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S9

The NBU decree on long-term refinancing: Good intention, questionable approach

Summary

High interest rates for credits represent one of the major impediments for real investment and sustainable economic growth in Ukraine. A new decree[1] intends to ameliorate this situation by allocating cheap, long-term NBU credits to commercial banks, which must redirect these funds to enterprises for investment purposes exclusively.

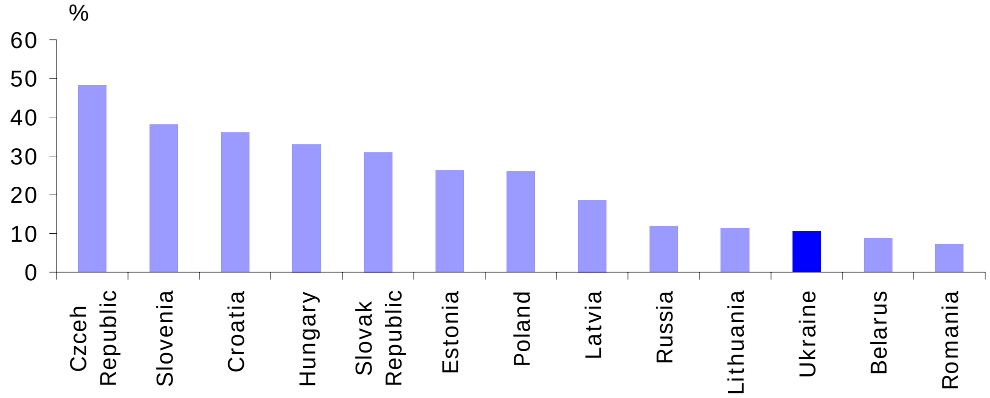
The government has been the main driving force behind this decree. This fact is important, because the decree implies significant money creation. The causal link between government and money creation is likely to produce negative expectations regarding future inflation and exchange rate stability. In this way, the decree could contribute to higher interest rates for long-term hryvnia credits and to lower investment, which is exactly the opposite of its intention. For this and further reasons we strongly advice the Ukrainian government and the NBU to abolish this decree as soon as possible.

1. Objectives of the decree: Lower interest rates, higher investment

The level of financial inter-mediation is very low in Ukraine. Figure 1 presents the claims of commercial banks on the private sector as a fraction of GDP for selected countries of central and eastern Europe. As can be seen, Ukraine has one of the lowest levels of banking inter-mediation.

[1] See NBU decree ("postanova") No. 283 of 2 August 2002 "On the procedure of the NBU crediting (refinancing) of banks extending long-term loans", which came into effect on 20 August 2002.

Figure 1.
Claims of commercial banks on the private sector as a percentage of GDP, selected countries (2000)



Sources: IFS, State Statistics Committee of Ukraine, State Statistics Committee of the Russian Federation, own calculations.

In addition, the term structure of loans is far from perfect in Ukraine. Only about one fifth of all loans to the private sector are long-term, that is with a maturity of over one year.

Furthermore, during periods of transition and economic recovery enterprises usually need additional resources to introduce new technology, renovate equipment and restructure their production processes. In this respect, the ability of the banking system to provide cheap long-term credits for investment purposes is of particular importance for the successful development of enterprises. However, in Ukraine the volume of long-term credits for *investment purposes* constitutes only 3.5%[2] of all credits. The low level of investment in general, and of investment into new and innovative sectors of the economy in particular, hinders sustainable economic growth and thus should be seriously tackled by economic policy.

The new NBU decree intends to tackle this low volume problem of long-term investment credits by enabling banks to charge lower interest rates for such credits. Since high interest rates are undoubtedly one of the major reasons for the low level of credits for investment activities[3], this objective makes much sense. Thus the decree envisages the allocation of long-term (up to 3 years) NBU refinancing credits to commercial banks. Commercial banks are to use these loans exclusively to finance long-term innovative investment projects approved by the NBU. The loans must also be secured by the banks' fixed assets or by government securities. The interest rate that banks pay for these refinancing loans is legislated to equal the discount rate (8% per year at present).

[2] As of the end of June 2002. *Source: Bulletin No. 6/2002 of the National Bank, own calculations.*

[3] Most certainly, there are other important reasons as well, such as the high level of enterprise insolvency and shortcomings in the Ukrainian legislation concerning bankruptcy procedures, which make investment crediting extremely risky for commercial banks. However, these factors have little to do with the decree and, thus, are beyond the scope of our analysis.

2. The problem of high interest rates: Causes and solutions

In order to analyse the effect of this decree on interest rates and on investment, we must look at why the interest rates for investment projects are so high in the first place, and then try to define a suitable approach for lowering these rates. We will only use data on long-term credits, since investment projects require long-term funding.

Why are the interest rates for long-term *hryvnia* credits so high?

On average, Ukrainian borrowers pay an average 20.1% annual interest for long-term credits in hryvnia. Interestingly enough, the corresponding figure for foreign currency credits is only 14.4%. This significant disparity can be explained by different costs for refinancing these credits. Commercial banks have to pay to Ukrainian depositors an average 21.3%[4] for long-term deposits in hryvnia, but only 9.6% for such deposits in foreign currency.[5]

Why are interest rates for long-term *hryvnia* deposits so high?

The reason behind this large disparity between interest rates for long-term deposits is the uncertainty of Ukrainian depositors about future inflation and exchange rate developments in their country. In other words, this significant spread reflects a lack of confidence in the national currency. This in its turn can be explained by Ukraine's monetary history since independence (hyperinflation and sudden devaluations of the hryvnia), but also by the potential - and to most people unclear - influence of the government on future central bank decisions, on money creation and on inflation.

What should be done to lower interest rates for investment?

The problem of a lack of confidence in the national currency can only be solved with a long-term strategy. The central bank and the government need to prove their ability to maintain price and exchange rate stability. They must convince the public by the means of facts and words that monetary stability is at the top of their economic agenda and will remain there.

During the last two years or so the NBU has successfully followed a long-term strategy towards monetary stability. This policy has already shown impressive results. The financing cost of investment has decreased significantly: Long-term interest rates for hryvnia credits went down from around 60% at the start of the year 2000 to slightly over 20% currently (see Figure 2).

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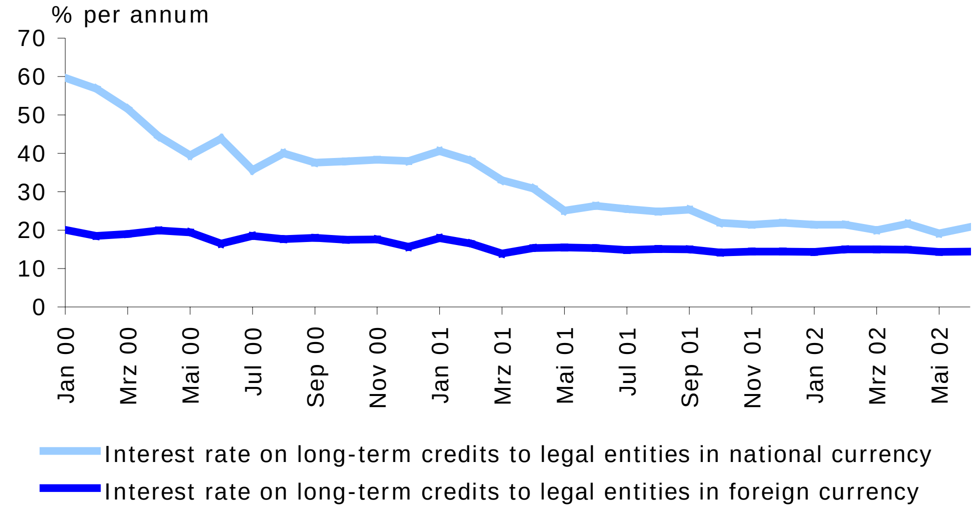
[4] The explanation of a higher average interest rate for long-term hryvnia deposits (21.3%) than for credits (20.1%) requires further investigation, which is beyond the scope of this paper.

[5] Interest rates are calculated as weighted averages for households and legal entities resting on NBU data.

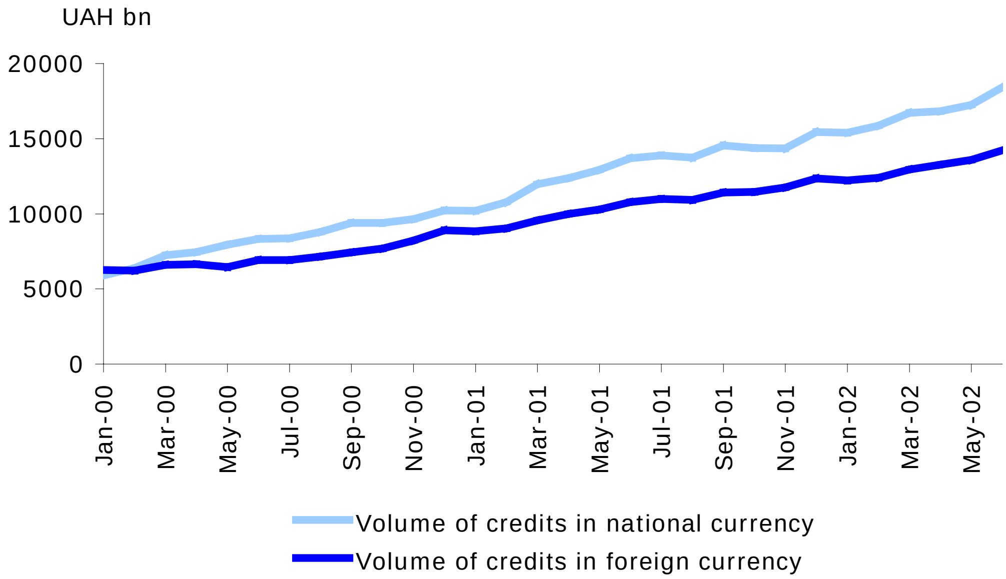
Figure 2.
Interest rates on long-term credits in national and foreign currency



Source: NBU

Furthermore, the banking sector strongly expanded, as can be seen in the huge increase in credit volume since the start of 2000 (see Figure 3). The fact that hryvnia credits grew more than credits in foreign currency is a further indication that the NBU's policy has led to increased confidence in the national currency.

Figure 3.
Bank credits in national and foreign currency



Source: NBU

In addition, the term structure of loans has been steadily rising over the last two years or so. The share of long-term loans in total loans has increased from 17.8% in the year 2000 to 23% in June of this year.

Thus, the solution to the problem of high interest rates for long-term hryvnia credits has already been found and successfully implemented by the National Bank. The way ahead is clear and simple: Let the NBU continue pursuing its remarkably successful policy.[6] Needless to say, the more independent the NBU is, the better it will be able to further contribute to lower interest rates and to higher investment in Ukraine.

3. Likely effects of the decree: Higher interest rates, lower investment

The government actively participated in the adoption of the NBU decree No. 283. Moreover, it is also involved in finding and selecting innovative investment projects, which would be eligible for NBU credits within the framework of this decree. That means the government plays a major role in this program.

Government programs involving cheap loans to enterprises that have been selected on the basis of objective criteria are common in western economies. But these programs are financed either by public revenues or by government debt. They are definitely not financed by money printing, as is the case in the "government" program behind the decree No. 283.[7] The reason for this is quite simple. Governments that are allowed to finance their programs by printing money tend to abuse - especially in times of budgetary problems - this source of finance and thus cause high inflation[8], which is bad for the economy.

The amount of money creation and the inflationary impact induced by the decree cannot be properly estimated, because neither the total amount of credits nor the duration of this program has been specified in the decree.[9] But the quantitative impact on inflation of *this* decree should not be at the center of the discussion. Much more important is the fact that the government has - for the first time since the prohibition of NBU credits to the government in 1999 - recur to money printing as a source of finance. This may be interpreted by the public as just the first step in a series of government inspired money printing, especially given the current budgetary problems and the various (overly) ambitious support programs for which no public financing is available.[10]

This link between government and money creation is likely to worsen expectations of depositors with respect to inflation and to the exchange rate.

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[6] Improvements in the deposit insurance system, in banking supervision and in the leasing legislation would also contribute to an increase in financing of investment projects in Ukraine.

[7] Credits by the NBU or by any other central bank are equivalent to money creation.

[8] The large increase in money demand in Ukraine during the last year or so has enabled the NBU to increase money supply significantly, without causing inflation. But this fortunate and non-permanent situation does not mean there is no link between money supply and inflation in Ukraine.

[9] The unofficial number of UAH 3 bn amounts to about 10% of the monetary base.

[10] See for example the program for supporting the grain market, which was discussed by us in policy paper S6. Another example is the expensive plan by the Ministry of Industry for supporting the metallurgical sector.

Therefore, depositors in Ukraine may well ask for higher interest rates for their hryvnia deposits, especially the long-term ones. This in turn would increase the refinancing costs of commercial banks and contribute to higher long-term hryvnia interest rates in Ukraine. Thus, the decree No. 283 could contribute indirectly to higher interest rates for investment credits and consequently to less investment, which is exactly the opposite of its intention.

4. Further negative effects of the decree

Lower quality of investment

According to the decree, the state will have a final say in the allocation of cheap credits to enterprises. This may lead to investment decisions based on political, and not on economic grounds. In other words, the funds may not flow to the most profitable (i.e. productive) investment projects, and the quality of many investments might be rather poor.[11] Consequently, the effect of the investment induced by this decree on economic growth might be rather limited.

Segmentation of the credit market and unfair competition

Due to the decree the credit market will be split into two segments. "Lucky" enterprises that receive cheap state loans will constitute one segment, and the "unlucky" ones that have to pay even higher interest rates than before will be part of the other. The "lucky" enterprises will enjoy lower credit costs and get a competitive advantage over the "unlucky" ones, without being necessarily more efficient. The artificial segmentation of the credit market produced by this decree leads to unfair competition and to the allocation of economic resources to inefficient enterprises, impeding overall economic growth.[12]

High administrative cost

The administrative costs of this decree will be quite high. The proofing of credit applications from commercial banks will involve many parts of the NBU, such as its territorial branches, the department for monetary policy, the general department for banking supervision and the Board.[13] Valuable resources (especially manpower) might thus be diverted from really important and necessary central bank functions, such as banking supervision.

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[11] As a further result, some of these credits might become "bad debts" of commercial banks and weaken the banking system in Ukraine. Furthermore, if Ukrainian banks identify the government as the main culprit for these bad debts, claims on public finances might arise, which would further add to the current budgetary problems of the Ukrainian government.

[12] Furthermore, the described segmentation of the credit market will intensify “rent seeking” activities by enterprises and lead to a waste of economic resources and to less economic growth.

[13] The application procedures for obtaining long-term loans from the NBU are described in part II of the decree.

Negative effect on investment decisions

Decisions on real investment do not only depend on interest rates, but also on expectations about future economic policy. The decree will have a negative effect on these expectations for two reasons. First, the decree violates in spirit, if not in words, the prohibition of credits from the NBU to the government. Investors might get the impression that the state does not obey its own laws. Second, this decree might be interpreted by investors as a measure of central planning, which shows some distrust of the state in the principles of market economies. For both these reasons, investment might decrease, quite independently from the level of interest rates.

5. Conclusions

One of the big success stories of Ukrainian policy since the crisis in 1998 has been its monetary and exchange rate policy. The wise policy of the National Bank has contributed to price and exchange rate stability in Ukraine. These achievements have positively influenced expectations in respect to the hryvnia. As a consequence, hryvnia credits and deposits grew stronger than the ones in foreign currencies, interest rates came down and lending increased significantly, contributing to investment and economic growth. This success story does not mean that one should be satisfied with the current situation in Ukraine. Actually, it is far from perfect. But in respect to monetary and banking policy, Ukraine is on the right track, which is the most important thing.

Decree No. 283 stands in sharp contradiction to this sensible policy of the past two years or so. In economic terms, it amounts to money creation by the government in times of budgetary problems and of (over)ambitious support policies. As a result, it might induce negative expectations towards the hryvnia and decrease the reputation of the NBU. Instead of lowering interest rates and fostering investment, it may very well contribute to higher interest rates and to lower investment.

Furthermore, it may induce investments of low quality and increase the commercial banks' level of "bad debt", lead to unfair competition, intensify "rent seeking" activities and corruption, increase administrative costs, destabilize the banking sector and negatively effect those investment projects, which are not particularly sensitive to interest rate levels.

For all these reasons we strongly advise the Ukrainian government and the NBU to abolish this decree and to avoid passing similar legislation in the future.

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