National Bank of Ukraine

Public version of the Strategy for easing FX restrictions, transition to greater exchange rate flexibility and return to inflation targeting

Key points

Regulatory basis.

The development of the Strategy for easing FX restrictions, transition to greater exchange rate flexibility, and return to inflation targeting (hereinafter – the Strategy) is aimed at implementing:

- the provisions of the Monetary Policy Guidelines for the period of martial law, which provide for a return to the inflation targeting regime with a floating exchange rate in the shortest possible time as the economy and financial system normalize;
- commitments under the Memorandum on Economic and Financial Policies with the International Monetary Fund (hereinafter – the IMF) under the Extended Fund Facility (EFF), Program, which provide for the easing of administrative FX restrictions, transition to a more flexible exchange rate and return to inflation targeting as soon as conditions allow, as well as consistency with the program's broader objectives of safeguarding price and external stability.

Purpose.

The purpose of the Strategy is to set out the priorities, principles and preconditions to guide the implementation of monetary and exchange rate policy measures to return to inflation targeting with a floating exchange rate, and to ease currency restrictions, in an orderly, consistent manner that will minimize risks to price and financial stability and maximize the potential for sustainable economic recovery. The implementation of the Strategy will be guided by the conditions elaborated below.

Motivation.

Following the outbreak of the war, a fixed exchange rate regime supported by tight FX restrictions has played an important role in stabilizing inflation and exchange rate expectations and reducing inflationary pressures.

However, such a regime comes with both benefits and costs, and over time, the costs could outweigh the benefits. For example, exchange restrictions could lose their effectiveness, and expectations around the credibility of the exchange rate peg could shift. In turn, this could result in increased market distortions, the shift of activity to the shadow economy, and the diversion of resources to unproductive uses while discouraging productive business activity. All of these could drive external imbalances with spillovers to fiscal management.

Furthermore, a prolonged peg could lead both stakeholders and market participants to internalize expectations of a fixed exchange rate. This could lead to a gradual degradation of their business models and risk management systems and stimulate the accumulation of currency risks. At the same time, the economy is deprived of the opportunity to adapt to changes in external and internal conditions through exchange rate flexibility, and the central bank loses an important policy tool. Accordingly, despite the favorable impact of fixing the exchange rate at the initial stage of disinflation, in the longer term it could become increasingly difficult to simultaneously achieve the goals of price and financial stability and the sustainability of economic growth.

Thus, the NBU should, as conditions permit, return to inflation targeting with a floating exchange rate as a regime that allows simultaneously to ensure long-term achievement of the central bank's goals of price and financial stability, as well as support sustainable economic growth.

Prioritization.

With due consideration to successful international experience, Ukraine’s past experience, as well as Ukraine’s economic challenges and policy objectives at the current juncture, the NBU will adopt a prioritization of measures across the three main policy areas—introducing exchange rate flexibility, easing FX restrictions, and transitioning back to inflation targeting—that supports the economy and safeguards external and financial stability.

The NBU will follow the general approach in which the refusal from the fixed exchange rate will precede the wide-scale liberalization of capital flows. In turn, the increase in exchange rate flexibility will be preceded by easing of the majority of FX restrictions imposed on trade transactions and those that distort the functioning of the FX market via multiple exchange rates. At the same time, the implementation of the Strategy will be supported by maintaining a tight monetary stance, via appropriately high real interest rates, which will support sufficient attractiveness of hryvnia assets and thereby help minimize risks to exchange rate stability when moving away from the fixed exchange rate regime and easing FX restrictions. Exchange rate sustainability will remain an important element of achieving the goals of the National Bank throughout the implementation of the Strategy.

Principles.

The NBU will proceed carefully along a gradual sequence of measures along these policy areas, including in view of the effects of incremental changes in one policy area on others as well as on the effectiveness of previous steps. In this regard, implementation will be supported by careful case-by-case analysis of the intended steps. Adjustments will take into account the above priorities and determined not by timeframes, but by the formation of appropriate macroeconomic preconditions (see below).

Preconditions.

Implementing any particular step of the Strategy will be informed by an assessment of a set of pre-established macroeconomic preconditions being met on a sufficiently durable basis. These criteria will ensure that adequate prerequisites are in place to support the successful implementation of steps under the Strategy, while safeguarding macroeconomic and financial stability amid a highly uncertain environment. These include assessing developments along several key parameters including:

- inflation and inflation expectation;
- FX reserves levels and FX market stability;
- interest rates (including positive real key policy rate and attractiveness of hryvnia instruments);
- and financial stability considerations.

Preparedness and risk assessment.

Implementation of the Strategy requires careful technical and operational readiness for implementing changes in monetary and exchange rate policy.

Given exceptionally high uncertainty associated with the war, progress under the Strategy will require an assessment of the balance of risks in the near term. Implementation of the Strategy's measures will take place when the probability of materialization of risks is assessed as acceptable, and/or it is possible to feasibly manage the impact of risk materialization. Intensification of risks may cause the suspension of the next steps or reversal of a previous step to safeguard macroeconomic and financial stability.

Joint assessment with the IMF.

The implementation of the Strategy will require a holistic assessment of its implications for other aspects of macroeconomic policy, and thus should be consistent with the objectives of the Extended Fund Facility Program. Thus, a joint assessment with IMF staff of the preconditions, likely impact on other policy areas, and risks will ensure that the Strategy is consistent with program objectives.

Key considerations of the three pillars of the Strategy are elaborated below:

1. **<u>Easing FX restrictions</u>**

The NBU has prepared a Roadmap for the Gradual Easing of FX Restrictions (hereinafter referred to as the Roadmap) that sets out general stages for easing FX restrictions. The main criterion for prioritizing the easing of FX restrictions is the urgency to correct distortions in the market and support the economic recovery, taking into account the relevant risks to exchange rate stability and international reserves.

The Roadmap generally envisages the following stages with an appropriate focus:

- Stage I – minimizing the practice of multiple exchange rates, liberalizing trade transactions and facilitating new loans and investments;
- Stage II – liberalization of trade finance, management of currency risks of banks, the possibility of repatriation of interest on "old" debt obligations and investments;
- Stage III – the possibility of payments on loans and investments, liberalization of household transactions and transactions with derivatives, the possibility of lending to non-residents and investments abroad.

and reflects the following priorities:

- easing restrictions on transactions related to the movement of goods and services relative to easing restrictions on transactions related to capital flows;
- easing restrictions on transactions with own FX currency relative to transactions at the expense of purchased FX currency.

Although the Roadmap sets out a sequence for easing FX restrictions, some steps (in particular within the specified stages) may be taken earlier or later than originally envisaged. This may happen if conditions arise under which a deviation from the envisaged sequence is determined to be more beneficial for the economy, the foreign exchange market and the financial system. At the same time, FX restrictions may be eased gradually, in particular by changing limits, calibrating levels, etc. Careful case-by-case analysis will help determine whether to deviate from this sequence and prioritization.

Key principles. The National Bank is committed to adhering to the following principles for the implementation of the Roadmap:

- easing of currency restrictions shall occur gradually, taking into account the above priorities and it shall be is determined not by the timeframes, but by the formation of appropriate macroeconomic preconditions;
- each step to ease currency restrictions shall be carried out on the basis of assessments of its impact on the foreign exchange market, international reserves, macroeconomic and financial stability, taking into account minimizing the risk of reintroducing the relevant FX restriction;
- easing of restrictions should not undermine the effectiveness of other restrictions that remain in force;
- each subsequent step shall be preceded by an assessment of previous measures to ease FX restrictions;
- introduction/easing/lifting of FX restrictions shall not be used to replace the necessary macroeconomic adjustment (in particular, using monetary or exchange rate policy instruments);
- in the event of adverse circumstances, the implementation of the Roadmap may be suspended, and FX restrictions may be reintroduced or further tightened if necessary.

2. Moving to greater exchange rate flexibility

In the early stages, the NBU will still rely heavily on the exchange rate as a nominal anchor for the economy. As conditions permit, the NBU will gradually introduce greater exchange rate flexibility. The gradual introduction of exchange rate flexibility will be informed by the assessment of macroeconomic and financial conditions.

As the proper preconditions are formed, the inflation target will gradually take over the role of a nominal anchor for inflation expectations, while the exchange rate will increasingly play the role of a corrective mechanism for the economy. Therefore, at subsequent stages, the NBU will allow for greater exchange rate flexibility, however, taking into account the consistency of policies to maintain confidence in the hryvnia and the actions of the National Bank to achieve inflation goals.

The increase in exchange rate flexibility will occur gradually. In the early stages, it is important to maintain maximum exchange rate stability to minimize the initial shock to expectations in view of the NBU's exit from its commitment to peg the exchange rate. To support this transition, the National Bank will maintain a sufficiently tight monetary policy stance that preserves the attractiveness of hryvnia assets in order to avoid uncontrolled increase in pressure on the FX market. Further, the gradual easing of certain FX restrictions would support the preconditions for a transition to greater exchange rate flexibility. At the same time, maintaining other FX restrictions will continue to support exchange rate stability. Thus, one of the critical prerequisites for the transition to greater exchange rate flexibility is to minimize the use of multiple exchange rates, which will help maintain control over exchange rate expectations.

3. Return to inflation targeting: Key steps

In the early stages of easing FX restrictions and transitioning to greater exchange rate flexibility, the NBU's key policy rate will continue to serve as an auxiliary tool to ensure the stability of the exchange rate regime and protect international reserves. In particular, the key policy rate will remain sufficiently positive in real terms during the period of return to inflation targeting, to help maintain the attractiveness of the hryvnia as a savings instrument, reduce demand for FX, and, thus, reduce pressure on the exchange rate and international reserves.

The NBU will also adjust the operational design of its monetary policy, as well as take other measures, including effective management of the banking system's structural liquidity position, to strengthen monetary transmission and ensure that hryvnia instruments are sufficiently attractive.

On the gradual normalization of the operational design of monetary policy, the NBU plans to reintroduce the main operation (placement of two-week NBU certificates of deposit) at the key policy rate. The final stage in the normalization of the monetary policy operational design would be to restore a symmetrical interest rate band for standing facilities around the key policy rate. Under the baseline scenario, the normalization of the monetary policy operational design will be synchronized with the key policy rate cuts cycle. At the same time, the NBU will take into account the need to maintain sufficient attractiveness of hryvnia assets to ensure proper implementation of measures to ease FX restrictions and move to greater exchange rate flexibility.

At the next stage of changes in the monetary regime, the NBU's nominal anchor would shift to inflation. The key policy rate will gradually restore its status as the main monetary instrument, as it regains its decisive influence on the state of the money market, the motives of economic agents, and the dynamics of macroeconomic indicators. This will be facilitated by the gradual restoration of the effectiveness of monetary transmission channels, as well as by the fact that the bulk of liquidity absorption transactions will be conducted at the KPR.

At the final stage of implementation of this Strategy, the NBU will return to inflation targeting using the principles and instruments pertaining to this monetary regime. The key policy rate will be used as the main instrument of monetary policy. Eventually, as conditions permit, the NBU will go back to a floating exchange rate regime that was in place before the full-scale war. To this end, the NBU will also adjust its FX interventions, taking into account the objectives and principles on which the floating exchange rate regime operates. The ban on monetary financing of the state budget by the NBU will also be reinstated.

A return to inflation targeting will require a gradual curtailment of unconventional measures in the field of interest rate and exchange rate policies introduced since the beginning of the full-scale war.

Thus, the return to inflation targeting will take place gradually in close and consistent relationship with phasing out of FX restrictions and transition to greater exchange rate flexibility, the disinflationary trend continues, and inflation expectations improve.

The NBU aims to return to full-fledged inflation targeting when the right preconditions are in place for a transition to a floating exchange rate and if such a transition, according to the updated macroeconomic forecast, allows bringing inflation to target over the monetary policy horizon (9-18 months).