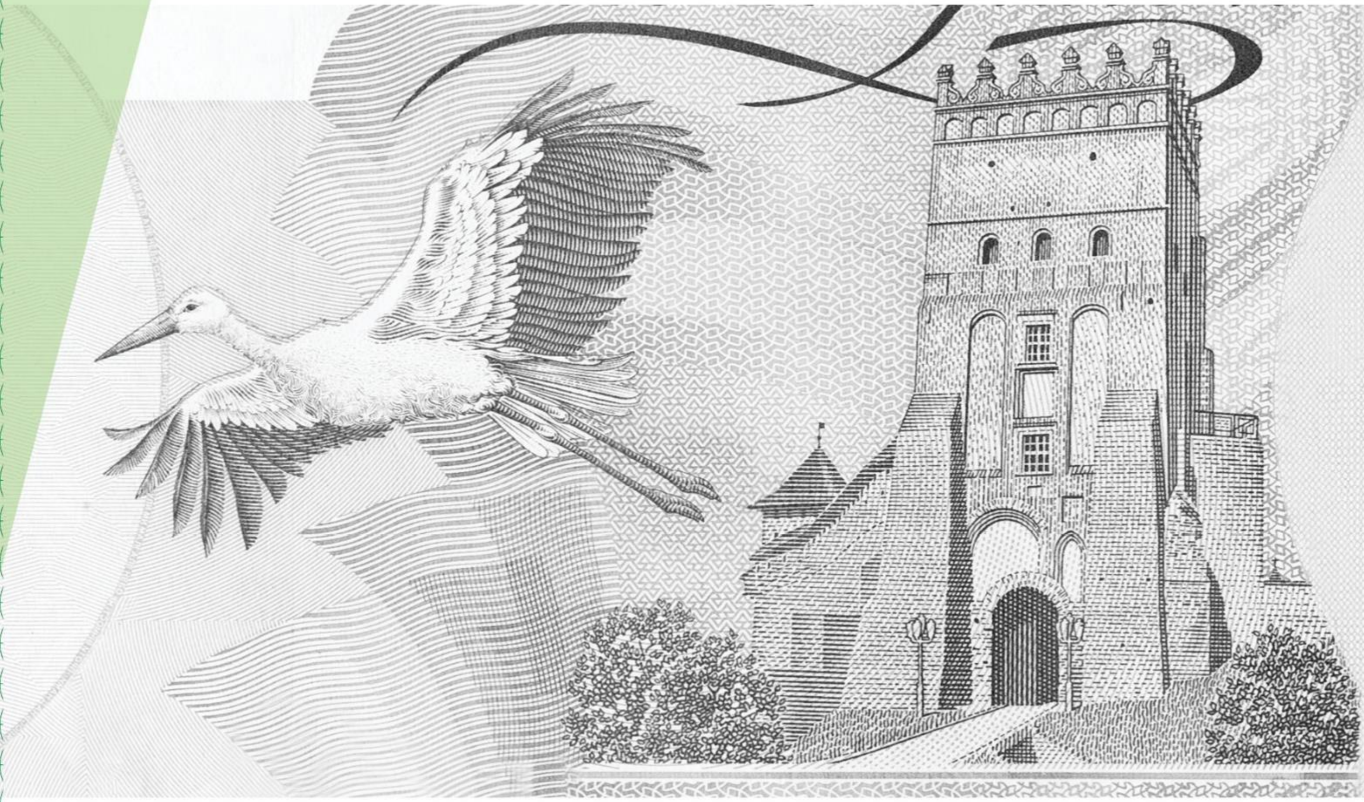
National Bank of Ukraine

Macroeconomic and Monetary Review

November 2021



Summary

External environment

Economic growth in some countries decelerated in November 2021, primarily due to the new onslaught of COVID-19. This led to a weakening of global demand for oil and a drop in its price. Another contributor to the decrease in oil demand was China's pledge to free up some of its strategic reserves and a U.S. call on other countries to do the same. Meanwhile, European prices for natural gas, which had stabilized temporarily, resumed growth due to limited Russian supplies and low stocks. Steel and iron ore fell in price amid sluggish domestic demand in China, as well as large inventories and weak demand in some Middle East countries. Wheat prices continued to rise because of low global stocks, strong demand for feed wheat, and higher fertilizer prices as natural gas prices rose. The latter was also a significant factor in supporting corn prices despite record harvests.

Global financial markets reflected the quick strengthening of the U.S. dollar against other major currencies, to the highest level in almost a year and a half. This was the result of better-than-expected macroeconomic data out of the U.S., the Fed's announcement to taper asset purchases, and plans to wrap up this process earlier if inflation remains elevated. As a result, most EM currencies depreciated against the U.S. dollar. The Turkish lira weakened the most as markets reeled from the key policy rate cut by the Central Bank of the Republic of Turkey in the face of rising inflation.

Inflation

Consumer inflation decelerated to 10.9% yoy in October 2021, primarily due to the slowdown in the growth of raw food prices. The pace of growth in administered prices also continued to decrease, mainly due to the waning of the low base effect and because of the annual contract option with a fixed price for natural gas. In contrast, the slowdown in inflation was restrained by sustained consumer demand and increased production costs, including wages and energy prices. These factors fueled a further rise in prices for services and processed foods. As a result, core inflation rose to 7.6% yoy.

Industrial inflation accelerated rapidly (to 57.2% yoy), driven by significant price increases in the supply of energy, in part due to the transition to the financial public service obligations (PSO) model[1], and in industries with a large share of natural gas costs (the manufacture of chemical, rubber, and plastic products). At the same time, the effects of lower global prices for metal ores restrained growth in the PPI.

Economic activity

The IKSO grew by 20.3% yoy in October. The bulk of this increase came from agriculture (up 61.0% yoy), primarily because the harvesting of late grains and industrial crops sped up, and owing to high yields of these crops. Industrial production volumes also grew (by 1.4% yoy). Specifically, extraction and mining of energy resources revived against the backdrop of high energy prices, while food production went up as the ample harvest was processed more actively. Energy generation increased amid cooler weather compared to last year and the somewhat improved supply of coal. Strong investment demand underpinned certain segments of machinery. By contrast, the growth in metallurgy was restrained by the weakening external demand, high energy prices, and repairs at some companies.

The lower-than-last-year budget financing of infrastructure projects resulted in a decline in construction volumes. Along with the lagged effect of slower harvesting in previous months, logistical hurdles, and production cuts in the manufacture of metallurgical and chemical products, the downturn in construction led to a drop in wholesale trade and freight turnover. Natural gas transit to Hungary terminated, making an additional negative contribution to freight turnover. Despite a number of regions having been designated as red-alert quarantine zones starting in the second half of October, the growth in retail trade decelerated slightly (to 5.7% yoy), while the pace of increase in passenger turnover picked up. This was driven, among other things, by the exemption from internal quarantine restrictions and permission to travel abroad for vaccinated individuals and those testing negative for COVID-19.

[1] From October 2021, NNEGC Energoatom and PrJSC Ukrhidroenergo were allowed to sell all generated electricity at market prices, including to providers of the universal service of electricity supply for households, whereas previously they had been selling electricity at a fixed reduced tariff. The difference between the reduced tariff and the purchasing price of electricity was covered by income from NNEGC Energoatom and PrJSC Ukrhidroenergo. According to NBU staff estimates, this explains about 4 pp of monthly PPI growth in October.

Labor market

Labor supply and demand remained high even as some areas received a red-alert quarantine designation. Wage growth continued to decelerate (to 15.4% yoy in nominal terms and 4% in real terms), including due to the high base effect (significant salary supplements to healthcare workers in October last year), and in real terms as a result of high inflation. Pension supplements for some categories of retirees boosted the growth in pensions.

Fiscal sector

In October, the state budget deficit narrowed (to UAH 14.7 billion), reflecting a significant slowdown in expenditure growth (to 1.9% yoy). The latter resulted from, among other things, lower-than-last-year expenditures on economic activities (including road infrastructure), healthcare, and social protection (with the base effect also contributing to the decrease). At the same time, defense spending rose sharply, in part due to increased allowances for military personnel. Although revenue growth also decelerated, the growth rate remained significant (22.5% yoy) due to an increase in nominal wages and sustained domestic demand. The state budget deficit was financed with previously accumulated funds and borrowings primarily denominated in foreign currency. Despite a significant surplus in local budgets, the consolidated budget went back into cumulative deficit.

Balance of payments

In October, the current account recorded a small surplus (USD 0.1 billion) despite the widening deficit in the merchandise trade balance both in monthly and annual terms. The latter was due to a significant slowdown in the growth of merchandise exports (to 38.8% yoy). In particular, the growth in metals-and-mining exports decelerated due to repairs at a number of metallurgical plants and a further reduction in iron ore prices. The increase in food exports also slowed amid a lower pace of corn and sunflower harvesting in previous periods. The growth in merchandise imports decelerated as well (to 36.4% yoy), though not as significantly as that in exports. Most of the slowdown occurred in nonenergy imports: the tightening of quarantine measures restrained consumer goods purchases, while the global shortage of semiconductors weighed on machinery purchases. At the same time, energy imports continued to surge as energy prices rose further. Coal purchases also increased due to low coal stocks.

The private and public sectors generated net financial account inflows (USD 1 billion). Public sector inflows were driven by the disbursement of macrofinancial assistance from the EU, and private sector inflows by the decrease in bank assets, primarily through FX sales in the interbank market. At the same time, FDI inflows decreased significantly, reflecting a drop in reinvested earnings after large dividend payments were made. The October overall balance of payments surplus (USD 1.1 billion) helped increase Ukraine's international reserves to USD 29.7 billion, enough to cover 3.9 months of future imports.

Monetary conditions and financial markets

The Ukrainian OverNight Index Average (UONIA) hovered within the NBU's rate corridor close to its lower bound in November amid a sustained significant liquidity surplus in the banking system. Meanwhile, the primary market yields on hryvnia domestic government debt securities, primarily short-term ones, edged higher due to the government's financing needs as the year draws to a close. In October, hryvnia interest rates on certain banking products crept up in a slow response to the tightening of the NBU's monetary policy. Banks continued to actively build up their loan and deposit portfolios.

The situation on the FX market was changing sharply in November. Specifically, the hryvnia strengthened in the first half of the month as FX supply significantly surpassed demand. FX supply in this period was primarily driven by export earnings from agricultural and metals-and-mining businesses, as well as funds from nonresidents. Also at play were upbeat expectations for a further progress with IMF cooperation following the staff level agreement in October. The NBU intervened to buy the surplus FX and replenish international reserves. In contrast, the hryvnia in the second half of November depreciated due to a significant increase in FX demand from energy companies and psychological factors caused by heightened geopolitical risks amid the build-up of Russian troops near the border with Ukraine. As a result, the official hryvnia exchange rate against the U.S. dollar weakened in November by 3.2% compared with the end of October. The average monthly depreciation, however, was much more moderate (0.3%). Despite large sales of foreign currency by the NBU to smooth out exchange rate volatility, the balance of NBU interventions remained positive in November, at about USD 0.4 billion.

The Macroeconomic and Monetary Review is a translation of the original report in Ukrainian. If there are any discrepancies between the original document and its English translation, readers should consider the Ukrainian version of the report as correct.