

Ukraine's Financial Risks

E. Segura, June 2008

There are three major financial risks that Ukraine is currently facing: (i) high inflation; (ii) increasing current account deficits; and (iii) large private foreign borrowings, particularly short term, that can jeopardize the banking sector and lead to devaluations. Our views on these three risks are as follows:

(i) Inflation.

If the country indeed has a good harvest this year and the NBU does not intervene in the FX market (thereby controlling the growth in money supply), inflation should go down during the rest of the year. This reduction of inflation assumes that the fiscal budget deficit this year will be at the planned level of 1.5% of GDP and that public expenditures will not explode.

On the above basis, inflation should be about 20-25% in 2008, going down to 10-15% in 2009 and around 7-10% thereafter.

Therefore, inflation per se may not be the trigger for a financial crisis.

(ii) Current Account (CA) Deficit.

The latest statistics indicates that the current account deficit is growing and may be around 6.5% to 7% of GDP this year (about \$12-14 billion). The question is whether this can be financed on a sustainable basis. With FDIs at \$4 billion in January-April, it is expected that FDIs may be close to \$10 billion in 2008. This would be enough to finance the CA deficit this year.

Next year, the CA deficit may increase by as much as \$5 billion (to around \$18 billion) due principally to expected large increases in energy/gas prices (which could add \$4 billion to the deficit). If FDIs were to continue at the level expected in 2008, there will be still a financing gap of \$8 billion that will need to be covered either by foreign debt or reductions in international reserves. Although this amount could still be fundable, it will depend on investors' sentiments and their desire to provide new funds in addition to roll-over existing debt. The international liquidity situation will be also a determining factor. Moreover, investors' sentiments may be more negative if the government does not succeed in controlling inflation.

(iii) Foreign debt and Banking Sector Vulnerabilities.

The new statistics on foreign debt are worrisome. As I said in my previous notes, the main reason why inflation has accelerated is the large increases in money supply and bank credit financed by large inflows of foreign debt contracted principally by commercial banks. To avoid Hryvnia appreciation, the NBU had been purchasing this foreign exchange with Hryvnias, thus increasing money supply by 45% pa. Since money demand has now stabilized, it is not surprising that inflation is high.

In January-March 2008, Ukraine's foreign debt further increased by \$8 billion to \$92.5 billion. This represents 61% of GDP thus exceeding the EU's guidelines that foreign debt should not exceed 60% of GDP. Furthermore, a lot of this debt is short term (about \$30 billion) and if we include the short term portion

of longer term debt, the current short term debt may be as high as \$50 billion, exceeding considerably the level of international reserves (currently \$34 billion). When short term foreign debt exceeds the level of international reserves, the country becomes vulnerable if a negative external event were to occur.

Most of this foreign debt was contracted by banks. It seems that the measures taken by the NBU to reduce capital inflows (such as tightening capital adequacy ratios and increasing reserve requirements) are not giving results.

This increase in foreign debt is additional to the increases in foreign capital due to FDIs (including the purchases of banks). It therefore appears that these inflows are principally speculative, to take advantage of higher lending rates coupled with an appreciating currency. Over the short term, this combination produces large profits for the banks. But this combination is not sustainable, principally if the quality of the bank investments is poor. As you are aware, I have been quite concerned for some time that the level of non-performing assets in the banking sector is significantly higher than the 4% reported by the NBU. This is due to inadequacies in the loan classification criteria that the NBU uses, which underestimate non-performing assets. The IMF estimates that the actual level of non-performing assets may be as high as 15% of assets. This means that the actual capital of many banks is significantly lower. There is also a lot of "circumstantial" evidence that many unqualified borrowers are getting significant bank credit to purchase houses, cars, etc. that significantly exceeds their repayment capacity.

The above combination of factors (high lending rates, appreciating currencies, large short term capital inflows and high non-performing assets) caused the financial crises in Asia. I am quite concerned that the same thing may happen here.

All that is needed is a "trigger" that would reverse investors' sentiments. This "trigger" could be a major bank collapse or to the growing current account deficits associated to a likely increase in gas prices next year, or a growing impatience with the political situation. These "triggers" could lead to a rapid outflow of this speculative short term capital, leading to a financial crisis, collapse of a few banks, a recession, and a large depreciation of the Hryvnia.

I believe that the new information of foreign debt suggests that this is a real risk now. Unfortunately, if now the government were to introduce additional measures to reduce capital inflows, these measures may even accelerate a financial crisis, as it happened in Malaysia in 1997. The only sustainable measure is to reduce government expenditures drastically and generate a fiscal budget surplus of 2-3% of GDP, a highly unlikely possibility given the current political environment.

In summary, I believe that the problems with inflation and the CA deficit may not per se trigger a financial crisis in the next couple of years. However, a reversal of short term foreign capital inflows may do it, principally if the Presidential elections lead to large fiscal deficits and political difficulties.