National Bank of Ukraine

Monetary Policy Guidelines for years 2016 – 2020

At its meeting on September [..] 2015 the Council of the National Bank of Ukraine approved Monetary Policy Guidelines defining the strategy aimed at achieving the primary goal of price stability and other goals of the National Bank of Ukraine (the NBU) according to the Law "On the National Bank of Ukraine" for the period of 2016 – 2020.

Understanding that low and stable inflation is the one of the main inputs for sustainable economic growth achievable by a central bank, the NBU considers Inflation Targeting (IT) as the most appropriate monetary regime for creating the environment of low and stable inflation.

It is envisaged that a formal regime of IT will be declared by the end of 2016 and steps will be taken to put in place all of the essential elements before that. During the transition period, the NBU will stay committed to the disinflation path, embraced under the EFF program with the IMF.

Monetary policy strategy: summary

The NBU will fulfil its mandate to achieve price stability by aiming at specific quantitative inflation objectives. The objectives will be set by the NBU`s Council based on the proposals of the Executive Board of the NBU, reflecting the goal of gradually lowering inflation in Ukraine towards the levels compatible with price stability. Once declared, the objectives will not change.

In accordance with the Law "On the National Bank of Ukraine" the NBU will also aim at goals of financial stability, supporting sustainable economic growth and economic policy of Government of Ukraine. The NBU will pursue these goals only to the extent that the fulfilment of the inflation objective is not threatened.

The medium-term inflation objective is set at 5% (for the annual increase in consumer price index) and will be achieved gradually. In particular, the short-term targets for the annual increase in consumer price index are going to be as follows:

- December 2016: 12 +/- 3 % YoY
- December 2017: 8 +/- 2 % YoY
- December 2018: 6 +/- 2 % YoY
- December 2019 and after: 5 +/- 1 % YoY

Simultaneously the NBU monetary policy will pursue the objectives of accumulating and then maintaining adequate international reserves and controlling monetary aggregates growth as envisaged by the IMF program.

The NBU will achieve the inflation objectives primarily by changing its key policy interest rate (synchronized with the NBU`s discount rate) – the interest rate on NBU`s operations, which have the largest market-moving effect. Other monetary policy instruments will have supportive roles; they should contribute to a smooth transmission of the key policy rate in the economy and balanced development of financial markets. In particular, the NBU will take all necessary measures to pursue a floating exchange rate regime.

The Executive Board of the NBU will take decisions on changes in its key policy instrument at pre-announced dates on the basis of economic and inflation outlook, elaborated by the staff.[1] The results and substance of the policy deliberations will be announced and explained to the public.

The NBU will inform the public regularly about fulfilment of the objectives and steps that will be taken to meet them in the future. The quarterly Inflation Reports, press releases and conferences, and other communication events will accompany monetary policy decision meetings.

Technical arrangements are being made to strengthen the capacity to meet inflation objectives in the areas of monetary and foreign-exchange operations, and monetary policy decision making. These arrangements will be introduced in several phases in the course of coming years.

A. Main principles of the monetary policy during 2016-20

- absolute priority of price stability over other monetary policy goals and tasks;
- floating exchange rate regime. Exchange rate will be largely determined by the market, without an ascertainable or predictable path for the rate. However, if necessary, the NBU will intervene on the foreign exchange market to accumulate the international reserves and to prevent undue fluctuations in the exchange rate;
- prospective decision-making based on solid macroeconomic background. The decisions on the parameters of monetary stance are based on the comprehensive macroeconomic analysis and forecast;
- transparency of the NBU activities. Detailed explanation of the reasons and actions of the NBU to the market participants shall be both provided right after the decision is made (press-releases, video addresses, briefings etc.) and summarized in the NBU official analytical documents to be regularly published on its official website;
- institutional, financial and operational independence of the NBU. The NBU will not use monetary instruments for any goal which undermines achieving price stability.

B. Motivation for the adoption of IT regime

There is strong consensus in the literature that low and stable inflation is the one of the main inputs for sustainable economic growth which can be delivered by central bank. At the same time Ukrainian economy for decades has been suffering from volatile and unpredictable inflation that undermined trust in hryvnia and, therefore, causing:

[1] The extraordinary meetings might be scheduled if needed

- high interest rates on deposits and loans;
- incentives for dollarization as a natural hedge for depositors and due to relatively low cost of credit for borrowers;
- impediments for economic growth because of unstable business environment.

Simultaneously in many developed and developing countries IT regime has been successfully adopted and explored in order to build an environment of low and stable inflation, in which:

- inflation is no longer a major concern for households and businesses;
- the usage of and credibility of the domestic currency is strengthened;
- the real value of household incomes and savings is preserved;
- the economic agents are not using foreign currency as a means of exchange, store of value and a price-wage setting mechanism;
- low nominal interest rates support investment process and economic growth;
- households and businesses adequately assess the exchange rate risks and are ready for potentially large fluctuations in the exchange rate, resulting in changes of the values of their savings and debts denominated in foreign currency.

The monetary policy of the NBU will be aimed at creation of macroeconomic environment in Ukraine with the above mentioned characteristics.

Given the changes in the macroeconomic fundamentals and on-going comprehensive reforms, the Ukrainian economy is likely to undergo substantial structural transformation in the coming years. Besides, Ukraine as a small open economy is exposed to the external shocks.

Under these circumstances, the fluctuations of nominal exchange rate should provide the main buffer of adjustment to these shocks. It means that in case of negative external shocks (for instance, decreasing demand for Ukrainian export or worsening terms of trade) affordable depreciation of exchange rate allows to preserve competitiveness, smooth effects on production sector and protect employment. In case of positive external shocks appreciation of exchange rate safeguards economy against overheating and high inflation.

This marks a significant departure from the fixed exchange rate policy applied in Ukraine in several lengthy episodes during the period of independence. Under that policy, the exchange rate was meant to be an anchor for all nominal contracts and level of inflation in the economy. Instead, the exchange rate peg has contributed to the accumulation of macroeconomic imbalances and proved incapable of securing stable and low levels of inflation, nor supporting growth in the medium term.

Moreover, the exchange rate peg has made public expectations highly sensitive to exchange rate movements. Consequently, it created incentives for the excessive risk-taking, thus limiting the usage of exchange rate as a buffer to the external shocks.

The aim of the NBU will be to gradually shift public attention from the exchange rate movements to the inflation rate. This could be done only by developing consistent, transparent monetary policy aimed at price stability. The real shift in the expectations could be achieved only with the successful story of bringing down inflation and keeping its stable.

The monetary targeting could be considered as a transitory option on the way to the full-fledged IT. Under the existing arrangement with the IMF the quantitative indicative targets for base money have been set in accordance with disinflationary objectives. These criteria are subject to the regular quarterly review and, as we progress with implementing the elements of an inflation targeting regime, we would aim at transforming the quantitative monetary targets into inflation target consultation clauses. This is because the experience of other countries points to many drawbacks monetary targeting has in a medium-term. In particular, in the emerging economies, like Ukraine, money demand is unpredictable, which makes it hard to anchor inflation expectations with the monetary targets.

Thus, eventually, IT framework, consisting of a set of practices to perform a rule-based, accountable and transparent monetary policy, is the most suitable prospective regime for Ukraine.

C. Exchange rate policy

The NBU is committed to the floating exchange rate regime, implying that the monetary policy will not be aimed at achieving the certain level or interval of exchange rate. The NBU will gradually reduce its presence in the FX market. The NBU will facilitate the unobstructed functioning of the FX market, and will make all regulations, rules, and procedures known and transparent to the market participants. The NBU will gradually relax administrative measures and regulations, which limit exchange rate flexibility, aiming at developing transparent and liquid domestic FX market

At the same time, the NBU will use its FX interventions for purposes of a) FX reserve accumulation, b) a smooth functioning of the foreign exchange market, c) support to the transmission of the key interest rate as the main policy instrument.

Rebuilding international reserves is considered as one of the important tasks of the NBU in the next few years, given fragile economic situation and unstable market expectations. Hence, the adequate level of international reserves will serve as a stabilizing safeguard of the financial system and the economy against potential shocks.

Objectives of the price stability and reserves accumulation have potential to be inconsistent with each other under certain circumstances. In such a case the priority of price stability goal will be respected.

The NBU will intervene in the foreign exchange market if necessary to smooth the excessive volatility of the exchange rate if it endangers the achievement of the NBU`s main goals. At the same time, the NBU does not intend to determine exchange rate dynamics. The possibility of exchange rate movements, equally in the both directions, will be an important element in limiting excessive risk taking by the economic agents.

D. Main elements of the new framework

Setting inflation objectives

The inflation objectives measured by the Consumer Price Index are to be set by the Council of the National Bank of Ukraine.

Law “On the National Bank of Ukraine” states that price stability is low and stable inflation rate, measured by consumer price index, in the medium term.

The medium-term inflation objective is set at 5% for the annual increase in consumer price index. The Council of the NBU deems this inflation rate as optimal in the medium term, given the fundamentals of the Ukrainian economy.

At the same time, this level is set on a slightly higher level compared with industrialized countries to reflect the processes of structural adjustment and productivity growth, which the Ukrainian economy is to undergo in the coming years.

The medium-term inflation objective will be achieved gradually. In particular, the short-term inflation objectives for the annual increase in consumer price index are going to be as follows:

- December 2016: 12 +/- 3 % YoY
- December 2017: 8 +/- 2 % YoY
- December 2018: 6 +/- 2 % YoY
- December 2019 and after: 5 +/- 1 % YoY

Achieving inflation objectives

The NBU will achieve the inflation objectives primarily by adjusting the key policy interest rate – the interest rate on the NBU`s main liquidity regulation operations, which have the largest market-moving effect. Hence, depending on structural liquidity position of the banking system (i.e. either shortage or surplus) key policy rate will be attributed to regular liquidity providing (e.g. refinancing tenders) or sterilization operations (e.g. the NBU`s CD placement tenders). These operations will be invariably conducted in a price setting manner.

The key policy rate (which will also be synchronized with the discount rate) is to be set by the NBU`s Executive Board and reflects the NBU`s monetary policy stance providing the operational target for short-term interest rates in the interbank money market.

The key interest rate will be supported by a corridor of interest rates on overnight lending and deposit facilities to steer short-term interest rates in the interbank money market by limiting their fluctuations around the key policy rate.

Further transmission of changes in the key policy rate and in short-term market rates into the real economy takes place through various channels (interest, exchange rate, other assets, credit, etc.).

Other monetary policy instruments will have supportive role in achieving inflation targets including:

(1) *fine-tuning and structural liquidity regulation operations*, i.e., refinancing tenders and CD placement tenders with maturities different from those under main liquidity regulation operations, repo transactions, FX swaps, purchase and sale of the Ukrainian government bonds etc**.** These operations will be used as complementary monetary policy instruments to smooth the effects on interest rates caused by large liquidity fluctuations in the market and contribute to a balanced development of money and securities markets. These additional instruments will be mostly provided in a price taking manner, as their objective will not be to influence the level of rates, but smooth out the functioning of the markets by assisting with liquidity management by market participants.

(2) *reserve requirements*. This instrument will be used to adjust the liquidity of banking system and smooth the transmission of the key policy rate to the interbank interest rates. Eventually, its use for monetary policy transmission will be discontinued.

(3) *foreign exchange interventions*. The NBU will intervene on the foreign exchange market in order to ensure the accumulation of international reserves to the desired level, to smooth out the excessive fluctuations of the exchange rate without negatively influencing the inflation target achievement, and to support the interest rate as the main policy instrument. However, no numerical targets for FX rate will be set. In the new monetary policy framework the FX rate is changing its role from an instrument to an indicator of monetary policy transmission. Monitoring of the FX rate developments will continue to be important for setting the key policy rate, as the FX channel is currently the most powerful one in monetary transmission mechanism.

The Executive Board of the NBU will make its decision on the key policy rate on regular and preannounced meetings (following the discussions on the Monetary Policy Committee). The decision on the key policy rate will be made based on a comprehensive analysis of macroeconomic, monetary and financial development, including macroeconomic forecast developed by the NBU. These projections of inflation and other macroeconomic indicators are based on quantitative models, the assumptions on regulated prices changes and other exogenous determinants of inflation, like the development of global economy, and the analysis of the real monetary conditions, including exchange rates, interest rates, monetary aggregates, credits and deposits, etc.

The process of formulating monetary policy decisions and forecasting inflation involves many uncertainties due to the exogenous shocks and ongoing systemic transformation processes in the Ukrainian economy. The NBU takes into account all available information at the point when inflation forecast and monetary policy decisions are done. The projections will be updated, as new information arrives. Policy actions (i.e. the change in the key interest rate) will be taken, if there is a significant risk of inflation will deviate from the declared objectives and the current monetary policy stance is deemed inconsistent with reaching the inflation objectives, so that the projections always reach the target on the desired horizon. The size and timing of the adjustment will be based on a view of monetary transmission and respecting its lags.

Inflation could deviate from the preannounced target over the short term due to the external and domestic shocks beyond the control of monetary policy such as swings in commodity prices and other highly volatile components of the CPI, divergence of administratively regulated prices from preannounced paths, etc. Bringing inflation down to targeted level in the shortest possible time in all such circumstances could be very costly in terms of economic growth. Thus the reaction of monetary policy will be to prevent the second round effects of such events in affecting inflation expectations and thus to preserve the goal of price stability in the medium run. The horizon on which the target should be preserved will be clearly communicated in every such case.

E. Communication of monetary policy decisions

In pursuing the inflation objectives, the NBU will implement monetary policy in a consistent, accountable and transparent manner to stabilize inflation expectations.

The NBU will inform the public regularly on fulfilment of inflation objectives, policy actions taken and reasons behind them.

Meetings of the Executive Board of the NBU on key interest rate decision will be held according to the pre-announced schedule. Its outcomes and the reasoning of the decisions made will be announced to the public.

The Inflation Report will be the main tool of the monetary policy communication to the general public. The first issue of the Inflation Report was released at the end of March 2015. It will be issued quarterly and contain the assessment of the current economic situation, macroeconomic forecast with a special focus on the projection of inflation and the analysis of main risks to meet inflation objectives, and the impacts of future developments and risks on monetary policy.

The NBU will communicate with the public and specific interest groups through a series of regular publications, press conferences and releases after policy decisions, as well as through ad-hoc analytical seminars, conferences and publications on special topics.

F. The NBU independence

Central bank’s independence is a cornerstone of maintaining price stability. The NBU has institutional, financial and operational independence that is enhanced by changes in the Law “On the National Bank of Ukraine” approved in 2015.

At the same time granting the central bank with higher independence assumes the growth of accountability which in case of the NBU will be achieved through stronger transparency and reporting to the public and to the Council of the NBU. The abovementioned changes in the legislation envisaged the greater supervisory role of the NBU`s Council under the monetary policy implemented by the NBU`s Executive Board.

The coordination of policies with the Government will be aimed at fulfilment of tasks defined in the Law “On the National Bank of Ukraine”. The NBU will not tolerate any pressure and will not use monetary instruments for any goal which creates threat to price stability.

The NBU will cooperate with the Government and other institutions in building the appropriate institutional conditions for effective targeting of inflation, including the prudent fiscal policy, development of the financial market and other activities related to the strengthening of credibility to the national currency.