Central Bank Monitoring

I/2023

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In this issue

Inflation has probably peaked in many of the countries under review, although it is still very high. Central banks are now trying to work out how much they will need to raise their interest rates to push inflation down to their targets. Some banks, including the Fed and the ECB, are continuing to raise their rates, while others have ended, or at least interrupted, their rate-raising cycles and left rates unchanged at their most recent meetings. Croatia became the twentieth member of the euro area in January. In recent months, attention has also focused on the Bank of Japan, which remains the last central bank with negative rates. However, the BoJ has changed the parameters of its regime for targeting the government bond yield curve and awaits a change of governor. The Fed created a new programme in March to support liquidity in the banking sector in response to the collapse of several US banks and associated growth in uncertainty in this segment. Financial market tensions have also increased outside the USA, and the SNB has had to address the related problems of Credit Suisse.

Spotlight discusses the monetary policy and other actions of the Ukrainian central bank in the extreme conditions of the war that Ukraine has been fighting for over a year now. In our *Selected Speech*, Deutsche Bundesbank Vice President Claudia Buch talks about central bank independence and institutional safeguards in the current economic context.

After the closing date for this issue, as part of the ongoing efforts to calm the tensions in the financial markets, an agreement was announced for the takeover of Credit Suisse by the bank UBS. This agreement was supported by liquidity provision by the SNB through a loan of up to CHF 100 billion. UBS also received a guarantee from the Swiss Government to cover losses of Credit Suisse up to CHF 9 billion (subject to certain conditions). Several key central banks (BoC, BoE, BoJ, ECB, Fed and SNB) also announced coordinated action to enhance the provision of dollar liquidity through dollar swap lines.

This publication aims to provide economists and other specialists with information on the latest monetary policy developments, strategies and communications at selected central banks.

Current and past issues can be downloaded free from the Monetary Policy section of the CNB website: https://www.cnb.cz/en/monetary-policy/monitoring/, where you can also download a file containing a list of all the thematic articles and speeches.

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Closing date for this issue: 16 March 2023.

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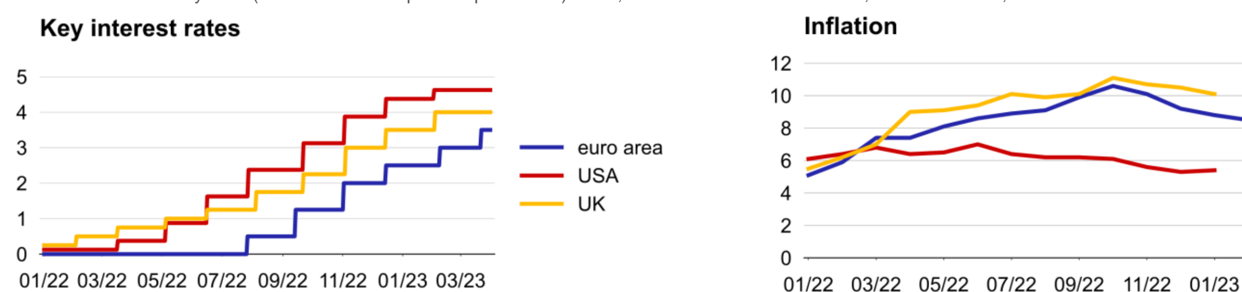
I. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

I.1 KEY CENTRAL BANKS OF THE EURO-ATLANTIC AREA

	Euro area (ECB)	USA (Fed)	United Kingdom (BoE)
Inflation target	2%	2%[1]	2%
MP meetings (rate changes)	2 Feb (+0.50) 16 Mar (+0.50)	31 Jan–1 Feb (+0.25)	2 Feb (+0.50)
Current basic rate	3.50%	4.5–4.75%[2]	4.00%
Latest inflation	8.5% (Feb 2023)[3]	5.4% (Jan 2023)[4]	10.1% (Jan 2023)
Expected MP meetings	4 May 15 Jun	21–22 Mar 2–3 May 13–14 Jun	23 Mar 11 May

Note: [1] as measured by PCE (Personal Consumption Expenditures) index; [2] chart shows centre of band; [3] flash estimate; [4] PCE index.



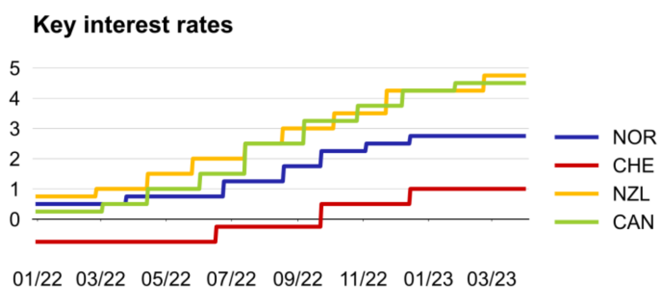
The **ECB** raised its rates by 50 bp at both the February and March meetings. Headline inflation is falling, but inflation excluding energy is rising. In its March forecast, the ECB revised the inflation outlook down (from 6.3% to 5.3% in 2023) owing to a smaller contribution from energy prices. The GDP growth outlook was revised up in the forecast. However, the ECB communicated that this forecast does not contain information on the latest financial market developments and is thus surrounded by a high degree of uncertainty. As a result, the ECB's next decisions will continue to be determined by the incoming data. The ECB also stands ready to use its tools to provide liquidity support to the financial system if needed. ECB President Christine Lagarde sees no trade-off between price stability and financial stability – the inflation forecast required a further rate hike, while the ECB has other tools to safeguard financial stability. APP asset holdings are declining as planned. The decline will amount to EUR 15 billion per month on average until June 2023.

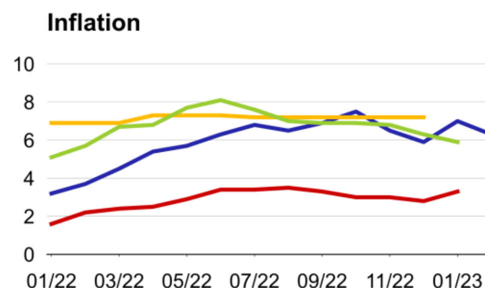
The **Fed** decided to raise the federal funds rate (FFR) by 25 bp to 4.5–4.75% at its monetary policy meeting in late January and early February. The next meeting will take place on 21–22 March, after the publication of this issue of *Monitoring*. The Fed has so far anticipated that ongoing increases in the FFR will be necessary to attain a policy that is sufficiently restrictive to return inflation to 2%. Inflation has been falling since mid-2022 but is still well above the target. Unemployment remains low and nominal wage growth is slowing but still elevated. The Fed will continue its policy of quantitative tightening. It has reduced its holdings of government securities and mortgage bonds by around USD 500 billion since June 2022.

The **BoE** decided to raise its policy rate by 50 bp at its meeting in February. Both private sector pay growth and services inflation were higher than forecasted in November. Headline consumer inflation has begun to edge back and is likely to fall further over the rest of the year, due partly to base effects, as past sharp increases in energy prices will drop out of the annual inflation figures. However, inflation will remain above the target both this year and the next, when the tight labour market and domestic price and wage pressures will foster inflation pressures. There are still considerable uncertainties around the outlook. The BoE in January completed its sales of government bonds purchased during its autumn intervention against the turbulence in the bond market (see Spotlight in the previous issue of *Central Bank Monitoring*).

I.2 SELECTED INFLATION-TARGETING NON-EU COUNTRIES

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)	Canada (BoC)
Inflation target	2%	0–2%	2%	2%
MP meetings (rate changes)	19 Jan (0.00)		22 Feb (+0.50)	25 Jan (+0.25) 8 Mar (0.00)
Current basic rate	2.75%	1.00%	4.75%	4.50%
Latest inflation	6.3% (Feb 2023)	3.3% (Jan 2023)	7.2% (2022 Q4)	5.9% (Jan 2023)
Expected MP meetings	23 Mar 4 May	23 Mar	5 Apr 24 May	12 Apr 7 Jun





The **NB** left its interest rates unchanged at the policy meeting in January. High inflation and higher interest rates are weakening household purchasing power, and many firms expect a fall in activity ahead. The NB has communicated that the policy rate has been raised considerably over a short period of time, and monetary policy has started to have a tightening effect on the economy. On the other hand, inflation is still markedly above the target. The outlook for the Norwegian economy is more uncertain than normal. Governor Ida Wolden Bache said that the policy rate is likely to be raised further at the meeting in March.

The **SNB** decided to raise its rate by 50 bp at the meeting in December. A policy meeting has not been held since then, and the next one will take place on 23 March, after the publication of this issue of Monitoring.

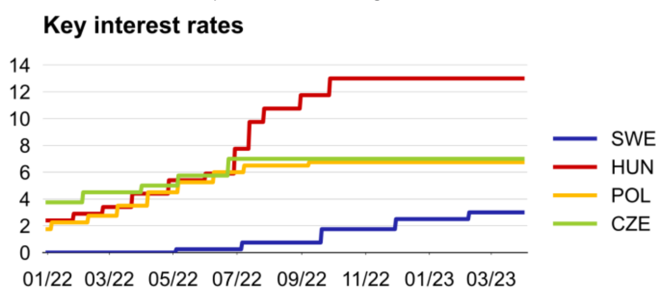
The **RBNZ** also raised its policy rate by 50 bp at the meeting in February. While there are early signs of price pressure easing, core inflation remains too high, employment is beyond its maximum sustainable level and near-term inflation expectations remain elevated. In February, New Zealand was hit by devastating Cyclone Gabrielle, which is expected to disrupt production in the near term and raise inflation. The timing, size and nature of funding of the fiscal response to the natural disaster and the monetary policy implications of these events are yet to be determined.

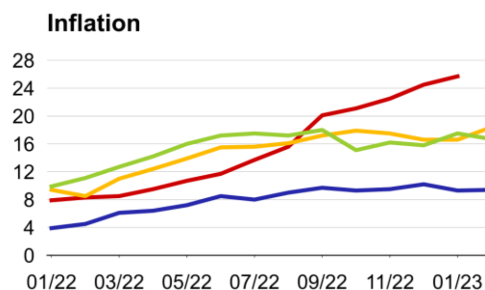
The **BoC** initially continued to raise its rate, doing so by 25 bp at the policy meeting in January, but at the meeting in March it kept rates unchanged at 4.5%. The BoC is continuing its policy of quantitative tightening. Inflation is still high above the target, although it has eased due to base effects and lower price increases for energy, durable goods and some services. The labour market remains tight and wages are growing at 4% to 5%. Economic growth halted in 2022 Q4, largely because of a sizeable slowdown in inventory investment.

I.3 SELECTED CENTRAL BANKS OF INFLATION-TARGETING EU COUNTRIES

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)	Czech Republic (CNB)
Inflation target	2%[1]	3%	2.5%	2%
MP meetings (rate changes)	8 Feb (+0.50)	20 Dec (0.00) 24 Jan (0.00) 28 Feb (0.00)	3–4 Jan (0.00) 7–8 Feb (0.00) 7–8 Mar (0.00)	21 Dec (0.00) 2 Feb (0.00)
Current basic rate	3.00%	13.00%	6.75%	7.00%
Latest inflation	9.4% (Feb 2023)	25.7% (Jan 2023)	18.4% (Feb 2023)	16.7% (Feb 2023)
Expected MP meetings	25 Apr	28 Mar 25 Apr 23 May	4–5 Apr 9–10 May 5–6 Jun	29 Mar 3 May

Note: [1] CPIF – consumer price index including fixed interest rate.





The **Riksbank** decided to raise its policy rate by 50 bp at the meeting in February. Inflation is still too high (and was higher than expected in December, mainly due to energy prices). The rate will probably be raised further during the spring. At the same meeting, the Riksbank decided to sell government bonds with longer maturities in order to reduce its asset holdings at a faster pace (the Riksbank had previously reduced its balance sheet only by not fully reinvesting maturing assets). The Riksbank will start selling the bonds in April at a pace of SEK 3.5 billion per month. The bank may alter the volume and terms if market conditions are unfavourable. It is not planning to sell its holding of non-government bonds.

The **MNB** left its policy rate unchanged at 13% at the meetings in December, January and February and is using alternative instruments to strengthen monetary policy transmission and absorb liquidity (the O/N collateralised lending rates remain at 25%). The MNB also raised the required reserve ratio to 10% in January (with effect from 1 April). At the February meeting, the MNB decided to exempt a quarter of the required reserves from bearing interest (it will continue to apply the base rate of 13% to the remaining three-quarters of the reserves). The required reserves will thus be remunerated at an effective rate of 9.75% overall. To further strengthen monetary policy transmission and financial market stability, the MNB will also continue to use one-day deposit tenders, the long-term deposit tender and FX swap transactions.

The **NBP** left its policy rate at 6.75% at the meetings in January, February and March. Year-on-year GDP growth slowed to 2.0% in 2022 Q4. Inflation was 18.4% in February. It increased compared to the end of last year, due largely to an increase in VAT rates for energy goods (gas, electricity and heat energy) and continued pass-through of higher costs caused by commodity prices. The NBP expects that the weakening of the external economic conditions, together with a decline in commodity prices, will curb global inflation, which will contribute to lower price growth in Poland.

The **CNB** left its 2W repo rate unchanged at the December and February meetings. Interest rates are at a level that is dampening domestic demand pressures. They are slowing growth in koruna bank loans to households and firms and hence also in the quantity of money in the economy. Monetary conditions have also tightened further due to the koruna appreciating against the euro. The CNB has returned to a monetary policy horizon of 12–18 months. It remains ready to prevent excessive fluctuations in the exchange rate of the koruna.

II. NEWS OVER THE LAST THREE MONTHS

Croatia joins euro area, while Bulgaria postpones its entry

On 1 January this year, Croatia became the twentieth member of the euro area. It had entered the ERM II exchange rate mechanism (with at least two years of membership being one of the conditions for euro adoption) in July 2020. In June 2022, the convergence reports of the European Commission and the ECB concluded that Croatia met the necessary criteria and was ready to join the euro area. Subsequently, Croatia's entry was officially approved by the EU Council. As an inherent part of Croatia's adoption of the euro, the governor of the Croatian central bank has become a member of the Governing Council of the ECB (the ECB's monetary policy decision-making body).

Along with Croatia, Bulgaria entered ERM II in July 2020. It was initially aiming to adopt the euro at the beginning of 2024. However, it has now abandoned these plans, as it does not meet the price stability criterion, has not yet implemented all the required changes in the area of legal compatibility and is currently facing political instability. Bulgaria's current objective is to adopt the euro in January 2025.

Fed participates in calming situation in US banking system…

On Friday 10 March, the US authorities seized control of Silicon Valley Bank (SVB), which was facing a run on its deposits. The bank had its assets largely concentrated in government bonds with long maturities, the price of which had fallen significantly as a result of rising interest rates. The bank was also specific in its focus on technology start-up clients, who are less likely to thrive in a higher interest rate environment and are more interest rate sensitive than households as regards their deposits. Most of their deposits were well in excess of the legal deposit insurance limit of USD 250,000 in the US. To ensure sufficient liquidity, the bank needed to sell some of its bond holdings (which it had originally planned to hold until maturity), the mark-to-market value of which had fallen due to rising interest rates, and it thus realised a loss. This was to be covered by a capital raise. However, the announcement of the capital raise triggered a panic, the bank's shares began to plummet in price, depositors started to withdraw their deposits in large volumes, and within a day the bank was closed. Two other smaller banks in the US also went under the same week.

While the problems of these banks were caused by their specific business models and probably by poor risk management, the loss of confidence threatened to spill over to other banks and result in a panic in the banking system. To calm the situation, therefore, during the weekend after SVB's collapse, the US Treasury, the Fed and the FDIC (which is responsible for deposit insurance) released a joint statement announcing a guarantee for all deposits held at SVB, even those in excess of the insurance limit. This support, however, would not apply to shareholders or bondholders of SVB and would be paid for by the banking sector, not the taxpayer. In addition, to secure liquidity in the banking system, the Fed has introduced a new Bank Term Funding Program under which banks can borrow for up to one year from the Fed with only a small interest mark-up against securities that will be valued at par.

…and the SNB also responded to the increased uncertainty

In the week after the collapse of SVB, Swiss bank Credit Suisse also came under pressure. It has been struggling for some time with deposit outflows, falling share prices and a general decline in confidence. In March, it was disclosed that the bank had found problems in its internal financial reporting controls. Then, at a time of high market tensions following previous events regarding SVB, a representative of Saudi National Bank, Credit Suisse's largest shareholder, refused to supply the bank with additional capital if needed. This triggered a market panic, associated with a fall in share prices and a significant increase in the probability of failure of the bank (as measured by the price of credit default swaps, i.e. the market price of insuring against the bank defaulting on its obligations). On the same day, the Swiss central bank and the Swiss supervisory authority FINMA published a statement that Credit Suisse met its capital and liquidity requirements but that the SNB was ready to provide the bank with liquidity if necessary. Soon after, Credit Suisse announced it would exercise this option pre-emptively to calm the situation and would borrow CHF 50 billion of liquidity from the SNB (fully collateralised by high-quality assets).

Bank of Japan adjusts parameters of yield curve control and is active in market…

The BoJ is still maintaining a very loose monetary policy (among other things, it is the last country in the world with negative interest rates), while facing speculation about tightening and struggling to maintain its yield curve control (YCC) regime. In December, it widened the band of tolerable fluctuations in 10-year government bond yields from ±0.25 bp to ±0.5 bp around the targeted 0% level, to which bond yields responded with an immediate rise to close to the upper bound of the new band (0.5%). According to the central bank's commentary, the move was not aimed at tightening monetary policy and did not represent a change of policy course, but was a reaction to bond market dysfunction.

In the following weeks and months, the BoJ bought government bonds in large volumes to maintain the yield curve (on some days the yield on 10-year bonds slightly breached the 0.5% threshold). In addition to 10-year bonds, it purchased bonds with other maturities. The BoJ also introduced the possibility to provide financial institutions with collateralised loans with maturities of up to 10 years at variable rates determined by market developments and increased banks' fees for short-selling government bonds. In its communications, the BoJ has so far refused to further widen the tolerance band for 10-year government bond yields (and did not do so at the January and March meetings).

…and awaits change of governor

The current BoJ governor Haruhiko Kuroda's term expires in April. The Japanese government has already decided on his successor, namely Kazuo Ueda, an academic with experience of serving on the BoJ Council in 1998–2005. According to analysts' and financial markets' expectations, the BoJ's loose monetary policy may gradually be normalised under Ueda's leadership, but at the same time (as the governor-in-waiting's comments so far also suggest) it cannot be expected to be sharply revised.

UK makes progress towards potential creation of CBDC

The Bank of England and HM Treasury have launched a public consultation on the potential implementation of a digital pound. A newly published consultation paper by the two institutions and a simultaneously published paper by the BoE summarising the technical aspects of the CBDC serve as the basis for the public debate. This advances the work on the CBDC from the initial research phase to the design phase of a particular digital currency model. A decision on the adoption of the CBDC is not expected until 2025 at the earliest, with potential actual implementation in the second half of this decade. The digital pound – if created – should be designed for retail use, should co-exist with cash (not replace it) and should be interest-free. CBDC represents an innovation in the payment system, and even though the UK's payment system is currently working well, the BoE argues that a longer-term perspective is needed. As the economy becomes increasingly digitalised, the central bank believes the likely benefits of the digital pound will grow.

Brainard leaves Fed and joins President Biden's administration

US President Joe Biden has appointed Lael Brainard, the hitherto vice-chair of the Fed, as director of the National Economic Council. The leadership of the National Economic Council is a key economic policy position in the US President's administration. Brainard was appointed to the Fed's Board of Governors in 2014 and has served as vice-chair since 2022. She resigned from her post at the Fed on 20 February this year to take up her new role at the National Economic Council.

Bank of Canada starts publishing minutes of its monetary policy meetings

Starting this year, the Canadian BoC began publishing minutes[1] of its monetary policy meetings. The minutes are the central bank's communication tool, allowing experts and the general public to gain a more in-depth understanding of the discussions and attitudes of monetary policymakers that led to the decisions taken. The Bank of Canada has also published an article summarising the benefits and risks of publishing the minutes, which served as a basis for internal discussions. The article also considers the specifics of the Canadian central bank, which, unlike many other banks, makes its decisions by consensus rather than by voting. In addition to internal discussions, the BoC's decision to publish the minutes reflects a previous IMF recommendation that the bank should disclose more information about its monetary policy deliberations. The Bank of Canada published its first minutes in February, about two weeks after the January meeting. These are anonymous minutes, so the specific arguments and reasoning presented are not attributed. Except for the Swiss SNB, all the central banks regularly covered by *Central Bank Monitoring* now publish some form of minutes.

Modified approach to management of foreign exchange reserves introduced in New Zealand

The RBNZ has introduced a new framework for managing foreign exchange reserves agreed with the local Ministry of Finance. This agreement gives the RBNZ greater discretion and independence in deciding on foreign exchange interventions. However, New Zealand intends to remain in a free-floating exchange rate regime and any interventions are reserved for very exceptional situations. The two institutions have also agreed to increase the level of foreign exchange reserves, which have remained roughly at 2007 levels despite the increase in the size of the economy and the foreign exchange market since then. The increase in the level of foreign exchange reserves will occur gradually over time in order to minimise any impact on financial markets.

[1] Officially, the Bank of Canada does not use the widely used term *minutes*; it calls the transcripts a *summary of monetary policy deliberations*.

RBNZ explains money creation in economy

The New Zealand central bank has published a paper describing how new money is created in the modern economy through lending. The article also looks at the impact of the unconventional monetary policy tools used by the RBNZ in the past on the money supply. The publication thus loosely expands on the Bank of England's 2014 educational article which also explored money creation – in its case in the context of the UK economy.

III. SPOTLIGHT: MONETARY POLICY IN THE MIDST OF WAR: THE CASE OF UKRAINE

February marked one year since the start of Russia's military aggression in Ukraine. Besides the Ukrainian army, government and local citizens, the Ukrainian central bank – the National Bank of Ukraine (NBU) – has had to deal with this shocking event. Before the war, the NBU had been operating a standard inflation-targeting regime, although it had only adopted it relatively recently. Given its previous experience of high inflation, it had set its target relatively high at 5%. After the start of the war, the central bank immediately switched from a floating to a fixed exchange rate, which it still operates today. To a limited extent, the NBU adopted monetary financing of government debt and also sharply increased the interest rate from 10% to 25%. The NBU has managed to ensure the basic functioning of the economy and the banking system. It has also succeeded in stabilising inflation for the time being, albeit at high levels. However, the NBU and Ukraine as a whole still face a host of difficult challenges ahead due to the ongoing fighting and the crippled economy.

Ukraine has been plagued by war for over a year. Given the situation, most attention is understandably focused on matters other than monetary policy. That said, the central bank is playing a major role in ensuring at least the basic functioning of society and the economy in wartime conditions. This article first summarises the monetary policy regime operated by the National Bank of Ukraine (NBU) before the war. It then looks at the approach taken by the NBU since the war broke out in February last year.

Pre-war monetary policy

The Ukrainian central bank's main statutory objective is to ensure price stability. Its other goals are to maintain financial stability and support sustainable economic growth and government economic policy (without prejudice to the primary mandate of price stability). In December 2016, the NBU formally adopted inflation targeting as part of its price stability mandate in a document outlining its monetary policy strategy for 2017 and in the medium term. In practice, the NBU had already been operating this regime since the first months of 2016. It adopted inflation targeting after several years of preparation involving changes to the monetary policy decision-making process, increased independence of the NBU, the removal of fiscal dominance and the development of macroeconomic forecasting models. Before adopting inflation targeting, the NBU formally operated money targeting.

In the above strategic document, the NBU set the medium-term inflation target at 5% ± 1 pp.[2] Given the high inflation prevailing at the time, the aim was to fulfil the target gradually. The short-term targets were annual inflation of 8% (± 2 pp) for December 2017 and 6% (± 2 pp) for December 2018. The target for December 2019 was the same the medium-term target of 5%. For the longer term, the central bank expected to maintain a constant target of 5%. It also said that the target might be further reduced as the economy advanced, but an increase was ruled out.

The new monetary policy regime was introduced partly in response to a highly unfavourable economic situation. Therefore, the main challenge was to gain credibility for the central bank's new approach and for the Ukrainian economy in general. The country had come out of a severe banking crisis in 2014–2016 and was grappling with low living standards, relatively high dollarisation and double-digit inflation (as well as a history of hyperinflation in the 1990s). A number of principles common in advanced inflation-targeting countries were applied in order to contribute to making the monetary policy regime credible. These included interest rates as the main monetary policy tool, a floating exchange rate for the hryvnia, monetary policy transparency, central bank independence and forward-looking monetary policy, including the use of forecasting models and expert judgement. Conversely, the specific features of the Ukrainian economy were reflected in the setting of the inflation target at the aforementioned level exceeding the targets in advanced countries.

The NBU managed to reduce inflation to single figures in 2018. Inflation subsequently dropped below the 5% target in late 2019 and early 2020. After the Covid pandemic started, inflation remained low in 2020. The central bank had been gradually reducing its key interest rate before the pandemic, and the outbreak accelerated this trend, with the rate decreasing from 13.5% to 6% between January and June 2020. The NBU also responded to the pandemic by introducing other measures to support banking system liquidity and lending. It gradually abandoned these steps during 2021 as the situation stabilised.

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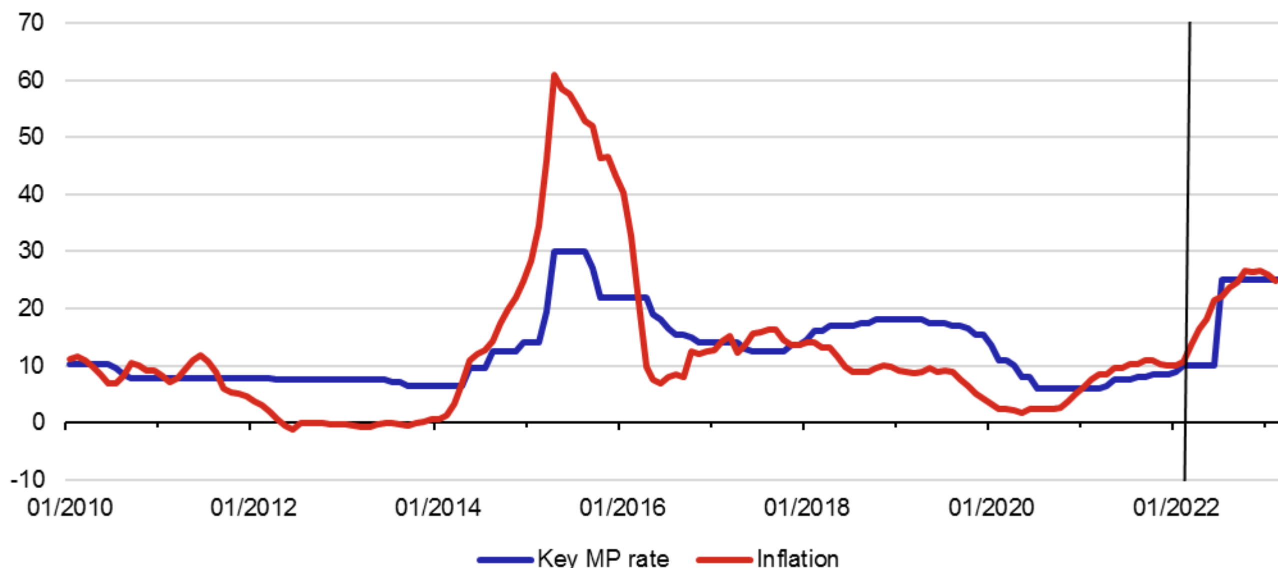
[2] The NBU defines its target with a specific numerical value and a set interval around this value. It can therefore be said to have a target band rather than a point target. The NBU also uses the term target band in a number of its documents. However, it sometimes only refers to the point target (the centre of the band) and in some instances uses the term tolerance band for the band around the target.

In the course of 2021, inflation in Ukraine – like in most countries – gradually started to rise. From mid-2021 until the start of the war, it was close to 10%. Starting in the first quarter of 2021, the NBU increased its interest rate in several steps to a final pre-war value of 10% (see Chart 1 for the evolution of inflation and interest rates).

Chart 1: Main monetary policy rate and inflation in Ukraine (year on year, in %)



Note: The vertical line denotes the start of the war.
Source: NBU website.

Monetary policy during the war

Russia's invasion of Ukraine on 24 February 2022 caused a surge in demand for foreign currencies. Those fleeing Ukraine sought to obtain money they could use abroad, while Ukrainian residents tried to maintain the value of their savings. To prevent a sharp, destabilising decline of the currency, the central bank responded immediately by introducing capital controls and a fixed exchange rate, pegging the hryvnia to the US dollar at a rate of 29.25 (see Chart 2 for the evolution of the exchange rate). The capital controls and associated restrictions on the purchase of foreign currency were intended to safeguard the sustainability of the fixed rate (FX market interventions by the NBU also contributed).[3]

Chart 2: Exchange rate of the hryvnia against the US dollar

Note: The vertical line denotes the start of the war.
Source: NBU website.

At the start of March, the NBU issued a statement postponing its key policy rate decision. The reason given was that the series of administrative measures introduced had significantly reduced the importance of market-based monetary instruments (especially the interest rate). The rate therefore stayed at 10% during this period. As well as the rate decision, the publication of the Inflation Report and macroeconomic forecasts was postponed. The NBU announced that when the standard transmission channels went back to normal and it became possible to calculate, with reasonable probability, the impact of monetary decisions over the policy horizon, it would return to active use of the key interest rate and other

[3] Besides economic issues, the NBU had to deal with sizeable operational obstacles. It had to conduct many of its activities in military shelters, its staff were evacuated to the western part of Ukraine, and so on. However, for security reasons, the bank did not provide detailed information on such matters.

monetary instruments. The NBU also declared that after Ukraine was liberated and the economy was back to operating on market-driven principles, it would return to its traditional inflation-targeting mode with a floating exchange rate.

Various other measures were introduced in the initial phase of the war. To safeguard the operation of the financial system, the NBU supplied banks with liquidity at 11% interest without the need for collateral. It also supported the government's financing of the budget deficit, announcing that it would buy government bonds on the primary market if needed (action that would be seen as very controversial in any country in peacetime).[4] The NBU did indeed become a major buyer of government bonds in the months that followed. To limit the risks stemming from its purchases of bonds on the primary market – the de facto monetisation of government debt – the NBU announced it would only finance critical government expenditure in limited amounts and would maintain maximum transparency around these transactions. In other steps, it also established donor accounts – one to support the Ukrainian armed forces and the other for humanitarian aid.

There was a significant shift in the NBU's approach in June, when it raised its key policy rate from 10% to 25%. It also widened the corridor for its other monetary policy rates (on refinancing loans and on certificates of deposit) from ±1 pp to ±2 pp around its key policy rate. After the initial shock from the war had given way, and given the gradual adjustment of the Ukrainian economy, it was appropriate to change the monetary policy approach – low yields on Ukrainian assets, the exchange rate depreciation risk perceived by households and businesses, and the threat of dollarisation of the economy led to a need to considerably support yields on domestic assets. Although international reserves were maintained at relatively high levels thanks to aid from abroad, there was a risk of them depleting rapidly. Inflation expectations were meanwhile rising. Considering all of these factors, and given that the transmission mechanism was still having only a limited effect in wartime and that the central bank saw a need to increase yields on hryvnia assets above expected inflation rates, the NBU decided to take the resolute step of raising rates by 15 pp.

This was also a period of extreme economic downturn. Ukraine's GDP fell by around 15% year on year in 2022 Q1 and by more than 37% in Q2 (and these numbers cannot capture the loss of life, human tragedy and devastation caused to many cities and to infrastructure). Inflation surged from around 10% to over 20% in the first half of 2022. Throughout history, growth in inflation has been a phenomenon commonly observed in wartime. The decline in Ukrainian GDP halted in mid-2022 (even though economic activity was and still is very hard hit by the effects of the war) and the rise in inflation has gradually slowed. Annual inflation stabilised at around 26% in October and has stayed there in the months that have followed (see Chart 1). In any event, the central bank's task was and still is to ensure that inflation, despite being at high values, does not get completely out of control and that the Ukrainian economy does not collapse. If this were to happen, it would be even more difficult for Ukraine to face up to Russia's aggression.

In this context, it is worth noting that we should exercise some caution when interpreting specific inflation figures (and other macroeconomic variables) in a war situation. Several previously quite ordinary and basic goods and services cease to be available, or are only available to a very limited extent. The relevance of comparing the growth in prices of these goods and services before and during the war is thus limited. Also, the methods for measuring inflation are themselves limited. However, the data can certainly provide us with at least a general picture of economic developments.

In July, the NBU moved the fixed hryvnia exchange rate to 36.57 to the dollar, 25% lower than before (see Chart 2). This move was aimed at limiting the imbalances on the foreign exchange market and adapting conditions to the economic developments since the start of the war. The NBU also introduced new or changed existing measures limiting the use of international reserves for non-priority spending (for example by introducing limits for individuals on withdrawals of foreign currencies from cash machines and on payments in foreign currency from hryvnia accounts). In July, the NBU also resumed publishing its Inflation Report (after skipping the April publication) and its macroeconomic forecast. According to the forecast, interest rates would be kept at 25% until at least 2024 Q2, although the bank admitted that they may also increase further due to inflationary risks.

In the months that followed, the NBU did not fundamentally change its policy. The previous sharp increase in rates and the shift in the exchange rate significantly eased the pressures on the foreign exchange market. This, in combination with international aid and a functioning "grain corridor"[5] important for Ukrainian exports, even led to an increase in the international reserves in the second half of 2022 (after a decline in the first half of the year). In October, the governor of the NBU was changed after Kyrylo Shevchenko resigned for health reasons. However, there was subsequent speculation

[4] In most countries, the purchase of government bonds by the central bank on the primary market is prohibited by law. This also normal applies in Ukraine, but martial law temporarily allowed such purchases.

[5] The grain shipping corridor is based on an agreement between Ukraine, Russia, Turkey and the United Nations enabling the export of Ukrainian food commodities by sea during the war. This is essential for food security, especially in developing countries, and is also important from the perspective of Ukrainian exports.

as to the reasons for his resignation and allegations of corruption in the period before he took over the helm of the central bank). Andriy Pyshnyy was appointed new governor.

In October, the NBU, in cooperation with banks, introduced a new instrument enabling households to buy US dollars for hryvnias at the official exchange rate, make term FX deposits and then change them back to hryvnias six months later at the earliest. The aim was to give households an alternative to buying FX cash, help them to maintain the purchasing power of their savings and also help stabilise the FX market. The NBU also gradually tried to limit the monetary financing of government debt. In December, it decided to increase the required reserve rate for retail deposits with immediate maturity by 5 pp (from 5% to 10% for hryvnia assets and from 15% to 20% for foreign currency assets). This was intended to foster greater competition among banks for time deposits and enhance monetary policy transmission in a situation where the rise in deposit rates was not in line with the previous increase in the monetary policy rate, in the context of a structural liquidity surplus on the market. Banks were able meet up to half of the reserve requirement by holding Ukrainian government bonds.

The NBU will maintain its interest rate at 25% this year as well. According to the latest January forecast, it envisages keeping its key policy rate at this level at least until 2024 Q1. The forecast sees inflation slowing to 18.7% in 2023 and then declining to 10.4% in 2024 and 6.7% in 2025, slowly approaching the target from above. The NBU expects the economy to be flat in 2023 and to gradually recover over the next two years, growing by 4.1% in 2024 and by 6.4% in 2025 (after having shrunk by around 30% overall in the past year). Understandably, the fulfilment of the forecast will fundamentally depend on the further course of the military conflict. The baseline scenario of the forecast assumes a significant relaxation of the security situation at the start of next year. The labour force also constitutes a major uncertainty – the main question is how many refugees will return to Ukraine in the future and how many more Ukrainian citizens will emigrate.

In January, the NBU also increased the required reserve ratio by a further 10 pp (with effect from March). Banks are no longer allowed to meet this requirement by holding Ukrainian government bonds. At the most recent meeting in March, the NBU took further steps to support competition among banks for households' term deposits.[6] Continued support from abroad, including significant progress in the negotiations with the IMF for additional aid[7] and cooperation between the NBU and the government to boost the domestic debt market, should make it possible to avoid monetary financing of government debt this year.

Conclusion

The events of recent years have presented, and continue to present, many challenges for most central banks. However, the NBU has had to deal with extremely challenging tasks over the past year in the midst of a war. So far, it has managed to safeguard the functioning of the banking and payment system and stabilise the hryvnia exchange rate and the country's international reserves. During the period of martial law, the NBU decided to skate on the thin ice of monetary financing of government debt. However, it used this tool to only a limited extent and is now abandoning it. International aid has also played a major role. Inflation is at high levels but has been stabilised, at least for the time being, and has not got completely out of control. This can be considered a success given the extraordinary nature of the situation, the sharp contraction of the economy by about one-third, and the high inflation even in countries not directly affected by the war.[8] However, numerous difficult challenges still await the Ukrainian central bank and the country as a whole. Unfortunately, Russia's aggression is still ongoing, inflation far exceeds the target, and even in the event of the war ending, Ukraine faces the challenging and long-term process of rebuilding a wrecked country and crippled economy. Hopefully, the NBU and the country as a whole will cope with these tasks as well as possible.

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[6] In particular, it allowed banks to make advantageous investments in certificates of deposit with three-month maturity, in which banks can invest depending on the volume of household deposits on term accounts with at least three-month maturity. Conversely, the use of overnight (O/N) certificates of deposit was disadvantaged by a reduction in the relevant interest rate.

[7] In autumn 2022, on the basis of an IMF mission, an agreement was concluded between Ukraine and the IMF on *Program Monitoring with Board Involvement*. This was subsequently reviewed in February, the individual targets having been successfully met. The IMF has also provided continuous aid to Ukraine in the past year. However, this agreement is a major milestone on the way to a comprehensive programme for longer-term, fully fledged aid to Ukraine from the IMF. The programme would also support the post-war reconstruction of Ukraine and its steps on the way to joining the European Union in the event of a favourable outcome of the conflict.

[8] In March, the portal *Central Banking* recognised the work of the NBU by naming it Central Bank of the Year. The NBU received the award for maintaining financial and macroeconomic stability in Ukraine in the face of extreme shocks.

IV. SELECTED SPEECH: Claudia Buch: Central bank independence and the mandate – evolving views

Claudia Buch, Vice President of the German Bundesbank, in her January speech at a symposium in honour of outgoing Swedish Riksbank Governor Stefan Ingves, talked about the impact of recent events on the importance of central bank independence, institutional safeguards and communication.

(New) challenges for central bank independence

With inflation rates running up to 10% in the euro area, the core mandate of central banks – price stability – is a key policy issue today. Over the past decades, as inflation was low, central bank independence was hardly at the centre of public debates. However, the macroeconomic situation has changed radically. This has implications for the public perception of central banks. Buch notes that central bank independence mitigates direct political intervention into their objectives. An independent central bank is free to make decisions about the tools it employs, subject to legal constraints. The central bank's general objectives are determined by government, while the central bank may enjoy discretion with respect to the clarification of its objectives. Central bank independence reduces the time inconsistency problem of monetary policy as well as the risk of fiscal and financial dominance. Similarly, policy decisions related to financial stability require central bank independence.

Buch sees three main reasons why central bank independence may move into the focus of public discussions. First, inflation is expected to remain comparatively high over the next couple of years. Demand and supply shocks have pushed inflation well above central banks' targets, and according to the recent projections by the ECB, it will return to target within the euro area only by 2025. Some structural features of the global economy which have kept inflation low over the past decade may reverse and contribute to higher inflationary pressure in the future. Second, vulnerabilities in the financial system and risks to financial stability have increased and financial conditions in Europe have deteriorated. Should risks to financial stability materialise, the role of central banks in maintaining financial stability would move into the limelight. The third reason, according to Buch, is that high levels of debt can lead to conflicts between price and financial stability. At the current juncture, higher interest rates are needed to fight inflation and to anchor inflation expectations. But higher market interest rates may also threaten debt sustainability and financial stability. Without sufficient buffers in the financial system to absorb losses, central banks might fight inflation less vigorously than needed if they fear adverse consequences for financial stability. Monetary policy may thus come under fiscal or financial dominance.

Central bank independence requires strong institutional frameworks and good communication

At the current juncture, risks to price and financial stability are heightened, and conflicts of interest may arise unless adequate institutional frameworks are in place. In Germany, trust in the central bank has been supported over decades by a societal consensus about the institutional role of the Bundesbank. This consensus in favour of central bank independence has carried over to the European level. A number of arrangements protect the ECB's independence: separate budgets, sufficiently long terms of office, no reappointment of members of the Executive Board, prohibition of monetary financing, functional independence, and the ECB's right to adopt binding regulations necessary for carrying out its tasks. In combining a clear mandate with operational independence, society has tied its preferences to the central bank's objectives. This provides democratic legitimisation for central banks to impose costs on society in the pursuit of their mandate without considering fiscal consequences.

After the global financial crisis, the powers and activities of central banks have broadened to include explicit roles in contributing to financial stability. According to Buch, one needs to acknowledge differences between monetary policy and financial stability policies. First, their time horizon differs. The objective of price stability is defined over the medium term. Financial stability policies aim at mitigating the build-up of vulnerabilities over the financial cycle, which is longer than the typical business cycle. Second, the policy objective differs. ECB defines price stability as an inflation rate of 2%. Defining and quantifying financial stability in a similar way is hardly feasible. Third, policy instruments differ. Policy rates are the key monetary policy tool, and this tool is firmly in the hands of central banks. Financial stability policy uses a range of tools and in many countries it is typically a responsibility shared by supervisory fiscal authorities and central banks. "Independence" in the context of micro- and macroprudential supervision thus differs from independence in terms of monetary policy.

In the last part of her speech, Buch notes that besides the institutional framework, transparency, accountability and communication are equally important to sustain public support for central bank independence. Communication has two types of addressees, though. Whereas communication with the expert community uses specialised language and can refer to structured frameworks, communication with the broader public requires different tools and simpler language. Translation from the language spoken by technocrats to the language spoken by the general public is an art rather than a science. However, this translation and a continuous dialogue with the public are crucially needed – in particular in times of structural change and a high degree of uncertainty – for sustaining societal support for an independent central bank.

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