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The Policy Interaction between the Government and the National Bank of Ukraine: Assessment of the Current Framework and Policy Recommendations

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The Policy Interaction between the Government and the National Bank of Ukraine: Assessment of the Current Framework and Policy Recommendations

Executive Summary

Monetary and fiscal policies have a strong influence on each other. In most cases, policies of central banks and government are of a complementary nature. Most actions taken by central banks to pursue price stability contribute to long-term fiscal stability, while a solid fiscal policy as a rule equally supports price stability. But in some cases, especially in the short-term, decisions by central banks can have a negative impact on fiscal policy, while measures taken by the government can also affect monetary policy in a negative manner. In order to secure macroeconomic stability in the short- and in the long-run, it is essential to minimise potential conflicts between the government and the central bank of a given country. This is usually done by establishing an adequate institutional framework for the policy interaction between these institutions.

While the policy framework in Ukraine has developed positively in recent years, there are several directions for improvement. First, this concerns the deposits of the government at the National Bank. In order to support monetary policy and liquidity management, a constant flow of information is required on the estimated daily net transactions at the government's account. Besides, plans to place government's funds with commercial banks using government bonds as collateral ("reverse repos") should not be adopted, since this would dry up liquidity in the market for government bonds. Second, a direct and unhealthy competition between NBU's and government's securities on capital markets should be avoided. Current government's plans to introduce a regular issuance calendar for government debt and the foreseen securitisation of government debt with the NBU would clearly contribute to avoiding such an unhealthy competition. Besides, the NBU should try to restrict its issuance to mainly short-term titles, once enough liquidity for government bonds exists. Third, conducting an effective anti-cyclical macroeconomic policy requires a better coordination of monetary and fiscal policies. Currently, monetary policy bears almost all the burden for fighting inflation, while fiscal policy remains expansive and thus inflationary. A coordinated macroeconomic approach would be much more effective. Also, it would lessen the need for the NBU to restrict monetary policy and to increase interest rates.

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1. Introduction

One of the key economic goals of the public sector in any country is to ensure macroeconomic stability. Empirical evidence shows that macroeconomic stability is a crucial prerequisite for long-term sustainable socio-economic growth and for the well-being of the population. A number of institutions within the public sector are responsible for ensuring macroeconomic stability. In most countries, the most prominent role belongs to the central bank and to the government, especially in the form of the ministry of finance. While the central bank is usually responsible for achieving price stability[1], a key responsibility of the ministry of finance consists in ensuring fiscal stability. Price and fiscal stability are the cornerstones of macroeconomic stability.

International experience has shown that the cooperation between the institutions involved in maintaining macroeconomic stability is in many countries far from optimal. This lack of effective cooperation can lead to conflicts, which attract the attention and the precious time of high-ranking state officials. More importantly, problems in the cooperation between involved institutions can jeopardize maintaining macroeconomic stability. Private sector expectations react very sensitive to the eruptions of such conflicts, and especially foreign financial investors can quickly decide to exit the country. All this seems rather astonishing, if we take into account that all institutions involved belong to one and the same public sector and that they all pursue the same goal of ensuring macroeconomic stability.

The reason for the problematic cooperation between central banks and governments/ministries of finance in many countries lies in the strong interaction between the activities of these institutions. Many measures taken by the central bank to ensure price stability do have an influence on fiscal policy, while actions by the government might impact monetary policy.

Some examples should illustrate this fundamental interaction between monetary and fiscal policy. When a central bank increases interest rates in order to reduce liquidity (i.e. the monetary base) and contain inflation, the cost of borrowing for the government might increase, thus creating annoyance at the ministry of finance. But also when the central bank issues own securities in order to reduce liquidity (which is a typical activity under fixed exchange rates and high capital inflows), the Finance Minister might not be happy to face competition and thus higher interest rates on the market for short-term securities, which might extend also to longer durations. A further conflict might arise when the government does not issue debt securities in a regular way. In such a case, the domestic market for government securities can become illiquid, thus taking away a crucial instrument for monetary policy. Large and unexpected deposits or withdrawals by the government from its account with the central bank can also create problems for the liquidity management and for monetary policy.

As shown above, there is lot of room for potential policy tensions between central banks and governments and the eruption of such conflicts might jeopardize macroeconomic stability. Consequently, it is crucial for every state to find ways to minimise the potential for conflict as a way of achieving stability. The most efficient way to minimise conflicts is by setting a clear and commonly agreed policy framework, in which all interrelated activities of the central bank and the government take place.

The goal of this paper is to contribute to the improvement of the existing policy framework in Ukraine. This issue is highly topical in Ukraine. Given the possible introduction of inflation targeting in the medium-term, the relationship between NBU and the government needs to be defined and clarified on several levels. The NBU has already produced a Green Paper on the topic[2]

[1] Price stability can be pursued directly (stability of domestic purchasing power of monetary unit) or indirectly by targeting the exchange rate (stability of the exchange rate with respect to a stable anchor currency).

[2] See NBU (2008): How to Strengthen the NBU Role in Supporting the Price Stability; Green Paper, Kiev.

and is currently preparing a White Paper. In Part 2 we identify the most important fields of interaction between central banks and governments by means of a general overview. In Part 3, we focus on selected fields of interaction, which are currently of high importance in Ukraine. In Part 4 we conclude.

2. Fields of policy interaction between governments and central banks: An overview

In this sector we identify the main fields[3] of interaction between governments and central banks. In Parts 2.1 to 2.4, the relationship between fiscal policy and the balance sheet of a central bank is analysed. Parts 2.5 and 2.6 take a macroeconomic perspective.

2.1 Direct credit of the central bank to the government

In many countries in the past, governments could receive direct credits from the central bank. Under such conditions of "fiscal dominance", the conflicts between monetary and fiscal policy become evident. Governments can use cheap long-term loans from the central bank for financing budget deficits und thus decreasing their cost of borrowing. But as a result, monetary aggregates increase in an uncontrolled manner and the central bank is not able to maintain price stability. Practically all hyperinflations had their roots in excessive borrowing of the government from the central bank. Nowadays this fundamental problem has been widely recognised and in most advanced countries central banks are not allowed to provide direct loans to the government. Rather, government financing requirements have to be conducted at the capital market, based on financing conditions prevailing in these markets.

2.2 Quasi-fiscal activities (QFAs)

At times governments can use the central bank for conducting "quasi-fiscal activities" (QFAs). In such cases, the cost of pursuing certain policy goals is not beard by the government in its budget (as it should), but by the central bank. For example, the government might request the central bank to provide preferential and long-term loans to commercial banks or to selected (state-owned) enterprises. Furthermore, state banks or the deposit insurance fund might be requested to buy government securities at below the market price, under the promise of receiving the corresponding finance from the central bank. A more serious example of QFAs is the direct involvement of the central bank in the bail-out of the banking sector, following a financial crisis. Such involvement – which can comprise various measures - has indeed happened quite often in the past in a number of countries affected by financial and banking crises. All such measures in essence try to achieve policy goals without any direct and visible fiscal cost recorded in the government budget. Instead, the "costs" are passed to the central bank, undermining its financial position and monetary management, which easily leads in turn to high inflation. In principle, QFAs work in a very similar, but much less transparent form than direct loans from the central bank to the government. Furthermore, QFAs make it difficult to assess the stance of monetary policy and can create a lack of confidence of market players in government institutions. Consequently, they should be completely avoided.

2.3 Central bank's profits

Central banks have a legal monopoly for issuing the legal tender. Due to this privilege, central banks make as a rule substantial profits. In the short-run, the more money the central bank issues, the higher its profits are ("inflation tax"). But the goal of central banks is not to maximise profits, but to provide price stability. Profits are purely a by-product of its legal mandate for providing the legal tender. As a result, central banks are not interested in conducting highly expansionary and inflationary policies. But ministries of finance can have a different point of view on this issue. Since large shares of central bank's profits are usually transferred to the

[3] It should be emphasized that this is not an exhaustive analysis of all possible fields of interaction between governments and central banks, but rather a concentration on the core topics. For a more comprehensive analysis see BIS (2003): Fiscal issues and central banking in emerging economies, BIS Papers No 20.

government as its shareholder, ministries of finance regard at times central bank's profits as a "sweet" source of revenue. In times of budgetary problems, government might try to influence the central bank to issue more money in order to increase its profits. Thus, a conflict between the interest of monetary and fiscal policies might arise here.

2.4 Government's account with the central bank

Government's account and overall liquidity management

In order to pursue its goal of price stability, central banks need to manage the overall level of liquidity and short-term interest rates. Funds at the government's account with the central bank cannot be used by the banking sector and thus do not form part of liquidity and monetary aggregates. Consequently, transactions in the government's account with the central bank have an immediate impact on liquidity and on interest rates. All other things equal, when the government deposits[4] large amounts on its account (e.g. due to tax payments), then liquidity decreases and interest rates go up. Such transactions do not pose a problem for liquidity management, as long as they are announced by the government to the central bank sufficiently in advance. In such a case, the central bank can plan and conduct counteracting measures, such as the provision of additional liquidity through different instruments. But when large deposits and withdrawals are not announced at sufficient pre-notice, then the central bank has no time to react. As a consequence, banking balances at the central bank and short-term interest rates become highly volatile, thus creating problems and costs for the refinancing of commercial banks on the interbank money market.

Remuneration of government's deposits and placement of government funds with the banking sector

In some countries governments are very keen to "earn" interests on their free liquidity. This can be achieved by obtaining interest payments from their account at the central bank or by placing free liquidity in the financial sector.

Interest payments on the government's account with the central bank make little economic sense. The payment of say 100 monetary units from the central bank to the government will as a rule lead to a corresponding reduction in the profit transferred from the central bank to the government by also 100 monetary units. Thus, it makes no financial difference to the government. Besides, both the central bank and the government are part of the public sector, which has the task of fulfilling certain goals such as monetary and fiscal stability. Thus, it should not matter who bears how much of the cost of achieving such goals. Distributional issues within the public sector should not play an important role. Thus, the remuneration of government's deposits does not comply with best practice.

A further issue relates to the attempts by some governments to shift interest-free deposits with the central bank towards interest-bearing investments with commercial banks in a discretionary manner and at short-term horizons. Such an action –even if it is conducted in a secured way so that the credit risk will be kept low - would have an impact on the overall liquidity and thus on the monetary base, whose volatility would increase as a result. In such a case the government could create great problems for the central bank to achieve its ultimate goal of price stability.

2.5 Monetary policy and government bonds

The policy of ministries of finance regarding debt issuance and management can have a strong effect on monetary policy. The key issues are as follows. First, when government debt becomes very high (e.g. as a % of GDP), the government has an interest to reduce its debt in real terms by increasing inflation. Thus, the government might try to influence the central bank to conduct an expansionary monetary policy, leading ultimately to higher inflation. Once market players develop

[4] An analogous example could be constructed for withdrawals of funds from the government's account.

higher inflationary expectations[5] in reaction to such pressure, inflation could go out of control.[6] The same could result from the desire of the ministries of finance to limit the cost of borrowing by lobbying for low interest rates, contrary to what is required form the central bank's point of view. Second, the currency and place, in which state debt is issued, can be of high importance. The issuance of debt in foreign currency and abroad (e.g. Eurobonds) leads to capital inflows, which under a fixed or a managed exchange rate can lead to considerably money creation and thus to inflation. Third, in case the government does not maintain a regular issuance schedule on the domestic market, the central bank cannot conduct regular open market operations (buying and selling of government securities on the secondary market) and thus lacks a fundamental instrument for conducting monetary policy. As a result, the central bank might issue its own debt instruments, which in turn pose an "unhealthy" competition with government securities.

2.6 Anti-cyclical macroeconomic policies

Central banks and governments can react to business cycle developments with policy measures, trying to smooth out cyclical variations and keeping output close to its potential. However, the repercussions of measures taken by these institutions can go in opposite directions and create considerably tensions. In case of a recession, the government might want to increase public spending in an attempt to foster aggregate demand. However, the central bank might become worried about the possible inflationary impact of such an anti-cyclical fiscal policy and thus increase interest rates, which would in turn reduce investment and consumption, and thus deepen the recession.

But also in case of high inflation the interests of the government and central bank might diverge. While the central bank might conduct a contractionary monetary policy to combat inflation and reduce the degree of overheating of the economy, the government might fear too strong an impact on the economy and thus counteract with an expansionary fiscal policy, which would in turn fuel inflation. As shown in such examples, there is a need to coordinate macroeconomic policy to avoid contradicting monetary and fiscal policy activities.

As shown above, the policy interactions between central banks and governments are multiple and of a complex nature. The analytical identification of six fields of interaction helps to structure the topic and contributes to a more constructive policy dialogue between these institutions with a view on Ukraine.

3 The current framework for policy interaction in Ukraine: Policy recommendations on selected issues

In Part 2 we identified the most important fields of policy interaction between governments and central banks. Practically all[7] fields are potentially of high importance for Ukraine and might require improvements in the policy framework. But as of today, three of the identified fields feature the highest attention.[8] These concern in detail the deposits of the Treasury at the NBU, the relation between monetary policy and government bonds, and the effective coordination of anti-cyclical policies.

[5] See also Kirchner/Giucci/Suchok/Kusiakiv/Movchan "Inflation Expectations: Importance and Measurement", policy paper PP/02/2008 of the German Advisory Group and the IER Kiev, www.ier.kiev.ua.

[6] This reasoning is the basis for the fiscal Maastricht criteria limiting government debt stock to 60% of GDP and annual budget deficits to 3% of GDP.

[7] One exemption concerns the direct credits from the central bank to the government (Part 2.1). While such credits were the main reason for Ukraine's hyperinflation in the early 90s, changes in legislation in 1999 preclude the NBU from providing any loans to the government (Article 54, NBU Law).

[8] We should however highlight our readiness to conduct further research and policy advice on the remaining fields of interaction, should this be of interest for the relevant institutions in the country.

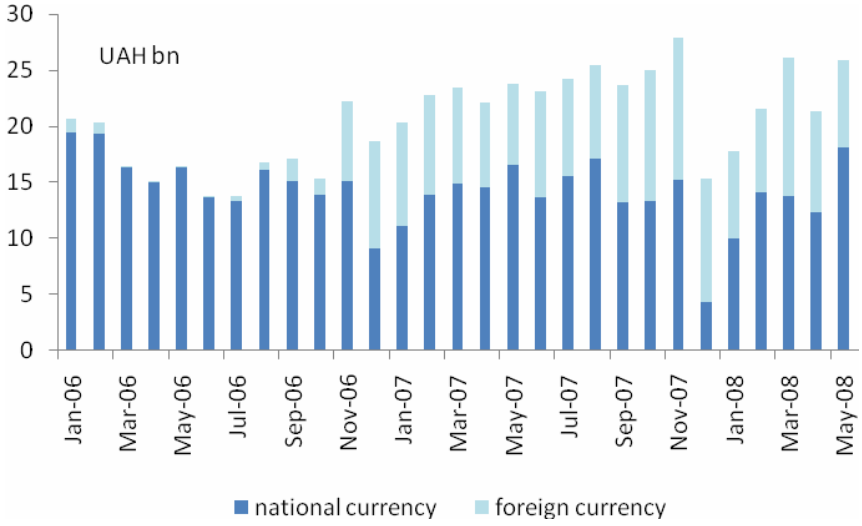
3.1 Government's account at the NBU

Government's deposits and overall liquidity management

The Government of Ukraine keeps its balances at the NBU in a Treasury Single Account (TSA). The corresponding legislation is laid down in the National Bank Law and the Budget Code. The latter prescribes further that a minimum amount of money is required[9], while no over-drafting is allowed. In recent years, relatively high balances on the account have been accumulated, as can bee seen in Figure 1:

Figure 1:

Treasury single account balance in national and foreign currency



Note: data are for the end of each month

Source: NBU, Treasury, own calculations

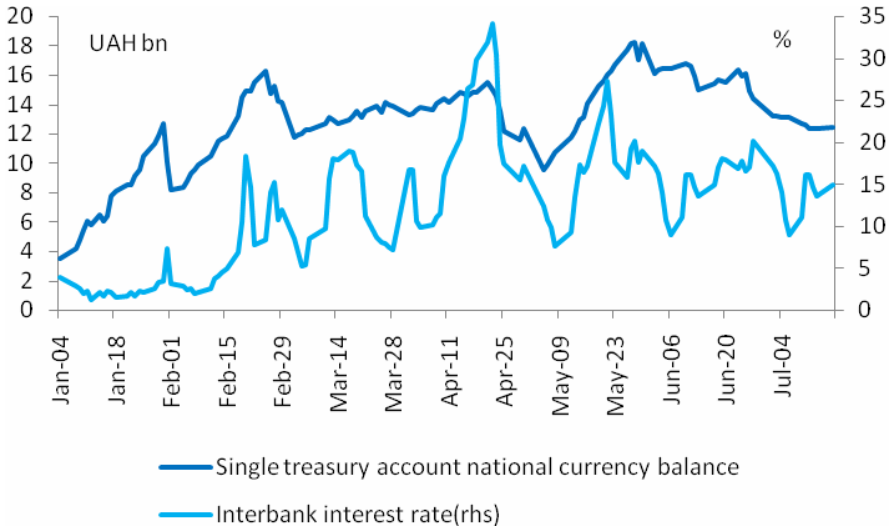
Swift and unpredicted draw downs in deposits may give the NBU no time to react to this, i.e. to sterilize the impact on the monetary base. The result is an unwarranted liquidity expansion, especially if such movements in the TSA are not coordinated in advance.

In the following Figure 2, we show daily dynamics of TSA balances and interbank interest rates over the recent past (2008), in a period where interest rates rose due to tighter liquidity. Here, some simple observations point indeed to periods (e.g. April-May), where sudden changes in the TSA caused fluctuations in interest rates. While other factors affect interbank interest rates, in particular monetary policy, some impact from the TSA can be seen.

[9] The Budget Code foresees since 2004 minimum cash balances of 2% of budget expenditures, which are to be set in each annual budget. However, annual budgets in 2005-2008 set this indicator at 2% of the discretionary budgetary expenditures (i.e. of the expenditures in the general fund).

Figure 2:

TSA and interest rates dynamics in 2008



Source: NBU, Treasury

The problems stemming from this induced interest rate volatility are obvious: Instability at the interbank market translates directly into volatile cost of short-term refinancing for commercial banks. This has a negative effect on the development of the interbank market and on the banking sector in general. Furthermore, policy signals that are intended by the NBU through its monetary policy actions may be biased or blurred in such case, resulting in confusion of market participants about the stance of monetary policy. It has to be stressed that for the conduct of monetary policy, the interbank market is of crucial importance.

In the past, the communication between the Treasury and the NBU regarding these deposits and their possible withdrawals could be described as relatively poor, as only limited institutionalised exchange of information took place. While the Treasury provides the NBU with monthly forecasts of TSA inflows and outflows since June 2005, this information is only of limited use in fine-tuning liquidity operations.[10]

A further improvement could be achieved along the following policy recommendations. In order to minimise the impact of fiscal "surprise" actions on liquidity expansion, the establishment of regular and well-structured institutionalised communication between the Treasury and the NBU seems necessary. Proper mechanisms of coordination and information-sharing agreements are thus called for, especially in the context of an emerging country such as Ukraine, where capacity to correctly forecast government cash flows is limited. This entails a daily information exchange[11] and notification from the Treasury on the planned/projected net activities on the account for the next e.g. 2 weeks. The latter point is important, as only the estimation of net transactions is needed by the NBU. There is no need to pass "confidential" information, on which concrete gross

[10] However, according to the Ministry of Economy a better information exchange on monetary and fiscal policy is available since March 2008, when 1-day advance notice of large TSA withdrawals was introduced. Also monthly forecasts of TSA foreign currency flows where introduced in 2008, as explained in the anti-inflation action plan performance review by the Ministry of Economy "Information on execution of plan in Jan-Jun 2008", posted on its website.

[11] In Slovenia, for example, under a formal agreement between the Ministry and the central bank, the latter is provided with regularly updated forecasts of day-to-day cash flows over 1 and 3-months horizons. Furthermore, in regular working meetings attended by officials technical implementation details are being discussed.

transactions will be conducted and for which purpose. Furthermore, this information exchange should not be limited to one way only, but a bilateral process. In exchange, the NBU can give the Treasury information on its planned monetary policy actions, which could prevent the latter from operating in the same market segment at the same time.

Recommendation 1: Liquidity management by the NBU and cash management by the Treasury needs to be better coordinated, especially at this (early) stage of market development. Therefore, the establishment of regular and institutionalised communication is required, enabling a constant flow of information-sharing and following international best practice.

Remuneration of government's deposits and placement of government funds with the banking sector

As shown in Figures 1 and 2, the Treasury holds currently large amounts of deposits with the NBU. The average opening daily balances in national currency over the first two quarters in 2008 were UAH 12.6 bn, while overall balances (including foreign currency) amounted to UAH 21.5 bn. Following wide international practice in emerging markets, the NBU law (Article 12.11) foresees no interest payments on such deposits. However, the Ministry of Finance plans[12] to place part of these deposits with the commercial banking sector to attract interest payments. The underlying reasoning is stated as follows:

- Additional revenues for the government (due to interest payments).
- Facilitation for the planned introduction of a regular issuance calendar and of a system of primary dealers. Since typically over January-October there is a budgetary surplus, there is no immediate need to issue interest-bearing debt. However, if the money raised can be invested, there is no problem for issuing debt over this period from a purely fiscal point of view.

The obvious credit risk associated with placing government funds with private banks would be mitigated by the use of collateral. This collateral would consist of previously issued government bonds. Using its own debt as collateral can be considered 100% safe for the Ministry of Finance.

The assessment of current plans and the justification brought forward for it points to several weaknesses. While the reasoning is clear, it involves some major problems:

- A fundamental point: the (domestic and foreign) assets that the NBU holds against government deposits are usually interest-bearing, and the profit of the NBU is to be distributed to its shareholder (i.e. the government). Therefore, indirectly, there are already interest payments on these deposits, even though they are not declared as such.
- As of the underlying motivation for the plan to introduce a regular issuance calendar aimed at increasing liquidity on the secondary market and thus decrease cost of borrowing by the government, the situation is as follows. If practically all issued bonds in a month are used as collateral for depositing money with banks, and are not freely circulating in the market, then liquidity will not increase and a primary dealer system cannot work effectively. Thus, the whole reasoning behind a regular issuance calendar falls apart. Rather, it is important that issued bonds can be traded freely among market participants. Only in this way liquidity can be created.
- A placement of funds by the Ministry of Finance in the banking sector has an effect on liquidity and thus monetary aggregates. In this case, the Ministry of Finance would influence the monetary aggregates and liquidity. This would involve a mixing up of responsibilities and is thus not advisable. Conflicts with the NBU could arise especially in periods of monetary tightening (and therefore higher interest rates), when incentives for the Ministry of Finance to place a higher amount of funds increase. However, this would

[12] These plans are also announced in the draft "Concept of domestic sovereign bonds development in 2008-2011" by the Ministry of Finance.

run exactly against the intention of the NBU in monetary tightening and could thus provoke conflicts.

To sum up, we do not recommend going ahead with such plans. Rather, the status quo should be maintained.

Recommendation 2: Although we fully support current plans by the Ministry of Finance to introduce a regular issuance calendar, we recommend that the funds raised should not be placed with commercial banks as it would not allow facilitating the achievement of above-mentioned goal.

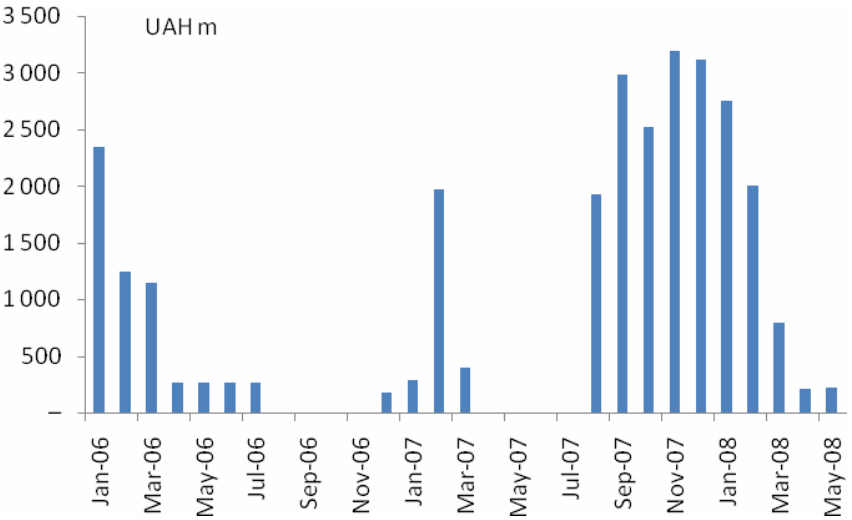
3.2 Monetary policy and government bonds

The monetary stance over the last years under the US dollar-peg was by and large determined by heavy inflows of capital and a corresponding increase in the money supply. The interest rate policy of the NBU was –not surprisingly- not very effective, as loans to commercial banks play only a minor role. In 2007, the NBU funds lent to banks were mostly below UAH 2 bn and provided less then 1% of total bank funding. In early 2008, when liquidity became tighter, NBU loans to banks grew by UAH 2 bn to almost UAH 5 bn in May and June. In May 2008, the NBU provided 98% of excess reserves to banks (defined as bank balances at the NBU less required reserves) and 74% in June as compared to less than 10% in most of 2007. Thus, while the interest rate policy indeed played a minor role before the liquidity squeeze, it developed into an important source of short-term funding.

The conduct of open market operations to mop-up excess liquidity was realistically not possible, because of an illiquid government debt market, where primary issuance is low and secondary market trading is infrequent and price discovery poor. Thus, the main instruments for sterilization purposes (apart from reserve requirements) were Certificate of Deposits (CDs). Before September 2007, the NBU issued exclusively overnight CDs at 0.5% interest rate and 14-day CDs at 1%. After inflation picked up, NBU started to issue CDs more actively, with interest rates of up to 8% and maturities of up to 90 days. From the end of 2007 onwards, banks gradually lost interest in CDs as interest rates picked up and liquidity became tighter, as can be seen in Figure 3.

Figure 3:

CDs outstanding



Source: NBU

In principle, own instruments like CDs are important elements in the toolbox of a central bank such as the NBU. International experience shows that many countries have such instruments, and frequently use them for regulating liquidity. However, since the existence of CDs alongside government bonds implies also a competition between sovereign issuers, this co-existence might also lead to crowding-out issues and less liquidity in each segment. Some international evidence shows that this theoretical argument is indeed valid from an empirical point of view[13].

Once the secondary market for government bonds becomes more liquid, the need for issuing CDs and thus the unwelcome competition would decrease significantly. Using only one instrument (bonds) for sterilization purposes would increase liquidity further and both institutions would potentially benefit from this. A liquid government bond market would thus facilitate the conduct of monetary policy, which could be executed smoothly without moving market prices and yields. Despite this fact, the NBU should maintain its right to issue CDs, because this instrument could help under certain conditions to combat inflation. However, in order to avoid debt fragmentation and thus direct competition, the maturity spectrum of NBU issued CDs and Ministry of Finance issued government bonds should be kept different.

Recommendation 3: The NBU should reduce the issuance of own CDs once the secondary market for government bonds becomes more liquid. Nevertheless, the NBU should keep this instrument in its toolbox, but restrict its issuance to the short end of the yield curve, which is not covered by Ministry of Finance issues.

A further step for reducing the competition between the NBU and the government for investors' money involves the securitisation of the government debt held by the NBU. This measure would provide the NBU with an effective instrument to fight inflation, while the budgetary implications for the government would be relatively small.[14] The recently presented draft laws[15] to the Verkhovna Rada on amendments to the Budget Law 2008 contain indeed such a clause, which in our view are a great step forward. Now it is in the hand of the parliament to decide upon this, which we strongly encourage.

Recommendation 4: The government debt held by the NBU should be securitised, also to reduce the competition between NBU and government on domestic capital markets. The securitization proposals currently foreseen in the draft laws on budget amendments 2008 are a right step in this direction.

Despite recent changes in monetary and exchange rate policy[16], the NBU will most likely continue to intervene in the foreign exchange market in the coming years, in order to limit exchange rate volatility during the transitional path towards inflation targeting. Under such circumstances, the currency denomination and the place of issuance of government bonds can influence monetary policy. If the government issues bonds in foreign currency abroad (usually Eurobonds), then the NBU might decide to increase interventions on the foreign exchange market in order to avoid too large an appreciation of the hryvnia. But because of the implied money creation, this would fuel inflation. In case bonds are issued domestically and bought to a large extent by domestic investors, the inflationary effect would much weaker. But on the other hand, on many occasions the Ministry of Finance might be interested in issuing Eurobonds, for example because of perceived cost advantages over domestic issuance.

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[13] See BIS (2005): Foreign exchange market intervention in emerging markets: motives, techniques and implications, BIS Papers No 24, p. 73.

[14] See Kirchner/Giucci/Kravchuk: Changing the Status of Government Debt to the NBU: Policy Options, policy paper W2 of the German Advisory Group and the IER Kiev, June 2007, www.ier.kiev.ua. For the budgetary implications of the securitisation of the debt, see Kirchner/Giucci/Kravchuk: Changing the Status of Government Debt to the NBU: Budgetary Implications, policy paper W6 of the German Advisory Group and the IER Kiev, September 2007, www.ier.kiev.ua.

[15] The section on debt securitisation is included in both (competing) draft laws by the Cabinet of Ministers (No.2713) and the President (No.2713-1).

[16] Regarding exchange rate policy in Ukraine see Giucci/Kirchner/Kravchuk: Learning to float: Recommendations on exchange rate policy in Ukraine during the transition period towards inflation targeting, policy paper PP/01/2008 of the German Advisory Group and the IER Kiev, June 2008, www.ier.kiev.ua.

The competence for decisions regarding the place and currency denomination of government bonds lies, as it should, exclusively with the Ministry of Finance. But it would make sense for Ministry of Finance to discuss issuing plans with the NBU, especially when the rate of inflation is very high. The Ministry of Finance might in view of the rampant inflation decide to accept higher interest rates in order to support fighting inflation. In fact, the "anti-inflation programme" jointly agreed upon by the NBU, the Ministry of Finance and the Ministry of Economy in March 2008 foresees no issuance of Eurobonds for the reasons explained above. But because of the rather comfortable budgetary situation in Ukraine, practically no bonds were issued this year. However, the recent plans to issue a Eurobond - even though postponed due to increased cost of borrowing at international markets - run against the declared intentions in the "anti-inflation programme".

Recommendation 5: The debt issuance policy of the Ministry of Finance, especially with regard to domestic/foreign issuance, should take into account its impact on monetary policy. A regular exchange of views with the NBU should be introduced and institutionalised, especially under the current rampant inflation.

3.3 Conducting effective anti-cyclical macroeconomic policies

In Part 2 it was argued that the right policy mix is needed to ensure a smooth and non-inflationary path of economic growth along its potential. Currently, Ukraine experiences a period of high inflation, which is the main economic problem today. In part, this originates from an overheated economy, where aggregate demand exceeds aggregate supply by a wide margin.

In the present situation, the application of joint anti-cyclical policies is urgently required, i.e. a consistent policy-mix is called for. If policy makers are able to coordinate their actions effectively, the resulting (short-term) burden will be distributed among many shoulders. This was - and still is - the original idea of the "anti-inflation programme" jointly agreed upon by the NBU, the Ministry of Finance and the Ministry of Economy in March 2008.

Otherwise, if no coordination would take place but rather divergent policy objectives pursued, this implies that one institution (i.e. the NBU) would need to tighten more than otherwise necessary. This could further lead to the situation that specific (interest-rate sensitive) sectors of the real economy (e.g. construction) are temporarily hit harder by this asymmetric policy tightening, a fact that can be avoided by choosing the right policy mix. Furthermore, uncoordinated actions cause normally a loss of credibility, which fails to stabilise inflation expectations, which in turn further drive inflation. The same can be said about short-sighted administrative measures, which tend to postpone the problem to the future, rather than to solve it at its root.

Although it is difficult to precisely evaluate the degree of consistency of the policy-mix that we currently observe in Ukraine, the asymmetry in tightening efforts seems indeed to be present, as the evaluation of the actions undertaken by different branches of the public sector signal. Right now, monetary policy has taken over the lead in tightening, while other institutions are lagging behind. In particular, fiscal policy remains expansive, as shown by the government's draft amendments to the Budget 2008, which were presented to Parliament recently. However, even now, and recognizing that the NBU's measures are under criticism from several sides, it is subject to debate if the tightening efforts by the NBU are sufficient.[17]

Recommendation 6: A consistent policy-mix, which balances the tightening efforts among several institutions, is required to tackle current high inflation in Ukraine. Otherwise, uncoordinated and larger than otherwise required efforts will put a high burden on specific sectors of the economy.

4. Conclusions

The framework for policy interaction between the government and the NBU has improved dramatically since Ukraine's independence. The days of direct lending from the NBU to the

[17] In a forthcoming policy paper, we plan to assess the current stance of monetary policy. This paper will attempt to answer the question whether the monetary tightening observed in the first half of 2008 is sufficient.

government in the early 90ies, which ended in hyperinflation, are gone for good. But despite this positive assessment, the policy framework in Ukraine should be further improved. In this paper, we identified a number of issues where such improvements promise immediate economic gains. This concerns the government deposits with the NBU, with the competition between securities issued by the government and the NBU, as well as with the effective coordination of macroeconomic policy. The importance of a better coordination of monetary policy and fiscal policy can be easily illustrated when looking at the current efforts in the country to fight rampant inflation. While monetary policy has become more restrictive (as it should), fiscal and wage policies remain expansionary. In such a way, the burden for fighting inflation is not evenly distributed within the public sector. This makes inflation fighting less effective and creates imbalances in the economy.

Further research might be necessary in other fields of policy interaction, which we have not looked at in detail. In particular, the distribution of the profits of the National Bank might be important fields for further institutional improvement.

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