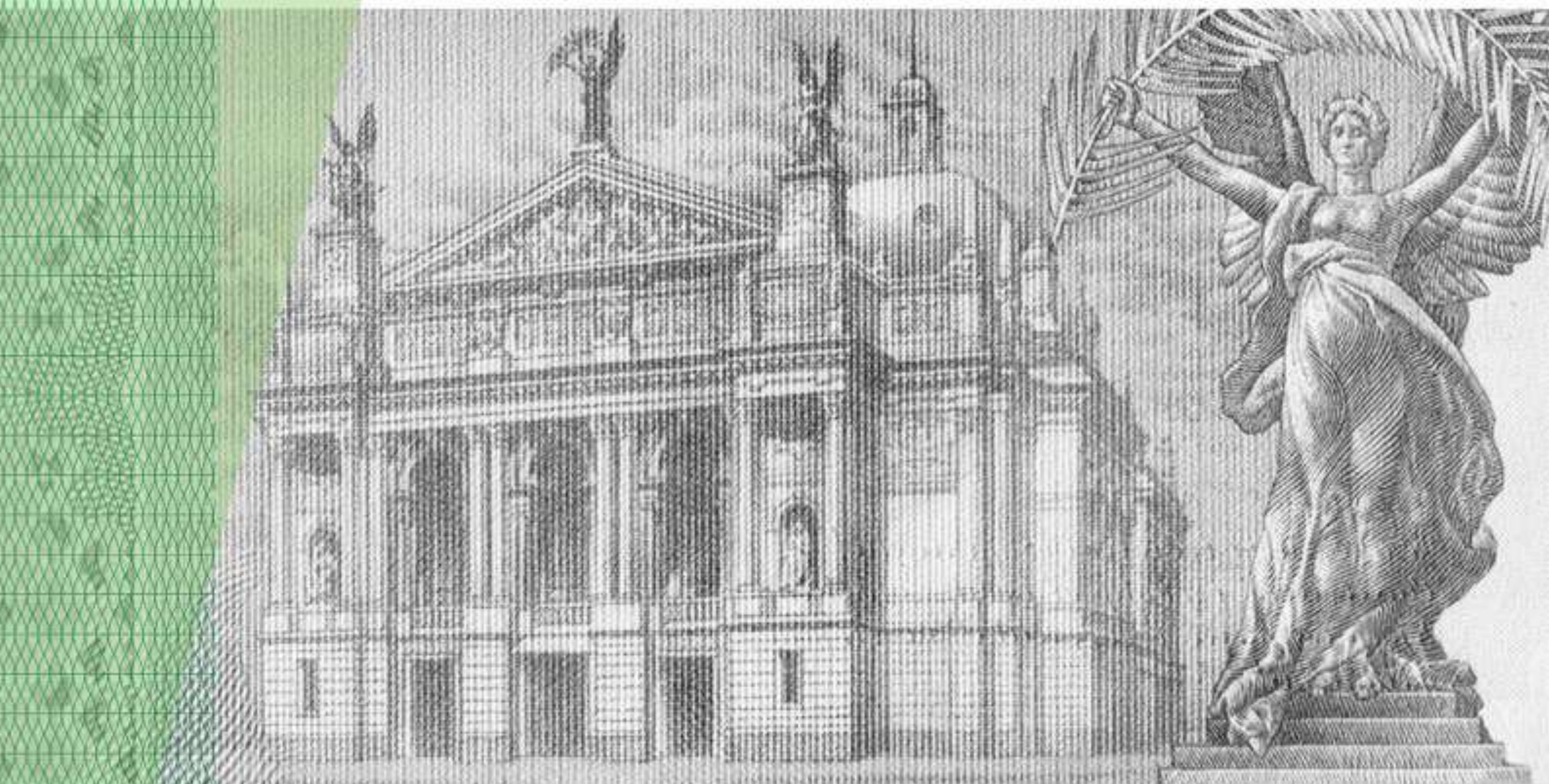
National Bank of Ukraine

Inflation Report

October 2018



PREFACE

The Inflation Report reflects the opinion of the National Bank of Ukraine (NBU) regarding the current and future economic state of Ukraine with a focus on inflationary developments that form the basis for monetary policy decision-making. The NBU publishes the Inflation Report quarterly in accordance with forecast frequency.

The publication of the macroeconomic forecast and its underlying assumptions aims at strengthening the transparency and predictability of the NBU's monetary policy. This should enhance society's confidence, an important prerequisite for anchoring inflation expectations and achieving price stability, which is the NBU's priority.

The Monetary Policy and Economic Analysis Department developed forecasts of inflation and other macroeconomic variables. The NBU Board approved the forecasts during a meeting devoted to monetary policy issues on 25 October 2018.[1] Macroeconomic projections, including inflation, comprise the principal input, but not the only one, the NBU Board considers in its decision-making. In addition to the projections of inflation and other macroeconomic variables, the NBU Board takes into account any new information appearing after the forecast has been developed. The assessment of risks to the outlook or relations between macroeconomic parameters may vary between members of the NBU Board.

The analysis in the Inflation Report is based on the macroeconomic data available at the date of its preparation; therefore, the time horizon of the analysis for some indicators may vary. This report used 24 October 2018 as the cut-off date for the data.

The Inflation Report is a translation of the original Report in Ukrainian. In case of any discrepancies between the original document and its translation to English, readers should consider the Ukrainian version of the Report as correct.

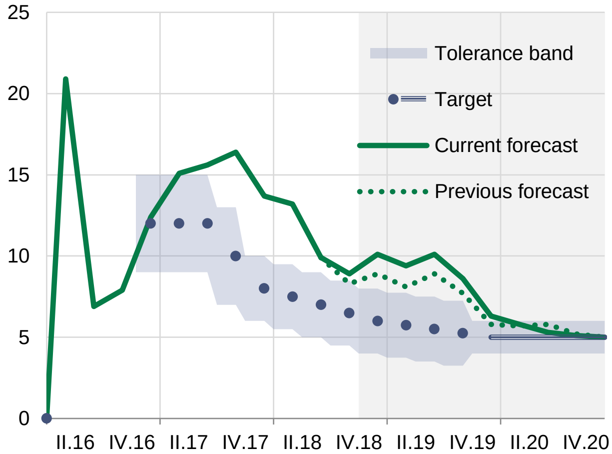
[1] NBU Board Decision No. 715-D as of 25 October 2018 *On the Approval of the Inflation Report.*

SUMMARY

Consumer price inflation continued to decline

In Q3 2018, consumer price inflation gradually decelerated (to 8.9% yoy in September), closely approaching the upper bound of the target range set by the Monetary Policy Guidelines for 2018 and the Medium Term (6.5% ± 2 pp as of the end of Q3 2018). However, the decrease in inflation was slower than the NBU had predicted in its July 2018 Inflation Report.

CPI, %



Source: SSSU, NBU.

Headline inflation slowdown was driven by weaker growth in food prices amid more ample supply of domestic and imported foods and a decline in global food prices. However, the underlying inflationary pressure remained significant, while growth in administered and fuel prices accelerated.

Core inflation slowed moderately (to 8.7% yoy), exceeding the forecast as well. As in previous months, consumer demand and a further rise in production costs – including those of labor and energy – continued to exert upward pressure on prices. Thus, household income in Ukraine grew rapidly, outpacing GDP growth by a wide margin. In August, for instance, the average monthly wages in nominal terms in Ukraine were 26% higher than last year. The growth in household income was additionally driven by an increase in social benefits (higher pensions for military pensioners, and the continued effects of modernization of pensions at the end of 2017).

The surge in global oil prices and the weakening of the hryvnia in recent months drove up domestic fuel prices, which were passed through to costs of other goods and services. Specifically, growth in administered prices accelerated, driven by higher fuel and labor costs, even as the government delayed raising household gas prices.

The hryvnia weakening against the US dollar in July - August affected the prices of certain goods, primarily imported ones. The FX market experienced heightened turbulence in Q3 2018 amid higher demand from energy importers, a typical development ahead of the fall months. In addition, market sentiments deteriorated after the IMF postponed the disbursement of financial assistance and global markets conditions worsened. Emerging market assets continued to lose their appeal to investors amid a further monetary policy tightening by the Fed. This caused emerging market currencies to depreciate against the US dollar, triggering financial instability in the most vulnerable countries (such as Turkey). Moreover, Ukraine saw a deterioration in its terms of trade amid falling prices for steel, sunflower oil, and corn and sharply rising crude oil prices.

The heightened FX market turbulence, along with the surging fuel prices, the announced increase in gas and other utility tariffs, and the run-up to presidential and parliamentary elections next year fueled inflation expectations. Inflation expectations of households and banks deteriorated, while those of professional forecasters and businesses remained high, and far above the NBU's inflation targets.

The fiscal policy impact on aggregate demand in the first nine months of 2018 is seen as rather moderate. The consolidated budget reported a surplus, formed as a result of gradually improving revenues and a marked slowdown in expenditures in Q3. The rapid growth in household income, a rise in corporate earnings, a recovery in the production of excisable goods, and a rise in imports all contributed to improved revenue performance.

The rising risks to bringing inflation back to the medium-term target necessitated monetary policy tightening in Q3 2018. The NBU raised the key policy rate by a total of 100 bp, to 18.0% per annum. The key policy rate hikes effectively transmitted into higher market interest rates on hryvnia instruments and domestic government bond yields. In real terms, yields on hryvnia-denominated bonds remained some of the highest among the emerging markets, which stemmed portfolio investment outflows as investor interest in emerging market assets waned. Along with that, banks retail interest rates have yet to adjust to fully reflect the effects of the key policy rate hikes and higher interest rates in the interbank market.

Consumer price inflation will continue to decelerate, but it will take longer to return it to the target range

The NBU revised its 2018 inflation forecast upwards to 10.1% (from previous 8.9%). This resulted from higher – than – projected global energy and wheat prices, and stronger growth in wages in Ukraine (compared to the July forecast).

The expansion in consumer demand, rapid wage growth, and the recent spike in crude oil prices will continue to impact consumer price inflation next year. This will keep inflation above the target range for longer than it was projected before. By the end of 2019, inflation will decline to 6.3%. It will enter the target range in Q1 2020, and reach the medium-term target of 5.0% at the end of 2020.

The tight monetary conditions, which resulted, inter alia, from the key policy rate hikes in the first three quarters of 2018, will be a major contributor to the slowdown in inflation. Furthermore, the drop in inflation will be driven by other factors that are restraining the growth in consumer demand, including:

- the further pass-through of the past key policy rate hikes to interest rates on hryvnia-denominated household deposits; these effects will be reinforced by the shrinking liquidity surplus in the banking system. In turn, the growth in deposit rates will provide incentives for households to increase their propensity to save;

- the deceleration in wage growth as migration processes decline in intensity, including (unlike in the past two years) through the saturation of the labor market in Poland.

In addition, prudent fiscal policy given the need to repay significant amounts of public debt and improved inflationary and exchange rate expectations will help contain price growth. The expectations will be favorably impacted by the progress in cooperating with official lenders, in particular the launch of a new arrangement with the IMF, which will carry over into the next year.

As a result, core inflation will decelerate from 7.9% at the end of this year to 5.1% in 2019, and to 3.6% in 2020.

Raw food inflation will decrease markedly this year, to 4.9%, as last year's supply shocks wear off, including those related to the strong growth in exports of some Ukrainian goods. Raw food inflation will continue to decelerate in 2019–2020, to 4% and 3.1%, respectively, dragged down by moderating global food prices.

Administered prices are expected to increase by 18.4% in 2018. The acceleration from the current level will reflect the effect of the planned hike in household gas prices and that of increased rates for heating and hot water. In 2019–2020, the growth in administered prices will decelerate to 11.7% and 10.8%, respectively. Their more rapid growth (relative to other components of the CPI) is fueled by the further gradual rise in gas prices towards the import parity price and by excise tax increases in subsequent budget periods.

As a result of the significant oil price increase since the start of the year, this year's forecast of fuel price growth has been revised to 17.5% with a further deceleration to 7.4% and 5% in the following years, primarily reflecting changes in global oil prices in hryvnia equivalent.

In 2018, GDP growth is driven by agriculture and sectors relying on domestic demand

In Q2 2018, real GDP growth accelerated to 3.8% yoy. The higher-than-expected GDP growth rates can be attributed to the early start to the harvesting campaign this year, which was reflected in the sharp rise in the gross value added (GVA) of agriculture.

As expected, domestic demand – mainly consumer demand – continued to be the main driver of real GDP growth, fueled by higher household income and improved consumer sentiment. This in turn, led to GVA growth in the transportation, trade and services sectors. An additional factor in Q2 was a noticeable acceleration in the growth in public spending, in particular on utility subsidies. Investment growth remained strong amid high business expectations.

The pickup in economic activity and strong business expectations sustained buoyant demand for labor . As a result, the unemployment rate fell sharply in Q2. In addition, following a prolonged decline, the labor supply also rose in H1 2018 as people looked for jobs more actively due to an increase in the required period of service to qualify for pensions, and strong wage growth.

Ukraine's economic growth slowed somewhat in Q3 2018, to 3.1% yoy, according to the NBU's estimates, amid weaker performance in most key economic sectors. In particular, lower yields of early grain crops adversely affected the agricultural performance. Less favorable conditions on the external markets, repairs at some metallurgical plants, as well as difficulties in transporting cargo held back the growth of industrial sector.These same factors dampened exports. Meanwhile, remittances from labor migrants increased further, which together with higher wages and social payments spurred consumer demand and imports.

As a result, the current account deficit widened significantly, to USD 2.1 billion in January – August. Rising dividend payments were another contributor to the widening.

The current account deficit was offset by financial account inflows. The net liabilities of the public sector grew, owing to foreign investors' interest in hryvnia securities at the start of the year and the issue of discount sovereign Eurobonds in August. Capital inflows to the private sector mainly resulted from foreign direct investment and long-term borrowings. Although overall BOP showed a small surplus, international reserves had shrunk because of repayments of IMF loans, standing at USD 16.6 billion as of the end of September 2018, or 2.8 months of future imports.

After speeding up in 2018, economic growth will slightly decelerate

As before, the NBU expects economic growth to accelerate in 2018, to 3.4%. The growth will continue to be bolstered mainly by private consumption, as household income will rise further, driven by strong growth in wages, pension payments, and remittances from abroad. Companies will also continue to invest actively.

In the current year, fiscal policy will have a mildly stimulative effect on economic growth, mainly through higher public spending on social payments. Q4 is expected to see a noticeable easing in fiscal policy once the government gets greater access to the external markets to finance its deficit following the resumption of cooperation with the IMF. In this light, the overall general government deficit is expected to rise to 2% of GDP.

In 2019, real GDP growth is set to decelerate to 2.5%, due to a slowdown in the global economy, worsened price conditions in global commodity markets, tighter fiscal policy given large public debt repayments, as well as tight monetary policy required to bring inflation back to its target.

In 2020, economic growth will speed up to 2.9%. The growth will be fueled by a gradual easing in monetary policy, which will become possible after inflation stabilizes at a level close to the target, as well as by the economy's greater investment attractiveness.

The budget deficit is expected to be 1.5% of GDP in 2019 – 2020. Public and publicly guaranteed debt will decrease over the forecast horizon, down to 60% of GDP in 2020. This will be due to the rapid nominal GDP growth , moderate exchange rate volatility, and a gradual decline in the share of external public debt as large debt repayments are made.

External accounts will be largely balanced in 2019 – 2020. The current account deficit will continue to hover between 2.5% and 3% of GDP, and will be offset by official financing and private capital inflows.

The key assumption underlying the macroeconomic forecast is the continued cooperation of Ukraine with the International Monetary Fund under a new Stand-By Arrangement. Loans from the IMF and other official lenders will secure access to the international capital markets over the forecast horizon, and will help rollover a portion of the debt, with the repayments peaking in 2019 – 2020. This will improve the expectations of economic agents and promote macrofinancial stability.

In Q4 2018, the overall balance of payments surplus, coupled with IMF loans, will push up international reserves to USD 19.2 billion, or 3.2 months of future imports. In 2019 -2020, international reserves will remain at virtually the same level.

A further deterioration in expectations and external conditions poses the major risk to the forecast

A worsening of depreciation and inflation expectations poses the major risk that could materialize due to the heightened uncertainty, as is usually the case when a new political cycle begins.

Another major risk to the baseline scenario is that external conditions will deteriorate. Any escalation of trade wars between the largest global economies (mainly the United States and China) could slow global trade and cause oversupply of raw commodities with the corresponding downward pressure on prices. In this case, or if access to some markets is restricted, Ukraine's foreign currency proceeds from exports will decline, which will put pressure on the hryvnia exchange rate and, hence, drive up inflation. There also remains a considerable uncertainty as to the scale of global energy price rises. A rather rapid monetary policy normalization by the major central banks increases the risk of a potential global economic downturn and capital outflows from emerging markets, including Ukraine.

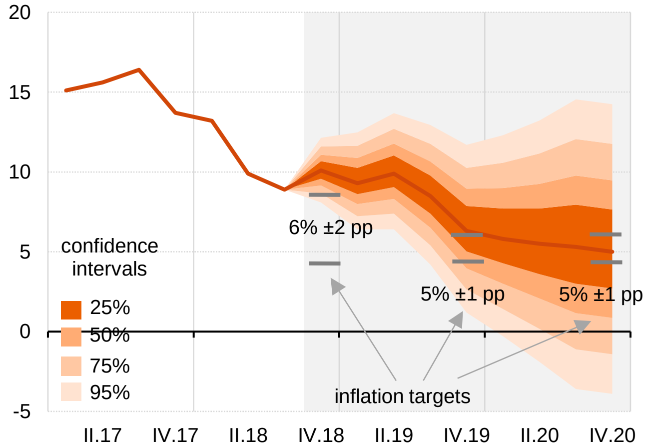
Another important remaining risk is that labor migration intensifies. Labor migration to Poland is expected to decline in intensity in the medium term, given the forecast deceleration of Poland's economic growth, and the weakening interest of Polish employers in hiring Ukrainian workers. However, there remains a risk that labor migration to other European countries, such as the Czech Republic and Germany, will intensify after plans to simplify employment procedures for foreigners were announced in these countries. Outflow of the labor force from Ukraine is exacerbating the mismatches between supply and demand on the labor market with subsequent wage increases, and local shortages of qualified staff, thereby restraining the potential for economic growth and putting pressure on the economy - wide price level.

Current and projected monetary conditions are tight enough to reduce inflation in the mid-term

Guided by a revised macroeconomic forecast and risk assessments, on 25 October 2018 the NBU Board decided to leave the key policy rate unchanged, at 18% per annum.The NBU has currently decided not to tighten monetary policy further in order to balance the need to bring inflation back to its target and support economic growth.

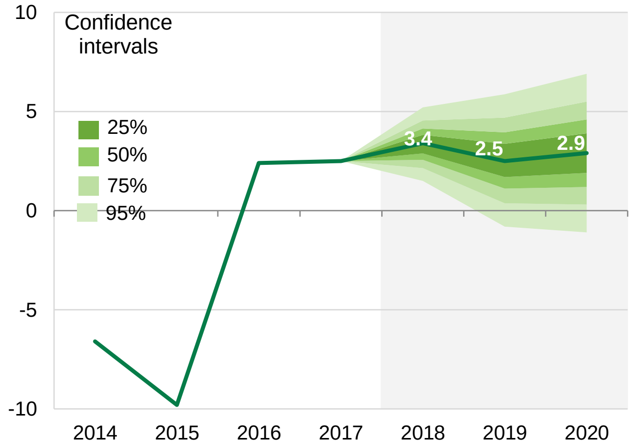
However, should inflationary pressures continue unabated or even intensify, driven by pro-inflationary fundamental factors, such as consumer demand, inflation expectations, and a lack of progress in cooperating with international official lenders, the NBU may deem it appropriate to tighten monetary policy further by raising the key policy rate.

CPI Growth Forecast and Targets, % yoy



Source: NBU.

Real GDP Growth, % yoy



Source: NBU.

Macroeconomic forecast (October 2018)

Indicators	2015	2016	2017	2018 I	2018 II	2018 III	2018 IV	2018 current forecast	2018 forecast 07.2018	2019 I	2019 II	2019 III	2019 IV	2019 current forecast	2019 forecast 07.2018	2020 I	2020 II	2020 III	2020 IV	2020 current forecast	2020 forecast 07.2018
REAL ECONOMY, % yoy, unless otherwise stated																					
Nominal GDP, UAH bn	**1989**	**2385**	**2983**	700	807	994	1038	**3540**	3460	795	902	1104	1149	**3950**	3845	873	987	1207	1253	**4320**	4188
Real GDP	**-9.8**	**2.4**	**2.5**	3.1	3.8	3.1	3.4	**3.4**	**3.4**	2.8	2.5	2.3	2.5	**2.5**	**2.5**	2.6	2.7	2.9	3.4	**2.9**	**2.9**
GDP Deflator	**38.9**	**17.1**	**22.0**	14.9	17.0	15.0	12.2	**14.8**	**12.2**	10.5	9.0	8.0	8.0	**8.9**	**8.4**	7.0	6.5	6.0	5.5	**6.3**	**5.9**
Consumer prices (period average)	48.7	13.9	14.5	-	-	-	-	10.9	10.7	-	-	-	-	8.8	7.7	-	-	-	-	5.6	5.5
Producer prices (period average)	36.0	20.5	26.3	-	-	-	-	18.1	15.7	-	-	-	-	12.5	8.1	-	-	-	-	7.8	8.1
Consumer prices (end of period)	**43.3**	**12.4**	**13.7**	13.2	9.9	8.9	10.1	**10.1**	**8.9**	9.3	9.9	8.5	6.3	**6.3**	**5.8**	5.8	5.5	5.3	5.0	**5.0**	**5.0**
Core inflation (end of period)	34.7	5.8	9.5	9.4	9.0	8.7	7.9	7.9	7.1	7.5	7.6	6.4	5.1	5.1	4.6	4.9	4.8	4.0	3.6	3.6	3.6
Non-core inflation (end of period)	49.7	17.5	19.4	17.9	10.3	8.9	13.0	13.0	11.3	11.8	13.1	11.3	7.9	7.9	7.5	7.2	6.4	7.1	6.9	6.9	6.8
raw foods (end of period)	40.7	1.2	23.5	23.3	5.2	0.8	4.9	4.9	5.4	3.7	6.5	5.1	4.0	4.0	4.0	3.3	3.0	3.1	3.1	3.1	3.5
administrative prices (end of period)	64.4	34.6	16.1	13.6	13.2	13.5	18.4	18.4	16.6	17.8	19.0	16.9	11.7	11.7	11.6	11.5	9.5	10.9	10.8	10.8	10.4
Producer prices (end of period)	**25.4**	**35.7**	**16.5**	15.9	18.4	18.9	17.2	**17.2**	**10.4**	15.7	13.7	11.0	8.7	**8.7**	**8.6**	6.8	8.0	7.8	8.2	**8.2**	**8.1**
FISCAL SECTOR																					
Consolidated budget balance, UAH bn	**-30.9**	**-54.8**	**-42.1**	-	-	-	-	**-69.1**	**-71.4**	-	-	-	-	**-58.3**	**-56.4**	-	-	-	-	**-64.5**	**-61.7**
% of GDP	-1.6	-2.3	-1.4	-	-	-	-	-2.0	-2.1	-	-	-	-	-1.5	-1.5	-	-	-	-	-1.5	-1.5
Public sector fiscal balance (IMF methodology), UAH bn	**-17.0**	**-50.3**	**-38.4**	-	-	-	-	**-69.3**	**-72.7**	-	-	-	-	**-57.3**	**-57.4**	-	-	-	-	**-63.8**	**-61.0**
% of GDP	-0.9	-2.1	-1.3	-	-	-	-	-2.0	-2.1	-	-	-	-	-1.5	-1.5	-	-	-	-	-1.5	-1.5
General government and Naftogaz financing, UAH bn	-37.5	-50.3	-38.4	-	-	-	-	-69.3	-72.7	-	-	-	-	-57.3	-57.4	-	-	-	-	-63.8	-61.0
General government and Naftogaz financing, % of GDP	-1.9	-2.1	-1.3	-	-	-	-	-2.0	-2.1	-	-	-	-	-1.5	-1.5	-	-	-	-	-1.5	-1.5
BALANCE OF PAYMENTS (NBU methodology)																					
Current account balance, USD bn	1.6	-1.3	-2.4	-0.5	0.2	-3.1	0.0	-3.4	-2.0	-1.2	-0.6	-1.4	-0.3	-3.5	-2.6	-1.5	-0.7	-1.3	-0.7	-4.2	-3.6
Financial account, USD bn	1.2	-2.6	-5.0	-0.2	-0.4	-2.1	-1.6	-4.2	-4.0	-0.4	-1.2	-0.5	0.0	-1.9	-2.4	-2.1	-1.4	0.0	-0.3	-3.9	-3.5
BOP overall balance, USD bn	**0.8**	**1.3**	**2.6**	**-0.3**	**0.6**	**-0.9**	**1.7**	**0.8**	**2.0**	**-0.8**	**0.5**	**-0.9**	**-0.4**	**-1.6**	**-0.3**	**0.6**	**0.7**	**-1.3**	**-0.4**	**-0.4**	**-0.1**
Gross reserves, USD bn	**13.3**	**15.5**	**18.8**	**18.2**	**18.0**	**16.6**	**19.2**	**19.2**	**20.7**	**17.9**	**19.2**	**17.7**	**18.6**	**18.6**	**18.8**	**19.6**	**20.3**	**19.5**	**19.1**	**19.1**	**19.7**
Months of future imports	3.1	3.0	3.2	3.1	3.0	2.8	3.2	3.2	3.5	3.0	3.2	2.9	3.0	3.0	3.0	3.2	3.2	3.1	3.0	3.0	3.0
Export of goods, % yoy	-29.9	-5.3	18.3	8.6	14.8	6.6	11.4	10.3	9.7	-0.9	-2.9	3.6	-3.5	-1.0	0.1	4.1	3.8	5.0	4.5	4.4	5.3
Import of goods, % yoy	-32.6	4.2	21.9	12.2	14.0	19.0	4.5	12.1	9.6	7.6	4.6	-3.6	0.8	2.0	4.0	2.5	1.2	2.2	4.2	2.6	5.6
MONETARY ACCOUNTS (Qumulative since the beginning of the year)																					
Monetary base, %	0.8	13.6	4.6	-1.5	5.2	6.3	12.2	**12.2**	11.0	-2.5	1.3	1.9	6.9	**6.9**	6.2	-2.5	1.1	1.3	6.0	**6.0**	4.6
Broad money, %	3.9	10.9	9.6	-3.3	0.3	3.3	9.6	**9.6**	10.4	-2.8	-0.6	1.5	8.7	**8.7**	8.7	-2.8	-1.3	1.6	8.3	**8.3**	8.2
Velocity of broad money (end of year)	2.0	2.2	2.5	-	-	-	-	**2.7**	2.6	-	-	-	-	**2.7**	2.6	-	-	-	-	**2.8**	2.7