



CENTRAL BANK OF  
MONTENEGRO

# INFLATION REPORT QUARTER II, 2014

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# CONTENTS

<b>1. INFLATION INDICATORS</b>	<b>5</b>
<b>2. INFLATION FORECASTS</b>	<b>9</b>
2.1. Banks' forecasts	9
2.2. Expectations of economy (except banks)	11
<b>3. INFLATION DETERMINANTS</b>	<b>14</b>
3.1. Demand	14
3.1.1. Salaries and other available demand determinants	15
3.1.2. Budgetary analysis	17
3.1.3. Economy	18
3.1.4. External demand and the current account	19
3.2. Supply and production	19
3.3. Stock exchange indices	20
<b>4. MONETARY POLICY</b>	<b>22</b>
<b>5. INFLATION FORECAST FOR 2014 AND Q2 2015</b>	<b>23</b>
5.1. Model assessment	23
<b>6. EXPECTED INFLATION IN 2014</b>	<b>26</b>



# 1. INFLATION INDICATORS

In Q2 2014, consumer prices increased by 0.7%, with the highest growth rates recorded in the category *hotels and restaurants* - 3.3%, *clothing and footwear* - 1.6% and *food and non-alcoholic beverages* -1.4%. Broken down by months, consumer prices growth was recorded in May (0.3%), and June (0.5%), while in April consumer prices declined by 0.2%. Observed annually, consumer prices in June fell by -0.1%, while the average rate (period on period) amounted to -0.8%.

Table 1

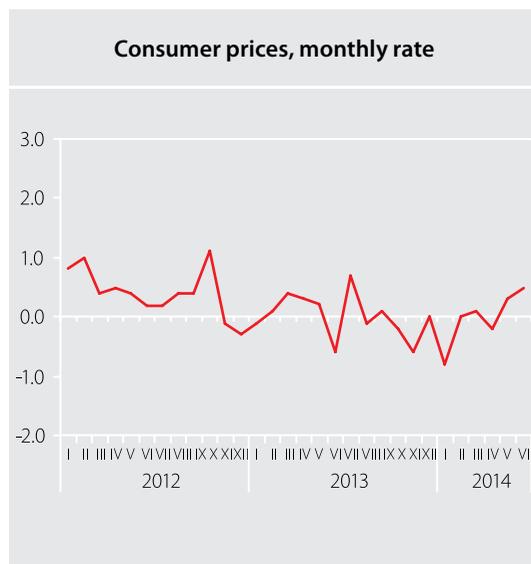
Inflation, %						
	2013				2014	
	III	VI	IX	XII	III	VI
Change in relation to previous year-end	0.5	0.4	1.1	0.3	-0.8	0.0
Annual change	3.3	2.2	1.8	0.3	-0.9	-0.1

Source: Monstat

In Q2, the company prices in the category *hotels and restaurants* increased by 3.3%, mainly due to higher prices of accommodation services by 12.3%. Prices of *clothes and footwear* increased by 1.6%, due to the increase of prices of footwear and clothes by 2.4% and 1%, respectively. Prices of *food and non-alcoholic beverages* increased by 1.4%, mainly due to higher prices of bread and cereals by 6.7%, meat by 0.2%, fruit 2.4%, vegetables by 0.9%, which affected positive contribution of food and non-alcoholic beverages in overall inflation by 0.5 percentage points. Prices of *other products and services* increased by 0.5%, *alcoholic beverages and tobacco* by 0.3% and *transportation* 0.2%. The highest price drop of 0.6% was recorded in the category *furniture and routine maintenance*, where the prices of household appliances recorded the highest decline of 1.8%. During Q2, prices of *housing, water, electricity, gas and other fuels*, and *recreation and culture* declined by 0.2%. Prices in the categories of *health, education and communication* remained unchanged in the Q2.

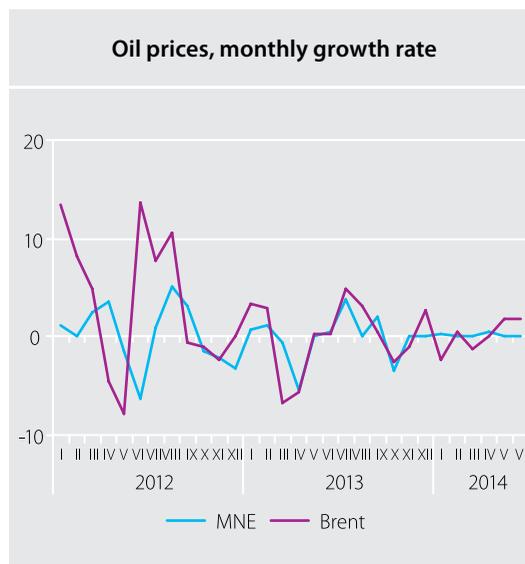
Monthly core inflation in May and June was lower than the official monthly inflation, while in April, core inflation was slightly higher than the official. Both indicators of inflation in April were negative, while in May and June they recorded positive rates.

Graph 1



Source: Monstat

Graph 2



Source: MONSTAT and "Monthly Oil Market Reports", OPEC

Q2 2014, there has been a rise in oil prices in relation to Q1. Average price of OPEC reference basket amounted to 105.9 USD/barrel, which is 1.1% more than the average price in Q1 2014. The average price of Brent in the second quarter was 109.7 USD/ barrel, which was 1.3% more than the average price from Q1 2014. As a result of the turbulences in Iraq, the crisis in Libya, rising tensions in Ukraine and concerns about oil supply from Russia, price of crude oil prices at world markets increased, especially in

Table 2

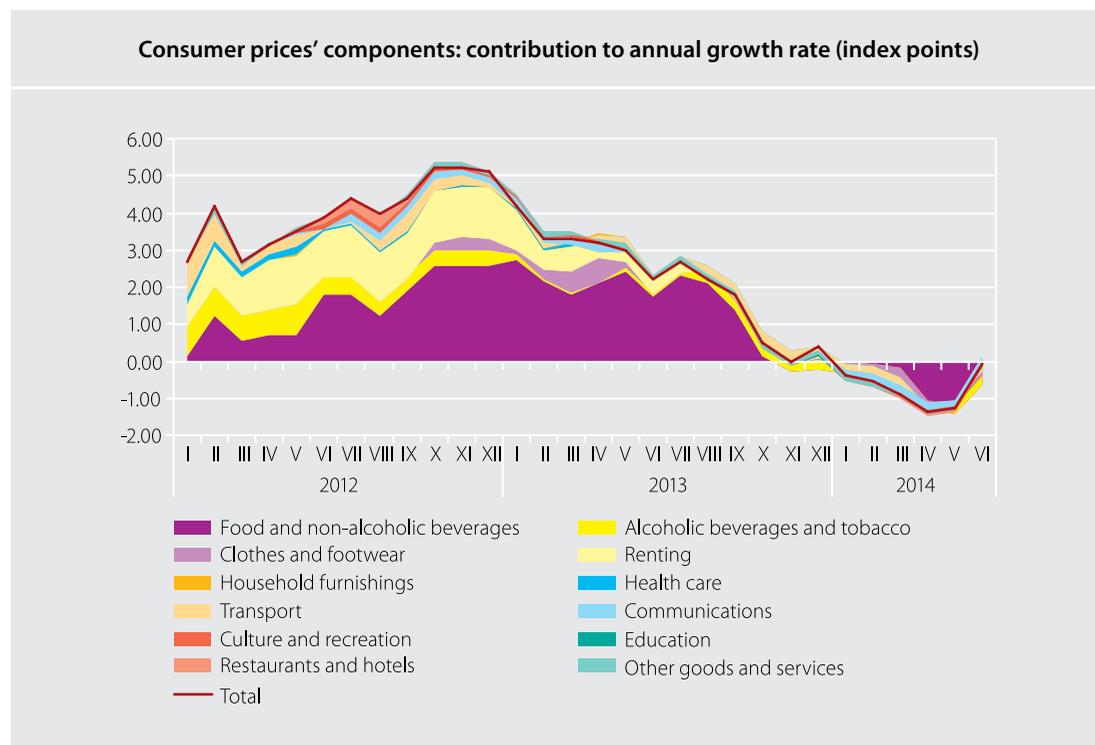
Share of individual categories in total inflation*				
	Weights	VI 14/III 14 index	Rate	Contribution
TOTAL	1000	100.7	0.7	0.7
Food and non-alcoholic beverages	386.4	101.4	1.4	0.5
Alcoholic beverages and tobacco	37.9	100.3	0.3	0.0
Clothes and footwear	70.7	101.6	1.6	0.1
Housing, water, electricity, gas and other fuels	153.1	99.8	-0.2	0.0
Housing and routine maintenance	46.9	99.4	-0.6	0.0
Health	38.2	100.0	0.0	0.0
Transportation	101.0	100.2	0.2	0.0
Communications	57.1	100.0	0.0	0.0
Entertainment and culture	27.2	99.8	-0.2	0.0
Education	15.7	100.0	0.0	0.0
Hotels and restaurants	23.0	103.3	3.3	0.1
Other goods and services	42.8	100.5	0.5	0.0

\* We would like to note that, despite the index changes, the share of certain categories is recorded only at the second or the third digit, due to the weighting structure.

Sources: Monstat and CBCG calculations

the second half of May and in June. The highest price of Brent was recorded in June 2014 - 111.66 USD/barrel and was higher by 3.8% than the average price in March.

Graph 3



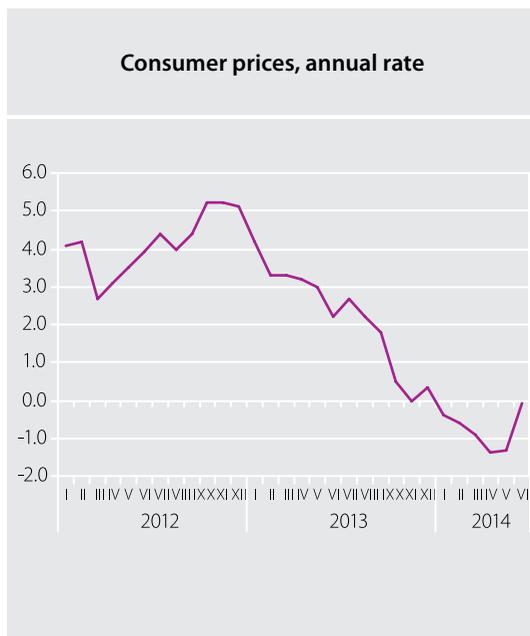
Source: Monstat and CBCG calculations

The annual rate of consumer prices in June amounted to -0.1%, while in March the annual rate was -0.9%. The largest contribution to annual inflation, in June this year, was provided by the prices of *alcoholic beverages and tobacco* with a growth of 5.8% and *housing, water, electricity, gas and other fuels*, and *transportation* with an increase of 1.6%, respectively. The largest negative contribution was recorded by the prices of food and non-alcoholic beverages due to a fall of 1.6% and prices of communication due to a decline of 3%.

**Producers' prices of manufactured products** in June compared to end-2013 increased by 0.6%. Prices increase was recorded in mining and quarrying by 4.2% and manufacturing industry by 0.4%, while prices in the sector of electricity, gas and water supply remained unchanged. Prices of manufactured products, on an annual basis, remained unchanged (0.0%).

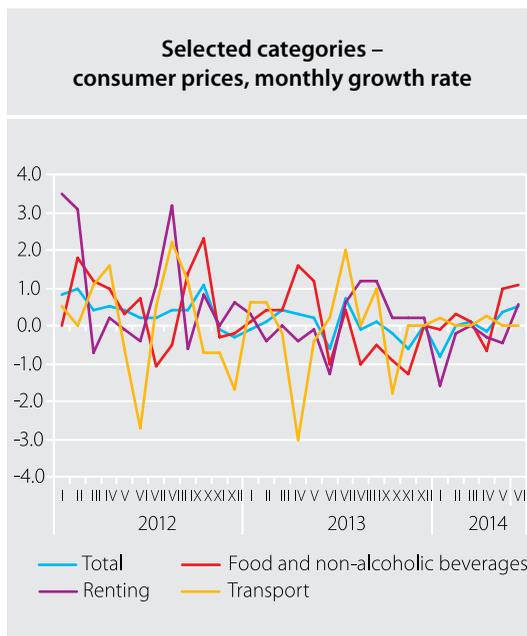
Comparison of the annual inflation recorded in Montenegro and inflation in selected countries, shows that, in addition to Montenegro, five more countries recorded a negative annual rate: Bulgaria (-1.8%), Bosnia and Herzegovina (-1.4%), Macedonia (-1.1%), Hungary (-0.1%) and Slovakia (-0.1%). Among neighboring countries the highest annual inflation was recorded in Albania (1.5%) and Serbia (1.3%).

Graph 4



Source: Monstat

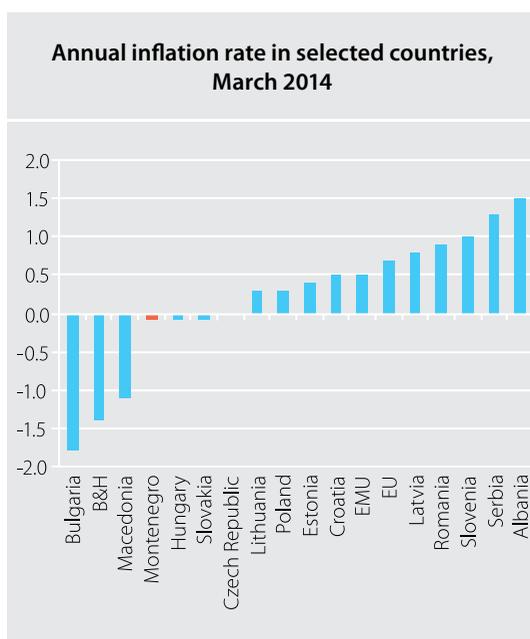
Graph 5



Source: Monstat

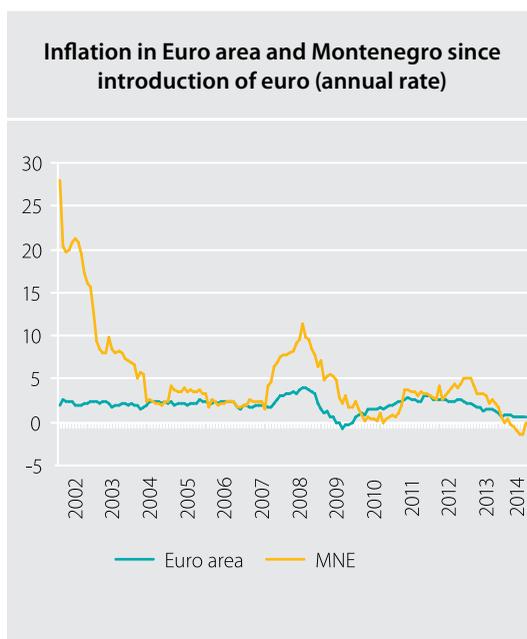
Measured by Harmonized Index of Consumer Prices (HICP), annual inflation growth rate recorded in the Euro area amounted to 0.5%. HICP inflation in Montenegro amounted to 0.2%, which was 0.3 percentage points lower than the rate in the Euro area.

Graph 6



Source: National Statistical Offices and Eurostat

Graph 7



Source: Monstat and Eurostat

## 2. INFLATION FORECASTS

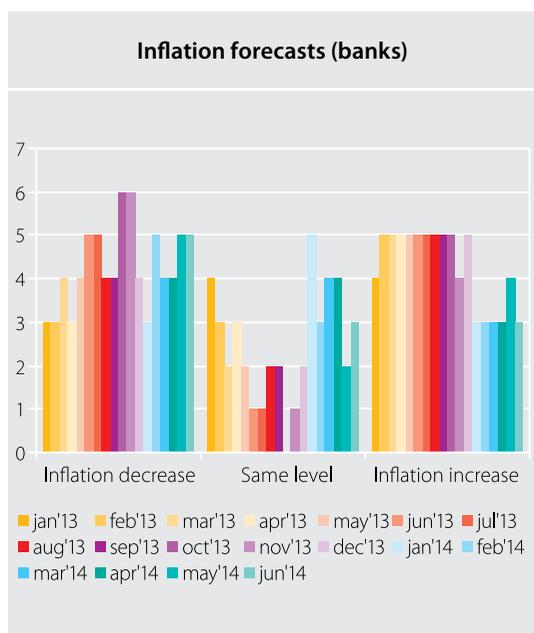
### 2.1. Banks' forecasts

Based on surveys conducted in June this year, three banks expected higher inflation rate, three banks expected the same level of inflation in 2014 compared to 2013, while five banks expected a lower inflation rate (Graph 8).

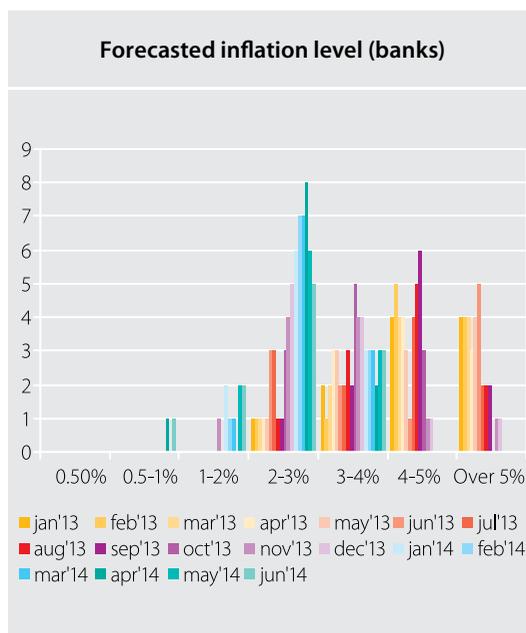
As Graph 9 shows, there are different expectations of banks on the movement and the amount of inflation by the end of this year. Five banks expect inflation in range of 2% - 3%, three banks (3% - 4%), two banks (1% -2%), while one bank expects inflation in range 0.5% - 1%.

Regarding expectations on in lending interest rates trend, six banks expected decline in nominal interest rates, and five banks expected the same level of nominal interest rates. As per effective lending interest rates, six banks expected decline, four banks expected the same level, and one bank expected growth in 2014 compared to 2013.

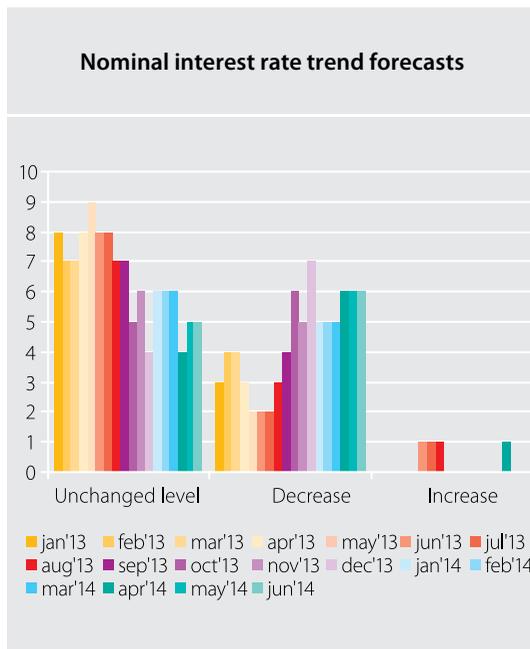
**Graph 8**



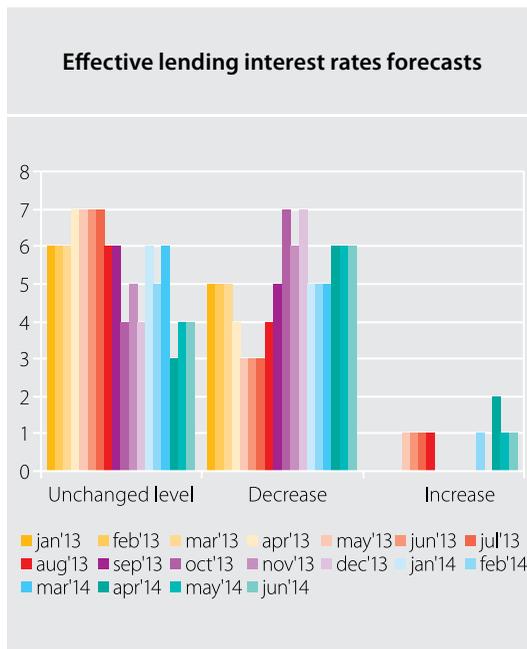
**Graph 9**



Graph 10

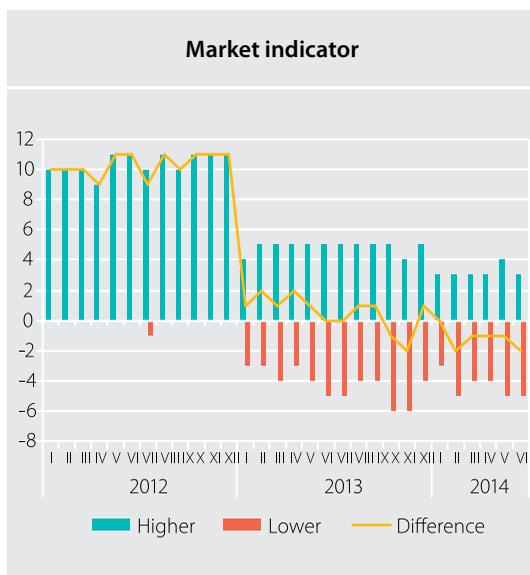


Graph 11



When it comes to expectations regarding the deposit interest rates, eight banks expected decline, and three banks expected the same level of deposit interest rates in 2014 compared to 2013.

Graph 12



For the purpose of calculating inflation forecasts we use market trend indicator (orange line in Graph 12). It is calculated as the difference between the number of banks that expect an increase in inflation (blue columns) and the number of banks that expect a decline in inflation (red columns). If the market trend indicator is negative, inflation rate is expected to decline in the forthcoming period. If there is a positive value, inflation is expected to grow in the upcoming period. If it has a zero value, it is expected that inflation rate will remain unchanged. The more negative its value, the lower inflation forecast is, while higher positive value represents higher inflation forecast level. Over the previous period, inflation forecasts, with minor fluctuations, were significantly lower, and this trend has been maintained during the first six months of 2014, because it reduced the number of banks that previously expected inflation growth.

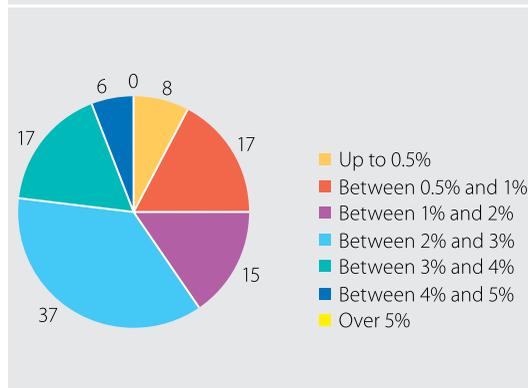
## 2.2. Expectations of economy (except banks)

### Inflation

Of the total number of surveyed companies, 37% believe that inflation in 2014 will range between 2% and 3%, 17% of surveyed companies expected inflation between 0.5% and 1%, while 17% expected it to range between 3% and 4%, while 15% of respondents expected inflation between 1% and 2%. Only 6% of companies expected inflation between 4% and 5%, while none of the respondents expects inflation to be higher than 5%. Lower level of wages of its employees is expected by 11% companies, 76% expects that wages will not change in 2014 compared to 2013, and the increase is expected by 13% of surveyed companies. As for the number of employees in the same period, 56% of respondents believe that this number will not change, 26% expects that the number of employees will decrease, while 18% believe this number will increase. The majority of surveyed companies (67%) expect unchanged level of prices of used production inputs, while 81% of respondents expect the same prices for their products (services) in 2014.

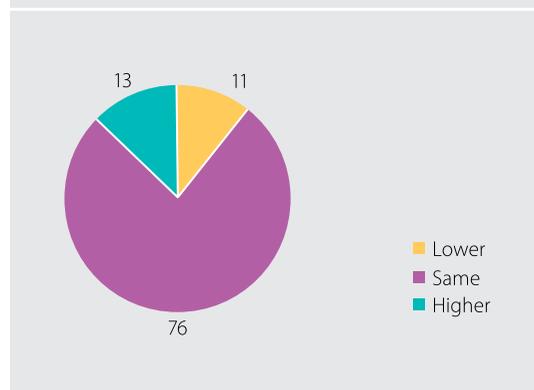
**Graph 13**

**Forecasted inflation in 2014 in relation to 2013**



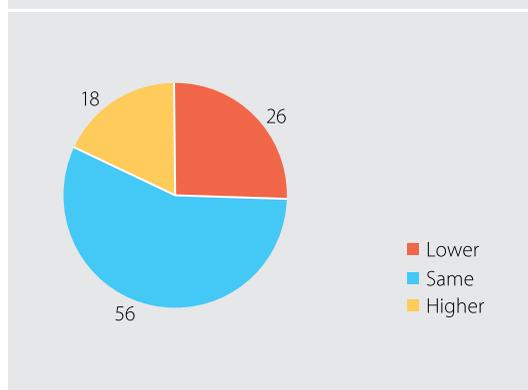
**Graph 14**

**Expected level of earnings in 2014 in relation to 2013**

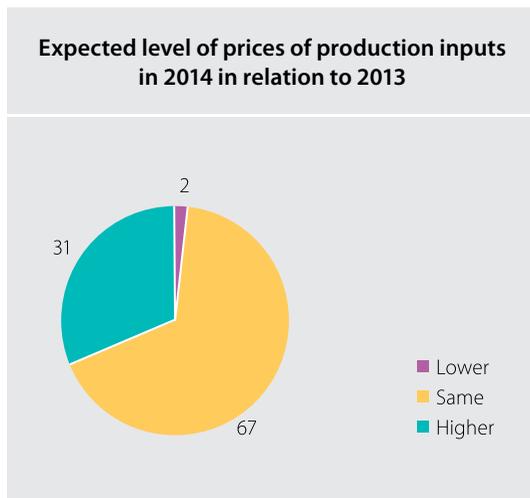


**Graph 15**

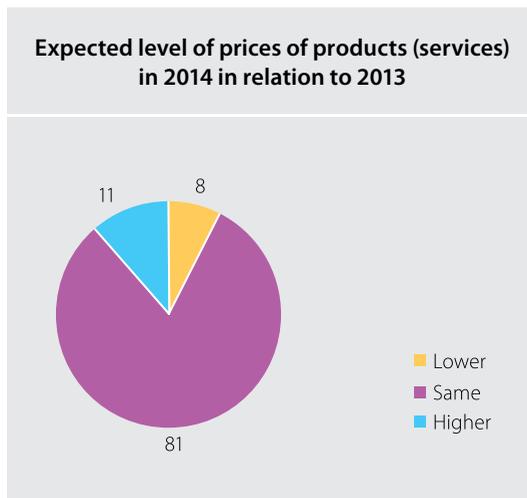
**Expected level in number of employees in 2014 in relation to 2013**



Graph 16



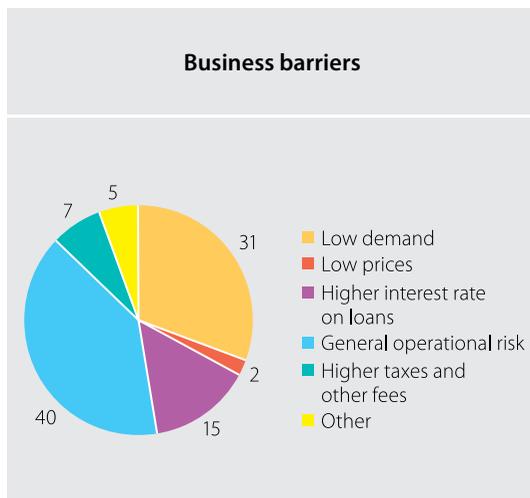
Graph 17



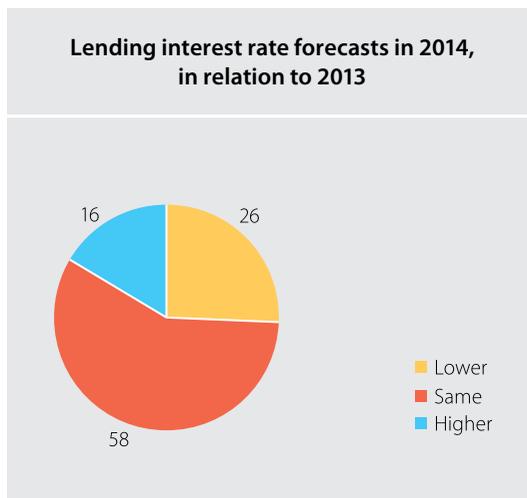
**Business environment**

The survey results show that most of the surveyed companies see the overall business risk (40%) as a business barrier, followed by low demand (31%) and high interest rates on loans (15%). Regarding lending interest rates in 2014 in relation to 2013, 58% of surveyed companies expects the same level, 26% expects lower level, while 16% expects higher level.

Graph 18



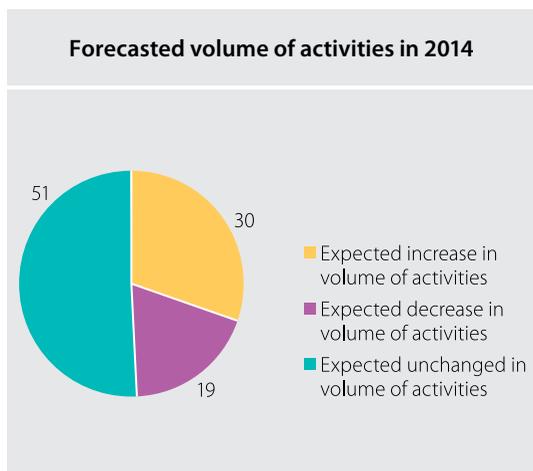
Graph 19



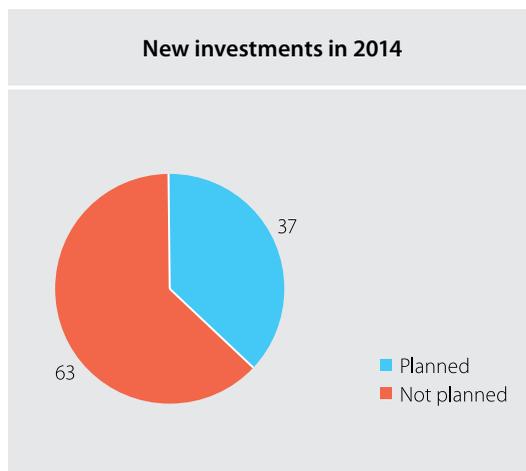
## Investments

Of the total number of surveyed companies, 30% plan to increase the scope of activities by the end of the year, i.e. 37% of respondents are planning new investments. The largest number of investments, 55% relates to the increase in fixed assets, and barriers to new investments are the following: low demand (44%), other barriers (27%), insufficient utilization of existing capacities (13%), high interest rates and unfavourable conditions for capital borrowings (13%) and high current production costs (3%).

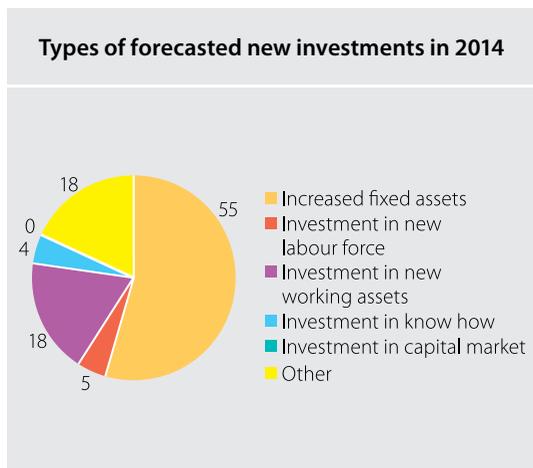
**Graph 20**



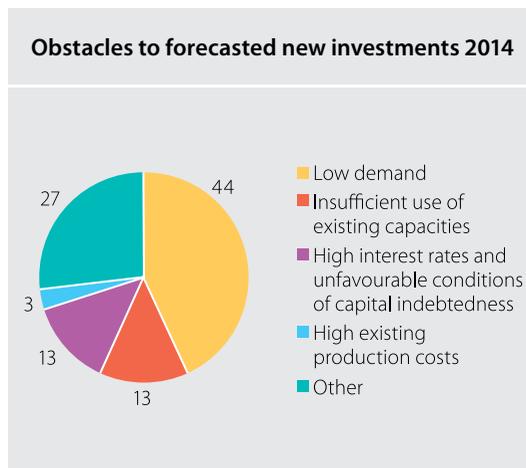
**Graph 21**



**Graph 22**



**Graph 23**



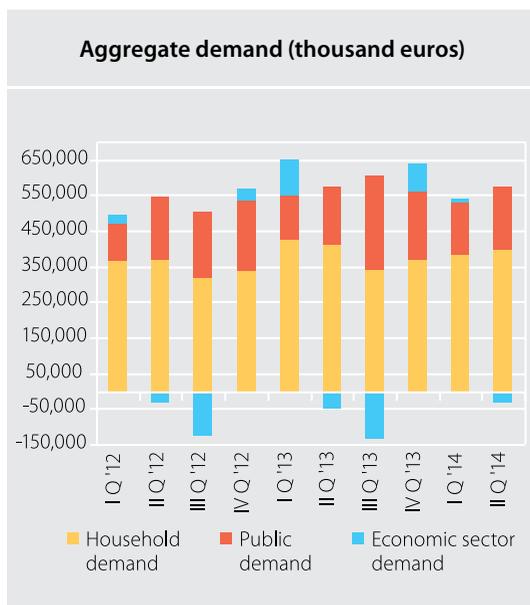
## 3. INFLATION DETERMINANTS

### 3.1. Demand

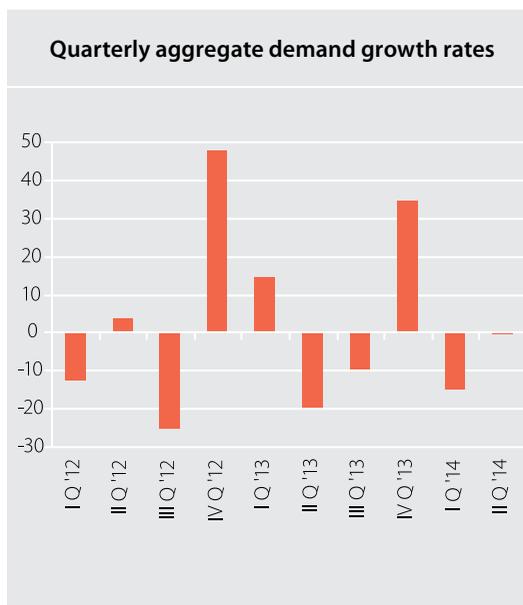
In Q2 2014, according to preliminary data, aggregate demand recorded a slight decline in relation to the previous quarter. Broken down by sector, household demand is slightly higher than in the previous quarter, as well as public consumption. Looking at the structure of the aggregate demand in relation to the structure from the previous quarter, the share of the household sector and public consumption has increased, while the share of economy declined.

The level of aggregate demand in Q2 2014 was slightly lower<sup>1</sup> than the level of the aggregate demand in the previous quarter.

Graph 24



Graph 25



<sup>1</sup> Change is under the percentage point (-0,13), thus it cannot be seen at the Graph 25.

### Box 1 – Methodology for calculating aggregate demand

For the purpose of complete monitoring of aggregate demand as the inflation determinant, the CBCG has developed the aggregate demand calculation methodology. The starting point of this methodology is that the aggregate demand is the total demand of three sectors: personal consumption (households), investment consumption (corporate sector) and public consumption. However, taking into account the lack of numerous data necessary for calculating the aggregate demand, the existing data should not be treated as the indicator of the exact amount of aggregate demand, but as an indicator showing the aggregate demand trend. In the existing methodology, a number of substantial data were not available, such as: corporate investments, revenues from selling shares, non-market incomes, non-observed economy revenues, and the like. The methodology for calculating the aggregate demand is given in the following equation:

$$AD = C + I + G$$

C = sum of paid salaries + sum of paid pensions + paid frozen foreign currency deposits + net compensations to households – net savings by households (savings – loans granted)

I = net savings of economy (deposits – loans)

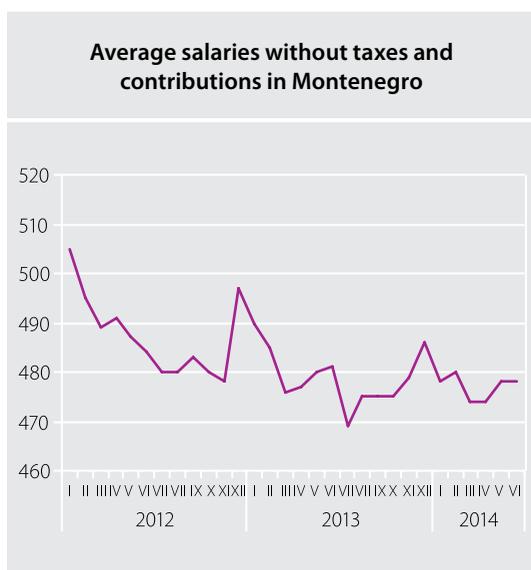
G = public consumption – paid pensions – salaries paid from the budget – net savings by the Government (deposits – loans – Treasury bills)

AD – aggregate demand, C – personal consumption, I – investment consumption, G – public consumption

#### 3.1.1. Salaries and other available demand determinants

The average salary in Montenegro in Q2 amounted to 724 euros, while the average wage without taxes and contributions amounted to 477 euros. Regarding the previous quarter, the average salary decreased by 0.2%, while the average wage without taxes and contributions remained the same.

Graph 26



Source: Monstat

Graph 27



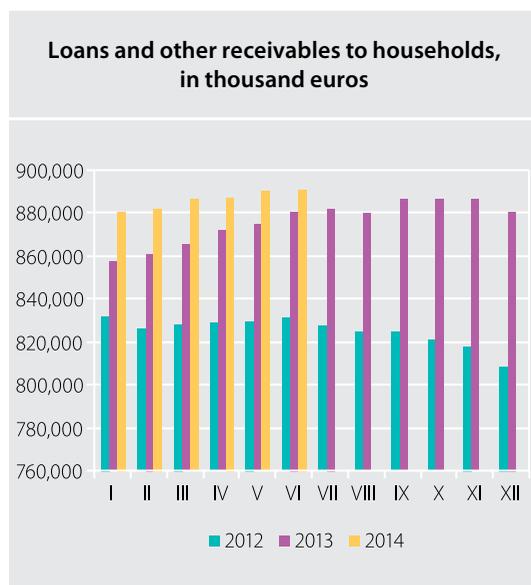
Source: Monstat

If we take into account consumer prices, i.e. trends in wages observed in real terms, it can be concluded that real wages in the second quarter recorded growth in April and May, while they declined in June.

Lending to the household sector during the first half of 2014 was marked by a positive trend. The average monthly loans to this sector grew at a rate of 0.2% (while in the same period of 2013 it was recorded an increase at an average rate of 1.4%). At the end of Q2 2014, total loans to the household

sector amounted to 891.5 million euros, which is 10.2 million euros or 1.2% more than at end-2013 or 10.5 million or 1.2% more than in the same period of the previous year.

Graph 28

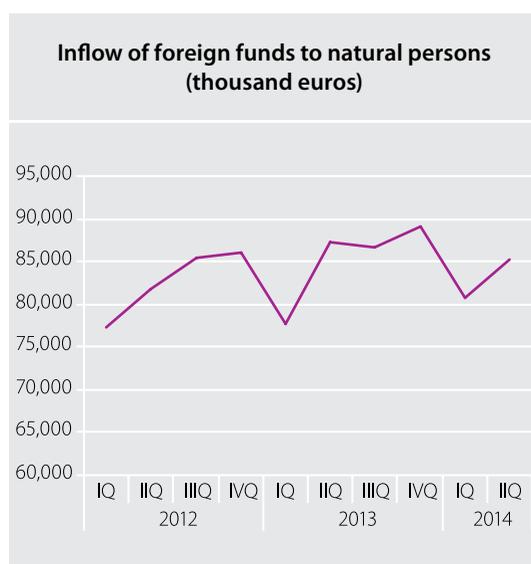


Per capita debt<sup>2</sup> amounted to 1.438 euros at end-June 2014, and was 1.2% higher than at the end-2013 as well as compared to the end of the second quarter of the previous year.

Total MFIs loans granted to the household sector amounted to 35.9 million euros at end-June 2014, which is 1.8 million or 5.4% more than in the previous year, and 1.4 million or 4.1% higher than a year before.

Deposits of the household sector recorded an average monthly growth of 0.1% (in the same period in 2013, there was an average monthly increase of 0.3%). Deposits in this sector amounted to 1,244.5 million euros at end-Q2 2014 and were 7 million euros or 0.6% higher than at end-2013 or 79.9 million euros or 6.9% higher than in the same period of the previous year.

Graph 29



Loans to deposits ratio for this sector amounted to 0.72 at end-June 2014. It was at a higher level than in the previous year (0.71), or at a lower level than in the same period of the previous year (0.76). The household sector recorded net savings totalling 353.1 million euros or, which is 3.1 million euros or 0.9% lower than at end-2013 or 69.3 million euro or 24.4% higher than in the same period of the previous year.

Balance of payments statistics shows that in Q2 2014, compared to Q1 2014, there was an increase in inflow of funds from salaries and compensation of employees, personal transfers (including

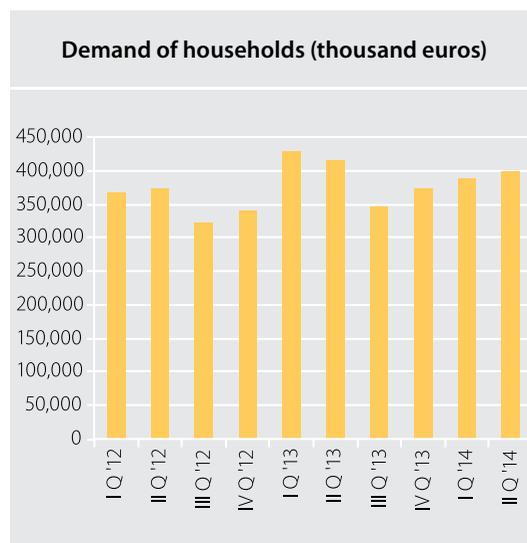
Source: CBCG

<sup>2</sup> Data on population is an assessment, mid-2012, source: Monstat.

remittances and all other transfers between natural persons), as well as pensions, disability allowances and other social benefits.

Looking at the overall demand of the household sectors by quarters, it is noted that demand in Q2 2014 was slightly higher than the demand in the previous quarter. The growth in household demand has been made in comparison with the demand from the third and fourth quarters of 2013, while decrease was compared to the demand from Q2 2013.

Graph 30



### 3.1.2. Budgetary analysis

According to the Ministry of Finance preliminary data, Montenegrin budget recorded total revenues<sup>3</sup> amounting to 676 million euros in the first six months of 2014.

Source revenues totalled 574.8 million euros or 16.4% of the projected GDP<sup>4</sup> and in relation to the plan grew by 5.6%. Compared to the same period in 2013, budget revenues were 10.9%. In the structure of source revenues, revenues from taxes had the largest share (62.8%), followed by contributions (31.5%), other revenues (2.4%), fees (1.4%), compensations (1.2%), donation (0.4%) and revenues from the repayment of loans (0.3%)

Revenues from taxes amounted to 360.9 million euros, which represents an increase of 1.7% compared to the plan, and compared to the same period of the previous year they increased by 10.2%. Nominally, the largest revenues growth over the previous year was recorded in the VAT of EUR 24.5 million or 13.4%. This growth in revenues from VAT is the result of the implementation of measures for shadow economy suppression.

Negative deviation in relation to the same period of the previous year was recorded in excise duties and international trade tax.

Revenues from contributions amounted to 180.9 million euros or 15.5% more compared to the first half of 2014, while compared to the same period of 2013 they increased by 15.4%.

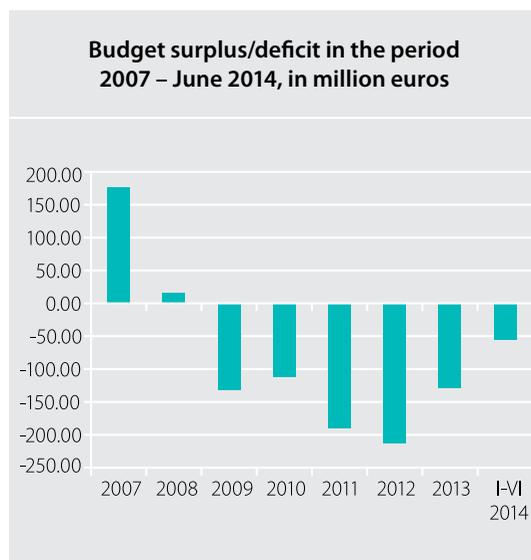
<sup>3</sup> Revenues include source revenues (direct and indirect taxes and non-tax revenues), borrowings, donations and revenues from privatization and sale of property.

<sup>4</sup> Source: Ministry of Finance; Estimated GDP for 2014 amounts to 3.52 billion euros.

In Q2 2014, *budget expenditures* amounted to 630.6 million euros or 17.9% of GDP. Realized expenditures in relation to the plan for the first half of this year declined by 5.7% but increased in relation to the same period of 2013 by 6% or 35.8 million euros, mainly due to paid guarantees in the amount of

9.7 million euros, transfers and the capital expenditures which recorded an increase of 4 million euros. Compared to the previous year, expenditures for pensions increased due to an increase in the number of beneficiaries of pension insurance.

Graph 31



Source: Ministry of Finance

Current budget expenditures amounted to 606.8 million euros or 17.3% of GDP, while the capital budget amounted to 23.7 million euros or 0.7% of GDP.

Current expenditures in the observed period amounted to 300.9 million euros and were lower by 3.8% than planned. Almost all current expenditures, excluding expenditures for interests, subsidies and other expenditures were below planned.

Montenegrin budget deficit was estimated to 55.8 million euros or 1.6% of GDP.

Graph 32



### 3.1.3. Economy

Due to the absence of data on investments by the corporate sector, net corporate sector leverage can be used for demand approximation.

During Q2 2014, loans to the corporate sector were significantly higher than the deposits of the sector. Thus, net debt of the corporate sector amounted to 374 million euros at the end of the observed period, and it was 21.9 million euros or 5.5% higher than at end-2013, while compared to Q2 2013 it was 77.1 million euros or 17.1% lower. At the end of the second quarter of 2014, the structure of loans in this sector was dominated by long-term loans with 69.8%, which indicates that corporate loans were predominantly used to increase the volume of economic activity.

### 3.1.4. External demand and the current account

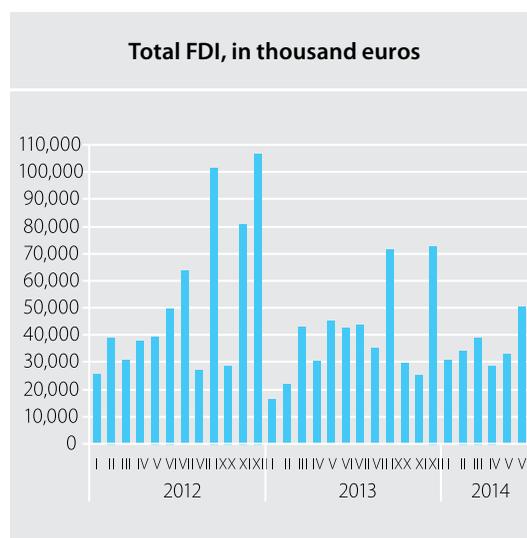
In the first half of 2014, the current account deficit increased, which is largely a result of adverse movements in the goods account. According to preliminary data, the current account deficit amounted to 441.8 million euros or 5.6% more than in the same period of 2013. In the reporting period there was an increase in the deficit at the goods account for 3.5%, as a result of a decrease in visible trade by 20%. Such developments were affected mostly by reduction in the export of electricity and metal products.

In Q2 2014, the international invisible trade of Montenegro recorded a surplus of 121.3 million or 11.6% more over the same period of the previous year. On account of primary income, due to an increase in outflows arising from the compensation for employees and paid dividends, the surplus recorded a decrease of 33% compared to the same period of 2013 and amounted to 22.7 million euros. Account of secondary income (transfers) recorded a surplus amounting to 57.7 million euros, which is 5.1% less than in the same period of the previous year.

In the first six months of 2014 there was an upward trend in FDI inflow. According to preliminary data net inflow of foreign direct investments in the period January-June 2014 amounted to 163.7 million euros, 5.5% higher than in the same period in 2013. Total FDI inflow amounted to 217.1 million euros, while at the same time outflow amounted to 53.4 million euros. In the structure of FDI, equity investments amounted to 97.4 million euros or 44.9% of the total inflows in the first six months of 2014, while the intercompany debt inflow amounted to 115.9 million or 17.8% more than in the same period in 2013.

In the first half of 2014, portfolio investment account recorded a net inflow of 144.8 million euros as a result of government borrowing by issuing Eurobonds at international capital market. Developments on the account of other investments are characterized by a reduction of liabilities of the government sector and banks for borrowings, while liabilities of other sectors (economy) increased. As a result of these trends at account of other investments there was a net outflow amounting to 46.2 million euros.

Graph 33



Source: CBCG

## 3.2. Supply and production

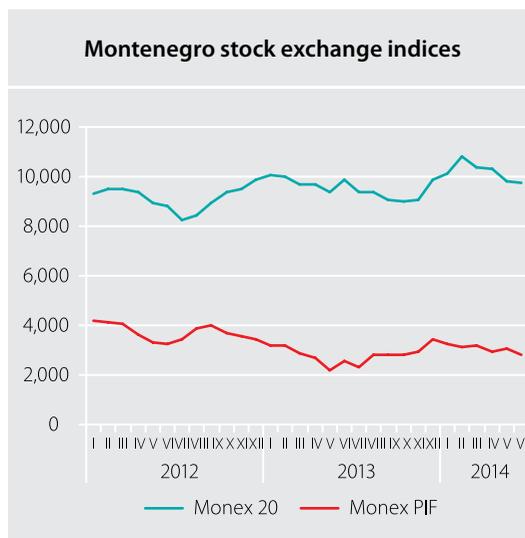
Overall industrial production in the first half of the year recorded a decline of 15.3% compared to the same period of 2013. Production decline was recorded in the sector of electricity, gas and water supply by 35%, while output growth was recorded in the manufacturing industry by 4.9% and mining and quarrying by 26.6%. Looking at the monthly data on industrial production, growth was recorded in February (0.4%) and April (0.6%), while a decrease was recorded in January (22.2%), March (6.5%), May (15.7%) and June (16.1%).



Compared to the end-June 2013, Monex 20 declined by 1.2%, while Monex PIF recorded growth of 9.8%.

In relation to their historical maximum values (reached in 2007), the indices at the end of June 2014 were lower: Monex20 - 5 times, and Monex PIF - 18 times lower.

Graph 35



Source: Montenegro stock exchange

Table 3

General data on indices				
	MONEX 20		MONEX PIF	
Value on 30 June 2014	9,724.84		2,830.95	
Absolute change of index in 2014	-125.34		-581.29	
Initial index value	1000.00	March 2003	1000.00	March 2003
Maximum value in 2014	10,802.05	28.02.2014.	3,443.25	15.01.2014.
Maximum historical value	48,617.88	07.05.2007.	50,780.54	17.08.2007
Minimum historical value	918.57	14.04.2003	959.53	02.04.2003
Growth (decline) in 2014	-1.3%		-17%	

Source: Montenegro stock exchange

## 4. MONETARY POLICY

During the first half of 2014, there were no changes to existing or new decisions were made related to the monetary policy of the Central Bank of Montenegro.

## 5. INFLATION FORECAST FOR 2014 AND Q2 2015

### 5.1. Model assessment

Graph showing „Fena“ inflation („fan chart“) of Montenegro is a graphical representation of the distribution of forecast related to inflation rate, expressed in terms of the consumer price index. In this way, instead of determining the specific points, the chart via distribution of probability takes into account potential risks and uncertainties, which in future could affect inflation. The very purpose of the chart „Fena“ is precisely to identify and take into account the uncertainty that exists in the actual economy trends, which is consequently reflected in the movement of the inflation rate (an increase in energy prices, increase-decrease in the external trade deficit, and the like).

Montenegro's fan chart for 2014 and Q2 2015 is based on the following three estimated components:

1. **The values of the central projection** - values of the central projection of the „Fena“ chart is derived from the ARIMA model;
2. **The level of uncertainty** - uncertainty level determines the width of the chart „Fena“. The coefficients of the level of uncertainty were obtained by the analytical assessment and calculation of the relative impact of potential internal and external shocks, which are possible in the Montenegrin economy for the period of one year, which are through the „thickness“ of the range around the central projection;
3. **Fan chart skewedness** – based on the level of skewedness of the distribution of inflation projection, the “Fena” chart is adjusted to the forecast to show whether the values of the central projections “overestimated” or “underestimated” the inflation rates. This will also influence the position of the mean value of inflation distribution.

#### “Fena” Chart central projection - ARIMA model for 2014 and Q2 2015

With a view to developing a fan chart, an ARIMA model of time series of inflation in Montenegro (Autoregressive Integrated Moving Average) was developed and showed through the Consumer Price Index.<sup>7</sup>

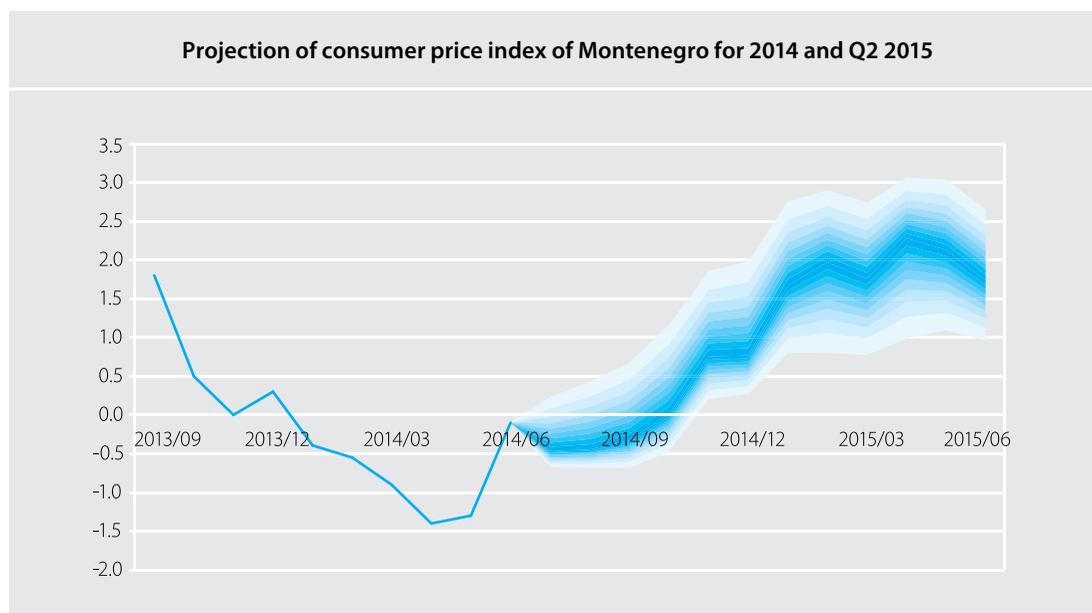
<sup>7</sup> A detailed explanation of the ARIMA model of Montenegro is given in the working study of the Central Bank of Montenegro No. 11 „Inflation Forecast: Empirical Research of Retail Price Index Movements in Montenegro in 2007 –Application of ARIMA Model“

ARIMA model was used for short term forecasts (12 months), whereby iteration of several ARIMA models was made, which were ranked based on their efficiency and quality of diagnostics. The selected ARIMA model, ARIMA (21, 1, 16)<sup>8</sup>, has sufficient confidence level for forecasts.

The monthly forecasts value was used as the value of central projection of the Fan Chart of CPI for 2014 and Q2 2015. The obtained values represent the distribution mode, i.e. values with the highest frequency in the distribution of this time series.

Mean value of the obtained model was 0.98, while skewedness varied from 0,5 to 1,5, and standard deviation value was 0,25. Similar to the projection from the previous quarter, central band was placed in lower part of distribution, in particular for 2014, i.e. the corresponding degree of uncertainty was concentrated towards higher inflation levels, which is reflected in the graph through “thicker” band concentrated above central “the deepest shade of blue” band. The fan chart presents a 90% probability of inflation distribution. The central projection is usually in the deepest shade of the Fan Chart, i.e. in the central 10% of probability.<sup>9</sup> The fan chart has an equal number of bands (eight) on either side of the central band whereby every band is of the same colour, both above and below the central band, cumulatively takes the inflation projection to the next 10% of probability. As the degree of uncertainty grows over time, so the fan chart spreads.

Graph 36



Source: CBCG, 2014

<sup>8</sup> ARIMA model is generally referred to as an ARIMA (p,d,q) where p represents the number of autoregressive variables, d refers to the level of dependent variable that needs to be made stationary, and q is the number of variables, moving averages, in the certain model.

<sup>9</sup> The mode value (central projection) is, by construction, always in the deepest band shade, but in the case of a heavily unbalanced risk, the central projection may not cover either of these values (Britton, E, Fisher, P.G. and Whitley, J.D. (1998), ‘The Inflation Report projections: Understanding the Fan Chart’, Bank of England, Quarterly Bulletin, 38, pp. 30–37)

„Fena“ chart inflation („fan chart“) of Montenegro, based on the ARIMA model for 2014 and two quarters of 2015, with a probability of 90% shows that inflation, measured by the CPI, depending on the month, will range from 0.7% to 3%. In addition, inflation is projected in the range of 0.27% to 2% for the end of 2014. Namely, with the increase of the time horizon for projecting, uncertainty is increasing as well, thus extending the range of forecasts.

The following basic assumptions have been taken into account when forecasting the inflation in 2014 and Q2 2015:

1. Growth of prices of oil and oil derivatives of 7%, bearing in mind geopolitical tensions;
2. Growth in electricity prices by 5% (with foreseen growth of prices in August 2014);
3. Potential increase in food prices up 5% compared to June 2014;
4. Real wages in 2014 will be the same as in 2013;
5. Stagnation of real estate prices;
6. VAT growth or other tax liabilities are not assumed;

Deviation of any of abovementioned parameters would require the correction of the forecast.

## 6. EXPECTED INFLATION IN 2014

The first half of 2014 was characterized by a negative inflation rate, although the prices rose by 0.7% in the second quarter. Very low inflation is not only the specificity of Montenegro, but also of the EU region. Core inflation is still lower than the current inflation, which suggests that there are no „inflationary pressures“ and that they should not be expected in future.

Market trend indicator points to a decline regarding the inflation rate, although the expectations of banks and the economy are higher than the current inflation rate. The level of the aggregate demand has remained at almost the same level as in the previous quarter.

The level of economic activity is slowly increasing and estimated GDP growth rate for the first quarter was approximately 2%. The survey conducted among businessmen suggests we may expect a similar trend that in the future.

The world economy continues to face numerous difficulties, which are further deepened by the Ukrainian crisis. Although USA expects somewhat stronger recovery, in EU the growth will continue to be very slow and there are numerous incentives for economic growth, including negative interest rates. Therefore, one should not expect inflationary pressures from the external environment.

The model estimate shows, with a probability of 90%, that inflation, measured by the CPI in 2014 and two quarters of 2015, depending on the month, will range from -0.7% to 3%. For the end of 2014, inflation is projected to range from 0.27% to 2%. Our expert estimation is similar to the model estimation and we expect inflation in the range from -0.5% to 2%. It is asymmetrical projection which provides higher probability to low inflation rates.

**Table 4**

Estimated inflation rate		
Optimistic assessment	Realistic assessment	Pessimistic assessment
-0.5%	0.5%	2%

The assumptions on which this estimate is based are the same as the assessments provided by the „fan chart“. The deviation from some of the parameters of the expected values would require a revision of the estimate.

