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UKRAINIAN FINANCIAL SYSTEM DEVELOPMENT: THE PATH TO EU

The paper is based on the comparative analysis of the main characteristics and features of the financial system of Ukraine and Bulgaria, and discusses the issues and prospects of building a modern institutional environment to meet the requirements for European integration, to support economic development and to prevent crisis shocks. The study includes an analysis of the characteristics of financial liberalisation, the dynamics of international investment flows, the requirements of the budget process, in particular the formation of the structure of domestic and foreign debt, the peculiarities of monetary and exchange rate policy.

The article determines the characteristic feature of small open economies, that is, the limited development of the institutional environment of the country's financial sector and a dominant banking sector. The article emphasises that in such terms, the public policy is focused on the development of the banking sector with a gradual increase in its internationalisation. A natural consequence is the large share of state and foreign capital in the financial sector of the economies in transition with the limited development of non-banking and stock market segments. Another feature is the reliance of financial stability on the external financing and inflow of foreign currency, including in the form of external and internal government borrowing and international private transfers.

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The mentioned peculiarities of the development of the financial systems of Ukraine and Bulgaria show that the institutional weakness of the financial system is due not only to the negative consequences of several financial and economic crises but also to errors in financial system reform policy. Attempts to build the financial system based on accelerated financial liberalisation, focusing on the banking sector separation of the latter from the real sector of the economy, laid the ground for the institutional weakness of the financial system. The authors stress that the elimination of these fundamental imbalances, supported by modernised approaches to monetary and macroprudential regulation, should strengthen the institutional capacity of Ukraine's financial system, bringing it closer to the requirements of the EU integration.
JEL: E52; E63; F21; G21; G28

Introduction

The formation of a fully functioning financial system is a prerequisite for the productive development of the national economy in the current globalisation trends. The growth of international capital flows, the internationalisation of trade and the integration of economic relations require adequate development of financial institutions, instruments and regulatory policies. Matching of the development level of the Ukrainian financial system to the EU's level along with meeting the requirements of integration has always been significantly determining the nature of financial system development.

There were attempts to introduce a free-floating exchange rate, liberalise the capital account, manage the budget deficit and introduce modern approaches to monetary regulation and recommendations of international financial institutions under conditions of macroeconomic growth in Ukraine. At the same time, periodic financial shocks of domestic and exogenous origin offset the results of the reforms.

This nature of the development of the Ukrainian financial sector was largely determined by the specifics of economic transition and dominant economic policy. At first glance, Bulgaria (taking into account its EU membership) is not a relevantly comparing country to Ukraine in terms of size, population, economic structure. Nevertheless, the similarity of the process of economic transition based on liberalisation views in anticipation of the EU membership has led to similar consequences despite different starting conditions. Having compared the characteristics of the development of the financial sector of Ukraine and Bulgaria, we demonstrated the absence of a consistent economic policy determined by national interests in conditions of international competition. Other CEE countries, including Hungary, can be used for comparison, and the result is likely to be very similar with few exceptions.

Analysis of the preconditions and consequences of the crisis shocks that affected Ukraine's financial system showed a lack of institutional capacity. In result, the reason lies in the incomplete reforms of the financial system in favourable periods of economic cycles. However, the analysis showed that obvious reasons for low institutional capacity might also be in errors of the pre-crisis approaches to the development of the national financial system. This is confirmed by the data presented in the article on the similarity of some trends of the development of the financial systems of Ukraine and Bulgaria. Meanwhile, Bulgaria has gone through the path of financial integration with the EU, but has also suffered in result of the global financial crisis (GFC). As such, the strengthened influence of financial crises, especially noticeable after the crisis of 2008 formed structural and functional preconditions defined in the article.

Hence, measures of financial liberalisation, foreign capital attraction, the pursuit of recommendations of post-crisis recovery and modernisation of monetary management in the form of inflation targeting, were carried out without coordination with the national economic development policy. This created similar conditions and led to similar results for the somewhat different economies as Ukraine and Bulgaria.

The lack of defined structural and functional goals of the financial system development, as well as lack of subordinating the goals of reforms in the financial sector to national interests and the needs of long-term macroeconomic policy, led to financial institutions' weaknesses and increased vulnerability of Ukraine's or Bulgaria's financial system to external shocks. At the same time, the experience was gained, both positive and negative, and generalisation of knowledge on the steep path gave grounds for confidence in the possibility of overcoming the current difficult situation and developing more rational approaches to building a financial system adequate to modern challenges of further globalisation, digitalisation and expected prolonged recession. This publication in the framework of a joint international research project presents merely a certain study of the peculiarities of financial system development in Ukraine on the path to the European integration and their comparison with the peculiarities of Bulgaria.

Financial Openness and Economic Development

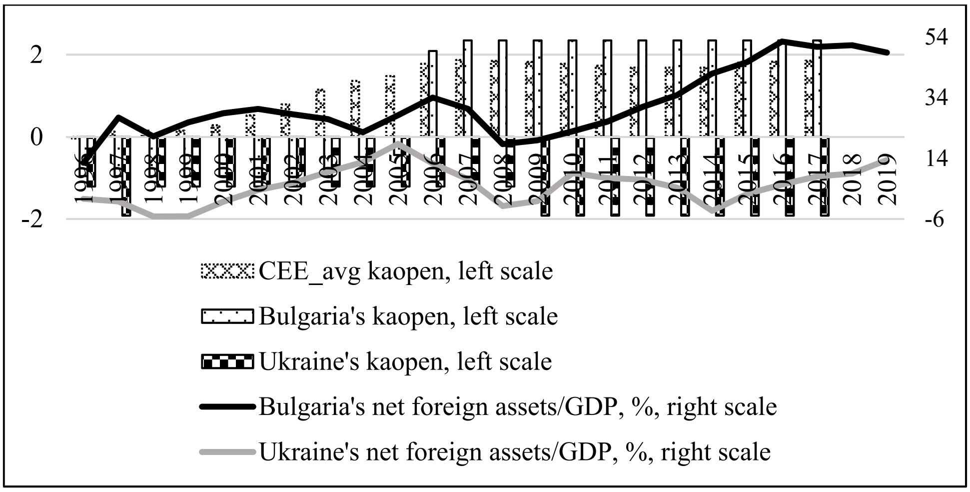
According to the neoliberal theory of economic development and the requirements of the European integration, financial openness is a crucial element of the economic reforms that the national economy must pursue on the path to the EU and to sustainable economic growth. The movement of transit countries in Central and Eastern Europe and the Commonwealth of Independent States towards financial openness was initially characterised by similar trends, determined by the processes of internal market liberalisation and privatisation. Subsequently, the process of the European integration became a decisive factor in the enhancing openness for the Eastern European countries. It was the implementation of the requirements of the European legislation on the path to the EU that led to a rapid increase in the level of financial openness (the "de jure" indicator according to the degree of capital account openness, known as the KAOPEN index by Chinn and Ito) of Bulgaria at the beginning of 2000 (Figure 1).

An approximately identical trend of the nominal financial openness of the countries up to 2000 has since then taken different directions and significantly diverged by 2006. Therefore, the level of restrictions on the capital flows in Bulgaria is much higher than the Ukrainian one and exceeds the average in the Central and Eastern European countries. Whereas, after the GFC, Ukraine's level of financial openness has decreased. Despite the relatively low financial openness of Ukraine's and Bulgaria's economies by the de jure parameter, the global capital flows moved to the markets of Ukraine and Bulgaria almost in parallel until 2006, when the boom in volatile capital movements erupted these countries (according to the measure of "de facto" financial openness proposed by Lane and Milesi-Ferretti (Lane, Milesi-

Ferretti, 2007)). Such a sudden increase in global financial flows laid the foundations for the systemic risk of financial instability and, at the same time, significantly influenced the economic development of these countries. However, the impact was not entirely as predicted by the neoliberal theory. Instead of accelerating economic growth, diversification and higher efficiency of the financial system, the inflow of foreign capital primarily financed the growth of the current account balance deficit (Figure 2).

Figure 1

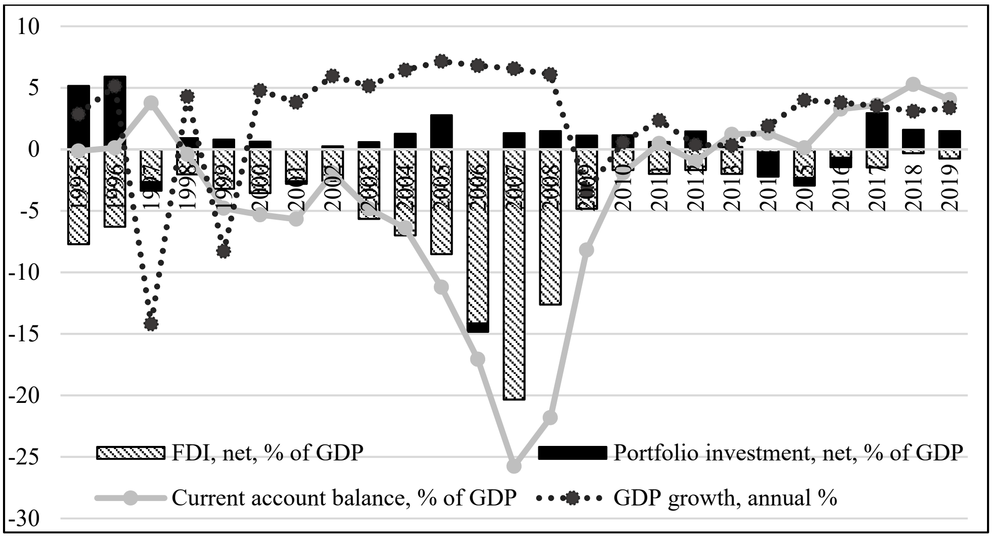
Financial openness “de jure” and “de facto” of Ukraine and Bulgaria



Source: Chinn-Ito Index, World Bank.

Figure 2

Capital flows and economic development in Bulgaria



Source: World Bank.

Inflows of FDI to Ukraine were mainly directed to the most profitable industries of mining and agriculture and high-yield financial instruments concentrated in the banking market After the acceleration of economic growth in the early 2000s. Overall, the implications of financial openness for Bulgaria and Ukraine are entirely consistent with the findings of the paper M. Fratzscher and M. Bussiere (Fratzscher & Bussiere, 2004). Such impact of financial openness has led to an increase in the share of foreign capital at the Bulgarian banking market. In turn, financial openness increased the dependence of the financial system on a stable inflow of foreign capital and led to the adverse effects of the infestation during GFC.

Despite the excellent level of financial openness “de jure” and less potential for financial integration, Ukraine also experienced a sudden influx of large amounts of foreign capital before GFC. FDI inflows to Ukraine began to grow in 2005 after the economic development intensification, the financial sector strengthened, and confidence in its markets increased. The main stage of privatisation had been completed by this period. Similar to Bulgaria, capital flows have had an impact on the Ukrainian economy through the financing of energy, agriculture and the acquisition of banking institutions. But part of FDI has its specifics in Ukraine, namely, return to the country in the form of investment of previous capital outflow (round-tripping) along with transforming of debt into equity capital (recapitalisation of banks). During the 2003–2007, the growth of FDI and portfolio investments in Ukraine were 2–4 times faster than the GDP growth. The increase of FDI inflows in 2005–2008 was characterised by a boom in foreign currency lending and the growth of banks with foreign capital. After the GFC, the decline of FDI in 2013–2014 was the consequence of the political crisis of early 2014, the occupation of Crimea and some districts of the Donetsk and Luhansk regions, and as a result, outflow of the Russian banking capital. The resumption of FDI inflows in 2015 was due to the requirements set for the recapitalisation of the Ukrainian banks, also since 2016, the ban on the repatriation of dividends for foreign investors/non-residents was cancelled. After a large-scale outflow of capital in 2014–2015, the inflow of capital to Ukraine resumed, but narrowed significantly compared to the pre-crisis period. It is important to note that, just as in Bulgaria, the FDI influx in Ukraine has primarily financed the negative current account balance (Figure 3). In turn, portfolio investments are directed almost to debt securities, namely to the general government sector (government securities) rather than to the real sector of the economy.

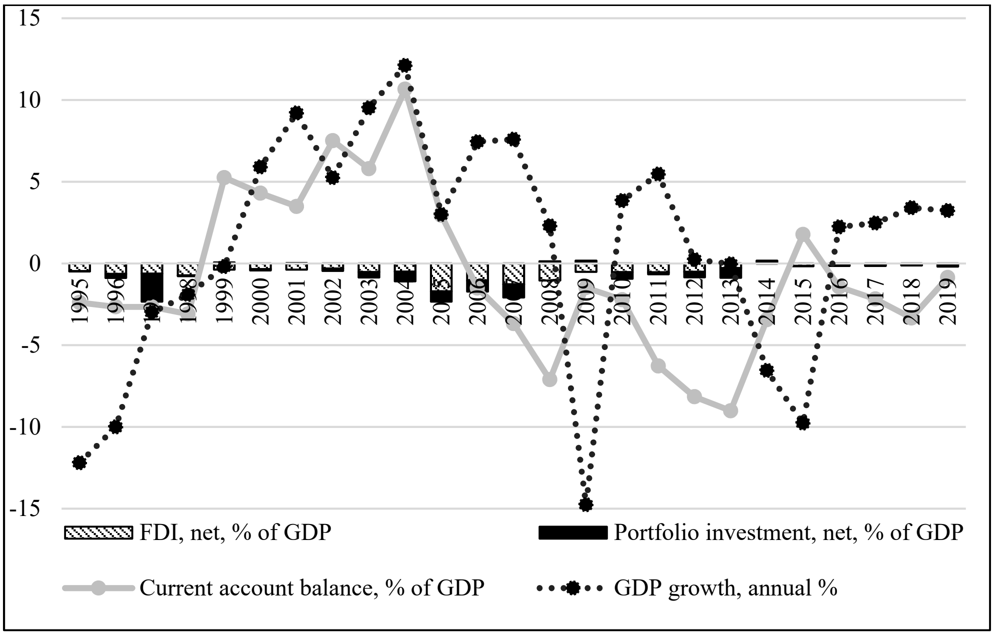
Although today investors prefer debt rather than share instruments, the only alternative becomes the financing from international organisations due to the sluggish interest of investors in risky assets in the Ukrainian financial market and high competition for financing between small open economies (all without exception, budget deficits are growing). Meanwhile, external borrowing is not supported by a reduction in the budget deficit, and therefore the current account deteriorates in Ukraine’s small commodity economy. In turn, significant payments of the public sector against the background of restrained growth of capital inflows affect the reserves, which in fact exhausted and were turned into the IMF credit resources[5]. At the same time, the size of the current Ukrainian account is affected by the increase in GDP, which causes a current account deficit (in 2006–2014). In a small commodity economy, the expansion of the current account deficit is a consequence of rising

[5] The Ukrainian government has not borrowed funds from the IMF in 1992–1993, 2002–2007, 2011–2013 and 2019 throughout the history of its independence.

energy prices, namely the excess of imports of goods over exports (peak periods in 2008 and 2013). Nonetheless, in 2019, the current account deficit narrowed due to the increased net inflow of funds on the financial account despite hryvnia appreciation caused by plunging imported energy prices.

Figure 3

Capital flows and economic development in Ukraine



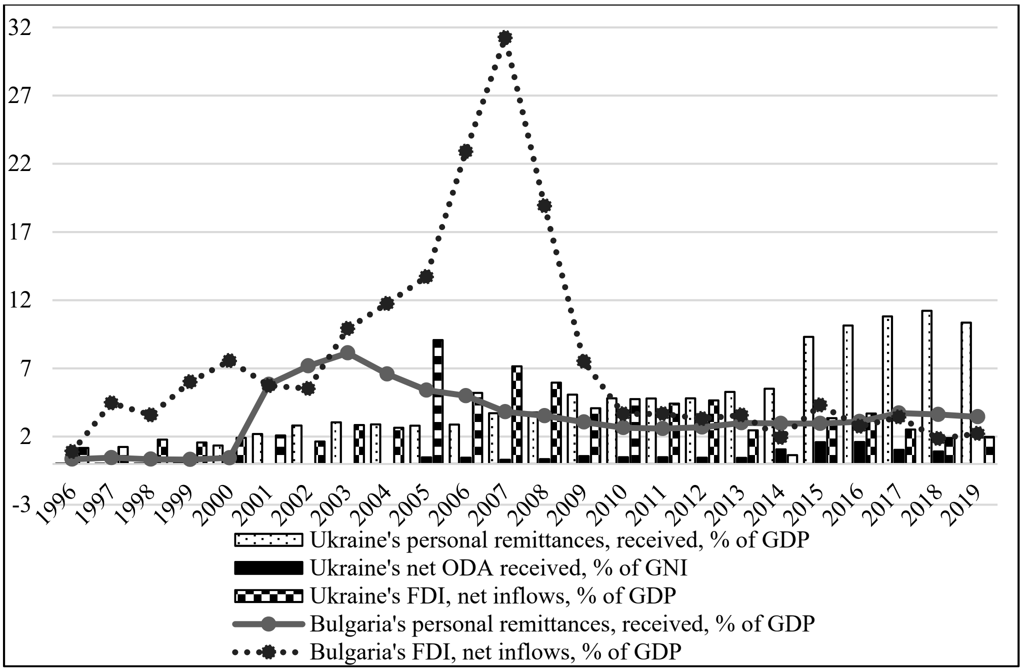
Source: World Bank.

Furthermore, remittance flows are an essential source of external financing for Ukraine, which remains a recipient country for cross-border remittances. Although since 2014, the geographical structure of the countries of destination of the Ukrainian workers changed significantly (the share of the Russian Federation decreased, and the number of EU countries increased), the volume of remittances of the Ukrainian migrants has increased substantially. This inflow was due to the explosive growth of migration itself and because of a significant expansion of the possibilities for carrying out such operations. The value of remittances for Ukraine is also confirmed by comparison with other financial flows from abroad, in particular, with FDI and official development assistance (Figure 4).

As remittances are more resilient than private borrowings or portfolio equity investments, these migrant's flows supported the hryvnia during the period when foreign investors lost interest in the Ukrainian economy. Although this source of funds can be seasonal and volatile, remittances reach those sectors of the economy where it is difficult to set standards for FDI and bank loans. In general, remittances have a positive effect on the balance of payments and are a source of foreign exchange inflows to Ukraine. Moreover, significant amounts of migration capital revenues contribute to the growth of the financial potential of the budget system of Ukraine. That is indirectly due to a substantial increase in the level of income of Ukrainians and their solvency. Therefore, migrants' transfers are the hefty source of external financing of the Ukrainian economy, which reinforce the importance of remittances as a stabilising economic factor and as a means of increasing a recipient country's credit-worthiness. Though remittances improve the balance of payments of the state, and this supports the hryvnia exchange rate, they do not guarantee the automatic development of the national economy. Remittances are not an alternative to the sources of endogenous economic growth.

Figure 4

Remittances[6] and other capital inflows



Source: World Bank.

Summing up, the low level of "de jure" financial openness in Ukraine did not particularly impede the capital movement through its jurisdiction. In Bulgaria, the liberalisation was conducted, while in Ukraine, the restrictions were introduced. Despite the differences in regulation, the intensification of the capital flow movement was almost synchronous. Herewith, the most productive period of economic growth in 2000–2004 was characterised by moderate capital flows to Ukraine. At the same time, the inflow of significant amounts of capital in the period 2005-2008 in both Ukraine and Bulgaria was due not to policies but to attractive signs of economic growth. However, the lack of a developed structure of the economy and financial markets has led to the same consequences – the exogenization of the

[6] Remittances include net compensation for employees and personal transfers.

banking market and limited lending to national enterprises. Thus, without a proper international capital flows regulatory policy, even large inflows of FDI did not have significant productive consequences. With this regard, the upsurge of the most developed segment, namely the banking market – was distinctive.

Banking Sector Development

In spite of the number of differences in terms of the formation of the financial systems of the countries, defined primarily by the more powerful euro integration vector of Bulgaria's development, a similar process of economic transition, privatisation and financial liberalisation with the advent of foreign financial institutions caused the similarity of many parameters of the financial markets. The GFC was particularly decisive for both countries in 2008, when the financial sectors of these countries drowned under quite similar conditions.

Characteristic features of the financial systems of Ukraine and Bulgaria include the formation of a bank-centric model with a limited level of development of the non-banking sector. Thus, in Ukraine, banking sector assets amounted to 52,7% of GDP in 2017, while insurance companies' assets accounted for 2–3% of GDP, other financial institutions – 6,5%, as well as limited capital stock markets less than 1% of GDP. At the same time, the main instrument in the stock market is government securities – an instrument that provides budget financing (Bublyk, 2018). It should be noted that by 2008 these indicators of both banking and non-banking sectors in Ukraine were 2–4 times higher, especially in the non-banking sector.

Limited development of the non-banking sector was also achieved in Bulgaria, although its indicators are more significant: the stock market capitalisation is about 10% of GDP, by the end of 2015, it is significantly higher than in Ukraine, but the absolute is pension fund assets – at 9,4% to GDP (Bulgaria: financial system stability assessment, May 2017). In other words, the banking sector, which accounts for about 85% of financial assets, is the primary source of financial security for investments and savings in both countries (Bulgaria: financial sector assessment program, July 2017). Meanwhile, a considerable part of the financial sector is represented by institutions with foreign capital, which is especially pronounced in Bulgaria – up to 80% of banks and insurance companies (Minassian, 2013). More than half of the assets in both countries are represented in foreign currencies.

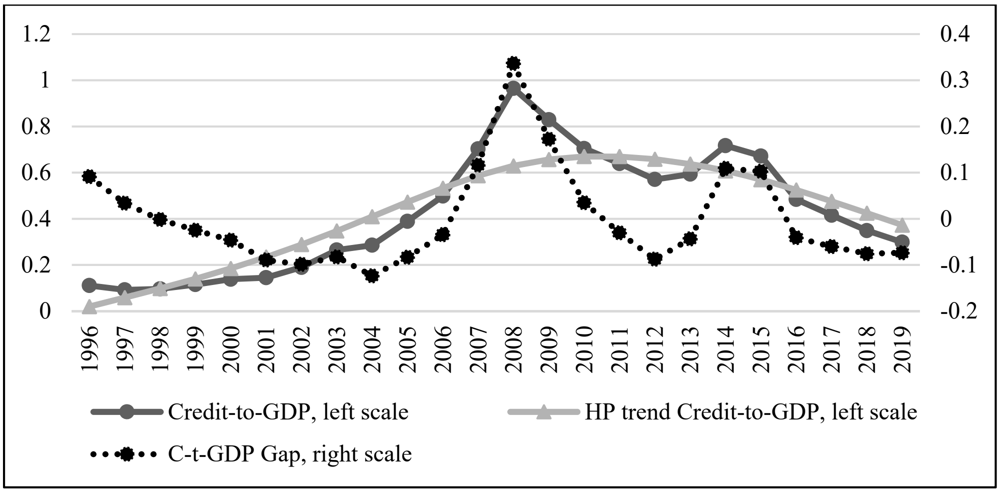
Such a large proportion of foreign capital reflects the specific structural problem of banking sector development inherent in Bulgaria and Ukraine. Under the conditions of the competitive pressure of large foreign financial institutions and the effects of several banking crises (2008 and 2014 in Ukraine, 1997 and 2008 in Bulgaria) national private banks, without state support, could not compete and gave way to market share (Mirchev, 2009). Herewith, if in Bulgaria national banks gave way to large foreign banks, in Ukraine this process has so far embodied the nationalisation of 60% of the banking market, which now accounts for the assets of the four largest state-owned banks. It is likely that in the future, in the process of privatisation, this share will also go to large foreign banks.

The consequence of such a structural feature of the financial sector was the restriction on lending to the economy. During 2005–2008, the surge of bank credit to the private sector of

Ukraine widened macroeconomic imbalances by financing the credit boom (Mendoza & Terrones, 2008) in the mortgage and consumer lending markets, which was accompanied by a rapid rise in price bubbles in the real estate markets (Figure 5).

Figure 5

Indicators of credit boom of Ukrainian economy



Source: State Statistics Service of Ukraine, National Bank of Ukraine.

Over the five years from 2004 to 2008, the banks' loan portfolio increased from 73,4 to 565,9 billion UAH in total (until the beginning of the next devaluation). This portfolio grew annually by 20–40%, and exceeded 60% of GDP by the beginning of the 2008 crisis (Bublyk, 2020, p. 144). Over this period, the significant growth rate of loans to households no longer supported economic activity in the real sector. But it mainly produced a price "bubble" in the real estate market. The same period was characterised by the most active inflow of foreign investment, which largely financed the development of the credit boom in the consumer lending market of Ukraine, which fueled the formation of "bubbles" in the real estate market (Bublyk, 2020, p. 145). Subsequently, the overheating of these markets caused a severe crisis in the banking markets as foreign capital inflows declined during the spread of GFC in the EU. Since 2015, the indicator of the credit boom reflects the long-term under-lending of the Ukrainian economy, among other things, due to the lack of foreign investment (Bublyk, 2020, p. 257). During 2014 and 2015, the decline in real GDP by 6,6% and 9,8% was accompanied and exacerbated by several waves of significant hryvnia devaluation and the banking crisis, which resulted in, in particular, a massive outflow of deposits from the banking system and bank failures.

Under such circumstances, banks adhere to conservative policies, preferring to invest in government securities or lend to affiliated or large for-profit enterprises. At the same time, lending to opening a new business by small and medium-sized enterprises (SMEs) seems to be highly risky for them and, therefore, unjustified due to the presence of more reliable tools and increased regulatory requirements for financial stability.

Bulgaria has also experienced a series of credit booms caused by sudden inflows of large amounts of foreign capital, which went to the consumer lending segment and led to excessive increases in real estate prices. In particular, such cases occurred in 1996–1997, 2004–2008 and 2012. It was possible to avoid the banking crisis for a long time until 2014 due to the "currency board" of Bulgaria.

Over the recent decade, the banking system regulations defined the state of the whole regulatory environment in Ukraine, which impacted the flows of both long-term and short-term capital. From the over-regulated, the banking system is slowly passing to liberalisation, removing constraints to the movement of capital, including procedural, maximum borrowing cost, reservation, withdrawal and currency control constraints. Also, on a positive side, the system of financial monitoring has been notably improved. Considering the share of the banking sector in the financial industry and the influence of the banking-related legislation, lately, the consolidated model of supervision of the non-bank financial market[7] oversight is discussed. As of the beginning of 2020 there are three financial regulators: the NBU, the National Securities and Stock Market Commission (NSSMC), and the National Commission for State Regulation of Financial Services Markets (NFSC). After the split will have been implemented, there will be two regulators left: the NBU, and the NSSMC[8]. Such a move, which means unified rules for all financial institutions, detection of financial system risks, quality regulation and monitoring, can be deemed positive by foreign investors (National Bank of Ukraine).

Thus, the nature of the financial sector development policy, due to the requirements of financial liberalisation, formal according to Bulgaria's EU membership and voluntary in Ukraine's pursuit of it, had similar consequences for them. The trends of exogenization of the banking market became noticeable as a result of discoordination with the state policy of economic development and the needs of financial support of domestic producers. The dominance of powerful foreign banking institutions has determined the limited development of lending to producers in favour of consumer lending with a natural consequence of the credit boom. In the context of subsequent economic stagnation, the low profitability of domestic producers demotivates banks to provide them with loans without government guarantees.

Monetary and Fiscal Sector Policies

To achieve and ensure price stability, the National Bank of Ukraine (NBU) uses the monetary regime of inflation targeting. In August 2015, the NBU Board proclaimed the target for

[7] The partly integrated model of financial sector regulation is laid out as an-IMF supported draft "Split" law, which literally determines the split of the existing National Commission for Regulation of Financial Services Markets and a pass to a "Two Agency" model, where one of the regulators is responsible for banks and insurance activities, and the other for market conduct. The model has been implemented in Italy, France, Greece, Serbia and is planned in China.

[8] The NBU will regulate insurance, leasing and factoring companies, credit unions, pawnshops and other financial institutions. Private pension funds, pension fund administrators and construction financing funds will be regulated and supervised by the NSSMC (National Bank of Ukraine).

inflation and in December 2016, the newly established NBU Council officially adopted inflation targeting. For 2019, a medium-term inflation target of 5% (year-over-year CPI growth) was fixed. For each year, intermediate targets were announced to establish a benchmark for the NBU, which in turn would arrive at the optimum 5%. The target of 12% was set in 2016, and as a result, inflation dropped from 43,3% to 12,4%. Nevertheless, during the 2017–2018, inflation targets were not reached. In December 2017, under the target of 8 %, inflation rose to 13,7%. In December 2018, under the target of 6 %, inflation dropped to 9,8%. Therefore, inflation expectations, in general, tend to decrease but exceed the inflation target of the NBU. However, as of the end of 2019, consumer inflation slowed down to NBU's target of 5%. It reached 4,1% partly owing to the hryvnia revaluation despite significant pressure from consumer demand (National Bank of Ukraine).

The NBU pursues its policy of inflation targeting within the flexible exchange rate regime. Generally, during most of its history, Ukraine operated under the fixed exchange rate, and only in 2014 the NBU adopted a flexible exchange rate as its monetary policy framework.[9] By changing the discount policy rate, the NBU determines the level of short-term interest rates on the interbank market that influence aggregate inflation.

During 2019, high real interest rates and simplified access to government securities due to new currency regulation system (launched in February 2019 and characterised by deregulation of investment procedures, broadening the list of authorised FX operations) contributed to a further capital inflow, namely into domestic government bonds (OVDPs). Foreign investments in hryvnia domestic bonds increased by around 4,3 billion USD (National Bank of Ukraine). Despite this fact, those significant investments, held by non-residents, form the largest share in long-term government bonds. This inflow of foreign investment is considered as a "hot" capital because of its character of abruptness. In turn, this capital enables financing of the state budget deficit: significant issues of government securities are directed not to fund the implementation of reforms, but to cover debts. On the other hand, due to the excess of placement of OVDPs over their repayment amounts, debt formed by government domestic securities is on the rise. The influx of foreign currency for the purchase of government bonds became a significant reason for large-scale NBU interventions in the FX market. Thus, during 2019 there was an increase in OVDPs issuing against the background of higher foreign exchange redemption, which contributed to the replenishment of international reserves.

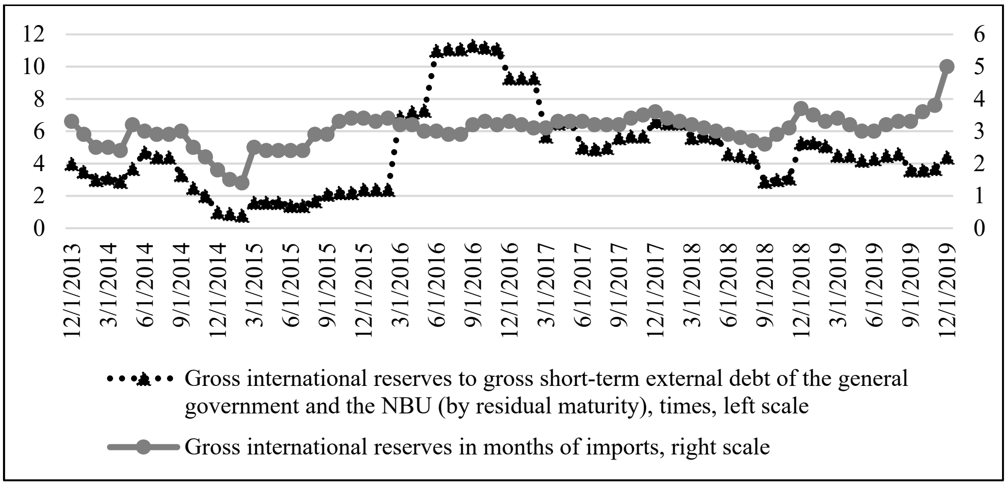
In general, after the GFC, the dynamics of the Ukraine's international foreign exchange reserves were volatile. Downward trends in reserves coincided with the hryvnia devaluation jumps. Over 2010–2013, the foreign exchange market stabilised. Starting from 2015, the NBU began to increase international reserves through Ukraine's cooperation with the IMF and other international creditors as well as foreign exchange interventions. At the end of 2019, a ratio of reserves to short-term debt was 4,4 (Figure 6). However, despite the reserves rise within the declining (but positive) dynamics, this ratio indicates the potential risk of

[9] Since 2014, Ukraine has been classified as a floating currency country according to the IMF's report AREAER. Before that, the exchange rate regime in Ukraine (according to the IMF classification) envisaged a conventional peg during 2005–2007, later another managed arrangement during 2008–2010, and stabilized arrangement during 2011-2013.

unstable Ukraine's foreign debt position. It also demonstrates the lack of official foreign exchange reserves to absorb financial account shocks if the current account and access to capital markets are limited for a year. Nevertheless, the increase of international reserves (since 2015) provided financing for imports for the future period over five months (as of the end of 2019) and reached the required level (>3). This is sufficient for the adequacy of Ukraine's obligations and the current operations of the NBU and the government, which are a condition for maintaining macroeconomic stability in Ukraine.

Figure 6

The sufficiency level of international reserves of Ukraine



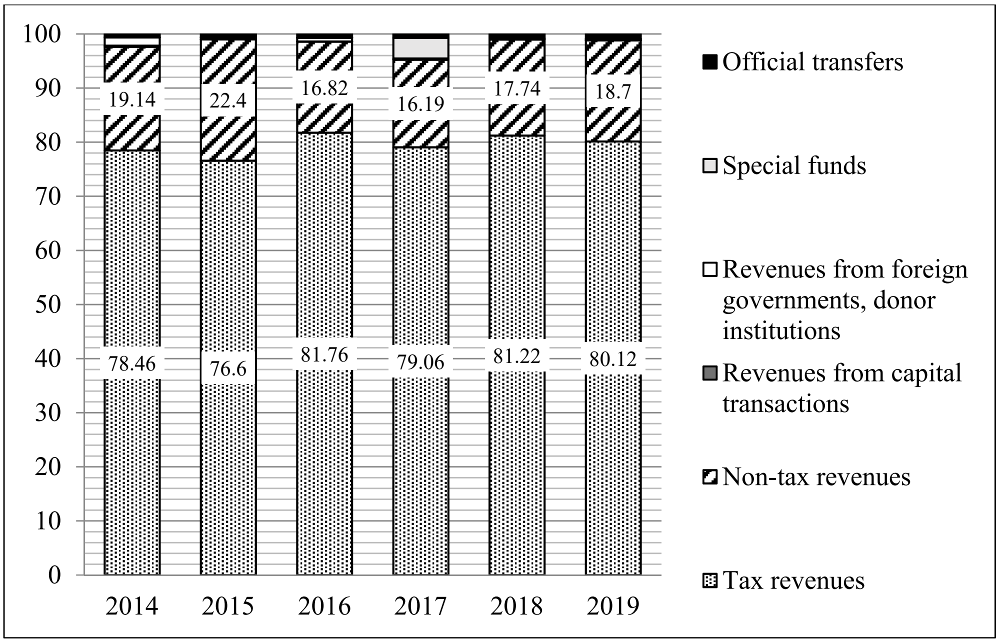
Source: National bank of Ukraine.

The primary fiscal levers of influence on the stability of the Ukrainian financial system are revenues and expenditures of the state budget. During the last five years, they have been increasing, that reflects both the instability of tax legislation and the peculiarities of the small open economy, which is highly dependent on world commodity prices. Revenues of the state budget of Ukraine in 2019 compared to revenues in 2014 increased almost three times (from 357,1 billion UAH in 2013 to 998,3 billion UAH in 2019). At that, nearly three times hryvnia devaluation has levelled this rise in dollar terms. The main item of the revenues of the state budget is formed through taxes. The share of tax revenues in recent years has been in the range of 75–82% (Figure 7). The percentage of internal taxes on goods and services (indirect taxes) fluctuates within 50% of all tax revenues. Direct taxes make up about 20% of all tax revenue.

The share of non-tax revenues in the structure of revenues of the state budget of Ukraine ranged from 15% to 23% of total revenues in different years. Other revenues occupy a relatively small place in the structure (less than 3% in total). Increasing budget revenues, which balances the budget and reduces the share of taxes, can be due to the expansion of non-tax revenues (capital operations, financial sanctions and administrative fees). The experience of the European countries shows that the share of non-tax revenues in total budget revenues varies from 9% in Belgium and 9,5% in Italy to 20% in Finland and 24% in Bulgaria. In terms of GDP, the highest non-tax revenues were in Finland and Hungary (11 and 9% respectively). The lowest non-tax revenues, less than 4,5% of GDP, were in the UK, Spain, and Ireland. Such heterogeneity arises from the attitude of governments of different countries to the various state ownership structures (revenues from state-owned enterprises), and differences in state rights with regard to the EU structural funds (Mourre & Reut, 2019).

Figure 7

State budget of Ukraine revenue structure, %



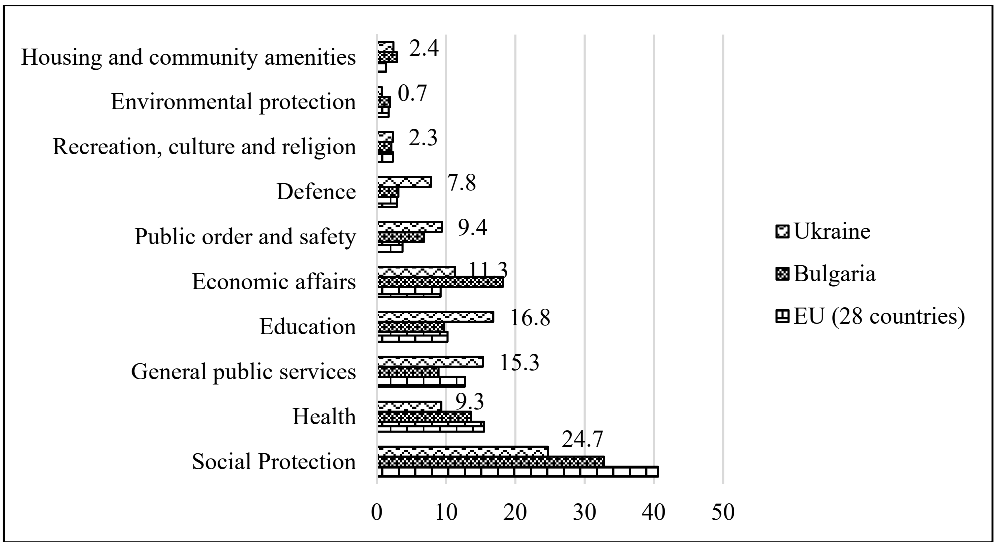
Source: Ministry of Finance of Ukraine, World Bank.

Despite several tax reforms (the fifth tax reform was carried out from the second half of 2010 till 2014), the efficiency of the tax system has not improved. Ukraine has mostly a tax burden lower than the global average, so proposals to reduce it by diminishing tax rates are not rational. The optimisation should include the broadening of the tax base and increasing taxpayers' number by reducing the shadow sector. During the last decade, the peak of the tax burden was in 2016, when the unified tax rate, at which employers pay to pension and social funds, was reduced (Figure 7). In 2019, the TTCR increased by 3,5% due to the rise in the minimum wage, which in turn hiked the single social contribution paid by employers. Payroll taxes have the most significant impact on the overall tax burden. Profit taxes have had a slight upward trend over the years due to a reduction in the share of labour taxes.

The main expenditures of the state budget of Ukraine are made to the destinations of the general public services; public order, security and judiciary; defence, social protection and social security; intergovernmental transfers. In total, the expenditures on these items in 2019 amounted to about 95%. Over the last five years, the share of spending on items such as public order (2,69%) and defence (3,58%) has increased. The percentage of intergovernmental transfers fell significantly from 30,36% in 2014 to 24,26% in 2019. That is a consequence of the financial decentralisation reform. Many of the financial resources have been transferred to local budgets. The general fund of local budgets has increased fourfold (from 68,6 in 2014 to 275,9 billion UAH in 2018). Comparing budget expenditures in Ukraine and the EU, the most significant percentage of the EU spending is social protection (Figure 8). A considerable percentage of the total expenditures in Ukraine compared to other EU countries is spent on defence, general public services, public order and education. At the same time, spending on health, housing and utilities, culture and environment are lower than European spending.

Figure 8

Government expenditure by destination in the EU, Bulgaria and Ukraine, 2018, %

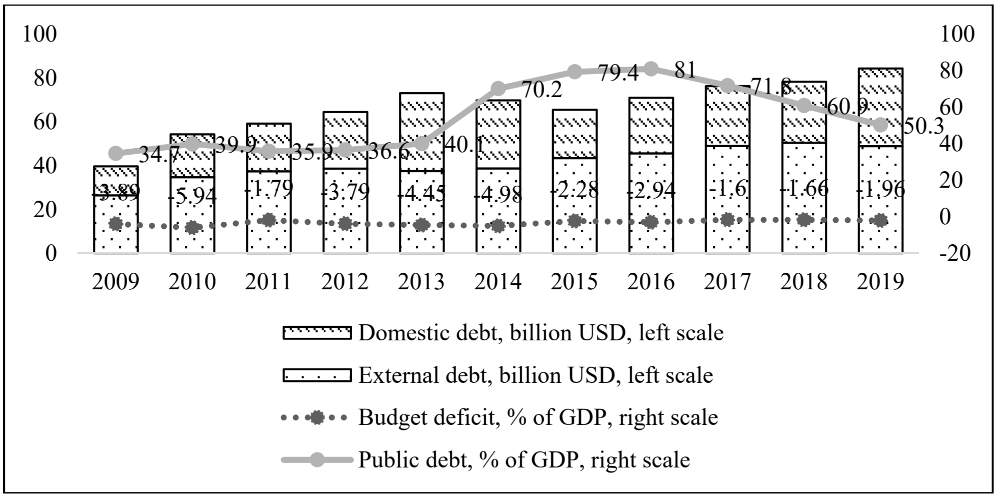


Source: Ministry of Finance of Ukraine, Eurostat.

Under the conditions of unbalanced budgetary policy, Ukrainian financial system development is characterised by a deficit not only within the economic downturn, but also when the economy recovers. Ukraine, in terms of the ratio of the state budget deficit to GDP, exceeded the maximum − the allowable volume during 1995–1997 and 2012–2014. Meanwhile, the main problem with the formation of the state budget remains high debt load tendency, which has been rising during the last decade (Figure 9). At the same time, since 2016, the public debt to GDP ratio is falling owing also to debt restructuring in 2015 and fiscal policy, primarily supported by the IMF programs and other international institutions. In 2019, external government debt decreased (not least because of the hryvnia revaluation), while domestic debt increased due to the issuance of government securities. The debt burden in 2020 is about 62% of GDP (the threshold should not be higher than 60%).

Figure 9

Budget deficit and public debt of Ukraine



Source: Ministry of Finance of Ukraine.

Overall, In Ukraine, the imbalance of the state budget is linked to the accumulation of significant public debt, which can lead to a debt crisis and default. Debt management should be a strategic priority for the Ukrainian government. The development of a government debt reduction scenario should include actions to mitigate currency risk, since the significant portion of the debt is denominated in foreign currency. Moreover, it should contain reorienting borrowing from external to domestic, gradually reducing the debt and loan load through preferential financing in cooperation with rating agencies, and active operations with public debt. Another problem is the high shadowing of the Ukrainian economy and the uneven fiscal burden on taxpayers, which affects budget revenues. Concerning the expenditures of the state budget, their formation must be consistent with the strategic economic goals, the development and the implementation of budget programs focused on achieving observable results.

The GFC harmed the Bulgarian as well as the Ukrainian economies and the formation of the budget deficit. During 2009–2015, the state budget of Bulgaria was formed with a deficit. The most massive deficit was in 2014 and amounted to 5,5% of GDP. During this period, Bulgaria's public debt was growing. Also, during 1999–2020, public debt averaged 26,6% of GDP, highest in 2015, and since 2017, on a downward trend. In 2016, public debt was 27,4%, then in 2017, it decreased to 23.3%. In 2018, it amounted to 20,5% of GDP. The decrease is related to the payment of debt under foreign bonds and the surplus of the Bulgarian state budget. Since 2016, the state budget surplus has grown from 0,1% to 2,1%, which enabled to skip issuing new foreign bonds and pay off debts of the previous period. The external debt-to-GDP ratio increased by about 7 % between 2009 and 2016.

Conclusion

Today, Ukraine is still in a transitional period, characterised by controlled exchange rate floating, inflation targeting and free movement of capital. We must note that currency regulation in small economies with local currencies circulation like Ukraine is re-directed at smooth movements of foreign funds. But at the same time, regulation should be accompanied by rapid actions to renew exchange rate stability, and by the introduction of instruments to hedge currency risk and enhance foreign investors' confidence.

The Ukrainian practice confirms the thesis about the ineffectiveness of restrictions on the capital flows in terms of institutional weakness of state regulators, as well as the fact that a small, open-to-trade economy without specific policies has insufficient capacity to resist the unproductive effects of foreign capital. In such conditions, despite the low level of de jure financial openness, the de-facto financial openness of Ukraine in some periods exceeded the average level of the region.

Still, onerous business regulations, unconfident political situation and the on-going reformation process raise the question of domestic stability and influences the terms of attraction of capital to Ukraine. These issues also have continuously moved the Ukrainian capital off-shore in search of more reliable investors and property rights protection, absence of sanctions effects (restricting smooth international settlements) and returned this capital in the form and status of foreign investment.

Generally, institutional development of the financial system, the consistent legal framework (including investment withdrawal and dividends, collateral and accounting procedures) as well as the trustworthy state monetary authorities, could give a spur to local savings as one of the sources of the investment money.

All in all, the comparative analysis of the parameters of the financial development in Bulgaria and Ukraine made it possible to distinguish several characteristics inherent in these countries. Such features include high volatility of capital flows, structural distortions of the financial sector with the predominance of banking institutions, and limited development of the stock and insurance markets. Also, a substantial fall in the activity of the financial markets after the unfolding crisis events with limited signs of the recovery process should be considered. In our opinion, the presence of some similar features of the financial development of the two countries, where one of them is more integrated in the EU financial market, reflects the natural consequence of extensive financial sector formation without adequate institutional infrastructure and tools.

One of the vital problems of the Ukrainian economy is that it has been mostly credited with short-term debt or has limited refinance possibilities at favourable terms, suffering from lack of term savings as well as capital flight in case macroeconomic or political conditions alter. The question of short-term hard-currency funding is in its burdensome character, which leads to the risk of default in case of insufficient foreign currency inflows (including from exports and remittances). Term financing, as a rule, comes from the institutional investors of the advanced economies, including insurance companies, pension and mutual funds. Foreign direct and portfolio investments as well as inflows within the current account, continue to represent one of the factors of the currency market and, in particular, exchange rate stabilisation for the national currency, considering that the export-import balance has been negative in recent periods. Proper and transparent regulation of the domestic market could create investor incentives and ultimately foster the economic development of Ukraine's small open economy.

There is a global demand for endogenisation of the effects of globalisation after a long period of its expansion. In our opinion, the solution to the identified problem of suboptimal development of the national financial sector of small open economies is to form a current targeted public policy. It does not mean a breach of the EU's commitment. The implementation of such an approach can also take place within an acceptable regulatory field. In particular, such prospects are possible due to macroprudential regulation, the measures of which are subject to financial stabilisation. These measures are recognised at this stage at the EU level. They open up the probability for the use of monetary, fiscal and prudential instruments to optimise the structure of financial markets. Current global trends suggest that in the future, the regulatory potential of macroprudential tools may be expanded in the interests of the structural development of the national economy.

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