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# Ukraine's Foreign Exchange Market: Current Situation and Prospects

O. Pogarska and E. Segura

Since mid-January 2014, the Hryvnia has been experiencing intensified depreciation pressures. As a result, the Ukrainian currency depreciated by almost 5% in January and 9.4% to date. On February 5th, the exchange rate reached UAH 9.4 per USD, the highest level since February 2009. There are both demand and supply causes of the depreciation pressures.

High demand for foreign currency is driven by (1) substantial debt repayments at the beginning of the year, (2) increased uncertainty regarding the predictability of the external support for Ukraine as well as (3) uncertainties regarding the resolution of current political crisis.

More specifically, the government had to repay around $0.7 billion and $0.4 billion to IMF on January 30th and early February 12th. Moreover, on January 22nd, the government had to repay $220.3 million of forex-denominated domestic securities. In addition, Naftogaz has to repay about $3.5 billion for Russian natural gas consumed in 2013 and January 2014. According to Russian Gasprom, the deadline was January 25th. Earlier there was information that these gas payments would be delayed until the spring of 2014. However, given the change in government in Ukraine, Gasprom may insist in early repayment.

Rising uncertainty over the predictability of the external financial support for Ukraine adversely affected population and business confidence in the national currency, feeding higher demand. At the same time, according to representatives of the commercial banks, surveyed by phone today, the demand for foreign currency was principally driven by commercial enterprises. Rising uncertainty over the likely resolution of the political crisis and the risk of a drastic change in the country's management, similar to the one that occurred at the end of 2004/the beginning of 2005, might have caused businesses to take precautionary measures, which took the form of capital outflow from the country.

Population demand for FX has tangibly increased over the last ten days, after it became clear that the National Bank of Ukraine refused to defend Hryvnia exchange at UAH 8.5 per USD. In fact, over the last week of January and the first few days of February, a number of commercial banks confirmed a growing number of Hryvnia deposit withdrawals. According to commercial banks' representatives, only during the past three days, the stock of Hryvnia deposits has declined by at least UAH 1 billion. The high Hryvnia deposit rates at 23-25% may be the principal reason for the delayed population response as even with 10% devaluation Hryvnia deposits still remained more attractive than FX ones.

At the same time, the supply of foreign currency continued to decline due to (1) worsening exports and (2) NBU decision to save international reserves.

According to preliminary NBU data, Ukraine's current account deficit reached $16.1 billion in 2013, which was wider than anticipated. Available information regarding exports from export-oriented companies was not encouraging. Demand for traditional Ukraine's exporting commodities remained weak in January 2014, which translated into a sharp decline in metallurgical production that month (around 12% yoy, according to select representatives of the industry). Though the decline in activity is typical for the first month of the year, it was the highest for the last five years. The main reason for the fall in output was that steel traders reduced new orders for metallurgical products preferring to deplete existing inventories amid growing economic and political uncertainty in the country. In addition, Ukraine's machine-building sector experienced a declining demand, which was the result of a notable economic slowdown in Russia. Furthermore, following the dismissal of the Ukrainian government in January, Russia again toughened customs clearance of the Ukrainian goods, which virtually blocked Ukraine's exports to this country.

According to preliminary estimates, NBU international reserves declined by $2-2.5 billion in January and stood at around $18 billion as of the end of January. In February, according to commercial banks, just during three days last week the NBU spend about $1 billion to calm the market. Yesterday's interventions are estimated at around $0.4 billion. If the estimates are correct, the level of NBU reserves fell to $16.5 billion as of now.

This current level of FX reserves is equivalent to about 2 months of imports. The representatives of commercial banks said in phone calls that the NBU 'was instructed' to save international reserves as much as possible. Such decision was made amid growing uncertainty regarding the external support from Russia. The Ukrainian authorities planned to issue $2 billion sovereign Eurobonds for their subsequent purchase by Russia. However, following the dismissal of the Ukrainian government Russia decided to wait and see as it fears that the new government may return to the signing of a free trade and association agreement with the EU. As a result, until recently the NBU made very limited interventions on the foreign exchange market, satisfying about 2% of the requested amounts. However, a sharp depreciation since the end of January made the NBU to increase interventions in order to prevent a large depreciation.

Recent developments

Yesterday, the NBU called an urgent meeting with banks' vice chairmen. According to representatives of the commercial banks, the main reason for the meeting was to know banks' assessments of the current situation on the foreign exchange market. The main question raised by the representatives of the NBU was what exchange rate the banking system may weather without jeopardizing system stability. According to our sources of information, the answered varied in the range of UAH 8.7 to 9.5 per USD. In fact, the representatives of commercial banks believe that a 15-20% depreciation (up to UAH 9.5 per USD) is the maximum depreciation that the economy and banking sector may withstand. If this level is exceeded, Ukraine will face a full scale currency crisis with uncontrolled devaluation.

Today, the NBU called for a meeting with the heads of commercial banks' treasury departments. The NBU informed that it will try to defend Hryvnia exchange rate at about **UAH 9 per USD**. The NBU also promised to punish those commercial banks that 'speculate' on the market. Commercial banks were also asked to make comments in the mass media aimed at calming foreign exchange expectations.

Prospects

Most commercial banks representatives believe that over the short term, the NBU will use the whole complex of measures to defend the new Hryvnia support level of UAH 9 per USD. These measures will include tightening banks' Hryvnia liquidity, 'punishment' of select commercial banks in the form of a temporary ban for such banks to trade on foreign exchange market, and limited forex interventions.

In case there will be observed continuing rapid withdrawal of Hryvnia deposits, the NBU may consider the imposition of a moratorium on deposits. Additional measures to reduce foreign currency demand may be introduction of a foreign currency transaction tax, etc.

These measures, however, may have a stabilizing effect only for a very limited period of time. Only a major and quick injection of FX liquidity would be able to restore FX reserves and increase confidence in Hryvnia. Without sufficient foreign financing to cover Ukraine's financing gaps, the Hryvnia will devalue rapidly in the future much more than the 20% that banks can withstand.