NATIONAL DIRECTORATE FOR ECONOMIC POLICY

QUARTERLY INFLATION REVIEW

JUNE 2014

n.10

EXECUTIVE SUMMARY

In June 2014 the year-on-year inflation rate in Timor-Leste was -0.6%. This means that on average the prices of goods and services in Timor-Leste were lower in June 2014 than June 2013 and that inflation is below the SDP target range of 4% to 6% per annum.

The largest decreases in prices over the 12 months before June 2014 were in the food and non-alcoholic beverages (-1.2%) and communication (-6.3%) categories. Food and non-alcoholic beverages account for 64% of the CPI basket and the fall in prices in this category has had a significant impact on the overall rate of inflation.

From May 2013 to May 2014 the USD appreciated against a weighted basket of currencies from Timor-Leste's major trading partners and international food prices fell. These two external factors have placed downward pressure on inflation and partly explain the fall in prices from June 2013 to June 2014. Increased competition in the telecoms industry has also contributed to falling prices. Other domestic supply side factors, particularly agricultural production, may have contributed to falling domestic prices and need to be further analyzed.

TRENDS IN INFLATION

Year-on-year inflation in Timor-Leste fell to -0.6% in June 2014 (see graph 1). This demonstrates that prices of goods and services in Timor-Leste were lower in June 2014 than they were in June 2013. The year-on-year rate of inflation has been sharply falling every quarter since June 2013 and is now well below the SDP target range of 4% to 6%.

The year-on-year inflation rates in June 2014 were -0.7% and -0.2% in Dili and the districts respectively. This shows the fall in prices in goods and services over the last year occurred throughout Timor-Leste but was largest in Dili.

The fall in year-on-year inflation in Timor-Leste was driven by sharp decreases in prices in May and June of 2014 (see graph 2). It is likely that non-seasonal factors are driving this price deflation, as the decline in prices is more severe than the seasonal slowdown traditionally seen around June each year.

The CPI basket in Timor-Leste consists of 10 categories of goods and services (see graph 3). There were falls in prices in the following three categories from June 2013 to June 2014:

- food and non-alcoholic beverages
- furnishing, household equipment and routine household maintenance
- communication

The food and non-alcoholic beverages category, with a weight of 64%, represents a large proportion of the CPI basket. The fall in this category drove the overall fall in prices from June 2013 to June 2014.

Five categories (clothing and footwear, housing, health, transport and education) saw small increases in prices of less than 2% from June 2013 to June 2014. Prices in the two remaining categories (alcohol and tobacco and recreation and culture) significantly increased by over 6%.

CONSEQUENCES OF INFLATION

High inflation can increase costs for businesses and may reduce living standards if prices increase faster than household income. The recent low inflation in year-on-year prices in Timor-Leste may therefore contribute to higher living standards and increase competiveness. Many poor household spend a large proportion of their income purchasing food and falling prices in this category may therefore contribute to poverty reduction. The fall in communication prices may have reduced costs for Timorese businesses and increased their competiveness.

CAUSES OF INFLATION

Inflation is affected by both international and domestic factors.

International Causes of Inflation

This review examines exchange rates from May 2013 to May 2014 as this variable likely affects domestic inflation with a slight lag.

From May 2013 to May 2014 the Nominal Effective Exchange Rate increased by 8.9% (see graph 4). This means that the USD appreciated against a weighted (by value of imported goods) basket of currencies from Timor-Leste's main trading partners. This appreciation was driven by the USD strengthening against the Indonesian Rupee and has placed downward pressure on the prices of imports and inflation in Timor-Leste.

The USD also appreciated by 1.1% and 9.5% against the Vietnam Dong and Thai Baht respectively from May 2013 to May 2014. Rice is imported from these two countries and the appreciation of the USD against their currencies may have placed downward pressure on its price in Timor-Leste. Rice has a high weighting in the CPI basket and therefore changes in its price have a significant impact on the overall rate of inflation.

International food prices also fell slightly from May 2013 to May 2014. This has likely underpinned the fall in food prices in Timor-Leste. International food prices have steeply declined since March 2014 slightly proceeding the sharp decline in food prices in Timor-Leste.

Domestic Causes of Inflation

Since the ending of Timor-Telecom's monopoly, competition has increased in the telecommunication sector. This probably contributed to the fall in prices in this category from June 2013 to June 2014.

Domestic agricultural production is also likely to affect inflation in Timor-Leste. Analysis of this relationship is, however, constrained by the lack of quarterly or monthly data on agricultural production.

Government recurrent expenditure is also likely to affect inflation in Timor-Leste and this determinant will be analyzed in greater detail in the next quarterly inflation review.

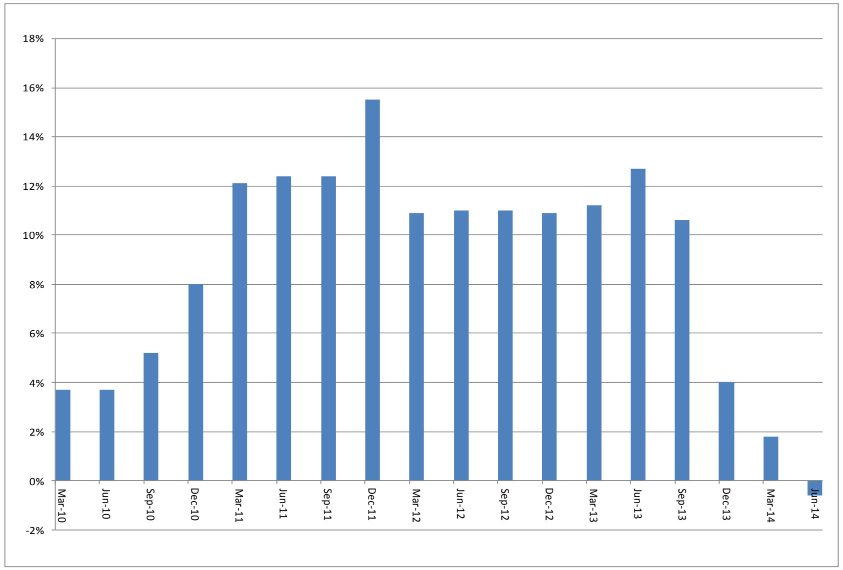
INFLATION PROSPECT

Going forward year-on-year inflation is likely to remain low (but may slightly increase from -0.6%) because:

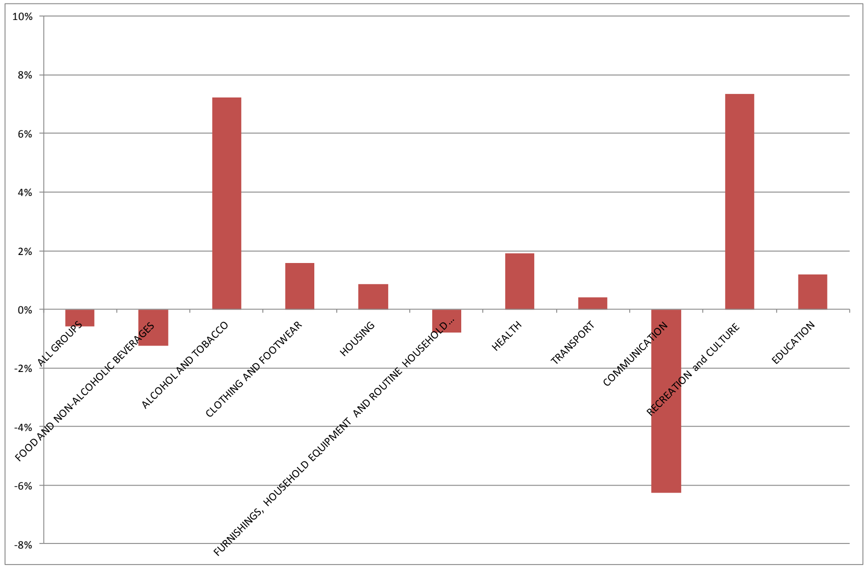
- International food prices fell in June and July of 2014 and are not expected to sharply increase this year
- The USD continued to appreciate against the Indonesian Rupee in June, July and August 2014

Higher budget execution may place upward pressure on inflation, but given the aforementioned factors is unlikely to result in a high overall level of inflation.

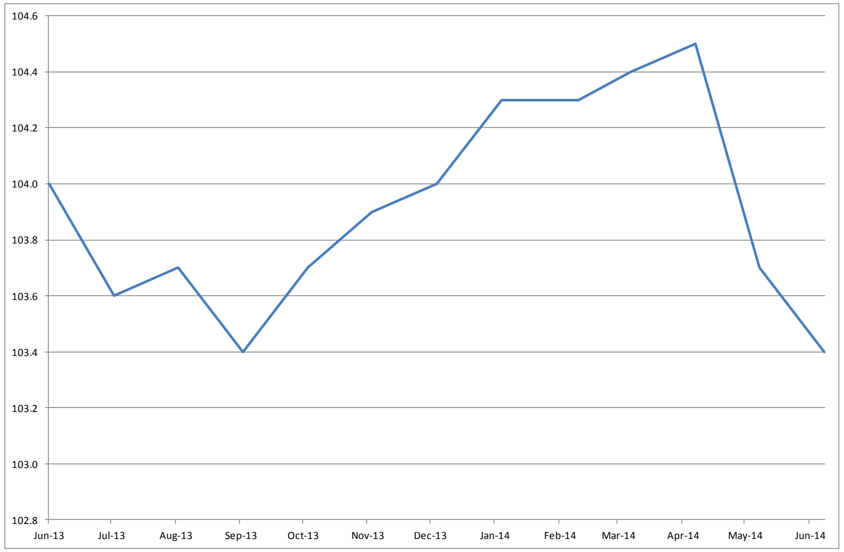
Graph 1: Timor-Leste Year-on-Year Inflation



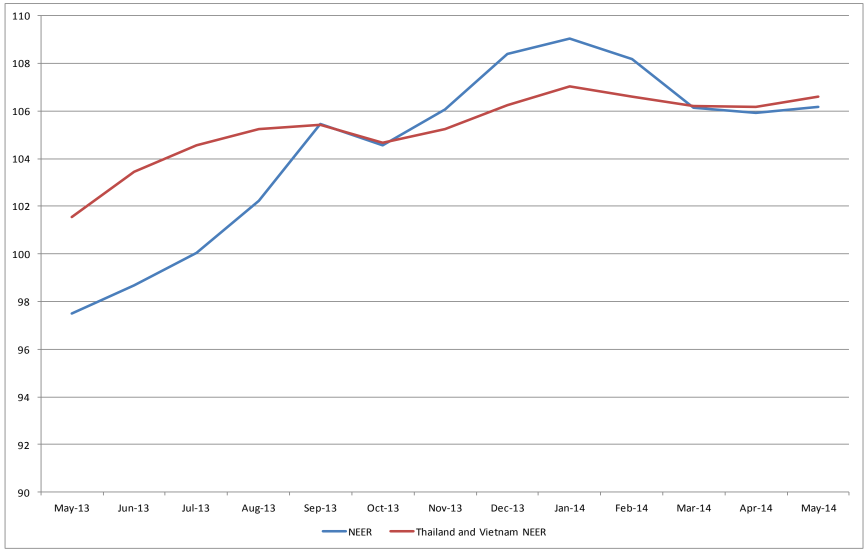
Graph 3: Percentage Change by CPI Category June 2013 to June 2014



Graph 2: Timor-Leste CPI Index



Graph 4: Nominal Effective Exchange Rates Index May 2013 to May 2014



Graph 5: FAO Food Prices Index