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## **Impact of the Global Financial Crisis on the Ukrainian Hryvnia**

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During the first half of 2008, the Ukrainian Hryvnia (UAH) appreciated on the inter-bank market by 9.9% from 5.05 UAH/US\$ in January 2008 to 4.55 UAH/US\$ in June 2008. This appreciation was mainly caused by significant inflows of foreign short term debt to take advantage of high interest rates in Ukraine and the expectation that the Hryvnia would not devalue in the short term.

However, since June, the Hryvnia inter-bank exchange rate has depreciated by 14.5% to a current rate of 5.20 UAH/US\$. This depreciation is due to deteriorating macroeconomic fundamentals and the fact that Ukraine may find it more difficult to isolate itself from the current international financial turmoil. In particular, due to international liquidity constraints, Ukraine may not be able to rollover its current large foreign short term obligations and may face a financial crisis and devaluations in the near future. Circumstantial evidence suggests that many local firms have started to accumulate foreign exchange in anticipation of future foreign exchange debt service and other requirements (such as future purchases of foreign inputs.)

Ukraine's large short term foreign debt requirements are due to a combination of larger current account (CA) deficits, sizeable external private debt service obligations and weaknesses in the banking sector.

Regarding the CA deficit, due to imminent further price increases of imported natural gas and forecasted lower international prices for metals, the CA deficit may widen next year to 10% of GDP (or \$24 billion). Even assuming foreign direct investments of about \$10 billion, which may be optimistic, Ukraine would need to secure additional foreign debt of about \$14 billion to cover this CA gap. In addition to these external financing needs, next year Ukraine will need to serve foreign short term debt that could amount to about \$40 billion (including the current portion of long-term debt). Therefore, the total amount of external financing requirements in 2009 may reach \$54 billion. Although a portion of this sum is either due by subsidiaries to parent companies or represents more stable trade credits, the net external financing requirements may amount to around \$30 billion. Under normal circumstances, this amount of external financing would be manageable. However, if global credit markets remain tight, Ukraine may fail to attract the required external funding and may face losses in reserves and devaluation pressures. This means that at present, the exchange rate outlook is particularly sensitive to the health of the global financial markets.

An additional source of concern regarding the exchange rate is the increasing solvency risk of the banking sector. Ukrainian banks may weaken due to a possible growing share of non-performing assets associated with the high credit expansion of recent years. Official NBU statistics indicate that in 2007 non-performing loans (defined as sub-standard, doubtful and loss loans) were still high at 13.2%, though they had declined from 19.5% in 2005. If the global slowdown were to affect the creditworthiness of the banks' main clients, they may fall short of resources to serve their debt, again leading to defaults. Furthermore, even moderate currency depreciations may impair the ability of banks' clients to pay their debts on schedule, as about 51% of all domestic loans are denominated in foreign currencies. Increasing defaults of the Ukrainian banks may further undermine creditors' confidence, which will encourage more foreign capital outflows and higher devaluation pressures. Domestic political instability adds to the

current uncertainties and may indeed lead to a drop in reserves and elevated currency depreciation pressures.

All these domestic and international developments have recently tilted the balance in favor of currency devaluation. Indeed, since mid-2007, the premiums for Ukrainian credit default swaps have increased from about 200 basis points to over 800 basis points. In addition, in the European forward markets, the three-year Hryvnia is now quoted at 9.62-9.80 UAH/US\$ (although not actively traded), a rate much higher than the rate of 6.0 UAH/US\$ in last June. The one-year forward is traded at 6.40-6.64 UAH/US\$. Furthermore, portfolio capital inflows to Ukraine declined from \$3.3 billion in H1 2007 to only \$350 million in H1 2008.

**The probabilities of a currency crisis have now increased.** But a soft landing, supported by monetary and exchange rate adjustments, is still possible. Below we present several possible scenarios of the exchange rate dynamics. Their realization depends on the near-term developments on international credit markets and the extent to which foreign investors and creditors incorporate this information into their judgment on Ukraine, given political uncertainties. Still, the recent unprecedented volatility of the global financial markets is leading global investors to a flight to quality and safe assets. This means that any negative news (either global or local) is likely to have considerable weight in the risk assessment of Ukraine in the short term.

1. Optimistic scenario (probability less than 10%). The US and EU governments quickly implement TARP-type programs, helping to unfreeze international credit markets. Relative political stability in Ukraine is restored and the government approves a balanced macroeconomic strategy to contain a financial crisis. Due to current account pressures and debt service obligations, the UAH exchange rate depreciates moderately to 5.5-6.0 UAH/US\$ by the end of 2009, while losses of the NBU foreign reserves are tolerable.
2. Medium scenario (probability up to 40%). The global economy enters a period of economic slowdown (1-2 years), which depresses commodity prices and slows down Ukrainian exports. Approval of TARP-type programs permits global credit markets to resume functioning at a reasonable level, albeit risk aversion and high premiums for risky debts continue to dominate investor sentiments. Facing CA deficits and high short term debt service, the UAH may depreciate by 15%-35% (to 6.0-7.0 UAH/\$) within the next four quarters. The NBU suffers a large, albeit not catastrophic, loss of its foreign reserves, while the government manages to rebuild investor confidence by consolidating its efforts on crisis management.
3. Most likely scenario (probability over 50%). Despite the approval of TARP-type programs, efforts to stabilize financial markets are only moderately successful. International credit markets remain anemic and investors shy away from the most vulnerable emerging markets such as Ukraine. The UAH exchange rate depreciates by over 35% (to about 7.0-9.0 UAH/\$) by the end to 2009. The Ukrainian government remains fragmented and ineffective in its efforts to prevent a financial crisis. As banks experience problems, credit growth decelerates, GDP declines, and real estate and asset prices enter a downward correction trend. Political risks remain elevated until the end of the next election cycle (end of 2009).

Based on these fairly negative scenarios, what can Ukraine do?

- Before the Crisis:
  - Build Confidence.

- Develop an early warning system which may indicate whether the probabilities of a crisis are increasing or fading away.
- Monitor closely the amounts of external private sector debt (banking and non-banking) that is maturing each month over the next 12 months and compare it with debt repayment capacities.

□ After the Crisis:

1. Agree on Organizational Arrangements to confront the crisis:
  - a. Enter a Memoranda of Understanding among government agencies (NBU, Cabinet, Ministry of Finance, Ministry of Economy, etc) to clarify responsibilities and actions to address the crisis.
  - b. Enter a Memoranda of Understanding with other Central Banks whose countries have a large banking presence in Ukraine, such as the ECB, Austria, Sweden, etc on matters of coordination, exchange of information and possible financing.
2. Agree and implement **Emergency Crisis Containment Measures**, which may include a deposit freeze, bank holiday, blanket deposit guarantees, initial liquidity support, lowering reserve requirements.
3. Agree and implement **Crisis Resolution Measures** (to rebuild balance-sheets), including:
  - a. Consider the desirability of a Bank Regulatory Forbearance to permit banks to operate with lower capital requirements.
  - b. Require all domestic banks to prepare contingency financing plans, identifying the various sources of financing that could be tapped and developing the necessary contingency arrangements to facilitate this financing quickly.
  - c. Developing Bank Resolution Options identifying the corrective actions that the government could take for different types of banks (such as closure, merger, restructuring), depending on their size, whether the problem is related to liquidity, related to solvency, related to bad management, capacity to raise equity, etc.
  - d. Consider the desirability of creating a government-owned Asset Recovery Company (similar to the RTC of the US) to buy and resolve some of the distressed assets of the banks.
  - e. Help banks to develop measures to address their distressed loans, including simplified legal and judiciary procedures for foreclosures of delinquent loans.
  - f. Consider modifications to the current Deposit Insurance to raise confidence and avoid bank runs, while avoiding moral hazards.
  - g. Adjust fiscal, monetary and foreign exchange rate policies to build confidence that the current issues (CA deficits, short term debt and banking sector weaknesses are addressed).
  - h. Implement a comprehensive program of economic reforms to improve Ukraine's investment climate and revive growth.
  - i. Consider implementing some major government investments in infrastructure to spur growth.
4. Develop possible confidence-enhancements measures such as road-shows, etc. to convince foreign banks and investors that the situation is under control.