



**NATIONAL BANK OF UKRAINE**

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## **Challenges for monetary policy and financial stability**

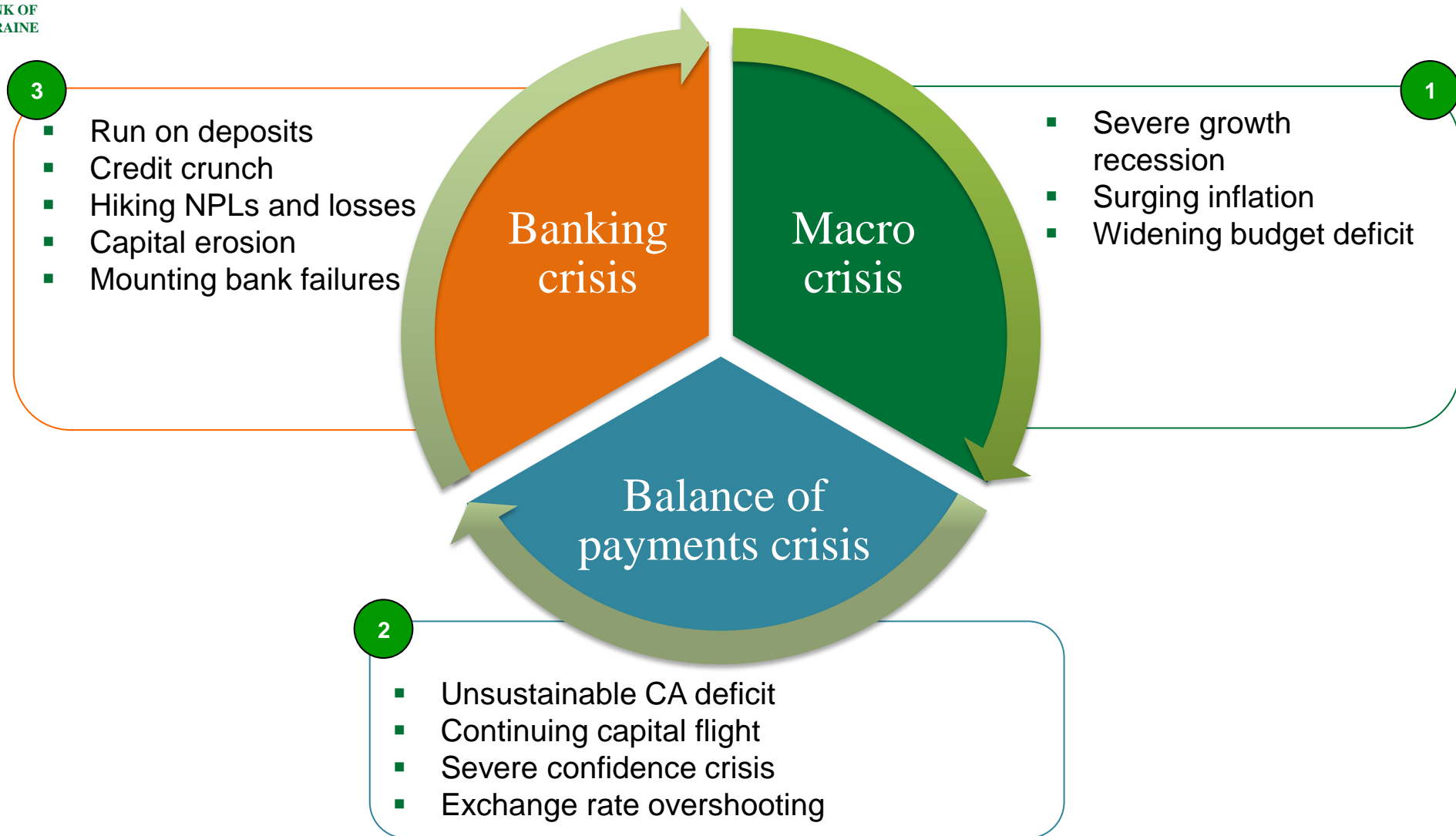
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Dmytro Sologub  
Deputy Governor  
National Bank of Ukraine



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# Ukraine: Plagued by the textbook “triple crisis”



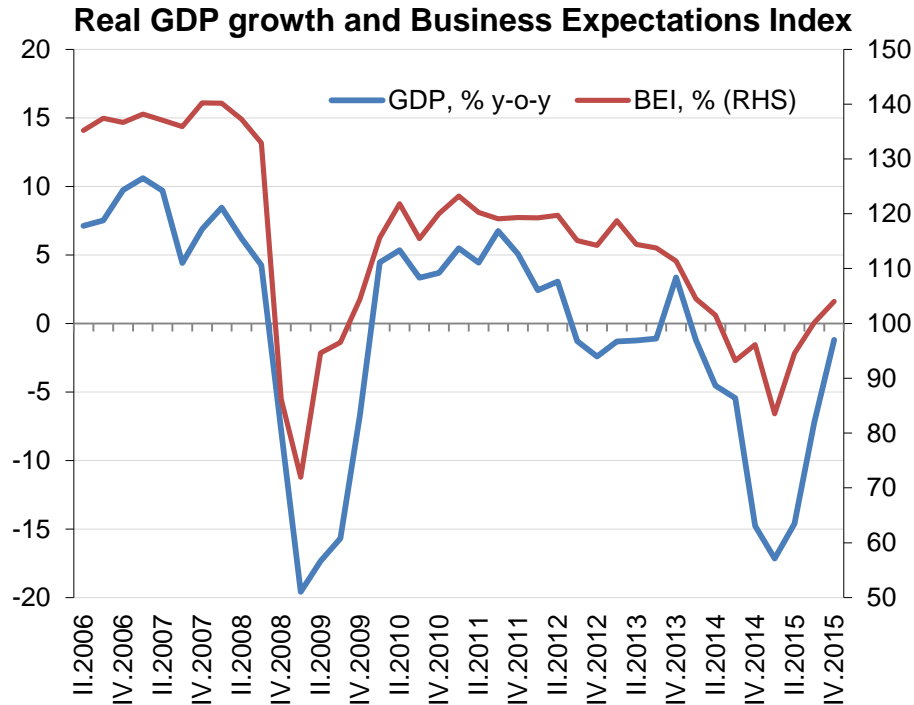
The situation in Ukraine is not unique:

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



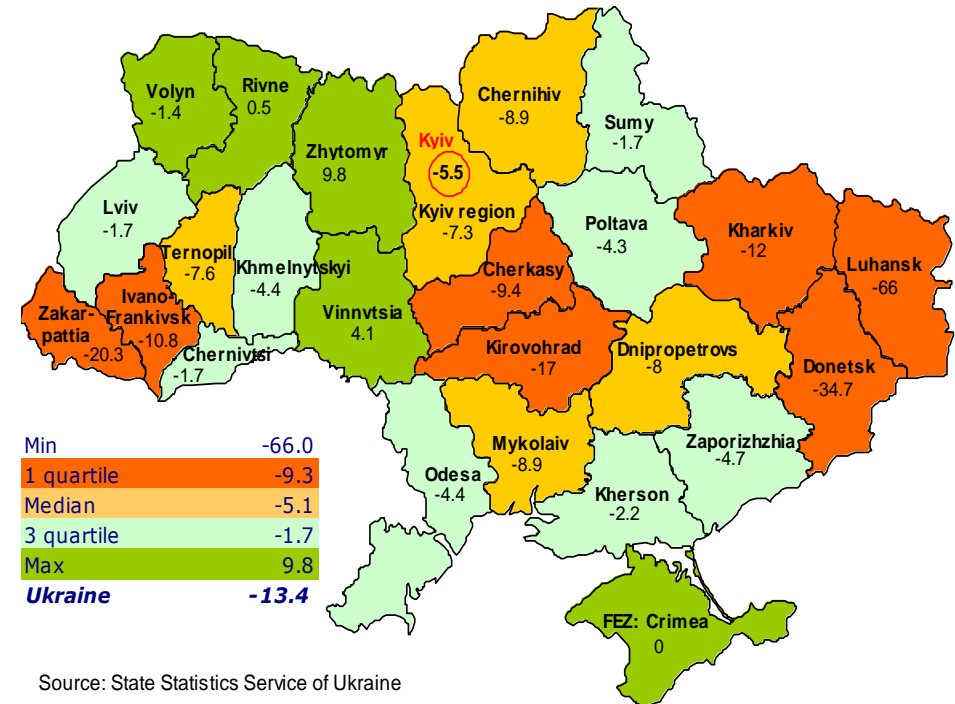
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# Sluggish economic recovery is underway



Source: State Statistics Service of Ukraine; NBU

### Industrial Output by Regions, 2015, % y-o-y



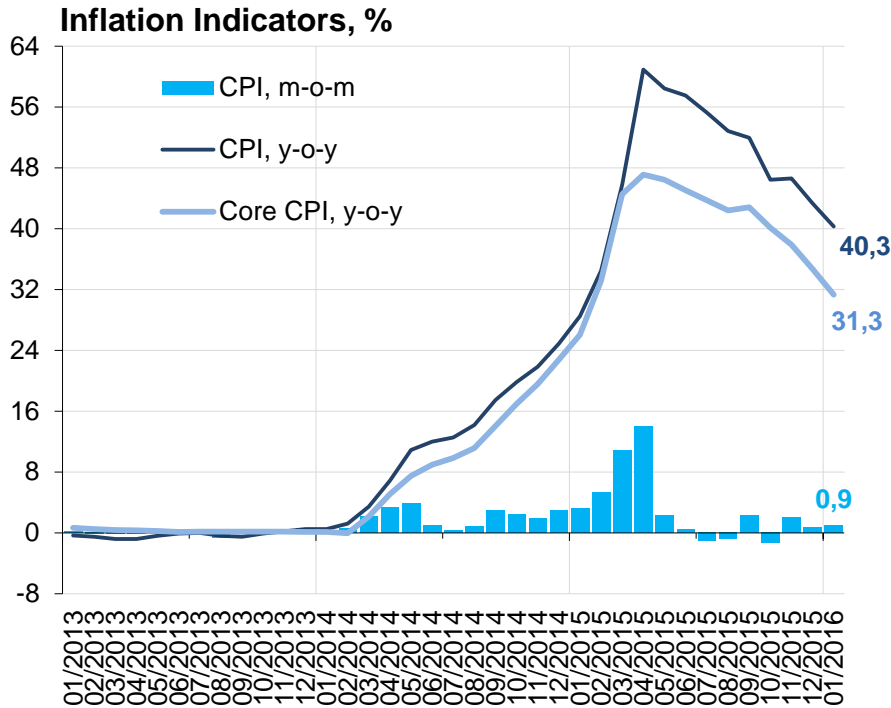
Source: State Statistics Service of Ukraine

- The economy is clearly bottoming out, posting positive growth rates (qoq, seasonally adjusted) for two quarters in a row. As a result, real GDP growth for 2015 as a whole came slightly better than expected – around -10%
- Consequently, business expectations are steadily improving
- Regional growth picture remains uneven, as the Eastern regions were hit disproportionately due to the proximity to the conflict zone and strong economic relations with Russia

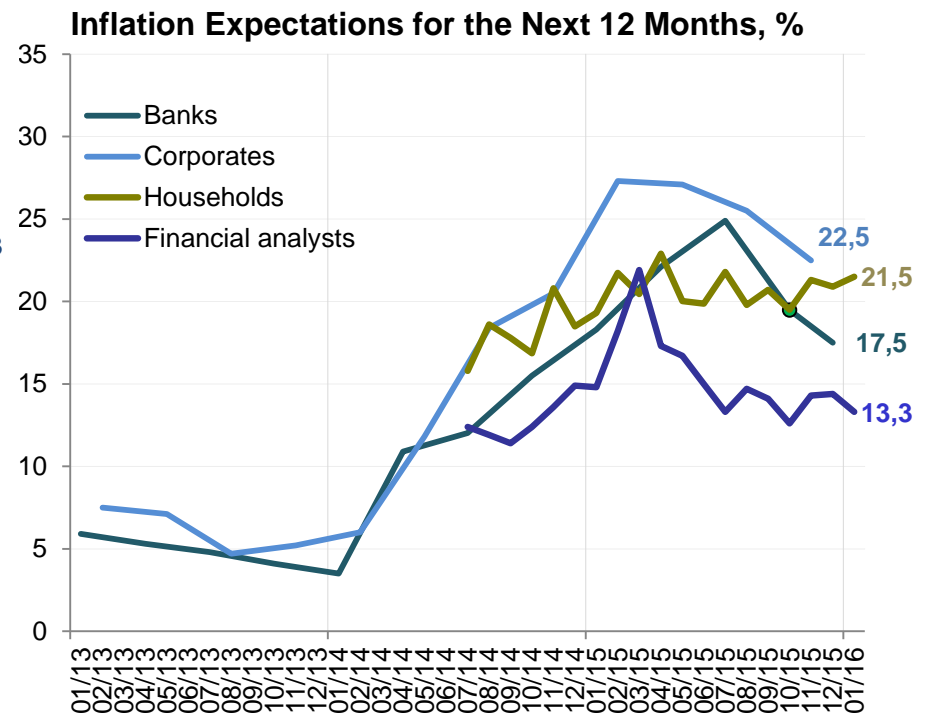


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# Inflation embarked on the steep downward path



Source: State Statistics Service of Ukraine



Source: NBU; GfK Ukraine surveys; NBU staff estimates

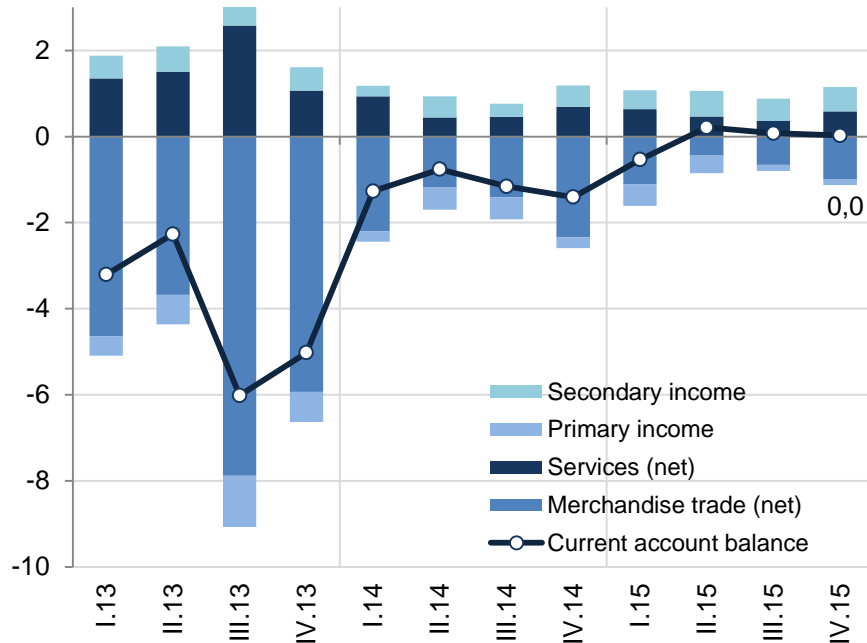
- Exchange rate stabilization, weak domestic demand, plunging global commodity prices and prudent monetary and fiscal policies contributed to the strong and persistent disinflation trend, emerged since mid-2015
- On the other side, public inflation expectations remain elevated, which could be traced back to the persistently high depreciation expectations and adaptive expectations' structure (i.e. the general public makes no difference between actual and expected inflation)



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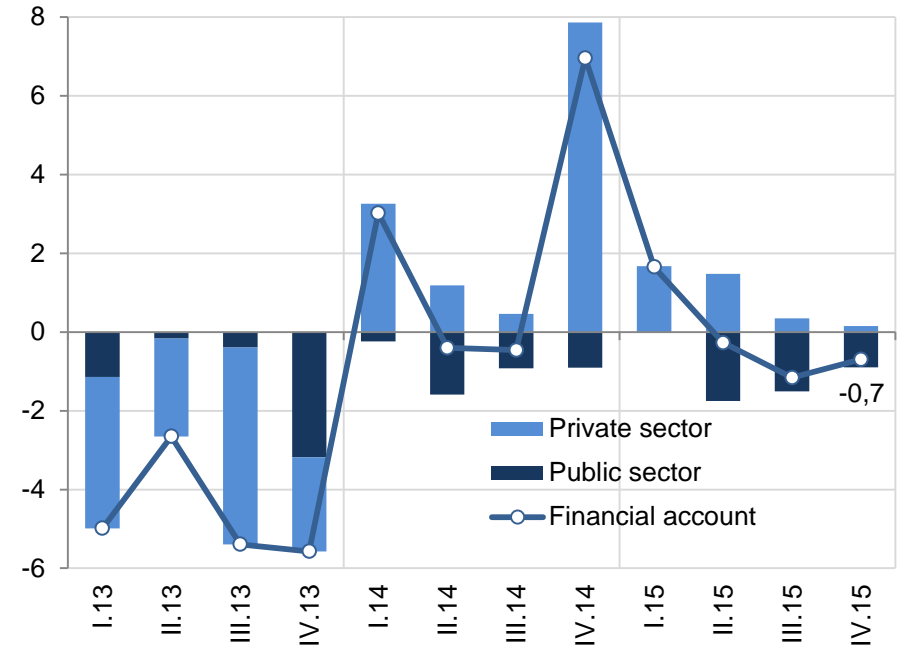
# External balance improved amid a sharp drop in imports and strong official financing inflows

Current Account Balance, USD bn



Source: NBU

Financial Account: Net External Assets, USD bn



Source: NBU

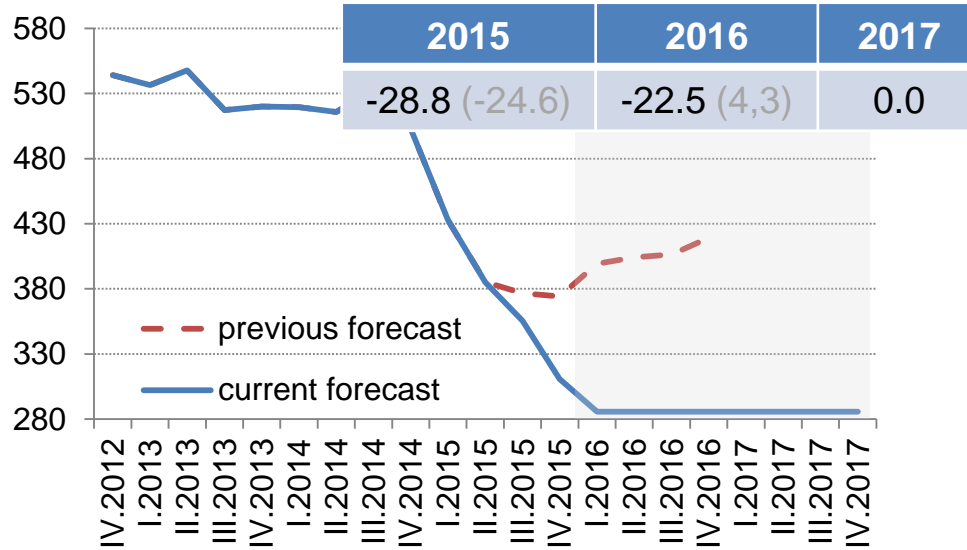
- In 2015, exports fell dramatically amid continued falling prices on world commodity markets and tensions with Russia
- Imports declined even sharper, partially due to lower volumes of gas imports
- External official financing and decline of FX cash outside banks were the main drivers for the net inflows in financial account
- The overall balance of payments posted a surplus of USD 0.8 billion in 2015 (in contrast to USD 13.3 billion deficit in 2014)



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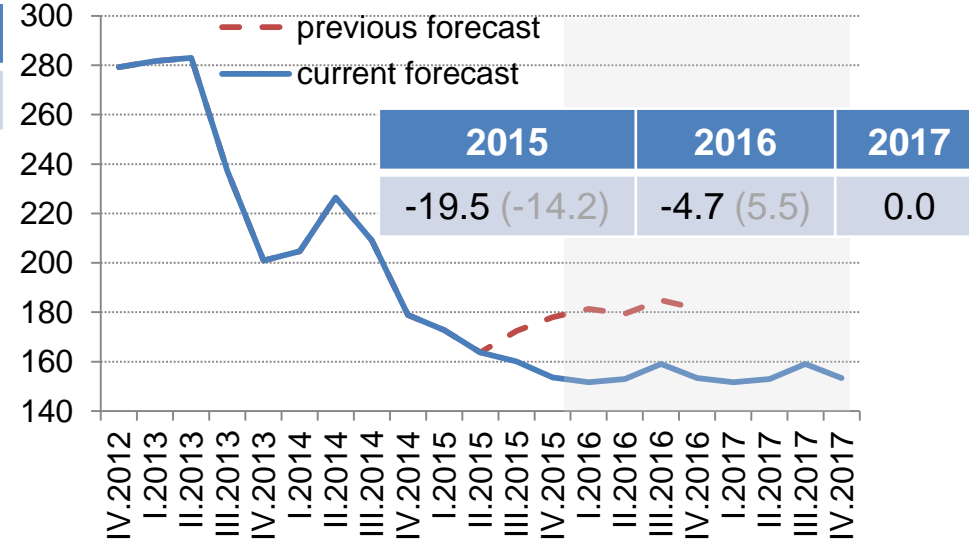
# ...but is to be hit by the sharply deteriorating terms of trade

### Ferrous Metals Export Price, USD per t



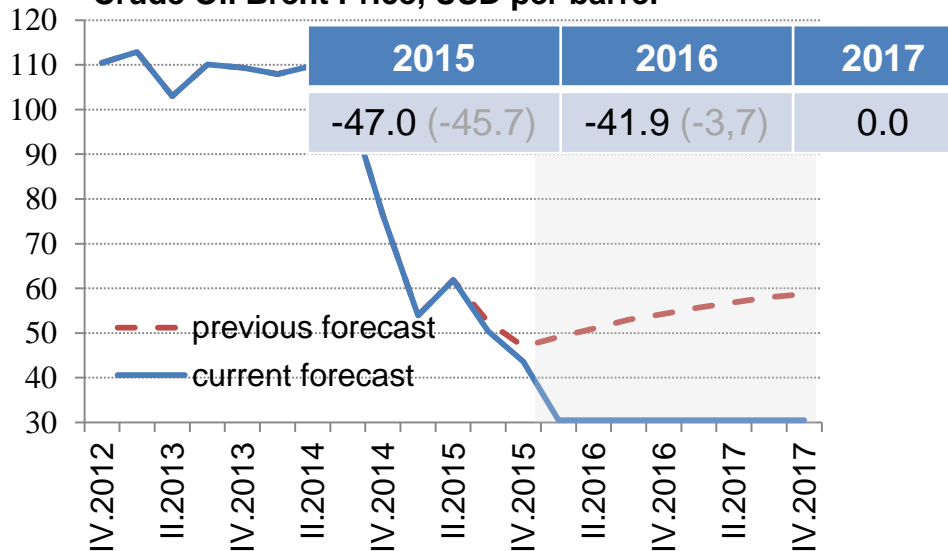
Source: own estimates

### Grains Export Price, USD per t



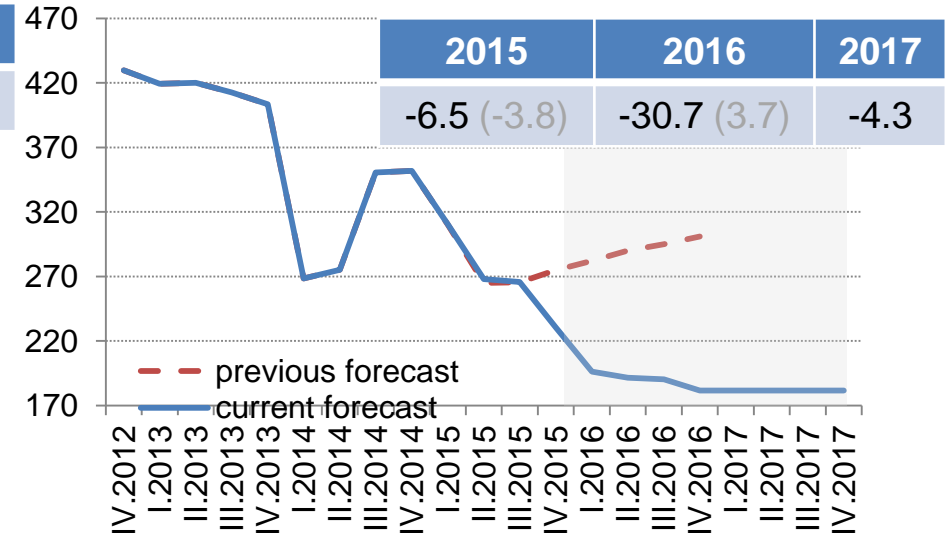
Source: own estimates

### Crude Oil Brent Price, USD per barrel



Source: own estimates

### Imported Gas Price, USD per 1000 m3



Source: own estimates

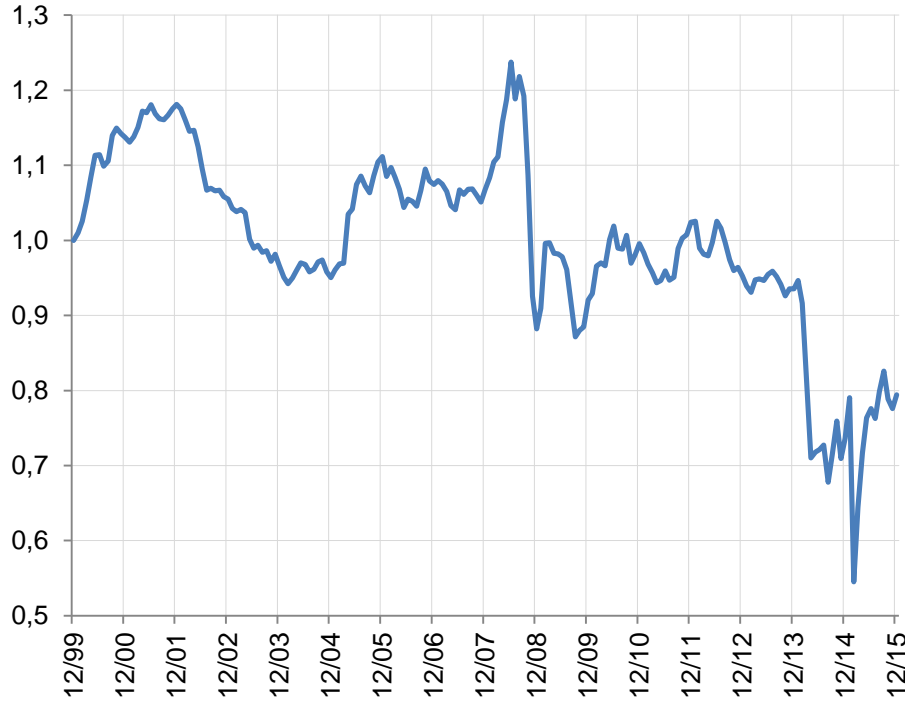
Data in the tables represents average price changes, % y-o-y



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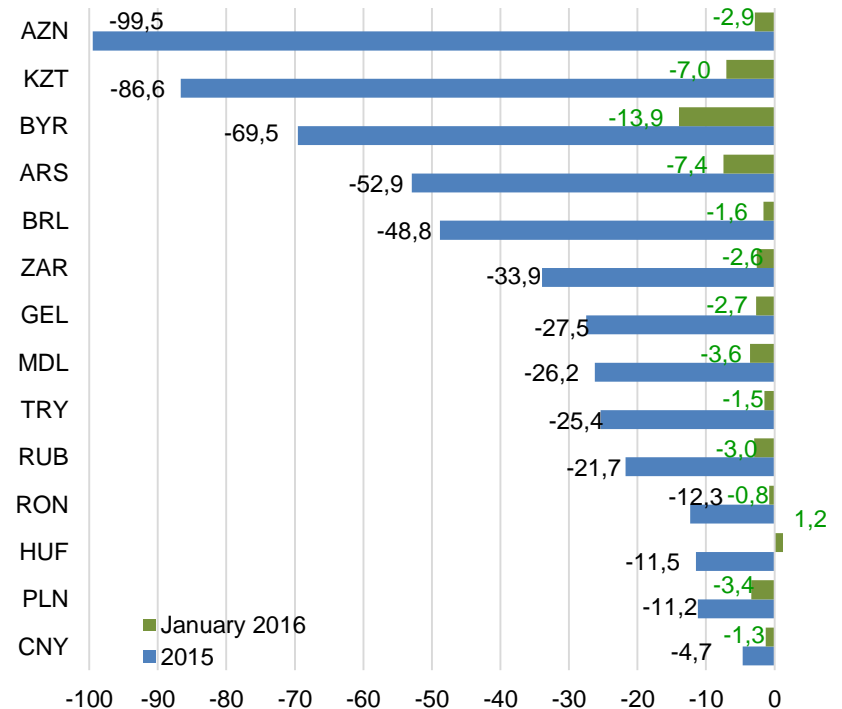
# The slide in EM currencies erodes the competitiveness of the Ukrainian economy

### Hryvnia REER Index (Based on Interbank Exchange Rate), Dec-1999=1



Source: IFS, NBU staff estimates (preliminary data)

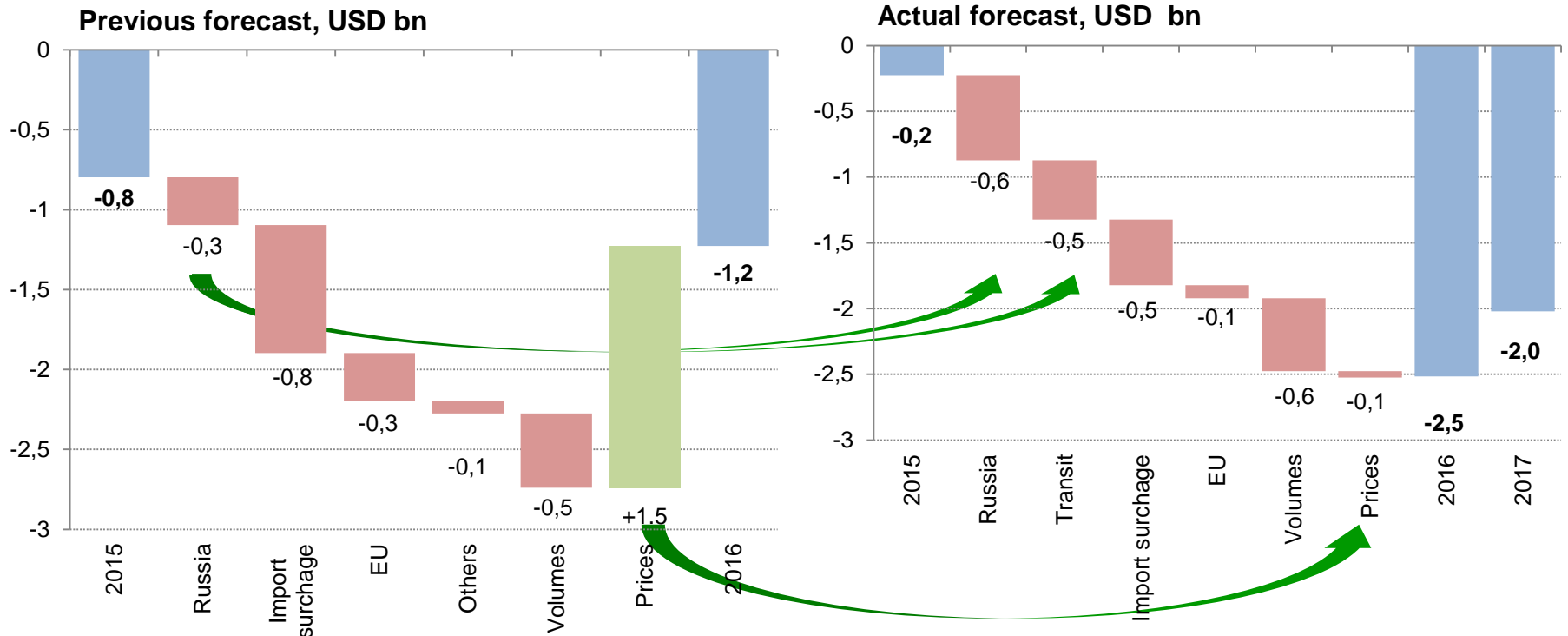
### Emerging Market Currencies versus US Dollar (% change, eop)



Source: Thomson Reuters Datastream



# The external position in 2016 is further damaged by the retaliation measures by Russia and abolition of special import surcharge



- Food exports to Russia almost stopped since January 1, 2016
- Russia repealed the Free Trade Agreement with Ukraine since January 1, 2016. That resulted in increase in imports duties to 5%-20% from 0% (average weighted – 7.7%). Also, Russia will be able to implement additional quotas, bans and others non-tariff limitations
- Losses of exports to third countries due to a transit ban through Russia's territory estimated to USD 0.46 bn. (calculations includes possible exports' reorientation through the other routes)

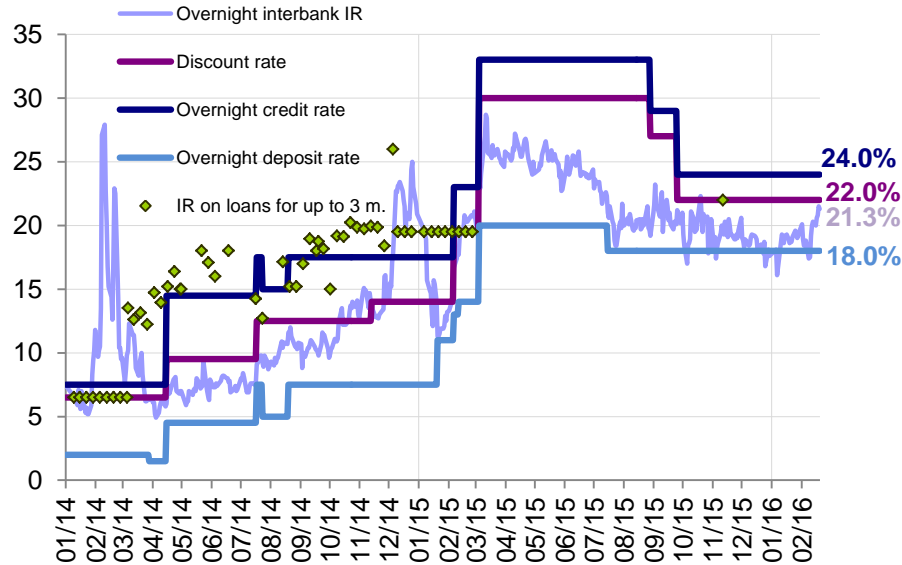




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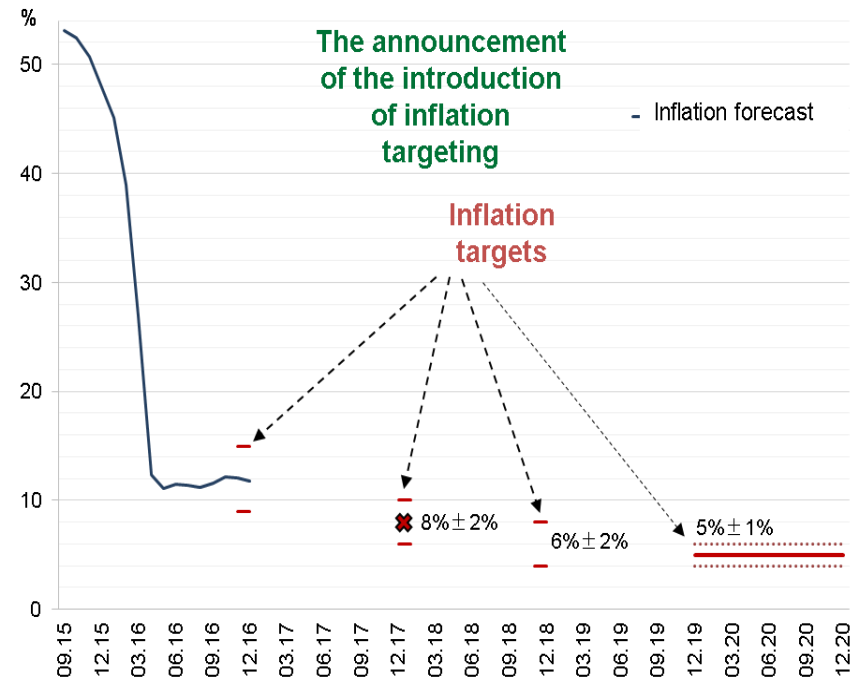
# NBU keeps tight monetary stance aiming at bringing inflation down to 12% target by end-2016

### Overnight Interbank IR and NBU Policy Rate, % pa (as of 19.02.2016)



Source: CredInfo; NBU

### Inflation objectives



- Easing of the monetary stance, started in August last year, has halted recently amid the delay in IMF program, elevated political risk and deteriorating terms of trade
- To re-anchor public expectation from the exchange rate to price stability the NBU put a strong focus on reaching 12% inflation target in 2016
- At the same time, to manage pass-through effect from the exchange rate to prices, the National Bank is trying to smooth exchange rate fluctuations by conducting FX interventions on both sides
- Tight capital controls, introduced in 2014-2015, remain largely in place, as the prerequisites for the removal have not been met yet



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# Policy stance is conditional on the political and macroeconomic developments

| Scenario  | Results                     | NBU actions                               |
|---|-----------------------------|---|
| <b>Base scenario</b>  | GDP +1.1% +3%<br>CPI 12% 8% | Administrative measures ↓<br>Key rate ↓   |
| <b>Pessimistic</b> <ul style="list-style-type: none"><li>- Escalation in the East</li><li>- Commodity prices ↓</li><li>- Impact of “Russian factor” ↑</li><li>- Political instability ↑</li></ul> | GDP ↓<br>UAH/USD ↑<br>CPI ↑ | Administrative measures =<br>Key rate = ↑ |
| <b>Optimistic</b> <ul style="list-style-type: none"><li>- Commodity prices ↑</li><li>- Privatization ↑</li><li>- Structural reforms</li></ul>   | GDP ↑<br>UAH/USD ↓<br>CPI ↓ | Administrative measures ↓↓<br>Key rate ↓↓ |



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# NBU policy actions: Gradual transition to inflation targeting regime

## CURRENT TARGETS TO ACHIEVE:

- Disinflation (inflation target for 2016 – 12%)/Maintaining FX market stability
- Successful implementation of the IMF program
- Replenishment of international reserves
- Gradual elimination of administrative measures

## Future evolution of MP regime and goals

Stage 1. Monetary targeting (framework of IMF program):

- accumulation of international reserves
- targets on NDA, base money and NIR
- flexible exchange rate
- disinflation

Stage 2. IT lite:

- price stability (1-digit target - 5%) as ultimate goal of the NBU monetary policy
- accumulation of international reserves
- interest rate as a key instrument

Stage 3. Full-fledged IT:

- price stability (CPI target 5%) as ultimate goal of the NBU monetary policy
- floating exchange rate

## Improvements that already done

- Establishment of NBU Board`s regular meetings on Monetary Policy issues. Decision making process is:
  - Clear and transparent
  - Forward-looking
  - Analytically supported
- More transparent and market-friendly MP instruments framework
  - Raising the role of key policy rate
  - Liquidity providing / absorbing auctions
  - Simplification of RR framework
- Improved communication framework:
  - Development of comprehensive communication strategy
  - Revamp of NBU analytical product line, including the publication of Inflation Report



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# NBU policy actions: revamping the banking system, liberalizing capital account and transforming the central bank

## Revamping the banking system

- Ensuring adequate capitalization of the banking system:
  - conducting diagnostic studies and stress-testing
  - sticking to the recapitalization schedule
- Solving the related party lending problem
- Addressing NPLs
- Strengthening banking supervision:
  - improving early warning signal system and implementing consolidated supervision
  - developing and implementing macroprudential supervision tools
  - ensuring transparent banks' ownership structure
  - making thorough analysis of banks business models

## Priorities in other sectors

- Foreign exchange liberalization:
  - cancelling the outdated Foreign Exchange Regulation Decree and reducing the number of regulatory acts in this field
  - liberalizing export of services
  - developing the long-term strategy of liberalizing capital account
- The development of cashless payments ("Cashless economy" project)
- An overhaul of Ukrainian securities market (jointly with the National Securities and Stock Market Commission) and setting up the efficient system of integrated prudential risk based supervision ("Risk based supervision")
- The continuation of internal transformations aimed at implementing the NBU's vision, mission and values, and, also, enhancing the efficiency of internal processes, and implementing 'the process management'
- Implementation of electronic document circulation