Challenges for Monetary Policy of EM Central Banks in the Current Environment: Case of Ukraine

Speaking points by Mr Dmytro Sologub, Deputy Governor at the National Bank of Ukraine, at the 7th Central and Eastern European (CEE) Investment Conference*, Ljubljana, 5 October 2018.*

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Introduction

Good morning, ladies and gentlemen. I would like to thank the organizers for inviting me to speak at this wonderful and interesting event, which also makes me feel like an integral part of the worldwide CFA community: I really appreciate that.

I'm going to talk today about the challenges currently faced by the central banks of small open EM economies with floating exchange rate regimes. And I find it rather symbolic that I'm making this speech here in Ljubljana – the capital of the country that was the first in our region to escape from such challenges by entering a monetary union. This move in turn apparently created a lot of other challenges, about which my colleague from the Bank of Slovenia has just spoken.

It's also interesting to note that if I had made this speech twelve months ago, the synopsis would have been completely different. As you may recall, until the spring of this year, the EM economies had been enjoying a long period of strong capital inflows and improving economic performance. In this environment, most of the EM central banks were in a relaxed mode – both in terms of their policy stance and mental condition.

However, 12 months on we are in the completely different world. In the last few months, emerging economies have faced tightening external financial conditions amid expected monetary policy normalization in advanced economies, a stronger dollar, growing trade tensions, and escalating geopolitical risks.

At the same time, not all EM's have been equally unfortunate - foreign and local investors have treated countries differently, with the more acute effects being seen in those countries beset with more evident vulnerabilities, and with central banks that are clearly deviating from the conventional policy toolkit. However, today even the essence of conventional (orthodox) monetary policy remains an open issue. In particular, the trilemma orthodoxy, under which capital mobility and floating exchange rates allow monetary policy autonomy, has recently been challenged by an alternative view that is currently gaining popularity. Rey (2013) argues that in times of high capital mobility, floating exchange rates provide much less autonomy than commonly thought. At the same time, a recent IMF paper shows that exchange rate regimes do matter, and countries with fixed exchange rate regimes are more exposed to financial vulnerabilities – faster domestic credit and house-price growth, and increases in bank leverage – than those with relatively flexible regimes (Obstfeld et al, 2017). Thus, the paper provides arguments for an independent monetary policy aimed at domestic targets – inflation and economic activity.

Another controversial topic is the need to account for financial stability issues when monetary policy decisions are taken. The 2015 IMF Staff Report on Monetary Policy and Financial Stability (Habermeier et al 2015) provides an excellent summary of the arguments for and against using policy rates to lean against the wind of excessive financial growth.

Thus, I will consider and discusses the three lines of defense against this challenging external environment, namely 1) orthodox monetary policy, meaning an interest rate policy directed at achieving declared inflation targets, 2) FX interventions, and 3) capital controls. Also, I will put special focus on CB communications, which could also be added to the toolkit of the CB.

And I also would like to note that my home country Ukraine provides a rather good case study on this topic. Following the devastating crisis of 2014-15, generated not only by external military aggression but also by the bursting of domestic economic imbalances that had built up for years, the monetary policy of the central bank was revamped completely, with a transition from a fixed ER regime to inflation targeting, the strengthening of the NBU's independence, and the enhancement of communication policies.

Despite there being a notable improvement in economic indicators over the last few years, Ukraine's economy remains highly vulnerable to external shocks amid a challenging external repayments schedule, relatively low reserve adequacy, high (but falling) inflation rates, and a fragile financial sector. However, the country has been fairing pretty well so far in the latest EM turmoil as, for example, the local currency, the hryvnia, has been one of the best performers against the US dollar in the EM universe this year. So, in the course of this presentation I will repeatedly draw on the experience of Ukraine's National Bank over the last few years.

The first line of defense is orthodox monetary responses

The situation that the emerging markets face now is stagflationary: capital outflows lead to depreciation pressure on national currencies and put a drag on economic growth. In these circumstances, the central banks face the classic short-term tradeoff between fighting inflation and supporting economic activity.

From the central banks' perspective, it is crucial to show commitment to price stability, especially when monetary policy is conducted under an inflation-targeting framework.

A trustworthy and durable policy framework needs to be sustainable over time. Adherence to goals, targets, and commitments is at the heart of such sustainability. The NBU has declared that its inflation targets won't be changed. A central bank shouldn't adjust its targets due to shocks hitting the economy. Otherwise, it will lose credibility through the continual erosion of expectations. The case of the central bank of Argentina, which increased its inflation target last year, is an obvious example.

However, a central bank is expected to deliver policy actions in reaction to shocks and risks. In such a way, it creates the predictability of its policy in an uncertain environment.

Thus, raising interest rates or delaying cutting them in an easing cycle seems to be a reasonable response. This helps not only to attract short-term capital, but also to boost the credibility of a central bank. This is especially important in cases when such credibility is still not perfect.

In addition, the impact of exchange rate devaluations on economic activity in emerging markets under conditions of high dollarization is not obvious. As a result, a central bank's reluctance to raise interest rates in order to defend the value of the national currency may produce even more harm to economic activity through the effects on the balance sheets of companies that are heavily indebted in foreign currency.

Certainly, the final calibration depends on the individual characteristics of a country.

Let us illustrate such an approach using the Ukrainian example.

From October last year to September this year, the National Bank of Ukraine raised its key policy rate from 12.5% to 18% in six moves, reacting to resurging domestic price pressures and looming external risks. In real terms, the key policy rate increased to 8-9 percent, significantly exceeding ones in peer economies.

As a result, trends on the FX market reversed at the beginning of the year and the exchange rate started to appreciate. Additionally, the Ukrainian financial markets operated surprisingly smoothly during the recent episodes of international turbulence and emerging-market selloffs. Definitely, favorable terms of trade, growing remittances and some seasonality in FX flows also contributed. While some depreciation pressure has reappeared recently, and the Ukrainian currency lost its crown as the best performer against the USD among the emerging-market currencies, at the end of July it remained 4.7% stronger against the USD compared to the beginning of the year. One should also take into account the still quite challenging domestic and external environment.

But it is not enough to take proactive and forward-looking decisions on the key policy rate. A central bank needs to effectively transmit these moves to the financial system. In some cases, central banks have an ineffective or artificially sophisticated operational design of their monetary policy, which prevents them from achieving this. Usually, such flaws are caused by a lack of operational independence or a desire to achieve multiple but inconsistent objectives. The NBU before 2015 could be seen as an example of such operational ineffectiveness, as the key policy rate had only a symbolic role and monetary policy lacked a signaling function. However, in 2015 the NBU switched to a new operational design of its interest rate policy that is quite simple but effective in steering money market interest rates. This reform made the key policy rate an important variable for the market, and its signaling role is now working at full capacity. Much still remains on the agenda for strengthening monetary transmission, including a banking sector revamp, FX liberalization, an overhaul of the local bond market, and so on. But without setting up this first part of a monetary transmission mechanism, the mission would be impossible.

The second line of defense is FX interventions

For many years, a floating exchange rate has been regarded as the cornerstone of an inflation targeting framework and a buffer for the economy. The rationale for this was quite clear: there is a risk that manipulating an exchange rate could undermine the credibility of the declared nominal anchor, i.e., an inflation target. In fact, inflation targeting emerged as a response to the negative experience of using an exchange rate as a nominal anchor, which in many cases resulted in the accumulation of macroeconomic imbalances and a loss of credibility. FX interventions were practically prohibited and used only in exceptional cases.

After the outbreak of the global financial crisis in 2008-09, the appropriateness and even necessity of taking into account exchange rate movements for emerging market economies with inflation targeting became obvious. FX interventions could help smooth the devastating effect of excessive exchange rate volatility and speculative capital flows on small open economies. If done prudently, they could enhance the credibility of the inflation-targeting regime by stabilizing expectations. FX interventions can have prolonged effects on macroeconomic variables, given some of their specific features.

Ostry et al. (2016) regard emerging economies as ones with two targets (inflation and exchange rate) and two instruments (interest rate and FX interventions). They highlight the importance of interventions as a tool against abrupt though temporary changes in capital movements. In contrast, the interest rate is best for dealing with persistent shocks. Generally speaking, interventions can act symmetrically against both capital inflows and outflows, though the only crucial difference is that a central bank may eventually run out of reserves in the face of outflows.

Survey evidence from BIS (2013) indicates that central banks have a range of different motives when intervening in foreign exchange rates. Broadly speaking, these motives can be grouped as follows: 1) leaning against the wind (the most common reason cited for emerging market central banks to intervene in foreign exchange markets was to limit exchange rate volatility and smooth the trend path of the exchange rate); 2) reducing the deviations from fundamental, 3) managing or accumulating FX reserves, 4) ensuring liquidity.

Recently Fratzscher et al (2017) examined foreign exchange interventions based on novel daily data covering 33 countries from 1995 to 2011, and found that interventions are a widely used and effective policy tool, with a success rate in excess of 80 percent under some criteria. The policy works well in terms of smoothing the path of exchange rates, and in stabilizing exchanges rate in countries with narrow band regimes. Moving the level of the exchange rate in flexible regimes requires some conditions to be met, including the trading of large volumes and appropriate communications work by central banks.

Grui and Lepushinskyi (2017), employing the Quarterly Projection Model of the National Bank of Ukraine and simulating different policy responses to various macroeconomic shocks, conclude that monetary policy could benefit from using interventions in addition to adjusting the key policy rate. This applies in particular to shocks to supply, the risk premium, and “hot” capital flows. This policy-mix, using both the key policy rate and FX interventions, brings down the volatility of inflation in addition to smoothing the volatility of the exchange rate, which is essential for expectations in dollarized countries.

At the same time, using FX interventions has its limitations – primarily, selling reserves is bounded by the zero (or minimum) level of reserves. Moreover, in the case of aggregate demand or under conditions of trade shocks, central banks in emerging markets need to refrain from using FX interventions (except marginal use for smoothing the functioning of the FX market), and instead allow the exchange rate to play the role of shock absorber.

Let us again refer to the Ukrainian case.

According the NBU FX intervention strategy for 2016-2020 (2016), the NBU performs the following tasks when conducting FX interventions: 1) accumulation of international reserves, 2) smoothening FX market functioning, 3) support for the transmission of a key policy rate as the main instrument of the monetary policy. The implementation of this strategy has helped ensure moderate volatility of the exchange rate, namely avoiding both: 1) excessive and disruptive volatility under conditions of low depth and liquidity of the foreign exchange market, and 2) the almost zero volatility observed in the past, which contributed to the accumulation of FX risks and macrofinancial mismatches.

This strategy has produced rather good results in practice. The abolishing of the exchange rate peg in 2014 was accompanied by the outbreak of war and a fully-fledged macroeconomic crisis. The volatility of the exchange rate at that time was enormous. However, since broad macroeconomic stabilization was achieved, and an FX intervention strategy successfully implemented, the volatility of the UAH/USD exchange rate has stayed within the range of 2-10%. This magnitude is typical for inflation-targeting countries. More importantly, such moderate swings in the exchange rate do not damage expectations. Such a situation was hard to imagine under the ER peg regime, when even small changes in the exchange rate caused panic among the public.

The third line of defense is capital controls

Certainly, these cannot be a substitute for prudent macroeconomic management, including in monetary policy.

As Ukraine's experience shows, capital controls are not effective in the long run, and are costly for economic growth and the development of the financial system. However, they may be extremely useful in circumstances in which market tools are not effective.

First of all, we refer to crisis episodes characterized by herd behavior and market failure. For instance, this happened in Ukraine in 2014-15 during the escalation of the military conflict. Neither hiking the interest rate, nor spending scarce international reserves were able to stop the panic. The only solution was to implement "draconian" measures, as they were called. They included raising the surrender requirement of all FX revenues, limits on FX purchases for the public, a ban on the repatriation of dividends, limits on banks' purchases for their FX positions, and so on.

As a result, the situation in FX markets calmed sufficiently. At the same time, the NBU understands the negative impacts of such controls, and is gradually withdrawing them as quickly as its macrofinancial stability stance allows.

However, it still useful to have such capital controls in the central bank toolkit, especially in a situation in which the central bank cannot ignore the probability of an escalation of the military conflict or other potential disruptive factors.

In addition, some capital controls may be useful in containing short-term capital inflows and a resulting widening of the current account deficit.

Importance of communications

Successful monetary policymaking is not about constantly keeping inflation on target. Success is about keeping inflation expectations well anchored. Thus, the policy framework needs to be well known to the market and society, as well as internally coherent. That is why communication is at the heart of modern policymaking.

Inflation-targeting central banks have been improving their methods of communication with the public for the almost three decades that have passed since the introduction of this monetary regime. The NBU, as the last central bank to join the club of inflation targeters, has had the advantage of being able to introduce the best and verified practices. The NBU used to communicate in the regime of "money likes silence" just five years ago. However, following the examples of leading central banks, we have managed to break this silence and bring NBU communications to a high level of transparency.

Experts and market participants have quite good understanding of the NBU's policy goals and reaction function. However, we don't think we need to limit our communications to these target groups. Nowadays, there seems to be a widespread movement among central banks to employ the mass media in order to reach a broader audience.

For instance, recently Coibion et al (2018) provided clear evidence that households and firms have limited knowledge about CBs' targets and the policies used to achieve them. Thus, their expectations are less anchored by the CB's targets and influenced by the CB's actions compared with the expectations of experts and market participants. But in fact the expectations of households and firms are the most relevant when taking decisions about consumption and investment. The authors highlight the importance of monetary policy makers in exploiting the new ways, besides the traditional news media, of transmitting information to the public. Information from CBs should be much better targeted and tailored to specific groups. The CBs can learn a lot from corporate marketers and politicians.

Conclusions

To sum up, mostly for the reasons already mentioned above, 2018 will probably be a challenging year for the emerging markets in general and the Ukrainian economy in particular. I wish to conclude by stressing that while the implementation of monetary policy through both interest rate management and using additional tools plays a fundamental part in overcoming these challenges; this is only one component of the set of policy tools available for this.

In this respect, it is important to note the following policies that are employed in the Ukrainian situation:

- a prudent fiscal policy, aimed at ensuring a downward trend in public debt as a share of GDP;
- a well-capitalized, profitable and liquid financial sector, with no risks of a systemic nature observed;
- the continuation of ambitious structural reforms; and
- the maintenance of support from official creditors, including the IMF, World Bank and the European Commission, which is crucial for the further replenishment of reserves.

To this end, it will be essential to continue and to build on the policies carried out so far, and to tackle the challenges we may face in the nearest future.

An additional challenge for the central banks is to change public opinion. After the global financial crisis, there has been a significant resurgence of populism in politics. Voters are dissatisfied with the elites, and this is causing deep splits in societies. In such an environment, central banks are facing low credibility and attacks on their independence. There is no other solution for the central banks but to enhance communications with the public, explaining what benefits to society their policies bring. Thus, efforts to improve financial literacy and to spread financial inclusion are on the agenda at most central banks.

These are tough challenges, but central banks can achieve promising results in these fields by sharing their experience.

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