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Current issues of monetary policy in Ukraine

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Executive Summary

Monetary policy is currently a hotly debated and highly politicised issue in Ukraine. In order to structure the debate, it is necessary to distinguish three fields: the stance, the instruments and the use of instruments of monetary policy.

Stance. Inflation has certainly slowed down in recent times, but it is still rather high (14.1% yoy in October). Inflation expectations are even higher (17% yoy according to latest NBU information), clearly showing that economic agents are worried about the topic. Furthermore, devaluation expectations are quite widespread in the population. Finally, fiscal policy is becoming very expansionary, as indicated by the rapidly growing budget deficit, the Draft Budget 2010 and the new law raising minimum wages and pensions. Under such difficult circumstances, monetary policy has to make a major contribution in reinstalling macroeconomic stability. The only way to do this is by conducting a restrictive monetary policy. Thus, we suggest the NBU to reject appeals from policy makers for a relaxation of monetary policy. Such a relaxation would put strong pressure on inflation and on the exchange rate, without contributing to ease the existing credit crunch.

Instruments. Overnight loans, i.e. the key instruments for providing liquidity to banks, are currently disbursed by the NBU at 15.5% (for secured loans) and at 17.0% (for non-secured loans). But the discount rate, the NBU's main instrument of communication with little importance for lending activities, stands merely at 10.25%. In our view, this discrepancy is confusing and might contribute to higher inflation expectations. Thus, we suggest bringing the discount rate in line with the rates of overnight loans.

The use of instruments. The provision of credits to the economy by the banking system can only run smoothly if it can count on liquidity from the central bank at any time, provided that banks can fulfil the collateral requirements and are ready to pay the established price for liquidity (i.e. the policy rate). If this is not the case, banks will tend to hoard liquidity, thus increasing the cost of borrowing for the real sector and contributing to a credit crunch. This is especially true under current conditions in Ukraine, in which the inter-bank market does not work properly. Consequently, the reported complete lack of access by several banks to NBU's loans is highly problematic. It is crucial that all banks are treated in the same way. Furthermore, the NBU should avoid supporting weak and practically insolvent banks by providing liquidity. Problems of solvency should be tackled by a separate institution, with specific competences and funded by a different source (i.e. from government funds). The NBU should focus on providing liquidity to those banks, which are solvent and comply with objective requirements.

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1. Introduction

Until 2008, the exchange rate of the hryvnia was pegged to the US dollar. Under such a system, monetary policy is subordinated under the exchange rate policy. The role of the central bank in such a fixed exchange rate system is basically limited to interventions on the foreign exchange market, i.e. buying and selling foreign currency in order to keep the exchange rate fixed. Key monetary variables such as the growth of monetary aggregates, inflation or interest rates are then not determined by the use of monetary policy instruments, but a direct consequence of such interventions. In short, until 2008, Ukraine had no independent monetary policy. Accordingly, the academic and public debate on the topic was rather limited.

However, in 2008 the NBU changed the system and introduced a flexible exchange rate system. Under the new system, monetary policy has a much bigger importance and economic relevance than before. In particular, the provision of liquidity and the interest rates in the market, both very topical issues, depend considerably on the conduct on monetary policy and the use of its instruments. Consequently, monetary policy has become a key issue of debate in Ukraine for both experts and policy makers.

In this paper, we present our views on current monetary policy in Ukraine. In order to structure the discussion, we distinguish three main topics. First, we look at the question of the appropriate stance of monetary policy. This question is crucial, given often appeals from policy makers for a relaxation of the current stance. Second, an analysis of the existing instruments of monetary policy is provided. We discuss both short- and long-term issues, using ECB instruments as a benchmark. Third, we analyse problems in the use of the existing instruments and derive recommendations to improve the situation.

2. The stance of monetary policy

2.1 What should be the stance of monetary policy under current conditions?

Monetary policy is currently facing very difficult conditions. Inflation has dropped significantly since its peak in May 2008 (31.1% yoy based on CPI), but it is still very high (14.1% yoy in October 2009). Besides, as shown by different business surveys, inflation expectations are still very high. As a rule, people expect an increase of inflation in the near future, a fact which could contribute to higher inflation, given the well-known dangerous dynamics of expectations ("self-fulfilling prophecies").[1] Furthermore, there are widespread depreciation expectations in the country, mainly due to internal political risks in the context of Presidential elections in January 2010. Finally, fiscal policy is clearly expansionary and is becoming more expansionary by the day, as indicated by the large deficit implied in the Draft Budget 2010 and by the new law introducing substantial increases in minimum wages and pensions.

Under such difficult conditions, a generous provision of liquidity could have disastrous consequences. An expansionary policy would directly (i.e. through an increase in monetary aggregates) contribute to higher inflation. But also the negative impact on inflation expectations would indirectly create pressures on prices. Furthermore, much of the additional liquidity might end up as demand for foreign currency, giving the existence of widespread devaluation expectations. As a result, the hryvnia might further depreciate against major international currencies, thus aggravating current problems related to balance

[1] See our policy paper on inflation expectations for an extensive discussion of the workings and measurement of inflation expectations in Ukraine: "Inflation Expectations: Importance and Measurement" by Robert Kirchner, Ricardo Giucci, Yaroslava Suchok, Oksana Kuziakiv and Veronika Movchan, Policy Paper 02, June 2008.

sheet effects of devaluation, but also putting more pressure on inflation. Finally, the current expansive fiscal stance does not allow for a further monetary impulse.

Conclusion: The stance of monetary policy in Ukraine should be restrictive, given very unfavourable conditions regarding inflation, inflation expectations, exchange rate and fiscal policy.

2.2 How to measure the stance of monetary policy?

The assessment of the stance of monetary policy is, in any country, a non-trivial task. There is a wide range of variables that could potentially be used for such an assessment, such as the growth of different monetary aggregates, the interest rates at which central banks provide loans to commercial banks, reserve requirements and market conditions regarding liquidity and interest rates. But also defining the relative importance of such variables is far from obvious[2].

A simple, but robust rule for assessing the stance of credit policy is based on the concept of the "real interest rate", i.e. the difference between the nominal interest rate and the rate of inflation. According to this rule, the stance of monetary policy can be derived from the existing level of real interest rates: High real interest rates imply a restrictive policy and low real interest rates imply an expansionary policy. While the question of what is "high" and "low" is not easy to answer, the prevailing of negative real interest rates is indisputably seen as a clear sign of an expansionary monetary policy. As shown in Figure A.1 (see Annex), positive interest rates prevailed in the majority of countries in the period 2004-2007.

But before applying this rule empirically to Ukraine, we have to deal with methodological issues. In particular, there are many ways to calculate the real interest rate, as both components (nominal interest rate, inflation) can be defined and measured in different ways.

Headline inflation versus core inflation

The first decision relates to the choice of the inflation indicator. While the headline consumer price index (CPI) is the best indicator capturing the overall changes in the cost of living, it can be impacted by administrative price changes, temporary and volatile supply shocks, etc., i.e. by factors mostly outside the control of the central bank. Therefore, core inflation indicators have been developed, which try to omit such volatile components.

In the following discussion, we will focus on the headline CPI, as this is the main inflation indicator in Ukraine. However, from late 2008 onwards (when it was first published), we will supplement our calculations using core inflation.

Expected versus realised inflation

The concept of the real interest rate normally involves the expected inflation rate, as this is a forward-looking concept (“ex-ante real interest rate”). However, this rate is unknown, which limits its use in empirical calculations. Instead, in such work usually the realised inflation rate is used (“ex-post real interest rate”). We use in our calculations this concept.

[2] The relevant academic and policy-oriented literature discusses a number of different indicators to measure the stance of monetary policy. See Fung/Yuan (1999) and Cespedes et al. (2005) for a respective overview.

Nominal interest rate

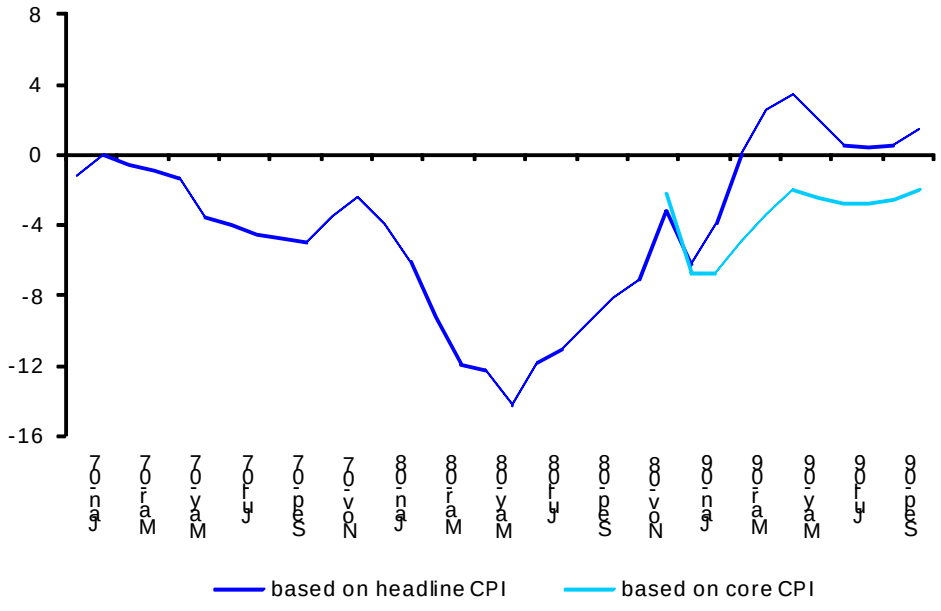
Lastly, also the nominal interest rate needs to be defined. Since we discuss policy rates, this needs to be a rate determined by the NBU. Here, we focus on the overnight NBU rate on loans that are secured with government T-Bills, as this is the main instrument for the provision of regular liquidity.

Conclusion: For the purposes of this paper we define the "real interest rate" as the difference between the NBU's overnight refinancing rate for secured loans and the actual level of headline inflation (CPI).

2.3 What is the current stance of monetary policy in Ukraine?

Figure 1 shows the dynamics of the real interest rate in Ukraine, as defined in Section 2.2. Throughout the period January 2007 - March 2009 the real interest rate is negative. As explained above, this is a clear indication of an expansionary stance of monetary policy. Consequently, the high level of inflation during this period has to be mainly attributed to a highly expansionary monetary policy. Only in April 2009 monetary policy became more restrictive, as suggested by the existence of positive real interest rates. As of today, the real interest rate is slightly positive and amounts to 1.4% (15.5% NBU policy rate for secured loans - 14.1% CPI inflation). If we use core inflation for calculating the real interest rate (the second curve starting in December 2008 in Figure 1[3]), the real interest rate is clearly negative and amounts to -2.0% (15.5% NBU policy rate for secured loans - 17.5% core inflation).

Figure 1:
Real interest rates in Ukraine



Source: NBU, State Statistics Committee, own calculations

Note: Real interest rates are calculated using actual inflation.

[3] The smaller sample size relates to the fact that core inflation has been published on a year-on-year basis only since December 2008.

Conclusion: Based on the concept of real interest rates, monetary policy has been very expansive in Ukraine in recent years and only became more restrictive since April 2009. A relaxation of the current stance would imply getting back to an expansionary policy.

Recommendation 1 (short-term): A relaxation of the current stance of monetary policy, as requested by several policy makers, would not be in the interest of the country. Instead, the NBU should keep its current, slightly restrictive stance of policy. This implies as of today that there should be no change in the interest rates charged for overnight loans.

Looking forward, monetary policy should remain relatively restrictive; as disinflation will only be slow (high inflation inertia) and inflation will stay in double-digit territory for some time. This will also keep inflation expectations high. According to the enterprise survey conducted by the NBU, inflation expectations (CPI growth in the next 12 months) in the third quarter increased to 17.5% as compared to 15.4% in the second quarter with 63% of respondents expecting inflation over 15% yoy[4]. However, inflation expectations remain lower than in the first two quarters of the economic crisis.

Recommendation 2 (medium-term): As inflation gradually falls, there may be some room for a more accommodative stance, involving an easening of policy rates. However, the recent success of reaching positive real interest rates must not be endangered.

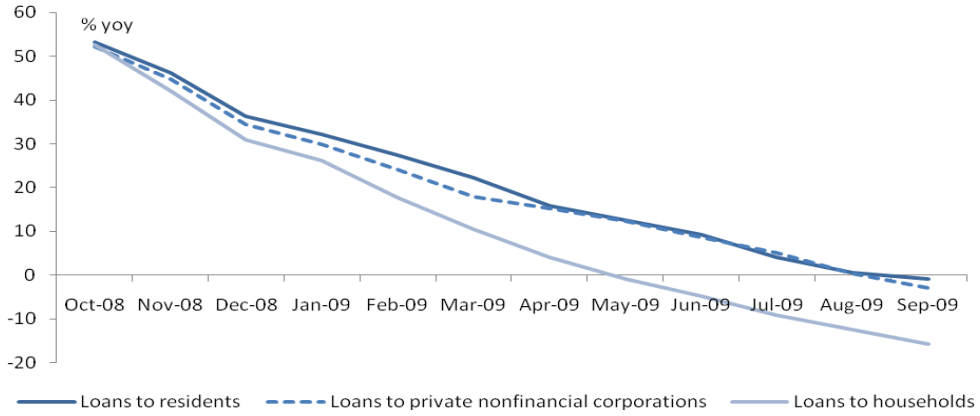
2.4 Restrictive monetary policy vs. credit crunch

Our recommendation for a continuation of the current restrictive stance of monetary policy is most likely to be confronted with the following argument: "Ukraine does not only face problems in the financial/monetary sector, but also in the real sector. In particular, the lack of access to credits (credit crunch) is a major impediment for economic growth. In light of this credit crunch, an increase in the liquidity provision by the NBU is necessary, i.e. an expansionary monetary policy."

The existence of a credit crunch is indisputable, as Figure 2 shows:

Figure 2:

Growth in loans outstanding (nominal)



Source: NBU, own calculations

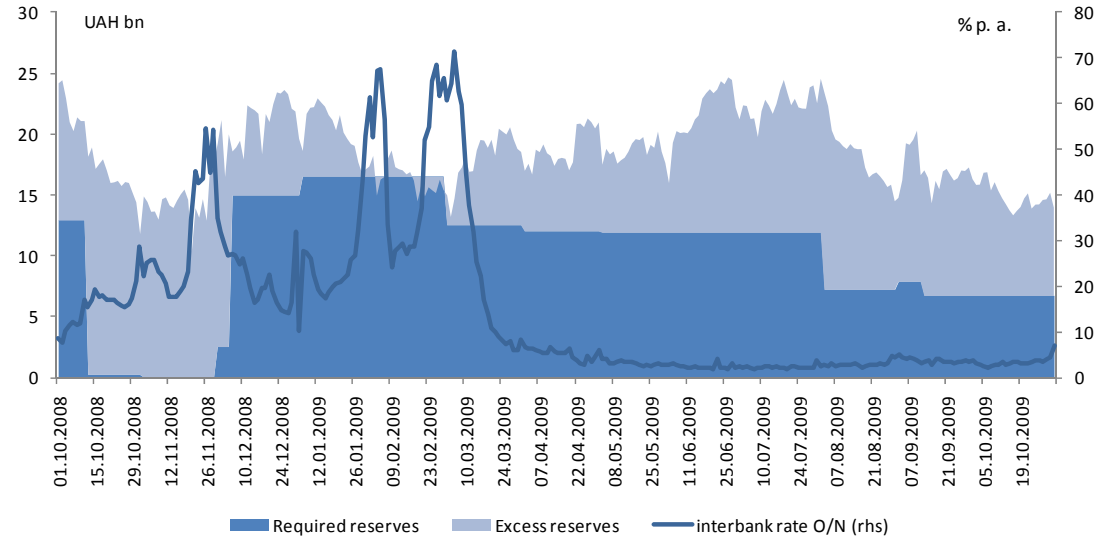
Note: Over the whole period, loans outstanding were recalculated using official exchange rates as of September 30, 2009

[4] See "NBU Business outlook survey" in the third quarter of 2009. The report can be downloaded at http://www.bank.gov.ua/Publication/research/Pub0309.pdf (in Ukrainian).

But in our view, the main reason for the existence of a credit crunch is not a lack of liquidity, but a lack of trust and confidence. Banks currently hold significant amounts of excess reserves at the NBU, a clear sign that liquidity is not excessively tight. Likewise, money market interest rates are relatively low. Both indicators are shown in Figure 3:

Figure 3:

Bank reserves at the NBU and money market interest rate



Source: NBU, own calculations

Note: Required reserves are estimated based on monthly data and NBU regulations. Required reserves at special accounts is not included

The fact that banks prefer to keep their balances with the NBU instead of providing loans to companies shows the lack of confidence in the system. While banks still experience a deterioration of their assets' quality, as demonstrated by rising non-performing loan ratios, they are at the same time under the threat of sudden withdrawals of parts of their deposit base. This combination makes new lending by banks quite unlikely. As a result, the transmission mechanism of monetary policy is damaged, e.g. monetary impulses set by the NBU do not impact real variables like output and employment as they should do under normal conditions. The main task for the NBU in this situation is to contribute to reinstalling macroeconomic stability, since this is a crucial factor for confidence. By pouring more money into the system, confidence will not increase, but decrease. Thus, this is clearly not the way ahead for combating a credit crunch under current conditions.

Conclusion: The problem of a credit crunch in Ukraine is serious, but it can and should not be fixed through an expansionary monetary policy. Instead, the NBU should focus on reinstalling macroeconomic stability, as this will eventually help banks to resume the normal lending process.

3. The instruments of monetary policy

The analysis of the stance of monetary policy determines how it should be set in order to achieve its stated objectives, i.e. gives important information regarding the further course of monetary policy. Once this is done, the focus is on the implementation of monetary policy decisions, i.e. on the operational framework. In this chapter, we will analyse and assess the currently available instruments of the NBU, also using an international perspective.

3.1 Overview and assessment of existing NBU instruments

In 2009, the NBU used loans, repo transactions and swaps to provide refinancing to banks. Regarding regular refinancing operations, the turnover of repo transaction was UAH 0.5 bn, while the NBU engaged in swaps in an amount of UAH 1.4 bn over January-September 2009, with the major part of it provided in March. The NBU issued further UAH 12.7 bn of overnight refinancing[5], and UAH 0.8 bn of refinancing loans with a maturity of up to 14 days[6]. For the regular liquidity provision in open market operations via overnight loans, the respective policy rate for secured or unsecured transactions is used (currently 15.5% and 17%, respectively).

At the same time, the NBU has currently a further interest rate in its toolkit of instruments, the discount rate. According to the Law on the National Bank, the discount rate is the rate used to discount drafts presented by commercial banks for refinancing. It also serves as an indicator of monetary policy as the lowest of the different refinancing rates. If the discount rate is adjusted, refinancing rates are usually changed too. In the past, the NBU actually used the discount rate for monetary policy operations; however, it ceased to do so[7].

A preliminary observation points to the big discrepancy between the current level of the discount rate (10.25%) and the benchmark overnight refinancing rates (15.5% and 17%). The discount rate signals a very expansionary stance of monetary policy, as it currently implies a real interest rate of -3.85%. This fact is problematic, as it might negatively impact inflation expectations of the private sector. Furthermore, since the actual liquidity provision is done at a different (and higher) rate, this might create confusion regarding the current stance of monetary policy.

For a successful move towards inflation targeting (IT) – the declared objective of the authorities - a clear and transparent communication strategy of the stance of monetary policy is a key element. This follows directly from the necessity to gain credibility and anchor (still high) inflation expectations, especially during the transition period to a full IT system. The continued use of the discount rate in its current, debatable form in communication with the public sends doubtful and confusing signals and is not in line with the requirements of a shift to IT.

Recommendation 3: The level of the discount rate should be aligned with the level of the benchmark refinancing rate actually used for liquidity provision. In such a way, the NBU can optimally signal its stance of monetary policy and manage the liquidity situation in the money market[8].

[5] The average daily amount outstanding was UAH 70 m.

[6] Regarding emergency refinancing operations to problem banks (which made up the largest part of refinancing loans), this was provided in the form of longer term loans (up to 1 year or longer).

[7] There are other functions of the discount rate apart from monetary policy purpose. The discount rate (or multiples of it) is also widely used in laws, other regulations, and contracts as statutory interest rate to calculate penalties, fees, damages, as a default interest rate if the actual rate is omitted from the contract, and as interest rate in different government lending programs.

[8] There is a certain analogy to the foreign exchange market, where a similar situation prevails. The official rate has no direct relation to the (interbank) market rate at which actual transactions are being conducted. This creates uncertainty, makes the evaluation of the stance of foreign exchange policy more difficult and negatively impacts the credibility of the NBU.

3.2 A long-term international benchmark: Instruments of the European Central Bank

On a *strategic* level, monetary policy decisions are taken in order to achieve final objectives, e.g. maintaining price stability. The concrete link between such final goals and intermediate targets/indicators like (long-term) interest rates, monetary aggregates, exchanges rates, etc. is part of the monetary policy strategy of the central bank. On a *tactical* level, the smooth implementation of such decisions is normally done using both instruments and operating targets. Such elements are normally part of the operational framework of central banks.

Monetary policy instruments at the hand of the European Central Bank (ECB)[9] can be divided into 3 groups, as Box 1 shows:

Box 1:

Monetary policy instruments of the ECB

Open market operations

Open market operations play a very important role in influencing interest rates, managing banks' liquidity and signalling the stance of monetary policy. The ECB conducts four types of such operations: main refinancing operations, longer-term refinancing operations, fine-tuning operations and structural operations.

Standing facilities

Standing facilities aim to provide and absorb liquidity at the discretion of individual banks. Accordingly, they consist of two components, a marginal lending and a deposit facility.

Reserve requirements

Banks have to apply a certain reserve ratio (currently 2%) on items of their reserve base (deposits, debt securities, etc.). These reserve holdings are remunerated at the rate of the main refinancing operations.

The main refinancing rate is the key policy rate for the ECB. Around this rate, the standing facilities form a transparent and explicit symmetrical corridor around this rate[10]. This "corridor model" aims to steer overnight money market interest rates and give a clear signal of the general monetary policy stance under normal circumstances. According to the theory of monetary transmission, controlling the short-term money market rate implies controlling (short-term) activity and ultimately, inflation.

Conclusion (long-term): During the transition period towards a fully-fledged inflation targeting system, the NBU needs to develop and improve its operational framework accordingly. Regarding the overriding aim of clearly signalling the stance of monetary policy, the ECB, with its "corridor model" of different interest rates can offer important insights.

[9] Actually, the following discussion relates to the Eurosystem, i.e. the ECB and the national central banks of the member countries of the Euro. However, we will continue to use the term ECB.

[10] The main refinancing rate is currently 1%, the marginal lending facility 1.75% and the deposit facility 0.25%. See Figure A.2 in the Annex.

4. The use of existing instruments

The last chapter demonstrated that it is important for the central bank to have the right instruments in place, in order to be able to conduct its monetary policy. It became clear that some changes are necessary in the process of shifting policy from fixing the exchange rate towards domestic objectives, i.e. targeting inflation. At the same time, it is important to use the existing instruments in such a way as to guarantee the normal functioning of the banking sector. A crucial precondition for this to happen is that banks must be confident to have access to NBU loans at any time, provided they comply with objective requirements, have adequate collateral and are ready to pay the required price (i.e. the interest rate) for liquidity.

According to many observers, the access to NBU loans seems to be a crucial practical problem for many banks operating in Ukraine today. Over the course of the crisis, large amounts of refinancing for some banks, especially troubled banks have been provided. To mention concrete figures, refinancing (i.e. loans) issued through programs of financial rehabilitation for problem banks amounted to UAH 44.2 bn over January-September 2009. In contrast, no or very little refinancing has been provided for relatively stable banks. The NBU provided only UAH 12.7 bn in overnight refinancing and UAH 2.7 bn in longer-term refinancing through regular channels.

The lack of access to NBU loans experienced by several banks is highly problematic, especially in the context of a malfunctioning interbank market, as is the case today. Loans of commercial banks to the real sector become more expensive, i.e. higher interest rates are the consequence. But also the quantitative availability of loans suffers, thus contributing to the current credit crunch.

Recommendation 4: Equal access to liquidity provision by the NBU should be secured for all those banks, which comply with objective criteria regarding appropriate collateral and who are willing to pay the respective price of liquidity.

While a clear distinction between liquidity and solvency support is in practice very difficult to draw, evidence reported so far suggest that in Ukraine too much emphasis has been put on liquidity support, probably also as a substitute for needed capital support. Using emergency lending by the NBU to continuously support weak and basically insolvent banks is quite dangerous from a monetary point of view. In case loans resulting from emergency lending operations are not paid back, the monetary base does not reduce automatically but stays permanently higher than before. Furthermore, the losses resulting from such operations might have negative implications for NBU capital, and might eventually jeopardize the NBU's ability to credibly perform its policy goals.

Recommendation 5: The role of the NBU as an emergency lender to distressed banks needs to be revised. In case capital support is necessary for certain systemic banks, other institutions (i.e. the Ministry of Finance) should deal with recapitalisation, in line with international experience during the crisis.

5. Conclusions

The transition from a system of a fixed exchange rate to inflation targeting is a lengthy process with many technical and political challenges to overcome. A crucial challenge is the repeated pressure from politics to relax monetary policy, a well-known problem in many countries. Currently, policy makers from different parties call on the NBU to relax its restrictive policy stance. But as explained in detail in this paper, a relaxation would create additional problems (higher inflation, weaker currency), without contributing much in supporting the real sector. The presence of a credit crunch is mainly due to a lack of confidence, not a lack of liquidity.

A further challenge concerns the development of instruments and the communication of policy through these instruments. Today, the discount rate plays the central role in the NBU's communication. But this rate has no apparent importance for concrete policy. Lending is conducted at 15.5% (secured loans) and at 17.0% (unsecured loans), while the discount rate amounts to only 10.25%. Such a low rate indicates an expansionary stance of policy and sends to wrong signals to economic agents, thus creating high inflation expectations. In our view, there is much room for improvement here.

Finally, in an inflation targeting framework all banks should face the same objective criteria to borrow from the central bank. The NBU should thus create equal conditions for all banks. Also, the focus of activity should be to provide liquidity to strong and solvent banks, which play a crucial role in financing the real sector of the economy. Weak and practically insolvent banks should not be supported by liquidity from the NBU, since this endangers the own capital position of the NBU. Instead, a separate institution should deal with problem banks.

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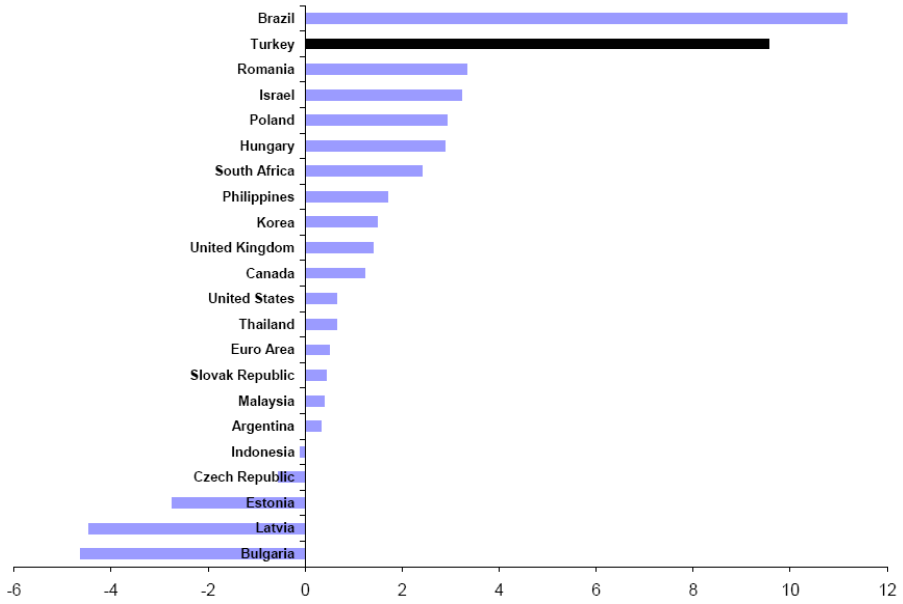
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Annex

Figure A.1 Estimated Real Interest Rates (average 2004-2007, in %)

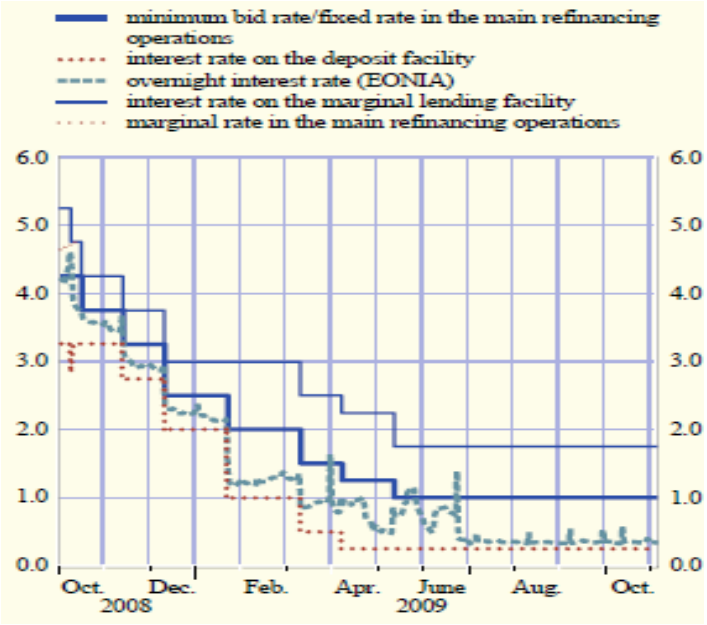


Source: Kannan (2008)

Note: Estonia, Latvia and Bulgaria have a currency-board framework

Figure A.2

ECB: Policy rate corridor and money market rates



Source: ECB (2009)

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