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Liberalizing the foreign exchange market: benefits and risks

In late March the Cabinet of Ministers and the National Bank of Ukraine jointly decided to abolish the mandatory sale of 50% of the foreign exchange receipts of exporters at the interbank market. The mandatory sale had been introduced after the financial crisis of 1998 to lift the strong devaluation pressure on hryvnia. Initially exporters were obliged to sell 75% of all foreign currency receipts within 5 days. In a while the restriction was softened to 50%. Since for cash flow reasons, exporters had to sell a substantial part of their foreign currency receipts in any case (i.e. to pay wages, materials, taxes, etc.) the regulation's impact was mainly on the time period within which foreign currency was supplied to the market, rather than on the amount of funds. Thus, by preventing economic agents from postponing their exchange operations and choosing the time that best suited them, the NBU guaranteed a continuous supply of foreign exchange at the interbank market that helped to alleviate the devaluation pressure.

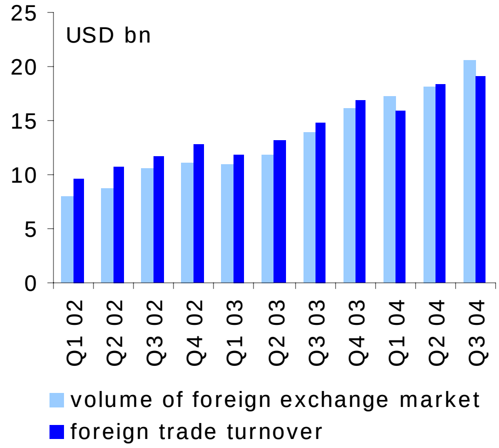
However, the mandatory sale of foreign currency receipts has it negative side. First, the requirement creates incentives for exporting enterprises to underreport export receipts, for instance by reducing the official price of the exported goods. Moreover, same as any other restriction it promotes illegal operations aimed at avoiding complying with the regulation. In addition, aside from raising the costs for the economic agents involved in the export operations it also increases the costs to the state associated with administration, regulation, monitoring and levying fines. For these reasons, a strict regulation, like the mandatory sale of foreign currency receipts, should not be employed whenever the macroeconomic situation is stable.

Over the last years the Ukrainian economy has shown signs of stabilization and recovery, as reflected in high GDP growth rates, large current account surpluses, relatively low inflation and growing popular confidence in the national currency. In this situation it seemed reasonable to abolish the restriction. However, the first months of 2005 revealed an accumulation of economic risks that makes the decision somewhat more dubious.

The economy is still reacting to the recent political crisis that destabilized the whole economy causing the substantial slowdown of economic growth and accelerating inflation. According to official sources, the decision to liberalize the restrictions will help to curb inflation. However, it is likely to only minimally affect the consumer price dynamics since most hryvnia resources supplied by the NBU into the banking sector in exchange for foreign currency go to enterprises through bank credits with very small amounts eventually appearing on the consumer market. Also, despite the unprecedented current account surplus last year, the on-going oil price increases (the biggest component of Ukraine's imports) together with the planned reduction of import tariffs on many goods may increase the import growth rate. Taking the great dependence of Ukraine's exports on developments in the world metal market into account, the commodity trade balance may turn negative quite quickly. So far, the inflow of funds from exporters has been the major source of foreign currency supply as compared to capital account items, such as FDI or portfolio investments. Should the situation at the external sector change for the worse; exporters may react by postponing exchange operations, which could force the NBU to sell its international reserves. While the current level of reserves may seem sufficient, the panic situation at the cash foreign exchange market at the end of 2004 clearly showed how quickly the NBU reserves might disappear.

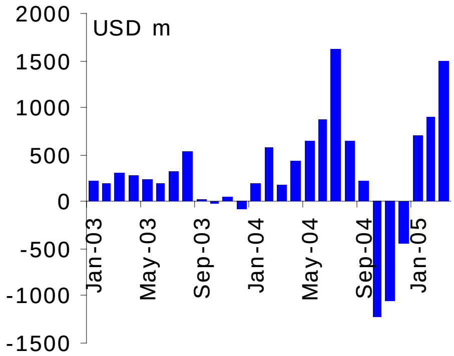
Thus, although liberalizing the foreign exchange market is welcome, it would have been better under the present macroeconomic risk situation to adopt a more gradual approach, for example, by first reducing the limit to 25% and increasing the time period for sale and then waiting for the exporters' reactions before proceeding further.

Volume of Foreign Exchange Market vs. Trade Turnover



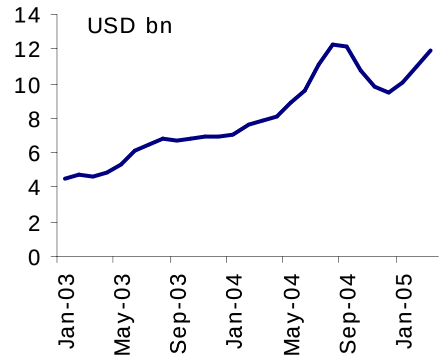
Source: NBU

NBU Interventions at the foreign exchange market



Source: NBU

NBU Gross International Reserves



Source: NBU

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Quarterly Trends

National accounts **		Q3 02	Q4 02	Q1 03	Q2 03	Q3 03	Q4 03	Q1 04	Q2 04	Q3 04	Q4 04
GDP	UAH bn	64.1	63.3	51.5	60.0	75.6	77.1	64.1	78.6	101.0	na
GDP (real)	% yoy	4.3	6.1	8.4	10.0	6.8	12.1	12.3	13.2	14.2	na
Households consumption (real)	% yoy	8.9	11.2	10.2	14.4	11.2	13.6	15.5	16.0	15.6	na
State consumption (real)	% yoy	-18.8	2.9	15.0	17.8	19.2	9.0	-3.6	-2.0	-3.0	na
Gross fixed capital formation (real)	% yoy	3.8	5.7	9.0	20.4	24.3	9.0	23.3	4.3	6.1	na
Exports of goods and services (real)	% yoy	15.3	17.0	9.9	9.8	9.8	11.6	16.5	15.2	6.2	na
Imports of goods and services (real)	% yoy	10.4	6.7	13.8	16.2	17.4	17.7	14.5	7.0	4.3	na
Agriculture, hunting, forestry (real)*	% yoy	2.1	1.3	4.0	-13.7	-22.5	6.7	-4.2	1.2	36.2	na
Manufacturing industry (real)*	% yoy	8.0	11.5	12.0	15.4	23.0	20.1	22.7	15.5	13.8	na
Construction (real)*	% yoy	-1.2	2.7	18.2	24.8	30.9	16.9	29.8	30.6	17.2	na
Trade, repair services (real)*	% yoy	8.8	3.5	7.2	15.1	22.6	29.6	23.5	35.1	3.0	na
Transport (real)*	% yoy	7.9	11.0	10.0	11.5	15.9	11.7	11.0	8.9	11.1	na
Balance of payments											
Current account balance	USD bn	0.8	1.0	1.1	0.7	0.7	0.4	1.6	2.3	1.7	1.2
Current account balance	% of GDP	6.4	7.9	11.2	7.0	5.0	3.0	13.5	15.5	8.8	6.2
Trade balance in goods	USD m	155	225	309	-42	-155	-381	933	1552	774	482
Trade balance in services	USD m	247	382	387	399	362	409	332	153	377	270
Current transfers	USD m	517	520	500	526	574	584	475	758	720	623
Direct investment (FDI)	USD m	156	300	238	454	390	329	334	614	422	345
Portfolio investments	USD m	-592	-520	-825	640	-444	-293	60	-406	781	-511
Gross international reserves	USD bn	4.1	4.4	4.6	6.2	6.7	6.9	7.9	9.6	12.1	9.5
Fiscal indicators											
Consolidated fiscal revenues	% of GDP	28.2	28.1	31.6	31.7	30.1	28.6	27.2	26.9	26.3	25.9
Personal income tax	% of GDP	4.9	4.9	5.7	5.7	5.3	5.1	4.4	4.1	3.8	3.8
Enterprise profits tax	% of GDP	4.1	4.3	5.7	5.1	4.8	5.0	3.9	4.0	4.1	6.1
Value-added tax	% of GDP	6.4	6.1	6.2	6.3	5.8	4.8	6.2	5.7	5.1	4.1
Excise tax	% of GDP	1.9	1.9	2.1	2.2	2.1	2.0	2.1	2.1	2.0	1.8
Consolidated fiscal expenditures	% of GDP	26.4	27.3	27.7	29.2	27.9	28.8	25.3	26.5	26.8	35.2
Current expenditures	% of GDP	na	na	na	26.3	24.2	24.3	22.4	22.7	21.7	27.2
Capital expenditures	% of GDP	na	na	na	3.0	3.7	4.4	2.9	3.8	5.1	8.0
Consolidated fiscal balance	% of GDP	1.7	0.7	3.8	2.5	2.2	-0.2	1.9	0.4	-0.5	-9.3
Privatisation receipts	% of GDP	0.3	0.3	0.6	1.0	1.0	0.8	1.5	3.7	3.5	1.0
Labour market											
Average wage (real)	% yoy	21.2	17.7	12.3	19.1	19.9	14.9	23.0	17.8	13.2	15.3
Household income (real)	% yoy	100.8	65.6	-1.2	8.6	10.0	8.7	15.7	13.0	9.9	16.5
Unemployment rate (ILO methodology)	%	9.2	11.1	9.4	8.8	9.2	9.0	9.7	7.9	6.1	na
Banking system											
Monetary aggregate M0	% yoy cum	46.0	35.8	32.4	37.0	30.5	25.3	29.1	25.6	37.1	27.9
Monetary aggregate M2	% yoy cum	46.5	42.2	47.8	54.6	49.9	47.6	45.4	44.8	51.5	32.3
Household deposits in national currency	% yoy cum	103.6	72.5	73.4	74.7	65.0	66.1	69.4	67.3	67.9	26.2
Household deposits in foreign currency	% yoy cum	55.1	59.3	71.2	70.2	70.4	77.5	67.0	61.7	55.2	54.3
Com. bank credits in national currency	% yoy cum	42.3	54.4	63.7	71.2	73.0	61.7	56.8	52.1	44.3	29.4
Com. bank credits in foreign currency	% yoy cum	37.3	40.3	44.1	48.4	57.7	60.9	63.6	56.2	43.5	32.2
Long-term com. bank credits	% yoy cum	85.8	92.5	110.6	156.4	164.0	157.9	141.7	102.7	82.7	57.1
Long-term com. bank credits	% of total	25.3	28.2	31.3	37.4	40.1	45.0	47.4	49.3	50.9	54.2
Average lending rate on national cur. credits	% p.a.	23.5	21.8	18.0	17.2	17.2	17.7	17.2	16.6	17.0	17.6
Average lending rate on foreign cur. credits	% p.a.	11.9	11.3	12.5	12.6	11.7	10.9	12.2	12.1	12.6	12.2

SOURCES: National Bank of Ukraine, State Committee of Statistics, State Treasury, Ministry of Finance, IER estimates

* change in value added

** preliminary

Notes:

yoy year on year change **p.a.** per annum