

# Taming Inflation in Ukraine

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## Recent Developments

Weak budget discipline and excessive public spending were the main factors behind high inflation rates in the early 1990s. However, during the period from 2000 to mid-2004, Ukraine maintained prudent fiscal policy (fiscal budgets were mostly balanced). On top of that, the national currency markedly depreciated in 1998-1999, which boosted current account surpluses in 2000-2005 (the current account surplus peaked at almost 11% of GDP in 2004). Current account surpluses together with foreign capital inflows have been steadily exerting upward pressure on the foreign exchange rate. As a result, the pegging of the Hryvnia exchange rate to the weakening US dollar<sup>1</sup> and the NBU's interventions at the forex market led to a significant growth in the money supply. Admittedly, all these factors allowed the Ukrainian economy to grow by 8.4% on average over 2000-2005. Moreover, despite large increases in money supply, inflation was contained to single digit levels, thanks to the fact that this money supply growth was matched by growing money demand, which reduced the income velocity of money.

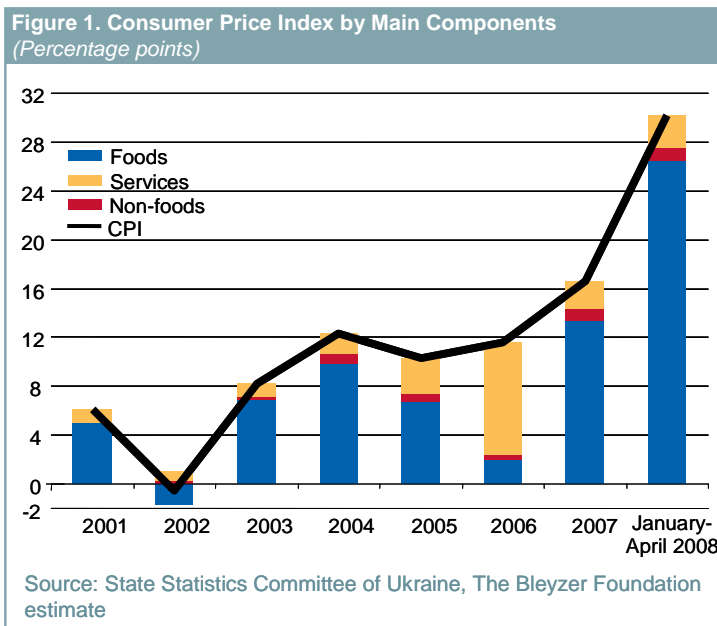
Although these improvements in the macroeconomic framework yielded good results, the progress in structural reforms was slow, particularly in the areas of land reform, energy reform, pension reform and the investment climate. Without adequate supply responses in these areas, the Ukrainian economy rapidly evolved towards macroeconomic disequilibrium, both external (high current account deficits) and internal (high inflationary pressures).

Since 2005, the current account surpluses achieved during 2000-2005 have been rapidly eroding, with a small current account deficit reported in 2006. In 2007, the current account gap widened to 4.2% of GDP and is expected to further deteriorate to 6.5% of GDP in 2008.

Furthermore, since 2004 Ukraine has been experiencing acceleration of inflation, which reached 16.6% in 2007. In 2008, consumer prices have continued to grow at a fast pace. Following consumer price surges of about 2.8% month-over-month (mom) in January and February

2008, inflation picked up to an average 3.5% mom in March-April. Over the last 12 months, the Consumer Price Index (CPI) increased by 30.2%.

The chart below presents the consumer price index growth by its main components. It shows the importance of the food component, not only because of increased food prices, but also because food items represent more than 50% of the CPI basket.



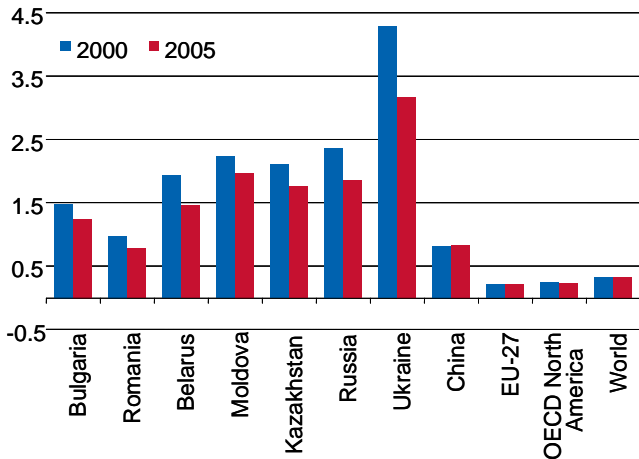
The recent high rates of inflation are the result of both supply-side shocks and demand-side factors.

## Supply-Side Shocks

Ukraine seems to now be paying for the delayed reforms in the energy and agricultural sectors. During Soviet times and for fifteen years since independence, the Ukrainian economy benefited from low energy costs. Cheap energy offered little incentive for Ukrainian enterprises to modernize outdated and highly energy-intensive production capacities and introduce energy saving technologies. As a result, Ukraine has remained among the most energy intensive economies in the world.

<sup>1</sup> Unparalleled loosening of the monetary policy by the US Federal Reserve System (interest rates were lowered to 1% in 2003-2004) encouraged the NBU to import loose monetary policy through the de facto foreign exchange peg to the US dollar.

**Figure 2. Energy Intensity by Selected Countries**  
(Total Primary Energy Supply per GDP\*)



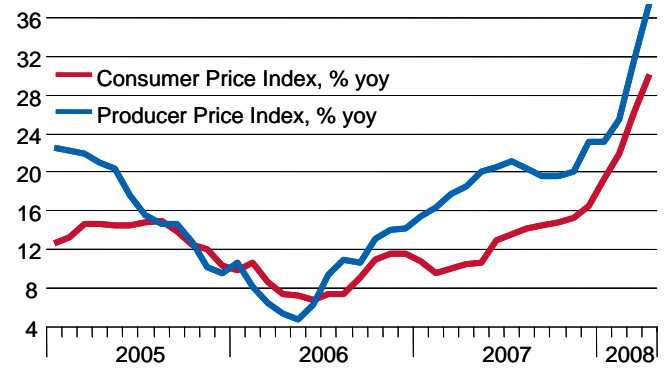
\*Tons of oil equivalent per thousands GDP in US\$ (measured at market exchange rates and 2000 prices).

Source: IEA, Energy Balances of Non-OECD Countries 2007

Being highly dependent on energy imports, the Ukrainian economy was badly hit by several sequential price hikes on imported natural gas. Currently, natural gas prices are almost three times more expensive than three years ago. In 2006, consumer price inflation was primarily driven by upward adjustments of utility tariffs. However, in 2007 the government decided to postpone the pass-through of 37% higher energy prices to consumers. Since the beginning of 2008, though imported natural gas prices were raised again by 38%, the pass-through was again suspended until the second half of the year. However, by allowing full pass-through to producers, higher energy prices affected consumer prices through the spill-over of producer price inflation.

Since 2007, the growth in food prices has become the principal component of consumer inflation. Advancing by about 24% yoy in 2007, the growth in food prices continued to accelerate in 2008, surging to 47.2% yoy in April 2008. In addition to skyrocketing price increases, these items are the weightiest component of the consumer basket (about 55%). To a significant degree, food inflation was a result of the 2007 harvest failure, record high global agricultural prices, booming production of biofuels, and growing demand for protein rich foods.

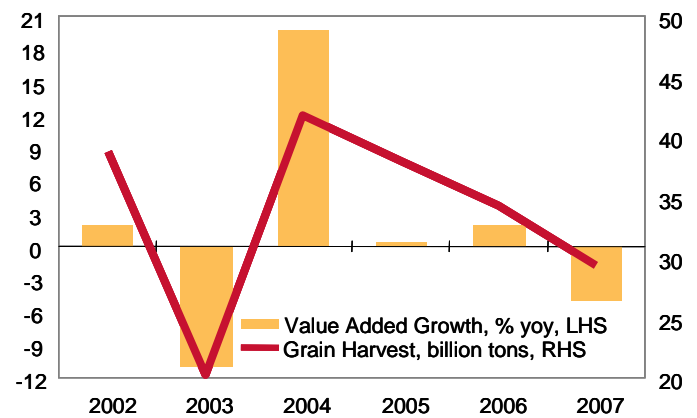
**Figure 3. Consumer and Producer Inflation**  
(Total Primary Energy Supply per GDP\*)



Source: State Statistics Committee of Ukraine

Food production in Ukraine, particularly cereals, decreased due to a severe drought in the summer of 2007, high agricultural input prices that resulted from higher fuel prices, as well as the changing structure of crops in favor of bio-fuel production. As a result, agricultural value-added declined by about 5% in 2007. This output reduction affected the entire food chain from prices of cereals, to prices of bread and bakery products (up by 35% yoy in April 2008), livestock products (meat up 47% yoy, milk and dairy products up 40% yoy).

**Figure 4. Grain Harvests and Value Added Growth in Agriculture**  
(Percent, year-over-year)

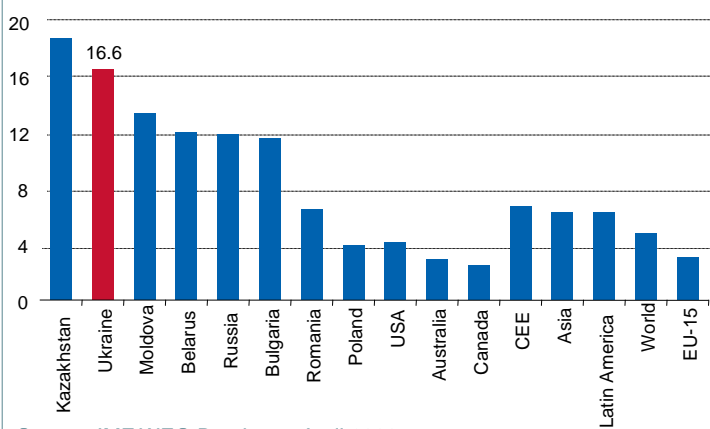


Source: State Statistics Committee of Ukraine, The Bleyzer Foundation

Ukraine is not unique in experiencing higher food prices. The sharp upswing in agricultural and food prices is a global phenomenon. A decrease in grain harvest was reported in many European countries, Latin America, Australia and Northern America. For instance, value added in agriculture declined by a real rate of 30% yoy in 2007 in Bulgaria and 17% yoy in Romania. However, the consumer price index growth in these countries was much more moderate than in Ukraine, which saw one of the highest

inflation rates in the world. Moreover, Ukraine has already been experiencing double-digit growth of consumer prices since 2004.

**Figure 5. Consumer Price Inflation in Selected Countries, eop (Percent)**



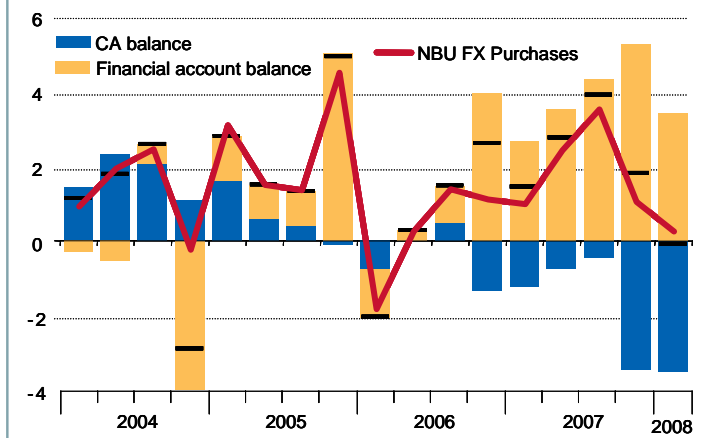
Source: IMF WEO Database, April 2008

This situation indicates that though supply side shocks definitely contributed to inflation developments in Ukraine, the major responsibility for persistently high price growth in Ukraine should be put on monetary and fiscal expenditure policies. In particular, aggregate domestic demand was boosted by loose monetary conditions stemming from anchoring nominal exchange rate stability amid large foreign capital inflows into the country and an expansionary fiscal expenditure policy over the last four years. Aggregate demand growth considerably outpaced the rise in productivity, thus notably contributing to the build up of inflationary pressures.

## Monetary Policy Impact on Inflation

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 fairly stable. However, with large trade surpluses (during 2003-2004) and large capital inflows (since 2005), the National Bank of Ukraine had to purchase large amounts of foreign exchange in order to maintain the exchange rate peg, thus injecting large sums of Hryvnias into the economy.

**Figure 6. Ukraine's External Sector Performance and NBU Interventions on the Forex Market (\$ billion)**

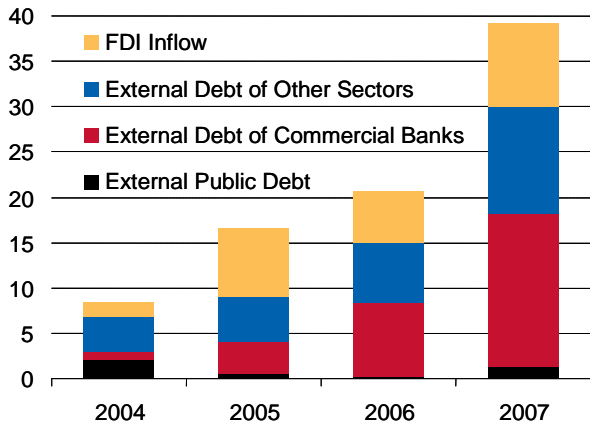


Source: NBU

Since 1999, the external sector has provided large inflows of foreign exchange into the country. Until 2004, exports provided most of the net foreign exchange inflows to the country. Although the current account turned into deficits starting in 2006, these deficits were more than compensated by significant capital inflows, reflected in large financial account surpluses. The foreign capital inflows were due to record high FDI inflows in 2005-2007 and to aggressive private sector borrowing from abroad. According to rough estimates, about 45% of total foreign capital inflows in 2004 were FDI and government debt inflows, with only 10% coming as commercial banks external borrowings.

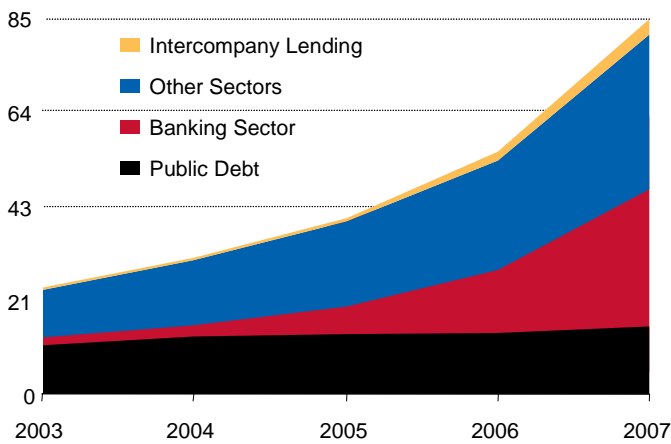
However, since 2006, external borrowings of commercial banks gathered momentum and became the principal source of foreign capital inflow to the country. Despite a record high inflow of \$9.2 billion of FDI in 2007, FDI inflows explained only 25% of foreign capital increases in 2007. Also, with moderate external public debt increases, the impact of government foreign borrowings was relatively insignificant. On the contrary, foreign borrowings of commercial banks accounted for about 45% of capital inflows. Indeed, money of foreign origin turned out to play an increasing role in the growth of domestic credit by the banking sector. While in 2003-2004, approximately 15% of the credit growth of commercial banks was financed by increases in commercial banks' foreign liabilities; in 2007 their share rose to about 45%.

**Figure 7. Foreign Capital Inflows**  
(\$ billion)



Source: NBU, The Bleyzer Foundation

**Figure 8. External Debt by Sectors**  
(\$ billion)



Source: NBU

Long-term foreign borrowings by corporations were also important in 2006 and 2007, accounting for about two-thirds of the increases in “External Debt of Other Sectors” in the preceding chart.

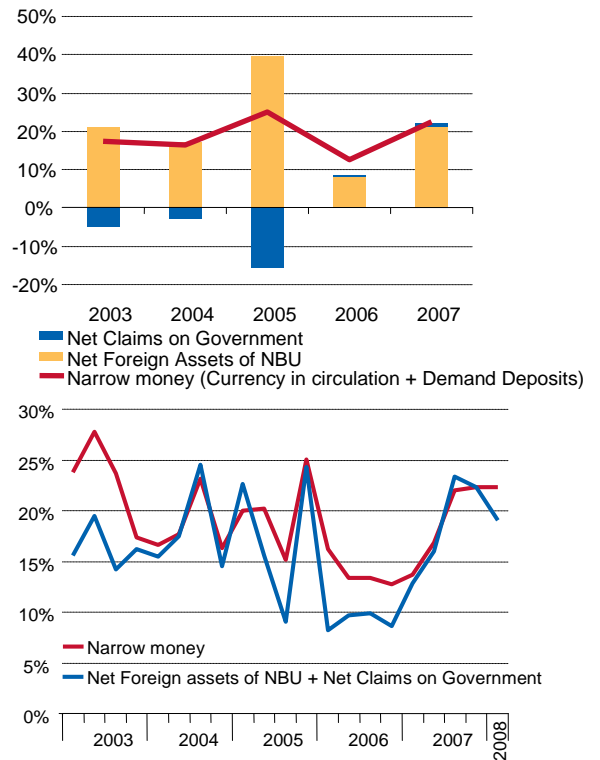
## Capital Inflows, NBU Interventions and Money Supply Increases

Without NBU interventions, these large capital inflows would have resulted in appreciation of the foreign exchange rate of the Hryvnia, with a minimum impact on money supply. However, the large purchases of foreign currency by the NBU have been the main contributors to the rapid growth of money supply. Indeed, net NBU interventions were mirrored in the growth of narrow money (M1, currency in circulation plus demand deposits) virtually on a one-to-one basis. Furthermore, during 2004-2007, the net purchases of foreign exchange by the NBU (amounting to

\$25 billion) represented about 40% the increase in broad money supply (M3) during the period.

The magnitude of changes in net foreign assets of the NBU on narrow and broad money notably outweighed the impact of changes in government borrowings to finance its fiscal budget deficits. The growth in narrow money, about 60% of which was due to increases in currency in circulation, also reflects limitations of the current monetary framework to control the money stock as tightening of this money component can be achieved only over time in the medium-term.

**Figure 9. Contributions to money supply growth by selected components and counterparts** (Percentage points)



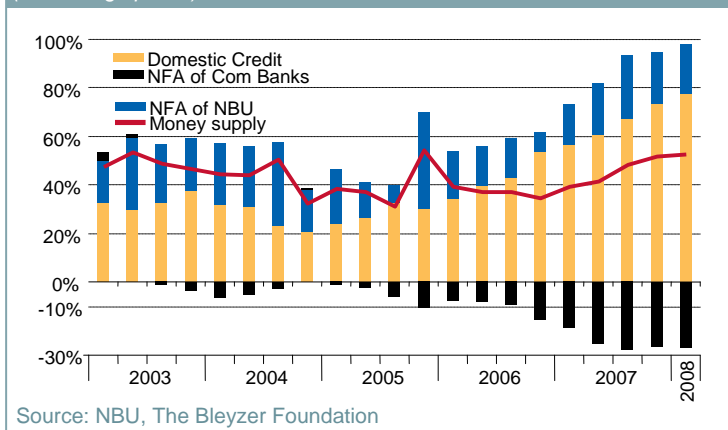
Source: NBU, The Bleyzer Foundation

Narrow money growth accounted for about 45% of the overall broad money supply expansion. The rest was due to the robust growth of term/saving deposits with commercial banks, which originated from higher income and wages in the country and the money multiplier effect of the banking sector.

Reinforced with aggressive commercial bank borrowing from abroad, the increases in money supply allowed commercial banks to expand their credit portfolios

by an impressive 70% yoy growth on average over the last three years.

**Figure 10. Growth of Money Supply and its Main Counterparts (Percentage points)**



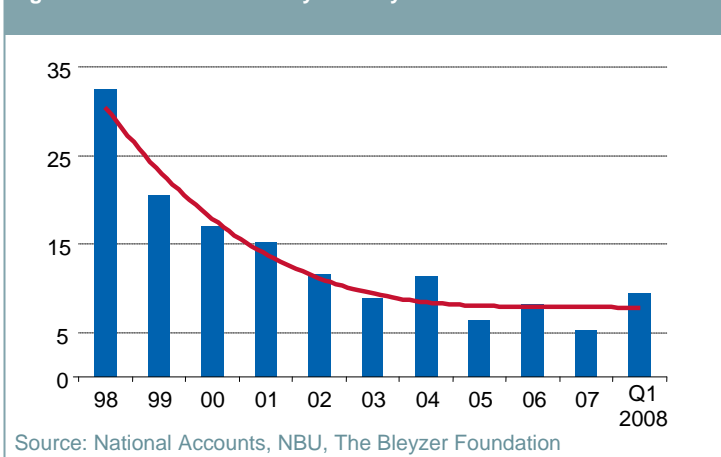
## Money Supply Increases and Inflation

Economic theory and the experience of many countries imply that inflation is predominantly a monetary phenomenon. The rate of inflation is positively related to increases in money supply and increases in expected or anticipated inflation. On the other hand, inflation is negatively related to increases in money demand (i.e., declines in money velocity) and increases in real output. The relationship between inflation and money supply is clear. However, the relation between money supply and income growth is more complicated; over the short term, with some price rigidity, a reduction in money supply will reduce income growth, but income should recover over the longer term as prices decline.

In Ukraine, a brisk growth of money supply had not been reflected earlier in high inflation thanks to the fast growth of money demand that accompanied high rates of GDP growth. Such conclusion can be made by calculating the evolution of money velocity on the basis of the quantitative equation that links the stock of money and the market value of output that it finances. Given that velocity and money demand are inversely related, available data suggests that money demand growth may be rapidly reaching its saturation level. As a result, the inflationary impact of money supply growth has now become more pronounced. This means that a tighter monetary framework should be enacted. The country can not expect that

increases in money demand will neutralize the inflationary effects of increases in money supply in the future.

**Figure 11. Evolution of Money Velocity**



The previous analysis shows that capital inflows from abroad (principally commercial bank borrowing) together with strong NBU intervention in the foreign exchange market were major factors creating inflationary pressures in Ukraine over the last few years. However, this is only part of the story as a significant portion of the increases in money supply are attributed to the rapid increases in deposits in the banking system. The latter is closely related to the rapid growth in households' disposable income and the expansionary role of fiscal expenditures.

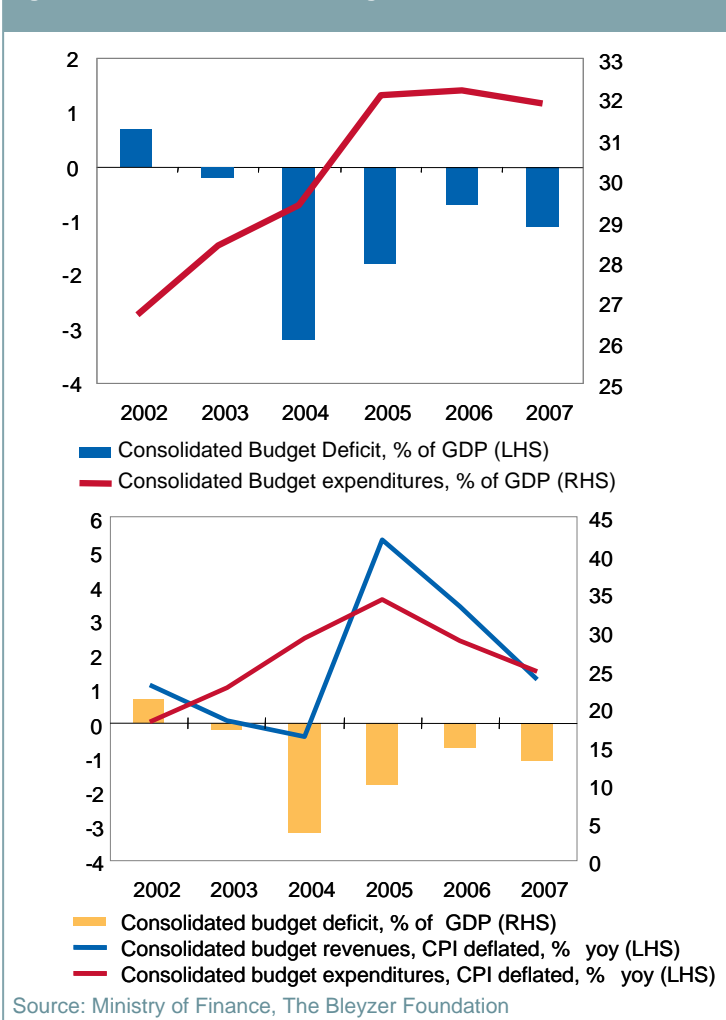
## Impact of Fiscal Policy on Inflation

Since the financial crisis of 1998, Ukraine has maintained fiscal budget deficits of less than 2% of GDP, except during the election year of 2004. These small budget deficits conceal the fact that fiscal budget expenditures were quite expansionary. The deficits were contained by significant increases in budget revenues that originated from the elimination of privileges and exemptions enjoyed principally by the corporate sector. While the fiscal budget deficit remained relatively under control, budget expenditures as a share of GDP grew rapidly since 2004 by about 30% per year in real terms. Today, Ukraine's ratio of consolidated fiscal expenditures to GDP is about 32%, a high ratio for a country with Ukraine's GDP per capita. These fiscal expenditures were directed principally to increased pension payments, public sector wage increases and social programs for low-income households, which became a powerful source of population disposable income growth. In fact, this fiscal budget policy represented a



massive transfer of resources from the corporate sector to the poorest segments of the population. Although this policy may have been socially desirable, the resulting increases in consumption contributed to the current inflationary pressures.

Figure 12. Consolidated Fiscal Budget Performance

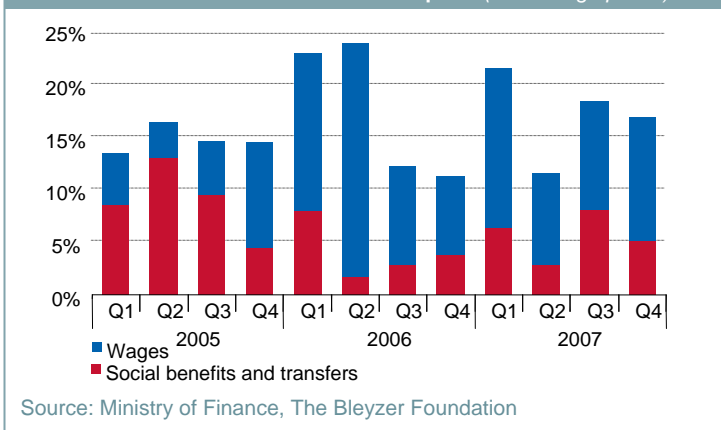


Furthermore, the fiscal budget shifted toward distributing a larger fraction of budget revenues to consumption spending rather than investment. This helped to form expectations that budget spending on social benefits would continue rising. According to our estimates, growing social benefits and transfers contributed over 60% to the real growth of households' consumption in 2005. Although this impact narrowed to about one third in 2007, fiscal policy remains a strong contributor to aggregate demand. Thus, notwithstanding modest overall fiscal budget deficits, growing budget spending added fuel to budding inflationary pressures.

## Credibility and Inflation

As noted earlier, the rate of inflation is positively related to money supply growth and increases in expected/anticipated inflation, and it is negatively related to increases in money demand (i.e., declines in money velocity) and increases in real output. Therefore, expectations about anticipated inflation are of great importance. That is, high **credibility** that the government is fully committed to tackling inflation is one of the most important ways to tame inflation. The impact of sound monetary and fiscal policies on consumer behavior will depend on whether these policy measures are perceived as **temporary or permanent**. Both economic evidence and theory imply that if the government fails to persuade the public about a **permanent** duration of their anti-inflation policies, these policies may not yield the desired impact on lowering inflation. Chronically increasing inflation requires a **permanent** shift toward a tighter fiscal and monetary stance. However, governments usually find it difficult to pursue a credible permanent fiscal tightening due to short election cycles (a recent feature of Ukrainian politics).

Figure 13. Contribution of Wages and Social Benefits to the Real Growth of Households' Consumption (Percentage points)



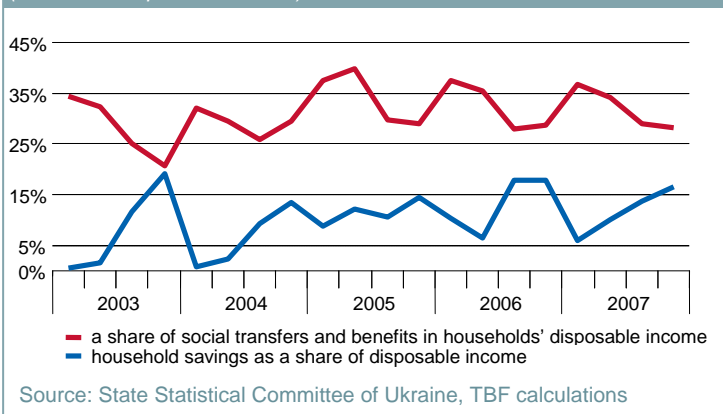
Certainly, policies that freeze social payments or increase taxes trigger a fall in disposable incomes, which should prompt households to reduce consumption. However, if such policies lack credibility, households will cut down savings without visibly adjusting consumption, as consumers expect the government to reverse course in the future. As a result, credibility problems on the permanency of tighter fiscal policy considerably restricts its dampening impact on aggregate demand and, thus, on inflation.



Credibility issues inherent to fiscal restraint may become even more challenging on the eve of national elections. If the public perceives the possibility of fiscal loosening during the pre-election period, households will maintain consumption levels. Indeed, consecutive elections and repeated claims to hike wages and pensions in the public sector have shaped deeply entrenched expectations about the government's powerlessness to restrain budget spending on social benefits and transfers. Admittedly, over the last few years the real economy has been benefiting from the expansionary fiscal policy. Robust economic growth, in turn, boosted real wages in the private sector, prompting further expansion of aggregate demand and consumer spending.

It is therefore critical for the successful control of inflation that the government commits itself in a credible manner to a responsible and tight fiscal and monetary policy. Without this credibility, maintaining price stability will remain a formidable challenge. Finally, if credibility of anti-inflationary fiscal policies is weak, the government will see a rising inflation-growth tradeoff. Indeed, policy makers will be forced to implement even tighter fiscal actions to bring down aggregate demand and, most importantly, to establish credibility. This means that fiscal policy must overshoot its initial targets. Under these conditions, short-term macroeconomic adjustments will almost certainly be more painful. However, if fiscal restraints are further postponed, these costs risk becoming prohibitively high, which hardly benefits political and economic stability in Ukraine.

**Figure 14. Households' Savings and Government Transfers**  
(Percent of disposable income)



Indeed, Ukrainian households tend to save a lower fraction of their income when a higher fraction of their disposable income comes in the form of government transfers and social benefits. Furthermore, a statistical relationship between household consumption, wages and monetary transfers from the government suggests that households' real consumption tends to increase by about 96 kopecks out of each additional real Hryvnia transferred by the government.<sup>2</sup> This means that the government may lack credibility to persuade households that its fiscal loosening is temporary and its fiscal tightening is permanent. All told, fiscal tightening in Ukraine may be ineffective to exert a meaningful restrictive impact on aggregate demand, while fiscal loosening has a disproportionately large impact on aggregate demand and inflation.

## Policy Responses to Secure Macroeconomic Stability

The government realizes that the social costs of soaring inflation are devastating. These costs tend to be disproportionately distributed across society with low income people feeling the largest impact of higher food and energy prices. Furthermore, persistently high inflation becomes deeply entrenched in inflation expectations, which makes stabilization policies even more difficult to implement. On the positive side, macroeconomic stabilization policies are straightforward. Fiscal discipline and monetary tightening usually work. In fact, in the short-term, giving the time lags to achieve increases in supply, restricting aggregate demand is the only available option to curb inflation. However, the unavoidable tradeoff between restrictions in aggregate demand and economic growth over the short term frequently cools enthusiasm for policy tightening, especially if governments are motivated by short-term considerations or face approaching national elections. Thus, to demonstrate that this is not the case, the government must resolutely commit to fiscal and monetary tightening. **At present, credible and responsible fiscal and monetary policies are the only solutions to anchor inflation expectations in the near future.**

The Government and the NBU have taken a number of measures to secure macroeconomic stability. This section describes these measures and tries to assess whether they will be sufficient to tame inflation.

<sup>2</sup> TBF calculations: OLS regression on quarterly households' income and consumption data, which cover a period of Q1 2004 to Q4 2007 and is measured in 2002 Hryvnias.

The ongoing policy initiatives to restore macroeconomic stability should be evaluated against two basic criteria: (1) whether they can **cool aggregate demand or stimulate supply**, (2) whether they **send a credible message** to the public. As noted above, more than anything, policy credibility is fundamental to anchor inflation expectations. Anti-inflationary policies that cannot be delivered on a credible basis fail to trigger a necessary shift in consumer behavior. Lack of policy credibility risks deepening existing economic imbalances even further, while social costs of these imbalances will visibly increase. Policy credibility calls for a strong and coordinated response from both the government and the National Bank. The longer such responses are delayed, the more painful and unpopular stabilization measures will be. Experiences in other countries suggest that policy credibility can be enhanced by the following:

- a. the policies should represent a Big Bang approach including strong fiscal, monetary and supply measures, since gradual or timid measures will not bring credibility;
- b. the real causes of inflation and the concrete anti-inflationary measures should be carefully explained to the public based on measures already taken -- just a list of "proposed" or "intended" measures will not be credible;
- c. the NBU should have as its major policy objective the control of inflation and it should not be concerned with any other policies attached to it, such as foreign exchange stability or economic growth. These other policy objectives are important; but they can be better achieved through other more efficient policy tools. Furthermore, the NBU should have sufficient independence to enable it to be responsible and accountable for inflation control; and
- d. in many cases it has been useful to get "conditional" assistance from international agencies to add credibility to the policy program.

## **Fiscal Policies**

A credible and prudent fiscal policy is still a challenge for the government, even though the government has already taken the following fiscal measures to control inflation:

First, the Ministry of Finance has announced that the fiscal budget deficit for 2008 is to be capped at 1.2-1.5% of GDP, while all budget revenues in excess of the projected amount will be channeled to reduce this gap. Second, 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. Third, better administration of taxes and custom duties may considerably facilitate this task.<sup>3</sup> Indeed, in the first quarter of 2008, state budget revenues surged by 43% yoy (nearly \$600 million above the target) driven by custom revenues, which surged 78% yoy. Fourth, medium-term actions will focus on the improvement of the budgeting process (including adjustments of custom tariffs and tax preferences), better public debt management and improved analytic capacity of the government to produce more accurate and realistic forecasts of macroeconomic fundamentals. And fifth, special emphasis is put on the development of transparent and efficient channels of communication between the fiscal and monetary authorities. This will improve overall government cooperation on macroeconomic policies and facilitate a prompt and coordinated response to economic challenges.

However, there are several reasons to believe that this program is not strong enough to meaningfully reduce inflation in the short-term and anchor inflation expectations. In particular, historically, Ukrainian governments have proven to be short-lived and therefore ill-fitted to push a credible long-term strategy. Therefore, credibility requires "over-adjusting" of the fiscal accounts, as was done by many countries that successfully controlled inflation. Nevertheless, this fiscal program is a good start to streamline government actions on macroeconomic stability, which may eventually improve the credibility of the government. Furthermore, increasing concern over inflation helps to consolidate authorities' efforts across all jurisdictions and political factions. This may ensure that the government will be guaranteed sufficient stability to enact necessary anti-inflationary policies.

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<sup>3</sup> For example, the State Customs Administration of Ukraine is notorious for the penetration of corruption. However, when the new government reshuffled top customs managers, overall operational efficiency tended to improve.

We believe that the following additional fiscal policy measures are necessary:

- **The budget should be brought into balance.**

The current fiscal policies are hardly tight enough to anchor inflation expectations at a non-accelerating level. Thus, fiscal credibility requires that the fiscal budget for this year should be balanced. A more meaningful spending cap on social benefits should facilitate this task. It is true that restraints on government spending will almost certainly impact the least socially protected groups of the population. Yet, if the government loses control over the growth of prices, especially prices of foods<sup>4</sup>, Ukraine's poor will see their purchasing power deteriorating even faster. On the positive side, it is feasible to partially compensate fiscal restraints with more accurate and precise targeting of the poor with special budget programs. This means that there is an urgent need to readjust budget programs so that the poor are better protected while overall budget spending on consumption is tightened or capped. Balancing the budget does not necessarily imply extremely restrictive income policies. The government has to cut its discretionary spending, while public pensions, wages and social benefits must grow much slower (at rates consistent with single-digit inflation) or should be frozen altogether. Additional budget revenues, including privatization revenues, are to be used to fill the budget gap. Admittedly, a shift in policy priorities (due to evolving political conjuncture) may result in increasing spending on new policy programs (for example, the restitution of lost savings). However, this spending must be necessarily offset with equivalent cuts (or elimination) of other budgetary programs. Otherwise, higher public spending will continue to feed inflation pressures. Furthermore, a government with low credibility will find it prohibitively costly and difficult to restore macroeconomic stability. *However, if the country is experiencing widening current account deficit,*

*balancing the budget may be insufficient. As international experience suggests, in this case the country should run significant fiscal surpluses.*

- **Credibility of the fiscal framework must be strengthened.** Sustainable fiscal policies require a well-developed fiscal management capacity of the government. This includes the capacity to maintain a sustainable and growing tax base, strong analytic capacity and regular and accurate development and public disclosure of medium and long-term macroeconomic strategies. Only a stable and predictable fiscal environment will encourage businesses to invest and increase supply. Equally important, accountable and economical utilization of public funds is essential to curb spending and improve efficiency of the public sector. Policies that strengthen the fiscal framework and integrate automatic policy stabilizers will make the government more flexible and responsive to macroeconomic shocks.
- **Public Governance must be improved.** Lack of policy credibility is the outcome of nearly two decades of inadequate public governance. Current impasses about the Constitution and recent conflicts in the State Property Fund send mixed message to the public, thus undermining the credibility of the government. The public sector remains inefficient, with unclear objectives and functions, cumbersome decision-making, and overlapping responsibilities. All this leads to wasteful utilization of funds and unjustified and competition-distorting subsidies and preferences. This means that all political factions and state jurisdictions must support a prompt modernization of the government machinery. Only a strong and determined commitment to better governance can improve public trust in the government.

## **Monetary Policies**

The NBU has been taking the following monetary policies actions to deal with inflation:

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<sup>4</sup> Foods occupy the largest position in the consumer basket for the poor. Thus, official CPI statistics may gravely underestimate the impact of inflation on their real income.

- The NBU has reduced its purchases of foreign exchange to avoid injecting Hryvnia liquidity into the inter-bank market. So far, this policy has allowed the exchange rate to go below the lower end of the exchange rate band (UAH/\$4.95-5.25) on the inter-bank market.
- 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 more precisely defining risky assets). These measures should help to contain the expansion of bank credit. Bank credit will also be contained by the current international liquidity crises, which is making it harder for banks to borrow from abroad.
- The NBU raised its discount rate by 400 basis points to 12%. Nevertheless, this rate still represents a negative rate when compared to the current inflation rate of 30% pa.
- The NBU carried out sizable sterilization operations, absorbing about \$12 billion of excess liquidity since November 2007.
- Over the next two years, the NBU is planning to introduce inflation targeting as its main intervention tool. Indeed, inflation targeting is an excellent tool to strengthen the credibility of the central bank by improving its capacity to shape inflation expectations. The experience of many emerging economies suggests that a credible inflation targeting regime considerably reinforces control over inflation and helps to contain inflation expectations. Many countries that successfully implemented this strategy saw their inflation rates falling below double digit rates to steady and comfortable levels. However, it is worth mentioning that inflation targeting requires a high level of technical and procedural sophistication and yields visible results only in the medium to long-term. Building credibility is a long-term process requiring

accurate, competent and realistic inflation projections and absolute institutional independence to maintain inflation targets. Unless the NBU noticeably **enhances its autonomy and analytical capacity**, the outcome of inflation targeting risks falling below expectations.

At present, the NBU follows moderate monetary tightening by increasing its interest rates on the one hand but, on the other hand, continuing to maintain at least a relatively narrow exchange rate band in theory. This policy may encourage higher inflows of short term foreign capital (especially on the back of widening international interest rate differentials due to the accommodative monetary policy of the major world central banks). These inflows would lead to the further accumulation of forex reserves of the NBU and, consequently, will increase money supply and inflation.

The NBU is considering further loosening its grip on the foreign exchange market.<sup>5</sup> Admittedly, this may help to reduce exchange rate pass-through on prices of imports if the Hryvnia were to appreciate significantly in the short-term. More important, a refusal to intervene at the forex market will stop the NBU from flooding the economy with money.

However, with the current account deficit already at 4.2% of GDP in 2007, a stronger Hryvnia may keep Ukrainian exports tame and will fan demand for imports, dragging the current account balance deeper into the negative territory. Indeed, a growing current account gap is a major threat to the credibility of a shift toward more flexible exchange regime. If economic agents expect that the current account deficit will continue to widen and exert downward pressure on the exchange rate, the central bank may not be able to build the credibility of its neutral stance at the foreign exchange market.

The current account deficit per se should not be a problem if the country is receiving significant amounts of foreign capital. Ukraine needs to import modern technology and capital goods to support sustainable gains in productivity and competitiveness. After all, Ukraine's peers

<sup>5</sup> The NBU has recently widened its foreign exchange band and revised the official forex rate. On May 22<sup>nd</sup>, the official exchange rate was set at UAH/\$4.85.

in Eastern Europe have been running current account deficits in excess of 10% of GDP for years. A more important question is whether this current account gap is sustainable, which implies that external debt to GDP ratios (both in the private and public sectors) are stable, while the current account gap is financed with long-term foreign direct investments. Readings on the balance of payment of Ukraine do imply that the current account remains a moderate concern. Although the inflows of foreign direct investments have been covering the current account deficit, the increasing size of the current account deficit makes this situation unlikely in the future. It is also unlikely that further increases in private external debt will be major factors to cover future current account deficits. Last year the external debt of the banking sector more than doubled. The current international liquidity crises make future borrowing of this size highly unlikely. Second, a recent widening of the trade in goods deficit is attributed to price hikes of imported natural gas as well as growing prices of other energy resources. Further energy price increases should be expected in the future. On the other hand, the same aggregate demand policies that may tame inflation would also help in reducing the current account deficit somewhat. In fact, imports of consumer durable and non-durable goods were fueled by rising household incomes and booming consumer credit. Consequently, growing aggregate demand was a major contributor to the current account deficit.

Greater foreign exchange flexibility will almost certainly entail additional pressures on the current account balance in the short-term. This means that a switch to a more flexible foreign exchange market must be accompanied with complementary policy measures (most importantly – fiscal policies that curb aggregate demand and, consequently, cool demand for imports) that will help to establish credibility of this new monetary framework.

We believe that the following additional monetary measures would add credibility to the anti-inflation stance of the NBU and the government:

- **The central bank must gain more control over monetary policy.** This means a more flexible exchange rate policy and tighter control over domestic credit. The foreign exchange rate peg is a serious constraint on the ability of the central bank

to execute independent and meaningful monetary tightening. Thus, it has to be replaced with a more neutral stance at the forex market, which precludes the central bank's interventions. Admittedly, tighter monetary policy and a flexible exchange rate will certainly bring more volatility into the country's external balances. This may put at risk the credibility of a shift in the exchange rate regime. This means that this policy shift must be accompanied by additional policy actions that strengthen the credibility of the central bank. In particular, credible inflation targeting, fiscal restraints on aggregate demand and policies to improve the investment climate will help the NBU to avoid the temptation to intervene at the forex market.

- **The central bank has to shift toward credible inflation targeting.** International evidence suggests that inflation targeting is a very effective monetary policy regime that can influence inflation expectations. Thus, the NBU has to advance its analytic and procedural capacity to apply this policy. Furthermore, the NBU must be empowered with real autonomy to conduct monetary policy and should be granted an unambiguous mandate to maintain price stability. All of this will help to improve the credibility of the central bank and create functioning transmission mechanisms with reasonable policy response lags.

## Supply Side Policies

Since inflation represents the gap between aggregate demand and aggregate supply, the government intends to implement short-term supply side strategies through more prudent management of the state reserves of staple commodities and supply interventions in the domestic food market. In the medium term, more transparency and competition at local markets will be enforced. Better regulation of the housing sector and natural monopolies are to be enacted. Finally, several provisions will attempt to promote higher productivity in agriculture and advance overall energy efficiency.

Needless to say, these supply-side initiatives are slow to reduce inflation in the short-term and, thus, anchor



inflation expectations. Indeed, policies targeting domestic supply will dampen inflation in the medium or long-term. Meanwhile, economic and social costs to implement these policies may impose a sizable financial burden on the public sector. Equally important, Ukraine's unbalanced executive power and lingering legislative stalemate may stymie many strategic policy programs. This means that building credibility and momentum for supply side policies is a fundamental precondition to encourage local and foreign investments into the expansion of domestic supply. To give credibility to the supply side policies, the following supply side measures should be taken:

- **Supply-side structural rigidities must be eased.**

Short-term constraints on domestic supply make the tradeoff between inflation and economic growth more painful. With supply constraints, excess demand tends to be absorbed through higher prices and imports. These supply constraints are more serious if the domestic investment climate is weak. On top of that, in a weak investment environment, foreign capital inflows (by strengthening the real exchange rate) will mostly boost consumption, while their impact on investment and growth may be negligible. Thus, the government must support its monetary and fiscal policies with a comprehensive package of structural reforms that improve the investment and business climate. Furthermore, a better investment climate will help to attract long-term foreign investments, which will ease current account financing risks.<sup>6</sup> A credible commitment toward business-friendly regulations and reforms will strengthen public trust into a more flexible exchange rate as well. However, these reforms may yield little tangible immediate benefits, which may put off their execution. Thus, strong leadership and political stability are essential to build needed reform momentum. Finally, neither structural transformation nor fiscal and monetary policies can guarantee sustainable macroeconomic stability if these policy actions are implemented in isolation. Thus, macroeconomic stabilization must be an

integral program that addresses many policy issues that affect the business environment and a supply response.

- Recent spikes of food prices are a part of a wider range of commodity price shocks. Indeed, there exists a strong common force that inflates energy prices, prices of industrial raw materials and prices of foods. In essence, commodity price co-movements are rooted in the rapid economic growth of emerging markets, recurring disruptions of energy supplies and persistent inefficiencies at the global agricultural markets. The current inflation in Ukraine creates favorable momentum to implement successful reforms in the country's agricultural sector, which remains hostage to many supply-side constraints and inefficiencies. The main reason to push this type of reform as soon as possible is due to the pronounced importance of foods on the menu of Ukrainian consumers. Worse, rapid and high growth of food prices has a very powerful distributional effect as poor consumers allocate an even higher fraction of their disposable income to foods. Reforms in the agricultural sector should strive to ease existing supply constraints by promoting investments, which will help to expand domestic supply of crops and other agricultural commodities and will support the local food-processing industry. In particular, the government should: (1) establish an open, transparent and competitive market for agricultural land by removing the moratorium on land purchases, (2) design a fiscal incentives system that favors utilization of land for crops used to produce foods rather than biofuels, (3) promote productivity and yield growth by removing all existing restraints on imports of seeds, fertilizers and agri-machinery, (4) upgrade and maintain regional infrastructure in the agricultural sector, including investments into modern and efficient irrigation systems.

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<sup>6</sup> Especially taken into account that the foreign borrowing of banks will almost certainly cease to go on rising as fast as in the past due to tighter international credit markets and stricter banking regulations of NBU.

## Conclusions:

The latest supply and demand side developments are clear symptoms of the inadequate availability of reliable instruments in the government's toolbox of monetary and fiscal policies. However, the recent measures taken by the government and the NBU show that the authorities are willing to strengthen their macroeconomic management with a more systematic and coordinated approach. A broad understanding appears to emerge that credible and independent monetary policy as well as prudent fiscal policy must be reinforced with structural and institutional reforms that support private sector development and generate productivity and employment gains.

Accelerating inflation is a clear symptom of pronounced supply-side rigidities. This means that higher aggregate demand is mostly absorbed by growing prices rather than increasing supply. Needless to say, the inadequacies of the investment climate are largely at play. Indeed, the World Bank ranks Ukraine 109<sup>th</sup> in terms of starting a new business, 174<sup>th</sup> in dealing with licenses and 177<sup>th</sup> in paying taxes.<sup>7</sup> Problems with the legal framework and the judiciary are well-known constraints. Regulatory constraints on entry and investments as well as the unjustifiably high cost of doing business<sup>8</sup> make it rather difficult to expand supply in the short-term. Lack of entry, in turn, suppresses competition and productivity growth, which puts additional upward pressure on prices. The government therefore must embark on the prompt implementation of a credible program to improve the investment climate in order to allow domestic supply to respond to growing demand.

Unfortunately, these supply measures take time to yield results as new investments take time to be conceived and implemented. With good supply policies, output would increase after only one to three years, depending on the speed of project implementation. In the meantime, the taming of inflation will require monetary and fiscal measures to **contain the growth in aggregate demand**.

Unfortunately, these measures do create a short term reduction in economic growth. But over the medium term, economic growth would be stronger whereas high inflation

will affect long-term growth. These measures to tame inflation should include:

1. The NBU should adopt a more flexible exchange rate regime and avoid interventions at the forex market.
2. Supplementary fiscal tightening is vital to support credibility of this policy transformation. The fiscal budget for 2008 should be balanced.
3. Independence of the monetary authority must be visibly reinforced through a shift toward inflation targeting. Furthermore, the NBU must by law be empowered with a binding mandate to maintain price stability. Essentially, credible inflation targeting involves several important dimensions:
  - full legal independence of the central bank;
  - institutional transparency of the monetary authority;
  - sophisticated analytical capabilities and competence to produce a reliable inflation forecast;
  - a healthy market economy, where prices and exchange and interest rates are set by private economic agents in competitive markets;
  - a developed financial system that enables monetary policy transmission.
4. High inflation is a recent phenomenon in Ukraine. This means that past low levels of inflation and exchange rate stability helped to curb inflation expectations. Thus, meaningful fiscal restraints on budget spending must be put in place to avoid significant unanchoring of these expectations. More than anything, the government should refrain from indexing wages and pensions in the public sector. Otherwise, inflation indexing will penetrate the contractual environment and will undermine disinflation initiatives.
5. Policies to reduce the current account deficit must be enacted. If pressures on the current account persist, the NBU will find it rather challenging to

<sup>7</sup> The World Bank. *Doing Business 2008*

<sup>8</sup> High costs of doing business tend to have a disproportionately high impact on the SME sector.



commit to independent monetary policy. This means that demand for imports should be restrained with tighter fiscal policies and a slower growth of money supply. On top of that, measures that distort international trade flows (i.e. playing with export quotas and tariffs) must be stopped.

6. The anti-inflation program must be a comprehensive and broad initiative. Without joint and credible efforts by the government and the central bank, policy accomplishments, if any, will remain fragile and easily reversible. In addition, stabilization efforts should cover a wide range of policy issues, including public governance, regulatory quality management, pension reform and banking supervision. An additional way to create credibility is to invite an independent and competent external institution (for example, the International Monetary Fund) who will help to design and implement this program and will monitor its execution.
7. The above demand side policies should be accompanied by the implementation of stronger measures to increase supply by improving the country's investment climate.