National Bank of Ukraine

Macroeconomic and Policy Outlook

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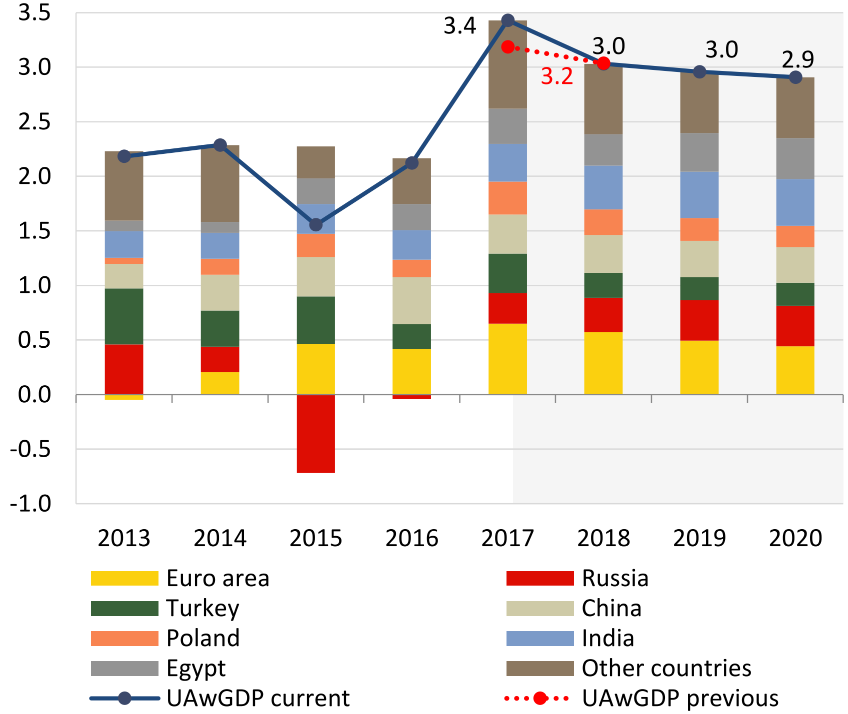
Deputy Governor

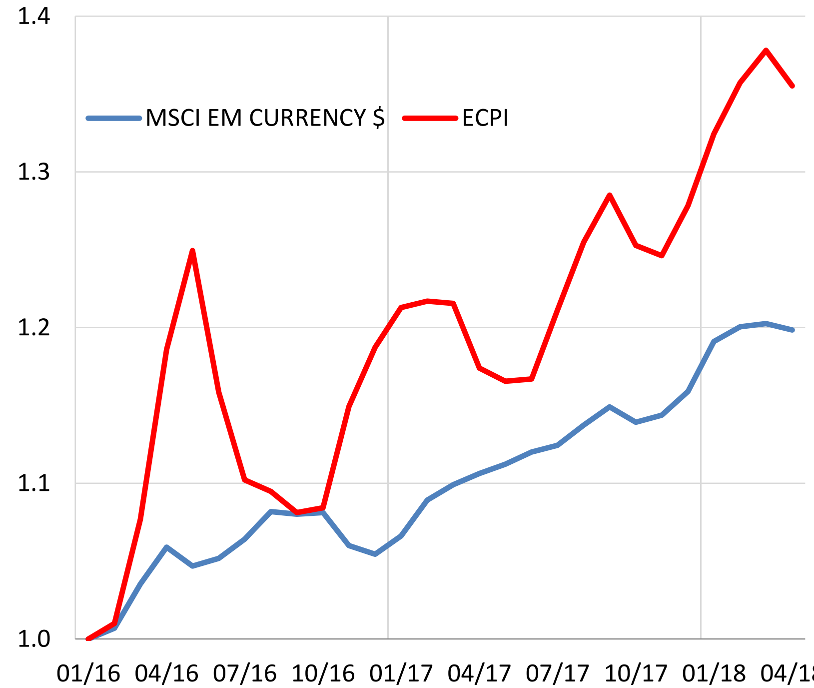
June 2018

The external environment remains favorable for Ukraine, but financial conditions for EMs have recently started to worsen

Contributions of Ukraine's MTP[1] Countries to the Annual Change in UAwGDP[2], %



External Commodity Price Index (ECPI[3]) and MSCI EM Currency, Jan. 2016=1



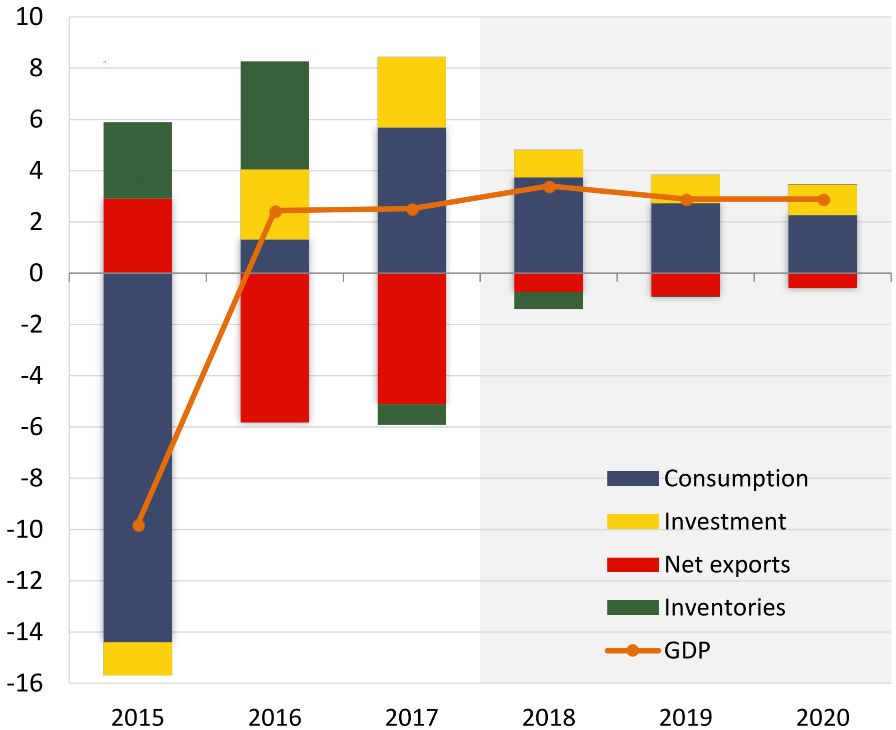
[1]MTP – main trading partners; [2]UAwGDP - the weighted average of annual economic growth rates of Ukraine's MTPs , [3]ECPI - an index of changes in global prices for Ukrainian export commodities.

Source: Thomson Reuters, NBU staff estimates

- The global economy is in an expansion phase, thanks to stronger domestic demand and a pickup in international trade. Global prices still remain favorable for commodity exporters
- However, financial conditions have recently worsened for EMs as investors anticipated a faster pace of Fed tightening, and also due to rising protectionism globally and renewed strengthening of the US dollar

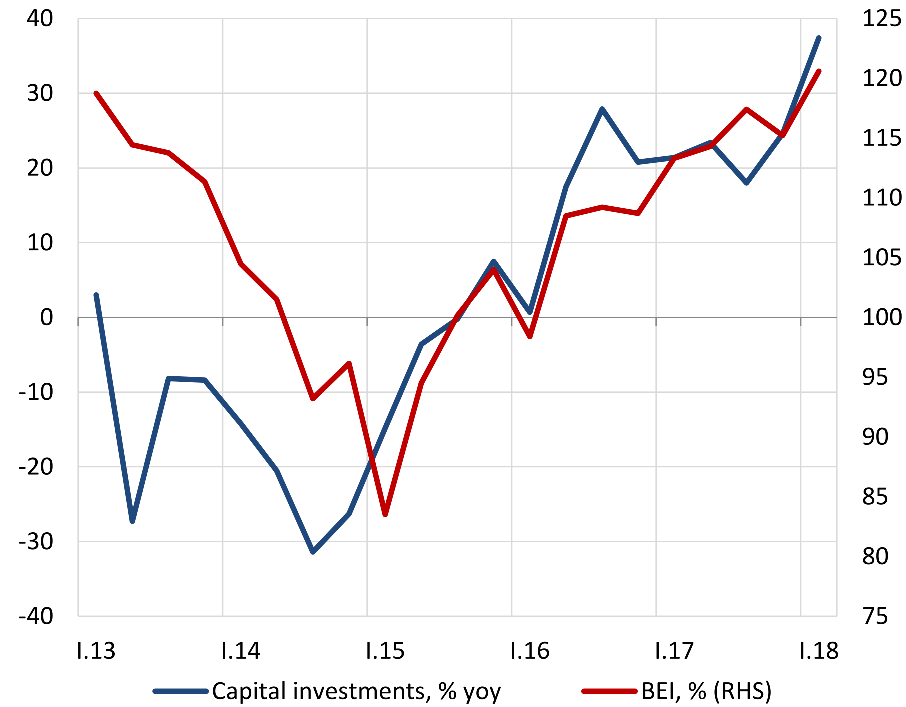
The Ukrainian economy has been recovering, despite military conflict headwinds and Russia's trade restrictions

Contributions to Real GDP Growth, pp



Source: SSSU; NBU estimates and forecast (April 2018 IR)

Capital Investments and Business Expectations Index

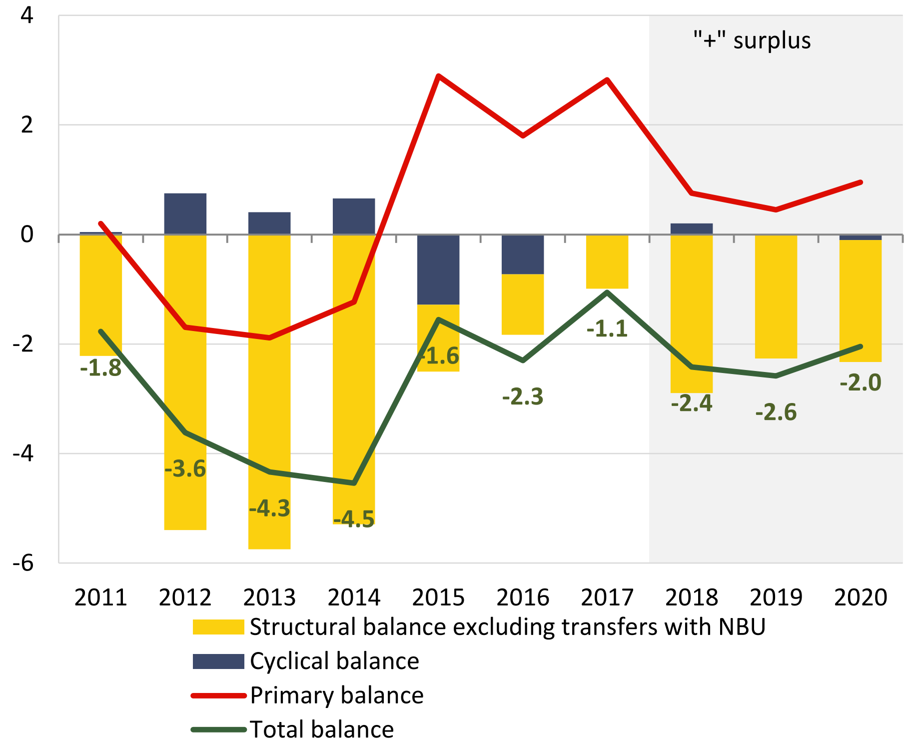


Source: SSSU; NBU staff estimates based on surveys of enterprises

- GDP grew by 2.5% yoy in 2017, underpinned by strengthening consumption and robust investment demand. Real GDP growth in Q1 2018 of 3.1% yoy also exceeded expectations
- Fiscal impulse and a favorable external environment will support real GDP growth in 2018, but tight monetary conditions will have a restraining effect
- Investment activity will stay robust, benefiting among other things from an improving business climate

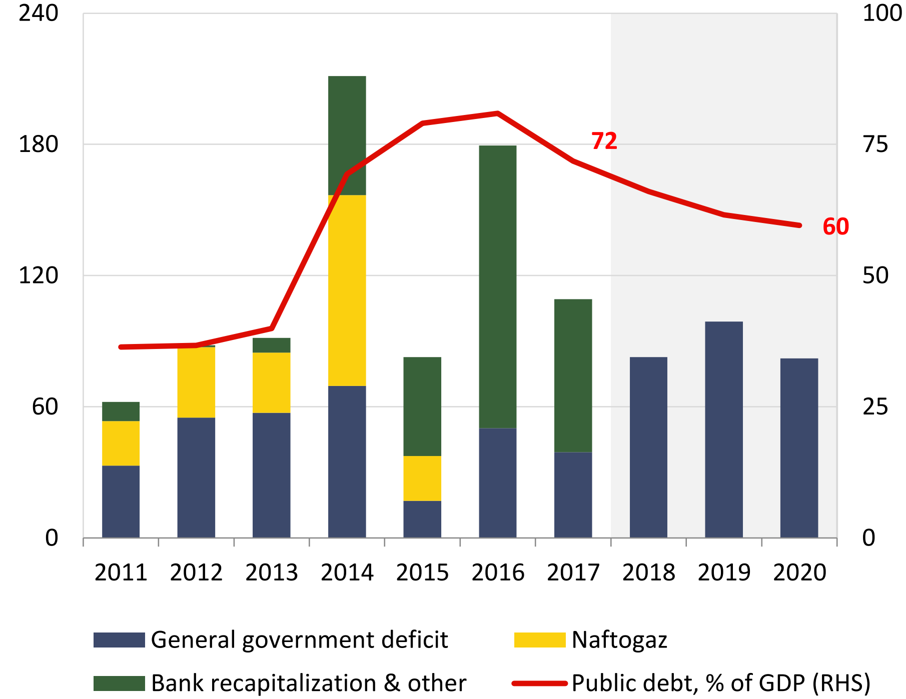
The surge in social spending stimulates economic activity, although generates inflationary pressures

Consolidated Budget Balance, % of GDP



Source: MFU, NBU calculations

Public Sector Deficit, UAH bn, and Public Debt-to GDP Ratio, %

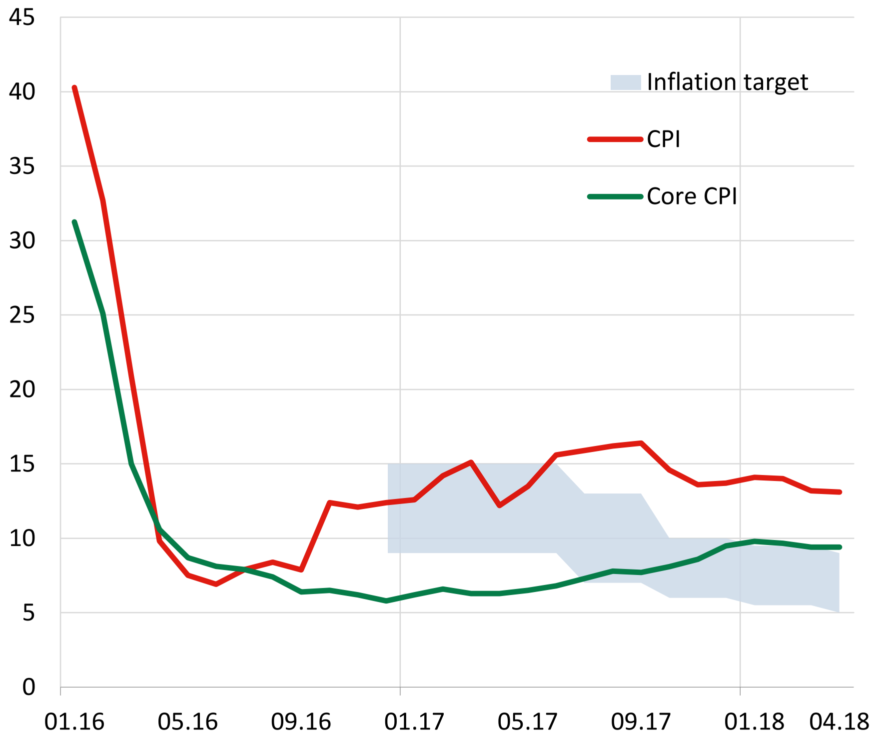


Source: MFU, SSSU, NBU calculations

- The fiscal policy has largely been in check over the last three years, although the latest social spending increases (minimum wage hike, pension increases) have pushed inflation up
- The fiscal deficit is to remain in the 2-3% of GDP range in 2018-20, while the public debt to GDP ratio will slide further, gradually approaching the threshold of 60%

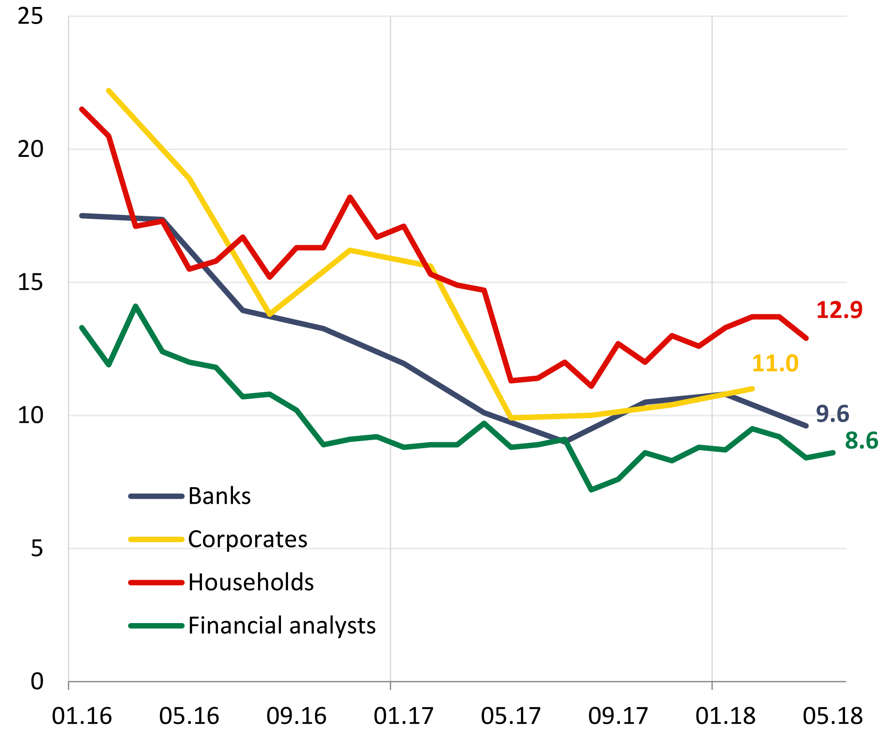
Following a remarkable disinflation in 2016, consumer inflation hovered at low double digits throughout 2017 and at the beginning of 2018

Headline and Core Inflation, % yoy



Source: State Statistics Service of Ukraine (SSSU)

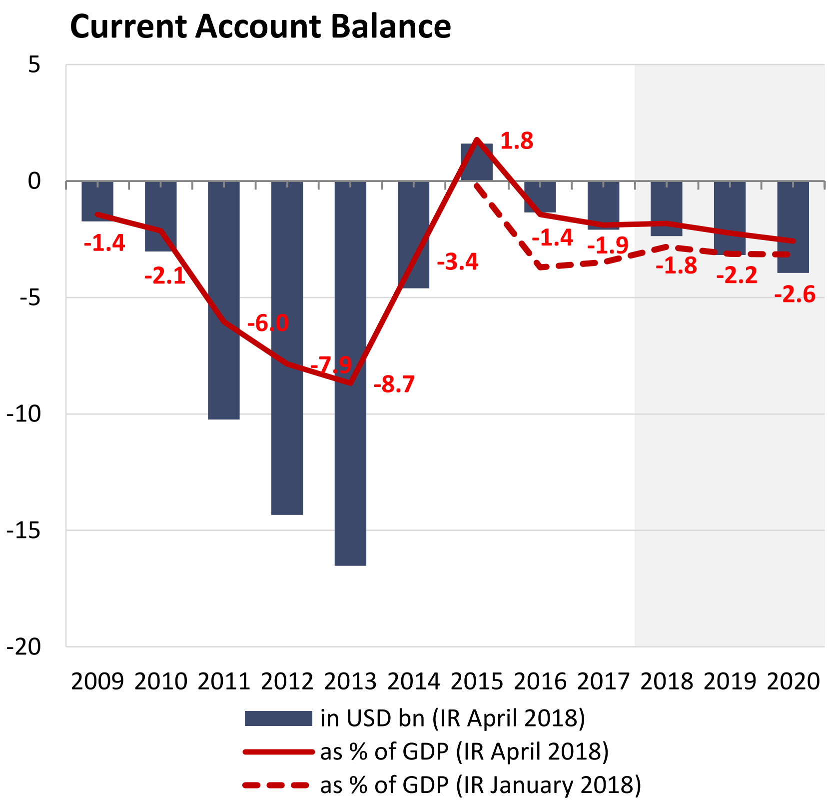
Inflation Expectations for the Next 12 Months, %



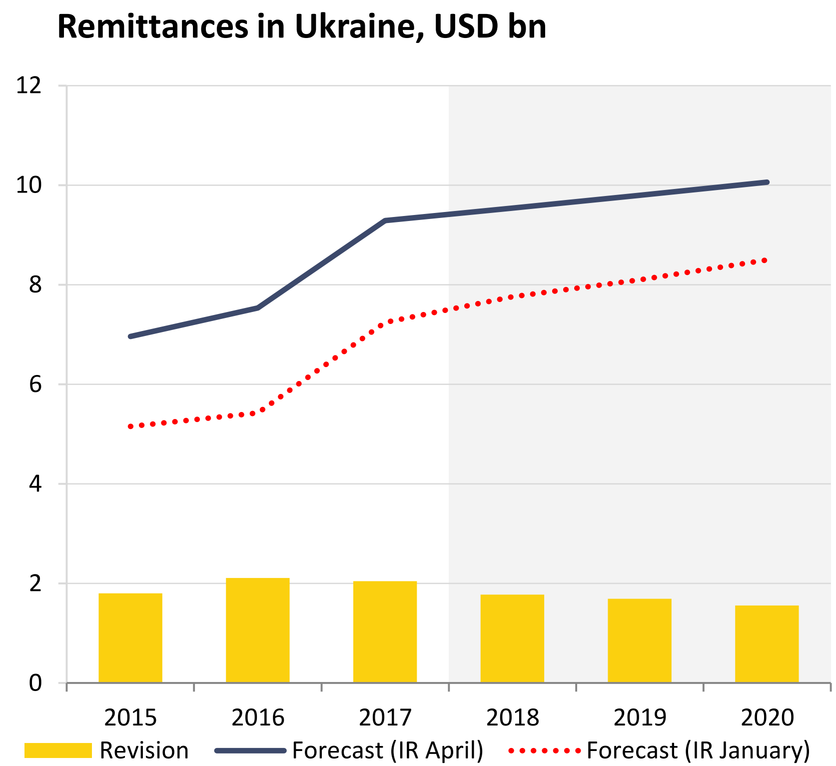
Source: NBU; GfK Ukraine surveys; NBU staff estimates

- Inflation has been above the target band since mid-2017 due to food supply shocks, related price movements and stronger domestic demand
- On the other hand, favorable FX market developments partially offset the impact of demand-pull and cost-push factors
- Inflation expectations for the next 12 months remained elevated at the beginning of the year, but have recently started to show signs of improvement

The CA deficit has been gradually widening, but is expected to stay in the safe zone thanks to favorable ToTs, strong remittance inflows, and flexible ER policy



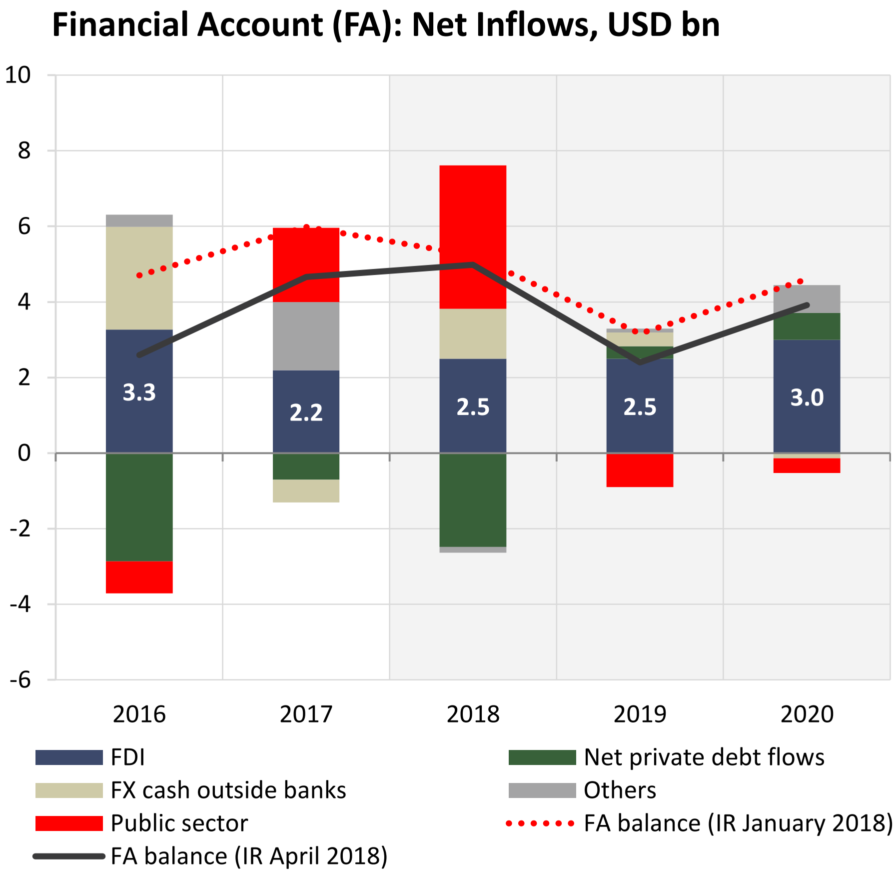
Source: NBU



Source: NBU

- In the coming years, exports will be supported by favorable terms of trade, improved competitiveness and growing external demand in MTP countries, but imports will stay elevated too due to robust domestic demand
- A gradual widening of the trade deficit will be offset by an increase in remittances (recently personal remittance data was revised upwards by about USD 2 billion each year in order to reflect increased labor migration)

Private capital inflows are to rise modestly, while the public sector will switch from net borrowings to net repayments in 2019-20, putting a drag on reserves



Source: NBU

Source: NBU

- In 2018-2020, FDI and debt capital inflows to the private sector are forecast to increase. However, due to peak repayments of external public debt in 2019-20, the overall balance of payments is expected to be in deficit, limiting the building up of reserves

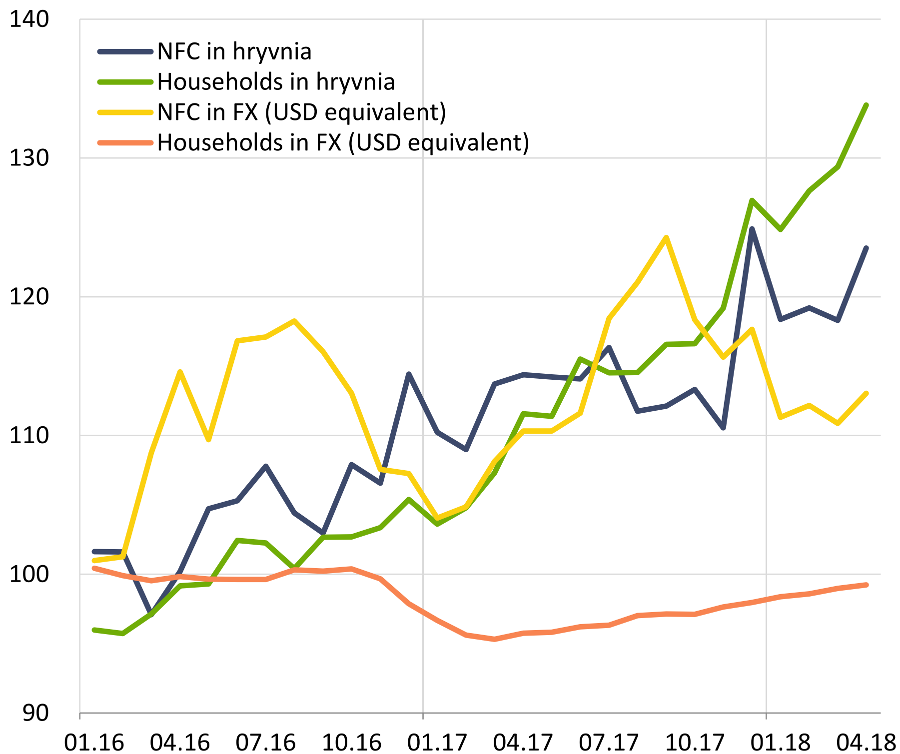
Key macroeconomic indicators (Inflation Report, April 2018)

	2017	2018f	2019f	2020f
Real GDP, % yoy	2.5 (2.1)	3.4 (3.4)	2.9 (2.9)	2.9 (2.9)
Nominal GDP, UAH bn	2983 (2930)	3451 (3394)	3842 (3779)	4186 (4117)
CPI, eop, % yoy	13.7 (13.7)	8.9 (8.9)	5.8 (5.8)	5.0 (5.0)
Core CPI, eop, % yoy	9.5 (9.5)	7.7 (8.2)	4.8 (4.8)	3.3 (3.2)
Current account balance, USD bn	-2.1 (-3.8)	-2.4 (-3.5)	-3.2 (-4.2)	-3.9 (-4.7)
BOP (overall), USD bn	2.6 (2.6)	2.6 (1.8)	-0.8 (-1.1)	0.0 (-0.1)
Gross reserves, USD bn	18.8 (18.8)	21.6 (20.5)	19.1 (17.8)	20.0 (18.6)

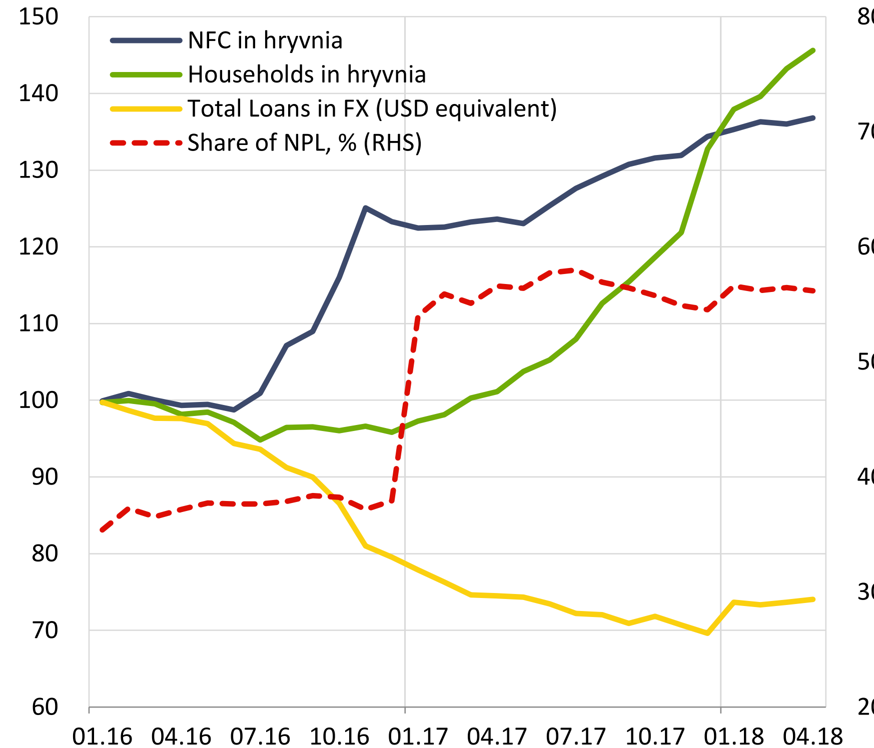
In parentheses: previous forecast (Inflation Report, January 2018)

The banking system has been gradually recovering from the crisis

Deposit developments, 12.2015=100



Loan developments, 12.2015=100



NFC – non-financial corporations; FX – foreign currency; NPL – non-performing loans

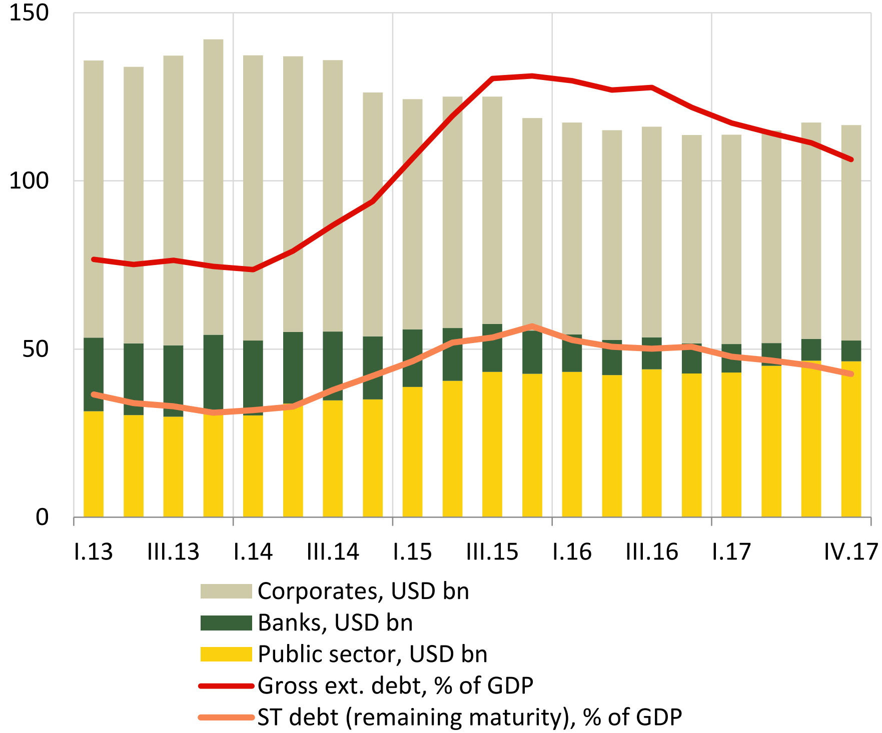
Source: NBU

Source: NBU

- Since 2017, nearly all key performance indicators improved: inflow of deposits continued, lending revived with consumer loans reporting remarkable growth
- The spike in the share of NPLs at the start of 2018 was mostly a reflection of new methodology

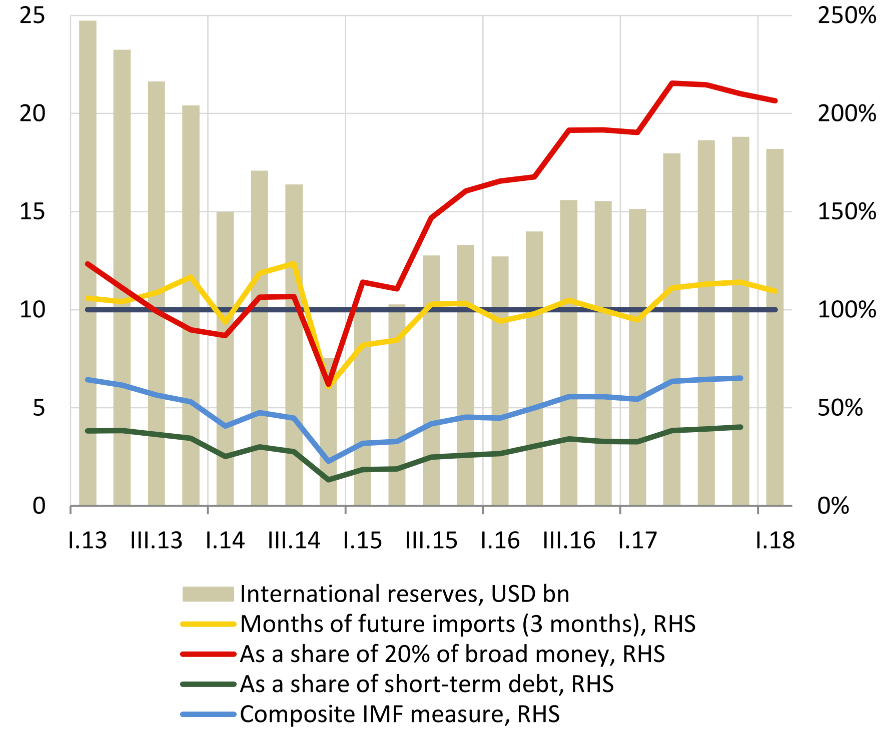
The gradual recovery of the economy and the relative stability of the exchange rate has led to an improvement in external sustainability indicators

External Debt



Source: NBU

International Reserves and their Adequacy Criteria, %



Source: NBU

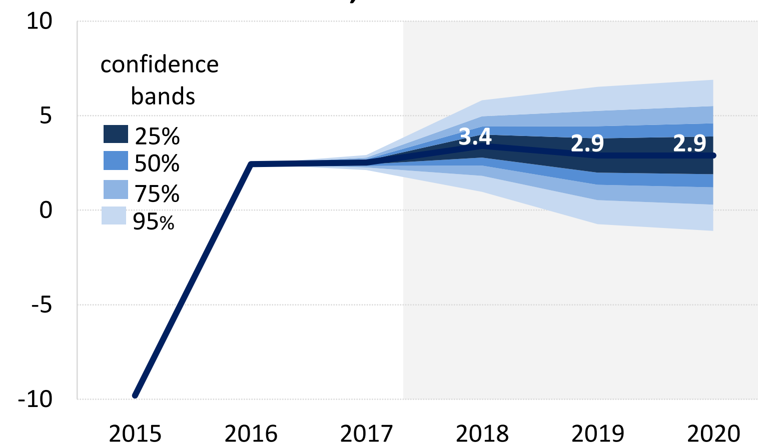
- The growth of gross external debt and short-term external debt by residual maturity were both backed by the public sector
- In Q1 2018, international reserves decreases slightly, mainly due to repayments of IMF loans
- Despite the improving external sustainability indicators, Ukraine remains extremely vulnerable to external shocks, in particular due to the significant debt burden on the public sector in the medium term

Key risks and challenges

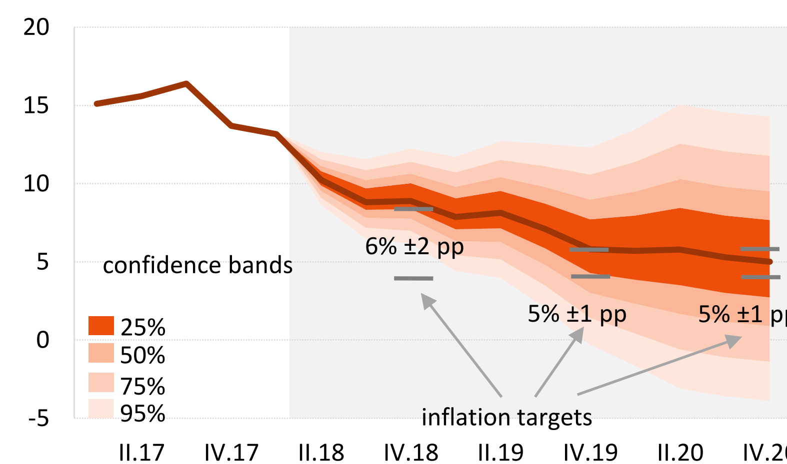
Key risks to the baseline macroeconomic scenario:

- Halt in IMF program due to delays in structural reforms (while Ukraine approaches high debt repayments)
- Further loosening of fiscal policy
- Escalation of the military conflict in eastern Ukraine
- Turbulent external environment (high risk of “trade wars,” geopolitical risks)

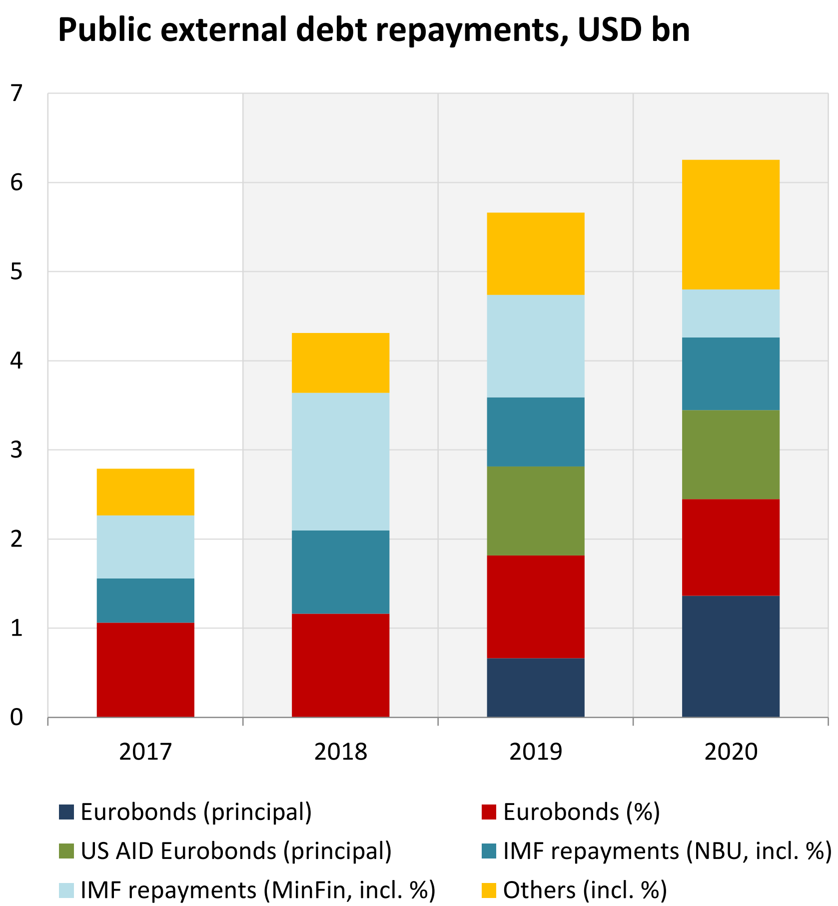
Real GDP Growth, %



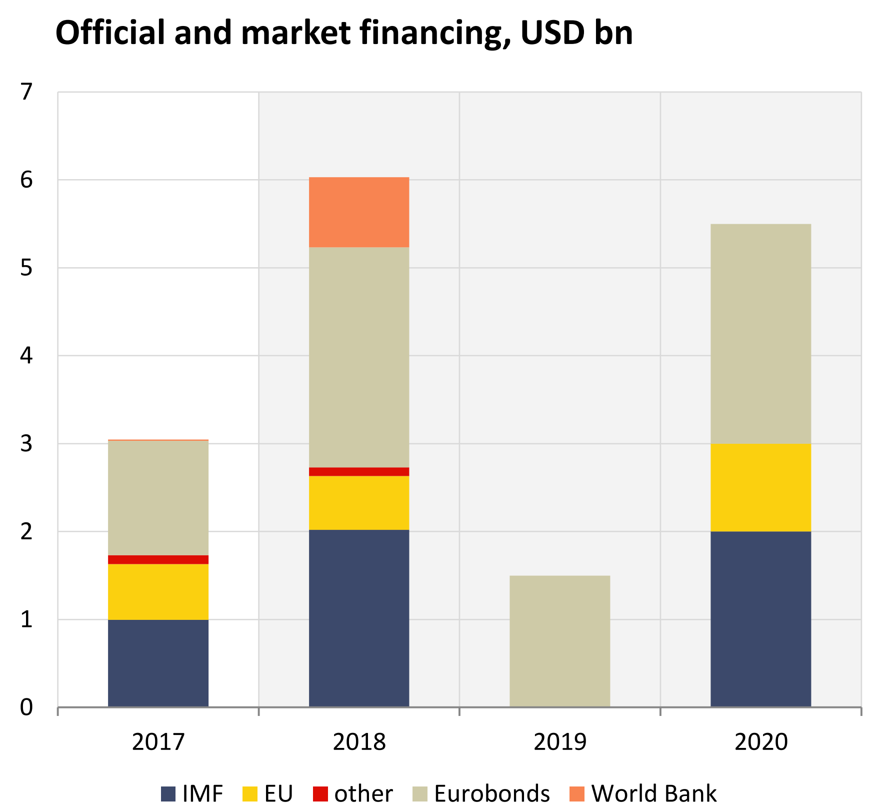
Consumer inflation and targets, %



Public external debt repayments significantly exceed official disbursements in 2019-2020



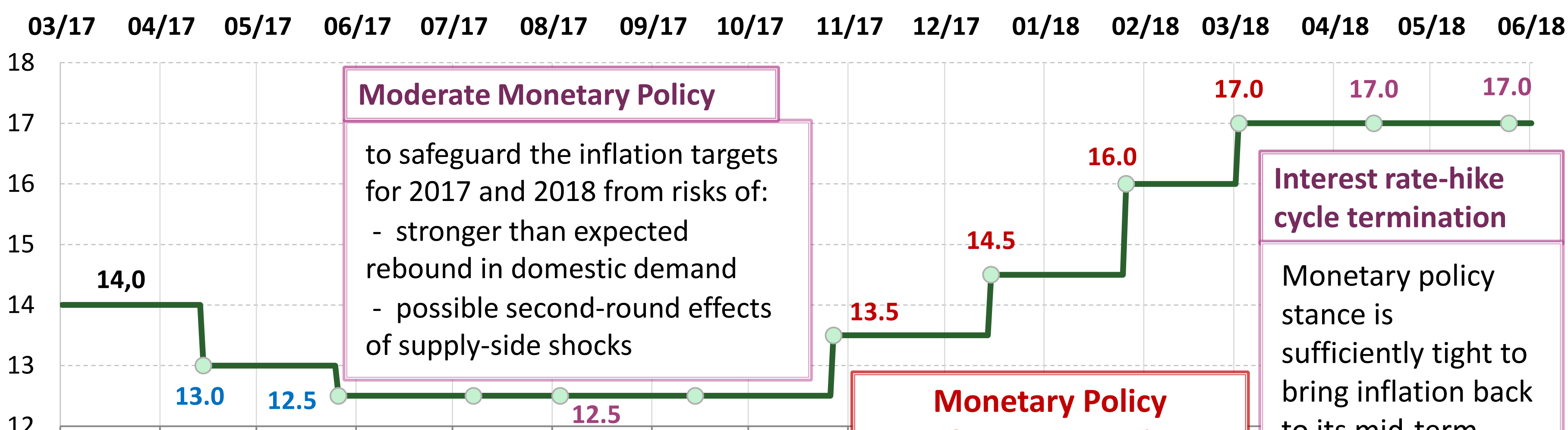
Source: IMF, C-bonds, NBU



Source: NBU

Responding to growing inflation risks, the NBU halted an easing cycle of monetary policy in mid-2017 and switched to a tightening cycle in Oct-2017

Key rate, %



Moderate Monetary Policy

to safeguard the inflation targets for 2017 and 2018 from risks of:

- stronger than expected rebound in domestic demand
- possible second-round effects of supply-side shocks

Interest rate-hike cycle termination

Monetary policy stance is sufficiently tight to bring inflation back to its mid-term target

Monetary Policy Easing:

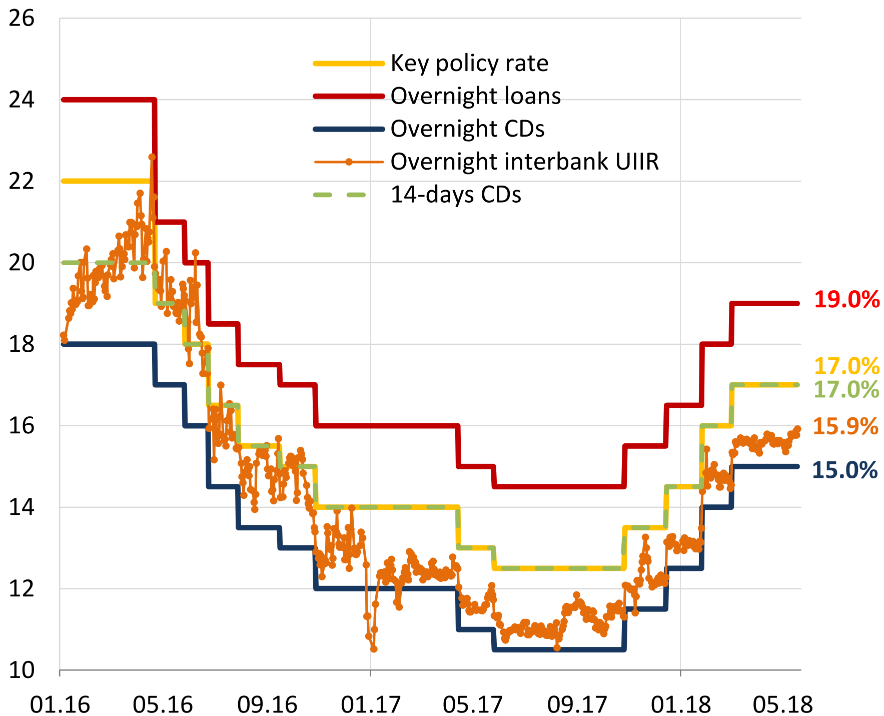
- improving inflation expectations
- the IMF program renewal
- Improving terms of trade
- favorable developments on FX market and exchange rate appreciation

Monetary Policy Tightening in order:

- to reduce impact of pro-inflationary risks:
  - the acceleration of consumer demand due to increase in social standards
  - deterioration of FX-market conditions in the last months of the year
  - delay in official financing
- to prevent further deterioration of inflation expectations
- to decrease inflation and bring it back to the target range in the middle of 2019

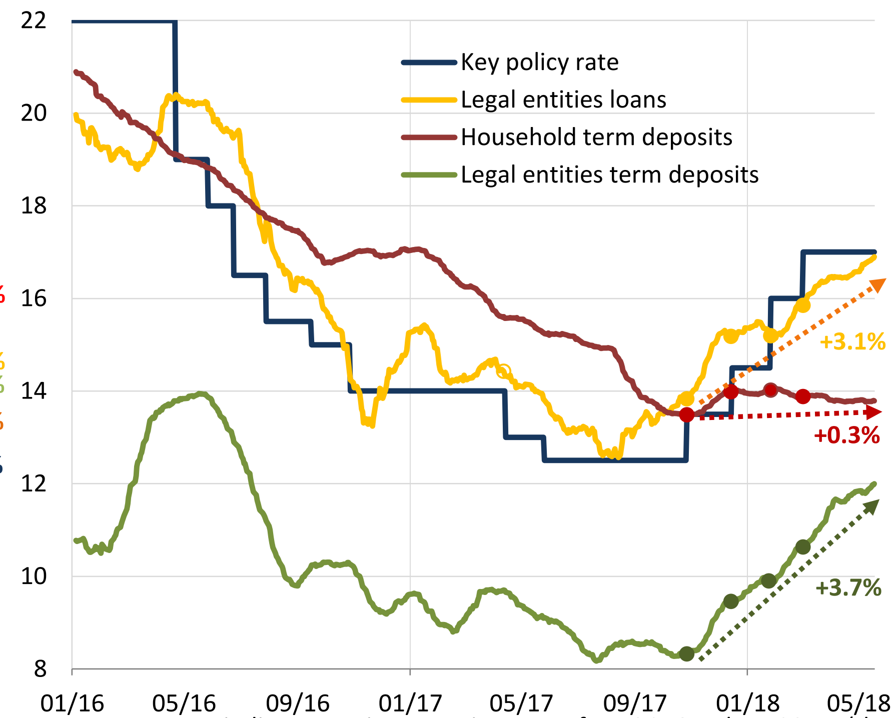
Key policy rate hikes swiftly transmitted into market interest rates

NBU Policy Rates and Ukrainian Index of Interbank Rates (as of 23.05.2018), % pa



Source: NBU

NBU Key Policy Rate and Selected Hryvnia Rates (monthly moving average), % pa



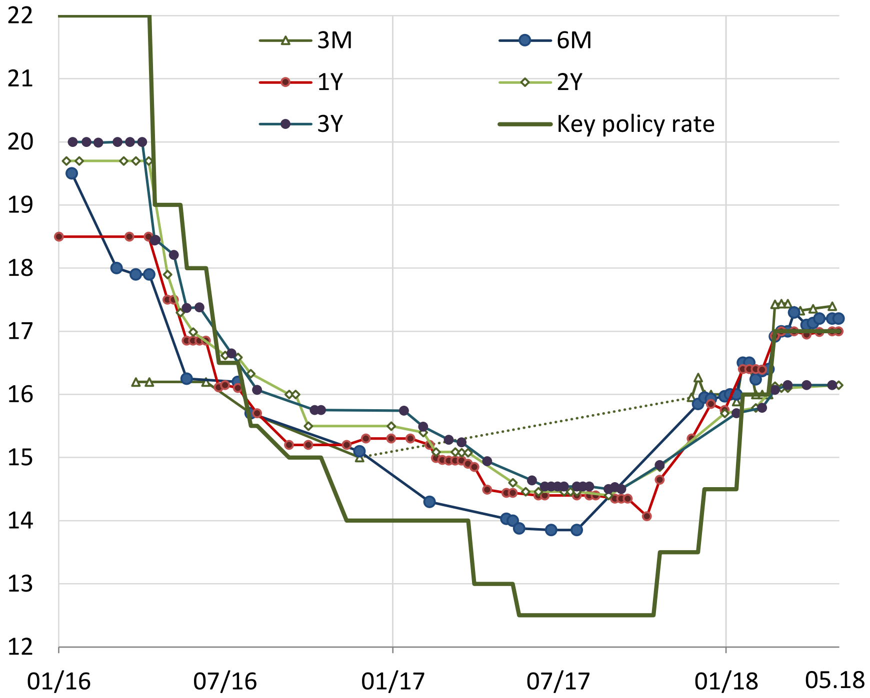
Note: arrows indicate an increase in rate after 26 October 2017 (the beginning of the NBU policy rate hike cycle)

Source: NBU

- 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
- Since then, market rates on hryvnia resources follow NBU key rate changes relatively closely, although hryvnia deposit and lending rates for households showed somewhat weaker response

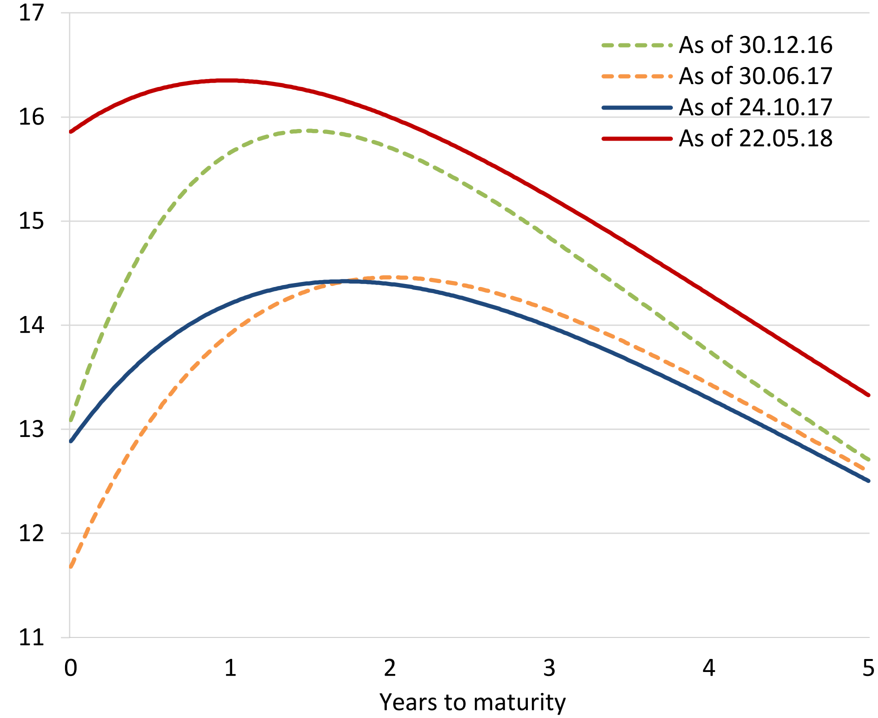
NBU policy rate is now a key factor that determines yields on government bonds

Term Structure of Hryvnia Yields on Primary Market (as of 22.05.2018), % pa



Source: NBU

Zero-Coupon Yield Curve for Hryvnia Bonds*, % pa

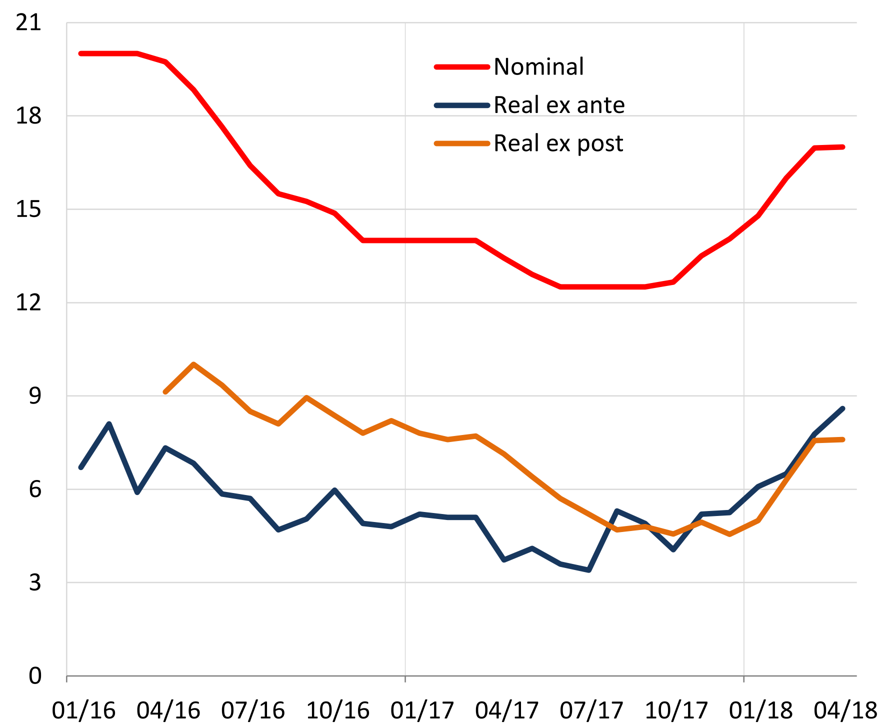


Source: NBU

- Since mid-2017, yields on hryvnia government bonds grew across all maturities. Partly this increase reflected higher government activity in domestic borrowing market
- The short end of the yield curve for government bonds is the most sensitive to the changes in NBU policy rates

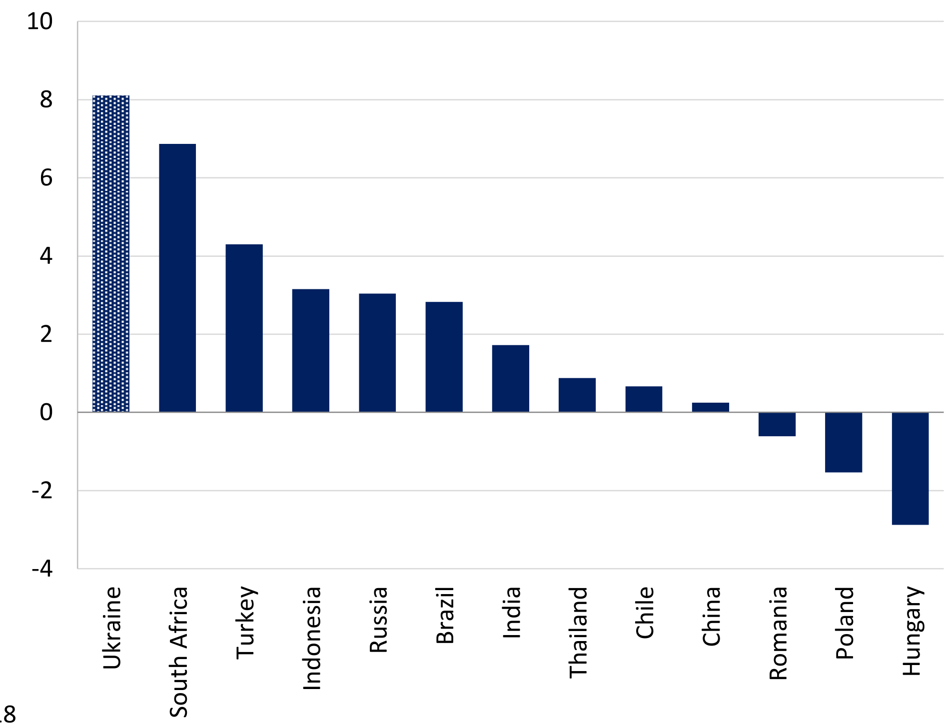
Monetary policy stance remained rather tight throughout 2017, but further tightening was needed to contain inflationary pressures

Nominal and Real NBU Key Policy Rate*, % pa



*Nominal rate is NBU's average rate on 14-days CDs
Real ex ante is nominal rate deflated by inflation expectations of fin. analysts
Real ex post is nominal rate deflated by current core CPI
Source: NBU

1-Year Real Interest Rates for EM countries, % (as of 23 May 2018)

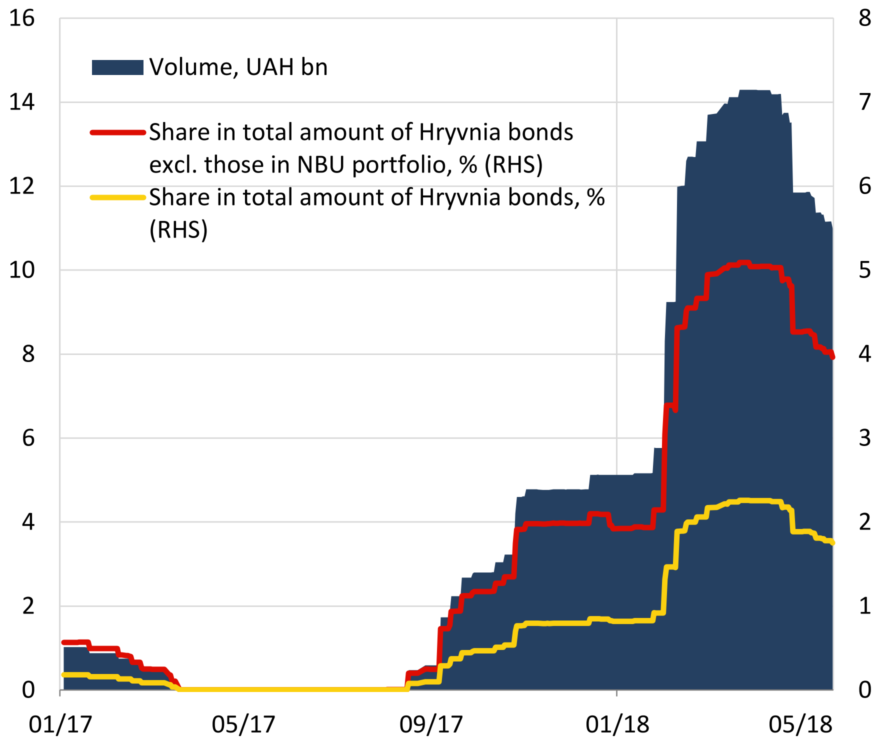


Real interest rate is calculated as a difference between 1-year bond yield (eop) and the inflation forecast from the IMF`s WEO (April 2018), (for Ukraine – based on NBU`s estimates).
Source: Thomson Reuters Datastream, IMF WEO, NBU calculations

- Despite monetary policy easing in H1 2017, monetary policy stance in 2017 remained rather tight as real key rate fluctuated in the range of 3.5-5.0% and reached around 8% recently
- As of the beginning of 2018, Ukraine's real interest rates were among the highest across EM countries

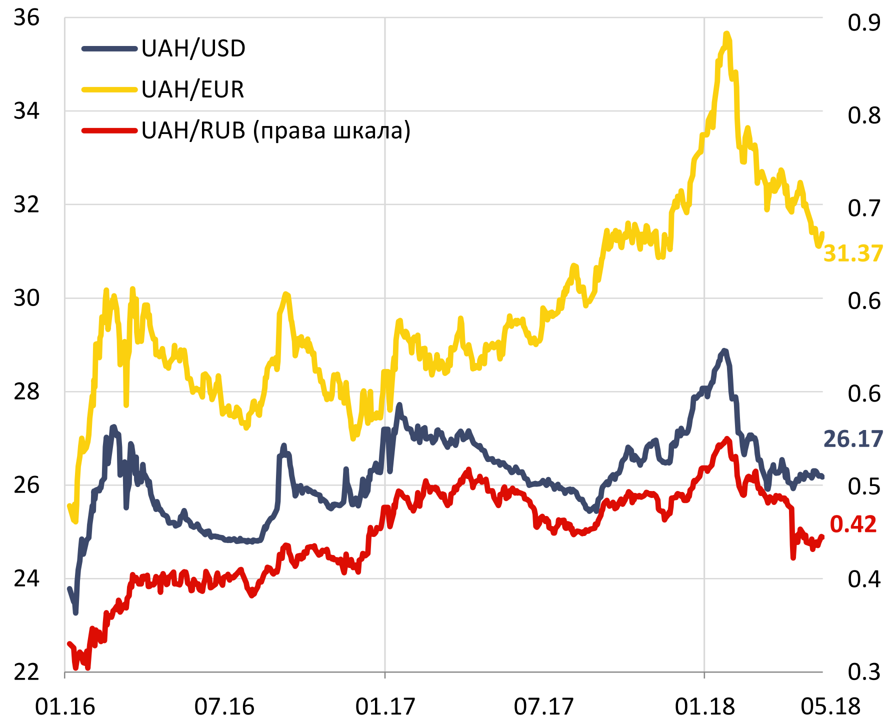
Higher interest rates have already contributed to stronger demand for hryvnia financial instruments

Hryvnia Domestic Government Bonds held by Non-Residents



Source: NBU

Official Hryvnia Exchange Rate, as of 22.05.2018

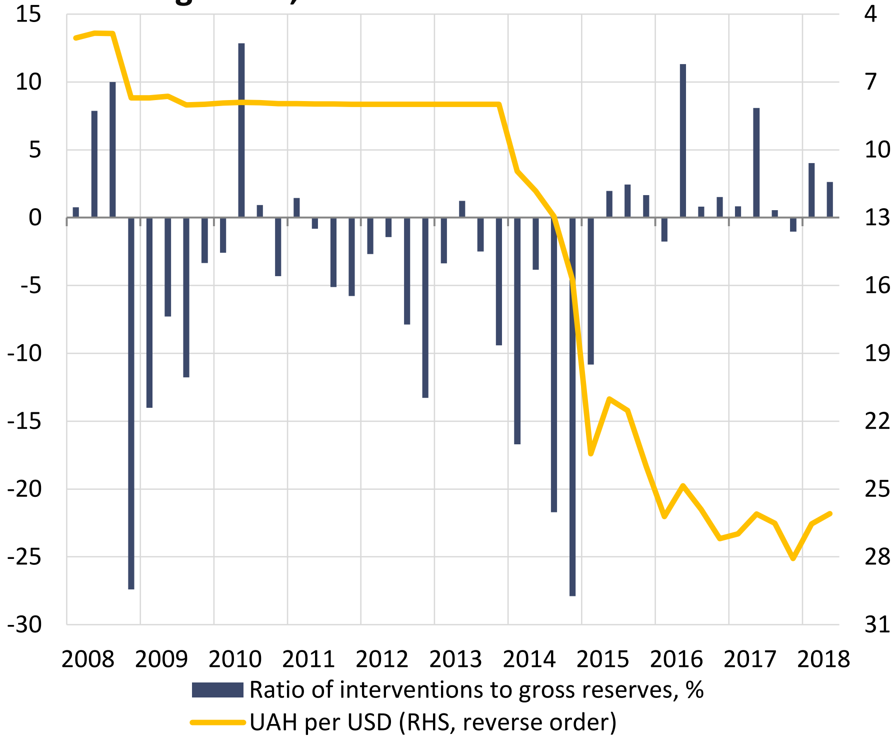


Source: NBU

- At the beginning of 2018, non-residents' interest to Ukraine's domestic bonds has increased, contributing to a turnaround in Ukraine's FX market

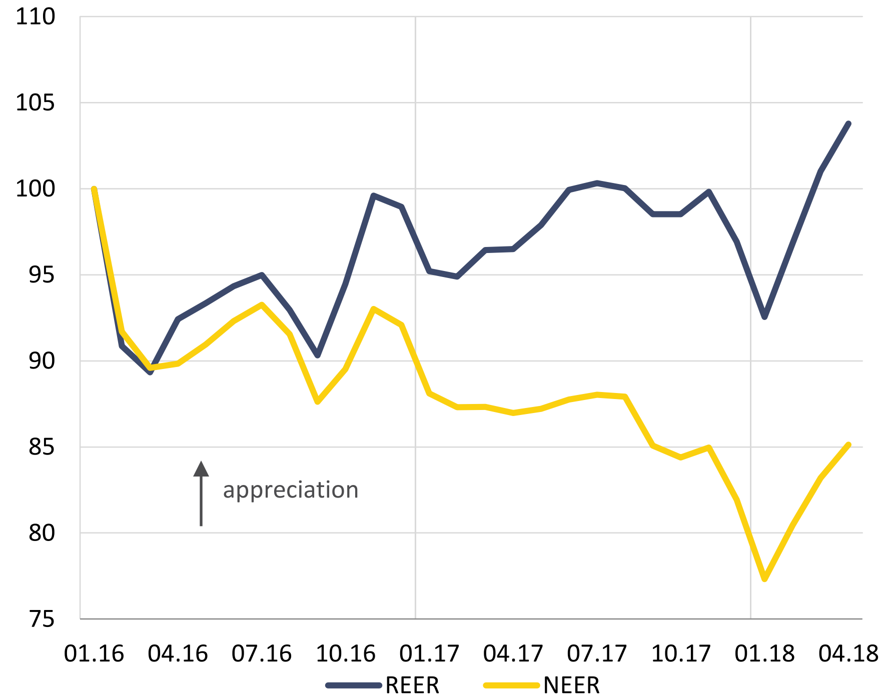
The NBU remains committed to a flexible exchange rate policy. However, it continues to play an active role in the FX market

Reaction to FX Market Pressures: Reserves vs Exchange Rate, as of 22.05.2018



Source: NBU calculations

Hryvnia REER and NEER Indices (based on interbank exchange rate), 01.2016=100

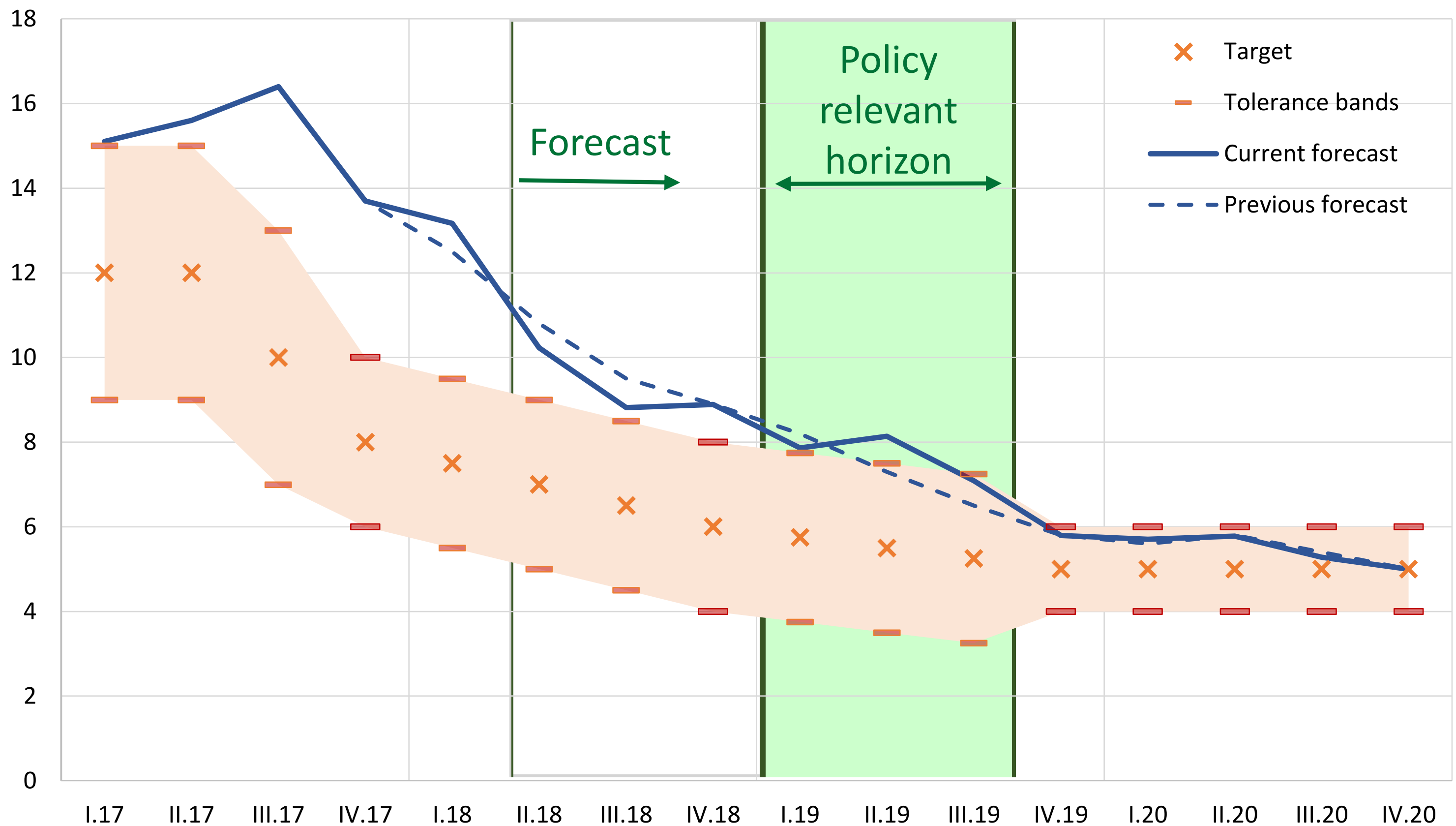


Source: IFS, NBU staff estimates

- Interventions are performed to achieve clear and specific tasks (e.g., smoothing ST exchange rate volatility and replenishing international reserves)
- As a result, over the last several years REER has remained relatively flat, while lower FX volatility has helped maintain macroeconomic and financial stability
- Conditional on the situation in the FX market, the NBU has been relaxing FX restrictions

Tighter monetary policy will help bring inflation to the target by mid-2019

Headline CPI, % yoy



- Demand pressure is to be the main inflationary factor, due to rapid household income growth resulting from both higher social standards and a further increase in wages in the private sector amid high demand for labor
- Past increases in prices for raw foods (mainly meat and raw milk) will continue to pass through to the prices of processed foods in core inflation

The NBU's 'routine' communications cycle on monetary policy issues is intended to explain to the market its reactions under uncertainty

Tuesday-Wednesday

The MPC meeting

Next day

Thursday

The NBU Board meeting on monetary policy issues

discussion of the economic situation and proposals from NBU staff for MP decisions

Key rate decision

Monetary policy statement, communication on decisions*

Thursday, 2:00 p.m.

Publication of the **press release, press briefing**

on the 11th day *Monday*

Publication of the **"Summary of the Discussion on the Key Policy Rate at the NBU MPC"**

on the 12th day *Tuesday*

Meeting with experts - discussion of the forecast and the Inflation Report (quarterly)

Unlike the press release, which reflects the **consensus** opinion of the Board members, "Summary of the Discussion" presents **the impersonalized view** of the MPC members regarding a monetary policy decision, and the logic behind it (including alternative views)

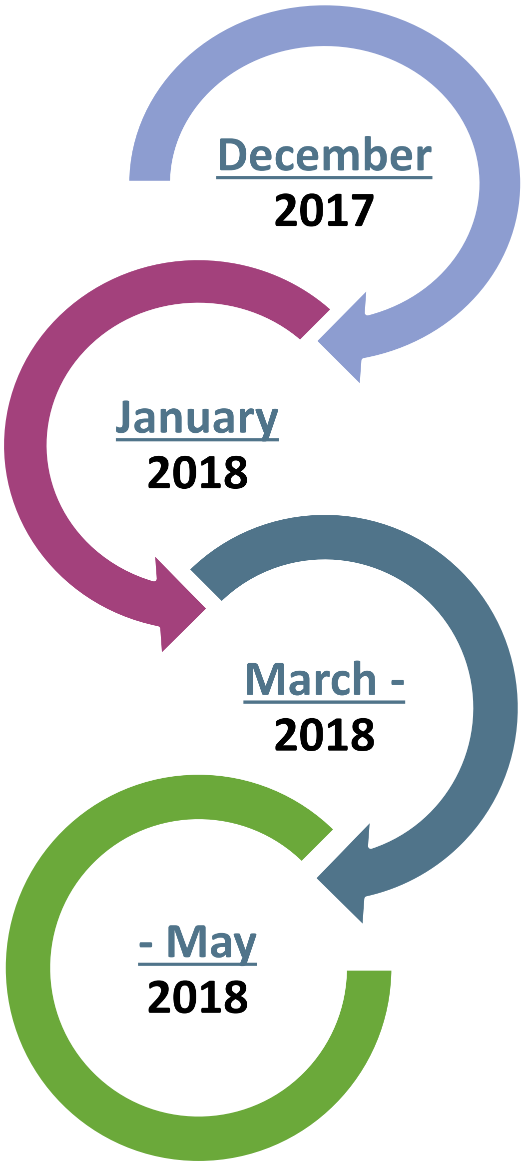
"… central bank should be 'boring' "

King (2000)

"The idea is that the monetary policy reaction function should be so well understood that all the relevant news for financial markets would stem from developments in the economy, not from the actions or words of the central bank"

** https://bank.gov.ua/control/en/publish/article?art_id=62251262&cat_id=21989631*

The NBU's press releases explain the factors that may drive the next decision



The NBU raised its rate in October, December 2017 and January, March 2018. In April, the NBU kept its rate on hold

If fundamental inflation risks increase further, **the NBU may resort to further key rate hikes** to bring inflation back to the target range

In the absence of indications of lowering inflationary pressures, **the NBU may further increase the key policy rate** to return inflation to its medium-term target

The current monetary conditions are sufficiently tight to bring inflation back to its mid-term target

However, If risks to lower inflation and macrofinancial stability rise, including due to a lack of progress in structural reforms and access to official financing, **the NBU may hike the key policy rate** to the level sufficient to drive inflation back to the established medium-term targets

The NBU is moving towards a new model of currency regulation

Novation	Comment
1 Freedom of currency operations	▪ All operations are free, except those directly forbidden by law
2 Currency types	▪ National currency ▪ Foreign currency ▪ Precious metals
3 All payments (for goods & services) in Ukraine – in UAH, except:	▪ Foreign investment operations ▪ Banking and financial services ▪ Non-banking financial companies and Ukrainian Post operations ▪ Other operations, as defined by the NBU
4 Only 2 types of licenses	▪ Banking (also includes currency license) ▪ Currency – for non-banking financial companies
5 Currency supervision	▪ Authorities: NBU, Tax office, ▪ Agents: local banks
6 Currency restrictions – temporary safeguard measures	▪ To be introduced by Financial Stability Council decisions ▪ Period – up to 6 months, with possible prolongation

Facing the perfect storm, the National Bank of Ukraine launched a comprehensive reform of the local banking industry

Clean-up

- Insolvent banks withdrawn from the market
- Banks recapitalized following AQR and stress-tests
- AML rules and procedures overhauled
- Real UBOs disclosed for all banks
- Unwinding of related-party lending launched

Reload

- Business strategy overhaul and management enhancement at state banks
- Resumption of full-fledged lending by banks
- Banking sector consolidation
- Enhancing NPL resolution mechanism
- Enhanced information disclosure standards

Sustainable Development

- Harmonization of banking regulations with Basel recommendations and EU Directives
- Implementation of effective risk-based banking supervision approach consistent with SREP
- Enhancement of creditor rights protection
- Implementing IFRS 9

2015 2016 2017 2018 2020

Today

In addition to the overhaul of the banking system, the National Bank of Ukraine simultaneously launched a radical internal transformation

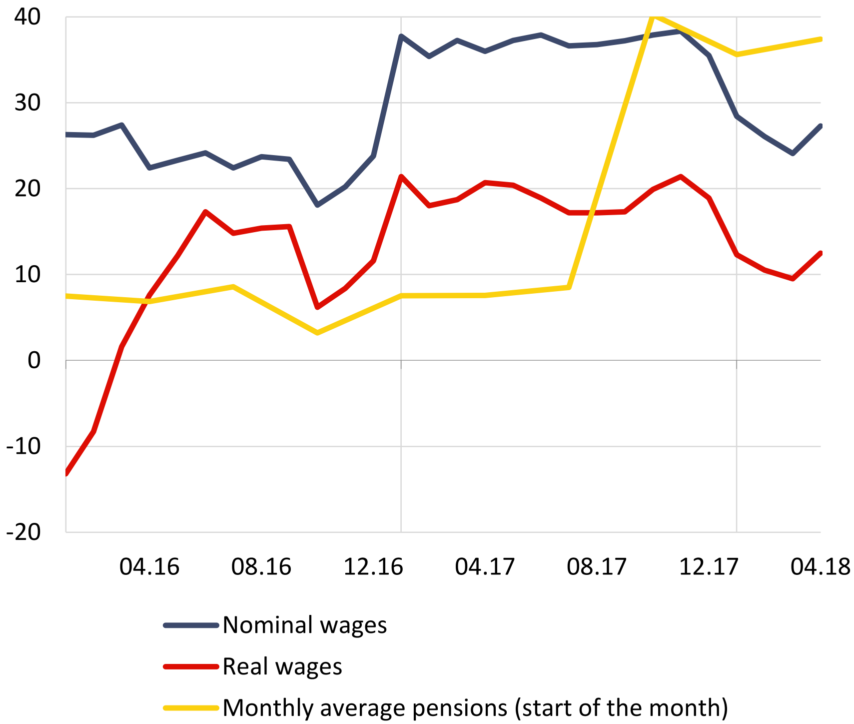
Key messages

- Ukraine's economy embarked on the recovery path in 2016, thanks to improved macroeconomic management, strong support from donors, and a favorable external environment
- The successful disinflation path was altered by idiosyncratic supply shocks, relative prices movement and recovering domestic demand, though tighter monetary policy will ensure inflation falls back into the target band over the forecast horizon
- Fiscal and external sustainability have improved remarkably over the last few years, but dangers remain, stemming from a possible halt in the IMF program, a peak in the domestic political cycle, and the potential risk of a full-scale global trade war
- The longer-term prospects of the economy remain strongly dependent on the realization of key structural reforms, which have to tackle major weaknesses such as the poor business climate, unfavorable demographics and deteriorating infrastructure
- NBU policy efforts will focus on securing price and financial stability, revamping the banking system and liberalizing the capital account
- Hence, **keep calm and carry on Ukraine!!**

National Bank
of Ukraine

Strong growth in real wages, underpinned by government's social policy and labor market tightness, drove private consumption

Growth in Nominal and Real Wages, and Average Pensions, % yoy



Source: SSSU, NBU staff estimates

Labor Demand* (end of quarter, thousand persons) and ILO Unemployment Rate (% of the economically active population aged 15-70)

* Measured as the number of vacancies as reported by State Employment Service of Ukraine

Source: SSSU, NBU estimates

- A twofold increase in minimum wage at the beginning of 2017 made a strong impetus to real wage growth, which was supported by the private sector amid growing labor demand and labor market tightness
- Labor market tightness was due to supply and demand mismatches (reflected in still high unemployment rate) as well as active labor migration outflow
- Amendments to pension benefit formula, enforced at the beginning of Q4 2017 (for old-age pensioners) and Q1 2018 (for military servants), caused a sharp increase in average pensions