

UKRAINE'S RESILIENCE TO CRISES: INFLATION



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TABLE OF CONTENTS

1. The current state and measures undertaken by the NBU	3
2. Inflation targeting as a risk response	5
3. Recommendations	9

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It is important for the public to understand the central bank's actions, to the greatest extent possible, not only for reasons of democratic legitimacy [...] but also in order for monetary policy to be most effective. For not only do expectations about policy matter, but, at least under current conditions, very little else matters.

Central-Bank Communication and Policy Effectiveness
Michael Woodford

Inflation risks undermine the country's resilience by reducing the business incentive to invest, deteriorating production factor efficiency and public spending, disrupting supply and production chains, increasing the uncertainty of economic agents and, finally, suppressing economic growth.

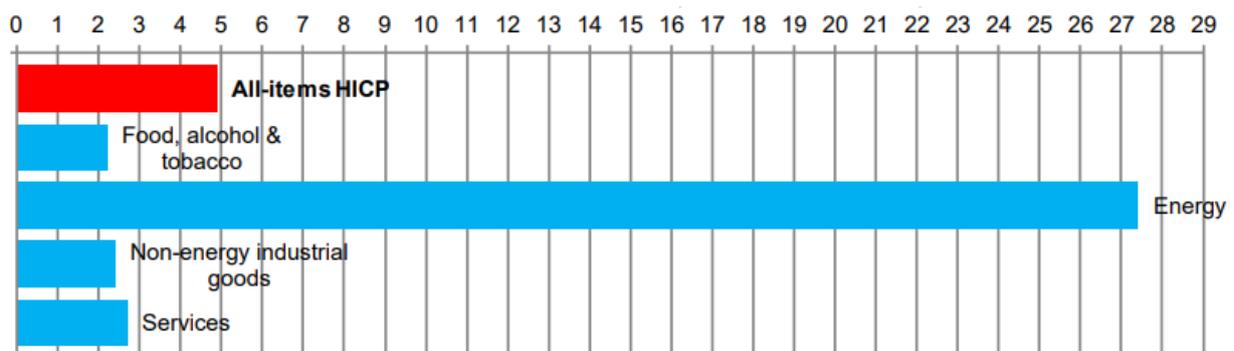
This note presents the Centre for Economic Strategy's analysis and the views of panellists who participated in the forum "Ukraine's Resilience to Crises: A Look into the Near Future"¹ organised by the Centre for Economic Strategy on 8 December 2021.

1. THE CURRENT STATE AND MEASURES UNDERTAKEN BY THE NBU

Following an inflation spike and economic crisis in 2014-2015 caused primarily by Russia's aggression against Ukraine, prudent monetary and fiscal policies have yielded results in the form of a single-digit inflation in 2018 (9.8%) and inflation rates within the target range of the National Bank of Ukraine in 2019 (4.1%) and 2020 (5%).

Global inflation accelerated at the end of 2020 due to the dynamic rebound of the global economy after the coronavirus shock: subdued demand, monetary and fiscal stimulus, combined with disruptions in global supply chains, resulted in higher prices. Among the global drivers of inflation were rising energy prices, especially for natural gas. In November 2021, the inflation rate reached a record 4.9% in the Eurozone and 6.8% in the USA.

Figure 1. Annual inflation rate in the Eurozone, November 2021,%



Source: Eurostat Flash estimate 133/2021

In line with the global trends, inflation in Ukraine has also started rising. In January 2021, the inflation rate went beyond the target range, and the National Bank revised its inflation forecast from 6.5% to 7%, expecting a rebound in consumer demand, rising labour costs (also due to an increase in the minimum wage), rising energy costs and the aftermath of a poor harvest in 2020.

¹ <https://ces.org.ua/ukraines-resilience-to-crises/>

However, consumer prices accelerated beyond the NBU's expectations, reaching a peak annual growth rate of 11% in September 2021, practically maintaining the pace in October (10.9%) and reducing the growth rate in November to 10.3%.

The National Bank has raised its key policy rate by 300 p.p. in March 2021 in reaction to the CPI spike. The latest increase took place on the 10th of December 2021, when the key policy rate was raised from 8.5% to 9%. We note that the majority of experts surveyed by the ICU Barometer² thought such an increase was reasonable but expected the NBU to keep the rate at 8.5%.

“Inflation is slowing down, but it still remains above the level we forecasted in the October inflation report. The structure [of inflation] is also important. [...] In the first half of the year, supply-side factors played the main role, but now the effects of the prices transfer to a wider range of goods and services are coming to the fore. This is worrying, we can see that the core inflation has risen to 7.7%.

In addition, we see that inflation may be affected by the situation in the currency market, financial markets, due to the intensified energy crisis, also grain prices remain higher than we had forecasted and we see that inflation expectations are marginally, nonetheless deteriorating.”

Sergiy Nikolaychuk, NBU Deputy Governor

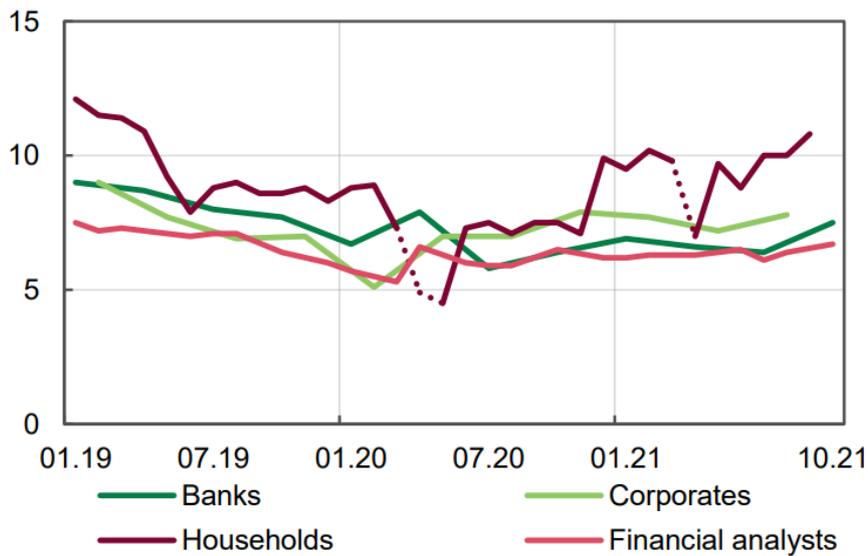
Also, the NBU has stopped providing long-term refinancing and interest rate swaps to Ukrainian banks since October 2021 and raised the refinancing rate by +1 p.p. to the key policy rate in order to limit the money supply in the economy.

It is important to take timely measures to bring inflation back to the optimal level as defined by the central bank. The negative marginal inflation rate is the most significant at the upper limit of the target range, and there is a risk of an inflationary spiral due to rising inflation expectations of businesses and citizens, which in turn will lead to rising wages and rental rates.

According to recent data observations, inflation expectations of businesses and banks remain below the 2019 figures, while inflation expectations of households are rising more dynamically (see Figure 2).

² <https://www.facebook.com/ICUua/posts/4653031651475424>

Figure 2. 12-month-ahead inflation expectations, %



Source: National Bank of Ukraine Inflation Report for October 2021

2. INFLATION TARGETING AS A RISK RESPONSE

The inflation targeting regime is a medium- to long-term instrument for addressing inflation risks.

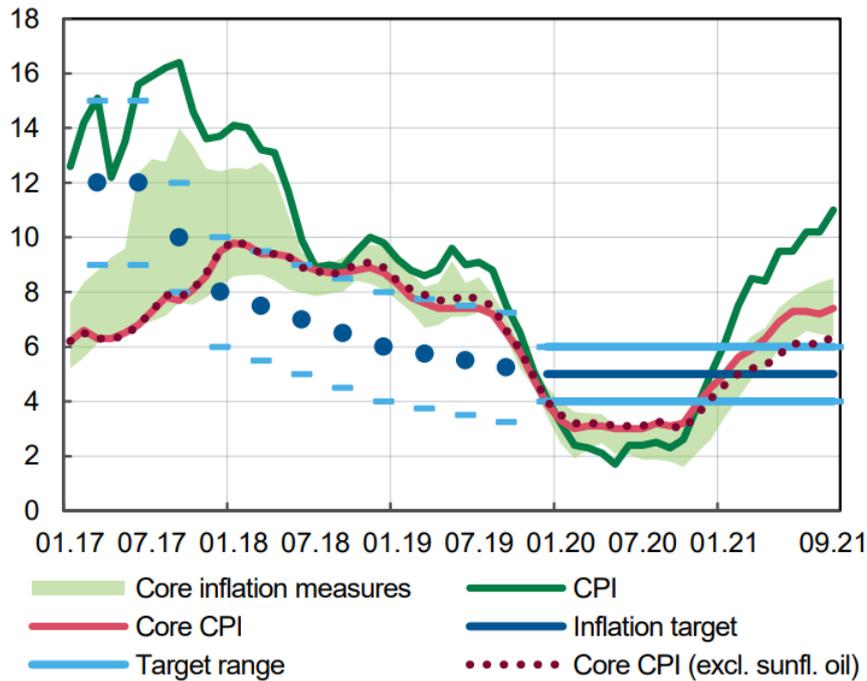
The core principle of targeting is that the central bank sets an inflation target that it considers optimal for the development of the economy and the achievement of its objectives thereby further defining its monetary policy on the basis of the inflation forecast, namely its deviation from the inflation target.

The key policy rate, namely, the cost of borrowing from the central bank, is a key instrument of monetary policy. If the inflation forecast is higher than the target inflation rate, the central bank implements a tighter monetary policy aimed at limiting the supply of money in the economy, in particular by raising the key policy rate.

And vice versa, if the forecast inflation rate is lower than the target inflation rate, the central bank implements a stimulative monetary policy aimed at increasing the money supply.

The National Bank of Ukraine shifted to inflation targeting in early 2016. By approving the Monetary Policy Guidelines for 2017 and Medium Term on 21 December 2016, the NBU Council formalised the inflation targeting regime and set a downward target trajectory for the annual change in the consumer price index, with an exit target of $5\% \pm 1$ p.p. starting in 2019.

Figure 3. CPI (end of period, % yoy), inflation targets and trend



Source: National Bank of Ukraine Inflation Report for October 2021

It is crucial that the National Bank of Ukraine is independent, and that market participants and citizens trust its policies, and in the current circumstances it is sufficient to avoid hyperinflation. However, there are several factors that could accelerate inflation.

Table 1: NBU inflation risk assessment

Degree of impact on the baseline scenario	Weak			
	Moderate	Smaller harvest of main agricultural crops	Intensified labor migration and wages growth	Deterioration in the terms of trade Tightening of quarantine measures
	Strong		Escalation of the military conflict Delays in cooperation with the IMF	Global inflation spike, stagflation, capital outflows from EM
		Low (<15%)	Medium (15-25%)	High (25%-50%)
		Probability that a risk will materialize		

Source: National Bank of Ukraine Inflation Report for October 2021

a) Depreciation

At the moment, the Ukrainian hryvnia does not seem to be overvalued, its exchange rate is shaped by the market. During 2021, the NBU bought \$3,665.7 million worth of currency and sold \$1,139.2 million, so the net purchase amounted to \$2,526.5 million.

Business expectations of the hryvnia exchange rate in next 12 months have improved from 28.71 UAH/\$1 in June to 28.50 UAH/\$1 in September according to the NBU's quarterly survey, so there is no significant pressure on depreciation expectations.

However, the risk of a sharp hryvnia depreciation remains present due to external disturbances, in particular, the security risks.

b) Further increases in global food and energy prices, inflation peak prolongation in the EU and the US

Further increases in global food and energy prices are possible. However, a rather moderate fiscal policy (the 2022 budget deficit is expected to be 3.5% of GDP) will not stimulate domestic demand, so producers and retailers will probably not shift the costs entirely to the final consumer but will take over some of them.

In May 2021, the Cabinet of Ministers of Ukraine adopted Resolution No. 586 approving the forecast for 2022. The price increase for heating is set at 6%, for water - 11%, for electricity - 0%, and for gas - 13%. The Memorandum between the government and the local authorities also ensures that gas is sold to households at a fraction of the market price. If the extra-high energy prices hold out until the next heating season, it will be necessary to bring the cost of utilities to an economically justified level. This will lead to the realization of a subdued inflation. If energy prices decrease next year to the annual average of \$460 per cubic meter, as projected by the NBU, we may expect this factor to be offset by budget expenditures.

“Thanks to sweeping up under the rug of energy inflation, which is the case all over the world, our inflation will be delayed - it's lower at the moment, but it will last longer. For the next year we are forecasting more than 8%.”

“Nothing can be done [by monetary measures] to tame producer inflation, something that will push up consumer inflation - tariffs and fertilisers have gone up”

“In a country with double-digit nominal wage growth, we can't expect inflation like in countries where wages are growing at 5% a year.”

Oleksiy Blinov, Head of Analytical Department, Alfa Bank Ukraine

c) COVID-19

The potential lockdowns caused by the spread of new coronavirus variants will have a downward impact on inflation through subdued demand in the short term and an upward impact in the medium term through the overlap of subdued demand with global supply chain disruptions and production outages.

Transmission mechanism efficiency

Sergiy Nikolavchuk estimates that the NBU's monetary instruments along with moderate fiscal policy will be enough to limit the impact of the existing factors and bring inflation within the target range by the end of 2022. But opinions on this matter differ.

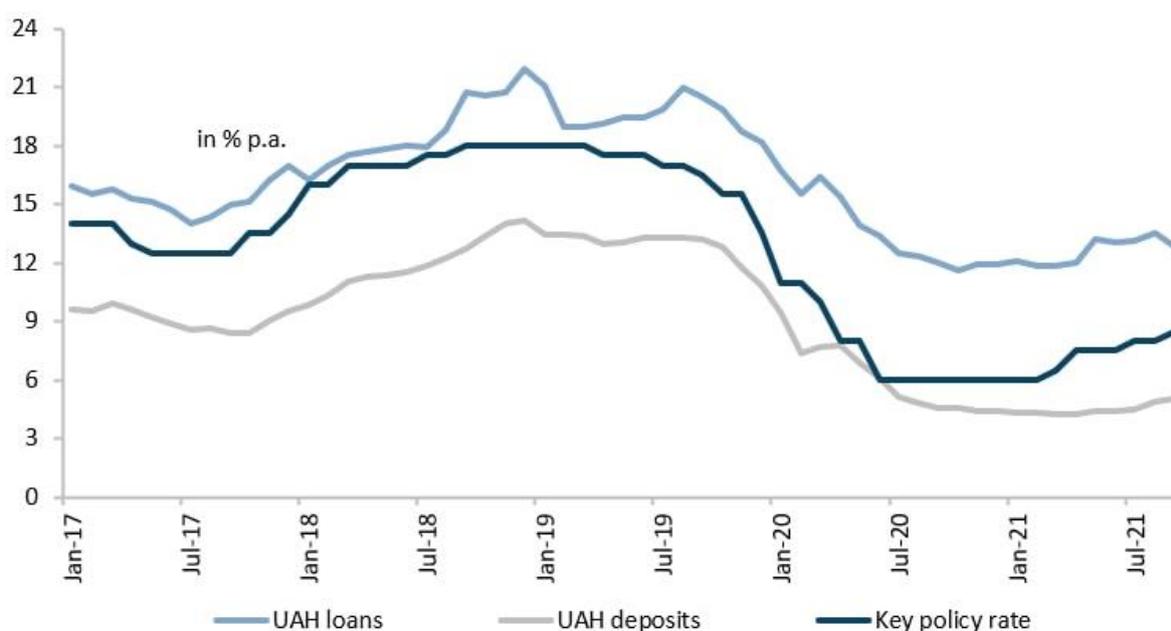
“In Ukraine, more than half of inflation variation is beyond [the influence of monetary policy]. [There should be no illusions that] monetary instruments work as a battery regulator.”

Oleksiy Blinov, Head of Analytical Department, Alfa Bank Ukraine

The effectiveness of monetary policy depends on the transmission mechanism, i.e., the transfer of changes in the key policy rate to the economy - through the cost of borrowing by commercial banks, the level of lending rates and the cost of other funding instruments.

NBU Deputy Governor Sergiy Nikolavchuk emphasises several factors which currently limit the efficiency of the transmission mechanism, i.e. transferring changes in the key policy rate to the economy: 1) excessive liquidity, which prevents banks from attracting funds from the market; 2) behaviour of market makers in the deposit market, who try to reduce their share by keeping interest rates low; 3) weak stock market and, consequently, lack of funding instruments, the value of which would be dependent on the key policy rate.

Figure 4. Dynamics of key policy rate (% yoy), loan and deposit costs



3. RECOMMENDATIONS

Besides pursuing an inflation targeting regime, the state needs to safeguard the institutional independence and competencies of the NBU, which will translate into accountable and high-quality monetary policy and trust towards the regulator, as well as to implement a responsible fiscal policy.

“Fiscal policy predictability is a very important factor under our circumstances. Increasing social standards at a pace consistent with productivity growth is an important component. This year, high growth rates in social standards and salaries for healthcare workers contributed to inflation.

Looking into the future - balanced fiscal policy above all, balanced decisions on social standards, balanced anti-monopoly policy - that's where we need the support from other authorities.”

Sergiy Nikolaychuk, NBU Deputy Governor³

The vaccination campaign should be reinforced to avoid the risks of severe quarantine measures, possible supply shocks (breaks in supply chains) and the need for fiscal incentives.

Further steps should be taken to bring regulated prices for energy and derived services closer to the market prices before the start of the next heating season. Prolonged administrative price regulation of significant volumes will lead to significant imbalances in the economy.

“When we talk about capping prices at some level, this is a mechanism that leads to imbalances in the economy. And someone has to pay for it inevitably - one market participant or another. Such mechanism may work in the short term, but not in the long term.

Sergiy Nikolaychuk, NBU Deputy Governor

“Inflation targeting is effective. There is a significant degree of conditioning of the inflation rate on institutional factors. If we want inflation to be lower and more sustainable, we should not talk about deviations from the target, but about lowering the target. Targeting should be accompanied by structural reforms. Those countries that don't implement structural reforms are left not only without structural reforms, but also with higher inflation and more inflation deviation from the target.”

Victor Koziuk, Member of the NBU Council⁴

³ Hereinafter quotations by Sergiy Nikolaychuk from an interview with the CES on 10 December 2021.

⁴ Quoting from a speech at the CES forum "Ukraine's Resilience to Crises: A Look into the Near Future"