

The Hryvnia under pressure: The role of the National Bank

Since August 2014 the Hryvnia has come repeatedly under heavy depreciation pressure. The National Bank of Ukraine (NBU) reacted swiftly to avoid excessive exchange rate fluctuations. However, the NBU didn't use market-oriented, but rather administrative measures. As expected, these measures have complicated life for business and households.

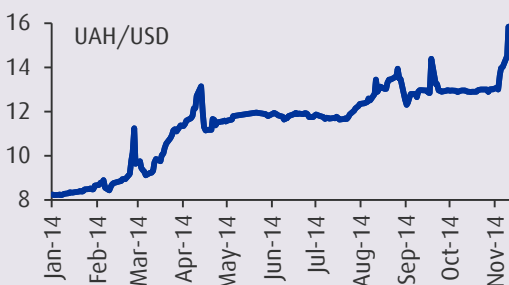
In our view, there was no alternative to this policy. Excessive fluctuations could have turned into panic reactions of the population and the conditions for the use of market-compliant instruments were not given. In particular, a further loss of foreign exchange reserves, which could have served the purpose of short-term stabilisation of the exchange rate, would have been irresponsible.

In this respect, the current fundamental criticism of the NBU is unfounded. Very alarming were also news during the coalition talks that also the Governor's post was up for negotiation. Only an independent central bank can implement a credible exchange rate policy, enforce an effective banking supervision against vested interests and hire professional staff. The new political leadership is therefore well advised to respect the independence of the NBU. This rationale should also be applied to many other governmental institutions.

Wide exchange rate fluctuations during the year

At the beginning of 2014, the NBU changed its exchange rate policy fundamentally. The transition to a flexible exchange rate system – as demanded by many experts for quite some time – was the right decision. The flexibilisation of the exchange rate was first accompanied by a strong devaluation of the Hryvnia. Later on in August, after several months of a relative stability of the Hryvnia, and parallel to a worsening of the conflict in the East, new depreciation pressures emerged, which were characterised by episodes of high volatility.

Exchange Rate to USD



Quelle: ICAP

In order to correctly assess the exchange rate development, several points need to be taken under consideration. The publicly discussed level of depreciation is often based on an incorrect accounting methodology, which results in distorted figures: A fall from, e.g., 8 UAH/USD to 16 UAH/USD implies a depreciation of 50%, and not 100% as often reported. Moreover, this happens in an illiquid market, thus the results need to be interpreted very carefully. In addition, the selected reference point of 8 UAH/USD is not appropriate, because at that level the Ukrainian Hryvnia was clearly overvalued.

Management of exchange rate fluctuations

The crucial question in terms of economic policy is whether the NBU should respond to the described depreciation pressure. Hereby it is important to distinguish between fundamental and non-fundamental ("excessive") fluctuations. Such fluctuations which are not based on fundamental factors, and often occur abruptly, can lead to various problems. This includes "self-fulfilling prophecies" which could lead to panic buying of US dollars, and push the exchange rate further and further away from its fundamental level. Excessive exchange rate volatility is also very problematic for the fragile banking sector, thus threatening the objective of financial stability. Excessive exchange rate fluctuations have also a negative impact on the real sector, especially on foreign trade and investment. Therefore, there are a number of reasons why the NBU should respond to such developments.

The reaction of the National Bank

The NBU did indeed respond to the depreciation pressures. However, no market-compliant, but administrative measures were applied. Over the past months, a number of regulations were introduced or strengthened, in order to reduce the excess demand for foreign exchange. For example, this concerns the mandatory surrender requirement of export revenues as well as restrictions on import payments and the repatriation of dividends as well as of capital. As a result of these measures, the exchange rate was "artificially" stabilised at a value of 12.95 UAH/USD before parliamentary elections in October. The excessive net demand for foreign exchange has, however, led to the formation of a black market.

Evaluation of measures

The administrative restrictions imposed by the NBU have to be partially assessed as problematic, since they produce distortions and affect households and businesses negatively. Over time, they typically will be undermined and will thereby lose their effectiveness. On a positive note, a number of very critical constraints have already been removed - thus the NBU has already partially responded to legitimate criticism.

At this point it must be emphasised, that the NBU is not interested to permanently fix the value of the Hryvnia (as it did before), but to manage a depreciation - this should happen gradually, not abruptly. After the elections, the Hryvnia continued its downward trend.

It also must be stated that there are realistically no genuine alternatives to the approach of the NBU in the currently very tense economic and geo-political context. Foreign exchange reserves are at an extremely low level, and - due to the IMF-Programme - are restricted in its free use; the key policy interest rates have already been raised several times. At the same time the NBU had comprehensible reasons to spring into action.

About the role of the National Bank

Traditionally the exchange rate policy is strongly in the focus of the public in Ukraine. Therefore it is not surprising that the NBU has fallen under strong criticism, even if -in principle- this criticism is inappropriate. However, public demands to replace the NBU leadership are a reason of major concern; during recent coalition negotiations the top post at the central bank seemed to be a kind of political bargain chip.

This development is counterproductive and harmful. By law, the NBU is independent - for good reason. Important in the current situation is the build-up of credibility; it is the only way to achieve a sustainable stabilisation of the currency. This only can take place if the NBU remains an attractive place of employment for new reformers; the current development acts as a deterrent here.

Besides the implementation of monetary policy, independence is a central pre-condition for the second essential function of the NBU, namely banking supervision. Currently, large capital needs are emerging in the banking sector; estimations assume capital needs of UAH 66 bn (about 4.5% of GDP) for the biggest banks. Unaffected by particular interests, the NBU has to ensure that these capital needs are covered (by private owners, or in case of systemic banks by the state), or the concerned banks will be subject to restructuring and resolution.

Conclusion

Considering the attempts by the NBU to deal with the strong exchange rate fluctuations by means of administrative measures, the impression arises that no fundamental changes in the mind-set of the bank have taken place. This impression is false; the current attempts to limit such fluctuations should not be confused with a renewed fixation of the exchange rate at a wrong level. The new management team of the NBU, which has a strong private sector background, is fully aware of this.

Politics and the public should respect the independence of the NBU, as it cannot fulfil its duties and responsibilities in an unstable personnel environment. This also applies to many other governmental institutions. A key element of the economic reforms must therefore consist of a strengthening of institutions.

Authors

Robert Kirchner, kirchner@berlin-economics.com
Ricardo Giucci, giucci@berlin-economics.com

Notes:

This is a translation of the November issue of the German newsletter.

A detailed analysis of the topic provides the Policy Briefing PB/10/2014 "How to deal with excessive fluctuations of the Hryvnia?"

Download at: www.beratergruppe-ukraine.de

German Advisory Group

The German Advisory Group on Economic Reforms, which is active in Ukraine since 1994, advises the Ukrainian Government on a wide range of economic policy issues and on financial sector development. The group is financed by the German Federal Ministry of Economics and Energy under the TRANSFORM programme and its successor.

Contact

German Advisory Group
c/o BE Berlin Economics GmbH
Schillerstr. 59, D-10627 Berlin
Tel. +49 30/20 61 34 64 0
Fax +49 30/20 61 34 64 9
info@beratergruppe-ukraine.de
www.beratergruppe-ukraine.de