

Status report on implementation of the monetary policy program (Inflation Report) Q4, 2011

2012-02-24

(2011/4) SUMMARY

In the fourth quarter of 2011 the inflation environment further eased, and the 12-month inflation rested within the confidence band at the end of the year as a result. This was driven by both domestic and external macroeconomic developments. Prices of food products and raw materials in world markets continued falling amid the world economic growth slowdown and escalation of debt problems in the Euro-area. In the meantime, attributable to tightened monetary conditions earlier the year, contractionary fiscal policy implementation, slowly recovering domestic demand, and increased supply of agricultural products, no inflationary pressures were observed in the domestic environment. Conditioned by the aforementioned factors, in the fourth quarter the 12-month inflation was 4.7 percent, reducing by 1.5 pp relative to the previous quarter's indicator. Price increase in food products made 3.1 pp of contribution to the 12-month inflation, of which 2.3 pp alone fuelled by price increases in such items as "sugar" "coffee, tea, cocoa", and "meat".

Price increases in non-food products and service tariffs made, respectively, 0.7 pp and 0.9 pp of contribution to the 12-month inflation. The Central Bank estimations based on y-o-y economic growth (EAI) indicator for the period January-December 2011 did not deviate from the forecast scenario, and are in the range of 4.1 ñ 4.5 percent¹. The drop of this indicator is totally offset by higher-than-expected growth in industry and agriculture as a result of upside risks in industry and agriculture and downside risks in construction, as were outlined in previous forecasts. Economic growth in this period of time was determined mainly by estimated y-o-y growth of 17.0 percent, 14.5 percent and 3.1 percent in industry, agriculture and services, respectively. In construction, the value added is estimated to reduce by around 13 percent. In the fourth quarter the average quarterly unemployment rate reduced, reflecting the growing demand for labor. Despite the slowing of the productivity growth rate in the fourth quarter, the growth of average nominal wages did not decelerate much in comparison with previous quarters, reflecting existing rigidities in the labor market. As a result, unit labor costs have somewhat increased, creating minor inflationary pressures in the economy.

In the fourth quarter private sector expenditures grew by around 3.5 percent y-o-y

relative to the previous year. Public expenditures in real terms grew by 1.2 percent y-o-y, while domestic demand increased by 3.7 percent y-o-y relative to the same period of the previous year. The growth rate of private spending slowed in the fourth quarter driven by external and internal factors.

In the fourth quarter the gap between private spending and their potential was still negative although it further narrowed as a result of slowing growth rate of private spending. In the light of the aforementioned

developments, the private sector spending had some 0.1 - 0.2 pp of impact on inflation in the fourth quarter.

The fiscal policy in the fourth quarter was further driven to maintain macroeconomic stability and ensured congruence with collection of revenues and savings on certain items of public expenditures. As a result, the fiscal policy's impact on aggregate demand, hence, inflation was 0.9 pp contractionary instead of the forecast neutral. This was driven by contractionary impulse from revenues (in line with the forecasts) and neutral impulse from expenditures (instead of projected expansionary).

Again, in the course of 12 months the fiscal policy's impact on aggregate demand was 1.3 pp contractionary, mostly explained by a restrictive effect from savings on expenditures.

In light of the above-mentioned developments in domestic demand and labor market, some deflationary pressures were observed in the economy during the fourth quarter of 2011, which were in the range of 0.5 - 0.6 pp y-o-y, according to the Central Bank estimates.

During 2011 current account improved markedly and, according to estimations, will reach some 11.8 percent of GDP against 14.5 percent recorded in the previous year. In the fourth quarter however, the current account further improved y-o-y on the background of slowing world economic growth rates and more uncertainties. These developments coupled with somewhat a sluggish domestic economic activity led to the slowdown of growth rates in export and import, individual remittances in dollar terms. With reducing international metals prices, the growth of real export remained strong driven by persisted high growth in industry. In the fourth quarter the growth of real import remained high, too, which was partly a result of high reducing y-o-y rates of real volumes observed in the fourth quarter of the previous year. The growth rates of inflow of noncommercial remittances of individuals via the banking system slowed down, influenced by the developments in Russian economy. As a result of the aforementioned developments, in

the fourth quarter the current account deficit reduced by USD 30.7 million y-o-y and amounted to USD 288.2 million.

Continued easing of the inflation environment and the path of inflation in the forecast horizon determined the attainment of the inflation target and monetary policy directions for the fourth quarter. As a result, the

directions were maintained in line with the baseline scenario outlined in the Monetary Policy Program Q4 2011, and the Central Bank implemented a neutral monetary policy.

In the fourth quarter, though the monetary policy developments were again mainly consistent with the scenario, nearly all monetary indicators outstripped annual growth rate benchmarks to some extent. So, broad money grew by 10.4 percent, dram broad money, by 11.4 percent, and monetary base, by 17.6 percent. The level of dollarization tended to subdue further in the fourth quarter by 0.5 pp relative to the previous quarter and by 1.3 pp against the same period of the previous year. The last quarter of the year was prominent for the highest growth of lending to the economy (8.9 percent) in comparison with the previous quarters' respective indicator, with quarterly growth rates of foreign currency deposits reaching 11.0 percent versus those of dram deposits, amounting to 6.6 percent.