



**Center for Social and
Economic Analysis**

Address: Bagatela St., 14,
00-585, Warsaw, Poland
Tel.: (48 22) 628-0912
Fax: (48 22) 628-6581
E-Mail: case@case.com.pl
case@case.kiev.ua



**Harvard Institute for
International Development**

Address: Khreschatyk St., 10 B,
Kiev, Ukraine, 252001
Tel.: (044) 228-8660, 228-1349
Fax: (044) 228-1349
E-Mail: hiid@hiid.kiev.ua

Interrelations between monetary and fiscal policy in Ukraine

Malgorzata Markiewicz

*Kiev
October 28, 1998*

Since the breakdown of the Russian market, Ukraine is experiencing a deep economic crisis. On September 5 the government and the National Bank of Ukraine (NBU) decided to review the parameters of the currency exchange corridor, changing the range to 2.5-3.5 UAH/USD¹. The new parameters were established for an unlimited period of time. Furthermore, on September 4, the International Monetary Fund's Board of Directors approved a three-year Extended Fund Facility loan of USD 2.2 bln. for Ukraine. The first tranche of the IMF credit, combined with introduction of administrative control on the currency market and restructuring of the internal public debt, allowed the authorities to curb the rapid depletion of foreign exchange reserves. However, these are only the short term measures to control the state's liquidity. The inflationary consequences of the hryvna devaluation are not fully visible yet, but the budgetary revenues have already fallen. Considering the huge amount of interenterprises arrears, budgetary arrears, restructuring of the public debt and sharp devaluation of the hryvnia, new anti-crisis measures must be adopted allowing to reestablish the confidence in the domestic currency. The following topics must be discussed.

Firstly, the opinion persists that the restrictive monetary policy caused the low level of monetization of the economy and big interenterprises arrears. Let us recall some facts. On Autumn, 1997 the central bank started to take part in the OVDP's primary market. From that time, the share of T-bills bought by NBU has been consequently increasing. As of August 21, 1998, the volume of OVDPs owned by the NBU was UAH 7588 mln (63% of the market). Since the time the central bank started to purchase T-bills at the primary market, the monetary policy could not be perceived as restrictive any more. From this time, the monetary policy was subjected to fiscal policy.

Secondly, the central bank has participated in negotiating the debt's conditions at the international financial markets contracted for budgetary purposes. The central bank was involved in the process of hedging the external credits in foreign currency, which from one side minimized the risk for an investor and from another increased the risk for the NBU. In the case of devaluation pressure it lowers the level of foreign currency reserves.

Thirdly, according to the decision of the central bank, OVDPs were used to meet reserve requirements. It means that the NBU created incentives to increase the demand for budgetary securities. The scale of NBU assistance for the budget to keep the liquidity of the public debt contradicts the opinion about restrictive monetary policy.

Until the beginning of crisis in August 1998 the central bank was able to neutralize the results of expansionary fiscal policy. Nevertheless the central bank's participation at the primary OVDPs auctions has changed its role from passive agent of the Ministry of Finance into active participant of the T-bills market. As a result, the central bank is also responsible for the fiscal policy conducted.

Another question concerns the relationships between the NBU and Ministry of Finance in the context of NBU's profit transfer to the budget. The central bank, as a public institution, should be obliged to transfer its profit to the budget. With the NBU participation at the OVDPs primary market, this obligation is even more obvious². The value of profit adopted as the fixed amount at the budget for the next year was not connected with the real NBU earnings on the OVDP actually

¹The previous exchange rate corridor 1,8-2,25 UAH/USD was announced on January 21 for the entire 1998. At the same time the monetary authorities abandoned the exchange rate corridor 1,75-1,95 that was established on October, 31, 1997 for the first half of the 1998.

²According to the budget for 1997, the NBU had to transfer 200 mln UAH as the profit to the budget. The realized amount was equal to 92,5 mln UAH. At the budget for 1998, the amount of 200 mln UAH was approved. According to the State Treasury, in the first half of this year the NBU transferred UAH 135 mln. in current profit to the budget. Amendments to the 1998 budget provide for increasing the NBU profit slated for the budget in 1998 from UAH 200 mln. to UAH 400 mln. This July, the National Bank transferred about UAH 180 mln. of its profit to the state budget.

purchased. As the result, these transfers have not reflected the actual central bank earnings, increased the public debt costs, decreased the budget revenues level and consequently augmented the budget deficit.

However, we could not say that the level of interest rates at the OVDP primary market was higher because preferential treatment of NBU. The high level of interest rates was the result of limited demand for T-bills. The increased NBU participation supports this thesis. The NBU was usually buying the OVDPs with the longest maturities (there was no demand at the market for such securities) at respectively lower rates. This could be explained as the result of expected disinflation policy. The lower nominal rates in the medium term indicated at least stabilization (or rather decreasing) of real revenues, as inflation would be decreasing.

Nevertheless, credit to the budget crowded out credit to the economy, because extending credit to the budget, the central bank, at the same time limited the amount of credit provided for the economy (see: table 1).

Table 1. The percentage change of the NBU balance sheet aggregates.

	dRM	DNFA*	dNetCG*	dCDepB*	DOINet*
I 1997	8.3%	1.8%	-4.6%	4.6%	6.4%
II	0.6%	2.2%	-0.6%	-2.8%	1.9%
III	-1.1%	-1.8%	2.2%	2.3%	-3.9%
IV	6.5%	2.9%	3.8%	0.5%	-0.7%
V	2.4%	-1.8%	1.6%	0.0%	2.6%
VI	6.7%	6.8%	-0.9%	0.0%	0.7%
VII	8.4%	1.7%	4.4%	2.8%	-0.5%
VIII	9.3%	14.8%	-3.5%	2.4%	-4.3%
IX	-6.0%	-10.6%	3.6%	0.5%	0.5%
X	-2.1%	-1.2%	-2.9%	-0.5%	2.1%
XI	2.1%	-2.7%	6.0%	0.2%	-1.1%
XII	6.8%	-3.3%	7.0%	3.4%	-0.4%
I 1998	-8.1%	-6.6%	4.8%	-2.5%	-3.8%
II	-2.6%	-0.2%	0.4%	-3.7%	1.0%
III	7.4%	2.0%	4.1%	-1.8%	3.1%
IV	1.7%	12.5%	11.9%	-0.7%	-22.0%
V	-1.7%	-9.0%	2.6%	-2.0%	6.8%
VI	2.1%	-9.2%	8.3%	3.2%	-0.3%
VII	1.9%	-8.4%	10.6%	0.4%	-0.8%

Where: d denotes the percentage change to the previous month, RM - reserve money, NFA* - net foreign assets, NetCG* - net credit to government, CDepB* - net credit to commercial banks, OINet* - other items net. The star mark means that all the values were corrected with valuation adjustment.

For better understanding the relationships between the NBU and the budget in Ukraine, consider now what happens if the central bank is playing at the primary market of T-bills.

1. The central bank starts to participate at the OVDPs primary market, buying treasury bills. The increase in the net credit to government results in a rise of reserve money by the same amount (lets assume temporarily, that the central bank does not conduct policy of negative sterilization³).
2. When the OVDPs sold to NBU are redeemed, the value of credit to government on the assets side of balance sheet, as well as the reserve money on the liabilities side is decreasing. If the Ministry of Finance pays off the interest on OVDP bought by NBU, then the drop in credit to the

³Negative sterilization means decreasing the level of foreign assets to neutralize the impact of growing credit to government for the reserve money.

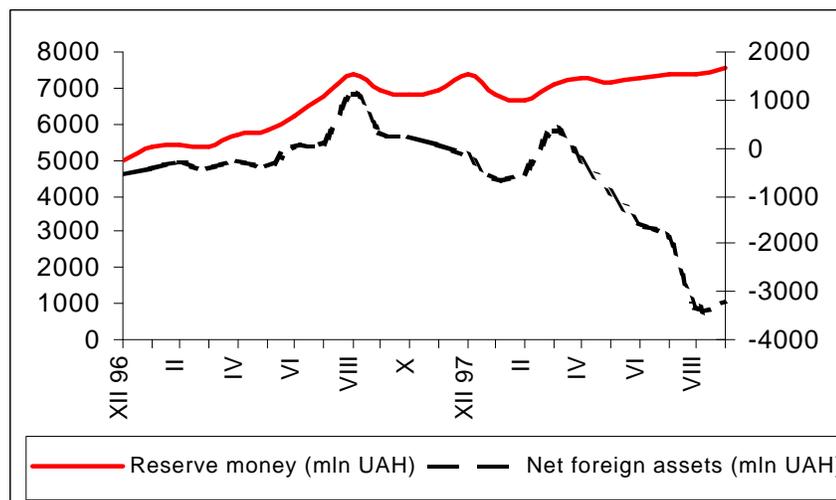
government and reserve money is higher than the initial growth of these categories caused by OVDPs issue. However, it should be noted that the growth in reserve money could be used by the commercial banks to expand their credit activity. From the perspective of the financial sector, the result of this operation could have different consequences. Although, at the moment of OVDPs redemption, the reserve money is decreasing, for the time of OVDPs in circulation, M2 could increase, creating inflationary pressure.

3. Let's assume now that the central bank is rolling-over the maturing bonds, spending all the earned money on OVDPs market (with interest) for purchases of new T-bills. Whatever is the discount rate of new issue, the reserve money grows only once, with the first purchase of OVDPs by NBU at primary market by the amount of T-bills without discount.

4. Let's assume that the NBU is extending its involvement in OVDP, rolling-over existing budgetary liabilities. If the value of NBU purchases is higher than value of rolled-over T-bills plus discount (face-value), the reserve money is growing every time by the amount of difference between the value of new T-bills bought and the T-bills rolled-over. In this case, the permanent source of reserve money creation appears.

The growth of budgetary liabilities at the central bank has not caused a direct inflationary consequences due to the negative sterilization policy held by NBU. The central bank was giving money to government (by new OVDP purchases) and simultaneously made the conversion for that part of OVDP withdrawn by non-residents from the market, decreasing the level of foreign reserves and curbing in this way the growth in reserve money (see: table 1). This could be considered as a short-term policy that creates new threats for macroeconomic stability. Firstly, the supportive monetary policy for the budget hampered necessary fiscal adjustments. Secondly, the policy of negative sterilization caused the additional pressure on the foreign currency reserves, and furthermore created a new threat to currency exchange stability. Thirdly, the central bank conducted the sterilization policy inconsistently (see: graph 1).

Graph 1. Net foreign assets of the central bank and reserve money for the period of January, 1996 - August, 1998.



Since the portfolio capital started to flow into the Ukrainian OVDP market, the reserve money, as well as monetary aggregate M2 growth followed the increment in net foreign assets. Autumn 1997, the short-term capital started to flow out from T-bills market. The drop in foreign assets of the central bank was not supported by proportional decrease in reserve money. The coverage ratio of net foreign assets and reserve money decreased. As a result, room for maneuver for monetary and exchange rate policy was reduced. The central bank conducted the policy of

trade off between the portfolio capital involvement at the OVDP primary market and the NBU participation. The lower was the share of short-term foreign capital, the higher was the T-bills market's share of NBU. The fall in reserve money was hampered. The liabilities side of the NBU balance sheet have not reflected the changes in assets structure (substitution of foreign assets with credit to government).

It is not possible to continue such a policy mix. Considering the current level of gross foreign assets and liabilities in foreign currencies the aim of foreign reserve accumulation (up to the safe level - at least for the coverage of two month import) is being seen as extremely difficult policy goal. The policy of negative sterilization can not be continued. If the central bank continues financing the budget by OVDP purchases, with the lack of negative sterilization, the increase in credit to government will cause the growth of reserve money, and with some lag would reinforce inflationary pressures. In case of strong devaluation expectations, any additional fiscal imbalances might lead to hyperinflation. The imminent result of crisis is the breakdown of OVDP market. From the beginning of September, the central bank is the only one participant at the primary auctions (on October, 1 the NBU possessed 75% of T-bills issued from the beginning of the year). It will take a lot of time to convince investors and reestablish government credibility. The crucial point is to adjust the relationship between fiscal and monetary authorities. The budget must not be financed by the NBU further. If we assume, that such policy will be abolished, the consolidated government budget should be balanced. A primary surplus should be achieved to allow servicing already existing liabilities.

The precondition to overcome the crisis is to adjust the relationship between monetary and fiscal policy. Fiscal policy is the source of current exchange rate policy problems (devaluation by above 60% from the beginning of crisis in the middle of August), and monetary policy (increasing inflation rate and changes in the NBU balance sheet structure). Without a reasonable budget for 1999 (which means a primary budget surplus), the crisis will only expand.