

Approved by
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№13, July 4, 2008,
№17, September 15, 2008,
№18, October 7, 2008 and
№ 21, October 27, 2008)

The Main Principles of the Monetary Policy for 2008

The Monetary Policy Fundamentals have been worked out on the basis of analysis of the socio-economic development results of 2006, current situation and forecasting of the economy and monetary sphere development for the next year and in the medium run. They substantiate the actions aimed at securement of monetary unit stability, accomplishment of currency circulation regulation and economy crediting by means of use of the monetary policy instruments and determine a set of variable indicators that can ensure execution of the purposes.

In **2006** there were observed economy development acceleration and output growth supported by a considerable increase in the internal demand and enhancement of investment activities. The Consumer Price Index made 111.6 per cent which had been caused by the rise in the natural gas prices resulting in a price increase for most services. To maintenance of the financial stability very conducive was the National Bank of Ukraine exchange rate policy that prevented sizeable fluctuations of the exchange rate vis-à-vis the US dollar – the basic exchange-rate-determining currency. Changes in demand and supply in the foreign exchange segment of the market (in consequence of changes in the balance of payments) made for a certain deceleration in dynamics of the monetary aggregates. The base money grew by 17.5 per cent, money supply – by 34.5 per cent, which was in line with the economy needs in payment facilities. Accelerated growth of the deposits in foreign currency resulted in dollarization level increase by 14.3 per cent.

In the **current year** the economy of Ukraine continues developing at a quick pace: the GDP in ten months increased, in comparison with the respective period of the last year, by 7.3 per cent. The economic growth was, mainly, owing to the growth of demand for the consumer items and capital goods as well as thanks to the high demand for ferrous metals in the global markets. The previous year trend towards strengthening of the internal factors of economic growth has been persisting, in particular

those of the consumptive use and accumulation of the fixed assets within the GDP structure together with the adverse impact of an external factor through the red ink in the balance of trade. In January-September of the current year growth of the nominal income of households came to 25 per cent. The growth rate of the real wages amounted to 12.2 per cent, while that of the real available earnings of households – to 11.7 per cent.

Brisk dynamics of the manufacturing industry development are a special feature of the current year. In January-October of the current year the gross value added in this branch of industry increased by 13.1 per cent, which was considerably more than the 2006 indicator. The output of metallurgy and complete fabricated metal products grew at a great pace (in the ten months it increased by 9.9 per cent), in the machine building the output augmented by 27.4 per cent, the output of foodstuffs, drinks and tobacco goods – by 12.1 per cent while that of the other minerals – by 18.6 per cent. Accumulation of the gross value added in the trade (by 17.2 per cent) and construction (by 11 per cent) also considerably influenced the GDP dynamics. Due to the current year crop failure, in the agriculture a reduction of the gross value added has taken place (by 5.3 per cent).

Situation in the labour market became better – number of the formally registered unemployed, from the late October of 2006 to the late October of the current year, reduced by 15.2 per cent or from 653.3 thousand to 553.7 thousand persons; in such a way the registered rate of unemployment, calculated with respect to the able-bodied population of the working age, decreased from 2.3 to 2 per cent.

January-September results showed a red ink foreign trade balance amounting to USD 3.71 billion, which was 2.6 times of that of the previous year. During the period exports of goods and services grew by 25.7 per cent to USD 41.98 billion, thanks mainly to the recovery of favourable conditions in the markets of ferrous materials and commodities made thereof. Imports of goods and services increased by 31.2 per cent to USD 45.92 billion. Underlying conditions of the increase had been the natural gas price rise, raising of imports of machine-building products, including those for investment purposes and of motor-cars, and growth of imports of financial services as well. At the same time, intensive inflow of raised capital and direct foreign investments considerably exceeded the red-ink balance of the current account. In particular, in 9 months of this year the net inflow of direct foreign investments came to USD 6.8 billion, which is 1.6 times of the 2006 January-September. A material part of these foreign investors' funds was

directed to the financial enterprises (32.2 per cent of the total funds invested).

Results of 2007 January-October showed that the state budget revenues totaled 127.4 billion hryvnias, which was 23.4 per cent higher than in the respective period of the previous year. The ratio of budget revenues to the GDP made 22.7 per cent, which is 3.1 percentage points lower than the respective value of the last year. The state budget expenditures in the period above amounted to 131.6 billion hryvnias.

In January-September the direct and guaranteed public debt grew by 2.1 per cent to 82.2 billion hryvnias, and its ratio to GDP came to 12.1 per cent vis-à-vis 15 per cent at the year beginning. From June the Government started actively internal and external borrowings. In June-October the State Budget of Ukraine received 2.8 billion hryvnias from placement of the internal state debt and USD 500 million – from that of the external one. In addition, guaranteed was the loan to the State Service of Motor Roads of Ukraine amounting to USD 465 million.

Development of the stock market of the country persisted: since the year beginning observed has been hasty growth of the PFTS index – as at October 31 it was equal to 1177 points having increased by 135.9 per cent versus the year beginning. At the same time, the total volume of trade in the securities issued by enterprises and authorities on the PFTS trade floor decreased in ten months of the current by 9.5 per cent in comparison with the respective period of 2006.

As regards the currency **issue** structure, this year the foreign exchange channel has recovered its domination: through it in January-October 37 billion hryvnias were issued into circulation while through the crediting channel – only 149 million hryvnias. The issue via the foreign exchange market is a usual phenomenon for Ukraine; however, such intensive filling of the economy with money under conditions of a considerable deficit of the trade balance has taken place for the first time. During the ten months the base money increased by 34 per cent, while the money supply – by 35.9 per cent. At the same time, favourable changes occurred in dynamics of deposits: the rates of growth of the hryvnia deposits of natural persons (47.7 per cent) materially exceeded those of the foreign exchange deposits (23.5 per cent). The process has had implications in lowering of the economy dollarization level that diminished from 26.97 per cent at the year beginning to 24.71 per cent as of November 1. In the money market the situation was reversal: the growth rate of the loans granted by commercial banks to natural persons in hryvnias (58 per cent)

was very much inferior to that of the foreign currency loans (84 per cent). The growth of foreign exchange loans was supported to a great extent by banks' borrowings abroad, which, in turn, generates destabilization risks for the financial market. Dynamics of funds on the accounts of the Government with the National Bank of Ukraine also produced substantial impact on base money formation: during the ten months the balances of the funds grew by 6.4 billion hryvnias up to 25 billion hryvnias. Large spending of the funds accumulated can even more complicate the pricing situation in consumer market. Deceleration of the economy monetization (during January-October the calculated monetization level grew by 7.1 per cent versus 11 per cent in the previous year) is evidence of exhausting potentialities in absorption of surplus money supply without inflation.

In early 2007 considerable deceleration of inflation rate took place (during January-May the average monthly rate was only 0.4 per cent), which was provoked, inter alia, by reaching saturation point by the consumer market. Nevertheless, since June the **inflation rate** has sharply accelerated and the results of the ten months show growth of the consumer market prices by 11.7 per cent (in October inflation was 14.8 per cent against the same period of the last year), which is the highest value for the period in the last seven years. The strongest influence on inflation during January-October was exerted by the rise in prices for foodstuffs by 18.2 per cent (for the last twelve months – by 19.6 per cent) caused, first of all, by the reduction of grain crop and exacerbation of the problems in animal husbandry due to the factor. This grain crop factor strengthened influence of other, not less important, factors the principal whereof were: accelerated growth of population income together with dynamic development of consumer credits; considerable growth of the producer prices (by 18.3 per cent since the year beginning); high inflationary expectations formed, mainly, due to imprudent statements with regard to the unsatisfactory harvest, ungrounded money issue, etc. The factor of political uncertainty should not be undervalued, as well as that of possibility of some market agents to act under such circumstances as profiteers, which, in turn, was conducive to the strengthening of inflationary expectations.

In spite of the trend towards the trade balance deterioration, **in the foreign exchange market** excess of supply over demand was observed. This made it possible to increase the gold and foreign exchange reserves from USD 22.3 billion at the year beginning to USD 31.7 billion as at November 1 and to ensure exchange rate stability. The exchange rate stability influenced favourably on curbing the inflation and simultaneously incited exports through antagonism against strengthening

of the foreign exchange rate which could have taken place owing to the increase of foreign investment inflow. The real effective exchange rate of hryvnia devaluated by 1.2 per cent in nine months of the current year. Artificial and natural persons serve their need in purchase/sale of foreign exchange in the non-cash and cash forex markets.

Nonetheless the economy dollarization remains at a high level, which reflects accelerated growth of crediting in foreign currency with simultaneous aggravation of the respective risks of further external debt growth which became more acute as early as the previous year. With taking this into consideration, the process of forex market liberalization, taking place during the recent years and having a further incentive under the circumstances of would-be Ukraine's entry into the WTO, should take into account the growth of the risks above and ensure mitigation of them.

The macroeconomic situation in 2008 is to be formed under the conditions determined by development dynamics of the economy and inflation of the current year. It is expected that thanks to the recovery of investment activities and end-product demand it will be possible to retain the rate of GDP growth at a level of 6.8 per cent. Expected acceleration in inflow of the direct and portfolio foreign investments is likely to produce considerable impact on dynamics of these indicators, although processes of raising capital in the international markets may become liable to deceleration. It is foreseen that thanks to the foreign investments and external borrowings a surplus balance of the financial account will compensate the red ink of the current account whose volume and structure may suffer certain changes due to the expected rise in fuel prices and deceleration of the world economy development and with taking into consideration the need in adaptation of the external economic relations of Ukraine to the rules of WTO, the entry to which is expected. Gradual growth of population income thanks to advancement of the social insurance level is expected to incite further development of the domestic market. According to the draft State Budget for 2008 financing the programs of social welfare and active development of the infrastructure is to become the top priority in the fiscal policy. Such factors as inflation acceleration in the current year, further fuel price advance, worsening of conditions in the international markets of the principal goods of the Ukrainian export may have an adverse impact on the economy development.

The National Bank of Ukraine will implement the monetary policy based on the **medium-term strategy** whose essentials consist in:

- orientation towards gradual transition to a monetary system based upon the price stability, establishment of several macroeconomic, financial and institutional conditions, including macroeconomic and financial equilibration, gradual transition to the arrangements of free float in the exchange rate, sufficient development of the securities market, transmission mechanisms, communication of the central bank with economic entities and population;
- perception of the necessity of a certain transition period to making use of the inflation target as the main goal of monetary policy; during the period the National Bank of Ukraine must aim all its efforts at maintaining both the external stability of the national currency by means of the exchange rate regulation and the internal stability of prices. The monetary policy priority is to move gradually towards achievement of the price stability while the exchange rate policy that is to become more flexible should be subject to this goal;
- maintenance of the consumer price growth in the medium-term run as a one-digit indicator with its gradual reduction;
- improvement of the foreign exchange regulation system in the tideway of gradual liberalization with taking into account specific macroeconomic and financial conditions. In order to mitigate shocks and seasonal fluctuations in the inter-bank forex market there will be carried out interventions and conditions for development of the instruments for hedging the exchange risk will be established;
- aiming the exchange rate policy at securement of the predicted exchange rate dynamics depending on the balance of payments position and prevention of considerable fluctuations of the rate, use of the foreign exchange reserves to ensure monetary policy flexibility and enhance its efficiency in maintenance of national monetary unit stability;
- strengthening of the interest rate policy within the framework for monetary regulation of the economic processes by means of improvement in regulation of the short-term market interest rates (via improvement of approaches to determination of the National Bank of Ukraine range of the rates on transactions with assets and liabilities) as well as making arrangements to reinforce the link between short- and long-term interest rates and prices for financial assets;
- rendering assistance to the Government with regard to further development and institutional improvement of the stock market and system of non-banking financial institutions, which is expected to make it possible to trigger, at a due level, featuring advanced

economies mechanisms of capital redistribution among different market segments and, in such a way, to ensure a more material response of the real economy sector to the monetary decisions;

- improvement of the procedures of decision-making in the monetary policy and system of public relations;

When taking the monetary policy decisions the National Bank will rely, on the one hand, on analysis of the rate of growth of the money supply with all its aggregates. Taking into account a rather weak connection of dynamics of the monetary aggregates with inflation, a rather wide range of money supply growth should be determined, which must arise from the nature of macroeconomic and monetary relationships. For analysis purposes used will be as well the dynamics indicators of base money and other monetary aggregates. Besides, the money supply growth should not have the status of a monetary policy goal and a deviation will not require an automatic policy adjustment but will be rather a reason for a deeper analysis.

On the other hand, carried out will be analysis of a wide spectrum of macroeconomic and financial indicators with regard to their influence on the price dynamics. In the course of such work revealed will be the factors having the most important impact on the price dynamics and the appropriate decisions will be taken, and the population will be informed of their essence. As before, due attention will be paid to the state of liquidity in the banking sector, dynamics of economy monetization, deposits, money income of households, rate of exchange, the multiplier, etc.

The National Bank intends to continue work on improvements in development and implementation of the monetary policy in order to ensure its adequacy for the new economic realities, to enhance understanding of the central bank actions by economic entities and households, to elevate efficiency of succeeding in its efforts.

In 2008 **the primary objective** of monetary policy is to be maintenance of the national monetary unit stability as an important precondition of the financial and macroeconomic equilibrium and sound socio-economic development of the country. Attaining this end will be based on adequate use of prescriptive, organizational and instrumental capabilities of the National Bank with taking into consideration the national strategic tasks and probability of destabilizing effects.

Available system of institutions and monetary policy levers enables to regulate adequately the supply and demand in the money market providing monetary basics for the economic growth and neutralizing eventual shocks. At the same time, it is taken into account that in 2008 the trend towards complication of the external and internal environment for monetary policy implementation will continue. The unstable situation in the world financial markets seems to persist, which is dangerous under conditions of excessive dependence on external conjuncture, high level of dollarization, strengthening of the foreign capital presence, growth of the gross external debt and necessity of gradual liberalization of the exchange rate regime. The changes in the balance of payments indicators which have been occurring lately affecting the supply and demand in the foreign exchange segment of the market may result in certain transformations within the structure of emission channels for securement of the due level of money supply with strengthening in importance of the credit and stock channels.

Monetization level lift may aggravate the problem of insufficient development of the non-banking segments in the financial market of the country. Crediting expansion of the banking system, including that of the consumption nature, should be accompanied with appropriate growth of capital and improvement of banking management. Presence of the foreign banking capital may be conducive to direct foreign investments in other economy branches. More severe competition and forecasted reduction of inflation and inflationary expectations is likely to provoke gradual lowering of the interest rates on loans and deposits. Within the composition of assets the share of the long-term loans and investments in securities is to become greater. However, these processes may be accompanied with a further increase of the share of external borrowings within the structure of liabilities of banks, which is likely to provoke growth of national banking system dependence on the exogenous shocks.

The monetary policy tasks for 2008 have been set with taking into account the economic and social development forecasting. Among them the most important are:

- support to inflation maintenance at a level of 15.9 per cent as well as to the forecasted dynamics of the rate of exchange;
- accumulation of the gold and foreign exchange reserves and maintenance thereof at a level appropriate for securement of equilibrium in the forex market and evening-out fluctuations of the conjuncture;

- promotion of confidence in the national currency, lowering of the economy dollarization level and dollarization regulation by monetary policy means, promotion of gradual levelling of the loan granting conditions between the national and foreign currencies;
- promotion of efficiency in the National Bank of Ukraine interest rate policy, establishment of regulatory and market conditions for efficacious regulation of the interest rates;
- support to provision of the conditions for stock market development in the context of growth of the real sector and banking system needs in reliable stock market instruments;
- support of competitiveness of the national banking system, further concentration of the national banking capital, development of the insurance system of natural persons' deposits and loan history data base;
- monitoring of the foreign capital presence within the banking system of Ukraine, optimization of interaction of the national banking sector with foreign investors, prevention of the monopolistic trends and lowering of the banking capital quality;
- provision of the economic conditions for increase of the share of investment-oriented long-term credits within the structure of bank assets through adequate risk management and improvement of corporate governance level;
- further development of the system for informing the economic entities and households of the situation in the money market and actions of the National Bank with regard to regulation of the market;
- improvement of the system for regulating the flow of resources received by the Ukrainian banks from non-residents.
- further development of the cashless settlements.

As regards the **exchange rate policy**, its main task for 2008 is to consist in promotion of the national monetary unit stability by means of affecting its exchange rate component. Performance of the task is likely to be complicated by the expected considerable changes in the processes of foreign exchange inflow/outflow, which may take place after Ukraine's entry into the WTO, further rise in the fuel prices, existence of the inflationary expectations and other risks. In view of the existent risks regarding the development of affairs in the economy and forex market, under such conditions retention of the exchange rate trends set during the recent years would be the most conducive to accomplishment of the objects, i.e. financial stability and economic growth. When solving the problem of improvements in exchange rate mechanisms, into account taken will be correlations between the exchange rates of basic world

currencies as well as application of the currencies in case of conducting the trade and other international transactions.

The real effective exchange rate of hryvnia will remain an important indicator of the forex segment state in the money market. In order to accomplish the exchange policy tasks a good deal of attention will be paid to further accumulation of the gold and foreign exchange reserves, which is to raise the national monetary unit supportability and confidence in the National Bank of Ukraine actions. Development of the foreign exchange regulation toolkit and methods is to be elaborated with taking into consideration the need of adaptation of them to the standards and rules existing in the international markets, on the one hand, and the necessity to lower the economy dollarization level and ensure reliable control over the risks for the banking system and economy, which are likely to be carried by the growing activity of the capital inflow/outflow processes, on the other hand.

In the context of the above mentioned financial and macroeconomic trends that can influence the monetary system in 2008, the following forecasted monetary area indicators have been envisaged: consumer price index (December to December of the previous year) – 115.9 per cent, rate of money supply growth – 135-140 per cent. The National Bank of Ukraine intends to adequately respond to changes in the macroeconomic and financial environment adjusting the forecasted indicators if necessary.