



NATIONAL BANK OF UKRAINE

Ukraine: Macroeconomic and Policy Outlook

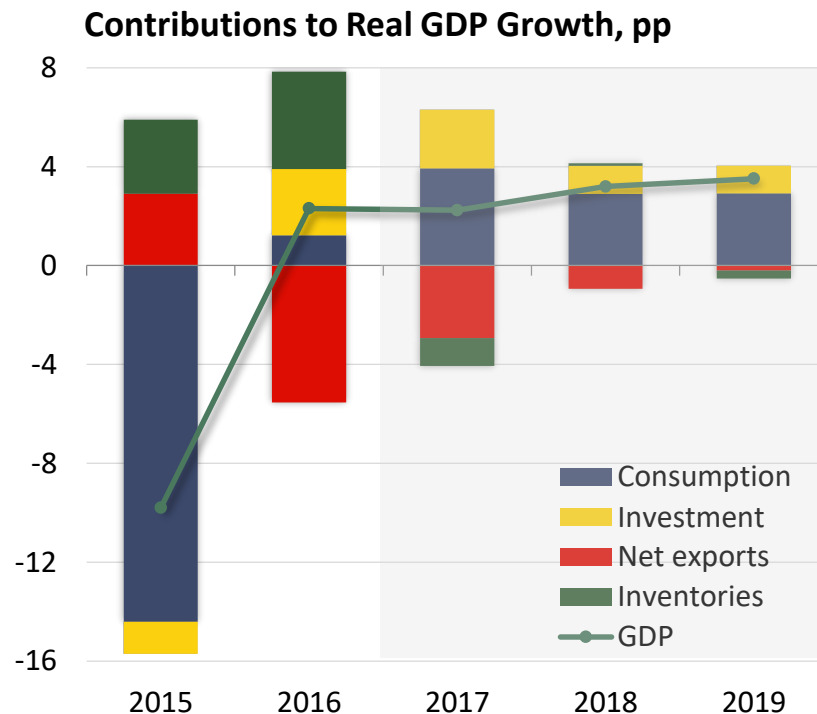
Dmytro Sologub
Deputy Governor
National Bank of Ukraine

Kyiv, November 2017



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The economy embarked on the steady recovery path in 2015, further growth acceleration is in the cards for 2018-19



Source: State Statistic Service of Ukraine; NBU

change, % (in real terms)	2016	2017	2018	2019
GDP	2.3	2.2 (1.6)	3.2 (3.2)	3.5 (4.0)
Consumption	1.4	4.6 (3.9)	3.3 (2.9)	3.3 (2.9)
Private consumption	1.8	6.0 (4.9)	4.0 (3.6)	4.0 (3.6)
Gross fixed capital formation	20.1	16.0 (7.4)	7.1 (5.5)	6.9 (6.7)
Export of goods and services	-1.6	5.1 (4.9)	3.3 (5.0)	3.2 (3.7)
Import of goods and services	8.4	9.8 (8.6)	4.7 (4.6)	3.2 (3.1)

Downward revision in 2018-2019

- ↓ Tighter monetary policy
- ↓ REER appreciation
- ↑ Private consumption and investments recovery
- ↑ Better terms-of-trade and external demand

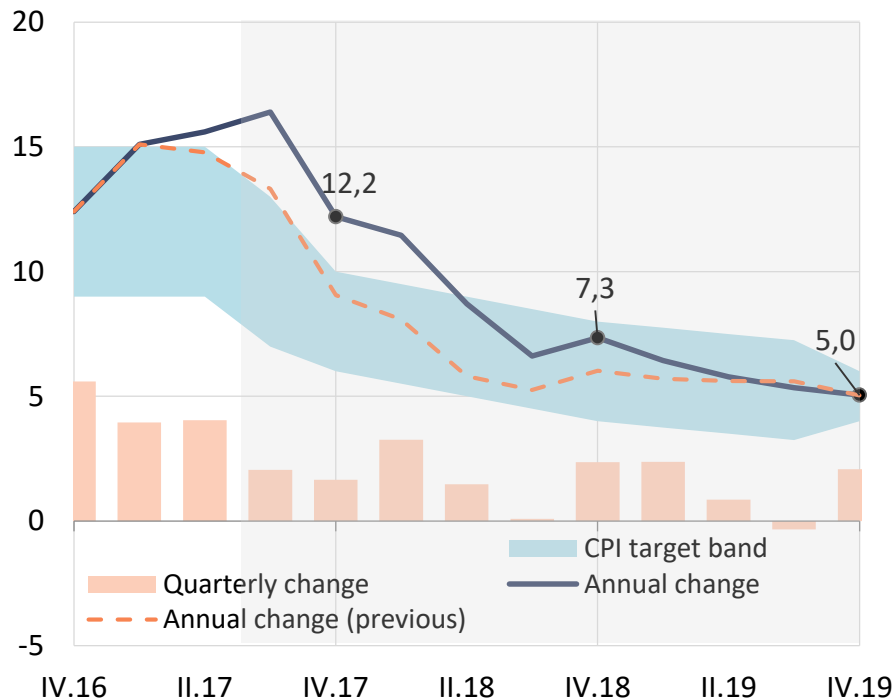
in () – previous forecast (IR, July 2017)



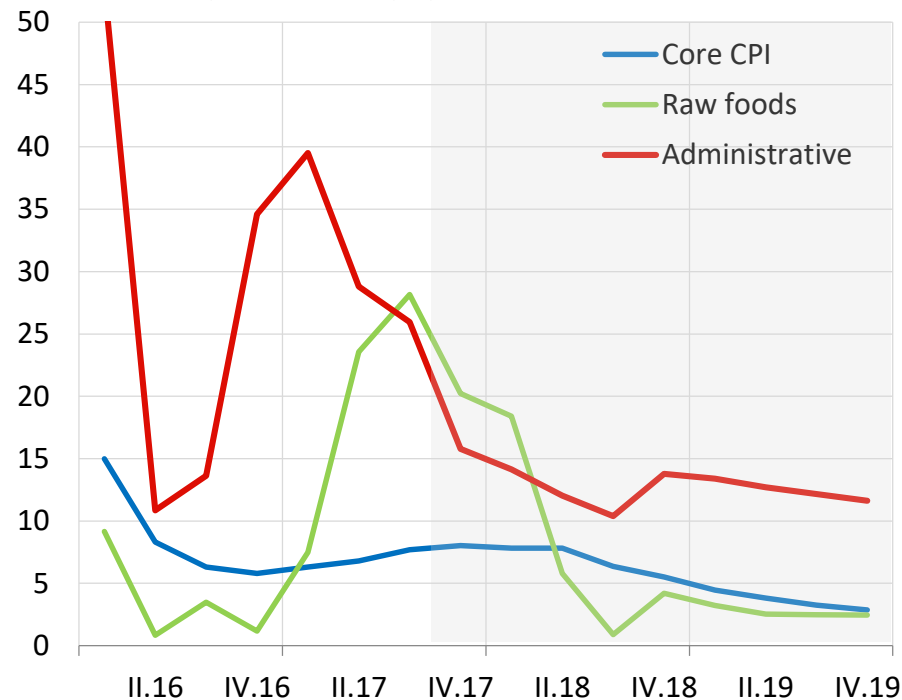
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Temporary spike in inflation is to wind down gradually amid tighter policies and petering out idiosyncratic supply shocks

Headline CPI, %



CPI components, % yoy



change, %	weight, %	2017	2018	2019
CPI	100.0	12.2 (9.1)	7.3 (6.0)	5.0 (5.0)
Core CPI	57.4	8.0 (6.1)	5.5 (3.9)	2.9 (2.8)
Raw food	19.0	20.2 (11.8)	4.2 (3.6)	2.5 (2.5)
Admin	18.6	15.8 (13.8)	13.8 (12.3)	11.6 (11.5)
Fuel	5.0	16.0 (13.0)	9.0 (8.0)	5.0 (6.0)

Inflation factors:

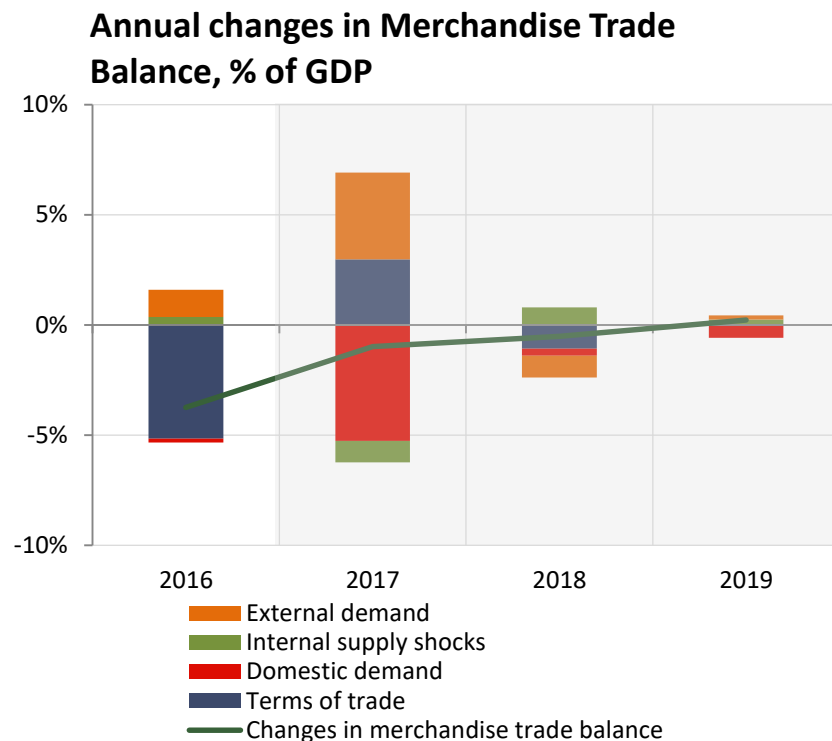
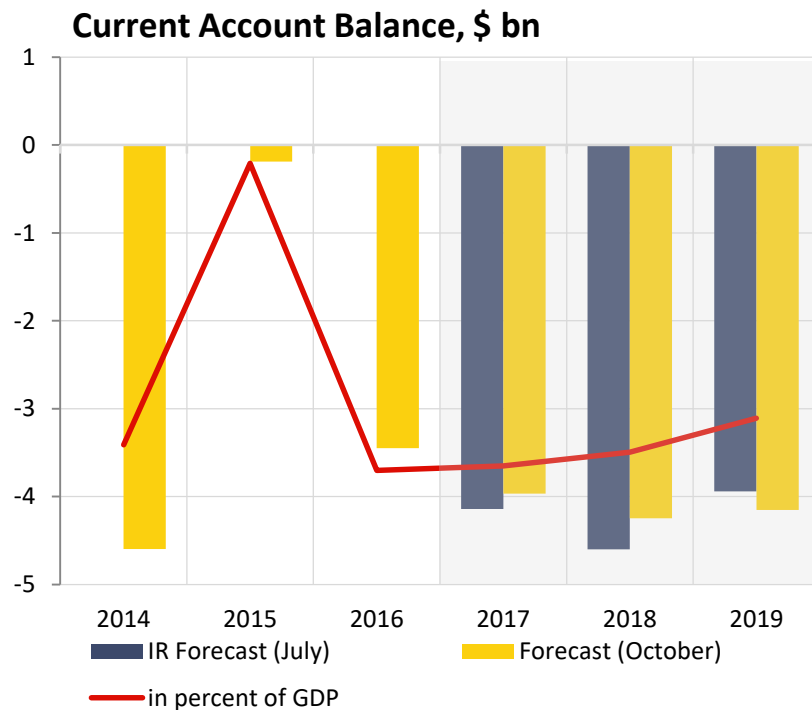
- ↑ Negative supply shocks on food markets
- ↑ High demand and private consumption
- ↑ Pension reform impulse
- ↑ Minimum wages growth impulse
- ↓ Stronger UAHUSD exchange rate
- ↓ Improved inflation expectations

in () – previous forecast (IR, July 2017)



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In 2017-2019, CA deficit remains almost unchanged in nominal terms, gradually decreasing to 3% GDP in 2019



Main factors of CA forecast revision in 2017-2019

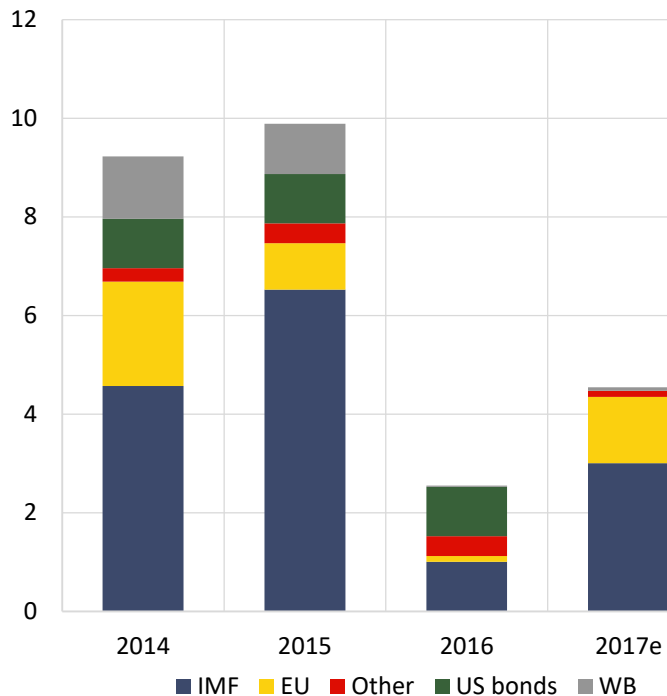
Trade balance (↓)	↓↓ Volumes of exported iron ore, ↓ Metallurgical imports ↑ Exports of grain in 2017/2018 MY, ↑ Steel prices in 2H2017-1H2018, ↓ Gas prices, ↑ Net exports of fertilizers
Balance of services (≈)	↑ Import of “travel” item, ↑ Exports of transportation services
Primary&secondary income (↑)	↑ Remittances



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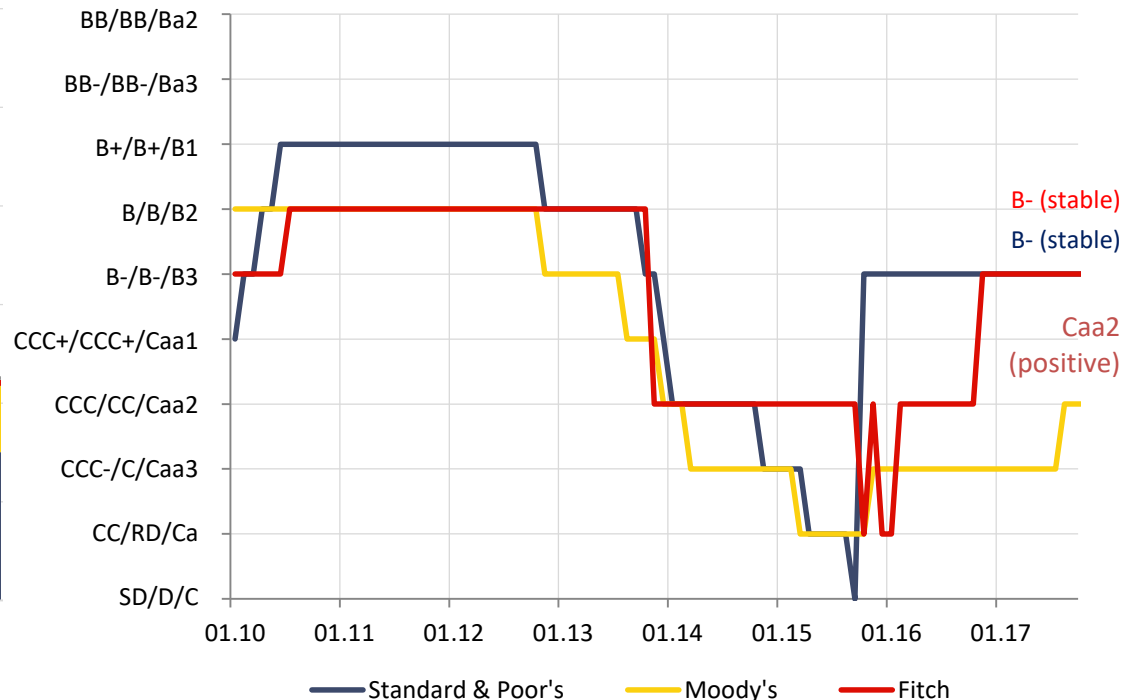
Ukraine renews access to the external capital markets, but so far official financing remained the dominant source

Official financing, USD bn



Source: NBU

Ukraine's sovereign ratings



Source: Rating Agencies

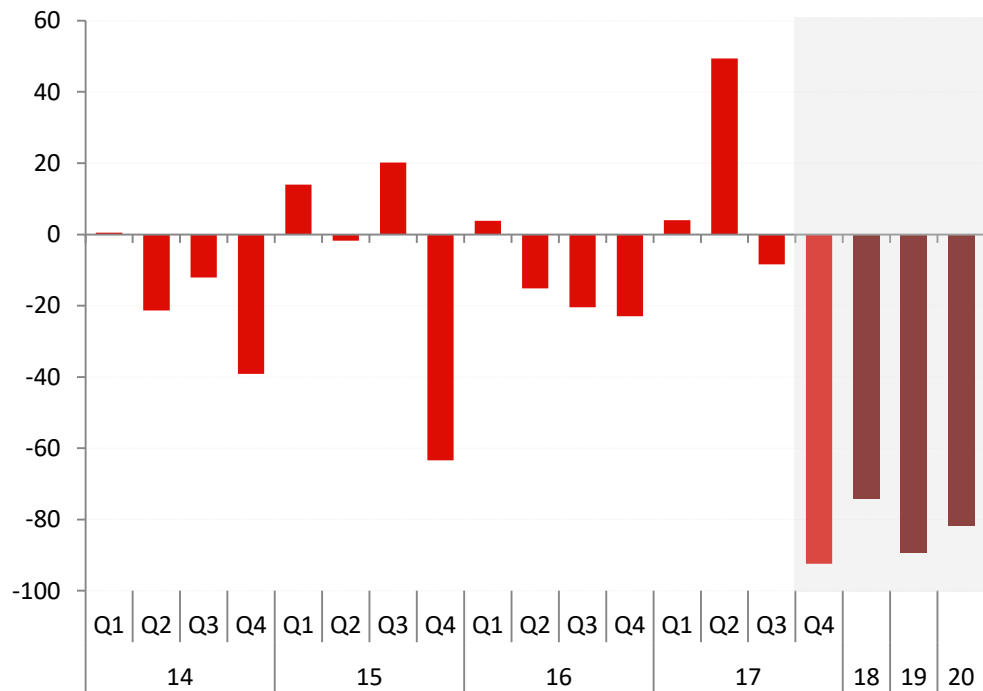
- Due to severe crisis and geopolitical risks, Ukraine's access to foreign financial markets has been virtually closed
- Ukraine relied on official financing to meet its foreign financing needs
- Since mid-2015, rating agencies started to raise Ukraine's sovereign ratings, acknowledging country's progress 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)



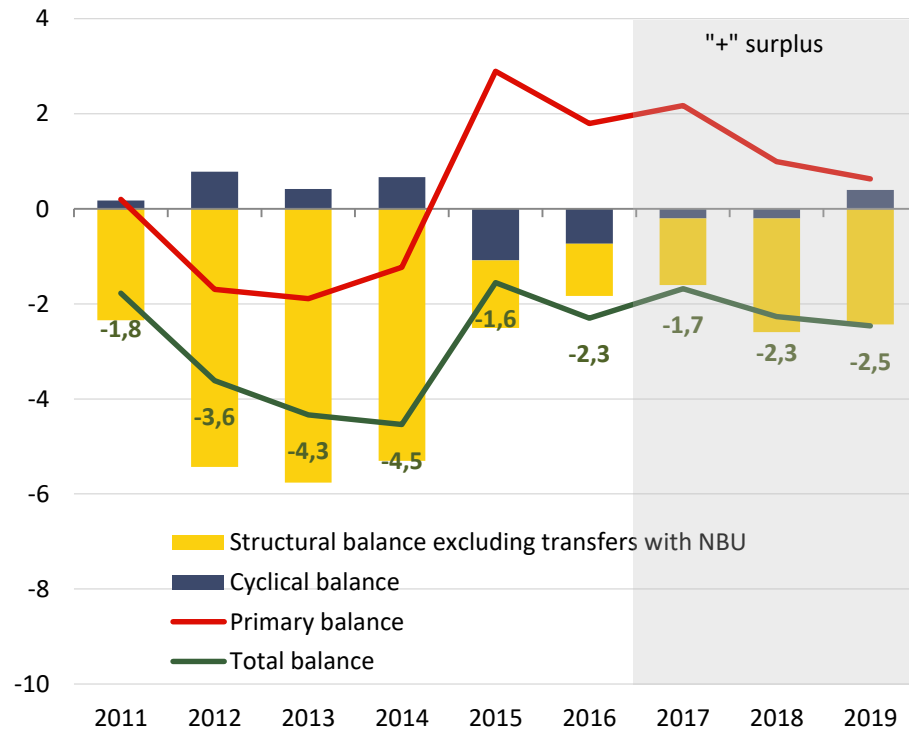
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Fiscal policy remains balanced with slight fiscal impulse

Consolidated Budget Balance, UAH bn



Consolidated Budget Balance, % GDP



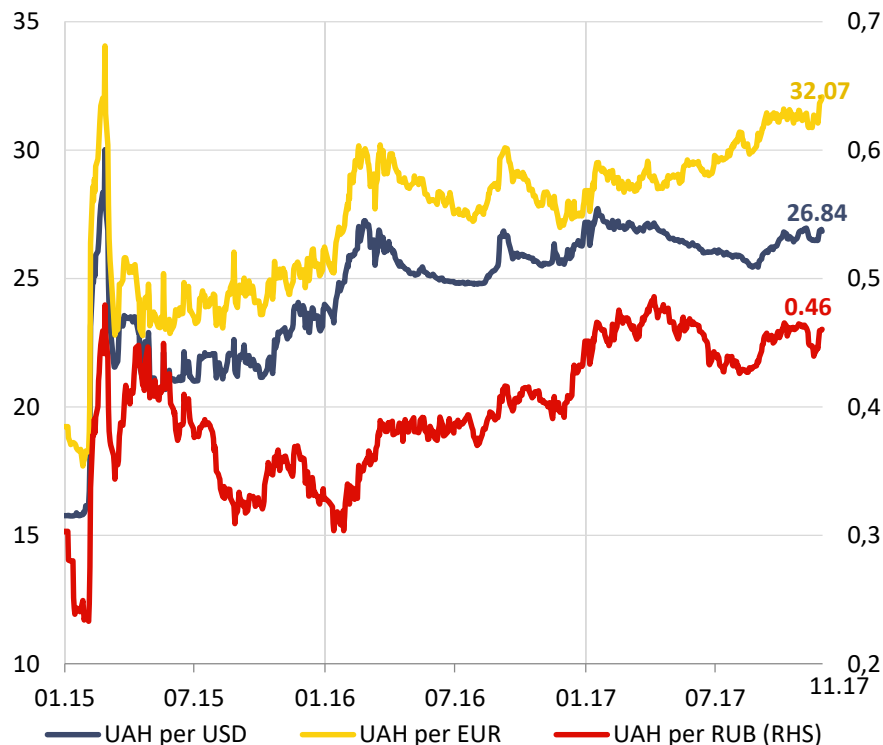
	2016	2017	2018	2019
Consolidated budget balance (UAH bn)	-54.8	-48.4	-74.1	-89.4



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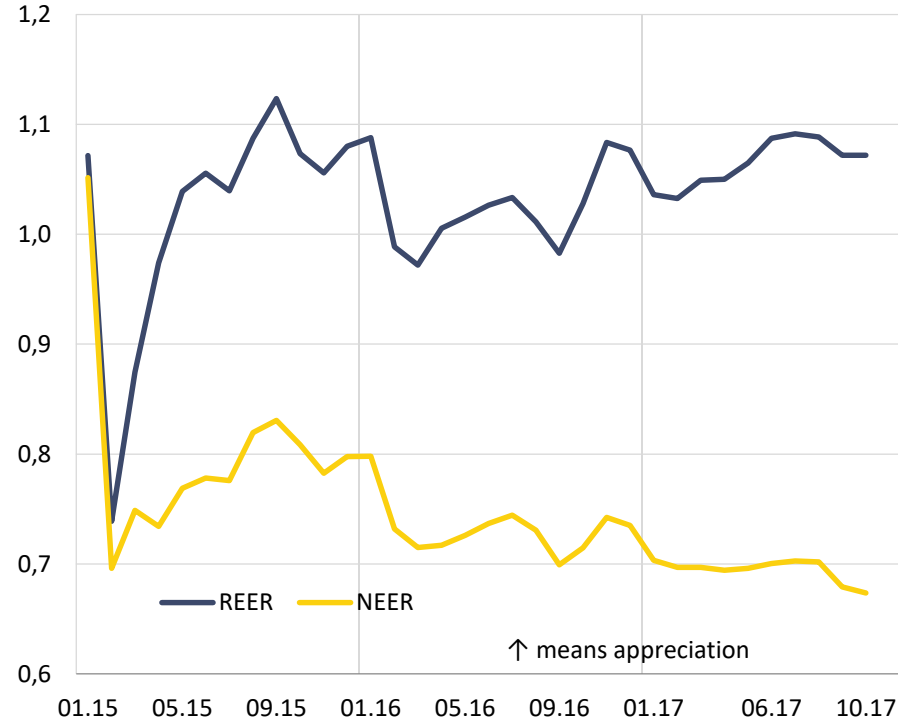
FX market has been broadly stable, with hryvnia exchange rate apparently close to the fundamentally justified levels

Hryvnia Exchange Rate, as of 28.11.2017



Source: NBU

Hryvnia REER and NEER Indices (based on interbank exchange rate), 12.2014=1



Source: IFS, staff estimates

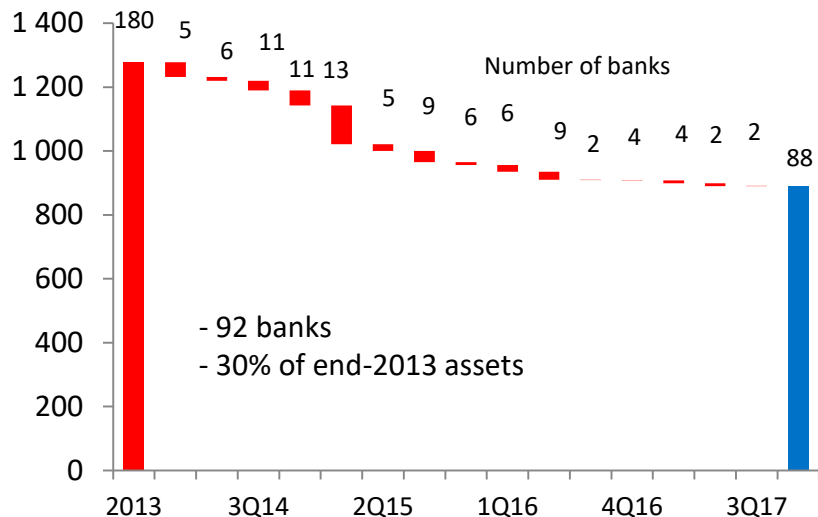
- The NBU is committed to flexible exchange rate policy, keeping exchange rate broadly in line with the fundamentals
- Meanwhile, it continues to play active role at FX market but interventions are performed for clear and specific tasks (e.g., smoothing ST exchange rate volatility and replenishing its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



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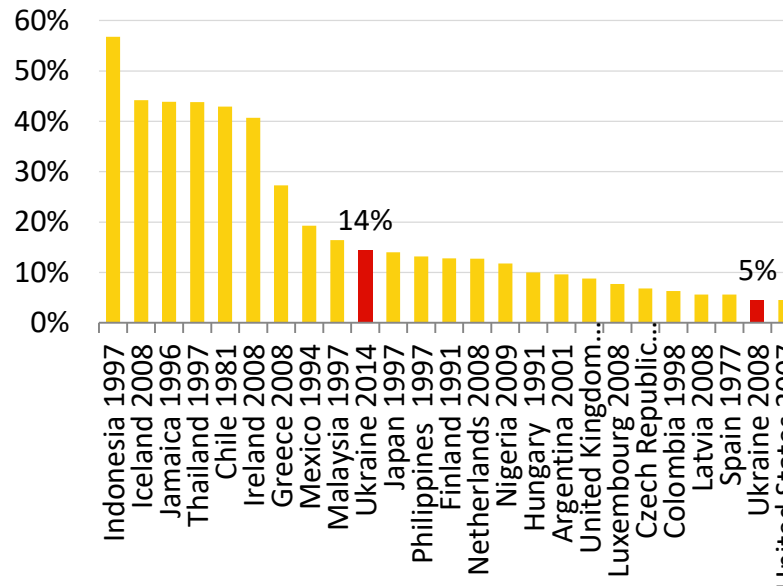
Banking sector clean-up was inevitable, costs of crisis are relatively moderate

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

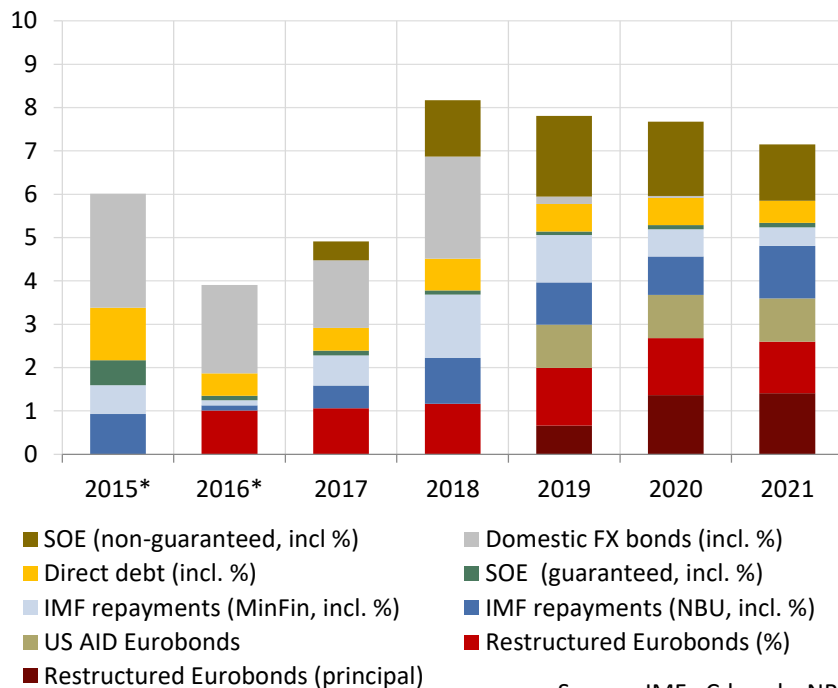
- Since early 2014, more than a half of all banks left the market
- In total, they accounted for 30% of banking sector assets as of early 2014
- The direct fiscal cost of resolving the banking crisis in Ukraine (14% of GDP) is moderate compared with crises in other countries
- The total cost of the crisis,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



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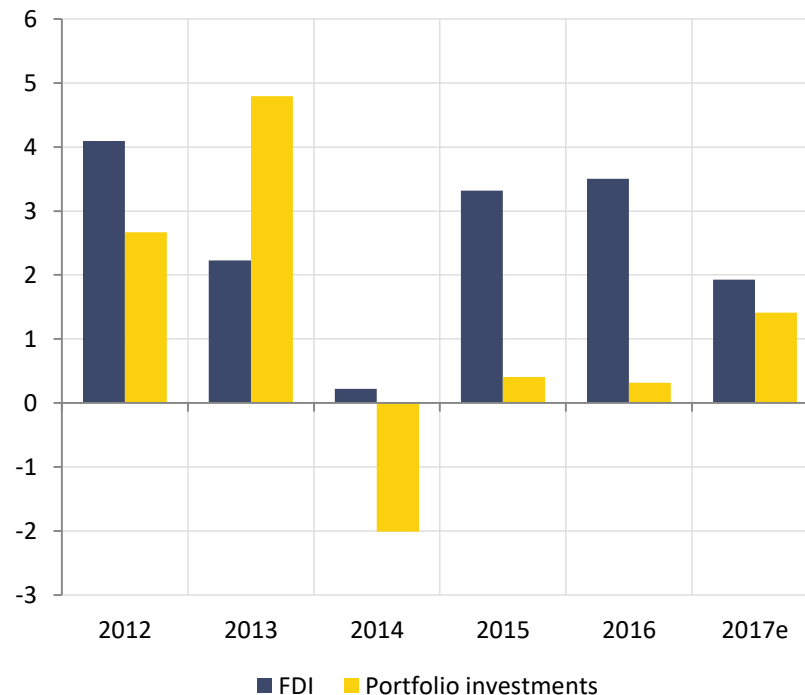
Challenges ahead: Ukraine's external sustainability is to be tested in 2019-20 due to a hike in public FX debt repayments amid subdued capital inflows

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



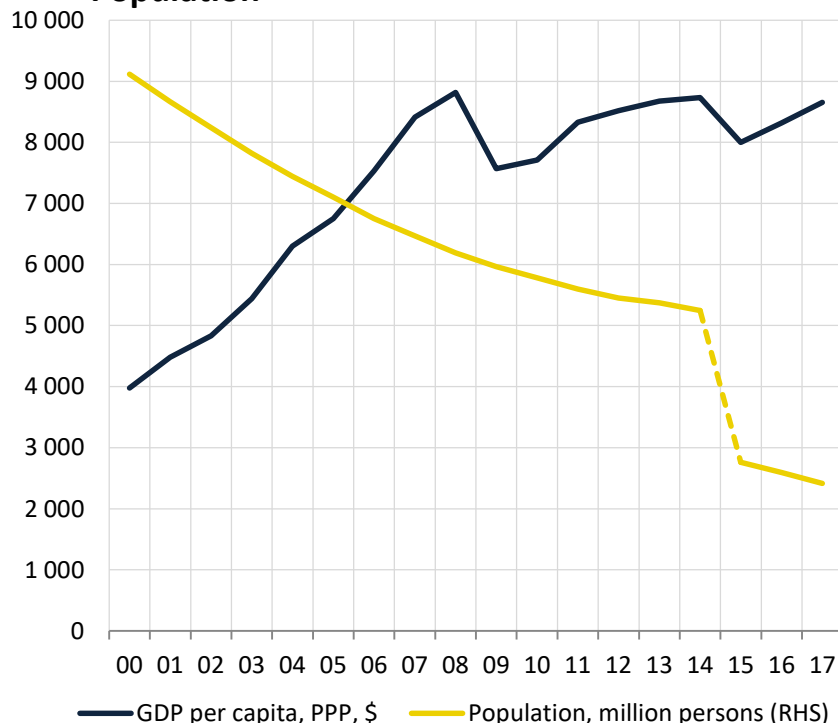
- Successful external debt operation carried out in 2015 and IFI official financing secured some time for Ukraine to gain macroeconomic stability and implement structural reforms
- However, since 2018 external debt repayments will increase notably, peaking in 2019-20
- These financing needs may be challenging 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 and accelerating outward labor migration

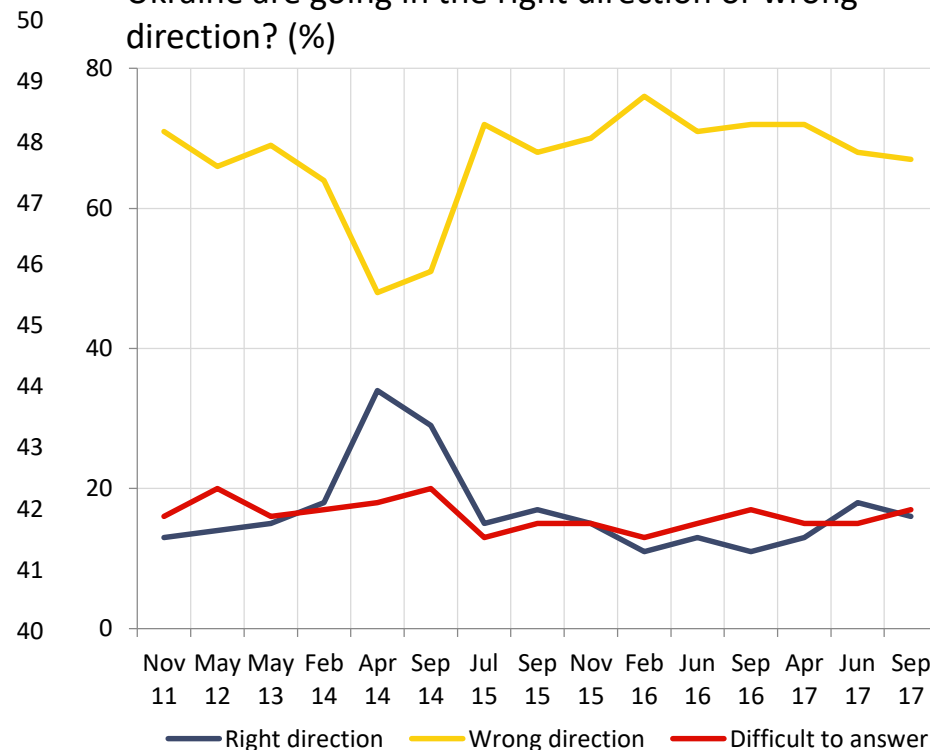
Ukraine's GDP per capita (PPP-based) and Population



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

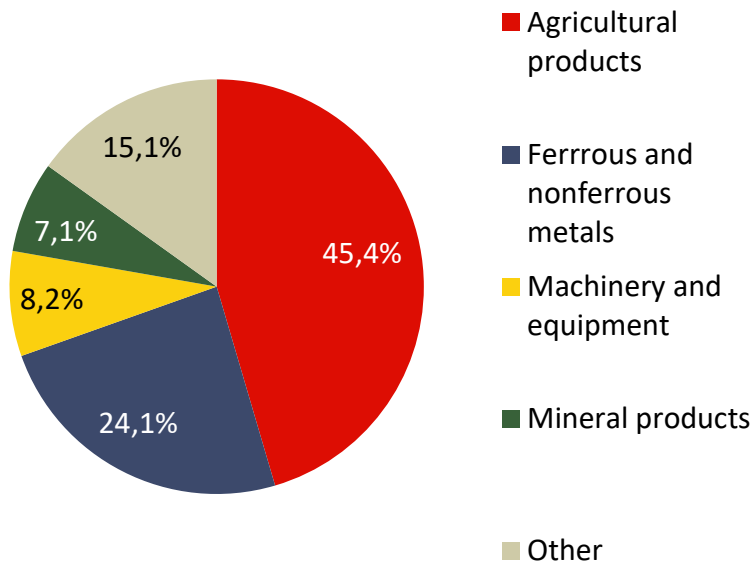
- Following a buoyant increase during 2000-2008, Ukraine's GDP per capita (PPP-based) stayed virtually flat even amid an ongoing decline in population
- Despite some structural reform progress, the share of those who believe the country is moving in the wrong direction remained high



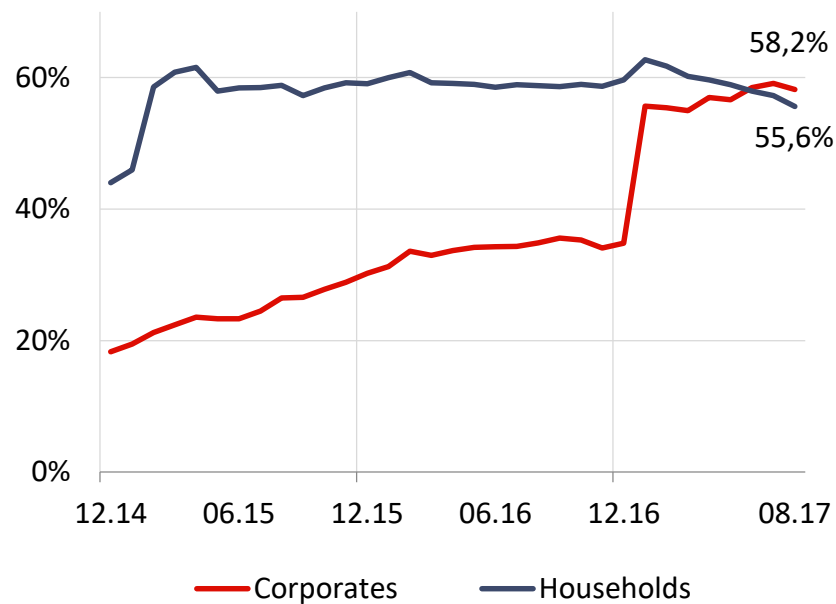
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Challenges ahead: Non-diversified economy and banking sector plagued by NPLs

Structure of export in 2016



Share of impaired loans in portfolios of reporting banks



Source: NBU

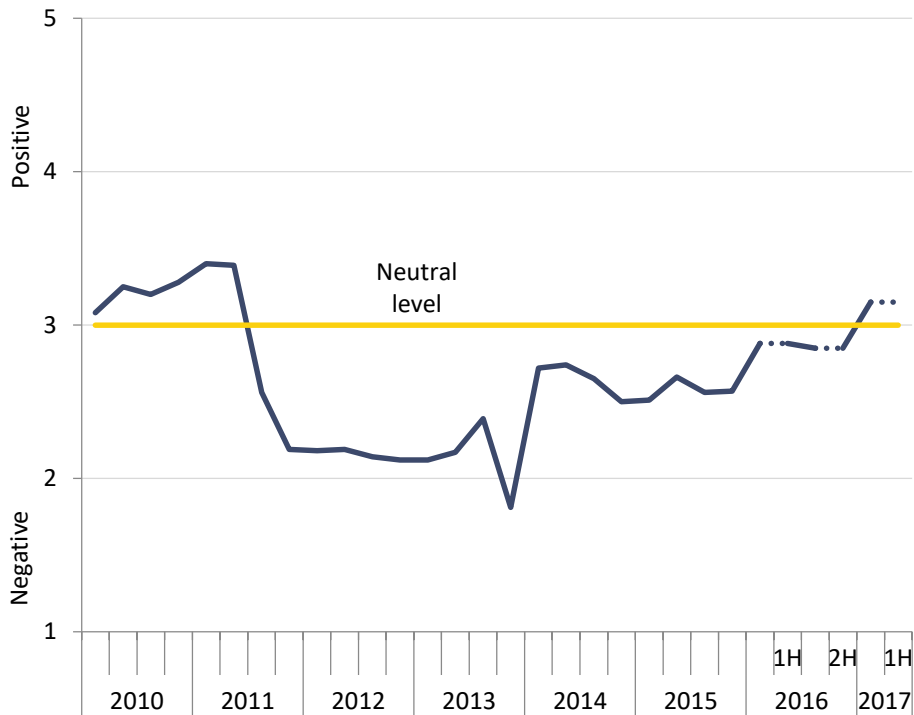
- High trade openness (as exports exceed 60% of GDP) is combined with the domination of agricultural and metallurgical industries in exports, highlighting Ukraine’s vulnerability to global commodity prices’ fluctuations
- The banking system emerged from the comprehensive clean-up with 57% NPL ratio mostly 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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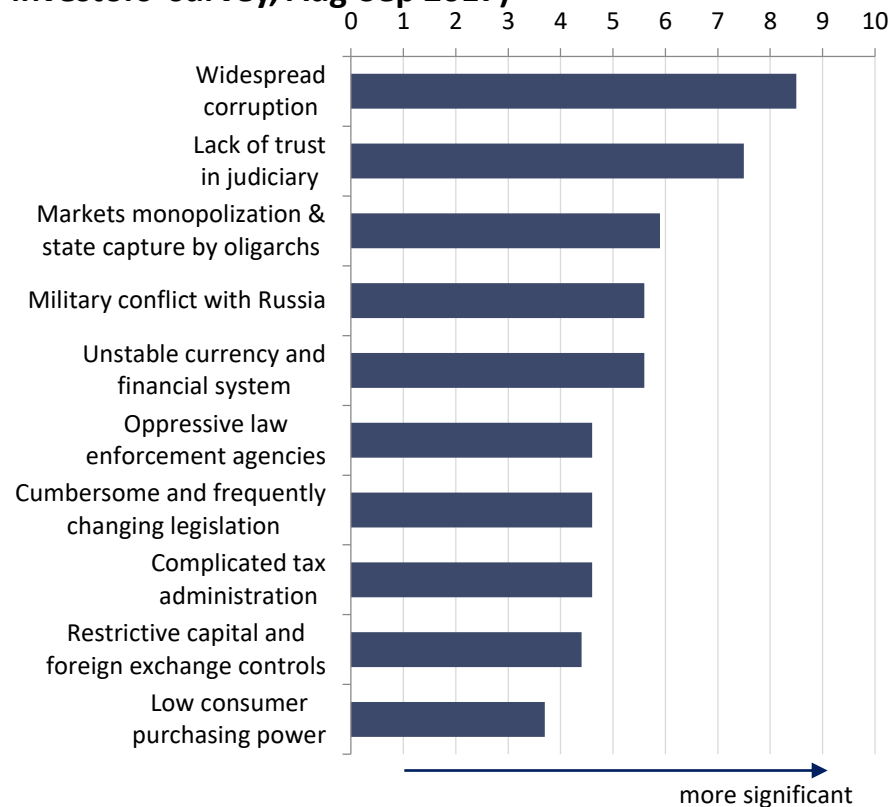
Challenges ahead: Despite recent improvement, business climate remains challenging for the foreign investors

EBA Investment Attractiveness Index



Source: EBA

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



Sources: EBA, Dragon Capital, CES



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

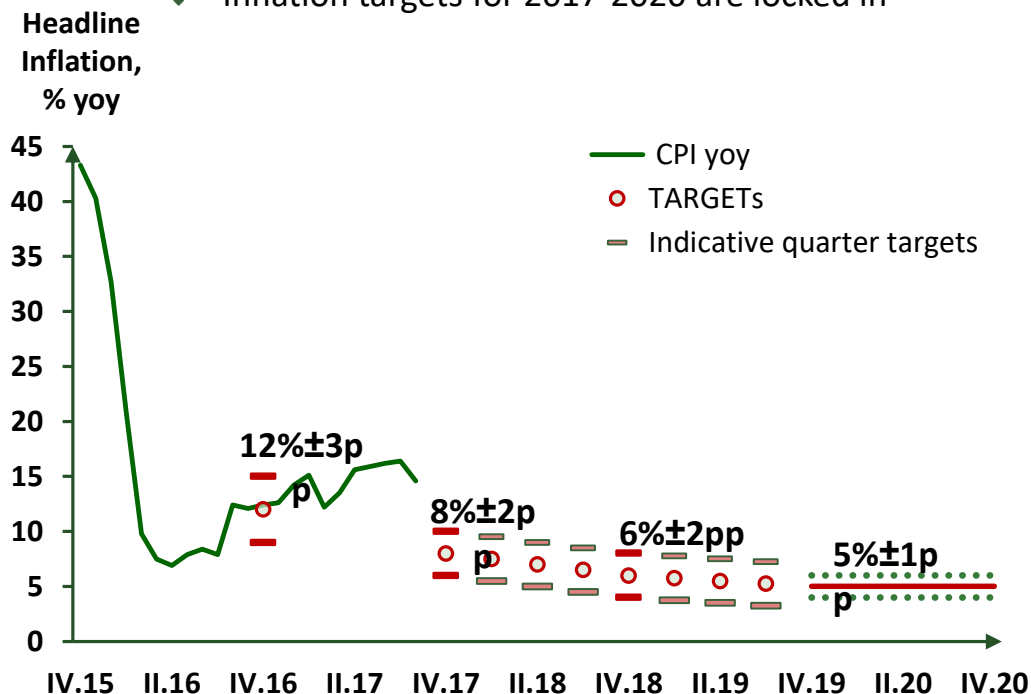
regular detailed explanations of the NBU actions and their reasoning

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





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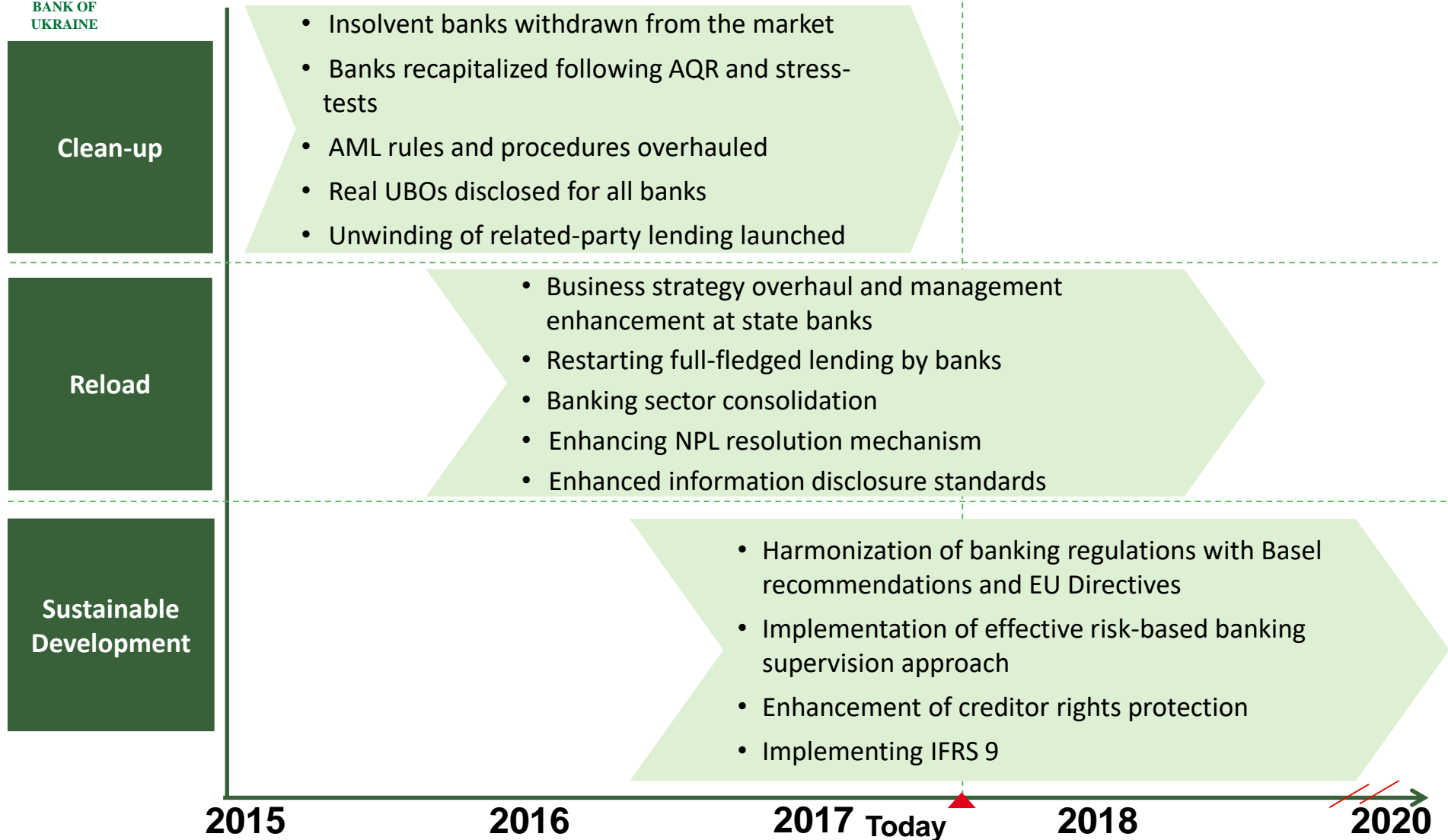
The NBU is moving towards the new model of currency regulation

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



NBU policy under different scenarios

“In the event of realization of the above mentioned inflation risks, **the NBU may further raise the key policy rate** to offset their effects and return inflation to its target path. However, in case of deceleration of inflation according to the forecast, further cooperation with the IMF, and pursuing prudent fiscal policy, the NBU may **return to the easing cycle of monetary policy at the end of 2018**”

Scenario	Results (2018-2019)	NBU policy
Baseline <ul style="list-style-type: none">- status-quo in the east- structural reforms- IMF program	GDP +3.2% +3.5% CPI 7.3% 5.0%	Admin. restrictions ↓ Interest rate =↓
Optimistic <ul style="list-style-type: none">- lower global energy prices (oil, gas, coal)- higher export prices- foreign capital inflows	GDP ↑ UAH/USD ↓ CPI ↓	Admin. restrictions ↓↓ Interest rate ↓ (earlier)
Pessimistic <ul style="list-style-type: none">- further delays in IMF tranches- expansionary fiscal policy (elections)- negative terms of trade shocks	GDP ↓ UAH/USD ↑ CPI ↑	Admin. restrictions = Interest rate ↑



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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!!**