Yakiv Smolii: National Bank of Ukraine press briefing - monetary policy statement

Speech by Mr Yakiv Smolii, Governor of the National Bank of Ukraine, at a press briefing on monetary policy, Kyiv, 18 July 2019.

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Dear colleagues,

Please be informed that **the Board of the National Bank of Ukraine has decided to cut the key policy rate to 17.0% per annum effective 19 July 2019.**

The NBU continues the cycle of monetary policy easing as inflation is declining towards the target of 5%.

What inflation developments followed the last monetary policy meeting?

In June, annual inflation came in at 9.0%. Thus, **inflation approached the trajectory of the NBU's April forecast** after temporary factors caused a deviation from the target in previous months.

Core inflation slowed somewhat in Q2, also being close to the forecast.

The tight monetary policy was the main factor that restrained the underlying inflationary pressure. In particular, due to the hryvnia appreciation and an improvement in expectations of households, businesses, banks, and financial analysts. At the same time, inflation remained relatively high. Robust consumer demand, higher production costs, and further growth in administered prices put pressure on prices.

What will be the future trajectory of inflation?

The NBU reiterates its forecast that inflation will decline to 6.3% as of the end of 2019, return to the target range in early 2020, and reach the medium-term target of 5% at the end of 2020.

The tight monetary conditions will continue to be the disinflation driver. Despite the fact that the key policy rate is reduced gradually, its real value will remain high on the back of improved inflation expectations. High real interest rates will make hryvnia financial instruments more attractive for investors, which will support the exchange rate of the hryvnia. Moreover, such monetary policy stance will limit the pressure from consumer demand.

Other factors contributing to slower inflation will include:

- a prudent fiscal policy
- the slowdown in wage growth
- relatively low energy prices in the global markets
- ample supply of domestic and foreign food products.

The NBU has also performed scheduled revisions of other macroeconomic forecasts

The NBU has revised its economic growth forecast to 3% in 2019 (from 2.5%) and 3.2% in 2020 (from 2.9%) amid stronger domestic demand, better terms of trade, and larger harvest of grain crops.

Domestic demand will remain the main driver of economic growth over the coming years. Private consumption growth will decelerate, albeit remaining high owing to an increase in real household income – wages, pensions, and remittances from abroad. Capital investment will continue to grow rapidly, which will also provide significant support to the economy.

Economic growth will be dampened by a weak global economic activity and decrease in gas transit to European countries starting in 2020, due to the construction of bypassing gas pipelines.

The 2019–2021 current account deficit will remain acceptable.

In 2019, the deficit will narrow to 2.6% of GDP, thanks to the bumper grain harvest, a drop in energy prices, and a decline in dividend repatriation. In future, the current account deficit will widen slightly, driven by the decrease in gas transit, less favorable terms of trade, and stronger consumer and investment demand.

Further cooperation with the International Monetary Fund remains the basic assumption of the macroeconomic forecast.

This will allow Ukraine to attract other official financing, improve the conditions of access to the international capital markets, and support the interest of investors in Ukrainian assets. These borrowings will make it possible for the government to finance large payments on the external public debt. In addition, the private sector will get an opportunity to attract foreign investment.

As a result, international reserves will reach USD 23 billion in 2021.

The main internal risk to the above scenario is a further strengthening of threats to macrofinancial stability.

Court rulings, legislative initiatives, or other steps that invalidate previous achievements, and delays in implementing key reforms may increase the vulnerability of Ukraine's economy and pose an obstacle to further cooperation with the IMF. That could affect exchange-rate and inflation expectations and make it harder for Ukraine to access international capital markets in order to repay a heavy debt load in the coming years.

The following risks also remain important:

- a suspension of Russian gas transit through Ukraine starting in 2020
- an escalation of trade wars and rising geopolitical tensions
- an escalation of the military conflict, and the imposition of new trade restrictions by Russia.

Considering the revised macroeconomic outlook and the balance of risks that threaten to worsen it, the NBU Board has decided to cut the key policy rate to 17.0%.

The NBU has also decided, from today onward, to start publishing the forecasts of its key policy rate as part of the quarterly revisions of the macroeconomic outlook.

Publishing interest rate projections marks an evolutionary improvement in the transparency of monetary policy conducted by inflation-targeting central banks.

The NBU expects that **the publication of the key policy rate forecast will improve the understanding of the NBU's monetary policy by all stakeholders.** This information will be useful to businesses, analysts, investors, and households. It may inform their investment decisions, business development plans, savings decisions, etc.

The key policy rate forecast will shape the expectations of financial market participants, enabling the NBU to strengthen the impact of the key policy rate on the value of financial resources and, hence, on inflation. The publication of the key policy rate forecast will make everyone better off.

It should be noted that the forecast imposes no obligations on the NBU, and thus the actual key policy rate may differ from the forecast if macroeconomic conditions change.

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

The NBU's baseline scenario envisages **the key policy rate to decrease further, to 8% over the coming years, provided that inflation steadily declines to the 5% target.**

This has been made possible by the years long, consistent, systemic policy of the reformed NBU, which ensured the reduction of inflation to a single-digit figure and which will continue to be the main driver of inflation-reducing efforts in the years to come.

The largest decrease is expected over 2020, along with inflation returning to the target range and inflation expectations improving.

If existing inflation risks, both internal and external, materialize, the key policy rate could decline to 8% more slowly.

At the same time, higher demand for hryvnia government bonds from nonresidents and the subsequent strengthening of hryvnia will allow reducing the key policy rate at a faster pace than envisaged in the baseline scenario.

As usual, a new detailed macroeconomic forecast will be published in the central bank's Inflation Report on 25 July 2019.

A summary of the discussion by Monetary Policy Committee members that preceded this decision will be published on 29 July 2019.

The next meeting of the NBU Board on monetary policy issues will be held on 5 September 2019.

Thank you for your attention!