

TO: Clients and Friends of the Firm
FR: Frishberg & Partners
RE: Currency Regulations: From Coupon to Hryvnia's Convertibility

I. Introduction

As a legal matter, Ukraine left the Soviet ruble zone on July, 2 1992, by introducing a temporary currency, known as the “karbovanets” (more affectionately known for what it had subsequently become, the “coupon”).

In its relatively brief tenure, the coupon suffered a variety of economic perversions at the hands of then-President Kravchuk, starting with the August 12, 1993 telegram, which was the Kravchuk administration's first of many major detours from the road of currency reform. This telegram created two legally recognized rates of exchange: “official” and “auction.” The “official rate” was set at 5,970 karbovantsi to 1 US dollar, which soon paled in comparison with the more realistic (but still very low) Interbank Currency Exchange Auction rate of November 4, 1993, which was 31,150 karbovantsi to 1 US dollar.

The “old timers” may recall that on December 23, 1993, the Kravchuk-controlled Ukrainian Interbank Currency Exchange held its first auction. This took place nearly two months after the suspension of its activities in November of 1993. This rather anticlimactic event was conducted in accordance with an equally exciting instruction entitled the “Temporary Procedure for Conducting [by the Center] of Clearing Accounts at Ukrainian Interbank Foreign Currency Exchange Currency Sales and Purchase Operations on a Tender Basis.”

This otherwise simple instruction drastically changed the role of the Interbank Currency Exchange: the Exchange no longer conducted an “auction” but merely effectuated an administrative function of receiving karbovantsi and transferring foreign currency to purchasers of currency. This was a complete reversion to the Soviet-like monopoly currency “auction” system employed by the National Bank. Many legitimate businesses were turned away from the “auctions” and had to obtain foreign currency by alternative methods, most of which flatly contradicted the then existing legislation.

With time, everyone established “alternative” means of transacting business commonly known as the “shadow economy.” As a result, the official Ukrainian economy suffered the biggest financial losses while the shadow economy profited proportionately. The benefits, gained by implementing dual exchange rates, befell a comparatively small group of companies and/or individuals, as most of the average Ukrainian entrepreneurs typically transacted business at the most favorable exchange rate offered on the black market.

The abuses of the “shadow market economy,” enhanced by the differences between the official and black market exchange rates, continued unimpeded until President Kuchma’s unexpected arrival as the undisputed leader of Ukraine in the summer of 1994. Largely unnoticed by outsiders, Ukraine’s fiscal reforms quietly began on September 22, 1994, with President Kuchma’s execution of the Decree “On Perfecting Currency Regulations.” This decree reversed many of former President Kravchuk’s previous decisions that directly contributed to (if not actually caused) an increase in the already healthy shadow economy in Ukraine.

In particular, Kuchma’s Decree de-centralized the function of the Ukrainian Interbank Currency Exchange, once again restoring its previous autonomy in setting the market rate. This decision squarely reversed Kravchuk’s November 2, 1993, Order No. 502/93 “On Additional Measures to Manage Currency Regulations,” which suspended the Ukrainian Interbank Currency Exchange system as well as other operations involving the sale and purchase of foreign currency at auctions. This decree also called for a unification of the dual rates of exchange, finally cancelling the infamous August 12, 1993 decision by the National Bank to set a fixed rate of 5,970 karbovantsi to 1 U.S. dollar.

Below we analyze the development of currency regulations, under both the Kravchuk and Kuchma tenures and analyze the legislative reforms which have resulted in the Hryvnia becoming an almost convertible currency.

II. Currency Reforms

A. IMF-Subsidized Rate Unification

On October 24, 1994, the National Bank issued Instruction No. 174, which required that a unified rate of exchange for the karbovantsi be determined as a result of trading at the Ukrainian Interbank Currency Exchange. On the same day, Ukraine received the first half of a rather large loan from the International Monetary Fund to provide sufficient foreign currency to absorb the excessive karbovantsi mass. A part of the loan was funneled into the currency exchange in order to stabilize the karbovantsi exchange rate.

In addition to creating a more stable fiscal environment, the rate unification was moderately successful in legitimizing at least some of the formidable shadow economy. Thus, the first step required for stabilization of Ukrainian currency had taken place.

B. Ban on the Use of Foreign Currency

To give some credibility and value to the Ukrainian karbovantsi, and in order to maximize the success of the 1995 introduction of the Hryvnia in November of 1994, the National Bank issued a telegram with President Kuchma’s support, banning foreign convertible currency from official circulation as of

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