Veremiienko Vitalii
4th year student, NaUKMA
Primierova Olena
Associate Professor of the Department of Finance, NaUKMA

UKRAINE'S COMPLIANCE WITH THE PREREQUISITES FOR SUCCESSFUL INFLATION TARGETING IN 2015, 2021, AND 2022

Historically, an inflation-targeting framework was first adopted by economies that had already been advanced and had sound financial systems and credible central banks (e.g., New Zealand, Canada, United Kingdom) [1]. And it was considered that such a framework had not been suited for emerging market countries due to numerous reasons, the most important of which constitute four groups:

- Institutional independence;
- Technical infrastructure;
- Financial system health;
- Economic structure.

This study is aimed to analyze the key prerequisites for successful inflation-targeting and evaluate Ukraine's compliance with them.

Institutional independence incorporates primarily four elements:

1. Monetary policy needs to be independent, especially from the executive branches of state power. This is needed in order to avoid the monetization of government debt and prevent statesmen who hold elective positions in the government from using their power to affect monetary policy and the business cycle in order to gain advantages during elections. The independence of the NBU is legally established by the Law of Ukraine On the National Bank of Ukraine [2], but it is really hard to assess its actual degree of independence from different authorities.
2. Instrument independence. A central bank needs not only to be independent in making decisions about the current policy but in its choice of instruments used for achieving the announced goals. IMF [1] considers instrument independence the most important criterion for central bank independence. According to the national legislature of Ukraine [2], the NBU has full instrument independence.
3. Security of employment for a governor and/or members of a board of governors of a central bank. It is particularly important that the tenures of key central bank policymakers exceed the tenure of elected statesmen who often are authorized for appointing them. Also, it is necessary that governors could not be fired without a substantial cause. Concerning this criterion, there are some inconsistencies as in

the last 3 years there were two resignations of NBU's governors in a shady political context [3] [4].

4. Freedom from commitment to another nominal anchor like the exchange rate or wages. A central bank is highly unlikely to achieve several targets simultaneously, as it will most probably create antagonism in the operational design of monetary policy, e.g., fixed exchange rate makes the exchange rate channel of the monetary transmission mechanism inactive which makes it less likely that changes in the key policy rate will stir inflation closer to the forecasted trajectory. That is why, if a central bank is committed to targeting inflation, it should be prohibited from targeting any other nominal indicator. Since the beginning of a full-scale russian invasion, the NBU [5] has fixed the exchange rate, which is why the war-time monetary policy regime cannot be classified as classical inflation targeting.

Technical infrastructure prerequisites include the following:

1. A central bank needs adequate forecasting capabilities (i.e., a structural model of an economy) and its staff should be able to use them to make macroeconomic "forecasts conditional on different assumptions for the monetary policy instrument" This is needed for two purposes: 1) to make reliable inflation forecasts that will serve as an operational target for monetary policy; 2) to link monetary policy instruments with its goals, to improve the understanding of the underlying mechanism of the monetary policy, build confidence in the central bank's abilities to attain the announced goals, and most importantly make informed decisions.

The National Bank of Ukraine employs a diverse set of modeling tools and meets this requirement [6].

2. A central bank needs to have access to reliable and comprehensive data, needed for forecasting and substantiation of monetary policy decisions. And the lag in data collection should be sufficiently small. The NBU meets this requirement as it uses traditional and modern tools for data extraction [7].

3. A central bank also needs "an operating procedure for adjusting monetary instruments" and should be able to conduct macroeconomic forecasting on a regular basis. In the case of NBU, since 2016 there has been established a routine cycle of making the monetary policy decisions, which corresponds to the world's best practices [8].

Financial system health prerequisites consist primarily of two main elements:

1. A sound banking system. This means that banks attract deposits from and provide loans to households and corporations and have sufficient sources of their own funding to sustain their operations. This is an important prerequisite as it directly influences the effectiveness of the main central bank's instruments. One of the indicators of banking system soundness is a share of non-performing loans. And there

is a significant increase in this indicator for hryvnia retail loans (by the end of 2022, both for car and housing loans the shares of NPLs have approached the range of 15-20% [9]) since the beginning of the full-scale russian invasion of Ukraine. There is still a lot to be done to improve the banking system's soundness.

2. Developed stock and bond markets. This means that there should be an extensive volume of financial operations designed for the redistribution of financial resources within a state. This precondition further strengthens the central bank’s ability to attain its announced inflation goals as it magnifies the effects of changes in its key instruments. In the case of Ukraine, there is a small stock market, which has become virtually non-existent since the beginning of the invasion. The bond market is more developed, but it is dominated by state borrowings (Figure 1).

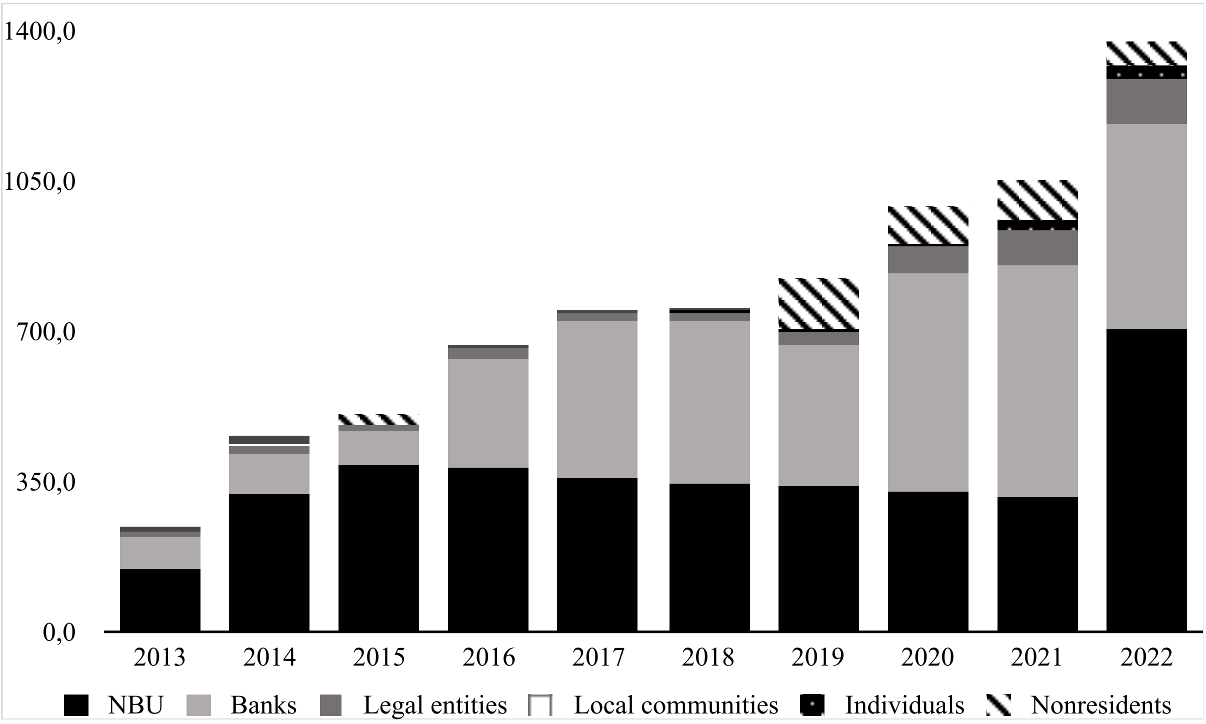

Figure 1. Holders of domestic government bonds, UAH billion, nominal prices

Source: calculated by the author based on the NBU data [10]

Economic structure prerequisites are even harder to satisfy as they typically correspond to rigid structural characteristics of an economy. These include: 1) the degree of financial dollarization; 2) inflation and exchange rate sensitivity to commodity prices; 3) the magnitude of the exchange rate path-through into domestic prices; 4) the scope of administered prices.

Even though the mentioned prerequisites do help a central bank in the effective implementation of inflation targeting, most of them could be achieved after the formal adoption of inflation targeting as a monetary policy framework. And there is a growing body of literature proving that the central bank’s commitment to such a monetary framework speeds up structural and institutional changes in an economy so that it faster moves to the attainment of the aforementioned preconditions [1]. For example, there is evidence that exchange rate pass-through decreases after the adoption of inflation targeting [11]. Some researchers also claim that high dollarization does not preclude the use of inflation-targeting as a policy rule, while inflation targeting has significant treatment effects on lowering actual financial dollarization [12].

So, evidence confirms that even if not all the prerequisites are in place, a strong commitment of the central bank to institutional changes and implementation of inflation targeting in a not fully prepared country greatly accelerates the improvements of the correspondence of the country's indicators to prerequisites for the successful conduct of inflation targeting.

References

1. IMF (2005). Does inflation targeting work in emerging markets? World Economic Outlook.
2. Law of Ukraine on the National Bank of Ukraine (1999). https://bank.gov.ua/en/legislation/Law_NBU
3. Reuters (2022, October 1). Ukraine’s central bank governor resigns, citing health reasons. https://www.reuters.com/world/europe/ukraines-central-bank-governor-tenders
4. Dan Hardie (2020, July 2). Ukrainian governor resigns in protest. Central banking. https://www.centralbanking.com/central-banks/governance/7650266/ukrainian-central-bank-governor-resigns-in-protest
5. NBU (2022, February 24). How Ukraine’s Banking System and FX Market Will Work from 24 February 2022 Under Martial Law Throughout Ukraine. https://bank.gov.ua/en/
6. Nikolaychuk, S., Sholomytskyi, Y. (2015). Using Macroeconomic Models for Monetary Policy in Ukraine. Visnyk of the National Bank of Ukraine, 233, 54-64. https://doi.org/10.26531/vnbu2015.233.054
7. Krukovets, D. (2020). Data Science Opportunities at Central Banks: Overview. Visnyk of the National Bank of Ukraine, 249, 13-24. https://doi.org/10.26531/vnbu2020.249.02
8. Lepushynskyi, V. (2015). A Strategic Document on Monetary Policy for the Period of the Inflation Targeting Adoption in Ukraine. Visnyk of the National Bank of Ukraine, 233, 24-38. https://doi.org/10.26531/vnbu2015.233.024
9. NBU (2022). Financial Stability Report, December 2022. https://bank.gov.ua/en/news/all/zvit-pro-finansovu-stabilnist-gruden-2022-roku
10. NBU (2022, February 19). Statistics at the National Bank of Ukraine. https://bank.gov.ua/en/statistic/nbustatistic
11. Kara, H., & Öğünç, F. (2008). Inflation Targeting and Exchange Rate Pass-Through: The Turkish Experience. Emerging Markets Finance & Trade, 44(6), 52–66. http://www.jstor.org/stable/27750642
12. Leiderman, L., Maino, R., & Parrado, E. (2006). Inflation targeting in dollarized economies (pp. 99-114). Palgrave Macmillan UK.