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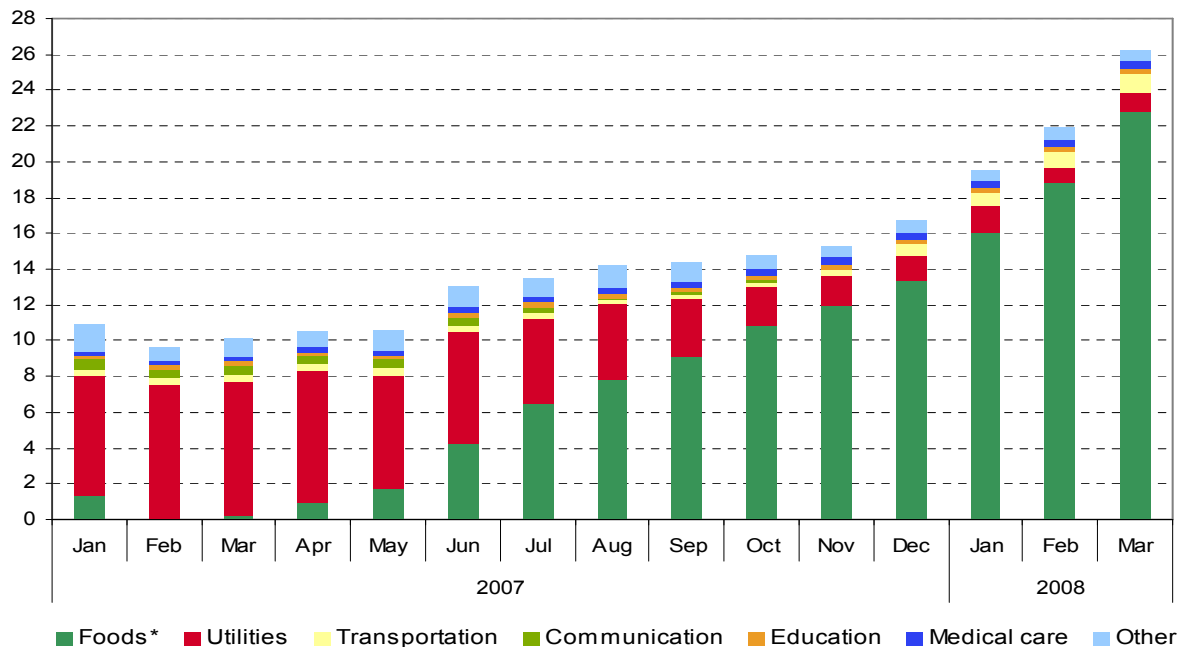
Ukraine - Recent Inflation Developments

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Following consumer price surges of about 2.8% month-over-month (mom) in January and February 2008, inflation picked up to 3.8% mom in March. For the last 12 months, the Consumer Price Index (CPI) increased by 26.2%. Such high rate of inflation was the result of both supply-side shocks and demand-side factors.

On the supply side, increases in food prices contributed the most to CPI growth. In addition to a 41% yoy increase in food prices, these items are the weightiest component of the consumer basket (about 55%). Food inflation was the result of a poor harvest in 2007 due to bad weather, sharp international price increases of agricultural commodities globally, and buoyant consumption. Food production in Ukraine, particularly cereals, decreased significantly due to a severe drought in the summer of 2007, high fuel prices passed on to agricultural production, as well as changing structure of crops in favor of bio-fuel production. This output reduction affected the entire food chain from prices on cereals, to bread and bakery products, and livestock products (meat, milk and dairy products). This poor 2007 harvest will continue to exact a toll on the supply of agricultural products and food prices in the first half of 2008.

CPI by component, % yoy



On the demand side, inflation was reinforced by growth in aggregate demand considerably outpacing the rise in productivity. The boost to demand came from expansionary monetary and fiscal policies.

The NBU's policy of fixing the Hryvnia exchange rate to the dollar was successful in reducing inflation from the very high levels of the 1990s. Since the financial crisis of 1998, the Hryvnia exchange rate to the dollar has been maintained fairly stable. However, with large trade surpluses and capital inflows, in order to maintain the exchange rate peg, the National Bank of Ukraine had to purchase large amounts of foreign exchange, thus injecting large sums of Hryvnias into the economy. These purchases of foreign exchange by the NBU contributed to the rapid growth of money supply, which on average increased by about 45% per year over 2004-2007. These increases in money supply, plus large private sector borrowing from abroad led to rapid increases in commercial bank credit, which averaged 70% per year during the last three years. These high increases in money supply and credit had not been reflected earlier in high inflation thanks to the fast growth of money demand that accompanied high rates of GDP growth. However, the inflationary impact of money supply increases are now being felt.

Since the financial crisis of 1998 Ukraine has maintained prudent fiscal budget discipline (with deficits of less than 2% of GDP, except during the election year of 2004). These small budget deficits were achieved despite large increases in government expenditures. The deficits were contained by significant increases in budget revenues that originated from the elimination of privileges and exemptions. Nevertheless, fiscal budget expenditures grew rapidly since 2004 by about 20% per year in real terms. These expenditures were directed principally to increased pension payments, wage increases and social programs for low-income households, which contributed to the current inflationary pressures in food items.

Government Measures to Control Inflation

Since November 2007, the government and the National Bank of Ukraine have taken a number of measures to reduce "absorption" or aggregate demand as the main strategy to control inflation. The government has emphasized that it does not plan to resort to administrative price controls to reduce inflation. The following measures have been taken so far to control inflation:

- The government has indicated that it will reduce its 2008 fiscal budget deficit to 1.5% of GDP (down from previously targeted 2.1% of GDP). During the first three months of 2008, the government maintained a consolidated fiscal budget surplus of about 4.9% of period GDP, despite compensation payments to the population for the depreciation of bank savings shortly after independence. The accumulation of extra budget revenues in the Treasury account complements the NBU efforts to contain money supply growth.
- The government postponed the issuance of Eurobonds to contain the inflationary pressures that may originate from the conversion of these bonds into Hryvnias. Instead, the government will rely on domestic borrowing to finance its fiscal deficit.

- Since May 2008, the government will pass through increases of energy prices to consumers by gradually raising natural gas tariffs for households by 19-49%. While this measure will add to consumer inflation about 0.6-0.7 percentage points, it will contribute to reduce aggregate demand. This measure will also help to bring a number of energy enterprises, including state monopoly Naftogaz Ukraine, into a healthier financial situation.
- The NBU has tightened reserve requirements on foreign capital borrowed from abroad (since December 2007, foreign borrowings are subject to a reserve requirement of 4% - 5%). The NBU has also tightened capital adequacy norms for commercial banks (by defining more precisely risky assets). These measures should help to contain the expansion of bank credit. Bank credit will be also contained by the current international liquidity crises, which is making harder for banks to borrow from abroad.
- The NBU raised its discount rate by 200 basis points to 10%.
- The NBU carried out sizable sterilization operations, absorbing about \$12 billion of excess liquidity since November 2007.
- The NBU will significantly reduce its purchases of foreign exchange to avoid injecting Hryvnia liquidity to the inter-bank market. So far, this policy has allowed the exchange rate to go to the lower end of exchange rate band (UAH/\$ 4.95-5.25) on the inter-bank market.
- Over the next two years, the NBU is planning to introduce Inflation Targeting, as its main intervention tool.

These measures as well as expected good harvest this year are expected to reduce inflation in the second half of 2008. For 2008, inflation is expected to be around 17%. If the above policies are sustained into 2009, inflation next year could be reduced to about 10%.