National Bank of Ukraine

Inflation Report (October 2024)

12 Nov 2024

Key takeaways

- **The increase in the price pressure in H2 2024 was expected**, reflected in the NBU's previous forecasts. At the same time, the **acceleration of inflation was faster than forecast**
- **In the coming months, the pressure on prices will persist** due to the further impact of food supply factors, increases in budget expenditures, rapid wage growth, and wider energy shortages. **That said, inflation will start to decline in spring 2025** (due to prudent monetary policy, weaker external price pressures and improvements in the energy supply)
- **The economy continues to grow**, albeit it remains constrained by the impact of the war. GDP growth is expected to accelerate in 2025-2026
- **International support for Ukraine will remain significant**
- **The revised NBU forecast envisages keeping the key policy rate at 13% for a longer period** – at least until the summer of 2025. If price pressure continues to exceed the forecast trajectory and threaten to unanchor inflation expectations, the NBU will be ready to tighten its interest rate policy and implement additional monetary measures

Macroeconomic forecast*: October 2024

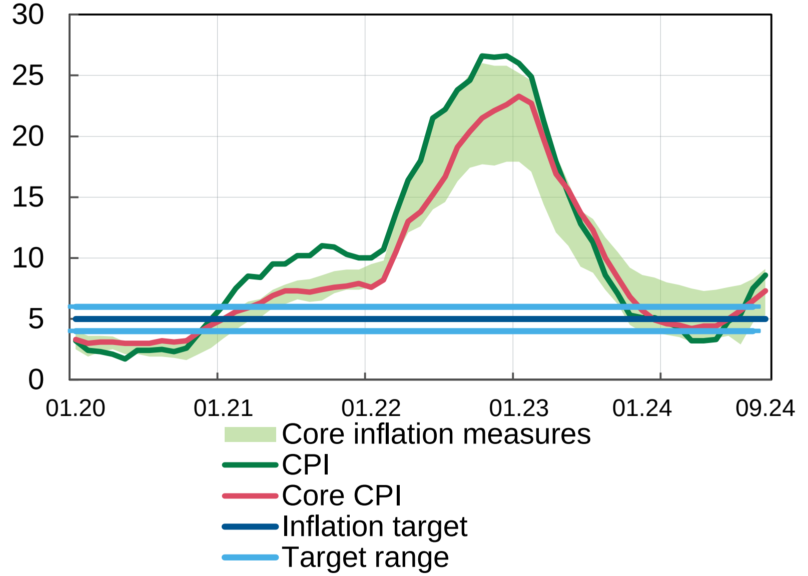
Forecast	2023**	2024	2025	2026
Real GDP, change, %	**5.3**	**4.0** (3.7)	**4.3** (4.1)	**4.6** (4.8)
CPI, % yoy (eop)	**5.1**	**9.7** (8.5)	**6.9** (6.6)	**5.0** (5.0)
Current account balance, USD bn	**-9.6**	**-16.3** (-14.2)	**-27.9** (-19.0)	**-28.4** (-23.5)
International reserves, USD bn	**40.5**	**43.6** (41.2)	**41.0** (37.3)	**34.7** (32.0)
Consolidated budget deficit, % GDP ***	**26.9**	**23** (23)	**20** (18)	**12** (10)

Assumptions	2023**	2024	2025	2026
Official financing, USD bn	**42.9**	**41.5** (37.9)	**38.4** (31.4)	**25** (21.1)
Harvest of cereals and legumes, million tons	**59.8**	**55.2** (53.7)	**57.9** (57.9)	**61.7** (61.7)
Migration (net), million persons	**-0.2**	**-0.5** (-0.4)	**-0.2** (-0.3)	**0.2** (0.4)
Real GDP of Ukraine's MTPs, %	**1.5**	**2.3** (2.3)	**2.8** (2.8)	**2.7** (2.7)
CPI of Ukraine's MTPs, %	**7.6**	**5.8** (5.6)	**3.9** (3.9)	**2.7** (2.7)

* in brackets – previous forecast (Inflation report, July 2024), decrease/increase marked by color
** actual
*** excluding grants

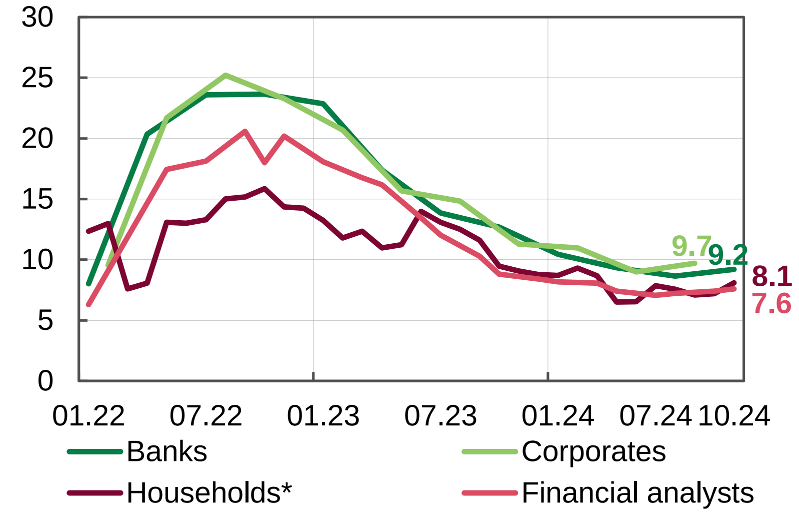
As expected, inflation has increased in recent months. However, the pace of the increase was somewhat faster than forecast

Consumer inflation and underlying inflation trends*, % yoy



* Read more in the January 2017 Inflation Report (pages 20–21). The target range remained in effect until August 2024 inclusive. Source: SSSU, NBU staff estimates.

Inflation expectations for the next 12 months, %

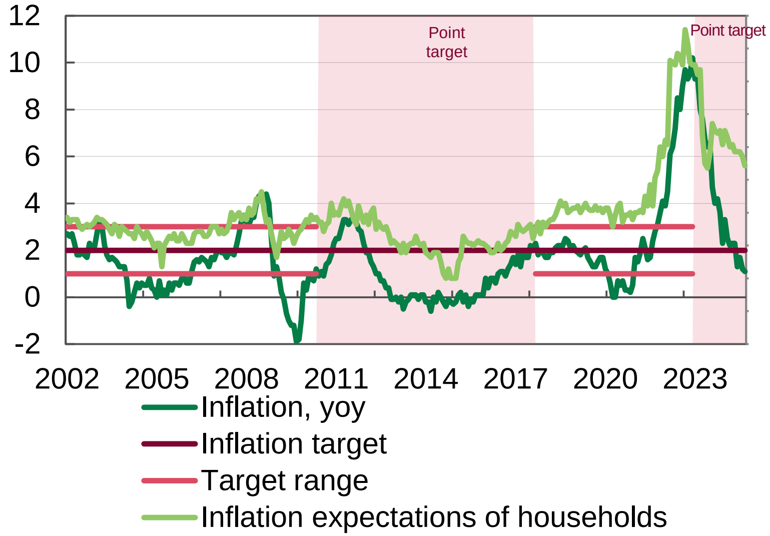


* In March 2022, the survey method was changed from face-to-face to telephone interviews.
Source: NBU, Info Sapiens.

- **In September, inflation expectedly accelerated, however was above the NBU's forecast** (July 2024 Inflation Report). Underlying inflationary pressures were also stronger than expected
- **The main drivers of inflation were:** a lower supply of food due to the impact of the summer drought, further increases in production costs, and the pass-through effects of the hryvnia depreciation in previous months
- Economic agents' **inflationary expectations remained sufficiently stable and controllable, albeit worsening marginally**

Box 1. Looking for Optimal Flexibility: Quantitative Inflation Target and Monetary Policy Horizon

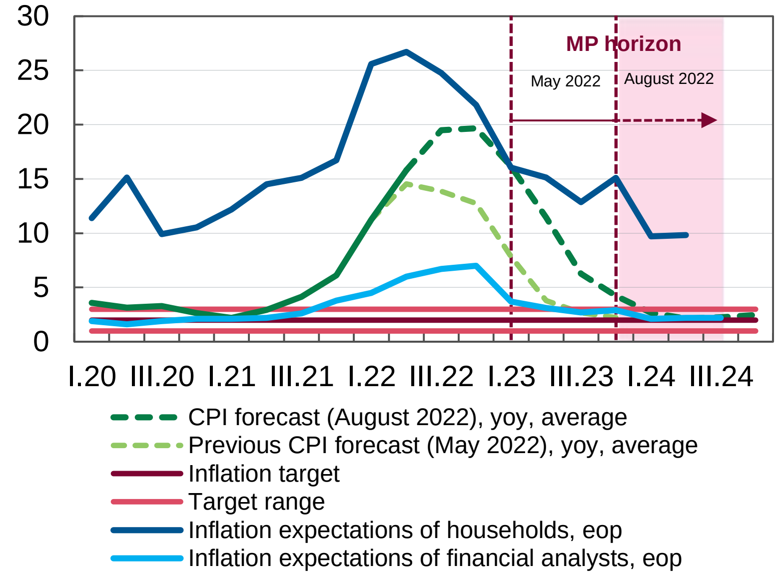
Sweden: inflation target, inflation* and 12-month-ahead inflation expectations of households, %



* CPI – until August 2017 inclusive, since then - CPIF

Source: Riksbank, Statistics Sweden.

Czech Republic: CPI, inflation target and 12-month-ahead inflation expectations, %

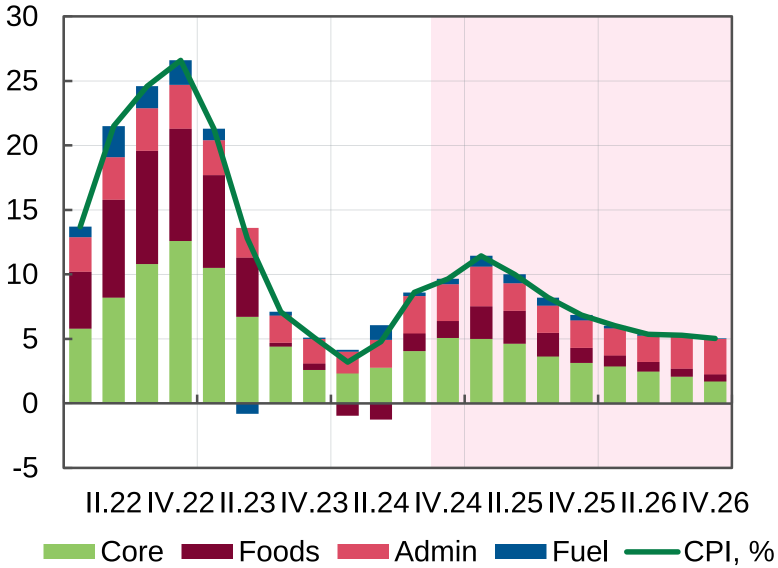


Source: Czech National Bank.

- Increased economic uncertainty may require CBs **to temporarily adjust the type of quantitative inflation target / extend the monetary policy (MP) horizon**, in particular:
  - in 2010−2017 and from the beginning of 2023, in conditions of significant increase in price volatility, Riksbank temporarily moved from variation band of 1–3% to the point target 2%
  - in Aug.2022, the Czech National Bank temporarily extended the MP horizon by 2 quarters
  - the Bank of Canada flexibly adapts the MP horizon during each macro forecast revision
  - due to the unprecedented challenges of the war, the NBU under flexible IT regime temporarily switched to a point inflation target (5%) and extended policy horizon
- At the same time, **increasing the flexibility of the MP should not call into question the CB's commitment / ability to ensure price stability**

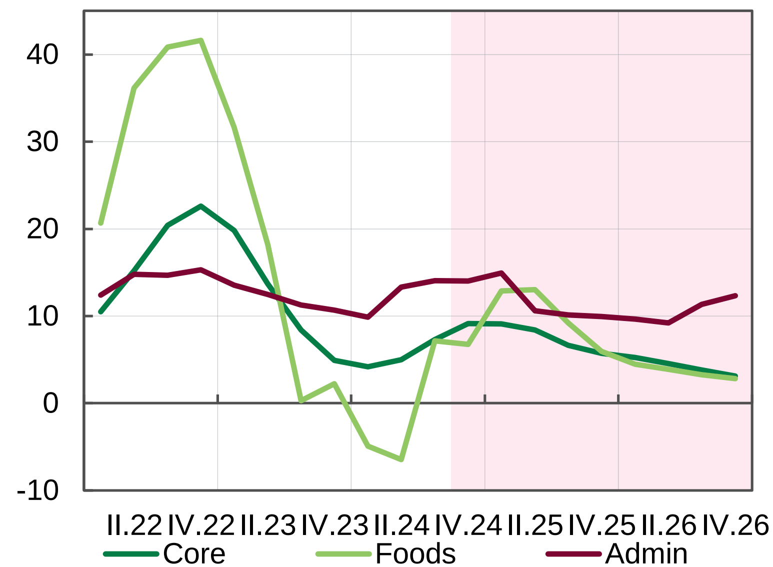
The pressure on prices will persist in the coming months, but inflation will start to slow in spring 2025

Contributions to the annual change in CPI, pp



Source: SSSU, NBU staff estimates.

CPI components, %

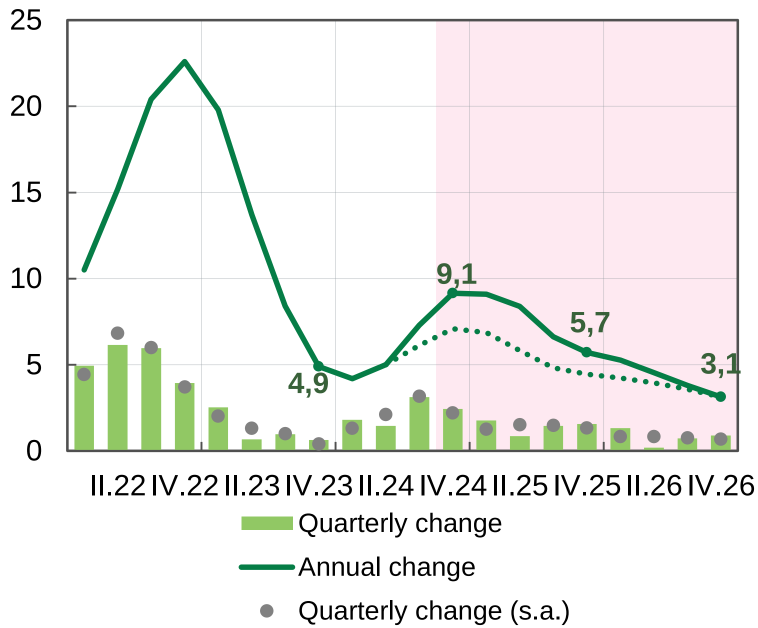


Source: SSSU, NBU staff estimates.

- **In the coming months, price pressure will persist** due to a lower supply of certain food products compared with last year, increased aggregate demand resulting from significant budget expenditures, high rates of wage growth and an increase in the energy deficit during the heating season
- **Inflation will begin to decrease in the spring of next year** and will reach the target of 5% in 2026, thanks to prudent monetary policy and weaker external price pressures, as well as by an improvement in the energy sector and an increase in harvests

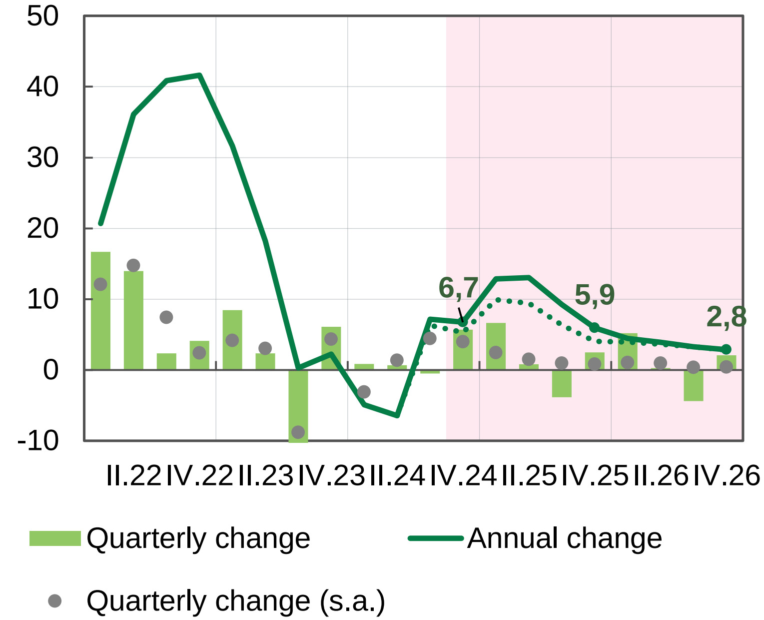
The increase in underlying inflationary pressure will be temporary and will subside due to monetary policy measures

Core inflation, annual change, %



Source: SSSU, NBU staff estimates.

Raw food inflation, %

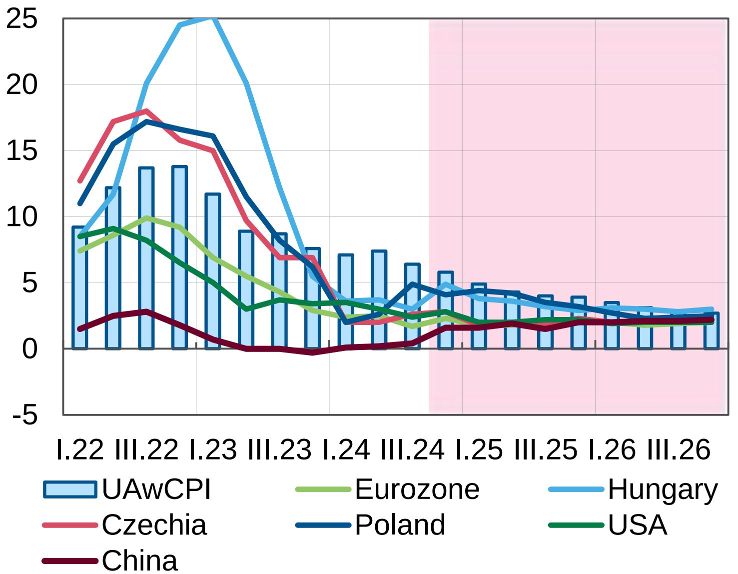


Source: SSSU, NBU staff estimates.

- **Rapid wage growth and continued pressure from other business costs will lead to a temporary intensification of underlying inflationary pressure** over the next few quarters, albeit in the future it will subside primarily due to the NBU's monetary policy measures
- **Food inflation will have a significant impact on the acceleration of headline inflation in the short term** (due to the summer drought affecting the supply of certain fruit and vegetable crops), but it will be relatively low in the longer term

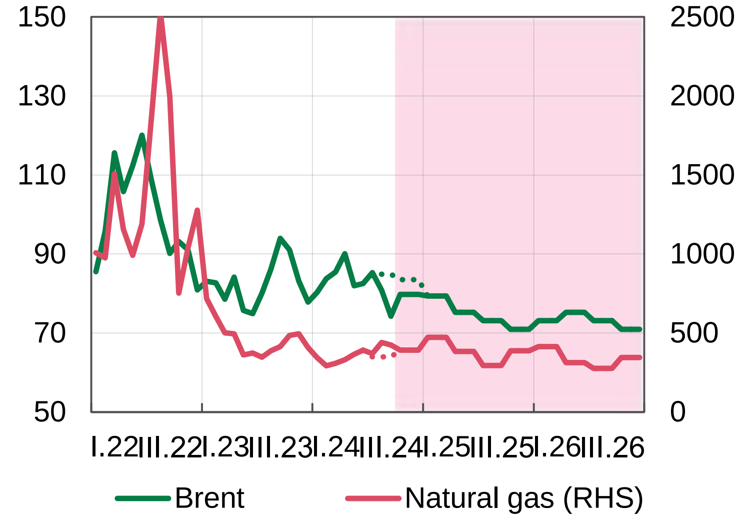
The easing of external price pressures will further contribute to lower inflation in Ukraine

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



Source: National statistical agencies, NBU staff estimates.

World crude oil prices (USD/bbl) and Dutch TTF natural gas prices (USD/kcm)

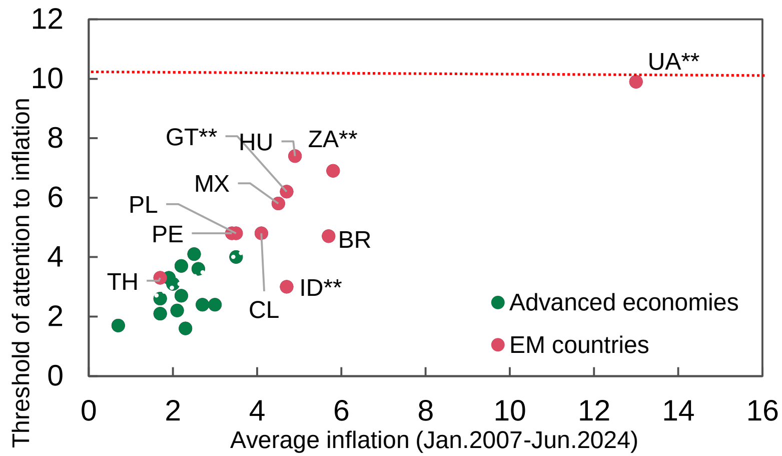


Source: World Bank, LSEG, NBU staff estimates.

- **Inflation in most of Ukraine's MTPs is expected to steadily decline** to targets in the second half of 2025 amid cheaper energy prices on global markets
- **Global energy prices will slowly decline despite high volatility**
- **Global financial conditions will continue to ease** as inflation slows

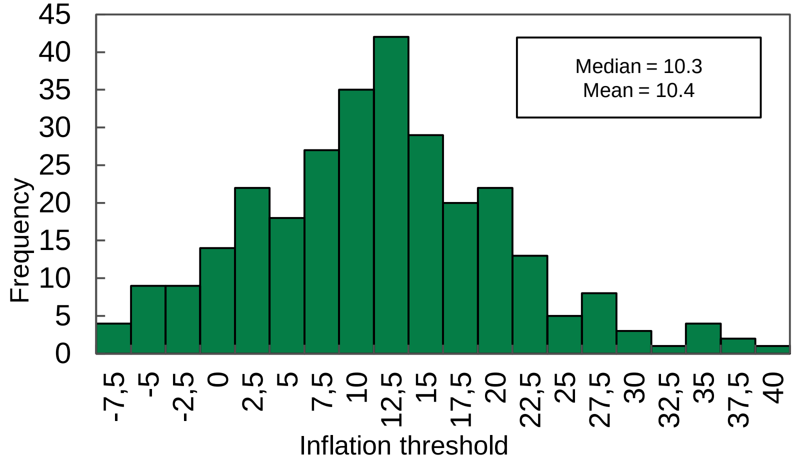
Box 2. Looking for Optimal Flexibility: What Deviation From the Target Is Acceptable

Average inflation rates in selected countries and inflation attention thresholds*, %



* Estimated with the methodology by Korenok et al. (2022) with sa index in Google Trends on the "Inflation" topic in 2007–2024. Shows only those countries where the values of the coefficients in the equation correspond to the expected ones.
** Adjusted for the trend in 2007–2010, before the methodological change. For Ukraine, it is also adjusted for periods of active hostilities in 2014−2016 and since 2022 with the dummy variables.
Source: Google Trends, Bloomberg, NBU staff estimates.

Distribution of estimated* attention thresholds in Ukraine for specific components of the CPI**



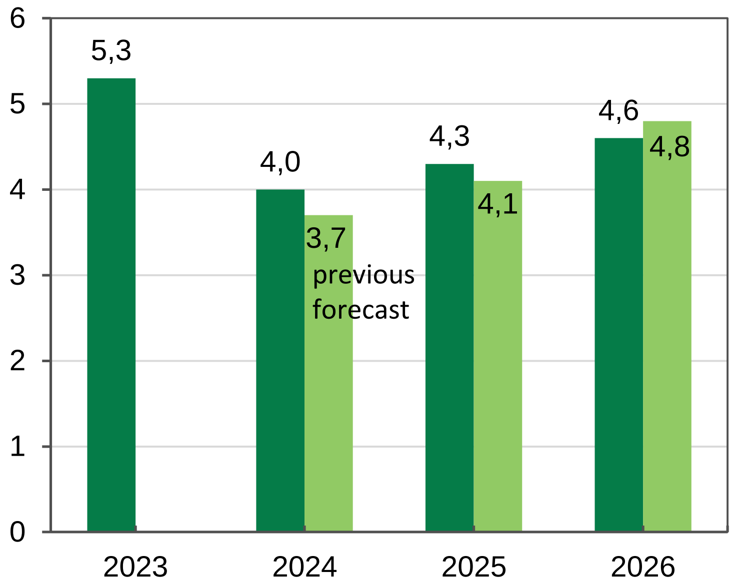
* Calculations are based on Korenok et al. (2023) using Google searches on the "Inflation" topic.
** Estimates for 320 CPI components, which have been included in the consumption basket over the entire estimation period (2018−2024). Estimated threshold levels are adjusted for outliers (the figure displays results from the 5th to 95th percentiles).
Source: Google Trends, SSSU, NBU staff estimates.

- The mechanistic focusing on keeping inflation close to the target can be counterproductive. So, **CBs may tolerate relatively predictable, moderate and short-term deviations from the target**
- A rapid, significant and/or **long-term increase in prices above a certain threshold level** strengthens expectations regarding the persistence of an inflationary surge → **risks of losing confidence in CBs and unbalancing inflationary expectations increase**. Hence, **CBs should react promptly and decisively**
- **Estimates* for Ukraine** based on Google searches for various components of the CPI show that, most often, attention to inflation increases rapidly after it reaches a double-digit level (10.3%)

** It should be taken into account that estimates of the inflation attention threshold according to the specified methodology for countries with high and volatile inflation are unstable and sensitive to the selected period for analysis*

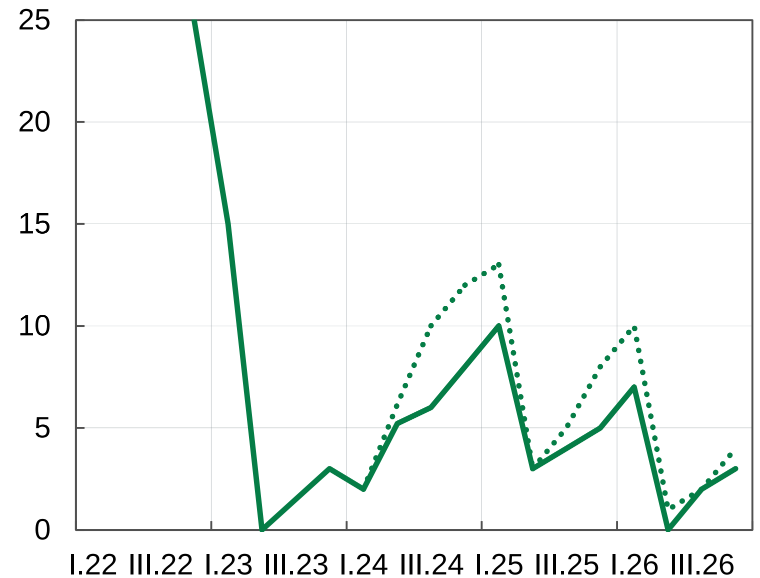
GDP growth will accelerate in 2025-2026, while the energy deficit will continue to constrain the recovery

Real GDP, %



Source: NBU staff estimates.

Electricity shortage, %

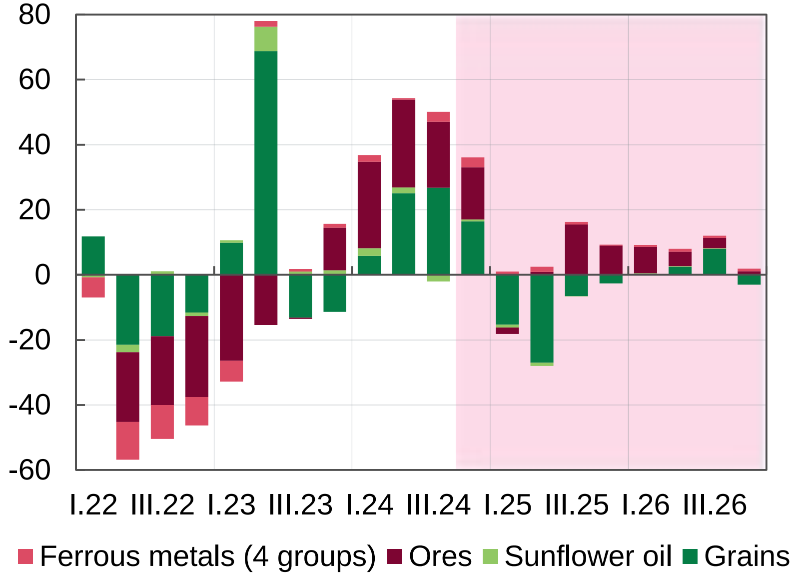


Source: NBU staff estimates.

- **The economy is recovering faster than expected** due to higher yields of early grain crops, lower electricity shortages and faster adaptation of businesses to energy outages. The GDP forecast for 2024 has been revised up to 4% (from 3.7%)
- **Economic growth will accelerate** to 4.3-4.6% in 2025-2026 thanks to the reconstruction of energy capacities, the stimulating role of the public sector, rising household incomes and sustained external demand
- Despite the improved assumptions, the **energy deficit will continue to restrain GDP recovery**

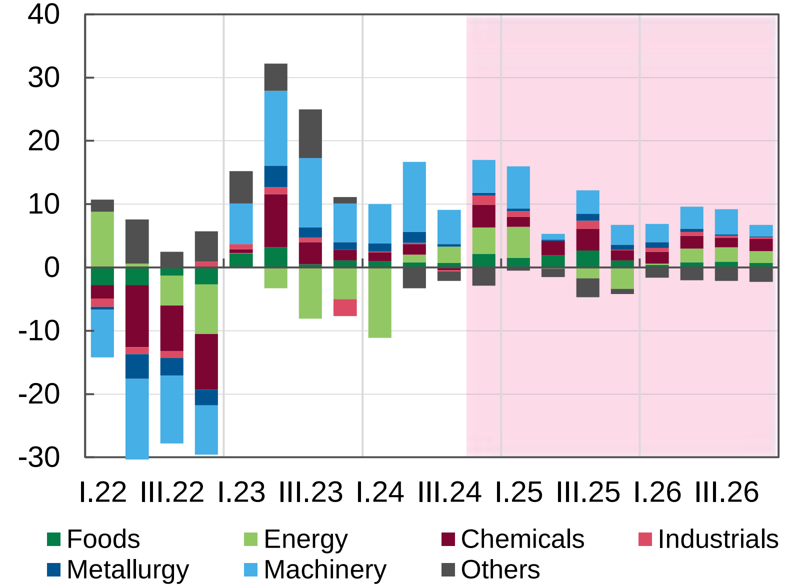
Growth in exports of goods will be constrained by limited production capacity and increased competition

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



Source: SCSU, NBU staff estimates.

Contributions to the annual change in imports, pp

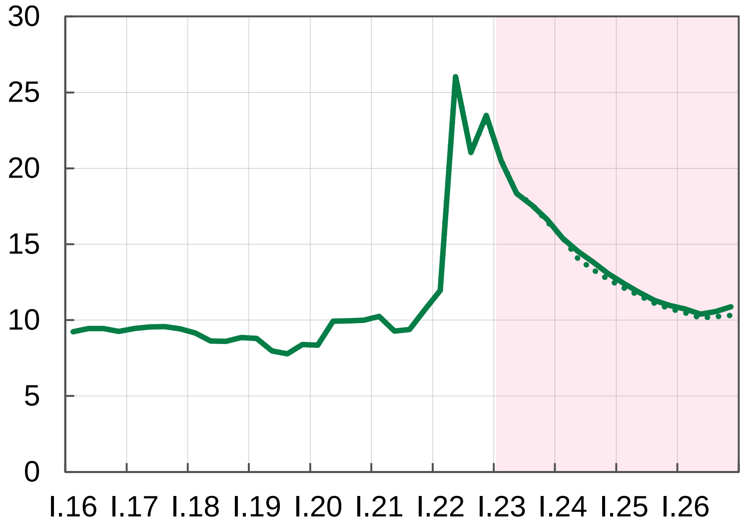


Source: SCSU, NBU staff estimates.

- **Amid a revival in economic activity in Ukraine's MTP countries, exports of ores and metals products will gradually increase**, albeit it will be limited by the competition for market share among the world's major steel producers. Lower harvest in 2024 will lead to a temporary decline in exports next year
- **The growth rate of imports of goods and services will slow, but remain high.** This will be driven by the persistently high needs of the defense sector, current consumption, and the need to invest in infrastructure restoration

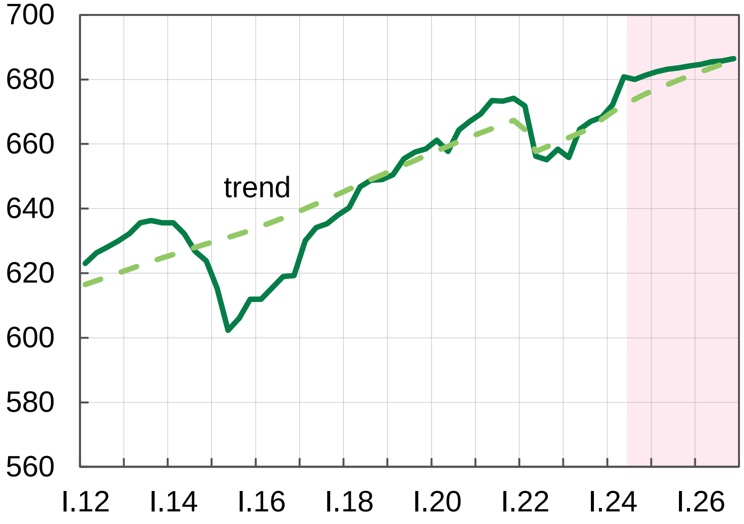
The labor market will remain tight and limit the economic recovery

Unemployment (ILO), %, sa



Source: SSSU, NBU staff estimates.

Real wages, level (logarithms)

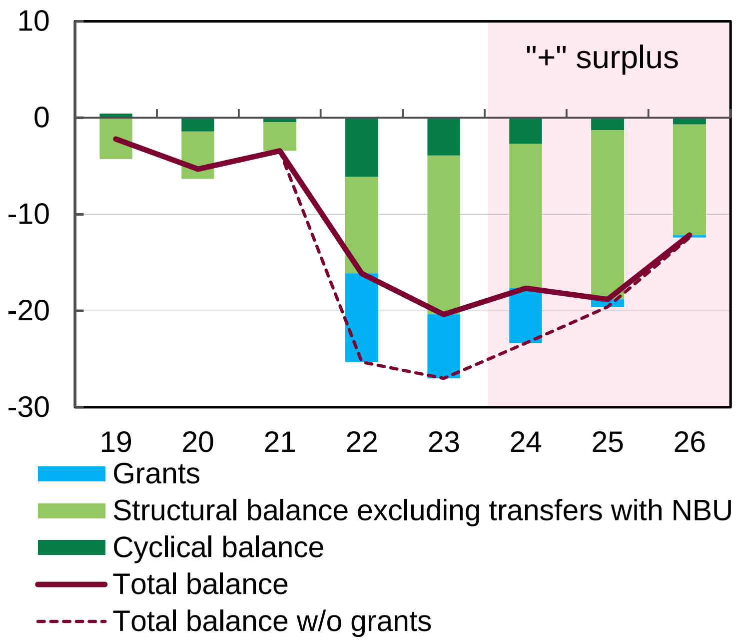


Source: SSSU, NBU staff estimates.

- **Real wages will exceed pre-war levels in 2024 and rise further** due to significant competition among employers for available labor force. This, along with loose fiscal policy, will fuel further growth in consumer demand
- **The unemployment rate will decrease** due to the increased demand for labor, albeit it will remain above the pre-invasion level. It will be determined by the prolonged imbalances in the labor market, primarily due to the limited supply of skilled labor

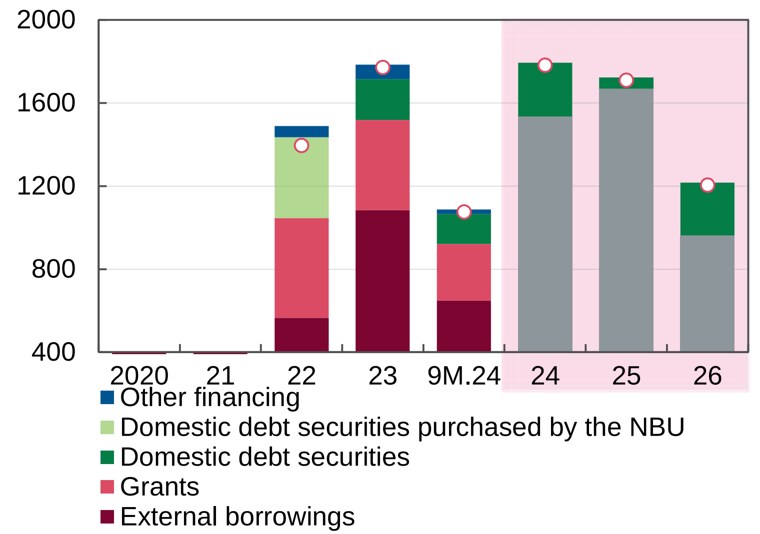
Significant budget stimuli will continue to stimulate economic activity

Consolidated budget balance, % of GDP



Source: STSU, NBU staff estimates.

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

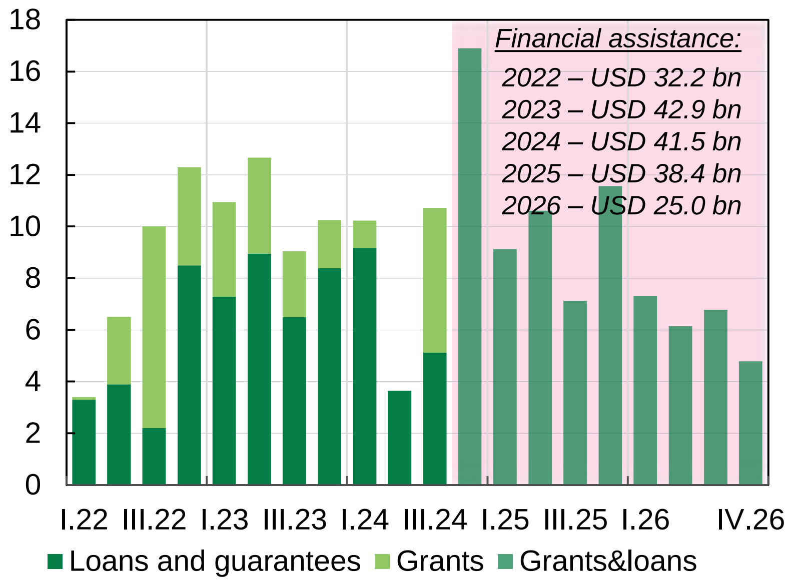


* Net borrowing. Deficit in 2024–2026 reflects the NBU's forecast. The grey color denotes external borrowing, grant funds, and other financing.
Source: STSU, NBU staff estimates.

- **Thanks to sufficient amounts of external support, the government will be able to continue financing significant budget expenditures. Therefore, budget deficits will remain significant, albeit they will gradually decrease** (from 23% of GDP in 2024 to 12% of GDP in 2026) due to the strengthening the domestic resource base amid further economic growth
- **The public sector will provide a boost to economic growth,** primarily due to significant expenditures on defense and security needs, reconstruction projects, and the humanitarian needs

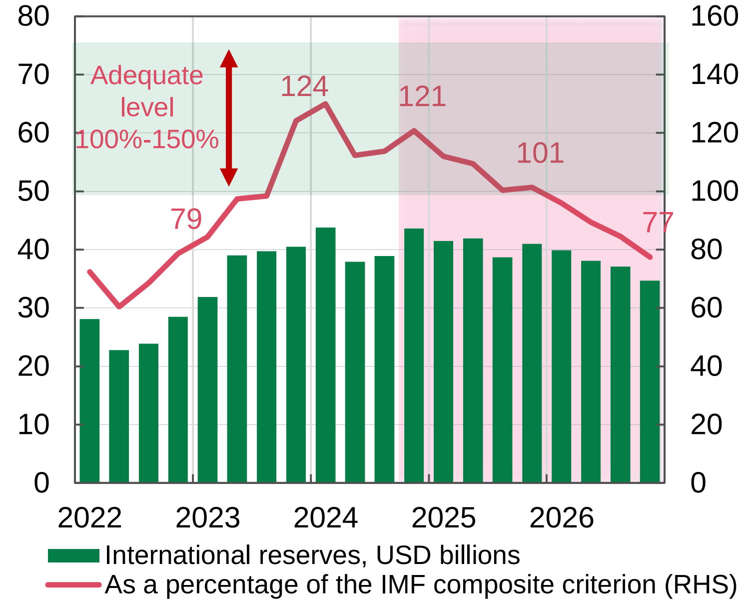
Thanks to sufficient external support, the NBU will be able to maintain an sufficient level of international reserves

International financial assistance, USD billions



Source: NBU, MFU, data from open sources, NBU assumptions.

Gross international reserves

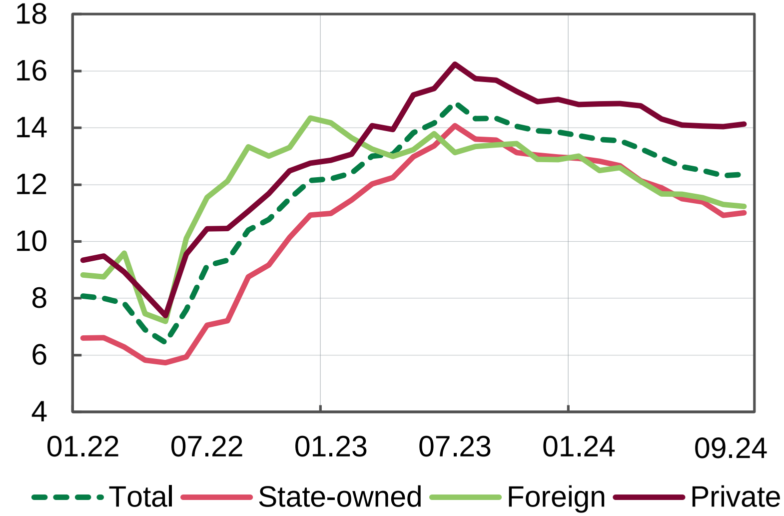


Source: NBU staff estimates.

- **Sustained external support will help to** compensate for the structural FX deficit in the private sector and smooth out excessive exchange rate fluctuations
- **The exchange rate will fluctuate moderately in both directions in response to changing market conditions**, which will further strengthen the adaptability of the FX market and the economy. The exchange rate dynamics will be in line with the NBU's goals of keeping inflation expectations under control, slowing inflation, and bringing it back to the 5% target

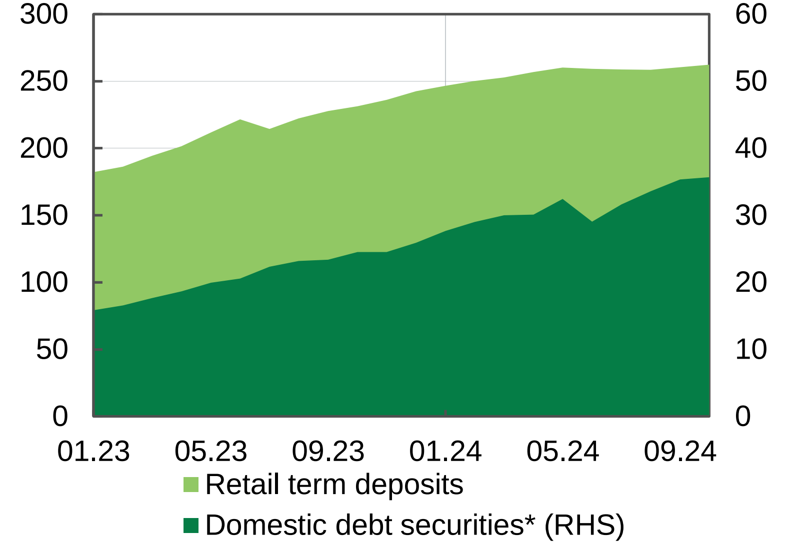
To counteract price pressure, the NBU has suspended the easing of its interest policy

Weighted average interest rates on hryvnia retail term deposits (by bank group), %



Source: NBU.

Rate on overnight CDs and weighted average rates on hryvnia retail term deposits, %

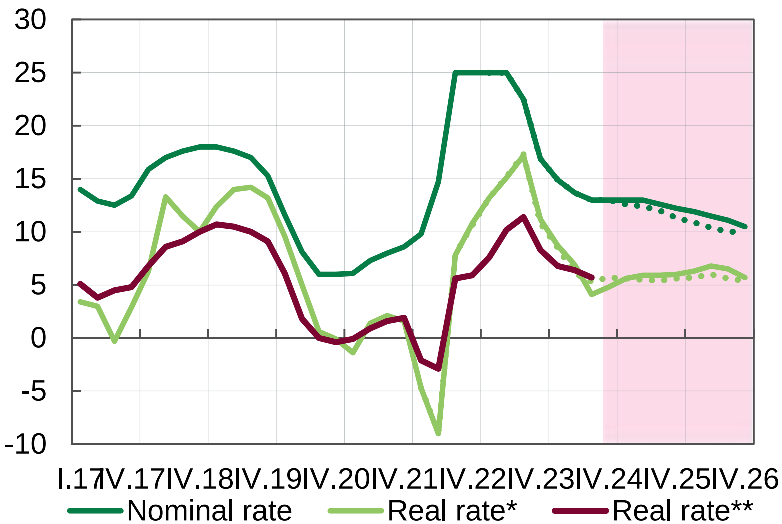


* At outstanding nominal value.
Source: NBU.

- **Keeping the key policy rate unchanged in recent months** has supported interest in hryvnia savings, with interest rates providing adequate protection against inflationary depreciation. In particular, the inflow of households' hryvnia term deposits resumed in the fall, and investments in domestic government debt securities continued to grow
- Despite the deterioration in households' exchange rate and inflationary expectations, the **current yields on hryvnia instruments are sufficient to support households' demand** amid stabilization in the FX market

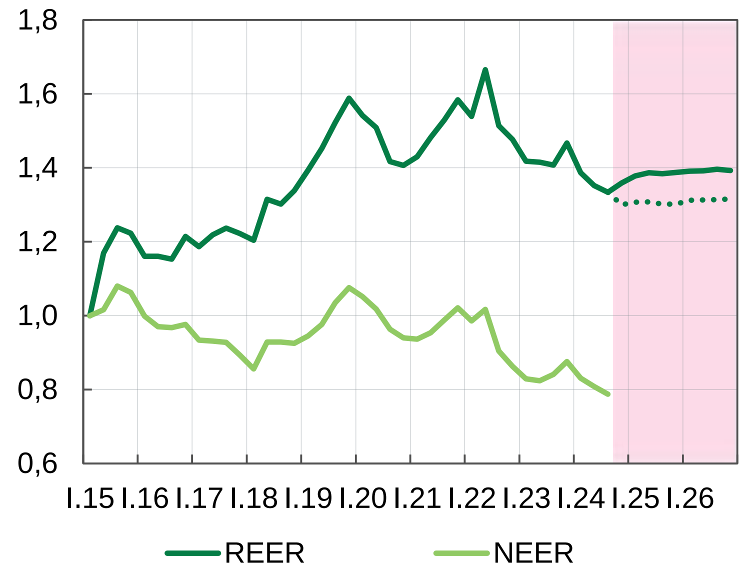
Maintaining moderate inflation and further reducing it to the target will require a more cautious approach by the NBU to its IR policy

Nominal and real key policy rate, period average, %



* Deflated on the model expectations (QPM).
** Deflated on the expectations of financial analysts.
Source: NBU staff estimates.

REER and NEER indices, I.2015 = 1



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

- **NBU forecast envisages keeping the key policy rate at 13%** at least until mid-2025. This, as well as the dynamics of the exchange rate, which will be consistent with the tasks of the NBU to keep inflation expectations under control, will help to slow down and bring inflation back to the target
- **At the same time, the key rate will remain positive (5-6%) in real terms** (the neutral level of the real rate in 2016-2019 was estimated at 3-4%), which is not excessive under the current conditions (high risks)
- **The REER will remain relatively strong**, which will contribute to maintaining sufficiently tight real monetary conditions

Box 3. Evolution of Monetary Regime during the War: From Hard Peg to Flexible Inflation Targeting

At the beginning of the full-scale invasion, **the NBU had to** temporarily switch to a fixed exchange rate, impose strict FX controls, and resort to the monetization of state debt for national defense purposes

Meanwhile, the NBU remained committed to its mandate of ensuring price and financial stability and **declared its commitment to return to IT** when conditions permitted

During 2022–2024, the following preconditions were established:

- enhancing monetary transmission and effectiveness of the key policy rate
- avoiding budget monetization since 2023, increasing confidence in the national currency, renewing of the interest in hryvnia-denominated assets, reducing dollarization and weakening demand for FX
- gradual easing of the most burdensome FX restrictions
- gradual shift in the role of the nominal anchor of monetary policy from the exchange rate to inflation
- transition from a fixed ER to managed flexibility of the exchange rate

Significant progress in these areas enabled the transition to flexible IT

Main features of the regime

- point target for CPI (without a range)
- extended policy horizon (up to 3 y)
- managed flexibility of the exchange rate
- consistent combination of interest rate and exchange rate policy tools, FX restrictions, and other tools to ensure price stability

+

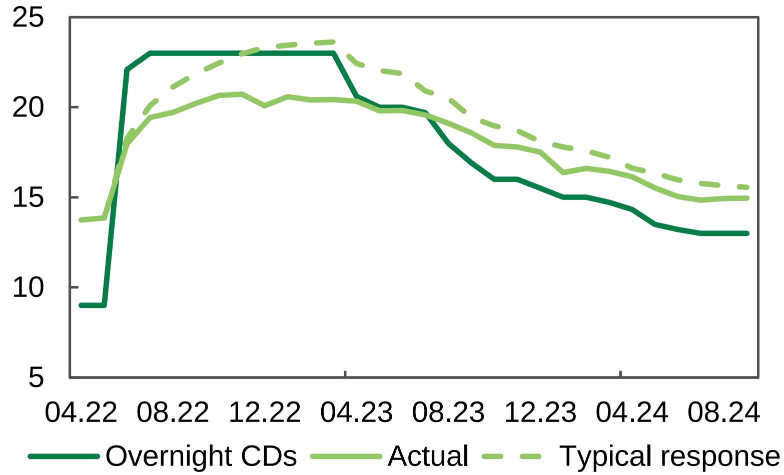
Flexibility of the monetary regime allows moderate and relatively short-term deviations of inflation from its quantitative target due to internal and external factors beyond the effective influence of the NBU's monetary policy

On the one hand, such approach helps the Ukrainian economy adapt to shocks and supports its recovery, while, on the other hand, allows keeping inflation expectations under control

! *The NBU intends to use **flexible inflation targeting until economy normalizes, allowing to resume full-fledged IT framework** with a floating exchange rate*

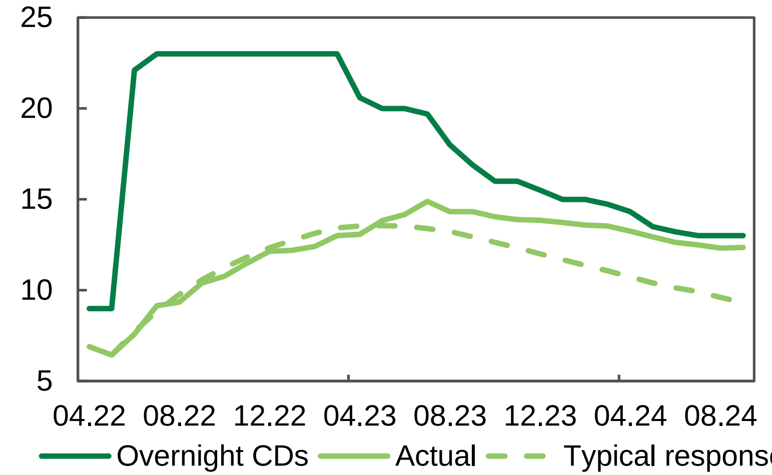
Box 4. Restoring sufficient effectiveness of the key policy rate as a prerequisite for the transition to flexible inflation targeting

Rate on overnight CDs* and weighted average interest rates on new hryvnia loans to NFCs, %**



* Monthly average ** Excluding transactions under additional agreements where there was a change in the loan principal and/or interest rate, as well as prolongation.
Source: NBU staff estimates.

Rate on overnight CDs and weighted average IR on hryvnia retail term deposits, %



* Monthly average
Source: NBU staff estimates.

- **The strength and predictability of market rates' response to the key policy rate is gradually increasing:**
  - a comprehensive set of NBU measures has contributed to greater competition among banks for households' hryvnia term deposits. After the transition to the policy easing cycle, it enabled for targeted control over the decline in deposit rates
  - transmission in the yields of hryvnia government bonds has improved, thanks to better coordination with the Ministry of Finance
  - the speed and effectiveness of transmission to corporate loan rates increased due to the preservation of macroeconomic stability and the resumption of market-based lending to businesses
- **The effectiveness of the key policy rate is still insufficient to fully serve as the main monetary tool**, albeit in combination with other tools, it is sufficient for the transition to flexible IT

The balance of risks is shifted towards increased price pressure

Degree of impact on the baseline scenario	Probability of Risk Occurrence: Low <15%	Average 15%–25%	High 25%–50%
Weak	Restoration of the blockade of the western borders or establishing additional restrictions on access to the European market		
Moderate	Rapid restoration of damaged energy infrastructure	Increased emigration Growing geopolitical tensions	Potential pass-through of additional tax increases and/or introduction of new taxes to prices
Strong	Rapid implementation of the large-scale plan for the reconstruction of Ukraine	Changes in the announced volumes of international aid	Escalation of hostilities, further destruction of production facilities Higher electricity deficit due to further damage to the energy infrastructure Additional budgetary needs