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Inflation revisited: new records

Over the last eight months, Ukraine experienced a jump in prices unseen since 2000. Consumer inflation in Ukraine accelerated from 14.2% yoy in August 2007 to 30.2% yoy in April 2008, with month-on-month price increases in the 2-4% range. Producer prices index (PPI) also accelerated rapidly to 37.5% yoy in April 2008 as compared to 20.4% yoy increase in August 2007.

The build-up in price levels was accompanied by massive shifts in relative prices. On the producer level, the surge in prices was lead by prices for energy with 45% increase on the raw materials and 69% increase on the processed products, and metallurgy with 89% increase in ore prices and 53% in manufactured products. These two main groups explain almost two thirds of producer price increase, while contributing only 42% to industrial output. Relative prices in consumer basket also experienced large shifts. Four groups of food products: meat, oil and fats, vegetables, and fruit that constitute just over a quarter of consumer basket (26.2%) experienced prices increase by 68.7% yoy and explained 60% of overall price growth. In contrast, prices for other consumer goods grew on average by 16.4%.

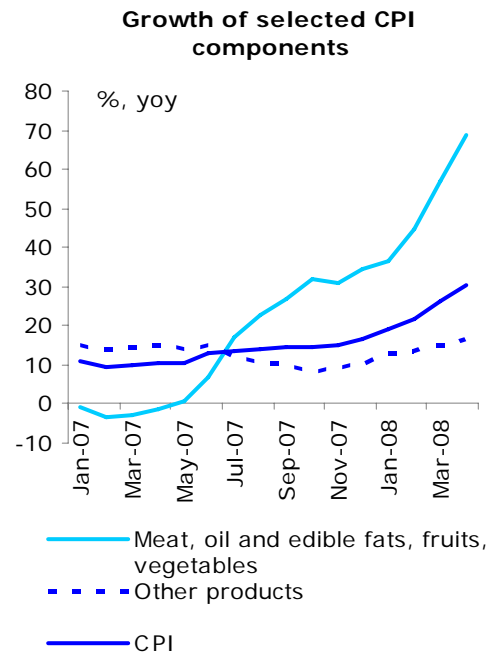
Changes in relative prices are explained primarily by external shocks. Strong economic growth in resource-intensive emerging market economies like India and China contributed to the increase prices for raw products like energy, food and metals. Especially sharp increases in prices for agricultural commodities can be attributed to unfavourable climate conditions in 2007 and the rise in biofuels production. External shocks specific to Ukraine include rising prices for imported gas and the re-opening of the Russian market for Ukrainian meat and milk products.

Partially the spillover of external shocks to price level was amplified by the inability of the agriculture and food industry of Ukraine to adjust quickly to the new market conditions. That happened due to monopolization of sectors and their overregulation including price controls, export restrictions, and subsidies.

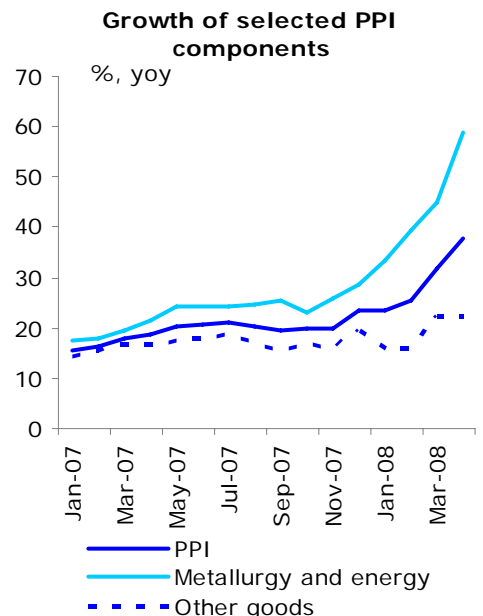
However, major stimuli for the accelerating increase in the price level was a lax monetary policy imported from USA under the fixed exchange rate and second-round effects of inflation. Due to hryvnia peg to US dollar, the large difference between interest rates in Ukraine and abroad stimulated capital inflows in Ukraine. The NBU sold UAH 36 bn to support exchange rate over the last 12 months and banks continued credit expansion (over two quarters ending in March money multiplier increased by 12%), resulting in 52.2% yoy growth of money supply in April. As the economy was not able to absorb rising money supply through economic growth (real GDP growth was 6.0% yoy in the first quarter of 2008) and money velocity decreased only by 4.9% yoy in April, the main outcome was accelerating inflation. Sustained high inflation also caused high inflation expectations putting pressure on wages and pricing, and created danger of inflation spiralling out of control.

High social spending and government-led wage increases put pressure on consumer prices. Growing inflation boosted budget receipts. Consolidated budget social and wages spending grew by 66.2% yoy in the first quarter and reached UAH 33.2 bn, while its share grew from 51.0% in the first quarter of 2007 to 57.0% in the first quarter of 2008. Thus almost 70% of the new budget receipts were funneled directly to consumer demand. Credit expansion also stimulated consumer spending. While in March 2007 consumption loans outstanding were 23.3% of total loans to residents (excl. financial corporations), over 12 months ending in March 2008 banks issued UAH 62.9 bn of consumption loans or 30% of total net issuance.

The inflation outlook remains mixed. Future path of world food and commodity prices is uncertain, but they are likely to remain elevated. Populist social policies are also unlikely to stop under the current political situation, while the major risk of wage-price spiral also remains. On the other hand, credit expansion will probably slow, and increased flexibility of the hryvnia will help decrease the monetary impact of capital inflows. A good harvest may also alleviate pressure on food prices to some degree. Thus, the IER forecasts CPI growth to reach 24-25% by the end of 2008.



Source: Derzhkomstat, IER calculations



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Quarterly trends

National accounts		Q4 04	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07	Q4 07
GDP	UAH bn	100.1	84.3	97.5	119.4	123.6	105.4	124.1	150.4	157.7	137.6	165.1	197.4	212.8
GDP (real)	% yoy	9.1	4.9	3.4	1.4	1.7	4.1	6.8	6.9	9.5	8.9	8.6	6.2	7.4
Households consumption (real)	% yoy	12.5	14.3	17.7	17.0	17.1	20.2	18.2	11.8	9.9	14.7	15.5	15.2	19.0
State consumption (real)	% yoy	0.9	6.1	0.0	1.0	4.0	9.6	5.8	5.8	1.0	0.8	6.2	4.4	2.4
Gross fixed capital formation (real)	% yoy	16.8	-2.3	-0.5	0.2	0.3	19.9	19.3	17.9	18.3	24.4	23.5	18.9	23.8
Exports of goods and services (real)	% yoy	11.7	-0.6	-14.0	-12.7	-15.5	-14.9	-9.6	3.2	1.0	4.9	5.2	0.1	5.6
Imports of goods and services (real)	% yoy	8.7	2.8	3.2	3.9	-0.9	10.7	0.9	8.3	6.4	12.9	19.6	13.7	27.2
Agriculture, hunting, forestry (real)*	% yoy	11.3	5.8	8.3	2.6	-7.2	3.8	2.8	-5.6	8.1	4.8	6.8	-9.3	7.1
Manufacturing industry (real)*	% yoy	6.9	7.0	1.8	-1.1	2.0	-1.5	6.1	7.3	7.2	15.0	13.2	13.1	4.4
Construction (real)*	% yoy	23.3	-8.4	-11.3	-8.5	-7.5	0.1	0.8	1.4	4.2	13.3	8.2	12.7	5.8
Trade, repair services (real)*	% yoy	2.5	-2.1	-10.7	-11.7	-11.9	6.2	16.4	20.0	21.9	14.3	17.5	25.3	15.0
Transport (real)*	% yoy	6.4	6.6	5.7	2.8	7.8	4.9	7.7	9.4	5.3	7.0	5.6	8.0	10.2
Balance of payments														
Current account balance	USD bn	1.1	1.6	0.6	0.4	-0.1	-0.8	0.0	0.5	-1.4	1.2	-0.8	-0.5	-3.5
Current account balance	% of GDP	5.7	10.1	3.2	1.7	-0.4	-3.7	0.0	1.7	-4.3	4.4	-2.4	-1.2	-8.1
Trade balance in goods	USD m	482	1020	-236	-1131	-788	-1353	-935	-884	-2022	-1735	-1701	-2684	-4452
Trade balance in services	USD m	157	188	392	1035	191	219	506	1054	347	103	512	1689	392
Current transfers	USD m	623	626	694	745	780	622	790	851	910	825	968	1099	1183
Direct investment (FDI)	USD m	344	247	365	477	6474	1053	1389	1636	1258	1709	1934	3927	1648
Portfolio investments	USD m	156	397	923	90	1347	4	-141	370	3350	1816	1477	517	1844
Gross international reserves	USD bn	9.5	12.0	13.1	14.3	19.4	17.3	17.6	19.1	22.3	23.5	25.6	30.6	32.5
Exchange rate, UAH/USD	aop	5.31	5.30	5.10	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05	5.05
Fiscal indicators														
Consolidated fiscal revenues	% of GDP	25.9	32.1	35.1	31.5	31.0	31.2	31.7	31.9	32.8	33.3	32.8	30.8	31.1
Personal income tax	% of GDP	3.8	4.3	4.4	3.9	4.2	4.4	4.6	4.1	4.1	5.1	5.3	4.9	4.8
Enterprise profits tax	% of GDP	6.1	4.8	5.9	5.3	6.3	3.4	4.6	4.3	6.7	3.8	4.1	4.1	6.4
Value-added tax	% of GDP	4.1	8.6	9.2	7.9	7.3	9.2	9.2	9.7	9.3	10.4	9.8	8.7	7.6
Excise tax	% of GDP	1.8	2.0	2.0	2.0	1.7	1.8	1.7	1.5	1.5	1.8	1.7	1.6	1.3
Consolidated fiscal expenditures	% of GDP	35.2	28.3	36.4	28.1	41.7	30.9	32.8	29.4	36.6	28.4	31.0	29.6	36.7
Current expenditures	% of GDP	27.2	26.5	33.6	24.0	34.2	28.9	29.7	24.9	29.2	26.9	28.4	25.9	27.3
Capital expenditures	% of GDP	8.0	1.8	2.7	4.1	7.5	1.9	3.2	4.5	7.4	1.6	2.6	3.7	9.4
Consolidated fiscal balance	% of GDP	-9.3	3.7	1.0	-5.0	6.2	-0.4	1.1	-2.4	4.0	4.7	1.7	1.2	-6.2
Privatisation receipts	% of GDP	1.0	0.2	0.6	0.6	16.0	0.1	0.1	0.1	0.1	0.5	0.5	0.3	0.4
Labour market														
Average wage (real)	% yoy	15.4	15.0	19.0	19.6	26.4	23.8	22.6	18.8	11.3	14.7	13.9	14.9	15.7
Household income (real)	% yoy	16.6	24.0	28.0	19.4	18.9	22.1	18.6	20.3	16.3	17.5	17.4	14.9	16.4
Unemployment rate (ILO methodology)	% cum	8.7	8.7	7.1	5.2	7.8	7.9	6.8	6.4	6.8	7.4	6.6	6.2	6.4
Banking system														
Monetary aggregate M0	% yoy cum	27.9	28.2	39.1	31.1	42.2	36.2	25.3	23.7	24.5	22.9	30.4	36.4	48.2
Monetary aggregate M2	% yoy cum	32.3	38.9	37.4	31.3	53.9	39.2	36.6	36.7	34.3	38.6	40.7	47.8	50.8
Household deposits in national currency	% yoy cum	26.2	28.3	31.6	30.4	90.8	54.6	41.1	39.7	37.3	50.7	56.3	64.8	71.9
Household deposits in foreign currency	% yoy cum	54.3	51.8	45.4	46.4	59.1	54.5	66.2	64.3	57.5	52.3	43.8	38.4	32.5
Com. bank credits in national currency	% yoy cum	29.4	28.3	32.6	43.4	58.7	59.8	53.7	49.0	52.3	52.4	57.2	60.7	72.7
Com. bank credits in foreign currency	% yoy cum	32.2	33.1	36.8	47.1	66.3	72.0	82.1	90.4	95.4	98.9	97.4	91.0	75.4
Long-term com. bank credits	% yoy cum	57.1	49.5	53.0	70.1	84.6	87.6	86.7	76.6	79.5	84.1	86.5	87.9	85.7
Long-term com. bank credits	% of total	54.2	54.4	56.1	59.7	61.8	63.1	63.4	63.5	64.9	65.8	67.3	68.2	69.2
Average lending rate on national cur. credits	% p.a.	17.6	17.0	15.4	15.4	16.4	15.8	15.5	14.6	15.1	14.0	13.9	13.7	14.0
Average lending rate on foreign cur. credits	% p.a.	12.2	12.1	11.0	11.3	11.7	11.5	11.3	11.3	11.5	11.5	11.4	11.3	11.1

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

* change in value added

° preliminary