National Bank of Ukraine

Ukraine: Macroeconomic and Policy Outlook

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Deputy Governor

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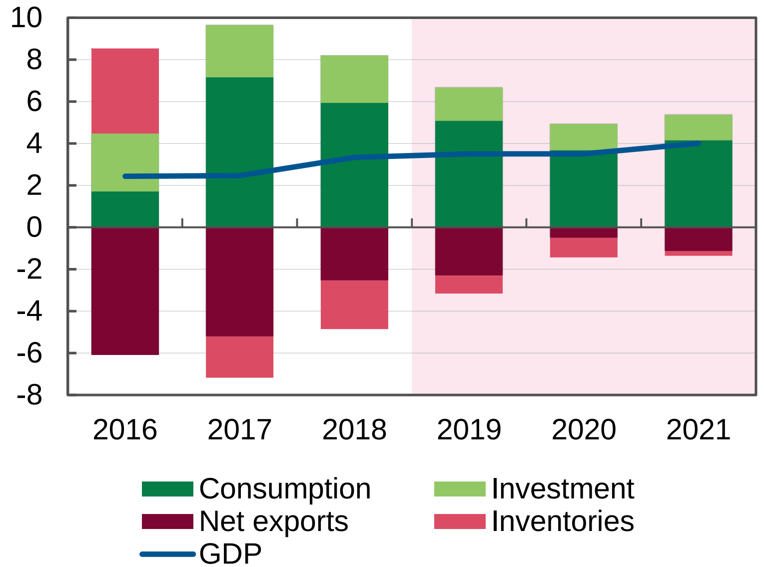
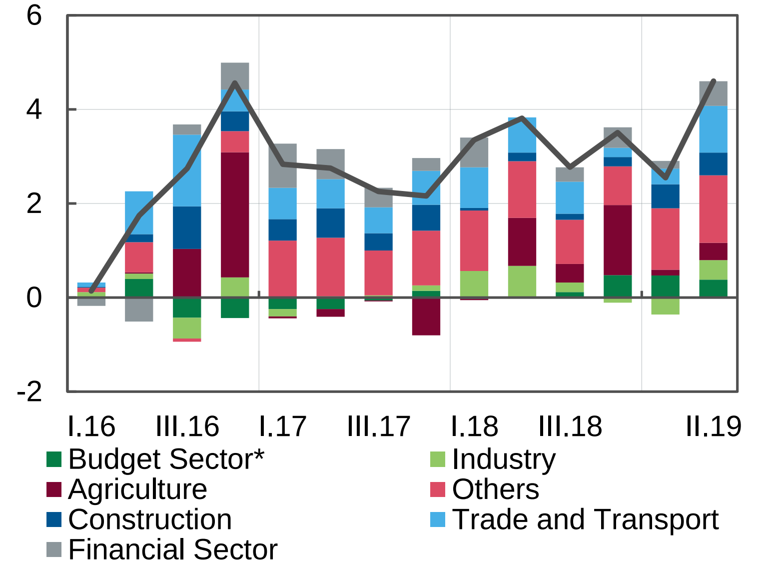
The Ukrainian economy has been recovering at a solid pace

Contributions to real GDP Growth, pp



Source: SSSU, NBU estimates and forecast (Inflation Report October 2019).

Contributions to annual real GDP growth by sectors, pp

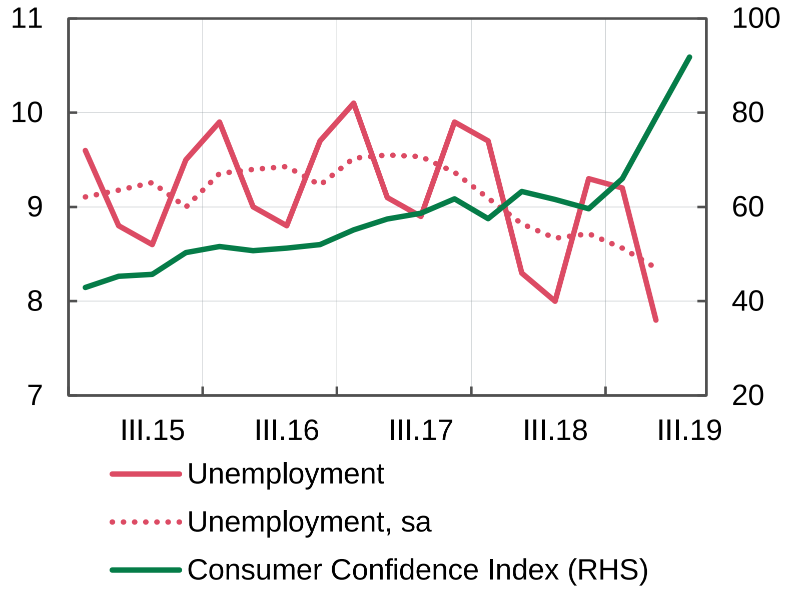


*Incl. public administration and defense; education; healthcare; administrative and support service; professional activities; arts and entertainment, etc.

- In H1 2019, real GDP accelerated to an estimated 3.6% yoy, driven by strong domestic demand and relatively favorable terms of trade
- By sectors, the growth is supported by expected another record high harvest of grains, improving performance in domestic trade and financial services
- In the forthcoming years, the growth will pick up as political uncertainty abates and monetary policy eases

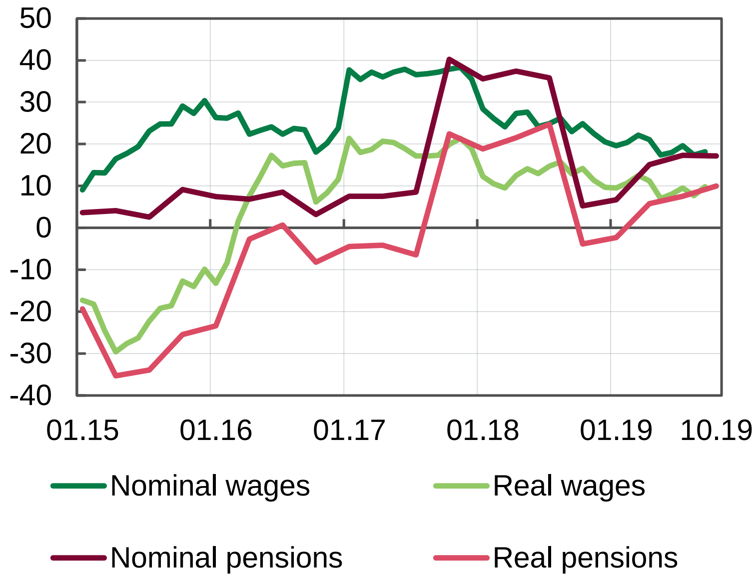
Acceleration in private consumption was supported by robust wage growth, improving employment and consumer sentiments

ILO Unemployment rate* and Consumer Confidence Index



* Unemployment – as a % labor force aged 15-70
Source: SSSU, InfoSapiens, NBU staff estimates.

Wages and Pensions (start of the month),% yoy

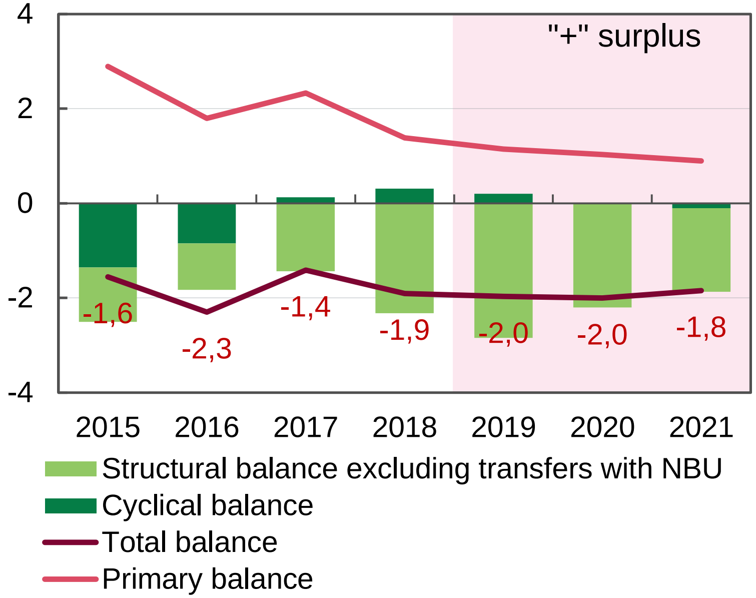


Source: SSSU, PFU, NBU staff estimates.

- Expanding economy underpinned solid labor demand, helping reduce unemployment rate
- Coupled with still persistent labor market mismatches, this caused wages to grow faster than expected. In addition, the growth in pensions picked up, reflecting planned adjustment of wage base in the pension benefit formula and a rise in benefits and one-off payments for selected groups
- Consumer sentiments are at many years' peak

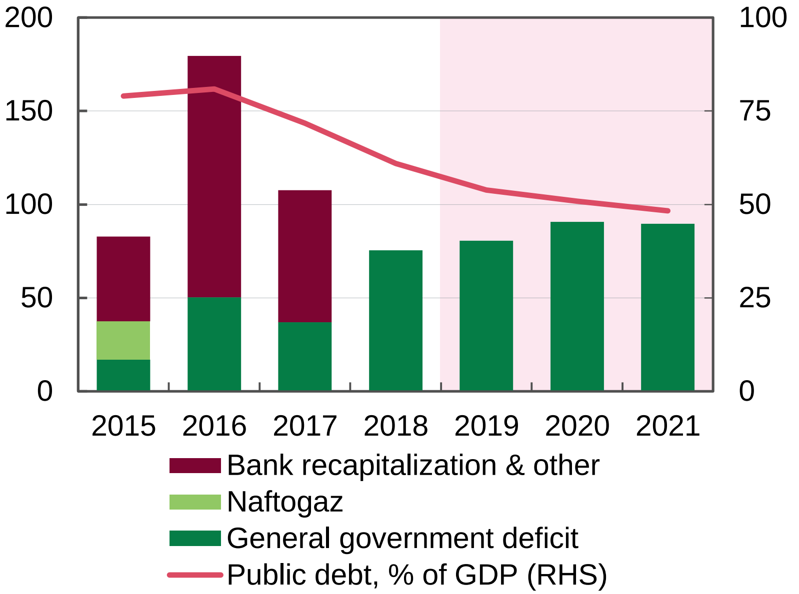
Fiscal policy has largely been in check over the last four years, in 2019-2021 fiscal policy will continue to be restrained

Consolidated Budget Balance, % of GDP



Source: MFU, NBU staff estimates and forecast (Inflation Report October 2019).

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

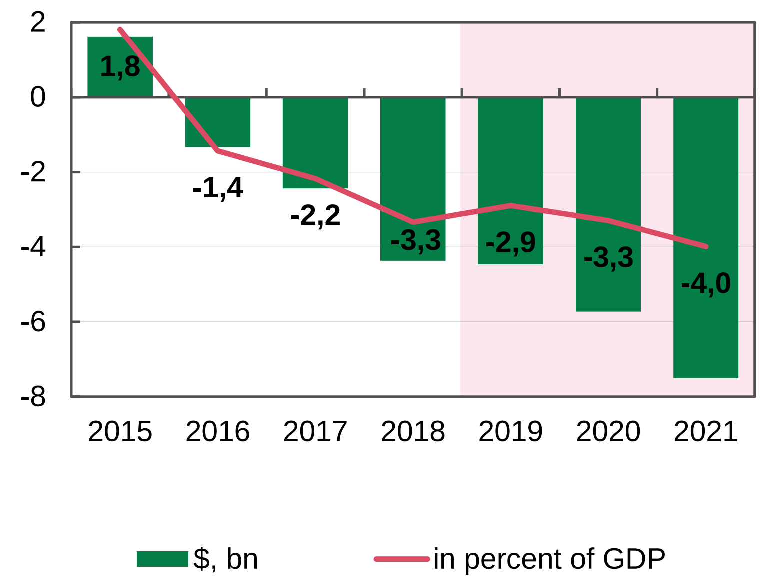


Source: MFU, SSSU, NBU staff estimates and forecast (Inflation Report October 2019).

- There is a strong commitment of the NBU to avoid any form of fiscal dominance
- 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 2019-2021 primarily because of large public debt financing needs amid peaks in external debt repayments
- The public debt-to-GDP is forecast to decrease further

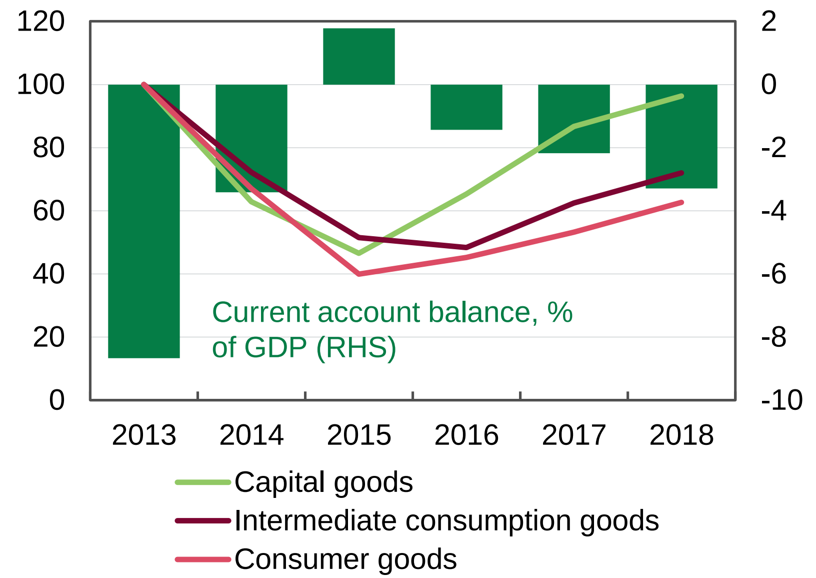
In 2019-2021 the CA deficit will remain at the sustainable level (3%±1 pp)

Current Account Balance



Source: NBU, Inflation Report October 2019.

CA Balance and Imports by BEC, 2013=100

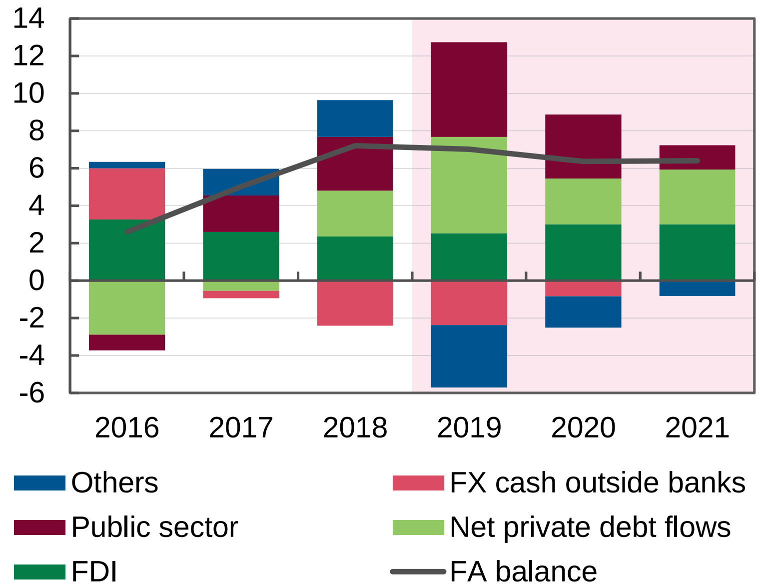


Source: NBU.

- After the 2014-2015 crisis, investment demand was the initial driver for the recovery in imports
- In 2019, the CA deficit will narrow to 2.9% GDP due to better ToTs, record high grain harvest
- In 2020-2021, the CA deficit will widen due to a decrease in pipeline transportation, worsening ToTs, and increased consumer and investment imports. Meanwhile, it will remain at sustainable level

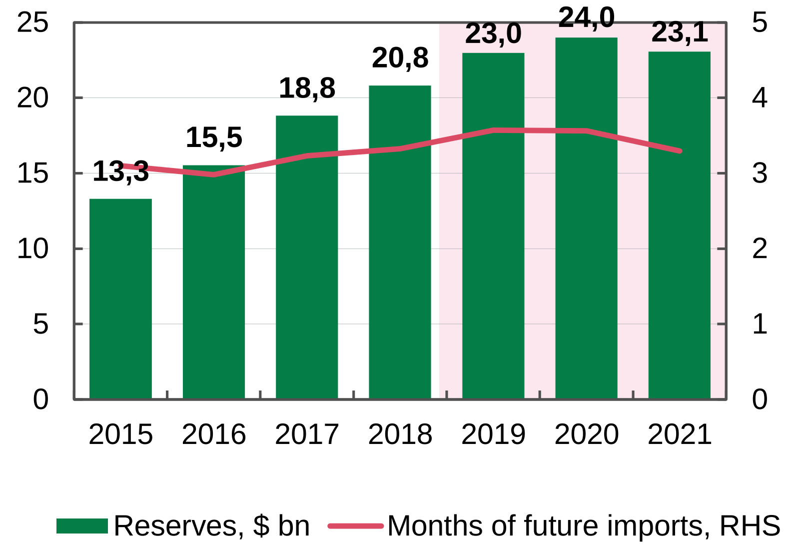
In 2020-2021, debt and investment capital inflows to private sector will remain the major source of financing the CA deficit

Financial Account (FA): Net Inflows, USD bn



Source: NBU, Inflation Report October 2019.

Gross International Reserves, USD bn

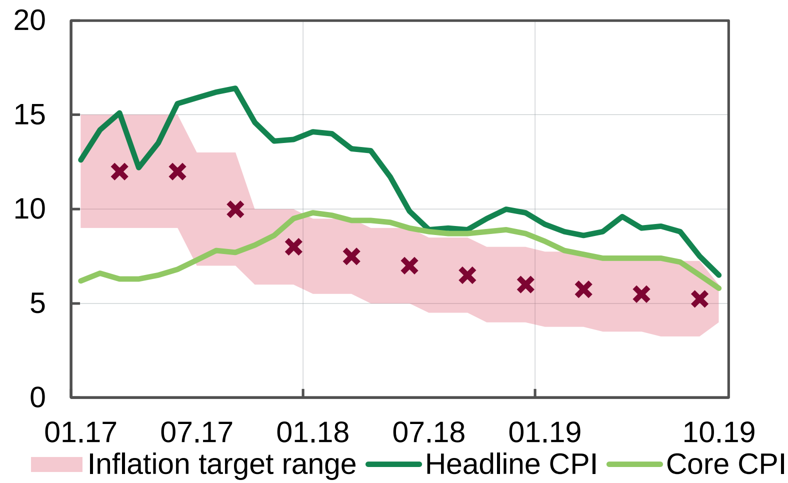


Source: NBU, Inflation Report October 2019.

- Capital inflows will be stable due to favorable interest rate on the background of easing monetary policy by main central banks and the beginning of the new program with IMF
- International reserves will hover at the level of USD 23-24 bn due inflows from the new IMF program

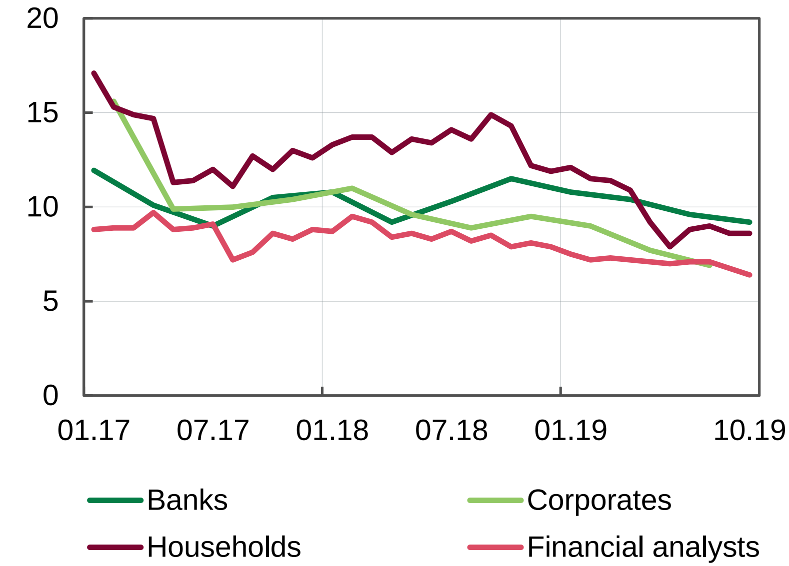
Inflation hit one-digit level in 2018 and continued to decelerate

Headline and core inflation, % yoy



Source: SSSU, NBU.

Inflation expectations for the next 12 months, %

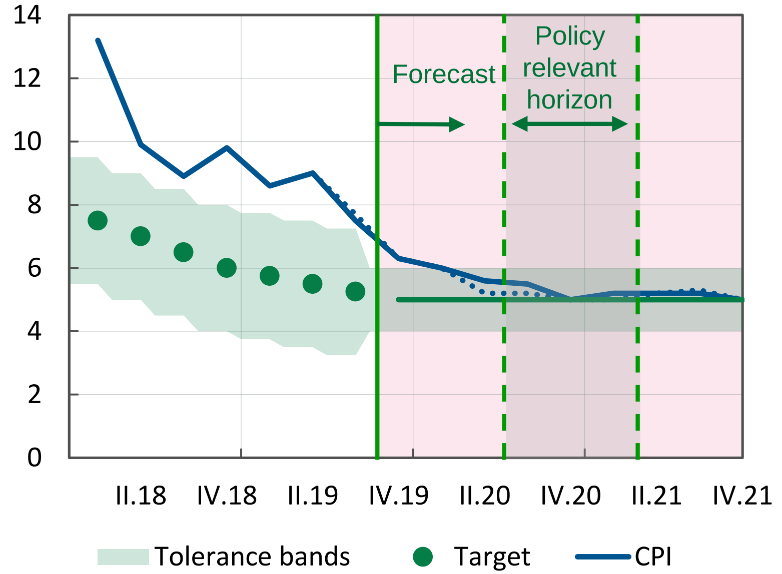


Source: NBU, GfK Ukraine surveys.

- In September-October, both headline and core inflation decelerated steadily
- Core inflation, administered prices and fuel prices grew slower than expected, mainly thanks to the continued appreciation of the hryvnia and falling world energy prices. That outweighed the impact of stronger consumer demand growth and selected food supply pressures
- Favorable FX situation helped to keep inflation expectations low

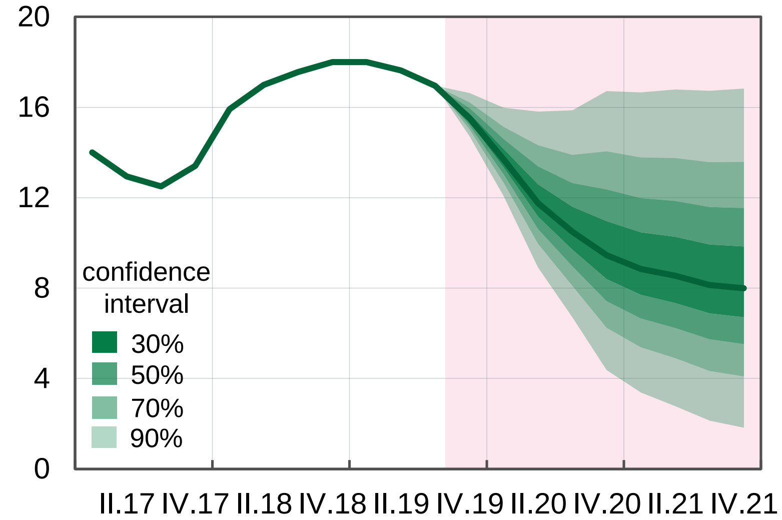
Monetary policy is committed to bring inflation to 5% target in 2020 via monetary conditions consistent with disinflation

Headline CPI, % yoy



Source: NBU (Inflation Report October 2019).

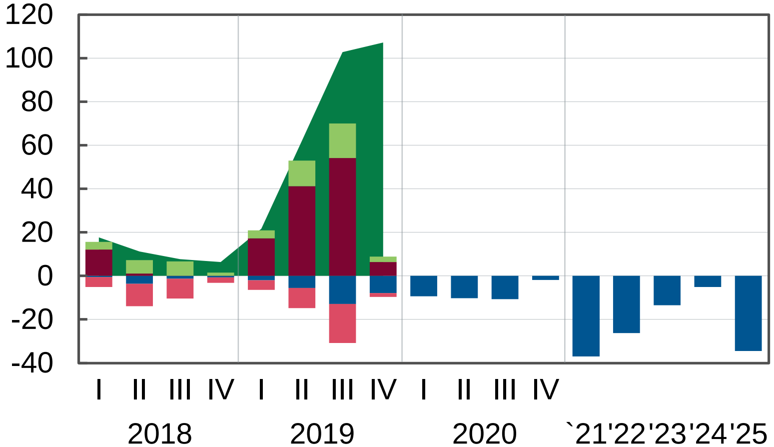
Key policy rate, average, %



Source: NBU (Inflation Report October 2019).

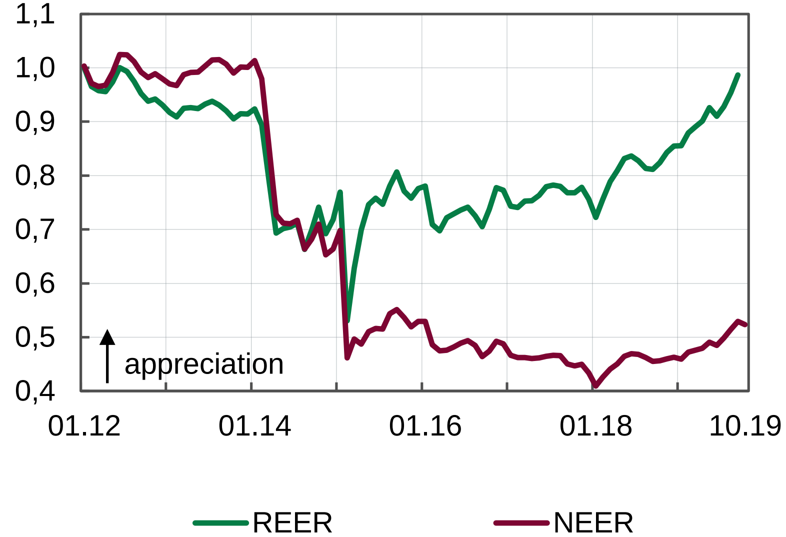
High real rates and simplifying access to government securities contributed to a further inflow of portfolio investments

Non-resident transactions with hryvnia government bonds and their scheduled redemptions*, UAH bn



* As of 08 November 2019.
Source: NBU staff estimates.

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



Source: NBU`s estimates.

- Foreign investments in hryvnia domestic bonds increased by almost USD 4.0 bn since the beginning of 2019, and their term structure has widened up to 6 years
- Non-residents' interest in hryvnia bonds amid favorable FX conditions contributed to appreciation of NEER/REER in 2019, while most currencies of Ukraine's trade partners depreciated against USD
- As a result, NEER/REER remained stronger than last year (by 11.4% and 17.2% respectively in August 2019) and the NBU forecast

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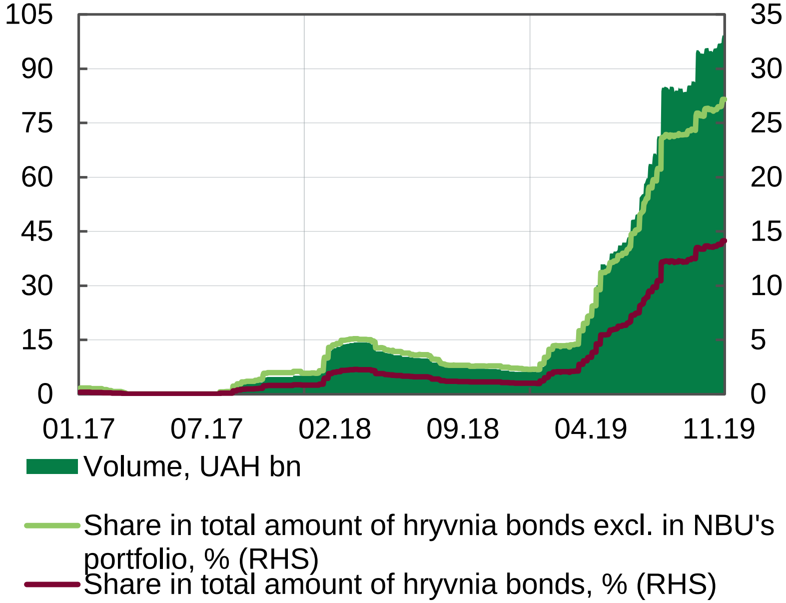
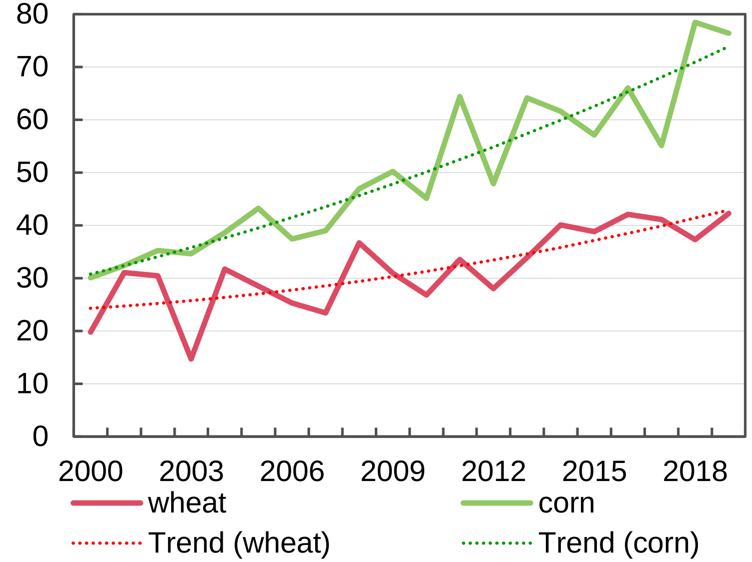
UAH appreciation is driven by strong portfolio inflows and boosting agricultural output

Hryvnia Domestic Government Bonds Held by Non-Residents



Source: NBU.

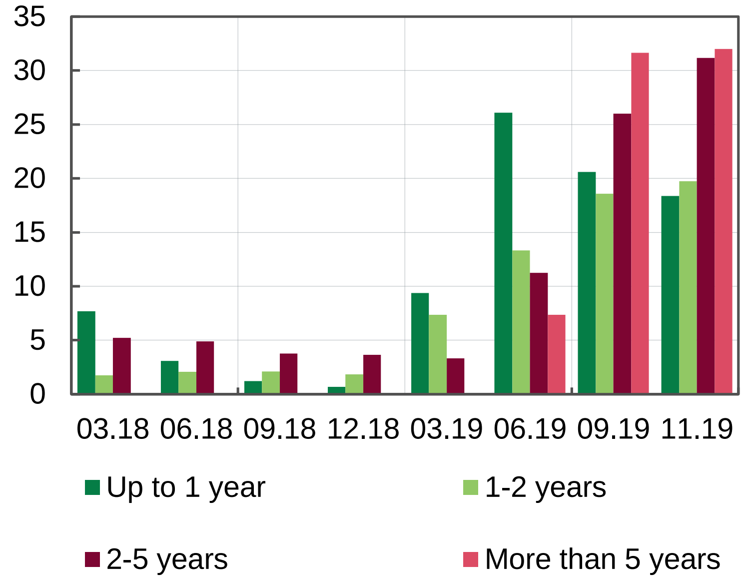
Wheat and corn yields in Ukraine, centers/ha



Data for 2019 – NBU estimate.
Source: SSSU.

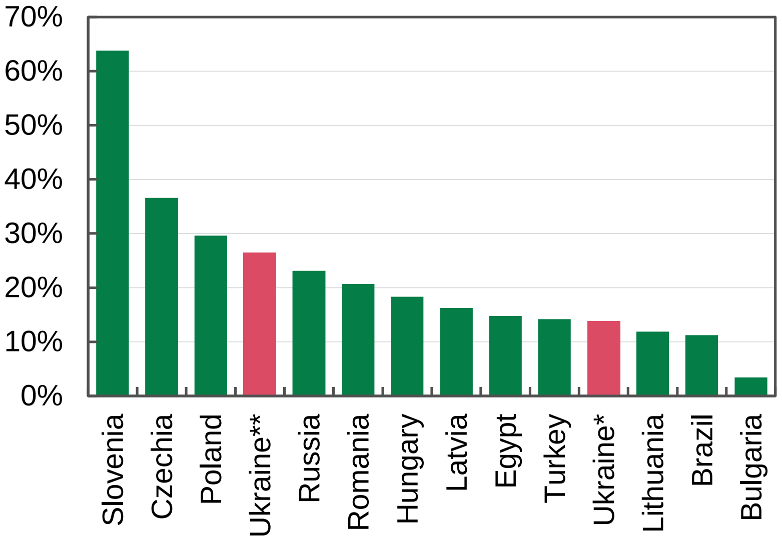
Myth 1: UAH appreciation is not in line with fundamentals due to the speculative nature of capital inflows

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



* As of 08 November 2019.
Source: NBU.

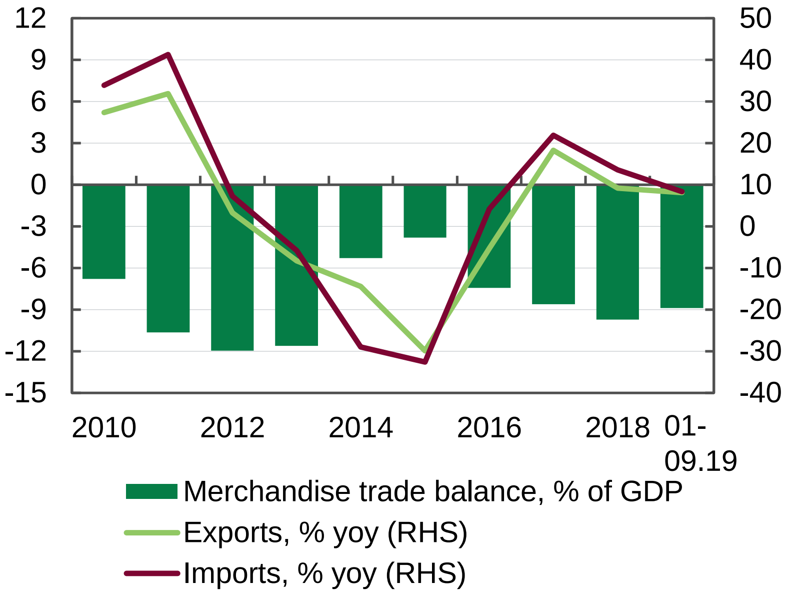
Non-residents share in Government Bonds in Local Currency in 2018, % eop



* Jan-Oct 2019;
** excluding NBU holdings of government bonds.
Source: NBU, IMF.

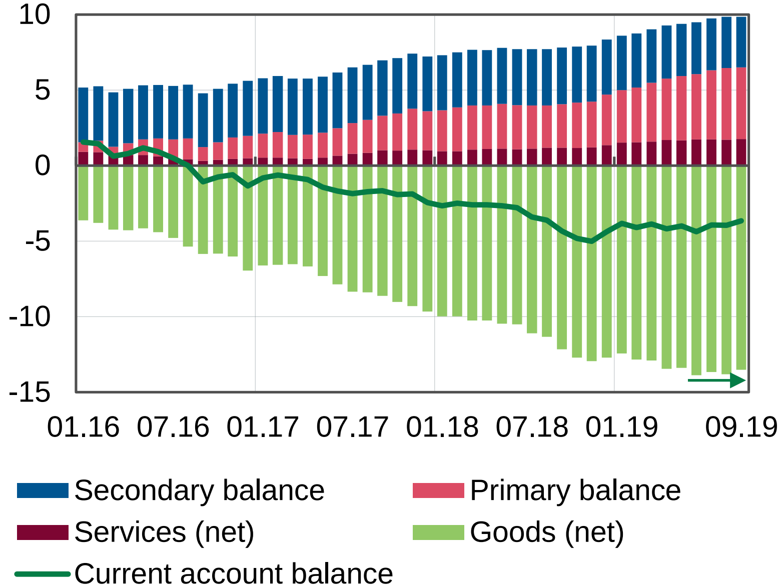
Myth 2: UAH appreciation is not in line with fundamentals due to the deteriorating external position

Merchandise trade balance indicators



Source: NBU.

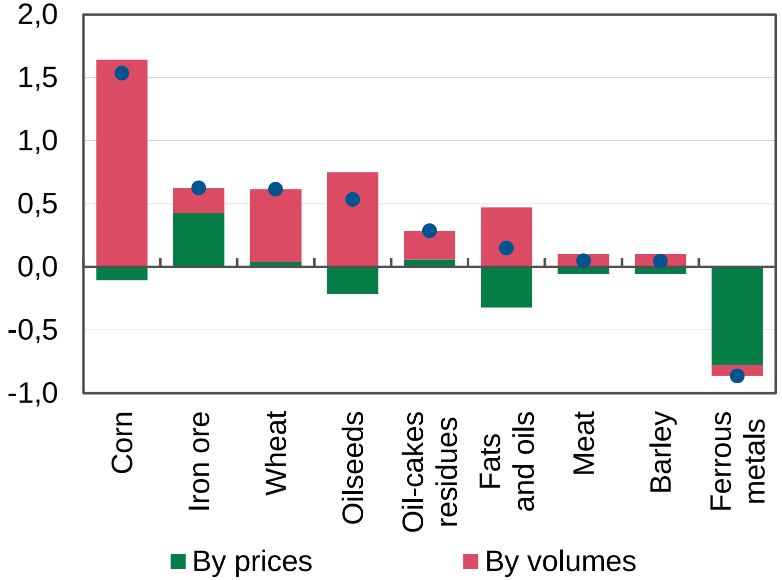
Current account, 12-month rolling, USD bn



Source: NBU.

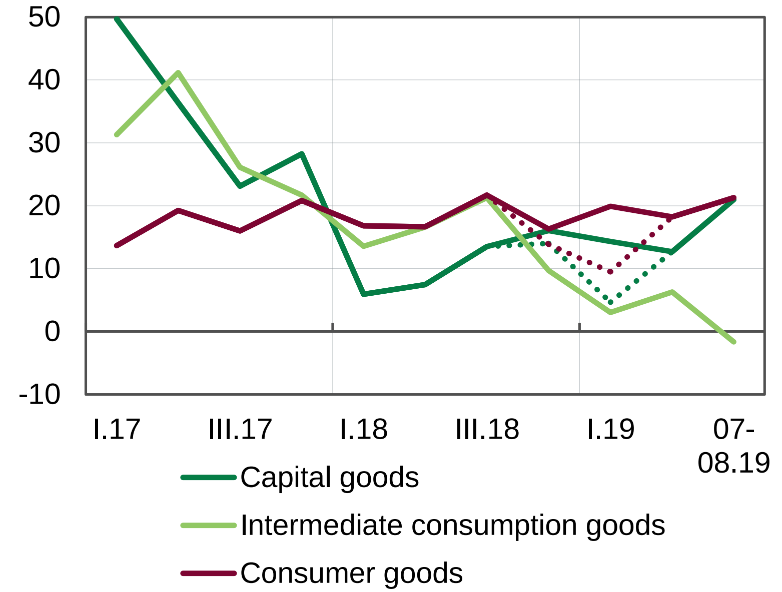
Myth 2: UAH appreciation is not in line with fundamentals due to the deteriorating external position

Exports of selected goods in Jan-Oct 2019, yoy change, USD bn



Source: NBU, SFSU.

Imports by broad economic categories*, % yoy



* Dotted line – excluding preferential custom clearance of motorcars.
Source: NBU.

Capital inflows into government bonds: possible policy options

Pros	Cons
Increase purchases of FX and prevent further UAH appreciation	
• increase reserves buffer	• inconsistent with IT: one-sided ER fluctuations (allowing only devaluation) will harm credibility and de-anchor expectations • could stimulate even more capital and attack on peg • inflationary pressure
Emergency key rate cut despite concerns over inflation	
• could prevent further inflows and reduce costs for MinFin	• inconsistent with IT and undermines NBU`s credibility • might provoke outflows
Capital controls	
? not applicable as capital flows into government debt	

Capital inflows into government bonds: policy reaction consistent with proclaimed strategy

NBU Monetary policy strategy

“ …the NBU shall consider achievement and maintenance of price stability in the country to be its priority…

…

The NBU will remain committed to the floating exchange rate regime, meaning that it will not use monetary policy to achieve a certain level or the band of exchange rate.”

In current circumstances that mean ⇒ continue balanced mix of UAH appreciation and FX accumulation

Results: enhanced credibility to inflation target

- ✓ de-anchoring inflation expectations and exchange rate
- ✓ de-dollarization
- ✓ extension of debt maturities and lower yields
- ✓ increase of salaries in USD terms – tamed labor migration

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
- Disinflation successfully proceeds, but its speed is altered by idiosyncratic shocks, further adjustment of administered prices and recovering wages and domestic demand. Tight monetary policy will ensure inflation falls back into the target band over the forecast horizon
- 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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