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Strategy for deregulation of foreign exchange market

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Since the Autumn 1997, as the result of outflow of short term foreign capital from Treasury securities market and negative balance of payments, Ukraine was experiencing pressure on the exchange rate. Gross foreign currency reserves decreased from USD 2,374 mln, at the beginning of 1998 to USD 900 mln, in the end of August 1998[1]. In reaction to the deepening crisis on the Russian market, which has started in August 1998, the exchange rate of hryvnia (UAH/USD) had dropped sharply. The exchange rate broke through the upper limit of the announced corridor for 1998 (already corrected once at the beginning of this year). On September 5, the government and NBU decided to review the parameters of the exchange rate band changing the range to 2.5-3.5 UAH/USD. Furthermore, the NBU introduced a broad range of administrative regulations to control the forex market. As it was announced, the administrative measures were introduced only temporarily, although without any declaration about concrete timing.

The NBU policy allowed to resist speculative pressure on the foreign currency exchange rate and hold it within the band. The devaluation expectations were remarkably curbed, which helped to avoid the high inflationary consequences. The banking sector was able to meet requests for deposits' withdrawn and there were no bankruptcy as a result of liquidity problems. Summarizing, the planned goals of foreign exchange rate policy were achieved. That is why it is the good time to consider abolishment of anti-crisis temporary administrative measures along with exchange rate policy option. The task of foreign currency market deregulation needs to elaborate the plan of timing and sequence. The main purpose of this paper is to present general framework of such policy and give arguments for the must to conduct it.

The paper is composed as follows. Section 2 discusses distortions in the economy as a result of implemented forex controls. It also points out rationales for necessary deregulation of the market. Distortive regulations cannot be, however, removed without consistent macroeconomic framework. Therefore, assumptions about monetary and exchange rate policies, which correspond to deregulation measures, are discussed in section 3. Finally, section 4 presents the sequence and timing of removing administrative controls in the forex market.

2. *Administrative measures on the foreign currency market: how do they work?*

With a wide range of administrative measures, the forex market is being kept under control. What is alarming about these measures is they are less and less efficient. The NBU and government have reacted by introducing additional measures. As a result, the forex market is highly regulated and thus extremely distorted (according to some evaluations the level of forex control could be compared to the situation on this market in the end of 1993). Participants of the forex market try to work out procedures and methods to avoid this control and to adjust to new environment. It is quite common that they use not only legal but unofficial solutions, as well. The administrative measures could be divided into two groups: official and unofficial (which means the right of making arbitrary decisions given to clerks of different public institutions). The consequence is non-transparent environment for economic agents dealing with foreign currency operations.

Before expressing the judgment about efficiency of adopted measures, let consider possible effects of existing controls (the list of adopted measures is attached in Appendix).

1. Decisions about concentrating currency operations on the UICE and suspension of the interbank currency market deprive the policy makers of information about the real market equilibrium exchange rate. The demand, supply, and exchange rate movements can be observed only indirectly. The cash black market, the non-cash transactions of residents and non-residents and market in Russia could serve as the approximation of exchange rate trends. Evaluation of the market tendencies by these measures, which can not be fully reliable and are by its nature difficult to capture, should be taken cautiously.

[1] *Net foreign assets of NBU decreased from –162 mln UAH to –3427.2 mln UAH at the same period.*

2. Capital control has distorted the structure of foreign trade. As the result of exchange controls, demand for import purposes could not be fully satisfied. On the other hand, 50% of revenues from export must be sold on the UICE. Both these measures contribute to changes in foreign trade. Many import transactions have been suppressed, which caused drop in the amount of import, and destroyed credibility of many Ukrainian importing enterprises bringing about loosing of clients. On the other hand, import payment restrictions have indirectly influenced the size of export, as import of many intermediary goods is used in the export production. According to commercial banks' representatives, the restrictions have adversely affected the economy's performance, particularly the operations of importers.

3. When the currency is under devaluationary pressure and foreign exchange controls are introduced, the emergence of a parallel foreign exchange market is fairly automatic. The black market exists for cash and non-cash transactions. Some operations are performed in cash, some through specific schemes involving the Russian ruble. There is a structure of quasi-banking institutions servicing foreign exchange transactions (acting illegally), big part of settlements is conducted through foreign banks, or banks located in the off-shore zones. The businesses are finding ways to avoid regulations of the NBU, which tries to forbid such transactions. It is possible to evaluate the exchange rate on these parallel markets only with approximation.

4. Existing foreign market control creates additional pressure on commercial banking sector. The banks were barred from different activities (see: Appendix). These regulations combined with the conversion of resident banks' Treasury securities portfolio (according to the published data 16 banks participated in the voluntary conversion of 35% of the total bond stock held by resident banks) influenced the level of banks liquidity and limited the range of activities, which could be undertaken by this sector. The banks have limited possibilities of risk diversification and management of a liquidity level.

5. When demand for currency exchange is not met, the speculative activities emerge and the arbitrage on currency is taken.

6. The procedures applied to collect documents for the purpose of foreign currency purchases are complicated and change unexpectedly. There is a big room for arbitrary decisions taken by clerks of the NBU, State Tax Administration and State Customs Service. The invisible hand of the market was replaced by hand of civil servant. This system could be corruptive and surely is not efficient in the sense of optimal allocation of a scarce resource (foreign currency).

7. So far, measures adopted in Russia do not allow to reject the possibility of the "second wave" of crisis. In the case of sharp devaluation of ruble, the pressure for hryvnia will emerge. The NBU has not enough foreign reserves to intervene, the room for additional foreign exchange control is also limited. The strategy how to counteract the above mentioned situation must be worked out before the new round of the ruble crisis would happen. The method of introducing stronger and stronger administrative control measures with every shock on a forex market is the way to nowhere: it does not help to solve the problems but only cumulate them.

8. Sharp devaluation undermined the credibility of domestic currency. Due to foreign exchange controls, the foreign currencies became the scarce goods. As the result of the above facts, the dollarization of economy has increased. Foreign exchange control favors the existence of parallel markets and the gap between official foreign exchange rate and the `black market’ one additionally stimulates devaluationary expectations and encourages the dollarization of the economy (people try to transfer their savings into the hard currencies).

9. Many enterprises intentionally violate Ukrainian legislation and fail to timely return currency earnings to Ukraine. According to the government, at the beginning of November about 363 enterprises fail to return USD 248.6 mln of currency earnings and assets to Ukraine[2]. Particularly, exporters are not in a hurry to return proceeds from export violating the deadline set by legislation. From the government sources we know that export proceeds not returned to Ukraine on time totaled UAH 2.86 bln. as of October 1. Existing administrative measures only encourage such behaviour.
10. Excess demand for foreign currency is channeled into the parallel market. The additional export revenues are sold on the black market too. The existence of currency control favors creation of network between importers and exporters, who satisfy their needs beyond the official market.
11. As the result of limited access to foreign currency, some enterprises were forced to shift their activity into the unofficial economy. Growing unofficial sector is not something, what Ukraine needs, at least in the light of its budgetary consequences and perspective of economic growth.
12. Foreign exchange control favors expansion of a barter payment system in foreign trade.

Being aware of all possible consequences of foreign currency control let us try to elaborate the framework of their withdrawn. The following general rule should be kept in mind: the more distorted is market, the higher will be price of adjustment connected with removal of administrative measures. If the administrative measures on the forex market were maintained it would create distorted multi-equilibrium foreign exchange market demanding more and more control. After it, in the case of eventual removal of these measures, the shock will be higher, and the time needed to converge all rates to one equilibrium level will be longer. That is why the sequencing matters.

The administrative control on the forex market, as was mentioned before, has wide distortive consequences for the whole economy, increasing the price of credit in the economy (as the result of limiting banking activities) and limiting the possibility of economic growth. Although administrative measures adopted on the forex market enable stabilize the official hryvnia exchange rate, their persistence will have many disadvantageous effects, for example, price distortion, creation of parallel forex market, impediments for small and medium size business, corruption, etc. Considering these negative effects, the evaluation of effectiveness of the anti-crisis administrative measures in medium and long run must be negative. This is the reason why they should be abolished as soon as possible (as we do not know when the advantages would be smaller then disadvantages). Market research shows that a lot of disadvantageous effects have already appeared. Below we propose the time schedule for abolishment of administrative restrictions.

3. Consistent macroeconomic framework for deregulation of the forex market

In order to relax administrative controls within consistent macroeconomic framework we have to make assumptions about monetary and exchange rate policies that have to be coordinated with fiscal policy as well. Following the NBU announcements, we assume monetary base to be the intermediate target of monetary policy and the main tool to stabilize the price level in 1999. Moreover, net credit to the government will virtually remain stable according to the new reduced budget deficit.

Finally, an increase of monetary base (consistent with a change of net foreign assets) will correspond to the inflation target for next year. Change of net foreign assets should be almost the only source of monetary base growth (very limited commercial bank’s refinancing) reflecting

[2] *This number reflects the liabilities of 363 enterprises owing at least USD 100 ths. each.*

increase of demand for hryvnia based on domestic and external sources. In such a fiscal and monetary framework (change of intermediate target from exchange rate to monetary base growth) a gradual abandoning of the forex controls implies introduction of '*dirty floating*' exchange rate as a new exchange rate regime.

We claim that considerate deregulation of the forex market gives no rational reasons for further devaluation of hryvnia in medium-term under condition of conducting consistent and consequent monetary policy. It means that the NBU will stick to its targets (increase in monetary base and price level) and not renege from the assumed consistent macroeconomic framework by increasing net credit to the government. Besides, refinancing credit will not support weak and hopeless commercial banks, which do not fulfil prudential regulations. The NBU will apply liquidation and/or rehabilitation procedures to these banks in order to heal financial sector[3].

4. *Sequence of removing administrative controls*

Under assumptions of consistent and consequent monetary policy discussed in the previous section, we present a general sequence and timing for removal of administrative controls in the forex market.

In the first step, say, as of January 1, 1999[4], procedures to apply for foreign currency purchases in the UICE should be simplified, more transparent and less arbitrary. In particular, certificates from tax administration should be immediately excluded from the list of required documents when applying for foreign currency. There is no point for this requirement, which only prompts corruption. In case of imbalance in the forex market - demand of hard currency exceeding its supply – we recommend to favor banks that regularly meet prudential regulations of the NBU.

At the same time, the permissible difference between the official and the currency exchange bureaus' selling and buying rates should be increased up to 10-15 % (pre-crisis level or a little bit higher to accelerate adjustment process) and the limit of USD 1000 for one client should be removed. This in turn will give more freedom in formulating the exchange rate to exchange points and reduce the black market for the hard currency. As a result, economic agents will have better information about tendencies in the currency exchange market. This should also help small „cash" importers to operate without additional costs for currency purchases. Finally, both measures will give a positive sign to the market with commitment to remove further regulations.

The next set of deregulatory measures should be taken under conditions of relative balance between initial demand and supply at the UICE and visible convergence of exchange rates – the currency exchange bureaus' selling rate should not differ by more than about 5% from the official rate (pre-crisis margin of exchange bureaus). The Moscow exchange rate and the black market rate have to indicate stabilizing tendencies around the official rate[5]. Given the above conditions, all import contracts (for all and not only specific goods) should be allowed to apply for currency purchases at the UICE. Moreover, banks can credit residents in the hard currency from their own resources - they still cannot apply for currency for credits at the UICE. In order to ease access to currency operation for commercial banks, we propose conditions on deposits on banks' applications to buy dollars should come back to pre-crisis rules (i.e. 10-40% deposit, see: Appendix).

Shortly after, 2 or 3 month prepayment for import contracts should be restored. It implies that importers could apply for currency in advance and complete contracts after 2 or 3 months. There is a threat that banks can use prepayment for import as a way to temporary increase

[3] For example in Kyrgyzstan, application of the NBKR's rehabilitation procedures means dismissal of current bank's management. Hence, the bank's shares serve as collateral for rehabilitation loan.

[4] This is the first acceptable date, which doesn't involve the decision about changing existing foreign exchange corridor.

[5] Stabilization process is not expected to be longer than 3-4 weeks.

holdings of foreign exchange for speculative purposes. Nevertheless, as it was said in Section 2, it is crucial for trade development to allow prepayment of import contracts since Ukraine has no international credibility and a large share of import is not realized.

The last step before re-opening the interbank market for hard currencies is to allow banks apply for dollars for non-trading operations in the UICE. This is also a step, which gives more speculative options to commercial banks and should be introduced, in relatively stable circumstances in the currency market.

The last step is to restore functioning of the interbank market for hard currencies, which implies that banks can freely sell and buy hard currencies among themselves for purposes allowed by the monetary authority. It means that banks act as the NBU agents in evaluating applications for the hard currency purchases. In addition to re-introducing the interbank market, banks should be allowed to run open currency positions (at pre-crisis level).

Other impediments to market-based operation on the forex market (like currency futures contracts, Nostro accounts, limit on interest rate on credits from abroad) can be removed subject to circumstances in the financial system (for example well functioning banking supervision). It is also important to keep in mind that specific timing of removing regulations in the market has to take into account those circumstances.

1. Simplifications of procedures to apply for foreign currency purchases in the UICE.
2. Deregulation of exchange bureaus' operations.

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1. All realized import contracts allowed to apply for currency purchases.
2. Banks can credit residents in the hard currency.
3. 100 % deposits on banks' applications to buy dollars are reduced to the pre-crises level.

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1. The possibility of two or three months prepayment for import contracts.
2. Banks can apply for dollars for non-trading operations without any limits in the UICE.

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1. Functioning of the interbank market for hard currencies.
2. Banks can run open hard currency positions up to the pre-crises level.

Appendix

Administrative regulations on the currency market

1. As of August 22, 1998 banks are barred from having open currency positions in freely convertible currencies (the August 18 NBU resolution). This requirement does not apply to operations connected with the purchase or sale of cash currency to cover a bank's cash handling functions or exchange points. Banks were previously permitted to have an open currency position amounting to 15% of capital.

— On November 10, 1998, the NBU re-imposed restrictions on demand for dollars for non-trading operations and limited amounts of dollars that bank may buy at UICE for their currency exchange bureaus. From November 12, 1998 the NBU required banks to specify the purpose of their applications.

2. As of August 22, 1998 banks are barred from concluding currency futures contracts (the August 18 NBU resolution), which is a preventive measure.
3. As of August 22, 1998 businesses, resident in Ukraine, are barred from making advance payment on import contracts (either foreign currency or hryvnia). Payment by a resident of a sum of over ten thousand dollars is to be made exclusively through forms of settlement employing a letter of credit or invoice (the August 18, 1998 NBU resolution). On November 13, 1998 NBU partially lifted ban on down payment for import contracts, mainly for services.
4. Possibility of foreign currency purchases was limited for foreign banks.
5. The NBU demanded that exchange points keep fixed exchange rates for cash sales throughout the day.
6. The commercial banks are not allowed to give credits to residents (in foreign currency), excluding transactions connected with critical import.
7. The interest rate on credits from abroad could not be higher than maximum yield in foreign currency of Treasury securities.
8. The NBU's board adopted several additional measures on September 4, 1998.

— introducing mandatory sale of 75% of enterprises' hard-currency proceeds on the Ukrainian Interbank Currency Exchange (beginning from September 7, 1998); mandatory sale of hard-currency proceeds was canceled in May 1997. On September 14, 1998 the Cabinet of Ministers has lowered this proportion from 75% to 50%;

— imposing a ban on issuance of credits and financial guaranty to banks that, as of July 1, 1998 had not finished creating reserves for covering their risks on currency operations;

— for hard currencies reducing from 10 to 5% the permissible difference between the official exchange rate and currency exchange bureaus' selling and buying rates, the amount of foreign exchange which could be bought by client at the exchange bureaus was limited to USD 1000 for one transaction;

9. The NBU banned hard currency operations on the interbank currency market on September 7, 1998. Subjects of the interbank currency market and their Ukrainian clients are to perform non-cash currency operations involving purchase and sale of foreign currencies classified into the NBU's currency group I[6] exclusively on the Ukrainian or Crimean Interbank Currency Exchanges (September 4, 1998 NBU directive). According to the September 4,

[6] *The NBU’s currency group I includes freely convertible currency as the United States dollar, the deutsche mark, among others.*

1998 NBU directive, the Ukrainian Interbank Currency Exchange (UICE) and the Crimean Interbank Currency Exchange do not deduct commission from foreign currency sellers during exchange transactions; commissions from foreign currency buyers may not be greater than 1% of the volume of transaction.

10. On October 1, 1998 the National Bank of Ukraine sharply tightened the rules governing the purchase of foreign currency.

— Among other things, the new rules stipulate that foreign currency may be purchased at the UICE by the authorized banks on condition that their clients produce a number of documents, including foreign trade contracts, tax clearances, customs clearances, etc., confirming that they have the right to purchase foreign currency. Moreover, banks are required to provide the State Tax Administration with information about their clients intending to buy foreign currency, including details of the passports of the client's director and accountant.

— The NBU's regional departments will decide whether a client has the right to buy foreign currencies. The regional departments will also conduct monthly inspection of banks to ascertain the use of the foreign currency thus purchased.

11. The Exchange Committee of the Ukrainian Interbank Currency Exchange (UICE) on October 1, 1998 introduced 100% deposit on banks' applications to buy dollars on the exchange. [The Clearing House Bank (the UICE's clearing center) on February 2, 1998 proposed the new payment procedures, under which banks were to deposit with the Clearing House Bank 10-40% of their volume of their applications for purchase or sale of foreign currency. From that time until October 1, 1998 The Clearing House Bank determined the amount to be deposited on the basis of the rating of each bank.]

12. From October 5, 1998 banks are prohibited to open correspondent „Nostro” accounts in currencies classified into group I, in offshore zones or in countries where local currencies are classified into another group.

13. The NBU has lifted a ban on granting foreign-currency bank loans to exporters, which are later resold to borrowers on the currency market (these loans were prohibited from December 1997). This decision would come into force after its registration with the Ministry of Justice.