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CHALLENGES OF INFLATION TARGETING IN UKRAINE: ESTABLISHING THE MEGA-REGULATOR

Abstract. The aim of this paper is to reveal the relationship between monetary policy and financial security and to show the possible influence on this relationship of establishing the mega-regulator in Ukraine.

It has also been considered of mega-regulators' functionality in the countries with Inflation Targeting regimes (hereinafter – IT) in order to compare it with national monetary policy and to investigate the challenges for central bank while conducting IT regime as a macro prudential institution.

Keywords: mega-regulator, central bank, inflation targeting, financial security

GEL Classification: E52, E58

Formulas: 0; fig.: 4; tabl.: 3; bibl.: 10

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ВИКЛИКИ ІНФЛЯЦІЙНОГО ТАРГЕТУВАННЯ В УКРАЇНІ: СТВОРЕННЯ МЕГА-РЕГУЛЯТОРА

Метою даного дослідження є виявлення взаємозв'язку між грошово-кредитною політикою та фінансовою безпекою та дослідження можливого впливу на ці зв'язки створення мега-регулятора в Україні.

Також розглянуто особливості функціонування мега-регуляторів в країнах з режимами інфляційного націлювання (далі – ІТ), для порівняння з національною монетарною політикою та визначення викликів для центрального банку при проведенні ІТ як макро-пруденційної установи.

Ключові слова: мега-регулятор, центральний банк, інфляційне таргетування, фінансова безпека

Формул: 0; рис.: 4; табл.: 3; бібл.: 10

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ВЫЗОВЫ ИНФЛЯЦИОННОГО ТАРГЕТИРОВАНИЯ В УКРАИНЕ: СОЗДАНИЕ МЕГА-РЕГУЛЯТОРА

Целью данного исследования является выявление взаимосвязи между денежно-кредитной политикой и финансовой безопасностью, а также исследования возможного влияния на эти связи создание мега-регулятора в Украине.

Также рассмотрены особенности функционирования мега-регуляторов в странах с режимами инфляционного нацеливание (далее – ИТ), для сравнения с национальной монетарной политикой и определения вызовов центрального банка при проведении ИТ как макро-пруденциального учреждения.

Ключевые слова: мега-регулятор, центральный банк, инфляционное таргетирование, финансовая безопасность

Формул: 0; рис.: 4; табл.: 3; библи.: 10

Introduction. The idea of creating a financial mega-regulator in Ukraine has been discussed for the last few years. Implementing such type of regulator can be done through integration of The National Commission for State Regulation of financial services markets into The National Bank of Ukraine (hereinafter – the NBU). As a result, the NBU will perform more functions and with longer spectrum more objectives in addition to promoting stability of the national currency, financial stability (which is the secondary objective according to Article 6 of the NBU Law [3]) etc. and could have stronger influence on financial security of the country.

Literature review. The IMF has a strong interest in ensuring that effective macroprudential policy frameworks are present in all countries, though there is a number of researches [2] that provide a review of the cross-country experience in choosing and applying macroprudential instruments (IMF Working Paper No. 11/238); find a correlation between policy response time and the involvement of the central bank in the macroprudential framework (IMF Working Paper No. 13/166); review the institutional underpinnings for macroprudential policies across countries, and explores ways to improve existing institutional setups (IMF Working Paper No. 11/250).

There are also a couple of research papers on the institutional transformation of the central bank [1,5]. Theoretical research in the area of financial security of the state engaged scientists such as, O.I. Baranowski T.M. Bolgar, A. Brishtev and others.

Issues on the relation between the monetary policy of the central bank and financial security of the state are not enough investigated.

Research findings. The state has to ensure its effective functioning and maintain economic stability in global environment. This can be achieved by economic security, the important components of which are financial, investment, innovation, foreign trade, energy, social, demographic security [8].

However, we consider the support of financial security of the state to be one of the highest priority of its bodies, as the influence of world financial systems on the country in the current conditions of the globalization of financial flows and the free movement of capital is intensifying.

By financial security we mean national security in the financial sector, which includes security issues in budget sphere, public debt management, sovereign public debt and debt of corporate sector in tax sphere, the real sector, the banking sector, the foreign exchange market and in the spheres of functioning of the non-banking financial sector in the stock market. The concept of national security in

the financial sphere is revealed in the guidelines for ensuring national security in financial sphere, approved by the Cabinet of Ministers of Ukraine [10]. In order to ensure financial security, it is necessary to monitor its indicators, showed in Figure 1 below.

Banking security indicators
<ul style="list-style-type: none"> •Level of NPL •The share of foreign capital in the authorized capital of banks •Return on assets etc
Non-banking sector security indicators
<ul style="list-style-type: none"> •Level of insurance penetration •Funding level of listing companies
Budget security indicators
<ul style="list-style-type: none"> •Level of GDP redistribution through consolidated budget •The ratio of budget deficit /surplus to GDP
FX security indicators
<ul style="list-style-type: none"> •Gross international reserves of Ukraine •The level of dollarization of the money supply
Monetary security indicators
<ul style="list-style-type: none"> •Total amount of financial resources outside the country •The average weighted interest rate on loans to corporations

Figure 1. Indicators of country financial security*
 *the list of indicators is inexhaustive and indicative
 Source: made by author on the base of [9,10]

Determining the essence and indicators of financial security of the state allows us to investigate the impact of the current regime of monetary policy (IT) on the key elements of financial security, such as banking, FX, monetary and fiscal security, which have to be considered.

The connection of monetary policy and financial security is ensured in the following areas, showed in Figure 2 below.

Monetary policy instruments	1. Interest rate	rate at which the central bank conducts its main liquidity management operations to exercise influence on the money market	➔	banks' financial stability	Banking security	access of all subjects of the economy to credit resources	Monetary security	The level of financial security
	2. Liquidity management operations	reducing the liquidity of the banking system		effective functioning of the economy		economic growth		
	3. Required reserves	allow mitigation of possible unexpected fluctuations of liquidity	➔	attraction of foreign investments	Foreign exchange market security	effective functioning of state bodies		
		limitation of excess liquidity of the banking system		the stability of the currency				
	4. Foreign exchange market interventions	accumulation of international reserves		public trust		Budget Security		
		graduation the functioning of the foreign exchange market						

Figure 2. A link between monetary policy instruments and financial security
 Source: made by the author

Thus, a link between monetary policy and financial security of the state (as shown in Fig. 2) exists due to several factors: the similarity of subjects of the implementation of the monetary policy regime of inflation targeting and ensuring the financial security of the state; the dependence of levels of financial security on internal and external financial and credit policy [8]; the presence of priority financial security objectives as a component of economic security and their relevance to the objectives of the IT regime; the level of monetary security as an integral element of financial security is ensured through the implementation by the National Bank of Ukraine of monetary policy in order to fulfill its main function – to ensure the stability of the national monetary unit.

As the financial security of the state and its indicators are defined, it is necessary to investigate the challenges of the NBU's monetary policy during the process of establishing single supervision in Ukraine.

According to the fact that a project of the Resolution 2413a/II draft of 07.07.2016 on the amendments to some legislative acts of Ukraine to consolidate the functions of state regulation of financial services [4] is assigned, the process of creating financial mega–regulator in Ukraine is active. Single supervision by the NBU means that in addition to its supervision of commercial banks, the function of a single regulator will also include monitoring non–bank financial institutions such as insurance companies, asset management companies, pension funds, factoring and leasing companies, as well as microfinance institutions.

Single supervision (mega–regulator) is established in different countries, such as Norway, Sweden, Denmark, Finland, Germany, United Kingdom, Australia, Singapore, Canada, etc. Some of them have such type of monetary policy as IT, list of these countries is given.

Table 1

Some countries with mega–regulator and IT monetary policy regime

Country	Mega–regulator	IT institution (Central bank)
United Kingdom	Financial Services Authority	Bank of England
Norway	Banking, Insurance and Securities Commission	Norges Bank
Sweden	Swedish Financial Supervisory Authority	The Riksbank
Japan	Financial Supervisory Agency	Bank of Japan
South Korea	Financial Supervisory Commission	Bank of Korea
Australia	Australian Securities and Investments Commission, Australian Prudential Regulation Authority	Reserve Bank of Australia
South Africa	Financial Services Board	South African Reserve Bank
Hungary	Hungarian Banking and Capital Market Supervision	Central Bank of Hungary
Canada	Office of the Superintendent of Financial Institutions	Bank of Canada

Source: made by author on the base of IMF [2]

As we see from Table 1, the institution that pursues an IT (Central Bank) differs from the institution that supervises the financial sector is a single regulator. The current practice in Ukraine differs from such trend, and the central bank will probably combine both roles, the one of a mega–regulator and the monetary authority.

In order to gain financial stability, these institutions are established to implement macro prudential policy, having macro prudential mandate (MPM) in other words.

Important factors that influence the difference between countries are in the practice of choice the macro prudential institution. As we see in Figure 3 below, providing central bank with the macro–prudential mandate is popular in 15 European countries, 10 Asian countries and some others. This can be due to bank–centralized economy, independence of national (central) bank and high level of trust to the banking sector in the country.

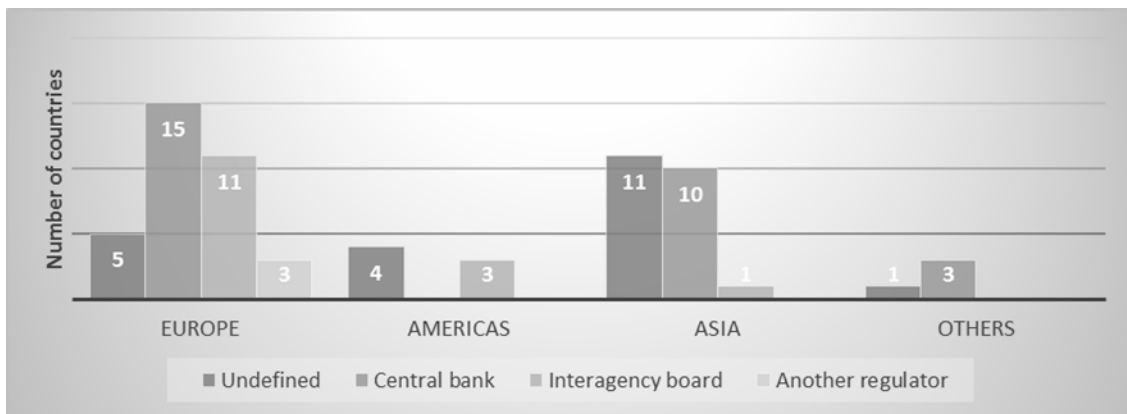


Figure 3. Macro prudential authorities by regions
Source: created on the base of [1]

As of today, the NBU de-facto performs the mandate for ensuring financial stability in Ukraine [1, p.26]. Some other bodies with MPM in the area of financial stability can be defined, for example – The Financial Stability Council, but it is not decision-making body. While other regulators (e.g. National Commission for State Regulation of Financial Services Markets) have no legal mandate for promoting financial stability (not to mention an MPM) despite their stake in financial stability and certain powers that can influence it [1].

In case of the appearance of the NBU as a single supervisory body, there would be a need to make a “clean-up of non-banking sector” as it was done to the banking sector during 2014–2016, because non-banking sector in Ukraine is that a market segment that requires active policy decided by a regulator. Taking into account the decrease of potential risks for banking sector (such as liquidity problems, low quality assets, needs for funding and capitalization as well as fraud, money laundering, non-transparent beneficiary of banks), which improves the stability of financial system and increases the level of trust to the banking sector, the non-banking sector has to be restructured and cleaned-up by the regulator also.

Such process can cause higher reputational risks for the regulator, while key prerequisite for conducting IT monetary policy is financial stability together with an open dialogue between the NBU and the public (transparent monetary policy, clear targets, comments in media, publications of inflation reports etc.).

It has to be emphasized that according to the data in Table 2, most countries with IT demonstrated a decrease in inflation rate and interest rate.

Decreasing level of interest rate means that the financial instruments for the whole financial sector (not only depositary institutions – banks) will be cheaper, so the demand for financial services of insurance companies, leasing and factoring institutions, pawnbrokers and pension funds will probably raise. There is a need in macro regulator as a single institution for making process of forecasting the cause of macroeconomic factors for IT easier. The body, which oversees and supervises the whole financial sector in conditions of IT monetary policy, is the best solution to conduct the effective monetary policy and provide financial stability in Ukraine.

Table 2

Comparison of interest and inflation rates for some countries, %

Countries with IT regime	Inflation rate			Interest rate		
	before IT	after IT	+/-	before IT	after IT	+/-
Australia	6,33	2,25	-4,08	12,1	5,29	-6,81
Czech Republic	15,9	0,77	-15,13	12,3	4,18	-8,12
Hungary	21,4	5,8	-15,6	19,4	8,7	-10,7
Norway	6,1	2,2	-3,9	6,5	2,6	-3,9
Slovakia	6,5	3,7	-2,8	3,1	1,18	-1,92
Turkey	82,3	10,2	-72,1	93,8	9,25	-84,55

Note* inflation rate and interest rate are calculated as average for the period before IT regime and after.

Source: made by author based on [2]

To investigate the challenges for the NBU while conducting IT regime as a macro prudential institution we have to examine the relationship between inflation and efficiency of conducted monetary policy. To measure the efficiency of MP a member of quantitative indicators is used, interest rate, which is set by the NBU (on a monthly basis) and exchange rate (average for the given period in hryvnias for 100 dollars), monetary base, which includes cash issued by the NBU and transferable deposits in national currency at the NBU (balance of funds at the end of the period in mln hryvnias) and currency in circulation (in mln hryvnias).

With the help of Fisher's ratio test ($F_{critical} = 2,58 < F_{statistical} = 125,6$) and valuating the closeness of curves Y and Y^ (Figure 4) it was found that the given econometric model adequately describes the data.

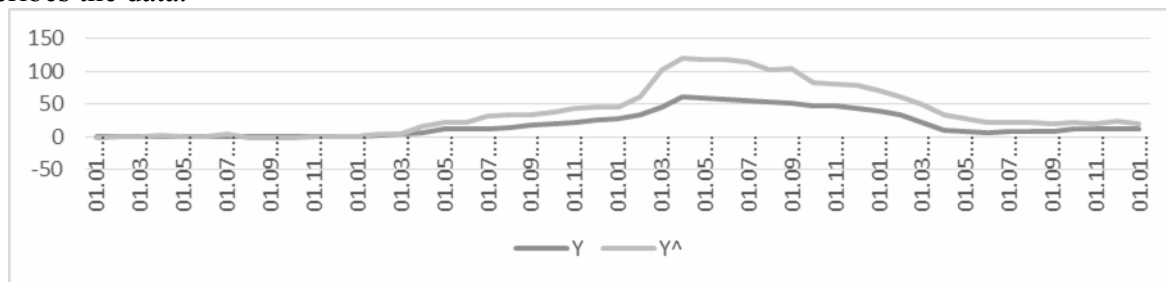


Figure 4. Closeness of Y and Y^ curves

Carrying-out Student's t-test shows that all the factors in the model are significant, but the most significant are interest rate and exchange rate (Table 3).

Table 3

Student's T-test		
T _{critical} (0,05;4)	2,776445105	T-test
Significant if	T _{critical} < T _{statistical}	
t0	-2,859846922	
t1	14,71193364	Significant
t2	-3,386645794	Significant
t3	4,084102041	Significant
t4	-4,264447613	Significant

Source: made by author

In the econometric model, we have valued how different economic indexes can influence the consumer price index and the most important problem here is to value not only the banking system, but also financial market as a whole, to prevent destabilization of financial system of the country.

Conclusions. The process of establishing mega-regulator in Ukraine is active, and as the NBU de-facto performs the mandate for ensuring financial stability, there is a possibility for the central bank of Ukraine to become a single supervisory body. As a result, the chosen monetary policy – Inflation Targeting, has to be developed taking into account the reputation risks of the NBU while conducting supervision in the non-banking sector, which influence the level of financial security of Ukraine.

The given econometric model shows that it is important to take into consideration not only interest and exchange rate while forecasting the inflation, but the significant factor is also the monetary base, which is influenced not only by banking sector, but also by the financial stability of insurance companies, leasing and factoring institutions and other financial companies, which are the components that influence the non-banking sector security. Activity of these companies creates demand and supply on single financial market, and as a result can be a negative/positive external shock and change level in inflation in the country.

The appearance of single supervisory body cause changes in objectives of monetary–credit policy of central bank, including the need in reviewing the Inflation Targeting mechanism, and the model with factors, which is used for prediction and forecasting the cause of external factors, the establishment of restricted supervision to the financial institutions (as it is done to the banking sector of Ukraine).

The effective monetary policy (IT) in Ukraine is possible if the NBU will be independent in decision–making processes in single financial market. Moreover, better results can be provided if the NBU uses its own estimated data, based on single supervision of financial sector of Ukraine.

The relationship between monetary macroeconomic indicators and some indicators of financial security would be a subject of further research in order to investigate what challenges the NBU will have if the single supervision is established.

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