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Decision-making and accountability in an inflation targeting central bank: Recommendations for Ukraine

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Decision-making and accountability in an inflation targeting central bank: Recommendations for Ukraine

The National Bank of Ukraine (NBU) is currently in a transition phase towards Inflation Targeting (IT). While this fundamental change in its monetary policy strategy is highly commendable, it nevertheless requires significant changes in the governance framework.

In this paper, we try to contribute to this reform process. We highlight two important areas where such changes are needed. First, this relates to the decision-making process, i.e. the way decisions are taken. Second, we look at the best way on how to ensure accountability vis-à-vis the public and its elected representatives. In order to derive policy recommendations, we review international best practices, primarily in inflation targeting banks in both developed and emerging markets.

In terms of proposed changes to the decision-making process at the NBU, we would like to stress the following points:

- **Board structure:** The current institutional setup with the Council and the Director's Board is suboptimal, given the unclear division of labor between them. In our view, the Director's Board should be turned into a smaller Management Board, which implements monetary policy decisions and runs the bank on a daily basis. A separate Monetary Policy Committee (MPC) should be established, which overtakes responsibilities for monetary decision making. The responsibilities of the Council need to be redefined, and subject to further investigation. One possibility would be to shift its role towards a supervisory board.
- **Structure of the MPC and its meetings:** The committee should consist of around 6-8 people. Meetings should take place regularly (e.g. at monthly frequency) and be scheduled and announced in advance. Each meeting should follow a fixed, pre-established order.
- **Strengthening the role of economic research:** Sound economic research is a key input for monetary policy decisions in an IT framework. Thus, the role that economic research plays at the NBU needs to be strengthened. The Chief Economist/Head of Economic Research should be given a prominent role in MPC meetings, both in terms of their preparation, and the discussion on the economic situation.

The governance framework under which monetary policy decisions are taken must also ensure a sufficient level of accountability. That means the NBU should be obliged to inform the public about its policy decisions and be able to justify them. In our view, the following issues are important in this regard:

- **Reporting:** The NBU should in general report to Parliament, rather than to the Government, or the President. The current detailed quarterly reporting requirements to the Government and the President should be slashed. The Annual Report delivered to the Parliament could be also automatically forwarded to the Government/President.
- **Transparency:** During the early stages of IT introduction, the NBU should concentrate on communicating the new strategy in a clear, coherent and understandable way, i.e. "speak with one voice". During this phase, further information like the results of the voting mechanism, or the minuets of the meetings, should not be made public. However, this could be considered at a later stage.

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1. Introduction

There is a wide consensus that central banks should be enabled to provide for a stable price level, as such an environment will foster long-term economic growth and social development. Many central banks in developed economies have introduced to this end an inflation targeting (IT) regime, the Bank of England is one of the most prominent ones. Central banks in former transition countries like Poland, Hungary and Czech Republic have also adapted an inflation targeting regime. Among those central banks which have no exchange-rate anchor, some 34 operated with an inflation targeting regime by the end of 2013, according to the IMF.[1]

The National Bank of Ukraine (NBU) first announced plans to move to inflation targeting in 2002 and some preparations to that end were done over the following years. Most prominently, the Parliament approved changes to the NBU Law in 2010, setting price stability as its primary goal. Still, de-facto targeting a fixed exchange rate versus the US-Dollar, which started in 1996, continued with some interruptions until February 2014. In April 2014 the National Bank of Ukraine (NBU) announced that an inflation targeting regime will be functioning in 2015, within 12 months. This ambitious time schedule requires numerous changes to the way the NBU currently conducts its monetary policy. In the scope of this paper, we try to address one particular aspect of this transition, which relates to the internal governance framework of the NBU, in particular the way internal decisions are taken and the accountability for these decisions versus the public is ensured. While an inflation targeting regime is widely accepted as a successful nominal anchor, it is less clear how optimal governance structure for a central bank in general and for an inflation targeting bank in particular should look like[2].

The paper is structured as follows. In the next chapter, we review international best practices of inflation targeting central banks, in particular in Central and Eastern Europe (CEE). The main focus is here on identifying common practices in internal decision-making structures, and the accountability of the central bank. In chapter 3, we analyse the current governance structure of the National Bank with respect to these two issues. The last part provides recommendations on how to change the governance structure of the NBU so that it can reflect best international practices.

2. International Best Practice

Concentrating on inflation targeting central banks, international comparison shows that there is a broad variety of governance structures and characteristics of monetary policy decision making bodies. However, there are some features these central banks have in common.

The question about the optimal governance design depends obviously very much on the question which tasks have to be fulfilled by the central bank. We concentrate here on the design of the monetary policy **decision making process**. Further, we assume that central bank independence should be warranted as this is viewed as international best practice with respect to the maintenance of price stability. In other words, de-politization of monetary policy decisions should be a target of any governance structure chosen. However, this does necessitate a sufficient level of **accountability**, to exclude a scenario where the central bank accumulates too much power or abuses its authority.

In the following sections, we will go through the most important subjects related to the optimal governance of an inflation targeting regime. In particular, we will focus on the structure of the central bank's boards (for example the question if different functions

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[1]26 central banks targeted certain monetary aggregates, and 39 central banks monitored other indicators. The ECB is following both, inflation and monetary aggregates as a target.

[2] Ukraine is not unique in this respect, as most central banks that introduced IT had also to adapt their institutional structure.

should be shared between different boards, or if they should be decided in one multifunctional board) as well as the accountability of the central bank. The latter refers above all to the accountability with respect to monetary policy decisions. Reference will be made especially to the inflation targeting central banks of Poland, Hungary and the Czech Republic. When comparing internationally this is usually done with respect to other Inflation Targeting central banks, unless it is noted otherwise.

a. Decision-making process

Central banks fulfil various functions, the most important being to decide upon monetary policy and to implement this policy. In this respect, we define **policy board** as the board responsible for monetary policy decisions, the **management board** as the board responsible for management and administration and finally the **supervisory board** as the board responsible for the oversight of the institution’s performance. While there are central banks which have more functions than the aforementioned, we will focus on decision making, its implementation and internal supervision. In this respect, we will deal in the following sections with aspects such as the number of boards; the question of how many people should do the policy decision, and the actual decision-making process. The latter refers not only to the voting mechanism, but also to the subject of how the interchange of information in the board should take place. In this process, we will shed some light on the US Federal Reserve Bank (Fed), the ECB and the Bank of England, which are generally seen as benchmarks for central banks around the globe, and which provide some interesting insights into their decision-making process.

<u>Should the different functions of a central bank (e.g. decision making, management, supervisory) be fulfilled by one board or by more than one board?</u>

- With respect to monetary policy decisions and the management of the daily operations implementing those decisions, it makes sense to have them **under the roof of one board** or at least (if there are two boards) **chaired by one person, the governor**. Mostly, one of these alternatives can be witnessed in central banks. To give an example, Hungary has one board for monetary policy decisions and one management board, both presided by the governor, while the Czech Republic's central bank has one board for both functions.
- In most central banks the monetary decision taking board is also responsible for other tasks like management or so. However, there are a growing number of central banks like the ones of Turkey, Poland and Hungary which have followed the example of Bank of England and have **dedicated monetary policy boards**.
- With respect to supervision, there is no clear tendency towards or against a **separate supervisory board**[3]. Hungary has indeed such a separate board. If the decision to install such a board is taken, it would be positive for the credibility of the central bank if it would not be chaired by the governor.

<u>How many people should be voting members of the monetary policy board, or actively participate in the monetary policy decision process?</u>

- Obviously there is a trade-off between benefits and costs of having involved many people in the decision process. While on the one hand many people should provide for a broader spectrum of views and competences, the decision process may take a longer time the more members are involved. International experience shows that in

[3] According to surveys (BIS 2009, and IMF 2004) around half of the 47 members of the Bank for International Settlements (BIS) had supervisory boards. Those that didn’t often had supervisory functions in external bodies, i.e. state audit institutions.

most inflation targeting countries, a **single digit number of members** are customary. One reason (apart from the one mentioned above) for this seems to be that, on the one hand, with a few people (say, three or four), there is a lack of diverse viewpoints and information which could mean that the decision does not take into account all issues. If, on the other hand, there are more than 9 or 10 people, some members may tend to free ride on the information gathered by other members, which is at least inefficient.

- The central banks of the Poland, Czech Republic and Hungary have 7, 6 to 9 (currently 9) and 10 members respectively, including the governor.
- The ECB and the Fed, which have 24 and 12 members, are exceptions to the rule, given their large currency regions and their federal structure.

How should the voting mechanism be designed?

There are two aspects to the voting mechanism:

- First, some central banks like the ECB do **not vote formally**, but are more consensus-oriented. Others, like the Bank of England, have an **explicit voting mechanism** and do also publish the results of the vote. The same is true for the central banks of Hungary and the Czech Republic. The ECB approach represents a more collegial way to find a decision, while the Bank of England approach is a more individualistic one. This aspect is very much related to the **publication and transparency of the voting results** and/or the individual contributions and opinions to the discussion. It looks as if an individualistic approach bears the risk of having a big variety of opinions with respect to the right interpretation of economic data and the right decision. This, however, could confuse both financial market participants and the wider public. Thus, the effectiveness of monetary policy may be put at risk, as the formation of expectations about future monetary policy would be more difficult.
    - While the Czech central bank has followed the example of the Bank of England, as it discloses the vote casts of the board members, it introduced this practice only in 2008, 10 years after the introduction of the inflation targeting regime. Hungary introduced the same scheme in 2011, also 10 years after starting the inflation targeting regime.
- Second, there is the aspect of **efficiency**. If the decision is taken by the simple majority, the process of decision taking is certainly more efficient than in the case of consensus decision. The most efficient way would be to let the governor decide alone. In some prominent central banks like the Bank of Canada the governor is legally the sole responsible, while the decisions are taken within the context of committee meetings that entail a vote or consensus mechanism. However, it may put too much responsibility on the shoulders of one person. Extreme outcomes may be more probable than in the case of a group deciding.

Should the policy board meet in a regularly manner? How often?

- The meetings should take place **regularly** and be **scheduled in advance**. The schedule should be published. In almost all central banks this is standard. To schedule the meetings in advance has the advantage of self-disciplining the board members to reflect steadily relevant monetary policy issues. In addition, a published schedule should add to the credibility of the central bank.
- Too frequent meetings could lead to unnecessary market rumors. The ECB has recently decided to cut the number of meeting from 12 per year to 8 per year with the purpose to bring more calm into the markets. Most central banks have still monthly meetings. If the economy is behaving in a volatile way (like many emerging economies do) a **monthly meeting** seems to be reasonable.

How should the policy meeting be prepared and who should prepare it?

- The most important input for a monetary policy meeting is the information about the current state of the economy and what the expectations are for the future development of the economy. Usually this information is prepared by the **research staff** of the central bank.
- There may arise the fear that the research staff could built up an **information monopoly**, thereby influencing the monetary policy decisions in the way they would like. However, this argument does not stand scrutiny. Firstly, every policy board member is at liberty to gather information from other external sources as well, be it from economic research institutes or from research departments of banks. And secondly, even if each member gets the same information, the interpretation of this information may vary considerably with respect to the meaning for the future development of the economy and the measures which should be taken in response.
- It seems sensible to provide the decision takers about **one week in advance** with the relevant information and forecasts prepared by the central bank's staff. Incoming information shortly before the meeting should be added on an ad-hoc basis.
- The Fed and the ECB have quite transparent ways how this information is being gathered and how it find its way into the decision process. In the Annex, a description of how the board meeting may take place in detail and what role information gathering is playing in the decision process in the Fed can be found.

Should there be a specific organisation of the monetary policy meeting?

The issue of the organization of the policy meeting is very much connected to the question **who dominates the decision making**. To put it differently, should the board be dominated by one person, or should it consider all individual viewpoints and opinions available?

- The advantage of having a board dominated by one person, which mostly is the governor, is that the central bank has a better chance to be perceived as speaking with one voice, thereby not confusing market participants.
- The disadvantage of having the board dominated by one person is the higher risk for extreme outcomes. At the same time the central bank forgoes probably important input from members who have information connected to their personal network, their individual educational background or other experiences.
- In case all board members contribute their opinions, the question is how to avoid confusing the markets. This is connected to the question about the communication strategy of the central bank, which is the next issue.

The optimum degree of transparency about the decision taking from a viewpoint of the effectiveness of monetary policy?

The issue of transparency has two general aspects: First, the question of **effectiveness of monetary policy**, and second the question of the central bank being accountable to the public. For discussion about the latter point please see the following chapter on "accountability". Here, the focus is on the effectiveness of monetary policy.

In addition, there is the question in **which form** the central bank should be transparent about their monetary policy. Usual tools are statements of the decision, minutes of the meeting, press conferences after the meeting with Q&A sessions, as well as speeches by the board members at various occasions.

- Monetary policy usually works with a certain lag. For example an interest rate cut usually takes some time until it brings down long term yields, while taking even more time to cause banks to adjust their credit conditions and companies to update their calculations for new investment projects.

- On the one hand, if market participants doubt that the monetary decision taken is reasonable and at risk of being reversed soon due to opposing opinions in the board, this could do harm to the effectiveness of monetary policy. The lag of monetary policy may be even longer than it would be anyway. This would be an **argument of not being too transparent** about the discussions in the board.
- On the other hand, the notion that a vivid debate is happening in the board signals to the public the efforts of board members to find the right way to fulfill the mandated target. In this sense, **more transparency** about the decision-making process **may add to the credibility** of the board. While the Bank of England is indeed going this way with some success (with voting and publishing the member's voting behavior) the BoE does not publish a statement of the monetary policy decision. This has obviously to do with the fact, that occasionally there is no consensus about the way this statement could be formulated.

Summing up, transparency about the decision finding and the different opinions should be limited and not going too much into detail with the main goal to make people understand why a certain monetary policy was taken by the majority of the board. Counterarguments to the decision taken should be weighted less, without ignoring them altogether. Naming the names of the members who did not support the monetary decision should be avoided at this stage as this may provoke political pressure on the corresponding board members.

Table 1

Overview of Governance Structure in Inflation Targeting Central Banks

	Mostly established practice in inflation targeting central banks	Czech Republic	Hungary	Poland
Number of boards/Structure of the monetary policy decision making body				
Are the different functions (policy, management, supervisory) of the central bank fulfilled by one board or by more than one board?	No standard. However, in most cases the supervisory board is not separate and mostly (also in some cases of separation) led by the governor.	Same board for monetary policy function and management.	Three different boards. The monetary council (monetary policy) and the board of directors (management) are chaired by the governor. The supervisory board is chaired separately	Two different boards for monetary policy functions and for management, both chaired by the governor
How many people are voting members of the monetary policy decision making body?	No standard. However, board sizes are mostly in the single digit area. In a few cases the governor alone can decide.	7	6 to 9 (currently 9)	10
Is the decision taking by voting majorities?	Mostly yes, in some cases consensus is required.	Yes	Yes	Yes
Has a government represantative a full membership in the decision making body?	Mostly No	No	No	No
Does the decision making body receive get an analysis about the economy and is this information provided by the research department of the central bank?	Yes	Yes	Yes	Yes
Is there a specific speaking order?	Mostly no fixed speaking order. In others the order changes every meeting (BoJ), or it is fixed that the Chief Economist (ECB) or the governor (CB of Norway) starts.	Rules exist, but room for flexibility	No fixed speaking order	No fixed speaking order
Accountability with respect to monetary policy				
To whom is the central bank reporting with respect to it's monetary decisions?	Often to the legislature or the government, sometimes both	To the legislature	To the legislature	To the legislature
How often the central bank has to report?	No standard, from bi-weekly to quarterly, but mostly on a regular basis.	Monthly	Bi-weekly	Monthly
Are the decisions publicly available?	Yes, to a certain extent and mostly in a timely manner	Press conference after the meeting. Minutes, 8 days after the meeting, including the voting positions	Only the decision, immediately after the meeting. Voting positions are published in the minutes	Press conference after the meeting. Voting positions are published no later than 3 months after the meeting
In what other ways does the central bank communicate to the public	Various publications, mostly on a monthly basis, as well as inflation reports, speeches and research papers	Press release, Inflation report, monthly report, speeches, research papers	Press release, Inflation report, monthly report, speeches, research papers	Press release, Inflation report, monthly report, speeches, research papers
Is there a legal oblilgation to share information with the government?	Yes, in different forms and frequencies	Yes, central bank informs government, governor may attend government meetings. May not take instructions.	Yes, central bank informs government. May not take instructions.	Yes, representative of Council of Ministers may submit motion for consideration, central bank president may attend meeting of Council of Ministers
Accountability with respect to financial conditions of the central bank				
Is the annual report including the financial statement externally audited?	Usually this is the case.	Yes	Yes	Yes

Source: Own display based Morris, J., & Lybek, T. (2004): Central bank governance: A survey of boards and management. IMF; IMF (2013): Annual Report on Exchange Arrangements and Exchange Restrictions, different websites of Central Banks; Maier, P. (2010): How Central Banks Take Decisions: An Analysis of Monetary Policy Meetings; Tuladhar, A. (2005): Governance Structures and Decision-Making Roles in Inflation Targeting Central Banks. IMF

b. Accountability of the central bank

The issue of accountability[4] surrounds the aspect of **responsibility** and **transparency** with respect to monetary policy. Obviously, it is difficult to separate the two aspects completely. The aspects of transparency were discussed above with a sole focus on the effectiveness of monetary policy, but the true dimension of this topic is much wider: While it may be good for accountability reasons to increase the degree of transparency this could be, however, a stumbling block for the goal to communicate in a simple and understandable way. The transmission process could suffer therefore. Thus, a balance has to be found between these two targets.

<u>Accountability to whom, and why?</u>

- A central bank whose statute provides for independence from political (especially the government's) influences is still an institution which must be accepted by the public of a democratic society. If the society is of the opinion that the central bank acts in the best interest of the broad public, the central bank has the best chances to be able to implement its monetary policy without political pressure and protests. Therefore the central bank has to **explain the policy measures taken regularly to the public**.
- The population is best represented by the **parliament**. Thus, the central bank should report regularly to the members of parliament. If instead the central bank was obliged to report to the government, this could lead to more political pressure.
- There may be a case of a **regular report to the finance minister** for the reason of maximizing the effectiveness of monetary policy. The reasoning behind this is the view of some economists[5] that monetary policy and fiscal policy should co-ordinate their work to increase the effectiveness of monetary policy. An example for this would be the goal of bringing inflation down which could be fulfilled probably in the fastest way by both, a restrictive monetary policy (hiking interest rates) and a restrictive fiscal policy (cutting spending).
- While accountability to the Finance Ministry is usually motivated by the fact that this ministry administers the government's ownership of the central bank, such **reporting could interfere with monetary policy issues.** This is the case if the finance minister is given too much room to interfere with respect to the dividend policy. This could put at risk the autonomy status of the central bank and/or the fulfillment of the inflation target.
- With respect to monetary policy issues the central banks **often report to the legislature** (like in Poland, Hungary and Czech Republic) but **also only to the government**. Sometimes they report to **both entities**. The ECB and the Fed both report to committees of the European parliament and the Congress (i.e. Parliament), respectively.

<u>How and how often should the hearings at the parliament take place?</u>

- Hearings at the parliament usually take place in front of the **banking committee** or another **specialized group of parliamentary members**. This makes sense as long as the committees represent the structure of the parliament with respect to the distribution of parties.

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[4] The special aspect of considering the financial situation of the central bank will not be the main focus of this chapter.

[5] A prominent representative of this view is the Nobel Prize laureate Christopher Sims.

- For example, the President of the **ECB** appears **four times per year** before the **European Parliament's committee on Economic and monetary affairs** and **once per year before the plenary of the European Parliament** (to present the Annual Report). The **Fed**'s Chair of the Board of Governors testifies **two times a year** before the **Congress' banking committees.** In both cases, members of parliament have the opportunity to ask questions. In addition, the sessions are made public.
- The central banks of Czech Republic, Poland and Hungary all report to the legislature.

<u>In what other ways should the central bank communicate to the public?</u>

- There are various ways to **communicate with the public**. In most cases, this communication is done first for reasons of **making monetary policy more effective**, and second to **make people understand that the central bank acts in the best interest of the public**, thus for accountability reasons. The various ways to communicate are mostly done for both reasons at the same time.
  - Poland's central bank uses the following tools of communication:

  1. Press conference after the meeting to explain the decision
  2. Press release to explain the decision
  3. Minutes of the meeting
  4. Inflation report (quarterly)
  5. Information bulletin (monthly report)
  6. Speeches of central bankers
  7. In addition, research papers are published

  - This is very similar to what the central banks of Hungary and the Czech Republic use as communication tools. Obviously, these central banks take the ECB's communication policy (which is almost the same, with the exception of the publication of minutes) very much as a model.
- The most critical part of this communication may be the **minutes**. The ECB for example has been reluctant until now to publish minutes. There is a certain risk that from the minutes it is easier to deduct who has voted in what manner, which in the case of the ECB, having different nationalities on the board, could lead to pressures from national governments. As a compromise, minutes will be published from next year on, but without publishing how the members have voted.
- Another critical point may be the **publication of the balance sheet**. In general, this is a good way to ensure the public is able to follow continuously financial conditions of the central bank. At some points (especially in times of crises), however, such a procedure may make it more difficult for the central bank to act without pressure from outside[6]. Most central banks publish the balance sheet more than once a year.

[6] For example if the balance sheet is used to rescue financial institutions in the function of lender of last resort, this can lead to criticism about loading the central bank with too much credit risk. This is actually what happened at the ECB and became known as the "TARGET balances" discussion.

Should the financial conditions be subject to an external audit?

- Yes, it is important to ensure in a credible way that resources of the central bank are not misused. In general central banks publish an annual report including a **financial statement** which is **externally audited**.

3. The current institutional set-up in Ukraine

a. Decision-making process

In Ukraine, the responsibility for monetary policy decision-making is divided between the NBU Council and the NBU Board. The **NBU Council** is mandated by the Constitution to define the guidelines for monetary policy and oversee their implementation. The Council is composed of 15 members, including 7 members appointed by the President and 7 members appointed by Verkhovna Rada for seven-year terms. The Governor is a member of the Council by virtue of his office. The Council operates with a quorum of two-third of its members and takes decisions with a simple majority of the members present.

Legislative changes approved in 2010 during a programme supported by the IMF were meant to strengthen the independence of the NBU Council, at least on paper. Members of Parliament, other persons with elected offices, political party leaders, ministers and recently retired ministers are now prohibited from serving on the Council. Council members must also have an impeccable business reputation, higher education or academic degree in economics, law or finance as well as 10-year working experience in bank, academia, Parliament or as high-level civil servant.

The NBU Council is supposed to approve the "Monetary Policy Guidelines (MPG)" for the next year by September 15 (the same as the budget deadline). These guidelines are supposed to set the main parameters of the monetary policy for the next year (i.e monetary and/or inflation targets, exchange rate policy framework) and guide the NBU Board in the operational conduct of monetary policy. In addition, the Council may issue non-binding recommendations to the Board to provide more short-term guidance on monetary policy.

In practice, the NBU council had little role in setting monetary policy. It generally approved a draft of the MPG prepared by the NBU staff. The NBU Council did not hold a single meeting in 2010 and 2011, and resumed its activities in 2012 only after the terms of some of its members appointed under the previous government expired and new members were appointed by the new government. In September 2012, the NBU council approved revised rules for the preparation of the MPG that gave Council members and the Council secretariat a leading role in the preparation of the guidelines[7]. The MPG for 2014 was approved only in March 2014, after new members were appointed by the Parliament. Recently, the Council declined to approve the MPG for 2015 as proposed by the NBU staff, and decided to study this issue further.

The **NBU Board** is responsible for all key operational decisions on monetary policy, including some approvals on individual monetary policy operations. Most importantly, it sets the discount rate, conditions of access to all operations, approves a list of acceptable collateral on refinancing operations, sets reserve requirements for operations, and decides on interventions in the foreign exchange market. More minute decisions are delegated to the NBU Monetary Policy Department, including on interest rates on overnight facilities.

The NBU board is composed of 11 members, including the Governor, Deputy Governors and Heads of Departments that are ex-officio members of the Board. Board members must conform to the same qualification requirements as Council members. The NBU

[7] It is unclear how and if this new arrangement was put into practice.

Board makes all decisions, including on monetary policy, by simple majority of members present as long as there is quorum of eight members (2/3). Members are appointed and dismissed in accordance to Civil Service regulations and with consent of the Council in case of Deputy Governors. Civil service regulations generally allow for dismissal from a position for cause, but this requirement can be avoided if the position is eliminated through restructuring.

The framework for monetary policy decisions is only partly public. There is a **resolution on interest rate policy by the NBU**, and one on **liquidity operations with commercial banks**. The first regulation briefly sets out the main considerations when setting interest rates, indicates a preference for a policy rate higher than the official forecast of inflation[8] and delegates to "person responsible for general management of monetary policy departments of NBU" the daily setting of interest rates for operations (deposit facilities, overnight refinancing and refinancing auctions). The second regulation details main types of liquidity operations, eligibility requirements, provides for weekly refinancing auctions (up to 14 days, every fourth week - up to 90 days) and general requirements for collateral. It also provides for ad-hoc repo operations and operations with government bonds based on negotiations between the NBU and interested banks. However, the **institutional framework for monetary policy decisions** i.e. how interest rates or reserve requirements on bank liabilities are set and reviewed and on what schedule **is not public**. NBU decisions on **foreign exchange interventions** are **even less public.**

To sum up, contrary to the legal framework, the control over monetary policy remained mostly concentrated with the NBU management i.e. the Governor, the Deputy Governor responsible for monetary policy, and the Director of the Monetary Policy Department. Monetary policy decisions were taken on an ad-hoc basis, without any regular decision cycle and until recently subordinated to the overriding de-facto goal of exchange rate stability versus the US-Dollar. Monetary policy was tightened in response to pressure on the exchange rate, and loosened when demand for foreign currency receded. This subordinated role of monetary policy to a fixed exchange rate limited at the same time the influence of the central bank on interest rates.

b. Accountability

The **NBU Council** is required to make public all their decisions, and members are required to participate in Council meetings or they may face dismissal (by President or Parliament, depending on who appointed the member). However, the Council is not required to hold public meetings or inform the public about the agenda and discussions held during the meetings. To guarantee the independence of the Council, members may be dismissed before their terms expires for misconduct or because of disability (i.e. unexcused absences at Council meetings, inability to participate in Council work for over four months, loss of qualifications for membership). Moreover, the President or the Parliament is not required to dismiss Council members even if there are grounds for dismissal. Thus, incompetence of Council members is not a ground for expulsion from the Council.

The **NBU Board** is required to publish the decisions with regulatory impact (i.e. outside of the NBU), but many monetary policy decisions are not regulatory or are binding only for the NBU and thus are not required to be published. It should be noted that some monetary policy decisions are published by the initiative of the NBU, and not due to legislative requirements. There also likely exist NBU Board resolutions that are relevant for monetary policy, but that were not made public. The NBU is subject to an annual audit by external auditors and it is required to publish an annual report on its activities.

[8] Implying an (ex-ante) positive real policy rate.

The NBU is required to provide information to the President, Government and the Parliament's Banking Committee on NBU operations, including bank refinancing, interventions on the interbank market and its operations with securities i.e. government bonds, on quarterly basis. It is unclear if this requirement entails providing something more than what is already published on the NBU's website. The NBU is also supposed to provide a forecast of monetary indicators for the next year to the President, Government and Parliament before April 15.

The NBU Council is the key body responsible for **overseeing** the activities of the Board. It regularly evaluates the conformity of monetary policy operations with the MPG, and approves financial statements, the financial plan and the annual report of the NBU. The NBU staff is required to provide all necessary information to the Council. However, if the Council disagrees with the Board on certain monetary policy decisions, the Council has only limited options. It can publicly state its disapproval, and/or ask the President and the Parliament to dismiss the Governor[9].

4. Recommendations for Ukraine

Inflation targeting is about communication, transparency and credibility. Each governance structure considered has to take these criteria into account. Is the structure suitable for being communicated in an understandable way? Is the structure transparent? And: Does the structure look credible to the public?

In the following part, we will present some recommendations on how the internal governance structure of the NBU could be adjusted to allow for a smooth transition towards an IT regime, with a special focus on monetary policy formation and implementation.

a. Decision-making process

<u>Board structure</u>

- With respect to monetary policy decisions, the **current structure** with two boards (the Council and the Director's Board) is **suboptimal** given the unclear division of labour between them.
- In our view, the Director's Board should be turned into a smaller **Management Board**, which basically implements monetary policy decisions and runs all administrative activities of the central bank on a daily basis
- A separate **Monetary Policy Committee** (MPC, or Policy Board) should be created, whose main responsibility is monetary decision making
- The **NBU Governor** should presides over both bodies, similar e.g. to the case of Poland. The exact composition of the MPC is a question that needs further study, as different models are possible
    - o In Hungary and the UK, additional Management Board members (Deputy Governors) are also member of the MPC
    - o The question of external members of the MPC (e.g. researchers from leading banks, or academia) needs also further analysis

- The role of the **Council** needs to be redefined. One possibility would be the (narrow) role of a **supervisory board** of the NBU on behalf of its owner, i.e. approving annual

[9] Unofficially, it may also pressure the NBU management by withholding approvals for appointments and through its authority over NBU financials.

reports and budgets. In this case, the members of this body should not be at the same time also members of the Management Board

  - Similar to the case of Hungary

Additional recommendations on the MPC/Policy Board structure

- **Number of people** in the MPC: Between 6 and 8
- The **meetings should take place regularly and be scheduled in advance**. The schedule should be published (standard in almost all central banks). Monthly meeting seems to be adequate. Coordination of the publication with the meetings: publish for example the monthly report before the meeting
- **Organisation of the meeting**: Each MPC member should have the opportunity to comment on first, the current economic situation and view on future developments and second, on the policy measures he would like to take. There should be a fixed order for each meeting which could be the same for each meeting or could rotate according to a certain scheme.

Strengthening the role of Economic Research

- Given that **economic research** plays a crucial role for understanding how the transmission process of monetary policy works (which is essential for decision making) and for the communication of the policy (which is central to the IT regime), **the role of the respective department should be upgraded** and given more weight
- In particular, the **Chief economist/Head of Economic Research** should be given a **prominent role in the MPC meetings** not only by being responsible for the preparatory documents, but also through a briefing about the current economic situation, including forecasts at the start of each meeting. This should be followed by each member's individual assessment of the economic situation, to get a broad picture
- The preparatory briefings should contain **proposals for monetary decisions** including the pros and cons to each decision
- The preparatory briefings should be send **one week in advance** to the meetings to the board members and participating staff
- The Economics Department should further orient its resources for economic research on the **process of inflation** and on **understanding the transmission mechanism** of monetary policy
- See Annex "How decisions may be taken in the US Federal Reserve" for more information in the case of the US.

b. Accountability

- **The NBU should report to Parliament**, not to the Government (the Ministry of Finance or the President). Currently, there is significant fiscal pressure on the NBU, which holds 60+% of local sovereign debt
- The detailed **quarterly reporting requirements** to the President and the Government should be **slashed**
  - A copy of the Annual Report delivered to Parliament could be forwarded to the President/Government
- For a central bank which is starting a new monetary policy regime like the NBU it may **not be wise to be extremely transparent** about the internal discussion. Instead, the central bank must thrive to communicate the new strategy of inflation targeting in the most clear and understandable way. Thus, the **NBU should speak with one voice**.

- **No open voting mechanism**. Too difficult to communicate the different positions. Consensus oriented, explanation of the decision and the pros and cons to the public
- **Perhaps later a more refined approach**, as in many other central banks in the region

Annex

How decisions may be taken in the US Federal Reserve

Around the table in the Federal Reserve Board's headquarters sit all 19 FOMC participants (...) as well as select staff and economists from the Board and the Reserve Banks. Because of the nature of the discussions, attendance is restricted (to only one staff member).

The meeting begins with a report from the manager of the System Open Market Account (SOMA) (...), responsible for keeping the federal funds rate close to the target level set by the FOMC. (...)

Up next is the Federal Reserve Board's director of the Division of Research and Statistics, along with the director of the Division of International Finance. They review the Board staff's outlook for the U.S. economy and foreign economies. This detailed forecast is circulated the week before the meeting to FOMC members (...).

Then the meeting progresses to the first of two "go-rounds," which are the core of FOMC meetings. During the first go round, all of the Fed Governors and Reserve Bank presidents discuss how they see economic and financial conditions. (...)

The policymakers have prepared for this go-round through weeks of information gathering. Before the FOMC meeting, each Reserve Bank prepares a "Summary of Commentary on Current Economic Conditions," which is published two weeks before each meeting. (...) The Reserve Bank presidents have also gathered information by talking with executives in a variety of business sectors and through meetings with the Banks' boards of directors and advisory councils. In addition, all Committee participants receive briefings on economic conditions by their Research Department staffs in the days leading up to the FOMC meeting. The briefings cover regional, national, and international business and financial conditions.

This first go-round covers valuable information about economic activity throughout the country (...). This portion of the meeting concludes with the FOMC Chairman summarizing the discussion and providing the Chairman's own view of the economy.

At this point, the policy discussion begins with the Federal Reserve Board's director of the Division of Monetary Affairs, who outlines the Committee's various policy options. The policymakers receive these options usually by the Friday before the meeting (...). Each option is described, along with a clear rationale, the pros and cons (...).

Then, there is a second go-round. The Reserve Bank presidents and Governors each make the best case for the policy alternative they prefer (...).

At the end of this policy go-round, the Chairman summarizes a proposal for action based on the Committee's discussion, as well as a proposed statement to explain the policy decision. The Fed Governors and presidents then get a chance to question or comment on the Chairman's proposed approach. Once a motion for a decision is on the table, the Committee tries to come to a consensus through its deliberations. Although the final decision is most often one that all can support, there are times when some differences of opinion may remain, and voting members may dissent.

At the end of the policy discussion, all seven of the Fed Governors and the five voting Reserve Bank presidents cast a formal vote on the proposed decision and the wording of the statement. (...)

Source: Excerpt of the document "A day in the Life of the FOMC", published by the Federal Reserve Bank of St. Louis

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