



Національний  
банк України

# Inflation report (October 2020)

November 3  
2020



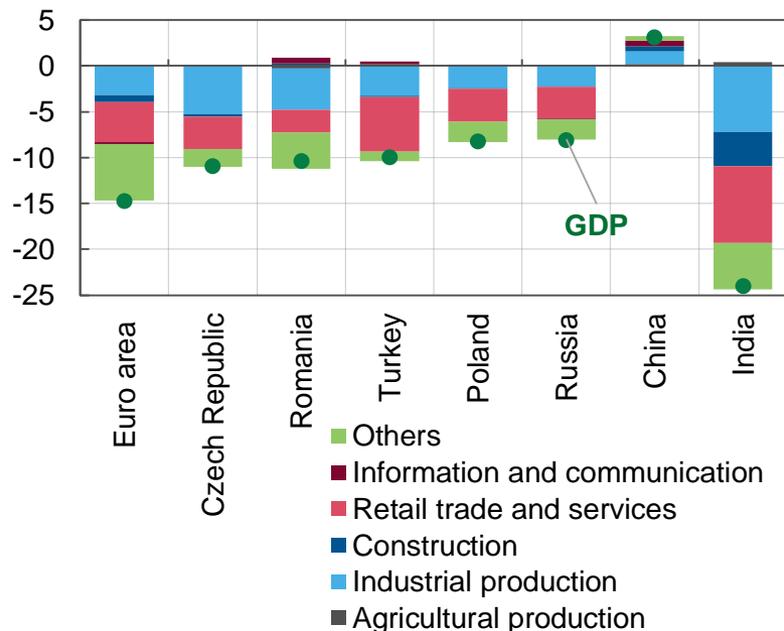
## Current Trends: summary

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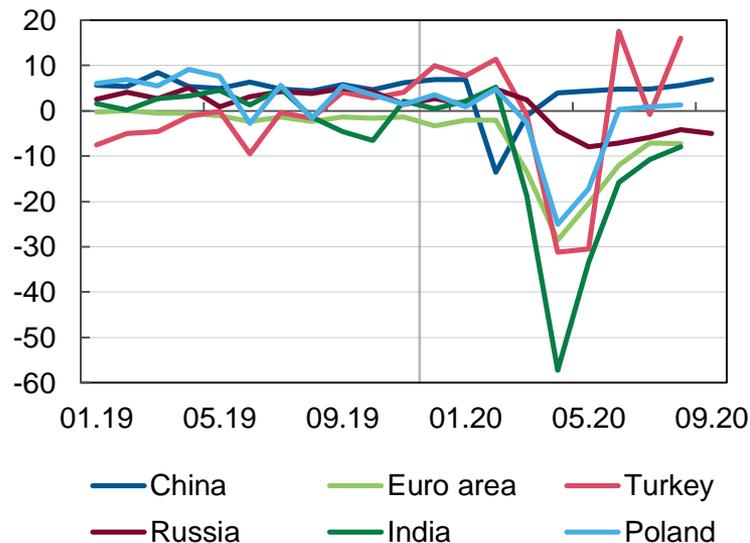
- **The NBU Board decided to keep the key rate unchanged (6%).** Maintaining a loose monetary policy is aimed at supporting economic recovery and achieving the inflation target
- **Inflation remains below the lower target bound** due to increase in food supply. This has offset the opposite pressure on prices from other factors, such as the hryvnia depreciation, higher energy prices, and a recovery in economic activity and consumer demand
- **In 2020, the forecast of real GDP remains unchanged (-6%).** The main reason behind the year-end economic contraction lies in difficulties faced by businesses in Q2, at the same time, business activity picked up markedly in Q3. A recovery in consumer and investment demand in H2 will offset the lower crop harvest and smaller fiscal impulse
- **The current account remained in surplus for the third consecutive quarter,** exports showed resilience to the crises due to a number of external and internal factors

## BOX: Quarantine measures against the background of a weakened global economy led to a sharp decline in Ukraine's MTP countries

Contributions to annual GDP growth by sector in Q2 2020, pp



Industrial production, % yoy



\* Euro area – s/a

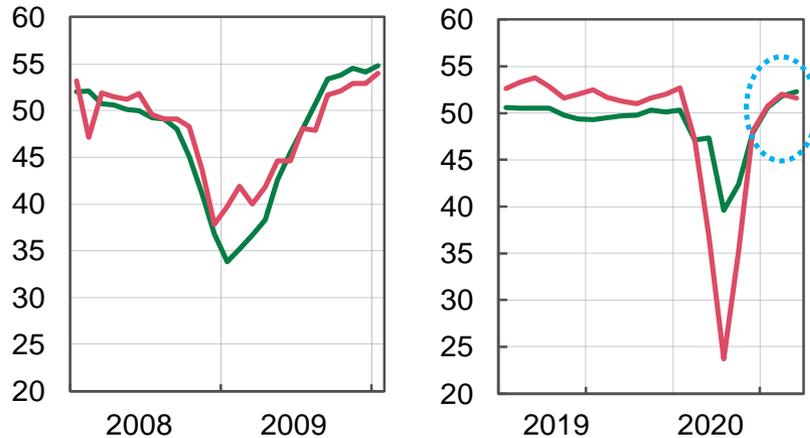
Source: Eurostat, National statistical agencies, NBU estimates

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- The services sector has been hit hardest by quarantine restrictions. However, industrial production also declined due to narrowed demand, both domestic and foreign
- The gradual lifting of quarantine restrictions against the background of large-scale fiscal support (the volume of which in some countries reached more than 40%) and the easing of monetary conditions has led to economic recovery
- In 2021, economic growth in MTP countries is expected to recover, but will not fully offset the unprecedented drop this year

# Global economy has been recovering, particularly the service sector, however, a new wave of COVID-19 has slowed this process

Global PMI in various crisis periods

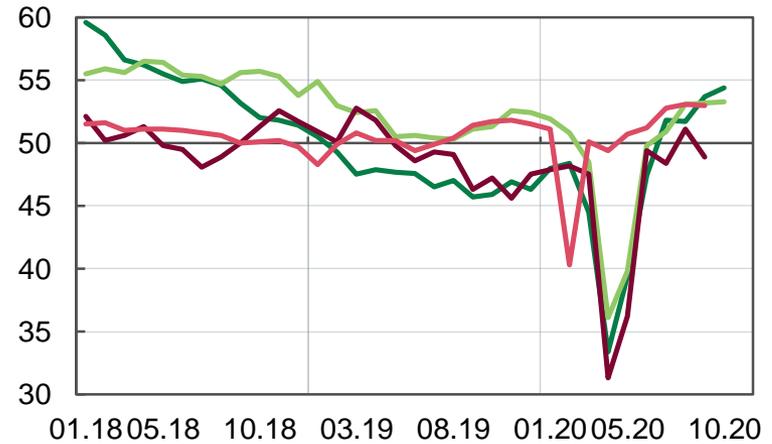


— Manufacturing

— Services

Source: IHS Market.

Manufacturing PMI in selected countries



— Euro area

— USA

— Russia

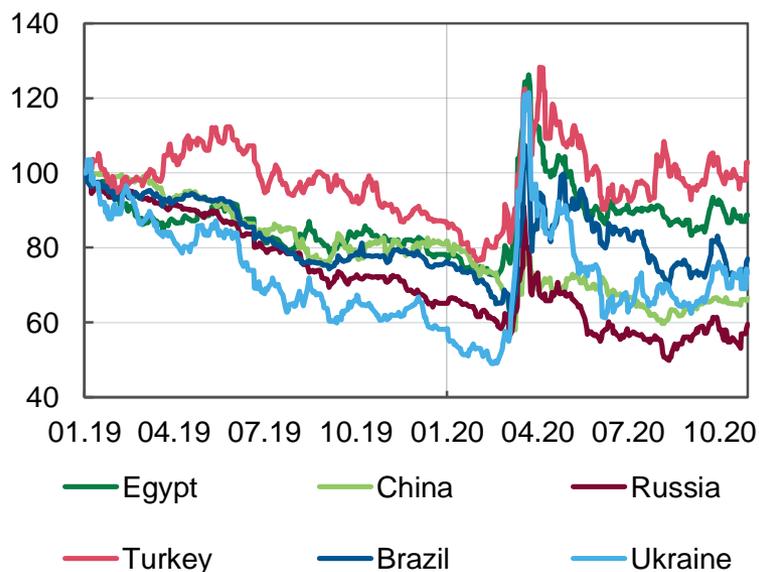
— China

Source: IHS Market.

- A specific feature of the current crisis is a relatively smaller impact on the manufacturing sector
- The service sector took a more severe hit due to quarantine restrictions. Following a short time period conditions in the service sector started to deteriorate, as the number of new cases increased
- Low business confidence levels imply low investment activity

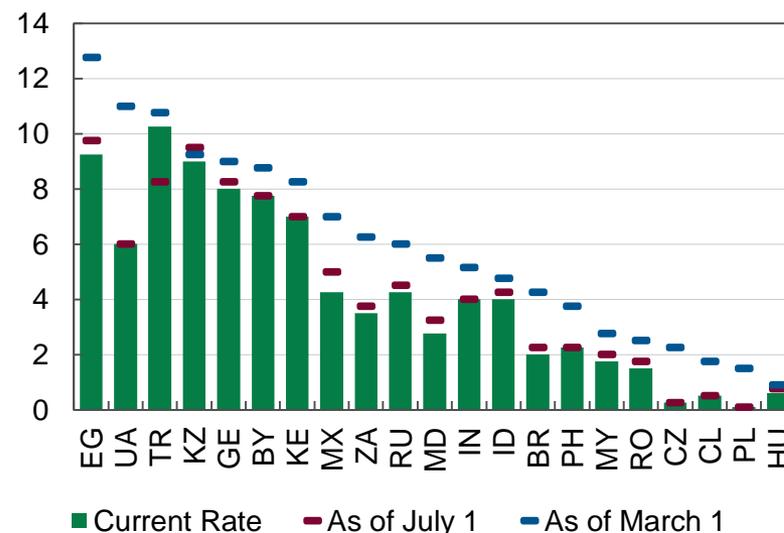
# Global financial conditions remain loose, but investor risk appetite weakened due to uncertainty

J.P.Morgan EMBI+, 01 Jan 2019 = 100



Source: Bloomberg, as of 29.10.2020.

Key Policy Rates in Selected EM Countries\*, %

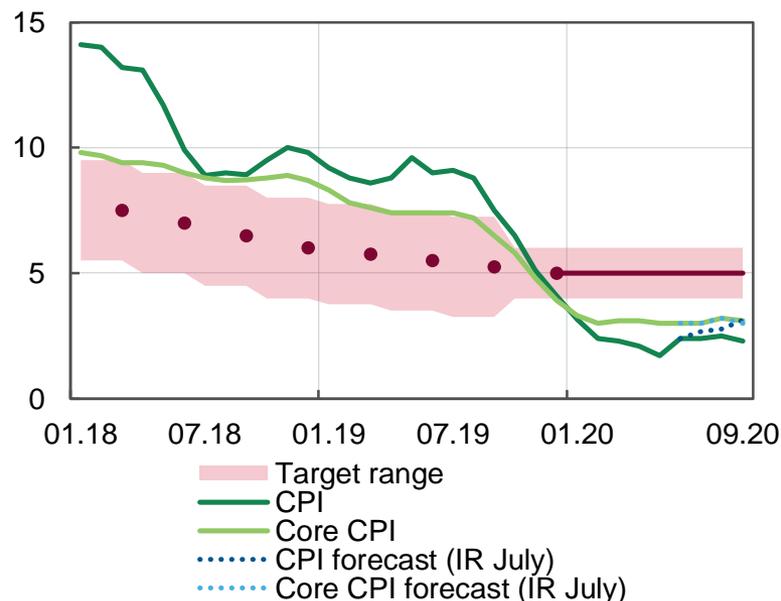


Source: official web-pages of central banks, as of 21.10.2020.

- Leading central banks will continue accommodative monetary policy at least for the next two years
- According to IIF data, the last weeks of September saw sharp capital outflows from EM, which compared to the 2013 “taper tantrum” market turbulence or renminbi depreciation in 2015
- The room for further policy easing by EM central banks is gradually waning

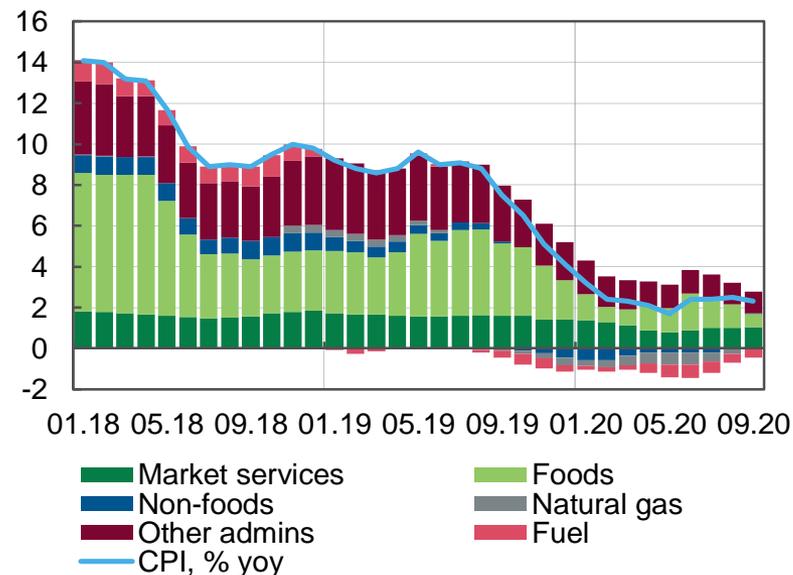
# Inflation remained low, mainly, due to subdued food price dynamics

Headline and core CPI\*, % yoy



Source: SSSU, NBU staff estimates.

Contributions to the annual change in CPI, pp

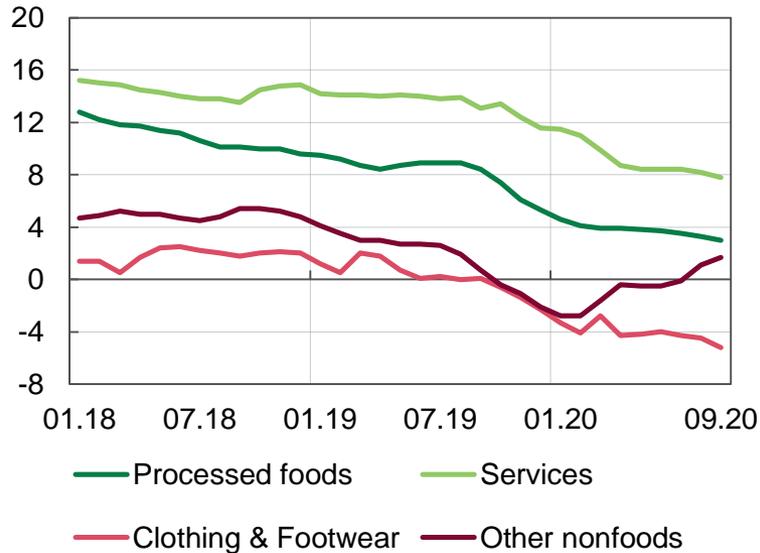


Source: SSSU, NBU staff estimates.

- Consumer inflation hovered at 2.0% - 2.5% yoy since February (2.3% yoy in September), below the target range of 5% ± 1 pp. Inflation was lower than the forecast published in the Inflation Report for July 2020
- The main contribution to the further slowdown came from changes in food prices driven by supply factors, some of which are temporary
- Additional factors were low fuel prices, in particular due to increased competition, and changes in consumer behavior, which affected certain non-food products

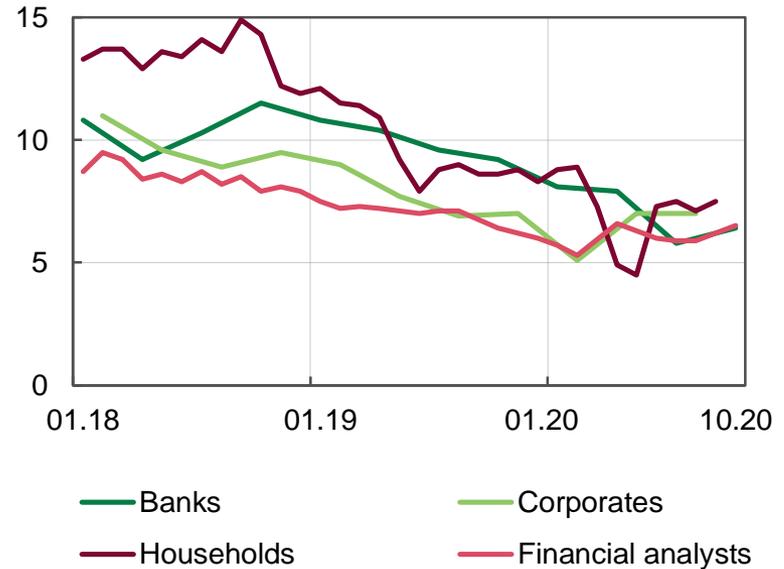
# Pressure from individual components of core inflation is gradually increasing despite a number of restraining factors

Main components of core CPI, % yoy



Source: SSSU, NBU staff estimates.

12-month-ahead inflation expectations, %

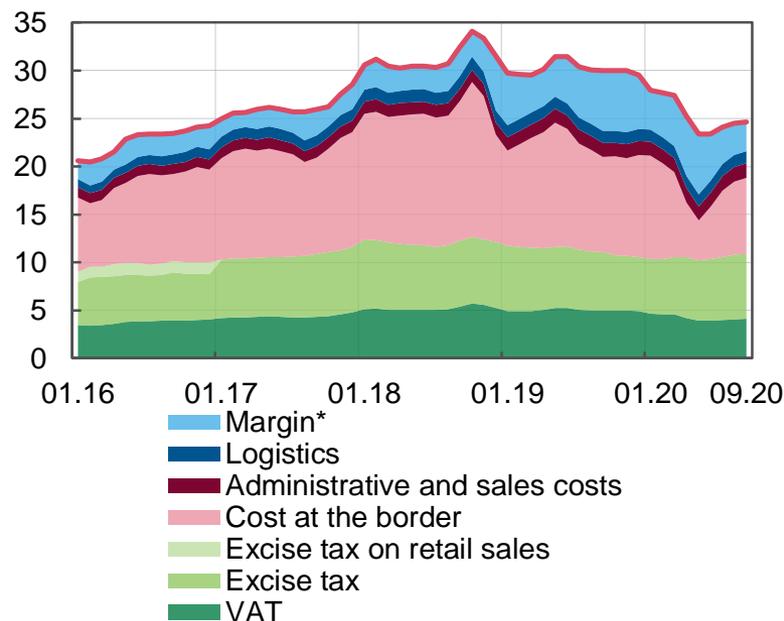


Source: NBU, GfK Ukraine, Info Sapiens.

- Rapid recovery of consumption and weakening of the hryvnia support the upward dynamics of non-food prices and keep services inflation elevated
- However, core inflation is constrained by weak dynamics in food, clothing, and footwear prices. The latter were particularly affected by changes in the nature of demand
- Inflation expectations of different groups of respondents remain elevated and are gradually deteriorating

## Box. Oil prices pass-through to consumer prices in Ukraine

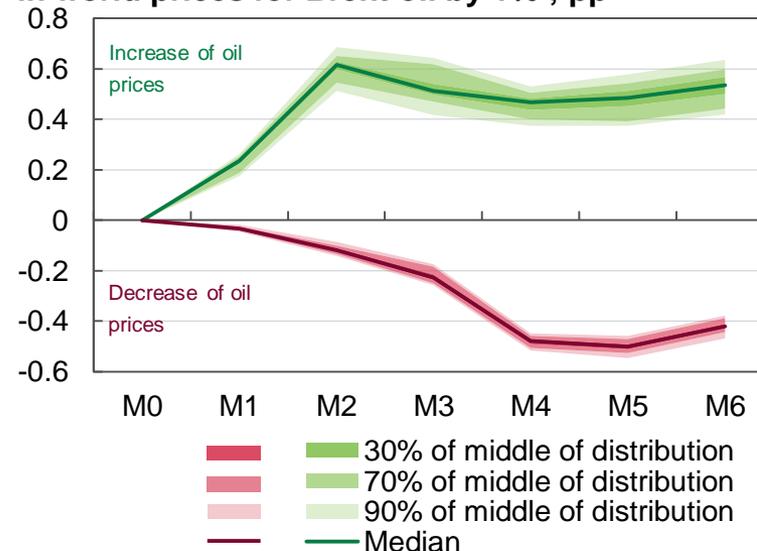
Structure of the retail price for gasoline A-95+, UAH/L



\* May include discounts on loyalty programs.

Source: minfin.com.ua, Refinitiv Datastream, NBU staff estimates.

Change in the A-95 gasoline price due to the change in world prices for Brent oil by 1%\*, pp



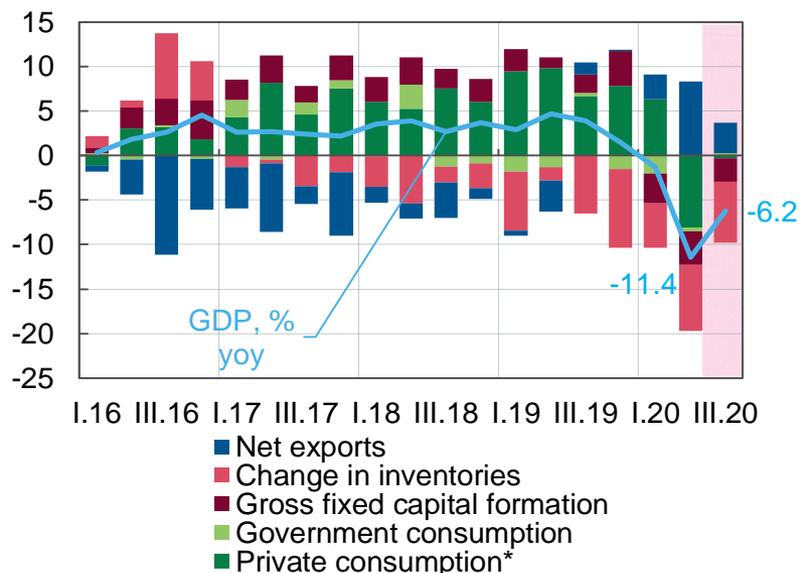
\* The median and distribution range is calculated based on standardized cumulative A-95 gasoline price responses in response to a 1% increase and decrease in oil prices for each equation used.

Source: NBU staff estimates based on SSSU, IMF, InfoSapiens.

- The cumulative effect of a 1% change in oil prices is only 0.4-0.5 pp in the price of fuel and is achieved in a few months
- The reaction of domestic prices to different directions of change in oil prices, i.e. to its rise or fall in price, is asymmetric. Thus, retail gasoline prices are more responsive to growth than to decrease of crude oil prices, but the magnitude of this impact is leveling off over time

# In Q3 2020, the Ukrainian economy was recovering faster than expected, primarily on account of private consumption

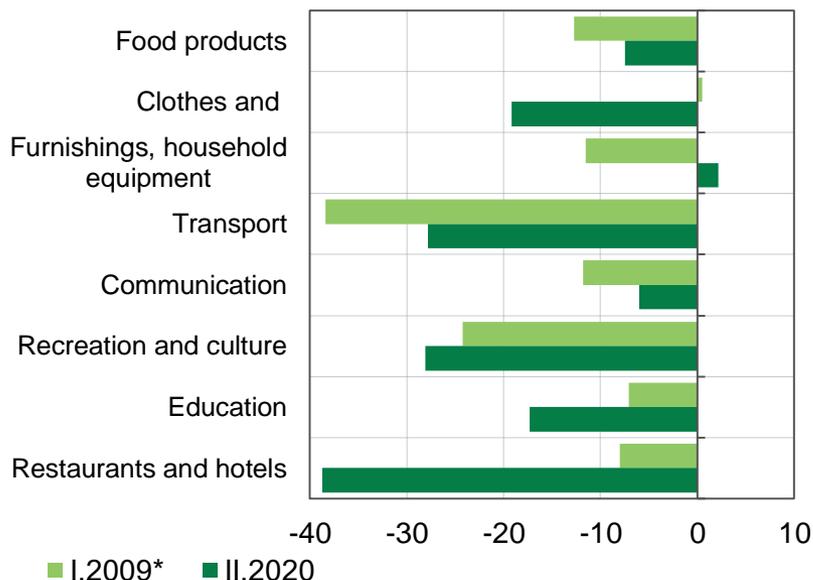
Contribution to real GDP yoy changes, pp



\* Including non-profit institutions serving HH and HH consumption.

Source: SSSU, NBU staff estimates.

Leading indicators of private consumption



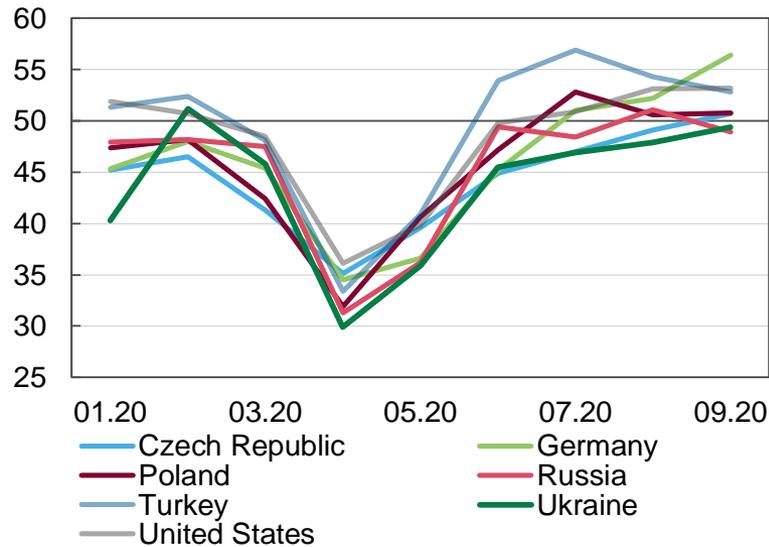
\* Q1 2009 was chosen for comparasing due to deepest economy fall in that period in crisis 2008-2009.

Source: SSSU, NBU staff estimates.

- Q3 2020 real GDP estimate was revised upwards to -6.2% yoy (-7.4% yoy in previous forecast) mainly on account of private consumption
- In contrast to the previous crisis in 2008–2009, the impact of this crisis on private consumption was relatively smaller, and the recovery was faster, in particular due to the virtually no fall in real wages, and absence of devastating depreciation and inflation
- Consumer behavior has changed due to the quarantine that physically restricted consumption and enhanced companies and education centers to massively adopt remote work and studying

# Box. Business activity outlook index is a leading indicator of economic activity

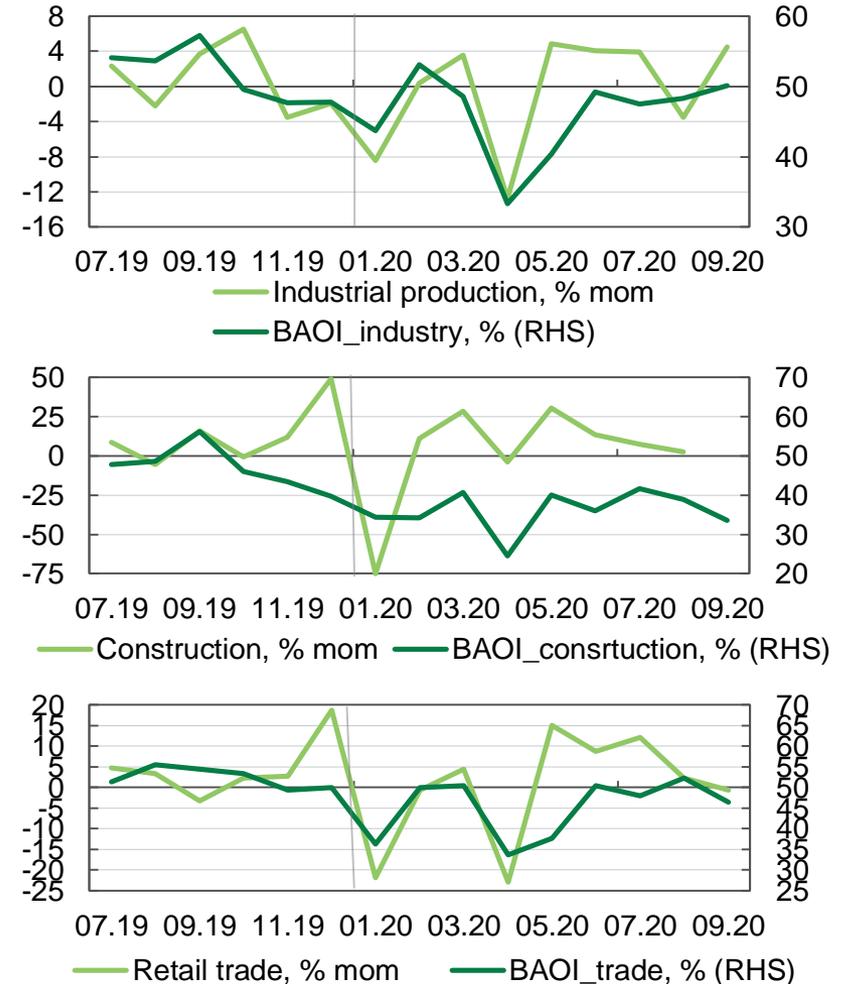
PMI for some countries and BAOI for Ukraine in 2020, %



Source: NBU, IHS Markit.

- Firms' estimates reflect economic situation and are available early than official statistics
- Quick survey data is more valuable in crisis time. During the quarantine in the spring of 2020, BAOI was taken into account in decisions to accelerate the easing of monetary policy, and further – to have a preliminary assessment of the pace of economic recovery

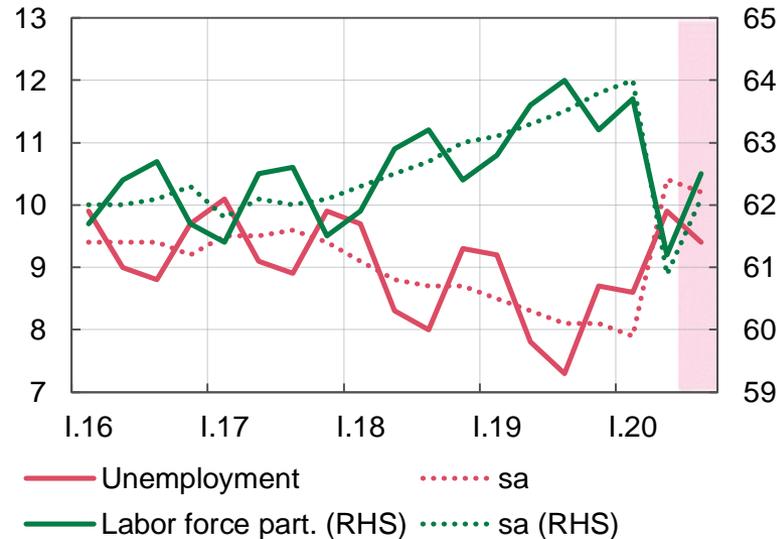
BAOI in industry, construction, trade and industrial production, construction, retail trade



Source: NBU, SSSU.

# Unemployment increased sharply, but was lower than expected due to labor force exits

ILO unemployment\* and labor force participation\*\* rate, %

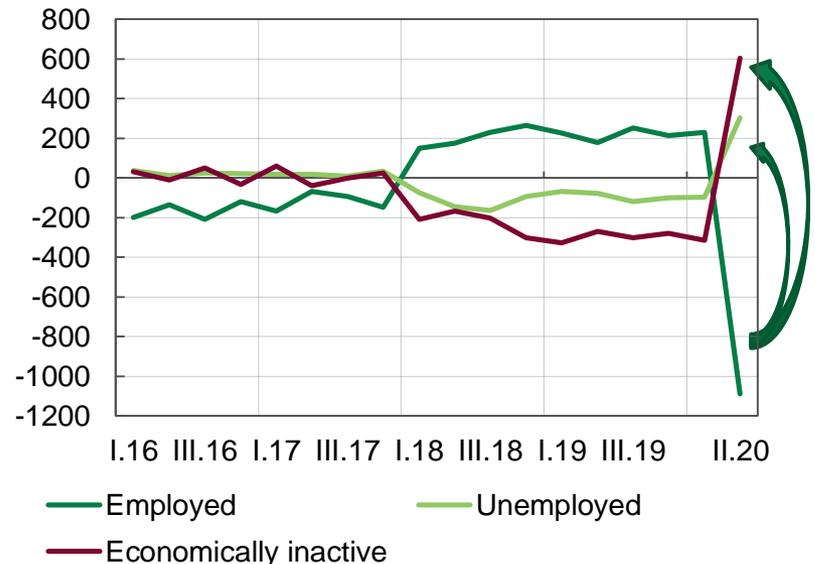


\* As a % of population aged 15–70 in the labor force.

\*\* As a % of total population aged 15–70.

Source: SSSU, NBU staff estimates.

Unemployed, employed, economically inactive, thousand persons, y-o-y

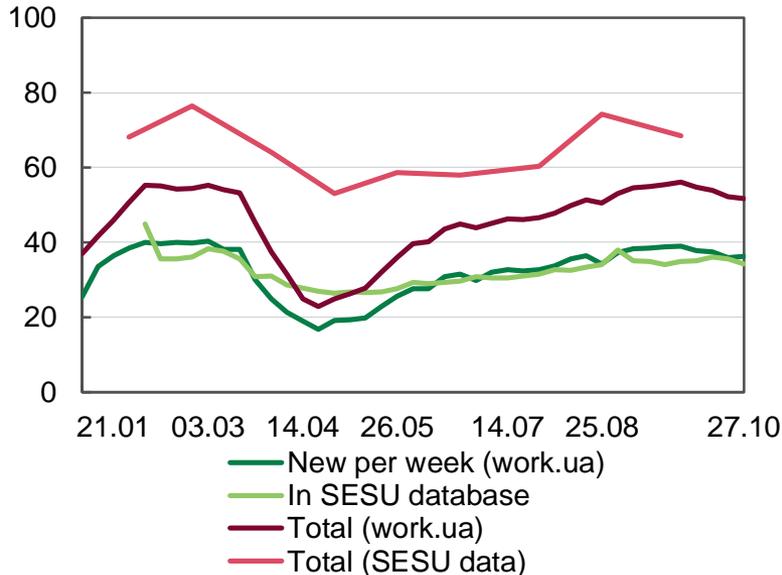


Source: SSSU, NBU staff estimates.

- Unemployment (sa) in Q2 2020 was the highest since 2001. However, the unemployment rate was lower than expected, as a large number of people, who lost their jobs, were not looking for a new one because of:
  - Fear of getting infected
  - Limited availability of transportation and other infrastructure (e.g. absence of access to Internet)
  - Need to look after children
- The decline in employment was broad-based across people of all ages, gender or place of residence. Young people and people from rural areas were most affected

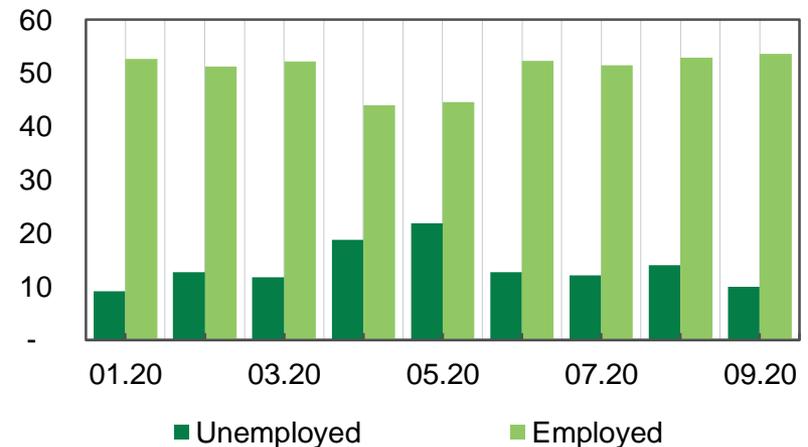
# Labor demand recovered and reached the pre-quarantine level, contributing to higher employment

Labor demand indicators: number of vacancies, thousand



Source: work.ua, SESU

Estimate of number of unemployed and employed based on household survey, %\*



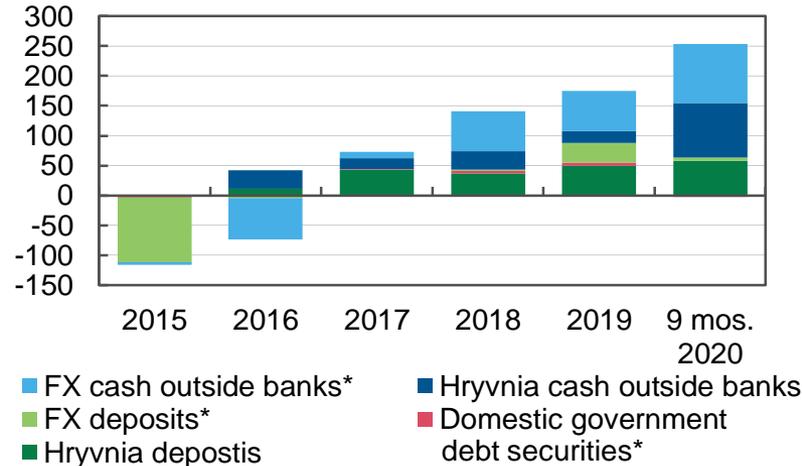
\* Share of household answers about their main occupation by InfoSapiens survey. Employed included private enterpriser, self-employed, employees.

Source: Infosapiens, NBU staff estimates.

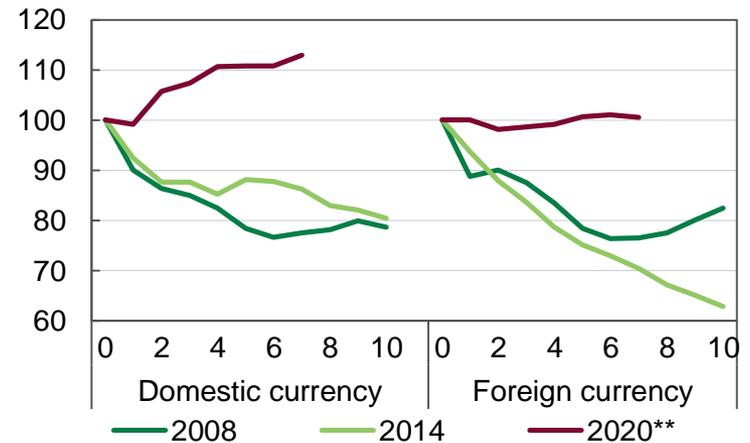
- The unemployment rate will decrease in Q3 2020, according to NBU estimates; however, it will remain virtually unchanged in seasonally adjusted terms
- This is explained by the expected partial returning to the labor force of persons with work ability

# Box. Household financial savings continued to increase, despite a "flight-to-liquidity"

Change in household deposits, holdings of government debt securities and cash outside banks#, bn UAH



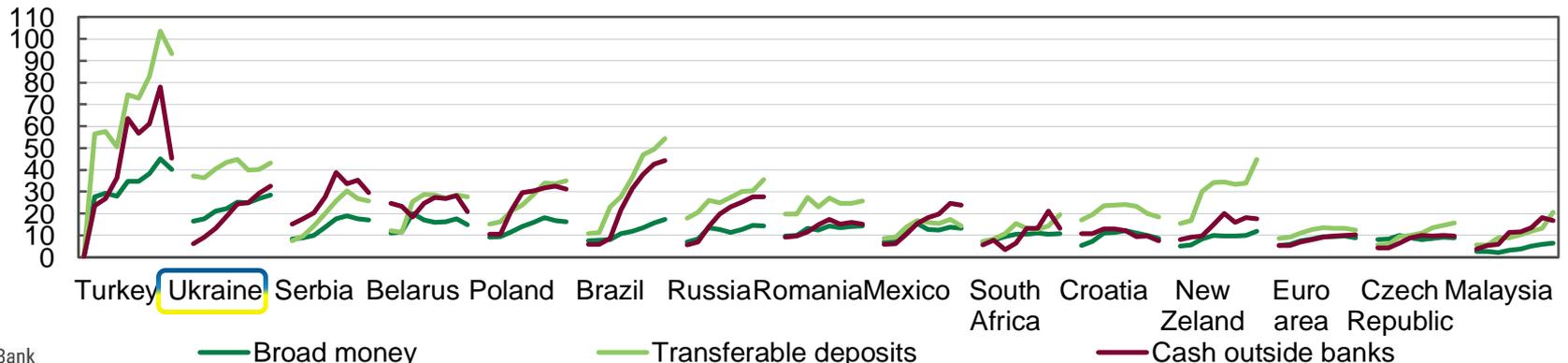
Household deposits by types of currencies during different crises, index, pre-crisis month = 100\*



# The contribution of change in cash outside banks is considered to be the upper bound as a breakdown by sectors is not available.  
 \* In UAH equivalent, excluding exchange rate revaluation effect.  
 Source: NBU staff estimates.

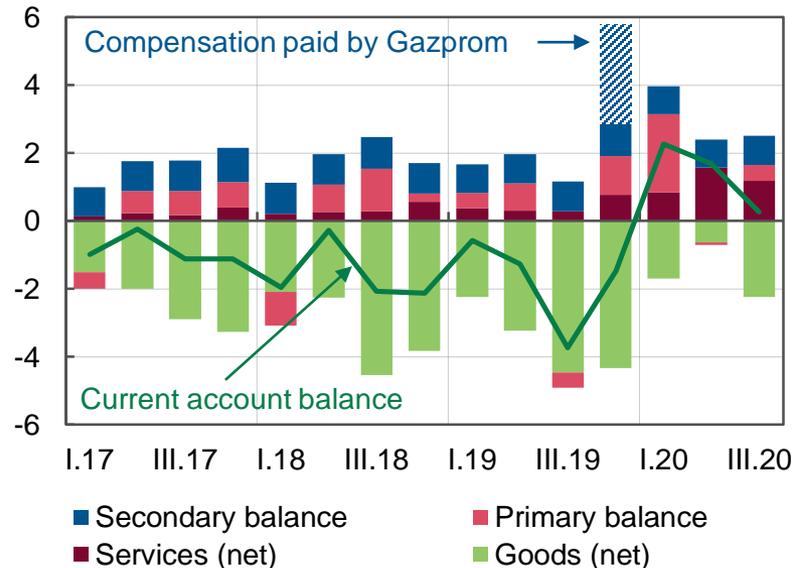
\* September 2008, January 2014, February 2020 respectively; \*\* As of September 2020.  
 Source: NBU staff estimates.

Growth rate of monetary aggregates across countries during January – August 2020, % yoy



# In Q3, the current account stayed in surplus

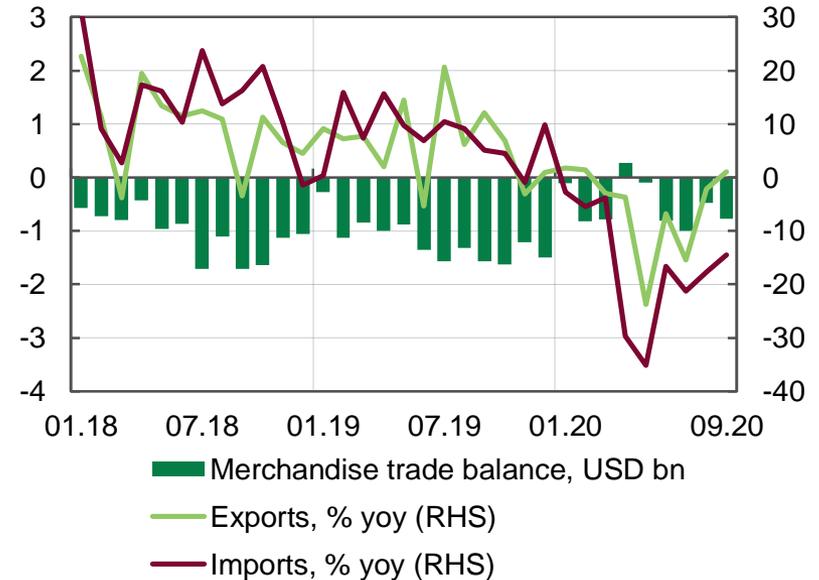
Current account balance\*, USD bn



\* In Q4 2019 – without compensation paid by Gazprom.

Source: NBU

Merchandise trade

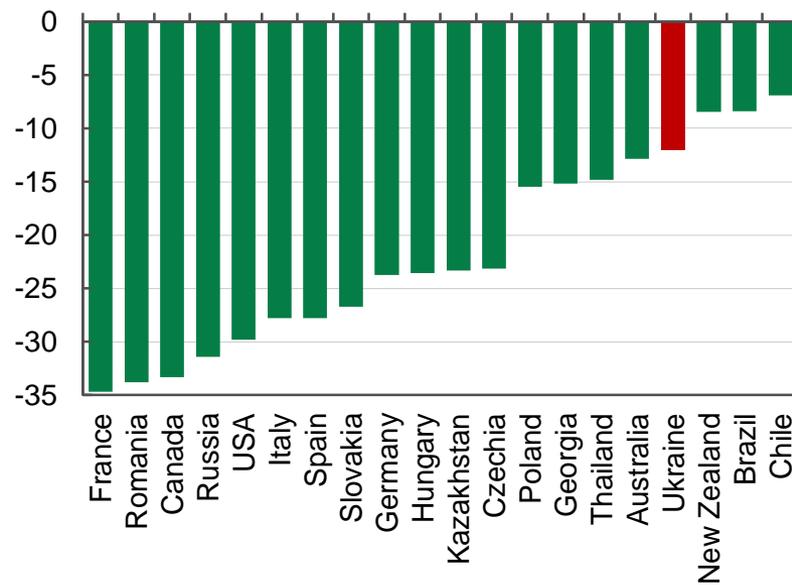


Source: NBU staff estimates.

- The CA surplus was achieved on the back of lower trade deficit compared to last year and high surplus in services trade
- The merchandise trade deficit has been widening, albeit moderately:
  - Merchandise exports have been recovering on the back of strengthening external demand, although lower harvest and agricultural stocks constrained further exports growth
  - The decline in imports also decelerated amid a recovery in domestic demand, but the depth of decline remained significant

## Box. In 2020, exports showed resilience to the crisis due to a number of external and internal factors

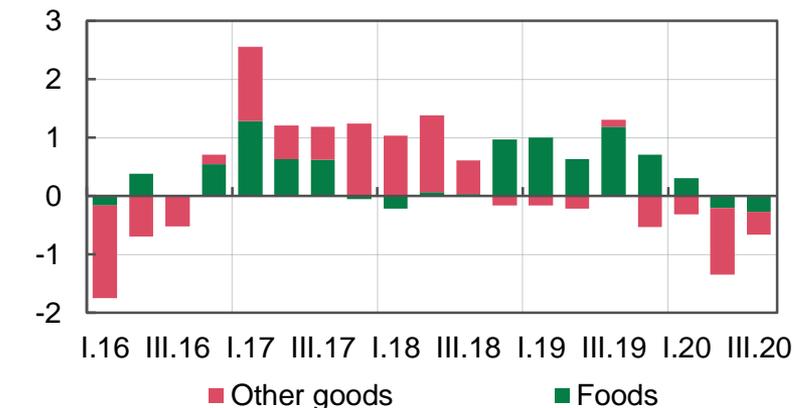
Merchandise exports in Q2 2020, % yoy



Source: Eurostat, ITC, SCSU, NBU.

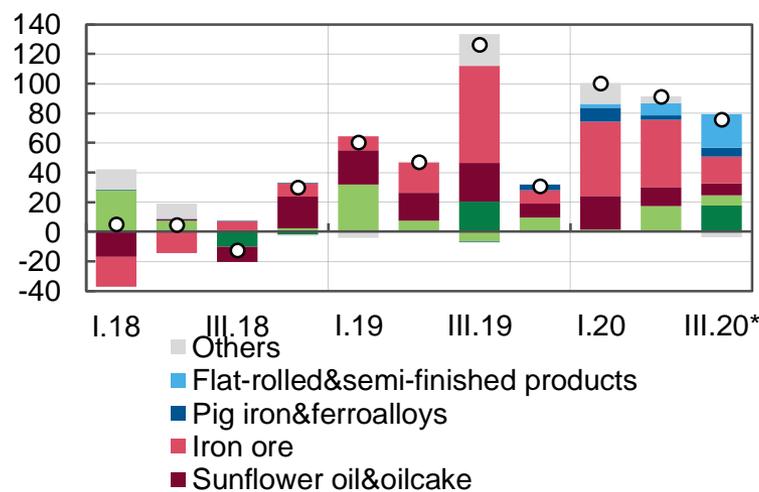
- High share of foods in exports served as a buffer during the crisis amid lower income elasticity of food demand
- Ukrainian exporters have taken the window of opportunity amid USA-China trade wars in 2019
- The Chinese economy has already recovered to the pre-quarantine level in Q2 2020

Absolute annual change in merchandise exports, USD bn



Source: NBU calculations

Contributions to annual change in exports to China, pp

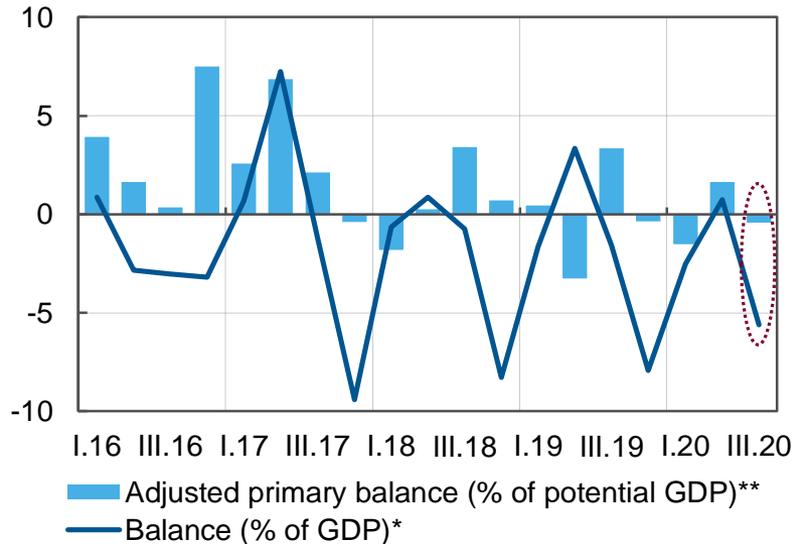


\* Estimated data for September.

Source: NBU calculations

# In Q3 2020, fiscal policy eased somewhat, but not as significantly as expected

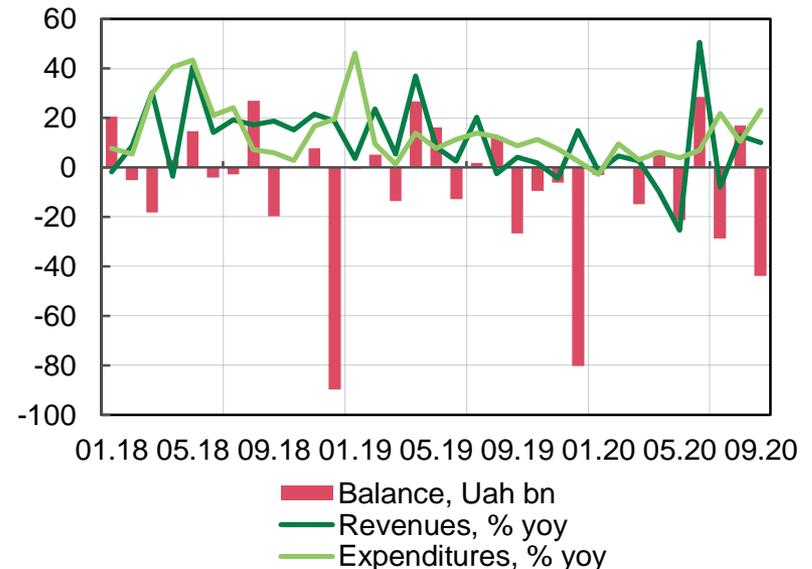
## Fiscal balance indicators



\*Overall balance (% of GDP) is the consolidated budget balance, taking into account loans to the Pension Fund from the STA. \*\* Cyclically adjusted primary fiscal balance (CAPB) of the general government (% of potential GDP). CAPB is the difference between seasonally adjusted.

Source: Treasury, NBU staff estimates.

## Main Consolidated budget figures



Source: Treasury, NBU staff estimates.

- The easing reflected an increase in expenditures, primarily due to the previously accumulated funds
- Social programs, health care and the road sector are spending priorities. Other expenditures are financed selectively due to funding difficulties
- State budget revenues improved thanks to tax revenues

## Macroeconomic forecast: summary

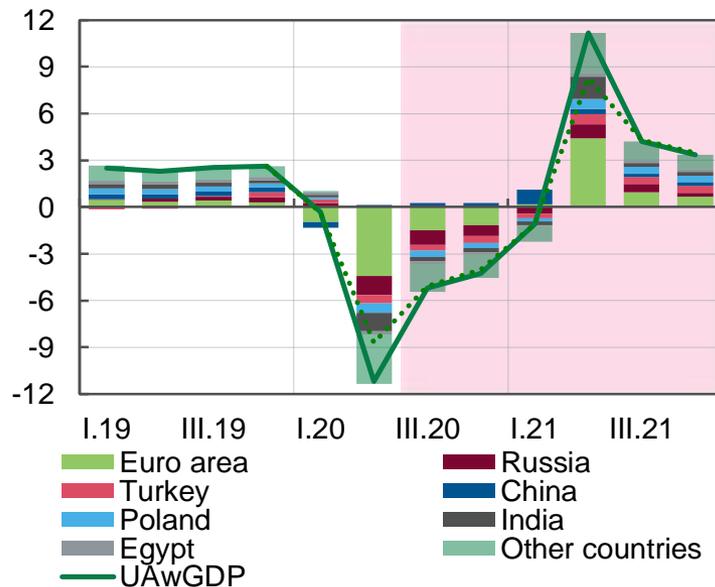
- **The world economy has reached the peak of the crisis due to quarantine measures and has begun to recover.** Prices on world commodity markets will be buoyed by the intensification of world demand
- **In 2020, GDP will decline by 6% due to quarantine and compression of external demand.** In 2021-2022, GDP will recover at about 4% rate and reach pre-quarantine level in 2022
- **Inflation will rise due to the recovery of aggregate demand, as well as the reversal of energy prices.** In 2021, the CPI will exceed the target range due to pressure from minimum wages and the effects of the hryvnia depreciation in Q3 2020. The CPI will return to the target range of 5% ± 1 pp in 2022 due to the monetary policy response
- **In 2020, a current account will be with surplus** due to the resilience of exports to crises and falling imports. In 2021-2022, the CA will return to the deficit due to the realization of deferred demand and the resumption of economic activity
- **Monetary conditions will remain expansionary till the end-2021,** even taking into account the expected increase in the key rate in response to increasing inflationary pressures

	2019	2020	2021	2022
<b>Real GDP, change, %</b>	3.2	-6.0 (-6.0)	4.2 (4.0)	3.8 (4.0)
<b>CPI, y-o-y, % (eop)**</b>	4.1	4.1 (4.7)	6.5 (5.5)	5.0 (5.0)
<b>Core CPI, y-o-y, % (eop)**</b>	3.9	4.2 (4.0)	5.4 (4.2)	3.8 (3.9)
<b>Current account balance, % GDP</b>	-2.7	2.9 (4.4)	-2.3 (-2.8)	-5.1 (-4.5)
<b>Gross reserves, USD bn</b>	25.3	29.1 (29.8)	29.5 (32.7)	28.8 (32.7)

\* in brackets – previous forecast (Inflation report, July 2020) \*\* end of period

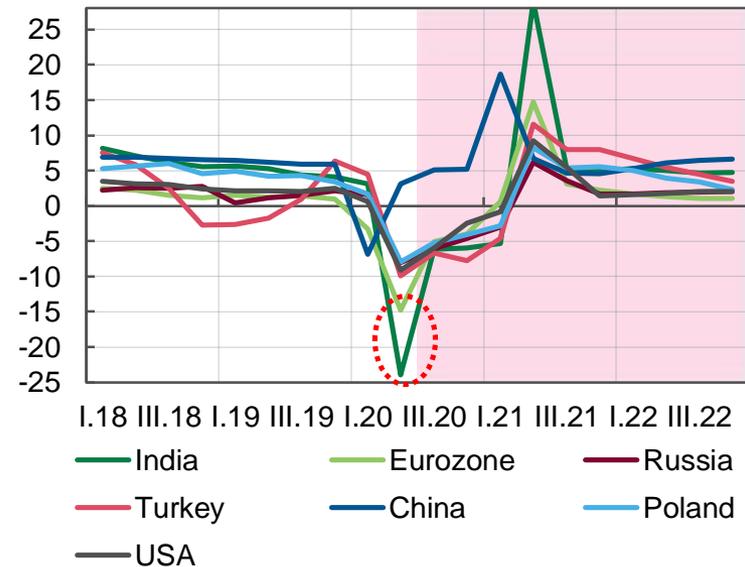
# Trading partners' economies reached the peak of the crisis and begun to recover

Contributions of Countries – MTP of Ukraine to the Annual Change of UA wGDP, %



Source: Official statistic pages, NBU staff estimates.

Real GDP of Selected MTP, %

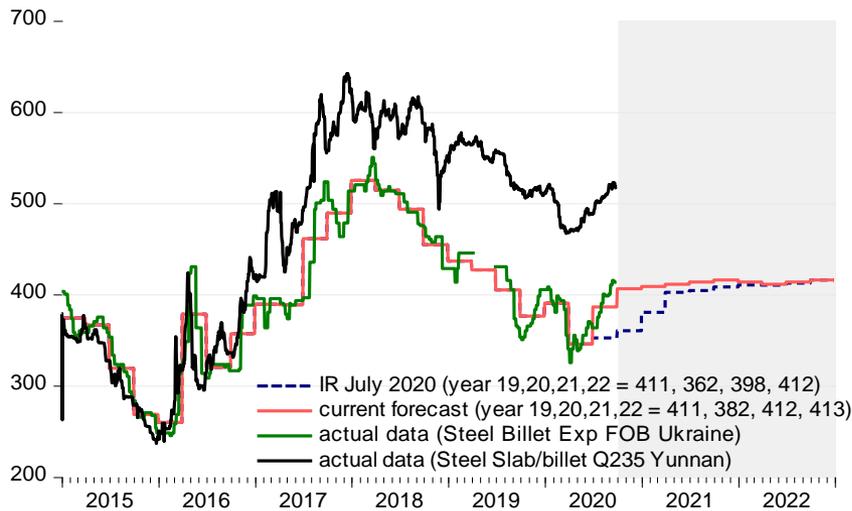


Source: Official statistic pages, NBU staff estimates.

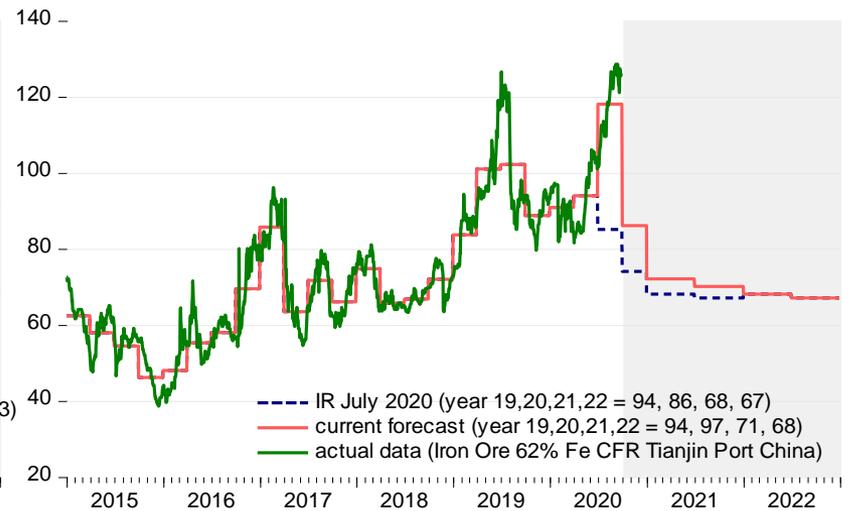
- The real GDP of Ukraine's main trading partners will decrease by 5.2% in 2020, but will increase by 4.4% in 2021

# Situation on the world commodity markets is more favorable than expected

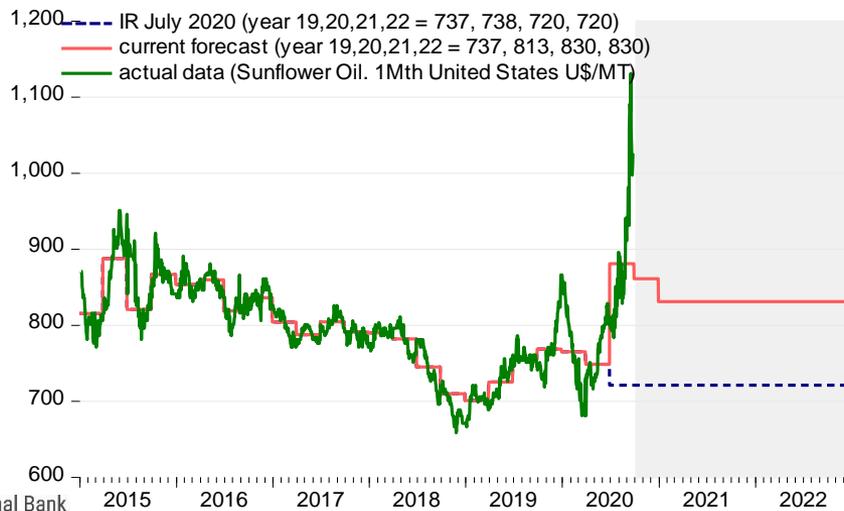
## Steel World Price, USD/MT



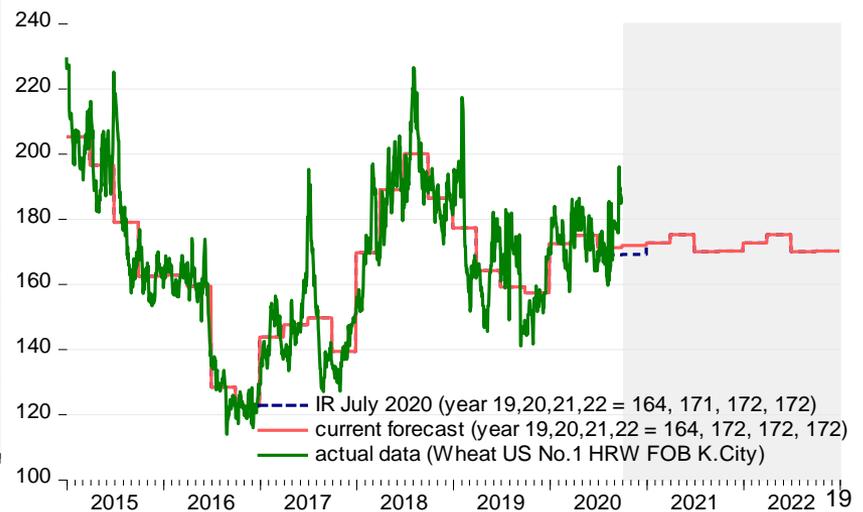
## Iron Ore World Price, USD/MT



## Sunflower Oil World Price, USD/MT

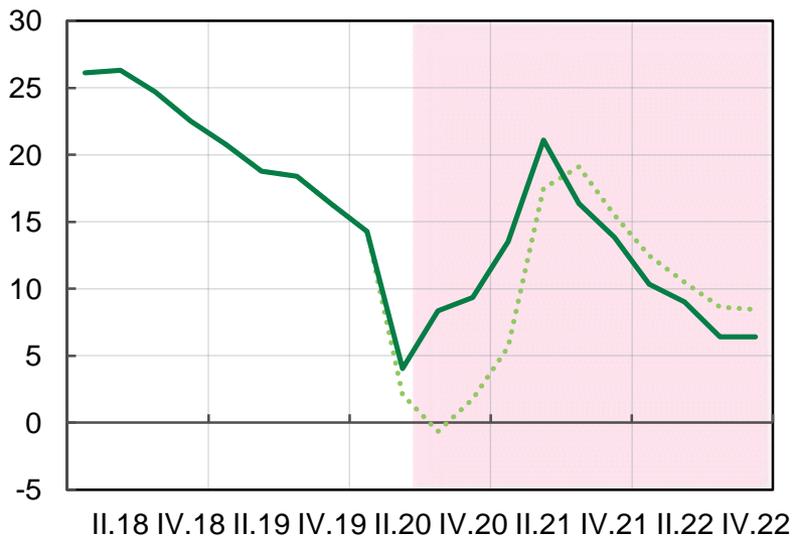


## Wheat World Price, USD/MT

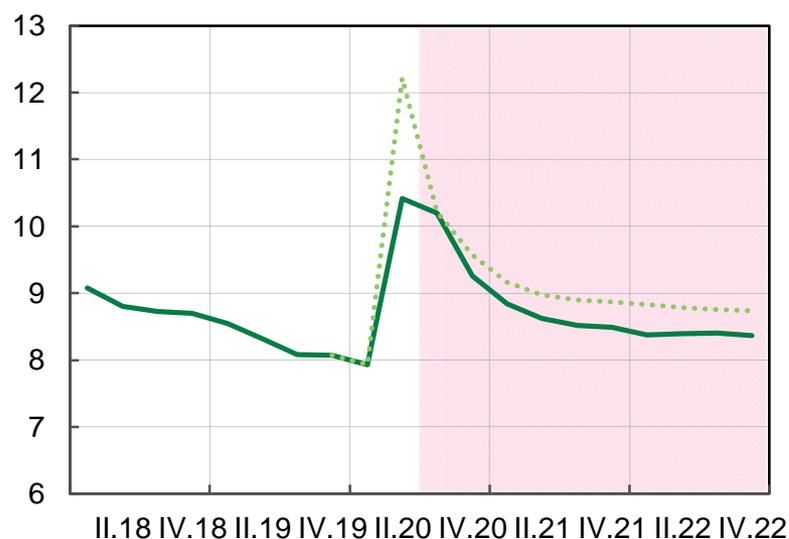


# Wage growth will accelerate due to economic recovery. Minimum wage hike will push up both average wages and unemployment

Nominal wages, annual change, %



ILO unemployment, sa, %

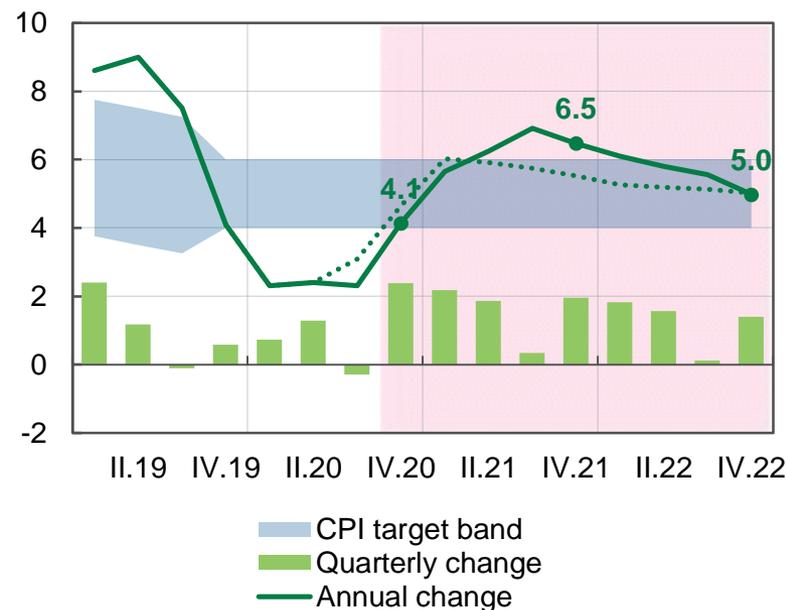


change, %	2019	2020	2021	2022
<b>Real wages</b>	<b>9.8</b>	<b>6.2</b>	<b>9.5</b>	<b>2.1</b>
- previous forecast		1.3	8.1	4.5
<b>Nominal wages</b>	<b>18.5</b>	<b>8.9</b>	<b>16.1</b>	<b>8.0</b>
- previous forecast		4.1	14.4	9.9

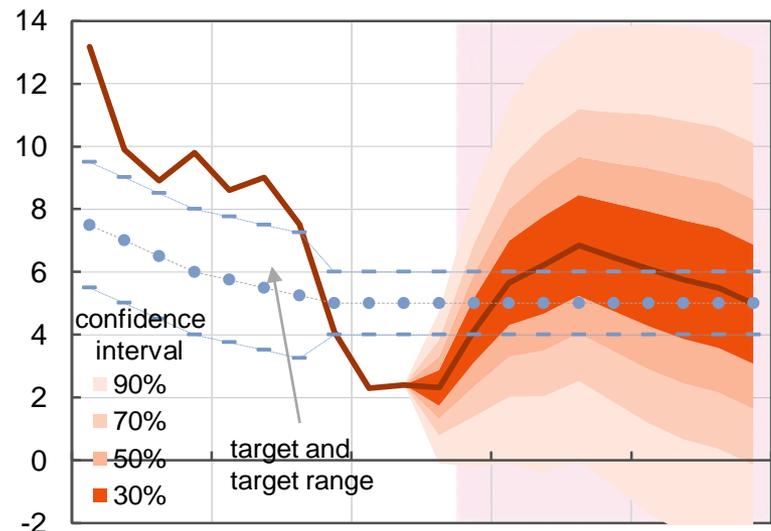
	2019	2020	2021	2022
<b>Minimum wage, UAH</b>	<b>4173</b>	<b>4815</b>	<b>6250</b>	<b>6700</b>
- previous forecast		4723	5003	5290
<b>change, %</b>	<b>12.1</b>	<b>15.4</b>	<b>29.8</b>	<b>7.2</b>
- previous forecast		13.2	5.9	5.7

# Inflation will accelerate and temporarily exceed the target range on the back of demand recovery, ER effects and minimum wage hike

Headline inflation, %



CPI, %



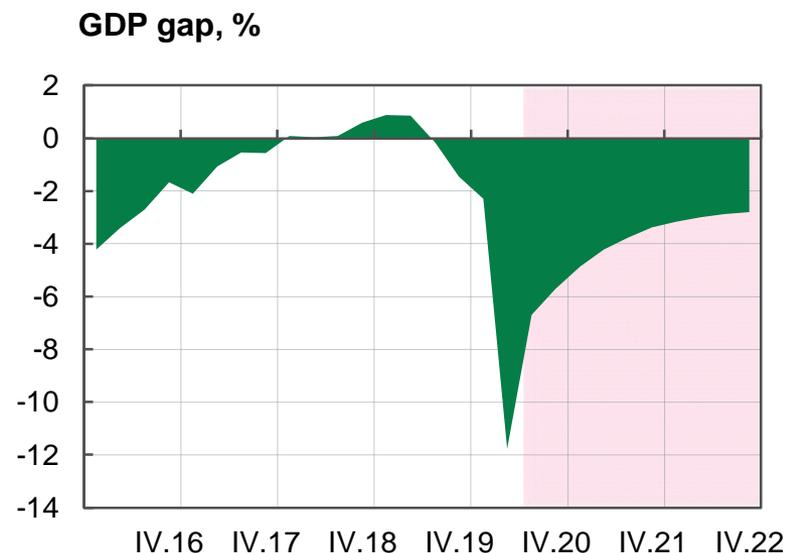
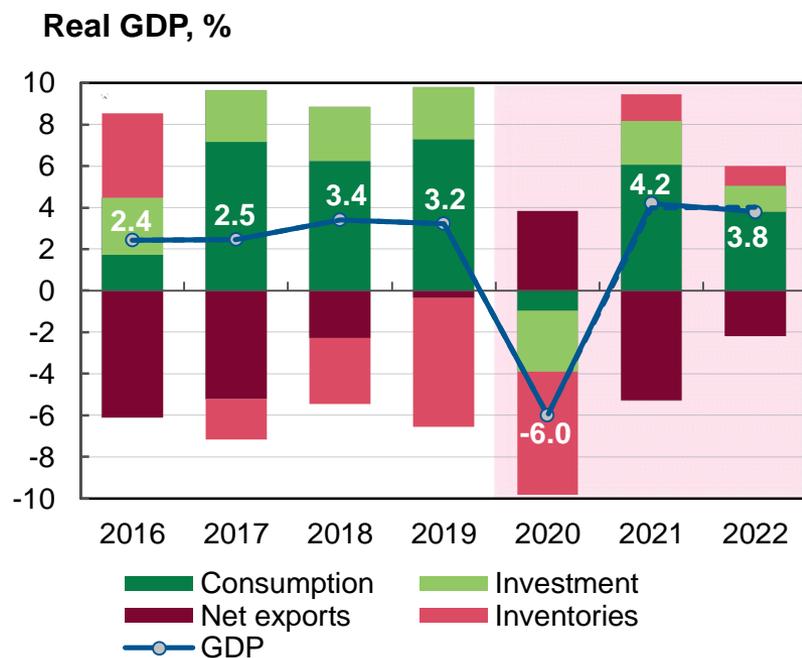
II.18 IV.18 II.19 IV.19 II.20 IV.20 II.21 IV.21 II.22 IV.22

change, %	weight, %	2019	2020	2021	2022			
<b>CPI</b>	<b>100.0</b>	<b>4.1</b>	<b>4.1</b>	<b>4.7</b>	<b>6.5</b>	<b>5.5</b>	<b>5.0</b>	<b>5.0</b>
Core CPI	59.4	3.9	4.2	4.0	5.4	4.2	3.8	3.9
Raw food	19.4	3.9	2.4	6.5	5.3	4.5	3.3	3.3
Admin	18.0	8.6	8.1	7.5	10.1	9.9	9.0	9.1
Fuel	3.2	-8.2	-13.9	-16.0	9.8	10.5	11.0	12.1

## The following factors will contain inflation:

- Economic activity level is below potential
- Low demand for clothes and footwear due to remote work
- Limited demand due to fears of a new lockdown and possible medical costs

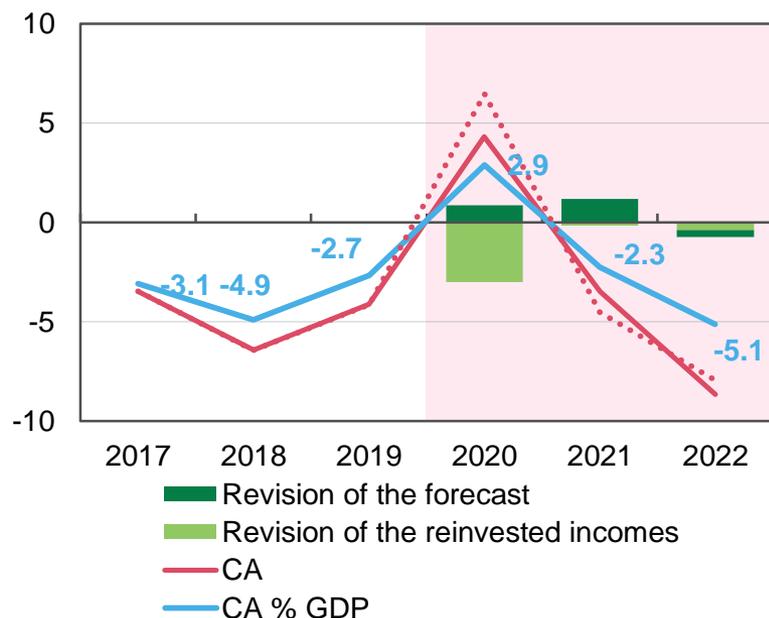
# Higher minimum wage will boost 2021 GDP but will restrain investment and GDP growth in 2022



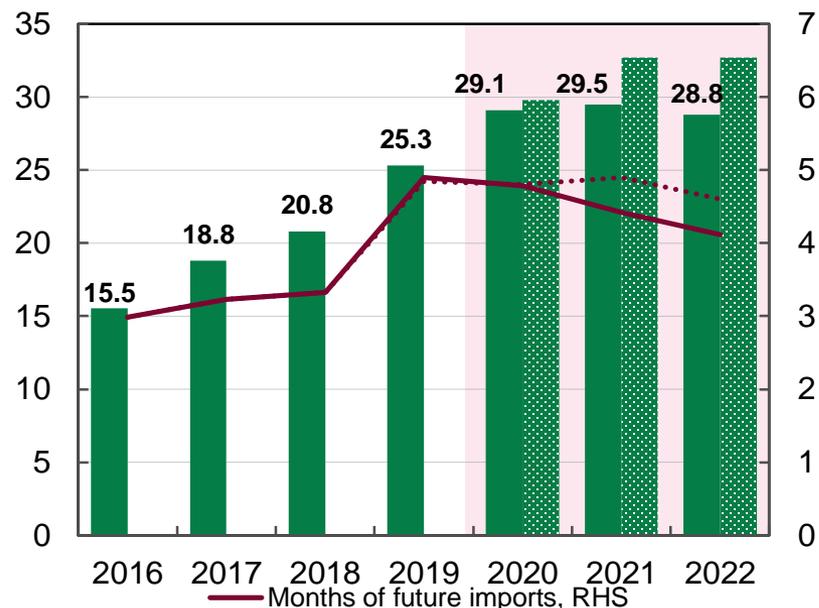
	Weight, %	2019	2020	2021	2022
<b>GDP</b>	<b>100</b>	<b>3.2</b>	<b>-6.0 (-6.0)</b>	<b>4.2 (4.0)</b>	<b>3.8 (4.0)</b>
Consumption	87	8.1	-1.0 (-5.4)	6.1 (5.3)	3.8 (4.3)
<i>Private consumption</i>	66	11.3	-1.1 (-6.0)	7.0 (6.0)	4.5 (5.0)
Gross fixed capital formation	16	14.2	-16.4 (-20.0)	14.0 (14.5)	7.7 (8.1)
Exports of G&S	48	6.7	-3.1 (-4.7)	2.7 (4.5)	2.0 (3.9)
Imports of G&S	56	6.3	-10.4 (-12)	14.6 (14.6)	6.5 (6.1)

# In 2021-2022, the private capital inflows along with the official borrowings will finance the CA deficit

Current Account Balance, USD bn



International Reserves, USD bn

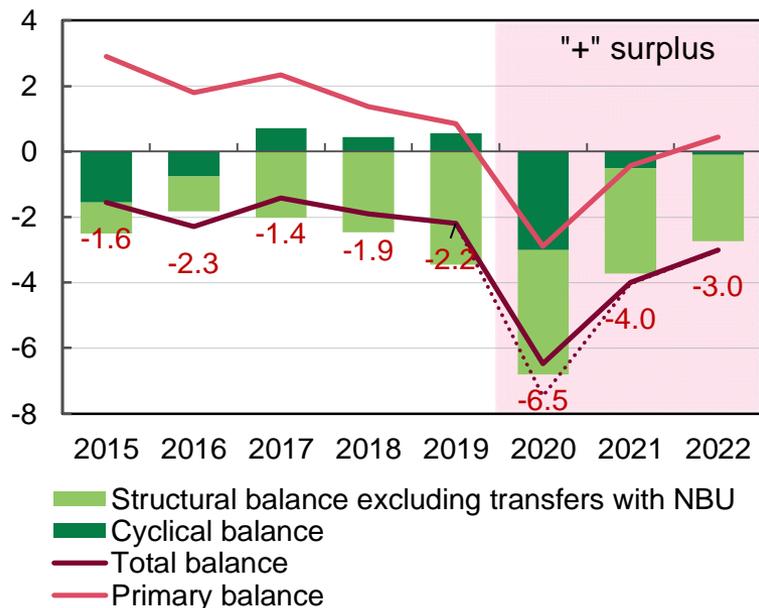


Source: NBU, NBU staff estimates, IR October 2020.

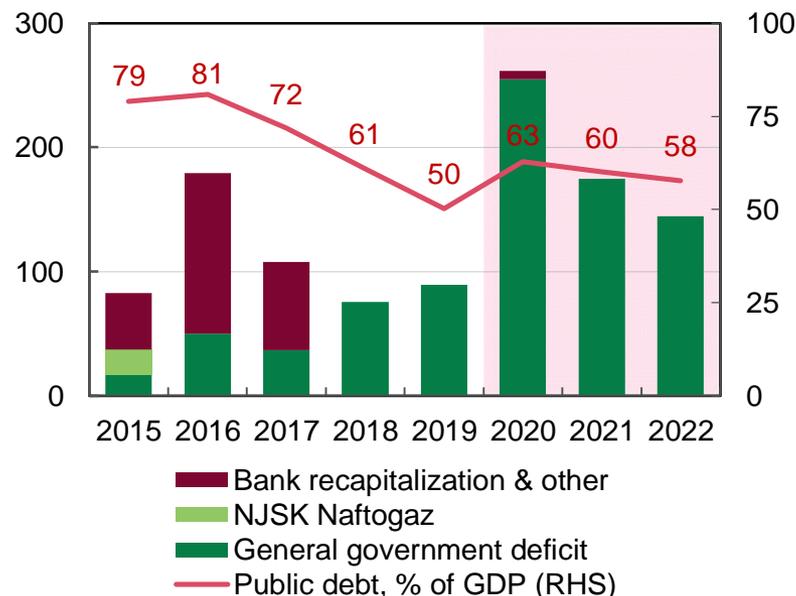
- In 2021-2022, the CA will turn to deficit due to recovery of domestic economic activity, some worsening of terms of trade, and lower revenues from natural gas transit
- In 2021-2022, inflows of debt and investment capital to the private sector will renew amid the recovery of the global economy
- Funding from the IMF and other official international partners will help Ukraine significantly build up its international reserves to USD 29 bn level by the end-2020. In 2021-2022 reserves will hover around this level which corresponds 92-96% of the lower bound of the IMF criterion

# In 2021, budget deficit will shrink to 4% GDP in accordance with financing capacity. Such a deficit helps to reduce debt to GDP ratio

Consolidated Budget Balance, % of GDP



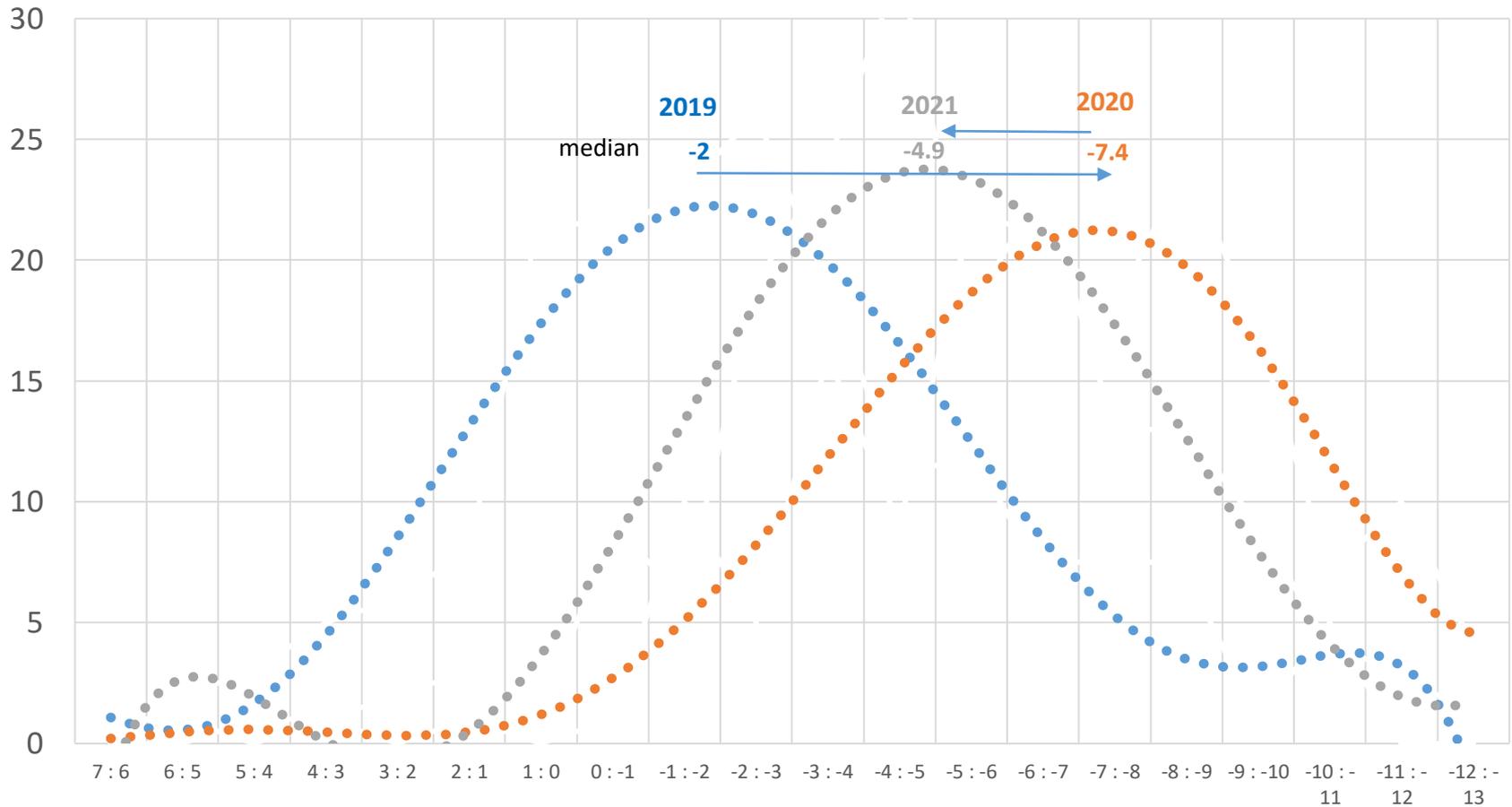
Public sector deficit, UAH bn, and public debt-to-GDP ratio, %



- In 2020, public debt-to-GDP ratio will increase to 63% due to widening of budget deficit and weaker ER
- Further on, this indicator will decline by 2–3 pp a year, driven by economic growth, prudent fiscal policy, and moderate exchange rate volatility

# Such policy is confirmed by the IMF estimates of fiscal consolidation worldwide (narrowing of deficits in 2021)

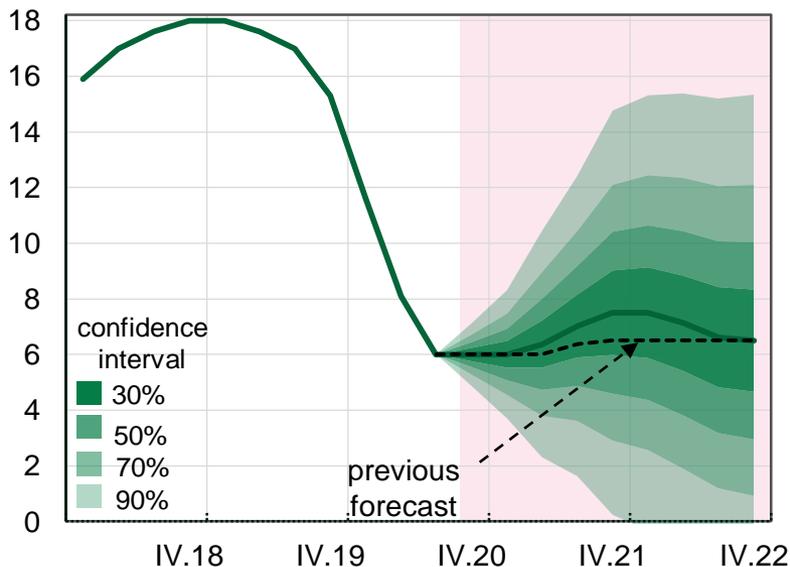
## Budget deficits, % GDP (distribution across 194 countries)\*



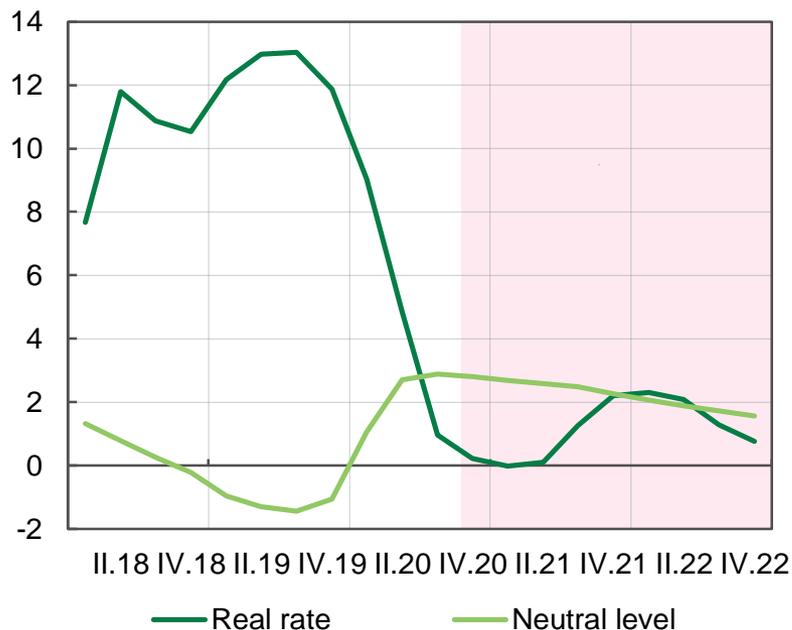
\* Horizontal axes – budget balance, % GDP («-» deficit, «+» surplus ),  
vertical axes – quantity of countries with correspondent deficit  
Source: WEO October 2020

# In 2021, the key rate will rise in order to contain rising inflation pressure. It will help bring inflation to the target range in 2022

Key rate, %



Key rate, real, %



- Even with tighter monetary policy, inflation will temporarily go beyond the upper bound
- Monetary conditions will remain expansionary. The expected increase in the key rate in 2021 will bring it closer to neutral level

# Risks

		Probability that a risk will materialize		
		Low <15%	Medium 15%–25%	High 25%–50%
Degree of impact on the baseline scenario	Weak	Higher volatility of global food prices		
	Moderate	Lower production of major agricultural crops		
	Strong	Escalation of the military conflict	Suspension of the program with the IMF  Judicial decisions on the financial system  Deep global economic recession	The coronavirus pandemic lasting longer