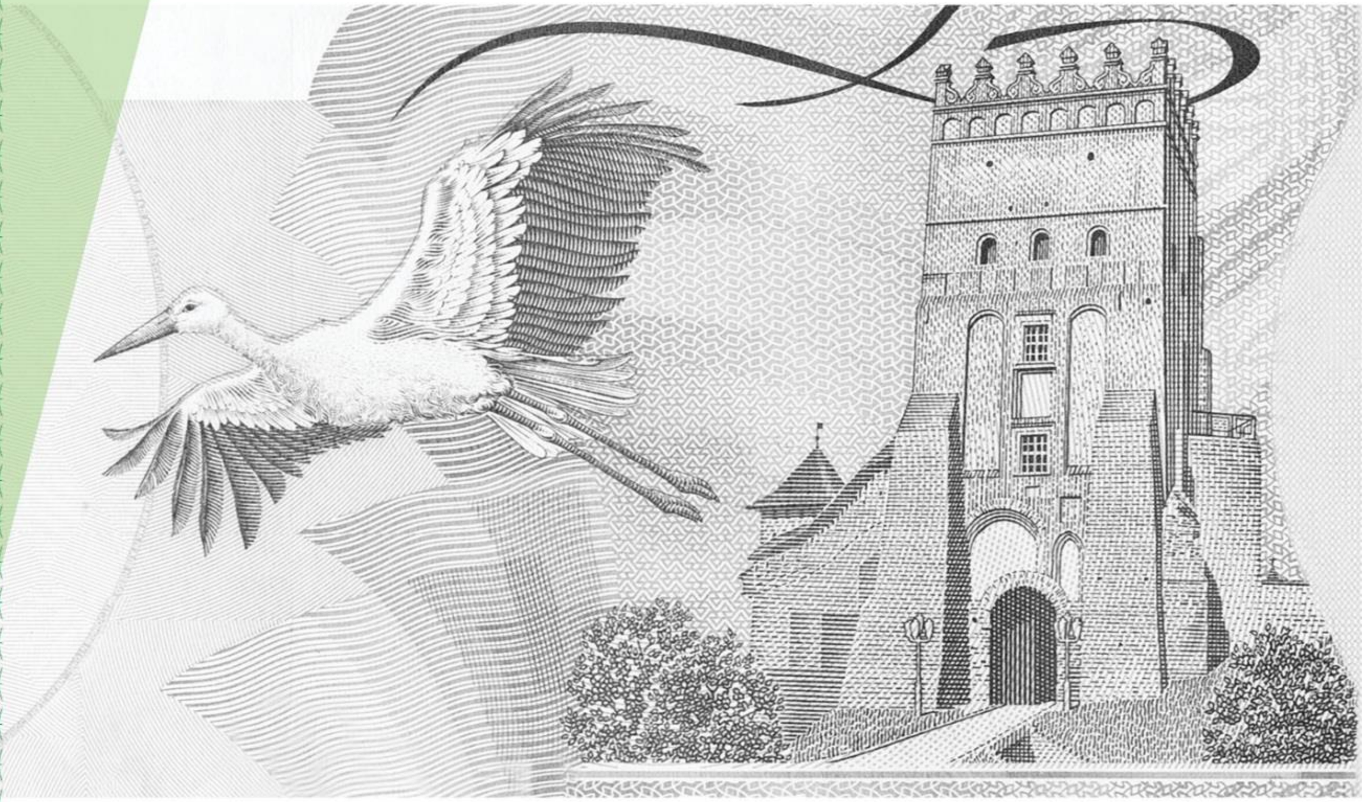
National Bank of Ukraine

Macroeconomic and Monetary Review

February 2020



Summary

External Environment

In February, global commodity and financial markets continued to reflect investors' fears that the coronavirus's spread may have a negative effect on the global economy. Global prices for most commodities edged lower. New Year celebrations in China headed into an extended weekend, significantly reducing demand for some goods – another factor that dragged down prices. Oil prices declined, held back from taking a deeper dive by supply disruptions from Libya and additional restrictions on production in OPEC+ countries. Lower steel and iron ore prices also reflected the drop in demand. Reduced ore shipments as heavy rains hit Brazil and Australia were the only reason why prices rose in late February. Wheat and corn prices fluctuated in a narrow band as high crop yields in the U.S., France, Ukraine, and Brazil outweighed Australia's poor harvest, which hit a 12-year low, and strong demand from ethanol producers.

Global financial markets were buoyed by better-than-expected macroeconomic data out of the U.S. and stimulus measures by the People's Bank of China. Yet investors fled to safe-haven assets as the coronavirus spread rapidly outside China in the last third of February. Most EM currencies depreciated as the events unfolded.

Inflation

In January 2020, consumer inflation slowed to 3.2% yoy (down from 4.1% in December). In monthly terms, prices grew by 0.2%. In January, the SSSU revised the CPI weights in a scheduled review to reflect an update of national accounts and a change in the regional structure. The revision had little to no effect on the annual CPI readings, which the NBU estimates changed by no more than 0.1 pp.

Inflation expectedly slipped below the lower bound of its 5% ± 1 pp target range, primarily owing to the ongoing impact of last year's hryvnia strengthening on consumer prices. This effect was amplified by lower global energy prices and a greater supply of raw food products. These factors outweighed the impact of rapid growth in consumer demand and wages. Improved inflation expectations also dampened inflationary pressure. As a result, core inflation slowed to 3.3% yoy.

Decline in producer prices decelerated to 5.9% yoy thanks to a slight improvement in the external price environment for Ukrainian exports and a slowdown in the fall in electricity prices in annual terms.

Economic Activity

Economic activity remained sluggish in January 2020 – the IKSO dropped by 3.4% yoy in annual terms. Among the key sectors making a negative contribution were industry, agriculture and transport. Despite a slight improvement in the external price environment, metallurgical output continued to drop in annual terms. Coal and energy production declined significantly, due to warm weather conditions. Mechanical engineering was adversely affected by a decrease in the number of orders for machinery products, such as wagons and locomotives, as well as machinery and equipment for other types of activities. In contrast, growth in the output of the chemicals and food industries held back the decline in the industrial sector.

Freight transportation volumes declined, primarily in the wake of a drop in gas transit volumes through Ukraine, because even the lower-than-expected contracted volumes were not used due to low demand for gas in Europe amid warm weather. A fall in agricultural output (data reflects only livestock breeding for the period from January through May) was driven by a decline in livestock production (in live weight) and milk production, which was only partially offset by an increase in egg production. Conversely, weather conditions were conducive to construction. Retail turnover growth accelerated, propped up further by the sustained growth in household income (average nominal and real wages increased by 16.3% yoy and 12.5% yoy respectively), and strong household consumer confidence.

Fiscal Sector

The state budget in January 2020 ran a deficit of UAH 15.3 billion. Revenues declined (by 6.6% yoy) due to both the negative effect of last year's high comparison base, when revenues had been boosted by one-off gains from the customs clearance of foreign-registered vehicles, and a number of economic factors, including a decline in imports and prices for certain imported goods, and a stronger hryvnia. Expenditures increased by a small 0.7% yoy as increases in compensation of employees and social security expenditures outbalanced reductions in current transfers and debt-servicing expenditures. As is customary for the month of January, local budgets recorded with a surplus (of UAH 13.5 billion). However, the consolidated budget ran a deficit (of UAH 3.1 billion) the same month, reflecting a significant state budget deficit.

Balance of Payments

The current account surplus in January, at USD 0.6 billion, was unchanged from last year's level, as a narrowing of the merchandise trade deficit outweighed the expected reduction in gas transit proceeds.

Merchandise exports increased by 2.3% yoy in January, primarily due to record deliveries of corn and sunflower oil. Iron ore exports, in particular to China, also rebounded due to shrinking shipments from Brazil and Australia. Shipments of ferrous metals increased compared to the previous month, but the year-on-year decline continued, including due to last year's high comparison base. Merchandise imports declined by 1.7% yoy in January, mainly due to energy imports. Imports of petroleum products fell, reflecting a drop in physical volumes as Belarus and several Russian oil refineries suspended deliveries of diesel fuel amid persistently low prices for these products. Coal purchases fell as the weather warmed up. In addition, the growth in imports of machinery products came to a halt due to the comparison base effect of the preferential customs clearance of cars early last year. Meanwhile, robust consumer demand and the hryvnia, which strengthened from last year, continued to drive the increase in imports of foods and industrial goods.

Unlike in previous years, the financial account recorded capital inflows (of USD 0.3 billion) in January, driven by public sector revenues. The bulk of capital inflows came from the issuance of 10-year Eurobonds and the sale of domestic government debt securities to nonresidents. At the same time, the private sector built up foreign assets and cut back on short-term liabilities. Specifically, the banking system's assets grew as the government redeemed FX domestic government debt securities and Naftogaz of Ukraine NJSC received guaranteed payments for the minimum gas transit capacity. Due to the overall balance of payments surplus (USD 0.9 billion), international reserves increased to USD 26.3 billion as of late January, covering 3.9 months of future imports.

Monetary Conditions and Financial Markets

At its January meeting, the NBU Board decided to speed up the pace of the monetary policy easing, cutting the key policy rate by 250 bp – to 11.0% – in a move that promotes economic growth and complies with the 5% inflation target. The UIIR, which moves closely in line with the key policy rate, also declined, continuing to stay close to the lower bound of the NBU's rate corridor for standing facilities. The sustained significant liquidity surplus of the banking system, driven by the narrowing of cash in circulation that typically occurs at the start of the year and lower government spending, was what pushed the UIIR closer to the lower boundary of the rate corridor. Following a significant drop in January, yields on domestic government debt securities remained virtually unchanged in February, due in large part to a worldwide trend that has seen foreign investors take a cautious approach to investing in risky assets as the Covid-19 outbreak has spread around the globe. In January, hryvnia rates for bank customers (except for household loans) declined in response to the overall downtrend in funding costs in the market.

Following a small correction in the FX market in January through early February, the hryvnia fluctuated around UAH 24.5 against the U.S. dollar. The NBU intervened in the interbank FX market, mainly to replenish international reserves. The NBU generated USD 0.7 billion in net FX purchases (USD 0.8 billion year-to-date).

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.