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## WHY IS THE HRYVNIA SO JUMPY?

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**During the last few months, the exchange rate for cash US dollars has significantly fluctuated compared to the official exchange rate, which has stayed at UAH 5.05/USD. In late August, the buy rate for US dollars fell below UAH 5.00, whereas in early October, it not only recovered, but even grew to the level observed right after the April appreciation. At the moment, the exchange rate for cash dollars is going down again**

Officially, the National Bank of Ukraine does not have to keep the UAH/USD exchange rate, or any other exchange rate for that matter, stable. According to Art. 6 of the Law “On the National Bank of Ukraine” and Art. 99 of the Constitution of Ukraine, the main function of the NBU is to ensure “the stability of the national currency.”

Determining a “stable exchange rate” is fairly complicated, especially for an economy as exposed as Ukraine’s. Growing prices on global markets for Ukrainian exports significantly raise the value of exports while leaving physical volumes practically unchanged. Growing world prices for critical imports such as oil and gas have the opposite impact on the trade balance. If the nominal UAH/USD exchange rate continues to be stable, the country will see domestic prices go up, that is, the NBU will fail in a key function—ensuring stable domestic prices.

### The end of a stable UAH/USD rate?

Even if the theoretical issue of how possible it is to actually maintain both internal (overall prices level) and external (real effective exchange rate) stability at the same time is set aside, the stability of the external exchange rate has to be evaluated not against one currency, but against a basket of currencies. Each currency in this basket must be represented in proportion to its share in the country’s exports or foreign trade turnover. For Ukraine, this basket should contain 25% EUR and 75% USD.

Thus, if the euro fluctuates against the dollar, the UAH/USD rate and the UAH/EUR rate must change in tandem to keep the overall value of this basket of currencies unchanged. Currently, the UAH/EUR exchange rate is a cross rate, that is, the NBU sets this exchange rate on the basis of the UAH/USD rate that it has established and the USD/EUR rate established on international forex markets. This is the reason behind the noticeable fluctuations in the euro exchange rate in Ukraine—they echo changes in the USD/EUR rate.

Currently, the NBU is continuing to debate the merits of gradually switching from a de facto fixed nominal US dollar exchange rate to a hryvnia exchange rate that is pegged to a basket of currencies. Not many countries officially peg their currencies in this way. This is because tightly pegging to a single currency, whether officially or unofficially, has a major psychological impact: the country’s residents see a stable exchange rate as a sign that their economy is stable and that there is no inflation.

In Ukraine, however, given the relatively stable nominal USD exchange rate, the real dollar exchange rate, that is, reflecting inflation, grew 12.8% during 2004 and 11.9% over 2005. Pegging the hryvnia not simply to the US dollar but to a USD–EUR basket will stimulate the development of trade between Ukraine and the EU as the exchange rate begins to fluctuate less.

If the NBU actually switches to pegging the hryvnia to a basket of currencies, Ukraine can expect less stability in the dollar exchange rate and more stability in the euro exchange rate. This will indirectly affect the share of personal deposits in foreign currency and reduce the buy-sell exchange rate corridor for the euro.

Clearly, the switch to a basket of currencies will most likely be very gradual. In other words, there is no reason to expect the US dollar exchange rate to suddenly become volatile. Moreover, if the NBU sees that the situation is deteriorating on the interbank or cash exchange markets as it switches to a basket of currencies, it can easily return to the previous exchange mechanism. According to unofficial sources, the Bank will switch to a basket of currencies over the next 12 months. At that point, it will be possible to say that the era of a stable official US dollar exchange rate is coming to an end.

## **The factors affecting the cash exchange rate are transient**

The official USD exchange rate should continue to be stable at least until the Verkhovna Rada elections. Still, the cash exchange rate will most likely continue to be jumpy. In early October, the US dollar went up again, to UAH 5.15/USD in Kyiv and even higher in some regions. The current leap is partly the result of temporary factors: at the beginning of the month, many people have to make payments in dollars, such as rent for apartments. Meanwhile, a scheduled wage rise in September raised personal incomes for Ukrainians, many of whom decided to buy foreign currency for a rainy day.

Since these factors are transitory, the exchange rate should return to its previous level. However, given that fall and winter in 2005 will be politically heated and that Ukrainians trust the American currency more than their own, other short-term upward spikes in the exchange rate are very likely.

Any temporary surplus or deficit on the foreign currency market is likely to increase the instability of the Ukrainian currency. In the short term, the exchange rate is much more affected by foreign currency flows in or out of the country than by macro indicators, such as economic growth or inflation. If, for example, a country's exports, imports and international money transfers are balanced, the overall demand for foreign currency will tend to match the supply. But if, say, foreign investment grows, this balance is disturbed. Thus, one of the factors behind the growing supply of foreign currency on the interbank market was the release of several large loans to Ukrainian enterprises in August. When the exchange rate is controlled, such imbalances do not affect the official rate set by the NBU, but the cash market tends to react to them.

In any case, it is practically impossible for the average Ukrainian to make money on shifts in the exchange rate, so it makes little sense to buy and sell foreign currency after each change in the price. It is much more profitable to deposit spare money at a bank. The NBU will continue to support an official exchange rate of UAH 5.05/USD at least until the Verkhovna Rada elections in March 2006 in order to avoid making the public nervous once again. This is stability people can count on.

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