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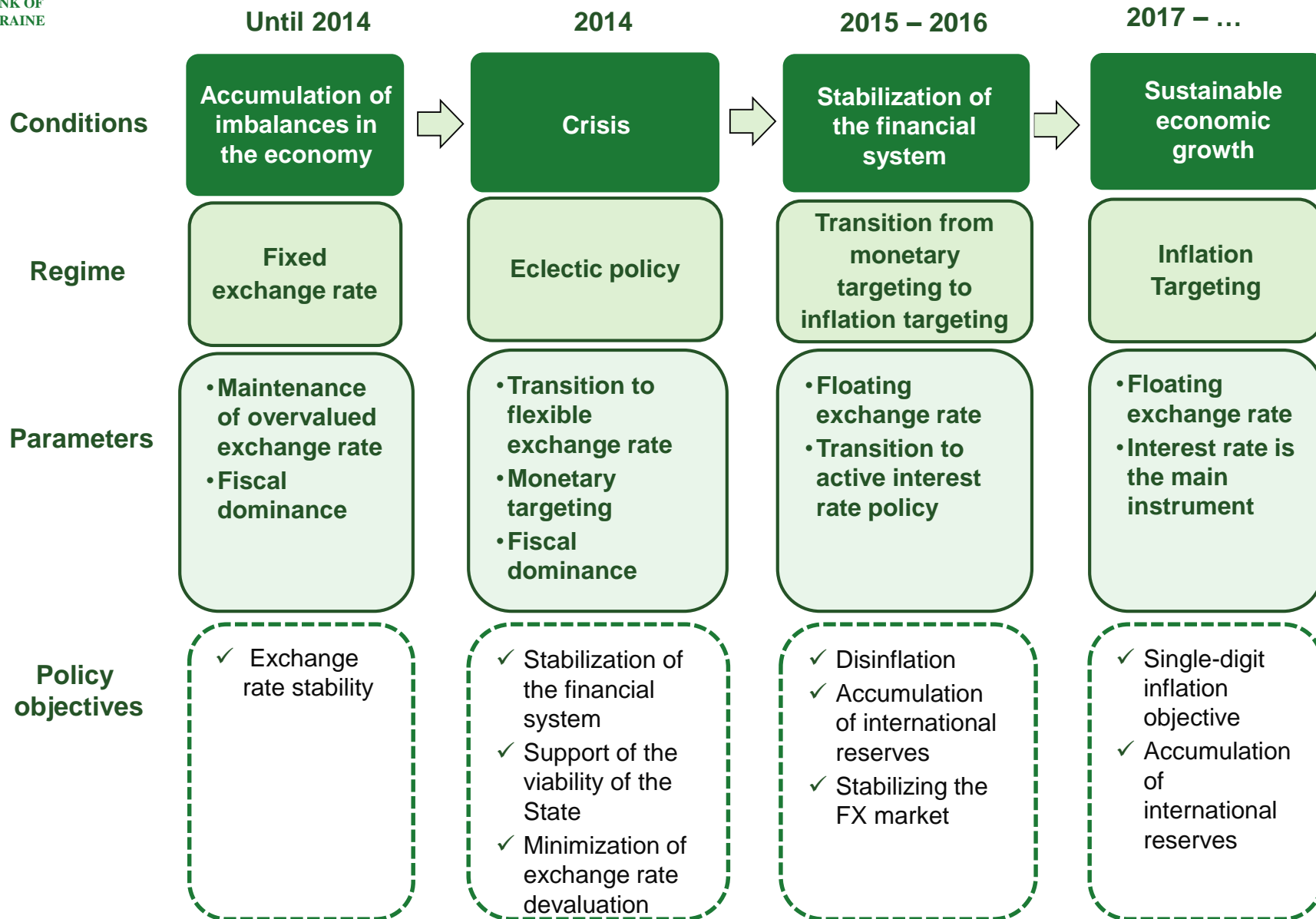
Road Map for Implementation of Inflation Targeting in Ukraine



National Bank of Ukraine, Kyiv
16 March 2016



Evolution of monetary policy regimes in Ukraine





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Transition to inflation targeting is a response to the shortcomings of other regimes

Reasons for transition to inflation targeting regime:

- ❖ Inability to use exchange rate as nominal anchor – because of economic overheating or exhaustion of international reserves
- ❖ No stable relationship between money growth and inflation – ineffectiveness of monetary aggregates objectives
- ❖ Necessity for fast disinflation
- ❖ Strengthening of the central bank's independence and elimination of fiscal dominance

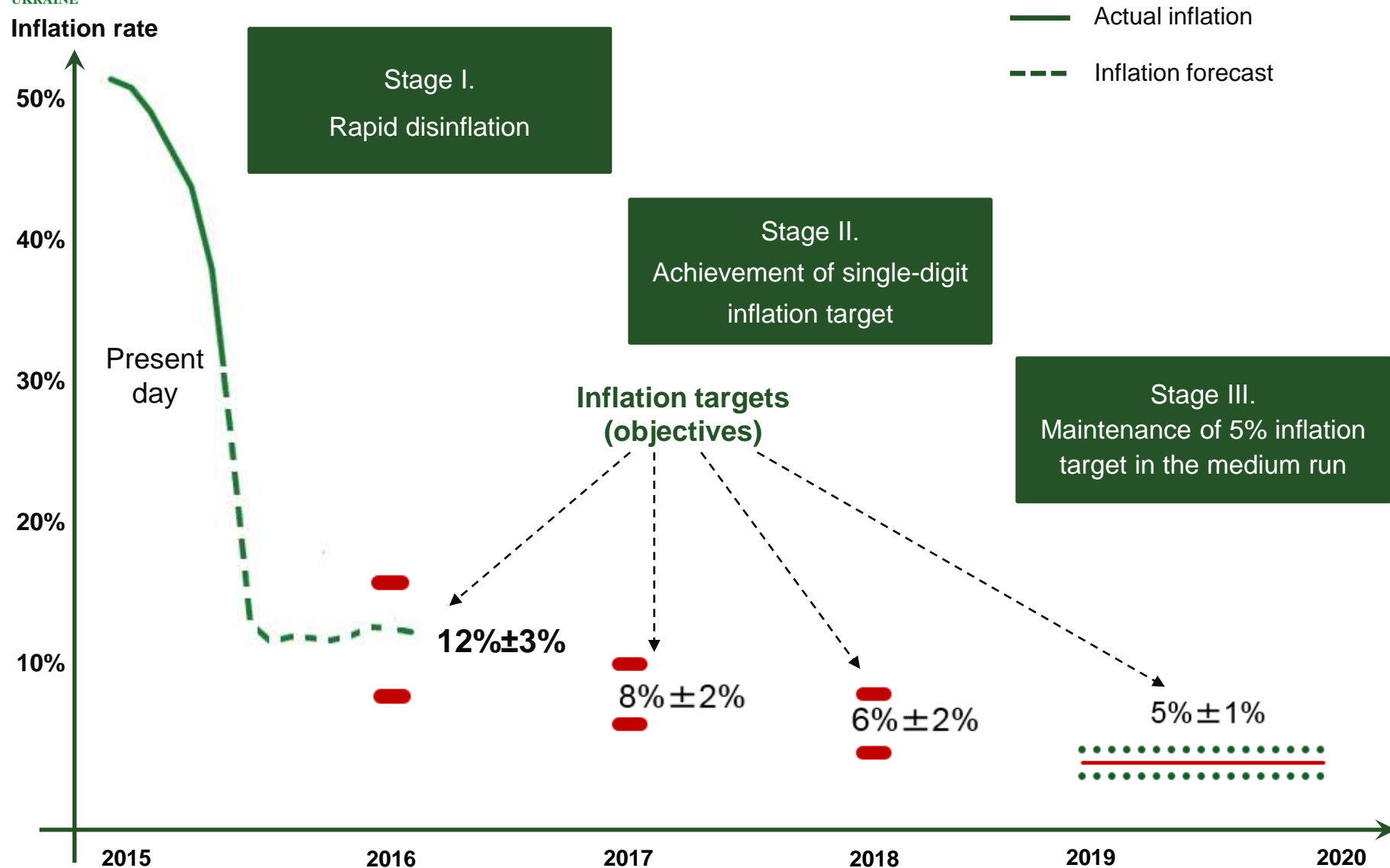
Countries with Inflation Targeting





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The main goal of monetary policy is achievement of price stability





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Required preconditions for functioning of the inflation targeting regime

**Crucial
at the
transition
stage**

Price stability as the main goal of monetary policy

Instrumental independence of the central bank

No fiscal dominance

**Required
for
successful
functioning**

Accountability, predictability, and transparency of policy

Comprehensive analytical support of monetary policy decisions

Efficient instruments for policy implementation

Developed financial markets

Reasonably stable financial institutes

Complete

Almost complete / some
improvement is needed

Low readiness / long-lasting
development is needed



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Comparative analysis of preconditions for implementation of inflation targeting

Country (inflation targeting adoption date)



CPI (average for 5 years before/after inflation targeting adoption)

Before After

- Ukraine
- Philippines (2002)
- Israel (1997)
- Czech Republic (1998)
- Peru (2002)
- Hungary (2001)
- Korea (1998)
- Brazil (1999)
- Chile (1999)
- Thailand (2000)
- Poland (1999)
- Colombia (1999)
- South Africa (2000)
- Mexico (2001)

Before	After
6,6	4,4
11,3	4,4
8,7	4,6
5,0	1,9
12,3	4,8
5,0	3,5
19,3	8,7
7,7	3,2
5,1	1,7
21,3	5,1
20,3	8,3
7,4	5,5
19,4	4,9

Ideal conditions

(0 – poor; 1 – ideal for each of the four categories of initial conditions)



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Preconditions and current conditions – comparative analysis before and after inflation targeting adoption

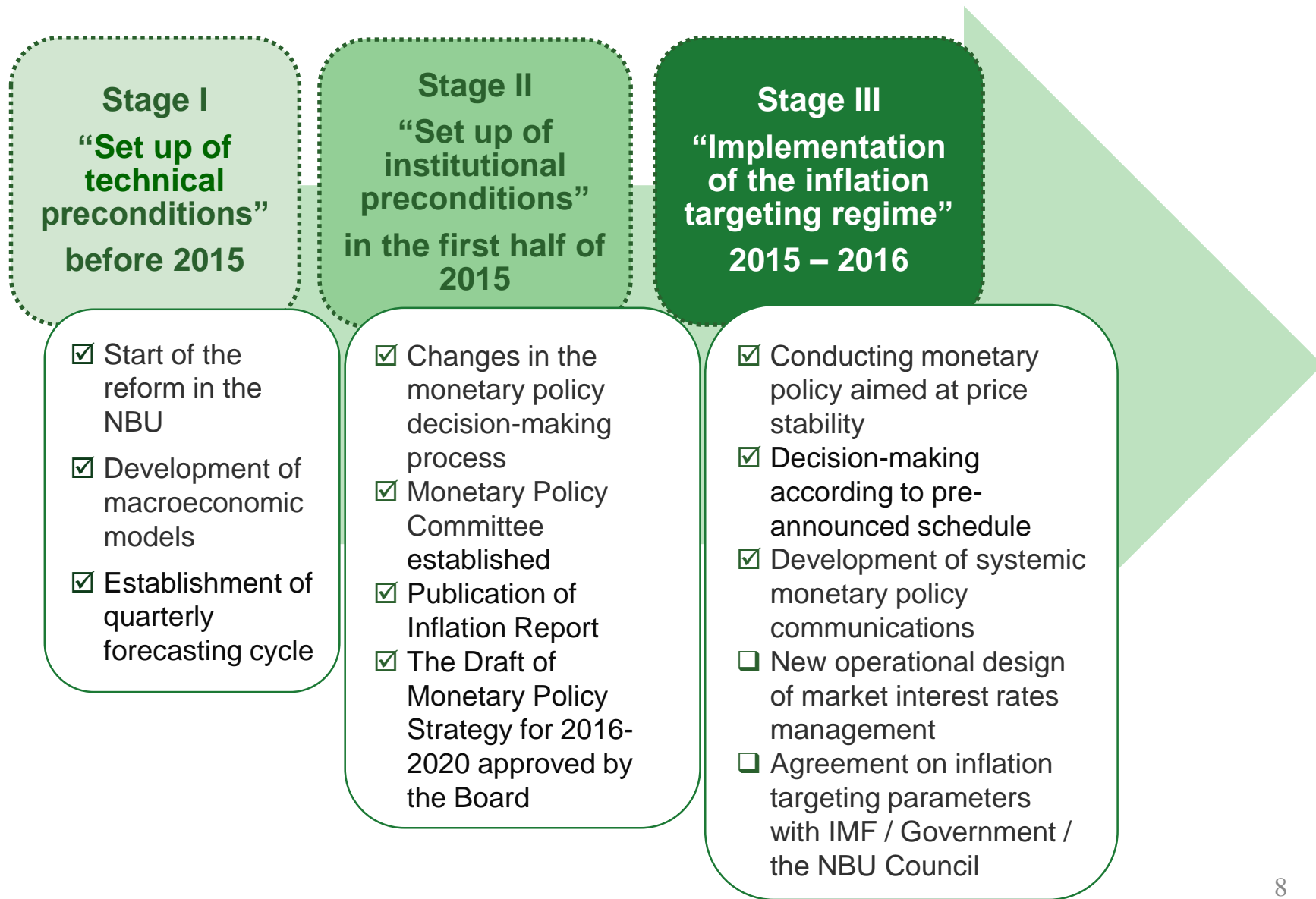
1 = best current practice

	Emerging markets		Developed countries	
	Before IT	Current	Before IT	Current
Technical infrastructure	0,29	0,97	0,74	0,98
Data availability	0,63	0,92	0,84	0,94
Systematic forecast process	0,10	1,00	1,00	1,00
Models capable of conditional forecasts	0,13	1,00	0,38	1,00
Financial system health	0,41	0,48	0,53	0,60
Bank regulatory capital to risk-weighted assets	0,75	1,00	0,75	1,00
Stock market capitalization to GDP	0,16	0,21	0,28	0,44
Private bond market capitalization to GDP	0,1	0,07	0,40	0,31
Stock market turnover ratio	0,29	0,22	0,28	0,35
Currency mismatch	0,92	0,96	1,00	1,00
Maturity of bonds	0,23	0,43	0,46	0,52
Institutional independence	0,59	0,72	0,56	0,78
Fiscal obligation	0,77	1,00	0,75	1,00
Operational independence	0,81	0,96	0,63	1,00
Central bank legal mandate	0,50	0,62	0,16	0,44
Governor's job security	0,85	0,85	1,00	1,00
Fiscal balance in percent of GDP	0,48	0,47	0,45	0,78
Public debt in percent of GDP	0,47	0,47	0,53	0,54
Central bank independence	0,26	0,64	0,44	0,72
Economic structure	0,36	0,46	0,47	0,55
Exchange rate pass-through	0,23	0,44	0,31	0,50
Sensitivity to commodity prices	0,35	0,42	0,44	0,56
Extent of dollarization	0,69	0,75	1,00	1,00
Trade openness	0,18	0,21	0,13	0,16

Source: World Economic Outlook, September 2005: Chapter 4. Does Inflation Targeting Work in Emerging Markets?



Stages of transition to inflation targeting regime





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What should be done to meet preconditions for successful functioning of inflation targeting in the next 12-18 months

Area

Expected outcome

1 Institutional capacity

Successful coordination between authorities influencing effectiveness of the inflation targeting regime

2 Monetary policy objectives and implementation

Harmonization of instruments, mechanisms and procedures with inflation targeting practice

3 Monetary policy decision-making process

Strengthening the analytic support of decision-making

4 Communications and transparency

Improving public's awareness and understanding of the NBU's monetary policy

5 Financial sector development

Improving effectiveness of monetary transmission mechanism



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Successful coordination between authorities influencing effectiveness of the inflation targeting regime

Institutional capacity

Monetary policy objectives and implementation

Monetary policy decision-making process

Communication and transparency

Financial sector development



Already exists

- De-facto announcement of inflation targets
- Elimination of fiscal dominance combined with prudent fiscal policy
- Central bank independence
- Legal mandate to achieve price stability
- “Political will” inside the NBU regarding implementation of inflation targeting

In process

NBU Council

- Cooperation on monetary policy strategy issues (formalization of inflation targeting regime)

Government

- Prudent fiscal policy
- Cooperation in forecasting process
- Policy coordination
- Development of market for Government bonds

IMF

- Modification of program conditionality – inclusion of inflation rate as a performance criteria

Ukrstat

- Improvement of methodology for calculation of inflation rates



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Harmonization of instruments, mechanisms and procedures with inflation targeting practice

Institutional
capacity

**Monetary policy
objectives and
implementation**

Monetary policy
decision-making
process

Communication
and
transparency

Financial
sector
development



**Already
exists**

- Clear distribution of responsibility between departments in decision-making process
- Capacity to influence short-term interbank market interest rates
- Flexible exchange rate
- Introduction of foreign currency auctions to smooth excessive exchange rate fluctuations

In process

Specification of Monetary Policy Strategy provisions

Improvement of the NBU's internal procedures, mechanisms, and instruments according to inflation targeting practice

Introduction of new operational design for interest rate policy

Converging the key policy rate with main liquidity management operations and aligning the corridor of interest rates on standing facilities to it

Development and introduction of strategy for capital account liberalization

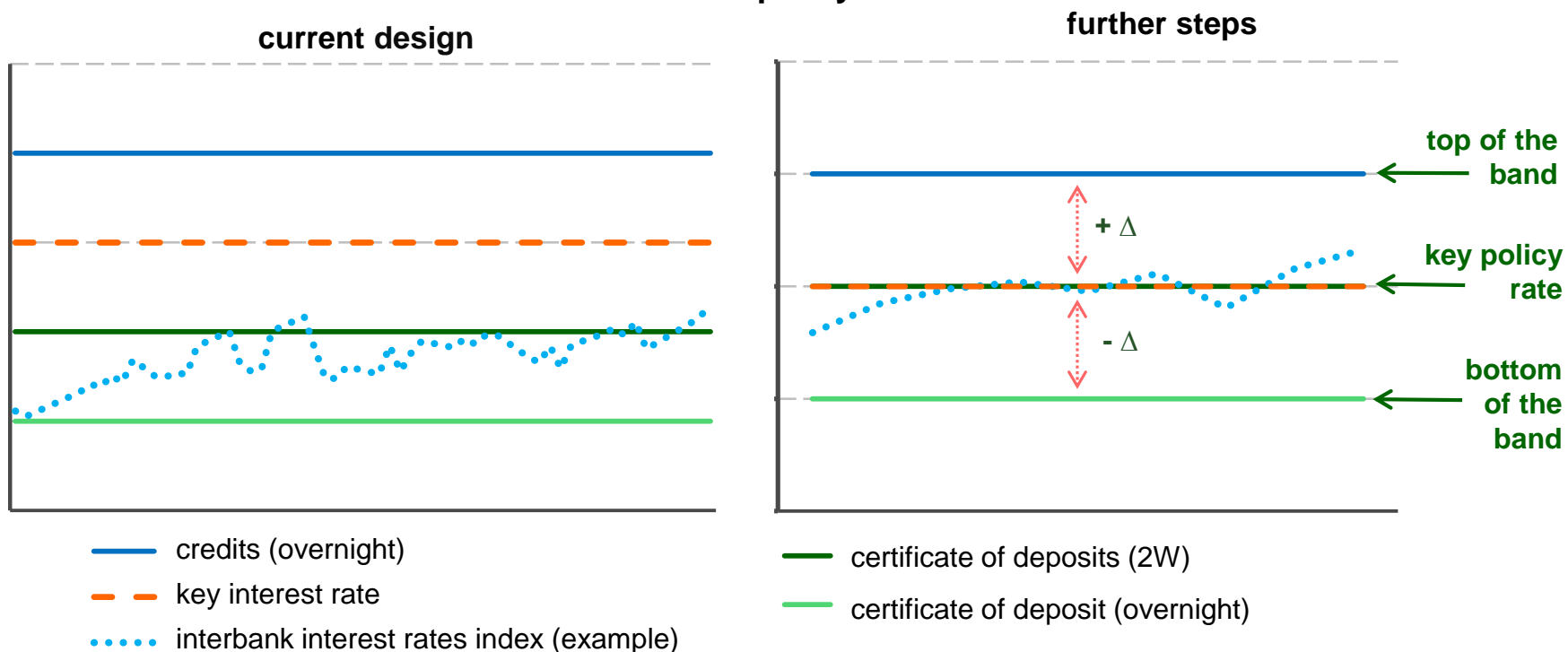
Phased revocation of temporary restrictions. Gradual liberalization according to EU standards



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Key interest rate is a main monetary policy instrument

Interest rate policy of the NBU



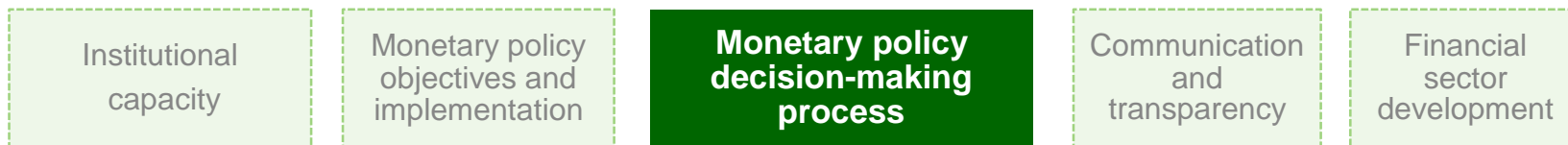
Transition to the new operational design of the interest rate policy considers:

- Determination of the key interest rate as an interest rate for main liquidity management operations (currently – CD of the NBU);
- Narrowing the corridor of interest rates on standing facilities around the key interest rate;
- All other operations (except main operations and standing facilities) will be performed in a price-taking manner to smooth sizable liquidity fluctuations and to promote financial market development.



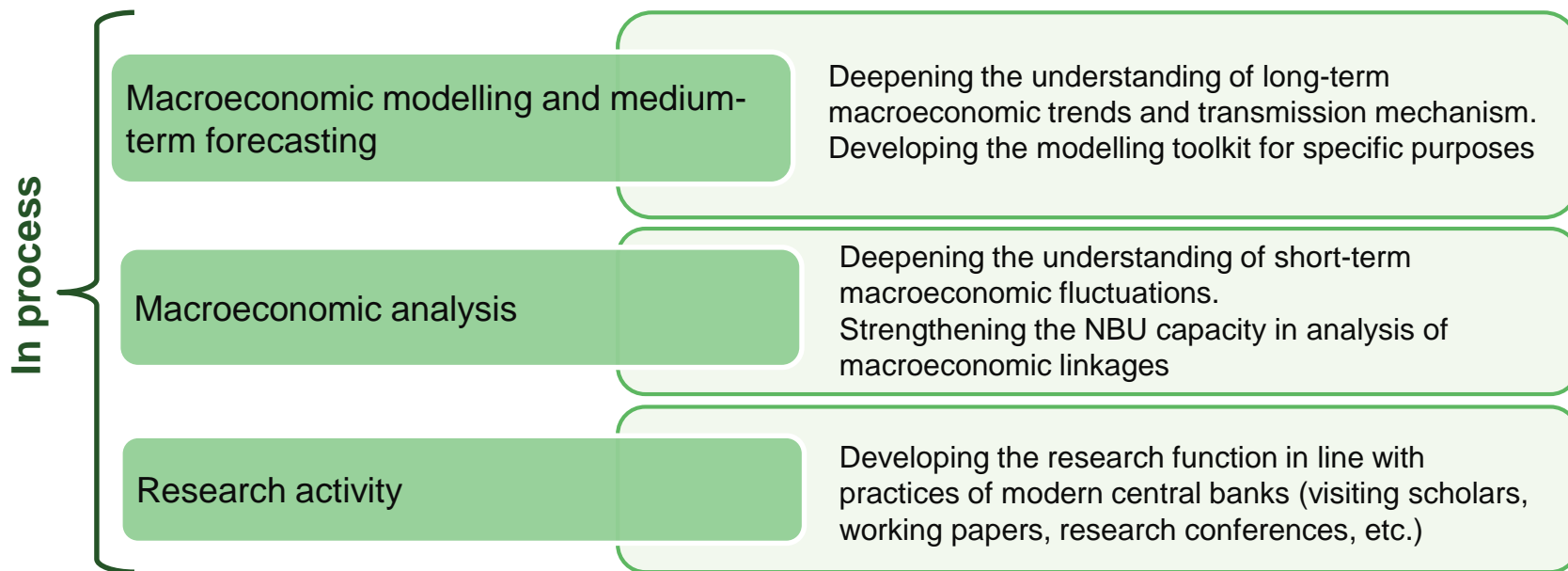
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Strengthening of the analytic support of decision-making



Already exists

- Decision-making procedures are formalized (MPC and Board meetings on monetary policy issues are established)
- Analytic support of monetary decisions is strengthened
- Statistics compilation process is centralized
- Reforming the NBU research activity is started (Visnyk of the NBU, open research seminars)





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Raising public awareness and understanding of the NBU's monetary policy

Institutional
capacity

Monetary policy
objectives and
implementation

Monetary policy
decision-making
process

**Communication
and
transparency**

Financial
sector
development



**Already
exists**

- Routine cycle of communications events regarding monetary policy decisions
- Inflation Report and comments on inflation are published
- Public events with different target groups (experts, business, students, etc.)
- Creating and backing “Monetary policy” section on the official NBU website

In process

Increasing the NBU's transparency and public's understanding of monetary policy

Updating the official NBU website for increasing availability of information regarding monetary policy and macroeconomic trends.
Improving the financial literacy of the public

PR support of official transition to the inflation targeting regime

Information campaign to explain the features and advantages of the new monetary regime to the public



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Improving of monetary transmission mechanism effectiveness

Institutional
capacity

Monetary policy
objectives and
implementation

Monetary policy
decision-making
process

Communication
and
transparency

**Financial sector
development**



**Already
exists**

- Completion of the main phase of banking system clean-up
- Development of the yield curve (including the MoF's return to the domestic government debt market)
- Introduction of the Ukrainian index of interbank interest rates (UIIR)

In process

Development of the government
bonds market

Development of primary and secondary bonds markets.
Further development of the yield curve

Development of the interbank credit
market

Liquidity forecast publication.
Derivatives market development

Improvement of the foreign exchange
market functioning

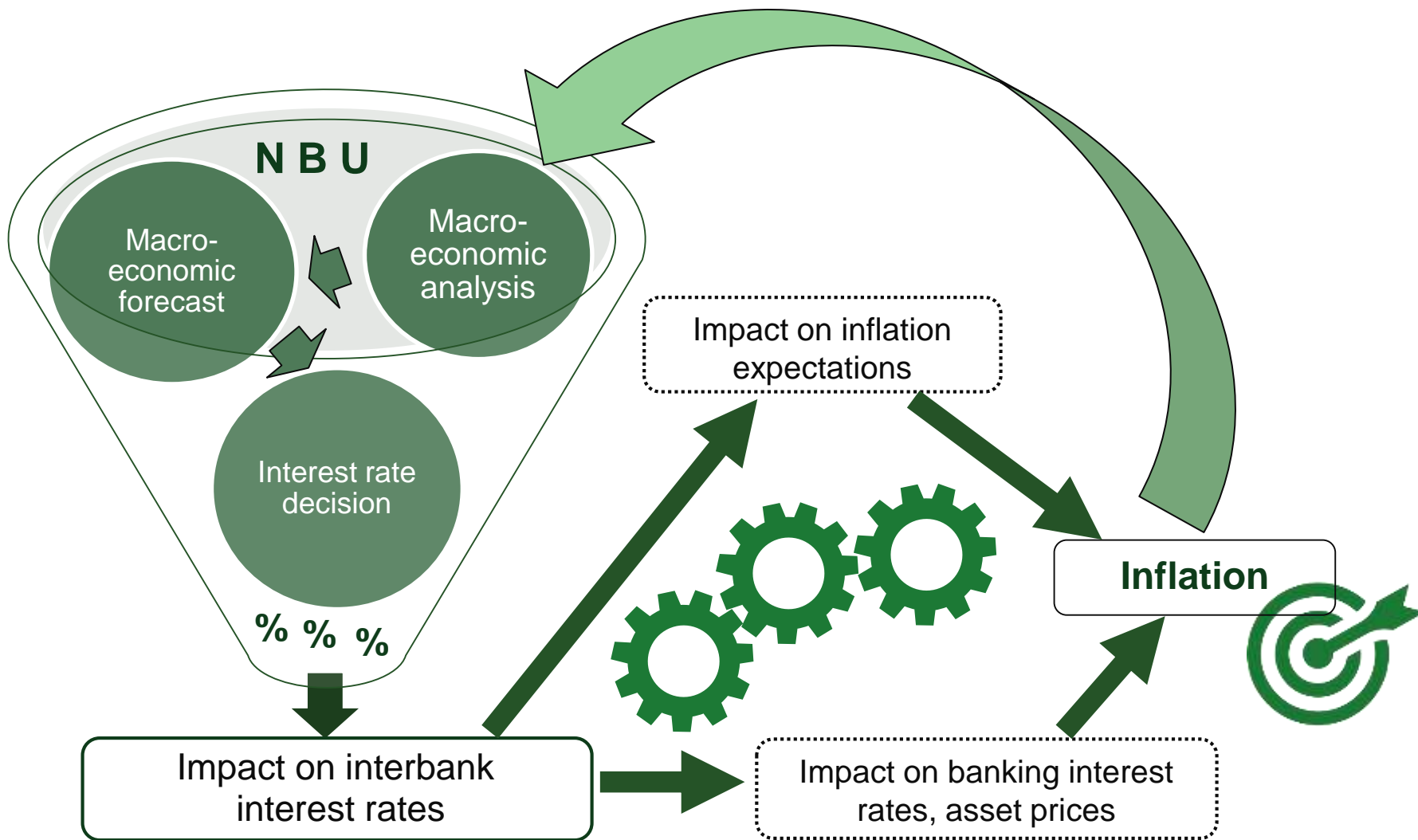
Lifting the administrative restrictions.
Revision and liberalization of the capital account.
Development of hedging instruments

Resetting the banking sector

Completion of bank recapitalization process.
Decrease in operations with related parties.
Full information disclosure concerning banks' ownership structure.
Ensuring creditors, consumers, and investors rights protection.
Restoring confidence in the financial system



Impact of the key policy rate changes on inflation





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Actions for reaching inflation targets (12% at the end of 2016 and 8% at the end of 2017)

Conducting interest rate policy, consistent with inflation targets

Maintenance of hryvnia inherent value owing to relatively high interest rates (tight monetary policy)

Smoothing the excessive exchange rate fluctuations

FX interventions will be used to smooth exchange rate fluctuations without resistance to fundamental appreciation / depreciation trends

No fiscal dominance

Monetary policy is aimed exclusively on price stability objectives, preventing use of money-printing for financing the fiscal and quasi-fiscal needs

Prudent fiscal policy

Reasonable budget deficit.
Social payments increase according to the plan

Bringing administered prices to fair market values

Elimination of quasi-fiscal imbalances.
Increase in administered prices according to the schedule



Resuming cooperation with the IMF
Conducting structural reforms

