National Bank of Ukraine

Macroeconomic and Policy Outlook

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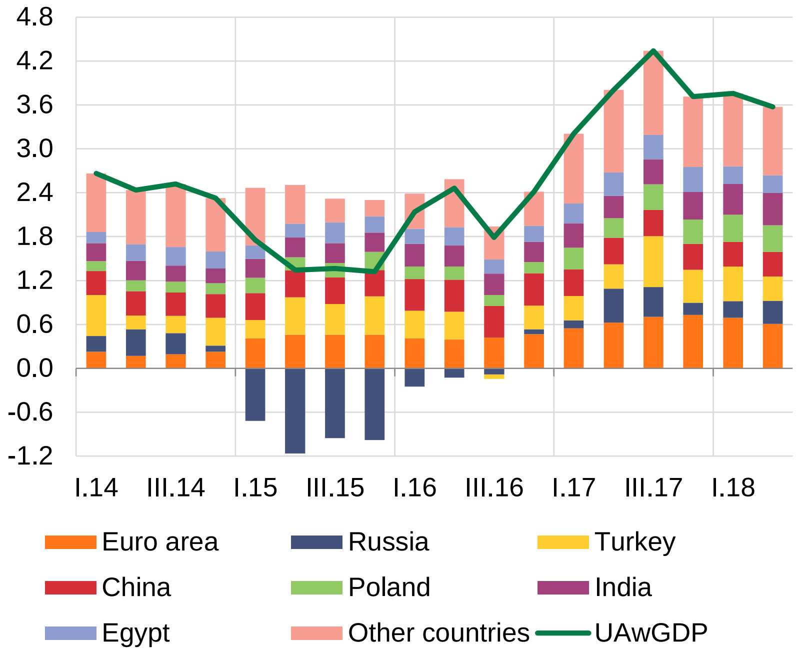
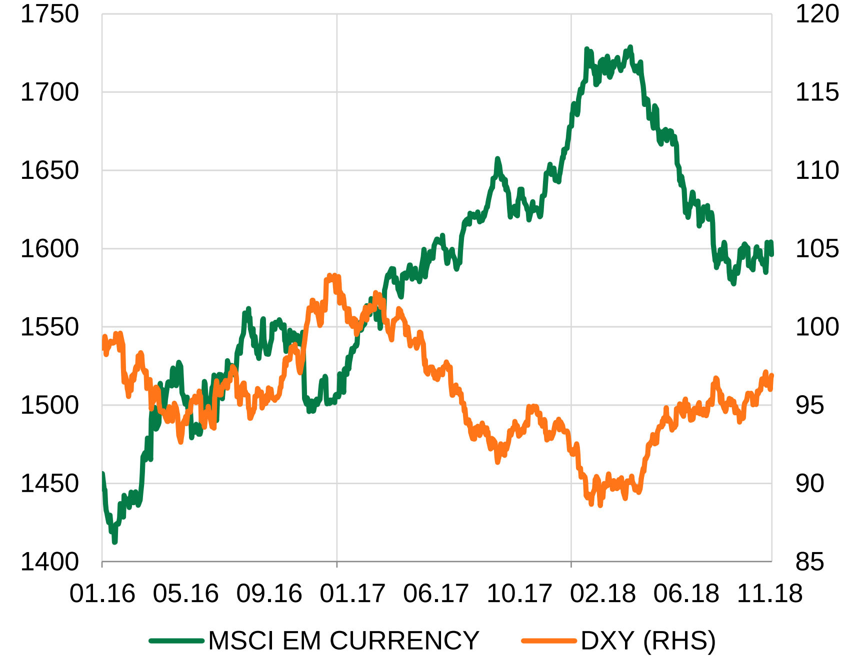
While terms of trade remain favorable, the external environment is more challenging amid financial turbulences and rising trade tensions

Contributions of Ukraine's MTP[1] Countries to the Annual Change in UAwGDP[2], %



MSCI EM Currency $ and DXY, as of 09.11.2018

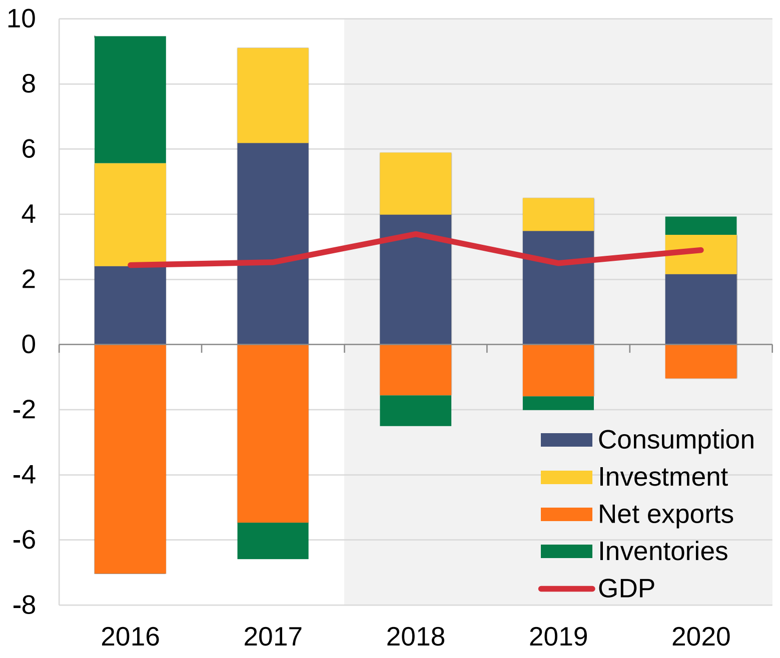


[1]MTP – main trading partners; [2]UAwGDP - the weighted average of annual economic growth rates of Ukraine's MTPs.
Source: Thomson Reuters, NBU staff estimates.

- Tightening global financial conditions due to rising rates in advanced economies take their toll on EMs, causing financial turbulences in selected countries
- Trade tensions between the United States and other countries are another source of uncertainty
- Foreign investors flee from EMs causes their currencies to weaken against the US dollar

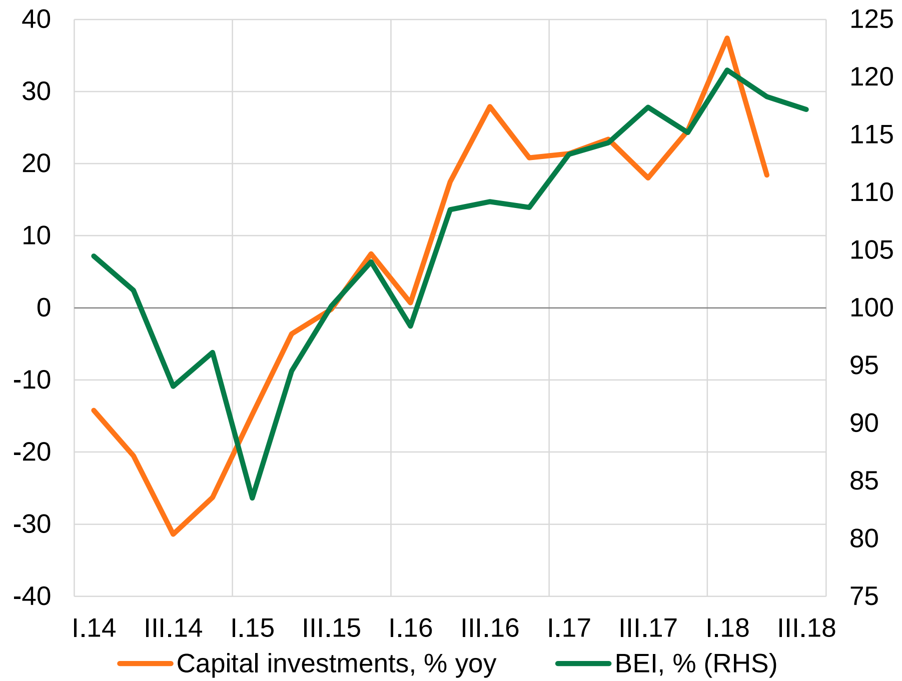
The Ukrainian economy has been recovering at solid pace, supported by improving terms of trade and robust domestic demand

Contributions to Real GDP Growth, pp



Source: SSSU; NBU estimates and forecast (October 2018 IR).

Capital Investments and Business Expectations Index

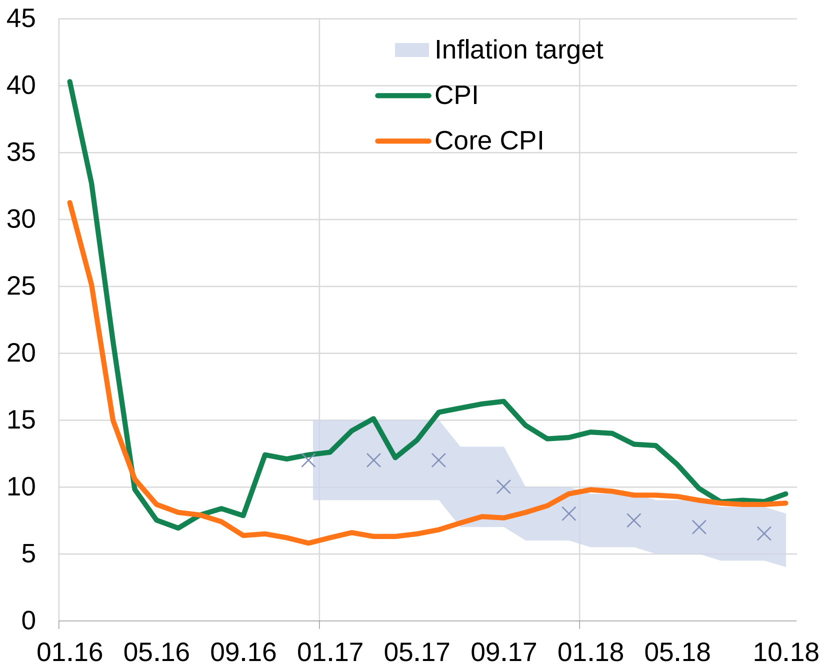


Source: SSSU; NBU staff estimates based on surveys of enterprises.

- GDP grew by an estimated 3.5% yoy in H1 2018, driven by strong consumption growth and investment activity
- Despite some deterioration of external conditions in recent months, strong inflow of remittances, high harvest, rising wages and pension benefits support real GDP growth in 2018
- After speeding up in 2018, economic growth will slightly decelerate due to a slowdown in the global economy, worsened price conditions in global commodity markets, tighter fiscal policy given large public debt repayments, as well as tight monetary policy required to bring inflation back to its target

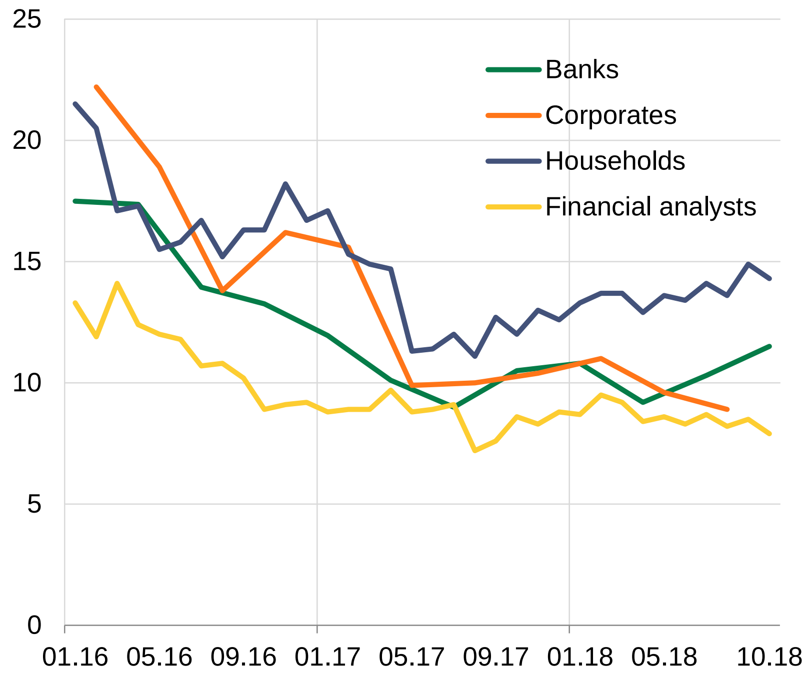
Inflation has slowed down to one-digit levels thanks to abating food price pressures and tight monetary policy

Headline and Core Inflation, % yoy



Source: SSSU, NBU.

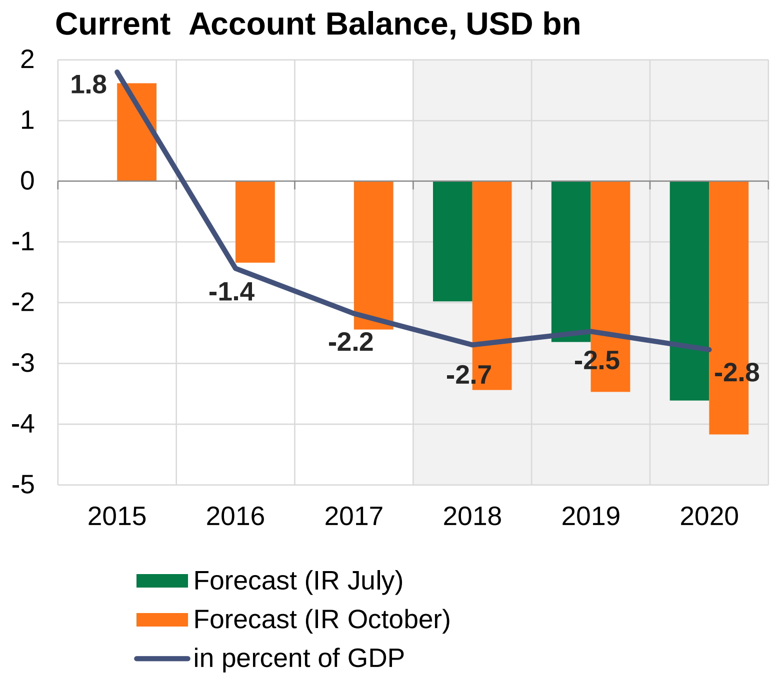
Inflation Expectations for the Next 12 Months, %



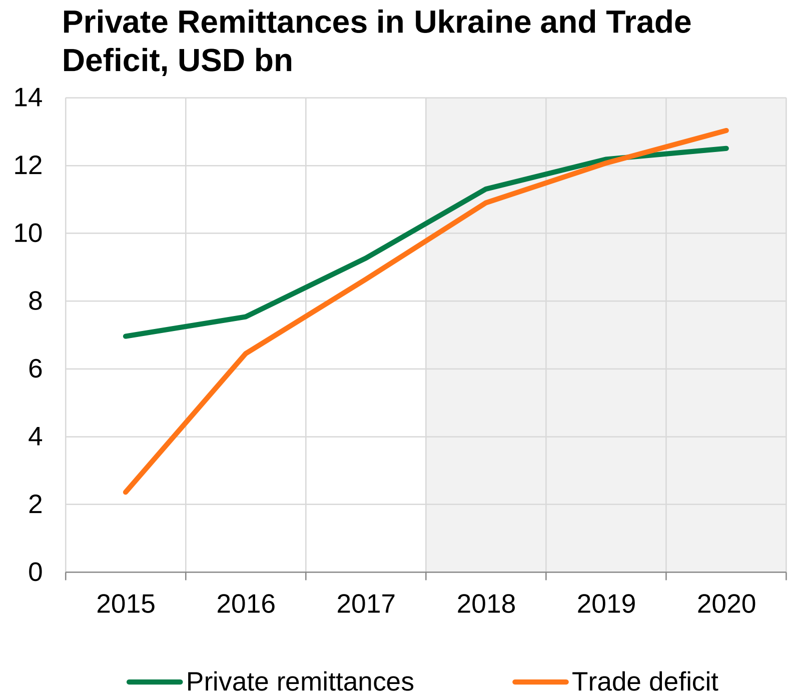
Source: NBU, GfK Ukraine surveys.

- Inflation has been above the target since mid-2017 due to strong domestic demand and rising production costs, including due to labor costs
- On the other hand, tight monetary stance, favorable FX market developments, and more ample supply of food products partially offset the impact of demand-pull and cost-push factors
- Inflation expectations for the next 12 months remained elevated, exceeding the NBU inflation targets

The CA deficit has been gradually widening, but is expected to stay in the safe zone



Source: NBU.

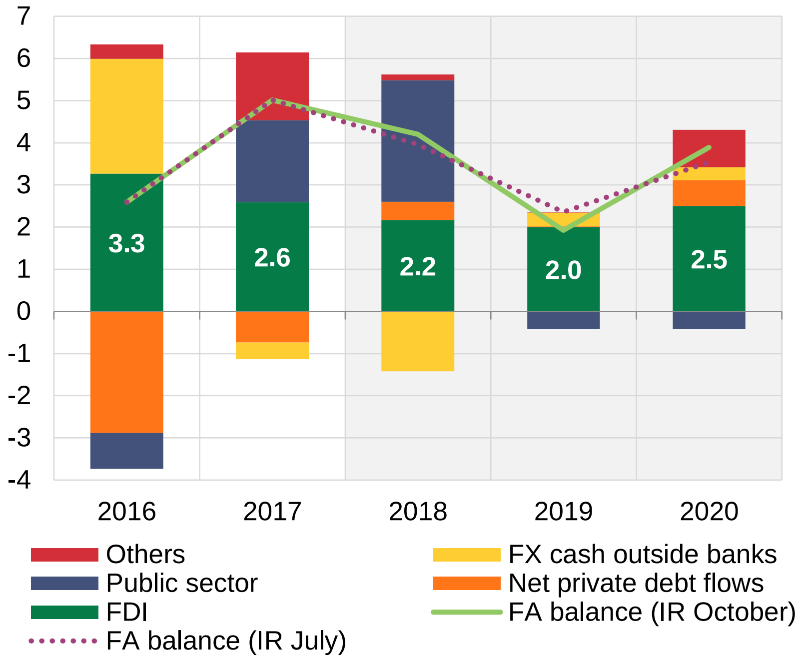


Source: NBU.

- Due to raising oil and gas prices, weakening global trade and its worsened outlook due to intensification of trade tensions, and solid growth in domestic demand, Ukraine's current account deficit widens in 2018 but will remain below the 3% of GDP threshold on forecast horizon
- A gradual widening in the trade deficit is partially offset by strong inflow of remittances

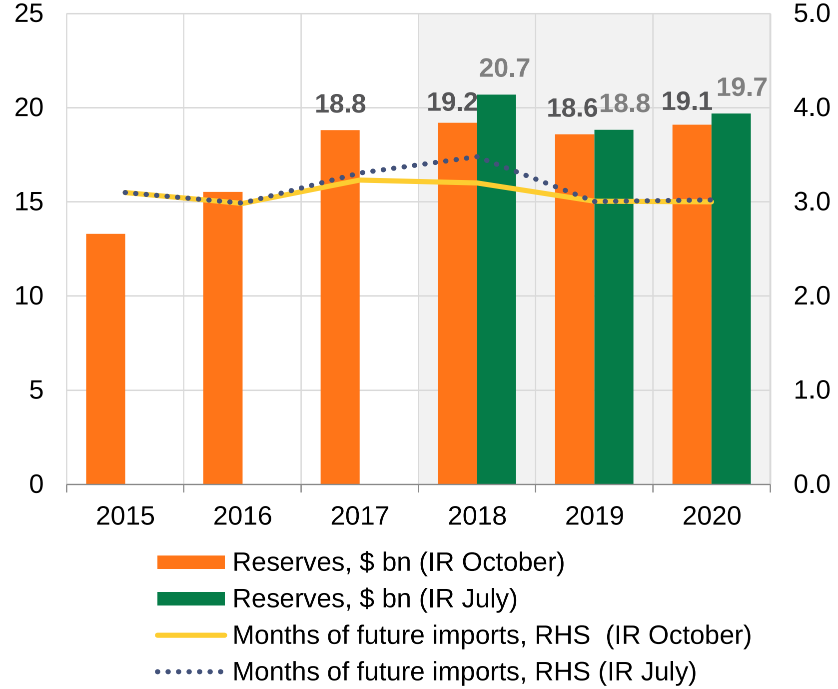
Large public sector repayments amid moderate increase in private capital inflows will put a drag on reserves

Financial Account: Net Inflows, USD bn



Source: NBU.

International Reserves, USD bn

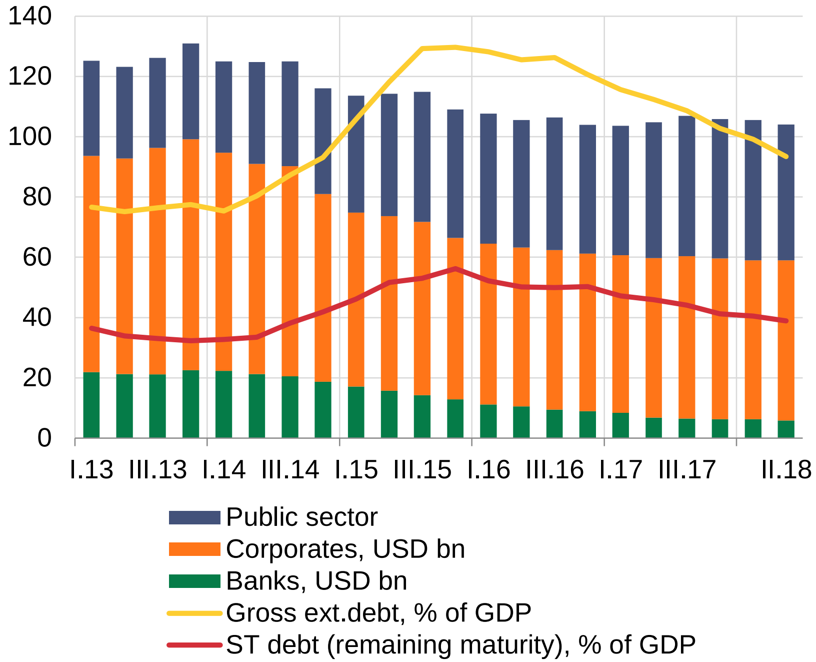


Source: NBU.

- In 2018-2020, FDI and debt capital inflows to the private sector are forecast to increase. However, due to peak repayments of external public debt in 2019-20, the overall balance of payments is expected to be in deficit, limiting the building up of reserves

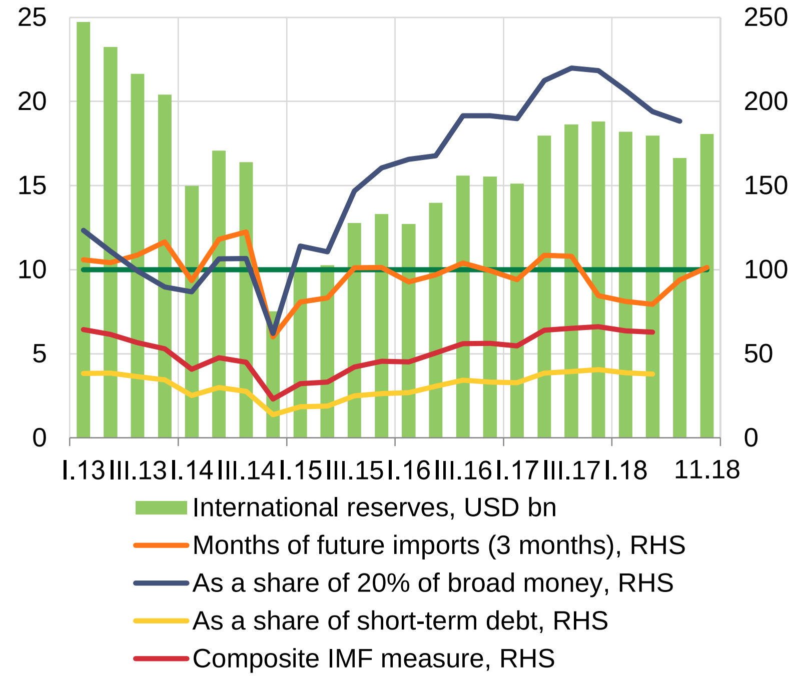
A gradual recovery of the economy and the relative hryvnia stability has led to an improvement in external sustainability indicators

External Debt



Source: NBU.

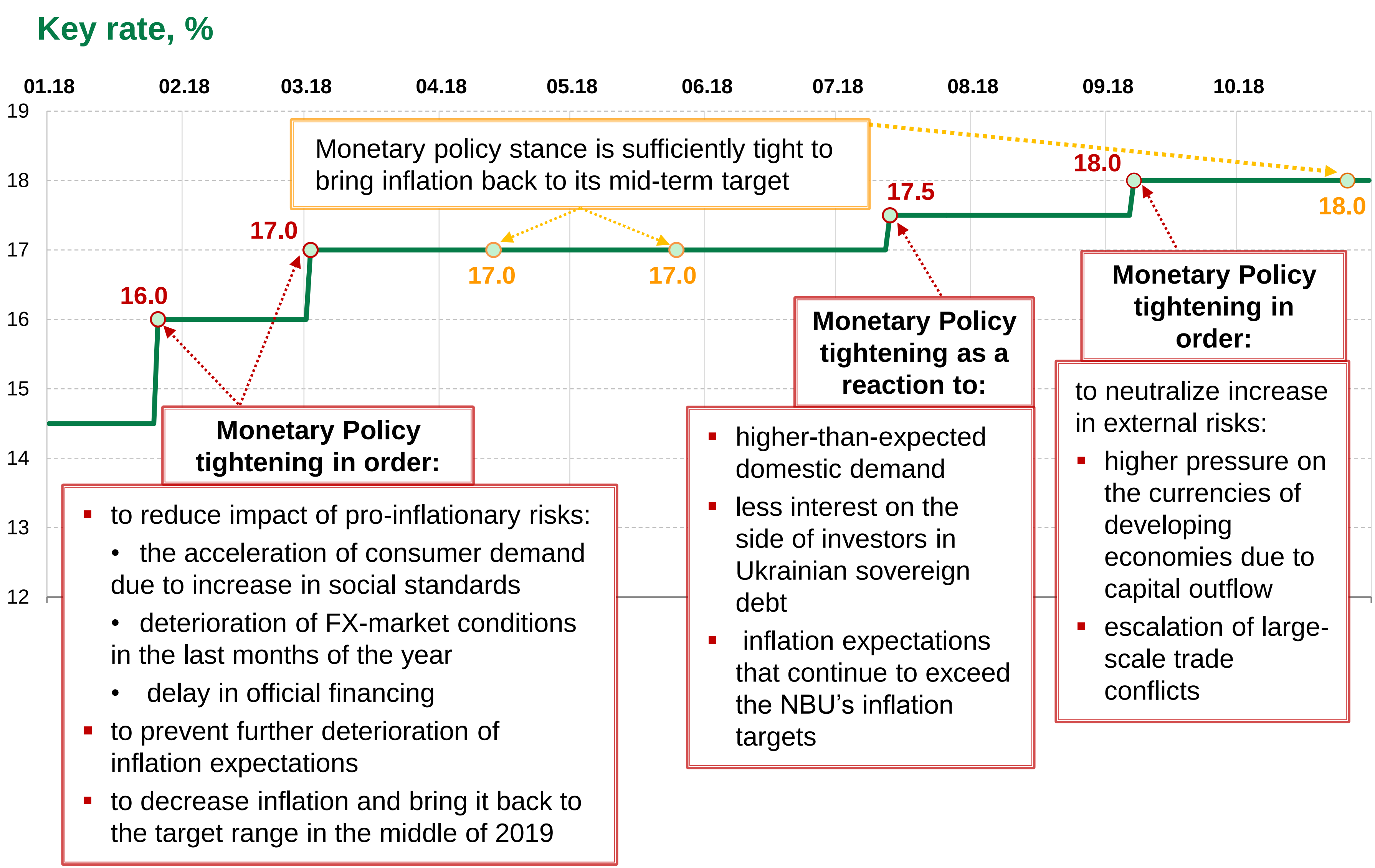
International Reserves and their Adequacy Criteria, %



Source: NBU.

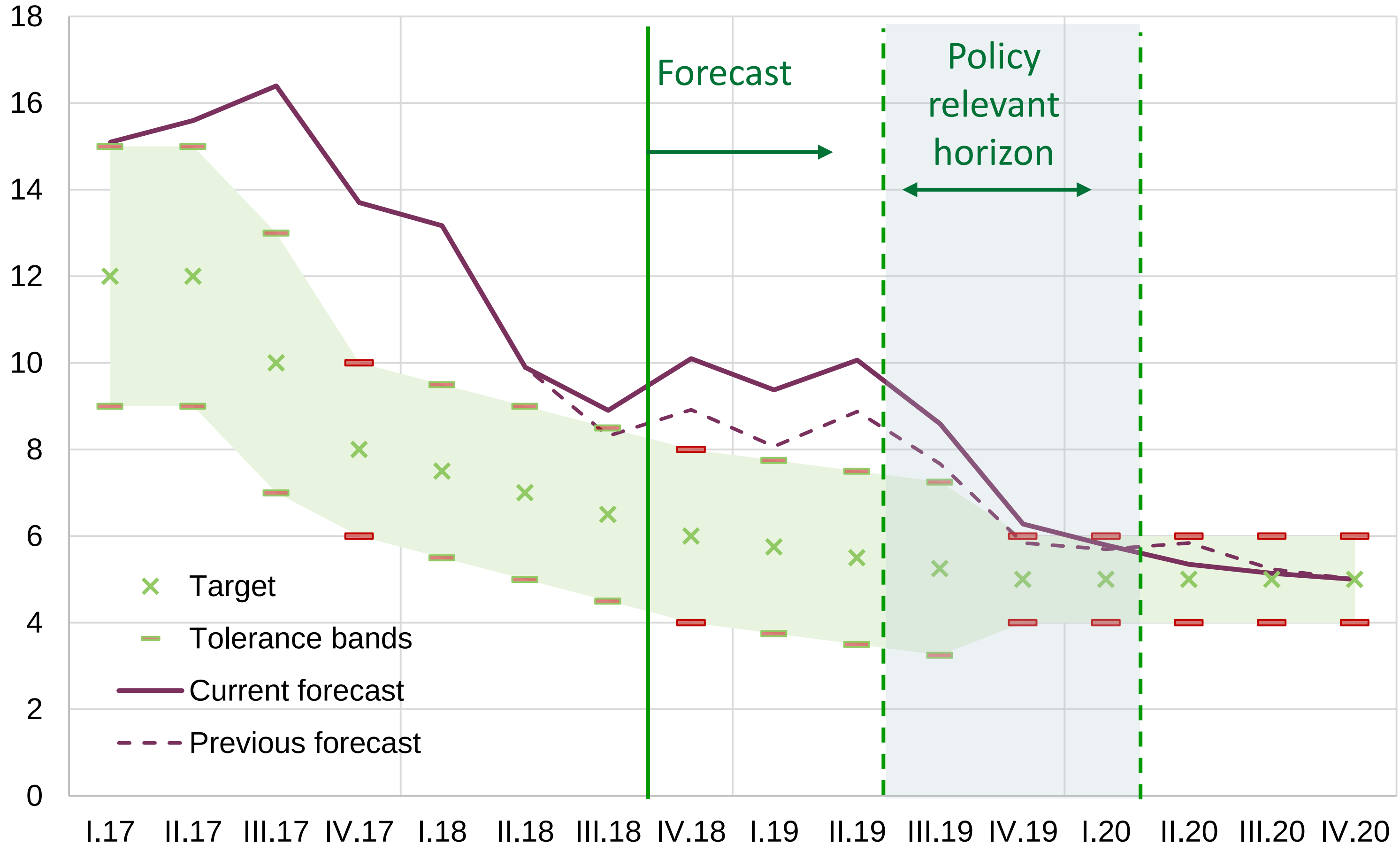
- The gross external debt has been gradually declining, despite larger external debt of the public sector. This was achieved on the back of decreasing private sector debt
- In 9M 2018, there was a decrease in international reserves, mainly due to repayments of IMF loans. As of 5 November 2018, due to the funds received from the issue of sovereign Eurobonds, the international reserves of Ukraine increased to USD 18.1 bn
- Ukraine remains extremely vulnerable to external shocks, in particular due to the significant debt burden on the public sector in the medium term

The NBU has left its key rate unchanged in October as monetary stance remains tight to bring inflation to its medium-term target



Current and future monetary stance is sufficiently tight to ensure disinflation to 5% in 2020

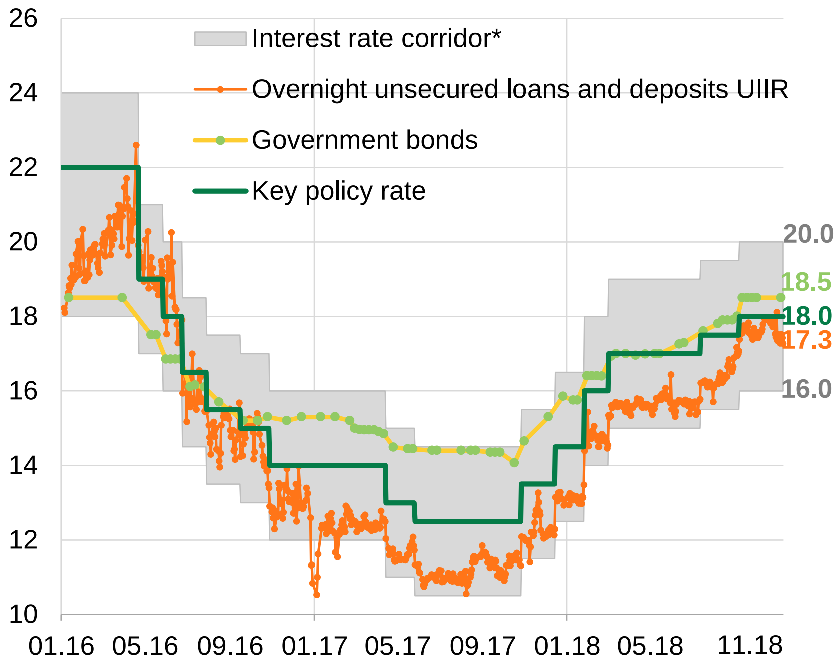
Headline CPI, % yoy



- The increase in consumer demand, robust wage growth, and the recent jump of crude oil prices will continue to impact consumer price inflation next year (6.3%)

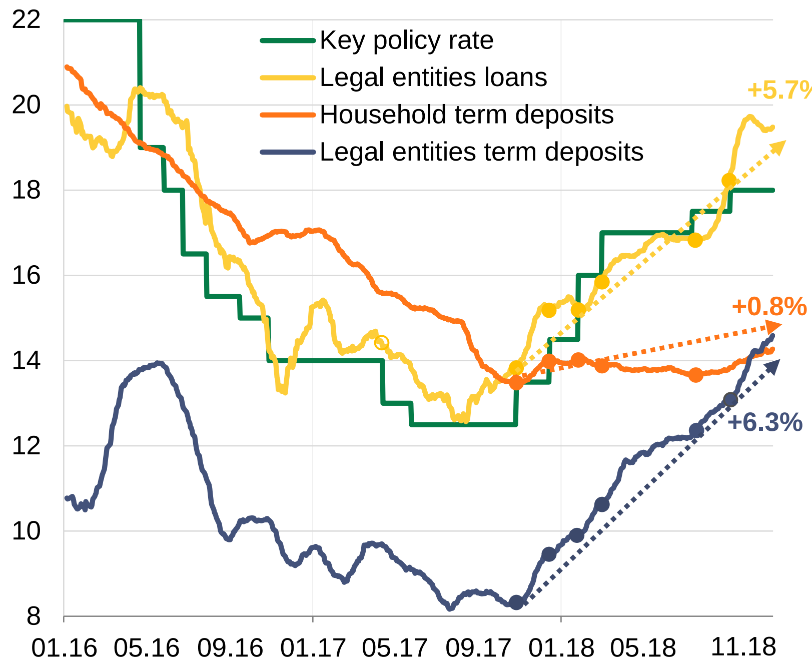
Key policy rate hikes swiftly transmitted into market interest rates

NBU Policy Rates, UIIR and 1-year Bond Yield on Primary Market, %pa



* Upper corridor bound – interest rate on overnight loans of the NBU, lower – overnight CDs of the NBU.
Source: NBU.

NBU Key Policy Rate and Selected Hryvnia Rates (monthly moving average), % pa

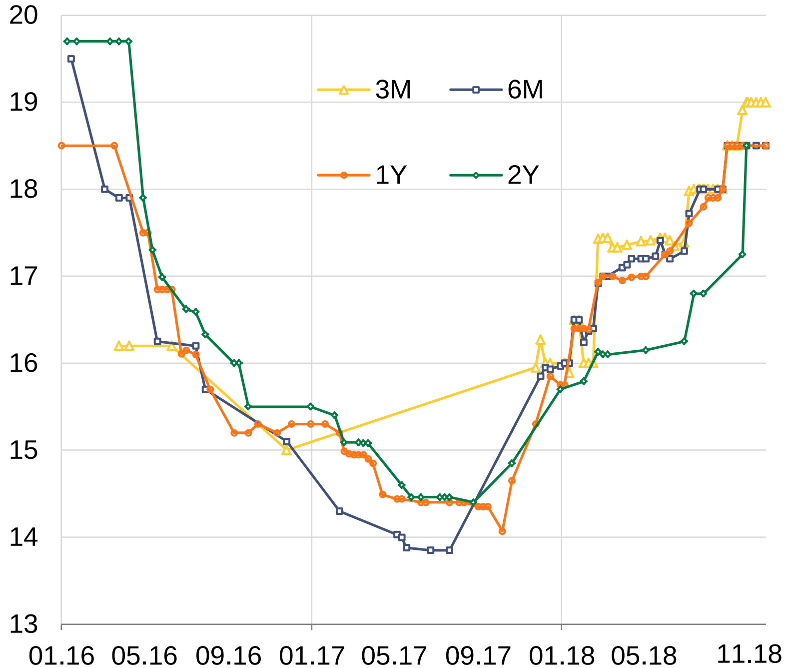


Note: arrows indicate an increase in rate after 26 October 2017 (the beginning of the NBU policy rate hike cycle).
Source: NBU.

- Market rates on hryvnia resources follow NBU key rate changes relatively closely, although hryvnia deposit and lending rates for households showed somewhat weaker response
- The NBU expects the further pass-through of the past key policy rate hikes to interest rates on hryvnia-denominated household deposits; these effects will be reinforced by the shrinking liquidity surplus in the banking system. In turn, the growth in deposit rates will provide incentives for households to increase their propensity to save

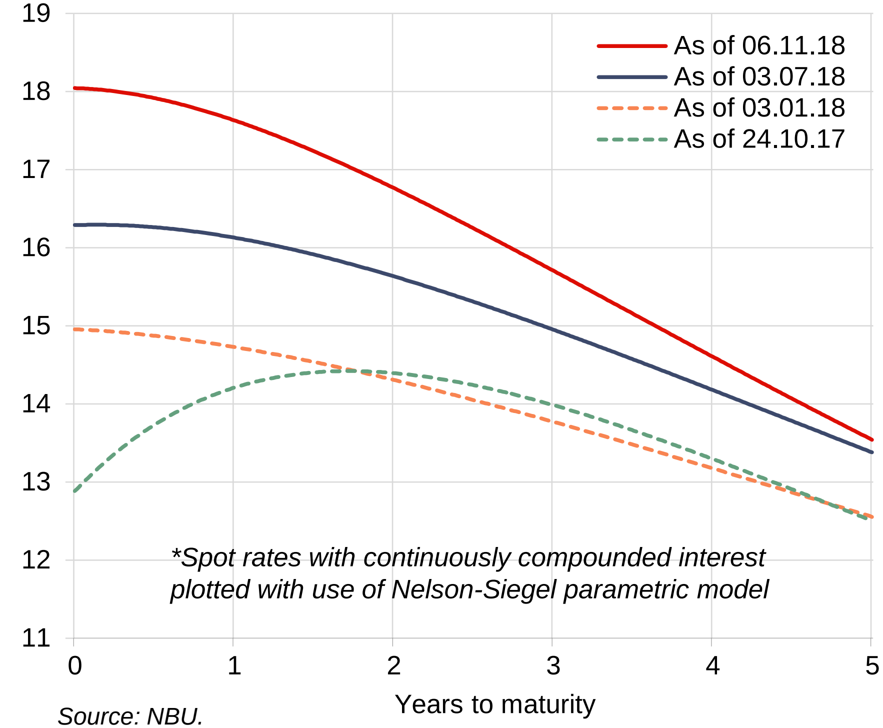
The NBU policy rate is now a key factor determining the short-term end of the yield curve for government bonds

Term Structure of Hryvnia Yields on Primary Market (as of 06.11.2018), % pa



Source: NBU.

Zero-Coupon Yield Curve for Hryvnia Bonds*, % pa

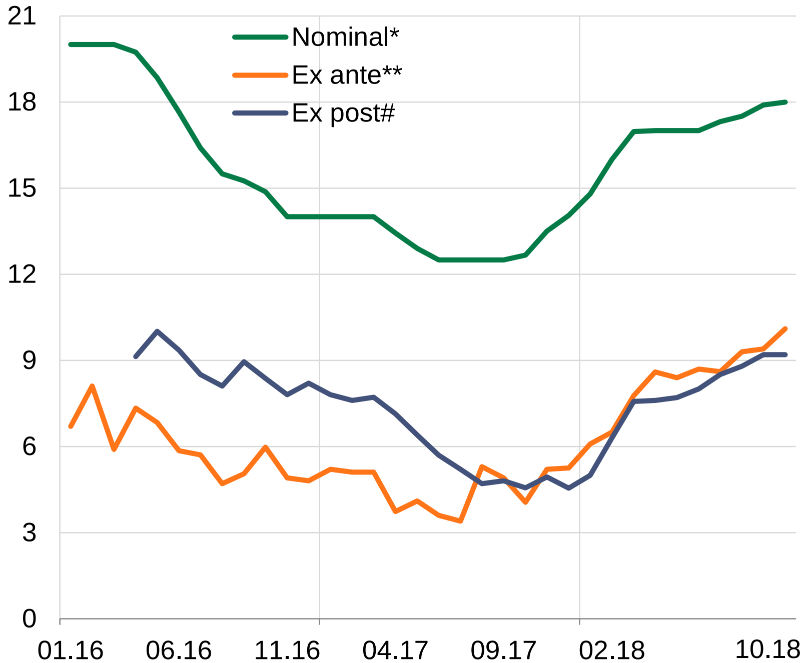


Source: NBU.

- Since mid-2017, yields on hryvnia government bonds grew across all maturities. Partly this increase reflected higher government activity in domestic borrowing market
- The short end of the yield curve for government bonds is the most sensitive to the changes in NBU policy rates

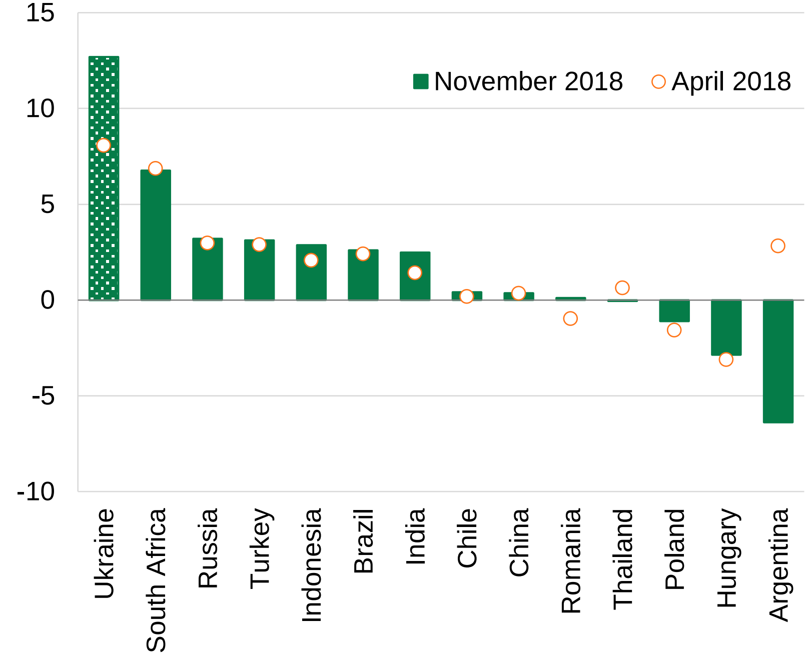
Real interest rates are high compared with other EM countries

Nominal and Real NBU Key Policy Rate*, % pa



*Nominal rate is NBU's average rate on 14-days CDs.
Real ex ante is nominal rate deflated by inflation expectations of fin. analysts.
Real ex post is nominal rate deflated by current core CPI.
Source: NBU.

Real Interest Rates* on EM bonds, % pa

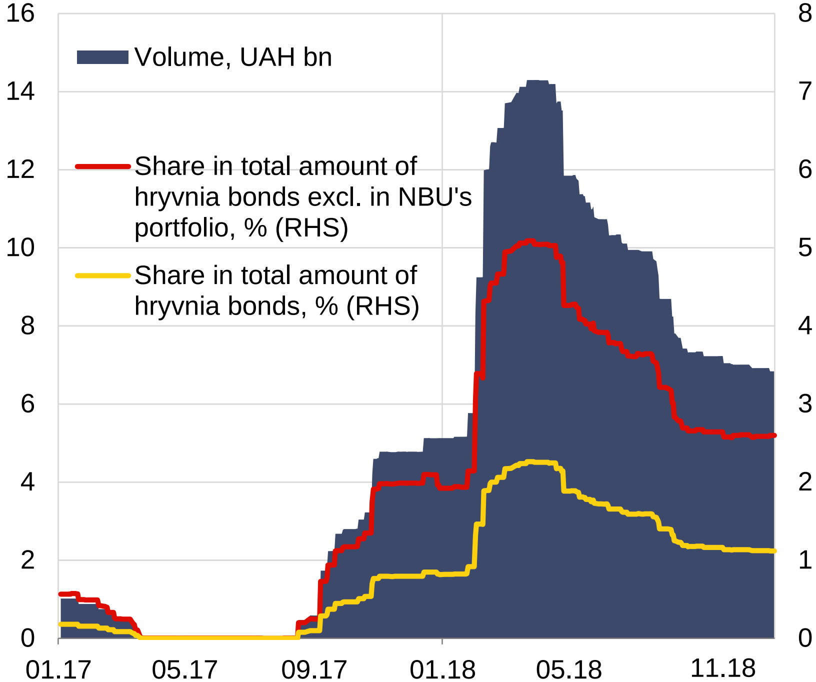


* Real interest rate is calculated as a difference of average monthly 1-year bond yield on the primary market and inflation forecasts (as of end-2019 for October, as of end-2018 for April). For Ukraine – based on NBU`s estimates.
Source: DekaBank, Consensus Economics, Thomson Reuters, NBU`s estimates.

- Monetary policy stance in 2017-2018 remained rather tight. The real key policy rate ranged from 5% to 9% in 2018 – far above the neutral level
- Since the beginning of 2018, Ukraine's real interest rates on government bonds were among the highest across EM countries. Due to financial turbulences, rates rose significantly in Turkey and Argentina

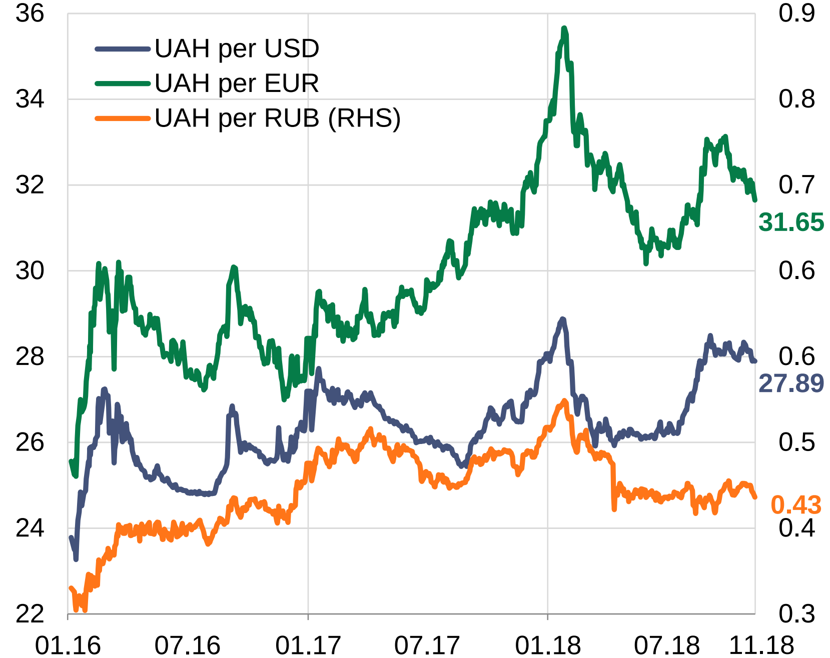
High interest rates helped moderate the foreign capital outflow from Ukraine amid worsening financial conditions for EMs globally

Hryvnia Domestic Government Bonds held by Non-Residents



Source: NBU.

Official Hryvnia Exchange Rate, as of 12.11.2018

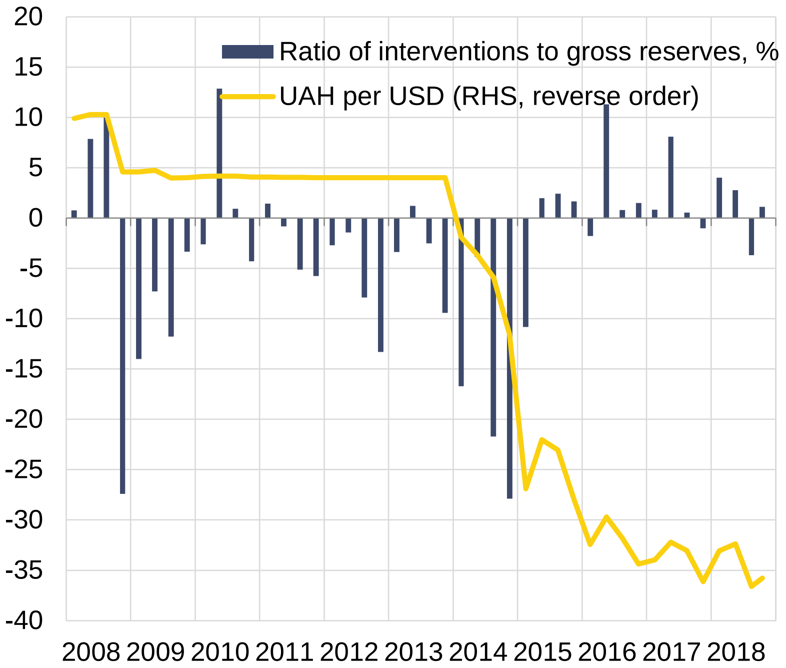


Source: NBU.

- At the beginning of 2018, non-residents' interest to Ukraine's domestic bonds has increased, contributing to a turnaround in Ukraine's FX market
- The outflow of foreign capital was moderate, and was mainly associated with the global capital outflows from emerging markets

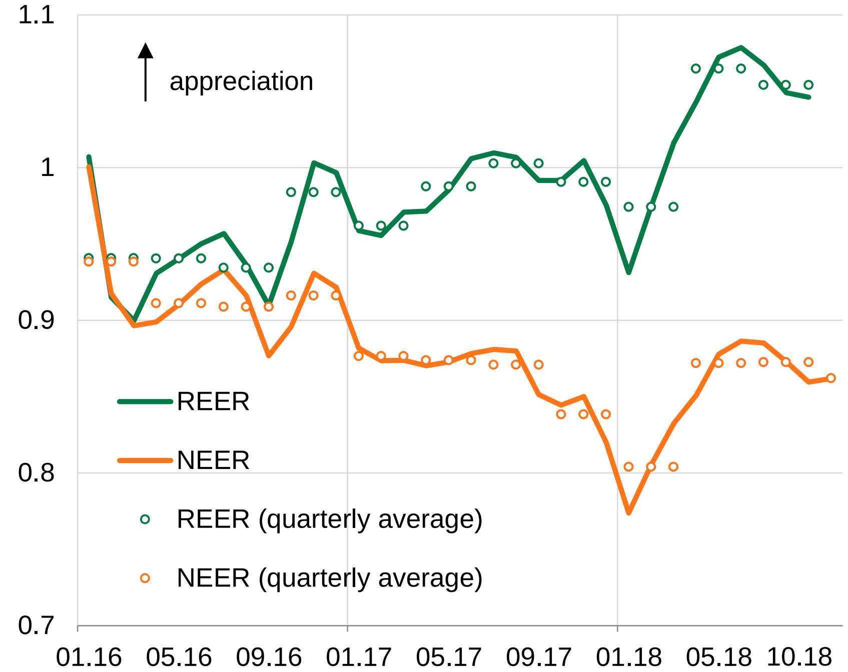
The NBU remains committed to a floating exchange rate policy. However, it continues to play an active role in the FX market

Reaction to FX Market Pressures: Reserves vs Exchange Rate, as of 12.11.2018



Source: NBU calculations.

Hryvnia REER and NEER Indices, 12.2015=1



Preliminary data.
Source: IFS, NBU staff estimates.

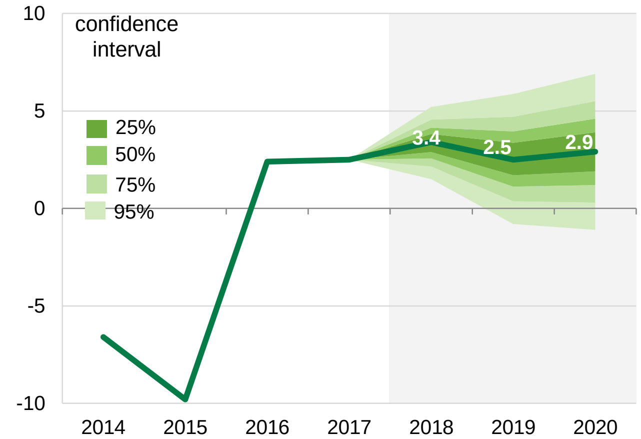
- Interventions are performed to achieve clear and specific tasks (e.g., smoothing exchange rate volatility and replenishing international reserves)
- Lower FX volatility has helped maintain macroeconomic and financial stability. Despite depreciation against USD in July-August 2018, NEER and REER of the hryvnia appreciated in annual terms
- Conditional on the situation in the FX market, the NBU has been relaxing FX restrictions

Key risks and challenges

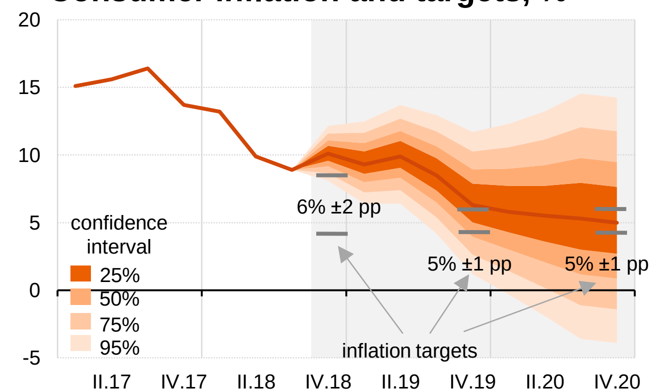
Key risks to the baseline macroeconomic scenario are worsening of **inflation expectations** and **external environment**

- **inflation expectations** could deteriorate amid the approaching presidential and parliamentary elections in 2019
- **turbulent external environment**, in particular:
  - faster cooling of the world economy
  - the outflow of capital from EM, as a result of the rapid transition to tighter monetary policy of AE central banks
  - lower world prices for commodities
  - the further rise in energy prices
  - high risk of “trade wars”
  - geopolitical risks
- Further intensification of **labor migration** to the EU

Real GDP Growth, %



Consumer inflation and targets, %



Key messages

- Ukraine’s economy embarked on the recovery path in mid-2015, thanks to the improved macroeconomic management, strong support from donors, and a favorable external environment
- The successful disinflation path was altered by idiosyncratic supply shocks, relative prices movement, and recovering domestic demand. The tighter monetary policy will ensure inflation falling back into the target band over the forecast horizon
- Fiscal and external sustainability have improved remarkably over the last few years, but dangers remain, stemming from the challenging external repayment schedule, a peak in the domestic political cycle, and the potential risk of a full-scale global trade war
- The longer-term economic prospects 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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