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## **Ukraine: Current economic developments**

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**Vladyslav Rashkovan**, deputy Governor, National Bank of Ukraine  
**Wien**, 26 Mar 2015



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# 4 MAJOR BLOCKS TO DISCUSS TODAY

1

## POLITICAL AND WAR ECONOMY

- How to neutralize the effect of politics on the financial sector?
- How to minimize the effect of the East military conflict for the macro economy and financial sector?

2

## MACRO ECONOMY

- How to ensure macro economy stabilization?
- How to get away from Soviet past and post-Soviet economic and behavioral traps affecting the financial sector?

3

## FINANCIAL SECTOR SITUATION

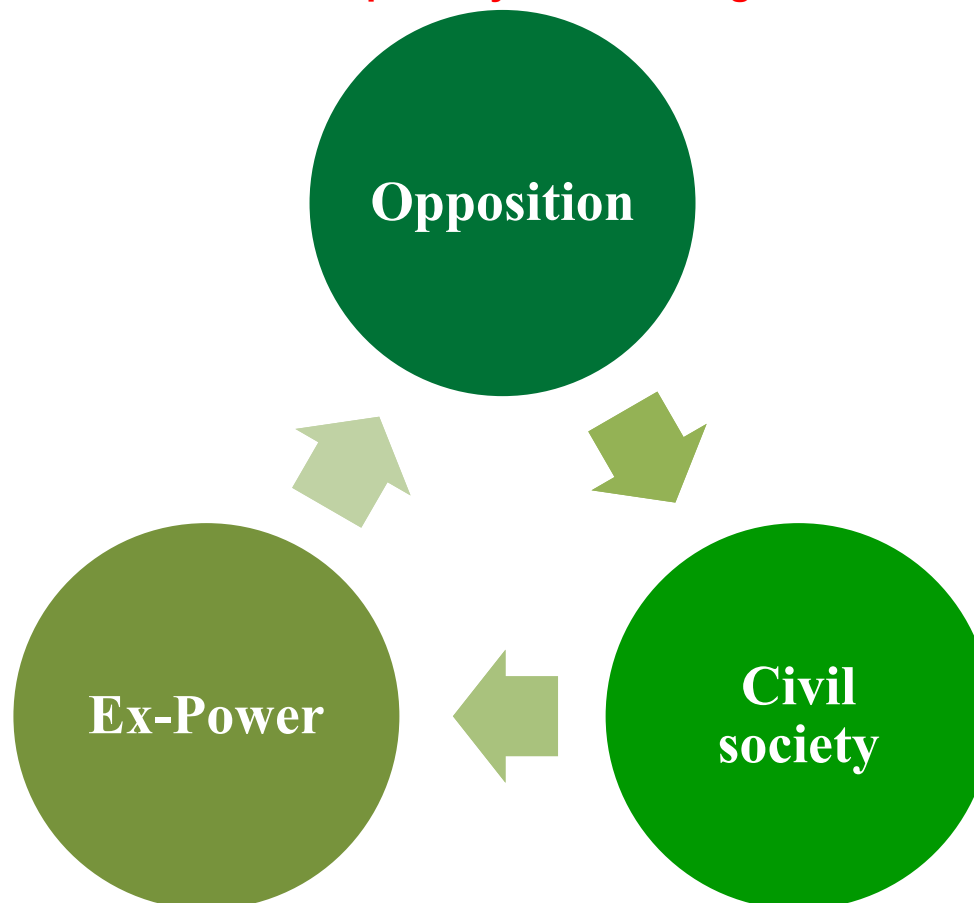
- How to achieve financial stabilization ?
- What are the growth pivotal points for the financial sector?

4

## FINANCIAL SECTOR REFORM STRATEGY

# THREE MAIN LOCAL PARTIES OF THE REVOLUTION OF DIGNITY HAD DIFFERENT KEY TARGETS

1. Become the Power
2. Keep the System working



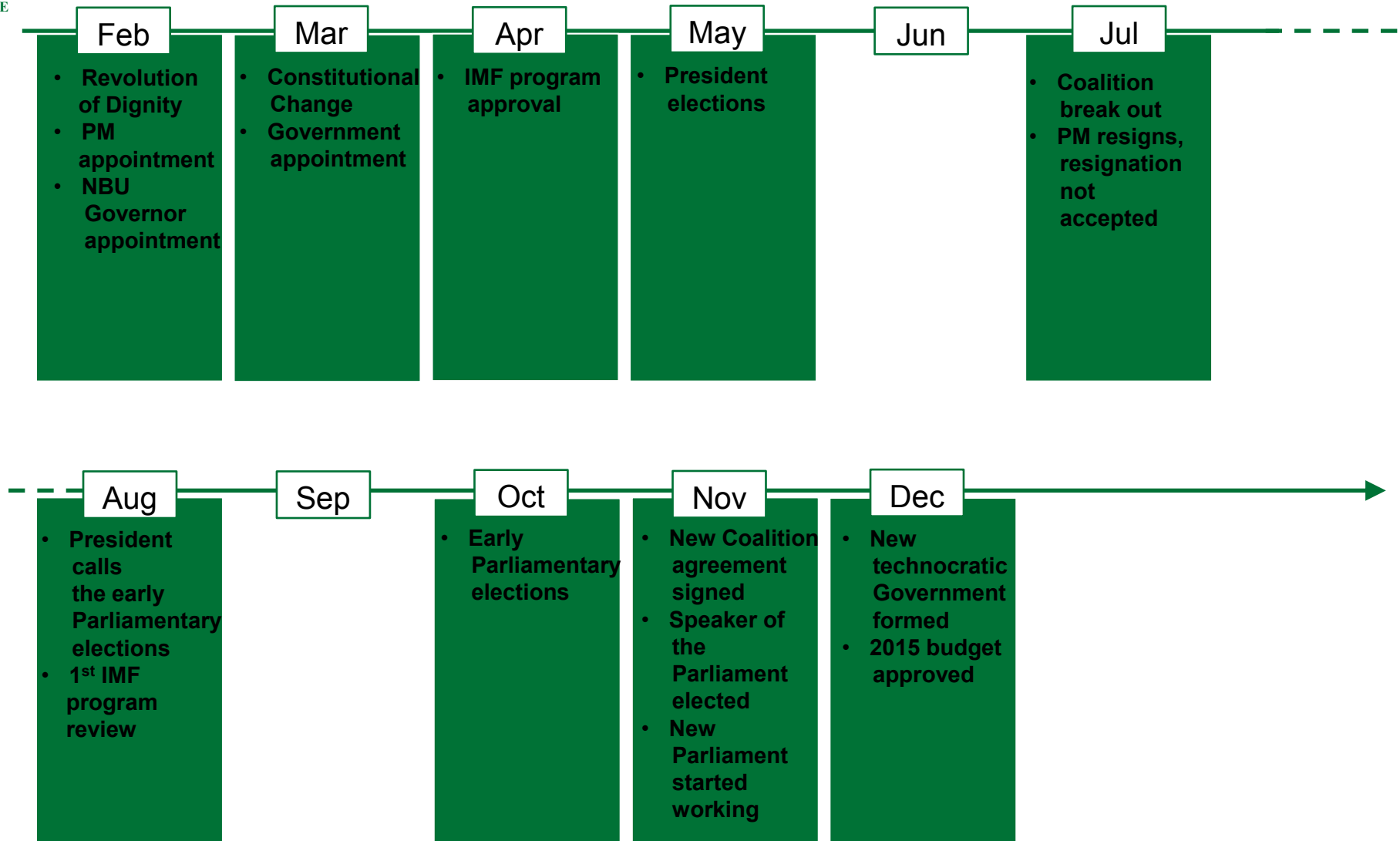
1. Retain the power
2. Keep the old System working

2. Change the System



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# 2014 WAS A VERY-VERY HEAVY YEAR IN RESPECT OF THE POLITICAL EVENTS

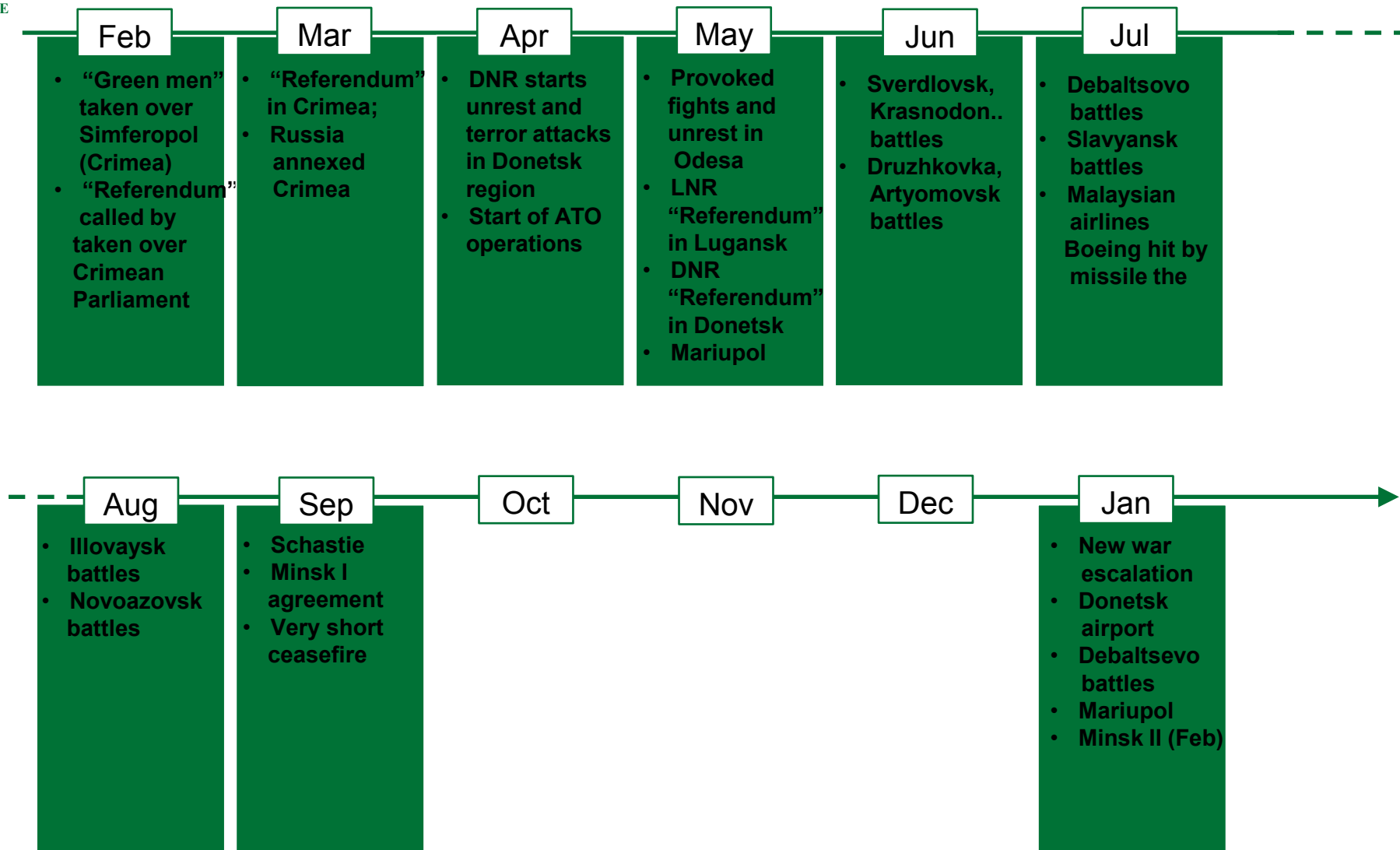


- Not in many countries have been effective in economic reforms in parallel with so many political events



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# THE MILITARY CONFLICT DIDN'T HELP THE REFORMS AS WELL



- Not in many countries we have been effective in economic reforms in parallel with the war on its territory



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# MAP OF THE MILITARY CONFLICT



# MILITARY CONFLICT IN DONBASS IS THE MAIN FACTOR FOR THE CAPACITIES DESTRUCTION AND THE OVERALL CONFIDENCE CRISIS

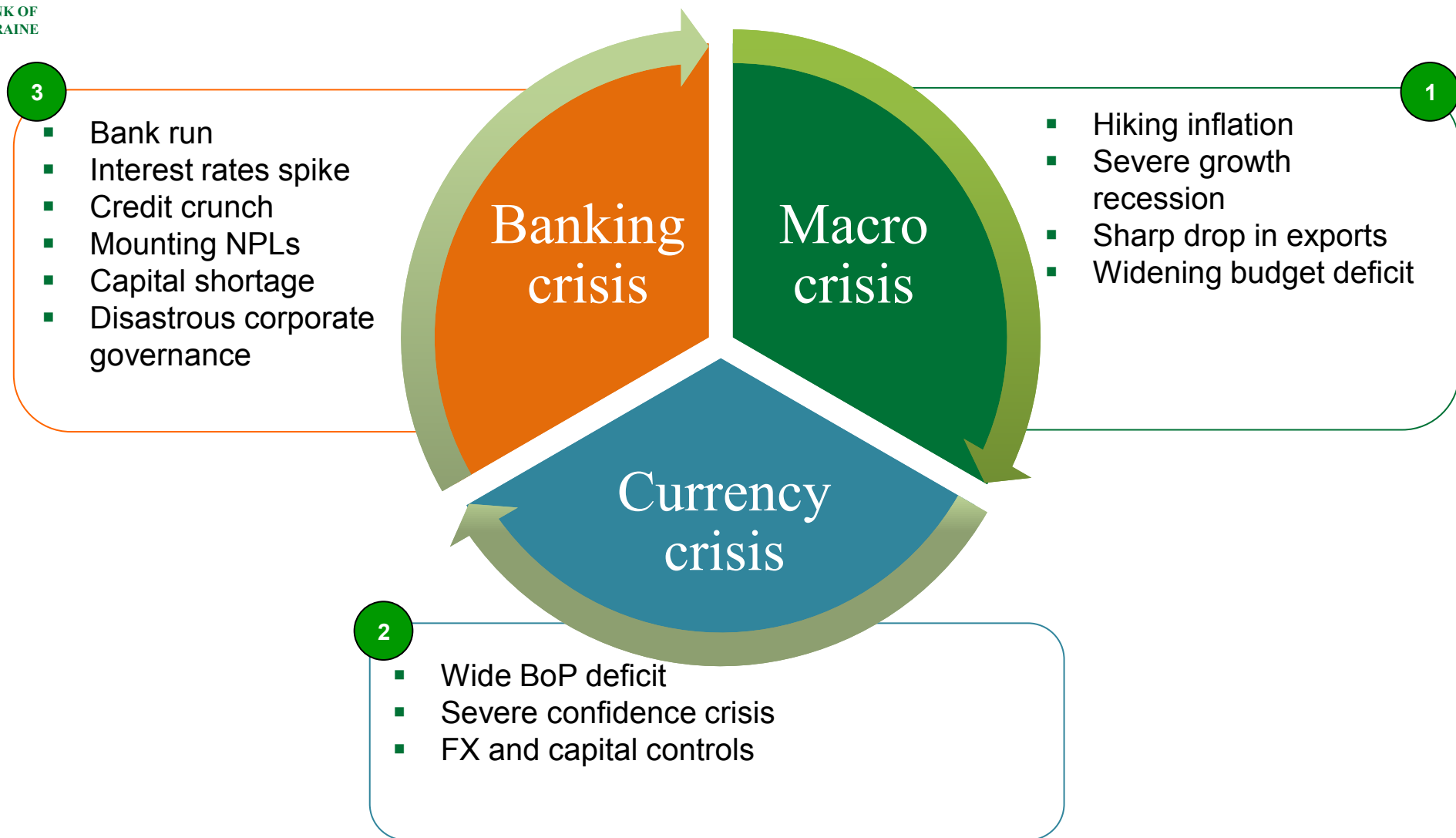


- Depending on the intensity of the fighting every day war costs from 2 to 7 mln. USD;
- ~ 1 mln of the internally displaced people
- ~ 600 ths people left the country (UN Office for the Coordination of Humanitarian Affairs figures)



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# UKRAINIAN ECONOMIC PERFECT STORM CONTINUES



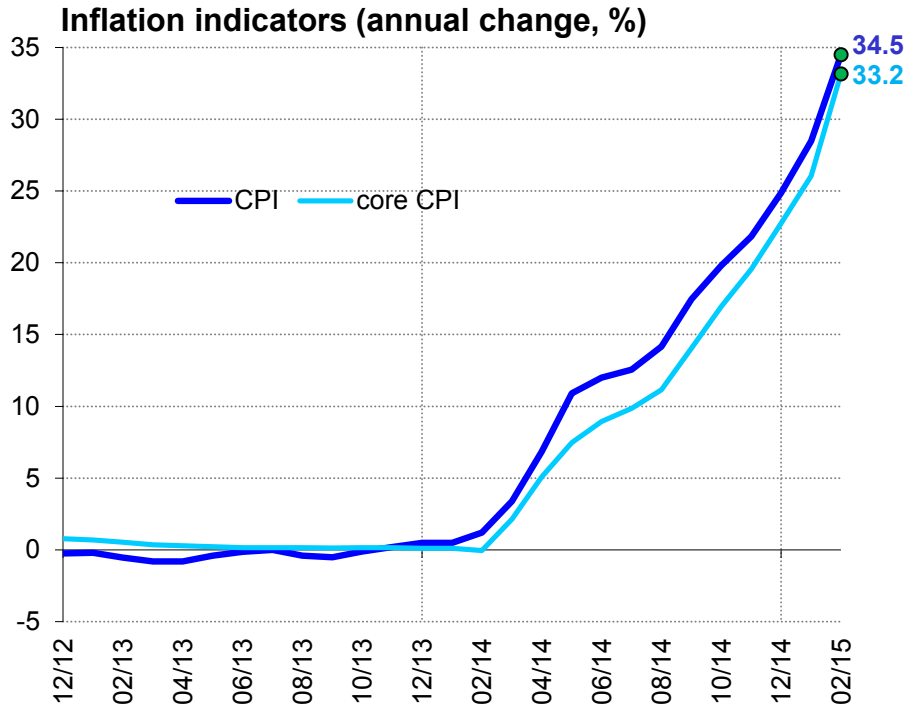
This is not the unique situation in Ukraine:

- Mexico (1994/95), Argentina (1994/95);
- Thailand (1997), Indonesia(1997), Malaysia(1997), Philippines(1997);
- Russia (1998); Brazil (1999/1999); Turkey (2001);

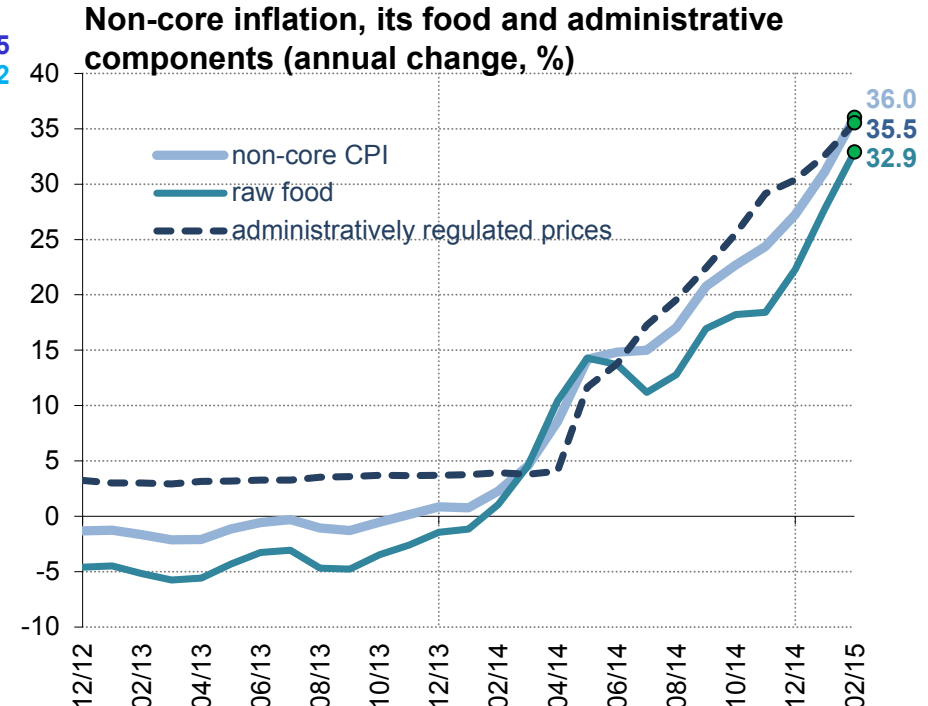




# INFLATION: Inflation upward trend has remained for almost one year following close to zero figures



Source: State Statistics Service of Ukraine.



Source: State Statistics Service of Ukraine and NBU calculations.

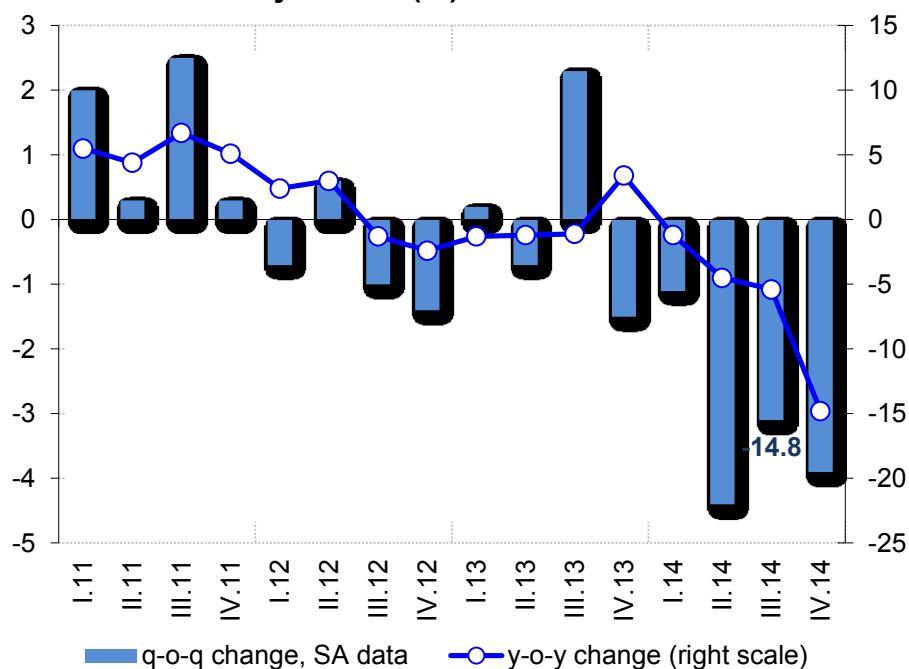
- Both core and non-core components were largely determined by hryvnia depreciation to US dollar (by 241% from the end of 2013).
- Administered prices and tariffs growth was driven largely by the start of utilities tariffs adjustment to the level of coverage their cost and excisable goods prices increase.



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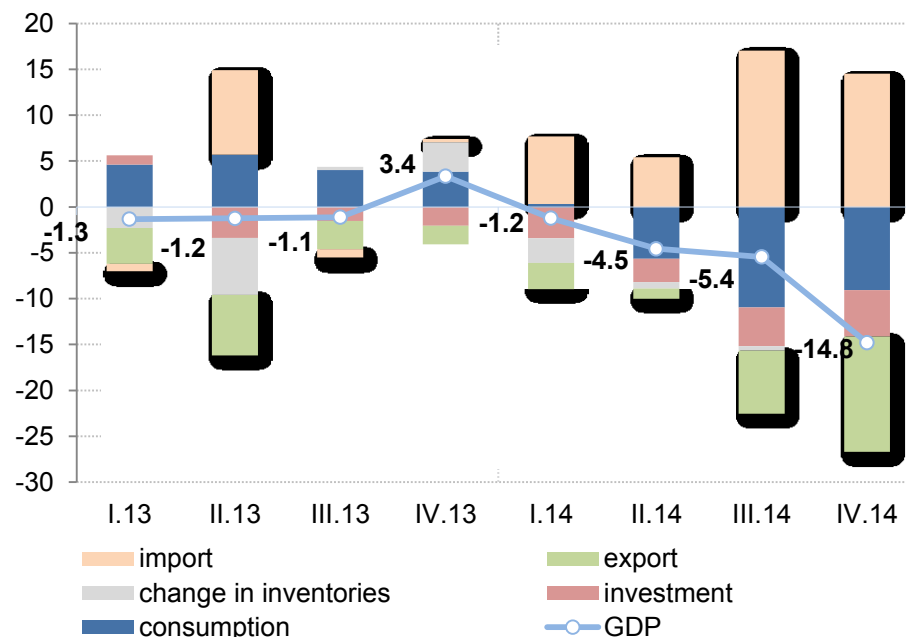
# REAL SECTOR: Real GDP decreased by 6.8% in 2014

### Real GDP dynamics (%)



Source: State Statistics Service of Ukraine.

### Contributions to GDP y-o-y change, p.p.



Source: State Statistics Service of Ukraine, NBU calculation.

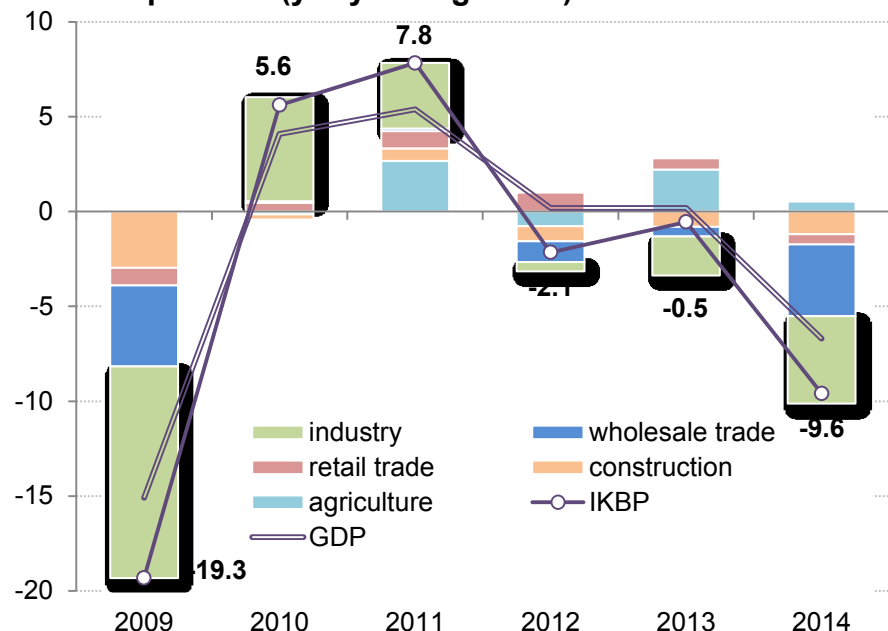
- Main factors of economic development in 2014:
  - military conflict in Eastern Ukraine
  - fall in global prices on commodities
  - worsening of trade relationships with Russia
  - low internal consumer and investment demand



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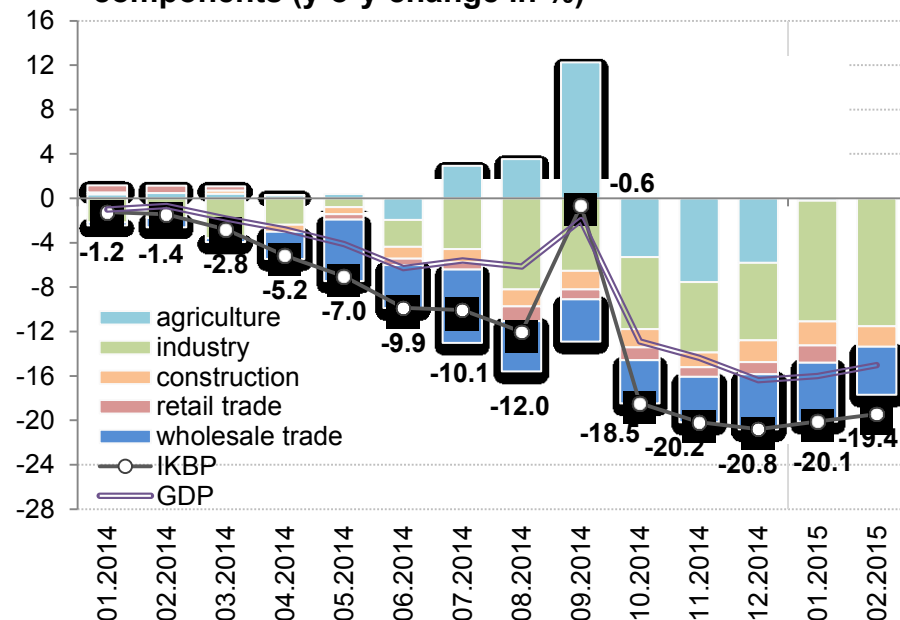
# REAL SECTOR: Key Sectors Production Index of Ukraine continued to decline in February, 2015

**Key Sectors Production Index and its components (y-o-y change in %)**



Source: State Statistics Service of Ukraine, NBU calculations.

**Key Sectors Production Index and its components (y-o-y change in %)**



Source: NBU calculations.

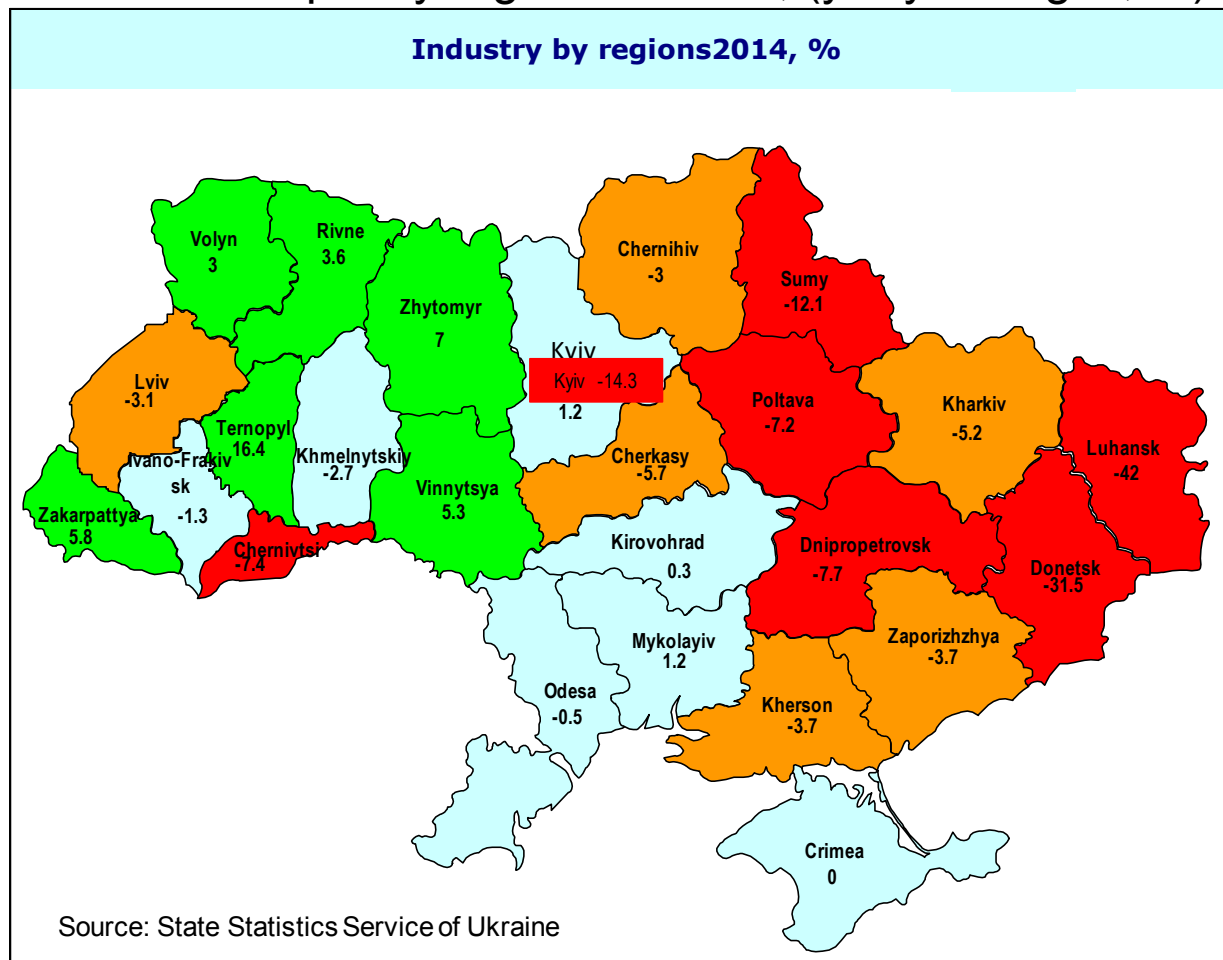
- The worst situation was observed in industry, wholesale trade and construction, primarily due to the destruction of transport infrastructure and production capacity in Donetsk and Luhansk regions.
- Agriculture output contribution to Key Sectors Production Index is very low in the beginning of the year.



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## REAL SECTOR: Military conflict shove off 2.5 p.p. from 2014 GDP

### Industrial output by regions in 2014, (y-o-y changes, %)



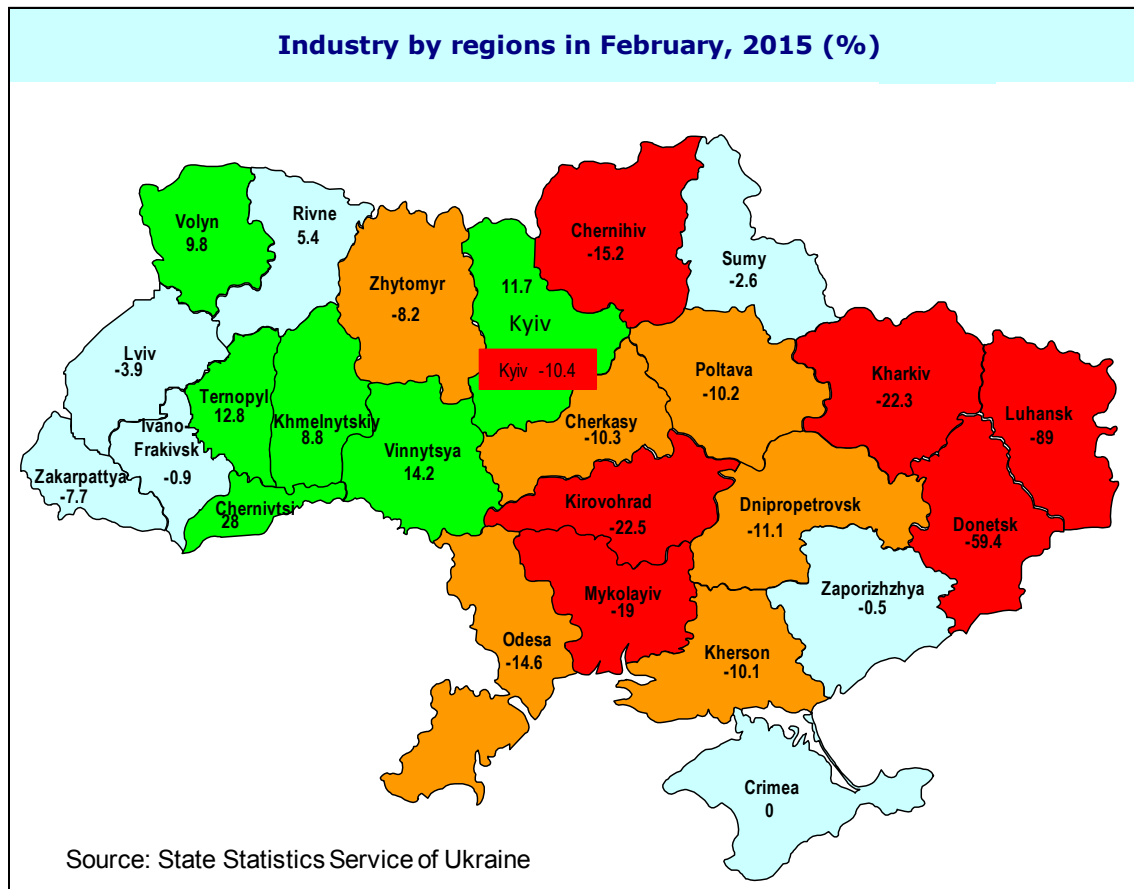
- Military conflict shove off 1.9 p.p due to fall in Donetsk and Luhansk regions and 0.6 p.p due to contagion effects.
- Loss of Crimea had no direct effects on 2014 real GDP growth rates due to shift to the SNA 2008 methodology with reconstructing of historical GDP series excluding Crimea.
- Contributions to 2013 GDP: Crimea – 3.7%, Donetsk region – 11.7%, Luhansk region – 4%.



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## REAL SECTOR: Industrial output continued to fall essentially in Donetsk and Luhansk regions

Industrial output by regions in February 2015, (y-o-y changes, %)



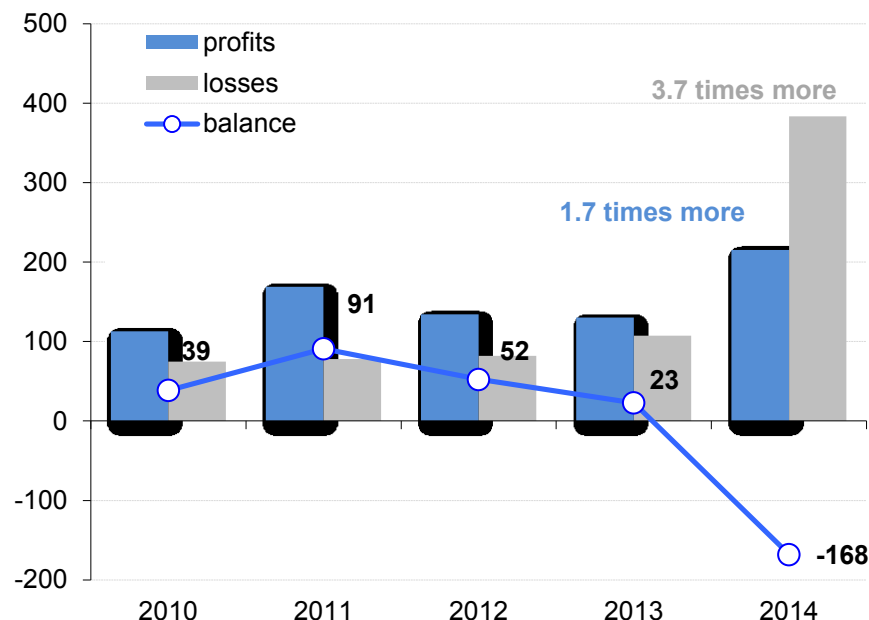
- Escalation of military conflict caused destruction of infrastructure and stop of production capacity in Donetsk and in Luhansk regions.
- Strong decline in South regions was caused by decrease in consumer demand and destruction of industrial links with Russia.
- But strong growth was observed in Western region (Chernivtsi, Ternopyl, Volyn, Vinnitsya).



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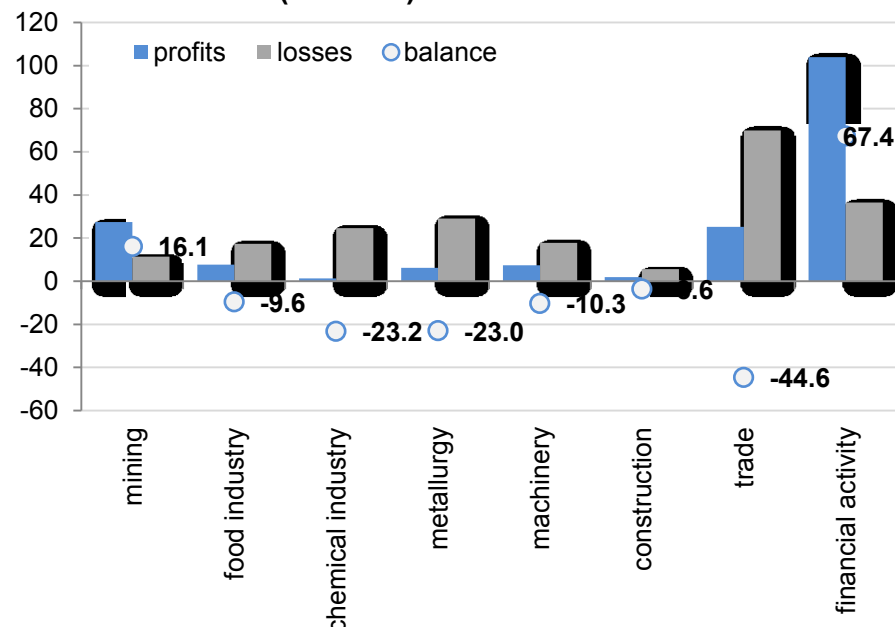
# REAL SECTOR: Huge deterioration of enterprises financial results

### Financial results for 9 m (UAH bn)



Source: State Statistics Service of Ukraine.

### Financial results by types of economic activity for 9 m 2014 (UAH bn)



Source: State Statistics Service of Ukraine.

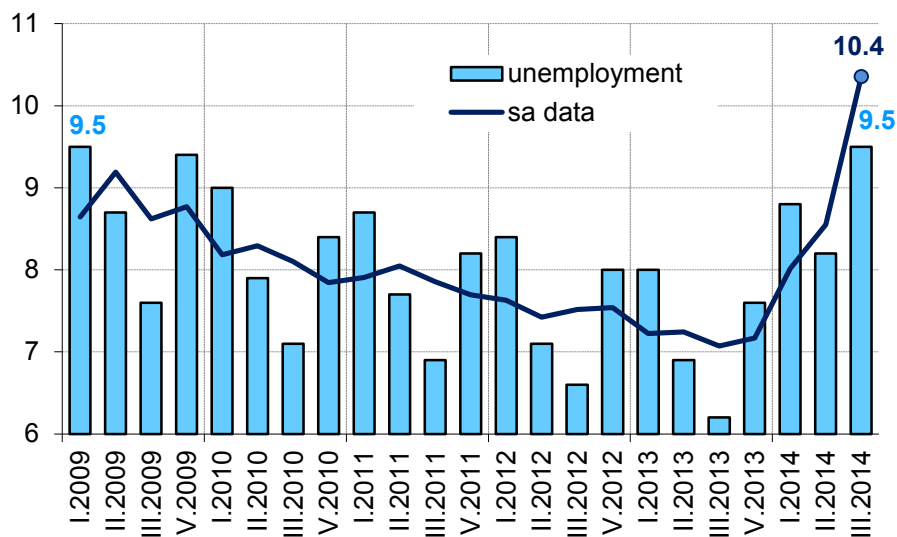
- Military conflict in Eastern Ukraine, devaluation of the national currency, unfavorable external conditions and resulting economic downturn have led to the huge deterioration of enterprises financial results.



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# REAL SECTOR: Labor market indicators as well as household income severely deteriorated

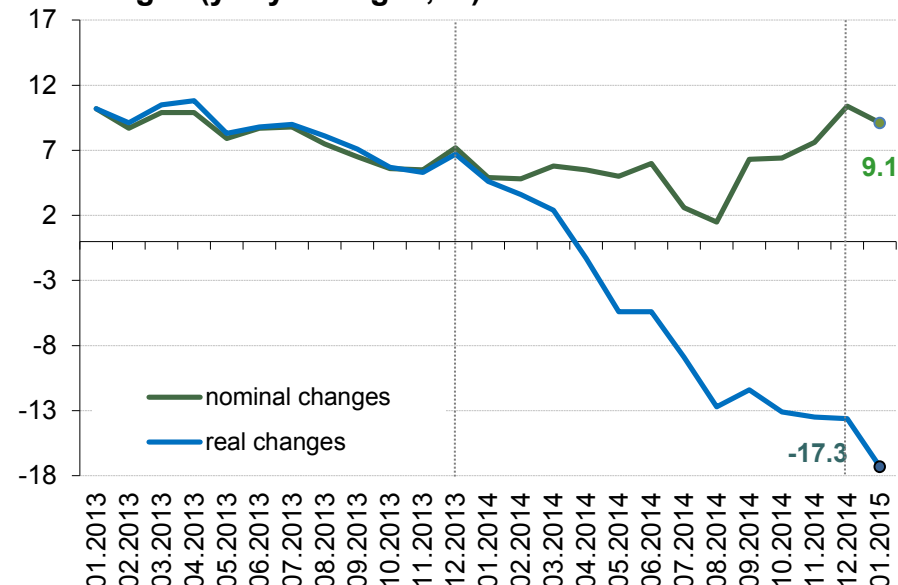
### Unemployment of population \* (ILO methodology) aged 15-70, of the economically active population



Source: State Statistics Service of Ukraine, NBU calculations

\* - temporarily occupied AR Crimea and Sevastopol excluded since 2<sup>nd</sup> q 2014

### Wages (y-o-y changes, %)



Source: State Statistic Service of Ukraine

\* - temporarily occupied AR Crimea and Sevastopol excluded since 04.2014

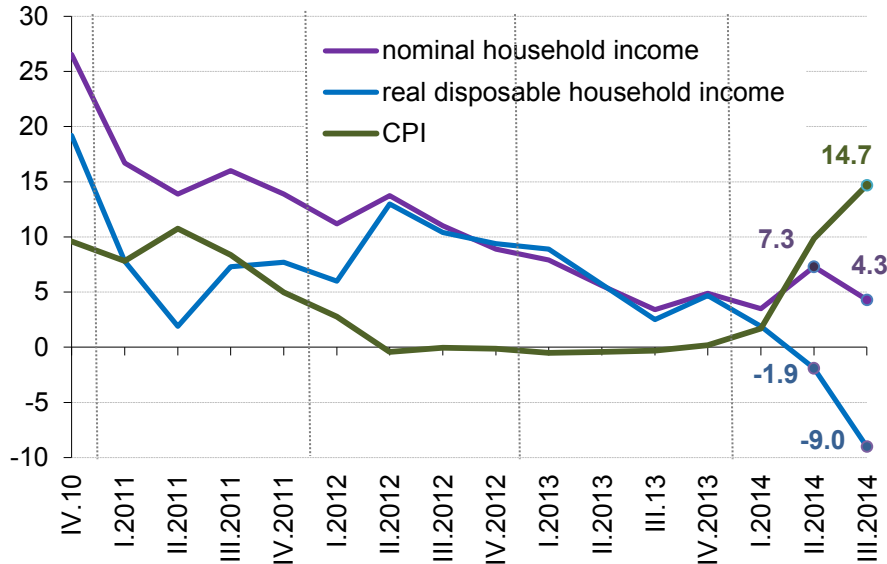
- Seasonally adjusted unemployment rate (according to ILO methodology) has reached the highest level since the beginning of 2000s. Official unemployment rate also increased to 2.0% in February 2015.
- Real wages have continued to decline since April 2014 (-17.3% y-o-y in January).
- These trends pose a significant danger of further social pressure increase. Additionally fiscal burden for subsidizing poverty will rise, especially taking into account Government intentions to accelerate administrative tariffs increase.



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# REAL SECTOR: Real disposable household income continued to decline sharply

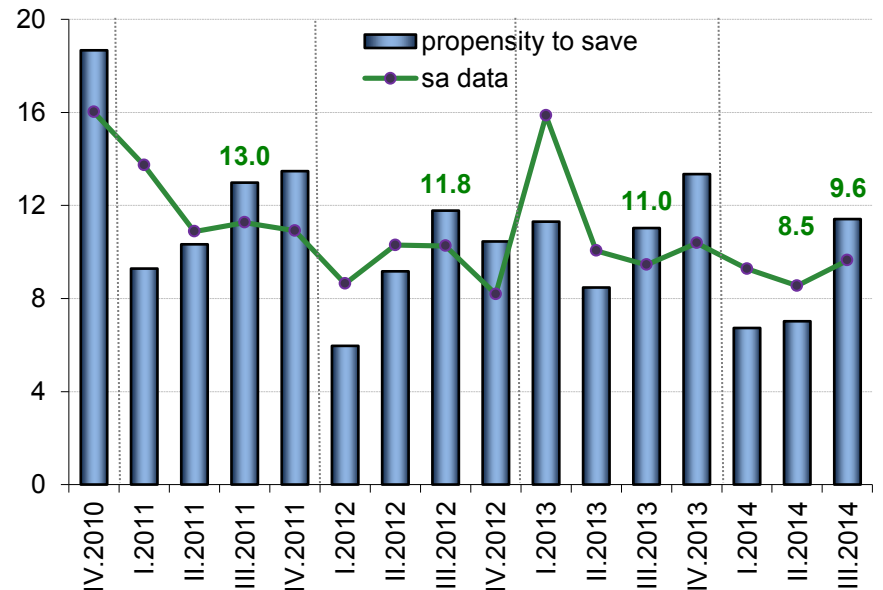
Nominal and real disposable household income\* (y-o-y, %)



Source: State Statistics Service of Ukraine.

\* - temporarily occupied AR Crimea and Sevastopol excluded since 2<sup>nd</sup> q 2014

Propensity to save\* (%)



\* Savings to disposable household income ratio.

Source: State Statistics Service of Ukraine, own calculations.

- Deceleration of nominal household income growth (down to 4.3% y-o-y) as well as inflation surge (up to 14.7% y-o-y) both contributed to continued decline of real disposable household income (-9% y-o-y in 3<sup>rd</sup> quarter of 2014).
- At the same time propensity to save increased (11.4% in 3<sup>rd</sup> quarter of 2014, 9.6% seasonally adjusted) mainly due to an increase in the deposit portfolio in foreign currency due to exchange rate correction (deposits grew by 74.3% after revaluation).

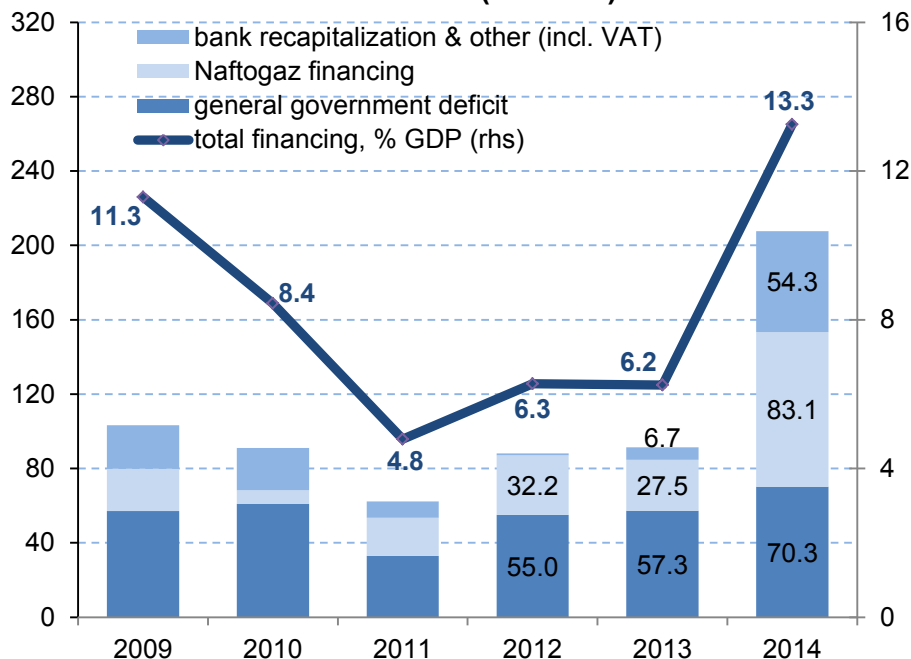




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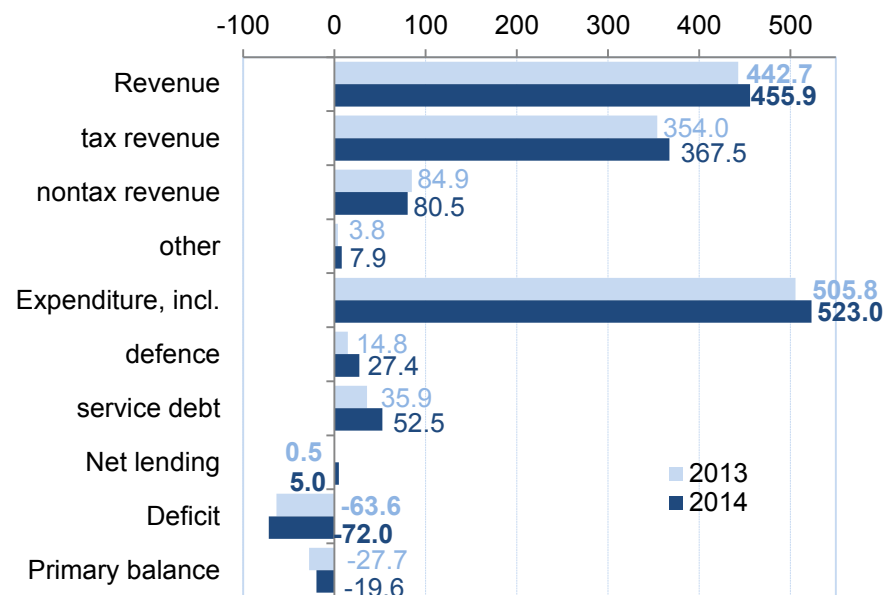
# FISCAL: Government broad deficit increased significantly in 2014

**Government broad deficit (UAH bn)**



Source: MFU, IMF, NBU calculations.

**Main indicators of consolidated budget (UAH bn)**



Source: Treasury, MFU.

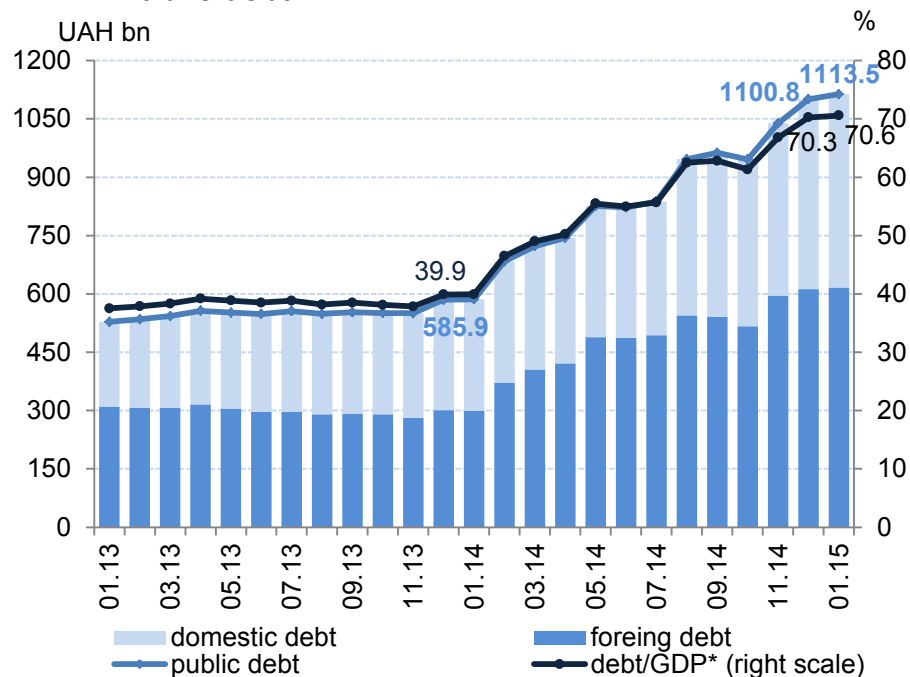
- In 2014 consolidated budget deficit grew to 4.6% of GDP mainly due to debt service expenditures growth (impact of UAH devaluation) and increase of defense expenditures (by 84.5%) caused by military conflict. Primary deficit fell by 0.7 p.p. to 1.2% of GDP compared to 2013.
- Quasi-fiscal deficit ran up to 8.8% of GDP (UAH 137.4 bn): Naftogaz – UAH 83.1 bn, banks and Deposit Guarantee Fund – UAH 26.7 bn and other – UAH 27.6 bn.



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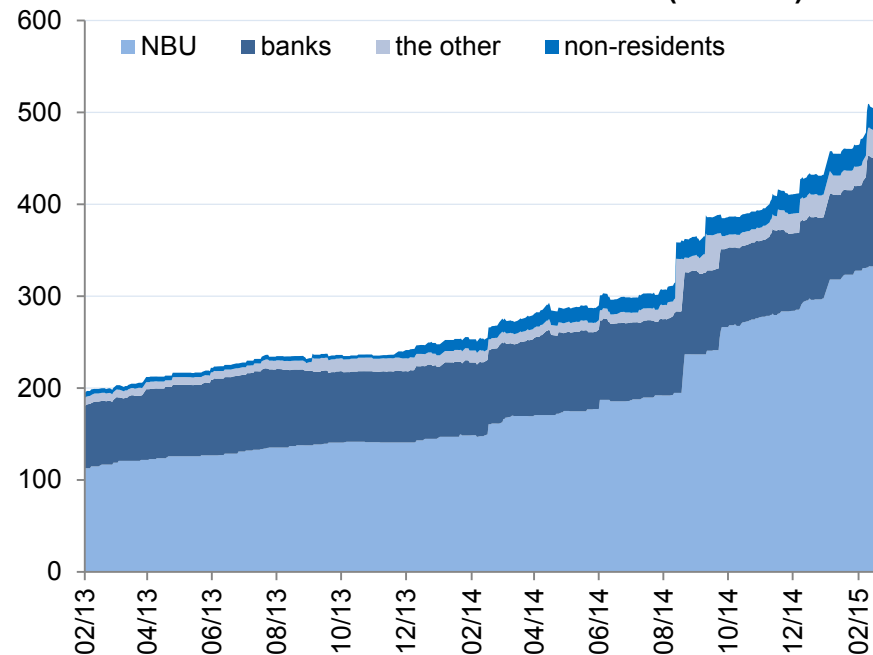
# FISCAL: Budget deficit was mostly covered by local QE in 2014 and at the start of 2015

### Public debt



Source: MFU, \*NBU estimations.

### Government domestic bonds holders (UAH bn)



Source: NBU.

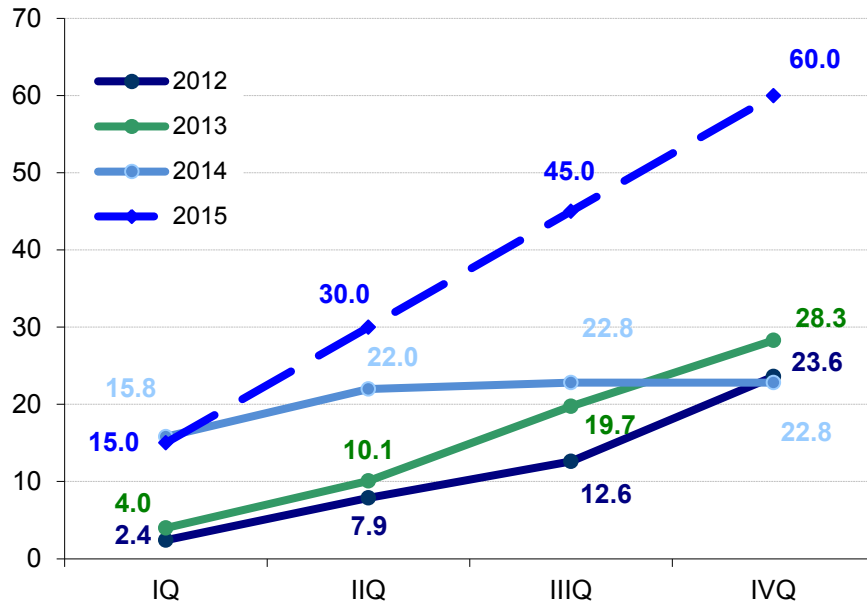
- In 2014 the public debt increased rapidly due to sizeable government broad deficit and UAH devaluation.
  - The state debt rose to UAH 947 bn from UAH 480.2 bn in 2013 (to 60.4% of GDP from 32.8% of GDP).
  - The public debt share in foreign currency (incl. foreign-currency-denominated domestic sovereign bonds) remained high – more than 62% in 2010-2014.
  - Public debt continued to grow in January 2015.
- NBU state bonds portfolio grew more than twice in 2014 and early 2015 (from UAH 147.1 bn to UAH 338.6 bn).



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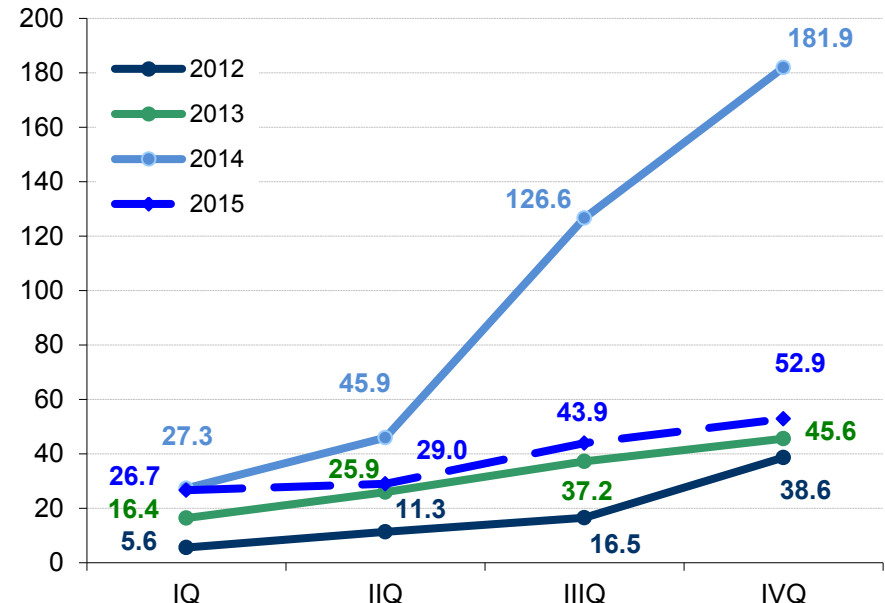
# MONETARY: Support to the Government by NBU has been significant in 2014

Transfer of NBU's profit (y-t-d, UAH bn)



Source: NBU

NBU purchase of securities at face value (y-t-d, UAH bn)



Source: NBU

## 2014

22.8 + 181.9 = UAH 204.7 bn  
 39% of cash expenditure of the Consolidated Budget of Ukraine

## 2015

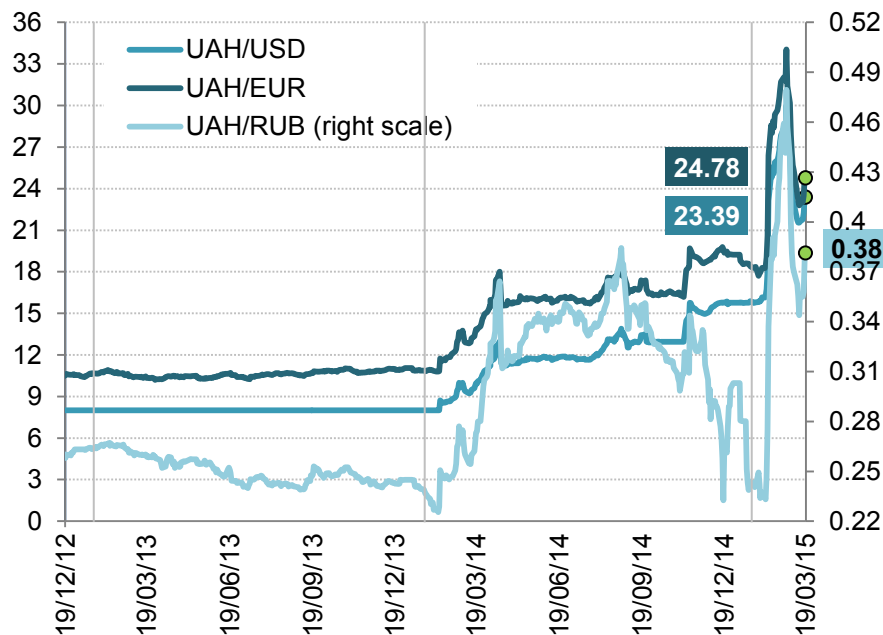
60.0 + 52.9 = UAH 112.9 bn  
 18% of cash expenditure of the Consolidated Budget of Ukraine



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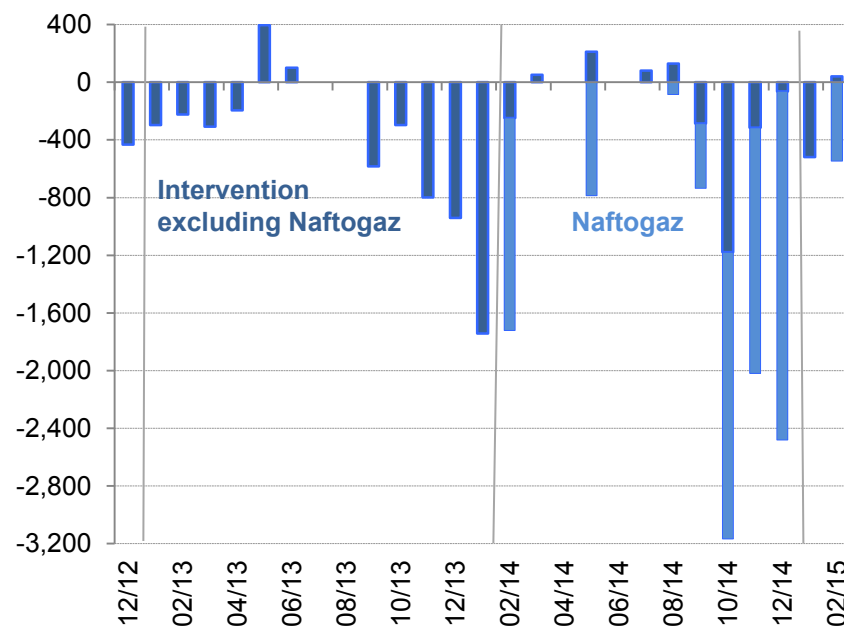
# MONETARY: The escalation of the conflict in Eastern Ukraine intensified hryvnia depreciation pressures

### Exchange rate of Hryvnia (as of 19/03/2015)



Source: NBU

### Interventions of NBU (USD m)



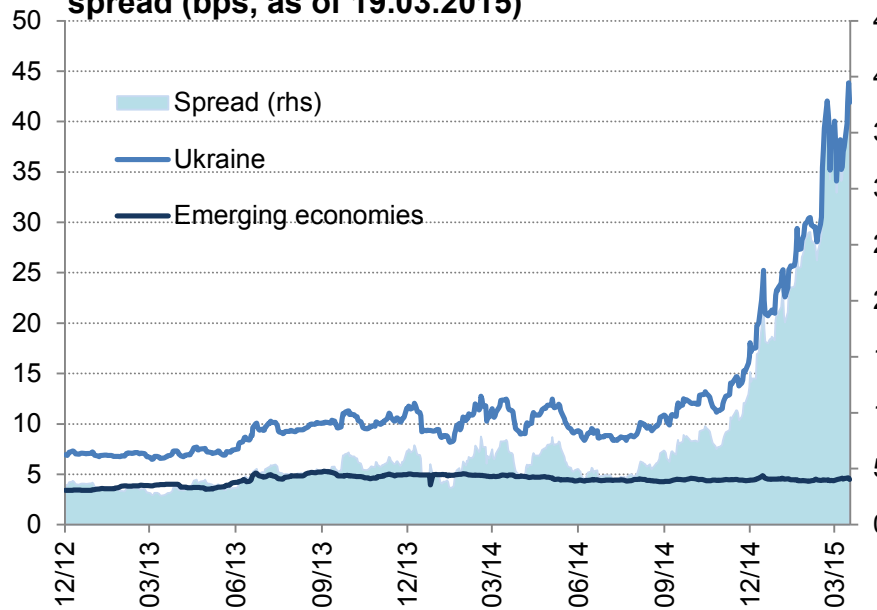
Source: NBU.



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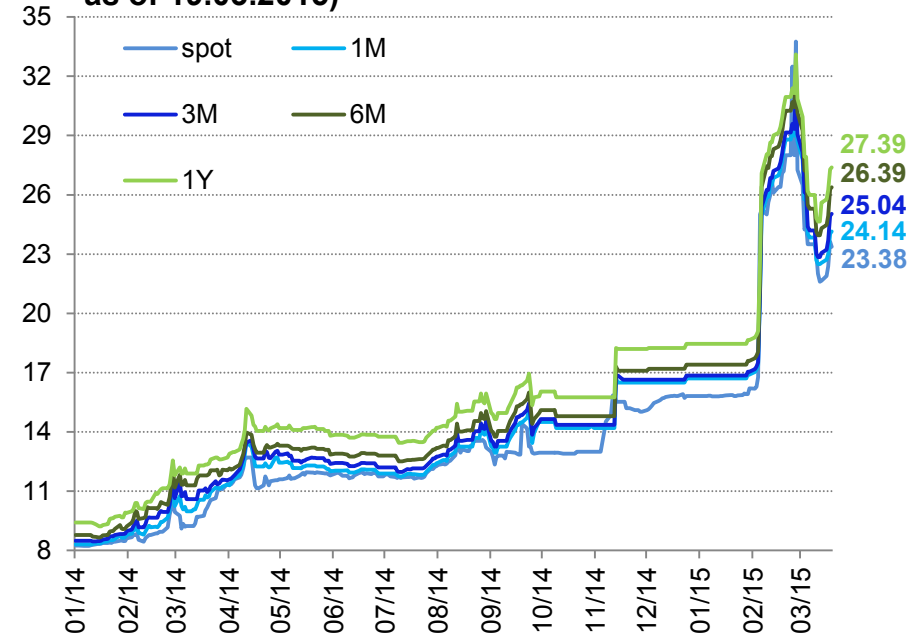
# MONETARY: FX Risk/expectations

**Weighted averages of sovereign bond yields of Ukraine, emerging economies and their spread (bps, as of 19.03.2015)**



Source: Cbonds.

**NDF market USD/UAH rates (UAH per USD, as of 19.03.2015)**



Source: Thomson Reuters Datastream.

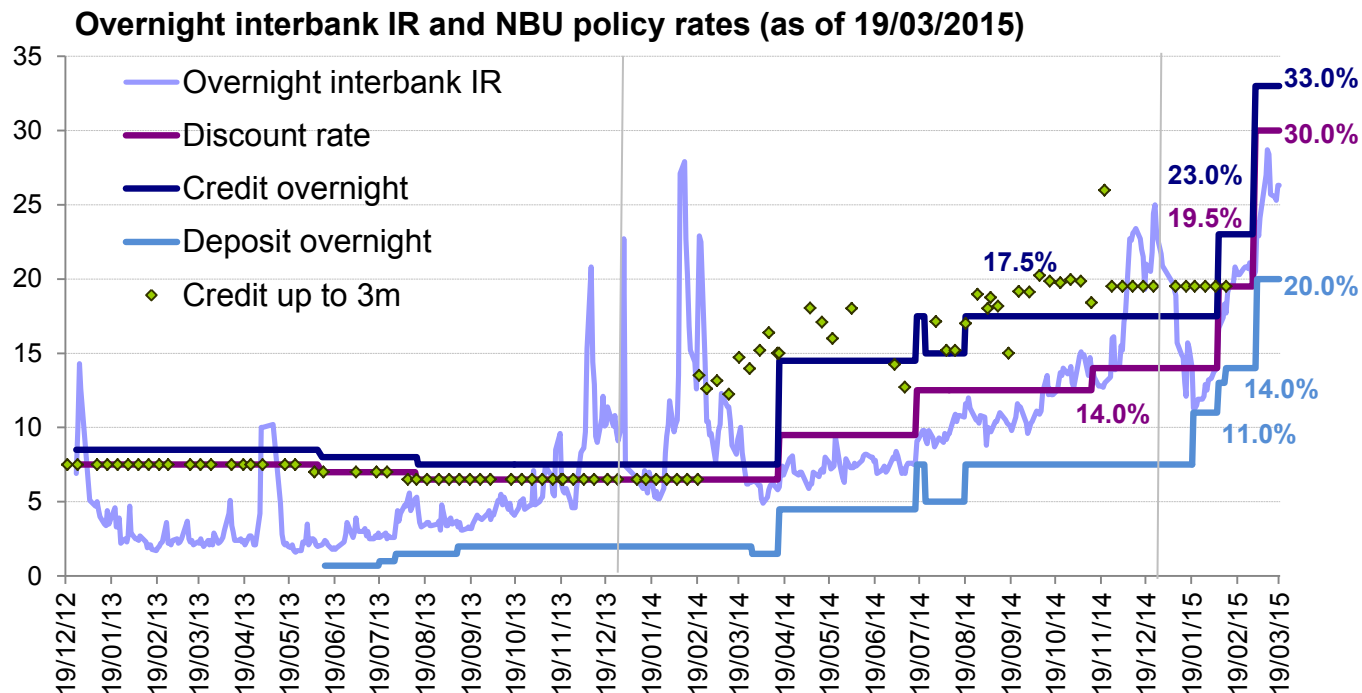
- The weighted average yield of the Ukrainian sovereign bonds has risen by 2.5 bps since the beginning of March (rose by 9.6 bps in February\*) and by 29.6 bps for the last 12 months to 41.9 bps. The spread between the weighted average yield of Ukrainian sovereign bonds and that of emerging economies was 37.4 bps as of 19.03.15 compared to 35.0 bps as of 27.02.15.
- According to NDF contracts as of 19.03.15, the Hryvnia is expected to depreciate by 3.3% in 1 month, by 7.1% in 3 months, 12.9% in 6 months and 17.2% in 1 year.

\*data as at the end of month



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# MONETARY: Interest rates: new operational framework of the NBU



Source: CredInfo, NBU

## NBU policy rates, effective from March 04, 2015:

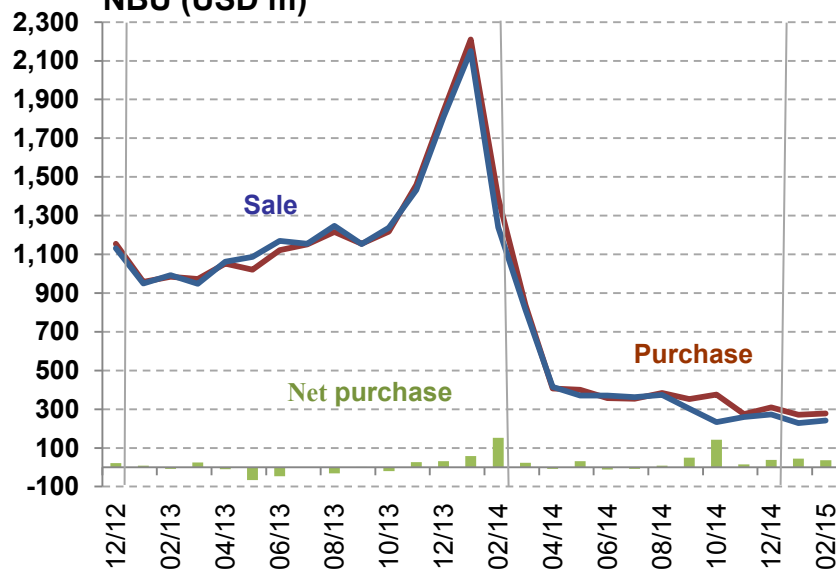
- Policy rate (discount rate) = 30.0%,
- Average weighted interest rate set based on the results of the last liquidity-providing tender = 31.7%,
- Overnight loans – 33.0%.
- Overnight CD`s – 20.0%,
- Quantitative tender for the allocation of NBU CD`s:
  - up to 7 days – 26.0%,
  - up to 14 days – 26.0%,
  - up to 30 days – 27.0%.



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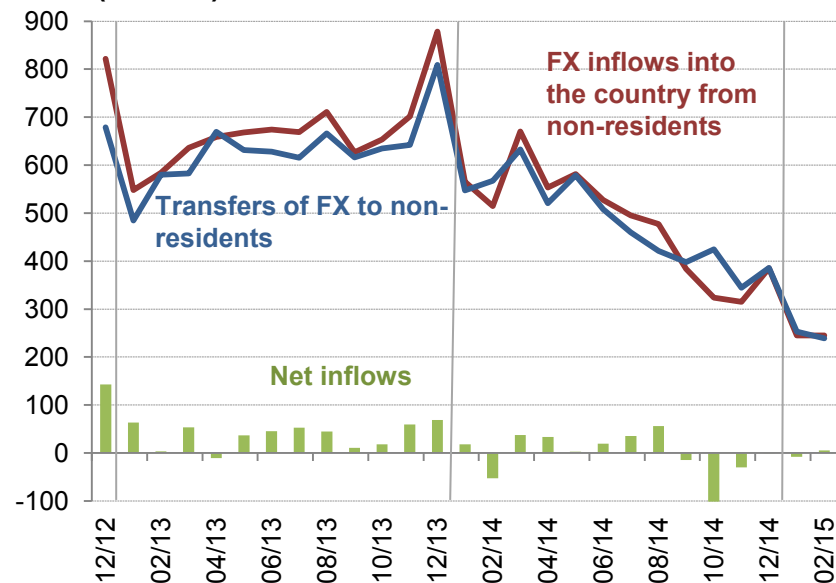
## MONETARY: Interbank FX market shrank

The daily average amount of transactions in the interbank FX market of Ukraine excluding NBU (USD m)



Source: NBU

Daily average non-residents' transactions (USD m)



Source: NBU

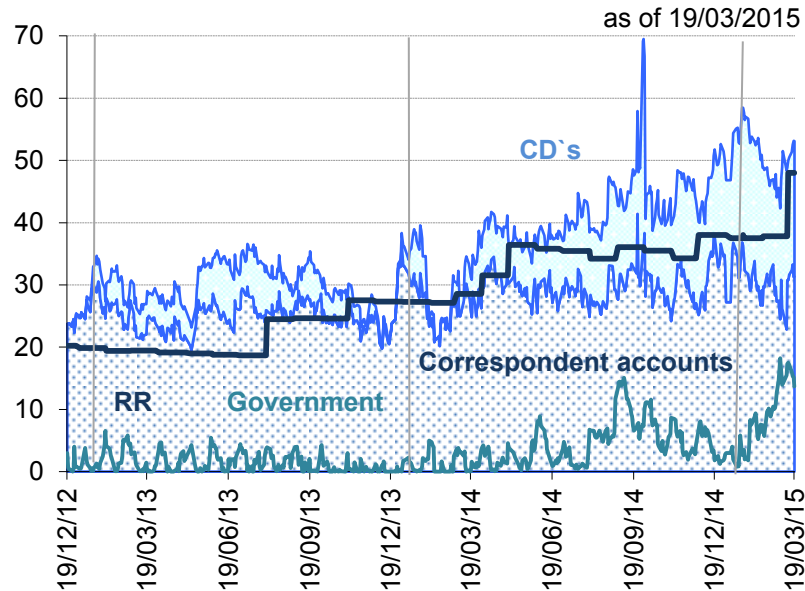
- FX inflows and transfers decreased. As a result volumes on interbank FX market dropped
- The official exchange rate of hryvnia is calculated as a weighted average of the exchange rates of the interbank market deals



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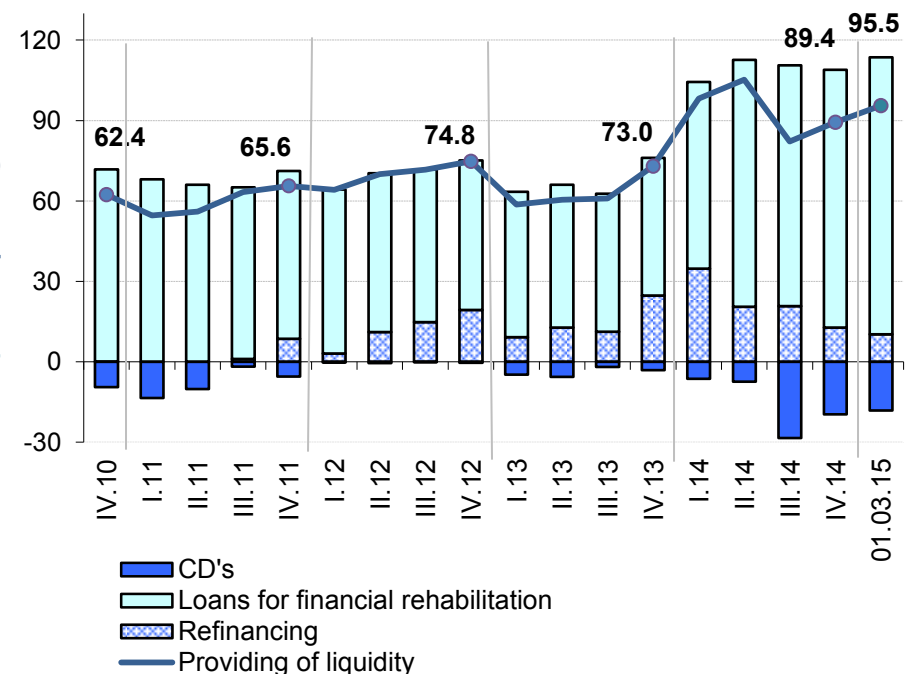
# MONETARY: Banking system liquidity is ample enough

Banking system`s liquidity (UAH bn)



Source: NBU

Regulation of banks' liquidity (UAH bn)



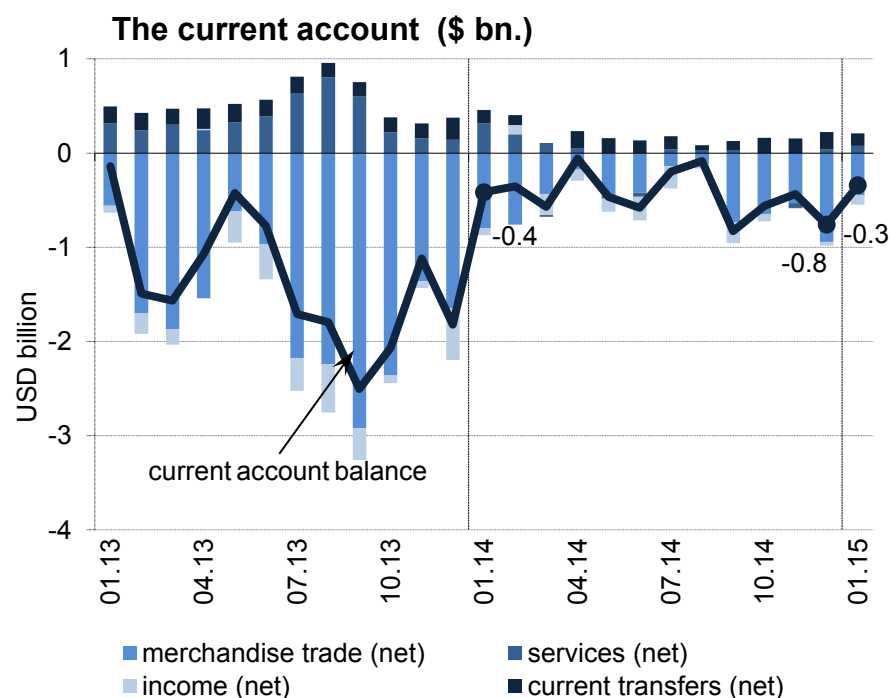
- In February 2015 the NBU contributed to the banking system liquidity reallocation under tight market conditions and in the face of deteriorating confidence.
- Starting from III.2014 the outstanding amount of active operations remained almost unchanged. As of March 01, 2015:
- The outstanding amount of **active operations** – UAH 113.6 bn (+ UAH 3.7 bn in February), including:
  - overnight – UAH 1.5 bn (+ UAH 0.3 bn),
  - tenders – UAH 5.7 bn (- UAH 0.5 bn),
  - direct repo operations – UAH 3.1 bn,
  - loans for financial rehabilitation – UAH 103.4 bn (+ UAH 3.9 bn).
- The outstanding amount of **of sterilization operations** – UAH 18.1 bn (- UAH 1.0 bn).



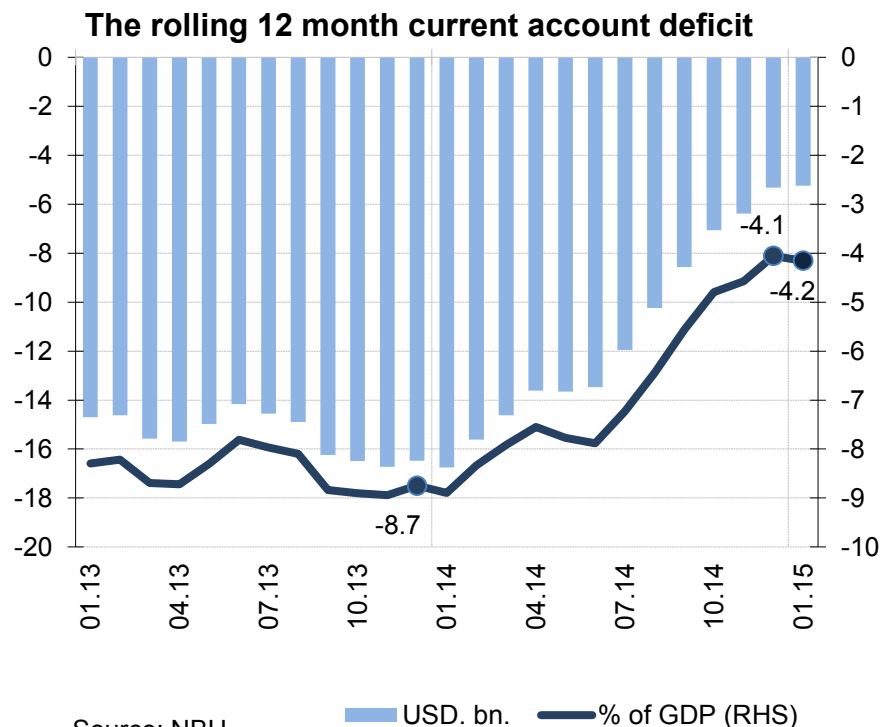


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## BOP: In January current account deficit shrank in nominal term, but deteriorated in % to GDP



Source: NBU



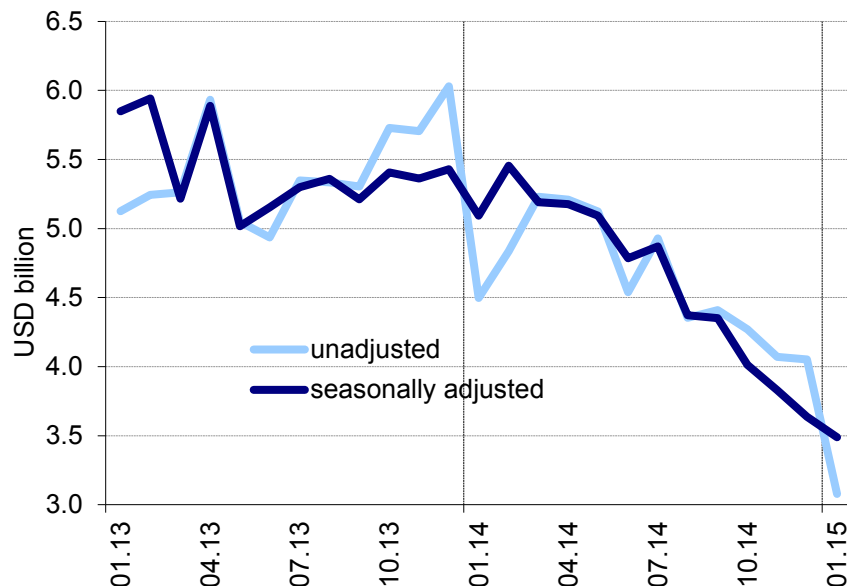
- In January 2015 current account deficit amounted to 4.2% of GDP on the rolling 12-month basis, which is marginally acceptable level for Ukraine in “normal conditions”;
- In nominal term deficit shrank to \$0.3 bn. driven by lower external trade deficit, as a positive impact of REER devaluation mostly manifested itself through a contraction of non-energy imports.



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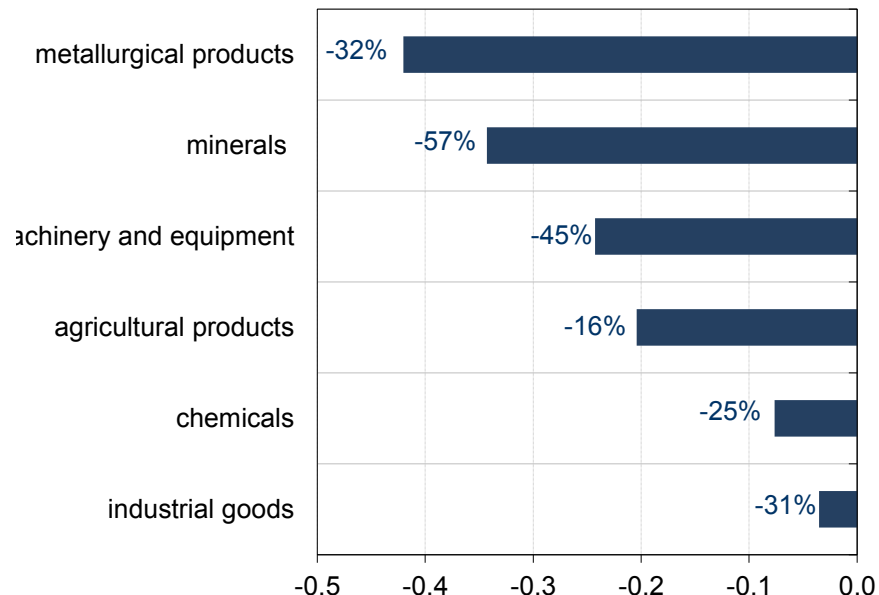
# BOP: Exports sharp drop in Jan.2015 was driven by decline in both volumes and prices

Seasonally adjusted Exports (\$ bn.)



Source: NBU

Merchandise exports change in Jan.2015 (y-o-y, \$ bn.)



Source: NBU

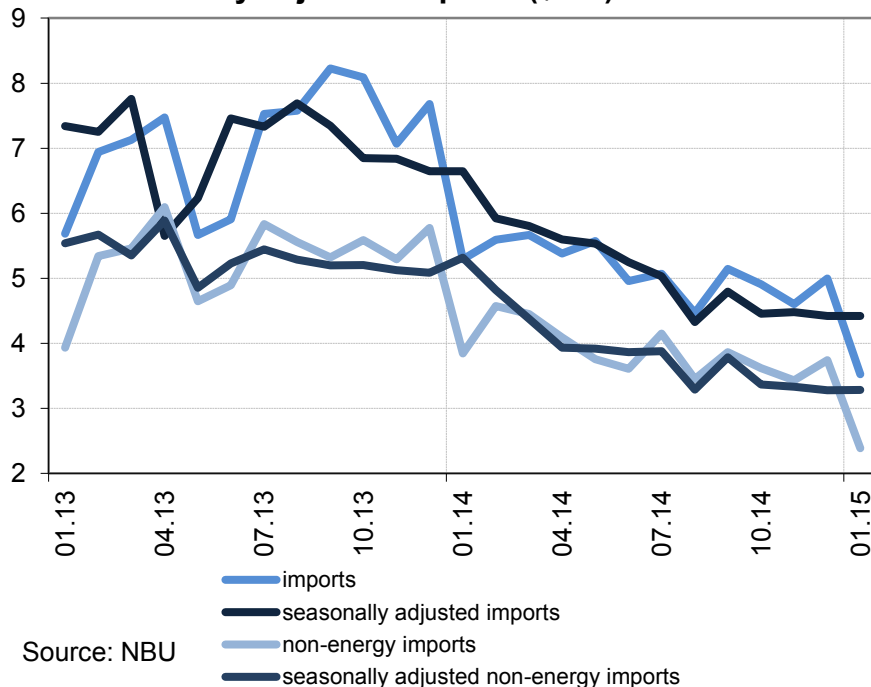
- Sharp decline of exports in January 2015 (31.6% y-o-y) was driven by the high basis of comparison in 1H2014, due to non-economic factors (military conflict in Donbass, trade tensions with Russia) and declining global commodity prices (steel, ore, grain);
- Share of agricultural products increasing (29%→35%), while share of mineral export decreasing (13%→8%) driven by discontinuing production of petroleum and coal shortage in the country;
- Exports remains quite well diversified geographically, the share of exports to Russia has decreased (9% in January 2015 vs. 17% in January 2014), while share of exports to Asia has increased (35% in Jan.2015 vs. 27% in Jan.2014). Share of exports to Europe has not changed – 35%.



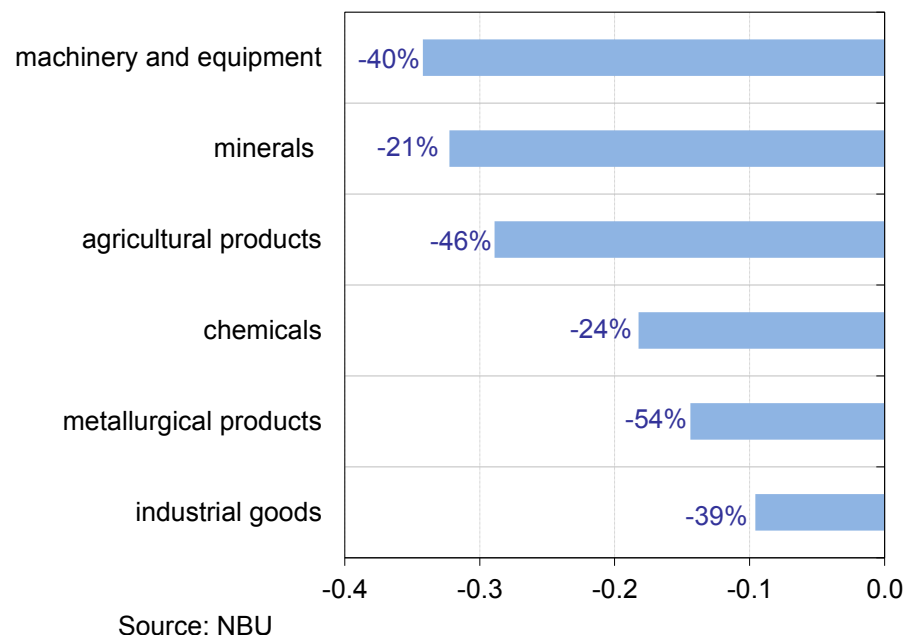
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# BOP: Imports dropped due to depreciation and low internal demand

Seasonally adjusted imports (\$ bn)



Merchandise imports change in January 2015 (y-o-y, \$ bn)



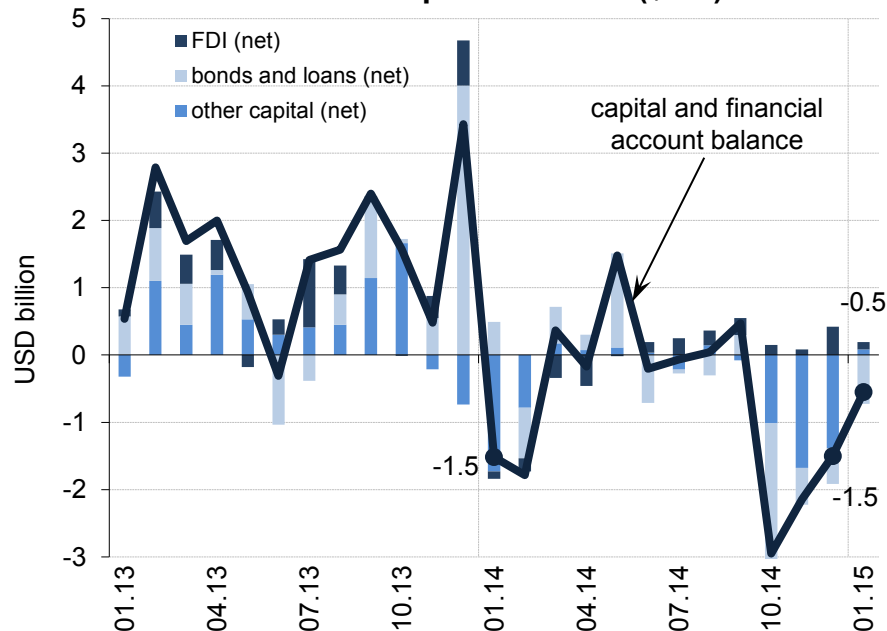
- Imports declined significantly in Jan.2015 (33.6% y-o-y) resulting from:
  - UAH devaluation in both real and nominal terms;
  - sluggish economic activity and low internal demand, especially consumption:
    - import of agricultural products and cars dropped twofold;
  - shrinking of energy consumption:
    - import of oil products fell by 3 times.
  - share of imports from Russia has decreased (18% in Jan.2015 vs. 28% in Jan.2014), while share of exports from Europe has increased (34% in Jan.2015 vs. 28% in Jan.2014).



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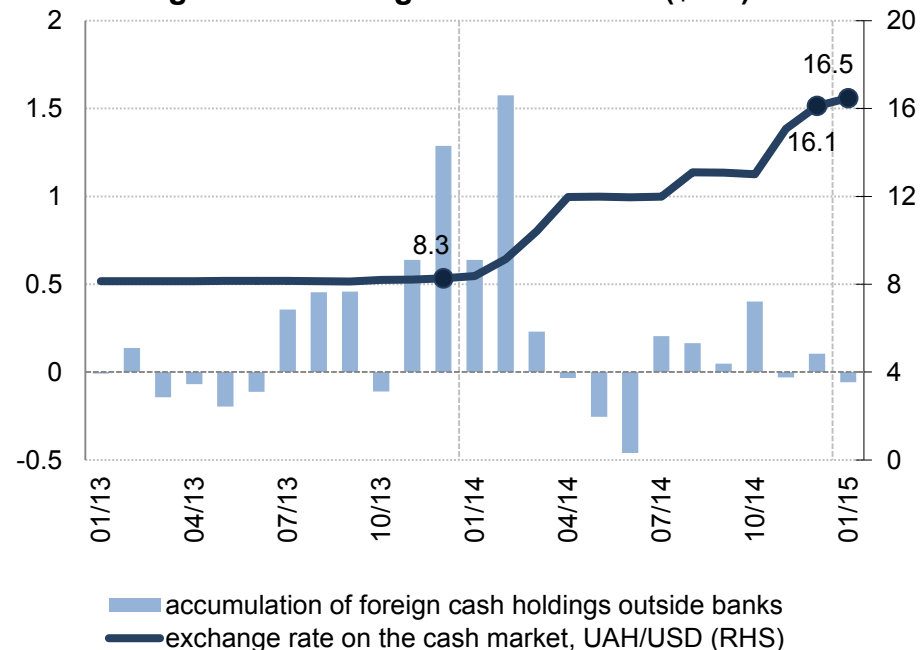
# BOP: Financial account deficit shrunk by 3 times compared with December 2014 and January 2014

The financial and capital account (\$ bn)



Source: NBU

Foreign cash holdings outside banks (\$ bn)



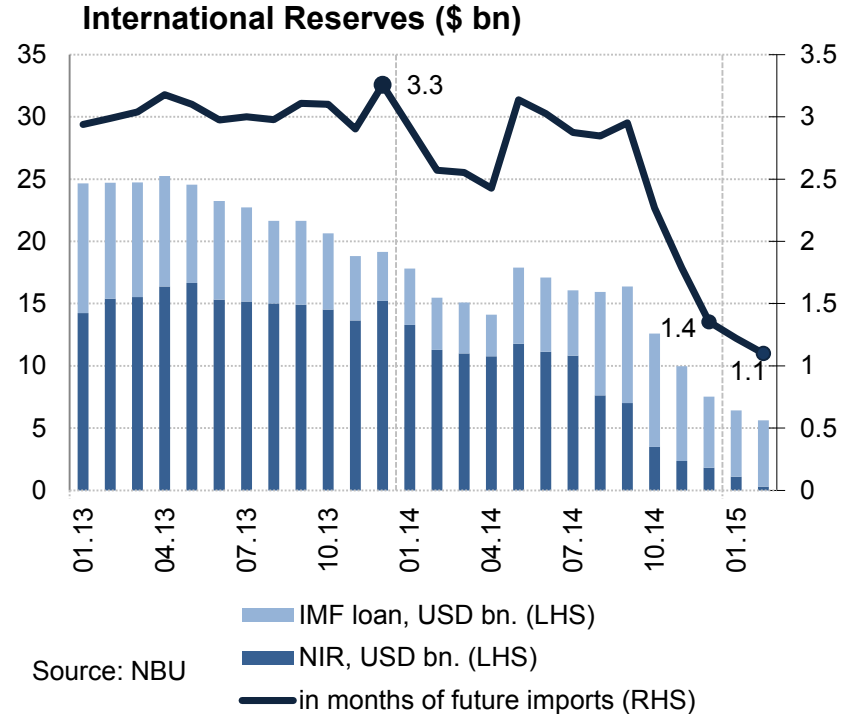
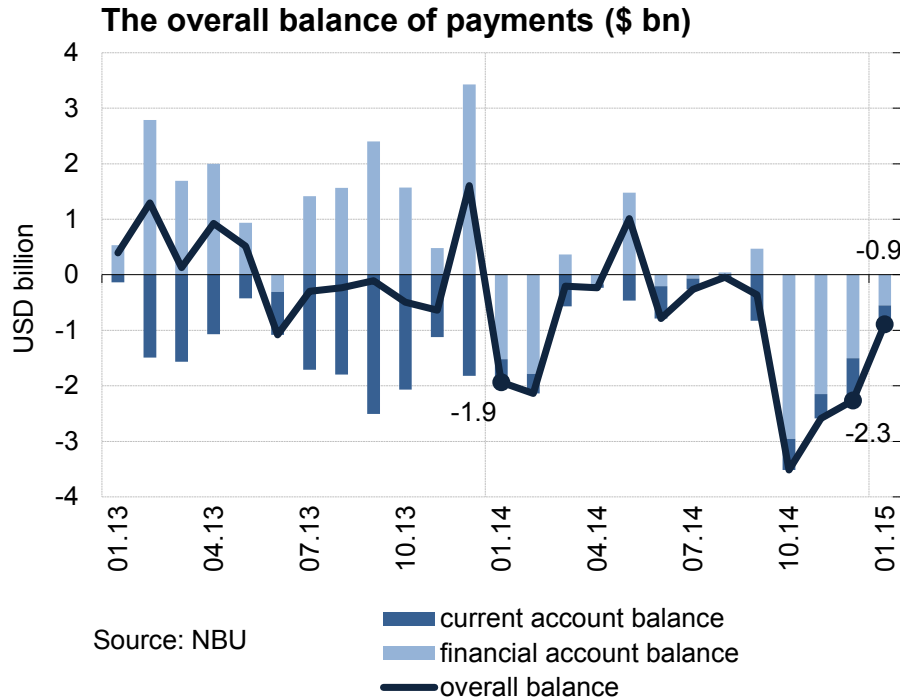
Source: NBU

- The net outflow of private debt capital in a wake of military conflict escalation was the main driver of financial account deficit:
  - rollover of private sector – 63%, incl. banks – 74%, corporates – 28%;
- Net outflows on loans and bonds of the private sector (-\$645 m) was only partially offset by foreign direct investment (\$108 m), and a reduction of currency outside banks (\$57 m).



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# BOP: In January Balance of Payments was with a double deficit for the fourth consecutive month



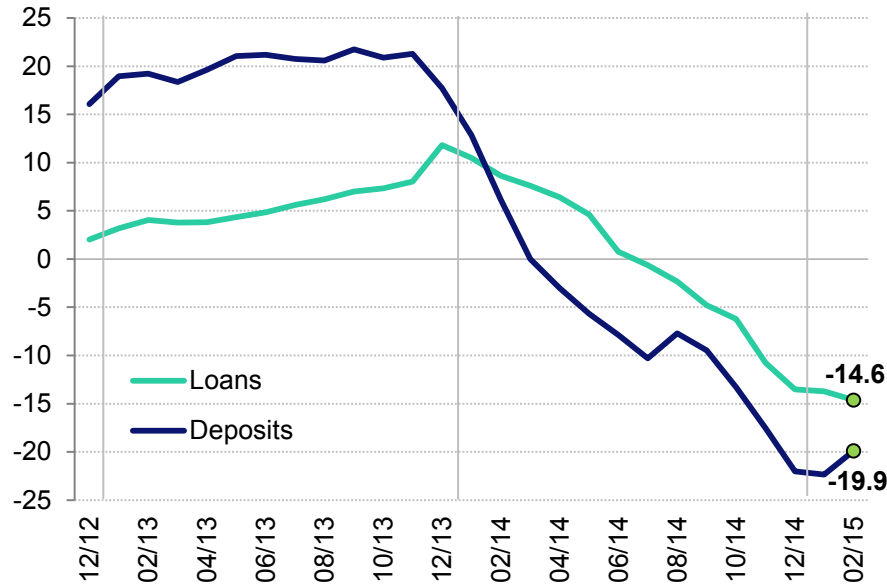
- Overall balance of payments deficit (\$0.9 bn) shrunk twice y-o-y in January 2015;
- International reserves continued to decline – \$5.6 bn as of 01.03.2015 covering 1.1 months of future imports;
- Scheduled repayment of IMF loan worth \$0.2 bn was done in January 2015.



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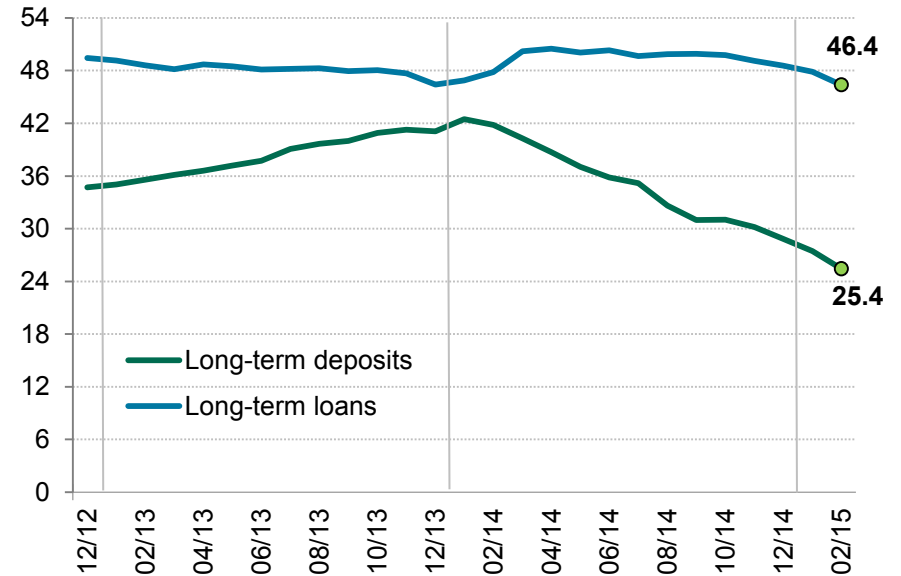
# BANKING: Banking sector has shrunk

### Banks loans and deposits (y-o-y change, %)



Source: NBU  
The calculated data, ex. rate 7.993 UAH/USD

### Shares of long-term deposits and loans in total deposits and loans (%)



Source: NBU  
The calculated data, ex. rate 7.993 UAH/USD

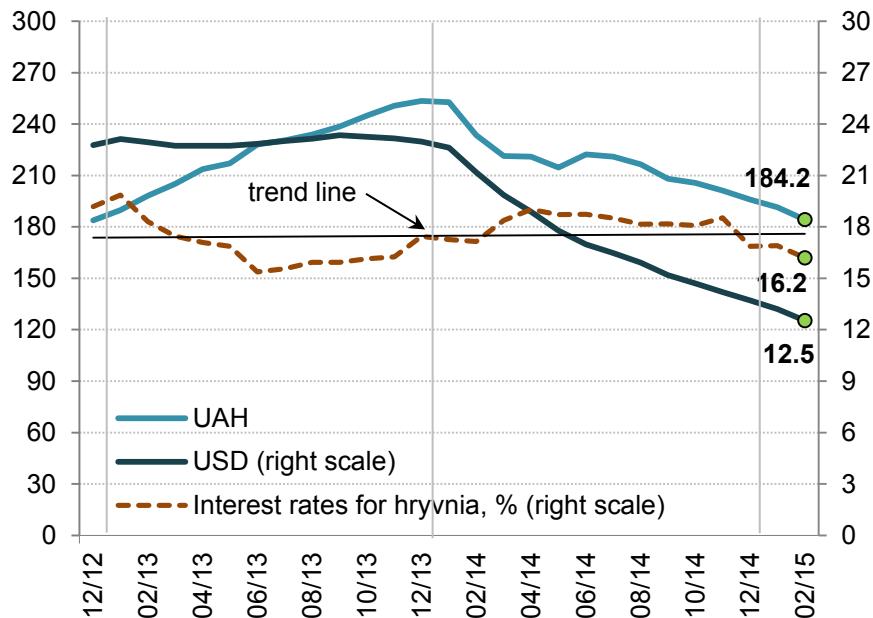
- The share of short-term deposits is higher than long-term deposits due to the depositors preferred short-term deposits to long-term ones.



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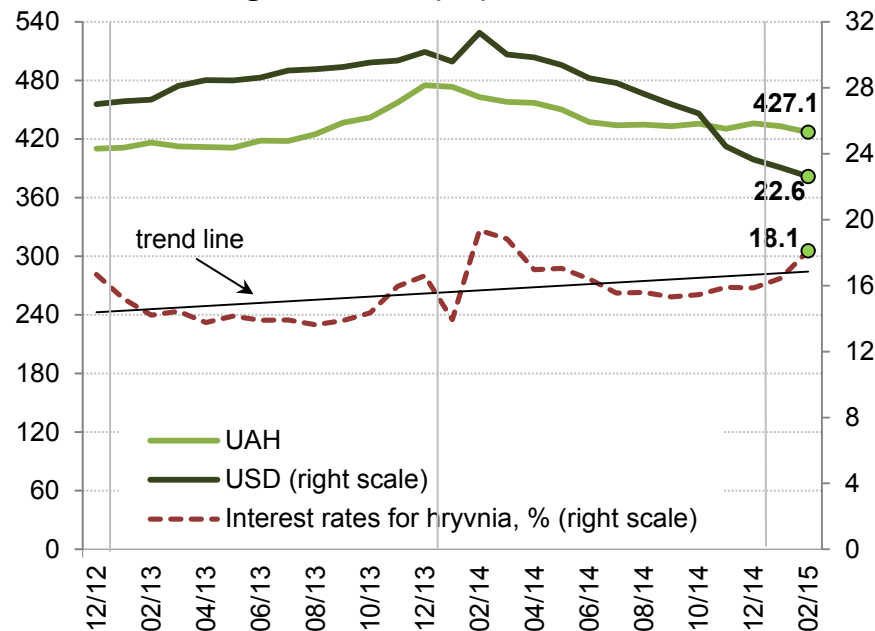
# BANKING: Volumes and price of money were uncorrelated

Deposits of individuals (bn)



Source: NBU

Loans of legal entities` (bn)



Source: NBU

- Market interest rates fluctuations under stressed money market did not reflect the objective picture of changes in the value of resources, as loans remain inaccessible for the majority of market participants.
- Deposits outflow was mainly caused by the lack of trust to banks and interest rates didn't play motivation role.

## Deposits of individuals

### 2014

UAH ↓ 57.5 UAH bn (22.7%),  
FX ↓ 9.3 USD bn (40.3%).

### February 2015 (y-t-d)

UAH ↓ 11.7 UAH bn (6.0%),  
FX ↓ 1.2 USD bn (8.7%).

## Loans to legal entities`

### 2014

UAH ↓ 39.0 UAH bn (8.2%),  
FX ↓ 6.5 USD bn (21.6%).

### February 2015 (y-t-d)

UAH ↓ 9.0 UAH bn (2.1%),  
FX ↓ 1.0 USD bn (4.4%).



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## BANKING: Different groups of banks face different problems during the crisis

	#	MkS assets, %	Related party lending	Corporate gover- nance	Liquidity (deposits outflow)	NBU refinancing	Capital needs	NPLs
Local SIFIs	2	18	Yellow	Yellow	Red	Red	Red	Yellow
State banks	6	22	Yellow	Green	Green	Red	Red	Yellow
Foreign banks	44	40	Green	Green	Green	Green	Green	Red
Russian banks	4	11	Green	Green	Red	Green	Yellow	Red
Local banks	86	6	Red	Red	Red	Yellow	Yellow	Red
Insolvent banks	16	3	Red	Red	Red	Yellow	Red	Red

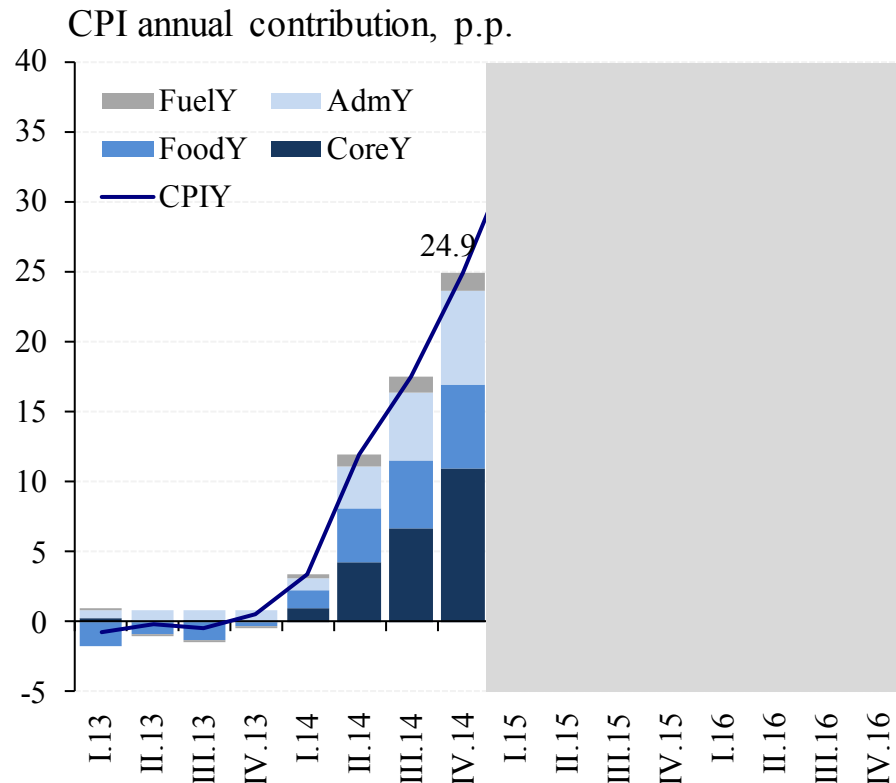
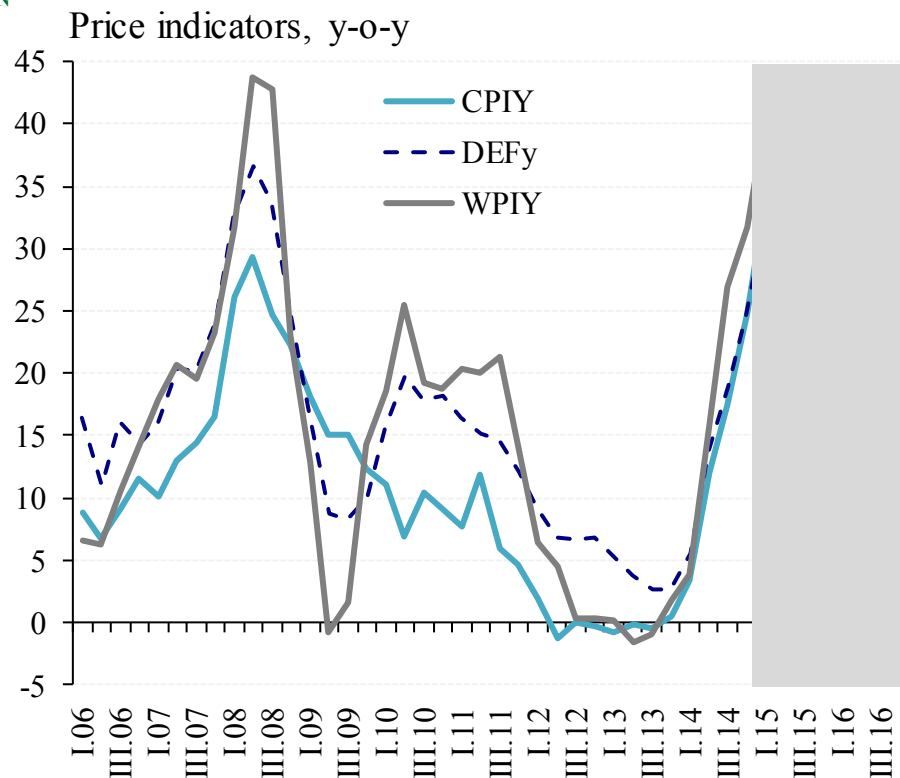
- Foreign banks are in relatively good position (only Russians ones experience strong deposit outflows)
- Local private banks (both large and small) are the most problematic





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# OUTLOOK: Consumer inflation will return to a single-digit level only in 2016



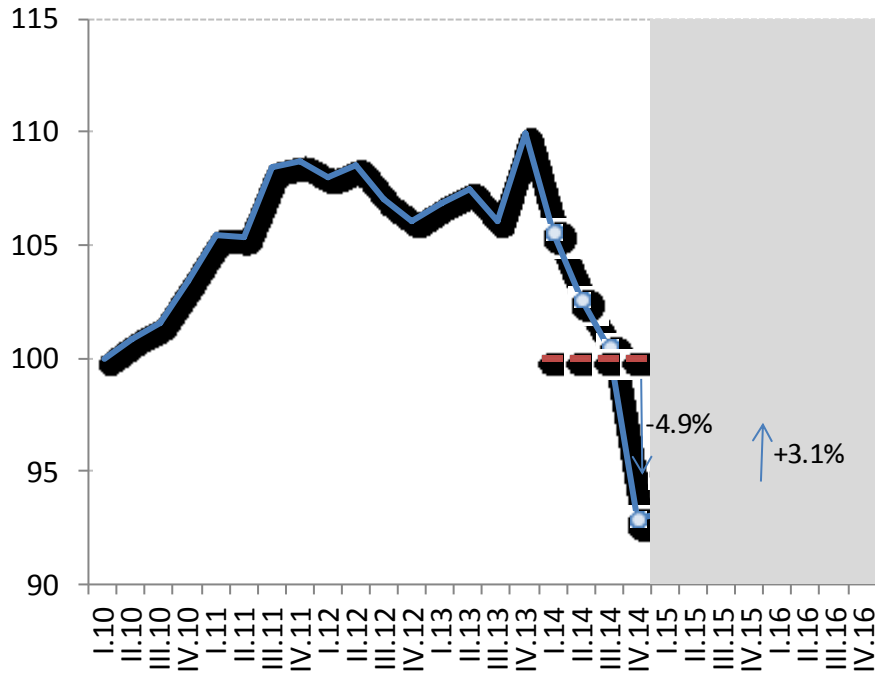
- According to our assumptions rise of administratively regulated prices will have about 12 p.p. effect on CPI in 2015 and 6 p.p. in 2016.
- Inflation will start to slow down in the second half of 2015 as effects of exchange rate correction will be decreased.



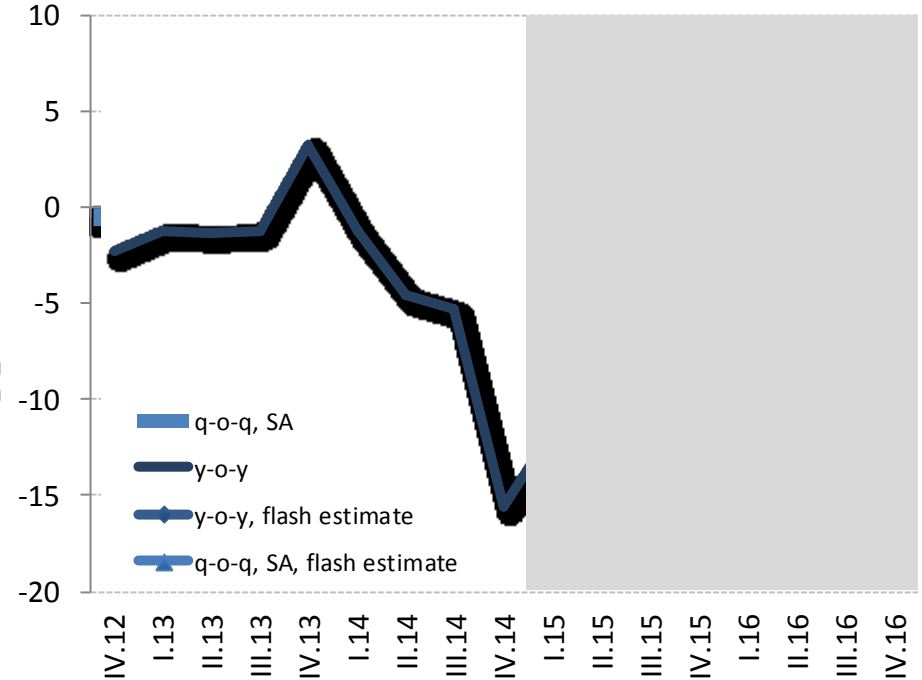
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# OUTLOOK: The recovery of economic activity will start from 2015Q2

Real GDP, I.2010=100, SA data



Real GDP, change, %



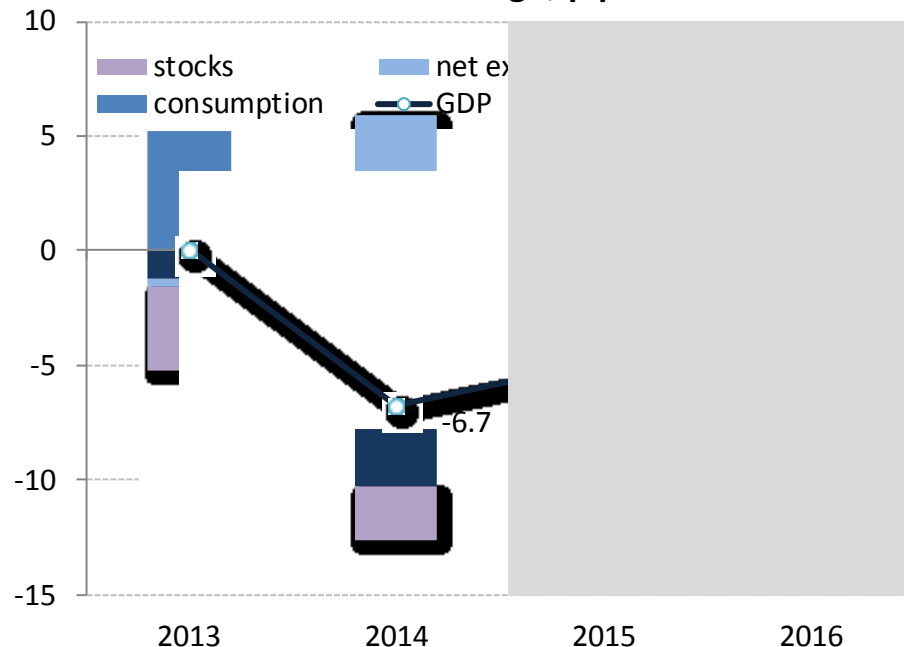
- GDP will be lower by 4.9% in 2015 compare to 2014. but the downsize risks are high
- Similarly, negative output GAP will be closing gradually until the beginning of 2016 (we assume some decrease in potential GDP level for 2014 due to military conflict).



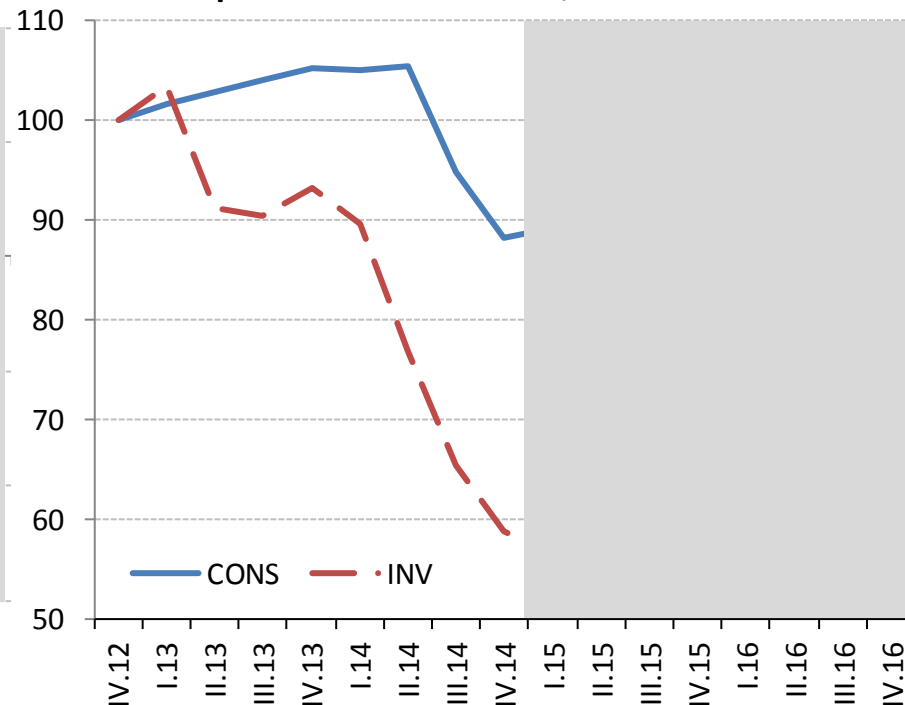
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# OUTLOOK: Net export will contribute mostly into GDP recovery in 2015. Growth of investment and consumer demand will resume in 2016.

Contributions to GDP change, p.p.



Consumption and investment, IV.2012=100



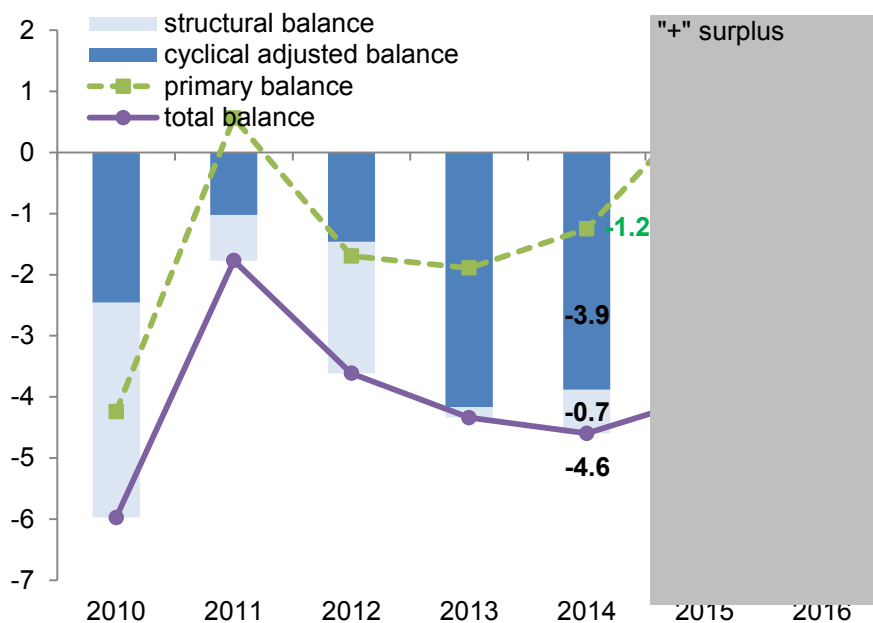
- We expect very slow (quarter-to-quarter) growth of consumption and investment.



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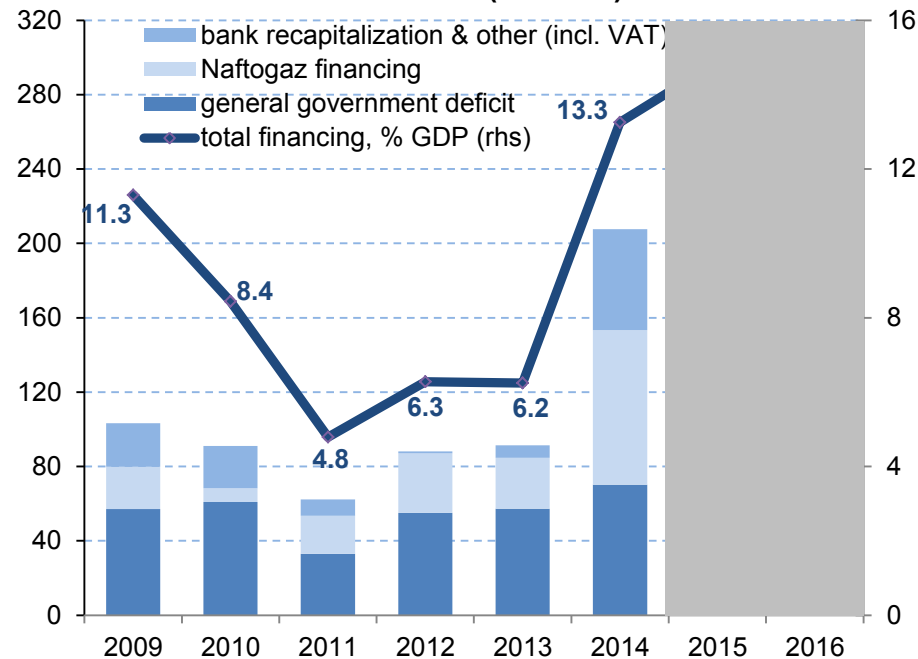
# OUTLOOK: Despite fast shrinking of fiscal deficit it remains high. Budget policy will be tight due to high debt repayments

### Consolidated budget balance (% GDP)



Source: Treasury, NBU calculations.

### Government broad deficit (bn UAH)



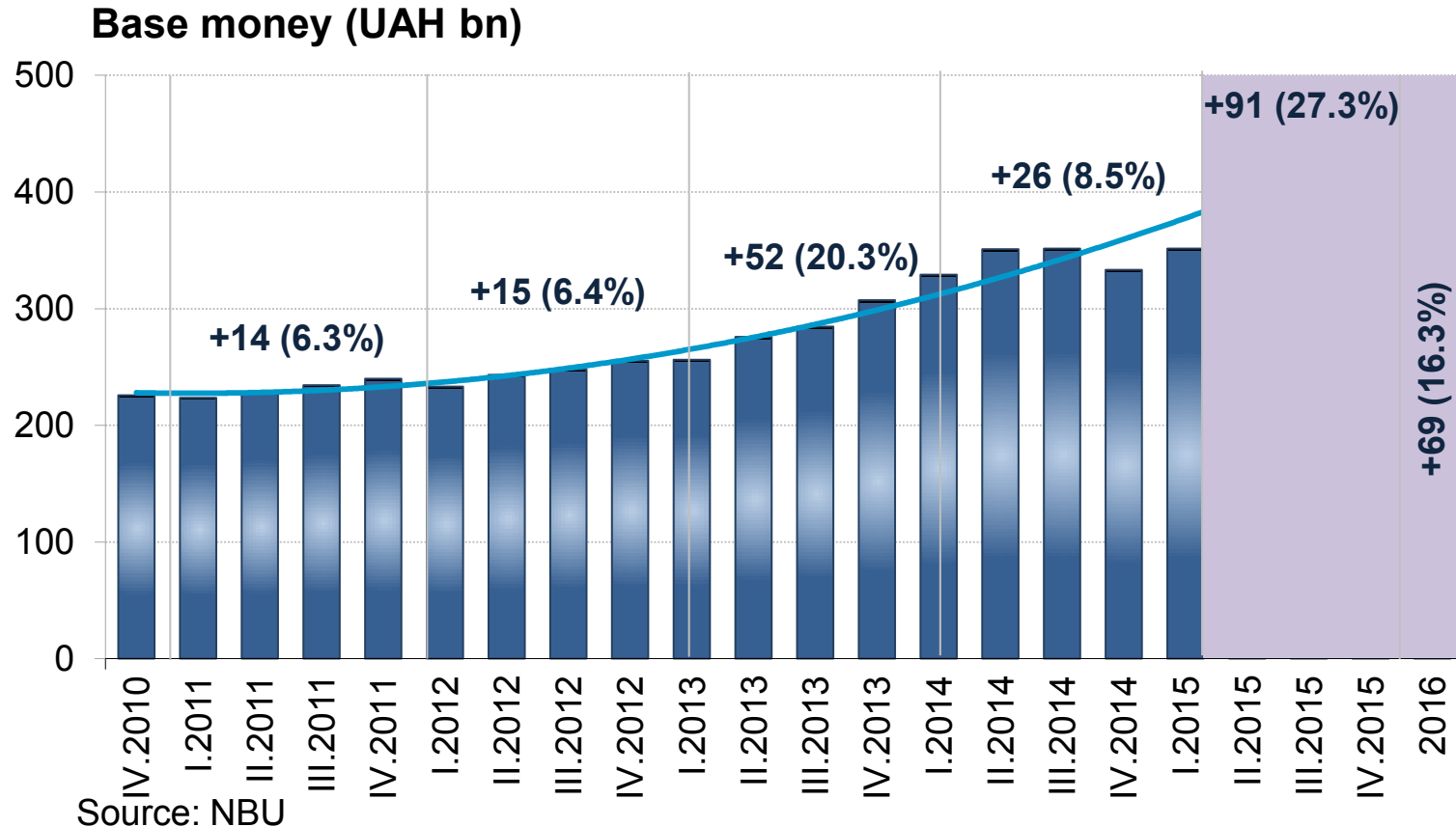
Source: MFU, IMF, NBU calculations.

- Consolidated budget deficit in 2015 is expected to be at 4.0% of GDP mainly due to debt service expenditures growth (impact of hryvnia devaluation) and increase of defense expenditures caused by military conflict
  - debt service will increase to 4.8% of GDP;
- Quasi-fiscal deficit might decrease due to energy tariffs adjustment (positive effect on Naftogaz deficit) but financial sector needs will remain on the high level (bank recapitalization, etc);
- Budget consolidation is necessary, but general government deficit optimization requires reforms of sectors with large role of state regulation (energy, transportation etc.)



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## OUTLOOK: New program with IMF assumes tight monetary policy



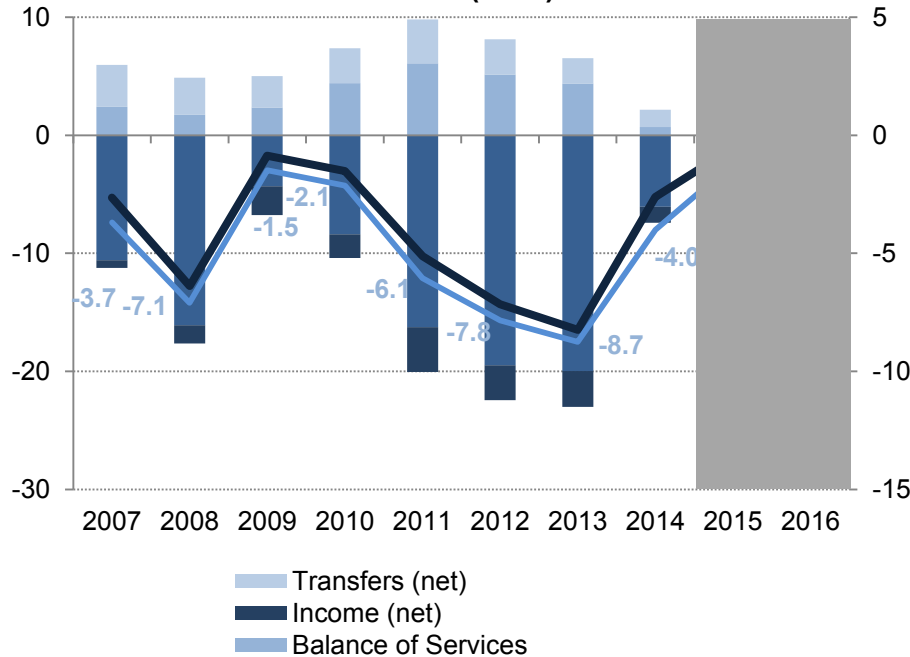
- The growth of the monetary base should not exceed UAH 91 bn to prevent destabilization of the financial system and the overall economy
- The bulk of base money growth will be supplied through support of Deposit guarantee fund and purchase of FX on market (to replenish foreign exchange reserves)
- The NBU will actively use sterilization to achieve the money supply target
- The purchase of T-bonds by the NBU will be limited to the amount agreed with IMF (Naftogaz mainly)



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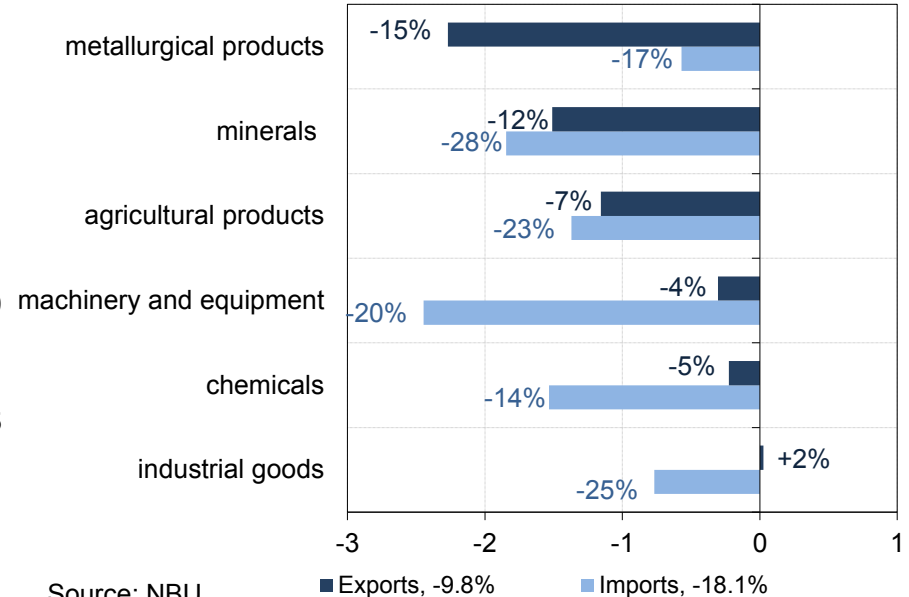
# OUTLOOK: Further improvement in the trade and C/A balances in 2015 is projected

Current account balance (\$ bn)



Source: NBU

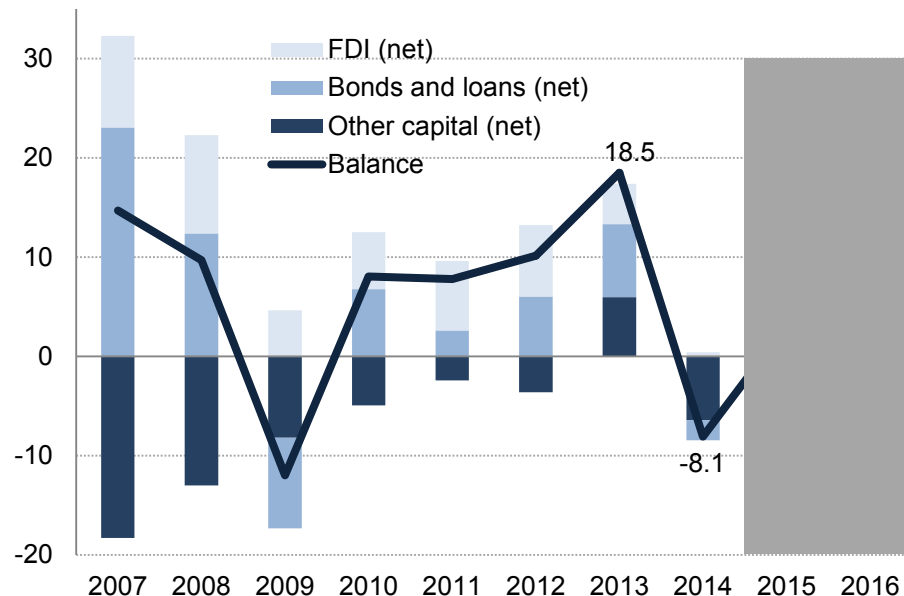
Merchandise exports and imports change in 2015 (\$ bn)



- Despite positive effect for exporters in a wake of price competitiveness improvement, exports will continue decreasing due to:
  - military conflict in the East and restrictive measures on trade with Russia;
  - lower prices for grains, metals and ores;
  - high dependence on imported raw materials;
  - significant competition in foreign markets;
- In case of deeper devaluation, exchange rate elasticity of imports will go down as the structure of imports will shift to inelastic intermediate goods, needed for exported products.

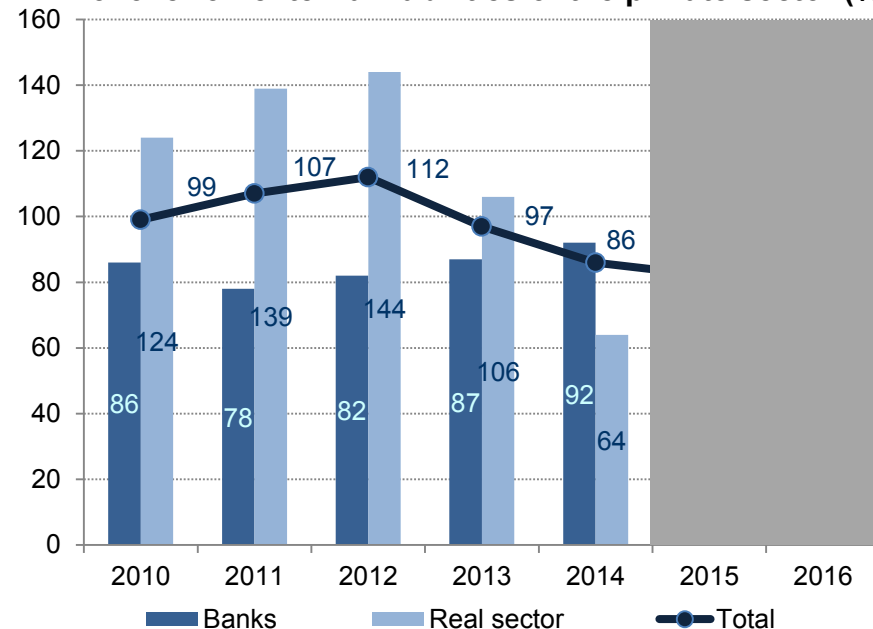
# OUTLOOK: Financial account will return to a positive area due to high public external financing

Capital and financial account (\$ bn)



Source: NBU

Rollover on external liabilities of the private sector (%)



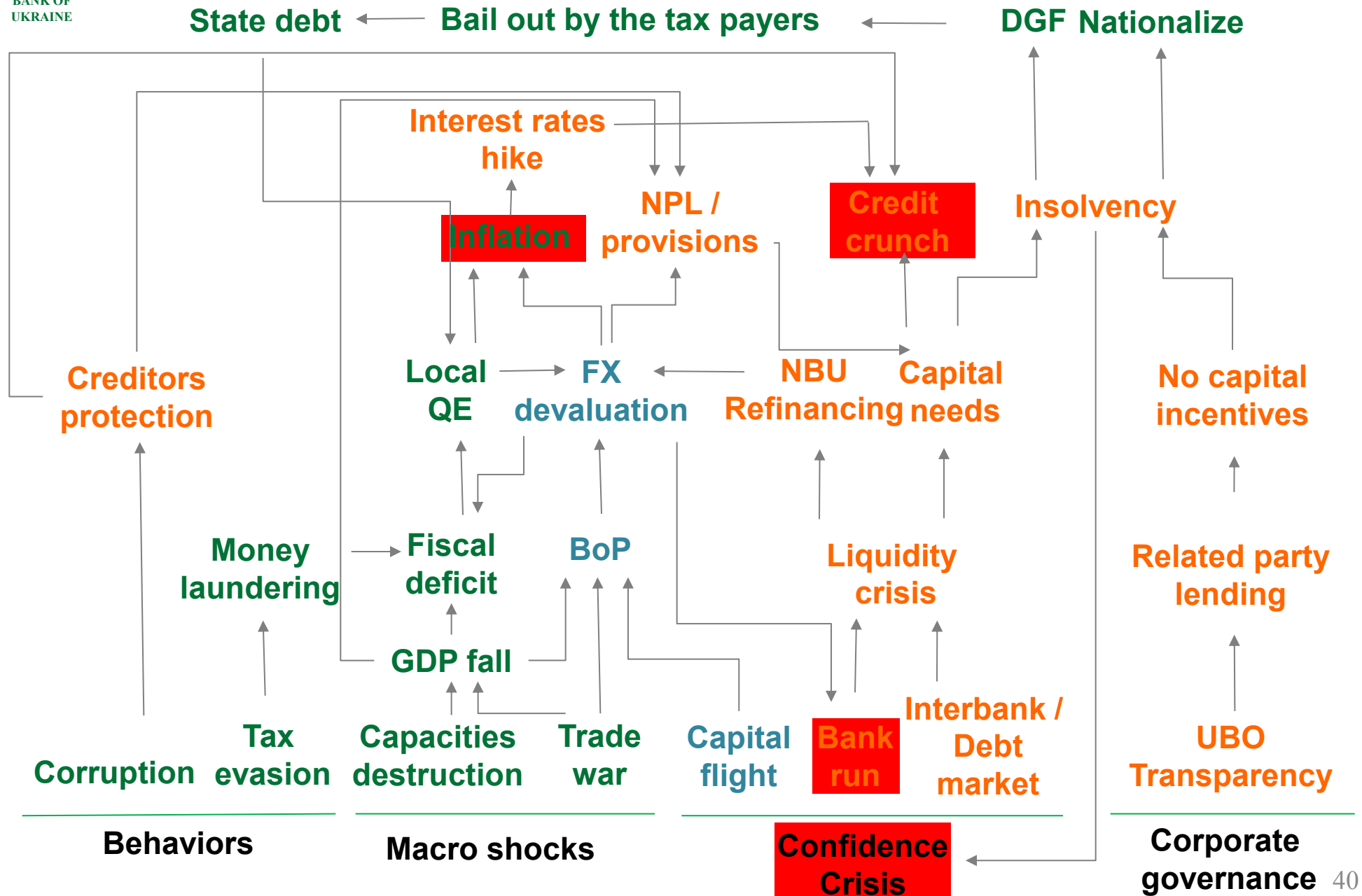
Source: NBU

- In 2015, we project financial account with a moderate surplus:
  - official financing: from IMF – \$8.3 bn, from other IFIs and bilateral loans – \$4.5 bn and Eurobonds under U.S. government guarantees – \$2 bn;
  - net inflow of foreign direct investment will increase to \$1.4 bn;
  - further outflow of currency outside banks is not expected (+\$0.1 bn) due to reduction of devaluation expectations.
- Rollover on external liabilities of the private sector is expected to decrease slightly in 2015, in 2016 we expect gradual recovery.



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# NBU current agenda is to resolve the accumulated structural imbalances, fight with inflation, calm down the confidence crisis and restart lending in the economy

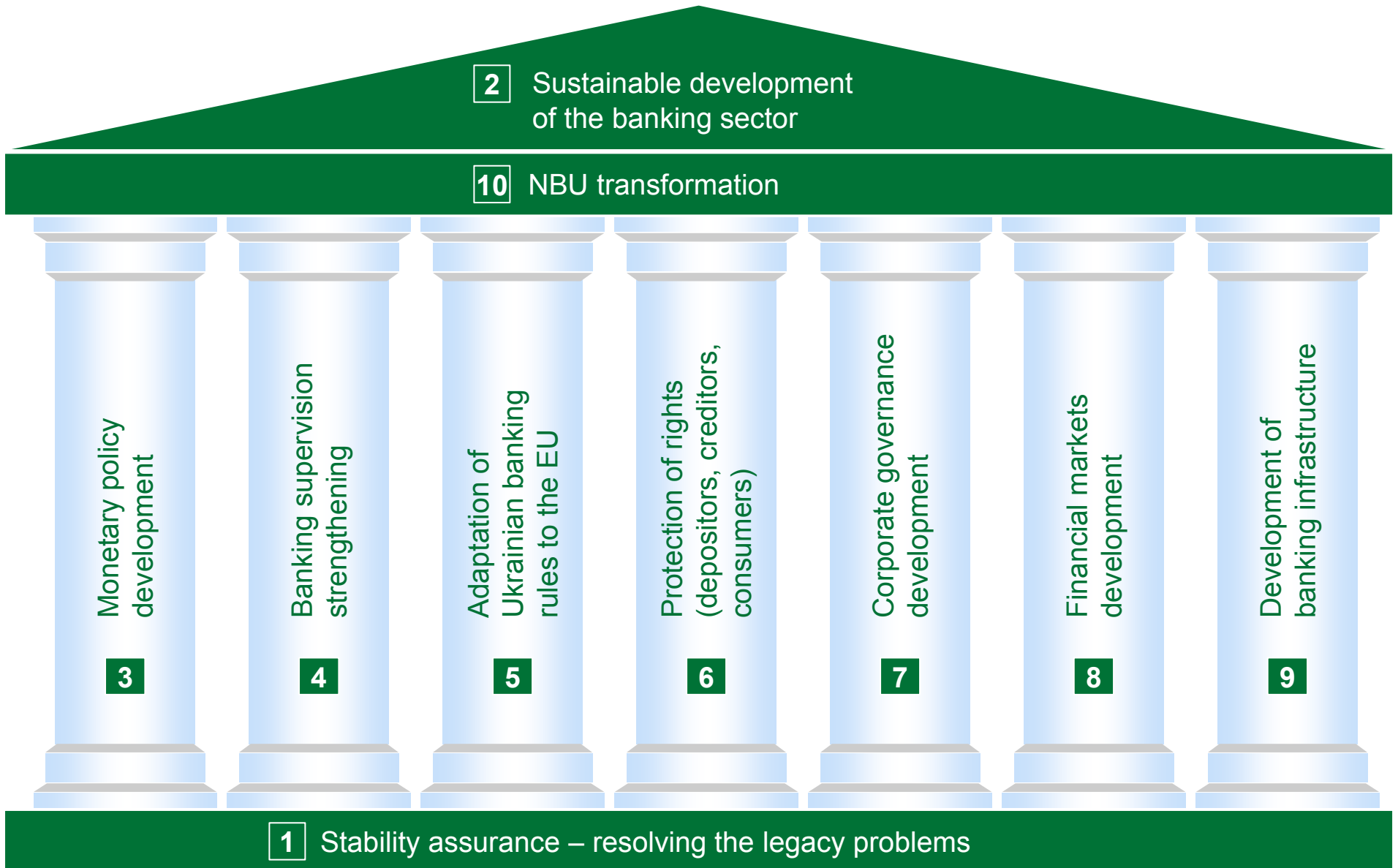






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# TO ADDRESS THE CURRENT AND FUTURE CHALLENGES NBU TEAM IS RUNNING THE 2020 BANKING SYSTEM REFORM PROJECT





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## What has been done in 2014 (1/2)

### Capitalization

- Stress test for top 35 banks accomplished; capitalization plans approved with the commitment of the key shareholders
- New capital requirements adapted (500 mln uah) for the banks
- Moving from peg currency regime towards floating Fx policy and inflation targeting

### Monetary policy

### Corporate governance

- Top 35 banks disclosed UBO, 25 banks with zero UBO disclosure warned and requested the disclosure; 40 more banks in the pipeline; new requirements for SB in force;

### DGF

- DGF capitalized; also provided with sufficient liquidity from NBU;
- The mechanisms for the nationalization of local SIFI have been agreed with MoF; new tools for banks resolution in place

### AML

- 7 money laundering banks closed;
- Money laundering discipline strictly monitored with no tolerance



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## What has been done in 2014 (2/2)

### Supervision

- Refinancing lines provided to the local SIFI banks
- New EWS is in place; curators in the banks

### NBU independence

- Changes to the NBU law to increase the NBU institutional and financial independence developed with support of IMF legal team
- Avoiding fiscal dominance situation

### Term deposits

- New law to make the deposits really term deposits in the Parliament – a good base for the future

### Creditors protection

- Amendments to different laws have been developed to increase the creditors protection; to be directed to the parliament by the year end



# Main targets for nbu transformation project are linked with strengthening of the nbu core functions

## NBU TRANSFORMATION AS A REGULATOR

### Supervision:

- Implement full **IFRS** by 2015 and **Basel III** by 2018;
- **Centralize** the regional **supervision**
- Create **macro prudential supervision** function;
- Implement sophisticated **EWS** to address the potential
- Strengthen the **risk management** of NBU
- Create the **financial macro regulator** based on the NBU
- Strengthen the **risk management** of NBU

### Monetary policy:

- Introduce the special supervision criteria/regime for **the local SIFI**;

## NBU TRANSFORMATION AS AN ORGANIZATION

- **Streamline the organizational structure** around the key pillars of NBU (core functions), decreasing non-core functions;
- **Optimize** the regional presence (decreasing number of the regional offices) followed by **right-sizing**
- **Educate (grow up)** new generation of NBU management via assessment, selecting the talents pool and potential executive pool, training, mentoring and ... empowering

## TARGETS TO ACHIEVE:

- IFRS compliant financial reporting of the banks in place for all the financial sector
- Building risk preventive supervision (vs current compliant-based supervision)



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# BACK UP

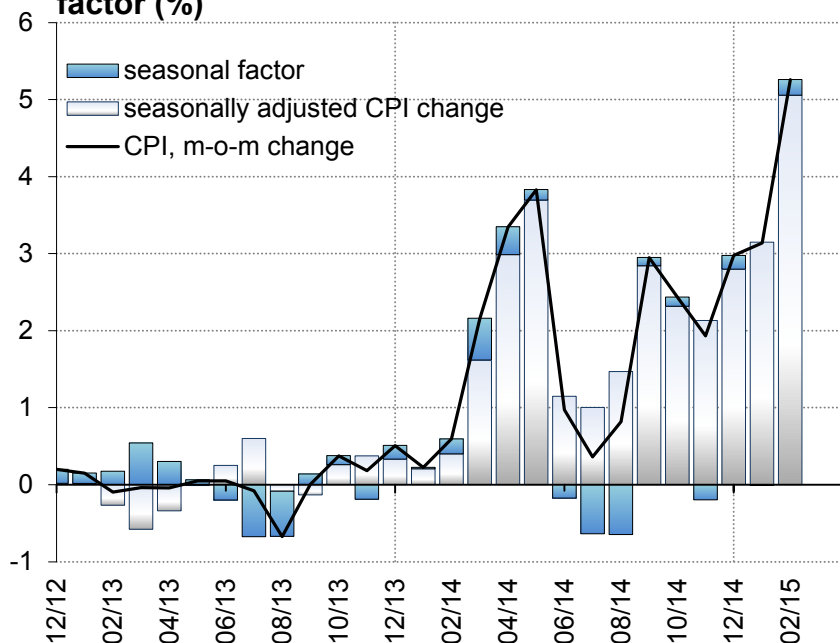
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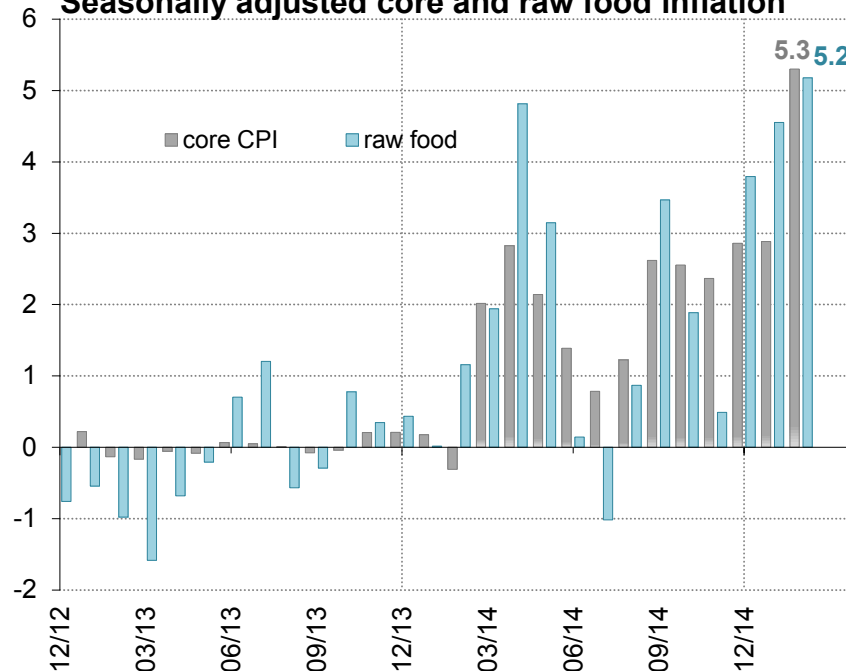
# INFLATION: In February seasonally adjusted CPI growth (5.1%) sharply accelerated after fluctuations within 2.1-3.1% in previous five months

### Seasonally adjusted CPI change and seasonal factor (%)



Source: State Statistics Service of Ukraine and NBU calculations.

### Seasonally adjusted core and raw food inflation



Source: NBU calculations.

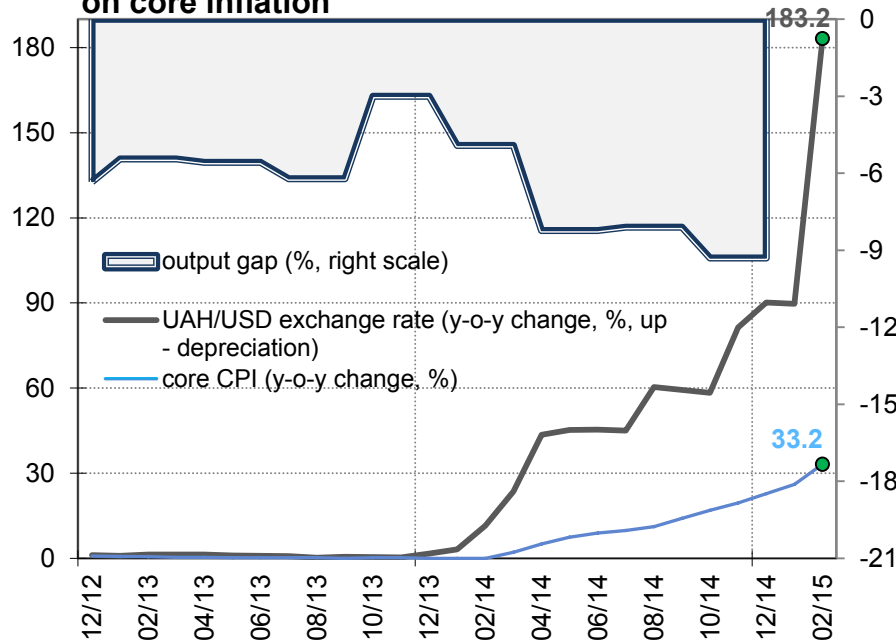
- Acceleration in February was observed across all main inflation components
  - in particular core and raw food inflation accelerated to 5.3% and 5.2% respectively.



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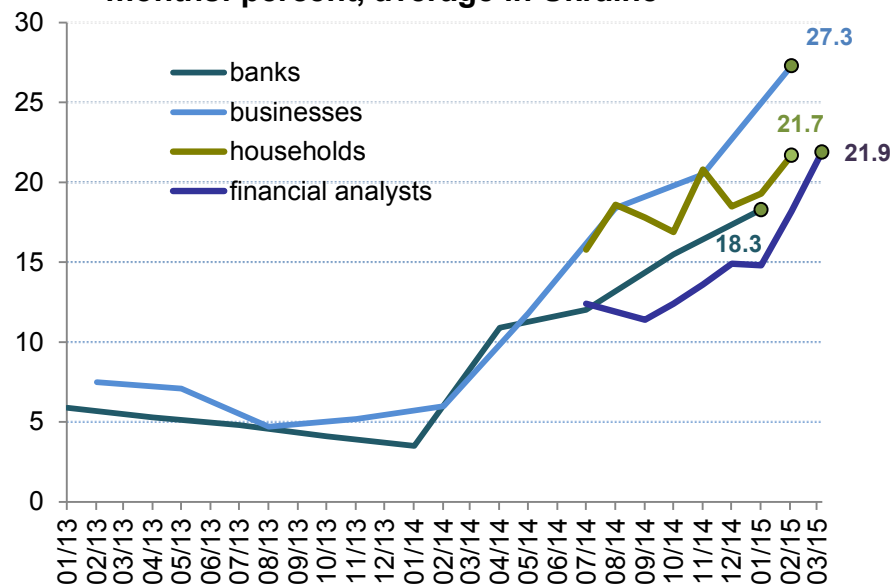
# INFLATION: Core inflation pace was defined mainly by hryvnia depreciation and only partly curbed by negative output gap

### Opposite influence of demand and ER factors on core inflation



Source: State Statistics Service of Ukraine and NBU

### Inflation expectations over the next 12 months: percent, average in Ukraine



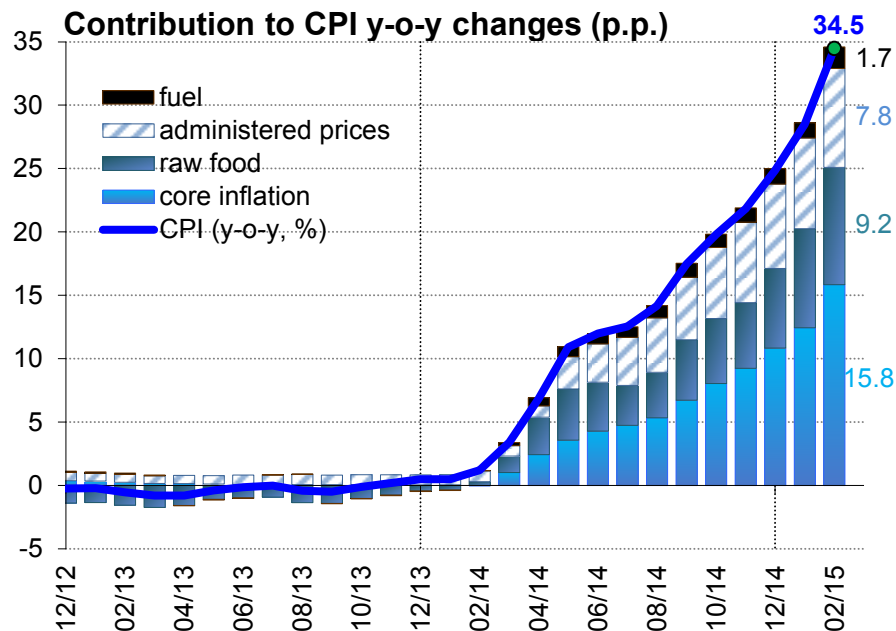
Source: NBU, GfK Ukraine surveys, NBU calculations

- Stable UAH/USD rate and negative output gap defined close to zero core inflation in 2012-2013.
- Strong inflationary pressure was also made by high inflation expectations in particular formed by occurred and expected in the future devaluation
  - households ER expectations over the next 12 months grew essentially (24.43 UAH/USD in February 2015).
  - 12 months NDF UAH/USD rate in February was on average 8.3% higher than spot UAH/USD interbank rate.



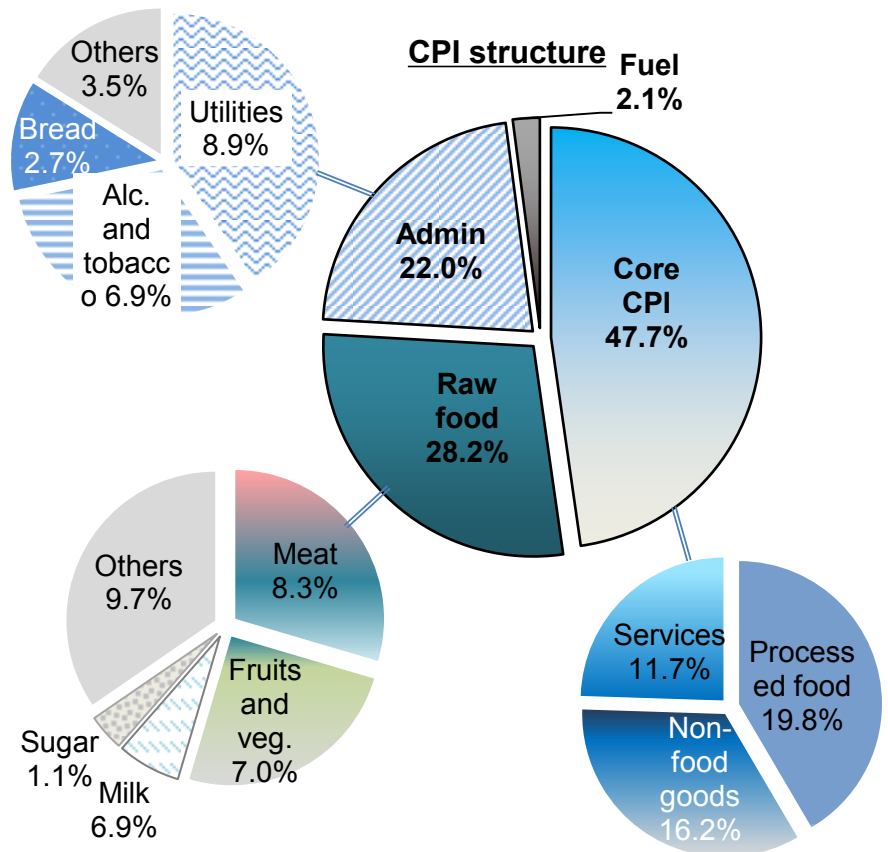
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# INFLATION: Non-core components explained the bulk (18.7 p. p.) of inflation



Note: The sum of the segment amounts may not equal the total amount due to rounding.

Source: State Statistics Service of Ukraine and NBU



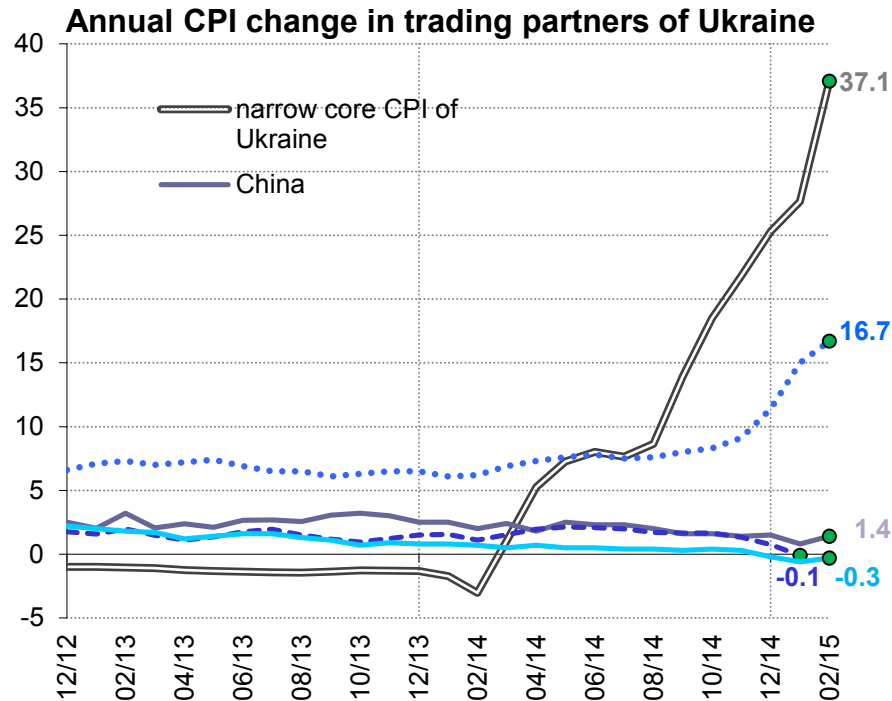
- Raw food prices dynamics after long period (29 months) of downward pressure on CPI provided growing positive contribution to annual inflation from the beginning of 2014



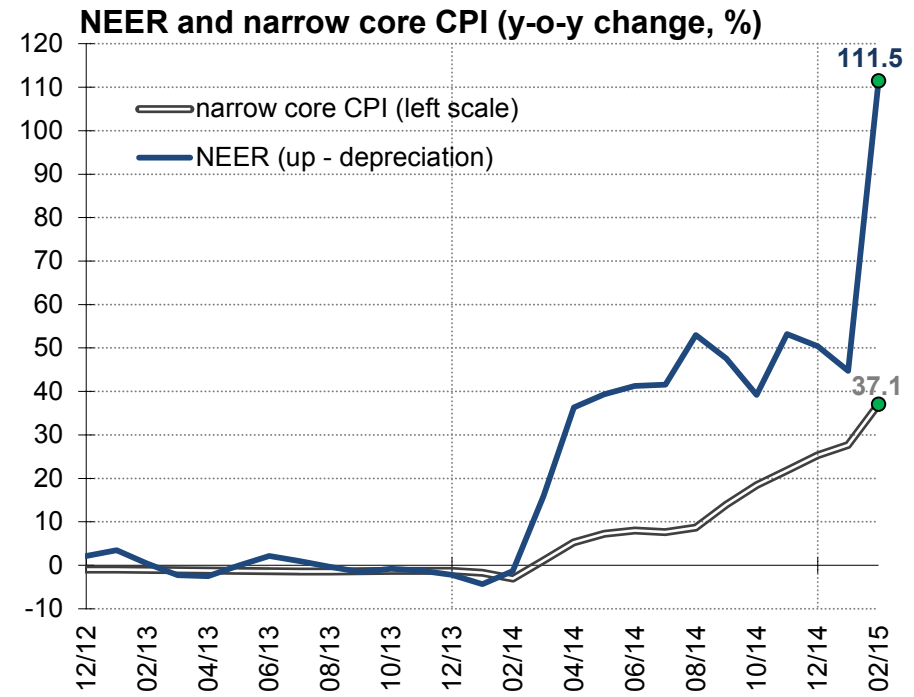


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# INFLATION: Narrow core inflation was mainly defined by NEER depreciation



Source: State Statistics Service of Ukraine and central banks data.



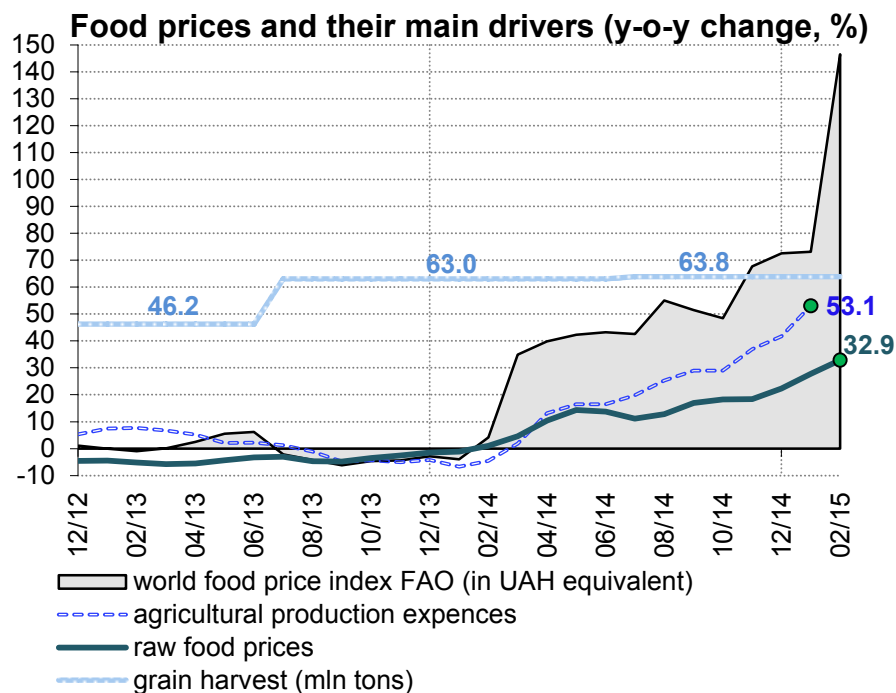
Source: central banks data and NBU calculations.

- Main trading partners of Ukraine are experiencing low inflation. Exception is Russia with 16.7% annual CPI.

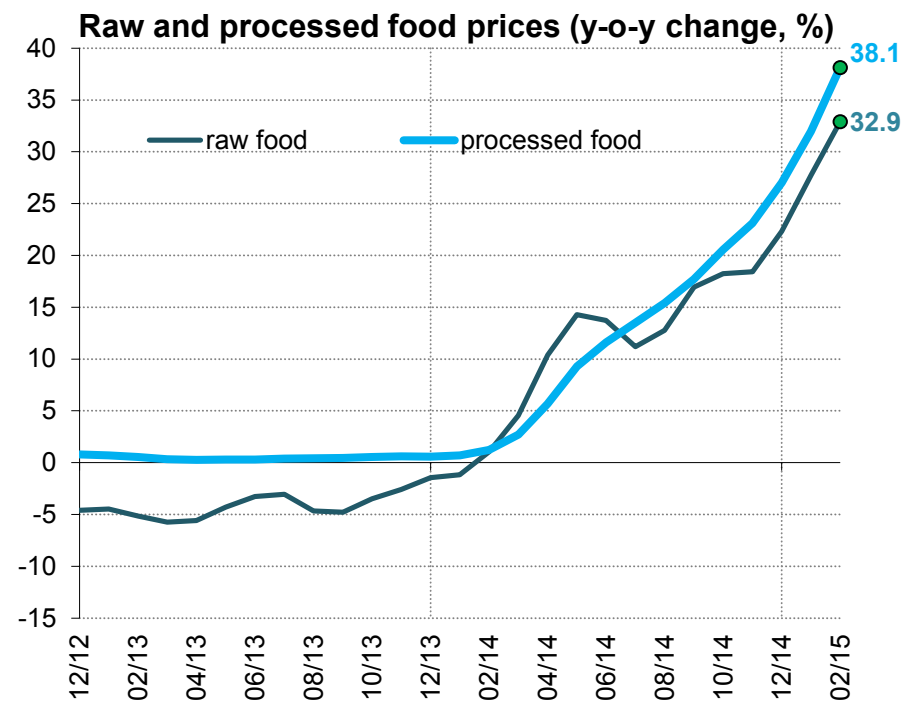


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# INFLATION: Growth of agricultural production expenses and devaluation-caused imported food inflation are the main drivers of food inflation



Source: State Statistics Service of Ukraine, FAO and NBU calculations.



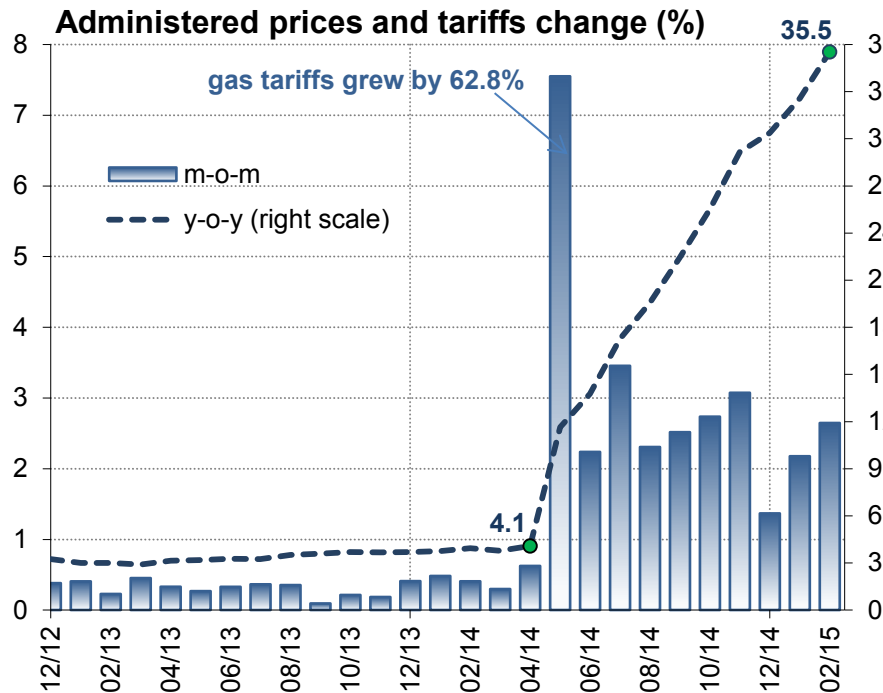
Source: State Statistics Service of Ukraine and NBU calculations.

- Raw food prices annual growth was largely defined by:
  - devaluation-caused imported food inflation: index FAO in USD decreased by 14% y-o-y, but its UAH equivalent grew by 146.5% y-o-y in February 2015;
  - growth of agricultural production expenses by 53.1% y-o-y as of January 2014.
- Processed food prices increased by 38.1% y-o-y due to direct devaluation effect and also energy and raw food prices growth.
- Record grain harvest in 2014 (in spite of Crimea exclusion from the calculations) contained food inflation.

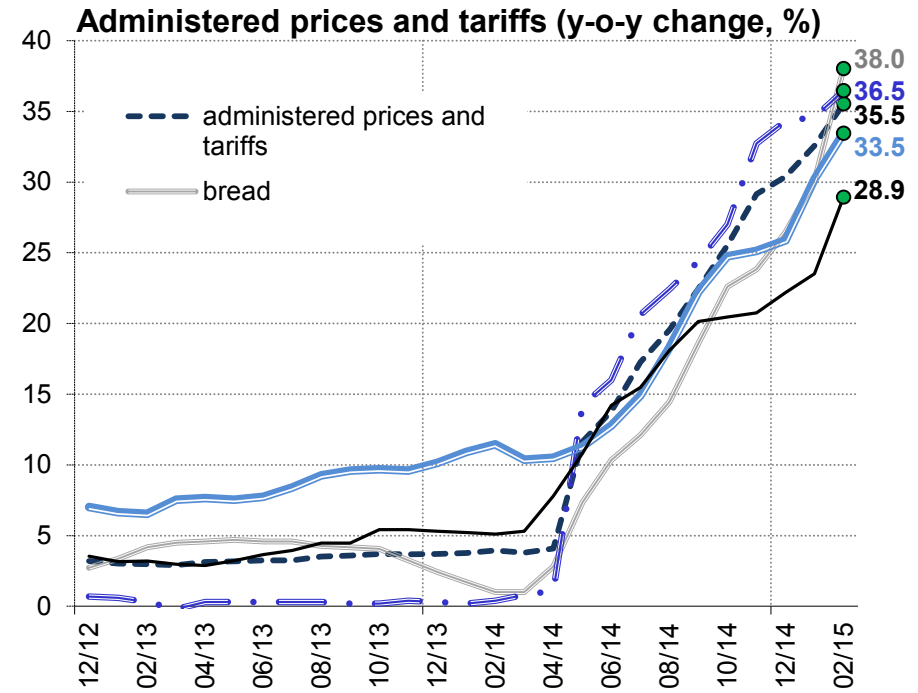


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# INFLATION: Administratively regulated inflation has been defined by recurrent raise in utilities tariffs and excisable goods prices



Source: NBU calculations.



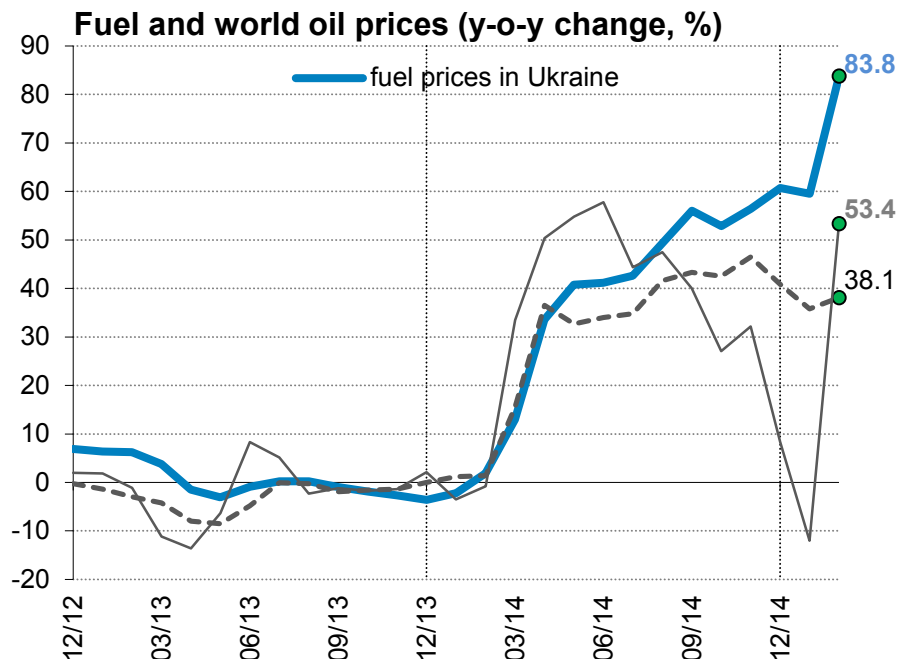
Source: State Statistics Service and NBU calculations.

- Utility tariffs started to raise to the level of recovering their cost from May 2014 (annual growth in February 2014 was 36.5%; contribution to headline inflation – 4.0 p. p.):
  - natural gas tariffs grew by 62.8% y-o-y, hot water and heating – by 45%, cold water – by 52.2%, sewerage – by 74.8%, electricity – by 11.3%.
- Annual increase of alcohol and tobacco prices accelerated to 33.5% y-o-y (2.3 p. p. – contribution to inflation) due to regular increase in excises duties, minimum retail prices (for alcohol) and introduction of excise taxes (5%) on retail sales of excisable goods in January 2015.



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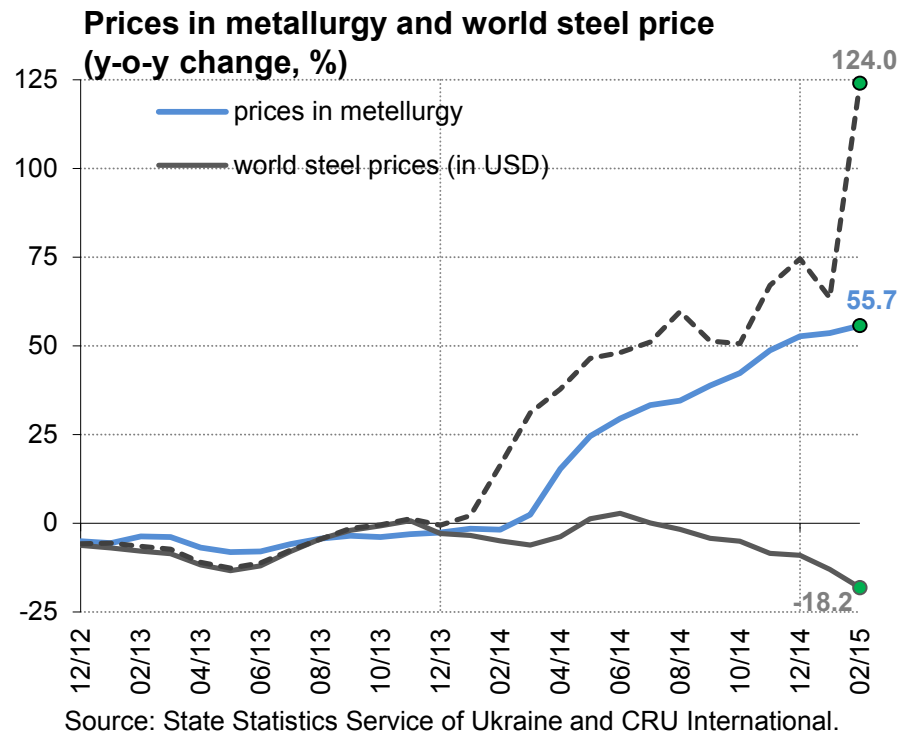
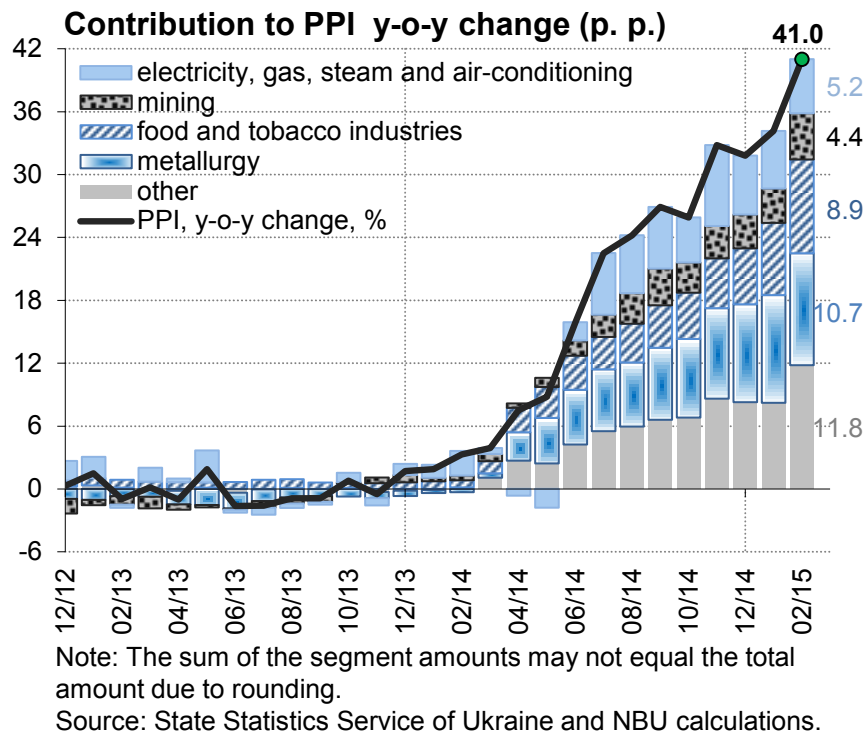
## INFLATION. Fuel prices grew sharply despite oil prices annual fall on global markets



Source: State Statistics Service of Ukraine, Reuters Datastream and NBU calculations.

- The inconsistency of fuel and world oil prices (in UAH equivalent) dynamics was significantly reduced after interbank exchange rate liberalization (adjusting it to the real rate on the market). Anyway some divergence existed due to:
  - increase in excise taxes for manufacturers and importers of petroleum products: in April 2014 for diesel – by 31-113%, in January 2015 mainly for liquefied petroleum gas – by 14% (for gasoline and diesel – by 2-3%);
  - excise tax introduction for alternative fuel manufacturers (since January 2015);
  - an additional tax on currency transactions since April 2014;
  - implemented in January 2015 excise tax (5% of sales) imposed on retailers selling of fuel;
  - existence of some psychological factors in price formation (growing retailers margin through unfounded price hike).
- In particular, last two factors and the use of domestically produced oil in petroleum production may explain significantly faster retail fuel prices growth (by 83.8%) compared with the growth of prices set by manufacturers (38.1%).
- Fuel prices rise provided small direct contribution to inflation (only 1.7 p.p.) but second-round effects could be important.

# INFLATION: Producer Price Index depended more on ER factor due to high industrial reliance on imported inputs and high links with global prices (which substantially grew in UAH equivalent)

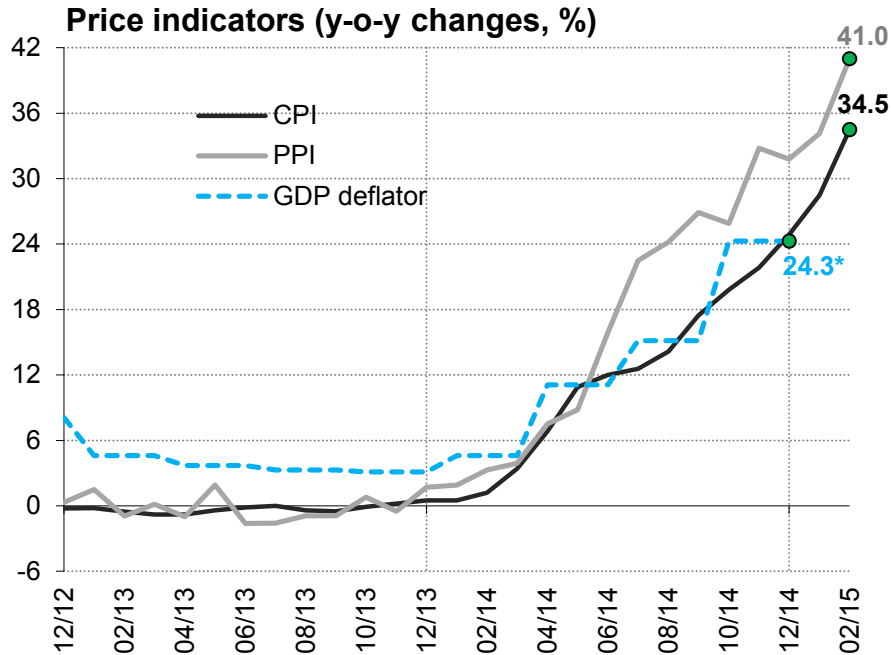


- Growth in Producer Price Index was mainly caused by UAH devaluation that gave a rise to:
  - UAH equivalent of external commodity markets prices (CRB index) grew by 118.5%, inflating the prices in export oriented industries, although nominated in dollar prices declined by 23.8%;
    - the increase in UAH equivalent of world steel price (by 124%) determined prices growth in metallurgy (by 55.7% contributing 10.7 p. p. to producer inflation).
  - imported raw materials and energy prices (marginal gas prices for industrial enterprises grew by 83.1%).

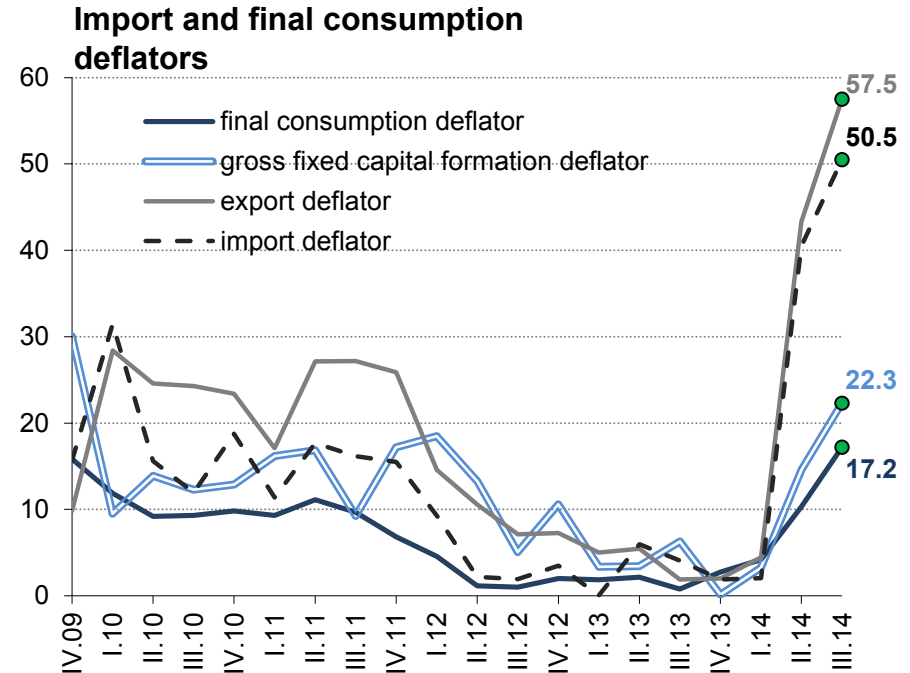


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# INFLATION: The GDP deflator was moving closely with CPI in general



\*IV quarter GDP deflator - NBU estimation.  
Source: State Statistics Service of Ukraine .



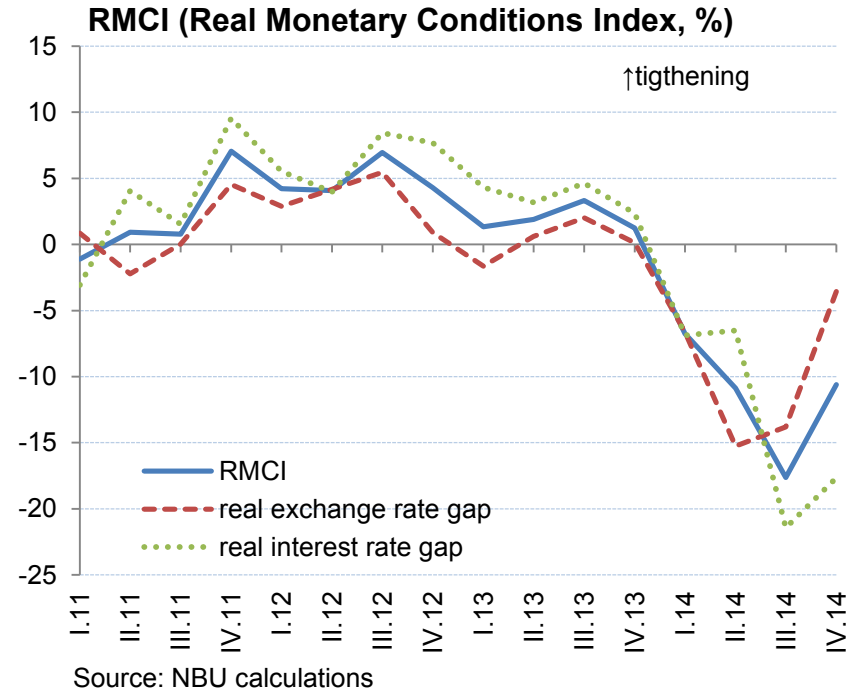
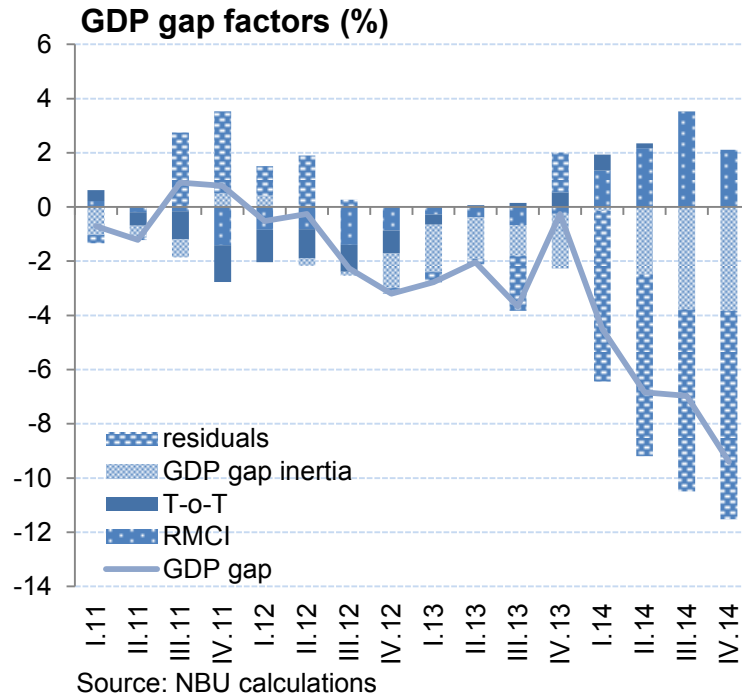
Source: State Statistics Service of Ukraine.

- Unlike CPI, GDP deflator includes capital goods and export products, but excludes import products
  - import exclusion should decrease devaluation pass-through to the GDP deflator, but devaluation was significantly translated into GDP deflator through export (in the III quarter 2014 export and import deflators made very close but opposite by signs contributions to GDP deflator: +27.6 p.p. and -25.6 p.p. respectively).



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# REAL SECTOR: Negative GDP gap increased because of confidence factors related to military conflict



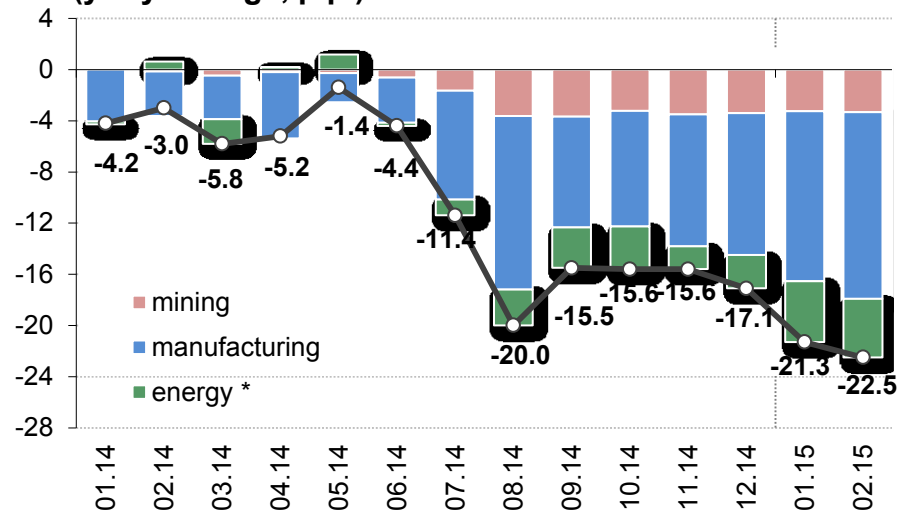
- We interpret large residuals of model-based estimates of output gap as military conflict impact
- Monetary factors supposed to be favorable for economic growth: both real exchange and interest rate were below their equilibrium levels.



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# REAL SECTOR: Fall in industrial output accelerated to 22.5% y-o-y in February, 2015

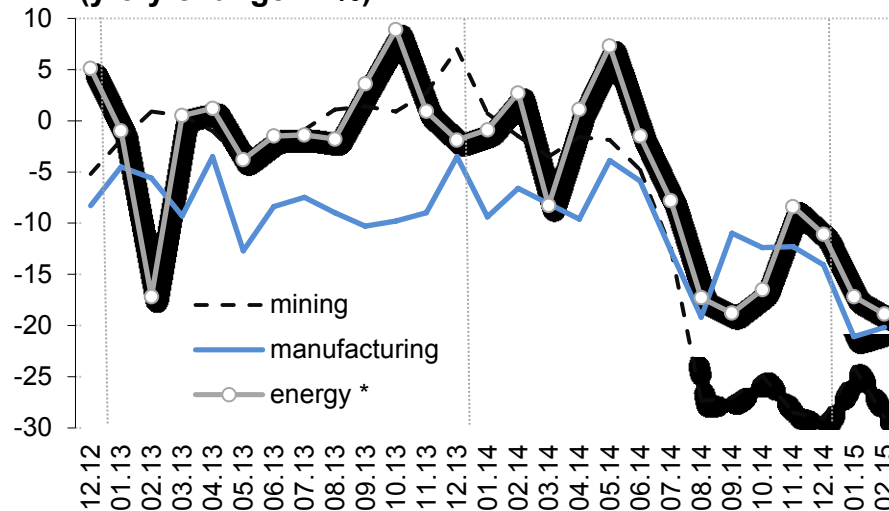
**Contributions to industrial output (y-o-y change, p.p.)**



\* - Energy includes electricity, gas, steam and air conditioning supply.

Source: State Statistics Service of Ukraine, NBU calculation.

**Main types of industrial activity\* (y-o-y change in %)**



\* - Energy includes electricity, gas, steam and air conditioning supply.

Source: State Statistics Service of Ukraine.

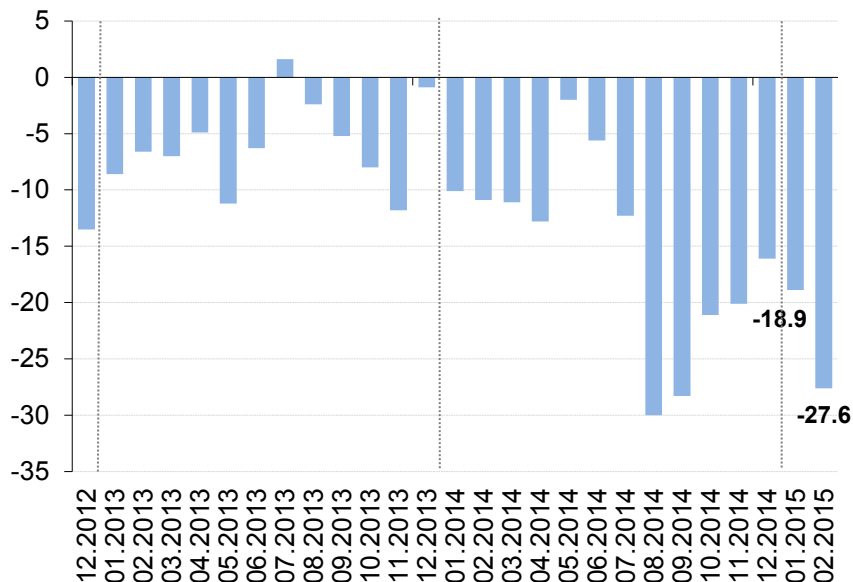
■ **Main factors of industrial dynamics:**

- military conflict in Eastern Ukraine (coal mining decreased by 61.7%, manufacture of coke and refined petroleum products – by 58%)
- low external demand, deficit of raw materials and “trade war” with Russia (metallurgy production decreased by 27.6%, machinery – by 21.7%)



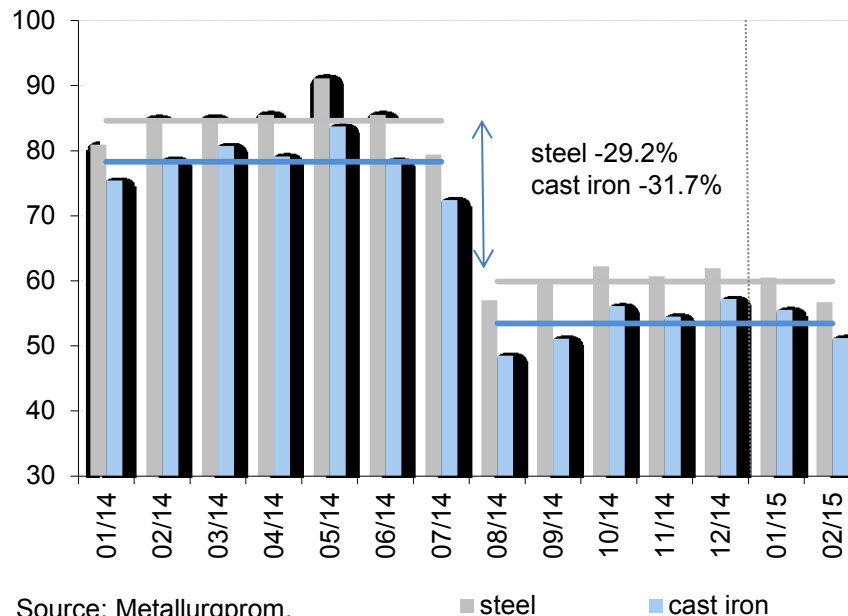
# REAL SECTOR: Fall in metallurgy output accelerated to 27.6% y-o-y in February, 2015

Metallurgy (y-o-y changes, %)



Source: State Statistics Service of Ukraine.

Average daily steel and cast iron production (ths t)



Source: Metallurgprom.

■ steel ■ cast iron

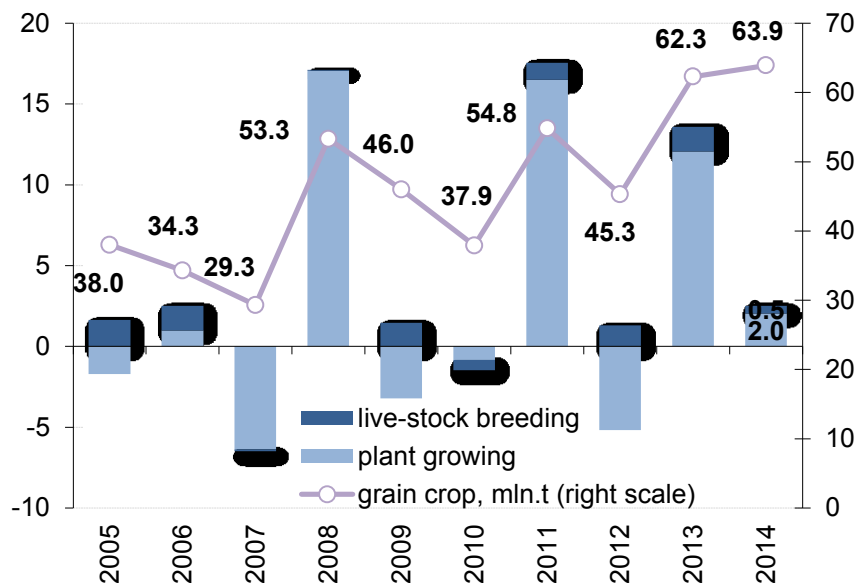
- Main factors of metallurgy dynamics were:
  - military conflict in Eastern Ukraine and as a result reducing capacity utilization due to destruction of rail and roads, power lines, pipelines and other infrastructure, speeded up the decline in industrial production in February to 27.6%,
  - declining of metal prices due to weak world economic growth.



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# REAL SECTOR: Food industry output fell in February, 2015 due to weakening of internal consumer demand

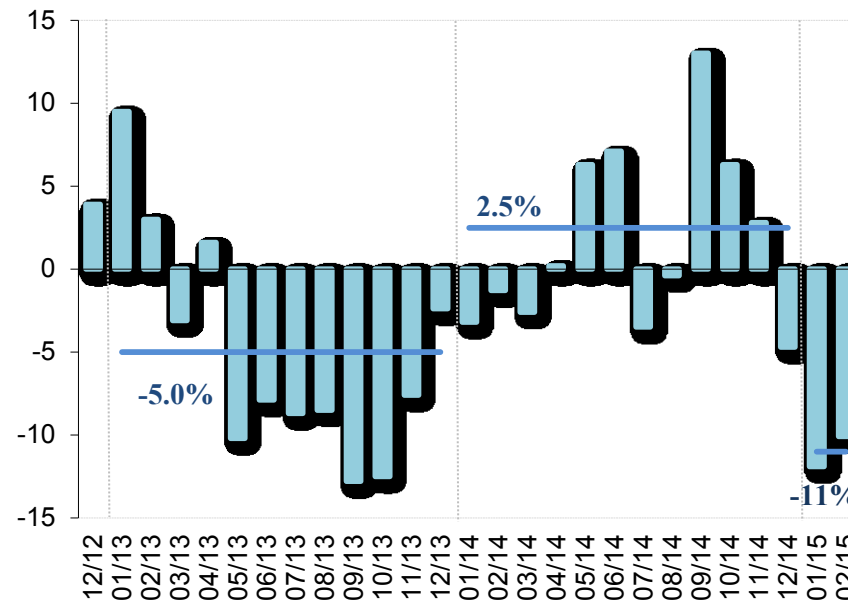
Agricultural production decomposition \*



Source: State Statistics Service of Ukraine, NBU

\* - 2010-2014 excluding Crimea

Food industry (y-o-y change in %)



Source: State Statistics Service of Ukraine. \* - 2014 excluding Crimea

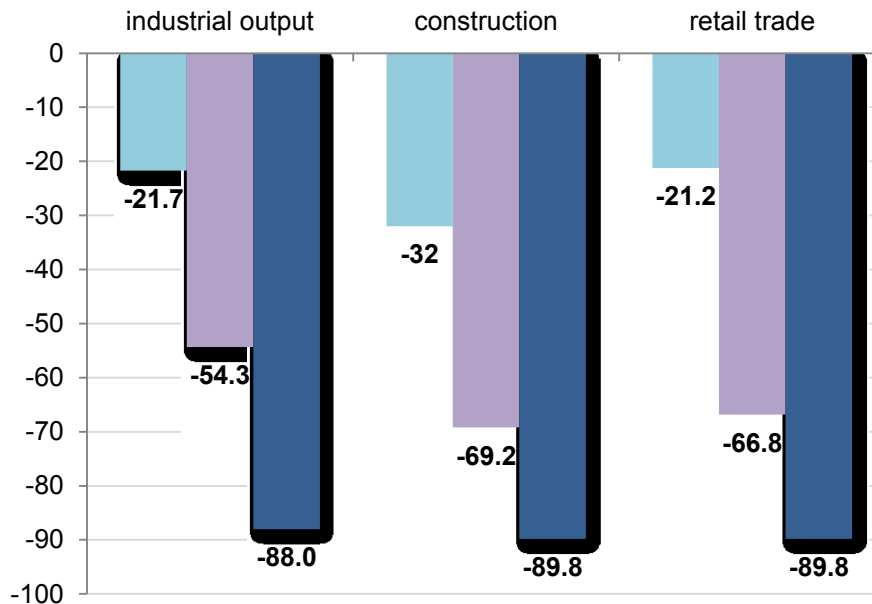
- Agricultural output increased by 2.5% in 2014 mostly due to a record harvest of cereals (63.9 m t)
- High harvest and trade liberalization in EU facilitated food industry development – its output increased by 2.5% in 2014.



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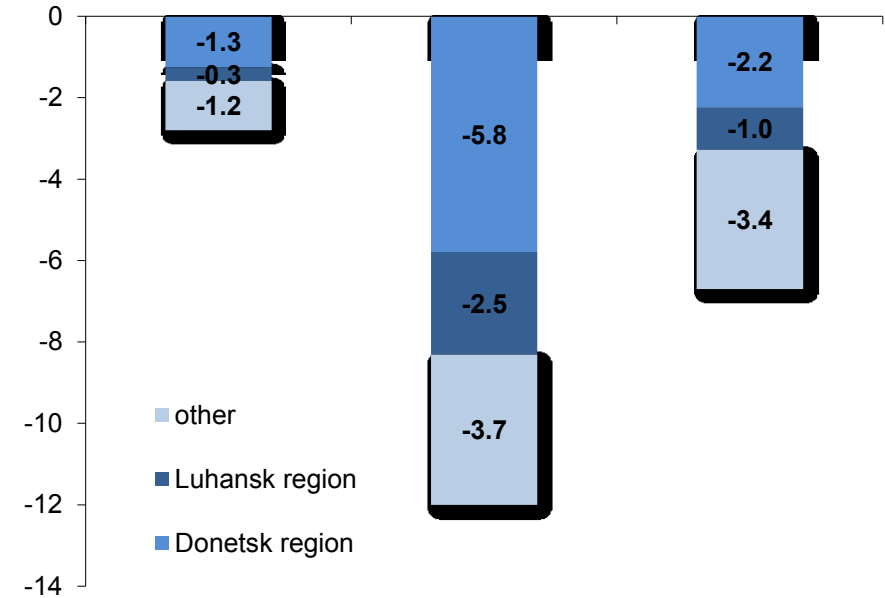
# REAL SECTOR: The worst situation was observed in Donetsk and Luhansk regions

Economic indicators in January-February 2015, %



Source: SSS, NBU calculation. ■ Ukraine ■ Donetsk ■ Luhansk

Real GDP in 2014 (%)



Source: NBU calculation. (estimation)

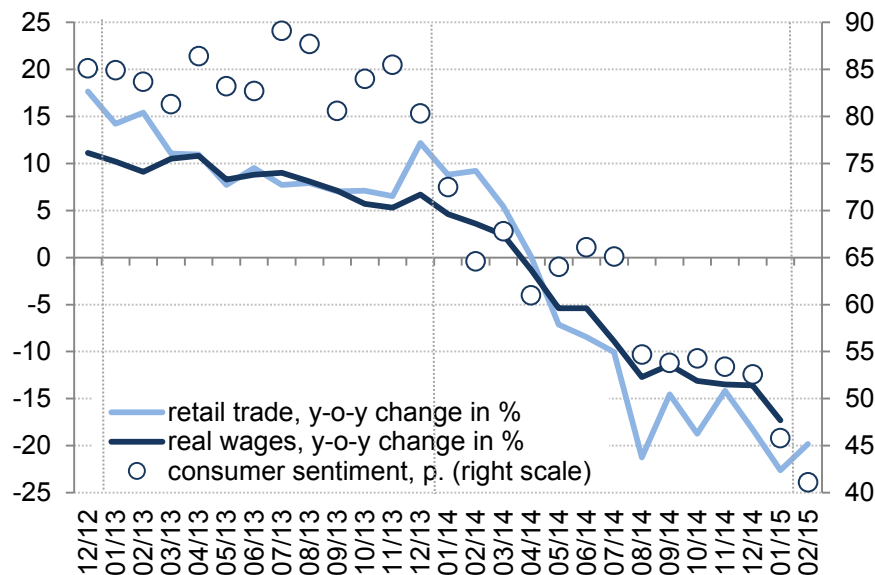
- The largest drop in industrial production, construction and retail trade in January-February 2015 was observed in the Donetsk and Luhansk region



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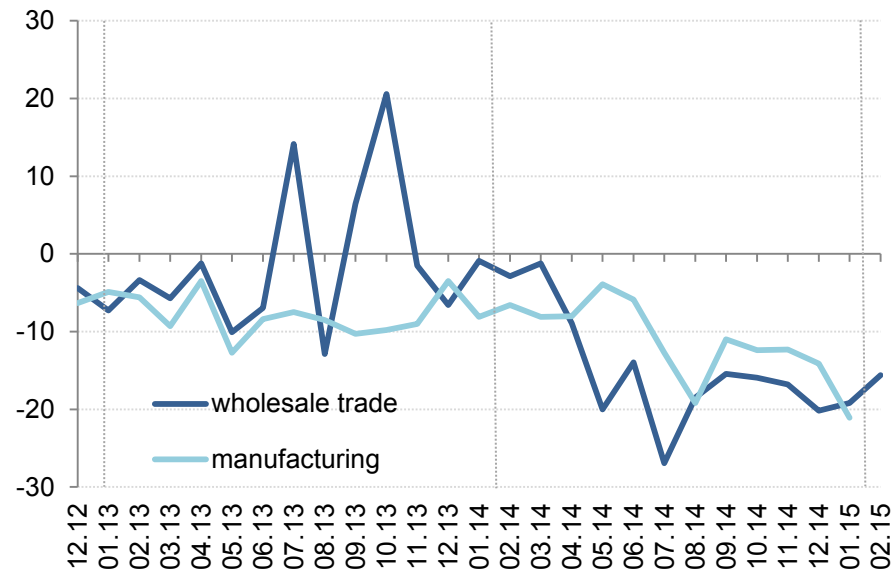
# REAL SECTOR: Shortening of the internal consumer demand caused the decline of trade turnover

### Retail trade, real wages and consumer sentiment



Source: State Statistics Service of Ukraine, GfK.

### Wholesale trade and manufacturing (y-o-y change in %)



Source: State Statistics Service of Ukraine, NBU calculations.

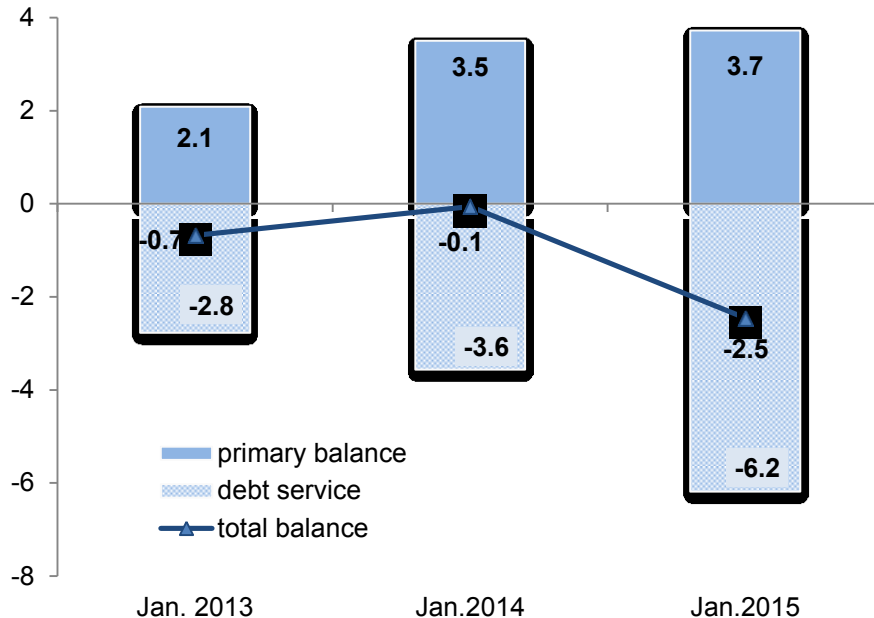
- Decline of consumer confidence, deterioration of financial results, low credit activity and reduction of government financing caused the decline of retail trade turnover (-19.8%) and the volume of construction works (-31.2%).
- Decline in manufacturing caused the decrease in wholesale trade.



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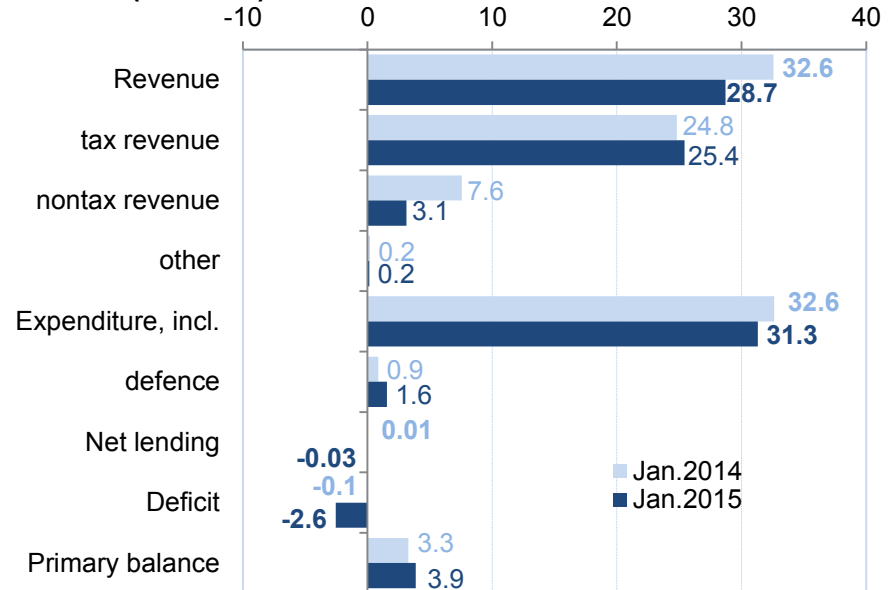
# FISCAL: Key trends of the consolidated budget execution haven't changed in January, 2015

Consolidated budget balance (% of GDP)\*



Source: Treasury, NBU calculations.

Main indicators of consolidated budget (UAH bn)



Source: Treasury, MFU.

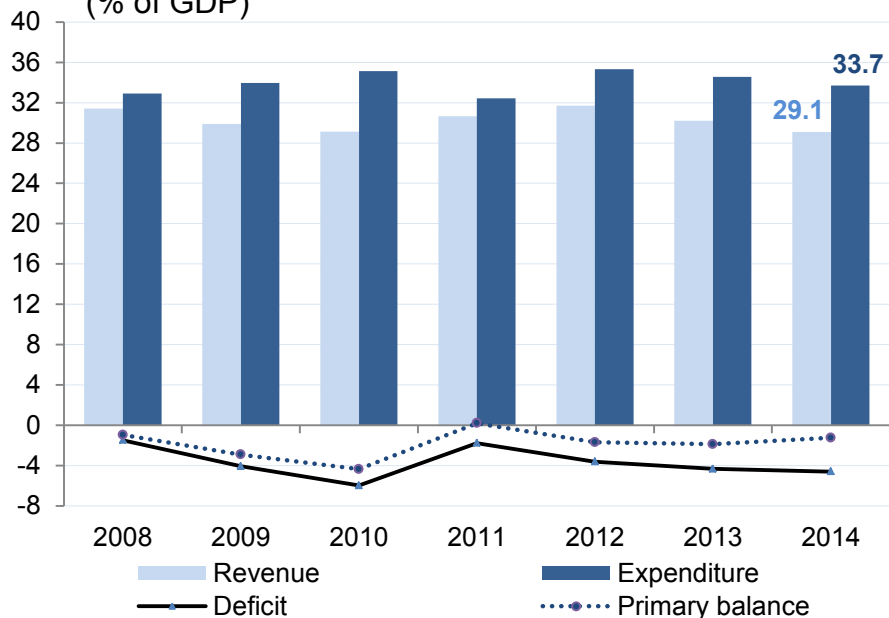
- Consolidated budget revenue and expenditure decreased in January 2015 (by 11.8% and 4% y-o-y).
- Consolidated budget deficit widened considerably. Simultaneously primary surplus increased by 0.2 p.p. to 3.7% of GDP compared to January 2014.



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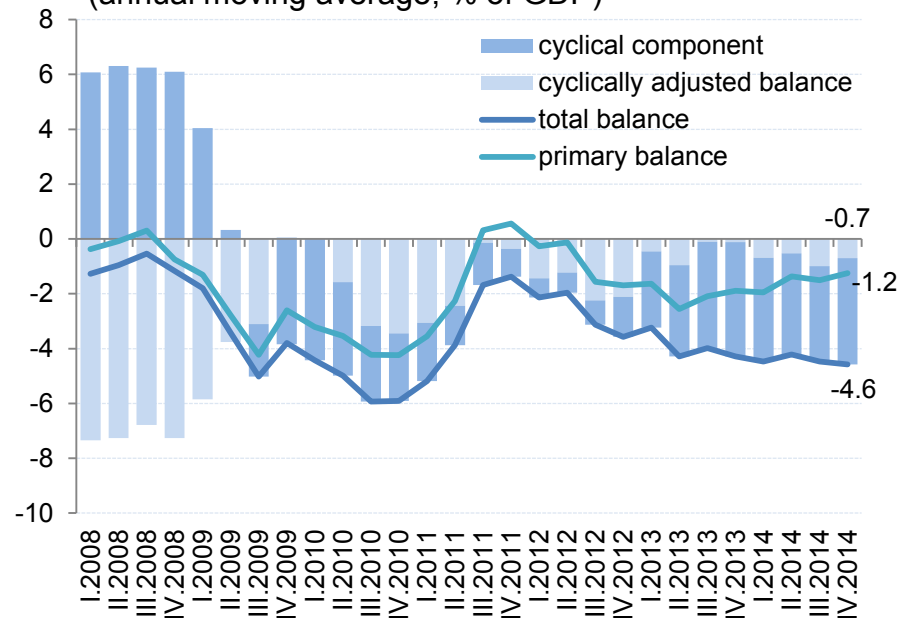
# FISCAL: Public sector share remains significant

### Main indicators of the consolidated budget (% of GDP)



Source: Treasury, SSSU.

### Consolidated budget balance (annual moving average, % of GDP)



Source: NBU calculations, Treasury.

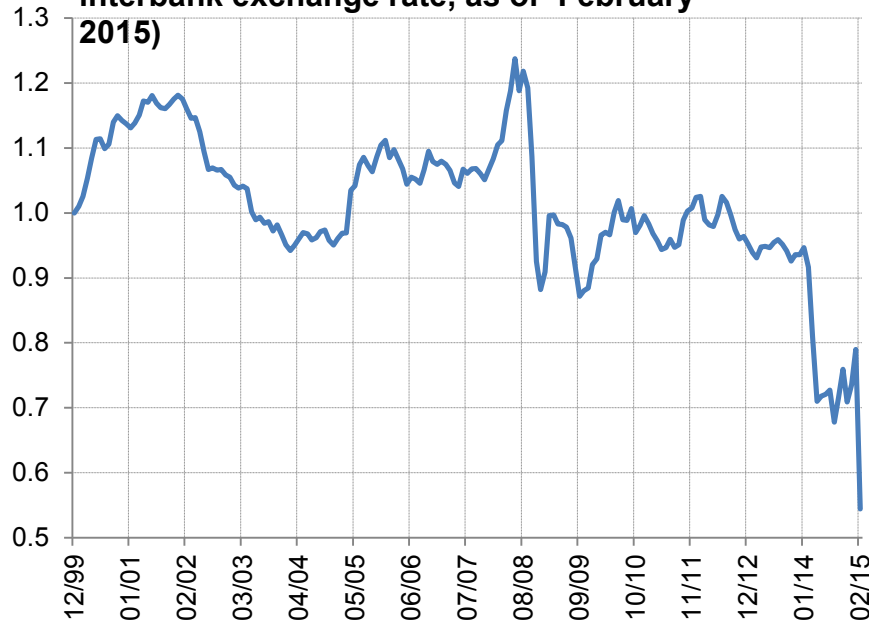
- The level of GDP redistribution through the consolidated budget remains constantly high (average level in 2008-2013: revenue – 30.5% and expenditure – 33.8%).
- General Government (average level in 2010-2013): revenue – 43.5% of GDP and expenditure – 47.9% of GDP.



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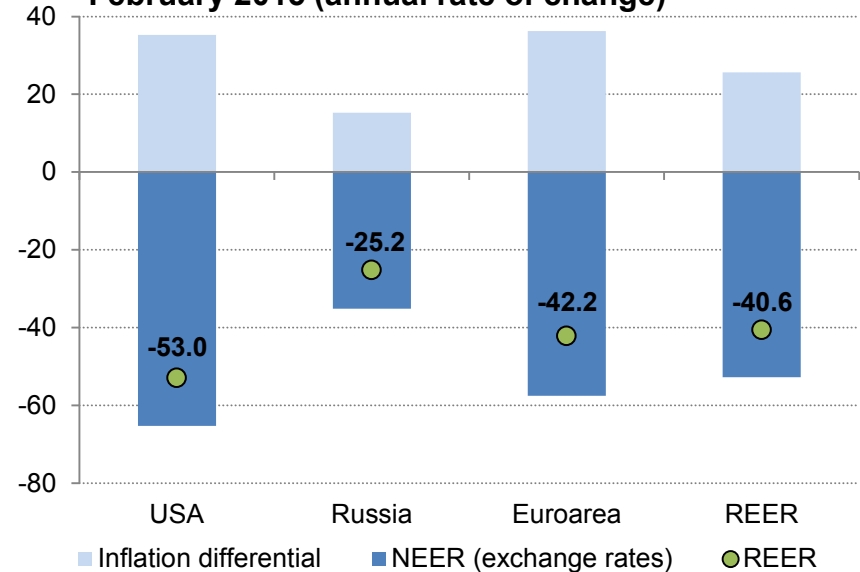
# MONETARY: REER depreciated sharply in February 2015

**Hryvnia REER Index (12.1999=1, based on interbank exchange rate, as of February 2015)**



Source: IFS, NBU calculations (preliminary data).

**The contribution to the change of REER and Hryvnia bilateral real exchange rates in February 2015 (annual rate of change)**



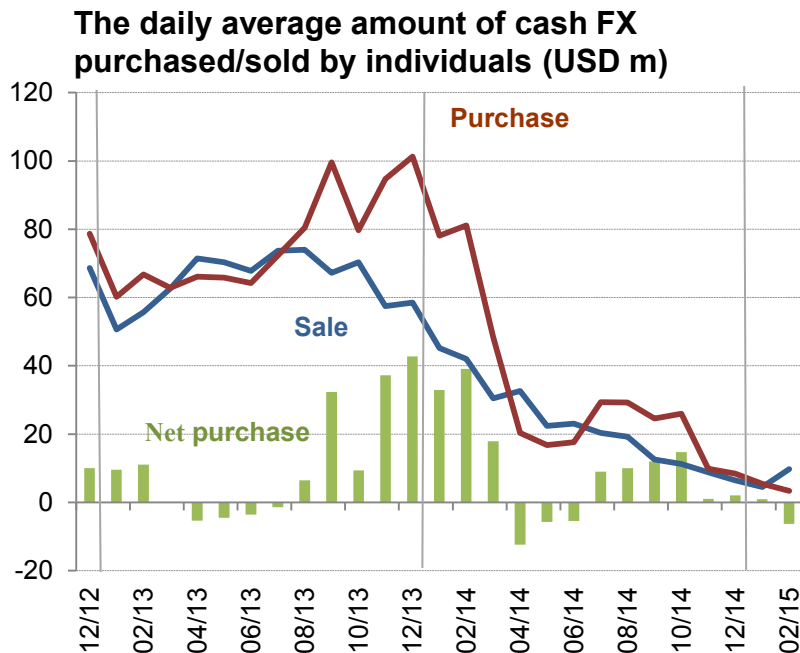
Source: NBU calculations (preliminary data).

- In February 2015 (preliminary data) REER depreciated by 31.1% due to the depreciation of the NEER (33.8%). The positive inflation differential is 4.1%.
- Since the beginning of the year REER has depreciated by 26.0% due to the depreciation of the NEER (30.4%). The positive inflation differential is 6.3%.



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## MONETARY: Insufficiency of FX market



Source: NBU

- The supply of foreign currency in the cash foreign exchange segment exceeded the demand for the first time since June 2014.

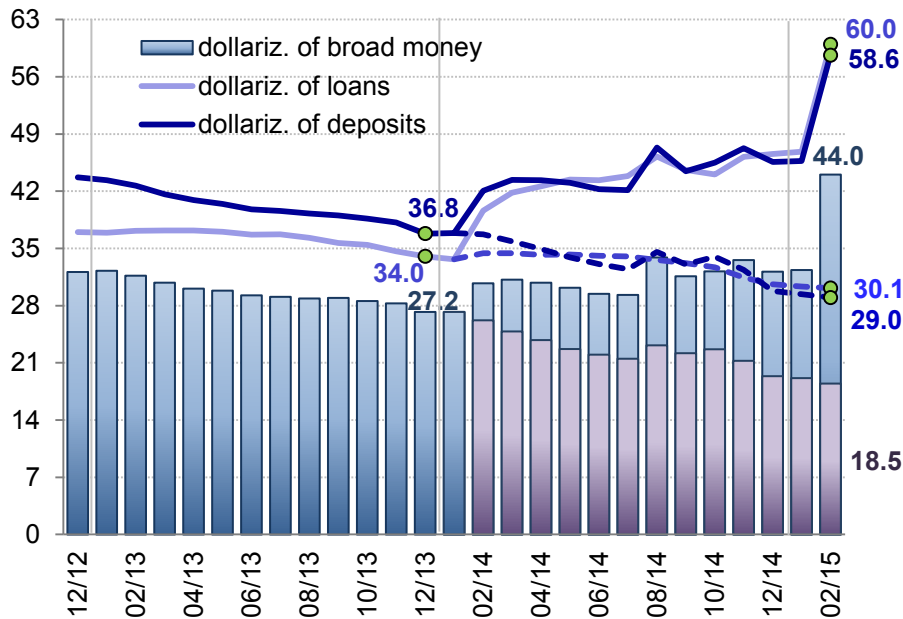




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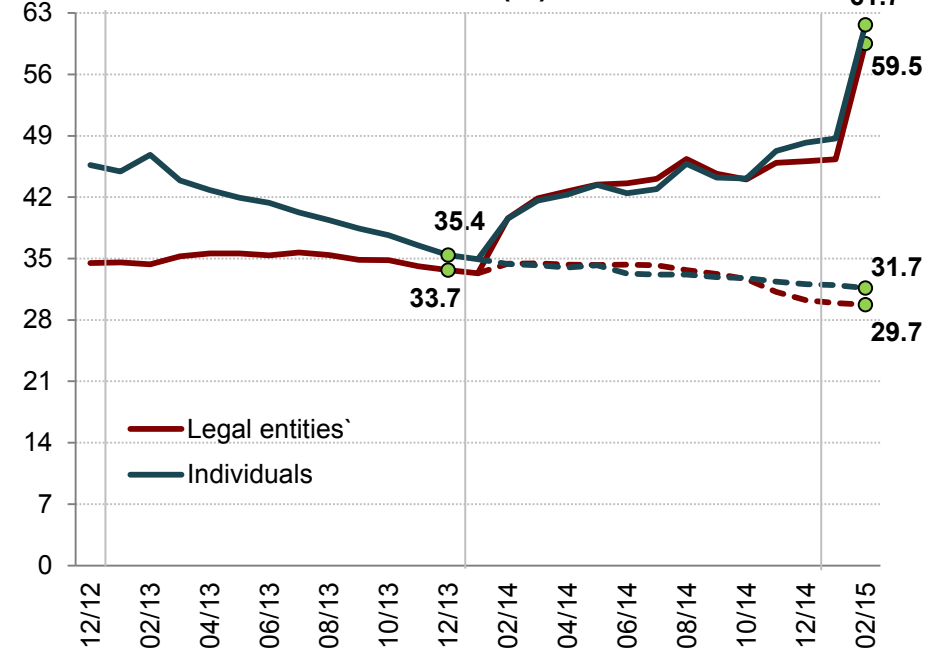
# MONETARY: Dollarization

### Dollarization level by a different methodologies (%)



Source: NBU

### Dollarization of bank loans (%)



Source: NBU

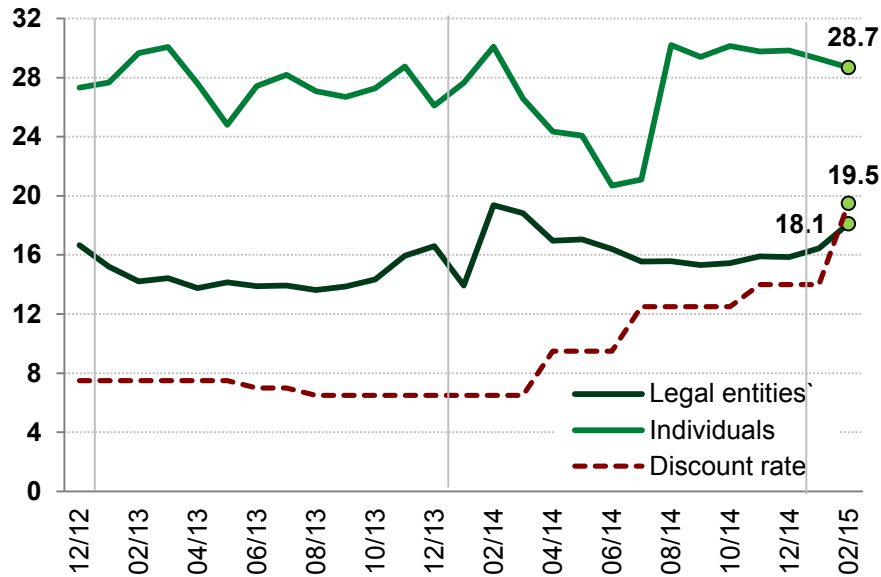
- Excluding exchange rate revaluation, dollarization level dropped.



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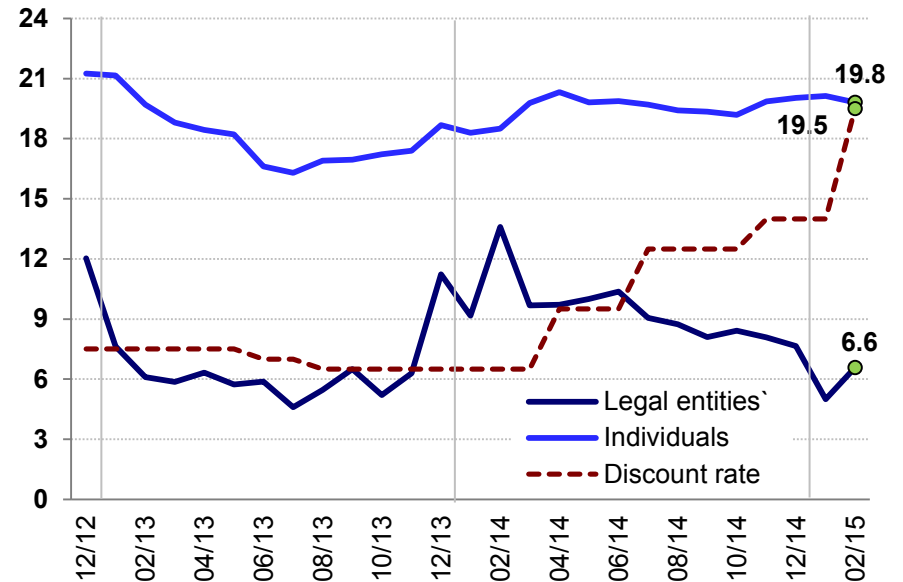
# MONETARY: Market interest rates do not reflect the real cost of funding

Average weighted interest rate on domestic currency loans (%)



Source: NBU

Average weighted interest rate on domestic currency time deposits (%)



Source: NBU

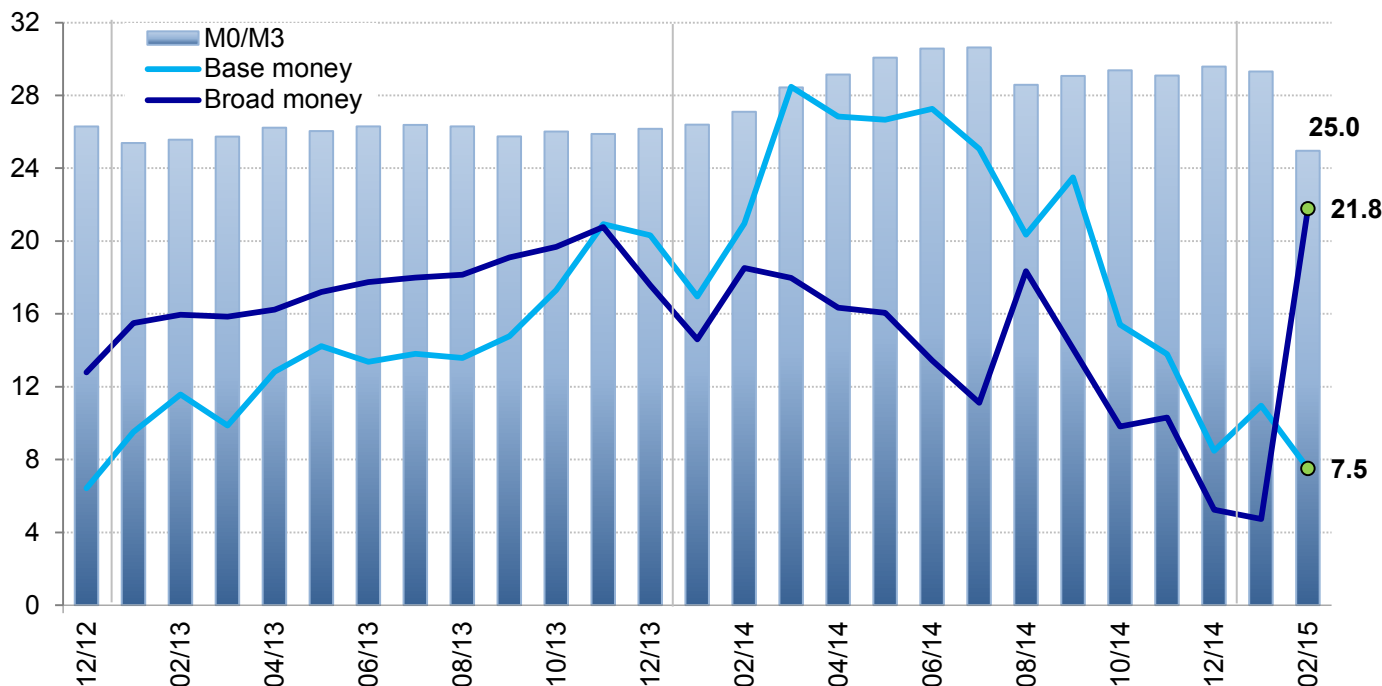
- Market interest rates do not reflect the real cost of funding because of prevailing qualitative criteria to the selection of borrowers. Currently, banks adopt a differentiated approach both for the borrowers and the eligible collateral.



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# MONETARY: Dynamics of monetary aggregates was determined by a loss of confidence in banking system

Monetary indicators (y-o-y change, %) & M0/M3 (%)

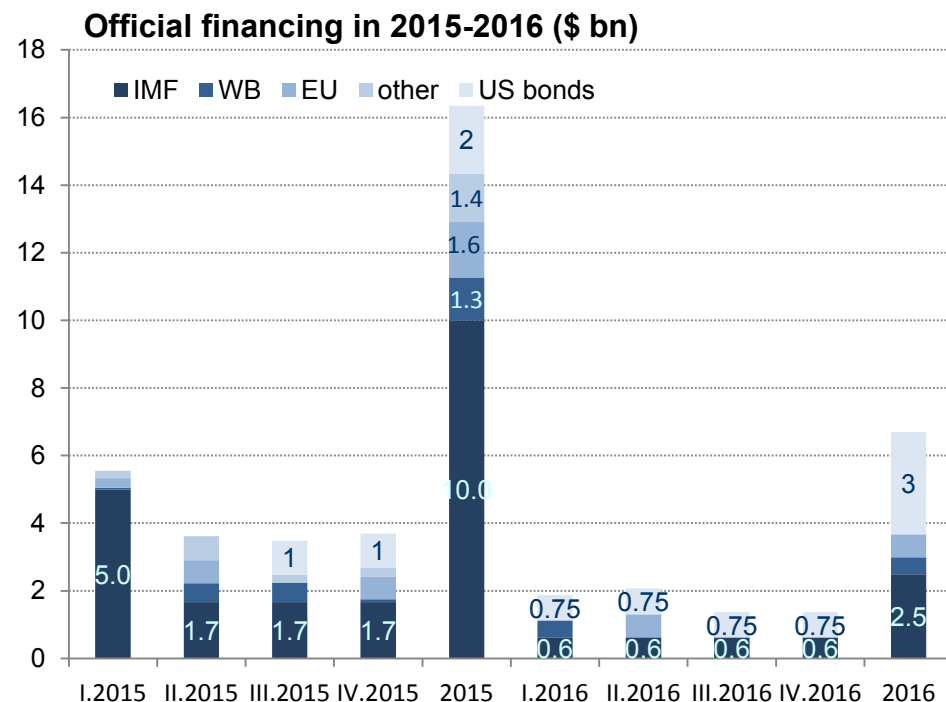


Source: NBU

- The growth of the broad money was driven solely by the growing funds in foreign currency resulting, first of all, from exchange rate revaluation.
- On the contrary, during the same period base money decreased, which was caused, in particular, by the increased Government's deposits in accounts with the NBU.



## OUTLOOK: Official financing in 2015-2016



Source: NBU, IMF

Total official financing projected in 2015 – 16.3 bn, including:

- IMF (EFF) – \$10.0 bn, WB – \$1.3 bn, Project financing (EBRD, EIB) – \$0.7 bn
- EU – €0.25 bn+ €1.2 bn, US – \$2.0 bn, Japan/Canada/Switzerland/Norway – \$0.7 bn

Total official financing projected in 2016 – 6.7 bn, including:

- IMF (EFF) – \$2.5 bn, WB – \$0.5 bn, EU – €0.6 bn, US – \$3.0 bn,



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## **POLICY: Temporary administrative measures to calm FX market**

<b>Export/Import operations</b>	<b>Capital controls</b>	<b>FX cash operations</b>
<ul style="list-style-type: none"><li>▪ surrender requirements - 75% of the foreign currency proceeds received from abroad (effective from 23 Sep 2014),</li><li>▪ conducting within 90 days settlements under export/import of goods transactions (effective from 19 Nov 2012)</li></ul>	<ul style="list-style-type: none"><li>▪ the prohibition of the repatriation of proceeds (the sale of securities (except for sovereign bonds), or corporate rights (other than shares) and dividends to foreign investors (effective from 03 Dec 2014)</li></ul>	<ul style="list-style-type: none"><li>▪ maximum amount of foreign currency that one bank can sell in cash per capita a day equals to 3,000 UAH (effective from 23 Sep 2014),</li><li>▪ FX cash transfers on behalf of individuals can be made abroad as current non-trade transactions without documentary evidence for the amount not exceeding an equivalent of UAH 15,000 within one banking, day (effective from 04 March 2015)</li><li>▪ the restriction on withdrawal of FX cash or investment metals from client`s accounts through cashier`s offices and ATMs up to an equivalent of UAH 150,000 per day per customer (effective from 04 March 2014)</li></ul>



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## **POLICY: Temporary administrative measures to calm FX market (cont.)**

### **FX operations of banks – limits by amount**

- the NBU's approval to make advance payments exceeding USD 50,000 (effective from 24 Feb 2015),
- the letter of credit under import contracts exceeding USD 500,000 is required to be confirmed by investment grade banks (effective from 24 Feb 2015),
- advance payments in FX under import contracts of exceeding USD 50,000 shall be executed on T+4 basis (effective from 25 Feb 2015),
- the restriction on the purchase of non-cash FX and banking metals for UAH for their own banks' benefit within a business day (effective from 04 March 2015)

### **FX operations of banks – limits to pay from short position in UAH**

- the restriction to purchase FX on behalf of a resident client with FX holdings on current and deposit accounts with banks, if the total FX amount held in client's accounts exceeds USD 10,000 (effective from 24 Feb 2015),
- the prohibition to extend loans in UAH to the customers, if the property rights for the FX held in the bank's accounts are pledged as collateral against such loans (effective from 04 March 2015),
- the ban is imposed on purchase of FX if loan in UAH is used for this purpose (effective from 04 March 2015)

### **FX operations of banks – extension of maturity**

- client's funds in UAH should be deposited upfront to a separate account to purchase FX and could be transferred not earlier than on the 4th day (effective from 25 Feb 2015),
- the restriction to prepay cross-border loans prior to their maturity date (subject to certain exceptions) (effective from 03 Dec 2014)



# POLICY: NBU strategy: a gradual move to Inflation targeting (IT)

## Future evolution of MP regime and goals

Stage 1. Monetary targeting (framework of IMF program):

- accumulation for international reserves;
- targets on NDA and NIR;
- flexible exchange rate;
- disinflation.

Stage 2. IT lite:

- price stability (1-digit target)
- accumulation of international reserves;
- Interest rate as a key instrument.

Stage 3. IT :

- price stability (1-digit target)
- Floating exchange rate

## Improvements that already done

- Establishment of Monetary policy committee which makes decisions:
  - Clear and transparent
  - Forward-looking
  - Analytically supported
- More transparent and market-friendly MP instruments framework
- Introduction of key policy rate and o/n corridor
- Avoiding of multiple currency practices

## CURRENT TARGETS TO ACHIEVE:

- Disinflation
- Successful implementation of IMF program
- Replenishment of international reserves
- Stabilization of the market