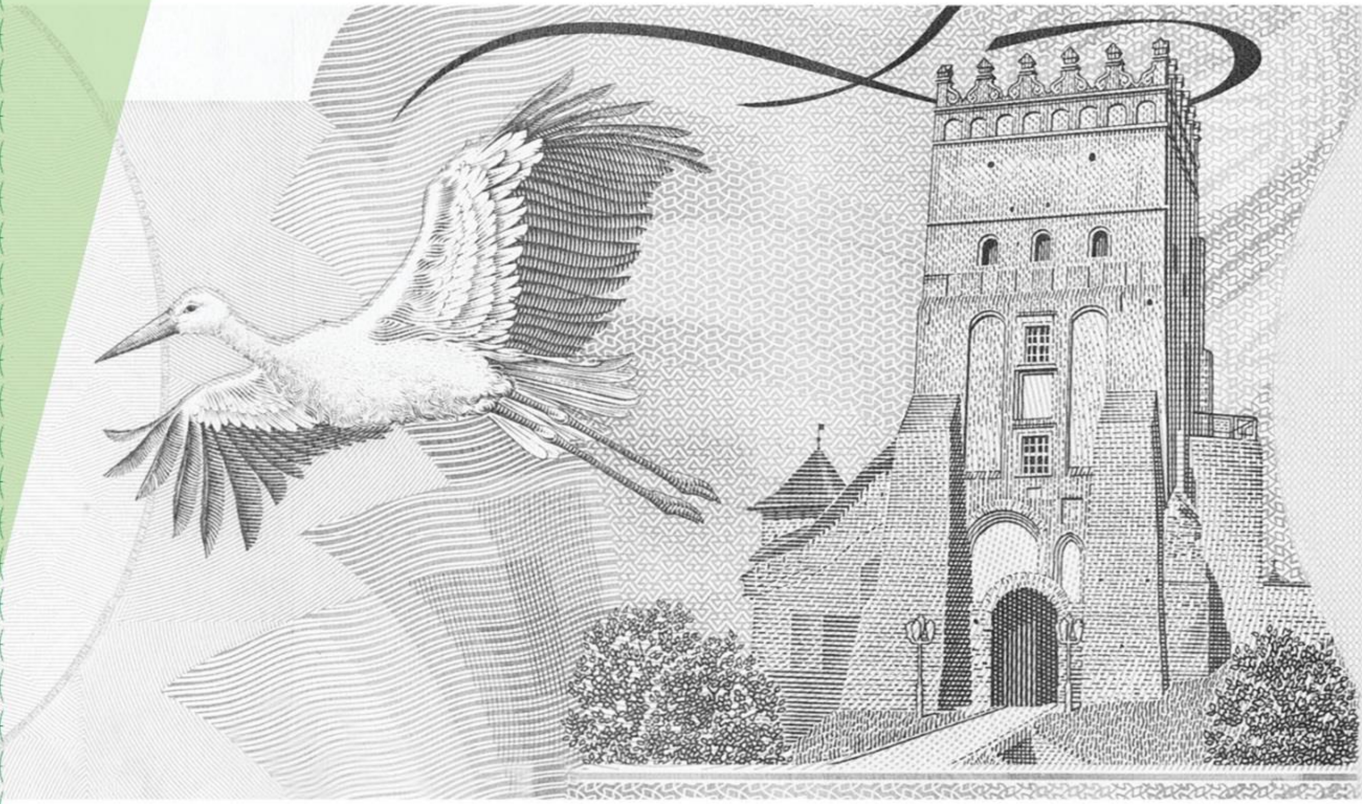
National Bank of Ukraine

Macroeconomic and Monetary Review

June 2020



Summary

External Environment

In June, optimism over the gradual easing of quarantine restrictions in a number of countries was partly overshadowed by growing fears amid heightened uncertainty about COVID-19 spread. This restrained the growth in prices in the global commodity markets and led to a correction in the global financial markets. Against the backdrop of the strictest production cuts under OPEC+ deal, oil prices hovered around USD 40 per barrel. Steel prices were supported by China's economic recovery and rising iron ore prices amid a drop in production in Brazil, which leads the world in terms of the spread of COVID-19. Unlike in previous periods, prices for grains, in particular wheat and corn, moved in opposite directions. Wheat prices edged lower ahead of the upcoming delivery of newly harvested crops to the market. In contrast, corn prices crept up as the current marketing year's inventories of this crop dwindled and demand strengthened.

Stock indexes fell on increasing uncertainty of the pandemic and continuing social unrest in the U.S. However, further economic stimulus from the Fed and a number of EU countries, primarily Germany, supported the markets. As a result, investor appetite for risky assets, including EM ones, has remained volatile, while EM currencies movements against the U.S. dollar varied depending on the macroeconomic environment.

Inflation

In May 2020, consumer inflation declined to 1.7% in annual terms, down from 2.1% in April. In monthly terms, prices grew by 0.3%. As expected, consumer inflation stayed below the 5% ± 1 pp target range.

Price growth was constrained by the continued benign FX market conditions and weaker consumer demand for most goods and services. As a result, core inflation was little changed from April, at 3.0% yoy. In addition, price growth was restrained by the further decrease in prices for energy (both oil and natural gas). These factors outweighed the effects of the faster growth in prices for some raw food products driven by limited supply and poorer livestock farming performance.

In May 2020, the fall in producer prices deepened (to 5.1% yoy) as prices for exported goods and energy declined, pulling down prices in the metals and mining industry, the manufacture of coke and petroleum products, and the chemical industry.

Economic Activity

In May, the decline in the IKSO slowed to 8.9% yoy (from 15.4% yoy in April) as economic activity gradually recovered, both in Ukraine and abroad, after quarantine restrictions were eased. However, a number of measures limiting the operation of individual sectors were left in place, remaining a major factor behind the economic downturn.

The decline in industry slowed to 12.2% yoy. A moderate strengthening of external demand amid optimism inspired by the gradual easing of the lockdown and rising budget expenditures on certain metallurgical products and machinery (including medical equipment and military products) relieved the slump in metallurgy, mining, and engineering. Yet the decline in the manufacture of motor vehicles and equipment for other industries (metallurgy, agriculture, railways) continued to be deep, signaling that domestic demand remained weak. As panic demand for antiseptics and drugs faded, production in the pharmaceutical industry started growing more slowly. The contraction in the chemical industry resumed after producers of fertilizers and cleaning agents scaled down production.

With consumer sentiment and wage growth improving and nonfood stores and markets reopening, the recovery in household demand slowed the decline in retail trade (to 3.1% yoy). A pick-up in activity led to lower paces of declines in electricity generation (to 8.2% yoy) and freight turnover (to 26% yoy), and put wholesale trade back on a growth track (1.6% yoy). The plunge in passenger turnover, though less steep than before, was still significant (up to 92.3% yoy), as railway and local transportation remained under lockdown for most of the month. On top of that, owing to the drop in the manufacture of all livestock farming products, the contraction in agriculture deepened to 4.0% yoy. Growing capital expenditures from the state budget helped slow the fall in construction (to 2.6% yoy).

Labor Market

The slowing of the decline in core industries buoyed the labor market somewhat, although labor demand remained weaker than before the lockdown was imposed. In particular, the growth in average wages edged up to 3.0% yoy in nominal terms and returned to growth in real terms (1.4% yoy). The increase in wages was also driven by wage supplements for healthcare workers treating COVID-19 patients. In addition, households' income was supported by social budget expenditures, through both the indexation of pensions in May and the automatic renewal of housing and utility subsidies.

Fiscal Sector

In May 2020, the state budget ran a significant deficit of UAH 24.5 billion. Budget revenues continued to decline (by 29.5% yoy) due to subdued economic activity and comparison base effects (this year, the NBU transferred all of its distributable profit to the state budget in April, whereas in May 2019 it only made a partial transfer). On the other hand, state budget expenditures continued to rise (by 2.7% yoy), driven by the increased support of the Pension Fund, healthcare expenditures, and road maintenance and construction. Local budgets went back into surplus (UAH 3.2 billion), but because of a significant state budget deficit, the consolidated budget recorded a deficit as well.

Balance of Payments[1]

As expected, the trade in goods balance in May moved back into deficit as exports of goods fell amid shrinking inventories of some crops. With further decrease in natural gas prices, delays in the public procurement of medicines, and subdued domestic demand, however, the decline in imports of goods deepened, resulting in a minor goods trade deficit. Given the sizable primary income surplus and the continued surplus in the services trade, the current account ended with a significant surplus of USD 1.4 billion.

Merchandise exports fell by almost a quarter from last year. Tighter competition from South American countries and the drawdown of previously harvested crops led to a significant reduction in maize and soybean exports, which was only partially offset by further increases in wheat and sunflower oil supplies. , Metallurgical exports continued to fall, weighed down by a narrow global demand, while iron ore exports declined as China curtailed its purchases of this commodity compared to April. Merchandise imports continued to plunge (by 35.5% yoy), primarily due to a drop in imports of energy and machinery products, most consumer goods, and energy. Furthermore, the decline in imports of chemicals also deepened, in part because of delays in the public procurement of medicines.

Financial account outflows increased to USD 1.7 billion in May after the government paid USD 1 billion in scheduled Eurobond repayments. The decrease in the volume of hryvnia government securities held by nonresidents was unchanged from previous months at USD 0.3 billion. Capital outflows from the private sector were somewhat lower compared to April, primarily due to slower growth in cash outside banks. Financial account outflows marginally surpassed the current account surplus. As a result, international reserves decreased by 1.2% mom, to USD 25.4 billion, covering 4.4 months of future imports as of late May.

Monetary Conditions and Financial Markets

In a scheduled monetary policy meeting, the NBU Board slashed the key policy rate by 200 bp to a historical low of 6% in nominal terms. The move to accelerate the monetary policy easing was motivated by the signs that consumer and investment demand was very likely to remain subdued for longer than forecast before. On the one hand, this will keep inflation below the target level for longer than projected in the April forecast. On the other hand, this means that the Ukrainian economy will face a deeper contraction than expected.. Simultaneously, the interest rate corridor for standing facilities was narrowed to ± 1 pp from ± 2 pp , allowing the NBU to achieve the operational target of monetary policy more effectively given the historically low key policy rate .

The interbank rates index, which closely correlates with the key policy rate, also declined, almost equaling this rate. Against the backdrop of the NBU's monetary policy easing efforts, the recovery in demand for hryvnia government debt securities contributed to the decrease in the yields on these securities in both the primary and secondary markets. In May, hryvnia rates on loans and deposits for bank customers declined in response to the overall downtrend in funding costs in the market. At the same time, the inflow of funds into banks continued, and the outstanding amount of hryvnia deposits exceeded pre-crisis levels. The slump in economic

[1] The balance of payments data presented here and below take into account the reinvested earnings added after the NBU revised its FDI data compilation methodology.

activity and the decline in household consumption resulted in outstanding loans declining in May from April.

Appreciation pressures continued to prevail in the FX market in June as FX supply surpassed demand, allowing the NBU to continue to buy foreign currency to replenish international reserves. Based on data for June, the NBU generated USD 1.2 billion in net FX purchases (USD 1.1 billion year-to-date). The NBU's FX purchases were a key source of liquidity for the banking system. However, due to the accumulation of funds on the government accounts and the growth in cash, the banking system liquidity narrowed.