

**COUNCIL OF THE NATIONAL BANK OF
UKRAINE**

**MONETARY POLICY GUIDELINES FOR 2019
AND THE MEDIUM TERM**

Approved by the Decision of the Council of the National Bank of
Ukraine dated 11 September 2018

Kyiv, 2018

Introduction

The Monetary Policy Guidelines for 2019 and the Medium Term (hereinafter– the MP Guidelines) were prepared by the Council of the National Bank of Ukraine (hereinafter – the NBU Council) in pursuance of Article 100 of the *Constitution of Ukraine* and Articles 8, 9 and 24 of the Law of Ukraine *On the National Bank of Ukraine*.

The essential characteristics, goals, principles, and instruments of monetary policy of the National Bank of Ukraine (hereinafter – the NBU) and the directions of their development are identified in the NBU Monetary Policy Strategy, which was prepared and approved by the NBU Council (hereinafter – the Strategy).

The Strategy lays the groundwork for the MP Guidelines, which provide a detailed description of the features of the implementation of monetary policy in a specific year and in the medium term, including the macroeconomic context.

The MP Guidelines outline the specifics of the implementation of monetary policy in 2019 and in the two years that follow.

In fulfilling its primary function under Article 99 of the *Constitution of Ukraine* and Article 6 of the Law of Ukraine *On the National Bank of Ukraine* – which is to ensure the stability of the Ukrainian currency unit – the NBU in its monetary policy will continue to prioritize the pursuit and maintenance of price stability in the country. The NBU's second most important monetary policy goal is to promote financial stability, including the stability of the banking system, as long as doing so does not hinder the achievement and maintenance of price stability. The third NBU's goal is to facilitate sustainable economic growth and to support the economic policies of the Cabinet of Ministers of Ukraine – unless these efforts conflict with the top two goals. Article 1 of the Law of Ukraine *On the National Bank of Ukraine* defines price stability as the preservation of the national currency's purchasing power through the maintenance, in the medium term (spanning three to five years), of low and stable rates of inflation, as measured by the Consumer Price Index. To achieve and maintain price stability, the NBU implements the monetary regime of inflation targeting, as price stability is best suited to ensuring sustainable GDP growth and eliminates the prerequisites for unpredictable and subjectively motivated decisions regarding changes in monetary policy.

The Strategy sets a medium-term quantitative inflation target of 5%.

The key policy rate is the main instrument of monetary policy.

The NBU will continue to adhere to a floating exchange rate regime, meaning that its monetary policy will not seek to set a certain exchange rate level or exchange rate band. However, the NBU may conduct FX interventions in order to:

accumulate international reserves

smooth excessive hryvnia exchange rate volatility that is not driven by changes in fundamentals

support the transmission of the key policy rate as the main monetary policy

instrument.

Because ensuring sustainable economic development in Ukraine is impossible without making progress in implementing reforms, the NBU will make every effort, jointly with the government, to continue to reform the economy and the financial system, including through cooperation with the IMF and other international financial institutions.

Under the *Constitution of Ukraine* and the Law of Ukraine *On the National Bank of Ukraine*, the NBU Council oversees the conduct of monetary policy and analyzes its impact on socioeconomic development. At its core, this oversight involves analysis of whether prior monetary policy decisions were in line with attaining the identified targets given existing risks at the time the decisions were taken, evaluation of the quality of underlying assumptions and macroeconomic forecasts – including inflation forecasts. On the basis of this analysis, the NBU Council draws up proposals to alter monetary policy if it deems this necessary.

1. Monetary Policy Implementation in 2019 and the Medium Term

1.1. External Macroeconomic Environment

Throughout 2018, the world economy has grown rapidly, matching its average pre-crisis growth performance. Both developed and emerging markets across major regions are reporting high economic growth rates. In line with this trend, many economies, including the United States – the world’s largest – are registering significantly lower unemployment rates. The accelerating rise in global trade and investment is continuing to underpin the rapid global expansion. Inflation rates in developed countries are gradually increasing from their lows, but are still short of central bank targets.

However, the global economic outlook appears less optimistic in the medium term compared to the current performance, both for the developed economies and for most countries exporting raw material and manufactured goods. For the former, the less upbeat outlook is due to the rapidly rising share of the retirement-age population, and the slow growth of total factor productivity.

Furthermore, inflation in developed economies is expected to accelerate, prompting the appropriate monetary policy normalization – mainly by winding down quantitative easing amid near-zero interest rates. The Federal Reserve is expected both to raise interest rates further, and to gradually reduce its balance sheet. In a similar move, the ECB plans to phase out its quantitative easing program by the end of 2018 and raise interest rates.

These developments would dent investor demand for risky financial assets and hence bring about tighter financial conditions for emerging markets. Amid the US dollar strengthening, pressure on these countries’ financial markets had already intensified in H1 2018, making the countries with a high level of external vulnerability – such as Argentina, Turkey and a number of others – most affected. Overall, however, emerging markets are currently better positioned to withstand financial pressure than they were before either the Asian crisis of the late 1990s or the global financial crisis

of 2007–2008. They now have larger international reserves and lower current account deficits, use more flexible exchange rate regimes, and are equipped with more systemic macroprudential instruments in their policy arsenals. Having adopted a floating exchange rate regime with price stability as a nominal anchor, Ukraine can be counted among these economies. Unfortunately, the slow progress of structural reforms eroded the country's ability to speed up growth after the 2014-2015 crisis. As a result, Ukraine still relies heavily on international investors, including the IMF, for financial assistance to close financial gaps and reduce its external-debt-to-GDP ratio in the coming years.

The global economic expansion will bolster prices on the international commodity markets, potentially boosting Ukrainian exports. Supported by robust international demand, including from the machine-building sector, prices for ferrous metals are expected to remain high, while global grain prices are projected to gradually increase as the growth of global consumption accelerates. Despite steadily growing demand, oil prices will likely fluctuate around the current level as OPEC+ members ramp up production and the United States extracts more shale oil. At the same time, a heavy burden of corporate debt, incurred during the period of low interest rates, poses a serious risk to the emerging markets, and so the onset of tighter financial conditions may put a serious drag on the indebted economies.

On the other hand, the global economy's recent exposure to increasing risks may cause it to diverge from the described above scenario of sustainable growth in the medium term if these risks materialize. These risks include:

rising protectionism in certain countries, causing a corresponding reduction in global trade and the shelving of investment projects

more rapid growth of interest rates in developed economies, including due to the acceleration in inflation, which could trigger, among other things, a - tightening in financial conditions for emerging markets and more significant and unanticipated commodity price volatility

geopolitical conflicts, trade wars, etc.

If they materialize, these risks could affect global demand and set in motion an intensifying correction of financial conditions and commodity prices. Such a correction could be unevenly spaced out over time, generating additional exchange rate fluctuations in emerging markets.

1.2. Domestic Macroeconomic Environment

Ukraine's economic growth is expected to accelerate to 3-4% in real terms over the next three years. The rate of growth will mainly depend on the conditions on the external commodity markets, and the speed of Ukraine's structural reforms. While private consumption will remain the main contributor to economic growth, companies are also expected to step up their investment activities. Investment will continue to be driven largely by the need to upgrade production facilities and to obtain certification

for products in order to gain greater access to the European market, as well as by gradual cuts in interest rates.

A change in labor migration intensity will be another important contributor to Ukraine's economic growth. On the one hand, the increased employment of Ukrainians abroad is pushing up their income and current FX receipts into the country, which is benefitting the current account balance of payments and the exchange rate performance. On the other hand, an expansion in migration will constrain the supply of labor within the country and put pressure on wages, reducing the price competitiveness of domestic companies.

Outflows of highly skilled workers to other countries will diminish labor productivity both in the high-tech industries and in other areas, such as education, healthcare, and services.

The NBU's macroeconomic forecast is based on rather conservative assumptions regarding the pace of structural reforms. However, faster progress in implementing the structural reforms that have been designated as structural benchmarks in the IMF-supported program will significantly boost investment and Ukraine's economic growth potential. Conversely, stalled structural reforms will adversely affect Ukraine's business climate and depress investment in Ukraine.

Meanwhile, the repayment of public debt, which will peak in the coming years, will be a drag on economic growth.

Given stronger consumer demand and buoyant investment activity, and provided that structural reforms speed up, the recovery in economic activity is expected to lead to a current account deficit of around 2-3% of GDP in 2019 – 2020. A widening in the external trade deficit could be offset by a further increase in transfers. In turn, financial account inflows will cover the current account deficit. In particular, the Ukrainian government is expected to actively borrow from official lenders, and on the international capital markets. As a result, international reserves will remain at a level sufficient to cover three months of future imports, and to enable Ukraine to meet its obligations, and for the Ukrainian government and the NBU to perform their current operations.

The forecast expects that inflation will gradually slow from its current high readings to its medium-term target of 5% by the end of 2019. The underlying assumptions of this forecast are continued prudent monetary and fiscal policies, the increased supply of food amid slower growth in import prices.

2. Risks

There are certain risks that could considerably alter the outlined macroeconomic scenario. The most significant ones are:

An escalation of the military conflict in eastern Ukraine. The situation in eastern Ukraine remains the most significant source of uncertainty. Any escalation of the conflict could worsen expectations and have negative social and economic implications.

Shipping problems through the Black Sea and the Sea of Azov. This could

significantly dampen exports of ferrous metals and agricultural products from eastern and southern Ukraine.

Delays in structural reforms. The pace of structural reforms, which are required to maintain macrofinancial stability, remains a major source of uncertainty. In particular, the pace could be slowed by the failure to implement legislation required to launch an anti-corruption court, speed up privatization, create the land market and establish a market mechanism for setting gas prices. Any delays in structural reforms could restrict Ukraine's access to the international capital markets at a time when large repayments of external debt are to be made, in 2019 – 2020. In particular, the 2019 presidential and parliamentary elections could increase this risk.

Labor migration. Labor migration is a major internal risk under the baseline forecast scenario. A further rapid outflow of workforce from Ukraine will continue to exacerbate the existing mismatch in the Ukrainian labor market, which could be accompanied by higher labor costs and rising inflation along with a decline in growth potential.

The global economy cyclical downswing. Considering that growth rates in many countries will remain above trend in 2018–2019, the global economy is likely to overheat and gradually move into recession. Other potential factors of recession include the risk of escalating trade wars, which could significantly depress business activity on the main commodity markets. Multiple trade standoffs could slow global trade, which has the potential to dramatically alter the overall landscape of the global economy. These factors could also increase the risk of a drop in global commodity prices, a shrinking of Ukrainian exports, and a decline in FX proceeds.

Capital outflows from developing countries. One of the potential triggers of these developments could be an overly rapid shift to tighter monetary policy by the countries that shape global monetary policy. As a result, Ukraine and other emerging markets could be hit by capital flight. In this case, the central banks of these countries would have to respond by raising interest rates.

A drop in gas transit volumes through Ukraine. The volume of gas transit through Ukraine remains a major source of uncertainty, as pipelines bypassing the country are being built to deliver gas to Europe and West Asia. In this light, beginning in 2020, Ukraine could see a dramatic decline in the volume of gas transit through its pipelines, which could worsen its current account and weigh on the hryvnia exchange rate.

Negative demographic trends are expected to push up budgetary spending, which will require steps to increase budget revenues and readjust fiscal policy.

3. The Specifics of 2019 Monetary Policy

The NBU is currently at the first stage of implementing inflation targeting. This stage is characterized by disinflation – a gradual decrease in inflation to its optimal target level. At this first stage, the NBU makes significant efforts to achieve the inflation targets set out in these M P Guidelines, and to establish the necessary conditions for the proper functioning of this monetary framework.

Among other things, the NBU will focus on:

boosting support from the public and the Ukrainian government with regard to achieving price stability under the inflation targeting regime

enhancing the role of the inflation target as a nominal anchor of monetary policy

upgrading the monetary policy toolkit further

strengthening analytical support for monetary policy decision-making, particularly in terms of enhancement of modeling tools and conducting research

improving the functioning of financial markets and the post-crisis recovery of the banking system, aimed at strengthening the monetary transmission mechanism

within its mandate, delivering the conditions required to decrease credit risks, and strengthening other incentives for bank lending to the real sector

increasing the transparency of monetary policy and improving communication with the general public in order to effectively manage economic agents' expectations.

The assumed quarterly trajectory for the annual CPI inflation to achieve the relevant quantitative inflation targets is the following:

- March 2019: 5.75% ± 2 pp
- June 2019: 5.5% ± 2 pp
- September 2019: 5.25% ± 2 pp
- Starting December 2019: 5% ± 1 pp

The NBU's monetary policy in 2019 will be shaped by the need to bring inflation down to its target. If core inflation decreases steadily, the NBU will gradually ease its monetary policy by cutting the key policy rate, thus promoting economic growth. However, the higher cost of borrowing on the international capital markets due to interest rate increases by leading central banks could limit the NBU's ability to ease its monetary policy.

If the risks that could strengthen inflationary pressures and worsen expectations of economic agents materialize, the NBU will mainly rely on the key policy rate in order to bring inflation back to its medium-term target, and to improve expectations. The impact of the key policy rate on the financial market and the economy will be secured through carrying out the basic liquidity management operations that have the strongest impact on the money market. These will be conducted at the key policy rate (or at a rate close to the key policy rate in the case of conducting auction-type operations).

The achievement of the set inflation targets will help ensure stable economic growth. Furthermore, the policy of price stability also contributes to the strengthening of market competition, which creates impetus for investment and innovation activities. Price stability is a fundamental precondition for decreasing long-term interest rates, which will help expand lending to the real economy, lower the cost of capital in the economy, and decrease the total expenses of economic agents, thus reducing price pressures.

Accelerating structural reforms and better coordination between monetary and fiscal policies will be important factors in supporting economic growth and bringing inflation back to its target.

The direction of the NBU's liquidity management operations in 2019 (predominant injections or absorption of liquidity) will depend on whether there is a structural liquidity deficit or surplus, helping maintain the impact of the key policy rate on interest rates in the economy. The NBU will maintain liquidity at a level sufficient to ensure the efficient operation of the banking system, and to provide lending support for economic growth. The NBU's foreign currency purchases to accumulate international reserves and transfers of the NBU's profit to the budget will be the main sources of the banking system's liquidity. The influence of these factors will be dampened by the government's redemptions of domestic government bonds held by the NBU.

If the liquidity surplus persists, sterilization operations will be the main liquidity management operations. If demand for cash rises and/or the government buys foreign currency to repay external debt, the banking system may move to a structural deficit. Under these circumstances, the NBU will focus largely on liquidity provision operations.

The NBU will remain committed to avoiding any type of fiscal dominance over monetary policy, and will not provide direct or indirect support to budgetary spending. In this light, the volume of government securities held by the NBU is expected to fall, given their planned gradual redemptions. At the same time, coordinating monetary and fiscal policies, including the issue of more even distribution of fund disbursements from the single treasury account over the year, the government's policy of borrowing and setting administrated prices will enable the NBU to perform its main functions effectively, as set forth in the Law of Ukraine *On the National Bank of Ukraine*.

The NBU will also use interventions as an additional instrument for smoothing out exchange rate fluctuations and balancing the FX market. The NBU will remain committed to the floating exchange rate regime, and will not counteract the fundamental exchange rate trends. As the FX market evolves, the NBU will gradually decrease its presence on the market. However, it will continue to make efforts to prevent, or quickly respond to, any FX market turbulence.

In 2018 – 2019, the central bank will also implement the requirements of the new Law of Ukraine *On Currency and Currency Operations*. The enactment of this law is expected to enable the gradual liberalization of foreign exchange regulations. Meanwhile, the NBU will take all measures and employ all instruments to prevent risks to price and financial stability. That is why delivering sustainable economic growth and improving the welfare of the population requires addressing domestic structural imbalances, and making the domestic economy less vulnerable to external factors.

The NBU will also continue to promote coordination between monetary and fiscal policies.

Under the Law of Ukraine *On the National Bank of Ukraine*, the NBU Council

oversees the conduct of monetary policy, and assesses how the NBU Board implements the MP Guidelines.