ICEG EUROPEAN CENTER

# NEWS OF THE MONTH
## *on EU-8 and CIS*

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## **News of the Month,** *on EU-8 and CIS*

The ICEG European Center issues its monthly publication, which includes 3-4 brief analyses dealing with underlying macroeconomic and microeconomic issues. The publication focuses on two groups of countries: *Countries of Independent States - CIS* (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) and *Eight New Member States – EU-8* (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia).

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# Chances of the minority government in Hungary

*Tamás Borkó and Gábor Pellényi*[1]

The Hungarian left-liberal coalition fell apart in spring 2008. The immediate reason was the dismissal of the Minister of Health (Alliance of Free Democrats) by Prime Minister Ferenc Gyurcsány (Hungarian Socialist Party) without consulting the coalition partners. This came after the devastating defeat of the government at the referendum held on symbolic reform measures in education and health care. The practical reason was, however, the continuous fall in popularity as a consequence of widely unsupported and unfavourably structured fiscal adjustment and public finance reform measures.

Since May 2008, the Socialist Party governs in minority. Theoretically, this formation can scrape through until the 2010 elections. In reality, the case for early elections is strong. The "conventional wisdom" of political economy literature on minority governments refers to their ineffectiveness in terms of policy-making. Even worse, minority governments tend to bring larger budgetary deficits in times of macroeconomic distress. But what does the practical experience of other Central Eastern European countries suggest?

## Mixed results in the Czech Republic

The Czech Republic already has an established tradition of minority governments as the electoral and political system tends to create weak governments. Proportional representation makes it difficult for any party to gain majority on its own. The communist party constantly has over 10% of seats in the lower house, but they are shunned by major parties; coalition partners are thus harder to come by. Finally, the lower house curiously has exactly 200 members. This can result in a stalemate, just as in 2006, when both the left and the right gained 100 seats.

Weak governments tended to shy away from "deep" reforms in the 1990s. Václav Klaus, then prime minister, declared as early as in 1994 that economic transformation was completed. However, corporate restructuring and reforms to public services (including health care and pensions) were largely avoided. This required high taxes to achieve a balanced budget, a cornerstone of the much-celebrated macroeconomic stability of the Czech Republic in the early 1990s.

The turning point came in 1997 as a devastating currency and banking crisis hit the Czech Republic. After the introduction of inevitable austerity measures the centre-right government of Václav Klaus (in office since July 1996) collapsed in November 1997 and a caretaker government ruled the country until early elections in June 1998. The centre-right was ousted from power but the social democrats failed to achieve a majority. However, the new premier, Milos Zeman struck an agreement with Mr. Klaus. This allowed his government remained in power for its full term with the outside support of the centre-right parties. The cooperation also permitted economic reforms which led the country out of the crisis.

The 2006 elections led to another prolonged paralysis. This time there was no agreement between the left and the right. The first centre-right cabinet of Mirek Topolánek failed after just 30 days. However, the second one has already survived three votes of confidence thanks to the external support of three left-wing MPs turned independent. Defying predictions, Mr. Topolánek managed to pass a fiscal reform package through the legislation last August. This includes spending cuts, co-financing in health care by patients and a flat tax regime. However, the delicate position of Mr. Topolánek means that some of his plans (including reforms to the civil service) may not come to reality.

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[1] The original version of this article was published in the Business News, the official publication of the British Chamber of Commerce in Hungary, June 2008

## Inevitable early elections in Slovakia and Poland

Slovakia had a minority government from late 2005, when the centre-right pro-reform coalition led by Mikulás Dzurinda disintegrated. Two parties of the coalition left following the halt of negotiations over a treaty with the Vatican. The government of Mr. Dzurinda held only 58 of the 150 seats in Parliament, but they were able to introduce some further measures, especially as the disagreement was based not on economic issues. However, early elections were unavoidable despite robust economic performance; they took place in June 2006.

In Poland the parliamentary elections in September 2005 ended without a definite winner despite the overwhelming victory of two centre-right parties, the conservative Law and Justice (PiS) and the liberal conservative Citizens Platform (PO). However, ideological differences were so great that a coalition between the two dominant parties was impossible. In the end Prime Minister Kazimierz Marcinkiewicz of PiS formed a minority government. After negotiating for almost half a year, in April 2006 he gained the support of the populist Self Defence and a few dissident MPs of the ultra-Catholic League of Polish Families. However, this coalition remained in minority.

The newly formulated government proved unsustainable. It left no mark beyond a hard-headed foreign policy, heated debates and some anti-corruption measures The PiS, recognising the long-term risk of its falling popularity, took the initiative and called a snap election for October 2007. All parties except the two junior coalition partners agreed to dissolve the Sejm (the parliament). However, the reputation of PiS and its partners was hurt beyond repair: they were ousted from the government. Self Defence and the League of Polish Families also failed to cross the 5% threshold and lost all their parliamentary seats. Prime Minister Donald Tusk of PO formed a coalition government with the People's Party.

## The real test comes in autumn

The experiences of the minority governments in the region are not particularly promising. In the Czech Republic only a grave economic crisis could bridge the gap between government and opposition, but consensus dissolved as soon as the immediate danger was over. In Slovakia and Poland minority governments tended to lose support and admitted the need for early elections.

Conditions in Hungary do not favour a lasting minority government either. Economic performance remains abysmal and public finances still require some deep-reaching reforms. As ideological and personal conflicts are apparent, the reigning government has no possible allies in the parliament.

The first weeks of minority government passed without serious difficulties. However, no hard decisions had to be made yet. The real test will be the 2009 budget: it will have to strike a balance between the needs to reduce the deficit, to woo voters and to please businesses. Meanwhile, all opposition parties would like to see tax cuts. If they vote in concert to achieve this, they can sabotage the budget (and the convergence programme). However, two factors reduce the incentive to obstruct budgeting. First, this would be a dangerous game: a loss of confidence by investors could still trigger capital flight and a massive devaluation. Second, early elections would also lead to the ejection of the Free Democrats from Parliament. Expect a summer busy with horse-trading, and a long, hot autumn.

# Monetary reactions on global challenges in the V4 countries

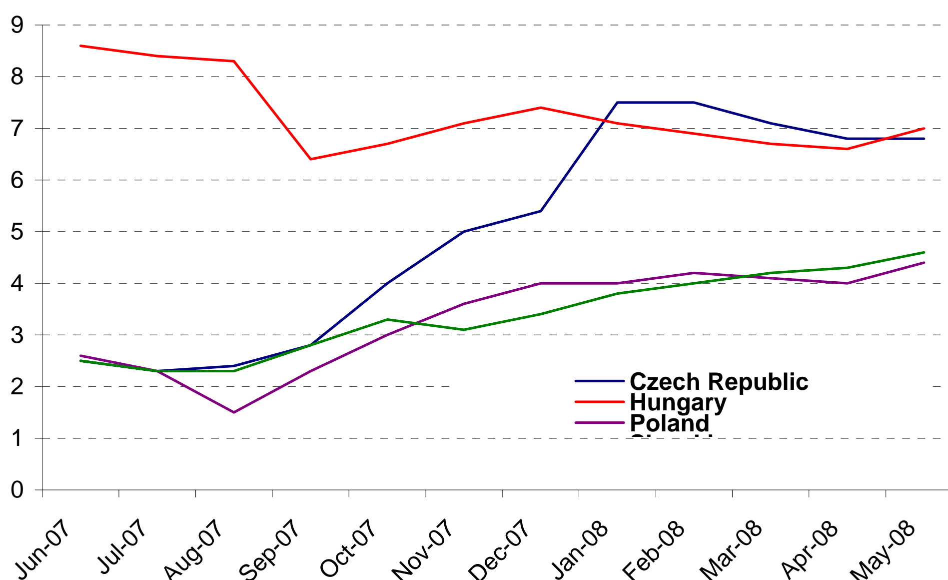
*Ákos Réger*

Nowadays, the world economy has to face new challenges. Growing global food end energy prices seem to be global problems which have harmful effects on the economies of all over the World. Although the 12 new members of the EU make up one of the most prospering region, the phenomena cannot be avoided or neglected. This short analysis is focused on the monetary reactions generated by external economic factors – mainly price level growth and exchange rates developments – in the four Visegrad countries (Czech Republic, Hungary, Poland and Slovakia).

## Inflationary pressures

Among others, significant increase of oil prices, sub-prime crisis in the United States, deteriorating agricultural productivity but widening demand for food and therefore rise in food prices are the main problems that nowadays the world economy has to struggle with. The Visegrad countries deeply got into the mainstream of the world economy, for this reason, the boost of world market prices also raises the consumer prices in the V4 countries. Although inflation has generally been diverse among the countries, the change in the consumer price indexes has been showing an increasing trend in all countries in question. However in Hungary, the inflation rate has been all the time high in the last months – no significant change in pace can be modelled. (*Chart 1*)

**Chart 1. Inflation rates (%, yoy)**




*Source: Central Banks of the Czech Rep., Hungary, Poland, Slovakia*

Even though the level of inflation rate is lower in Slovakia and Poland than in the Czech Republic or Hungary, former inflationary expectations of the central banks have been exceeded. For a long time, monetary policy-makers have been too optimistic with their predictions compared to the realised values. Except Slovakia – that has been officially accepted to join the euro zone –, the Visegrad countries should effectively tackle the rising inflation. Otherwise the related Maastricht Criteria will not be fulfilled.

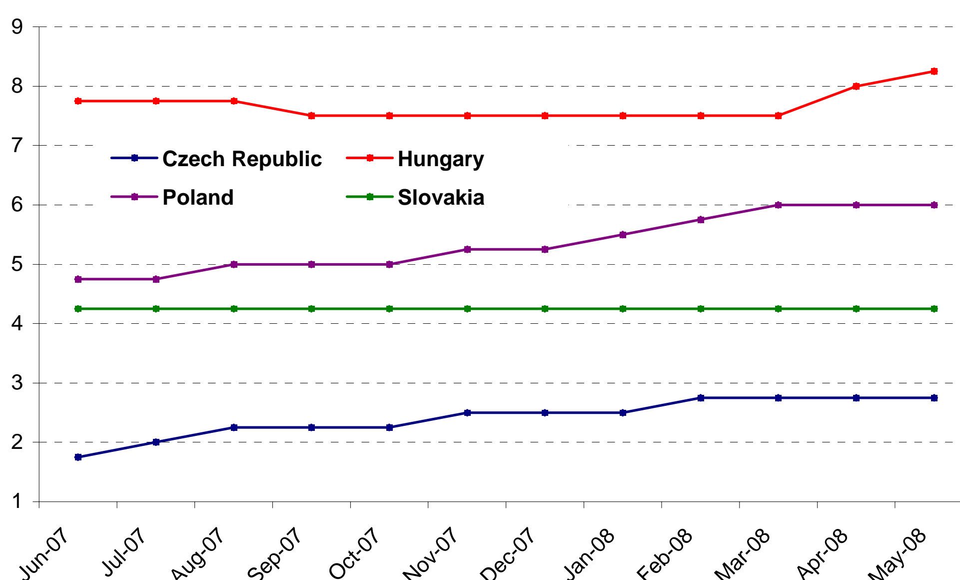
In Slovakia and Poland, mostly the external circumstances are leading to the increase of prices. At the same time, in the Czech Republic and Hungary, higher inflation rates are also generated from inside. Last year in

Hungary and this year in the Czech Republic, the headline rate of inflation was boosted by several policy measurements (e. g. raising tax rates, excise duties, price deregulation) and by the unstable political situation.

On the one hand, the obligation of the convergence reports and the monetary policy systems of the V4 countries affect the central banks. All of them follow an inflation targeting system which aims at a low inflation rate in the long-run. According to the rule of thumb of the monetary policy, too high inflation rate can be fought by raising the interest rates. If interest rates are higher, the economic actors extend their savings and decrease their level of investments and consumptions. This results in a lower cost-push as well as a lower demand-pull inflation.

Although the reaction of the economy to alterations in the base interest rate is time-lagged, the monetary policy has immediate effects on markets as well. The increase of the interest rate depreciates the growth of prices, even in the short-run: change in future expectations can generate immediate reactions.

**Chart 2. Policy interest rates**




*Source: Central Banks of the Czech Rep., Hungary, Poland, Slovakia*

However, not all the Visegrad countries' central banks seem to follow this basic rule. The immediate answer realised by the monetary policy for inflation shocks characterises the Hungarian and Polish central banks, but not the Czech, and not even the Slovak one. (*Chart 2*) The Hungarian central bank has been trying to impede strong inflationary pressures by strict monetary policy, meaning that the central bank raised the base interest rate to an extremely high level. As a result, the Hungarian nominal rate has become the highest in the region. The same policy measurements were observed in Poland: the base interest rate has been by two percentage points higher than the actual inflation rate. As a consequence these countries achieve the objective of inflation targeting by strict interest rate policy.

As for the Slovak central bank, they have not changed the interest rate for more than one year. They did not have any reason to raise it hastily as the increase of prices has been kept under the base interest rate (and the Maastricht criteria, too). This is not the situation in the Czech Republic: the inflation has speeded up lately, despite the interest rate has remained much lower than the inflation. The Czech central bank does not raise the interest rates because they claim that the inflation is not generated merely from inside: the inevitable effects of world market prices of oil and food cannot be abolished by internal monetary actions.

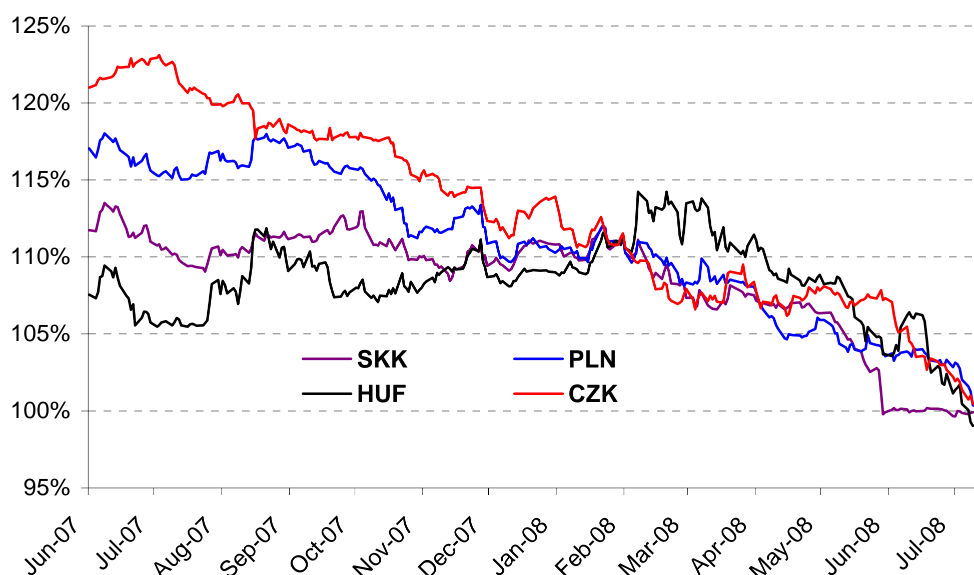
## The role of exchange rate

Beyond immeasurable factors like inflation expectations or output-gap alterations, there is a substantial and more measurable element which is driven by the change of prices in a country: the exchange rate.

The economy of the Czech Republic operates in the so-called managed floating regime, meaning the exchange rate is floating, but the central bank may turn to interventions should there be any extreme fluctuations. In contrast to the Czech economy, in Slovakia the euro has been the anchor currency since 1999, and now – as the official conversion rate is decided – the Slovak system can be seen as fixed. The Polish currency is determined by a floating exchange rate that is not subject to any restrictions. The same exchange rate policy has been conducted in Hungary, however, only for a couple of months, since the exchange rate bands were abolished.

Inflation and the interest margin are the two main factors which generate upward exchange rate pressures. In the Visegrad countries the exchange rate has been strengthened in the last months. (*Chart 3*) The reasons are mainly the interest margin and inflation, but the significant cross-country effects – which are very typical of the region – have important role, too. There are observable impacts of the given up exchange rate bands in Hungary and the revaluation of the currency against the euro in Slovakia. The exchange rate of the SKK fluctuates around the appointed conversion rate.

**Chart 3. The currencies of the V4 countries against the euro (in percent of the recent value, 2008.07.15 = 100)**




*Source: European Central Bank*

There is a conspicuously strong correlation concerning the variables of the former chart: last year, all four currencies went through a considerable appreciation against the euro. The Czech Crown has been appreciated approx. by 23 %, the Polish Zloty by 18 %, the Slovak Crown by 13 % and the Hungarian Forint by 10 %.

In case of the Hungarian forint, the appreciation rate grows up to 15 % in total, as we should compare the recent exchange rate value to the rate in February 2008 when the central bank introduced the free floating regime. I assume that the revaluation of the forint could have begun earlier if the edge of the managed floating system's strong band had not hindered the market mechanisms. In fact, the appreciation of the currencies was in favour of the growth of the price index. If the currency appreciates, exports drop and

therefore it results in a slower GDP growth**.** Adding the effect of lower investments and consumption, this could cause a heavy decrease in the GDP. At the same time, the strong exchange rate keeps inflation rate down in small open economies by decreasing the price of imported goods.

Appreciation of the currency seems to be a double-edged sword: it has a smaller positive impact on inflation and can be more harmful for the export sector and the whole economy. However, it is still not visible in the Visegrad countries: the GDP growth remains relatively high, with exception of Hungary.

## Conclusion

The main economic problems central banks of the V4 countries have to face arise from external sources, namely the increasing food and oil prices. However, the internal policy of a country had and has undeniable influence on the level of inflation.

Whereas in Slovakia and Poland, the increase of prices is still acceptable, in Hungary and in the Czech Republic the inflation has hit a critical level. In fact, the inflation has been rising in all countries recently – except Hungary where the growth of prices has been prominently high during the examined period.

The most prevailing monetary policy is restraining inflation by raising base interest rates. In the countries that improve an inflation targeting system interest rate policy is the main instrument. In Hungary and in Poland the monetary measurements are characterised by strict interest rate policy. In Slovakia and in the Czech Republic the central banks do not considerably apply this tool of the monetary policy.

Exchange rate has an important role, too. Strong currencies can assist to keep inflation down but it can also have negative effects on the economy as a whole. The exchange rate mechanism is very similar in the V4 countries. The currencies of the countries have had significant appreciation against the euro during the last 12 months which weakens the inflationary pressures through weakening imported inflation pressures.

# Some current issues in foreign trade in the new WTO member Ukraine

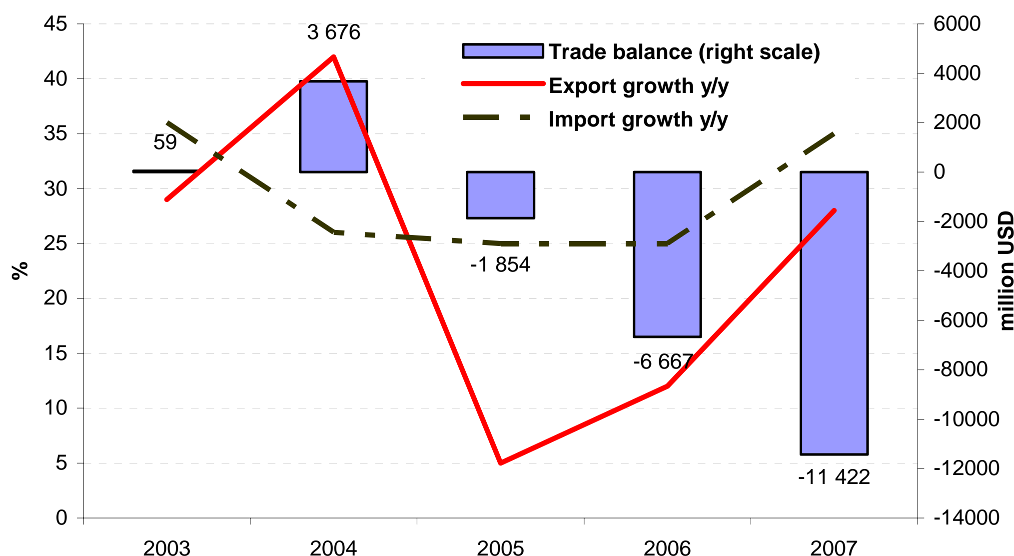
*Ágnes Magai*

Ukraine made an important step towards deeper integration into the world economy by joining the World Trade Organisation (WTO) in 2008. In February the WTO General Council formally endorsed Ukraine's membership of the world trade body and on 16 May 2008 Ukraine became a full member of the organisation. Barriers to entry, exit and competition hampers dynamic economic expansion, trade growth and capital inflow. According to latest Market Access Trade Tariff Restriction Index, Ukraine is ranked 100th of 125 countries and has relatively less favourable access to foreign markets than an average lower-middle income country.[2] Trade liberalisation means guaranteed access for Ukrainian companies to all economies of the WTO and enhance competition in the domestic market. Foreign trade without restrictions on the global market is extremely valuable for an increasingly strong agricultural and metal exporter.

## Recent trends in foreign trade

Ukraine has enjoyed robust economic growth since 1998, after severe transition recession of the nineties. Real GDP growth averaged 7.4% during 2000-2006. 2007 was another year with strong GDP growth (7.6%). In the first quarter of 2008 real GDP was up 6.5% on yearly basis. The expansion of the economy has been fuelled by strong consumption and high fixed investments in recent period. According to national account data domestic demand contributed 16 percentage points to the GDP growth in 2007. The demand growth was supported by increase in terms of trade.[3] This can be explained by the rising international prices of metals, which accounts for more than 40% of exports.

**Chart 4. Export and import growth, and trade balance**




*Source: State Statistics Committee of Ukraine*

In the last five years export and import growth rates have fluctuated *(Chart 4)*. Except for 2004 import growth rate outpaced export one. Last year imports surged by 19.9% in real terms while exports grew by only 3.2%.

[2] World Bank: Ukraine Trade at a glance, April 2008

[3] in the period 2002-2006 by a cumulative 17% increase; in 2007 by 9.8 %

However, higher steel, chemical and food prices boosted the term of trade by 10%, keeping the current account deficit to 4.2% of GDP in 2007. Exports of goods grew by 28% while imports were up 35% yoy in 2007 in USD prices. The trade balance showed a deficit of USD 11.42 billion in 2007.

## Export and import structure of Ukraine

The Ukrainian export structure is highly concentrated. The country's export competitiveness is very narrowly based: products with lower value added are dominating in the export structure. The main export goods are: ferrous and nonferrous metal, fuel and petroleum products, chemicals, machinery and transport equipment, food products (*Table 1*). Low value added products such as food products, minerals and metals accounted for 65% of total export in 2006, up from 59% in 2000. Agricultural products account for about 13% of total Ukrainian export, while more than 70% of the export consists of manufactured products. The remaining part consists of fuels and mining products.

**Table 1. Value and structure of Ukrainian merchandise export in 2007**[4]

| Commodities* | USD million | 2006=100 | % of the total volume |
|---|---|---|---|
| Live animals and livestock products | 747 | 189 | 1.5 |
| Paper bulk from wood or other vegetable fibres | 768 | 129 | 1.6 |
| Wood and articles of wood | 827 | 137 | 1.7 |
| Plastics and rubber | 987 | 123 | 2.0 |
| Textiles and articles of textiles | 990 | 108 | 2.0 |
| Animal or plant fats and oils | 1 718 | 177 | 3.5 |
| Plant products | 1 726 | 89 | 3.5 |
| Finished food industry products | 2 056 | 148 | 4.2 |
| Ground, air and water transport facilities | 3 305 | 159 | 6.7 |
| Products of chemical and allied industries | 4 047 | 120 | 8.2 |
| Mineral products | 4 275 | 110 | 8.7 |
| Machines, equipment and mechanisms, electric and technical equipment, audio and video equipment, TV equipment | 4 977 | 150 | 10.1 |
| Base metals and preparations thereof | 20 787 | 127 | 42.2 |
| **Total export** | **49 248** | **128** | **100.0** |

** By Ukrainian Classification of Commodities in Foreign Trade, Source: State Statistics Committee of Ukraine*

In 2004 about 60% of manufactured goods were produced by medium low technology, 20% by low technology, and more than 10% by medium-high technology, while only about 3% by high technology[5]. This reflects an internationally uncompetitive manufacturing sector structure. This can be explained by the fact that the country hasn't attracted FDI in significant value[6], which could facilitate industry modernisation and would affect productivity growth. Further privatisation and WTO accession may boost inflow FDI, since diminishing of formal and informal barriers to foreign investment, the strengthening of property rights may create overall welfare gains.

In 2007 export growth was fuelled by rising export of machinery equipments (+50%), vehicle (+59%), agricultural products (+50%), metals (+27%) and chemical products (+20%). Plant products, mainly grain export fell significantly in 2007 due to export restrictions. [7] Steel prices have risen dynamically in the past few years, underpinning Ukraine's favourable export performance. Steel is accounting for more than one-third of

[4] Contains only the commodity groups with more than 1.5% share of the total merchandise export

[5] OECD Economic Assessment of Ukraine 2007: Raising the competitiveness of the economy, 2007

[6] The country's FDI stock per capita (EUR 565) and FDI inflow per capita in 2007 was one of the lowest among Eastern and Southeast European countries

[7] Restrictions on grain exports were lifted in Mai 2008, therefore exports are expected to rise notably this year.

total good exports; therefore steel prices have significant effect on growth and export receipts. Strong dependency on metal production and export has adverse effects on the economy if metal prices fluctuate.

Ukraine's major export partners are the European Union, Russia and Turkey. In 2007 38% of total Ukrainian export went to CIS countries (including Russia with 26% share), 28% to the EU (12% to the new member states and 16% to the old ones). Turkey received more than 7% of total Ukrainian export. The EU enlargement in 2004 and 2007 had positive effects for Ukraine, because Ukrainian exporters have direct access to a single large market. However, while total export more than doubled in 2007 (in terms of USD) as compared to 2002, export grew only by 57% in relation to new member states and by 71% to old ones.

**Table 2. Value and structure of Ukrainian merchandise import in 2007[8]**

| Commodities* | USD million | 2006=100 | % of the total volume |
|---|---|---|---|
| Live animals and livestock products | 771 | 119 | 1.3 |
| Plant products | 860 | 128 | 1.4 |
| Products from stone, gyps, cement, asbestos, glass | 991 | 134 | 1.6 |
| Optical, cinematographic, measuring, medical and surgical apparatus and instruments and cameras, watches, musical instruments | 1 008 | 145 | 1.7 |
| Textiles and articles of textiles | 1 487 | 109 | 2.5 |
| Paper bulk from wood or other vegetable fibres | 1 523 | 130 | 2.5 |
| Finished food industry products | 2 091 | 126 | 3.4 |
| Plastics and rubber | 3 413 | 135 | 5.6 |
| Base metals and preparations thereof | 4 743 | 143 | 7.8 |
| Products of chemical and allied industries | 5 317 | 137 | 8.8 |
| Ground, air and water transport facilities | 8 217 | 160 | 13.5 |
| Machines, equipment and mechanisms, electric and technical equipment, audio and video equipment, TV equipment | 10 572 | 134 | 17.4 |
| Mineral products | 17 280 | 128 | 28.5 |
| **Total import** | **60 669** | **135** | **100.0** |

** By Ukrainian Classification of Commodities in Foreign Trade, Source: State Statistics Committee of Ukraine*

Economic growth of Ukraine is domestic demand driven. Stronger consumption and industry production boost import in the country. The main import products are energy, machinery, equipments and chemicals *(Table 2).* Manufactured products account for about 60%, fuels and mining for more than 30% of Ukraine's import. Rising fuel and natural gas prices hit production and export competitiveness, since large part of Ukrainian export products produced by energy intensive manufactures. In 2007 import growth was mainly due to dynamic inflow of vehicles and machinery products.

Ukraine's major import partners are the European Union, Russia and China. In 2007 24% of total Ukrainian import stem from the old EU member states, 13% from the new ones. The EU-10[9] exported twice as more goods to Ukraine in 2007 than in 2002 and EU-15 countries more than tripled their exports. The CIS countries without Russia gave 14% of the total import while Russia 28%. 15% of Ukrainian import is Asian originated; main partners are China and Korea. Ukraine has the highest trade deficit with European countries (more than USD 8bn in 2007) and CIS (more than USD 7bn in last year). This can be explained on one hand by high import of manufactured products (machinery, equipments, vehicles chemicals and food) from the European countries. On the other hand huge deficits with CIS countries are due to strong mineral import from Russia and Turkmenistan. Negative trade balance however compensated some with surplus in relation to Asian (mainly Arabic countries), American and African economies.

8 Contains only the commodity groups with more than 1.3% share of the total merchandise import

9 Central European countries joined the EU in 2004 and 2007

## Conclusions

By the theory, opening the economy to trade and foreign direct investments raise income and diversifies exports. Membership will be particularly beneficial for powerful steel industry. Exporters of chemicals and wheat and sunflower seeds will also benefit from cut in export duties. However, small scale enterprises, including smallholder farmers, and automotive industry and white-goods makers are expected to suffer from WTO accession because of lower import duties.

Adapting legal commitments framework means an increased credibility of the Ukrainian government policies and institutions making the country more attractive for foreign investors. The membership makes it possible to start negotiations between the European Union and Ukraine on establishing a free trade zone, which will be a key chapter in an enhanced partnership. Russia, still outside the WTO, needs Ukrainian support to join the WTO which opens new possibilities for the resolution of Ukrainian trade complaints. Namely restrictions imposed by the Russian on Ukrainian goods have caused huge deficits for Ukraine.

# Inflation could reach two digit figures this year in Georgia

*Mihály Borsi*

Georgia's economic performance has been impressive since 2004, mostly relying on base money operating targets and a greater exchange rate flexibility. Real GDP was 12.4% in 2007, making Georgia one of the fastest growing economies in the region. While both foreign aid and privatisation proceeds from non-residents counterbalanced the loose fiscal policy until the late 2004, external shocks could not be absorbed in the long run. The high share of fiscal revenues that is unfortunately not the result of steady real economic processes has presumed a challenge for monetary policy, as inflationary pressures were on the rise. Consequently, - even though the government took steps in order to reform taxation and customs - maintaining inflation in single digits has proved to be impossible since October 2007.

## Economic developments

Georgia's economy saw great improvement in recent years, explained by increasing tax revenues and large amount of foreign inflows in form of FDI and sizable increases in remittances. High GDP growth was mainly driven by strong domestic demand, especially public consumption and gross fixed capital formation. Real GDP growth was 9.4% in 2006, increasing to 12.4% in 2007 and continuing to be strong due to the recovery in agricultural production and the country's growing attractiveness for foreign investors.

The large-scale privatisation programme launched in September 2004 has been successful and significantly progressed; the process accelerated and the licensing and authorising procedures were gradually simplified. As a result, 15.1% of total fiscal revenues came from privatisation receipts between 2004 and 2007. Privatisation of large establishments and state-owned enterprises turned to private property, while selling prices have boosted as foreign investors have become active. In addition, development of the CIS countries has also contributed to the success, since investors from the region – especially from Russia and Kazakhstan - were the most active actors in the programme. Privatisation proceeds combined with tax reforms have facilitated the increase of pensions and economic infrastructure, a notable reduction in public debt was even achieved in the observed period.

However, favourable investment climate and growing confidence in the national currency (GEL) as well as fiscal over-expenditure has led to sharp increase in money supply, generating irreversible inflationary pressure on the economy, despite the consolidated budget revenues that were primarily conditioned by the large increase in tax revenues[10]. Furthermore, rapid import growth and declining export at the same time has resulted in the deterioration of the current account deficit, which was mostly financed by privatisation revenues and private capital inflows[11] that further increased the broad money per GDP ratio. While increase in imports could be explained by growing domestic demand and rising energy prices, export growth slowed down due to the Russian embargo introduced in 2006. As Russia banned wine, mineral water and agricultural product imports from Georgia, top export commodities became copper ore and concentrates, black metal scrap, ironmongery, fertilisers, motorcars, and alcoholic beverages[12]. Main imports are natural gas, oil products, machinery and parts, and transport equipment. According to Davit Armaglobeli, acting president of the National Bank of Georgia (NBG), Russian ban on imports was one of the root causes for the country's inflationary tendencies. Although the NBG has taken efforts to control inflation through the

[10] Annual increase in tax revenues amounted to 55.5% in 2006

[11] Foreign Direct Investment (FDI) was USD 285 million in the first quarter of 2007

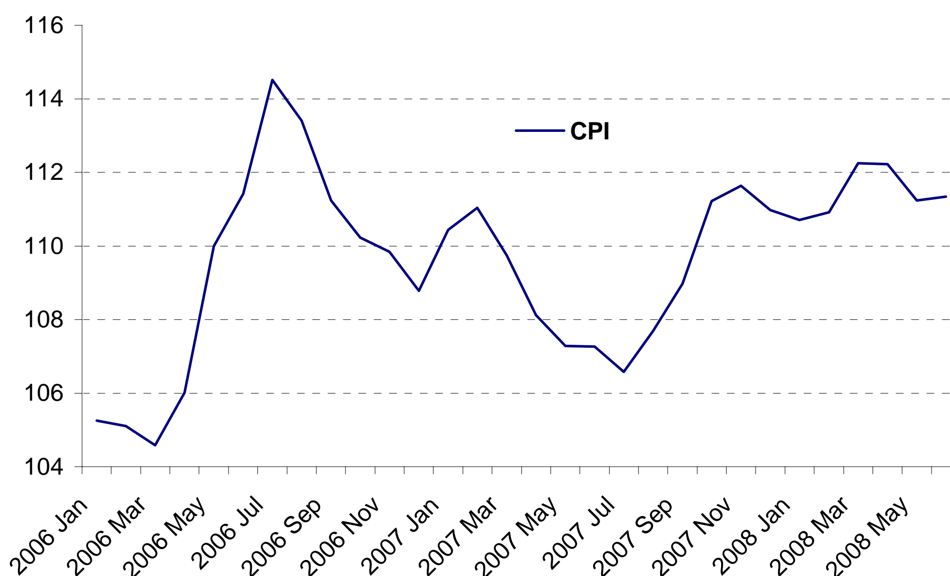
[12] ICEG European Center (2007): Caucasian and Central Asian Economic Report

sterilisation of excess money in order to keep reserve money growth in line with the one-digit inflation target, consumer prices continued to increase.

## Consumer prices

Consumer prices were on the rise since 2004, registering an annual average inflation rate of 9.2% both in 2006 and 2007, and not leaving double digits since October 2007. The International Monetary Fund (IMF) has warned Georgian authorities to reduce inflation in August 2006 after hitting 14.5% in July, however, fiscal and monetary policies were not tightened enough in the long run. The Central Bank's major goal - already in 2006 - was to prevent inflation rate from reaching two digit figures, but demand pressures in the economy resulting mainly from excess money supply as well as external factors such as rising energy prices have further deteriorated the situation. In spite of the worsening tendencies, the National Bank has decided to set an official inflation target of 8% for 2008 in November 2007, which was recently increased to 9%.

**Chart 5. CPI inflation (%, monthly, y-o-y)**




*Source: National Bank of Georgia*

As mentioned before, inflation in Georgia was not only triggered by internal monetary reasons caused by large amount of foreign inflows. The ex-president of the NBG, Roman Gotsiridze said that consumer price index was 8.8% year-on-year in 2006, 5.6% of which had been generated by external shocks, mainly by Russia's economic embargo and its increase in gas prices for Georgia, which was followed by a spike in the rate of inflation. Annual growth rate of exports slowed down to 4% in the first quarter of 2007 after the introduction of a series of trade and transit barriers by the country's main trading partner.

Similarly to other countries in the region, Georgia is no exception to face current international inflationary pressures, such as the surge in food and energy prices lately. Concerning the main components of inflation, prices of food, non-alcoholic beverages, electricity, energy and other costs of housing were the most important contributors, while transportation prices have increased rather in the first half of 2008, as a consequence of fuel price tendencies.

**Table 3. Consumer price index by commodity group (%, yoy)**

| *Month* | All items | Food and alcoholic beverages | Housing, water, electricity, gas | Furnishings, household equipment | Health | Transport | Communication |
|---|---|---|---|---|---|---|---|
| **2004 XII.** | 107.5 | 112.1 | 104.5 | 103.7 | 98.7 | 105.7 | 101.9 |
| **2005 XII.** | 106.2 | 104.1 | 105.9 | 102.5 | 100.8 | 106.9 | 93.9 |
| **2006 XII.** | 108.8 | 113.4 | 122.2 | 101.5 | 116.0 | 102.5 | 99.9 |
| **2007 I.** | 110.4 | 116.4 | 125.2 | 101.8 | 118.5 | 102.7 | 100.1 |
| **2007 II.** | 111.0 | 117.4 | 130.1 | 102.3 | 118.2 | 102.1 | 100.2 |
| **2007 III.** | 109.7 | 114.3 | 131.4 | 101.4 | 119.4 | 102.9 | 100.1 |
| **2007 IV.** | 108.1 | 111.7 | 132.6 | 101.2 | 120.5 | 102.3 | 100.7 |
| **2007 V.** | 107.3 | 108.3 | 139.1 | 102.0 | 121.2 | 100.7 | 100.7 |
| **2007 VI** | 107.3 | 108.4 | 121.8 | 101.5 | 116.8 | 102.2 | 100.8 |
| **2007 VII.** | 106.6 | 107.5 | 119.2 | 102.3 | 106.4 | 107.9 | 100.9 |
| **2007 VIII.** | 107.7 | 109.9 | 120.2 | 101.4 | 106.8 | 107.6 | 100.8 |
| **2007 IX.** | 109.0 | 112.1 | 121.5 | 102.8 | 107.4 | 107.6 | 100.9 |
| **2007 X.** | 111.2 | 115.5 | 123.2 | 113.0 | 107.4 | 109.8 | 100.7 |
| **2007 XI.** | 111.6 | 114.9 | 124.3 | 110.9 | 109.5 | 113.1 | 100.7 |
| **2007 XII.** | 111. | 112.9 | 123.9 | 110.7 | 108.9 | 115.6 | 101.3 |
| **2008 I.** | 110.7 | 113.3 | 118.4 | 112.0 | 109.2 | 116.2 | 101.3 |
| **2008 II.** | 110.9 | 113.5 | 114.4 | 112.2 | 112.3 | 117.1 | 101.3 |
| **2008 III.** | 112.3 | 115.2 | 117.2 | 112.7 | 112.2 | 120.1 | 101.5 |

*Source: Statistics Georgia*

## Further steps

According to the National Bank of Georgia, inflation would be contained below 8% in 2008 through the implementation of a tighter fiscal stance and stricter monetary policy, even despite its negative effect on the growth rate in short terms. The NBG's Monetary Policy Committee has also decided to raise its key interest rate to 12% in an effort to slow inflation. Moreover, the Central bank and the government have agreed on sharing responsibility if the one-digit inflation target is not met.

A draft law passed on 14 March assumed that the president of the National Bank would have to resign if annual inflation reaches 12% in 2008, but the final document states that the Parliament - if the target is missed - can recommend the president to dismiss the head of the NBG. Finally, the Parliament will also have the right to raise the cabinet's responsibility in case of failure.

Even though annual inflation rate has somewhat decreased and amounted 11.3% in June 2008, down from 12.3% in March, anti-inflationary measures are unavoidable, and special attention should be paid to public expenditure management in order to ease upcoming (domestic) pressures in the second half of the year. The risks in connection with international environment however remain determining.