

Inflation report 2014/3 (Monetary Policy Program Q3 2014, Status report on Implementation of the Monetary Policy Program Q2 2014)

2014-08-15

Executive summary

According to the Central Bank forecasts, in the short run the 12-month inflation rate will gradually increase from a relatively low level to be near the lower bound of the confidence band in the end of the year, but in the 1st quarter of 2015 it will come closer to the target and stay around in the rest part of forecast horizon. The economic growth will speed up in 2015 and stabilize around its potential in the rest part of forecast horizon.

In the 2nd quarter of 2014 too, the economic environment remained sluggish due to weak external and domestic demand. The latter, in turn, reflected the slow pace with which private consumption growth rates rebounded while investment activity continued to be low: in the 2nd quarter of 2014, private consumption growth was an estimated 4.1% y/y and private investment growth, 5.4% y/y. In agriculture, lower than expected output growth was due to bad weather conditions, which was also a drag to the economic activity. As a result, it is expected that economic growth in the first half of the year would be in the range 3.4-3.6% y/y.

According to short-term forecasts, private consumption growth rates will accelerate whilst a stable investment environment can be expected, under which circumstance private consumption in 2014 will grow by 4.0% and private investment, by 1.8%. In anticipation of expansionary fiscal policy during the year, the fiscal impulse is an estimated 0.3 pp expansionary. Based on the 2014 results, the real growth of export of goods and services will be in the range of 2.0-4.0%, the real growth of import within 1.5-3.5% and the growth rate of remittances of individuals within 1.0-3.0%. As a result, economic growth in 2014 is estimated in the range 3.6-4.2% (a central forecast value – 3.9%), due mainly to good performance in the agriculture and service sectors (a total contribution of 2.9 pp).

In the forecast horizon the economic growth is expected to somewhat accelerate and stabilize around its potential, reflecting increasing private consumption growth rates and slowly rebounding private investment. Thus, in the forecast horizon, with stabilizing private demand as well as mostly a neutral impact of the fiscal policy, expanding of an

inflationary environment is not likely.

In external sector in the 2nd quarter of 2014, geopolitical developments brought in more uncertainties. In such a situation, weak deflationary patterns prevailed in international markets of basic commodities and food products.

In the forecast horizon, global economic growth rates will continue to recover at a slow pace, under which conditions notable inflationary pressures from international markets of basic commodities and food products are not likely.

In the 2nd quarter of 2014, the 12-month inflation rate further trended down to 1.8% in late June, below the lower bound of the confidence band. During the quarter, core inflation followed a downward path as well, with its 12-month indicator dropped to 0.4% from the previous quarter's 1.8%.

In the 2nd quarter of 2014, the Central Bank reduced the refinancing rate by 0.5 pp to 7.0% in late June (see details in section 3.1.1 Actual inflation and attainment of target).

In view of the public sector wage growth since the second half of the year, electricity price rise from August as well as stamp duty introduced to a variety of goods starting from the 4th quarter of 2014, inflation will somewhat increase in the second half of the year. It will nevertheless remain at a low level in the yearend, closer to the lower bound of the target. In the 3rd quarter of 2014, the Central Bank will continue loosening the monetary conditions. This, coupled with the easing of monetary conditions to date and an expansionary fiscal policy anticipated during the year, will stimulate aggregate demand and push inflation rates to rebound. As a result, the economic activity will somewhat revive in the upcoming period of time whilst facilitating the inflation to stabilize around its target in the medium run.

Risks to inflation deviating from the projected value are estimated as balanced in both short and medium-term perspectives. External sector risks are primarily associated with development perspectives in emerging economies, and Russia in particular, and how their potential impact would be spilled over to basic commodities and food product markets. Risks deriving from the domestic environment are attributable to domestic demand developments, particularly capital investment recovery rates, the state budget performance as well as the developments in agriculture sector which is largely reliant on climatic conditions. If such risks materialize, the Central Bank will react accordingly by maintaining the inflation target in the medium run.

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