German Advisory Group
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Policy Paper Series [PP/01/2008]

Learning to float: Recommendations on exchange rate policy in Ukraine during the transition period towards inflation targeting

Ricardo Giucci, Robert Kirchner, Vitaliy Kravchuk

Berlin/Kyiv, June 2008

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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 Berlin Economics
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

The exchange rate targeting practiced in Ukraine till the start of 2008 has clearly failed to provide price stability; thus, it should be replaced by a new monetary strategy. While most experts agree on the necessity to install a full-fledged inflation targeting regime in the medium term (i.e. in 3 years or so), less agreement exists with regard to the transition period towards the new regime. In this paper, we focus on this transition period.

The transition period should pursue two main goals. On the one hand, it has to provide the National Bank of Ukraine (NBU) enough room for fighting the current rampant inflation. On the other, it should give the public some guidance about the future development of the exchange rate. The best way to achieve both goals is to install a band for fluctuations of the exchange rate. The band should be defined in terms of the US dollar (i.e. not a currency basket) and has to be wide enough to allow combating inflation effectively. If the defined band hinders the effective fight with inflation, then it should be redefined. Furthermore, we suggest to refine the role of the official exchange rate. This rate should be based on market conditions and be set daily by the NBU, in order to provide the public with an objective reference rate for private contracts. Last, the communication of the NBU should be improved helping to prepare for the introduction of inflation targeting in the future.

Authors

Robert Kirchner	kirchner@berlin-economics.com	+49 30 / 20 61 34 64 2
Ricardo Giucci	giucci@berlin-economics.com	+49 30 / 20 61 34 64 1
Vitaliy Kravchuk	kravchuk@ier.kiev.ua	+380 44 / 235 63 27

Acknowledgements

The authors would like to express their gratitude to Veronika Movchan for lectoring the paper.

Contents

1. Introduction

2. The strategic decision for the NBU: exchange rate vs. inflation targeting

3. Exchange rate policy during the transition period towards inflation targeting

4. The role of the official exchange rate

5. Exchange rate flexibility and international competitiveness

6. Conclusions

1. Introduction

Since 2000 the hryvnia has been de facto pegged to the US dollar. Until 2005, the dollar provided good services as a nominal anchor of monetary policy and the peg contributed to lowering inflation relatively quickly. But since 2005, capital inflows into Ukraine increased sharply and since then the system has not worked well anymore, as shown by the latest inflation figures of over 30%.1 In short, the US dollar cannot be considered as a nominal anchor, which guarantees sustainable moderate inflation anymore 2.

After trying to tighten monetary policy by several means3 since the end of 2007, the National Bank of Ukraine (NBU) recognized the poor performance of the currency peg and decided in March 2008 to reduce its interventions on the foreign exchange market and to allow for more flexibility of the exchange rate. As a result, the hryvnia appreciated significantly against the US dollar. Later, on May 21, the NBU board decided to change the official rate of the hryvnia from previously 5.05 UAH/USD to 4.85 UAH/USD to bring it closer to the market rate. Subsequently, this new official rate was adjusted on a daily basis in very small increments. But besides these actions, no clear picture has emerged as to the future monetary and exchange rate policy of the country.

We have provided a number of arguments for more exchange rate flexibility in previous papers4; insofar we welcome the initial steps taken by the NBU towards more flexibility. In the present paper we discuss and put forward recommendations regarding the future monetary and exchange rate policy of Ukraine. In Part 2, we analyse the strategic decision between exchange rate and inflation targeting. In Part 3, we focus at the transition period towards inflation targeting and provide recommendations on the exchange rate policy for this period. In Part 4, the role of the official exchange rate is studied. In the following Part 5, we discuss the implications of more exchange rate flexibility on international competitiveness, which is of major importance for Ukrainian businesses. Part 6 concludes.

2. The strategic decision for the NBU: exchange rate vs. inflation targeting

Economic theory suggests that it is not possible to successfully target the exchange rate and secure price stability in the presence of liberalised capital flows (“impossible trinity”). The recent Ukrainian experience provides further empirical support for this theory. Until 2005, i.e. in times of very limited international capital flows in Ukraine, the NBU was able to keep inflation at bay by targeting the exchange rate versus the US dollar. But since 2005 Ukraine became an important destination for foreign investors and capital inflows grew dramatically. As a result, the goals of external and internal stability of hryvnia could not be combined anymore. While the external value of the hryvnia vis-à-vis the US dollar remain stable, inflation soared, surpassing 30% in April 2008. In other words, the US dollar failed to work as a nominal anchor for monetary policy.

Taking Ukraine's status as a fast growing transition country in mind, this surge in inflation is not surprising, as under the fixed peg this is the only way that a real appreciation can take place in the presence of large capital inflows. Keeping the nominal exchange rate fixed in such a situation forces the NBU to intervene regularly on the foreign exchange market, buying large amounts of foreign currency with freshly printed hryvnias. As sterilisation possibilities are limited, this increase in monetary aggregates leads ultimately to inflation. It is very important

1 Despite this conclusion, the fixed exchange rate should not be considered as the only reason for the current high inflation. See also Kirchner/Giucci/Kravchuk (2007): “High Inflation in Ukraine: Analysis and Policy Recommendations”, policy paper W10 of German Advisory Group/IER, www.ier.kiev.ua.

2 In principle, such foreign exchange inflows could also originate in the current account, e.g. due to steep improvements in the terms of trade. The implications for money creation and inflation would be similar.

3 The NBU tightened minimum reserve requirements, stepped-up its sterilization operations via sales of certificates of deposits (CDs), and raised the discount rate several times.

4 See for example Kirchner/Giucci/Kravchuk (2006): Exchange Rate Policy in Ukraine: Why and how to float the hryvnia, policy paper V10 of German Advisory Group/IER, www.ier.kiev.ua.

that the power to increase (policy) interest rates to fight inflation in such a scenario is very insufficient, and rather counterproductive. Any increase of domestic interest rates relative to foreign ones can attract currency speculators (carry-traders), which try to earn the interest rate differential with limited downside risk (as the exchange rate is fixed). Therefore, the increase might actually bring more foreign capital into the country, forcing more interventions and increases in the money supply. A vicious cycle, in the literature denoted as "sterilisation trap", is the result of such ill-fated actions.

Given that capital inflows will most certainly continue to enter the country for many years to come, the NBU will face problems to combine exchange rate and price stability in the future. Consequently, NBU has to decide which goal is more important. In our view, price stability is more important than exchange rate stability, as it is a prerequisite for supporting long-term economic growth. This fundamental decision implies that the new explicit goal of monetary policy should be maintaining price stability, as it is the case in the Eurozone and in most of the new EU members in Eastern Europe. The most suitable way to achieve this goal is by implementing the strategy of inflation targeting (IT).

But before introducing a full-fledged IT some preparations are needed. During the transition period towards IT, the exchange rate will continue to play relatively major role in the economy of Ukraine. This is rather typical for many emerging markets and transition countries which move from a fixed peg towards more flexibility. Besides, the public needs time to get used to the new flexibility. Consequently, it is crucial to study the transition period and provide recommendations as to how to manage it.

Recommendation 1: The NBU should focus its monetary policy actions on maintaining domestic price stability, as opposed to exchange rate stability. This fundamental decision implies the introduction of inflation targeting in the medium-term.

3. Exchange rate policy during the transition period towards inflation targeting

The switch from exchange rate to inflation targeting should not be conducted abruptly for many reasons. First, the public needs some time to get used and acquainted with more exchange rate flexibility. Consequently, it is necessary to restrict exchange rates fluctuations for some time to come, in order to avoid false reactions by the public. Second, a sudden significant increase in exchange rate volatility may cause serious problems in emerging countries like Ukraine that have a high degree of dollarisation and still relatively weak financial systems. Therefore, these countries often exhibit a "fear of floating" (see Box 1 below).

Box 1: Fear of Floating

Many emerging markets and countries in transition exhibit an empirically observable "fear of floating" their exchange rate. This implies that variations in the nominal exchange rate (versus an anchor currency) are frequently limited by the authorities, while international reserves and interest rates act as shock absorber and exhibit a much higher degree of variation. This behaviour is often in stark contrast to authorities' declared strategy of a floating exchange rate.

One of the major reasons for such behaviour, which is in contrast to flexible exchange rate policies of major developed economies, is rooted in the limited ability of financial sectors in emerging markets to cope with exchange rate volatility. A floating exchange rate, which is to equilibrate supply and demand in the market, normally leads to an increase in exchange rate volatility. In emerging markets, this can put especially the financial sector under stress due to some commonly observed characteristics:

1. High, non-hedged (liability) dollarisation

2. Balance sheet mismatches

3. Fragile financial sector

While assets are often denominated in local currency, foreign-currency denominated liabilities create a currency mismatch in the balance sheets of private agents. This can lead in case of a sudden and unexpected depreciation to serious problems in the balance sheets of the respective agents (households, enterprises), especially when the exposure is not hedged (eg non-hedged borrowing in foreign currency). As a result of such problems, the net worth of the respective agents will drop. Since banks perform the bulk of financial intermediation in these countries, sectoral balance sheet deterioration will almost immediately affect and threaten the stability of the domestic financial sector. From here, the spill-over to the real sector is not far.

Because of these legitimate reasons for fearing to float, we advocate a gradual transition towards a flexible exchange rate system in the context of inflation targeting.

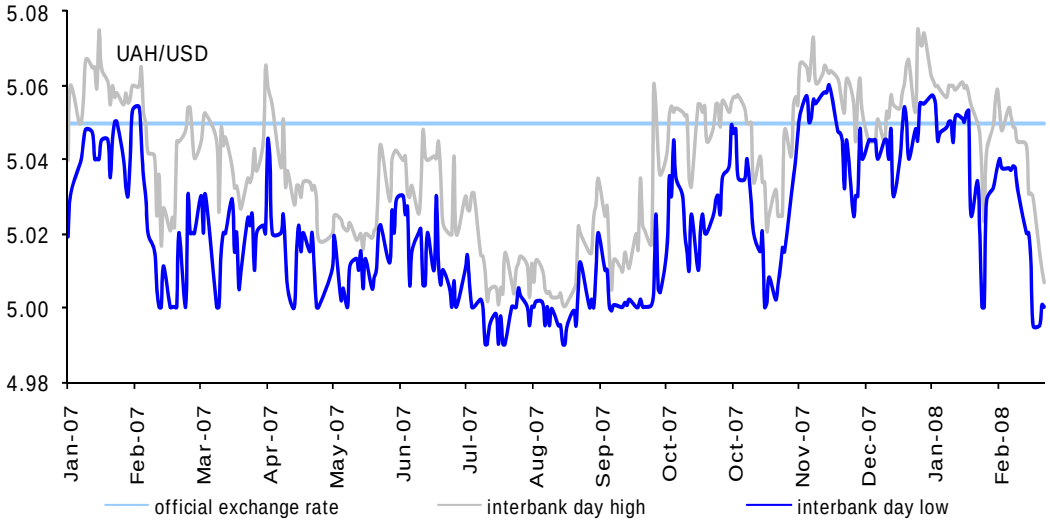
For further reference see Calvo/Reinhart (2002): Fear of Floating, Quarterly Journal of Economics, 117, pp. 379-408.

Third, several technical preparations are needed for the introduction of IT. Most importantly, the forecasting of inflation has to be improved, given its crucial role in an IT-system. Fourth, in order not to discredit the new system from the start, it would be important to reduce inflation before the introduction of IT. The targeting of a rather high rate of inflation of e.g. 15% would not be compatible with the ultimate goal of IT and could damage the reputation of the new system and the credibility of the NBU.

This brings us to the topic on how to design policy during the transition towards IT. The transition period should strike a balance between monetary and exchange rate policy. On the one hand, the NBU should obtain enough room to conduct an active monetary policy with the aim of reducing inflation, on the other hand extreme exchange rate fluctuations, exchange-rate overshooting or disorderly markets should be avoided, given the still high level of dollarisation and the existence of currency mismatches in the non-financial sector of the economy. In order to achieve both goals, the centrepiece of the transition period should be the establishment and the announcement of a new band for exchange rate fluctuations vis-à-vis the US dollar. The band should be sufficiently broad, in order to enable fighting inflation effectively, even in the presence of strong capital inflows. As a minimum, the band's width should amount to 30 kopeks. Furthermore, the exchange rate to the US dollar should be allowed to fluctuate relatively free within this band. Interventions within the band (i.e. not at the margin) might make sense under certain circumstances, but no informal "inner" band should be created, as was the case in 2005-2008. While the official band in 2007 (and 2008) was 4.95-5.25 UAH/USD according to the country's monetary policy guidelines, the NBU basically did not allow the hryvnia to leave the informal narrower band of 5.00-5.06 UAH/USD, which was defended by interventions (see Figure 1).

Figure 1

Daily market exchange rate and official exchange rate (1.1.2007-19.3.2008)



Source: Reuters Investor

Recommendation 2: A new band for exchange rate fluctuations should be created and announced. The band should be sufficiently wide, in order to enable the NBU to fight inflation effectively.

A crucial question concerns the level of the new band. The new band should comfortably cover the market rate at the time of its introduction at both sides. If conditions change dramatically after a few months and the band does not allow fighting inflation in an effective manner, then a new band should be set. It is crucial not to forget that fighting inflation should be a key goal of the transition system and that the exchange rate management is done mainly to calm expectations by avoiding excessive fluctuations.

Recommendation 3: The level of the new band should be set according to market conditions. In case such conditions change significantly, a new level for the band should be set and announced.

Given the weakness of the US dollar in recent years (see Figure 2) some analysts argue against its use for defining the new band in the transition period.

Figure 2

Nominal US Dollar index against major currencies



Source: Federal Reserve

Also the low importance of Ukraine's trade with the USA has been put forward as a reason for not defining a new band in terms of the US dollar. Following this reasoning, the NBU should define the new band in terms of a different currency (such as the Euro) or of a currency basket. But we do not favour such a change. Taking NBU data on currency invoicing in trade transactions into account, the US dollar still dominates in export and import transactions. In 2007, the US dollar had a 75% share in current account inflows and a 71% share in current account outflows, versus 14% and 8% for the Russian ruble and 10% and 20% for the Euro, respectively. Furthermore, the purpose of the new band is not to establish a new exchange rate system, but to calm expectations and to ensure a smooth transition to IT. By making fundamental changes on the way the external value of the hryvnia is measured and referred to, the NBU would not calm expectations, but create great confusion among the public. It should be taken into account that Ukraine's population and business people have long used the US dollar as a unit of account and will continue to do so for many years to come. Last, it makes little sense to introduce a new definition of the external value of the hryvnia, which will be dropped soon anyway, once IT is introduced.

Recommendation 4: The new band should be defined in terms of the US dollar. A currency basket should thus not be introduced.

During the transition period and under an IT regime, exchange rate fluctuations will become a common phenomenon. Actually, this should be welcomed by the authorities, as these fluctuations create gradually a perception of a "two-way" exchange rate risk, which might help to deter speculative currency transactions. As was written previously, the currently large interest rate differentials between domestic and foreign rates (e.g. as observed in the spread KIEVPRIME versus US-LIBOR at different maturities) might attract currency speculators or carry traders. More flexibility in the exchange rate might help to fight them off, as risk-averse agents will take smaller positions in the presence of such fluctuations.

At the same time, the expected increase in exchange rate volatility will also help to limit vulnerabilities due to still wide - spread dollarisation, for which the shape of the exchange rate regime seems to play some role. In particular, a more flexible exchange rate increases the two-side exchange rate risk and might thus support the de-dollarisation of the economy.

Recommendation 5: The exchange rate should fluctuate freely within the specified band.

Furthermore, exchange rate fluctuations are not a huge problem, as long as economic agents are able to hedge against such fluctuations. But currently Ukrainian enterprises have

practically no possibility for hedging against such risks. In practice, domestic markets for forward agreements and exchange rate futures are underdeveloped and illiquid. Therefore, an essential complement to the new exchange rate policy must be the lifting of any existing restrictions and impediments and allow the creation of effective hedging instruments. This is connected with improvements in the necessary infrastructure and institutions to guarantee a liquid and efficient foreign exchange market both in spot and future products.

Recommendation 6: In order to manage the risks associated with higher exchange rate volatility, current legal impediments for the development of hedging instruments should be lifted.

A crucial task of the transition period is to prepare the public for the introduction of a full-fledged IT system in the medium term; a clear and coherent communication of monetary policy objectives and actions play a major role for achieving this goal. If private agents are not able to understand monetary policy decisions due to a lack of information, or due to conflicting signals, excessive volatility of financial markets (as observed in interest rates and the exchange rate) is likely. But in case private agents are able to better understand and predict policy actions due to improved communication, the credibility and success of the NBU will increase[5]. Besides, since communication is an essential part of a full-fledged IT system, improving communication today can be seen as the creation of an important requisite for the introduction of IT in the medium-term.

Recommendation 7: The new monetary and exchange rate policy should be communicated to the public in a very clear and transparent manner, in order to increase the credibility of monetary policy.

4. The role of the official exchange rate

The NBU sets an official exchange rate against major currencies, which is also published on its website and widely covered by the public. Throughout 2007, the official exchange rate against the US dollar remained constant at 5.05 UAH/USD, while against other currencies it moved accordingly. On 21 May 2008, following several weeks of appreciation of the hryvnia on the interbank market, the NBU Board set a new official rate of 4.85 UAH/USD.

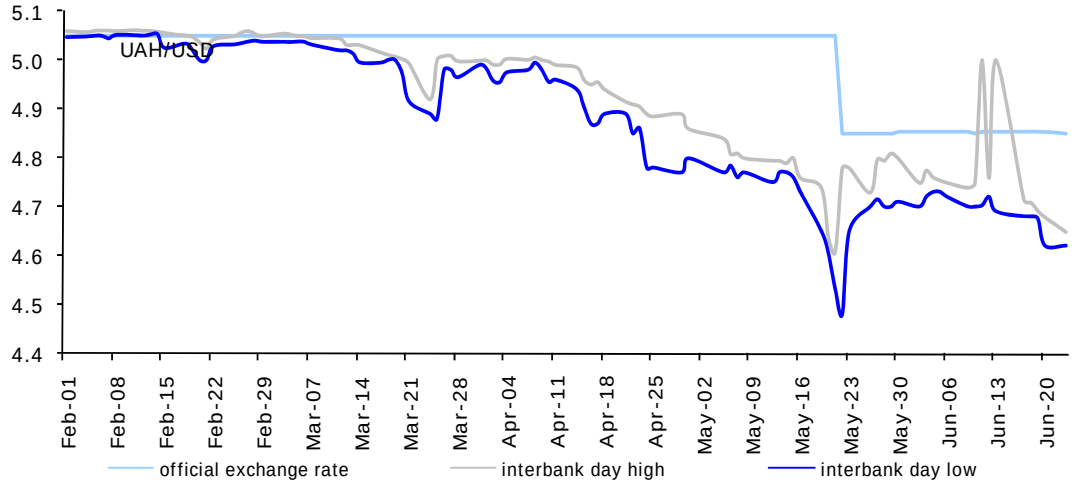
This rate fulfils two main functions. First, it provides guidance to the public on what the NBU considers to be an appropriate level of the exchange rate. By sending clear signals to the public, the rate is supposed to work as a nominal anchor of exchange rate policy. Second, the rate is binding for several transactions with the government (mostly tariffs and taxes on foreign trade) and within the government, mainly transactions between the Treasury and the NBU. Third, it is used for certain accounting purposes. For clarity purposes, it should be also highlighted which functions the official rate does not fulfil. The rate implies no commitment from the side of the NBU to intervene at the set level, a fact which stands in accord with the de facto nature of the exchange rate targeting (i.e. no formal exchange rate targeting). Also, the official rate does not reflect the day to day changes on the interbank market and is thus not a suitable rate to be used in private contracts.

Until 2008, the official exchange rate against the US dollar fulfilled its functions well. It sent a strong signal to the public about the desired level of exchange rate and the public based its expectations on this signal. But in 2008 the official and the market rates drifted apart, questioning the signalling functions of the official rate (see Figure 3). On 20 May 2008 for example, the market rate amounted to 4.63 UAH/USD, while the official rate remained at 5.05 UAH/USD.

5 There is a relatively broad consensus among economists that improved central bank communication can be welfare-enhancing under certain conditions. See for example Jansen/de Haan (2004): Look who's talking: ECB communication during the first years of EMU. CESifo Working Paper Series 1263, CESifo.

Figure 3

Daily market exchange rate and official exchange rate since February 2008



Source: Reuters Investor

The future of the official exchange rate depends on the future exchange rate policy of the NBU. Should the NBU decide to maintain the old system of exchange rate targeting (be it at a new level of say around 4.85 UAH/USD instead of 5.05 UAH/USD), then it would be logical to keep the old function of the official rate. But as explained above, the old system will not be able to reduce inflation and thus a new transitory system is needed. Consequently, the relevant question is what the role should be of the official rate in the transition period.

As stated above, the transition period should provide some guidance concerning the exchange rate, but it should also prepare for more flexibility in the future. In our view, the announcement of a band for the exchange rate provides enough guidance to the public. Besides, maintaining of a fixed official rate would suggest some form of fixing and thus not prepare the public for more flexibility to come, once IT is fully installed. Last, the market rate is supposed to fluctuate considerably during the transition period, a fact that implies significant differences between market and official rates. This could be misleading and hurt the credibility of the NBU. Consequently, the NBU should not declare a fix official exchange rate during the transition period.

Instead, we recommend introducing a flexible official exchange rate against the US dollar. The recent steps by the NBU to conduct small changes to the official rate on a daily basis are thus encouraging, but they should continue. The new official rate should de-jure and de-facto reflect market conditions, i.e. be calculated on the basis of concrete deals on the exchange rate market (interbank market). The official rate should be published daily on the website of the NBU. Also the information about past official rates should be easily accessible through the Internet, including past time series. In such a way, economic agents would have a solid and objective basis for setting the value of the hryvnia for different transactions. Also, such a measure would limit the power of commercial banks for setting a very different exchange rate for selected transaction by their clients. The lack of transparency regarding the "market" exchange rate can be used by banks for charging hidden fees on its clients.

The "reference rate" published by the European Central Bank (ECB) on a daily basis might in fact act as a model for the new official rate (see Box 2 below). But in order to keep things simple, the old name "official exchange rate" should be kept in Ukraine.

Box 2. The European Central Bank (ECB) reference rate

The ECB currently publishes reference exchange rates of the euro against 35 currencies. Reference rates are released after a daily "concertation" procedure involving consultations with central banks within and outside the Eurozone. The ECB tries to ensure that reference rates reflect the market conditions prevailing at the time of the procedure, which is normally 14.15 CET. Only one reference exchange rate (i.e. the average of buying and selling rates) is published for each currency. The number of significant digits used may vary according to the currency, reflecting market conventions. However, in most cases five significant digits are used.

Source: European Central Bank

Recommendation 8: The NBU official exchange rates (including the US dollar rate) should be calculated and published daily, based on market transactions. The reference rate by the ECB should be used as a model.

5. Exchange rate flexibility and international competitiveness

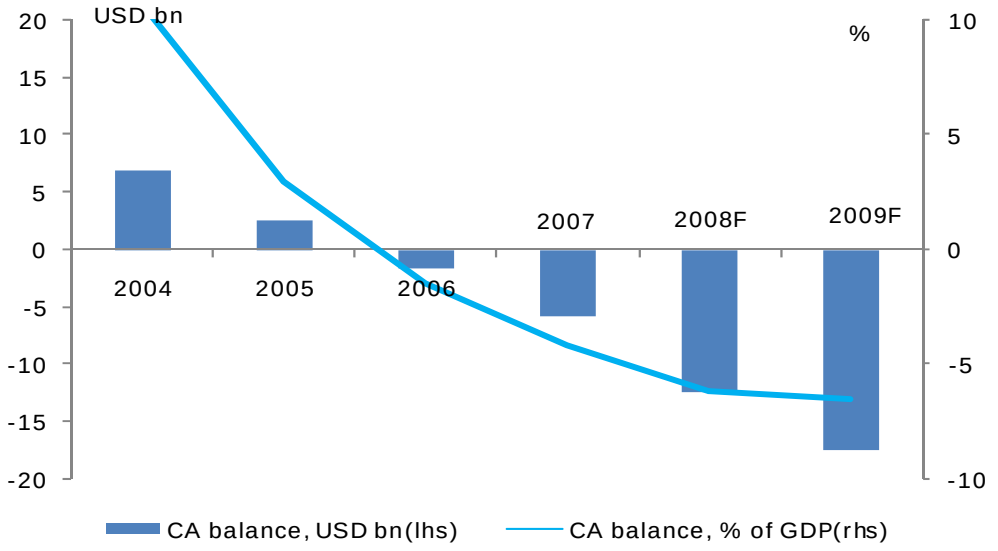
At the end of the first quarter of 2008, the NBU allowed much more flexibility, a move that implied under the reigning market conditions a considerably appreciation of the hryvnia against the US dollar. This in turn has provoked criticism from exporters and import-competing businesses, which are worried about the loss in their international competitive position. From a macroeconomic perspective, some observers claim the recent appreciation will reduce exports and lead to more imports, and thus increase the already high current account deficit; also economic growth will be hurt in their view. Taking into account the importance of international competitiveness to support sustainable economic growth in an open economy like Ukraine, this point deserves special consideration.

In our view, fighting inflation should be today's priority of macroeconomic management. If fighting inflation involves some reduction in exports in the short run, then this economic cost must be accepted. The critics of the NBU should be reminded that if inflation is not combated successfully now, then the economic costs of bringing down inflation in the future will be much higher, and a "hard landing" scenario of the Ukrainian economy becomes more likely. Thus, this critique is very short-sighted. Besides, many exporters faced recently extremely favourable terms-of-trade developments, in particular high prices for metals and fertilizers. As a result, there should be enough room to accommodate the recent appreciation of the hryvnia. Furthermore, the competitive position of exports depends both on the nominal exchange rate and on inflation (i.e. on the real exchange rate), a crucial point that is often neglected in the current discussion. Since the higher flexibility including the appreciation will contribute to bring down inflation, also exporters will gain from such a move in the recent future, as their local cost base will grow less quickly. On the other hand, if inflation is not contained, this would be the major threat to competitiveness as the real exchange rate would appreciate and might become overvalued at some point in the future. Besides, there is wide room for improving the international competitive position of Ukrainian exporters by increasing investment, especially in energy saving technologies. It should be reminded that an appreciation also makes imports of capital goods from abroad cheaper, facilitating such a structural change. However, the main driver for improving the competitive position of Ukraine should be a proper management and investment policy of companies, not exchange rate policy. Lastly, it should be noted that lower exports in some sectors automatically reduce imports. Thus, the net effect of an appreciation on the trade balance and on economic growth is often exaggerated by using gross numbers.

Turning the perspective into the medium-term, it should be emphasized that more flexibility does not automatically imply an appreciation of the hryvnia and thus lower exports. This is definitely the case in the short-term, as shown by recent developments. But taking into account the high and further growing current account deficit (Figure 4) and rising import prices for energy, greater flexibility might well imply a depreciation of the hryvnia in the medium-term. But also in the event of a substantial decrease in capital inflows could the exchange rate depreciate.

Figure 4

Current account balance 2004-2009F



Source: NBU, IER forecast

This flexibility in turn will contribute to absorb adverse external shocks and to maintain external stability in Ukraine, which is crucial for foreign trade and for exporters in particular. In this sense, a flexible exchange rate can provide a less costly and much faster adjustment mechanism to changes in relative prices at home and abroad in the presence of such shocks.

Recommendation 9: The critique from exporters and import-competing businesses on the recent appreciation of the hryvnia is short-sighted and not completely well founded. It should by no means distract the NBU from fulfilling its crucial task of fighting rampant inflation in Ukraine.

6. Conclusions

Inflation is currently by far the biggest economic and social problem in Ukraine. It is essential to bring down inflation using standard economic policy instruments, rather than relying on administrative measures, as soon as possible. Otherwise, inflation expectations will further increase and be used as a basis for the formation of wages and prices in the coming period ("price-wage-nexus"). As a result of these second round effects, the inflation process could be driven by its own dynamics and the possibilities to reduce inflation by the NBU would be rather limited. Under such circumstances, as shown by international experience, the costs of fighting inflation in terms of economic growth become very high (the output-inflation "sacrifice ratio").

Consequently, the main objective of the NBU today should be fighting inflation. Since the de-facto exchange rate targeting has not delivered price stability in recent times, it must be abandoned. The economic conditions to move to a more flexible system are generally quite good right now. The NBU has accumulated a sizable amount of foreign reserves, which allow it to intervene in the foreign exchange market to cushion shocks. At the same time, several observers state that the hryvnia is currently trading broadly consistent with its fundamental factors. This is another argument for more flexibility right now, as sudden and violent swings of the exchange rate are not expected under such a scenario. In the medium term, i.e. in around 3 years, a full-fledged IT regime should be installed. In the mean time, i.e. during the transition period towards IT, exchange rate policy should be directed to reduce inflation, while providing some guidance to market participants with regards to the exchange rate. As explained above, the best to achieve these goals is by announcing a wide band for exchange rates fluctuations, which will gradually be increased.

To sum up, there is no sensible alternative to increasing exchange rate flexibility. Clinging on to the old system of exchange rate targeting would be a strategic mistake. Instead, the new focus should be on the transition period towards inflation targeting. Macroeconomic stability is likely to be enhanced by a gradual move towards the pursuit of a more independent monetary policy directed at domestic objectives (i.e. price stability), while the exchange rate adjustments will increasingly play the role of insulating the economy from the impact of major external shocks.

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