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The last days of fixed exchange rate

Since April 2005 hryvnia exchange rate to US dollar had remained in very tight bounds. The NBU had sold dollars for UAH 5.06 per USD and hryvnias for UAH 5.00 per USD limiting interbank exchange rate variations to about 1%. At the same time the NBU had maintained official exchange rate unchanged at UAH 5.05 per USD. As interbank foreign exchange market had been quite illiquid, the NBU had also worked as market-maker smoothing out fluctuations of supply and demand.

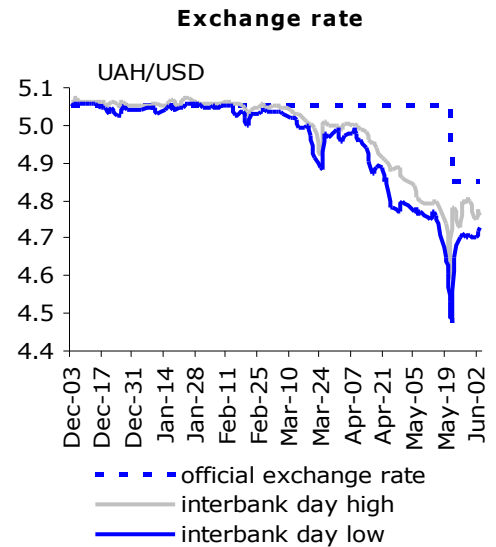
In general, official exchange rate is indicative: no parties are required to conduct currency exchange transactions at official rate except the NBU and Treasury. However, official rate is mandatory for use in accounting and customs applications. As foreign currency is generally forbidden for use in domestic payments, official rate is also widely used for converting payments denominated in foreign currency to hryvnias.

In 2007 the NBU reduced participation in US dollar segment of interbank market, but still bought large volumes of foreign currency preventing exchange rate from appreciation. Purchases of foreign currency contributed to expansion of money supply and acceleration of inflation. Therefore, in September 2007 the NBU officials started to warn about possible increase of exchange rate flexibility in 2008. Accordingly, in the end of 2007 and in the beginning of 2008 the NBU several times allowed the exchange rate to cross informal exchange rate band of UAH 5.00-5.06 per USD before intervening to maintain exchange rate. Starting from February 2008 the NBU withdraw from UAH/USD market completely. As supply of foreign currency continued to be larger than demand, hryvnia started to appreciate against US dollar in March and April from UAH 5.00 per USD to UAH 4.80 per USD. As official exchange rate remained at 5.05 UAH per USD, disparity between market and official rate reached 5%. Such situation became essentially a trade barrier for importers that overpaid custom duties and the VAT by 5% and also caused payments tied to official rate to become too high.

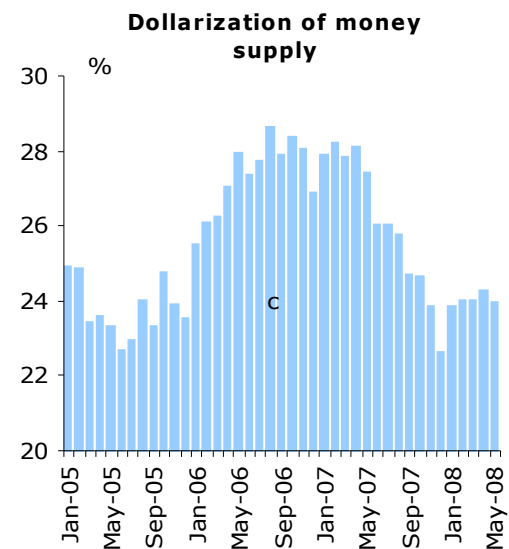
In the middle of May tight liquidity forced banks to sell off dollars causing hryvnia to appreciate up to UAH 4.50-4.60 per USD making the gap between official and market rate even larger. Thus the NBU board decided to close the gap by increasing official rate to 4.85 UAH per USD and intervening the interbank market at 4.80 UAH per USD. The change in official rate decreased the VAT and duties paid on imports expressed in UAH by 4%. Besides if official exchange rate remains high up to the end of 2008, enterprises with net debt in foreign currency will be forced to mark it down and pay enterprise profit tax on additional profits. Assuming unchanged official rate in the end of 2008 and external assets of the Ukrainian enterprises at USD 8 bn, net foreign currency liabilities of nonfinancial corporations can be estimated at USD 47 bn while additional taxes can reach UAH 2.4 bn out of UAH 9.6 bn of new profits.

Change in official rate prompted strong statements by exporters and politicians against revaluation despite the fact that actual appreciation of hryvnia on the interbank market started several months before. Such controversial reaction could be explained by still high dollarization in Ukraine and biased view on the exchange rate policy due extensive presence of exporter lobby. Independence of NBU in monetary policy execution was under threat as NBU Council tried to suspend the change in official exchange rate acting beyond the bounds of its authority. Draft laws proposing to allow the NBU Council to override the NBU Board in particular on official exchange rate or to transfer responsibility for defining exchange rate policy to the Government from the NBU were also introduced. Moreover, some politicians seemed to think that the Government already sets exchange rate policy.

Public debate over official rate shows that the NBU needs to improve transparency of exchange rate policy and educate stakeholders to prevent misunderstandings over its role and actions. Another lesson of official exchange rate change is that qualification requirements for the NBU Council members should be increased both *de jure* and *de facto*.



Source: Reuters Investor



Source: NBU

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Quarterly trends

National accounts		Q4 04	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07
GDP	UAH bn	100.1	84.3	97.5	119.4	123.6	105.4	124.1	150.4	157.7	137.6	165.1	197.4	212.8
GDP (real)	% yoy	9.1	4.9	3.4	1.4	1.7	4.1	6.8	6.9	9.5	8.9	8.6	6.2	7.4
Households consumption (real)	% yoy	12.5	14.3	17.7	17.0	17.1	20.2	18.2	11.8	9.9	14.7	15.5	15.2	19.0
State consumption (real)	% yoy	0.9	6.1	0.0	1.0	4.0	9.6	5.8	5.8	1.0	0.8	6.2	4.4	2.4
Gross fixed capital formation (real)	% yoy	16.8	-2.3	-0.5	0.2	0.3	19.9	19.3	17.9	18.3	24.4	23.5	18.9	23.8
Exports of goods and services (real)	% yoy	11.7	-0.6	-14.0	-12.7	-15.5	-14.9	-9.6	3.2	1.0	4.9	5.2	0.1	5.6
Imports of goods and services (real)	% yoy	8.7	2.8	3.2	3.9	-0.9	10.7	0.9	8.3	6.4	12.9	19.6	13.7	27.2
Agriculture, hunting, forestry (real)*	% yoy	11.3	5.8	8.3	2.6	-7.2	3.8	2.8	-5.6	8.1	4.8	6.8	-9.3	7.1
Manufacturing industry (real)*	% yoy	6.9	7.0	1.8	-1.1	2.0	-1.5	6.1	7.3	7.2	15.0	13.2	13.1	4.4
Construction (real)*	% yoy	23.3	-8.4	-11.3	-8.5	-7.5	0.1	0.8	1.4	4.2	13.3	8.2	12.7	5.8
Trade, repair services (real)*	% yoy	2.5	-2.1	-10.7	-11.7	-11.9	6.2	16.4	20.0	21.9	14.3	17.5	25.3	15.0
Transport (real)*	% yoy	6.4	6.6	5.7	2.8	7.8	4.9	7.7	9.4	5.3	7.0	5.6	8.0	10.2
Balance of payments														
Current account balance	USD bn	1.1	1.6	0.6	0.4	-0.1	-0.8	0.0	0.5	-1.4	1.2	-0.8	-0.5	-3.5
Current account balance	% of GDP	5.7	10.1	3.2	1.7	-0.4	-3.7	0.0	1.7	-4.3	4.4	-2.4	-1.2	-8.1
Trade balance in goods	USD m	482	1020	-236	-1131	-788	-1353	-935	-884	-2022	-1735	-1701	-2684	-4452
Trade balance in services	USD m	157	188	392	1035	191	219	506	1054	347	103	512	1689	392
Current transfers	USD m	623	626	694	745	780	622	790	851	910	825	968	1099	1183
Direct investment (FDI)	USD m	344	247	365	477	6474	1053	1389	1636	1258	1709	1934	3927	1648
Portfolio investments	USD m	156	397	923	90	1347	4	-141	370	3350	1816	1477	517	1844
Gross international reserves	USD bn	9.5	12.0	13.1	14.3	19.4	17.3	17.6	19.1	22.3	23.5	25.6	30.6	32.5
Exchange rate, UAH/USD	aop	5.31	5.30	5.10	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05
Fiscal indicators														
Consolidated fiscal revenues	% of GDP	25.9	32.1	35.1	31.5	31.0	31.2	31.7	31.9	32.8	33.3	32.8	30.8	31.1
Personal income tax	% of GDP	3.8	4.3	4.4	3.9	4.2	4.4	4.6	4.1	4.1	5.1	5.3	4.9	4.8
Enterprise profits tax	% of GDP	6.1	4.8	5.9	5.3	6.3	3.4	4.6	4.3	6.7	3.8	4.1	4.1	6.4
Value-added tax	% of GDP	4.1	8.6	9.2	7.9	7.3	9.2	9.2	9.7	9.3	10.4	9.8	8.7	7.6
Excise tax	% of GDP	1.8	2.0	2.0	2.0	1.7	1.8	1.7	1.5	1.5	1.8	1.7	1.6	1.3
Consolidated fiscal expenditures	% of GDP	35.2	28.3	36.4	28.1	41.7	30.9	32.8	29.4	36.6	28.4	31.0	29.6	36.7
Current expenditures	% of GDP	27.2	26.5	33.6	24.0	34.2	28.9	29.7	24.9	29.2	26.9	28.4	25.9	27.3
Capital expenditures	% of GDP	8.0	1.8	2.7	4.1	7.5	1.9	3.2	4.5	7.4	1.6	2.6	3.7	9.4
Consolidated fiscal balance	% of GDP	-9.3	3.7	1.0	-5.0	6.2	-0.4	1.1	-2.4	4.0	4.7	1.7	1.2	-6.2
Privatisation receipts	% of GDP	1.0	0.2	0.6	0.6	16.0	0.1	0.1	0.1	0.1	0.5	0.5	0.3	0.4
Labour market														
Average wage (real)	% yoy	15.4	15.0	19.0	19.6	26.4	23.8	22.6	18.8	11.3	14.7	13.9	14.9	15.7
Household income (real)	% yoy	16.6	24.0	28.0	19.4	18.9	22.1	18.6	20.3	16.3	17.5	17.4	14.9	16.4
Unemployment rate (ILO methodology)	% cum	8.7	8.7	7.1	5.2	7.8	7.9	6.8	6.4	6.8	7.4	6.6	6.2	6.4
Banking system														
Monetary aggregate M0	% yoy cum	27.9	28.2	39.1	31.1	42.2	36.2	25.3	23.7	24.5	22.9	30.4	36.4	48.2
Monetary aggregate M2	% yoy cum	32.3	38.9	37.4	31.3	53.9	39.2	36.6	36.7	34.3	38.6	40.7	47.8	50.8
Household deposits in national currency	% yoy cum	26.2	28.3	31.6	30.4	90.8	54.6	41.1	39.7	37.3	50.7	56.3	64.8	71.9
Household deposits in foreign currency	% yoy cum	54.3	51.8	45.4	46.4	59.1	54.5	66.2	64.3	57.5	52.3	43.8	38.4	32.5
Com. bank credits in national currency	% yoy cum	29.4	28.3	32.6	43.4	58.7	59.8	53.7	49.0	52.3	52.4	57.2	60.7	72.7
Com. bank credits in foreign currency	% yoy cum	32.2	33.1	36.8	47.1	66.3	72.0	82.1	90.4	95.4	98.9	97.4	91.0	75.4
Long-term com. bank credits	% yoy cum	57.1	49.5	53.0	70.1	84.6	87.6	86.7	76.6	79.5	84.1	86.5	87.9	85.7
Long-term com. bank credits	% of total	54.2	54.4	56.1	59.7	61.8	63.1	63.4	63.5	64.9	65.8	67.3	68.2	69.2
Average lending rate on national cur. credits	% p.a.	17.6	17.0	15.4	15.4	16.4	15.8	15.5	14.6	15.1	14.0	13.9	13.7	14.0
Average lending rate on foreign cur. credits	% p.a.	12.2	12.1	11.0	11.3	11.7	11.5	11.3	11.3	11.5	11.5	11.4	11.3	11.1

SOURCES: National Bank of Ukraine, State Committee of Statistics, State Treasury, Ministry of Finance, IER estimates

* change in value added

° preliminary