International Center for Economic Growth
Európai Központ

NEWS OF THE MONTH

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6/B Dayka Gábor Street, Budapest, H-1118
Tel: +36 (1) 248-1160 *E-mail:* office@icegec.hu *Web-site:* www.icegec.org

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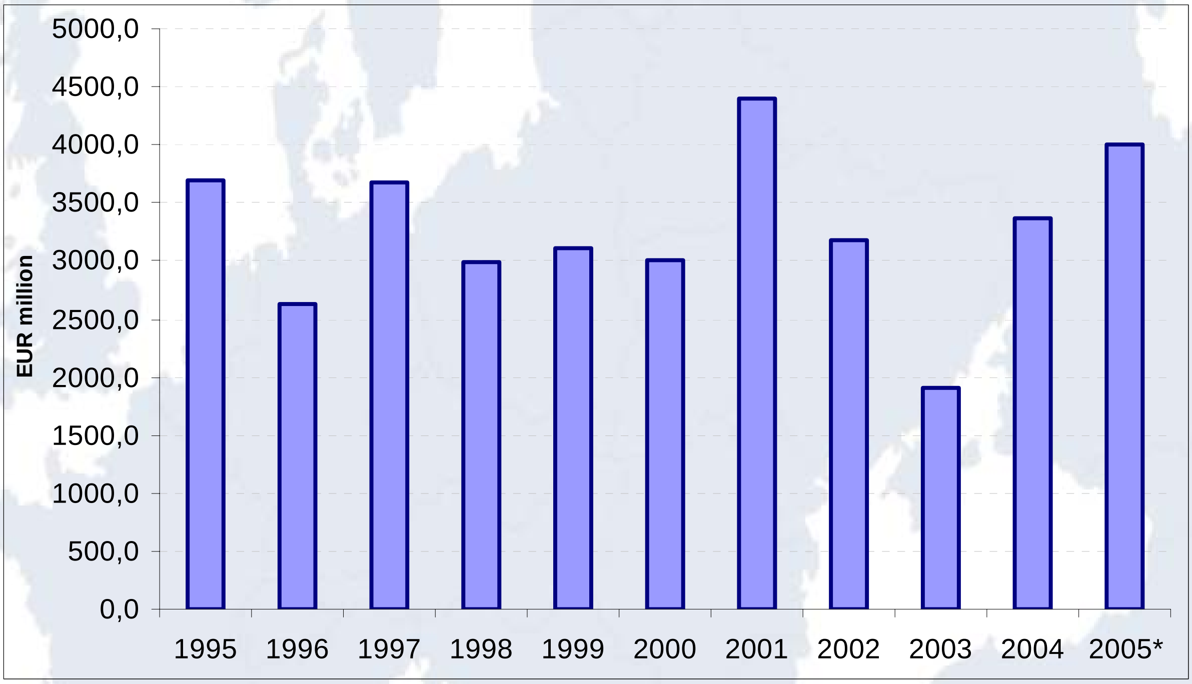
SIGNIFICANT PERFORMANCE OF INWARD FDI HUNGARY

The Hungarian government has signed a contract with Hankook Tire in Seoul about building its first European factory in the "town of steel", Dunaújváros. The investment amounts to EUR 500 million (HUF 130 billion) with an estimated governmental contribution of 15%. The factory should start its operations in 2007 reaching full capacity of 10 million tires and employing 1500 people in 2010.

TENDENCIES OF INWARD FDI

The development of inward FDI in Hungary has entered its second phase recently. In 1995 the share of privatization in inward FDI was 75.7%, which decreased to 17.9% in 1999. There are only few state properties planned to privatize in coming years. Thus other types (green-field investments, reinvested capital etc.) of inward FDI will have a more important role in the Hungarian economy. Chart 1 shows the development of inward FDI in the last 10 years. Data on 2005 is estimation and can be even higher in case the transaction of Budapest Airport Rt. (public limited company – PLC) will be finished this year. The investment of EUR 2.42 billion in the first half of 2005 represents a record. The inward FDI reflects the tendencies in the world market as the amount of FDI faced a rapid decrease after September 2001 and has made good recovery recently. Besides this setback the inward FDI moved in the interval between EUR 2.5 and 4.5 billion.

Chart 1. Development of FDI in Hungary 1995-2005



Source: MNB

**Estimation*

The biggest investors concerning seed fund were Deutsche Telekom AG with EUR 673 million, E-on Energie AG with EUR 371 million and Audi AG with EUR 94 million investments. Hankook jumps into the second position after its current investment of EUR 500 million, which will triple the South-Korean inward FDI of Hungary. Hankook is not the only tire producer setting up production capacities in Hungary. The world number one Michelin invested EUR 60 million into a new factory near the town Nyíregyháza producing yearly 800 thousand tires and employing 250 people. Bridgestone (the second biggest tire company) is going to build a factory investing EUR 190 million near the town Tatabánya. The factory generating 185 new jobs will start production in 2009 having a capacity of 8000 tires daily (approximately 2 million per year). Due to these investments Hungary will become the "tire empire" of Europe.

COMPETITION OF VISEGRAD COUNTRIES

The transitional economies of Poland, Czech Republic, Slovakia and Slovenia are the closest fierce competitors of Hungary in the region for further inward FDI. According to UNCTAD these countries are front-runners (having high FDI potential and high FDI performance) except for Poland that belongs to the group of countries achieving below potential (high FDI potential but low FDI performance). Hungary lost its leading position in FDI Performance among these countries and is only at third place. In case of the Hungarian Inward FDI Potential there is an improvement from the fifth to the third position. Comparing these countries based on their potential there are only slight differences.

Table 1. Rankings of Inward FDI Performance and Potential 1995-2003

	Inward FDI Performance			Inward FDI Potential		
	1995	**2000**	**2003**	**1995**	**2000**	**2003**
Czech Republic	34	18	19	39	40	39
Hungary	***4***	***26***	***39***	***60***	***43***	***40***
Poland	43	47	72	55	41	43
Slovakia	64	41	14	51	51	46
Slovenia	88	113	49	43	29	28

Source: UNCTAD

EUR 22 billion FDI arrived in this region in 2000, which is 2.3% of the total FDI in the world. Only 8% of the investment aimed at Hungary. The proportion of the Czech Republic and Poland was above 20% each. Although the position of Hungary is worsening the country is still leading in the FDI stock per capita. In June 2005 this figure was EUR 5112 compared to EUR 4555 in the Czech Republic and EUR 1643 in Poland. While Hungary practically stopped the process of privatization Poland and the Czech Republic still rely on this source of FDI (with almost 50% and 14% of their total FDI).

There are still factors that can make Hungary attractive for foreign investors including Hankook. The corporate tax is still among the lowest in the region and the possibility of deduction of local tax on industrial activity from the corporate tax base will enhance further advantages. However, tax burden on employment is still too high despite of reform proposals of the government.

The central location of the country provides good access to the Western-European markets for non-EU investors. (Hankook's exports to Europe accounted for 36.8% of its total exports last year, amounting to EUR 250 million.) There is a continuous infrastructure development. (Hankook will establish its tire factory next to the new built highway M6.) The number and quality of skilled workers is also an advantage especially for investments in knowledge-based industries with high value added, but not for industries seeking for specialized knowledge, skilled laborers of concrete professions. Last but not least the Hungarian government is willing to subsidize foreign investors even more than the governments of the neighboring countries. (Slovakia offered first 21% of the total investment but then the offer was changed to 6% compared to Hankook's demand of 10%). By the estimation of EU around HUF 60 billion is granted to foreign companies on creative or transparent way.

Advantages and Disadvantages of Hankook

Although tire production is a knowledge-based, innovation oriented industry Hankook is going to build a factory using outdated technology that arises doubts about the environmental externalities. The quality of the Hankook tires is lagging behind the major tire companies. According to the tests of the German ADAC (Auto club) the Hankook winter tire Ice Bear is not suggested for drivers because it is dangerous.

The state support of around EUR 75 million means EUR 50 thousand per new work place. This amount of money could be enough for paying the minimal wage for 8 to 12 years. The investment of Hankook is worth the support of the government in case the company stays longer than 8 to 12 years. In the era of globalization it is a question how long Hankook will find Hungary the most profitable location for its production facilities. Of course there will be more new work places as input producing companies will follow Hankook and the taxation will increase providing more income for the budget but getting back the government's outlays is only long term possible.

Concerning the amount of the invested capital it seems to be advantageous to have such a big investor. On the one hand the higher the inward FDI the more budget deficit can be financed. On the other hand it involves risk for the country or the region to have few big income sources and employers. If the main investor closes its factory, all the accompanying firms will leave the area causing high unemployment and economic decay.

The most remarkable benefit of the Hankook investment is its effect on other South-Korean companies. The government has started negotiations with Sony and Toshiba about investments worth EUR 216 million. All together 12 major investments are under negotiation including the production of LCD monitors, plasma TVs or medicine, but also biotechnology, environmental projects or tourism are among the possible newcomers.

Expectations

The competition for FDI is very hard in the region. Hungary cannot base its competitive advantage on cheap labor any more but still has attracting features. The major threat that can have a negative influence on the chances of the country in the competition for FDI is the high deficit of the Hungarian budget, the growing state debt and the related macroeconomic risks.

Growing budget deficit can force the country to attract investors like Hankook with high state subsidies otherwise the deficit should be financed by credits. The budget deficit reached EUR 4.4 billion, 5.4% of the GDP in 2004 by the Eurostat and this year will likely reach even by most careful expectations 6-7% of the GDP. The inward FDI was only EUR 3.3 billion in the same year. What is more, high budget deficit postpones the date of joining to the euro zone. Recent changes of budget targets, non-transparent accounting practices and missing credibility of convergence program have eroded the credibility of fiscal policy, thus Fitch Ratings has downgraded the Hungarian credit rating that means simply more expensive credits in the future. Thence it arises that Hungary should increase inward FDI (especially in fields of knowledge intensive, high-tech industries instead of outdated, environment polluting and lease-work type technologies that can ensure a modern economic structure, higher value-added and a better use of governmental subsidies) and decrease budget deficit in the coming years.

OVERVIEW OF POLISH LABOR MARKET: DECREASING UNEMPLOYMENT AND LOW WAGE GROWTH

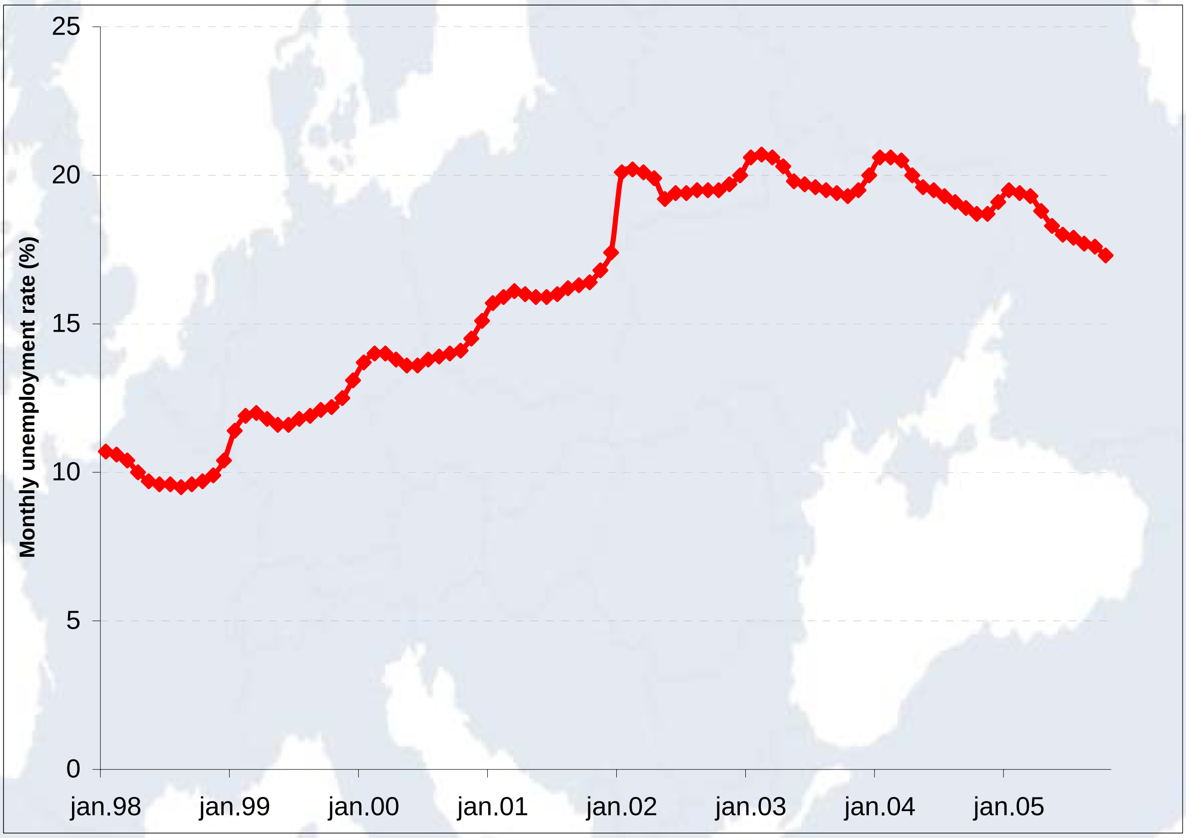
The situation in the labor market in Poland was much more favorable than in the previous year. A stable growth of employment was observed for a few months in annual terms. The unemployment rate fell to 17.3% in October, from 17.6% in September. But according to Eurostat, this remained the highest unemployment rate in the EU. The average monthly gross wages and salaries rise sharply in October: the year-on-year increase was 6.4%, and the monthly was 2.2%.

THE BACKGROUND OF THE POLISH ECONOMY

The first half-year of 2005 was marked by a moderate economic growth as compared to the high rate last year. In the second quarter the growth of the real GDP accelerated to 2.8% from 2.1% in the first quarter, but this growth rate is much weaker than was in the former year, however, the third quarter brought a 3.7% growth in real GDP. The Polish real GDP rose average at 5.4% in 2004 and at 3.8% in 2003.

According to these facts the main targets of new polish government - the election was in September 2005 - are fulfillment of fast, stable economic growth and pushing down the high unemployment in the country.

Chart 2. Unemployment rate in Poland 1998-2005



Source: Central Statistical Office in Warsaw

Development of the Unemployment Rate

Unemployment rate in Poland inched down to 17.3% in October, from 17.6% in September and from 18% in June. At the end of October, there were 2712.1 thousand unemployed persons registered in the labor offices. But the number of the unemployed persons decreased the most among people of age below 27 years (by 3.4% year-on-year) and increases the less among people of age over 50 years (by 1% year-on-year) apart from the groups of the disabled.

In the first half of 2005, a gradual improvement of the difficult situation in the labor market was recorded too. In this period of the year the highest drop in the number of the registered unemployed was observed in Voivodships (Administrative Units) Lubusz (by 9.7%), Lower Silesia and Opole (by 9,3% each), while the lowest in Masovin (by 5.9%), Swietokrzyskie (by 6.4%). But in point of the unemployment rate the Voivodships showed a different view: the highest rate was in the northern Voivodships (max. 27.6%), while the lowest rate was observed in Lesser Poland Voivodship (14%) and Masovian Voivodship (14.4%). The centers of these two Voivodships in a fixed order are Krakow and Warsaw.

This rate is the highest in the EU (the EU-25 average was stable at 8.5 in October), but the index stand already at a lower rate than the top (the rate was at 20.7% in February 2003) since the change of the political and economic regime.

Average employment in September 2005 amounted to 7359 thousand persons and was 1.3% higher than the previous year. The increase of the average employment was observed in many sections (after a decrease in the previous year) like education (by 2.3%), financial intermediation (by 1.8%) and total industry (by 1.2%). The growth was still measured in area hotels and restaurants (by 3.5%), trade and repair (by 4.6%), and public administration and national defense, compulsory social and health insurance (by 2.3%). A significant negative tendency appeared in other sections like agriculture, hunting and foresting (by 1.6%) and health and social work (by 1.1%). (*Data source: Central Statistical Office of Poland*)

Table 2. Average paid employment in Poland 2003-2004

	Total	Agriculture	Industry	Trade and repair	Hotels	Financial inter-mediation	Public administration	Education	Health, social work
2003.12.01. *	***8600***	98	2639	1308	135	226	531	961	654
2004.12.01. *	***8591***	93	2655	1319	141	226	538	953	634
Corresponding period of previous year =100	***99.9***	95.1	100.6	100.8	104.5	99.7	101.3	99.1	97.0
2003.12.01	***7343***	90	2424	804	89	216	529	952	626
2004.12.01	***7273***	84	2414	812	90	215	535	944	606
Corresponding period of previous year =100	***99.1***	93.4	99.6	100.9	100.7	99.6	101.2	99.2	96.9
2004.09.01	***7263***	84	2407	813	90	218	536	940	605
2005.09.01	***7359***	82	2437	850	93	222	548	990	598
Corresponding period of previous year =100	***101.3***	98.4	101.2	104.6	103.5	101.8	102.3	102.3	98.9

Source: Central Statistical Office in Warsaw

** Data covers complete statistical population*

SLOWLY RISING WAGES

The average corporate gross wage measured PLN 2538.88 (~ EUR 636.42) in October 2005, a 6.4% y-o-y increase and a monthly increase of 2.2%. In front of the sharply raise of October, in the first half of 2005, average monthly gross wages and salaries in the national economy amounted to 2267.42 PLN (~ EUR 561.23), i.e. the level higher by 3.8% than in the same period of the previous year. Compared to the first half of 2003, a growth in wages and salaries was observed in all sections. The year-on-year figures of the different sections in September 2005 were the following: agriculture, hunting and forestry (by 8.3%), real, renting and business activities (by 8.1%), mining and quarrying (by 7.1%), education (by 4.6%), while the lowest growth was observed in trade and repair (by 0.9%). The average total number of retirees and pensioners in the fist half of 2005 stood at 9184.3 thousand persons and was by 0.4% lower than the previous year. (*Data source: Central Statistical Office of Poland*)

EXPECTATIONS

The report of an economic research institute, the Adam Smith Center (CAS) revealed that, although until 1999 Poland was the fastest-developing country in the region, it fell below average in 2000. Even last year's significant GDP growth (by 5.3%) was lower than in the other new members of the EU. But the new Prime Minister of Poland declared that the trend will likely change. He announced that by the end of next year GDP could reach even 5%. At the end of 2005 we can see these positive changes in development of GDP, according to the third quarter 3.7% growth.

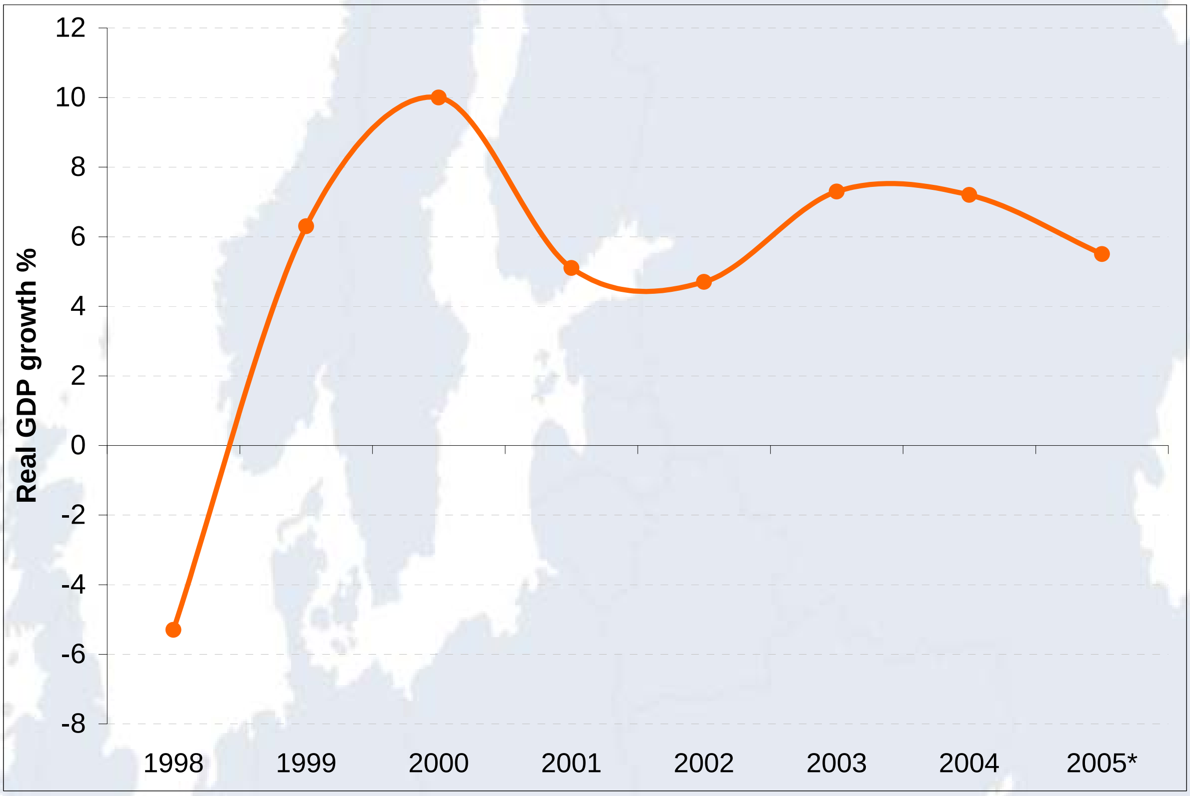
Experts acknowledge that the main factor contributing to the rise continues to be net exports, which made up 2.1% of total GDP. Another element influencing the third quarter boom was domestic demand, which increased by 1.6%. Private consumption grew from 1.6% in second quarter to 2.7% in third quarter. What analysts are particularly happy about is that investment growth was 5.7%, which, with the exception of fourth quarter in 2004, is the best result in the last six years.

For further improvement of the GDP growth the domestic demand must further intensify. And the new government promise that investments and consumption will grow further due to the planned revaluation of the pension and retirement, one can already observe an increase in salaries and employment. According to the experts we can expect that after the restructuring of the polish firms (and after the dismissals) the employment will rise.

RUSSIAN GDP GROWTH RATE SOFTENED TO 5,5%

Since 1998, Russia has been displaying robust economic growth. (Chart 1) In recent years, the main factors of this recovery have been terms-of-trade gains (the rise and sustained high level of commodity prices, most importantly of crude oil and natural gas) and a somewhat stabilized economic and political environment. This impressive growth, however, while still robust enough, has slowed down recently with GDP growth in 2005 estimated at 5.5% by the IMF.

Chart 3. GDP Growth



Source: IMF

** IMF estimation*

The main driving force behind the latest stage of Russia's economic recovery has been the oil sector. (For a more detailed analysis of oil and the economy of Russia, see the *October issue of News of the Month*). Triggered by rising world oil prices, oil output and revenues have soared. Besides a high increase in export revenues, this resulted in long-needed increased investment both inside and outside the oil sector by commodity-based companies. This in turn triggered a significant growth in total factor productivity (TFP) and real wages, leading to an increase in consumption and domestic demand.

While Russia's growth has been on the whole quite impressive, there are some causes for concern. First of all, much of the growth itself is directly commodity-dependent, and thus vulnerable to the changing fortunes of the *oil industry*. Even if the world oil price were to remain at its current level over a sustained period, Russia would probably be unable to benefit from it to the extent it did over the last couple of years. The reason for this is that the oil production capacity of Russia is already overstretched and output cannot be increased any further (mainly because of bottlenecks in the transportation system and a lack of new fields).

According to a recently published report of the International Energy Agency, the crude output of Russia has actually decreased in 2005.

This has further reverberations for the economy as a whole. *Productivity* growth, another main engine of the recovery, is contingent upon investment, and most of the investment has come from commodity-based firms, as growth in SMEs has been limited and foreign investment is largely limited to the energy sector. Accordingly, the slowdown in oil output has been accompanied by a mild deceleration of investment, consumption and real wages.

As far as *consumption*, the main source of domestic demand growth, the main issue here is that, despite the recent deceleration, it may still be increasing too rapidly. According to a recent study by Price-Waterhouse-Coopers, consumer expenditure in Russia increased by 22% in 2004, compared to an 18% increase in the real income of the population.

A closer look at the components of GDP reveals that behind the impressive aggregate GDP growth, there are serious discrepancies among sectors (Table 1).

Table 3. Growth Rate of Value Added by main Sectors

(To period of previous year)

	Q1-04	Q2-04	Q1-05	Q2-05
GDP growth rates	7.6	7.7	5.2	6.1
Of which				
Extraction of mineral resources	7.9	8.2	3.0	1.2
Manufacturing	9.6	8.4	-0.4	2.8
Electricity, gas and water	-0.4	3.5	0.6	0.7
Construction	13.9	14.7	4.6	6.6
Transport and communication	9.4	11.7	6.2	6.8
Trade (wholesale and retail)	9.5	10.5	9.4	10.8
Hotel and catering business	7.7	8.6	11.6	10.9

Source: World Bank

The (retail) trade boom (fuelled by the real wage increase and high consumption) continues at a pace of around 10%. As far as industrial production is concerned, however, both the extraction of mineral resources and manufacturing has experienced a significant slowdown. The same applies to transport and communication and construction.

The reasons for the slowdown in the extraction of mineral resources (primarily though not exclusively crude oil and natural gas) have been discussed above. As far as *manufacturing* is concerned, there are several factors contributing to the slowdown. Real wage increases and a slowly but steadily appreciating ruble make Russian enterprises less competitive. Also, investment has been meager in many sectors in recent years, resulting in low productivity and limited capacities.

The fortunes of the oil industry have strongly affected other macroeconomic indicators as well. Monetary authorities have been intervening heavily to counter the effect of windfall export revenues and hold the ruble's rate against the dollar relatively steady. This in turn resulted in excess liquidity and increased consumption, which is responsible for a robust two-digit inflation (which will be up around 12.9% for 2005 according to IMF estimates, a 2 percentage point increase from last year, and is clearly above the official and year target of 8.5%). Moreover, the steady real appreciation of the ruble has had a negative effect on competitiveness: a recent study by the World Bank concludes that most of the growth in the economy has been concentrated in non-tradable sectors.

In terms of *external balances*, windfall oil revenues naturally had a largely positive effect: the situation has been steadily improving significantly since 1998. The years 2004 and 2005 has been spectacular in this respect, and *current account and trade balances* are estimated by the Central Bank of Russia to be at a robust USD 69.1 and 92.8 billion, respectively in the third quarter of 2005. *Foreign reserves* have increased dramatically in recent years too: they stood at about USD 165 billions in November 2005, compared to USD 50 billion at the end of 2002. However, one should keep in mind the fact that the rise of non-commodity exports has been far less spectacular. As a matter of fact, if one excludes oil, gas and metal exports from the analysis, the trade balance of Russia has actually somewhat worsened recently. A recent study by the World Bank indicates that while import has grown by 28% in USD terms in the first 9 months of 2005, non-commodity exports have actually declined.

In terms of *fiscal policy*, by IMF estimation Russia is to have a high budget surplus of about 8.9% of GDP in 2005 due to higher than expected oil revenues. So far, Russia has successfully resisted the temptation of spending this considerable amount of money on inefficient investment and populist social schemes: since 2004, an automatic saving mechanism has directed unexpected fiscal oil windfalls into the so-called Oil Stabilization Fund (OSF). (So far, part of the money in the Fund has been used to finance early repayment of parts of Russia's debt to IMF and the Paris Club.) The budget for 2006 is considerably prudent too. Nevertheless, several pitfalls still lie ahead: an approved increase in the reference oil price may weaken the automatic saving mechanism of OSF, and a recently proposed reduction of the VAT rate (from 18 to 13%) in order to enhance competitiveness is controversial as well since VAT is among the more stable sources of revenue for the government and could prove crucial if windfall commodity revenues started to decrease.

SUMMARY

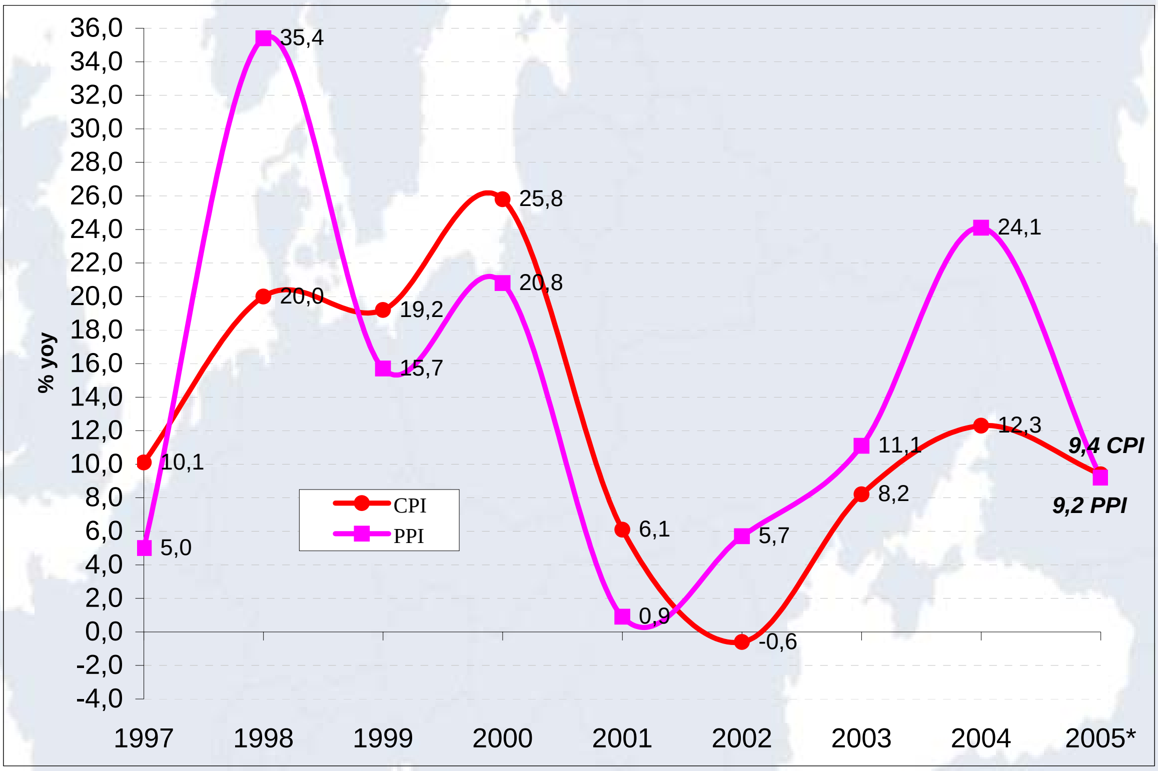
In sum, despite its recent softening, Russia's GDP growth is still robust and is likely to remain so in the next few years in the absence of any unforeseen major shocks. This favorable situation offers a good chance to bring about long-needed structural reforms. In fact, without these structural reforms implemented, it is unlikely that Russia could continue on the path of sustained robust GDP growth. Other important tasks in terms of economic policy are the further improvement of the investment climate and the diversification of an economy with an unhealthy dependence on commodities (and oil in particular). Inflation continues to be a problem, and Russia is in risk of getting the 'Dutch disease': an appreciating currency, increasing imports and less competitive exports. In short, the robust growth should not be taken granted; rather, it should be interpreted as a unique opportunity to implement reforms that are long overdue and absolutely necessary.

DECELERATING, BUT STILL HIGH INFLATION IN UKRAINE

By the expectation of IMF, Ukraine will finish the year 2005 with two-digit, namely 13% inflation rate. The concrete order of magnitude is in question, but the two-digit extent is sure according to most of expectations of economic institutes.

After several years of serious structural problems originated from transition, economic decline accompanied with hyperinflation, when in the first five years of transition prices were growing at an average monthly rate of almost 30%, in 1996, after the introduction of new currency, the Hryvnia, some macroeconomic stability was achieved with a two-digit yearly inflation rate. This was due to heavy structural reforms and bound Hryvnia to the USD by an exchange rate corridor that stabilized the expectations of economic actors. In 1998, the Russian crisis contaminated Ukraine as well and caused Hryvnia devaluation and considerable price index rise. The recent relative stability of the currency and of prices was reached in 2000 by stabilization of foreign exchange market (switch from managed peg to free float – de facto fixed to USD by National Bank of Ukraine intervention). Till the year of 2005, it meant for Ukraine relative price stability and one-digit CPI (Consumer Price Index) rates, with exception of last year when the CPI inflation amounted to 12.3% y-o-y.

Chart 4. Development of Consumer and Producer Price Indices 1997-2005



**November 2005 to December 2004*

Source: State Statistics Committee of Ukraine

The year 2005 brought some changes in the economic performance of Ukraine. The real GDP growth rates seem to be considerably under the rates of the previous year. This means real GDP growth in 2005 not more than 3-4% in contrast to record high 12.1% y-o-y of 2004.

CURRENT PROCESSES

According to data originated from State Statistics Committee of Ukraine (Derzhkomstat), the January-November 2005 consumer price index was 13.8% (in per cent to corresponding period of previous year). The November 2005 CPI to December 2004 is 9.4% in contrast to the November 2004 9.7% of previous year December. The CPI of the month November reached the 1.2%. Taking into consideration that these indices were 0.0% in August, 0.4% in September and 0.9% in October, this is an accelerating trend. As regarding the price trends of industrial production, the PPI rose by 9.2% during the first eleven month of the current year in contrast with considerable 22.9% of the previous year. Thus, it can be stated that the trends of consumer and producer indices are on downward, despite the acceleration of monthly indices.

Table 4. Changes of the CPI and PPI in November 2005

	To previous month			To December of previous year	
Activities	**September 2005**	**October 2005**	**November 2005**	**November 2005**	**November 2004**
Food products	99.4	100.9	101.4	109.5	111.6
Non-food goods	100.6	100.3	100.1	104.0	104.6
Services	103.7	101.6	101.5	114.4	107.1
All goods and services (CPI)	**100.4**	**100.9**	**101.2**	**109.4**	**109.7**
Mining and quarrying	100.9	99.7	100.7	126.8	121.2
Manufacturing	101.8	100.2	99.5	106.6	124.9
Machine-building	100.7	100.3	100.0	105.5	111.9
Electricity, gas and water supply	103.7	98.4	102.6	113.4	112.5
Industry of Ukraine (PPI)	**101.9**	**100.0**	**99.9**	**109.2**	**122.9**

Source: State Statistics Committee of Ukraine

SUPPLY FACTORS

In the case of **CPI**, the services sector was the main contributor with its 14.4% increase within 11 months, followed by food products' 9.5% rise. The prices of non-food products remained relatively stable.

Among the services, the urban and highway transport and lending of private real estate performed above 20% price growth. The education and health care services also performed around 16-17% increase. Only the communication and railroad transportation tariffs remained unchanged. The leading forces within the group of food products were because of its season affected summer run: sugar (22.6% -only in April 10.3%), fruits (19.6%), meat (16%) and diary (16%). The prices of eggs, vegetables and vegetable oil even decreased considerably. As regarding to non-food goods, all of them performed around the average level, only the fuel conveyed 28.8% rise in first 11 month of 2005, which is still less aggressive price development than 62.4% in the same period of previous year.

As of **PPI**, the prices of mining and quarrying both of energy producing materials and other materials increased by 26.8%. The electricity, gas and water supply production prices rose considerably by 13.4%. In the manufacturing industry, the price pull power was proved by the chemical industry and the production of construction materials. The manufacture price of machinery, electronic and electrical equipment were pushed by more than 10% and only the production of transport equipment kept relatively low the price index of machinery-building.

OTHER FACTORS

The main factors of the inflation pressure from outside was the rising price of oil, that influenced the cost side of the production, the fuel price increase and also as it is proved from import, through imported inflation. The fuel price boosted the transportation costs, influencing the overall economic performance.

In connection with imported inflation important to mention that Russia and the EU are the biggest importers of Ukraine with share 40 and 32% respectively. Russia is performing continuously two-digit inflation rates. Additionally, Russia supplies Ukraine with oil and gas, and even in the case of contractual under-world-market prices it puts remarkable pressure on domestic price developments.

The Ukrainian national currency (UAH) against EUR evolved slight inflation pressure on prices in Ukraine. Although the National Bank of Ukraine (NBU) keeps the UAH/USD exchange rate de jure free floating de facto fixed around the 5.05 UAH/USD level, the NBU revaluated the Hryvnia against USD two times in the year of 2005 from 5.30 UAH/USD, boosting the import into the country. This means that the foreign exchange policy was in favor of inflation policy of the NBU, through stronger Hryvnia.

The NBU also operates with money supply (by the aggregate monetary base). By the finding of Institute for Economic Research and Policy Consulting, the effect of money supply growth on price dynamics is weak, implying that the power of monetary policy is low.[1] Nevertheless, it is inevitable to draw the development of it. Parallel with the diminishing real GDP growth rates, monetary policy started to tighten that led to remarkable slowdown of monetary base from 45.5% y-o-y in March to 27.2% in September. As the inflation rates started to slack in the last few months, no need for remarkable sterilization appeared. The official NBU discount rate is 9.5% from 8th of October 2005 that is the highest since 7th of May 2002, reflecting stricter monetary policy approach.

Further element of the inflation tendencies is the development of consumption trends in Ukraine. The development of demand side of GDP shows an obvious shift in favor of households' consumption from investment and export-boosted economy. Households' expenditures have grown by 35% in real terms in January-September 2005 compared with the same period of 2004, when it has grown by 23%, expressing increasing importance of private consumption. This phenomenon is backed by rising wages (23.8% real wage growth in 2004 and 17.8% in first nine months of 2005) and social benefits that were mainly used for imported goods. These wage developments threaten the monetary policy with wage-inflation pressure.

The expectations of Ukrainian consumers and producers are the leading factors in country that passed a so-called hyperinflationary period during transition. Thus, the credibility of monetary

[1] Olena Bilan and Boris Siliverstovs (2005): Inflation Dynamics in the Transition Economy of Ukraine, Institute for Economic Research and Policy Consulting, Working Paper No. 28, page 14.

policy, especially through keeping foreign exchange rates (particularly USD) is crucial in the moderate inflation.

EXPECTATIONS

By the current trends of economic development in Ukraine, the GDP growth rate in the following time period will remain moderate. The consumption will be the main contributor of growth and also of inflationary developments. In this way, the development of wages and the measures related to minimal wage formation by the parliament is matter.

Ukraine characterized by high degree of state intervention in the price formation mechanism, mainly in the field of commodities in form of explicit fixing of prices to administrative regulations (export bans, firms mark-up constraints). The expected WTO entry can direct Ukrainian economy into a country with less tariffs and barriers on goods; it can cause negative or positive price shocks.

Summarizing the expectations of the analysis, a further decline in inflation is expected. Ukraine will likely to perform one-digit inflation rate in the next year.