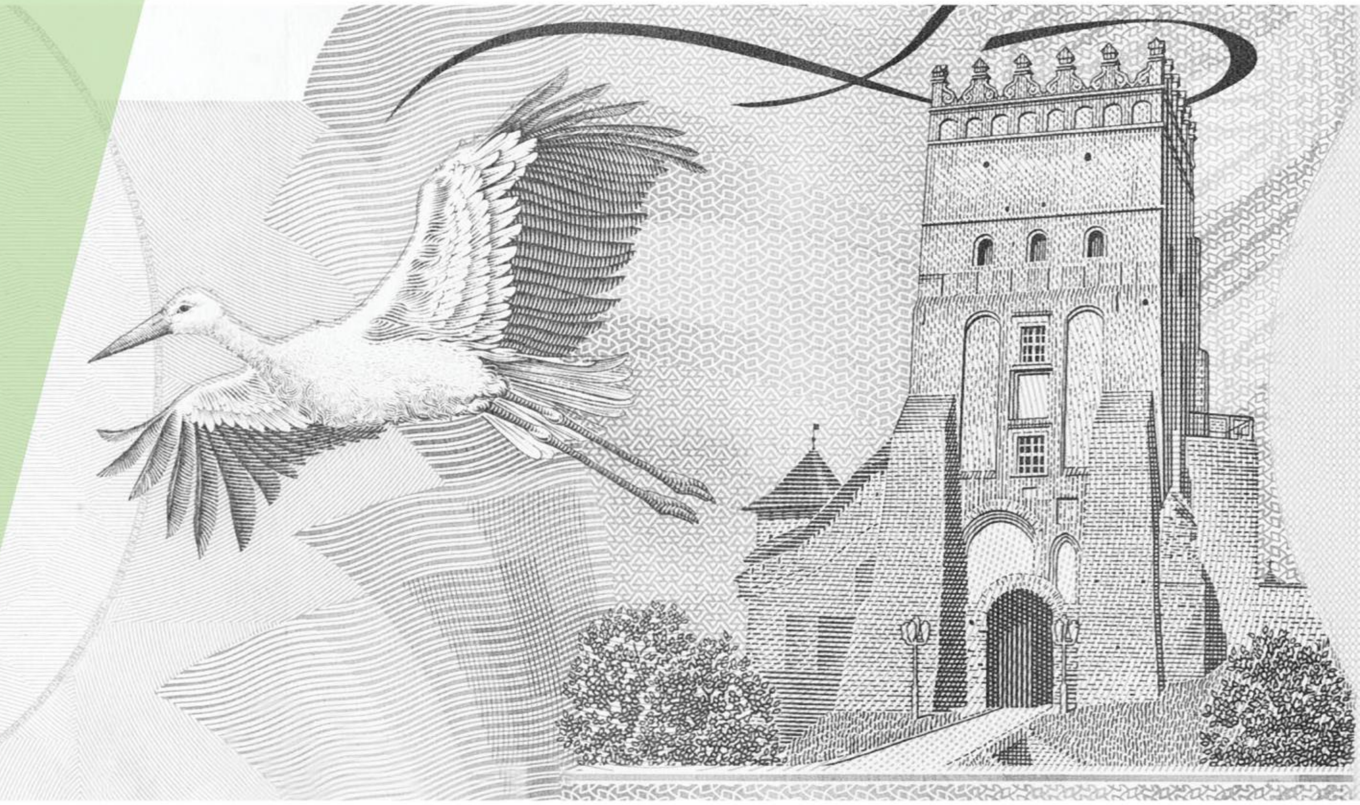
National Bank of Ukraine

Macroeconomic and Monetary Review

November 2019



Summary

External Environment

Global commodity and financial markets rallied in November on expectations that the U.S. and China would sign ”a phase one” trade deal before the year was over. Oil prices edged up as new drilling activity in the U.S. slowed and market players anticipated the OPEC+ deal would be extended until at least June 2020. Natural gas prices grew on forecasts of a cold snap in late November through early December. Steel prices recovered as some of China’s steelmakers held back on production amid the relatively robust demand from construction companies. Seasonally weaker iron ore supply outweighed the impact of headlines at the start of the month that Vale was resuming operations at Brazil’s largest mines, driving iron ore prices higher. Ample harvests in Brazil and Ukraine drove corn prices down. Meanwhile, wheat prices rose due to adverse weather conditions in the U.S. and Europe, which disrupted the planting of winter crops, and an outbreak of fungal disease in Argentina.

The sentiment towards risky assets improved after the U.S.-China talks made progress, and minutes of the Fed’s latest meeting showed cautious optimism about the U.S. economy. With U.S. macroeconomic data . above market expectations, this strengthened the U.S. dollar against the basket of major currencies, including the euro, which was depressed by somewhat weaker economic data from Germany. As a result, most EM currencies lost ground against the U.S. dollar.

Inflation

In October 2019, consumer inflation decelerated to 6.5% yoy, while core inflation slowed to 5.8% yoy (from 7.5% yoy and 6.5% yoy in September, respectively). Tight monetary policy was a major factor in holding back underlying price pressures. This was manifested through the exchange rate channel and an improvement in inflation expectations among all groups of respondents. The stronger hryvnia led to a decrease, from October of last year, in prices for nonfood products, which are primarily represented by imported goods or have a high import share in their costs.

At the same time, inflationary pressures persisted, coming from the steady growth in consumer demand and production costs, wages in particular. This was reflected, in particular, in the acceleration of prices for services. The growth in raw food prices was spurred by this year’s poor harvest of some crops. Administered prices grew less rapidly, in part due to cheaper natural gas. Benign conditions in Ukraine’s FX market and a drop in global energy prices contributed to a decrease in fuel prices. The same factors continued to put downward pressure on producer prices, rising a slower 0.2% yoy.

Economic Activity

The Index of Key Sectors Output (IKSO) fell in October 2019 (by 2.6% yoy). Despite the ample harvest of grains, crop farming output fell as a result of both lower yields of some crops relative to last year and the faster harvesting campaign of the previous months. The increase in animal farming production, driven in particular by poultry production, offset the overall negative contribution of agriculture to some extent. The decline in industry deepened as well (to 5% yoy) due to a worsening in the performance of all of its core sectors. More specifically, in the manufacturing sector, metallurgy declined at a faster pace, driven by unfavorable external conditions. Production of food, beverages, and tobacco declined, as did machinery output. Sluggish demand from Ukrainian metallurgical industry and a decrease in global prices for metal ores led to a drop in their mining.

At the same time, the decline in the IKSO was restrained by improved construction performance, in part due to favorable weather conditions, trade, and transportation. The growth in retail trade turnover sped up (to 11% yoy) and continued to be driven by a sustained increase in household incomes (the average wage rose in nominal and real terms by 16.4% yoy and 9.2% yoy, respectively), and a further improvement in consumer confidence.

Fiscal Sector

In October, the state budget ran a deficit (of UAH 9.6 billion), as revenues fell and expenditures rose. Specifically, revenues were 2.4% lower than a year ago due to the reduced production of tobacco products, increased VAT refunds, and the weak growth in imports. Expenditure growth accelerated in October (to 12.4% yoy from 4.7% in September), driven by social spending, debt servicing expenditures, and capital expenditures. Local budgets recorded a small surplus (UAH 0.2 billion), as revenues increased and the growth in expenditures decelerated. As a result, the consolidated budget ran a deficit of UAH 9.4 billion.

Balance of Payments

The current account deficit narrowed in October compared to September (to USD 0.7 billion) in the absence of repayments on restructured external debt (which come due in March and September). The growth in merchandise exports (7.1% yoy) outpaced that in imports (2.9% yoy), contributing to the reduction in the merchandise trade deficit and current account deficit compared to October of last year.

The increase in merchandise exports was driven by high yields of grains and oilseeds, with their exports hitting an all-time high. In addition, the volume of deliveries of ferrous metallurgy products increased as well. Meanwhile, as global prices for metals and iron ore continued to decline in October, the growth in the value of exports decelerated. Import growth remained restrained by low energy prices, while the volume of energy purchases rose. The high level of access of agricultural companies to fertilizers and crop protection agents, combined with lower prices, contributed to a decrease in imports of chemical products. Imports of equipment for the construction of alternative energy facilities and grain elevator complexes remained significant. However, the growth in imports of machinery products decelerated due to an increase in last year's comparison base.

Financial account inflows declined in October, to USD 0.5 billion. More specifically, the banking sector's external assets increased, including through the redemption of domestic Treasury bonds and bills by the government. Debt and investment capital inflows to the real sector were offset to some extent by an increase in cash outside banks. Capital inflows to the government sector came from the government's scheduled borrowings. As a result, the balance of payments recorded a slight deficit (of USD 0.1 billion), while international reserves remained almost unchanged from September and stood at USD 21.4 billion or 3.4 months of future imports as of the end of October.

Monetary Conditions and Financial Markets

Hryvnia loan rates in Ukraine are gradually declining, primarily driven by the reduction in the NBU's key policy rate (including a 100 bp cut to 15.5% in late October).., In November, the UIIR declined, fluctuating slightly above the lower bound of the NBU's rate corridor for standing facilities. Expectation of a further rapid decline impacted the interest rates of longer-maturity assets. Most specifically, the yields on hryvnia domestic Treasury bonds and bills fell in November across all maturities, driven by strong demand. Hryvnia rates for nonfinancial corporations continued to fall in October, reacting to earlier cuts to the key policy rate. Despite the weaker response of household loan rates to the reduction in other market rates, the trend for them to increase that was seen in earlier months came to a halt: in October, they remained almost at the previous month's level ..

In November, the FX market continued to be dominated by an appreciation trend, which was driven by an increase in portfolio investments, an inflow of foreign currency from traditional export-oriented industries (in particular, agro-industrial complex), and the restrained demand for foreign currency from importers. The NBU continued to conduct FX interventions to replenish international reserves without counteracting market trends. In November, the NBU's positive net FX position as a result of transactions in the interbank FX market was USD 0.9 billion (and has been USD 5.0 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.