National Bank of Ukraine

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

Date of the meeting: **5 September 2018**

Attendees: ten 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
Kateryna Rozhkova	First Deputy Governor
Roman Borysenko	Deputy Governor
Dmytro Sologub	Deputy Governor
Serhii Kholod	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, **all MPC members spoke in favor of increasing the key policy rate.**

In substantiating their view, members of the committee emphasized that, although inflation continues to decline in line with NBU predictions, risks arising from the global environment have increased since the last time the MPC met. If materialized, the risks may impair the lowering of inflation to the end-2019 target level currently envisaged by the NBU forecast. To eliminate the risks, it is thus necessary to conduct a tighter monetary policy.

First, capital outflows from emerging markets are exerting depreciation pressure on their currencies. Currency depreciation in Ukraine's trading partner countries may limit Ukrainian goods' competitiveness in external markets. In addition, the global decline in investor interest towards emerging market assets could make it harder for Ukrainian borrowers to access international capital markets.

Second, uncertainty is on the rise regarding the impact of trade conflicts on global commodity market conditions. It is highly likely that they may deteriorate, potentially negatively impacting Ukraine's export revenues.

Members of the MPC discussed, in particular, how the depreciation pressure on the hryvnia exchange rate against the dollar that has been observed since late July may impact future inflation developments. The meeting's participants agreed that the direct impact on inflationary processes would not be significant, as the hryvnia has lost much less value year-to-date compared to the currencies of its trading partners. Accordingly, the effect on the import component of inflation will be negligible.

That being said, the rise in the hryvnia's exchange rate volatility against the US dollar may cause a deterioration of inflationary expectations. To eliminate that risk, the NBU should continue making

FX interventions, smoothing out fluctuations in the hryvnia exchange rate without counteracting the prevailing market trend of its movement.

Among urgent inflation risks that were also discussed at the meeting, there remains a stronger-than-predicted acceleration in consumer demand. At this time, the high rates of growth in retail trade turnover and passenger transport are evidence that consumer demand remains robust.

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

Eight MPC members concurred in the idea **to raise the key policy rate by 50 bp up to 18.0%.**

The MPC members provided a number of reasons for such an increase:

- The decision to hike the key policy rate will confirm the consistency of monetary policy as the NBU reacts to changes in assessment of risks which, if realized, may threaten the achievement of inflation targets within the forecasted timelines. At the same time, raising the key policy rate by more than 50 bp is excessive, taking into account the progress in cooperation with the International Monetary Fund, particularly its visit to Kyiv.
- If the key policy rate is increased more than the previous times while growth in inflation risks is not as strong, it may be perceived as if the decision is aimed at securing the exchange rate at a certain level, but not at reducing inflation to the target level.
- Raising the key policy rate leads to a short-term improvement in the balance of payments due to greater capital inflows. Alongside, this creates risks over the longer term as exporters face higher lending costs. Therefore, the NBU must be cautious.

Giving these reasons in favor of increasing the key policy rate by 50 bp, the MPC members noted that the NBU will have the time necessary to react to realization of existing risks or occurrence of new ones and will be able to resort to another rate hike if needed in future.

Two of the MPC members favored increasing the key policy rate by 100 bp to 18.5%.

They believe that spreading apprehensions may pose a risk of a downfall on the global market. In view of this, the NBU needs to be proactive in monetary policy issues and resort to much higher rate to minimize vulnerability of Ukraine's economy to external shocks.

All the MPC members agreed that if the global market conditions deteriorate and/or risks of inflation materialize, the NBU could raise the key policy rate again to a level required to bring inflation back to its target within a reasonable timeframe.

The Board of the National Bank of Ukraine decided to set the key policy rate at 18% per annum at the meeting on monetary policy issues held on 6 September 2018.

Besides the current decision on the key policy rate, the **MPC members also discussed potential needs in further modification of the operational design of the monetary policy.** Since mid-summer 2018, liquidity surplus decrease has been registered in the banking system and, consequently, growth in hryvnia resources in the interbank lending market. The NBU expects that this trend will continue unchecked until the end of the current year, so that next year the banking system could even witness a liquidity deficit.

In view of the possible changes in the structural position of the banking system, the MPC members considered potential changes to the monetary policy's operational design so that the NBU's rate policy remain efficient in influencing the interest rates in the interbank lending market.

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.