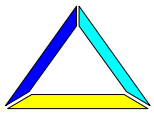
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To devalue or not to devalue? That's *not* the question.

1. Introduction
2. What should be the main goal of the current exchange rate policy in Ukraine?
3. How should the trade surplus goal be achieved?
   3.1 Choosing an intermediate target
   3.2 Establishing the intended path for the intermediate target
4. The current debate in Ukraine: to devalue or not to devalue?
5. Summary

1. Introduction

Any exchange rate policy involves taking two major decisions. The first decision concerns its purpose: *what* should be the main goal of the exchange rate policy? The second decision concerns the methods to be employed to achieve this purpose: *how* should this main exchange rate policy goal be achieved? In this paper we present our view on short term[1] Ukrainian exchange rate policy by answering both questions.

Furthermore, we use our analysis to contribute to the current national debate on exchange rate policy. Among other things, we shall discover that the question whether to devalue or not to devalue, which is at the centre of this debate, is not the appropriate one.

2. What should be the main goal of the current exchange rate policy in Ukraine?

Exchange rate policy can be used to pursue different economic goals. The most common goals are price stability, influencing foreign trade and as a result the trade balance, attracting foreign capital, achieving a certain level of official foreign reserves and integration into an economic area like the European Union. Unfortunately, no exchange rate policy can achieve all of these goals simultaneously and to the same extent. That is why a fundamental decision has to be taken, as to the main goal of a given exchange rate policy.

[1] By 'short term' we mean the next 12 to 18 months.

In our view, the main goal of the exchange rate policy in Ukraine in the short term should be to maintain a significant surplus in the trade balance.[2] The demand (excluding international trade) for foreign exchange in the short term will be relatively high, due to the scheduled interest and debt redemption payments to non-residents and to the sensible plan of the NBU to further increase its foreign reserves. The supply (excluding international trade) of foreign exchange is unlikely to reach the demand level, because neither important FDI nor significant foreign portfolio investment can be expected. Thus, exports need to exceed imports in order to balance supply and demand on the foreign exchange market. Without a significant trade surplus, timely servicing of the foreign debt cannot be guaranteed, official foreign reserves might decrease and exchange rate instability might occur, thus jeopardising the current external stability and economic growth enjoyed by Ukraine.

The decision to pursue the trade surplus goal implies not pursuing (at least to their fullest extents) any of the other potential goals of exchange rate policy. In the current situation, this does not pose a serious problem, since all alternative goals are either less attractive than a trade surplus or they can be pursued much more effectively by means other than exchange rate policy.

At this point in time, price stability should not be the central goal of exchange rate policy, because inflation is under control and is not expected to become a major problem in the near future.[3] The same applies to integration into the European Union (EU). Membership in the EU and adoption of the euro as the national currency of Ukraine are still far in the future. At this time, there is no need to peg the hryvnia to the euro in order to fulfil the Maastricht convergence criteria.

Attracting foreign capital is a valid goal of economic policy, but it should not be pursued by way of exchange rate policy. Ukraine should concentrate on attracting equity investment (FDI and shares), and not on potentially unstable credits and bond investment. In order to achieve this goal, several measures should be taken to improve corporate governance, and increase transparency and efficiency at the administrative, customs and tax levels. These measures are much more likely to attract foreign capital than any exchange rate decisions ever could.

3. How should the trade surplus goal be achieved?

Having established that a significant trade surplus is the main goal of its exchange rate policy, the central bank has to decide on how this short term goal can best be achieved. This question involves choosing an intermediate target and determining the intended path for the intermediate target. We shall look at these two aspects in sequence.

3.1 Choosing an intermediate target

In order to pursue its goals, the central bank has several instruments at its disposal, like lending rates to commercial banks, reserve requirements, open market operations and foreign

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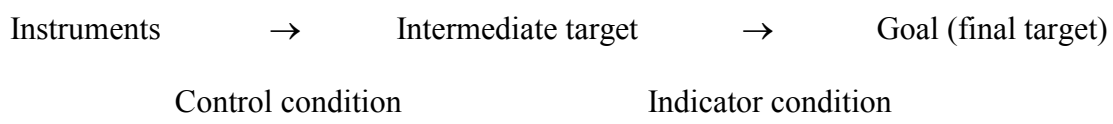
[2] In the middle run, Ukraine should become a net importer of capital, in order to modernise and increase its capital stock and foster sustainable economic growth. Thus, the goal of a surplus in trade and current account balances, which implies Ukraine being a net exporter of capital, only makes sense in the short term. The task for Ukrainian policy in the middle term is to ensure a net import of capital, without jeopardising the current external stability.

[3] In our view, inflation does not pose a serious problem to the economy, as long as it stays in the single digit realm.

exchange interventions. However, final goals like a trade surplus cannot be reached directly by using any of these instruments, because the links between them and the trade balance are rather complex and have long time horizons. Therefore, the central bank needs to pursue its goals in an indirect manner, by choosing an *intermediate target*, which in time terms stands between the instruments and the final goal.

An appropriate intermediate target must fulfil two conditions. On the one hand, the central bank must be able to determine the intermediate target by using its instruments (control condition). On the other hand, the relationship between the intermediate target and the trade balance must be strong and stable, such that changes in the intermediate target will - after a certain period of time – translate into targeted changes in the final goal. Thus, the intermediate target must be a good indicator of the future trade balance (indicator condition). The relationships between instruments, intermediate targets and goals of monetary and exchange rate policy are shown in Figure 1.

Figure 1: The link between instruments, intermediate targets and goals of monetary and exchange rate policy



In our view, the most appropriate intermediate target for pursuing the goal of a trade surplus is the real effective exchange rate. The easiest way to substantiate this claim is to show why the nominal exchange rate of the hryvnia against the US dollar should not be used as an intermediate target.

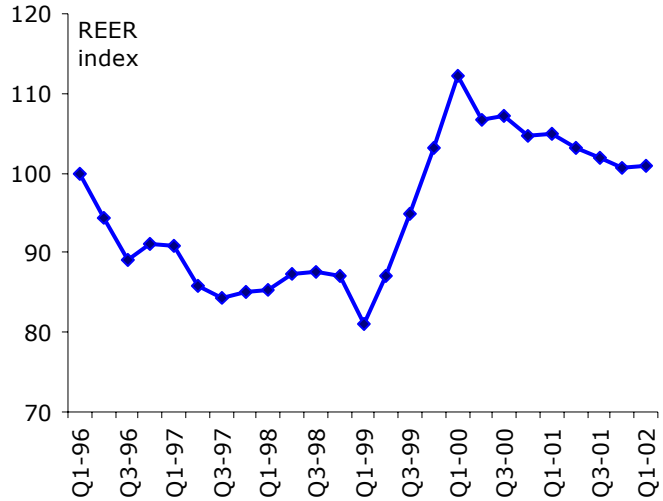
The exchange rate of the hryvnia vis-à-vis the US dollar is not an appropriate intermediate target, because it is not a good indicator of future trade balance developments (indicator condition, see Figure 1). In particular, a constant hryvnia-dollar exchange rate by no means implies a constant internationally competitive position of Ukrainian enterprises and a constant result in the trade balance. This can be explained by two factors. First, the US dollar is not the only relevant currency for Ukraine's foreign trade. Thus, Ukrainian exports would be hurt by a significant appreciation of the hryvnia against the euro or the Russian rouble, even if the hryvnia-dollar exchange rate did not change. The final goal of a substantial trade surplus should thus be pursued using a currency basket as an intermediate target, and not a single currency. In technical terms, a currency basket is referred to as an *effective* exchange rate. Second, the hryvnia-dollar exchange rate says nothing about price developments in Ukraine and abroad. A significant rise in the price level in Ukraine would lead to higher costs to Ukrainian enterprises and to a worsening of their international competitive position, notwithstanding a constant hryvnia-dollar exchange rate. For this reason, the central bank should incorporate the domestic and some foreign inflation rates into its intermediate target, which aims at influencing the trade balance. In technical terms, this is referred to as a *real* exchange rate. Combining both considerations, we come to the conclusion that the central bank should use a real effective exchange rate (REER) as its intermediate target to pursue its goal of maintaining a trade surplus.

The REER is a theoretical concept. For practical purposes, a REER index has to be constructed. This requires deciding on the formula of the index, including most prominently the make up of the currency basket. In our view, the REER index for the purpose in question should feature the following properties: It should be based on a simple formula and only

include the most important currencies applying to Ukrainian foreign trade. The formula should not change over time, in order to guarantee continuity and prevent manipulation. This implies using constant weights for the currencies that make up the currency basket. Furthermore, empirical evidence should be available to demonstrate a strong link between the REER index and the trade balance.

The REER index constructed by us features all these properties. The currency basket includes only the three most important currencies, namely the US dollar, the euro and the Russian rouble. Each of these currencies constitutes one third of the basket, because they are of almost equal importance for Ukrainian foreign trade. This weighting scheme is kept constant over time, thus ensuring continuity and preventing manipulation.[4] Furthermore, an econometric analysis has shown a rather strong relationship between the REER index and the trade balance for the period 1996 to 2001. A real effective depreciation of the hryvnia is shown to lead to an improvement in the trade balance[5] after half a year.[6] Last but not least, we think that the NBU should be able to target the development of this REER index in the short term using its instruments (control condition, see Figure 1). The targeting of the index should be pursued mainly by influencing the (nominal) exchange rates to the US dollar, euro and Russian rouble through interventions at the foreign exchange market.[7] The development of our REER index since 1996 is shown in Chart 1.

Chart 1: REER index for the period Q1-1996 to Q1-2002



Note: an increase in the index means a real effective depreciation of the hryvnia

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4 Also, a geometrical average weighting technique is used. As a measure for inflation we chose the producer price indices (PPI) for the four countries in question (Ukraine, USA, the eurozone and Russia). For a precise description of our REER index see Mankovska/Giucci/Betliy (2002), *The Influence of the Real Effective Exchange Rate on the Trade Balance in Ukraine*, Ukrainian Economic Trends, Quarterly Issue, March 2002, p. 74-79.

5 The data on the trade balance includes trade in goods and services, and was taken from the quarterly balance of payments published by the NBU. For details see Mankovska/Giucci/Betliy (2002).

6 A real effective depreciation of the hryvnia leads to a worsening of the trade balance after one quarter and to an improvement of it after two quarters. This result confirms the existence of a J-curve in Ukraine. For details see Mankovska/Giucci/Betliy (2002).

7 Basically, the NBU has two ways to control the REER index. In the very short term, that is on a daily basis, it can determine the REER index by influencing the (nominal) exchange rates to the US dollar, euro and Russian rouble through interventions at the foreign exchange market. In the medium term, it can influence the inflation rate in Ukraine through open market operations (selling and buying state bonds), credits to commercial banks and by determining the rates for reserve requirements. In our view, the NBU should try to keep the rate of inflation at a low and stable level.

Chart 1 reveals strong and sudden changes in the REER index between 1996 and 2000. Obviously, the NBU has not targeted the REER during that period. One might ask whether targeting the REER during that period could have prevented the exchange rate crisis of 1998. Unfortunately, it is not possible to answer this question. But we are convinced, that targeting the REER now would help preventing a future crisis such as the one experienced in 1998.[8]

3.2 Establishing the intended path for the intermediate target

So far we established a trade surplus as the main goal of the exchange rate policy in the short term and the REER as the appropriate intermediate target for achieving this goal. Under these conditions we now have to ask and debate *the question* about the appropriate development (time path) of the REER in order to achieve the goal of a specific trade balance surplus. In particular, is it necessary to have a real effective depreciation? And if so, how big should it be during say the next 12 months? Or is the established goal to be achieved by keeping the REER constant? Or is it even necessary to have a real effective appreciation, in order to avoid too large a trade surplus?

As stated by economic theory[9] and as shown by empirical research, the degree of real effective appreciation depends on the labour productivity growth at home relative to that of the trading partners. The stronger the labour productivity grows in Ukraine relative to abroad, the higher the corresponding real effective appreciation of the hryvnia. Thus, the establishment of the intended path for the REER should be based on expectations about the short term development of labour productivity in Ukraine.

Labour productivity at the economic level depends on several factors such as real investment, financial intermediation, organisational and working skills, market structures, efficiency of the juridical system, infrastructure and administrational burdens. It is undeniable, that in general terms these factors are improving in Ukraine. But it is also a fact that they are not improving very fast. Thus, one should not expect a significantly higher productivity growth in Ukraine than abroad in the short term.[10] Consequently, at least for the time being, we would advise the NBU to establish a more or less constant intended path for its intermediate target.[11] A significant real effective appreciation should be avoided.

The adoption of an intended path for the REER implies some further decisions by the central bank, which we will shortly name. Firstly, it has to be decided with what precision the REER should be targeted. For instance, does a deviation of say 3% from the intended path require action? Or should 3% be considered too small for action? Secondly, how quickly should the NBU react to changes in the REER? Should it wait a little to see whether the changes are of a temporary nature, or should it react straightaway? Thirdly, the possibility of changing the intended path after positive or negative shocks and the process for changing this path should be established beforehand.

Finally, we must clarify one important topic, in order to avoid misunderstandings. We know that Ukraine has a large potential for increases in labour productivity and thus a potential for a real effective appreciation. We also believe that a real effective appreciation, provided that it

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8 We do not exclude the possibility, that the NBU has already started targeting some REER index in the recent past. But no official anouncement has been made so far.

9 We refer here to the well-known Balassa-Samuelson effect.

10 Labour statistics and consequently data on labour productivity are not reliable in Ukraine. For this reason, we prefer not to base our argumentation on empirical data.

11 This advice is based on the assumption, that the current level of the REER is an appropiate one.

is sustainable, would be very advantageous for Ukraine. The imports of capital and energy goods, which are needed for production, would become cheaper in real terms. But also servicing the foreign debt would become easier. Thus, a real effective appreciation is potentially possible and desirable. However at this time, due to the slow process of economic reform in Ukraine, a real effective appreciation could not be sustained and would thus worsen the trade balance and destabilise the economy. Consequently, a real effective appreciation should not be tolerated or even aimed at using the argument, that it is good for the economy. It would be good, if it where sustainable. But since it is not sustainable, it is a bad thing for the economy.

4. The current debate in Ukraine: to devalue or not to devalue?

Exchange rate policy is widely debated these days in Ukraine. The National Bank, which is responsible for exchange rate policy, has even been criticised by the government, which by any standards is quite a strong thing to happen. In this part of the paper, we want to contribute to this debate by using the analytical framework developed above.

A broad consensus prevails among Ukrainian policy makers at this time with respect to the goal of exchange rate policy. According to this consensus, the exchange rate policy should in the short term maintain a significant trade surplus, which is seen as the cornerstone of the external stability regained in the year 2000. In particular, the large trade surpluses in the last years are acknowledged to have made an increase in official foreign reserves possible, which are still considered to be too low, and a reduction in the government's foreign debt, which is still considered to be too high. This state of things is remarkable for two reasons. Firstly, the fact that such a broad consensus exists on what should be the main goal of exchange rate policy is remarkable and cannot be said of many other countries. Secondly, it is also remarkable that the policy makers agree on what is in our view the right goal of exchange rate policy.

Interestingly enough, this consensus about the main goal of exchange rate policy is not accompanied by a consensus on how to achieve this goal. At the centre of the current debate lies the question, whether it is necessary to devalue the hryvnia or not, in order to maintain a trade surplus in the short term. The 'devaluation camp'[12] points to the present problems in the metallurgical sector, which accounts for roughly 40% of exports. They demand a devaluation of the hryvnia, in order to improve the internationally competitive position of metallurgical enterprises in Ukraine, increase exports and sustain a trade surplus. On the other side of the debate stands the 'anti-devaluation camp', which strongly opposes devaluation. Their followers do not think that devaluation would significantly improve the trade balance, because of the inelastic nature of Ukrainian imports. Around 50% of Ukrainian imports are energy goods, the demand for which would not significantly decrease in the event of a devaluation. Furthermore, this camp points out that devaluation would make the import of capital goods and the servicing of the foreign debt more expensive. As a result of devaluation, the modernisation of Ukrainian industry and the improvement of Ukraine's international financial position would be slowed down. It should be noted, that the term 'devaluation' is used by both sides with the same meaning, namely in the sense of a rise in the nominal exchange rate between the hryvnia and the US dollar, which now stands at roughly 5.33 UAH/USD.

The most striking thing about this debate is the fact, that it is not based on correct assumptions. The hryvnia-dollar exchange rate is just one of several monetary factors, which

[12] The terms 'devaluation camp' and 'anti-devaluation camp' have been chosen by the author.

influence the trade balance. Other important factors like the exchange rates to the euro and to the Russian rouble, and the inflation rates in Ukraine, USA, the eurozone and Russia are completely ignored in the debate. The debate should not focus on the nominal exchange rate to the US dollar, but on the REER, which incorporates all important monetary factors for the future development of the trade balance. The question at the centre of the debate on exchange rate policy should be whether the current development of the REER is appropriate or not. Once this fundamental question is answered, the secondary question regarding the need for a nominal devaluation against the US dollar will be automatically answered.

So, does the REER develop as it should? Broadly speaking, the REER has been more or less constant since the start of the year (see Chart 1). The exchange rates to the US dollar, euro and Russian rouble did not change significantly, and inflation in Ukraine has been comparable to inflation abroad. Thus, the recent development of the REER is consistent with our recommendation of a constant path for the REER in the short term. This assessment implies, that there is no need to devalue the hryvnia against the US dollar for the time being. Thus, at this time we are against devaluation.

Does this mean that we side with the anti-devaluation camp? The answer is no. We came to the same conclusion with respect to the hryvnia-dollar exchange rate, but only because the other six factors which we consider to be as important as the dollar rate are rather constant at the moment. But this has not always been the case in the past[13] and will definitely be different at some future time. For instance, should inflation pick up strongly in Ukraine[14] and other relevant factors remain equal, then we will certainly favour devaluation against the dollar, in order to maintain the REER at a constant level. It goes without saying, that this would not mean that we were changing sides and became members of the devaluation camp.

Finally, we would like to comment on some other aspects of this debate. Let's look first at the anti-devaluation camp. We do not agree, that devaluation would not positively influence the trade balance at this time. Devaluation would imply a real effective devaluation, which would lead to an improvement in the trade balance after half a year. The existence of this relationship has been shown by our empirical research. The anti-devaluation camp seems to focus too narrowly on the inelastic imports and forgets about the exports, which is the other component of the trade balance. Furthermore, we agree that a strong hryvnia facilitates the import of capital goods and the servicing of the foreign debt. As we said before, a real effective appreciation is advantageous, provided it is sustainable. But because of slow economic progress and a moderate growth in labour productivity in Ukraine, a real effective appreciation would at this time not be sustainable.

Let's turn now to the devaluation camp. The metallurgical sector in Ukraine has serious structural problems. In particular, its capital stock is to a large extent outdated and its energy intensity is very high. In order to sustain metallurgical exports at a high level, but also for internal reasons, a restructuring of this sector is badly needed. The sooner this happens, the better for the country. Of course, restructuring such a huge and important sector is not an easy task and requires tough decisions. A devaluation of the hryvnia would briefly alleviate some problems in the metallurgical sector, but it would not solve any of them. In fact, it would make the eventual restructuring even more difficult, because it would start later. Thus,

[13] For example Ukraine's inflation rate in 2000 was much higher than in the USA and the eurozone.
[14] This is just an example. We do not expect a very strong rise in inflation in Ukraine in the near future.

devaluation is not the solution to the structural problems of the metallurgical sector. Structural problems need to be tackled by structural, not by exchange rate policies.[15]

5. Summary

This paper presents our position on the exchange rate policy of Ukraine. The main goal of this policy in the short term should be to maintain a significant surplus in the trade balance, in order to ensure a further increase in the official foreign reserves and a further decline in the government's foreign debt. This decision implies, that other potential goals of exchange rate policy, such as price stability or the attraction of foreign capital cannot be pursued to their fullest extents by exchange rate policy. In our view, this does not pose any serious problem, because these goals are either less attractive than a trade surplus or because they can be pursued more effectively by other means than exchange rate policy.

In order to pursue the agreed upon goal, the NBU should use a real effective exchange rate (REER) as the intermediate target. In particular, we suggest to use the REER index developed by us, which includes the seven most important monetary factors for the trade balance, namely the dollar, euro and rouble rates to the hryvnia as well as the inflation rates in the USA, eurozone, Russia and Ukraine. The dollar-hryvnia exchange rate should definitely not be used as an intermediate target, because it is just one of these factors and is thus on its own not a good indicator of the future development of the trade balance.

With the help of this analysis, we are able to shed some light on the current national debate on exchange rate policy in Ukraine. Although there is a broad consensus in Ukraine, that the goal of exchange rate policy in the short term should be to maintain a healthy trade surplus, no consensus exists as to how to achieve this goal. Some argue that devaluation against the US dollar is necessary, while others strongly oppose devaluation. In our view, this debate is misleading, because it is based on just one factor of the trade balance, namely the dollar-hryvnia rate. The debate should properly be about the development of the REER, not about the dollar rate. The appropriate level of the dollar must be derived from the fundamental assessment, whether the present development of the REER is appropriate or not.

We think that the rather constant REER since the start of the year is appropriate for the main goal of keeping a trade surplus in Ukraine. Thus, there is no need to change the time path of the REER. Given present circumstances, this fundamental assessment implies, that no change in the dollar rate is necessary. Consequently, we are against devaluing the hryvnia at the moment. But if a significant real effective appreciation should take place sometime in the near future, than we will indeed favour devaluing the hryvnia.

R.G., Lector V.V.
July 2002

[15] In addition, the quantitative importance of the metallurgical sector for net exports and for the economy as a whole has been often overestimated. Production in this sector requires significant energy inputs (about 30% of production costs), which have to be partly imported. Furthermore, only 5% of GDP is created in the steel industry.