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INFLATION TARGETING IN UKRAINE: PRECONDITIONS, CHALLENGES AND PROSPECTS

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Summary. The main challenges for the effective inflation targeting implementation in Ukraine are studied in this paper. We define the range of essential actions that are to be realized immediately by the Ukrainian government and the central bank.

Анотація. У статті досліджено основні чинники ефективного впровадження механізму інфляційного таргетування в Україні. Обґрунтовано заходи, прийняття яких є обов'язковими для уможливлення ефективної реалізації інфляційного таргетування в Україні.

Аннотация. В статье исследованы основные факторы эффективного внедрения механизма инфляционного таргетирования в Украине.

Обоснованно меры, принятие которых являются основным условием эффективной реализации инфляционного таргетирования в Украине.

Key words: *inflation-targeting regime, to float exchange rate, the central bank, credibility, communication.*

Ключові слова: *режим інфляційного таргетування, плаваючий валютний курс, центральний банк, надійність, комунікація.*

Ключевые слова: *режим инфляционного таргетирования, плавающий валютный курс, центральный банк, надежность, коммуникация.*

1. Introduction

The science society has no single opinion about the inflation targeting consequences. From one hand, there are no doubts about the market character of this policy that causes the financial regulatory openness and the conducting an effective communication among public, central bank and government. Thought, at the same time there are radically different experts' conceptions about the level of the inflation targeting regime efficiency on the ensuring economic growth, the crisis avoiding or its influence minimization [1; 2]. This topic is always discussed in the sections of economy's types for the deep distinctions of the inflation targeting implementation even in different countries, not just economies. Due to this and the final Ukraine's European Choice it is worth studying the experience of the inflation targeting in order to find an effective models for Ukrainian market management.

2. Ukraine's European Choice

It is worth mentioning that Ukraine from the very first moments of its statehood and cultural forming in the time of Kyivan Rus' always sought for the European way of development. The same happened in present-day Ukraine that proclaimed its sovereignty in 1991. Ukraine has involved in partnership and cooperation with European Community since 1994. The memorable event for Ukraine happened in 2006 when US Department of the Treasury and EU recognized the market status of Ukraine's economy. As a result, it gave an opportunity to the domestic enterprises to compete with other companies in the foreign market on a parity basis. The next significant signal of the Ukraine's European choice was the beginning of the negotiations between Ukraine and EU in March 2007 and their synchronous ratification in September 2014.

All these events have already touched all economic spheres and financial system as well. The most meaningful events are as follows: 1) the National Bank of Ukraine was opened and the two-tier banking system was created in 1991; 2) the IAS methodology was implemented into the national accounting system in 1998; 3) the Law of Ukraine "On the National Bank of Ukraine" was adopted in 1999; 4) the achievement and the support of the price stability was stated as the priority of the central bank monetary policy (The Law of Ukraine "On the National Bank of Ukraine", article 2, part 2, 2010). However, at the same time the Constitution of Ukraine still defines the stability of domestic monetary unit as the main function of the NBU (Constitution of Ukraine, article 99).

3. The Inflation targeting in Ukraine

The NBU's intention to introduce the inflation-targeting regime was promulgated for the first time in Memorandum on the economic and financial policy [3] in August 2014 and was repeated in the Main aspects of the monetary police for 2015 [4] in September 2014. According to these documents, the NBU intends to introduce the inflation-targeting regime in the second half of 2015. It is noteworthy that these actions previously require the conduction of some structural economic reforms that could ensure the global perception of Ukraine as a perspective and reliable partner. The reforms' necessity is caused by the deeply spoilt Ukrainian economy by the corruption that distorts and weakens the market mechanism functioning, increases risks, worsens the economic environment and the conditions of the business conduction as well. That is why the radical worsening of the macroeconomic indicators is not the main problem of Ukraine, but huge corruption, bribery, ineffective state management.

Recurring to the subject of the inflation-targeting regime it should be mentioned that each country has its peculiarities for introducing. As experience proves in many advanced economies that pursue inflation targeting, this regime has been introduced only after price stability has been reached [5]. But this is not the case in the transition economies that introduce inflation targeting for the price stability reaching. The execution of this police becomes some more complicated if the economy has deep structural disproportions and a high degree of openness. Ukraine's openness provides by its high import orientation and

since 2005 the imports of goods and services have exceeded exports stably (Table 1).

So, as we can see despite of market status of Ukraine from 2006 that was expected to stimulate the export of the domestic products and the technological improvement of the domestic enterprises it has not happened. Even more, since 2005 Ukraine has become less attractive to the foreign investors (Table 1). We think that the main reasons are the corruption and the rule of the law fully absence.

While studying the bases of the effective inflation-targeting regime introduction the scientists define as follows: 1) the real political and operational independence of the central bank; 2) the determination of the price stability as a main task of the monetary policy; 3) the statement of the distinct price index to target; 4) the respond of the central bank to the deviation of the actual inflation from the target [6; 7; 8; 9].

Despite of the Ukraine government announcing about the abandonment of the central bank's profit transferring to the state budget in advance it has not had any legislative confirmation yet (the Law of Ukraine "On the state budget of Ukraine for 2014", article 15). Thought, this year the NBU has started to define the inflation targets independently and to use own predictions to conduct monetary policy (earlier the Ministry of the economic development and treasure of Ukraine set the main economic indicators and inflation as well). Another essential handicap is the lack of coordination between government and the NBU in the inflation target setting: the NBU has already set the inflation target for 2015 on 9% and the government is calculating the budget for 2015 on the CPI 5,4%. As a result, any wage's indexation will not be consistent with the expected inflation by at least 3,6% and it complicates the central bank's communication with the public initially. But according to the new addition of the NBU's document [4] from 23.04.2015 abovementioned target was replaced by another target – the growth of the monetary base.

At the same time, the process of implementation of the monetary regime involves the specific technical features identifying, including: 1) the determination of the price index target; 2) the determination of the target object – a point or a range; 3) the determination of the target horizon; 4) the level of governments involving determination; 5) the incorporation of the exchange rate into the inflation-targeting framework [10].

Table 1

Ukraine's macroeconomic indicators in 2000-2013

Indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
GDP per capita (current US\$)	636	781	879	1049	1367	1829	2303	3069	3891	2545	2974	3575	3873	4029	3082
GDP (bl US\$)	31,261	38,009	42,392	50,132	64,883	86,142	107,753	142,719	179,992	117,227	136,419	163,421	176,603	183,310	131,805
Exports of goods and services (% of GDP)	62,0	55,0	55,0	58,0	61,0	51,0	47,0	45,0	47,0	46,0	51,0	54,0	51,0	43,0	49,2
Imports of goods and services (% of GDP)	57,0	54,0	51,0	55,0	54,0	51,0	49,0	50,0	55,0	48,0	54,0	61,0	59,0	52,1	53,2
Foreign direct investment, net in-flows (BoP, bl US\$)	0,595	0,792	0,693	1,424	1,715	7,808	5,604	10,193	10,7	4,769	6,451	7,207	7,833	4,509	0,847
Foreign direct investment, net in-flows (% of GDP)	1,9	2,1	1,6	2,8	2,6	9,1	5,2	7,1	5,9	4,1	4,7	4,4	4,4	2,5	0,6
Total reserves (m US\$)	3095,0	4018,0	6937,0	9524,0	19394,8	22256,4	32462,1	31543,3	26505,0	26505,0	34570,0	31764,6	24546,0	20415,7	7533,3
Degree of economy's dollarization, %	-	-	-	-	-	23,6	27,0	22,8	30,6	31,7	29,1	30,4	32,5	27,2	32,2

Source: The World Bank data: <http://data.worldbank.org/indicator>,
The National Bank of Ukraine data: http://www.bank.gov.ua/control/en/publish/category?cat_id=47389.

The NBU has chosen the CPI as a target for its clearness to the public. It should be taken into account the high sensitivity of this index on a large number of different economic processes that are out of the central bank impact. In particular, they are the administrative regulated prices and tariffs and their increasing because of the imminent economic reforms; events on the Eastern Ukraine and as a result, a radical changes in economic relations with Russia. We agree with Frederic S. Mishkin that a more narrowly defined measure of inflation that excludes possible effects of transitory shocks could be better controlled by a central bank, but at the same time, it could be more difficult for the public to assess the conduct of monetary policy based on such measure. Given into consideration the low level of the credibility to all state institutions, including the central bank, the NBU is forced to take a responsibility for more difficult task; its realization will allow obtaining the highest market value – the trust of the public. On the other hand, it is also reasonable to study the experience of the Czech National Bank that introduced a new concept, so-called net inflation, which excluded regulated prices.

The NBU is going to target a point with a short-time horizon – one year. We share Frederic S. Mishkin's opinion that trying to achieve annual inflation targets required heavier reliance on manipulating exchange rates, which led to its having large swings. Taking into account the level of Ukraine's openness, high level of economy dollarization (Table 1), and the fact that the dynamics of the hryvnia exchange rate has a significant impact on inflation, we consider more appropriate is to establish a medium-term horizon and to target a range. It won't worsen the cred-

ibility of the central bank that can't be affirmed in the case of the point target deviation.

The NBU has introduced the “exceptions” that could justify missing an inflation target in short and medium terms. For the short-time period they are: unstable political situation and the continuation of the war conflict on the east of the country. As to the second position, they are unfavorable global financial and commodity markets, and economic reforms ineffectiveness. Should be mentioned that the Czech Republic, unlike Poland and Hungary, used the same practice.

Another very important question is the exchange rate regime and its use as an economy anchor. As pointed out by the experience of the Czech Republic, Poland and Hungary only the Czech Republic introduced inflation targeting before moving to a floating exchange rate. That is why it is often called a “big bang” or a “shock therapy” approach. At the same time, Poland and Hungary chose gradualistic approach. Thus, Poland in 1998 announced the inflation targeting introducing, but only in 2000 moved to a fully floating currency regime. Ukraine follows the Czech example and has already moved to a floating exchange rate. Though there is no fully foreign exchange market liberalization in Ukraine because of the series of restrictive measures concerning foreign currencies transactions. The main reasons that encouraged Ukraine to introduce the floating exchange rate so urgently are the critically low amount of total reserves (in November 2014 they were 12 587 m US\$) and a low level of the credibility to the national currency, which partly explains the high level of dollarization of the Ukrainian economy (Table. 1).

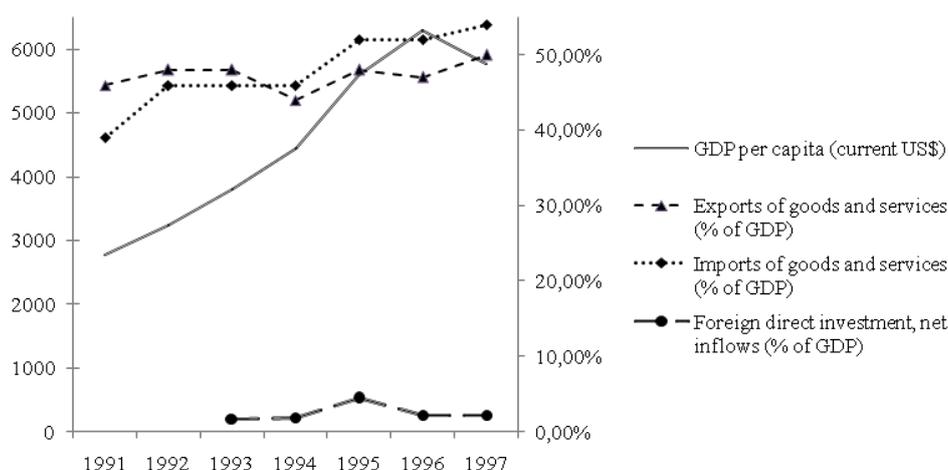


Figure. 1. Economic preconditions of the inflation targeting implementation in the Czech Republic in 1991-1997

Source: The World Bank data: <http://data.worldbank.org/indicator>;

So as we see Ukraine has chosen the Czech Republic experience as a landmark for inflation-targeting regime implementation. That is why it's important to understand the level of comparability of Ukraine's and Czech's economic preconditions (as the Czech Republic introduced this regime in 1997 we studied the time period 1991-1997). The common features are the volume of export-import operations in % of GDP during 1991-1997, the stable imports excess over exports and poor investment climate (Fig. 1).

However, the Czech Republic had much higher level of the citizens' well-being and a lower level of economy dollarization (Table. 1, Fig. 1).

4. Conclusion

In this paper, we have discussed the preconditions and the challenges for Ukraine in the context of the effective inflation-target regime introduction. In our research we proceeded from the opinion though inflation targeting in transition economies is more difficult than in advanced economies, it brings

significant benefits. We define some aspects that do complicate the inflation targeting in Ukraine and come into consideration that firstly it should be real anticorruption actions done. The second one is to give the NBU a real political and operational independence. What about technical aspects we think to be more efficient the NBU to choose a medium-term horizon and to target a range not a point. The main attention of the NBU should be paid for constructing a clear communication with public. As Ukraine has a situation when exchange rate influences greatly on the CPI so on citizens' well-being, the NBU must explain the reasons of hryvnia's sharp, stable devaluation, and don't shift its responsibility wholly on citizens. The next problem of the same importance is to adjust the relationships between the central bank and the government on a parity basis and to introduce mutual responsibility for success or failure of this regime. So, for Ukraine the prospects of this regime could be only as the results of the consequent actions of the central bank and government.

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