THE RATIONALE FOR THE APPLICATION
OF THE INFLATION TARGETING REGIME IN UKRAINE

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Abstract. The *purpose* of the paper is the consideration of the basic choices of a monetary regime of monetary policy, which include the monetary targeting regime, the regime of exchange rate targeting, the inflation targeting regime, and a strategy without an explicit nominal anchor. The article also discusses their implementation in various countries of the world and the resulting consequences. The subject of research is the consideration of the existing monetary regimes and the rationale for the selection of one of them to ensure sustainable development of the economy of Ukraine. This research examines, among other things, such unresolved parts of the general problem as the search for ways how to increase the degree of the Central Bank influence on the economy by changing the existing monetary regime to more optimal. *Methodology*. The research is based on a comparison of data on the effectiveness of monetary policy in different countries in specific time periods. Given the consequences of the implementation of certain monetary regimes in different countries, there are drawn conclusions about the appropriateness of the choice of a specific regime for the Ukrainian economy. The *results* of the comparison showed that the most suitable choice for the economy of Ukraine is the choice of the inflation targeting regime, since it generates the inflation expectations at a low level, in most cases allows reducing inflation in the short term, contributes to strengthening the Central Bank independence and credibility, allows overcoming internal and external shocks, eliminates the contradictions connected with the objectives of monetary policy, reduces the likelihood of crises, as well as creates positive conditions for the development of the economy as a whole. *Practical implications*. Thoroughly examined the advantages and disadvantages of the underlying monetary regimes, conclusions were drawn concerning the promising directions of development of monetary policy in Ukraine, as well as recommendations on further actions of the state bodies of Ukraine. *Value/originality*. The conclusions of the research substantiate the benefits of inflation targeting regime to enhance the effectiveness of monetary policy, as well as provide recommendations concerning the further implementation of the inflation targeting regime in Ukraine.

Key words: monetary policy, monetary regime, nominal anchor, targeting, inflation.

JEL Classification: E42, E52

1. Introduction

In conditions of low economic growth rates, inflation and devaluation of the national currency, it is extremely important to find ways to overcome the negative effects of the aforementioned processes and phenomena. Given the uncertainty factor, the influence of the Central Bank on the country's economy is quite powerful. The main direction of a monetary policy improvement is to change its regime on more effective. The research urgency is caused by the desire of the National Bank of Ukraine (NBU) to move in the near future to full-fledged inflation targeting. In the "Main Principles of Monetary Policy for 2015", it is noted that strategic objective of the NBU is to achieve and maintain in the medium term low and stable inflation (5% per year with a tolerance of ±1%) and a gradual transition to inflation targeting.

Thus, the research problem is stated as follows: is the inflation targeting regime the best choice for Ukraine? The current paper aims to demonstrate differences in an implementation of basic monetary regimes and to prove that the inflation targeting regime will be the most effective for Ukraine.

2. Basic monetary regimes

In most cases, central banks choose one of three basic nominal indicators characterizing the results of its activity: the existing amount of money in circulation, the value of the exchange rate or the inflation rate. Providing the stable dynamics of these variables on the level for a certain period of time is called its targeting (Koncewicz, 2012).

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We can consider three basic choices of monetary regime. The first is *the regime of monetary targeting*. It is based on the belief that the change in the money supply entails a corresponding change in the rate of inflation. In order for this regime to be effective, a necessary condition is an existence in the economy a stable connection between the change in the money supply and inflation.

The second monetary regime is based on *the exchange rate targeting*. It suggests that the Central Bank as the intermediate target of monetary policy sets the nominal exchange rate and tries to provide stability against the currencies of the so-called countries of the anchor due to interest rate changes and direct foreign exchange intervention.

The third monetary regime is based on *inflation targeting*. Also, some central banks are adopting a *strategy without an explicit nominal anchor*, which consists in establishing and achieving several goals simultaneously (Gnativ, 2009).

3. Monetary regimes' features and different countries' experience

The essence of *monetary targeting* is that the Central Bank, on the basis of the inflation tar-get, estimate of potential output growth and the dynamics of money velocity within the quantitative equation of exchange ($MV = PY$) determines the target rate of monetary aggregates growth and announces it to the public.

For the implementation of monetary targeting in the country, an important condition should be met: the demand for money within the country should be stable. This means that the velocity of money has to be on the same level for a certain horizon targeting. This condition is quite difficult task for the Central Bank. The reason is that the demand for money depends essentially on the changes occurring in the socio-economic relations, the stability of international financial markets, and the like. Given this, the effectiveness of this regime is low in countries with economies in transition.

During 1970-2000 the monetary targeting was tried in many countries such as the UK, Greece, Albania, Georgia, China, etc. Most of them were forced to abandon this regime due to a low efficiency of monetary aggregates influence on the ultimate goal – price stability.

Examples of effective targeting of the money supply are Germany and Switzerland. Indicators of monetary targets in these countries were achieved only by 50%; however, inflation has been kept at an average level that does not exceed 3%. The effectiveness of this regime in Germany and Switzerland was based on the confidence in the monetary authorities (Radionova, 2009).

Ukrainian scientist T. Slipchenko noted that the main advantages of monetary targeting as a monetary regime are "sovereignty" – the Central Bank chooses the inflation target, and has the ability to adjust policy depending on internal changes in the volume of production and a close

relation-ship with the instruments of monetary policy, that is, a high level of control by the Central Bank, since monetary aggregates are measured quickly enough, and, accordingly, reports on the implementation of monetary targets communicated to the public with relatively short time lags up to several weeks (Slipchenko, 2010).

As you can see, the advantages of this regime include a high level of coordination of monetary and overall macroeconomic policy, the ability to a rapid reaction by the Central Bank and the stability of expectations associated with full awareness.

The disadvantages include the impossibility of control over the money supply in case of a high share of cash, insolvency in case of significant fluctuations in the demand for money, the ambiguity of the relationships between changes in the money supply and its actual performance in time intervals (Prushkovskaya, 2010).

Not less than 50 economies of the world continue to rigidly fix the courses of their currency units relative to third currencies. These include, for example, Hong Kong, Malta, Latvia, Lithuania, Estonia, etc. Selection of the regime of the exchange rate targeting is an effective tool to control inflation. The effectiveness of this regime directly depends on such factors as the degree of openness of the economy measured by share of imports in consumption, the volume of foreign exchange reserves and so on (Papaika, 2010).

The disadvantages of this regime are the dependence of monetary policy on external economic factors, the possibility of an inflow of short-term speculative capital and the risk of destabilization of the financial system in the global currency crises.

As shows the analysis of the experience of individual countries, the policy of the exchange rate targeting may have different consequences. Thus, the positive results were achieved in Bulgaria, Latvia, Tunisia, Argentina. A classic example of a country that had a bad experience is Brazil, where the application of *the regime of the exchange rate targeting* led to hyperinflation.

In 1990, the Reserve Bank of New Zealand was the first to use *inflation targeting regime*. Currently, such policy is carried out in at least 26 countries, including economically developed countries (Australia, Sweden, Canada, UK), developing countries (Brazil, Chile, Mexico), and countries with emerging market economies (Poland, Czech Republic, Slovenia, Hungary). The last introduced the inflation targeting regime during the transition period, with the result that has reached the low level of inflation and sustainable economic growth, and also raised public confidence in the monetary authorities.

The concept of "inflation targeting" is defined as the monetary strategy that involves the public announcement of the inflation temps by the Central Bank that must be achieved within a certain period, and provides increased transparency and accountability of the monetary regulation bodies.

An important condition for the transition to the inflation targeting regime is a presence of the Central Bank's clear vision of how monetary policy affects the real economy. This makes it possible to determine, which instruments are appropriate to use in a given situation, a time lag of the measures of the Central Bank impact on macroeconomic indicators and how they will be effective. In the developing countries, the influence of monetary policy on the economy is characterized by a greater uncertainty due to permanent institutional and structural changes.

The technology of conducting monetary policy under inflation targeting is based on two main principles. *The first* is a forecast of how the inflation process will develop for the assumption that monetary policy will not change. *The second* is a prediction as to what will be the future inflation and other macroeconomic indicators in the case of current changes in monetary policy.

So, if the inflation forecast exceeds the inflation target, the Central Bank needs to raise interest rates, and vice versa, if the inflation forecast is below the inflation target, the Central Bank should reduce the interest rate.

It should be noted that the effects of monetary policy occur with a time lag, so the medium-term forecast of macroeconomic development, in particular, inflation, has a sufficient importance. Since the applying of inflation targeting regime, the deviation of the predicted values of inflation from the target acts as an intermediate goal, so the quality of the forecast becomes the key element of the effectiveness of monetary policy (Gritsenko, 2008). Thus, the effective system of analysis and forecasting is one of the most important preconditions for a successful transition of central banks from the exchange rate targeting regime to the inflation targeting regime.

Central banks applying inflation targeting, target out also inflation expectations, which serve as a connecting thread between operating targets and the ultimate goal of monetary policy. Not only the officially proclaimed inflation target is affected by the expectations of economic agents, but also its forecasts, which are specified by the Central Bank in periodic public reports.

The process of forecasting by the monetary authorities is a "black box" for the public and associated with the use of a number of complex macroeconomic regimes. If economic agents trust the Central Bank, even unexpected external and internal shocks, which were not considered by the Central Bank in the forecasting process, may be impaired by the influence of optimistic inflation expectations. That is, the expectations of economic agents are influenced both by the actual change of the direction of monetary policy, and just announcements about upcoming intentions of the Central Bank.

4. Advantages and disadvantages of inflation targeting

Inflation targeting is implemented through *active* and *passive approaches*.

The passive approach includes the following monetary policy tools: a narrow corridor of the interest rates in the interbank market, the conduct of irregular transactions in the open market, the use of reserve requirements to regulate liquidity.

T*he active approach*, in turn, provides for a wide interest rate corridor, the lack of regular transactions in the open market and minimal use of reserve requirements.

International experience of inflation targeting regime confirms its effectiveness, since none of the countries that have adopted this strategy, abandoned it. In these countries, today the macroeconomic situation is characterized by steady economic growth, less vulnerability to external shocks, low and stable inflation.

Application practice shows the existence of *subtypes* of this regime, as different countries use inflation targeting that was developed according to their system characteristics. Such subtypes include:

- *full-fledged inflation targeting* – full transparency lighting inflation target, strict adherence to the selected target without corrective measures from the central banks. First used in New Zea-land, later it spread among developing countries, particularly in Brazil, Colombia, Hungary, Mexico and Poland;
- *disguised inflation targeting* – allows changes in the level of inflation. In this subtype of the regime, there is certain opacity. Used by the European Central Bank and by the Federal reserve system of the United States;
- *experimental inflation targeting* – means the broad inflation tasks proclamation in conditions of low public confidence in the Central Bank.

The advantages of inflation targeting are: the ease of evaluating the effectiveness of monetary policy, a flexible exchange rate policy and a creation of conditions for the balanced development of all sectors of the economy, slowed because of the negative impact of inflation.

According to domestic economist V. Gordienko, significant benefits of the monetary policy regime of inflation targeting include:
1) formation of inflation expectations at a low level;
2) in most cases allows reducing inflation in the short term;
3) helps to strengthen the actual Central Bank's independence and credibility;
4) allows overcoming internal and external shocks;
5) resolves contradictions associated with the objectives of monetary policy;
6) reduces the likelihood of crises;
7) creates positive conditions for the development of the economy as a whole (Gordienko, 2012).

The disadvantages of this regime you need to include are the impact of factors that are not controlled by the Central Bank (e.g., the status of the financial sector) on the inflation dynamics, as well as limiting opportunities for stimulating economic growth and reducing unemployment with monetary policy instruments.

5. Recommendations for Ukraine

Based on the experience of other countries, the main direction for improving the monetary policy of Ukraine is determined as a phased transition from the regime of targeting the exchange rate (which was defined as a financial priority of the monetary policy of Ukraine in 1997 (Bazilevich, 2007)) to the regime of inflation targeting.

During *the first stage*, you need to reduce utilization of foreign exchange interventions that will make the exchange rate more flexible and to increase the influence of interest rate policy, which should become the main tool of the NBU. It is also important to implement a number of measures aimed at the development of the stock market of Ukraine.

The purpose of *the second stage* is the transition to full inflation targeting by further liberalization of operations with capital movement. The main results of the second stage should be the transparency and efficiency of the impact of interest rate policy and a flexible exchange rate.

The criteria for the formation of the most favourable environment for the transition to the inflation targeting in the country are: the Central Bank independence, transparency and informational openness of the NBU, Central Bank credibility, a qualitative inflation forecast, high level of training of analysts and a robust statistical base, a developed financial market, free pricing, low level of dollarization of the economy, coordination of instruments of monetary and fiscal policy.

So, the possible positive aspects of the implementation of inflation targeting in Ukraine include:

1) increasing trust of the population, primarily in the National Bank of Ukraine and the Government, which is one of the factors in the formation of inflation expectations;

2) ensuring stable economic development of Ukraine in the long term;

3) increasing of foreign investment (which will affect the development of financial-credit sector and the economy as a whole);

4) lower prices for imported goods;

5) increasing transparency and efficiency of functioning of the government securities market;

6) creation of mechanisms to counter external shocks and manage cash flow in all sectors of the economy;

7) reducing the likelihood of crises.

However, according to Vishnevska, the implementation of the inflation targeting regime in Ukraine in the absence of basic preconditions was a necessary step, but, as practice shows, untimely, and the proof is the inability of the NBU in 2014 to ensure price stability in conditions of macro-economic instability (Vishnevska, 2015).

The inflation targeting regime was implemented in unfavourable for Ukraine's economy conditions, in particular with inflation almost of 24.9 % in 2014, the devaluation of hryvnia by almost 310 % (from 8.3 UAH/USD in 2013 to around 34,0 UAH/USD in February 2015) and the fall of GDP by 15.2% in 2014. The influence of the external environment will further increase the dependence of inflation targeting on the budget needs (Kornev, 2015).

6. Conclusions

One of the main preconditions for the effective functioning of the economy is ensuring of a stable and low inflation. The achievement of the inflation target is possible primarily due to the choice of the optimal Central Bank monetary policy. Given the socio-economic realities of Ukraine, the most expedient one is the implementation of the inflation targeting regime.

Inflation targeting should be viewed as a monetary system device, which is characterized by a public proclamation of the official quantitative inflation target in the medium term and a clear understanding and confidence that low and stable inflation is the primary goal of monetary policy in the long run. In addition, an important condition for the implementation of this monetary regime is understanding that it will stimulate positive changes concerning the implementation of monetary policy, strengthening the effectiveness of the use of its main tools to increase the independence of the Central Bank in terms of accountability and transparency and will contribute to the development of the system analysis and forecasting of the inflation target in the country.

There are the following ways to improve monetary control in conditions of implementation of the inflation targeting regime: enhancing the role of interest rates in managing inflation through adherence to the basic rules of interest policy; strengthening the capacity of the NBU to develop its own forecasts of macroeconomic indicators, which will be the basis for making monetary decisions and will enhance the independence of the regulator; improving the efficiency of the process of making monetary decisions and improving communication policy with the aim of restoring confidence in the regulatory actions; a better coordination of monetary and fiscal policy to achieve the inflation target and keeping it at low levels for a long time.

A promising direction for further research is an in-depth analysis of the transmission mechanism of monetary policy, directly connected with the inflation targeting regime and that may lead to the more effective impact of the Central Bank on the economy of Ukraine.

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Роман КАЛИНОВСКИЙ

ОБОСНОВАНИЕ ЦЕЛЕСООБРАЗНОСТИ ПРИМЕНЕНИЯ РЕЖИМА ИНФЛЯЦИОННОГО ТАРГЕТИРОВАНИЯ В УКРАИНЕ

Аннотация. *Целью работы* является рассмотрение базовых вариантов выбора монетарного режима денежно-кредитной политики, к которым относятся режим монетарного таргетирования, режим таргетирования обменного курса, режим таргетирования инфляции, а также стратегия без явного номинального якоря. Исследуется их внедрения различными странами мира и вызванные ими последствия. *Предметом исследования* является рассмотрение существующих монетарных режимов и обоснование выбора одного из них для обеспечения устойчивого развития экономики Украины. В данном исследовании рассматриваются, помимо прочего, такие нерешенные части общей проблемы, как поиск путей повышения степени влияния центрального банка на экономику посредством изменения существующего монетарного режима на более оптимальный. *Методика*. Исследование основано на сравнении данных о степени эффективности проведения денежно-кредитной политики разными странами мира в определённые периоды времени. Рассматривая последствия внедрения тех или иных монетарных режимов в разных мировых экономиках, делаются выводы о целесообразности выбора определённого режима для экономики Украины. *Результаты* сравнения показали, что наиболее целесообразным для экономики Украины является выбор режима инфляционного таргетирования, поскольку последний формирует инфляционные ожидания населения на низком уровне, в большинстве случаев позволяет снизить уровень инфляции в короткий срок, способствует укреплению фактической независимости центрального банка и доверия к нему, позволяет преодолеть внешние и внутренние шоки, устраняет противоречия, связанные с целями монетарной политики, снижает вероятность возникновения кризисов, а также создает положительные условия для развития экономики страны в целом. *Практическое значение*. Всесторонне исследовав преимущества и недостатки базовых монетарных режимов, были сделаны выводы относительно перспективных направлений развития монетарной политики в Украине, а также даны рекомендации относительно последующих действий государственных органов Украины. Наиболее значимыми являются такие рекомендации, как снижение степени использования валютных интервенций, что сделает обменный курс более гибким, и усиления влияния процентной политики, которая должна стать основным инструментом НБУ. Также важно осуществить ряд мероприятий, направленных на развитие фондового рынка Украины. Для перехода к режиму полного таргетирования инфляции необходима дальнейшая либерализация операций, связанных с движением капитала. Основными результатами этих действий должны стать прозрачность и эффективность влияния процентной политики и гибкий валютный курс. *Значение/оригинальность*. Полученные выводы обосновывают преимущества применения режима

инфляционного таргетирования для повышения эффективности монетарной политики государства, а также предоставляют рекомендации относительно дальнейшего внедрения режима таргетирования инфляции в Украине. Перспективным направлением дальнейших исследований является углубленный анализ трансмиссионного механизма денежно-кредитной политики, который непосредственно связанный с режимом инфляционного таргетирования и может привести к более эффективному воздействию центрального банка на экономику Украины.