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Budapest, Hungary, Phone: +36 1 248 1160, +36 1 248 1161 Fax: +36 1 319 0628
E-mail: office@icegec.hu Website: www.icegec.org

TABLE OF CONTENTS

TRANSNISTRIA - THE UNRECOGNISED COUNTRY IN MOLDOVA

A small Moldavian territory east of the Dniester River, landlocked by Ukraine has been struggling for independence with its approximately 550 thousand citizens for the eighteenth year now. Transnistria - officially called Pridnestrovie or Pridnestrovian Moldavian Republic according to its own constitution - is a small seceder republic *de facto* independent, however, still legal part of the Republic of Moldova, not accepted by any state or international organisation. The unrecognised republic declared independence from Moldova after the collapse of the USSR on 27 August 1991, with capital Tiraspol. Igor Smirnov has been the President since gaining independence and is currently serving his fourth mandate, striving constantly to resolve the political status of the region lacking recognition, but still functioning as a state with its own government, parliament, constitution, flag and national anthem.

Especially after the accession of Romania to the European Union on 1 January 2007, the EU began to pay closer attention to the ongoing conflict within the borders of Moldova - the poorest country of Europe - as it has become a serious threat on its immediate border.

A 'FROZEN' CONFLICT

The separatist region is the biggest challenge for the Republic of Moldova, since its status concerning the degree of autonomy has not yet been resolved after the ceasefire signed in 1992, putting an end to a long-lasting confrontation with the Moldavian army. Henceforth, in 1997, the Republic of Moldova and Transnistria signed a memorandum on the Transnistrian settlement that proposed a common state for both signatories. As a result of no clear definitions to the terms, there was no consensus on the fundamental issue of a state with full autonomy. Unfortunately, the conflict remained 'frozen'.

After the collapse of the USSR followed by Moldova's independence, many from the eastern bank of the Dniester River were beware of the fact that Moldova would join Romania. Whilst Russians and Ukrainians were dominant ethnic groups in the region, the fear over accession became a driving force of breakaway in this narrow strip of land. Concerning the ethnicity, 32% Moldavians, 31% Russians and 29% Ukrainians live in Transnistria, however the conflict was not based on ethnic identities since no tensions exist between these three major groups living there. It was rather the economic factors and business interests related to the ex-Soviet Union that led to the willingness of secession and that also explain the wide support received from the motherland throughout the past decades. Although independent from the USSR since 1991, the so-called Russian (ex-Soviet) 14th Army has remained in Transnistria, supporting the Slavic majority population and acting as peacekeepers up to this day.

As mentioned before, it is not the issue of ethnic dimensions that contributed to the 'never-ending' conflict between the two sides of the river; it is the Republic of Moldova that still holds on to the region, with a fairly justified reason. In spite of Transnistria's small size (12% of the Moldavian territory); most Moldovan industry is located in Transnistria. Back in 1990, Transnistria (with its 17% of the Moldavian population) assisted to nearly 40% of the former Moldavian GDP, 33% of its industrial output and 90% of its energy output. Besides losing the aforementioned, significant part of domestic production, Moldova had to face a range of practical problems regarding the eastward orientation of trade. Bypass of traded goods through Transnistria was limited after consequently investing into diverting railways and roads to the north and south of its border with Ukraine. Obviously, this has raised product prices in general, since increase in transportation prices had to be balanced somehow.

CHARACTERISTICS OF THE ECONOMY

Transnistria has achieved a relatively high degree of self-sufficiency during its nearly eighteen years of self-proclaimed independence. It enjoys a robust infrastructure (railroads, gas and power supply networks, etc.), has introduced its own currency, and implemented an effective export policy. Its own central bank - the Transnistrian Republican Bank – is responsible for the 'Transnistrian rouble', the local currency that is convertible at a freely floating exchange rate only within the borders of the unrecognized country. According to the government[1] (statistics may vary), the 2006 annual real GDP growth was 7.7% and the inflation rate was 8.9% year-on-year. Even so, the 'republic' became a paradise for illegal arms sales, smuggling, and money laundering. Due to the fact that its economy is not accounted for in official Moldavian economic statistics, Transnistria relies on three main sources of income: legal trade, Russian subsidies and illegal trade, more known as smuggling. Corruption is one of the most critical elements of the region's economy, which is also a factor of attraction to the neighbouring – Moldavian, Russian and Ukrainian – black markets.

The economy of the 'country' is based on a mix of heavy industry, electricity production and manufacturing. With a large scale privatisation process in the late 90s, followed by the privatization of state-owned enterprises by the government in the year of 2000, the problem of an evolving fiscal crisis could be avoided, since the government had accumulated a massive external debt by that time. The government took over three-quarters of the state assets, which was primarily sold to Russian companies. The sell-off included such, strategically important enterprises as the Moldovan Hydroelectric Power Station in Cuciurgan and the Moldovan Metallurgical Plant in Ribnita, which generates about 40% of the budget revenue of Transnistria. This makes us clear how much the region continues to be a drag on Moldovan economy, as the illegal separatist regime took over income sources that originally concern the Republic of Moldova. In 2005, revenues from privatisation funded more than 50% of the region's budget, while debt was still more than USD 1.5 billion in March 2007. The government's budget for 2007 was USD 246 million with an estimated deficit of USD 100 million that is planned to be reduced by approximately USD 20 million with income from tax increase and further privatisation processes. In addition, most of the debt accumulated during the past years is owed to Gazprom (approx. USD 1.3 billion in 2007), mainly for gas imports[2], even though Russia concedes a preferential rate for its natural gas and energy imports.

FOREIGN TRADE

Transnistria's economy is very open; foreign trade turnover in the first nine months of 2007 was USD 1346.1 million (foreign trade turnover was 309.7% of GDP in 2006). Its main trading partners are Russia, Belarus, Ukraine and the Republic of Moldova; however, goods are even exported to the US, the EU, Africa and Asia. The breakaway country is a net importer, the Transnistrian Republican Bank reported exports of USD 422.1 million and imports of USD 738.4 million in the year of 2006. Besides textiles and electricity, export consists mainly of steel products; steel produced by the state-owned plant in Ribnita accounts

[1] Source: Trans-Dniester Republican Bank

[2] In March 2007, Transnistria's gas debt was sold to the Russian businessman, Alisher Usmanov, who controls the largest enterprise in Transnistria, the Moldova Steel Works. Eventually, the president, Igor Smirnov has announced that "Transnistria has no legal debt to Gazprom", hence no pay off will occur.

for approximately 60% of total official export earnings. Considering its imports, food products add up to the 20% of total imports but the emerging country also imports energy, non-ferrous metals, transport equipment and chemicals.

A brief explanation to the fact that Transnistria is several times referred to as the black hole of Europe, comes in the followings. Transnistrian authorities apply very low or rather no tax on imports and exports, and even Moldova agreed to exempt Transnistrian foreign trade from taxation in the beginning. A highly profitable re-export business has developed this way, until the Republic of Moldova has introduced a registration system for Transnistrian companies exporting goods to Ukraine in 2003. Although it was seen as a constructive approach to the resolution of trade issues by the government of Moldova, in practice however, there were still no taxes paid after exports to the Moldovan state. The actual winners of the unresolved problem were the individuals and their business partners in Russia and other countries, bordering Transnistria. As Vladimir Voronin, the President of Moldova recently said, the Transnistrian conflict is "a conflict of interests". According to Voronin, an estimated USD 2 billion per year is generated illegally in the black hole, not to mention the fact that the lack of trading accountability assumes that human and arms trafficking through the breakaway state remain significant concern to the European Union.

Chart 1. Foreign Trade Turnover, 2004-2007 (USD million)

Source: Trans-Dniester Republican Bank

The roots of today's major concern for the Transnistrian Parliament go back to the 3 March 2006, when Ukraine implemented new customs regulations for goods imported from the separatist regime. The system was actually the realisation of the joint customs protocol between Ukraine and the Republic of Moldova signed in December 2005, which says that goods from Transnistria could only be imported with documents processed by the Moldovan customs offices. Additionally, the EU launched a border assistance mission (EUBAM) in Ukraine, on the Transnistrian part of its border with the Republic of Moldova, in order to fight contraband between the two states. Not surprisingly, both Transnistria and its biggest trading partner Russia have denounced it as an economic blockade. Transnistria responded the following day by blocking all Moldovan and Ukrainian transport at its borders but it was lifted already after two weeks. Quoting the words of Helen Chernenko, the Ministry of Economy of Transnistria, blockade not only meant the loss of several millions of USD but "there is also another loss which is even more important: the loss of confidence in Moldova as a serious partner with whom Transnistria can build a common state in the future."

International Attention

Already from the beginning of 2003, international attention towards the Republic of Moldova increased significantly with the establishment of an EU Commission Delegation office in Chisinau that focused on the Transnistrian conflict. The Organization for Security and Co-operation in Europe (OSCE) that opened its first branch office in Tiraspol on 13 February 1995 was not too successful in resolving the conflict so far. The mission of the OSCE is to consolidate the independence of the Republic of Moldova and to reach an understanding on the unique status of the Transnistrian region. The aim of the organisation also covers a wide range of human issues as democratisation, minority rights and media freedom. In 2005, the EU as well as the United States gained observer status in the OSCE-lead, five-sided negotiations between the OSCE, Ukraine, Russia and the two conflicting parties, which was only promising until the implementation of the customs regulations in 2006. Besides the EU such foreign donors took part in the support of the state and its civil society as the Soros Foundation Moldova, the British Peace-building Framework Project and the US Embassy.

After all, Western attention today is still not too significant, as most states and organisations have lost their interest for certain reasons. Lack of any progress in terms of settling the Transnistrian conflict lead to growth in discontent; although several memorandums were proposed already by each country involved, such as the Kozak Memorandum in 2003 suggesting an asymmetric federal Moldovan state[3], no proposal could bring the issue any closer to a solution to this very day. Concerning Moldova, a central question has made it even more difficult to resolve the conflict: Relationship and cooperation should be strengthened with Russia and the CIS countries or rather tendencies towards the European integration should be set prior? Linkage to the Russian and CIS system would suggest independence to the region, while integration with the European Union would necessitate democratic means of consolidating the ongoing conflict, offering Transnistria favourable conditions to reunite with the rest of the country. The so-called '3D Strategy' initiated by the Moldovan civil society to demilitarise, decriminalise and democratise Transnistria to integrate it back to Moldova has also remained a plan followed by no action, as no political, economic or social incentives urge Transnistria for unification.

The position of the United States[4] on the conflict is made quite clear; it fully respects the territorial integrity of Moldova and considers Transnistria a part of it, and by all means, considers separatism unacceptable since the secession of the region does not meet the appropriate conditions of international law. According to the US government, citizens of Transnistria do not constitute a "people"; they do not suffer serious harms and have other solutions than secession to the problem. Finally, as considered a de facto regime, it does not have the legal right to make any change in the economic structure of Transnistria by selling assets of the Moldovan government, as emphasised before.

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[3] Tiraspol has always supported the establishment of a federation made up of two equal parts – with veto power over Moldovan policies, such as the question of future EU integration - instead.

[4] Separatism in Moldova: Political and legal aspects of a "frozen conflict" (2006): Woodrow Wilson International Center for Scholars

CURRENT STATUS AND CONCLUDING REMARKS

A referendum was organized on 17 September 2006 by the Transnistrian authorities. The results – that may not be completely reliable - showed that the population voted solidly in favour of independence from the Republic of Moldova and free association with Russia. Moreover, a new opinion poll carried out by the CBS_AXA Center for Sociological Research and Marketing revealed that less than 5% of all Moldavians – excluding the population of Transnistria – consider Transnistria an important issue for the country, especially compared to the question of European integration.

However, it is unlikely that the 'frozen' conflict will be solved any time soon; it should be placed higher on the agenda of the international community. Europe needs to play a far stronger role and should develop its own clear position in the resolution of the Moldavian conflict, as becoming neighbours after the accession of Romania to the European Union. Moreover, Europe should work in coordination with the OSCE not only to demilitarise the region of Transnistria but to revise the situation of democracy in the Republic of Moldova as a whole. Securing democratic environment would also suggest free independent media, plural education system and freedom of association on both sides of the Dniester River. The EU should stand by the increase of financial assistance in order to fulfil all democratic criteria and economic development in Transnistria, not leaving it alone in dealing with Russia, thus taking no effort in the improvement of the problematic situation. The Speaker of Transnistria's Parliament, opposition leader Yevgeny Shevchuk has also announced that international relations will be intensified in the year of 2008.

Sustainability of External Balances in the Baltic Countries

This analysis deals with the current account[5] (CA) and trade balance developments of three Baltic States: Estonia, Latvia and Lithuania. The possibility of sustaining a high current account deficit is examined.

Current Account

Economists have been studying for a long time whether sustained CA deficits have a negative impact on a country's economy. In the currency crises of Argentina and Mexico back in the 1990s high CA deficits definitely played a role. But the case of Argentina and Mexico is hardly comparable to the Baltic States. This because of differences in the economic, legal and institutional setup: the institutionally more mature, rapidly growing small open Baltic States can maintain large CA deficits more easily.

For a decade, all Baltic countries encountered huge and increasing CA deficits. Out of the three economies, Lithuania has somewhat lower one than the other two; such figures could have also been seen among selected Central European, Visegrád (V4) countries. Latvia and Estonia, however, exhibit outstandingly high deficits.

Table 1. Current Account Balances of Baltic and V4 States, 1996-2006 (% of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Estonia	-8.6	-11.4	-8.7	-5.3	-5.5	-5.6	-10.2	-13.0	-13.2	-10.0	-15.5
Latvia	-5.0	-5.7	-9.7	-8.9	-4.7	-7.7	-6.6	-8.2	-12.4	-12.5	-22.4
Lithuania	-9.0	-10.0	-11.7	-11.1	-6.0	-4.7	-5.2	-6.9	-8.0	-7.2	-10.8
Czech Republic	-6.6	-6.2	-2.0	-2.4	-4.8	-5.3	-5.5	-6.2	-5.2	-1.8	-3.3
Poland	-2.1	-3.7	-4.0	-7.4	-5.8	-2.8	-2.5	-1.9	-4.2	-1.6	-3.2
Hungary	-3.8	-4.3	-7.0	-7.6	-8.4	-6.0	-6.9	-7.9	-8.4	-6.8	-6.6
Slovakia	-9.2	-8.4	-8.8	-4.8	-3.4	-8.3	-7.9	-0.8	-3.4	-5.3	-9.7

Sources: OECD, Institute of Baltic Studies, Eurostat

CA balance can be expressed by the equation CA = S – I, where S is the country's aggregated savings and I is the level of investments. If investment rate is lower than aggregated savings, the remained amount of savings is lent abroad, resulting CA surplus. CA deficit appears if investments exceed domestic savings. The major problem in all the Baltic States is the large private sector savings-investment imbalance. In Estonia and Latvia the year-on-year upward quantity of foreign direct investments, in Lithuania the insufficient public savings are added to the reasons why CA deficit occurs.

In the case of the Baltic States, currently, the deficit is highest in Latvia and smallest in Lithuania. Whereas the CA deficit is much higher in the Baltic States than in the countries of

[5] The balance of payments records all economic transactions that take place between the residents of a country and their foreign partners. It consists of the current account, the capital account and the financial account. The current account balance consists of the balance of trade of goods and services, the income balance and the transfer balance.

the V4, which mainly bases on the differences of the economies. Size, structure, monetary and fiscal conditions are discrepant – enough to observe how the states fulfil the Maastricht criteria. Baltic Countries are not claimed to have bad economic situation: large CA deficit has a number of negative effects – devaluation pressure on currency; risk of crisis if CA deficit is funded by short-term borrowing, lower expected rate of economic growth in the future –, but the considerable inflow of foreign direct and portfolio investments can be favourable for the economy offsetting some of the negative impacts of the decline in savings. Although on the way of becoming a developed country it is a natural phenomenon that quantity of investments exceeds total savings, it does not mean necessarily crisis in the future as both investments and savings are the results of inter-temporal decisions.

However, persistent and substantially large CA deficits can generate some risks in the economy. The level of risk is higher in countries that peg their national currency to a single foreign currency or a pre-defined set of foreign currencies, or follow currency board.

Estonia has set up a currency board to manage the Estonian crown. Currency board is a monetary regime, one aspect of which is that the exchange rate is fixed vis-à-vis a chosen foreign currency or set of foreign currencies. In the case of Estonia the base currency is the euro (formerly the ECU). Latvia and Lithuania had a free floating regime until 1994. In that year they changed their policy system simultaneously: Lithuania pegged litas to the USD, and Latvia also implemented a fixed exchange rate system. Lithuania began pegging its currency to the euro in 2002, so recently Estonia and Lithuania implement currency board, Latvia aims at maintaining exchange rate stability and controlling the amount of banks' reserves which similar to that of a currency board. The main objective of the applied policies is the future accession to the Euro zone. Before the accession, the candidate countries have to adopt the ERM II system. Currencies in ERM II allowed floating within a range of ± 15 % with respect to a central rate against the euro. All the Baltic States are members of the ERM II regime. Currency board seems to be a well applicable institution to manage the currency within this range.

High CA deficits coupled with a fixed exchange rate (currency board) endanger macroeconomic developments in a country. A boosting economy tends to have real appreciation in the currency. If it cannot go off for the sake of fixed exchange rate it appears as higher inflation which worsens price-competitiveness. As it is followed from a board where the currencies are pegged to the euro, an appreciation of the euro against dollar actuates imports, reduces exports causing higher CA deficit. The other risk if foreign investors find the CA-deficit unsustainable, they can withdraw floating, short-term capital, resulting sharp depletion of central bank reserves forcing the devaluation of the national currency. The risk of a devaluation of the currencies would have an undesirable influence before the accession to the euro zone on the Maastricht criteria.

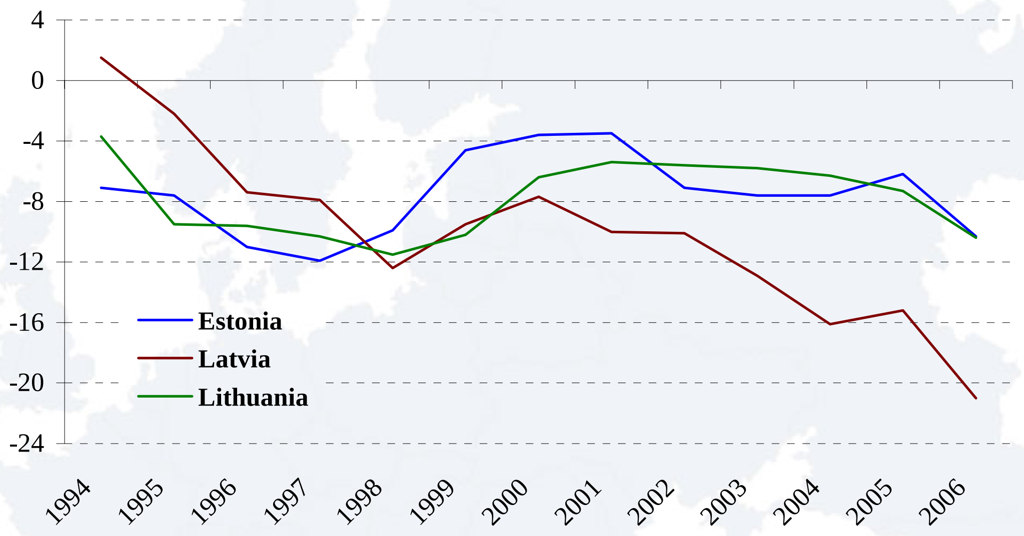
Whether negative CA balances can be maintained on a long run is quite a complex issue. Basically, it is connected to long-term solvency. If a country is believed to remain solvent in the future, a negative current account balance does not necessarily induce risk expectations. The negative position can therefore be consistent with pursuing the recent economic policy: steady growth, transparent political decisions, and investment-friendly economic environment.

Two main arguments have been submitted to support a moderate scrutiny on the balance of payments problem in the Baltic countries. On the one hand Estonia, Lithuania and Latvia have for years benefited from large-scale foreign direct investment (FDI) inflows. FDI contributes not only to high GDP-growth year by year but also has a favourable impact on the structure of financing the CA deficit (by alleviating the need for debt-type capital inflows and by constraining the risk of fast capital outflow). On the other hand all three countries are characterized as internationally competitive economies which also reduce the hazard of depression.

TRADE DEFICIT

Trade balance shows a country's external position in the field of goods and services. Trade balance contains two sections: merchandise trade and trade of services. On the long run the deficit of trade balance of goods and services has to be reduced, inasmuch as sooner or later the income transfers on debts have to be moderated. If the CA deficit is triggered by huge trade deficits the debt burden is below its long-run equilibrium value – the latter case trade deficit causes upward pressure on the debt burden. Based on the data of *Chart 2*, the Baltic States have to face this problem.

Chart 2. Trade Balances of Baltic States, 1994-2006 (% of GDP)



Source: Institute of Baltic Studies, Eurostat

Similarly to V4 economies, the split-up of the Soviet block had a significant effect on the Baltic States. Estonia, Lithuania and Latvia suffered even deeper impacts than other countries. They all were affected by the recession of the 1990s with cumulative output declines of 40-50%. This mainly reflected the collapse of their "traditional" trade connections: approximately 70% of their trade was directed to (or came from) the Soviet Union.

After the dissolution of the USSR, the three Baltic countries launched intensive liberalisation process following the recommendations of the Washington Consensus. It has been a remarkably rapid shift from a centrally planned to a market based economy. Estonia was the first to implement the complete liberalisation of export and import in 1993. Lithuania and Latvia followed Estonia next year. Capital flows were also liberalised in Lithuania and Latvia by 1993 and by 1994 in Estonia.

Small and open economies like the Baltic States depend strongly on foreign trade. In the phase of the transition process, the opening of new trade relations was a substantial component. In all states foreign trade has a substantial share in the countries' GDP.

All Baltic States face a sizable trade deficit. A shift in economic activity from the traded to the non-traded sector had the most influential effect on the evolution of the CA and trade deficits. The shift manifested itself in the contraction of manufacturing and agricultural production and an expansion of wholesale trade, real estate related services and construction. When the performance of the traded sector improved in Estonia and Lithuania between 1998 and 2001, this caused an observable temporary improvement in the trade deficit.

Fixed or pegged exchange rate regimes have an additional effect on trade balances. A devaluation of the currency would help to reduce the big difference between the amount of exports and imports. On the other side, current-account deficit paralleled to fixed exchange rate has positive impact on the country's GDP as high rate of FDI contributes to the increase of total investments. The abdication of currency board would have harmful effect on development, so there is no economic reason to eliminate it. The devaluation of the currency would close the imbalance between savings and investments primarily by reducing investments. The mentioned accession process to the monetary union, however, limits the room to use exchange rate operations as a correction of foreign trade problems.

OTHER INDICATORS

There are other factors beside huge inflows of FDI and transparent economic policies that can help to sustain high CA deficit, even combined with a fixed exchange rate regime.

The economy's openness, flexible labour markets and a low level of public debt are those indicators which help assessing the sustainability of the CA-deficit. A number of economists say current account deficit does not matter as long as the public sector is in balance. The level of public debt in the three Baltic States remains well under the level of the European Union as a whole.

Table 2. Public debt, 1997-2006 (% of GDP)

Country	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Estonia	6.4	5.6	6.0	4.7	4.7	5.8	6.0	5.5	4.4	3.9
Latvia	-	9.8	12.6	12.9	15.0	14.2	14.6	14.7	12.0	9.8
Lithuania	15.2	16.5	23.0	23.8	22.9	22.4	21.4	19.6	18.6	18.2
EU average	**71.0**	**68.9**	**67.7**	**64.1**	**63.1**	**61.5**	**63.1**	**62.5**	**63.4**	**63.8**

Source: Institute of Baltic Studies, Eurostat

The proportion of long-term public debt is relatively high in all the examined countries. It is alleged that the policy of long-term borrowing is an important element in a long-term sustainable current account deficit. Whereas the difficulty of renewing public debt financed by further debts in the future appears mainly in the countries which have high level liabilities denominated in foreign exchange. It is not the case of the Baltic States as the governmental debt has primarily domestic sources.

In the Baltic countries the extremely high amount of short-term foreign debt causes adverse impact. In Estonia the total foreign debt has increased from EUR 1.3 billion in 1996 to EUR 9.5 billion in 2005. In Latvia and Lithuania the similar indices are EUR 1.2 billion and EUR

1.9 billion in 1996 and EUR 18.2 billion and EUR 14.4 billion in 2006. While in Lithuania the foreign debt ratio to GDP remained moderate (60.9% in 2006), the same indicator generates dilemmas in Estonia and Latvia where the foreign debt/GDP index equals to 83.9% and 94% (2006). All the three Baltic countries face the problem that short term external debt extensively shares in total foreign debt which increases external vulnerability. Short term borrowing is more likely to cause economic problems as it is more risky and unstable source of finance. Recently there are some phenomena which support this view.

CONCLUSION

As in the Baltic States the main sources of current account deficit are the foreign direct investments it is unlikely that the three Baltic Countries will have to face with serious difficulties based on the negative position of balances. FDI capital is more difficult to withdraw than short-term capital. However, the huge quantity of short-term external debt generates anxiety. Besides, the high level of FDI can pose a further problem in the form of increasing outflow of dividends in the future. If it appears it would have substantial pressure on the devaluation of the currencies. Based on the theory of smoothing in time CA-deficit is going to fall back by the time investment propensity slows down and savings rate starts increasing.

MONETARY CHALLENGES AT THE END OF 2007 IN RUSSIA

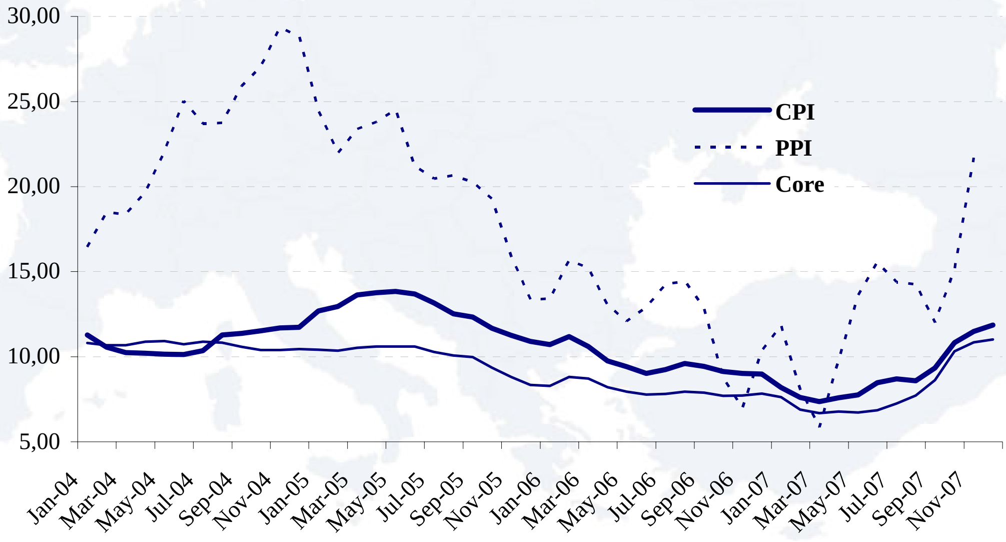
Russia experiences a new challenge concerning its economy, namely the surging inflation. After almost a decade of successful disinflation process, growth developments, world market energy prices and extreme capital inflows might modify these downward moving prices. After the 9.0% of 2006, Russia is likely to publish higher inflation rate for 2007. The World Bank estimate was closed to 11% inflation rate in December 2007, as compared to the same month of 2006. Statistical Office of Russian Federation published 11.9% for the same data that is exceeding the government's plan by almost 3 percentage points.

TRENDS AND CURRENT DEVELOPMENTS

Investigating the time-series of inflation, Russia managed to realise a continuous and unbroken disinflation process. In the course of five years in 2002-2006, the monetary policy managed to decrease slowly and carefully the pace of inflation from 15.1% to 9.0%. This is a quite considerable performance, especially in the light of different pressures on prices in the case of Russia.

Nevertheless, the first signs of change were observed in the second quarter of 2007. The annual inflation in March 2007 reached a record low point by its 7.4%. Since that time, inflation accelerated to 11.9%. Both the Producer Price Index (PPI) and the Core inflation show similar developments. (*Chart 3*) Thus the core inflation is the main contributor of the CPI, while PPI reflects that production faces also significant upward pressure. The with some month time lag will likely to appear in final products.

Chart 3. CPI, PPI and Core Inflation in Russia, 1995-2006 (%)



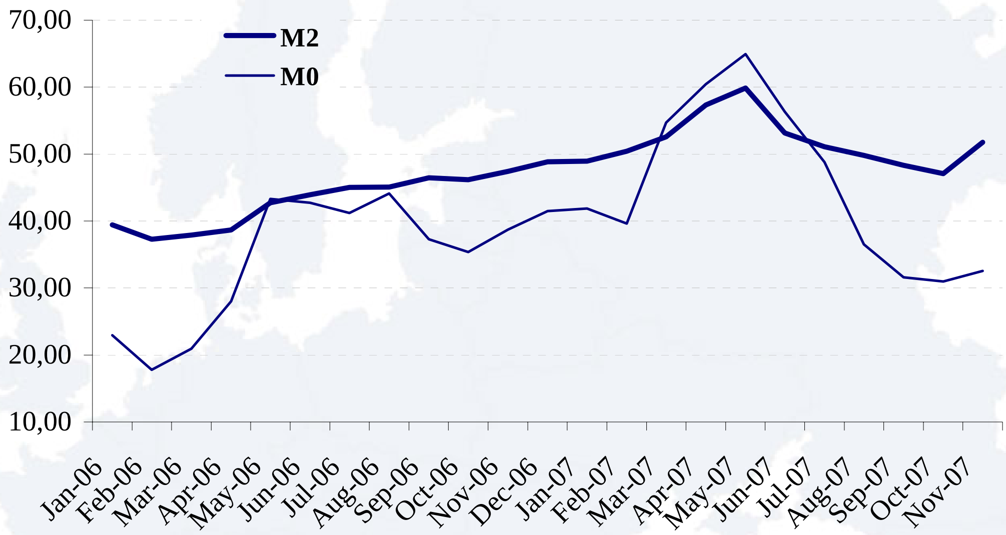
Source: Rosstat, own calculations

FACTORS BEHIND

In the basket used for measuring CPI, the main contributors of inflation were prices of food and non-tradable goods and services. As for food products, according to *Rosstat*, meat products, milk and milk products, bread and bakery products and fruits and vegetables contributed considerably to end-year acceleration. This is a consequence of the rise in international food prices caused by increasing demand on mentioned food products in populous emerging countries (China, India etc.) and supply-side shortages coming from worse food related agricultural production observed on a world-wide scale.[6] Increasing investments and booming construction activity caused relative shortage of construction materials that led to extreme rise in prices of these products. Among services, the communication services became more expensive as compared to the previous year.

From monetary point of view, accelerating inflation also could be a consequence of monetary pressures. Time series of monetary aggregates (M0 and M2) shows that money supply growth accelerated in the second quarter of 2007. Taking into consideration that money supply influences the inflation with a time lag of some months, it is clear that why inflation experienced rise at the end of the year. From this point of logic however, the drop in the pace of money supply growth will result in restrictive monetary conditions for the beginning of 2008. (*Chart 4*)

Chart 4. Development of Money Supply, 2006-2007 (%, y-o-y)



Source: Bank of Russia

Obstacles of Interaction

The current trends of inflation may threaten economic policy with serious obstacles of counteraction, as the international and domestic conditions are not in favour of effective measures.

The Russian government took administrative steps in order to weaken international food price developments. Temporary price controls, introduced export tariffs and cuts in import tariffs of main food products can moderate current pressures, while distorting relative prices. Sooner or later these measures will be abolished. These administrative solutions are likely to fail treat monetary type pressures, caused by extreme natural resource windfalls and capital inflows, which is reflected in processes concerning money supply.

[6] Also a serious challenge for the world food markets is the shift of agricultural production towards biofuel crops.

High foreign currency inflow means increasing demand for domestic currency that by non-flexible exchange rate and without monetary sterilisation causes inflationary pressures. The Stabilisation Fund is a solution of natural resource windfalls, while for capital inflows there is no such automatic stabiliser. Capital inflows directly influence the reserves of Bank of Russia and this way the money supply. In the case of flexible or more flexible nominal exchange rate, nominal appreciation would balance real exchange rates. This seems to be a good solution, even if the economic growth can decelerate consequently.

From other, monetary point of view, increased official interest rate could be also a solution through monetary rigour, attracting domestic currency out of the real economy. Nevertheless, this can undermine economic growth through increasing costs of investments and this can lead to further capital inflow. Such kind of trap needs to be avoided.

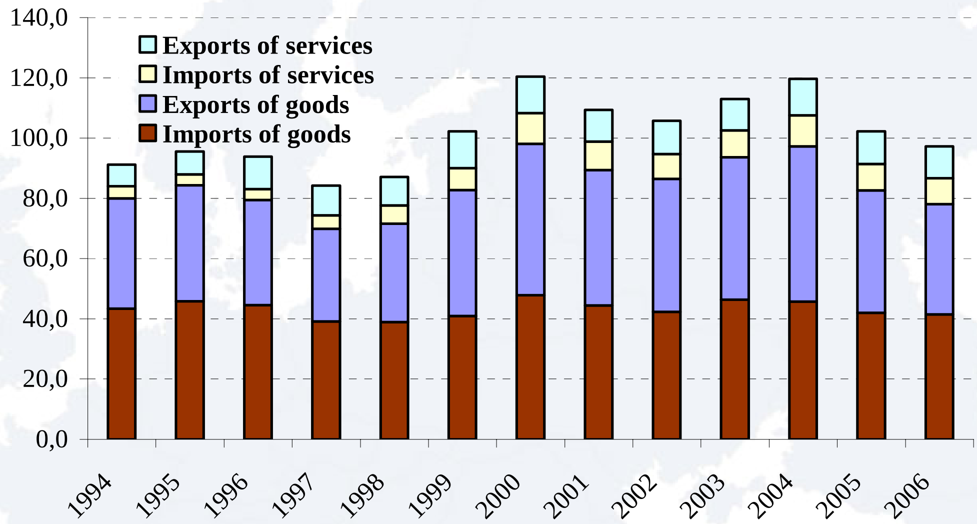
INCREASING EXTERNAL IMBALANCES IN UKRAINE

Parallel with decreasing openness, challenges concerning balance of payments are in rise. In first nine month of 2007 current account (CA) deficit reached USD 2.2 billion after USD 1.6 billion in all four quarters of 2006. This is accompanied with continuous increase of gross external debt, as in the first ten month of 2007 it increased by USD 9 billion to USD 74 billion. By the estimation of *ICEG European Center* the CA deficit to GDP will exceed 3%.

EXTERNAL PROCESSES AND DETERMINING FACTORS

In the last 15 year, the economic openness of Ukraine changed significantly, as its exports and imports of goods and services increased. However in the last two years, Ukraine was not able to increase its foreign trade relative to GDP. (*Chart 5*) This happened mainly because of relative drop of exports of goods to 37%, and even the share of imports of goods decreased to 40% of the GDP.

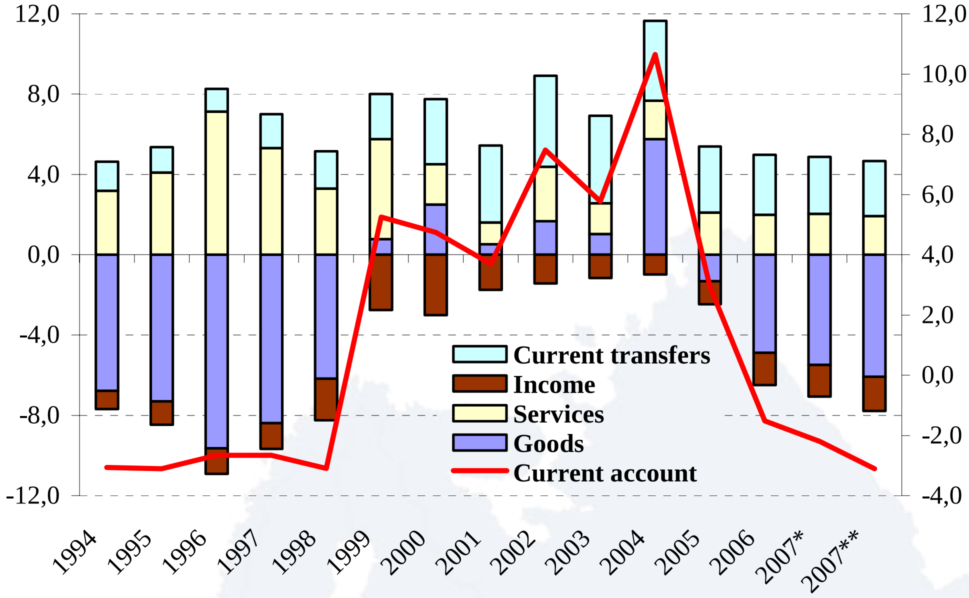
Chart 5. Trade Openness, 1994-2006 (% of GDP)



Source: WIIW, own calculations

While the openness of the economy decreases, the external balances are continuously worsening. This is reflected mainly in the rising of the CA deficit. In nominal terms after three quarters it was higher by USD 600 million than in the whole 2006, and by USD 2 billion than in the first three quarters of 2006. The CA deficit of first nine months as a ratio of GDP of first three quarters reached 2.2% that is an almost ten-year record. Taking into consideration that the last quarter of the year used to show the highest deficit, it is likely to reach CA deficit above 3% of GDP in 2007. (*Chart 6*)

Chart 6. Current Account (right) and Its Components (left), 1994-2007 (% of GDP)



**January-September 2007, **ICEG EC estimation for 2007*
Source: WIIW, National Bank of Ukraine, own calculations

The main reason is the increasing deficit of merchandise trade that was only partially offset by the balance of services. After the first nine months of 2007, the balance of goods was USD 5.4 billion, while the balance of services amounted to USD 2 billion. It is also worth mentioning the income balance that is traditionally negative and the balance of current transfers that used to be positive are relatively stable and covers each other.

It is clear after investigation of data that the main determining factor of the worsening external position is the performance in exports of goods. In 2005-2006, exports of goods value decreased in real terms.

ASPECTS OF SUSTAINABILITY

From the point of view of financing, it seems there is no room for worry, as the CA deficit is completely covered by long term capital inflow. Namely, net foreign direct investments (FDI) in the first nine months of 2007 reached USD 7.1 billion (5.3% of expected GDP in 2007) due to USD 7.8 billion inward FDI and USD 0.7 billion outward FDI. This favourable process started in 2005, by accelerating privatisation.[7]

Table 5. Financial Account and Its Main Components, 2005-2007 (USD billion)

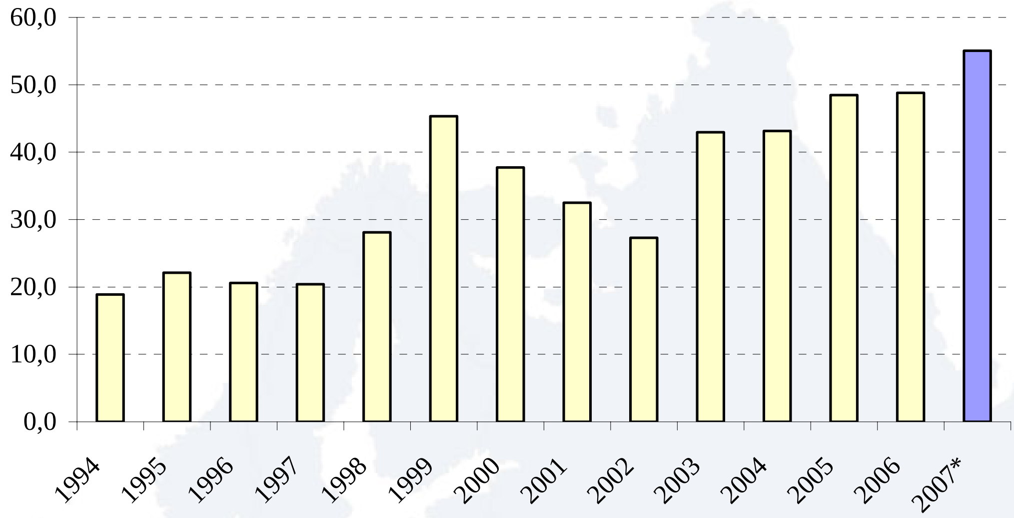
Financial account	**2005**	**2006**	**Q1-Q3 2007**
Direct investment (net)	7533	5737	7137
Portfolio investment (net)	2757	3583	3812
Other investments (net)	-2483	-5644	-641
Reserves assets (net)	-10425	-1999	-7528
TOTAL	-2683	1677	2780

Source: National Bank of Ukraine

[7] Stable FDI Performance Despite Political Turbulences in Ukraine, News of the Month, September 2007

The other factor that has to be investigated is the external debt and its structure. After first nine months of 2007, gross external debt of Ukraine reached USD 74.3 billion, that is already more than 55% of the estimated GDP. (*Chart 7*)

Chart 7. Current Account (right) and Its Components (left), 1994-2007 (% of GDP)



**January-September 2007*
Source: WIIW, National Bank of Ukraine, own calculations

It is clear that the pace of growth of gross external debt is unsustainable however its level seems not so high, if comparing with other CIS, Balkan or EU countries. In 2006, Russia's gross external debt to GDP was 36%, Croatia's 85.3%, while Hungary 94%. Beyond the level of the debt, the healthy structure is more important.

Data gives us calming picture about the structure of external debt. In the last three years external debt increased mainly due to private sectors of the economy, while the maturity structure improved as a consequence of increasing share of long-term debt to total. Undoubtedly, the main contributors to growth of external debt are banks, reflecting fast-developing financial sector. *(Table 6, on the next page)*

CONCLUDING REMARKS

Mainly because of changing relative prices, international competitiveness of Ukrainian goods deteriorated in the last few years that led to slower growth of exports. Domestic demand driven real GDP growth however remained relatively high, resulting to decreasing openness of the economy.

These developments influenced external balances. CA deficit increases dynamically year-by-year, mainly because of increasing gap between exports and imports. We expect CA deficit above 3% of GDP, while the merchandise trade balance is likely to exceed 6% of the GDP. Components and thus underlying economic structure is quite balanced, as none of the sectors owe overwhelming importance. This is possibly to change, as Ukraine is still a country in transition.

One should not worry yet about the current account deficits, as the financing of it is rather ensured, mainly due to increasing inflow of FDI. Although external debt increases at a fast pace, its structure changes favourably regarding its structure of maturity and debtor. We also found some not-robust evidence that financial sector of Ukraine develops rapidly that is a condition of highest importance to ensure not only sustainable external positions, but also sustainable economic growth.

It seems that fierce competition among political powers in Ukraine is a base for on short-term seemingly unfavourable, but on long-term promising structural, institutional changes.

Table 6. Gross External Debt and Its Components, 2004-2007

USD million	01.10.2004		01.10.2005		01.10.2006		01.10.2007	
	Amount	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
General government	10091	34.8	11640	32.3	11312	24.5	13215	17.8
Long-term	*10091*	*34.8*	*11640*	*32.3*	*11312*	*24.5*	*13215*	*17.8*
Monetary authorities	1692	5.8	1345	3.7	945	2.0	540	0.7
Long-term	*1692*	*5.8*	*1345*	*3.7*	*945*	*2.0*	*540*	*0.7*
Banks	2348	8.1	4454	12.4	9641	20.9	25712	34.6
Short-term	*1455*	*5.0*	*2391*	*6.6*	*4398*	*9.5*	*10440*	*14.0*
Long-term	*893*	*3.1*	*2063*	*5.7*	*5243*	*11.3*	*15272*	*20.5*
Others sectors	14211	49.1	17861	49.6	22671	49.0	31757	42.7
Short-term	*8926*	*30.8*	*9710*	*26.9*	*8758*	*18.9*	*10241*	*13.8*
Long-term	*5285*	*18.2*	*8151*	*22.6*	*13913*	*30.1*	*21516*	*28.9*
Inter-company lending	622	2.1	737	2.0	1666	3.6	3109	4.2
Total public	**11783**	**40.7**	**12985**	**36.0**	**12257**	**26.5**	**13755**	**18.5**
Total private	**17181**	**59.3**	**23052**	**64.0**	**33978**	**73.5**	**60578**	**81.5**
Total short-term	**10381**	**35.8**	**12101**	**33.6**	**13156**	**28.5**	**20681**	**27.8**
Total long-term	**18583**	**64.2**	**23936**	**66.4**	**33079**	**71.5**	**53652**	**72.2**
EXTERNAL DEBT	**28964**	**100.0**	**36037**	**100.0**	**46235**	**100.0**	**74333**	**100.0**

Source: National Bank of Ukraine, own calculations