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Policy responses to heightened uncertainty

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Dealing with uncertainty in monetary policymaking

Baseline scenario (or 2 of them)	▪ The proper identification of assumptions for the baseline scenario is needed to preserve the consistency in policymaking and communications
Alternative Scenarios	▪ Alternative scenarios – a good way for elaborating policy response, however, at the cost of losing the focus on the main scenario: not too much, not too little ▪ Alternative scenarios remain useful even in the case when policy outcomes coincide → provide good guidance for expectations
Contingency plans	• proactive elaboration of action plans (Plan B, Plan C …) for relevant scenarios
Consistent communications	▪ CB needs to be humble: the main goal is not to convince the public of the baseline forecast, but to make sure that the reaction function of CB is understandable and known ▪ Gentle balancing: not to be overconfident, but preserve consistency of policy
Policy Mix instead of single instrument	▪ Policy mix of instruments instead of a single main one (KPR) allows for a tailor-made policy response to the set of negative scenarios

The separation between baseline and alternative scenarios is needed for consistency in policymaking and communications

Following the baseline scenario (or 2 of them at max) to guide the policy

- consistency and predictability of actions to strengthen trust, anchor expectations
- avoidance of excessive optimism (on the one hand) and reasons for panic (on the other) in communicating forecasts
- avoidance of steps that are difficult to deploy under adverse scenarios
- data-driven approach in extreme cases

Defining the need for reaction due to materialization of risk

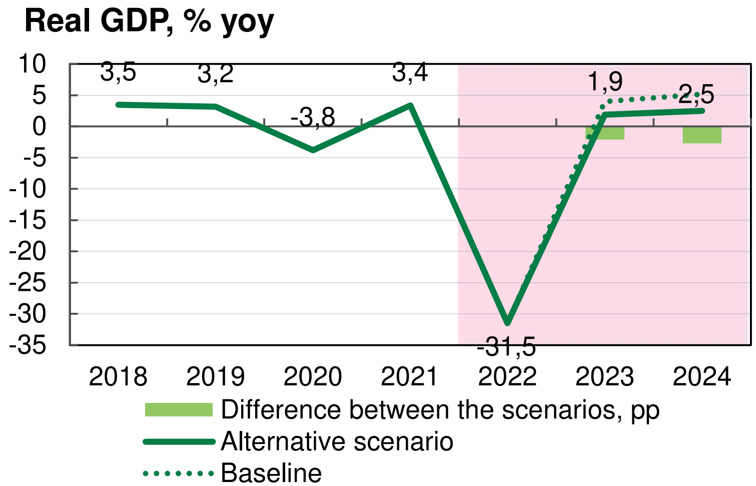
- monitoring of leading indicators to identify the diversion from baseline
- Informing policymakers on the need for reaction and elaboration of alternative scenario
- decision to switch to the alternative scenario or "plan B"

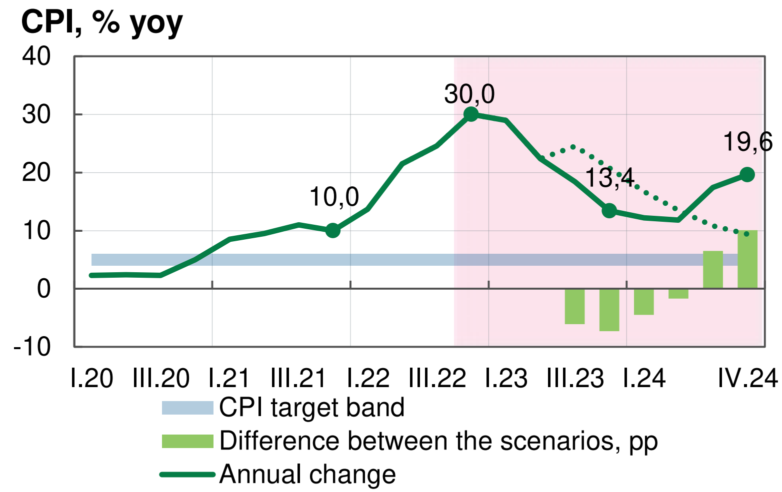
Awareness of risks and readiness to react in line with alternative scenarios / contingency plans

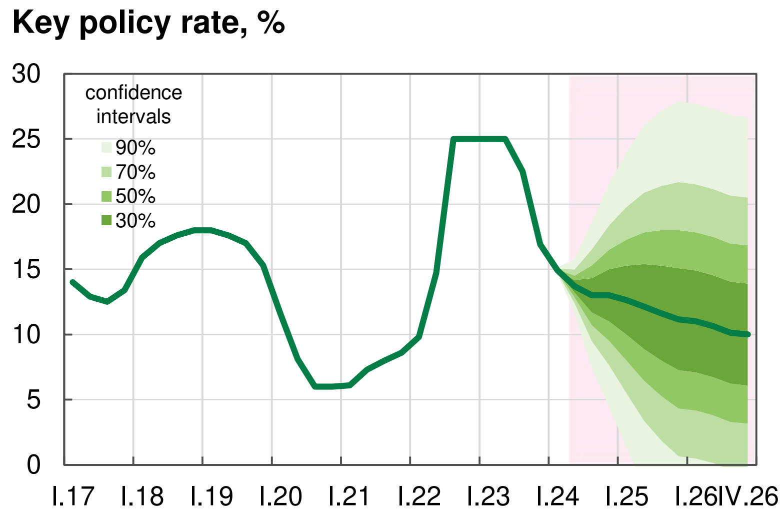
- proactive elaboration of action plans for relevant scenarios
- avoidance of premature steps that could weaken the effectiveness of the MP and provoke a crisis by themselves
- application of action plans upon confirmation of the materialization of an alternative scenario

Alternative scenarios are useful for guiding expectations, but overuse can cause confusion. The key is balance: not too much, not too little

Alternative scenario: "slow normalization" of security situation







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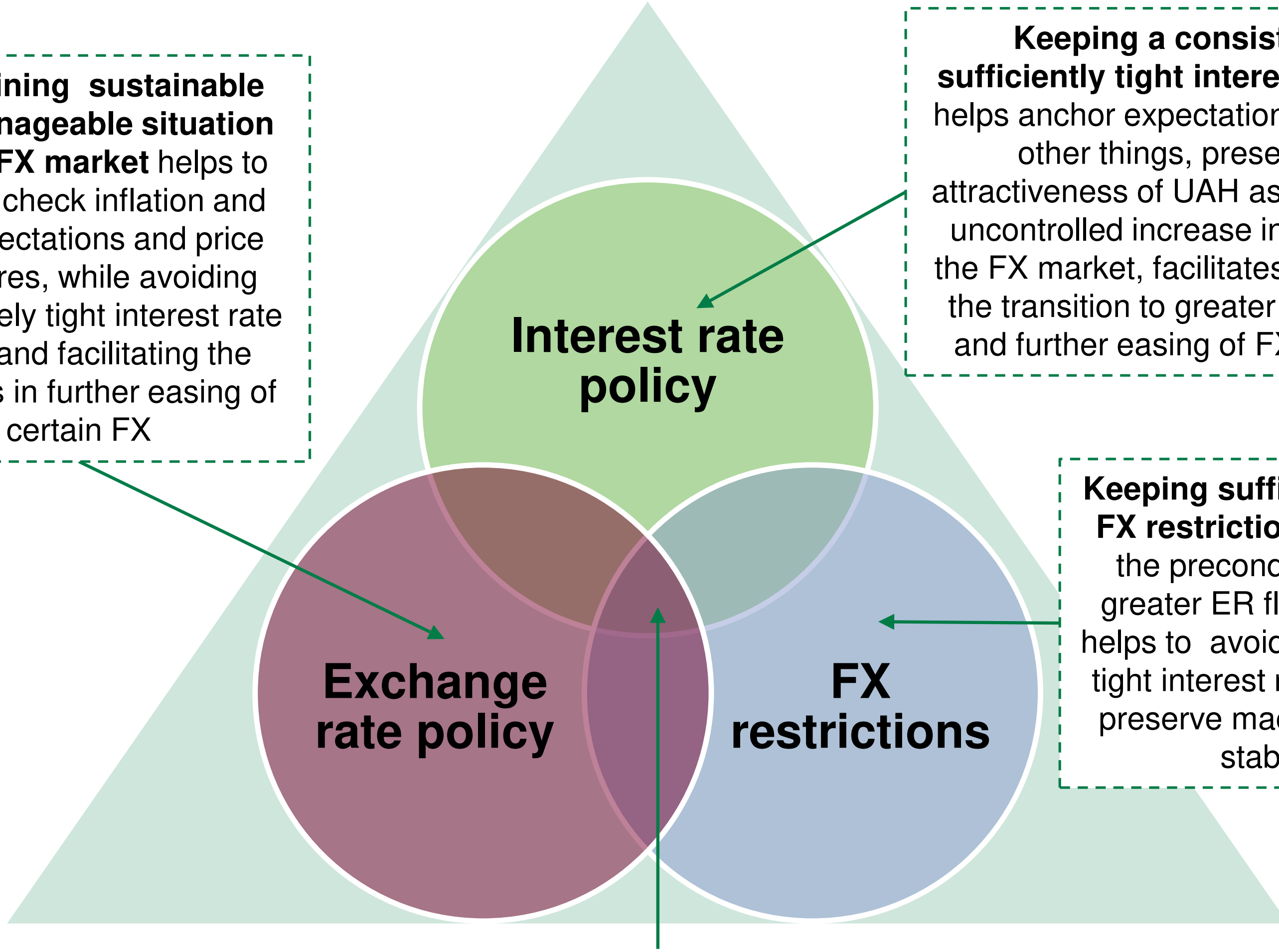
Preparing to react in times of uncertanty: the NBU uses a consistent mix of instruments instead of a single main one (KPR)

Maintaining sustainable and manageable situation on the FX market helps to keep in check inflation and ER expectations and price pressures, while avoiding excessively tight interest rate policy and facilitating the progress in further easing of certain FX

Keeping a consistent and sufficiently tight interest rate policy helps anchor expectations and, among other things, preserves the attractiveness of UAH assets, prevents uncontrolled increase in pressure on the FX market, facilitates a progress in the transition to greater ER flexibility, and further easing of FX restrictions



Keeping sufficiently tight FX restrictions supports the preconditions for a greater ER flexibility and helps to avoid excessively tight interest rate policy to preserve macro-financial stability

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