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Role of the Financial System in Economic Growth in Transition Countries – the Case of Ukraine’s Banking System

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Abstract

The banking system in Ukraine is one of the weakest in the world, with the 200 odd banks providing very little inter-mediation. Deposits from firms and households, as well as lending to the private sector, are tiny even when compared to very poor countries. This weakness has serious implications for growth. There is empirical evidence that shows that a well functioning financial system is a precursor for growth. This paper attempts to find out the main constraints on the banking system in Ukraine and suggests actions that are required to remedy the situation. Failure to take remedial action quickly could land the country into a poverty trap.

Keywords: Banking System, Collaterals, Contract Enforcement, Directed Lending, Economic Growth, Financial Institutions, Land Market, Transition Economies, Ukraine

JEL codes: G18, G21, G28, N1

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ROLE OF THE FINANCIAL SYSTEM IN ECONOMIC GROWTH IN TRANSITION COUNTRIES – THE CASE OF UKRAINE’S BANKING SYSTEM

Khwaja M. Sultan and Dimitar G. Mishev

1. Introduction

A great deal has been written about the role of the financial system in facilitating growth in a market economy. In transition economies, the evolution from a rudimentary financial structure, through various stages of maturity, has provided evidence that help us to understand this role in economic growth.

Under the soviet system, all financial resources were allocated by the state, based on the priorities of the Gosplan. These allocation decisions were taken on ideological and political reasons rather than on the basis of economic efficiency. Unlike in a market-based system, different economic players did not compete for financial resources based on who was prospectively the most efficient, and so there was no great need for a developed financial system. Joseph Schumpeter (1912) maintains that a well-functioning financial system spurs technological innovation mainly by identifying and supporting entrepreneurs with the best chances of success. A growing body of empirical analyses, including firm-level studies, individual country studies and broad cross-country comparisons, demonstrates a strong positive link between the functioning of the financial system and long-run growth (Ross Levine, 1997).

$$\text{Economic growth} = f(\text{Financial system})$$

In fact, empirical evidence suggests that the development of the financial system is a precursor and a necessary condition for sustained growth and economic transformation, especially in transition economies. Ross Levine (1997) argues that the current level of

financial development is a good predictor of future rates of economic growth, capital accumulation and technological change.

$$\text{Economic growth}_{t+n} = f(\text{Financial system}_t)$$

This statement has serious implications for Ukraine. If its weak financial sector is not transformed soon enough, Ukraine could continue in its present state of decline for many years to come. Despite numerous affirmations of intention by the government to carry out institutional reform, no serious effort has been made. Indeed, the World Bank's *World Development Report* (1996) ranks Ukraine as one of the slowest reformers.

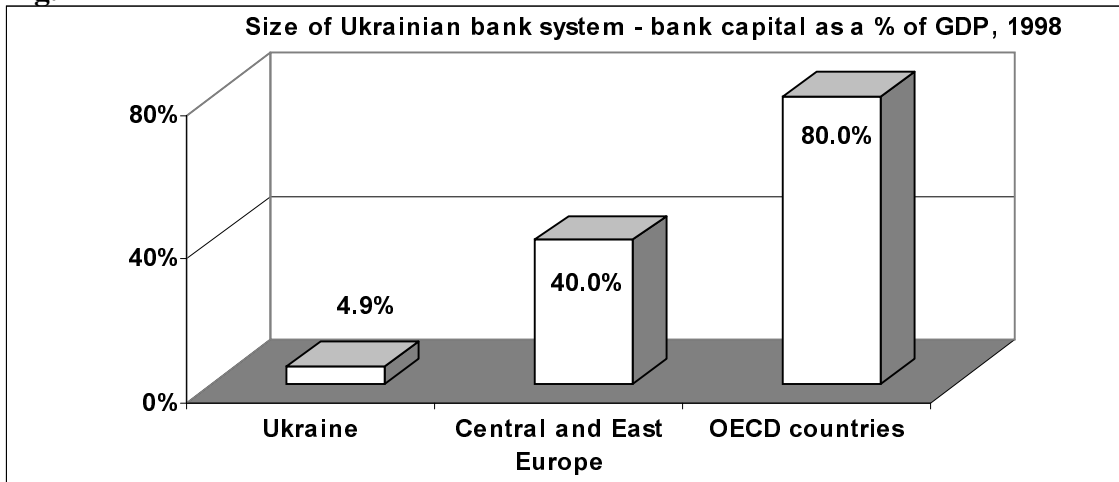
The present study was undertaken to improve our understanding, generally, of the role of the financial system in promoting growth and recovery in transition countries, and more specifically, of the problems in the Ukrainian banking system, their causes and how they affect the economy. In this paper, we present, in section 2, a cross-country analysis of the banking systems in order to show the relationship between the size of the financial system and growth and to demonstrate how weak the Ukrainian banking system is relative to the rest of the world. We also discuss the important functions that a banking system performs in a market economy, and argue that if these functions are not discharged, the transition from planned to market economy becomes very difficult and prolonged. In section 3, we highlight some important characteristics of the banking sector in Ukraine, especially those relating to capital structure and credit portfolio, with a view to identifying the chronic problems in the sector. In section 4, we explore the possible constraints that affect the development of the banking system in Ukraine, and argue that these constraints push the costs of financial resources so high that, at those costs, there are practically no consumers of banking service. In effect, there is very little financial intermediation in Ukraine. Finally, we attempt to draw up an agenda that policymakers could use to free the system of its constraints and thus allow the banking system to develop and clear the way for economic growth.

2. What a Weak Banking System means for the Economy

A. CROSS-COUNTRY ANALYSIS

The development of the banking system is critical for capital accumulation, technological change and growth. Many transition countries, through speedy institutional changes, have created conditions that has allowed their banking sector to grow rapidly. The Ukrainian bank system, on the contrary, has remained very small compared to other transition economies and developing countries. Its aggregate bank capital as a percentage of GDP is only one-eighth of the average for the transition economies of Central and Eastern Europe (fig. 1).

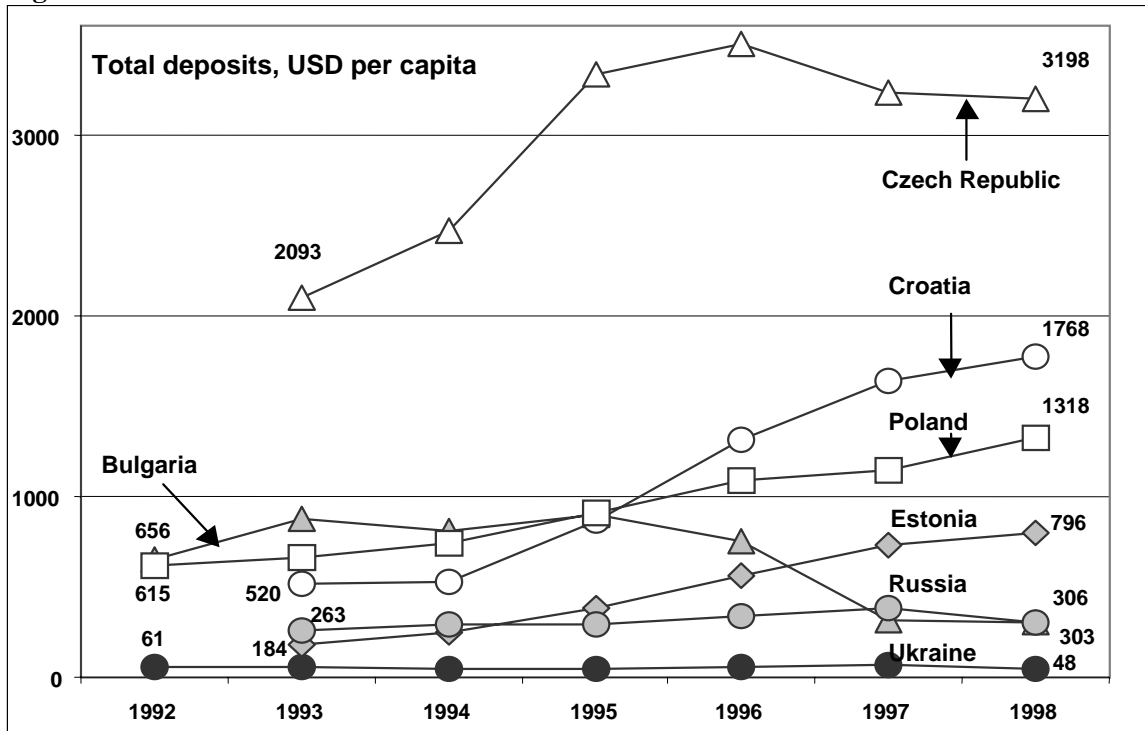
Fig. 1



Data source: World Development Report

Ross Levine (1997), while comparing deposits in banks as a percentage of GDP, noted that, on average, ‘very rich’ countries have bank deposits equivalent to 53% of their GDP, ‘rich’ countries 31%, ‘poor’ countries 20% and ‘very poor’ countries 13%. Even though Ukraine (in terms of GDP) is a poor country, its deposits (8%) as a percentage of GDP are much lower than the average of even very poor countries.

Fig. 2



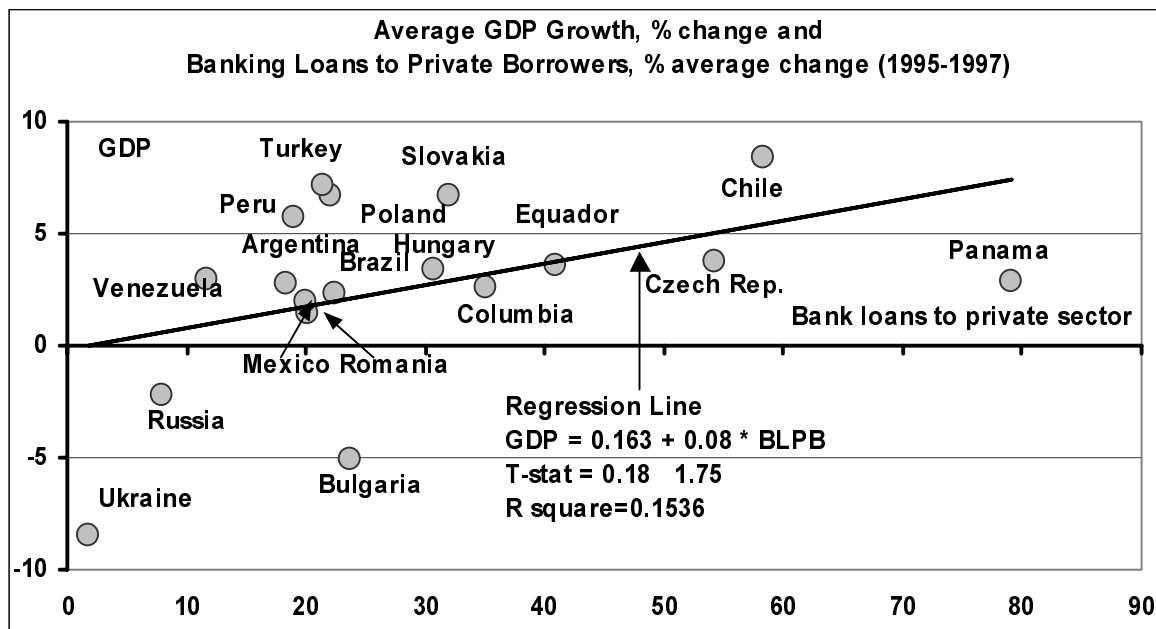
Data source: "Emerging Markets Quarterly Outlook", Chase Securities Inc. December 18, 1998

Evidence from transition countries (figure 2) shows that growth in banking activity (measured in terms of aggregate deposits and aggregate lending to the private sector) go hand in hand with economic growth. Countries with sizeable increase in banking activity show significant increase in GDP. In effect, increased banking activity becomes a proxy for economic growth. In Poland, deposits per capita have risen from US\$ 742 in 1994 to US\$ 1,318 in 1998. During this period, Poland's growth rate has averaged 6%. Other countries like the Czech Republic, Croatia, and Estonia have similarly experienced growth in deposits coupled with growth in GDP (Appendix I). In Ukraine, deposits per capita have remained static at around US \$ 50 in the same period. This coincides with decline in GDP over the last eight years.

Regression analysis, using data from twenty countries in Central and Eastern Europe and Latin America, shows that growth has a positive relationship with lending to the private sector. We took the average of GDP growth between 1995 and 1997 as the dependent

variable and the average increase, for the same period, in credit to the private sector as the independent variable. The results of the regression (figure 3) show that countries with higher growth of private lending have higher levels of growth. This seems logical. Increase in private lending is a proxy for private investment. Greater investment generates greater capacity to generate income. Level of credits to private borrowers (as a percentage of GDP) in Ukraine is one of the lowest for emerging markets (see Appendix II).

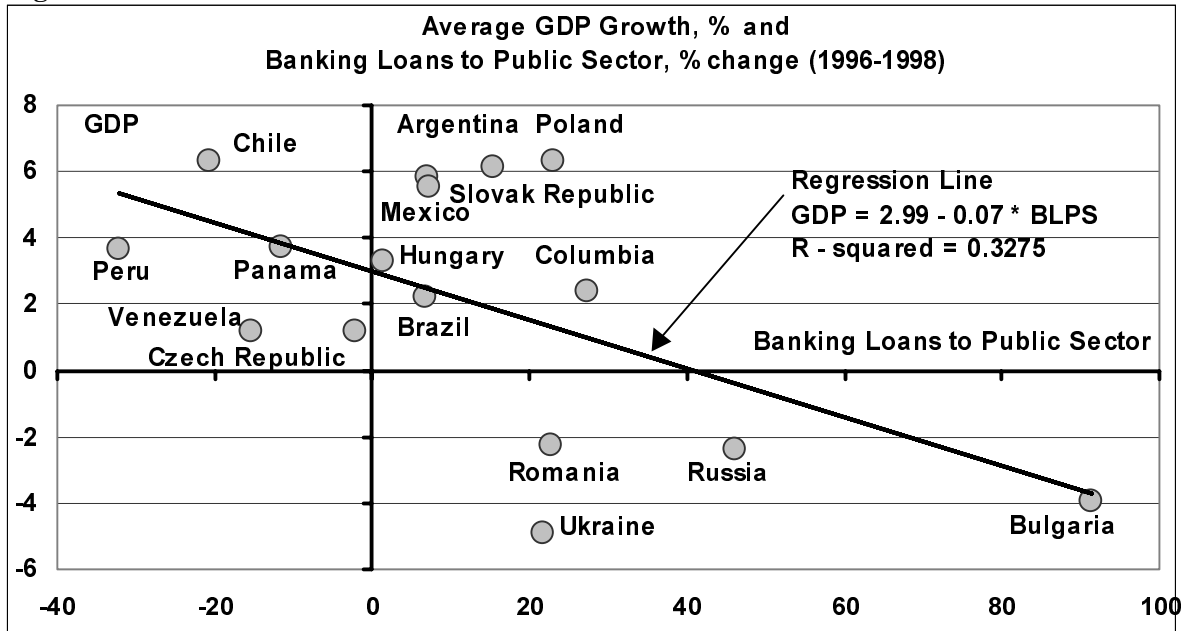
Fig. 3



Data source: "Emerging Markets Quarterly Outlook", Chase Securities Inc. December 18, 1998

Interestingly, lending to the public sector adversely affects growth (figure 4). Countries with higher level of lending to the public sector typically have lower level of growth than those with smaller lending to the public sector. There are several possible reasons for this. Governments often use borrowings for financing current expenses rather than for investments. So, no new income-generating capacity is created. Even when governments borrow to invest on social overheads, its effect on income growth is very slow.

Fig.4



Data source: "Emerging Markets Quarterly Outlook", Chase Securities Inc. December 18, 1998

B. IMPORTANCE OF THE BANKING SYSTEM

Banks provide an important medium between savers and entrepreneurs in an unclear environment. Banks perform the following important functions in a market economy (Ross Levine, 1997): (1) allocating resources from the savers to the most promising entrepreneurs, (2) monitoring the managers of the borrowing enterprises, (3) trading of risks and (4) mobilizing savings. These functions are especially relevant for transition economies that need to bolster private financial resources for investment in new businesses.

For individual savers, it is costly to evaluate different firms that need money, or the managers that control those firms. Most households do not have the time, capacity or expertise to judge market conditions accurately. Savers would be reluctant to invest without reliable information about the borrowers or the market. Banks employ specialists who provide this expertise on behalf of all savers who have entrusted their money to the

banks, and thus economize on acquisition of information. By carefully selecting the right enterprises, they allocate the financial resources with the least possible risks.

It would be inefficient for individual savers to monitor the borrowing enterprises. It would impede investment and business decisions. Without specialization in business process, such interferences by lending individuals would divert enormous resources and time. Also, individual savers would not have the strength to enforce financial discipline or to exert control on the enterprises. On behalf of the borrowers, banks undertake delegated monitoring, which not only economizes on cost of the savers but also helps firms deal with only a few specialist monitors.

Banks provide pooling, trading and hedging of risks. Most projects require long-run commitment of capital. Savers, on the other hand, do not like to surrender control of their savings for a long duration. Banks offer liquid deposit schemes to savers and provide cover against liquidity risk by using a suitable mix of liquid and illiquid investments.

For firms, it is costly to mobilize savings from individual savers who may not know enough about the borrowing firms. If banks are performing effectively their role as allocators of resources, monitors of managers and traders of risks, savers feel comfortable to entrust their money to the banks.

By overcoming informational asymmetries, and economizing costs, banks efficiently mobilize resources for investment and play a key role in technological upgradation and innovation. In Ukraine, the banks are not able to effectively perform their roles and as such are not able to provide impetus for investment and growth.

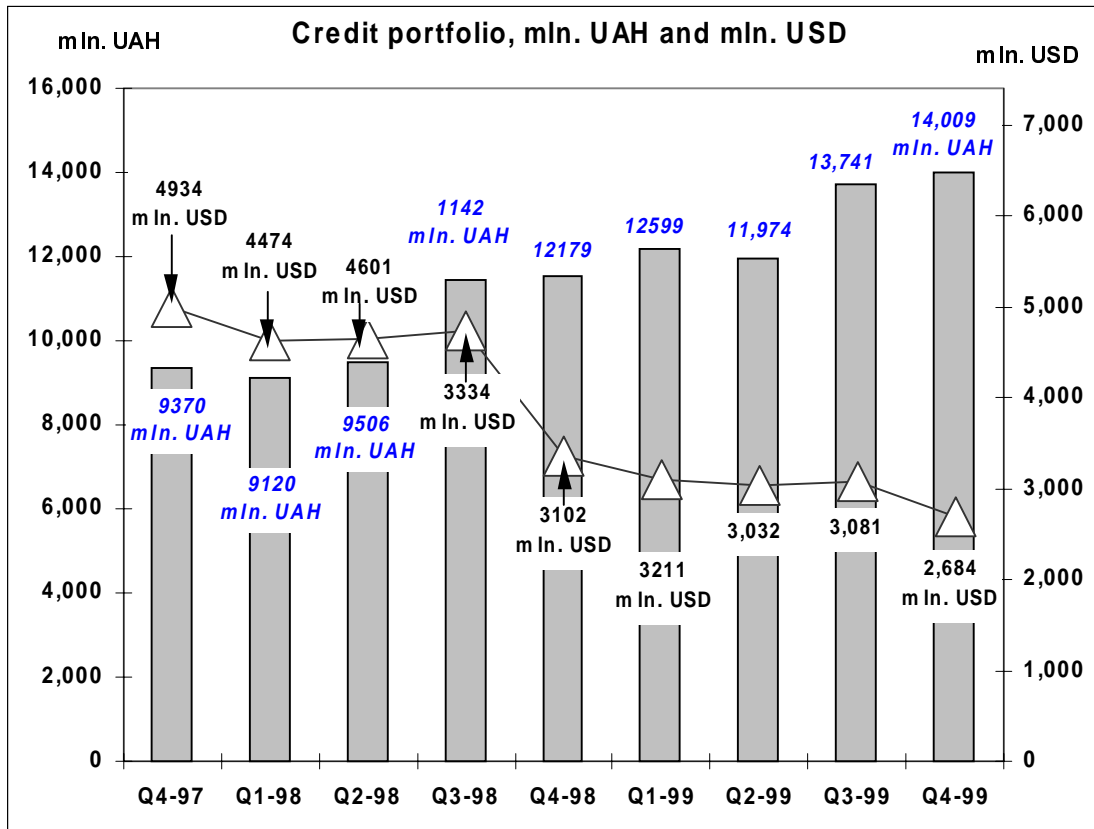
3. Features of the Banking System in Ukraine

We tried to study what the binding constraints are in the banking sector. For this, we looked at the structure of the credit portfolio, the nature of bank deposits, the capital structure and the cash flows in the banking system in Ukraine. We were helped greatly by in our analysis by data from the NBU and the Association of Ukrainian Banks.

CREDIT PORTFOLIO OF UKRAINIAN BANKS

Total credit portfolio of Ukrainian banks in 1999 amount to 11% of annual GDP, one of the lowest in Central and East Europe. For the period from Q4: 97 to Q4: 99, the credit portfolio grew, in nominal terms, by 49%. However, in USD terms, the credit portfolio declined by 46% for the same period (fig. 5); (see Appendix III – Structure of assets of Ukrainian commercial banks).

Fig.5

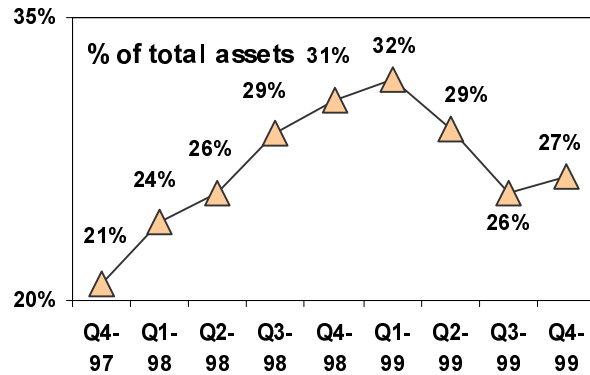


Data source: Consolidated balance sheet of commercial banks: National Bank of Ukraine

Unfortunately, 27% of this portfolio consists of overdue, extended and doubtful debts (Q4 – 99). With such a high level of bad debts, commercial banks have to immobilize a large part of their funds for credit risk reserves. Also, this enormously increases the cost of lending money, because lending becomes very risky.

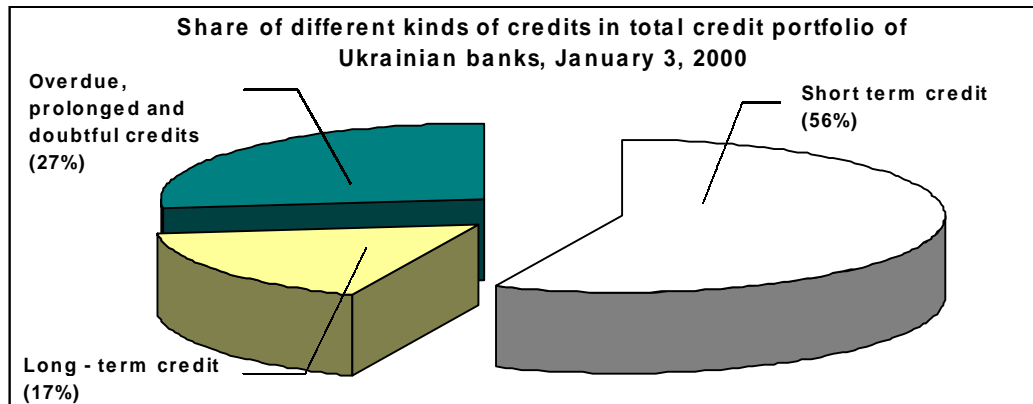
Fig 6.

Level of bad credits in total credit portfolio has increased rapidly from 21 to 32% for the period Q4 1997 – Q1 1999, but declined to 27% for Q4 - 99 (figure 6). This obstructs the normal functioning of credit operations and limits the potential for the bank to generate profit.



Another interesting phenomenon was the high level of short-term credit (figure 7). Of the total credit, 56% are short-term and only 17% long-term.¹ While it is true that because of high risks in lending, banks lend mainly on short-term basis, there is anecdotal evidence that, in Ukraine, credits with irregular servicing are very often rolled over and documented as short-term. This allows bankers not to extend the level of risk reserves that they are required to have. Thus, we believe, a significant portion of the large portfolio of short-term credits or long-term credits would be bad loans too.

Fig. 7



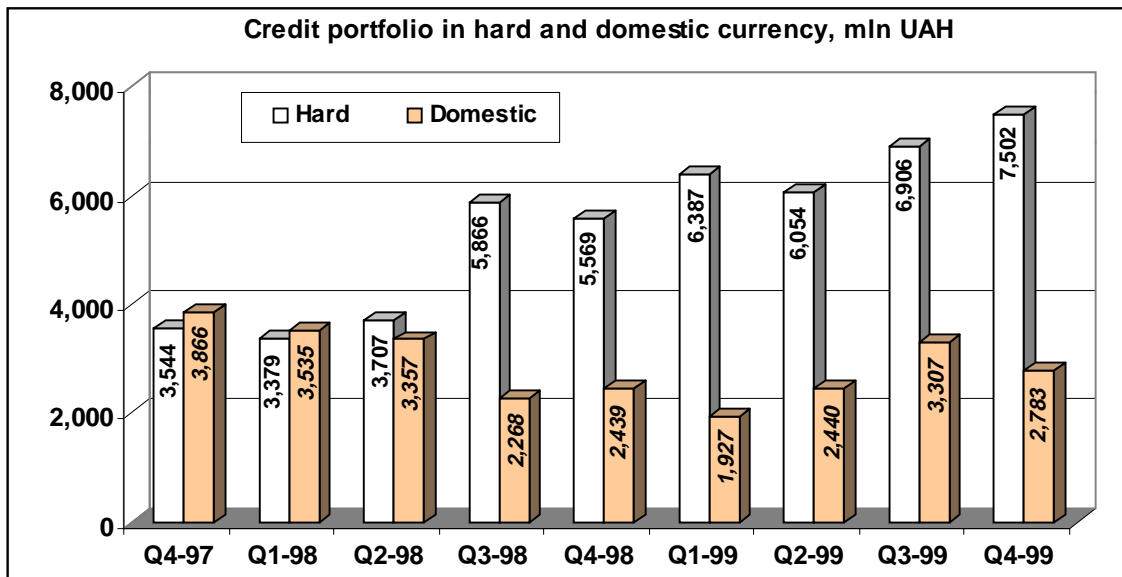
Source: Consolidated balance sheet of commercial banks; National Bank of Ukraine

¹ It is difficult to quantify how much of the short-term credits would, in reality, be rolled over doubtful debts.

There is very little lending to households. Only about 5% of total credits are loans to households. With weak property rights, households usually do not have sufficient collaterals that could be used for borrowing from banks. Households in market economies borrow based on a projection of their future earnings. With great economic uncertainties even in the near-future, most households do not have much idea of what their future earnings will be. As a result, they are not able to take investment decisions about their households.

We noticed that the ratio of credit portfolio denominated in hard currency is growing. This is mainly due to the depreciation of the hryvna that took place in the autumn of 1998 and in March 1999. For the period Q1 1998 – Q4 1999 credit portfolio denominated in hard currency grew from 37% to 54% of total credits (figure 8).

Fig. 8



Source: Consolidated balance sheet of commercial banks; National Bank of Ukraine

Note: The overdue, extended and doubtful credits are not included at the graph above.

THE SHIFT FROM GOVERNMENT SECURITIES TO DEPOSITS IN FOREIGN BANKS

Government securities in banks assets portfolio have been declining starting from the last quarter of 1998. At the end of fourth quarter of 1999 the T-bills portfolio of commercial banks amounted to UAH 633 million as against UAH 2,435 million for the end of second quarter of 1998, a decline of 74%. In a risky lending environment as exists in Ukraine, government securities used to be one of the few sources of profit for banks. However, government’s inability to repay the T-bills in the later half of 1998, and the forced restructuring that followed, made even this instrument risky. As a result, banks have almost stopped buying new government securities. The existing portfolio consists mainly of restructured securities that the banks could not get out of. Without the T-bills market, commercial banks lost one of their main sources of income. They were constrained to reorganize their portfolios switching to deposits in foreign banks. These have grown substantially during the same period (figure 9).

Fig. 9

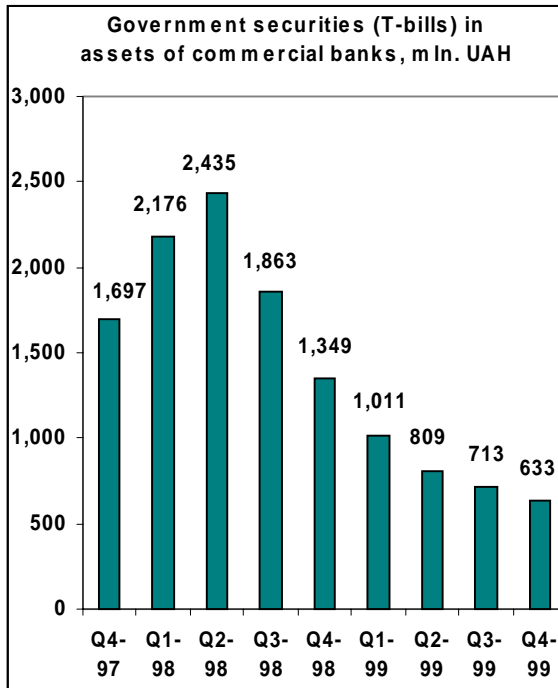
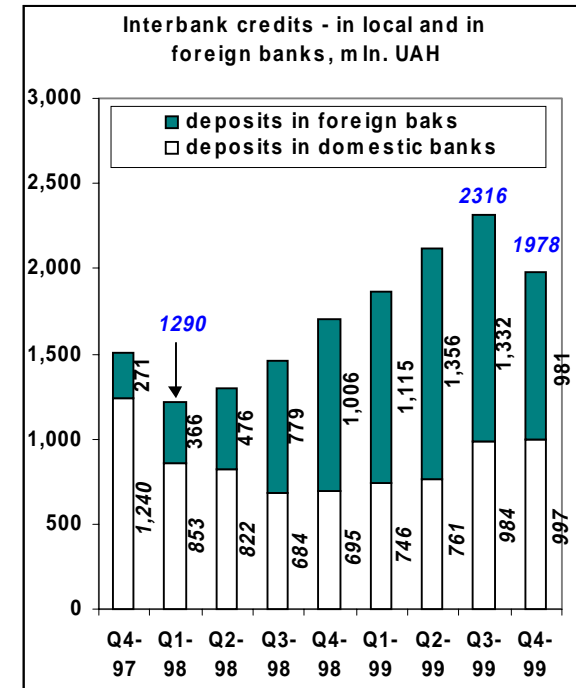


Fig. 10



Source: Consolidated balance sheet of commercial banks; National Bank of Ukraine

While, level of inter-bank credits to local bank declined from UAH 1.2 billion in Q4 1997 to UAH 1 billion in Q4 1999, inter-bank credits to foreign banks increased from UAH 271 million to UAH 1.4 billion, but declined to 1 billion for Q4 1999. Some of this huge increase of 681% for the period Q4 1997 – Q2 1999 is due to the hryvna depreciation, but to a large part this is a result of the loss of confidence in local banks.

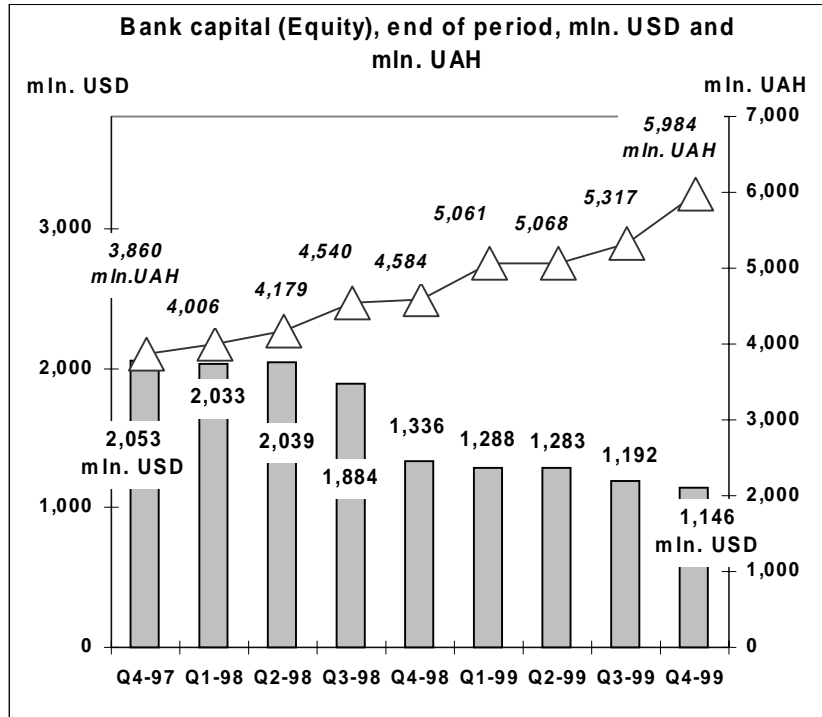
CAPITAL STRUCTURE

The depreciation of the hryvna has further weakened the already feeble capital structure of Ukrainian banks. Although in hryvna terms, bank capital (equity) has grown from UAH 3.9 billion (Q4 – 97) to UAH 6.0 billion (Q4 – 99), in dollar terms, capital shrank by almost a half for the two-year period 1998 - 1999 (from USD 2.0 billion to USD 1.1 billion) (figure 11). The increase in hryvna term has been due to increase in reserve requirements. Banks' compliance with creating reserves has been quite weak: instead of the required UAH 1.7 billion, they held less than UAH 1 billion as of June 1, 1999.

Capital of commercial banks as a percentage of total liabilities declined from 15.9% in Q4 1997 to 9.0% in Q4 1998, but went up again to 12.6% at the beginning of 1999. The increased level this year is due to increase in reserve requirements.

While it is true that bank capital increased in UAH terms because of the NBU requirements, there is anecdotal evidence that, in Ukraine, part of the expansion of the capital base is based on capital swap operations - exchange of new emission of stocks of one bank for new emission of stocks of another bank (An alternative is emission of credit and further purchase of stocks from the same bank (with the same funds)). This allows bankers to extend the level of capital. This, we believe, is a very risky operation leading to increasing the risk in banking sector. In case of bank panic this will result in a chain of bank failures, as happened in Bulgaria in 1996.

Fig. 11:



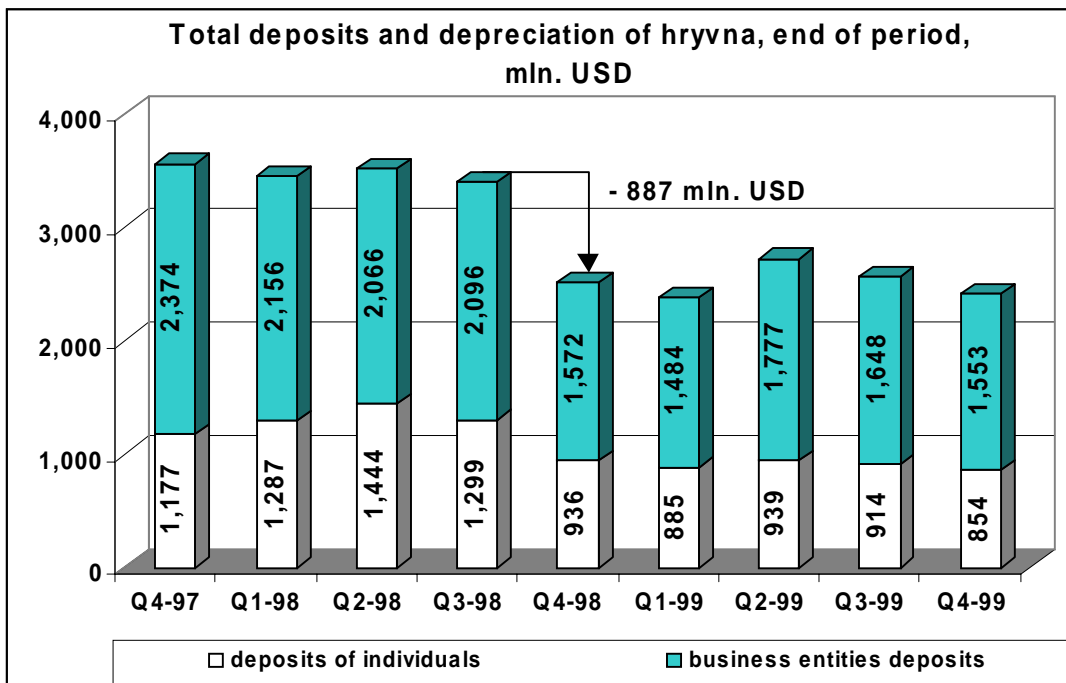
Source: Consolidated balance sheet of commercial banks; National Bank of Ukraine

EFFECT OF HRYVNA DEPRECIATION ON BANK DEPOSITS

Figure 12 shows how the depreciation of the hryvna in September 1998 had adversely affected the real value of deposits of both individuals and businesses (USD 1 billion).

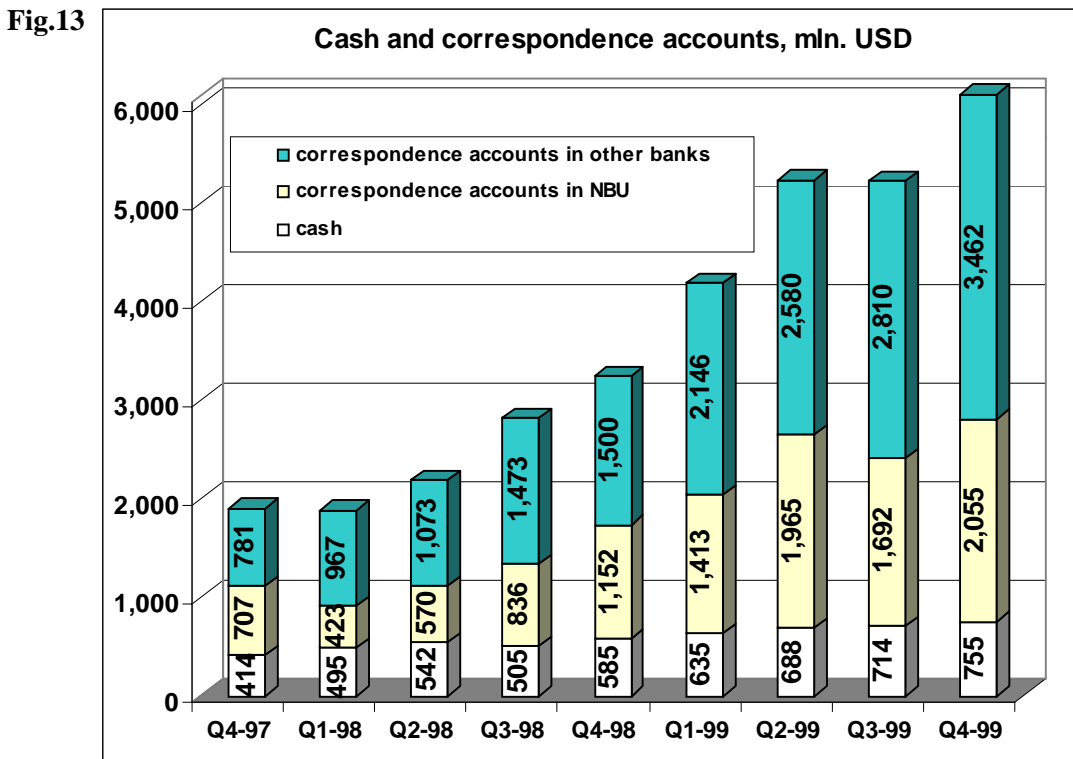
Fig. 12

Source: Consolidated balance sheet of commercial banks; NBU



LIQUIDITY

Cash and correspondence accounts (in NBU and in commercial banks) increased in 1998 and also in first two quarters of 1999. This increase is due to changes in level of reserves on credit risk requirements from 15% to 17% and extension of level of minimum capital requirements from ECU 0.75 million to ECU 1 million (April 1, 1999). Although the correspondence accounts are counted as liquid assets, and theoretically the liquidity of banks seem to have increased, the actual cash with banks remain pretty much at the same level as in 1997 in nominal terms, though it decreased significantly in real terms (fig. 13).

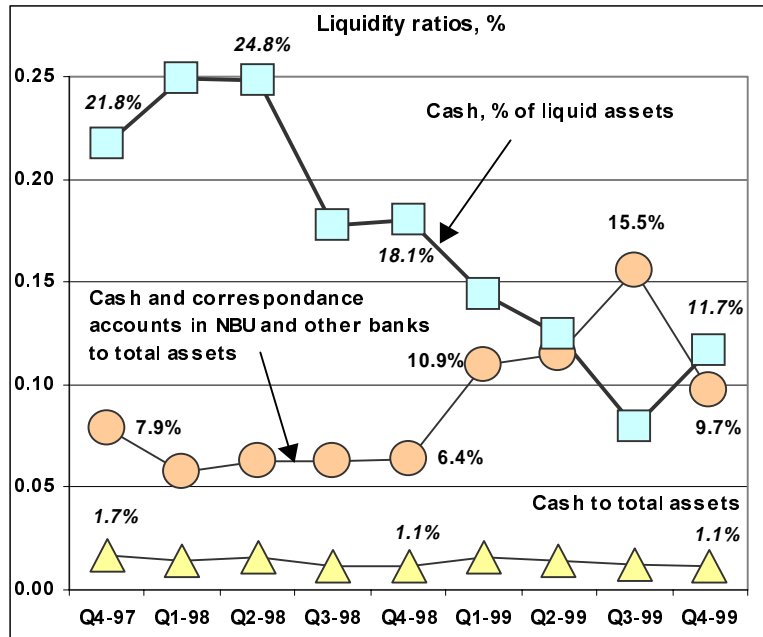


Source: Consolidated balance sheet of commercial banks; National Bank of Ukraine

For the end of fourth quarter of 1999 cash in Ukrainian banking sector amounted to UAH 755 million, or 1.4% of total assets. At the same time, cash as a percentage of liquid assets dropped from 26% for the first quarter of 1998 to 14% for first quarter of 1999, a decline of 46%. The increase of total liquid assets in UAH is due to the extension of correspondence accounts in correlation with restrictive Central bank policy. For 1998 and

1999, the cash as a percent of total assets and as a percent of liquid assets declined (figure 14).

Fig 14.



Data source: Consolidated balance sheet of commercial banks - assets; NBU

4. Why the Banking Sector is not growing in Ukraine

Several external factors hinder the normal function of the banking system in Ukraine. These factors together make using of banking services unattractive both for the borrowers and the lenders. Most of these factors are directly or indirectly the result of government policies.

TAX COLLECTION AND KARTOTEKA 2

Banks in Ukraine act as tax collectors. Under the ‘kartoteka 2’ system, cash coming into the bank accounts of firms that have tax or wage arrears is automatically taken over for payment of those arrears. As a result, firms avoid transacting through banks. It is not so much the ‘kartoteka 2’ system itself as the intensity with which it is implemented by the tax administration that is driving firms away from the banking system. As of 1st March 1999, kartoteka 2 charges on banks were UAH 52 billion, which was higher than the total assets of the banking system (UAH 37 billion). This imposes a very high transaction cost on the banking system. Although the kartoteka 2 has been removed in June 1999, several enterprises have confirmed that it continues to be rigorously implemented.

DIRECTED LENDING AND GOVERNMENT GUARANTEED LOANS

According to banks, the volume of credit given by them on the direction of the government was UAH 1.6 billion. Although such lending is against state guarantees, often these obligations are not met. Most of this lending is given to loss making sectors. This adversely affects the profitability of the banks and imposes an additional cost to the banking system.

WEAK IMPLEMENTATION OF BANKING REGULATION

Implementation of banking regulations is weak and the status of the National Bank as the regulator of the banking system is still ambiguous. As a result, the mechanism of banking

regulation is still not properly enforced. 24 banks have statutory funds less than the requirement of one million euros. 49 banks including all the largest (out of 214) have not met the reserve requirement ratio of 17% as of March 1, 1999. This results in many small banks continuing to operate although they are clearly not viable. Lack of consolidation means that there is a large number of small banks that cannot achieve economies of scale.

THE CRISIS OF CREDIBILITY – CONTRACT ENFORCEMENT – BANKRUPTCY – LAND MARKET – COLLATERALS

The unclear valuation of firms' soviet-era assets and the virtual absence of a land market leave banks with no collateral on which to hedge their lending. Weak institution for contract enforcement also makes it difficult for banks to lend at reasonable rates. Weak bankruptcy procedures mean that banks are rarely able to recover their funds by liquidation of enterprises. These risks make lending to firms very unattractive and expensive for banks. Most banks made profit only when they were operating in the T-bill market. The inability of the government to redeem the T-bills, since the autumn of 1998, has left the banks with practically no profitable activity. Many of them have increased their deposits in foreign banks rather than lend to the real economy in Ukraine.

The weak bankruptcy procedures make lending to the real sector a risky operation. This risk makes lending unattractive for commercial banks and pushes the level of credit interest rates to a very high level. This level makes loans not very attractive for the real sector.

The land market in Ukraine is almost non-existent. A large part of the land remains in state or collective hand (only 3.5 million hectares, or about 5.5% of all land, are in private hand), because the procedures for land privatization and sales are very complicated. Under Ukrainian laws, foreign citizens and businesses having foreign capital are not entitled to own land. This can create some obstacles for companies with foreign capital to receive credits from Ukrainian commercial banks. Although the legislation gives the individuals right to use their privately owned land plots as a collateral in the transaction

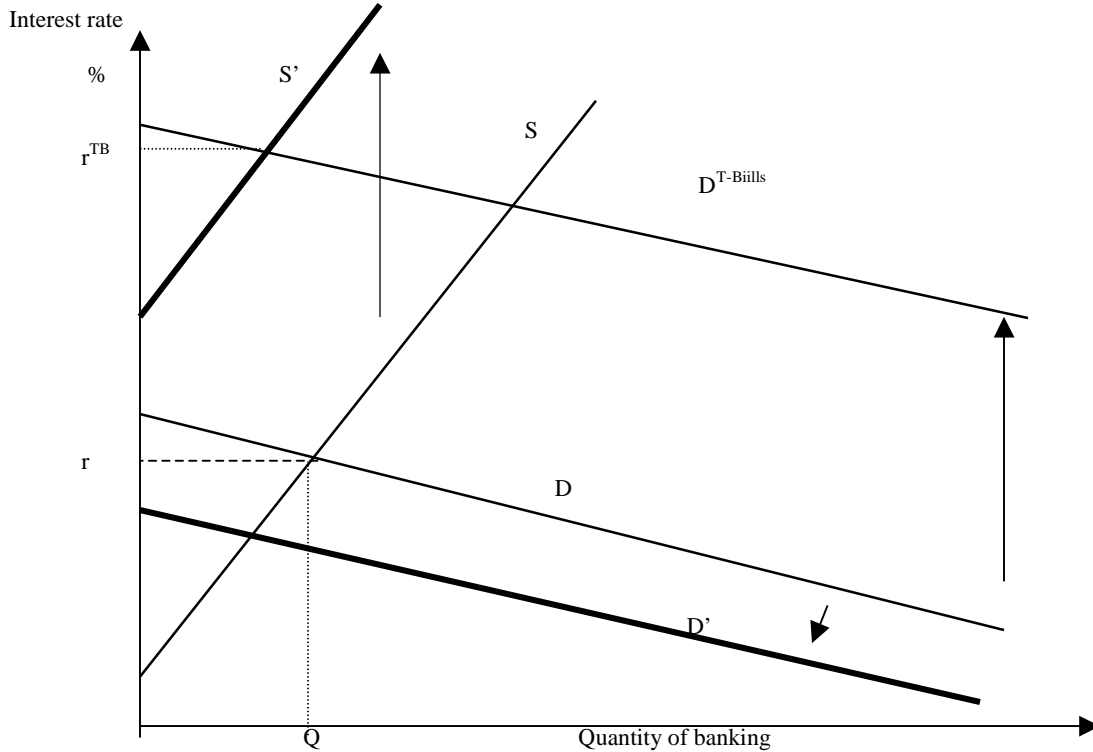
with banks and other crediting institutions, most of the individuals do not own their land plots on the private property title, but on the permanent use title. At the same time, most of the enterprises, with the exception of agricultural enterprises, are not entitled to have land as private (or collective) property. Currently, there are a number of presidential decrees that allow Ukrainian enterprises to buy land plots from the state, but such decrees contradict the Land Code of Ukraine. All these provisions leave banks with virtually no possibilities to get collateral when giving credits to individuals or businesses.

EXCHANGE RISKS, BARTER

The exchange rate regime relies on currency corridors that the government has been unable to support. As a result, exchange rate risk is high. This increases the cost of lending. Because of high interest rate, people cannot avail of working capital from banks. Since cost of money is so high, barter (which under normal circumstances has high transaction costs) becomes a more viable alternative.

The following chart (fig. 14) shows how the above-mentioned factors make banking unviable in Ukraine. Under normal conditions, and without the constraints the supply for banking (S) and its demand (D) would have resulted in a quantity (Q) of banking services at a rate of interest (r). However, in Ukraine, the high taxes push a large segment into the shadow economy that cannot use the banking system. This pushes the demand curve to D' . At the same time, the high costs imposed by the factors mentioned above push the supply curve up to S' . At this level, only the T-bill market is able to avail of the banking system at an exorbitant rate, r^{TB} . At this rate, the rest of the economy is not able to use the banking system. The effective demand for banking (D') does not meet the effective supply (S') at any positive level of banking. This illustrates why there is practically no banking in Ukraine. Total long-term hryvna lending to the private sector is only UAH 600 million (i.e., US \$ 150 million), equivalent to only \$3 per capita.

Fig. 14



A weak banking system is particularly vulnerable to external shocks. The financial crisis in September 1998 resulted in the banks registering an overall loss of UAH 153 million. The savers lost value of their deposits to the tune of one billion dollars, while banks' capital fell by US \$ 700 million. At the same time, banks' portfolio of bad and doubtful debts (officially recognized²) almost doubled.

²In addition to the amounts officially recognized as bad and doubtful debts, a large portion of banks' portfolio of short-term credits is, in reality, the rolling over of non-performing loans.

5. Agenda for policymakers

In order for the banking system to develop, it is necessary to remove the impediments to its growth. This will help reduce the high transaction costs of banking, which in turn will pull the supply curve down so as to meet the demand curve at a positive level of banking. It is important for the government to ensure that the removal of kartoteka 2 is implemented. There is an urgent need to develop the system of collaterals and land market, and to establish effective bankruptcy procedure.

Because of forced restructuring of T-bills, and the frequent going back on the commitment created by the currency corridor, the government's credibility has been undermined. Contract enforcement should start with the government. If the ability to support the corridor is absent, it is better to establish a managed float³. In such a situation, investment decisions will be made taking into account the exchange rate risks. The false assurance created by a currency corridor is very damaging for investment decisions, when the assurance cannot be met. To build credibility in the banking system, foreign banks should be encouraged to operate in Ukraine. Simultaneously, the foreign exchange operations should be further liberalized.

Only when the banking system is able to get rid of its hindrances will it be able to perform the important role of financial intermediation. Political and legal impediments to financial development are usually difficult to change. Yet insufficient institutional development in the banking system creates a poverty trap, which can be a serious obstacle to growth, even if there is macroeconomic stability.

³ A managed float can help prevent temporary monetary shocks. It will however be able to adjust the currency in case of real shocks.

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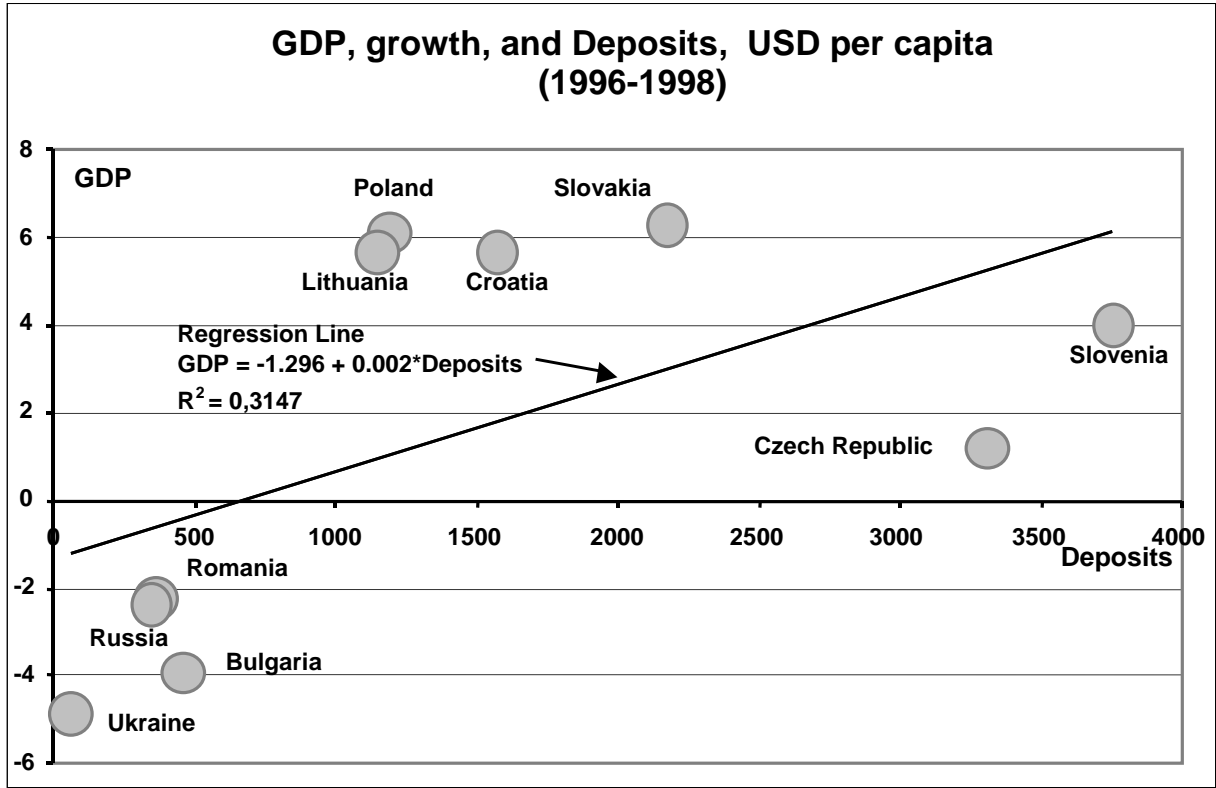
Quarterly Bulletin of the National Bank of Ukraine (several volumes) and web site of NBU (www.bank.gov.ua)

Ukrainian Economic Trends (several issues), TACIS, European Commission, Brussels

World Bank. World Development Report (1996)

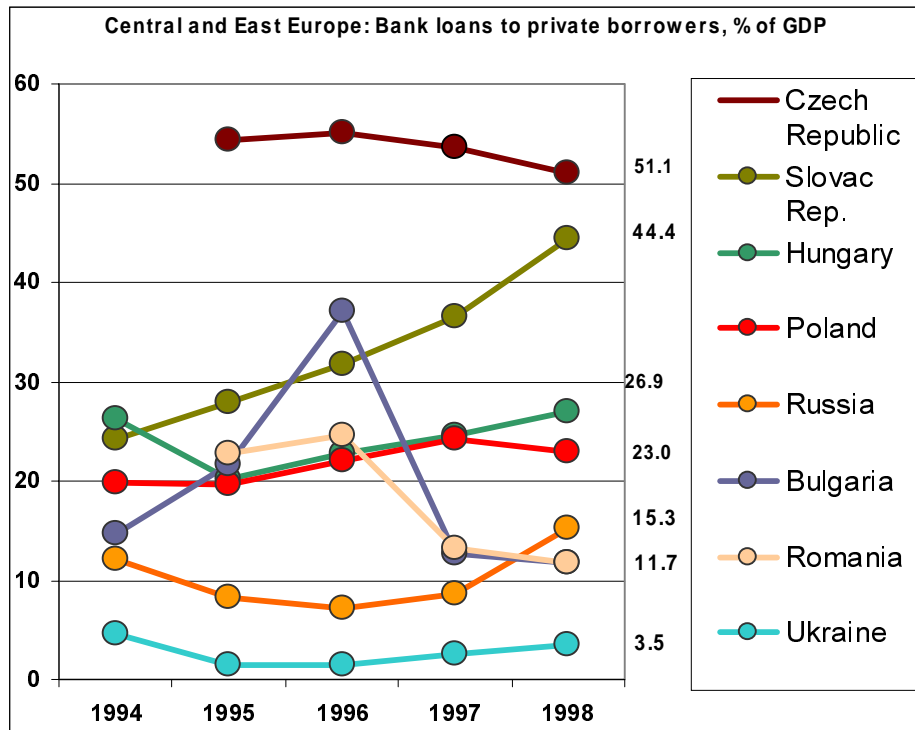
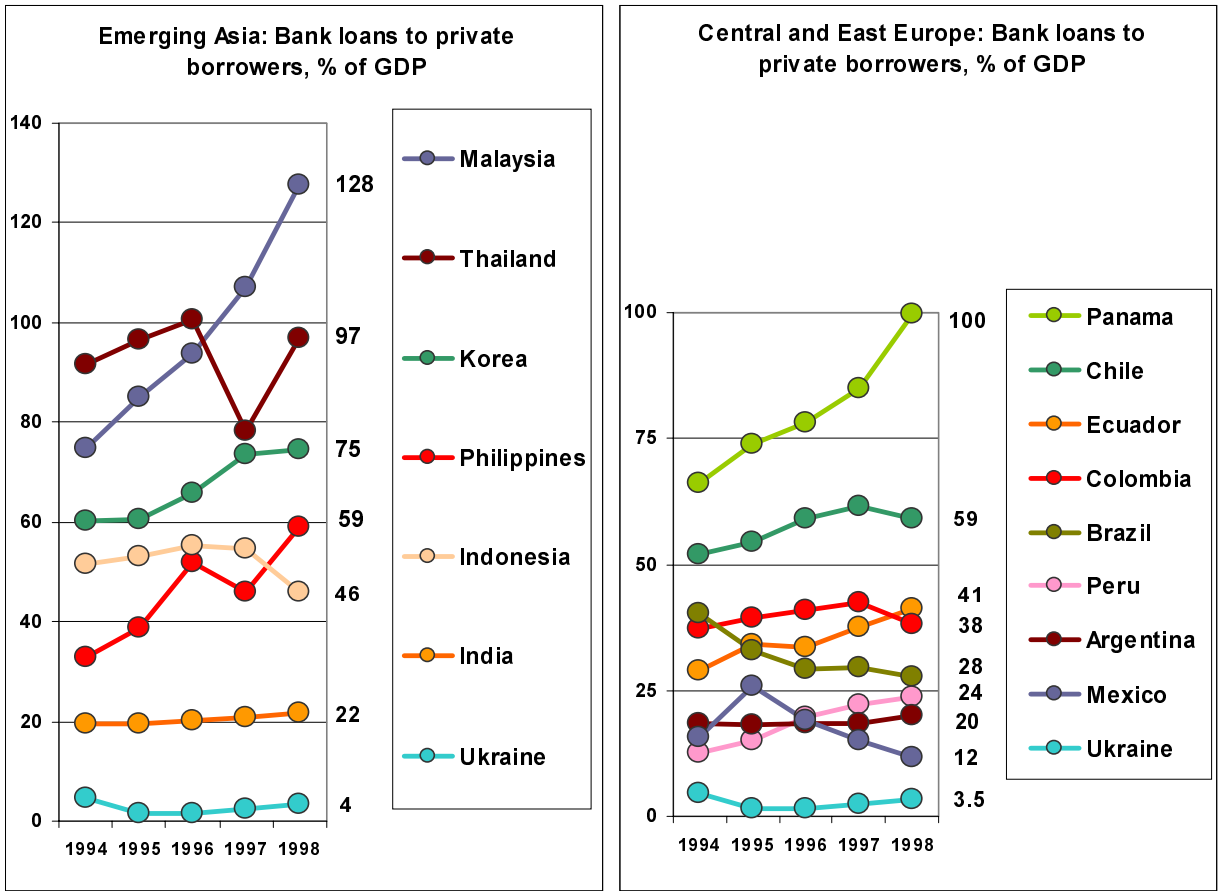
Appendices:

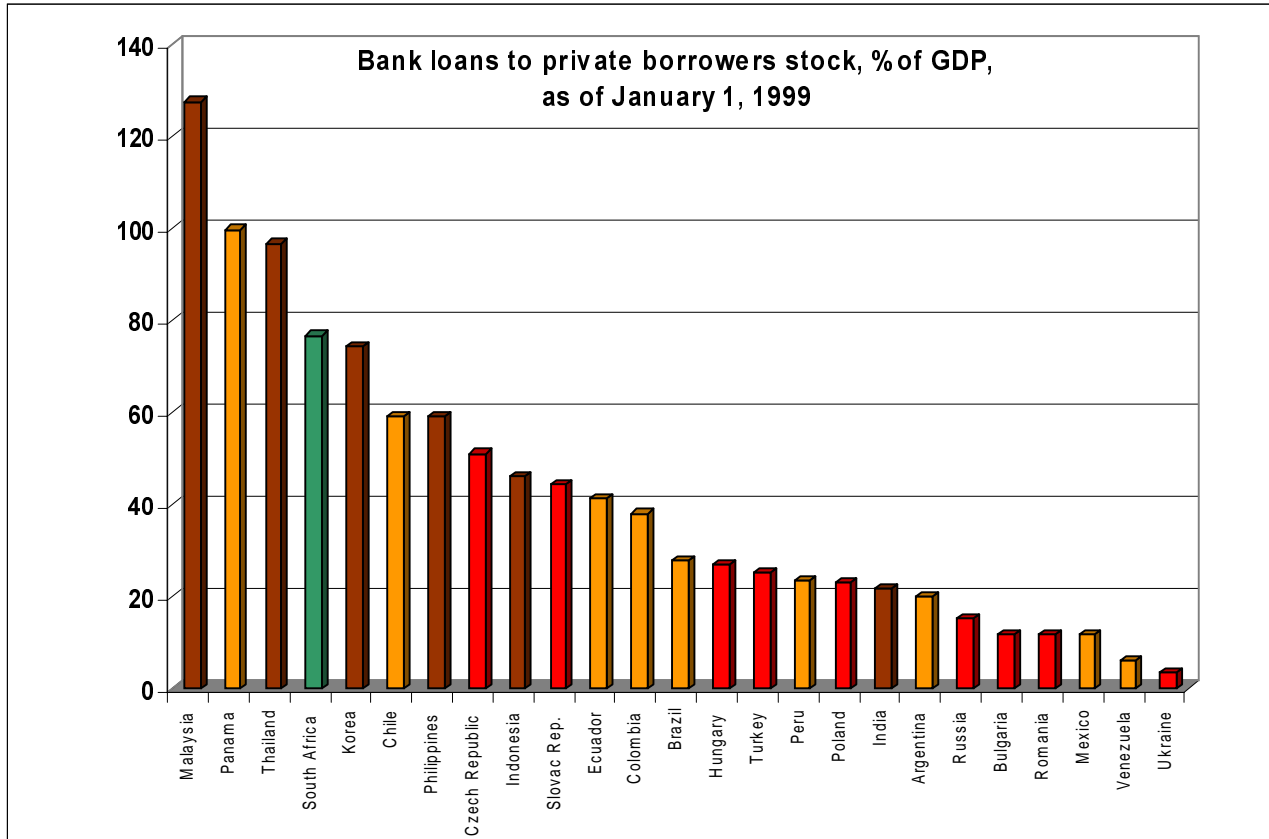
Appendix I – GDP and Deposits (1996 – 1998)



Data source: IMF, International Financial Statistics, Yearbook 1998

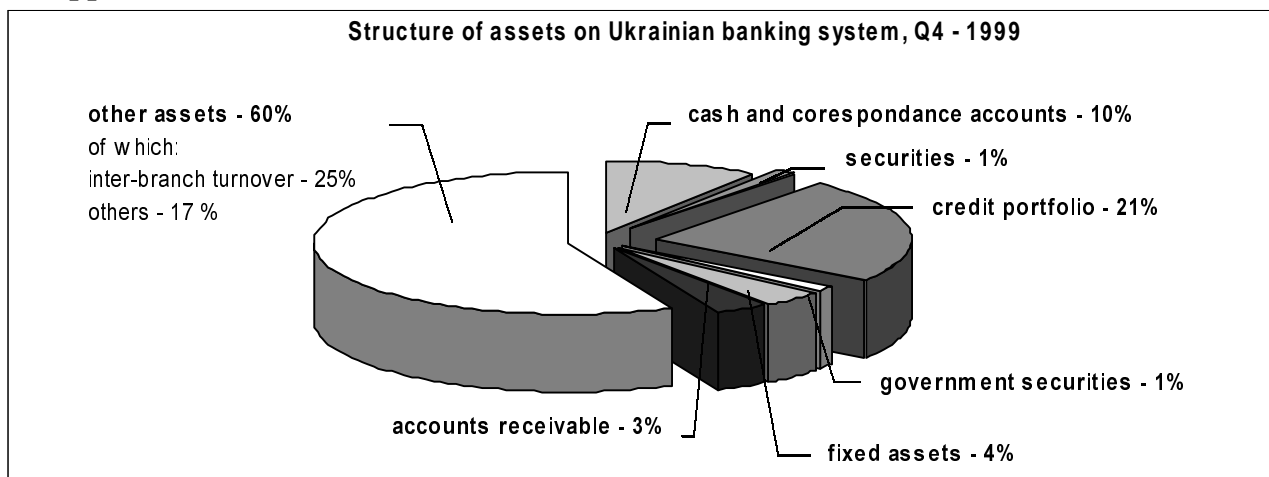
Appendix II – Bank loans to private sectors – Emerging Asia, Latin America, Central and East Europe





Data source: *Emerging Markets Quarterly Outlook, Chase Securities Inc.*

Appendix III – Structure of assets of Ukrainian commercial banks



Data source: *Consolidated balance sheet of Ukrainian commercial banks*