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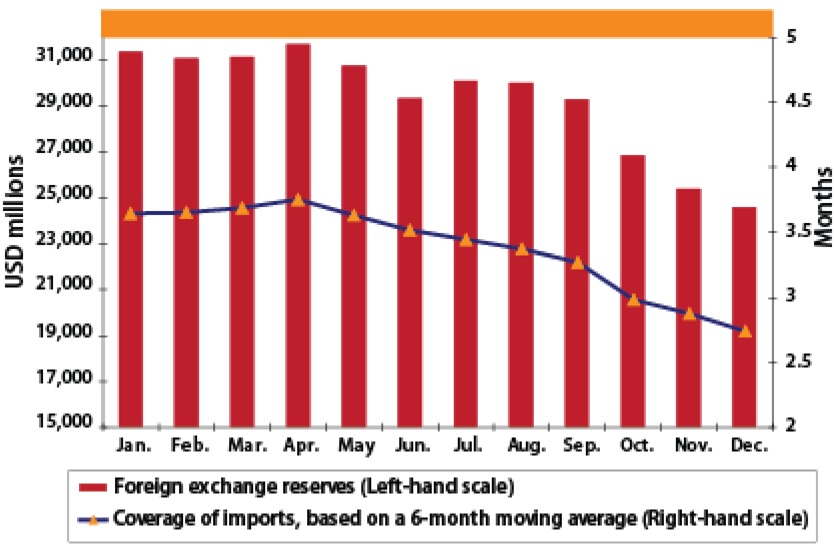
Ukraine faces exchange-rate policy challenges

Over 2012, the National Bank of Ukraine has lost approximately one quarter of its international reserves in an effort to maintain a de facto dollar peg with the local currency (hryvnia) (see chart 1). Concerns about the large current account deficit (see chart 2) and fragile fiscal position plus widespread fears of a devaluation after the October parliamentary elections boosted strong foreign currency demand and contributed to the depreciation pressure. To maintain currency stability, at the end of 2012 the authorities resorted to administrative measures, such as introducing a mandatory sale of 50 per cent of exporters' foreign exchange revenues on the interbank market. Still, in December the reserves reached the dangerously low level of below three months of import coverage. In addition, in January the Russian Federation requested Ukraine to pay a $7 billion gas bill. This added to worries about the country's fragile balance-of-payment position and currency stability.

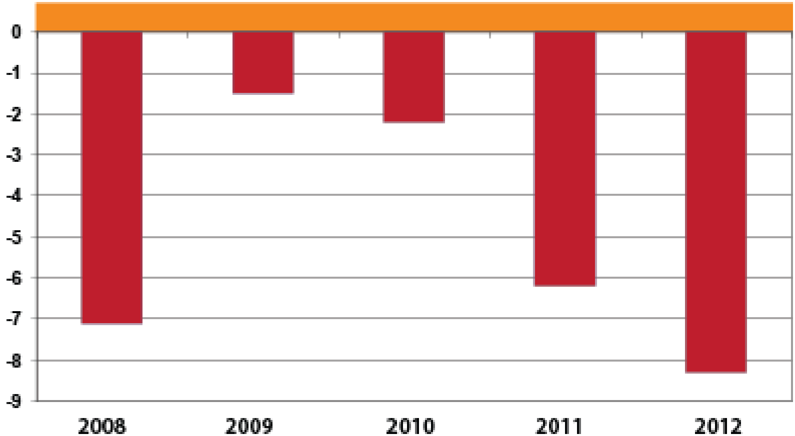
Chart 1: Foreign exchange reserves and import coverage in Ukraine, 2012



Source: IMF, National Bank of Ukraine.

Although maintaining the peg is becoming increasingly costly, a drastic uncontrolled devaluation would create serious balance sheet effects for the country where a large number of consumer and business loans are denominated in the foreign currencies, and may affect some trading partners in the CIS. Therefore, managing a smooth currency depreciation—which would also help to support exports and correct the burgeoning current-account deficit, remains a challenge.

Chart 2: Ukraine's current-account deficit as a share of GDP (percentage)



Source: IMF, National Bank of Ukraine.

Facing payments on previous IMF loans and Eurobonds in 2013, Ukraine may need balance-of-payments support and is seeking a new loan from the IMF, which would facilitate tapping international capital markets. Benefiting from improved global liquidity conditions, in February Ukraine issued $1 billion Eurobonds; however, failure to make a deal with the IMF and to attract sufficient funds for external debt repayment may put the country in a precarious position.