National Bank of Ukraine

Inflation Report (April 2024)

7 Apr 2024

Summary: forecast

- **In Q1 2024, consumer inflation slowed more rapidly than expected by the NBU.** The deviations from the forecast were primarily driven by factors that were difficult to predict, including temporary ones
- **Underlying inflation pressure also eased and core inflation was close to the NBU's forecast**, in particular thanks to improved inflation expectations
- **The NBU has improved its inflation forecast for end-2024 to 8.2%** and expects inflation to settle within the target range of 5% ± 1 pp in the coming years
- This will be facilitated by a gradual normalization of conditions in which the economy operates, an easing of external inflationary pressures, and the NBU's consistent monetary policy
- **Taking into account the balance of risks, as well as favorable macrofinancial trends, in particular better inflation dynamics, the NBU Board decided to cut the key policy rate by 1 pp, to 13.5%.** The interest rates on refinancing loans were reduced more pronouncedly – by 2 pp, to 17.5%
- **The NBU sees some room for the further loosening of its interest rate policy, provided that favorable macrofinancial trends continue.** The baseline scenario of the NBU's forecast envisages a cut in the key policy rate to 13% this year
- With the level of international reserves being comfort, the situation on the FX market being under control, and there being expectations of further international assistance inflows, **the NBU anticipates taking in the coming weeks a number of steps to liberalize the FX market**
- **The NBU will adapt its monetary policy if the balance of risks changes significantly.** Thus, lower risks to inflation and exchange rate sustainability could create preconditions for further cuts in the key policy rate and an easing of FX restrictions, which would support lending and economic recovery

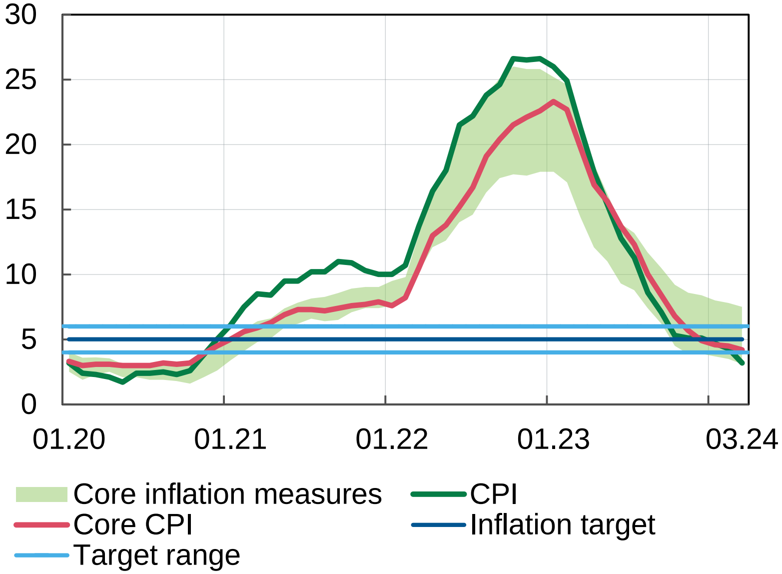
The NBU updated the macroeconomic forecast*: weaker inflationary pressure, but also slower recovery

	2023**	2024	2025	2026
Real GDP, change, %	5.3 (5.7)	3.0 (3.6)	5.3 (5.8)	4.5 (4.5)
Nominal GDP, UAH bn	6 538 (6 510)	7 590 (7 580)	8 705 (8 710)	9 685 (9 690)
CPI, % yoy (eop)	5.1	8.2 (8.6)	6.0 (5.8)	5.0 (5.0)
Core CPI, % yoy (eop)	4.9	6.7 (6.4)	3.6 (3.1)	3.0 (2.9)
Current account balance, USD bn	-9.2 (-9.7)	-20.2 (-16.9)	-18.2 (-19.8)	-23.1 (-23.8)
International reserves, USD bn	40.5	43.4 (40.4)	44.3 (42.1)	39.3 (36.9)

* in brackets – previous forecast (Inflation report, January 2024)
** actual/estimate

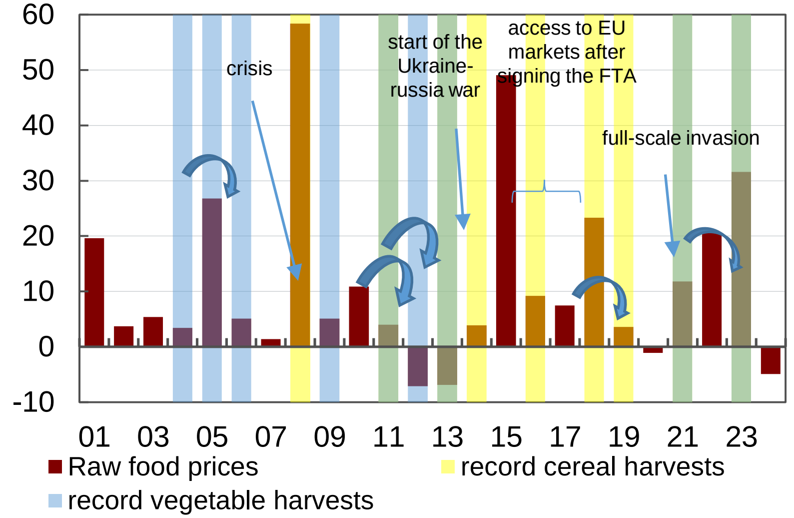
Consumer inflation decreased rapidly primarily due to supply factors of a temporary nature

Consumer inflation and underlying inflation trends*, % yoy



Source: NBU staff estimates.

Raw food prices in March, % yoy and harvests

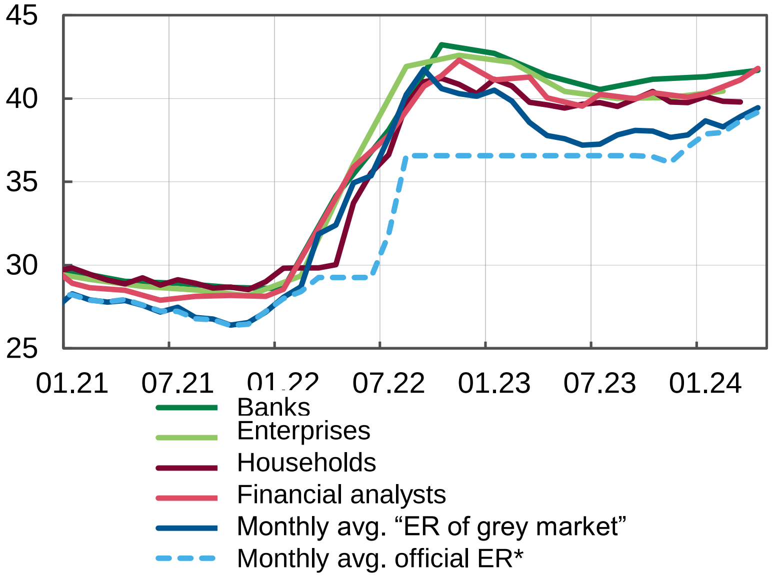


The green area indicates record harvests of both cereals and vegetables. The 2023 harvest is shown as a record per capita.
Source: SSSU, NBU staff estimates.

- **Inflation decreased sharply** thanks to the effects of consistent monetary policy, in particular, the controlled situation on the foreign exchange market, the increase in the supply of certain food products, and less pressure from the costs of raw materials and energy. These factors outweighed the effects of further pressure on labor costs and the temporary impact of the blockade of the western borders
- **The biggest contribution to the slowdown in inflation was made by the prices of raw products**, which decreased by 4.9% y/y in March. The dynamics of their prices at the end of 2023 and the beginning of 2024 also reflected the effects of the large harvests of the previous few years. Although grain and vegetable harvests in absolute terms in 2023 were not record-breaking, their supply per capita was the highest in Ukrainian history due to population decline due to migration

Against the background of slowing inflation, expectations continue to improve despite the weakening of the hryvnia

12-month-ahead ER expectations*, UAH/USD



* Values for April – as of 04/18/2024.
Source: NBU, Info Sapiens, open sources.

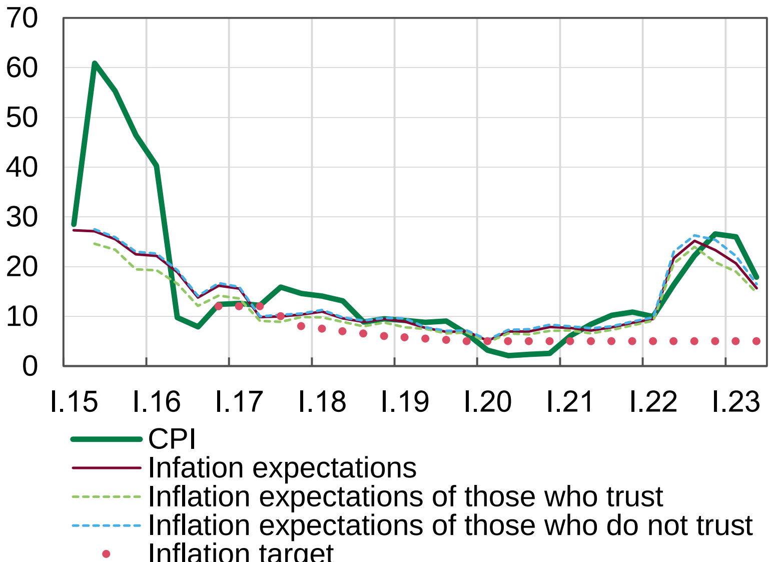
12-month-ahead inflation expectations*, %

* The dotted line indicates a change in the method of survey for a telephone interview. Source: NBU, Info Sapiens.

- **Despite a certain weakening of the official exchange rate, the situation on the foreign exchange market remains under control, and exchange rate expectations remain moderate**
- **Against this background and in the conditions of low current inflation, as well as the effect of the moratorium on the increase of tariffs for utilities, inflation expectations demonstrate stability and continue to improve**. It also ensured a decrease in fundamental inflationary pressure

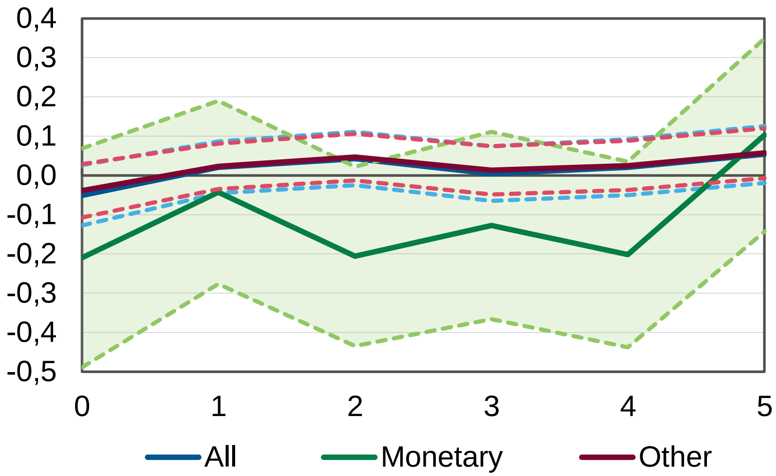
Box. Inflation expectations: the influence of the NBU's credibility, its communications and the level of financial literacy

One-year-ahead inflation expectations of firms (by level of trust in the NBU), inflation, and inflation targets, % yoy



Source: Savolchuk & Yukhymenko (2023).

Reaction of financial experts' inflation expectations to increased NBU's communication



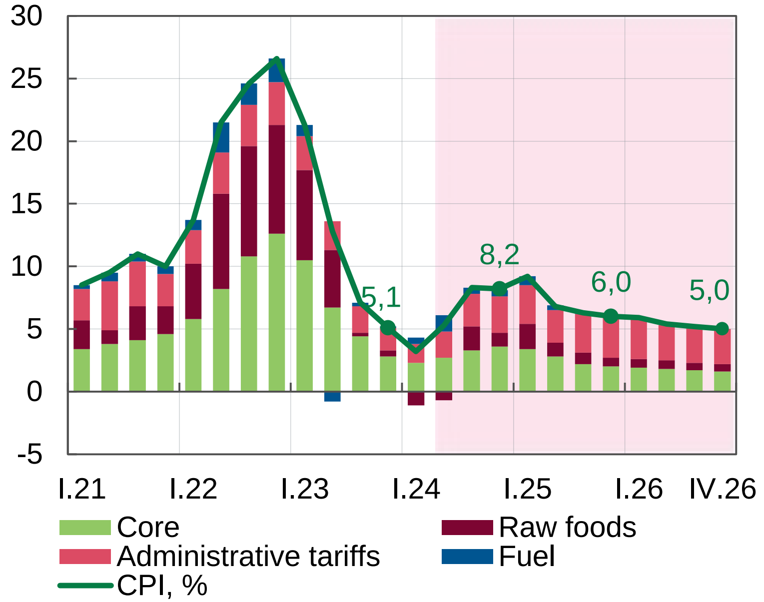
Note: Dashed lines show the confidence interval at the 95% level.

Source: Yukhymenko & Sorochan (2024).

- **Expectations play a key role in maintaining low and stable inflation.** Their anchoring is a complex, long-term and versatile process. In conditions of significant shocks that limit the effectiveness of traditional central bank tools, the role of expectations management only grows
- **Research conducted by the NBU shows that the stronger the credibility of NBU and the banking system, the closer inflation expectations are to the target**, and the active communications of the central bank and public literacy contribute to their anchoring. Therefore, the central bank should build trust in its policy through high-quality communication and active measures to develop financial literacy

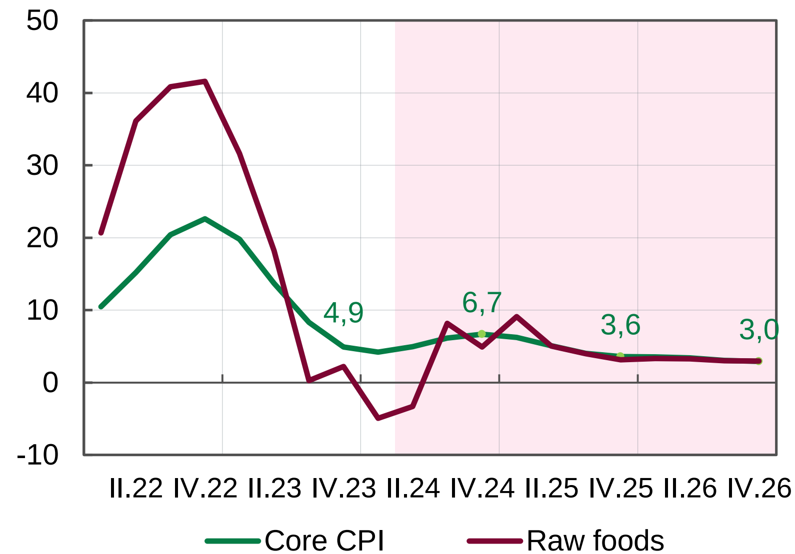
Inflation will temporarily accelerate above the target range, but return to it in 2025

Contributions to the annual change in CPI, pp



Source: SSSU, NBU staff estimates.

Core CPI and raw food inflation, %

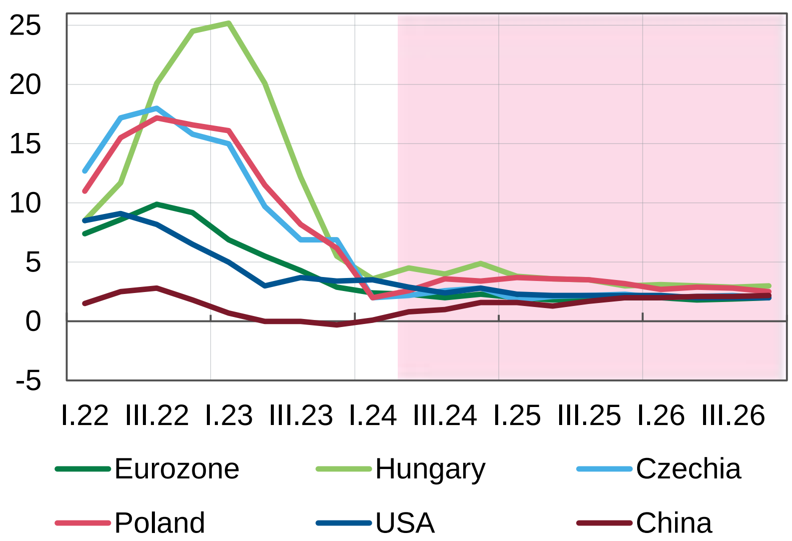


Source: SSSU, NBU staff estimates.

- **From mid-2024, inflation is expected to rise temporarily above the target range**, in particular due to the exhaustion of the effects of the previous year's larger harvest, a further recovery in consumption and increased business costs in wartime conditions
- **At the same time, the NBU improved the inflation forecast to 8.2% for 2024 and expects it to be fixed in the target range of 5% ± 1 in. in the following years**
- **This will be facilitated by a consistent monetary policy**, in particular measures to maintain a controlled situation on the foreign exchange market, as well as a weakening of external inflationary pressure

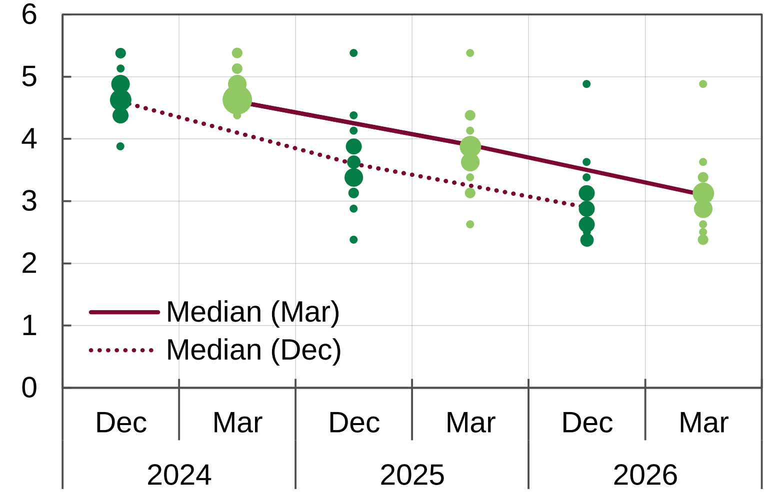
Weakening external inflationary pressures will be an important factor in slowing inflation in the coming years

Consumer inflation in selected countries – Ukraine's MTPs (eop), % yoy



Source: national statistical agencies, NBU staff estimates.

The number of FOMC members that expect the respective policy rate at the end of the year, based on the results of the meetings

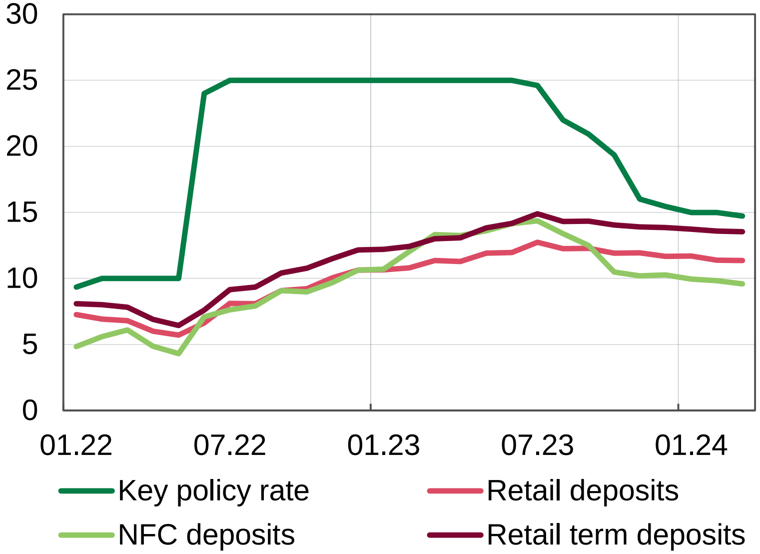


* The size of the circle is determined by the number of participants supporting the respective rate level.
Source: Fed.

- **Strong labor markets and resilient demand will limit the decline in service prices.** As a result, core inflation will remain stable at least until the end of 2024. This, together with the effects of the comparison base, will keep headline inflation in many of the countries that are Ukraine's MTPs close to the upper bound of the target range in the coming months, and even temporarily accelerate in the middle of the year
- **Headline inflation will return to the CB's targets on a sustainable basis in 2025 and remain close to them thereafter**, thanks to moderate labor costs and the exhaustion of the negative effects of the energy shocks of previous periods and supply chain bottlenecks
- **Global financial conditions will remain tight** in real terms until at least mid-2025

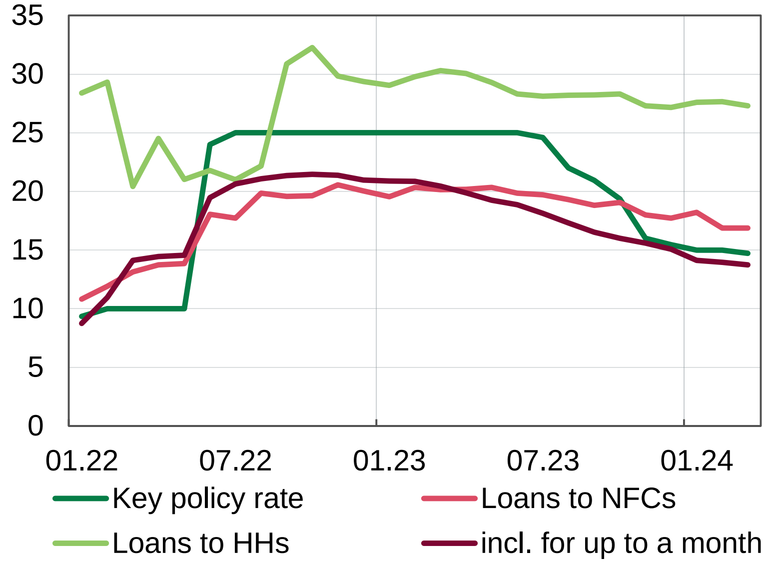
Banks continued to slowly reduce rates on households' term deposits...

Weighted average interest rates on hryvnia deposits and monthly average key policy rate, %



Source: NBU.

Weighted average interest rates on hryvnia loans and monthly average key policy rate, %

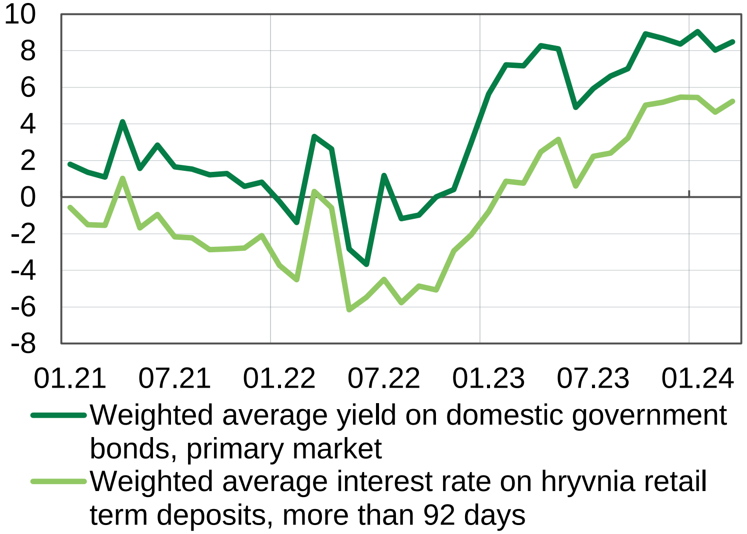


Source: NBU.

- **Thanks to the incentives embedded in the operational design of the interest policy, banks continued to discreetly reduce rates** on households' term deposits
- **Transmission to market rates was most reflected in the cost of attracting deposits of the corporate sector**, the decrease in yield of which does not create additional pressure on the FX market. Thus, the weighted average interest rate on hryvnia term deposits of the NFCs decreased by 0.7 pp during the first quarter, while for deposits of individuals – only by 0.3 pp

... however hryvnia instruments will continue to protect savings from inflationary depreciation

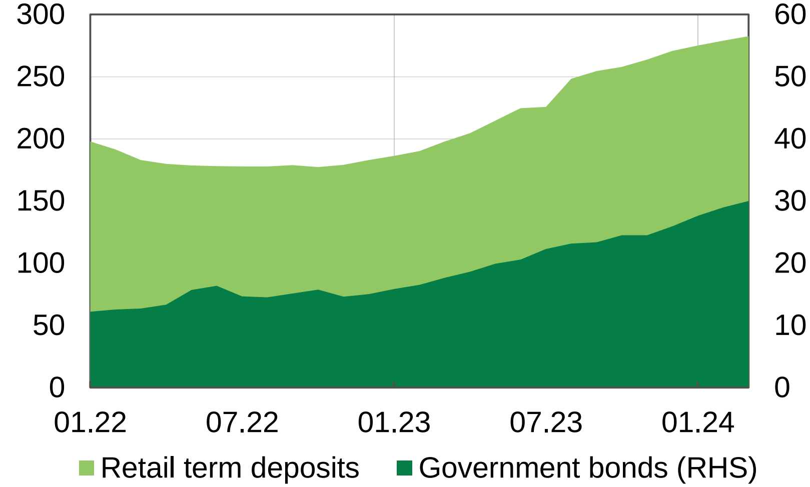
Real interest rates* on hryvnia domestic government bonds and retail term deposits, %



* Deflated by households' 12m-ahead inflation expectations.

Source: NBU staff estimates.

Stock of hryvnia government bonds held by individuals and hryvnia retail term deposits, UAH bn



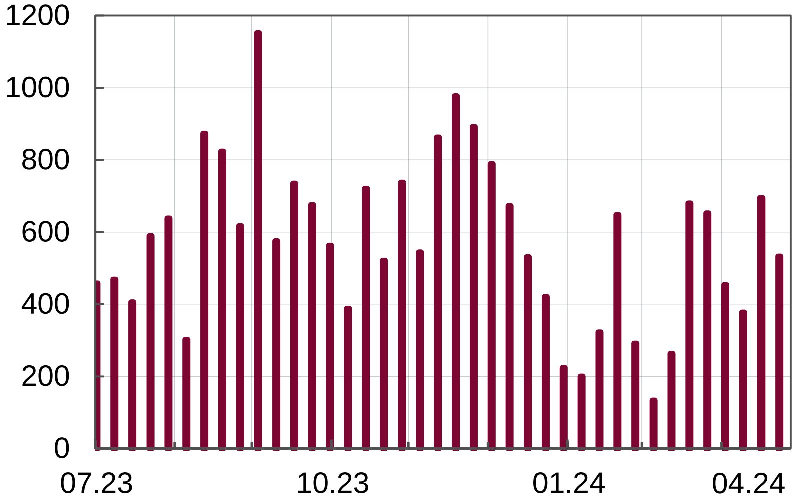
* At outstanding nominal value.

Source: NBU.

- **Currently, the yield on hryvnia term instruments exceeds the 12-month-ahead inflation expectations** of households
- **This fuels public interest in hryvnia instruments, despite increased exchange rate volatility:** the volumes of hryvnia term deposits and government bonds held by individuals continue to grow, albeit at a lower rate

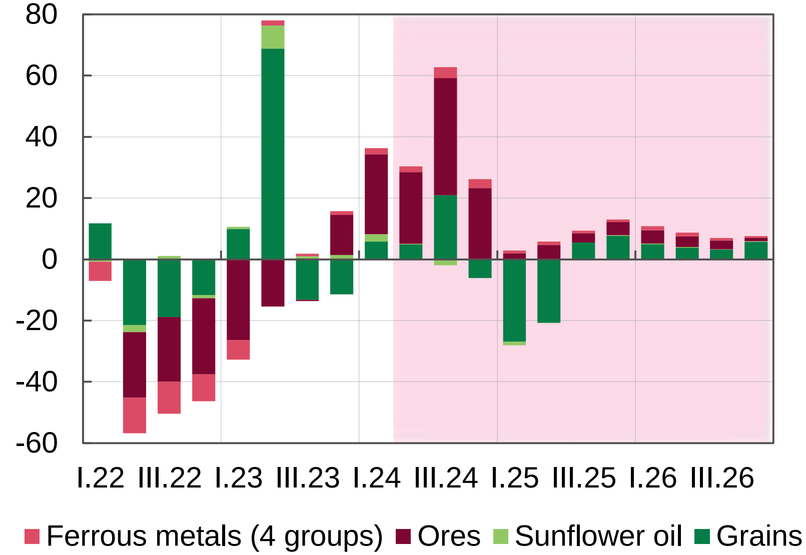
NBU interventions cover the structural deficit on FX market and smoothen excessive exchange rate fluctuations

Net NBU's weekly FX sales*, USD m



* Deal date.
Source: NBU.

Contributions of selected commodities to the annual change in exports volumes, pp

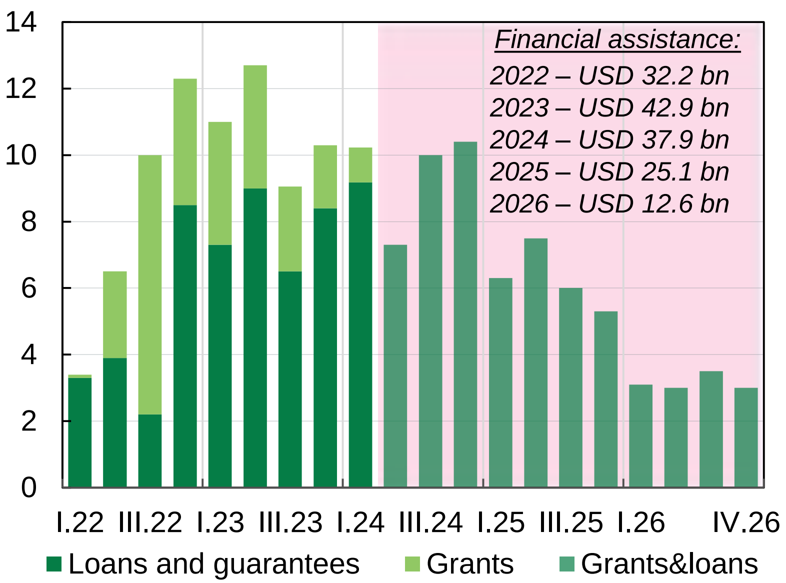


Source: SCSU, NBU staff estimates.

- Moderate demand for FX for most of Q1 2024 allowed the NBU to significantly reduce the sales of FX. Exchange rate fluctuations were moderate and multidirectional. **The NBU's interventions will continue to be the main mechanism for balancing the FX market**, which will help maintain stability and ensure moderate exchange rate fluctuations
- Stable operation of sea routes will stimulate further growth in exports of iron and metal products. **The increase in exports will improve the financial position of companies and help strengthen the stability of the FX market**

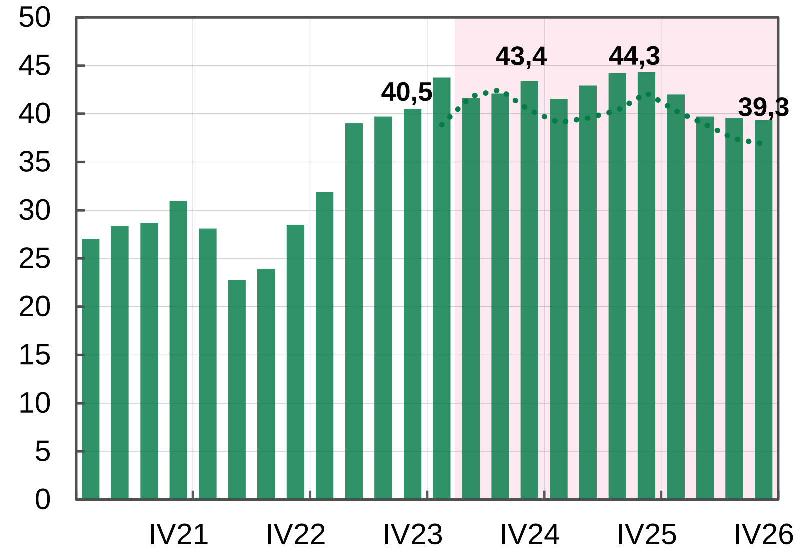
International support has resumed, increasing the NBU's ability to ensure exchange rate sustainability

International financial assistance, USD bn



Source: NBU, MoF, data from the open sources, NBU assumptions.

International reserves, USD bn

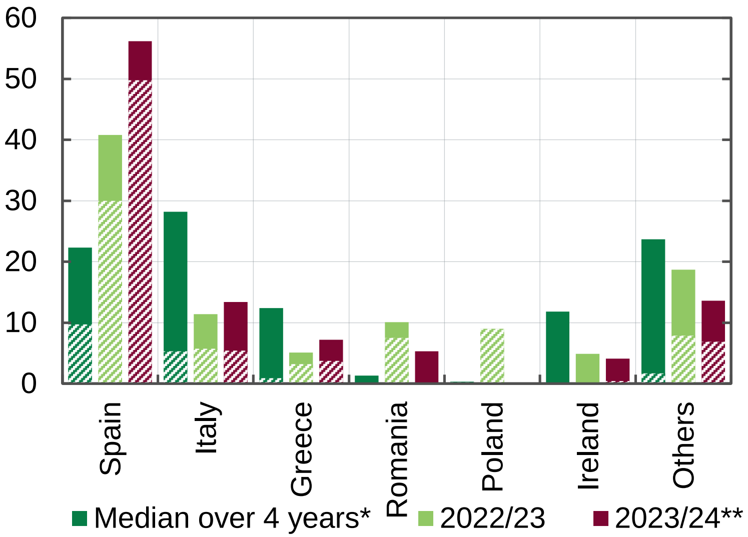


Source: NBU.

- **The official financing inflows helped keep the international reserves at a comfortable level.** The NBU continued to compensate for the structural deficit of FX. In April, a package of military and financial aid from the United States was approved. In total, Ukraine can receive USD 38 bn of budgetary support this year
- Progress in reducing inflation and improving inflation expectations, maintaining a controlled situation at the FX market, and accumulating a comfortable level of international reserves **have created an opportunity for further steps in FX liberalization** and easing interest rate policy

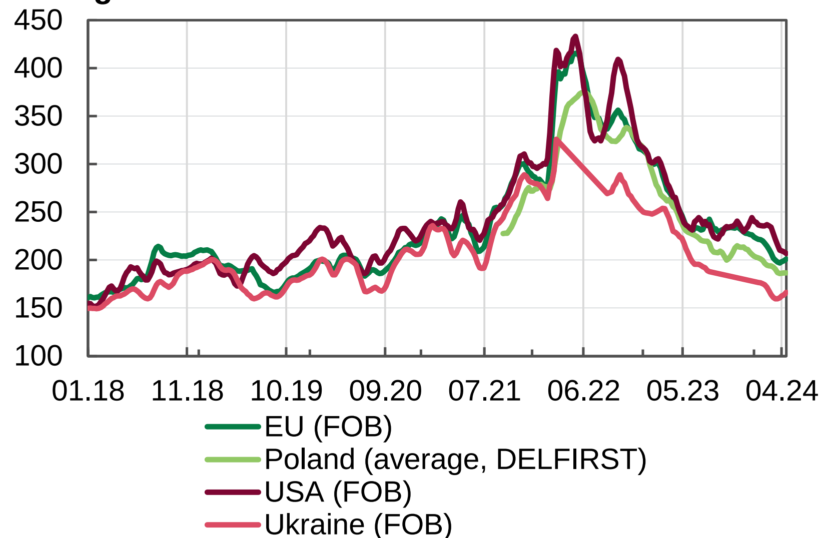
Box. Challenges in trade between Ukraine and Poland: reasons and consequences for Ukrainian economy

Extra-EU imports of wheat by EU countries, % of total



Shaded part of the bar shows imports from Ukraine.
* MY 2018/19 to MY 2021/22. ** Preliminary data.
Source: European Commission.

Prices* of feed wheat, EUR/MT, four-week moving average

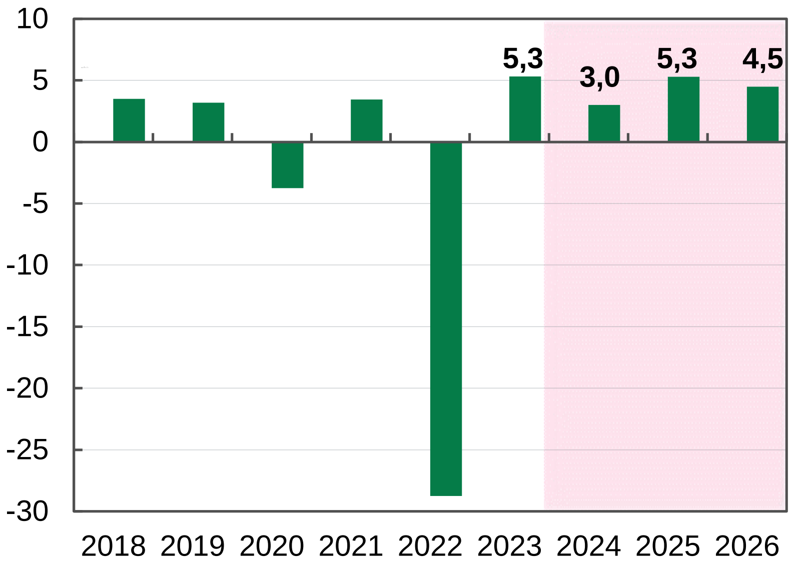


* DELFIRST – delivered to first customer (silo, processing plant), FOB – export prices.
Source: European Commission.

- **After the full-scale invasion by russia, Poland became Ukraine's largest trading partner:** its share in Ukraine's exports in 2022 increased to almost 15%, and in imports – to 10%. The most important group of goods in exports to Poland became food products. The significant increase in competition between Ukrainian and Polish goods in the EU market, along with the decrease in global grain prices, prompted the introduction of import bans and later border blockade
- According to NBU estimates, **net losses from the import of goods in the first month of the blockade amounted to USD 500 m, while for exports, it was USD 160 m.** Partial compensation for import losses was achieved through increasing supplies via alternative routes, and for export losses, through increasing shipments via the new sea corridor. It is expected that this short-term impact will be compensated for by the use of existing stocks and certain overcompensation of supplies in subsequent periods

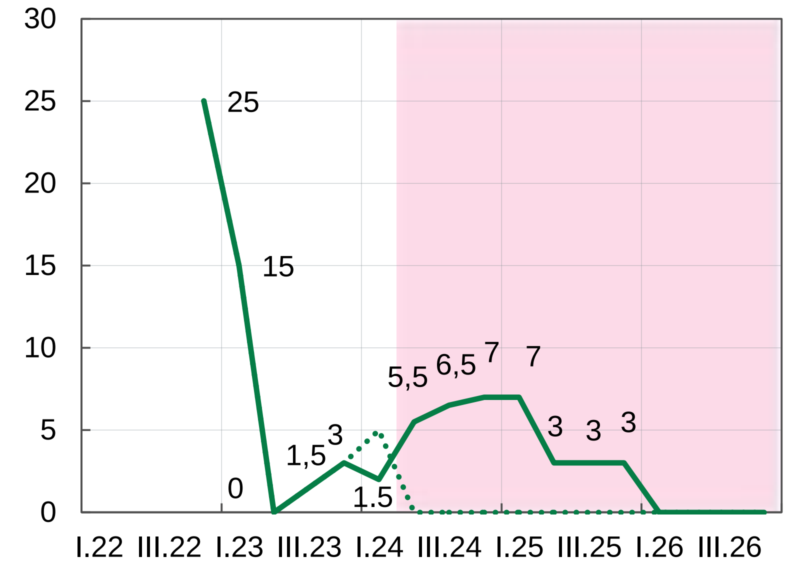
Economic recovery will continue due to business adaptability, loose fiscal policy and revival of external demand

Real GDP, %



Source: SSSU, NBU estimates.

Deficit of electricity, %

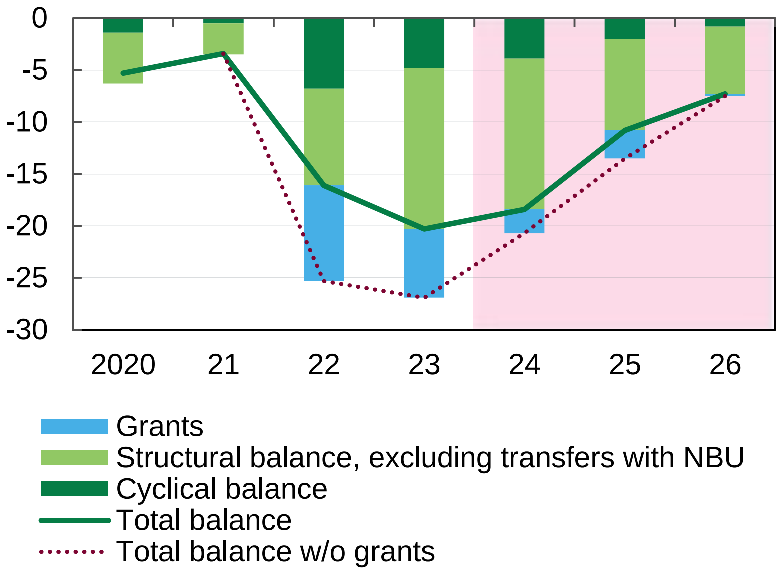


Source: NBU estimates.

- **The economic recovery will continue** thanks to the adaptability of Ukrainian business, a loose fiscal policy, the revival of external demand and the growth of household incomes
- **Taking into account the attacks on the energy infrastructure, we assume an energy deficit of about 5%** in 2024-2025, but the risks of new destruction and correspondingly higher deficits remain. However, the level of preparedness of businesses and the population for potential power outages is higher than in 2022-2023, which will limit the negative impact of power shortages on the economy. The negative contribution of the wider e/e deficit to the change in GDP is 0.6 p.p. in 2024 (0.5 in 2025)
- **With the normalization of conditions for the functioning of the economy, GDP growth will accelerate** to 4.5–5.3% in 2025–2026

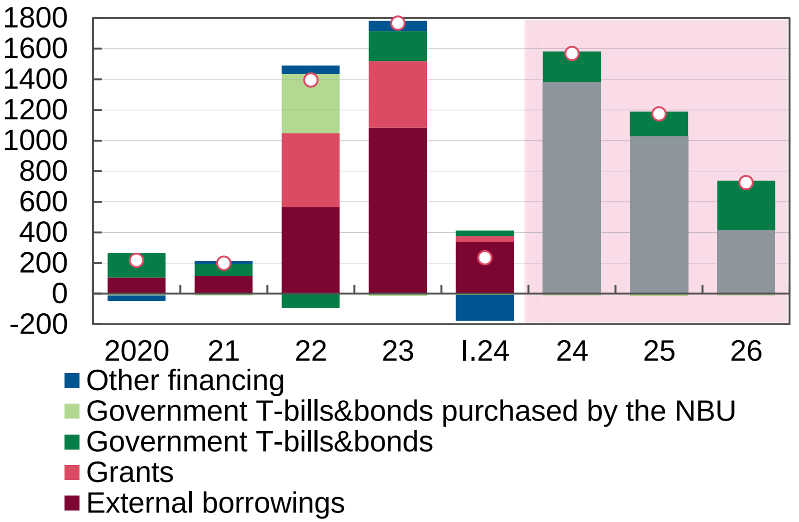
Budget deficits will remain significant given the needs of the defense sector, social support and recovery

Consolidated budget balance, % of GDP



Source: STSU, NBU staff estimates.

Financing* of the state budget deficit (excluding grants in revenues), UAH billion



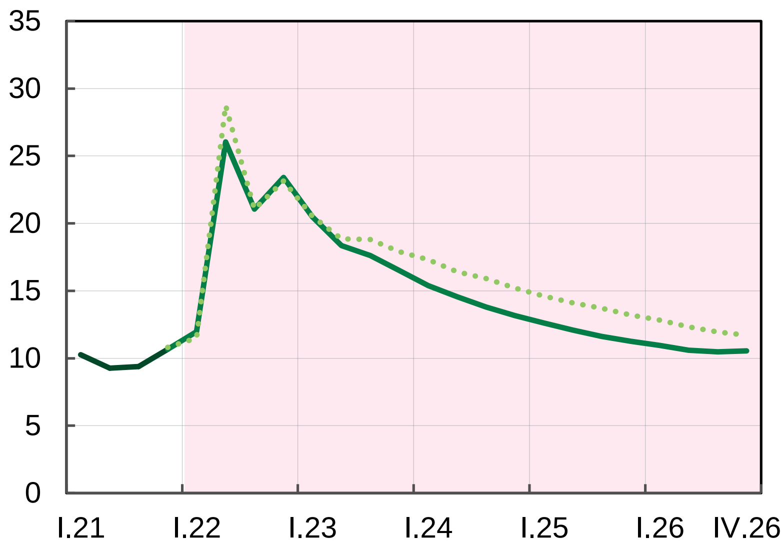
* Net borrowing. Deficit in 2024-2026 reflects the NBU's forecast. The grey fill denotes external borrowings, grant funds and other financing.

Source: STSU, NBU staff estimates

- **Despite the gradual fiscal consolidation, the budget deficit will be significant** due to high defense expenditures, as well as reconstruction and social support needs. It will be financed by international aid (which, however, will gradually decrease) and domestic borrowings
- **The scenario provides for the gradual implementation of additional fiscal measures** in the amount of up to 2.5% of GDP until 2026
- **The debt-to-GDP ratio will grow moderately** due to significant budgetary needs

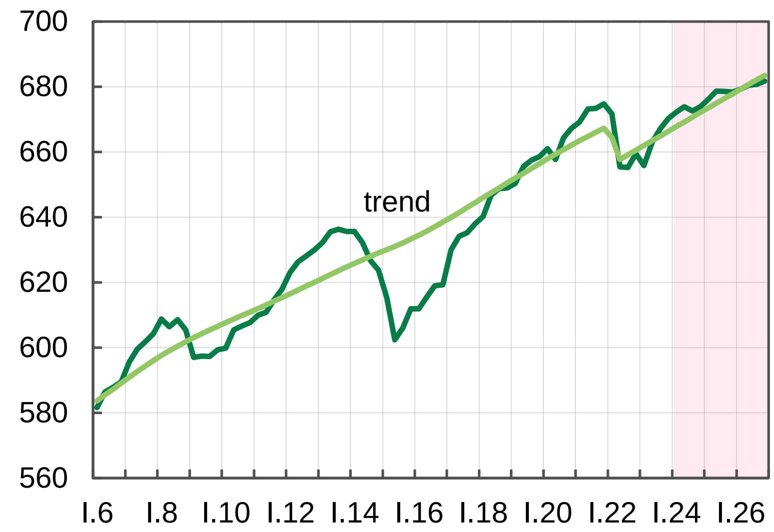
Wages will increase due to the revival of economic activity and the lack of qualified personnel

ILO unemployment, sa, %



Source: SSSU, NBU staff estimates.

Real wages, level (logs)

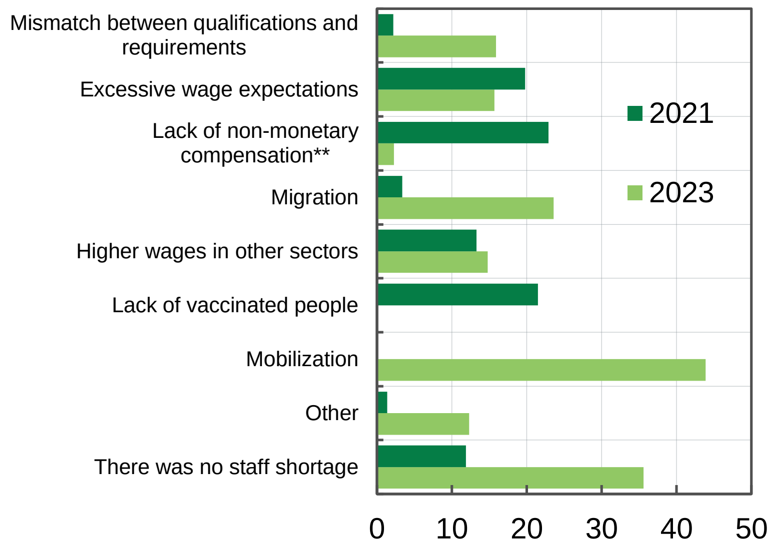


Source: SSSU, NBU staff estimates.

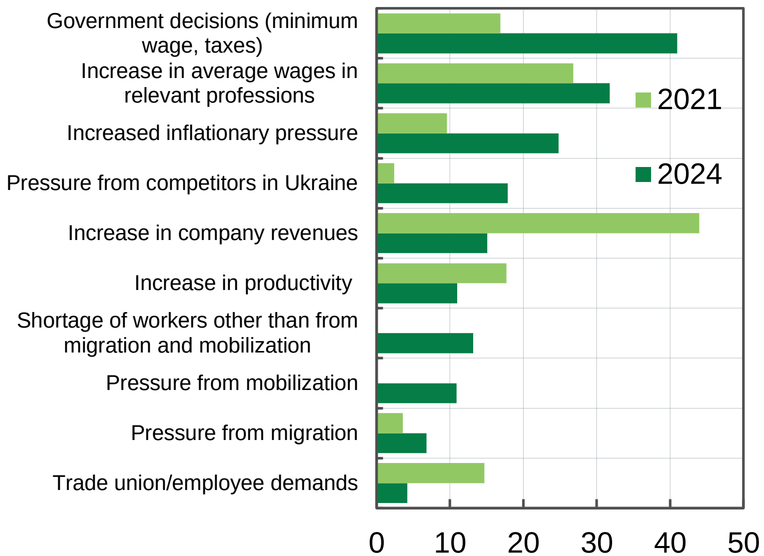
- **Due to the increase in labor demand, the unemployment rate will gradually decrease**
- **However, it will remain higher than the rate before a full-scale invasion** due to changes in the structure of the economy, migration, uneven recovery by regions and industries, and therefore - an increase in the mismatch between the needs of employers and the skills of employees
- **In 2025, real wages in the economy will exceed their pre-war level** and will continue to rise, in particular due to increased competition for labor

Box. How the labor market has changed in the two years of the full-scale invasion

Reasons for staff shortages in 2021 and 2023, % of responses*



Factors driving wage increases in 2021 and 2024, % of responses*

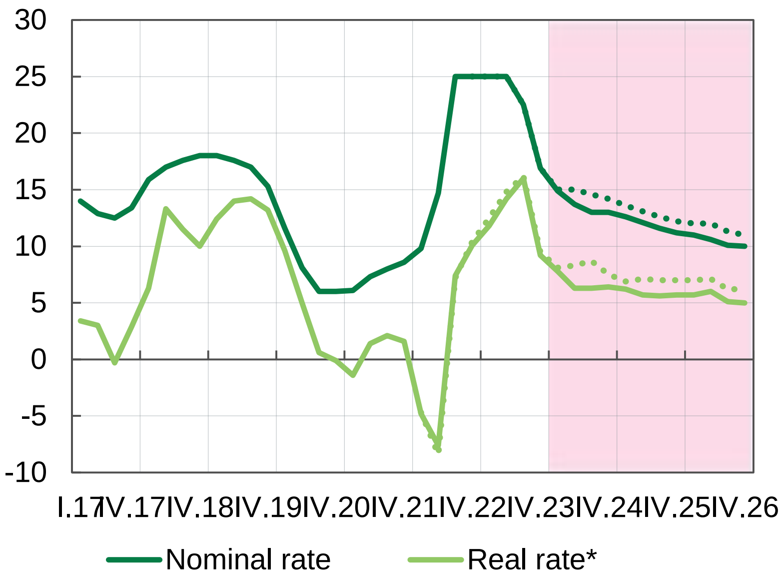


* More than one answer is possible. ** Non-monetary compensation includes insurance, transportation and/or hybrid work formats: remote work, reduced working hours, etc.
Source: NBU.

- **Both the COVID-19 crisis and the full-scale war** have led to job losses, an increase in unemployment, a drop in labor incomes, also businesses have reported staff shortages. During the quarantine, it was mainly due to the inability to work remotely (23% of responses) and the lack of vaccinated staff (22%). Mobilization (44%) and migration (24%) was the main reasons during the war
- **At the same time, the negative impact of staff shortages on business operations increased significantly during the war** (26% of responses in Q1 22 and 38% in IQ1 24) and is uneven across sectors. This indicates structural changes and a much more significant contraction in the labor market compared to the economic downturn. **Because of intense competition for employees, companies are forced** to raise wages and attract groups of people who were previously less represented in the labor market

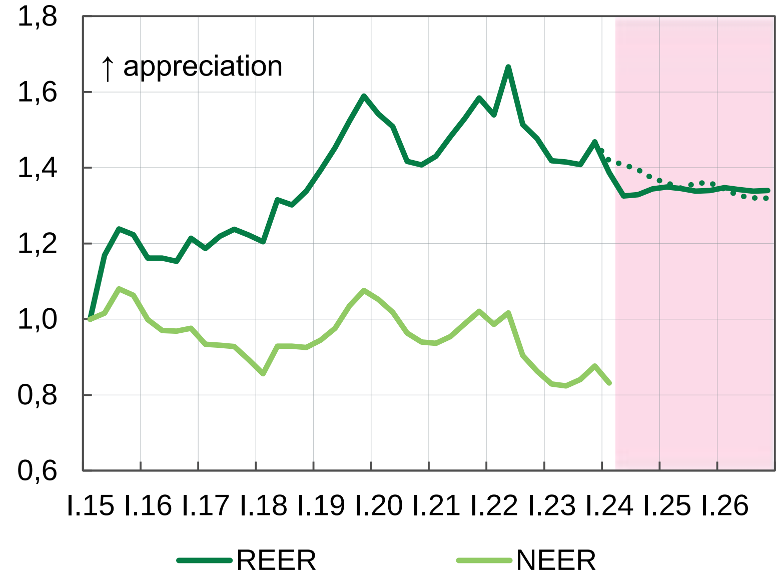
A modest rate cut will support the recovery of the economy without additional risks to macro-stability

Nominal and real key policy rate, period average, %



* Deflated by model expectations (QPM).
Source: NBU staff estimates.

REER and NEER indices, I.2015=1



Source: IMF, national statistical offices, NBU staff estimates.

- **At the current stage, the achievement of the NBU's goals is ensured by a consistent mix of instruments: exchange rate, interest rates, and currency restrictions**
- **The NBU's forecast envisages a cut in the key policy rate to 13% this year.** Although the discount rate will decrease faster than the previous macro forecast, in real terms it will remain positive. This is consistent with the need to maintain a controlled situation in the foreign exchange market and contain inflation from rising excessively in 2024, returning to the target range in 2025 and keeping it close to the target thereafter
- **Since the beginning of the year, REER has devalued, which will contribute to a certain improvement of the foreign trade balance** and support inflows to the foreign exchange market

The balance of risks is shifted towards the deterioration of economic growth rates and strengthening of price pressure

The degree of influence on the baseline scenario	The likelihood of risk: Low <15%	Average 15%–25%	High 25%–50%
Weak		Aggravation of the situation in the Red Sea	
Moderate		Higher emigration The continuation of the partial blockade of freight transportation at border crossings with some EU countries	
Strong		Rapid implementation of the large-scale plan for the reconstruction of Ukraine Decrease in the volume or delays in receiving of international financing	Longer duration of the war, escalation, eco-terrorism of the occupiers Greater budgetary needs Further damages to energy and port infrastructure

Alternative scenario: slow normalization

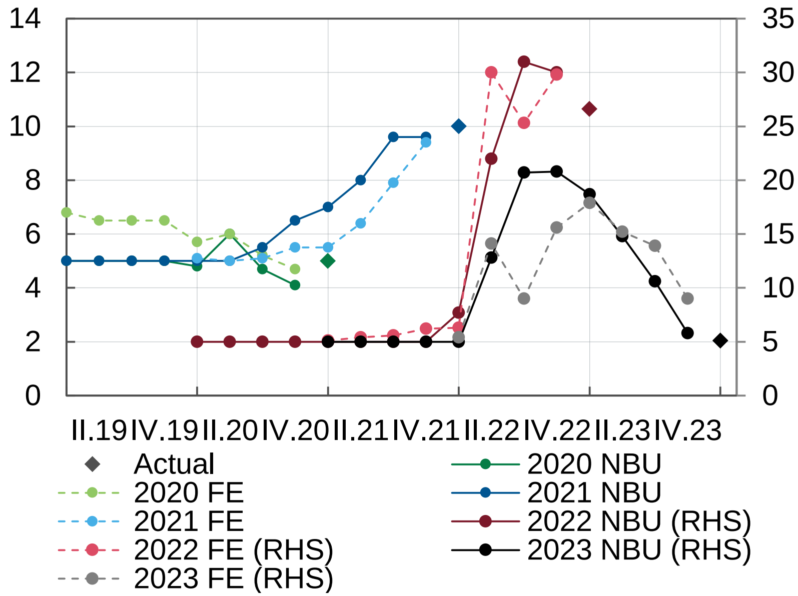
- **The alternative scenario is based on the assumption of higher security risks and**, accordingly, a slower return of the economy to normal operating conditions
- **The recovery of the economy in the alternative scenario will be more fragile even with much wider budget deficits**
- **Ensuring macro-financial stability will require somewhat larger volumes of international aid and, at the same time, significantly higher costs of NBU reserves** to maintain a controlled situation on the foreign exchange market and moderate inflation
- **The key rate will remain similar to the baseline scenario.** In real terms, the key rate will also remain positive

	2024	2025	2026
Real GDP, %	**3.0** [3.0]	**3.3** [5.3]	**5.6** [4.5]
CPI, %	**8.6** [8.2]	**5.5** [6.0]	**5.0** [5.0]
International reserves, USD bn	**43.0** [43.4]	**38.0** [44.3]	**33.3** [39.3]
Key rate, %, average	**13.6** [13.6]	**11.9** [11.9]	**10.4** [10.4]
Official financing, USD bn	**37.9** [37.9]	**28.7** [25.1]	**18.5** [12.6]
Budget deficit, % of GDP*	**20.7** [20.7]	**18** [13.5]	**12** [7.5]
Grain crop, million tons	**53** [53]	**55.1** [59.5]	**58.3** [65.5]
Migration (net), mln**	**-0.2** [-0.2]	**-0.2** [0.4]	**0.4** [0.8]

* without grants in revenues ** '+' return alternative [baseline]

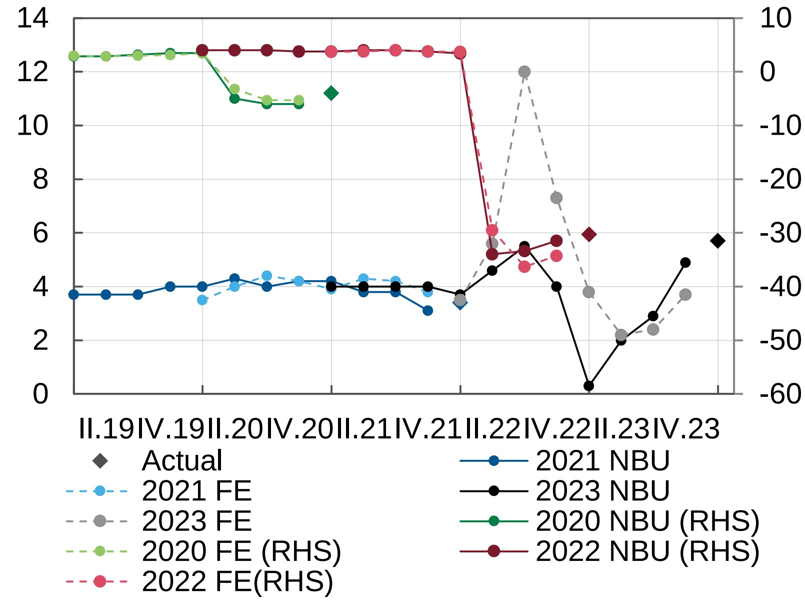
Box. Accuracy of the macroeconomic forecasts

Forecast history: CPI (2020–2023), annual change eoy, %



Source: SSSU, NBU staff estimates.

Forecast history: GDP (2020–2023), % yoy



Source: SSSU, NBU staff estimates.

- Macroeconomic forecasts are an important component in NBU decision-making, the effectiveness of monetary policy depends on their accuracy
- Throughout 2023, **the NBU's forecasts in general traditionally remained more conservative than the forecasts of other market participants**, since losses from errors in the conduct of monetary policy are asymmetric
- The inflation forecast for 2023 was gradually revised downward by both the NBU and other organizations, the accuracy of the NBU inflation forecasts is higher than average