National Bank of Ukraine

Macroeconomic and Monetary Review

March 2018

Monetary Policy and Economic Analysis Department

Summary

● **In March, Ukrainian exporters continued to enjoy largely favorable global market conditions; however, risks for global trade and economic growth heightened materially amid fears of escalating trade wars.** Positive trends in commodity markets, despite a slight downward adjustment of prices for selected commodities (e.g., for grains), were underpinned by a pick-up in economic activity and strong global demand. However, the US decision to embrace a tough protectionist policy and potential retailiatory measures by other countries might hurt global trade and global growth. Heightened risks of trade wars along with other factors have already caused stock indices to plunge. Against this backdrop, the US Dollar has been kept under depreciation pressure, partially offset by another Fed rate hike. Amid a weak US dollar and commodity prices staying high, most emerging market currencies have strenthened.

● **The hryvnia also strenthened, both against the US Dollar and a trade-weighted basket of currencies**, bolstered, in particullar, by the consolidated balance-of-payments surplus of USD 0.3 billion. This outcome was a result of net capital inflows of USD 0.2 billion, with the current account balance remaining close to zero. Net capital inflows were largely generated by the public sector due to a rise in non-resident investment in the domestic Hryvnia sovereign bonds. The latter enjoyed robust demand of non-residents in March as well. That, along with high commodity prices, caused appreciation pressures on the hryvnia to prevail throughout March, enabling the NBU to continue purchasing FX to replenish international reserves.

● **Stronger demand, both external and domestic, for hryvnia financial instruments was facilitated, inter alia, by the NBU's monetary policy tightening.** At its last monetary policy meeting the NBU Board decided to raise the key policy rate by 1.0 pp to 17.0% per annum, effective from 2 March 2018. The fourth consecutive increase in the key police rate was prompted by elevated inflation risks, in particular, due to high inflation expectations of economic agents and rapidly strengthening consumer demand. A tighter monetary policy, which cycle the NBU started in October last year, pushed the yields of hryvnia financial instruments and interest rates on bank operations up.

● **The hryvnia appreciation since mid-January helped containing inflationary pressures, which, however, remained elevated.** In February 2018, headline inflation slightly decelerated to 14.0% yoy with core inflation down 9.7% yoy. However, actual inflation came in somewhat above the NBU's forecast published in the January 2018 Inflation Report. This primarily reflected a higher-than-expected increase in prices for raw foods and fuels. Sufficiently tight monetary conditions set by the NBU should ensure a gradual slowdown in consumer inflation and its return to the target range in mid-2019, despite the projected acceleration of economic growth with the corresponding demand pressure on prices in 2018.

● **The cumulative measures of the real sector performance during January-February 2018 suggested economic activity gained momentum in early 2018, both compared to the previous year and the previous quarter.** At the same time, in February 2018, economic activity recovered at a slightly slower pace than in January, partly due the impact of adverse weather conditions (which affected, in particular, the volume of construction works and cargo transportation by most means of transport). Growth in wholesale and retail trade moderated with the latter affected, among other factors, by somewhat slower real wage growth compared to the previous periods, although still quite strong. The agricultural output decreased due to a deteriorating performance across all animal breeding industries. The manufacturing output grew at a slower pace than in January primarily due to a decline in the food processing industry, a more moderate growth in metallurgy and machine building. At the same time, the mining industry returned to growth and the decline in the energy industry slowed due to a lower comparison base that reflected the impact of the trade blockade of non-government controlled territories last year. A weaker industrial sector performance also contributed to growth slowdown in merchandise exports, with transportation difficulties caused by adverse weather conditions being an additional factor. Meanwhile, import growth slowed down substantially too due to lower imports of energy and chemical products amid significant volumes of their supplies in the previous months and likely a later start for this spring agricultural works compared with the previous years.

● **Slower paces of increase in foreign trade turnover and hryvnia strengthening restrained the growth of state budget revenues.** As a result, in February 2018, the state budget recorded a deficit of UAH 9.5 billion, which, however, was narrower than last year, due to a reduction in expenditures. Also, consolidated budget reported a cumulative surplus of UAH 15.3 billion for the first two months of the year owing to local budgets surplus.

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