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Currency liberalization in Ukraine: a fundamental step forward

Since February 7, 2019, the new Law on Currency has taken effect. It shifts the authority on certain capital flow restrictions from the level of Parliament to the level of regulatory acts issued by the National Bank of Ukraine. In contrast to the previous post-Soviet spirit of strict capital controls, the new law is based on the fundamental principle: "Everything which is not specifically forbidden is allowed".

The law was adopted within the framework of the EU-Ukraine Association Agreement and aims to facilitate free capital movements in the longer term. However, certain currency restrictions still remain – although much more liberal than the previous ones. A continued stabilization of the economic situation in Ukraine, together with deeper EU integration, could lead to the elimination of remaining capital controls in the future.

Previous currency controls: what was wrong?

Before the new law came into force, Ukraine's currency operations were regulated through an old Decree by the Cabinet of Ministers adopted in 1993, which legally had the same status as the Law on Foreign Currency Transactions, and numerous related acts and regulations. These old, post-Soviet currency regulations specifically prohibited investments abroad for individuals and legal entities (licensing conditions existed on paper, but were impossible to meet in practice) and allowed purchasing foreign currency for only a very limited amount of purposes (which had to be protocoled and were held under strict control). Violations of currency legislation carried severe administrative or even criminal liability: companies could face a complete freeze of all cross-border payments or individual licensing for each transaction for just a minor violation of the regulation.

During the 2014-2015 crises, the National Bank of Ukraine had to impose additional currency restrictions to prevent the Hryvnia from an uncontrolled devaluation. These emergency measures included an introduction of maximum limits for cash withdrawals (both for Hryvnia and for foreign currency), an obligation for exporters to sell 100% of foreign currency proceeds (later relaxed to 75%), the introduction of a 3-day reservation period when purchasing foreign currency (the so-called t+4 rule) and the prohibition of dividend repatriation.

However, these strict capital controls imposed in order to overcome the currency and banking crisis came at a price:

- The interest rates policy was less efficient because of low capital mobility.
- The 2014-2015 restrictions boosted black FX market activity, fueled the shadow economy and facilitated a shift to offshore transactions.
- They damaged foreign investment inflows to Ukraine: after dividend repatriation restrictions were introduced in 2015, FDI inflows have never recovered from their low levels.

Overall, capital controls complicated doing business in Ukraine by imposing an additional transactional burden and made as a consequence local firms less competitive on the global arena. This had a negative impact on economic growth.

Currency deregulation package: what's in it?

The new law was adopted as part of Ukrainian commitments under the EU-Ukraine Association Agreement and meets the requirements of Directive 88/361/EEC, which proclaims the free movement of capital. As a supplement to the new Currency Law, the NBU published 8 main resolutions. Resolutions No. 1, 2 and 3 determine a framework of the Ukrainian currency market after achieving macro-financial stability. Resolutions No.4 and 6 identify the list of possible safeguard measures and conditions of their usage. In Resolution No. 5, current restrictions in the FX market are represented. Thus, the restrictions which were previously defined by law could now be changed with the NBU's resolutions.

Compared to the previous capital controls, the new ones are much softer. Today, Ukrainian importers and exporters are able to close their export-import contracts in a period of up to 365 days (it was only 90 days during the crisis), the compulsory amount of currency proceeds surrenders decreased from 50% to 30% and the t+4 rule was abolished. Smaller transactions below UAH 150 thsd or FX equivalent are not controlled anymore. The new legislation abolished the freeze of cross-border payments and individual operations licensing regimes as sanctions for currency regulation violations and replaces them with administrative penalties. Foreign investors are now allowed to open current accounts in both Hryvnia and foreign currencies and the limit on dividend repatriations was increased to EUR 7 m per calendar month. Companies are not obliged to register loans from abroad with the NBU any longer, and the fixed interest rate cap was abolished and replaced with an "arm-length" market transaction benchmark basis.

Ukrainian residents will now be able to invest abroad. A system of electronic limits substitutes individual licenses, which allows Ukrainian legal entities and individuals to open accounts overseas and invest abroad freely up to EUR 50 thsd and EUR 2 m per year, respectively. Individuals are able to buy foreign currency online and make cross-border remittances in amounts up to UAH 150 thsd and transport cash up to EUR 10 thsd.

The all-encompassing control over currency transactions, which was previously performed by the NBU, is now replaced by risk-based supervision, and the banks have almost full discretion over the transaction decisions. It is still a bit confusing for them and their clients, but the ongoing dialogue should bring sustainable market practices in medium term.

What are the visible results of the liberalization so far?

Contrary to some concerns, the enactment of the new currency regulations has not caused panic in the market and did not lead to a mass purchase of foreign currency. During the first month after implementation, Ukrainian resident have spent online a relatively minor sum of USD 52 m, invested approximately USD 10 m abroad and attracted only 105 foreign loans without the NBU issuing a special permission. In line with this smooth introduction, the Hryvnia has appreciated during the last month from 26.96 UAH/USD as of 7 February 2019 to 26.35 UAH/USD as of 12 March 2019, while foreign currency reserves remained at a 5-year high of more than USD 20 bn.

First implications for investments and trade will become clear once more detailed balance of payments data is published. However, as Ukrainian banks and companies are right in the middle of adopting their behaviour to what can be called the most revolutionary change in Ukrainian currency regulation since the collapse of the Soviet Union, it will take some more time until the exact impact become visible.

Why is the movement of capital not free yet?

Current regulations, with numerous restrictions still in place, are an interim phase between capital controls and a regime of free capital flows. The necessary conditions for further liberalization are the stabilization of the macroeconomic environment and the implementation of a "Base Erosion and Profit Shifting (BEPS)" legislation package drafted to eliminate tax avoidance by shifting profits to off-shore zones.

But what's more important is the unresolved question on cross-border financial services. While, according to the new Law on Currency, residents can open accounts in foreign financial institutions and perform currency operations via them, these foreign financial institutions cannot act as FX trade service providers under the NBU regulations supplementing the law. This contradicts the Association Agreement clauses on national treatment and market access for financial services. Considering the inalienable rights of residents, foreign banks must service their operations. The Association Agreement also defines that Ukraine will provide a favorable regime for foreign legal entities, branches and representative offices in the same manner as for national entities. This implies that foreign legal entities should function freely in Ukraine. To eliminate this discrepancy, the National Bank will have to enact additional resolutions.

Providing market access to foreign financial institution will have positive effect on the national economy, foreign trade and investments, as well as decrease the state's borrowings costs, which are now as high as 16-20% per annum in local currency. On the other hand, it might make the FX market more volatile, less predictable and harder to control for the NBU. Therefore, it remains to be seen when further steps to eliminate this discrepancy will be taken.

Conclusion

The new currency legislation is a big step towards economic freedom. However, current currency regulations are still more restrictive than envisioned by the Association Agreement. With political and economic stabilization and deeper integration with the EU, Ukraine will likely abolish the remaining capital controls, leading to free movement of capital in the longer term.

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