INFLATION REPORT

April 2017

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 13 April 2017.[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 07 April 2017 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. 235-D as of 13 April 2017 *On the Approval of the Inflation Report.*

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TERMS AND ABBREVIATIONS

ATO	Anti-Terrorist Operation
NGCA	Non-government controlled area
Core CPI	Core consumer price index
GDP	Gross domestic product
GVA	Gross value added
SESU	State Employment Service of Ukraine
SSSU	State Statistics Service of Ukraine
SFSU	State Fiscal Service of Ukraine
EU	European Union
SSC	Social Security Contribution
ECB	European Central Bank
FTA	Free trade agreement
IKSO	Index of Key Sectors Output
IIF	Institute of International Finance
CPI	Consumer price index
PPI	Producer price index
Treasury	State Treasury Service of Ukraine
CMU	Cabinet of Ministers of Ukraine
BPM5 BPM6	IMF Balance of Payments Manual (5th edition) IMF Balance of Payments And International Investment Position Manual (6th edition)
IMF	International Monetary Fund
ILO	International Labor Organization
MY	Marketing year
MFU	Ministry of Finance of Ukraine
NBU	National Bank of Ukraine
NEER	Nominal effective exchange rate
REER	Real effective exchange rate
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
MTP	Main trading partner
VAT	Value added tax
FDI	Foreign direct investment
RF	Russian Federation
CIS	Commonwealth of Independent States
WTO	World Trade Organization
USA	United States of America
DGF	Deposit Guarantee Fund
FED	Federal Reserve System
CEE	Central and Eastern Europe
EFF	Extended Fund Facility
FAO	Food and Agriculture Organization
MSCI	Morgan Stanley Capital International Inc.
PMI	Purchasing Managers' Index

m	million
bn	billion
UAH	Ukrainian hryvnia
USD	US dollar
RUB	Russian rouble
M0	cash outside banks
M3	money supply
pp	percentage points
bp	basis points
USD/bbl	US dollars per 1 barrel
USD/ton	US dollars per 1 ton
USD/EUR	US dollars per 1 euro
UAH/USD	Ukrainian hryvnia per 1 US dollar
RUB/USD	Russian roubles per 1 US dollar
yoy	in annual terms; year-on-year change
qoq	in quarter terms; quarter-on-quarter change
mom	in monthly terms; month-on-month change
sa	seasonally adjusted
pa	per annum

1. SUMMARY

As expected, inflation pressures intensified in early 2017

In March 2017, CPI grew by 15.1% yoy. The acceleration of consumer inflation from 12.4% yoy in December 2016 was expected. At the same time, actual inflation came in below the NBU's projection of 16.4% yoy, which was published in the Inflation Report (January 2017).

The growth accelerated for most CPI components amid increased production costs and a low comparison base. At the same time, supply-side factors and favorable developments in global commodity markets restrained the pace of price growth. Notably, the economies of Ukraine's major trading partners have continued to gain momentum since the start of 2017. Ukrainian exporters have also enjoyed an increase in prices for steel, iron ore, and grain in Q1. High export revenues have outweighed the negative impact of the seasonal and temporary factors, causing the hryvnia to strengthen since mid-January. This has combined with prudent fiscal and monetary policies and improved inflation expectations, resulting in restrained core inflation (at 6.3% yoy in March 2017, also marginally below the NBU's previous forecast). A slight acceleration of core inflation reflected higher production costs and secondary effects from rising raw food prices. The adoption of new CPI calculation methodology was another factor contributing to the slower-than-expected inflation rate.

A gradual pick-up in economic activity and improved business outlook contributed to a recovery in labor demand in early 2017. With the minimum wage doubled to UAH 3,200 as of 1 January 2017, nominal and real wages rose sharply in January-February 2017. Despite these factors, consumer demand remained subdued in Q4 2016 and early in 2017. In particular, labor market mismatches drove a still high unemployment level in Ukraine. Meanwhile, real disposable income shrank in Q4 2016 in annual terms amid high housing and utility tariffs and a sluggish increase in non-wage household income.

Fiscal policy remained relatively tight in early 2017. Although both social and capital expenditures grew sharply (atypical for the start of the year), these were offset by robust budget revenues, boosted by general economic factors and tax amendments. As a result, January-February 2017 posted a primary surplus and an overall consolidated budget surplus, the latter at a record level.

Consumer inflation is projected to continue trending lower

The National Bank of Ukraine has left **inflation projections** for 2017, 2018, and 2019 unchanged at 9.1%, 6.0%, and 5.0%, respectively. The inflation projections remain within the targets previously announced in the Monetary Policy Guidelines for 2017 and the Medium Term (8% ± 2 pp for 2017, 6% ±2 pp for 2018, and 5% ± 1 pp for 2019 and over the medium-term).

The projected slowdown of consumer inflation in 2017 will be primarily a reflection of a lower contribution of regulated prices and the use of monetary policy tools to restrain underlying inflation pressures. In the meantime, core inflation is expected to accelerate to 6.5% yoy in 2017 due to a recovery of consumer demand and secondary effects from rising food inflation. Raw food inflation is also expected to accelerate (to 7.8% yoy), driven by higher global food commodities, the opening of new foreign markets for selected Ukrainian food products, and high growth in household incomes.

Regulated prices are expected to post the highest growth rates among inflation components over the forecast period, largely due to rising energy prices and government excise policy. This will maintain annual consumer inflation in double-digit levels over the first three quarters of 2017. Meanwhile, a sharp slowdown of regulated price inflation in the Q4 will be key to the continued trend of disinflation.

In 2018, inflation is forecast to continue to slow, returning to the mid-point of the target range. Sound monetary and fiscal policies will be a key factor for maintaining the disinflation trend. Core inflation is expected to slow (to 4.3% yoy) amid low exchange rate volatility, with aggregate demand below potential and a low inflation environment in major trading partner economies. Over the mid-term, bountiful harvests driven by investment into agriculture will restrain food price inflation.

In 2016, high investment demand and a record harvest were key factors driving economic growth

In Q4 2016, **real GDP growth** accelerated to 4.8% yoy, exceeding the NBU's projection. Overall in 2016, GDP grew by 2.3% yoy. As expected, the acceleration of investment growth (to 27.1% yoy in Q4) provided the largest support to the economy. On the other hand, domestic consumer demand lost momentum. Agriculture also contributed strongly, with record grain and oil harvests and a bountiful sugar beet harvest, among others, leading to a sharp increase in inventory levels.

In Q1 2017, real GDP growth decelerated in annual terms driven by the suspension of freight transport in Eastern Ukraine and the seizure of companies in Donetsk and Luhansk oblasts. This resulted in a decline in the mining industry and metallurgy, with a consequent deterioration in adjacent activity. Meanwhile, improved terms of trade, robust foreign demand, and sustained investment activity partially offset the impact of the events in Eastern Ukraine.

Exports of food and steel products rose at a high pace driven by the previous year's strong harvest and an improved external environment. This was a major factor behind a narrowing of the **current account deficit** to USD 0.5 billion in January – February 2017.

Net financial account inflows declined to USD 0.3 billion. As in 2016, the real sector took in those inflows, in particular via net short-term drawings and a reduction in FX cash outside banks. FDI inflows remained minor, directed entirely to the real sector. **Foreign reserves** declined to USD 15.1 billion as of the end of Q1 2017 (3.2 months of future imports) driven by the overall **balance-of-payments deficit** of USD 0.2 billion in January-February and March's interest and principal payments on public and publicly guaranteed foreign currency debt. However, the reserves grew to USD 16.7 billion as of April 5, 2017 after the disbursement of the fourth tranche under the IMF's EFF arrangement and the second tranche of macro-financial assistance from the European Union.

Economic growth will slow down in Ukraine in 2017

In 2017, economic growth is expected to slow down to 1.9% yoy as production in several sectors will decline after freight transport was halted along the contact line in Donetsk and Luhansk oblasts and after the seizure of enterprises in the occupied territories. The downward revision of the growth forecast is a reflection of a higher negative contribution of net exports. This will occur due to a shift to imported raw materials by producers in the energy sector and metallurgy to replace the lost resource base, as well as due to a loss of production capacities in export-oriented industries. The impact will be partially offset by a favorable global price environment, with average prices growing in 2017, primarily due to ferrous metal, iron ore, and grain prices.

In 2018-2019, real GDP growth is projected to accelerate to 3.2% yoy and 4.0% yoy, respectively. Growth will be driven by robust consumer and investment demand, higher exports amid improved terms of trade, large harvests, and the securing of alternate sources of raw materials. Meanwhile, rising consumer and investment demand will be largely met by imports, resulting in almost no contribution by net exports in 2018-2019.

Private consumption will be the major driver of economic growth over the forecast period, reflecting a doubling of the minimum wage, improved consumer sentiment, and a gradual easing of monetary policy. Meanwhile, investment growth will slow amid higher production costs and against a higher comparison base. The agriculture sector will remain the primary destination for the investment.

The current account deficit is expected to widen moderately in 2017-2018 compared with 2016, hovering around 4% of GDP. An improvement in the terms of trade will be offset by the negative effect of the halted freight traffic along the contact line in Eastern Ukraine and a further recovery in demand for imported consumer and investment goods prompted by rising household incomes and significant investment in machinery and equipment.

Debt capital inflows to the private sector and the continued reduction in household demand for cash holdings will contribute to net financial account inflows of USD 5 billion in 2017. In 2018, the private sector will have a broader range of opportunities to raise both debt capital and attract foreign direct investment as business sentiment improves and economic growth accelerates.

This forecast is based on the key assumption of continued cooperation with the IMF, which is an important source of replenishing foreign exchange reserves, facilitates access to funding from other international donors, and is an indicator of progress in structural reforms and of the country's investment attractiveness. Together with the overall balance-of-payments surplus, the disbursement of scheduled tranches under the EFF arrangement will enable an increase in international reserves to USD 26.1 billion (5.1 months of future imports). With government loan repayment expected to increase, foreign reserves will decline to an estimated USD 25.1 billion in 2019 (4.7 months of future imports).

Fiscal policy is forecast to become more accommodative, as evidenced by the expected expansion of the structural deficit. Fiscal stimulus to the aggregate demand will be mostly implemented to a large degree through growth of private consumption. In the medium term, room to ease fiscal policy further will be limited due to the commitment to keep the general government deficit within 3% of GDP. Capital expenditures are also expected to grow, yet they will be restrained given the budget deficit ceiling and by growing wage and other social expenditures like subsidies for household utilities. Growth in revenues from the Single Social Contribution will enable a reduction in budget support to the Pension Fund. The primary consolidated budget surplus will stay flat at around 1% of GDP taking into account large debt service payments.

Further monetary policy easing is conditional upon mitigation of risks for the achievement of inflation targets

In Q1 2017, the NBU Board refrained from cutting its key policy rate to mitigate risks hampering the achievement of inflation targets for 2017-2018. At the same time, an aggressive easing of monetary policy by the NBU last year continued to transmit into market interest rates. Interest rates in the interbank lending market and yields on domestic government bonds have been decreasing. However, banks' retail interest rates still remained elevated.

February saw hryvnia deposit inflows resume. Nevertheless, the stock of domestic currency deposits still marginally decreased in the first two months. **Lending** activity remained subdued against the backdrop of persistently high credit risks and high leverage

in the corporate sector. At the same time, the stock of domestic currency loans to households grew for the second straight month -, notably for durable goods purchases.

In April, the NBU resumed monetary policy easing. Thus, from 14 April 2017, the NBU cut its key policy rate by 1 pp to 13%. This was the first reduction in the key policy rate since October 2016. The NBU move is fully consistent with inflation targets set for 2017-2019 and is expected to support economic growth.

The central bank expects to ease monetary policy further gradually. However, monetary conditions will remain relatively tight to bring inflation down in line with the approved inflation targets.

Balance of risks to inflation projections will be symmetrical on the forecast horizon

The balance of risks to inflation projections is symmetrical; however, some internal and external factors will have opposing effects.

A major risk internally is the potential for the private and public sector to fail to efficiently mitigate losses from halted freight traffic along the contact line in Donetsk and Luhansk oblasts. In addition, the risk of an escalation of the military conflict in the east remains high.

Also, considerable uncertainty remains as to the implementation of the macroeconomic policy and structural reforms required to maintain macrofinancial stability, boost the economy's potential and continue cooperation with the IMF. Inefficient reform implementation would push risk premiums up, worsening inflation and exchange rate expectations and intensifying inflationary pressures.

A more significant increase of social benefits by the government and changes in the government household subsidy assistance policy will affect aggregate demand and, consequently, the current account and inflation trends. Increases in administered prices, particularly natural gas (the separation of transportation and distribution costs from the price of gas as a commodity) and electricity prices also add uncertainty.

External risks mostly arise from uncertainty related to the implementation of newly elected US President Donald Trump's announced fiscal stimulus package. The prospect alone pumped global commodity prices higher. Meanwhile, there is an even higher likelihood that the Fed will tighten monetary policy. If that takes place, developing economies can expect currencies to depreciate against the USD. Disintegration risks in Europe, greater protectionist and nationalist sentiments may adversely affect the effectiveness of international cooperation and cause investors to become more risk averse. Finally, geopolitical risks are mounting as tensions escalate, especially in the Middle East and on the Korean peninsula.

If these and other risks materialize during the forecast period, actual inflation may deviate from its projected path, and the reassessment of risks could prompt the NBU to take action as required by the new conditions.

2. CURRENT ECONOMIC SITUATION

2.1. EXTERNAL ENVIRONMENT

In Q4, external demand (expressed as the weighted average of annual economic growth rates of major trading partners) strengthened, boosted by a rebound in economic activity on the back of rising global prices and domestic consumption in Ukraine's main trading partner countries (MTPC). Data available since early-2017, suggest positive economic developments in several of Ukraine's MTPCs.

Ukrainian exporters faced more favorable external price conditions in Q1 2017 vs. Q4 2016 as prices for steel, iron ore, fertilizers, and grain crops rose.

In Q1 2017, crude oil traded in the range of USD/barrel 50-57. The commitment to the Algiers Accord was the main driver behind the increase in prices versus the previous quarter. However, increased oil production and inventories in the US restrained further price increases .

Global financial markets were influenced by the positive economic outlook for developed economies, rising corporate profits, and the interest rate hike by the US Federal Reserve (FED).

The environment for emerging market financial assets improved amid broad optimism about the accelerating global economic activity and rising commodity prices ; capital inflows resumed and these countries' currencies mostly strengthened against the USD.

In Q4 2016, the weighted average of annual economic growth rates of Ukraine's MTPCs (as expressed by changes in the UAwGDP index) accelerated versus the previous quarter. All of Ukraine's MTPCs showed positive developments, notably:

– In Q4 2016, US GDP growth accelerated to 1.9% yoy. Economic growth recovered mostly due to consumption, which accounts for approximately 70% of the country's GDP. The rise in consumer spending came on improved labor market performance (unemployment stabilized at 4.6%-4.7%, initial jobless claims fell to a low level) and improved consumer confidence.

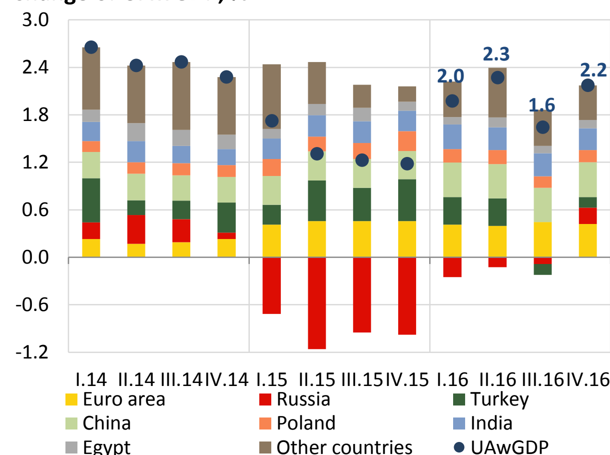
– Higher consumer spending, maintaining of the ECB's quantitative easing policy, and an acceleration in investment growth after a slowdown in Q3 supported steady economic growth in the euro area. Rising global commodity prices also supported the economy.

– Economic growth in the CIS countries accelerated. Russia's and Kazakhstan's economies are gradually stabilizing thanks to rising external demand and global commodity prices, primarily, for oil and gas. In addition, the decline in Belarusian economic growth eslowed down driven by surging non-energy exports (nearly 20% higher yoy in Q4 2016).

– Economic activity in Central and Eastern Europe (CEE) countries, included in the index, accelerated as internal and external demand picked up. However, investment volumes in the CEE countries remained low.

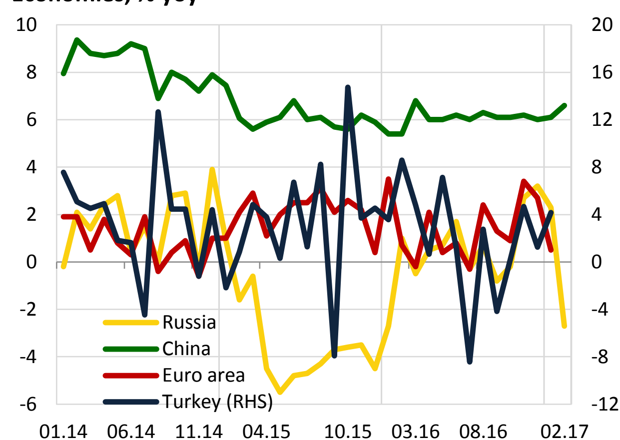
– The pace of China's economic growth accelerated to 6.8% yoy in Q4 as consumption picked up and global commodity prices rose (despite the government's policy aimed to reduce steel and

Contributions of Ukraine's MTP Countries to the Annual Change of UAwGDP, %



Source: NBU staff estimates (preliminary data)

Industrial Production in Selected Advanced and Emerging Economies, % yoy



Source: National Statistical Offices

coal inventories, Chinese manufacturers increased production volumes amid rising global commodity prices).

– Turkey's economic growth recovered after a weaker Q3 thanks to competitive price advantages after the Turkish lira depreciation and due to stable growth in its MTPCs (particularly, in Germany and Great Britain, which account for approximately 10% and 6% of Turkey's exports, respectively).

Since the start of 2017, the economies of some of Ukraine's MTPCs have continued to strengthen. The growth in internal and external demand in China contributed to industrial production growth, while private investment growth rates doubled. China's economic recovery provided an impetus to both Asian countries and global commodity markets. The positive trends in commodity markets supported the growth of the CIS economies, apart from Russia, where industrial production fell in February due to a decline in the manufacturing output. Industrial output in the euro area rose as manufacturing in the key euro area countries, Germany and France, recovered, supported by foreign trade growth.

In Q1 2017, inflationary pressures in Ukraine's MTPCs as expressed by the UAwCPI index[2] intnsified slightly. The euro area and CEE countries contributed the most to the index's increase as the ECB's monetary easing and higher commodity prices spurred inflation. At the same time, inflationary pressures in developing countries, in particular the CIS and China, subsided.

Overall, the external price environment has become more favorable for Ukrainian exporters in Q1 2017 despite a decline in prices for certain goods in the quarter. In Q4, the external commodity price index (ECPI) grew 7.3% qoq (19.2% yoy), mainly due to the increase in prices for steel, iron ore, grain crops, and fertilizers.

In early 2017, growth in steel product prices globally was driven by:

– Raw material costs, especially for iron ore.

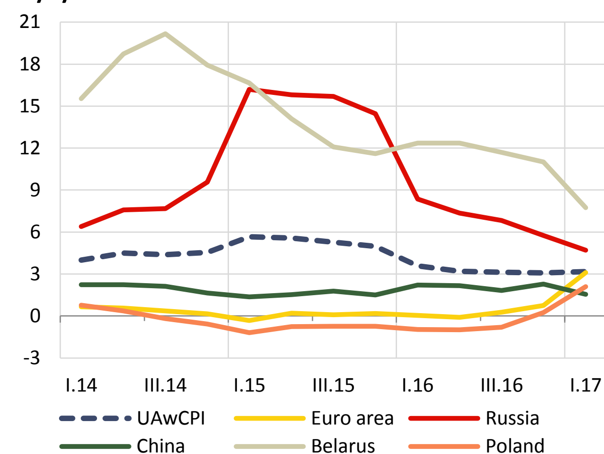
– The recovery of Chinese domestic demand after the New Year holidays, mainly due to re-stocking activity. The growth in steel product prices in China prompted a similar increase in prices for those products around the world.

– Anti-dumping duties, especially in Europe, supported prices despite higher steel output.

– Stronger domestic currencies in a number of steel producing countries, including India, Russia, and South Korea.

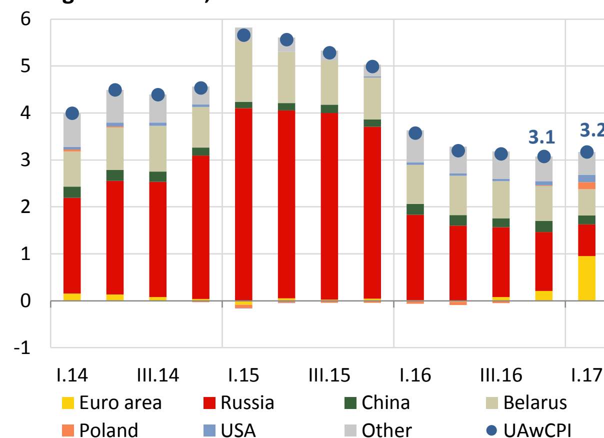
At the same time, lower prices for Turkish goods in late January to early February caused by the lira depreciation intensified competition among importers of square billets and turned the former net importer Turkey into a net exporter of this semi-finished steel good. This drove a significant reduction in prices for Ukrainian and Russian products as Turkey was a major importer of products from those trading partners. In mid-February, the lira strengthening pushed domestic prices up, leading to higher prices for Ukrainian steel.

Consumer Price Indices in Ukraine's MTP Countries, % yoy



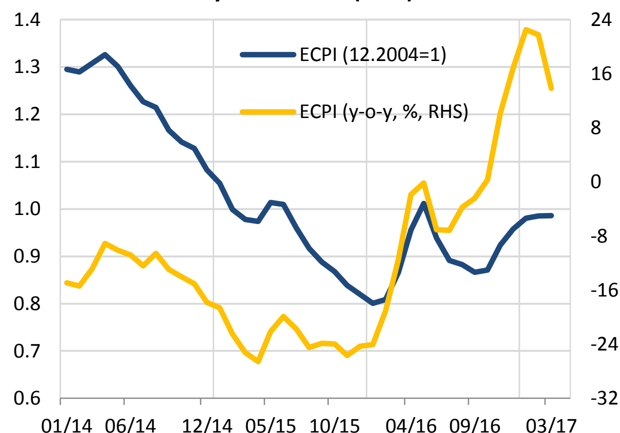
Source: NBU staff estimates (preliminary data)

Contributions of Ukraine's MTP Countries to the Annual Change of UAwCPI, %



Source: NBU staff estimates (preliminary data)

External Commodity Price Index (ECPI)

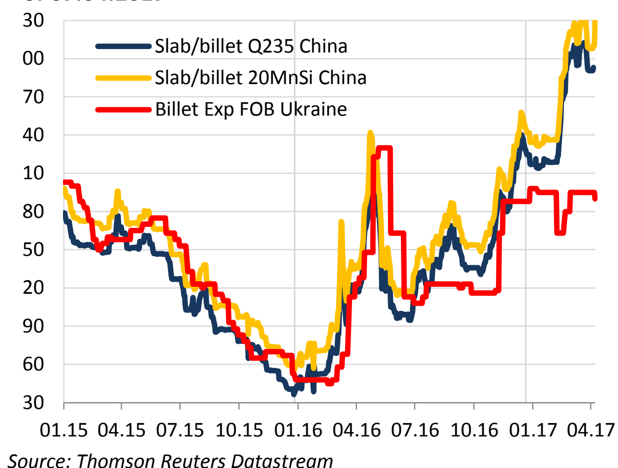


Source: NBU staff estimates

[2] The UAwCPI is an index of inflation in Ukraine's MTPCs, weighted by the volume of Ukraine's goods and services imports from each country.

In late March to early April, prices for steel products declined in certain markets. Factors that affected prices included growth in production and exports (in particular in India and the US), high inventories of steel in China (reaching a record since 2004), and a weaker demand for steel in Turkey caused by uncertainty on the eve of the constitutional referendum. However, in Q1 2017 average prices for semi-finished steel goods remained substantially higher not only versus the previous quarter, but also comparing with the same quarter of the previous year.

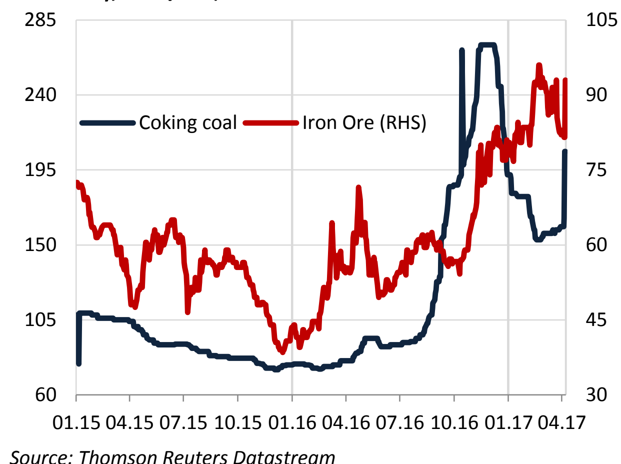
Semi-Finished Steel Prices in China and Ukraine, USD/MT, as of 07.04.2017



Source: Thomson Reuters Datastream

Iron ore prices have been rising since the beginning of the year and reached a three-year high in February. This was primarily caused by higher global steel production and China's active participation in the market (an accumulation of ore inventories before the New Year holiday and a revival of activity after the holiday), as well as a contraction of exports, especially by Brazil. In the second half of the quarter, prices declined again on fears of reduced demand from China, which had accumulated large inventories of the raw material. Nevertheless, on the whole, Q1 2017 prices were considerably higher versus the previous quarter and the previous year.

Iron Ore and Coking Coal Prices (import of China from Australia), USD/MT, as of 07.04.2017



Source: Thomson Reuters Datastream

In early 2017, despite a record harvest volume, global grain prices increased owing to:

– Unfavorable weather conditions (a drought in Brazil, frost without snow in the EU, etc.), which caused concerns about the new harvest.

– A seasonal increase in demand for high-quality wheat, including Ukrainian and Russian wheat, in the second half of the marketing year. Algeria and Egypt have been active buyers in the market.

– A reduction in corn exports by Brazil amid steady demand (in 2016, gross corn yield was the lowest in the last five years at 67 million tons as a result of drought, down by 21% yoy).

However, in early March, grain prices resumed decline, caused by the sell-off of the record harvest inventories, in order to generate cash for the new sowing campaign (primarily in countries of the Black Sea region and the US).

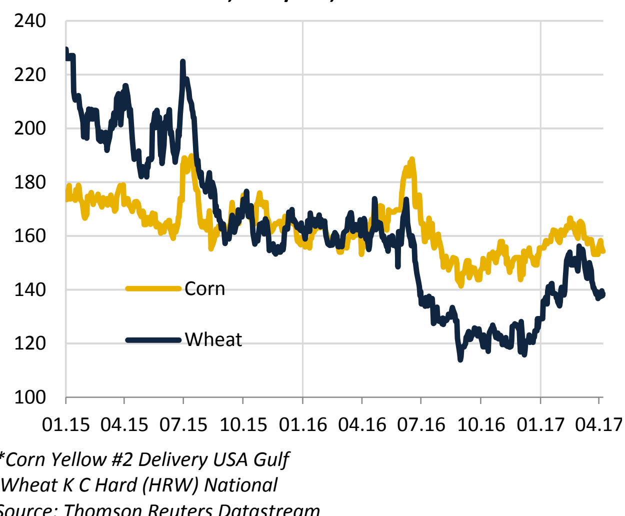
Except for the second half of March, global oil prices fluctuated in the range of USD 50-57/barrel in Q1 2017. The commitment to the Algiers Accord, concluded by key oil-producing countries, had a major influence on prices. Prices were also supported by:

– Increasingly tense relations between the US and Iran.

– China's high oil imports caused by replenishing strategic oil reserves and growth in processing capacities[3], as well as the announced intent by China's National Commission for Development and Reform to gradually reduce domestic oil production and increase imports.

– Growth in India'a crude oil imports (by 10% mom in January), with plans to increase imports by almost 39% by the year end.

World Cereal Prices*, USD/MT, as of 07.04.2017



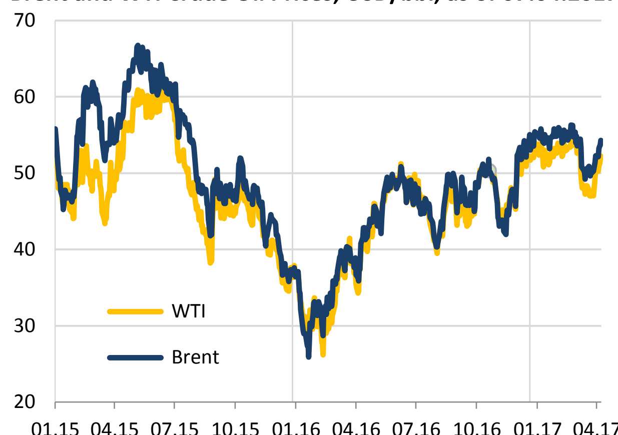
**Corn Yellow #2 Delivery USA Gulf*
Wheat K C Hard (HRW) National
Source: Thomson Reuters Datastream

[3] In January, China's oil imports grew 26.2% yoy to nearly 32 million tons.

On the other hand, a number of factors weighed on prices:

– The US and Canada re-started oil production.
– The US increased inventories of oil and oil products.
– Sales of tanker-stored oil grew[4].
– Iraq increased oil exports 10% qoq to 3.3 million barrels/day.
– The mounting risks of violations of the Algiers Accord because of:
– Increased oil production by Nigeria, Iran (exceeding approved levels), and the UAE, as well renewed growth in oil production by Saudi Arabia in February.
– Plans by Libya's National Oil Corp. to nearly double oil production to 1.25 million barrels per day by the end of 2017 (Libya is exempt from the OPEC quota system).
– The publication of information on the planned sale of Rosneft's controlling stock in Grozneftegaz (Chechnya), which could significantly impact Russia's implementation of agreed production levels.

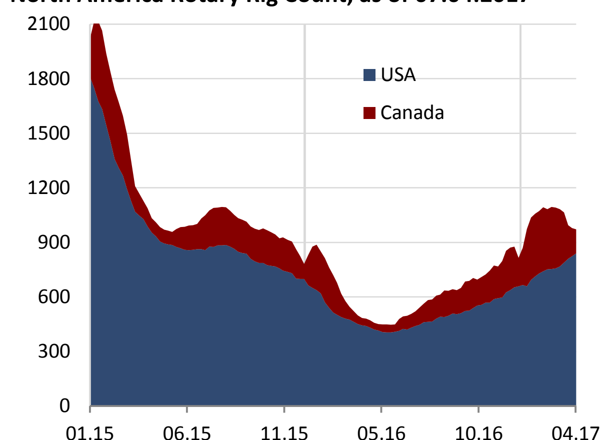
Brent and WTI Crude Oil Prices, USD/bbl, as of 07.04.2017



Source: Thomson Reuters Datastream

Starting in mid-March, oil prices fell dramatically as statistics showed rapid growth in crude oil inventories in the US to a new record high, US oil production continued to grow, and the USD strengthened against major currencies. Since the start of 2017, conditions in global financial markets have generally been favorable both for advanced countries and emerging markets. The S&P 500 Index has climbed on investor optimism about the effect of new US economic policy measures on business activity and corporate profit growth. The index benefited from a number of resolutions adopted by the US president regarding the launch of the Keystone XL and Dakota Access oil pipelines, the expansion of energy infrastructure, and an increase in domestic industrial production, as well as President Trump's confirmed plans for tax reform, infrastructure spending, and simplified financial regulations. The start of the Q4 2016 earnings season also proved successful, marking the end of the longest period of declining corporate profits. Signs of an acceleration in economic activity offer investors optimism onthe growth potential of the stock markets in 2017.

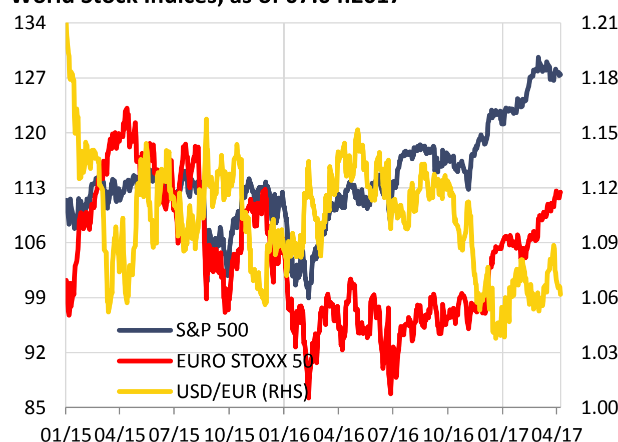
North America Rotary Rig Count, as of 07.04.2017



Source: Baker Hughes

The EURO STOXX 50 Index was boosted by the economic recovery of the euro area in Q3 and Q4 2016, as well as by expectations of continued positive trends amid progress in meeting the inflation target (euro area inflation came in at 2% yoy in February 2017). At the same time, the EURO STOXX 50 was held back by rising political risk in Europe, in particular due to Brexit, Scotland's independence referendum, and elections in France and the Netherlands, which could influence the future of the EU as a union of states, as well as by problems in the banking system.

World Stock Indices, as of 07.04.2017



Source: Thomson Reuters Datastream

The monetary policies of leading central banks met expectations in early 2017. As expected, in March the FED increased its key federal funds rate by 25 bp to 0.75%-1.00%. This decision was made possible by steady economic growth, continued employment growth, and confidence that inflation will match the target. However, comments from Federal Reserve officials (in post-

[4] According to preliminary estimates by VesselsValue, January volumes of tanker supplies reached a record, accounting for 22% of total supplies in 2016 (which translates into a growth of nearly 1.3 million barrels/day versus the average daily volumes of 2016).

meeting press releases and statements from the FED chair and members) pointed to a gradual pace of interest rate increases in the future and signaled the possibility of two more hikes of the benchmark rate in 2017. The message was seen as dovish and, combined with other factors, drove yields on 10-year US treasury bonds lower at the end of March after peaking at 2.62% in the middle of the month.

In turn, the ECB and the Bank of Japan left their monetary policy unchanged. Meanwhile, central banks in most developing markets have cut interest rates in light of decreasing inflationary pressures (in particular, Russia, Chile, Brazil, Kazakhstan, Armenia, and others).

With yields of developed countries' long-term bonds on the rise, global capital flows continued shifting from the bond market into stocks in Q1 2017.

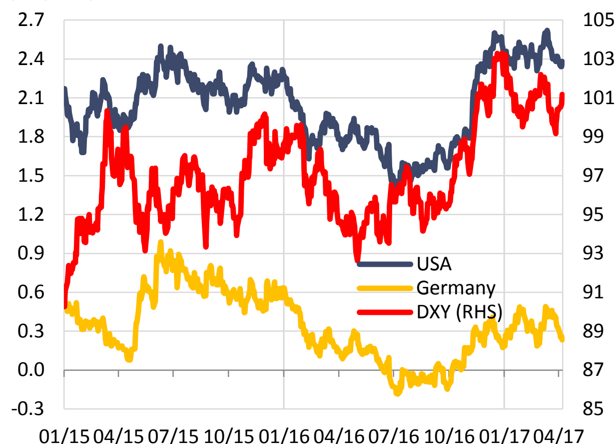
In Q1 2017, investors regained their appetite for emerging market financial assets thanks to:

- Favorable conditions in global financial markets.
- Expectations of a further acceleration of the US economy, which will spur economic growth globally and in emerging markets.
- Expectations that the significant differential in growth rates between developed and developing countries will be maintained.
- Rising global commodity prices.
- The significant potential for the currencies of these countries to strengthen (after the prolonged decline of their exchange rates in 2014-2015).

In January-February, net portfolio flows to emerging markets reached its highest level since June 2016 (approximately USD 30 billion). The improved domestic environment made the greatest contribution to the positive performance, while the influence of expectations regarding the FED's monetary policy was almost negligible[5]. Globally, all regions showed growth. Moreover, in March net capital inflows accelerated to a four-month high. Capital inflows to China turned net positive for the first time since 2014.

In Q1 2017, most developing countries' currencies managed to recoup the losses they incurred after the US presidential election results were announced. Among other factors, this was driven by the USD depreciation on global FX markets in January (on the ambiguous actions and words of the US president, the DXY Index fell 2.6% mom, the worst start to a year in the last three decades), as well as by growing carry-trade demand for these currencies under conditions of reduced volatility on global financial markets.

Government bonds yields (10 year) of USA and Germany, as of 07.04.2017

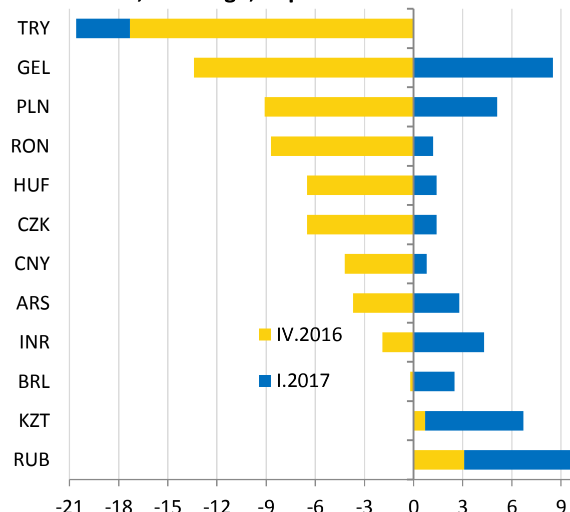


Source: Thomson Reuters Datastream

Emerging market stock indices, 01 Jan 2014=100, as of 07.04.2017

Source: Thomson Reuters Datastream

Exchange Rates of Emerging Market Currencies versus US Dollar in 2016, % change, eop



Source: Thomson Reuters Datastream

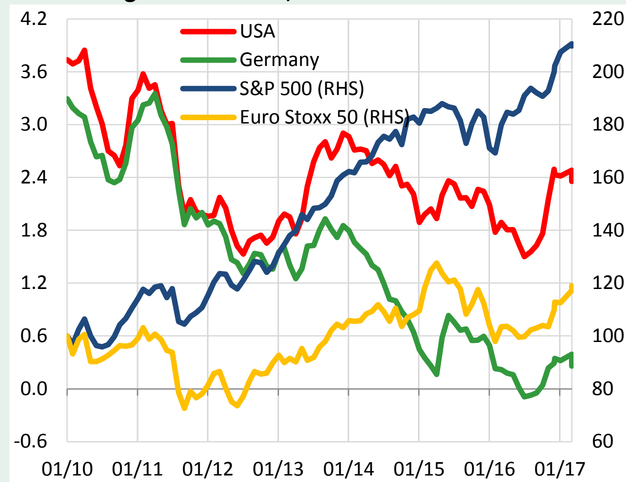
[5] According to the IIF.

Box: Financial Conditions for Emerging Markets

The current tendency towards the acceleration of inflation in developed markets and expectations of a faster pace of interest rate increases by the FED, which has led to a rapid strengthening of the USD, have exerted upward pressure on long-term interest rates globally. This could significantly influence the redistribution of capital flows between developed markets, making them more attractive, and developing markets, which are facing tougher financial conditions.

Most recently financial conditions tightened for developing markets in 2014-2015 after the FED completed its quantitative easing program. The latter indicated the recovery of the US economy, contributed to a strengthening of the USD, and also prompted a downturn in prices for exchange-traded commodities, particularly oil and ferrous metals. In turn, this contributed to the slowdown in economic activity in emerging markets and caused their domestic currencies depreciate. As a result, risk aversion of investors increased, triggering capital outflows from emerging markets.

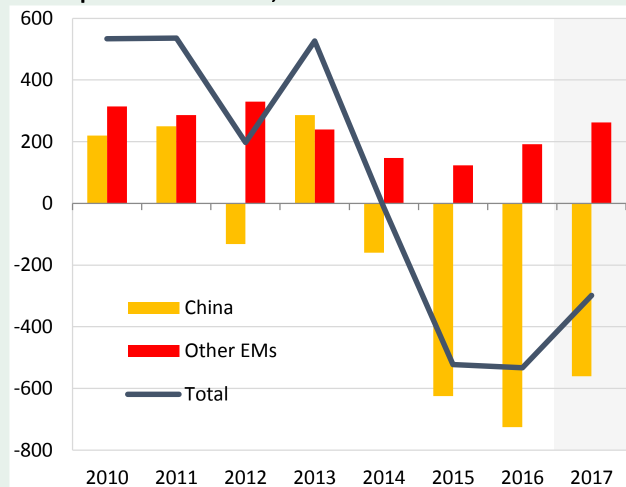
Government Bonds Yields (10 year), monthly average, %, and Leading Stock Indexes, 01 Jan 2014=100



Source: Thomson Reuters Datastream, as of 07.04.2017

From a financial standpoint, a weak recovery of capital inflows notwithstanding, 2016 was the worst year for developing countries since the 2008 crisis. According to the IIF, portfolio investment inflows as amounted to merely USD 27.6 billion (of which net inflows into equity funds accounted for USD 61.4 billion with net outflows of USD 33.8 billion from bond funds). The largest bout of capital flight took place after the US presidential election, when the risk of protectionist policies rose prompting expectations of the faster tightening pace of the Fed's monetary policy. This caused a steep rise in interest rates in developed markets, which adversely affected investors' risk appetite. In Q4 2016 alone, capital flight from developing countries stood at USD 38.4 billion. The capital outflows, primarily from bond markets into developed market stocks, indicate that investors expect fiscal stimuli to boost corporate profits in developed countries.

Net Capital Flows to EMs, USD bn



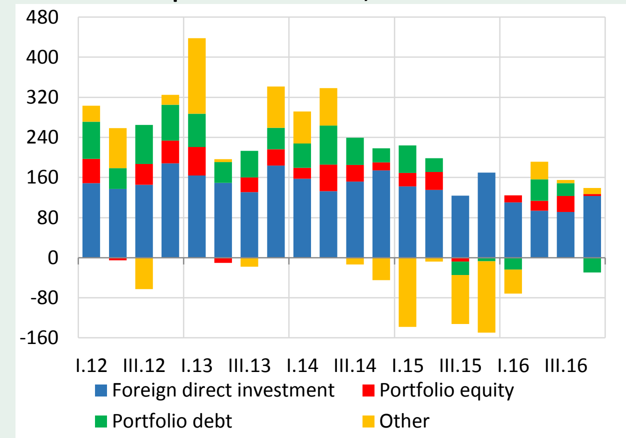
Source: estimates based on IIF

In 2017, factors restraining capital inflows to developing countries will remain in place:

The current acceleration in inflation in developed markets and expectations of a faster pace of the FED's rate increases, which strengthens the USD and continues pushing global long-term interest rates upwards.

Narrowing spreads between debt yields in developing and developed markets. To that point, according to JPMorgan Chase & Co, the yield spread of FX-denominated debt securities shrank at the end of February to its lowest since November 2014.

Nonresident Capital Flows to EMs, USD bn



Source: IMF

The expected recovery of developed market economies. This could reduce the volume of foreign direct investment and portfolio investment into equity capital in developing markets (which account for nearly half of total capital inflows) to their lowest level since the start of the financial crisis. In particular, in 2017 foreign direct investment inflows into developing markets are projected at approximately USD 386 billion, almost 30% lower than the average over 2010-2015[6].

A strengthening US Dollar against major currencies, which will intensify depreciation pressures on developing market currencies.

[6] According to the IIF (February 2017).

The steep fall of the Chinese yuan could lead to a global sell-off of risk assets and trigger a capital flight from developing markets.

The likelihood of trade wars between the US and China, Mexico, South Korea. At the same time, a trade war with China, heavily indebted as the country is, could lead to a financial crisis in China and a spill-over to other developing markets through financial and commodity markets.

The negative impact of those potential factors on the external conditions for developing markets would likely be offset by:

The wide yield spread between developing and developed countries despite its recent narrowing.

The economic recovery of these countries in an environment of rising global commodity prices. These expectations are sending the stock indices of developing markets soaring, since economic growth and price increases traditionally increase corporate profits, which makes them more attractive for investment. In Q1 2017, the MSCI Emerging Markets Index rose by over 11%, while the indices of some countries including Ukraine, Romania, Poland, Argentina, and others grew by more than 15%. The S&P500 and Euro Stoxx 50 indices rose by approximately 6% in the same period.

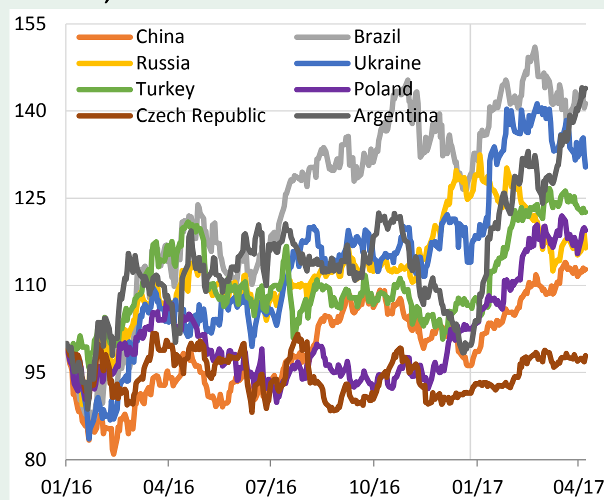
The large appreciation potential of currencies of these countries (after the lasting decline in 2014-2015).

Continued accommodative monetary policy by the ECB and the Bank of Japan.

Political risks in the euro area as a result of elections in 2017, the weakness of the banking sector, and Brexit, which boosts the attractiveness of countries that are less exposed to those factors. Several European countries belong to this group, including the Czech Republic, Hungary, and Poland, as well as Russia, India, Brazil, Argentina, and Chile.

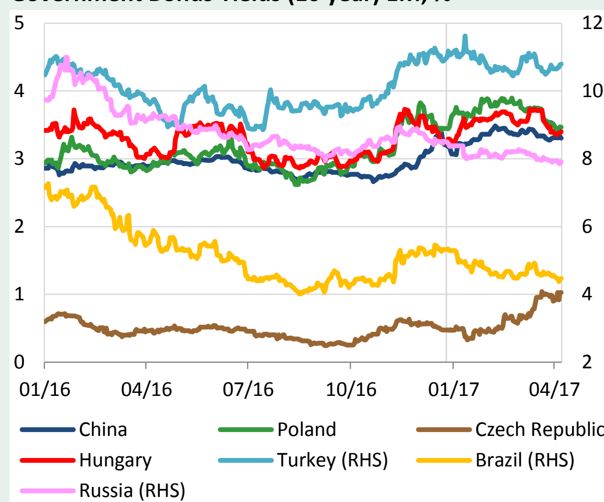
As a result, interest rate hikes in developed markets in 2017 are expected to have only a limited impact on financial conditions in developing markets. Capital inflows to those countries will gradually recover.

MSCI EM, 01 Jan. 2016=100



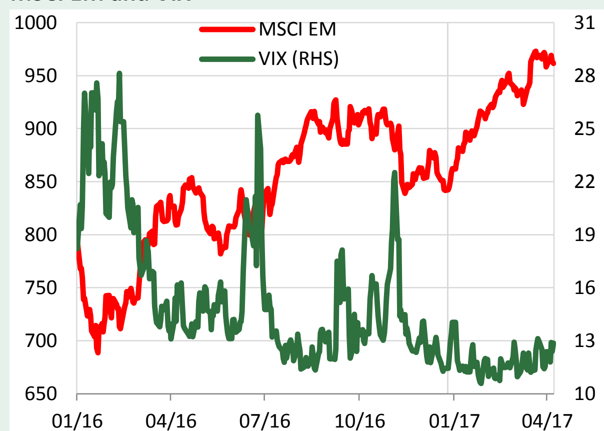
Source: Thomson Reuters Datastream, as of 07.04.2017

Government Bonds Yields (10 year) EM, %



Source: Thomson Reuters Datastream, as of 07.04.2017

MSCI EM and VIX



Source: Thomson Reuters Datastream, as of 07.04.2017

2.2. DOMESTIC ECONOMY

2.2.1. INFLATION DEVELOPMENT

In Q1 2017, inflation accelerated, as expected, to 15.1% yoy in March, up from 12.4% yoy in December 2016.

Actual headline inflation came in somewhat below forecast published by the NBU in Inflation Report (January 2017). The NBU had projected headline inflation of 16.4% yoy in March. A number of supply factors explained the deviation of actual inflation from the expected figures. The adoption of a new methodology for calculating CPI by the SSSU was an additional factor. The NBU views this factor as temporary and expects it to be fully offset by other statistical effects in H2 (see Box for details).

In Q1 2017, prices for most major components in the consumer basket accelerated due to higher production costs and a low comparison base. At the same time, supply factors, an improved situation on the FX market since the start of the year, and a further reduction in inflation expectations restrained price growth. The above factors, along with prudent fiscal and monetary policies and still weak consumer demand resulted in moderate growth in core inflation, which also came in below forecast.

Core Inflation

Core inflation accelerated to 6.3% yoy in March 2017 from 5.8% yoy in December 2016, below the NBU's forecast of 6.8% yoy. The slight acceleration of core inflation was expected, driven by an increase in production costs and second-round effects of higher raw food prices.

Among components, the growth of prices for services included in core inflation accelerated (to 9.8% yoy in March from 8.7% yoy in December 2016). This could be a reflection of increased production costs, including higher labor costs due to an increase in the minimum wage. Similarly, prices increased for services in restaurants and hotels, hairdressing salons, taxis, household services, telecommunications, outpatient medical services, and finance and insurance services.

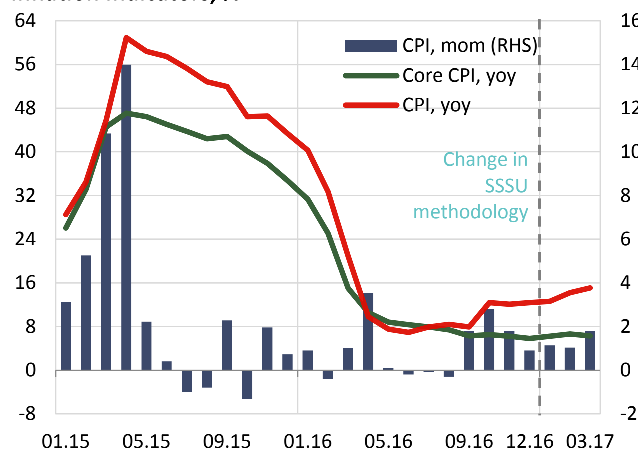
Alternative core inflation measures also indicated moderately higher underlying inflationpressures[7]. However, by any of the calculation methods core inflation remains much lower than headline consumer inflation and the same indicators from the previous year.

Core inflation was held back by prudent fiscal and monetary policies as well as by improved conditions in global commodity markets, which caused the hryvnia to strengthen against the USD from mid-January. In addition, underlying inflation pressures were restrained by a further decrease of inflation expectations for the next 12 months among all respondents, as well as by consumer demand, which remains weak.

Among other core inflation components, processed food prices continued growing rapidly, as expected (7.5% yoy in March versus 5.7% yoy in December 2016). This was driven by the second-

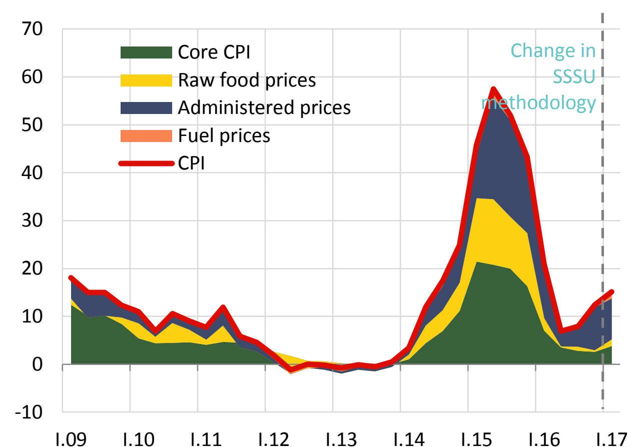
[7]Read more in the January 2017 Inflation Report (pages 20-21).

Inflation Indicators, %



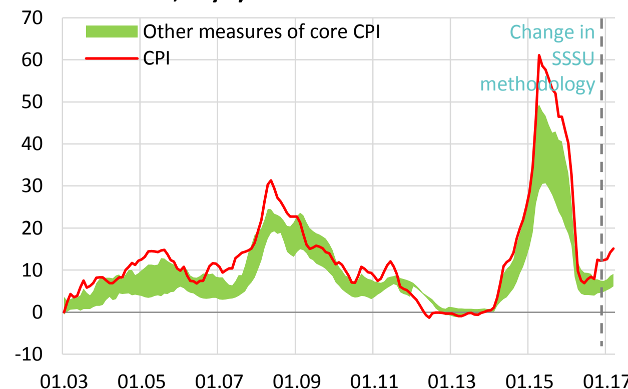
Source: SSSU

Contributions to Annual Inflation, pp



Source: SSSU; NBU staff estimates

Price Indicators, % yoy



** Green field - a range of core inflation indices*

Source: NBU staff estimates

round effects of an increase in prices for raw foods, especially milk and meat.

At the same time, due to a stabilization of the hryvnia exchange rate, the annual growth rates of prices for certain imported goods slowed: clothing and footwear (4.5% in March versus 5.5% in December), home appliances (4.1% versus 5.7%), pharmaceutical goods (3.3% versus 6.6%). In annual terms, prices for certain goods even decreased (EU-imported vehicles by 2.4%, audio and video devices by 1.6%, laptops by 3.4%, detergents by 0.5%).

Non-Core Inflation

In Q1 2017, non-core inflation accelerated, as expected, to 23.2% yoy in March from 17.5% yoy in December. All non-core components – administered prices and tariffs, raw foods, and fuel – contributed to the increase.

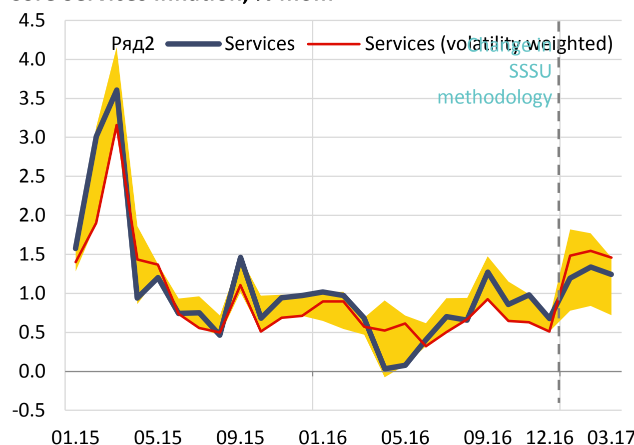
The growth in administered prices accelerated to 39.5% yoy in March from 34.6% yoy in December. The uptick was driven by an increase in passenger road transport fares on the back of rising costs, including fuel. In addition, prices for tobacco products rose significantly owing to an excise tax hike from the start of the year and against a low base. On the other hand, the increase in excise taxes on alcoholic drinks had a more limited effect. Growth in prices even slowed in annual terms, which can be attributed to sales of accumulated inventories and a markup generated after the rise of minimum prices in December 2016.

In March 2017, electricity tariffs for households were raised by 28.1% mom, which pushed annual growth rates up to 63.7% from 60.0% in December. Postal services also became more expensive: starting 24 March, the national mail carrier Ukrposhta PJSC raised prices, primarily due to higher labor costs[8]. The growth in prices for "social" bread continued to gain momentum in Q1, primarily due to higher production costs.

In March, growth in raw food prices accelerated to 7.5% yoy from 1.2% in December. This was primarily due to a low comparison base. Pprices for raw foods fell sharply last year after Russia imposed trade and transit restrictions on Ukrainian as well as Turkish goods. As a result, the pace of decline in prices for fruits and vegetables slowed in annual terms as expected, to 19.4% and 2.0%, respectively. The effect of the low comparison base also pushed egg prices up in annual terms (by 12.9%) even as they dropped significantly in the quarter (by 24.6%). This was caused by restrictions on poultry product exports from certain Ukrainian regions to a number of countries owing to an unstable situation with animal diseases (similar restrictions were in place in Q1 2016).

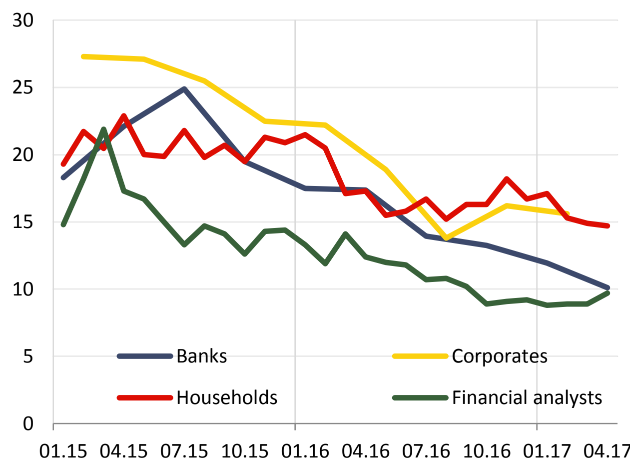
In addition, growth in prices for all types of meat accelerated on the back of higher production costs and a reduction of livestock. The same factors, combined with a pick-up in exports, drove up milk prices further - to 25.9% yoy in March 2017. This occurred in spite of an increase in raw whole milk production by agricultural companies and a slower decline in household production. In

Core Services Inflation, % mom



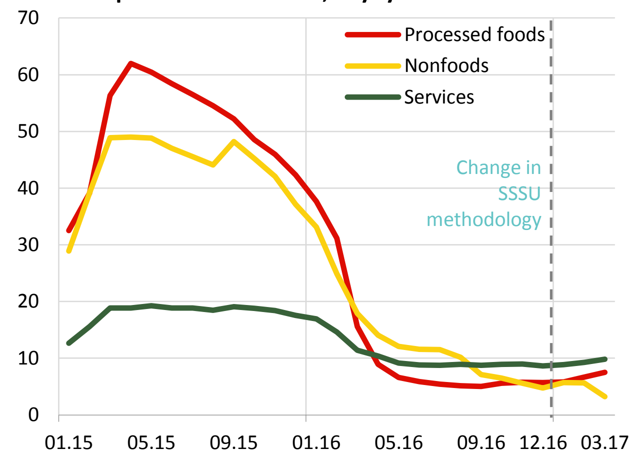
Yellow field – a range of the following indicators: seasonally adjusted index of service prices that are included in core CPI, weighted index of seasonally adjusted price indices for individual services, and weighted index of individual prices indices for services with no seasonal factor in price developments (based on Demetra seasonality test)
Source: State Statistics Service of Ukraine; NBU staff estimates

Inflation Expectations for the Next 12 Months, %



Source: NBU; GfK Ukraine

Main Components of Core CPI, % yoy



Source: SSSU; NBU staff estimates

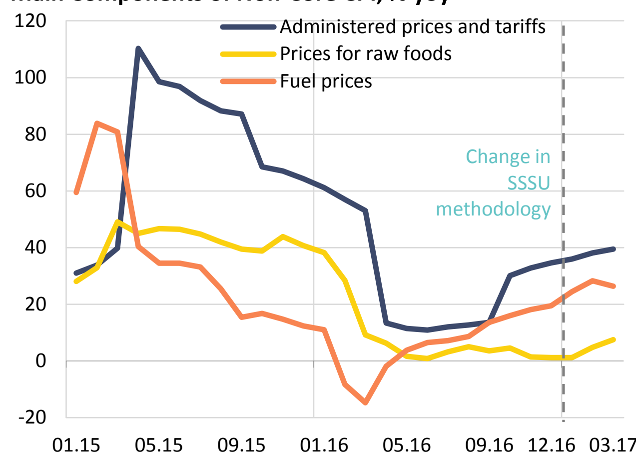
[8]Labor costs and related payroll charges account for approximately 70% of Ukrposhta's cost structure. As a result, the legislated MWR significantly impacts the cost of postal services Ukrposhta PJSC provides. Read more: http://ukrposhta.ua/zmineni-tarifi-na-universalni-poslugi-poshtovogo-zvyazku-nabuli-chinnosti.

addition, milk prices in Ukraine were influenced by high global raw milk prices .

The completion of the sugar refining season and high external demand drove sugar prices higher (up 6.2% yoy in March versus a 1.2% yoy drop in December).

Growth in fuel prices accelerated to 26.3% yoy in March (from 19.5% yoy in December) due to a lagged effect of a rise in global oil prices in the previous months.

Main Components of Non-Core CPI, % yoy



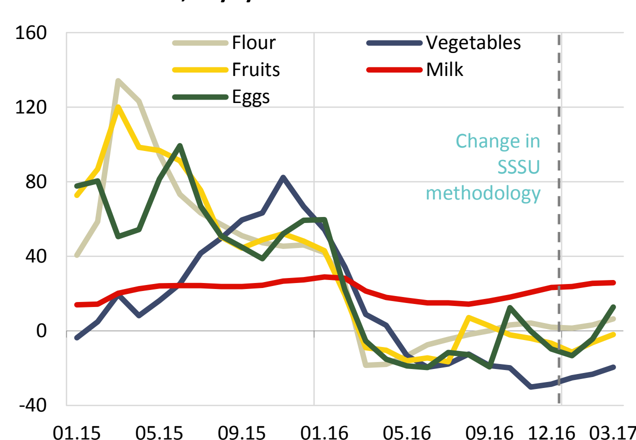
Source: SSSU; NBU staff estimates

Producer Price Index

In Q1 2017, PPI growth continued to accelerate, to 38.3% yoy from 35.7% yoy in December. This was primarily driven by price trends on global commodity markets, as local producers are largely export-oriented. At the same time, according to the NBU estimates, the increase in producer prices had a relatively limited impact on consumer prices[9].

Higher global prices for iron ore caused prices in metal ore mining to surge (up to 142.6% yoy versus 107.2% yoy in December). Early in the quarter, producer prices in crude oil and gas production increased to 88.3% yoy from 76.5% in December following an upturn in global oil prices. Growth in those producer prices slowed at the end of Q1 as global oil prices stabilized and the hryvnia strengthened. The increase in coal prices slowed to 20.5% yoy.

Raw Food Prices, % yoy



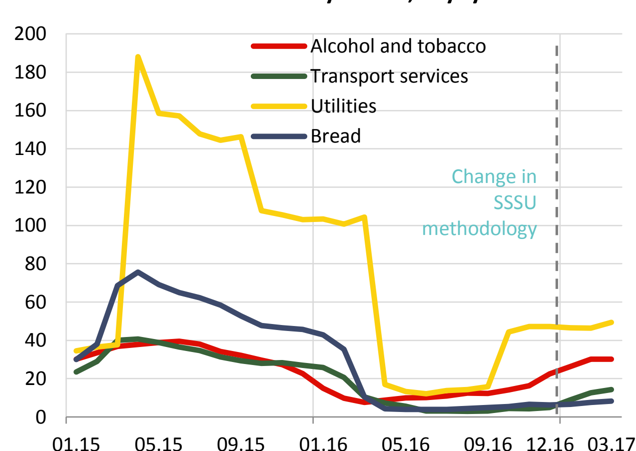
Source: State Statistics Service of Ukraine

As a result, price growth in the mining industry continued to accelerate (to 94.7% yoy from 85.1% yoy in December) spilling over into the prices along the production chain, particularly in metallurgy (up to 54.0% yoy) and in production of coke and refined products (to 80.6% yoy).

Prices grew in other processing industries as well, but at a slower pace. Prices in the chemical industry have been growing since January (up by 12.5% yoy in March following a 1.4% decline in December) amid rising global fertilizer prices.

Producer prices in food processing industry remained almost unchanged (16.6% yoy in March versus 16.2% in December) reflecting diverse trends in different industries. In particular, price growth accelerated sharply in bread, bakery, and flour production on the back of increased production costs. Prices also grew in production of meat, meat products, and dairy products due to a continued reduction in livestock. Dairy product prices were additionally boosted by robust exports, especially of butter. Apart from that, sugar production prices grew at a much faster pace in Q1 2017, reflecting stronger exports. At the same time, growth in beverage production prices slowed against a high comparison base last year.

Administered Prices and Utility Tariffs, % yoy



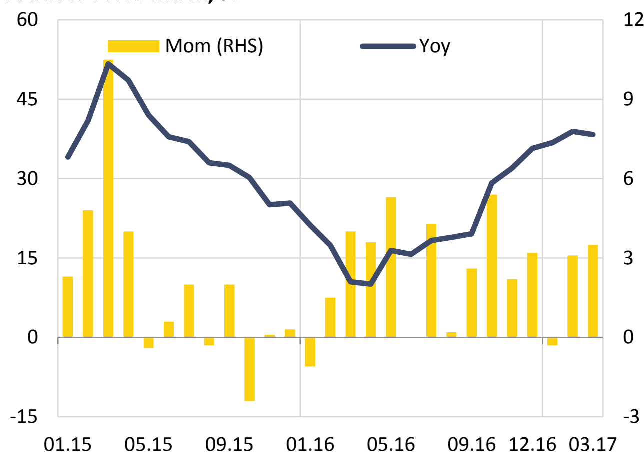
Source: State Statistics Service of Ukraine

The increase in prices for the supply of electricity, gas, steam, and conditioned air decelerated (to 42.6% yoy in March versus 51.5% yoy in December) despite higher electricity production costs resulting from a coal price hike at the end of Q1. This was driven by a significant reduction in the wholesale market electricity price by the National Commission for the State Regulation of Energy and Public Utilities (NCSREPU). The reduction was related to a

[9] Read more about the impact of industrial inflation on consumer prices in the July 2016 Inflation Report, pages 16-17.

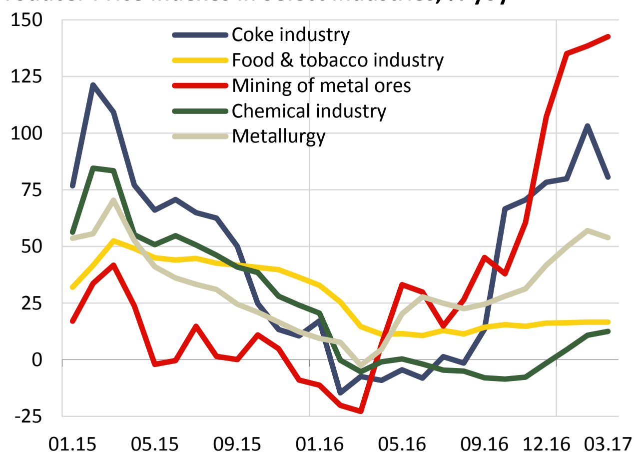
gradual elimination of cross subsidies and a gradual adjustment of electricity prices (in order to bring prices for households in line for in line with other consumers).

Producer Price Index, %



Source: SSSU

Producer Price Indexes in Select Industries, % yoy



Source: SSSU

Box: New Methodology for Calculating the Consumer Price Index

The SSSU introduced changes to the methodology for calculating the Consumer Price Index, effective January 2017, to continue bringing it into compliance with international standards.

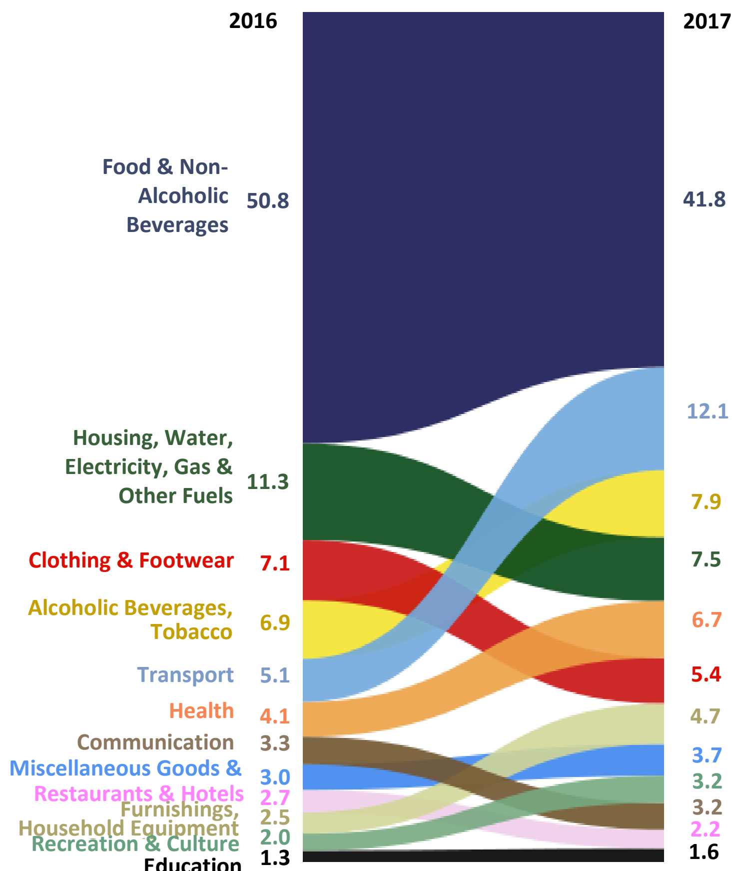
First, items in the consumer basket of goods and services used to calculate CPI were revised and updated. This review takes place every 5 years. In particular:

– goods (services) with a share of less than 0.1% (including red caviar, low alcohol beverages, fitted carpeting, linoleum, cars manufactured in CIS countries, A-76 and A-80 petrol, telephones, MP3 and DVD players, photography services, and others) were removed

– goods (services) currently popular in Ukraine (leaf salads, laminated flooring, tablets, e-books, health insurance services, and others) were added

– some goods (for example, wines were split into Ukrainian and imported; housing rent into 1-room and 2-room apartments) were disaggregated , or, conversely, merged with others.

CPI Structure in 2016 and 2017, %



Source: SSSU

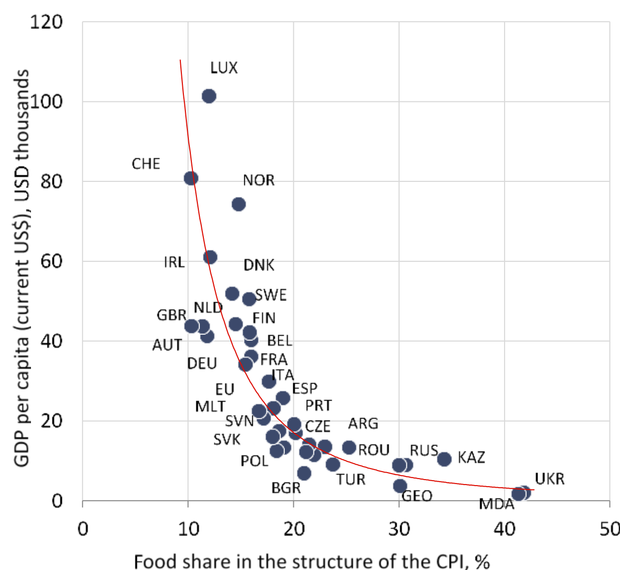
Secondly, the SSSU fundamentally changed the calculation of the weight structure of inflation components. In the past, the calculation was based on the results of the Household Living Conditions Survey (HLCS), a special survey of a limited number of Ukrainian households. The new structure is based on data from the national accounts (SNA) regarding household consumer spending based on the purpose-based classification of individual consumption. It takes into account the whole household population in the country.

Another change: consumer basket weights will be revised annually in January, not in June (the revision didn't take place in 2016 due to preparations for the new methodology adoption).

As before, basket weights will be calculated based on the structure of consumer spending for the year before the previous one, not the previous year, as the calculations are time consuming. For example, CPI in 2017 is calculated based on the spending structure of 2015 (and inflation for 2016 was calculated using 2014 weights, based on HLCS data). These weights are then updated based on price trends in the base year (2016 is the base year for calculating CPI in 2017). The update is made by adjusting the weight of each CPI component (328 components in 2017) for the price change in the base period and further normalizing the resulting coefficients[10]. In this way, components with faster price growth are assigned a greater weight.

Some categories of goods and services are excluded from the SNA-based weight structure (narcotic products, imputed rentals, gambling, life insurance, self-produced goods, purchases made by residents outside the country, and others).

GDP per capita* and food share in the structure of the CPI



** Data for 2015*

Source: Statistical services of the respective countries; The World Bank

[10]For more information, see *The Methodological Provisions for Arranging a Statistical Survey of Changes in Prices (Tariffs) for Consumer Goods (Services) and CPI Calculations – Kyiv: SSSU, 2016. – pages 28-29*.

Data from the HLCS are used to further disaggregate certain goods and services.

The abovementioned changes have resulted in structural shifts, outlined below. The share of food and non-alcoholic drinks has fallen by more than 9 pp. By contrast, the share of transportation services, household goods, and medical services has risen, which more accurately reflects actual household spending. Despite a significant decrease, food and non-alcoholic beverages still account for a much larger share than in other countries, including countries with comparable per capita income. A large share of food and non-alcoholic beverages in the consumption structure is typical for countries with low household incomes. At the same time, the share of utility services in Ukraine is among the lowest. The shares of transportation and medical services have grown nearer to the levels of other countries.

Despite higher utility prices, the weight of utilities decreased. This is the result of a larger number of subsidized households, but also of the new calculation method that includes all Ukrainian households rather than a sample. Apart from residents' expenditures, the calculation of weight under the SNA also includes spending by non-residents, who have a different consumption structure. In particular, they use less utility services compared to the HLCS which is based on a survey of a separate sample, i.e. only certain residents.

The methodology for calculating the core CPI has been also changed. The list of core inflation components was expanded from 229 to 240 and they now account for over 57% of the total CPI basket. This can be attributed to a transfer of certain goods from other groups (primarily raw foods), an increased share of goods and services already on the list (household goods, home appliances, medical products, cars, and more), and new goods and services added (e-books, tablets, life insurance).

At the same time, the share of goods and services with administered prices (NBU classification) decreased after certain goods were moved to the core CPI, particularly because of the cancellation of state regulation (for example, for certain types of bread) and the elimination of some components from the basket (low alcohol beverages, fortified wines). In addition, the structure of administered inflation also changed slightly – the share of alcoholic beverages has grown, with the share of utilities down by almost the same amount.

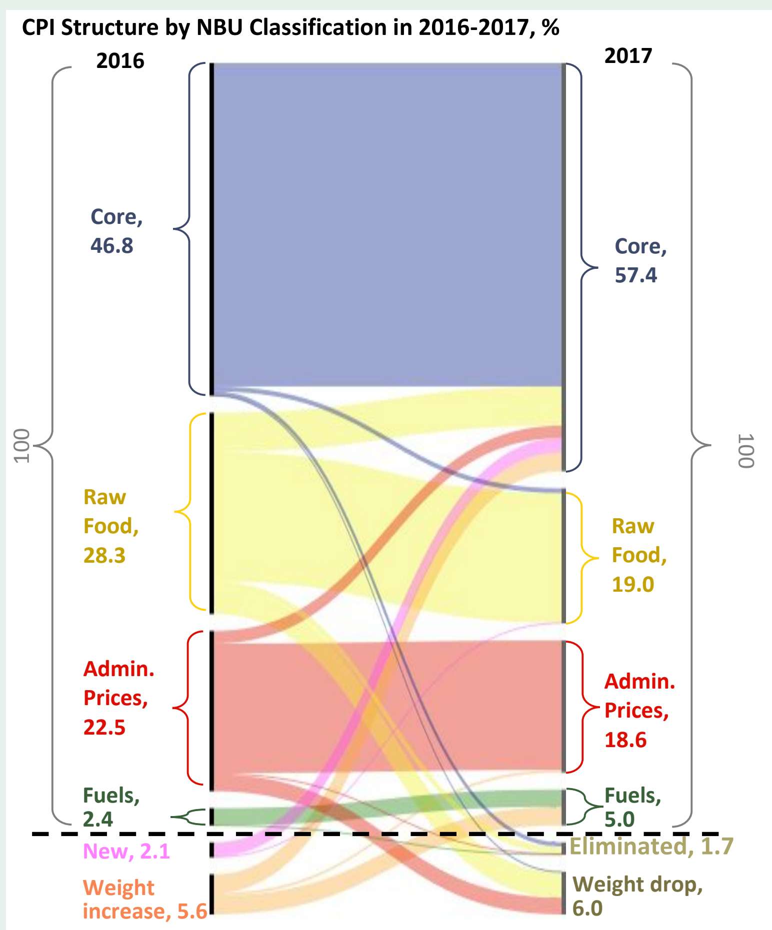
The share of fuels has more than doubled, even though one fuel component was excluded from the basket. This more accurately reflects the actual household spending under the SNA.

The new methodology resulted in lower inflation readings in Q1 2017 compared to the forecast published in the Inflation Report (January 2017). According to the NBU estimates, this effect will only be felt in Q1 and will be completely offset by other statistical effects in the second quarter, especially due to the influence of dynamic weights.

The SSSU will not review data for the previous periods, so the comparison base remains unchanged.

The NBU positively assessesthe new CPI calculation methodology as it aims to more completely and accurately reflect consumer prices in Ukraine. This will contribute to implementing effective monetary policy under the inflation targeting regime. The new methodology has not impacted the NBU's headline inflation forecast of 9.1% for the end of 2017 and 6.0% for the end of 2018.

CPI Structure by NBU Classification in 2016-2017, %



Source: SSSU

2.2.2. DEMAND AND OUTPUT

In Q4 2016, real GDP growth accelerated to 4.8% yoy, which exceeded the NBU's forecast, driven primarily by high investment growth rates. For 2016 as a whole, GDP expanded 2.3% yoy.

As expected, the economy in 2016 was fuelled mostly by investment, which accelerated throughout the year (to 27.1% yoy in Q4).

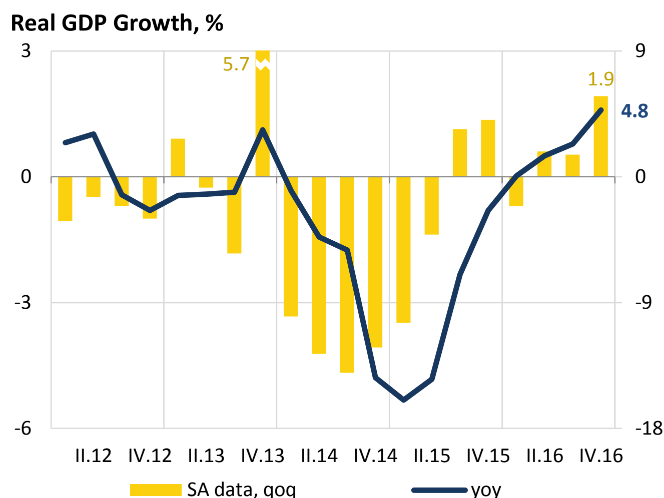
Strong agricultural performance explained the positive trends of some other end-use categories. High crop yieldsled to higher input inventories, which contributed significantly to the GDP growth (5.8 pp). Strong grain and oil exports played a major role in reversing the long-term decline in exports. Although the growth in investment demand also caused imports to accelerate, the negative contribution of net exports declined to 5.2 pp.

Meanwhile, domestic consumption faltered. In particular, the growth of household consumption slowed as households' disposable incomes declined.

In early 2017, the growth momentum maintained. According to NBU surveys, business expectations improved. The low comparison base also influenced the annual trend for certain industries. However, the transport blockade in the east of Ukraine caused a steep fall in mining, metallurgy, coke production, as well as a loss of momentum in allied industries.

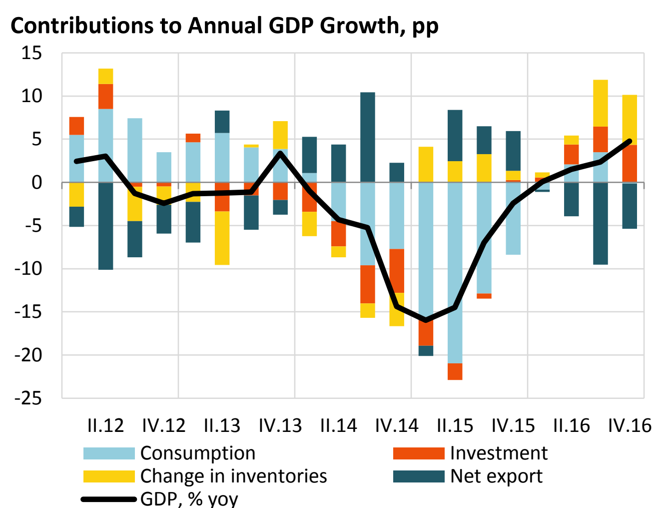
According to the NBU, consumer demand remained moderate in Q1 2017, while investment continued growing rapidly.

Real GDP Growth, %



Source: SSSU

Contributions to Annual GDP Growth, pp



Source: SSSU; NBU staff estimates

Domestic Demand

Growth in gross fixed capital formation accelerated throughout the year (27.1% yoy and 10.5% qoq in Q4). Improved earnings and business outlook, significant budget capital expenditures, and deferred investment demand contributed to stronger investment activity.

In Q4, investment into non-residential construction surged to 35.3% yoy against a backdrop of significant capital expenditures from the consolidated budget at the end of the year, especially on road infrastructure.

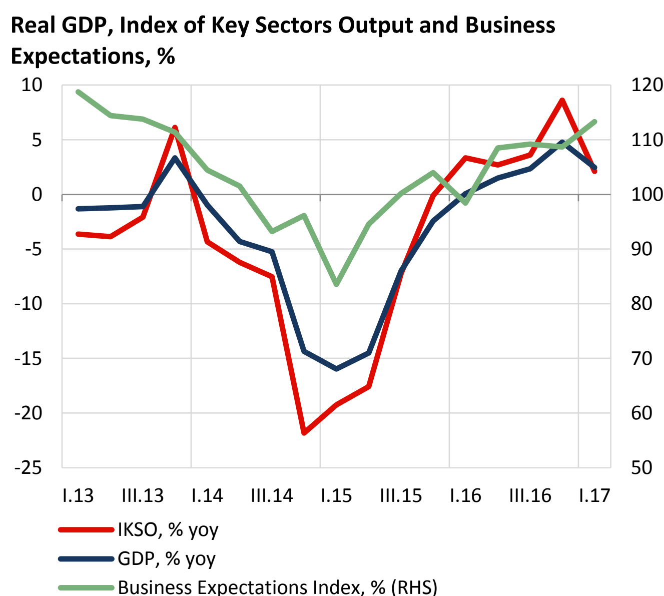
The intellectual property category grew significantly (by 40.3% yoy) on the back of software upgrades, including in public bodies. However, this type of investment still accounts for an insignificant share of overall investment spending in the economy.

Investment into machinery and equipment has been growing rapidly (by 35.2% yoy), driven by several factors, notably the need to modernize amid increasing domestic competition and a penetration into new sales markets.

Investment activity gained momentum in most industries. Ground transport and pipeline companies increased investment amounts dramatically (2.9 times). As one example, Ukrzaliznytsia renovated its fleet of freight cars at the end of the year.

Industry continued to increase investment (by 25.1% yoy). The investment in light industry grew rapidly (2.8 times), that could reflect a potential for further import substitution.

Real GDP, Index of Key Sectors Output and Business Expectations, %



Source: SSSU; NBU staff estimates and surveys

The agricultural sector has long been showing a sustained recovery of investment demand, becoming the leader in terms of fixed asset acquisition in 2016. In particular, purchases of imported agricultural equipment increased rapidly. However, the growth rate of investment by agricultural enterprises slowed in Q4 due to a high comparison base.

Along with agriculture, investment grew steadily in the service sectors. Just like in agriculture, however, the growth rate dipped because of a high comparison base. Investment into healthcare and social services accelerated significantly (by 2.2 times).

Investment demand was still primarily financed through own funds of enterprises. The share of investment financed through debt and foreign investment remained relatively insignificant. Investment needs were covered mainly by imports given a significant increase in the supply of means of production into the country. Nevertheless, according to the NBU, certain industries in Ukraine also benefited from a pick-up in investment demand in 2016.

Domestic consumption weakened in Q4. General government consumption resumed its decline (by 2.2% yoy), possibly as a result of slower growth in the consolidated budget's current expenditures due to the base effect – expenditures were more evenly spread in 2016 than 2015.

In Q4, growth in private consumption slowed dramatically (to 0.9% yoy) due to lower disposable income, restrained consumer sentiment, and hikes in utility rates and transportation expenses. Household budgets were limited with consumption falling from the previous quarter based on seasonally adjusted data, even though households accessed savings.

Consumption dropped the most for goods and services that had posted the highest inflation rate in annual terms. Those include utility services, alcohol and tobacco products, education, restaurants, and hotels.

High crop yields led to an accumulation of inventories. As a result, changes in inventories made a significant positive contribution (5.8 pp) to GDP growth for the second consecutive quarter.

External Demand

In Q4 2016, the negative effect of net exports diminished (to -5.2 pp), as expected.

The long-term decrease in exports was reversed thanks to grain and oil exports, with exports increasing (by 9.7% yoy) for the first time in six years.

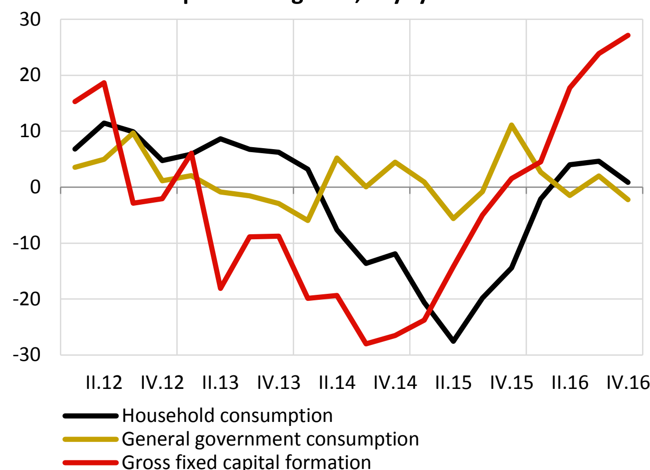
Imports were supported by investment demand and by increased energy purchases (to 19.6% yoy).

Output

Across industries, agriculture was the main economic growth driver in Q4 – the growth in its gross value added (GVA) accelerated to 18.4% yoy, resulting in a direct 2.6 pp contribution to the change in GDP.

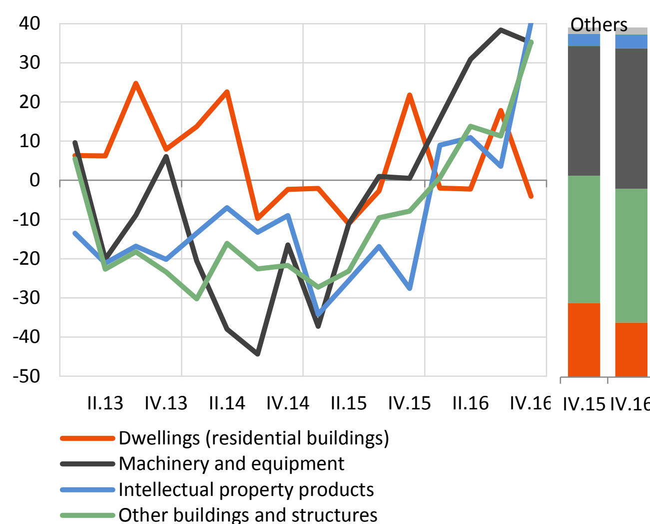
In the agricultural sector crop farming showed a particularly strong performance, primarily due to record grain (66.1 million tons) and

Domestic Consumption Categories, % yoy



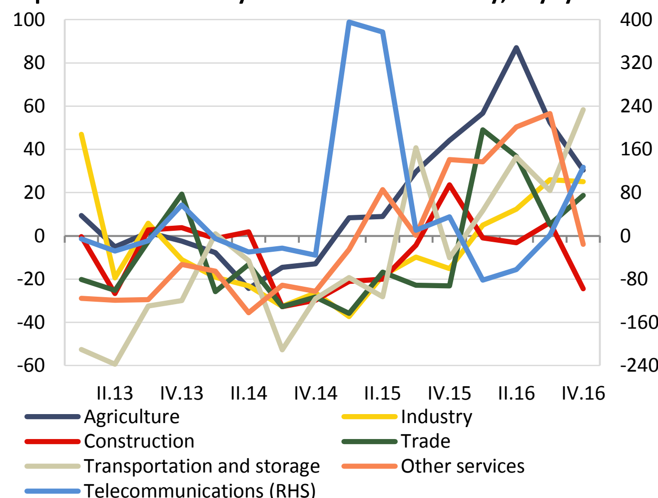
Source: SSSU

Gross Fixed Capital Formation by Types of Non-financial Assets, % yoy / **Structure of Fixed Capital Formation, %**



Source: SSSU; NBU staff estimates

Capital Investments by Sectors of the Economy, % yoy



Source: SSSU; NBU staff estimates

oil crop harvests as well as high harvests of some other industrial crops and vegetables in 2016.

The downturn in animal production persisted across all major types of activity. In particular, the decline in animal breeding activity (measured by live weight) deepened further, among other factors, due to the spread of animal diseases.

Despite the continued decline in animal production, high technical crop yields contributed to accelerating growth of the food industry (production of sugar and oil). This was a significant factor behind the renewed growth in GVA of industrial activity as a whole (by 2.1% yoy).

Across industries, machine-building started recovering as well. Production growth in certain sub-industries reflected a pick-up in investment demand. Production of machinery and equipment dedicated to activities (like metallurgy, food production, agriculture, etc.) expanded at a fast pace. In addition, production of freight cars and flat cars increased materially, driven by demand from Ukrzaliznytsia.

Meanwhile, growth in metallurgical production has slowed for three consecutive quarters (down to 2.6% yoy). The production of selected finished metal products resumed a moderate decline. At the same time, trends improved in the production of cast iron, steel, rolled metal, and pipes thanks to stronger global steel prices and as transport problems were resolved[11].

Chemical production resumed its decline led by fertilizer output on the back of higher production costs and stronger competition in domestic and external fertilizer markets.

As expected, construction activity continued to recover quickly, reflecting first of all the support to investment demand from significant budgetary capital expenditures. However, the GVA of the construction industry grew at a slower pace (15.6% yoy) owing to a high comparison base and unfavorable weather at the start of Q4.

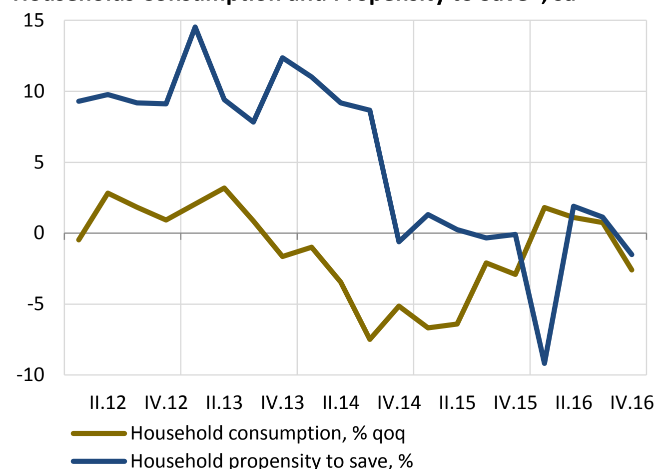
The base effect also explained the slower growth in GVA in trade (to 1.9% yoy). The drop in household consumption additionally affected trading activity; the same as in private consumption, GVA in trade decreased 1.0% seasonally adjusted compared to the previous quarter.

In Q4, almost all service sectors experienced an improvement in GVA trends. Most of these sectors grew compared to the previous quarter in seasonally adjusted terms. After a lasting slump, GVA in the financial and insurance sectors returned to growth in annual terms (by 11.8% yoy) on the back of improved banks' earnings .

Estimates for Q1 2017

Real GDP growth slowed to 3% yoy in Q1 2017, according to the NBU estimates. In early 2017 growth momentum maintained and business expectations improved[12]. In addition, the annual trends of certain industries benefitted from a low comparison base in January 2016[13]. However, as early as February, an opposite effect

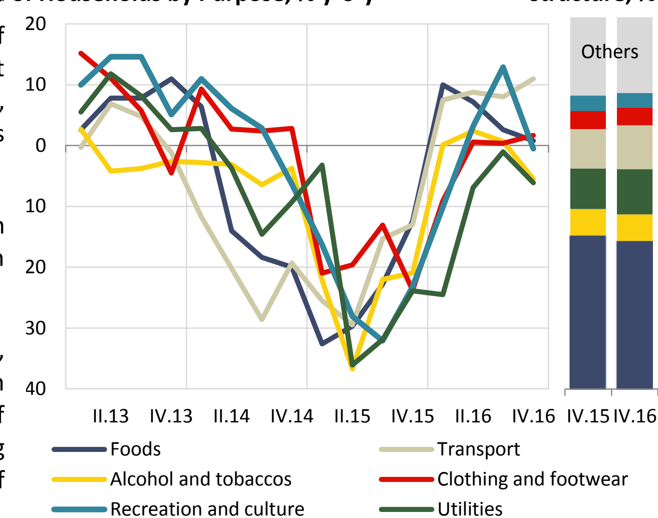
Households Consumption and Propensity to Save*, sa



* The ratio of personal savings to disposable income

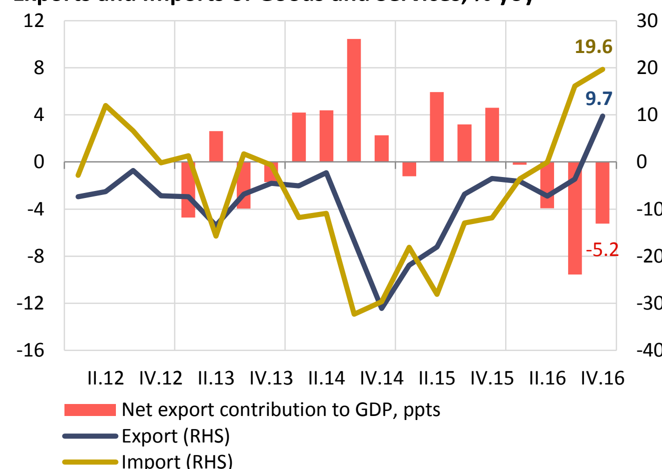
Source: SSSU; NBU staff estimates

Final Consumption Expenditures of Households by Purpose, % y-o-y | **Expenditure structure, %**



Source: SSSU; NBU staff estimates

Exports and Imports of Goods and Services, % yoy



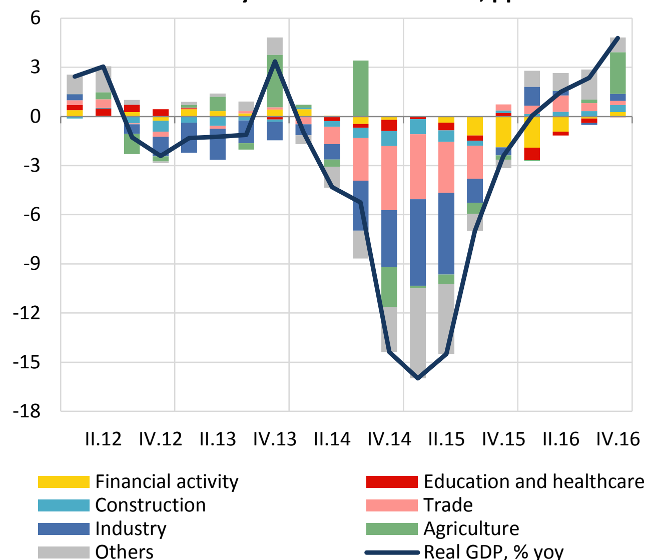
Source: SSSU; NBU staff estimates

[11] In mid-November 2016, a key section of the rail connection with metal plants in Mariupol reopened after repairs.
[12] According to NBU survey the Business expectations index in Q1 2017 increased to 113.3 compared with 108.7 in Q4 2016.
[13] In early 2016, economic activity was significantly affected by Russia's trade and transit restrictions on Ukrainian goods as well as by unfavorable weather.

emerged as the month had fewer days than the leap year in 2016. At the same time, the transport blockade in the east of Ukraine became a turning point. It caused a steep decline in mining, metallurgy and coke production: in March, average daily output of steel and cast iron was 15% and 18%, respectively, below January levels). Allied industries were also affected.

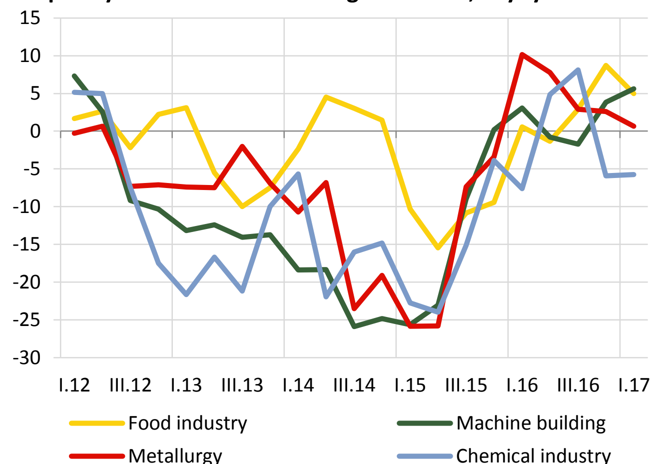
Consumer demand has remained moderate despite a doubling of the minimum wage. In particular, in January-February 2017, seasonally adjusted retail trade turnover was largely stable compared with Q4 2016. In addition, investment continued to grow at a fast pace, based on NBU estimates. This was evidenced by the significant growth in machinery and equipment production suited to particular needs of major industries (especially the growth in rail rolling stock manufacturing), as well as rapid growth in construction output and machinery imports. That said, the annual investment trend was formed under conditions of the low comparison base.

Annual GDP Growth by Secroral Contriutions, pp



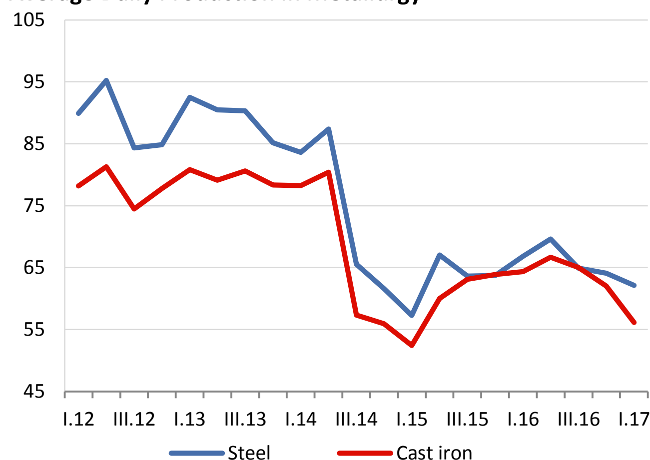
Source: SSSU; NBU staff estimates

Output by Certain Manufacturing Industries, % yoy



Source: SSSU

Average Daily Production in Metallurgy*



** Average daily volumes provided by "Metalurgprom" are quarterly averaged.*
Source: Metalurgprom; NBU staff estimates

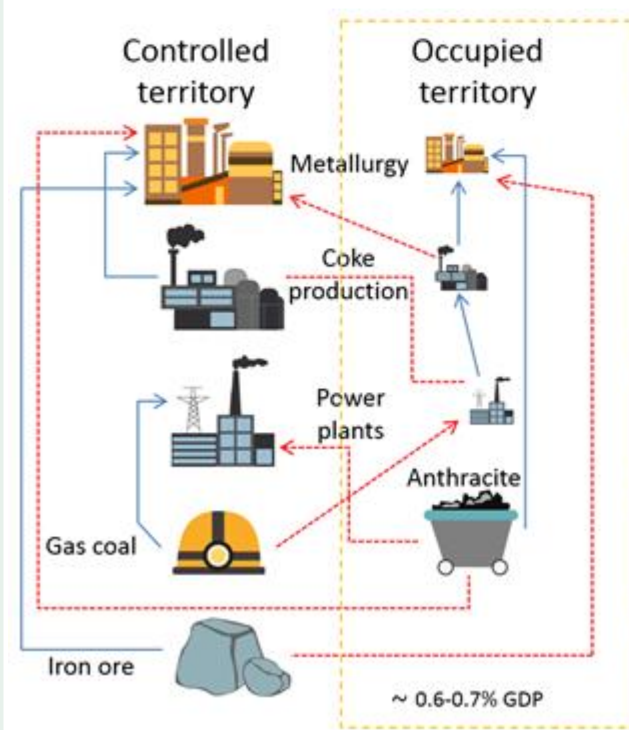
Box: Results of the Halted Freight Traffic between the Controlled and Uncontrolled Territories

In March 2017, the National Security and Defense Council of Ukraine suspended cargo transportation across the contact line within Donetsk and Luhansk oblasts (Decision No. 62 of the National Security and Defense Council of Ukraine of 15 March 2017)[14]. The decision was approved in light of the escalation of the security situation in the ATO zone in Donetsk and Luhansk oblasts, the takeover of Ukrainian enterprises located in certain areas of Donetsk and Luhansk oblasts, and a decree from the president of Russia recognizing documents and vehicle registration numbers issued to persons permanently residing in the certain areas of Donetsk and Luhansk oblasts[15].

The halt in trade will affect a number of production and finished goods supply chains that still exist between enterprises in controlled and uncontrolled territories. This will first of all affect metallurgical, coke, and electricity enterprises, as well as the mining industry, and will reduce production volumes.

In particular, some metallurgical plants that were located in the uncontrolled territory but abided by Ukrainian law and were accounted for in Ukrainian statistics had been receiving iron ore supplies from the territory under Ukraine's control. In turn, finished goods from these facilities were also shipped to the controlled territory. At the same time, some metallurgical enterprises and coking plants located in the controlled territory relied heavily on supplies of coke and coking coal from the uncontrolled territories.

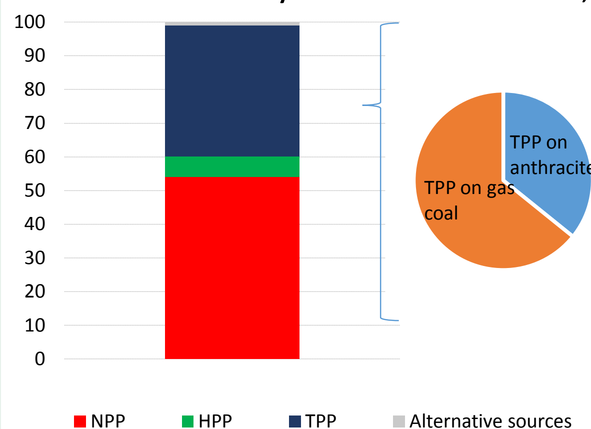
Main Production Linkages among the Enterprises on Controlled and Uncontrolled Territories



**Based on the volumes of 2016*
Source: NBU staff estimates based on the data of enterprises

The power industry is also exposed to significant risks. For instance, in 2016 thermal power stations accounted for a 39% share of total electricity production, of which almost 1/3 were fueled by anthracite. The occupied territories account for the bulk of anthracite supplies. A thermal power station fired with gas coal supplied from the controlled territory is also located within the uncontrolled territories of Donetsk and Luhansk oblasts and is an important electricity source for Avdiivka. In addition, power lines crossing the contact line within Donetsk and Luhansk oblasts are regularly damaged by the hostilities.

The Structure of Electricity Production in Ukraine 2016, %



Source: Minpalivenergo; NBU staff estimates

The macroeconomic impact of the suspension of trade with certain areas of Donetsk and Luhansk oblasts was estimated based on a number of assumptions. First, seized enterprises were excluded from forecasts of economic activity with a negative effect on potential GDP. Second, enterprises located in the controlled territory that obtained raw materials from uncontrolled territories gradually shifted to other supply sources, either through increased production at enterprises on controlled territory, or at the expense of import. As a result, as early as by the end of 2017, most metallurgical and coking plants are expected to recover production to late 2016 levels. Third, the reduction in anthracite-generated thermal power will be compensated by electricity production at nuclear power plants and gas coal-fired thermal power stations. In addition, the indirect effects that will occur through inter-industry connections were taken into account, in particular reduced freight turnover and wholesale trade.

[14] The ban on cargo transportation will remain in force until clauses 1 and 2 of the *Package of Measures for the Implementation of the Minsk Agreements* from 12 February 2015 are met (regarding the cessation of hostilities and withdrawal of heavy weaponry from the contact line in Donetsk and Luhansk oblasts), as well as until seized enterprises return to operation under Ukrainian law. http://www.rnbo.gov.ua/documents/441.html.

[15] Decree No. 74 from the president of Russia *On the Russian Federation Recognizing Documents and Vehicle Registration Numbers Issued to Citizens of Ukraine and Persons without Citizenship Permanently Residing in Certain Areas of Donetsk and Luhansk Oblasts of Ukraine* of 18 February 2017 http://kremlin.ru/events/president/news/53895.

Overall, the trade blockade is estimated to subtract -1.3 pp from real GDP growth in 2017. However, in 2018 real GDP growth is projected to accelerate by 0.4 pp thanks to a lower comparison base and the establishment of alternative production ties. In addition, a more favorable external environment than expected will mitigate the negative impact on economic activity. On balance, real GDP is projected to grow 1.9% in 2017 and 3.2% in 2018.

Lower production volumes will weigh on metallurgical exports. It is also possible that imports of coke and power-generating coal will rise. Both are expected to be more expensive owing to the cost of the coal itself and freight costs. This will impact the current account of the balance of payments as well as foreign currency sales on the interbank market. At the same time, this will be partially offset by additional exports of iron ore that have been freed up through the lower use by the metallurgical industry. The loss on the balance of payments current account is projected at USD 1.8 billion in 2017 and USD 1.1 billion in 2018. However, more favorable external conditions prompted a revision of the current account deficit to USD 4.3 billion in 2017 (from USD 3.5 billion in the previous forecast).

The contribution to the growth of real GDP and industrial production, pp

Indicator that is affected	2017	2018
Industrial production	***-4.8***	***1.6***
Mining	-7.4	2
Metallurgy	-20.4	8.4
Coke production	-17.2	7.1
Electricity	-3.2	1.3
Contribution to GDP of industrial production change	***-0.9***	***0.3***
Other sectors (crossectional linkages), contribution to GDP	-0.4	0.1
Real GDP	**-1.3**	**0.4**

According to the NBU estimates, the situation in the east will have a limited impact on the exchange rate. The negative effect of the trade blockade on the balance of payments will be compensated by favorable conditions in global commodity markets. In addition, to mitigate the impact of the trade blockade on the FX market, the NBU can reduce interbank FX purchase operations it conducts to replenish foreign reserves.

At the same time, the macroeconomic impact from the suspension of trade between the controlled and uncontrolled territories could prove more significant if actual events deviate from the current assumptions, for example, if it takes more time to set-up alternate supply sources of raw materials or if external conditions deteriorate.

The effect on the current account of the balance of payment, USD bn

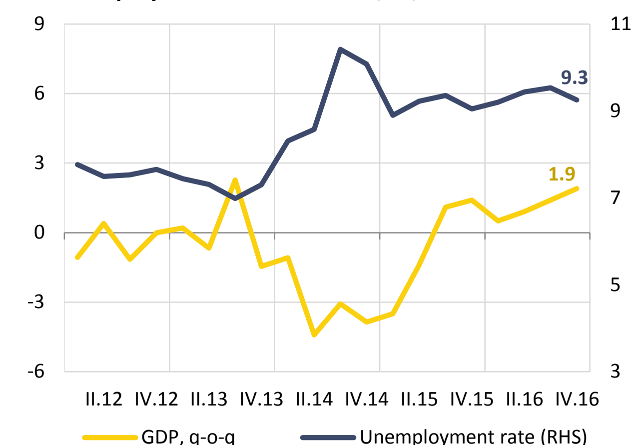
The contribution to indicator change	2017	2018
Export of metallugrical products	-1.3	0.7
Import of antracite	-0.4	-0.3
Import of coke and/or coking coal	-0.5	-0.3
Export of iron ore glut	+0.4	+0.2
Current account of the balance of payment	**-1.8**	**-1.1**

2.2.3. LABOR MARKET AND HOUSEHOLD INCOME

Demand for labor continued to recover in Q4 2016, driven by a pick-up in economic economic activity in the course of last year, and an improved financial performance of businesses. Nevertheless, the seasonally adjusted unemployment rate according to the ILO's methodology remained high, indicating a significant mismatch between labor supply and demand.

Nominal household income growth slowed in Q4 2016 compared to the first three quarters. This weaker growth was mainly the result of a slowdown in the largest income components – wages, social benefits and other current transfers received. This, together with an expected rise in inflation, reduced growth in real wages (as a part of household income), pushing real disposable household income down in annual terms. With utility prices high and an elevated unemployment rate, households continued to rely on savings for consumption. As a consequence, households' propensity to save returned to negative territory.

ILO Unemployment* and Real GDP, sa, %

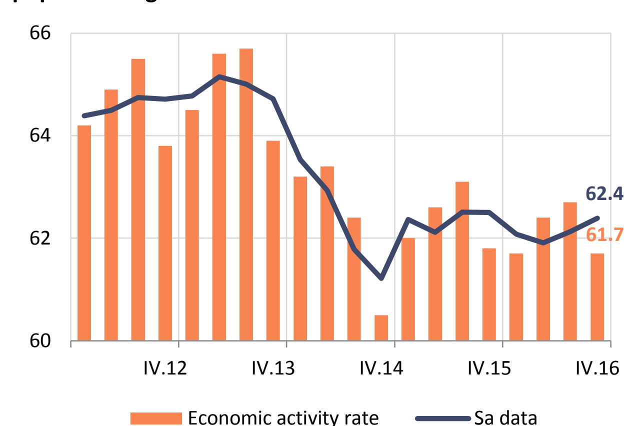


** % of economically active population aged 15 – 70 years*
Source: SSSU, NBU staff estimates

The Labor Market[16]

The economically active population decreased by 0.6% yoy to 17.8 million persons in Q4 2016, largely reflecting demographic factors and migration. The number of employed persons declined at a similar rate (by 0.7% yoy to 16.1 million persons). However, the economic recovery and a doubled minimum wage may have motivated previously discouraged people to look for jobs. This pushed the population's seasonally adjusted economic activity up in late 2016.

Economic Activity Rate of Population, % of the total population aged 15 – 70

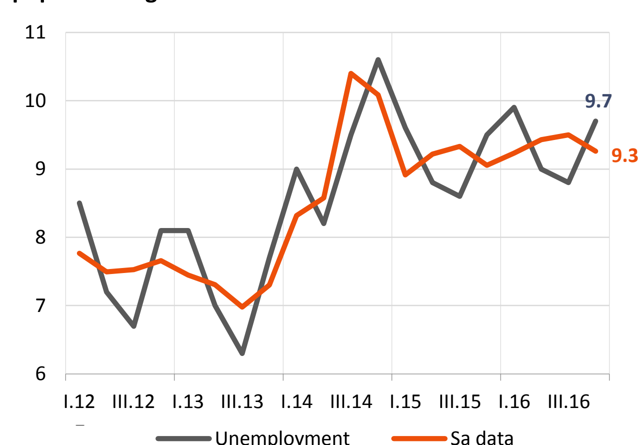


Source: SSSU, NBU staff estimates

The economic recovery slowed the pace of decline in the number of staff employees, which account for approximately half of all employed persons (7.8 million as of the end of 2016). However, the number of part-time employees increased slightly in H2 2016. According to SESU, in 2016 the number of workers forced for economic reasons into a part-time workday (week) stood at 5.9% of the average numberof staff. This form of employment was the most common trend in the R&D and industrial sector; by regions – in Luhansk, Zaporizhia and Donetsk oblasts.

The total number of staff employees dropped further in January-February 2017 (to 7.7 million as of the end of February), reflecting cuts in most industries (except ground transport, pipelines, air transport, and warehousing). This may have been caused by businesses being cautious about hiring employees due to higher wage costs. However, according to the SESU data in January-February 2017 the number of employees that received planned lay-off warnings fell by half yoy to 41,000 people. The employees in public administration and defense, and those employed in mandatory social insurance, represented over half of those who were notified of their job loss.

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



Source: SSSU, NBU staff estimates

The rebound in labor demand throughout 2016 continued into January and February 2017. This was confirmed by data from the SESU and job search sites[17]. However, job search sites reported a slower recovery in labor demand than SESU. This may have been

[16] From the beginning of 2015, SSSU publishes data excluding part of ATO zone; therefore, some labor market indicators may be underestimated.
[17] Currently, searching for jobs online is one of the most effective ways of finding a job, so, recently, the increasing number of unemployed as well as employed have been searching for jobs online, without registering at the State Employment Service of Ukraine. This can be explained by the requirements people have to meet in order to get registered / retain the unemployment status, as well as the unwillingness of some people to contact public employment offices because they offer low-paid jobs and a low level of unemployment benefits.

due to an increase in the number of employers who cooperated with employment offices (up by 25% yoy to 60,000 enterprises). Indeed, the SESU reported that the number of registered vacancies increased by 47.6% yoy in February 2017 compared to 30.0% yoy as reported by private recruitment agencies. As a result, the number of applicants per vacancy declined 41% yoy based on SESU data and 15% yoy based on job search websites.

The ILO unemployment rate (in percent of the economically active population aged 15 to 70) rose to 9.7% in Q4 2016, driven largely by a seasonal decrease in demand for labor in agriculture and construction[18]. Male workers in rural areas suffered most from the seasonal drop in demand. The seasonally adjusted unemployment rate, although down slightly (to 9.3%), was also higher than that seen last year. Over 2016 as a whole, the unemployment rate grew 2.2 ppts to 9.3% yoy. The rise in the unemployment rate can be attributed to large mismatches between labor supply and demand despite the economy being on the track to growth and the demand for labor rising. In 2016 the highest ILO unemployment rate was recorded among young people aged 15 – 24 years (with 23% facing difficulties in the post graduate employment). In terms of regions, Luhansk and Donetsk oblasts had the highest unemployment rates, 16.0% and 14.1%, respectively.

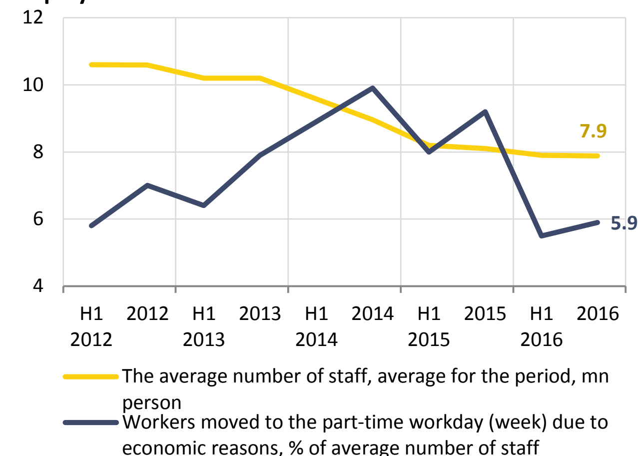
The SESU also reported that as of January 1, 2017 one third of all the vacancies were found in Kyiv, Dnipropetrovsk and Kharkiv oblasts; in terms of economic activities, as of 1 March 2017, industry, trade and agriculture posted the largest number of vacancies (22%, 18%, and 14% respectively); in terms of occupations, the largest number of vacancies was for equipment and machinery operators and skilled operators of instruments (40%). The highest number of applicants per vacancy was reported among skilled agricultural and forestry workers (24 persons), as well as legislators, chief executives, senior officials and managers (17 persons). According to Internet data, the legal profession had 73 persons per vacancy, financing and banking had 40, while education and science had 36.

Household Income and Savings

The growth of nominal household income slowed in Q4 2016. The largest income components grew at a slower pace: growth in wages slowed to 20.1% yoy, while social benefits and other current transfers received slowed to 6.9% yoy. A high comparison base caused the slowdown in social benefits and other current transfers received[19]. A rise in subsidies for utility services to households pushed up the share of social benefits and other current transfers received to 38.0% in percent of household income, almost equal to the wage share, which fell to 39.1%. Overall, nominal household income increased 15.4% yoy in 2016, mainly due to the increase in wages, which contributed 9.9 ppts to annual growth.

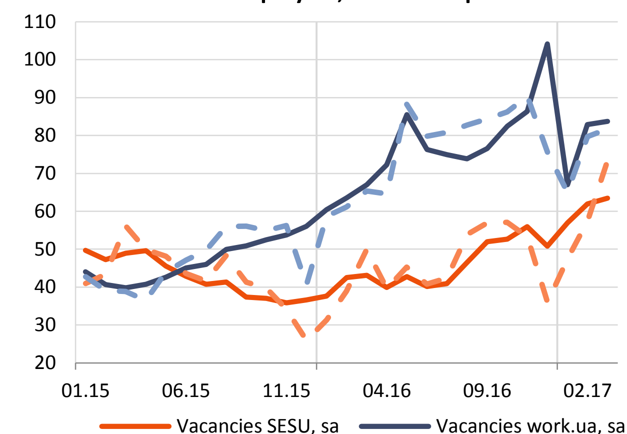
Growth in real wages classified as part of household income slowed to 6.1% yoy[20], while real disposable income dropped again (by 1.0%

The average Staff Number and Level of Forced Part-Time Employment*



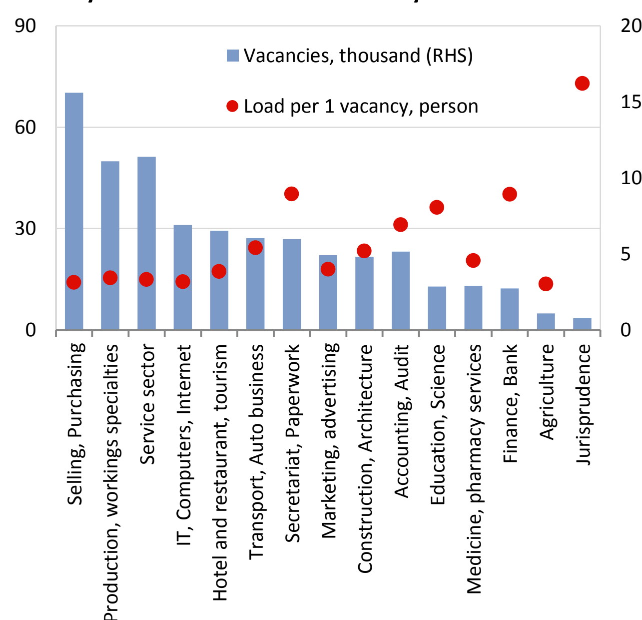
** Excluding Crimea and Sevastopol since 2014 and also part of ATO zone since 2015*
Source: SSSU

Labor Demand from Employers, thousands person



Source: State Statistics Office of Ukraine, NBU estimates

The Share of Vacancies on www.work.ua, the Load per 1 Vacancy for Activities as of 28 February 2017



Source: www.*work.ua, NBU estimates*

[18] At the same time, the SESU reported that the share of people with a higher education among the unemployed remained high (41% of all the registered unemployed or 180,000 persons as of March 1, 2017).

[19] A portion of pensions for January 2016 was paid in late 2015 (UAH 14.0 billion), while the portion of the January 2017 pensions that were paid before the pay date in December 2016 were lower - only UAH 10.4 billion

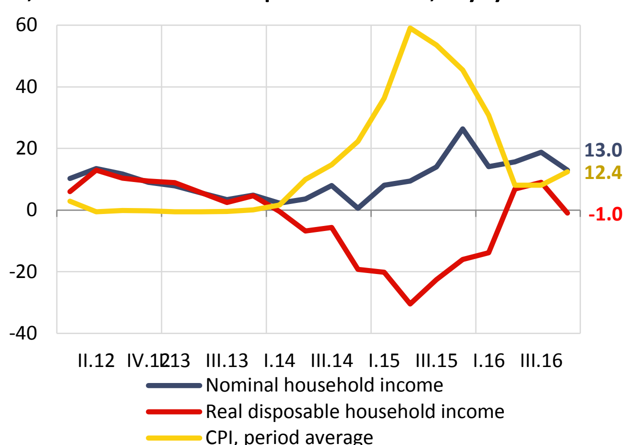
[20] The growth rate of wages included in the composition of incomes and nominal average wages (per permanent employee) differ as a result of methodological peculiarities in the corresponding calculations. Thus, wages as part of household incomes were calculated on the basis of a wider sample. In particular, cash coverage of military staff and freelance staff, payments for temporary disability, wages of individual entrepreneurs, and other payments, which are disregarded when calculating average nominal wages (per permanent employee) are taken into account.

yoy) amid expectations of higher headline inflation in Q4 2016. This was an important factor behind a slower growth of household consumption of goods and services.

As has been the case for the last two years, households continued to rely on savings to maintain consumption levels. In 2016, excess FX sales over purchases were the largest ever since the survey began, although down slightly in Q4 2016. Meanwhile, household propensity to save returned to negative territory, including in seasonally adjusted terms.

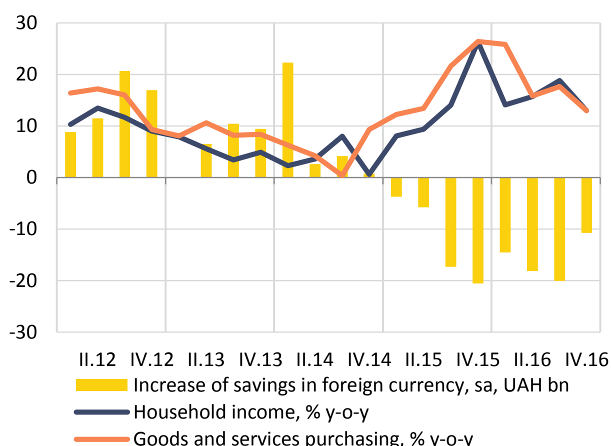
Average nominal and real wages (per permanent employee) increased at a higher pace in January-February 2017 (by 36.5% and by 19.8% yoy, respectively), due to the doubling of the minimum wage (to UAH 3,200) from 1 January 2017. The NBU expects this will support consumer demand in 2017. However, moderate growth in household income from sources other than wages and mismatches in the labor market will weigh on consumer demand.

CPI, Nominal and Real Disposable Income, % yoy



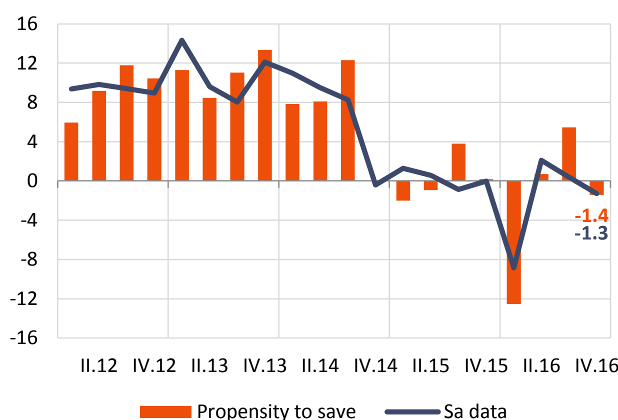
Source: SSSU

Household Income, Goods and Services Purchasing, Increase of Savings in Foreign Currency



Source: SSSU, NBU staff estimates

Household Propensity to Save*, %



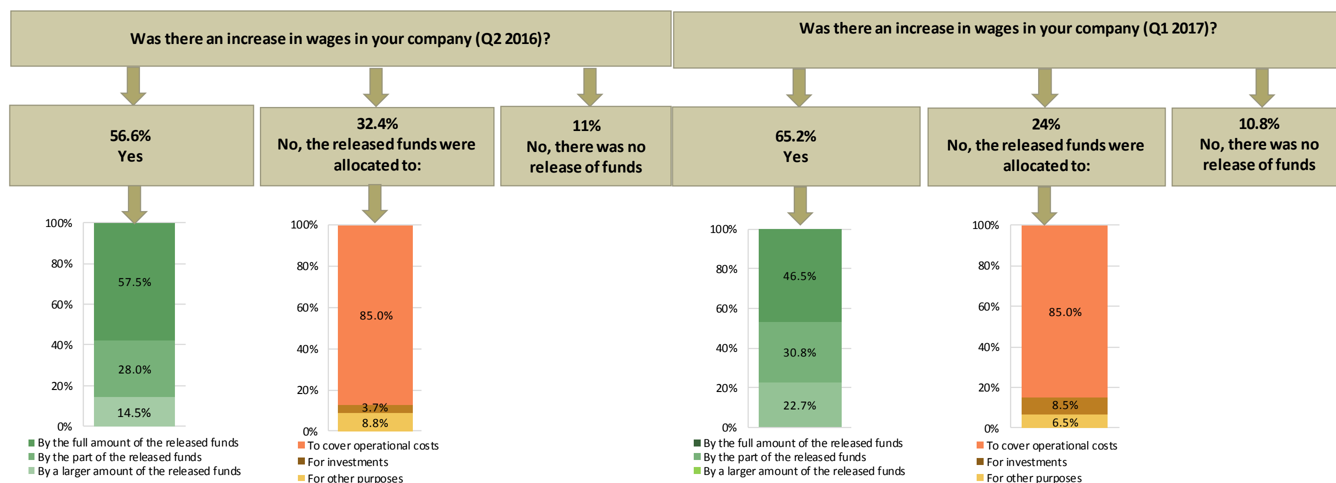
**Savings to disposable household income ratio*
Source: SSSU, NBU staff estimates

Box: One year after the cut in the unified social contribution rate

The government's decision to significantly cut the rate of the unified social contribution payable from the payroll fund from 2016 had an impact on the behaviour of Ukrainian businesses and on fiscal sector performance.

The Business outlook survey carried out in Q1 2017 showed that most enterprises had raised the wages of their employees following the cut in the unified social contribution rate in 2016 (the percentage of enterprises that did that grew by 8.6 pp compared to the previous survey, to 65.2%). In most cases, wage increases totaled the amount of released funds or were even larger. Some companies attributed a larger wage increase to adjustments for inflation.

Allocation of Funds Released after SSC Reduction, % of the respondents



Source: Business Outlook Survey of Ukraine (NBU)

The industrial sector (mining and manufacturing) reported a higher percentage of enterprises that raised wages after the rate cut than the Ukrainian average. On the other hand, the increase was below average at transportation and construction companies (despite strong construction industry performance last year). Even in these sectors, however, more than 50% of companies raised wages. Wage increases at agricultural companies (which also performed well last year), trade firms, and exporters exceeded the amount of released funds.

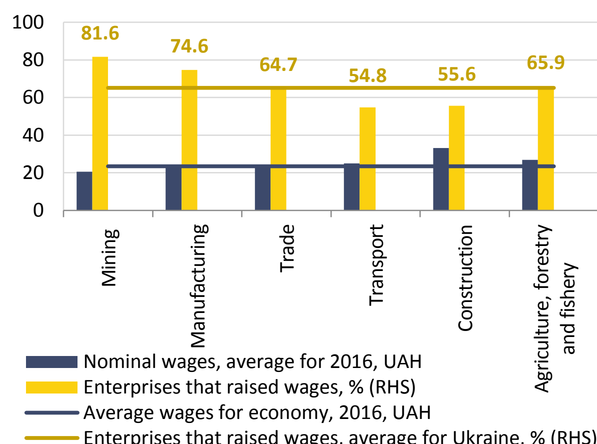
As in the previous survey, companies that did not raise wages used the released funds to finance current operations (20% of companies, lower by 8 pp). Released funds were used to pay other taxes, purchase raw materials and fuels, which increased in price last year. They were also used to pay wages to individuals serving in the ATO area and to those conscripted for military service (as required by law). Construction firms comprised the largest percentage of companies that used released funds to finance current operations.

The percentage of those that used released funds for investment remained small – albeit increasing (2% of respondents compared with 1.2% in the previous survey). In particular, agricultural companies, which invested more than other sectors last year, used these funds to finance the construction of new production lines. The percentage of large companies that used released funds for investment was also above the Ukrainian average.

The percentage of enterprises that saved no funds after the tax cut was flat, at about 11%. These included, for example, companies that hired more staff. A larger percentage of such companies was among transportation and construction companies, small enterprises and companies that perform only domestic operations. The percentage of those who saved no funds after the contribution rate was cut and unified was the smallest among mining enterprises, due to a higher rate applied to these enterprises previously.

Another positive influence of the contribution rate cut was a reduction in the tax burden on Ukrainian enterprises, which led to higher profits. Indeed, in the first nine months of 2016, the profits of profitable enterprises were up by 15% compared with the same period a year ago, while loss-making enterprises turned to profits from (UAH - 184 billion) in the first nine months of 2015 to UAH 82 billion in the same period of 2016.

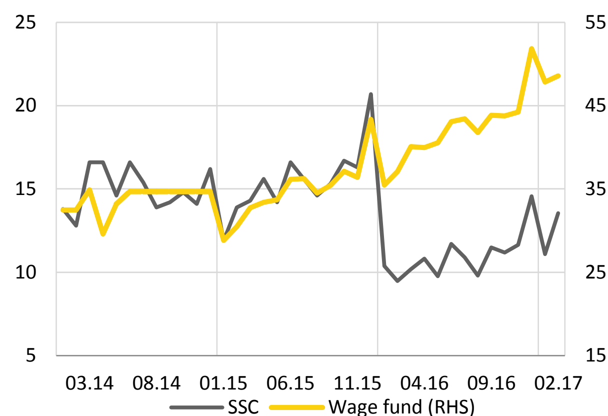
Nominal Wages and Share of Enterprises that Raised Wages after Payroll Tax Reduction



Source: SSSU, Business Outlook Survey of Ukraine (NBU)

Higher wages (the payroll fund increased by 20.7% y-o-y in 2016) and a stable macroeconomic environment offset a drop in unified social contribution revenues (the revenues decreased by around 30% y-o-y in 2016). An increase in the maximum amount on which the unified social contribution is paid from 17 to 25 minimum monthly wages also played an improtant role. Overall, the pension fund received 1.7% more than expected in unified social contribution revenues.

The Social Security Contribution and Wage Fund, UAH bn



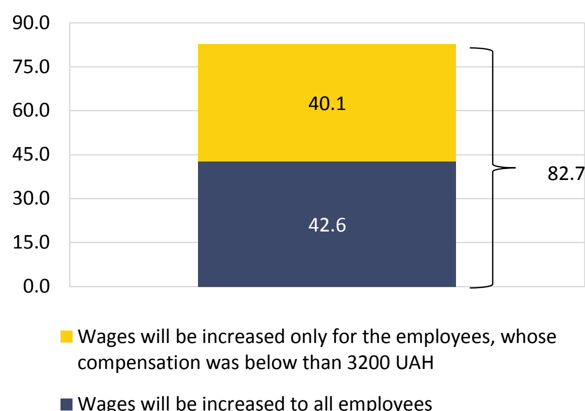
Source: STSU, SSSU, NBU staff estimates

At the same time, a drop in revenues of social funds, especially the Pension fund, compared to a year ago, increased the amount of money paid from the budget to support these funds (by 50.4% y-o-y). In 2016, the budget paid out UAH 84.9 billion to cover a shortfall in the Pension fund. A total of UAH 142.6 billon of the state budget resources was used to pay pensions (expenses related to the payment of pensions, supplementary pensions and increased pensions payable under pension schemes), as well as to pay the unified social contribution for certain categories of people. This increased the need to carry out a pension reform in order to increase the Pension fund revenues and cover expenses. However, the doubling of the minimum wage, which forms the calculation base for the unified social contribution, is expected to have a larger impact on wages and unified social contribution revenues in 2017.

Box[21]: Implications of the doubling of the minimum wage for companies according to a business outlook survey

To assess the influence the doubling of the minimum wage that took place at the beginning of 2017 is expected to have on companies in Q1 2017, the NBU added specific questions to the regular Business survey questionnaire[22]. Based on the companies' assessments and expectations, the main result will be an increase in wages. Most respondents (83%) said they intended to raise wages. Slightly over half of respondents (51%) reported intentions to raise wages for all employees. In particular, all wages are expected to be increased in proportion to the wage scale that is in place at their enterprises. Other respondents said they intended to increase wages for a part of employees. This will be done by making additional payments to, or raising the wages of, staff, such as blue-collar workers, whose wages are lower than UAH 3,200. At the same time, these respondents do not intend to increase the wages of staff that have medium or high wages. This indicates a risk of a narrowing in the difference between wages for unskilled and skilled labor, which could demotivate staff and negatively impact business activity.

The Share of Enterprises that will Increase Wages due to Rising Minimum wage, %



Source: Business Outlook Survey of Ukraine (NBU)

The percentage of respondents that intend to increase wages is higher among agricultural and construction companies than the Ukrainian average. Meanwhile, energy, utility, and transportation companies mostly said they would only raise wages for employees whose current wages are below the new minimum level.

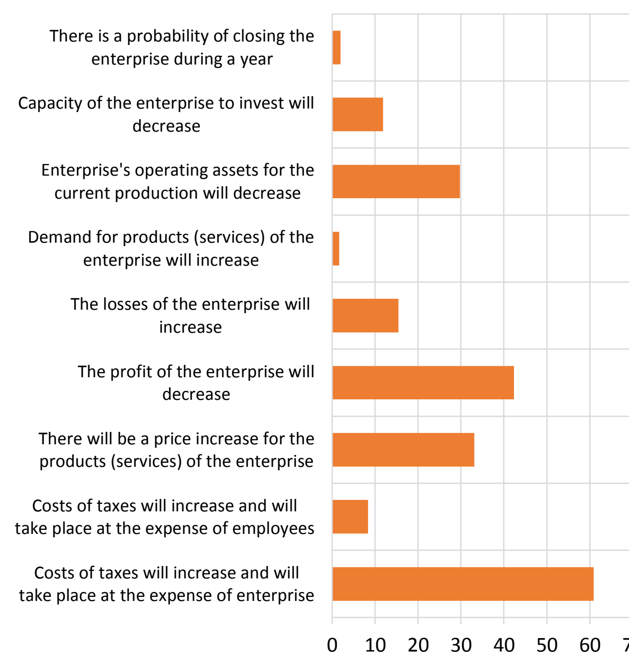
Respondents hope that growth in sales, regular orders and payments for these orders made by counterparties in due time will enable them to increase wages.

Companies expect that the doubling of the minimum wage will increase expenses related to taxes and contributions. Respondents say that these expenses will be mostly covered by enterprises rather than employees (61% and 8% of responses respectively). A total of 33% of respondents intend to cover these expenses by increasing the prices of their goods and services. Companies in the manufacturing and construction sectors reported the highest expectations of an increase in selling prices, while small businesses reported the lowest expectations in this regard. This could be attributed to the limited ability of small enterprises to push prices up, owing to the greater elasticity of demand for their products, which are mostly sold on the domestic market. Most respondents (over 90% for two quarters in a row) expect an increase in the prices of raw materials and services purchased from domestic suppliers.

Higher production costs can reduce profits or increase losses, which may cut the budget corporate profit tax revenues.

Other negative implications of higher production costs could include a decline in current assets and in investment. The construction and agriculture sectors reported the highest expectations of a drop in investment, while construction, transportation, and manufacturing companies reported the highest expectations of a decline in current assets. Some companies expect an increase in fines imposed on them for breaching labor law, as well as increased pressure from regulators. However, only 2% of respondents said they saw the possibility of business closures over the next year. Small firms had the highest response rate to this issue (3.6% of responses).

Expected Effects of Raising Minimum Wage for the Enterprise,%



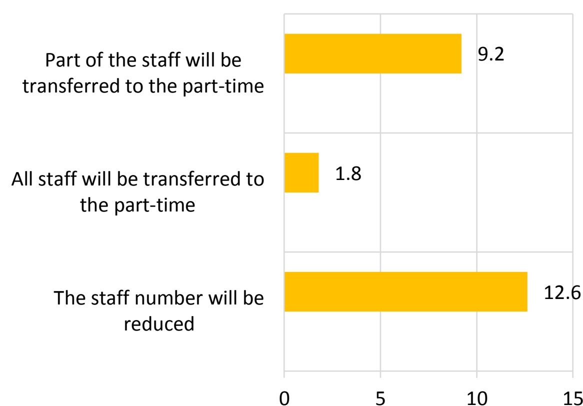
**Totals may not equal 100% as companies may have chosen more than one response.*
Source: Business Outlook Survey of Ukraine (NBU)

[21]The survey was carried out from 7 February to 6 March 2017. A total of 673 enterprises from 22 regions took part in the survey (excluding the temporarily occupied territory of Crimea, the city of Sevastopol, and well as Donetsk and Luhansk oblasts). The respondents represent a range of enterprises from all of the main economic and business activities, and of all sizes based on staff numbers (excluding private entrepreneurs).
[22]The survey only reflects the opinions of respondents (managers of Ukrainian companies) polled in Q1 2017; it does not represent NBU forecasts or views.

Respondents reported moderate expectations of changes in the number of employees at their companies: only about 24% of respondents expect changes in employment and plans to shift to a shorter working day. About 13% of respondents intend to cut their staff, in particular low-skilled employees. Small firms had higher expectations of staff cuts than the Ukrainian average. Another 9% of respondents intend to put some of their staff onto a short working day schedule. About 2% of respondents plan to shift all employees to a shorter working day. Large companies are least inclined to introduce a short working day/week.

Overall, expectations of wage hikes and staff-level changes are in line with the NBU's earlier projections of stronger growth in wages for low-paid workers and a moderate decline in the employment rate (for more details, see the January 2017 Inflation Report). The NBU's assessments of a higher elasticity of the influence of the doubling of the minimum wage on small enterprises are also confirmed.

Expectations of Enterprises for the Employment Level, %



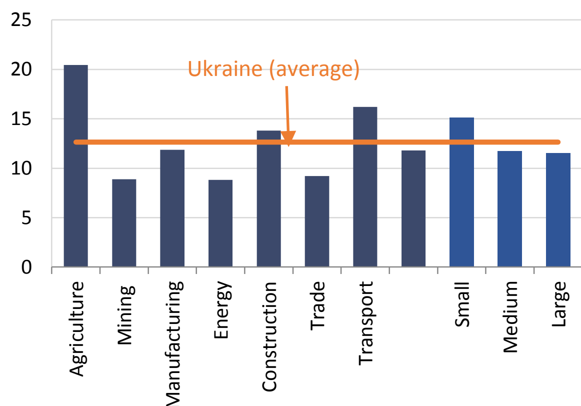
**Responses of the companies that said they expected staff level changes.*
**Totals may not equal 100% as companies may have chosen more than one response.*

Source: Business Outlook Survey of Ukraine (NBU)

About 10% of enterprises do not expect any wage or changes in the number of staff. Some of these companies attribute this to the high wages already paid to their staff, with their lowest wage exceeding UAH 3,200. Specifically, about 16% of respondents from the city of Kyiv and Kyiv oblast said they did not expect any of the above changes. Other companies, although not intending to raise wages, expect an increase in the amounts of the unified social contribution they pay.

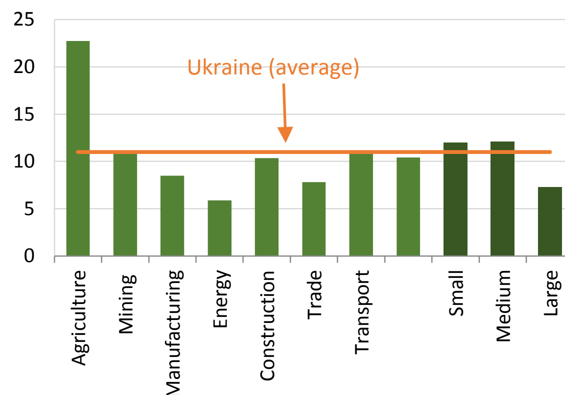
Some companies expect the doubling of the minimum wage will have positive influence. In particular, they see domestic demand for their products rising, driven by higher wages in the public sector and increased social benefits. This is also in line with the NBU's earlier projections of a pick-up in domestic demand due to the doubling of the minimum wage, which will contribute another 0.5 pp to real GDP growth.

Share of Companies that Expect Staff Cuts in Terms of Economic Activities and Size, %



Source: Business Outlook Survey of Ukraine (NBU)

Share of Companies that Intend to Shift Employees to the part-time Employment, %



Source: Business Outlook Survey of Ukraine (NBU)

2.2.4. FISCAL SECTOR

In early 2017, fiscal policy remained prudent despite a sharp increase in expenditures (primarily social spending). With the minimum wage doubling from 1 January 2017, the budget sector saw increased expenditures on wages and related employee payments. On the other hand, as expected, an increase in revenues from the social security contribution (SSC) led to a moderate growth in transfers to the Pension Fund.

Nevertheless, the consolidated budget generated a significant surplus of UAH 18 billion in January-February 2017. This was driven by a significant acceleration of growth in budget revenues on the back of more favorable general economic factors (strong economic performance at the end of last year, improved financial results, significant imports, and an increase in the minimum wage) and tax changes (the introduction of VAT on imported gas for all market participants during customs clearance and higher excise taxes on tobacco products from 1 January 2017).

Public and publicly guaranteed debt stood at UAH 1 941 billion as of late February 2017, virtually unchanged from the start of the year despite placement of a large volume of government securities for quasi-fiscal financing needs.

Revenues

Growth in consolidated budget revenues accelerated considerably in January-February 2017 (to 55.3% yoy) thanks to both tax and non-tax proceeds.

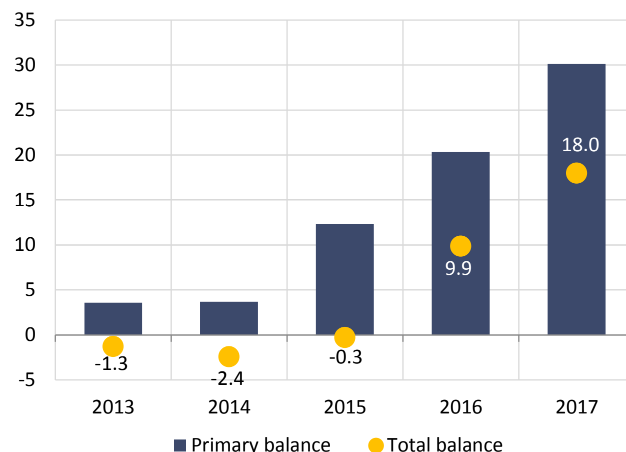
Tax revenue growth accelerated (to 57.5% yoy) on the back of more favorable economic factors and tax changes. The sizable tax revenues of early 2017 were the result of a robust performance of several economic sectors at the end of the previous year, particularly agriculture. VAT proceeds contributed most to the growth, up by 71.8% yoy. Significant imports and a weaker hryvnia against the dollar at the start of the year were the main drivers behind the trend. The elimination of a special tax regime for farmers and the introduction of a unified tax rate on gas imports for all market participants during customs clearance were additional factors supporting higher VAT revenues. At the same time, VAT refunds grew by only 6.6% yoy over the first two months of the year, which contributed to the high collection rates of this tax.

Corporate income tax was another important factor behind the growth of tax revenues. The collection of corporate income tax nearly quadrupled yoy. However, this was largely the result of a change in the approach to administering the tax[23]. Another major factor was a noticeable improvement in the financial standing of companies, including of state-owned companies.

Revenues from personal income tax continued growing at a high rate (comparable to last year's pace) thanks to a further increase in nominal wages, including a doubling of the minimum wage.

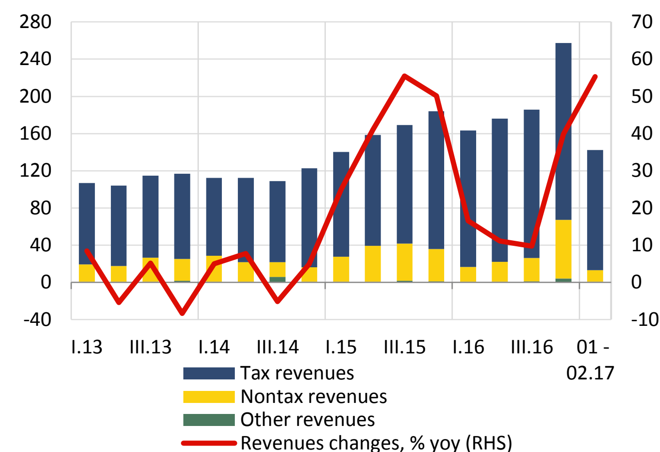
In contrast to the prior year, non-tax revenues grew, up by 36.3% yoy. This is primarily attributable to a transfer of a portion of net

Consolidated Budget Balance in January-February, UAH bn



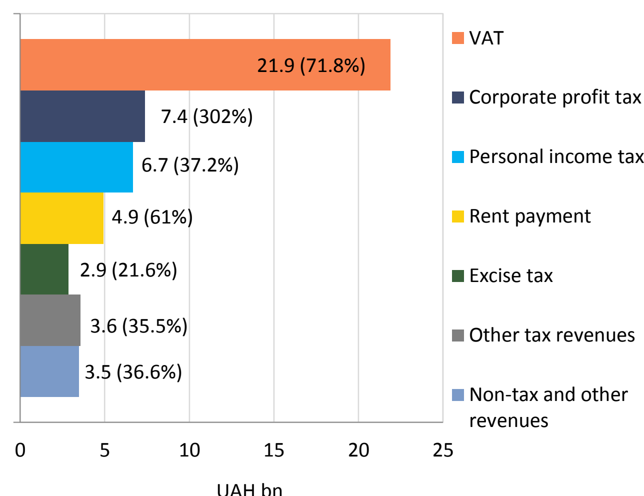
Source: STSU, NBU staff estimates

Consolidated Budget Revenues, UAH bn and % yoy



Source: STSU, NBU staff estimates

Consolidated Budget Revenues in January-February 2017, compared with the previous year, UAH bn and %



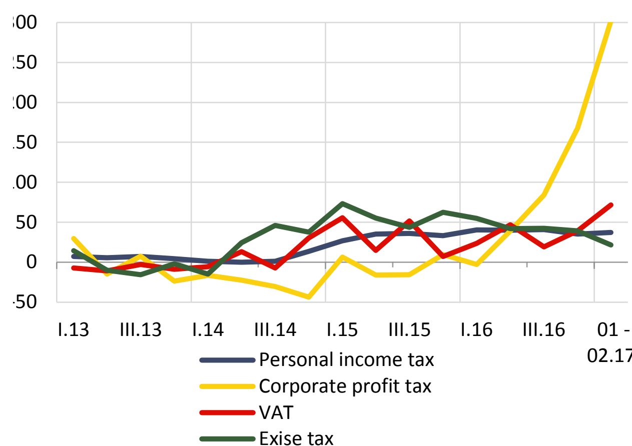
Source: STSU, NBU staff estimates

[23] In 2016, quarterly corporate income tax payments were actually received starting from the second quarter since collections of this tax in 2015 were conducted on an advance payment basis.

profit from state-owned and communal companies as well as dividends[24] and own proceeds of budgetary institutions.

At the same time, in January-February 2017, growth in excise tax revenues slowed significantly (to 21.6% yoy). The slowdown was a statistical effect as the first two months of 2016 saw a spike in manufacturing of excise products subject to labeling requirements (particularly wine and vodka) in the run-up to a hike in the tax rate. At the same time, revenue growth was supported by an increase in the excise tax rate on tobacco products, a gradual hryvnia depreciation in early 2017 and high imports. The last two factors also contributed to continued growth of revenues from taxes on international trade.

The Main Budget Taxes, % yoy



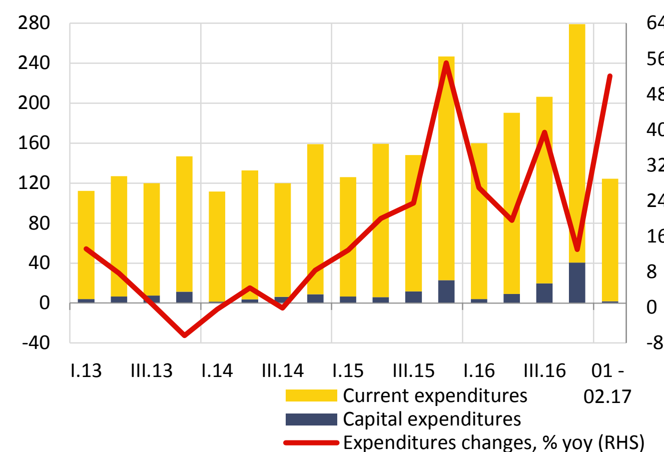
Source: STSU, NBU staff estimates

Expenditures

Consolidated budget expenditures rose sharply in January-February 2017 (up by 52.1% yoy) as a result of an increase in capital and current expenditures. Social expenditures were a key driver of the latter.

Spending on the social sphere grew at the fastest rate (up by 87.1% yoy), driven by expenditures on benefits and utility subsidies to households amid higher tariffs compared with last year and higher energy consumption owing to a severe winter. In addition, budget expenses on salaries and related employee payments increased (up by 34.4% yoy), particularly due to the higher expenses on salaries at budgetary institutions after the minimum wage doubled. At the same time, higher income from the SSC (up by 24.2% yoy in January-February 2017) led, as expected, to moderate growth in transfers to the Pension Fund, even against a low comparison base last year.

Consolidated Budget Expenditures, economic classification, UAH bn and % yoy



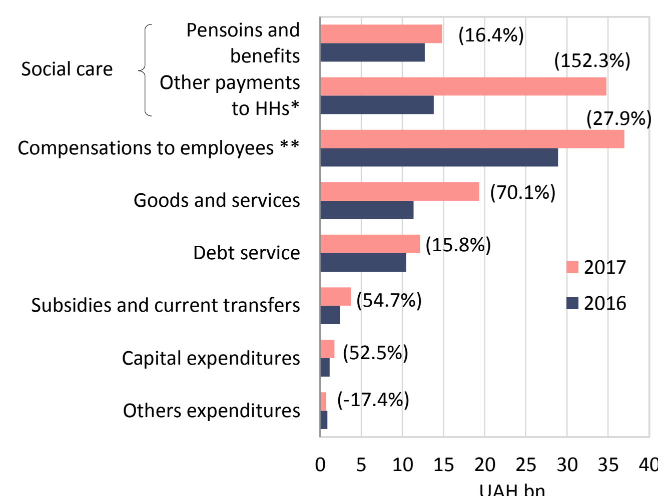
Source: STSU, NBU staff estimates

Other current expenditures also grew yoy. Spending on usage of goods and services posted the highest growth rate as government (regional) programs were implemented and payments for utilities and energy supplies were made. Expenditures on subsidies and current transfers to enterprises also increased substantially. On the other hand, debt servicing grew only moderately, as expected.

In January-February 2017, capital expenditures were higher yoy and were carried out primarily via local budgets, which saw capital expenditures double. In particular, funds were allocated to improve road infrastructure.

In January-February 2017, based on the functional classification, expenditures on social security, education, and public health care rose rapidly. Growth in education and health care spending first of all reflected rising expenses on salaries, particularly following the minimum wage increase.

Consolidated Budget Expenditures in January-February, by economic classification, UAH bn (% yoy in 2017)



** Other payments to the population include benefits and subsidies to households for utility payments, scholarships, etc.*
*** Compensations to employees include wages, allowances for the Ukrainian military personnel, and SSC.*

Source: STSU, NBU staff estimates

Balance

The consolidated budget showed a substantial surplus of UAH 18 billion in January-February 2017. Local budgets were the main contributors with a surplus of UAH 16.6 billion while the state budget posted a moderate surplus (UAH 1.4 billion).

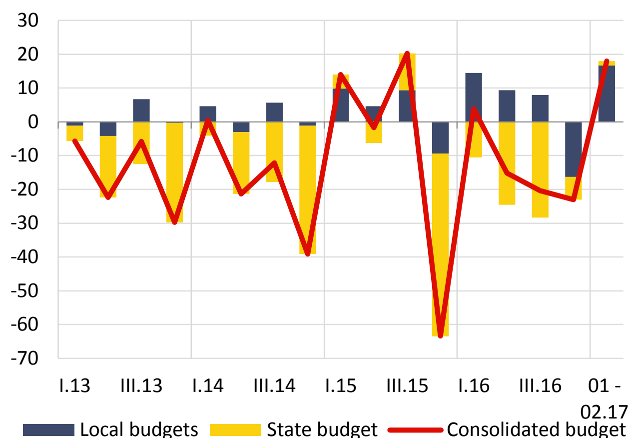
As of early 2017, the government continued issuing short-term and medium-term domestic currency (OVDP) bonds. Maturities of greater than one year accounted for the lion's share of domestic borrowings, thus reducing the budget burden. Additionally, the multiple key policy rate cuts initiated by the NBU in 2016 helped

[24] The portion of net profit (income) from state-owned companies and their unions that is deducted to the appropriate budget and dividends (income) accrued on shares (interests, stakes) of companies with state or municipal participation in their authorized capital.

lower the cost of borrowing secured by the MFU in the domestic market and, accordingly, their spending on debt servicing. At the same time, government securities continued to be issued for quasi-fiscal financing needs: UAH 16.3 billion since the start of the year to support banks.

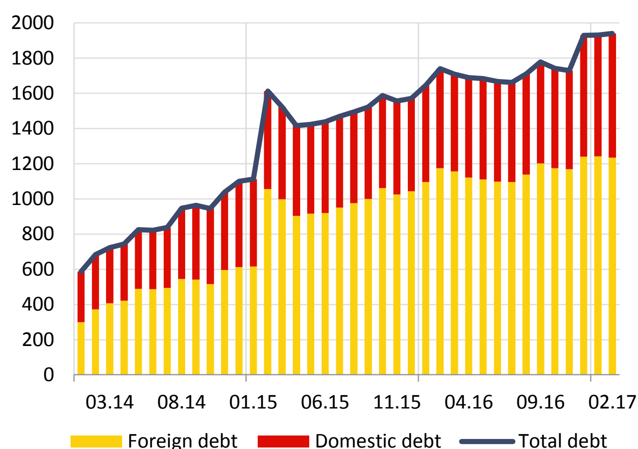
Despite significant issuance of government bonds, Ukraine's public and publicly guaranteed debt was virtually unchanged from the start of the year to late February 2017 (up by only 0.6%). Among other reasons, this was driven by a reduction in the amount of foreign publicly guaranteed debt.

Consolidated Budget Balance, UAH bn



Source: STSU, NBU staff estimates

Public and Publicly Guaranteed Debt, UAH bn



Source: MFU, NBU staff estimates

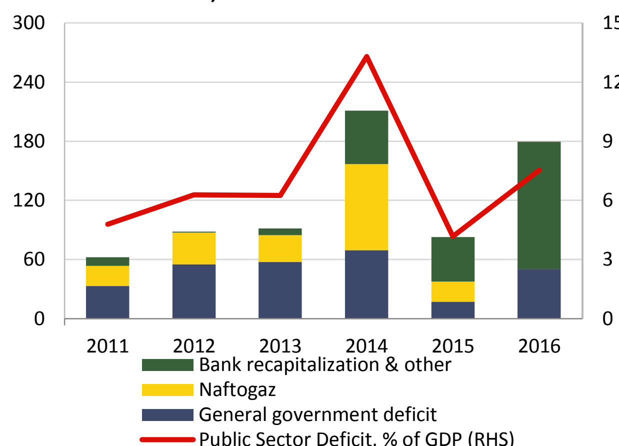
Box: The public sector balance and the structural balance of the budget

According to international methodology, the public sector balance takes into account all public sector finances, including quasi-fiscal operations. In Ukraine's case, these operations include support to the banking sector, NJSC Naftogaz of Ukraine, social funds, etc. In recent years, these have grown in scale, but have only partially been reflected directly in the consolidated budget. Therefore, when analyzing the impact of government policy on economic performance, the broad public sector balance is used.

As projected, the deficit of the public sector expanded in 2016 to 7.5%[25] of GDP, influenced by:

– A projected increase in the public sector deficit on the back of a widening of the consolidated budget deficit. This was largely the result of additional support for the Pension Fund of Ukraine to compensate for the loss of own revenues amid the SSC reform. Transfers to the Pension Fund totaled 6.0% of GDP (of which 3.5% of GDP allocated to cover pension deficits). With other expenditures restrained, the consolidated budget balance would have turned positive (at 3.7% of GDP), excluding these expenditures. In addition, strong tax revenues resulted in the public sector deficit of 2.1% of GDP, substantially below the IMF's requirement (3.7% of GDP).

Public Sector Deficit, UAH bn and % of GDP



Source: STSU, MFU, IMF, NBU staff estimates

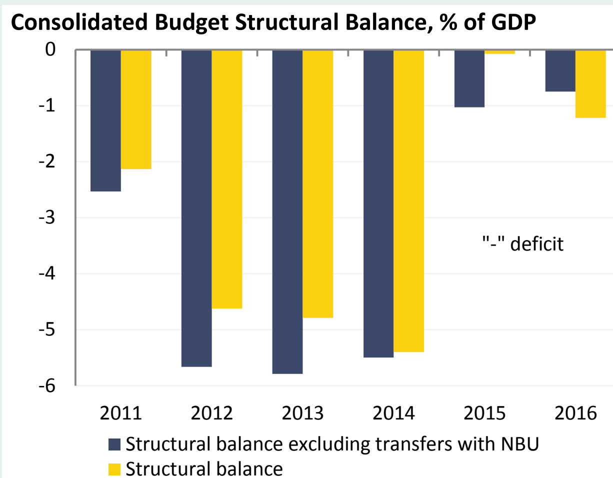
[25] Previous estimates.

– An increase in funds allocated to support the banking system, primarily for the formation of banks' authorized capital through the issuance of government securities, and also to shore up the DGF (up to 5.4% of GDP).

Compared with the prior years, NJSC Naftogaz improved its financial standing materially by raising utility rates to economically feasible levels earlier than planned. As a result, the company required no financing from the budget.

Over the forecast period, along with a lack of need for state support for NJSC Naftogaz, expenses to support the banking sector are expected to decrease as the clean-up of the system has been completed. Coupled with a prudent approach towards the public sector financing, these measures are expected to keep the public sector deficit within manageable limits, which will gradually bring the debt-to-GDP ratio down.

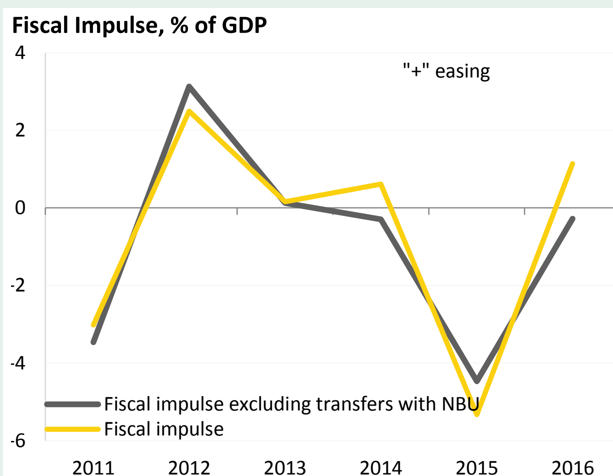
Consolidated Budget Structural Balance, % of GDP



Source: NBU estimates

A structural balance budget indicator is used to assess the fiscal policy stance (expansionary, neutral, or contractionary) and changes in policy over time. The overall consolidated budget balance is adjusted to account for the current stage of the economic cycle by decomposing certain types of revenues and expenditures into structural and cyclical components. Generally, a structural surplus is a sign of an austere policy. However, depending on the stage of the cycle, the nature of policy may vary even as indicators of the annual budget balance remain unchanged.

Fiscal Impulse, % of GDP



Source: NBU estimates

The direction of changes in fiscal policy is determined through fiscal impulse, which represents a change in the structural deficit compared to the previous period. A positive impulse indicates policy easing compared to the previous year.

All things being equal, the profit transferred by the NBU to the budget, as part of incomes,help reduce the budget deficit. However, these are not funds the government obtains from the economy. At the same time, expenditures on servicing public debt, held in the NBU portfolio, are also not channeled into the economy by the state. As a result, the accuracy of assessments of the impact of fiscal policy on the economy given the phase of the economic cycle is improved by excluding mutual settlements between the government and the NBU from the structural balance and fiscal impulse.

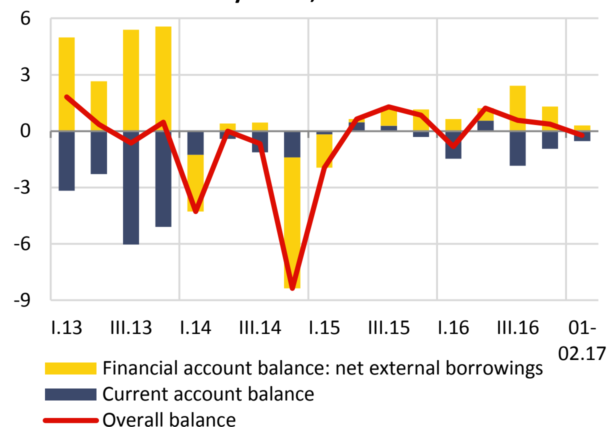
Past estimates show the government pursued a rather strict policy over 2015-2016. Although fiscal policy was eased in 2016, these measures excluding settlements with the NBU suggest a trend towards moderate fiscal policy aimed at renewing the sustainability of public finances. Over the medium term, all other things being equal, these measures are expected to bring the ratio of public and publicly guaranteed debt to GDP down to a sustainable level.

2.2.5. BALANCE OF PAYMENTS

In January-February 2017, the current account deficit narrowed compared with corresponding period last year (down to USD 0.5 billion) as the supply of commodities grew. As expected, the value of food and metal exports grew as a result of the previous year's high yields and improved external economic conditions. Imports also continued growing. Low temperatures, high demand from farmers ahead of the upcoming sowing campaign, and growth in oil prices boosted energy imports. At the same time, the annual growth rates of non-energy imports decelerated slightly.

Net financial account inflows decreased to USD 0.3 billion. As in 2016, these inflows, at USD 0.8 billion, were absorbed by the real sector. In particular, net borrowings in the form of short-term loans increased while the volume of FX cash outside banks continued declining. Meanwhile, foreign direct investment inflowsremained low at USD 62 million and were entirely directed to the real sector. By the end of Q1 2017, foreign reserves declined to USD 15.1 billion (3.2 months of future imports) reflecting a minor overall BOP deficit of USD 0.2 billion in January-February () and payments in March to service and settle public and publicly guaranteed debt denominated in foreign currency.

Overall Balance of Payments, USD bn

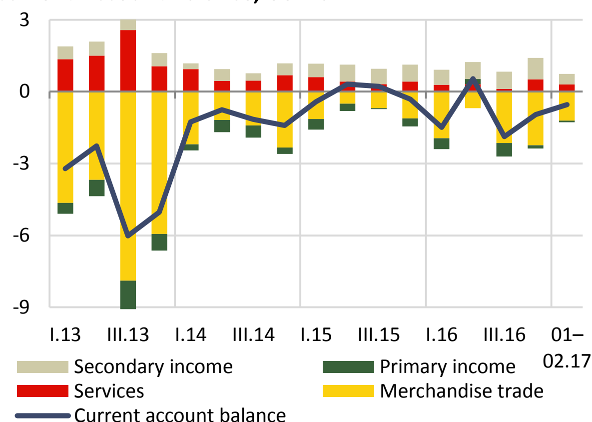


Source: NBU

Current Account

In January-February 2017, the value of goods exports rose 34.6% yoy driven by improved external economic conditions and the previous year's high grain yields. Food exports increased the most on the back of growing supplies of grain crops and sunflower oil (up by 19.8% yoy and 21.8% yoy, respectively). In the 2016/2017 marketing year, Japan, Vietnam, and Bangladesh became new markets for Ukrainian corn. In addition, a simplification of grain import procedures by Egypt in January 2017 supported the rapid pace of grain exports. India and countries of the EU have remained the main consumers of Ukrainian sunflower oil.

Current Account Balance, USD bn

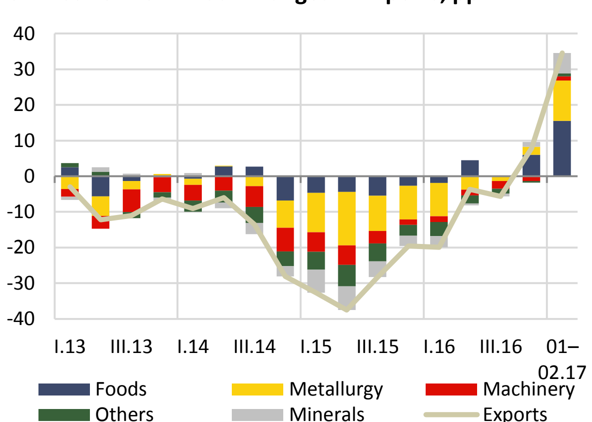


Source: NBU

Exports of other food products also grew rapidly. The resumption of Ukrainian poultry product exports to EU countries drove an increase in meat exports (up by 1.8 times compared with January-February 2016). High sugar beet yields and expansion into new markets helped sustain high growth rates of sugar exports. In addition, exports of butter continued rising, particularly to Morocco, Egypt, and some CIS countries.

Overall, exports of food products increased 33% yoy to USD 2.7 billion in January-February, close to pre-crisis levels of USD 2.9 billion in January-February 2013.

Contribution to Annual Changes in Exports, pp



Source: NBU staff estimates

Rising global prices drove a substantial increase in the value of metal and ore exports (up by 1.5 and 1.9 times yoy, respectively). The high prices offset the decline in volumes of exported metallurgic products (-4.2% yoy), which was the result of increased competition from Turkish producers. A suspension of trade with the certain areas of Donetsk and Lugansk oblasts had a minimal impact on metallurgic exports, largely due to lagged effects.

Machinery exports grew 16.3% yoy driven by higher supplies of machines and equipment. In particular, exports of some products increased to Hungary, possibly following agreements struck at the Hungarian-Ukrainian Business Forum in November 2016.

Export growth accelerated across all broad economic categories. Exports of consumer goods showed the fastest growth (51.2% yoy), while intermediate consumption goods contributed the most to the increase in exports of goods. They accounted for 81% of total exports of goods, up by 33.3% yoy in January-February 2017.

Across regions, Asian and European countries were the major consumers of Ukrainian goods, delivering export growth of 34.4% and 17.6% yoy, respectively. A substantial increase in grain supplies accounted for around half of the growth in exports to Asia. Among other factors, the expansion of Ukrainian corn into new markets was a significant driver. In addition, sunflower oil exports continued their growth to Asia, to India in particular.

Exports growth to European countries continued driven by ferrous metals and iron ore amid rising prices and anti-dumping duties imposed on some countries, particularly China.

Goods exports to CIS countries increased against a low comparison base, for the first time since 2012 (up by 1.5 times yoy), which, among other things, is related to new transport routes opened after Russia banned transit. Ferrous metals and machinery products showed the fastest growth.

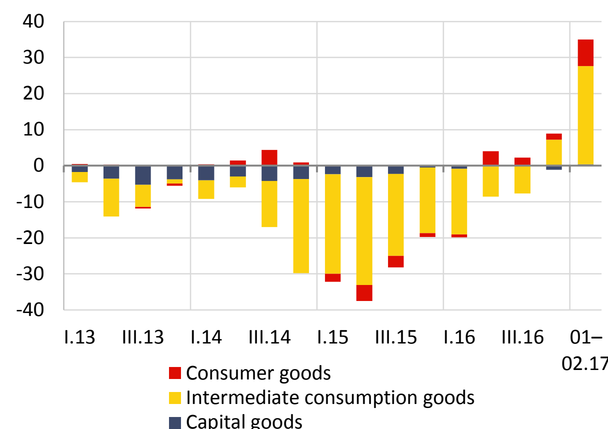
In January-February 2017, imports also accelerated (to +23.5% yoy). This was primarily driven by an increase in energy imports (1.6 times yoy). The cold snap in January-February 2017 prompted Ukraine to increase imports of natural gas, up by 30% yoy to 2.8 bcm. Additional factors included higher demand for oil products from farmers ahead of the sowing campaign and ahead of a 1 March hike in export duties on oil products by countries of the Eurasian Economic Union. As a result, with oil prices on the rise, the value of oil products imports increased 1.7 times yoy.

Unlike the previous year, the Russian Federation's share of energy imports rose, to 14.6% compared with 10.0% in January-February 2016. This was driven by increased purchases of coal and oil products owing to price advantages. At the same time, an increase in natural gas supplies, exclusively from Europe, was the main driver of growth in imports from Europe (by 22.7% yoy). Europe's share of total imports was stable at 40.4%. Imports from Asia registered the slowest growth rate (15.0% yoy), which pushed their share of imports down to 18.3% from 19.7% in January-February 2016.

In January-February, non-energy import growth slowed to 13.8% yoy on the back of a decrease in food imports (8.6%). Strong competition caused citrus fruit imports to decline (down by 20.7% yoy in value terms). The volume of pharmaceutical product imports also contracted (down by 19.5% yoy) in response to uncertainty on the eve of the Cabinet of Ministers of Ukraine's (CMU) resolution on drug price regulation[26]. As a result, growth in chemical product imports slowed to 7.3% yoy. At the same time, imports of machinery continued growing rapidly (37.3% yoy) as imports of agricultural machinery and equipment grew 1.5 times.

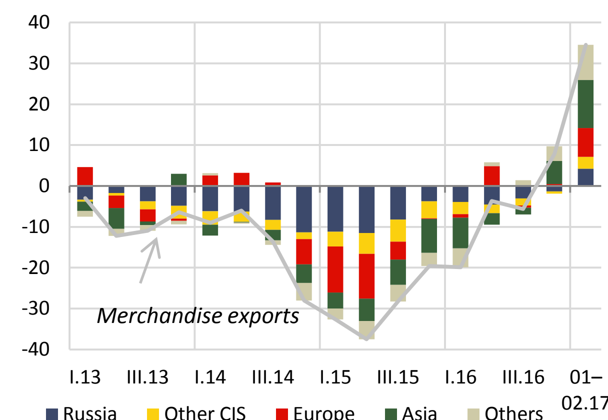
Among broad economic categories, imports of capital goods rose rapidly in January-February 2017 (43.7% yoy), with its share reaching 17.4% (up from 14.9% in January-February 2016). Due to

Contribution to Annual Changes in Exports by Broad Economic Categories, pp



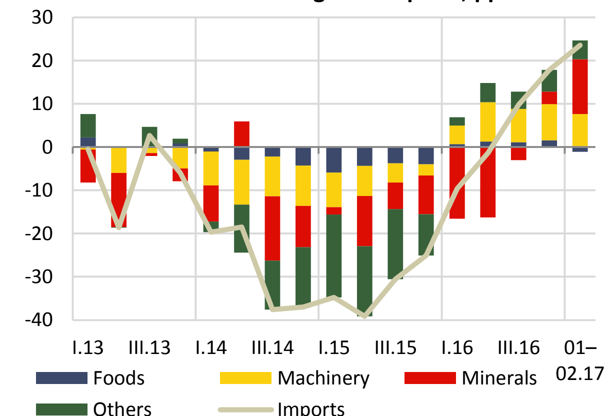
Source: NBU staff estimates

Contribution to Annual Changes in Exports by Regions, pp



Source: NBU staff estimates

Contribution to Annual Changes in Imports, pp



Source: NBU staff estimates

[26]On 9 November 2016, the CMU adopted Resolution No. 862 On the State Regulation of Drug Prices, with the Ministry of Healthof Ukraine to set price guidelines on 1 April 2017. This would allow a reduction in drug prices to bring them in-line with peer countries. On the eve of the introduction of the price guidelines, some representatives of the pharmaceutical industry requested a longer transition period in order to sell inventories of the drugs subject to price control.

Ukraine's high energy needs, intermediate consumption goods held the largest share of imports (58.6%) having increased 25.3% yoy accounting for the largest positive contribution to import growth. At the same time, growth in consumer goods imports decelerated as real disposable incomes declined in Q4 2016.

In January-February, the services trade surplus increased to USD 303 million. Exports of services grew 11% yoy primarily owing to greater gas transit to Europe (31% yoy). The share of pipeline transportations in services exports rose to 25.5%. The growth rate of IT servicesto non-residents, at 22.8% yoy, also remained high, with their share reaching almost 20%.

Imports of services grew at a slower pace (5.2% yoy) than exports in January-February. Increased imports of rail and sea transportations were responsible for the growth, possibly related to using a new cargo route to Asia after Russia's ban on the transit of Ukrainian goods through its territory imposed early last year. Imports of travel services also grew at a slower pace (4.8% yoy).

Primary and secondary income balances recorded a surplus of USD 368 million in January-February. The key driver was an 8.1% yoy increase in private remittances to Ukraine to USD 0.8 billion, coming primarily from Europe and the US. At the same time, remittances from Russia declined as Ukraine banned several Russian payment systems in late 2016.

Financial Account

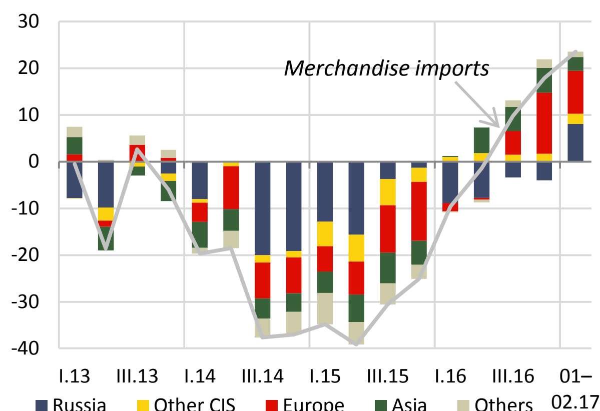
In January-February, net financial account inflows slipped to USD 0.3 billion. As in 2016, the private sector generated those inflows (USD 0.4 billion). Net borrowings by the real sector (USD 0.8 billion) were in the form of inflows of short-term loans (USD 0.3 billion) and a further reduction of FX cash outside banks (USD 0.4 billion). At the same time, the banking sector generated net payments of USD 0.5 billion (USD 0.4 billion paid on interbank loans). Private sector net debt capital outflows reached USD 194 million in January-February.

The rollover rate of long-term private external debt reduced slightly (to 37%) in January-February 2017 from the previous quarter, but still far exceeded the level of the same period last year. Limited capital inflows contributed to a decrease in the banking sector's rollover rate (down to 19%). Inflows of foreign direct investment, at USD 62 million, were also low, primarily directed to the real sector.

Rollover of long-term private external debt, %

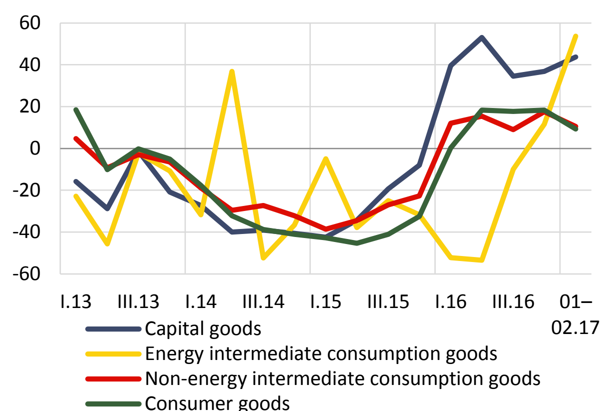
	I.16	II.16	III.16	IV.16	2016	01–02.17
Banks	9	20	42	57	26 (58)[27]	19
Corporates	67	53	62	58	60	45
Total	31	40	52	58	43 (59)	37

Contribution to Annual Changes in Imports by Regions, pp



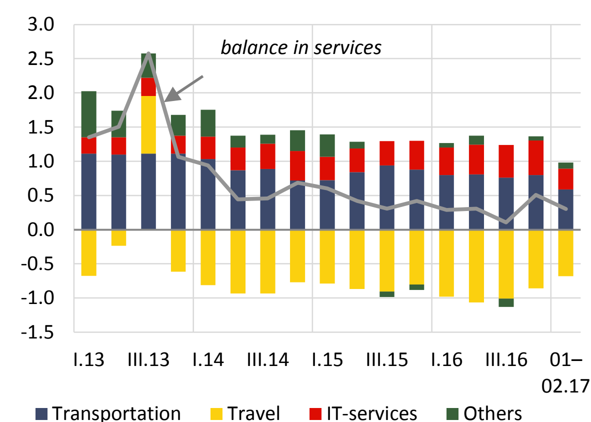
Source: NBU staff estimates

Contribution to Annual Changes in Imports by Broad Economic Categories, pp



Source: NBU staff estimates

External Trade in Services, USD bn



Source: NBU

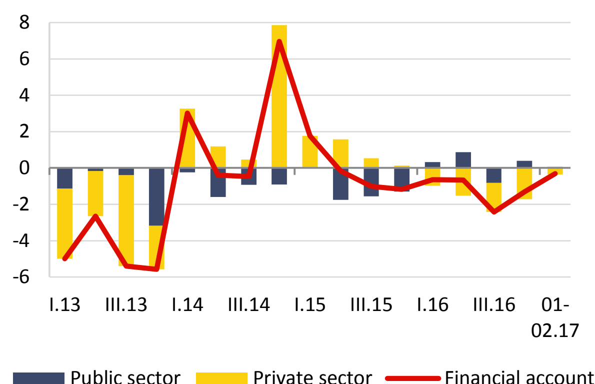
[27] Excluding debt-to-equity operations.

With external financing postponed, the government sector reduced net external liabilities by USD 63 million.

Reserve Assets

As of the end of Q1 2017, international **reserves** decreased to USD 15.1 billion (3.2 months of future imports) driven lower by a minor overall BOP deficit in January-February (USD 0.2 billion) and payments for servicing and settling public and publicly guaranteed foreign currency debt in March. However, Ukraine in early April received the fourth tranche under the IMF's Extended Fund Facility (EFF) and the second tranche of the EU's Macro-Financial Assistance program, boosting reserves to USD 16.7 billion as of 5 April 2017.

Financial Account: Net External Assets, USD bn

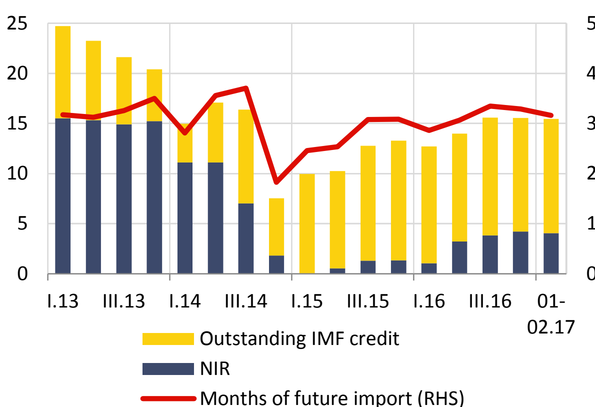


Source: NBU

External Sustainability

In Q4 2016, external sustainability indicators moved in opposite directions as a reduction in gross external debt was accompanied by growth in short-term debt by remaining maturity. Most adequacy indicators for international reserves remained nearly flat compared to the previous quarter.

Gross International Reserves, USD bn



Source: NBU

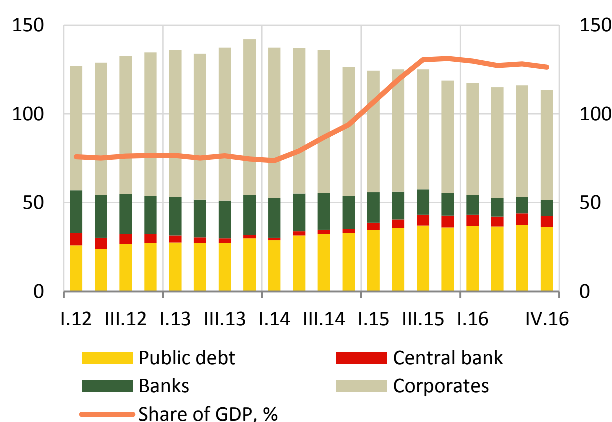
External sustainability and international reserve adequacy indicators

%	I.2015	II.2015	III.2015	IV.2015	I.2016	II.2016	III.2016	IV.2016
External debt/GDP	106.7	119.3	130.5	131.3	129.8	127.2	128.2	121.8
External debt/exports of goods and services	206.9	229.8	248.3	248.1	255.8	252.7	257.7	246.9
Short-term debt/gross debt	43.5	43.6	41.0	43.1	40.6	39.8	39.1	41.4
Short-term debt/GDP	46.4	52.0	53.5	56.6	52.7	50.6	50.1	50.5
Short-term debt/exports of goods and services	90.0	100.1	101.7	107.0	103.8	100.5	100.7	102.3
Openness of the economy[28]	106.6	106.9	107.9	107.7	104.6	104.2	104.8	105.0
Reserves/short-term debt	18.4	18.8	24.9	26.0	26.7	30.6	34.4	33.0
Reserves, composite IMF measure	31.9	32.9	41.9	45.3	44.8	50.1	55.8	55.8
Reserves in months of future imports (3 months)	81.9	84.5	102.6	102.8	95.2	102.0	111.4	110.3
Reserves as a share of broad money	22.8	22.1	29.4	32.1	33.1	33.5	38.3	38.3

In Q4, Ukraine's gross external debt decreased by USD 2.5 billion to USD 113.5 billion (or 121.8% of GDP), with all sectors reducing debt. Total general government liabilities decreased by USD 1.3 billion driven lower by a reduction in domestic state bonds (DSB) held by non-residents (by USD 0.5 billion) as well as a decrease in liabilities of the central bank and the government under long-term loans (USD 0.7 billion).

The banking sector reduced its external debt by USD 0.5 billion on a conversion of Eurobonds and subordinated debt into equity (bail-in operation). The decline in the real sector's liabilities occurred mostly in long-term debt (USD 0.4 billion), which was accompanied by a significant accumulation of arrears in Q4 (USD 4.3 billion). In total in 2016, the real sector's arrears rose from USD 12.0 billion to USD 18.2 billion.

Gross External Debt, USD bn



Source: NBU

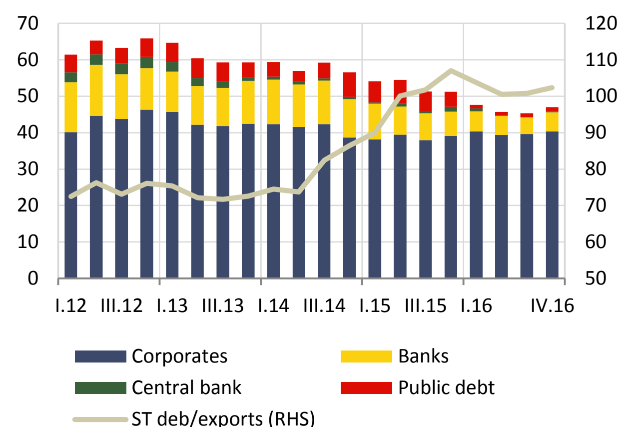
[28]Calculated as a ratio to GDP of the 12-month moving average of a sum of exports and imports for the relevant period.

At the same time, in Q4 2016, short-term debt by residual maturity increased by USD 1.7 billion to USD 47.0 billion (or 102.3% of exports) primarily due to growth in scheduled payments by the private sector. Liabilities of the general government and the central bank to mature in the following 12 months grew by only USD 0.3 billion to USD 1.5 billion.

Payments on long-term loans due within 12 months increased by USD 1 billion, increasing the real sector's short-term external debt by residual maturity by USD 0.8 billion (to USD 37.0 billion). Short- and long-term debt in interbank loans increased by USD 0.6 billion, leading to a USD 0.7 billion increase in the banking sector's outstanding debt (to USD 5.3 billion). The private sector is scheduled to make external debt payments of USD 45.6 billion in 2017, or 64.3% of total private sector gross external debt.

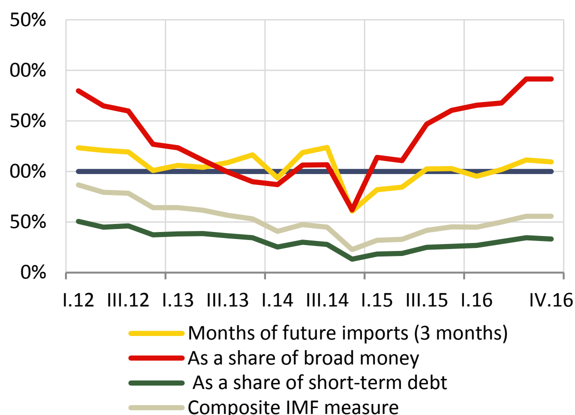
In Q4, foreign reserves remained nearly unchanged, as did their main adequacy indicators. In particular, the ratio of reserves to broad money and reserves in months of imports remained at 38.3% and 3.3 months, respectively. The ratio of reserves to the IMF's composite metric (ARA metrics) also remained stable at 56%. The ratio of reserves to short-term debt (the Guidotti-Greenspan criterion) decreased by 1.4 pp to 33% due to rising short-term debt by residual maturity.

Short-term External Debt by Remaining Maturity, USD bn



Source: NBU

Adequacy Criteria of International Reserves, %



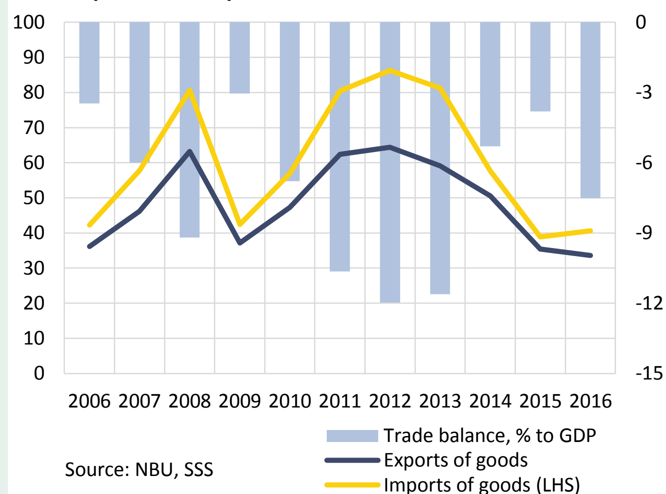
Source: NBU staff estimates

Box: Analysis of Ukraine's External Trade in Goods by Regions: Long-Term Trends

Ukraine's external trade in goods has evolved substantially over the last decade. Overall, the development can be divided into several main periods:

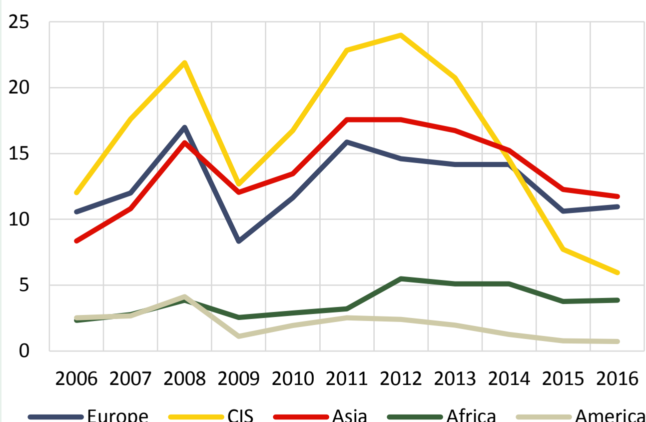
- The rapid growth of the external trade deficit in 2006-2008. Favorable external conditions drove a rapid growth in Ukrainian exports, with annual average growth rates of over 25%. However, imports grew at an even faster pace (averaging 33% per year), fuelled by stronger domestic consumption amid higher real incomes and a significant expansion of consumer lending. As a result, the external trade deficit grew from 1.4% of GDP in 2006 to 9.2% of GDP in 2008, making the Ukrainian economy highly vulnerable in the face of adverse external shocks and, eventually, the financial and economic crisis of 2008–2009.
- The global financial and economic crisis of 2008–2009, which prompted a dramatic fall in global commodities prices, drove a sharp decline in Ukrainian exports in 2009. At the same time, the crisis and the hryvnia's depreciation weighed on domestic demand, causing a major reduction in goods and services imports. As a result, the external trade deficit fell to 3% of GDP.
- The rapid growth of goods exports and imports in 2010-2013 was driven by a favorable price environment, rising domestic demand, and higher prices for imported energy. However, growing tensions in external trade relations with Russia starting in 2012 contributed to a slowdown in export growth and caused the external trade deficit to widen further to unsustainable levels (11.6% of GDP in 2013).

Exports and Imports of Goods, USD bn

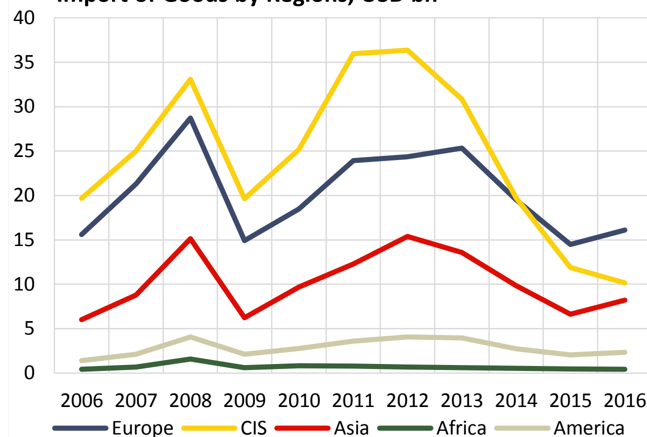


Source: NBU, SSS

- As a result of accumulated macroeconomic imbalances and the Russian Federation's armed aggression in the east of Ukraine, external trade dropped significantly starting in 2014; exports fell 1.7 times and imports halved in 2014-2016. At the end of 2016, exports and imports were both close to 2005 levels.



Source: NBU



Source: NBU

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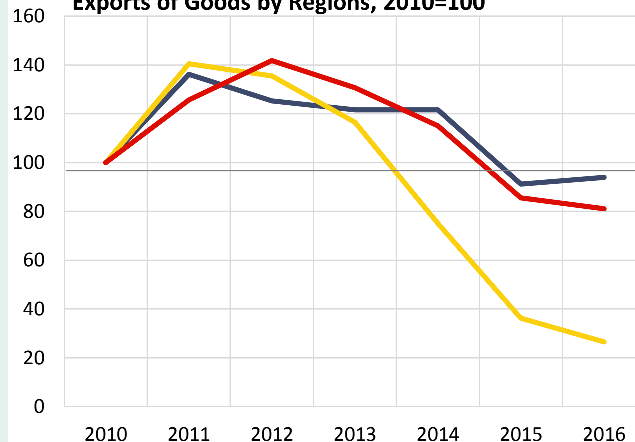
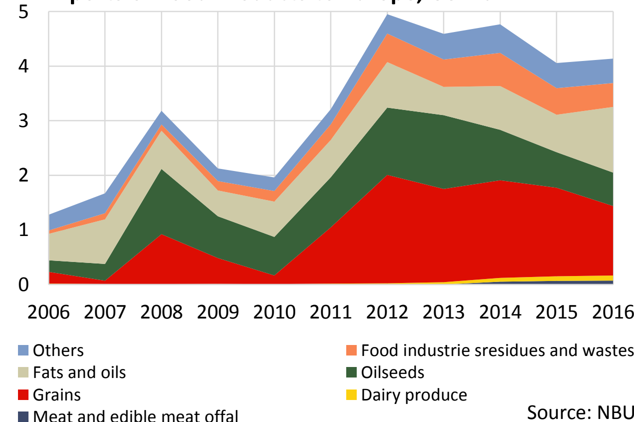
During this period, the geographic structure of external trade in goods also changed significantly. Despite the European integration strategy declared by Ukraine, the share of goods exported to the EU had been gradually falling up until 2013. Instead, the share of exports to Russia and CIS countries had grown until 2012. However, after the intensification of the so-called trade wars and Russia's armed aggression in the east of Ukraine, the share of Russia and the CIS countries in Ukraine's external trade turnover began falling, mostly at the expense of Russia.

At the same time, in April 2014 the EU unilaterally approved a preferential treatment, which eliminated import duties on most food and industrial products. Starting from January 1, 2016, a deep and comprehensive free trade zone was launched. As a result, starting in 2014 the share of exports to Europe began growing rapidly. Although weaker global prices and events in Ukraine had also affected exports to the EU, they were still the least affected during the crisis years of 2014-2016. The quality of Ukraine's trade has started to improve, although gradually.



Source: NBU

Food products drove the most significant changes in exports of goods to Europe. Exports of grains and sunflower oil grew the most, and other food products (honey, milk, meat) also increased although their share of exports remained low. In addition, the EU Association Agreement and moratorium on unprocessed log exports prompted structural changes in wood exports. In particular, wood product exports increased their share. Over the last few years, industrial goods exports have grown – glass and glassware (carboys, bottles, jars), ceramic products (sinks, ceramic flags and paving), etc. – but their share remains negligible.

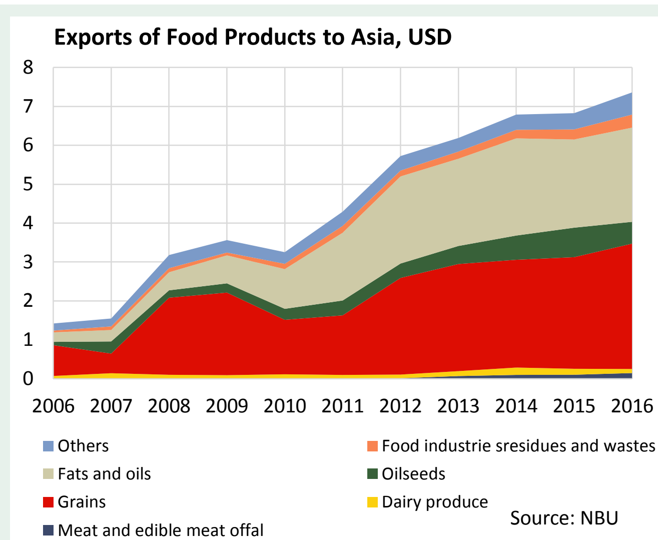


Source: NBU

Almost 3/4 of all exports are directed to 10 European countries. Italy holds the largest share of goods (metals, sunflower oil, and wheat), followed by Poland (ores and sunflower oil).

Over the last three years, energy resources gained a larger share of imports from Europe as Ukraine has refused to import Russian gas. However, imports from Europe are still dominated by high-tech machinery products and pharmaceutical products The majority of goods are imported from Germany (machinery), Poland, and France (chemical products from both countries). High prices for those products are the main cause of the persistent deficits in Ukraine's external trade with European countries.

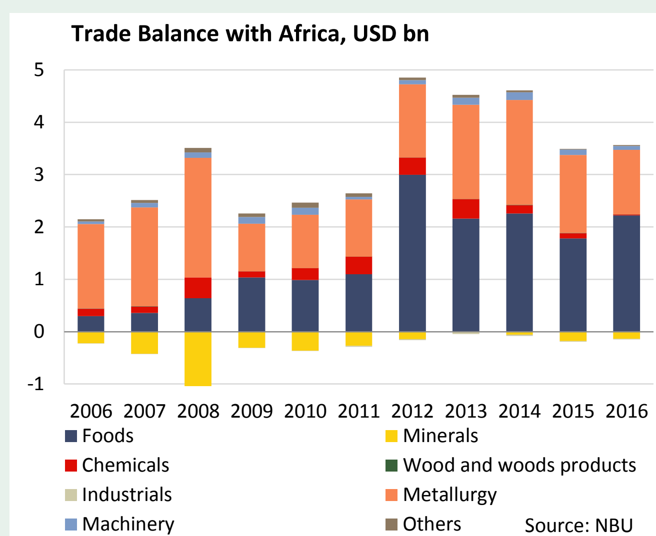
Over the last decade, Ukraine also increased exports to Asia. Over the last three years, Asian countries have become the largest consumer markets for Ukrainian exports. Food products have been a key growth driver, with exports having increased more than five times over the last 10 years. In particular, rising incomes across countries in the region have boosted demand for sunflower oil. As a result, Ukrainian sunflower oil exports to Asia reached USD 2.4 billion in 2016, accounting for 20.6% of exports to the region and 7.2% of total exports. Grain exports also increased significantly due to greater corn supplies. At the same time, wheat exports exceeded corn exports in 2016 as a result of drought in the region. In addition, exports of other food products (honey, milk, meat, eggs) to Asia rose even though their share was relatively minor. On the other hand, China's emergence as a powerful player on the global metals market in the late 2000s gradually reduced demand for Ukrainian metallurgy products in the region. The share of metallurgy exports in goods exports to Asia decreased from 62% in 2007 to 19% in 2016.



Over 2006-2016, imports of goods from Asia also grew at a substantial rate (by 1.4 times) mostly due to increased supplies of machinery products and industrial goods (clothing and footwear). Machinery accounts for around 40% of imports from the region (home appliances and ground transport). Ukraine runs consistent surpluses in trade with Asian countries.

The largest volume of goods is exported to Turkey (metals and oilseeds), India (seed oil), and China (ores, seed oil, and corn). China holds the largest share of imports, with import volumes having doubled driven by machinery (home appliances, spare parts) and industrial goods (textiles and footwear). As a result, Ukraine runs a significant trade deficit with China.

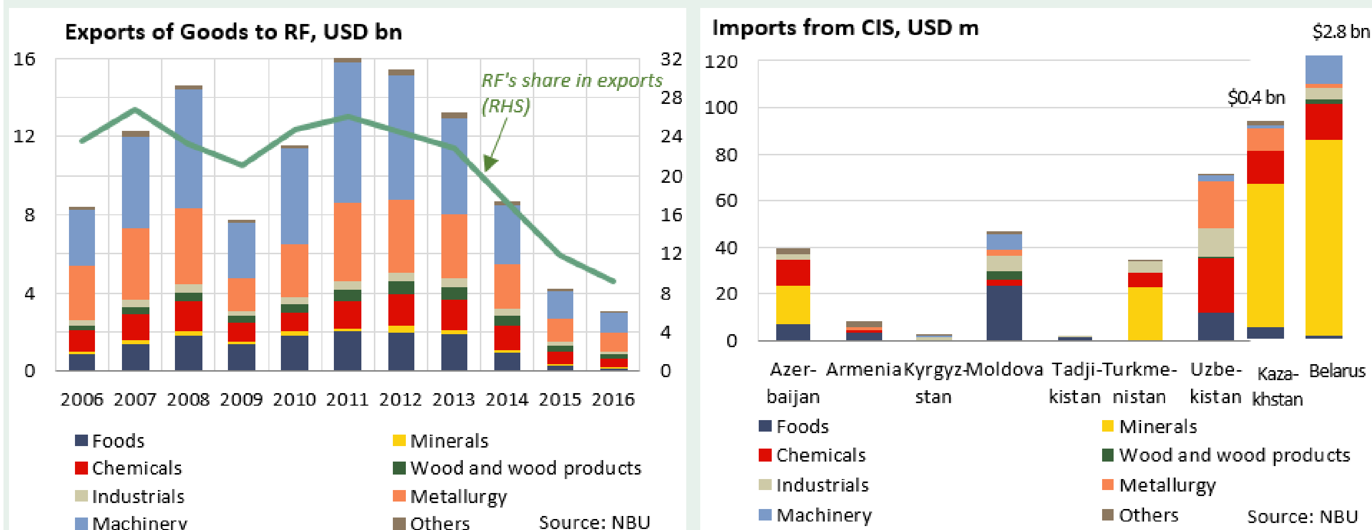
Trade with African countries is less diversified – grains and ferrous metals account for over 70% of exported goods. In terms of geographies, Egypt accounts for more than 50% of exports. Over the last decade, exports to Africa have grown by 1.6 times, with the largest growth occurring after 2012 on increased wheat supplies. African countries are Ukraine's main suppliers of ores. Other core imported goods include food products and cocoa in particular. In general, however, imports from the region are insignificant, which results in a high trade surplus with African countries.



Exports to the Americas are rather limited and have been declining in recent years. The US is the main trading partner in the region. Metalls account for the bulk of exports of goods to the Americas. Since a peak in 2011, goods exports to the region have fallen 3.4 times, a trend driven by a reduction in fertilizer and oil product supplies due to a drop in domestic production. At the same time, exports of grains to Ecuador and dairy produce to Canada and the US have grown significantly in recent years. Over 2006-2016, goods imports grew 1.7 times. Machinery (mainly vehicles) and foods (fruit, nuts, and oilseeds) account for the bulk of imports.

The CIS was the only region with which trade turnover decreased over 2006-2016. Up until 2014, the CIS was Ukraine's largest trading partner. Trade with CIS countries, with Russia in particular, started decreasing in 2012 and fell by 2.5 times after Russia's armed agression began in 2014. As a result, the CIS' share of total exports has fallen to 17.8% as of 2016 from 36.6% in 2011. Despite this decline, the Russian Federation remains Ukraine's largest trading partner in the region, as Russia banned the transit of goods across its territory to other countries.

Metallurgy and machinery products continue to dominate exports to Russia, while mineral products (coal, oil, and petroleum products) account for a major share of imports. Machinery exports decreased by the largest amount, particularly due to limitations on the supply of railway locomotives to Russia, which had accounted for around 20% of exports in 2011. Food product exports fell to almost zero as a result of the trade wars and an embargo on food imports in early 2016. Russia's armed aggression in the east of Ukraine and the loss of production capacities were key drivers behind a reduction of metallurgy exports. Over the period from 2012 (the peak) to 2016, the volume of goods imports from Russia fell 5.2 times to USD 5 billion. Imports of mineral products, especially natural gas, dropped the most.



The Russian Federation's ban on goods transiting to Kazakhstan and Kyrgyzstan through its territory caused all exports to those countries to tumble. Belarus was the only country in the CIS to which goods exports increased in 2016. Excluding Russia, the main goods shipped to the CIS include food products (bakers' wares, sugar confectionery, sugar, sunflower oil, and tobacco). The import structure differs drastically by countries. Oil products dominate imports from Azerbaijan, Belarus, and Turkmenistan, oil, oil products, and coal dominate from Kazakhstan, alcoholic beverages are the predominant item from Armenia and Moldova, raw hides and skins from Kyrgyzstan, nuts and fruits from Tajikistan. A significant deficit persists in trade in mineral products with CIS countries, which exceeds the total trade surplus in all other product groups.

In spite of a large reduction in exports in recent years, Ukraine's economy remains relatively open. Moreover, there is a greater reliance on exports of raw materials after a decline in exports of machinery products (primarily to the CIS). At the same time, Ukraine remains dependent on imports of raw materials and high-tech products.

In addition, exports of food products have grown significantly, primarily on the back of grain crops and sunflower oil. Moreover, Ukraine began tapping into new markets for some goods (both food products and industrial goods) in part thanks to the EU Association Agreement. Ukraine is continuing to push to enter new markets. To that end, Ukraine has signed a Free Trade Agreement (FTA) with Canada[29], negotiations on an FTA with Turkey are in the final stages, and negotiations for agreements with Israel, Turkey, and some African and Asian countries are underway.

Free trade agreements are no guarantee of an increase in trade turnover. However, they encourage local producers to improve the competitiveness of their products, including by adapting to new standards, certification rules, and control procedures, and by modernizing production. Evidence from countries from Latin America and Central and Eastern Europe show that free trade agreements spur institutional reforms aimed at removing regulatory and logistic barriers to external trade, increase the share of high value-added goods, and growth of non-traditional exports. Free trade areas with other countries also improve a country's attractiveness in the eyes of foreign investors and open a wider access to large markets and to a high quality imported machinery and equipment. In the short-run, the liberalization of external trade will lead to growth in traditional exports. In Ukraine's case, food product exports are expected to increase.

[29]The FTA with Canada was finalized on 11 July 2016 and the Verkhovna Rada of Ukraine ratified it on 14 March 2017. The agreement will come into force once it is ratified by the Parliament of Canada and signed by the President of Ukraine and the Governor General of Canada.

2.2.6. MONETARY SECTOR AND FINANCIAL MARKETS[30]

Despite a pause in the monetary policy easing cycle, the weighted average interest rate on hryvnia loans decreased in early 2017. Interbank interest rates declined in response to policy easing in 2016 and liquidity surplus in the banking system. However, retail interest rates responded with a lag and remained fairly high.

The FX market was mostly stable, except for the first half of January. Temporary factors causing the hryvnia depreciation in late 2016 and early 2017 faded and Ukrainian exporters enjoyed favorable external conditions. As a result, the hryvnia fully recovered to the level of the start of the year and the NBU resumed FX purchases to replenish international reserves. At the same time, the hryvnia's NEER weakened (down by 8.2% in February 2017 versus December 2016) as the currencies of the majority of Ukraine's MTP countries appreciated to a greater extent against the USD (on average since the start of the year). This resulted in a 7.1% depreciation of the hryvnia's REER. In annual terms, the hryvnia's NEER depreciated by 9.1%, which was still offset by Ukraine's higher inflation relative to the MTPCs, resulting in the virtually flat hryvnia's REER (down by only 0.3%).

February saw hryvnia deposit inflows resume to the banking system. However, domestic currency deposits decreased slightly over the first two months of the year, largely due to seasonal factors (a reduction in January after a rally in the final days of December).

In general, lending remained sluggish in January-February 2017 amid the persistently high credit risk and heavy debt burden of corporate borrowers. At the same time, hryvnia loans to households grew for the second consecutive month. With borrowing costs gradually declining, the growth was driven by increased demand from households.

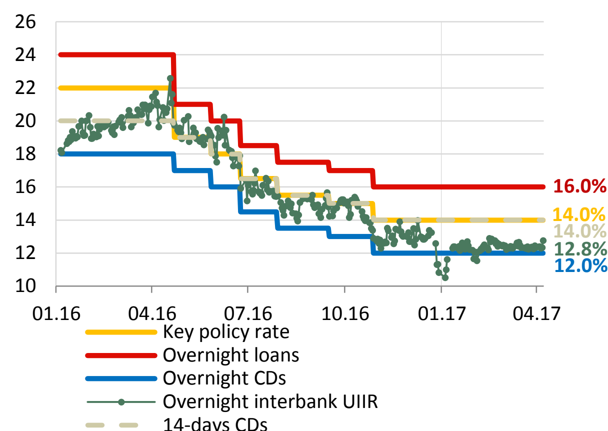
Interest Rates

At its monetary policy meeting, the Board of the NBU approved a 1 pp cut to its key policy rate to 13% per annum, effective as of 14 April. Prior to that decision, the easing of monetary policy had been paused for almost 6 months to mitigate risks related to compliance with the inflation targets for 2017 and 2018.

Despite the unchanged key policy rate, interbank lending rates continued their gradual decline in Q1, driven by monetary policy easing in previous periods and liquidity surplus in the banking system. The weighted average interbank lending rate declined by 0.9 pp to 12.7% per annum in March 2017 from December 2016. In addition, a reduction in the volume and cost of transactions at CB PRIVATBANK PJSC (last year the bank attracted funds at a rate above the market average) and the revival of interbank lending for longer maturities affected rates.

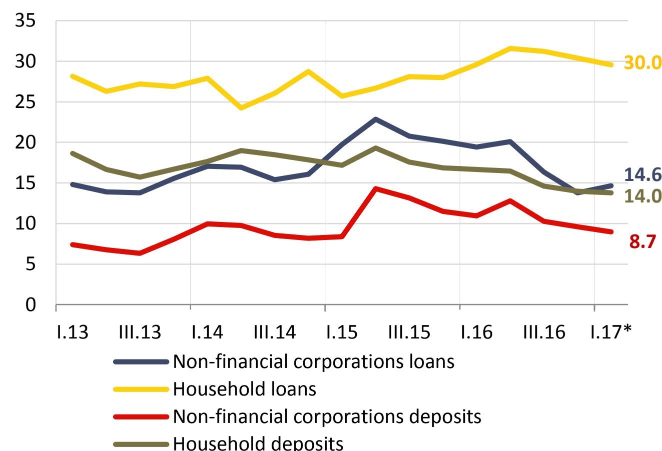
The weighted average yield for domestic currency government bonds in the primary market also continued declining. In January, market activity was weak, keeping yields on government securities virtually unchanged. The weighted average yield of hryvnia bonds fell substantially following a surge in demand in the primary market. Although yields for nine-month bonds dropped the most,

NBU Policy Rates and Ukrainian Index of Interbank Rates % pa, as of 07 April 2017



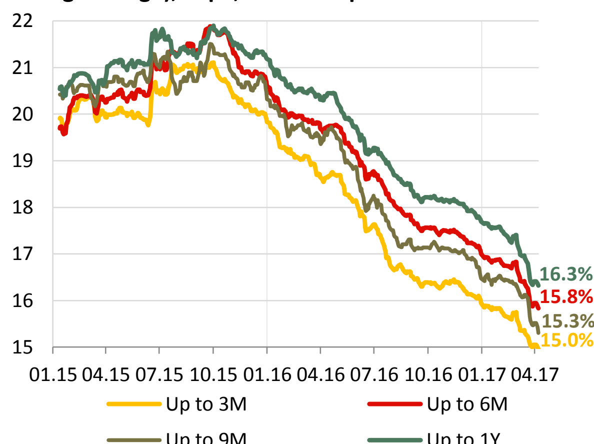
Source: NBU

Average Weighted IR on New Hryvnia Loans (excluding overdrafts) and Deposits, % pa



**January-February 2017*
Source: NBU

Ukrainian Index of Hryvnia Retail Deposit Rates (5-day moving average), % pa, as of 07 April 2017



Source: NBU

[30] The information is based on current data.

medium-term securities were in greater demand. By satisfying competitive bids, the government raised approximately UAH 4 billion to the budget in January-February (excluding securities issued for state-owned banks recapitalization). In March, the primary market was subdued and bond yields stayed at February levels. In Q1, the yield on hryvnia bonds in the secondary market declined gradually as well.

The change in retail interest rates was smaller. Weighted average interest rates on loans to households (excluding overdraft) decreased. However, they remain high. Most of this segment is comprised of relatively more expensive consumer loans and credit card debt. Weighted average interest rates on domestic currency loans for non-financial corporations (excluding overdraft) grew slightly. This particularly reflected the fadingeffect of a growing share of long-term loans observed in late 2016 as a result of active FX loan restructuring. In January-February 2017, deposit rates for non-financial corporations continued to decline. At the same time, the weighted average deposit rate for households remained at a Q4 2016 level, even after the resolution of the situation with CB PRIVATBANK PJSC mitigated uncertainty in the market reducing the cost of deposits for all maturities in February-March.

FX Market

Despite favorable external conditions (primarily high comodity prices for Ukrainian exports), the depreciation pressure on the hryvnia exchange rate intensified at the start of the yeardue to temporary and seasonal factors. Those factors included a delayed effect of last year's large budgetary spending and VAT compensation in the last days of 2016, as well as decreasing FX supplies as business activity dropped at the start of the year.

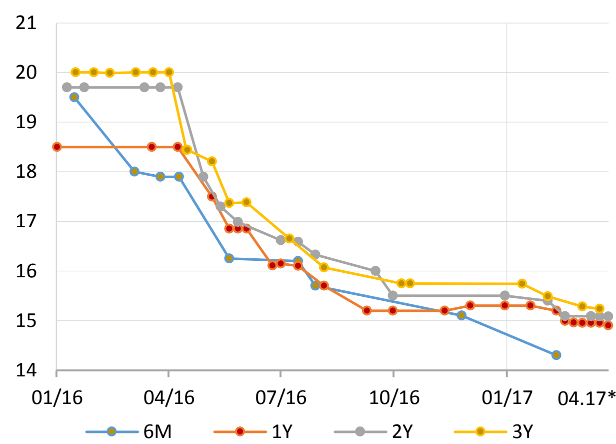
Under the floating exchange rate regime, the NBU has used FX sale auctions to smooth excessive fluctuations without counteracting the prevailing trends. Moreover, as outlined in the Foreign Exchange Market Intervention Strategy for 2016-2020, the NBU in January launched a new type of FX intervention tool: requests for best quotations. This tool's advantage lies in its speed, making it the most efficient tool for smoothing interbank FX volatility.

As a result of favorable external conditions and the elimination of temporary factors, starting in mid-January the hryvnia exchange rate not only recovered lost ground, but it also strengthened slightly as of the quarter-end. The NBU resumed FX purchase auctions to replenish international reserves. In spite of a deficit in January, in Q1 2017 (as of 7 April 2017) the NBU net FX purchase ammounted to USD 146.2 million.

At the same time, the hryvnia's NEER weakened (down by 8.2% in February 2017 versus December 2016) as the currencies of the majority of Ukraine's MTPCs appreciated to a greater extent against the USD (on average since the start of the year). As a result, the hryvnia's REER declined by 7.1%. The hryvnia's NEER depreciation by 9.1% yoy was offset by higher inflation in Ukraine compared with the MTPCs. This kept the hryvnia's REER virtually unchanged (a minor 0.3% reduction).

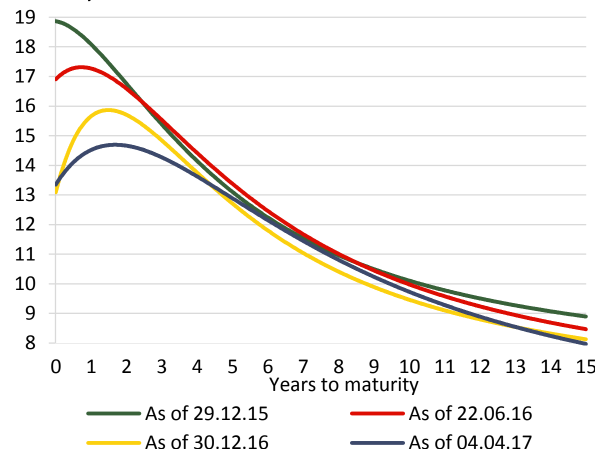
The net FX purchase remained positive in Q1 2017, although down in annual terms. This was primarily caused by increased household FX purchases, although sale volumes grew as well. The growth of transactions in the official FX market was expected in light of

Yields on Government Bonds by Maturity, % pa, as of 07 April 2017



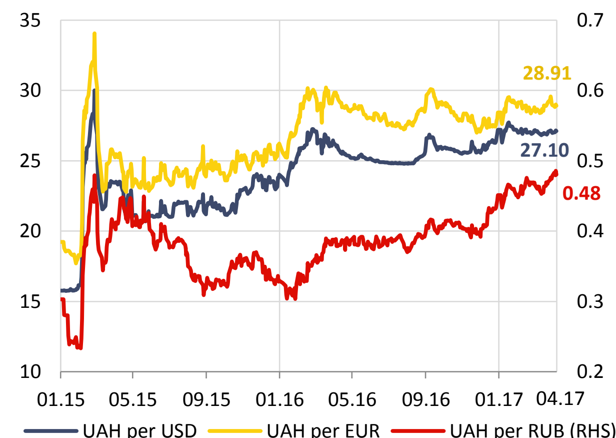
** One-year securities include bonds maturing in 11 months*
Source: NBU

Zero Coupon Yield Curves for Hryvnia Government Bonds*, %



**Spot rates with continuously compounded interest plotted with use of Nelson-Siegel parametric model.*
More detailed information is available at https://bank.gov.ua/control/en/publish/article?art_id=25023355&cat_id=12064024
Source: NBU

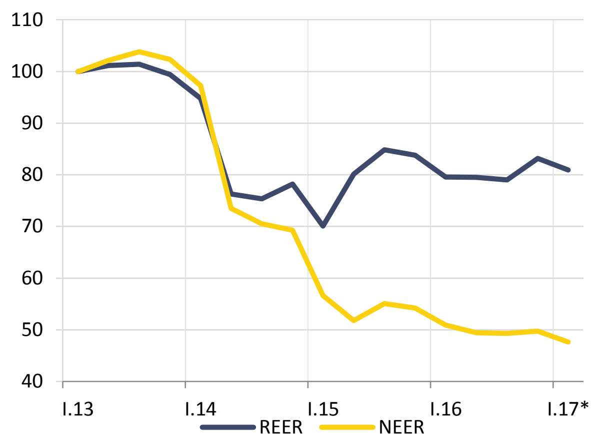
The Official Hryvnia Exchange Rate, as of 07 April 2017



Source: NBU

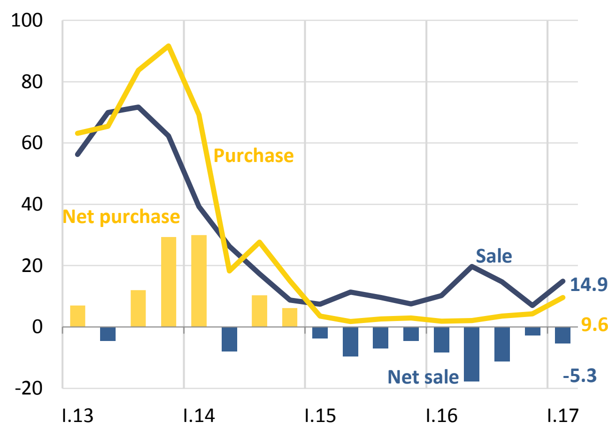
relaxation of FX controls, including the cancelation of the 2% pension charge on households purchasing FX starting in 2017.

Hryvnia NEER and REER Indexes Based on Monthly Average Interbank Exchange Rate, I.2013=100



** Preliminary data, January-February 2017*
Source: IFS, staff estimates

Daily Average Amount of Cash FX Purchased/Sold by Households, USD mn



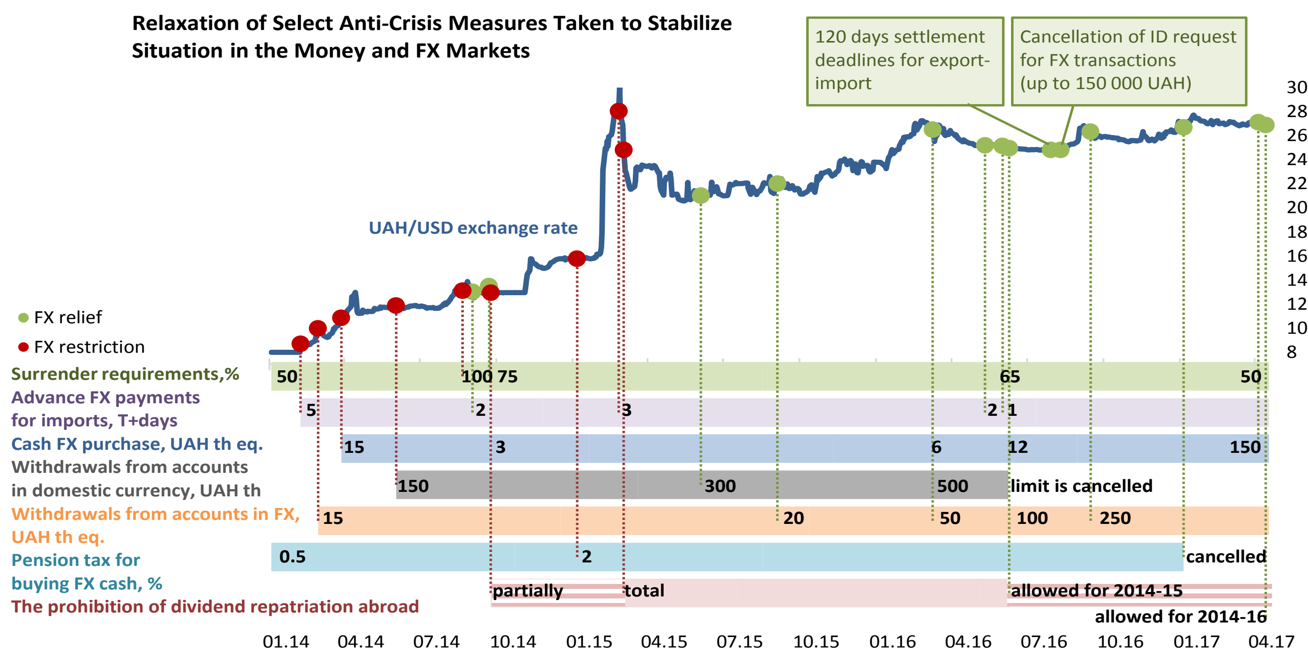
Source: NBU

Box: Measures taken by the NBU to Liberalize the FX Market and Improve the Functioning of Financial Markets

In Q1 and in early April 2017, the NBU continued to ease restrictions on the FX market and improve financial market operations. This process, however, was more gradual than in previous periods due to temporary spikes in FX volatility and increased depreciation pressure at the start of the quarter. In particular, the NBU has:

– exempted FX proceeds received from non-residents from surrender requirements if these funds are received as a security deposit (guarantee fee, collateral, down payment, deposit, guarantee);
– eased requirements on banks purchasing FX for clients by raising the purchase limit (from USD 25,000 to USD 100,000) and permitting cash cover to not be included in the total balance of FX on a resident's account;
– increased the amount of banks' net FX purchases to 0.5% (from 0.1%) of regulatory capital;
– cancelled licensing requirements for individuals depositing FX funds originating abroad as well on the investment of those funds;
– simplified the procedure for bank customers to purchase FX/make FX transfers abroad in favor of non-residents and changed control regulations to prevent high-risk FX operations;
– allowed economic entities to purchase FX using hryvnia loans guaranteed by the government raised to implement projects designed to enhance the country's defense capacity and state security;
– simplified rules for carrying foreign currency cash through Ukrainian customs by expanding the list of documents individuals must submit under the customs declaration procedure and extending their term by three times;
– simplified the procedure for registering agreements for residents borrowing in FX from non-residents (simplified registration procedures, new automated system for agreement registration, cancelled the requirement for resident borrowers to provide a certificate declaring the amount of the loan and debt repayment);
– reduced surrender requirements on FX proceeds to 50%;
– raised limits on FX sale to individuals up to USD 150,000 (in equivalent);
– reduced bureaucracy in registering changes to loan agreements by cancelling the requirement to submit scanned copies of the changes to the NBU;
– implemented the NBU's Public Offer to become the contractual basis for issuing NBU certificates of deposit;
– improved the procedure for issuing NBU certificates of deposit;
– cancelled the requirement for banks to comply with the procedure for the formation and maintenance of required reserves in order to participate in the issuing of NBU certificates of deposit;
– allowed banks to pledge mixed collateral against overnight loans.

Moreover, on 13 April 2017, the NBU Board allowed the repatriation of dividends for 2014-2016 and simplified the process to take advantage of this simplification. In addition, the NBU allowed early repayment of loans to non-resident banks with a rating no lower than A and eurobonds, also increased the maximum amount of advance payments under import agreements without using letters of credit.

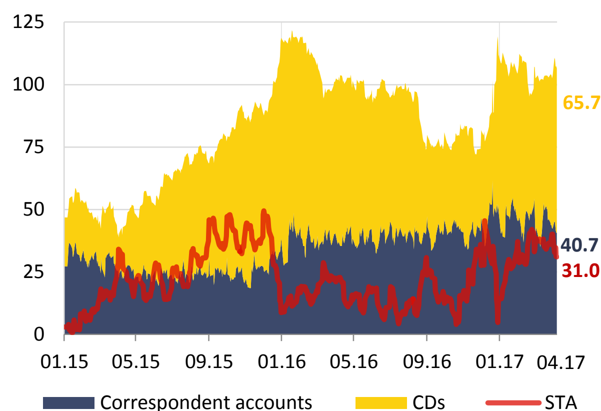


Monetary Base and Banking Liquidity

In Q1 2017, banking liquidity grew, as is typical for the start of the year. Banks' average daily stocks of NBU CDs and correspondent accounts increased by 46.8% and 6.8% qoq, respectively.

Cash was the main channel of liquidity injection into the banking system. After a surge in December 2016, cash volumes have been falling in the current year (down by UAH 29.6 billion overall), driven by seasonal and psychological factors (related to the CB PRIVATBANK PJSC situation). The growth of correspondent accounts was also caused by the NBU's FX market operations (net FX purchases amounted to UAH 3.4 billion) as well as by operations of the DGF (estimated net effect of UAH 5.2 billion). In addition, the NBU's open market operations of UAH 3.9 billion also reinforced liquidity in the banking system. As part of the resolution of CB PRIVATBANK PJSC, in January the NBU monetized UAH 1.4 billion of the government bonds issued by the CMU to recapitlize the bank. However, the funds received by the bank remained on its correspondent account with the NBU as they were used to maintain required reserves.

Select Indicators of Banking System Liquidity, UAH bn, as of 07 April 2017

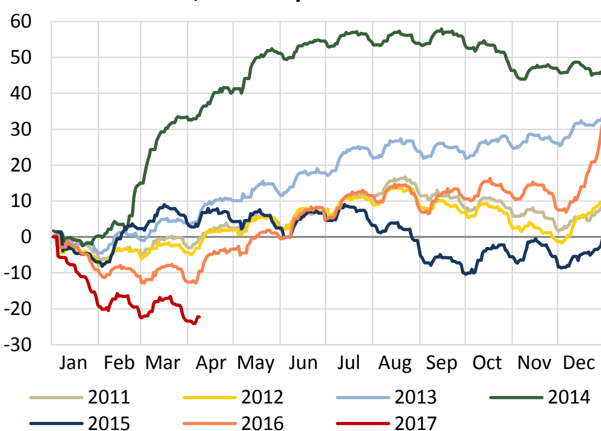


Source: NBU

As is typical for the start of the year, the main channel of liquidity absorbtion was the accumulation of funds on the single treasury account (STA), including quarterly taxes and other budget payments. The net impact of government operations is estimated at UAH 32.7 billion.[31] In addition, liquidity in the banking system decreased as banks repaid previously granted loans from the NBU (net volumes stood at UAH -5.5 billion).

The reduction of cash volumes by end-March far exceeded the growth of banks' correspondent accounts, which resulted in a 6.5% contraction of the monetary base in Q1 2017 versus December of last year. Annual growth fell to 9.1% yoy.

Cash in Circulation, UAH bn ytd

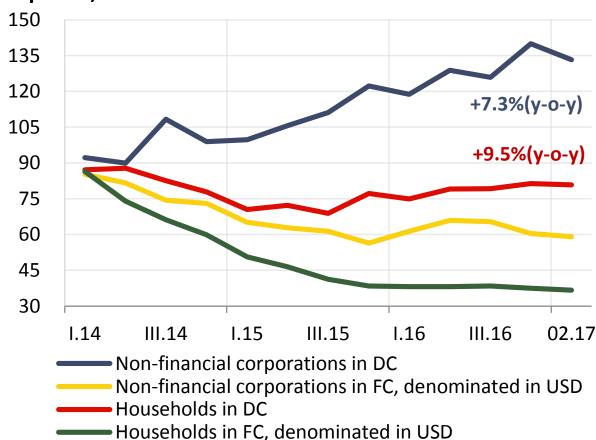


Source: NBU

Money Supply and Its Components

In January-February 2017, deposits moved in opposite directions. In January, the stock of domestic currency deposits decreased. This was mainly driven by the base effect as December saw strong growth in deposits on the back of significant budget spending in late 2016. In February, inflows of hryvnia deposits to the banking system resumed. This growth was driven by banks receiving budgetary funds (largely to local budget accounts), as well as household deposits, which outweighed a further reduction in deposits by non-financial corporations, typical for the quarterly tax period. However, the growth in deposits in February did not offset the the previous month's decline with deposits down by 0.4% in January-February. Still, growth in domestic currency deposits accelerated to 9.2% yoy in February from 8.8% in December 2016.

Deposits, IV.2013=100



Source: NBU

The stock of FX deposits (in USD equivalent) continued decreasing largely driven by household deposits. On the other hand, the stock of FX deposits of non-financial corporations grew on the back of increased exports and financial operations with non-residents. However, total FX deposits (in USD equivalent) decreased by 2.0% over the two months and 2.3% yoy.

[31] The impact of fiscal factors on growth in banking system liquidity was calculated based on changes in STA balances (up by UAH 18.6 billion), debt repayments of the government to the NBU (UAH 13.7 billion), and government transfer of funds to the DGF and bank liquidators (UAH 0.4 billion).

As a result of those deposit trends along with a reduction in cash outside banks, money supply decreased by 3.9% in January-February, with annual growth rates decelerating to 4.4%.

Loans

Bank lending activity remained subdued in January-February 2017 on the back of persistently high credit risk and a heavy debt burden of corporate borrowers. In addition, banks` internal requirements on collateral and loan maturities and amounts also restrained growth of the loan portfolio.

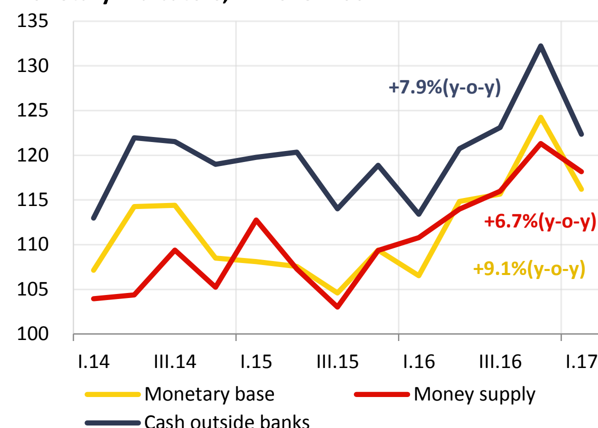
At the same time, in February, the stock of hryvnia loans disbursed to households grew for the second consecutive month (by 2.4% since the start of the year, with the annual rate of declinedecelerating to 1.8%). This was driven by increased household demand forfunds as the borrowing cost gradually came down. However, the stock of loans to non-financial corporations decreased in the current year, slightly lowering annual growth rates - to 21.5%.

FX lending also continued decreasing (in USD equivalent), down 4.1% overall versus December 2016 and 22.7% yoy.

Nevertheless, bank lending is expected to recover amid gradual economic recovery and high investment demand. According to the results of the Q1 2017 *Lending Survey* [32], for the first time in four quarters, respondents in Q4 2016 forecast a revival of corporate lending within the following 12 months and an improvement of loan portfolio quality of both corporate clients and households.

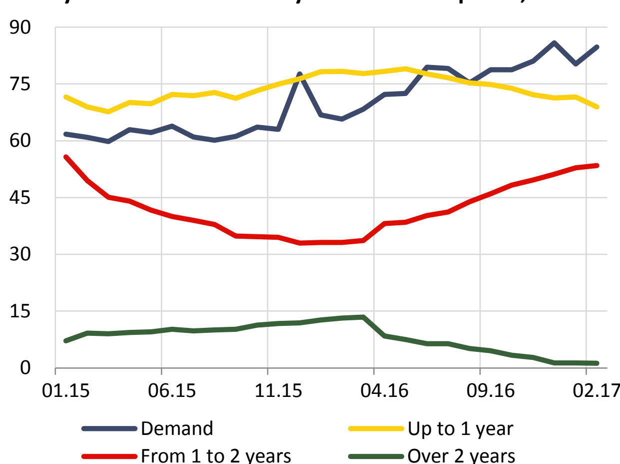
Moreover, banks expected a further easing of lending standards, even for corporate FX loans (for the first time since 2013). As a result, this fueled expectations that demand from corporations will grow for all types of loans except FX loans, while households will take on more consumer loans.

Monetary Indicators, IV.2013=100



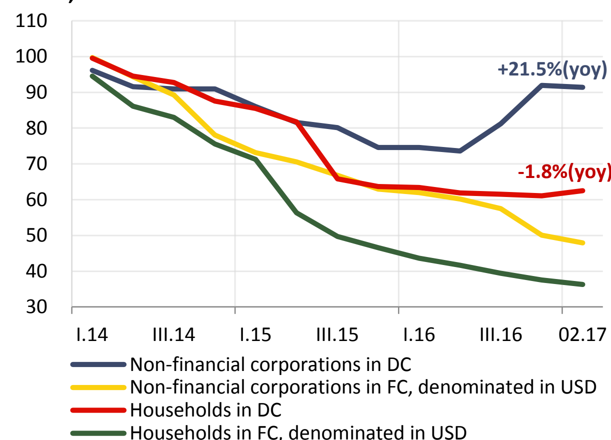
Source: NBU

Maturity of Domestic Currency Household Deposits, UAH bn



Source: NBU

Loans, IV.2013=100



Source: NBU

[32] For more information, see: https://bank.gov.ua/doccatalog/document?id=43952340 .

3. PROSPECTS FOR THE DEVELOPMENT OF THE ECONOMIC SITUATION IN UKRAINE

3.1. ASSUMPTIONS OF THE FORECAST

In 2017-2019, growth is expected to accelerate in Ukraine's Main Trading Partner Countries (MTPCs) on the back of improved global commodity prices and fiscal stimulus, primarily in the United States and China. Meanwhile, headwinds for growth are expected to include political risks related to the uncertainty about election outcomes in some European countries, geopolitical risks related to a possible escalation of conflicts in the Middle East and Ukraine, and risks for foreign trade stemming from the likelihood of trade wars, especially between the US and China. The following trends will prevail in certain countries:

– GDP growth in the US will accelerate in 2017-2018, driven by fiscal expansion and improved global price conditions. However, increased budget spending and growing domestic demand amid low unemployment will induce inflationary pressures. This, in turn, will prompt the U.S. Federal Reserve (FED) to raise the benchmark interest rate at a faster pace than previously expected, which will boost investment inflows.

– Economic growth in the euro area is expected to slow. This will be driven mostly by: uncertainty over the beginning of the Brexit process; a deterioration in the investment climate related to elections; unresolved problems in the banking sector; an absence of stable fundamentals for enforcing the inflation commitment[33];

– Economies of Central and Eastern Europe (CEE) will grow steadily due to a recovery in global commodity prices and increased interest in their financial assets, as they are less dependent on the situation in the euro area. However, a slowdown of financing from EU development funds will adversely impact CEE countries.

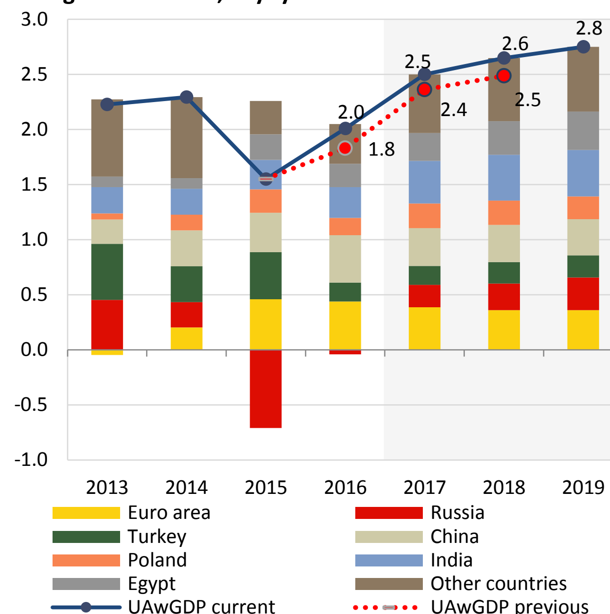
– China's economic growth will decelerate further, but still remains among the the world's fastest-growing economies. An improvement in global commodity markets on the back of significant public funding of infrastructure and production-related projects will support the Chinese economy. On the other hand, economic growth will be held back by high corporate debt, capital outflows, and possible trade wars between China and the US.

– Political instability and weak domestic demand will remain the main drag on Turkey's economic growth. However, the country's economy will be supported by benign prices for ferrous metals, a partial resumption of trade relations with Russia, and competitive prices for Turkish products on global markets, as a result of the significant depreciation of the national currency in 2016 and in early 2017. As a result, Turkey's economic growth will accelerate in 2017-2019 from 2016, but still remains weaker than during 2010-2015.

– Egypt's economic growth will gradually accelerate due to measures adopted under the IMF program and increased demand from its main trading partners, in particular the euro area, China, the United States, and the Russian Federation. The strong depreciation of the Egyptian currency in 2016 will improve the balance of trade.

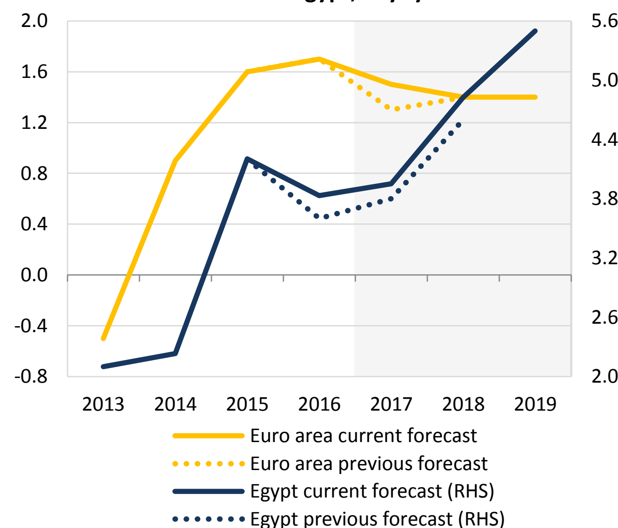
– The Russian economy will slowly recover as oil prices grow gradually, ferrous metal markets rally, inflationary pressures ebb, and domestic demand revives. These trends will also benefit

Contributions of Ukraine's MTP Countries to the Annual Change of UAwGDP, % yoy



Source: NBU staff estimates (preliminary data) based on IMF

Real GDP of euro area and Egypt, % yoy



Source: NBU staff estimates, 2019 - based on IMF

[33] The recent growth in inflation in the euro area, to 1.5% yoy in March, is mostly the result of renewed growth in energy prices. Domestic demand within the euro area remains weak.

neighboring countries, such as Kazakhstan and Belarus. The RUB/USD exchange rate will fluctuate within a narrow band. Any appreciation in the exchange rate due to higher commodity prices will be offset by the central bank's efforts to replenish international reserves, after a material depletion in recent years.

Following a surge in prices in late 2016 and early 2017, global prices will gradually adjust downward by the end of the year. Nevertheless, in 2017, average prices will be higher than in 2016, mainly due to prices for ferrous metals, iron ore, and grains.

Despite a possible correction, prices for ferrous metals are expected to remain high, underpinned by increasing demand, relatively high prices for raw materials, and anti-dumping duties by some countries. In 2017, global demand could grow by 0.5%-1.5%, mainly driven by the US (up 3%-4%), Europe (up 0.5%-1.5%), Brazil (up 3%-4%) and India, whose economy is growing rapidly. An increase in US shale-oil production capacitieswill boost demand for steel[34]. Supply glut in the steel market will persist. India expects to increase steel output to 122 million tons/year (ranked #2 globally) as domestic demand grows. By contrast, China confirmed plans to continue cutting excess capacity in the steel and coal sectors in a rapid manner to fight smog.

Iron ore prices will remain relatively high in the coming months on stronger demand from the US and the expected suspension of unprocessed iron ore exports from Iran, a top-10 exporter of ore worldwide. According to the Iron Ore Producers and Exporters Association of Iran, exports will decrease as domestic demand increases on a hike in metallurgic production. Starting in the middle of Q2 2017, iron ore prices are expected to fall as China reduces ore imports due to a reduction in steel output, and as demand grows from the US, Australia, and Brazil. In 2018-2019, iron ore prices will fluctuate within a 53-60 USD/ton range as supply and demand are expected to remain broadly balanced.

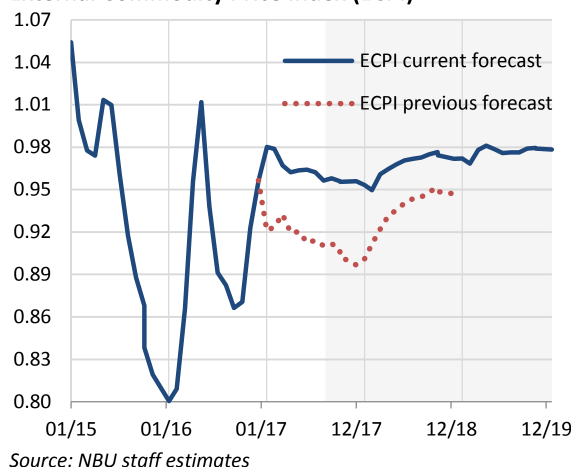
After grain prices reached a low in the latter half of 2016, growing demand will gradually push them up in spite of a world record harvest. A slight increase in fuel prices that account for a significant share of total production costs will be yet another factor contributing to the increase in grain prices.

Excluding a 2.2% yoy rise in wheat production in the 2016/2017 marketing year (MY), demand will grow 2.5%, [35] driven primarily by countries of North Africa, notably Egypt and Algeria.

The prospects for the winter wheat yield (which will be included in grain production figures for the 2017/2018 MY) are generally favorable despite current difficulties. The global area under crops remained unchanged – a reduction in the US has been offset by a substantial expansion of sown areas in India, Russia, and North Africa. However, existing problems (a deterioration of weather in some regions) will affect the timing of grain crop supplies to the market, which will result in some growth in wheat prices.

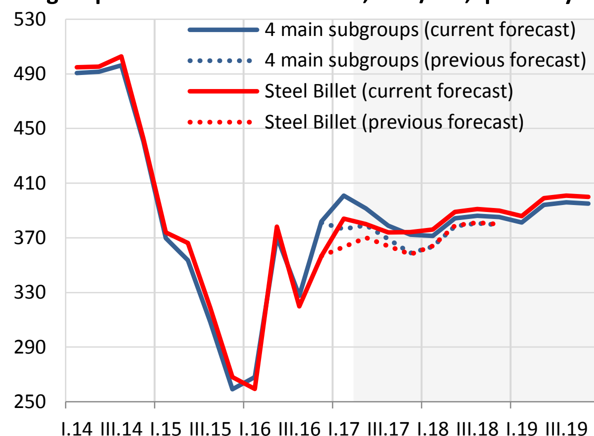
Unlike wheat, the global supply and demand balance of corn will decline in the 2017/2018 MY. This is first of all related to an expected decline in production in the US as the country partially shifts to soya, a more profitable crop. As a result, the forecast for corn prices has been revised by a greater amount than for wheat prices.

External Commodity Price Index (ECPI)



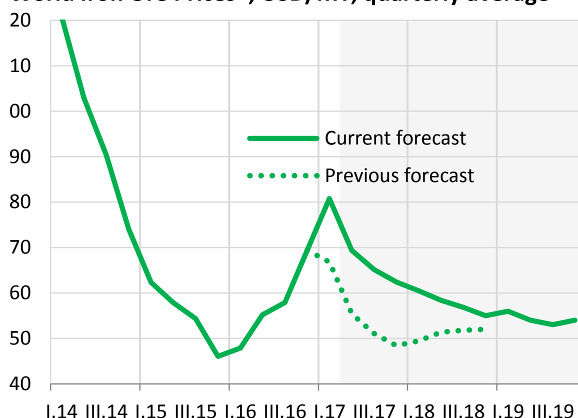
Source: NBU staff estimates

Estimated world price of ferrous metals based on 4 main subgroups and Steel Billet Prices*, USD/MT, quarterly average



**Steel Billet Exp FOB Ukraine.*
Source: NBU staff estimates, based on Metal Expert

World Iron Ore Prices*, USD/MT, quarterly average



** China import Iron Ore Fines 62% FE spot (CFR Tianjin port)*
Source: NBU staff estimates

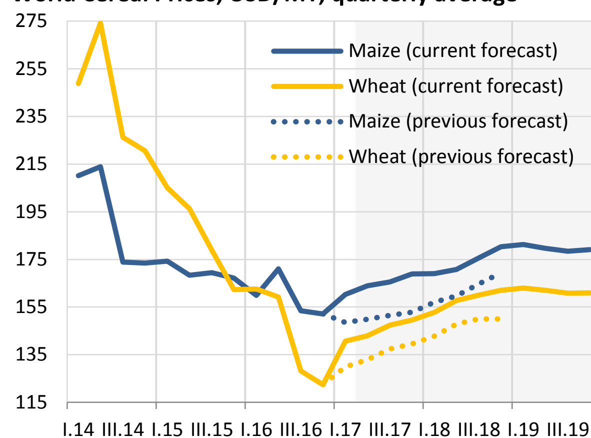
[34]According to S&P Global Platts Oil & Gas Consulting, as of early 2017, the average gas well requires 400 tons of steel compared with 210 tons in 2010.
[35]According to estimates by the International Grain Council from 23 February 2017.

Global oil prices are expected to gradually edge up as the major oil producers stick to the agreement to cut production. The NBU estimates that crude oil prices will fluctuate within a range of 52-59 USD/barrel in 2017 and gradually increase to 66 USD/barrel in 2018-2019. A gradual increase in demand from Asia will additionally support price growth. In particular, against a backdrop of a lower domestic output, China plans to raise net oil imports by 5.3% yoy to a new record of 8 million barrels/day by the end of 2017. India plans to increase crude oil imports by almost 39% by the year-end.

However, prices will be held back from sagnificant growth by:

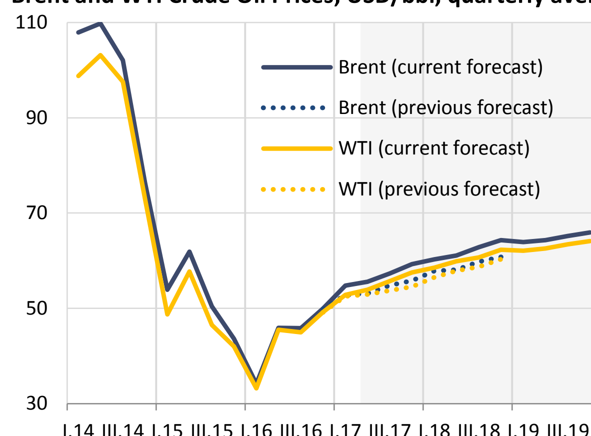
- A resumption of output at oilfields in the US and Canada (the number of oil rigs grew 32.9% from the start of the year to 10 March 2017) and further plans to develop domestic production;
- The US selling some of its strategic inventory;
- Iraq, Iran, and Libya planning to expand production and export more crude oil from reserves.

World Cereal Prices, USD/MT, quarterly average



Source: NBU staff estimates, based on IMF

Brent and WTI Crude Oil Prices, USD/bbl, quarterly average



Source: NBU staff estimates

	CPI, change as of the end of period, %			GDP, annual change, %			Exchange rates*		Commodity Prices**, USD			
	Euro area	Russia	USA	Euro area	Russia	USA	USD/EUR	RUB/USD	Imported gas, per 1m³	Brent crude oil, per bbl	Ferrous metals export, per ton	Grain export, per ton
2014	-0.2	11.4	0.8	0.9	0.7	2.4	1.33	38.3	292.5	99.1	481.5	201.2
2015	0.2	12.9	0.7	1.6	-2.8	2.6	1.11	61.0	274.0	52.5	336.1	166.9
2016	1.1	5.4	2.1	1.7	-0.2	1.6	1.11	67.1	200.9	43.9	299.4	153.4
2017	1.1	4.0	2.0	1.5	1.1	2.3	1.05	60.5	247.7	56.8	361.0	156.3
2018	1.4	4.0	2.0	1.4	1.3	2.4	1.05	61.3	273.3	62.1	365.2	164.0
2019	1.6	4.0	2.0	1.4	1.6	2.2	1.05	61.3	292.0	64.8	376.5	164.3
annual change, *%*												
2015							*-16.5*	*59.1*	*-6.3*	*-47.0*	*-30.2*	*-17.1*
2016							*0.0*	*10.0*	*-26.7*	*-16.4*	*-10.9*	*-8.1*
2017							*-5.4*	*-9.8*	*23.3*	*29.4*	*20.6*	*1.9*
2018							*0.0*	*1.3*	*10.3*	*9.3*	*1.2*	*4.9*
2019							*0.0*	*0.0*	*6.8*	*4.3*	*3.1*	*0.2*

** Average for the year.*

*** Average weighted by volume, excluding oil*

3.2 PRICES

Headline inflation will continue to fall over the forecast period and remain within the announced target ranges: 8% ± 2 pp in 2017, 6% ± 2 pp in 2018, and 5% ± 1 pp in 2019. As projected previously, inflation will deviate from the mid-point of the target range only this year. Inflation is projected at 9.1% by end-2017 as a result of increasing domestic demand and higher production costs, prompted by the doubling of the minimum wage in early 2017.

This will put additional pressure on the main inflation components in 2017: core inflation will rise to 6.5%, while raw food inflation will rise to 7.8%. Growth in food prices will be driven by rising global prices for agricultural products, as well as the opening of new markets for some Ukrainian food products. Among inflation components, administered prices will show the highest growth rates, mainly due to a rise in global energy prices and Ukraine's excise policy.

Prudent fiscal and monetary policies will help curb inflation in the medium term. Against this backdrop, core inflation will stabilize at approximately 4% while food inflation will fall to below 4%, disregarding the effects of possible supply shocks.

Core inflation is expected to **accelerate** to 6.5% in 2017 from 5.8% in 2016. Increased household incomes and higher production costs on the back of the minimum wage hike early this year are still the main drivers along with secondary effects of higher raw food inflation.

A reduction in imported inflation on the back of low exchange rate volatility, above-equilibrium unemployment rates, a relatively tight monetary policy, and below-potential aggregate consumer demand are factors holding back core inflation.

Over the medium term core inflation is expected to fall to 4.3% in 2018 and below 4% in 2019. Imported inflation is expected to be low, driven by the low-inflation environment in Ukraine's main trade partners and acceptable volatility of the nominal exchange rate.

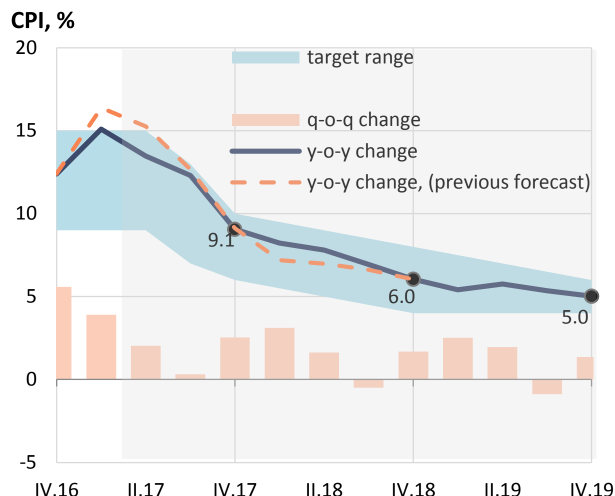
Raw food inflation will increase to 7.8% in 2017. This is mostly related to the opening of new export markets for Ukrainian food products (dairy products, in particular), which limits domestic supply and consequently exerts upward pressure on prices. At the same time, growth in household nominal incomes will keep food inflation above the previous year's level.

As forecasted earlier, the wearing-off of supply factors related to redirecting exports from other countries (particularly Turkey) to Ukraine will be an additional factor behind an upward adjustment in domestic food prices.

In 2018-2019, raw food inflation is expected to be close to 4%, mostly due to a gradual growth in global food prices. Nevertheless, high crop yields, resulting from investment in agriculture, will contain food inflation over the mid-term.

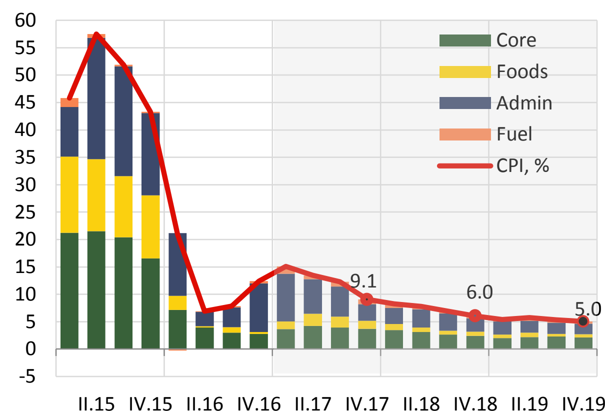
Growth in administered prices will slow down on the forecast horizon, although their growth rates will outpace other components (16% in 2017, 11.6% in 2018, below 10% in 2019), making it the largest contributor to the CPI change.

CPI, %



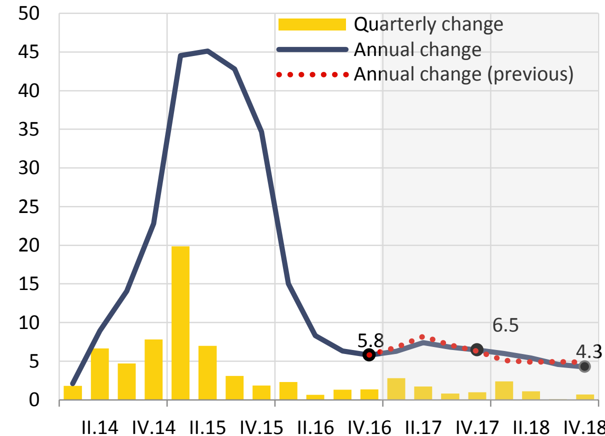
Source: SSSU, NBU staff estimates

Contribution to Annual Growth of CPI, pp



Source: SSSU, NBU staff estimates

Core Inflation, %



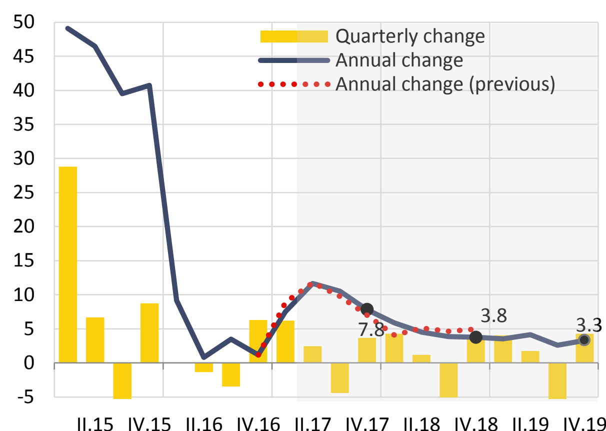
Source: SSSU, NBU staff estimates

Higher prices for imported fuels, impacting tariffs for gas, central heating and hot water for households, remain a major factor behind their increases. Under the current forecast, natural gas prices for households and thermal power producers will be reviewed semi-annually[36]. This schedule also determines the timing and the magnitude of reviews of central heating and hot water prices.

Increases in excise duties on tobacco and alcohol in the coming budget periods will be the main driver of rising prices for these products (up by 20% and 13%, respectively, in 2017 and 13% and 10%, respectively, in the years to come). Ukraine has undertaken to harmonize tobacco excise duties with those in the EU.

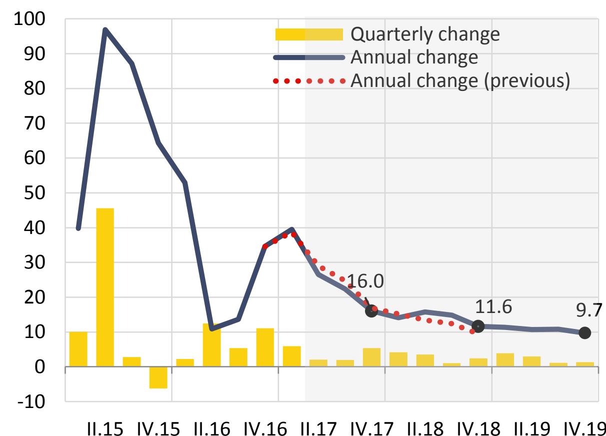
Fuel prices are forecast to rise by 17.5% in 2017, driven by higher global crude oil prices. Looking ahead, fuel prices will continue to reflect changes in global oil prices in hryvnia equivalent, taking into account tax policy adjustments.

Raw Food Inflation, %



Source: SSSU, NBU staff estimates

Administered Prices, %



Source: SSSU, NBU staff estimates

[36] According to Resolution No. 90 of the Cabinet of Ministers of Ukraine of 21 February 2017.

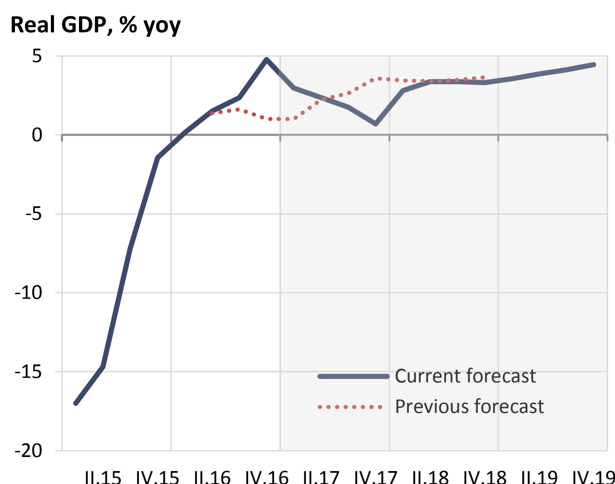
3.3. THE REAL ECONOMY

In 2017, economic growth is expected to slow down to 1.9% as production in several sectors declines after the closure of the territory across the line of contact in Donetsk and Luhansk oblasts for freight traffic and following the seizure of enterprises located in the uncontrolled territories.

The need to shift to imported raw materials to replace the lost resource base in the energy sector and metallurgy, as well as the loss of production capacities in export-oriented industries, substantially reduces the contribution of net exports to GDP growth. Net exports are expected to subtract -3 pp in the current year (-1.5 pp in the previous forecast), which is the key factor behind a revision of the real GDP growth forecast for 2017.

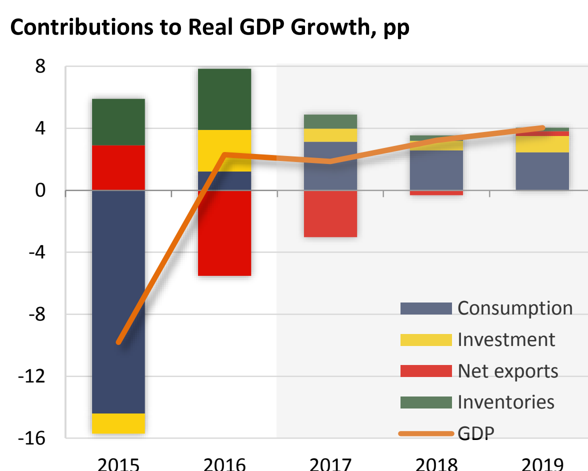
Economic growth will accelerate to 3.2% in 2018 and 4.0% in 2019amid a reasonably robust growth in consumer and investment demand, higher exports owing to improved terms of trade, strong crop yields. Another contributing factor will be solving the problems with raw material supplies caused by the haulted freight traffic across the line of contact in Donetsk and Luhansk oblasts. The contribution of net exports to GDP growth will be close zero in 2018 and 2019 as growth of domestic demand and capital investments will mostly be covered by imports.

Real GDP, % yoy



Source: SSSU, NBU staff estimates

Contributions to Real GDP Growth, pp

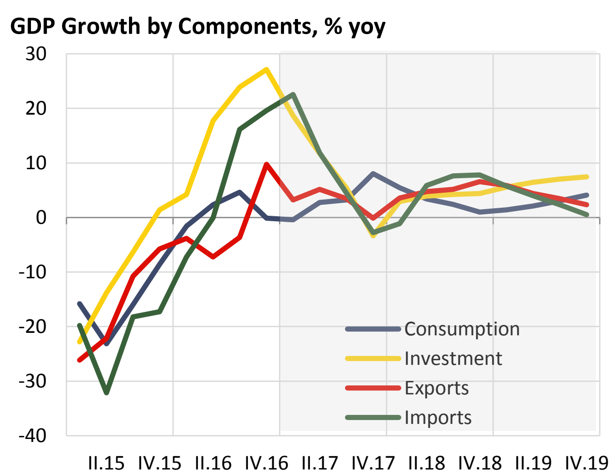


Source: NBU staff estimates

Private consumption will be the major driver of economic growth on the forecast horison. It is projected to rise by 4.9% in 2017 and 3.4% in 2018. The growth will be supported by a substantial increase in real wages (including the doubling of the minimum wage) and improved consumer sentiment. However, the government has recently began pursuing a gradual reduction of energy subsidies by reducing qualifying levels, which, within limits of incomes available to households, will restrain the growth of private consumption. Over the medium term, the easier monetary policy will reduce interest rates, spurring lending and private consumption.

In 2017, the growth of investment into the Ukrainian economy will slow down to 5.7% as a result of higher labor costs and the statistical effect of a high comparison base after the previous year's increase of 20.1%. Investments will be mostly directed into agricultural and mining industry enterprises (in particular into the production of coke and coking and gas coal) which may act as alternative suppliers of goods obtained from the certain areas of Donetsk and Luhansk oblasts. The launch of projects aimed at reducing the use of anthracite coal in the energy industry will also support the growth of capital investment. Over the medium term, investment will grow at a moderate pace, up to 7% annually.

GDP Growth by Components, % yoy



Source: SSSU, NBU staff estimates

Capital goods imports, in particular imports of machinery and equipment, will lead investment imports. Household demand for imported goods will also grow as real incomes areforecast to increase.

However, the transport blockade across the front line of the ATO zone and the subsequent resolution by the National Security and Defense Council of Ukraine to halt the freight traffic across the line of contact in Donetsk and Luhansk oblasts were the major reason for raising the forecast for import volumes to 8% (from 7% in the previous forecast) in 2017 and 5% (from 3.9%) in 2018. Additional imports will be needed to replace some goods supplied from the uncontrolled territories.

This will mostly impact energy imports, which will be driven higher by a shift to external supplies of coal and further economic growth. Gas imports will also increase to fill underground storage facilities. Over the medium term, the decline in energy imports will be determined by the implementation of energy-saving solutions, as well as by an increase in the domestic production of primary energy resources.

Real exports will rise by 2.9% in 2017, returning to growth for the first time after a five-year recession. Agricultural exports will be the major driver of the recovery. However, the forecast for exports growth was lowered from the previous Inflation Report (5.4%) in light of problems in metallurgy, caused by the halted freight traffic across the line of contact in Donetsk and Luhansk oblasts and the seizure of enterprises located in the uncontrolled territories. At the same time, surplus of iron ore not consumed domestically is expected to be exported.

As early as in 2018, export-oriented enterprises are expected to fully shift away from products from the certain areas of Donetsk and Luhansk oblasts, which will allow Ukrainian companies to recover lost metallurgic production, thus contributing to export growth. Over the medium-term, favorable external economic conditions and high grain and oilseed yields will also contribute to export growth (by 5% in 2018 and by 4% in 2019).

Potential GDP and the Cyclical Position of Ukraine's Economy

In Q1 2017, potential GDP resumed growing yoy and will accelerate to 2.5% by the end of 2018. Growth in total factor productivity remains the main driver, enabled by progress in structural reforms and the convergence of Ukraine's economy with developed economies. Moreover, the expected impact of productivity was reinforced by improved global conditions for Ukrainian exports.

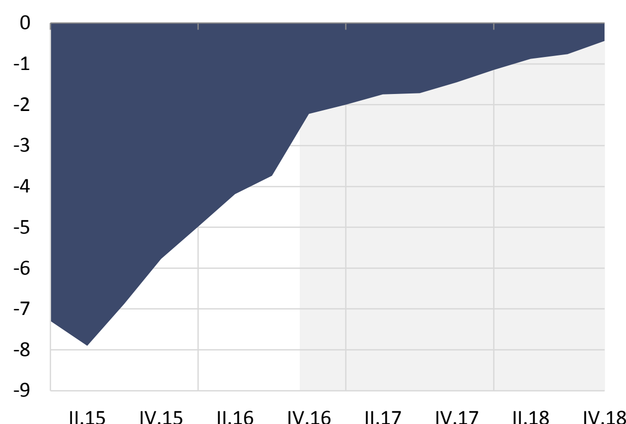
Growth will be restrained by the effect of the halted freight traffic across the line of contact in Donetsk and Luhansk oblasts. The seizure of enterprises in the certain areas of Donetsk and Luhansk oblasts and the forced change in logistical networks for enterprises in the controlled territory will dampen potential output growth in 2017, although in 2018 the growth will resume.

Insufficient levels of available capital will continue to partially restrain growth in potential GDP. Investment activity that surprised positively in the latter part of 2016 mitigated the negative effect of this factor, but we continue to expect fixed capital formation to remain slightly below the level of depreciation. Accordingly, the level of capital in real terms will continue to decrease.

Unfavorable demographics, including migration, is another constraint. At the same time, structural labor market imbalances will determine a high natural rate of unemployment.

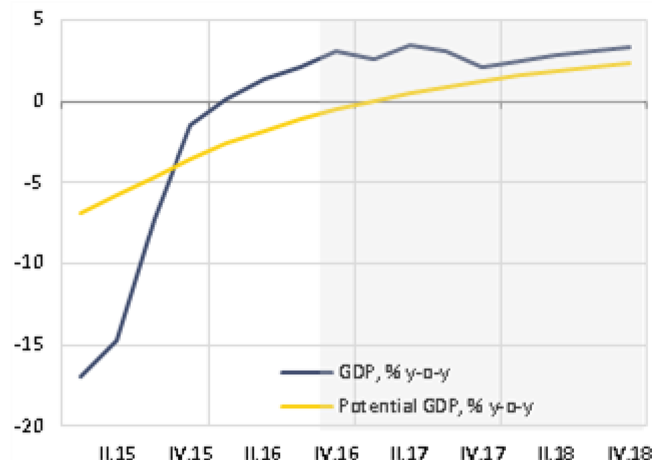
The estimate of the output gap in Q4 2016 was improved to -1.3% (from -2.2% in the previous report). This revision was the result of higher-than-expected output growth and a revision of actual data for the previous periods by the State Statistics Service of Ukraine. The negative gap widened to -2.8% in Q1 2017 as a result of the halted freight traffic across the line of contact in Donetsk and Luhansk oblasts, although it should narrow gradually on the forecast horizon. Such a contraction of the negative GDP gap is related to the fading of the abovementioned effect, the

GDP Gap, %



Source: NBU staff estimates

Potential GDP, % yoy



Source: SSSU, NBU staff estimates

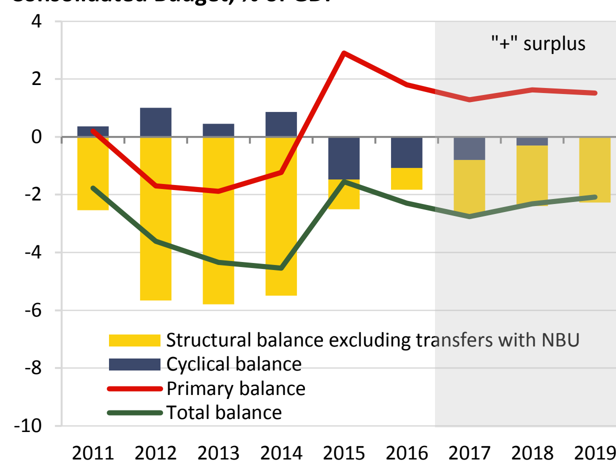
revival of investment and consumer demand, and easing of fiscal and monetary policy.

Fiscal policy will be eased in 2017, as indicated by the expected growth of the structural deficit. Fiscal stimulus will impact aggregate demand through growth in private consumption, primarily due to an increase in the minimum wages. Over the mid-term, a further easing of fiscal policy will be limited to the need to keep the general government sector (GGS) deficit inline with obligations to the IMF.

This year, the GGS budget deficit will remain within 3% of GDP. Given a high debt servicing burden on the budget (4% of GDP), the consolidated budget will have a primary surplus of over 1% of GDP.

Growth in consolidated budget revenues will exceed headline inflation. The NBU expects the largest increases to be in individual income tax and excise duty revenues. Given that the Government of Ukraine anounced allocation of funds to road construction, capital expenditures will also grow, but they will still be restrained by the overall budget deficit ceiling as well as by increased labor costs and other social spending (such as utility subsidies for households). Over the forecast horizon, the quasi-fiscal needs from the banking sector and the DGF will be moderate. Naftogaz of Ukraine NJSC will not require any budget financing as utility prices are adjusted to cost recovery levels.

Consolidated Budget, % of GDP



Source: NBU staff estimates

3.4. BALANCE OF PAYMENTS

The current account deficit as a percentage of GDP is projected to widen slightly in 2017 followed by a subsequent gradual reduction in 2018-2019 (the nominal deficit will remain almost unchanged in 2017-2019). The balance of trade will be mostly affected by halted freight traffic of commodities across the line of contact in Donetsk and Luhansk oblasts. The NBU estimates the net effect of the ban at USD 1.8 billion in 2017. The trade balance will also be adversely affected by the continued growth of investment demand, mostly driven by the agriculture sector, and consumption demand as a result of a gradual increase in real disposable income of households. Improved terms of trade and higher grain and oilseed yields will partially offset these factors.

As in previous years, in 2017 a reduction in FX cash outside banks will drive net capital inflows in the financial account. In 2018-2019, this reduction is projected to decelerate while FDI and debt capital inflows to the private sector should resume. Moreover, as access is gained to international capital markets, the government is expected to issue Eurobonds, which would enable it to refinance a portion of public debt, whose repayments are scheduled to peak in 2019.

As a result, in 2017-2018 the overall balance of payments surplus combined with financing received from the IMF will increase international reserves to USD 26.2 billion (or 5.1 months of future imports) as of the end of 2018. In 2019, though, international reserves will decrease to USD 25.1 billion, or 4.7 months of future imports, due to large public debt repayments.

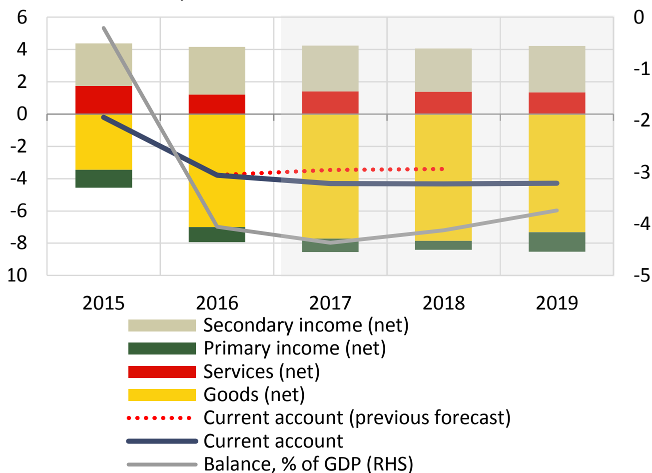
In 2017, the current account deficit is expected to reach 4.2% of GDP (or USD 4.3 billion). The halted freight traffic from companies located in the certain areas of Donetsk and Luhansk oblasts will reduce exports and increase imports. However, this effect will be partly offset by higher global commodity prices and higher grain yields. In the meantime, machinery imports will continue growing rapidly to meet the need of fixed asset replacement. In addition, dividend repatriation is projected to grow as a result of the continued gradual liberalization of the capital flows.

For the first time since 2012, goods exports are expected to grow in 2017 (by 11.2%) across most categories of goods, primarily owing to further price increases in commodity markets.

Ore exports will grow the most (by 41%) in the composition of commodity exports in 2017 since additional volumes were released due to the halt in supplies to metallurgy companies located in the certain areas of Donetsk and Luhansk oblasts. At the same time, growth in metallurgy exports will slow to 5.9%, driven by a volume decrease (by 12.2%) caused by the seizure of plants in the certain areas of Donetsk and Luhansk oblasts and lower production at plants located in Ukraine controlled territory . Food exports will grow (by 8.6%) as sugar and other food exports increase after new markets – Asia in particular – were opened in 2016, also reflecting increased grain exports. In addition, machinery exports are expected to grow as exports will be shifted away from Russia to other markets.

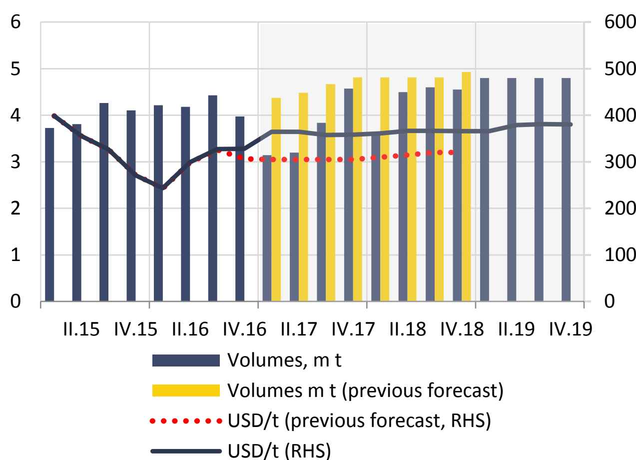
In 2017, merchandise import growth is also expected to accelerate (by 11.0%) due to both energy and non-energy imports. The increase in energy imports (by 33.5%) will be driven by higher

Current Account, USD bn



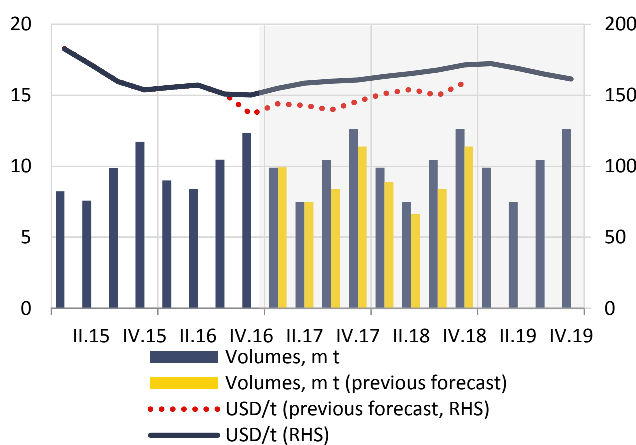
Source: NBU

Ferrous Metals Exports (four main sub-groups)



Source: NBU

Grains Exports



Source: NBU

imports of coal and coke to replace supplies from the certain areas of Donetsk and Luhansk oblasts, as well as by higher prices for oil products and gas. Machinery products will remain the main driver in non-energy imports, largely owing to a high demand from agricultural companies. In addition, food imports are also projected to grow as consumer demand gradually rebounds.

Compared to the previous forecast, the growth rate of merchandise exports was increased by 2 pp owing to better terms of trade, larger volumes of ore supplies, and higher grain yields, despite a reduction in volumes of ferrous metals exports. At the same time, the forecast for growth of merchandise imports was raised by 3.7 pp, reflecting increased coal volumes , higher prices for energy resources, and a faster recovery of investment demand.

Growth in services exports will contribute to a higher services trade surplus (by 5.7%). This will primarily be driven by a further rise in exports of IT services as registration procedures have been simplified. In addition, both exports and imports of transportation services will rise as a result of the increased trade turnover. This will boost total services imports (up 4.7%).

In 2017, private remittances are expected to grow by 2.8% yoy due to an increased number of migrant workers, primarily to the EU and the US. The NBU estimates that Russia's ban on money transfers to Ukraine via international payment systems will not significantly impact amounts transferred. Most remittances from Russia will be redirected via banks, payment systems of the third countries, and informal cash transfer channels. In addition, the repatriation of dividends accrued to foreign investors over 2014-2016 was incorporated in the forecast, with payments evenly distributed over time. At the same time, interest payments will decrease slightly as the share of the private sector in external debt reduced, which can negotiate higher interest rates compared with the public sector.

The current account deficit is projected to narrow gradually to 4.1% of GDP in 2018 and 3.7% in 2019 (or USD 4.3 billion) as export potential of Ukraine's economy increases.

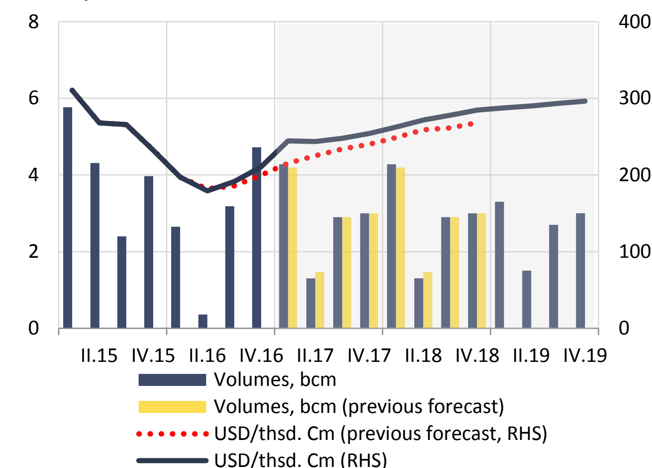
In 2018-2019, merchandise export growth will be driven by a further rebound in prices and increased volumes. Metallurgy companies located in Ukraine controlled territory will boost output by re-establishing their production chains as well as by partially fulfilling contracts previously carried out by plants in territory not controlled by Ukraine. In addition, food exports to Asia will expand. Exports of other groups of goods will expand thanks to faster economic growth in Ukraine's main trading partner countries (MTPCs).

Imports of goods will grow in 2018-2019 on the back of both non-energy and energy imports. High consumer and investment demand caused by acceleration of economic activity in Ukraine will prompt growth in non-energy imports. Energy imports will increase as prices gradually rise.

In 2018-2019, exports and imports of services will continue rising due to a recovery in trade turnover and business activity. An increase in the number of migrants working abroad will further boost private remittances.

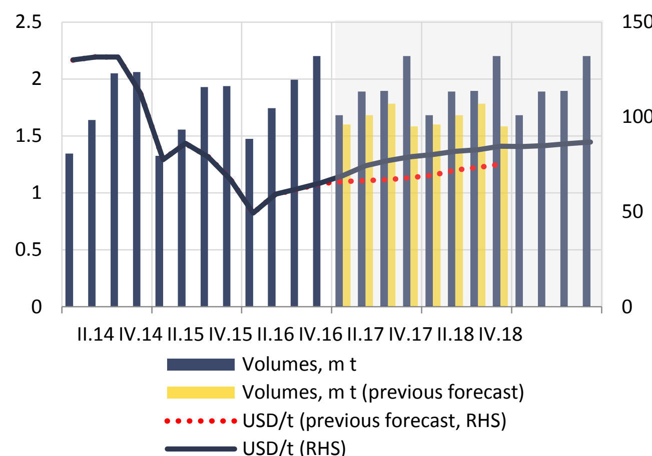
The forecast of net capital inflows of the financial account, at

Gas Imports



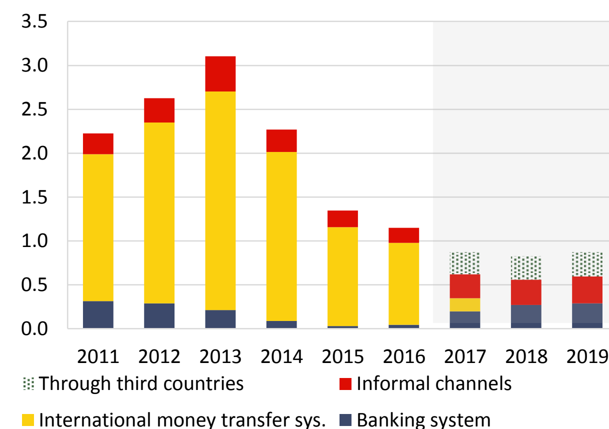
Source: NBU

Oil Products Imports



Source: NBU

Private Remittances from Russia by Channels, USD bn



Source: NBU

USD 5.0 billion for 2017, barely changed from 2016. Capital inflows will largely result from a reduction in FX cash outside banks (USD 3.0 billion) on the back of a stable FX market and improved consumer sentiments.

FDI is projected to remain flat (USD 1 billion) in 2017, excluding debt-to-equity operations in banking sector.

In 2017, the private sector is not expected to regain full access to external capital markets. Thus, banks and the real sector will continue to repay outstanding debts from past years. As a result, the private sector's rollover rate for long-term external debt will stand at 90% with net debt capital outflows estimated at USD 0.4 billion.

In addition, two loans with a cumulative total of USD 1.3 billion are expected to be received from the EU and USD 0.3 billion from other donors.

As a result, in 2017, the overall balance of payments surplus (USD 0.7 billion) coupled with net inflows from the IMF under the EFF program (USD 4.6 billion) will increase international reserves to USD 21.1 billion, or 4.2 months of future imports.

Financial account inflows are forecast to increase to USD 7.5 billion in 2018 owing to a better investment climate: both FDI and debt capital inflows will grow. As a result, the rollover rate for long-term private debt will rise to 100%, and FDI – to USD 2.2 billion, with the real sector remaining the largest FDI recipient . FX cash outside banks will decrease (to USD 2.2 billion), however such an amount to remain comparable with investment capital inflows.

In 2018, the Government is expected to issue Eurobonds worth USD 2 billion for the first time since the start of the crisis.

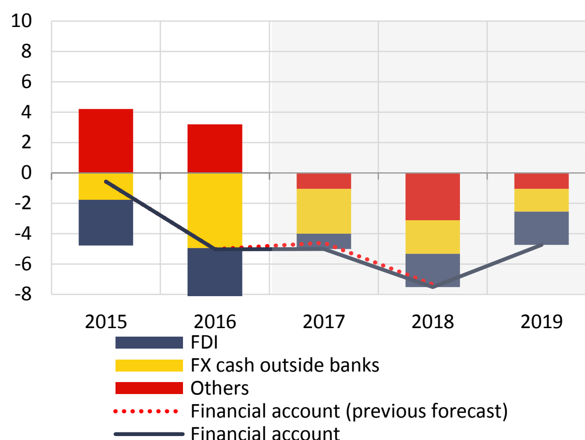
The overall balance of payments surplus (USD 3.2 billion) and net inflows from the IMF (USD 1.8 billion) paid under the EFF will increase international reserves to USD 26.2 billion (or 5.1 months of future imports), close to 92% of the IMF's composite measure for reserve adequacy.

Net financial account inflows are forecast to drop in 2019 (to USD 4.8 billion), as a large portion of government debt falls due. A further Eurobonds issuance by the government will help refinance these payments.

At the same time, a favorable investment climate will allow the private sector to continue attracting more FDI and debt capital. This will compensate the gradual reduction in FX cash selling by the population.

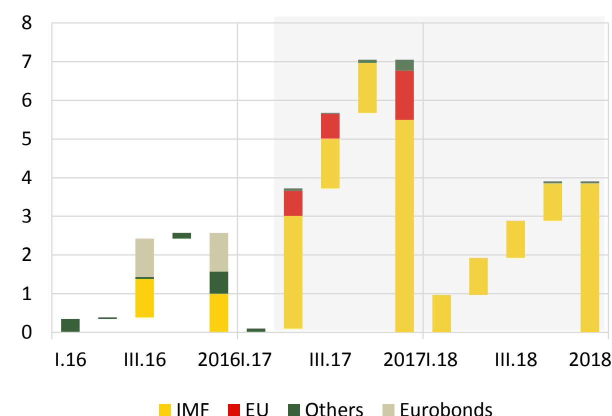
Despite the overall balance of payments surplus (USD 0.5 billion), in 2019 international reserves will decrease to USD 25.1 billion (or 4.7 months of future imports) due to a repayment of the IMF loan (USD 1.6 billion).

Financial Account, USD bn



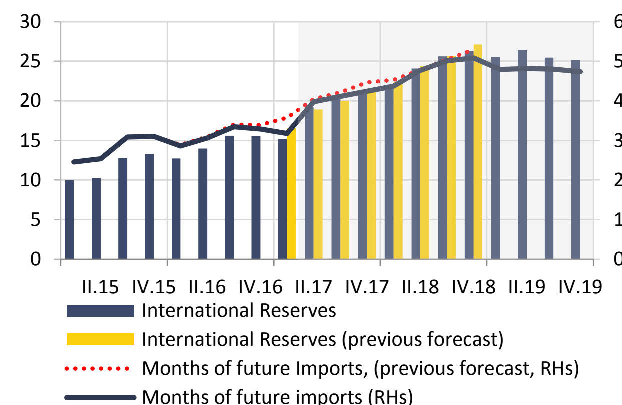
Source: NBU

Official Financing in 2016-2018, USD bn



Source: NBU

Gross International Reserves, USD bn



Source: NBU

3.5. MONETARY SECTOR AND FINANCIAL MARKETS

The regulator expects to moderately ease monetary policy further in 2017. At the same time, since the publication of the previous forecast, growth prospects have deteriorated as military operations in Eastern Ukraine have intensified and trade with the east has been suspended. These developments are reflected in the downgrade to the forecast for net FX purchases for replenishment of international reserves. Also, against the background of a slower economic recovery, the projected annual growth rates of the deposit and cash components of money supply will be lowered from the previous forecast. The banking system will continue to record a liquidity surplus, mainly amid the NBU FX purchases aimed to replenish international reserves.

The money supply is forecast to grow by 10.7%. The gradual development of the banking system and an increase in cashless payments will raise the money multiplier. Deposits are projected to grow further, both in hryvnia and foreign currency,outpacing growth of cash outside banks (12.9% versus +5.2%) in 2017.

In Q1 2017, monetary aggregates underperformed projections due to dynamics of cash outside banks. With expectations deteriorating temporarily on the back of the situation with CB PrivatBank PJSC, cash volumes grew at the end of last year. However, following the resolution of that situation, the banking system began to rapidly absorb hryvnia cash. Seasonal factors will lead to a gradual pick-up in demand for hryvnia cash.

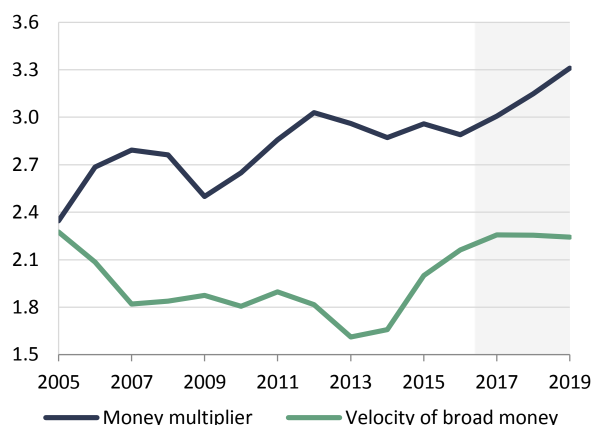
The monetary base is expected to increase by around 6%, driven by cash outside banks and stocks of bank's correspondent accounts.

Amid the surplus of liquidity in the banking sector, issuance of NBU CDs will remain the main tool for managing interbank interest rates. The NBU's FX purchases to replenish international reserves will be the main channel of the banking system's liquidity surplus. In the meantime, liquidity will be absorbed through government debt repayments on securities to the NBU as they reach maturity.

In 2018-2019, monetary policy will aim at maintaining the disinflation trend and keeping inflation within the target range. The easing of monetary conditions will depend on assessments of the risks to price stability and inflation expectations. Monetary conditions will also depend on prudent fiscal policy over the coming years.

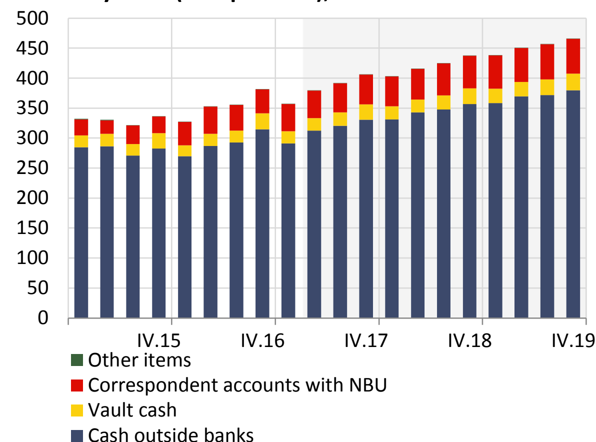
The money supply is forecast to increase by 13% in 2018 and 12% in 2019 owing to deposit and cash components. The development of the banking system and especially cashless payments will further boost the money multiplier. Under these conditions, the growth rate of the monetary base in 2018-2019 (8% and 7%) will lag behind the growth of money supply.

Money Multiplier and Money Velocity



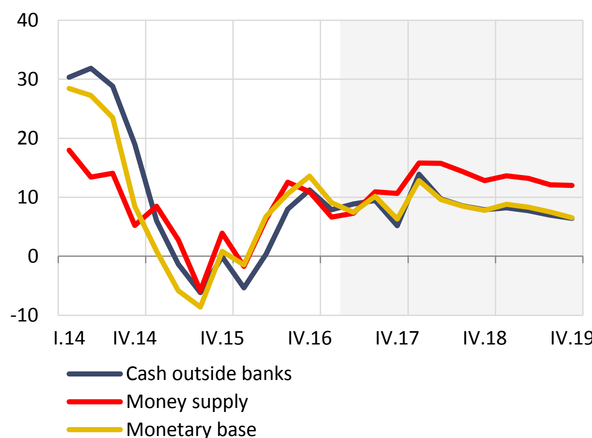
Source: NBU

Monetary Base (Components), UAH bn



Source: NBU

Monetary Indicators, % yoy



Source: NBU

3.6. RISKS TO THE FORECAST

As in the previous forecast, the risks to the forecasts for economic growth and inflation are balanced, but internal and external risks have opposing effects.

The major internal risk is related to the the efficiency of implementation of adjustment mechanismsto minimize losses from the halted freight traffic from companies located in the certain areas of Donetsk and Luhansk oblasts. This risk is related to both the private sector (mainly large business, including metallurgy and energy industry companies) and public administration bodies, whose regulatory and strategic decisions will determine the extent and pace of the economy's adaptation to the suspension of trade with the areas not under Ukraine's control. In addition, there is a significant risk of escalation of the military conflict in Eastern Ukraine.

There is also considerable uncertainty over the implementation of macroeconomic policy and structural reforms required to preserve macro-financial stability, boost the economy's potential and continue the program with the IMF. Ineffective reforms will push risk premiums up, causing a deterioration of inflation and exchange rate expectations, and raising inflationary pressure.

In the fiscal sector, there is a risk that raising social standards by the government will be larger than the level consistent with the meeting of the inflation targets, taking into consideration growth in labor productivity in the economy. Such a fiscal policy will lead to a decline in public investment, causing the current account deficit to widen and enlarging the debt burden, simultaneously weakening external competitiveness and affecting economic agents' perceptions of exchange rate prospects. One of the characteristics of a prudent fiscal policy will be compliance with budget parameters and ensuring that proceeds from privatization cover as much of the deficit as possible.

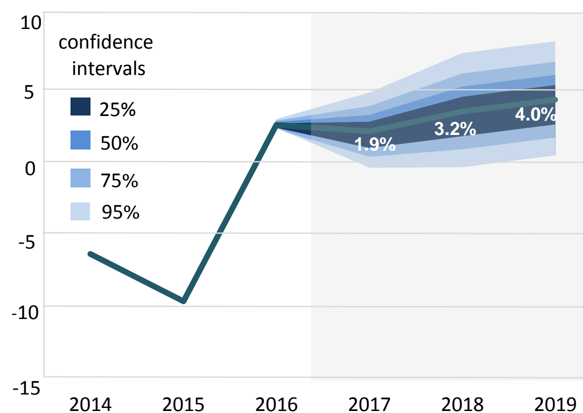
Another risk arises due to changes in government policy on household subsidies, which would impact aggregate demand in the economy and inflationary pressure resulting from rising real disposable incomes of households.

Additional uncertainty arises from increases in administered prices, particularly for natural gas (the separation of gas transportation and distribution costs from the price of gas as a commodity) and electricity prices.

External risks are mostly related to uncertainty caused by global commodity prices that surged in a relatively short time span in response to the fiscal stimulus plan announced by US President Donald Trump. However, expectations for a quick implementation of the plan are turning more cautious, which threatens to undermine the recent upward trend in commodity prices. In this context, declining commodity prices would reduce export proceeds, putting a drag on the country's balance of payments and economic performance.

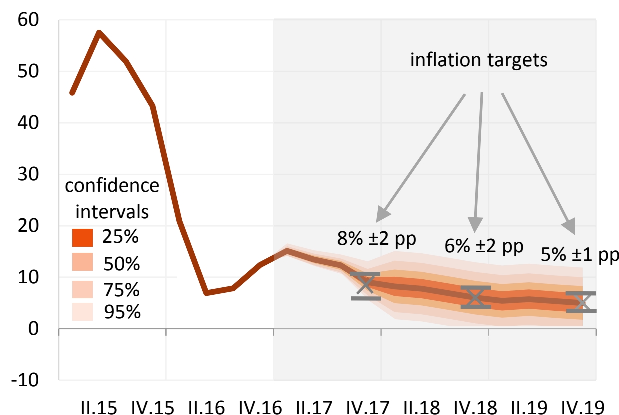
In case the Fed opts to tighten monetary policy in response to fiscal stimulus in the US, emerging market currencies could weaken significantly against the US dollar. This could also weaken demand for Ukrainian exports in major trading partners, which would create additional pressure on the hryvnia's REER. On the other hand, the effect would be offset by higher commodity prices as a direct result of the US fiscal stimulus package, with a corresponding positive impact on the balance of payments.

Real GDP Growth, % yoy



Source: NBU

CPI Growth Forecast and Targets, % yoy



Source: NBU

Political uncertainty has intensified in Europe, particularly over the results of the presidential elections in France and federal elections in Germany. A growing list of domestic problems and mounting discontent with government policies in the EU is playing into hands of political forces that until recently had no chance of success. In addition, uncertainty persists over Brexit proceedings. The uncertainty is related to the extent of disintegration, which will determine the free movement of people across the border, as well as trade conditions with Britain’s partners in the EU. Protectionist and nationalist sentiment dominating in Europe and the US could hinder effective international cooperation, slowing Ukraine's integration into Western and European society and prompting investors to adopt a more cautious attitude.

At the same time, global commodity markets may be more volatile due to a risk of conflict escalation in the Middle East and the current aggravated situation on the Korean peninsula. In this case, investors would become risk averse towards emerging markets, driving capital outflows. Under this scenario, Ukraine’s economic growth rate could decline and the competitiveness of Ukrainian goods could weaken amid a depreciation of the currencies of Ukraine’s MTPs.

If these and other risks materialize over the forecast period, actual inflation may deviate from the projected path, prompting the appropriate policy response from the NBU.

Indicators	2014	2015	2016	2017						2018						2019					
				I	II	III	IV	current forecast	forecast 01.2017	I	II	III	IV	current forecast	forecast 01.2017	I	II	III	IV	current forecast	forecast 01.2017
REAL ECONOMY, % yoy, unless otherwise stated																					
Nominal GDP (SNA'2008), UAH bn	**1587**	**1989**	**2383**	544	625	778	808	**2755**	2739	615	704	878	908	**3106**	3081	684	782	979	1015	**3460**	-
Real GDP	**-6.6**	**-9.8**	**2.3**	3.0	2.4	1.8	0.7	**1.9**	2.8	2.8	3.4	3.4	3.3	**3.2**	3.0	3.6	3.9	4.1	4.5	**4.0**	-
GDP Deflator	**15.9**	**38.9**	**17.1**					**13.5**	13.0					**9.2**	9.2					**7.1**	-
Consumer prices (period average)	12.1	48.7	13.9	-	-	-	-	12.4	13.3	-	-	-	-	7.4	6.8	-	-	-	-	5.5	-
Producer prices (period average)	17.1	36.0	20.5	-	-	-	-	25.1	18.3	-	-	-	-	9.6	9.7	-	-	-	-	8.0	-
Consumer prices (end of period)	**24.9**	**43.3**	**12.4**	3.9	2.0	0.3	2.5	**9.1**	9.1	3.1	1.6	-0.5	1.7	**6.0**	6.0	2.5	2.0	-0.9	1.4	**5.0**	-
Core inflation (end of period)	22.8	34.7	5.8	2.8	1.7	0.8	1.0	6.5	6.3	2.4	1.1	0.1	0.7	4.3	4.8	1.6	1.5	0.2	0.4	3.7	-
Non-core inflation (end of period)	26.8	50.9	18.3	5.4	2.5	-0.3	4.6	12.5	11.6	4.1	2.3	-1.2	3.0	8.4	7.1	3.7	2.6	-2.3	2.7	6.8	-
raw foods (end of period)	23.2	40.7	1.2	6.2	2.4	-4.4	3.7	7.8	7.0	4.3	1.2	-5.0	3.6	3.8	5.0	4.1	4.3	0.0	0.0	3.3	-
administrative prices (end of period)	29.0	64.4	34.6	5.9	2.0	1.9	5.3	16.0	16.9	4.2	3.5	1.1	2.4	11.6	9.5	3.9	3.0	1.1	1.3	9.7	-
Producer prices (end of period)	**31.8**	**25.4**	**35.7**	6.4	3.2	1.3	0.8	**12.2**	10.2	3.2	3.7	1.5	1.0	**9.7**	9.6	1.9	3.3	1.3	1.1	**7.9**	-
FISCAL SECTOR																					
Consolidated budget balance, UAH bn	**-72.0**	**-30.9**	**-54.8**	-	-	-	-	**-76.8**	-78.7	-	-	-	-	**-72.6**	-85.8	-	-	-	-	**-72.4**	-
% of GDP	-4.5	-1.6	-2.3	-	-	-	-	-2.8	-2.9	-	-	-	-	-2.3	-2.8	-	-	-	-	-2.1	-
Public sector fiscal balance (IMF methodology), UAH bn	**-70.3**	**-17.0**	**-50.3**	-	-	-	-	**-79.3**	-81.0	-	-	-	-	**-74.8**	-88.1	-	-	-	-	**-77.8**	-
% of GDP	-4.4	-0.9	-2.1	-	-	-	-	-2.9	-3.0	-	-	-	-	-2.4	-2.9	-	-	-	-	-2.2	-
General government and Naftogaz financing, UAH bn	-157.6	-37.5	-50.3	-	-	-	-	-79.3	-81.0	-	-	-	-	-74.8	-88.1	-	-	-	-	-77.8	-
General government and Naftogaz financing, % of GDP	-9.9	-1.9	-2.1	-	-	-	-	-2.9	-3.0	-	-	-	-	-2.4	-2.9	-	-	-	-	-2.2	-
BALANCE OF PAYMENTS (NBU methodology)																					
Current account balance, USD bn	-4.6	-0.2	-3.8	-1.4	-0.5	-1.7	-0.8	-4.3	-3.5	-1.6	0.0	-1.5	-1.3	-4.3	-3.4	-1.2	0.0	-1.8	-1.3	-4.3	-
Financial account balance, USD bn	9.1	-0.6	-5.0	-0.8	-1.6	-1.7	-0.9	-5.0	-4.6	-1.9	-1.7	-2.6	-1.4	-7.5	-7.3	-1.0	-1.4	-1.4	-1.1	-4.8	-
BOP overall balance, USD bn	**-13.3**	**0.8**	**1.3**	-0.6	1.1	0.0	0.2	**0.7**	1.1	0.3	1.7	1.1	0.2	**3.2**	4.0	-0.2	1.4	-0.4	-0.3	**0.5**	-
Gross reserves, USD bn	**7.5**	**13.3**	**15.5**	15.1	19.1	20.1	21.1	**21.1**	21.3	21.8	24.0	25.5	26.2	**26.2**	27.1	25.4	26.3	25.3	25.1	**25.1**	-
Months of future imports	**1.8**	**3.1**	**3.3**	3.2	4.0	4.1	4.2	**4.2**	4.5	4.4	4.8	5.0	5.1	**5.1**	5.3	4.8	4.8	4.8	4.7	**4.7**	-
Export of goods, % yoy	-14.5	-29.9	-5.2	21.2	3.5	12.4	9.6	11.2	9.2	5.9	11.4	7.3	2.5	6.5	4.1	7.5	4.6	3.4	4.8	5.0	-
Import of goods, % yoy	-29.0	-32.6	4.4	18.3	14.9	9.1	4.5	11.0	7.6	5.7	4.9	5.8	6.4	5.7	4.3	0.7	2.8	4.7	3.5	3.0	-
MONETARY ACCOUNTS (Cumulative since the beginning of the year)																					
Monetary base, %	**8.5**	**0.8**	**13.6**	-6.5	-0.7	2.5	6.3	**6.3**	7.7	-0.7	2.4	4.6	7.8	**7.8**	8.2	0.2	2.9	4.4	6.5	**6.5**	-
Broad money, %	**5.3**	**3.9**	**10.9**	-2.6	0.8	6.0	10.7	**10.7**	11.5	1.9	5.5	9.6	12.8	**12.8**	13.3	2.6	5.8	8.9	12.0	**12.0**	-
Velocity of broad money (end of year)	**1.66**	**2.0**	**2.2**	-	-	-	-	**2.3**	2.2	-	-	-	-	**2.3**	2.2	-	-	-	-	**2.2**	-