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, 24 October 2019.

* * *

Dear colleagues,

Please be informed that **the Board of the National Bank of Ukraine has decided to cut the key policy rate to 15.5% per annum effective 25 October 2019.**

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

What price developments followed the last monetary policy meeting?

In September, consumer inflation declined to 7.5% yoy, below the NBU's July forecast. Inflation continued to slow in October according to the NBU's preliminary estimates based on online analysis of prices.

The steady disinflation has been driven by a gradual easing of underlying pressures on prices. That was reflected in a rapid slowdown of core inflation. The tight monetary policy was one of the reasons behind the strengthening of the hryvnia and improvement in inflation expectations. With a time lag, that produces a major impact on prices, offsetting the effect of the sustained consumer demand and worse harvest of some vegetables, which push prices upwards.

What will be the future trajectory of inflation?

Same as before, the NBU expects inflation to decline to 6.3% as of the year-end. On the one hand, core inflation will slow more than expected, while fuel prices will remain below last year's levels due to the stronger hryvnia. On the other hand, smaller supply of some vegetables will push prices upwards. However, these factors will offset each other, which leaves this year's inflation forecast unchanged.

Inflation will meet the target range of 5%+/-1 pp in early 2020 and reach the medium-term target of 5% at the end of 2020. As in 2019, tight monetary conditions will curb price growth. Despite the fact that the key policy rate is reduced gradually, its real value will remain high on the back of improved inflation expectations. Relatively high real interest rates will keep hryvnia financial instruments attractive for investors and thus support the exchange rate of the national currency.

As a result, the more favorable FX market will neutralize the pressure domestic demand has on prices, which will be somewhat higher according to the new forecast.

Other factors behind the gradual disinflation will include:

- a prudent fiscal policy
- relatively low energy prices on the global markets
- an increase in food supply driven by higher productivity in agriculture.

The NBU has also performed scheduled revisions of other macroeconomic forecasts

The NBU has revised its economic growth forecast upwards, to 3.5% in 2019–2020 and 4% in 2021. The revision was driven by the sustained domestic demand, higher productivity in agriculture, and improved consumer sentiment.

In the meantime, slower growth in the global economy and worsened terms of trade will weigh on economic growth in 2020.

The 2019–2021 current account deficit will remain acceptable. In particular, it will narrow to 2.9% of GDP this year despite the stronger hryvnia. That will be driven by an improvement in the terms of trade and the rich grain harvest.

Conversely, the current account deficit will widen slightly in the years to come, as a result of a decrease in gas transit and less favorable global commodity prices. In particular, the NBU expects somewhat lower iron ore prices and higher energy prices.

What does the realization of the said macroeconomic forecast depend on?

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

The current NBU forecast assumes a new IMF cooperation program will be approved by the end of 2019. 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.

As a result, notwithstanding large external debt repayments, international reserves will range at around USD 23–24 billion in the coming years, which is sufficient to cover three months of future imports.

The NBU currently sees two key risks to the above macroeconomic forecast, and in particular to inflation decreasing to its target in 2020.

The first risk is a delay in signing a new program with the IMF.

The second risk is about increasing threats to macrofinancial stability, mainly due to Ukrainian court rulings.

If materialized, these risks could worsen exchange rate and inflation expectations, and make it harder for Ukraine to access the international capital markets in order to repay a heavy debt load in the coming years.

The following risks also remain important:

- a complete halt of the transit of Russian gas through Ukraine
- intensified trade tensions and more turbulent global financial markets
- an escalation of the military conflict and new trade restrictions introduced by Russia.

Why, given the said risks, did the NBU cut the key policy rate by 1 pp?

Although still existing, these risks have neither worsened nor improved since the last monetary policy decision was made. This means that the balance of risks has remained unchanged since early September. However, there has been a change in economic conditions – underlying inflationary pressures are declining more quickly than the NBU anticipated. This has made it possible to ease monetary policy somewhat more quickly this year than envisaged in the previous macroeconomic forecast. As a result, the Board has cut the key policy rate by 1 pp, to 15.5%.

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

The NBU's forecast scenario envisages that the key policy rate will be cut further, to 8% as of the end of 2021, provided that inflation steadily declines to its 5% target.

As before, the largest decrease in the key policy rate is expected to take place in 2020, along with inflation returning to its target range and inflation expectations improving.

However, the actual pace at which the key policy rate is cut to 8%, together with any actual actions taken to achieve this goal, will depend on many factors.

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

That said, the key policy rate could be cut further, to 8%, much more quickly. These cuts will greatly depend on whether or not key internal reforms are sped up. These reforms are those that are envisaged in the memorandum of understanding signed by the Ukrainian government and the NBU, and the judicial reform required to establish the rule of law in Ukraine.

Thank you for listening!