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Ukraine: Macroeconomic and Policy Outlook

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The Ukrainian economy keeps recovering, although the growth in 2017 has weakened amid new challenges

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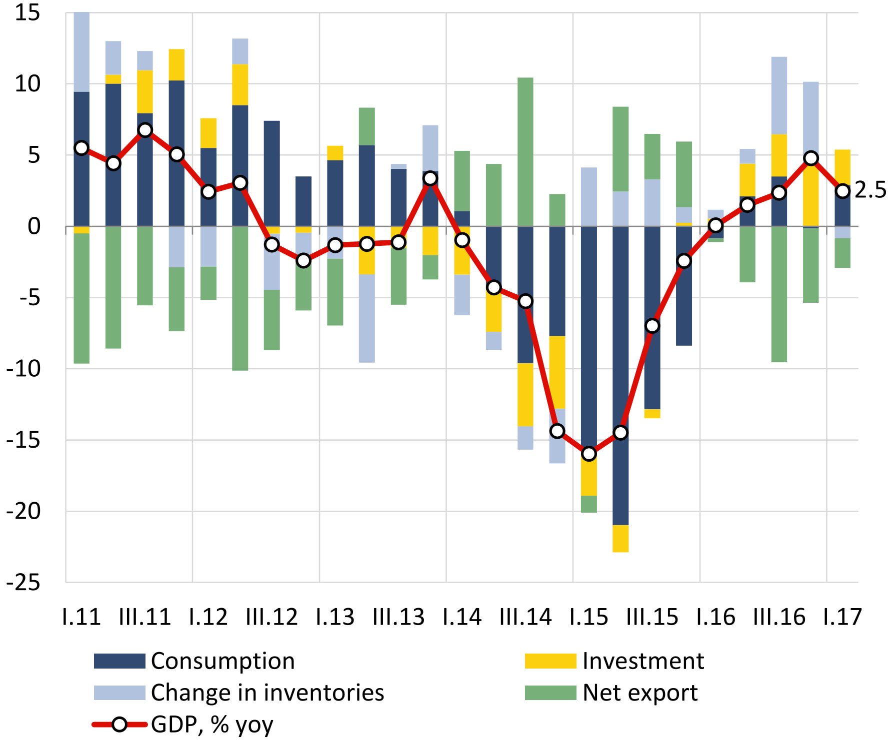
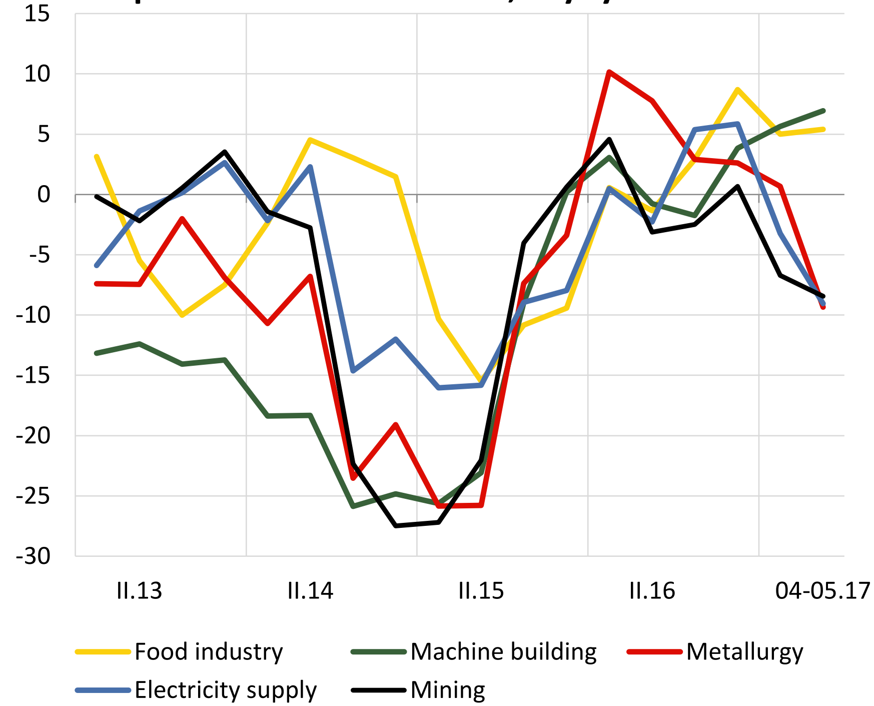
Contributions to Annual GDP Growth, pp



*The preliminary estimate of State Statistics Service of Ukraine
Source: State Statistics Service of Ukraine; NBU staff estimates

Output in Certain Industries, % yoy



Source: State Statistics Service of Ukraine

- In Q1 2017, the growth momentum has weakened due to seized industrial enterprises in non-government controlled area (NGCA) and halted freight traffic with NGCA
- As expected, industrial sector, mainly metallurgy and mining industry, was hit the most. Overall, economic developments were in line with the NBU expectations, except energy sector (however, worse energy performance is partly attributed to temporary weather factors)
- However, investment activity remained strong (+20% yoy) and private consumption has rebounded too

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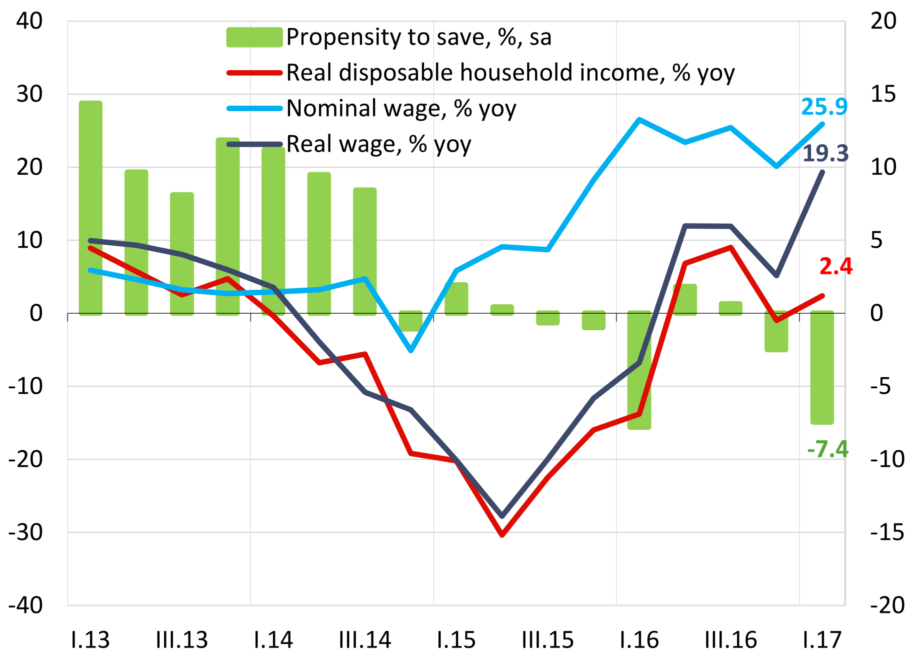
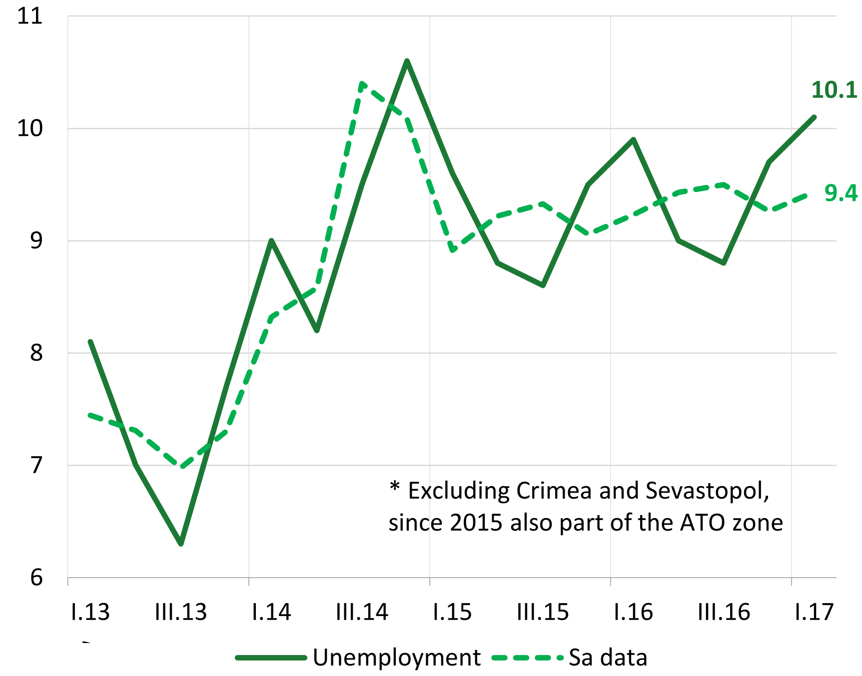
Despite higher contribution, private consumption growth remained moderate

Real disposable household income by source and propensity to save



Source: SSSU, NBU staff estimates

ILO Unemployment*, % of the economically active population aged 15-70



Source: SSSU, NBU staff estimates

- As expected, consumer demand strengthened in 2017, underpinned by high growth in nominal income, including thanks to minimum wage doubling since the beginning of 2017, and wider coverage of utility subsidy program
- However, income from sources other than wages reported meager growth (from business and property) or even declined in nominal terms. Households continued to use past savings to support consumption
- An increase in unemployment rate was another reason for sluggish increase in consumption

Over the forecast horizon, private consumption will become the main driver of real GDP growth, although investment demand will contribute as well

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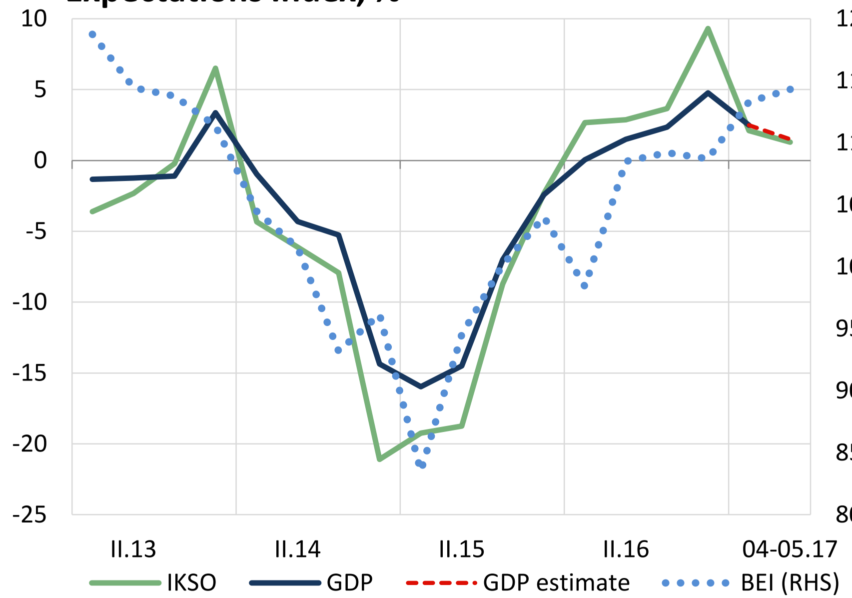
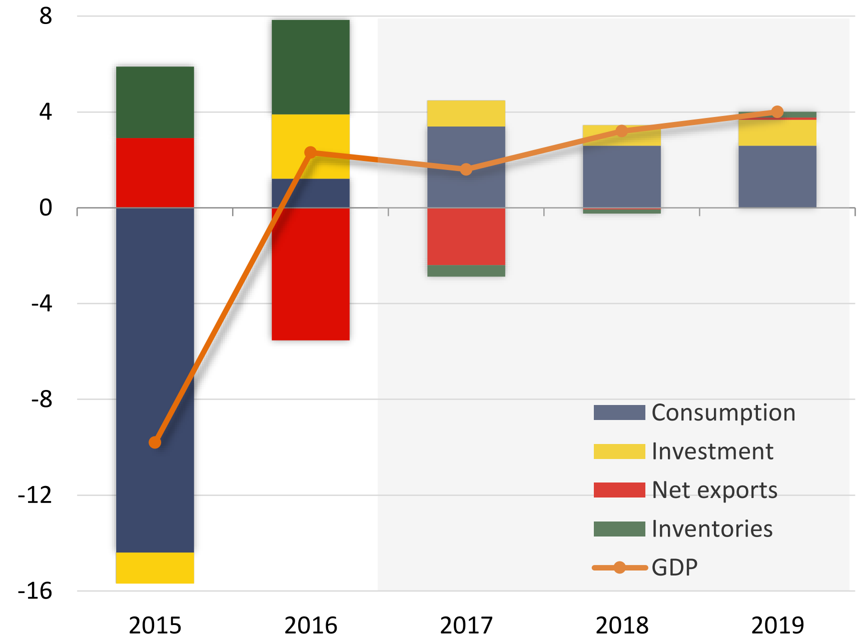
Selected Output Indicators, % yoy, and Business Expectations Index, %



*IKSO – Index of Key Sectors' Output (incl. Agriculture, Industry, Domestic Trade and Transport)

Source: State Statistics Service of Ukraine; NBU staff estimates

Contributions to Real GDP Growth, pp



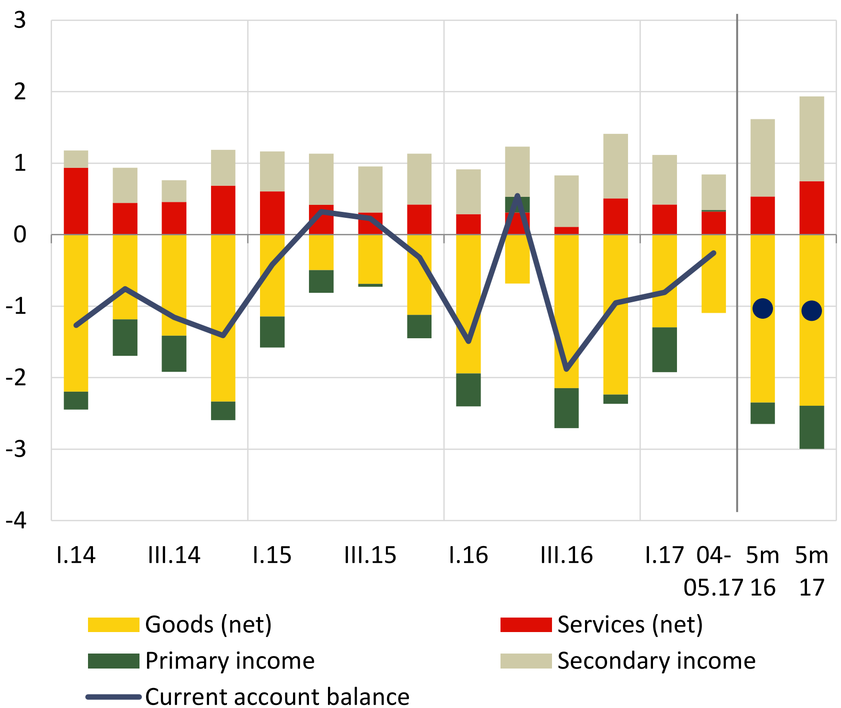
change, % (in real terms)	2016	2017	2018	2019
GDP	**2.3**	**1.6** (1.9)	**3.2** (3.2)	**4.0** (4.0)
Consumption	1.4	3.9 (3.6)	2.9 (2.9)	2.9 (2.8)
Private consumption	1.8	4.9 (4.9)	3.6 (3.4)	3.6 (3.3)
Gross capital formation	40.8	2.1 (5.7)	5.2 (6.0)	7.6 (7.5)
Gross fixed capital formation	20.1	7.4 (5.7)	5.5 (4.0)	6.7 (6.8)
Export of goods and services	-1.6	4.9 (2.9)	5.0 (5.0)	3.7 (4.0)
Import of goods and services	8.4	8.6 (8.0)	4.6 (6.0)	3.1 (3.0)

in ( ) – previous forecast (IR, April 2017)

- Private consumption will be supported by gradual easing of fiscal policy (including a rise in pension benefits planned for autumn 2017), reviving lending activity and firming consumer confidence
- Investment activity will stay robust, inter alia benefiting from improving business climate

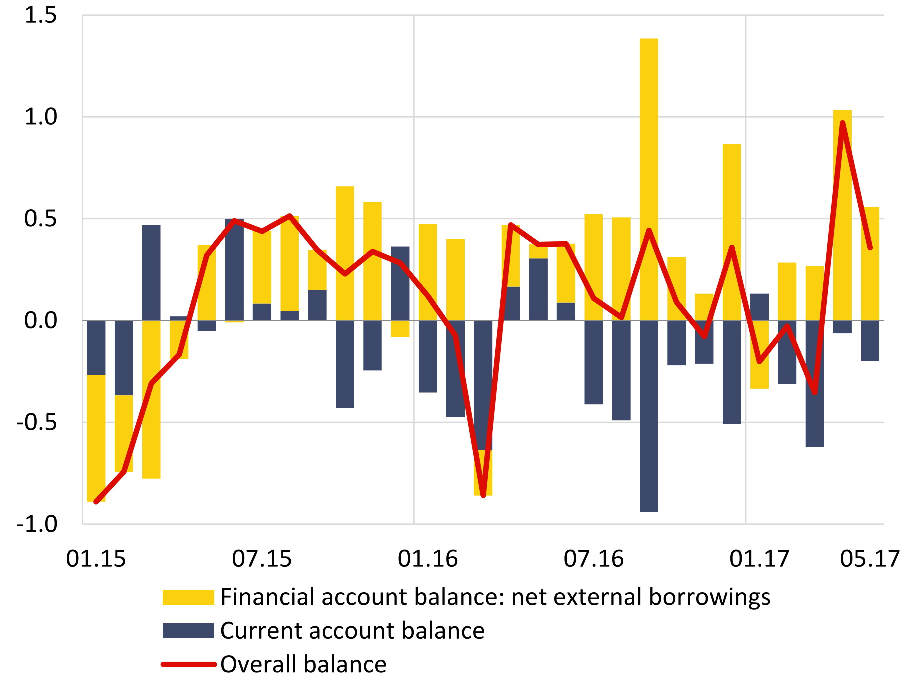
In Jan-May 2017, the overall balance of payments reported a surplus amid favorable external economic conditions and official financing

Current Account Balance, USD bn



Source: NBU

Overall BoP, USD bn



Source: NBU

- Over Jan-May 2017, Ukraine benefited from favorable commodity prices and strong agricultural exports. But energy imports were on a rise, inter alia due to coal deficit
- The financial account recorded net inflows in Jan-May 2017 mostly on decrease in FX cash outside banks, FDI inflows and official financing
- Thanks to overall BoP surplus and the next IMF tranche within EFF program international reserves grew to USD 18.0 bn or 3.7 months of future imports as of end-June

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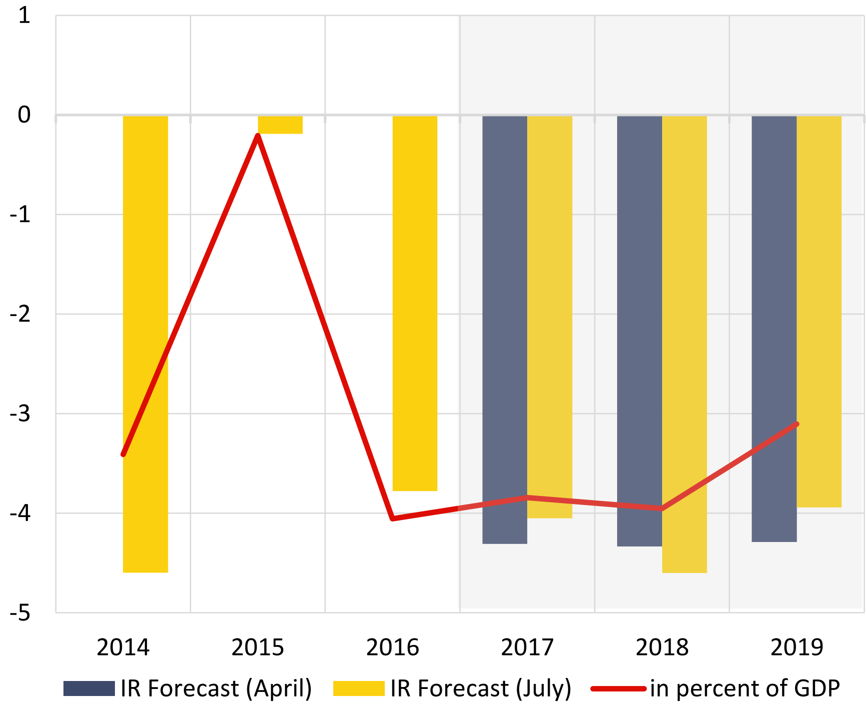
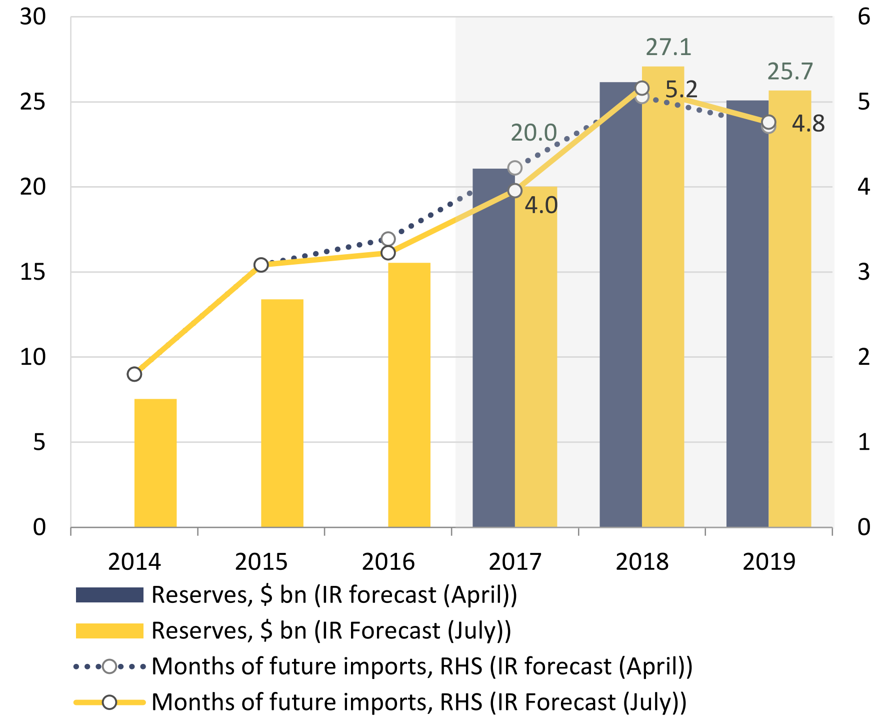
CA deficit will stay manageable, fully covered by capital inflows, thus facilitating reserves' build-up

Current Account Balance, USD bn



Source: NBU

Gross International Reserves



Source: NBU

- In the coming years, CA deficit is expected to fluctuate around $4 bn, balanced between improved export competitiveness and stronger demand for investment imports due to recovered domestic demand
- Net negative effect on trade balance from blockade is estimated as $1.8 bn in 2017 and $1.1 bn in 2018 and partially offset by favorable terms of trade and record high harvest of grains in 2016/2017
- Official inflows will be the main source of CA deficit financing in 2017-2018, while the much-needed pick-up in the private inflows should facilitate reserves' build-up and help to create a strong cushion against the increase in external public debt repayments coming from 2019

FX market has been broadly stable; hryvnia has been under appreciation pressures with respect to US dollar since early 2017

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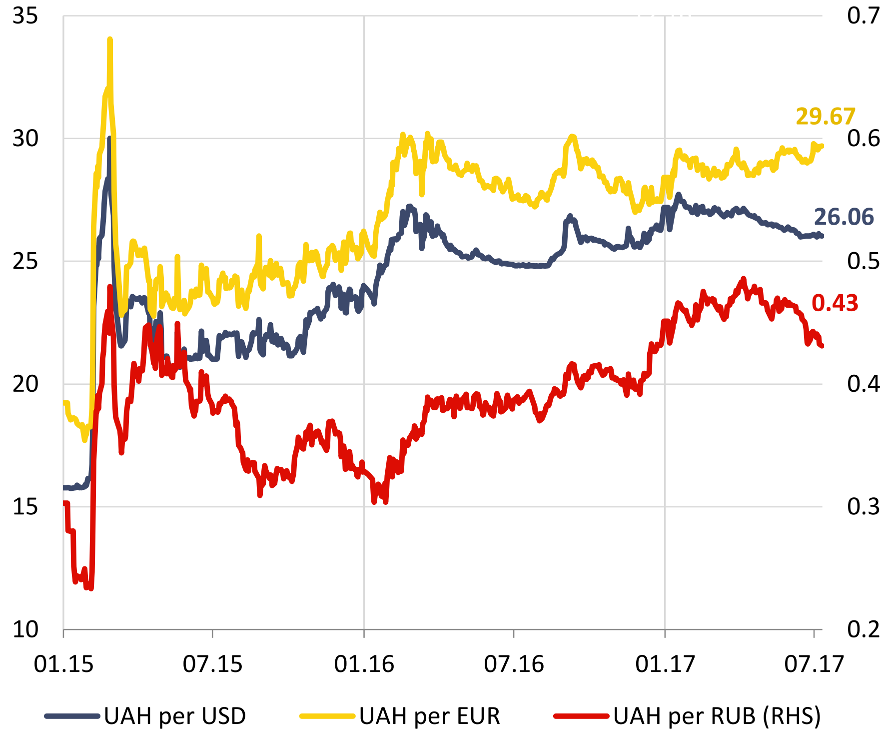
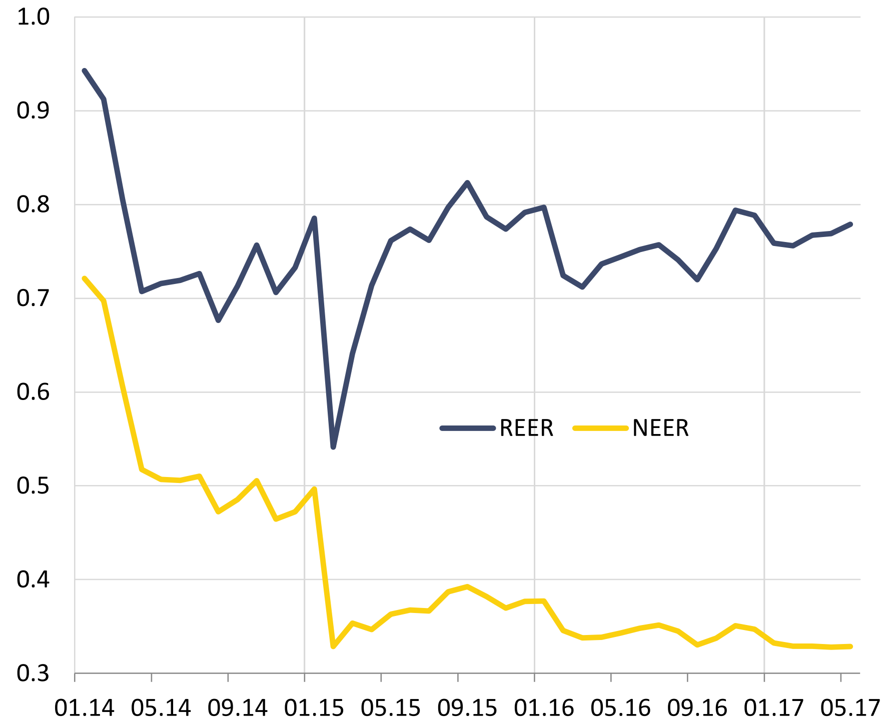
Hryvnia Exchange Rate, as of 09.06.2017



Source: NBU

Hryvnia REER and NEER Indices (based on interbank exchange rate), 12.1999=1



Source: IFS, staff estimates

- The NBU is committed to flexible exchange rate policy, keeping exchange rate broadly in line with the fundamentals
- Meanwhile, it continues to play active role at FX market but interventions are performed for clear and specific tasks (e.g., smoothing ST exchange rate volatility and replenishing its international reserves)
- Moderate exchange rate fluctuations over last 2 years contributed to macroeconomic and financial stability

Volatile headline inflation is attributed to utility tariff adjustments and raw food supply shocks, fundamental inflationary pressures remain subdued

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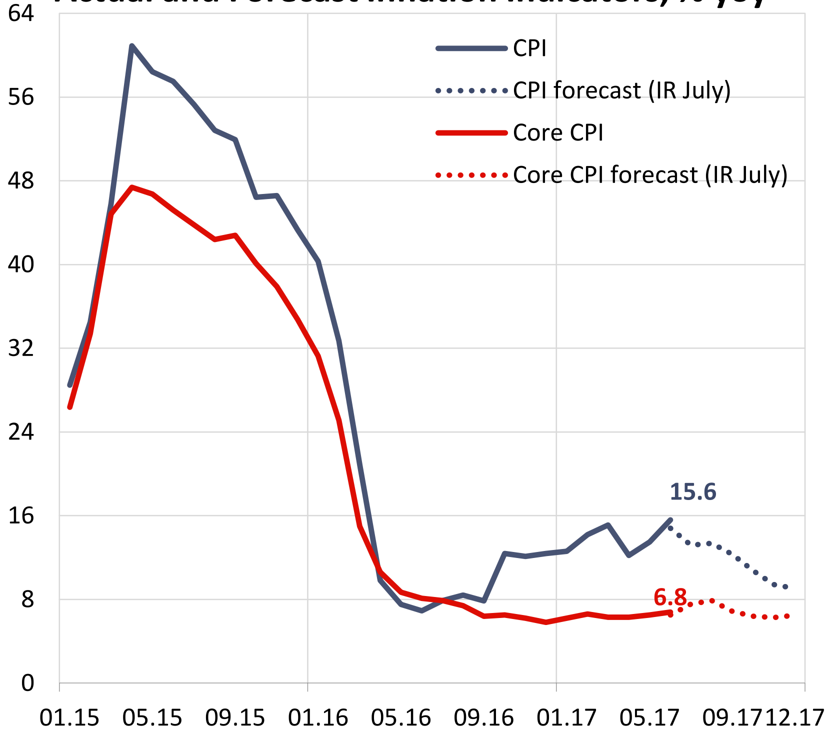
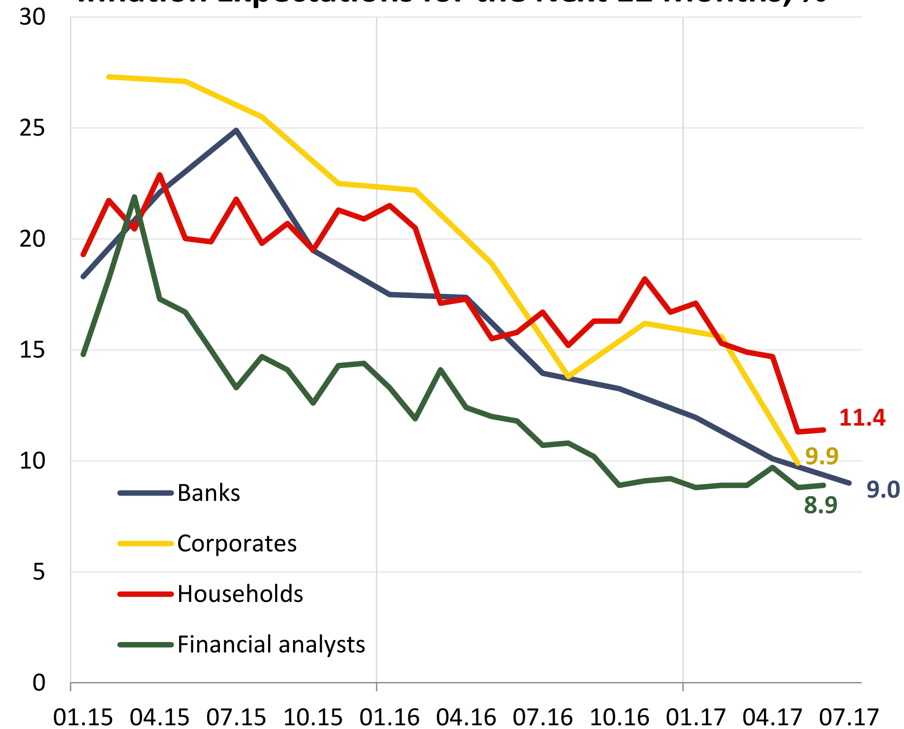
Actual and Forecast Inflation Indicators, % yoy



Source: State Statistics Service of Ukraine; NBU staff estimates

Inflation Expectations for the Next 12 Months, %



Source: NBU; GfK Ukraine surveys; NBU staff estimates

- Raw food prices are driven by a number of supply side factors (strong exports of meat and dairy products amid high global prices, spring frosts and a partial loss of fruit and early vegetable crops, changes in SSSU methodology for registering seasonal goods)
- Administratively regulated price path reflects base effects and scheduled increases in 2017, difficulties distribution of tobacco products
- Fundamental inflation pressures are contained by prudent monetary and fiscal policies, aggregate demand still being lower than its potential level, descending imported inflation
- Steady improvement in inflation expectations is another important factor that helps rein in price growth

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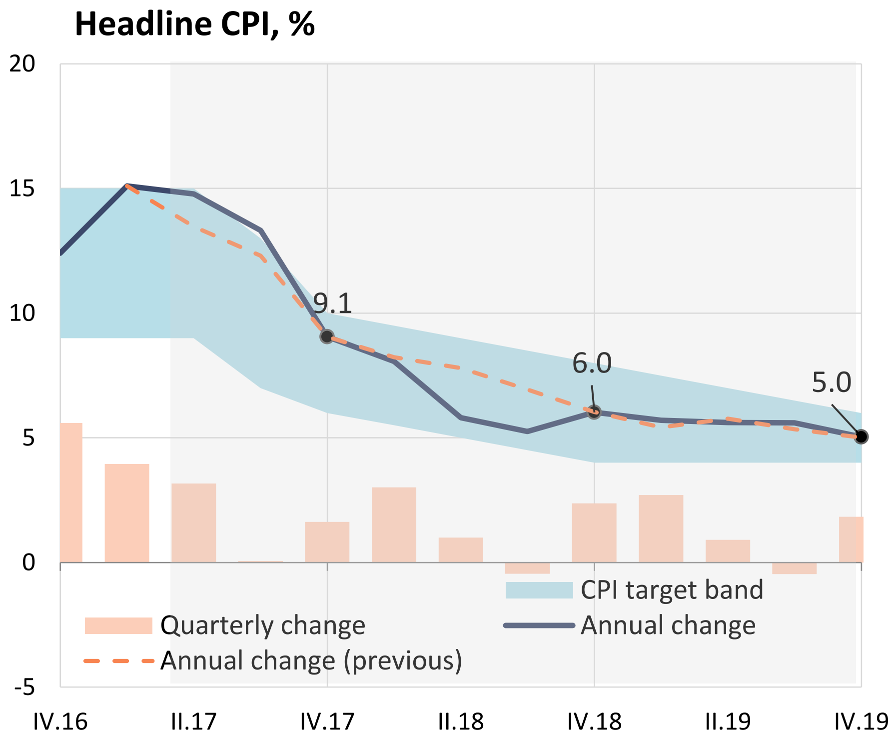
Disinflation will go on in line with targets



change, %	*weight, %*	2017	2018	2019
CPI	*100.0*	9.1 (9.1)	6.0 (6.0)	5.0 (5.0)
Core CPI	*57.4*	6.1 (6.5)	3.9 (4.3)	2.8 (3.7)
Raw foods	*19.0*	11.8 (7.8)	3.6 (3.8)	2.5 (3.3)
Admins	*18.6*	13.8 (16.0)	12.3 (11.6)	11.5 (9.7)
Fuels	*5.0*	13.0 (17.2)	8.0 (8.0)	6.0 (7.0)

in ( ) – previous forecast (IR, April 2017)

NBU kept is inflation projections for 2017 due to counterbalancing factors:

- ↑ Negative supply shocks on food market
- ↑ Pension reform impulse
- ↓ Stronger exchange rate
- ↓ Improved inflation expectations
- ↓ Postponed increase in gas prices in 2017

- Over the medium term, administered prices will remain the key driver of inflation, supported by recovering domestic demand. But fundamental pressures will remain contained thanks to prudent fiscal and monetary policies, improving expectations

According to Inflation Report (July 2017)

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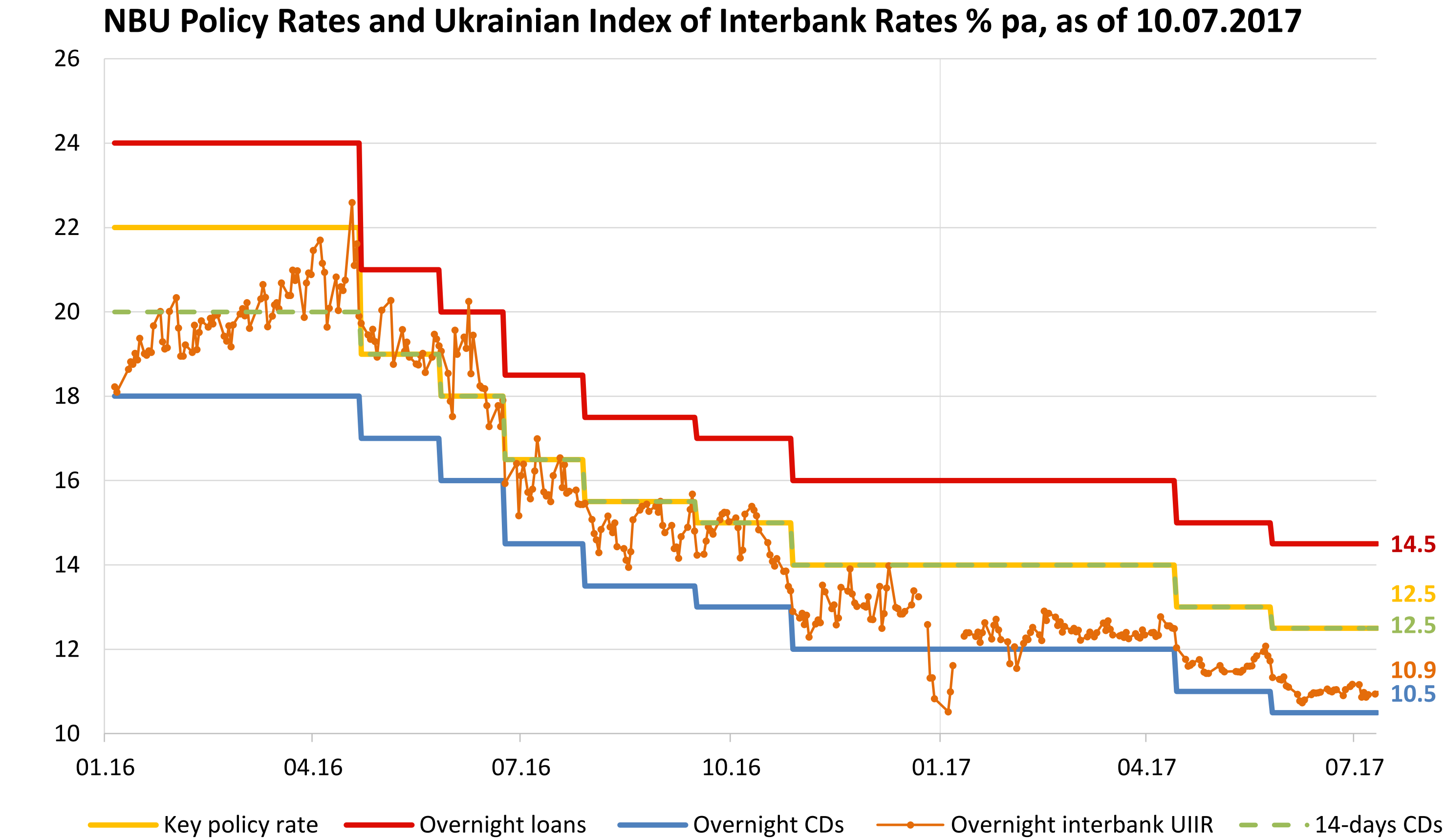
NBU policy stance is conditional upon macroeconomic developments



Source: NBU

- In Q2 2017, the NBU Board resumed the easing cycle of its monetary policy
- However, on its latest meeting the key rate was left unchanged to contain the likely impact of faster growth in food prices on inflation expectations and mitigating demand-pull pressures stemming from expected increase in pension benefits
- But accounting for favorable FX market conditions, FX restrictions were relaxed further

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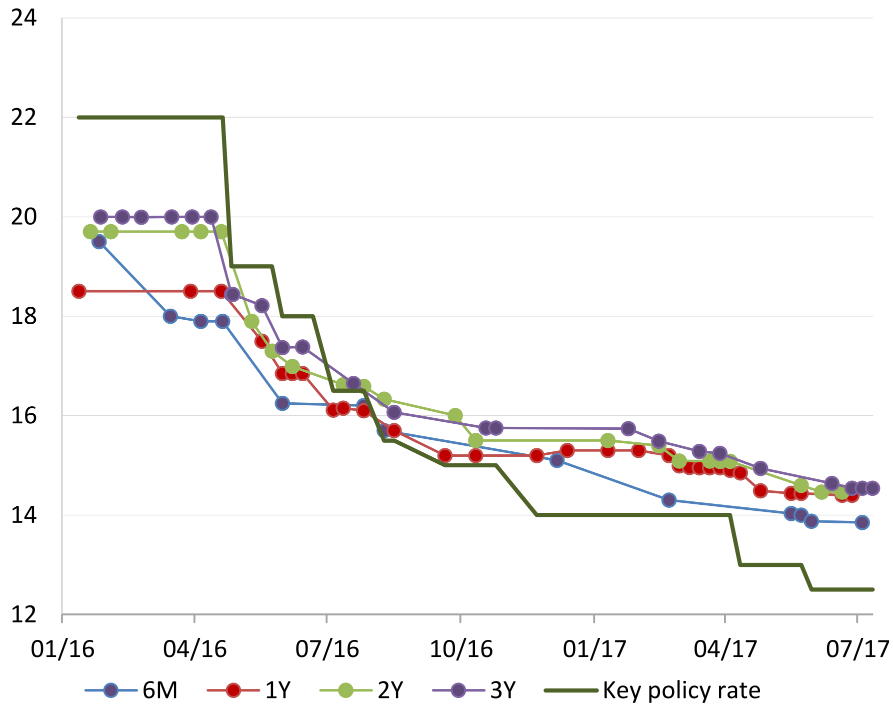
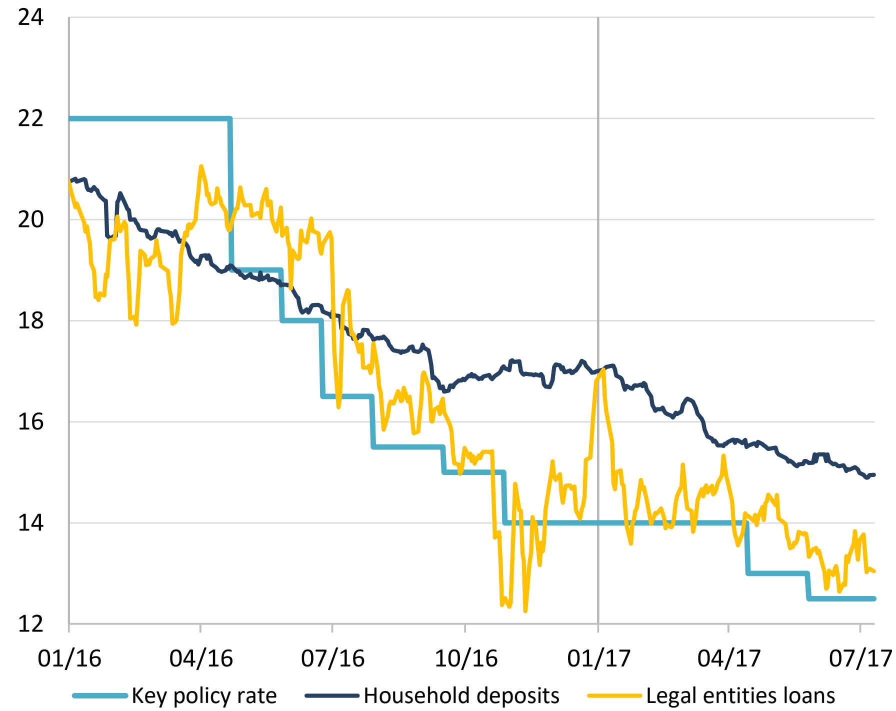
NBU rate decisions were swiftly transmitting into market interest rates

Term Structure of Hryvnia Yields on Primary Market (as of 10.07.2017), % pa



* YTM of government bonds up to 1 year includes 11M bonds.
Source: NBU

Key Policy Rate and Retail Hryvnia Interest Rates, % pa, as of 10.07.2017



Source: NBU

- In the past, the NBU's policy rate played a virtual signaling role
- In April 2016, the NBU strengthened the role of interest rate policy by defining the key rate as the interest rate on key NBU operations (the provision or absorption of liquidity), setting a symmetric and fixed band for standing facilities, and optimizing auxiliary tools
- The rate decisions filtered swiftly through to market interest rates. It is believed there is still some room for past decision transmission

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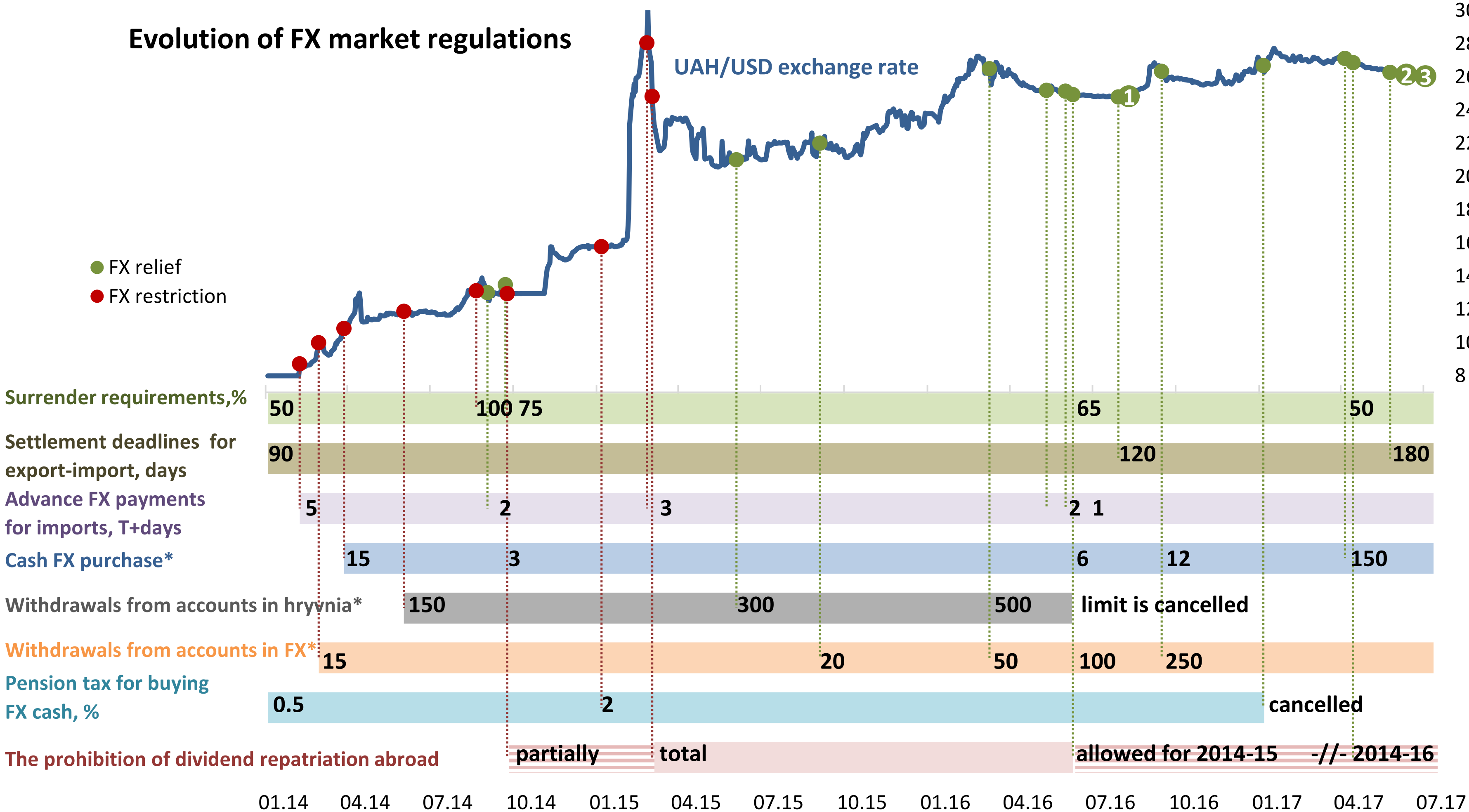
The National Bank of Ukraine continued relaxing administrative restriction introduced in 2014-2015 to calm FX market



* measured in thousand UAH equivalent

1 Cancellation of ID request for FX transactions (up to 150 000 UAH)
2 Lift of select restrictions on: (I) repatriation of funds invested in Ukraine and (ii) transfers abroad by individuals related to non-commercial operations. (iii) Increase of annual limit for investing abroad from USD 0.6 to 2.0 bn
3 Launching E-licenses for FX transfers abroad by individuals

Further liberalization steps are conditional upon sustained improvements on FX and money markets

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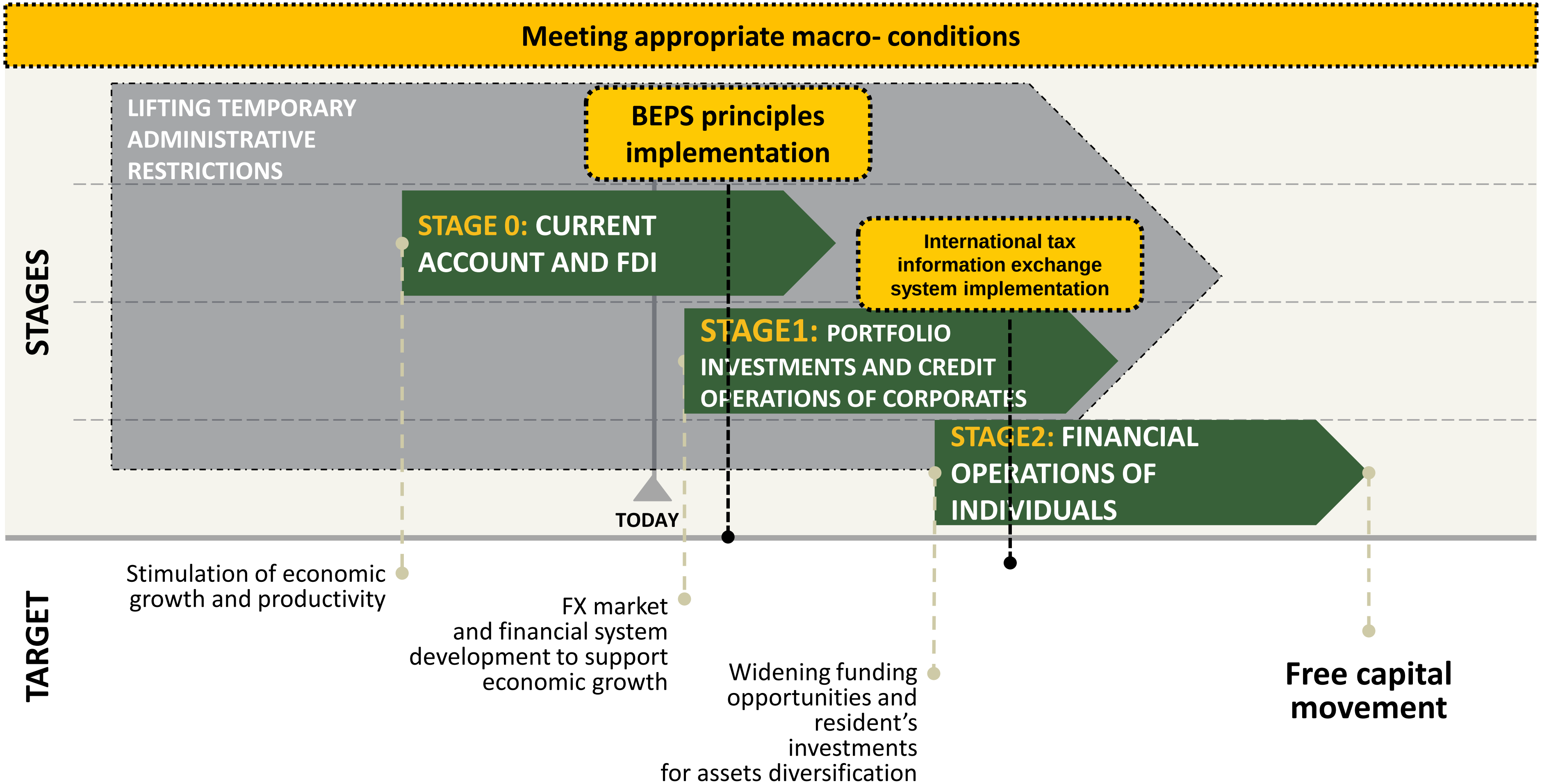

- Transition to the next stage of currency liberalization can be done in case of implementation of OECD recommendations to BEPS resistance and unified standard of automatic exchange of financial information

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Key messages to retain

- Ukraine has been recovering from "**perfect storm**", caused by the grave combination of severe shocks, including an armed conflict and annexation of Crimea
- Macroeconomic stabilization, the first signs of which were ensured in mid-2015, was maintained in 2016, despite numerous challenges (noisy political environment, large commodity price swings, delays with official financing, sporadic conflict escalation)
- **In 2017, the recovery will proceed but at slower pace than previously expected due to a halted trade with non-government controlled area**
- **The NBU ultimate objective is price stability**. Hence, reducing inflation to its medium-term target of 5% yoy under inflation targeting framework will be the main task for NBU monetary policy
- Other policy efforts will focus on securing financial stability (including a further build-up of international reserves), revamping the banking system, liberalizing capital account and promoting cashless economy
- Hence, **keep calm and stay long Ukraine!!**