

MEMU Supplement No. 09-2005

Is Ukraine on the verge of capital account liberalization?

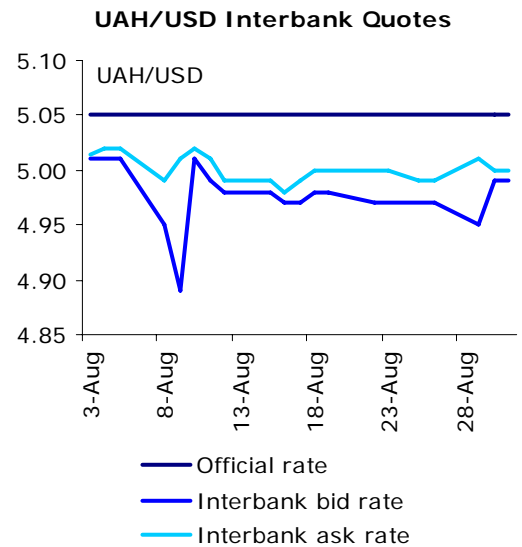
August was marked by turmoil at the foreign exchange market that started with the unexpected decision of the NBU to stop foreign exchange interventions for two days. As a result, bid quotes for hryvnia with respect to the US dollar at the interbank foreign exchange market fell to 4.89 UAH/USD compared to 5.01 UAH/USD two days earlier. Later on the interventions were resumed, although at a lower amount than the excess supply of foreign currency.

The NBU's foreign exchange market conduct, followed by the resignation of its Deputy Head, Serhiy Yaremchenko, strongly raised the expectations among bankers and the general public that the NBU would soon revalue the hryvnia. This expectation was supported by the sharp hryvnia revaluation in April when the hryvnia's value changed by 3.8% in one day after having stayed at an almost constant rate with respect to US dollar for several years. Yet, the revaluation expectation did not materialize. The official exchange rate was kept constant at 5.05 UAH/USD throughout the whole month.

The NBU's decision to reduce its presence at the foreign exchange market can be interpreted in two ways. On the one hand, it could have been a response to the recently resumed calls by some top government officials to continue the hryvnia revaluation in order to curb inflation. But it could also have been a signal for banks and businesses to start accounting for exchange rate risks, which had been neglected during the long constant exchange rate period. The need to account for exchange rate risks takes on special importance in light of capital account liberalization currently being prepared by the NBU.

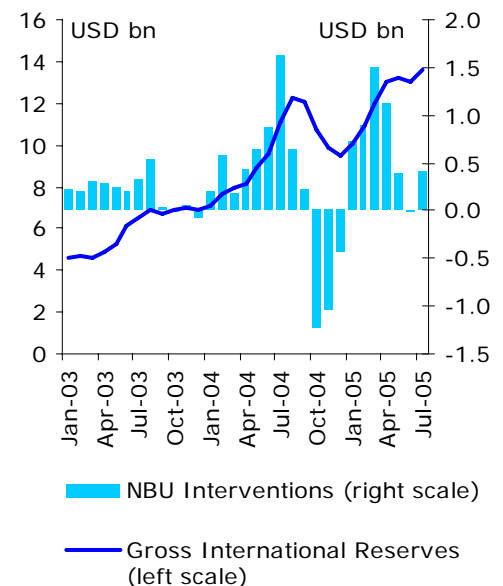
According to NBU officials, some important restrictions on foreign exchange operations will soon be lifted. Among others, the central bank is going to allow certain types of arbitrage operations, e.g. the sale and purchase of the same currency during one trading session, as well as forward operations with the most solid currencies. In addition, the procedure of investing in Ukraine from abroad is going to be substantially simplified. After eliminating the obligatory sale of 50% of the currency receipts in March 2005, this will be the second biggest step towards foreign exchange market liberalization since the 1998 crisis. Yet, it is not likely to significantly change the situation on the foreign exchange market. Although introducing arbitrage and forward operations will undoubtedly be beneficial for banks, which will be able to efficiently satisfy urgent needs for foreign or domestic currency and hedge their currency risks, the 1.5% duty currently levied on all non-cash foreign exchange purchases significantly lowers the attractiveness of these operations. Also, simplifying the foreign investment procedures will not by itself attract foreign capital unless the investment climate too is substantially improved.

Nevertheless, as an improvement in the investment climate is expected soon after the parliamentary elections in the spring of 2006, the need for low cost financing of investments is likely to push the country towards further liberalization of its foreign exchange market and capital accounts. This will increase the volatility of the market, sooner or later confronting the NBU with a dilemma – to lose autonomy of monetary policy or to increase the flexibility of the exchange rate, since according to the well-known “incompatible trinity” concept it is impossible to simultaneously maintain open capital markets, a fixed exchange rate, and the autonomy to use monetary policy to pursue goals for domestic economic activity and price stability. At a certain stage one of the three must be sacrificed. For the Ukrainian economy, which relies heavily on exports, the decision to move towards more flexible exchange rate regime, thus sacrificing the de-facto fixed exchange rate, may strike against repulse of exporters and politicians, despite the fact that having an independent monetary policy is a key long-run tool to pursuing domestic stabilization objectives, especially low inflation.



Sources: NB U, Ukrainian financial server

NBU International Reserves and Interventions at Forex Market



Source: NB U

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Quarterly Trends

National accounts **		Q1 03	Q2 03	Q3 03	Q4 03	Q1 04	Q2 04	Q3 04	Q4 04	Q1 05	Q2 05
GDP	UAH bn	51.5	60.0	75.6	77.1	64.7	79.0	100.5	100.6	82.5	-
GDP (real)	% yoy	8.4	10.0	6.8	12.1	12.7	13.7	14.0	8.5	5.0	-
Households consumption (real)	% yoy	10.2	14.4	11.2	13.6	14.6	16.8	13.1	16.2	16.4	-
State consumption (real)	% yoy	15.0	17.8	19.2	9.0	3.3	1.0	5.0	10.1	5.2	-
Gross fixed capital formation (real)	% yoy	9.0	20.4	24.3	9.0	18.4	6.5	4.6	12.9	-2.6	-
Exports of goods and services (real)	% yoy	9.9	9.8	9.8	11.6	18.1	19.9	10.5	8.6	0.1	-
Imports of goods and services (real)	% yoy	13.8	16.2	17.4	17.7	13.8	7.3	6.7	7.8	6.6	-
Agriculture, hunting, forestry (real)*	% yoy	4.0	-13.7	-22.5	6.7	-4.4	0.9	35.7	9.9	5.9	-
Manufacturing industry (real)*	% yoy	12.0	15.4	23.0	20.1	23.9	16.3	12.5	9.4	7.8	-
Construction (real)*	% yoy	18.2	24.8	30.9	16.9	29.9	30.6	16.4	3.9	-5.9	-
Trade, repair services (real)*	% yoy	7.2	15.1	22.6	29.6	23.6	35.0	2.7	13.7	-1.5	-
Transport (real)*	% yoy	10.0	11.5	15.9	11.7	10.1	8.0	12.3	10.5	7.3	-
Balance of payments											
Current account balance	USD bn	1.1	0.7	0.7	0.4	1.6	2.3	1.7	1.2	1.7	-
Current account balance	% of GDP	11.2	7.0	5.0	3.0	13.5	15.5	8.8	6.2	10.8	-
Trade balance in goods	USD m	309	-42	-155	-381	933	1552	774	482	1051	-
Trade balance in services	USD m	387	399	362	409	332	153	377	270	257	-
Current transfers	USD m	500	526	574	584	475	758	720	623	624	-
Direct investment (FDI)	USD m	238	454	390	329	334	614	422	345	231	-
Portfolio investments	USD m	-825	640	-444	-293	60	-406	781	-511	-114	-
Gross international reserves	USD bn	4.6	6.2	6.7	6.9	7.9	9.6	12.1	9.5	13.1	-
Fiscal indicators											
Consolidated fiscal revenues	% of GDP	31.6	31.7	30.1	28.6	27.2	26.9	26.3	25.9	32.1	35.1
Personal income tax	% of GDP	5.7	5.7	5.3	5.1	4.4	4.1	3.8	3.8	4.3	4.4
Enterprise profits tax	% of GDP	5.7	5.1	4.8	5.0	3.9	4.0	4.1	6.1	4.8	5.9
Value-added tax	% of GDP	6.2	6.3	5.8	4.8	6.2	5.7	5.1	4.1	8.6	9.2
Excise tax	% of GDP	2.1	2.2	2.1	2.0	2.1	2.1	2.0	1.8	2.0	2.0
Consolidated fiscal expenditures	% of GDP	27.7	29.2	27.9	28.8	25.3	26.5	26.8	35.2	28.3	36.4
Current expenditures	% of GDP	na	26.3	24.2	24.3	22.4	22.7	21.7	27.2	26.5	33.6
Capital expenditures	% of GDP	na	3.0	3.7	4.4	2.9	3.8	5.1	8.0	1.8	2.7
Consolidated fiscal balance	% of GDP	3.8	2.5	2.2	-0.2	1.9	0.4	-0.5	-9.3	3.7	1.0
Privatisation receipts	% of GDP	0.6	1.0	1.0	0.8	1.5	3.7	3.5	1.0	0.2	0.6
Labour market											
Average wage (real)	% yoy	12.3	19.1	19.9	14.9	19.9	18.6	14.7	15.4	15.0	19.0
Household income (real)	% yoy	-1.2	8.6	10.0	8.7	11.7	16.3	11.3	16.6	24.0	28.0
Unemployment rate (ILO methodology)	%	9.4	8.8	9.2	9.0	9.3	8.3	8.1	8.7	8.7	-
Banking system											
Monetary aggregate M0	% yoy cum	32.4	37.0	30.5	25.3	29.1	25.6	37.1	27.9	28.2	39.1
Monetary aggregate M2	% yoy cum	47.8	54.6	49.9	47.6	45.4	44.8	51.5	32.3	38.9	-
Household deposits in national currency	% yoy cum	73.4	74.7	65.0	66.1	69.4	67.3	67.9	26.2	28.3	31.6
Household deposits in foreign currency	% yoy cum	71.2	70.2	70.4	77.5	67.0	61.7	55.2	54.3	51.8	45.4
Com. bank credits in national currency	% yoy cum	63.7	71.2	73.0	61.7	56.8	52.1	44.3	29.4	28.3	32.6
Com. bank credits in foreign currency	% yoy cum	44.1	48.4	57.7	60.9	63.6	56.2	43.5	32.2	33.1	36.8
Long-term com. bank credits	% yoy cum	110.6	156.4	164.0	157.9	141.7	102.7	82.7	57.1	49.5	-
Long-term com. bank credits	% of total	31.3	37.4	40.1	45.0	47.4	49.3	50.9	54.2	54.4	-
Average lending rate on national cur. credits	% p.a.	18.0	17.2	17.2	17.7	17.2	16.6	17.0	17.6	17.0	15.4
Average lending rate on foreign cur. credits	% p.a.	12.5	12.6	11.7	10.9	12.2	12.1	12.6	12.2	12.1	11.0

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