



# MEMU Supplement No. 05-2005

## Hryvnia Revaluation as a Measure to Combat Inflation?

Over the last five years the NBU foreign exchange policy was rather strict aiming at keeping the hryvnia exchange rate against the US dollar at an almost constant level and preventing foreign currency speculations. For quite a long time this policy served Ukraine well. It kept much needed stability at the market, contributed to a rapid build-up of international reserves, and strengthened the positions of Ukrainian exporters. Over time, however, the need for a hryvnia revaluation became obvious, as the constant exchange rate supported by the NBU against a background of a huge current account surplus (10% of GDP in 2004) caused a very loose monetary policy that sooner or later would spill over into inflation.

Following frequent calls from the IMF to allow a more flexible exchange rate regime and a recent declaration of intention by government officials to revalue hryvnia, the NBU took the plunge on April 21<sup>st</sup> to revalue the hryvnia by 3.8% from 5.25 to 5.05 UAH/USD.

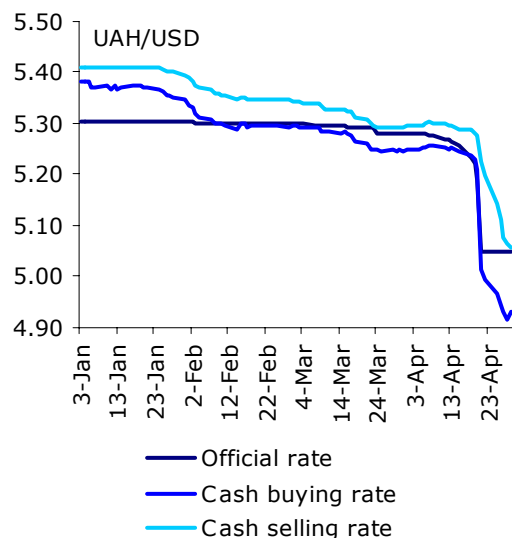
According to NBU and government officials, this move was mainly aimed at curbing inflation (14.7% yoy in March 2005). Although the on-going price growth was largely fuelled by an expansionary fiscal government policy and by structural imbalances at some markets (especially at the meat market), the strengthening of the hryvnia is likely to positively affect inflation through reductions of prices on imported oil and energy products, as well as other imported goods present in the consumer basket. Besides, the inflationary pressure will be somewhat attenuated by lower money supply growth rates, since following revaluation the NBU will create fewer hryvnia resources in exchange for foreign currency than before.

However, on the real economy side, the hryvnia appreciation is expected to dampen exports and stimulate imports, contributing to a decrease in the commodity trade surplus and to a likely slowdown of economic growth. The hryvnia revaluation could promote long-term economic growth in the country through a reduction of prices on imports of investment goods. However, taking into account rising political risks at the eve of the parliamentary elections in March 2006, the investment activity in Ukraine is expected to be low this year and next year as well.

The way the NBU conducted the hryvnia revaluation, i.e. in one completely unanticipated step, affected the distribution of wealth of different groups of the population. The sudden appreciation adversely affected those who hold savings in foreign currency. Also, individuals whose wages are pegged to the US dollar suffered from an erosion of their purchasing power. This effect, however, has its positive side, since the sudden hryvnia appreciation is likely to change people's traditional perception of the US dollar. Due to the long-standing NBU policy of supporting the national currency exchange rate, Ukrainians perceived the US dollar as a savings instrument with no risks, which of course it is not. Therefore, the NBU's step in fact created an incentive for people to switch from foreign currencies to hryvnia, thereby stimulating a de-dollarization of the economy, making it less vulnerable to exchange rate fluctuations. This will affect the banking sector. The volume of deposits in hryvnia in Ukrainian banks is likely to rise, whereas deposits in US dollars are expected to fall. Hence, the interest rate spreads on deposits (and credits) between foreign currencies and the national one are expected to become smaller.

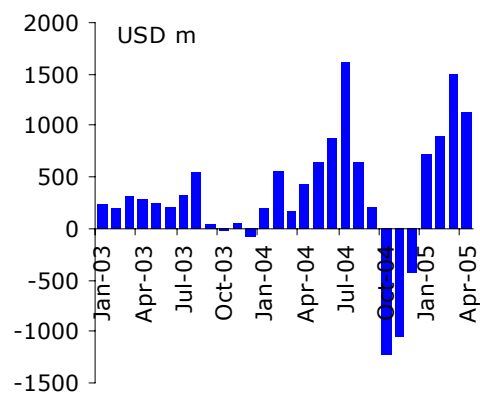
Overall, the NBU policy aimed at appreciating the hryvnia agrees with economic fundamentals. Although it may result in some slowing down of short-term economic growth, its effect on the inflation dynamics and the de-dollarization process will be positive. However, it should not be seen as an effective tool for fighting consumer price increases, since the current inflation dynamics are more attributable to fiscal policies pursued by the government, and to existing structural problems at selected markets.

**UAH/USD Exchange Rate**



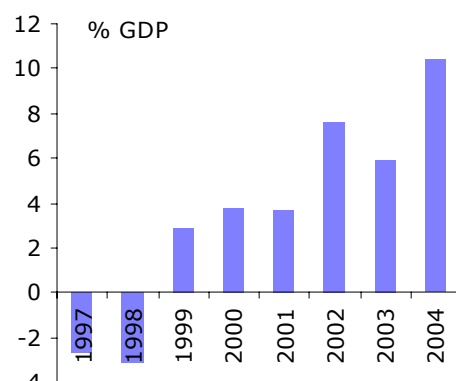
Sources: NBU, Ukrainian financial server

**NBU Interventions**



Source: NBU

**Current Account Balance**



Source: NB U, Derzhkomstat

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## Quarterly Trends

<b>National accounts **</b>		<b>Q3 02</b>	<b>Q4 02</b>	<b>Q1 03</b>	<b>Q2 03</b>	<b>Q3 03</b>	<b>Q4 03</b>	<b>Q1 04</b>	<b>Q2 04</b>	<b>Q3 04</b>	<b>Q4 04</b>
GDP	UAH bn	64.1	63.3	51.5	60.0	75.6	77.1	64.7	79.0	100.5	100.6
GDP (real)	% yoy	4.3	6.1	8.4	10.0	6.8	12.1	12.7	13.7	14.0	8.5
Households consumption (real)	% yoy	8.9	11.2	10.2	14.4	11.2	13.6	14.6	16.8	13.1	16.2
State consumption (real)	% yoy	-18.8	2.9	15.0	17.8	19.2	9.0	3.3	1.0	5.0	10.1
Gross fixed capital formation (real)	% yoy	3.8	5.7	9.0	20.4	24.3	9.0	18.4	6.5	4.6	12.9
Exports of goods and services (real)	% yoy	15.3	17.0	9.9	9.8	9.8	11.6	18.1	19.9	10.5	8.6
Imports of goods and services (real)	% yoy	10.4	6.7	13.8	16.2	17.4	17.7	13.8	7.3	6.7	7.8
Agriculture, hunting, forestry (real)*	% yoy	2.1	1.3	4.0	-13.7	-22.5	6.7	-4.4	0.9	35.7	9.9
Manufacturing industry (real)*	% yoy	8.0	11.5	12.0	15.4	23.0	20.1	23.9	16.3	12.5	9.4
Construction (real)*	% yoy	-1.2	2.7	18.2	24.8	30.9	16.9	29.9	30.6	16.4	3.9
Trade, repair services (real)*	% yoy	8.8	3.5	7.2	15.1	22.6	29.6	23.6	35.0	2.7	13.7
Transport (real)*	% yoy	7.9	11.0	10.0	11.5	15.9	11.7	10.1	8.0	12.3	10.5
<b>Balance of payments</b>											
Current account balance	USD bn	0.8	1.0	1.1	0.7	0.7	0.4	1.6	2.3	1.7	1.2
Current account balance	% of GDP	6.4	7.9	11.2	7.0	5.0	3.0	13.5	15.5	8.8	6.2
Trade balance in goods	USD m	155	225	309	-42	-155	-381	933	1552	774	482
Trade balance in services	USD m	247	382	387	399	362	409	332	153	377	270
Current transfers	USD m	517	520	500	526	574	584	475	758	720	623
Direct investment (FDI)	USD m	156	300	238	454	390	329	334	614	422	345
Portfolio investments	USD m	-592	-520	-825	640	-444	-293	60	-406	781	-511
Gross international reserves	USD bn	4.1	4.4	4.6	6.2	6.7	6.9	7.9	9.6	12.1	9.5
<b>Fiscal indicators</b>											
Consolidated fiscal revenues	% of GDP	28.2	28.1	31.6	31.7	30.1	28.6	27.2	26.9	26.3	25.9
Personal income tax	% of GDP	4.9	4.9	5.7	5.7	5.3	5.1	4.4	4.1	3.8	3.8
Enterprise profits tax	% of GDP	4.1	4.3	5.7	5.1	4.8	5.0	3.9	4.0	4.1	6.1
Value-added tax	% of GDP	6.4	6.1	6.2	6.3	5.8	4.8	6.2	5.7	5.1	4.1
Excise tax	% of GDP	1.9	1.9	2.1	2.2	2.1	2.0	2.1	2.1	2.0	1.8
Consolidated fiscal expenditures	% of GDP	26.4	27.3	27.7	29.2	27.9	28.8	25.3	26.5	26.8	35.2
Current expenditures	% of GDP	na	na	na	26.3	24.2	24.3	22.4	22.7	21.7	27.2
Capital expenditures	% of GDP	na	na	na	3.0	3.7	4.4	2.9	3.8	5.1	8.0
Consolidated fiscal balance	% of GDP	1.7	0.7	3.8	2.5	2.2	-0.2	1.9	0.4	-0.5	-9.3
Privatisation receipts	% of GDP	0.3	0.3	0.6	1.0	1.0	0.8	1.5	3.7	3.5	1.0
<b>Labour market</b>											
Average wage (real)	% yoy	21.2	17.7	12.3	19.1	19.9	14.9	23.0	17.8	13.2	15.3
Household income (real)	% yoy	100.8	65.6	-1.2	8.6	10.0	8.7	15.7	13.0	9.9	16.5
Unemployment rate (ILO methodology)	%	9.2	11.1	9.4	8.8	9.2	9.0	9.3	8.3	8.1	8.7
<b>Banking system</b>											
Monetary aggregate M0	% yoy cum	46.0	35.8	32.4	37.0	30.5	25.3	29.1	25.6	37.1	27.9
Monetary aggregate M2	% yoy cum	46.5	42.2	47.8	54.6	49.9	47.6	45.4	44.8	51.5	32.3
Household deposits in national currency	% yoy cum	103.6	72.5	73.4	74.7	65.0	66.1	69.4	67.3	67.9	26.2
Household deposits in foreign currency	% yoy cum	55.1	59.3	71.2	70.2	70.4	77.5	67.0	61.7	55.2	54.3
Com. bank credits in national currency	% yoy cum	42.3	54.4	63.7	71.2	73.0	61.7	56.8	52.1	44.3	29.4
Com. bank credits in foreign currency	% yoy cum	37.3	40.3	44.1	48.4	57.7	60.9	63.6	56.2	43.5	32.2
Long-term com. bank credits	% yoy cum	85.8	92.5	110.6	156.4	164.0	157.9	141.7	102.7	82.7	57.1
Long-term com. bank credits	% of total	25.3	28.2	31.3	37.4	40.1	45.0	47.4	49.3	50.9	54.2
Average lending rate on national cur. credits	% p.a.	23.5	21.8	18.0	17.2	17.2	17.7	17.2	16.6	17.0	17.6
Average lending rate on foreign cur. credits	% p.a.	11.9	11.3	12.5	12.6	11.7	10.9	12.2	12.1	12.6	12.2

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

\* change in value added

\*\* preliminary

### Notes:

**yoy** year on year change

**p.a.** per annum