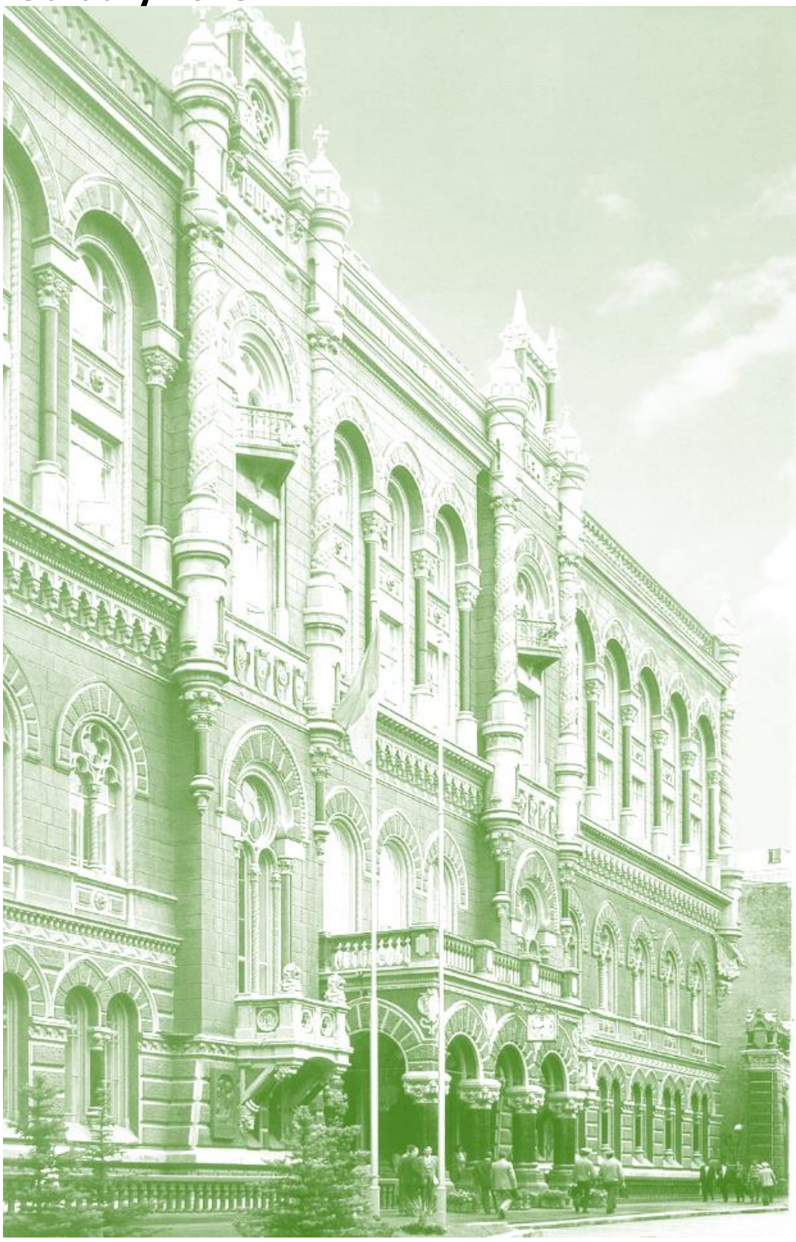
Macroeconomic and Monetary Review

NATIONAL BANK OF UKRAINE

February 2018



Monetary Policy and Economic Analysis Department

Summary

● **Global financial conditions for emerging market economies have tightened; however, the external price environment remained favorable for Ukrainian exporters.** February saw heightened turbulence in global financial markets – amid rising bond yields in developed countries the U.S. stock market entered 'correction' territory with contagion to other regions, including to emerging markets. However, investors remained confident that the full-scale crisis was not justified by underlying fundamentals. That helped the market to start recovering since mid-February. Emerging market currencies were predominantly depreciating, pressured by global financial market instability. However, rising commodity prices and the stock market recovery lessened the depreciation pressure.

● **In Ukraine inflation pressures stayed elevated.** In January 2018, headline inflation accelerated to 14.1% yoy with core inflation up 9.8% yoy. The actual inflation came in higher than the forecast trajectory published in the January 2018 Inflation Report as prices for raw foods, services and fuels rose faster than projected. In January 2018, the producer price index accelerated (to 22.0% yoy) due to a hike in electricity tariffs for industrial energy consumers.

● **The economy gathered momentum early in the year.** In January 2018, the Index of Key Sectors Output accelerated to 5.2% yoy. Retail trade turnover grew at a fast pace (9.6% yoy) due to continuing wage growth; wholesale trade also rose strongly (13% yoy) as foreign trade picked up. Growth in industrial output resumed (3.6% yoy) led by manufacturing, as output in metallurgy, chemical industry and machine building accelerated. Agricultural output grew 1.1% yoy, driven by animal breeding. Improved performance in these sectors offset declines in freight turnover (due to lower transit volumes) and in construction.

● **The economy gathered momentum early in the year.** Nominal average wages kept rising at a fast pace (primarily due to the increase in the minimum wage since the beginning of the year), while decelerating to 28.4% yoy. This, along with the acceleration of inflation, slowed down real wage growth (to 12.3% yoy).

● **In January 2018, state budget returned to a surplus** (UAH 7.8 billion) due to the under-fulfillment of expenditures. Despite largely favorable macroeconomic environment, revenues decreased in annual terms mostly due to lower VAT receipts, with the latter reflecting the temporary base effect (minor amount of VAT refunded in January 2017). Expenditures rose at a modest pace. Typically for January, local budgets showed surplus (UAH 12.6 billion). As a result, the consolidated budget surplus made up UAH 20.5 billion.

● **There has been a turnaround in FX market – the hryvnia has been strengthening substantially in February after weakening late last year and in January 2018.** In January, the overall Balance of Payments returned to a deficit (USD 449 million), which led to a decline in gross international reserves to USD 18.6 billion as of the end of January, or 3.5 months of future imports. With the current account balance close to zero, the financial account recorded a net outflow of USD 0.4 billion. Such outflows were mainly driven by the real sector debt repayments. At the same time, the increase in non-residents investments into domestic bonds contributed to net capital inflows to the public sector. These inflows increased in February, which, together with higher export proceeds amid favorable external price environment, predictably contributed to the supply of foreign exchange in the interbank market. This helped the hryvnia strengthen against the US Dollar and allowed the NBU to resume foreign exchange purchases to replenish its international reserves.

● **NBU's policy rate decisions contributed to improvement in FX market situation.** At its January 2018 monetary policy meeting the NBU Board decided to raise the key policy rate by 1.5 pp to 16.0% pa. The tighter monetary policy was aimed at preventing further deterioration of household and business inflation expectations, resulting from high current inflation rates, and bringing it back to the target range by mid-2019. Market interest rates for hryvnia resources, especially for interbank loans, bond yields and bank's funding costs, responded to the rise in the key policy rate.

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.