

**Financial and Banking Services Market**

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**FOREIGN EXCHANGE REGULATION:
POLAND'S EXPERTISE IN UKRAINE****Abstract**

The main issues of the Ukrainian Foreign Exchange legislation are considered in the article. Its connection within Poland's legislation and expertise is explained, which was used as the model. The author analyzes the logics of a further development of Ukraine's FX legislation and emphasizes the need of its improvement on the base of Monetary Policy Concept, which should be reconciled on all branches of the Authority.

Key words:

Foreign Exchange Regulation, exchange rate, convertibility, foreign exchange control.

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The issue of foreign exchange regulation is among the most important ones in the debate on economic reforms in Ukraine. «Thus, we have to investigate the cases properly to use the right [exchange regime – O. Sharov] regime for the country» (Siskou, Savelyev, 2016, June, p. 214). Many experts believe that this is due to outdated Ukrainian exchange legislation. Indeed, the fundamental legal document in this area (the Government Decree) was adopted in early 1993. At the same time, it used to be stressed the fact that the majority of claims and proposals on improvement of the monetary policy actually does not require changes to the rules and terms of the Decree on FX Regulation and FX Control, as the main problems are not so much due to its imperfections, but mostly to its unwillingness and failure of the monetary authorities to provide stability and modernity exchange relations in the economy. That is why, despite the numerous attempts to replace the Decree by a new law on FX regulation (since 1995), all of them ended inconclusively.

This is largely explained by systemic and conceptuality norms of the Decree, which is based on the Polish law on currency regulation (Ustawa z dnia 15 lutego 1989, Prawo dewizowe). Unlike the «Soviet models», which describes the allowed operations, Polish lawmakers proceeded from the fact that the law should include a comprehensive list of truly necessary restrictions and prohibitions (the principle of «allowed everything that is not prohibited»). The Polish experts were aware of the opportunity to liberalize or eliminate certain restrictions and, therefore, did not offer to fix them «dead». As professor of Gdansk University W. Wojtowicz has rightly noted: «in a market economy currency legislation is introducing only due the difficult economic or political situation and the foreign exchange transactions are regulated in exceptional situations, after ending of which regulations or restrictions are cancelled and the freedom of currency agreements is restored» (Wojtowicz, 1994).

The drafting of the first Ukrainian law on currency regulation has begun in March 1992. Its developers proceeded from the fact that Ukraine in the early 1990s has the same problems that were resolved in Poland, (which economy at that time was comparable by size to the economy of Ukraine) several years earlier. Because, «the post-socialist countries including Poland inherited from the centrally planned economy an inappropriately developed economic structure (not suited to the demands of open markets), dramatically low capacities for absorbing technological innovations by the domestic economy and businesses, lack of financial capital, low level of institutional readiness of the society and politicians, including business sector, for absorption of knowledge-based economy, inadequate command of English, robust administration, and excessive compulsory labour costs» (Woźniak, March, 2007).

First of all, it was about ensuring internal convertibility of the currency – of course, taking into consideration certain (rather significant) differences. Mostly, it was that Ukraine had not its own currency (its first version – s. c. «Ukrainian ruble» was introduced only in October 1992) and the country's acting Soviet law on currency regulation was administrative economy – oriented and it does not fit in a market economy. That is why the Draft Law had to prescribe certain concepts that were absent in the Polish law. Also, it was taken into account the differences in conceptual approaches to currency regulations between the central bank and the government (or Ministry of Finance), which also thinking about the new law, but saw it rather based on «Soviet sample». By this reason the Draft Law had to put all the functions of regulator and controller of currency relations to the central bank, although the Polish law provided broad authority in this area strictly for the Ministry of Finance. A similar Law of 1994 (article 17) has directly stated that «the body responsible for currency regulation is the Ministry of Finance» and «The Minister of Finance has general supervision over currency matters and the extent of such supervision ensures the uniform application of the Law» (Prawo dewizowe, 1994). It should be noted that the functions of foreign exchange control in those days relied on government agencies not only in the European [Economic] Union, but in many other countries (Centre for Co-operation with European Economies in Transition. OECD, 1993) (including Japan and Russia).

Fundamentally important element of the new exchange rate mechanism was considered mandatory surrender requirements for foreign exchange earnings and their sale to the state (central bank), as envisaged also by the Polish currency legislation (incidentally, this requirement was preserved in the new law, adopted in 1994). The logic of this approach is clear: high inflation and lack of monetary system at the time of the introduction of new legislation pushed exporters to keep currency earnings abroad, depriving thus the domestic market needed foreign exchange resources – primarily to pay for energy imports (excluding then production in the country would be completely stopped). The list of «critical imports» had included also some other vital goods, such as medicines, some food and spare parts for machinery. However, it was lack of understanding that such move was compelled and logical one exactly in the Government (which should have been first who is interested in the creation of the state foreign exchange reserves) and by this reason the Draft Law was withdrawn from consideration by the Verkhovna Rada of Ukraine in «last moment» – on the request of Deputy Prime Minister V. Lanovyi.

The delay of reforms resulted by a significant complication of the economic situation in the country. In the field of currency regulation it founds its expression in particular in an attempt to preserve the Soviet practice to sale «shortage» goods and services (i. e. goods of the high demand) for foreign currency, and the creation of national and local «foreign currency funds» (models, as well predicted by the Soviet legislation). In order to fill these funds (which were passed by the

relevant executive authorities) it was introduced the tax on foreign exchange earnings in the amount from 15 to 75 percent – paid in the State Currency Fund and the 5 percent – in local currency funds (Resolution of the Verkhovna Rada of Ukraine «On the forming of the Currency Fund of Ukraine in 1992», № 2101-XII of 05.02.1992). As might be expected, the effectiveness of this tax was very low, the actual revenues from the new tax for 1992 the barter trade and concealment of currency proceeds in offshore jurisdictions.

Thus, the establishment of the official foreign exchange reserves of the central bank was not just welcomed by top officials of the economic block of the government, but actually it was ignored by them: for instance, the «stabilization reserve», – which was created by «swap» credit from the Central Bank of Russia in the amount of 40 billion «Russian»¹ rubles (at the time equivalent of 100 mln. USD.) in process of the entering Ukraine's own currency (Ukrainian *karbovanets*) in October 1992, – was soon used not for intervention operations of the National Bank, but (at the request of the government) to pay for deliveries of Turkmen gas. Of course, this transaction did not fundamentally solve the problem of payment for energy, but deprived the central bank's possibility of market impact on the dynamics of the national currency.

At the same time it was reflected the impact of the Russian Side, which originally prepared for the Ukrainian currency the fate of the Scottish pound (Law of the USSR, March, 1991), – in line with the idea of the Governor of the Central Bank of Russia Dr. G. Matyuhin, the «national character» of own currencies of former Soviet republics had to be limited by a presence of national heroes' portraits on banknotes, while the emissions' limits would be adopted by the Central Bank of Russia as the principal regulator for money supply around the «single currency area. «However, when- after introduction in June 1992 of its currency (the crown) by Estonia and the confirmation as for issuing of its own *karbovanets* by Ukraine – it became understandable of the futility of hopes for such «quazi-reform». Then the Central Bank of Russia on July 1, 1992 had introduced a special procedure for settlements between central banks of the «ruble zone»: non-cash funds denominated in rubles, which came to the Russian resident, were credited to individual correspondent accounts of central banks of the respective countries and subsequently used only for payments in relevant geographical areas subject. Such way, in fact «general rubles» were separated by its «nationality» (or, as warned Dr. G. Matyuhin – Russia had «introduced» their currency to the former Soviet republics).

The delay of introduction of its own currency by Ukraine itself was also caused by the position of the International Monetary Fund, which then was expressed by M. Spencer as the need to preserve «the single ruble space». Thus,

¹ On that moment Russia still did not introduced own currency and from formal point of view the ruble was the common currency of the CIS countries (except that ones who introducing its own currency).

Ukraine has joined the International Monetary Fund in September 1992, even not having its own currency.

As it was known later, the IMF had given the similar advice to other countries of the former Soviet Union, and it even had threatened refusal to support to those ones which insisted to issue its own currency (Robinson, 1992, May). However, as late events showed, the fast introduction of own currency had to be done at least because to apply for the IMF loans in principle could only country with its own currency. The implementation of the recommendations of the IMF (to refuse from own currency) could lead to the situation when the IMF credits would be transferred to us not directly but through Moscow (with all of the mediation). The International Monetary Fund has changed its opinion on the opposite one in 1993 only – after Baltic countries firstly and Ukraine later had introduced their own currency, avoiding many of the problems that had trouble those which have hesitated.

It should be noted that the market exchange rate of the ruble began to be based on trading results on the Currency Exchange of the State Bank of the USSR (since January 1992 – the Moscow Interbank Currency Exchange – MICEX). Ukraine's independence at first did not change anything in this situation and the exchange rate of still the single currency continued to be determined in Moscow. Ukrainian businessmen made transactions on the MICEX too (mainly through brokers of the agro-industrial bank «Ukraine»). But in February 1992, the National Bank of Ukraine was instructed by Verkhovna Rada (parliament) «during a month to conduct organizational work on the creation of the Ukrainian Currency Exchange, to establish the procedure of interbank trading in foreign currencies». However, nothing in this direction was done (as it turned out – due to the practical absence of experts on foreign exchange transactions in the central bank). But as people say, «a holy place could not be empty» and the management of the Ukrainian Stock Exchange promptly lobbied for the creation of the «exchange platform» on its territory (which was allowed by the President's Decree of 19 March, 1992) without any objections from the then National Bank. However, the organization of foreign exchange trade by non-specialized institution did not meet the vision of the structure of the FX market by the new management of the central bank, which actively began to create its own Currency Exchange. Unfortunately, due to organizational problems (including, drafting currency legislation, ordering of the system of licensing of currency transactions, hiring of professional dealers, etc.) the Currency Exchange (as a commercial division of the NBU) was established in September 1992 only. However, on the moment of the introduction into circulation of the own Ukraine's currency – *the karbovanets* (November 1992) the Exchange fully ensures the activity of the market mechanism to establish its exchange rate. In fact it was achieved also the «internal convertibility» of the Ukrainian currency, to move to which was decided not slowly, but at once – also, incidentally, taking into consideration the Polish experience and advice by L. Balcerowicz. However, the obligations under Ar-

ticle VIII of the IMF Agreement (concerning the convertibility of its currency) Ukraine has ratified in September 1996 only (preliminary significantly limiting its use during the so-called «fixed exchange rate» period).

In compliance within Poland's experiences were linked also expectations to receive from the IMF and the West the «stabilization fund» to keep stable the exchange rate of the Ukrainian currency. As in the case of Poland (Law of the USSR, 1992, March, p. 51), we looked for 1 billion US dollars. But no official request in this regard has been done (what is understandable, bearing in mind the aforementioned the IMF's restrained view as for introduction by Ukraine its own currency).

Finally, taking into account the emergency economic situation in the country, the new Government of Ukraine (led by L. Kuchma) had received from Verkhovna Rada of Ukraine the right to reform the economic system in the country by issuing of Decrees (which have the force of law). One of the first ones was the Decree on FX Regulation and FX Control (February, 1993), which was based on the aforementioned Draft Law prepared by the National Bank of Ukraine. However, the Decree includes some innovations that were not in compliance neither the Polish experience nor the logic of the FX market development, provided for by the Draft Law. First of all, it concerned the issue of compulsory sale of foreign exchange earnings to the State. The Government has gone to the compromise and provided obligation to sale it on the foreign exchange market (the Currency Exchange). In practice, firstly, it provoked a high (largely, speculative) demand for the foreign exchange, leading to a catastrophic devaluation of the Ukrainian *karbovanets*. Secondly, in fact it did impossible for the National Bank to accumulate official foreign exchange reserves, depriving it of instruments for the impact on the dynamics of the exchange rate. Consequently, the National Bank of Ukraine failed to implement the strategy of introduction of «crawling peg» as it was done by the National Bank of Poland: in the end of 1992 the official exchange rate of the Ukrainian *karbovanets* has reached 638 per 1 US dollar, in the end of 1993 – 12610, in the end of 1994 – 104.2 thousand *karbovanets*. Actually, Ukraine just repeated Poland's experience, but unfortunately, negative one. As it was noted by L. Balcerowicz, «[an] escape from the national currency to goods is an especially intensive when – as in Poland in 1989 – the interest rate is much lower than inflation. Then it is not profitable to save, but it is worth to try to replace the national currency exactly by goods or foreign currency. And that, in turn, leads to a growing free-market exchange rate of foreign currency, which increases the price of imported goods» (Spencer, 1992, pp. 40–41). It is exactly happened in Ukraine too².

² The author has analyzed this issue more in-depth in: Independent Ukraine's Currency Policy: a decade of Successes and Failures// Transition: Visions and Reality – Warsaw, 2001, pp. 187–216.

The devaluation of karbovanets was not possible to stop even at the expense of fundamental change in exchange rate policy, which found its expression in return for administrative and adjustable exchange rate (officially so called – «fixed rate»), launched in August 1993. (Mechanism of establishing of such rate was constantly «perfected»: in November trading on the interbank foreign exchange market was wholly suspended, a «manual» redistribution of foreign exchange funds was performed by the government «Tender Committee» headed by Vice-Prime-Minister Vladimir Landyk. Unfortunately the papers (records) of the «tender» Committee are not available (if any), and therefore we will not try to do in-depth analysis and just can to stress that one of the «fathers» of the idea of «so-called «fixed rate» – V. Suslov, – continues to believe this method was «original» one (*although one can hardly come up with something more «original» that the establishment of a special exchange coefficients for the rate, whose numbers in 1980-th in the Soviet Union had reached to 2000 – a personal «exchange rate» was fixed not for each group of products only, but even for some large companies*) – but he believes that «it had played a positive role» to stabilize the situation. Although the author of the idea in the same interview confirms the «stabilizing effect» by specific figures: «The pace of currency depreciation: in 1992, US \$ 1 was worth 208 kuponokarbovanets, in 1993 – 4539, in 1994 – 31 700, in 1995 – 147,463» (Papava, 2001).

Unfortunately, it was said nothing in the interview about who, how and under what conditions could at this time to receive foreign exchange for half of the market price (through the «tender» Committee). It used to be paid attention to the fact that by the reason of disagreement with the decision had resigned not only me (as the Deputy Governor of the National Bank – what was logically), but also the Vice Prime Minister for economic reforms (already pointing to uncertainty on this issue in the Government) and finally – the Prime – Minister himself (whom adviser was at the time Dr. V. Suslov for), what generally raises the question of procedure of the development and the implementation of the economic policy of the government at that time and makes mention of proverbs on a «tail that wag the dog».

The system of so-called «fixed exchange rate» – *which, by the way, was not fixed, but became the system of multi currency practice, because were a «special» exchange rates for certain «chosen» (by unknown principles) customers* – was abolished in 1994 (in the end of government of Mr. Ye. Zvyahilskyi, who was the main «promoter» of that exchange rate system, when it was not convenient to openly use that corruption-led mechanism in the face of the IMF (which is expected the first systematic transformational loan from). So, in March 1994 it was renewed Exchange Auctions to sell the dollar, German mark and the Russian ruble, and from October the Ukrainian Interbank currency exchange resumed its activities in full, what allowed the return to the market exchange rate. It made things go back to the way they were before – except 2.5–3.5 bln.

US dollars, which, according to expert estimates, were illegally transferred abroad during the existence of a «fixed» rate.

Thus, when in September 1996 was finally introduced a new Ukrainian currency (hryvna) there were all the technical conditions precedent to insure its exchange rate as marketable and stable one: it was kept during a nearly two years within the informal «exchange rate corridor» of 1,7–1.9 per 1 US dollar (which is not much different from the rate initially set at 1.76 USD per dollar).

Another Decree's innovation (compare with the Draft Law) was the prohibition to use the national currency for the international settlements. In this case, by contrast, Government officials returned to the Polish experience, which was not accepted by the National Bank of Ukraine. The reason for such Bank's position was explained by the fact that in the early of the 1990s, the lion's share of Ukraine's foreign trade with Russia and other post-Soviet CIS countries was paid by the common currency – the ruble, and then – by local currencies (what was inevitable in conditions of shortage of necessary foreign exchange earnings in all of these countries). Under these conditions, the prohibition of settlements in national currencies meant to provoke a disaster. It has become clear in just two months, when there was an actual suspension of trade turnover between Ukraine and some CIS countries (above all, Belarus and Moldova), what forced to urgently look for ways out of government issued rules. Such solution was found in a legally-casual interpretation of the Decree of the Cabinet of Ministers, which was proposed by the central bank and set out in a joint regulatory letter on the order of payments to the countries of «ruble zone» operation. The Letter has explained that the restriction, establishing Article 7 of Decree does not apply to payments to residents of the ruble zone operation that can be carried in the Ukrainian karbovanets, as it fixed in the contracts. This order was due to the need to preserve the regime of convertibility of the ruble against the Ukrainian karbovanets under Article 8 of the President's Decree of November 7, 1992 («On the reform of the monetary system of Ukraine»). Once more, it was stated that the settlement in Ukrainian karbovanets between CIS countries is allowed by the interstate and inter-bank agreements. This, of course, was a palliative but its effect lasted almost to the end of 2011 (when the wording of Article 7 of the Decree was amended by the legislator in the framework of an agreement with the Central Bank of Russia for use in two-way trade in national currencies – which is also hardly a fundamental change in the position of Ukrainian authorities in relation to the perspectives and needs of their own currency's convertibility).

Introduction of Poland's expertise to Ukraine FX legislation was carried out with an understanding not only some differences between the economies of both countries, but also the need for its constant and purposeful modernization in order of certain stages of economic reform, which required achieving first domestic (resident), then – foreign (non-resident) convertibility of the national currency and, ultimately, the possibility that its transformation into an «international currency». That ensured in the first stage of liberalization of foreign exchange trans-

actions within the country (mainly current ones), while in the second stage – a liberalization of foreign counterparts transactions (including capital transactions). In Poland the new legislations on currency regulation were adopted in 1994, in 1998 and in 2002 (with recent changes to the law came into effect in July 2015). However, the obligation to sell foreign exchange earnings to the state was lifted only in December 1995, simultaneously with the abolition of the ban on the use of the zloty in international payments (when it became clear that the country's foreign exchange market operates fairly stable). The Law of 1998 (entered into force in January 1999) has provided zloty convertibility for all transactions (including investment and capital). It allowed the opening and maintenance of accounts in PLN abroad, including offshore banking centers. For calculations of the official central rate of the zloty against the euro the National Bank of Poland began to use «currency basket» (55% – the euro, 45% – US dollar). The similar step by the National Bank of Ukraine is still discussed by experts for almost twenty years.

As an «external carrot» to adopt the new rules for Poland was used the accession to the IMF, the OECD and the EU. Actually the watershed changes to the currency legislation were determined by the OECD requirements regarding the liberalization of FX relations with non-residents, particularly on the capital transaction. These requirements are fixed in the three international conventions: The Code of Liberalization of Capital Movements), The Code of Liberalization of Current Invisible Operations and The National Treatment Instrument.

Ukraine, as mentioned above, has joined the IMF without even its own currency, and talks on closer relations with the OECD and the EU dragged on for years, though the European integration direction of the economic system was meant initially (because at that time it was well known by professionals the intent to create the Monetary Union of the EU set out the «Werner Plan» (1970), «Delors Report» (1989) and finally provided by the Maastricht Treaty (1992). However, no one predicted that Ukraine in its currency (and in general – economic) policy would fall asleep on the spot and «slow integration processes to the European and world economy were a choke point for Ukraine since independence» (Siskou, Savelyev, 2016, June, p. 150).

As for the «internal incentives», we have to note, that the uncertain monetary policy and low institutional and functional development of the financial market as a whole (and the foreign exchange, in particular) does not create a large enough pressure on the government towards further modernization of the system of currency regulation. But now it seems the Poland's experience may again be suitable for radical modernization currency legislation and FX market of Ukraine. However, by the simple translation, even of the Poland's currency legislation, we do not correct the situation. First, **we need to develop and reconcile on all branches of the Authority the Monetary Policy Concept** (that used to be based on the General Concept of economic development of Ukraine), and then pass the Law – which would be an effective tool to implement a new strategy for monetary policy.

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