Ukraine: Macroeconomic and Policy Outlook

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Ukraine had a good crisis thanks to:
1. Beneficial terms of trade and C/A rebalancing

- In 2020, the current account surplus reached one of the highest levels on record – 4.3% of GDP
- The trade deficit narrowed significantly due to:
  - Favorable terms of trade, robust global demand for food and IT services, and rapid economic recovery in China (Ukraine's exports of goods and services decreased by a moderate 4.6%)
  - A decrease in energy prices, dwindling domestic demand and halt in the international tourism (imports fell by almost 18%)
Ukraine had a good crisis thanks to:
2. Prudent macro policy framework in the last 5 years

- Following the painful realignment with market fundamentals in 2014-2015, macro stability has been restored: real GDP rose at a steady pace, disinflation proceeded well, reserves were on a solid path towards the healthy levels
- Ukraine managed to achieve a breakthrough in eliminating large quasi-fiscal deficits of the energy and banking sectors
- General government deficits were taken under control. All this helped to bring debt-to-GDP ratio to just slightly above 50% of GDP as of end-2019
Ukraine had a good crisis thanks to:

3. Proper countercyclical policy response

Key rate, %

At the beginning of 2020 key rate = 13,5%

- **Continuing MP easing because:**
  - inflationary pressures were moderate, and the economy required substantial support due to the adverse impact of quarantine measures on business activity, consumption and employment

- **Keeping key rate unchanged because:**
  - there are rising inflationary risks
  - previous key policy rate cuts have not been fully transmitted to the cost of financial resources
  - low monetary impulse from additional cuts
  - worsening inflation expectations among businesses and households

- **Keeping key rate unchanged because:**
  - pro-inflationary factors are mostly temporary and beyond the MP influence
  - inflation expectations are worsening
  - weak investment activity, businesses’ depressed sentiment amid tighter quarantine measures
  - key rate on hold would strike the right balance between responding to inflation risks and supporting economic recovery

- **Monetary policy tightening because:**
  - fundamental inflation pressure is increasing
  - inflation expectations remaining elevated
  - inflation surge will be counterproductive for further economic development
  - it would gradually return inflation to the target amid recovery of global and Ukrainian economy

- **Continuing MP easing because:**
  - consumer and investment demand is most likely to remain subdued. This will keep inflation below the target level
  - Ukrainian economy will face a deeper contraction than expected
  - MP easing would help to support the economy as the country gradually lifts quarantine measures

- **Keeping key rate unchanged because:**
  - high level of uncertainty
  - inflation expectations of businesses and households continued to deteriorate
  - consistent with market expectations on NBU key policy rate
  - loose MP would help to support economic recovery and bring inflation to the target
In contrast to 2008-09 crisis Ukraine this time fared relatively well comparing to the regional peers

Real GDP of Ukraine and selected countries in different crisis periods,%

- Ukraine 2020 - preliminary estimate
- Georgia - Forecast 2020 GDP - IMF WEO October’20

Source: National statistical agencies.

Selected currencies vs USD, % change in different crisis periods

- Crisis 1 – from 01 September 2008 to 31 December 2009
- Crisis 2 – from 06 March 2020 to 02 March 2021

Source: Refinitiv, Investing, NBU estimates

• Unlike the previous global crisis episodes, when Ukraine was among the hardest hit countries, during the current crisis the decrease in GDP was on par with regional peers
• Ukraine avoided devastating depreciation thanks to the floating exchange rate that served as a shock absorber
After double-digit slump in Q2, GDP recovered pretty quickly driven by robust external and domestic demand

- Real GDP shrank by in 2020, much less than expected at the start of the coronavirus crisis
- The uncertainty related to the pandemic and quarantine measure hit investment activity hard
- However, the Ukrainian economy recovered quickly in H2 2020, supported by:
  - steady foreign demand for food products and reviving industrial activity in many countries amid sizable fiscal and monetary stimulus
  - solid growth in domestic consumption, both private and government

* Including non-profit institutions serving households.
Source: SSSU, NBU staff estimates.

* σ – standard deviation.
Source: SSSU, NBU staff estimates.
Private consumption was supported by mostly unabated wage growth despite weak labor market data

- The unemployment rate shot up at the start of the pandemics but then has been ebbing gradually amid restart of the economic activity
- The weaknesses of the labor market were largely offset by the increased social support from the government and solid wage growth

* Estimates as for 01.03.21.
Source: SSSU, PFU, NBU staff estimates.

** As a % of total population aged 15–70.
Dotted lines show sa series.
Source: SSSU, NBU staff estimates (January 2021 Inflation Report).
Rapid disinflation in 2019-20 supported expectations’ anchoring, though the job is not yet finished

During most of 2020, inflation was below the 5% ± 1 pp target range. Falling global energy prices coupled with narrowed demand for non-staple goods and services restrained price growth during the pandemic.

Inflation accelerated to the target (5%) in late 2020 and went above the upper bound of the target range in January 2021 due to the surging global commodity prices and robust domestic demand.
Inflation and FX volatility declined markedly, facilitating long-term investment and saving decisions

- Following the introduction of the IT regime, the volatility of inflation decreased noticeably.
- While the regime rests on the floating exchange rate, the volatility of the hryvnia exchange rate stayed within the range of 2-15%, typical for IT countries for non-crisis periods.
- Moreover, volatility of the hryvnia exchange rate remained within this range even during the acute phase of the crisis.
Monetary policy easing had a profound impact on the interest rates

- The accelerated cuts by the NBU in H1 2020 brought its key policy rate in real terms below the neutral level, making the monetary policy accommodative.
- The cuts in the key policy rate were effectively transmitted into interbank rates, which hovered just above the lower bound of the NBU interest rate corridor.
- The cost of funds in financial markets needed some time to respond and continued to reflect the cuts of the key rate in the subsequent months, albeit more slowly since late 2020.

Graphs showing:
- NBU policy rates, UIIR/UONIA and government debt securities yields on the secondary market, %
- Key policy rate, interest rates on new hryvnia loans and deposits, %
Contrary to the previous crisis episodes, the banking system is not facing funding squeeze this time

Retail deposits in hryvnia, the last day before the outflow* = 100% (at solvent banks as of 1 February 2021)

All deposits

FX deposits (USD eq.), the last day before the outflow* = 100% (at solvent banks as of 1 February 2021)

All deposits


Source: NBU, daily data, including certificates of deposit.
The corona crisis weighed down on bank lending

- Demand for corporate loans is low since the end of 2019
- In 2020-21, the slowdown in the growth of loans to households intensified

Source: NBU, at solvent banks as of 1 February 2021.
Banks’ efforts on NPL resolution resulted in improved quality of loan portfolio

- The NPL ratio declined to 41% in January 2021 after peaking at 58% in July 2017. The NPL ratio decreased the most at private and foreign banks (except Russian banks).
- In 2H20, NPL ratio decline was mostly driven by write-offs of legacy NPLs.
- NPL coverage ratio (all loan loss provisions / NPL) reached almost 98% in the end of 2020.

* Including interbank loans; all banks, including insolvent ones; no off-balance liabilities.
** The five largest foreign banks by net assets as of 1 February 2021 (not counting banks with Russian capital).
Source: NBU.
The fiscal sector proved the only soft spot last year as budget financing plans were strained by the delay in IMF program.

At the start of the pandemic, the government designed the proper countercyclical fiscal response by drafting the amended budget with 8% of GDP deficit (to be financed by official external borrowings).

However, the delay in IMF program put budget financing plans in tatters, forcing the government to effectively cut budget deficit to 5.5% and tap domestic debt markets at a large scale, which promptly caused yields to shoot up.

* Excluding special fund and extra debt operations (derivatives and early repayment/purchase of selected Eurobonds).
** Pattern fill reflects bilateral external financing not planned in the original budget.

Source: Treasure, MFU, NBU staff estimates.

Zero coupon yield curves for hryvnia government debt securities on the secondary market*, %

- As of 31.01.20
- As of 31.03.20
- As of 30.09.20
- As of 30.06.20
- As of 31.12.20

* Spot rates with continuously compounded interest plotted using Svensson parametric model.

Source: NBU.
World commodity prices rose, driven by global economic recovery and supply constraints.

Source: Refinitiv, NBU estimates.
Inflation will temporarily accelerate on the back of supply shock, demand recovery, weaker ER and minimum wage hike.

**Contributions to annual CPI growth, pp**

| Source: SSSU, NBU staff calculations, IR January 2021. |

<table>
<thead>
<tr>
<th>change, %</th>
<th>weight, %</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPI</td>
<td>100.0</td>
<td>5.0</td>
<td>7.0</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td>Core CPI</td>
<td>59.4</td>
<td>4.5</td>
<td>5.9</td>
<td>3.8</td>
<td>3.8</td>
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<tr>
<td>Raw food</td>
<td>19.4</td>
<td>4.1</td>
<td>6.0</td>
<td>3.4</td>
<td>3.4</td>
</tr>
<tr>
<td>Admin</td>
<td>18.0</td>
<td>9.9</td>
<td>10.5</td>
<td>9.4</td>
<td>9.1</td>
</tr>
<tr>
<td>Fuel</td>
<td>3.2</td>
<td>-10.5</td>
<td>13.2</td>
<td>6.7</td>
<td>6.0</td>
</tr>
</tbody>
</table>
The economy will grow rapidly. GDP will still be below its equilibrium level, which will constrain the inflationary pressure.

Source: NSSU, NBU staff calculations, IR January 2021.
Fiscal policy will be more restrained as the economy emerges from the crisis

Consolidated Budget Balance, % of GDP

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

"+" surplus

Source: SSSU, NBU staff calculations, IR January 2021.

Public debt-to-GDP ratio will gradually decrease due to economic growth and prudent fiscal policy
The CA will turn to the deficit due to recovery of the economic activity. International reserves will hover at the level $29-$31 bn

Starting in 2021, the current account will return to deficit, which will widen in coming years, driven by rising domestic demand and a gradual worsening in terms of trade.

Capital inflows to Ukraine will resume on the back of continued cooperation with the IMF, rebounding economic activity, and persisting loose monetary conditionals globally.

As a result, international reserves will hit about USD 30 billion, or 90% to 100% of the IMF composite measure.

Source: SSSU, NBU staff calculations, IR January 2021.
# Macroeconomic forecast

<table>
<thead>
<tr>
<th></th>
<th>2019</th>
<th>2020 actual/est.</th>
<th>2021 forecast</th>
<th>2022 forecast</th>
<th>2023 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Real GDP, change, %</strong></td>
<td>3.2</td>
<td>-4.2</td>
<td>4.2</td>
<td>3.8</td>
<td>4.0</td>
</tr>
<tr>
<td><strong>Nominal GDP, UAH bn</strong></td>
<td>3,978</td>
<td>4,079</td>
<td>4,580</td>
<td>5,015</td>
<td>5,475</td>
</tr>
<tr>
<td><strong>CPI, % yoy (eop)</strong></td>
<td>4.1</td>
<td>5.0</td>
<td>7.0</td>
<td>5.0</td>
<td>5.0</td>
</tr>
<tr>
<td><strong>Core CPI, % yoy (eop)</strong></td>
<td>3.9</td>
<td>4.5</td>
<td>5.9</td>
<td>3.8</td>
<td>3.8</td>
</tr>
<tr>
<td><strong>Current account balance, USD bn</strong></td>
<td>-4.1</td>
<td>6.5</td>
<td>-3.2</td>
<td>-7.4</td>
<td>-9.3</td>
</tr>
<tr>
<td>% GDP</td>
<td>-2.7</td>
<td>4.3</td>
<td>-2.0</td>
<td>-4.2</td>
<td>-4.9</td>
</tr>
<tr>
<td><strong>Gross reserves, USD bn</strong></td>
<td>25.3</td>
<td>29.1</td>
<td>30.7</td>
<td>29.7</td>
<td>29.1</td>
</tr>
</tbody>
</table>

Source: SSSU, NBU, IR January 2021.
Despite raising the key rate, the policy will remain loose

- An earlier increase in the key rate is due to the realization of pro-inflationary risks and faster recovery of consumer demand.
- Higher export prices will curb inflationary pressures through the exchange rate channel, and therefore the rate increase in 2021 will be more moderate than previously expected. However, the rate will remain at 7% longer due to the effects of higher world inflation.
<table>
<thead>
<tr>
<th>Influence on baseline</th>
<th>Risk probability</th>
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<tbody>
<tr>
<td></td>
<td>Low &lt;15%</td>
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<tr>
<td>Weak</td>
<td>Higher volatility of global food prices</td>
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<tr>
<td>Moderate</td>
<td>Lower harvest</td>
</tr>
<tr>
<td>Strong</td>
<td>Escalation of the military conflict in eastern Ukraine</td>
</tr>
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<td></td>
<td>High capital inflow</td>
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Key takeaways

- Ukraine entered the COVID-19 crisis with solid fundamentals – GDP growth was stable, inflation and the current account deficit were moderate, and the banking sector and public finances were healthy.

- The key difference with previous crises is that there is an IT regime in place, resting on a floating exchange rate, which serves as a cushion against adverse shocks. As a result, this crisis has not been accompanied by devastating depreciation and skyrocketing inflation.

- The economy was hit hard by the lockdowns, both domestic and abroad. However, the real GDP contraction in 2020 (by 4.2%) was smaller than expected when the coronavirus crisis started. In 2021–2022, GDP will grow by about 4%, buoyed by monetary and fiscal stimulus and rebounding external demand.

- In late 2020 - early 2021, inflation accelerated and breached the target range of 5% ± 1 pp. Inflation will accelerate in H1 2021 on the back of strong consumer demand, higher energy prices, last year’s lower harvests of agricultural crops and higher production costs. The impact of pro-inflationary factors will weaken in H2, which will reverse the inflation pattern. The reaction of monetary policy in 2021 will return inflation to the target range of 5% ± 1 pp in H1 2022.

- Continued cooperation with the IMF remains the key assumption underlying the NBU macroeconomic forecast.