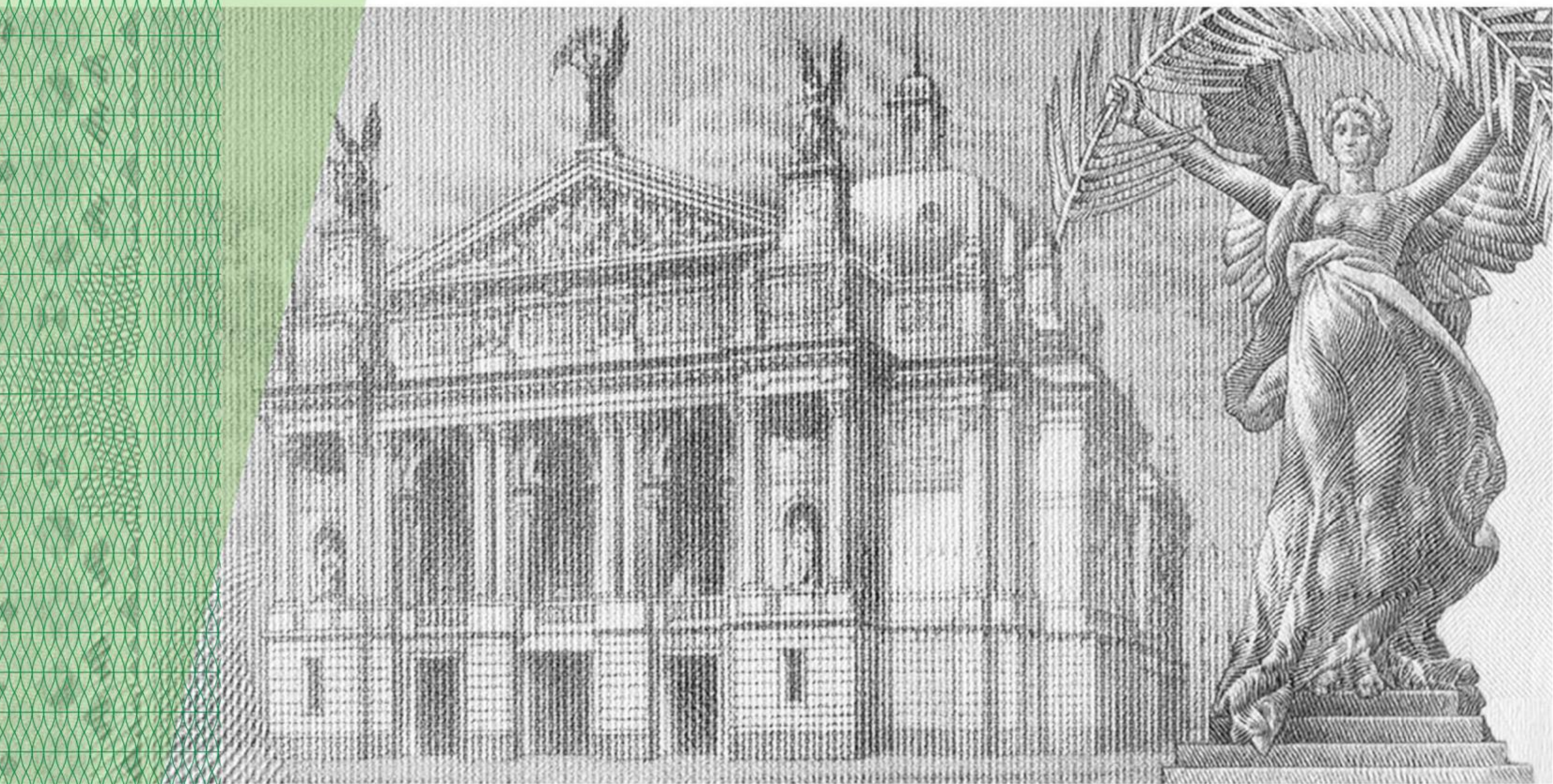
National Bank of Ukraine

Inflation Report

January 2019



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 31 January 2019. [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 30 January 2019 as the cut-off date for the data.

Previous issues of Inflation Report, presentation of the Inflation Report, summary of macroeconomic projections, time series and data for charts and tables in the Inflation report are available at the following link:
https://bank.gov.ua/control/en/publish/category?cat_id=16036612.

[1] NBU Board Decision No. 90-D as of 31 January 2019 On the Approval of the Inflation Report.

Summary

Consumer price inflation declines to a five-year low

Consumer price inflation declined to a five-year low of 9.8% in 2018, from 13.7% in 2017. The reversal of the inflation uptrend seen in 2017 is primarily due to the NBU's tight monetary policy stance. The NBU has raised the key policy rate six times since October 2017, by a total of 5.5 pp, to the current 18.0% per annum. The rate hikes affected market interest rates on hryvnia resources and thereby incentivized savings.

The tight monetary conditions were among the reasons for the strengthening of the hryvnia – by 6.8% for the NEER and 13.2% for the REER over the course of 2018. High global prices for exported goods over most of 2018, a record harvest of grain crops, and a substantial amount of remittances also contributed to the stronger hryvnia. Favorable FX market conditions over most of the year enabled the NBU to replenish international reserves via FX interventions.

The expansion in the domestic supply of some foods (fruit, milk, meat, etc.) and lower global food prices were additional factors that contributed to the decrease in inflation, causing the growth in raw food prices to slow sharply (to 3.3% yoy).

Despite the decrease, inflation had exceeded the NBU's target of 6% ± 2 pp by the end of 2018, as specified in the Monetary Policy Guidelines for 2018 and the Medium Term. The NBU deliberately chose a lengthier path to bringing inflation to its target in order to minimize costs for economic growth. Being able to strike a balance between the need to bring inflation to the target and the support of economic growth reflects the flexibility of the inflation-targeting regime.

The deviation of inflation from the target was largely due to factors over which monetary policy has only a limited effect. These factors include the growth in administered prices and tariffs (which accelerated to 18% yoy) and the increase in global oil prices, which lasted for most of the year.

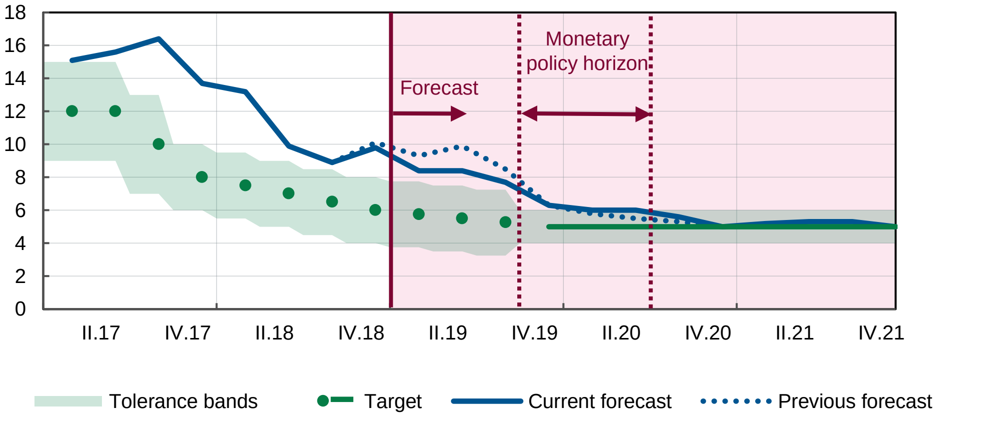
Furthermore, consumer demand and further growth in production costs – including due to higher labor and energy costs – continued to push prices higher during the year. In particular, real wages increased by 12.5% in 2018. The effects of the adjustment of pension benefits and further growth in labor migrant remittances made a substantial contribution to household income growth. Uncertainty over further cooperation with the IMF and heightened external risks weighed on economic sentiment throughout most of the year, and hence impeded the improvement of inflation expectations. As a result, core inflation slowed moderately, to 8.7% yoy, in 2018.

Consumer price inflation will continue to decelerate and will return to its target range in early 2020

The forecast for 2019 year-end inflation remains unchanged at 6.3%, but the projected dynamics of some of inflation components have been partially revised. The disinflation effects of lower global energy prices and the stronger hryvnia will be offset by the continued pressure from wages and somewhat faster growth in administered prices. Headline inflation is expected to decline to the upper bound of the target range, 5% ± 1 pp, in early 2020, and to reach the target level of 5% at the end of that year.

The main factors behind further disinflation on the forecast horizon will be the reasonably tight monetary conditions and strict fiscal policy, which will slow aggregate demand growth and bring back the negative output gap. The relatively low exchange rate volatility and a moderate rise in prices for imported goods, including energy and food, will be additional contributors. The inflationary impact of higher wages will weaken due to less intense labor migration and narrower wage gaps with neighboring countries than in previous years.

Figure 1. CPI (end of period, % yoy) and Inflation Targets



Source: SSSU, NBU staff estimates.

Thanks to these factors, core inflation will slow to 5% in 2019 and stay below 4% in 2020–2021. Raw food inflation is anticipated to remain within the 3.0%–3.5% range both this year and in the medium term, provided no major supply shocks hit the economy as a result of a poor harvest or a change in Ukrainian producers' ability to tap into certain external markets.

Administered prices will rise 13.6% in 2019. The revision of their growth rates compared to the previous forecast (up from 11.7%) is primarily due to the postponement of planned increases in central heating and hot water prices to January 2019 (from December 2018), and to somewhat higher increases in the excise tax on tobacco products. A significant contribution to administered price inflation will come from the further growth in natural gas tariffs for households in accordance with the IMF memorandum (the next increase is expected in Q2 2019). In the medium term, the growth in administered prices will decelerate to 10% in 2021.

The material correction in oil prices in Q4 2018 led to a downward forecast revision for the domestic fuel prices. Assuming no changes to existing excise tax policy, fuel prices are forecast to rise at 4%–5% per year.

Agriculture and domestic demand – oriented sectors propelled GDP growth in 2018

In 2018, economic growth accelerated to 3.3% (according to NBU estimates) – the highest growth rate in seven years.

Steady expansion in consumer demand, fueled by solid growth in real disposable income of households, supported the robust growth in domestic demand – oriented sectors, including retail trade, passenger transport, and other services. In addition, agriculture was one of the major drivers of real GDP growth, thanks to a record-high harvest of grain and oilseeds.

However, industrial production grew at a moderate pace due to transportation challenges in the Sea of Azov in H2 2018, and the carrying out of repairs at several metallurgy plants. Furthermore, the growth in the global economy and trade slowed in H2 2018 amid ramped up protectionist measures, and the global commodity price environment worsened. That weighed on the growth in exports and companies' financials and, coupled with uncertainty over further cooperation with the IMF and the upcoming elections, shifted investment activity into a lower gear. Meanwhile, robust consumer demand and high energy prices drove growth in imports value for most of the year. The current account deficit increased to 3.6% of GDP[2], according to the NBU, (from 2.2% in 2017), driven by larger foreign trade deficit and higher dividend payments. At the same time, remittances increased by 18.7%, containing the widening of the current account deficit.

The financial account inflows helped offset the current account deficit. Ukraine recorded USD 7.5 billion of capital inflows for the year, generated by both the private and public sectors. The

[2] Hereinafter, the NBU's estimate for GDP in 2018 and projections for 2019-2021 are taken for calculating ratios with respect to GDP.

role of the latter grew in importance through the end of the year, primarily due to the placement of Eurobonds and the arrival of official financing. The private sector received capital inflows in the form of net FDI and real sector borrowings. The surplus in the overall balance of payments helped increase international reserves to USD 20.8 billion by the end of last year, covering 3.4 months of future imports.

The fiscal policy stance underwent major changes – from a loose fiscal policy in H1 2018 to a tight one in H2 2018 with the expected easing late in the year. The consolidated budget recorded a wider deficit (of UAH 67.8 billion at yearend) but maintained a significant primary surplus. Along with the strengthening of the hryvnia, this pushed public and publicly guaranteed debt as a percentage of GDP further down (to 61%).

In 2019, economic growth will temporarily decelerate

Looking ahead, real GDP growth will, as projected earlier, decelerate to 2.5% in 2019. The tight monetary policy needed to bring inflation back into the target range and the strict fiscal policy due to substantial public debt redemptions will put the main drag on growth. In addition, the grain harvest is expected to be lower compared with a record last year, meaning agriculture will make a negative contribution to GDP growth. Another factor will be a gradual deceleration of growth in the global economy and trade, including due to protectionist measures.

Economic growth will continue to be primarily driven by private consumption, fueled by a further increase in real household income, which will in turn be supported by the growth in wages and pensions, although slower than last year. Investment activity is set to slow materially, but will continue to fuel the robust demand for imported means of production. As a result, imports will grow faster than exports in real terms, even amid improved performance of export-oriented industries and record grain exports. Thus, the contribution of net exports to GDP will remain negative, although it will be smaller than in previous year.

Going forward, real economic growth will start picking up, reaching 2.9% and 3.7% in 2020 and 2021, respectively. The growth will be propelled by a gradual easing of monetary policy, which will bolster domestic demand, and a pick-up in investment activity as uncertainty about the political situation diminishes.

In 2019 - 2021, fiscal policy will be tighter than in 2018. The NBU expects the consolidated budget to record a deficit of no more than 1.5% of GDP as external debt repayments reach peak levels. The continued rapid nominal GDP growth, low exchange rate volatility, and the continuing primary surpluses in the consolidated budget (over 1% of GDP a year) amid large repayments will reduce public and publicly guaranteed debt to below 60% of GDP.

After widening in 2018, the current account deficit will range between 3% and 4% of GDP throughout the forecast horizon. In 2019, the deficit will narrow to 3.1% of GDP due to the bumper corn harvest in 2018 and a drop in energy prices. In 2020–2021, the current account deficit will widen somewhat, on the back of a decrease in gas transit, the waning effects of the record high harvest in 2018, and a rise in investment imports following the elections. The widening of the trade deficit will be partially offset by greater private remittances as labor migrants' incomes increase.

Further cooperation with the IMF remains a key assumption underlying the macroeconomic forecast

Securing the financing from the IMF and other official creditors will enable Ukraine to retain access to international capital markets over the forecast horizon. At the same time, the continuation of the reasonably tight monetary policy stance will contribute to debt inflows, which, together with continued inflows of foreign direct investment, will help finance the current account deficit. Large external public debt repayments due in 2019–2020 will be partly rolled over thanks to official external borrowings and the placement of sovereign Eurobonds. This will improve the expectations of economic agents and foster macrofinancial stability. International reserves will stabilize at the current level (close to USD 21 billion) over the forecast horizon.

A deterioration in expectations and external conditions are the main risks to the forecast

The usual increase in uncertainty during the presidential and parliamentary elections poses the main risk to the macroeconomic forecast outlined above, including Ukraine's ability to meet its inflation target in 2020. This, in turn, could affect inflation expectations.

Another important risk to the baseline scenario is deterioration of external conditions as a result of a potential downswing phase in the global economy and higher volatility of world commodity prices. Risks of a sharper slowdown in the global economy have been on the rise recently, amid heightened geopolitical tensions, Brexit uncertainty, a sharp slowdown in the euro area economy, deleveraging in the Chinese economy, and increased financial market volatility.

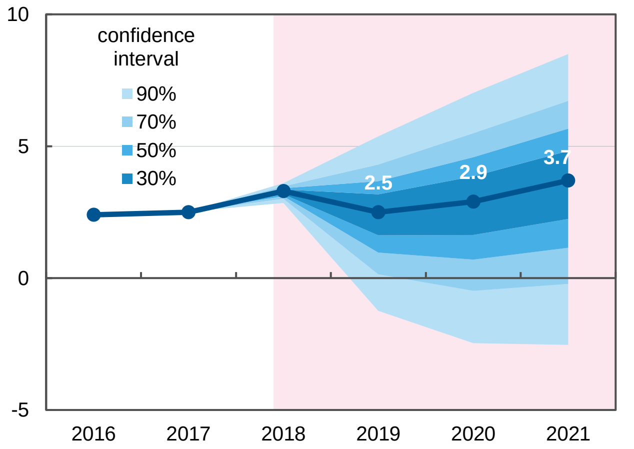
Risks related to Russian aggression also increased late last year. Although port access conditions in the Sea of Azov have returned to normal, the risk of transportation problems via the Sea of Azov remains high. In addition, the risk of intense labor migration and the resulting pressure on wages remains valid. Another risk to the forecast is uncertainty over the volume of gas transit through Ukraine starting from 2020, as pipelines bypassing the country are being built to deliver gas to Europe.

Monetary policy will remain reasonably tight to reduce inflation to the target

Considering the updated macroeconomic forecast and the risks outlined above, the NBU Board decided on 31 January 2018 to keep its key policy rate at 18.0% per annum. Keeping the rate at this level is aimed to ensure a firm disinflation trajectory and a return of inflation to the target range in Q1 2020.

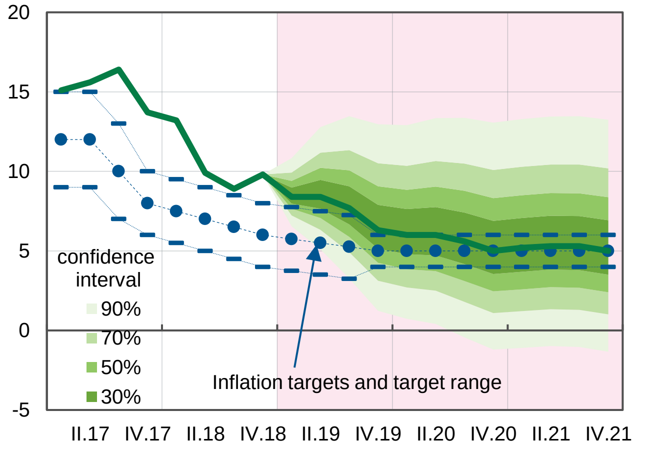
Further changes to the key policy rate during the forecast horizon will be contingent on inflation developments, as well as on whether risks to price stability materialize. The NBU Board sees potential for a monetary policy easing if inflation risks were to considerably subside and inflation were moving towards the target along the path specified in the new macroeconomic forecast. However, if underlying inflationary pressures rise, and the risks that endanger the return of inflation to the target materialize, the NBU could raise the key policy rate.

Figure 2. **Real GDP Growth, % yoy**



Source: NBU staff estimates.

Figure 3. **CPI Growth, % yoy**



Source: NBU staff estimates.

Macroeconomic forecast (January 2019)

Indicators	2015	2016	2017	2018						2019						2020						2021				
				I	II	III	IV	act/ est	forecast 10.2018	I	II	III	IV	current forecast	forecast 10.2018	I	II	III	IV	current forecast	forecast 10.2018	I	II	III	IV	current forecast
Real economy, % yoy, unless otherwise stated																										
Nominal GDP, UAH bn	**1 989**	**2 385**	**2 984**	**700**	**807**	**994**	**1 051**	**3 553**	3 540	**797**	**902**	**1 105**	**1 160**	**3 965**	3 950	**875**	**989**	**1 211**	**1 261**	**4 336**	4 320	**953**	**1 081**	**1 327**	**1 383**	**4 744**
Real GDP	**-9.8**	**2.4**	**2.5**	**3.1**	**3.8**	**2.8**	**3.3**	**3.3**	3.4	**2.9**	**2.5**	**2.4**	**2.3**	**2.5**	2.5	**2.6**	**2.9**	**3.1**	**3.0**	**2.9**	2.9	**3.2**	**3.6**	**3.9**	**4.0**	**3.7**
GDP deflator	38.9	17.1	22.1	14.9	17.0	16.1	13.3	15.3	14.8	10.5	9.0	8.0	8.0	8.9	8.9	7.0	6.5	6.0	5.5	6.3	6.3	5.5	5.5	5.5	5.5	5.5
Consumer prices (period average)	48.7	13.9	14.4	-	-	-	-	10.9	10.9	-	-	-	-	8.1	8.8	-	-	-	-	5.7	5.6	-	-	-	-	5.2
Producer prices (period average)	36.0	20.5	26.4	-	-	-	-	17.4	18.1	-	-	-	-	9.6	12.5	-	-	-	-	7.3	7.8	-	-	-	-	7.8
Consumer prices (end of period)	**43.3**	**12.4**	**13.7**	**13.2**	**9.9**	**8.9**	**9.8**	**9.8**	**10.1**	**8.4**	**8.4**	**7.7**	**6.3**	**6.3**	**6.3**	**6.0**	**6.0**	**5.6**	**5.0**	**5.0**	**5.0**	**5.2**	**5.3**	**5.3**	**5.0**	**5.0**
Core inflation (end of period)	34.7	5.8	9.5	9.4	9.0	8.7	8.7	8.7	7.9	7.9	7.6	6.5	5.0	5.0	5.1	4.5	4.1	3.8	3.6	3.6	3.6	3.6	3.8	3.7	3.7	3.7
Non-core inflation (end of period)	49.7	17.5	19.4	17.9	10.3	8.8	10.7	10.7	13.0	9.1	9.8	9.3	8.1	8.1	7.9	8.1	8.7	8.0	7.0	7.0	6.9	7.2	7.3	7.3	6.9	6.9
Raw foods (end of period)	40.7	1.2	23.5	23.3	5.2	0.8	3.3	3.3	4.9	1.2	3.0	3.1	3.4	3.4	4.0	3.9	5.5	4.6	3.0	3.0	3.1	3.1	3.3	3.3	3.0	3.0
Administrative prices (end of period)	64.4	34.6	16.1	13.6	13.2	13.5	18.0	18.0	18.4	18.0	18.0	17.7	13.6	13.6	11.7	12.7	12.7	11.8	11.1	11.1	10.8	11.0	10.6	10.6	10.3	10.3
Producer prices (end of period)	**25.4**	**35.7**	**16.5**	**15.9**	**18.4**	**18.9**	**14.2**	**14.2**	**17.2**	**11.9**	**10.5**	**7.6**	**8.2**	**8.2**	**8.7**	**6.6**	**7.3**	**7.2**	**7.6**	**7.6**	**8.2**	**7.6**	**8.0**	**8.0**	**7.3**	**7.3**
Fiscal Sector																										
Consolidated budget balance, UAH bn	**-30.9**	**-54.8**	**-42.1**	**-**	**-**	**-**	**-**	**-67.8**	**-69.1**	**-**	**-**	**-**	**-**	**-61.4**	**-58.3**	**-**	**-**	**-**	**-**	**-67.2**	**-64.5**	**-**	**-**	**-**	**-**	**-73.5**
% of GDP	-1.6	-2.3	-1.4	-	-	-	-	-1.9	-2.0	-	-	-	-	-1.5	-1.5	-	-	-	-	-1.5	-1.5	-	-	-	-	-1.5
Public sector fiscal balance (IMF methodology), I	**-17.0**	**-50.3**	**-38.4**	**-**	**-**	**-**	**-**	**-72.8**	**-69.3**	**-**	**-**	**-**	**-**	**-59.6**	**-57.3**	**-**	**-**	**-**	**-**	**-63.7**	**-63.8**	**-**	**-**	**-**	**-**	**-70.9**
% of GDP	-0.9	-2.1	-1.3	-	-	-	-	-2.0	-2.0	-	-	-	-	-1.5	-1.5	-	-	-	-	-1.5	-1.5	-	-	-	-	-1.5
Balance of payments (NBU methodology)																										
Current account balance, USD bn	1.6	-1.3	-2.4	-0.6	0.0	-2.7	-1.3	-4.7	-3.4	-1.0	-1.0	-1.8	-0.7	-4.5	-3.5	-1.7	-1.3	-1.7	-1.0	-5.6	-4.2	-1.4	-1.3	-1.9	-1.5	-6.2
Financial account balance, USD bn	1.2	-2.6	-5.0	-0.3	-0.6	-2.0	-4.6	-7.5	-4.2	-0.7	-1.9	-0.3	-0.5	-3.4	-1.9	-2.5	-2.0	-0.6	-0.5	-5.5	-3.9	-2.1	-1.6	-0.7	-1.1	-5.5
BoP overall balance, USD bn	**0.8**	**1.3**	**2.6**	**-0.3**	**0.6**	**-0.7**	**3.3**	**2.9**	**0.8**	**-0.4**	**1.0**	**-1.5**	**-0.2**	**-1.1**	**-1.6**	**0.7**	**0.7**	**-1.0**	**-0.5**	**-0.1**	**-0.4**	**0.7**	**0.2**	**-1.2**	**-0.5**	**-0.7**
Gross reserves, USD bn	**13.3**	**15.5**	**18.8**	**18.2**	**18.0**	**16.6**	**20.8**	**20.8**	**19.2**	**20.0**	**21.7**	**19.6**	**20.6**	**20.6**	**18.6**	**21.8**	**22.5**	**21.9**	**21.4**	**21.4**	**19.1**	**22.5**	**22.7**	**21.9**	**21.4**	**21.4**
Months of future imports	3.0	3.0	3.2	3.0	2.9	2.7	3.4	3.4	3.2	3.2	3.5	3.1	3.3	3.3	3.0	3.4	3.5	3.4	3.3	3.3	3.0	3.4	3.4	3.2	3.1	3.1
Exports of goods, % yoy	-29.9	-5.3	18.3	8.6	14.8	6.3	7.4	9.2	10.3	4.0	-0.4	2.6	0.5	1.6	-1.0	-0.7	0.6	5.9	6.3	3.1	4.4	3.9	3.8	4.0	2.0	3.4
Imports of goods, % yoy	-32.6	4.2	21.9	12.8	14.7	17.4	11.5	14.0	12.1	10.2	7.5	-2.0	-3.4	2.5	2.0	2.9	0.7	3.6	5.2	3.1	2.6	2.7	4.3	4.9	5.5	4.4
Monetary accounts (Qumulative since the beginning of the year)																										
Monetary base, %	0.8	13.6	4.6	-1.5	5.2	6.3	9.2	9.2	12.2	1.1	5.3	5.1	10.7	10.7	6.9	-2.8	1.5	1.2	6.5	6.5	6.0	-3.0	0.8	0.7	6.2	6.2
Broad money, %	3.9	10.9	9.6	-3.3	0.3	3.4	5.6	5.6	9.6	-1.1	1.4	3.8	8.9	8.9	8.7	-2.1	0.7	2.7	8.5	8.5	8.3	-2.4	-0.2	2.5	8.5	8.5
Velocity of broad money, ratio (end of year)	2.0	2.2	2.5	-	-	-	-	2.8	2.7	-	-	-	-	2.9	2.7	-	-	-	-	2.9	2.8	-	-	-	-	2.9