ICEG European Center

NEWS OF THE MONTH
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A Report by the ICEG European Center
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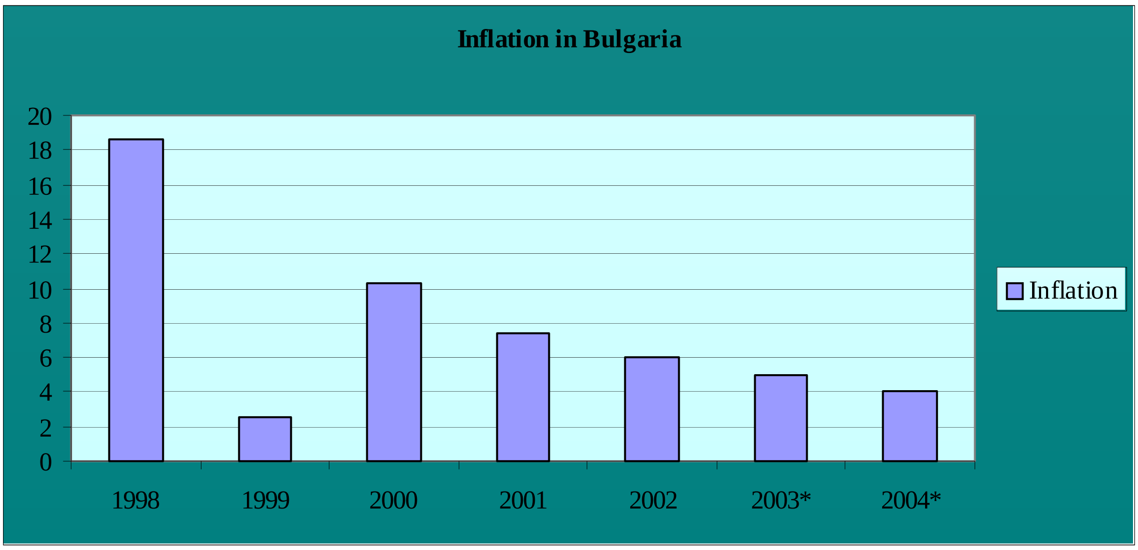
I. Inflation performance and outlook in Bulgaria

Until 1997 Bulgarian economy was marked by poor performance, massive external borrowing, slow reforms and hyperinflation. Deep-lying problems led to a severe economic crisis in 1996-97 followed by the introduction of the currency board arrangement. The currency board achieved and ensured low inflation level and financial stability, which were essential to attain stable and sustainable growth. The clarity, consistency and predictability of this regime provided an effective nominal anchor for the Bulgarian economy and stabilized inflationary expectations.

Currency board arrangement had altogether very positive effects on the Bulgarian economy, including the contribution to stable and sustainable growth, price and financial stability, improving budget balance due to reduced interest payments and growing tax base, and also positive effect on foreign trade. The restructured and reformed banking system and wide-ranging structural programs also provided a solid ground for economic growth.

As a result Bulgaria has exhibited a reasonable progress towards long-term macroeconomic stability. and an important step toward improving living standards and accession to the EU. The government's actual program supported by IMF and World Bank aims real GDP growth of 4-5 per cent per annum for the next years and it looks to be feasible at the moment. In the program the internal accounts are expected to be in balance and the already declining indebtedness is forecasted to continue the tendency. These factors require conservative fiscal policy that is guaranteed by the currency board and is helpful for keeping down inflation.

Chart 1.



Currency board arrangement has forced inflation from hyperinflationary levels to one digit one. After quick fall in consumer price index it remains higher than in EMU countries caused only by differences in the structure and flexibility of the economies concerned. They do not result from monetary factors and do not create permanent inflationary expectations. *The average inflation has been kept low, and fell in 2001.* The average inflation rate based on the harmonized index of consumer prices for 1997-2001 was 2.7%. The currency board, the trade and financial liberalization, the fiscal discipline imposed by the currency board, the structural changes among them the increased competition in domestic markets, and low wage pressures kept inflation down. Due to a number of one-off factors, including high oil prices, drought and increases in VAT rates, inflation jumped to 5.2% at the end of 2000. Afterwards, it fell back to 2% when the transitory effects had subsided. Inflation (CPI) has fallen to 7.4% on average in 2001 and to 4.8% at the end of 2001 year on-year.

Inflation declined to a rate of 6.0% on average in 2002, mostly due to a combination of one-off effects arising from increases of administered prices and of indirect taxes which were offset by low food prices. Moderate income policies, increasing competition on product markets and tight fiscal policies should allow inflation to decline further to a level of around 5% in 2003 and 4% in 2004. However, accelerating growth and the need for further liberalization of administered prices and changes in indirect taxation will make it difficult to reduce inflation much further.

Even if personal incomes raise moderately and fiscal policy is tight, other factors - the fast growth in GDP, adjustment in administered prices and continuous increase in indirect taxes - will not let inflation rate be lower. External and internal shocks, especially positive shocks, are likely to turn upwards inflation. For example, in the past few years the level of investment has been constantly raising in Bulgaria. This year the Government is going to continue the privatization drawing a great amount of foreign capital in the economy in this favorable macroeconomic situation. That means increasing money supply which can endanger inflation goals.

Since the institution of the currency board arrangement, inflation in Bulgaria has been driven to a large extent by changes in administered prices, excise duties, food prices as well as import prices. Changes in administered price in the next years will follow the schedule already announced by the government. The envisaged price increases in electricity and heating will significantly contribute to consumer price increases. Remaining administered prices (medicines and telephone services among them) will also be subject to adjustments, but the direct effect on the price level is expected to be limited. Given that most of the excise duty rates now effective in Bulgaria are lower than the EU rates, their adjustment will have a slight upward effect on the price level and inflation.

Volatility of inflation can not be fully avoided because of one-off price-rises, structural reforms, raising indirect taxes and adjustment in administered prices. Meanwhile these factors are partly counterbalanced by stable food prices.

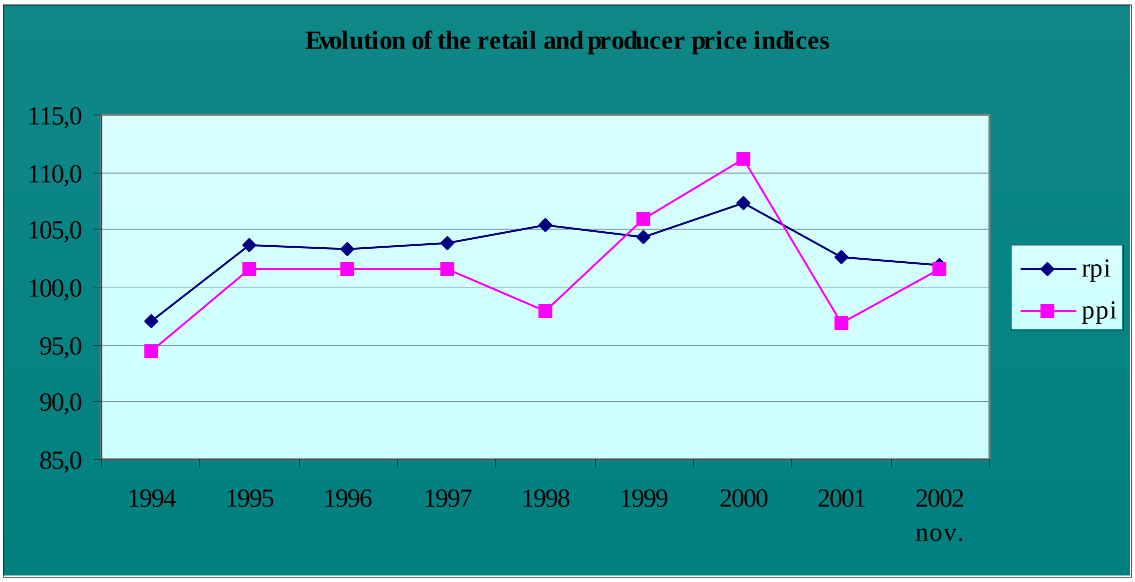
II. Inflation in Croatia

BRIEF BACKGROUND ON INFLATION. Croatia became independent in 1991, and adopted the former Yugoslavian currency, the dinar. As a consequence of war, the inflation was raging at more than 1200% per year and it ended in a stabilization program in 1993, containing restrictive monetary, fiscal and income policies, and several structural measures.

The main component of the program was the introduction of a new currency, the kuna, tied on a managed float basis to the German mark. The program was successful, the Central Bank could keep the exchange rate within a narrow band to the German mark, than to the Euro and could keep price pressures subdued and prevent the re-emergence of inflation.

Since the first year of the introduction of the new regime the country experienced a strong disinflation due to the stability of the exchange rate, periodically restrictive fiscal policies and moderate wage growth restricted by extremely high and persistent unemployment. There was a jump in the price index however in 2000, which was mainly caused by high deficit in the consolidated central budget (reaching around 5% of the GDP), and rising energy costs due to higher oil prices.

Chart 2.



TRENDS IN 2002. Inflation measured by the y/y rate of change in the retail price index (RPI) remained within the range of price stability of 4% in the first eleven months of 2002. It trended downward from 3.3% in January to 2% in November. The fall in August in comparison with July 2002 was caused by the strong decrease in the y/y growth rate of services prices, as a result of a rise in telecommunication services prices in August last year. The y/y core inflation rate, which excludes agricultural product prices and administrative prices continued its downward trend; it fell from 1.9% in January to 1.1% in October.

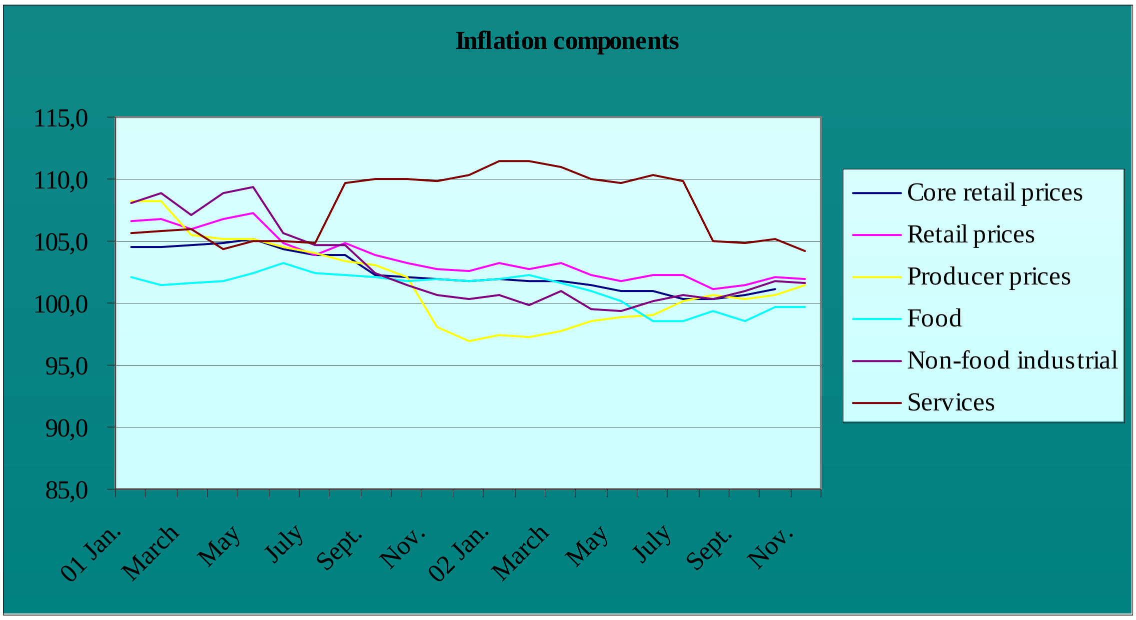
The total Retail Price Index (RPI) increased by 2% in y/y basis. The main components of RPI are the following (with their respective shares in brackets): non-food industrial products (50.3%), services (21.9%), food (19.0%), tobacco (4.8%), beverages (4.0%). The chief factor of the 2% increase in RPI is the result of an increase in prices of services by 4.2% within which the prices of housing and public utilities, financial and other services increased by 9 to 9.2%. The prices of non-food industrial products increased by 1.6%, including the biggest riser medicines by 12.8%, woven clothing by 7.2%, and the group of "household articles" where prices decreased by 2.1%. The food and tobacco prices remain almost unchanged, while beverages rose by 5%.

The declining trend in the y/y rate of change of food prices and non-food industrial prices was markedly determined by a relatively stabile exchange rate against the Euro (recently also by the appreciation of the kuna against the US dollar), increased competition in the retail trade and the liberalization of foreign trade.

From the second quarter of 2002 there weren't any significant external inflationary pressures. From April to August prices of liquid fuels and lubricants in the domestic market were adjusted only twice; they rose on average by 2.6% in April, and fell by 1.4% in June. This was a result of both the relatively stable oil prices and the nominal appreciation of the kuna against the US dollar.

However, the y/y growth rate of prices of raw materials traded in the world commodity exchanges accelerated from -6% in March to 2.8% in August, expressed in US dollars, this acceleration did not significantly increase imported inflationary pressures thanks to the mentioned appreciation of the kuna against the US dollar. In addition industrial producer prices in the Euro-zone recorded a slight annual fall.

Chart 3.



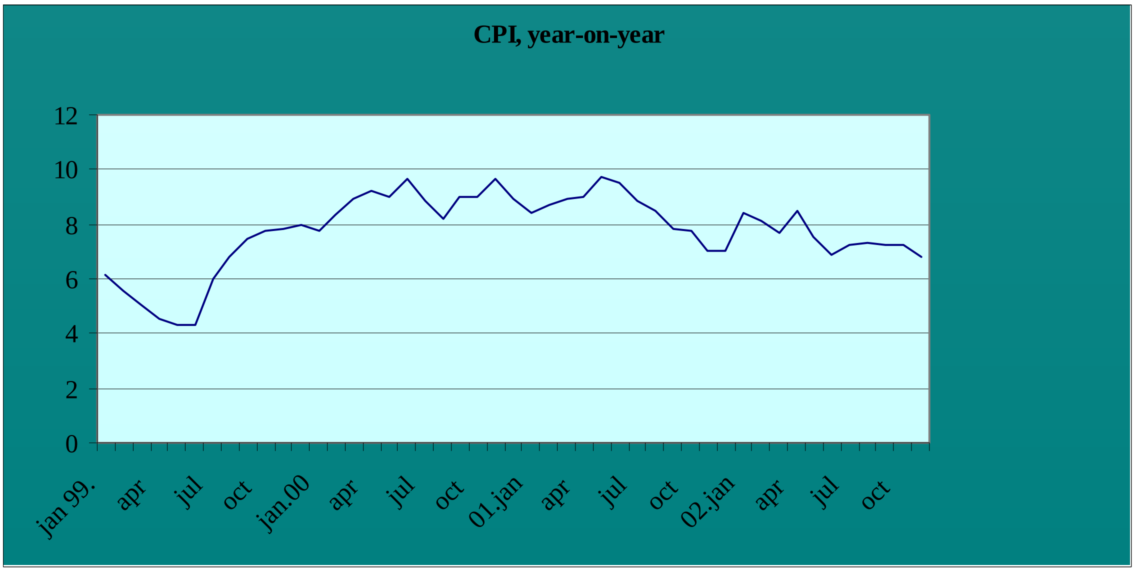
The annual growth rate of producer prices has been trending upward since the beginning of 2002, indicating that slight upward pressures on retail prices might come from this source in the future. The y/y inflation rate measured by movements in the RPI is expected to grow slightly until the end of 2002 as a result of the increase in electricity and gas prices, the impact of the base period and a potential upsurge in crude oil prices.

The increase in electricity prices for households in September caused by the adoption of the new tariff system has already boosted the RPI, however its price for industry remains at the same level preventing the spillover effect. Moreover, the Government approved an increase in the producer price of natural gas in September, but that would not affect the RPI directly due to the fact that natural gas assigns a rather small weight in this index.

III. INFLATION REMAINS HIGH IN SLOVENIA

After a considerable decrease from 9.75 per cent in May to 7 per cent in December 2001, the y/y inflation started climbing again in the first quarter of 2002 and has been moving in a band of 6.8 to 8.5 per cent since then. These hectic movements in inflation were caused by opposite driving forces throughout the year. On the one hand some factors which influenced last year's inflation were independent from the economic policy (the international environment), but on the other hand some others and actually the majority were government arrangements with a negative effect on prices having resulted in a break in the decreasing trend. The overall inflation was expected to be at about 7.5 per cent at the end of 2002. Core inflation has continuously been falling from over 8 per cent since mid-2001 having reached 6.1 per cent in September 2002 and it was expected to stay at the very same level at the end of the year.

Chart 4.



The persistent inflation was on the domestic side was determined by two major factors: fiscal policy and changes in administered prices. In the first half of 2002 comprehensive tax changes boosted inflation, first of all when value-added tax rates were modified (general rate from 19 to 20 per cent, reduced rate from 8 to 8.5 per cent) and excise duties on tobacco and alcoholic beverages were increased in January.

Furthermore, the introduction of taxes on environmental discharges and the higher rate of local authority charges also had an appreciable influence on price rises in the first quarter of the year. The last contribution to inflation of the fiscal policy was a further increase in excise duty on tobacco, alcoholic beverages and liquid fuels in April.

All these measures have had a contribution of 1.5 percentage points to last year's inflation. The administered prices rose fast in the first four months of the year and moderately thereafter reaching an estimated 10 per cent increase on a y/y basis by the end of 2002. That includes the rises of telephone and postal services' prices in February, the higher prices of local utility services in April and August and some other changes in car insurance and prices of package holidays. The signaling effect of such price increases has undoubtedly the strongest influence on inflationary expectations, that can easily accelerate inflation triggering further price rises in sectors in which the competition is rather weak or price-cartel dominates.

Besides the endogenous factors the international environment showed a mixed picture in relation to inflation. Oil prices have been growing since the end of 2001 and they were quite volatile during the last year thanks to the Middle East crises in the first half of the year and the American preparations for war with Iraq later on. The leaps in oil prices affected consumer prices through the direct impact on refined oil products and indirectly by pushing costs of services and products in sectors such as transport and housing.

On the other hand, there were also some favorable developments in the international environment, that could mitigate the negative shocks. First, the weakening dollar from the second quarter of the year made imports less expensive. Exchange rate movements had another benign effect on inflation when the Bank of Slovenia lowered the depreciation rate of the Tolar (from 3.8 to 3.5 per cent y/y) resulting in a relatively slower increase in import prices.

In small, opened economies such as Slovenia, Hungary and the Czech Republic exchange rate policy is an efficient tool to reduce inflation using the exchange rate as a nominal anchor especially if the gap between internal and external inflation is high. The last factor affecting positively the inflation trend in 2002 was the hang in the growth of monetary aggregates. At the end of 2001 all monetary indicators (M1, M2 and M3) were growing fast mainly because of the Euro changeover, transfers of government payments to the Bank of Slovenia and foreign currency inflows.

Since then some kind of correction has been taking place, so all monetary aggregates are increasing with lower speed. Despite the increased volume of money in circulation there is no sign of any demand side pressures on prices thanks to the sufficient level of financial savings.

On the whole, it can be stated that recent inflation trends in Slovenia were mainly determined by internal, cost push factors. Most of them were one-off events (e.g. tax changes, introduction of compulsory car insurance etc.) confirmed by the decreasing trend of core inflation. Prospects for the future may vary according to occurring changes in administered price policy, tax policy, and monetary and exchange rate policies. With an objective of a 5.3 per cent inflation rate by the end of 2003 and a 3.5 per cent rate by the end of 2004 economic policy should be restrictive in order to meet both the target of the Central Bank and the conditions of the Maastricht Treaty.

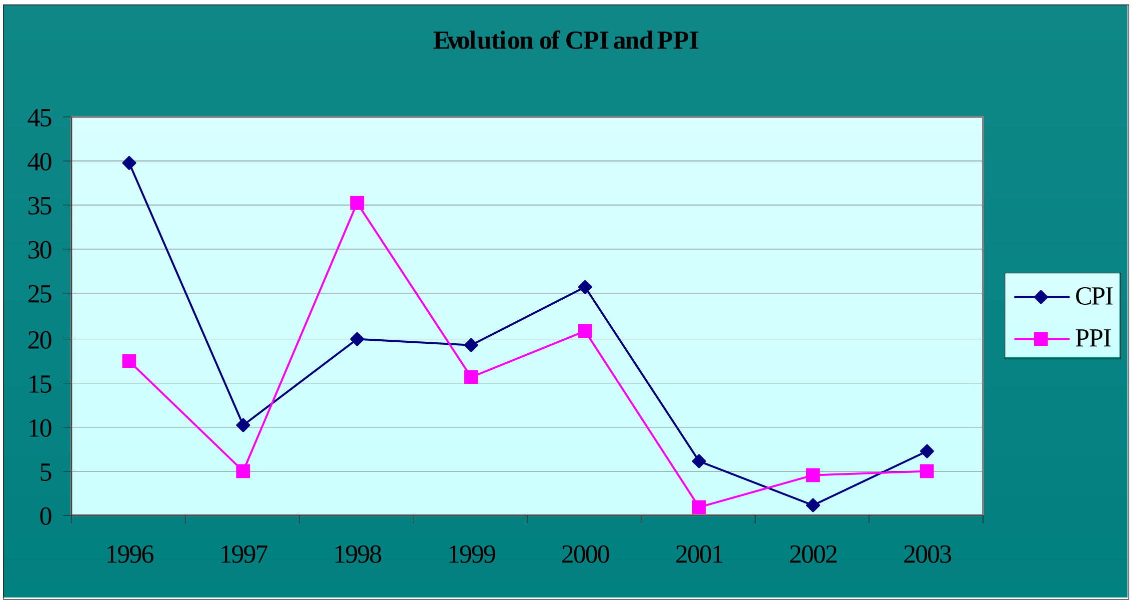
The biggest question mark concerning this year's inflation is the development of world oil prices because of the permanent uncertainty in the Middle East, which can easily divert inflation from the desirable trend. Apart from this possible exogenous shock this year's target definitely seems to be feasible provided that moderate economic policy measures especially on the field of administered prices will be taken.

IV. SLIGHTLY DECLINING INFLATION IN UKRAINE

Background on inflation and stabilization. After the disastrous experiences with its first national currency, the Karbovanets, the need for macroeconomic stabilization and economic reforms led to the introduction of Hryvnia. While microeconomic and structural reforms were muddling through, macroeconomic stabilization was attained in 1996, and inflation did not rise above 20 percent a year even during the financial crises of 1998 and 1999. From 1999 and 2000 onwards more ambitious economic reforms were implemented that tried to improve the structural features of he economy and to put it on a more solid foundation.

These reforms – among other the fiscal reforms, land reform, energy reform, banking sector reform - and the favorable exogenous conditions (growth in Russia and among other major trading partners) resulted, after almost a decade of uninterrupted decline of GDP, in 2001 in a 9,1 % growth and in 2002 GDP growth was expected to reach 4,3 %.

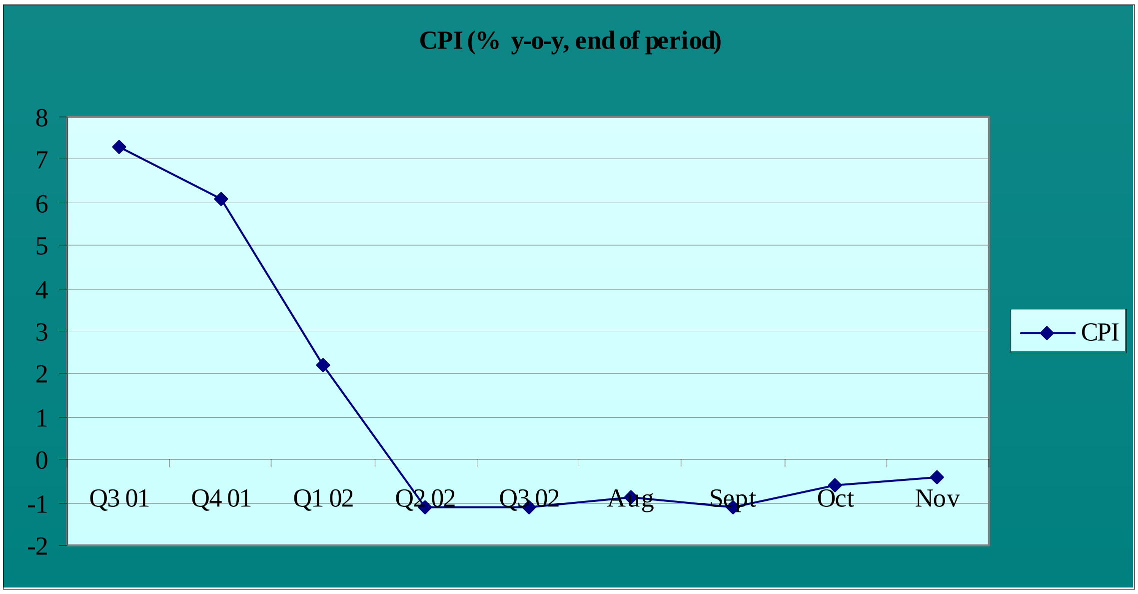
Chart 5.



Inflation in 2002. Last year was quite unusual in terms of consumer price dynamics observed in the first 11 months. In particular, downward movement of consumer prices was driven by increased competition in food market as well as administrative intervention in price formation. The CPI nevertheless increased by approximately 1,4 % y/y by the end of 2002 due to higher administratively set tariffs on utilities and other services, as well as seasonal increases in agricultural products.

Several factors have explained the downward developments in price increases. First, foreign exchange rate stability became one of the main factors of disinflation, as the stability of the national currency had a positive direct and indirect effect ion price increases. The stability of hrivnya strengthened the positive effect on inflation caused by the lower imported inflation due to moderate global price increases.

Chart 6.



Another factor contributing to disinflation was the low progress with price liberalization as still very high percentage of process are set administratively and the process of price liberalization has been slowed down to keep price increases at lower level.

Finally, in 2002 the monetary policy of the central bank changed compared to one observed in 2001. The net purchases of foreign exchange by the NBU in 2001 resulted in a significant expansion of the monetary base (37.4%). Thanks to high economic growth and increasing monetisation of the economy, this monetary expansion did not lead to acceleration of inflation. The net purchases of foreign exchange by the National Bank were lower in 2002: as a. result the central bank was in a much better position to control money creation and keep inflation on declining trend.

This year CPI growth is expected to be higher and reach 7,6 % y/y. There are several reasons behind this forecast. First, it is expected that the reduction of food prices caused by competitive pressure will decelerate due to slower growth rates of foods industry and further quality differentiation of products. Second, the increase in real money demand will slow down, leading to higher inflation with unchanged increase in money supply. Third, inflationary expectations may increase if the NBU applies its new refinancing program. The NBU credits will mean money emission, producing pessimistic expectations on inflation and exchange rate.

V. Low inflation in Poland

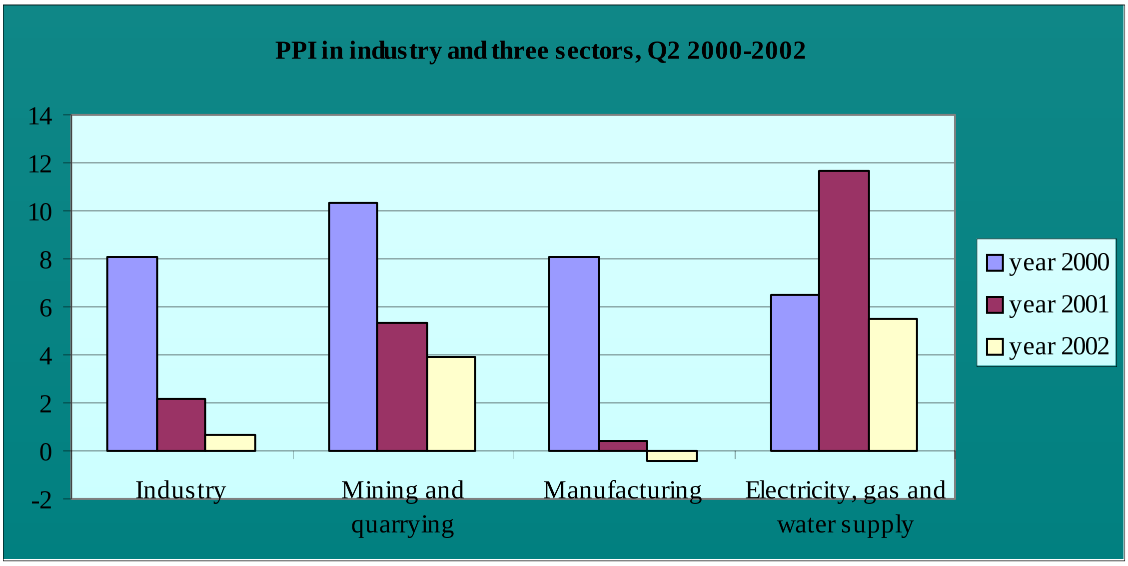
In the last quarter of the year 2002 CPI in Poland remained low, after its rapid drop in the second quarter of 2002. CPI has been decreasing since the beginning of the year, from a level of 3.4% (y/y) in January to 1.1% in October. Because of the drop in the CPI the National Bank of Poland has changed (at the end of June) its inflation target for 2002 from 5% +/-1 percentage point to 3% +/-1 percentage point. This will remain the inflation target for the year 2003, as well.

The above-mentioned rapid drop in consumer prices was a result of the earlier usual drop in food prices, which resulted from good harvest and the growth of food supply. At the same time the world oil market has not experienced any major shocks, and this fact contributed to the stabilization of domestic fuel prices at a low level. On the demand side the low rise in consumers' disposable income persisted, which reduced the growth rate of prices for non-foodstuffs and some services.

In the second quarter of 2002 prices for food and non-alcoholic beverages were the only group that displayed a y/y drop. The drop in the prices of meat and milk contributed to it the most. In the remaining three categories of consumer prices (officially controlled prices, non-food articles excluding officially controlled prices, and services excluding officially controlled prices) the y/y increase has slowed.

The impact of the low food and steady fuel prices is also observable in the core inflation measures. The "net" inflation measure, which is calculated by excluding the food and oil prices from the CPI remained the highest of all core inflation measures (3.1% in June, y/y, while y/y CPI was 1.6%). The second highest measure was core inflation excluding the most volatile prices and fuel prices (2.1% in June, y/y). This indicates that if the favorable tendencies in food and fuel price development end, a rising tendency in CPI may begin.

Chart 7.

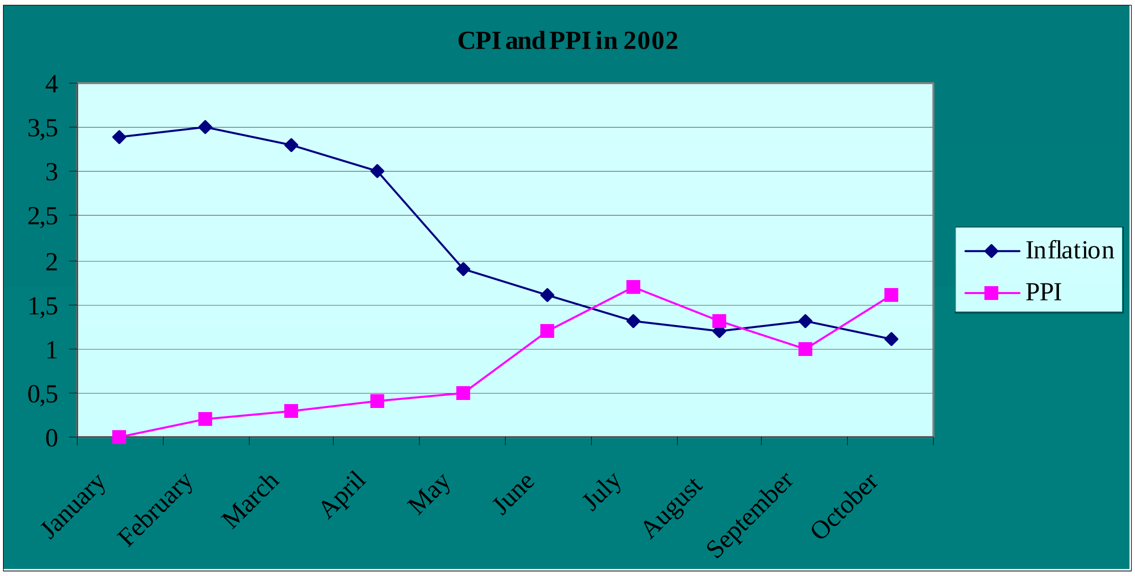


While we have seen a decreasing tendency in consumer prices in 2002, producer prices have increased compared to the beginning of the year (from 0% y/y PPI in January to 1.6%

y/y PPI in October), but they were not following a continuously rising trend. PPI was rising from January until July, between July and September it was dropping, and from September it was rising again. By October the PPI was above the CPI (just as in July and August). The rising PPI and at the same time decreasing CPI indicates that while the producers are facing increasing production costs, they do not charge more for their products, as they do not want to lose their market shares.

As for the contribution of the three sector of the industry to the rising PPI, the effect of the distribution of electricity gas and water was the most significant in the second quarter in 2002 (5.5% y/y). Compared to the corresponding period of the previous year, this growth rate is significantly lower. A similar tendency is observable in the case of industry overall, as well as in mining and quarrying. As for manufacturing the growth rate was negative (-0.4% y/y), thus manufacturing contributed to the reduction of the PPI. In construction the PPI growth rate was higher in the second quarter of 2002 then the PPI growth rate in industry (4.4% and 2.2% y/y respectively). It is true for both construction and industry, that the y/y growth rate of PPI was lower in Q2 2002 then in Q2 2001. At the same time the rising tendency of the overall PPI in the second quarter of 2002 is the result of the considerable weakening of the Zloty exchange rate in the same period.

Chart 8.



The rate of inflation was expected to rise slightly by the end of the year, and stabilize at the level of, or slightly below the 3% inflation target set by the National Bank of Poland. This was the result of the economic recovery that Poland is experiencing. As the Polish economy was starting to get on a growth path again after it's long stagnation, this could contribute to the slight rise in the CPI (given that domestic food prices and world oil prices remain stable) compared to its 1.1% y/y level in October. As the increasing trend of the PPI was expected to continue, the PPI and the CPI were both be following a rising trend towards the end of 2002.