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Ukraine: Macroeconomic and Policy Outlook

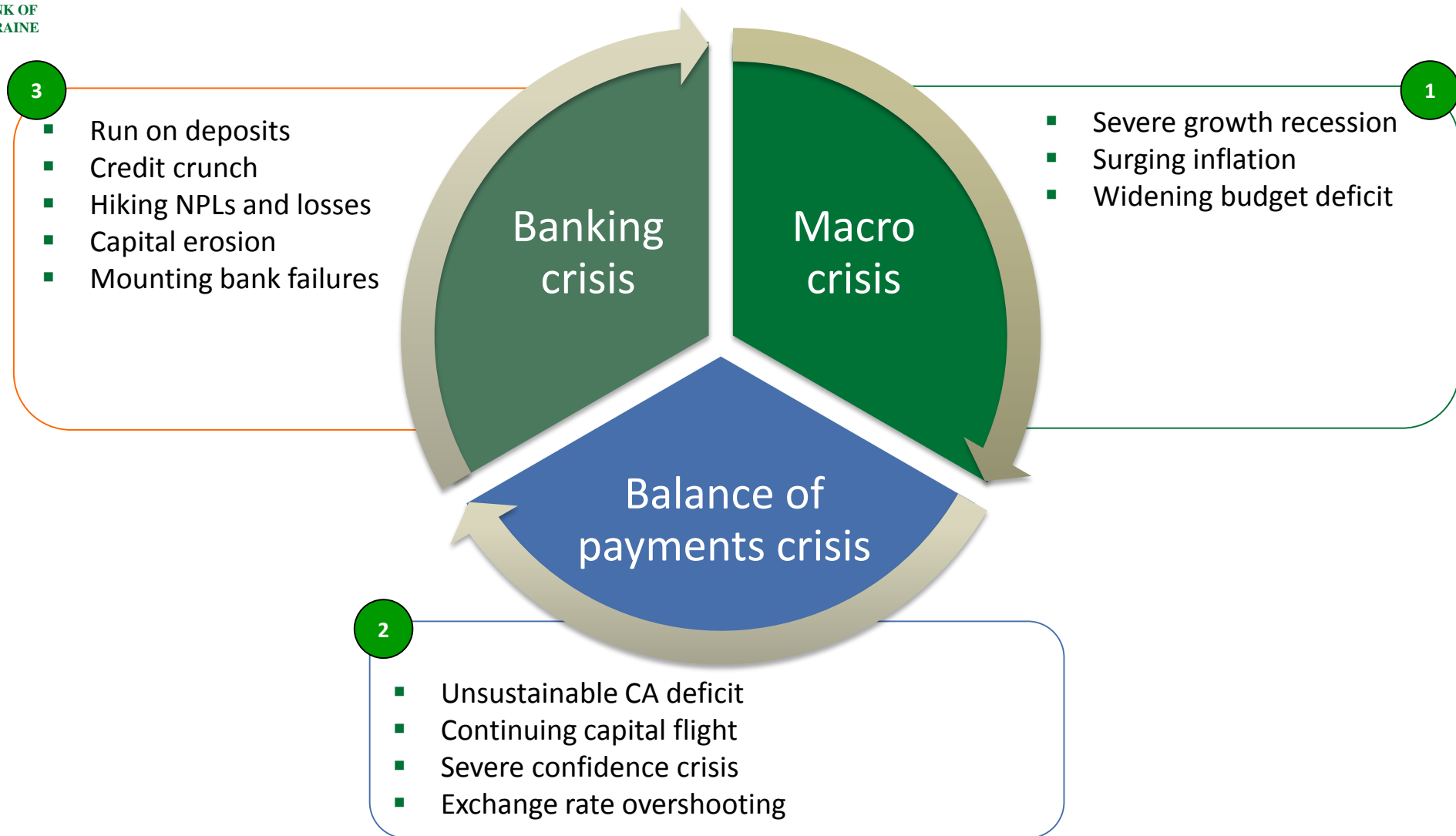
Dmytro Sologub
Deputy Governor
National Bank of Ukraine

Kyiv, October 2017



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Ukraine: Recovering from the “triple crisis” of 2014-2015



The situation in Ukraine was not unique:

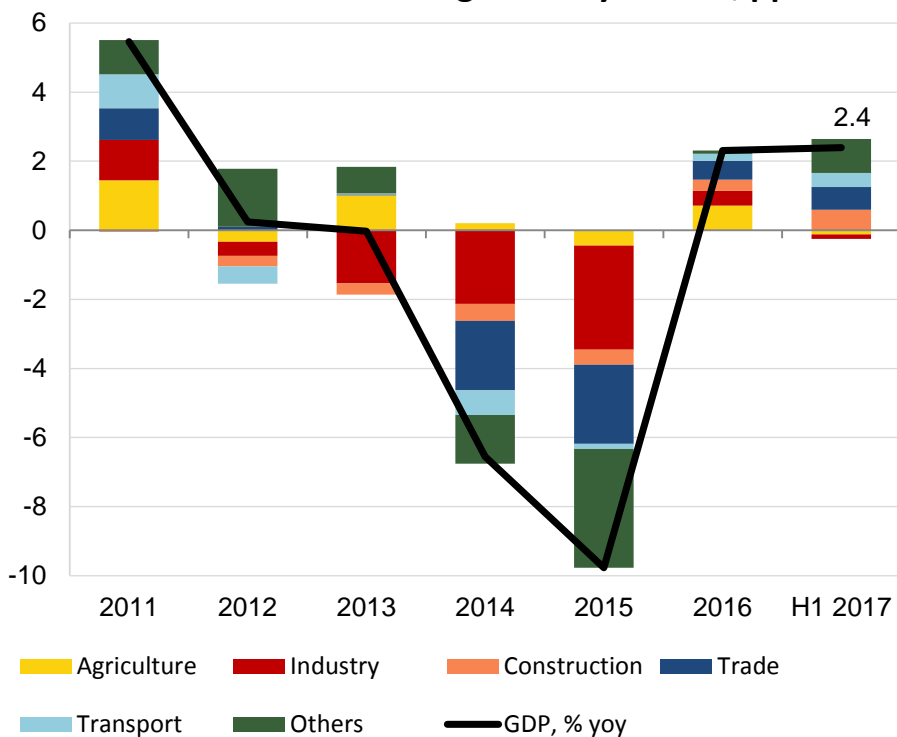
- Mexico (1994/95), Argentina (1994/95);
- Thailand (1997), Indonesia (1997), Malaysia (1997), Philippines (1997);
- Russia (1998); Turkey (2001); Ukraine (2009).



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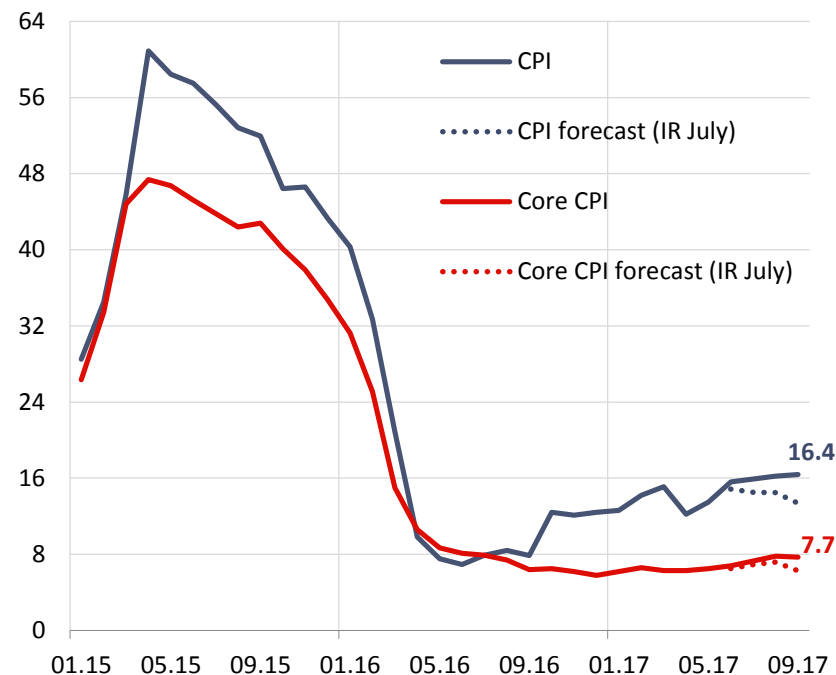
The economy embarked on the steady recovery path since mid-2015 as the growth restored and inflation has been brought down

Contributions to real GDP growth by sectors, pp



Source: State Statistics Service of Ukraine; NBU staff estimates

Actual and projected inflation indicators, % yoy



Source: State Statistics Service of Ukraine; NBU staff estimates

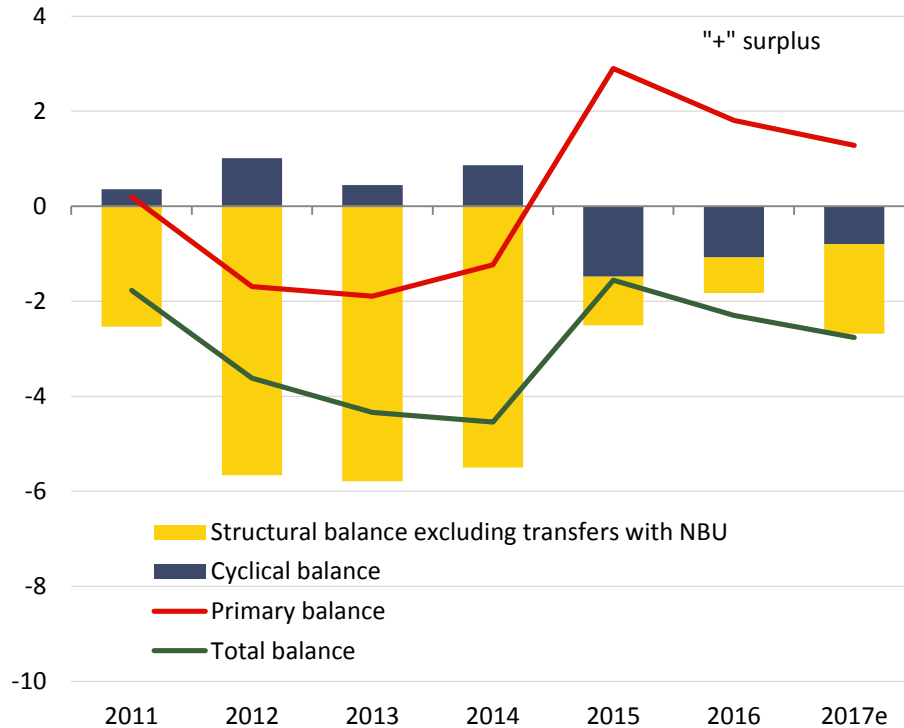
- The Ukrainian economy has been growing at 2-2.5% yoy over 2016-2017, driven by strong investment demand and recovering private consumption
- The growth was achieved despite a number of adverse shocks (Russia's trade restrictions, the halted trade with non-government controlled area (NGCA) and the seizure of enterprises there)
- Subdued core inflation reflects a solid improvement in inflation expectations, stronger hryvnia to US dollar and economy still remaining below its potential
- Higher and volatile headline inflation is due to supply factors (foods, tobacco) and utility tariff adjustments



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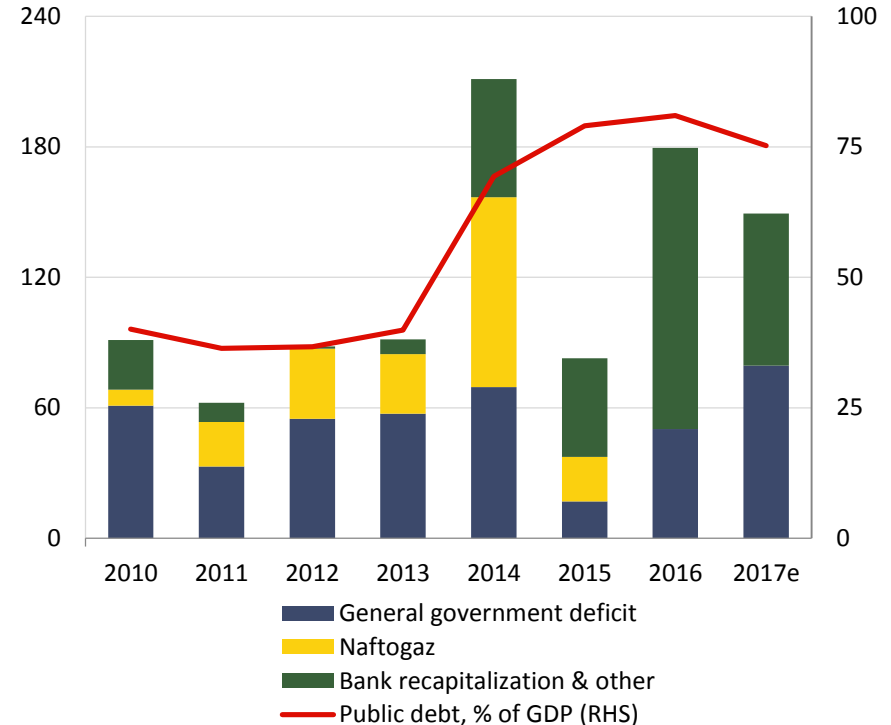
The remarkable progress in fiscal consolidation has been achieved, though public debt surged as a legacy of the latest crisis

Consolidated budget balance, % GDP



Source: MFU; NBU staff estimates

Public sector deficit, UAH bn, and public debt, % of GDP



Source: MFU; NBU staff estimates

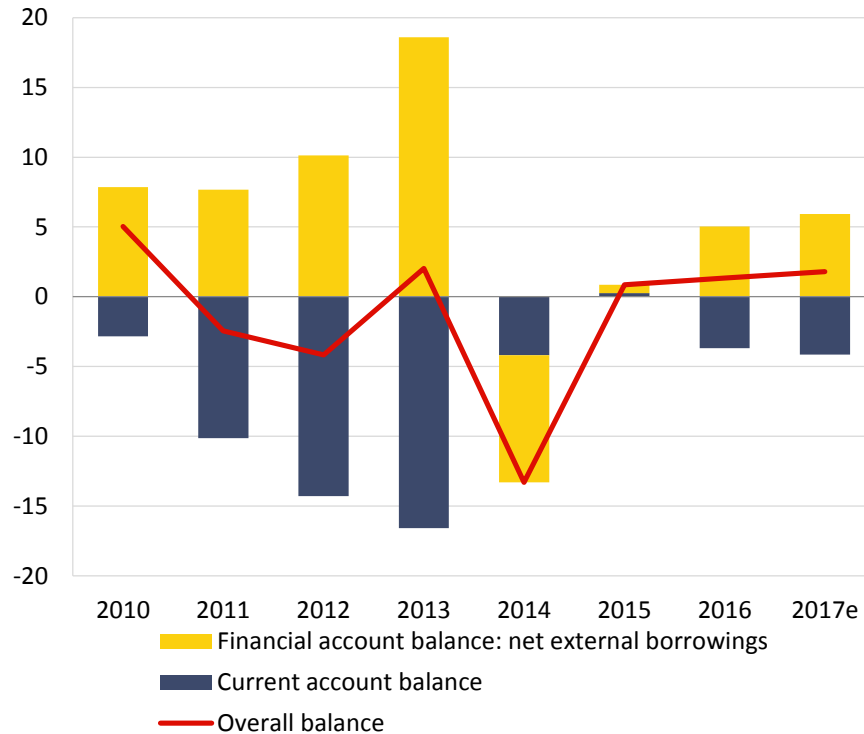
- In contrast to large fiscal deficits in the past, Ukraine has been maintaining primary surpluses since 2015 despite some fiscal loosening measures (a sharp reduction in the single social contribution rate, a hike in the minimum wage, etc.)
- Large tariff adjustments wiped out a sizeable Naftogaz deficit
- Debt-to-GDP ratio increased due to past hryvnia depreciation, economic recession and banks' support



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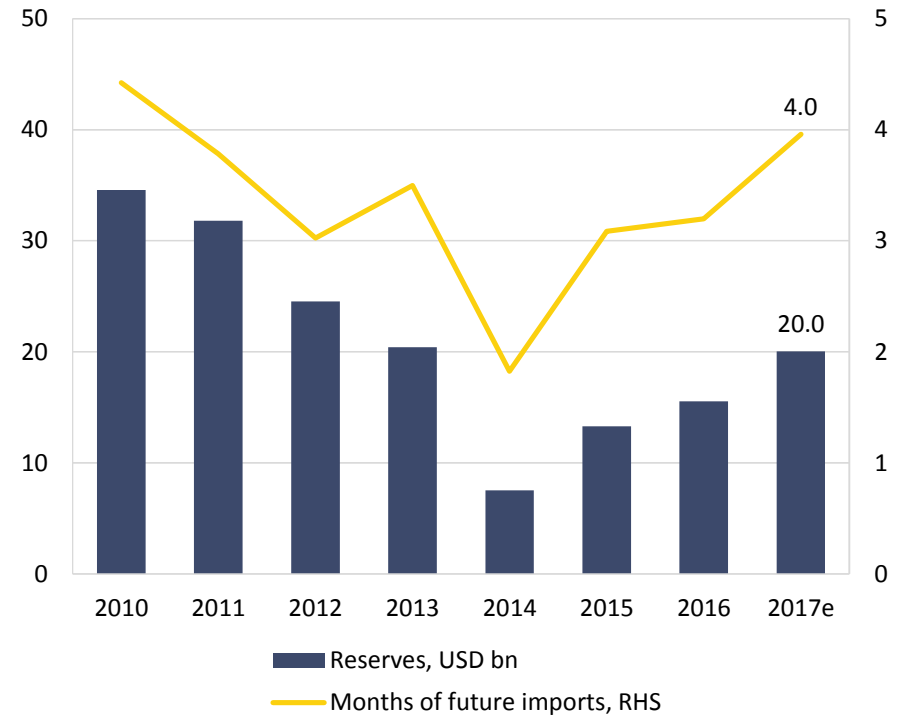
The current account deficit remains manageable and is fully covered by the capital inflows, enabling a steady build-up of the FX reserves

Balance of Payments, USD bn



Source: NBU

Gross international reserves



Source: NBU

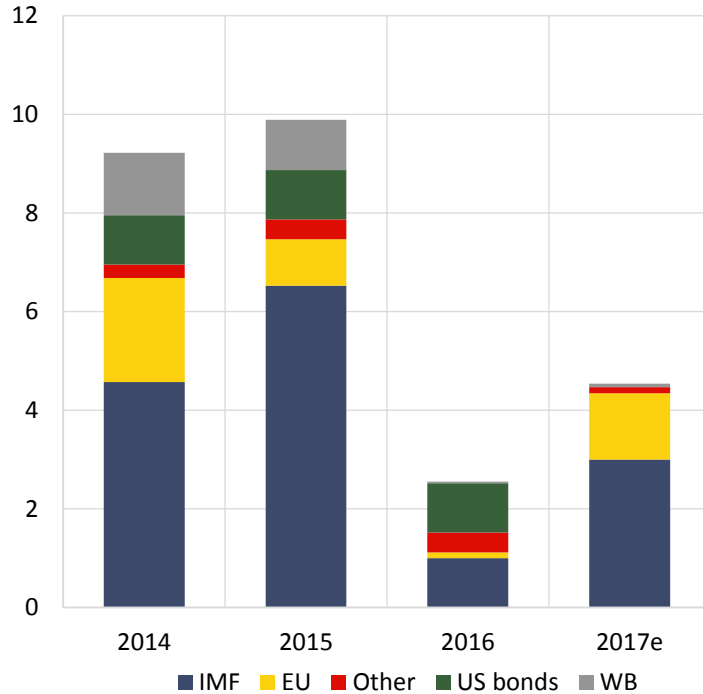
- Following a sharp adjustment in 2015, the CA deficit widened moderately in 2016-2017
- Exports were supported by improved external environment and expanded trade opportunities thanks to FTA with the EU. But it underperformed due to Russia's trade restrictions and the trade ban and seizure of enterprises in NGCA. Meanwhile, strong investment demand spurred imports
- Solid net FA inflows reflected significant decrease in FX cash outside banks, FDI inflows and official financing
- Thanks to overall BoP surplus and IMF tranches, Ukraine is on its way to build sufficient cushion to meet its external debt obligations due in 2019-2020



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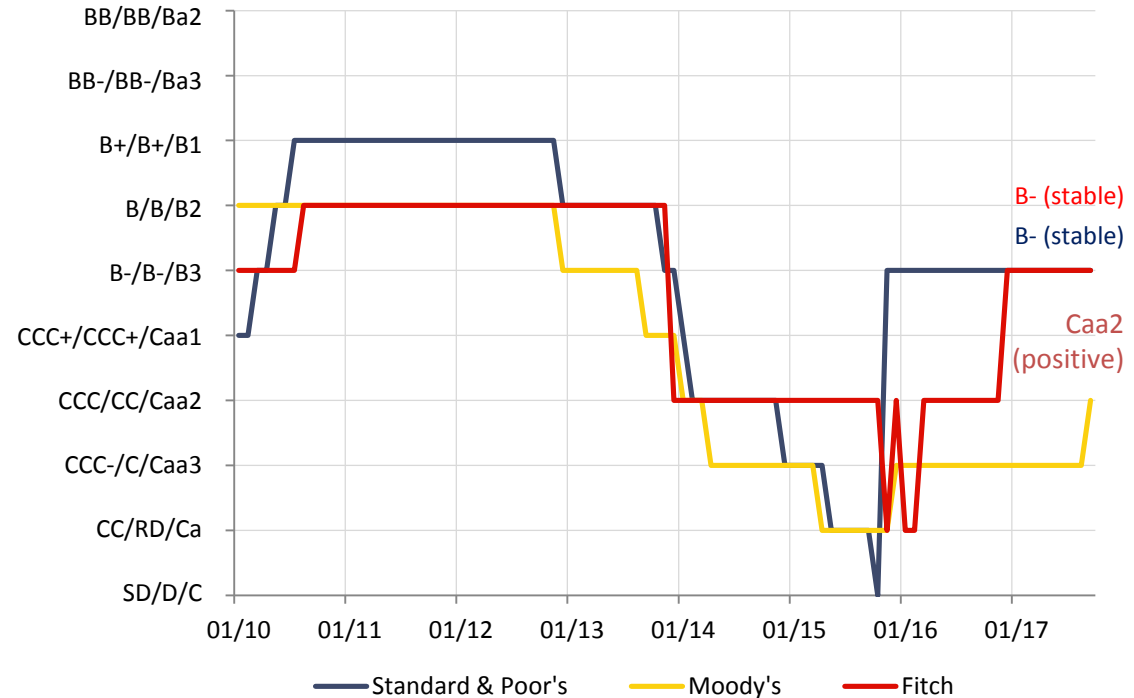
Ukraine renews access to the external capital markets, but so far official financing remained the dominant source

Official financing, USD bn



Source: NBU

Ukraine's sovereign ratings



Source: Rating Agencies

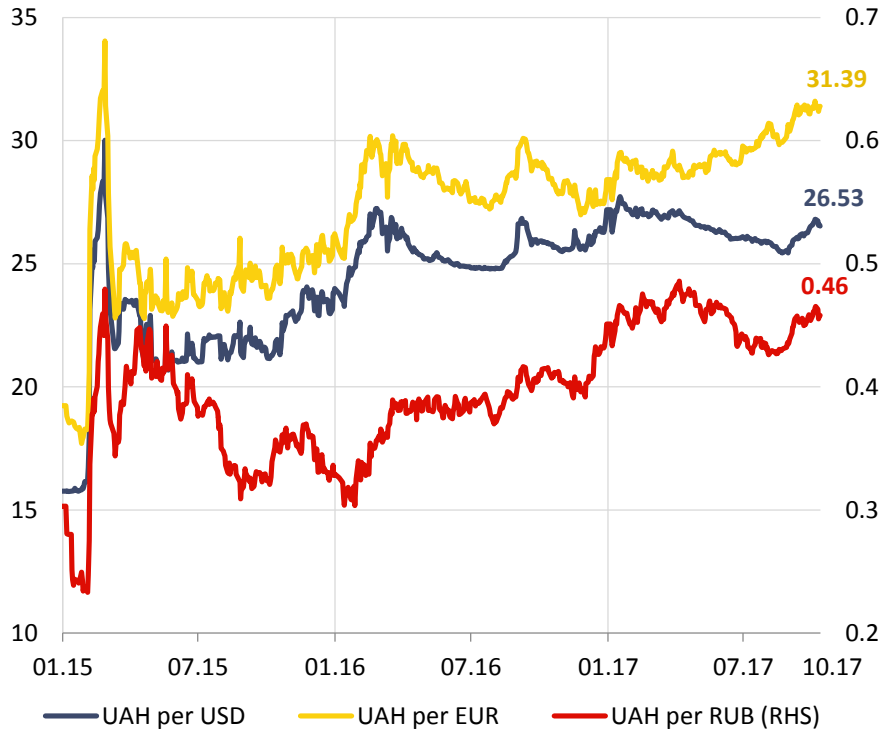
- Due to severe crisis and geopolitical risks, Ukraine's access to foreign financial markets has been virtually closed
- Ukraine relied on official financing to meet its foreign financing needs
- Since mid-2015, rating agencies started to raise Ukraine's sovereign ratings, acknowledging country's progress in macrostabilization and structural reforms
- For the first time since 2014 Ukraine has issued USD 3.0 bn of sovereign Eurobonds (USD 1.7 bn - to buy back principal amount of the outstanding 2019-2020 Eurobonds and USD 1.3 bn – for budget financing)



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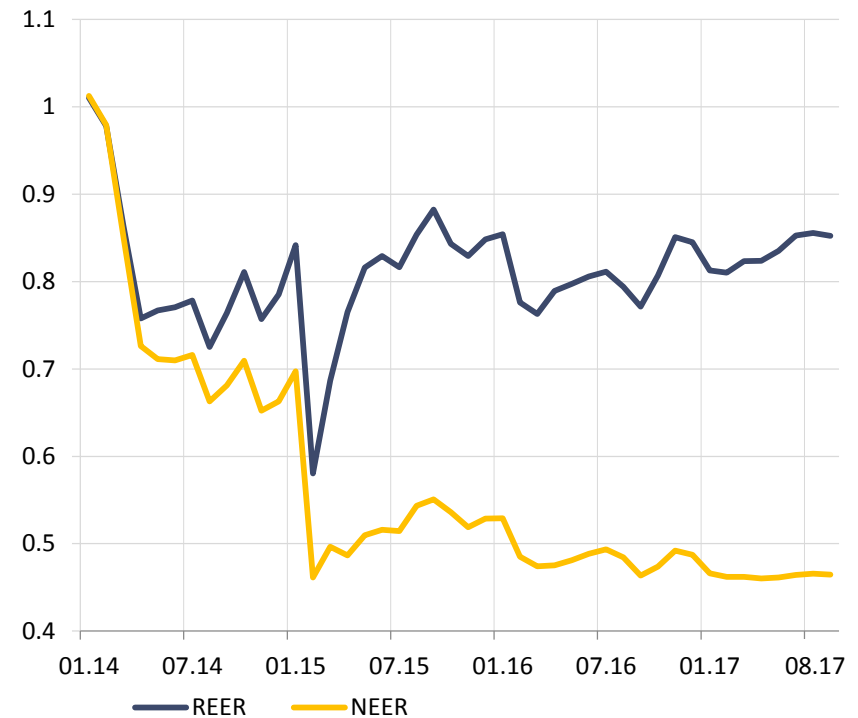
FX market has been broadly stable, with hryvnia exchange rate apparently close to the fundamentally justified levels

Hryvnia exchange rate, as of 12.10.2017



Source: NBU

Hryvnia REER and NEER indices (based on interbank exchange rate), 12.2013=1



Source: IFS, staff estimates

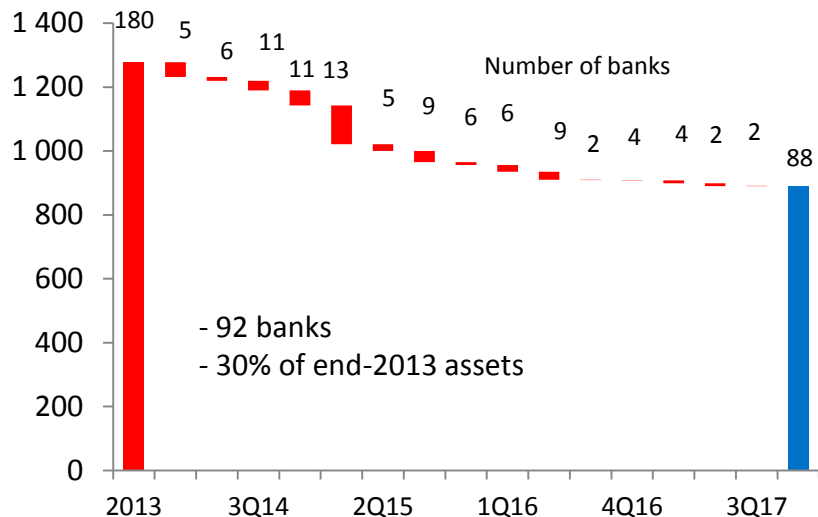
- The NBU is committed to flexible exchange rate policy, keeping exchange rate broadly in line with the fundamentals
- Meanwhile, it continues to play active role at FX market but interventions are performed for clear and specific tasks (e.g., smoothing ST exchange rate volatility and replenishing its international reserves)
- Moderate exchange rate fluctuations over last 2 years contributed to macroeconomic and financial stability



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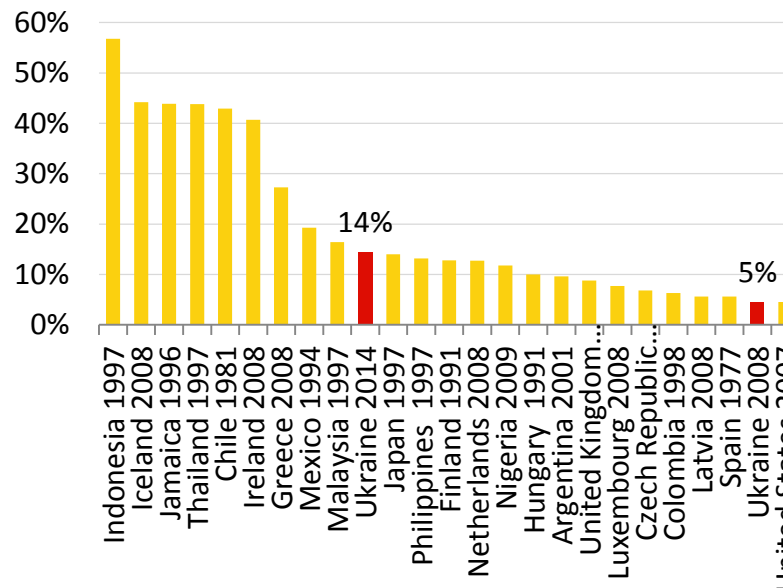
Banking sector clean-up was inevitable, costs of crisis are relatively moderate

Banking sector end-2013 assets, UAH mln



Source: NBU

Fiscal Costs*, % of GDP



* Fiscal costs are defined as the component of gross fiscal outlays related to the restructuring of the financial sector. They include fiscal costs associated with bank recapitalizations but exclude asset purchases and direct liquidity assistance from the treasury.

Source: IMF

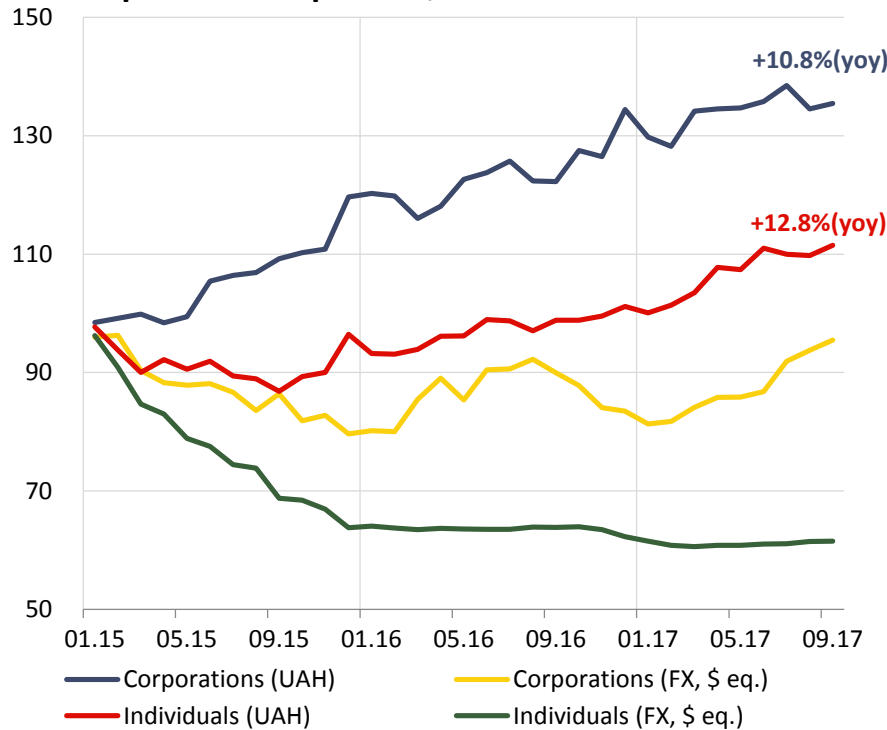
- Since early 2014, more than a half of all banks left the market
- In total, they accounted for 30% of banking sector assets as of early 2014
- The direct fiscal cost of resolving the banking crisis in Ukraine (14% of GDP) is moderate compared with crises in other countries
- The total cost of the crisis, including the direct cost to the private sector, is estimated at 38% of GDP



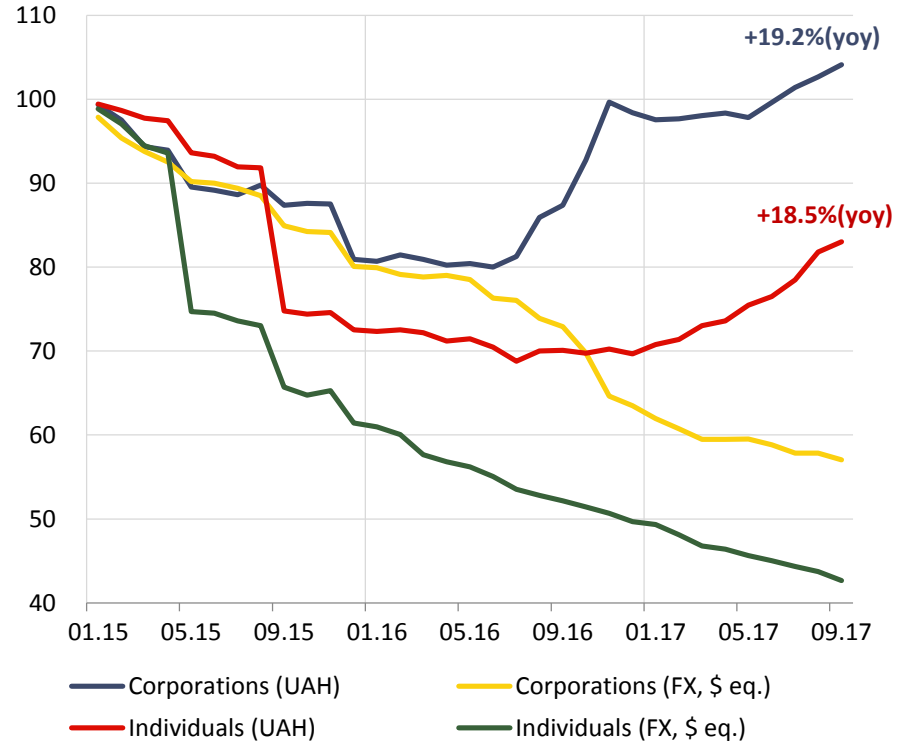
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Hryvnia deposits are flowing back into the banking system, lending activity is subdued with some signs of recovery visible in the retail segment

Deposit developments, 12.2014=100%



Loan developments, 12.2014=100%



Source: NBU

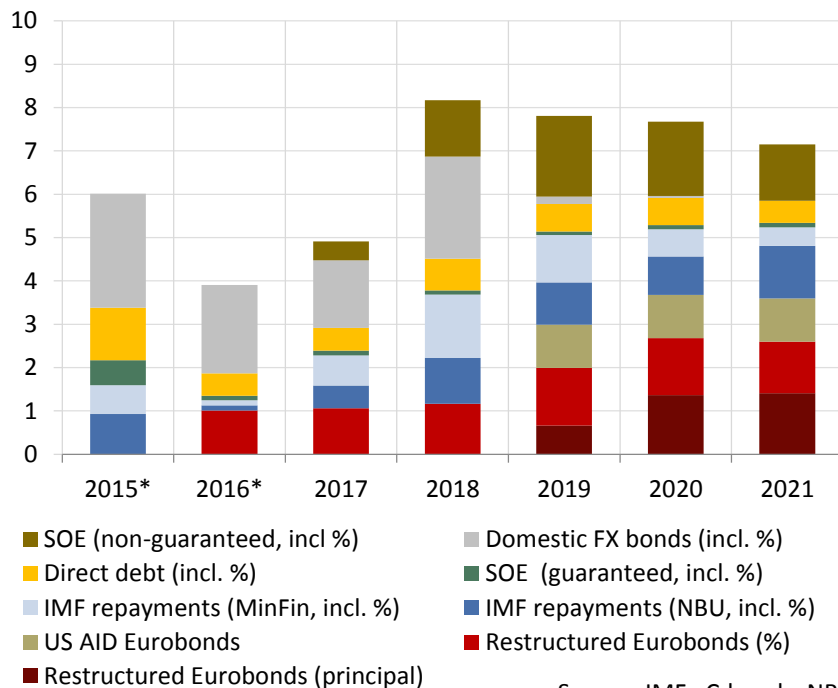
- During the last two years, both corporate and retail hryvnia deposits have been increasing. Corporate FX deposits dropped due to confiscation of funds stolen by ex-president and his entourage
- Robust growth in nominal wages supported the growth of retail hryvnia deposits and loans
- Corporate lending showed signs of recovery. However the growth was largely driven by corporate FX loan restructuring, particularly in H2 2016



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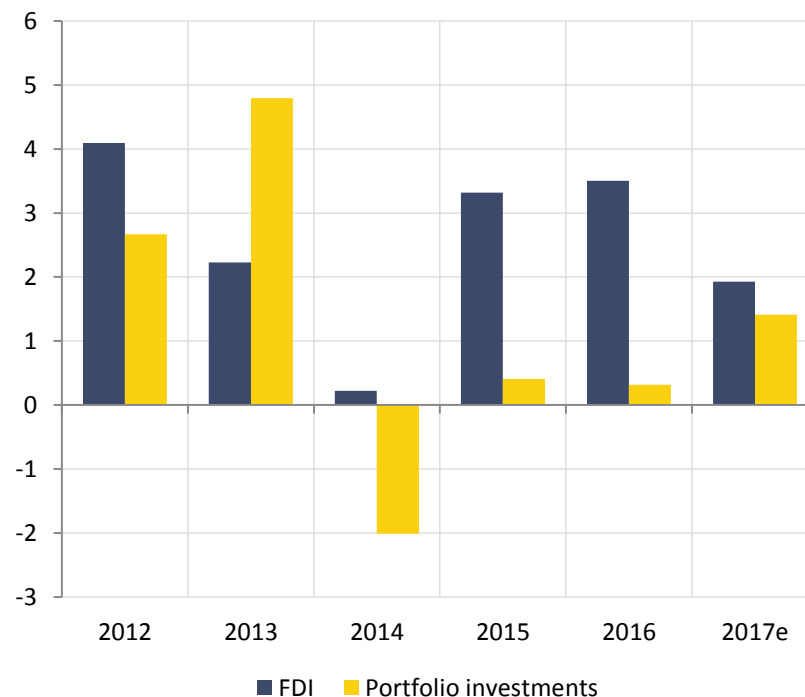
Challenges ahead: Ukraine's external sustainability is to be tested in 2019-20 due to a hike in public FX debt repayments amid subdued capital inflows

FX public debt repayments, USD bn



* SOE (non-guaranteed) repayments data is not available
 ** According to IR (July 2017), adjusted on Eurobond placement
 Source: IMF, C-bonds, NBU

Net FDI and portfolio investment, % GDP



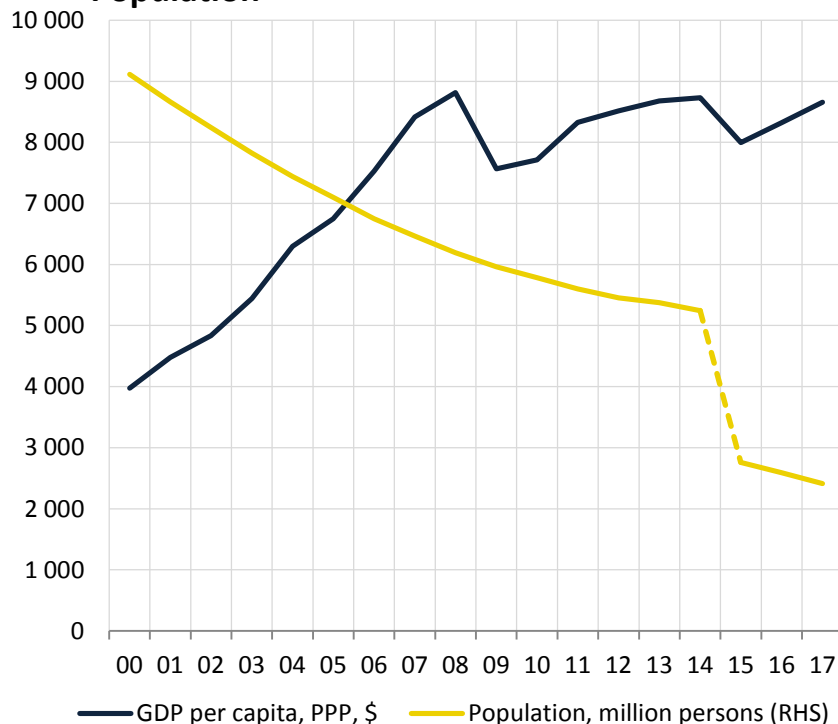
- Successful external debt operation carried out in 2015 and IFI official financing secured some time for Ukraine to gain macroeconomic stability and implement structural reforms
- However, since 2018 external debt repayments will increase notably, peaking in 2019-20
- These financing needs may be challenging for Ukraine given still moderate private capital inflows (excluding debt-to-equity operations in banking system)



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Challenges ahead: Stagnant household incomes might lead to the rising social tensions

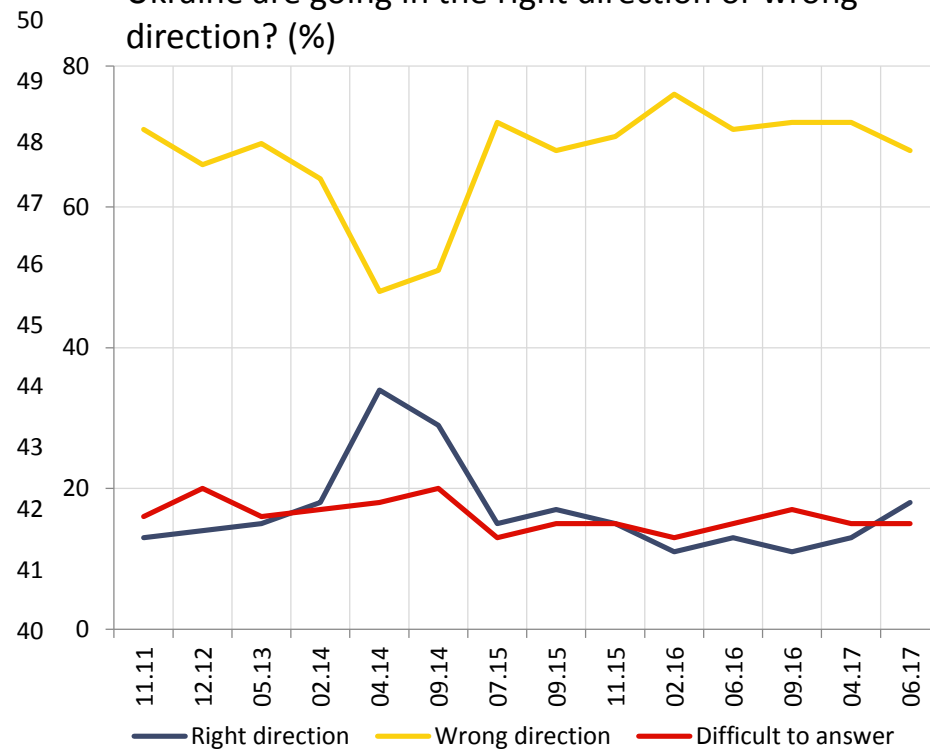
Ukraine's GDP per capita (PPP-based) and Population



Source: IMF WEO database (October 2017), SSSU

Public opinion survey:

Generally speaking, do you think that things in Ukraine are going in the right direction or wrong direction? (%)



Source: GfK Ukraine with Center for Insights in Survey Research

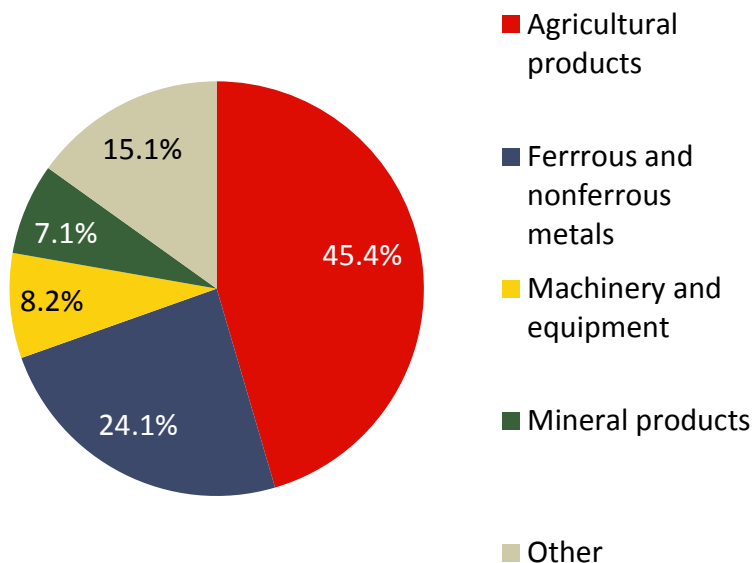
- Following a buoyant increase during 2000-2008, Ukraine's GDP per capita (PPP-based) stayed virtually flat even amid an ongoing decline in population
- Despite some structural reform progress, the share of those who believe the country is moving in the wrong direction remained high



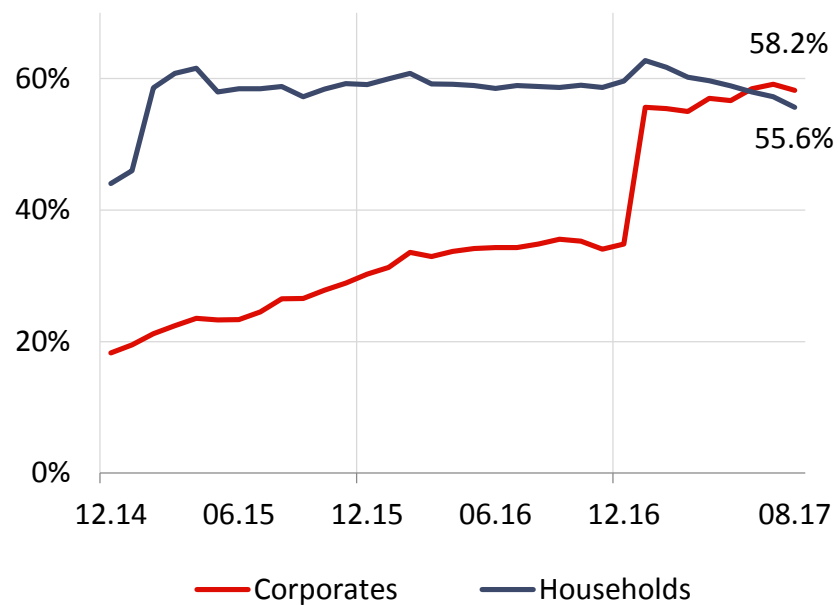
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Challenges ahead: Non-diversified economy and banking sector plagued by NPLs

Structure of export in 2016



Share of impaired loans in portfolios of reporting banks



Source: NBU

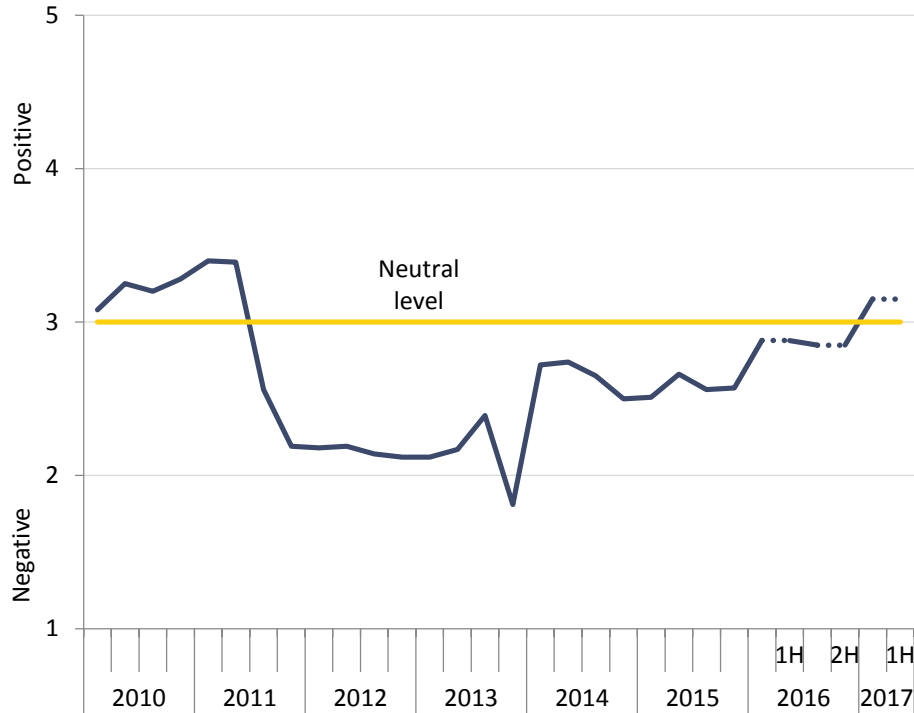
- High trade openness (as exports exceed 60% of GDP) is combined with the domination of agricultural and metallurgical industries in exports, highlighting Ukraine’s vulnerability to global commodity prices’ fluctuations
- The banking system emerged from the comprehensive clean-up with 57% NPL ratio mostly driven by the massive defaults on loans by the major industrial groups
- While most of these loans has been provisioned, the lack of efficient write-off procedures and imperfect legal proceedings put a drag on the new lending



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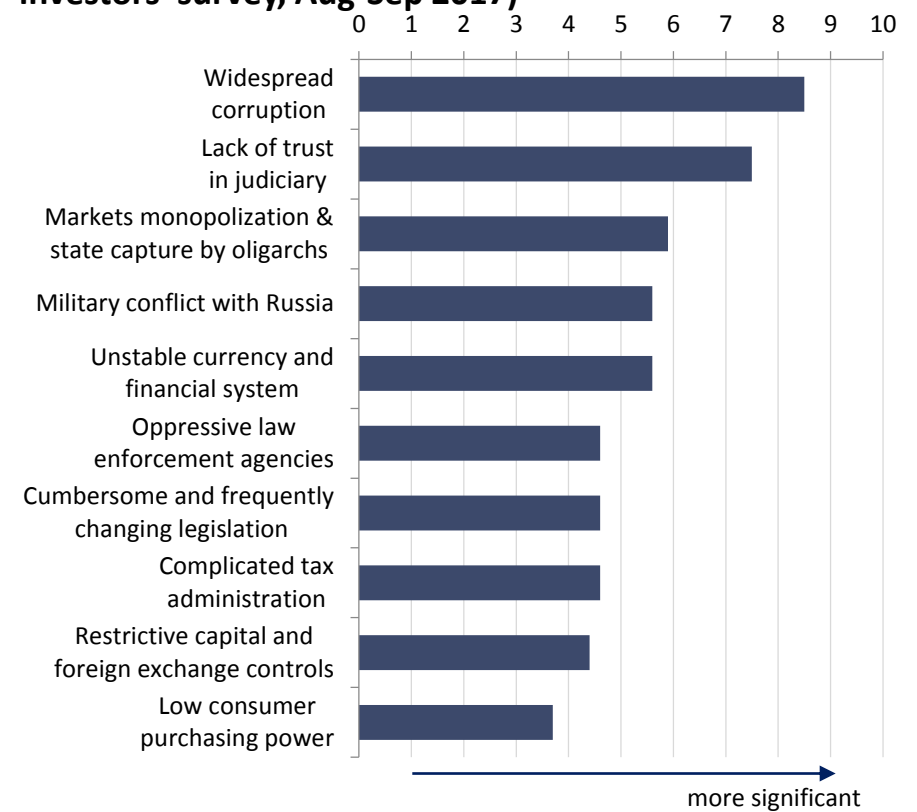
Challenges ahead: Despite recent improvement, business climate remains challenging for the foreign investors

EBA Investment Attractiveness Index



Source: EBA

Main impediments to FDI in Ukraine (foreign investors' survey, Aug-Sep 2017)



Sources: EBA, Dragon Capital, CES



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How to tackle these challenges?

Macroeconomic stabilization

Prudent monetary policy under Inflation Targeting

Conducting interest rate policy, consistent with inflation targets
Smoothing the excessive exchange rate fluctuations
Securing autonomy to conduct monetary policy (no fiscal dominance)

Prudent fiscal policy aimed at lowering public indebtedness

Medium-term budget planning
Reasonable budget deficit in line with robust fiscal rules
Social payments increase according to the plan
Lowering the share of public debt in FX

Structural reforms

Pension reform

Energy sector reform

Land reform

Education reform

Healthcare reform

Financial sector reform

Fighting corruption; Judiciary reform



Continue cooperation with the IMF





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The NBU ultimate monetary policy priority: targeting low and stable inflation

Main principles of new monetary policy framework

Price stability priority

reducing inflation to low level and keeping it there

Forward-looking decision-making

forecast-based decisions to ensure anchored expectations

Transparency

regular detailed explanations of the NBU actions and their reasoning

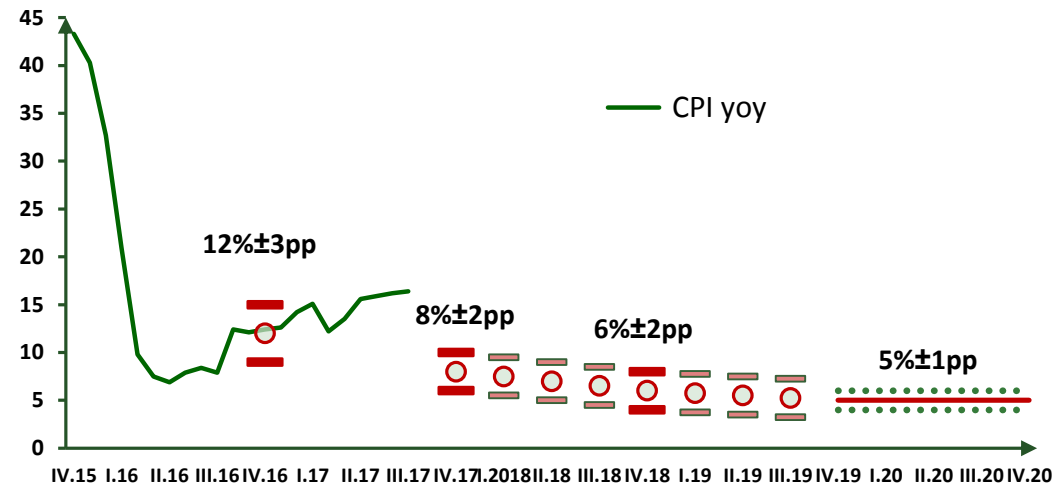
NBU independence

Floating exchange rate

- smoothing excessive exchange rate volatility
- gradually reducing the NBU presence in FX market

- ❖ Inflation targeting framework is announced by NBU Board in August 2015
- ❖ The adoption of inflation targeting is officially defined in the Monetary Policy Guidelines for 2017 and the medium-term (approved by the NBU Council)
- ❖ and confirmed in the Monetary Policy Guidelines for 2018 and the medium-term
- ❖ Inflation targets for 2017-2020 are locked in

Headline Inflation, % yoy





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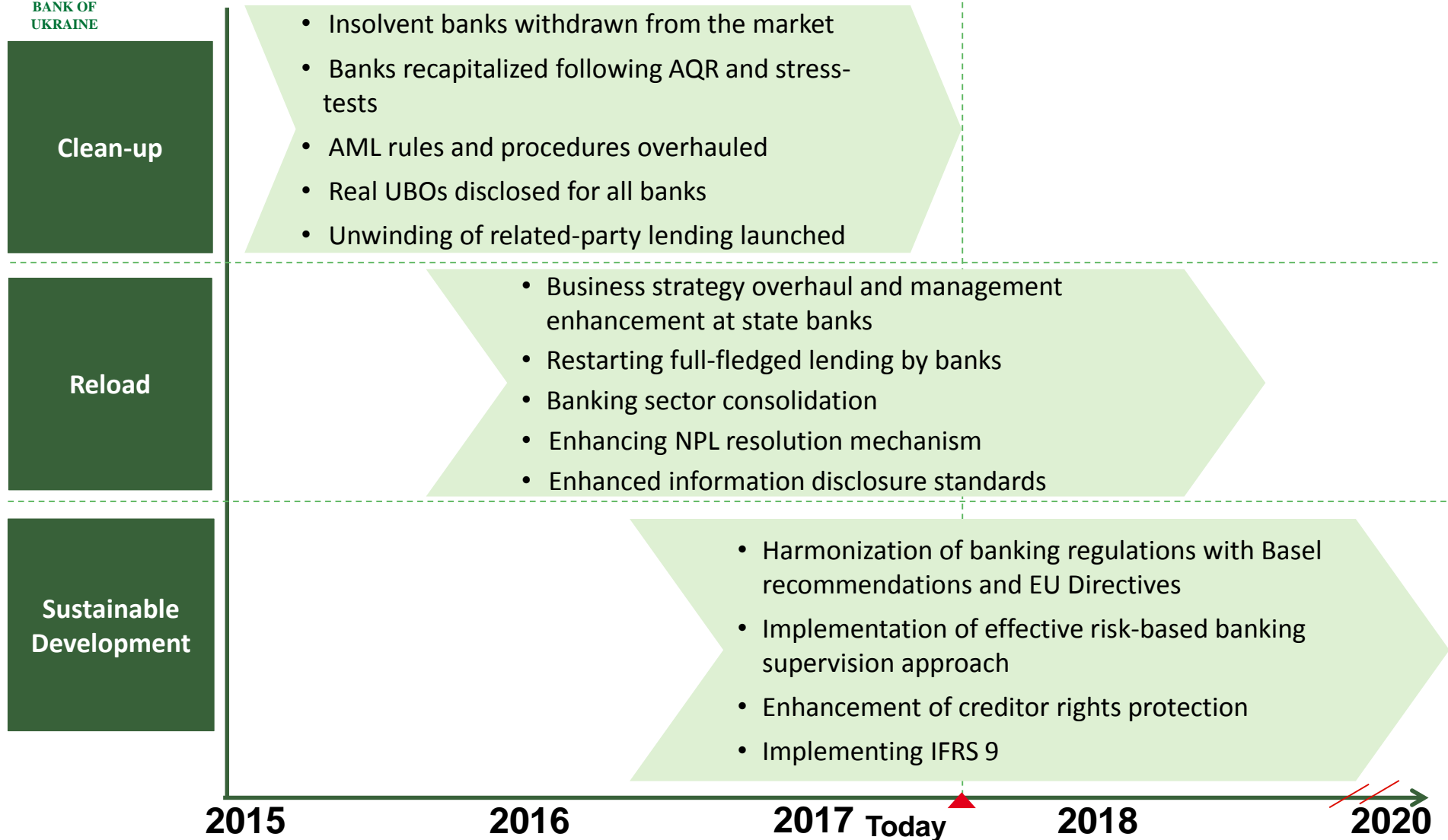
The NBU is moving towards the new model of currency regulation

Novation	Comment
1 Freedom of currency operations	<ul style="list-style-type: none">▪ All operations are free, except ones, directly forbidden in the Law
2 Currency values	<ul style="list-style-type: none">▪ National currency▪ Foreign currency▪ Precious metals
3 All payments (for goods & services) in Ukraine – in UAH, except:	<ul style="list-style-type: none">▪ Foreign investments operations▪ Banking and financial services▪ Non-banking financial companies and Ukrainian Post operations▪ Other operations, defined by NBU
4 Only 2 types of licenses	<ul style="list-style-type: none">▪ Banking (also includes currency license)▪ Currency – for non-banking financial companies
5 Currency supervision	<ul style="list-style-type: none">▪ Authorities: NBU, Tax office,▪ Agents: local banks
6 Currency restrictions – temporary safeguard measures	<ul style="list-style-type: none">▪ To be introduced by Financial Stability Council decision▪ Period – up to 6 months with possible prolongation



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Facing the perfect storm, the National Bank launched the comprehensive reform of the local banking industry



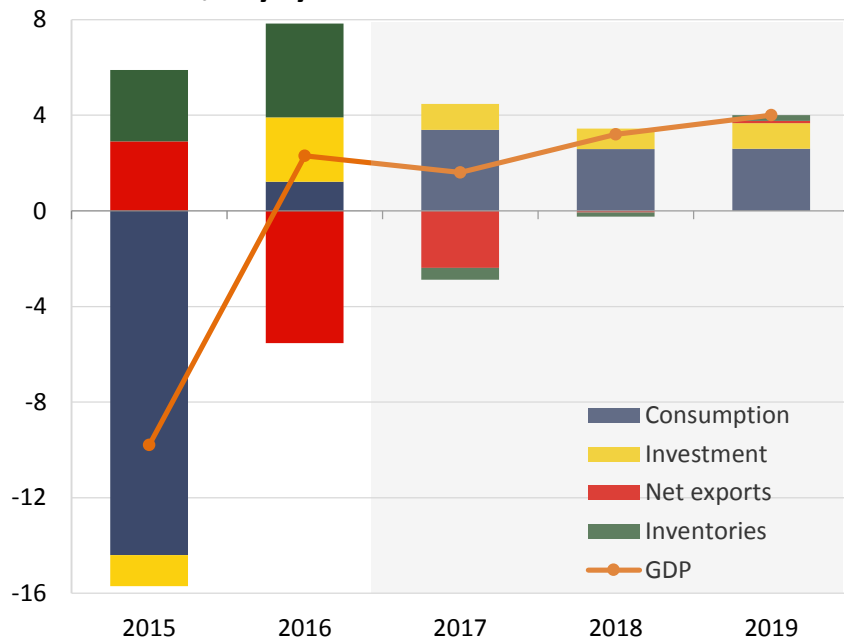
In addition to the overhaul of the banking system, the National Bank simultaneously launched radical internal transformation



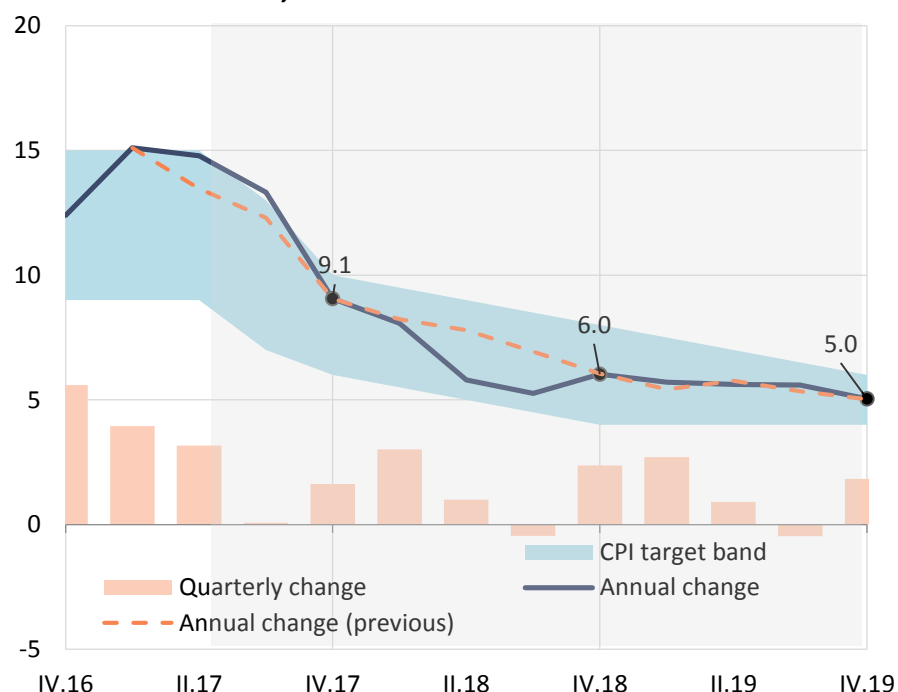
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OUTLOOK: The economy will continue recovering despite the negative effect of the trade blockade; disinflation will be in line with NBU targets

Real GDP, % yoy



Headline CPI, %



Year average, %	2016	2017e	2018f	2019f
GDP growth	2.3	1.6	3.2	4.0

CPI growth by components, eop, % yoy	2016	2017e	2018f	2019f
CPI	12.4	9.1	6.0	5.0
Core CPI	5.8	6.1	3.9	2.8
Raw foods	1.2	11.8	3.6	2.5
Administrative	34.6	13.8	12.3	11.5
Fuel	19.5	13.0	8.0	6.0



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Key macroeconomic indicators

	2016	2017e	2018f	2019f
Real GDP, % yoy	2.3	1.6	3.2	4.0
Nominal GDP, UAH bn	2383	2 850	3 220	3 585
CPI, eop, % yoy	12.4	9.1	6.0	5.0
Core CPI, eop, % yoy	5.8	6.1	3.9	2.8
Current account balance, USD bn	-3.8	-4.1	-4.6	-3.9
BOP (overall), USD bn	1.3	1.8	2.5	0.1
Gross reserves, USD bn	15.5	20.0	27.1	25.7
Base money, eop, % yoy	13.6	6.4	7.8	6.0
Broad money, eop, % yoy	10.8	9.0	13.5	12.6

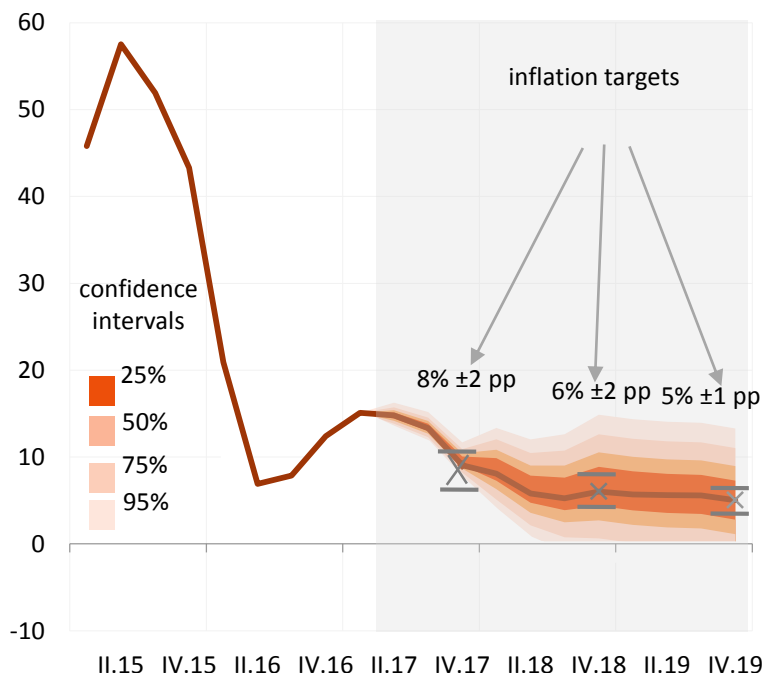
eop – end of period



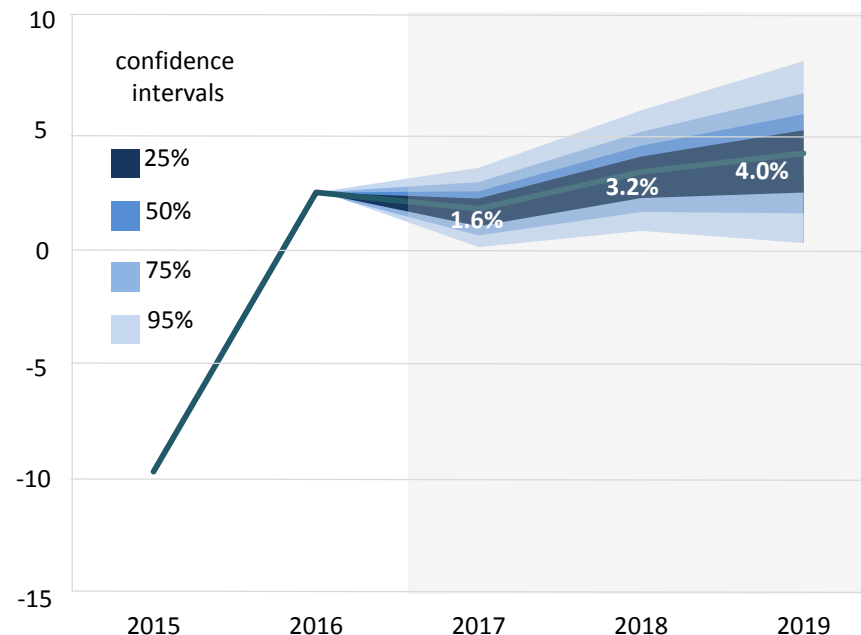
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OUTLOOK: Risks are still looming high

CPI Growth, % yoy



Real GDP Growth, % yoy



- **Key risks** to the baseline macroeconomic scenario:
 - Escalation of the military conflict in the Eastern Ukraine
 - Slow adaptation of the private sector and the government to new business conditions following the halted trade with NGCA
 - Faster adjustment of utility tariffs (natural gas in particular) and more significant food supply shocks
 - Domestic policy uncertainty (macro and structural reforms, including pension reform)
 - Turbulent external environment (Trump policy unpredictability, global commodity prices, geopolitical risks)



NBU policy actions

Macroeconomic stability

- Securing low and stable inflation
- A build-up of foreign reserves
- Foreign exchange liberalization:
 - replacing the outdated Foreign Exchange Regulation Decree and reducing the number of regulatory acts
 - Relaxing FX restrictions and capital controls as conditions allow

Priorities in other sectors

- Promoting cashless payments (“Cashless economy” project)
- Enhancing financial awareness of the population
- The continuation of NBU internal transformation, implementing project management approach, Open data project, etc.

Revamping the banking system

- Ensuring adequate capitalization of the banking system
 - conducting asset quality reviews and stress-testing for small banks
 - sticking to the recapitalization schedule
- Restoring bank lending activities
 - ensuring implementation of effective mechanism for creditor’s rights protection
 - capacity building for effective resolution of NPLs
- Solving the related party lending problem
- Implementing new Basel-consistent capital and liquidity regulations
- Strengthening banking supervision
 - implementation of risk-based supervision approach consistent with SREP (supervisory review and evaluation process)
 - improving early warning system
 - developing and implementing macroprudential supervision tools



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Key messages to retain

- Ukraine has been recovering from “**perfect storm**”, caused by the grave combination of severe shocks, including an armed conflict and annexation of Crimea
- Macroeconomic stabilization, the first signs of which were ensured in mid-2015, was maintained in 2016 and 2017, despite numerous challenges (noisy political environment, large commodity price swings, delays with official financing, sporadic conflict escalation)
- **The Ukrainian economy is projected to continue recovering but at slower pace than previously expected due to a trade ban with non-government controlled area**
- **The NBU ultimate objective is price stability.** Hence, reducing inflation to its medium-term target of 5% yoy under inflation targeting framework will be the main task for NBU monetary policy
- Other policy efforts will focus on securing financial stability (including a further build-up of international reserves), revamping the banking system, liberalizing capital account and promoting cashless economy
- Hence, **keep calm and stay long Ukraine!!**