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*Disclaimer. This is a translation of the original Ukrainian version of the Macroeconomic Radar July issue from 16.07.2020.*

Over the last month, changes in macroeconomic forecasts were concerned primarily with the key policy rate. As we noted last time, market participants traditionally lag behind the decisions of the NBU. Thus, only now they have significantly revised down their forecasts after June's key policy rate cut to 6%. At the same time, all available macroeconomic forecasts were published before the resignation of NBU Governor - Mr. Smoliy, which shocked the Ukrainian financial markets. Following this event, a number of forecasters announced an increase in exchange rate risks towards a more significant devaluation. Besides, due to uncertainty about the policy of the new Governor, as well as, growing turbulence on the financial markets, several organizations are no longer betting on further lowering of the NBU policy rate during next week's monetary policy meeting.

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## **The economy continues to recover from the April's bottom, however, the fall of GDP for the year is still expected to be significant**

Based on the monthly data from the State Statistics Service of Ukraine, Dragon Capital and ICU agree that the decline of GDP in May slowed to 10% YoY compared to 13-16% YoY in April. The estimates of the Ministry of Economy regarding the fall of GDP in January-May by 5.9% YoY go in line with such assessment. Some leading indicators suggest that the economy continued to recover in June at a fairly rapid pace. However, most forecasters expect the recovery to be gradual due to weak demand and the negative impact of other post-pandemic constraints on productivity. As before, most organizations predict that Ukraine's real GDP will fall by 5-6% in 2020 and grow by 4-5% in 2021. Next week, the NBU will publish its new macroeconomic forecast and, judging by previous statements, economic activity projections may be downgraded compared to a 5% drop in 2020 in the April forecast.

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## **Inflation forecasts are gradually declining**

Despite the acceleration of inflation in June to 2.4% YoY, the consensus forecasts for this and subsequent years continue to decline gradually, as we assumed last time. Forecasters have been increasingly taking into account the fact that the effects of weak demand and falling world energy prices outweighed other factors. At the same time, current consensus forecasts of the consumer inflation for the end of this and next years are very close to the NBU's inflation target - 5%. The NBU itself is likely to revise downward its current inflation forecast for the end of 2020 (6%) next week. At the same time, the Government's inflation forecast for this year (11.6%) looks like a "white crow" against this low-inflation background.

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## **Further cut of the key policy rate is under the threat due to the saga with the appointment of a new NBU Governor**

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The cut of the key policy rate to 6% was taken into account by forecasters in their projections at the beginning of the month. As a result, the expected level of key policy rate was reduced to 5.5% by the end of this year and to 5.7% by the end of next year. However, the resignation of Mr. Smoliy from the position of the NBU Governor and the resulting reaction of the financial markets caused the analysts of Goldman Sachs and JP Morgan to withdraw their forecast of further rate reduction in the 3rd quarter. Before Mr. Smoliy's resignation, a cut to 5% was expected. At the same time, a number of analysts, including ICU, believe that the low-inflation environment still gives the NBU reasons to lower the rate slightly. Therefore, we expect both the NBU's decision on the rate and publication of its updated forecast next Thursday. The appointment of a new Governor of the NBU and greater certainty about his position on monetary policy may have an important impact on these decisions.

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## **The projections of current account deficit are probably too conservative**

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Due to the change in the methodology of accounting of reinvested earnings and improvements in foreign trade, the current account surplus amounted to \$5.6bn in January-May this year. However, analysts are taking this into account in their forecasts so far very slowly. Despite the consensus forecasts of the current account balance have improved, the prevailing number still sticks to the view that this year Ukraine will run a current account deficit (on average - 1.3% of GDP), and next year it will even expand (to 2.1% of GDP). Analysts are likely to upgrade their forecasts of the current account balance in the coming months.

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## **The international reserves forecasts are declining and may deteriorate further**

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The inflow of official financing from the IMF and the EU, as well as the NBU's FX purchases, allowed the NBU to increase reserves to \$28.5bn at the end of June. However, consensus forecasts of international reserves have deteriorated slightly - to \$25bn at the end of this year and \$26bn at the end of 2021. Uncertainty about receiving new tranches from the IMF and freezing the already agreed tranche from the World Bank due to the resignation of Mr. Smoliy may lead to further deterioration of forecasts of international reserves. On this background, the IMF's expectations of falling reserves to \$19.3bn this year may no longer seem so unrealistic.

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## The exchange rate will strongly depend on following NBU policy

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The Government's forecast of the average exchange rate for this year (29.5 UAH/USD) also seemed completely unrealistic until recently. However, after public statements of the President of Ukraine and growing uncertainty about future NBU policy due to a change of Governor, analysts may cease to rule out such a scenario. Prior to that, forecasts were more restrained - on average, analysts expected a moderate weakening of the exchange rate - to 28 UAH/USD by the end of this year and up to 28.2 UAH/USD by the end of next year.

## Conclusions

Last time we noted that despite the coronavirus pandemic, the situation in the financial sector remains stable and the implementation of crisis scenarios is possible only in the event of a political crisis. Unfortunately, the resignation of Mr. Smoliy and uncertainty about the policy of the NBU under the new Governor significantly increased the likelihood of such a crisis scenario. The cancellation of the almost completed agreement on the placement of Eurobonds, low demand for hryvnia domestic government bonds, increasing yields on domestic and foreign government bonds are clear confirmation of this. It is still possible to remedy the situation through the appointment of a "technocratic" Chairman of the NBU, who will continue the policy of maintaining price and financial stability. How well Kyrylo Shevchenko, whose candidacy was proposed by the President and supported by the Parliament, will meet these criteria remains open. If the NBU's policies are shifted towards shorter-term political interests, the further prospects of the domestic economy will deteriorate, and the "security margin" gained in recent years will melt quickly.

Annex. Forecasts of key macroeconomic indicators of Ukraine

| Yearly forecasts         |                       |                |       |       |       |          |          |          |          |          |       |      |          |          |          |          |
|--------------------------|-----------------------|----------------|-------|-------|-------|----------|----------|----------|----------|----------|-------|------|----------|----------|----------|----------|
|                          |                       |                | 2018  | 2019  | 2020  |          |          |          |          |          | 2021  |      |          |          |          |          |
|                          |                       |                |       |       | Cons  | Gov      | NBU      | IMF      | WB       | EBRD     | Cons  | Gov  | NBU      | IMF      | WB       | EBRD     |
|                          |                       |                |       |       |       | 29.03.20 | 23.04.20 | 09.06.20 | 08.06.20 | 13.05.20 |       |      | 23.04.20 | 09.06.20 | 08.06.20 | 13.05.20 |
| Activity                 |                       |                |       |       |       |          |          |          |          |          |       |      |          |          |          |          |
|                          | Real GDP              | YoY, %         | 3,4   | 3,2   | -5,3  | -4,8     | -5,0     | -8,2     | -3,5     | -4,5     | 4,4   |      | 4,3      | 1,1      | 3,0      | 5,0      |
|                          | Nominal GDP           | UAHbn          | 3 561 | 3 975 | 3 899 | 3 986    | 3 970    | 3 908    |          |          | 4 272 |      | 4 360    | 4 277    |          |          |
|                          | Nominal GDP           | US\$bn         | 130,8 | 155,2 | 146   |          |          |          |          |          | 154   |      |          |          |          |          |
|                          | Unemployment          | %              | 8,8   | 8,2   | 10,6  | 9,4      | 9,5      | 12,6     |          |          | 9,4   |      | 8,6      | 12,0     |          |          |
| <b>Inflation</b>         |                       |                |       |       |       |          |          |          |          |          |       |      |          |          |          |          |
|                          | Headline inflation    | YoY, %, e.o.p. | 9,8   | 4,1   | 5,2   | 11,6     | 6,0      | 7,7      |          |          | 5,1   |      | 5,0      | 5,9      |          |          |
|                          | Headline inflation    | YoY, %, avg.   | 10,9  | 7,9   | 3,7   | 6,8      | 4,3      | 4,5      |          |          | 5,9   |      | 5,8      | 7,2      |          |          |
|                          | GDP deflator          | YoY, %         | 15,4  | 8,1   | 3,6   | 5,3      | 5,1      | 7,1      |          |          | 4,9   |      | 5,1      | 8,2      |          |          |
| <b>Exchange rates</b>    |                       |                |       |       |       |          |          |          |          |          |       |      |          |          |          |          |
|                          | UAH/USD               | e.o.p.         | 27,7  | 23,8  | 28,00 |          |          |          |          |          | 28,20 |      |          |          |          |          |
|                          | UAH/USD               | avg.           | 27,2  | 25,8  | 26,72 |          |          |          |          |          | 27,81 |      |          |          |          |          |
| <b>External balances</b> |                       |                |       |       |       |          |          |          |          |          |       |      |          |          |          |          |
|                          | C/A balance           | US\$bn         | -4,4  | -1,3  | -1,8  |          | -2,5     | -2,2     |          |          | -3,2  |      | -5,3     | -2,9     |          |          |
|                          | C/A balance           | % of GDP       | -3,3  | -0,9  | -1,3  |          |          | -1,7     |          |          | -2,1  |      |          | -2,0     |          |          |
|                          | Trade balance         | US\$bn         | -11,4 | -12,4 | -10,9 | -8,3     | -12,4    | -7,5     |          |          | -13,4 |      |          | -12,9    |          |          |
|                          | Exports               | US\$bn         | 59,1  | 63,4  | 58,5  | 59,9     | 63,4     | 56,1     |          |          | 61,5  | 61,6 | 63,2     |          |          |          |
|                          | Imports               | US\$bn         | 70,5  | 75,8  | 69,4  | 68,2     | 75,8     | 63,6     |          |          | 74,9  | 75,3 | 76,0     |          |          |          |
|                          | Reserves              | US\$bn         | 20,8  | 25,3  | 25,3  |          | 27,2     | 19,3     |          |          | 26,1  | 28,6 | 23,4     |          |          |          |
| <b>Interest rates</b>    |                       |                |       |       |       |          |          |          |          |          |       |      |          |          |          |          |
|                          | NBU's key policy rate | %, e.o.p.      | 18,0  | 13,5  | 5,5   |          | 7,0      |          |          |          | 5,73  |      | 7,0      |          |          |          |
| <b>Fiscal Balance</b>    |                       |                |       |       |       |          |          |          |          |          |       |      |          |          |          |          |
|                          | Budget balance        | % of GDP       | -2,4  | -2,1  | -7,2  |          | -8,0     | -7,7     |          |          | -3,7  |      | -2,8     | -5,3     |          |          |
|                          | Public debt           | % of GDP       | 60,9  | 50,6  | 62,9  |          |          | 65,4     |          |          | 60,9  |      |          | 62,7     |          |          |