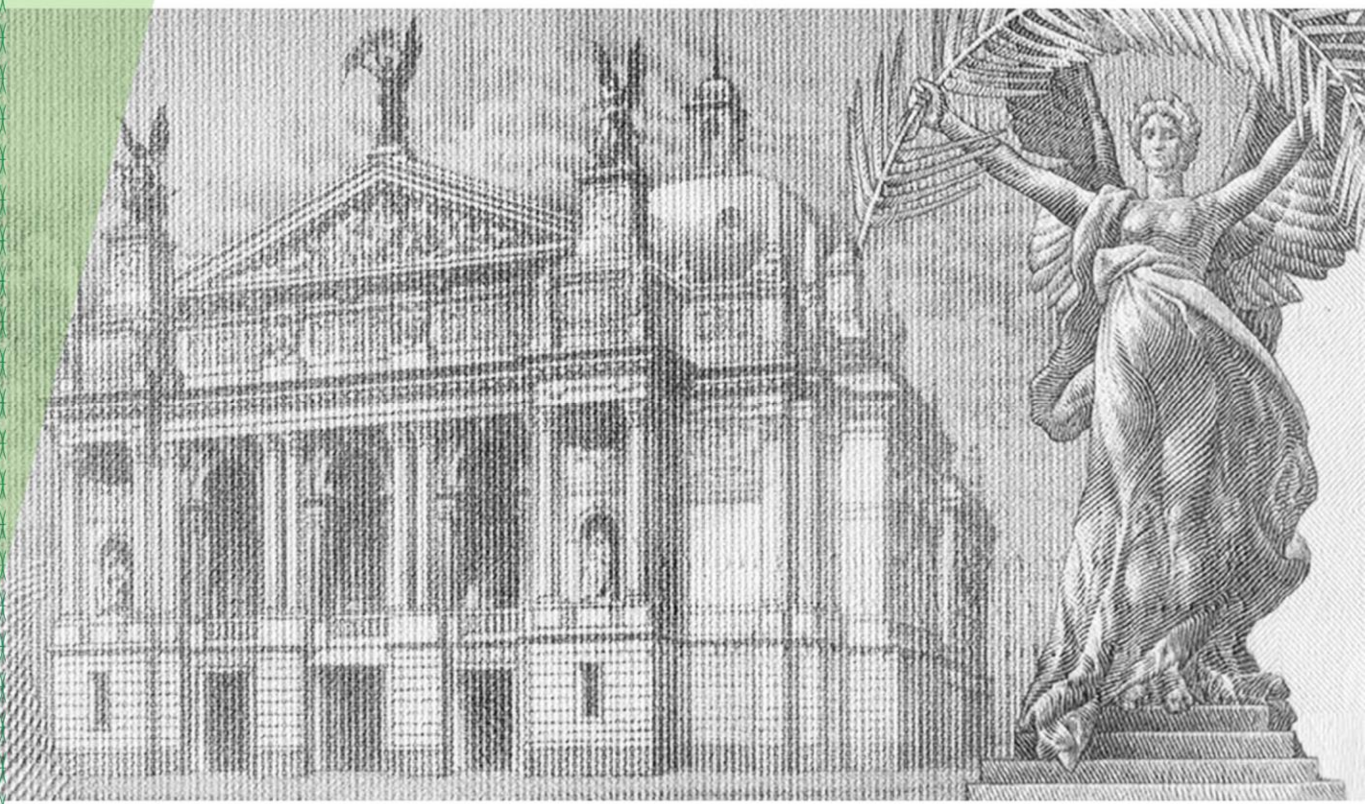
National Bank of Ukraine

Inflation Report

July 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 12 July 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 11 July 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. 442-D as of 12 July 2018 *On the Approval of the Inflation Report.*

SUMMARY

Consumer price inflation continued to decline

June 2018 saw a slowdown in consumer price inflation to 9.9% yoy, somewhat below the NBU's forecast published in the April 2018 Inflation Report. However, inflation was still higher than the target of 7.0% ± 2 pp set for the end of Q2 2018 in the Monetary Policy Guidelines for 2018 and the Medium Term.

The continued deceleration of annual inflation was mainly the result of a sharp slowdown in food price inflation. In particular, the effect of the temporary supply factors that stood behind the high inflation readings in H2 2017 and in early 2018 is gradually fading. This is attributed to a greater supply of food products, both domestically and from abroad.

Moreover, FX market conditions were benign. The economic upturn in Ukraine's main trading partners, high prices for Ukrainian exports, an increase in private remittances, and the tight monetary policy made the hryvnia strengthen both against the US dollar and the currencies of the trading partner countries. This, in turn, influenced the cost of imported goods and the prices of goods and services with substantial import content.

Growth in the core consumer price index (CPI) also slowed to 9.0% yoy. However, core inflation still kept high, indicating the persistently strong underlying inflationary pressure. This is mainly driven by a sustained expansion in consumer demand, which is fueled by a rapid rise in household income that substantially outpaces the rates of economic growth. In particular, in May, the average nominal wage in Ukraine increased by 28%yoy. The rapid wage growth was largely due to strong demand for labor and active labor migration. Inflows of remittances also continued to grow rapidly. In January–May, they increased by 30% yoy and reached USD 4.5 billion. This is attributed to further growth in the number of labor migrants and an improvement in economic growth in Ukrainian migrants' destination countries. High growth rates of social benefits, especially on the back of larger payments to various categories of pensioners, also contributed to the increase in household income.

In Q2 2018, the NBU maintained the tight monetary policy stance: it kept the key policy rate on hold at 17% per annum. In real terms, the key policy rate grew from 5% per annum early in the year to 8-9% per annum in June. As a result of the tight monetary policy, real yields on hryvnia bonds remained some of the highest among emerging markets. This helped maintain attractiveness of the hryvnia assets at a time, when emerging markets faced heightened turbulence on global financial markets and the IMF financing was further postponed.

Consumer price inflation will continue to decelerate and will return to the target range in late 2019

The NBU has kept its inflation forecast for year-end 2018 unchanged at 8.9%, whereas the core inflation projection was lowered to 7.1%. A faster-than-expected inflation slowdown in May–June 2018 will be offset in the second half-year due to a stronger impact of inflation factors. This is due to a greater-than-anticipated increase in administered prices which is expected at the end of the year, as domestic gas prices are being brought closer to the import parity price. This factor will also influence inflation levels in the first three quarters of the next year, which will not allow the NBU to bring inflation to the target range before Q4 2019. At the same time, in H2 2018 and 2019, a number of factors of a more fundamental nature, as distinct from the rise in administered prices, will affect inflation. Among them:

– higher-than-expected domestic demand, among other things, due to rising wages and remittances from labor migrants,
– weakening of investor appetite for Ukrainian sovereign debt as globally foreign investors flee emerging markets and postponed financing under the IMF cooperation program,
– inflation expectations that continue to exceed the NBU's inflation targets.

The tight monetary policy will offset the effect of these factors and will become a key determinant enabling to bring inflation to the target range in Q4 2019. In addition, prudent fiscal policy in response to budget constraints due to substantial government debt repayments, moderate imported inflation on the back of relatively low exchange rate volatility, and lower impact of administered price inflation will contribute to inflation slowdown.

Other factors include the weaker pressure from food prices in the current year. This is especially related to prices for fruit and vegetables. Alongside, robust external demand for some foods (particularly, butter and eggs) and the convergence of domestic food prices to levels of neighboring countries, as well as greater export opportunities for Ukrainian businesses will boost prices.

Therefore, the inflation forecast for the coming years remains unchanged: consumer price inflation is expected to stand at 5.8% at year-end 2019 and decelerate to 5.0% in 2020, reaching the midpoint of the target range (5.0% ± 1 pp).

Domestic demand drives GDP growth in 2018

In Q1 2018, real GDP growth accelerated to 3.1% yoy. Same as in 2017, domestic demand was the main driver of real GDP growth, with both consumption and investment rising.

The steady rise in consumer demand was propelled by stronger household income (wages, pensions, remittances). Alongside, higher wages and changes into the pension legislation provided incentives to official employment, as indicated by the growth in economically active and employed population as well as a lower unemployment rate.

Investment growth, which has been accelerating for the third consecutive quarter and was broad-based across most industries, remained an important economic growth driver. In particular, capital investment into industrial production showed robust growth.

The rise in investment was supported by further improvement of business expectations and financial standing of enterprises. The sale of 4G licenses by the government contributed to higher investment into the telecommunication industry.

The acceleration in real GDP growth in Q1 2018 was primarily reflected in a pickup in trade on the back of strong consumer demand and a revival in industrial production. Industrial production grew on increased output in mining, metallurgy, and the energy sector, driven, among other things, by the comparison base effect related to the last year's trade ban with the non-government controlled areas (NGCA) and seizure of companies on these territories, which affected the above industries the most.

This effect, coupled with the favorable external economic conditions, influenced the performance of goods exports in H1 2018. Meanwhile, stronger domestic demand, primarily investment demand, drove faster growth in imports of goods. This caused the trade deficit to widen over five months of 2018. Alongside, the continued increase in the number of labor migrants led to a substantial rise in remittances, thus leaving the current account deficit broadly unchanged at USD 0.4 billion over five months of 2018, close to the previous year's level.

Since early 2018, inflows to the financial account have maintained, primarily generated by the private sector, as opposed to last year. At the same time, following dramatic growth in Q1 2018, non-residents cut their holdings of domestic currency government bonds. The total inflow of foreign direct investment (FDI) remained relatively low and was mainly directed to the real sector. Despite the balance of payments surplus, international reserves as of the end of June decreased to USD 18.0 billion, covering 3.1 months of future imports, largely due to debt repayments to the IMF by the government and the NBU.

In Q2 2018, Ukraine's economy kept growing. The high business expectations of companies were evidence of sustained growth in investment activity. The further increase in personal income fueled consumer demand. A sharp rise in budgetary current and capital spending gave a boost to consumer and investment demand. Moreover, external market conditions remained broadly favorable. As in Q1, the disruption of ties with NGCA last year had an impact on the pace of economic growth. As a result, gross value added in the metallurgy, mining industry, and energy sector kept growing despite being held back somewhat by repairs at several large enterprises of the mining industry and metallurgy. The harvesting campaign started earlier than last year, thus driving agricultural growth. Overall, real GDP growth in Q2 2018 is estimated at 3.2% yoy.

After speeding up in 2018, economic growth will slightly decelerate

Same as before, the NBU expects real GDP growth to accelerate to 3.4% in 2018. Economic growth will continue to be largely driven by private consumption, which is fueled this year by rapid growth in wages, remittances, and pensions. Investment activity is also anticipated to remain high. Favorable terms of trade, a recovery in the industrial sector, and the greater access of Ukrainian exporters to foreign markets will help decrease the negative contribution of net exports to GDP.

In 2019, however, economic growth will decelerate to 2.5% (below the previously forecast 2.9%). This will be a result of waning effects of a rapid rise in social standards in the previous years amid prudent fiscal policy which is necessitated by large repayments of public debt. Furthermore, tight monetary conditions that are necessary to bring inflation back to the target will affect growth. In 2020, the real economy is expected to grow by 2.9%.

Spurred by rising remittances, thanks to an increase in the number of labor migrants, private consumption will continue to be a major driver of growth in the medium term. At the same time, labor migration will have a reverse effect on economic growth due to a reduction in workforce and worsening of companies' ability to build up investments amid rapidly rising wages.

The external trade deficit will persist, if not widen, with a significant share of domestic consumer demand and capital investment needs met by imports. Exports will also grow, primarily driven by increasing demand from Ukraine's major trading partners. Labor migrants' remittances will keep rising as a result of both continued migration and higher nominal income in the US dollar equivalent that migrants receive abroad. As a consequence, the current account deficit will gradually widen to 2.4% of GDP in 2020.

A key assumption underlying the macroeconomic forecast remains further progress in carrying out structural reforms, as envisaged by the current IMF-supported program and a new program with the IMF which is expected to be signed in 2020. These reforms are critical for ensuring macrofinancial stability and sustainable economic growth in the long term. Access to the official financing provided by the IMF and other international lenders will enable the government to obtain financing from international capital markets on reasonable terms.

In 2018, the NBU projects disbursements of approximately USD 2 billion from the IMF, in addition to loans pledged by the EU and the World Bank Group and a Eurobond placement by the government. Those funds will have boosted international reserves to USD 20.7 billion (covering 3.5 months of future imports) by the end of 2018. Going forward, a rather moderate inflow of investment capital and debt capital into the private sector and market borrowings by the government are anticipated. As a result, in 2019–2020, the balance of payments is expected to run a deficit amid peak repayments on external public debt, and international reserves will amount around USD 20 billion.

The impact of fiscal policy on the economy in 2018 is considered to be pro-inflationary, mainly due to rising social spending, including an increase in pensions as a result of the pension system reform and a rise in public-sector wages and military compensation. The robust social spending will fuel an expansion in domestic demand but constrain the government's ability to finance development projects, as it will be necessary to keep the general government deficit in line with Ukraine's obligations to the IMF. The general government deficit is thus projected to reach 2.1% of GDP this year, exceeding the last-year level by an insignificant amount.

The approaching period of peak repayments on external public debt amid growing interest rates in the international markets and the closure of the IMF-supported program in 2019 lay the groundwork for a tighter fiscal policy in 2019–2020 with a dampening effect on both economic growth and inflation. In that period, the budget deficit is projected to be less than 1.5% of GDP under the baseline scenario, while the primary balance will continue to be positive.

Public and publicly guaranteed debt is expected to decrease as a percentage of GDP over the entire forecast horizon. This will be due to the rapid growth in nominal GDP, relatively low exchange rate volatility, and a gradual decline in the external debt amid large debt repayments by the government.

Stalling reforms is a major risk to the economy

A lack of structural reforms that are essential to maintaining macrofinancial stability and continuing cooperation with the IMF poses a major risk to the implementation of the mentioned scenario. A further delay in implementation of commitments under the ongoing IMF-supported program reduces the likelihood that Ukraine will receive financing envisaged under the program. This increasingly narrows down the country's window of opportunities to secure financing from international capital markets, needed to make peak public debt repayments. Therefore, receiving less disbursements than the planned amount will complicate the financing of budgetary spending and deteriorate devaluation and inflation expectations. The latter will also reflect the increase in uncertainty usually seen in the run-up to elections.

Bringing the prices of natural gas for households to the market level creates a significant uncertainty to the inflation outlook. Delays in taking this action and changes in the calculation of the import parity price may cause the inflation trajectory to substantially deviate from the baseline scenario as a result of administered tariffs.

Labor migration is a major risk for the baseline scenario. A further rapid outflow of workforce from Ukraine will continue to exacerbate mismatches between supply and demand in the labor market, which will be accompanied by wage growth and inflation, while also reducing economic potential.

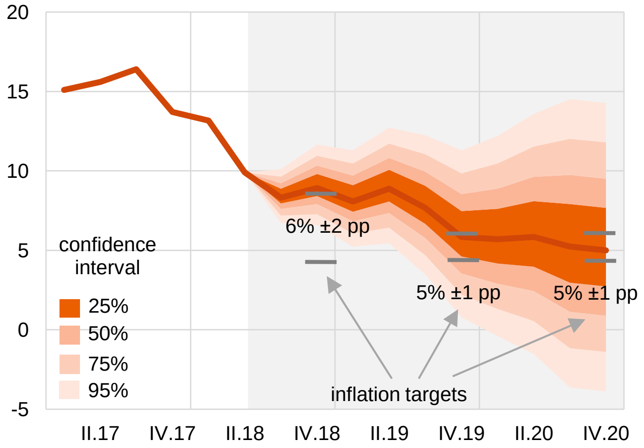
On the external front, considering the above-trend growth in many countries in 2018–2019, the global economy is highly likely to overheat and slide into the downturn phase. The other likely drivers of recession include the looming threat of large-scale trade wars, which, if materialized, will cause a slowdown in world trade and problems in China's financial system. The abovementioned factors have the potential to trigger a drop in global commodity prices, a shrinking of Ukraine's exports, and a decline in FX proceeds with an ensuing correction of the hryvnia exchange rate.

The risks of capital flight from emerging markets are also heightening. One of the potential triggers of these events would be an overly rapid shift by advanced countries to tighter monetary policies. As a result, Ukraine and other emerging markets may be hit by capital flight.

Monetary policy will be sufficiently tight over the forecast horizon to bring inflation back to the target

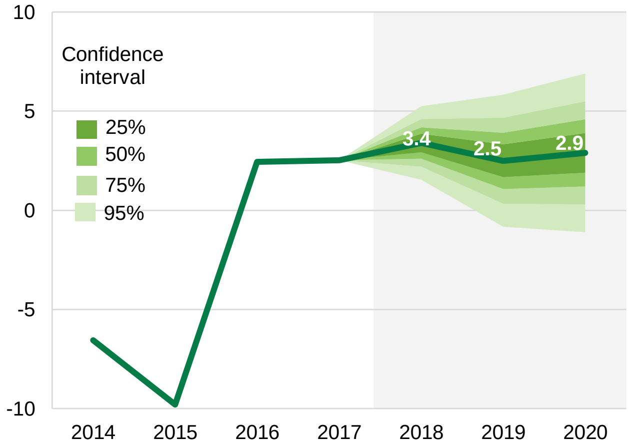
Under the baseline scenario of the macroeconomic forecast, to return inflation to the target range by the end of next year and lower it to 5% in 2020, monetary policy conditions need to remain sufficiently tight. A tight monetary stance will help mitigate the described pro-inflation factors, given increasing likelihood of the abovementioned inflation risks. Furthermore, tighter financial conditions for emerging markets were an additional argument in favor of raising interest rates as leading central banks normalized their monetary policy. As a result, on 12 July 2018 the Board of the National Bank of Ukraine decided to hike its key policy rate to 17.5% per annum, effective from 13 July 2018. If the probability that abovementioned risks would materialize continues to increase or new significant threats to inflation and to macrofinancial stability arise, the NBU may continue to raise the key policy rate to a level that is necessary to bring inflation back to targets over a reasonable time horizon.

CPI Growth Forecast and Targets, % yoy



Source: NBU.

Real GDP Growth, % yoy



Source: NBU.

Macroeconomic forecast (July 2018)

Indicators	2015	2016	2017	2018 I	2018 II	2018 III	2018 IV	2018 current forecast	2018 forecast 04.18	2019 I	2019 II	2019 III	2019 IV	2019 current forecast	2019 forecast 04.18	2020 I	2020 II	2020 III	2020 IV	2020 current forecast	2020 forecast 04.18
REAL ECONOMY, % yoy, unless otherwise stated																					
Nominal GDP, UAH bn	**1989**	**2385**	**2983**	700	772	969	1019	**3460**	3451	782	859	1074	1130	**3845**	3842	858	935	1171	1224	**4188**	4186
Real GDP	**-9.8**	**2.4**	**2.5**	3.1	3.2	3.8	3.3	**3.4**	3.4	2.7	2.6	2.3	2.4	**2.5**	2.9	2.5	2.8	3.1	3.2	**2.9**	2.9
GDP Deflator	**38.9**	**17.1**	**22.0**	14.9	12.5	11.0	10.3	**12.2**	11.9	8.7	8.5	8.3	8.2	**8.4**	8.2	7.0	6.0	5.4	5.0	**5.9**	5.9
Consumer prices (period average)	48.7	13.9	14.5	-	-	-	-	10.7	10.9	-	-	-	-	7.7	7.4	-	-	-	-	5.5	5.5
Producer prices (period average)	36.0	20.5	26.3	-	-	-	-	15.7	13.5	-	-	-	-	8.1	8.1	-	-	-	-	8.1	7.8
Consumer prices (end of period)	**43.3**	**12.4**	**13.7**	13.2	9.9	8.3	8.9	**8.9**	8.9	8.1	8.9	7.7	5.8	**5.8**	5.8	5.7	5.8	5.2	5.0	**5.0**	5.0
Core inflation (end of period)	34.7	5.8	9.5	9.4	9.0	8.1	7.1	7.1	7.7	6.6	6.7	5.9	4.6	4.6	4.8	4.4	4.4	3.7	3.6	3.6	3.3
Non-core inflation (end of period)	49.7	17.5	19.4	17.9	10.3	8.6	11.3	11.3	10.5	10.1	11.7	10.0	7.5	7.5	7.1	7.4	7.8	7.3	6.8	6.8	7.2
raw foods (end of period)	40.7	1.2	23.5	23.3	5.2	0.6	5.4	5.4	5.9	4.3	9.6	7.0	4.0	4.0	4.0	3.7	3.5	3.6	3.5	3.5	3.1
administrative prices (end of period)	64.4	34.6	16.1	13.6	13.2	14.4	16.6	16.6	14.6	15.9	15.1	13.8	11.6	11.6	10.0	11.5	12.2	10.6	10.4	10.4	10.4
Producer prices (end of period)	**25.4**	**35.7**	**16.5**	15.9	18.4	15.0	10.4	**10.4**	8.8	9.0	7.0	8.0	8.6	**8.6**	8.4	6.9	8.8	8.6	8.1	**8.1**	8.1
FISCAL SECTOR																					
Consolidated budget balance, UAH bn	**-30.9**	**-54.8**	**-42.1**	-	-	-	-	**-71.4**	-81.9	-	-	-	-	**-56.4**	-100.3	-	-	-	-	**-61.7**	-84.1
% of GDP	-1.6	-2.3	-1.4	-	-	-	-	-2.1	-2.4	-	-	-	-	-1.5	-2.6	-	-	-	-	-1.5	-2.0
Public sector fiscal balance (IMF methodology), UAH bn	**-17.0**	**-50.3**	**-38.4**	-	-	-	-	**-72.7**	-82.8	-	-	-	-	**-57.4**	-98.9	-	-	-	-	**-61.0**	-82.1
% of GDP	-0.9	-2.1	-1.3	-	-	-	-	-2.1	-2.4	-	-	-	-	-1.5	-2.6	-	-	-	-	-1.5	-2.0
General government and Naftogaz financing, UAH bn	-37.5	-50.3	-38.4	-	-	-	-	-72.7	-82.8	-	-	-	-	-57.4	-98.9	-	-	-	-	-61.0	-82.1
General government and Naftogaz financing, % of GDP	-1.9	-2.1	-1.3	-	-	-	-	-2.1	-2.4	-	-	-	-	-1.5	-2.6	-	-	-	-	-1.5	-2.0
BALANCE OF PAYMENTS (NBU methodology)																					
Current account balance, USD bn	1.6	-1.3	-2.4	-0.6	0.4	-1.5	-0.3	-2.0	-2.4	-0.8	-0.4	-1.4	0.0	-2.6	-3.2	-1.3	-0.4	-1.4	-0.5	-3.6	-3.9
Financial account, USD bn	1.2	-2.6	-5.0	-0.3	-0.1	-2.2	-1.4	-4.0	-5.0	-0.6	-1.8	-0.1	0.1	-2.4	-2.4	-2.0	-1.3	0.2	-0.3	-3.5	-3.9
BOP overall balance, USD bn	**0.8**	**1.3**	**2.6**	-0.3	0.5	0.7	1.1	**2.0**	2.6	-0.2	1.3	-1.3	-0.1	**-0.3**	-0.8	0.7	0.9	-1.6	-0.2	**-0.1**	0.0
Gross reserves, USD bn	**13.3**	**15.5**	**18.8**	18.1	18.0	20.1	20.7	**20.7**	21.6	20.0	20.8	18.9	18.8	**18.8**	19.1	20.0	20.9	19.8	19.7	**19.7**	20.0
Months of future imports	**3.1**	**3.2**	**3.3**	3.1	3.1	3.4	3.5	**3.5**	3.7	3.3	3.4	3.1	3.0	**3.0**	3.1	3.2	3.3	3.1	3.0	**3.0**	3.2
Export of goods, % yoy	-29.9	-5.3	18.3	8.7	14.7	8.9	7.0	9.7	6.3	-0.9	-1.9	0.5	2.3	0.1	4.5	4.6	4.7	6.0	5.8	5.3	5.7
Import of goods, % yoy	-32.6	4.2	21.1	12.6	12.2	10.6	4.2	9.6	5.9	4.9	6.3	3.3	1.9	4.0	5.6	6.4	3.3	4.9	7.5	5.6	4.7
MONETARY ACCOUNTS (Cumulative since the beginning of the year, %)																					
Monetary base	**0.8**	**13.6**	**4.6**	-1.5	5.2	5.8	11.0	**11.0**	11.0	-2.6	0.7	0.8	6.2	**6.2**	5.2	-2.6	0.2	-0.5	4.6	**4.6**	3.8
Broad money	**3.9**	**10.9**	**9.6**	-3.3	0.1	3.0	10.4	**10.4**	10.6	-2.3	-0.3	1.7	8.7	**8.7**	8.5	-2.5	-0.6	1.2	8.2	**8.2**	8.3
Velocity of broad money (end of year, times)	**2.0**	**2.2**	**2.4**	-	-	-	-	**2.6**	2.6	-	-	-	-	**2.6**	2.6	-	-	-	-	**2.7**	2.7