

“I Can’t Advise Forgetting either the Hryvnia or the Dollar.” Interview with NBU Governor Yakiv Smolii

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Photo: NBU

Ukraine’s government will change tomorrow, as will the nation’s economic landscape. As Ukraine goes through turbulent times, investors are looking for signs of stability that would make them believe the economy is on the right track. It is only natural that they look to the NBU as an authority that can signal whether the rules of the game are still clear. Since 2015, the NBU has been purposefully “tightening the screws” by keeping its key policy rate high and requiring banks to increase their capital. Some consider these actions to be correct, as they lead to macroeconomic stability that enables investors to make long-term decisions about investing in Ukraine. But others criticize the NBU for being overly conservative and thus holding back economic growth.

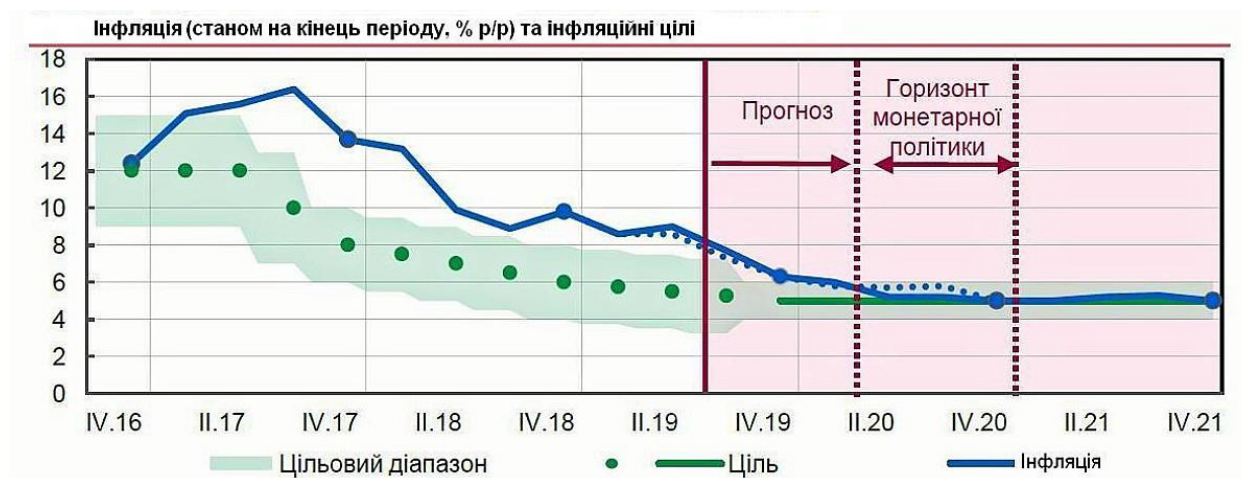
What will the NBU do after the new Cabinet has taken office? What is the regulator’s plan in case the global economy is hit by a financial crisis? NBU Governor Yakiv Smolii

answered these and many other questions in the interview below. He said, among other things, that he had no intention of resigning before his contract expired.

I interviewed one of NBU executives here five years or so ago. We talked about the policy shift from keeping the exchange rate unchanged to inflation targeting, or achieving a certain level of inflation, that is. What has it led to?

The NBU switched to the inflation targeting regime in 2015. At that time, inflation was higher than 40%. Last year, inflation had moved into single digits for the first time in five years, hitting 9.8%. The NBU estimates that by the end of the year, inflation will

have fallen below 7%. This is the result of the tight monetary policy the NBU resorted to at the time. The high key policy rate is painful, of course, as it restrains lending to the real economy. But low inflation lays the groundwork for future economic growth. Our economy has already been growing for 14 quarters running. The NBU has even upgraded its GDP growth forecast from 2.7% to 3% for this year.



Inflation (as of the end of period, % yoy) and inflation targets
Forecast **Monetary policy horizon**
Target range **Target** **Inflation**

Source: SSSU, NBU staff estimates

In July, those familiar with the matter started talking about deviations from the NBU’s inflation forecast of 6.3% for late 2019. How significant were they?

The NBU did not change the forecast in July. In Q4, inflation will decline more quickly because of a difference in comparison bases. But it’s up to the NBU to revise the forecast in October.

Are you saying it’s pure math that’s driving inflation down?

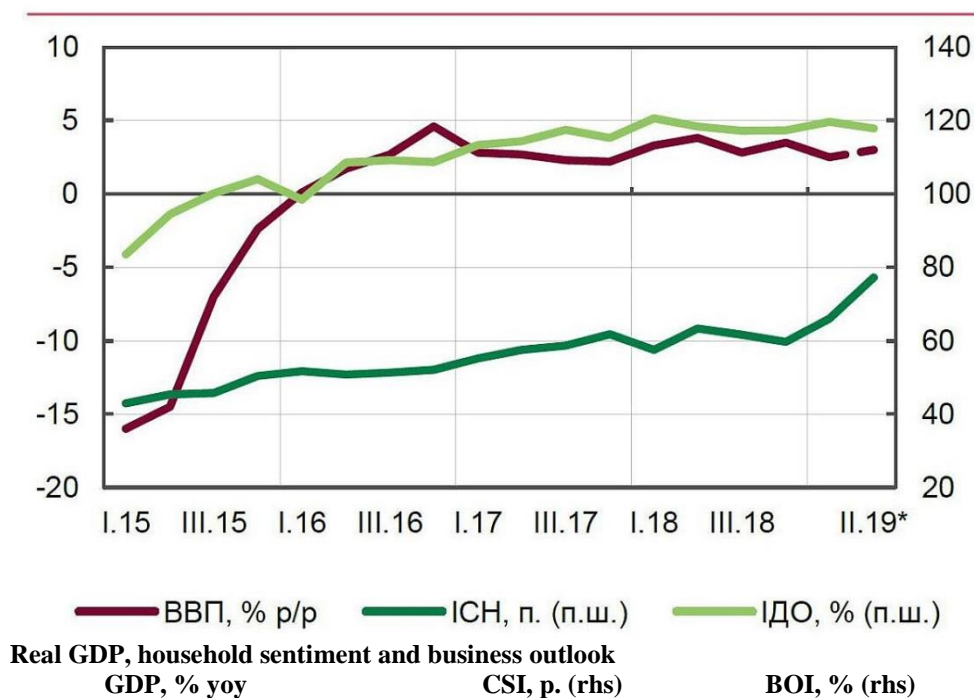
No, not just math. The drop in inflation is being driven by economic factors. Labor migration has declined. Labor migration used to drive wages higher, which led to higher consumption and higher prices. In addition, thanks to the NBU’s monetary policy, sufficiently high real interest rates will continue to help curb inflation.

Economists around the globe are increasingly talking about an upcoming financial crisis. Some predict a recession for Germany. The trade war between the United States and China is far from over. How will the NBU adjust its projections if a global crisis arrives?

The NBU expects the Ukrainian economy to grow by 3% in 2019–2020. I don’t see what could prevent that from happening. Cereal harvest projections are good. International markets continue to favor Ukrainian goods. Prices for wheat and corn are little changed from previous years. The situation with prices for metal products remains normal. Without a doubt, the U.S.-China trade standoff and a worldwide recession may partially affect Ukraine. However, continued cooperation with the IMF will give Ukraine access

to external financing that is cheaper than the funds it can raise by placing securities. This will help the nation meet the peak debt repayments scheduled for this year and the next.

Реальний ВВП, споживчі настрої населення та ділові очікування підприємств



Q2 2019: GDP – NBU estimate, CSI – average for April–May 2019. Source: SSSU, NBU staff estimates

Representatives of the real economy are mainly criticizing the NBU for being too slow in cutting the key policy rate. Why not do it faster? Wouldn't the economy receive a stronger boost from bigger rate cuts?

The NBU expects the Ukrainian economy to grow by 3% in 2019–2020. I don't see what could prevent that from happening.

The NBU has declared and made clear to all stakeholders that it will reduce the key policy rate as economic conditions change. The NBU's goal is to cut the key policy rate to 9% by the end of 2020, and to 8% by late 2021. In the meantime, inflation should reach 5%. The NBU estimates that inflation will decline more rapidly next year. But if favorable factors emerge, the NBU may consider the possibility of easing its monetary policy and cutting the key policy rate again this year.

The NBU pursues a tight monetary policy. Meanwhile, the ECB says it's preparing to launch a new round of economic stimulus in September. The Fed has lowered its federal funds rate as well. Shouldn't the NBU revise its conservative approach to monetary policy?

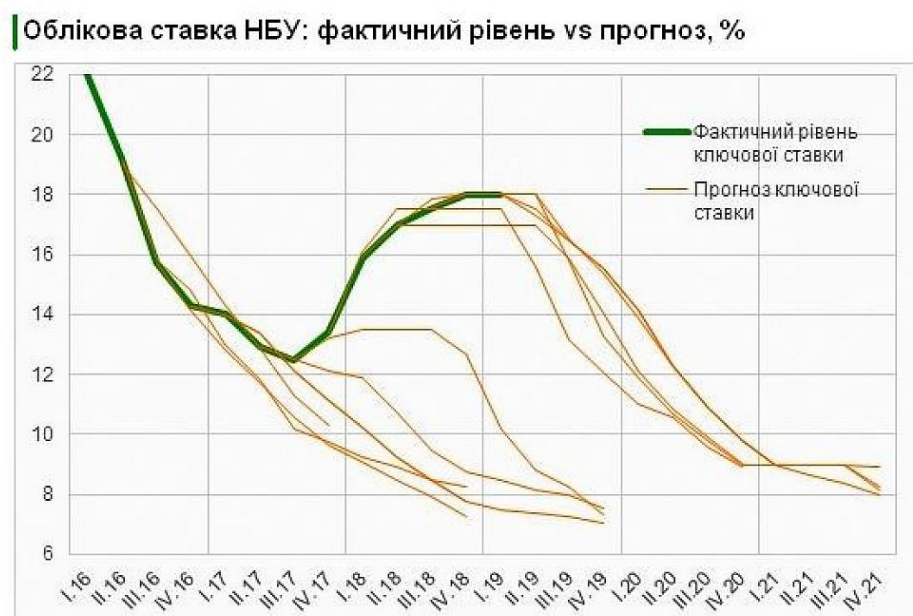
The NBU is watching how events unfold in international markets, of course. But the NBU has goals to meet. I would say that today certain entities perceive the NBU's key policy rate as some sort of benchmark for the cost of funding. This is true for the interbank market. But in terms of lending and the cost of financing to businesses, the NBU's key policy rate is not what should guide the decisions of economic entities.

Does this mean that nobody keeps them from charging lower interest rates on loans?

There is no direct relationship involved, because the cost of funding in the banking sector depends on the cost of term loans and funds in current accounts. And, as a rule, the average value of portfolios is always lower than the NBU's key policy rate. However, the margin that commercial banks charge when making loans takes into account not only the cost of the funding but also the risks involved.

A representative of the Office of the President said that next year banks would be able to charge 12%–13% on hryvnia-denominated mortgage loans. What do you make of that? Is that a possibility?

Absolutely. That is rather in line with the 8%–9% key policy rate the NBU predicts for next year. Add a margin of 4%–5%, and you get 12%–13%.



NBU's key policy rate: actual rate vs forecast, %
actual key policy rate
key policy rate forecast

Source: bank.gov.ua

Other than cuts to the key policy rate, what should be done to make that happen?

The Verkhovna Rada has received a number of draft laws it needs to pass to augment the reforms Ukraine has already implemented. The NBU expects these laws will be adopted after the newly elected Verkhovna Rada has started to work. It is important for the NBU and entire financial sector today that the government complete the reform of the judiciary. The laws on creditor rights protection have yet to be fully implemented. Entities that make loans today are unable to reduce margins because of high risks, and this affects interest rates. There is also a need for stronger protection of consumers in financial services. On top of that, it's necessary to increase the financial literacy of borrowers so that they are better aware of the terms of loan agreements they conclude

with banks. Combined, these measures will create a comfortable relationship between the lender and the borrower. That applies to mortgage lending in particular.

How would you evaluate the banking system now? On a five-point scale, for example.

In the first seven months of the year, the banking system earned UAH 37 billion in profits.

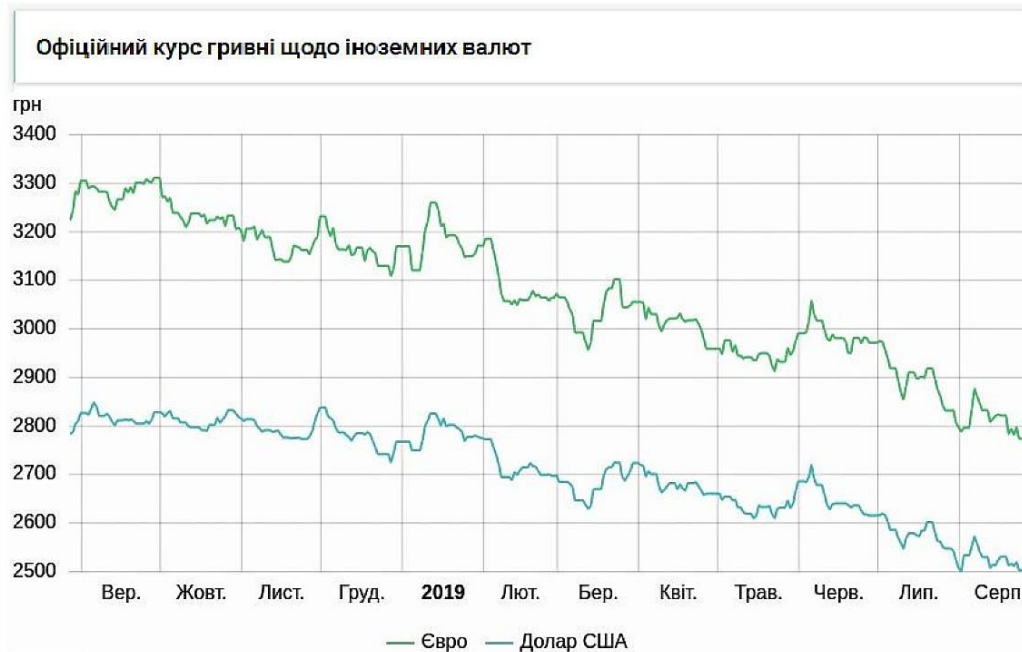
I'd rather not use any kind of scale. The NBU has come close to aligning its practices with international standards for banking supervision, bank capital requirements, and asset quality assessment. All Ukrainian banks have sufficient capital, as stress tests the NBU conducts every year have shown. At the end of the year, the NBU will publish the results of its ongoing bank resilience assessment. The banking system today is stable, liquid, and profitable. In the first seven months of the year, the banking system earned UAH 37 billion in profits. This figure is very healthy. This is more than Ukrainian banks were able to generate in any of the past few years.

Are there any risks?

Risks always exist. From the NBU's perspective, the main risks are the ones threatening to hamper the continuation of cooperation with the IMF, and access to financing (this is one of the potential challenges for both the NBU and government). Banks' portfolios are rather heavily dollarized. The share of foreign currency in both deposits and loans exceeds 40%. This share is declining, but the norm for an economy like Ukraine's is 20%, meaning there is still work to be done.

In 2015, the then NBU Deputy Governor Vladyslav Rashkovan advised Ukrainians to forget about the dollar and euro, and to think in hryvnia terms instead. But this hasn't happened. We keep mentally converting hryvnia amounts into dollars. When can we finally forget about the dollar?

I can't advise forgetting either the hryvnia or the dollar. Individuals have to stop fearing that the domestic currency may depreciate. People in every line of business and every market are talking about the notable stability of the past two to three years.



Official hryvnia exchange rate
euro U.S. dollar

Source: bank.gov.ua

Do you think Ukrainians have confidence in the hryvnia? The average American saves in dollars, the average German saves in euros, while I have to save in dollars. When will this change?

Public confidence in the banking system is gradually increasing. Because individuals are making hryvnia deposits, we can talk about increasing trust in the domestic currency.

But you mentioned Germany. A look at recent publications reveals that German pension funds are investing in government securities. Some of them have a maturity of 30 years and bear near-zero interest. This means that in 30 years, the pensioner will have no additional investment income. He or she will only receive the face value of the security, provided the yield is not in fact negative. In other words, the ability of a currency to be both legal tender and a means of savings depends on the country and the situation within it.

What can guarantee that the NBU will retain its institutional independence under the new government?

Various politicians are attempting to use the media to threaten the NBU or to manipulate information so as to vilify the NBU's leadership and staff. These are elements of psychological pressure intended to throw an individual off their balance. The NBU stands ready to comment on each of these criticisms.

But then again: what is central bank independence? This is a concept whereby the regulator does not change its leadership to meet the demands of individual politicians every time the country changes its government. If the NBU is independent and pursues its mandate, and changes in the NBU Board take place in accordance with the Law *On the National Bank of Ukraine*, then the NBU's policy is hereditary and predictable. By

contrast, if the nation's new leaders were to undo all reforms the NBU introduced three to four years ago (the shift to inflation targeting, the floating exchange rate regime, etc.), then anyone who used to shape expectations and make projections would find themselves hard-pressed to understand what will happen in the market tomorrow.

Currently, I don't see any of such threats to the NBU's independence, any statements by new political forces as to the need for a change in the course the NBU pursues, or any decisions of that kind.

Still, they are pretty vague about their staffing decisions. For instance, Oleksii Honcharuk, Deputy Head of the Office of the President of Ukraine, told us in an interview that the course would remain the same. Their human resources policy, however, is a different matter.

My term of office is seven years. It started in March 2018. I have no plans of early resignation.

I can't comment on Honcharuk's words. You have my comments on the provisions of the law. I have already said once that we have no plans of early resignation. I can only leave when the term is over or in the event of any force majeure... My term of office is seven years. It started in March 2018.

When Valeria Gontareva was leaving her post, she said that her mission was accomplished. When your seven years are over, what will you say?

We set a goal to decrease inflation. We were planning to have several draft laws adopted in order to implement reforms. The law *On Currency and Currency Operations* was among them. It is effective and almost fully implemented. The NBU expects the adoption of the "split" law, the law on protection of consumer rights in financial services, the law on one-time declaration, and the amendments to the laws on preventing corruption and on terrorism financing. In addition, The NBU is waiting for several laws on BEPS and financial information exchange for taxation purposes, so that we can fully achieve the free flow of capital. Hence, I can't pick just one thing that stands out from the rest. Many reforms have not been started yet.

One-time declaration. Does it mean "zero declaration"?

Yes, the so-called zero declaration. Here is how everyone understands it: declare once and pay nothing to the budget. Instead, the idea is about a one-time declaration of unreported assets.

Jointly with other financial regulators, the NBU has prepared the draft strategy of financial sector development until 2025. Currently, the NBU is discussing it with market players. It has five areas of work: strengthening financial stability, fostering macroeconomic development and economic growth, developing financial markets, enhancing financial inclusion, and introducing innovations into the financial sector. We expect for the document to be finalized in November 2019.

Banks charge 20% interest on loans today, while credit unions charge 120%.

You've mentioned the split law. It stipulates the separation of powers between the NBU and other regulators. Why does it cause disputes?

The law stipulates the liquidation of the National Commission for the State Regulation of Financial Services Markets and the separation of its functions between the NBU and the National Securities and the Stock Market Commission. Currently, each regulator has its own powers in the market. The NBU's powers are more restricted than those of the others. Banks charge 20% interest on loans today, while credit unions charge 120%. At the same time, no law on protection of consumer rights in financial services has been adopted, and thus, the end consumer has nowhere to turn to when facing fraud or concealment of the terms and conditions of a loan.

He or she may come to the NBU's building to protest.

We've had such cases.

This occurs not only in Ukraine. Central banks are tightening their policies – we see interest rates going down. A lot of new financial institutions are emerging and providing the same services without being regulated. It's a global trend. Do you wish this tendency did not exist in Ukraine?

On the contrary, the NBU wants this to happen. The more market players, the higher the competition among them: as they try to win over a client, the quality of the services rises, and the cost of the services decreases. However, all market players should have a level playing field. We need civilized rules applicable to everyone.

Will they be forced to become banks?

Not necessarily. Why become a bank when an institution intends to make FX transactions, service money transfers, or issue loans? The end consumer should know and understand all terms and conditions. An individual should be well-informed to decide what to choose – a bank or a financial institution.

Will the NBU also regulate insurance companies?

According to the draft law on the "split," pension funds and asset management companies should be regulated by the NSSMC. The NBU will regulate insurance companies, pawnshops, and credit unions.

Are there any estimates as to the volume of financial transactions within this unregulated market?

If we look at the assets of nonbank financial institutions, they make up only 10% of the financial institutions market. However, the situation is reversed if we consider the quantity: nonbanks account for 96% of financial service providers. The majority of them are small and medium enterprises. They ensure employment, service provision, and availability of services. Banks do not always wish to open offices in smaller district centers or towns. Meeting all requirements may not have economic feasibility in such cases. Then, the niche is taken by nonbank financial institutions.

Will you continue the FX market liberalization?

In February 2019, the parliament adopted a new law on currency and currency operations, which lifted over 30 restrictions. In particular, the NBU has canceled the requirement to make hryvnia-denominated deposits prior to buying foreign currency, doubled the time limit for settlements under export and import agreements, and permitted businesses to purchase foreign currency with borrowed funds. The NBU has also canceled individual foreign exchange licenses for the general public and permitted individuals to purchase foreign currency online. The surrender requirement for foreign currency proceeds was lifted on 3 June 2019. The limits on repatriation of dividends by investors were canceled on 3 July 2019. To ensure the truly free flow of capital, Ukraine still has to adopt a number of draft laws, as I've mentioned before. These draft laws pertain to BEPS, tax information exchange, declaration of the assets held abroad, and payment of any unpaid taxes on such assets. We need these laws to enable all individuals to feel secure, without any fear of prosecution, to be sure of their law compliance, and to be able to freely manage their assets held in Ukraine.

Is it in your plans?

Of course. These are the draft laws developed by the NBU jointly with the Ministry of Finance of Ukraine. Once they are adopted, it will be possible to extend the scope of the FX liberalization somewhat.

So, ideally, if I happen to have some foreign currency, I will be able to dispose of it as I wish, right?

Sure, it is yours.

The NBU has fully lifted all restrictions on selling foreign currency. Have you already estimated the influence of this decision on hryvnia exchange rates?

Before taking this decision, we analyzed the way businesses dispose of their foreign currency proceeds. We learned that our restrictions had little impact on their decisions as to the amount of foreign currency to sell. In most cases, enterprises sold over 90% of their foreign currency proceeds, while the requirement was 50%. Hence, these restrictions were moral, rather than economic, in nature. Yet, we could not adopt this decision earlier. We had to make sure it would not affect exchange rates. The market is well-balanced now. This is evidenced by the fact that exchange rate fluctuations, though present, remain mild.

Speaking about exchange rates. The hryvnia's strengthening came under strong criticism this summer. People wondered why the NBU let this happen, with lesser proceeds to the budget and the decreasing profitability of placement of bonds. What are your comments on this issue?

The NBU does not fix exchange rates. They are market-driven.

But you could support it a bit, purchase some of the hryvnia.

The NBU can't set a goal of increasing or decreasing its currency purchases

The NBU can't set a goal of increasing or decreasing its currency purchases. Once there is a surplus causing dramatic fluctuations, the NBU intervenes by making a purchase. If the market is short of the currency, the NBU sells it. The NBU sold the hryvnia in June, as it was in demand due to the alleged possibility of default. The situation reversed itself in July, so the NBU purchased a surplus from the market. The NBU has purchased nearly USD 3 billion since the beginning of the year. Is this figure large or small? We can compare it to the results of the previous years. International reserves amount to USD 22 billion at present. Everything the NBU purchases is for Ukraine to receive. You're saying we should have purchased more. The NBU could have created a hryvnia shortage, had it purchased more than the market allowed. This would have broken the exchange rates trend, triggering hryvnia depreciation. That is not our goal. The NBU's goal is to prevent high volatility of exchange rates, since it adversely affects price stability, and to replenish gold and foreign exchange reserves, which is what the NBU is doing.

Have you had any thoughts about the state budget receiving less because of that? You published a forecast. The government used it as it planned the budget, and now it is short of budget revenues.

That is a complex matter. Let's look at the structure of Ukraine's public debt. It includes external obligations amounting to an equivalent of USD 40 billion. When it strengthens the domestic currency by UAH 1, the NBU decreases Ukraine's obligations by UAH 40 billion. This is true for debt-servicing interest payments as well. We should also consider imports. All businesses import something for production purposes. As a minimum, Ukraine imports fuel at present. Its cost decreases as our domestic currency becomes cheaper. We have to look at the matter holistically, without focusing on the income lost due to exchange rate differences. This year, the NBU has transferred to the state budget UAH 17 billion more than the revenue that the government projected the state budget would receive from the NBU's proceeds. That is another balancing factor. This means that we can't judge by one aspect only and make a conclusion that we suffer a loss.

The matter requires a holistic perspective. A strengthening of domestic currency is a sign of stability, which has been mentioned today as well.