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Pavlo Strunin

East Ukrainian National University by V.I. Dal, Ukraine

THE UKRAINIAN TICKET

Before discussing future implications of the global financial crisis for Ukraine's economy, let us consider if it has already affected us. The national economic system is integrated into the world economy closely enough to be involved in the global processes. The eroded macro-stability of international markets could not but impact internal developments in Ukraine. The global financial crisis of 2007-2008, as any other, has been unfolding in several waves. We have survived the first two without great losses, although not without mistakes.

The first wave rose in 2007, when stock indices of the world's leading banks and financial institutions went down. Under the circumstances, risk capital looking for stable yet high-profitability markets moved from developed to emerging markets, which continued to show high growth rates and profitability. According to financial experts, the risk to profitability ratio in those emerging markets was fairly attractive. As a result, stock markets in respective countries grew in 2007, China and Ukraine being leaders of such growth.

The inflow of credits was also substantial: in 2007, Ukrainian economy borrowed USD 24,3 billion in middle- and long-term credits.

The second wave started in early 2008, when the ongoing fall in the world stock markets re-directed cash flows from one class of assets to another, in particular to commodities and energy resources. These assets became more marketable, and commodity prices soared up. In January-July, average metal prices in eight regions of the world rose by 81 %; "Brent" oil price rose by 32 %. By the time first favorable forecasts appeared as to the global gross grain harvest in 2008/2009 marketing year, wheat prices (USA, FOB) for 2007/2008 marketing year had grown by 79 %, on average.

Ukraine's economy responded to the challenges, mentioned above in the following way.

The overall inflationary background intensified. Inflationary spiral, set spinning in 2007, has been in motion in 2008. Political instability affected economy. Over the first eight months of 2008, industrial manufacturers' prices grew by 36,5 %, especially in such sectors as mining of mineral resources (except for fuel-and-energy ones) by 70,4 %; metallurgy and metal works by 68,1 %, coke production by 64,3 %; and the chemical industry by 55,9 %. All of these sectors are oriented towards foreign markets or towards servicing export-oriented production.

The convergence factor (resulting from openness of the Ukrainian economy to global trends, e.g. to the 2008 consumer price rise in most countries of the world) also accelerated inflation processes in the domestic consumer markets. In

September CPI amounted to 101,1 % (in January-September it amounted to 116,1 %), but it was much less than in 2006 and 2007, when it grew by 2,0 % and 2,2 %, respectively. So in general, in Q3 Ukraine had the lowest rate of price rise in the last four years – as low as 0,5 %. The overall inflation was driven, first and foremost, by rising prices (tariffs) for services.

The role of export-oriented production in the country's economic growth increased. In early 2008, production growth in export-oriented sectors accelerated, and the financial resources of the national economy were re-distributed, in particular through the banking system, from other sectors into commodities and export-oriented ones. Thus, in the first seven months of 2008, production growth in metallurgy was 3,5 %; in the chemical industry it was 5,2 %. It accounted for relatively high growth rates in industry at large – 7,3 %.

Over the same period, the share of profitable companies in the total number of enterprises increased from 65,1 % in January-July 2007 to 66,9 % in January-July 2008, and their profits boosted by 71,7 % as compared to the corresponding period of 2007. Leaders of profitability growth were coke production and oil refinement (by 5,7 times), the mining industry (by 2,2 times), and chemical and petrochemical industries (by 2,5 times).

Lending also increased, especially in such sectors as agriculture (135,1 %), coke production and oil refining (132,5 %), machine building (132,1 %), chemical and petrochemical industries (130,6 %).

In early 2008, the Ukrainian economy remained attractive for foreign investors. The growth of total foreign capital investments in the national economy was 2,7 times as rapid as in the corresponding period of 2007. And again, most essential capital investments went to well-performing sectors: agriculture (149,7 %), banking and financial activity (142,1 %), coke production and oil refining (123 %).

Against a backdrop of positive balance of payments and excessive supply of hard currency, the official exchange rate of hryvna to the US dollar decreased by 3,96 % to reach 4,85 UAH/USD in late August. In January-August, foreign currency reserves augmented by USD 56 billion – to USD 38,1 billion.

The second wave of the global financial crises set off ripples in the Ukrainian stock market. The PFTS index lost 43,5 % in the first seven months of 2008, primarily due to the withdrawal of some foreign investors (the so-called "jobbers") from Ukrainian, as well as from the global, markets and to political instability in Ukraine.

Almost all companies listed on PFTS suffered a decline in share and securities prices. Under the conditions of free capital flows, the Ukrainian economy demonstrated market-driven tendencies to seeking super-profits, which enhanced its export-oriented and commodity components, especially given intensified commodity drivers in the global markets.

The third wave of the global financial crisis is unfolding before our eyes.

It has already caused a series of bankruptcies of the world's leading financial companies and financial crisis rollover to the real economy sector, drop in demand on global markets and, as a result, plummeting commodity prices and stagnation of leading economies. In August-September, average metal prices in eight regions of the world fell by 18,3 %, and oil prices fell by 26,5 %.

The Ukrainian economy has not yet felt the consequences of the third wave in full. At this juncture, it is hard to estimate their severity and duration, but some impact has been obvious.

Thus, in August, for the first time since October 2002, industrial production decreased by 0,5 % (y-o-y), in particular in metallurgy – by 8,6 %, the chemical industry – by 9,1 %, and coke production and oil refining – by 4,9 %.

In other words, a set of external shocks, coupled with the export-oriented companies' strategy geared towards searching out niches in foreign markets while underestimating domestic ones, slowed growth, which, in the first eight months of 2008, was as low as 2 % in metallurgy and 3,5 % in the chemical industry. In general, rates of industrial production growth fell to 6,3 % in the first eight months of 2008.

The PFTS index continued to go down, losing another 43 % in the last two months. Bad news from mining industries and metallurgy had an adverse impact on the PFTS index, too.

In view of the above, the GPD growth of 7,1 % was achieved at the expense of other sectors, chiefly, agriculture, where the harvest was unusually rich.

Devaluation processes became manifest in the currency market, and in September foreign currency reserves reduced by USD 0,6 billion. Negative inflation expectations contributed to the overall turmoil. A negative balance of sale/purchase of cash foreign currency by the population amounted to USD 1,321 million.

The third wave of global financial crisis forced governments in the world's largest economies to revise their policy vis-à-vis financial markets. In particular, the governments of the USA, the UK, Germany, Russia, the Benelux States and other countries decided to support some of the troubled financial institutions.

In light of the escalating global financial crisis, the government and National Bank have taken a number of measures allowing for the reduction of the risk of its profound destructive influence. They include a package of anti-inflation initiatives, steps to enhance banking sector stability and to minimize the impact of the global financial crisis on Ukraine's economy. In early 2008, the National Bank passed a resolution toughening requirements to calculating the banks' regulatory capital adequacy (long-term asset transactions with time of floatation exceeding the time of funding should be additionally risk adjusted at 50 % rate and so on), which enabled banks to adjust and improve their position.

In addition, Ukraine has an "insurance police" of sorts in the form of Euro-2012. If the planned scope of work is fulfilled, the country will get a guaranteed inflow of foreign direct investments, mid-term and long-term loans, because investors worldwide view such events as image-building, promotional projects with low financial risks.

As a popular saying goes, hope for the best and prepare for the worst. The current challenges and threats require that public authorities and the private sector address them effectively and take additional preventive measures.

What can NBU do? In order to prevent a banking crisis, NBU should establish principles of refinancing commercial banks that have short-term liquidity problems for the period of financial crisis. A currency crisis can be averted with a series of measures precluding the exchange rate destabilization by speculators. NBU should continue to pursue the policy of increasing the rate volatility in order to reduce risks to the balance of payments.