German Advisory Group
Institute for Economic Research and Policy Consulting

Policy Paper Series [PP/05/2009]

Administrative measures to support the hryvnia: An appropriate instrument of exchange rate policy?

Ricardo Giucci, Robert Kirchner, Vitaliy Kravchuk

Berlin/Kyiv, October 2009

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Institute for Economic Research and Policy Consulting
Reytarska 8/5-A,
01034 Kyiv, Ukraine
Tel: +38 044 / 278 63 42
Fax: +38 044 / 278 63 36
institute@ier.kiev.ua
http://www.ier.kiev.ua

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German Advisory Group
c/o BE Berlin Economics GmbH
Schillerstr. 59
D-10627 Berlin
Tel: +49 30 / 20 61 34 64 0
Fax: +49 30 / 20 61 34 64 9
info@beratergruppe-ukraine.de
www.beratergruppe-ukraine.de

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Executive Summary

Over the recent past, the National Bank of Ukraine (NBU) has implemented a number of administrative measures in an attempt to regulate the foreign exchange market. It seems the authorities wanted to pursue several goals at the same time, like closing loopholes for currency speculation and decreasing the level of dollarisation. The underlying motive for these measures, however, seems to be an attempt to support the exchange rate of the hryvnia. For instance, the NBU Resolutions No. 107 and 109 oblige commercial banks to keep provisions for foreign currency loans in hryvnia and not in foreign currency, as was previously the case. In such a way, the NBU is clearly aiming at increasing the supply of foreign currency and/or the demand for hryvnia on the foreign exchange market. Despite the fact that such measures were heavily criticised, especially by commercial banks, there is an ongoing discussion on the implementation of further administrative measures, such as prescribing commercial banks to pay out interest and/or principal on foreign currency deposits only in hryvnia (i.e. not in foreign currency).

In this paper we review and assess the economic impact of selected administrative measures that were recently implemented, or are currently under discussion. At a first glance, such measures seem to support the exchange rate of the hryvnia. But a more profound analysis shows that in fact such measures are more likely to weaken than to strengthen the hryvnia. Economic agents interpret such measures as a clear evidence of the weakness of the national currency and react accordingly by holding foreign currency. Furthermore, the use of non-market based instruments of exchange rate policy increases uncertainty about more extreme measures being implemented in the future, such as the forced conversion of foreign currency deposits into domestic currency. As a result, many households prefer to keep foreign currency in cash, thus weakening not only the hryvnia, but also the banking sector. In short, administrative measures are generally speaking counterproductive.

But this does not mean that the NBU should do nothing about the exchange rate. In order to prevent sharp and volatile movements in the exchange rate, the NBU can intervene on the foreign exchange market, as far as the level of official reserves permits this. Also, the NBU can support the hryvnia by conducting a relatively tight monetary policy and thus controlling the supply of hryvnia. But also allowing effective hedging instruments such as forwards to function would be a crucial step, since this would under current conditions reduce demand for foreign currency and thus put less pressure on the exchange rate.

Authors

Ricardo Giucci	giucci@berlin-economics.com	+49 30 / 20 61 34 64 1
Robert Kirchner	kirchner@berlin-economics.com	+49 30 / 20 61 34 64 2
Vitaliy Kravchuk	kravchuk@ier.kiev.ua	+380 44 / 278 63 42

Acknowledgements

The authors would like to express their gratitude to Veronika Movchan for lecturing the paper. The usual disclaimer applies.

Contents

1. Introduction 1

2. Overview of recent administrative measures to support the hryvnia 1

2.1 General overview 1

2.2 Specific measures 2

3. Economic analysis of selected administrative measures 3

3.1 NBU Resolutions No. 107 and 109 3

3.2 NBU Resolution No. 108 4

3.3 Paying out interests on foreign currency deposits in hryvnia 5

4. Concluding remarks 6

List of recent Policy Papers 7

1. Introduction

In the fourth quarter of 2008, the hryvnia lost much of its value against international currencies such as the US dollar and the Euro. In our view, this flexibilisation was a necessary step which helped to rebalance the trade flows in the aftermath of the international financial and economic crisis, and thus facilitated external adjustment. Today, the current account is in a much better shape than when the crisis started. However, due to the widespread dollarisation and the relatively high level of external debt in Ukraine, the devaluation also had negative balance-sheet effects. In many cases, domestic borrowers are not able to pay back their credits in foreign currency at the current exchange rate, thus weakening the banking sector. At the same time, many banks and enterprises which borrowed abroad face problems in paying back their external debt, whose value in domestic currency has considerably increased.

In total, the economic benefits of the devaluation clearly outweigh its costs. Despite this, the devaluation has been profoundly unpopular and as a consequence policy makers put heavy pressure on the NBU to strengthen the currency. In what could be seen as an attempt to react to such pressures, the NBU introduced several administrative measures to support the hryvnia. Also, further measures are currently being discussed and might be implemented in the near future. In Part 2 we review measures, which were recently adopted or that are being currently discussed. An economic analysis of the impact of the selected measures is presented in Part 3. Finally, Part 4 draws the conclusions.

2. Overview of recent administrative measures to support the hryvnia

2.1 General overview

According to Ukrainian legislation, the stated objective of the NBU is to ensure the stability of the national currency. It thus has a wide discretionary authority to regulate the foreign exchange market. The statutory basis for this authority is a law approved in 1993, which had only several minor amendments over the 16 years it is in effect. Even before the crisis, the foreign exchange market was tightly regulated. Banks have to register every interbank foreign exchange transaction with the NBU and maintain supporting documentation for cashless transactions with their clients, as the NBU limited the purposes for which foreign currency can be acquired. Generally, all current account transactions were allowed, with restrictions placed mainly on financial account operations.

As exchange rate volatility increased sharply in October 2008, the NBU introduced additional administrative measures. The most visible measures were tightened restrictions on the cash market, as NBU stepped up efforts to stabilise the interbank market in the first half of November and reached indeed a short-lived stabilisation. As the hryvnia continued to depreciate, and under IMF advice, the NBU cancelled the cash market restrictions. Other administrative measures were generally related to the closure of (perceived) loopholes in current regulations. Some of these measures were cancelled following IMF requirements during the first review of the stand-by agreement, while a stabilisation of the market limited their usefulness.

The Verkhovna Rada also discussed a number of currency regulations/balance of payments restrictions, including the prohibition of foreign currency lending to borrowers without foreign currency revenues, the forced sale of part of foreign currency receipts received by exporters, and import restrictions. The only decision passed by the Verkhovna Rada that became a law introduced a 13% import surcharge for six months for a number of consumer products, including cars and fridges. This measure expired in September. While the Verkhovna Rada managed to gather enough votes to approve several other draft laws,

despite the absence of a permanent majority, they were subsequently vetoed by the President.

2.2 Specific measures

The NBU first reacted to the crisis by approving the Resolution No. 319 from 11 October 2008 (it became effective on 13 October 2008). This resolution and its successor Resolution 413 from 4 December 2008 (and amendments to both resolutions) contained a large part of the foreign exchange restrictions introduced.

The Resolution 319 and amendments (Resolutions 328 from 16 October 2008, 353 from 5 November 2008, 356 from 7 November 2008) limited bid-ask margins on the cash market, first to 5%, then to 3%. Besides, the NBU required banks to maintain their exchange rate quotes unchanged during the day. In November, the cash exchange rate was also tied to the official rate, as ask rates were limited to the official rate +1.5%. However, administrative price setting proved futile and lead to widespread gray and black market transactions. On 1 December, cash market controls were cancelled by NBU Resolution 408.

Resolution 319 also prohibited foreign currency payments by banks before the maturity of their respective obligations, to limit capital flight. The prohibition was affirmed by Resolution 413 in weaker form and is effective at the date of writing. Another measure to limit capital outflows that was introduced by Resolution 319 was the prohibition on paying for imports of goods and services without entering Ukrainian territory. The rationale for this action was allegations that some companies engaged in fictitious import transactions to move money to offshore accounts. However, the IMF demanded it cancelled as prior condition for the second tranche of the stand-by agreement (cancelled by Resolution 269 from 6 May 2009).

The NBU also tried to limit foreign currency balances of banks and companies. Resolution 319 required the foreign currency purchased to be used for stated purpose within 5 days after purchase. This measure was included in Resolution 413 and remains effective.

Changes in Resolutions 107-109 from 28 February 2009 (effective from 23 April 2009) had to be enforced in a short timeframe of sixty days (i.e. by 22 June 2009). Before the resolutions were approved, the NBU allowed purchasing foreign currency to build provisions for losses on foreign currency loans. The purchased foreign currency was not counted in open foreign exchange position requirements. After the resolutions came into force, the foreign currency purchased for provisions was included in open positions, forcing banks to sell foreign currency. From 22 June 2009 onwards, banks could be sanctioned for holding excess open positions.

Other facets of the NBU policy were efforts to fight devaluation expectations and dollarisation. Foreign exchange forward and spot[1] transactions were banned until the end of 2009 by Resolution 108 from 28 February 2009. The decision was cancelled by Resolution 416 from 21 July 2009 (effective from 17 August 2009 for spot transactions and 26 October 2009 for forwards). The NBU also restricted foreign currency lending to companies and individuals without foreign currency income. This was limited to amounts outstanding as of 13 October 2008 by Resolution 319. Thus, banks could issue new loans only within the amounts repaid. Resolution 413 cancelled the limitation. However, Resolution 406 from 17 December 2008 (effective from 28 December 2008) introduced a 50% provision requirement for standard loans to borrowers without foreign exchange income and 100% provision for lower quality loans[2]. The new requirement applies only to loans originated after 17

[1] Spot transactions imply that the settlement occurs within two days of a trade (T+2), as is international standard for most currencies. However, most transactions on the market in Ukraine are conducted on a “tod” basis (T+0, i.e. transaction and settlement on the same day), which is not affected by the ban.

[2] Provisioning amounts are net of collateral, which makes these requirements less severe.

December 2008. Banks were allowed to honor existing commitments under credit lines or restructure loans issued before the resolution will come into force.

Representatives of NBU further discussed recently paying out interest or even principal of foreign currency deposits in hryvnia. It is questionable whether the requirement related to interest payments may have a legal basis. This could only be the case, if interest payments are viewed as a payment for financial services provided. National legislation requires all payments for goods and services in Ukraine to be made in hryvnia, with only very limited exceptions. On the other hand, the forced conversion of principal would require legislative action or even may be prohibited as being in contradiction to the Constitution. Due to these uncertainties, the proposal met both, internal and external opposition, including from the NBU Council.

3. Economic analysis of selected administrative measures

In this part we analyse the economic effects of three administrative measures: The Resolutions No. 107 and 109, which came into force on 23 April 2009, the Resolution No. 108 and the suggestion to pay out interest on foreign currency deposits in local currency, as it is currently publicly discussed. The analysis of these three selected measures should serve as an illustration of the general problems involved with conducting exchange rate policy through administrative measures.

3.1 NBU Resolutions No. 107 and 109

Formerly, banks in Ukraine had to build provisions for loans in the same currency as the loan. For example, loans in US dollar required the creation of provisions in US dollar. In such a way, banks avoided entering a currency risk, on top of the existing credit risk. The NBU Resolutions No. 107 and 109 changed this. According to the new regulation, provisions for any kind of loans (including foreign currency loans) have de facto[3] to be conducted in hryvnia. Besides, banks were given only 60 days to comply with the new regulation. Finally, the new regulation applies not only to new, but also to outstanding loans.

The prescription to build provisions only in national currency is not necessarily a bad idea. Banks are discouraged to provide new loans in foreign currency (because of the higher risk) and as a consequence the financial dollarisation could be reduced. But targeting also outstanding loans is a questionable approach, and this is particularly worrisome at a time of high exchange rate volatility. Banks are forced to enter a currency mismatch between outstanding loans and the correspondent provisions. In case of a sizeable devaluation of the hryvnia, banks would be additionally hit by keeping provisions in the "wrong" currency. Thus, the new regulation makes the banking sector more fragile. Because of this, commercial banks strongly criticised the new regulation. And according to some insiders, many banks have rejected implementing the new rules and are thus risking being fined (or otherwise sanctioned) by the NBU for non-compliance.

But if the new regulation does not make sense from a banking regulatory point of view, why was it introduced in the first place? In order to comply with the new regulation, banks need to sell large amounts of assets (including currency) denominated in foreign currency and purchase assets (including currency) denominated in national currency within a very short time of 60 days. In such a way, the supply of foreign currency and the demand for hryvnia increase strongly within the adjustment period of 60 days, thus contributing to a stronger exchange rate of the hryvnia. As it looks, Resolutions No. 107 and 109 were in fact not

[3] According to the Resolutions No. 107 and 109, provisions in foreign currency are not taken into account for the calculation of the open foreign exchange position of a bank. In economic terms, this regulation is equivalent to the prescription to keep provisions only in national currency.

motivated primarily by sound banking regulation, but were an attempt to support the exchange rate of the hryvnia using administrative measures.

Probably, the new regulation had some short-term effect on the exchange rate. According to market estimates around USD 5-6 bn had to be sold by banks in order to be in compliance with the new regulation. After the new regulation came into force on 23 April 2009, the hryvnia appreciated against the US dollar from 8.5 UAH/USD to around 7.6 UAH/USD in mid-June.[4] But after the completion of the adjustment period of 60 days on 22 June 2009, the hryvnia became weaker again and is now back at around 8.5 UAH/USD. Thus, the regulation might have had some effect on the exchange rate, but only a temporary and very short-lived one. Besides, this short-lived support of the hryvnia comes at too high a price, i.e. at the cost of increasing the vulnerability of the already fragile banking sector. Last, since many banks apparently decided not to follow the new rules, the new regulation creates a new grey zone for regulators, which might be conducive of corruption.

Recommendation 1: The new regulations, according to which provisions for outstanding loans in foreign currency are to be built in national currency, should be abolished. Furthermore, the merits of applying such a regulation to new loans should be thoroughly analysed and reconsidered.

3.2 NBU Resolution No. 108

When the hryvnia was floated, especially during the fourth quarter of 2008, there were basically no functioning instruments for hedging against exchange rate risks (such as currency forwards). Even though some instruments were legally allowed, a liquid market did not develop due to several constraints. This situation changed for the worse with the adoption of NBU Resolution No. 108 on 28 February 2009, which basically forbid the conduct of forward (and spot) transactions completely for the whole year 2009.

In a flexible exchange rate framework, the availability of hedging instruments[5] plays an important role, as this is an efficient way to deal with exchange rate volatility and uncertainty. In Ukraine, the shortcomings of an absence of such instruments due to legal reasons have been clearly demonstrated over the last months. Given the need to repay high amounts of foreign currency by different economic agents in Ukraine in combination with widespread devaluation expectations, many agents choose to purchase foreign currency in advance (pre-purchasing). Consequently, the lack of hedging instruments led under the current situation to a stronger demand for foreign currency and a weaker hryvnia.

Recent legislative action shows that policy makers have understood the deficiencies of the existing regulation, and have undertaken steps to change them. Resolution 416 from 21 July 2009 basically lifts the ban of forward (and spot) transactions. Regarding currency forwards, this will happen from 26 October 2009 onwards[6].

Recommendation 2: Currency forwards should be allowed to develop in Ukraine, since they represent simple and robust hedging instruments. Thus, we support the recent legal actions taken by the NBU in order to re-establish a legal framework for conducting currency forwards.

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[4] The short-lived strengthening of the hryvnia in this period can also be (at least partly) explained by positive expectations in the context of the disbursement of the second tranche of the IMF loan.

[5] For concrete recommendations for the introduction of hedging instruments in Ukraine see German Advisory Group policy paper PP/09/2008: Developing the market for foreign exchange derivates in Ukraine: Sequencing the reform steps (http://beratergruppe-ukraine.de/download/Beraterpapiere/2008/pp_0908_en.pdf).

[6] However, in order to develop a liquid market for hedging instruments, other impediments like the foreign exchange pension fund tax need to be abolished.

3.3 Paying out interests on foreign currency deposits in hryvnia

As described in Part 2, some representatives of the NBU publicly discussed the possibility to prescribe banks to pay out interest on foreign currency deposits in national currency (and not in foreign currency, as is the status quo). The reasoning behind such an idea might go as follows: If such a regulation were to be adopted, banks would need less foreign currency to pay out interests to depositors. As a result, demand from banks for foreign currency would decrease and this would support the hryvnia.[7]

But in our view, this arguing is short-sighted for several reasons. First, if foreign currency depositors continue to prefer interest income in foreign currency, they will simply go to the cash market, and exchange their local currency interest income into foreign currency. Thus, the only result is a shift in the relative demand/supply balance in different market segments, with no overall impact on the exchange rate. Second, such an intrusive regulation will most likely be interpreted by depositors as a sign of weakness of the national currency. As a result, the expectations for a further devaluation of the hryvnia might increase and this would lead to a weakening, not a strengthening of the hryvnia. Thus, the effect of such measures on the exchange is far from obvious.

But far more important is the potential effect of such a measure on the banking sector. Depositors are confronted with uncertainty in a number of areas. First, in case the interest payments for foreign currency deposit are done in hryvnia, which exchange rate will be used: The economically relevant market rate (interbank rate) or will the NBU prescribe the use of the official rate, which continues to be linked only loosely to the market rate? Second, if the NBU starts using such "strong" instruments to curb demand for foreign exchange is it not likely that even stronger instruments will follow suit? Might the NBU even prescribe a forced transformation of foreign currency deposits into hryvnia ones, as has been the case in some countries? In such a case, which exchange rate will be used? In short, foreign exchange depositors will wonder whether their money is safe in the banks, despite the fact of being held in foreign currency accounts. As a reaction to such thoughts, many foreign exchange depositors will opt for withdrawing foreign currency from banks, thus destabilising the banking sector and creating downward pressure on the hryvnia. This would contribute to a demonetisation of the economy, shift foreign exchange assets into the grey economy and abroad, i.e. essentially out of control of the NBU.

To sum up, as in the case of the Resolutions No. 107 and 109, such a measure would help little to support the exchange rate, whilst heavily damaging the banking sector. This would in turn damage the deposit base, decrease financial intermediation and thus reduce the perspectives for the real sector of the economy to receive credits.

Recommendation 3: The recently discussed measure of paying out interest on foreign currency deposits in hryvnia should not be implemented. Furthermore, such ideas should not be publicly debated by representatives of the NBU, as they increase uncertainty and destabilise the fragile situation in the banking sector.

[7] The motives behind the idea of paying out interests on foreign currency deposits in hryvnia can also be interpreted in other ways. A rather "legalistic" interpretation highlights the NBU mandate for enforcing the hryvnia as the only legal means of payment. Since interest payments are payments for a service (lending money), the correspondent payments should be conducted in hryvnia, as is the case with any other service. Furthermore, the idea can also be interpreted as a way to combat dollarisation in Ukraine. However, the fact that this idea pops-up in the midst of high currency volatility clearly suggests that our interpretation might indeed be the most appropriate one.

4. Concluding remarks

The economic analysis above shows clearly that administrative measures are not an adequate instrument for conducting exchange rate policy. The merits of administrative measures in supporting the exchange rate are very limited and in the best of cases very short-lived. But at the same time they tend to have very high costs in terms of stability of the banking sector. Generally speaking, the foreign exchange market should be allowed to function without imposing too many restrictions, so that it can perform its important economic tasks.

Recommendation 4: The NBU should not conduct exchange rate policy with the help of administrative measures, since the costs of such measures clearly outweigh their (debatable) merits.

But this does not mean that the NBU has no possibilities to influence the exchange rate in the context of a flexible exchange rate system[8]. First, the NBU can and should intervene (in both directions, i.e. by buying and selling foreign currency) in order to limit excessive fluctuations. However, a certain degree of fluctuations in response to fundamental economic forces are necessary to demonstrate market participants the existence of a two-way exchange rate risk, which helps to limit speculative activity. Second, the exchange rate of the hryvnia mirrors the conduct of monetary policy. In order to support the hryvnia, the NBU needs to control the supply of hryvnia on the market, i.e. it needs to conduct a relatively tight monetary policy.[9] If, on the contrary, the banking system is provided with excessive liquidity and a monetary overhang builds up, this will most likely find its way into the foreign exchange market and cause depreciation pressure.

Recommendation 5: In order to support the hryvnia, but also to combat inflation, monetary policy has to be relatively tight.

Finally, taking a long-term view on the subject, it is rather obvious that the confidence in the hryvnia and its exchange rate highly depend on institutional aspects of the NBU. The massive political interference in exchange rate policy in recent months is to a large extent responsible for the lack of trust in the national currency, and an associated increase in devaluation expectations. In order for the population to regain confidence in the hryvnia, institutional changes to support the credibility of the NBU are needed. Also, the external communication of the NBU with the public needs to improve, as this is a major prerequisite for an effective conduct of monetary policy. This implies efforts to strengthen the overall governance structure of the NBU, including the issue of its accountability.

Recommendation 6: Institutional reforms should be conducted with regard to the NBU as soon as possible, with the aim of minimising political interference, which clearly undermines confidence and weakens the currency.

[8] For an economic analysis of the merits of a flexible exchange rate system in Ukraine see German Advisory Group policy paper PP/01/2008: Learning to float: Recommendations on exchange rate policy in Ukraine during the transition period towards inflation targeting (http://beratergruppe-ukraine.de/download/Beraterpapiere/2008/pp_0108_en.pdf).

[9] See also the forthcoming paper by the German Advisory Group on current issues of monetary policy in Ukraine.

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