

Status report on Implementation of the Monetary Policy Program Q3, 2010. Inflation report

2010-11-12

(2010/3) Summary

The main macroeconomic developments in the third quarter of 2010 were characterized by deepening inflationary environment and slowing recovery rates in world and domestic economies. A high inflationary environment was mostly attributable to the downfall in agriculture and steep price rise in food products, wheat in particular, in global markets. Also, the tightening of monetary policy since the beginning of the year, including the developments in the foreign exchange market, as well as still slowly recovering domestic demand further contributed to somewhat mitigate inflationary pressures. Inflation in the third quarter was 0.2 percent whereas the 12-month inflation indicator has been 8.6 percent, growing by 2.8 pp in relation to the respective indicator of the previous quarter. Price increases in items “fruit” and “vegetable and potato” contributed 3.3 pp and item “bread products” 1.5 pp to the 8.6 percent of the 12-month inflation. Under such a circumstance, the 12-month core inflation reduced by 0.5 pp in relation to the respective indicator of the previous quarter to reach around 4.9 percent.

*Over the quarter, food prices fell by 0.2 percent (with -0.1 pp contribution to headline inflation), non-food prices remained almost unchanged, while service tariffs rose by 1.1 percent (with 0.3 pp contribution to headline inflation). Whereas in recent years change in prices in items “vegetable and potato” and “fruit” made an average -2.6 pp contribution to the quarter’s inflation, these items in the third quarter of 2010 contributed a mere 0.1 pp, that is 2.7 pp higher, and which is why the actual indicator deviated from the Q3 projection almost to the same extent. In the third quarter of 2010 economic growth rates further slowed down, posting as low as 2.8 percent y-o-y * growth indicator for the period January-September. Relative to the second quarter, the slowdown has been driven largely by the downfall in agriculture due to unfavorable weather conditions.*

In the third quarter industry and services reported, respectively, 13.4 percent and 4.5 percent y-o-y growth of value added, whereas construction and agriculture reported, respectively, 13.4 percent and 4.5 percent y-o-y decline of value added. Notwithstanding the slowing of economic growth rates, there was an improvement in the labor market indicators in the third quarter. Average quarterly unemployment reduced, reflecting the growing demand for labor. Average nominal wages grew, too, reflecting the increase of

wages in firms in the private sector and in several budget-supported organizations. In spite of the growth of nominal wages labor productivity has somewhat decreased, due to the severe decline recorded in agriculture, thus pushing unit labor costs to increase to some extent. As a result, inflationary pressures in the economy have been estimated in the range of zero to slightly inflationary, up to 0.5 percent.

In the third quarter of 2010 the growth of domestic demand slowed against the previous quarters to 1 percent y-o-y, due to the slowdown in economic growth rates and reduced government expenditures. In the structure of domestic demand, private spending grew by around 4 percent y-o-y, with private consumption increased by nearly 1 percent y-o-y and private investment, by 12 percent y-o-y. In the third quarter too, private spending remained placing a restrictive impact on inflation. According to Central Bank estimations, private sector expenditures in real terms have been 1-2 percent below the equilibrium, thus creating some 0.4-0.6 percent deflationary pressures in consumer market. In the third quarter of 2010 too, fiscal policy's expansionary impact further diminished. As a result, the impact of the fiscal sector on aggregate demand and inflation has been less expansionary, according to the fiscal impulse indicator, and amounted to 0.8 pp. As such, the revenues impulse made up 2.6 percent restrictive while the expenditures impulse made up 3.4 percent expansionary.

With the above developments in domestic demand and labor market, slight inflationary pressures were observed during the third quarter, which, according to the Central Bank estimates, were in the range of 0 - 0.3 percent. In the times of slowing recovery rates in global and domestic economies in the third quarter of 2010 current account deficit somewhat improved y-o-y, running at a high level, however. In the meantime, considerable was the decline in dollar growth rates in export and import, which has been attributable mainly to the developments in the domestic economy as well as reduced y-o-y growth rates in international metals prices. The aforementioned developments were reflected primarily in the declines of growth rates of import volumes. At the same time, the y-o-y growth rates of remittances have recovered after the slowing in the previous quarter. In the outcome, in the third quarter current account deficit reduced by USD 13.2 million y-o-y to amount to USD 270.7 million.

The above-mentioned trends determined the attainment of the inflation target and monetary policy directions over the quarter. The Central Bank withheld from tightening monetary conditions, in consideration that inflation reached a high level influenced primarily by supply shocks and that its rate would gradually slow down as the above shocks are expected to come to an end in a one-year horizon and when transmitted impact from tightened monetary conditions is showed up. Under such a circumstance, the

refinancing rate over the previous three quarters remained unchanged, at a 7.25 percent level. Given the actual environment of the first half of the year and planned measures to fight dollarization, the third quarter monetary policy program envisaged a modest growth of monetary aggregates and faster growth rates in dram deposits over those of foreign currency deposits. The expectations were justified inasmuch as the monetary environment stated a weakened dollarization, reducing as much as by 4.1 percent and reflecting 1.2 percent reduction in foreign currency deposits (a mere 0.5 percent growth, when the exchange rate change is excluded) and 12.9 percent increase in dram deposits. At the same time, foreign currency loans continued growing during the quarter, at 10.3 percent (12.1 percent growth, when the impact of exchange rate change is excluded), owing mainly to excess funds on correspondent accounts in foreign currency. Over the quarter, the lending in dram has grown merely by 2.4 percent, and the increase of the volume of economy lending has increased by 6.5 percent and 22.4 percent y-o-y, as a result.

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