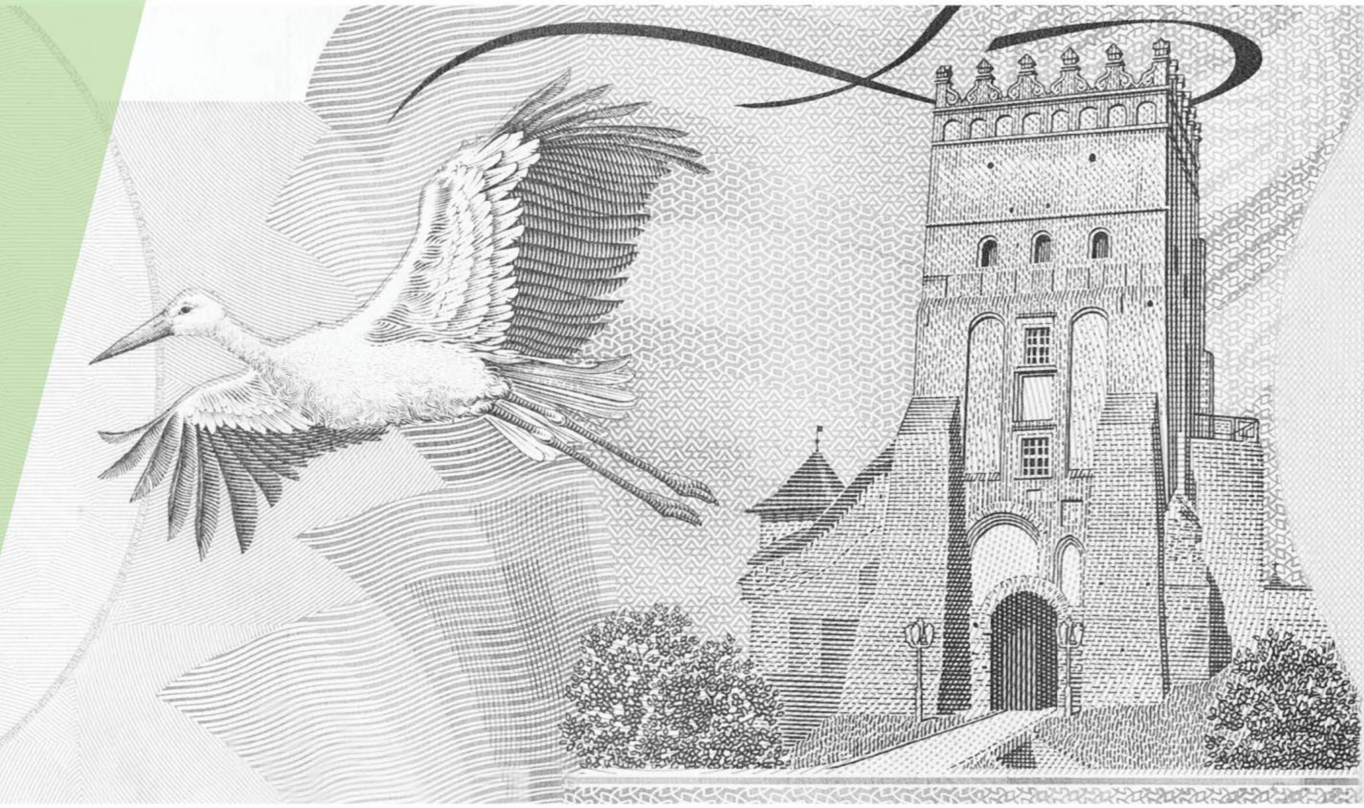
National Bank of Ukraine

# Macroeconomic and Monetary Review

October 2019



# Summary

### External Environment

In October, Ukrainian exporters continued to face deteriorating global commodity market conditions as global trade weakened further. Steel and iron ore prices declined, while grain prices adjusted slightly upward after harvest was revised down amid a drought in Australia and an early frost in the U.S. Energy prices fluctuated in a narrow range, supported by expectations of trade talks between the U.S. and China (which may ramp up China's demand for U.S. oil), a reduction in the number of drilling rigs in the U.S., and a high level of compliance with the OPEC+ agreement. Market supply nevertheless remained ample, which, along with the softening of demand, particularly from China, put downward pressure on prices.

Financial market conditions improved due to signs of progress in the U.S.-China trade talks, the Brexit extension granted by the EU, Germany's improved business expectations, and the Fed's anticipated interest rate cut.

### Inflation

In September 2019, consumer inflation decelerated to 7.5% yoy (from 8.8% yoy in August), while core inflation slowed to 6.5% yoy (from 7.2% yoy in August). Tight monetary policy continued to contain underlying price pressures, particularly through the exchange rate channel. This was mainly reflected in the prices of nonfood products and services with a high import share in their cost.

Food price growth decelerated as the supply of most of the newly harvested vegetables expanded and an ample grain harvest was gathered. Potato prices bucked the trend, more than doubling in annual terms due to a poor harvest of this crop. Also, the strengthening of the hryvnia together with the fall in global energy prices caused fuel prices to fall. In addition, administered prices rose at a slower pace, primarily due to lower gas prices. The same factors affected producer price developments, with producer price inflation slowing to 1.7% yoy in September, the lowest since the beginning of 2014.

### Economic Activity

In September 2019, the growth in the IKSO accelerated (to 3.5% yoy). Following a temporary slump in August, agriculture returned to growth, driven by higher corn and sunflower yields than last year. The growth in construction work picked up, fueled by the previous month's increase in capital expenditures from the budget and more favorable weather than a year ago. The growth in retail trade turnover also sped up (to 8.6% yoy) and continued to be driven by a sustained increase in household incomes and a further improvement in consumer confidence. Among household income components, wages continued to grow fast, accelerating to 18.2% yoy and 9.8% yoy in nominal and real terms, respectively. Consumer confidence soared to a 12-year high.

The downturn in industrial production slowed (to 1.1% yoy) on the back of improved manufacturing performance. Specifically, the increased output in the food industry (primarily due to high grain yields) and the chemical industry, coupled with a deceleration of the decline in machinery, outweighed the impact of the further downturn in metallurgy. The latter was the result of both worsened external conditions and internal factors such as repairs and infrastructure constraints. Weaker demand from metallurgy led to a fall in metal ore extraction and worsened performance in mining as a whole.

### Fiscal Sector

The state budget recorded a UAH 23.1 billion deficit in September as projected, due to a continued weakness in revenue growth (up by 1.1% yoy). The latter resulted from a deceleration in the growth of imports and purchases of natural gas, which was customs-cleared under what is known as a *customs warehouse regime*. Expenditure growth also decelerated sharply (to 4.4% yoy), reflecting a reduction in debt-servicing expenditures, current transfers, and capital expenditures. Local budgets also ran a deficit (of UAH 3.6 billion) after the growth in expenditures, in particular on education, accelerated.

## Balance of Payments

In September, as expected, the current account deficit widened from August (to USD 1.1 billion) due to scheduled interest payments on restructured government Eurobonds. However, the deficit was lower than in September last year due to a smaller merchandise trade deficit, which was down to USD 1.4 billion on the back of the acceleration in the growth of merchandise exports (to 11.9% yoy) and a significant deceleration in import growth (to 2% yoy).

The improvement in export performance was driven by the bumper harvests of grains and oilseeds, as well as the supply of machinery products. This outweighed the decline in exports of metallurgical products and the slowdown in the growth of iron ore exports. The reduction in energy imports remained one of the main reasons behind the slowdown in the growth of overall imports. The introduction of special duties on pipeline deliveries of diesel fuel from Russia led to a decrease in its purchases in annual terms. The contribution of the further fall in energy prices also remained significant. In addition, the increase in imports of machinery products slowed down, in particular due to ramped-up purchases of electrical equipment for alternative energy last year in anticipation of legislative changes.

The financial account recorded an increase in capital inflows (to USD 1.2 billion), which were primarily driven by the private sector. More specifically, the real sector attracted investment and debt capital, including through the placement of Eurobonds by several Ukrainian companies. In September, nonresident investments in hryvnia domestic government securities increased from August, but following the government's scheduled redemption of Eurobonds, the government sector generated marginal capital outflows. Due to repayments on IMF loans, international reserves decreased compared to August, yet grew from the beginning of the year to USD 21.4 billion or 3.4 months of future imports, as of late September.

## Monetary Conditions and Financial Markets

At its October monetary policy meeting, the NBU Board decided to continue the monetary policy easing cycle by cutting the key policy rate by 100 bp to 15.5%. Monetary conditions nonetheless continued to be reasonably tight, as the rate cut came amid improved inflation expectations. The tight monetary stance will ensure that inflation reaches the 5% target in 2020.

The lowering of the key policy rate and the high likelihood that the rate cuts will continue contributed to the decrease in the interbank funding costs and the yields of hryvnia domestic government securities. Hryvnia rates for bank customers (except rates on household deposits) also declined slightly, but the effect of the monetary transmission mechanism was weakened by market-driven and structural factors. In particular, a significant impact on the growth of interest rates on household deposits came from the interest rate policy of several state-owned banks, which other market participants believe serves as guidance for action, and from higher yields on hryvnia domestic government securities, despite a decline in the latter.

In October, the hryvnia weakened slightly against the dollar and euro, but remained 9.7% stronger year-to-date against the dollar (12.5% against the euro). Short-term volatility spikes were driven by slightly increased demand from importers of energy and for consumer goods, as well as by the prevalence of demand over the supply on the cash market. However, overall, the FX market conditions remained benign, allowing the NBU to continue purchasing foreign currency to replenish its international reserves. NBU's net FX position was positive at nearly USD 200 million in October, and USD 4.1 billion since the beginning of the year.

*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.*