

NBU's Smolii speaks out about political interference

Central Banking met with Yakiv Smolii on March 13 in London, prior to the governor accepting the 2019 Central Banking Transparency Award on behalf of the National Bank of Ukraine

Politically powerful people in Ukraine are still trying to block economic reform, but transparency is helping, says National Bank of Ukraine governor



You were named acting governor in May 2017, but Ukraine's parliament, the Rada, only appointed you to the permanent role in March 2018. Why was there a delay?

Some bureaucratic procedures related to Ukrainian legislation needed to be met before the previous governor could step down and the next governor could be appointed. These procedures not only need to be followed by the parliament, but also by the president when submitting the candidates. So, the necessary steps took some time.

Was this a source of any frustration? Are there any plans to change the system?

Having an acting governor for a sustained period of time was not particularly good for the institution, rather than being a particular issue for any particular person. During my service as acting governor, the media published many rumours about possible candidates for the office. They were widely discussed, but it did not affect the operations of the central bank. When I was asked, I said I had no desire to hold the governor position. But, having served for a year as the acting governor, I felt confident I could take on the role of governor.

“Reforms may never be exhausted”

The National Bank of Ukraine (NBU) has carried out major reforms of the country's financial sector over the last five years. Can you now say that there are no more major changes to make? Or are there some important tasks left to complete?

Financial sector reforms may never be exhausted. New challenges arise daily, and the regulator has to deal with them prudently. Last year, we presented a strategy that sets out seven goals for the NBU over the coming years. This includes not just daily tasks, such as ensuring price stability, but also kick-starting lending after the financial sector reforms, as well as pursuing a financial inclusion mandate. Some of our efforts are related to regulatory oversight of non-banking financial institutions by the central bank.

One of the strategy's top goals is the free flow of capital and more broadly the liberalisation of capital in Ukraine. This is being done now. The Law on Currency and Currency Operations, passed by Ukraine's parliament, allowed the NBU to develop a new currency regulation system and introduce around 30 easing measures in February. Consumer protection is also another important area of focus.



L to R: Yakiv Smolii and Central Banking's Dan Hardie

There have been some very high-profile cases of politically influential people in Ukraine putting pressure on lawmakers to resist financial or economic reform. Does the NBU still face these pressures?

When we started our banking sector reforms in 2014, we faced opposition – both directly and indirectly, through the media – from many, politically well-connected bank shareholders. They tried to put pressure on us. We dealt with this pressure through our communications strategy. We became more transparent and better at putting our case in the open and arguing back. This was how we defended ourselves.

Once you become open, it is very hard to close yourself off again, so we are taking more and more steps towards broader transparency. For example, we publish the results of stress tests and publish details of sanctions that we have imposed. We are being proactive and being open while implementing our policies.

Are people still trying to stop you from reforming the financial sector?

Frankly, yes. At the moment, our reform agenda is slowed down by the need for Ukraine's parliament to vote through legislation. That legislation is being geared down by any political means by interested parties who want to stop reforms because it would have a direct bearing on their interests. On the other hand, we received support from parliament for the introduction of some other reforms. In 2018, for example, parliament voted for the implementation of five laws we had recommended. These laws made it easier to protect creditors' rights, enhanced lenders' risk assessment, improved corporate governance for state-owned banks and helped the overall functioning of the financial sector.

At the moment, we have two draft laws dating back to 2015, when they were submitted to parliament, which have still not been passed. One is the law that would wind up the National Commission for State Regulation of Financial Services Markets, and split its functions between the NBU and the National Securities and Stock Market Commission. The other law would give the central bank a mandate to establish effective consumer protection for financial services. We think these two laws are very important to ensure the proper functioning of the financial sector. But we've had them sitting there since 2015, and they have not received the second vote in parliament that they need to become law. These are top priorities for the NBU. They have been stuck for almost four years.

There are other draft laws in parliament that are moving a little and do not face such big slowdowns. There are also laws that have not yet been submitted to parliament – for example, on establishing infrastructure for the secondary trade of assets, which we believe will be the basis for further non-performing loan legislation. We view these bills as moving quite slowly, but still normally, unlike the two important laws I mentioned earlier, which are stuck.

IMF co-operation is “cornerstone” of Ukrainian economy

International Monetary Fund managing director Christine Lagarde has intervened several times in recent years to support reforms of Ukraine's economy. How important is the IMF's support to the NBU?

We have said numerous times that co-operation with the IMF is the cornerstone for the Ukrainian economy in the coming years. These years will see the repayment of large amounts of IMF debt by Ukraine, and this will be very important. The IMF support is also very important to us during this year of

double elections. [Presidential elections started in March and will conclude in April this year, and parliamentary elections must be held before the end of the year.]

The IMF is also very important in encouraging outside investors to 'open their purses' to Ukraine. Its support sends a very strong signal both to international investors and to other outside organisations, such as the European Union. The NBU has both internal and external stakeholders. The IMF is a very important external stakeholder for us.



L to R: Central Banking's Christopher Jeffery with Yakiv Smolii

In March 2018, you said you were very disappointed by the failure of lawmakers to improve governance at state-owned banks. Has that changed at all?

Indeed, I said that. But in July 2018, parliament adopted the necessary amendments that enabled better governance at the state-owned banks. This enables the creation of central bank-appointed supervisory boards for the state-owned banks. At the moment, the creation of these supervisory boards is ongoing, although some authorities have already appointed their board members as well as representatives for the committee that should appoint independent board members. This is also part of our agreement with the IMF. We are optimistic that this will improve the governance of state-owned banks.

What does the NBU intend to make the priority in its next set of stress tests for banks?

Similar to the 2018 stress tests, this year's stress tests will take a risk-based approach. We test two scenarios – baseline and adverse scenarios. The adverse scenario contains the factors we believe could trigger the largest risks, with assumptions based on data from past crises and consistent in terms of macroeconomic linkages. It is designed to primarily trigger credit risk, as well as interest rate and foreign exchange (forex) risks. However, the results of stress tests conducted according to the adverse scenario should not be understood as our forecast for the banking sector. It is a simulation of possible outcomes of a crisis.

Our assessment of risk will be communicated to banks in a clear and timely manner, and our regulations will not come as a surprise to them

This year, we will also pay close attention to the risks related to the rapid growth of consumer lending. For the past two years, it has increased significantly. As of today, risks involved are minor, but if banks underestimate credit risks and relax lending standards going forward, it will make the financial system more vulnerable to shocks. That's why this year we will also focus on the consumer loans portfolio in our stress tests. If we realise that risks have started to build up, we may, for example, issue a regulation requiring banks to increase prudential provisions or hold more capital to cushion against consumer loan defaults. Our assessment of risk will be communicated to banks in a clear and timely manner, and our regulations will not come as a surprise to them.

Inflation in Ukraine diverged from the NBU's new targets for much of the last two years. Are you confident it will meet the NBU's target before the end of this year?

It's true that inflation exceeded both our expectations and our target in 2018. But it was still in single digits for the first time in years. We have increased policy rates up to 18% and we see the results. We managed to break the trend of inflation from more than 40% in 2015 to single figures, and that's a good result. The strict monetary policy proved its effectiveness.

We see positive trends in inflation. For example, at the end of December 2018, inflation was 9.8%. At the end of February this year, it was down to 8.8%, which is close to our expectations. According to our inflation forecast, at the end of this year, inflation will be around 6%, which still exceeds our target, but it is declining. We expect to get inflation within the target range by the first quarter of 2020.

Why did inflation exceed the NBU's expectations in 2017 and 2018?

The central bank's monetary policy doesn't have an exhaustive influence on inflation. There are other factors that are out of reach of the central bank's mandate. These include utilities tariffs, the situation in external markets, tensions over possible disputes – for example, with China – that have an influence on our trade. These are factors we cannot control.

Forex reform needs “complete transparency”

The NBU is undertaking an ambitious liberalisation of Ukraine's currency regime. What are the next steps? Did you encounter any unforeseen problems?

When this law became effective on February 7 this year, around 30 restrictions in total were either eased or removed. But some of the restrictions we had to introduce in 2014 and 2015 during the crisis still remain. Our priorities are lowering and then cancelling the limit on repatriation of dividends as well as abolishing requirements for the mandatory sale of foreign-denominated proceeds of companies. There is now only the mandatory conversion of 30% of foreign-denominated proceeds, whereas at the beginning of the year, it was 50%. I should stress, however, that complete forex liberalisation will not be possible without full-scale transparency on fiscal matters. We need to have complete transparency about the assets of Ukrainian citizens and know the beneficiaries of capital flows outside Ukraine. One of the necessary steps in this direction is the adoption of the draft law on the prevention of unproductive capital outflows from Ukraine (an effort to combat base erosion and profit shifting)).



Do you think you will get that transparency?

It will take some time: we have to adopt some business legislation and conclude some bilateral agreements. But we are moving in the right direction. The NBU pursues the ultimate goal of removing all current restrictions and making possible a transition to free movement of capital – a regime that will lay the groundwork for easing the conduct of business, improving the investment climate in Ukraine, attracting foreign capital and ensuring sustainable economic growth.

Ukraine's conflict with Russian-backed separatists in the country's eastern regions has, in the past, resulted in the NBU using monetary means to help finance increased defence spending. Does the conflict continue to place any strains on the NBU?

The occupation of Crimea and the Russian aggression in the east of Ukraine [in 2014] caused a large drop in GDP and strongly influenced the Ukrainian economy at that time. However, it hasn't had a significant impact on the policy of the central bank. Ukrainian business managed to adapt to the situation and to focus on export markets other than Russia, so export proceeds are now rising. We now have enough of them to be comfortable in our new forex regime, which we introduced in 2015. This is highlighted by the 2018 statistics. GDP growth was the highest for seven years, at 3.3%, forex reserves rose to \$20.8 billion, and inflation was at its lowest for five years.

You don't anticipate carrying out any monetary financing if the fighting increases?

The central bank is an independent institution, and the monetary and fiscal policy of the state are independent of each other. According to the law on the NBU, we must not finance state spending directly or indirectly. During the past two years, we have managed to decrease the proportion of state loans in our portfolio. We foresee no possibility of the NBU financing government spending.



How easy is it for the NBU to find the staff it needs, and to retain them?

The central bank is a competitive institution in the Ukrainian labour market, and not just due to salaries. We offer our employees educational opportunities and the opportunity to represent the central bank at events in Ukraine and abroad. We have also introduced cutting-edge practices into our HR management – for example, in the way we assess the remuneration of each position. For top management positions – those sitting on the board and one level below that – we hold open competitions. Each time we do this, many candidates apply, which is a sign that we are attractive in the market.

“Interference is unacceptable”

Ukraine's parliament has passed several laws since 2014 to increase the NBU's independence. Are you independent or do people pressure you to do certain things?

It is not only a matter of what's in the law, but also the practice – what actually happens. Maybe there were some attempts to influence us in the past, but over the last three years, we have made it clear that such interference is unacceptable. It's been a journey. But I can say that now we are independent. There have been some messages for us in the media over the last few months, but we treat them as signs of the coming elections. In these circumstances, we act as usual, as an independent central bank. We have all the legislation to guarantee independence, and we stick to that.

When you were asked to become deputy governor, how did you react? It was a very difficult time in Ukraine.

I received an offer to join the central bank team after the 'Revolution of Dignity' in 2014. [This was the year pro-Russian president Viktor Yanukovich was forced out of office after street protests.] For me, it was a patriotic call, which I couldn't reject. I was willing to work in any position offered to me, and I was asked to work as deputy governor. I felt I had to do it.

What were the most valuable things about central banking that you learned when you were NBU deputy governor? What have you learned since you became governor?

The first thing is how to show leadership in a team of professionals. It is very important for a leader to send signals in an atmosphere of uncertainty, which was there in 2014. The second most important thing is the constant need for self-improvement. We all need to do that, but your need for it is doubled or tripled if you are the governor of the central bank. I managed to learn it through my contact with other central bankers – seeing what they did and how they behaved.

Yakiv Smolii became governor of the National Bank of Ukraine in March 2018. Prior to this, he was acting governor, after the resignation of his predecessor, Valeria Gontareva, in May 2017. Smolii, who holds a degree in mathematics from the Ivan Franko National University of Lviv, spent his early career as a software engineer before becoming head of the IT division and deputy head of the NBU's Ternopil regional office between 1991 and 1994. He then pursued a commercial banking and business career before he rejoined the NBU in the aftermath of the country's revolution against then-president Viktor Yanukovich, becoming deputy governor in April 2015 and first deputy governor in October 2016.