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Why Ukraine needs a first-rate national development bank¹



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Introduction

Ukraine is a Lower Middle-Income Country (LMIC) with a three-year average Gross Domestic Product (GDP), in terms of Purchasing Power Parity (PPP) and 2017 United States Dollars (USD), between 2019 and 2021 of USD 530.57 billion. (CIA, 2023). In terms of area, Ukraine is the second-largest country in Europe. (Statista, 2023) In terms of population, ignoring migration due to Russia's war of aggression, according to a 2021 United Nations (UN) estimate of 43.5 million, Ukraine ranks seventh in Europe. (Wikipedia, 2023)

Because of its GDP (in PPP terms), population size, and national aspirations, Ukraine will have to borrow and deploy substantial resources in order to rebuild and progress from LMIC to Upper Middle-Income Country. Setting up and reinforcing indispensable institutions is a key first step because it is reasonable to assume that the cost to rebuild is difficult to predict and that convergence to a politico-economic equilibrium will be a dynamic process.

In this article, the argument that Ukraine needs a first-rate NDB is advanced. Drawing on the experience of the Federal Republic of Germany (FRG) and the International Bank for Reconstruction and Development (IBRD), the establishment of an NDB similar to Kreditanstalt für Wiederaufbau (KfW) is proposed.

Five R's: relief, recovery, reconstruction, restructuring, and reform

Following World War II (WWII), Germany was a devastated, occupied, and divided nation. After being split between "the East" and "the West" for forty-five years, Germany had to undergo a challenging and costly reunification process. Between 1990 and 2018, a cumulative amount exceeding two trillion British Pound Sterling (GBP), in terms of 2019 GBP, was committed to reunification. (Enkel, K. and Rösel, F. 2022) The cost of reunifying the FRG with the German Democratic Republic (GDR) was much greater than originally foreseen.

The higher-than-expected debt led to rising interest rates and declining growth rates. Moreover, the composition of the spending posed challenges. Because political stability was to be maintained and former-GDR migration was to be limited, most of the funds were channeled into pension plans, social services, and unemployment benefits. As a consequence, there was an upsurge in inflation.⁴

In the aftermath of the Russo-Ukrainian War, Ukraine's situation may be analogous to Germany's: Ukraine, which seeks memberships in the EU and the North Atlantic Treaty Organization, may be devastated, occupied, and divided. Therefore, although relief and recovery, which tend to be relatively uniform in nature, are of principal interest at present, reconstruction, restructuring, and reform, which are dependent on the vision for the country, are likely to attract the vast majority of resources—both financial and human. In particular, the recent estimate of USD 411 billion for recovery and reconstruction may prove too optimistic. (World Bank, 2023) Also, the cost of eventual reunification may surpass that of recovery and reconstruction.

Because Ukraine's geopolitical positioning and population distribution may be comparable to those of post-WWII Germany's, a first-rate Ukrainian NDB that can facilitate and finance Ukraine's socio-economic development and regional integration is of paramount strategic significance. In 1948, as part of the European Recovery Program (the Marshall Plan), KfW was founded. (KfW, 2023) KfW has played an essential part in the transformation—from reconstruction to reunification—of Germany. KfW is the largest NDB in the world, and its operations eclipse those of multilateral institutions. In 2021, KfW extended financing of 107 billion euro (EUR) (KfW, 2023. Op cit.) and, in 2022, KfW raised EUR 90 billion in capital markets. (KfW, 2023. Op cit.) By comparison, in 2021, the European Investment Bank Group (EIB) provided EUR 95 billion in financing, and, in 2022, EIB raised EUR 44 billion in capital markets. In its own words, the EIB is "the world's largest multilateral borrower and

lender." (EIB, 2022)

The importance of Capital Markets operations, which are usually executed within a development bank's Treasury, has been recognized not only on the national and regional levels but also on the global level. Launched four years before KfW, IBRD has relied heavily on the resources of capital markets and the ingenuity of Treasury staff to deliver development impact around the world. Offering liquidity and standardization, Capital Markets operations are the epitome of "replicable and scalable." Jessica Einhorn, Treasurer of the World Bank between 1992 and 1995, has explained this reality succinctly:

It's crucial to link development to capital markets because only capital markets can provide the volumes of funds that are needed in order to have an impact on development. (The World Bank Treasury, 2018, p 54)

Due to the breadth and depth of IBRD's experience with Capital Markets operations, the opinions of IBRD's leadership provide useful insights. For instance, Jim Yong Kim, while President of the World Bank Group, summarized the contributions of the World Bank's Treasury as follows:

In the following pages, you will read about World Bank Treasury's 70-year history of driving financial innovation and pioneering new ways to raise funds from the capital markets: issuing its first bond in July 1947; inventing the formal swap in 1981—an instrument that's widely used today to help manage risk; providing catastrophic bonds to insure countries against natural disasters; and initiating a global response to help countries like Jordan and Lebanon host growing numbers of refugees. Responding to the Ebola crisis, the World Bank Treasury team introduced the first-of-its kind pandemic bond to get money to countries quickly and help prevent the disease from spreading. More recently, in the Spring of 2018, the World Bank Treasury introduced the International Development Association (IDA)—the World Bank's fund for the poorest countries—to the capital markets. IDA joined a select group of top-tier,

supranational issuers with an inaugural bond that raised \$1.5 billion from investors around the world. IDA's entry into the global capital markets was historic: for the first time, the World Bank is able to leverage private sector capital to augment traditional donor funding for the poorest countries. (*The World Bank Treasury*, 2018. *Op cit*, p2.)

A solid grasp of the challenges faced by a developing country usually leads to the conclusion that intermediating funds from global capital markets to local development projects does not suffice. Transferring best practices and skill sets is vital to long-term sustainability. Arunma Oteh, while Treasurer of the World Bank, stated the following:

The work of the World Bank Treasury in leveraging the capital markets for development extends far beyond bond issuance. ... The capital markets have also been important sources of knowledge for the training and advisory services that we offer our client countries in financial structuring, analytics, debt management and asset management. (The World Bank Treasury, 2018. Op cit, p14.)

The experience of IBRD, which is similar to the experience of KfW, in the post-WWII world supports the thesis that Ukraine needs a highly capable NDB—an NDB that can access capital markets efficiently and that can promulgate world-class standards. Just as IBRD was launched during WWII, the groundwork for such an NDB should be laid now.

Operationalizing a first-rate Ukrainian NDB

Establishing a Ukrainian NDB that can facilitate and finance Ukraine's socio-economic development and regional integration, accessing capital markets efficiently and spreading world-class standards effectively, will require commitment and resources. An NDB resembling KfW is only possible within a Ukrainian assistance program resembling the Marshall Plan.

Operationalizing the NDB will be a relatively standard exercise. Once the NDB's legal basis, promotional mandate, and ownership structure are determined, the NDB's financing operations, in terms of activities (for example, projects, export-import, and privatizations/nationalizations), beneficiaries (for example, individuals, private companies, and public enterprises), and instruments (for example, grants, loans, guarantees, and equity), should be specified. With a credit rating in mind, the corporate structure and management team (related to enterprise risk) should be selected, and the capital adequacy framework and funding/liquidity policies (related to financial risk) should be adopted. It would be prudent to establish a facility akin to the InvestEU Advisory Hub that can help identify

bankable projects and bring projects to bankability.⁵ In time, the facility can also help prepare private companies for domestic or international initial public offerings.

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Notes

1. This article represents a shortened version of an April 2023 paper.

2. The views expressed herein are those of the au-

thor and do not necessarily reflect the views of his employer.

3. Writing in his personal capacity.

4. Ukraine may be able to control—to some extent—consumption-driven inflation using Value Added Tax (VAT). Standard VAT in Ukraine is 20%, and several European Union (EU) countries have higher standard VAT rates. The highest standard VAT rate in the EU, which is Hungary's, is 27%.

5. Information on the InvestEU Advisory Hub can be found here: <https://advisory.eib.org/index.htm>