Kateryna Rozhkova: National Bank of Ukraine press briefing – monetary policy statement

Speech by Ms Kateryna Rozhkova, Acting Governor of the National Bank of Ukraine, at a press briefing on monetary policy, Kiev, 31 January 2019.

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Dear colleagues,

Please be informed that the Board of the National Bank of Ukraine has decided to keep its key policy rate at 18.0% per annum. The rate was maintained at the same level in order to drive inflation down to the target of 5% in 2020.

First, let us summarize the inflation development in 2018:

Last year, consumer price inflation declined to a five-year low of 9.8% (versus 13.7% in 2017). The reversal of the trend after the rise in inflation in 2017 is primarily due to the NBU's tight monetary policy. The series of interest rate hikes that started in October 2017 increased the attractiveness of saving.

Moreover, the tight monetary conditions were among reasons for the strengthening of the hryvnia. High global prices for exported goods, a record harvest of grain crops, and a substantial amount of remittances also contributed to the stronger hryvnia.

In addition to monetary factors, an increase in the domestic food supply and lower global prices for food products dampened inflationary pressures.

Despite having decelerated, inflation was, as expected, above the central bank's target range of 6% +/-2 pp at the end of 2018. The deviation from the target was largely due to factors over which monetary policy has only a limited effect:

- higher administered prices
- wage-driven growth in production costs
- crude oil prices rising throughout most of the year
- a narrowed supply of vegetables due to unfavorable weather.

Consumer demand, fueled by higher wages, was also an important inflation driver. Real wages grew by 12.5% yoy in 2018. Uncertainty as to whether or not cooperation with the International Monetary Fund would resume and high external risks also weighed on economic sentiment throughout most of the year.

The NBU deliberately chose a **more lengthy path to bringing inflation to the target in order to minimize the loss of economic growth**.

Being able to balance the need to drive inflation to the target, and the need to support economic growth, shows the flexibility of the inflation-targeting regime.

How will inflation behave in the coming years and when will it meet the NBU target?

Inflation will continue to decline gradually. As before, we expect inflation to decline to 6.3% at year-end 2019 and reach 5.0% at the end of 2020. That said, inflation will already be in the target range of 5% +/- 1 pp in early 2020, as planned.

The disinflation will primarily be due to the tight monetary policy. Inflation will be also curbed by:

- prudent fiscal policy driven by the repayment of large volumes of public debt in 2019–2020;
- slower wage growth, as domestic wages converge with wages in neighboring countries and migration moderates;
- relatively low exchange rate volatility resulting in low imported inflation;
- a decrease in energy prices in the global markets;
- weak growth in raw food prices.

These factors will make core inflation decline to 5% in 2019, down from 8.7% in 2018, and to a level below 4% in 2020–2021.

At the same time, the further planned increases in administered prices, which are required to bring them to market levels, will impact consumer price inflation.

The NBU has also performed scheduled revisions of other macroeconomic forecasts

Last year, the Ukrainian economy grew more rapidly than in any of the past seven years – by 3.3% according to our latest estimates.

However, **real GDP growth will slow to 2.5%** this year, as predicted. The slowdown will be driven by the tight monetary policy necessary to bring inflation down to the target level and by the conservative fiscal policy intended to finance significant public debt repayments this year.

In addition, the grain harvest is expected to decline from the record levels that made agriculture the primary driver of economic growth. Another factor will be a gradual deceleration of growth in the global economy and trade, including due to protectionist measures.

Private consumption will remain a key driver of growth as real household income – wages, pensions, and remittances from abroad – continues to grow.

Although investment activity will slow down, it will remain an important driver of demand for investment imports. As a result, even given a revival in export-oriented industrial production and record grain exports, imports will grow faster than exports in real terms. Consequently, the contribution of net exports will remain negative, although smaller than before.

Next year, real economy growth will start to accelerate, hitting 2.9% in 2020 and 3.7% in 2021. The growth will mainly be propelled by a gradual easing in monetary policy, which will bolster domestic demand, and a pick-up in investment activity, as uncertainty about the political situation diminishes.

After widening to 3.6% of GDP in 2018, the current account deficit will range between 3% and 4% of GDP in 2019 and 2020. In 2019, the deficit will narrow to 3.1% of GDP, due to the 2018 bumper corn harvest and a drop in energy prices.

In 2020–2021, the current account deficit will widen slightly, on the back of a decrease in gas transit, a poorer grain harvest, and a rise in investment imports after the elections.

A widening in the trade deficit will be offset by greater private remittances, supported by the higher incomes of labor migrants.

A key assumption of the macroeconomic forecast is that Ukraine will continue to cooperate with the IMF and enjoy relatively favorable access to the international capital markets.

At the same time, reasonably high interest rates will contribute to the inflow of debt capital, which, together with continued inflows of foreign direct investment, will finance the current account deficit.

External official borrowing and the government's placement of Eurobonds will make it possible to repay external public debt, the repayments of which will peak in 2019–2020. This will improve the expectations of economic agents and promote macrofinancial stability.

As a result, international reserves will hover around USD 21 billion in 2019 and 2020.

The usual increase in uncertainty during presidential and parliamentary elections poses the main risk to the said macroeconomic forecast, including Ukraine's ability to meet its inflation target in 2020.

This, in turn, could affect inflation expectations.

External risks are also important. These include:

- a more significant slowdown in the global economy, including in the economies of Ukraine's main trading partners;
- a drop in the global prices of the commodities exported by Ukraine;
- persistently strong labor migration and the resulting pressures on wages;
- geopolitical risks, such as an escalation of the Azov Sea conflict, which could cut export earnings;
- uncertainty over the volume of gas transit through Ukraine starting in 2020, as pipelines bypassing the country are being built to deliver gas to Europe.

Why did the Board decide to leave the key policy rate unchanged?

Taking into account the updated macroeconomic forecast and the above risks, the NBU Board deems it necessary to maintain the existing reasonably tight monetary conditions in order to ensure that inflation returns to its target range in Q1 2020.

What will the NBU's monetary policy stance be in future?

Any further changes to the key policy rate will depend on inflation developments, as well as on whether or not risks to price stability materialize.

The Board sees reasons for launching a monetary easing cycle, as risks of inflation decrease steadily, and inflation returns to its target, along the trajectory outlined in the central bank's new macroeconomic forecast.

However, if underlying inflationary pressures rise and risks that inflation may not return to its target increase, the NBU could raise the key policy rate.

A new detailed macroeconomic forecast will be published in the Inflation Report on 7 February.

A summary of the discussion by Monetary Policy Committee members that preceded this decision will be published on 11 February.

The next meeting of the NBU Board on monetary policy issues will be held on 14 March.

Thank you for your time!