



Inflation targeting for Ukraine: caution is needed

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Workshop on

Ukraine's economic development and the EU Association Agreement

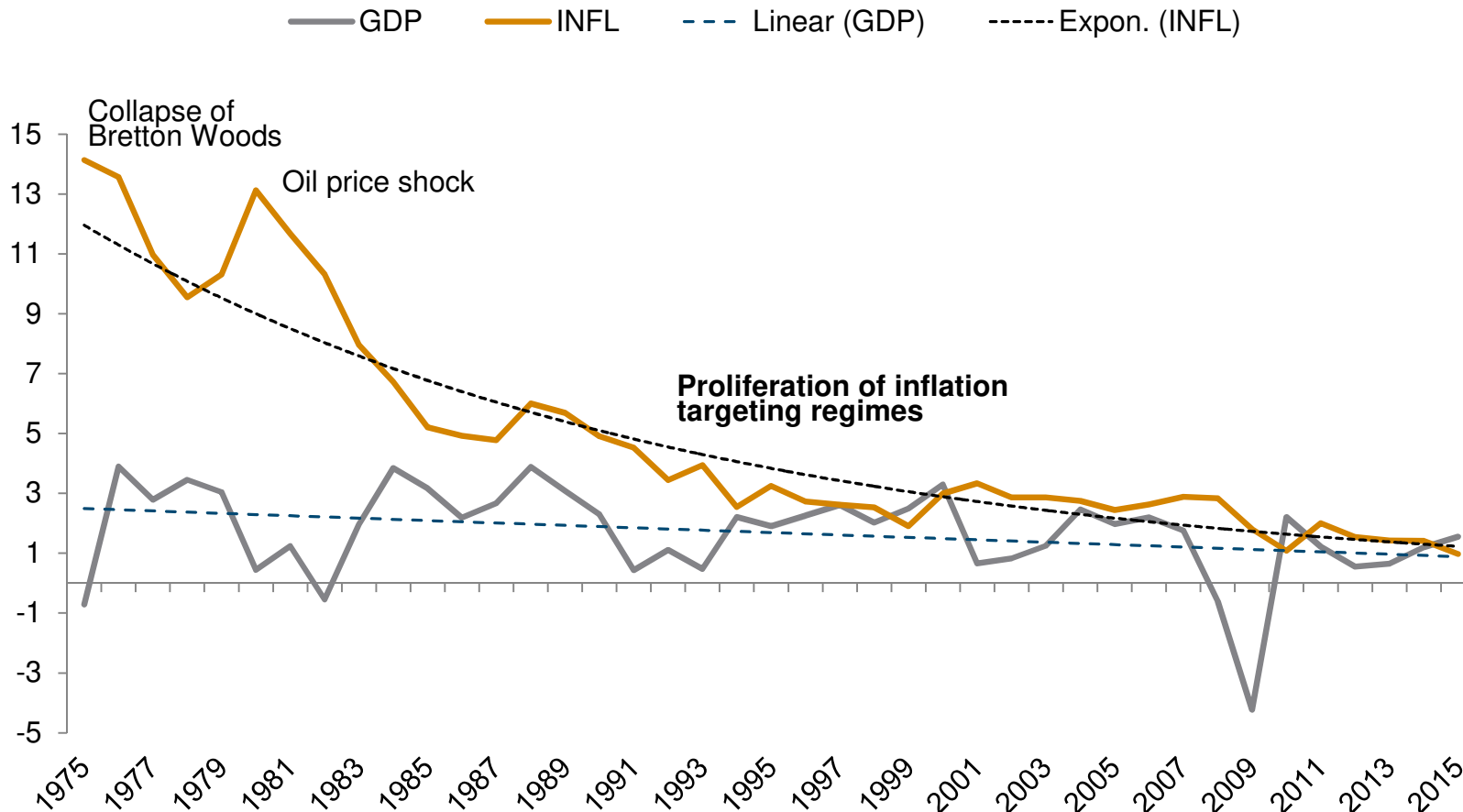
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Key messages

- Inflation targeting (IT) may constrain economic growth
- The ‘fear of floating’ is to a large extent justified

History: Was disinflation* really thanks to IT?

Rather: (i) internal liberalisation and (ii) globalisation



* OECD countries.

Source: World Development Indicators, World Bank.

IT may suppress economic growth

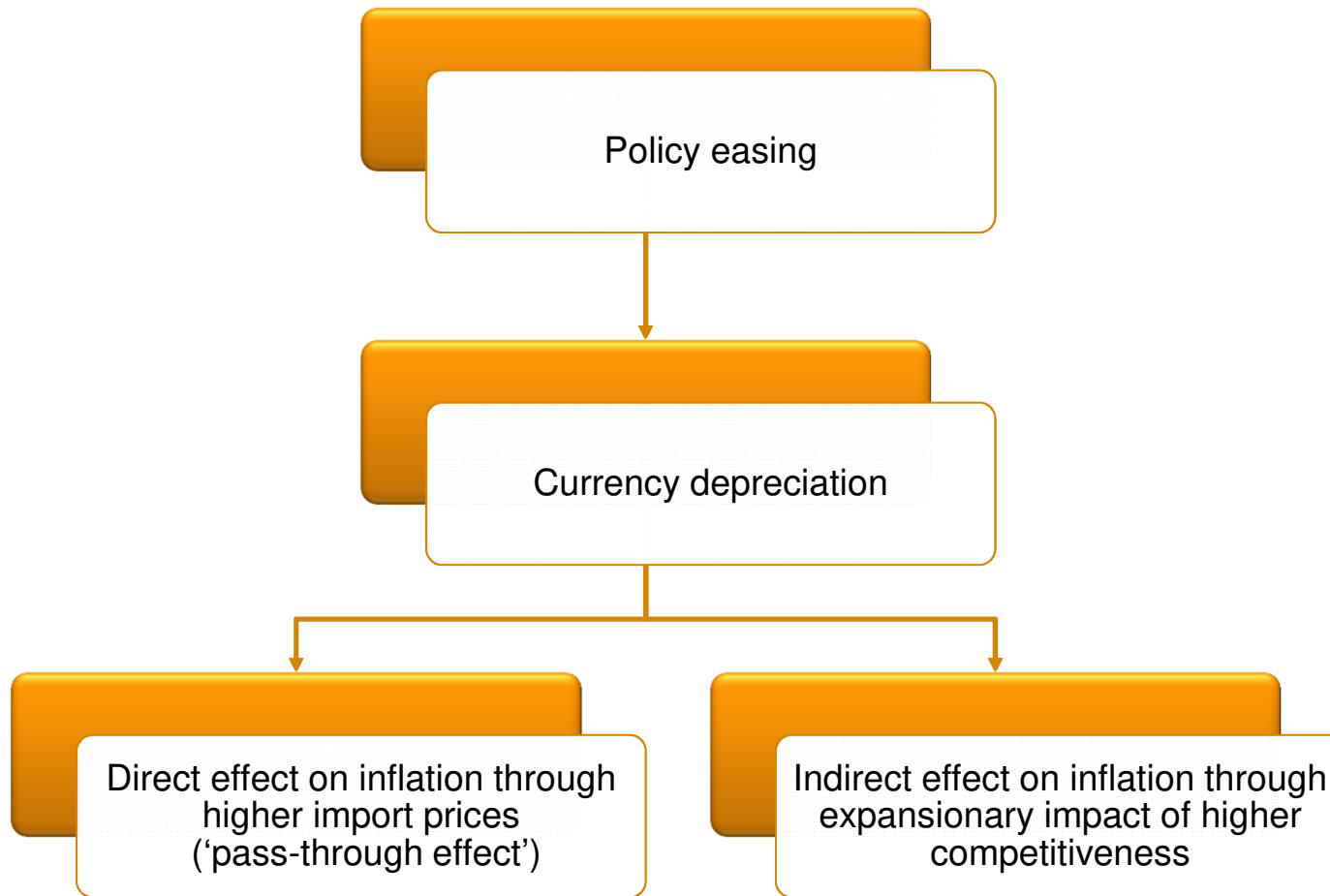
- Impact of IT on growth more immediate than on inflation
- Besides: transmission channel is asymmetric
 - Interest rate hike (‘pulling on a string’) works better than interest rate lowering (‘pushing on a string’)

- For medium- and low-income countries:

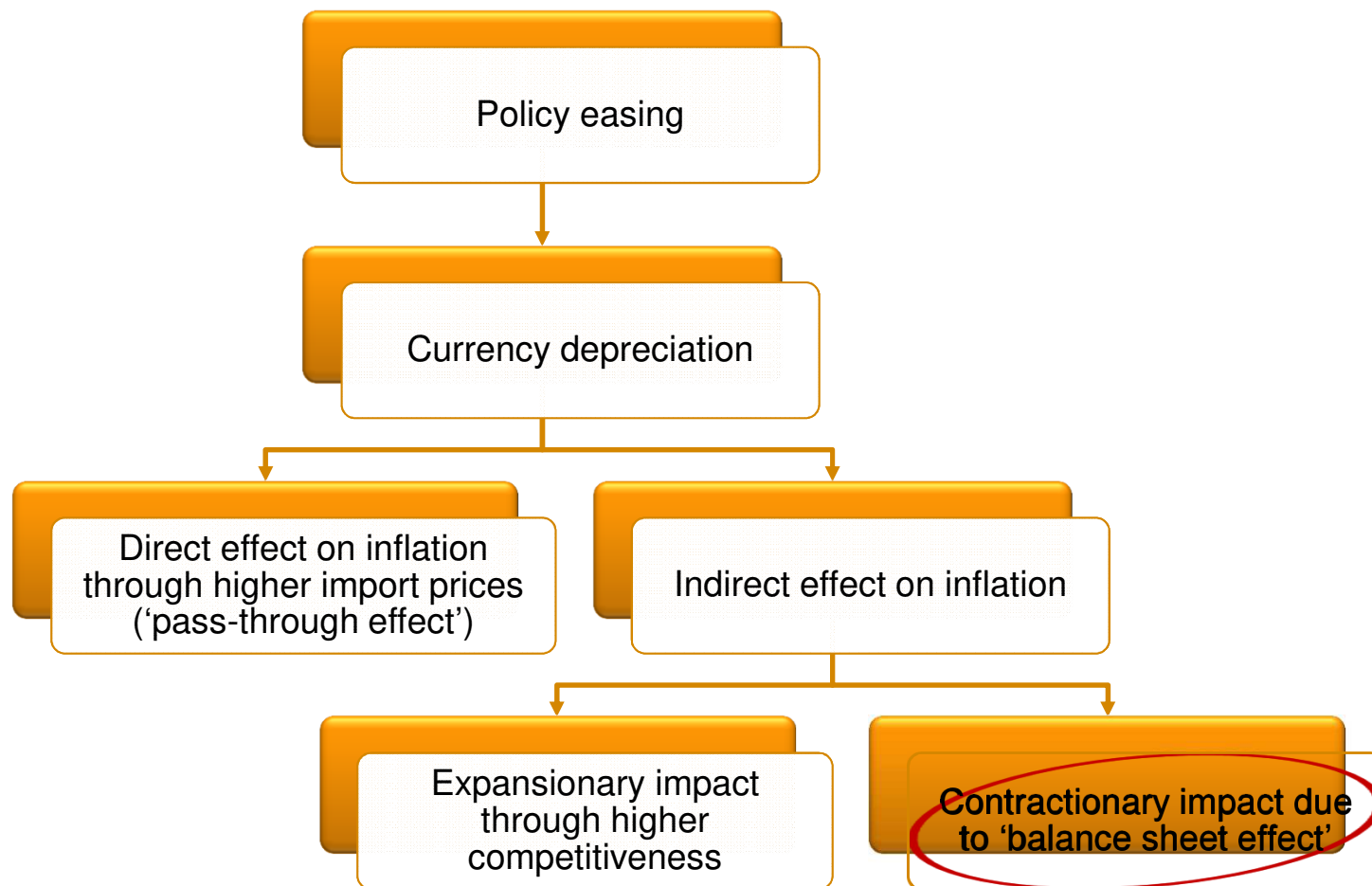
Higher inflation is associated with higher GDP growth, up to inflation threshold of:

- 10% (Espinoza et al., 2011)
 - 14-16% (Pollin and Zhu, 2006)
- Therefore: 5% medium-term inflation target set by NBU is too low for Ukraine’s development level

The role of exchange rate: non-dollarised economy



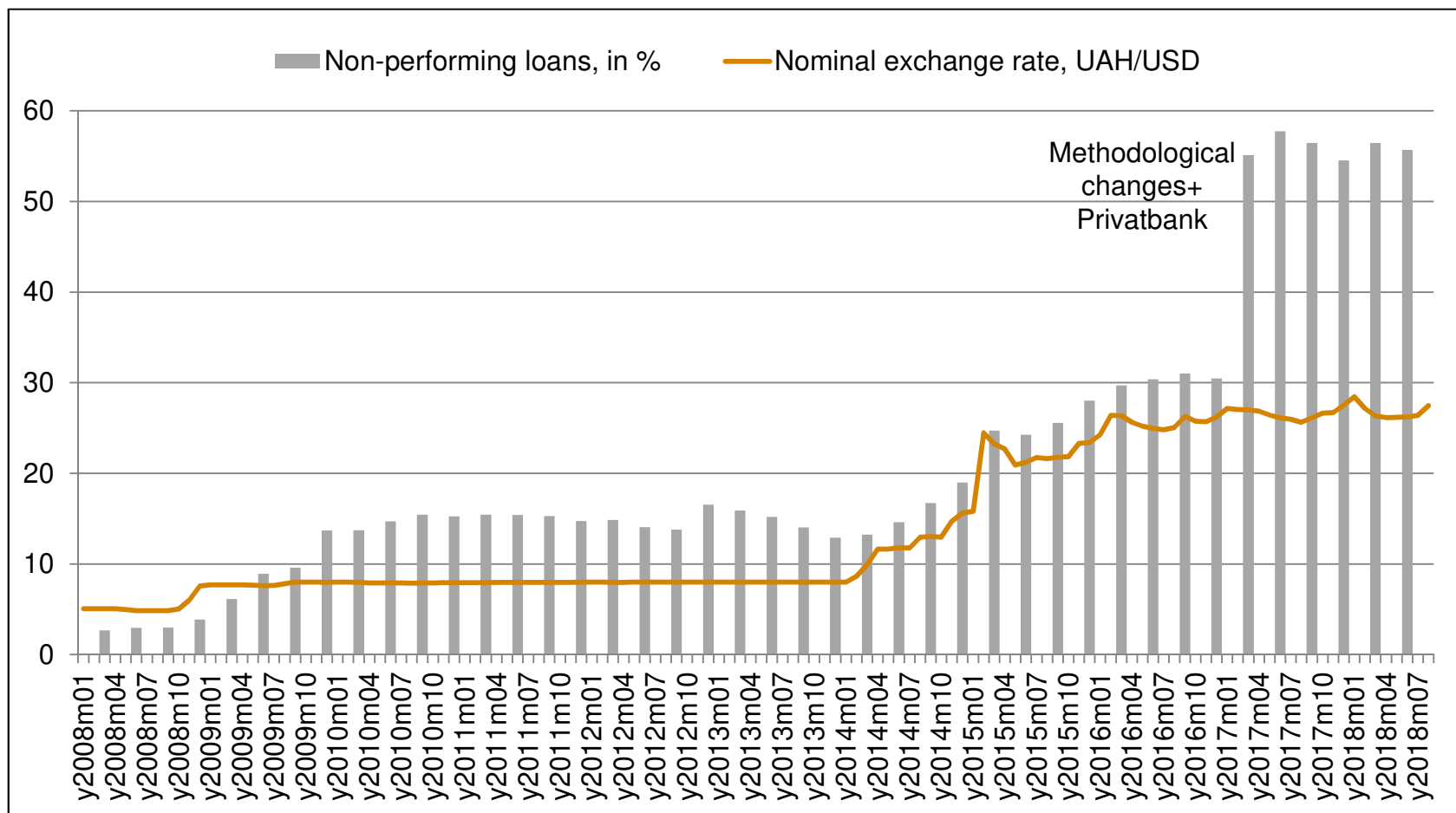
The role of exchange rate: dollarised economy



Hence: pure IT in a dollarised economy can be pro-cyclical!

'Balance-sheet effect' matters in Ukraine

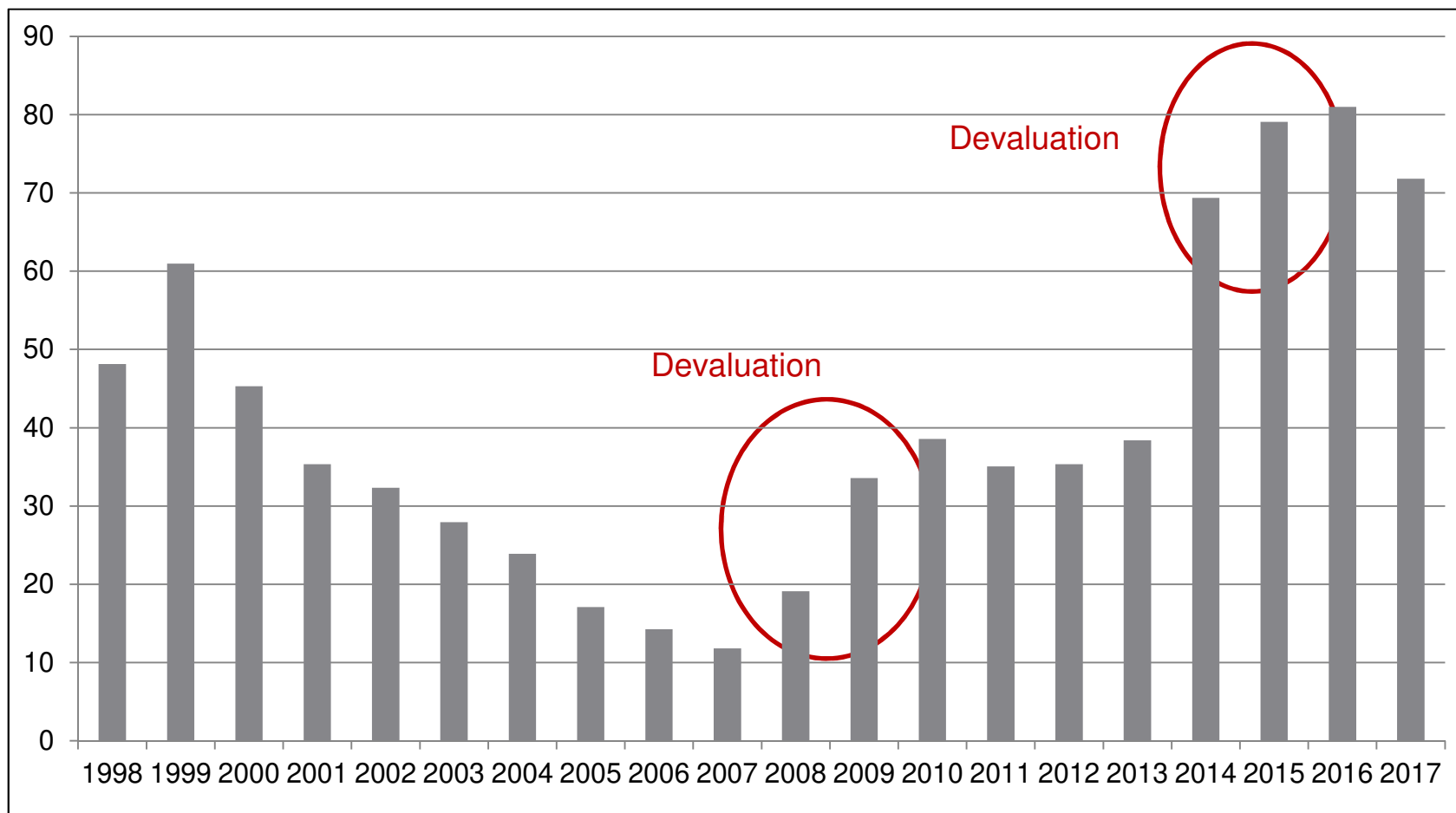
half of all loans denominated in foreign currency



Source: wiiw.

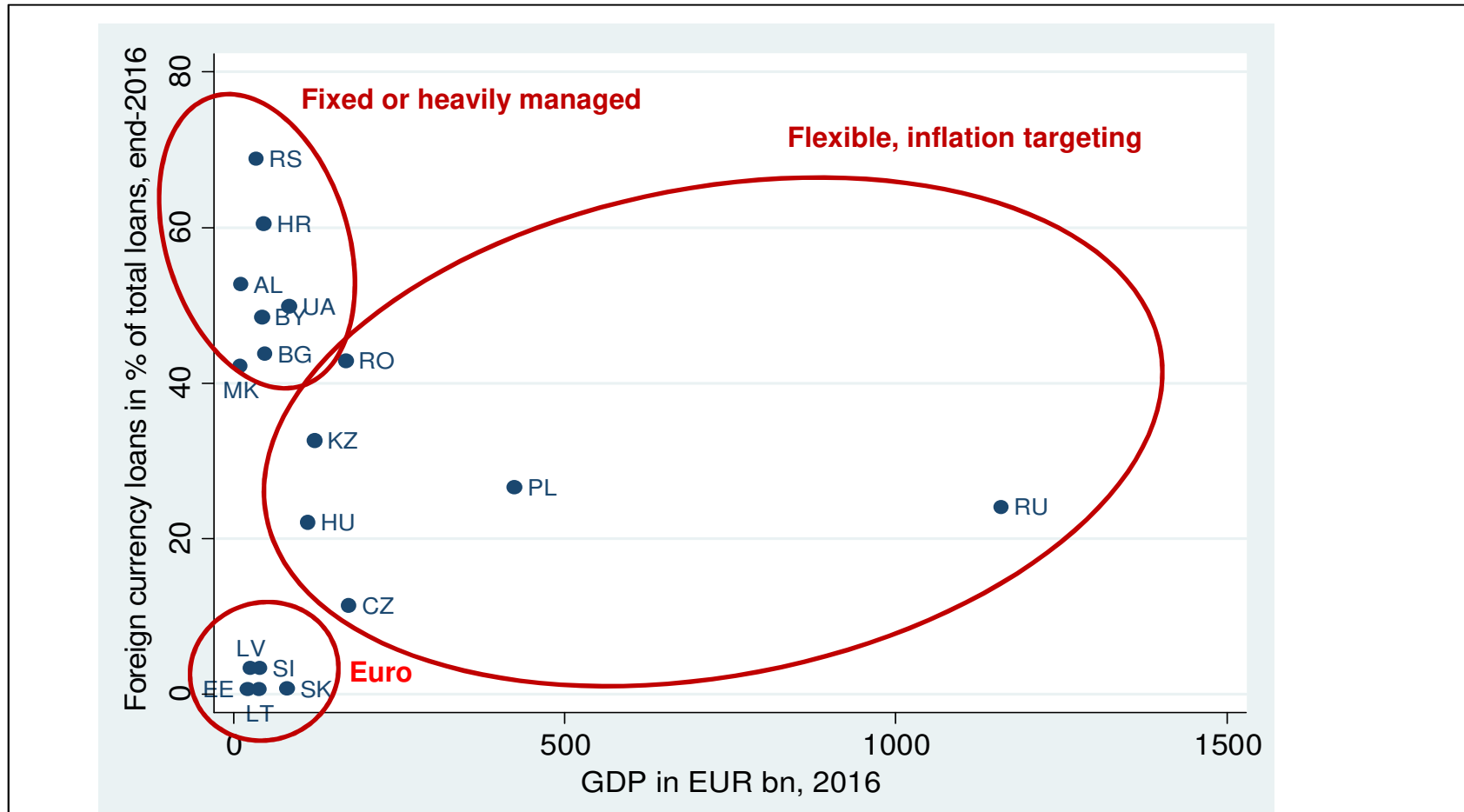
'Balance-sheet effect' matters in Ukraine

~70% of public debt denominated in foreign currency



What is the optimal exchange rate regime?

A look at Central and East European countries



Policy recommendations

- Adoption of inflation targeting regime in Ukraine is premature
- 5% inflation target will require overly restrictive monetary policy
- Flexible exchange rate resulted in excessive depreciation, with devastating consequences for real economy
- Ukrainian hryvnia likely prone to speculative attacks also in future
- Therefore: Stability of exchange rate is crucial...
- ... and should be ensured primarily by interventions rather than interest rates policy (which works pro-cyclically)

References

- Espinoza, R., H. Leon and A. Prasad (2011), 'When Should We Worry About Inflation', *The World Bank Economic Review*, Vol. 26, No. 1, pp. 100-127.
- Leiderman, L., R. Maino and E. Parado (2006), 'Inflation targeting in dollarized economies', *IMF Working Paper* 06/157, June.
- Pollin, R. and A. Zhu (2006), 'Inflation and Economic Growth: A Cross-Country Non-Linear Analysis', *Journal of Post Keynesian Economics*, Vol. 28, pp. 593-614.

Thanks for your attention !!!