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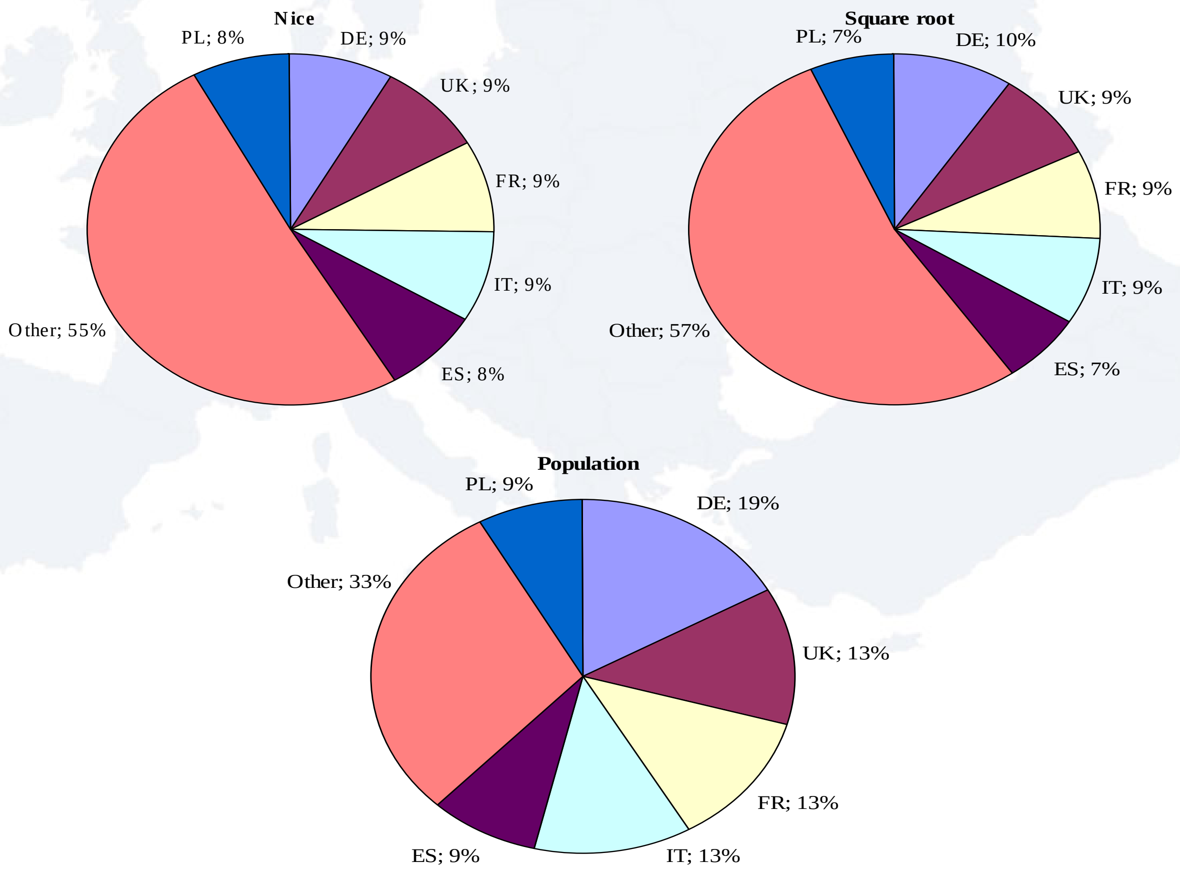
POLAND IN THE EU – OLD HISTORICAL WOUNDS, NEW ECONOMIC CONFLICTS

Since its accession to the European Union and especially under the leadership of the twin brothers Lech and Jaroslaw Kaczynski (president and prime minister, respectively), Poland has been seen and portrayed by many as a cumbersome troublemaker, flouting the well-established rules of the club and acting on old prejudices and historical wounds. In this analysis, we explore some of the recent controversies (such as last month's European summit and the Russian veto) and show that while Poland's behaviour is indeed partly rooted in old historical reflexes, it is far from irrational and can be seen as a response to recent economic and geopolitical developments.

VOTING POWER

Poland's hard-nosed bargaining was at display at last month's EU summit, where their opposition to new voting rules almost derailed an agreement on the new, modified constitutional treaty. The EU's main decision-making body, the Council of Ministers, reaches some of its less sensitive decisions with majority voting. In order to defend small states from being outvoted by a few large ones, the Treaty of Nice allocated voting powers so that it overrepresented small and medium sized states, giving Poland (39 million inhabitants) almost as many votes as Germany (82 million).

Chart 1. Voting Power Diagrams



Source: European Commission

According to the new Treaty discussed in last month summit however, all states would have voting power strictly proportional to their population size. Small states' right would be safeguarded by a formula called qualified majority voting (which requires that a motion be supported by at least 55% of the member states, which together represent at least 65% of EU's population). Because these new provisions would diminish Poland's voting power with regard to large states such as a Germany, Polish leaders vehemently opposed it, and instead proposed that voting power should be proportional to the square root of a country's population. (*Chart 1*)

While bargaining hardly for political influence is nothing new in the EU, Poland's stubborn behaviour was widely regarded as eccentric. The new voting system enjoyed the support of 25 out of 27 states, whereas only the Czech Republic supported the Polish position, and some of Poland's arguments (e.g. that it needs extra votes to compensate for the wartime population loss during World War 2) were rightly seen as irrelevant and unfair.

Earlier this year, Poland has vetoed the start of new EU trade talks with Russia, as a response to a Russian ban on meat imports from Poland. While many in the EU regarded the import ban unfair, the veto seemed to signal that Poland is willing to put its own interest above that of the EU as a whole.

Besides these developments, there are other signs that signal an uneasy relation between Poland and the EU and other member states. Polish politicians are sceptical about the euro and unenthusiastic about the reforms need to introduce it. The EU commissioner for economic and monetary affairs has complained about a lack of cooperation on Poland's side.

Many analysts and politicians have regarded these events as proofs that Poland is an inward- and backward-looking country, oversensitive about its historical grievances, which acts on its deeply held and irrational fears of malicious foreign interference, especially on the part of its large neighbours, Russia and Germany. This impression has been reinforced by the nationalistic rhetoric of many leading Polish politicians.

However, this analysis is many ways incorrect. First, it is quite natural that Poland defends its interests resolutely. Poland is one of the larger European countries, militarily strong and a key ally of the US, it is natural for it to join the club of the tough bargainers.

Moreover, much of what is seen as irrational stubbornness is in fact a rational answer to existing threats, such as the new German-Russian Baltic pipeline or Russia's growing pressure (meat import ban).

Russia, Gas and Beef

In 2005, under the auspices of then chancellor Gerhard Schröder, a Russian-German consortium of Gazprom (51%), E.on (24.5%) and BASF (24.5%) started the construction of a EUR 5.7 billion pipeline running directly from Russia to Germany under the Baltic Sea. The Nord Stream pipeline (which should start operation in 2010) thus bypasses Poland and other Central-European states and creates a direct link between Russian Federation and Western Europe. (*Map 1*)

Map 1. Nord Stream Pipeline

Source: Nord Stream

German politicians argued that the new direct pipeline would enhance the energy security of Germany and Western Europe. Poland, however, interpreted this event as a sinister and clever Russian move against Central European states. Not only do Poland and other states lose hefty transit fees because of the new pipeline. The separate infrastructure means that Russia will be able to blackmail Poland (and Ukraine) over energy supplies while continuing to supply Germany and Western Europe. Because of this, the cooperation of Germany in the project was seen as an act of betrayal by Poland: in their view, Germany in effect helped Russia to undermine Polish energy security. The general closeness of Germany and Russia under Chancellor Schröder has only added to the impression of Russia and Germany plotting against Poland.

In a broader sense, Poland's fears seem justified and point to an important problem: the lack of a common European energy policy. In the past years, Russia has been busy signing long term bilateral energy contracts with large Western-European companies, thereby eliminating the prospect of a strong common EU energy policy. Because of its vulnerable position, Poland is naturally sensitive to this issue and is probably right when complaining about a lack of solidarity on Germany's part.

The issue of the meat import ban should be interpreted in this context as well. Since November 2005, Russia has blocked meat imports from Poland citing food safety concerns (ironically, countries such as Britain have no such concern). Poland has interpreted this as thinly veiled political pressure with good reason and expected that its fellow EU members will side with it against Russia on the issue. When this failed, Poland has vetoed the start of new EU-Russia talks. This may have brought home the importance of solidarity to EU leaders, as during the 2007 May EU-Russia summit, both EC President Barroso and German Chancellor Merkel expressed that they stand with Poland in its dispute with Russia.

STYLE, SUBSTANCE AND SOLIDARITY

In short, Poland's behaviour in the EU was in part a rational answer to economic and geopolitical realities, and to a lack of solidarity on the part of Germany in particular and other member states in general. Nonetheless, this reaction was doubtless biased and distorted by historical prejudices. Talking of solidarity, it also needs to be added that Germany is the main "paymaster" of the EU, and Poland is one of the main financial beneficiaries, furthermore, in recent months, chancellor Merkel has made many concessions in order to restore a better German-Polish understanding.

Poland's hard-nosed bargaining in the EU, while perfectly legitimate and often right in its objectives, may well have been counterproductive in many cases. By dwelling on such lost issues as voting power, Poland may have alienated many possible allies (such as fellow sceptic Britain), and wasted a lot of bargaining power. There are many tough issues in the EU, which concern Poland deeply, such as energy policy, an eventual reform of the CAP, a common foreign policy, so it would be wiser for Poland to pick its fights more carefully and concentrate on those, which really matter.

In sum, bargaining behaviour of Poland in EU negotiations, while somewhat eccentric, does highlight real economic and geopolitical problems and dilemmas.

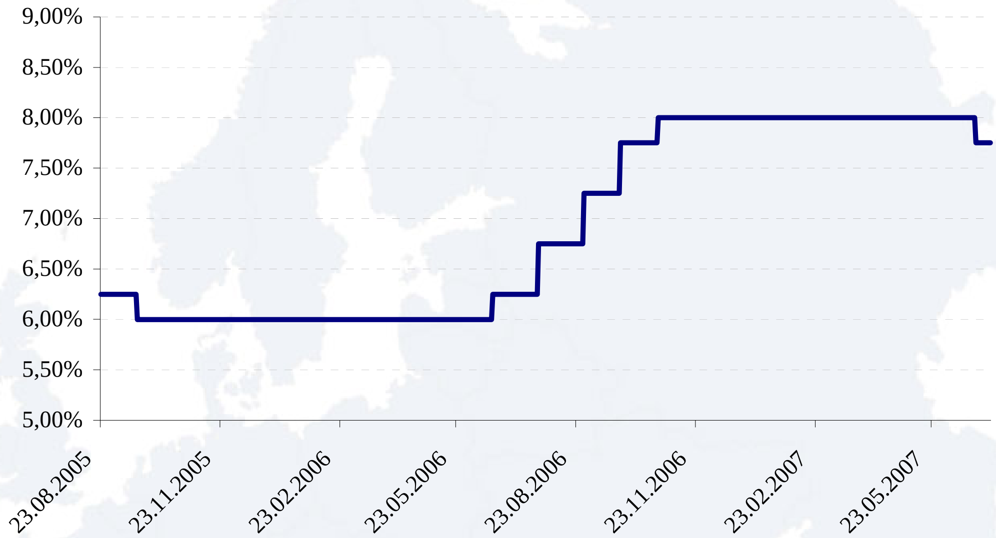
BREAK OF TREND IN THE HUNGARIAN INTEREST RATE PATH

On 26 June 2007, the Monetary Committee of the Hungarian National Bank voted to ease monetary conditions by 25 basis points interest rate cut to 7.75%. The decision seems to be the end of the 12-month tightening cycle, as the Hungarian monetary Authority did not take adjustment to easing since June 2006. (*Chart 2*)

BACKGROUND

As the Hungarian interest rate level is strongly influenced by global tendencies, it is worth having a look at main external monetary developments before giving an opinion about the modification.

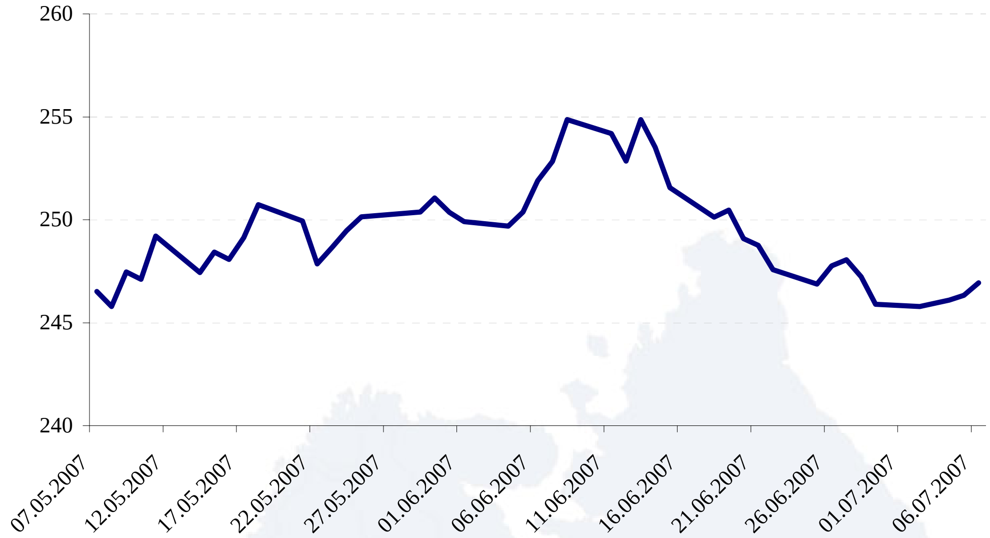
Chart 2. Development of Official Interest Rate in 2005-2007



Source: National Bank of Hungary

On the one hand, the American Central Bank, the Fed, has taken no interest rate move since August 2006, thus the American central bank base rate is stable at the rate of 5.25 %. On the other hand, on 6 June 2007, the European Central Bank decided to make a step to increase the interest rate level by 25 basis points to 4%. As *Chart 3* shows, the effect of this foreign step upon the main monetary indicator – the exchange rate – was unconsidered in Hungary. After the euro interest rate change, the forint got into a quite considerable depreciating period, reducing from HUF/EUR 249 to HUF/EUR 254.9; but after a week, a trend change happened in the exchange rate performance and the conversion between the Hungarian forint and the euro returned to be around HUF/EUR 246-247. This means, that the foreigners abode the lowered risk premium for Hungary, so they evaluate the country risk lower than before.

Chart 3. Exchange Rate Development in Hungary in May – July 2007



Source: National Bank of Hungary

OFFICIAL EXPLANATION

After the interest rate adjustment, the President of the National Bank designed the reasons from the Monetary Council decided to lower the interest rate spread. The Monetary Council's main reasons can be summarised in three bullets.

1. "…The data for the past month provides evidence, that inflation has passed its peak. The seasonally adjusted month-on–month rate of core inflation has fallen to 3%, a level consistent with the price stability. Against this background, the risk of inflation remaining stuck at elevated levels appears to have eased. Domestic demand has been rising at a moderate pace, broadly in the line with the Council's expectations…"

2. "…According to the wage data for April, the rate of nominal wage growth in the private sector continues to rise, however the changes to labour market and taxation rules distort the official numbers. After eliminating the labour market and taxation distortion, it seems that the rate of wage growth has not picked up further. In addition seasonally adjusted month-on-month rate of wage growth also slowed…"

3."…The reduction in uncertainty around the outlook for inflation has made it possible for the Bank to reduce the policy rate in line with the market's favourable sentiment about Forint-denominated assets…"

FACTS

The 25 basis points reduction is indeed signalling. Namely, the National Bank of Hungary attempted to transmit the esteem of the Monetary Committee. It can be summarised as the following. The uncertainty in the Hungarian economy has decreased; moreover there is a trend change lately; which cause lowering inflation in the next period. That gave an impetus to the Hungarian National Bank (MNB) to change its conditions by cutting back the central bank base rate to 7.75

Why reaching low inflation level is so important for Hungary abide the well-known anti-inflation policy reasons. One should highlight at least two main reasons. First is the extant inflation targeting regime in Hungary from 2001, the other is the planned accession to the European Monetary Union for adopting the euro as soon as possible and its document called Convergence Programme.

From 2001, the Hungarian Monetary Authority has been operating in an inflation-targeting regime, which means that the National Bank envisages the inflation target directly and commits itself to keep this aim. In this system, expectations and credibility of the national bank are the most important factors. Credibility makes national bank able to navigate expectations and the expectation is the basic of the inflation developments. As the inflation target of the Hungarian National Bank is 3% from 2007, it is naturally, that it would like to convergence to this level.

From the EU-accession in 2004, Hungary has the aim to adopting the euro. It has some well-known requirements, which a country has to meet for this objective. One of them is the inflation-abolition. Another indirect requirement influenced by the inflation, is the ERM II membership. ERM is the Exchange Rate Mechanism, in which the country must represent that its currency can be stable during a longer – 2-year period. Inflation can generate incredibility, which makes exchange rate more volatile and the exchange rate band is hard to hold up. The conclusion is that, economies described by high inflation should not join the ERM-II system, because of the high risk of high exchange rate volatility.

Two reasons were detailed in the previous paragraph, which makes reaching low inflation level fair important. Nevertheless, how the National Bank of Hungary can have effect on this main economic index? The Monetary Authority has an indirect instrument, which could control the inflation, namely the interest rate.

There are two channels, through the monetary easing influence the inflation level: the interest rate channel and the exchange rate channel. When National Bank cuts the base rate, it leads market deposit and lending rate to change – drop – as well, since commercial banks' sources (from the National Bank) become cheaper. As consumers could invest or consume, decreasing rate of return makes them increase their consumption. Higher demand generates higher consumer prices, higher inflation. It is said to be the interest rate channel.

On the other hand, base-rate cutting diminishes interest rate spread, which means: home-currency-denominated resources turn to be less attractive. It weakens the home currency, and makes import goods more expensive through the exchange rate movements. Its spillover effect into the hone prices will also increase the home inflation. It is called exchange rate channel.

In fact, the National Bank of Hungary ascertains the interest rate trajectory in the function of the expected path of the home CPI – inflation (consumer price index) and not just from the past price development's trend. After reconsidering these processes, the conclusion is, that the National Bank of Hungary takes decreasing (ore yet decreased) inflation-risk into account in the ulterior period.

SUMMARY

Analysing the interest rate decision of 26 June, one can declare that the 25 basis points careful interest rate cut was rather a signal step, than a quantity decision. The Council's perception has been changed about the future inflation risk and it wanted to emphasise this process and deliver its approach to the market players. The interesting question of the next period: is the interest rate step the start of an easing-period or market should wait for the next adjustment for a while?

COMPETITIVENESS OF THE LEAST-DEVELOPED REGIONS IN V4

Nowadays the concept of competitiveness is used very often. It seems to be accepted in wide range that not only companies but also regions compete with each other. There is no single definition for competitiveness accepted. By definition of European Commission, the competitiveness is "the ability of companies, industries, regions, nations and supra-national regions to generate, while being exposed to international competition, relatively high income and employment levels".[1]

The analysis deals with the competitiveness of the least-developed NUTS-2 regions with smallest GDP per capita located in four Visegrád countries (V4): *Stredni Morava* (Czech Republic), *Észak-Alföld* (Hungary), *Lubelskie* (Poland) and *Vychodne Slovensko* (Slovakia). The competitiveness of these regions is analysed by indicators based on two measurable concepts found in the EU-definition (income, employment)[2] in the period 2000-2004[3], investigating whether the differences among regions as among countries are similar.

REGIONAL INCOME

The regional income can be examined by two ways. The income coming from the economic activity, which can be measured by the GDP per capita and households' disposable income, which refers to the welfare of inhabitants are taken into consideration.

According to Eurostat data for 2004, the GDP per capita in the Czech region, Stredni Morava reaches almost 59.8% of the EU-27, while the other three regions perform much worse: the Slovak Vychodne Slovensko reaches 42.3%, the Hungarian Észak-Alföld 41.9% and the Polish Lubelskie 35.2%. This predicts that the Czech region is the most developed.

Chart 4 shows the GDP per capita in the examined regions. In 2004, the highest GDP per capita can be found in the Czech one that outstrips the Hungarian, the Slovakian and the Polish, respectively. The Hungarian and the Slovakian region are quite similar in this condition. Concerning dynamics of GDP per capita growth from 2000 to 2004, the highest pace of growth was in the Hungarian Észak-Alföld (32%), then in the Slovak (28.5%), in the Czech (22%) and finally in the Polish Lubelskie (16.5%).

The disposable income of households shows somewhat different picture (*Chart 4*). The Czech region has the highest level, while the three other ones have similar level by 2004 data. It is crucial to see that this equal situation was achieved by different performances from 2000. In Hungarian region this indicator increased by more than 27%, while the remaining regions of others has disposable income growth of 13-16%.

According to the examined data, one can see that the Czech region, Stredni Morava has the highest GDP per capita and disposable income in the examined years, though the Hungarian Észak-Alföld performs the best in the period of 2000-2004 – since the highest growth in the GDP per capita and the disposable income was experienced here.

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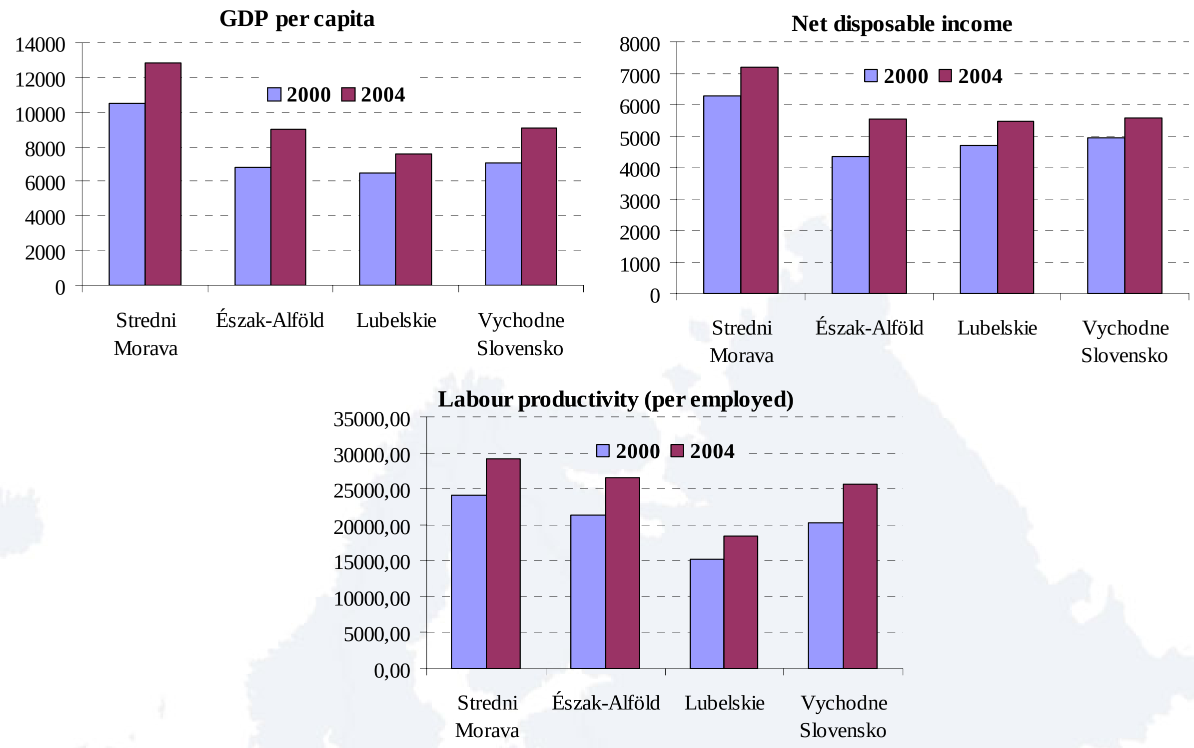
[2] Because of the lack access of regional data, it is assumed – because the countries, where these regions are located, are not closed countries – that the regions take part in the global competition.
[3] In case of some indicators newer data are unavailable, because of the ability of comparison the second year is 2004.

Chart 4. GDP per Capita and Households' Net Disposable Income in 2000 and 2004 (PPS)



Source: Eurostat

EMPLOYMENT AND LABOUR PRODUCTIVITY

Concerning the employment rate, the Czech region possesses the most favourable indicator in 2004 than any other region. Nevertheless, it has to be taken into consideration that only one region could increase the employment rate, namely the Hungarian Észak-Alföld – despite the lowest initial employment level. All other regions experienced decline in employment rates. (*Table 1*)

Table 1. Employment and Unemployment Rate in 2000 and 2004 (%)

Region	Employment rate		Unemployment rate	
	2000	2004	2000	2004
Stredni Morava (CZ)	62.7	61.8	10.6	9.8
Észak-Alföld (HU)	49.0	50.4	9.2	7.2
Lubelskie (PL)	58.6	54.5	14.1	16.7
Vychodne Slovensko (SK)	52.3	51.8	24.0	24.2

Source: Eurostat

As for the unemployment rate, the lowest unemployment rate can be experienced in Észak-Alföld. What is more, this rate decreased by 2 percentage points during the investigated period. The Czech region also achieved drop in unemployment, while others increased its relative number of unemployed. The situation is the worst in Vychodne Slovensko with extremely high and growing unemployment rate. Lubelskie is the region, where the unemployment rate increased with the highest extent (by 2.6 percentage points).

Regarding labour productivity (*Chart 4*) Although the highest indicator can be found obviously in the Czech region. Észak-Alföld and Vychodne Slovensko seem to near Stredni Morava – owing to very fast improvement in productivity – the labour productivity reaches the Czech region's 90% in case of Észak-Alföld and 88% in case of Vychodne Slovensko in 2004. Lubelskie cuts a poor figure, as its indicator reaches only the 62-63% of the Czech region. It is even surprising as its initial productivity level is a good opportunity for faster development.

CONCLUSION

To give a single picture of the regions' relative position, their rank has been determined in case of each indicator used and finally a final score has been created (*Table 2*). It is fair to mention that concerning absolute numbers the Czech Stredni Morava region seems to be the most developed with its highest GDP per capita, employment rate and labour productivity, forestalling the quite similar Hungarian and Slovakian region and the least developed Polish one.

At the same time, it is more important to base the ranking on the dynamic parameters. From this point of view, the Észak-Alföld region achieved the best performance outpacing Vychodne Slovensko, Stredni Morava and finally Lubelskie.

Table 2. Ranking of the Regions

Indicators	Stredni Morava (CZ)	Észak-Alföld (HU)	Lubelskie (PL)	Vychodne Slovensko (SK)
Growth of GDP per capita	3	1	4	2
Growth of households' income	3	1	2	4
Change of employment rate	3	1	4	2
Change of unemployment rate	2	1	4	3
Growth of labour productivity	4	2	3	1
Summa (Final score)	15	6	17	12
RANK	**3**	**1**	**4**	**2**

Source: own calculation

The EU-definition for competitiveness requires permanent relatively high income and employment level. With watching the strict sense of the definition, we could mention that although Stredni Morava possesses the highest value of the examined indicators, Észak-Alföld is the only region where favourable changes happened from 2000 by 2004 on every field (income, employment and labour productivity). Észak-Alföld is the only one where not only the income of the economy and that of the households increased but also the employment rate – while the unemployment rate decreased. Therefore, the Hungarian region managed to improve its competitiveness.

As a conclusion, it is fair to mention that the results of analysis refer to the period of 2000-2004 because of restricted availability of regional statistics. It is obvious, that many considerable changes have happened since 2004, just referring to agonising Hungarian growth following considerable fiscal adjustment efforts, while booming Slovakian, Polish and Czech economy.

UKRAINE PERFORMED TWO-DIGIT INFLATION RATE IN 2006

The inflation rate (measured by the Consumer Price Index) has risen rapidly in the last few years. It reached its peak in 2005, when CPI inflation was 13.5% year-on-year in average and amounted to 10.3% year-on-year at the end of the period. Although many of the forecasts said that the inflation rate will decelerate and perform a one-digit rate in the year of 2006, the consumer prices increased by 11.6% year-on-year. Thus, inflation remained above 10% for the third year in a row, instead of a gradual decrease, as was expected before.[4] In addition, it is important to note that expectations cannot take into account such external factors as the Russian gas price rise during the winter of 2005.

RELATIVE STABILITY AND STEADY INCREASE OF CONSUMER PRICES

The Ukrainian transition economy achieved some macroeconomic stability in 1996 after sharp economic decline and hyperinflation. After the introduction of the new national currency, the hryvnia, one digit price increase was only achieved in 2001, when the inflation rate dropped from 25.8% to 6.1%, year-on-year. Following the switch from managed peg to free float, the National Bank of Ukraine (NBU) started pursuing a tight monetary policy to fight inflation in January 2000. CPI growth rate declined already in February by 0.9% month-on-month.

The relative stability could be preserved until the end of 2004. The three main factors that contributed to the first year when double-digit inflation rate occurred were the followings: summer increase in gasoline prices, end-year fiscal expansion and the low supply of some agricultural products, which obviously pushed the prices up. Until the year of 2005 even a constant growth in GDP could be observed, which broke a record in 2004 with a year-on-year 12.1% real growth. Because of the decline, real GDP grew by 2.4% in 2005, due to lower growth rates in industry, construction, trades and seasonal slowdown in agriculture. The lack of political stability during the elections in November-December - which lead to the "Orange revolution" - also contributed to the rapid deceleration.

Table 3. Key Economic Indicators 1998-2006

Key Indicators		1998	1990	2000	2001	2002	2003	2004	2005	2006
Nominal GDP	USD billion	41.9	31.6	31.3	38.0	42.4	50.1	65.0	86.2	106.5
Real GDP Growth	% yoy	-1.9	-0.2	5,9	9.2	5.2	9.6	12.1	2.7	7.1
CPI	% yoy eop*	20.0	19.2	25.8	6.1	-0.6	8.2	12.3	10.3	11.6
PPI	%yoy eop	35.4	15.7	20.8	0.9	5.7	11.1	24.1	9.5	14.1
Monetary Base	%yoy eop	21.9	39.3	39.9	37.4	33.6	30.1	34.1	53.9	17.5
Exchange Rate	USD eop	3.43	5.07	5.44	5.30	5.33	5.33	5.31	5.05	5.05

** eop = End of period*
Sources: Derzhkomstat, NBU, IFS, Ministry of Finance

According to Derzhkomstat - the State Statistics Committee of Ukraine - the Consumer Price Index topped at 14.9% year-on-year in August 2005. Concerning food products, one of the major determinants of high rate inflation was the increase in price for meat. From March 2004 to March 2005 the price for meat increased by 56.8%[5]. Both supply and demand factors

[4] Decelerating, but Still High Inflation in Ukraine (2005. November): ICEG European Center - News of the Month, page 13.
[5] OECD and World Bank (2004): Achieving Ukraine's Agricultural Potential: Stimulating Agricultural Growth and Improving Rural Life.

contributed to higher meat prices, the combination of lower supply and higher demand explains the huge increase. Monetary expansion was not the only cause of the problems; the high protection of foreign competition and increased social transfers to the population at this time did not support the development of the inflation rate. The first step towards deceleration was made in October when domestic meat prices were reduced while gasoline prices started to go down at the same time, which led to the reduction of world oil prices. In addition, the National Bank of Ukraine was also in the favour of the inflation policy by revaluing the hryvnia against the US dollar from 5.19 UAH/USD to 5.05 UAH/USD in April 2005. The revaluation of the official currency contributed to lower inflation by boosting import in the country and reducing the trade surplus over time.

Table 4. Determinants of Annual CPI Inflation in March 2005.

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**

Source: State Statistics Committee of Ukraine

HIGH EXPECTATIONS, HIGH INFLATION RATE

In accordance with various forecasts by the Institute for Economic Research and Policy Consulting[6], the consumer price inflation was expected to stay within the double-digit level until the end of 2005 due to both supply and demand side pressures, such as growing household consumption and increase of fuel prices. In 2006 inflation was expected to be more cost-driven, transportation and utility tariffs were thought to be revised after parliamentary elections. Taking into consideration that private consumption pressure even strengthened since wages and social benefits rose significantly, the inflation forecast for 2006 was still somewhat lower than 9.6%. High expectations for the deceleration of consumer prices were supported by such factors as the expected membership in the WTO - which would definitely lead to tariff reductions on agricultural and food products - and the development of a more sustainable, less expansionary fiscal and social policy.

Although in January 2006 consumer price growth decelerated to 9.8% year-on-year, acceleration was expected in March due to moderate agricultural harvest and increased gas prices. Unanticipated rapid growth in sugar prices that surged by 25% over month caused the temporary speeding up of the inflation rate, pushing food-product prices up to 11.4% year-on -year and the CPI level to 10.7% year-on-year. Domestic sugar prices stabilised soon at a higher level than before, but non-food product prices increased at the same time as well as services tariffs.

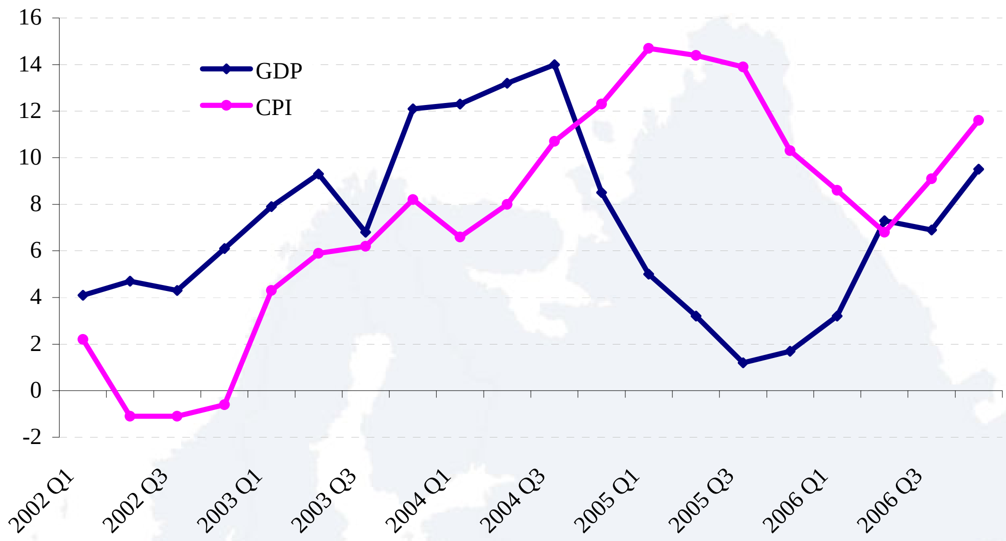
KEY FACTORS OF PRICE GROWTH

In the first quarter of 2006, monetary policy had to face political uncertainty due to elections. Moreover, Russia banned its imports from Ukraine. As a result, consumer price growth decelerated again by the fall of food prices. The consecutive slowdown of inflation stopped

[6] See Veronika Movchan, Ricardo Giucci (2005. September): Macroeconomic Forecast Ukraine, Institute for Economic Research and Policy Consulting, Forecast no. 2 (8)

after five months, in July. Moderation of price growth can be attributed to further ban of exports of dairy products to Russia, but inflation was predicted since increase in administratively regulated tariffs such as gas tariffs was announced. In May, energy prices and tariffs increased by 19.9% that were not offset by the run of food prices (especially sugar and potato prices) anymore.

Chart 5. Consumer Price Index and Real GDP Growth 2002-2006 (quarterly, y-o-y)



Source: State Statistics Committee of Ukraine

Despite political turmoil, real GDP Growth was speeding up constantly, explained by the expansion of industrial production and high growth rates of services. On the demand side, economic growth can be attributed to the development of households' consumption trends (19.7% year-on-year growth) and the recovery of investment activity. Governmental subsidies and growth of real wages caused gradual increase in consumption, which was the key factor of inflation besides the steadily increasing gas tariffs and further ban of exports to Russia.

Ukraine even faced comparatively low rates of monetary expansion this year. From August, only stable prices on imported consumer goods were favourable to the inflation rate, but it was not enough to offset the abrupt rise in petroleum product prices. The growth of utility and in particular, electricity tariffs for households by 25% contributed to the jump of inflation to 11.0% in October. With the unexpected rise of the prices of food products, Ukraine closed the year of 2006 with a CPI inflation that amounted to 11.6% year-on-year, which rate remained in the double digits for the third year in a row.

Concluding Remarks

Expectations concerning the development of consumer prices were wrong in the sense that Ukraine did not perform one-digit inflation rate in 2006. Although CPI rate slowed to 6.8% year-on-year in the middle of 2006 because of favourable food market conditions and export restrictions to Russia, unexpected increase of food and imported gas prices, continuously growing consumption rates and sharp increase in utility tariffs drove inflation above 10% again in the second half of the year. The government was optimistic about Ukraine's accession to the WTO however, due to the lack of legislation and ratification of the WTO membership agreement it had to be delayed. Accession to the WTO could have moderated trade restrictions and protectionist governmental policy that put remarkable pressure on domestic price developments. Ukraine faced a consumption boom in 2006, real final consumption of households increased by 20% year-on-year. The boom can be explained by the strong increase in household income – real wages grew by 18.4% year-on-year in 2006 -, social transfers and easier access to credits. Expansive fiscal policy and wage developments threatened the economy with wage-inflation pressure as well.

Although in January 2007 CPI growth rate amounted to 10.9% year-on-year, in this way marking an end of six-month CPI acceleration, annual inflation is still expected to remain in double digits as a result of rise of food prices, wage increase in the public sector and government policy concerning regulated prices. Longer-term disinflation could not be achieved since the temporary fall of food prices was counterweighted by the increase of minimum wage and subsistence minimum already in March. The 17.5% year-on-year growth of real household incomes in the first four months is likely to speed up later this year, - caused by further increase in wages and pensions - contributing to higher consumption growth and accelerating inflation rate. CPI inflation peaked at 13.0% year-on-year in June as grain prices increased due to expected poor harvest and growth of world prices. Besides continued rise in food prices, the ongoing political crisis did not affect inflation significantly yet, although the election campaign and governmental decisions may shape inflation development in the next several months.