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INFLATION TARGETING AS A TOOL TO STIMULATE ECONOMIC GROWTH IN UKRAINE

The link between inflation and economic growth is one of the most important controversies in the economic literature. The paper to be presented in the Conference investigates the relationship between the economic growth and the inflation in Ukraine during the last decade. The aim of such attempts is not only to determine the impact of inflation on economic growth but also to assess efficiency of the inflation rein-in policy, for example, the policy of inflation targeting, provided by the National Bank of Ukraine. The paper discusses the important banking policy implications of the results and provides substantial recommendations.

Considering the conceptual ideas mentioned above, the authors would like to emphasis that the relationship between inflation and economic growth is one of the most important economic controversies among the economists, policymakers and monetary authorities in the last few decades. In particular, the core of argument is that whether inflation is necessarily for economic growth or it is harmful to economic growth. Although the relationship between inflation and economic growth has been widely examined and investigated over the years the relationship is being debated in economic literature

The empirical and theoretical evidences provide basically three types of relationship between the inflation and the economic growth, positive, negative and none [1; 2]. Sharing this point of view, author analyzing the inflation-growth dynamics over the world and, particularly, in Ukraine during the last decade, find

a significant positive as well as negative relation between two variables in different countries in the long run. These divergent results confirm that there is a debate yet on the relationship between inflation and economic growth in the literature. This controversial condition encourages for further studies in examining the dynamics of the relationship between inflation and economic growth.

It is necessary to note that it is the general consensus that the developing countries are more susceptible to supply shocks causing high variability in inflation and disturb the consumption, investment and production behavior. Moreover, more government interventions in financial and goods markets and macroeconomics behavior cause economic instability and market failure. ***Therefore, prices do not give correct signals about the policies and the course of actions of the economy agents in the most of developing countries, including post-soviet bloc, particularly, Ukraine.*** In this context, the examination of inflation-growth relationship with respect to developing countries is imperative [3, p. 44].

Analyzing the relations between the bank rate, inflation and economic growth in thirty counties, as developed, as well as developing, the authors came to the conclusion that the most countries are currently competing with each other in terms of the magnitude of negative real interest rates. Among developed countries, the leaders in the "negative" category are the Eurozone, the USA, the United Kingdom, and Scandinavia. Among developing countries such are Turkey, Thailand, Hungary, Argentina, South Korea, Chile, Malaysia, and Taiwan.

In essence, the entire civilized world is in the "zone of negative real interest rates", with countries literally competing with each other to provide their businesses with a larger interest rate advantage and, thus, a more efficient credit lever [4].

Ukraine, therefore, is the only country among those thirty that have been analyzed, where the credit interest rate exceeds the inflation level (in our case, the consumer price index). Upon realizing this, the authors set out to analyze the global practices of central banks in different countries that, while achieving relatively high, and more importantly, stable economic growth rates, managed to keep inflation at relatively low levels.

It was concluded that central banks most often employ the following monetary policy regimes: targeting the exchange rate of the national currency, monetary targeting, and inflation targeting. Exchange rate targeting focuses on the national currency exchange rate as the target inflation indicator [5].

Monetary targeting implies managing the volume of the "broad" money supply. In this targeting approach, the influence on the inflation level is exerted through control over the dynamics of the corresponding money aggregate (M2 or M3).

When it comes to inflation targeting, the most commonly chosen target indicator is the consumer price index or its derivative - core inflation, which excludes short-term sharp price changes influenced by administrative, seasonal, or cyclical factors. This regime aims to reduce the inflation expectations of the population and entrepreneurs by increasing their confidence in the central bank's credit and monetary policy.

According to IMF data as of 2022, the inflation targeting regime was applied in 38 countries, as well as in the Eurozone (comprising 19 countries) [6].

In Ukraine, the National Bank (NBU) began implementing the inflation targeting procedure (IT) in 2016 in line with the Monetary Policy Strategy for 2016–2020. As a result, the NBU transitioned from a de facto fixed exchange rate to an inflation targeting regime. Under this approach, quantitative inflation targets are published, and the central bank commits to meeting those targets over the medium term. However, the NBU has no control over setting prices for goods and services.

Despite the criticism that accompanies the use of this mechanism of monetary regulation, it is necessary to objectively assess the potential positive consequences of this regime. In particular, it establishes a nominal anchor for monetary policy that most closely aligns with price stability. In the IT regime, there is flexibility in the choice of monetary policy instruments, allowing for the selection of the most suitable methods for achieving target indicators in a given situation and specific macroeconomic environment. Finally, a clear criterion for the central bank's performance emerges, which is the stabilization of price expectations among the population.

After a deep analysis of the specialized literature on the researched issue, the authors conclude that in each specific case, the intermediate goal of monetary policy is the forecast of inflation over a certain period of time. For this reason, inflation targeting is often referred to as ***"forecast targeting"*** [4, p. 38]**.**

By adjusting monetary policy based on new information, the central bank affects expected inflation and gradually brings it in line with the target. Acting in this way, it eventually aligns actual inflation with the target level. The key phrase here is "over time."

When applied to the Ukrainian economy, inflation targeting has its specifics. In particular, international experience suggests that inflation targeting can be effective when it is based on a long-term experience of low inflation. However, in the years leading up to the introduction of this regime, inflation in our country was very high: 24.9% in 2014 and 43.3% in 2015.

Desiring to reduce the level of inflation, the NBU introduced the IT procedure in 2016, which was a logical response to such high price growth rates. It may seem that achieving the inflation target in 2016 indicates the correctness of transitioning to inflation targeting. However, firstly, the transition to this regime is recommended after several years of low inflation, and secondly, the reasons for the significant slowdown in price growth in 2016 could have been natural and not solely a result of the IT regime (the end of the devaluation shock also played a role). Perhaps that's why the successes that the NBU had in inflation targeting are temporary in nature for now [7].

In addition, the experience of developed countries shows that effective achievement of the inflation target is possible only with stable rates of economic growth over a long period of time, in the absence of serious imbalances in its structure, and with low rates of price growth in industry. In the period preceding the introduction of the IT regime, significant economic growth rates were not

observed in Ukraine. Thus, in particular, in 2014, GDP decreased (compared to 2013) by 6.8%, in 2015 (compared to 2014) - by 9.9. The structure of the economy was clearly skewed towards the dominance of the production of raw materials and semi-finished products, and remained so. Prices in industry grew at a high rate: in 2014 - by 31.8%, in 2015 - by 25.4 [8].

So, there were many prerequisites lacking for the transition to an inflation targeting regime in our country. Inflation is a complex, multifactorial, and contradictory process, and monetary policy measures often have an impact on the economy with a significant time lag. Inflation is subject to significant inertia, and plans to bring it to specific levels over a few years were not realistic, as the authors had pointed out back in early 2016.

Additionally, in Ukrainian conditions, inflation often arises due to uncoordinated actions of government bodies. The reliability of forecasts in our conditions is inherently questionable (there are also doubts about the forecasting abilities of NBU specialists). Therefore, they may not always serve as a quality basis for decision-making.

In discussions about the benefits or harms of inflation targeting, it is crucial not to forget about our main strategic goals - economic growth, reducing unemployment, and increasing people's incomes. Stabilizing inflation at a low level by itself does not guarantee the achievement of these goals. Moreover, the instrument currently used by the NBU for this purpose - raising the discount rate - leads to more expensive loans.

Of course, the National Bank is obligated to strive for inflation stabilization at a level around the specified target. The authors believe that this level should fall within the range of single-digit figures, closer to 5-7%. However, the National Bank may also desire to promote economic growth at the maximum potential level. The stabilization of real sector variables, such as production growth and employment, does not always make it into the list of goals for the central bank of any given country. But inflation targeting can vary from rigid, where the central bank is not concerned with the problems of the real sector of the economy, to flexible, where it shows some concern about it. Considering that dynamic economic growth is what the people of Ukraine expect from the government, the NBU needs to consider a variant of using flexible inflation targeting that does not hinder economic growth, at the very least [4].

In answering the question of whether combating inflation or economic growth is more important, the authors believe that these issues are equally significant. Furthermore, they argue that reasonable compromises are needed to avoid pursuing one goal at the expense of complicating the achievement of the other. Addressing the question of how suppressing inflation contributes to economic growth, they typically respond that when economic agents are confident in price stability, they are more likely to increase production. While this argument has some validity, low inflation alone will not solve key problems such as weak domestic demand, technological lag, and high energy and material intensity. Affordable loans for the real sector of the economy can help address these issues.

The conditions in the Ukrainian banking system in 2012–2013 are a clear example of the effect high rates have on expectations of low inflation and a stable exchange rate. Despite the recession that began in the second half of 2012, growth in hryvnia retail deposits accelerated when real interest rates (nominal rates less inflation) increased substantially, which was one of the reasons why inflation was near zero in those years.

Obviously that transmission via any channel takes some time. For example, in Ukraine, it takes 9–18 months for a change in the NBU's key policy rate to have a major effect on inflation. Therefore, central banks often change the key rate at times when the need for that shift is not obvious based on available inflation data. For example, central banks often reduce key rates amid growing current inflation or hike rates when inflation is on the decline. This is because central banks focus mainly on the most probable future trends rather than on current inflation.

Russia's imperialist aggressive war against Ukraine has led to the significant decrease not only in GDP growth rate but to its absolute value. According to the State Statistics Service of Ukraine, the national economy shrank by 30.4% in 2022, compared to the 3.4% growth in 2021. It is the biggest contraction since independence in 1991 due to the large-scale invasion by Russia in February 2022 [8]. The rate of inflation accelerated from 10 percent in 2021 to almost 20 percent in 2022[8]. The main drivers of the inflationary surge were the limitation of domestic supply due to hostilities, the destruction of raw material/energy supply chains and the transition to more expensive substitutes, the devaluation of the hryvnia exchange rate and an increase in the cost of imported goods, price shocks of the world market for food and energy products.

An essential factor in maintaining economic stability was the early implementation of an official fixed exchange rate for the national currency. This measure helped to control exchange rate expectations and alleviate market pressures, despite the significant uncertainty faced by businesses at the time. At the beginning of the war, the National Bank of Ukraine temporarily moved away from its flexible exchange rate policy and fixed the rate at 9.25. Since July 21, 2022, the exchange rate for the dollar has been fixed at 36.57 UAH/USD, resulting in a devaluation of 25% [7].

From all the above, two exceptionally important theoretical conclusion emerges, according to which: A) ***it is absolutely necessary to return to a market exchange rate when the interest rate is increased; B) if there is no opportunity for currency arbitrage, the movement of the policy rate is absurd, as it does not affect either the exchange rate or capital movement.***

Assessing the need for credit resources, the authors believe that the total requirements for small and medium-sized enterprises (SMEs) alone amount to $73 billion, with the average amount required for one firm (ticket size) ranging from $30,000 to $300,000 in additional financing. Therefore, the government needs to expand the existing "Affordable Loans 5-7-9%" program. However, the state alone cannot provide the required funding. This is why it is urgently necessary to reduce the National Bank of Ukraine's policy rate and, as a result, increase the accessibility of cheap credit resources.

Another equally important goal should be to attract private investments, as the government and international donors cannot cover all the expenses. The ultimate goal should be to increase the level of investment to 30-35% of GDP over the next 8-10 years, with at least half of these investments coming from non-government sources. An effective way to stimulate investments could be EU support in the form of joint investment funds and guarantees.

In the conditions of war, a significant reason for the lack of funding for enterprises is that they cannot obtain insurance against military risks. Although, as explained earlier, the direct risk to enterprises outside the combat zone is relatively low, military risks cannot be insured. The problem for insurance companies is that since July 2022, international reinsurers do not provide opportunities to insure military risks for insurers operating in Ukraine. The absence of insurance not only hinders the development of Ukrainian businesses and investments but also represents one of the major obstacles to attracting foreign direct investment into the country.

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