National Bank of Rwanda

QUARTERLY INFLATION REPORT

WP02/2014Q2

Kigali, September 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.

After the 2013 economic slowdown, the Rwandan economy has continued to perform well in 2014. In 2014Q2, real GDP growth slightly dropped to 6.1% from 7.5% in 2014Q1 compared to 4.8% in 2013Q1 and 7.2% in 2013Q2. However, average real GDP growth stood at 6.8% during the first two quarters of 2014 compared to 6.0% in the same period of 2013. Consequently, growth is evolving towards the attainment of the projected real GDP growth rate of 6% by the end of 2014. Growth in 2014Q2 is affirmed by the fact that total turnovers increased by 20.1% in 2014Q2 from 12.6% in 2014Q1 and 9.0% of the previous quarter.

Positive growth prospects for 2014Q3 are premised on the upward trend in total turnovers, the Composite Index of Economic Activities (CIEA) and economic financing. In the July-August 2014, total turnovers increased by 13.5% from 9.6% in the same period of last year. The CIEA rose in real terms by 10.1% in August 2014 compared to 6.9% of the same period in 2013.

Economic financing has improved as shown by the increase in money supply (M3). Between December 2013 and August 2014, money supply (M3) rose by 18.1% compared to 10.5% recorded in the same period of 2013. During the same period, credit to the private sector increased by 11.7% against 7.6% recorded in the same period of 2013 whereas new loans grew by 36.7% during the first two months of 2014Q3 from -15.5% in the same period of 2013.

Though the RWF depreciated by 2.1% against the USD, imported inflationary pressures will remain dampened by the appreciation of the RWF against most of the regional currencies. However, some exchange rate pressures exist as a result of the widening trade deficit.

Inflationary pressures have continued to ease as a result 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 0.9% in August from 2.4% in January 2014. However, there are some risks linked to especially the less than expected season B 2014 harvests and the end-of-year festivities. Nonetheless, inflation will remain on the downside given the low level of aggregate demand and the softening in international commodity prices. In view of the above, inflation is expected to be around 1% in September and around 3.2% in December 2014.

ACKNOWLEDGEMENTS

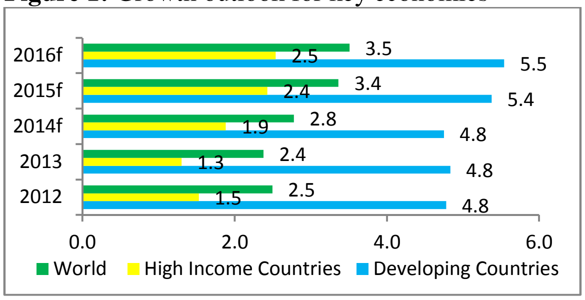
A team from the Monetary Policy & Research Department, spearheaded by the Modeling and forecasting division, prepared the 2014Q2 inflation report with notable contribution from Mr. Mathias KARANGWA (Manager, Modeling & forecasting division) & Mr. MWENESE Bruno (Senior Economist, Modeling & forecasting 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 Analysis division).

1. EXTERNAL ENVIRONMENT

1.1. Global Economic Activity

The global growth projection was revised downwards by 0.3 percent to 3.4 percent as a result of the weak performance in the first quarter. However, the world economy strengthened in 2014Q2 and was mainly supported by the recovery in US and in emerging markets. Growth is still fragile in the Euro area while it contracted in Japan.

Figure 1: Growth outlook for key economies



Source: World Bank, GEP (June 06th 2014)

Compared to the same quarter of the previous year, the world economy slowed down from 2.6% in 2013Q4 to 1.9% and 2.4% in 2014Q1 and 2014 Q2 respectively. In annual terms, the global economy is expected to slightly grow from 3.28% in 2013 to 3.31% in 2014.

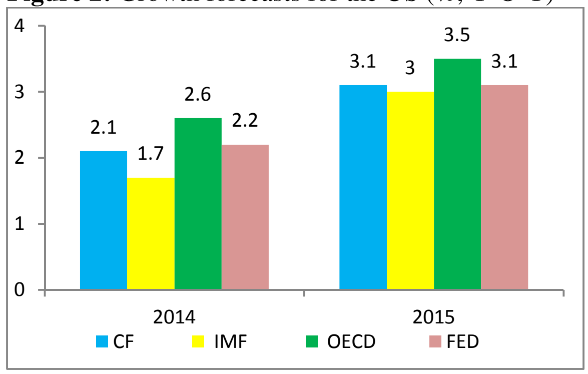
Table 1: Real GDP growth (% change)

	Quarterly				Annual	
	2013	2014				
	Q.IV	Q.I	Q.II	Q.III	2013	2014
World (Y0Y)	2.6	1.9	2.4	2.8	3.3	3.3
USA (QoQ)	3.5	-2.1	4.6	3.0	2.2	2.2
Euro area	0.5	1.0	0.7	0.8	-0.4	0.8
Japan (QoQ)	-0.5	6.0	-7.1	3.4	1.5	0.9
UK (YoY)	2.7	2.9	3.2	3.0	1.7	3.2
China (Y0Y)	7.7	7.4	7.5	7.2	7.7	7.4
India (YoY)	4.6	4.6	5.7	5.1	5.0	5.6

Source: BLOOMBERG & IMF

Despite the 2.1% contraction in 2014Q1 from 3.5% of the previous quarter mainly due to adverse weather conditions, the US economy recovered to 4.6% in 2014Q2 in line with previous expectations. The improvement was broad-based; consumer spending, fixed investment, net exports, employment and government all recovering well. However, the US economy is expected to slightly decelerate from 2.21% in 2013 to 2.15% in 2014.

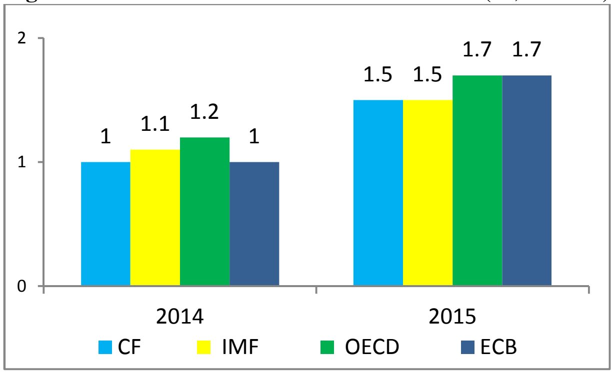
Figure 2: Growth forecasts for the US (%, Y-O-Y)



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

Growth in the Euro area fell from 1.0% in 2014Q1 to 0.7 in 2014Q2. In 2014Q1, growth remained unbalanced across countries with the Germany economy contracting between April-June, a flat growth in France and deceleration in Italy and Netherlands, only Spain performed well in 2014 second quarter. However, growth should firm further as ECB announced substantial policy easing, cutting its deposit rate to below zero, lowering its benchmark rate and announcing significant credit easing measures. Overall, the Euro area is expected to grow in annual terms from -0.4% in 2013 to 0.8% in 2014.

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



Source: IMF, Consensus Forecasts (CF), ECB & 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 -0.5% 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 deccelerate in annual terms from 1.5% in 2013 to 0.9% in 2014 following the government's reflationary agenda.

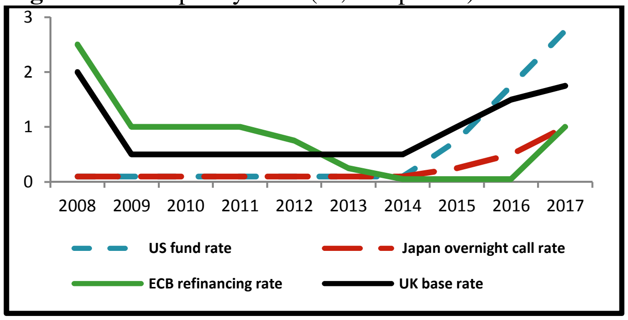
After 2014Q2, the global economic recovery remains on track and has been dependent on the good economic performance of advanced economies supported by expansionary monetary and fiscal policies especially in the US, UK and Japan. Thus, the current major risk to the growth outlook includes monetary policy tightening and fiscal consolidation especially in the US as well as geo-political tensions in countries like Ukraine/Russia, Iraq and Syria. However, the growth pace is still contingent on the stronger performance in the Euro area.

1.2. Monetary policy and international financial markets

In the developed economies, monetary policy remained accommodative to boost economic activities in 2014 Q2. The policy rate was maintained at 0.25% in USA, 0.50% in UK and 0.10% in Japan. However, in the Euro zone, the ECB reduced its key policy rate from 0.25% to 0.15% in June to reflate the faltering economic recovery. This rate was reduced further in September 4th to 0.05% to continue supporting the financing of the economy.

The expected rise in the official interest rates in the US has generated speculation in the financial markets. However, this is unlikely to happen before the end of 2014. Monetary policy rates increased in some of developing countries experiencing currency depreciation, self-sustained economic recovery or in response to inflation expectations. For some others facing weakening economic activity, they loosened monetary policy. The room for monetary policy accommodation is expected to gradually diminish for most developing countries as the U.S. Federal Reserve moves closer to its own tightening cycle.

Figure 4: Main policy rates (%, end period)



Source: Economic Intelligence Unit (2014)

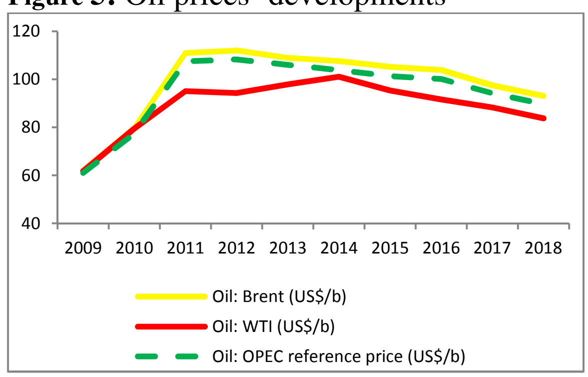
During the first quarter of 2014, the dollar weakened versus the Euro (0.2%), the Pound (1.9%) and the Yen (0.3%). Data for May 2014 indicate that the dollar recovered by 1.7% versus the Euro and by 0.7% versus the GBP. The dollar was still losing versus the Yen for the April and May on the back of strong 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.

The euro has finally begun to depreciate against the US dollar, after displaying surprising resilience for much of 2014. However, the strengthening US economy, a dramatic loosening of monetary policy by the European Central Bank (ECB) in June and the recent stumble in Germany have caused the euro to slip to a nine-month low against the US dollar in mid-August, at US$1.335:€1. As the Fed ends its quantitative easing (QE) program and markets turn their attention to the timing of the first US interest-rate increase, the euro will continue to weaken. Emerging-market currencies belonging to countries with large external financing needs and political instability will also come under downward pressure, prompted by speculation about tighter US monetary policy.

1.3. International commodity prices

International crude oil prices increased to USD 106.3/barrel in 2014 Q2 from USD 103.7/barrel in 2014 Q1 on average. Contrary to expectations, oil prices declined to 105.2/barrel and 100.1/barrel in July and August respectively. Despite conflicts concerns in oil producing countries, oil supply increased and demand remained sluggish especially in Europe.

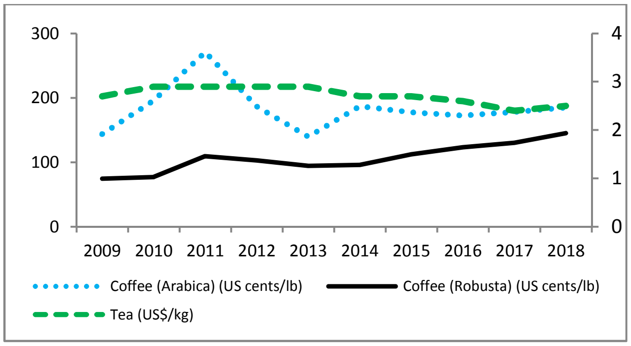
Figure 5: Oil prices' developments



Source: EIU, July 2014

In 2014 Q2, except for coffee whose prices are still high, agriculture prices for most crops fell on account of good harvests owing to favorable weather after a bad winter. Metal prices rose by 4.3% in July for the first time after a decrease recorded in 2014Q2 due to declining stocks for some metals.

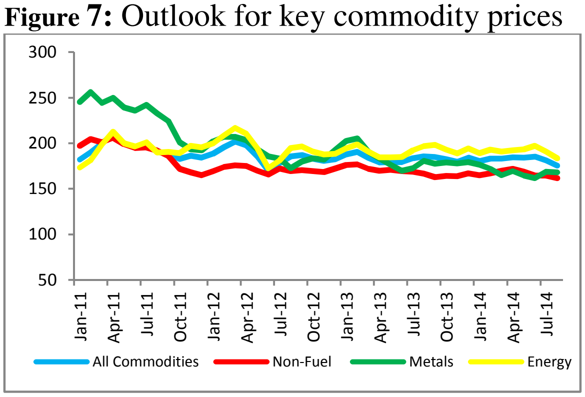
Figure 6: Non-oil prices developments



Source: EIU, July 2014: **Tea prices on the right scale***

Globally, commodity prices rose by 0.5% in June after a decline of 0.2% recorded in May. However, in July and August global prices fell by 2.2% and 3.2% respectively and are expected to continue declining for some commodities like energy and metals. However, agriculture commodity prices are expected to increase following the onset of the winter season. The main risks still reflect the geopolitical uncertainty in Russia and Ukraine and weather related risks.

Figure 7: Outlook for key commodity prices



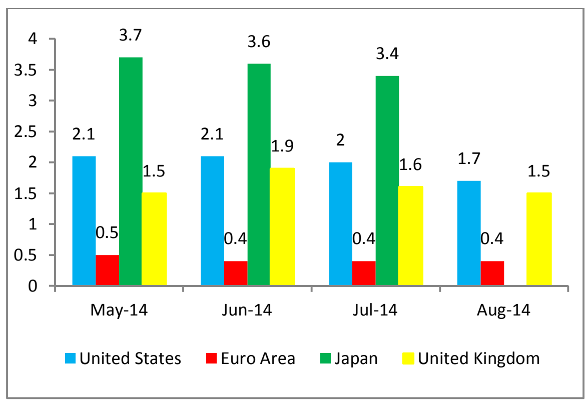
Source: IMF (Sept 2014).

1.4. Global inflation developments and outlook

Despite having increased in recent months, global inflation remains relatively low reflecting rather stable commodity prices and ample global spare capacity. Headline consumer price inflation in the OECD area further picked up to 2.1% in 2014 Q2 from 1.6% of first quarter but slightly decreased to 1.9% in July. It was mainly driven by a higher contribution from energy and food prices. The pick-up in inflation was evident in the majority of advanced economies, notably outside Europe, as well as in most large emerging market economies.

Inflation generally remained on the downside reaching 0.3% in August 2014 from 0.4% and 0.5% of the two previous months in the Euro zone due to capacity under-utilization. Inflation declined to 2.0% in July 2014 from 2.1% of end June for the US due to easing energy costs. Similarly, it reduced to 3.4% in July from 3.6% in June 2014 in Japan as the impact of past yen depreciation on prices continued to fade.

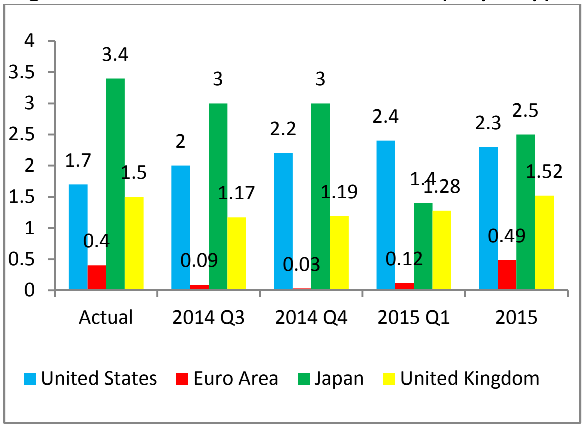
Figure 8: Inflation in key economies (%, y-o-y)



Source: http://www.tradingeconomics.com

The outlook for global inflation is strongly influenced by commodity price developments and, more importantly, by energy prices. After a moderate increase in June, oil prices declined by about 6% in July. Political instability and technical issues continue to weigh on oil production. On the demand side, growth in global oil demand remained subdued in line with moderate growth in global GDP.

Figure 9: Global inflation outlook (% y-o-y)



Source: http://www.tradingeconomics.com/forecasts

Since 2013, headline inflation has remained moderate throughout the EAC region. For 2014, headline inflation declined in Uganda to 1.4% in September from 2.8% in August, 4.3% in July and 5.0% in June 2014 following the continued easing of food inflation. Headline inflation remained relatively high in Tanzania and Kenya. In Kenya, it stood at 6.6% in September from 8.4% in August, 7.7% in July and 7.4% in June 2014, mainly driven by prices of several food commodities, cooking fuels and rents and electricity charges while in Tanzania, it stood at 6.7% in August from 6.5% in July and 6.4% in June 2014. In Rwanda, inflation declined to 0.9% in August from 1.9% and 1.4% in July and June 2014 respectively reflecting the decline in food prices. Burundi inflation picked up to 5.9% in August from 3.1% in July and 3.3% in June 2014 mainly due to the increase in food prices.

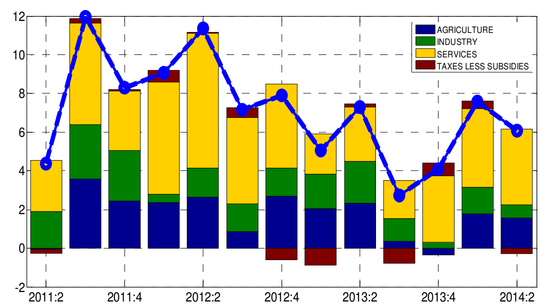
2. THE DOMESTIC ECONOMY

2.1. Domestic demand and output

After the 2013 economic slowdown, the Rwandan economy has continued to perform well in 2014. In 2014Q2, real GDP growth slightly dropped to 6.1% from 7.5% in 2014Q1 compared to 4.8% in 2013Q1 and 7.2% in 2013Q2.

However, average real GDP growth stood at 6.8% during the first two quarters of 2014 compared to 6.0% in the same period of 2013. Consequently, growth is evolving towards the attainment of the projected real GDP growth rate of 6% by the end of 2014.

Figure 10: Real GDP by Sector (% y-o-y)



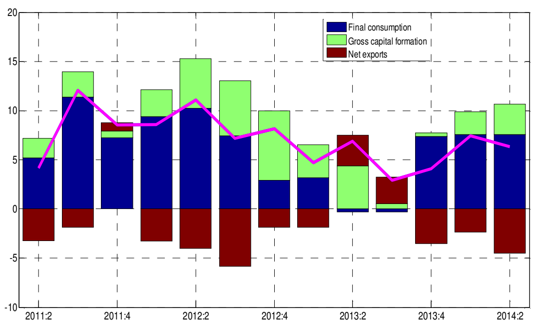
Source: BNR, Monetary Policy & Research Department (2014)

The services sector is still the main driver of economic growth, registering growth of 9% and with a share to total GDP of 47% in both 2014Q1 and 2014Q2 respectively. Growth in the agriculture sector significantly increased from -1% in 2013Q4 to stabilize at 5% in both 2014Q1 and 2014Q2 while the industry sector grew from 3% in 2013Q4 to 9% in both 2014Q1 and 2014Q2.

From the expenditure side, growth in real GDP in 2014Q2 was mainly driven by domestic demand (i.e. total final consumption and gross capital formation) while net exports contributed negatively.

In 2014Q2, total final consumption expenditure increased by 9% from 8% in 2014Q1 against 0% in 2013Q2 and 4% in 2013Q1. Gross capital formation grew by 11% in 2014Q1 from 8% of the previous quarter as compared to 18% in 2013Q2 and 13% in 2013Q1. The contribution of net exports in 2014Q2 became more negative following the 4% contraction in net exports from 14% in 2014Q1, 45% in 2013Q2 and 5% in 2013Q1.

Figure 11: Real GDP by expenditure (% y-o-y)



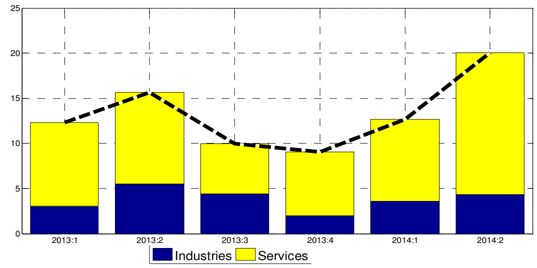
Source: BNR, Monetary Policy & Research Department (2014)

Growth in 2014Q2 is affirmed by the fact that total turnovers increased by 20.1% in 2014Q2 from 12.6% in 2014Q1 and 9.0% of the previous quarter. Economic growth is expected to strengthen in 2014Q3 as indicated by the leading indicators of economic activity notably turnovers of industry and service sectors, the composite index of economic activities and credit to the private sector.

In the July-August 2014 period, total turnovers increased by 13.5% from 9.6% in the same period of last year.

The services sector will continue to be the engine of growth as its total turnovers in July-August 2014 increased by 16.2% from 4.2% in the same period of last year whereas the industry sector total turnovers decelerated to 7.3% from 24.2% during the same period.

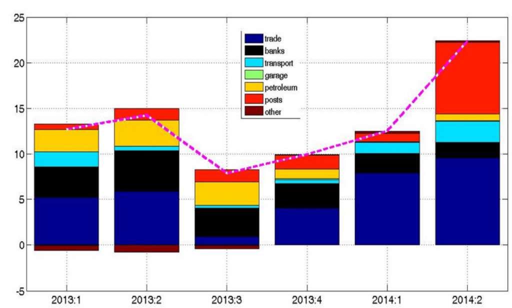
Figure 12: Total turnovers



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

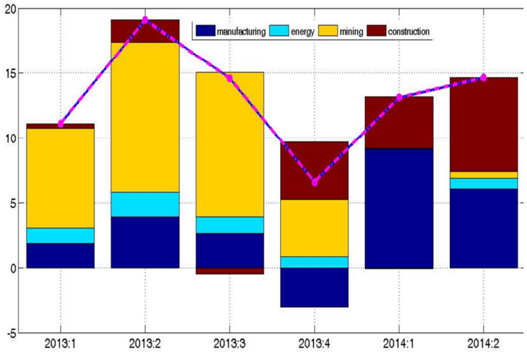
While growth in the service sector turnovers in 2014Q2 was propelled by posts & telecommunications, it is likely to be driven by trade services in 2014Q3 as their turnovers for July-August 2014 increased by 26.9% from -3.2% in the same period of last year.

Figure 13: Services turnover



The deceleration in the industry sector turnovers in July-August period was due to the fall in mining turnovers from 160.3% in 2013 to -5.8% in 2014 and energy turnovers from 20.4% to 9.7% during the same period. The sector was however bolstered by manufacturing whose turnovers increased from 6.8% to 7.6% and construction from 9.3% to 18.8% during the same period.

Figure 14: Industry turnovers

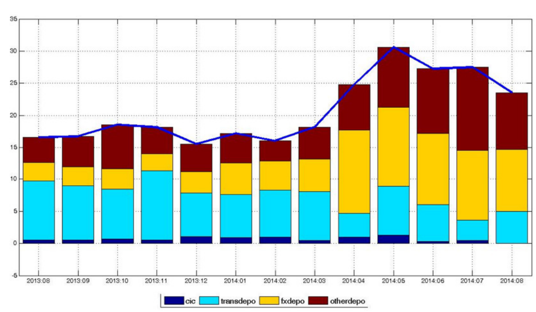


Source: BNR, Monetary Policy & Research Department (2014)

The developments in the Composite Index of Economic Activities also indicate an increase in economic activities during the first two months of 2014Q3, rising in real terms by 10.1% from 6.9% in the same period of 2013.

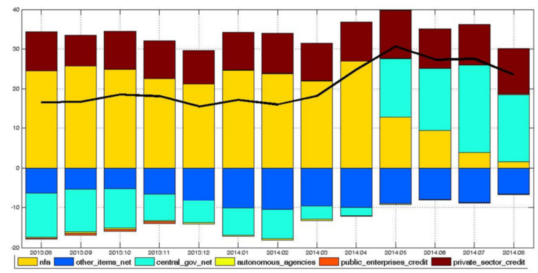
Economic financing has continued to increase as indicated by growth in both money supply and credit to the private sector. Between December 2013 and August 2014, money supply (M3) rose by 18.1% compared to 10.5% recorded in the same period of 2013. This increase was mainly supported by the uptick in transferable deposits.

Figure 15: M3 from the liability side (%, y-o-y)



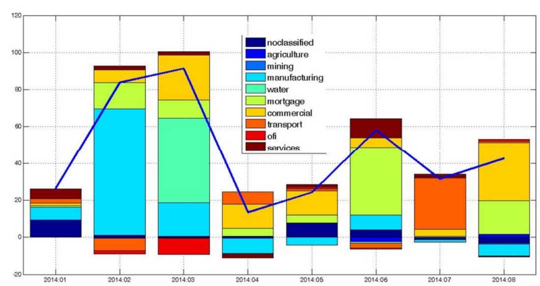
From the asset aside, M3 growth was mainly supported by the high increase in Net Domestic Assets (NDA) of the banking system offsetting the decline in Net Foreign Assets (NFA). Between August 2014 and December 2013, Net Domestic Assets grew by 86.1% due to high increase in net credit to government (96.7%) and the increase in the outstanding credit to the private sector which increased by 11.7% against 7.6% recorded in the same period of 2013.

Figure 16: M3 from the asset side (%, y-o-y)



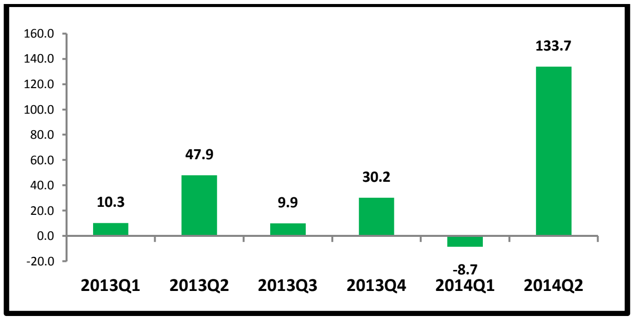
In 2014Q2 new loans to the private sector rose by 29.9% from 1.6% in 2013Q2. Considering the first two months of 2014Q3, new loans grew by 36.7% from -15.5% in the same period of 2013. In July 2014, most of the new loans went to transport and commercial services while in August, loans to commercial services and mortgages took the largest share.

Figure 17: 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. However, the level of government injection is still low to stimulate quick recovery in aggregate demand.

Figure 18: Government net liquidity injection (FRW Billions)



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

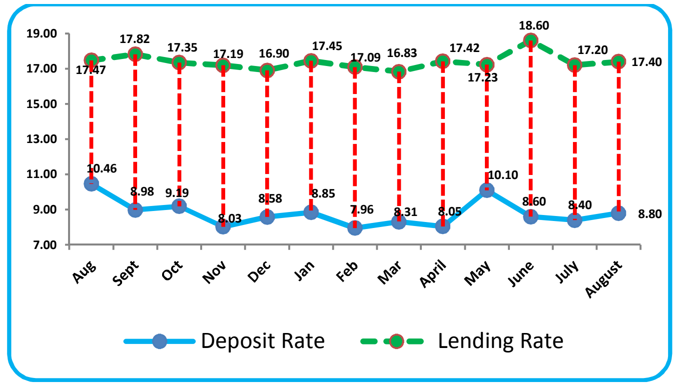
2.2.Financial Sector developments

2.2.1 Interest rate developments

The loose monetary policy has resulted into high banking system liquidity as well as the decline in short term interest rates whereby the T-bills and interbank rates declined respectively from 5.6 % and 5.7% end June 2014 to 5.2% and 5.5% end August 2014.

The response of commercial banks interest rates to changes in the key repo rate is still characterized by the rigid movements in the lending rates compared to the deposit rate. Commercial banks deposit interest rates stabilized around 8.5% in the first eight months of 2014 from 10.5% recorded in the same period of 2013 while the lending interest rate remained stable around 17.27% from 17.32% in the period under review.

Figure 19: Deposit and lending rates

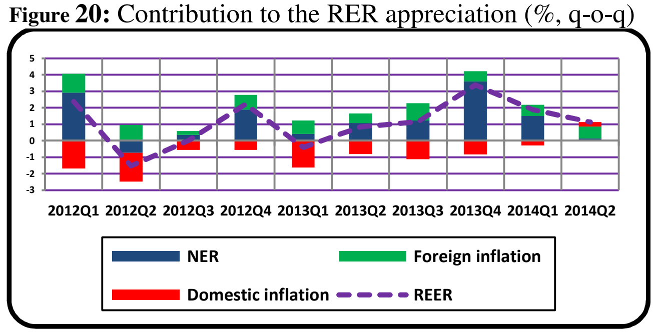


Source: BNR, Monetary Policy & Research Department (2014)

2.2.2 Exchange rate developments

The real effective exchange rate (RER) started to depreciate since 2013Q1 though the depreciation started easing in 2014Q1. The REER has slightly depreciated by 0.3% by end July 2014 mainly driven by the increase in relative prices and the slowing pace of the nominal effective exchange rate depreciation.

Figure 20: Contribution to the RER appreciation (%, q-o-q)



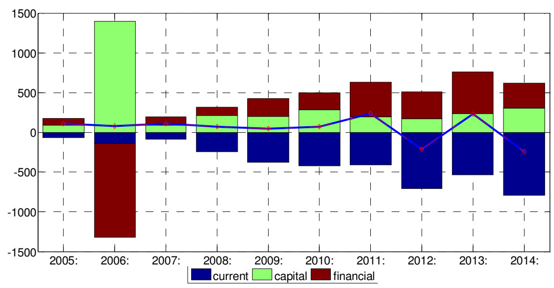
Source: BNR, Monetary Policy & Research Department (2014)

Concerning the bilateral nominal exchange rate, the Rwandan franc depreciated against the USD by 2.1%, by 2.9% against the GBP and appreciated by 2.2% versus the EURO.

The RWF however appreciated by 0.9% against the Kenya shilling, by 2.5% versus the Ugandan shilling, and by 5.3% against the Tanzanian shilling but depreciated by 0.6% versus the Burundian franc. The appreciation of the FRW against the Kenyan, Ugandan and Tanzanian shillings was due to the fact that these currencies strongly weakened against the USD.

Estimates show that the balance of payments will deteriorate by the end of 2014, falling from USD 228.5 million in 2013 to USD -241.5 million in 2014. This deterioration will result from the widening of the current account deficit and will continue to exert pressures on the exchange rate developments.

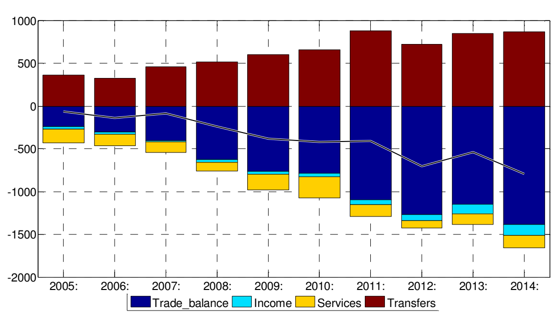
Figure 21: The BOP decomposition (Millions USD)



Source: BNR, statistics department (2014)

The current account deficit will be dragged downwards by the increase in the trade deficit from USD -1148.4 million in 2013 to USD -1384.4 million in 2014. Other negative contributors are services and income while transfers are expected to have a positive but stable contribution.

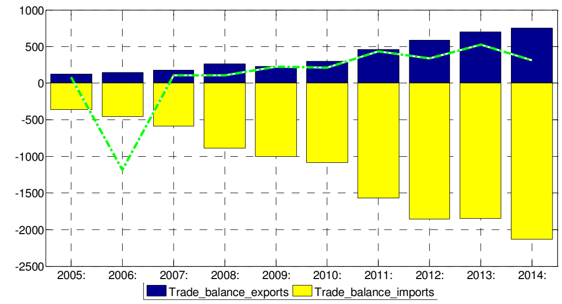
Figure 22: The current account (Million USD)



Source: BNR, statistics department (2014)

The projected 2014 widening of the trade deficit implies that exports will be smaller in value compared to the value of imports. Imports are projected to reach USD 2135.4 in 2014 million from USD 1851.5 million in 2013. Exports are expected to rise to USD 1384.4 million from USD 1148.4 million during the same period.

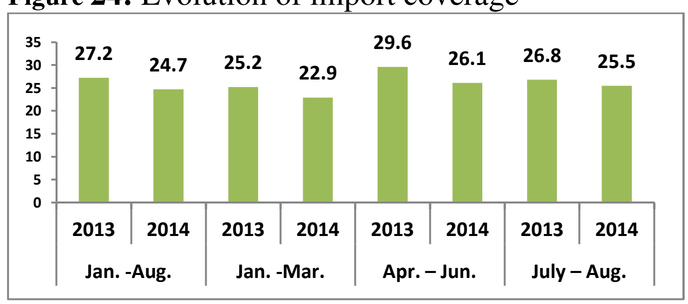
Figure 23: Evolution of the trade balance (USD, millions)



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

The export coverage of imports dropped to 24.7% in January-August 2014 from 27.2% of the same period in 2013.

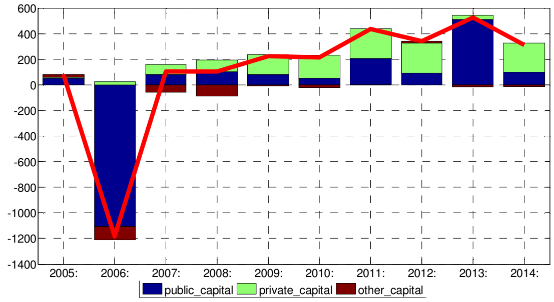
Figure 24: Evolution of import coverage



Source: Monetary Policy & Research Department (2014)

The financial account balance is projected to decline by 41% in 2014, from USD 528.01 million in 2013 to USD 313.24 million in 2014, mainly due to the expected huge decrease in public capital from USD 512.7 million in 2013 to USD 101.5 million in 2014 whereas private capital is projected to rise from USD 32.5 million to USD 224.3 million over the same period.

Figure 25: The financial account (Million USD)



Source: BNR, statistics department (2014)

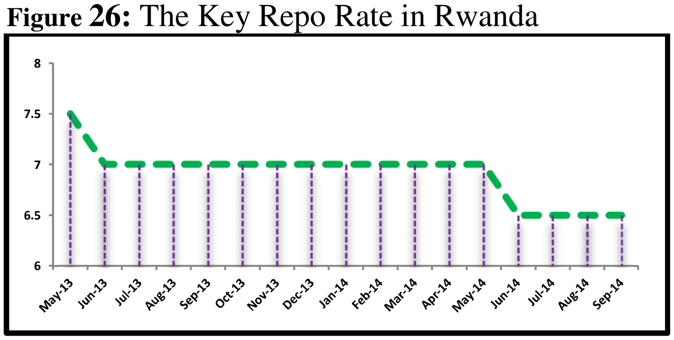
2.3. Fiscal spending

Government expenditure, especially capital expenditure and expenses for purchases for goods and services rose by 23.3% and 11.7% respectively in the 2013/14 fiscal year after 29.4% and -21.5% in 2012/13 fiscal year. However, this increase in fiscal spending will remain non-inflationary given the current and projected low level of aggregate demand.

2.4.Previous monetary policy stance

Since June 2013, the National Bank of Rwanda has been pursuing a supportive monetary policy stance. Monetary policy was loosened further in June 2014 when the KRR was lowered from 7.0% to 6.5% and this rate was maintained at the start of 2014Q3.

Figure 26: The Key Repo Rate in Rwanda



Source: Monetary Policy & Research Department (2014)

The continued adoption of the accommodative monetary policy is aimed at stimulating credit to the private sector so as to sustain the ongoing economic recovery. This is also motivated by the low inflationary pressures and the still weak aggregate demand.

2.5.Domestic inflation developments

Headline inflation remained subdued in the second quarter of 2014 standing at 2% on average. Headline inflation is expected to remain below this level in quarter Q3 given that it fell to 0.9% in August from 1.9% in July. As usual, movements in CPI inflation were driven by food prices, restaurants & hotels prices as well as transport prices.

Table 2: Inflation developments

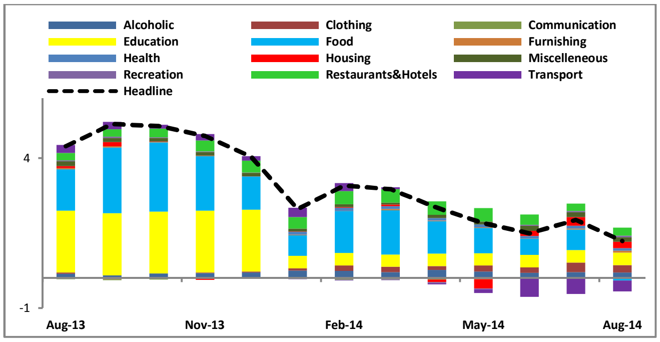
	2013	2014						
	Aug	Feb	Mar	Apr	May	Jun	July	Aug
Core	3.56	2.76	2.64	2.29	2.35	2.00	2.33	2.5
Domestic	4.38	3.67	3.84	3.09	2.29	2.11	2.28	1.0
Education	35.18	7.07	7.07	7.07	7.07	7.07	7.07	7.1
Energy	2.03	1.60	0.75	-0.52	-4.15	0.21	2.21	0.8
Food	4.90	4.98	5.24	3.84	2.99	1.91	2.44	-0.2
Fresh Products	6.98	7.60	8.30	6.18	3.00	-0.47	-0.38	-5.6
Imported	2.66	2.54	1.71	1.20	0.86	-0.39	0.79	1.1
Transport	1.48	1.49	0.38	-0.19	-0.75	-3.40	-2.89	-2.1
Headline	4.04	3.45	3.43	2.72	1.93	1.44	1.90	0.9

Source: BNR, Statistics department (2014)

Food inflation decelerated from April to June as a result of falling vegetable prices following good harvest in marshlands of Byumba and Butamwa. Transport prices declined mainly due to a decrease in selling prices of some cars mainly Jeep Suzuki Mark Jimmy and Toyota Corolla.

In 2014 Q2, the main contributors to inflation came from food with 42.7%, education (23%) and restaurants &hotels (20%) on average. Deflationary pressures emanated from transport and housing whose contributions reduced by -2% and by -3.1% on average respectively.

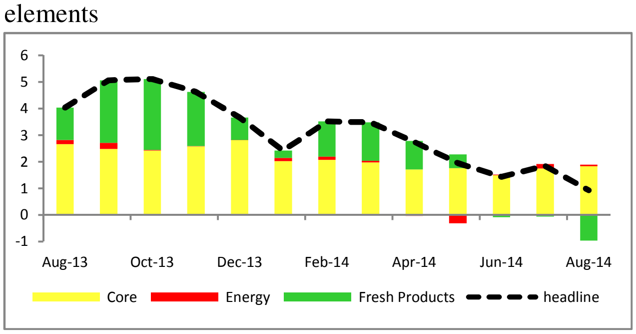
Figure 27: Weighted contribution to headline inflation



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

Core inflation, which excludes fresh products and energy, also declined from 4% on average in 2013 Q2 to 2.2% over the same period in 2014 as a result of weak aggregate demand. However, the contribution of core inflation increased from 62.3% in April to 104.7% in June 2014. The contribution of fresh products into inflation increased from 0.2% in April to 29.5% in June in 2014 contrary to 2013 where it dwindled from 39.14% in April to -5.77% in June.

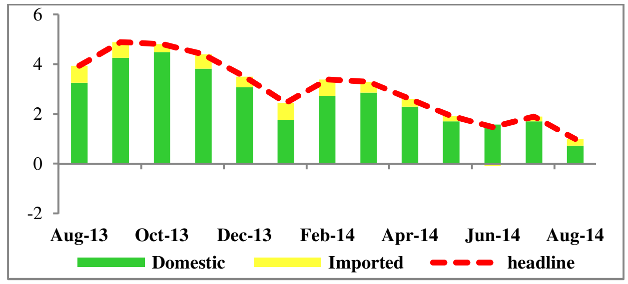
Figure 28: Decomposition of inflation into core and non-core elements



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

In 2013 Q2, the contribution of imported inflation declined from 22% to 5.5% in 2014 Q2 on average. The decline was reflected in imported food, clothing and transport. As a result, the contribution of domestic inflation increased from 88% in April to 106.7% in June compared to the increase from 76% to 88% during the same period in 2013.

Figure 29: Decomposition of inflation by origin

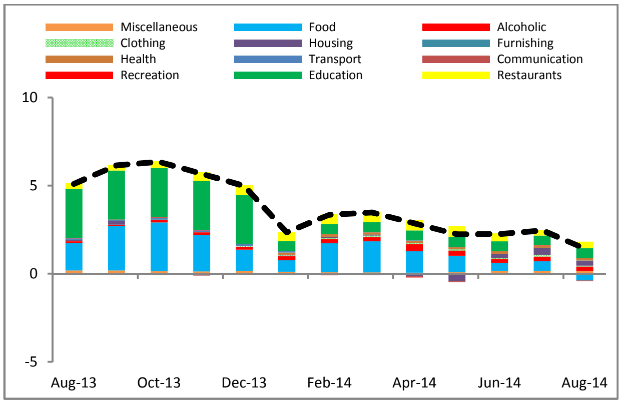


Source: BNR, Monetary Policy & Research Department (2014)

Imported inflation remained low, declining from 1.2% to -0.4% between April and June on the account of some factors such as falling transport prices, a generally stable inflation in the region and the relative stability of the RWF against the currencies of major trading partners.

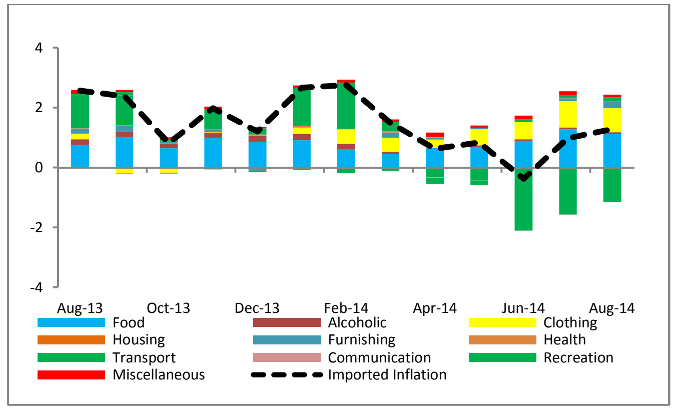
Despite upward pressures from restaurants & hotels and alcoholic beverages, domestic inflation also fell from 3.1% to 2.1% between April and June. Following falling inflation in education since the beginning of 2014, domestic inflation is driven by food, housing and restaurants & hotels which jointly accounted for 51.5% in June. The contribution from food inflation drastically fell from 41% in May to 20% and to -26% in June and August 2014 respectively while the contribution from housing inflation sharply increased from -18.6% to 11% and to 19.76% over the same period.

Figure 30: Weighted contribution to domestic inflation



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

Figure 31: Weighted contribution to imported inflation



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

3. THE INFLATION OUTLOOK

3.1. Risks to the inflation outlook

3.1.1. The external economic environment

The ongoing global economic recovery is expected to lead to the increase in Rwanda's exports. However, projections show that the trade deficit will widen in 2014 and drag down the current account balance, putting pressures on the exchange rate.

3.1.2. The domestic output gap

By the end of 2014Q2, the output gap is still negative but improving. Aggregate demand remains weak but slowly recovering associated with the upward path in economic activities as observed from the trend in the CIEA, in turnovers and in credit to private sector. Generally, there are no significant pressures from the aggregate demand side.

3.1.3. Global inflationary pressures

Global inflationary pressures have generally remained subdued in 2014. In the Euro area, Inflation slid to 0.4% in July from 0.5% in June 2014. In USA, inflation stood at 2.0% in July slightly lower compared to 2.1% recorded in June 2014. In EAC, headline inflation has declined in Uganda and Rwanda but remained relatively high in Kenya, Tanzania and Burundi, though still at single digit. These developments indicate that global and regional price levels are unlikely to weigh much on inflation.

3.1.4. International commodity prices

As expected, commodity prices continued to fall. In July 2014, agriculture products prices declined by 1.8% and energy prices fell by 3.5%. Oil prices also decreased by 2.9% as a result of slowing demand and the non-occurrence of the supply shock as had been previously expected. Generally, aggregate commodity prices fell by 2.2% and at this trend there are likely to be no inflationary pressures coming from international commodity prices. In March 2014, local pump prices were lowered from 1030 RWF/Liter to 1010 RWF/Liter.

3.1.5. Exchange Rate movements

The Real Effective Exchange Rate (REER) depreciated by 0.3% in July. The Rwandan franc depreciated against the USD and the GBP but appreciated versus the EURO and most of the regional currencies. This will help to limit the pass through to imported inflation.

3.1.6. Market expectations

The August 2014 price expectations survey results show that 42.9% of the selected companies indicate that they will adjust their prices in the next quarter. Out of these, 42.9% (against 33.3% in the last survey) expect to raise their prices in the next quarter on the back of anticipated increase in demand during the festive season and expected increase in input costs. The mini-market survey results reveal that prices for fresh food items especially vegetables have eased due to good harvests in season C. However, these fresh foods are not storable and may not fully offset the food crop production deficit realized in season B 2014. Thus, some pressures on inflation are expected in the coming months.

3.1.7. End-of-year festivities

Inflationary pressures always tend to build up towards the end of the year due to increased spending during the festive season. As a result inflation tends to go especially in December.

3.1.8. Credit to Private Sector

Between December 2013 and August 2014, private sector credit increased by 11.7% against 7.6% recorded in the same period of 2013. In 2014Q2 new loans to the private sector rose by 29.9% from 1.6% in 2013Q2. Considering the first two months of 2014Q3, new loans grew by 36.7% from -15.5% in the same period of 2013.

Clearly, economic financing has increased following BNR's accommodative monetary policy stance. However, given the current low level of inflation and aggregate demand, the increase in credit to the private sector poses no serious challenges to the inflation outlook.

3.1.9. Supply shock

Average rainfalls decreased from 91.3 millimeters in February-July 2013 to 79.5 millimeters in the same period of 2014. This might have caused a deficit in agriculture production in season B of 2013/14. The recent decline in food prices was due to high season C production of mostly fresh foods such as vegetables and may not fully offset the effects of season B production deficit.

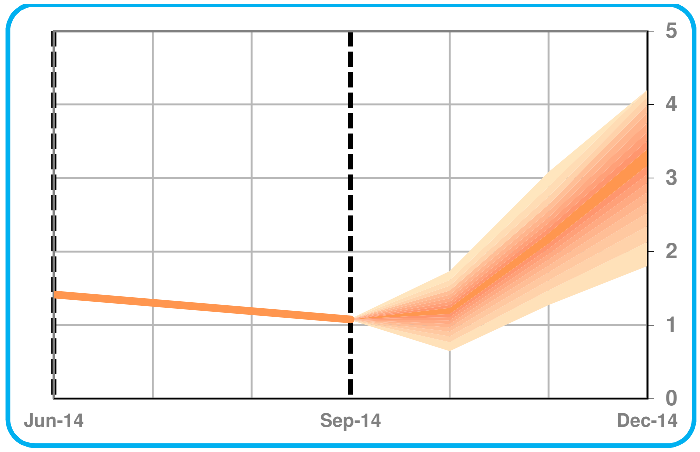
3.2. Inflation forecasts

Headline inflation has eased over the last eight months of 2014, falling from 2.38% in January to 0.90% in August and averaging around 2.3% for the entire 8 months period against 4.0% of the same period in 2013. This continued decline in inflation was due to the significant drop in food inflation from 2.52% in January to -0.20% in August 2014 with an average of around 3.0% in the first eight months of 2014 against 4.8% of the same period in 2013.

Looking ahead, the main upward risks to the inflation outlook are the lagged effect of season B food production deficit, end-of-year festivities and the likely increment in imported inflation due to exchange rate depreciation. The main downside risks remain weak aggregate demand and low international commodity prices.

Given the above assessment of both upside and downside risks, inflation is expected to slightly go up but remain on the downside. Headline inflation is projected to stand at around 1% in September and 3.2% in December 2014.

Figure 31: Inflation forecasts (fan chart)



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

****
****
****
****
******
***
*

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