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**HOW CENTRAL BANK'S
POLICIES UNDERMINE A
TROUBLED CURRENCY
AND EXACERBATE
RECESSION: THE CASE OF
UKRAINE**

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Global Health, and Study of Business Enterprise



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How central bank's policies undermine a troubled currency and exacerbate recession: the case of Ukraine

by Dr. Yuri Poluneev

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About the Series

The *Studies in Applied Economics* series is under the general direction of Prof. Steve H. Hanke, Co-Director of the Institute for Applied Economics, Global Health and Study of Business Enterprise (hanke@jhu.edu).

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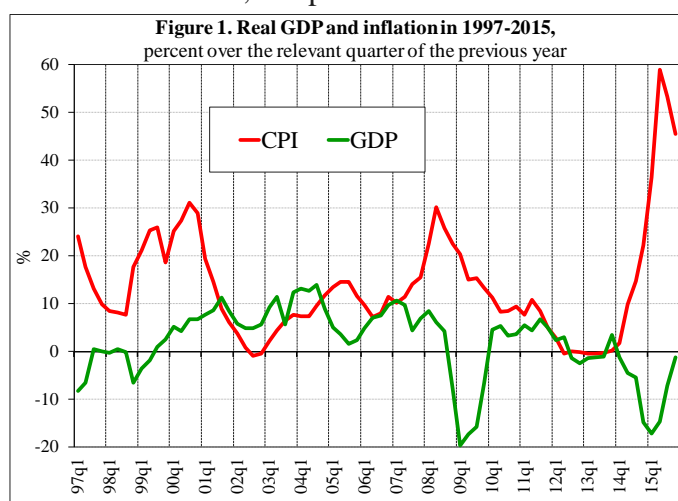
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Summary

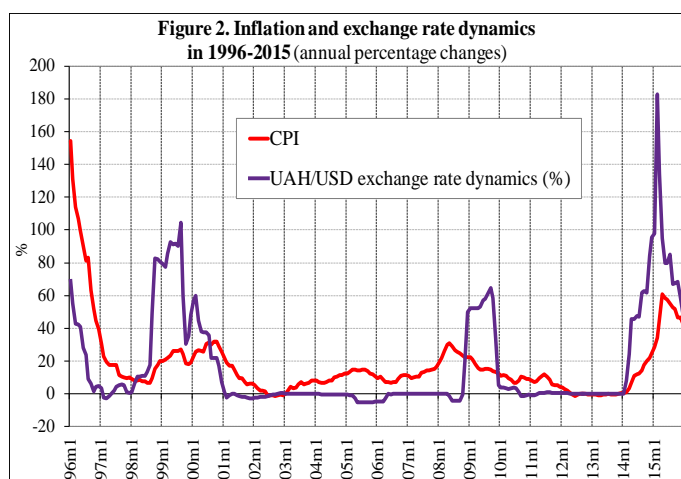
In the last two years, ongoing military conflict in the East, deep economic recession and the downfall of national currency have become biggest shocks to Ukraine, its households and business enterprise. As a result, the country, one of the largest in Europe's geographical centre, has quickly evolved into a geopolitical spot of extreme instability where internal and external shocks can trigger “snow slide” effects.

Stakes are rather high. If Ukraine overcomes, both politically and economically, it may become a kind of Europe's «Mannerheim» wall and possibly another European “tiger”. If it fails, already weakened dramatically by the undeclared war, domestic economic strife and persisting political corruption, the country could become, for many decades onwards, Europe's only “hot spot” and biggest political and financial liability for the West.

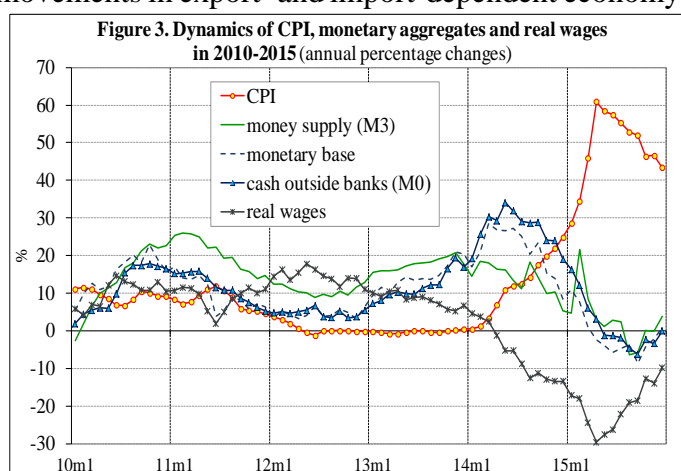
At this “bifurcation point”, half-measure action is even more damaging than no action at all. In such a critical situation, the only way out would be a proper implementation of genuine economic rescue and reform measures underpinned by a consolidated and well coordinated external assistance. And yet such prospects have recently been thrown into great doubt, mainly due to a continuing state capture by oligarchs and regional “elites”, growing domestic instability and rampaging political corruption.



Whereas a well coordinated and internationally supported implementation of comprehensive and genuine market reforms, including complete “de-oligarchization” and eradication of corruption, profound fiscal consolidation, streamlining of government expenditures and bureaucracy, complete overhaul of legal and judicial systems, strengthening private sector competitiveness, should be the right answer to Ukraine’s economic woes, important role in this process would have to be played by adequate and balanced monetary policy, effective foreign exchange regulation and transparent commercial bank supervision. Resulting financial stability, including predictability of foreign exchange movements in export- and import-dependent economy is a main pre-requisite for any sustained economic recovery.



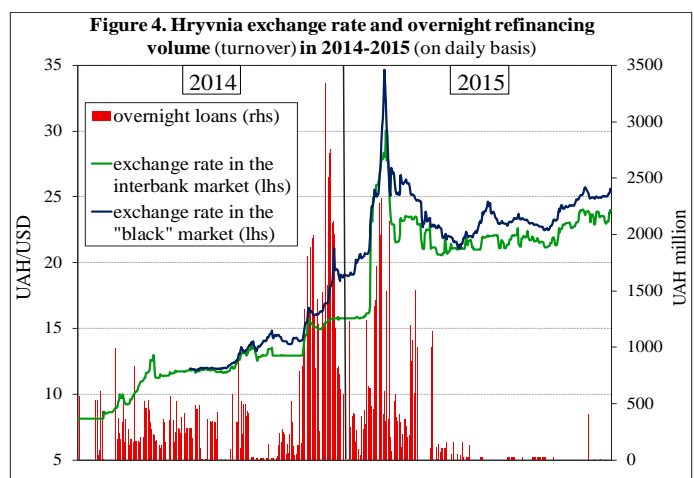
As these functions in Ukraine are vested with its central bank, National Bank of Ukraine, the logical questions arise: *Has the institution been up the standard and performed these functions well in the recent years? And if not, what were the policy miscalculations and implementation deficiencies? What other emerging market central banks can learn from these mistakes in order not to aggravate performance of troubled currencies and affect economic growth?*



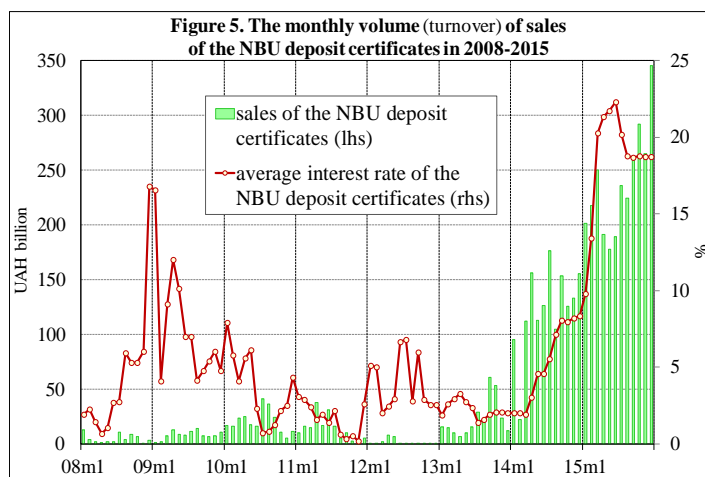
This article aims to explore these issues in proper detail.

Mixed track record

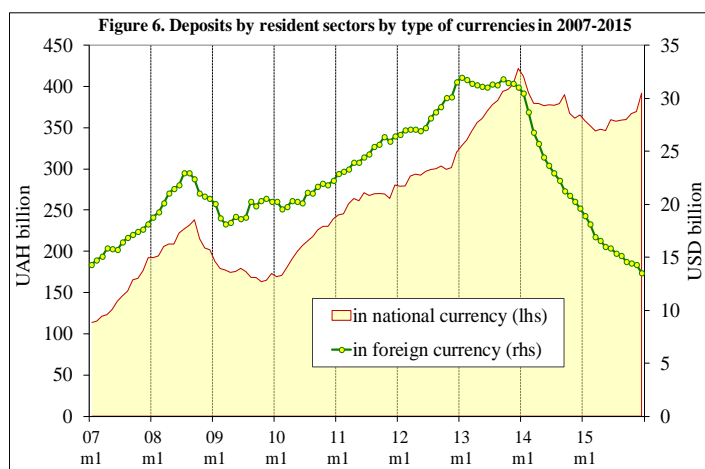
Ukraine's central bank has had a mixed track record, of both commendable successes and regretful failures. In 1996, it attracted international acclaim for the «textbook» currency reform and exemplary introduction of Hryvna, for efficient conduct of hyper-inflation policy and resulting sustained financial stability. By early 2000s, the NBU had in place a well-developed, even by European standards, infrastructure for monetary policy and bank supervision. The Bank, again, coped well with financial instability during the 2004 “Orange revolution” and paved the way for subsequent 12% annual economic growth.



Against these successes, the NBU top management team appointed in 2014 presided over serious policy miscalculations and misjudgements that dramatically undermined already troubled national currency, allowed for double digit galloping inflation, aggravated systemic bank sector crisis, undercut economic recovery prospects and completely destroyed public trust towards this important institution.

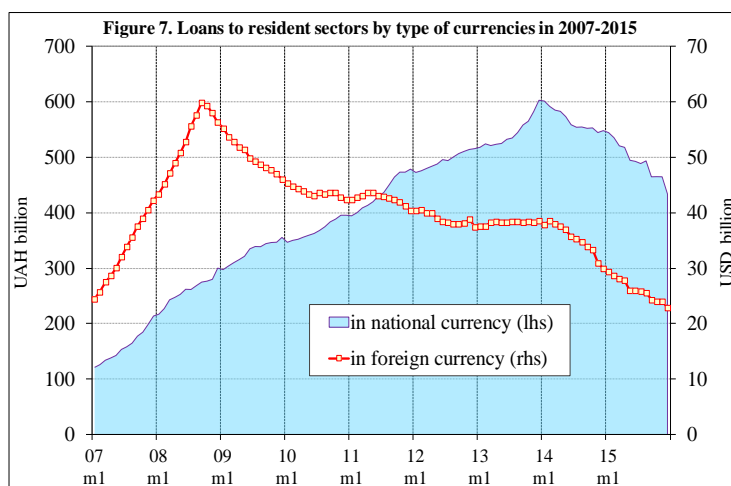


Confirmation of these conclusions has been recently provided in various international publications, including Global Finance magazine, and by important country competitiveness ratings.¹ The WEF's Global Competitiveness Report 2014-2015 ranks soundness of Ukraine's banks as the worst in the world (140/140) and quality of public institutions in general as one of the worst (130/140).² Obvious institutional weakness in monetary and bank supervision policies has been accompanied by numerous mass media allegations about corruption and misuse of power among the regulator's top officials.³



The diagnostics of problems

Ukraine's economy has been continuing its downslide in the stagflation mode (fig.



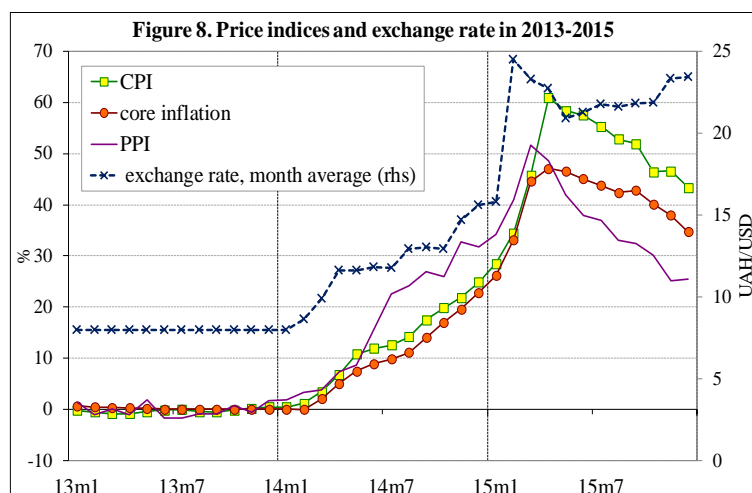
¹ <http://thehill.com/blogs/congress-blog/foreign-policy/263750-ukraines-national-bank-makes-the-federal-reserve-seem>; <https://www.gfmag.com/magazine/october-2015/central-banker-report-cards-2015?page=2>;

² http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2014-15.pdf.

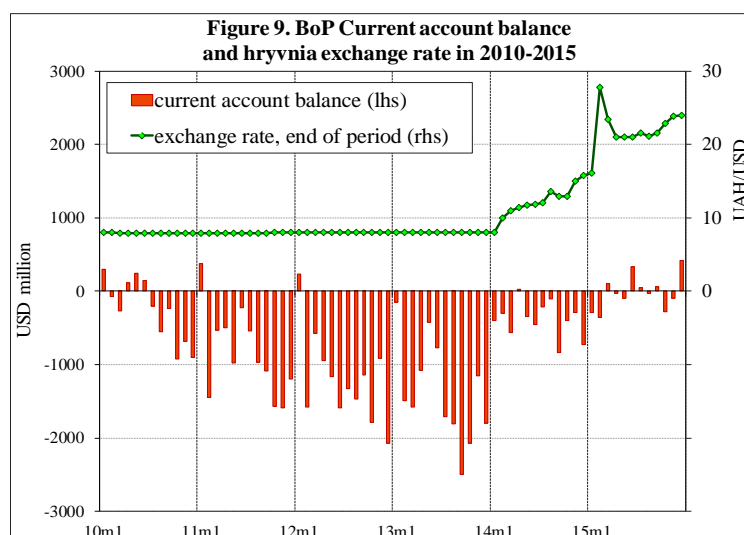
³ <http://thehill.com/blogs/congress-blog/foreign-policy/263750-ukraines-national-bank-makes-the-federal-reserve-seem>; <http://finbalance.com.ua/news/Henprokuratura-pidozryu-NBU-v-spivuchasti-u-vivedenni-535-mln-dol-z-Delta-Banku>; <http://finbalance.com.ua/news/Sprava-Hontarevo-Antikoruptysiyne-byuro-vzalyosya-za-hlavu-NBU-cherez-depozit-sina-u-Delta-Banku>; <http://obozrevatel.com/crime/23057-gontarevu-vyvedut-iz-nbu-v-naruchnikah-depkontrol.htm>

1⁴): GDP has been shrinking against the background of galloping inflation (year-on-year inflation in December 2015 was 43.3%). For the transition economy plagued by deeply entrenched vested interests and top level political corruption, change of “elites” in power has been permanently accompanied by the infighting for asset re-capture. However, the present economic crisis is unprecedented by its pure scale and, in a way, unique since introduction of Hryvna in 1996.

During 2014-2015, Ukrainian currency had been massively hit by devaluation that reached almost 300%, which, due to a pass-through effect, gave strong momentum to so-called devaluation-inflationary spiral. Sharp increases in household utilities tariffs served as additional boost to accelerating inflation. In April 2015, year-on-year inflation topped 60%, the highest level since 1996 (fig. 2).



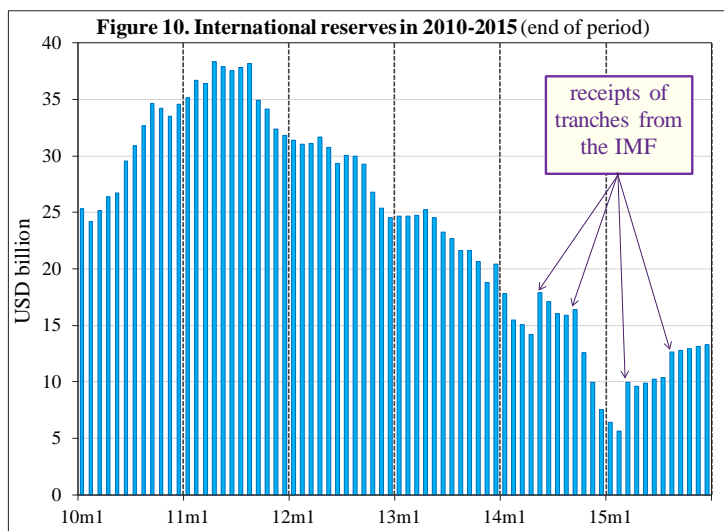
The start to unprecedented freefall of Hryvna and galloping inflation was given in early 2014, when the country’s central bank, under informal “advise” of the IMF that was preparing a decision on providing EFF loan to post-Yanukovich government, fully liberalised UAH exchange rate regime and committed to keep its refinancing facility fully open for commercial banks. In fact, these two policy actions were conditions precedent for the loan approval in March that year. There would be nothing wrong in these IMF conditions in normal circumstances as fixed exchange rate, against the background of continuous current account deficit, led to depletion of forex reserves and weak competitiveness for the exporters. But those policy decisions were being made at the time when it was already evident that annexation of Crimea, spreading violence and military tensions in Donbas were creating unmanageable risks for economic and financial stability and that liberalisation of exchange rate and free access for banks to central bank liquidity would enormously intensify those risks and inflationary pressures rather than stabilise the banking system. This happened mainly due to the fact that free access to liquidity was used by poorly governed banks not so much to stop the run on their deposits as to increase speculative demand for hard currency on the forex market and thereby contribute to faster depreciation.



When it was clear, by autumn of 2014, that either complete bank holidays with freeze on deposits or massive forex interventions would save quickly depreciating national currency, the central bank, continued to act in the business-as-usual manner and, guided by the EFF conditionality, compounded devaluation pressures by regularly acting as a buyer on already speculative domestic

⁴ All figures in the article are based on official statistics from the National Bank of Ukraine.

forex market. The regulator's lack of independent judgement and anti-crisis strategy were contributing to problems rather than addressing them.

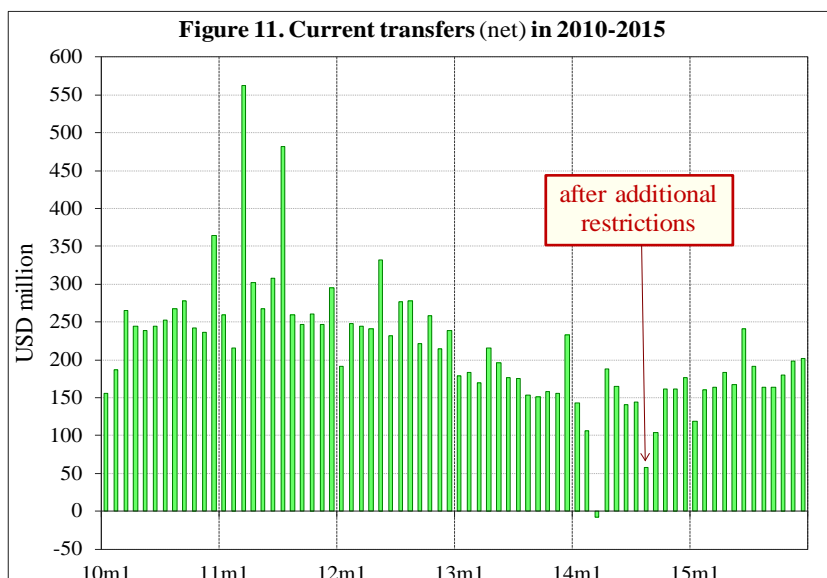


Deep and sustained devaluation triggered a sharp increase in Hryvna-denominated external debt, enhanced real risk of the country's default, caused a massive deposit flight from the banks, worsened banks' toxic asset problems and distorted radically bank balance sheets. All this provoked a full scale banking crisis accompanied by a sharp drop in household real incomes (by more than 30%) as well as increased social and political tensions.

It's worth to mention that devaluation and inflation unravelled against the background of **downward trends** in monetary aggregates and real wages (fig. 3). In 2015, negative rates of growth of all monetary aggregates, underpinned by restrictive fiscal policies, reached a historic maximum. In other words, galloping inflation was accompanied by acute "money hunger" in the real sector. This type of inflation has atypical cost inflation nature. So classical anti-inflationary methods of cooling down demand wouldn't be effective to meet the challenge.

A key problem in this case wouldn't be so much excessive money supply but rather **deficient management of monetary emission**, i.e. wrong choice of channels, instruments as well as parameters of interventions. The core of the problem was that *productive emission* (the one with positive spill-over effects for the real sector) was highly insufficient while *non-productive emission* (the one that contributed to growth in asset bubbles) – too excessive. On one hand, unjustified expansion by the regulator of its overnight refinancing **loans** (standing facility) led to surge in forex arbitrage and additional speculative pressures on Hryvna (fig. 4). On the other hand, the NBU with its hands stimulated "financial bubble" by unwinding unprecedented sales of its own deposit certificates with high yields funded by surplus emission (fig. 5). These certificates, being rather profitable and risk free instruments, further demotivated commercial banks in their lending activity.

Funds on commercial banks' correspondent accounts shrank: from UAH 29.2 billion in 2014 to 26.2 billion on average in 2015. Normative level of mandatory reserves at this time (UAH 40.6 billion on average in 2015) substantially exceeded the banks' balances on correspondent accounts. Bank deposits in national currency dropped by UAH 30 billion during 2014-2015, while in foreign currencies they decreased by more than USD 17.5 billion reaching the 2006 level (fig. 6). Bank loans in national currency dropped by UAH 169 billion (by 28%), while in foreign currencies – by 17.5 billion (41%) (fig. 7).

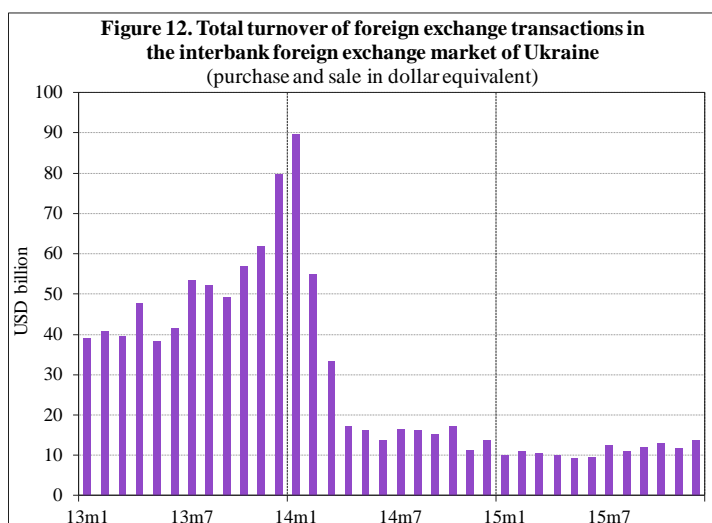


Hryvna devaluation had also a detrimental effect on producer price dynamics: they surged from 31.8% to 51.7% annual growth during the 1Q 2015 but later in the year decreased to 25.4% (fig. 8), and the slower growth rates were caused by temporary strengthening of Hryvna, drop in investment demand and lower world prices on oil and ferrous metals.

Therefore, it becomes obvious that in 2014-2015 unprecedented devaluation of already troubled national currency, Hryvna, became a powerful factor in exacerbating systemic crisis of Ukraine's economy triggered by combination of many shocks and factors and that still persists despite domestic efforts and sizeable international assistance.⁵

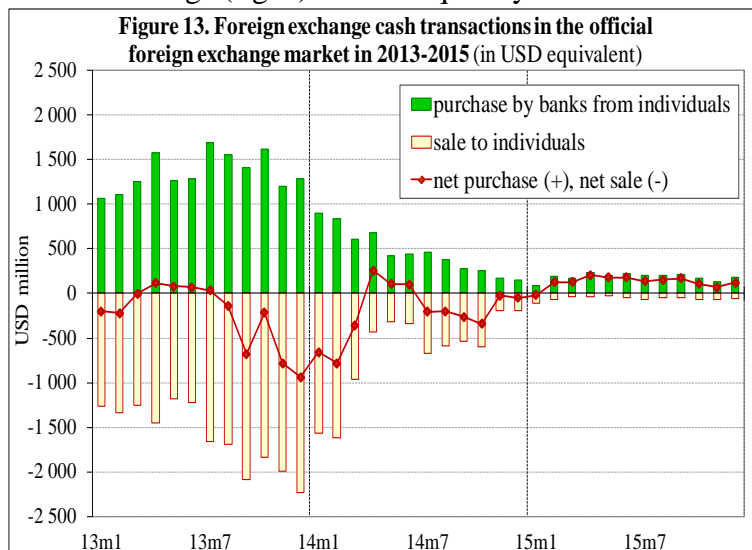
From a troubled to a “failed currency”: how Ukraine's central bank performed?

A number of external and domestic shocks merged in the unfortunate “constellation” over Ukraine's economy back in 2014 to cause unprecedented currency devaluation crisis. Balance of payments disproportions accumulated over a long period of time, insufficient level of international reserves, excessive political and social risks forced the country's central bank to publicly depart on 07.02.2014 from a fixed rate regime in favour of a free float. Prior to that, Hryvna had been pegged to USD at 7.99 for almost four years.



⁵ See: http://krieger.jhu.edu/iae/economics/Yuri_Poluneev_Ukraine_Ten_Shocks.pdf

Hryvna's weakening against US dollar in April 2014 when UAH devalued by more than 50% and started to fluctuate within the UAH 11.11 – 12.98 range (fig. 9) led subsequently to current account adjustment and equilibrium: even a small surplus of USD 31 million was achieved. By May 2014, Ukrainian government also managed to mobilise some USD 5.4 billion of external and domestic debt financing: from IMF - USD 3.2 billion, World bank – 0.9 billion, euro currency market – 1.0 billion (backed by US Treasury guarantee), domestic borrowing – 0.3 billion. This allowed to temporarily stabilise situation with Hryvna, at least until August of that year.

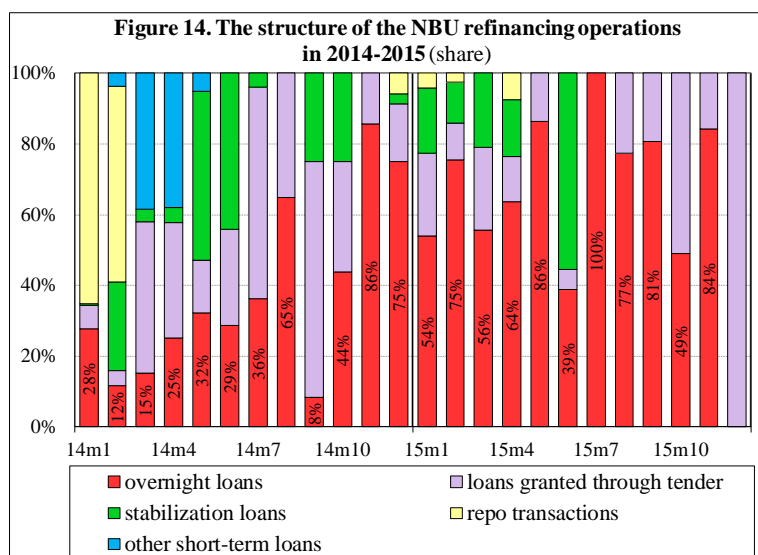


In August 2014, foreign exchange restrictions and capital account controls were substantially strengthened by the regulator, including introduction of 100% mandatory sale of export foreign currency receipts and forced conversion of foreign currency transfers to the households from abroad. The NBU's rationale for introduction of further restrictive policies, which was to increase supply of foreign exchange and stabilize exchange rate, didn't materialize.

On the contrary, the measures, accompanied by unacceptably poor public communications, led to a whole new range of negative effects: dramatic fall in export receipts (as exporters reacted to restrictions by hiding revenues offshore), surge in devaluation expectations, squeeze in official forex market activities, growth in shadow forex operations and general loss of confidence towards the regulator's agenda. Balance of unrequited transfers, positive for many proceeding years, had dramatically fallen (fig. 11), official inter-bank and cash foreign exchange markets came to a standstill (fig. 12 & 13), while shadow market operations, so characteristic of early and mid-1990s, returned and abounded.

"Puzzled" by such market reaction, the NBU reversed a few months later: lowered mandatory sale requirement to 75% and cancelled mandatory sale of currency transfers to households. But this policy correction failed to restore public trust and diminish inflationary and devaluation expectations.

As statistics show (fig. 9), current account deficit reached its all-year bottom of USD 0.8 billion in September 2014 accompanied by the UAH/USD 12.53 – 13.53 rate range. The subsequent improvement in current account balance wasn't used by the NBU to stabilize national currency. On the contrary and incidentally, the NBU tried its best to keep the exchange rate stable ("fixed") in the run-up towards the parliamentary elections in October



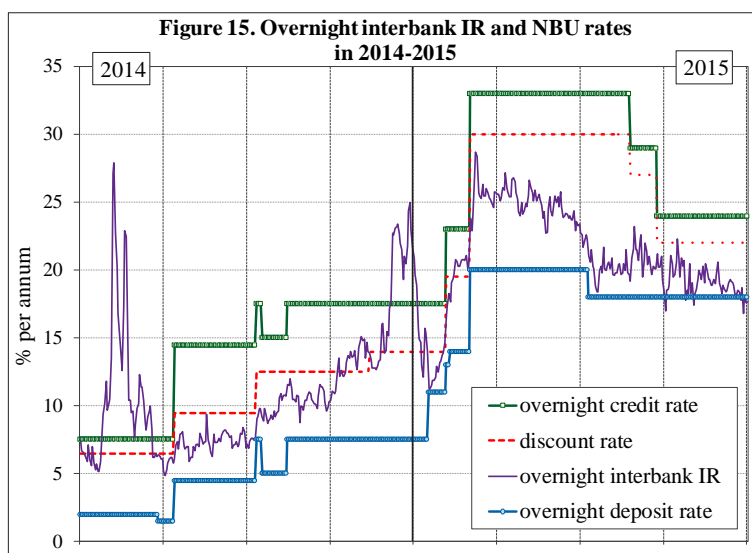
2014 and let it fully go afterwards, which led to another landslide devaluation and another round of inflationary spiral.

The “miscalculations” in the NBU policy mix at that period of time stand out very clearly:

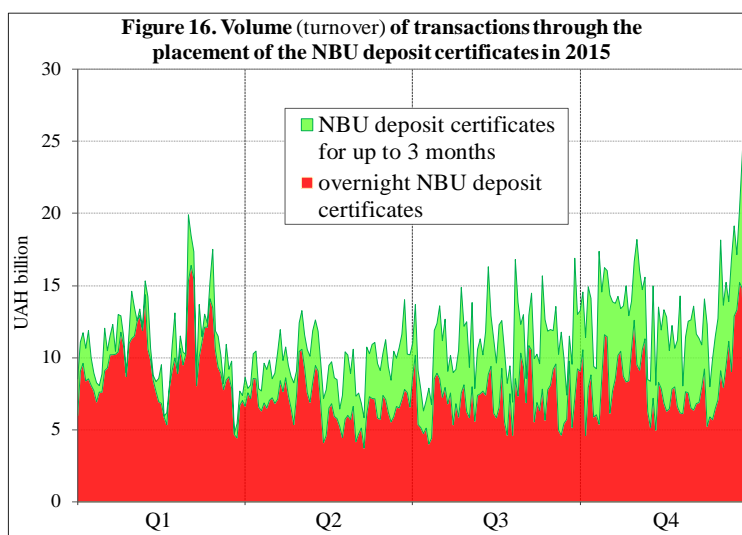
- on one hand, controversial massive refinancing credit lines to selected banks, some of which later were declared insolvent and liquidated by the State Deposit Insurance Fund, contributed to further fragmentation of the inter-bank market and irreversibly undermined household and business confidence;
- on the other hand, the focus of monetary policy (standing facilities) had eventually shifted towards providing shorter term maturities (fig. 14) and towards unprecedented expansion, from November 2014 to March 2015, of overnight refinancing loans to banks (graph 4). Obviously, such “super” short refinancing instrument couldn’t address the growing problem of the run on bank deposit. On the contrary, it created conditions for frequent speculative attacks against national currency;
- very chaotic and illogical interest rate policy also encouraged the banks to lean heavily in favour of open-access standing facility operations (overnight refinancing). In this context, a characteristic episode took place in July 2014 when a “routine” NBU discount rate increase triggered increase in overnight interest rate (from 14.5 to 17.5%) that in a few days was lowered to 15%, then stayed at this level for 30 days and again shot up to 17.5%. This level of overnight rate was supported by NBU for almost six months (!) despite growing devaluation and inflationary pressures as well as NBU discount rate increase. In December 2014, NBU overnight refinancing rate dropped below the level of inter-bank overnight interest rates, and that was a clear departure from principles of optimal liquidity policy management. A very dangerous financial destabilizer under the conditions of uncontrollable devaluation and huge inflationary expectations!

In other words, *the central bank had willingly transformed itself into a massive last resort supplier of super short-term money* that could not by definition address the problem of bank deposit flight. Such interest policy led to unprecedented growth (500%) in volume of overnight refinancing in just one month at the end of 2014. Moreover, the regulator provided free access to high volumes of super short-term liquidity at negative real

interest rates to those banks whose instant liquidity coefficients exceeded the normative levels by more than 6-7 times. Such prudential “oversight” encouraged above banks to use the central bank funds as a “cushion” for speculative arbitrage against failing national currency. As fig. 4 shows, devaluation pressures grew exponentially in such periods.



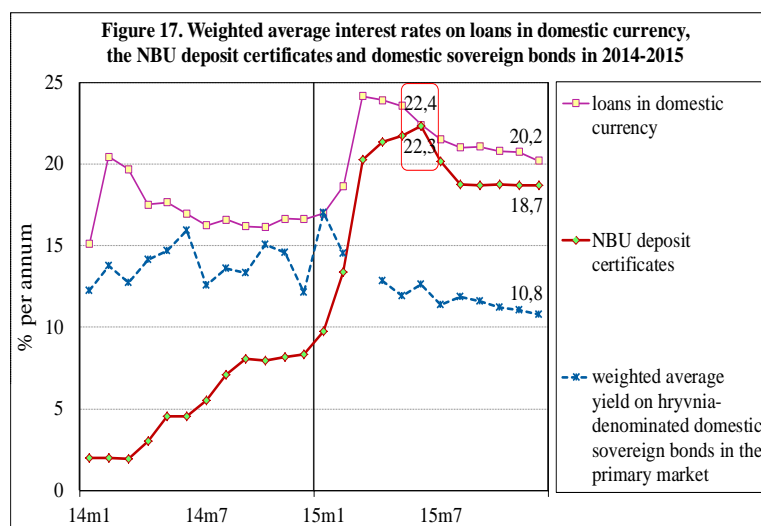
In December 2014, volume of overnight refinancing loans continued to grow, while inter-bank interest reacted not so much to NBU discount rate but rather to foreign exchange rate fluctuations, which highlighted deficiency of central bank rate policy. To further complicate growing financial instability, foreign exchange black market returned for the first time after 1990s and pushed UAH/USD exchange rate to 30% above the central bank official rate. In view of the financial crisis, the central bank supervisory board recommended the management board to undertake urgent action for “streamlining” monetary policy and working out coordinated policy response.



However, policy reaction was delayed until February 2015 when interest rate was increased from 14.0 to 19.5% whereas overnight rate – from 17.5 to 23.0%. At the same time, inflation rate at 28.5% on year-to-year basis in January continued its upward trend.

Parallel to interest rate increase, the central bank dramatically changed the foreign exchange trade rules – by suspending long-standing practice of daily forex auctions and refusing to further use so called indicative foreign exchange rate. NBU management thus declared that exchange rate would be set on the basis of market demand and supply. As a result, the official exchange rate dropped down to par the “black market” rate. Therefore, potential stabilisation effect from interest rate increase was completely wiped out. Combination within the same period of those two policy measures could hardly be characterised as logical.

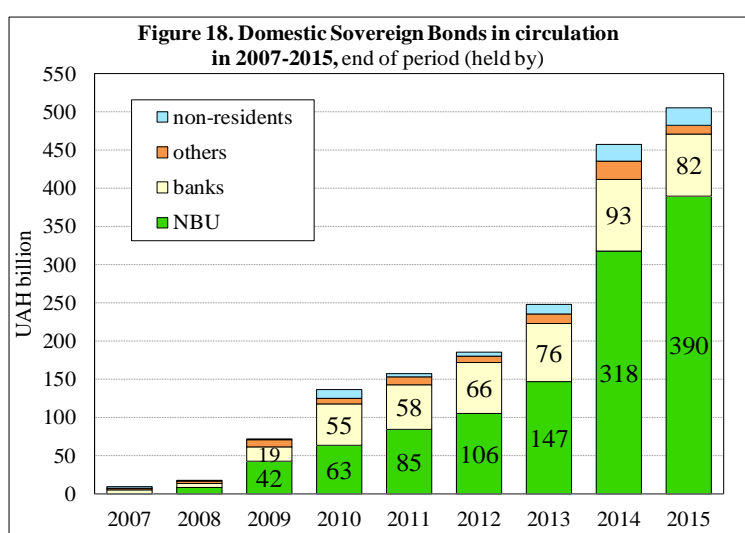
Moreover, when on 12 February 2015 the UAH/USD exchange rate reached a psychological level of 25:1 the central bank management approved a policy measure whereby maximum single-bank overnight refinancing limit collateralized by Ukraine’s T-bills was raised from 70 to 100% of mandatory reserve level, which led to upsurge in daily refinancing volumes but only a group of 8-11 banks selected on subjective and non-transparent basis had exclusive access to this instrument. In other words, limits for NBU overnight refinancing were substantially lifted up in the period when inflation rates were accelerating beyond control!



When, on 24.02.2015, devaluation peaked in the “black market” at UAH/USD 40:1 while the official exchange rate, on 26.02.15, exceeded 30:1, the NBU’s decree completely banned the banks from purchasing foreign exchange on behalf of their clients. Next day, this decree was cancelled. Such inconsistency in the regulator’s actions completely undermined the market and household confidence.

Devaluation trend was halted only after the sharp reduction in the volumes of overnight open market operations by NBU as well as introduction of further dramatic foreign exchange restrictions that particularly affected importers and businesses by substantially undercutting imports of goods, services and business inputs.

And, despite the obvious logic of higher interest rates as one of anti-devaluation measures, the central bank kept its interest rates on open market interventions unchanged during the peak pressures on the forex markets. And only three months later, in early March 2015, when Hryvna appreciation trend became visible, the Bank management approved a decision to raise a discount rate to 30% and overnight rate – to 33%. Again, timeliness and adequacy of the regulator’s policy reaction comes into question.

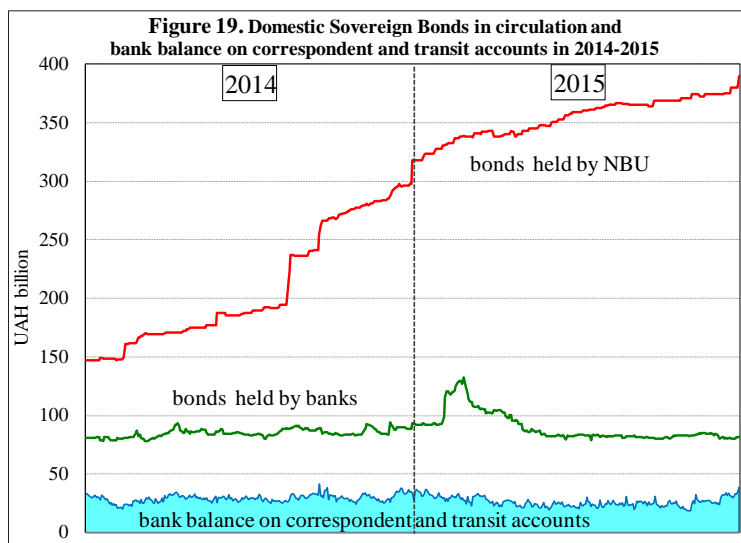


On top of all this, such late and inadequate interest rate measures have been accompanied by active expansion of central bank’s liquidity sterilisation (mobilisation) operations conducted through the sale of NBU high-yield deposit certificates (fig. 16). In 2015, average monthly interest rate for this instrument reached the level of bank lending rates (fig. 17) and thus demotivated banking sector for lending to the real sector.

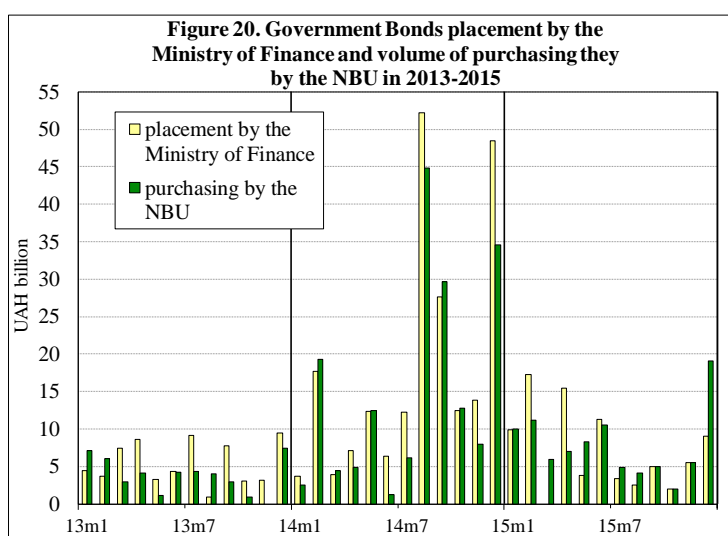
During 2014, volumes of liquidity sterilisation operations by the NBU amounted in volume to the country's GDP – an unprecedented record in the history of Ukraine's monetary policy! And all this was against the background of massive flight of bank deposits and bank liquidity crisis. These disproportions are also characteristic for 2015: the NBU deposit certificate sales had exceeded the GDP level, while the central bank's interest expenses exceeded, by our estimate, the UAH 8.0 billion threshold by end of last year.

In other words, instead of facilitating the consolidation of inter-bank market and its “business-as-usual” operation, instead of stimulating bank lending to corporate sector, **the central bank with its own hands has created and inflated a risk-free high-yield instrument** (overnight

NBU deposit certificate) that created for the state a super costly “financial bubble” – a spiral of structural liquidity surplus propped by obstacles for the banks to expand credit operations. In fact, instead of monetary regulator role Ukraine's central bank assumed the role of a financial broker in the inter-bank market thus distorting competition and liquidity allocation in the banking system.



Main “deficiencies” in the NBU monetary policy have been not only in a highly arguable levels of nominal rates set for the Bank's active and passive operations but in profound departure from the logic of liquidity management and in the inconsistency of monetary and foreign exchange regulation, which in turn contributed during 2014-2015 to the depth of financial crisis. These deficiencies, in one form or the other, continue to persist at present creating additional risks for financial stability and further transforming a troubled currency into a failed one.



Monetization of state budget deficit by the central bank

The country's central bank has been an active investor into the state's T-bills (bonds). In 2014, the scope of budget deficit monetisation grew exponentially and exceeded in volume the monetisation for all proceeding years altogether. Despite evident and substantial bank liquidity disproportions, this instrument was used by central bank to predominantly finance deficits of the public sector enterprises, mainly the state-owned oil and gas holding NAK “Naftogaz”. On the whole, this practice had continued in 2015 when holdings of T-bills on the central bank's balance

sheet grew by almost UAH 72 billion exceeding the total of UAH 390 billion.⁶ By the end of 2015, the share of T-bills in the central bank's asset portfolio reached a historical 75 per cent level (fig. 18).

In parallel, the banks' T-bill portfolio decreased by UAH 12 billion – down to UAH 82 billion (fig. 19) while their balances on correspondent accounts with the central bank also fell during 2015 – from UAH 32.6 to 24.6 billion (November 2015). This decrease was connected not with the sale of T-bills to the NBU but with their redemption by the ministry of finance with further sterilisation of funds through the issuance of the NBU deposit certificates.

Central bank's T-bill monetisation operations were mainly caused by the needs to close the gap in budget deficit financing. Characteristically, in 2015, the NBU investment into Hryvna-denominated T-bills covered the primary emission of these securities by 110% (UAH 93.7 out of 85 billion). This is nothing else but monetisation of the increase in domestic debt through the use of money print by the central bank.

This departure from prudent monetary policy could, in part, be justified by Ukraine's extremely complex geopolitical and macroeconomic situation in 2015. Plus, the NBU operations with government T-bills had insignificant impact on bank liquidity. Operations, technical in nature, were conducted through a few state-controlled banks without creating a spill-over effect for the system in general.

Lessons that can be drawn for other emerging market economies from Ukraine's central bank behaviour during crisis?

First and foremost: genuine and true independence of the central bank's top management from domestic politics and control of "big money" as well as proper corporate governance are **an absolute must** for emerging economies plagued by institutional corruption, profound state capture by corporate "moneybags" and deeply vested political interests.⁷

In Ukraine's case, the obvious institutional deficiency lies in the constitutional and legal framework governing the NBU top appointment, who, as a rule, is chosen among loyalists, former business partners or associates. And such a system creates a fertile ground for using central bank as an instrument for insider windfall profits through foreign exchange arbitrage, huge volumes of proprietary T-bill operations, for using bank supervision as anti-competition tool or bank asset stripping facilitator, saying nothing about ample opportunities for illegal profiteering from in-house procurement schemes. In Ukraine, non-transparent, biased and allegedly corrupt central bank supervision, on the one hand, «cleaned up» more than a third of banking system (63 banks) but, on the other, contributed to much deeper mistrust towards the regulator, further financial instability and fast deleveraging in the real sector economy.

Most recent events in Ukraine's parliament when no-confidence vote to discredited and highly unpopular government was torpedoed by MPs loyal to the head of state and to most powerful oligarchs led to gruesome conclusions made in the Foreign Policy magazine: "...after two years of empty promises, neither Ukrainians nor their foreign partners should be satisfied. In Ukraine, it

⁶ In comparison, the monetary base at the end of 2015 was estimated at UAH 336 billion.

⁷ These interests are concentrated on the very top of the country's political hierarchy. See latest article in The Economist: <http://www.economist.com/news/europe/21692917-ukraines-grace-period-tackling-cronyism-may-have-run-out-dear-friends?frsc=dg%7Cd>

doesn't matter who runs the government or the General Prosecutor's office. ...the alliance of oligarchs and corrupt officials will stand strong..."⁸ And it is, indeed, the alliance of top office holders with oligarchs that in reality shapes the hidden agenda of the central bank. Something that is incompatible with the whole idea of central bank as an independent regulator and credible monetary policy maker.

A logical question arises: why the corporate governance (i.e. supervisory board, the Council of the National Bank of Ukraine) that has existed at Ukraine's central bank almost since its establishment failed to improve the situation and make its own contribution to improved policy making capacity of a regulator?

The answer to this question is rather simple. Despite formal existence, the supervisory board has not been vested, until very recent amendment to the Law on the National Bank, with any real power to control the NBU top management or its policies. The mentioned amendment, approved at the insistence of the international donors, fundamentally reshapes the regulator's supervisory board on a more professional and politically neutral basis. But the main channel of the Bank's political dependence, a direct linkage to the political institution of the country's president, remains intact.

Similar situations might create for any emerging economy irreparable financial and reputation risks, especially when a weak national currency fully reflects a country's institutional immaturity and dwindling international competitiveness.

Second: importance of highly professional judgement on domestic economic situation as well as of independent and well-grounded position vis-à-vis international official lenders. The latter, as was Ukraine's case in early 2014, "recommended" a very arguable action to the country's central bank (full float of the currency and unlimited access to refinancing for commercial banks against the rise in military operations and related instability and risks), which later led to bank deposit flight, deep devaluation and outburst of inflation, highest since hyperinflation in 1992-1994.⁹

In this respect, it is difficult to disregard two arguments: one put forward by Nobel prize winner Joseph Stiglitz that Bretton Woods institutions provide loans to developing countries to force them open domestic markets and public wealth for looting by multinationals,¹⁰ and the other made by prof. Richard Werner who argues that in some cases "central banks intentionally impoverish their host countries to justify economic and legal changes which allow looting by foreign interests".¹¹ One could argue with such a bold conclusion made by the renowned author of the quantitative easing but Ukrainian central bank's case provides a very strong argument in its favour: intentional actions and/or unintentional policy blunders by the country's regulator in 2014-2015, which resulted in unprecedented devaluation-inflationary spiral, wiped out, by modest estimates, more than 30% of households' real incomes and savings as well as most of corporate profits in the enterprise sector and thus contributed to further impoverishment of the host country.

As former chief economist of Ukraine's central bank recently pointed out: "In expert and business communities, more and more popular is a point of view that authorities themselves (in particular, representatives of certain financial and political groups with access to state financial resources and levers of regulation and pressure upon business) are interested in preserving uncertainty and lack

⁸ <http://foreignpolicy.com/2016/02/17/now-we-know-who-really-runs-ukraine/>

⁹ Steve H. Hanke. On Hyperinflation Hype. - <http://www.zerohedge.com/news/2016-02-11/hyperinflation-hype>.

¹⁰ <http://www.theguardian.com/business/2001/apr/29/business.mbas>

¹¹ <http://www.zerohedge.com/news/2016-02-11/central-banks-are-trojan-horses-looting-their-host-nations>

of confidence. And, therefore, in preserving high devaluation and inflationary expectations and in further depreciation of Ukrainian assets.¹²

Third: consistency of banking sector laws and regulations. The central bank's main mandate should be clear and unequivocal. The laws should be consistent in setting the CB main policy anchor - whether it be a stability and purchasing power of national currency (exchange rate) or inflation targeting. Ukraine's example should be avoided at all costs whereby the country's Constitution defines stability of the national currency (stability of its exchange rate) as the main NBU function while the Law on the National Bank of Ukraine adds up another three priorities (in the order of importance) to the central bank mandate: price stability (inflation targeting), financial stability, including stability of the banking sector, as well as a support to the government's policy aimed to achieve sustainable economic growth. Such legal ambiguity exposes central bank to political speculations and manipulations, public relation failures, policy indecisiveness and useless internal debates. A lot of frictions that hampered effective anti-crisis response by the NBU were due to heated and futile arguments over interpretation of the NBU mandate between its management and supervisory board.

Fourth: a lack of a balanced and well thought-over central bank's crisis management strategy may lead to regulatory inconsistencies and action gaps, which, in turn, further weaken national currency, accelerate inflation and undermine public trust. Sometimes, it is better not to act (or react) at all then to act in a chaotic and non-systemic manner and be held hostage by the brutal market sentiment and political populism. Consistency of policy measures and their implementation, the regulator's strategic confidence is often a much more valuable asset than actions that imitate activity. In Ukraine's case, lack of a coherent strategy in the conduct of monetary policy led to regulatory inconsistencies and costly mistakes, which in turn exacerbated devaluation and inflation pressures.

Fifth: importance of consistency in foreign exchange regulations. If a regulator formally declares introduction of a certain currency regime (fixed or floating rate or other) it should do its utmost to genuinely support declared objective and create most favourable framework for its implementation. Central bank's duality vis-à-vis a currency regime sends mixed signals to the market, stimulates currency arbitrage and informal forex market. In Ukraine's case, the dualism was obvious: despite the fact that a floating rate regime was formally announced in 2014 due to current account sustained deficit, in reality the regime turned out to be more rigid than a classic fixed rate one, the situation that eventually erased any perceived advantages of both regimes and enhanced all risks against the background of falling forex reserves, rampant black market activities and "awkward" interest rate policy.

Sixth: key role that has to be played by competent and efficient interest rate policy. The latter should contribute to improved market liquidity on a sustainable basis and NOT result, like in the case of Ukraine, in huge market liquidity disproportions. During the 2014-2015 currency crisis, unprecedented expansion of refinancing operations at low rates to selected banks created additional speculative demand for foreign exchange. This had led to a landslide Hryvna devaluation in early 2015 – from UAH 7.99/\$ 1.00 to UAH 30.00 (and even 40.00 on the black market). Data on a few banks that benefitted from such cheap liquidity «waterfall» has not been so far officially disclosed. On the other hand, liquidity mobilization operations with other banks have been characterised by excessively high interest rates that led to frequent disruptions in inter-bank market, surplus liquidity spiral between central bank and regulated banks. All that, in the end, almost completely paralyzed real sector lending.

¹² <http://gazeta.zn.ua/finances/bankovskaya-sistema-o-pagubnosti-nedoreform-i-ostroy-neobhodimosti-nastoyaschego-ochischniya-i-ozdorovleniya-.html>

Responsible authorities in any emerging country should make sure that mistakes and misjudgements in monetary and foreign exchange policies by a central bank during the crisis do NOT become one of the key factors in conserving or even aggravating economic recession at the grass roots level. A lot of success in central bank's activities depend upon such intangible public capital as trust. The latter is extremely difficult to accumulate but very easy to lose. Without trust, implementation costs of any central bank's monetary policy quickly escalate resulting in additional inflationary expectations and financial instability.

It may sound as a paradox but central banks, at least in some of the emerging market economies, can be more detrimental to financial stability than any exogenous or indigenous shocks altogether. "The Achilles' heels of these countries are their crummy little central banks," stated a while ago Prof. Steve Hanke, a leading international authority on monetary policy and troubled currencies. He believed that the central banks' poor track record made clear that they could not be trusted to make prudent decisions, that they were susceptible to political pressures and poor judgment and tended to do more harm than good.¹³

And as this article demonstrates, Ukraine's central bank seems to be one of most recent eloquent examples that prove the above argument.

So, what are the ways out of this paradox? The obvious solution is to turn the central bank into a truly professional, efficient, highly reputable and politically independent market regulator, which, provided the current circumstance in Ukraine, seems a rather unlikely scenario. Or, according to Hanke, to enforce more radical solutions: either to introduce a currency board, which would take control over the exchange rate and money supply away from corrupt politicians (i.e. introduce de facto hard budget constraint), or implement full "dollarization" of the financial system, which would abolish the need for a central bank and replace a troubled national currency with a strong foreign one, for instance US dollar.¹⁴

Whatever is the outcome, but it is increasingly important that **central bank's policies become a part of overall solution within a package of reforms rather than a part of the overall problem.**

¹³ <http://pages.jh.edu/jhumag/0999web/hanke.html>

¹⁴ See: Steve H. Hanke. Currency Boards. - <http://object.cato.org/sites/cato.org/files/articles/steve-hanke-annals.pdf>; Steve H. Hanke. On Dollarization and Currency Boards: Error and Deception – Policy Reform, 2002, Vol. 5(4), pp. 203-222.