National Bank of Ukraine

Ukraine: Macroeconomic and Policy Outlook

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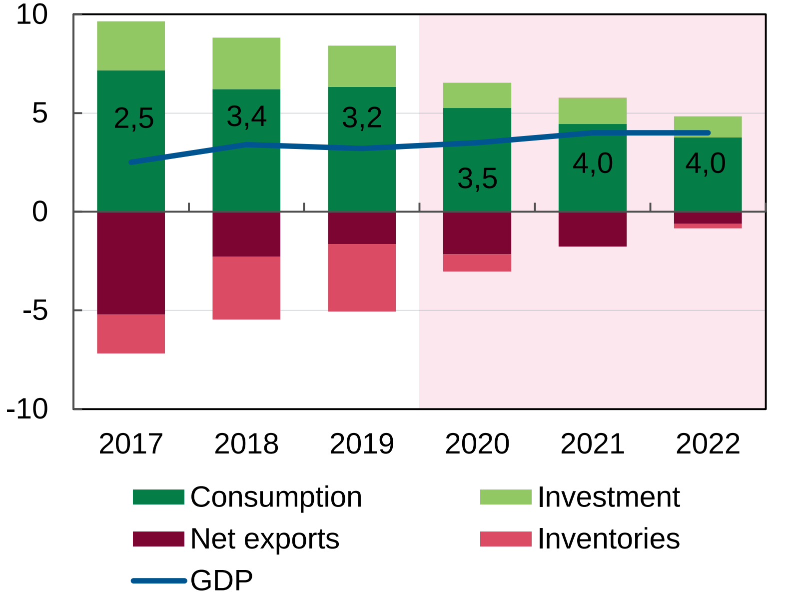
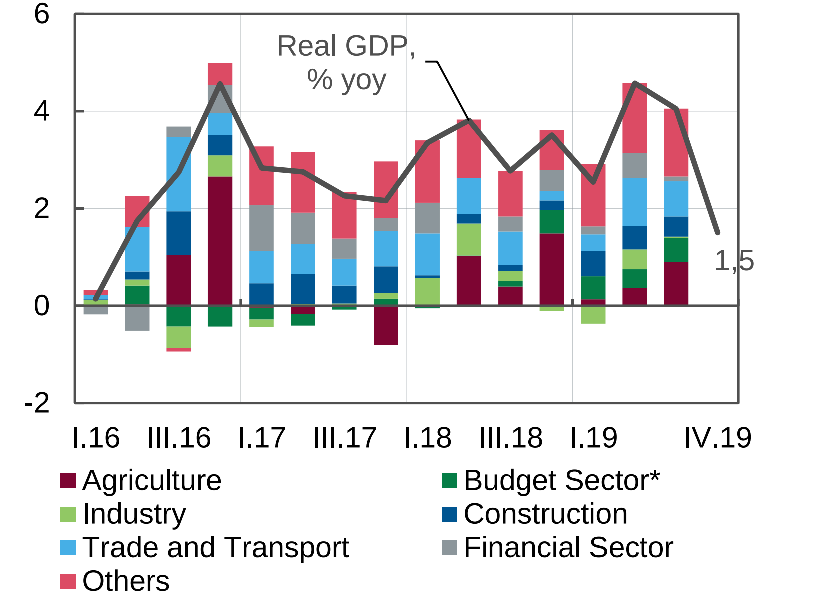
The Ukrainian economy has been recovering at a solid pace

Contributions to real GDP Growth, pp



Source: SSSU, NBU estimates and forecast (Inflation Report January 2020).

Contributions to annual real GDP growth by sectors, pp

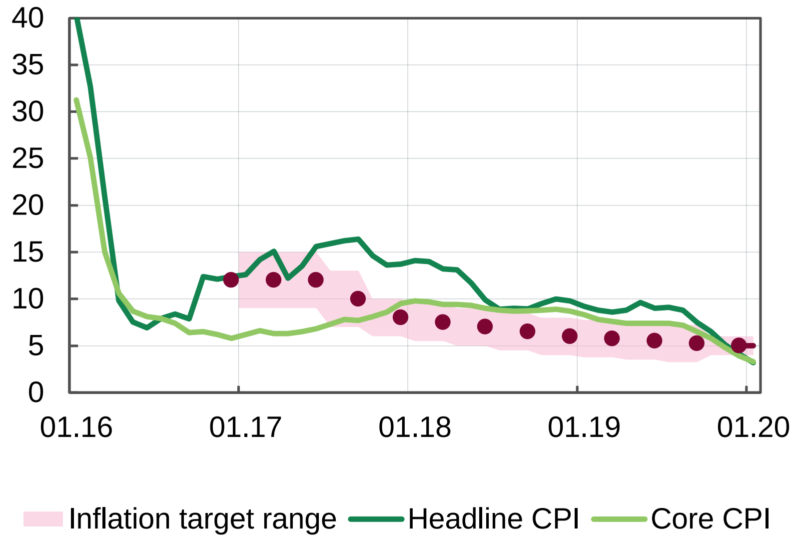


*Incl. public administration and defense; education; healthcare; administrative and support service; professional activities; arts and entertainment, etc.
Source: SSSU, NBU staff estimates.

- In 2019, real GDP grew by 3.2% yoy, driven by strong domestic demand and relatively favorable terms of trade (a sharp decrease in import prices)
- Economy somewhat lost momentum by the end of 2019 mainly on account of agriculture (faster harvesting campaign in the previous quarter) and industry (including due to warm weather)
- The domestic demand, fueled by monetary policy easing and still robust income growth will remain the main growth driver in the years ahead

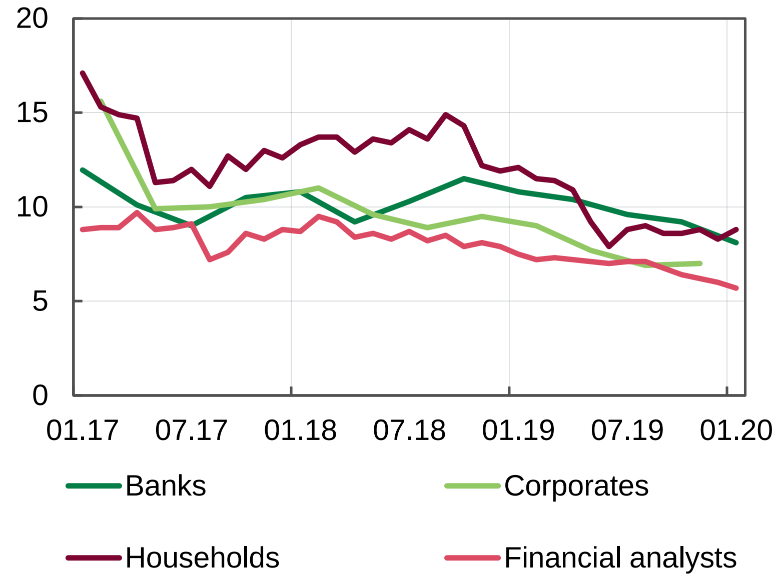
NBU achieved its inflation target of 5% ± 1 pp in 2019 and temporarily entered the below-target phase at the start of 2020

Headline and core inflation, % yoy



Source: SSSU, NBU.

Inflation expectations for the next 12 months, %

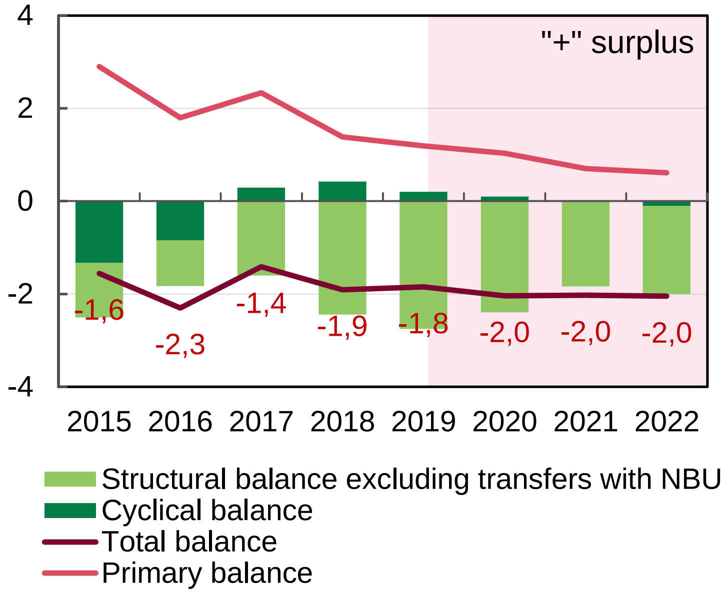


Source: NBU, GfK Ukraine surveys.

- The fall in inflation to its target in 2019 mainly resulted from the NBU's consistent monetary policy aiming to deliver price stability, and the government's prudent fiscal policy
- The further drop in inflation is primarily due to the impact of last year's strengthening of the hryvnia on consumer prices. The drop in the prices of the energy resources and subsiding pressures from the supply of food also contributed
- The inflation expectations of financial analysts, businesses and banks have been improving

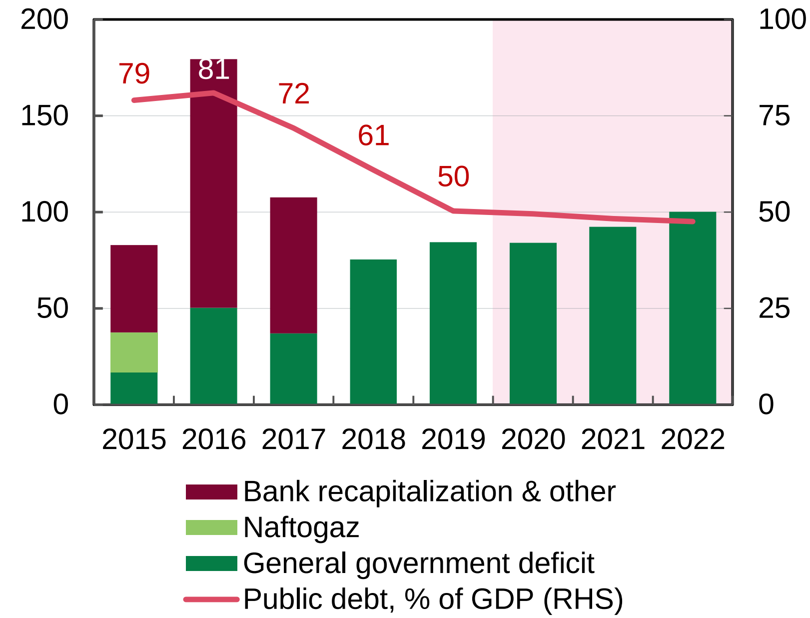
Fiscal policy has largely been in check over the last years helping to reduce debt-to-GDP ratio to moderate levels

Consolidated budget balance, % of GDP



Source: MFU, NBU staff estimates and forecast (Inflation Report Jan 2020).

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

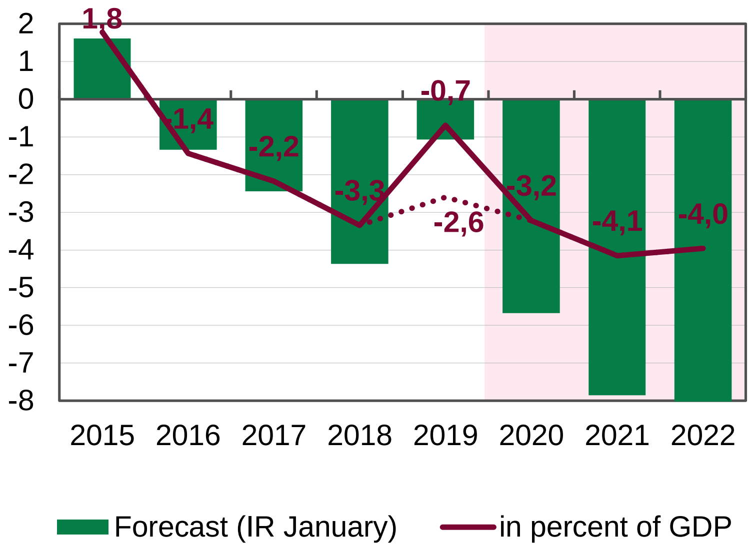


Source: MFU, SSSU, NBU staff estimates and forecast.

- Ukraine has achieved remarkable progress in fiscal consolidation, wiping out large quasi-fiscal energy deficit
- The consolidated fiscal deficit is forecast to remain at about 2% of GDP in 2020-2022 primarily because of large public debt financing needs amid peaks in external debt repayments
- In four years, the public debt-to-GDP ratio fell from 81% to just 50% of GDP in 2019. In addition, the share of UAH denominated debt increased

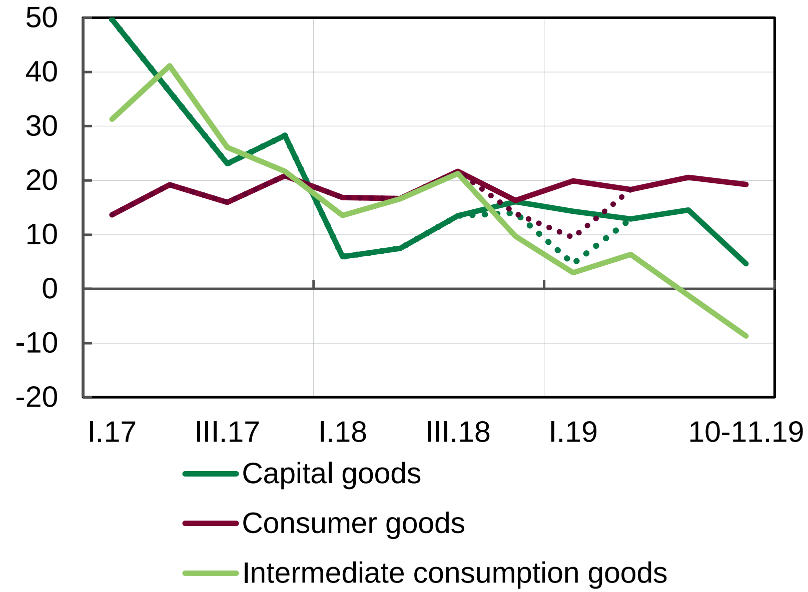
The CA deficit remains at the sustainable level (3%- 4%)

Current account balance



dotted line – without Gazprom compensation
Source: NBU, Inflation Report January 2020.

Imports by broad economic categories*, % yoy

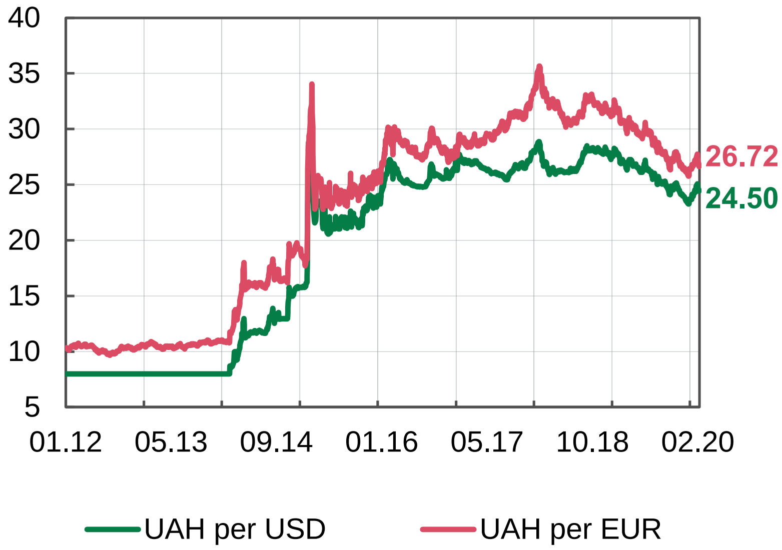


Dotted lines – excluding registration of foreign cars imported in previous periods
Source: NBU.

- In 2019, the CA deficit narrowed, despite appreciating UAH, driven by plunging imported energy prices combined with record high harvests in 2018-2019
- Both consumer and investment imports have been rising at steady pace despite stronger domestic currency
- In 2020-2022, CA deficit widens due to strong REER and lower gas transit. However, restrained in 2020 due to lower gas imports

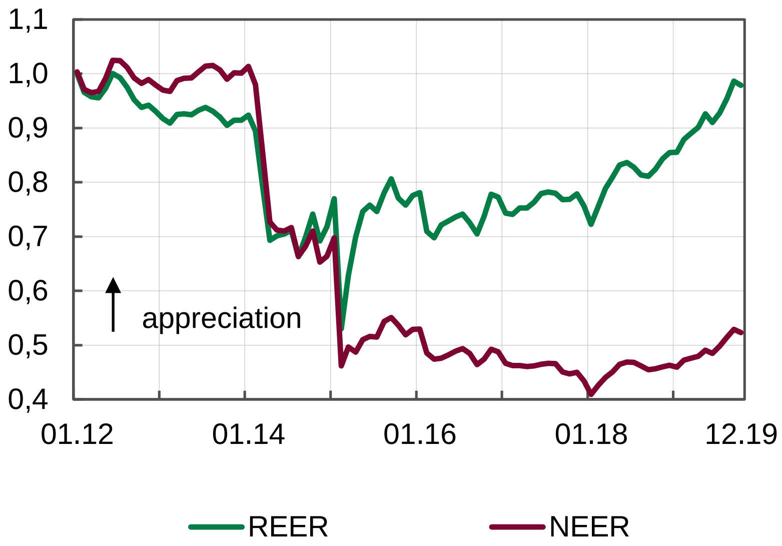
In 2019, hryvnia gained 14.5% to USD, thus partially erasing overshoot and underinvestment losses of the past few years

The official hryvnia exchange Rate*



* The latest data points are for 13 February 2020.
Source: NBU.

Hryvnia REER and NEER indices, monthly average, 12.2011=1



Source: NBU`s estimates.

- NEER/REER of the hryvnia strengthened by 18.3% yoy and 19.1% yoy as of December 2019
- Favorable FX conditions supported by record high harvest, lower energy imports, non-residents' interest in hryvnia bonds, and record private sector external borrowings were among principal contributors

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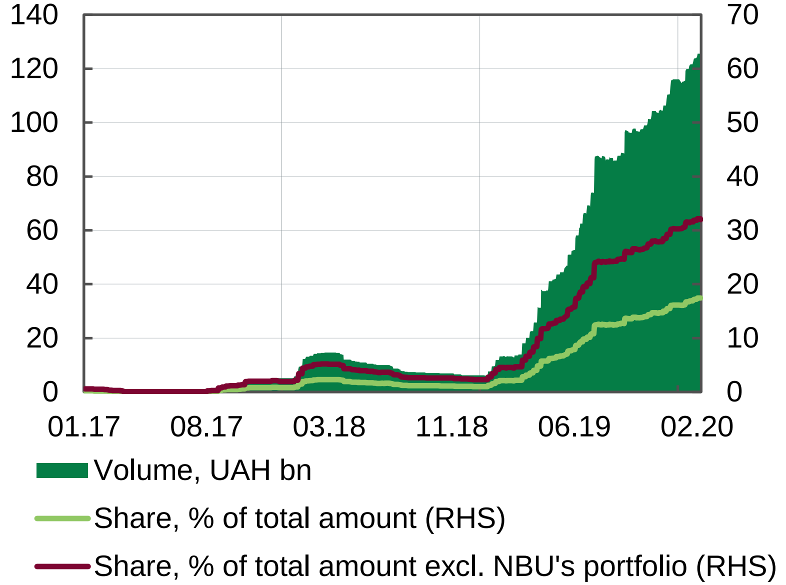
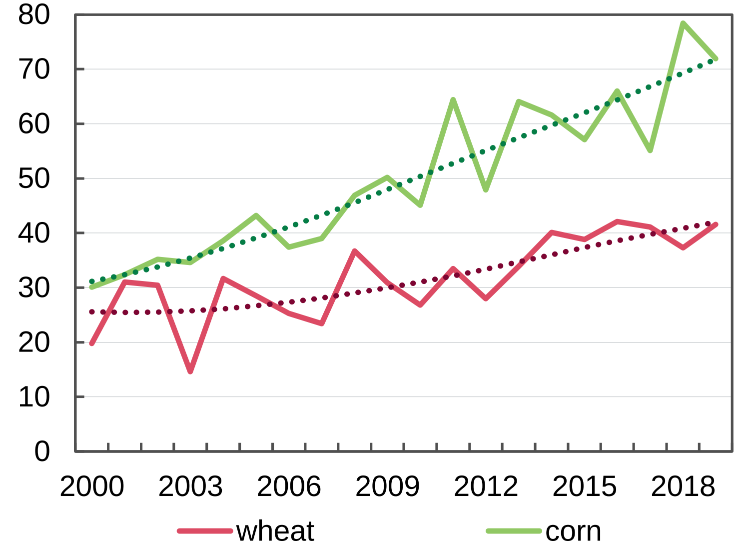
Hryvnia appreciation was driven by strong portfolio inflows and boosting agricultural output

Hryvnia Domestic T-Bills and Bonds Held by Non-Residents



Source: NBU.

Wheat and corn yields in Ukraine, centers/ha

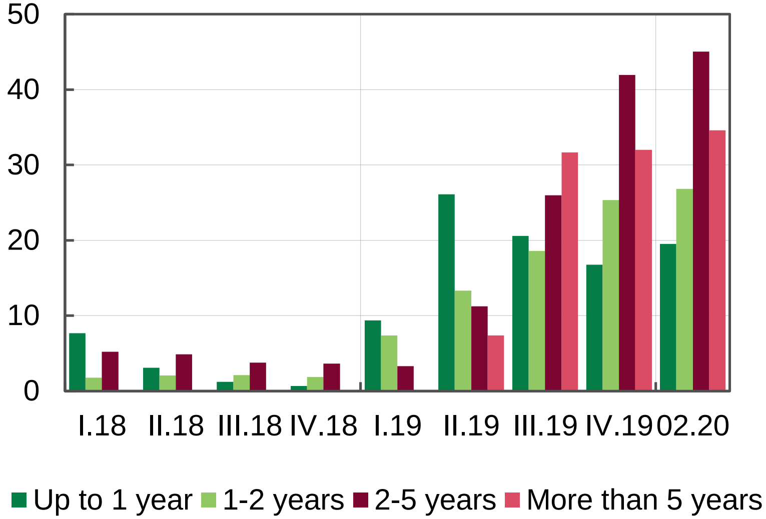


Source: SSSU.

- Foreign investments in hryvnia domestic bonds increased by around USD 4.3 bn during 2019
- Over the past 5 years, wheat and corn yields grew 24% and 16% over the average for the previous 5 years (33% and 58% for 10-year averages, respectively)
- A strong increase in productivity of the agricultural sector was the compound impact of investments into agro machinery and seeds, better use of fertilizers and improved skills

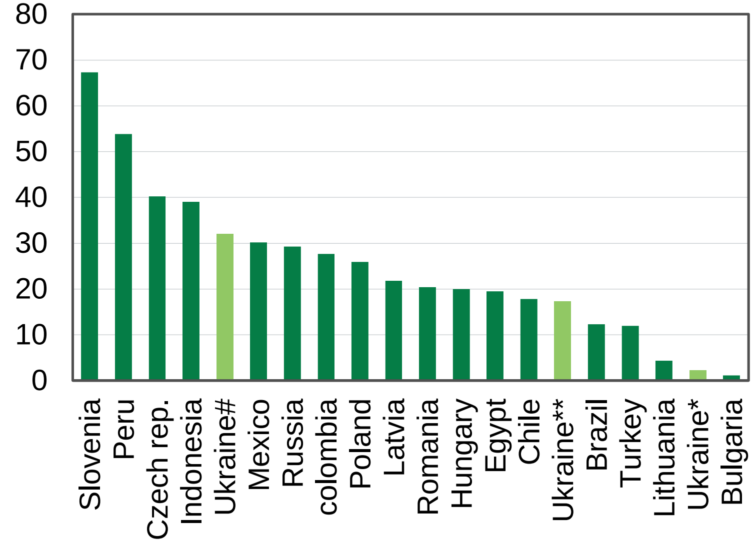
Myth 1: UAH appreciation is not in line with fundamentals due to the speculative nature of capital inflows

Hryvnia government bonds in non-residents` portfolio by maturity, UAH bn



* As of 12.02.2020
Source: NBU.

Non-residents share in Government Bonds in Local Currency in 2Q2019, % eop

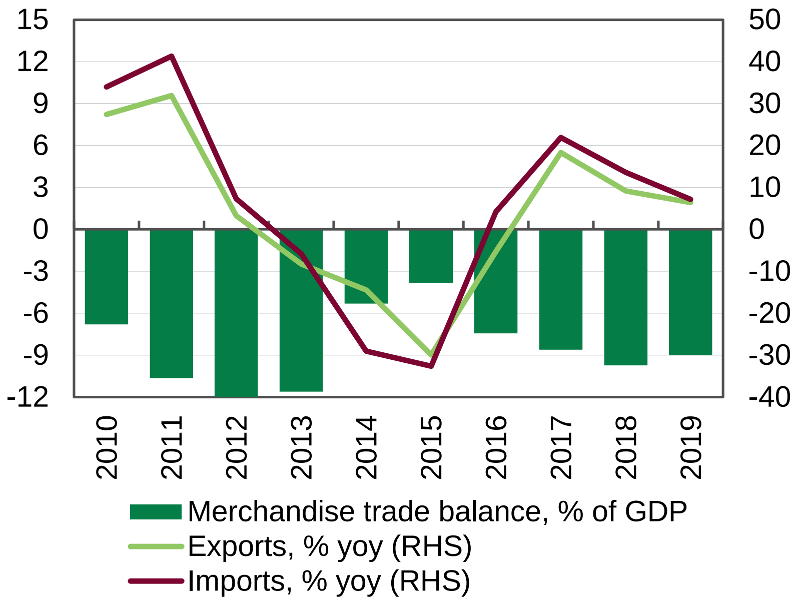


Note: Excluding NBU portfolio in case of Ukraine
* As of 12.02.2019, ** as of 01.07.2019, # as of 01.01.2020
Source: NBU, IMF.

- Non-residents invested in hryvnia government bonds along all maturities up to 7 years. Unlike in the past, more than 60% of bonds in the non-resident portfolio have maturity over 2 years
- The share of non-residents in hryvnia government bonds increased to 32% in early 2020, which is between the average shares for EM countries (~20% as of mid-2019) and select advanced economies (~45% as of mid-2019)

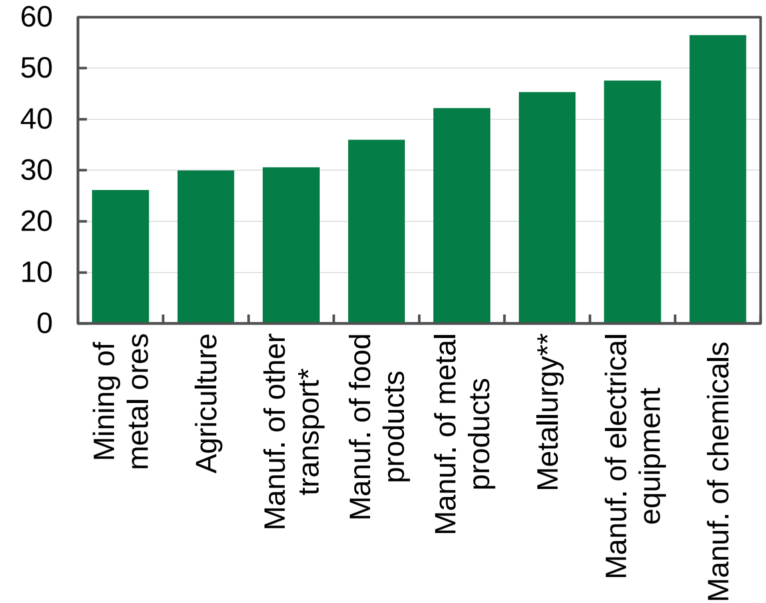
Myth 2: UAH appreciation is not in line with fundamentals due to the deteriorating external position

Merchandise trade balance indicators



Source: NBU.

Import content of exports (incl. secondary effects#) by selected types of economic activity, 2017, %



Including imports used in intermediate consumption by other sectors, used in the production of the final product of the respective exporting sector

* Incl. manufacture of freight wagons and their components.

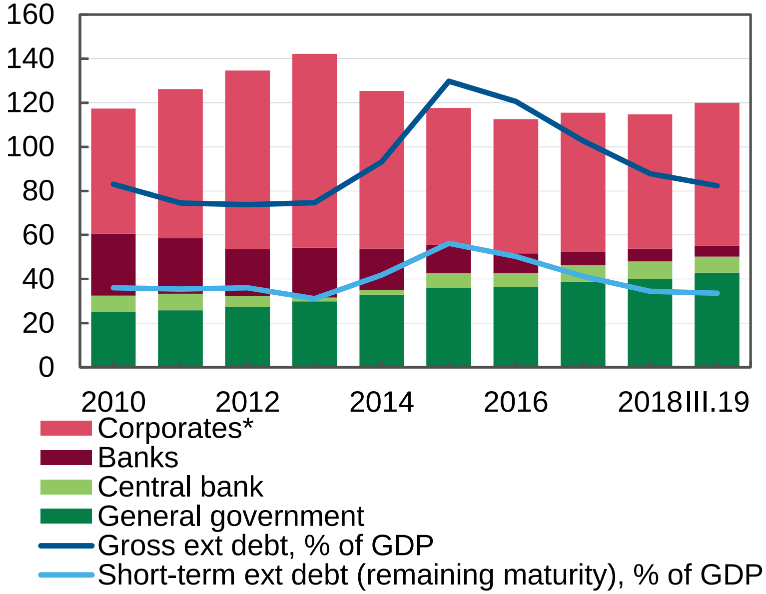
** Incl. production of base ferrous and non-ferrous metals.

Source: SSSU, NBU staff estimates.

- In 2019, despite hryvnia appreciation trade deficit narrowed due to ToT improvement and productivity growth
- Exporters' losses from domestic currency appreciation should be adjusted by cost-saving due to the cheaper imports

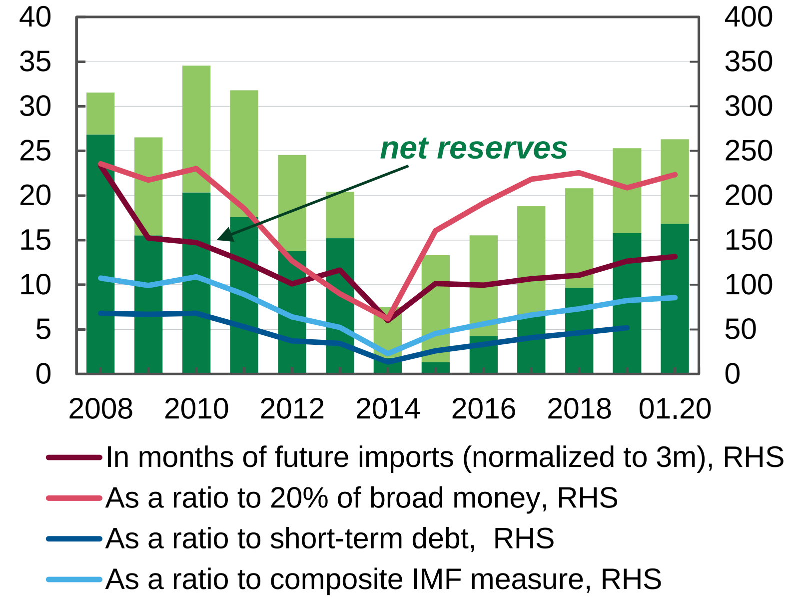
External sustainability indicators of Ukraine have been improving despite large external debt repayments

External debt, USD bn



* Including intercompany lending.
Source: NBU.

International reserves, USD bn, and select adequacy criteria, %



Source: NBU staff estimates.

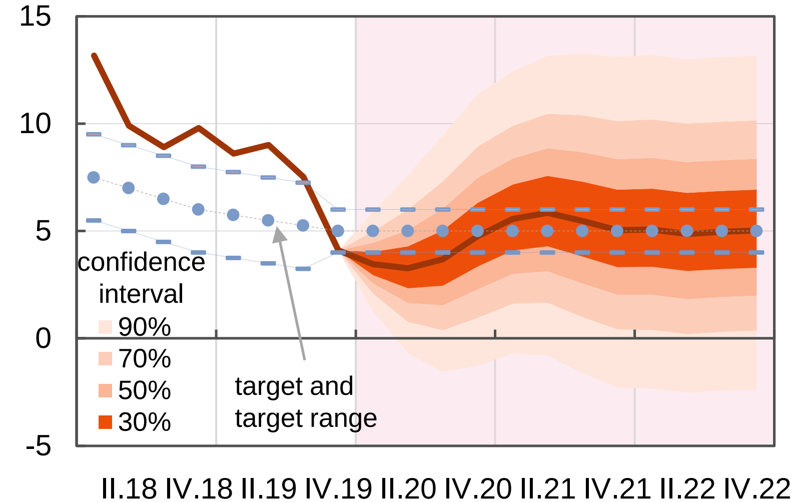
- External debt-to-GDP ratio decreased to 82% as of end September 2019 due to robust economic growth and stronger hryvnia
- Despite the pick-up in external debt repayments in 2018-19, FX reserves jumped to 7-year maximum of USD 25.3 bn by end-2019, bringing reserve adequacy ratios close to the levels last seen in 2011. Moreover, FX reserves further replenishment left them at 26.3 USD bn as of late January

Main risks

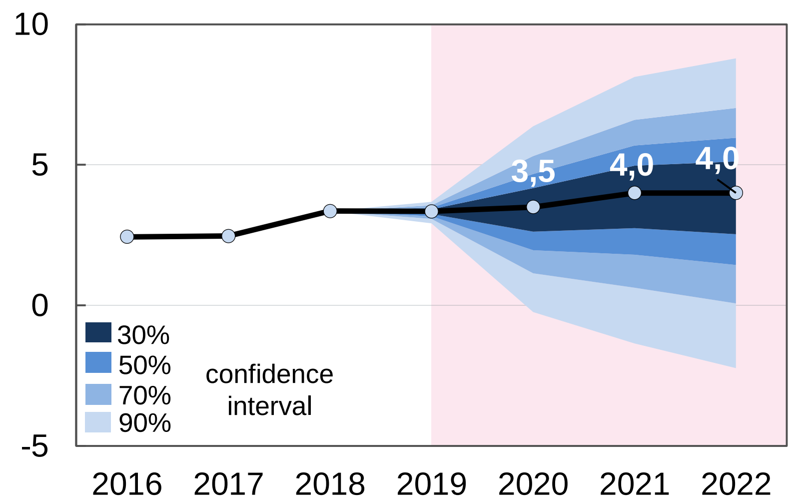
Key risks:

- a delay in entering into a new cooperation agreement with the IMF, and increased threats to macrofinancial stability
- the continued cooling of the global economy and a further deterioration in terms of trade, including due to coronavirus outbreak
- an escalation of the military conflict and new trade restrictions introduced by Russia
- weak harvests of grains, fruit and vegetable crops in the wake of unfavorable weather
- the higher volatility of global food prices, driven by global climate change
- a decrease in foreign capital inflows

CPI forecast and inflation targets, % yoy



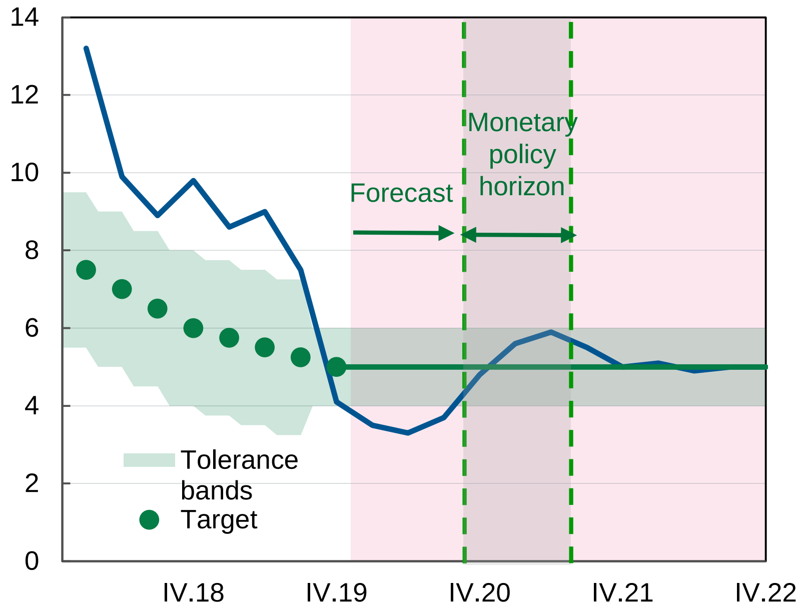
Real GDP forecast, % yoy



Source: NBU (IR Jan 2020).

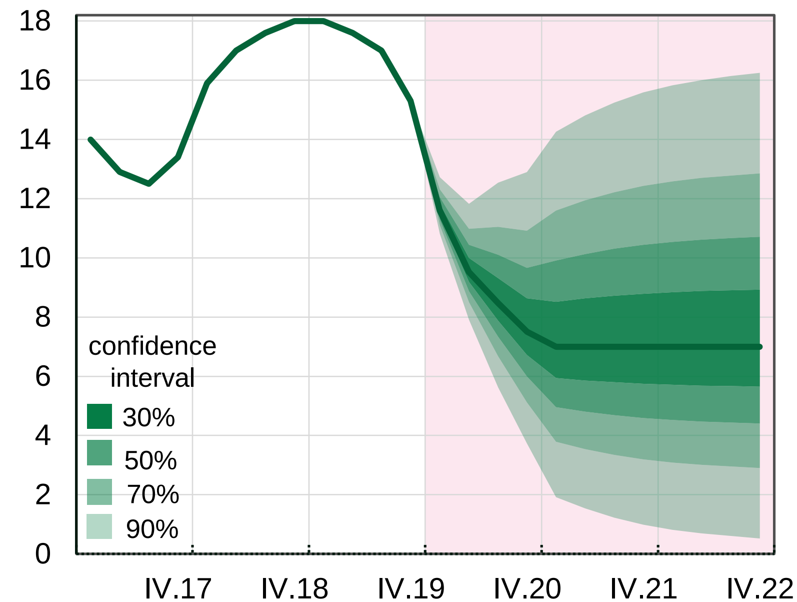
Monetary policy is committed to bring inflation to 5% target

Headline CPI, % yoy



Source: NBU (Inflation Report January 2020).

Key policy rate, average, %



Source: NBU (Inflation Report January 2020).

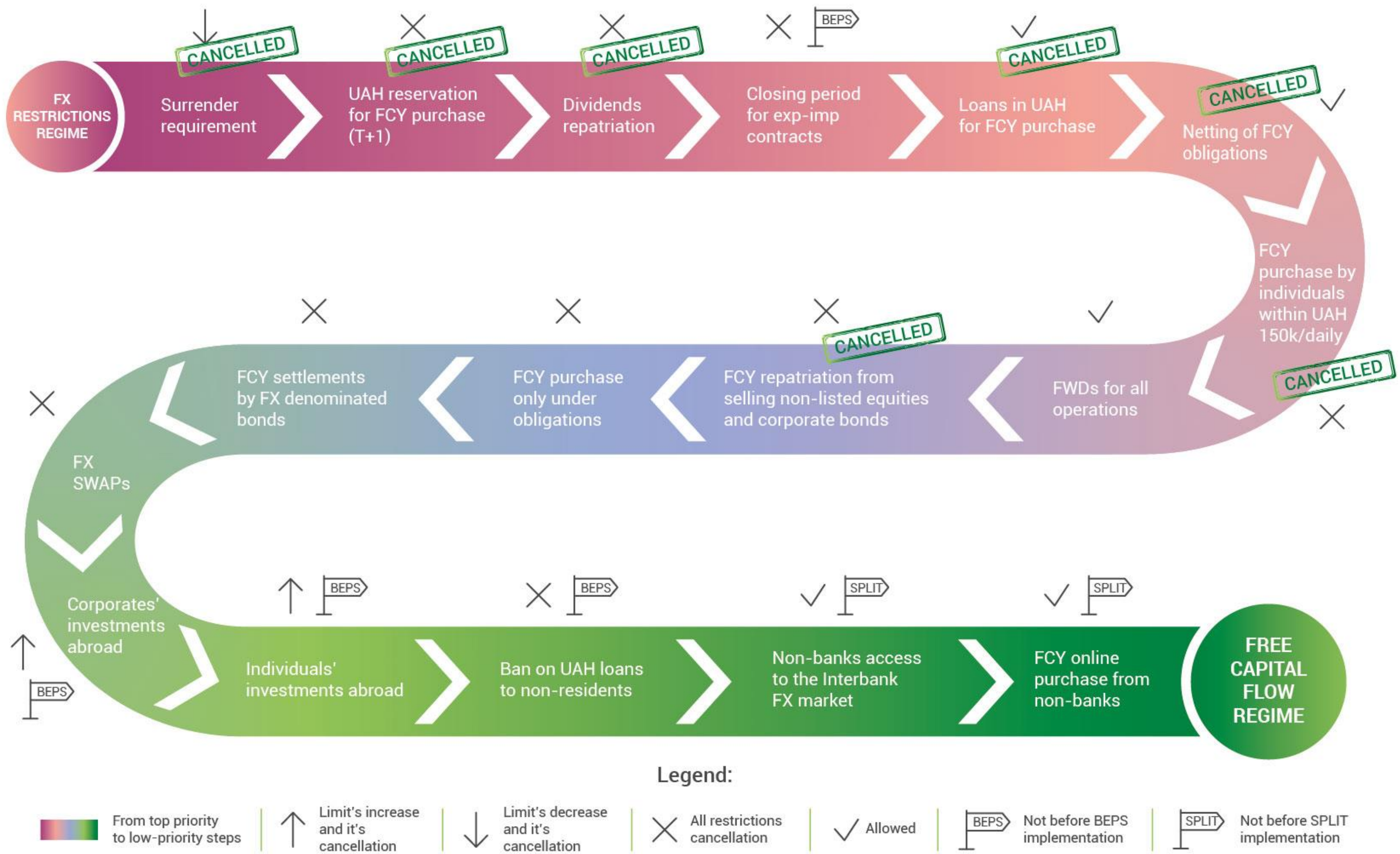
Key macroeconomic indicators

	2019	2020 NBU forecast	2021 NBU forecast	2022 NBU forecast
Real GDP, % change	3.2	3.5	4.0	4.0
Nominal GDP, UAH bn	3 975	4 290	4 682	5113
CPI, % yoy (eop)*	4.1	4.8	5.0	5.0
Core CPI, % yoy (eop)*	3.9	3.5	3.8	3.8
Current account balance, USD bn	-1.1 (-4.0**)	-5.7	-7.9	-8.0
% GDP	-0.7 (-2.6**)	-3.2	-4.1	-4.0
BOP (overall), USD bn	6.0 (3.1**)	3.2	1.6	0.4
Gross reserves, USD bn	25.3	29.3	31.6	32.3

* end of period (December to December of the previous year)
** excluding "Gazprom" payment

The road map for cancelling FX restrictions

(According to the dynamics of macroeconomic preconditions improvement)



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
- Price stability and flexible exchange rate are the "new normal" in Ukraine. The NBU monetary policy is aiming at keeping inflation around 5% target
- Fiscal and external sustainability have improved remarkably over the last few years, but risks remain amid threats 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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