Summary of the Key Policy Rate Discussion by the NBU Monetary Policy Committee

National Bank of Ukraine

Date of the meeting: **30 January 2019**

Attendees: nine out of ten members of the NBU Monetary Policy Committee (MPC):

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
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

During the discussion, **eight of the MPC members advocated maintaining the key policy rate at the current level (18.0%).**

The reversal of the upward trend in inflation and its decrease to 9.8% in 2018 improved public confidence in the NBU's monetary policy and its ability to manage inflation.

Keeping the key policy rate at the current level is in line with the need to control inflation and further reduce it to the medium-term target of 5% in 2020 specified by the NBU in its macroeconomic forecast, the MPC members said. This will, in turn, bring about a sustainable decline in inflation expectations and their stabilization at the target level.

To support their decision not to change the key policy rate, the MPC members cited a number of risks that have the potential to prevent inflation from decreasing to the levels specified in the NBU's macroeconomic forecast. Uncertainty over the upcoming elections is the main domestic risk. This may have a negative effect on inflation expectations and should be considered by the NBU when taking action.

In addition, the tight monetary policy should counteract the still significant underlying inflationary pressure, most of the MPC members said. In particular, core inflation is decreasing at a slow pace, as a result of the still robust growth in consumer demand, fueled by the substantial increase in wages, the MPC members emphasized. In its forecast, the NBU assumes that the wage growth will gradually decelerate as wages approach those of neighboring countries, and labor migration declines in intensity. However, this process runs the risk of being slower than expected and thus limiting the decrease in inflation.

The MPC members also cited pertainent external risks: the risk that terms of trade for domestic producers of exported goods will deteriorate in the case of a more substantial cooling-off of the global economy and a decrease in global prices of Ukrainian-produced commodities, geopolitical risks, and uncertainty over the volume of gas transit through Ukraine starting from 2020, after pipelines bypassing the country to deliver gas to Europe have been built.

Therefore, if underlying inflationary pressures rise and risks that inflation may not decline to the target level increase, the **NBU could raise the key policy rate, the MPC members said.**

At the same time, the MPC members emphasized a number of positive **factors that make it possible to consider a future easing of monetary policy.** These factors include:

- lower risks to macrofinancial stability thanks to the approval of the new program of cooperation with the IMF and the arrival of official financing
- favorable FX market conditions and foreign investors' renewed interest in Ukrainian government securities
- lower prices of imported energy.

In addition, the MPC members underscored the potential positive effect of a key policy rate cut on the resumption of lending and reducing the current account deficit.

Future cuts to the key policy rate should be well thought-out and made gradually, and only if inflation risks abate and inflation begins to move towards the target, along the trajectory specified in the macroeconomic forecast, the participants of the MPC meeting said.

By contrast, **one MPC member argued that the key policy rate should be cut immediately** (by 0.5 pp, to 17.5%). Monetary policy has already generated the momentum required for a deceleration in inflation, and is currently unnecessarily tight, the MPC member opined. The period of turbulence that warranted the monetary policy tightening is already over, the MPC member said. Cutting the key policy rate in January would send a positive signal to the market and improve expectations, the MPC member said. This signal would facilitate an inflow of capital and, hence, a decrease in borrowing costs, the MPC member added.

On top of that, the MPC members discussed the matter of boosting foreign capital inflows into hryvnia-denominated government securities. The NBU's tight monetary policy makes hryvnia-denominated financial instruments more attractive.

Nonresidents' purchases of hryvnia-denominated securities do not pose risks to the economy at this time, the participants of the MPC meeting believe. As a rule, risks that are related to inflows of short-term debt capital arise from capital inflows into the private sector that overheat consumer demand, the MPC members noted. When most of the capital inflow goes into government debt instruments, vulnerability risks to the economy are mitigated. Furthermore, the capital is flowing into hryvnia-denominated debt instruments, shifting FX risks to foreign investors.

Along with this, nonresidents' investment into domestic government bonds is insignificant relative to the amount of outstanding domestic government bonds, and is still lower than last year. In addition, the NBU uses capital inflows to increase international reserves, thus creating a safety cushion with which to cover potential capital outflows.

The decision to set the key policy rate at 18.0% per annum was approved by the NBU Board at the monetary policy meeting held on 31 January 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 monetary policy issues are made by the NBU Board.