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Ukraine: Macroeconomic and Policy Outlook

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Motivation behind the NBU’s monetary decision

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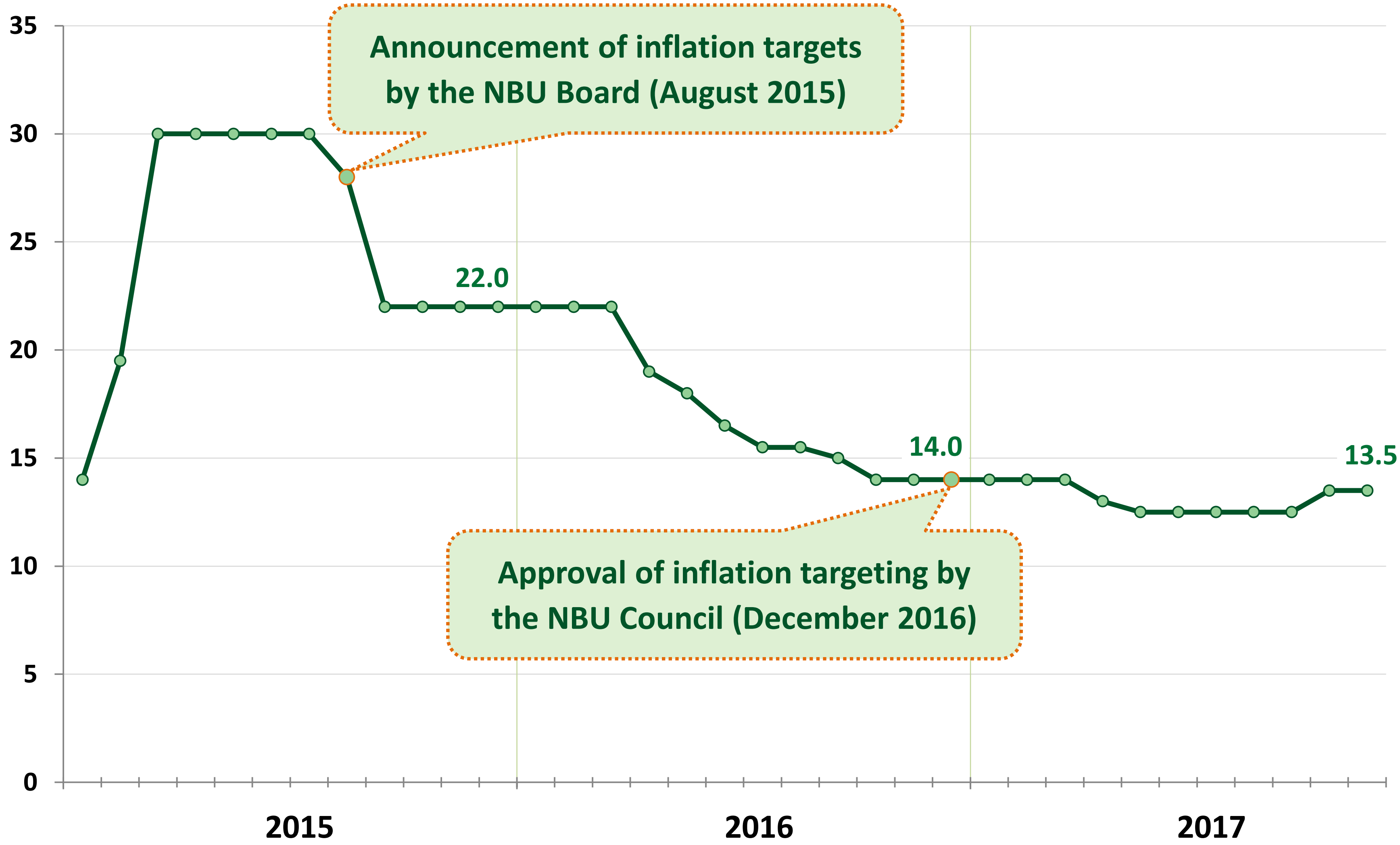
The NBU hiked the key policy rate for the first time since the adoption of inflation targeting

Key policy rate (end of month), %



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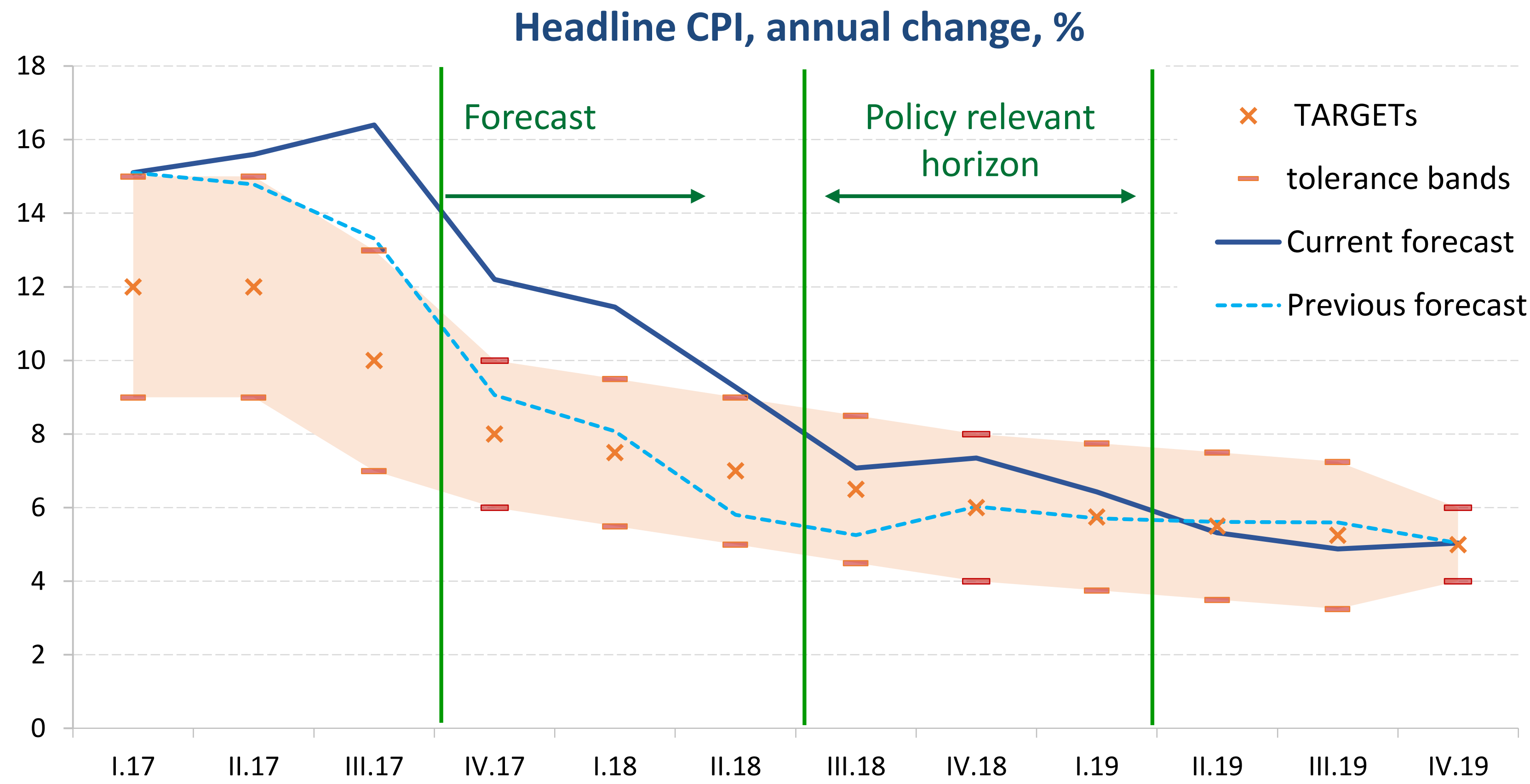
Motivation behind the key rate hike

- Reversing inflation trend and bringing inflation down to the target
- Regaining control over inflation expectations and anchoring them firmly to the target before return to the easing cycle
- Counteracting growing demand and labor market pressure
- Balancing upward risks for inflation outlook (IMF program delay, increase in social benefits, etc.)



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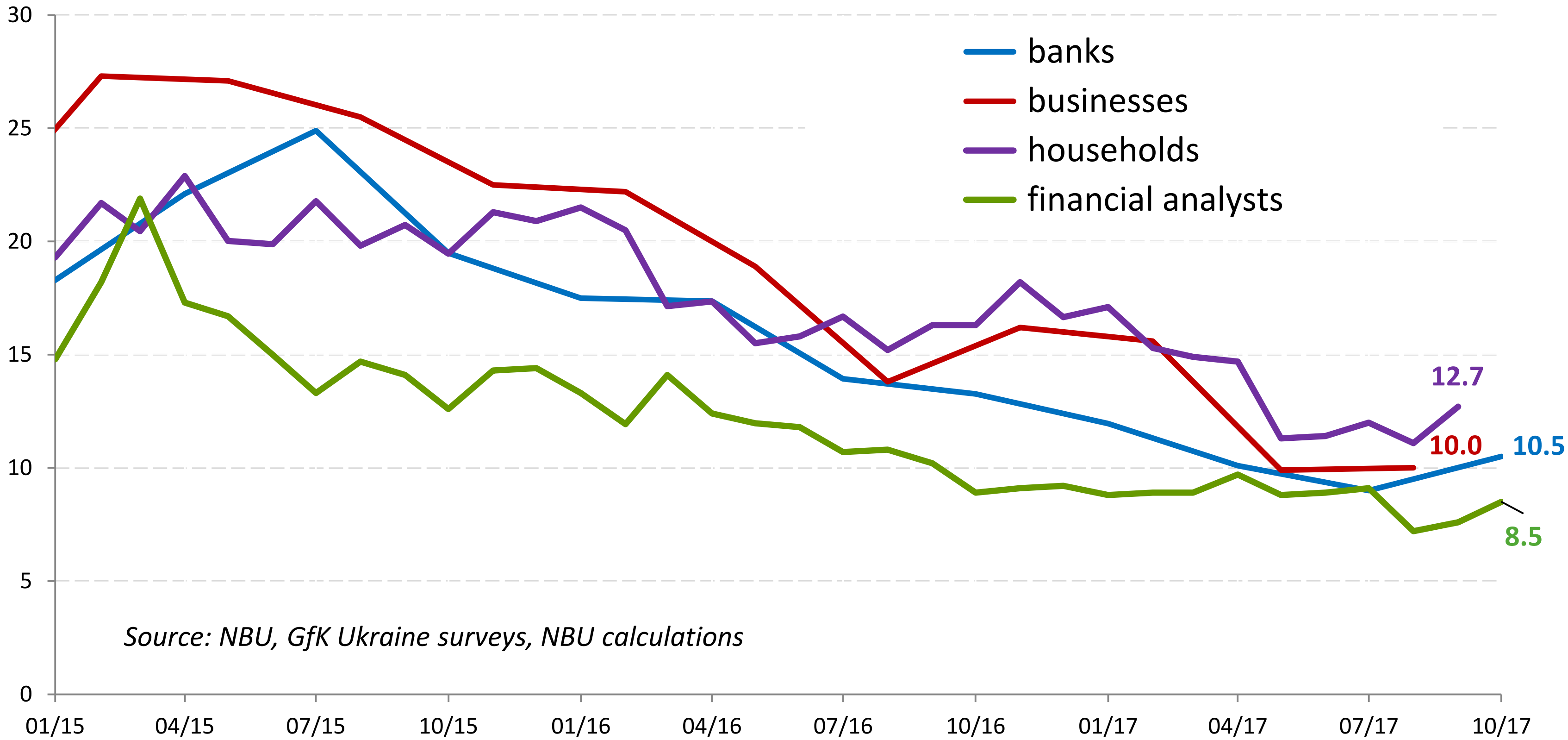
Inflation expectations worsened recently as a consequence of high actual inflation and other factors

Inflation expectations over the next 12 months, %



- Inflationary shocks have already translated into short-term forecasts; however, 12-months inflation expectations are much more persistent
- Meanwhile, professional analysts forecast inflation at the end-2018 close to upper border of NBU's target tolerance band
- Risks of self-fulfilling inflation expectations and higher inflation persistency are building up

Evolution of forward guidance in NBU`s press releases

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July 2017

For the key policy rate to be reduced further, the NBU needs to have clear indications that the above stated risks would not translate into a stronger inflationary pressure and impede the achievement of inflation targets in the medium term

August 2017

We added … At the same time, should underlying inflation pressure increase, **the NBU will implement a rather tight monetary policy for a longer term** to put inflation back on a downward trend in accordance with the announced targets

September 2017

New wording was included… However, should demand-driven inflationary pressures increase, including due to a rise in social standards that is inconsistent with economic productivity growth as well as a significant increase in inflation expectations, the **NBU may resort to a tighter monetary policy and raise its key policy rate** to mitigate inflationary pressures and return inflation to the target level

October 2017

In the event of realization of the above mentioned inflation risks, **the NBU may further raise the key policy rate** to offset their effects and return inflation to its target path. However, in case of deceleration of inflation according to the forecast, further cooperation with the IMF, and pursuing prudent fiscal policy, the NBU may return to the easing cycle of monetary policy at the end of 2018

NBU key rate hike transmitted into interbank market

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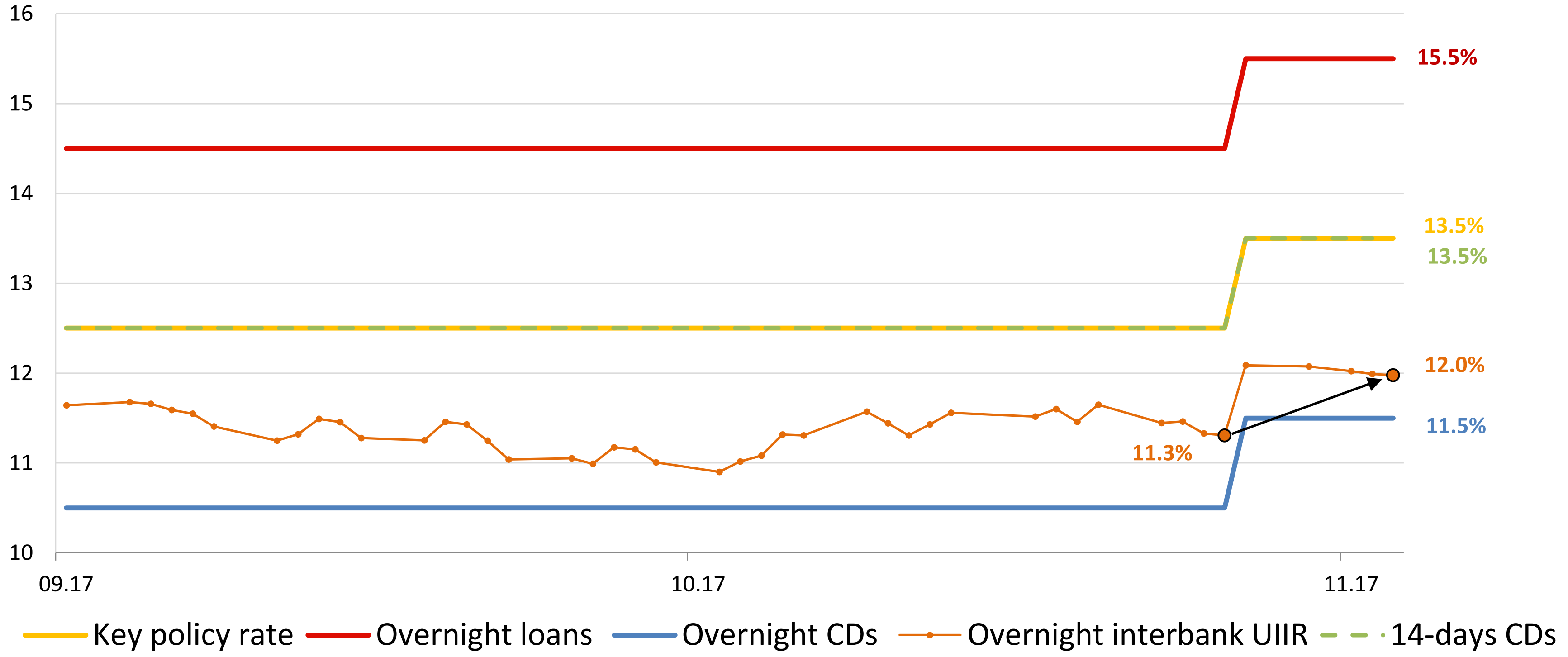
NBU Policy Rates and Ukrainian Index of Interbank Rates (as of 02.11.2017), % pa



Source: NBU

NBU key rate hike is expected to transmit into financial sector. Then it will affect inflation developments

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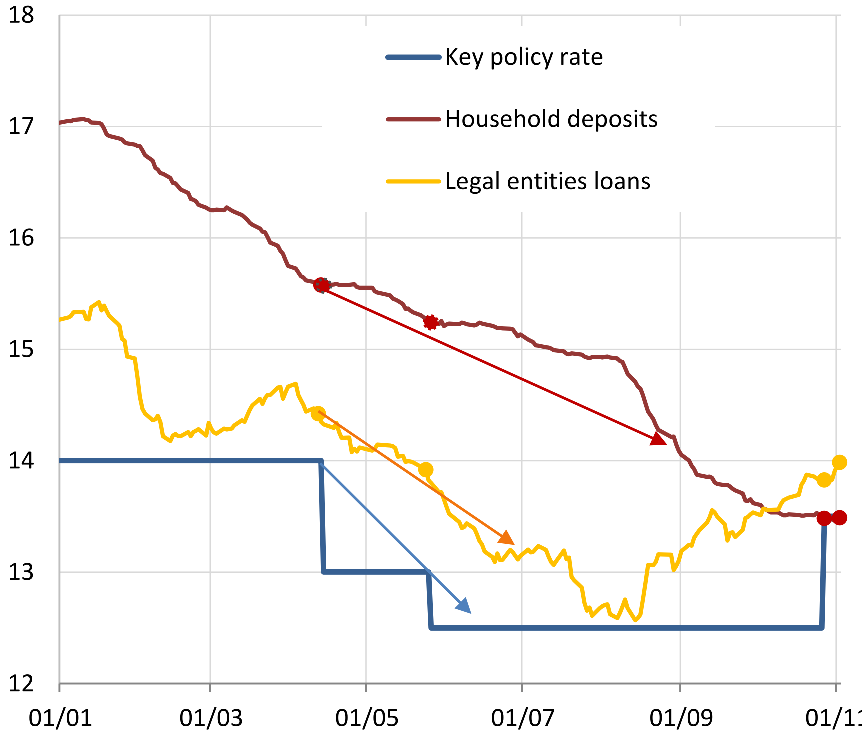
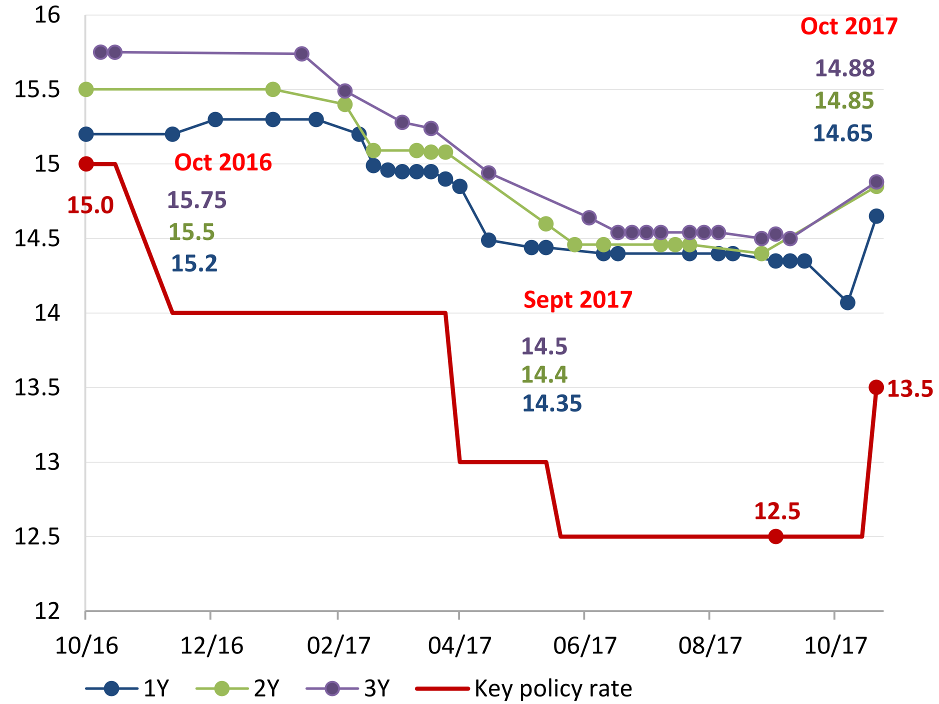
Key Policy Rate and Retail Hryvnia Interest Rates, % pa (Monthly Moving Average), as of 02.11.2017



Source: NBU

Term Structure of Hryvnia Yields on Primary Market, % pa



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

- In the past, the NBU's policy rate played a virtual signaling role. Nowadays, financial market reacts to key rate changes. The transmission mechanism is actively developing
- That's too early to assess the transmission of the last decision on banking rates. But there is anecdotal evidence that some banks have already increased their deposit rates

New macroeconomic forecast

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Summary

- Assumptions for global economic growth were revised upwards on forecast horizon, terms of trade are also favorable for Ukraine
- GDP growth forecast in 2017 is revised up to 2.2% (from 1.6%) due to higher than expected acceleration of investment and private consumption. Real GDP growth is projected to accelerate to 3.2% in 2018 and 3.5% in 2019
- NEER and BoP projections remain almost unchanged (CA deficit is flat in nominal terms – around $4bn, but decreases from 3.7% of GDP in 2017 to 3.1% of GDP in 2019). However, both exports & imports forecasts were revised upwards. International reserves are expected to rise at a slower pace than projected before due to lower official borrowings (only 2 IMF tranches are expected in 2018)
- Large budget deficit is expected in Q4 2017 on the back of a hike in pensions and capital expenditures; however, fiscal policy remains fairly tight in 2018-19 despite a further increase in social standards
- Consumer inflation will slow down by the end of 2017 (to 12.2% yoy) but will exceed the target band mainly on account of strong supply shocks. Further slowdown of inflation will be constrained by growing internal demand, including due to minimum wage increase and pension bill hike, higher excises, second-round effects from supply shocks. Tight monetary policy will be able to bring inflation closer to target level only in Q3 2018

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Key macroeconomic indicators

	2016	2017	2018	2019
Real GDP, change, %	2.3	2.2 (1.6)	3.2 (3.2)	3.5 (4.0)
Nominal GDP, UAH bn	2 383	2 880 (2 850)	3 270 (3 220)	3 628 (3 585)
CPI, yoy, %	12.4	12.2 (9.1)	7.3 (6.0)	5.0 (5.0)
Core CPI, yoy, %	5.8	8.0 (6.1)	5.5 (3.9)	2.9 (2.8)
Current account balance, USD bn	-3.5	-4.0 (-4.1)	-4.2 (-4.6)	-4.2 (-3.9)
BOP (overall), USD bn	1.3	2.2 (1.8)	2.2 (2.5)	0.6 (0.1)
Gross reserves, USD bn	15.5	18.6 (20.0)	22.2 (27.1)	21.2 (25.7)
Base money, eop change, %	13.6	3.3 (6.4)	6.2 (7.8)	5.0 (6.0)
Broad money, eop change, %	10.8	6.8 (9.0)	9.1 (13.5)	9.8 (12.6)

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

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Assumptions (external)

GDP growth, %	2016	2017	2018	2019
Euro area	1.7	1.9 (1.5)	1.7 (1.4)	1.5 (1.4)
Russia	-0.2	1.5 (1.1)	1.7 (1.3)	2.0 (1.6)
China	6.7	6.8 (6.6)	6.7 (6.5)	6.5 (6.3)
Commodity prices				
Oil (Brent), USD/bbl	43.9	53.7 (55.1)	62.1	64.8
Steel Billet Exp FOB Ukr, USD/MT	328.6	425.4 (379.3)	418.8 (386.5)	396.5
Wheat, USD/MT	143.1	146.7 (146.0)	158.1	161.7
Exchange rates (average)				
USD/EUR	1.11	1.13 (1.09)	1.18 (1.11)	1.18 (1.11)
RUB/USD	67.1	58.3 (58.0)	58.1	58.1

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

Faster recovery in domestic demand drives GDP in 2017. Tighter policy and stronger REER appreciation restrain growth in 2018-19

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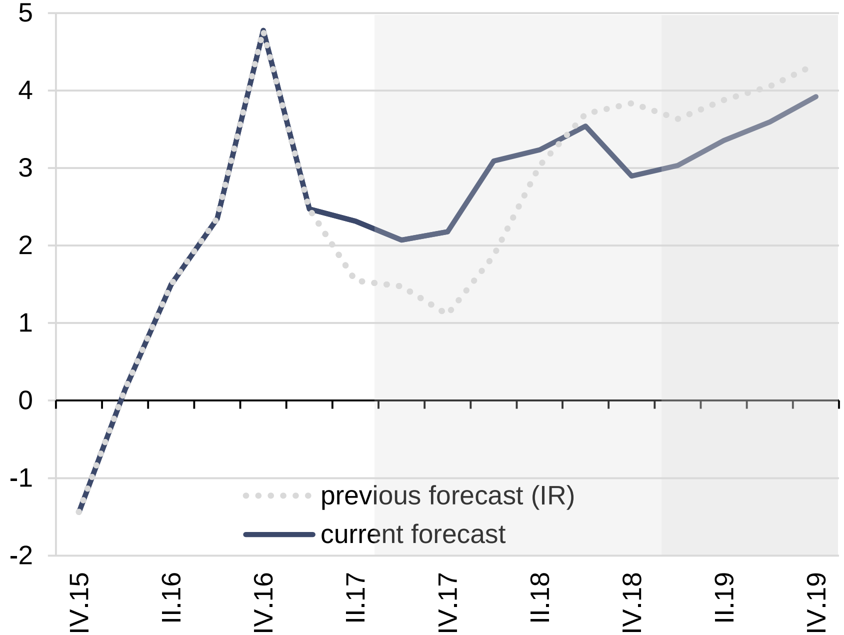

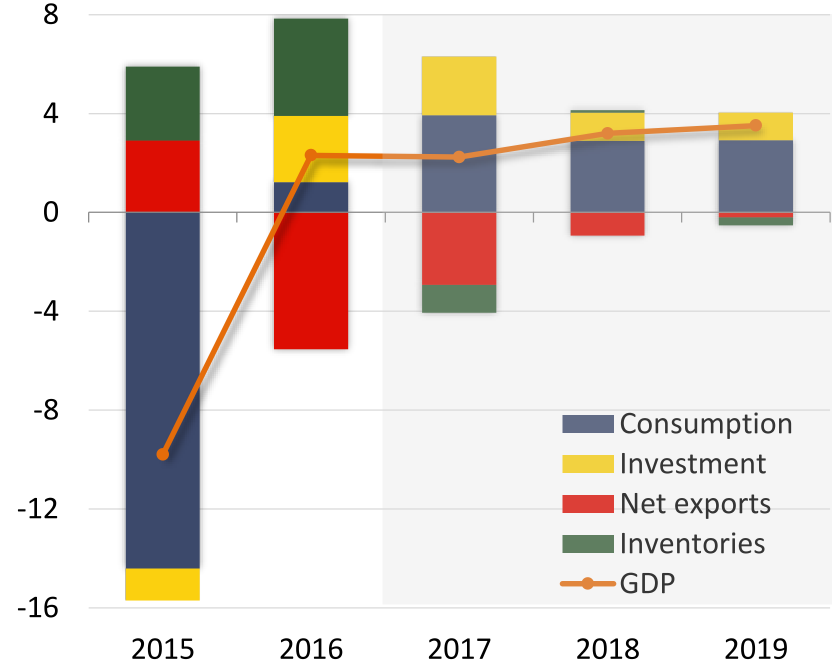

Source: State Statistic Service of Ukraine; NBU

change, % (in real terms)	2016	2017	2018	2019
GDP	**2.3**	**2.2** (1.6)	**3.2** (3.2)	**3.5** (4.0)
Consumption	1.4	4.6 (3.9)	3.3 (2.9)	3.3 (2.9)
Private consumption	1.8	6.0 (4.9)	4.0 (3.6)	4.0 (3.6)
Gross fixed capital formation	20.1	16.0 (7.4)	7.1 (5.5)	6.9 (6.7)
Export of goods and services	-1.6	5.1 (4.9)	3.3 (5.0)	3.2 (3.7)
Import of goods and services	8.4	9.8 (8.6)	4.7 (4.6)	3.2 (3.1)

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

Downward revision in 2018-2019

- ↓ Tighter monetary policy
- ↓ REER appreciation

- ↑ Private consumption and investments recovery
- ↑ Better terms-of-trade and external demand

Raw food inflation surged due to more prolonged upsurge in world meat prices; other supply shocks also contributed strongly

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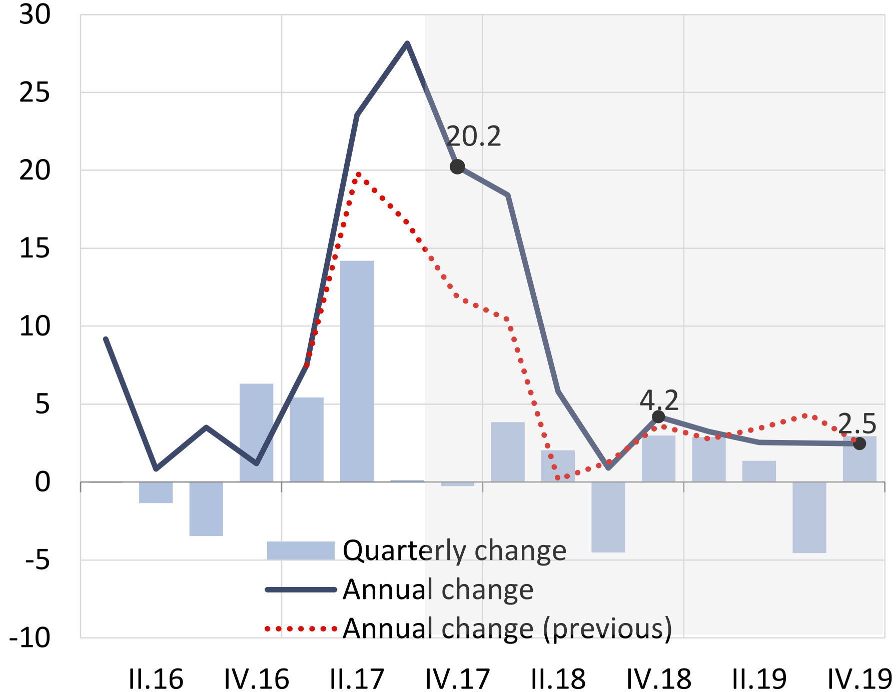
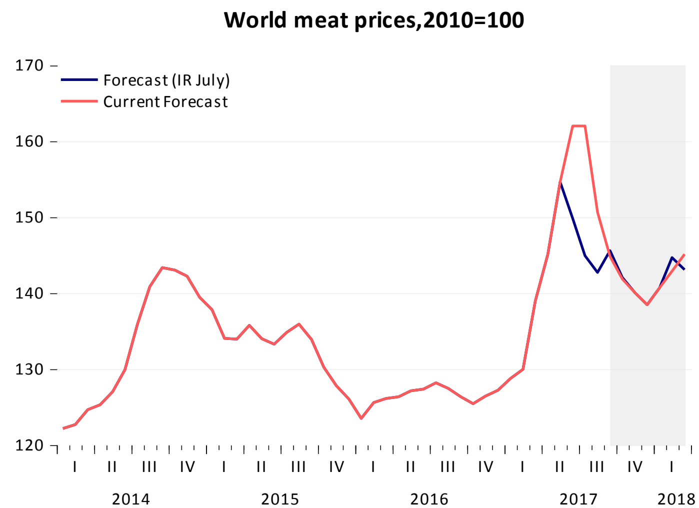
Raw food prices, %



Assumptions, Underlying the Forecast

Meat Index (01.2004=1)



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

Price change, %	*weight , %*	2016	2017	Factors of revision
Cereals	*1.8*	9.5	0.1 (5.2)	Lower than expected world grain prices
Meat	*7.4*	5.1	24.5 (12.1)	Soaring world meat prices, increase in exports, decrease in livestock
Milk	*2.2*	23.3	12.0 (12.0)	≈
Eggs	*1.2*	-9.6	4.7 (4.6)	≈
Fruit	*2.7*	-6.6	32.2 (14.2)	Poor harvest of fruit (e.g. apples in UA and PL)
Vegetables	*2.3*	-28.6	20.4 (13.3)	Low harvest expectations (unfulfilled) and changing the SSS methodology drove prices up in 9M2017, projected more sticky prices in future
Sugar	*1.5*	-1.3	4.6 (5.2)	≈

Core inflation is higher due to inflation persistence, pass-through from food supply shocks and real marginal costs contribution

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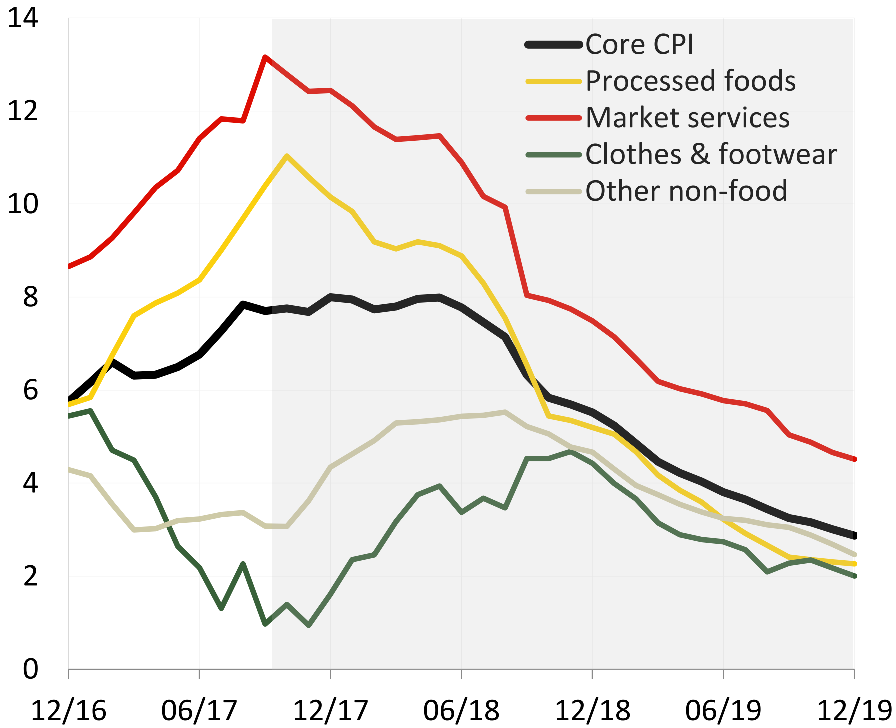

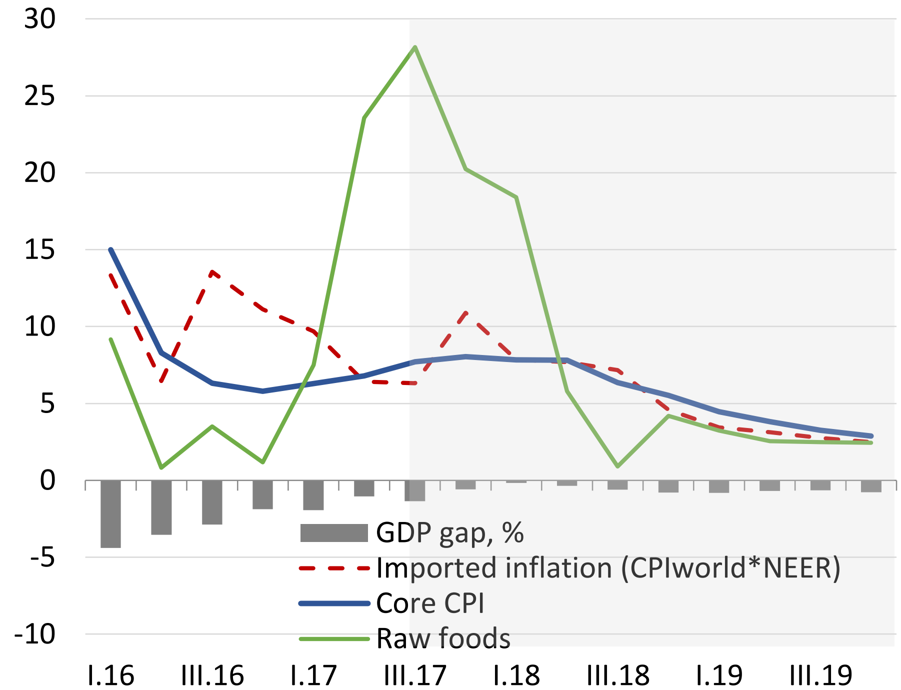

change, %	*weight,%*	2016	2017		2018		2019	
Core CPI	***57.4***	**5.8**	**8.0**	**(6.1)**	**5.5**	**(3.9)**	**2.9**	**(2.8)**
Processed foods	*20.1*	5.7	10.2	(6.6)	5.2	(2.0)	2.3	(1.8)
Market services	*12.4*	8.7	12.4	(8.3)	7.5	(5.1)	4.5	(3.4)
Clothes & footwear	*5.4*	5.4	1.6	(2.2)	4.5	(2.3)	2.0	(1.3)
Other non-foods	*19.5*	4.3	4.3	(4.6)	4.7	(5.7)	2.5	(3.7)

Growing domestic demand and further growth in real wages impose additional upward pressure on inflation

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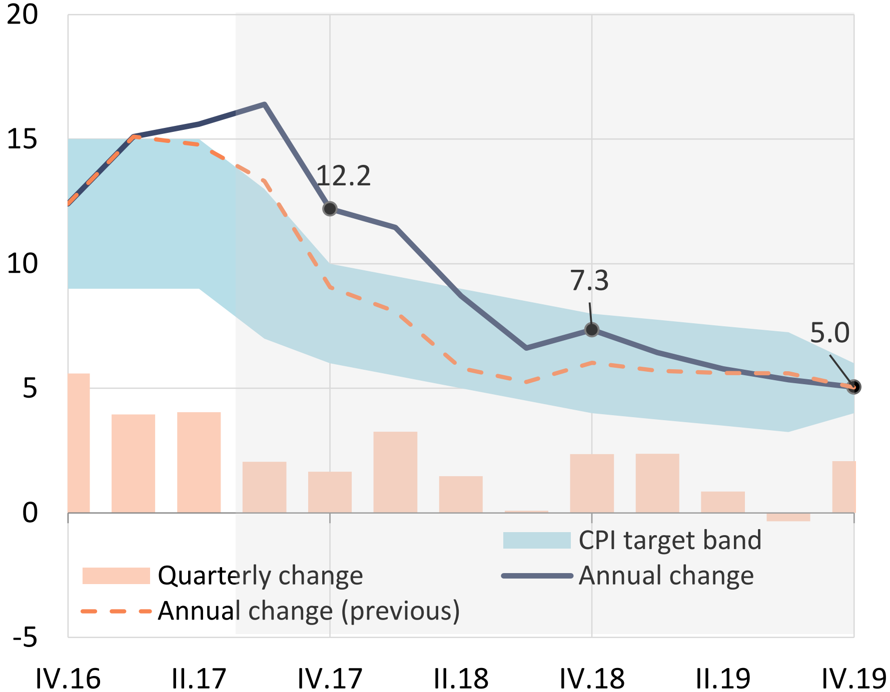
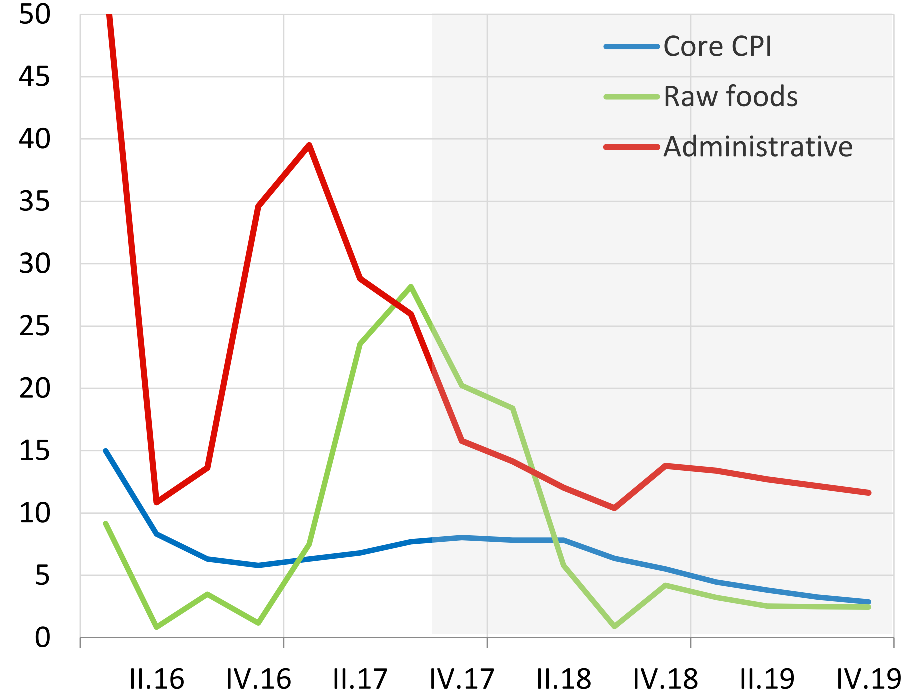
Headline CPI, %



CPI components, % yoy



change, %	*weight, %*	2017	2018	2019
CPI	*100.0*	12.2 (9.1)	7.3 (6.0)	5.0 (5.0)
Core CPI	*57.4*	8.0 (6.1)	5.5 (3.9)	2.9 (2.8)
Raw food	*19.0*	20.2 (11.8)	4.2 (3.6)	2.5 (2.5)
Admin	*18.6*	15.8 (13.8)	13.8 (12.3)	11.6 (11.5)
Fuel	*5.0*	16.0 (13.0)	9.0 (8.0)	5.0 (6.0)

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

Inflation factors:

- ↑ Negative supply shocks on food markets
- ↑ High demand and private consumption
- ↑ Pension reform impulse
- ↑ Minimum wages growth impulse

- ↓ Stronger UAHUSD exchange rate
- ↓ Improved inflation expectations

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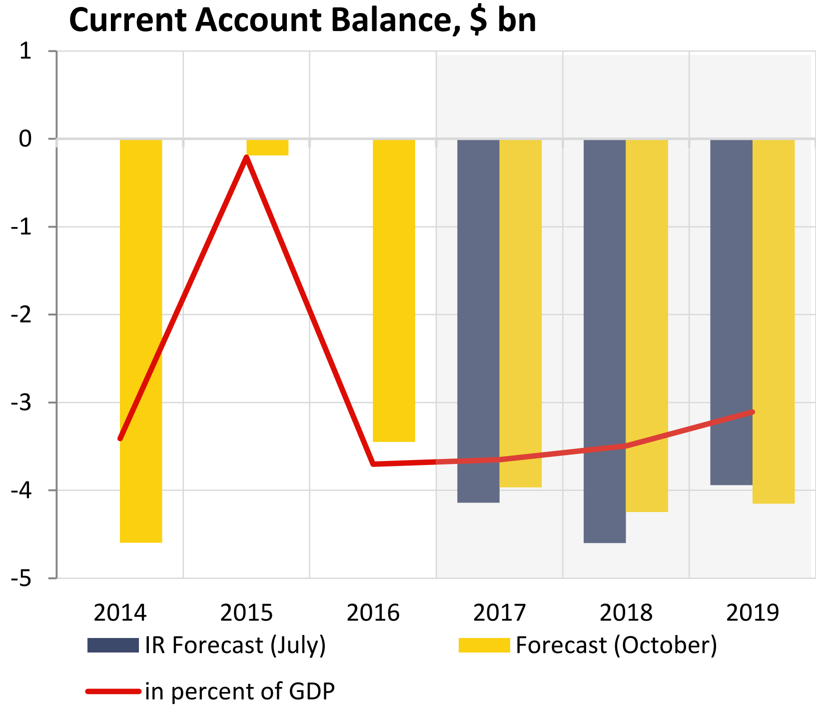
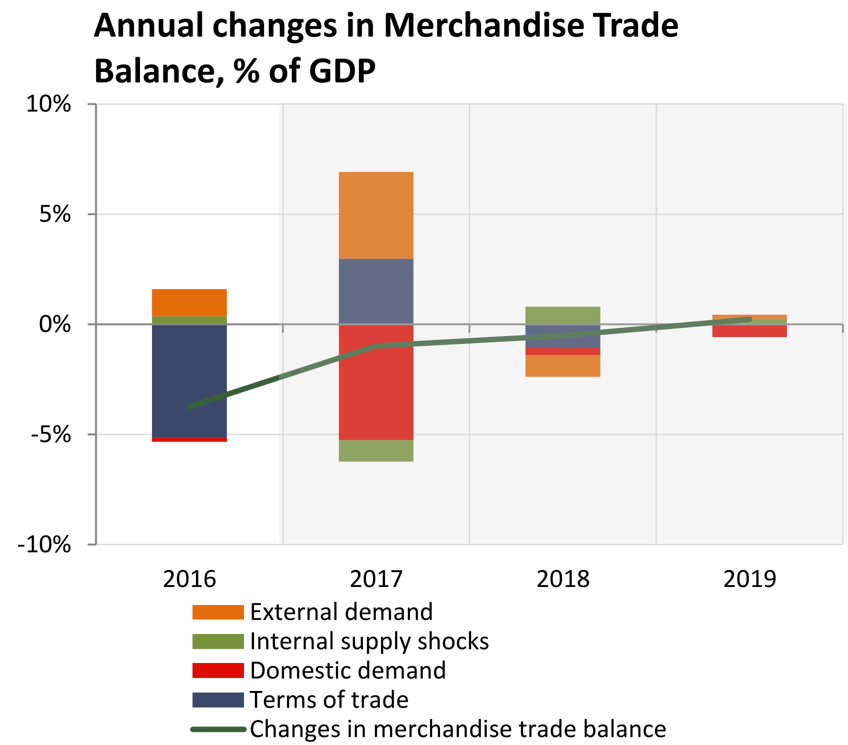
In 2017-2019, CA deficit remains almost unchanged in nominal terms, gradually decreasing to 3% GDP in 2019





Main factors of CA forecast revision in 2017-2019	
Trade balance (↓)	↓↓ Volumes of exported iron ore, ↓ Metallurgical imports
	↑ Exports of grain in 2017/2018 MY, ↑ Steel prices in 2H2017-1H2018, ↓ Gas prices, ↑Net exports of fertilizers
Balance of services (≈)	↑ Import of “travel” item, ↑ Exports of transportation services
Primary&secondary income (↑)	↑ Remittances

Fiscal policy remains balanced with slight fiscal impulse

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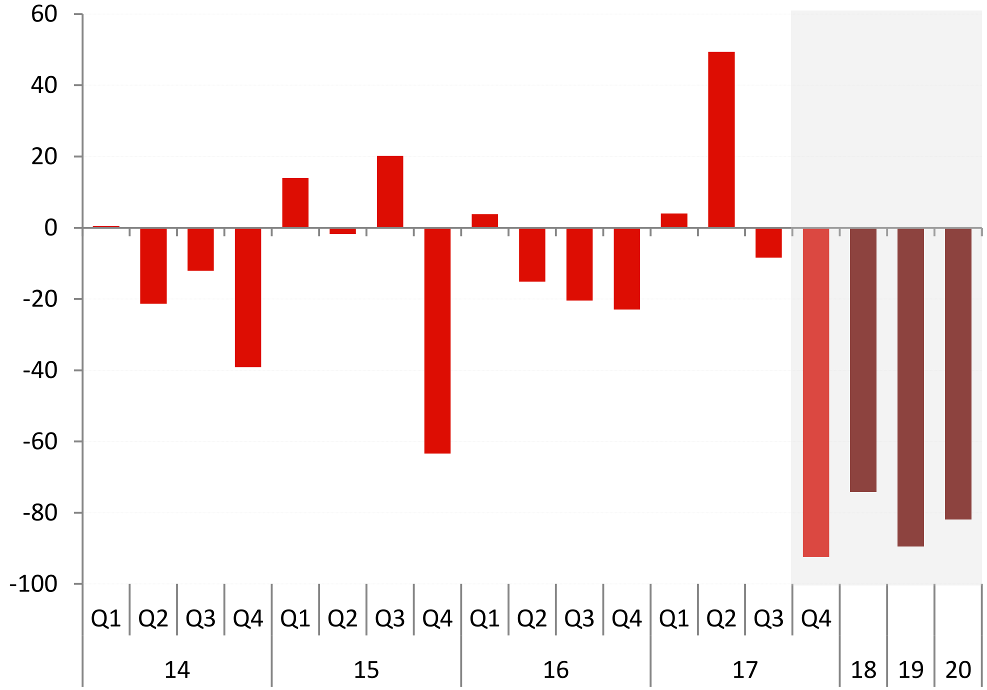
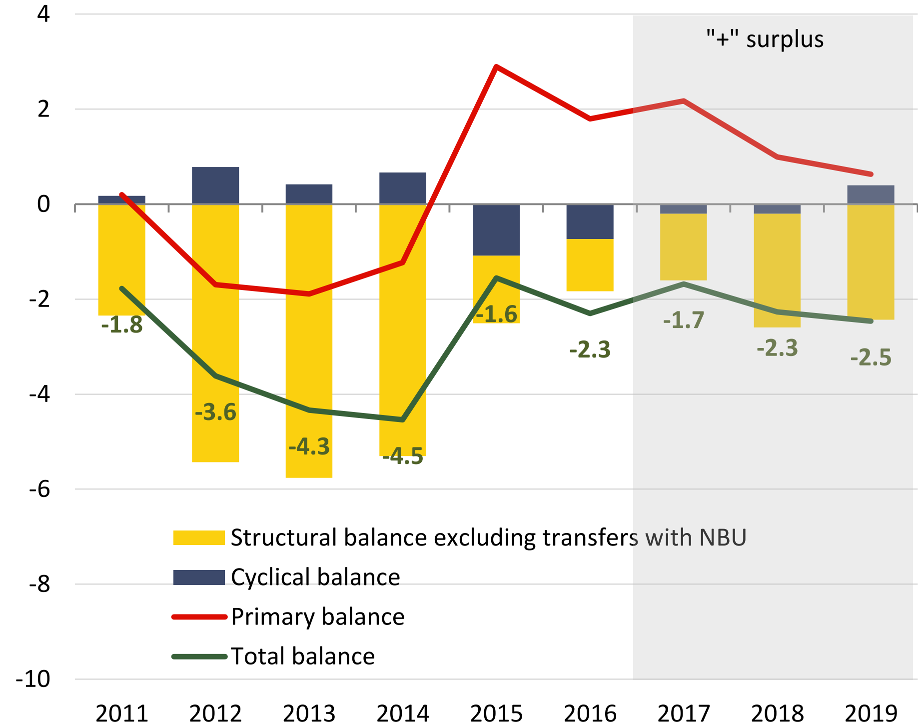
Consolidated Budget Balance, UAH bn



Consolidated Budget Balance, % GDP



	2016	2017	2018	2019
Consolidated budget balance (UAH bn)	-54.8	-48.4	-74.1	-89.4

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NBU policy under different scenarios

"In the event of realization of the above mentioned inflation risks, **the NBU may further raise the key policy rate** to offset their effects and return inflation to its target path. However, in case of deceleration of inflation according to the forecast, further cooperation with the IMF, and pursuing prudent fiscal policy, the NBU may **<u>return to the easing cycle of monetary policy at the end of 2018</u>**"

Scenario	Results (2018-2019)	NBU policy
Baseline - status-quo in the east - structural reforms - IMF program	GDP +3.2% +3.5% CPI 7.3% 5.0%	Admin. restrictions ↓ Interest rate =↓
Optimistic - lower global energy prices (oil, gas, coal) - higher export prices - foreign capital inflows	GDP ↑ UAH/USD ↓ CPI ↓	Admin. restrictions ↓↓ Interest rate ↓ (earlier)
Pessimistic - further delays in IMF tranches - expansionary fiscal policy (elections) - negative terms of trade shocks	GDP ↓ UAH/USD ↑ CPI ↑	Admin. restrictions = Interest rate ↑