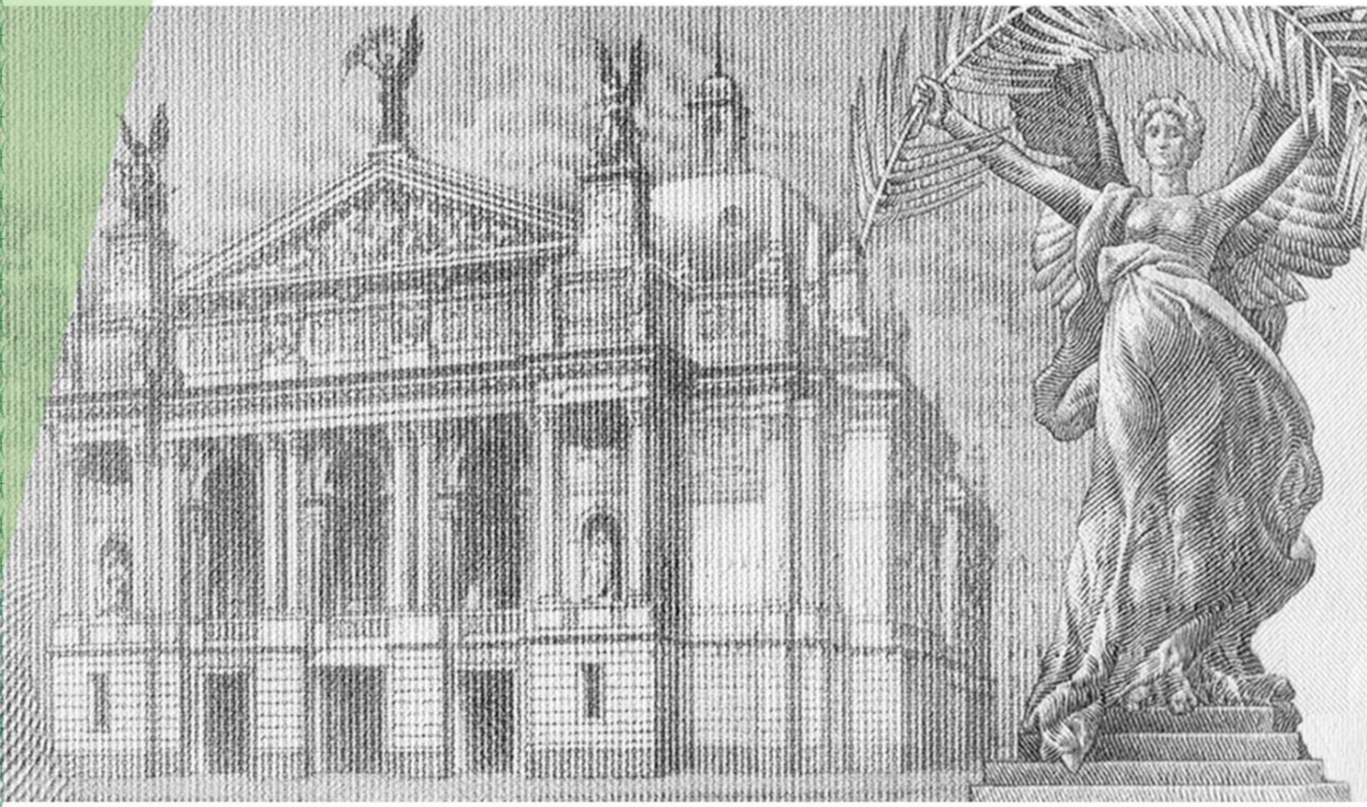
National Bank of Ukraine

Inflation Report
(Summary)
January 2020



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 the forecast cycle.

The primary objective of monetary policy is to achieve and maintain price stability in the country. Price stability implies a moderate increase in prices rather than their unchanged level. Low and stable inflation helps preserve the real value of income and savings of Ukrainian households, and enables entrepreneurs to make long-term investments in the domestic economy, fostering job creation. The NBU also promotes financial stability and sustainable economic growth unless it compromises the price stability objective.

To ensure price stability, the NBU applies the inflation targeting regime. This framework has the following features:

- A publicly declared inflation target and commitment to achieve it. Monetary policy aims to bring inflation to the medium-term inflation target of 5%. The NBU seeks to ensure that actual inflation does not deviate from this target by more than one percentage point in either direction. The main instrument through which the NBU influences inflation is the key policy rate.
- Reliance on the inflation forecast. In Ukraine, it takes between 9 and 18 months for a change in the NBU's key policy rate to have a major effect on inflation. Therefore, the NBU pursues a forward-looking policy that takes into account not so much the current inflation rate as the most likely future inflation developments. If inflation is projected to be higher than its target, the NBU raises the key policy rate to bring inflation down to the 5% target. And vice versa, if inflation is projected to be below its target, the NBU cuts the key policy rate.
- Open communications with the public. The transparent and predictable monetary policy of the NBU, which is achieved among other things by publishing this Inflation Report, enhances public confidence. Public confidence, in turn, is an important prerequisite for the effective management of inflation expectations and ensuring price stability.

The NBU Board decides on the key policy rate eight times a year, in line with a schedule it publishes in advance. The decisions the NBU Board makes in January, April, July, and October are based on new macroeconomic forecasts. At the remaining four meetings (taking place in March, June, September, and December), the NBU Board makes its interest rate decisions based on new economic developments in Ukraine and beyond that have emerged since the latest forecast.

The NBU Board announces its interest rate decision at a press briefing held on the same day at 2 p.m., after the NBU Board's monetary policy meeting. A week later, the NBU publishes the Inflation Report with a detailed macroeconomic analysis and outlook underlying its interest rate decisions. The Summary of the Discussion on the Key Policy Rate at the Monetary Policy Committee is published on the 11th day after the decision is made. In contrast to press releases on monetary policy decisions, which reflect the consensus position of the NBU Board, the summary shows depersonalized opinions of all MPC members on the monetary policy decision to be made and their positions. That includes not only the opinions expressed by the majority, but also dissenting views.

The analysis in the Inflation Report is based on the macroeconomic data available at the date of its preparation. Thus, for some indicators, the time horizon of the analysis may vary. The cut-off date for the data in this report is 31 January 2020.

The forecasts of inflation and other macroeconomic variables were prepared by the Monetary Policy and Economic Analysis Department and approved by the NBU Board at its monetary policy meeting on 30 January 2020[1].

Previous issues of the Inflation Report, the presentation of the Inflation Report, the forecast of the main macroeconomic indicators, and time series and data for tables and charts in the Inflation Report are available on the NBU website at the following link: https://bank.gov.ua/monetary/report.

[1]NBU Board decision No. 77-D *On Approval of the Inflation Report* dated 30 January 2020.

Summary

Inflation pressures have decreased thanks to consistent monetary policy

In 2019, consumer inflation fell to a six-year low of 4.1% (versus 9.8% in 2018). The NBU thus achieved its medium-term inflation target of 5% ± 1 pp. This was due to lower underlying inflationary pressures, as reflected in the slowdown of core inflation (to 3.9% yoy). The fall in inflation to its target in 2019 was mainly the result of the NBU's consistent monetary policy, which aims to deliver price stability, and prudent fiscal policy.

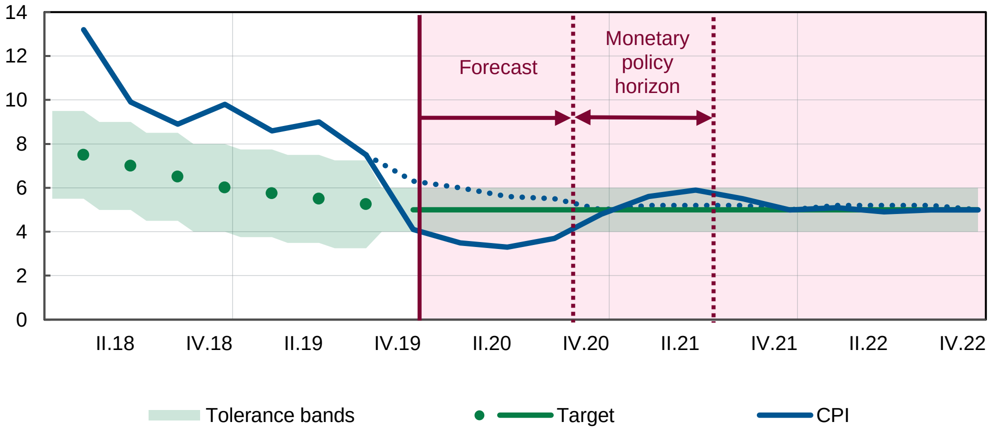
The key factor behind the rapid disinflation was the appreciation of the hryvnia, fueled by the surplus of foreign currency on the market that persisted throughout most of last year. The increase in foreign currency supply was in turn caused by exporters selling large amounts of their foreign currency revenues and foreign investors showing lively interest in hryvnia-denominated government bonds. In the wake of a long-running period of macroeconomic stability and attractive yields, in 2019 the portfolio of hryvnia-denominated domestic government debt securities held by nonresidents rose by USD 4.3 billion. On the other hand, higher productivity – especially in agriculture, leading to another record harvest of grain and oil crops – ensured high export proceeds. As global import prices decreased more than prices for exported goods, terms of trade improved, which also contributed to the growth in the foreign currency surplus in Ukraine.

Apart from the FX factor, the decline in inflation was also driven by an improvement in inflation expectations, lower fuel prices, and weaker pressure from the food supply and administered prices. However, consumer demand and rapid wage growth continued to put pressure on prices, reflected in a moderate slowdown in the growth of services prices.

Consumer inflation will return to the target range at the end of 2020 and remain at the level of 5% after that

According to the NBU's estimates, inflation continued to slow in January. Consumer inflation will stay below the 5% ± 1 pp target range throughout most of 2020. It will accelerate in Q4, to 4.8% in December, thus returning to its target range.

Figure 1[2]. CPI (eop, % yoy) and inflation targets



Source: SSSU, NBU staff estimates.

The effects of the hryvnia's appreciation in 2019 will continue to be reflected in the prices of imported goods, and in those for products with a large share of imported inputs – this will also helpdecrease inflation expectations. Underlying inflationary pressures will remain weak: Core inflation will continue to slow, reaching 3.5% by the end of 2020. Continued relatively low global energy prices will limit rises in domestic fuel prices. In the absence of supply shocks, food price inflation will be subdued, owing to expected higher yields of fruit and vegetables. Only administered prices will grow somewhat faster, mainly due to excise taxes on tobacco products continuing to be adjusted to European levels. However, administered inflation will be restrained by the government's decisions to cut utility tariffs on the back of low energy prices.

[2] Unless specified otherwise, the dashed line in the figures indicates the previous forecast.

Driven by the monetary policy easing, inflation in 2021–2022 will remain within the medium-term target of 5% ±1 pp. A continued, stable, low pace of inflation will be ensured also by:

- a prudent fiscal policy
- relatively low energy prices on the global markets
- the higher productivity of the Ukrainian economy.

The economy of Ukraine grew steadily in 2019

The NBU estimates real GDP growth in 2019 at 3.3% yoy, virtually flat compared to 2018. Major drivers of this growth were the pickup in private consumption on the back of higher wages and pensions, improved consumer sentiment, and rapid growth in investment. These, in turn, promoted growth in trade, transportation, construction, and in a number of services sectors. Another record harvest of grains and oilseeds made a significant contribution to the growth in GDP and exports. That said, the performance of industrial production was weak for the year as a whole due to the unfavorable external price environment, a decrease in price competitiveness driven by the stronger real effective exchange rate, and warm weather. Economic growth in 2019 spurred the demand for labor, which led to a decline in unemployment rate and an increase in the employment rate.

In 2019, the current account deficit narrowed substantially, to 0.7% of GDP. An important factor behind the decrease in the deficit was the compensation received by Naftogaz of Ukraine from Russian Gazprom under a ruling of the Stockholm arbitration court. However, apart from that, the current account deficit shrank due to the decreased trade deficit in goods, steady growth in services exports, and smaller amounts of repatriated dividends. Thanks to capital inflows to the public sector and increased borrowing by the real sector, gross international reserves in H2 2019 grew to the highest level since the end of 2012 (USD 25.3 billion or 3.8 months of future imports).

Economic growth in Ukraine will gradually accelerate to 4% in 2021–2022

Economic growth will accelerate to 3.5% in 2020 and 4% in the following years. The easing of monetary policy will contribute to this faster economic growth. Robust private consumption and investment will remain the main drivers of the growth. At the same time, the contribution of net exports to GDP will remain negative due to the real sector's considerable need for investment imports.

Real household income will grow at a fast pace, which will further narrow the wage gap with neighboring countries. This will continue to encourage Ukrainians to seek work in Ukraine rather than abroad.

Fiscal policy will be close to neutral over the forecast horizon, putting no pressure on inflation or economic growth. The general government will continue to run a deficit of about 2% of GDP annually. This deficit will be largely financed by the government issuing hryvnia securities, which will remain in demand with nonresidents. The ratio of public and publicly guaranteed debt to GDP will decrease over the entire forecast period, to below 50%, driven by sustained economic growth, low exchange rate volatility, and the persistence of the primary budget surplus. The currency composition of public debt will improve.

The current account deficit, as before, will remain sustainable in 2020–2022

Economic activity and global trade are expected to pick up in the coming years, as the United States and China reach agreement on trade. This will support global commodity prices for Ukrainian exporters. The current account deficit will range from 3% to 4% in 2020–2022. The widening of the deficit will be caused by large volumes of investment imports and decreased proceeds from gas transit. However, this will be offset by greater capital inflows to the private sector amid an improved investment climate.

The NBU is easing its monetary policy more quickly in order to maintain inflation at its 5% target, and to promote steady economic growth

The more pronounced reduction in inflationary pressures over the monetary policy horizon and the unchanged balance of risks has enabled the NBU Board to cut the key policy rate more quickly: in Q4 2019, the NBU Board decreased the key policy rate twice, by a total of 300 bp to 13.5%, and cut the rate by another 250 bp in January 2020. These decreases in the key policy rate, coupled with expectations of further cuts, reduced the yields of domestic government debt securities and most interest rates for banks' clients.

In light of the more rapid improvement in Ukraine's macroeconomic conditions, the NBU now expects to cut the key policy rate more quickly than it anticipated earlier. Given low inflation environment over 2020 and aiming to support economic growth, the key policy rate could be cut to 7% by late 2020. It will remain at this level beyond 2020, if the inflation rate stabilizes close to its target of 5%. The NBU estimates the new neutral level of the key policy rate to be exactly 7%. The most pronounced cuts in the key policy rate are expected to take place in H1 of the current year. This will decrease loan rates for businesses and households, thus stimulating business activity. On the other hand, a more significant cut in the key policy rate would mean there was a risk of inflation overshooting the upper band of the target range in 2021.

The real effective exchange rate of the hryvnia will be relatively stable in 2020–2022, on the back of low inflationary pressures and an eased monetary policy.

Further cooperation with the IMF under a new program remains the underlying assumption of the macroeconomic forecast

The NBU expects that a new cooperation program with the IMF will be signed in the coming months, after parliament approves relevant draft laws. The new cooperation program, official borrowing, and nonresidents' continued interest in domestic government debt securities will sustain an annual rise in international reserves, despite Ukraine going through a period of peak external public debt repayments. International reserves will exceed USD 29 billion in 2020, and will continue to rise in 2021–2022.

The key risk to the forecast is that there is a delay in entering into a new cooperation program with the IMF

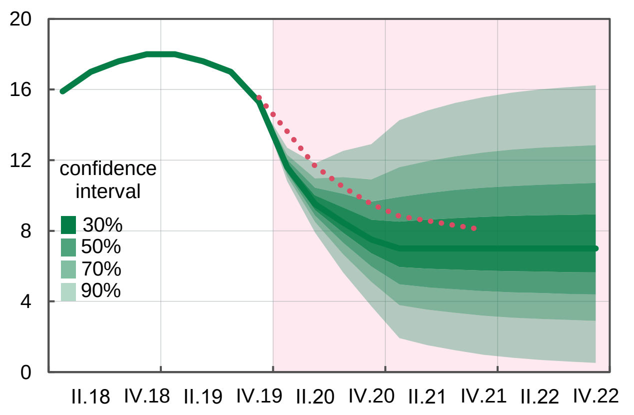
Risks to macrofinancial stability also remain. These risks could mainly arise from Ukrainian court rulings on the responsibility and liability of the former owners of insolvent banks to the state.

There are other significant risks. They include:

- the continued cooling of the global economy and a further deterioration in terms of trade, including due to spreading of the coronavirus
- an escalation of the military conflict in eastern Ukraine and new trade restrictions introduced by Russia
- a drop in the harvest of grain, fruit and vegetable crops in Ukraine in the wake of unfavorable weather
- the higher volatility of global food prices, driven by global climate change
- a decrease in foreign capital inflows.

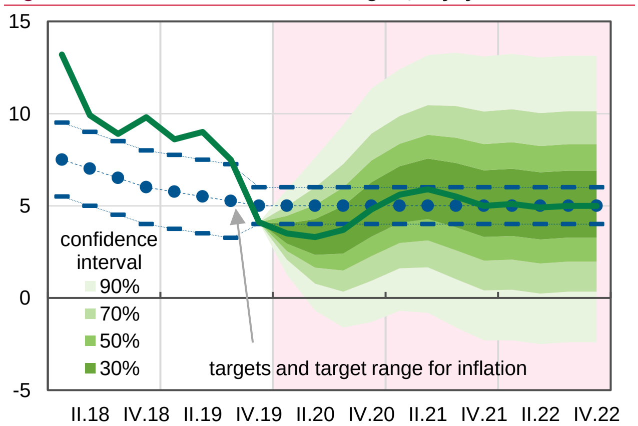
If materialized, these risks, both internal and external, could worsen exchange rate and inflation expectations, and make it harder for Ukraine to access the international capital markets in order to repay the heavy debt load of the coming years. As a result, the key policy rate could be cut to 7% more slowly than envisaged in the baseline scenario. Conversely, the faster implementation of reforms, coupled with significant investment inflows, could enable the NBU to cut the key policy rate more quickly.

Figure 2. Key policy rate, average, %



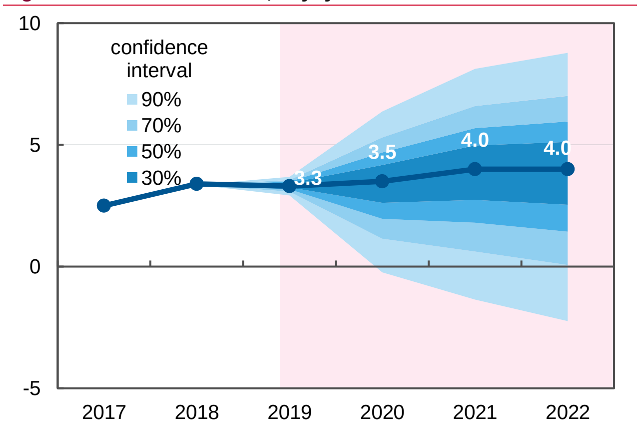
Source: NBU staff estimates.

Figure 3. CPI forecast and inflation targets, % yoy



Source: NBU staff estimates.

Figure 4. Real GDP forecast, % yoy



Source: NBU staff estimates.

Macroeconomic forecast (January 2019)

Indicators	2016	2017	2018	2019 I	2019 II	2019 III	2019 IV	2019 current forecast	2019 forecast 10.2019	2020 I	2020 II	2020 III	2020 IV	2020 current forecast	2020 forecast 10.2019	2021 I	2021 II	2021 III	2021 IV	2021 current forecast	2021 forecast 10.2019	2022 I	2022 II	2022 III	2022 IV	2022 current forecast
REAL ECONOMY, % yoy, unless otherwise stated																										
Nominal GDP, UAH bn	**2385**	**2984**	**3559**	808	928	1106	1134	**3975**	4020	868	996	1193	1233	**4290**	4420	946	1087	1303	1347	**4682**	4850	1033	1187	1422	1470	**5113**
Real GDP	**2.4**	**2.5**	**3.4**	2.5	4.6	4.1	2.2	**3.3**	3.5	3.5	3.1	3.5	3.8	**3.5**	3.5	3.9	4.0	4.0	4.0	**4.0**	4.0	4.0	4.0	4.0	4.0	**4.0**
GDP Deflator	17.1	22.1	15.4	11.7	9.4	6.8	4.2	8.0	9.2	3.8	4.1	4.4	4.7	4.3	6.2	4.9	5.0	5.0	5.0	5.0	5.5	5.0	5.0	5.0	5.0	5.0
Consumer prices (period average)	13.9	14.4	10.9	-	-	-	-	7.9	8.3	-	-	-	-	3.6	5.6	-	-	-	-	5.5	5.2	-	-	-	-	5.0
Producer prices (period average)	20.5	26.4	17.4	-	-	-	-	4.1	6.2	-	-	-	-	-3.5	7.7	-	-	-	-	4.9	7.6	-	-	-	-	5.0
Consumer prices (end of period)	**12.4**	**13.7**	**9.8**	8.6	9.0	7.5	4.1	**4.1**	6.3	3.5	3.3	3.7	4.8	**4.8**	5.0	5.6	5.9	5.5	5.0	**5.0**	5.0	5.1	4.9	5.0	5.0	**5.0**
Core inflation (end of period)	5.8	9.5	8.7	7.6	7.4	6.5	3.9	3.9	5.3	3.1	2.8	2.7	3.5	3.5	3.7	4.0	4.0	3.7	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8
Non-core inflation (end of period)	17.5	19.4	10.7	10.0	11.7	9.4	4.8	4.8	8.3	3.9	3.6	4.9	6.4	6.4	6.8	7.5	8.1	7.7	6.7	6.7	6.5	6.6	6.1	6.3	6.5	6.5
raw foods (end of period)	1.2	23.5	3.3	3.6	7.8	8.6	3.9	3.9	7.2	2.0	2.6	2.0	3.8	3.8	3.5	5.0	5.7	4.6	3.0	3.0	3.0	3.4	2.9	2.9	3.3	3.3
administrative prices (end of period)	34.6	16.1	18.0	18.7	17.0	14.1	8.6	8.6	11.7	7.5	7.0	8.5	9.3	9.3	10.0	9.5	10.1	10.1	9.8	9.8	9.8	9.6	9.4	9.3	9.1	9.1
Producer prices (end of period)	**35.7**	**16.5**	**14.2**	8.9	4.5	1.7	-7.4	**-7.4**	5.8	-6.3	-2.3	-3.0	5.4	**5.4**	7.3	4.9	4.5	4.9	5.1	**5.1**	7.0	5.0	5.0	5.0	5.0	**5.0**
Nominal wages (period average)	23.6	37.1	24.8	20.8	18.8	18.4	16.3	18.5	18.2	15.2	13.0	10.5	10.2	12.1	12.0	10.3	10.3	9.9	9.9	10.1	9.3	9.6	9.5	8.9	8.8	9.2
Real wages (period average)	9.0	19.1	12.5	10.9	8.6	9.0	10.5	9.7	9.2	11.2	9.7	6.7	5.6	8.2	6.0	4.6	4.4	4.2	4.6	4.5	4.0	4.3	4.3	3.7	3.6	4.0
Unemployment (ILO)	9.3	9.5	8.8	-	-	-	-	8.3	8.4	-	-	-	-	8.3	8.3	-	-	-	-	8.2	8.2	-	-	-	-	8.2
FISCAL SECTOR																										
Consolidated budget balance, UAH bn	**-54.8**	**-42.1**	**-67.8**	-	-	-	-	**-84.3**	-80.2	-	-	-	-	**-85.4**	-90.6	-	-	-	-	**-92.6**	-89.7	-	-	-	-	**-101.2**
% of GDP	-2.3	-1.4	-1.9	-	-	-	-	-2.1	-2.0	-	-	-	-	-2.0	-2.0	-	-	-	-	-2.0	-1.8	-	-	-	-	-2.0
Public sector fiscal balance (IMF methodology), UAH bn	**-50.3**	**-37.0**	**-75.4**	-	-	-	-	**-84.3**	-80.6	-	-	-	-	**-84.0**	-90.5	-	-	-	-	**-92.3**	-89.5	-	-	-	-	**-100.1**
% of GDP	-2.1	-1.2	-2.1	-	-	-	-	-2.1	-2.0	-	-	-	-	-2.0	-2.0	-	-	-	-	-2.0	-1.8	-	-	-	-	-2.0
BALANCE OF PAYMENTS (NBU methodology)																										
Current account balance, USD bn	-1.3	-2.4	-4.4	-0.2	-0.5	-2.2	1.8	-1.1	-4.5	-1.5	-1.5	-2.2	-0.5	-5.7	-5.7	-2.0	-2.2	-2.8	-0.8	-7.9	-7.5	-2.4	-2.1	-2.8	-0.7	-8.0
Exports of goods and services, USD bn	46.0	53.9	59.1	15.1	15.5	16.3	16.5	63.4	63.1	15.2	15.6	16.5	18.1	65.5	63.7	15.8	15.8	17.0	18.5	67.0	65.1	16.3	16.4	17.4	19.0	69.1
Imports of goods and services, USD bn	52.5	62.5	70.5	16.9	18.4	20.3	20.0	75.5	75.1	18.6	19.5	20.6	21.2	79.9	77.2	19.7	20.6	21.9	22.1	84.2	80.8	20.6	21.2	22.5	22.5	86.9
Financial account, USD bn	-2.6	-5.0	-7.2	-0.5	-0.9	-3.6	-2.0	-7.0	-7.0	-3.6	-1.4	-1.6	-2.2	-8.9	-6.4	-3.0	-3.1	-2.4	-1.0	-9.4	-6.4	-2.6	-2.9	-2.6	-0.4	-8.5
BOP overall balance, USD bn	**1.3**	**2.6**	**2.9**	**0.3**	**0.4**	**1.5**	**3.8**	**6.0**	2.6	**2.1**	**-0.1**	**-0.5**	**1.7**	**3.2**	0.6	**1.0**	**0.9**	**-0.4**	**0.1**	**1.6**	-1.1	**0.3**	**0.7**	**-0.3**	**-0.3**	**0.4**
Gross reserves, USD bn	**15.5**	**18.8**	**20.8**	**20.6**	**20.6**	**21.5**	**25.3**	**25.3**	23.0	**27.5**	**27.5**	**27.0**	**29.3**	**29.3**	24.0	**29.7**	**31.5**	**30.5**	**31.6**	**31.6**	23.1	**31.2**	**32.7**	**31.7**	**32.3**	**32.3**
Months of future imports	3.0	3.2	3.3	3.2	3.1	3.3	3.8	3.8	3.6	4.1	4.0	3.9	4.2	4.2	3.6	4.2	4.4	4.2	4.4	4.4	3.3	4.2	4.3	5.2	4.2	4.2
MONETARY ACCOUNTS (cumulative since the beginning																										
Monetary base, %	13.6	4.6	**9.2**	-2.8	2.1	1.2	9.6	**9.6**	8.1	-4.1	0.0	0.2	6.1	**6.1**	6.5	-4.3	0.1	0.2	6.1	**6.1**	6.3	-4.4	-0.1	-0.1	5.6	**5.6**
Broad money, %	10.9	9.6	**5.7**	-1.9	0.8	2.2	12.3	**12.3**	8.7	-1.5	2.3	4.5	10.1	**10.1**	8.9	-2.1	2.6	5.0	9.5	**9.5**	9.2	-2.7	1.8	4.5	9.4	**9.4**
Velocity of broad money (end of year)	2.2	2.5	**2.8**	-	-	-	-	**2.8**	2.9	-	-	-	-	**2.7**	2.9	-	-	-	-	**2.7**	2.9	-	-	-	-	**2.7**