sector of European countries has a significant impact on economy-wide status of our state in particular, the result of the crisis in European countries is a drop in foreign trade and foreign direct investment in Ukraine, the formation of negative tendencies of enterprises real sector of economy and the suspension of economic growth.

On the current stage of development the problem of the impact of external economic factors on the national economy and its integration in the world economy is becoming more urgent. Ukraine has entered the world economy on the economic and organizational base of market relations and this fact has brought not only mutual advantages in cooperation, but also an array of problems of the world economy.

Leading economists, scientists and practitioners are expecting the premises of the second stage of global recession. The reasons are the world-wide tendencies of the most important global markets which almost resemble the world economic situation in 2008. The global financial system is a footstep away from a new crisis which can overcome the effects of the previous one in 2008–2009. Although the previous time there were the US private loans that catalyzed the crisis phenomena, this time the problem is in national debt of the European countries.

The worldwide known economists have warned about the destructive consequences of globalization and the probability of the global financial crisis. Among them such personalities as M. Allais, P. Herst and G. Thompson, D. Held and E. McGrew, J. Soros, J. Stiglitz, A. Anikin, etc. Due to these experts' criticism, the positive impact of globalization processes is highly doubtful and the measures should be taken to overcome their destructive consequences and create effective methods of crisis exclusion.