UKRAINE'S MONETARY AND EXCHANGE POLICIES IN THE CONTEXT OF THE ECONOMIC AND FINANCIAL CRISIS

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Abstract

In order to understand the peculiarities of Ukraine's monetary and exchange policies relative to the 2008-2009 crisis, one should refer to the period following this country's outcome of the previous crisis of 1998-1999. That comparatively distant past has a direct relation to what is happening during the present crisis and, without such a retrospective reference, any modern assessments would be a bit unilateral.

Keywords: financial crisis, inflation, exchange rate, economic policy.

JEL Classification: E_{52}, E_{63}, G_{01}.

The financial crisis of 1998-1999 whose main peculiarity in Ukraine was the government's excessive activities on the market of domestic borrowing to finance the budget ended, as is usual in such cases, with an economic decline, devaluation of the national currency, and flight of the non-residents which had bought the government's securities, and, as a result, with a creation of a certain reserve of price competitiveness of Ukraine's economy. Using the favorable foreign conjuncture, as well as the idle capacities released during the previous transformational recession, Ukraine's economy, with the above mentioned price-competitiveness reserve, started a period of a solid (over 7% on average) growth that continued until mid-2008. As shown in Table 1, during that period, annual increase in money supply exceeded 40% on average, though with some exceptions (in 2004, in 2006 and in 2008).

Table 1.

Increase in money supply and inflation in Ukraine's economy in 2000-2009

	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009- (January-April)**
Growth rates of money supply, as % to previous year	46,1	41,9	41,8	46,5	32,4	54,3	34,5	51,7	29,9	-9,9
Growth rates of consumer prices in %	25,8	6,1	-0,6	8,2	12,3	10,3	11,6	16,6	22,3	6,9

Source: official site of the National Bank of Ukraine (www.bank.gov.ua)

The period of 2000-2008 can be divided into two sub-periods, namely 2000-2003 or the first 4 years with a quite low inflation and very high rate of money supply, and the second one or the following 4 years when the rates of money supply remained quite high. Especially high they were in 2005 and 2007 (over 50%) with a gradual decrease to 30% in 2008. However, the second period is characterized with a high inflation whose rate was never lower than 10,3% peaking in 2007 (16,6%) and in 2008 (22,3%).

What else was characteristic for all those years?

First of all, it is the fact that average weighted refinancing rate of the National Bank of Ukraine decreased to reach its minimum in 2007 (10,1%), and, correspondingly, a quite high rate of economic crediting was observed. While, in 2004, its amount was 25,7% of GDP, then, as early as in 2007, that indicator reached 59,9%. In the process, as suggested by data in Figure 1, the rate of credits granted to physical persons was also quite high which could not but push the rates of inflation towards increase.

Figure 1 shows two quite distinct waves of increase in such credits: in 2000-2003, and then, after a certain slow-down of their rate from 271% in 2003 to 165% in 2004 (which was most likely a result of the high base of 2003), another increase began ending in another decline of that indicator after 2008 when the threat of the crisis became quite real. The crisis was predicted by the author as early as in 2006, about which he warned in his publications, including in mass media.

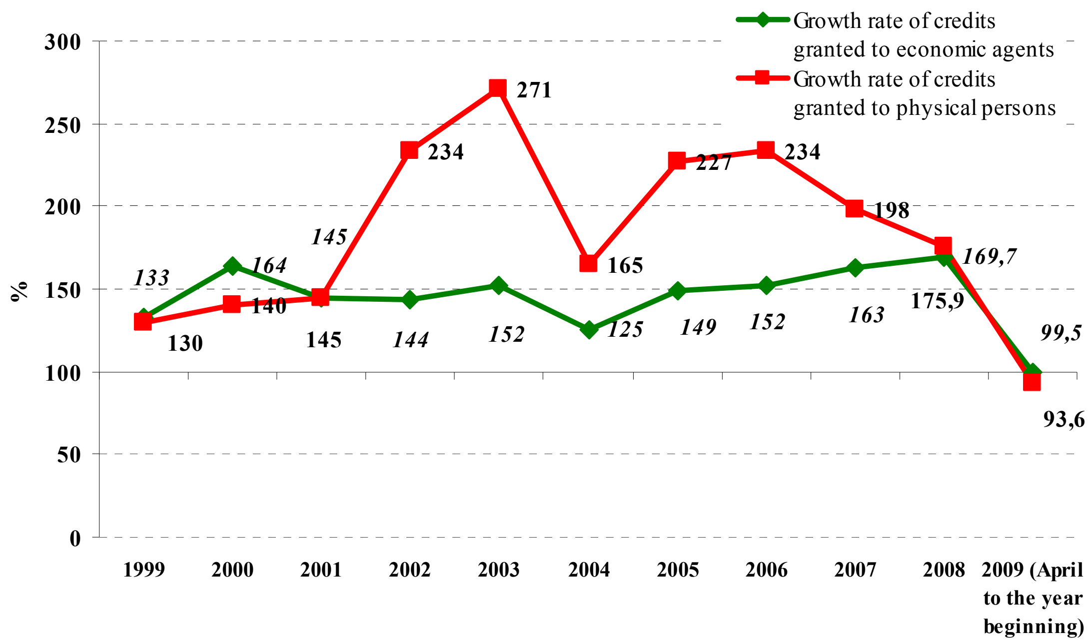

Fig. 1. Dynamic of crediting economic agents and physical persons

Source: official site of the National Bank of Ukraine (www.bank.gov.ua)

However, the rush for profit and the aspirations to earn on the policy of the growth of people's incomes provoked by the increase in social payments from the government's budget both prevented the above mentioned process from stopping.

The governments of that time reported economic growth and increase in people's incomes, the businessmen earned high incomes (especially in the banking sector) and the fear to lose part of the credit market prevented them from restricting their activities even when they faced a real threat of destabilization.

The credits granted to physical persons were consumer ones, which greatly aggravated the situation against the background of the financial (and consequently economic) crisis of 2008. Table 2 and its graphic interpretation in Figure 2 suggest that, during 1999-2000, accrued index of nominal exchange rate was almost 300% (relative to late 1997), while producers' and consumers' price indexes were only 189,1% and 174,2%, which caused an increase in price competitiveness of Ukraine's economy at the expense of the devaluation of the hryvnia from the 1997 level (taken as 100%) to 221,3% in 1999 and 292,2% in 2000.

Table 2.

Accrued dynamics of exchange rate (Hrn/USD) and inflation in 1998 – April 2009

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009 (April)
Nominal exchange rate index	180,5	274,7	286,2	279,0	280,8	280,8	279,4	265,9	265,9	265,9	405,5	405,5
Consumer price index	120,0	143,0	179,9	190,9	189,8	205,3	230,6	254,3	283,8	316,8	387,4	414,2
Industrial producer price index	135,3	156,5	189,1	190,8	201,7	224,1	278,1	304,5	347,4	428,4	527,1	545,5

(in %; 31.12.1997 = 100%)

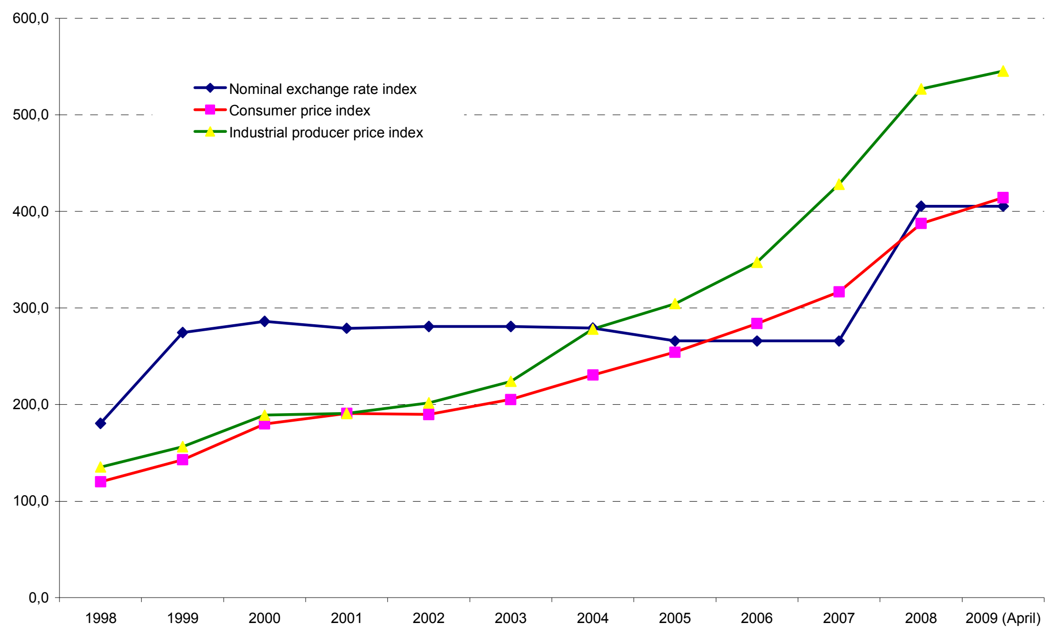

Fig. 2. Accrued dynamics of exchange rate (Hrn/USD) and inflation in 1998 – April 2009

Source: calculated on the data of the official sites of Ukraine's State Committee of Statistics (http://www.ukrstat.gov.ua) and the National Bank of Ukraine (www.bank.gov.ua)

In what followed, as suggested by Table 2, annual rates of industrial producers' price index and those of consumer price index exceeded the pace of nominal exchange rate. Industrial producers' price index outstripped that of nominal exchange rate as early as in

2005, and consumer price index did so in 2006. As suggested by Table 3 and Figure 3, beginning with 2000 and practically all the time until October 2008, index of nominal exchange rate was negative, which reduced the reserve of price competitiveness of Ukraine's economy (which remained only thanks to the depreciation of the dollar against euro). In their turn, domestic prices grew, which made it possible for the importers and foreign producers to have a good earn on the combined effect of the above mentioned factors.

Beginning from late 2008, the situation began to change. Index of minimum exchange rate in 2008 and especially until April 2009 increased and, (during 4 months) outstripped the index of consumer prices and that of industrial producers as % to previous year. In 2009, accrued dynamics of the index of nominal exchange rate practically caught up with that of consumer prices, but is lagging much behind that of industrial producer prices. The latter gap is quite considerable (140 pcp), which leaves practically no room for supporting price competitiveness of the national industrial producers. In this case, in near future, one should expect growth of industrial imports. And such cases are already taking place. Thus, due to the high domestic prices for metallurgy items, (which according to statistics, exceeds the import ones by 50-100 USD), in I quarter of 2009, purchases of metallurgy produce abroad were already registered, partly caused by the fact that, on the world markets, the prices for metal items declined. And in Ukraine industrial prices keep growing (see Table 2 and Figure 2), while the decrease in industrial output has accelerated.

Table 3.

Dynamics of exchange rate (Hrn/USD) and inflation in 1997-2009

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009 (April)
Index of nominal exchange rate (annual average)	101,8	131,6	168,6	131,7	98,7	99,2	100,1	99,7	96,3	98,5	100,0	104,3	152,5
Index of consumer prices (as % to previous year)	115,9	110,6	122,7	128,2	112,0	100,8	105,2	109,0	113,5	109,1	112,8	125,2	119,1
Index of industrial producer price (% to previous year)	107,7	113,2	131,1	120,8	108,7	103,0	107,6	120,5	116,7	109,6	119,5	135,5	114,3

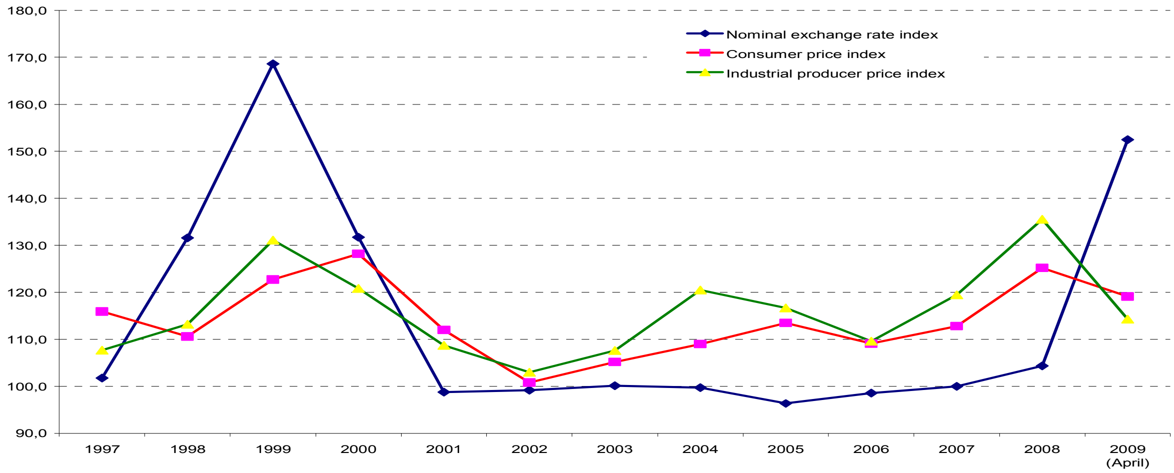

Fig. 3. Dynamics of exchange rate (Hrn/USD) and inflation in 1997-2009

Source: calculated on the data of the official sites of Ukraine's State Committee of Statistics (http://www.ukrstat.gov.ua) and the National bank of Ukraine (www.bank.gov.ua)

The results of the calculations made at the Institute for Economics and Forecasting, Ukrainian NAS (see Figure 4), suggest that, already from late 2003 and mainly from 2004 on, inflation was the essential cause of the decrease in the price competitiveness of Ukraine's economy. In April 2009, the inflationary component caused a 41,9% decline in the price competitiveness, while the exchange-rate one caused this indicator's 49,3% increase, which reflected the depreciation of the dollar during the period of observation.

Thus quite logical is the question whether the conducted monetary policy was a result of the price increase, which aggravated the condition of Ukraine's economy in the second half of 2008 and in 2009, when the tendencies of decline in industrial output and GDP became acute and obvious with the latter indicator in the first quarter of 2009 lower than in the same period of previous year by more than 20%.

Before the beginning of the world financial crisis, Ukraine's financial condition was very unstable, because the dynamics of money supply in both considered periods was approximately by 80-90% determined by the purchase of foreign currency by the National Bank of Ukraine. But the underlying tendencies were different. While in 2000-2003 export revenues exceeded imports, and current account indicators in the balance of payments testified about an increase in the foreign currency reserves, then in 2004 several decisions were taken, which, preserving the previous predominant mechanism of money supply formation, completely changed, in the following years, its internal character.

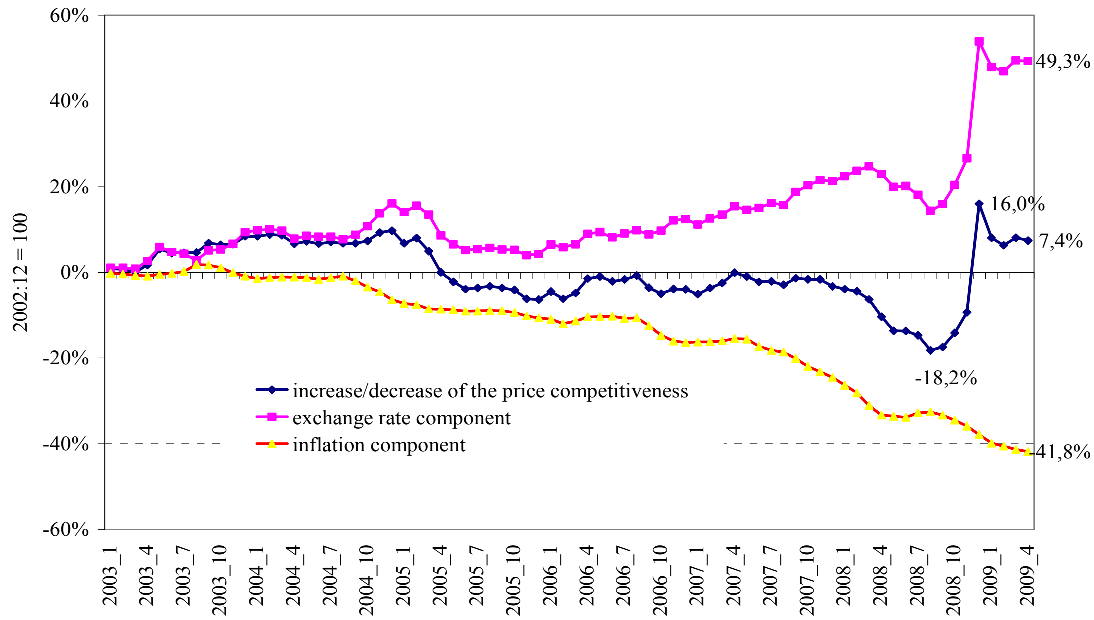

Fig. 4. Dynamics of price competitiveness with a breakdown by separate components

Source: data provided by Ukraine's Derzhkomstat (Central Statistical Office), other statistical offices and central banks of Ukraine's main trade partners

In Ukraine, the year 2004 was a year of presidential election. The struggle for the votes determined the realization of the well known in economic theory and practice so called political cycle in economic policy. It was initiated with the decision to raise the pensions which were lower than subsistence level (that applied to all disabled persons). That measure caused a more than three-fold rise in nominal pensions and misbalance of the pension fund. That very year also saw an unjustifiedly great rise in average monthly wages. Figure 5 shows that, for example, in 2004, the increase in average monthly wages in the industry exceeded that of productivity by 13,4 pcp.

That was a turning point both in pension and wage policies. Its results immediately affected the inflation rates. After three years (2001-2003) of relative stability in industrial producers' prices, in 2004, they increased by 20,5%, and CPI reached 109,0% (see Table 3 and Figure 3). At the same time, in that year, other negative macroeconomic results were still absent, because the current account was positive in the amount of 7 bln. USD, (which was very important for the economy), 2,4 times as much as in the quite successful year of 2003 and 2,2 times more than in the no less successful year of 2002. And the rise in the negative financial account balance (7,3 times in 2004 as compared to 2003), was explained first of all by a certain political instability, which appeared during the election of the President of Ukraine.

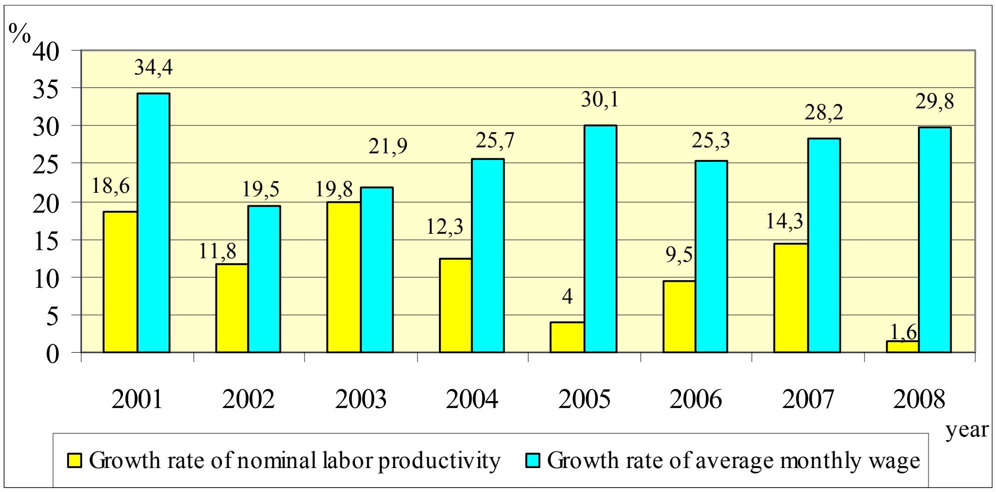

Fig. 5. Dynamics of the increase in productivity and average wages in Ukraine's industry in 2001-2008 (as % to previous year)

Source: data by Ukraine's Derzhkomstat

In 2005, the macroeconomic situation abruptly aggravated. The price rise in 2004 and 2005-2008 forms in Ukraine an environment of constantly growing demand, which, as early as in 2005, became impossible to satisfy with domestic economic capacities alone, because the domestic reserves were exhausted. A rapid growth of imports began favored both by the decrease in the level of tariff protection of Ukraine's territory and by the 3,8% revaluation of the national currency unit by the National Bank of Ukraine in April 2005, which was first of all caused by the inflow of foreign currency as a result of the policy of foreign borrowing conducted by both corporative and the banking sectors. As a result, the foreign trade balance on goods and services declined by more than 7,4 bln. USD. However, as this country's financial account, after several years of negative values, became positive in the amount of almost 8,2 bln. USD, the government managed to maintain a stable balance of payments. Such a change in the tendencies was very significant at that time due to the following reasons: *First*, economic agents (corporations) and private banks began to try to earn as much as possible on the price rise on the domestic market. At the same time, they were the very entities who were destroying that market with their actions, because they pumped it with increasingly greater amounts of exported goods and borrowed financial resources.

Secondly, the share of foreign capital in this country's banking system abruptly increased. In 2005, the share of foreign capital in the banks' authorized capital more than doubled, and by early 2007 it reached 37,2% meaning an almost four-fold increase in somewhat more than 5 years (See Figure 6).

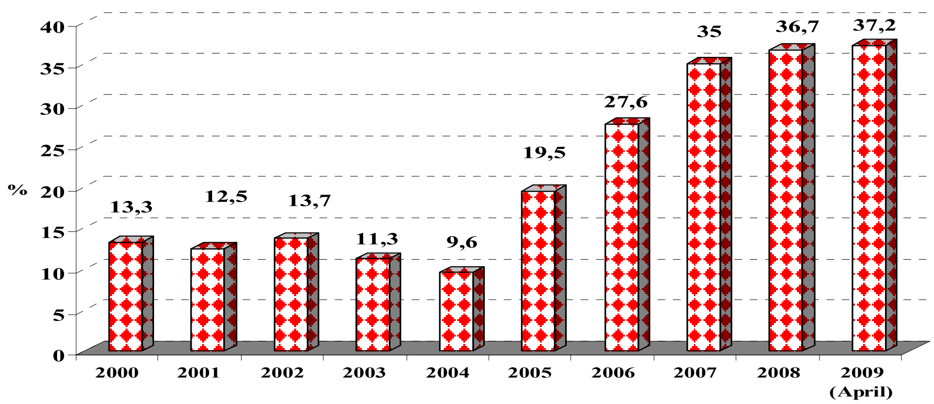

Fig. 6. The share of foreign capital in authorized capital of Ukraine's banking system (%)
Source: data by the official site of the National Bank of Ukraine (www.bank.gov.ua)

Thus, the world financial system expanded its influence over Ukraine both by crediting the national financial institutions and by way of acquisitions of Ukrainian private banks by foreign banks (so called "mother banks"). The latter contributed to the expansion of crediting the households (first of all consumer crediting) and earned in so doing on the increase in the households' incomes due to the rise in pension, benefits, scholarships and salaries in the government-funded sector and the unjustified rise in wages in the real sector. The latter was, to a certain extent, a reaction to the income increase in the budget funded sector.

Thirdly, Ukraine, due to the political cycle in its economic policy, which started in 2004, beginning with 2005, again got into the trap of foreign borrowing, which determined both the dynamics of the generation of money supply including aspects of both monetary and exchange-rate policies of that periods. The resources for such borrowing were exhausted both due to domestic reasons (because, already in 2007, this country's foreign debt reached an amount close to 60% of its GDP (the level which has often caused crises in other countries), and, due to external conditions, because the world financial crisis caused a shortage of financial resources both for the present and for the future (While money supply in the world economy is growing and will keep growing, it will, most likely, have a different origin, despite the fact that so far the essence of the functioning of the world financial system remains unchanged). However, due to the decision by the USA government, that in essence lifts the restrictions on the growth of money supply, the status quo may hold. As the resources of the world financial system will be directed, first of all, to improving the condition of the developed economies, here one should make a different conclusion.

Fourthly, during the crisis and after it, for Ukraine, as for many other developing markets, external sources of financing will be quite restricted and more expensive. That is demonstrated by both the efforts of the local branches of foreign financial institutions to carry their money out of Ukraine, and the desire of the foreign creditors to get back their money on the debts at least at the established date, as well as the actions of those investors who consider it necessary to carry out their profits from previous investments without re-investing them during the next two years due to the political crisis with unknown outcome. The volumes of such resources are quite sizable, and so are Ukraine's debts on energy materials, which testifies about a real crisis of this country's balance of payments. That is why, with the simultaneous efforts made by many economic agents and some businesses from the financial sector to carry their resources abroad, there are not so much reserves left to maintain the balance of payments. And it is obvious that, without lowering the exchange rate of the national currency, it would be very difficult to re-establish it. (On the other hand, the beginning with early 2009 consolidation of real effective exchange rate due to the considerable inflow of foreign currency after the IMF loans, as well as various administrative measures taken by the National Bank of Ukraine will again promote increase in the deficit of the current account and, in the future, that of the capital account of the balance of payments. In is quite possible, that such developments, in 2- 3 years, will provoke a new threat of balance-of-payments crisis and another debt trap for this country making the post-crisis growth a temporary process of just several years. However, such a conclusion requires a more detailed and consistent retrospective consideration). For now, the policy conducted by Ukraine's current executive authorities, fails to promote macroeconomic stability, which has been also the case during several previous years.

The governments substituting each other during 2004-2008 never abandoned the political cycle in their economic policy, because the permanent elections and struggle for votes never ceased. From year to year, the growth of wages exceeded that of productivity and, naturally, that of GDP. As a result, the current account of the balance of payments became negative as early as in 2006 (-1,6 bln. USD), and in 2007 its deficit reached almost -5,9 bln. USD, being the balance of goods and services already at -7,9 bln. USD. In 2008, its negative amount exceeded -10 bln. USD. In the previous years of the above mentioned period, that deficit was covered by the positive balance of this country's financial account, which, in 2006, amounted to 3,9 bln. USD and in 2007 – to 15,7 bln. USD. Finally, by 2008, Ukraine's foreign debt amounted to 100 bln. USD, which approached the critical threshold, being its future repayment increasingly difficult, especially after the considerable devaluation. *As a result, this country's foreign debt exceeded 90% of GDP which has led to the expected GDP decline of 13-15% in 2009.*

One can safely state that the economic policy of 2004-2008 was extremely dangerous, but, probably, it would have ensured a relative stability during the whole of 2008, because, even in mid 2008, the inflow of foreign capital to Ukraine was quire considerable. But the latter fact provoked the National Bank of Ukraine to carry out another, almost 5%, revaluation of the national currency, which further aggravated the condition of the current accounts, what was reflected, as was already mentioned, in the corresponding indicators for the first 9 months of 2008.

That measure was caused by the desire of the National Bank of Ukraine to reduce inflation in 2008, which was expected to rise and reach, according to many experts, a level of 21-23% at late 2008. But that method of inflation-curbing was very dubious, as the original reason of inflation consisted in the policy of incomes generation at the expense of the budget and pension fund. With the aggravated financial situation of September-November 2008 that emerged due to the beginning of an abrupt change in the condition of the balance of payments, the population made a massive rush to the banks to take their hryvnia deposits and convert them into foreign currency in the expectation of the decrease in the hryvnia exchange rate, and, in so doing, caused its even more dramatic fall. That process was further aggravated by the policy of the commercial banks, who received a huge amount of funds for refinancing and spent its considerable part on the purchases of foreign currency purchase and, apparently, transferred their foreign currency reserves abroad.

As a result, today we can observe a situation when money supply grows and liquidity of the banking system remains at the same extremely unsatisfactory level and is unable to perform its function, which leaves the confidence in the banking system at a very low point.

Due to the panic, the exchange rate of the hryvnia decreased, during October 2008, by more than 20%, being its decline from July to October over 30%. As a result, the National Bank of Ukraine had to introduce, as a measure to fight the panic, certain restrictions on cancellation of the agreements of the people's long-term deposits, as well as some others administrative restrictions, which somewhat stabilized the situation.

Now, in Ukraine's economy, one can expect a certain increase in price competitiveness if the hryvnia's exchange rate reaches 8 per one USD. However, it is easy to suppose that, with such a great devaluation of the national currency relative to 2006 and 2007 levels, when the bulk of the present consumer and mortgage credits were granted, the creditors will face a massive non-repayments leading to bankruptcy of those financial institutions (first of all, banks) who had granted credits in foreign currency (the share of such credits is about 70-

80%), which is already the case. The situation began to worsen already in November 2008, and now, taking into account future massive dismissals (due to the expected further economic decline), ony may expect its further aggravation.

Presently, Ukraine's economy is in a double trap of its own and the world financial crises with both banking crisis and a rather deep economic decline threatening with massive discontent, because, in 2009, the rate of unemployment may exceed 11%, which, under Ukraine's conditions is a serious level preventing the budget and pension fund from properly performing their obligations. And, against that background, the rate of inflation, in the current year, has a tendency to rise to about 15-20%. Due to one of the highest loads on the economy from the expenditures on supporting pensioners and other strata receiving the budget benefits, such a level of unemployment may become critical as early as in 2009 (in the pessimistic forecast), which would also require government support. That, in turn, means it would be necessary to make, in the budget and pension fund, a series of changes directed to maximum possible reduction of privileges and unjustified salaries and pensions of certain strata, as well as state management expenditures and some national and regional programs. On the whole, it is necessary to have in mind, that it will be impossible to avoid the social crisis, so it is essential to rationalize the budget expenditures in 2009, because, if we fail to solve the problem of social tensions (which is further aggravated by the present political crisis), we will not avoid serious social troubles.

Certainly, the government must not allow, in 2009, the appearance of another source of social tension, which are numerous as it is. That is why it can and should strengthen its efforts to attract new loans from the World Bank and the IMF under the government's guarantees in order to restructure the national banking system and acquire control packets of a series of commercial banks. Such banks should be harmonically united with the now state-owned ones making the state's share of the banking system's authorized capital stock no less than 20%. After such a restructuring, it will be possible to create in Ukraine a competitive banking environment, in which the banking capital would be approximately evenly controlled by the state, domestic private business and foreign capital. In such a system, the state would not lose levers to influence the banking activities. Similar objectives, as suggested by the experience of fighting the current financial crisis, are attained in the developed economies by way of increasing the state's share in banking capital. As a result, the state's regulatory policy in the monetary sphere can be more successful.

Besides, under the government's control, it is important to carry out another program of banking system restructuring, which is already stipulated by the agreement between Ukraine and the IMF signed in October 2008 as a condition of the stabilization loan. In this context, one should not have hoped that Ukraine would avoid spending the IMF resources received for

stabilization purposes (though such suggestions were voiced). Analysis of the use of similar loans received from the IMF by other countries shows that no country managed to avoid it. The minimum use of such funds took place in Russia in 1998 (33% of the whole amount), and in Brazil in 1997-1998 (72%). The rest of the countries spent up to 80% and more of IMF funds. For example, Indonesia in 1997 spent 95% of the IMF loan.
In Ukraine, one should expect that a considerable part of the IMF loan and the National Bank of Ukraine's resources will be spent in 2009, because the total amount of this country's debt repayment and servicing due in 2009 reaches 40-50 bln. USD (taking into account the expected deficit of the balance of payments). Based on the estimate that the National Bank's reserves together with the IMF loan amount to about 50 bln. USD, one may state that it will be impossible to do without devaluation of the national currency in the current year, and maybe in the future. Which means that, in this country's economy, apart from the existing inflationary factors, there will appear new ones related to the expected devaluation and difficulties with the debt servicing. Among the measures to curb inflation, it will be necessary to impose restrictions on the rise of salaries as follows from the memorandum signed with the IMF. However, such measures alone will be clearly insufficient. Besides, the National Bank of Ukraine, in order to fight inflation, will conduct a restricting money policy (see Figures 7,8,9), which will in essence lead to relative reduction of money supply instead of its expansion as an advisable means to encourage demand for money.

Those who elaborated and signer the memorandum, considered that demand for money would decrease. In this case, they probable based on an assumption of decreased real DGP. But such an approach contradicts the logic of overcoming the kind of crisis, which Ukraine is undergoing for the first time in its history, when demand for money should be stimulated, including by means of lowering the interest rates. The memorandum signed with the IMF declares that the National Bank of Ukraine will raise the interest rates on the NBU deposits in order to bridge their gap from the rate of re-financing rate meaning the latter will not reduce, which, naturally, raise the interest rates instead of lowering them, which is already the case. In all appearances, to revive demand for money, it is necessary, on the one hand, to implement a program of the expansion of the ongoing infrastructure projects, and, on the other hand, to ensure their purpose oriented and transparent financing through the banks participating in such projects. The same applies to housing construction.

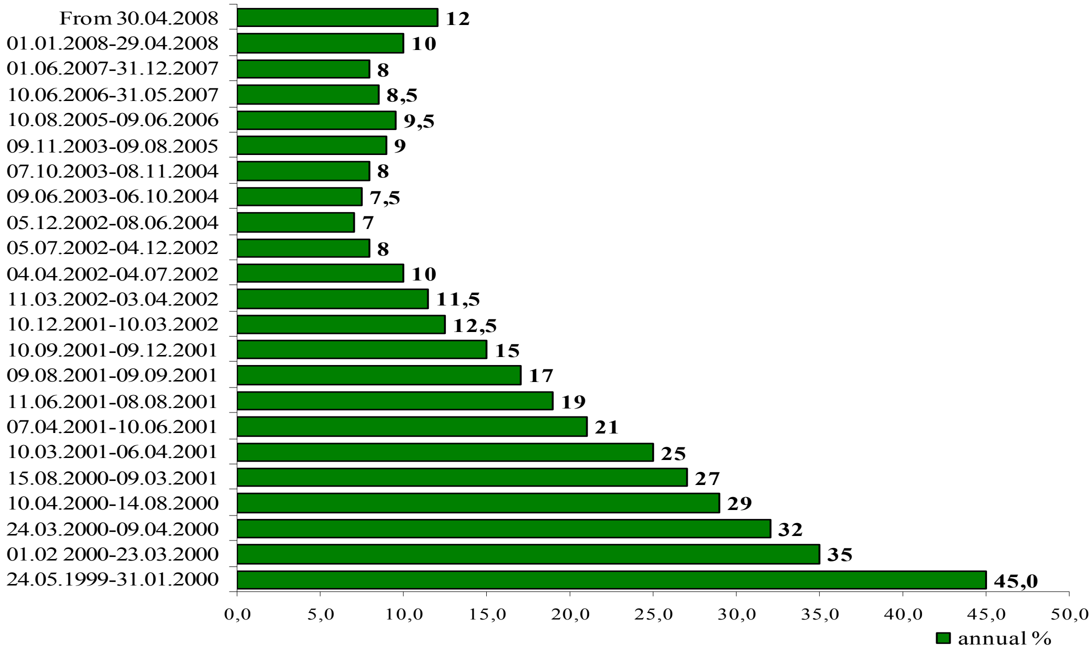

Fig. 7. NBU discount rate in 2000-2008

Source: data by the official site of the National Bank of Ukraine (www.bank.gov.ua)

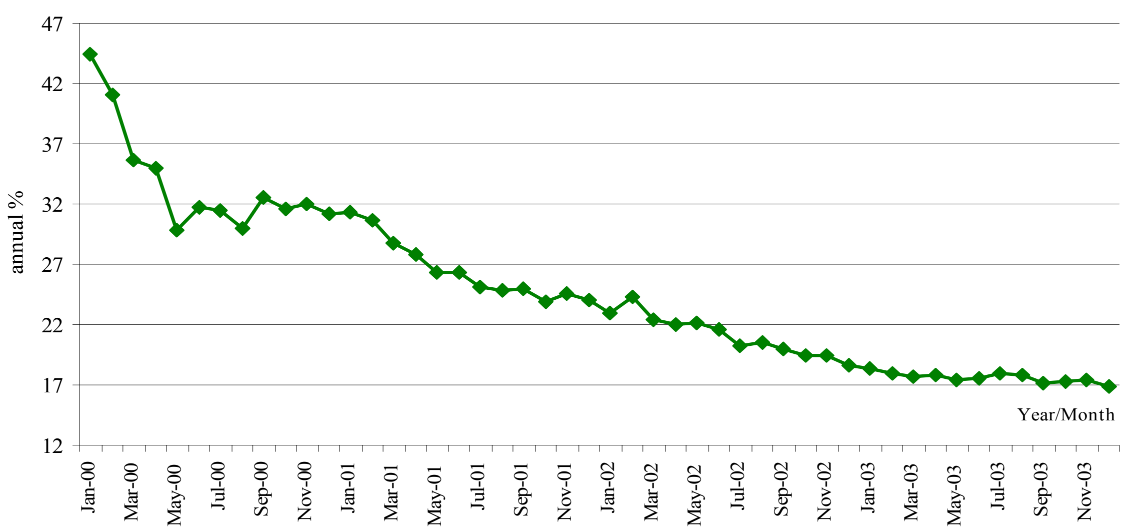

Fig. 8. Average weighted interest rates on credits in 2000-2003

Source: data by the official site of the National Bank of Ukraine (www.bank.gov.ua)

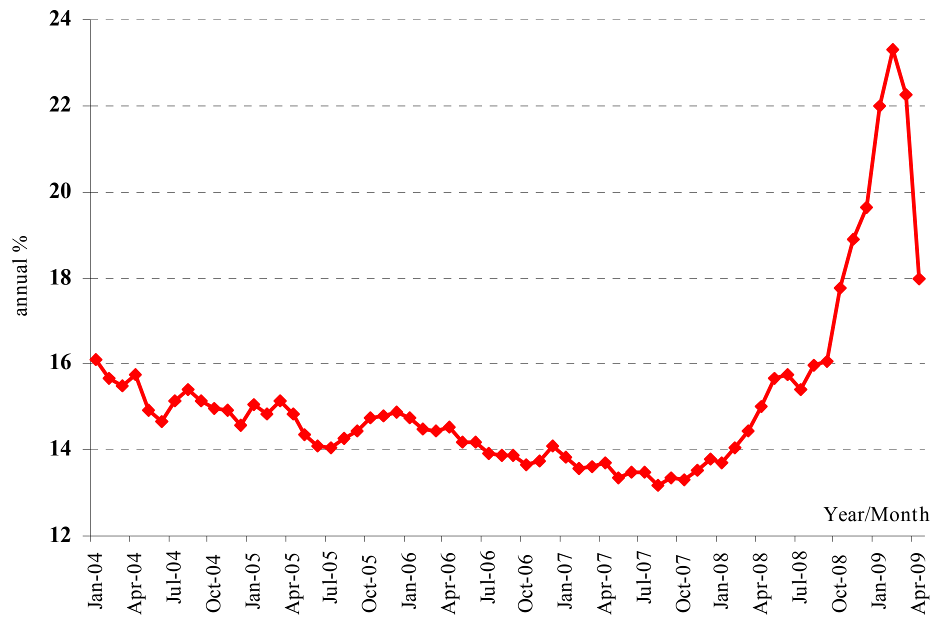

Fig. 9. Average weighted interest rates on credits in 2004-2009

Source: data by the official site of the National Bank of Ukraine (www.bank.gov.ua)

On the whole, taking into account the amount to be spent on servicing Ukraine's both private and state debts in 2009, one may conclude that this country will probably lose almost all its exchange reserves. However, Ukraine will most likely avoid default, despite its threat in the IInd and IVth quarters of 2009.

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