



MEMU Supplement No. 01-2005

Causes of inflation in 2004 and perspectives for 2005

Consumer prices grew at the forecast level of 12.3% yoy in 2004, driven mainly by the prices of food products, which grew by 15.3%, while the prices of non-food products increased by 5.4% and services by 7.9%. Several supply and demand factors contributed to the two-digit inflation rate in 2004. On the supply side, gasoline prices surged in late May, also there was a lower supply of certain agricultural products. The demand side was dominated by the sharp increase in social payments on the eve of the presidential election.

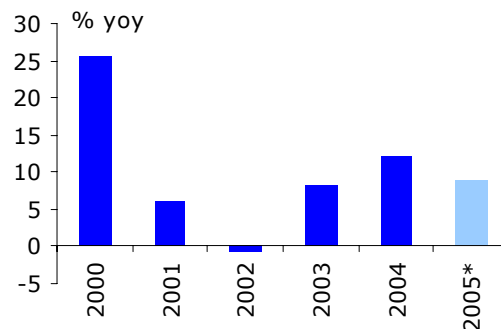
The rising world oil prices induced increases in the prices for oil products within Ukraine. Within two weeks at the end of May, domestic petroleum prices had jumped by 30-40%. The government reacted by introducing administrative regulations on the gasoline market, such as suspending the export of oil products, conducting tax checks at the oil refineries, etc. Eventually, the government and the oil refineries agreed on price ceilings for most popular types of gasoline, which, however, were still 40-60% higher than a year earlier. The higher gasoline prices had only a minor direct effect on the CPI due to the small weight of gasoline in the consumer basket; however it impacted on many other consumer product prices through higher transportation costs. Another supply factor contributing to inflation was a lower agricultural products output, especially concerning meat and sunflower seeds. Meat became more expensive because the poor grain harvest of 2003 had reduced the livestock volume, while the sunflower-seed oil prices rose due to a poor harvest. The grain harvest, however, being much better than in 2003 resulted in lower flour, bread and bread products prices, offsetting to some extent the higher meat and sunflower oil prices.

Most of the inflationary pressure on the demand side was caused by amendments to Budget-2004 adopted by Parliament just prior to the presidential election. The budget amendment directed additional fiscal revenues and privatisation receipts to raising pensions, stipends and other social benefits, which substantially increased the earnings of lower-income groups of the population who normally spend major parts of their incomes on food products. Although the amendments benefited low-income people, the effect did not last very long since the resulting expansion of demand for consumer products caused prices to rise, making pensioners and students even worse-off in real terms. Also, together with the panic at the foreign exchange market this development spurred inflationary expectations, which added to price growth at the end of the year as well.

It is expected that the inflationary pressure will remain rather strong during the first half of 2005. The main risks are likely to come from a continuing impact of inflationary expectations and from increases in the tariffs for public transportation, housing, and utility services. It is also anticipated that the administrative regulations for commodity prices will be eased at the beginning of 2005, resulting in price increases for all products that will be affected. Although the on-going downward price trend at the world oil market gives some grounds to expect that Ukrainian petroleum consumers will continue to benefit from reasonably low prices, the future price dynamics are quite uncertain. As the world market remains volatile, the risk of negative shocks to the Ukrainian petroleum market is quite high.

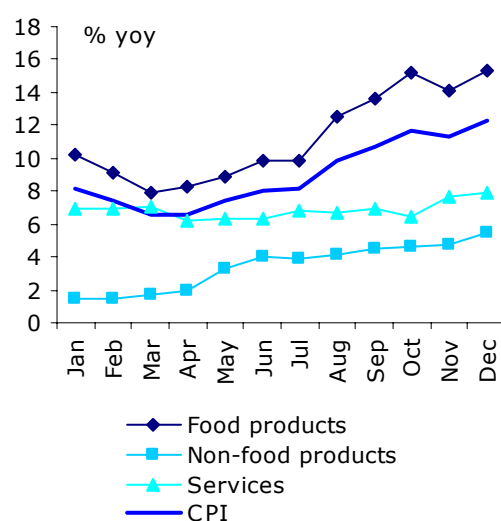
We do not expect any significant adverse shocks on the fiscal side, provided the recently approved Budget-2005 is not significantly modified. The present version of the budget does not envisage significant social expenditure increases. Hence, it is expected that the most striking fiscal imbalances will be eliminated in the first half of 2005. We also expect that the monetary policy will remain prudent enough this year to avoid creating additional inflationary pressures. As a result, the CPI inflation is forecast to return to a more moderate rate of 9% towards the end of the year.

Yearly Inflation Rates



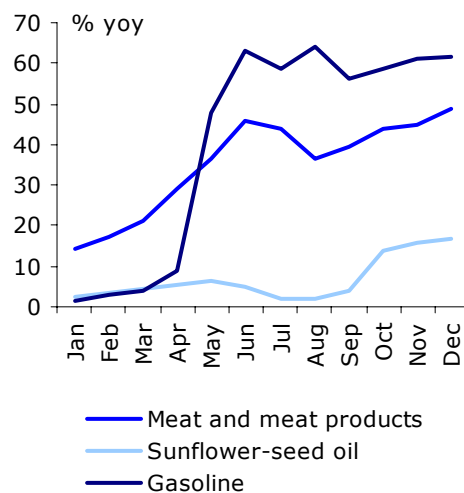
* IER forecast
Source: Derzhkomstat

CPI and Components in 2004



Source: Derzhkomstat

Prices for Selected Products in 2004



Source: Derzhkomstat

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Quarterly Trends

| National accounts ** | | Q2 02 | Q3 02 | Q4 02 | Q1 03 | Q2 03 | Q3 03 | Q4 03 | Q1 04 | Q2 04 | Q3 04 |
|---|------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| GDP | UAH bn | 49.9 | 64.1 | 63.3 | 51.5 | 60.0 | 75.6 | 77.1 | 64.1 | 78.6 | 101.0 |
| GDP (real) | % yoy | 4.7 | 4.3 | 6.1 | 8.4 | 10.0 | 6.8 | 12.1 | 12.3 | 13.2 | 14.2 |
| Households consumption (real) | % yoy | 2.0 | 8.9 | 11.2 | 10.2 | 14.4 | 11.2 | 13.6 | 15.5 | 16.0 | 15.6 |
| State consumption (real) | % yoy | 5.4 | -18.8 | 2.9 | 15.0 | 17.8 | 19.2 | 9.0 | -3.6 | -2.0 | -3.0 |
| Gross fixed capital formation (real) | % yoy | 7.8 | 3.8 | 5.7 | 9.0 | 20.4 | 24.3 | 9.0 | 23.3 | 4.3 | 6.1 |
| Exports of goods and services (real) | % yoy | 2.5 | 15.3 | 17.0 | 9.9 | 9.8 | 9.8 | 11.6 | 16.5 | 15.2 | 6.2 |
| Imports of goods and services (real) | % yoy | 1.4 | 10.4 | 6.7 | 13.8 | 16.2 | 17.4 | 17.7 | 14.5 | 7.0 | 4.3 |
| Agriculture, hunting, forestry (real)* | % yoy | 12.1 | 2.1 | 1.3 | 4.0 | -13.7 | -22.5 | 6.7 | -4.2 | 1.2 | 36.2 |
| Manufacturing industry (real)* | % yoy | 10.6 | 8.0 | 11.5 | 12.0 | 15.4 | 23.0 | 20.1 | 22.7 | 15.5 | 13.8 |
| Construction (real)* | % yoy | -7.9 | -1.2 | 2.7 | 18.2 | 24.8 | 30.9 | 16.9 | 29.8 | 30.6 | 17.2 |
| Trade, repair services (real)* | % yoy | 5.3 | 8.8 | 3.5 | 7.2 | 15.1 | 22.6 | 29.6 | 23.5 | 35.1 | 3.0 |
| Transport (real)* | % yoy | 0.5 | 7.9 | 11.0 | 10.0 | 11.5 | 15.9 | 11.7 | 11.0 | 8.9 | 11.1 |
| Balance of payments | | | | | | | | | | | |
| Current account balance | USD bn | 0.6 | 0.8 | 1.0 | 1.1 | 0.7 | 0.7 | 0.4 | 1.7 | 2.3 | 1.7 |
| Current account balance | % of GDP | 6.7 | 6.4 | 7.9 | 11.2 | 7.0 | 5.0 | 3.0 | 14.3 | 16.5 | 9.7 |
| Trade balance in goods | USD m | 87 | 155 | 225 | 309 | -42 | -155 | -381 | 767 | 1460 | 683 |
| Trade balance in services | USD m | 244 | 247 | 382 | 387 | 399 | 362 | 409 | 542 | 307 | 549 |
| Current transfers | USD m | 441 | 517 | 520 | 500 | 526 | 574 | 584 | 465 | 746 | 703 |
| Direct investment (FDI) | USD m | 119 | 156 | 300 | 238 | 454 | 390 | 329 | 310 | 574 | 388 |
| Portfolio investments | USD m | -311 | -592 | -520 | -825 | 640 | -444 | -293 | 60 | -409 | 779 |
| Gross international reserves | USD bn | 3.4 | 4.1 | 4.4 | 4.6 | 6.2 | 6.7 | 6.9 | 7.9 | 9.6 | 12.1 |
| Fiscal indicators | | | | | | | | | | | |
| Consolidated fiscal revenues | % of GDP | 29.9 | 28.2 | 28.1 | 31.6 | 31.7 | 30.1 | 28.6 | 27.2 | 26.9 | 26.3 |
| Personal income tax | % of GDP | 5.2 | 4.9 | 4.9 | 5.7 | 5.7 | 5.3 | 5.1 | 4.4 | 4.1 | 3.8 |
| Enterprise profits tax | % of GDP | 4.3 | 4.1 | 4.3 | 5.7 | 5.1 | 4.8 | 5.0 | 3.9 | 4.0 | 4.1 |
| Value-added tax | % of GDP | 6.6 | 6.4 | 6.1 | 6.2 | 6.3 | 5.8 | 4.8 | 6.2 | 5.7 | 5.1 |
| Excise tax | % of GDP | 1.9 | 1.9 | 1.9 | 2.1 | 2.2 | 2.1 | 2.0 | 2.1 | 2.1 | 2.0 |
| Consolidated fiscal expenditures | % of GDP | 28.4 | 26.4 | 27.3 | 27.7 | 29.2 | 27.9 | 28.8 | 25.3 | 26.5 | 26.8 |
| Current expenditures | % of GDP | na | na | na | na | 26.3 | 24.2 | 24.3 | 22.4 | 22.7 | 21.7 |
| Capital expenditures | % of GDP | na | na | na | na | 3.0 | 3.7 | 4.4 | 2.9 | 3.8 | 5.1 |
| Consolidated fiscal balance | % of GDP | 1.5 | 1.7 | 0.7 | 3.8 | 2.5 | 2.2 | -0.2 | 1.9 | 0.4 | -0.5 |
| Privatisation receipts | % of GDP | 0.4 | 0.3 | 0.3 | 0.6 | 1.0 | 1.0 | 0.8 | 1.5 | 3.7 | 3.5 |
| Labour market | | | | | | | | | | | |
| Average wage (real) | % yoy | 20.0 | 21.2 | 17.7 | 12.3 | 19.1 | 19.9 | 14.9 | 23.0 | 17.8 | 13.2 |
| Household income (real) | % yoy | 61.3 | 100.8 | 65.6 | -1.2 | 8.6 | 10.0 | 8.7 | 15.7 | 13.0 | 9.9 |
| Unemployment rate (ILO methodology) | % | 9.7 | 9.2 | 11.1 | 9.4 | 8.8 | 9.2 | 9.0 | 9.7 | 7.9 | 6.1 |
| Banking system | | | | | | | | | | | |
| Monetary aggregate M0 | % yoy | 48.0 | 46.0 | 35.8 | 32.4 | 37.0 | 30.5 | 25.3 | 29.1 | 25.6 | 37.1 |
| Monetary aggregate M2 | % yoy | 39.5 | 46.5 | 42.2 | 47.8 | 54.6 | 49.9 | 47.6 | 45.4 | 44.8 | 51.5 |
| Household deposits in national currency | % yoy | 90.1 | 103.6 | 72.5 | 73.4 | 74.7 | 65.0 | 66.1 | 69.4 | 67.3 | 67.9 |
| Household deposits in foreign currency | % yoy | 47.4 | 55.1 | 59.3 | 71.2 | 70.2 | 70.4 | 77.5 | 67.0 | 61.7 | 55.2 |
| Com. bank credits in national currency | % yoy | 34.5 | 42.3 | 54.4 | 63.7 | 71.2 | 73.0 | 61.7 | 56.8 | 52.1 | 44.3 |
| Com. bank credits in foreign currency | % yoy | 32.1 | 37.3 | 40.3 | 44.1 | 48.4 | 57.7 | 60.9 | 63.6 | 56.2 | 43.5 |
| Long-term com. bank credits | % yoy | 70.6 | 85.8 | 92.5 | 110.6 | 156.4 | 164.0 | 157.9 | 141.7 | 102.7 | 82.7 |
| Long-term com. bank credits | % of total | 23.5 | 25.3 | 28.2 | 31.3 | 37.4 | 40.1 | 45.0 | 47.4 | 49.3 | 50.9 |
| Average lending rate on national cur. credits | % p.a. | 25.0 | 23.5 | 21.8 | 18.0 | 17.2 | 17.2 | 17.7 | 17.2 | 16.6 | 17.0 |
| Average lending rate on foreign cur. credits | % p.a. | 12.9 | 11.9 | 11.3 | 12.5 | 12.6 | 11.7 | 10.9 | 12.2 | 12.1 | 12.6 |

SOURCES: National Bank of Ukraine, State Committee of Statistics, State Treasury, Ministry of Finance, IER estimates

* change in value added

** preliminary

Notes:
yoy year on year change

p.a. per annum