COUNCIL OF THE NATIONAL BANK OF UKRAINE

MONETARY POLICY GUIDELINES

FOR 2017 AND

MEDIUM TERM

Approved by Decision of the National Bank of Ukraine
Council No. 1 of 21 December 2016

Kyiv, 2016

Monetary Policy Guidelines for 2017 and Medium Term (hereinafter - MP Guidelines) have been prepared by the Council of the National Bank of Ukraine 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* (hereinafter - the NBU Law).

MP Guidelines aim to implement Article 99 of the Constitution of Ukraine that declares ensuring the stability of the Ukrainian currency as the primary function of the NBU. Pursuant to Article 6 of the NBU Law, when carrying out its primary function, the NBU shall give priority to the achievement and maintaining price stability in the country. The NBU, in line with its responsibilities, promotes financial stability, including the stability of the banking system, provided that this activity does not hamper the achievement of the NBU's priority target. The NBU shall also facilitate sustainable economic growth and support the economic policies of the Cabinet of Ministers of Ukraine, unless it conflicts with achieving price and financial stability goals.

MP Guidelines are based on Articles 1 and 6 of the NBU Law, the targets of the economic program supported under the Extended Fund Facility (EFF) Arrangement with the International Monetary Fund (IMF)[1], the Forecast of Economic and Social Development of Ukraine for 2017 and Key Macroeconomic Indicators of Economic and Social Development of Ukraine for 2018 and 2019[2], and the macroeconomic forecast of the NBU[3].

MP Guidelines set a priority target and define the monetary policy principles for 2017 and the medium-term, taking into account specific current trends in global markets, their effect on the Ukrainian economy, approaches the NBU takes to perform its functions, as well as macroeconomic indicators and mid-term NBU performance indicators, any potential associated risks, and ways to mitigate them.

Pursuant to Article 100 of the Constitution of Ukraine, the NBU implementation of the MP Guidelines shall be controlled by the NBU Council.

Article 9 of the NBU Law provides that the MP Guidelines shall be prepared on an annual basis. Consequently, the MP Guidelines for 2018 and the medium-term

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[1] Memorandum of Economic and Financial Policies of 1 September 2016.

[2] Resolution of the Cabinet of Ministers of Ukraine No. 399 of 1 July 2016 *On the Forecast of -+Economic and Social Development of Ukraine for 2017 and Key Macroeconomic Indicators of Economic and Social Development of Ukraine for 2018 and 2019.*

[3] Decision of the NBU Board No. 373-D of 27 October 2016 *On Approval of the Inflation Report.*

shall be prepared, published, and communicated to the Parliament before 15 September 2017.

1. Monetary Policy Implementation Conditions

World Economy - Global Context

The world economy faces high risks. Its growth is slowing down for the third year in a row. According to the IMF[4], it will drop further from 3.4% in 2014 to 3.1% in 2016.

GDP growth of the most advanced economies will go down from 2.1% in 2015 to 1.6% in 2016. Respective declines are expected in the USA (from 2.6% to 1.6%), in the EU (from 2.3% to 1.9%), and in China (from 6.9% to 6.6%). Subdued economic growth in Japan may stay at its minimum level of 0.5%.

A slower economic decline is projected for the CIS economies, -0.3% in 2016 compared with -2.8% in 2015. Although in 2014 their GDP grew at 1.1%.

Headline inflation in advanced economies stays dangerously low, it can amount to 0.8% in 2016. Higher inflation (4.5%) in developing economies shows additional risk of macroeconomic adjustment. The above in combination with subpar global growth does not mean that international risks have gone down, but rather uncovers the global unpreparedness to mitigate them. As a consequence, active investment decisions are delayed at the global level. At the beginning of 2016, capital flows to emerging market economies shrank to 1.5% of GDP, which is six times less than before the 2008-2009 global crisis (almost 9% in 2007).

Moreover, the IMF recorded a reduction in cross-border banking flows. It might lead to narrowing correspondent relations between banks from advanced economies and from small developing economies. The above hampers global trade. Global trade has reached a size that sharply raises the issue of its potential pace and forms of further globalization.

Due to that and the Ukrainian economy's characteristics (small open economy with low add-value production dominating), Ukraine's financial stance and economy will depend on the global environment in 2017 and further on.

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[4] World Economic Outlook (WEO) October 2016: Subdued Demand: Symptoms and Remedies, IMF.

Ukraine: External Environment and Balance of Payment Risks

Despite projections of global output and trade picking up to 3.4% and to 3.8%, respectively, in 2017, expected price increases vary for different commodity export groups. For example, when oil prices might have a 17.9% rebound, non-energy commodity prices will grow by only 0.9%. For energy-dependent economies like Ukraine, it means higher financial risks.

Against this backdrop, we can see unfavorable trends affecting key markets for Ukrainian exports. Although global metal prices might increase by 2% in 2017, such a modest rebound will not compensate for the 8% slide in 2016. Wheat prices might come under downward pressure with the favorable production and expectation of higher grain stocks in the USA and Europe.

These projections are in line with the current price dynamics for traditional Ukrainian exports. In particular, the prices for steel and metal ore have shown signs of a slight pickup in 2016, when corn and wheat prices stayed low. These factors do not favor the gradual dissipation of external and internal imbalances in the Ukrainian economy.

Loss of the traditional markets, like Russia and some other CIS countries, is yet another challenge for Ukraine's economy. Because access to the EU single market stays limited, albeit the free trade agreement, and has failed yet to offset the losses. It takes further extensive adaptation to new standards, regulations, certification rules, and control procedures to fully use the EU trade potential. Entering new markets in Asia, Africa, and America is also a scenario for the medium-term horizon.

When consumer imports remain sensitive to increases in domestic nominal income, this situation causes the enduring risk of a widening current account deficit. According to NBU projections, the deficit may grow from USD 0.2 billion in 2015 to USD 2.5 billion in 2016, and 2.9 billion in 2017. The projected current account deficit will not be excessive if triggered, among other things, by investment imports demand, and the improvement of business climate is followed by the capital inflow.

At the same time, external financing of the current account deficit is exacerbated by the limited access of Ukrainian businesses to international financial markets. In addition to war-related factors, access is limited due to the low sovereign ratings of Ukraine, a shallow stock market, high FX risks, other global issues, etc.

Under these circumstances, the balance of payments and its dynamics depend on support from Ukraine's official creditors and international financial institutions (IFI).

The above underscores the importance of productive relations with IFIs and shows no grounds for deep liberalization of transactions that may serve to drain foreign currency from the country.

Macroeconomic Scenarios

MP Guidelines rely on Scenario 1 of the government forecast for the key macroeconomic indicators, used for the Draft State Budget of Ukraine for 2017, and on the NBU projections[5]. According to these forecasts, GDP is expected to increase by 2.5-3.0% in 2017, CPI inflation will be at the level of 8% (on December-to-December basis), nominal GDP will reach UAH 2,585-2,627 billion.

Broad money and base money are forecasted to grow at 13.2%and 8.4, respectively according to the NBU forecast.

The NBU will use these projections as reference points when making its monetary policy decisions. At the same time, the choice of specific monetary policy solutions will depend also on external market developments, the situation in domestic monetary and FX markets, and NBU progress in achieving its medium-term targets. Regular updates to the forecast as external and internal monetary policy conditions change will play key role in the process of targets achievement.

2. Monetary Policy Targets and Principles for 2017 and the Medium-Term

Priority Objective

Given the requirements of Article 6 of the NBU Law, monetary policy is primarily aimed at reducing inflation (in CPI terms) to a single digit rate and maintaining it at that level in the medium-term.

The trajectory of headline inflation targets is determined taking into account the balances of inflation risks, the need to maintain stable economic growth, and financial stability in the country.

[5] See key indicators in Annex 1

Since low and stable inflation is a major contribution to sustainable economic growth, which can be ensured by the central bank, the NBU will conduct its monetary policy based on a price stability framework. The monetary policy regime that will be used to achieve the priority objective is inflation targeting (IT). Low inflation expectations become a key element in improving the macroeconomic environment and restoring the economic potential of Ukraine.

The NBU's headline inflation target (i.e., changes in the consumer price index) for 2017 is 8% ±2 pp (December to December of the previous year).

The mid-term target for inflation is set at 5% ± 1 pp (the annual growth of consumer price index) and to be achieved gradually. In particular, the following trajectory has been defined as to the targets for annual changes in consumer price index:

December 2018 – 6% ±2 pp;

December 2019 – 5% ±1 pp.

Achieving the defined targets rests on the need to build a foundation of stability both in the short-term and the medium-term horizons.

Inflation targets for 2017-2020 cannot be changed once they are declared. Subsequently, as Ukraine's economic development will advance, the medium-term inflation targets may be revised downward.

In the short-term outlook, inflation may deviate from the pre-announced targets as it is influenced by external and internal shocks, which are outside the scope of the monetary policy's control. In particular, these are fluctuations in commodity prices and other highly volatile components of CPI, deviation of administered prices from the previously declared levels, etc. Under such circumstances, bringing inflation in line with its target level as soon as possible may drag down economic growth. In this case, monetary policy measures will be aimed at preventing the impact of second-round effects of such developments on inflation expectations while contributing to the maintenance of price stability over the medium-term. In any such case, the public will be informed about the period of time determined for bringing the inflation rate back to the target level.

Stabilization of inflation expectations is a key element in enhancing the effectiveness of other macroeconomic measures carried out by the NBU and the Ukrainian government, which are designed to restore Ukraine's economic potential. In addition, the achievement of the priority objective of price stability will help the NBU succeed in implementing its other objectives.

Other Objectives

According to Article 6 of the NBU Law, the NBU also pursues other tasks that contribute to the realization of its primary objective. They include:

- promoting financial stability, within the limits of NBU authority, including stability of the banking system, without prejudice to the priority objective; and
- facilitating sustainability of economic growth and supporting the Ukrainian government's economic policy, provided that it does not prevent the NBU from attainment of the objectives of price and financial stability.

The achievement of financial stability objectives along with maintaining sustainable economic growth can become factors or even prerequisites for ensuring price stability in the country.

A disinflationary trend, which shows the reduction of the annual increase in consumer prices from 43.3% in December 2015 to 12.1% in November 2016, against the backdrop of emerging signs of FX market stabilization, mutually favor price stability and economic growth, as well as financial stability, including stability of the banking system.

Monetary Policy Principles

The implementation of monetary policy will be based on the following main principles:

- Priority of achieving and maintaining price stability in the country;
- The NBU will comply with a floating exchange rate regime. One of the goals of FX interventions is to dampen excessive volatility of exchange rate. As the FX market resumes stable functioning, the NBU will gradually reduce its presence there and relax its administrative regulatory measures;
- Forward-looking decisions elaborated on a macroeconomic basis and aimed at promoting economic growth. The parameters of monetary policy will be built on comprehensive macroeconomic analysis and forecasts;

- The transparency of NBU activity. Market participants will be regularly informed about actions undertaken by the NBU, as well as reasons that prompted such actions, already at the stage of elaboration of relevant decisions and immediately after their adoption;
- Institutional, financial, and operational independence that will be explored by the NBU to fulfill its primary objective to ensure the stability of the Ukrainian currency.

3. Promoting Financial Stability

The environment with stable inflation and the use of a floating exchange rate will contribute to the implementation of the NBU's second priority objective regarding financial stability. It will be achieved through curbing inflation expectations and restoring confidence in the national currency accompanied by gradual de-dollarization.

At the same time, Ukraine's financial stability can be seriously challenged due to the openness of the Ukrainian economy and the weakness of its financial system. Thus, should crisis situations emerge, the NBU is ready to apply its monetary policy tools for mitigating the impact of shocks to the financial system of Ukraine. This, particularly, may take place through the use of key policy rate and foreign exchange interventions, the performance of the function of a lender of last resort for stabilizing expectations, and overcoming market dysfunctions in times of financial stress.

Meanwhile, the NBU will focus its efforts on eliminating risks to financial stability by developing macroprudential tools.

Also, the NBU will carry out a systematic analysis of the causes and consequences of the banking crisis in the period of 2008-2009 and 2014-2016 with the aim of developing measures necessary to prevent such events in the future.

Acknowledging the importance of the sustainable development of the financial system as a guarantee of its ability to counteract shocks, the NBU will continue to initiate changes aimed at strengthening the protection of creditors' and depositors' rights, enhancing corporate governance and fair competition in the financial sector, promoting cashless payments, etc., as provided for by the Comprehensive Program of Ukrainian Financial Sector Development Until 2020. The implementation of these objectives will be fostered by a gradual liberalization of capital flows, which will be established in line with fulfilling certain prerequisites.

The NBU will continue to work closely with the government and other regulatory authorities to achieve objectives set for financial stability, in particular through the activity of the Financial Stability Council. Cooperation with the Ukrainian government will help the NBU define methods and tools for minimizing systemic risks that threaten the stability of the country's banking and/or financial systems.

Such measures will not only promote the financial stability objective, but also enhance the monetary transmission mechanism, in particular, its interest rate channel.

4. Supporting Sustainable Economic Growth and Economic Policy of the Government

An environment with low and stable inflation will be a major contribution of the NBU to sustainable economic growth.

As sustainable economic development in Ukraine is impossible without progress in implementing reforms, the NBU will make every effort to continue together with the government implementing measures envisaged within the framework of cooperation with International Financial Institutions (IFIs).

In cooperation with the government of Ukraine, the NBU has to focus on the fulfillment of tasks defined by the NBU Law. The NBU will not succumb to pressure, nor will it use monetary policy tools to achieve objectives that are not compatible with its priority objective.

The NBU will cooperate with the government and other agencies to develop appropriate institutional arrangements to ensure the achievement and maintenance of price stability in the country, including prudent economic and fiscal policies, financial market development, and other activities related to the strengthening the confidence in the national currency.

The NBU will seek to strengthen coordination between monetary policy and the economic and fiscal policies of the Ukrainian government in view of their interdependence and obvious relationship among the monetary sector, real production, fiscal system, and the balance of payments.

Improving the quality of such coordination will favor the leveling off of existing structural imbalances in the domestic economy and enhance its financial stability, as well as the ability to minimize negative effects of external and internal shocks.

The above stated will be a significant factor in strengthening the stability of the currency of Ukraine.

The NBU will support effective functioning of key elements of financial (money and FX) markets infrastructure, promoting FX and banking stability, as well as lowering inflation amid a floating exchange rate.

5. Monetary Policy Instruments and their Application

Efficient implementation of the MP Guidelines requires that the NBU should be flexible in applying the whole set of available instruments of monetary policy.

The NBU will fulfill its inflation targets, primarily, by adjusting its key interest rate (the interest rate under liquidity regulation operations that affect the money market in the most significant way).

The key policy rate will be set by the NBU Board and reflect the state of monetary policy, functioning as the operational target for short-term interest rates on the interbank credit market.

The key policy rate will be complemented with an interest rate corridor under overnight lending and deposit operations to manage short-term interest rates on the interbank market by limiting their fluctuations around the key policy rate.

However, it is necessary to consider specific situations and the actual state of the national economy of Ukraine that influence the effectiveness of the set of interest rates applied by the NBU, as well as related instruments of monetary policy, including:

- an underdeveloped stock exchange, especially in relation to private securities (they account for no more than 5% of total stock exchange contracts);
- a large segment of the economy that is not covered by bank settlements (the share of the M0 component in the money supply volume stands at about 28%, evidencing an abnormally high level of cash dependence of the economy when compared internationally);
- active use of foreign currency cash as a means of private savings and informal settlements. Although its actual volume defies precise estimation, it is believed to be worth tens of billions of dollars, according to experts;
- a sharp tightening of interbank credit market (over the last three years, its average daily volume has shrunk to its 2005 level); and

- existing practices of related party lending under non-market conditions.

The gradual leveling of these factors will enhance the efficient application of the NBU key policy rate. This is reflected in strengthening the effects of the interest rate transmission mechanism not only on the interbank credit market, at the time of transformation of impulses from short- to medium- and long-term interest rates, and financial resources of relevant maturities, but with regard to decision making by businesses in the real economy.

In addition, decisions concerning monetary policy will be made taking into account the dynamics of monetary aggregates, particularly with due regard to the quantitative performance indicator for net domestic assets and the indicative target for the base money, as provided for by the cooperation program with the IMF.

6. Exchange Rate Policy

Besides the stabilization processes observed during the current year, external risks and uncertainties had a bearing in the Ukrainian FX market. Volumes of FX transactions remained low, the share of investments and external loans under FX receipts from nonresidents decreased, and export revenues were mainly proceeds from low-tech exports, primarily agrarian and metallurgical.

Amid unstable and slowly improving external conditions, further support of both the Government of Ukraine and the NBU is needed to facilitate FX market stabilization. To this end, a set of measures should be taken to prevent unmanageable FX risks that would hamper or even endanger the NBU's achievement of its primary function of ensuring stability of the currency of Ukraine, as well as macrofinancial stability.

In view of scarce possibilities to stabilize hryvnia exchange rate fluctuations, safe FX market developments might be achieved through flexible implementation of FX regulation and control measures, microprudential and macroprudential supervision, monetary policy tools, and international reserves.

As a factor of the structural transformation of the Ukrainian economy, the price stability policy will help reduce long-term FX rate volatility through mitigating negative pressures on the exchange rate generated by fast deterioration of the BoP current account responding to unproductive demand.

On the other hand, the FX policy should support the NBU's efforts in achieving its priority target. Therefore, the NBU will pursue a floating exchange rate regime, meaning that the monetary policy will not be aimed at maintaining a certain exchange rate level or range. Following the FX market restoring its normal operations, the NBU will gradually reduce its presence there and relax its administrative regulatory measures.

FX regulation should be improved based on the prudency principle as required by the EFF program. In particular, loosening of administrative measures should be allowed only when well-justified. Administrative measures will be eased prudently, with freshly revealed imbalances being leveled-off to prevent possible shocks in the FX market. The approach mentioned will help improve FX market sustainability, harmonize its operational environment, and support the NBU's focused efforts in building up its international reserves.

The NBU shall set pre-defined criteria, conditions, and timing for these regulatory steps to improve the balance between progress in FX stabilization and mitigation of administrative restrictions' negative effects on the domestic economy, especially when it concerns the capability of attracting foreign investments.

Gradual lifting of FX administrative measures shall depend on whether the country is capable of mitigating long-term internal and external financial imbalances and, even more so, doing it without the assistance of IFIs.

The NBU will use FX interventions with the aim of:

accumulating international reserves;

smoothing out the functioning of the foreign exchange market; and

supporting the transmission of the key policy rate as the main monetary policy instrument.

In view of unfavorable external situation and hindered access to global financial markets, build-up of net international reserves shall be seen as a specific target for 2017 and the mid-term. Sufficient international reserves will serve as stabilization safeguards of the financial system and the economy to offset effects from external shocks.

The NBU will use interventions in the FX market to mitigate excessive FX rate volatility, if this will not endanger its performance of the objective. However, equally possible FX rate upward and downward changes will be an important element of limiting excessive risks undertaken by economic agents.

Price stability and international reserves targets might be conflicting at some point. In this case, achieving price stability is the NBU's priority.

7. NBU Communication Policy

To stabilize inflation and FX expectations and meet its priority target, the NBU will pursue a consistent, accountable, and transparent monetary policy.

The NBU will regularly inform the NBU Council and the public on the performance of the MP Guidelines, providing detailed explanations of the nature, reasons, and expected effects of both measures planned and taken.

The NBU Board meetings on monetary policy issues and the key policy rate changes will be held in accordance with a pre-announced schedule. The decisions and their justification will be disclosed to the public.

8. Cooperation with IFIs

The NBU will continue to actively cooperate with IFIs in accordance with objectives set forth by law.

In pursuance of Article 100 of the Constitution of Ukraine regarding the development of the MP Guidelines and carrying out of control over implementation of monetary policy, the NBU Council evaluates risks related the effects of international legal agreements and commitments on the monetary policy and elaborates appropriate recommendations for the NBU Board and the Cabinet of Ministers of Ukraine.

The NBU Council approves an NBU Board decisions about the central bank's participation in IFIs.

9. NBU Independence

The independence of the NBU is the cornerstone of price stability. The NBU's institutional, financial, and operational independence was strengthened in 2015 after amendments were introduced to the NBU Law.

Higher independence means better accountability of the NBU, which will be achieved through higher transparency of its activities and reporting to the NBU Council and the public. The legislative amendments also provided the NBU

Council with more supervisory powers over the NBU Board's pursuit of monetary policy.

10. Peculiarities of Monetary Policy Implementation in 2017

Monetary Policy Priorities

NBU monetary policy will be aimed at inflation risks mitigation and reaching the inflation target of 8% (± 2 pp) by the end of 2017.

With inflation processes adequately controlled, the NBU will gradually ease its monetary policy, which will make credit resources cheaper and support economic growth.

Also, following the decline in inflation risks and the situation in the FX market, the NBU will further relax administrative restrictions and liberalize FX regulation. These measures will facilitate development of a liquid FX market able to absorb external and internal shocks and create a favorable business environment. Furthermore, relaxed administrative restrictions shall stimulate a deepening the FX market and development of currency risk hedging tools, which will allow a reduction in the NBU's participation in the market.

The NBU will seek to facilitate the adoption by the Verkhovna Rada of Ukraine (the Parliament of Ukraine) of initiatives that aim to stimulate lending in Ukraine, particularly, by introducing an effective mechanism for protection of creditor rights, improving financial restructuring mechanisms, building up infrastructure required for efficient problem asset management, including streamlining taxation of operations related to the recovery of non-performing debts. Further, the NBU will continue to initiate legislative changes aimed at creating conditions for free movement of capital in accordance with EU standards; improving anti-money laundering and counter-terrorism financing mechanisms; advancing cashless circulation and retail cashless payments using electronic payment instruments; developing infrastructure that ensures an efficient storage and exchange of information about borrowers' credit history; simplifying the procedure for bank mergers. As part of reforming the financial sector, the NBU will support draft laws that: facilitate the development of the financial sector's infrastructure; strengthen control and responsibility for related party transactions, tighten requirements regarding solvency and liquidity of financial sector participants, and improve the transparency of their activities and reporting; and enhance the protection of rights of consumers and investors of the financial sector.

Risks

External support of reforms and no adverse shocks in external markets or escalation of hostilities in the east of Ukraine will be the key factors keeping inflation in line with declared targets, and, consequently, ensure further improvements in inflation and foreign exchange expectations of businesses and households.

Facing positive shocks stimulating a higher FX supply, the NBU will be intensively accumulating international reserves aiming at bringing them to the level sufficient for State obligations to be performed timely and in full and achieving the monetary policy priority target, regardless the availability of loans from IFIs.

Facing negative shocks, the NBU will focus its efforts on locating and leveling them off, being unbiased in applying all the monetary policy tools available.