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, 25 July 2024.

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Dear colleagues,

The Board of the National Bank of Ukraine has decided to keep its key policy rate at 13% per annum. This decision is intended to ensure the sustainability of the FX market and bring inflation closer to its 5% target within the forecast horizon.

Inflation has expectedly accelerated and approached 5% in recent months

After a long period of decreases, inflation returned to growth in May and picked up to 4.8% yoy in June. This inflation trajectory came out only slightly below the NBU's forecast. Lower-than-expected increases in food prices made up for a more significant increase in household electricity tariffs.

At the same time, core inflation came in at 5% yoy in June, matching the NBU's forecast. Underlying price pressures intensified as businesses' expenses on labor and power grew. In addition, developments in some of the core CPI's components reflected a weakening of the hryvnia's exchange rate.

Inflation will rise going forward, but will begin to ease next year already

Price pressures will persist in the coming months, fueled by further increases in business costs and higher excise taxes. This will also be driven by the fading effects of last year's large harvests and the adverse impact of the summer drought on this year's crop yields. Early estimates of inflation in July confirm its further acceleration.

However, inflation will remain moderate, at 8.5% at the end of the year, the NBU's updated forecast shows. This will be partly due to the NBU's measures to safeguard households' hryvnia incomes and savings from inflation and ensure the sustainability of the FX market. The ongoing moratorium on increases in utility tariff for natural gas, heating, and hot water supply will also have a restraining effect on prices.

The NBU's balanced interest-rate and exchange rate policies and the weakening of external inflationary pressures will make it possible to slow inflation to 6.6% as soon as 2025. In 2026, inflation will return to the NBU's 5% target as the economy gradually normalizes and the energy situation continues to improve.

Economic recovery will carry on, but will be restrained by the war's impact, including extensive damage to the energy system

Economic growth continued in H1 2024, but has decelerated in recent months, impeded by Russia's attacks on energy infrastructure. However, businesses have partially adapted to rolling blackouts. The stable operation of the sea corridor has also provided significant support for economic activity.

Despite power shortages and smaller harvests compared to a year ago, the NBU has even slightly upgraded its economic growth forecast for this year, to 3.7%. This was made possible by better Q1 results and an anticipated expansion of fiscal stimulus, as well as by the development of distributed generation with support from large-scale lending programs.

The step-by-step normalization of economic activity and the steady pursuit of loose fiscal policy, combined with the development of export routes and the revival of external demand, will help speed up real GDP growth to 4%–5% in 2025–2026.

Significant international financial aid will enable the government to finance the budget deficit, and the NBU to maintain a comfortable level of reserves

Under the forecast's baseline scenario, Ukraine will keep receiving substantial external financing inflows. However, they will slowly decline with the growth in the internal capacity to use domestic resources to finance budget expenditures. International partners are expected to provide about USD 38 billion in soft loans and grants to Ukraine this year, and no less than USD 31 billion next year.

Such volumes of external inflows, coupled with growing domestic borrowing, will make it possible to cover a significant budget deficit of about 23% of GDP in 2024 and 18% in 2025. For its part, the NBU will be able to maintain a sufficient volume of international reserves to ensure the sustainability of the FX market and moderate inflation.

The course of the war continues to be the key risk to inflation dynamics and economic development

The duration and nature of Russia's aggression will continue to have a notable impact on Ukraine's inflation and economic development. A prolonged high-intensity war will curb the economy's return to normal conditions and make it difficult to bring inflation to the NBU's target.

There are other risks, most of which are also directly or indirectly related to the war, including:

- the emergence of additional budget needs, mainly those to maintain defense capabilities
- the pass-through to prices of certain new business taxes, the introduction of which is currently being discussed at the state level
- further damage to infrastructure, especially energy and port infrastructure, which will limit economic activity and put supply-side pressures on prices
- the deepening of adverse trends in migration.

There is also a risk that international partners will reduce their support for Ukraine more significantly, in particular due to elections in many countries.

At the same time, a number of positive scenarios are also likely to materialize. These scenarios are related to the further expansion of export opportunities, the acceleration of European integration processes, the implementation of a large-scale recovery program, and a faster pace of repairs in the energy sector.

In addition, the practical implementation of the Extraordinary Revenue Acceleration Loans (ERA) mechanism, secured by future revenues from immobilized Russian assets, could provide Ukraine with additional financial resources starting in 2025. This will reduce risks to the timely and regular inflow of international financing.

Taking into account the need to ensure the sustainability of the FX market and to bring inflation closer to its 5% target over the forecast horizon, the NBU Board decided to keep the key policy rate at 13%

Despite a gradual decline in hryvnia deposit rates and in interest rates on domestic government debt securities, the yields of these instruments currently protect households' hryvnia savings from being eroded away by inflation. In particular, the rates on these instruments exceed both the NBU's inflation forecast and households' inflation expectations.

At the same time, household hryvnia term deposits stopped growing in June. Given that a further acceleration of inflation could worsen expectations and decrease the real yields on hryvnia instruments, it is advisable to keep the key policy rate at 13%.

The NBU will also maintain an active presence on the FX market to cover the structural deficit of foreign currency, support bilateral exchange rate fluctuations, and smooth out excessive volatility

The NBU aims to ensure that the FX market is in such a state that the central bank will be able to control inflation expectations and achieve its inflation target over the forecast horizon.

The baseline scenario of the forecast assumes that the NBU will only return to a key policy rate easing cycle in early 2025. However, the NBU will respond flexibly to changes in the balance of risks to inflation and the FX market

If the risks to inflation and the FX market ease, in particular as a result of Ukraine receiving more financial support, the NBU will consider resuming the key policy rate easing cycle at an earlier date.

At the same time, the NBU will be ready to tighten its monetary policy in the event of a significant increase in price pressures and risks of expectations becoming unanchored.

Thank you for your attention!