THE BLEYZER FOUNDATION

26, Lesya Ukrainka Blvd., 5th Floor
Kiev 01133 Ukraine
Phone: (044) 296-19-90
Fax: (044) 295-73-92

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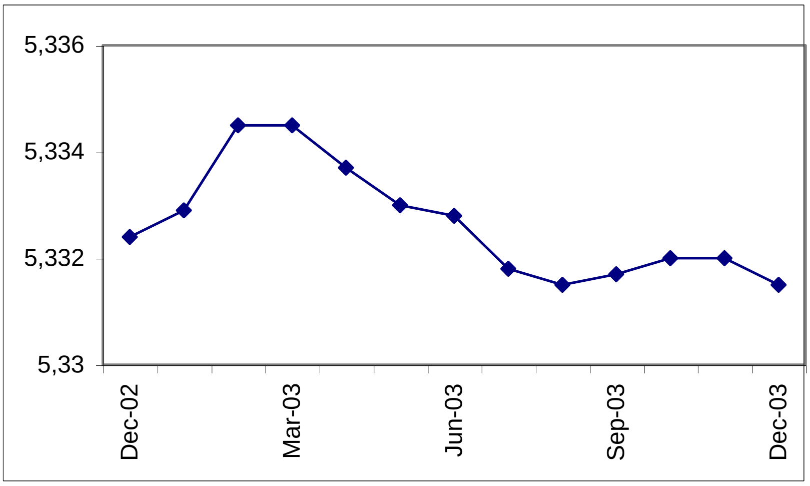
Foreign Exchange Rate Developments

Dr. Edilberto Segura

Over the last few years, the official USD/UAH exchange rate remained rather stable having fluctuated within a rather narrow band (see chart below). Over 2003, Ukrainian hryvnia was slowly appreciating against the dollar in nominal terms - from 5.333 UAH/USD in January to 5.3315 in December.

Dynamics of Official UAH/USD Exchange Rate in 2003



Source: NBU

The stability of the Hryvnia has been due to the combination of two factors:

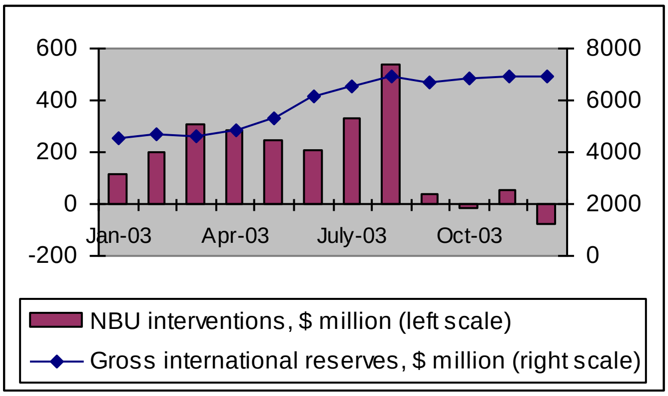
(a) plentiful availability of foreign exchange that came from a current account surplus that reached 5.9% of GDP in 2003, and

(b) the significant buyouts of excess supply of foreign exchange by the NBU, which was implicitly targeting exchange rate stability.

Thanks to the NBU interventions the hryvnia exchange rate has remained competitive, thus facilitating robust export growth during the year (24% export growth in 2003). According to the IMF estimates, the annual average real effective exchange rate posted 6.9% depreciation in 2003 (that is, the exchange rate against the currencies of Ukraine's major trading partners).

At the same time, large foreign exchange purchases allowed the NBU to build up its international reserves to record high levels, which is a quite positive development taking into account rapid imports expansion and heavy external debt obligations. As of end-2003, gross international reserves of NBU reached $6.9 billion, or almost 3 months of imports equivalent (see chart below).

NBU Forex Market Interventions and International Reserves in 2003, $ million



Source: NBU

Throughout 2003 most of the NBU's interventions have been unsterilized (foreign exchange was purchased with Hrynias, without the placement of securities to reduce Hryvia supply). This fueled money and credit growth (47% and 64% yoy growth respectively). In spite of these increase in money supply, the inflation rate has been under control (inflation in 2003 was 8.2%) due to extremely strong increases in money demand. Money demand expanded thanks to economic growth and increasing confidence in the Hryvnia.

So far, the NBU's policy aimed at targeting exchange rate stability has been sustainable. However, as inflation pressures rise (growing producers' inflation, containment of services and food prices) and explosive credit growth poses risk for banking system stability, the NBU will have to follow a more flexible exchange rate policy. In particular, the IMF has recommended that Ukraine should develop the tools to move towards a monetary policy based on 'inflation targeting". This move however, should not be made now, but within the next 12 to 24 months. Ukraine needs first to develop better forecasts and indicators of anticipated inflation. It also needs to develop the security markets to permit the NBU to undertake open market operations.

NBU's Monetary Policy

After the financial crisis of 1998, NBU restricted deals with foreign currency, including prohibition of arbitrage, requirement of mandatory sale of 80% of export proceeds, ban to lend in foreign currency and etc. Since that time NBU has been gradually lifting forex market restrictions. Since then, the NBU has introduced several measures on foreign currency market liberalization. NBU allowed commercial banks to purchase foreign currency at interbank currency market even without having liabilities denominated in this currency. The NBU also lifted a ban to grant foreign currency denominated loans to individuals by commercial banks. The NBU also cancelled the 5% fluctuation band from the official exchange rate for cash operations. In fact, in early 2000, Ukraine officially introduced a managed floating exchange rate system, with the rate set by market mechanisms in the interbank currency rate. The NBU influences the exchange rate principally through its purchase or sale of foreign exchange in the interbank market.

The major foreign exchange restriction still in place is the mandatory sale of export revenues at the local interbank market. This is considered the main regulation at the forex market. But the mandatory sale of foreign exchange earnings has been reduced from 80% to 50%. The NBU has announced that this restriction will be removed gradually over time, but it has not set an schedule for it.