National Bank of Ukraine

Inflation Report (July 2024)

6 Aug 2024

Key takeaways

- **After a long period of decline, inflation returned to growth** in May and picked up to 4.8% yoy in June (slightly below the NBU's April forecast). Underlying price pressures intensified as business expenses on labor and power grew
- **Inflation will rise in the coming months, yet it will stay moderate** – 8.5% at the end of the year. NBU's balanced policy and weakening of external inflationary pressures will make it possible to slow inflation down – to 6.6% as soon as 2025. In 2026, inflation will return to the NBU's 5% target as the economy gradually normalizes and the energy situation continues to improve
- **Economic recovery will continue** but will be constrained by the war's impact, including extensive damage to the energy system
- **Significant international financial aid** will enable the government to finance the budget deficit, and will allow the NBU to maintain a comfortable level of reserves
- Considering the need to maintain the sustainability of the FX market and bring inflation closer to the 5% target over the forecast horizon, the **NBU Board decided to keep the key policy rate at 13%**
- **The NBU will also maintain an active presence on the FX market** to cover the structural deficit of FX, support two-way exchange rate fluctuations, and smooth out excessive volatility
- **The NBU forecasts the key policy rate easing cycle to resume** only in 2025. However, the NBU will respond flexibly to changes in the balance of risks to inflation and the FX market

Macroeconomic forecast*: July 2024

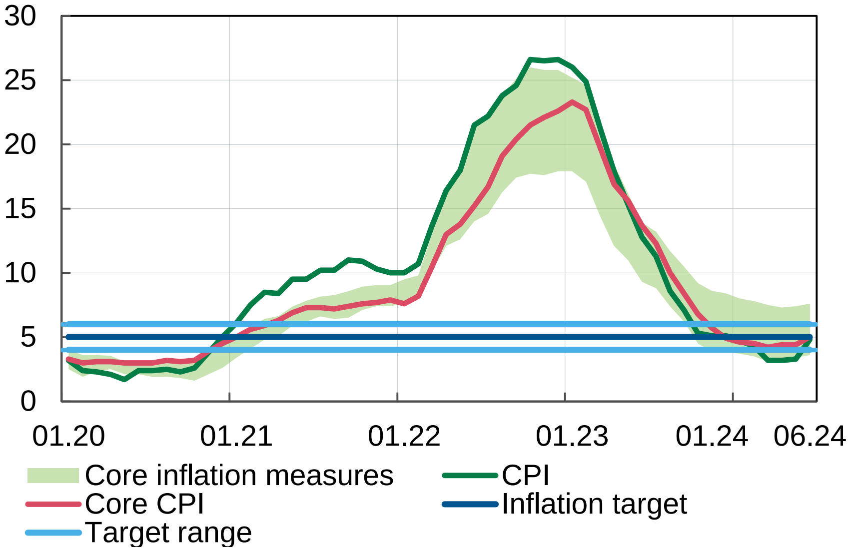
	2023**	2024	2025	2026
Real GDP, change, %	**5.3**	**3.7** (3.0)	**4.1** (5.3)	**4.8** (4.5)
CPI, % yoy (eop)	**5.1**	**8.5** (8.2)	**6.6** (6.0)	**5.0** (5.0)
Current account balance, USD bn	**-9.7** (-9.2)	**-14.2** (-20.2)	**-19.0** (-18.2)	**-23.5** (-23.1)
International reserves, USD bn	**40.5**	**41.2** (43.4)	**37.3** (44.3)	**32.0** (39.3)
Consolidated budget deficit, % GDP ***	**26.9**	**22.8** (20.7)	**17.8** (13.5)	**10.3** (7.5)

Assumptions	2023**	2024	2025	2026
Official financing, USD bn	**42.9**	**38.0** (37.9)	**31.4** (25.1)	**21.1** (12.6)
Migration (net), million persons	**-0.2**	**-0.4** (-0.2)	**-0.3** (0.4)	**0.4** (0.8)
Real GDP of Ukraine's MTPs, %	**1.5** (1.4)	**2.3** (2.3)	**2.8** (2.8)	**2.7** (2.7)
CPI of Ukraine's MTPs, %	**7.6**	**5.6** (5.5)	**3.9** (3.9)	**2.7** (2.7)
Harvest of cereals and legumes, million tons	**59.8**	**53.7** (53.0)	**57.9** (59.5)	**61.7** (65.5)

* in brackets – previous forecast (Inflation report, April 2024)
** actual/estimate
*** excluding grants

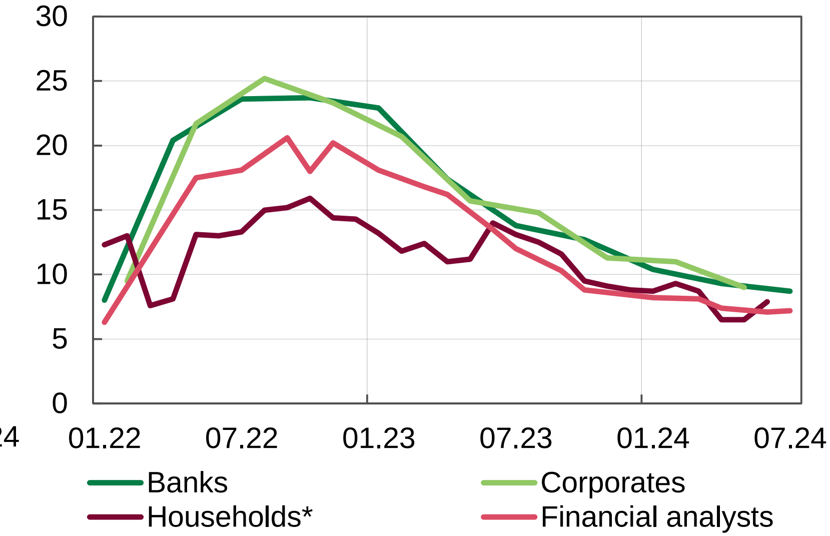
In Q2, as expected, inflation rose to nearly 5%, and inflation expectations are gradually responding to this

Consumer inflation and underlying inflation trends*, % yoy



* Read more in the January 2017 Inflation Report (pages 20–21).
Source: SSSU, NBU staff estimates.

Inflation expectations for the next 12 months, %

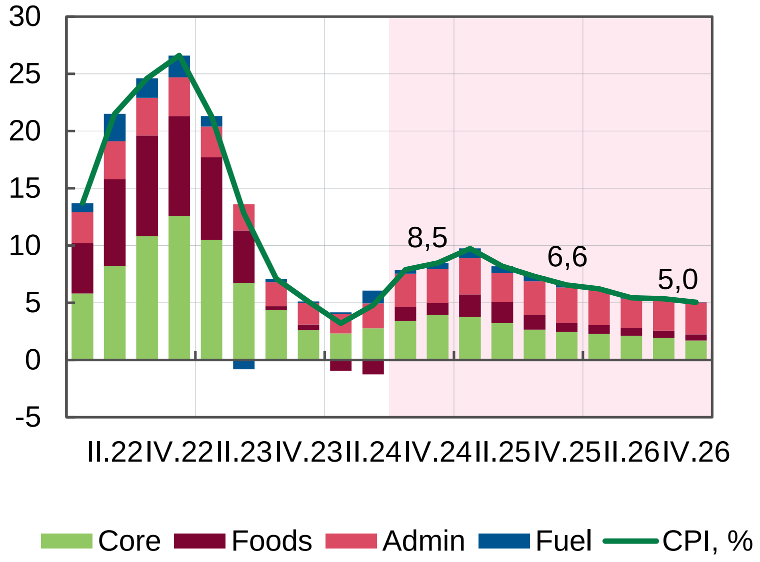


* From March 2023, the survey method was changed from face-to-face to telephone interviews.
Source: NBU, Info Sapiens.

- **After a long period of declining inflation, its trajectory reversed in May, with inflation accelerating to 4.8% yoy in June (compared to 3.2% yoy in March)**
- **Underlying inflationary pressures remained stable for a long time** and began growing as expected, confirming that the low consumer inflation in the previous months was temporary. **The persistence of underlying inflationary pressures largely reflected further increase in business costs** due to maintenance of high security risks, higher wages amid a shortage of personnel, and a difficult situation in the energy sector. The effects of the bumper harvest of 2023 were also gradually waning off

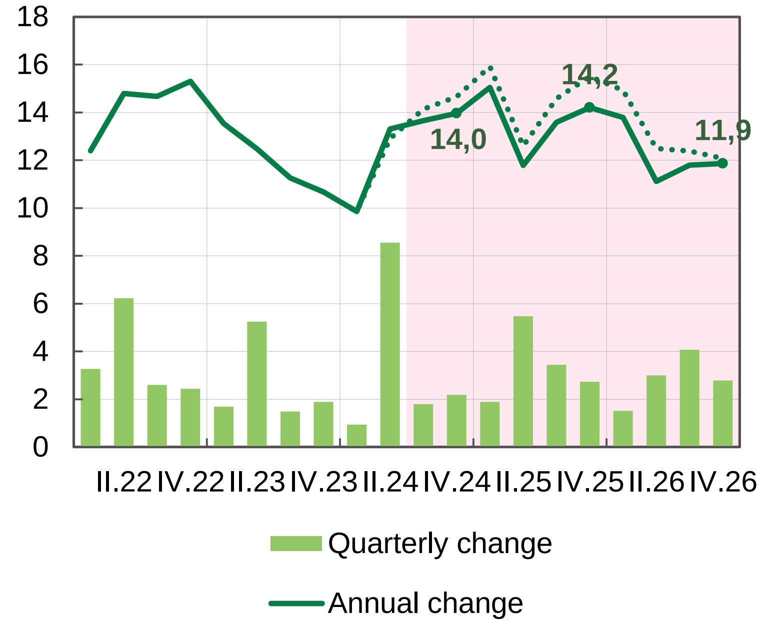
Inflation will accelerate over the next 3 quarters but will remain moderate, and subsequently will move towards the target

Contributions to the annual change in CPI, pp



Source: SSSU, NBU staff estimates.

Administratively controlled prices, annual change, %

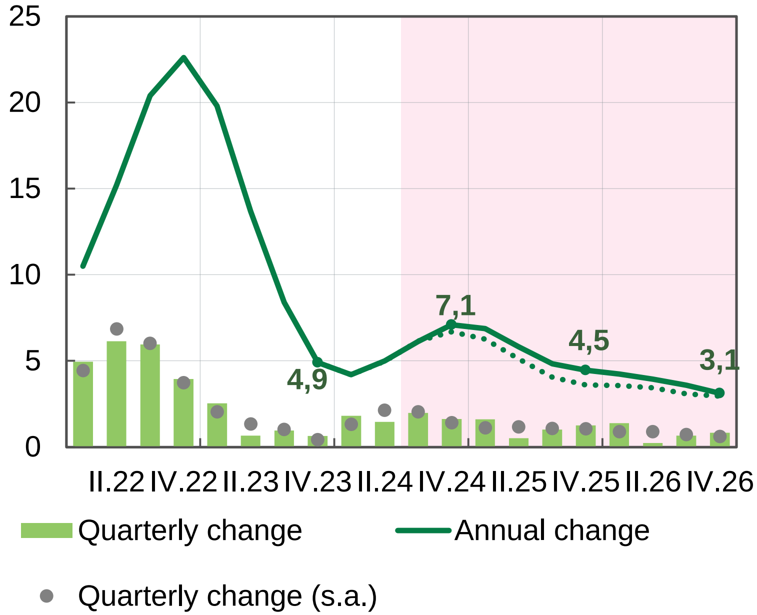


Source: SSSU, NBU staff estimates.

- **Price growth will continue to accelerate** due to exhaustion of the effects of last year's high harvests, significant pressure from the side of business costs in the conditions of electricity shortages and lack of workers, influence of the revision of administrative tariffs and excise taxes, as well as negative impact from the summer drought on this year's yields. **Inflation will reach 8.5% by the end of this year**. In 2025, it will begin to decrease thanks to NBU's monetary policy measures, weakening of external price pressure and improvement of the situation in the energy sector
- **In the following years, administrative inflation will grow by more than 10%.** Therefore, in order to ensure headline inflation at the level of 5%, monetary policy should be aimed at maintaining other components of the CPI (primarily the core inflation) at the level of about 3%

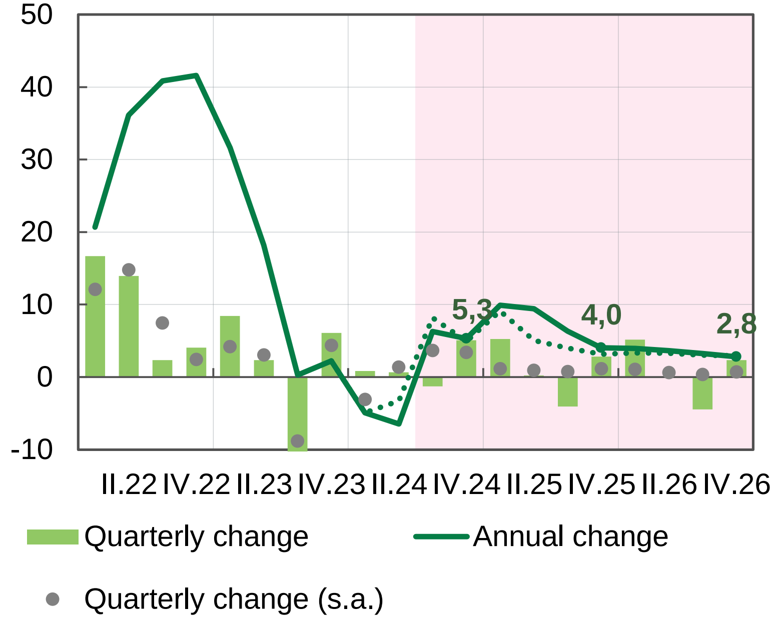
Rising food inflation (exhaustion of the effects of 2023 harvest + drought) **will drive the CPI growth until the end of the year**

Core inflation, annual change, %



Source: SSSU, NBU staff estimates.

Raw food inflation, %

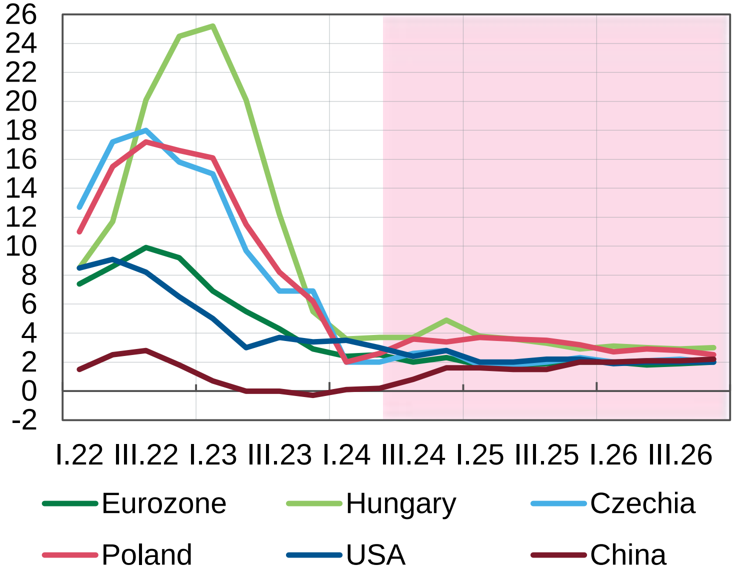


Source: SSSU, NBU staff estimates.

- **By the end of 2024, a temporary acceleration of core inflation to about 7% is expected** due to the effects of the hryvnia ER weakening in the first half of the year, secondary effects of rising prices for raw foods and pressure from business costs.
- **From the middle of 2025, core inflation will begin to slow down** thanks to monetary policy measures aimed at maintaining the attractiveness of hryvnia assets and reducing inflation in the MTPs. In the future, this will also be facilitated by the reduction of uncertainty regarding the security situation, optimization of logistics and production processes
- **In 2025-2026, food inflation will remain relatively low** thanks to gradual growth of harvests and improvement of logistics

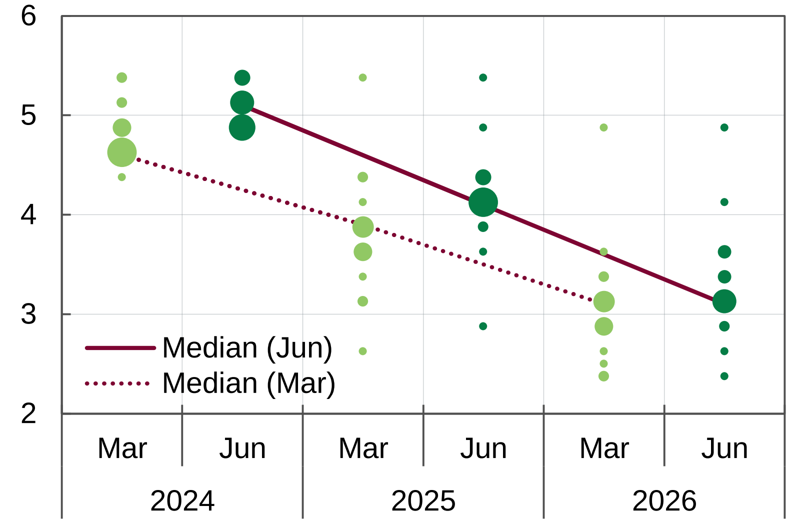
Slowdown in inflation over the coming years will be facilitated by easing of inflationary pressures from Ukraine's MTPs

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



Source: National statistical agencies, NBU staff estimates.

Projected appropriate policy path at the end of the year according to the expectations of the FOMC members, based on the results of the meetings

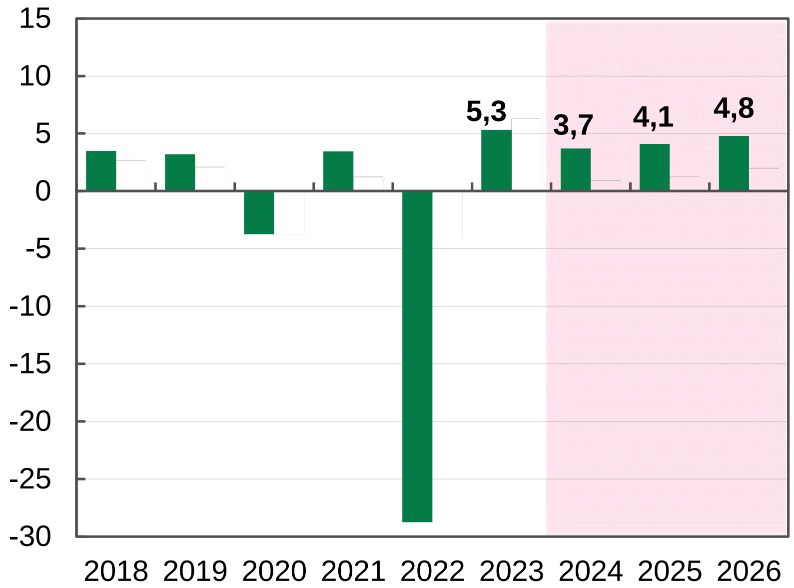


* The size of the circle is determined by the number of participants supporting the respective rate level.
Source: Fed.

- **Inflation is expected to return to targets sustainably by the end of 2025.** Most measures of core inflation continue to decline, reflecting the fading impact of previous large shocks, as well as weak demand amid tight monetary policy. An additional factor in restraining inflation is the long-term inflation expectations, which remain generally stable in Ukraine's MTPs
- **Global financial conditions, despite partial easing, will remain tight for longer, given the persistence of inflation**

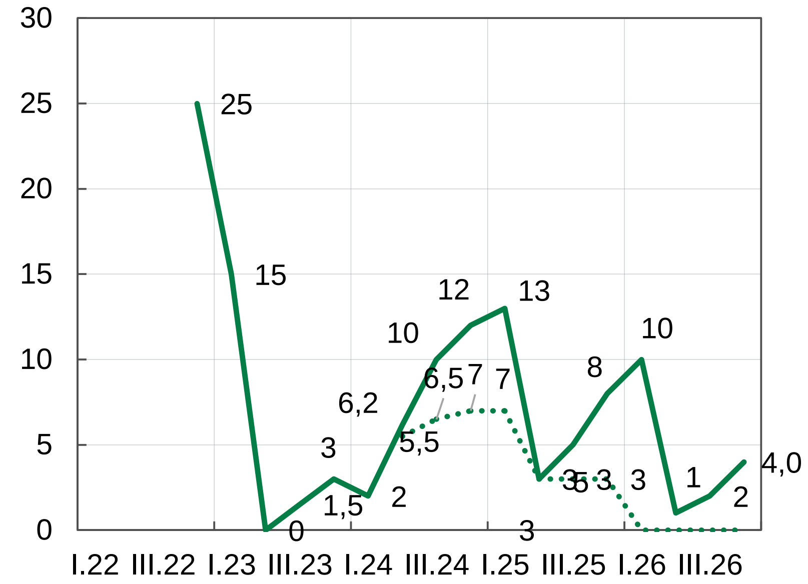
Maintaining a loose fiscal policy amid normalization of conditions for economic activity will ensure GDP growth

Real GDP, %



Source: SSSU, NBU estimates.

Electricity deficit, %

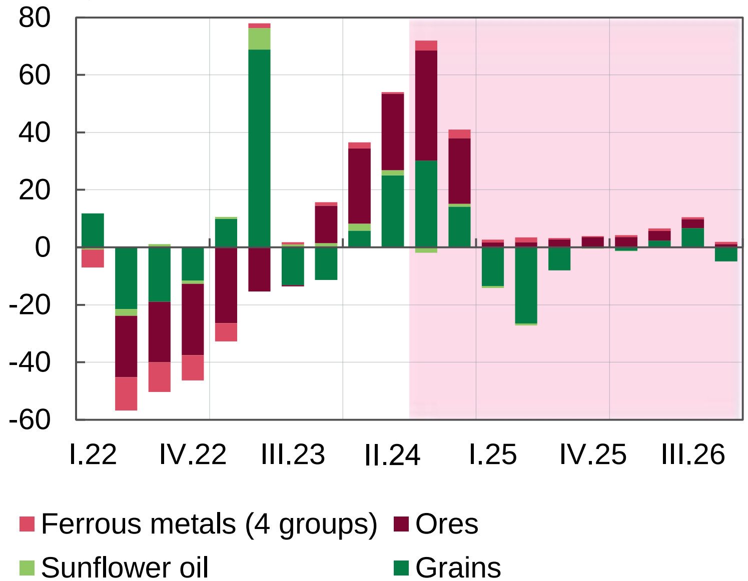


Source: NBU estimates.

- After a strong surge at the beginning of the year, **GDP growth will slow further** due to a significant electricity shortage
- A loose fiscal policy and further development of export routes amid the revival of external demand **will support GDP growth** (by 3.7% in 2024)
- Reconstruction of the damaged energy infrastructure will require significant resources and time, so the **energy deficit will persist over the forecast horizon and restrain economic growth**

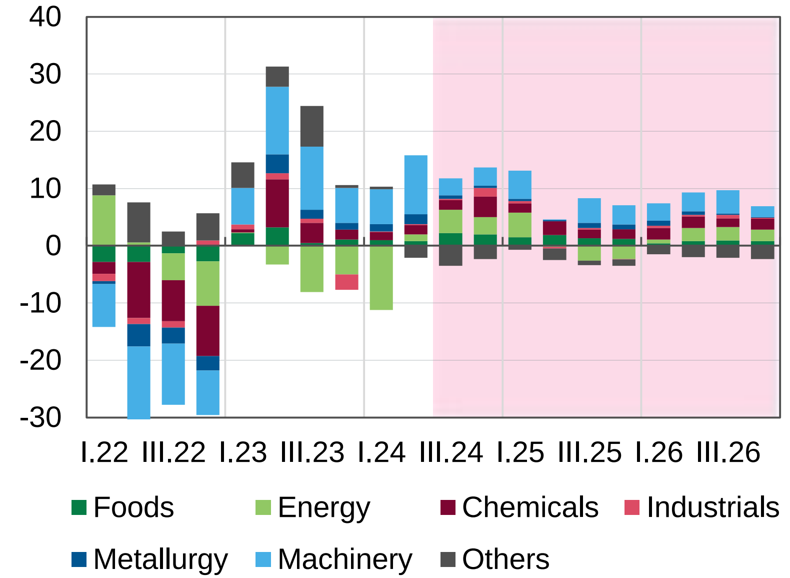
Exports will be supported by sufficient transportation capacity, yet constrained by limited production potential

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



Source: NBU staff estimates.

Contributions to the annual change in imports, pp



Source: NBU staff estimates.

- The destruction of production facilities and electricity shortages will result in weak exports of metallurgy and machinery. **Meanwhile, the swings in exports will be determined primarily by agricultural harvests**
- **The need to restore the power system** will cause **growth in imports of certain machinery products**, and purchases of electricity and goods for energy autonomy will remain significant. **The recovery of economic potential and high budget expenditures** will also drive demand for imported products

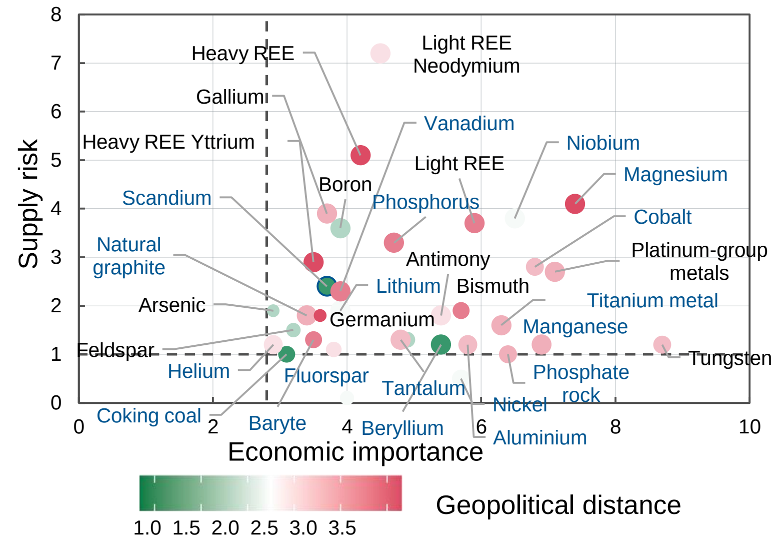
National Bank of Ukraine

Box. Friend-shoring for the EU: an opportunity for Ukraine?

The EU's direct and indirect dependency on imports from China and russia at the sectoral level in 2020, % of value added

Source: OECD TiVA 2023, icio Stata tool, NBU staff estimates.

Critical raw materials by EU dependency and weighted geopolitical distance to suppliers

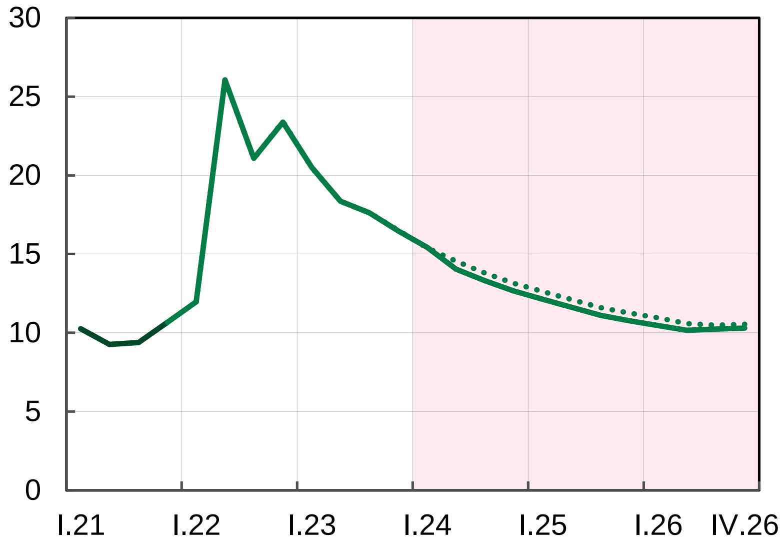


CRMs, deposits of which Ukraine possesses or already has under development, are in blue.
Source: European Commission, BRDO, State Service of Geology and Mineral Resources of Ukraine, NBU staff estimates.

- **Foreign trade closely connects the EU with countries of other geopolitical vectors.** About 20% of EU imports come from China
- **Strategic dependencies between the EU and other countries exist in energy-intensive manufacturing, renewable energy, defense and aerospace, digital technologies, electronics, and healthcare.** Their primary cause is the EU's lack of significant deposits of critical raw materials, which, however, are partially available in Ukraine
- **Prospects for Ukraine are cautiously optimistic both in traditional industries** (agriculture, mining and metallurgy) **and in the production of technological goods, in particular the military-industrial complex**

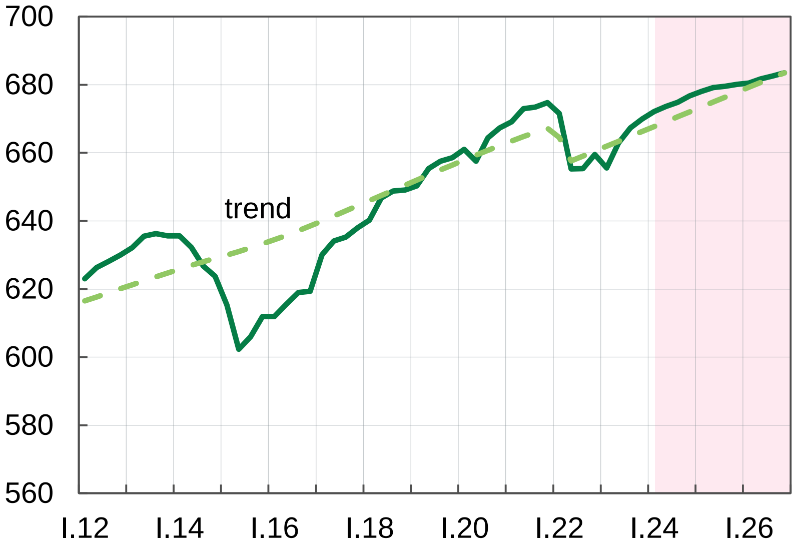
Wages will continue to grow due to the economic recovery and the labor shortages

Unemployment (ILO), %, sa



Source: SSSU, NBU staff estimates.

Real wages, level (logarithms)

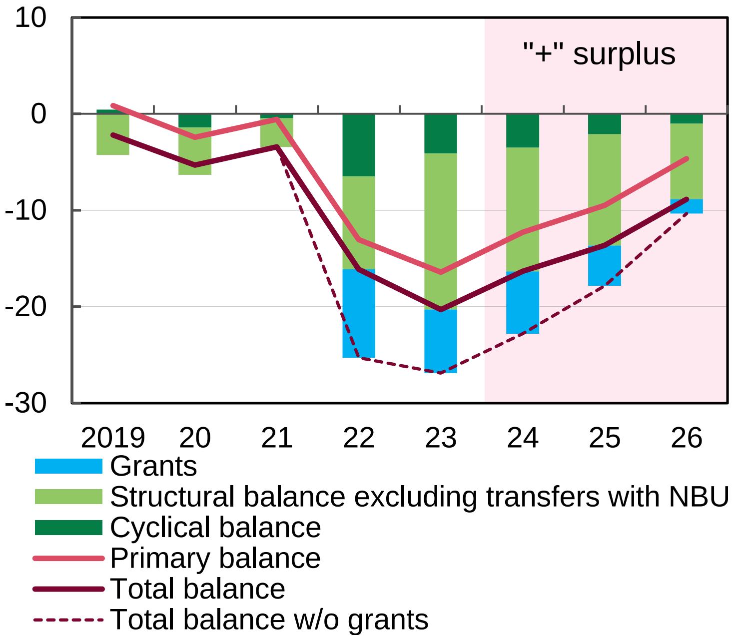


Source: SSSU, NBU staff estimates.

- **Significant imbalances in the labor market will persist** over the forecast horizon. The unemployment rate will therefore decrease, but will remain elevated compared to pre-invasion levels
- **At the same time, increased competition for available labor and the continuation of a loose fiscal policy will remain steady drivers of wage growth** in the private sector and, consequently, consumer demand
- **Real wages are expected to exceed their levels prior to the full-scale war over 2025** and continue to rise beyond

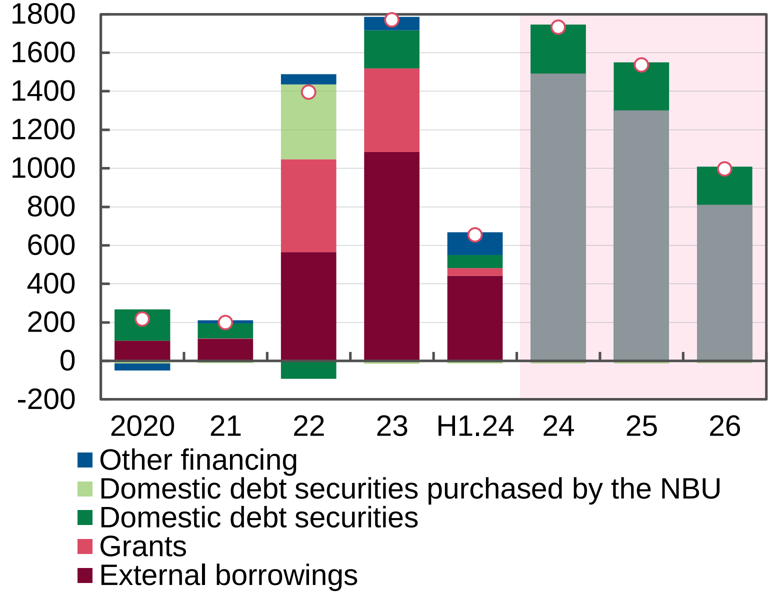
Budget deficits will remain significant due to the needs of the security and defense sector, social support and reconstruction

Consolidated budget balance, % of GDP



Source: STSU, NBU staff estimates.

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



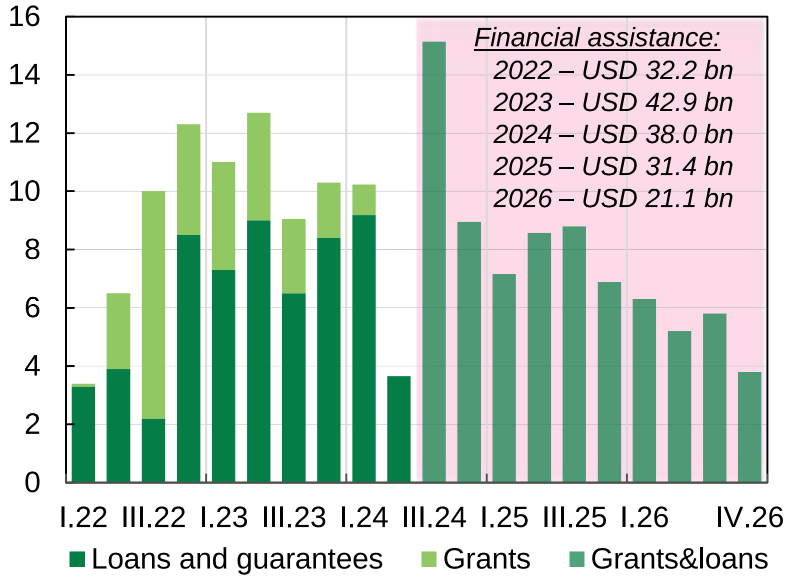
* Net borrowing. Deficit in 2024–2026 reflects the NBU's forecast. The grey color denotes external borrowing, grant funds, and other financing.

Source: STSU, NBU staff estimates.

- **Government expenditures will remain a major driver of economic growth**
- **The budget deficit will remain significant due to high defense spending** as well as critical rebuilding and social support needs, and later on – needs for reconstruction and humanitarian projects. The expansion of the domestic resource base will ensure a consistent narrowing of the budget deficit, although the fiscal policy will remain loose
- **A substantial budget deficit will continue to be a key factor in the growth of debt levels**

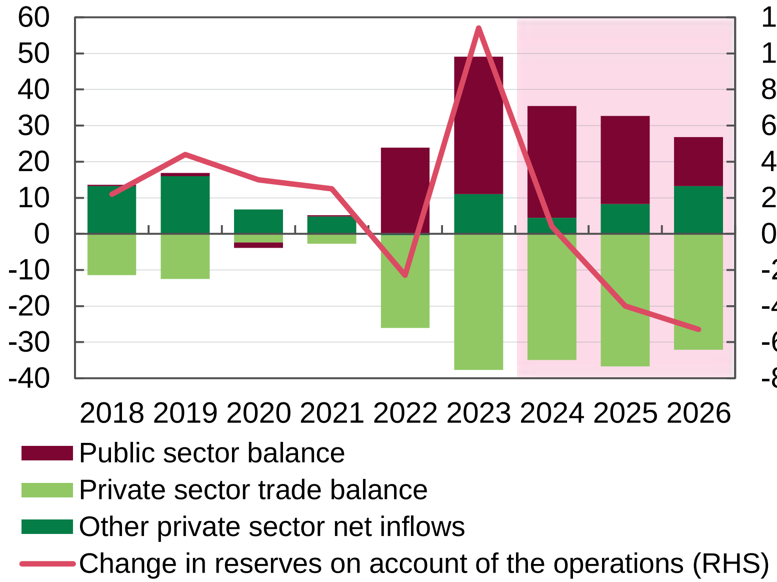
The level of international reserves will remain sufficient to ensure the stability on the FX market

International financial assistance, USD bn



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

Private sector debt capital flows, USD bn

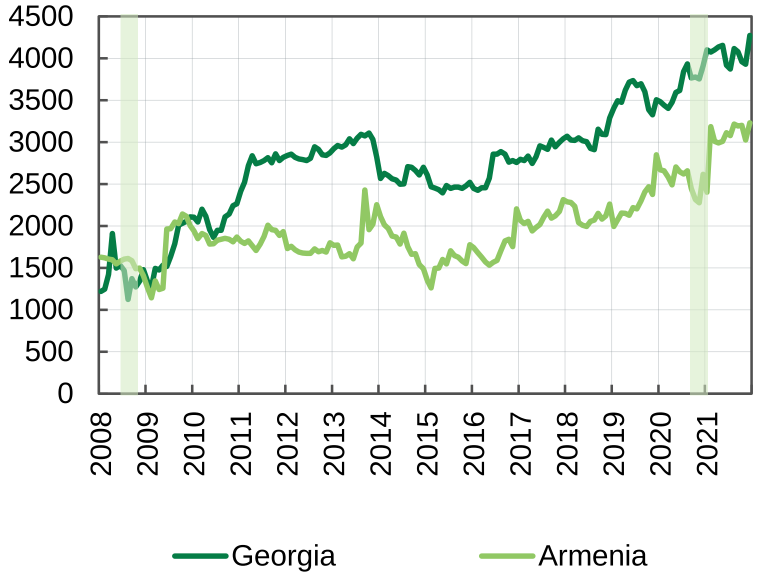


Source: NBU staff estimates.

- **A reduction in international financial assistance** amid a significant net FX outflow from the private sector will lead to a gradual **decline in international reserves to USD 32 bn** by the end of 2026
- **The NBU will continue to maintain an active presence in the FX market** to cover the structural deficit of FX, ensure two-way exchange rate fluctuations, and smooth out excessive volatility
- The NBU aims to ensure such a state of the FX market that will allow to **control inflation expectations and achieve the inflation target** over the forecast horizon

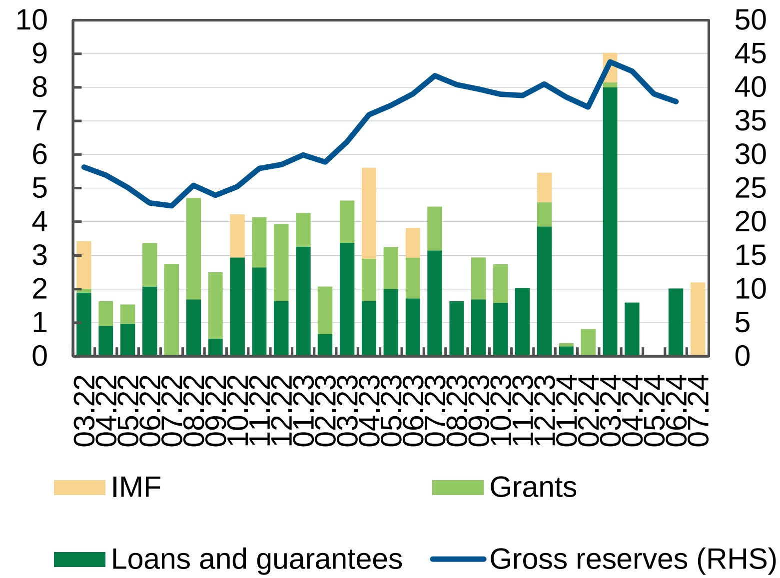
Box. The gross international reserves of Ukraine: what level is sufficient in wartime conditions?

Gross international reserves of Armenia and Georgia, USD million



Source: official websites of central banks.

External financial assistance and gross international reserves of Ukraine, USD bn

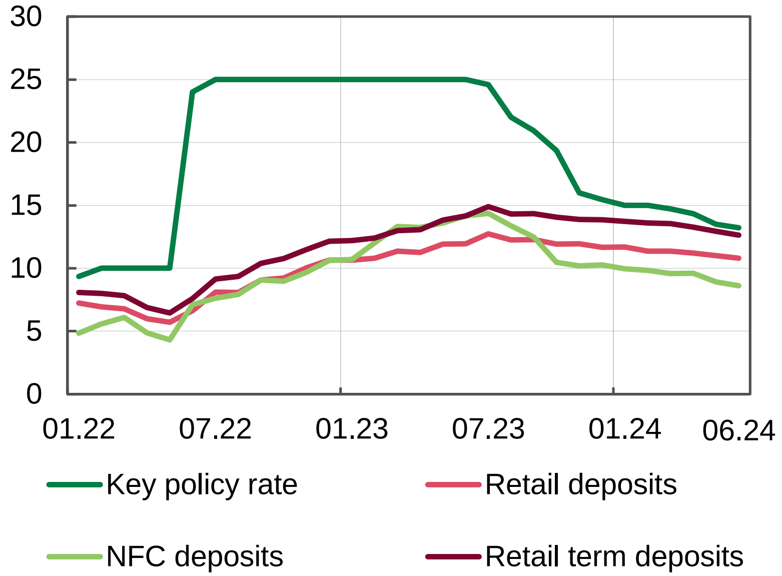


Source: NBU, MoFU, open sources data.

- As of June 30, Ukraine's international reserves reached nearly USD 38 bn. **This amounts to 111% of the minimum required level according to the IMF's composite criteria**. While this may seem like a high level, the 2008 crisis demonstrated the positive impact of substantial international reserves on the resilience and economic situation of a country amid economic turbulence
- **Reserves are especially crucial for countries in military conflicts**. Under conditions of high uncertainty, the ability of the central bank to react quickly and effectively determines whether it can prevent the destabilization of the financial system and the economy
- **The issue of international financial support remains significant**. The current situation is fragile, and reserves play a crucial role as a necessary buffer in the event of adverse developments

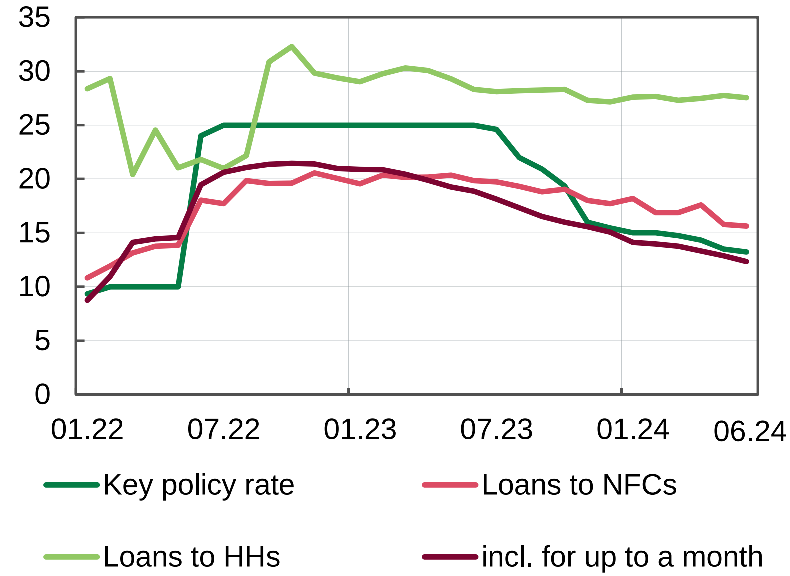
The cost of borrowing and rates on deposits in hryvnia continued to decline due to interest rate policy easing and low inflation

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, %

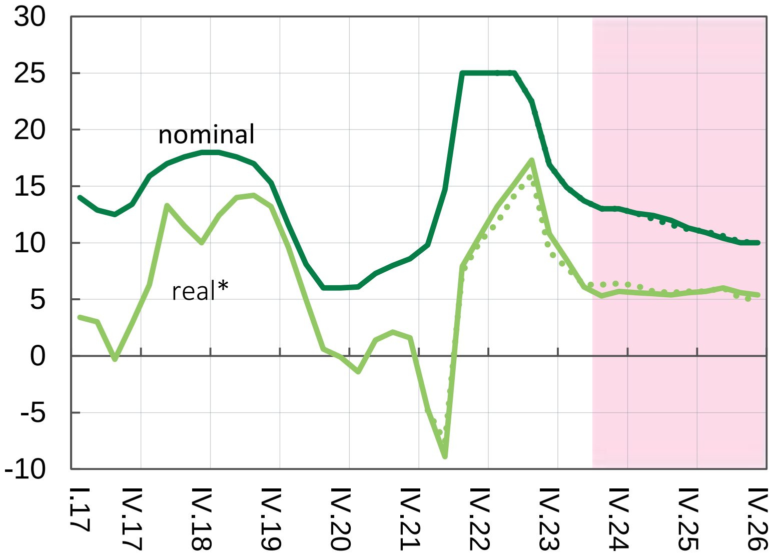


Source: NBU.

- **The transmission of the key policy rate cuts to bank retail rates intensified in Q2, as expected**. The weighted average rate on HHs term deposits decreased by 0.9 pp, and on NFCs deposits by 1.0 pp. Intense competition for solvent clients also prompted banks to cut interest rates on corporate loans more actively. The weighted average interest rate on NFCs loans decreased by 1.2 pp, and on ultra-short-term loans (up to 1 month) by 1.4 pp.
- **This contributed to the further growth of corporate lending in hryvnia, which has a positive impact on the revival of economic activity in general.** Gross hryvnia loans to NFCs increased by almost UAH 20 bn over the quarter (including by UAH 12.6 bn in June). The fastest growth was in lending to small and medium-sized businesses

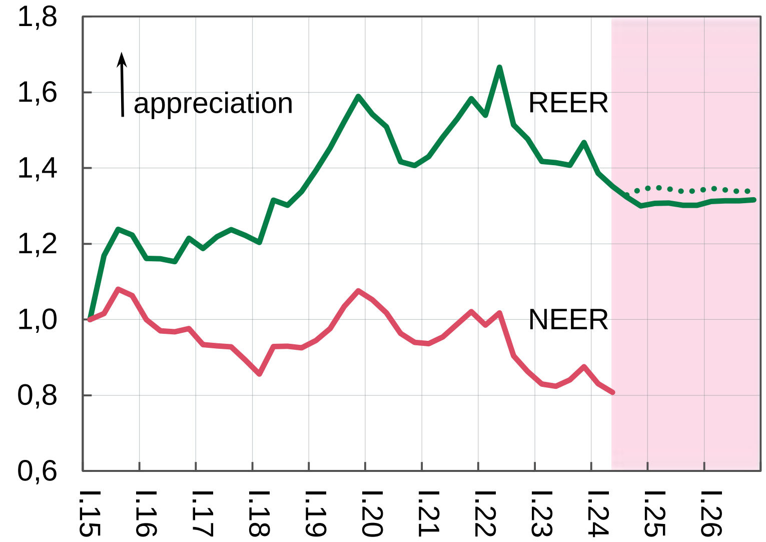
The NBU will apply a mix of tools to achieve the 5% inflation target over the forecast horizon

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.

- The NBU will coordinate IR and FX policy measures, as well as the easing of FX restrictions **in order to maintain control over inflation expectations and achieve the inflation target of 5% over the forecast horizon**
- **The current balance of risks for inflation forecast is shifted upwards**, so the potential for lowering the key policy rate is likely exhausted this year. The cycle of lowering the KPR may resume in 2025, which will support the recovery. **However, even if KPR were to go down, it would remain positive (5-6%) in real terms** (the neutral interest rate in 2016-19 was estimated at 3-4%), which is not excessive under the current conditions (of high risks)
- Stabilization of trade balance and NBU's monetary policy measures will keep REER at a level needed for the formation of a stable disinflationary trend

The balance of risks is shifted towards worsening GDP growth and increasing price pressure due to possible tax changes

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 introduction of additional restrictions on access to the European market		
Moderate		Increased emigration Growing geopolitical tensions Rapid restoration of damaged energy infrastructure	Potential pass-through to prices of tax rate hikes or introduction of additional taxes
Strong	Rapid implementation of the large-scale plan for the reconstruction of Ukraine	Inflows of profits generated by frozen russian assets Lower amounts of international aid	Higher electricity deficit due to further damage to the energy infrastructure Longer duration of the war, escalation, eco-terrorism by russia Higher budgetary needs