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Getting Prepared for a Financial Crises

(Statement to the Macroeconomic Working Group of the PM's Investors' Council)

E. Segura, July 2008

The current international liquidity crisis is making many countries more vulnerable to financial crises. Some studies show that the most vulnerable countries are those with a high ratio of short term debt to international reserves (e.g., more than 1.0), high current account deficits in the BOP (e.g., exceeding 5% of GDP), and fast expansion of consumer credits (in excess of 15% pa). Ukraine meets all these vulnerability criteria.

So far, until now, Ukraine has been relatively unaffected by the international crisis.

Nevertheless, over the last few months, there have been an increasing number of market signals accompanied by statements of some of the major international banks in Europe and New York about the increasing financial and banking risks in Ukraine. These concerns have emerged despite the recognition that most banks are profitable and well-capitalized, and that the presence of foreign-owned banks has strengthened the sector.

Many economists in these institutions have expressed concerns that Ukraine may be facing a financial crisis in the near future, that is, within the next 12 months. Standard-and-Poor's has also now formally stated that it believes that Ukrainian banking sector has become vulnerable due to its dependence on foreign loans and fast growth of consumer credits.

Their concern is based on the deterioration of some indicators that in the past have predicted crises in other countries. For example:

1. The amount of short term foreign borrowings by the private sector has been increasing fast in the last couple of years. Private short term foreign debt used to be around $11 billion in early 2006 but in two years it has grown to $26 billion at present. In addition, if the short term maturities of long term foreign debt are included – as many countries do -- the amounts of foreign short term debt may be as high as $45 billion. This amount exceeds by almost 30% the current level of international reserves of the NBU. Most foreign banks are concerned when external short term debt exceeds the level of international reserves. This is because if there were to be a deterioration of investors' sentiments, it would be hard to roll-over this short term debt and reserves would be insufficient to serve this debt.

2. The problem with short term debt is seen as more serious because the deficit of the Current Account of the balance of payments is deteriorating rapidly (which will require more external financing). Just in first five months of 2008, the current account deficit increased US$6.2 billion which is about 9% of GDP in the period. This is twice the amount in the same period of 2007. Many banks forecast large Current Account deficits for 2008. For example, some published forecasts for the CA deficit in 2008 are: $17 billion by JPMorgan, $18 billion by Morgan Stanley, $16 billion by Unicredit, $16 billion by HSBC, etc. There are fears that these current account deficits could be even higher given the current appreciation of the Hryvnia.

3. These Current Account deficits of about $16-18 billion would not be a problem if they can be covered by Foreign Direct Investments or soft-lending from international institutions, which is the case with Romania and Bulgaria. But in Ukraine these deficits may not be fully covered by FDIs. From January to May, FDIs amounted to $4 billion (and may reach $10 billion by the end of the year). This is a large amount, but not enough to cover the CA deficit. And if foreign borrowings were to become more difficult, international reserves may deteriorate by the end of the year. This would bring pressures for depreciation of the Hryvnias.

4. The fast expansion of money supply and consumer credits granted by banks is also a source of concern to many foreign investors. Bank credit has been growing at 70% pa. Although this expansion has been important in supporting GDP growth, it also makes banks more vulnerable. This is because many international studies have shown that when the growth of consumer credits exceeds 15% pa, the number of non-performing loans tends to growth as management processes tend to fail. Furthermore, there is concern that a large portion of consumer credits are granted in foreign currency to un-hedged consumers.

The combination of large short term debt, high current account deficits and fast expansion of consumer credits makes Ukraine more vulnerable. Reflecting these vulnerabilities, there has been a decline in portfolio capital inflows to Ukraine. The inflow of portfolio capital declined from US$1.8 billion in the first quarter of 2007 to only $220 million in the same period of 2008. Partly as a result, the PFTS index declined by 45% year-to-date (as of July 20, 2008). In addition, since mid-2007 external spreads on Ukrainian bonds have risen from about 250 basis points to about 480 basis points, which is a larger increase than in other similar countries.

These vulnerabilities do not mean that a crisis will occur with a 100% certainty; but that the probabilities are now quite substantial. Nobody can predict the timing of a crisis because the crises will depend of non-economic factors. But anything can trigger a crisis. It could be an overwhelming major increase in gas prices, or it could be the failure of a single bank, or it could be a crisis in a neighboring country, or it could be a major drop in export revenues.

The main recommendation that we make is that the country should now take a number of contingency measures to enhance its capacity to deal effectively with a probable financial crises, if one were to emerge in the future. International experience says that when a crisis comes, there is no time to think, no time to go to the Rada, no time to develop plans. There is a need to take immediate actions. This is what is called Prompt Corrective Actions. But to take fast and proper/correct responses, the country needs to have a "road map" which shows what to do if a crisis emerges.

These contingency measures would include:

- Development of an early warning system with indicators of vulnerabilities to a financial crisis which may indicate whether the probabilities are increasing or fading away.

- Preparation of Memoranda of Understanding among government agencies (NBU, Cabinet, Ministry of Finance, Ministry of Economy, etc) to clarify responsibilities and actions in case of crisis.

- Preparation of Memoranda of Understanding with other Central Banks whose countries have a large banking presence in Ukraine, such as Austria, Sweden, etc on matters of coordination and exchange of information.

- Preparation of a 'dormant' Crisis Management Unit and possibly an Asset Recovery Agency that can be activated in case of a crisis.

- Developing Bank Resolution Options identifying the corrective actions that could be taken for different types of banks, depending on their size, on whether the problem is related to liquidity, related to solvency, related to bad management, etc. This plan will permit to deal expeditiously with any bank that could be in trouble.

- Requiring domestic banks to prepare contingency financing plans, identifying the various sources of financing that could be tapped in case of a crises and developing the necessary contingency arrangements to facilitate this financing quickly.

- Developing possible confidence-enhancements measures such as road-shows, etc. to convince foreign banks and investors that the situation is under control.

Other countries have found useful to take all these preparatory steps to address a potential crises, minimize its negative effects, and recover expeditiously. Sweden is a good example of a country with sophisticated contingency plans. They even carry periodic “simulations” of crises to identify weaknesses in their preparedness. It may be useful to see if the Central Bank of Sweden can provide support in developing similar plans here.

But in any case, the Macroeconomic Working Group will be elaborating a document elaborating of the measures that could be taken to be prepared for a crisis. This document should be ready in about two-three months.

The second recommendation that we want to make is that a working group should be established to identify measures to facilitate or remove bottlenecks to the development of domestic sources of financing for the banking sector, which is a needed alternative to foreign borrowings.