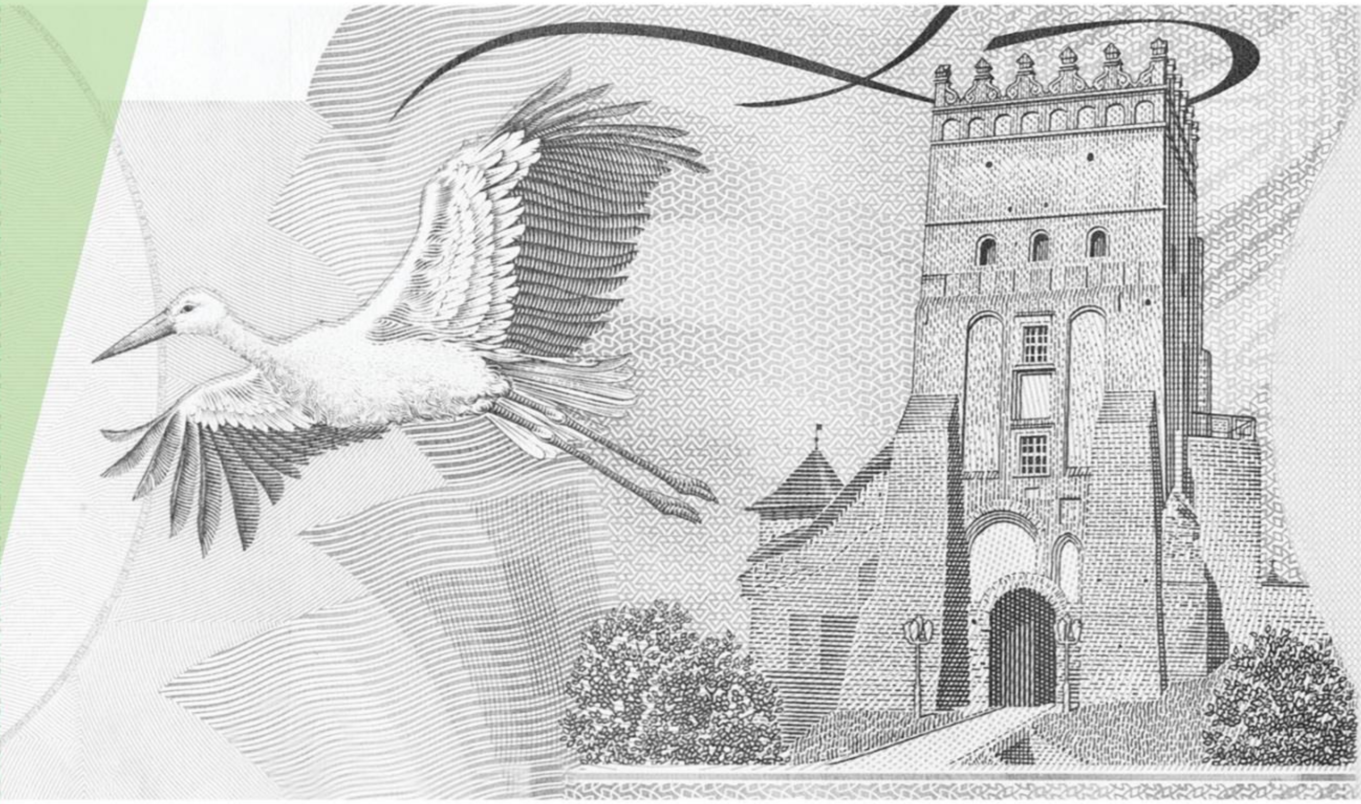
National Bank of Ukraine

Macroeconomic and Monetary Review

January 2020



Summary

External Environment

The expectations and the subsequent signing of the “phase-one” trade deal between the U.S. and China bolstered an upbeat sentiment in commodity and financial markets as 2020 began. Steel and iron ore prices also increased as China banned launching new steel production capacity in 2020 and poured more government funds into infrastructure projects. Wheat and corn prices were buoyed by logistical hurdles in France and Australia, an increase in export tariffs in Argentina and a chance of Russia imposing similar tariffs, and expectations that Ukraine's exports would fall in the second half of marketing year 2020. As a result, the External Commodity Price Index for commodities prevailing in Ukrainian exports increased. As tensions in the Middle East escalated, energy prices rose for a while at the start of the year, but subsequently adjusted downwards due to excess supply. Global prices edged lower across all commodities as coronavirus fears spread heading into the end of the month.

Positive sentiment prevailed in global financial markets, helped by progress in U.S.-China trade talks and better-than-expected leading economic indicators from the EU. However, the U.S. dollar strengthened as U.S. stock indices outpaced their EU peers. Most EM currencies weakened as a consequence.

Inflation

Consumer inflation reached the target of 5% ± 1 pp in 2019, slowing in December to 4.1% yoy (the lowest since April 2014). In monthly terms, the CPI decreased in December by 0.2% in what appears to be the first recorded incidence of deflation since observations started in 1991. The fall in inflation to its target in 2019 was mainly the outcome of the NBU’s consistent monetary policy, which aims to deliver price stability, coupled with the government’s prudent fiscal policy.

The hryvnia’s strengthening against the currencies of Ukraine’s MTPs was the main factor behind the inflation slowdown. This was primarily reflected in the easing of underlying inflationary pressures: core inflation decelerated to 3.9% yoy despite persistent pressure from the rapid growth in consumer demand and wages. Apart from the direct effect of the hryvnia appreciation against the currencies of Ukraine’s MTPs, core inflation was also driven by an uptick in inflation expectations. Other factors behind the disinflation were a drop in global energy prices and lower pressures from the supply of raw food products. Producer prices continued to decline (to 7.4% yoy in December), driven by lower global prices and cheaper inputs amid a strong hryvnia.

Economic Activity

The growth in the IKSO in 2019 slowed to 1.4%. Among the core sectors, construction, trade, transportation, and agriculture pushed the IKSO higher, while industry made a negative contribution. Specifically, the growth in construction accelerated (to 20.0%), in particular due to the active development of facilities for alternative energy generation and the modernization of a number of industrial companies. The increase in retail trade turnover sped up (to 10.5%), driven by sustained growth in household incomes (the average wage rose in nominal and real terms by 18.4% yoy and 9.8% yoy, respectively), and robust consumer confidence.

A relatively small increase in agriculture (1.1%) occurred as expected, despite bumper harvests of grains and sunflower. The reasons were a relatively high comparison base and weaker harvests of some other industrial crops (soybeans, potatoes, sugar beet). Industrial production fell by 1.8%. The drop was mainly driven by unfavorable external price conditions, which primarily affected metallurgy, by trade restrictions on machinery products from Russia, and by warm winter weather both at the beginning and at the end of the year. These factors precipitated the fall in the energy sector amid lower demand from other industries. On a positive note, the industrial decline was held back by the growth in the chemical and food industries.

Fiscal Sector

As expected, the state budget deficit in February amounted to UAH 43.2 billion, widening the cumulative deficit to UAH 78 billion. Revenues increased in December by 16.2% yoy, driven by steady revenues from the personal income tax, an early payout by Naftogaz of Ukraine PJSC of a part of 2019 dividends and taxes, an increase in VAT revenues (both from imported and domestic merchandise due to slightly smaller amounts of VAT refunds in December compared to average monthly amounts in previous months), and an increase in the proceeds from the domestic excise tax that preceded the scheduled hike in the excise tax on tobacco products. Despite the seasonally sizable mom growth in expenditures in December, they declined (by 2.2% yoy) from the same month a year ago. Compensation of employees and social security expenditures continued to rise, but capital expenditures and expenditures on goods and services, including imports, declined. As is typical for the month of December, local budgets ran a deficit (of UAH 34.2 billion). As a result, the consolidated budget recorded a deficit in December of UAH 6.2 billion, bringing the cumulative deficit to UAH 84.3 billion.

Balance of Payments

The current account ran a sizable surplus in November (USD 2.4 billion), primarily due to the receipt of outstanding compensation from Gazprom PJSC under the Stockholm Arbitration. However, this transaction was offset by changes in the assets of the public sector (as recorded in the central bank's account) and the banking sector, leaving the balance of payments unchanged.

The merchandise trade deficit widened slightly in December compared to November and December of last year. Merchandise exports returned to growth (1.4% yoy), fueled by record supplies of corn (and grains in general). Metallurgical exports nevertheless declined due to adverse global price conditions in previous months amid the launch of repair works by a number of companies. Merchandise imports also grew (by 7.9% yoy), overtaking the growth in exports. Imports of machinery products increased more rapidly due to deliveries of equipment for alternative energy generation and significant purchases of new and used cars. Robust consumer demand amid a strong hryvnia supported the rapid growth in imports of foods and industrial goods. The renewal of pipeline deliveries of diesel fuel from the Russia slowed the fall in energy imports.

The financial account inflows increased to USD 0.9 billion even though the receipt of outstanding compensation from Gazprom PJSC was recorded as a capital outflow. This was a consequence of large inflows of debt capital to the real sector and the continued inflow of nonresident investments in hryvnia Treasury bonds and bills. As a result, the overall balance of payments surplus increased (to USD 3.3 billion), bringing international reserves to a seven-year high of USD 23.5 billion or 3.8 months of future imports.

Monetary Conditions and Financial Markets

In January 2020, the NBU continued the cycle of monetary policy easing, reducing the key policy rate by 250 bp to 11.0%. The deeper key policy rate cuts were made possible by a substantial drop in inflationary pressure over the policy horizon due to, among other things, the hryvnia's strengthening in late 2019 and lower energy prices. Movements in the UIIR closely correlated with earlier key policy rate cuts. At the same time, the UIIR stayed close to the lower bound of the NBU's rate corridor for standing facilities due to a significant surplus in the banking system's liquidity. In particular, the yields of hryvnia Treasury bonds and bills continued to decline across all maturities. Hryvnia rates for bank customers continued to decrease in December, reacting to the overall downtrend in the cost of market resources.

The hryvnia depreciated in January amid seasonally low activity in the FX market as the year started. Although the NBU intervened both to buy and to sell foreign currency, the NBU's net FX purchases in January remained positive (USD 151 million).

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.