Kyiv
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Ukraine:
Macroeconomic Radar

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Over the past month, the NBU and the Government have updated their forecasts almost synchronously. Traditionally, the latter has not discovered the updated figures for the current year. Any changes in the Government's forecast immediately cause unhealthy excitement among MPs due to the possibility of the revision of budget expenditures. In their turn, inflation and, accordingly, nominal indicators in the Government's forecast traditionally exceed consensus estimates significantly. However, this year the Government forecasters have an objective reason for this. Their forecast takes into account the rapid increase in the minimum wage during the next year announced by the Government (up to UAH 6,000 from January 1st and to UAH 6,500 from July 1st). Other organizations, including the NBU, did not take into account such generosity from the Government in their forecasts. But the question now is to what extent the renewed NBU will agree with such a forecast of high inflation next year and how it will react with its monetary instruments.

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Economy: plunge in the 2nd quarter is followed by a moderate recovery

Ukrainian GDP fell by 11.4% YoY in the 2nd quarter. Most analysts expected GDP to decline by about 10.5% YoY, while the Ministry of Economy and the NBU projected a decline of 11% YoY. In the nearest future, the economy will continue to recover. 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 Ukraine's real GDP to fall by 5-6% in 2020. Meanwhile, the consensus estimates of growth next year have deteriorated slightly - to 4.2%. New estimates of the Government are more optimistic - 4.6%, while the NBU stays more conservative - 4.0%. Given the negative assessments of the impact of a sharp increase of the minimum wage on post-pandemic recovery (see, for example, here), the optimism of the Government requires additional justification.

Consensus inflation forecasts continue to decline, however, the next year is cooking surprises

As we assumed before, the downward trend in the inflation forecasts has maintained. Currently, consensus estimates for this and next years are close to the NBU's target of 5%. However, it is highly unlikely that any of the forecasters included in their projections the same assumptions about raising the minimum wage as the Government did. As a result, the latter's inflation forecast is significantly higher than the "market" - 7.3% (and 8.7% on average, which assumes annual inflation of about 9-10% within the year). In recent years, this has become a tradition for the Government to "distrust" the NBU's inflation targeting policy and to rely on too "optimistic" forecasts for inflation and, accordingly, nominal indicators. Thus, the forced aggressive anti-inflation policy of the NBU previously was always perceived as a surprise by the Government. Whether the NBU's policy under the new leadership will be as hawkish remains to be seen. So far, the NBU has avoided a direct answer, publishing its forecast on the previous wage trajectory. Therefore, inflation for next year in its forecast does not differ much from the target and consensus - 5.5%.

Further path of the key policy rate – political vs economic factors

Unexpectedly, the NBU kept the key policy rate on hold at 6% at the end of July and published a new rate path, according to which no further reduction is planned. On the contrary, the NBU plans to raise the rate to 6.5% in a year. Moreover, the rapid increase in the minimum wage next year with the corresponding pro-inflationary effects, together with the already obvious pause in receiving tranches from the IMF, creates the preconditions for a faster and more decisive rate increase. However, the consensus forecasts have hardly changed even after the July decision. The market still sees the key policy rate at 5.7% at the end of this year and keeping it at the same level for the next year. The only logical explanation for this vision is the "soft" rhetoric of the new NBU Governor K. Shevchenko before his appointment and the latest personnel changes at the NBU, where 2 more Board members have been changed. Besides, other authorities and some influential groups continue to call for further easing of monetary policy. Previously, the NBU in its monetary decisions relied primarily on macroeconomic factors and the need to achieve inflation targets. Whether this policy continues will be the answer to the question of whether the NBU has saved its independence.

The projections of current account deficit are probably still too conservative

The NBU has significantly improved its current account forecast, factoring in changes in the methodology of accounting reinvested earnings and the positive effects of the corona-crisis on external trade. A surplus of $6.5bn this year and a deficit of $4.5bn next year is expected. As we mentioned previously, analysts do not hurry up with improving their current account forecast - most forecasters still have a current account deficit in their forecasts.

NBU’s optimistic view on international reserves

Successful placement of Eurobonds even in the context of net sales of currency by the NBU grounded for the further increase of international reserves in July - up to $28.8bn. This led to improved consensus forecasts of international reserves at the end of this year - up to $26-27bn. However, this level is much lower than the updated forecast of the NBU, according to which reserves should grow to almost $30bn by the end of the year. In this light, the IMF forecast of the international reserves for the end of this year ($19.3bn) looks already super conservative.

The exchange rate will strongly depend on future NBU policy

The strong current account position and the Government's attraction of funds from international capital markets probably determined almost unchanged exchange rate forecasts for the end of this and next years - 28 UAH/USD and 28.2-29.5 UAH/USD, respectively. In this context, there are no special questions for the Government's exchange rate forecast for the next year (28.8 UAH/USD at the end of the year, 29.1 UAH/USD on average).

Conclusions

The first decision of the renewed NBU on the key policy rate was as technocratic as possible and allowed to calm the passions on the domestic financial market. However, the decision of the Government to increase the minimum wage significantly complicates the further life of the new NBU leadership. After all, in the coming months, it will be pushed to react on the future acceleration of inflation, which is already included in the Government's forecast. The lack of a proper and prompt response is likely to result in a significant acceleration of inflation, which will require a much stronger tightening of the monetary policy or follow a Turkish scenario of permanent cycles of high inflation and devaluation. At the same time, the aggressive reaction of the NBU as in 2017-18 will significantly complicate the life of the Government and its task of reducing market rates to resume lending. In many respects, this decision will determine future macroeconomic scenarios.

Annex. Forecasts of key macroeconomic indicators of Ukraine

Yearly forecasts													
			2019	2020					2021				
				Cons	Gov	NBU	IMF	WB	Cons	Gov	NBU	IMF	WB
					29.03.20	23.07.20	09.06.20	08.06.20		29.07.20	23.07.20	09.06.20	08.06.20
Activity													
	Real GDP	*YoY, %*	3,2	-5,6- -5,1	-4,8	-6,0	-8,2	-3,5	4,2	4,6	4,0	1,1	3,0
	Nominal GDP	*UAHbn*	3 975	3 955	3 986	3 910	3 908		4 438	4 506	4 300	4 277	
	Nominal GDP	*US$bn*	155,2	148					160				
	Unemployment	*%*	8,2	10,6	9,4	10,0	12,6		9,3	9,2	9,0	12,0	
Inflation													
	Headline inflation	*YoY, %, e.o.p.*	4,1	5,0-5,2	11,6	4,7	7,7		4,7-5,6	7,3	5,5	5,9	
	Headline inflation	*YoY, %, avg.*	7,9	3,4	6,8	2,9	4,5		5,6	8,7	5,8	7,2	
	GDP deflator	*YoY, %*	8,1	5,0	5,3	4,7	7,1		7,7	8,1	5,7	8,2	
Exchange rates													
	UAH/USD	*e.o.p.*	23,8	28,00					28,2-29,5	28,80			
	UAH/USD	*avg.*	25,8	26,68					27,81	29,10			
External balances													
	C/A balance	*US$bn*	-1,3	-0,7-1,6		6,5	-2,2		-2,0		-4,5	-2,9	
	C/A balance	*% of GDP*	-0,9	-1,0 -+0,9			-1,7		-3,2- -2,0			-2,0	
	Trade balance	*US$bn*	-12,4	-10,5	-8,3	-3,2	-7,5		-12,9	-10,4	-12,1	-12,9	
	Exports	*US$bn*	63,4	58,3	59,9	60,1	56,1		60,8	60,2	62,9	63,2	
	Imports	*US$bn*	75,8	68,8	68,2	63,3	63,6		73,8	70,6	75,0	76,0	
	Reserves	*US$bn*	25,3	25,6-27,3		29,8	19,3		26,9-28,4		32,7	23,4	
Interest rates													
	NBU's key policy rate	*%, e.o.p.*	13,5	5,5-5,7		6,0			5,7-6,5		6,5		
Fiscal Balance													
	Budget balance	*% of GDP*	-2,1	-7,1		-7,5	-7,7		-3,9		-4,0	-5,3	
	Public debt	*% of GDP*	50,6	62,9			65,4		61,5			62,7	

Do you have any comments or questions?
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