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Monetary Policy and Economic Growth in Ukraine: Case of Small Open Economy

The government and central bank can maintain economic growth through their actions taken in two areas: monetary policy and fiscal policy. Monetary policy influences economy through monetary factors: money supply, inflation, credit, etc. Since 2014, the Central Bank of Ukraine has officially switched to inflation targeting. Inflation targeting regime consists in public disclosure of target inflation rate and central banks' policy to reach it.

Monetary policy decisions are made with inflation forecasting taken into account. The main monetary instrument and operational tool for keeping up a monetary regime is the interest rate. If the projected inflation rate exceeds the target, then central bank conducts a policy of «expensive money». Conversely, with a lower projected inflation rate than the target level, a policy of «cheap money» is conducted. Ultimately, by changing the interest rate, the central bank supports economic activity. However, there are other monetary factors that also influence the economy: bank credits, external debt, and the exchange rate of the national currency. The case of Ukraine is interesting in terms of these factors' influence on the economy, because not all of these factors were market driven. The UAH/USD exchange rate was actually fixed over some time and did not depend on the current account balance. The central bank struggled with inflation after its actual disturbances.

Ukraine moved to inflation targeting in 2014, and this step has led to a significant transformation of monetary policy. Maintaining the exchange rate on an objective level had to be cancelled as the National Bank's reserves had been already exhausted by that time. Since 1996, when the Ukrainian currency hryvnia was adopted, the interest rate has not shown to be the effective tool of monetary policy and, therefore, it was not applied by the National Bank of Ukraine in carrying out inflation policy and stimulating economic development. On the other hand, Ukraine has experienced since then some economic growth and increase of GDP, in spite of all turbulences. So, the question is whether there is any link between monetary policy and economic growth in Ukraine. Has monetary policy exerted any influence on economic growth in Ukraine in the period 2006–2019?

The purpose of the study was to determine the impact of monetary factors (money supply, UAH/USD exchange rate, UAH/EUR exchange rate, interest rate, consumer price index, producer price index, loans issued to the economy, external debt) on economic growth in Ukraine. The results obtained should be considered with some caveats in mind. During the analyzed period, the central bank' s policy was not consistent. Until 2014, there was no inflation targeting in Ukraine, so the actions of the central bank were aimed not at achieving a certain inflation rate but at combating the effects of inflation. For this reason, the relationship between inflation and GDP can only be established by statistical methods, since there is no economic basis for their correlation. From 2014 to 2019, the central bank targets inflation and this influences business activity and the economy through inflation expectations. As a result of variance decomposition of GDP, we see that in the long run, the impact of inflation on GDP increases by increasing the impact of CPI.

The effect of the UAH/USD exchange rate on economic growth is quite insignificant, although the vast majority of Ukrainian exports and imports are made in US dollars. Such a low degree of influence may be explained by the fact that up to 2014, the UAH/USD exchange rate was actually fixed, not floating. Thanks to central bank reserves, exchange rate stability of the hryvnia was maintained, while a constant current account deficit was experienced. In this case, GDP growth rates did not reflect the actual national currency depreciation. Only after 2014 the exchange rate is determined on the basis of market conditions. According to our calculations, the impact of the exchange rate on GDP will increase in the long run.

The key interest rate of the central bank, which has been used as an inflation targeting tool since 2014, has also had insignificant impact on economic growth. According to Taylor' s rule, an increase in the interest rate has a negative effect on economic growth. However, in Ukraine this mechanism of influence was rather weak. The reason for this was the inefficiency of the central bank interest rate as a tool to influence inflation expectations in the period up to 2015.

What is interesting, loans to businesses have had an insignificant effect on economic growth. This can be explained by the fact that before 2015 the majority of loans granted by the banking system were issued to related parties and very often these loans were not repaid. This has led to a crisis in the banking system and the liquidation of about 100 banks. In this case, the loan was not a form of financing the economy, but a way of withdrawing capital abroad by bank owners.

According to the research results, the central bank can be encouraged to strengthen its credit channel for its impact on the economy, as it is essential in promoting economic growth. Inflation targeting policies should also be pursued, as price stability and exchange rate stability are prerequisites for improving economic agents' expectations. A stable macroeconomic environment is a prerequisite for economic growth in Ukraine.