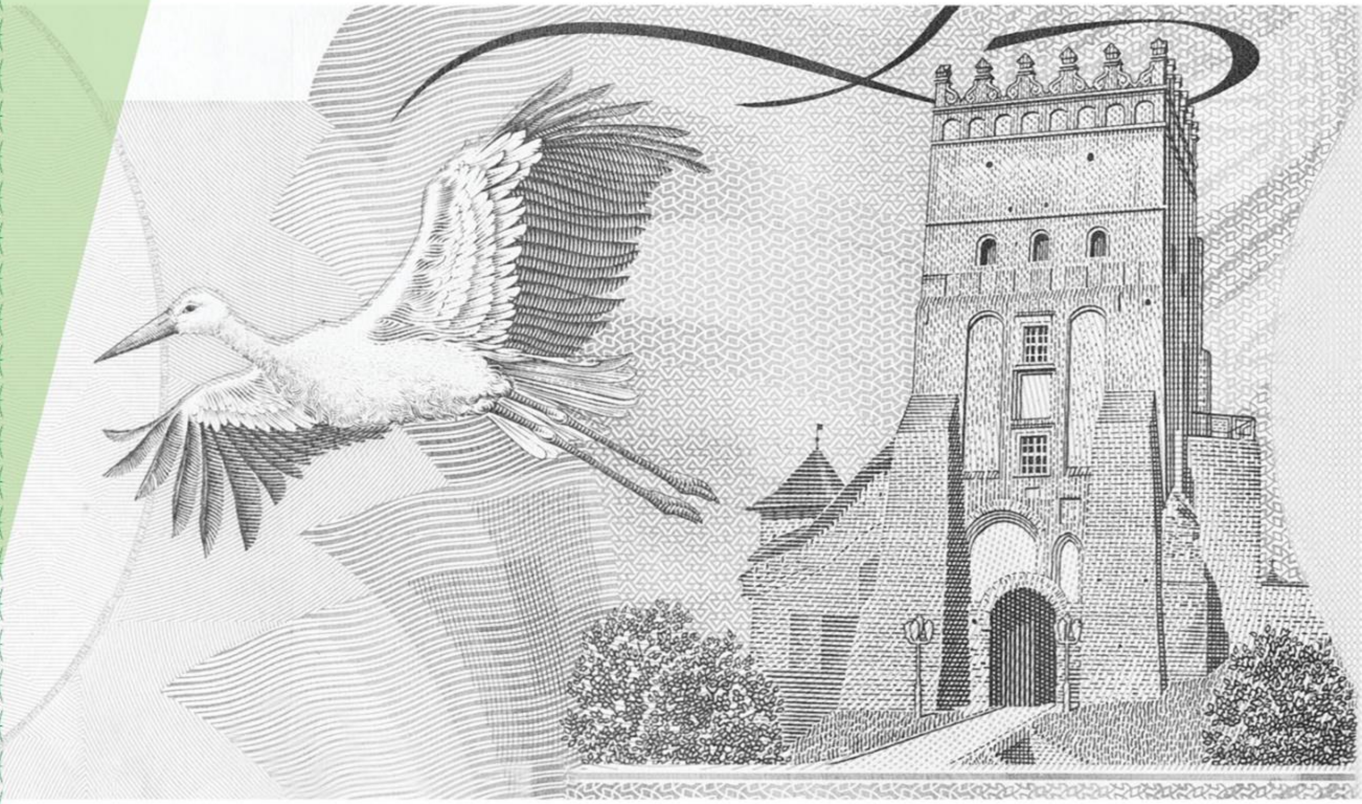
National Bank of Ukraine

Macroeconomic and Monetary Review

December 2021



Summary

External environment

Uncertainty related to the spread of the Omicron variant throughout a number of countries, restrained global economic growth in December. Along with the U.S., China, and Japan freeing up some of their strategic oil reserves, the slowdown in global growth continued to put downward pressure on oil prices. In contrast, natural gas prices in the EU market soared to new all-time highs, boosted by strong demand while Russia refused to deliver higher-than-contracted volumes of gas. Price growth was further supported by operation of the Yamal-Europe gas pipeline in reverse mode (from Germany to Poland). In late December, the increase in LNG imports from the U.S. and wind power generation caused the price correction. Steel continued to fall in price due to weak demand from China and the wait-and-see approach taken by other buyers. By contrast, iron ore got more expensive amid strong buildup of inventories in anticipation of a revival of Chinese steel production. Prices for grain, including wheat and corn, fluctuated at high levels, propped up by strong demand, revised yield estimates in different countries, and increased production costs owing to higher natural gas prices.

Investor sentiments toward EM assets in global financial markets was dampened by rising inflation, faster tightening of the Fed's monetary policy stance (despite the ECB keeping its monetary policy accommodative), and the slow recovery of EM economies due to the slow vaccine rollout and lower fiscal support. At the same time, key policy rate hikes by most EM central banks resulted in their currencies strengthening against the U.S. dollar.

Inflation

In November 2021, consumer inflation declined (to 10.3% yoy), primarily as a result of ample harvests and the hryvnia's appreciation in previous periods. The growth in administered prices also continued to slow due to the annual contracts with a fixed natural gas price for households and constant prices for other utilities. At the same time, core inflation increased (to 7.7% yoy) against the backdrop of higher prices for processed foods and services because of high prices for raw materials and energy and higher production costs, including wages.

Producer price inflation continued to accelerate (to 60.7% yoy), fueled by sharp price increases in the energy sector and industries with a large share of natural gas costs (the manufacture of chemical, rubber, and plastic products). At the same time, lower prices for sugar, sunflower oil, and iron ore, as well as the stalled growth in steel prices, restrained the increase in the producer price index.

Economic activity

In November, the IKSO grew by 13.7% yoy. The main contribution to this increase came from agriculture (up 53.8% yoy) primarily due to the record harvest of late grains and industrial crops, including corn. Industrial growth decelerated (to 0.4% yoy). Thus, the energy sector declined due to weather having been warmer than last year and because of coal shortages. Despite crop yields having been high, production in the food industry decreased, in part due to the lower output of sugar amid rising natural gas prices. The growth in the mining industry remained subdued as the extraction of coal and metal ores fell further, while demand from construction underpinned high volumes of extraction of other minerals.

The chemical industry grew after getting a boost from the completion of major repairs at some companies, and owing to the ramped up production of medical oxygen amid the coronavirus's accelerated spread. The growth in metallurgy was driven by an increase in the manufacture of pipe products as the oil and natural gas sector stepped up consumption, as well as by the easing of coke shortages thanks to imports. The revival of investment demand spurred the growth in machinery. The decline in construction slowed (to 1.4% yoy) owing to improved performance of civil engineering's construction amid increased budget financing of infrastructure projects. Active agricultural exports and higher imports of petroleum products contributed to the growth in wholesale trade and freight transport. The tightening of COVID-19 restrictions as most oblasts got the "red zone" designation caused a slowdown in passenger transport growth. Although the restrictions became stricter, the increase in retail trade picked up slightly. This was made possible by the high pace of growth in real wages, and the exemption from quarantine restrictions of vaccinated individuals and persons with negative PCR test results.

Labor market

Labor demand and supply weakened slightly while tightened quarantine measures were in force. However, wage growth accelerated in November (to 19.2% yoy in nominal terms and to 8% yoy in real terms). Specifically, wages rose sharply in healthcare, presumably due to wage supplements amid the accelerated spread of COVID-19, in the hotel and restaurant business, as the impact of quarantine eased compared to last year, in part because of the exemption of vaccinated individuals from restrictions, and in agriculture, thanks to high crop yields and solid financial performance.

Fiscal sector

In November, the state budget recorded a moderate deficit (UAH 11.5 billion) despite a sharp acceleration in expenditure growth (to 37.2% yoy from 1.9% yoy in October). Expenditures increased primarily due to higher spending on road infrastructure, healthcare (amid the prevalence of Covid-19), and social protection. At the same time, revenue growth also accelerated (to 36% yoy). In particular, tax revenues increased due to the solid financial performance of businesses, wage growth, and higher imports. Thanks to domestic and external borrowings, not only was the November deficit financed, but also significant amounts of hryvnia and FX funds were accumulated in government accounts. With borrowings in December having been significant, expenditures are expected to make a major pick up at the end of the year.

Balance of payments

In November, the current account ran a deficit (USD 0.4 billion) due to a significant widening of the negative balance of merchandise trade compared to previous months and November of last year. Specifically, imports growth accelerated significantly (to 47.6% yoy) and outpaced the increase in exports (45.5% yoy), primarily due to the nonenergy component. In particular, purchases of investment-oriented machinery products increased, while the dynamics of chemicals imports was shaped by a significant increase in the cost of fertilizers and plastics. Energy imports remained significant due to the further growth in their prices and because of record purchases of petroleum products. Growth in exports also sped up amid record grain supplies. However, it was restrained by the narrowing of external demand for metals-and-mining products.

The financial account continued to record capital inflows, driven primarily by the private sector. In particular, the real sector raised capital by issuing green Eurobonds by Ukrenergo NPC (USD 825 million) and increase in liabilities under trade loans. At the same time, FDI inflows to the private sector continued to decline as reinvested earnings fell amid significant dividend payouts. Financial account inflows exceeded the current account deficit. Coupled with the disbursement of an IMF tranche, this enabled Ukraine to increase its international reserves to USD 30.5 billion as of end-November, which covers four months of future imports.

Monetary conditions and financial markets

In December, the NBU raised its key policy rate by 0.5 bp, to 9.0%. This decision was warranted by the need to eliminate additional pro-inflation risks and improve inflation expectations, which will contribute to a gradual return of inflation to its target. UONIA – the Ukrainian OverNight Index Average – increased, but it stayed within the NBU's interest rate corridor near its lower bound because of the sustained significant volume of liquidity in the banking system. Primary market yields on hryvnia domestic government debt securities also increased, reflecting the government's need for funding at the end of the year. This allowed the Ministry of Finance to raise a significant amount of funds, including through demand from nonresidents.

In November, banks raised slightly their rates on hryvnia deposits in a gradual response to the NBU's previous decisions to tighten its monetary policy. The weighted average cost of retail loans decreased significantly given special offersby the state-owned banks. On the other hand, weighted average interest rates on loans to nonfinancial corporations remained at the previous month's levels. Banks continued to actively build up their loan and deposit portfolios.

FX market was largely balanced in December. This was the result of an increase in export earnings of agricultural and net supply of FX cash. However, persisting geopolitical tensions depressed market sentiment. To smooth out excessive exchange rate fluctuations, the NBU intervened in the market both with the sale and purchased of foreign currency. With the sales being relatively larger in volumes, they generated about USD 0.2 billion in net FX sales in December.

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.