

Inflation report 2013/3 (Monetary Policy Program Q3 2013, Status report on Implementation of the Monetary Policy Program Q2 2013)

2013-08-13

Executive summary

The second quarter of 2013 was remarkable for high inflationary environment determined by events (heavy hails and partly postponed vegetation period) in agriculture as well as some rise in service prices that time. As a result, the 12-month inflation rate in end-June was 6.5%, above the upper bound of the confidence band. Moreover, during the quarter the 12-month inflation went an up-sloping path, from 4.2% in the previous quarter to 5.5%, which was mainly due to the rise in service prices.

In the second quarter of 2013 economic growth rates slowed down, and there will be 5.5-5.7% economic growth instead of 6.3-6.7% growth expected for the first half of 2013, according to the Central Bank estimates. This is mainly due to negative developments in construction.

Also, in the second quarter the Government implemented a more contractionary fiscal policy than planned the collection of taxes was over-performed and expenditures were curtailed.

As was outlined in the second quarter monetary policy program, the impact of phasing out agricultural supply shock had to also help reduce the excess growth of real private consumption. In the second quarter the real private consumption growth rate slowed down to 4.8% y/y. Decline in construction output resulted in more-than-expected reduction in private investment (an estimated 2.8%) in the second quarter.

In the forecast horizon, private consumption growth rates will stabilize while private investment will start slowly recovering from the third quarter. In this case, the growth of private consumption in 2013 will reach 4.5% whereas private investment will stay at the previous year's level. Net export growth will reach 6-7% owing to increased exports and reduced imports. As a result, the economic growth will be 4.7-5.3%, mainly due to the growth in industry and services (with a combined contribution of about 3.8 pp).

In the forecast horizon, domestic prices will feel little deflationary pressures as the private demand stabilizes and the fiscal policy implementation remains an estimated neutral.

In external sector in the second quarter of 2013 world demand remained sluggish primarily due to the problems in European Union, although economic growth rates in the U.S.A. have accelerated to some extent. In such conditions no inflationary trends were observable in basic food and raw material markets of the world, and even some markets started seeing deflationary patterns.

In the forecast horizon, no inflationary pressures will be seen in the external sector. It is anticipated that world economic growth rates will slowly recover, so, driven by a sluggish external demand, international prices of major raw materials and food products will behave relatively steady. In the light of the aforementioned developments in external and domestic economies, in the second quarter of 2013 the 12- month inflation went an up-sloping path and reached 6.5%, which is more than predicted and one percentage point higher than the upper bound of the band.

In the second quarter of 2013, in view of the transient nature of the high inflation, core inflation staying closer to the target, the positive level of real interest rates as well as the lack of inflationary pressures from external sector and domestic economy, the Central Bank continued implementing a neutral monetary policy by leaving the refinancing rate unchanged (see details in section 3.1. Actual inflation and attainment of target).

However, in view of second-round effects of the increase of energy tariffs from July on domestic prices as well as inflationary expectations of economic agents, the inflation is expected to be higher in the third quarter compared to the second quarter of the previous year, as the 12-month inflation will reach 8.5% in that time.

In an inflationary environment like this, the Central Bank will adjust the current directions of the monetary policy by raising the refinancing rate in order to mitigate second-round effects of the increase of energy tariffs and have inflation expectations anchored. It is expected that the 12-month inflation would slow and come closer to the target during 2014, whilst staying within the confidence band in the forecast horizon. In the event inflation subsides gradually and economic growth slows, the Central Bank will react accordingly by easing the monetary conditions.

The risks that inflation would deviate from the forecast value are estimated downside, reflecting risks to the slow recovery of the global economy as well as possible weakening of the domestic demand. If such risks materialize, the Central Bank will respond

accordingly, making sure the inflation target is attained in the medium term. The inflation risks in the medium term are balanced.

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