National Bank of Rwanda

QUARTERLY INFLATION REPORT

WP02/2014Q1

Kigali, July 2014

Contents

EXECUTIVE SUMMARY

The quarterly Inflation report presents the National Bank of Rwanda's assessment of the current and future macroeconomic developments influencing inflation. The inflation forecasts are one of the inputs to the Monetary Policy Committee decision making process.

The Rwandan economy continues to recover from the 2013 slowdown as indicated by the good performance registered in the first two quarters of 2014. In 2014 quarter 1, Real GDP grew by 7.4% in 2014Q1 from 4.1% in 2013 Q4 and 2.9% in 2013 Q3 as a result of good performance in industry (9%), services (8%) and agriculture (5%).

The economy is expected to continue recovering in 2014 Q2 given the on-going positive developments in turnovers and economic financing. Total turnovers increased by 20.1% in 2014 Q2 from 12.6% in 2014 Q1 and 9.0% in the previous quarter. Real GDP growth is expected to continue being driven by the service sector given the high increase in services turnovers to 22.4% in 2014 Q2 from 12.5% of the previous quarter. The industry sector turnovers registered modest growth of 14.6% from 13.0% during the same period. With regard to economic financing, new authorized loans increased on annual basis by 29.9% in 2014 Q2 compared to 15.6% of the same period in 2013. Net government injection reached 133.7 RWF Billion in 2014 Q2 from -8.7 RWF Billion realized in the previous quarter. On average, during December-June 2014, M3 increased from 8% in 2013 to 19.2% in 2014.

Regarding the external sector, total exports increased by only 2.26% whilst total imports grew by 13.0% during the first six months of 2014 and thus leading the widening of the trade deficit from -765.37 USD Millions in 2013 to -898.59 USD Millions in 2014. On the foreign exchange market, the depreciation against the USD has remained contained and stands at 1.9% between December 2013 and June 2014 compared to 6.1% for the whole of 2013. The RWF appreciated by 5.3% against the GBP, 1.0% against the EURO, 0.9% against the Kenyan shilling, 2.5% versus the Ugandan shilling, 5.3% against the Tanzanian. The Real Effective Exchange Rate (REER) slightly depreciated by 0.11% in June 2014 following an uptick in relative prices (higher level of foreign inflation relative to domestic inflation) as well as the easing nominal exchange rate depreciation.

Inflation continues to be low and stable on the account of sustained and well-coordinated monetary and fiscal policies, limited inflationary pressures from trading partners, stability of international oil prices and good performance of the national economy. Inflation decelerated to 1.4% in June from 2.4% in January 2014. Inflation is expected to be around 3% in 2014 Q3 and around 5% in 2014 Q4. However, there are some risks linked to agricultural production given the poor performance in season B 2014 harvests and geopolitical problems in Eastern Europe and the Middle East which may lead to increase in oil prices.

ACKNOWLEDGEMENTS

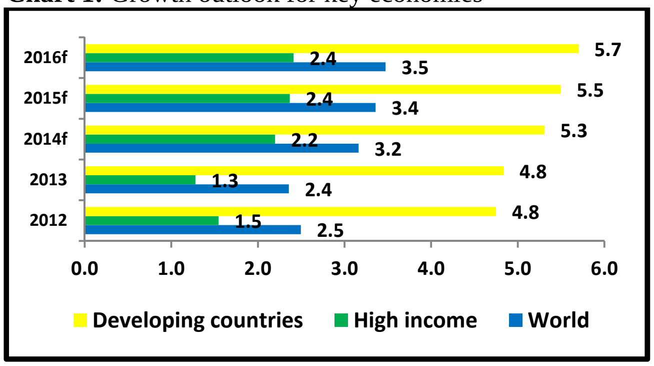
A team from the Research Department, spearheaded by the Modeling and forecasting division, prepared the 2014Q1 inflation report with notable contribution from Mr. Mathias KARANGWA (Manager, Modeling & forecasting division) & Mr. MWENESE Bruno (Senior Economist, Modeling & forecasting division) whereas Mr. Ananias GICHONDO (Director, Monetary policy & Research Department) and Dr. Thomas Kigabo RUSUHUZWA (Chief Economist and DG-Monetary Policy Directorate) edited and reviewed the report. Other contributors include Mr. NUWAGIRA Wilberforce (Principal economist, Economic Research and Financial Stability

1.0. EXTERNAL ENVIRONMENT

1.1. Global Economic Activity

Despite some moderation in 2014 Q1, global economic recovery remains on track in 2014 Q2 and will continue to be supported by the gradually improving economic performance in advanced economies especially in US, Japan and Europe.

Chart 1: Growth outlook for key economies



Source: World Bank, GEP (Jan. 2014)

Compared to the same quarter of the previous year, the world economy slowed down from 2.5% in 2013 Q4 to 1.8% and 2.4% in 2014 Q1 and 2014 Q2 respectively. In annual terms, the global economy is expected to grow from 3.2% in 2013 to 3.4% in 2014.

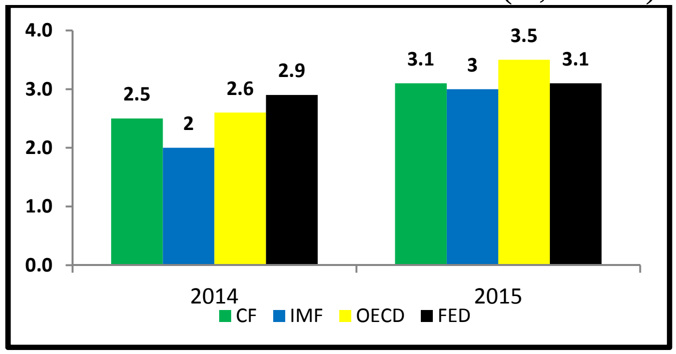
Table 1: Real GDP growth (% change)

	Quarterly : BLOOMBERG						Annual: IMF	
	2013				2014			
	Q.I	Q.II	Q.III	Q.IV	Q.I	Q.II	2013	2014
World (Y0Y)	1.7	2.2	2.6	2.5	1.8	2.4	3.2	3.4
USA (QoQ)	1.1	2.5	4.1	2.6	-2.1	4.0	1.9	1.7
Euro area (YoY)	-1.1	-0.6	-0.3	0.5	0.9	0.9	-0.4	1.1
Japan (QoQ)	4.9	2.9	1.3	0.3	6.7	-5.2	1.5	1.6
UK (YoY)	0.5	1.7	1.8	2.7	3.0	3.1	1.7	3.2
China (Y0Y)	7.7	7.5	7.8	7.7	7.4	7.5	7.7	7.4
India (YoY)	4.4	4.7	5.2	4.6	4.6	5.0	5.0	5.4

Source: BLOOMBERG & IMF

Despite the 2.1% contraction in 2014 Q1 from 2.6% of the previous quarter mainly due to adverse weather conditions, the US economy recovered to 4.0% in 2014 Q2 as investors are expected to resume investments deferred during the first quarter. However, the US economy is expected to slightly decelerate from 1.9% in 2013 to 1.7% in 2014.

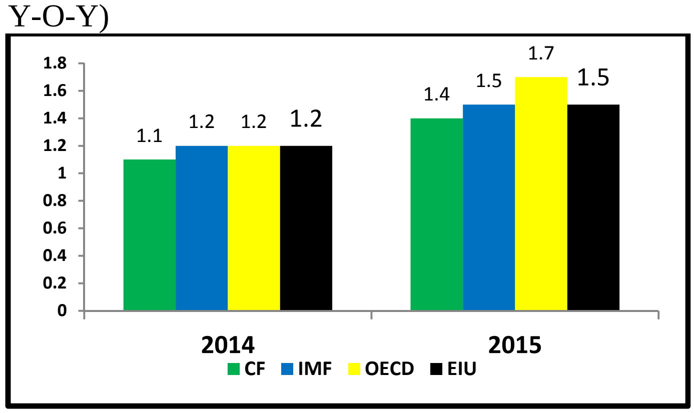
Chart 2: Growth forecasts for the US (%, Y-O-Y)



Source: IMF, Consensus Forecasts (CF), OECD & FED

Growth in the Euro area stood at 0.9% in 2014 Q1 as well as in 2014 Q2. In 2014 Q1, growth remained unbalanced across countries with positive growth in Germany and Spain, flat growth in France and deceleration in Italy and Netherlands. Overall, the Euro area is expected to grow in annual terms from -0.4% in 2013 to 1.1% in 2014.

Chart 3: Growth forecasts for the Eurozone (%, Y-O-Y)



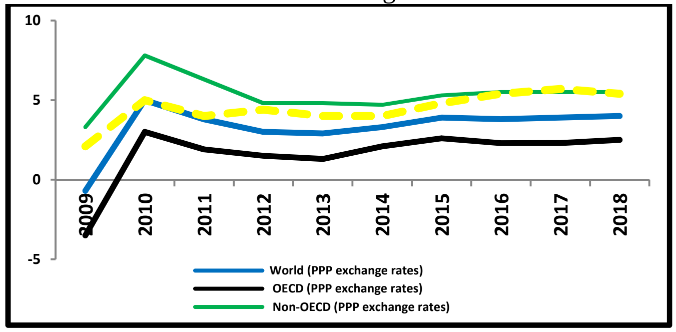
Source: IMF, Consensus Forecasts (CF), EIU & OECD

In Asia, growth was mainly driven by China and India despite some moderation in the Chinese growth to 7.4%, on quarterly basis, in 2014 Q1 from 7.7% in the previous quarter due to the weak performance in real estate, heavy industry sector and in external demand. Nonetheless, the Chinese economy grew at 7.5% in 2014 Q2.

In Japan, the economy is expected to contract on quarterly basis by -5.2% in 2014 Q2 after higher growth of 6.7% in 2014 Q1. Growth in the first quarter of 2014 was mainly driven by higher demand ahead of the announced future tax hike. Despite the tax bite, the Japanese economy is projected to slightly accelerate in annual terms from 1.5% in 2013 to 1.6% in 2014 following the government's reflationary agenda.

With reference to the Economist Intelligence Unit forecasts released in June 2014, World annual economic growth, measured at PPP[1] exchange rates, is expected to rise from 2.9% in 2013 to 3.3% in 2014 and 3.9% the following year. OECD countries' growth will accelerate from 1.3% in 2013 to 2.1% and 2.6% during the next two years respectively while growth in non-OECD countries will slightly drop from 4.8% in 2013 to 4.7% in 2014 before rebounding to 5.3% in 2015. Measured at market exchange rates, growth is expected to remain modest and stable in Sub-Saharan Africa, standing at 4% in annual terms in both 2013 and 2014 and gradually rising to 4.8% the following year.

Chart 4: Growth outlook across regions



Source: Economic Intelligence Unit (June 2014)

Global economic recovery has in the recent past been dependent on the good economic performance of advanced economies supported by expansionary monetary and fiscal policies especially in the US and Japan. Thus, the current major risk to the growth outlook include monetary policy tightening and fiscal consolidation especially in the US as well as geo-political tensions in countries like Ukraine/Russia, Iraq and Syria, coupled with the ongoing economic slowdown in China.

1.2. Monetary policy and international financial markets

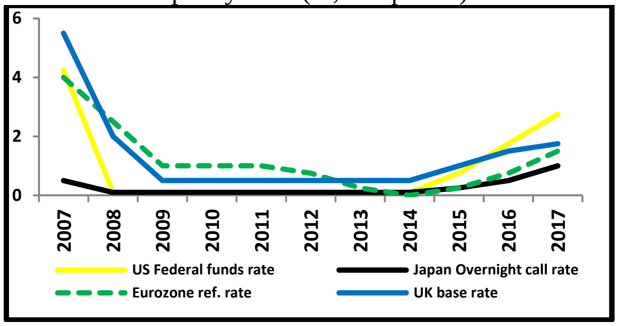
Until the second half of 2014, monetary policy remained accommodative to boost economic activities especially in the Eurozone. On 5th June 2014, the ECB further reduced its key policy rate from 0.25% to 0.15% to reflate the faltering economic recovery in many Eurozone economies. Elsewhere, central bank rates remained unchanged, standing at 0.25% in USA, 0.50% in UK and 0.10% in Japan.

Monetary policy in US is expected to tighten and this will have repercussions on emerging economies (mainly for the so-called fragile five: Brazil, India, Indonesia, Turkey and South Africa)

[1] PPP stands for Purchasing Power Parity

in terms of funds outflows and worsening terms of trade.

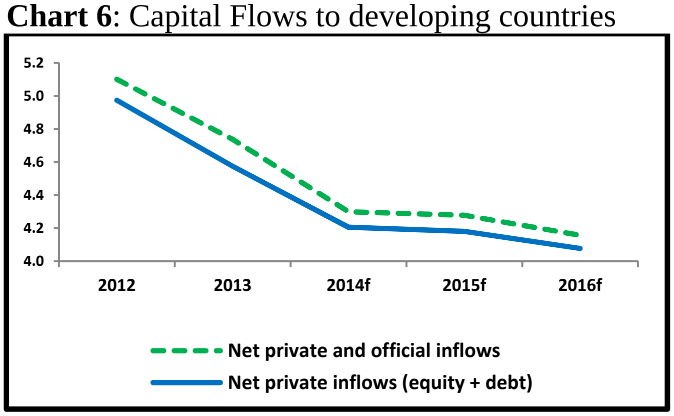
Chart 5: Main policy rates (%, end period)



Source: Economic Intelligence Unit (2014)

During the first quarter of 2014, the dollar weakened versus the Euro (0.2%), the Pound (1.9%) and the Yen (0.3%). Data for May 2014 indicate that the dollar recovered by 1.7% versus the Euro and by 0.7% versus the GBP. The dollar was still losing versus the Yen for the April and May on the back of strong Japanese trade data and the latest policy stimulus. Quantitative Easing (QE) is expected to continue unfolding especially in Euro area and this will continue to pose risks to exchange rate developments especially for those developing and emerging economies facing current account and fiscal deficits and therefore with limited means to intervene in foreign exchange markets to smooth out foreign exchange volatility.

Chart 6: Capital Flows to developing countries



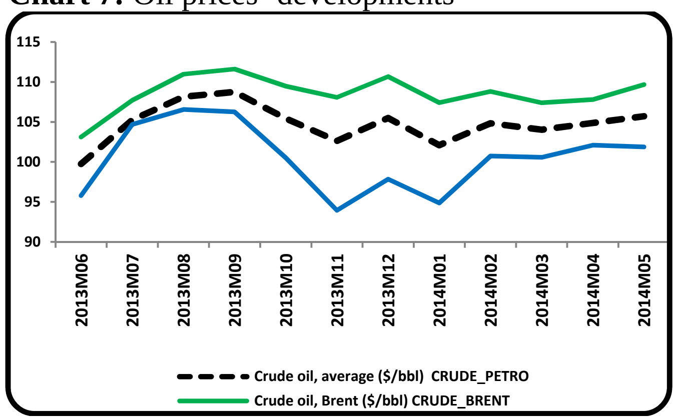
Source: World Bank, GEP (Jan. 2014)

1.3. International commodity prices

International oil prices have hitherto remained moderate with Brent prices averaging around USD 109.78/barrel in 2014 Q2 after USD 107.88/barrel in 2014 Q1.

In May, crude oil prices were particularly affected by rising tensions between Western countries and Russia over the Ukrainian conflict and lower production in OPEC countries. Metals and minerals prices' increase in April was due to the cutback in production of minerals such as Aluminum and Nickel.

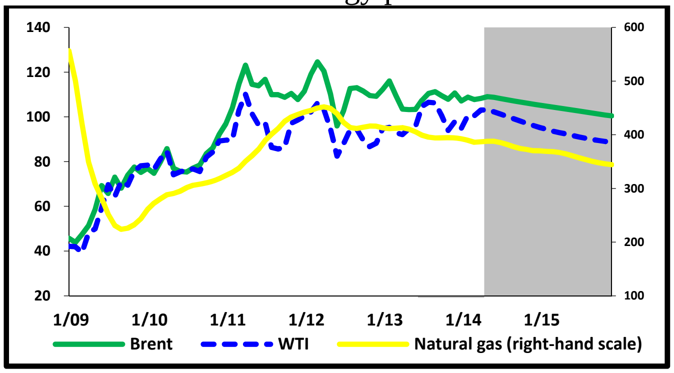
Chart 7: Oil prices' developments



Source: IMF (WEO, May 2014).

In 2014 oil prices are expected to slightly increase by 0.1% from a decline of 0.9% in 2013. The main risks to oil prices outlook include geo-political tensions in Syria, Iraq and Nigeria that may disrupt supply though this is likely to be offset by higher oil production in North America.

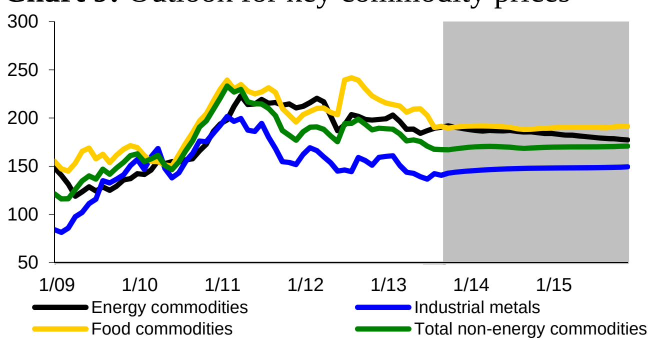
Chart 8: Outlook for energy prices



Source: IMF (May 2014).

Commodity prices remained almost stable during the first quarter of 2014 and in April-May 2014 as result of ample agricultural supply and low demand for industrial raw materials particularly by China. Globally, commodity prices are expected to weaken further in 2014 as the world expects aggregate demand in China to decline. Moreover, there are signs of better agricultural produce for most products except for coffee where a supply shock is expected to come from Brazil, the biggest producer.

Chart 9: Outlook for key commodity prices



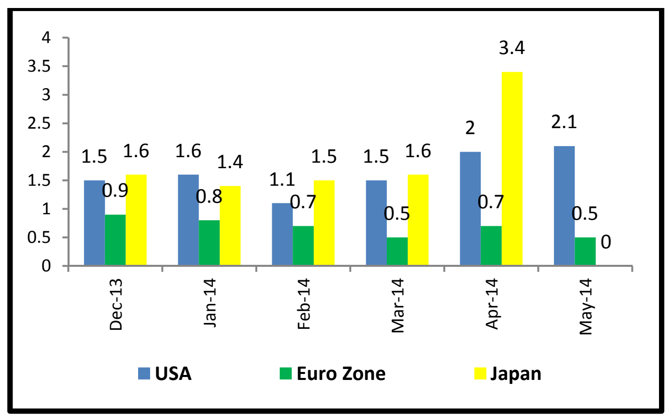
Source: IMF (May 2014).

1.4. Global inflation developments and outlook

Most advanced economies are still constrained by capacity under-utilization as shown by the recovering but still negative output gaps implying weak aggregate demand. This, together with the continued moderation in international commodity prices has not only resulted into subdued inflation but has also given room for accommodative monetary policy aimed at supporting growth.

Inflation generally remained subdued, reaching 0.5% in May 2014 from 0.7% of the previous month in the Euro zone due to capacity under-utilization. Inflation rose to 2.1% in May 2014 from 2.0% of the previous month for the US due to strengthening demand. Similarly, it hiked to 3.4% in April from 1.6% in March 2014 in Japan following an increase in consumption and yen depreciation.

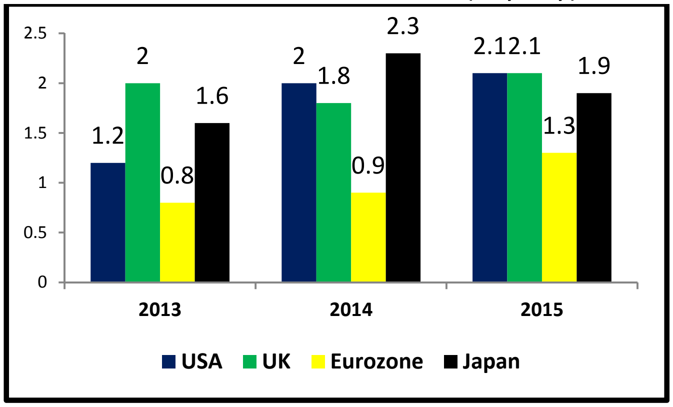
Chart 10: Inflation in key economies (%, y-o-y)



Source: http://www.rateinflation.com/

Looking ahead, inflation is generally expected to remain on the downside in major advanced economies until 2015. In USA, annual inflation may slightly increase from 1.2% to stabilize at around 2% in the next two years. Inflation in UK and Japan will hover around 2% for the coming two years while the Eurozone is set to continue having lower inflation rates of lower than 1% until 2015.

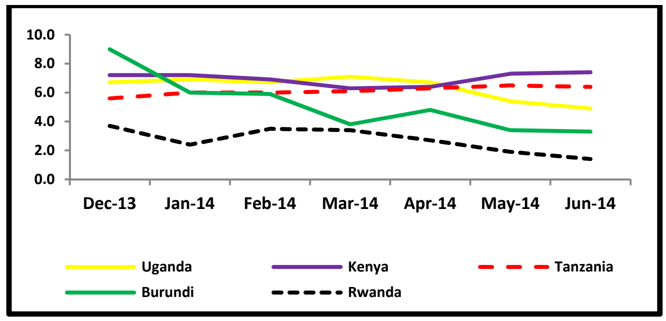
Chart 11: Global inflation outlook (% y-o-y)



Source: WEO update (April. 2014)

Since 2013, headline inflation has remained moderate throughout the EAC region. For 2014, headline inflation declined in Uganda to 4.9% in June from 5.4% in May and 6.7% of the previous month following the continued ease of food inflation. Headline inflation remained generally stable in Kenya and Tanzania. In Rwanda, inflation declined to 1.4% in June from 1.9% in May and 2.7% in April 2014 reflecting the decline in the cost of transport, electricity, water, gas and other fuels. Burundi inflation slowed to 3.3% in June from 3.4% in May and 4.8% in April 2014 following a decline in prices of alcoholic beverages and tobacco.

Chart 12: Headline inflation in EAC (% y-o-y)



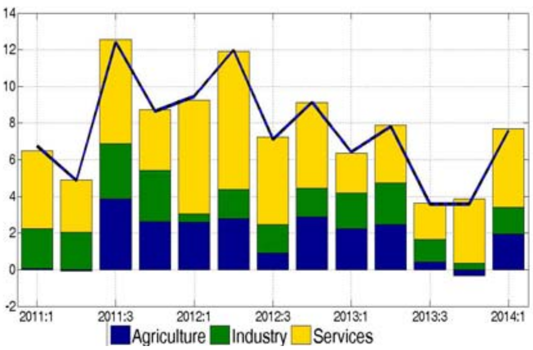
Source: Central Banks' websites

2.0.THE DOMESTIC ECONOMY

2.1.Domestic demand and output

The Rwandan economy is recovering from the slowdown observed in 2013, recording real GDP growth of 7.4% in 2014 Q1 from 4.1% in 2013 Q4 and 2.9% in 2013 Q3.

Chart 13: Real GDP by Sector (% y-o-y)

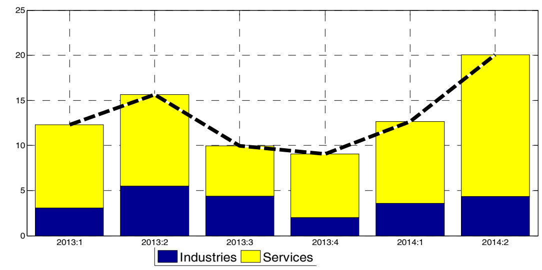


Source: BNR, Monetary Policy & Research Department (2014)

The economic recovery in 2014 Q1 was propelled by growth in the agriculture sector from -1% in 2013 Q4 to 5% in 2014 Q1, in the industry sector from 3% to 9% while the service sector registered modest growth from 7% to 8% during the same period respectively. The economy is expected to continue recovering in 2014 Q2 given the trend in turnovers and in money supply (M3) indicated by the rise in outstanding credit, new authorized loans as well as government injections.

Total turnovers increased by 20.1% in 2014 Q2 from 12.6% in 2014 Q1 and 9.0% of the previous quarter. Real GDP growth is likely to be driven by the services sector given that the increase in total turnovers during 2014 Q2 was propelled by high increase in services to 22.4% from 12.5% of the previous quarter while the industry sector moderately increased to 14.6% from 13.0% during the same period.

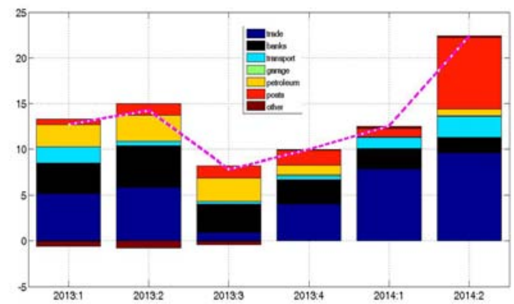
Chart 14: Total turnovers



Source: BNR, Monetary Policy & Research Department (2014)

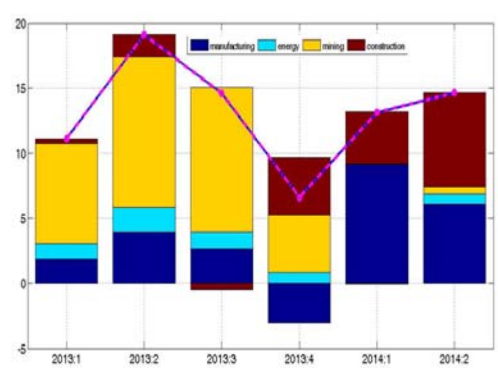
In 2014 Q2, growth in the services sector will be mainly driven by posts & telecommunications as services turnovers increased on annual basis from 12.4% in 2014 Q1 to 101.1% in 2014 Q2.

Chart 15: Services turnover



Despite a sharp increase in construction turnovers from 15.8% in 2014 Q1 to 27.2% in 2014 Q2, total turnovers for the industry sector registered modest growth in 2014 Q2 following a decline in manufacturing turnovers from 18.8% to 13.1% during the same period.

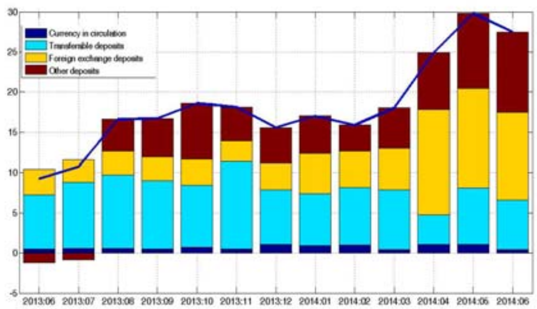
Chart 16: Industry turnovers



Money supply started to increase with the adoption of an accommodative monetary policy in June

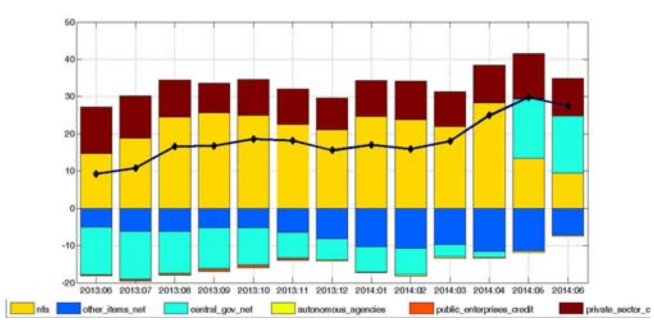
2013. On average, during December-June, M3 increased from 8% in 2013 to 19.2% in 2014 as a result of the increase in: foreign currency deposits from 20.4% in 2013 to 49.8% in 2014, other deposits from 5.4% to 19.8% and transferable deposits from 9.4% to 17.1% during the same period.

Chart 17: M3 from the liability side (%, y-o-y)



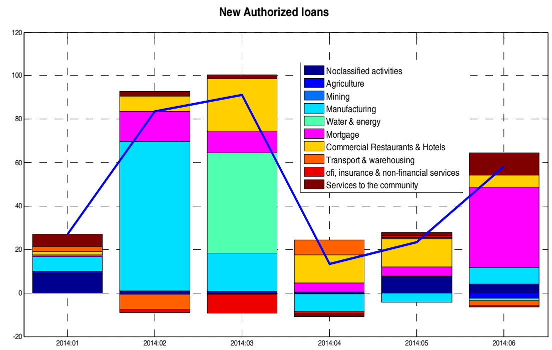
From the asset aside, the major contributors to annual growth in M3 during the first six months of 2014 were net foreign assets and credit to the private sector. On average, net foreign assets grew by 36.2% in January-June 2014 from -3.8% of the same period in 2013 while there was an uptick in credit to private sector since the beginning of 2014, growing from 11.1% in December 2013 to 12.2%, 15.1% and 13.4% in January, May and June 2014 respectively.

Chart 18: M3 from the asset side (%, y-o-y)



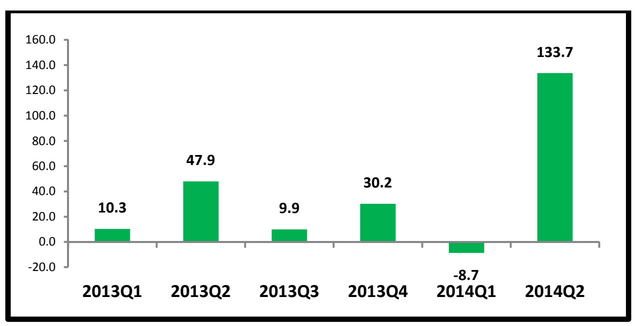
New authorized loans increased on annual basis by 29.9% in 2014 Q2 compared to 15.6% in 2013 Q2. In the first six months of 2014, new authorized loans increased by 47.8% to FRW 325.6 Billion compared to FRW 220.4 billion recorded in the same period of 2013. In the industry sector, most of the loans were allocated to mortgages while in the services sector bigger loan allocations went to commercial restaurants and hotels.

Chart 19: New authorized loans



Liquidity conditions remained supportive to economic growth with net government liquidity injection reaching 133.7 Billion RWF in 2014 Q2 from -8.7 RWF Billion realized in the previous quarter.

Chart 20: Government net liquidity injection (FRW Billions)



Source: NBR, Monetary Policy & Research Department (2014)

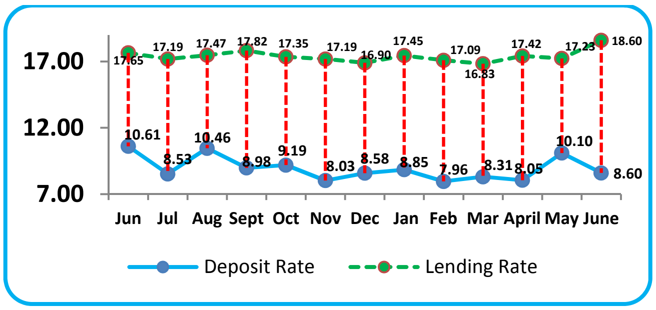
2.2.Financial Sector developments

2.2.1 Interest rate developments

In the first half of 2014, short-term interest rates on the money market continued to be low as a result of sound liquidity in the banking system and the current accommodative monetary policy stance.

Commercial banks' deposit interest rates stabilized at around 8.5% in the first half of 2014 from 10.9% recorded in the same period of 2013 while the lending interest rate remained stable at around 17.2% in January-June 2014 from 17.3% in the same period of 2013.

Chart 21: Deposit and lending rates

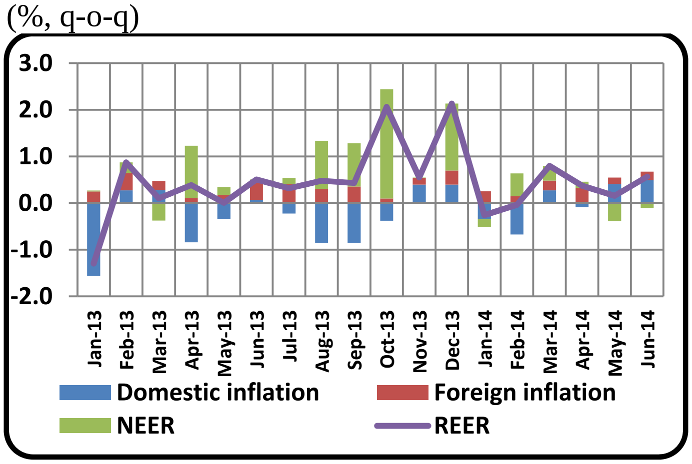


Source: BNR, Monetary Policy & Research Department (2014)

2.2.2 Exchange rate developments

On the foreign exchange market, the Real Effective Exchange Rate (REER) slightly depreciated by 0.11% in June 2014 following a small uptick in relative prices (higher level of foreign inflation relative to domestic inflation) that was outweighed by the depreciation of the nominal effective exchange rate.

Chart 22: Contribution to the RER appreciation (%, q-o-q)

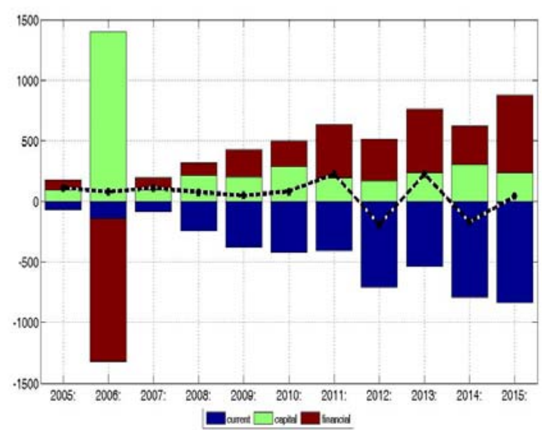


Source: BNR, Monetary Policy & Research Department (2014)

The depreciation against the USD has remained contained and stands at 1.9% between December 2013 and June 2014 compared to 1.8% for the same period of 2013. In the first half of 2014, the banking system recorded a shortfall of 5.5% and 11.4% respectively in forex resources and expenditure compared to the same period of 2013, leading to a cash deficit of USD 109.3 million at the level of commercial banks and thus explaining the small increase in the above mentioned nominal exchange rate depreciation.

During the same period, the RWF appreciated by 5.3% against the GBP, 1.0% against the EURO, 0.9% against the Kenyan shilling, 2.5% versus the Ugandan shilling, 5.3% against the Tanzanian shilling but depreciated by 0.6% versus the Burundi franc.

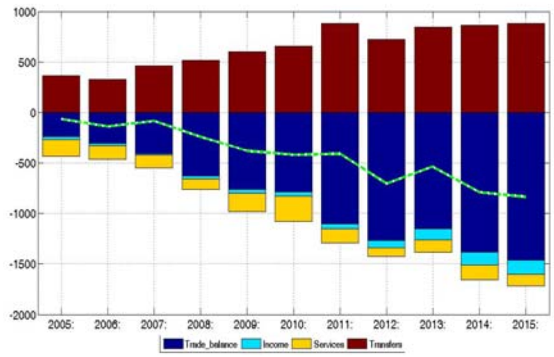
Chart 23: The BOP decomposition (Millions USD)



Source: BNR, statistics department (2014)

The expected widening of the current account deficit will be due to the anticipated widening of the trade deficit while income and services are likely to remain relatively stable though on the upside. Transfers are likely to remain stable, and they will continue to be outweighed by the downside current account components.

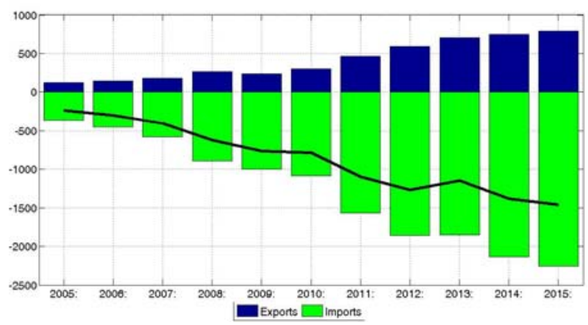
Chart 24: The current account (Million USD)



Source: BNR, statistics department (2014)

The current account deficit is expected to be driven by the increase in the trade deficit from -1148.5 USD Millions in 2013 to -1384.4 USD Millions as a result a very big increase in imports relative to exports.

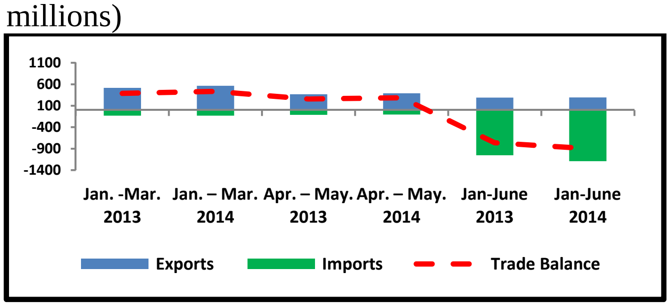
Chart 25: Merchandise trade (Million USD)



Source: BNR, statistics department (2014)

In the first six months of 2014, total exports increased by only 2.26% compared to the 13.0% increase in total imports and thus leading to the widening of the trade deficit from -765.37 USD Millions in 2013 to -898.59 USD Millions.

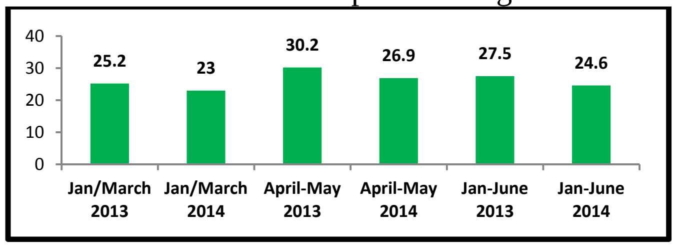
Chart 26: Evolution of the trade balance (USD, millions)



Source: **Source:** BNR, statistics department (2014)

Rwanda is generally a net importer, with export coverage of imports dropping to 24.6% in January-June 2014 from 27.5% of the same period in 2013.

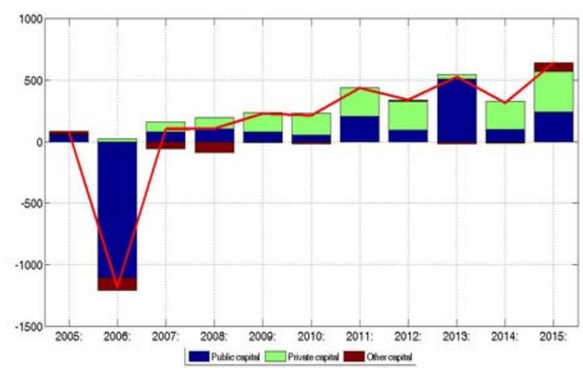
Chart 27: Evolution of import coverage



Source: Monetary Policy & Research Department (2014)

In 2013, the financial account was in upswing and almost solely driven by an uptick in public capital. It is expected that in 2014 public capital will decline but likely to be partially offset by the increase in private capital. Thus, the net effect will be a drop in the financial account.

Chart 28: The financial account (Million USD)



Source: BNR, statistics department (2014)

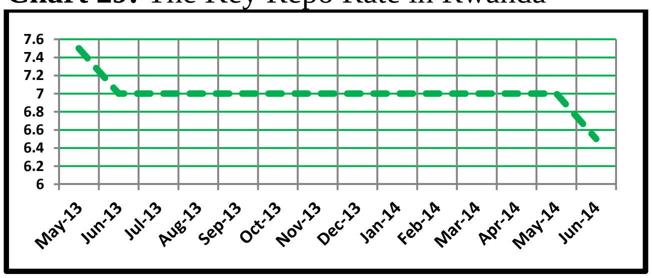
2.3. Fiscal spending

Comparing the original and revised 2013/14 budget, the government generally increased its expenditure by 24.2 Billion RWF, the lagged effect of which is likely to push up aggregate demand. Nonetheless, this will remain less inflationary. The 2014/15 national budget stands at 1753.3 RWF Billion compared to 1677.7 RWF Billion of the previous fiscal year's budget. The biggest chunk (49%) of the 2014/15 budget is planned to finance investment projects in order to continue supporting economic growth. Recurrent budget dropped from 917.5 RWF Billion of 2013/14 to 864.5 RWF Billion of 2014/15 thus posing no serious challenges to the inflation outlook.

2.4.Previous monetary policy stance

Since June 2013, the National Bank of Rwanda has been pursuing a supportive monetary policy stance until 2014 Q1 when the KRR was revised downwards from 7% to 6.5% with the objective of supporting growth.

Chart 29: The Key Repo Rate in Rwanda



Source: Monetary Policy & Research Department (2014)

The downward revision of the KRR on 25th June 2014 was aimed at stimulating credit to the private sector so as to sustain the ongoing economic recovery. This was also motivated by the low inflationary pressures, weakening aggregate demand and relative stability of the RWF.

2.5.Domestic inflation developments

Headline inflation remained subdued in the first and second quarter of 2014. Consistent with previous expectations, headline inflation was maintained below the 5% target during the first two quarters of 2014 and is likely to remain so in 2014Q3. On average, headline inflation decelerated from 4.1% in 2013 to 2.6% in 2014 in the January-June period.

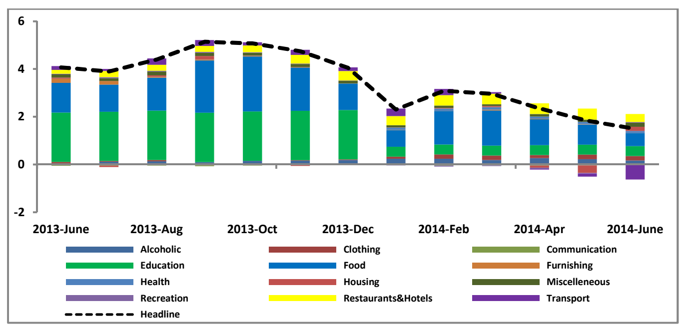
Table: Inflation developments

	2013-Sept	2013-Dec	2014-Jan	2014-Feb	2014-Mar	2014-Apr	2014-May	2014-June
Core	3.32	3.76	2.71	2.76	2.64	2.29	2.35	2.00
Domestic	5.74	4.15	2.38	3.67	3.84	3.09	2.29	2.11
Education	35.18	35.18	7.07	7.07	7.07	7.07	7.07	7.07
Energy	2.82	0.04	1.55	1.60	0.75	-0.52	-4.15	0.21
Food	7.77	3.91	2.44	4.98	5.24	3.84	2.99	1.91
Fresh Products	13.59	4.88	1.56	7.60	8.30	6.18	3.00	-0.47
Imported	2.45	1.64	2.62	2.54	1.71	1.20	0.86	-0.39
Transport	1.40	0.88	1.75	1.49	0.38	-0.19	-0.75	-3.40
Headline	5.10	3.65	2.43	3.45	3.43	2.72	1.93	1.44

Source: BNR, Statistics department (2014)

For January-June 2014, inflationary pressures from many components reduced; with significant downswing from education, housing and transport. Around 61% of the overall inflation jointly came from food and hotels& restaurants, with 42% coming from food and 19% from Hotels & restaurants.

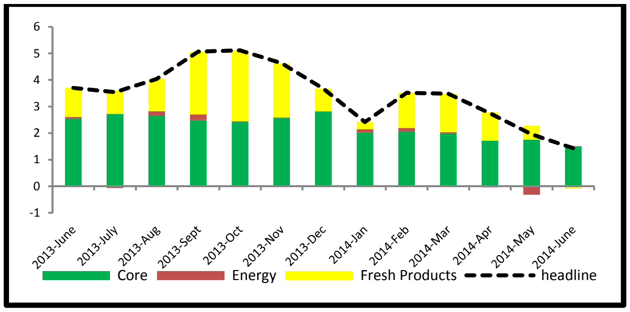
Chart 30: Weighted contribution to headline inflation



Source: BNR, Monetary Policy & Research Department (2014)

Core inflation, which excludes fresh products and energy, also declined from 2.46% on average in January-June 2013 to 4.46% of the same period in 2014. During the same period, months of peaks in headline inflation correspond to higher prices of fresh products resulting from poor performance in agriculture season A whereas the continued deceleration since March is due to weakening aggregate demand.

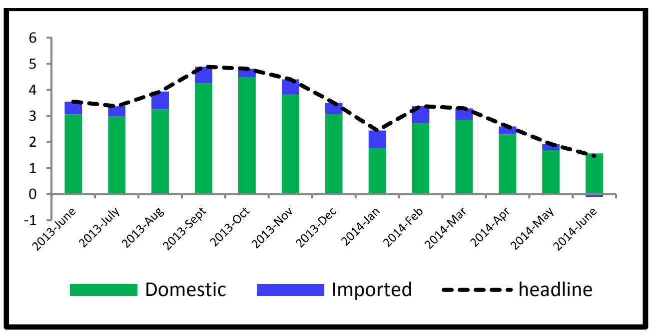
Chart 31: Decomposition of inflation into core and non-core elements



Source: BNR, Monetary Policy & Research Department (2014)

In June 2014, the contribution of domestic inflation to headline inflation increased to 106.74% from 72% of January 2014. The contribution of imported inflation declined from 27.6% in January to -6.74% in June 2014.

Chart 32: Decomposition of inflation by origin



Source: BNR, Monetary Policy & Research Department (2014)

Imported inflation remained low, declining from 2.6% to -0.4% between January and June on the account of some factors such as falling transport costs, a generally stable inflation in the region and the relative stability of the RWF against the currencies of major trading partners. Despite upward pressures from restaurants & hotels and alcoholic beverages, domestic inflation also fell from 3.1% to 2.1% between April and June. Following falling inflation in education since the beginning of 2014, domestic inflation is driven by food and restaurants & hotels which jointly accounted for 40.3% in June. The contribution from food inflation drastically fell from 41% in May to 20% in June 2014 while the contribution from housing inflation sharply increased from -18.6% to 11% over the same period.

Chart 33: Weighted contribution to domestic inflation

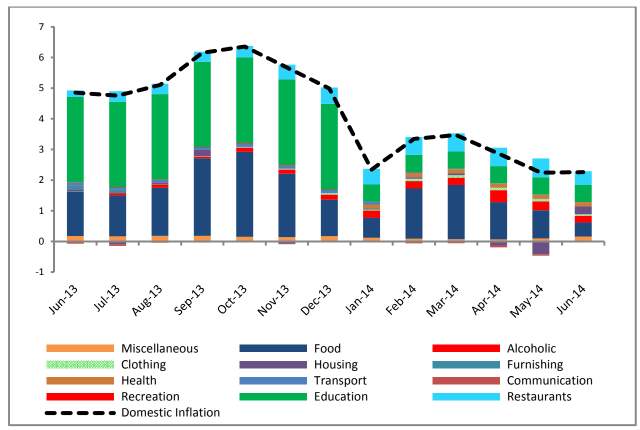
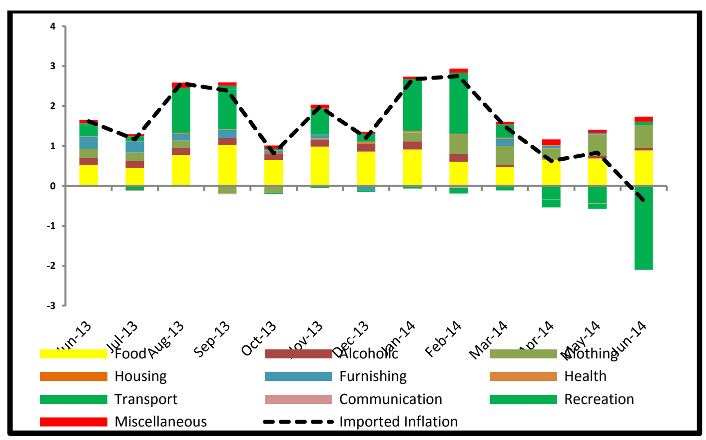


Chart 34: Weighted contribution to imported inflation



3.0. THE INFLATION OUTLOOK

3.1. Risks to the inflation outlook

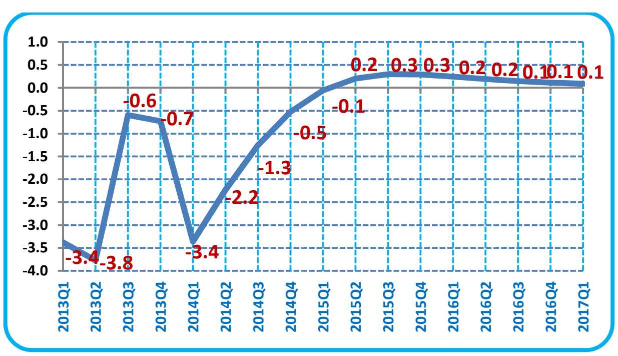
3.1.1. The external economic environment

As the world economy continues to rebound, exports for Rwanda may surge leading to higher export revenues despite the fact that Rwanda's export sector did not perform well in 2014 Q1 and the trade balance continued to widen for the first six months of 2014. The boom in exports is still contingent on global demand as well as the trend in commodity prices, which have remained stable over the past and are likely to fall in the near future.

3.1.2. The domestic output gap

In 2014 Q1, the domestic output gap became more negative and almost reached the 2013 Q1 level reflecting the weakening in both private and public demand. Thereafter, the output gap is recovering and is projected to close in mid-2015 though it will remain slightly positive until 2015-2016. This development indicates that the short-run aggregate demand will not exert inflationary pressures to the economy.

Chart 35: Output gap for Rwanda



Source: BNR, Monetary Policy & Research Department (2014)

3.1.3. Global inflationary pressures

Inflation is at the moment at low levels around the world, in USA, Eurozone and EAC. Of particular interest, inflation has remained low and relatively stable throughout the EAC region. This continued stability of regional inflation gives confidence regarding the moderation of imported inflation.

3.1.4. International commodity prices

International commodity prices are expected to decline in the rest of 2014 and export revenues are likely to dwindle. This may exert upward pressures on the foreign exchange rate and imported inflation. Falling international oil prices with effects on international transport costs may ease pressures on imported inflation.

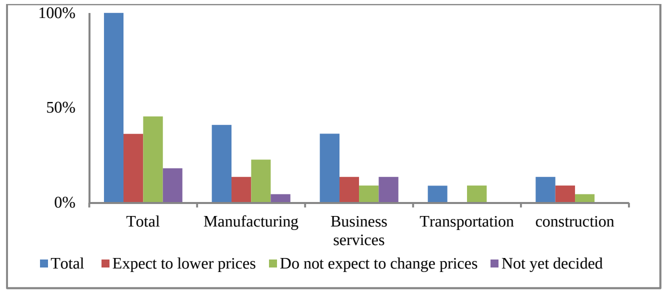
3.1.5. Exchange Rate movements

The real effective exchange rate continued to depreciate during 2014 Q1 but at a decelerating rate mainly due to an increase in the relative prices and the decreasing rate in nominal exchange rate. The slowing pace of real exchange rate depreciation in 2014 Q1 helped to lessen imported inflation. This is likely to go on in next quarters given that global and domestic inflation rates are projected to remain stable and nominal exchange rate depreciation is decelerating.

3.1.6. Market expectations

The most recent expectations survey indicates decreasing inflationary pressures as 36.3% of sampled firms assert that they expect to lower the prices of their products in the next quarter compared to 33.3% that were expected raise prices in last survey. 45.5% may keep prices stable and 18.2% are still undecided in contrast to 28.6% and 38.1% of the last survey respectively. However, mini-market survey reveals that prices for food items are anticipated to increase on the back of poor agricultural production that is likely to feed through to the next quarter's food prices

Chart 36: Expected upward revision of prices for 2014Q2



Source: BNR, Monetary Policy & Research Department (2014)

3.1.7. Monetary policy stance

In March 2014 BNR reduced the key repo rate given the prevailing low level of domestic inflation, the negative output gap and a recovery in credit to private sector. A supportive monetary policy is expected to remain in the near future following the continued low inflation and weak aggregate demand so as to continue to support growth and help the economy to fully recover from the adverse effects of cuts and delays in budget support disbursements faced in 2012.

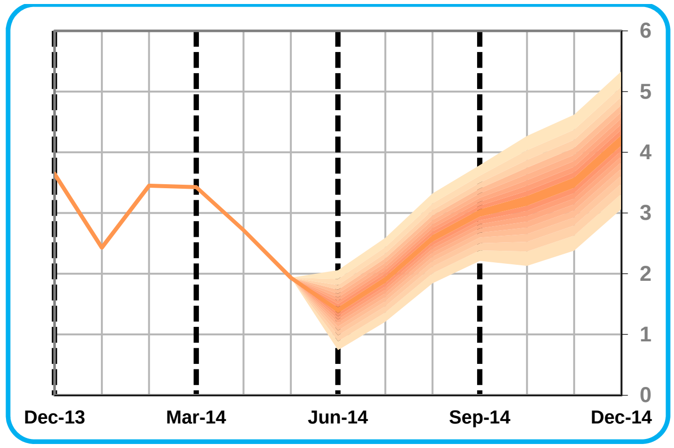
3.2. Inflation forecasts

Headline Inflation has remained moderate, standing at 3.4% in March and 1.4% in June 2014. Previous forecasts estimated inflation to evolve around 4.2% in 2014 Q1 and 4.6% in 2014 Q2. These forecast errors came from the more than expected deceleration in aggregate demand and in food inflation.

Looking ahead, inflation is expected to gradually go up but remain on the downside. Aggregate demand is still weak and likely to remain negative for the rest of 2014. Imported inflation is likely to remain low given the expected decline in international commodity prices, the slowing down in exchange rate depreciation as well as the moderation of inflation in the EAC region. Following the poor performance in agricultural harvests for season B 2014, food prices are likely to continue dominating developments in headline inflation.

The following fan chart takes into account the uncertainties around the central inflation projections as a result of the aforementioned risks to the inflation outlook. Generally, headline inflation is expected to remain moderate, standing at around 3% in September and around 5% in December 2014.

Chart 37: Inflation forecasts (fan chart)



Source: BNR, Monetary Policy & Research Department (2014)

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KN 6 AVENUE 4, P.O. Box 531 Kigali
Tel. :(250)252 574282, Fax: (250) 252 577391
Email: info@bnr.rw
Web: www.bnr.rw
Swift code: BNRWRWRW