Andriy Pyshnyy: National Bank of Ukraine press briefing - monetary policy decisions

Speech by Mr Andriy Pyshnyy, Governor of the National Bank of Ukraine, at a press briefing on monetary policy decisions, Kyiv, 26 October 2023.

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Today the Board of the National Bank of Ukraine has taken a decision to set its key policy rate at 16% effective 27 October 2023, making it equal to the rate on overnight certificates of deposit (CDs). In such a way, the NBU is modernizing the operational design of its monetary policy in line with the lower-bound system.

Interest rates on the NBU's other transactions with the banks have been set as follows: the key policy rate + 4 pp (20%) for three-month CDs and the key policy rate + 6 pp (22%) for refinancing loans. The rates on the NBU's transactions with the banks will thus actually remain unchanged.

The modernization of monetary policy operational design will reinforce the signaling role of the key policy rate amid the structural liquidity surplus. In particular, such changes will enable the NBU to maintain short-term hryvnia interbank rates close to the key policy rate. As a result, the NBU will have more power to influence expectations of economic agents and motives of their economic behavior.

At this point in time, keeping rates on the NBU's transactions with the banks unchanged conforms with the need to maintain the attractiveness of hryvnia instruments, which is important for ensuring moderate inflation and exchange rate sustainability over the forecast horizon.

Inflation has been decreasing rapidly over past months, primarily on the back of strong harvests of agricultural crops

In September, inflation declined to 7.1% yoy. Such price dynamics were driven by large supply of agricultural produce of the new harvest and the moratorium on raising some utility tariffs.

Stable FX market conditions limited the rise in prices for goods with a significant import component. As a result, core inflation also slowed considerably in September, to 8.4% yoy.

According to the NBU's estimates, inflation continued to decelerate in October. Among other things, this was driven by the maintained exchange rate sustainability against the backdrop of the successful transition to managed exchange rate flexibility.

At the same time, other underlying factors continued to put pressure on the inflation rate. The gradual economic recovery is being accompanied by a revival of demand for consumer goods and services. The shortage of skilled workers, particularly due to migration, is prompting companies to raise wages relatively quickly. Moreover, the pressure on business costs remains high due to the consequences of the war.

Inflation will remain below 10%, albeit rising temporarily next year

The NBU has improved its end-2023 inflation forecast, from 10.6% to 5.8%. This was mainly driven by the impact of the large harvest on food price dynamics.

At the same time, the NBU has revised its 2024 inflation forecast upward, from 8.5% to 9.8%. The accelerated growth in prices will be caused by this year's low base for food prices, persisting pressures on business costs due to revised security risk assumptions, higher wages, and faster increases in administered prices.

Going forward, inflation will decelerate to 6% in 2025. This will be primarily driven by the expected decline in security risks assumed by the NBU's forecast.

The recovery in optimal logistics and production in the post-war period will enable an increase in supply of goods and limit price pressures. The expected decline in global energy prices will also have a major impact on price movements.

Economic growth will resume as of the end of 2023 and will continue further on

The NBU improved its real GDP growth forecast from 2.9 to 4.9% in 2023. The faster pace of economic recovery is driven by a number of factors. They include improved adaptability of businesses and households to wartime conditions, better estimates of harvests, more alternative routes of export supplies, and larger budgetary spending.

In 2024, the economy will grow by 3.6% despite persistently high security risks. The economic recovery will be supported by continued development of alternative supply routes and sustained loose fiscal policy, which will support consumer demand. On the other hand, still complicated logistics and investment being limited by the war will be a drag on economic growth.

The NBU forecasts that real GDP growth will accelerate to 6% in 2025. This will be primarily driven by the expected decline in security risks. As these risks subside, migrants will gradually return from abroad, consumer and investment confidence will improve, optimal supply and production chains will be restored, and damaged infrastructure will be reconstructed.

Thanks to official financing, the NBU will be able to maintain a sufficient level of international reserves and therefore the sustainability of the FX market

One of the assumptions is that Ukraine will receive a total of USD 45 billion in financial aid loans and grants this year. These disbursements remain the main source of covering the high budget deficit, which stands to widen to almost 29% of GDP this year.

Through aid, Ukraine has also been able to finance its considerable current account deficit, and the NBU has maintained a high level of international reserves and balanced the FX market.

Ukraine's needs for external financing in the years ahead will remain significant despite the gradual mobilization of domestic financial resources and fiscal consolidation.

An important assumption underlying the forecast remains the sufficiency and regularity of such aid, which requires that Ukraine meet its commitments to international partners.

This will make it possible to finance the budget's critical expenditures and avoid having to rely on monetary financing, going forward. For its part, the NBU will be able to maintain international reserves at above USD 40 billion despite making significant interventions to preserve the sustainability of the FX market amid further currency liberalization measures, among other things.

The key risk to the forecast is the longer duration and the unpredictable nature and intensity of the war

The war continues. The NBU has revised its main assumption regarding the longevity of high risks to security. The updated forecast envisages that they will persist until at least the end of 2024.

Uncertainty over the length of the war remains high. An expedited end to the war would promote faster economic growth and eliminate a large part of the inflationary risks.

By contrast, if security risks were to persist for longer than currently expected, they could lead to additional losses of Ukraine's economic potential and heavier inflationary pressures throughout the forecast horizon.

The following risks also remain relevant:

- decreased or less regular disbursements of international aid
- emergence of additional budget needs to maintain defense capabilities and substantial quasi-fiscal deficits, in the energy sector in particular
- significant damage to port and energy infrastructure that will restrain exports
- adverse trends in migration.

In contrast, the implementation of large-scale reconstruction projects in Ukraine could help accelerate the economic recovery significantly.

What is more, economic growth in the short run may be quicker than expected, if the capacity of sea export routes increases more significantly.

Taking into account the balance of risks and the need to continue to ensure that hryvnia-denominated assets are highly attractive, especially as FX market participants adjust to the managed flexibility of the exchange rate, the NBU Board has decided not to change the interest rates for the NBU's transactions with the banks

The previous steps to loosen the interest rate policy led to anticipated decreases in rates on hryvnia instruments. At the same time, current rates on hryvnia domestic government debt securities and deposits are sufficiently protecting the hryvnia from inflation-driven erosion of purchasing power.

On the other hand, the potential for easing the interest rate policy is currently limited, given the need to keep real interest rates on hryvnia instruments in positive territory.

In addition, to stimulate the further improvement of the term structure of bank deposits, the NBU has decided to adjust the parameters of the banks' investments in three-month certificates of deposit.

Specifically, from December 2023 forward, the only basis for calculating the cap on the banks' investments in three-month CDs will be the increase in hryvnia retail term deposits with maturities of more than three months. This will induce the banks to actively work with depositors to ramp up term deposits.

The ongoing interest rate policy easing will be balanced against the need to maintain the attractiveness of hryvnia assets.

Provided there are no signs that the balance of risks is deteriorating, and provided that market participants have successfully adapted to the new FX regime, the NBU sees the possibility of cutting the key policy rate further at its upcoming meeting.

That said, the expected trajectory of inflation and planned steps to liberalize the FX market some more limit the room for easing interest rate policy next year.

The NBU will only be able to return to the key policy rate easing cycle in 2024 if risks to exchange rate sustainability and inflation decline substantially.

Thank you for your attention!