

ICPS newsletter[®]

Local government reform: Comparing Ukrainian and Hungarian practice

Over 1–14 March, ICPS and the Center for Ukrainian Reform Education (CURE) held their second round of public consultations on local government reform under a project of the same name. Project analysts and a foreign expert—the deputy director of the Hungarian Regional Development Agency, Georgya Nikos—visited seven oblast capitals in Ukraine. During these events, a White Paper on local government reform written by ICPS analysts was presented. According to the authors, this second round of consultations made it possible to look at current problems with local government in Ukraine from a different angle, based on the experience of neighboring Hungary. The presentation of Hungarian practice in reforming local government bodies led to the most intense discussion

EU territorial units

During the discussion of Hungarian practice, participants learned about the existence of a system of territorial divisions in the EU called NUTS. Its purpose is to collect and work up EU statistics and to distribute the resources of EU structural funds.

According to EU classifications, NUTS-2 level territorial units should have a population of 800,000 to 3,000,000. It is these nominal units who are the recipients of the bigger share of money from EU structural funds. One of the ideas that circulated at the consultations was that if Ukraine hoped to eventually become a member of the Union, it needed to consider the existence of this division in the process of its own territorial reforms.

Microregions—united we stand

It turns out that the problem of many scattered communities with small populations is fairly widespread in Eastern Europe. Hungary overcame this by instituting microregions, that is, unions of municipalities around common objectives.

Hungary's central government uses financial incentives in the form of grants and subsidies to get communities to join forces in such microregions. Using economic reasons for joining rather than political force is the recipe Hungary offers Ukraine.

Changing administrative structures: Not a constitutional issue

Since Hungary did not have option of changing its Constitutionally established administrative structure, the country was able to modify this structure significantly to help regional development by adopting the necessary legislation.

Hungary's Constitution establishes two administrative levels: the municipality and the district. Each of these levels elects a general assembly. However, according to the country's 1996 law on regional development and state planning, two more administrative levels were introduced: microregions, which are government by microregional councils that are essentially an assembly of representatives of the municipalities that belong to that microregion, and seven regions that are equivalent to the EU NUTS-2 level.

At this level, there are also regional development councils that are assemblies of local government bodies belonging to these regions and the Regional Development Agency. Although this system is somewhat hard to comprehend, it is quite effective. Hungarian practice shows that the necessary changes can be made to the country's administrative organization even without resorting to Constitutional amendments.

Voter participation in policy-making: A common problem

On one hand, Hungary experiences the same problems with getting voters involved in the policy-making process as does Ukraine. For instance, public hearings (town hall meetings) must be held at the municipal level at least once a year, by law. And although each municipality faithfully does so, it is rare for local voters to show up for such meetings more than the minimum required number of times.

Still, the Hungarian specialist noted that there were other mechanisms that might be helpful in Ukraine's situation. For instance, committees can be formed within local representative bodies consisting half of local elected deputies and half of interested local voters and businesses. Such committees can often be empowered to make policy decisions. Thus, the community is directly involved in local government and in developing the necessary policies. This kind of practice could prove very useful for Ukraine as well. ■

The "Public Consultations and Awareness Campaign for Reforming Local Government in Ukraine—Phase 2" project is being funded by the Westminster Foundation for Democracy. Its purpose is to increase the role of public consultations in the public policy-making process and to inform the community, including government representatives, more widely about various aspects of local government reform in an open manner that takes public opinion into account.

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The Great Dollar Panic

In mid-March, the hryvnia suddenly and sharply rose against the dollar, taking many in Ukraine by surprise. For the first time in years, there were long lines at exchange points in Ukraine. What underlay this panic and does it make sense to sell off dollars at this time or, on the contrary, is it a good time to buy them. These and other questions were tackled by ICPS economist Oleksandr Zholud in an article called "Dollar panic" published in the journal Glavred

A shortage of hryvnia in circulation

Let's start with the main reason: there's a shortage of hryvnia in circulation in Ukraine today. The National Bank of Ukraine has been sticking to a tight monetary policy for the third month in a row, and that mostly means it is controlling the supply of money. The purpose of this move is to stem the inflation that has been evident since the middle of 2007. The Bank's approach is varied, ranging from changes in reserve requirements—banks were forced to increase their reserves, money that otherwise could have gone into lending—to the sale of certificates of deposit (CDs)—for which banks hand cash over to the NBU for up to two weeks at a minimal interest rate.

This reasonably consistent policy led to a situation where domestic banks had little free cash. Demand for hryvnia tends to be uneven during the course of a month: a major part of outlays, such as salaries and pensions, takes place at the beginning of each month, while contributions to the Budget or reviews of bank reserve compliance take place at the end. This meant that when companies went to their banks for short-term credit during the second half of March to pay out taxes and wages, there was a sudden shortfall of hryvnia.

The NBU position: maintain the UAH/USD rate

Although the National Bank has no legal obligation to keep the UAH/USD rate at the same level, this remains the Bank's one clearly state position. Normally, when the supply of dollars exceeds demand by a certain amount and the exchange rate slips to UAH 5.00, the National Bank buys up surplus dollars for this price. If the opposite situation arises, it sells dollars for up to UAH 5.06. This has been the case since 2005 and this what everyone counted on recently as well.

For the first time, banks felt a hryvnia pinch in February. The overnight rate on the interbank credit market jumped from an average level of 3% to 11%, and by 20 February, it had soared to 19.4%, a difference of several fold.

The situation repeated itself in March, with the one difference that, at the beginning of the month, the dollar rate, beaten down by high interest rates, was not 5.06, as in February, but around 5.03. This made it a lot

easier for the dollar to hit the bottom limit. Because of this, most dealers expected the NB to quickly buy up dollars. But when the interbank rate fell to 5.00 and the market waited for the NBU to step in, there were no interventions. Nor did the National Bank buy up dollars over the next few days.

Why did the NBU suddenly change tack?

The point is that, if the central bank injects hryvnia into the economy by buying up dollars with the national currency, this will cancel out its previous reduction in the money supply. This is why the Bank waited for the market to regulate itself. But the market decided not to wait for the NBU to arrive and broke through the UAH 5.00 barrier, dropping at first to 4.99, and a few days later, on 24 March, to 4.88. At the same time as the dollar fell, hryvnia interest rates began to rise: overnight rates grew from 7.1% over 3–11 March to 15–20%. In this situation, the Bank also began to inject hryvnias into the economy, not by buying up dollars this time, but by offering short-term (1-14 day) credits. As of 11 March, it began to issue from UAH 300mn to over UAH 1bn daily.

Why was the Bank not buying dollars, on one hand, and issuing credits on the other? The point is that when the Bank picks up dollars, it gives up hryvnia "forever," that is, the supply of the national currency remains high, even when demand goes down. At the same time, loans are given out for a fixed term and this money automatically returns to the NBU when there is no longer a need for it.

But domestic factors were not the only ones affecting the dollar's decline. The dollar has been in steady decline against all of the world's key currencies: the euro, the yen and the Swiss franc. Moreover, its fall began to accelerate starting in August 2007, when the US found itself facing a mortgage crisis and it turned out that many major players were hit by it. The situation in the US continues to go worse and this year, most analysts say that the country has gone into recession, meaning a relatively minor, non-critical decline in industrial output and the end of economic growth.

The problems in the US had an impact on the dollar-euro rate. Thus, prior to the crisis, in July 2007, the rate was US \$1.37 to the euro. By the end of the year, it had fallen to

US \$1.47, and not long ago, 18 March, it hit US \$1.58. Of course, being tied to the dollar at the UAH 5.05 level for nearly three years now means that the hryvnia has been falling alongside the greenback.

To hedge against inflation, Ukrainians have by long tradition bought hard currency. In the past, this was predominantly the dollar, but now, more and more are buying euros. Moreover, most Ukrainian travelers tend to go to Europe, where they also buy euros. The dollar, by contrast, is losing ground because it's obvious that it is losing ground against the single European currency.

When the press began to talk about the dollar's collapse against the euro and people could see its decline at exchange points, the most panic-oriented part of the population rushed to sell off dollars and buy euros—which created additional pressure on the dollar exchange rate. This can easily be seen in the gap between the rate that the dollar and euro were selling at at exchange points and the official exchange rates.

What will the future bring?

The NBU is continuing to keep the official hryvnia exchange rate at UAH 5.05. Because the hryvnia that come in the form of tax receipts will go to pay public sector employees and other benefits at the beginning of the new month, the supply of hryvnia will grow once more. Similarly, the hryvnia-dollar exchange rate should return to its previous levels in the first week or so of April.

To forecast this rate, it is important to remember that most of the money attracted by banks over 2006–2007 is supposed to be returned over 12-36 months. This means that Ukraine has to look for hard currency, not only to cover its current account deficit, but also to repay debts. When this money was borrowed, the assumption was that it could be covered by further borrowings. But right now it's not so clear that the money will be lent again. This means that the negative situation on external markets over which Ukraine has no influence could confront the country with a currency shortfall as soon as 2009. This is understood at the NBU as well, which means it is highly unlikely that the Bank will risk depreciating the hryvnia against the greenback this year. ■

The complete article is available at <http://glavred.info/archive/2008/04/01/112248-7.html>.

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icps newsletter is a weekly publication of the International Centre for Policy Studies, delivered by electronic mail.

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