TITLE: Ukraine After the Monetary Reform of November 12th

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Abstract

The new non-cash money introduced in Ukraine on November 12th does not appear to have in any way stabilized the monetary situation. In the twelve days following this move, the Ukrainian cash coupon depreciated 14 percent against the Russian ruble and more than 20 percent against the dollar on the black market. Food prices continue to rise rapidly -- our food price index increased 15 percent from mid-October to mid-November.

In the last ten days, the Ukrainian government has clearly announced that it wants to stabilize the economy. However, its own pronouncements have also confirmed that Ukraine faces three serious problems: a massive budget deficit, a consistent current account deficit on transactions with Russia, and an accelerating rate of inflation. The partial monetary reform of November 12th does not deal with the fundamentals of these problems, but rather reveals the overwhelming need of the Ukrainian government to finance itself through printing money. It is quite ironic, but the formal delinking from the ruble appears to have removed the last nominal anchor in the Ukrainian economy.

Ukraine After the Partial Monetary Reform
of November 12th*

1. The Partial Monetary Reform

On November 12th, 1992, Ukraine introduced a new form of money and the Russian ruble ceased to be legal tender in Ukraine. The new money exists only for non-cash (beznalichnye in Russian) transactions between enterprises -- following the previous Soviet practice of distinguishing between cash and non-cash money. However, in fact Ukraine has finally created a non-cash counterpart to the cash money, karbovanets (Ukrainian for ruble and popularly known as the coupon), which was introduced in January 1992.[1] Why was this non-cash money created and what are the implications?

Throughout early fall 1992 the Ukrainian newspapers repeatedly stated that the country was on the edge of an energy crisis. Exactly the same theme was stressed by Prime Minister Leonid Kuchma in his speech on October 27th to the Ukrainian Supreme Soviet (Uryadovii Kurer, No. 48-49, October 30th, 1992). The principle cause of this crisis was stated to be that Ukraine simply did not have enough money -- i.e., Russian non-cash rubles -- to pay for Russian oil.[2] According to its government, Ukraine introduced its own beznalichnye money in large part so as to be able to buy oil again.

When the new non-cash coupon was introduced, existing balances in Ukrainian banks were converted from non-cash rubles to non-cash coupons at an exchange rate of one for one. For all new transactions, however, the beznalichnye coupon-ruble exchange rate was

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fixed by the Ukrainian National Bank at 1 ruble to 1.45 coupons. The idea apparently was to convert the existing stock of money at a relatively appreciated rate, in order to reduce its purchasing power, but then to set a fairly depreciated rate, with the goal of at least eliminating the current account deficit with Russia. The introduction of the non-cash coupon should be interpreted as part monetary reform and part devaluation.

Ukrainian commercial banks now also have the right to set their own exchange rate between the beznalichnye coupon and the ruble, although this rate cannot vary more than 3 percent from the rate set by the Ukrainian National Bank. The coupon-ruble non-cash rate is at present a single unified fixed exchange rate, with coupons fully convertible into rubles, at least for current account transactions. However, it remains to be seen how long this precise arrangement will last.

The most serious immediate danger to this system is that the fixed rate will diverge from the market determined black market rate between cash coupons and cash rubles. As Table 1 (page 7) shows, the black market rate was 1 ruble to 1.4 coupons initially but then fell rapidly and had reached 1 to 1.6 by November 22nd -- a 14 percent depreciation in 10 days. This is particularly remarkable because the black market cash rate had hovered around 1 to 1.4 for at least the last six months.

Helped by the direct and presumably more rapid transactions between banks it will be possible in principle to conduct arbitrage on the differences between the fixed and floating rates, for example by buying rubles with coupons at the official rate (obtaining 1 for 1.45 coupons), and then selling rubles at the black market rate (obtaining 1.6 coupons for 1 ruble). Given the new direct links between commercial banks in Russia and Ukraine, it may even be possible for Russian enterprises to make money in this way.[3] Alternatively there could be a straightforward speculative run on the coupon.

One possible consequence is that the Ukrainian National Bank may run out of ruble reserves and be forced to float the beznalichnye coupon. Alternatively, and more probably, access to rubles from the central bank will be restricted and a significant gap will develop between the black market cash rate and the official controlled beznalichnye rate. A legal or semi-legal parallel market between beznalichnye coupons and rubles is also likely to develop.

More fundamentally, the full effects of introducing this new money depend on how it fits in to the government's overall package of economic policies. On this point there are contradictory indications: the government has made some encouraging statements over the past couple of weeks, but the inflation news continues to be bad and there may now be little time left to prevent the onset of hyperinflation.

2. Stabilization Policies

In mid-November representatives of the new government made various pro-stabilization statements, culminating in Prime Minister Kuchma's speech to the Ukrainian parliament on November 18th (Golos Ukraini, November 19th, No. 221.) This speech was billed as addressing the required anti-crisis measures, but in fact it was not very specific about what would be done. The basic message, however, was clear -- Ukraine is on the brink of a serious crisis and the blame should be placed on the previous government of Vitold Fokin.

Kuchma estimated that the government budget deficit this year would be 1.5 trillion coupons, while government revenue (other than through printing money) would be only 1.08 trillion. He therefore put the deficit at 150 percent of budget revenues, and said this amounted to 44 percent of GNP.[4]

In the same speech, Kuchma claimed that the level of consumer goods production was 10 percent lower now than at the same time in 1991. He also referred to catastrophic falls in the output of coal, metal, chemical, and machine building industries. Resolving the crisis in agriculture -- according to Kuchma -- would require an investment of 0.9 trillion coupons.

As for policy implications, Kuchma did say that price controls were necessary on some goods, but he did not provide any further details. Other government documents have suggested that the pace of privatization should be accelerated, although the precise desired pace remains unspecified. Over the past few weeks, Kuchma and other government officials have also made vague statements in favor of foreign business activity in Ukraine.

All these pronouncements add up to good intentions, but not much more. Kuchma's tough talk helped to ensure that parliament conferred broad economic powers on the government and in contrast with the situation in Russia, the Ukrainian government faces little effective opposition. However, there have not yet been any signs of real policy changes.

Meanwhile inflation continues to be high. One indicator is provided by our "Ukrainian Army Price Index."[5] In mid-October this basket of goods cost 2,812.9 coupons, when calculated using average prices from Kiev, Lutsk and Donetsk. The same basket cost 3,221 coupons in the second week of November -- implying inflation of 15 percent per month.

Table 2 (page 8) shows the price news is quite mixed. Our surveys revealed lower prices for bread and potatoes, both of which are very important to the Ukrainian consumer. However, in the overall index these falls were dominated by the rises in other prices, particularly meat and cabbage. In terms of the availability of goods, we could detect no significant changes between October and November. The availability of goods in state stores -- as indicated in Table 2 -- remains practically unchanged. There certainly has been no discernible improvement in the quality of food products available in state stores.

Even more worrying is that the black market exchange rate for the coupon against the dollar has fallen still further. Table 1 shows a decline from 620 coupons per dollar when the new non-cash money was introduced on November 12th, to 758 coupons per dollar on November 25th. A depreciation of more than 20 percent in thirteen days is not an encouraging sign.

The Ukrainian government has been authorized by the parliament to take decisive steps, and official pronouncements correctly identify inflation as a major problem. However, given that the government already has a huge budget deficit, credible anti-inflation policies are needed right away. These policies are not yet in sight.

3. Conclusions

Ukraine has three closely connected problems: a budget deficit, a current account deficit on transactions with Russia, and inflation. Ukraine introduced the new non-cash money primarily because it was no longer able to buy Russian oil using Russian rubles. This was both a budget problem and a current account problem -- the Ukrainian government was no longer able to issue Russian rubles to buy Russian oil. However, the partial monetary reform of November 12th does not address any of the fundamental problems.

According to the government, there is already a very large budget deficit. The priority for monetary policy is likely to continue being the generation of enough seigniorage to pay for energy imports and to finance other essential government spending. Despite the new anti-inflation rhetoric of the government, a further acceleration of money printing is to be expected.[6]

As for the current account, it seems unlikely that the existing exchange rate regime will prove helpful. If Ukrainian inflation accelerates further and prices rise faster in Ukraine than in Russia, then the fixed official exchange rate will quickly become overvalued. The probable outcome is a rapid depreciation of the black market rate at the same time as the official rate is held constant and appreciates in real terms. Inflation is unlikely to be slowed significantly by this combination, but to the extent transactions do take place at the official rate, exports will tend to fall and imports will tend to rise.

Ironically, it appears that by breaking its direct link with the ruble, the Ukrainian government may have eliminated the last nominal anchor in the economy. The willingness of the Russian central bank to finance Ukraine may have been a very imperfect anchor previously, but it is now gone. The coupon is a money with no credible prospect of stabilization and the partial monetary reform of November 12th has only made this point clearer. Unless the government changes its policies very quickly, hyperinflation will be the result.

Table 1

Exchange Rates in November 1992

Date November	Coupon-Dollar Exchange Rate	Coupon-Ruble Exchange Rate
7th	610	
8th	610	
9th	610	
10th	610	
11th	620	
12th	620	1.4
13th	620	1.4
14th	638	1.4
15th	670	1.5
16th	715	1.55
17th	725	1.55
18th	730	1.55
19th	730	1.55
20th	748	1.55
21st	750	1.55
22nd	750	1.6
23rd	755	1.6
24th	758	1.6

Notes.
1. The reported exchange rates are the averages of the selling and buying rates for dollars and rubles. The coupon-dollar exchange rate is coupons per dollar, and the coupon-ruble exchange rate is coupons per ruble.
2. Trading on Saturdays and Sundays (November 14th, 15th, 21st and 22nd) is often thin and quotes should be used with care.
3. Prior to November 12th we did not regularly monitor quotes for the coupon-ruble exchange rate. However, it is common knowledge in Kiev that this rate had hovered around 1 to 1.4 for at least the six months prior to November.

Source: exchange rate quotes were obtained by asking traders on the streets, using the methodology in Johnson and Ustenko, "Ukraine on the Brink of Hyperinflation," Table 6 (distributed by NCSEER November 19, 1992).

Table 2

Food Prices in November 1992
(Elements of the Ukrainian Army Ration)

	October		November	
	Price	Available in State Stores	Average Line	Price
Butter	240	+	12	250
Sugar	70	+	14	75
Meat	247	-	20	305
Bread	14	+	11	12
Cabbage	30	-	5	45
Tomatoes	65	-	-	100
Cucumbers	100	-	-	115
Potatoes	40	-	-	35
Eggs (10)	128	-	-	140

Notes.
1. All prices are per kilogram, except eggs which are for 10.
2. For the column "Available in State Stores," a "+" sign indicates the good was available in at least 50 percent of surveyed stores.
3. "Average Line" is for stores in which the good was present. An average line of "-" indicates the good was not found in any surveyed stores.

Source: these prices are averages from our food price surveys in Kiev (6 stores), Lutsk (3 stores) and Donetsk (3 stores).

Endnotes

1. By late spring 1992, the coupon was being used for almost all cash transactions in Ukraine. For more details see Johnson and Ustenko, "Ukraine on the Brink of Hyperinflation," (distributed by NCSEER November 19, 1992).

2. At the beginning of October, the Russian central bank stopped honoring at least some of the payments authorized -- in Russian rubles -- by the Ukrainian central bank. The Russians subsequently made it clear that ex-republics should either abide by Russian monetary rules or get out of the ruble zone. In mid-October, Russia apparently also forbade its enterprises from selling oil to Ukraine for rubles. Ukraine promptly left the ruble zone.

3. Direct connections between commercial banks -- through correspondent accounts -- were permitted by an instruction issued by the Ukrainian Cabinet of Ministers on October 12th, 1992 (Uryadovii Kurer, No. 48, October 30th, 1992.)

4. This number seems implausibly high -- it is unlikely that the Ukrainian government can really obtain so much revenue. However, even if the budget deficit were 10 percent of GNP it would still represent a serious problem given that the Ukrainian government cannot sell its debt to anyone except the central bank.

5. The reasons for establishing this index are explained in Johnson and Ustenko (1992). This index includes the price of 0.9 kg of butter, 1.5 kg of sugar, 4.5 kg of meat, 12 kg of bread, 2 kg of cabbage, 2 kg of tomatoes, 2 kg of cucumbers, 9 kg of potatoes, and 8 eggs. We use state price stores unless either these goods are not found in at least half of the surveyed stores or the line for these goods exceeds 15 people. In addition, we include the cost of payments for apartments and for local transport.

6. At the same time, allowing direct transactions between commercial banks and more rapid payments between enterprises may reduce the demand for real money balances still further. This would also tend to increase inflation.