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Devaluation of hryvnia – impacts on the agriculture sector

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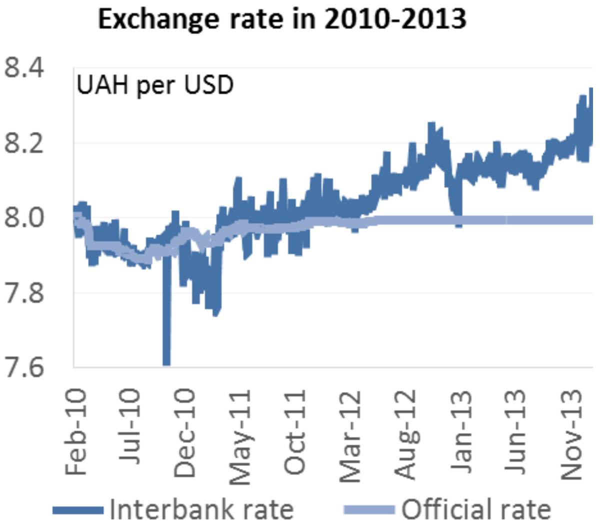
Devaluation of hryvnia is expected to have impact on the agriculture sector of Ukraine, which became particularly in recent years a significant player in national economy and international trade.

Despite the overall negative trade balance of Ukraine, agriculture contributes positively to trade balance. Exports consist mainly of commodities, whereas imports contain some inputs and large part of investment goods. Thus it is generally expected that devaluation of hryvnia would lead to improvement of competiveness of the agriculture sector in general. But the impact depends not only on the balance of imported and exported goods, but also on the size of the domestic market for inputs and produced goods as well as impact of the devaluation on related sectors and economy as a whole.

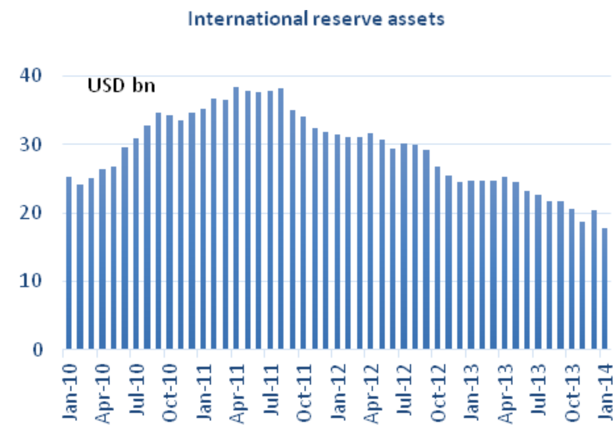


Sources: ICAP, NBU

Brief overview of exchange rate policy until January

After massive economic crisis in 2008, exchange rate of Ukrainian hryvnia versus US dollar weakened to UAH 8 per USD. The central bank (NBU) was unable to maintain the unofficial peg of national currency to US dollar established in 2001[1] at UAH 5 per USD. The main reasons for depreciation were sharp reduction in export revenues in response to crash in commodity prices, stop of external capital inflows and internal capital flight as demand for cash foreign currency (mostly US dollars) rose dramatically.

After brief period of floating, the NBU returned to fixed exchange rate in 2009 and maintained peg to US dollar on a level of roughly UAH 8 per USD until January 2014. However, exports remained anaemic and prices for key export commodities remained lower than before crisis. At the same time payments for imports grew as consumption exceeded pre-crisis levels and Ukraine had to pay for imported gas from Russia at high prices. Inflows of FDI dropped and access to external capital markets was episodic[2].



Source: NBU

As a result, NBU had to use large part of international reserves to support exchange rate after lending program with the IMF went off-track in 2011. International reserves of the NBU dropped by over 50% from maximum value of USD 38.2 bn in September 2011 to USD 17.8 bn by the end of January 2014. Central bank also had to introduce administrative measures to support exchange rate. Among others, exporters are required to transfer payment for exported goods to accounts in Ukrainian banks within 90 days and immediately sell 50% of received funds. This measure was introduced in November 2012 and will remain in force at least until May 2014. NBU also allowed the UAH/USD exchange rate to weaken gradually by about 3% between 2010 and 2013.

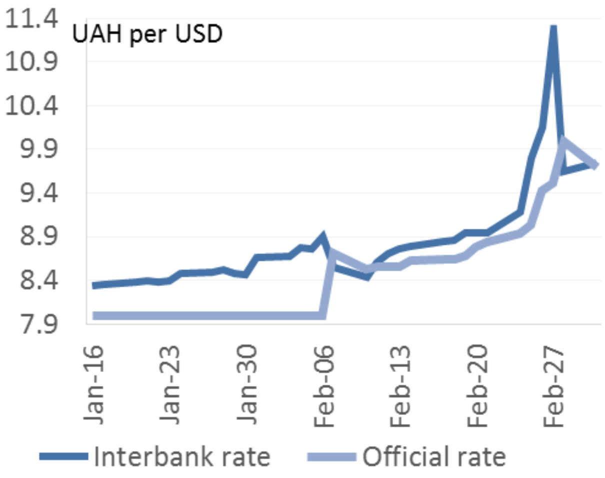
[1] In 2005 hryvnia appreciated by about 5% and in the end of 2007 and in the beginning of 2008 hryvnia appreciated by another 4%

[2] Central banks of developed economies adopted "quantative easing" policies flooding markets with liquidity and depressing interest rates for safe assets. This created windows of opportunity for the countries with low credit rating to get relatively cheap funding when market confidence picked up.

Current situation and prospects

Due to falling reserves, the NBU became reluctant to intervene on the foreign exchange market over the last months. State-owned banks started to act as market makers on the interbank foreign exchange market instead of the central bank. In the end of January and in the first days of February demand for foreign currency on interbank market jumped likely due to capital flight and/or large scheduled payments in foreign currency. Interventions by the NBU were insufficient to stabilize exchange rate while export revenues and other incoming transfers were seasonally low. As a result, interbank exchange rate[3] shot up from UAH 8.3 per USD on January 15 to over UAH 9 per USD by February 5.

Exchange rate in 2014



Sources: ICAP, NBU

In response, the NBU introduced a number of emergency measures on February 6. The NBU required all companies to deposit hryvnia funds and wait six working days before receiving purchased foreign currency. The NBU also prohibited outward FDI and early repayments of loans, limited bank transfers abroad by individuals to UAH 50.000 per month, lifted 20% unremunerated reserve requirement on short-term external borrowing. NBU also started to set official exchange rate (used for customs and taxation purposes and as a reference in some contracts) at the level of the average interbank rate for the previous day[4]. As a result, official exchange rate jumped by 9% from UAH 7.993 per USD (effective from July 2012) to UAH 8.708 per USD on February 7 and later moved in line with interbank rate as reported by the NBU.

Furthermore, interbank market turnover fell sharply and exchange rate initially retreated to UAH 8.6 per USD. However, exchange rate gradually weakened to UAH 9 per USD by February 21 and shot up past UAH 10 per USD for a few days after new NBU management was appointed by the new government.

It is not clear how long the increased flexibility of the exchange rate will last. The NBU is unlikely to conduct significant interventions on the foreign currency market until government secures support package from the IMF and/or other official creditors (IFIs, US and EU countries). Nevertheless, the NBU may continue to use capital controls to manage exchange rate. The NBU is also expected to spend USD 6 bn to cover repayments of foreign currency government debt[5] by the end of 2014. Thus, large-scale interventions are unlikely even when the funding is secured.

Overall, if external funding is secured the NBU will likely be able to keep exchange rate in the range UAH-9-10 per USD in 2014. This will be achieved through continued administrative measures and decrease in capital flight. Further devaluation will be politically unpopular and may be damaging to economic growth.

However, if government fails to secure funds exchange rate is likely to be much more volatile and may easily remain at UAH 10-13 per USD or even higher.

Impact on economy

Under optimistic scenario (i.e. UAH 9-10 per USD) impact of devaluation on the economy will be limited. Competitiveness of exports will be preserved as labour costs in Ukraine may drop slightly in relation to competitors and price of untradeables (goods and services that don't compete with foreign goods) will decrease. Imports of consumer goods will likely be most affected due to weak consumer demand, direct impact on consumer prices and in some cases competition from domestically produced goods. Imports of consumer goods accounted for nearly 1/4 of total merchandise imports in 2012 and 2013. Imports of invest-

[3] We use market close rate as reported by ICAP
[4] Previously the NBU used bogus transactions by government-owned banks to report unrealistic interbank rate. This practice stopped or reduced in scale significantly.

[5] NBU purchases foreign currency raised by the government and sells it to the government when repayments are due.

ment goods and production inputs by domestically oriented branches of economy will react to lesser degree as they will be able to pass on some of the additional costs to consumers and they may become more competitive on domestic market. Import by export-oriented industries is likely to react slowly to changes in exchange rate due to dollar-denominated sales and usually limited sources of supplies on domestic market. Imports of energy are not very flexible in response to moderate changes in prices/exchange rate and especially in short-term. Current account deficit will likely remain high at 8-9% of GDP (8.9% of GDP is preliminary observed in 2013).

Inflation is expected to increase in response to higher prices for gasoline, production inputs and imported consumer goods. However, weak nominal consumer demand may cause that consumer prices for imported goods will decrease slightly in dollar terms (reflecting domestic component in costs). During previous devaluations price increases were proportional or even larger than change in exchange rate.

Balance sheets of banks and nonfinancial corporations are unlikely to worsen significantly due to devaluation. Most bank customers should be able to shoulder additional costs of debt service as foreign currency loans are issued after 2008 to exporters or customers with other source of foreign currency income. At the same time, banks formed significant loss provisions for pre-2009 loans.

Impact on fiscal situation is likely to be balanced in the short-term. Budget will receive additional revenues from VAT and duties on imports. Higher inflation should boost other revenues but spending on debt service will also increase. In the medium term impact would likely be negative as VAT from imports (with high collectability) will be replaced by domestic VAT (with higher tax evasion) and increased debt service costs would continue[6].

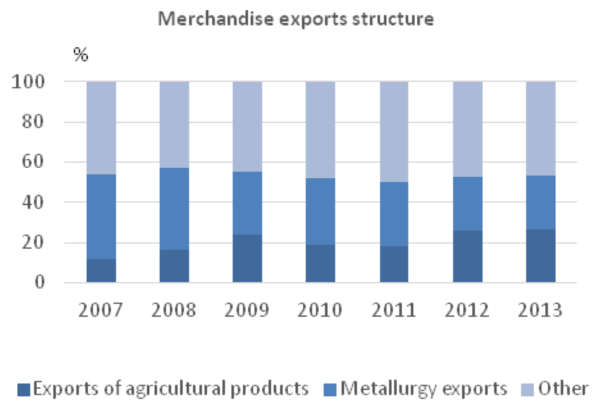
Overall impact of devaluation on the GDP growth is likely to be close to zero under optimistic scenario.

Under pessimistic scenario, higher devaluation may be accompanied by full-scale economic crisis. This may lead to fall in GDP, problems in financial sector, cutbacks in social payments, restructuring of external debt, significant decrease in the current account deficit. However, threat of a possible economic crisis will likely act as powerful incentive to secure external financial assistance.

[6] Although higher inflation will reduce hryvnia-denominated debt relative to GDP

Impact on Ukrainian agriculture

Exports of agricultural products in Ukraine increased sharply over the last five years while exports of other products recovered slowly after crisis. As a result, it accounted for over a quarter (26.2%) of merchandise exports as compared to 12.5% in 2007. This reflected primarily sharp increase in exports of cereals and oil products. Government gradually removed restrictions on grain exports and crops grew relatively steadily. Grain harvest in five of the last six years (2008-2013) was higher than observed in all previous seventeen years (1991-2007) with even more impressive results for sunflower seeds. External competitiveness of Ukrainian products was also supported by hryvnia devaluation in 2008.



Source: NBU

Ukraine also exports diversified range of finished food products to Russia and other CIS countries. It accounted for 5-6% of merchandise exports over the last years but it didn't experience boom similar to exports of cereals. On the contrary, Russia's consumer safety authorities subjected Ukrainian products to increased scrutiny banning exports of some products.

Hryvnia devaluation in general should make Ukrainian agricultural goods more competitive both on external and domestic markets. Grain exports is growing and becomes increasingly important source of export revenues while finished food products are increasingly exposed to competition from imports on domestic market.

However, in 2012 only less than 10% of agricultural output was spent on labour costs while prices for main components of intermediate consumption i.e. seed grain, fuel and fertilizers as well as investment goods, e.g. machinery and agriculture equipment are dependent on international prices. At the same time over the last few years wages in the agriculture and to the lesser degree in food industry grew faster than average. Thus, wages of agricultural workers are unlikely to decrease in dollar terms under small–scale devaluation. Thus, agricultural exports are unlikely to become noticeably more competitive as compared to 2013 under optimistic scenario of devaluation up to UAH 10 per USD.

Still devaluation of hryvnia vs USD will prevent agriculture from decrease in competitiveness due to growing wages and deprecation of the number of emerging market currencies. This may be particularly important for exports of food products for consumers in Russia and CIS. Depreciation will also make Ukrainian products more competitive on domestic markets. Share of imported food products in retail sales grew from 9% in 2005 to 14% in 2013 (even though real sales doubled over this period). However 2008 devaluation only slowed but didn't reverse the process.

Impact on Ukraine's agricultural trade with Germany

Agricultural products account for relatively small portion of trade between Ukraine and Germany at 13% of exports and 9% of imports between January and November of 2013. While the general agriculture trade balance of Ukraine is positive, imports of agricultural products from Germany (USD 0.6 bn) are much larger than exports (USD 0.2 bn / mostly grain and sunflower seeds). Moderate depreciation is unlikely to have significant impact on trade in agricultural products as Ukraine's exports is small and agricultural and food products imported from Germany are likely to be in less price-sensitive segments of the market. In light of the ongoing devaluation of hryvnia imports of agricultural machinery and other inputs from Germany might be expected to lose competiveness in comparison to domestic producers, although imports from Germany will be supported by the high image of quality as well as continued competitiveness of Ukrainian agriculture.