

Status report on Implementation of the Monetary Policy Program Q3, 2011. Inflation report

2011-11-22

(2011/3) Summary

In the third quarter of 2011 the inflation environment further eased, driven by both domestic and external macroeconomic developments. Prices of food products and raw materials in world markets behaved stably and prices of some commodities even went down. In the meantime, conditioned by slowly recovering domestic demand, influence of implemented contractionary fiscal and monetary policies and increased supply of agricultural products, no inflationary pressures from domestic environment were shown up. Yet, because of tightened tax administration in sugar market and some food and non-food product markets, at the end of the quarter the 12-month inflation was still above the confidence band.

At the end of the third quarter the 12-month inflation was 6.2 percent, reducing by around 2.3 pp relative to the previous quarter's indicator. Price increase in food products made 5 pp contribution to headline inflation, of which 3.4 pp alone fuelled by price increases in sugar, meat, dairy and egg. Price increases in non-food products and service tariffs made, respectively, 0.5 pp and 0.7 pp contribution to headline inflation.

The Central Bank estimations based on y-o-y economic growth indicator for the period January-September 2011 are in line with previous forecasts. The decline in construction was totally offset by higher-than-expected growths in industry and agriculture as a result of materialization 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 14.8 percent, 15 percent and 3.7 percent in industry, agriculture and services, respectively.

In the third quarter the average quarterly unemployment rate reduced, reflecting the growing demand for labor. At the same time, the growth of average nominal wages was consistent with the growth of labor productivity. As a result, no significant changes in unit labor costs were seen, so one may affirm that the impact of the change in unit labor costs on inflation in the third quarter was almost neutral. In the third quarter private sector expenditures grew by around 6 percent relative to the previous year. Public expenditures in real terms grew by nearly 1 percent, while domestic demand increased by 5 percent

relative to the same period of the previous year. Private consumption grew by around 6 percent and private investment by roughly 4 percent relative to the previous year.

In the third quarter the gap between private spending and their potential was still negative although it further narrowed as a result of continuously growing private spending. In the light of the aforementioned developments, the private sector spending did not have a significant impact on inflation in the third quarter. The fiscal policy in the third quarter was further driven to maintain macroeconomic stability and ensured congruence with collection of revenues and savings on public expenditures. As a result, the fiscal policy's impact on aggregate demand, hence, inflation was 0.5 pp contractionary instead of the forecast 0.8 pp expansionary. This was driven by almost neutral impulse from revenues and -0.5 pp contractionary impulse from expenditures. In general, in the course of nine months the fiscal policy's impact on aggregate demand has again been neutral.

In light of the above-mentioned developments in domestic demand and labor market, some deflationary pressures were observed in the economy during the third quarter of 2011, which were in the range of 1.5 - 2 pp y-o-y, according to the Central Bank estimates.

In the third quarter current account performed on the background of slowing world economic growth rates and increasing uncertainties associated, particularly, with Euro-area debt crisis. So, current account tended to improve in line with the developments in world and domestic economies. With sustained high levels of metals prices in global markets and reported high growth in industry in the third quarter, the growth of export of goods remained strong. Grown economic activity led to increased volumes of import of goods in both dollar terms and real terms, which topped the expectations. The developments in world economy, the tightness in the banking sector in Russia in particular, was especially noticeable in September when growth rates of inflow of non-commercial remittances of individuals via the banking system slowed down. High growth of transfers however remained strong in the third quarter due to reported high growth in July and August. As a result of the aforementioned developments, in the third quarter the current account deficit reduced by USD 65.1 million y-o-y and amounted to USD 204.8 million. In the period January-September 2011 the share of current account deficit in GDP has improved by 3.7 pp.

The above-mentioned trends determined the attainment of the inflation target and monetary policy directions for the third quarter. Despite easing of the inflation environment, in July and August the Central Bank withheld from changing the interest rate in the face of escalated debt problems in world economy as well as higher-than-expected

prices of some food products and non-food products. However, given the prevailing influence of key factors pushing inflation down, at the end of the quarter monetary conditions were loosened to some extent with the aim to bring the inflation indicator possibly closer to the central value in confidence band in the 12-month horizon subsequent to the third quarter. This could create additional stimuli to shore up economic activity. In the third quarter monetary policy developments were again mainly consistent with the scenario. Broad money grew by 4.7 percent, dram broad money, by 8.0 percent, and monetary base, by 9.7 percent. The level of dollarization further tended to subdue in the third quarter by 1.7 pp relative to the previous quarter and by 1.5 pp against the same period of the previous year. Despite some sluggishness in growth rates in relation to the first two quarters of the year, growth of lending volumes remained strong this quarter too, 6.2 percent.

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