National Bank of Ukraine

Summary of the Discussion on the Key Policy Rate at the NBU Monetary Policy Committee

Date of the meeting: **11 April 2018**

Attendees: nine out of ten members of the Monetary Policy Committee (MPC) of the National Bank of Ukraine:

Yakiv Smolii	Governor of the National Bank of Ukraine
Roman Borysenko	Deputy Governor
Kateryna Rozhkova	Deputy Governor
Dmytro Sologub	Deputy Governor
Oleg Churiy	Deputy Governor
Vitalii Vavryshchuk	Director of the Financial Stability Department
Sergiy Nikolaychuk	Director of the Monetary Policy and Economic Analysis Department
Yurii Polovniov	Director of the Statistics and Reporting Department
Serhii Ponomarenko	Director of the Open Market Operations Department

MPC members unanimously agreed that the key policy rate must remain unchanged at the level of 17.0% per annum.

Justifying their position, they emphasized that with the current level of the the key policy rate the monetary policy is tight enough to bring inflation down to the target level over the time horizon planned before. Since the last Board meeting on monetary policy issues, there have been no events that would enhance the underlying inflationary pressure or create new risks to inflation decreasing to the target.

The MPC members pointed out that, on the one hand, the favorable FX market conditions will enable a faster-than-expected decline in core inflation this year.

On the other hand, this effect will be offset by a more rapid growth in food prices amid large export volumes and strong consumer demand. The MPC members also noted that fiscal policy primarily focuses on current consumption this year and thus puts an upward pressure on inflation. As a result, depreciation and inflation expectations are still high.

Therefore, the MPC concluded that the inflationary pressure remained unchanged overall. Consequently, same as in January, the NBU's April macroeconomic forecast envisages inflation to decelerate to 8.9% as of the end of 2018, enter the target range in the middle of 2019, and reach the mid-term target of 5% in 2020.

Since, at the previous meeting in early March, the MPC members agreed that further hikes of the key policy rate would be reasonable only under conditions of new pro-inflationary factors, the April decision to keep the key policy rate unchanged reaffirms the succession in monetary policy making.

In addition, some MPC members pointed out that raising the key policy rate would not be reasonable under given conditions, as monetary policy should not counter-balance price growth that is due to convergence with price levels in trading partner countries. Such monetary policy reaction would lead to unjustified losses in economic growth.

MPC members also discussed the mechanism of monetary policy transmission and its time lags. The previous increases in the key policy rate allowed to reverse the depreciation trend of the hryvnia exchange rate in late January and thus changed the traditional seasonality on the FX market. Sizable foreign currency proceeds from exports and nonresidents who invested into the hryvnia domestic government bonds not only fostered strengthening of the hryvnia, but also allowed the NBU to replenish international reserves by significant amounts. Increasing international reserves enhances the NBU's potential of maintaining the macroeconomic stability (particularly if capital flows reverse) and meeting the mid-term inflation targets.

At the same time, previous increases in the key policy rate led to growth in banking interest rates across most market segments but have had only a partial effect on household deposit interest rates so far. This is caused by sizable inflows of household bank deposits. However, the MPC members expect that these interest rates will continue to increase in the future. In particular, thanks to a large gap between bank deposit interest rates and yields on government securities that are an alternative investment option for private individuals. This gap is likely to narrow. Moreover, competition for retail deposits has already intensified among banks. The MPC members believe that higher deposit interest rates will restrain inflation in the future.

Discussing possible risks to price stability, the MPC members paid special attention to the delay in resuming cooperation with Ukraine's official lenders that narrows the country's opportunities to receive financing required for making public debt repayments, which will peak in 2018-2020. Fulfilling obligations under the program is not as important for receiving the funding as for maintaining investors' trust in Ukraine and ensuring sustainable economic growth.

In addition, the discussed risks included the possibility of fiscal policy easing accompanied with an increase in social standards.

Alongside, the MPC remarked that the stimulating effect that fiscal policy has on consumer demand may be moderate due to the limited possibility to increase revenues and budget deficit funding. As a result, this will automatically stabilize growth in spending. The NBU's commitment to refrain from fiscal dominance will remain a major restriction for fiscal expansion.

In this context, the participants also discussed possible consequences of no progress in receiving financing from the IMF and, as a result, from other official lenders. The MPC members believe that the budget sector will be affected in the first place as there will be fewer opportunities for deficit financing, which will lead to the need to cut the budgetary spending. The influence on the FX market will remain limited for some time thanks to a favorable external environment and international reserves accumulated by the NBU in the previous periods. However, in this case, risks of a deterioration in depreciation and inflation expectations would require the NBU to tighten its monetary policy more than envisaged in the baseline scenario. Besides, negative implications for the economy and the FX market might be much greater if external conditions worsen and official financing is not available.

MPC members scrutinized potential external economic risks, in particular global risks of large-scale trade wars, which could cause dramatic fluctuations in global commodity prices, restrict access to external markets for Ukrainian exporters, and consequently, decrease foreign exchange earnings.

MPC members have agreed that if underlying inflation risks increase further, the NBU may have to raise the key policy rate again in order to bring inflation back to its mid-term target.

Discussing the prospects of the monetary policy, most MPC members reckoned that the key policy rate is unlikely to be decreased this year. Moreover, the NBU might be forced to maintain tight monetary conditions longer than projected earlier, in particular, due to steeper interest rate hikes by the US Fed.

However, one MPC member was more optimistic and believed that a certain decrease in the key policy rate would be possible at the year end.

The Board of the National Bank of Ukraine decided to keep the key policy rate at 17.0% per annum at the meeting on monetary policy issues held on 12 April 2018.

For reference:

The Monetary Policy Committee (MPC) is the NBU's advisory body created for sharing information and opinions on monetary policy formation and implementation in order to deliver price stability. The MPC consists of the NBU Governor, other NBU Board members, and directors of the monetary policy and economic analysis, open market operations, financial stability, and statistics and reporting departments. The MPC meets one day before the NBU Board meeting on monetary policy issues. Decisions on the monetary policy issues are made by the NBU Board.