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Monetary Policy in Ukraine: Past, Present and Future

Sergiy Nikolaychuk

Director of Monetary Policy and Economic Analysis Department

National Bank of Ukraine

University of Bergen

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Monetary policy evolution in Ukraine: From fixed exchange rate to inflation targeting

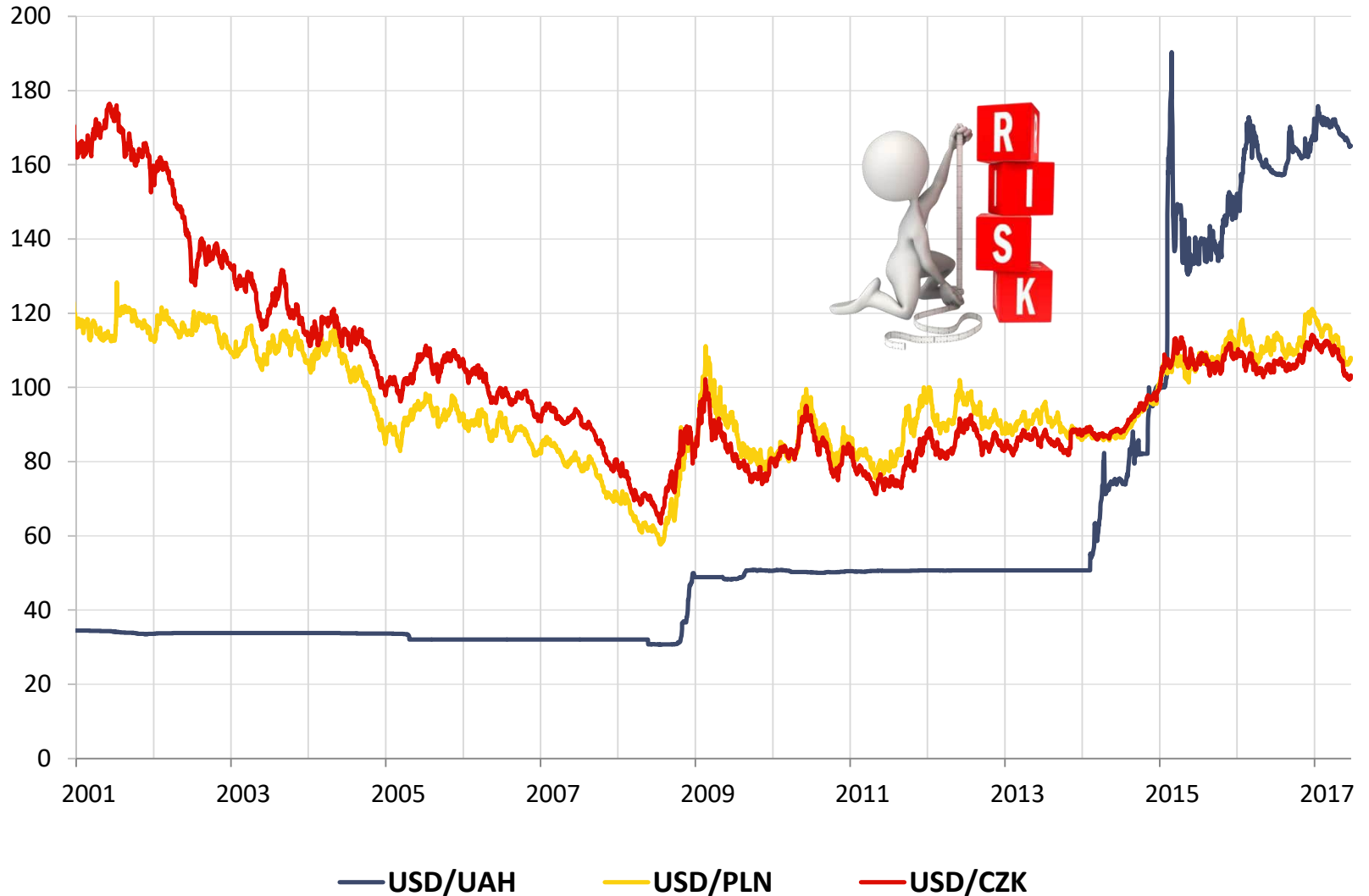
MONETARY POLICY		
Before 2014	2014 – 1H 2015	2H 2015 – nowadays
Fixed exchange rate	<p>Eclectic monetary policy aimed cleaning-up the consequences of crisis</p> <p>Building preconditions to inflation targeting adoption</p>	Flexible exchange rate
Unstable and unpredictable inflation		Disinflation and improving inflation expectations
Ad-hoc and discretionary decision-making		Proactive rule-based decision-making
Fragile communications on monetary policy decisions		High transparency and accountability of the NBU
Low institutional strength and independence of the NBU		High institutional standards and independence of the NBU
NBU`s participation in financing fiscal and quasi-fiscal deficits		No fiscal dominance



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Ukraine experienced several currency crises while using hard peg regime. Economy functioned without credible nominal anchor

Exchange rates, 31.12.2014=100

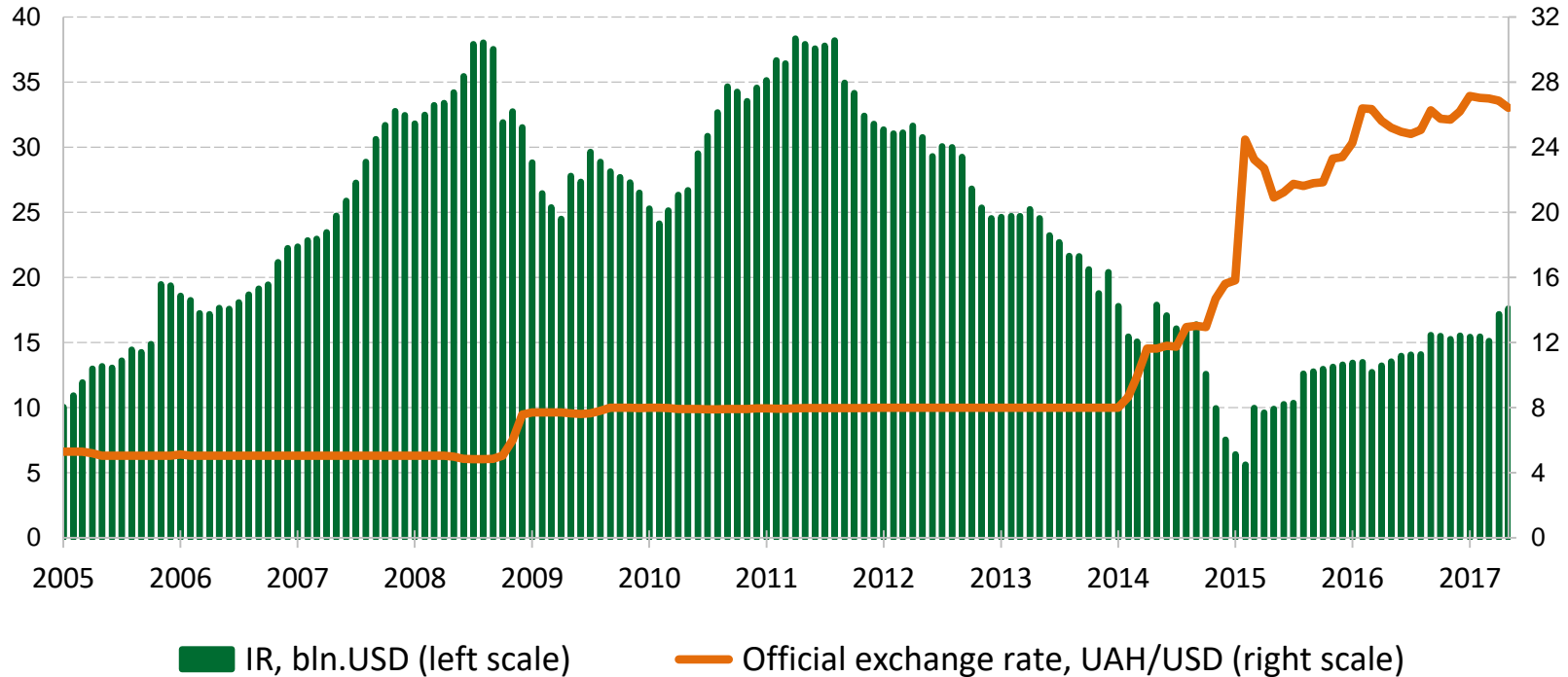




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Fixed exchange rate creates an illusion of stability... ... which disappears with depletion of international reserves

International Reserves and Hryvnia Exchange Rate per USD



**Maintaining the
exchange rate stability
(unchanged level)**



international reserves decreasing



loss of competitiveness by domestic
producers



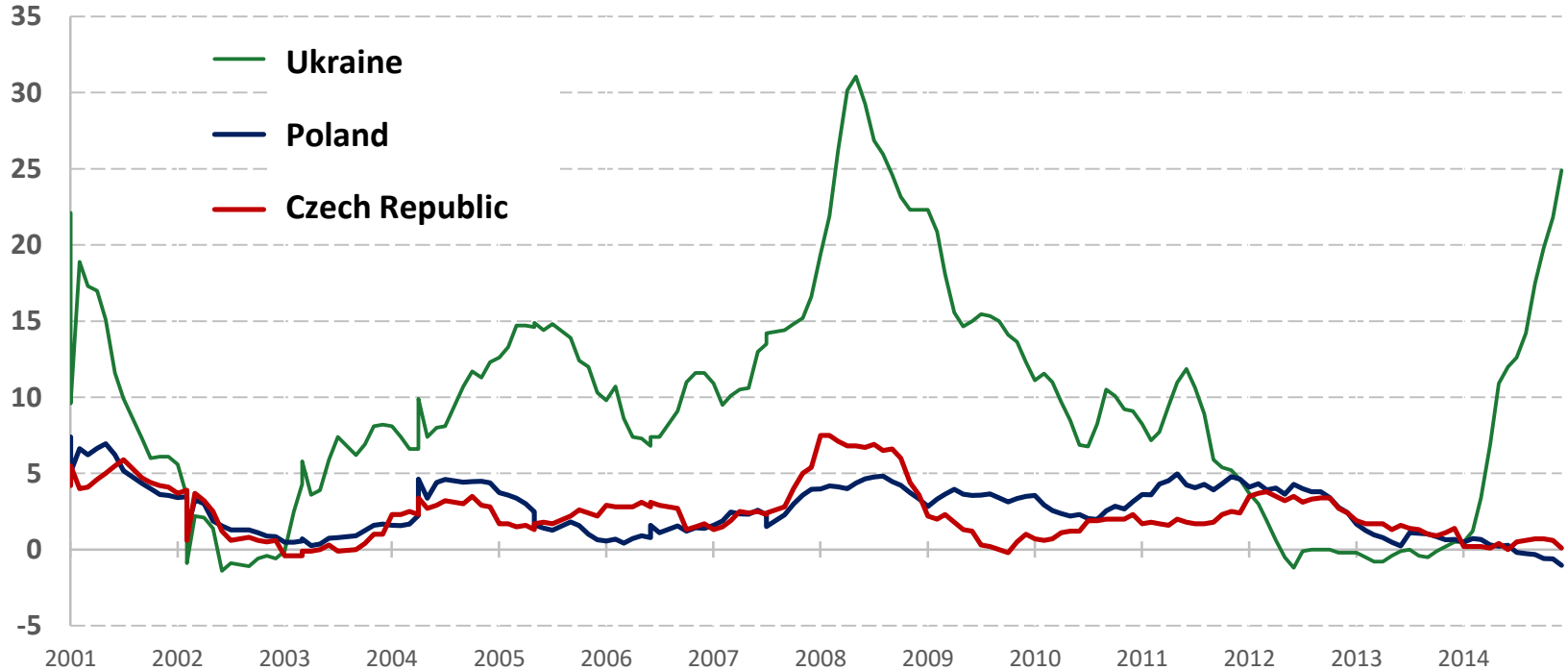
domestic currency devaluation and
increasing of inflation



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Economy had been highly vulnerable to external shocks under hard peg

Inflation in 2001-2014, % yoy

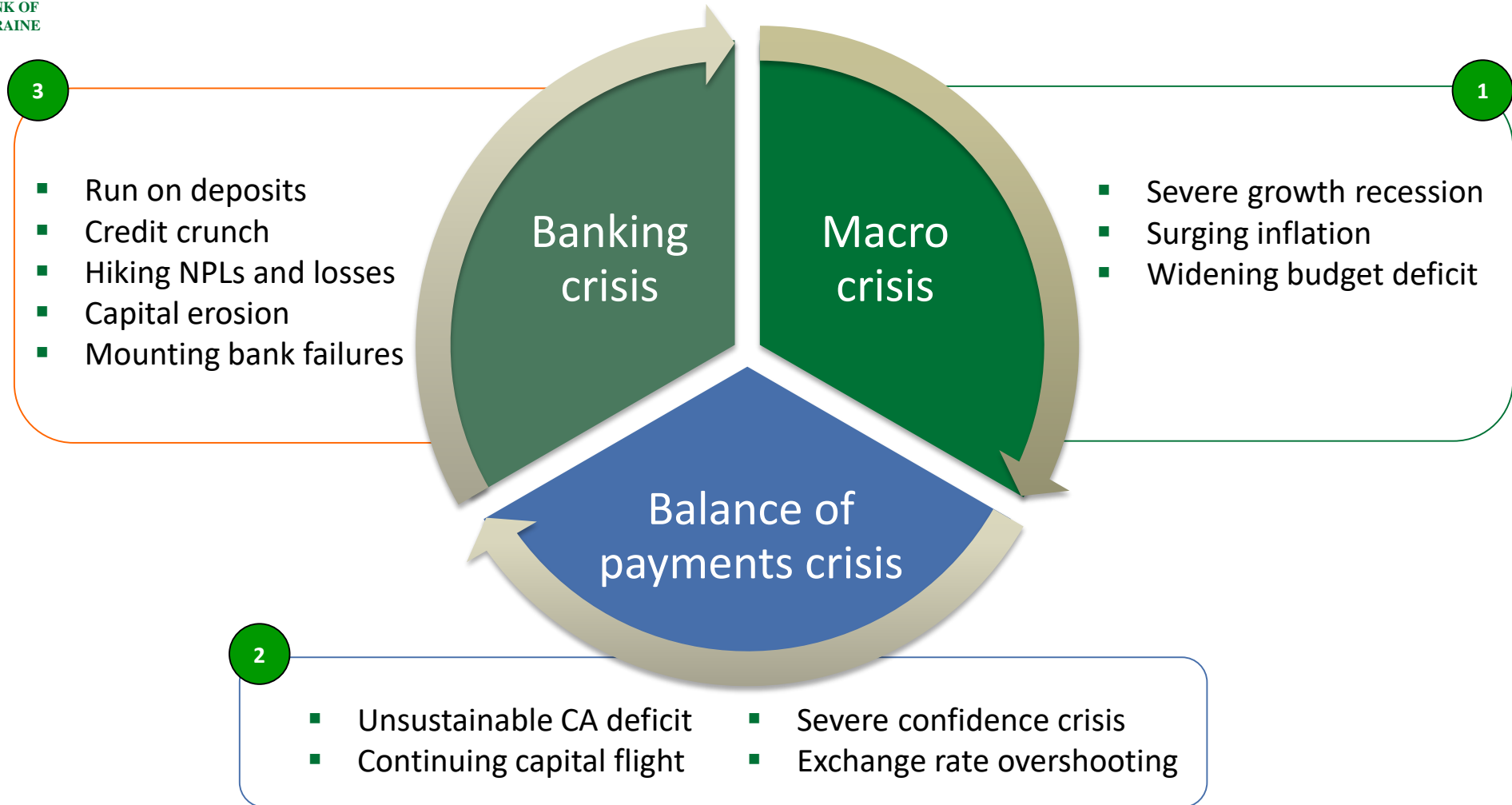


Unexpected inflationary dynamics complicates the process of making decision on savings and investments of economic agents



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Ukrainian economy in 2014-15: Plagued by the textbook “triple crisis”



The situation in Ukraine is not unique:

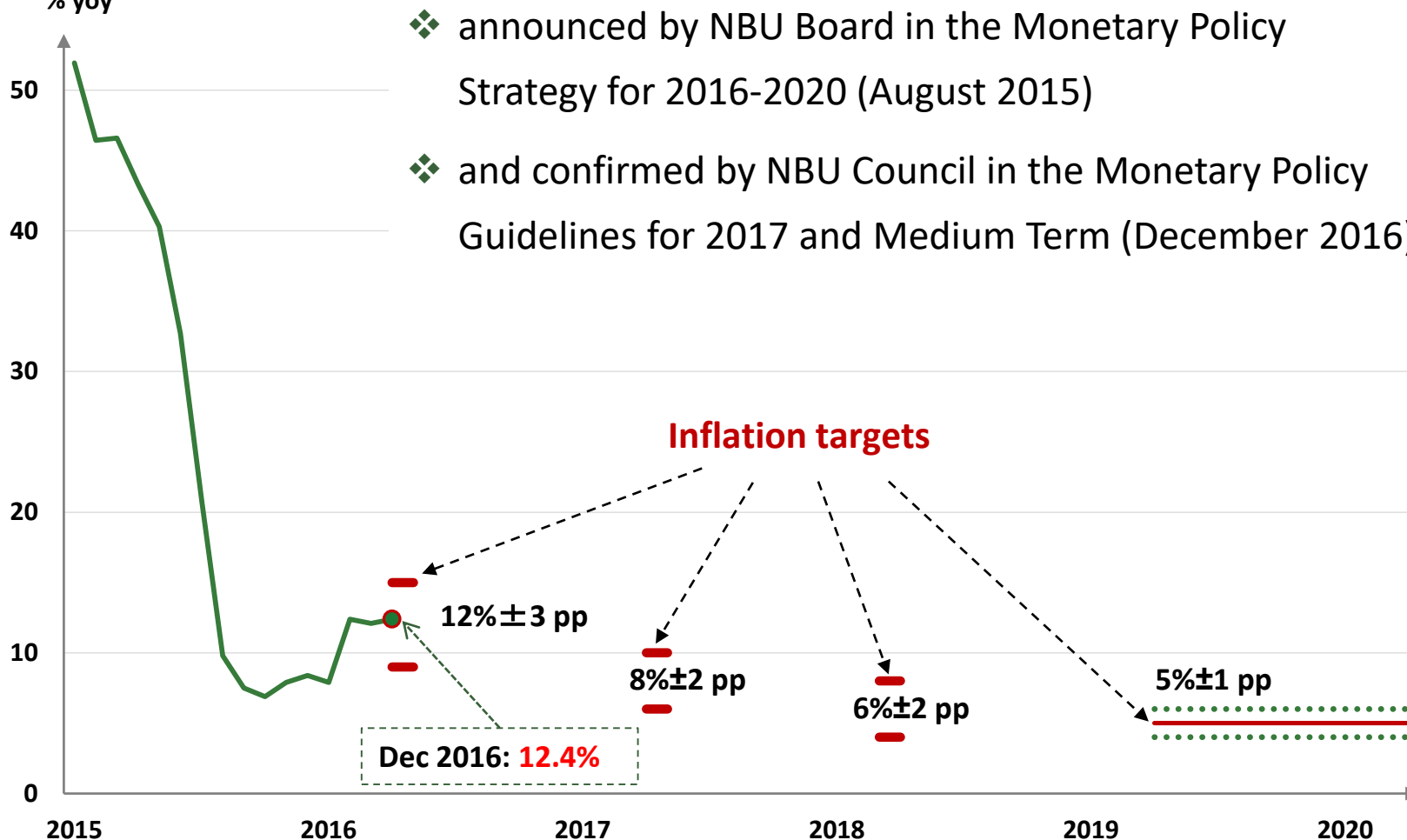
- Mexico (1994/95), Argentina (1994/95)
- Thailand (1997), Indonesia(1997), Malaysia (1997), Philippines (1997)
- Russia (1998); Turkey (2001); Ukraine (2009)



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Transition to Inflation targeting as monetary policy framework by the NBU

Headline Inflation,
% yoy



- ❖ announced by NBU Board in the Monetary Policy Strategy for 2016-2020 (August 2015)
- ❖ and confirmed by NBU Council in the Monetary Policy Guidelines for 2017 and Medium Term (December 2016)

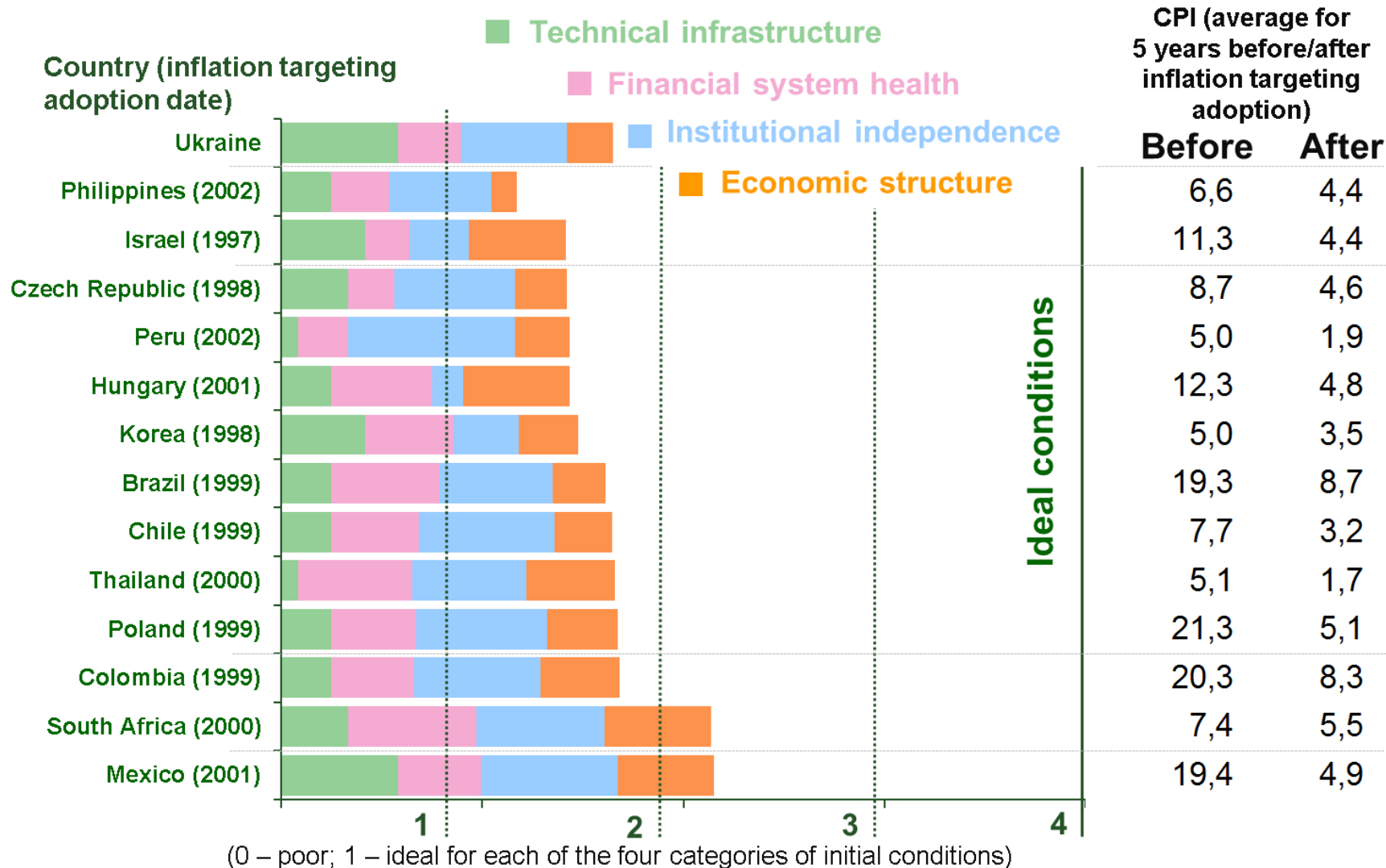
Inflation targets

! Inflation target for 2016 year-end was achieved



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Comparative analysis of preconditions for implementation of inflation targeting

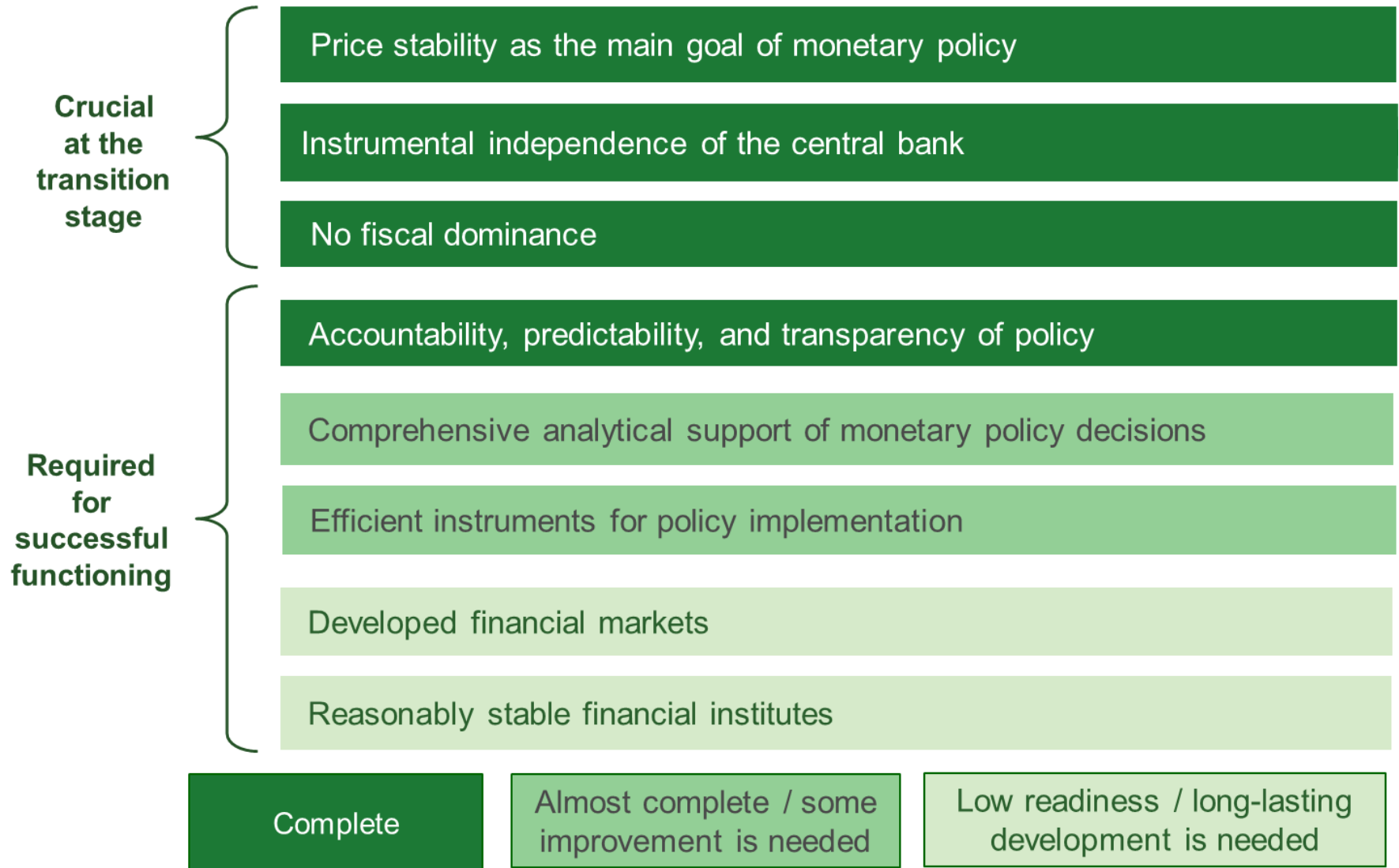


Source: World Economic Outlook, September 2005: Chapter 4. Does Inflation Targeting Work in Emerging Markets?
NBU staff estimates



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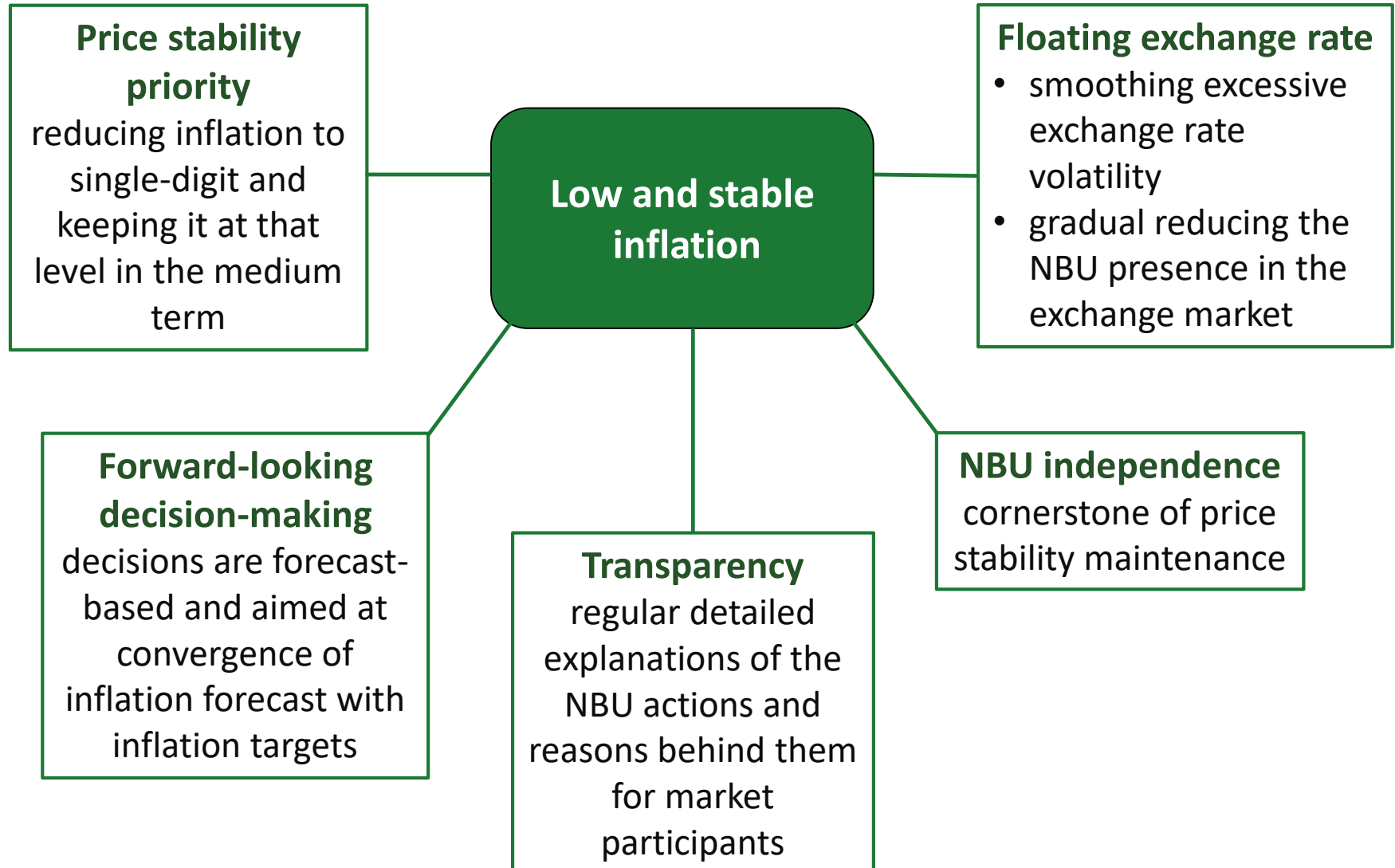
Required preconditions for functioning of the inflation targeting regime





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Main principles of monetary policy implementation (according to MP Guidelines for 2017 and medium term)





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Actions for reaching inflation targets

**Conducting interest rate policy,
consistent with inflation targets**

Maintaining monetary policy appropriately tight

**Smoothing the excessive exchange rate
fluctuations**

Using FX interventions to smooth exchange rate fluctuations within flexible exchange rate framework

No fiscal dominance

Securing autonomy to conduct monetary policy aimed exclusively on price stability objectives, prevent the use of money-printing for financing fiscal and quasi-fiscal needs

Prudent fiscal policy

Reasonable budget deficit.
Social payments increase according to the plan

**Bringing administered prices to fair
market values**

Elimination of quasi-fiscal imbalances.
Increase in administered prices according to the schedule



**Continue cooperation with the IMF
Carry out structural reforms**

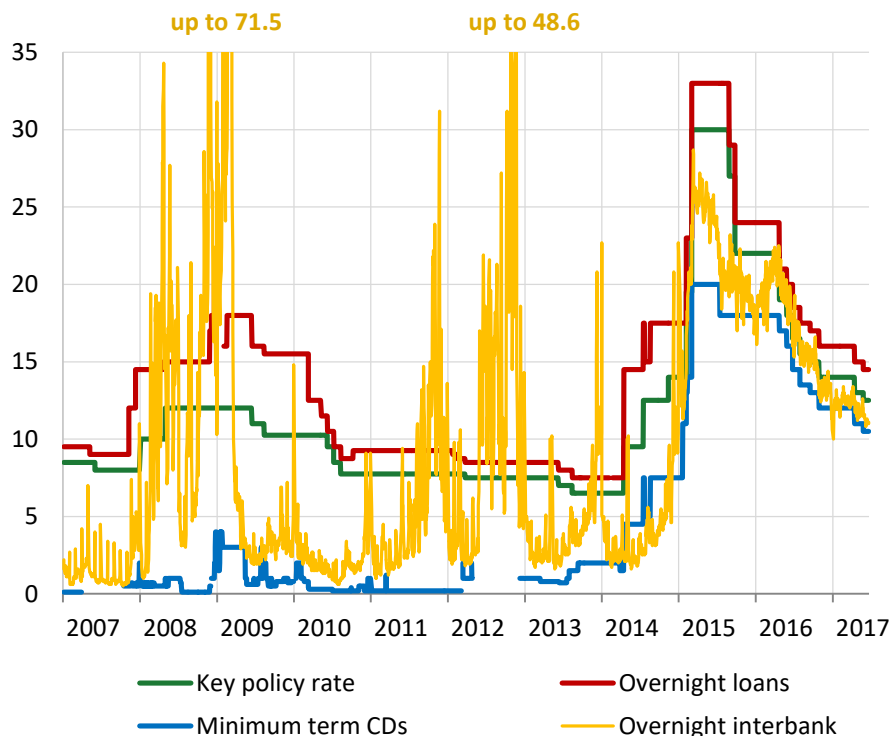




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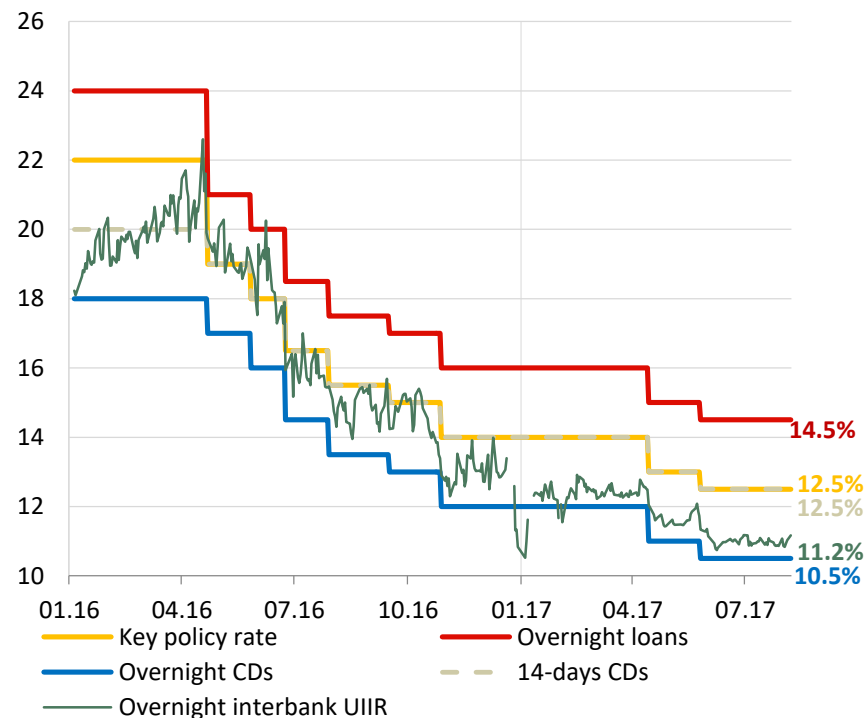
NBU has streamlined its interest rate policy framework

NBU's policy rates and Overnight Interbank (as of 21.06.2017), % pa



Source: CredInfo, NBU

NBU's policy rates and UIIR (as of 07.08.2017), % pa



Source: NBU

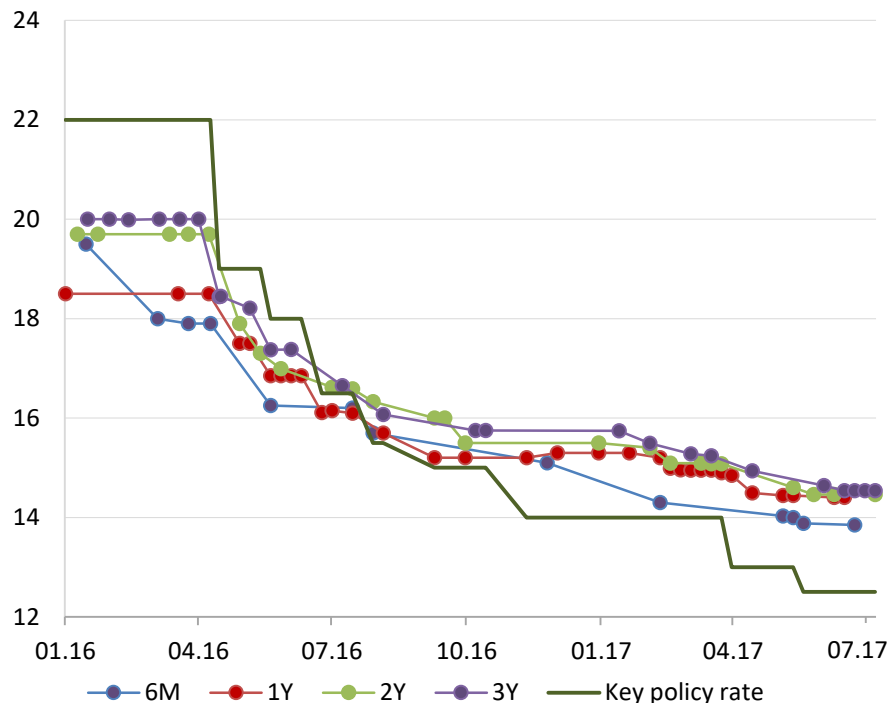
- In the past, NBU policy rate played a virtual signaling role
- In April 2016, the NBU strengthened the role of interest rate policy by defining key rate as the interest rate on main NBU operations (liquidity providing or absorbing), setting a symmetric and fixed band for standing facilities, and optimizing auxiliary tools
- Disinflation trend in 2016-2017 allowed to actively cut key policy rate, which swiftly transmitted into market interest rates



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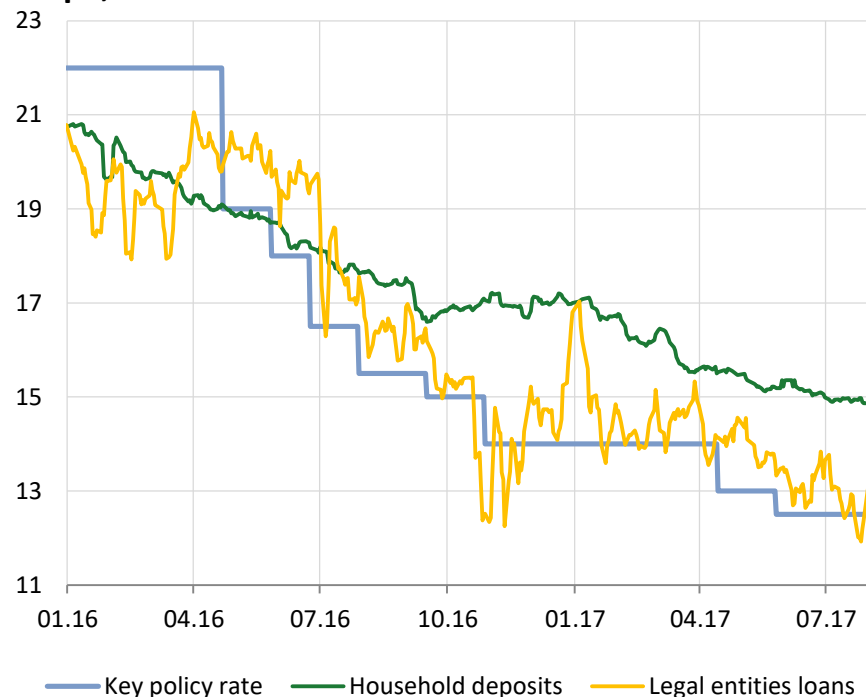
NBU rate decisions were swiftly transmitting into market interest rate developments, although retail rates respond with some delay

Yields on Government Bonds by Selected Maturity*, % pa, as of 18.07.2017



* One-year securities include bonds maturing in 11 months
Source: NBU

Key Policy Rate and Retail Hryvnia Interest Rates, % pa, as of 03.08.2017



Source: NBU

- Since late 2016 until April 2017, the NBU Board paused monetary policy easing cycle amid increased risks to the inflation targets for 2017-2018, including due to an unanticipated increase in minimum wage
- As a result, market interest rate developments also flattened
- In April and May, the NBU Board resumed the easing cycle, cutting its key policy rate by 1 p.p. and 0.5 p.p., respectively, to 12.5%. The market rates are expected to follow up



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Peculiarities of monetary transmission mechanism in Ukraine

Peculiarities	Consequences
<ul style="list-style-type: none">• Long-term yield curve is not formed yet	<ul style="list-style-type: none">• The NBU has limited influence on long-term interest rates
<ul style="list-style-type: none">• ER pass-through is strong and quick	<ul style="list-style-type: none">• High dependence on external factors
<ul style="list-style-type: none">• High inertia of ER expectations and administrative restrictions on FX market	<ul style="list-style-type: none">• ER response on rates movement is quite limited
<ul style="list-style-type: none">• Banking system under stress	<ul style="list-style-type: none">• Low impact of rates on domestic demand
<ul style="list-style-type: none">• Adaptive expectations are considerably focused on ER	<ul style="list-style-type: none">• Anchoring role of NBU's inflation targets is poor
<ul style="list-style-type: none">• Sizable share of food products in CPI basket structure	<ul style="list-style-type: none">• Significant impact of shocks from the supply side

- Developing financial markets and promoting financial stability should improve the functioning of monetary transmission mechanism



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Inflation targeting = inflation forecast targeting ('constrained discretion')

The policy rule:

- The policy rule defines the level of policy instrument at which the forecast of targeted variable matches the target
- In the case of monetary policy: the target is inflation, the instrument is interest rate, and the policy rule determines the level of interest rate at which the inflation forecast meets the inflation target
- In practice, the policy rule is more flexible (in the form of Taylor-type rule):



$$i_t = \alpha i_{t-1} + (1 - \alpha) [\bar{r}_t + \pi_t^{\text{exp}}] + \beta (\pi_{t+4} - \pi_{t+4}^{\text{arg}}) + \gamma y_t^{\text{gap}}$$

Backward-looking
persistence

Neutral real
Interest rate

Expected
inflation

Deviation
from target

Output
GAP

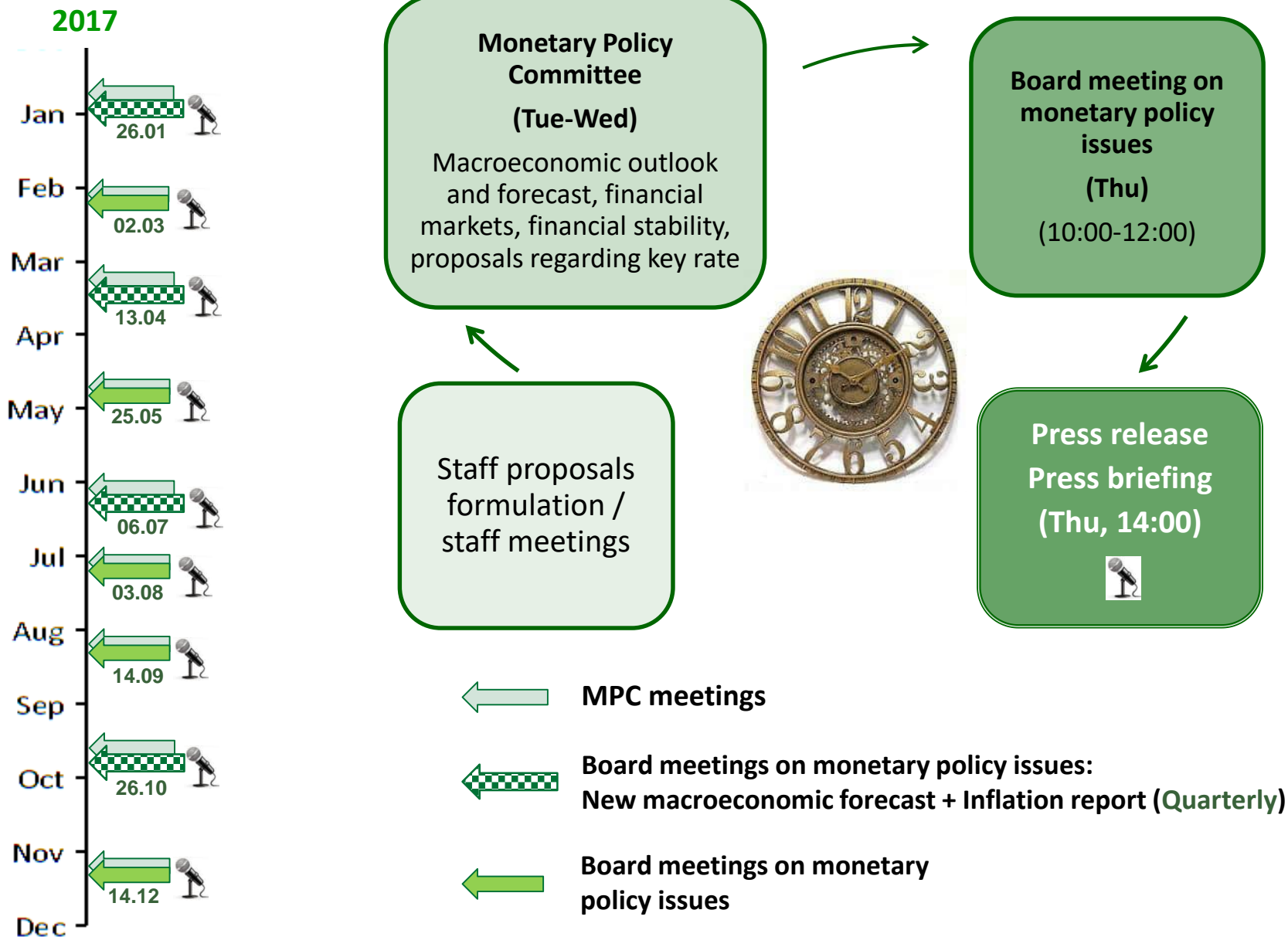
Inflation targeting is much more complex monetary regime compared with others

- decisions should be taken now without information about future shocks, which leads to permanent errors



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Decision-making cycle at the NBU



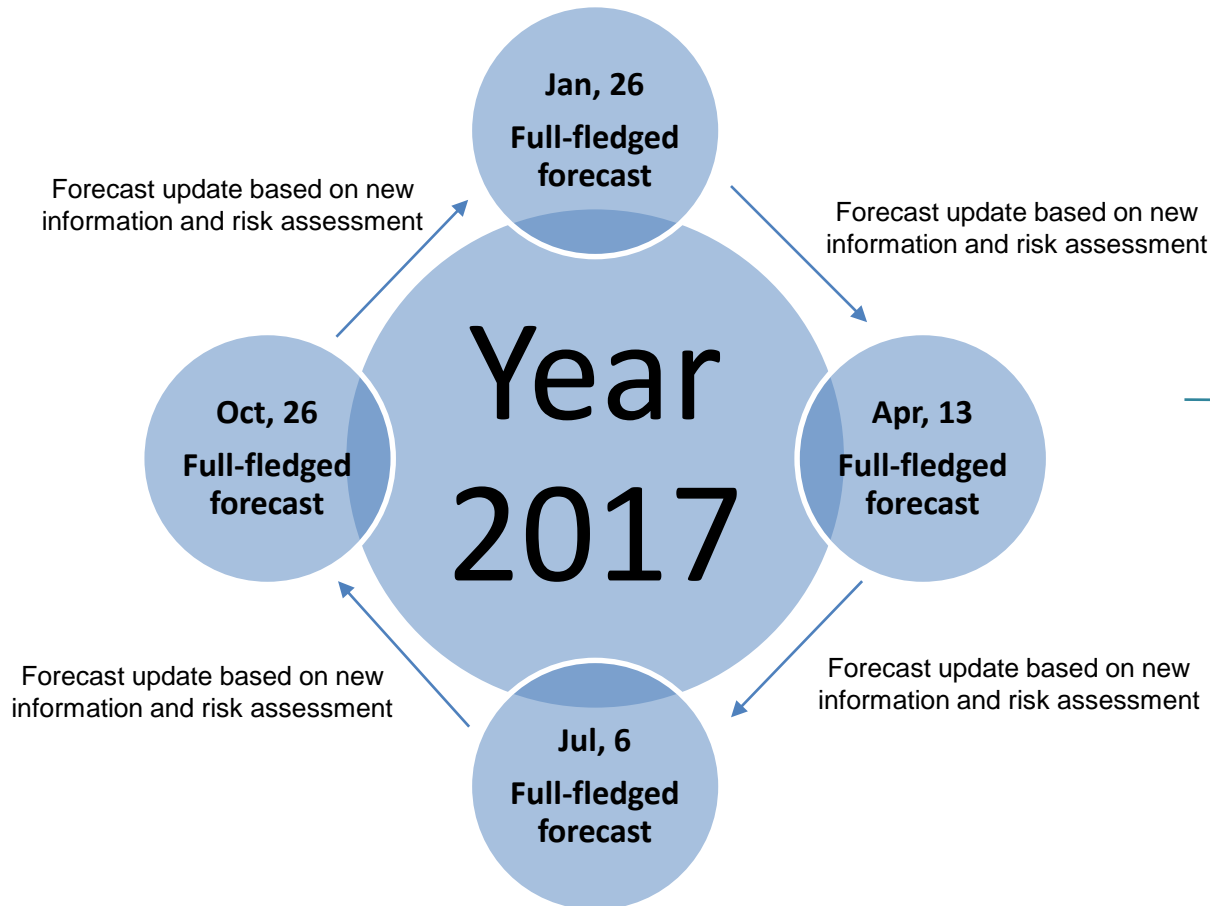


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Forecasting process

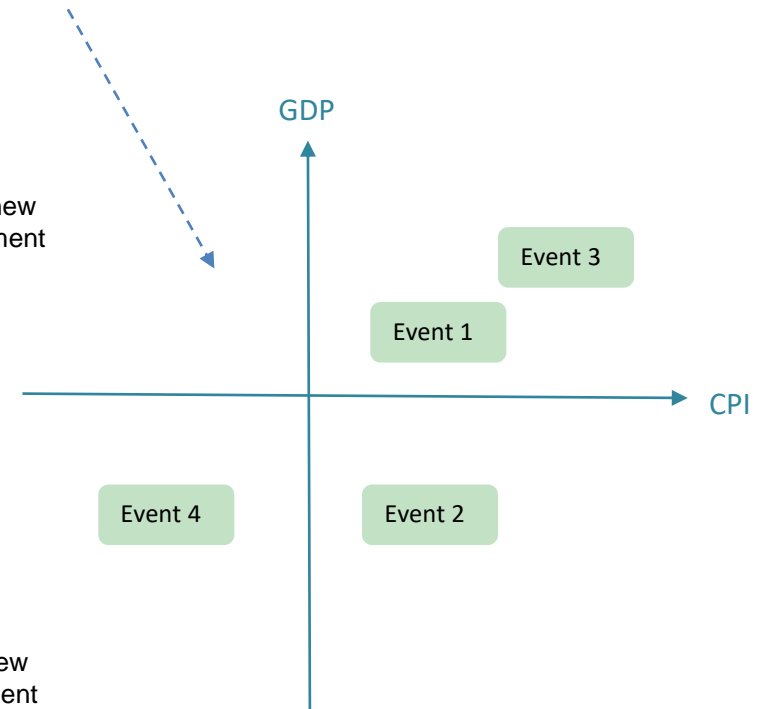
- **Main meetings (4 times per year)**

- full macroeconomic forecast based on the core model



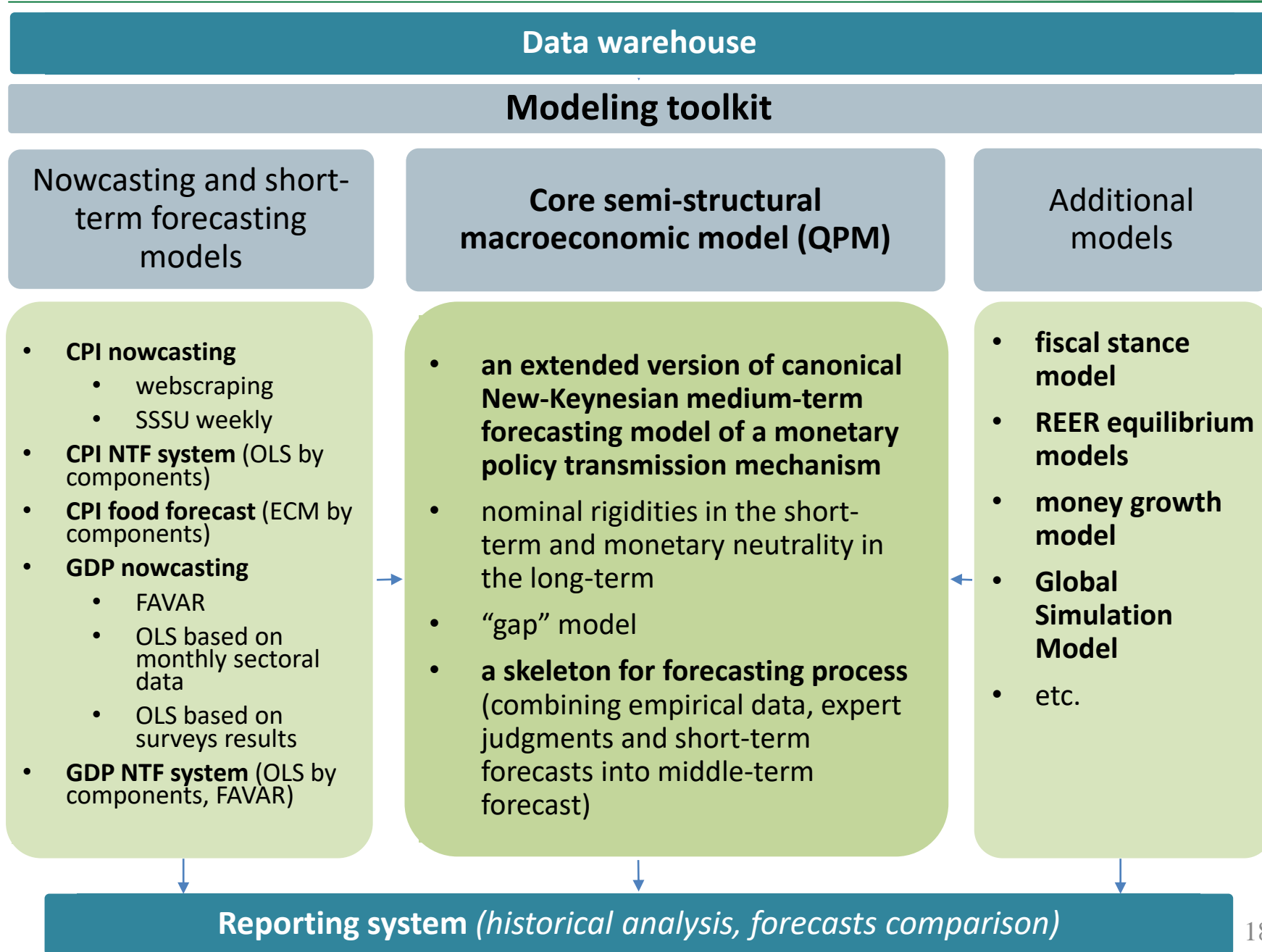
- **Intermediate meetings (4-5 times per year)**

- New data vs forecast
- Short-term forecast update (simple models)
- Balance of risks





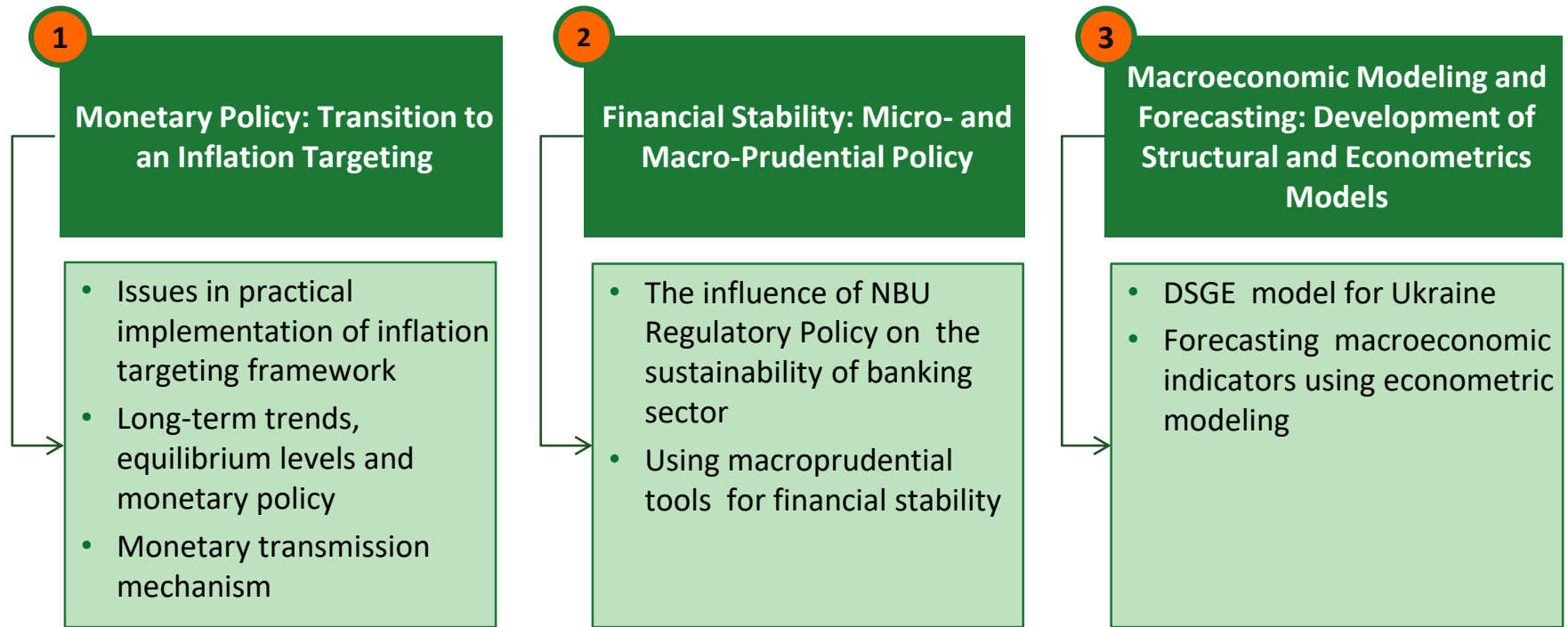
Modeling toolkit: General overview





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Research Priorities of the NBU in 2017-2019 and selected ongoing projects in monetary policy area



- The evaluation of the equilibrium interest rate for Ukraine
- Using FX interventions: Assessing the impact on ER
- Evaluation of Core Inflation Indicators
- CPI Nowcasting Using Web Scraping Tools
- Estimating Exchange Rate Pass-Through Using Micro Price Data
- Short-term Forecasting of Economic Activity in Ukraine Using Business Survey Data
- Forecasting Economic Activity with Dynamic Factor Models
- Assessing Financial Conditions
- Fiscal Impulse Estimation
- Nonlinear Estimation of Fiscal Multiplier in Ukraine
- Forecasting with DSGE



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Outline of Research activities at the NBU

- Research Unit is founded in 2015
- Reformatting the “Visnyk of the NBU” according to the requirements of international citation databases
- Launched the Working Paper Series of the NBU
- 15 open research seminars (including 7 seminars in 2017)
- Annual Research Conference:
 - “Transformation of Central Banking” organized in cooperation with Narodowy Bank Polski (19-20 May 2016)
 - “The Role of the Central Bank in Economic Development” organized in cooperation with Narodowy Bank Polski (18-19 May 2017)
- The conference for students and young researchers «Banking sector and monetary policy: the prospects for development» (21 April 2017)
- Launched Internship Program at the Research Unit
- Enhanced international cooperation with Riksbank, BOFIT, NBP and foreign academics
 - Visiting Scholar Program (2 participants in 2017)
 - Secondment from Swedish Riksbank (1 participant in 2017)



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Transparency and accountability are crucial issues under IT: “Doing What You Say and Saying What you Do”

Main Communication Channels:



Regular press-conferences
and press-releases



Meetings with experts,
round tables



Meetings with market
participants and business
representatives



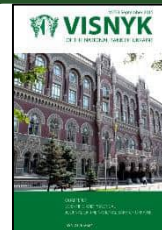
Lectures in Universities,
Seminars for Lectures



Inflation Report,
Macroeconomic and
Monetary Review
(monthly), Comments on
Inflation, etc.



Web site (chapter
«Monetary Policy»)



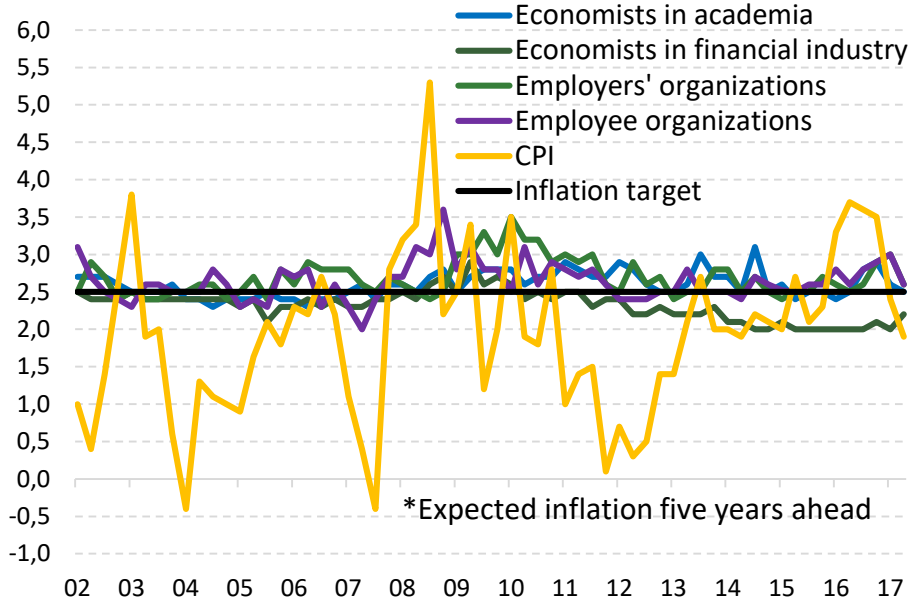
Research Journal “NBU
Visnyk”, NBU Working
Papers Series, other
research publications



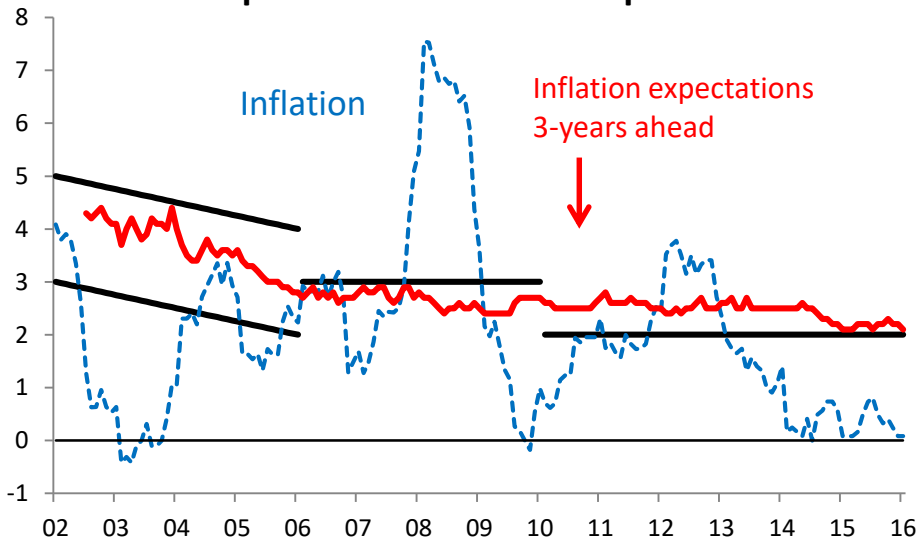
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IT implementation facilitates lowering and anchoring inflation expectations

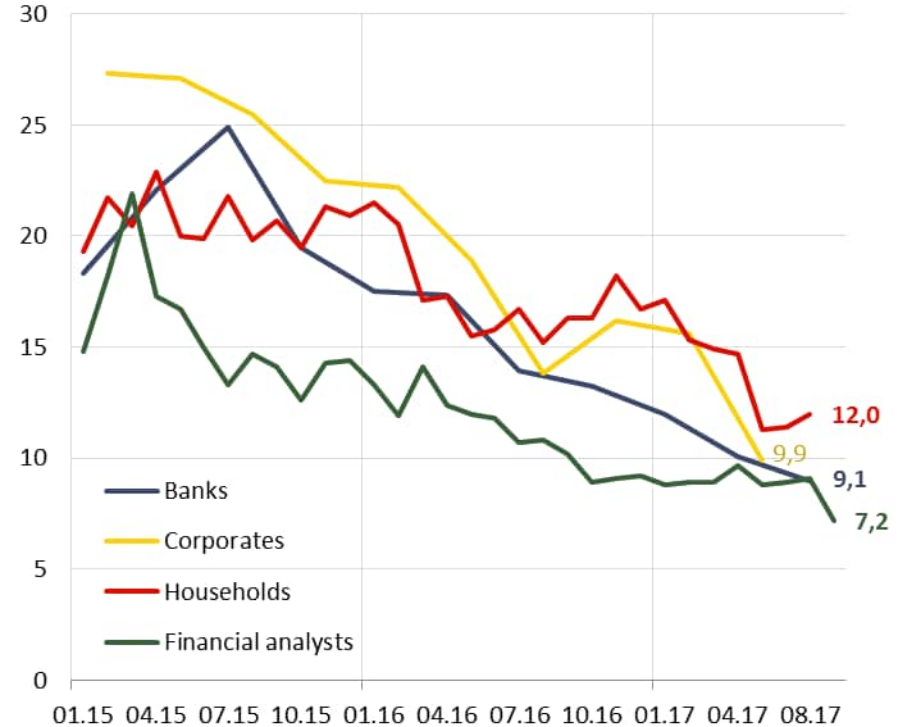
Norway: inflation and expectations*



Czech Republic: inflation and expectations



Inflation expectations for the next 12 months (average in Ukraine, %)

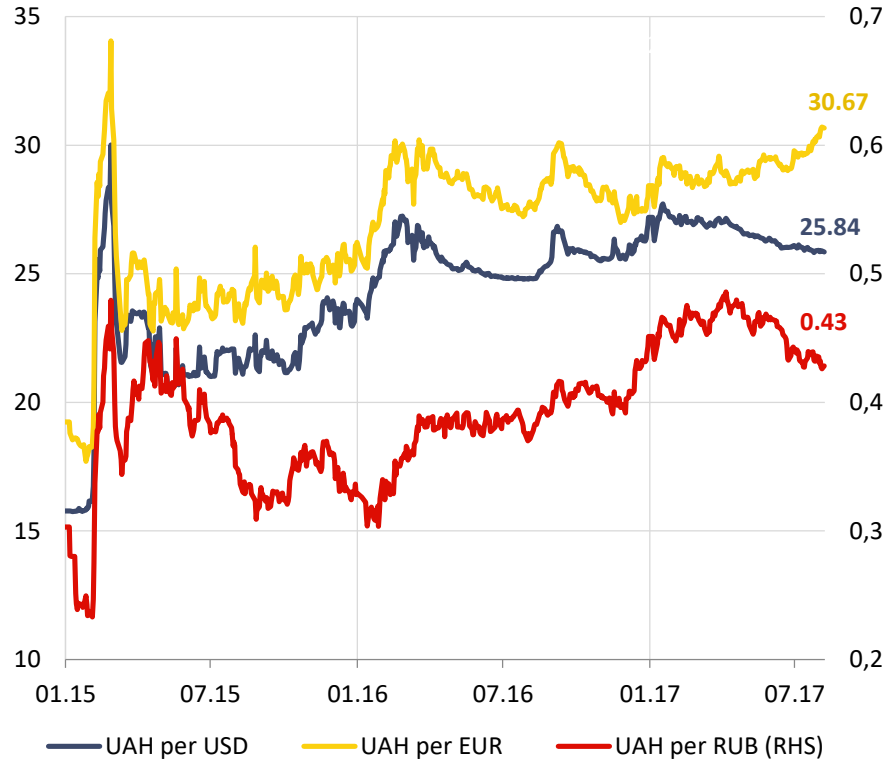




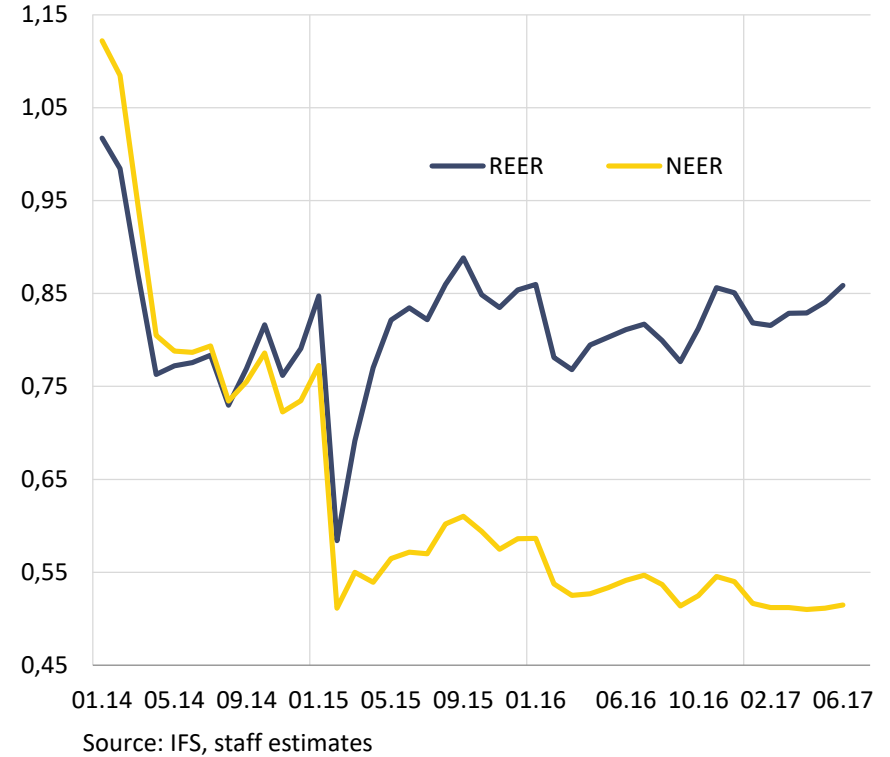
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The monetary policy is not be aimed at achieving the certain level or interval of exchange rate

Hryvnia Exchange Rate, as of 07.08.2017



Hryvnia REER and NEER Indices (based on interbank exchange rate, 12.2014=1)



- The NBU is committed to flexible exchange rate policy, keeping exchange rate broadly in line with the fundamentals
- Meanwhile, it continues to play active role at FX market but interventions are performed for clear and specific tasks (e.g., smoothing ST exchange rate volatility and replenishing its international reserves)
- Moderate exchange rate fluctuations over last 2 years contributed to macroeconomic and financial stability



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FX Intervention is an additional monetary instrument to perform clear and specific tasks

Tasks

- ❖ accumulation of international reserves
- ❖ smoothing out the functioning of the FX market
- ❖ supporting the transmission of the key policy rate as the main monetary policy instrument

Principles

- FX Strategy is consistent with Inflation targeting and floating ER
- NBU insists in minimizing the role of FX intervention as policy tool
- NBU does not counteract fundamental trends, only smooths their effects
- Criteria of banks' participation are open and transparent

FX Interventions Strategy

Forms

- FX auctions
- single-rate interventions
- request for quotations
- targeted interventions

Communications

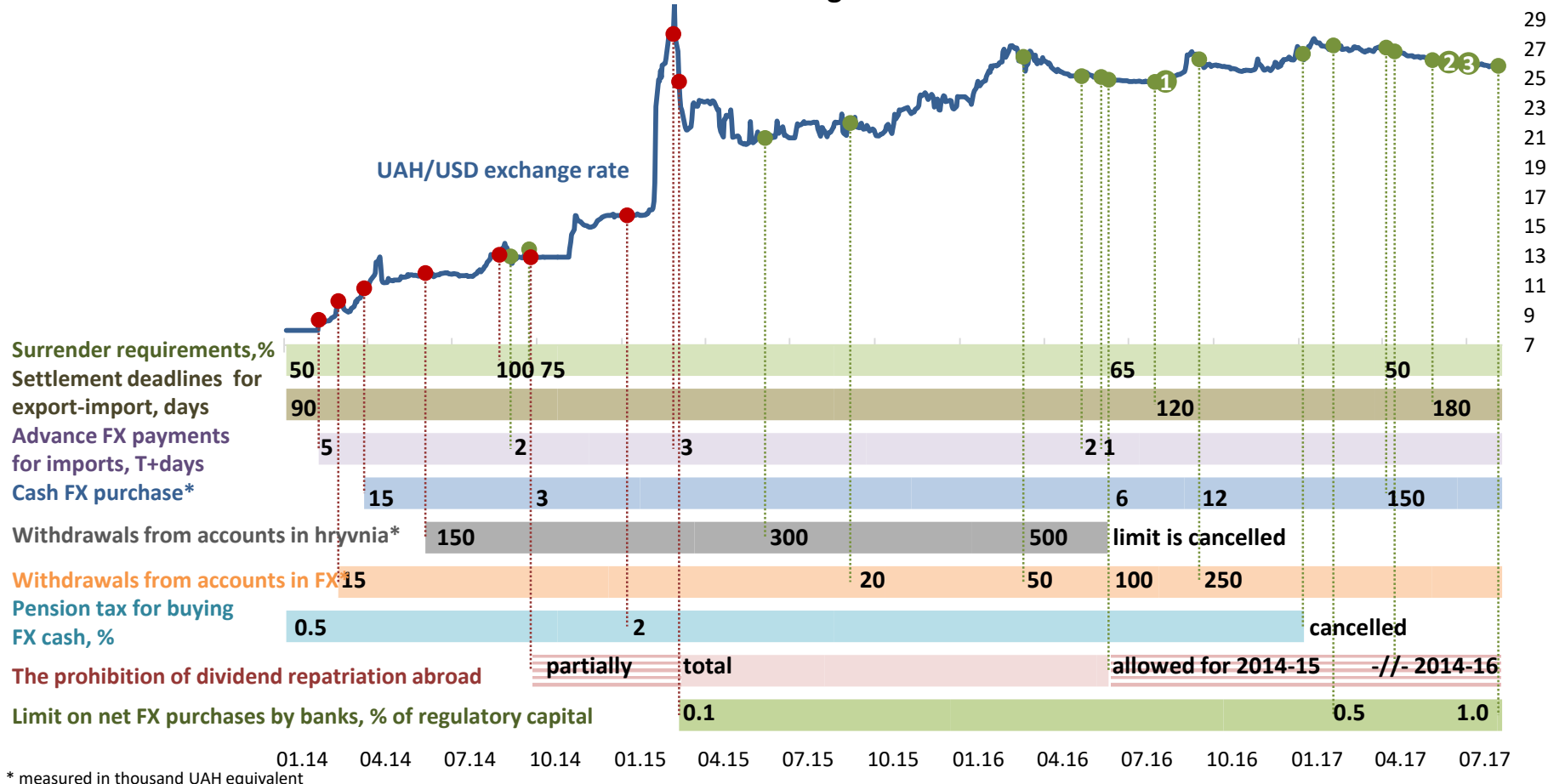
the NBU maintains a reasonable level of transparency while disclosing information about its intentions to conduct FX interventions and their outcomes



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The National Bank of Ukraine continued relaxing administrative restrictions introduced in 2014-2015 to calm FX market

Evolution of FX market regulations

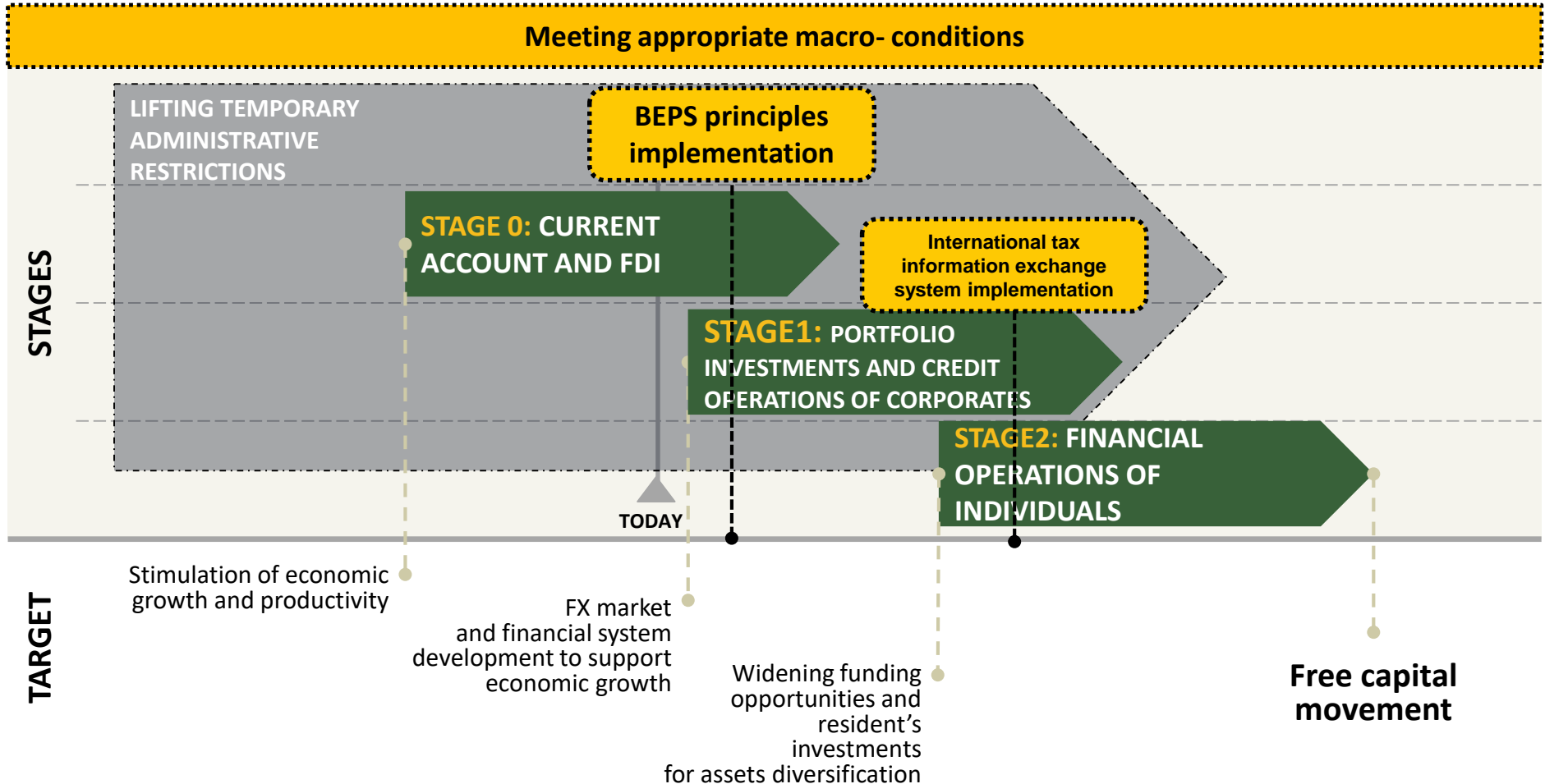


- ① Cancellation of ID request for FX transactions (up to 150 000 UAH)
- ② Lift of select restrictions on: (i) repatriation of funds invested in Ukraine and (ii) transfers abroad by individuals related to non-commercial operations. (iii) Increase of annual limit for investing abroad from USD 0.6 to 2.0 bn
- ③ Launching E-licenses for FX transfers abroad by individuals



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The NBU has been implementing conditional FX liberalization plan



- Transition to the next stage of currency liberalization can be done in case of implementation of OECD recommendations to BEPS resistance and unified standard of automatic exchange of financial information



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NBU policy actions to revamp the banking system and transforming the central bank

Revamping the banking system

- Ensuring adequate capitalization of the banking system
 - conducting asset quality reviews and stress-testing for small banks
 - sticking to the recapitalization schedule
- Restoring bank lending activities
 - ensuring implementation of effective mechanism for creditor's rights protection
 - capacity building for effective resolution of NPLs
- Solving the related party lending problem
- Implementing new Basel-consistent capital and liquidity regulations
- Strengthening banking supervision
 - implementation of risk-based supervision approach consistent with SREP (supervisory review and evaluation process)
 - improving early warning system
 - developing and implementing macroprudential supervision tools

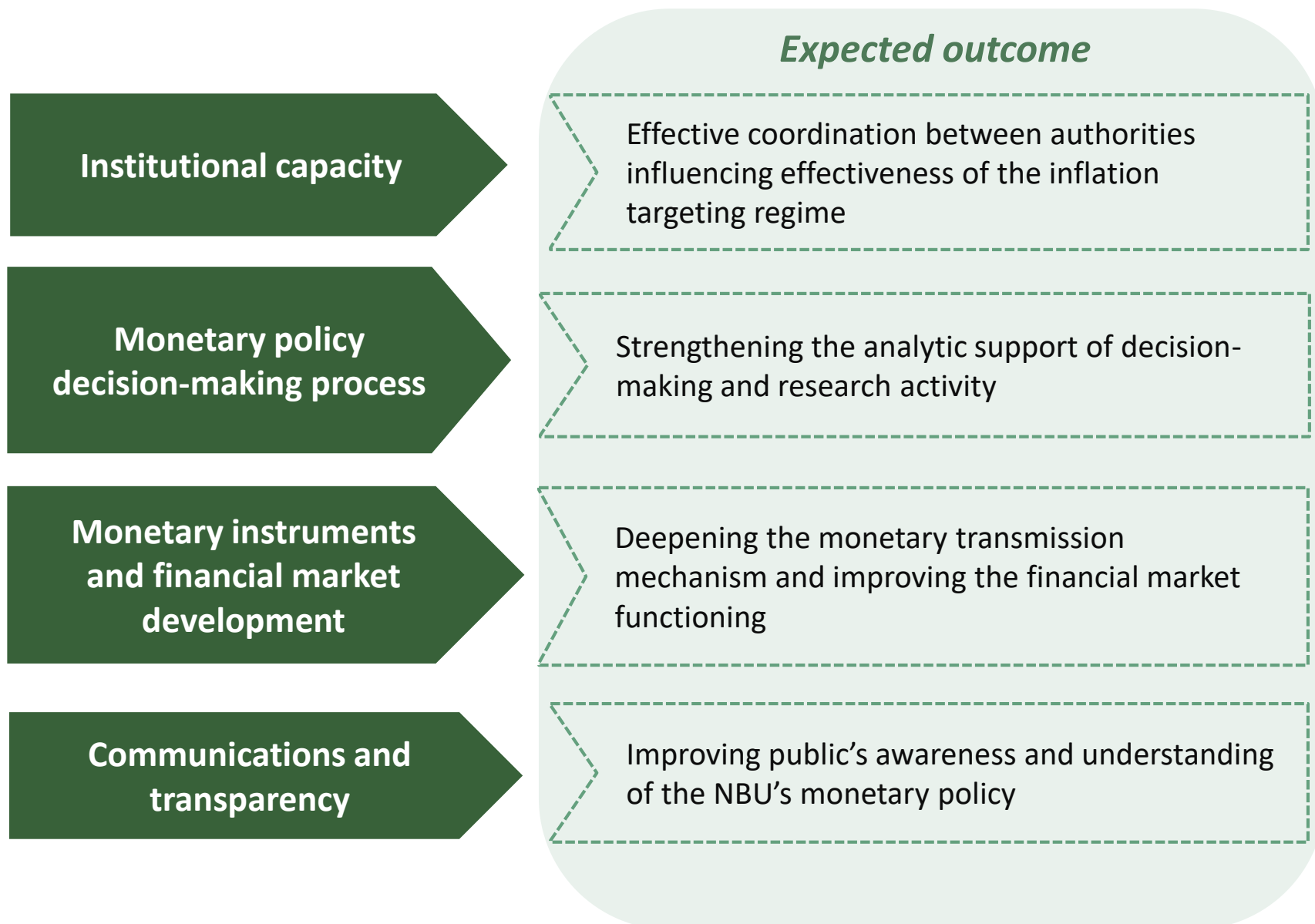
Priorities in other sectors

- Promoting cashless payments ("Cashless economy" project)
- Enhancing financial awareness of the population
- The continuation of NBU internal transformation, implementing project management approach, Open data project, etc.



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Main directions of further actions in monetary policy area





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Moderately optimistic view for the future



The NBU's efforts in 2017-2019 will be aimed at:

- Achieving the declared inflation targets (2017 – 8% +/- 2 p. p., 2018 – 6% +/- 2 p. p., 2019 and further – 5% +/- 1 p. p.)
- Easing monetary policy as inflation risks mitigate
- Promoting financial stability and supporting economic growth (to the extent that does not interfere ensuring price stability)
- Relaxing FX restrictions
- International reserves accumulation



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Key messages to retain

- The NBU has moved to Inflation targeting which is considered as a collection of modern central banking practices for achieving price stability
- Monetary policy is about making decisions on interest rate (and other instruments) in order to bring inflation forecast to target level

Changes the way monetary policy is done

- Floating ER
 - Interest rate is a main monetary policy tool
 - Prominent role of forecasts and risk analysis
 - Focus on transparency and accountability
- The priority of long-term results on short-term success
 - **Monetary decisions focused on achieving inflation targets and their communication to public are the self-generating instruments for anchoring inflation expectations**
 - **NBU's first experience was successful so far, but a lot of technical and policy work is ahead...**

