THE COUNCIL OF THE NATIONAL BANK OF UKRAINE

MONETARY POLICY STRATEGY OF THE NATIONAL BANK OF UKRAINE

Approved by the decision of the Council of the National Bank of Ukraine dated 13 July 2018

Kyiv, 2018

Preface

The Monetary Policy Strategy of the National Bank of Ukraine (hereinafter the "Strategy") defines the main goals, principles, and tools of monetary policy conducted by the National Bank of Ukraine (hereinafter the "NBU") and the directions of their evolution.

Approval of the Strategy is aimed at ensuring consistency of monetary policy and immutability of its goals and principles. This will contribute to enhancing predictability and consistency of monetary policy and stabilizing inflation expectations. At the same time, the detailed description of the goals, specifics of using the monetary policy tools, and the macroeconomic context of its implementation will be provided in the annual Monetary Policy Guidelines.

Monetary Policy Objectives and Monetary Regime

According to the Constitution of Ukraine, ensuring the stability of the currency unit shall be the major function of the central bank of the State – the National Bank of Ukraine. According to Article 6 of the Law of Ukraine *On the National Bank of Ukraine*,

when exercising its function, the NBU shall consider achievement and maintenance of price stability in the country to be its priority.

In line with Article 1 of the aforesaid Law of Ukraine, price stability means retaining purchasing power of domestic currency by maintaining low and stable rates of inflation, measured by the Consumer Price Index, over the medium term (from 3 to 5 years).

The NBU, acting within the scope of its authority, also promotes financial stability, including the stability of the banking system, without compromising its primary objective of price stability.

The NBU facilitates sustainable economic growth and supports the economic policies pursued by the Cabinet of Ministers of Ukraine, provided they do not contradict the NBU`s objectives of price and financial stability.

To attain its priority objective, the NBU applies the monetary regime of inflation targeting. This regime allowed many countries to reduce inflation to low levels and stabilize it, thus fostering stability of their national currencies. In turn, low and stable inflation is a prerequisite for macroeconomic stability and, therefore for creating the favorable environment for financial stability, rapid and sustainable economic growth, low real and nominal interest rates, low unemployment, and improved investment attractiveness of Ukraine. The NBU is currently at the first stage of inflation targeting implementation. This stage is characterized by disinflation, that is a gradual decrease in inflation to its optimal target level. At this first stage, the NBU makes efforts to enhance its institutional capacity of reaching the inflation targets and ensuring the necessary conditions for proper functioning of this monetary regime.

In particular, the central bank is working on:

obtaining support from the public and the government of Ukraine with regard to achieving price stability under the inflation targeting regime developing monetary policy tools and the operational design of monetary policy

bolstering analytical support for monetary policy decisions, particularly in terms of modeling tools enhancement and conducting research

improving the functioning of financial markets and the post-crisis recovery of the banking system, aimed at strengthening the monetary transmission mechanism

increasing transparency of monetary policy and improving the NBU’s communication with the public in order to effectively manage economic agents’ expectations.

Starting at the end of 2019, the NBU will apply the inflation targeting regime based on a constant medium-term inflation target. By that time, all necessary institutional conditions should be created to ensure successful conduct of monetary policy under this monetary regime.

The essence of inflation targeting regime lies in the public announcement of quantitative targets for inflation and the central bank's commitment to reach them over the medium term. The key policy rate is the main monetary tool and operational benchmark under this monetary regime. Monetary policy decisions, particularly those on the key policy rate, take into account inflation forecasts based on the comprehensive analysis and projections for the country’s macroeconomic, monetary, and financial development. In general, the applied approach envisages that if the forecasted inflation level is above the target, the key policy rate is increased to reduce it. And vice versa, if forecasted inflation is lower than the target level, the key policy rate is decreased. At the same time, monetary policy decisions will take into account the fact that the NBU reaches its inflation targets over the medium term.

By changing rates on its operations with banks, the NBU influences conditions under which banks make deals with each other on the money market and therefore influences the cost of short-term loans. As capital flows from one sector of the financial market to another, the cost of short-term funds impacts bank interest rates on loans and deposits for businesses and households, the hryvnia exchange rate, and prices of other financial assets.

In the end, by changing the interest rate, the NBU exerts an indirect influence on macroeconomic indicators such as GDP and inflation.

Principles of Monetary Policy

The NBU will carry out its monetary policy based on the monetary regime of inflation targeting under the following principles:

- the priority of achieving and maintaining price stability in the country
- forward-looking nature of monetary policy decisions, aimed at bringing inflation to the target over the medium term
- using the key policy rate as the main monetary policy tool
- improvement of the forecasting tools on an ongoing basis, including, in particular, the analysis of all available data, application of forecasting models and expert judgements
- adherence to the floating exchange rate regime

- the NBU's institutional, financial, and operational independence for the proper exercise of its functions
- transparency and accountability of the NBU's activity via established communication system with the public.

Quantitative Target for Inflation

The NBU considers that, based on the fundamentals of the Ukrainian economy at the present stage, the optimal target level of inflation (the annual CPI change) is 5 percent ±1 pp. The phase of reducing the inflation target from the current level to 5 percent will last until December 2019.

Starting at December 2019, the target of 5 percent will become a constant one to be revised only downwards, and only if the hryvnia exchange rate volatility and relative price volatility go down and the effects of Ukraine's economy convergence with the main trading partners weaken. This will bring the economic environment in Ukraine closer to the low-inflation conditions of the European Union. As Ukraine's domestic prices continue to approach the level of developed countries due to faster expected GDP growth, the medium-term inflation target is set above the level of developed countries. This will make the hryvnia real exchange rate stronger. Such appreciation that is driven by a somewhat higher inflation but not by the increase in the hryvnia nominal exchange rate is more attractive in view of ensuring competitive advantages in foreign trade and resilience of the economy's external position. In addition, the fact that Ukraine's inflation target exceeds the levels in developed economies reflects a higher relative price volatility, providing economic agents with important information signals they can use to achieve efficient allocation of resources.

A constant inflation target contributes to stabilization of expectations and higher transparency of the NBU's actions. This will allow interest rates to reflect inflation risks more accurately and allow interest rates to settle at a low level. The predictability of inflation and reduction of its volatility will further the development of the money market and facilitate borrowing for investment purposes.

In certain periods, inflation may deviate from the set target under the influence of the factors that are outside the scope of the NBU's monetary policy. In particular, these are changes in prices of raw commodities and other highly volatile components of the Consumer Price Index, deviations of administered prices from previously declared levels, and other.

The NBU will apply monetary policy tools to bring inflation back to the target within a reasonable policy horizon and, preventing harm to economic growth, will maintain inflation expectations at the level of the medium-term inflation target.

Anchoring inflation expectations at the level of the inflation target and actual inflation meeting the medium-term target are the main success criteria of monetary policy.

Coordinating Price and Financial Stability objectives

The environment of low and stable inflation and the floating exchange rate will help the NBU to fulfill its financial stability objective. This will be due to the stabilization of inflation expectations, prudent assessment of foreign exchange risks by economic agents, stronger trust to the hryvnia coupled with a gradual de-dollarization of the economy, and improved confidence in banks and other financial institutions.

The NBU applies monetary tools to support financial stability only in cases when systemic risk and complications in financial markets functioning significantly affect the prospects of inflation and economic activity.

Financial stability is a precondition for the proper functioning of the monetary transmission mechanism, particularly its interest rate and lending channels, and therefore an important factor of monetary policy efficiency. At the same time, financial stability is a prerequisite for stability of the domestic currency, which was particularly evident during financial and economic crises of the past decades.

The need to harmonize the objectives of price and financial stability is driven by the NBU’s dual role of the monetary and prudential authority.

The NBU assumes that the short-term interest rate is not the most optimal instrument to solve the problem of financial imbalances, while monetary policy has a limited effect on mismatches in the financial system.

Inflation targets are primarily attained by using monetary tools, while fulfilling the financial stability objectives involve the use of micro- and macroprudential regulation and supervision. Along with that, all objectives, carried-out functions, and used tools must be coordinated.

Increasing and maintaining net international reserves at high level will be another priority. The volume of and changes in international reserves shape the expectations of FX market participants because reserves can be used to smooth out peak increases in the exchange rate and support a stability of national currency over the medium term. An adequate level of international reserves will serve as a safeguard for the financial system stability and a buffer for offsetting the effects of external shocks on the economy.

Under certain conditions, the objectives of delivering price stability and accumulating international reserves may contradict one another. In this case, price stability will be the NBU’s priority both *de jure* and *de facto*.

Coordinating the objectives of price stability and promoting sustainable economic growth

The NBU’s main contribution to Ukraine’s sustainable economic growth in the long-term is creating the environment of low and stable inflation, as well as contributing to, within NBU’s remit, the country’s financial stability.

The NBU will rely on the flexibility of inflation targeting and, if the Ukrainian economy is affected by internal and external shocks, will mainly focus on bringing inflation back to its target, while also factoring in the need to bring GDP back to its potential level.

Inflation may deviate from its announced short-term targets because of factors over which monetary policy has no influence.

Under such circumstances, bringing inflation back to its target as soon as possible could have additional negative effect on economic growth. In this case, the NBU will aim its monetary instruments on preventing the second-round effects that arise from such developments, affecting inflation expectations, and on bringing inflation projections into line with inflation targets over a certain period.

The timeframe during which inflation will be brought back to its target will be communicated in a clear manner to the general public in each particular case.

Monetary instruments

The key policy rate. While conducting monetary policy aimed at achieving inflation targets, the NBU will use the key policy rate as its main monetary instrument. This rate is set by the NBU Board, taking into account prior discussions at a meeting of the Monetary Policy Committee[1], and reflects the monetary policy stance. At the same time, the key policy rate is the operational target of monetary policy for short-term interbank loan rates.

If inflation is projected to be higher than its target, the NBU will have to tighten its monetary policy to bring projected inflation back to the target level. Conversely, if inflation is projected to be below its target, the central bank will resort to monetary easing. By these means, inflation will always meet its mid-term target.

The main liquidity management operations, which have the strongest impact on the money market, will be conducted at the key policy rate (or at the rate that is close to the key policy rate in the case of auction-type operations)._Depending on the banking system's structural liquidity position (i.e. whether there is a deficit or surplus of liquidity), liquidity will be either provided or absorbed at this rate.

The overnight rate corridor. The corridor for overnight lending and deposit rates will be set alongside the key policy rate with the purpose of managing short-term interest rates on the interbank credit market, through limiting their fluctuations around the key policy rate.

Other instruments. The NBU will actively manage the banking system's liquidity by using other monetary instruments. These instruments, which will help the NBU to perform its functions (such as managing interbank credit market rates) and to foster the development of the financial markets as a whole, include:

refinancing tenders and issuance of NBU Certificates of Deposit through tenders with various maturities, repos, FX swaps, purchase/sales of government securities, and other instruments

reserve requirements. This instrument will be used to manage liquidity in the banking system, and to enhance the influence of a change in the key policy rate on interbank market rates.

Differentiated reserve requirements may be used in order to make liquidity regulation more effective, and to encourage banks to attract mainly deposits in hryvnia and for longer terms.

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[1]The Monetary Policy Committee (MPC) is an advisory body that was established with the aim of sharing information and opinions on monetary policy formulation and implementation in order to ensure price stability.

long-term refinancing. The NBU may provide refinancing loans with maturities of up to five years at a floating rate with the purpose of hedging risks of a change in liquidity conditions over the mid-term. These refinancing operations will be transparent and conducted on the equal access principle. Refinancing loan rates will be based on the key policy rate, which will help reinforce the interest rate channel of the monetary transmission mechanism.

This instrument will also serve to enhance the banking sector’s potential to lend to the real economy.

In order to prevent monetary inflation risks, monetary instrument decisions will factor in movements in monetary aggregates and liquidity in the banking system.

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The exchange rate regime and FX interventions

The NBU will remain committed to the floating exchange rate regime, meaning that it will not use monetary policy to achieve a certain level or the band of exchange rate.

The NBU will intervene in the FX market in order to:

accumulate international reserves

smooth hryvnia exchange rate volatility

and support the transmission of the key policy rate as the main monetary policy instrument.

As international reserves reach a sound level, the FX market performance is improved, its ability to balance supply and demand is noticeably enhanced, and the influence of the key policy rate on macroeconomic processes is made more effective, the NBU will gradually taper off its FX interventions and other types of interventions in the FX market that have the purpose of achieving the said goals.

Transparency and accountability

With the aim of stabilizing inflation expectations and meeting its priority objective, the NBU will conduct a consistent, accountable and transparent monetary policy.

The NBU will, on a regular basis, communicate its monetary decisions to the general public, providing detailed explanations of the nature, purpose, and expected effects of measures that are planned or have been taken. If inflation deviates from its target, the central bank will inform the general public of the reasons for this deviation, as well as about the actions that have been taken or are planned to bring inflation back to its target.

The NBU Board will hold monetary policy meetings in accordance with a pre-announced schedule. The results of decisions taken, and the rationale behind them, will be made public. The NBU will also make available Summary of the Discussion on the Key Policy Rate at the NBU Monetary Policy Committee on the regular basis.

The analytical materials and forecasts that provide the foundation for NBU Board monetary policy decisions will be published in Inflation Report and other public documents.

The NBU Council supervises the conduct of monetary policy. The procedure for such supervision is stipulated in a separate regulation.

The Monetary Policy Committee

The Monetary Policy Committee is an advisory body created for sharing information and views on monetary policy formulation and implementation in order to ensure price stability.

The main tasks of the Committee are to study and discuss the following issues:

formulating the principles of, and conducting, monetary policy with the purpose of meeting the objectives and performing the tasks set forth in Ukrainian laws and Monetary Policy Guidelines,

setting monetary policy objectives and benchmarks,

and using monetary instruments to meet policy objectives.

The Monetary Policy Committee meets the day before NBU Board meetings on monetary policy issues take place. The Committee can hold unscheduled meetings, if required.

Members of the Monetary Policy Committee: The NBU Governor – the head of the Committee; the Deputy Governor, who is responsible for formulation of the principles for the conduct of monetary policy and monetary stability, – the deputy head of the Committee; other members are the other Deputy Governors, the Directors of the relevant departments, and the Committee's secretary.

Coordinating monetary and fiscal policies

Important factors of influence on inflationary developments and the stability of Ukraine's national currency fall within the government's mandate. These include corrections of administered prices and deciding on the specific nature of economic and fiscal policies. Under such conditions, only a close coordination of the NBU's monetary policy with the government's economic and fiscal policies will ensure that monetary objectives and tasks are met.

The NBU and the government will join efforts to deliver macroeconomic conditions supportive for low and stable inflation. The central bank and the government will closely cooperate in order to coordinate monetary and fiscal policies – including with regard to the impact that the issuance of domestic government bonds and budget expenditures have on the money market – as well as in order to deliver financial sustainability.

Cooperation of the Government with the NBU will be held exclusively with respect to the independence of the last. The NBU will remain committed to avoiding any type of fiscal dominance, and will not provide direct or indirect support to budgetary spending. This commitment will be an important contributor to boosting confidence in monetary policy objectives.