NATIONAL
BANK
OF UKRAINE

MONETARY POLICY FUNDAMENTALS

FOR 2015

Monetary Policy Fundamentals are developed by the NBU Council in pursuance with Article 100 of the Constitution of Ukraine and Articles 8, 9 and 24 of the Law of Ukraine *On the National Bank of Ukraine*. Pursuant to Article 100 of the Constitution of Ukraine, the NBU implementation of the Monetary Policy Fundamentals shall be controlled by the NBU Council.

According to Article 99 of the Constitution of Ukraine, **the main function of the National Bank of Ukraine** is to ensure stability of the monetary unit of Ukraine.

Monetary Policy Fundamentals for 2015 contain its main objective and performance indicators of the National Bank of Ukraine in the medium term, provide assessment of the monetary policy implementation in 2014 - early 2015, define key strategic principles of the NBU monetary policy, main objectives and indicators for 2015, as well as outline macroeconomic conditions, risks and trends in monetary and fiscal areas, which may influence the monetary policy.

Monetary Policy Fundamentals are published on the official website of the National Bank of Ukraine and in other official publications.

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Introduction

The main aim of the monetary policy is to ensure stability of the monetary unit of Ukraine. In this respect, the NBU shall proceed from the priority of achievement and retention of the price stability in the country. It implies maintaining the domestic currency purchasing capacity through keeping low and stable inflation rates in a middle-term run (from 3 to 5 years), ensuring price predictability in long-term planning and managerial decision-making on economic and social development. The monetary policy objective in the medium term is to reduce inflation to 5% per year with an acceptable deviation of ± 1 percentage point.

The current governmental forecast for 2015 (Resolution of the Cabinet of Ministers of Ukraine No. 404 of 27 August 2014 in the wording of Resolution No. 76 of 14 February 2015) includes three development scenarios, according to which the Consumer Price Index growth (as calculated for December to December of the previous year) may amount to 26.7%, 38.1% and 42.8% respectively. Obviously, none of the above mentioned values may serve as a monetary policy target, since even the lowest of them is inconsistent with the price stability concept.

In this respect, the main target of the monetary policy for 2015 shall be the maximum possible disinflation rate year on year with the aim of breaking inflation's ascending trend as well as creating the basis for achieving the medium-term objective. Operational targets of monetary policy will include quantitative performance criteria and recommended target values in the framework of the cooperation with the IMF for net international reserves, net domestic assets and monetary base.

Other objectives of the National Bank of Ukraine are promotion of the banking system stability and support of economic growth providing that it does not impede ensuring the price stability.

Aggravation of the socio-political situation last year, military aggression, Crimea annexation and military actions in the east of the country made it impossible to conduct controlled economic activities in parts of the country's territory. Decreasing domestic demand and unfavorable external economic conditions led to a decline in real GDP, by 6.8% in the end of 2014. The deficit of the balance of payments current account accumulated over the past years, outflow of capital from the country and of deposits from the banking system increased devaluation pressure on the domestic currency. In view of the limited international reserves, the National Bank of Ukraine had to abandon its practice of keeping the exchange rate within strict limits. However, due to an underestimation of systemic risks and insufficiently prudent monetary policy, this led to deep foreign exchange and banking crises.

In addition to the material objective destabilizing factors of non-monetary nature, the Council of the National Bank of Ukraine acknowledged that deterioration in the monetary situation was also caused by insufficient consistency or efficiency of the actions of the National Bank of Ukraine. Monetary Policy Fundamentals for 2014 were not implemented, the exercise of the monetary policy failed to meet the aim of ensuring the stability of the national currency and the priority of preserving price stability. Thus, the primary task is to correct mistakes in the areas of monetary, foreign exchange and banking regulation.

The key feature of this year determining the monetary policy tactics is that the **economy acquired stagflation macroeconomic dynamics**, i.e. the process of reduction in GDP production is combined with a significant increase in prices. This calls for measures to reduce inflation, on the one hand, and to support economic growth, on the other hand. To overcome the crisis and to ensure the price stability, the National Bank of Ukraine has to pursue strategically and tactically prudent monetary policy (which is the basis of sustainable exchange rate dynamics and inflation reduction) along with the gradual transition to inflation targeting.

Section 1. Monetary policy implementation in 2014 - early 2015 in light of foreign exchange and banking crises

In **2014**, the key factor in the formation of money market conditions was hryvnia devaluation. Abandoning the practice of keeping the exchange rate within fixed limits that had been the anchor of price stability and implied a dominant role of foreign exchange issue channel was not supported by systemic actions of the National Bank of Ukraine towards transition to another stability anchor by optimizing the use of other channels and instruments to regulate liquidity nor by the well-considered monetary policy measures. This ruined the monetary basis for the provision of stable exchange rate dynamics and safe inflation rates. The absence of clear transparent and systemic actions in the field of monetary policy undermined the confidence in the National Bank of Ukraine. Its actions in terms of administrative measures and foreign exchange interventions proved to be inconsistent and inefficient.

Last year, the hryvnia to dollar interbank exchange rate fell by 93.5% - to UAH 15.77 per US dollar. The volume of international reserves shrunk from USD 20.4 billion to USD 7.5 billion or by 63.1%. The level of headline inflation was 24.9%, having significantly exceeded the benchmark established in the Monetary Policy Fundamentals (19%). During the year, the rate of core inflation accelerated from 0.1% to 22.8%, the producer prices grew by 31.8%, which in aggregate reflects the impact of currency devaluation. Thus, in 2014, the economy entered a phase of stagflation, when production and employment decline occurs together with the prices increase.

The exceptional hryvnia depreciation against macroeconomic destabilization as well as the inefficient implementation of the communication and monetary policy, the lack of systematic measures of the National Bank of Ukraine to ensure financial stability resulted in the growing devaluation expectations and reduced confidence in the banking system, having led to a significant decline in deposits. Investments in the domestic currency decreased by UAH 56.5 billion (by 13.4%), in the foreign currency - by USD 11.4 billion (by 36.9%).

During the year, 33 banks were declared insolvent, many of which were deemed to be liquidated. A significant increase in allocations to provisions against asset operations, caused by hryvnia devaluation, resulted in a record loss in the banking sector (UAH 53 billion). Loan balances in the domestic currency declined by UAH 53.8 billion (by 9.0%) for the year, in the foreign currency - by USD 8.6 billion (by 22.2%).

Considering that the main drivers of inflation were treated as exogenous in terms of monetary environment, the response of the NBU to the inflation dynamics acceleration was ineffective. Excessive use of administrative measures in foreign exchange regulation led to a reduction in FX funds inflows into the country, to the emergence of shadow currency markets, the multiplicity of exchange rates and thus to a partial loss of control over the pricing.

Higher interest rates were used as the main instrument to prevent inflation acceleration. The discount rate was gradually increased from 6.5% to 14.0%; rates on NBU asset- and liability-side operations underwent significant growth. However, despite rising interest rates on asset operations, in the second half of the year, the real interest rates began to acquire negative values, first in the banking system and then in the National Bank of Ukraine. Interest rates on bank loans and deposits were mostly irresponsive to changing rates of the National Bank of Ukraine; in the second half of the year, the discount rate increase was accompanied by a decrease in loan and deposit rates in the banking system. At the end of the year, the overnight rate in the interbank market significantly exceeded the NBU rate on overnight loans and was more responsive to the foreign exchange rate dynamics in the shadow market. This attests to the inefficiency of the implementation of the interest rate policy in terms of stable exchange rate dynamics and controlled inflation under a flexible rate.

During the year, UAH 222.3 billion was issued into circulation through refinancing procedures; the return of the then existing loans by banks amounted to UAH 189.4 billion. As a result, the banks debt to the National Bank of Ukraine for the refinancing loans increased by UAH 32.8 billion, up to UAH 108.9 billion for the year. In terms of individual refinancing instruments, the largest volume of transactions was carried out as overnight (UAH 95.2 billion).

The NBU investing in government bonds directly correlated with the needs of the public sector deficit financing (in particular, Naftogaz NJSC) and had no significant impact on the banks correspondent accounts. The volume of purchases of hryvnia government bonds by the National Bank of Ukraine for the year (UAH 181.9 billion) amounted to 83% of their issue by the Ministry of Finance of Ukraine (UAH 218.0 billion). As a result, the balance of government bonds in the NBU portfolio increased by UAH 171.1 billion (by 116.3%) and amounted to UAH 318.1 billion (about 70% of the total volume) as of the end of the year, while the portfolio of commercial banks increased by only UAH 12.4 billion (to UAH 93.4 billion).

Based on the results of the year, the amount of mobilization operations with the NBU deposit certificates in order to absorb excess liquidity in the banking system amounted to UAH 1,472.7 billion (almost equal to the annual GDP), which is over five times higher than the turnover of the previous year (UAH 270.4 billion) and 88 times higher than the 2012 volume (UAH 16.7 billion). The annual interest expenses of the National Bank of Ukraine on deposit certificates amounted to UAH 698.3 million (UAH 161.5 million in 2013). The unprecedented volumes of mobilization operations along with a significant refinancing turnover attest to inconsistency in the monetary regulatory actions, the NBU taking over the interbank market functions and artificial distortion of the market mechanism of liquidity redistribution. The fragmentation of the interbank market with the simultaneous existence of the structural surplus as well as the liquidity deficit in the banking system also show a lack of effective actions in the field of banking regulation.

Thus, over the past year, due to the exogenous factors and insufficiently prudent actions of the National Bank of Ukraine in the spheres of monetary, foreign exchange and banking regulation and supervision, the functioning of credit interbank and foreign exchange markets as the major elements of the market infrastructure was largely disturbed. This caused substantial institutional risks and called for urgent measures to restore proper functioning of these markets being necessary parts of the transmission mechanism of the monetary policy as well as to ensure the price and exchange rate stability.

As a result of all these operations, in 2014, the monetary base growth amounted to 8.5%, which is three times less than had been envisaged by the Monetary Policy Fundamentals (to 28%). Such a low rate of the monetary base growth was caused by absorption of hryvnia resources through the FX channel and active use of mobilization operations through the NBU deposit certificates. At the same time significant amounts of funds were issued through channels of refinancing and government bonds purchase, which created devaluation pressure and increased inflationary risks in the medium term.

In early 2015, most recessionary tendencies remained. Production reduction was ongoing, particularly, in January-March compared with the corresponding period last year, the industrial production index decreased by 21.4%.

Due to the large volumes of refinancing by negative real interest rates (the January-March turnover totaled UAH 57.5 billion, including UAH 37.9 billion of overnight transactions) and an insignificant supply of foreign currency in the official foreign exchange market, the hryvnia exchange rate reached the level of UAH 30.01/USD 1 in late February. After discontinuing the practice of daily FX auctions and refusing to use the indicative rate, the official exchange rate approached the shadow market rate.

Under the influence of devaluation, in March, the annual inflation rate accelerated to 45.8%, core inflation - to 44.6%.

For the period of January-March, deposits in the domestic currency fell by UAH 20.7 billion (by 5.7%), in the foreign currency - by USD 2.8 billion (by 14.4%).

In response to accelerating inflation and devaluation dynamics, the National Bank of Ukraine raised the discount rate twice: on 6 February - to 19.5%, and on 4 March - to 30.0%. At the same time, the rates on NBU asset operations increased. In March, there was a significant reduction in the volume of overnight loans. Due to this as well as to a number of administrative measures to restrict access of importers to the foreign exchange market, the exchange rate was slightly strengthened.

From the beginning of 2015, mobilization operations continued to increase. The maximum amount of deposit certificates, for which the banks may address the National Bank of Ukraine, was increased from 70% to 100% of the amount specified in accordance with the established requirements for the amount of mandatory provisions for the previous waiting period. Rising interest of the banks in depositing funds with the National Bank of Ukraine was caused by a sharp increase in the rates on such operations. Based on the results of the first quarter, the total volume of these operations amounted to UAH 663.5 billion, including UAH 577.8 billion of overnight transactions; and their rate has increased from 7.5% to 20% since beginning of the year. The rate on deposit certificates for the term of one month reached 27% in March. Such unprecedented increase in volumes and profitability of liability transactions of the National Bank of Ukraine has widened the spiral of the structural liquidity surplus in the banking system with simultaneous shortage of financial resources in the real economy due to lower lending motivation of the banks. Not only is this costly for the state, but it also results in unproductive issues (i.e. issues that are not used in the real sector), and in a further increase in the structural liquidity surplus due to large interest payments to the banks. In the first quarter of 2015 alone, the interest expenses on NBU deposit certificates exceeded the respective amount in the previous year and totaled UAH 830.6 million. Thus, setting the ultra-high interest rates on NBU deposit certificates violates the effectiveness principle of the interest rate policy, under which the rate on mobilization operations with the permanent access must be the lowest in the money market.

Thus, the said shows that along with the unfavorable macroeconomic factors, there are significant shortcomings of the monetary policy, which hinder the restoration of price stability and need to be overcome as soon as possible.

Section 2. Strategic principles of the monetary policy

Strategic principles of the monetary policy define key approaches of the National Bank of Ukraine to fulfilling its constitutional functions. The strategic aim of the monetary policy is to achieve and to maintain low and stable inflation rates (5% per year with a permitted deviation of ± 1 percentage point) as well as the stable domestic currency dynamics in the medium term, with due account to the need of overcoming stagflation processes in the economy and of a gradual transition to the inflation targeting.

Strategic approaches which need legislative amendments among other things are as follows.

Ensuring institutional and operational independence of the National Bank of Ukraine which requires at this stage:

broadening of powers of the NBU Council to strengthen control over monetary regulation risks;

NBU's independent forecasting of price behavior and defining inflation targets as well as coordinating these processes with the Government;

setting the limits on the amount of government securities in the NBU portfolio to prevent monetization of the state budget deficit through excessive currency issue;

optimizing the organizational structure of the National Bank to strengthen methodological and organizational support of monetary regulation in the context of a gradual transition to the inflation targeting and floating exchange rate.

Increasing confidence of market participants and society at large in the National Bank of Ukraine, which will play an important role in ensuring confidence in the state by keeping out of politics and private business interests; pursue effective policies in the field of monetary, foreign exchange and banking regulations; take into account social restraints and risks in the development and implementation of measures to stabilize the monetary market and the banking system; implement professional communication strategy in cooperation with society; be guided exclusively by constitutional objectives and legal priorities.

Resuming and sustainable maintaining of adequate functioning of key elements of the monetary market infrastructure, in particular of FX and credit interbank markets to promote foreign exchange and banking stability as well as to reduce inflation under a floating exchange rate. This implies the following:

prohibition of actions that may complicate foreign exchange inflows into the country and result in the development of shadow FX markets;

effective use of foreign exchange interventions to smooth peak exchange rate fluctuations;

adoption of a new law on foreign exchange regulation and control in order to harmonize with the EU legislation and to ensure phasing out the capital movement restrictions;

development of tools for foreign exchange risk insurance (in particular, through legislative regulation of the derivatives market);

reduction of dollarization of banks assets and liabilities;

overcoming the fragmentation of the interbank credit market, which hindered the efficient redistribution of liquidity between banks and posed risks to the financial stability.

Improving the effectiveness of the credit issue channel and open market operations as the main means of regulating liquidity in the banking system to ensure monetary and price stability, involving in particular:

optimization of the volumes of refinancing operations and funds mobilization using transparent criteria for effective management of the banking system liquidity;

improving efficiency of interest rate policy, which involves the formation of optimal thresholds of interest rates for controllability of money market rates. The highest overnight market rate will be the NBU rate on overnight loans. This will facilitate the central bank exercise of its functions as the last (rather than the first) instance and will prevent it from using these operations for purposes other than the technical function of smoothing one-day liquidity gaps and implementing banking ratios. The lowest money market rate will be the NBU rate on overnight deposit certificates. It will provide a way out of structural liquidity surplus and unproductive issues; activate the interbank market as an institution for redistribution of liquidity between banks, and will create a monetary basis for the banks to lend to the real sector;

it will provide for the development of tools for and improve the practice of the use of the NBU's open market operations to ensure the leading role of this channel in the management of the banking system liquidity;

it will promote the use of refinancing instruments for structural support for economic recovery and for promoting economic policy of the Government, unless it impedes the objectives of ensuring the price stability.

Section 3. Key monetary policy objectives for 2015

Based on the priority objective of price stability in the medium term and given the peculiarities of the economic climate, the main objective of the monetary policy for 2015 is to reduce inflation to levels that will help restore public confidence in the domestic currency and lower inflation expectations.

Operational targets of the monetary policy will include quantitative performance criteria and recommended target values in the framework of the cooperation with the IMF for the net international reserves, net domestic assets and monetary base. The upper limit of the monetary base growth for 2015 was set at UAH 90.8 billion or 27%. These figures may be adjusted in cases of changes in the conditions of external borrowings, financing the critical energy imports, reconsideration of loan volumes for the Deposit Guarantee Fund, purchase by the National Bank of Ukraine of government bonds issued with the aim of banks recapitalization.

To achieve the main objective, effective measures will be used to stabilize the foreign exchange market, to bring back the whole scope of FX transactions into the legal environment and to ensure stable margins of exchange rate fluctuations by optimizing the monetary policy, banking regulation and supervision, easing FX restrictions and introducing incentives for the return of FX earnings of exporters into the country. In case the devaluation pressure remains, in order to stabilize the FX expectations and to follow the stable exchange rate dynamics, it is possible to use soft modes of rate pegging or the administered exchange rate.

A prerequisite for balancing the money market is to increase confidence in the National Bank of Ukraine and the banking system, as well as to restore the interbank credit market as an effective institution for liquidity redistribution. This will be facilitated by measures of banks recapitalization, cautious actions in the field of banking supervision, moderation in decisions to declare banks insolvent and by ensuring equal access of banks to the NBU resources based on transparent criteria.

The main tasks of the interest rate policy is to create incentives for the restoration of positive deposit dynamics in the banking system, to facilitate balancing of the foreign exchange and interbank credit markets, to lower inflation, and to prevent banks from losing motivation to lend to the real sector due to high returns of the operations on the NBU deposit certificates. Fulfilling these tasks implies the following:

maintaining the positive actual level of rates on the NBU asset operations;

in the context of a flexible exchange rate, the discount rate will become the key tool of market regulation, and the change of its level will serve as a signal of the monetary policy direction;

preventing banks from losing motivation to lend to the real sector due to high returns of the operations on the NBU deposit certificates. Developing and implementing monetary policy measures aimed at directing the structural surplus of bank liquidity to use in the real economy sector;

using the best rate band for daily ongoing operations to effectively influence the situation in the interbank credit market; the lower limit of the band will be the NBU rate on overnight deposit certificates which will be the lowest in the money market, while the top limit will be the NBU overnight rate on refinancing loans. These rates will outline the scope for setting interbank market rates;

when setting rates for monetary operations, the National Bank of Ukraine, serving as a lender of the last (rather than the first) instance, will be guided by the priority of the interbank market development and by minimization of volumes of continued access operations to halt the structural liquidity surplus and unproductive issues;

the efficiency of interest instruments will increase through active use of open market operations in order to create an optimal level of liquidity in the banking system. The limitation of the maximum amount of internal government loan bonds that may be included in the NBU portfolio will improve the efficiency of application of the said instrument.

Given the lack of development of the government securities market, which limits the effectiveness of open market operations, NBU credit-deposit operations will play a significant role in the regulation of bank liquidity. As the main bank crediting tool weekly refinancing tender procedures will be used, for which the cost of funds will be mainly determined based on the level of the discount rate.

The volume of NBU operations on refinancing and attracting funds will be brought to reasonable levels, based on transparent criteria of optimal liquidity management in the banking system and on preventing the use of NBU refinancing for speculative trading in the foreign exchange market.

If necessary, the National Bank of Ukraine may provide additional support to banks by increasing the volumes of standard monetary operations and using additional temporary facilities to support liquidity. These tools, in case of their implementation, will be based exclusively on transparent tender procedures with equal access for all banking institutions.

With the progress in achieving the primary objective of the monetary policy as well as in stabilizing the banking system, certain measures will be used to support the activities of the Government with the aim of restoring the economic growth. Here the main focus will be on developing and implementing the programs for boosting banks lending to the real economy and on fulfilling specific obligations of the Ukrainian Government under the program of cooperation with the IMF.

The National Bank will closely cooperate with the Government in order to align the monetary policy with the budgetary policy. Among other things, they will focus on the impact the issue of government bonds will have on the money market, as well as on matters related to ensuring stability of the financial system and improving its instruments.

Certain measures in the sphere of administered prices will have a significant influence on the price dynamics. The National Bank of Ukraine will, to a limited extent, respond to such price changes on the assumption that structural reforms (including the energy prices increase), while causing price fluctuations in the short term, in the medium term will help to restore price stability through the elimination of disparities and improvement of the efficiency of the respective industries.

Section 4. Macroeconomic conditions and risks that influence the monetary market

When developing the Monetary Policy Fundamentals, in accordance with Article 24 of the Law of Ukraine “On the National Bank of Ukraine”, there were used macroeconomic indicators calculated by the Cabinet of Ministers of Ukraine, as the predicted conditions that will influence the monetary policy. Significant uncertainty of the economic development dynamics in 2015 was also taken into account, which resulted in a wide margin of macro values in the mentioned government projections of the economic and social development of Ukraine for the different scenario assumptions.

Monetary Policy Fundamentals provide that during 2015, the stagflation macroeconomic dynamics (a drop in production alongside with a price rise) will significantly influence decisions in the field of monetary policy.

The decline in production and gross value added, which took place due to lower production capacity of the country as a result of certain violations of the industrial base, infrastructure and economic relations, triggered pressure on prices on the supply side (cost inflation), which will be taken into account in the monetary policy measures . In January-March, the decline in industrial production accelerated to 21.4%. The sectors with enterprises in the conflict area were affected the most: coal mining decreased by 58.5%, production of coke and refined petroleum products - by 51.9%, metallurgical production- by 26.8%, and machinery - by 25.1%.

It is assumed that in 2015, a positive external factor will be the growth in the global economic, up by 3.5%, and in the euro area economy, up by 1.2%. A significant loss of access to Russian markets, on the one hand, and an open window of opportunities of foreign trade in other markets, including in the EU markets, on the other hand, will remain the main factors of influence on volumes of exports. Possibilities of exports growth will depend on effectiveness of the economic policy of the Government to encourage geographical and product diversification of export, including the high-tech segment, as well as on the sound actions of the National Bank of Ukraine in the spheres of foreign exchange, monetary and banking regulations to support this economy sector.

The current decline in domestic consumer and investment demand may lead to a further reduction in imports. As a result, it is expected that the trend towards balancing the trade balance and current account of the balance of payments will remain, which will help to stabilize the foreign exchange market.

With the planned changes in the fiscal sector, the state budget revenues are expected to increase; the focus of expenditures will shift from the social area to the investment one, and a budget deficit (together with financing "Naftogaz” NJSC) is planned to be reduced to 7.4% of GDP.

In the context of low current credit ratings of Ukraine, a high level of risk of government Eurobonds and negotiations on restructuring of the sovereign debt, getting new foreign borrowings from international financial markets could remain problematic until the end of the year. There is a high probability that the absolute amount of external debts of the banking and real sectors of economy will continue to fall this year.

The risks with a negative impact on lending to the economy are expected to persist. An effective program developed and implemented by the National Bank of Ukraine to stimulate banks to lend to the real sector will mitigate this negative impact.

Net repayment of external borrowings by the private sector will be largely balanced by loans to the government sector from international financial organizations and foreign states. The inflow of foreign investment will depend on the speed of economic reforms of the Government to improve the business climate and to optimize monetary and foreign exchange regulation.