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Accelerating inflation: reasons and outcomes

Inflation in Ukraine as measured by year-on-year consumer price index (CPI) growth accelerated from 9.5% yoy in February to 14.4% yoy in September. Moreover, in September retail food prices grew by 16.3% yoy as compared to 1.5% yoy decrease in February. Food that constitutes roughly the half of official consumer basket clearly defined inflation dynamics in 2007, while in the previous year the key impetus for the CPI growth was an increase in tariffs on services.

Reasons for such rapid build-up in food prices are manifold. On the demand side, worldwide food shortage caused strong external demand and thus higher prices. Government spending spree on social spending and minimal wage increases fostered internal demand. Strong capital inflows further expanded internal demand as the NBU was accumulating international reserves and selling hryvnia. Cash in the circulation grew to UAH 99.0 bn in October (44.8% yoy) compared to UAH 71.8 bn (28.6% yoy) in February. Rising utility and transport costs, poor harvest, and government clampdown on "grey" meat imports were among supply-side factors of the inflation. Moreover, high price volatility and poorly managed government anti-inflation campaign reinforced inflationary expectations. This resulted in increased demands for higher wages adding pressure on both demand and supply.

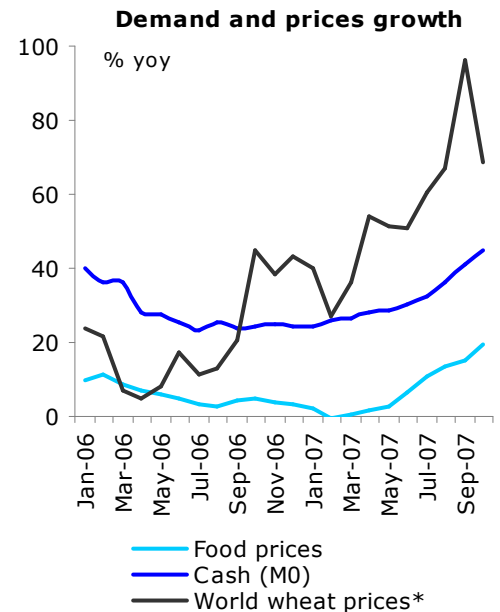
Some of the CPI acceleration this year can also be attributed to the revision of statistical methodology. Over the last years Derzhkomstat systematically and largely underreported growth in prices for seasonal goods, namely vegetables. Revised methodology introduced in 2007 reversed this point. Therefore so-called traditional summer drop in prices was much smaller than the government expected.

In addition, there are some structural problems revealed by increased inflation. Ineffective government interference in the economy over the last years through subsidies, price controls and export restrictions weakened market infrastructure and undermined competitive environment. Deficient market mechanism amplified price swings when the balance of demand and supply changed.

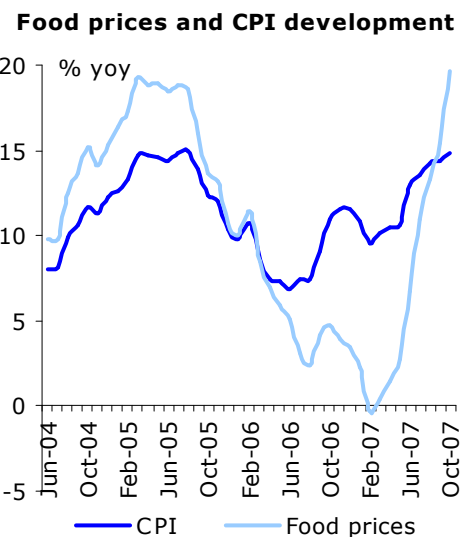
Though some government officials promised quick remedies and lower prices, they generally failed to deliver on these promises. Government reached some success in bringing down heavily regulated bread prices or restrain price growth through newly enacted regulations, talks with producers and market interventions. However, its actions didn't have a major effect on the price level. In absence of social tensions local authorities used expanded price regulation powers sparingly.

According to the IER estimates, inflation may decelerate during next months. Social spending growth may slow in next several months, as the election campaign is over, and no changes in Budget 2007 are expected. Also, the monetary pressure on price may ease, as the NBU tries to limit monetary expansion. Those two trends could constrain internal demand. As of external demand, the adjustment to world prices alleviates the pressure in the short run. However, significant risk remains that inflation expectations will become permanent. In combination with higher energy prices this can lead to wage-price spiral. Populist social policies may have similar consequences. On the other hand, more efficient communication strategy and realistic attitude towards inflation processes can boost government credibility and help allay excessive inflation expectations.

In the medium run the world food demand will continue to grow, while food production will face increasing competition from biofuel industry. Productivity gains will only partially cover gap between demand and supply. Thus food prices are expected to rise. Ukrainian food market is unprepared to cope with external shocks. Therefore the development of market mechanisms in the agriculture through reduced government interference, enforcement of competition legislation, land reform, protection of property rights, and removal of entry barriers is necessary to protect Ukrainian market from future price volatility.



Sources: NBU, Derzhkomstat, International grain council
* FOB, up river, Argentina



Source: Derzhkomstat

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Quarterly trends

National accounts		Q2 04	Q3 04	Q4 04	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07
GDP	UAH bn	78.6	99.4	100.1	84.3	97.5	119.4	123.6	105.4	124.1	150.4	157.7	133.1	161.4
GDP (real)	% yoy	12.7	14.3	9.1	4.9	3.4	1.4	1.7	4.1	6.8	6.9	9.5	8.0	7.9
Households consumption (real)	% yoy	18.0	9.7	12.5	14.3	17.7	17.0	17.1	20.2	18.2	11.8	9.9	14.7	15.5
State consumption (real)	% yoy	1.3	3.9	0.9	6.1	0.0	1.0	4.0	9.6	5.8	5.8	1.0	0.8	6.2
Gross fixed capital formation (real)	% yoy	22.6	23.8	16.8	-2.3	-0.5	0.2	0.3	19.9	19.3	17.9	18.3	24.4	23.5
Exports of goods and services (real)	% yoy	21.1	14.3	11.7	-0.6	-14.0	-12.7	-15.5	-14.9	-9.6	3.2	1.0	4.9	5.2
Imports of goods and services (real)	% yoy	10.9	7.2	8.7	2.8	3.2	3.9	-0.9	10.7	0.9	8.3	6.4	12.9	19.6
Agriculture, hunting, forestry (real)*	% yoy	0.2	35.6	11.3	5.8	8.3	2.6	-7.2	3.8	2.8	-5.6	8.1	4.8	6.8
Manufacturing industry (real)*	% yoy	15.0	9.9	6.9	7.0	1.8	-1.1	2.0	-1.5	6.1	7.3	7.2	15.0	13.2
Construction (real)*	% yoy	23.3	11.9	23.3	-8.4	-11.3	-8.5	-7.5	0.1	0.8	1.4	4.2	13.3	8.2
Trade, repair services (real)*	% yoy	17.4	13.9	2.5	-2.1	-10.7	-11.7	-11.9	6.2	16.4	20.0	21.9	14.3	17.5
Transport (real)*	% yoy	14.9	12.5	6.4	6.6	5.7	2.8	7.8	4.9	7.7	9.4	5.3	7.0	5.6
Balance of payments														
Current account balance	USD bn	2.3	2.1	1.1	1.6	0.6	0.4	-0.1	-0.8	0.0	0.5	-1.4	-1.3	-0.7
Current account balance	% of GDP	15.8	11.0	5.7	10.1	3.2	1.7	-0.4	-3.7	0.0	1.7	-4.3	-5.0	-2.0
Trade balance in goods	USD m	1552	774	482	1020	-236	-1131	-788	-1353	-935	-884	-2022	-1753	-1430
Trade balance in services	USD m	198	749	157	188	392	1035	191	219	506	1054	347	50	403
Current transfers	USD m	758	720	623	626	694	745	780	622	790	851	910	789	923
Direct investment (FDI)	USD m	614	420	344	247	365	477	6474	1053	1389	1636	1258	1162	1772
Portfolio investments	USD m	149	1313	156	397	923	90	1347	4	-141	370	3350	1818	1519
Gross international reserves	USD bn	9.6	12.1	9.5	12.0	13.1	14.3	19.4	17.3	17.6	19.1	22.3	23.5	25.6
Exchange rate, UAH/USD	aop	5.33	5.31	5.31	5.30	5.10	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05
Fiscal indicators														
Consolidated fiscal revenues	% of GDP	26.9	26.3	25.9	32.1	35.1	31.5	31.0	31.2	31.7	31.9	32.8	33.3	32.8
Personal income tax	% of GDP	4.1	3.8	3.8	4.3	4.4	3.9	4.2	4.4	4.6	4.1	4.1	5.1	5.3
Enterprise profits tax	% of GDP	4.0	4.1	6.1	4.8	5.9	5.3	6.3	3.4	4.6	4.3	6.7	3.8	4.1
Value-added tax	% of GDP	5.7	5.1	4.1	8.6	9.2	7.9	7.3	9.2	9.2	9.7	9.3	10.4	9.8
Excise tax	% of GDP	2.1	2.0	1.8	2.0	2.0	2.0	1.7	1.8	1.7	1.5	1.5	1.8	1.7
Consolidated fiscal expenditures	% of GDP	26.5	26.8	35.2	28.3	36.4	28.1	41.7	30.9	32.8	29.4	36.6	28.4	31.0
Current expenditures	% of GDP	22.7	21.7	27.2	26.5	33.6	24.0	34.2	28.9	29.7	24.9	29.2	26.9	28.4
Capital expenditures	% of GDP	3.8	5.1	8.0	1.8	2.7	4.1	7.5	1.9	3.2	4.5	7.4	1.6	2.6
Consolidated fiscal balance	% of GDP	0.4	-0.5	-9.3	3.7	1.0	-5.0	6.2	-0.4	1.1	-2.4	4.0	-4.8	1.7
Privatisation receipts	% of GDP	3.7	3.5	1.0	0.2	0.6	0.6	16.0	0.1	0.1	0.1	0.1	0.5	0.5
Labour market														
Average wage (real)	% yoy	18.6	14.7	15.4	15.0	19.0	19.6	26.4	23.8	22.6	18.8	11.3	11.5	12.0
Household income (real)	% yoy	16.3	11.3	16.6	24.0	28.0	19.4	18.9	22.1	18.6	20.3	16.3	11.1	10.8
Unemployment rate (ILO methodology)	% cum	8.3	8.1	8.7	8.7	7.1	5.2	7.8	7.9	6.8	6.4	6.8	7.4	6.6
Banking system														
Monetary aggregate M0	% yoy cum	25.6	37.1	27.9	28.2	39.1	31.1	42.2	36.2	25.3	23.7	24.5	22.9	30.4
Monetary aggregate M2	% yoy cum	44.8	51.5	32.3	38.9	37.4	31.3	53.9	39.2	36.6	36.7	34.3	38.6	40.7
Household deposits in national currency	% yoy cum	67.3	67.9	26.2	28.3	31.6	30.4	90.8	54.6	41.1	39.7	37.3	50.7	56.3
Household deposits in foreign currency	% yoy cum	61.7	55.2	54.3	51.8	45.4	46.4	59.1	54.5	66.2	64.3	57.5	52.3	43.8
Com. bank credits in national currency	% yoy cum	52.1	44.3	29.4	28.3	32.6	43.4	58.7	59.8	53.7	49.0	52.3	52.4	57.2
Com. bank credits in foreign currency	% yoy cum	56.2	43.5	32.2	33.1	36.8	47.1	66.3	72.0	82.1	90.4	95.4	98.9	97.4
Long-term com. bank credits	% yoy cum	102.7	82.7	57.1	49.5	53.0	70.1	84.6	87.6	86.7	76.6	79.5	84.1	86.5
Long-term com. bank credits	% of total	49.3	50.9	54.2	54.4	56.1	59.7	61.8	63.1	63.4	63.5	64.9	65.8	67.3
Average lending rate on national cur. credits	% p.a.	16.6	17.0	17.6	17.0	15.4	15.4	16.4	15.8	15.5	14.6	15.1	14.0	13.9
Average lending rate on foreign cur. credits	% p.a.	12.1	12.6	12.2	12.1	11.0	11.3	11.7	11.5	11.3	11.3	11.5	11.5	11.4

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

* change in value added

° preliminary