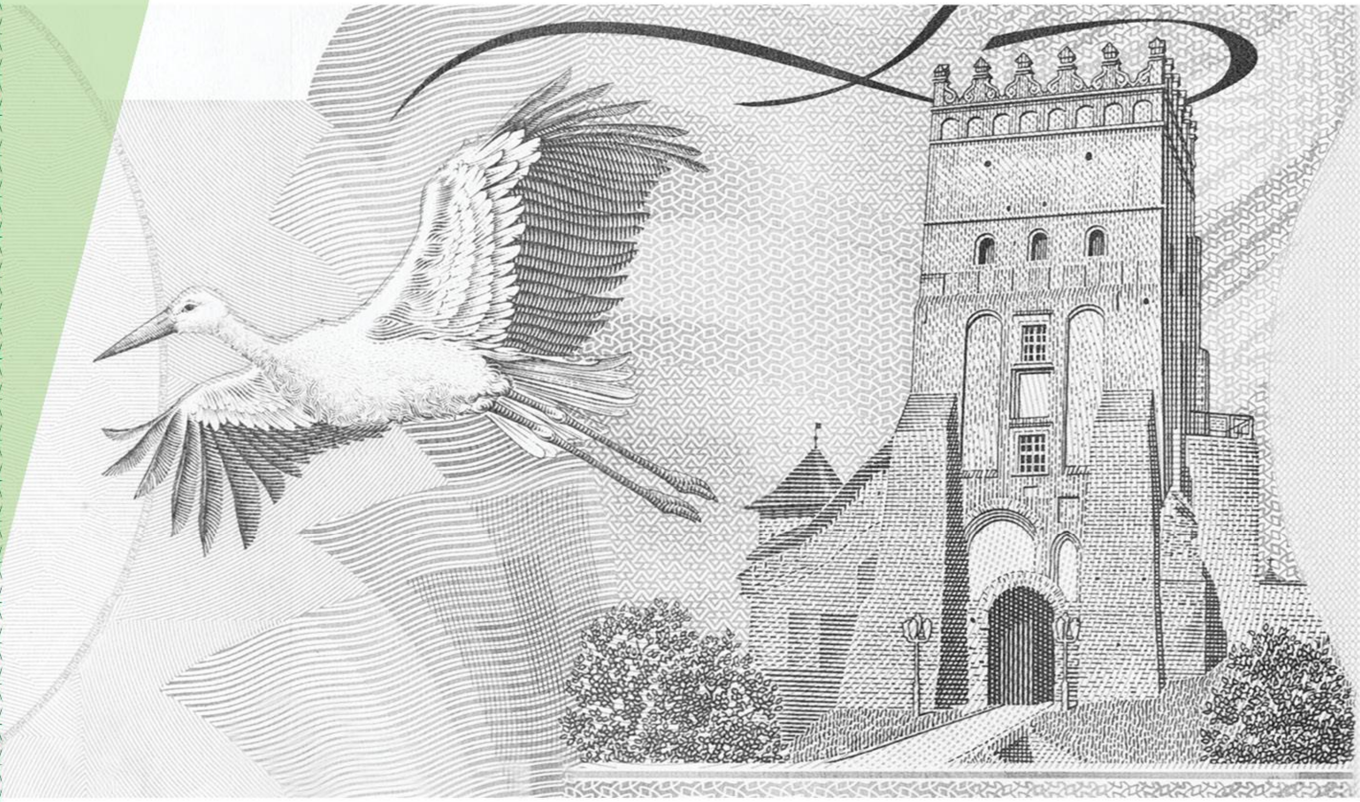
National Bank of Ukraine

Macroeconomic and Monetary Review

March 2020



Summary

External Environment

The rapid spread of the coronavirus pandemic in March and the restrictions imposed to combat it have affected conditions on the global commodity and financial markets. Another influencing factor was the virtual suspension of the OPEC+ agreement, after Russia refused to cut back on oil production. As a result, Saudi Arabia led OPEC members in flooding the market with oil and slashing prices for clients, and global oil prices plunged. Steel prices continued to decline as demand and business activity waned. Meanwhile, iron ore prices were supported at a relatively high level by dwindling supplies as a number of countries imposed quarantine restrictions and were affected by poor weather. Prices for grains, including wheat and corn, declined as the EU, Ukraine, and Argentina increased exports and harvest estimates for these countries were revised upwards. An uptick in demand in Europe, China, and several other countries, coupled with the logistical fallout from quarantine measures, drove prices for grains slightly higher at the end of the month. Nevertheless, the External Commodity Price Index that comprise external price developments on commodities prevailing in Ukraine's exports continued to decline.

Stock indexes tumbled the most since the global financial crisis as the coronavirus outbreak took the world by the storm and oil prices collapsed. Trading in stocks was halted on four occasions in March whenever the S&P 500 lost more than 7% of its value in a day –the first time this has happened since 1997. A cooling of investor appetite for risky assets also affected the emerging markets: capital outflows from these countries in the first three months of 2020 were comparable with the cumulative amount of capital inflows for 2019 (nearly USD 79 billion), while their currencies dropped in value significantly against the U.S. dollar.

Inflation

Consumer inflation decelerated to 2.4% yoy in February, down from 3.2% yoy in January. Core CPI decreased by 0.3% in monthly terms. Consumer inflation was below the 5% ± 1 pp target range, as expected. However, inflation continued to decline faster than according to the projected trajectory published in the January 2020 Inflation Report. Core inflation slowed to 3.0% yoy. Further disinflation was driven by the ongoing pass-through of last year's hryvnia appreciation on prices of goods, lower energy prices, and expanded supplies of raw foods. These factors outweighed the upward pressure on prices from steady increases in consumer demand and wages. The decline in producer prices deepened in February (to 6.8% yoy), primarily due to a drop in energy prices, which was driven by both a fall in global energy prices and a decrease in domestic demand due to warm weather.

Economic Activity

The fall in the IKSO slowed significantly in February 2020 (to 0.8% yoy) as industry and transportation improved their performance (trimming their declines to 1.5% yoy and 12.5% yoy, respectively). Metallurgy, for instance, showed lower paces of decrease amid shrinking supplies from China to the global market. Growth in the manufacture of foods, beverages, and tobacco products accelerated. The chemical industry reported output increases amid a further decline in the cost of raw materials, among other reasons. Production in the energy sector grew, thanks to some expansion in demand from the manufacturing industry and the similarity between this year's and last year's weather conditions. At the same time, engineering showed a steeper drop in output. The fall in freight transportation decelerated thanks to higher natural gas transit compared to January.

The increase in retail trade continued to speed up (to 15.7% yoy), driven by sustained growth in household incomes (the average wage rose in nominal and real terms by 15.0% yoy and 12.2% yoy, respectively) and still robust consumer confidence. Production volumes in agriculture increased (by 1% yoy), primarily due to poultry farming. However, the manufacture of construction products declined for the first time since 2016 (by 4.2% yoy), due to a drop in the construction of engineering structures, in particular because of limited government financing, and the continuing downturn in housing construction. Wholesale trade turnover also went down (by 3.1% yoy), largely reflecting a decrease in imports of fuel and coal.

Fiscal Sector

The state budget deficit narrowed in February 2020 to UAH 6.4 billion as revenues grew. Revenues gained 2.3% yoy even as they continued to be weighed down by lower imports and falls in prices for certain imported goods. The increase in revenues was driven by a steady rise in nominal wages, the resumption of tobacco production, the return of VAT refunds to a level just shy of last year's monthly average, and improvements in the way this tax is administered. Expenditure growth accelerated (to 8.0% yoy), fueled by social spending, the use of goods and services, and debt servicing expenditures. Local budgets ran a surplus (of UAH 6.9 billion in February), as normally happens in the early months of the year. As a result, the consolidated budget showed a small surplus.

Balance of Payments

The current account ran a marginal deficit (of USD 0.2 billion) in February. This outcome, however, was better than in February last year, owing to a narrowing of the merchandise trade deficit and a widening of the services trade surplus, which outweighed the increase in scheduled external debt servicing expenditures.

The worsening of the external price environment and the quarantine measures introduced by China have yet to be reflected in the performance of Ukraine's foreign trade in goods. Exports continued to grow (adding 1.2% yoy). Exports of sunflower oil and iron ore continued to grow at a high pace. The fall in metallurgical exports decelerated significantly, mainly due to the fading effect of a high comparison base. This completely offset the expected decrease in grain deliveries. The fall in merchandise imports deepened (to 4.7% yoy), mainly due to lower imports of machinery products against a high comparison base (primarily due to the preferential customs clearance of used cars last year). Although Ukraine increased its natural gas purchases for the second month running, energy imports extended their decline. The decrease was driven by the further reduction in global energy prices, lower diesel imports as Belarusian refineries held back on shipments and coal imports fell amid warm weather and high reserves. Imports of foods and industrial goods continued to rise at a steady pace.

Net financial account inflows increased to USD 0.9 billion, driven by capital inflows into the real sector. Specifically, FDI inflows increased to USD 0.25 billion. In addition, Vodafone Ukraine conducted a Eurobond placement in a bid to refinance short-term liabilities. Net capital inflows into the government sector were marginal. The growth in the external assets of the banking sector was relatively insignificant as well. Thanks to the overall balance of payments surplus (USD 0.7 billion) and despite scheduled repayments on IMF loans, international reserves increased, to USD 27 billion, and now cover four months of future imports.

Monetary Conditions and Financial Markets

At its March meeting, the NBU Board cut the key policy rate by 100 bp – to 10.0%. The NBU Board has moved to ease monetary policy due to inflationary pressure abating faster than expected and economic growth being in need of support amid risks that the global economy may cool off.

Deteriorating conditions in the global financial and commodity markets, combined with heightened uncertainty in the domestic market, triggered a surge in FX market turbulence. These same reasons led to higher yields on hryvnia government debt securities. Under these conditions, the MoF in March primarily sold FX domestic government debt securities. The NBU stepped up efforts to intervene in the FX market to smooth out excessive exchange rate fluctuations, while not counteracting market trends. Net FX sales amounted to USD 2.2 billion in March (USD 1.4 billion year-to-date). The hryvnia weakened by 7.4% in March from February as measured by the average UAH/USD exchange rate, ending the month 14.3% lower against the U.S. dollar. On the other hand, most of the currencies of Ukraine's main trading partners also depreciated against the U.S. dollar. As a result, the NEER weakened by a moderate 4.2%.

The speed with which events unfolded after the coronavirus began to spread created liquidity gaps in some banks and triggered demand for interbank lending resources. As a result, the UIIR increased and breached the NBU's rate corridor for standing facilities halfway into March. To promote financial stability, the NBU modified the operational framework of its monetary policy, launched long-term refinancing loans for banks, injected FX cash into banks to support them, extended capital buffer deadlines for them, and prompted banks to introduce a special grace period for loan repayments by individuals and businesses (also known as a loan break), among other measures.

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.