



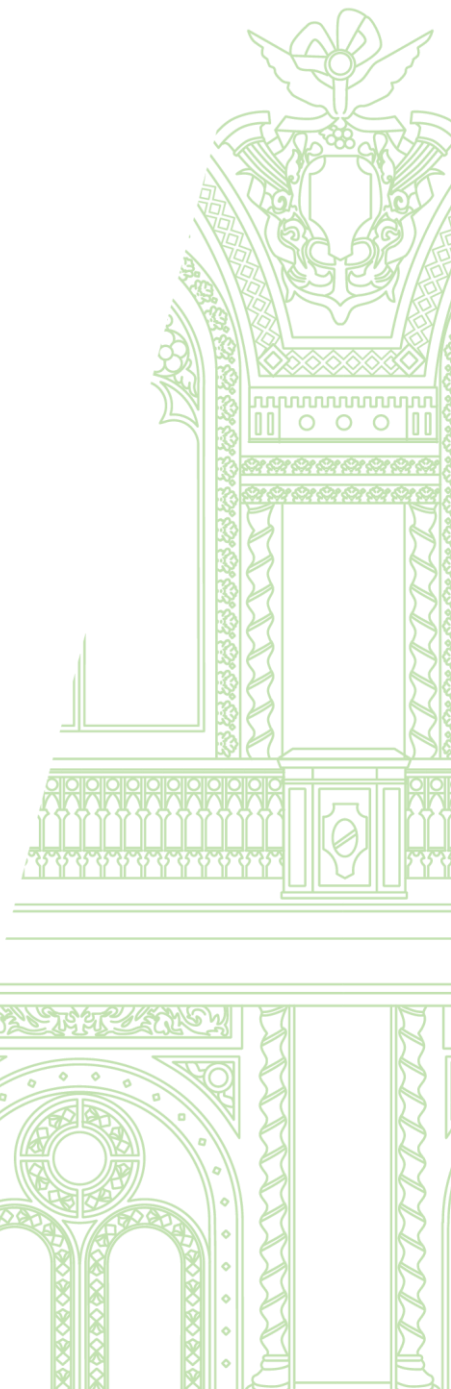
National Bank  
of Ukraine

# Monetary and fiscal policies in Ukraine: from cooperation to coordination

Olga Pogarska

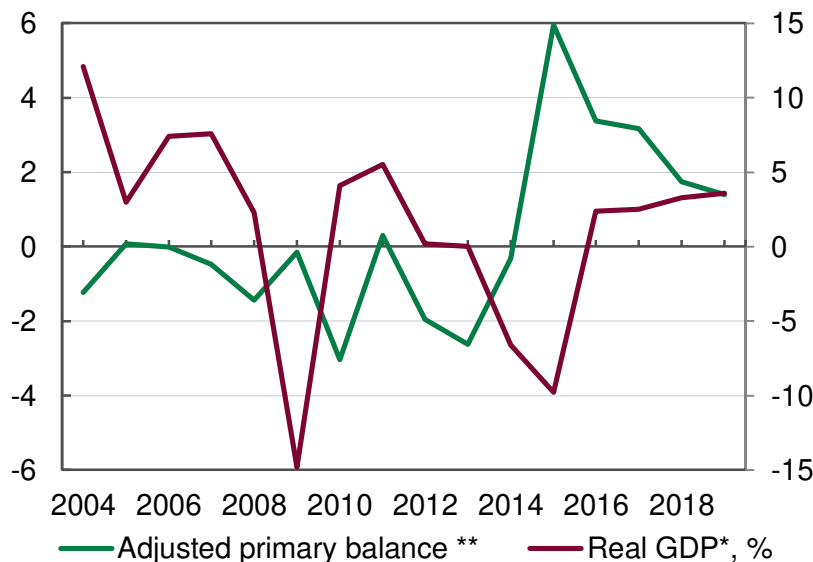
Monetary Policy and Economic  
Analysis Department

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Geneva, September 2019

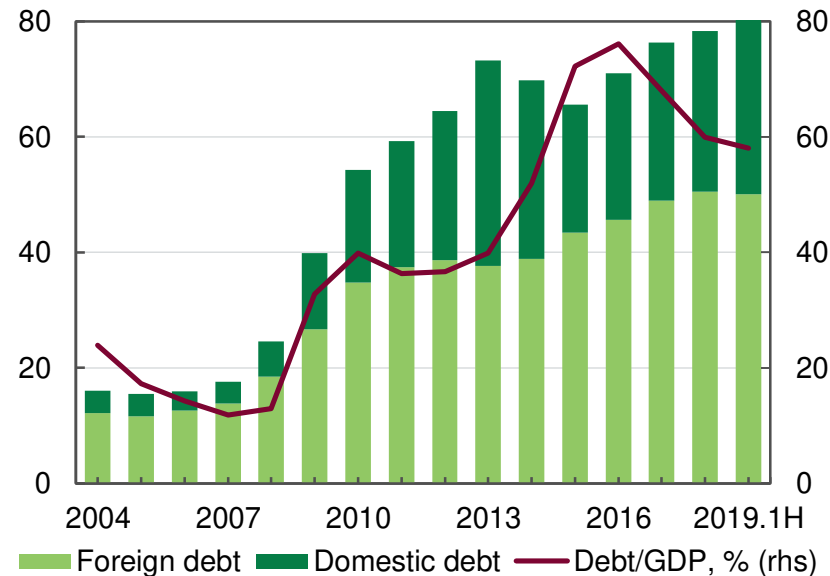


# In the past, Ukraine's fiscal policy was expansionary even during the good times, leading to debt accumulation

**Cyclically adjusted general government primary balance and economic growth**



**Public and publicly guaranteed debt, USD billion**



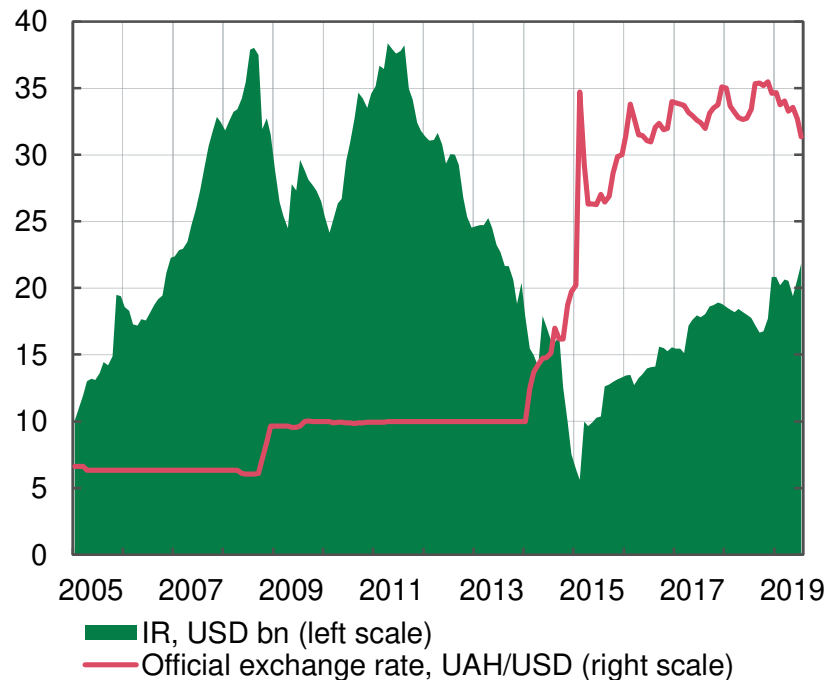
\* Starting 2011 data excludes Crimea, the city of Sevastopol; starting 2014 – also a part of the temporarily occupied territories in the Donetsk and Luhansk regions; \*\* CAPB is the difference between revenues, in the structure of which tax revenues were adjusted for cyclical changes in GDP, and primary expenditures

Source: Ministry of Finance of Ukraine (MFU), State Statistics Service of Ukraine (SSSU), NBU calculations.

Persistent structural deficits  $\Rightarrow$  growing debt  $\Rightarrow$  rising share of FX-denominated debt  $\Rightarrow$  increasing vulnerability to adverse domestic and external shocks  $\Rightarrow$  free float fear and pressure on monetary policy for financing

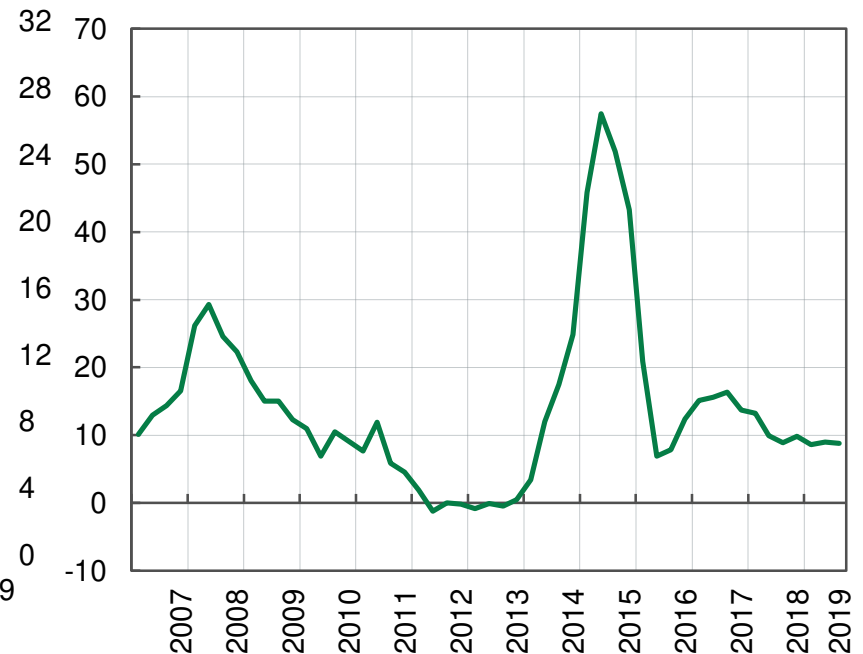
# As a result, fiscal and monetary policies in Ukraine often 'cooperated', forming inconsistent macro policy mix

International Reserves and Hryvnia Exchange Rate per USD



Source: NBU.

Headline consumer inflation, % yoy, end of quarter



Source: NBU.

- While there were provisions in the legislation prohibiting the direct fiscal deficit financing, they were creatively by-passed, so that monetary policy actually served the needs of the fiscal policy
- Fixed exchange rate created an illusion of stability but prevented the economy from adjustment, exacerbating the impact of the shocks

# A switch to IT monetary regime required new forms of interactions between fiscal and monetary authorities

Changes to the Ukrainian legislation, enhancing the NBU independence, preceded the introduction of the IT regime, de facto carried out in mid-2015

## A common goal of price stability (5% inflation target)

was recognized by both the monetary and fiscal authorities as a prerequisite for sustainable economic growth

## The Financial Stability Council

was established in 2015 to discuss macrofinancial stability issues and develop public policy proposals



## Other forms of interactions



Regular consultations and discussions, including at the experts' level



Common efforts to develop domestic financial market and...



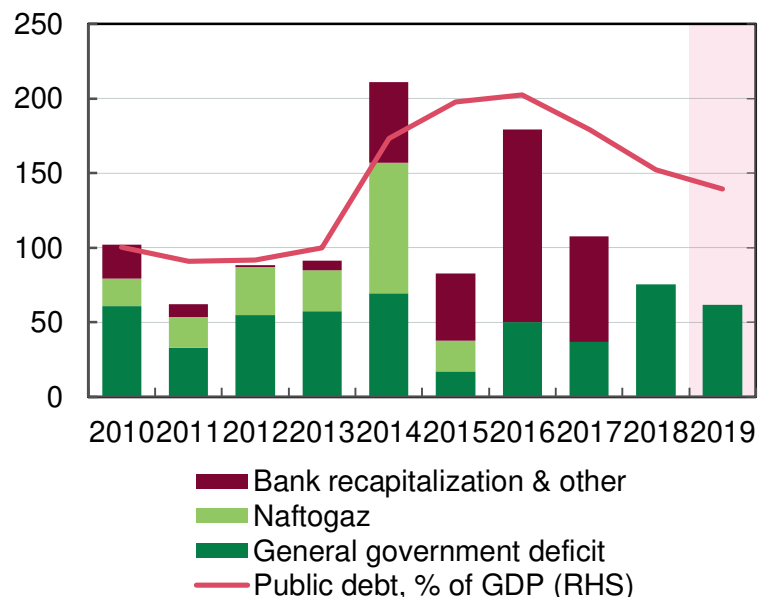
...instruments to share the responsibility for attaining inflation target (inflation-indexed bonds)



Information disclosure and regular exchange of information

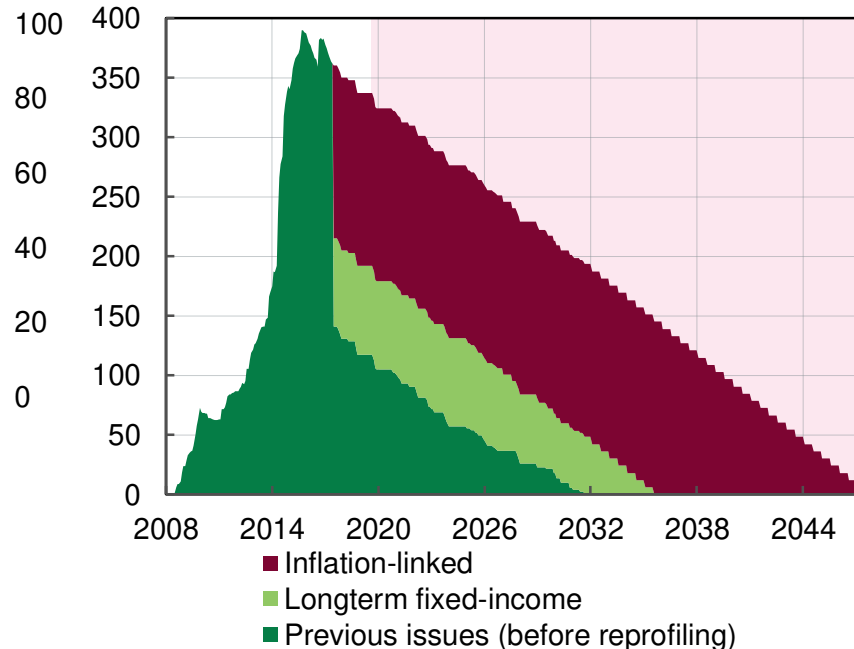
# Implementation of IT regime disciplined fiscal authorities

Public sector deficit, UAH bn, and public debt-to-GDP ratio, %



Source: MFU, SSSU, NBU calculations and forecast (Inflation Report July 2019).

Government bonds in the NBU's portfolio, UAH bn

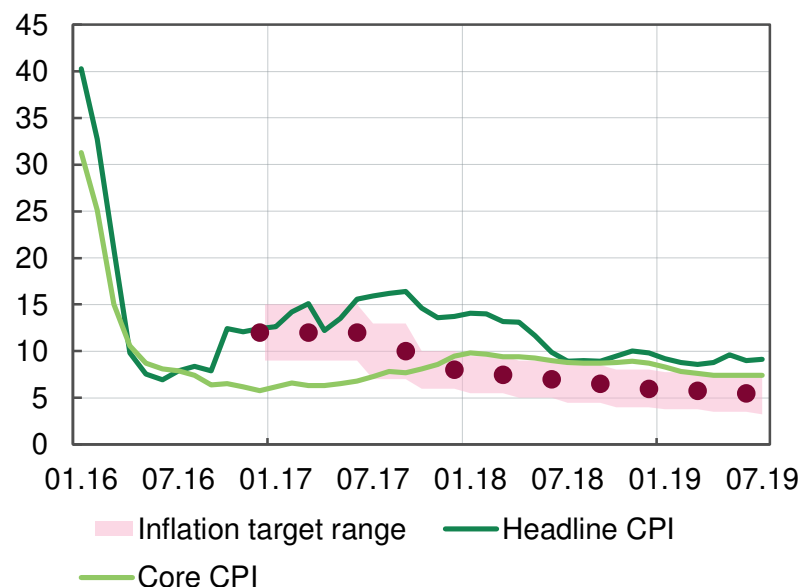


Source: NBU.

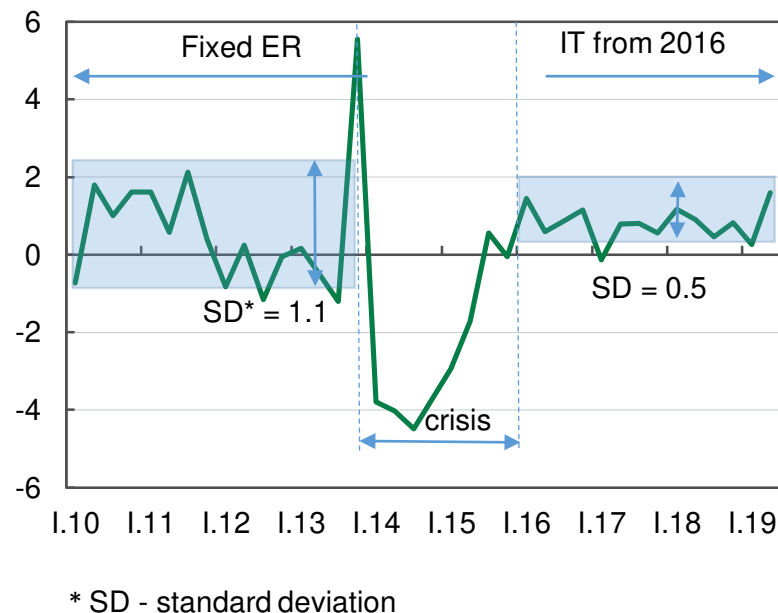
- There is a strong commitment of the NBU to avoid any form of fiscal dominance. Deep economic crisis and banking sector clean-up required some adjustments
- Nevertheless, Ukraine has achieved remarkable progress in fiscal consolidation
- In October 2017, the MFU completed debt reprofiling, when part of bonds in the NBU portfolio were converted into inflation-linked bonds with long maturity
- In addition, caps on the outstanding amount of government bonds in the NBU portfolio were set since 2018

# A combination of tight monetary and prudent fiscal policies brought their fruit in terms of macrofinancial stabilization

Headline and Core Inflation, % yoy



GDP in quarterly terms, % (seasonally adjusted)

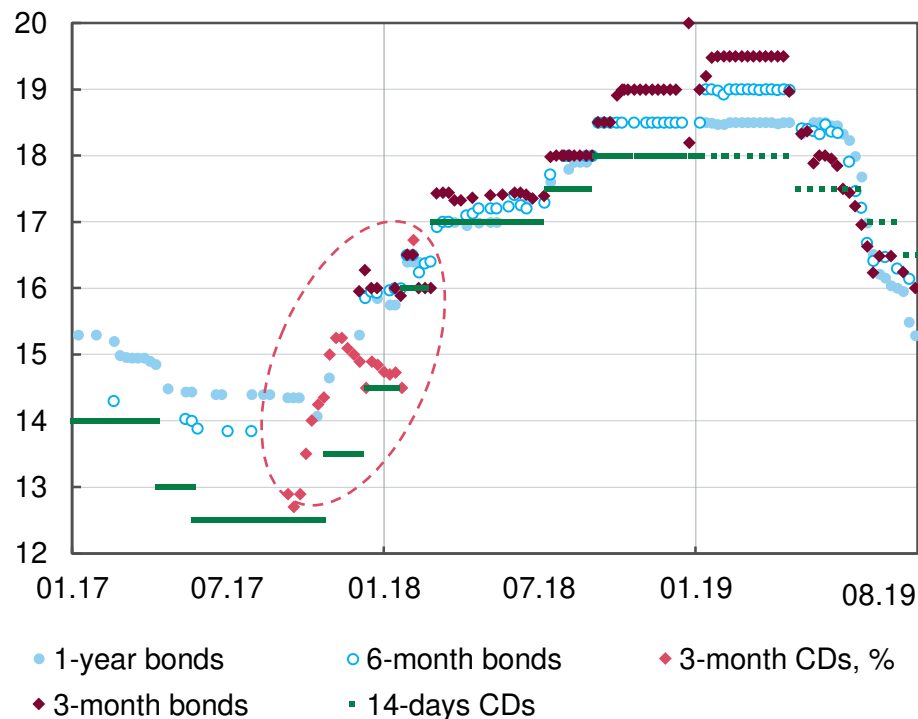


Source: SSSU, NBU calculations.

- Fourth year of IT in Ukraine: initial success and strong headwinds thereafter
- Nevertheless, inflation was reduced and it is on its way towards medium-term target of 5% +/- 1 pp
- Volatility of both inflation and economic growth decreased significantly

# Common efforts helped to shape domestic bond yield curve

Yields of money market instruments, %

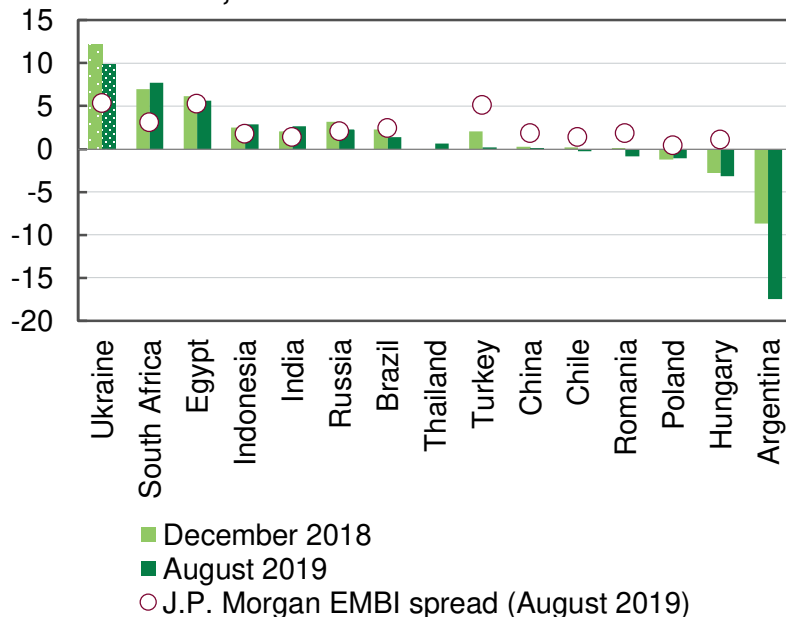


Source: NBU.

- The NBU had been issuing minor amounts of 3-month CDs in order to develop money market yield benchmark as there was a gap in term structure on the short end of the yield curve
- Issuing 3-month CDs was ceased by the NBU right after the government had resumed short-term borrowings

# Progress is not without challenges: there is always a trade-off between short-term and long-term objectives

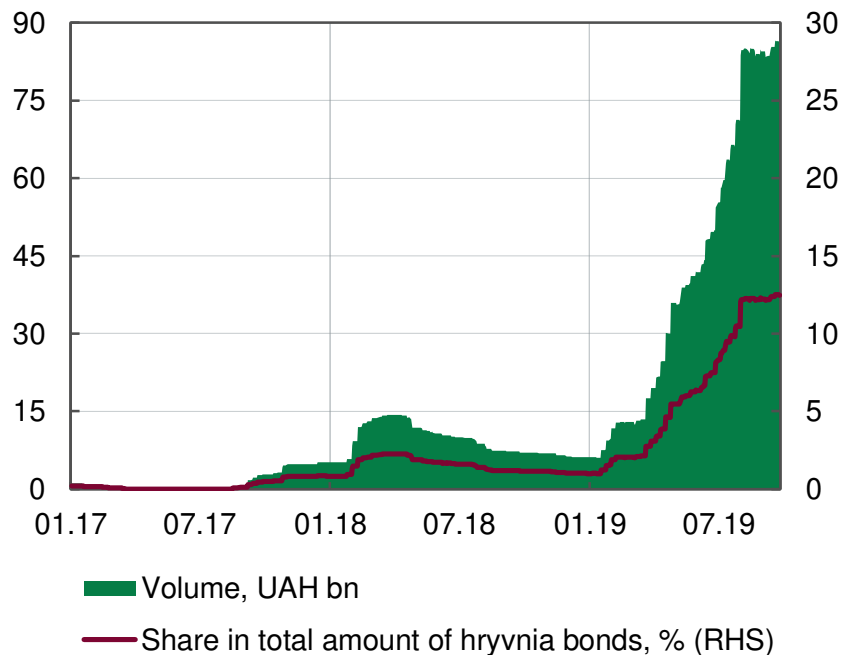
**Real Sovereign Bond Yields\* and Risk Premium in Selected EMs, %**



\* Difference between monthly averages of 1-year bond yield on the primary market and inflation forecasts as of end-2019.

Source: DekaBank, Refinitiv, Bloomberg, NBU staff forecast and estimates.

**Domestic Currency Government Bonds Held by Non-Residents**



Source: NBU.

- Tight monetary policy => stronger hryvnia exchange rate => lower budget revenues from imported goods
- Tight monetary policy => high cost of borrowing on domestic market

But

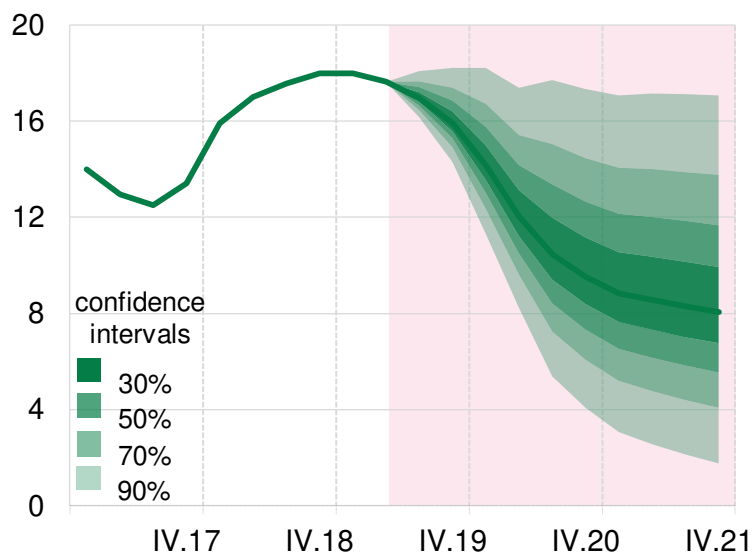
- High domestic bond yields => strong non-resident interest into domestic-currency-denominated bonds => gradual improvement of the currency structure of public debt



# The NBU started publishing key rate forecast, helping to reduce the yields on medium-term securities

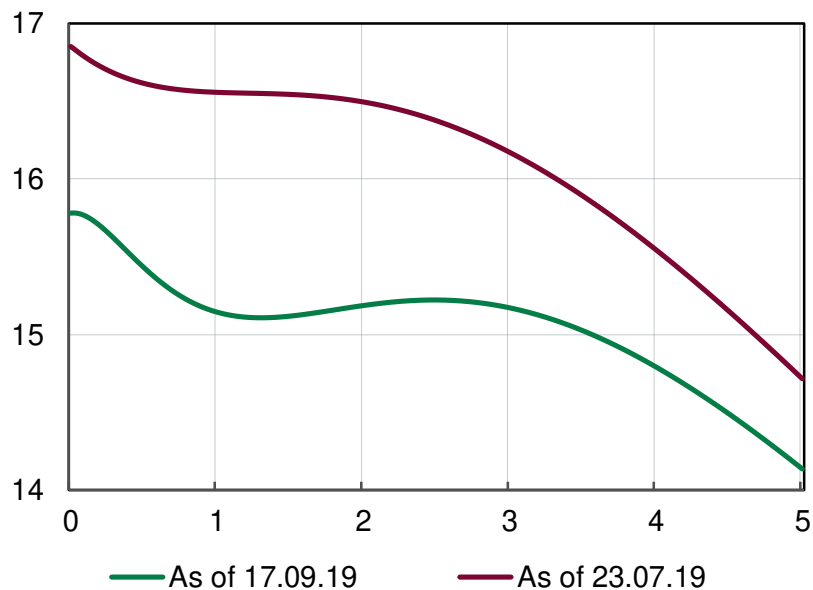
**Key rate forecast** is an integral part of macroeconomic forecast and consistent with other forecast indicators.

**Key rate (%) and uncertainty**



Source: NBU Inflation Report (July 2019).

**Zero-Coupon Yield Curve for Hryvnia Bonds on the Secondary Market\*, %**

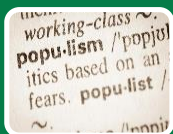


\* Spot rates with continuously compounded interest plotted with use of Svensson parametric model.

Source: NBU.

The NBU became the eighth central bank in the world that publishes its interest rate forecast

## Other challenges



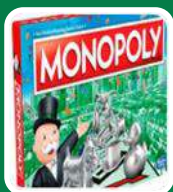
### Populism

In 2017, the government w/o prior announcements and discussions decided to double minimum wage



### Inadequate government liquidity management

Budget expenditures are heavily skewed towards the end of the year  
Fiscal needs and resources are not well balanced throughout the year



### Imperfect markets and transmission

Still high share of administratively regulated prices  
Lack of effective antitrust policy  
Weak interest rate channel transmission due to judicial inefficiency, weak creditor rights, etc.)



### Attacks on CB's independence

Political pressure to reduce key policy rate to stimulate economic growth  
PrivatBank uncertainty  
Court decisions, suspending the first deputy governor from duty, etc.

# Implementation of best practice in communications and being as much transparent as possible help preserve the independence

2013



NBU transparency

2019



Strategy of monetary policy:  
clear numerical targets



Established decision-making & operational design  
of MP



Regular & proactive monetary policy  
communications (press releases, press briefings,  
Inflation Reports, Minutes, interest rate path)



Broad public access to data



Expanding communications in non-MP areas  
(financial stability, banking supervision, financial  
literacy, etc.)



# Conclusions

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- Ukraine has successfully moved from fiscal dominance towards coordination between fiscal and monetary policy
- Implementation of the inflation targeting regime per se 'disciplined' fiscal authorities
- The current forms of interactions include Financial Stability Council discussions, expert meetings, information disclosure and regular exchange of information, inflation-linked instruments, etc.
- However, challenges remain and the best way, in our view to respond, is to be as transparent as possible and to implement the best practices and methods of communication

Thank you for your attention!



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# Major changes to the Law «On The National Bank of Ukraine» strengthening its institutional capacity (2015)

- ✓ Changing the order of NBU`s profit transfer to the State Budget – by residual principle
- ✓ Changes in the composition and power of the NBU Council and the NBU Board
- ✓ Ensuring the continuity of management of the NBU by using the 'shift schedule' appointment procedure
- ✓ Strengthening the independence of the NBU Council and the NBU Board members
- ✓ Reform of the internal audit
- ✓ Priority of the Law «On the NBU» over other laws