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Andreas FÖRSTER

PROSPECTS FOR INTEGRATION OF THE UKRAINIAN ECONOMY INTO THE EUROPEAN ECONOMIC AND MONETARY ZONE: MONETARY ASPECTS

Ukraine is approaching western European economic and monetary area. In the first half of 2005, for example, Germany was the second most important trade partner for Ukraine after Russia (German Foreign Ministry, 2006). In the course of approximation with Europe, Ukraine's intermediate goals are its accession to international institutions, such as the World Trade Organization (WTO). Further important goals on the Ukraine's path towards the European Community are the reduction of inflation rate and the guarantee of legal certainty to promote investment. Along this path, Ukraine possesses numerous advantages, such as low costs of labour, which among other factors are responsible for economic growth.

This situation particularly requires reforms in the practice of monetary policy. If Ukraine wants to align itself with the Euro-currency area, it is necessary to reduce current rate of inflation of nearly thirteen percent to approximately two percent. The convergence criteria for accession to the monetary union call for the inflation rate close to that of the countries «which have achieved the best results in the area of price stability» (Article 121 I (1) TEC, 2003). By doing so, Ukraine will not only move closer to Europe, but it can also minimize the loss of

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Förster Andreas, PhD Student, Dresden University of Technology, Germany.

prosperity associated with inflation and increase the growth potential of the national economy (ECB, 2004).

The collapse of the eastern block states triggered a trend towards hyperinflation, which in the meantime has been reduced to the greatest possible extent and has now levelled off at approximately 10 percent (from 2003 to 2005). The preceding hyperinflation was brought in by privatization of state enterprises, which were in a position to set monopoly prices after the introduction of the market economy. These monopoly prices were met by increased demand, and both these factors, among other things, were responsible for the enormous inflation rates (Illing, 1997).

The current inflation rates can be attributed to the insufficient realignments of the fixed exchange rate system; the current rate is 5.05 Hryvnia per US-Dollar. As Ukraine can boast a trade surplus, it earns the respective foreign currencies, which in turn are exchanged back into the Ukrainian currency. Exports of goods and capital imports lead to an increase in currency reserves, which is reflected in the assets of the central bank's balance sheet, and for which a corresponding offsetting item on the liabilities side of the central bank's balance sheet must be formed. If a Dollar flows into the central bank, it must increase the money supply by 5.05 Hryvnia. This is essentially an increase in the money supply, which increases the price level in the medium-term by transmissions. There are three ways out of this situation:

1. Creation of a flexible exchange rate; the central bank would gain autonomy by this, but at the same time, it would lose the possibility of pegging itself to a stable currency.

2. More frequent realignments (adjustments of the fixed exchange rate); the central bank would generally have to intervene less than previously, which would likely stop the expansion of the money supply, which results from purchasing foreign currencies. Ukraine would thus be subject to pressures for revaluation. This should presumably be avoided, in order not to endanger exports.

3. Creation of a stable financial sector, which is in a position to absorb the money supply released by the acquisition of foreign currencies and peg it to financial securities.

Problems arise in particular when Ukraine is integrated into the Euro currency area. A monetary union only makes sense when the resulting utility – abolition of transaction costs – exceeds the costs. The latter results in particular from the different ways of dealing with macro-economic shocks, which, on the one hand, arise from internal disturbances, such as economic policy, and, on the other hand, external disturbances, such as oil price shocks. The more homogenous the countries in the currency union are, the better they are able to collectively deal with the shocks without being asymmetrically affected by them. If national economies tend to be heterogeneous, a flexible exchange rate helps countries protect themselves from the spread of the disturbance. If country strives to become a member of the Euro currency area, this is only advanta-

geous when its economy is homogeneous to that of the Eurozone. An accession to the Euro currency area then leads to a better capacity to absorb exogenous shocks. Crucial for the accession to the EU are, on the one hand, broad product diversification in order to avoid and absorb potential sectoral shocks and, on the other hand, relatively stable real exchange rates. Only when the exchange rate is stable in the middle- to long-term, i.e. there tends to be purchasing power parity between the countries, does it make sense to surrender flexible exchange rate as an equilibrium mechanism (Mundell, 1961).

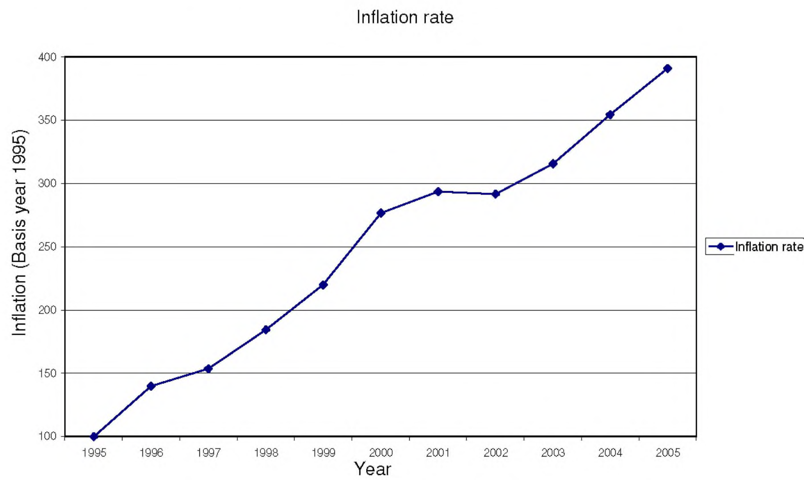
Countries, which are still in the process of catching up economically, are recommended not to participate in the common currency until the convergence process has been completed. The economy should first become or remain competitive. When selecting the exchange rate, a flexible real exchange rate is recommended, in order to generate a stable real exchange rate in the long term, as is necessary for joining the Euro currency area. On the other hand, Ukraine's fixed-rate system also offers advantages, since it is able to increase its exports due to favourable *terms of trade.* Along with that, a fixed-rate system can provide for import of price level stability, which helps Ukraine combat high rate of inflation. (However, this requires an anchor currency with a stable price and/or policy of monetary sterilization in order to prevent inflationary expansion of money supply). The foremost monetary policy objective of Ukraine should be price level stability. With a growth rate of gross domestic product of approximately 5 percent, the expansion of money supply M3 between 30 and 40 percent in the previous 10 years was not justified. This only leads to greater inflationary pressures. The revaluation of the Hryvnia, which would result from flexibilization of the exchange rate system, can stop the expansion of money supply and, thus, take away the inflationary pressure. This measure would bring Ukraine a step closer to the European Union, as it would create conditions for fulfillment of the convergence criteria for the EU accession.

Ukraine is on a good path in its approximation with Europe. It may not appear easy to reach European standards, in particular economic standards, because the country is only at the beginning of the economic convergence process. Crucial significance in this process can be attributed to monetary policy, which must provide for an economic climate that promotes growth. Once again, the stabilization of the price level comes into play here.

Appendix

Figure 1.

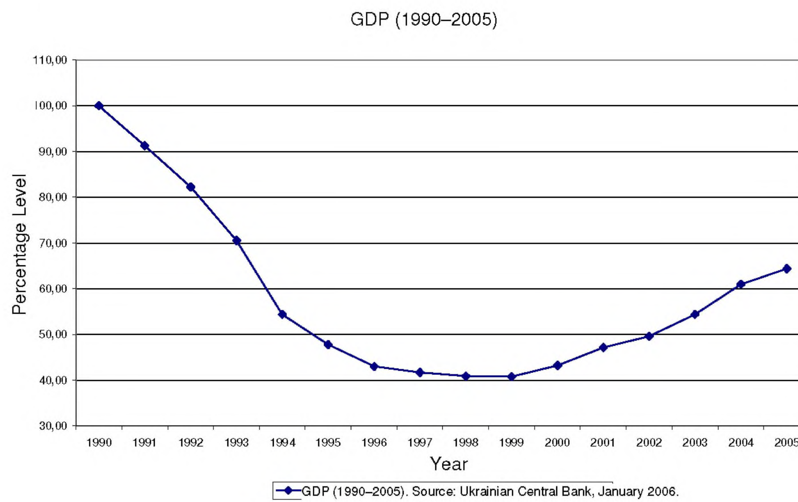
Development of Consumer Prices, 1995–2005



Source: Ukrainian Central Bank, Updated January 2006.

Figure 2.

Development of Gross Domestic Product, 1990–2005



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