The Moscow Times
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Ukraine Hryvna's Slide Risks Spooking Household Savers

By The Moscow Times

February 04, 2014

Ukraine's hryvna currency could slide further after losing more than 5 percent in January, if its weakness shakes households' faith in the safety of their bank deposits and prompts them to seek refuge in dollars.

The central bank appears to have eased its tight grip over the hryvna since mid-January, allowing it to tumble as much as 2.5 percent against the dollar last Friday — the currency's biggest one-day fall since October 2009.

Its reluctance to intervene is significant given the bank's staunch defense of the hryvna even before Ukraine secured a loan agreement with Russia in mid-December. Prior to Moscow's bailout, the cost of clinging to the currency's crawling peg had helped halve central bank reserves from highs of about $40 billion reached in 2011.

A weaker currency is not a bad thing for an economy that is mired in recession and which has almost flat price growth. A more flexible hryvna exchange rate was also the condition set by the International Monetary Fund in its failed talks on an aid package with Kiev last year.

"You can take a positive or negative view of the hryvna slide. The positive is that it needs to slide and it is better they do not waste a lot of hard currency reserves defending a currency that deserves to slide," said Gabriel Sterne, an economist at Exotix in London.

"The risk is the depreciation hits 20 to 30 percent and becomes uncontrolled and then leads to stress in the corporate and banking sectors."

As emerging market crises over many decades have shown, central banks have little power to steady a currency once it has entered a downward spiral. That often happens when a country's households lose their trust in the local currency, withdraw their savings from banks and convert them into hard currency.

No such shift has yet been seen in Ukraine. Central Bank data shows that households held 437 billion hryvna ($54.7 billion) in deposits with commercial banks on Jan. 1, of which 58 percent was in hryvna and the rest in hard currency.

But currency forwards are betting on more depreciation, with current prices suggesting the hryvna will trade 9 percent lower in six months' time. That implies an exchange rate of 9.5 to the dollar compared to the current 8.65.

Moreover, depreciation bets are picking up speed — the six-month non-deliverable forward, or NDF, traded at 8.8 per dollar just two weeks ago. Currency traders in Kiev said Monday there was a constant bid for dollars on the interbank market.

"So far it is an amber warning, rather than a red light that is flashing for the hryvna," Sterne said.

Ukrainians are worried, although individuals interviewed for this article declined to be quoted by name.

"I do not keep my money in banks at all, I do not trust them," said an analyst at a local brokerage. "If there is a run on deposits, the central bank could put a temporary freeze on withdrawals as it did in 2004."

Most Ukrainians have kept faith with the currency, however, enticed possibly by the 14 to 25 percent rates available on bank deposits. Dollar bank deposits pay 10 percent or less.

Because of those rate differentials, being long dollar and short hryvna would amount to a very negative carry trade for Ukrainians, says David Hauner, head of EEMEA fixed income strategy and economics at Bank of America Merrill Lynch.

"It is pretty clear there is rising demand for dollars in Ukraine," Hauner said. "Last year when Russia promised funds, the concerns subsided, but now the worry is whether the regime can actually hold on to power."

With one-third of Ukraine's exports going to the former Soviet market, to remain competitive, Kiev may have no choice but to allow the hryvna to follow suit, as it did following a big depreciation in the Russian currency in 2008.

"At the moment you have a chunky gap of 10 percent, that is the carry you get on a hryvna deposit over a dollar deposit," Sterne said. "If you think the exchange rate will depreciate 10 percent or less, then you will be okay sticking with the hryvna."