Exchange Rate Policy in Ukraine

- Assessment and Recommendations -

Robert Kirchner/ Dr. Ricardo Giucci

German Advisory Group

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Structure

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2. Current exchange rate policy
3. Assessment of current policy
4. Current policy and future shocks
5. Recommentations
6. Conclusions

Annex I: Russia

Annex II: Belarus

Contacts

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1. Introduction

Motivation:

- Exchange rate policy generally a widely discussed topic in Ukraine
- Currently there is significant pressure on the exchange rate
- This has also major implications for monetary policy, which is intrinsically linked to exchange rate policy
- Our aim is to assess the appropriateness of current policy, also in light of future developments, and to provide respective recommendations

Structure of presentation:

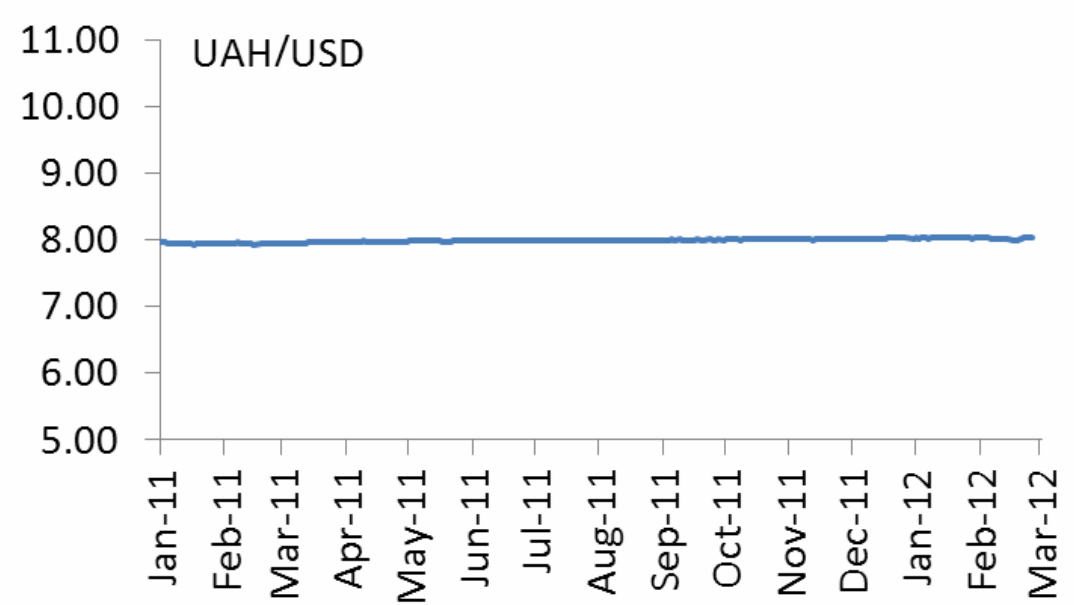
- Description of current exchange rate policy
- Evaluation of current policy
- Suitability to deal with future shocks
- Recommendations
- Conclusions

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2. Current exchange rate policy

- Exchange rate is de-facto tightly pegged to US-dollar

Nominal Exchange Rate



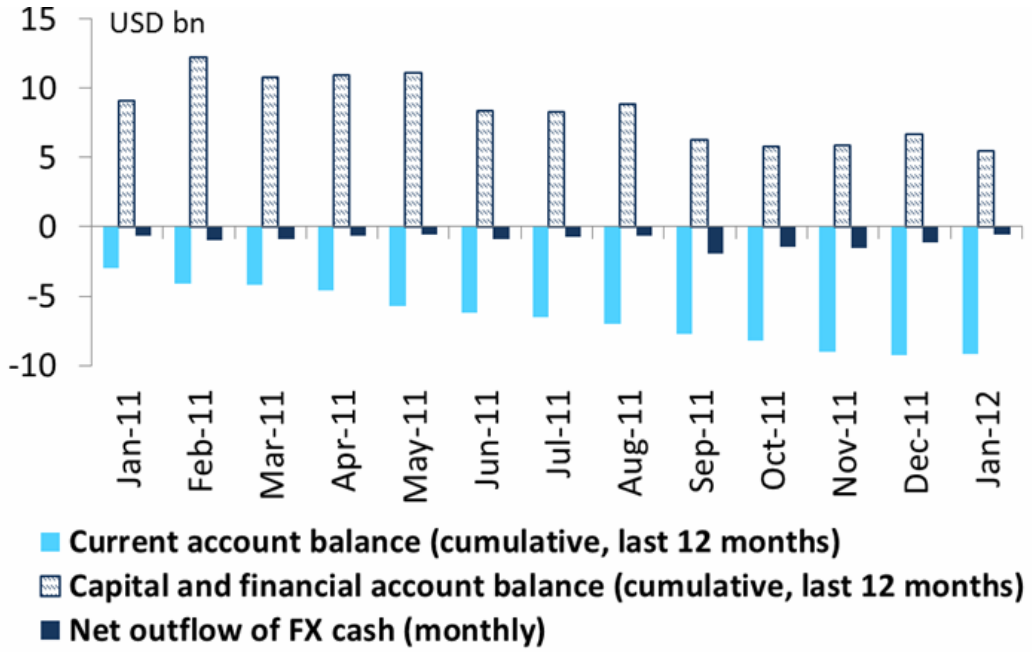
Source: NBU

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Foreign exchange market pressure (1)

- But several indicators signal exchange rate pressure:
  - Current account balance deterioration (energy/gas is important here, as the energy deficit amounted to 14% of GDP in 2011)
  - Capital and financial account also deteriorated
    - Net capital inflows decreased
    - Domestic capital outflows (net purchases of cash foreign exchange by population) – low confidence in domestic currency

Balance of Payments Trends (source: NBU)

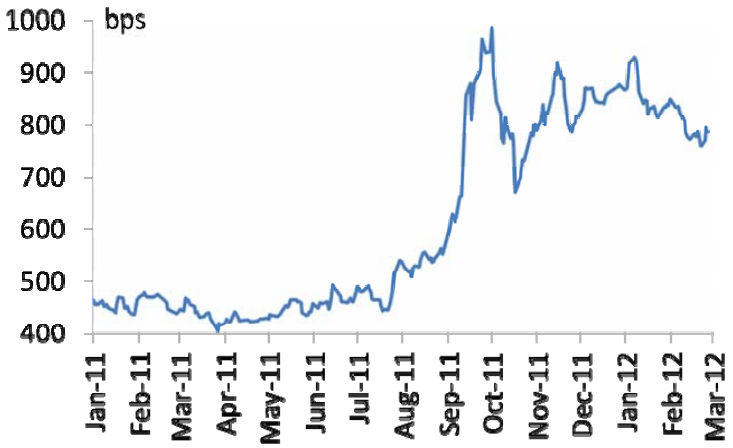


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Foreign exchange market pressure (2)

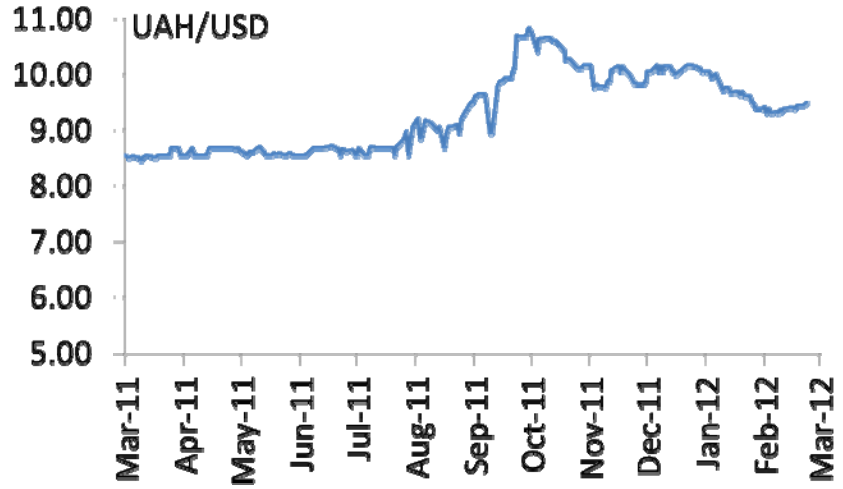
- High risk-premiums on external sovereign debt
- High devaluation expectations on offshore markets

Credit Default Swaps (5-year CDS)



Source: AYA Securities

Non-Deliverable Forwards (1-year NDF)



Source: AYA Securities

- International debt (and equity) markets closed for new issuance, at the same time significant external debt redemptions (incl. IMF debt). As of September 2011, external debt maturing in less than one year amounted to USD 53 bn

Conclusion: External pressure currently originates from two sides, i.e. the current and capital/financial account

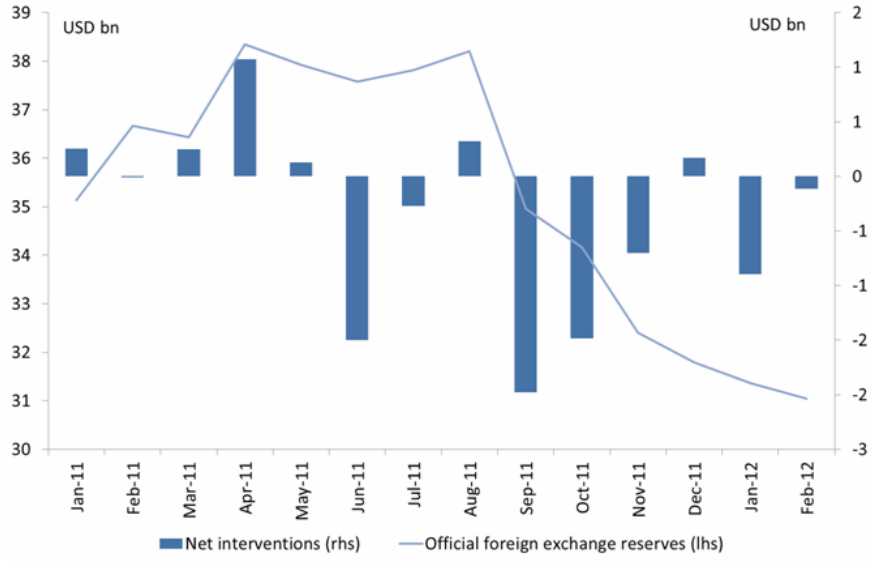
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Implications of fixed exchange rate (1)

Foreign exchange market:

- Consistent pressure during the last months led to:
  - Monthly net sale interventions on foreign exchange market by NBU, thus
  - Official reserve losses: NBU reserves dropped from USD 38.2 bn (Aug 11) to USD 31 bn currently (average loss of more than USD 1 bn per month); less than 4 months of (expected) import cover

Official Reserves and Net Interventions of NBU



Source: NBU

Administrative restrictions:

- A further implication of continuous exchange rate pressure and the loss of reserves was the re-emergence of administrative restrictions, especially on the local FX cash market

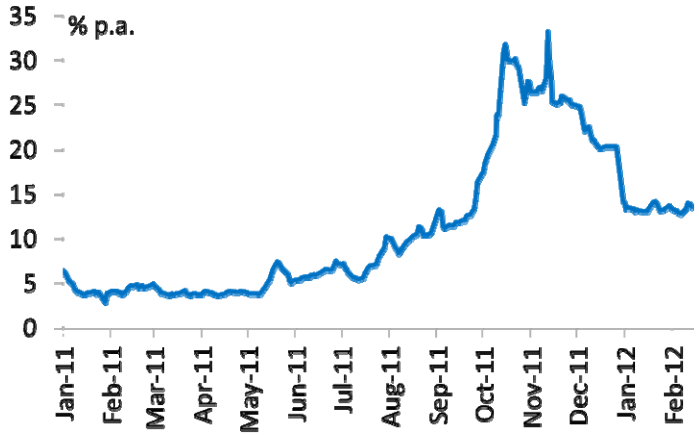
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Implications of fixed exchange rate (2)

Monetary policy:

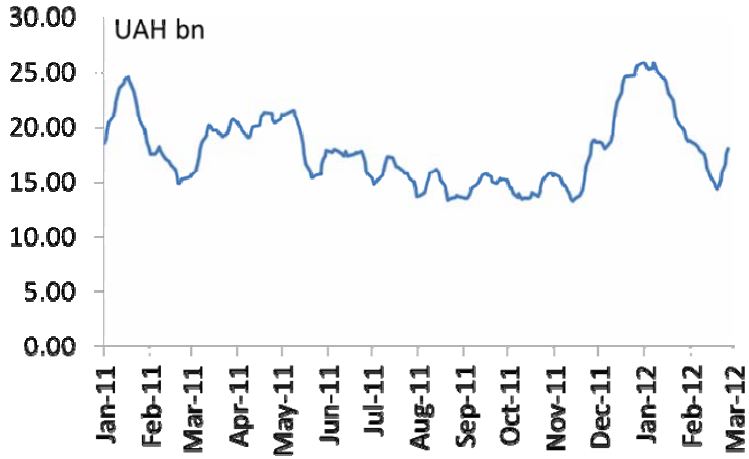
- Monetary policy subordinated to exchange rate policy ("endogenous")
- Imperfect capital mobility (e.g. due to administrative restrictions) allows for some degree of independence, but this is limited
- Recent pressure led to significant tightening of monetary policy, as is clearly visible in the data:
  - Significant increase in money market rates
  - Liquidity: Very volatile, as one would expect under a fixed exchange rate and very tight

Kiev-Prime interest rate (1 month)



Source: AYA Securities

Banking sector liquidity (UAH bn)



Source: NBU

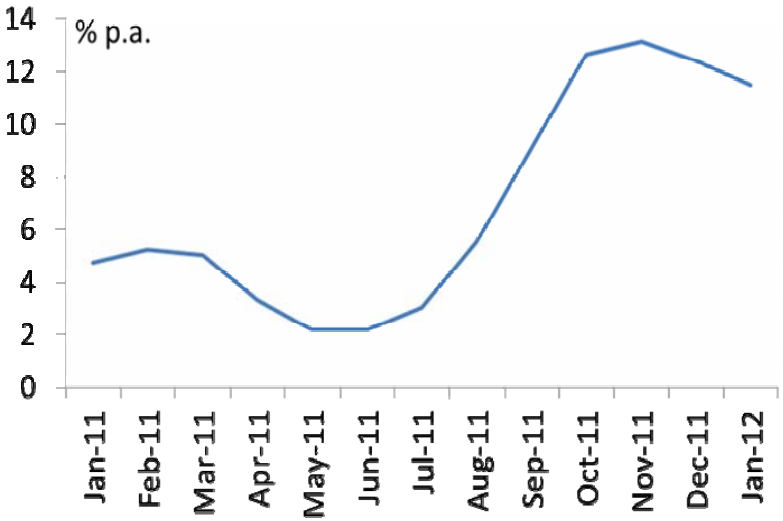
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Implications of fixed exchange rate (3)

Monetary policy:

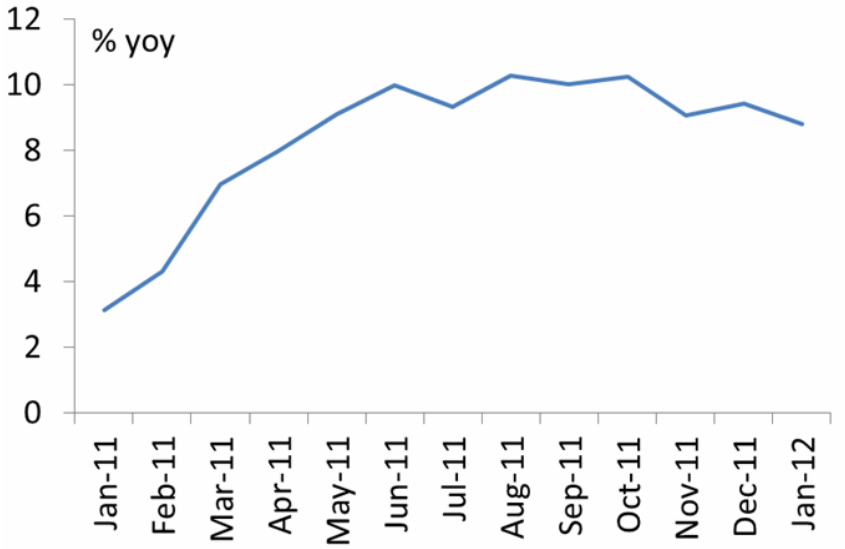
- Transmission of these restrictive tendencies to the banking sector, where interest rates increased and loan growth stagnated

Real bank lending rate



Source: NBU, State Statistics Committee

Bank loan growth



Source: NBU

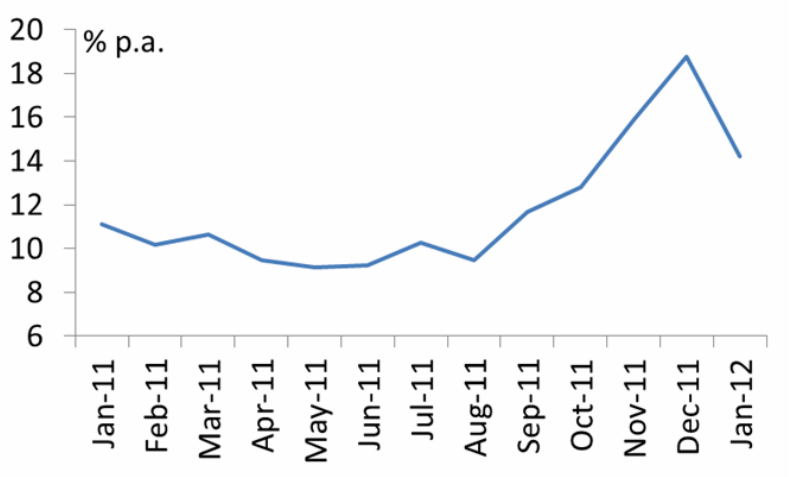
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Implications of fixed exchange rate (4)

Fiscal policy:

- Increase in interest rates has also implications for Ministry of Finance, which needs to fund the budget deficit and upcoming redemptions
- Interest rates on local debt have increased, and the primary issuance accordingly decreased
- This has motivated MinFin to introduce new local instruments (US-dollar linked, and US-dollar denominated), increasing thereby its foreign exchange exposure/risk

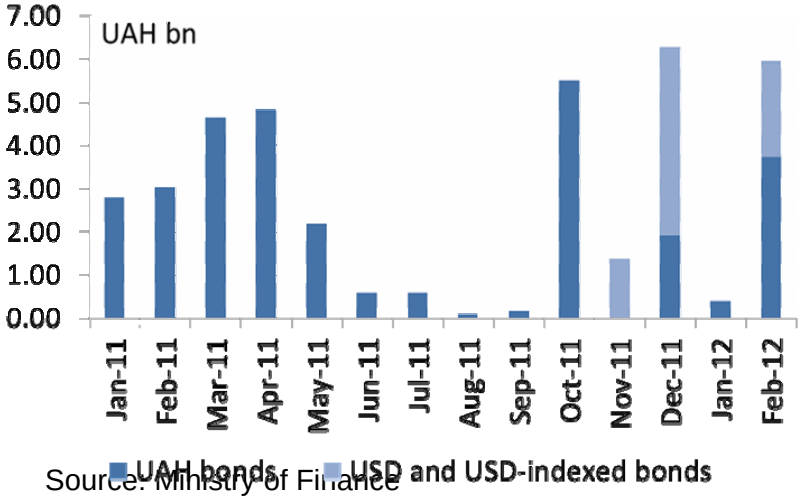
Yields on sovereign local bonds



Source: NBU

Note: Weighted average of executed trades in OVDPs with maturity of 1-2 years

Primary market issuance volumes



Source: Ministry of Finance

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3. Assessment of current policy (1)

Foreign exchange market:

- Different indicators suggest that the exchange rate is not at its equilibrium value
- Our empirical research (Policy Briefing PB/18/2011) supports this claim, even though degree of overvaluation seems not very large
- However, if pressures persist, significant and uncontrolled one-off adjustment cannot be excluded; **negative scenario**

Administrative restrictions:

- Negative impact in terms of trust/credibility, and highly doubtful if effective in the longer term
- Not the right instrument to deal with sustained exchange rate pressure

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3. Assessment of current policy (2)

Monetary policy:

- Exchange rate pressure implied significant tightening of monetary policy due to the intrinsic links between them
- This comes in a situation where the banking sector is still in a recovery mode, and the real sector is dependent on new loans
- Threat to financial and real sector stability

Fiscal policy:

- The tight liquidity situation has also negative implications for fiscal policy, as it is getting increasingly difficult to attract domestic financing by MinFin

Assessment I: External accounts in Ukraine are on an unsustainable path. Fixing the exchange rate in such an environment entails high economic costs in terms of threatening financial and economic stability. Thus, the current fixed exchange rate system should be changed and more exchange rate flexibility should be allowed

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4. Current policy and future shocks (1)

- Against the negative background discussed above, new external and internal risk factors have appeared on the horizon, making Ukraine increasingly vulnerable to uncertain developments (“shocks”)
- Foreign exchange policy needs to take these risks into account and react in a forward-looking manner
- External risks:
  - Deterioration of Eurozone debt crisis, which is not yet fully under control might increase risk aversion
  - Continued deleveraging of Eurozone banks abroad (related to debt crisis)
  - Negative terms-of-trade shocks (i.e. steel/gas prices)
  - Global economic growth deterioration (“second wave of crisis”)

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4. Current policy and future shocks (2)

- Internal risks:
  - Danger of expansionary fiscal policy, which is increasingly in election mode, as demonstrated by new social spending recently announced by the President. According to preliminary estimations, this spending will amount to UAH 16 bn, i.e. more than 1% of GDP
    - Pension and social assistance increases
    - Partial compensation for “lost” Sberbank deposits
    - Launch of new state mortgage lending program (not in costs above)
  - Re-emergence of domestic capital flight, which has calmed down over the last months

Assessment II: New internal and external risk factors strengthen the call for more exchange rate flexibility, as policymakers must also be able to deal with such shocks in a forward-looking manner

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5. Recommendations

- Conclusion from our analysis so far: The fixed exchange rate system should be changed, as it currently puts a heavy economic and financial burden on the economy and is not able to address possible future shocks in an appropriate manner
- If pressure persists - and new risk factors have appeared on the horizon - it cannot be excluded that a large one-off adjustment is needed – this can come sooner than expected (“speculative attack”) and would entail even larger problems for economic and financial stability
- Gradual flexibilisation of exchange rate is thus our preferred strategy, as this would allow the exchange rate to move towards its equilibrium value as defined by economic fundamentals
- As a result, economic stability could be eventually achieved, which should not be confused with exchange rate fixation
- Good news: Current need for fundamental adjustment not too large
- But: How to implement the transition to this new strategy?

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Gradual exchange rate flexibilisation

- Elements of shifting to a new system:
  - Gradual and controlled (“managed”) approach needed, no full flexibility to prevent disorderly market movements
  - Currently existing pressure points to weaker currency, even though not by a large degree
  - A two-way risk (perception) is clearly needed, e.g. some noticeable movements in both directions needed to limit speculation (“one-way bets”)
  - Hedging instruments need to be further developed
  - IMF support would be ideal (loan and increase in credibility)

- Positive effects of such a shift:
  - Protection of FX reserves; increase in confidence by investors
  - Gradual improvement in the current account, less speculative pressure
  - Relaxation of currently tight monetary policy possible, better support of banking/lending/real sector
  - Broadly more balanced recovery

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6. Conclusions

- Our assessment of the current stance of exchange rate and monetary policy clearly suggests more flexibility is needed
- This is further confirmed by looking at future risk scenarios. A switch to more flexibility is the best response to deal with potential shocks
- A gradual flexibilisation of the exchange rate, which should start immediately, means that the exchange rate could move gradually towards its equilibrium value, make the system more stable. Official reserves could be protected, a move that would increase confidence
- This is supported by regional experience: Russia's recent move towards more flexibility is described in Annex I (see Annex II for the case of Belarus, which shows some of the dangers of fixation)
- Jointly with other macroeconomic policies (e.g. fiscal policy) the right "policy mix" would be an important element of achieving macroeconomic stability and thus supporting sustainable long run economic growth
- IMF support in form of a re-started program would give the necessary credibility to undertake such a move

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Annex I: Russia

- Experience of Russia during the aftermath of the crisis
  - Starting in 2009, Russia changed its monetary policy framework, allowing for more flexibility of the exchange rate during this process
  - Elements of new framework:
    - Reduced foreign exchange market interventions
    - Greater role of interest rate policy
    - More transparency in monetary policy communication
  - Results:
    - Monetary policy is increasingly oriented at domestic objectives (i.e. inflation)
    - A gradual de-dollarisation in the banking system – which started already before the crisis- can be observed
    - The ruble is gaining broad confidence among the population

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Annex II: Belarus

- Experience of Belarus during 2010 - 2011
  - Belarus experienced last year a massive economic crisis, caused by an unsustainable policy mix in the run-up of Presidential elections in late 2010:
    - Exchange rate fixation
    - Loose fiscal and incomes polices
    - Loose monetary and credit policies
  - Result:
    - Massive BOP crisis, after unsuccessful measures to control FX market by administrative measures, massive devaluation (from 3,000 in Jan 2011 to 8,800 in Nov 2011 versus USD)
    - Inflation currently running at 107.4% yoy!

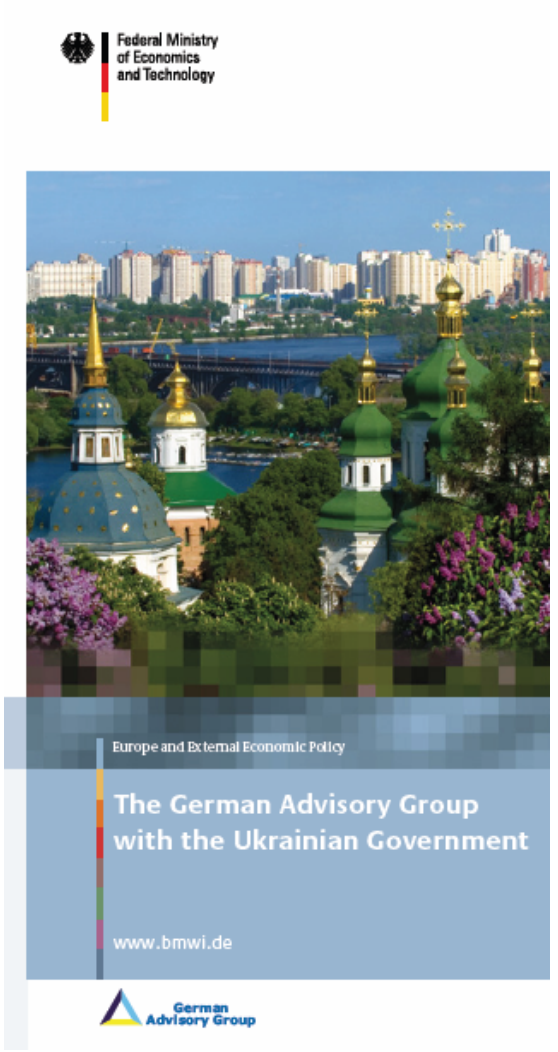
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Contacts

Robert Kirchner
kirchner@berlin-economics.com

Ricardo Giucci
giucci@berlin-economics.com

German Advisory Group
c/o BE Berlin Economics GmbH
Schillerstr. 59, D-10627 Berlin
Tel: +49 30 / 20 61 34 64 0
Fax: +49 30 / 20 61 34 64 9
E-mail: info@beratergruppe-ukraine.de
www.beratergruppe-ukraine.de



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