National Bank of Ukraine

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

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

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

Yakiv Smolii	Governor of the National Bank of Ukraine
Kateryna Rozhkova	First Deputy Governor
Roman Borysenko	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

In the course of the discussion, **the majority of MPC members (eight persons out of nine) spoke in favor of increasing the key policy rate.**

The MPC members backed their opinion by pointing out factors that could slow the pace of disinflation and pose a threat to inflation approaching the target in 2019. The focus was on inflation factors to be neutralized by the NBU's monetary policy tools – namely:

- continued rapid growth in consumer demand, which can make underlying inflationary pressures persist over the forecast horizon. This is reflected by the core inflation measure, which remained high despite a decline and made 9.0% yoy in June. Consumer demand is supported by the growth in real wages and remittances from labor migrants, which outpace the previous NBU forecasts, as well as by greater social payments
- lower investor interest in assets of developing countries, being the result of monetary policy tightening by leading central banks. In particular, there is already an outflow of non-resident funds from the hryvnia domestic government bond market. Notwithstanding that the outflow is insignificant, the fact itself signals of the need to tighten the monetary policy stance. For example, other central banks of developing countries raised their interest rates or paused the rate decrease cycle over the past months
- delayed implementation of the IMF cooperation program, which narrows further the country's opportunities to secure financing from official lenders and the international capital markets that is required for making public debt repayments peaking in 2018–2020. Although there has been a substantial progress in the implementation of the EFF program, the current delay already matters. Had the steps required to receive the official financing been taken earlier, today macrofinancial risks would be much more moderate, which would influence the decision on the level of the key policy rate. However, as of now, the non-receipt of the funds as planned aggravates problems in public finance in the first place

- high inflation expectations that remain above the inflation target for 2019 in spite of the tight monetary conditions. Most analytical organizations base their inflation forecasts on the assumption that the NBU will refrain from hiking the key policy rate. At the same time, they forecast inflation to exceed the target range set for 2019 and the NBU's forecast. As the NBU strives for its inflation targets to be trusted, it is reasonable to lower inflation expectations by means of monetary policy tightening. This will also lay ground for a decline in long-term interest rates, which will benefit Ukraine's economy in the long run.

During the discussion, some MPC members drew attention to the fact that certain market participants and the public could have had incorrectly interpreted the rationale behind the rate hike as inflation in May–June 2018 was somewhat below the forecast published in the April 2018 Inflation Report. However, in its previous communications, the NBU repeated several times that it could resort to this measure in the event of higher risks to inflation decreasing to the medium-term target over the forecast horizon. Therefore, the decision to raise the key policy rate will be consistent with the NBU's previous communications and will once more demonstrate that the central bank's reaction is aimed at medium-term inflation risks, but not the current inflation trend.

At the same time, the MPC members were not unanimous about the scale of the increase in the key policy rate.

Five MPC members concurred in the idea to raise the key policy rate by 100 bp up to 18.0%. They remarked that hiking the rate by 100 bp would be sufficient to eliminate inflationary pressure factors and drive inflation back to the target range in 2019. Moreover, this increase would help build up trust in inflation targets and improve expectations.

Three MPC members stood for increasing the key policy rate by 50 bp to 17.5%. In their opinion, a moderate hike would suffice, as transmission of the previous monetary decisions through the financial system was still in progress. In the coming months, the pass through effect will reach interest rates on bank retail deposit and government securities. The increase of 50 bp will also be sufficient to influence expectations. In addition, as voiced by one of the MPC members, the NBU will have enough time to provide a key policy rate response in September in case inflation risks continue to increase.

One MPC member favored keeping the key policy rate unchanged.

The idea to make no change in the key policy rate was backed with the fact that inflation trend was slopping downwards, while main inflation factors of H2 2018, particularly the rise in administered prices, were beyond the reach of monetary policy tools. Under such conditions, even if the inflation target were not met in 2019, the disinflation trend generated by the tight monetary policy would ensure the proper level of trust in the NBU's actions. That said, a later achievement of the inflation targets would provide a better balance between different monetary policy goals.

To substantiate the position taken, the MPC member also noted that the impact of labor migration, particularly on wage growth, was a long-term structural factor. Therefore, tight monetary policy should not be the only means used to adjust for such effects. On the contrary, given more tight lending conditions, businesses' productivity growth might not catch up with the pace of wage growth. This might affect competitiveness of Ukrainian producers. In addition, remittances from migrants push the hryvnia exchange rate to strengthen, which partially offsets the inflationary impact of active labor migration.

The MPC member also expressed confidence that keeping the key policy rate unchanged would be consistent with the NBU's previous communications: the central bank did not specify the risks that could prompt it to hike the key policy rate, so it would be reasonable to refrain from this measure for now.

The MPC members agreed that if realization of the above risks or occurrence of new risks to lower inflation or macrofinancial stability became more probable, the NBU could raise the key policy rate again to a level required to bring inflation back to its medium-term target.

The Board of the National Bank of Ukraine decided to set the key policy rate at 17.5% per annum at the meeting on monetary policy issues held on 12 July 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 and may not coincide with the distribution of the views of the members of the MPC.