

# ICPS newsletter®

## The world financial crisis and Ukraine

*Sharp fluctuations on stock and commodity markets in the US and the bankruptcies and sales of the top investment banks on Wall Street have affected financial markets around the world, including in Ukraine. International Centre for Policy Studies economist Oleksandr Zholud analyzes current trends and predicts a major devaluation of the hryvnia*

### Summer–Fall financial trends

Over the summer of 2008, there was a strong trend for the hryvnia to appreciate. The seasonal spending of dollars by Ukrainians during the vacation period led to a steady rise in the hryvnia at exchange points. Even as prices began to fall on steel markets and war exploded in the Caucasus, the interbank exchange rate remained a steady UAH 4.65–4.70/USD in August. At that time, the market still partly felt the liquidity crunch that had led to the appreciation of the hryvnia in the first place, back in May. True, whereas July purchases of foreign currency by the NBU added up to US \$2.3bn, by August they were barely half as much, at US \$1.2bn.

The hryvnia began to fall sharply in September. On 1 September, the rate jumped UAH 0.085 on the interbank market. Over the following two weeks, it fluctuated mildly, generally less than UH -0.01 daily. Although the political crisis was prompting non-residents to leave the market, it was not having much of an impact on the overall situation.

The big change began 16 September. The dollar rose UAH 0.045 in a single day, then jumped another UAH 0.115 the next day, and two days later, a further UAH 0.075. Just three days later, the interbank raised its dollar rate from the official UAH 4.85 and crossed the UAH 5.00/USD threshold again. The following week, the dollar continued to rise and shortly reached the official cap for 2008, UAH 4.85+4%, that is, UAH 5.044.

The NBU Board immediately instituted a new corridor, UAH 4.95 ± 8%. However, even this ceiling, UAH 5.34, was broken: on 9 October, the dollar hit UAH 5.64/USD. Only massive sales on the part of the National Bank, which experts expect

to total over US \$1bn in October, and administrative restrictions on imports were able to “force” the exchange rate back into its corridor.

### What caused this shift and have things stabilized?

Some business papers rushed to blame the change in the exchange on the coming of Naftogaz Ukrainy to the currency market, and then on non-residents, which supposedly caused demand for dollars to rise sharply. But despite the significant volumes of payments necessary for imported gas by the country’s largest company, this technical explanation hides far more significant macroeconomic factors.

Back in the spring, when the hryvnia appreciated, Naftogaz was also linked to the phenomenon—that time because it failed to show on the market at the end of Q1. However, even after the company eventually bought the dollars it needed, the exchange rate did not fall back to its previous levels.

The factors that are putting pressure on the exchange rate are global in nature. On one hand, there has been such a steep fall in world prices for ferrous metals, that some Ukrainian producers were forced to stop production. The export of metals is very important in Ukraine’s foreign trade. In H1’08, such exports accounted for 38.6% of all export revenues. But in August, output volumes in Ukraine’s steel industry fell 8.6% and a whopping 17% more in September, compared to the same months last year. This was the result of prices on metal markets plunging from a record high of US \$1,100/t in July to US \$500–600 in October.

Meanwhile, Ukraine, like most countries in Central and Eastern Europe that have a serious current account deficit in their

### Ukraine–NATO partnership network to raise public awareness

ICPS and the Razumkov Center have launched a joint project called “Ukraine–NATO partnership network to raise public awareness” with the financial support of Ukraine’s Ministry of Education and Science.

The project includes a cycle of workshops directed at instituting a single methodological approach to the development of a rational system of national security in Ukraine.

The target audience for these events is field specialists in the departments of central executive bodies, educational institutions and scientific facilities in Ukraine.

The first such seminar took place 16 October 2008. Its participants expressed confidence that the proposed CSO initiative was very relevant and that they were prepared to take active part in the development, agreement and introduction of a professional language of communication and methodological approaches to resolving problems in the security sector.

By the end of 2008, four more series of lectures, expert debates and roundtables will be held, to be topped off by the publication of a Handbook on these issues.

*Those who would like to participate in these events can contact*

*Project Manager Serhiy Donskoy  
by phone (050) 311 65 02  
or via e-mail at [donskoy@asta.edu.ua](mailto:donskoy@asta.edu.ua).*

balance of payments, lost its source for covering this deficit almost overnight as investors began to take their money away from emerging markets in response to the global financial crisis. In Ukraine, the credit default swaps that indirectly indicate the minimal level of interest rates at which money can be had grew from

around 500 basis points in January–July to 1,550 bp on government securities. In other words, were the Government to issue bonds, it would have to propose more than 16% p.a. for hard currency. For private borrowers, this means that international money markets are, for all intents and purposes, completely closed because of excessive cost.

Given the rising trade deficit, falling prices for steel and iron, and an expected further rise in the price of imported gas at the beginning of 2009, the hryvnia is only likely to go down more in the foreseeable future. So far, the NBU has not given any clear messages about how it intends to deal with the consequences of the financial crisis.

### Ukraine at the crossroads

The Government needs to choose now whether to establish temporary stability through administrative means or to switch now to a much weaker national currency. The NBU has already tried administrative measures, including restricting imports (by making it harder for importers to work on credit) and

directly injecting currency through the interbank market, in order to support the private sector's ability to settle its external debts.

Against the background of a political stand-off that is growing worse in the face of the upcoming snap election, stability is extremely important. However, administrative methods are likely to reinforce the current imbalances, both in the banking system and in the real sector. This means that, if administrative means are permanently weakened, the fluctuations in the exchange rate are likely to be more severe.

According to the author, the NBU already needs to prepare business and the general population for a much weaker hryvnia. Although state intervention is completely justified during a time of crisis, the economic situation in Ukraine requires a change of course. Current trends on world commodity markets mean that currency revenues from exports are going down, even if actual volumes remain the same. At the same time, prices for most imports, including investment goods and gas, are not about to go down significantly. This

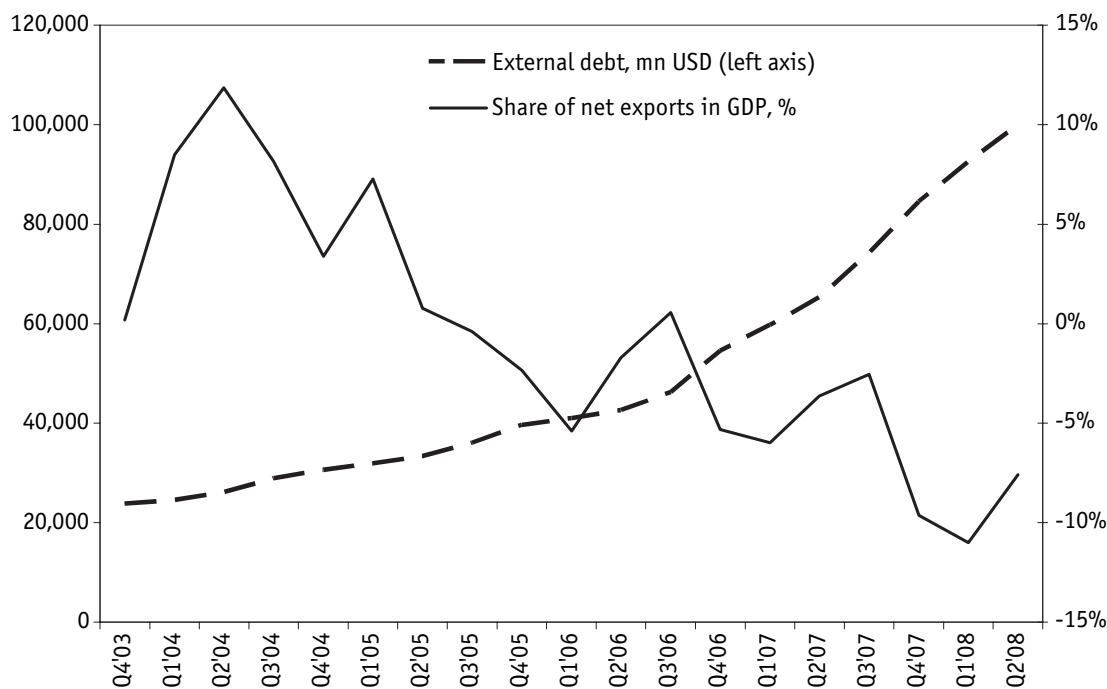
### By the way...

The "Developing Socio-economic Performance and Potential Analysis Capacity" project that ICPS is implementing jointly with the Conference Board of Canada with funding from the Canadian International Development Agency (CIDA) has moved into its next phase. ICPS experts are developing an integral rating of Ukraine's oblasts to determine the quality of life. The study will also focus on the problem of environmental quality and public attitudes in different regions around this issue. The results of this research will be presented in the second issue of "Performance and Potential."

means that the trade deficit is only going to grow and financing it will become harder and harder. ■

For additional information, contact ICPS economist Oleksandr Zholud by phone at (380-44) 272 10 50 or via e-mail at [ozholud@icps.kiev.ua](mailto:ozholud@icps.kiev.ua).

Chart 1. Ukraine's external debt and GDP share of net exports



Sources: Derzhkomstat, NBU

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**icps newsletter** editor: Olha Lvova ([olvova@icps.kiev.ua](mailto:olvova@icps.kiev.ua))  
 Phone: (380-44) 484-4400. Fax: (380-44) 484-4402  
 English text editor: L.A. Wolanskyj  
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 Address: vul. Pymonenka 13A, Kyiv, Ukraine 04050  
 Web-site: <http://www.icps.com.ua/eng/>