National Bank of Ukraine

Macroeconomic Forecast and Monetary Policy Update

Sergiy Nikolaychuk

Director of Monetary Policy and Economic Analysis Department

Kyiv, 09 July 2019

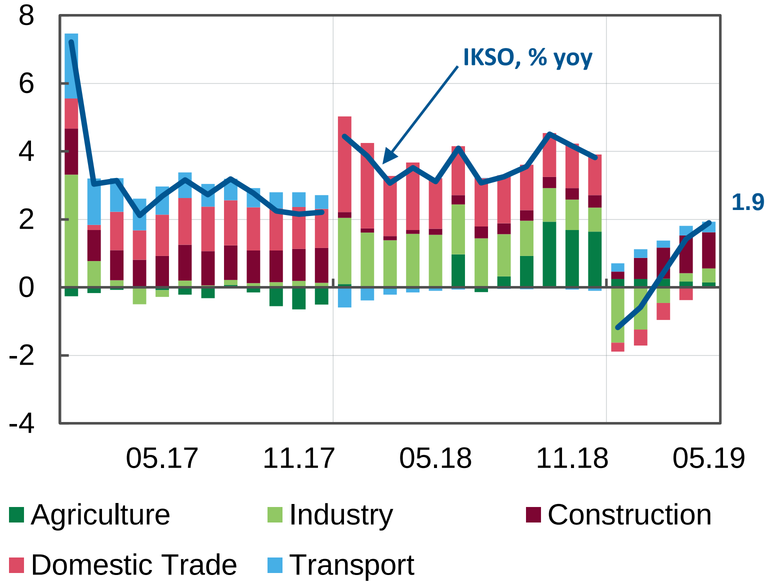
Key macroeconomic indicators in April Inflation Report

	2018	2019	2020	2021
Real GDP, change, %	3.3 (3.3)	2.5 (2.5)	2.9 (2.9)	3.7 (3.7)
Nominal GDP, UAH bn	3 559 (3 553)	3 970 (3 965)	4 342 (4 336)	4 750 (4 744)
CPI, y-o-y, %	9.8	6.3 (6.3)	5.0 (5.0)	5.0 (5.0)
Core CPI, y-o-y, %	8.7	5.0 (5.0)	3.7 (3.6)	3.7 (3.7)
Current account balance, USD bn	-4.5 (-4.7)	-4.9 (-4.5)	-5.8 (-5.6)	-6.7 (-6.2)
% GDP	-3.4 (*-3.6*)	-3.3 (*-3.1*)	-3.6 (*-3.6*)	-4.0 (*-3.9*)
BOP (overall), USD bn	2.9	-0.3 (-1.1)	-0.1 (-0.1)	-0.7 (-0.7)
Gross reserves, USD bn	20.8	21.2 (20.6)	21.9 (21.4)	21.8 (21.4)

Source: Inflation Report, April 2019, in brackets – previous NBU forecast (Inflation report, January 2019)

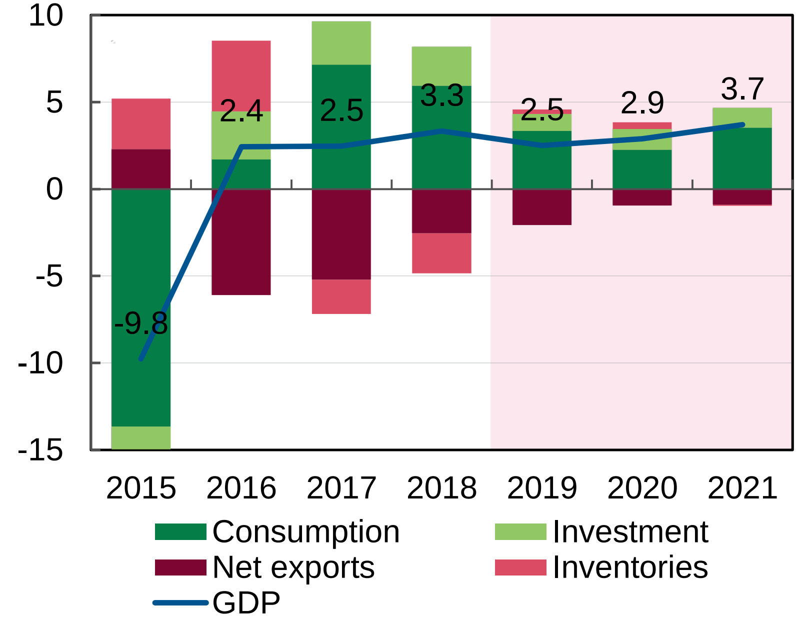
The Ukrainian economy has been recovering at a solid pace despite military conflict headwinds

Index of Key Sectors Output, cumulative, % yoy



Source: SSSU, NBU staff estimates.

Contributions to Real GDP Growth, pp

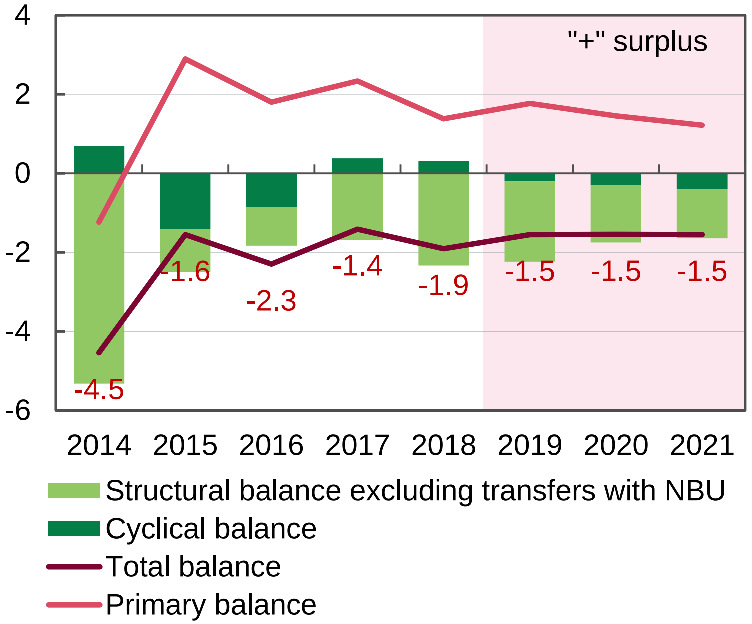


Source: SSSU; NBU estimates and forecast (April 2019 IR).

- In 2018, GDP grew by 3.3% thanks to favorable terms of trade, robust domestic demand and record harvest of crops
- In 2019, the growth is forecast to temporarily decelerate to 2.5% due to waned effect of record high harvest, less benign external conditions and tight monetary and fiscal policies
- In the forthcoming years, the growth will pick up as political uncertainty abates and monetary policy eases
- *Compared with April forecast: better terms of trade, easier global financial conditions, stronger domestic demand, higher grains harvest*

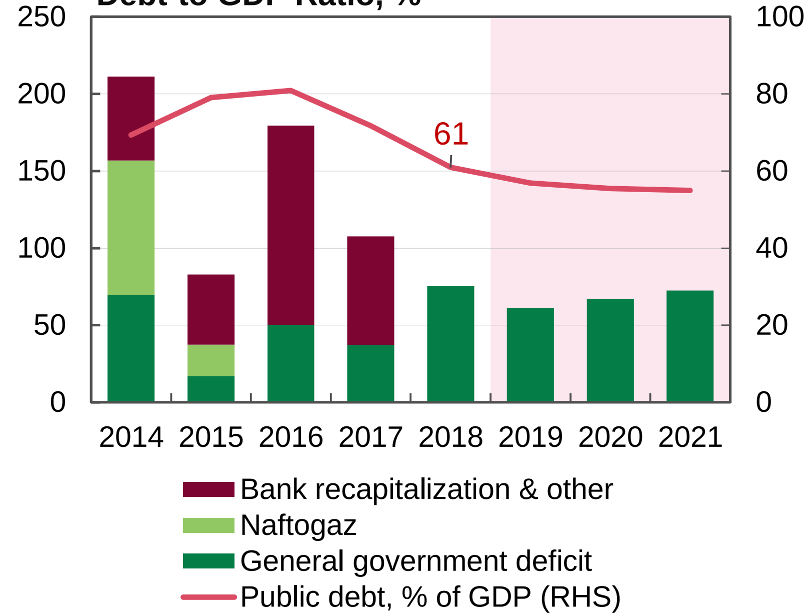
Fiscal policy has largely been in check over the last four years; in 2019-2021, fiscal policy will continue to be restrained

Consolidated Budget Balance, % of GDP



Source: MFU, NBU calculations and forecast (Inflation Report April 2019).

Public Sector Deficit, UAH bn, and Public Debt-to GDP Ratio, %

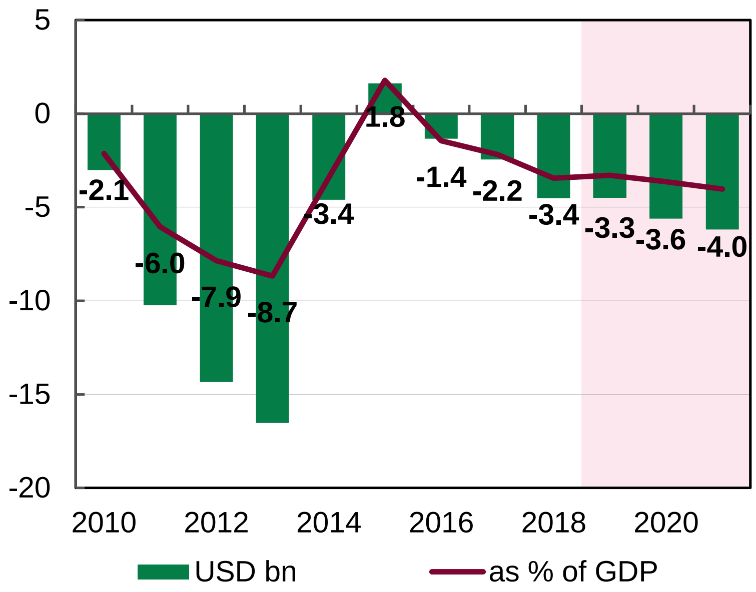


Source: MFU, SSSU, NBU calculations and forecast (Inflation Report April 2019).

- In 2018, the general government deficit moderately widened, spurred by larger social spending (pension expenditures and wages) and capital expenditures. However, the deficit remained well below the IMF target and the primary surplus was preserved
- Given also favorable FX market performance, this helped the public debt to GDP ratio to slide further, gradually approaching 60% threshold
- The consolidated fiscal deficit is forecast to remain in the range of 1.5% of GDP in 2019-2021 primarily because of the Government's limited capacity to raise its public debt during the peak pay-off period

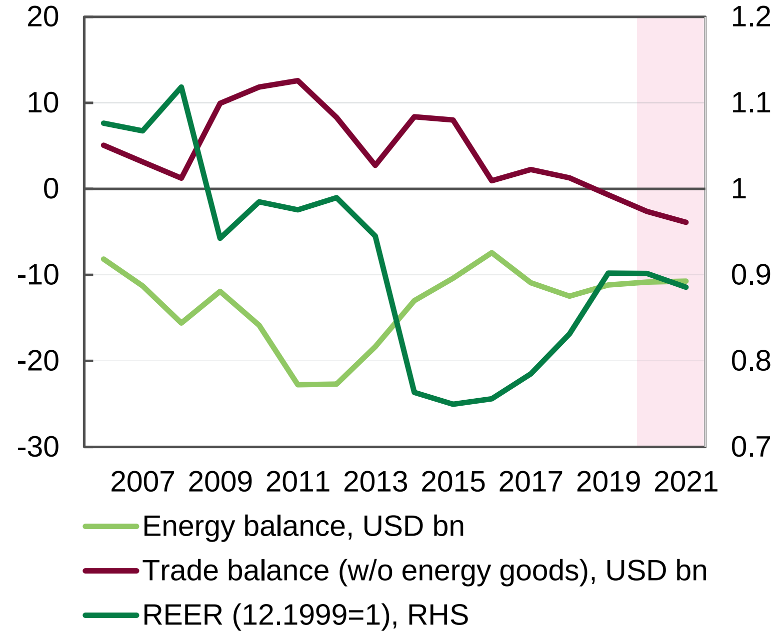
CA deficit remains in the range of 3-4 percent of GDP as domestic and external factors counterbalance each other

Current Account Balance



Source: NBU, Inflation Report April 2019.

Trade Balance and REER of the Hryvnia

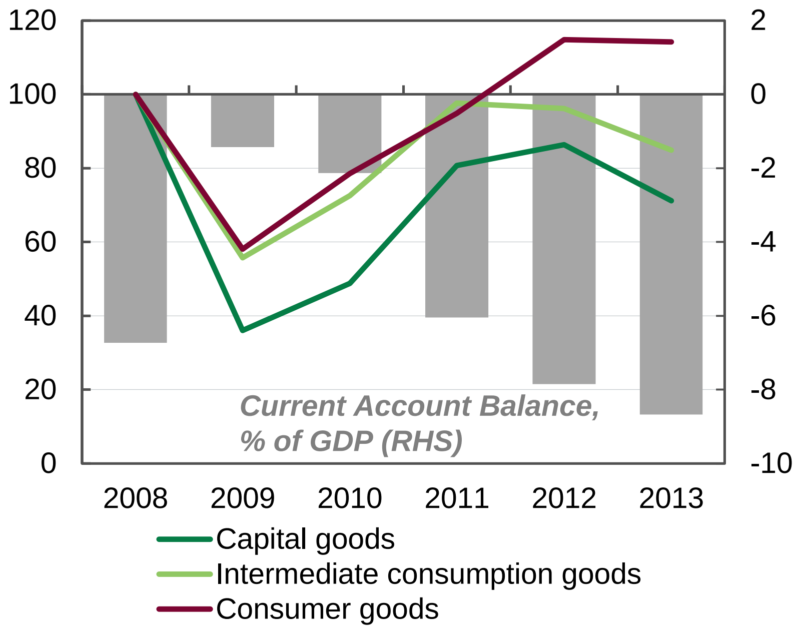


Source: NBU, Inflation Report April 2019.

- Imports continues growing fast, driven by solid consumer and investment demand
- In 2019, CA deficit is almost unchanged: better ToT and large stocks of record high corn harvest are offset by the slowdown of MTP's economies which puts drag on exports and remittances
- In 2020-2021, CA deficit will widen due to a decrease in pipeline transportation, lower than record 2018 grain harvests and reviving investment activity after the elections
- *Compared with April forecast: better terms of trade, higher grains harvest, stronger domestic demand, precautionary gas imports*

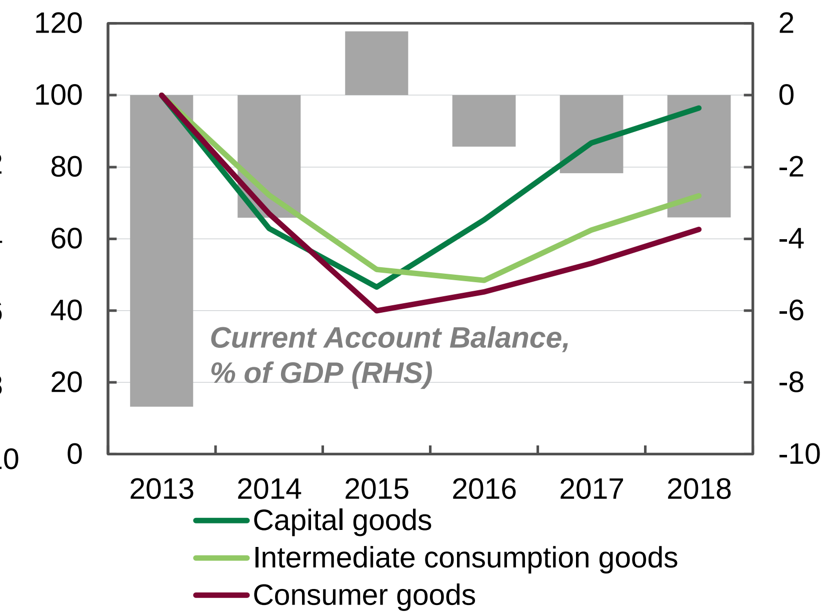
After the 2014-2015 crisis, investment demand was the initial driver for the recovery in imports

CA Balance and Imports by BEC, 2008=100



Source: NBU.

CA Balance and Imports by BEC, 2013=100

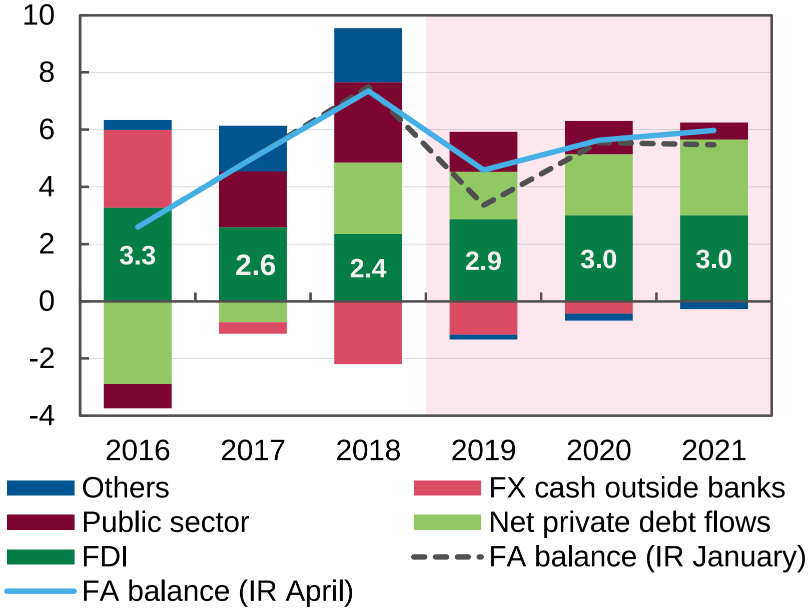


Source: NBU.

- During 2009 - 2013, buoyant consumer demand, mainly on cars and non-durable consumer goods, was the key factor, driving the widening of the current account deficit
- Investment growth also contributed in 2011-2012, but it was partly boosted by Euro-2012 football championship projects
- After 2014-2015 crisis, the CA deficit has been also gradually widening. However, unlike in the previous periods, it was mainly driven by robust investment activity, including due to high demand from agricultural sector and green energy projects

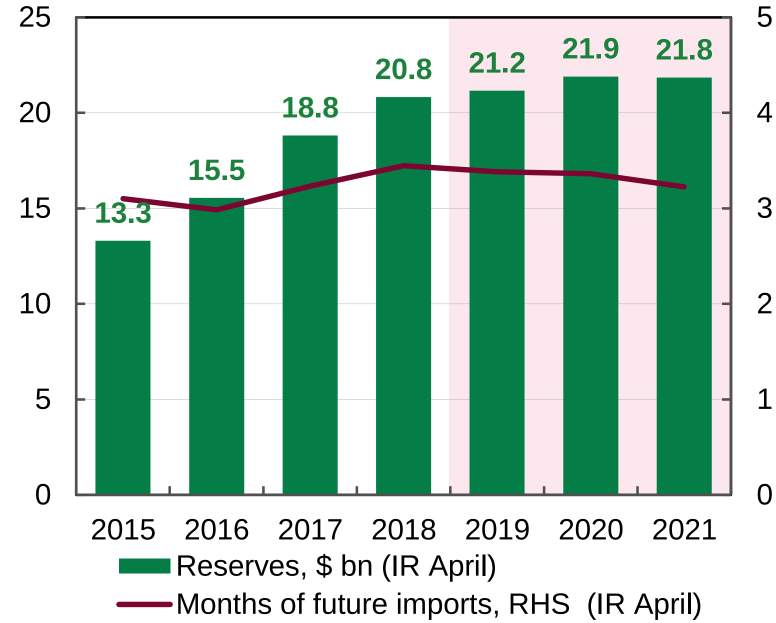
In 2018, reserves reached a 5-year maximum. However, large public debt repayments will put a drag on further reserve accumulation

Financial Account (FA): Net Inflows, USD bn



Source: NBU, Inflation Report April 2019.

Gross International Reserves, USD bn

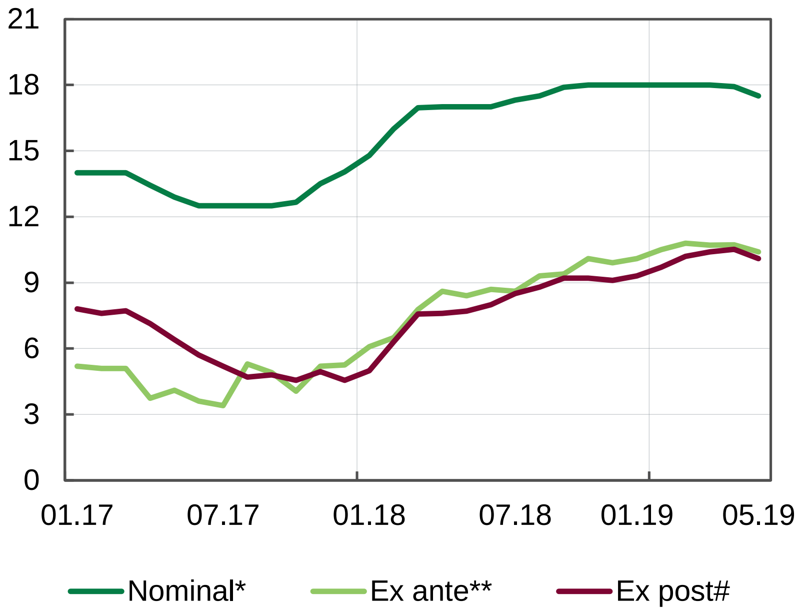


Source: NBU, Inflation Report April 2019.

- In 2018, FA inflows were generated by both public and private sectors, exceeding the CA deficit. This allowed to increase international reserves to a 5-year maximum of USD 20.8 billion as of end-2018
- In 2019-2021, FDIs and debt capital inflows to the private sector are forecast to increase. However, due to peak repayments of external public debt, the overall balance of payments is expected to be in a moderate deficit, limiting the building up of reserves
- *Compared with April forecast: termination of IMF SBA program, higher portfolio investments into Government bonds in UAH*

Real interest rates are high compared with other EM countries

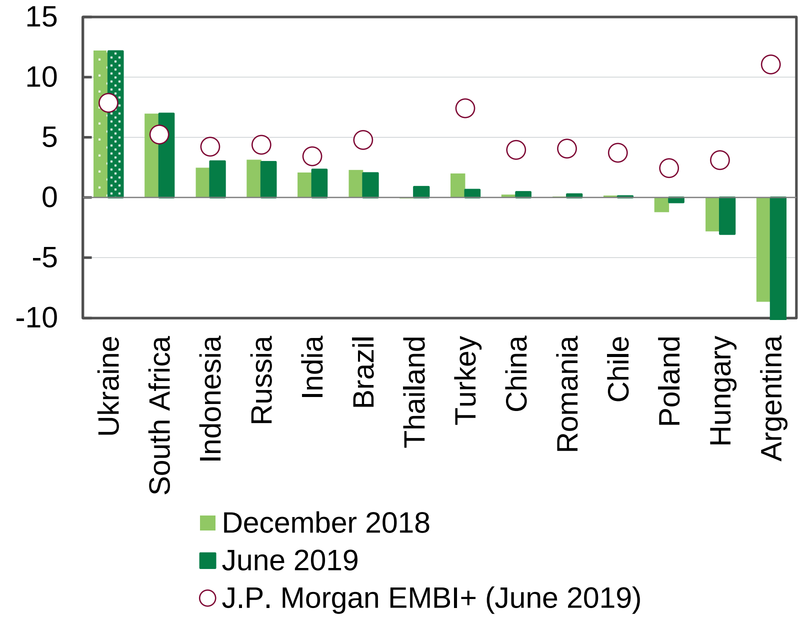
Nominal and Real NBU Key Policy Rate*, % pa



* Nominal rate is NBU's average rate on 14-days CDs.
** Real ex ante is nominal rate deflated by inflation expectations of fin. analysts.
\# Real ex post is nominal rate deflated by current core CPI.

Source: NBU.

Real Sovereign Bond Yields in Selected EM*, % pa



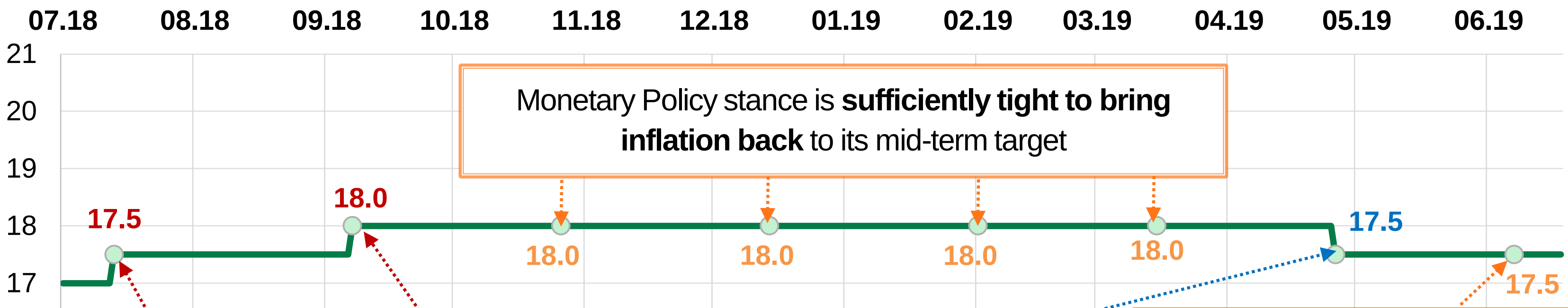
* Real interest rate is calculated as a difference of average monthly 1-year bond yield on the primary market and inflation forecasts as of end-2019. For Ukraine – based on NBU`s estimates.

Source: DekaBank, Consensus Economics, Thomson Reuters, Bloomberg, NBU`s estimates.

- Monetary policy stance in 2017-2019 remained rather tight. The real key policy rate ranged from 10% to 11% in 2019 – far above the neutral level (3-4%)
- Yields on hryvnia government bonds in real terms are among the highest across emerging markets

In April 2019, the NBU started the easing cycle. However, its evolution is contingent on inflation risks

Key rate, %



Monetary Policy tightening as a reaction to:

- higher-than-expected domestic demand
- less interest on the side of investors in Ukrainian sovereign debt
- inflation expectations that continue to exceed the NBU's inflation targets

Monetary Policy tightening in order:

- to neutralize increase in external risks:
- higher pressure on the currencies of developing economies due to capital outflow
- escalation of large-scale trade conflicts

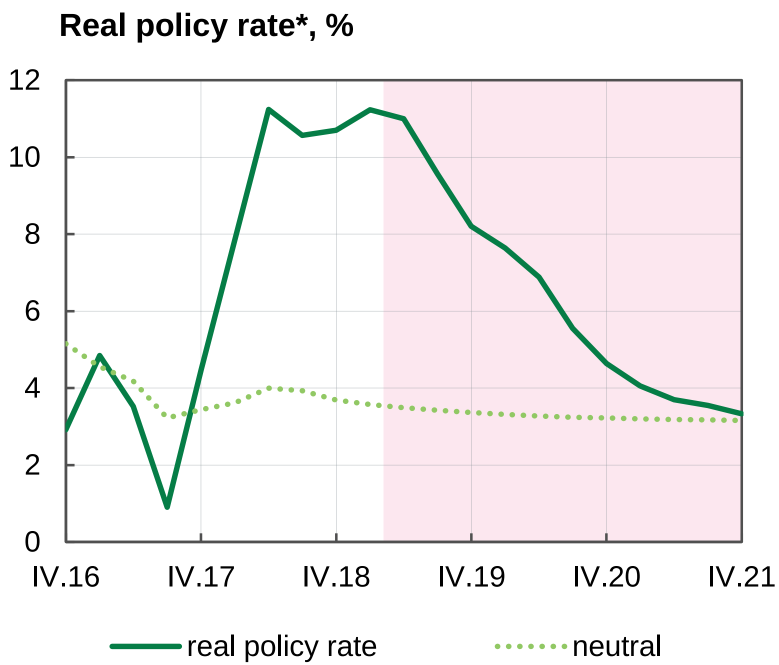
Monetary Policy easing because of:

- steadily declining of inflation towards the target of 5%;
- benign situation on the financial market;
- improving inflation expectations;
- other factors behind the further decline in inflation:
  - slower growth in wages;
  - hryvnia appreciation;
  - lower global prices for natural gas;
  - larger supply of both domestic and imported food products

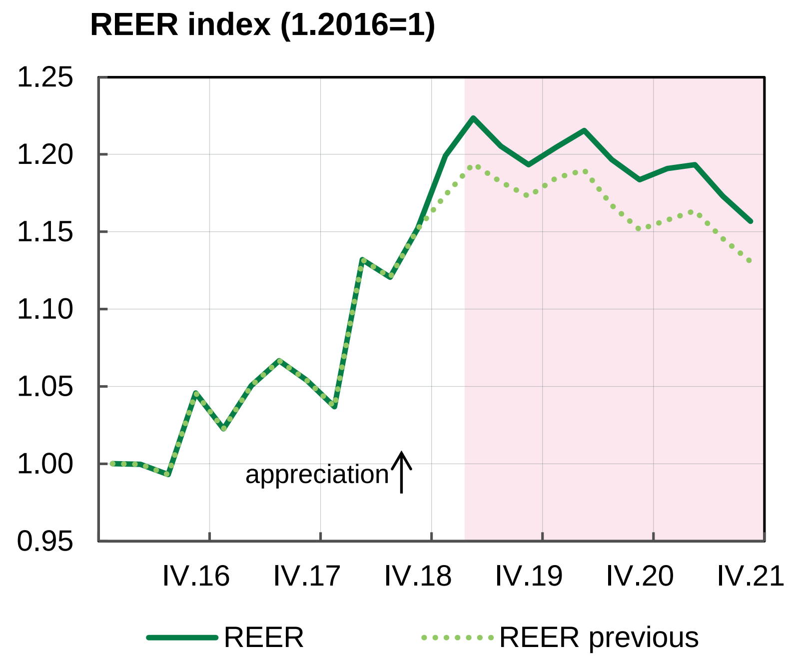
Postponing of Monetary Policy easing because of:

- signs of higher-than-expected domestic demand
- raised threats to financial stability due to:
  - speculative information about external public debt in the media;
  - delay of the IMF financial support;
  - current court proceedings (PrivatBank)
- external risks that remain relevant:
  - global recession and lower commodity prices;
  - escalation of trade conflicts;
  - uncertainty over the volume of gas transit through Ukraine;
  - military conflict development and new trade restrictions introduced by Russia

Monetary conditions ease on forecast horizon, but ensure the hitting inflation targets in 2020-21



* deflated by model-based inflation expectations



average	2018	2019	2020	2021
REER, % change	5.9	8.6 (+6.3)	-0.4 (-0.6)	-1.8 (-2.0)

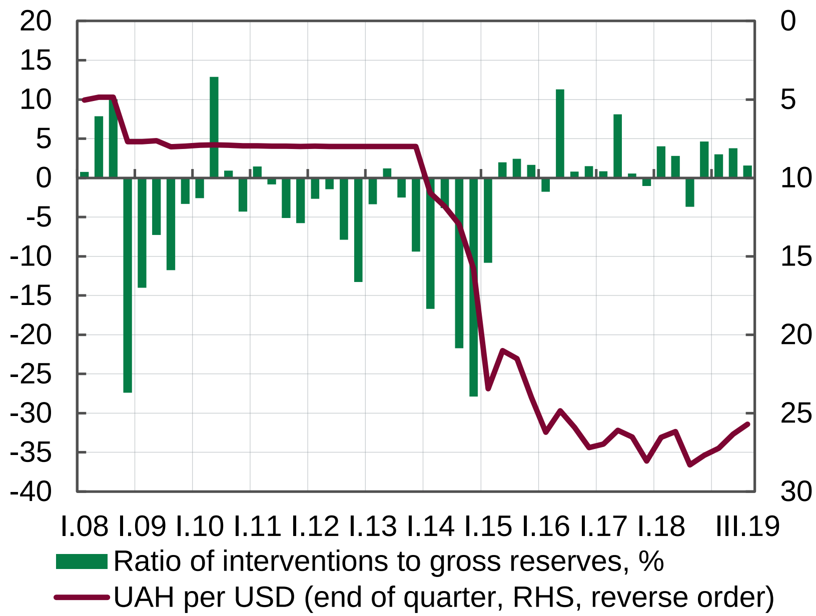
in ( ) – previous forecast (IR, January 2019)

!!! The NBU is going to publish projected path of key policy rate in July Inflation Report

(Compared with April forecast: better ToT, higher portfolio investments into Government bonds in UAH)

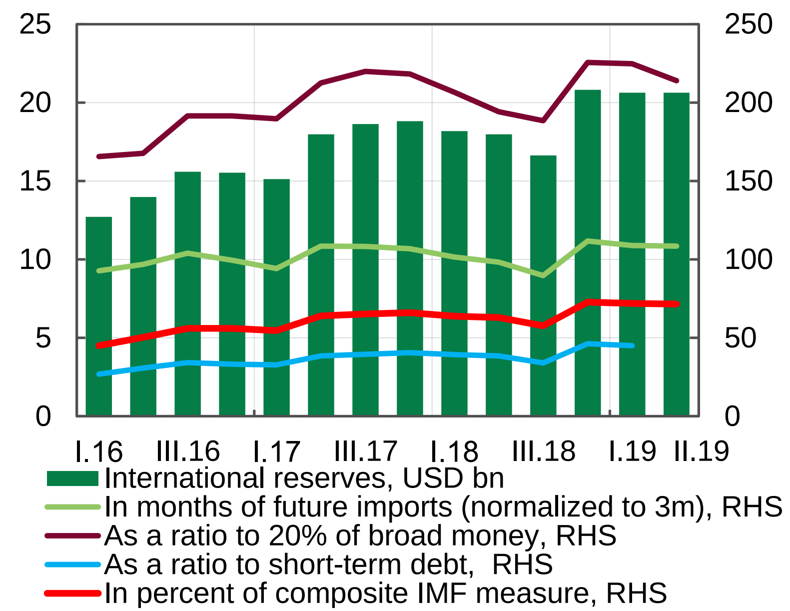
The NBU remains committed to a floating exchange rate policy

Reaction to FX Market Pressures: Reserves vs Exchange Rate, as of 08.07.2019



Source: NBU calculations.

International Reserves and Adequacy Criteria, %

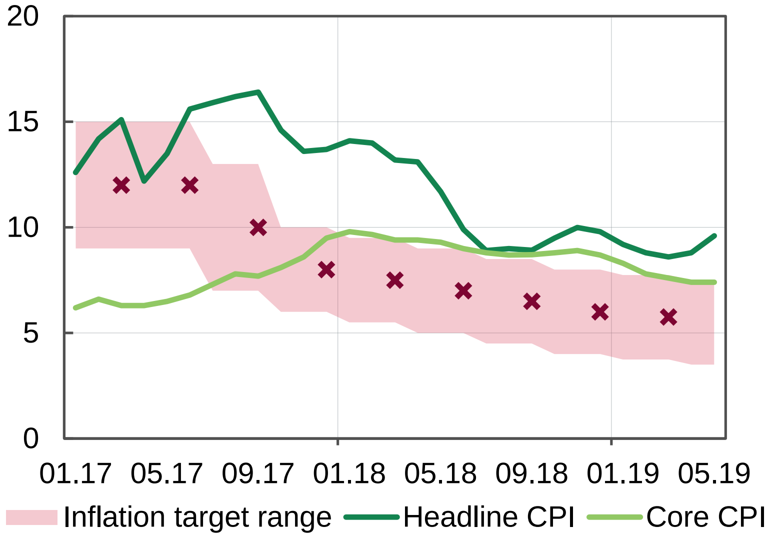


Source: NBU calculations.

- The NBU continues to play an active role in the FX market, but its interventions are performed to achieve clear and specific tasks – smooth exchange rate volatility, replenish international reserves, and enhance monetary policy transmission
- Over the last couple of years, hryvnia has strengthened against the currencies of MTP
- The new currency regulation system has started working on 7 February 2019. It deregulates investing procedures, eases cross-border transactions with currency valuables, and enlarges the list of authorized FX operations

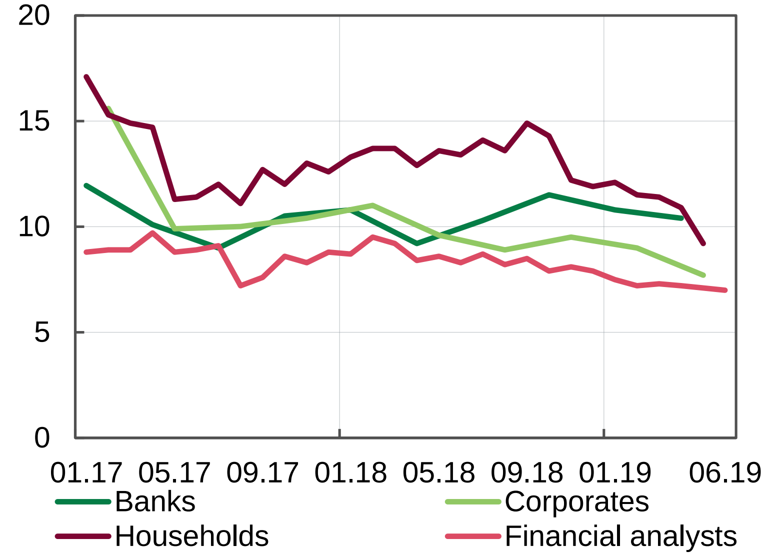
In 2018, consumer inflation slowed down to a 5-year minimum and temporary surged in April-May 2019

Headline and Core Inflation, % yoy



Source: SSSU, NBU.

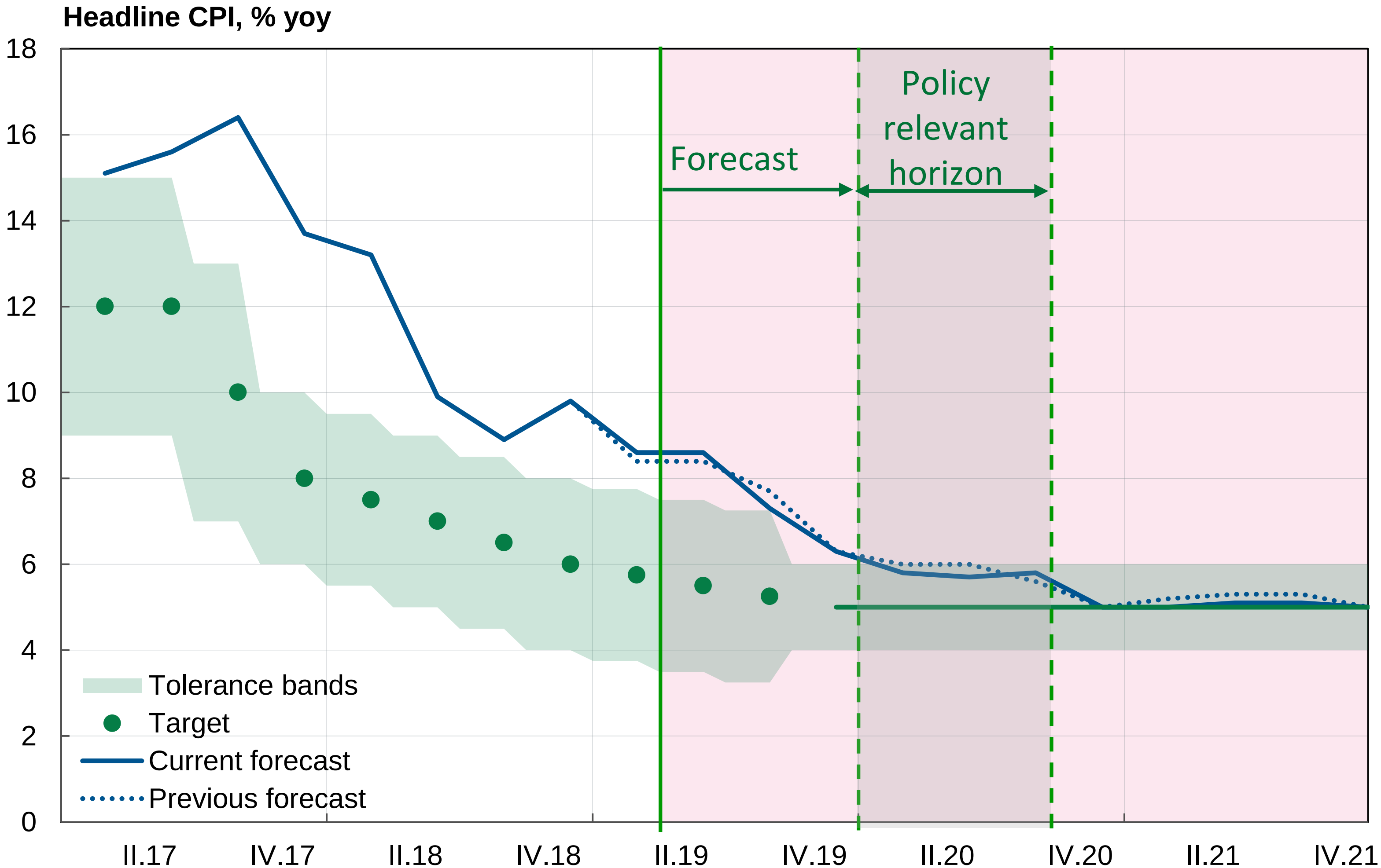
Inflation Expectations for the Next 12 Months, %



Source: NBU, GfK Ukraine surveys.

- In April - May 2019 disruptions to the supply of oil products and speculative demand for certain raw food products due to their limited supply drove the acceleration in the growth of fuel and raw food prices
- By contrast, core inflation declined more tangibly than projected, including due to the NBU’s tight monetary policy
- Stronger Hryvnia also contributed to improving inflation expectations despite elections

Monetary policy is directed to bring inflation to the target range in 2020



Source: NBU Inflation Report, April 2019.

(Compared with April forecast: stronger ER and lower gas prices vs robust domestic demand growth)

Key messages

- Ukraine's economy embarked on the recovery path in 2016, thanks to improved macroeconomic management, strong support from donors, and a favorable external environment
- Disinflation successfully proceeds, but its speed is altered by idiosyncratic shocks, further adjustment of administered prices and recovering wages and domestic demand. Tight monetary policy will ensure inflation falls back into the target band over the forecast horizon
- Fiscal and external sustainability have improved remarkably over the last few years, but risks remain, stemming from a peak in the domestic political cycle, potential risk of a full-scale global trade war and global recession
- The longer-term prospects of the economy remain strongly dependent on the realization of key structural reforms, which have to tackle major weaknesses such as the poor business climate, unfavorable demographics and deteriorating infrastructure
- NBU policy efforts will focus on securing price and financial stability, revamping the banking system and liberalizing the capital account

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