Macroeconomic and Monetary Review

NATIONAL BANK OF UKRAINE

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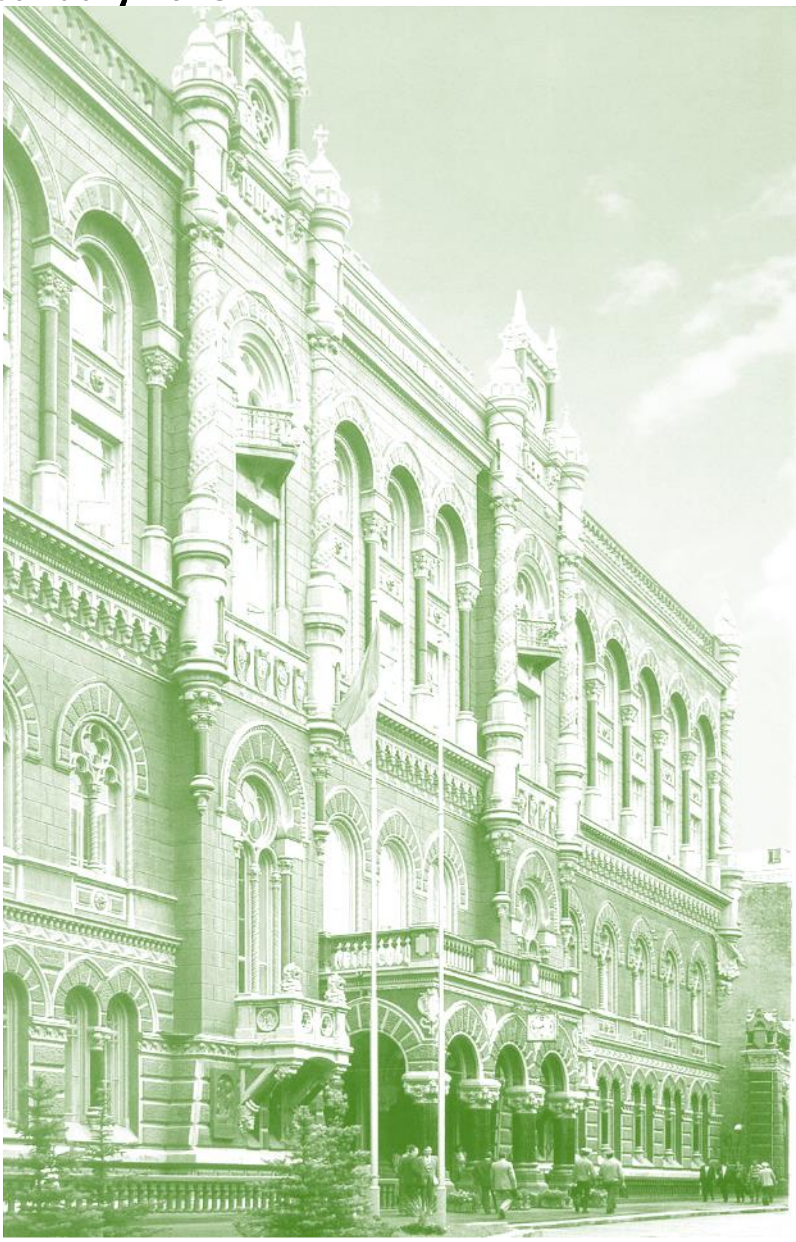

Monetary Policy and Economic Analysis Department

Summary

● Since the beginning of 2018, the external price environment has remained favorable for Ukraine's major export commodities. An upward trend in steel prices continued, supported by a limited supply from China. On the other hand, strong demand for iron ore from those Chinese steel mills that are not subject to restrictions, especially in southern China, has supported iron ore prices at high levels. Grain prices have increased on the back of adverse weather conditions. Oil prices have reached their maximum for the past three years due to supply disruptions, geopolitical instability, and high compliance with the OPEC+ agreement. Emerging market assets remained attractive to investors, while currencies of this group of countries have mostly strengthened amid US dollar weakening against the basket of world currencies.

● In 2017, headline inflation in Ukraine reached 13.7% yoy. The higher-than-expected growth in consumer prices was primarily due to factors on which monetary policy tools have only a limited effect, in particular: a decrease in supply of some products, rising global prices, and higher external demand for domestic food products. Moreover, rising production costs, labor costs in particular, a fast recovery of consumer demand, and stronger depreciation pressure on the hryvnia and a significant loosening of fiscal policy in the last months of the year have also contributed to the increase in prices. Inflation expectations have also deteriorated slightly. Therefore, core inflation accelerated to 9.5% yoy. At the same time, the producer price index grew at a significantly slower rate in 2017 of 16.5% yoy, primarily reflecting global price trends.

● In December, the growth of the Index of Key Sectors Output accelerated to 3.5% yoy. Retail trade turnover picked up by a strong 16.1% yoy due to a rapid growth in real wages and an increase in pension benefits. Construction continued to increase at a solid pace (9.7% yoy) thanks to favorable weather conditions. Freight turnover and wholesale trade performance improved as well. A decline in agriculture slowed down substantially (to 1.5% yoy) in December, mainly reflecting data for late technical crops. All this offset a 0.5% yoy decrease in industrial production, caused by deeper declines in the mining industry and electricity production.

● Average nominal wages continued to grow at a fast pace, slightly decelerating to 35.5% yoy. As annual rate of CPI growth remained flat in December, real wage growth slowed down as well (to 18.9% yoy).

● In December 2017, as expected, the state budget recorded a UAH 53.4 billion deficit, which was noticeably above the December 2016 level. On one hand, this was driven by a decrease in both tax and non-tax revenues, including due to a high base effect. On the other hand, expenditures traditionally surged up in the last month of the year. However, given that a cumulative surplus had been retained over the first eleven months, the annual deficit was smaller than in 2016 and below the target for 2017. Taking into account a substantial increase in the local budget deficit in December (up to UAH 22.6 billion), the consolidated budget deficit (UAH 76 billion) was particularly high, even for December. Nevertheless, thanks to a relatively tight fiscal policy during most of the year, the cumulative consolidated budget deficit was moderate in 2017 (UAH 42.1 billion).

● In December, the current account deficit widened compared with the previous month (to USD 0.7 billion), mostly due to worse exports performance (mainly on account of grains and metallurgical products). Net financial account inflows increased to USD 0.7 billion, backed by the private sector. In particular, net FDI inflows amounted to USD 233 million, and were mainly directed to the real sector. Despite a near-zero balance of the overall BoP, international reserves decreased slightly in December due to the scheduled IMF loan repayments. For 2017 as a whole, reserves increased by 21% to USD 18.8 billion or 3.6 months of future imports.

● At its last monetary policy meeting the NBU Board decided to raise the key policy rate by 1.5 pp to 16.0% per annum, effective from 26 January 2018. The tighter monetary policy will contribute to a gradual decrease in headline inflation and bring it back to the target range in the middle of 2019. A response of market interest rates to the key policy rate hike evidences that the interest rate channel of the monetary transmission mechanism works effectively. In December, banks' deposit and loan portfolios in hryvnia kept growing.

The Macroeconomic and Monetary Review is a translation of the original Report in Ukrainian. In case of any discrepancies between the original document and its English translation, readers should consider the Ukrainian version of the Report as correct.