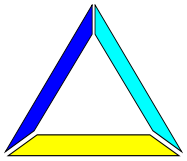
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**V10**

# Exchange Rate Policy in Ukraine: Why and how to float the hryvnia

**Executive Summary**

In early 2000 the value of the hryvnia was de facto pegged to the US dollar. In April 2005 the National Bank of Ukraine (NBU) took some steps, which can be interpreted as the start of a more flexible exchange rate policy. In particular, the hryvnia was allowed to appreciate by 4.8% against the US dollar and to fluctuate within a tight band. Also, the regulation of foreign exchange market has been relaxed.

We support this slight change in policy and argue that the exchange rate should become more flexible over the coming years for several reasons. First, the almost constant value of the hryvnia over the last years has led to a significant underestimation of the exchange rate risk and consequently to a potentially dangerous currency mismatch in the corporate sector. Second, it is doubtful whether low inflation will be achievable under a fixed system. Third, a flexible exchange rate can help to absorb both downside (e.g. higher gas prices) and upside (e.g. higher FDI inflows) external shocks, which might occur in the near future. Fourth, a flexible rate can better facilitate the expected real appreciation of the hryvnia in coming years.

We recommend a gradual approach towards more flexibility. The hryvnia should be allowed to float within an undisclosed band, which has to be regularly broadened in the next 4 years, until an alternative nominal anchor (e.g. inflation or monetary targeting) is installed. The establishment of the new policy should be clearly communicated to the public, to avoid misunderstandings and false reactions. It should be emphasized that the future introduction of a more flexible exchange rate system does not preclude interventions by the NBU on the foreign exchange market. In fact, several central banks using inflation targeting do intervene in the foreign exchange market if conditions require it.

**Contents**

1. Introduction

2. Exchange rate policy in 2000-Apr 2005 as a response to the post-crisis situation

3. New challenges for exchange rate policy in Ukraine today

4. How should the exchange rate policy respond to the new situation?

5. Complementary recommendations

6. Final remarks

## 1. Introduction

The exchange rate is one of the most important prices in an economy. This is especially true for open and dollarised economies. Thus, it is only natural that exchange rate policy is strongly debated in Ukraine, a highly open economy with a share of trade (exports and imports) to GDP of 103% (2005) and a high level of cash and financial dollarisation.

The current debate in Ukraine focuses on two main topics. The first topic concerns the main goal of monetary and exchange rate policy: Should the NBU focus on the external value of the hryvnia (i.e. on the exchange rate) or on the internal value (i.e. on inflation)? While some policy makers favor a continuation of the exchange rate peg to the US dollar, other analysts argue that inflation fighting should play a more predominant role. The second debate focuses on how to substitute the current de facto exchange rate peg. What kind of new system should be established? What would be the anchor of the new system? How should the transition towards the new policy be conducted?

In this paper we contribute to the current discussion in Ukraine by dealing with these two topics. In Part 2 we analyze the situation after the crisis in 1998 in Ukraine and explain how the authorities reacted to this situation by establishing a de facto exchange rate peg in 2000. In Part 3 we argue that the current situation is not comparable to the post-crisis situation and that important new challenges have emerged in recent times. In Part 4 we present our views on how Ukraine should react to this new situation and new challenges in the realm of monetary and exchange rate policy. Part 5 contains complementary recommendations and in Part 6 we provide final remarks.

## 2. Exchange rate policy in 2000-Apr 2005 as a response to the post-crisis situation

The specific exchange rate policy of a country at a concrete time is always an attempt to achieve certain goals. And the goals to be pursued by a country depend crucially on the concrete historic situation and on the expectations for the future. Thus, in order to understand the exchange rate policy of Ukraine in the period from 2000 to April 2005, one has to deal with the underlying goals set by the monetary authorities and the concrete situation of the country at the time when these goals were set.

The situation after the crisis in September 1998 was very unstable. As shown by several indicators, the confidence of the population and business in the national currency was extremely low. The interest rate spread between hryvnia and US dollars amounted to a massive 34.5% for deposits and 12.6% for credits in the same year. Furthermore, large amounts of cash US dollar were kept at home. The lack in confidence in the hryvnia at that time can be explained by several factors. First, the hryvnia lost 48% of its value against the US dollar in the period September 1998 to January 2000. Second, the official reserves of the NBU stood in early 2000 at around USD 1 bn, which corresponded to only 3 weeks of import coverage and were thus perceived as being insufficient for defending the national currency. Third, a significant demand for US dollars (currency outflow) was expected for the near future, in order to repay the large state foreign debt. Fourth, no considerable supply of US dollars (currency inflow) was expected, since many Ukrainian institutions, including the Ukrainian state, were not creditworthy.

The authorities were rather unhappy with the described situation and as a reaction set themselves a clear goal, to be treated with absolute priority: *To restore the confidence in the national currency*. In order to achieve this goal of paramount importance, the NBU drafted a specific exchange rate policy. More specifically, the value of the hryvnia was unofficially pegged in early 2000 to the US dollar at the rate of 5.44 UAH/USD. Thus, the US currency was used as an external anchor for stability ("credibility import from the US dollar"). The peg level of 5.44 UAH/USD implied a significant under-valuation of the hryvnia and an improvement in the international competitiveness of Ukrainian enterprises. The NBU regularly intervened at the foreign exchange market on both sides (i.e. by buying and selling US dollar) and prevented almost any deviation from this official rate. Despite this clear peg to the US dollar and the existence of an "official exchange rate", the NBU restrained from publicly announcing a formal commitment to keep the exchange rate constant. Thus, this was not a formal exchange rate

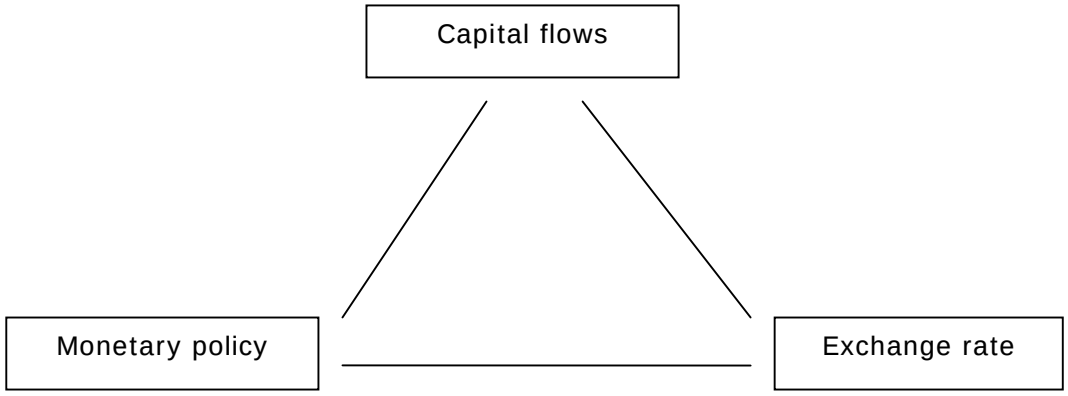
system, but only a de facto peg to the US dollar.[1] A further measure to support the currency peg was the severe regulation of the foreign exchange market and of international capital flows. Speculation (i.e. buying or selling of foreign currency without an underlying real or financial transaction) and forward trading were forbidden, exporters had to convert a minimum of 50% of foreign receipts, banks were only allowed to either sell or buy in one day and in general the NBU took a central role as manager of the foreign exchange market. Furthermore, monetary policy was completely subordinated under the exchange rate policy. The creation and reduction of money supply (i.e. monetary policy) resulted almost exclusively from foreign exchange interventions by the NBU; only minor sterilizations of money creation were conducted through monetary instruments.

It should be emphasized that the described limitations regarding capital flows and monetary policy were not goals of the NBU, but necessary consequences of a policy, which gives absolute priority to maintaining a currency peg. As explained in Box 1, it is technically impossible to fix the exchange rate and at the same time conduct an independent monetary policy and allow a free flow of capital. Consequently, the strong limitations on monetary policy and on the regulation of international capital flows should be considered as the cost for successfully fixing the external value of the hryvnia.

**Box 1**
Capital flows, monetary and exchange rate policy: theoretical considerations

A useful starting point to analyse the relationship between the exchange rate, monetary policy and unrestricted capital flows is within the framework of the "impossible trinity" displayed below:

**Figure 1: The "impossible trinity"**




T

he theoretical framework underlying Figure 1 is the open-economy Mundell-Fleming model, which suggests that it is impossible for a country to simultaneously achieve the three goals of a fixed exchange rate, an independent monetary policy and perfect capital mobility. Therefore, this situation is referred to as an "impossible trinity".

If a country decides to liberalize its capital account, and capital is therefore freely mobile, a fixed nominal exchange rate leads to a loss in monetary policy independence, as capital flows tend to drive domestic interest rates towards the level of foreign rates. In the context of such a pegged regime, it is therefore required that monetary policy is subordinated to the maintenance of the nominal anchor and domestic interest rates can adjust freely in response to international capital flows. On the other hand, an independent monetary policy that is assigned to domestic objectives (e.g. inflation or money supply targeting) leaves under the restriction of an open capital account the exchange rate to be determined by market forces.

This fundamental relationship is modified in the case that countries (like Ukraine did in the past, especially in the aftermath of the crisis in 1998) maintain capital controls, or domestic and foreign assets are not considered to be perfect substitutes. In both cases, the central bank may retain some control over monetary policy even with a fixed exchange rate. However, these instruments loose their effectiveness in the rapidly ongoing process of international financial integration, a process that can bring important long-term benefits for the country with it. A liberalised capital account will therefore bring more sharply into focus any existing inconsistencies between monetary and exchange rate policy: if monetary policy is targeted at domestic inflation, the exchange rate cannot be targeted at the same time (e.g. to manage competitiveness). Therefore, the possibility to assign monetary and exchange rate policy to achieve different macroeconomic targets at the same time become ultimately impossible with an open capital account.

[1] This could be explained by the low level of official reserves of the NBU and by the bad experience with the formal fixed exchange rate system before the crisis in August 1998.

## 3. New challenges for exchange rate policy in Ukraine today

### (i) The situation today

Today's situation is not comparable to the unstable times following the 1998 crisis. As shown by the features below, the confidence in the national currency has been restored to a large degree.

#### 1. Long period with a rather constant UAH/USD rate

The hryvnia exchange rate is effectively stable since early 2000, as it has seen very little exchange rate movement versus the US dollar. The official nominal rate appreciated only marginally from 5.44 UAH/USD in the middle of 2000 to 5.33 in April 2002 and was kept very close to this level until 2005. However, due to the build-up of increasing inflationary pressure, the NBU allowed the official rate of the hryvnia to appreciate in April 2005 by 4.8% to 5.05 UAH/USD, which is the current official rate in place.

This move was accompanied by a number of key liberalization steps in the foreign exchange market, which can be seen as first steps towards greater exchange rate flexibility. Over the course of the year 2005, the NBU removed some major impediments for an efficient and liquid foreign exchange market. From April onwards, the NBU abandoned the mandatory sales of 50% of export receipts (in place since the financial crisis of 1998). Starting September 2005 foreign exchange trading in the interbank market was considerably liberalized; banks were now allowed to simultaneously buy and sell foreign currency within the same day, which was previously forbidden. Furthermore, the conduct of forward foreign exchange operations was allowed, even though some limitations remained in place. In the beginning of 2006, the pension fund tax on purchases of non-cash foreign currency[2], which continues to hinder market development, was (marginally) reduced to 1.3% from 1.5%.

Turning to the liberalization of international capital flows, over the course of the year 2005 the NBU also relaxed the procedures for foreign investing and divesting in Ukraine by nonresidents, thereby making this process more transparent and efficient. At the same time, however, the NBU introduced some debatable restrictions on non-residents' purchases of short-term government securities and reserve requirement on short-term foreign exchange borrowing in an attempt to combat the negative effects of speculative short-term capital inflows.

#### 2. Relatively high level of official reserves

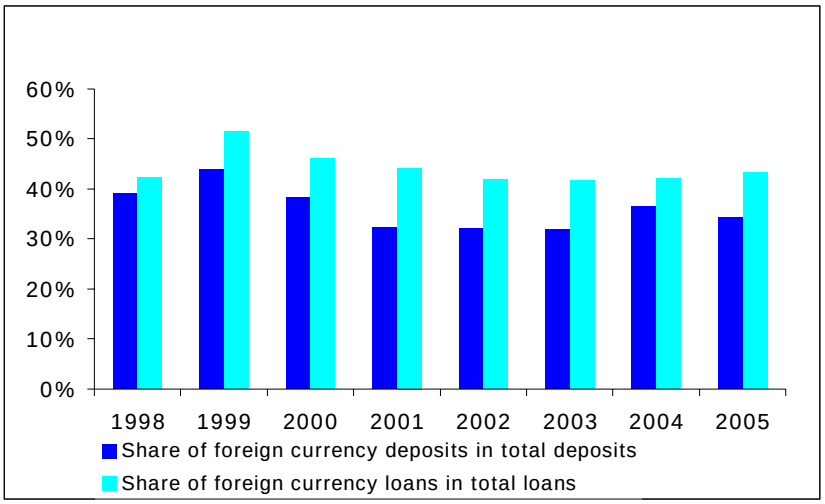
The growth in gross official reserves has been impressing. Starting from a very low level of USD 1 bn or 3 weeks of import coverage at the beginning of 2000, they stand currently (June 2006) at USD 17.7 bn, which corresponds to more than 4 months of import coverage. While periods of political uncertainty in the past led to temporary losses in reserves, this development has been relatively quickly reversed, resulting in a positive trend-growth in reserves.

#### 3. Regained, but not full confidence of the public in hryvnia

The long period of exchange rate stability without surprise devaluations lead to increased confidence in the use of the national currency from the side of the public. This process of “re-monetisation“ was visible in the strong growth in real money demand, which also helped to accommodate the strong growth in monetary aggregates stemming (un-sterilised) foreign exchange interventions over the period. However, the phase of “de-dollarisation”, through which the economy is currently passing, is far from over, as can be seen in Figure 2 in the relatively stable shares of bank loans and deposits in foreign currency:

[2] See our Policy Paper V7 for a detailed analysis of the economic effects of this tax.

**Figure 2**
Share of foreign currency deposits and loans in total amounts outstanding 1998 - 2005

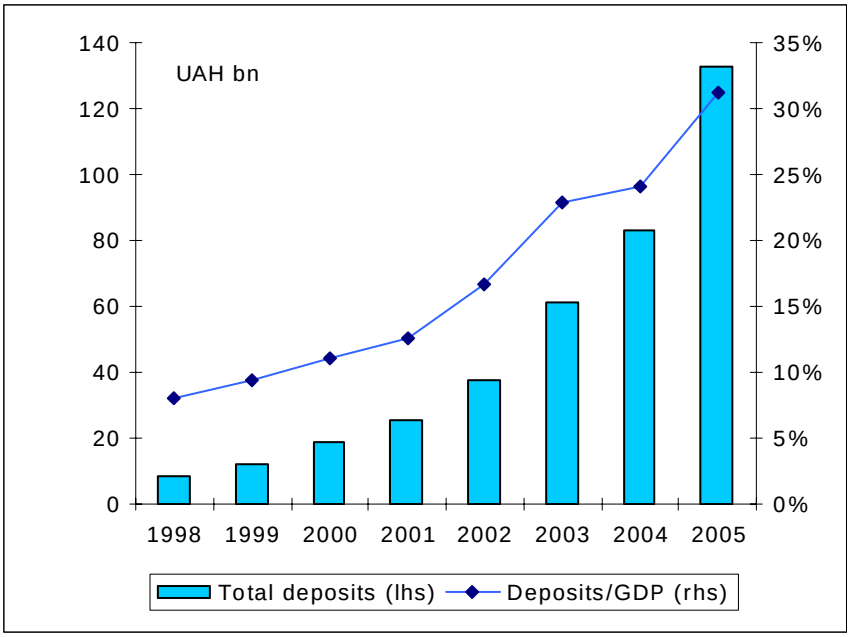



Note: end of period data
Source: own calculations based on NBU data

## 4. Larger and growing banking sector

After a sharp drop in financial intermediation after the 1998 crisis, the banking sector in Ukraine is now among the most dynamic in transition countries in terms of annual growth of loan and deposit volume. Figure 3 shows this development for banking deposits, both absolute and relative to GDP:

**Figure 3**
Growth in total banking deposits 1998 - 2005




Note: end of period data
Source: own calculations based on NBU data

This impressive growth, fuelled by real disposable income growth as well as an increase in confidence in the banking sector, however, is in part due to the low base effect in the aftermath of the financial crisis in 1998 with the result that the banking sector is still small, fragmented and relatively underdeveloped when compared to international peers.

### (ii) New Challenges

While the developments sketched so far show a positive picture of the situation in Ukraine today, there are, however, some challenges that need to be addressed by policymakers.

#### 1. Underestimation of exchange rate risk under the current peg

The perception of a rigidly fixed exchange rate, also for the future, has led the private sector to underestimate and, consequently, underprice exchange rate risk. Lower rates on foreign currency loans as compared to local currency loans made such loans more attractive, as can be seen in their steady increase over time. This is, however, implicit on the assumption that there is no move in the exchange rate.

The high degree of dollarisation under the current system is a direct consequence of such a wrong perception of the non-existence of exchange rate risk, which can have dramatic consequences for private sector balance sheets. These vulnerabilities in case of shocks that lead to a depreciation don't necessarily have to show up directly in the balance sheets of the banks, which are hedged against foreign exchange risk to a large degree. However, the private sector who has taken out loans in foreign currency but whose earnings base is in local currency will be first hit by such a mismatch, since they are not hedged. As soon as companies are unable to repay their dollar-denominated loans, the banks will be affected by these non-performing loans and are in danger of becoming insolvent due to the increase in credit risk. In the end, the financial meltdown due to collapsing balance sheets can lead to an economic downturn in such a scenario, which originated from an incorrect perception and pricing of foreign exchange risk.

One solution to this potentially dangerous development would be to allow gradually some more exchange rate flexibility, to force the public to recognize that exposure in foreign currency is not free from exchange rate risk, as there can be always shocks that make an adjustment in the exchange rate necessary. This increase in risk perception due to actual (but rather small) movements in the market exchange rate will most likely influence the borrowing behaviour of the public in the right direction (i.e. towards less foreign borrowing) and make the balance sheets of both the financial sector and the private non-bank sector more healthy and stable.

#### 2. Inflation

Even though Ukraine has followed a relatively successful path of disinflation after the 1998 crisis, there are still considerable upside inflation risks, and inflation is –even compared to other transition countries- relatively high and might increase further. This requires a further tightening of monetary policy from the side of the NBU in order to reduce excess liquidity in the banking sector and to contain inflation. In this respect[3], there are doubts that the exchange rate peg in place is able to provide an effective anchor for maintaining low and stable inflation and helps the NBU to reach its stated inflation goals. Uncertainties regarding the future growth in money demand, which supported the gradual process of disinflation so far, should also be taken into account, as it is not clear whether its robust growth so far extends to the future.

#### 3. External shocks in the short- to medium term future

The performance of Ukraine as a highly open transition economy is subject to a variety of external shocks. In this respect, a number of challenges can be identified that will influence the economic conditions in the country, even though their qualitative and quantitative impact remains to a large degree uncertain from an ex-ante point of view.

Regarding the current account, possible external shocks in the short- to medium run relate to the uncertain world price development of major export (e.g. metals) and import (e.g. energy) goods. It is therefore likely that the terms-of-trade are subject to certain negative (downside) risks in the future.

The second major source of external shocks in the short- to medium run can be seen in expected inflows of large amounts of foreign capital, especially against the background of an expected gradual liberalisation of the capital account. These inflows (e.g. FDI, bank lending and portfolio flows) while likely to be volatile and quickly responding to the economic and political situation (e.g. privatisation), could translate into possible positive (upside) risks to the capital account.

[3] See Box 1 in chapter 2 on the underlying theoretical considerations.

More nominal exchange rate flexibility has appealing features in dealing with the above-described shocks. Real shocks require ultimately an adjustment in the real exchange rate, which can take place through nominal exchange rate adjustment, or an adjustment of prices (or both). Policy makers can determine the speed and manner of this adjustment, especially in the presence of rigid and inflexible prices. In such circumstances, real activity (i.e. output and employment) is better insulated from terms-of-trade shocks, if the adjustment is done via a shift in the nominal exchange rate. Similarly, the impact of high and volatile inflows of foreign capital can in most cases be more easily managed with a flexible exchange rate, as it shields domestic variables from these external sources. This is especially valid for dealing with short-term capital inflows: if the current exchange rate is widely perceived to be misaligned, this fact in itself can generate excessive short-term capital inflows of a speculative and destabilizing nature. Exchange rate flexibility would introduce a sufficient amount of uncertainty about short-term movements in the exchange rate, i.e. increase the risk of taking positions and therefore limit the amount of these potentially destabilizing inflows.

### 4. Long-term real appreciation trend of hryvnia

Taking a long-term view on the transition path of Ukraine, which is motivated by theoretical considerations as well as the experience of more advanced transition countries, it is likely that the real effective exchange rate of the country is bound to appreciate. This observation can be often made in fast growing (catching-up) countries, with high relative productivity growth in the tradable sector. However, this process should be interpreted as an equilibrium phenomenon, and not as a permanent loss of competitiveness, as typically high levels of investment and associated relative productivity growth support it. This long-term trend appreciation can be in principle engineered by two different means: nominal appreciation and higher inflation vis-à-vis the foreign countries. There are again good reasons to favour an adjustment through nominal appreciation rather than higher inflation, as there can be considerable economic cost associated with the latter. This further strengthens the case for a certain degree of exchange rate flexibility.

**Proposal 1: Overall, the stabilization objectives after the crisis have been met but new challenges for the future have arisen. Therefore, the necessity of a formulation of new goals and, correspondingly, a new exchange rate policy to achieve these goals becomes clear. The need to stabilize the economy with an external anchor seems less necessary, but a more domestically oriented monetary policy within a more flexible exchange rate regime seems a more appropriate strategy to cope with above-mentioned challenges.**

## 4. How should the exchange rate policy respond to the new situation?

As became clear in the last section, new challenges to monetary and exchange rate policy have arisen. Therefore, the following sections try to establish (i) new policy goals, (ii) the general outline for a new exchange rate policy in response to these goals, and (iii) concrete implementation issues for the new exchange rate policy.

### (i) What goals should be set?

It is by now consensus that an environment of low and stable inflation seems best to support economic development in the long term, which makes it a primary objective for central banks. Central banks around the world focus on achieving this outcome by setting their monetary policy accordingly, and consequently subordinate other macroeconomic objectives under this overall goal.

A further (subordinated) goal of the central bank should be to avoid sharp and drastic changes in the exchange rate, i.e. to limit its flexibility and prevent it from overshooting. While exchange rate flexibility can be an optimal adjustment instrument in the event of external shocks (as demonstrated above), a still considerable degree of dollarisation in the economy, competitiveness issues and a high degree of exchange rate pass-through to inflation prevents the immediate adoption of a freely floating exchange rate. However, the optimal degree of flexibility will most likely change over time towards a more flexible stance, as the private sector adjusts to the new exchange rate policy with an improved risk management and credible new monetary policy anchors become available that effectively steer expectations.

### (ii) How to achieve these goals? The new exchange rate policy

An optimal policy response towards a fulfilment of above-mentioned goals would consist in a gradual shift towards a more flexible exchange rate regime. This could be helpful in both controlling the risk of domestic inflation and in reducing the effects of possible external shocks on the real economy. As became clear from the analysis so far, making ultimately inflation the primary objective of monetary policy brings clearly economic benefits, but has also to be supported by a shift to a more flexible exchange rate regime, especially under increasing international financial integration[4].

### (iii) Timing and concrete implementation of the gradual system shift

If we refrain from the official rate of 5.05 UAH/USD for a moment, the operational conduct of the current exchange rate policy is already using an undisclosed, i.e. implicit band of 5.00 – 5.06 UAH/USD. If this band is being touched by the market exchange rate, the NBU stands most of the time ready to defend the system, even though there were times in the past where it withdraw, thereby creating certain confusion among the market participants.

The concrete implementation of our proposal to allow for more **exchange rate flexibility** clearly connects to the system already established. The best way to allow for more flexibility is to make the edges of the band gradually wider, while keeping their level undisclosed, the latter being in line with current practice. The reason not to establish an official band and to communicate it openly is to allow for some flexibility in exchange rate management from side of NBU, and to discourage speculators to test the credibility of the central bank by attacking the officially announced band. However, it is important that the market knows the percentage increase in the band over time, which could be announced at different time intervals (i.e. monthly or yearly), in order to prepare for flexibility in an orderly manner. We would opt for a semi-annual announcement of the increase in the bandwidth, as this seems an optimal trade-off between the flexibility of monthly announcements and the confidence benefits of more long-term announcements.

With respect to the **concrete increase in the band** we would propose to start with a rather small band increase as a first step, say to 4.95 – 5.15, making use of the official rate of 5.05 that is already communicated to the market[5]. This implies an asymmetric shift of the current band in place (the lower edge of the band doesn't move as much as the upper edge), but it brings the official rate more in line with actual intervention behaviour. Current practice suffers to some degree from its asymmetric construction, as the undisclosed edges of the band are not equally away from the official rate. If the edges of the band and the official rate were brought consistently in line through such a step, the next move would be to allow for more flexibility of around +/- 5%, i.e. to 4.80 - 5.30, with similar steps ahead as time passes.

The optimal **timing** of such a regime shift is vital for its success. The proposed system change should take place if the current external and internal environment supports such a move. Internally, the main focus is on political stability, as otherwise the risk of depreciation expectations can become self-fulfilling and endanger an orderly transition towards such a flexible system. Externally, an ideal situation would be a time where the hryvnia trades close to its equilibrium exchange rate. Without going into much detail into the (more academic) discussion, where the equilibrium exchange rate of the currency currently is, there are certain indicators that show that the exchange rate is now possibly not too far from short-run equilibrium (stable reserve levels, the C/A-deficit in relation to FDI flows).

Turning to the **duration** of the regime shift proposed, we would favour a more gradual approach towards inflation targeting, as it gives the central bank the necessary time to develop and improve the necessary institutional requirements for such a drastic change in monetary policy strategy. While exchange rate pegging is relatively easy from an operational point of view, as it requires no complex monetary instruments or a detailed knowledge of the transmission mechanism, inflation targeting requires a much more complex institutional requirement[6]. Taking

[4] This follows immediately from the theoretical discussion in Box 1 (the "impossible trinity").

[5] This would imply a band of around +/- 2% around the official rate of 5.05 UAH/USD.

[6] See the following chapter for more information on some of these institutional requirements.

all this into account, we would propose a shift that is closer to 4 years, as this gives enough time to lay the necessary institutional conditions.

Regarding the necessity of **NBU interventions** in the foreign exchange market within such a proposed undisclosed band system, two basic forms can be distinguished: interventions at the edges of the band versus intra-marginal interventions within the band targeted. In order to keep the market exchange rate within the band, the NBU needs to stand ready to defend the edges of the band, as soon as the exchange rate starts to reach them. This mechanism is vital for the success of the system and as such a system-immanent feature. The second possibility of NBU interventions in the market are interventions conducted *within* the band, i.e. when the exchange rate has not yet touched the edges of the band. In the context of a relatively small band in the beginning of the shift towards a more flexible exchange rate system, these intra-marginal interventions need not be necessary. However, with a gradual increase of the band size over time, such interventions can become an important policy tool to stabilize the market exchange rate in turbulent and volatile periods, even though the edges of the band haven't been hit. This instrument of foreign exchange interventions is also available in a fully floating regime, as there can be always adverse market developments that make it necessary to support the exchange rate. Even the major central banks around the world that operate under fully floating exchange rates (Federal Reserve, ECB, Bank of Japan) have made occasionally use of foreign exchange interventions to reach certain policy goals, albeit to a different degree.

The experience of other, more advanced transition economies can give some advice regarding the possible development steps and the timing of a shift towards a more flexible regime. Box 2 shows the evolution of the Polish exchange rate system in the 1990s, which started from similar conditions of a fixed USD-peg and moved gradually towards full exchange rate flexibility.

**Box 2**
From fixed to floating: The Polish experience in the 1990s

Poland, a relatively advanced transition country which is a EU member since 2004, followed in the last decade during its transition process three different strategies of monetary and exchange rate policy.

In January 1990, at the beginning of the transition period, Poland adopted a fixed exchange rate towards the USD with the principal objective to fight hyperinflation. This stabilization period, which involved discretionary adjustments in the peg, took around 18 months and allowed the national currency, the zloty, to regain its role as a medium of exchange and a store of value despite a still relatively high rate of inflation.

The exchange rate peg was abandoned in October 1991 and transformed into a crawling peg system anchored towards a basket of currencies in order to prevent the real exchange rate from excessive appreciation and preserve foreign competitiveness. The rate of crawl (initially set at 1.8% monthly devaluation) changed over time, and occasionally there happened to be discretionary de- and revaluations in order to cope with exogenous shocks. In 1995, a band within which the currency was allowed to fluctuate was officially introduced at +/-7%, even though in practice the authorities controlled an informal exchange rate band of +/-2.5% within the officially band and conducted their interventions within this narrower band. However, the general success of Poland during its transition path caught the attention of foreign investors, which resulted in large inflows of short-term capital. This became a problem for the central bank, as controlling the money supply became more and more difficult for the authorities under the current regime. A new framework was therefore required to clarify the priorities of monetary policy. This development has been mirrored in the second half of the 1990s, apart from Poland, also in several other Central and Eastern European transition countries, which made large progress in disinflation, economic growth and the attraction of considerable foreign capital inflows (which were nevertheless volatile, leading sometimes to speculative attacks on the currencies). As a direct consequence, these countries (e.g. Hungary, the Czech Republic, among others) moved towards more flexible regimes where monetary policy is based on a different nominal anchor.

Poland adopted formally inflation targeting in early 1999 in order to anchor its domestic monetary policy. This regime shift included the establishment of the independence of the National Bank in terms of both goals (inflation targets) and monetary policy instruments (the short term interest rate). Furthermore, in order to prepare the public for this regime shift, the transparency of both goals and instrument use was enhanced by better communication with the market mainly through regular press conferences, publication of inflationary reports and explanations of conducted monetary policy actions. On the exchange rate side, this move was accompanied by a considerable widening of the exchange rate band, to +/-15%. The rate of crawl was progressively reduced from 1% per month in the beginning of 1997 to 0.3% in March 1999, so that the pre-announced inflation target set by the central bank (headline CPI) could be achieved more easily. Finally, a pure floating exchange rate was introduced in April 2000, which marks the last stage of the development of the exchange rate regime in Poland. Since then the central bank has not intervened on the foreign exchange market, and the inflation rate seems more or less under control of the central bank.

Sources: Pruski, Jerzy [2002]. Poland as an Example of Successful Transition From Inflation Targeting Lite to Fully Fledged Inflation Targeting, Conference at the IMF in Washington, D.C., “Challenges to Central Banking from Globalized Financial Systems” September 16–17,2002; Creel, Jerome and Sandrine Levasseur [2004]. How would a fixed exchange rate regime fit the transition economies? The cases of the Czech Republic, Hungary and Poland, Revue de L'OFCE No. 91 (April), pp 83-120.

**Proposal 2: We propose a gradual shift towards a more flexible exchange rate regime, as this can be seen as a first-best solution to the challenges identified. An undisclosed band system with a gradually increasing bandwidth is our preferred strategy for such a move towards a freely floating exchange rate.**

## 5. Complementary recommendations

A move towards a more flexible exchange rate regime brings two immediate implications with it, which need to be addressed. The first deals with the establishment of an alternative nominal anchor, the second with the development of adequate instruments to deal with the associated exchange rate risk.

Exiting an exchange rate peg by gradually increasing exchange rate flexibility creates the need to replace the existing anchor with a new and credible nominal anchor for monetary policy, as inflation expectations need to be kept at a low and stable level. However, such an alternative anchor is not established overnight, but requires extensive preparation from the side of the policymaker. Basically, there are two conventional alternative anchors available, namely direct

inflation targeting and money supply targeting. In order to select the right framework, several initial conditions need to be in place, which we will briefly examine.

In view of problems with alternative anchors, a number of emerging markets have increasingly switched to **inflation targeting**. In order to establish such a monetary policy framework, a number of institutional requirements need to be addressed, which include:

- a clear priority to make price stability the primary, explicitly announced objective of monetary policy, above other competing objectives;
- to establish the central banks operational independence;
- to improve the transparency and effective communication of both its monetary policy framework and the conduct of its operations, such as clarity of objectives, use of monetary policy instruments, and regular communications to the public about past policy decisions;
- to further develop the necessary instruments to implement monetary policy
- to develop a reliable methodology for forecasting and measuring inflation

The other alternative nominal anchor is monetary targeting, which assumes a stable relationship between the targeted monetary aggregate and inflation. In case this relationship is stable and predictable, monetary policy can be anchored on such monetary targets. The stability of this relationship is an empirical issue, which needs to be studied for the case of Ukraine[7].

The move towards a more flexible exchange rate with a newly established nominal anchor (be it inflation targeting or monetary targeting) creates exchange rate risk for the private sector (i.e. for exporters, importers, and increasingly also capital transactions). It is therefore necessary to develop adequate **hedging instruments** to enable the sector to manage the associated risks efficiently.

The basic hedging instruments for such risks are forward contracts, whose onshore-trading is allowed in Ukraine since the lifting of the respective trading ban in September 2005. Such forwards are bilateral (over-the-counter) derivative contracts, which make it possible to agree already today on a concrete exchange rate in the future. In more mature and developed markets, these contracts are often accompanied by currency futures, which are highly standardised, liquid exchange-traded contracts.

However, the actual development of forward trading in Ukraine, which is insignificant to date, shows that important steps need to be taken in order to facilitate the efficient working of such hedging instruments. From conversations with market analysts it becomes clear that the main impediment that continues to hinder the effective functioning of such forward contracts is the pension funds tax on purchases of non-cash foreign currency development. Furthermore, the existing strict regulation (complex documentation necessary, only for current account transactions allowed) concerning the use of these contracts contributes as an additional negative factor. Therefore, the adequate steps that have to be taken include the abolishment of this tax, as it hinders the creation of a liquid foreign exchange market, both in the spot and the forward segment, and a relaxation of respective regulation. If regulation is too strict, it will drive related financial business offshore, a fact that can be seen in the development of active offshore forward markets (non-deliverable-forwards, NDFs) in the hryvnia.

**Proposal 3: The regime shift towards more exchange rate flexibility must not be seen in isolation. A more flexible exchange rate permits an independent monetary policy, which has to be based on alternative anchors (inflation targeting, monetary targeting). Furthermore, the associated increase in exchange rate risk makes the efficient functioning of markets for hedging instruments (i.e. forward contracts) necessary.**

## 6. Final remarks

When it comes to exchange rate policy, it is crucial to do the right thing at the right time. But what means to do the right thing in the current situation? As we argued above, the new Ukrainian situation and challenges require more flexibility. Thus, the right thing to do is to move

[7] See IER Working Paper No. 28 by Olena Bilan and Boriss Siliverstovs "Inflation Dynamics in the Transition Economy of Ukraine", February 2005, also published in: Eastern European Economics, Vol. 43, Issue 6, November-December 2005.

away from the fixed exchange rate system established in the year 2000 towards a more flexible exchange rate policy. After a transition period of about 4 years, the hryvnia should be allowed to float freely. The external anchor of exchange rate policy (i.e. the US dollar) should be replaced by a nominal anchor of monetary policy, within the framework of inflation or monetary targeting.

And what about the timing? When should the NBU start changing its exchange rate policy? We argue that the change should start as soon as possible for several reasons. First, there are signs that the hryvnia lies currently at its short-run equilibrium level. Thus, increasing the flexibility of the exchange rate now will not necessarily lead to a significant change in the level of the exchange rate, which makes the change in the system smoother and easier to be accepted by the public. Second, the public already accepted a first period of slight flexibility since April 2005 and is now ready for a second move, as we found out in several conversations with market participants. Third, a change in exchange rate policy should be conducted from a position of strength, not from weakness. This is the best way to make sure that the public accepts the change and the new policy is successful. Today we have a strong position, since there are no significant pressures on the hryvnia and the official reserves are rather high. Consequently, waiting for "better" times to start changing the system entails the risk of getting into a weak position, which in turn will question the acceptance and the success of the new system. In fact, "waiting for too long" and thus missing the optimal time for change has been a typical mistake of several countries in the recent past.

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