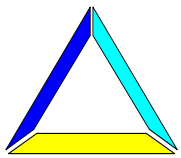
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High inflation in Ukraine: Roots and remedies

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Summary

The rates of inflation have been increasing steadily in the recent past in Ukraine. But almost half of March's yearly inflation rate of 14.7% was due to a huge increase in the price of just *one* good, namely meat. This is a clear sign that inflation has not been mainly caused by monetary, but by real factors. The price for meat increased (on a yearly basis) by 56.8%, making meat more expensive in Ukraine that on the world-market. The increase can be explained by the high degree of protection of this market, which prevented additional supply in the form of imports. Also the recent increase in social transfers contributed to the price rise, because it fuelled demand for meat (and other food products).

The National Bank has adopted adequate measures to combat the high rate of inflation. The hryvnia has been revalued and monetary policy has been tightened. But the Government introduced some questionable measures such as price regulation and direct purchases of meat from producers. In our view, these measures are only of a short-term nature and will not solve the underlying problems. We thus advocate to open up the Ukrainian meat (and food) market to foreign competition instead. Higher imports will reduce prices for meat (and food), thus protecting consumers and especially the low-income population. Besides, a more liberal trade policy will contribute to a modernization and to the efficiency of meat production in Ukraine. Furthermore, fiscal and social policy should become less expansive. All this makes clear that the main responsibility to combat the high rate of inflation currently lies with the Government, not with the National Bank.

1. Introduction

The inflation rate as measured by the consumer price index (CPI) has risen significantly in Ukraine. Whereas in March 2004 the yearly rate amounted to 6.6%, the value for March 2005 was 14.7%. This rise from single- to double-digit inflation provoked concern in the population. In politics, a debate started on how to deal with the problem. Different measures were taken by Government and the National Bank. In this paper, we will look in Part 2 at the roots of the high rate of inflation. In Part 3 we review critically the measures taken by the Government and put forward our own recommendations. In Part 4 we consider the reaction by the National Bank to the high rate of inflation. In Part 5 we conclude.

2. Determinants of the high rate of inflation in Ukraine

The **major** determinant of the current high rate of inflation is the increase in the price for meat[1]. From March 2004 to March 2005 the price for meat increased by 56.8%. The share of meat in the goods basket used to measure inflation is 12.4%. Consequently, meat contributed 7.0 percentage points (or 47.6%) to the yearly inflation rate of 14.7% in March 2005.

The *reasons* for this huge rise are to be found in the real economy. Let's look at the *supply* side first. The cost of feeding animals rose significantly in 2003 and 2004, because of the high price for grain following the poor grain harvest in 2003. As a result, many animals were slaughtered in 2003 and 2004, which reduced the supply of meat in 2005. But also *demand* factors contributed to higher meat prices. Low-income households experienced a large increase in their income, following several rises in pensions and other social transfers since September 2004. A large share of the additional income has been used to demand food products and particularly meat. The combination of lower supply of and higher demand for meat explains this very dramatic increase in prices for meat. In an open economy, imports of meat would have stabilized the price and protected the consumers. Not so in Ukraine. Prohibitive high tariff and non-tariff barriers make sure that producers face practically no international competition. The effective protection of meat producers in Ukraine amounts to around 50-60% for beef and pork meat and to 100% for poultry meat.[2]

A **further** determinant of the high rate of inflation is the increase in food products (excluding meat[3]). The average price for food products (excluding

[1] By "meat" we mean "meat and poultry", as defined by Derzhkomstat.
[2] See OECD and World Bank (2004): Achieving Ukraine's Agricultural Potential: Stimulating Agricultural Growth and Improving Rural Life. Joint Publication by the Organization for Economic Cooperation and Development and the Environmentally and Socially Sustainable Development Unit, ECA.
[3] We exclude "meat and poultry" from the category "food products", because we have already dealt with the increase in meat prices above.

meat) increased by 7.8% from March 2004 to March 2005.[4] The share of food products (excluding meat) in the goods basket is 48.9%. Thus, food products contributed 3.8 percentage points (or 25.9%) to the yearly inflation rate in March 2005.

The *causes* for the rise in food prices (excluding meat) are very similar to the factors behind the surge in meat prices. On the *demand* side, increased social transfers, higher average wages[5] and a considerable monetary expansion[6] in previous years contributed to higher prices for food (excluding meat). On the *supply* side, the high degree of protection inhibited imports and allowed prices for several food products (sugar, fruits and vegetables) to rise and stay above the world-market level.[7]

The identified determinants and their contribution to the rate of inflation are summarized in Table 1.

Item	Contribution in percentage points	Contribution in %
Meat and poultry	7.0	47.6
Food products (excluding meat)	3.8	25.9
Rest	3.9	26.5
Total	**14.7**	**100.0**

Table 1: Determinants of yearly CPI inflation in March 2005.

Based on the analysis above, we come to the following **conclusions**:

(i) The inflation rate of 14.7% yoy in March 2005 is determined to a large extent by the increase in the price of just *one* good, namely meat.

(ii) The combination of high protection from foreign competition and increased social transfers to the population explains the surge in meat prices and the high rate of inflation. Thus, the Government's trade and social policy are the main reasons behind the inflation problem.

[4] Food prices (including meat) increased by 19.2% yoy in March 2005. Prices for meat (a sub-category of food products) increased by 56.8% yoy. Since meat accounts for 20.2% of food products, meat contributed 11.4 percentage points to the increase in food products prices. As a result, prices for food products (excluding meat) increased by 7.8% yoy.

[5] Average wages rose by 30.7% from March 2004 to March 2005.

[6] To estimate the effect of monetary policy on inflation is an impracticable task, due to the fact that the consumer price index reported by Derzhkomstat covers only limited number of goods, mainly those consumed by low-income population. For that reason, CPI development is to large extent driven by changes in supply of agricultural products and is subject to strong seasonal fluctuations. In this respect, there is an urgent need for a better measurement of inflation in Ukraine.

[7] A further factor on the supply side is the increase in transport costs, following the rise in oil prices in recent months.

(iii) Therefore, the high rate of inflation should not be mainly explained by monetary factors and/or by monetary policy.

3. The role of Government in fighting inflation

(i) Measures to combat the high price of meat and food products

The Government has recently taken some measures to combat the high price of meat. Prime Minister Tymoshenko struck a "friendly deal" with Ukrainian poultry producers according to which poultry prices are supposed to be reduced by 15%. Dealing with pork and beef producers is much more difficult, because around 70% of raw meat is supplied by small farms. Consequently, a different approach has been chosen to deal with high prices for pork and beef. The State Material Reserve (Derzhreserve) has been ordered to buy meat directly from producers and sell the meat to consumers using the cooperative shops.[8] The Government tries apparently to reduce the price for pork and beef by "saving" the cost of intermediation between producers and consumers of meat. After some minor purchases by Derzhreserve in April, producers are reportedly not willing to continue to sell because of the low price offered by Derzhreserve. Thus, the scheme is not working properly.

In our view, both measures are of a questionable nature. Price regulation on the poultry market provides some relief in the short-run, but it does not solve the underlying, long-term problem of low efficiency in meat production. Moreover, the Derzhreserve scheme is doomed for failure. It is questionable whether the Government will be able to bridge the distance between producers and final consumers in a more efficient way than private enterprises. The high cost of bringing meat from producers to final consumers[9] is mainly due an inefficient production and marketing structure. Just by playing the middleman, the Government will not be able to reduce cost. Besides, such bureaucratic solutions to economic problems can open the door for corruption.

But if the measures taken by the Government were not the appropriate ones, which are the proper measures to deal with the problem? The answer is rather simple and straightforward: Reduce considerably the tariff and non-tariff protection of Ukrainian meat producers from foreign competition. Higher imports will increase supply and reduce the problem of high prices. Besides, foreign competition will put pressure for restructuring the inefficient meat sector, especially for pork and beef. The same line of argumentation applies for several further food products.

[8] Government also undertook "soft" measures, such as the requirement to organize special trading stands in open-markets for direct producers of meat, price monitoring, etc. But also these measures were ineffective.

[9] By mid-March 2005 the average farm-gate price for pork was UAH 11.2 per kilo (UAH 11,200 per ton) and the average price to final consumers was UAH 21 per kilo. (Sources: Ministry of Agrarian Policy, State Inspection on Price Control.)

(ii) Measures to reduce the demand-driven increase in meat and food prices

The political motivated social expansion, which started in September 2004, amounts to a major exogenous macroeconomic shock to the economy. At risk is nothing less than the public good "macroeconomic stability". The most obvious risk relates to fiscal policy. It is questionable whether the Government will be able to raise the additional UAH 20 bn in 2005 to pay for the extra social expenditures. Besides, this is a long-term problem, since social expenditure is re-current. But the social expansion posts also severe risks for price stability. The higher demand for food products from the low-income population drives prices up and creates inflation.

Instead of this sharp social expansion, we advocate a step by step approach. The changes in social expenditure should be more gradual and take place only after there is a solid base for their financing. More concretely, we propose to revise the recent social expansion. The increases in pensions and minimum wages should be more modest or be postponed for the future. This will help to save macroeconomic stability and in particular to combat the high rate of inflation. One should not forget that the main losers of high rates of inflation are low-income households. It make no sense to provide low-income households with some extra income, if this measure inevitably leads to a reduction in the purchasing power of their income.

4. The role of the National Bank in combating inflation

The National Bank seems to be very concerned about inflation, as it should be. Consequently, some measures were taken to combat inflation. From 15 April on, the regime of reserve requirements was sharpened. Among other things, cash in vaults of banks cannot be used anymore to fulfill the reserve requirements. This led to a reduction in liquidity in the banking sector and thus to less pressure on consumer prices.

In a further step to fight inflation, the National Bank revalued on April 21 the hryvnia against the US dollar from 5.19 UAH/USD to 5.05 UAH/USD. This revaluation comes on top of smaller revaluations steps since the start of the year, when the exchange rate was 5.30 UAH/USD. A revaluation of the hryvnia contributes to lower inflation through two channels. Firstly, the price for imported goods (mostly important oil and consumer goods) goes down when measured in national currency, which contributes to lower inflation. Secondly, over time the revalued hryvnia is likely to reduce the trade surplus. This in turn contributes to a lower excess supply of US dollars at the foreign exchange market and to lower levels of interventions by the National Bank. The result is again a more moderate growth of monetary aggregates, which will finally lead to a lower rate of inflation.

In our view, both measures were appropriate, since there is a need to fight inflation and the measures do contribute to lower inflation. But having said that, one should not forget that the main roots of the high rate of inflation are to be found in the real, not in the monetary field of the economy. Thus, the responsibility to reduce inflation should not lie with the National Bank alone. Ukraine should not further tighten its monetary policy and further revalue its currency to protect an inefficient agricultural sector and to maintain an unsustainable fiscal and social policy.[10] More generally, monetary and exchange rate policy should not be misused to combat structural problems.

5. Conclusions

The current inflation rate is very high, even for a transition economy such as Ukraine. Moreover, it is a clear sign of inadequate economic policies. The root of the problem lies in an excessively protectionist policy in the agricultural and food sectors and in unsustainable expansionary fiscal and social policies. Monetary expansion might have contributed to the inflation rate, but its effect has not been decisively. In order to solve the problem, it must be tackled at it's real roots. A better trade and fiscal policy is needed.

There might be a need to reformulate monetary and exchange rate policy in Ukraine in the near future. The NBU has to think about the adequate level of the exchange rate and whether further revaluations make sense. Also, it should be considered whether a more flexible exchange rate or the introduction of a currency basket as a target would be in the economic interest of the country. But whatever happens with monetary and exchange rate policy, it should not be conducted with the aim of solving structural and fiscal problems. The responsibility to solve the current problem of high inflation rate lies with the Government, not with the NBU.

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[10] A further revaluation of the hryvnia might make sense for other reasons. But this is not the topic of this paper.