Central Bank of Armenia

April **2024**

Executive Monetary Policy Statement

Published April 30, 2024

A. Executive Monetary Policy Statement

The Board of the CBA today reduced the Refinancing Rate to 8.25%.

At its meeting today, the Board of the Central Bank of Armenia decided to decrease the key policy rate (refinancing rate) by 0.25 percentage points, setting it at 8.25 percent. The Board agrees that a lower refinancing rate is necessary to continue to meet its price stability objective of ensuring an inflation rate of 4 percent over the medium term.

Annual CPI inflation has continued to remain at low levels well below the target, registering -1.2% in March 2024. Core inflation also continued to decrease, at -0.7% year-over-year in March.

In the first quarter of 2024, risks of slowing economic growth globally and in the key trading partner countries of Armenia continue to persist. Global inflation continues to decline, but sticky prices continue to remain relatively elevated in key trading partner economies. At the same time, overheated labor market conditions continue to contribute to sustained high demand conditions in key trading partner economies. Geopolitical tensions in the Middle East since the beginning of the year continue to create risks for future growth in global energy prices and potential disruptions in global supply chains. In this context, it is likely that key trading partner central banks, and in particular the US Fed, would maintain tight monetary conditions for longer. Consequently, weak deflationary effects are expected from the external sector on the Armenian economy.

Economic activity in Armenia remained robust in the first quarter, continuing to be largely driven by meaningful growth in the trade and industry sectors. The latter continues to be impacted by certain short term factors, carrying real uncertainties with respect to the sustainability of economic growth and its long-term outlook. External demand for domestic services is slowing, while high growth in private investments continues to contribute to domestic demand. At the same time, risks for additional demand pressures stemming from fiscal policy continue to persist. The inflationary environment in Armenia continues to remain low, driven by the monetary policy implemented by the CBA in recent years, weak deflationary pressures from the external sector, and the implications of the appreciated dram. At the same time, growth in labor supply has somewhat eased labor market conditions, which has been reflected in cooling wage growth as well as declining non-traded sticky price inflation and inflation expectations.

In the face of high uncertainty, and given its commitment to achieving the price stability objective, the Board considers multiple scenarios during its deliberations. On the one hand, the Board discussed scenarios where possible underlying developments—including tighter monetary conditions in key trading partner countries, as well as uncertainty related to the country risk premium and neutral interest rates—would require a tighter policy stance relative to current market expectations in order to manage risks that threaten the price stability objective. On the other hand, the Board discussed scenarios where potential economic developments—including continued growth in domestic labor supply, as well as a rapid deceleration in demand—would cause inflation to persistently remain at a low level. This would imply a more rapid and aggressive downward path for the policy rate than what is currently priced in markets in order to sustainably bring inflation back to target in the medium-term horizon.

In summary, balancing the aforementioned risks in both directions, the Board of the Central Bank of Armenia finds it appropriate to continue to gradually ease the policy stance. The Board will continue to monitor risk scenarios, and stands ready to take adequate actions to ensure that the price stability objective of 4 percent inflation over the medium-term horizon is met.

Approved by the Board of the Central Bank of Armenia
April 30, 2024

Governor
Martin Galstyan

Deputy Governors
Hovhannes Khachatryan
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B. Summary of Economic Conditions

Global Economy

In 2024Q1, economic activity among Armenia's main trading partners has been mixed; however, risks of weaker economic activity going forward continue to persist. Despite continued contractionary monetary policy stances in the US and Russia, both economies continue to experience high rates of growth, driven primarily by domestic demand factors. Given continued inflationary trends in the United States, the US Fed would be expected to continue to maintain a contractionary policy stance, keeping rates at higher levels for longer than what markets previously expected. On the other hand, risks of economic contraction in the Eurozone, as well as concerns related to the stability of the real estate market and financial system in China, continue to remain key sources of uncertainty driving a weaker global economic outlook. Nevertheless, economic activity somewhat improved in both the Eurozone and China in the first quarter of 2024.

The overall inflationary environment in the global economy continues to weaken. Nevertheless, strong labor markets across many countries have helped sustain high demand, causing sticky prices to continue to remain relatively elevated. At the same time, heightened geopolitical tensions in the Middle East continue to pose a risk for both higher and more volatile energy prices as well as potential disruptions to global supply chains. In this context, it is expected that key trading partner countries would primarily maintain tight monetary policy conditions in the near future. As a result, modestly deflationary effects from the external environment on the Armenian economy would likely persist.

Domestic Demand Conditions

The growth rate of economic activity in Armenia in Q1 2024 remained well above estimates of long-run sustainable growth (approximately 5%), comprising 14.3% Y-o-Y growth in January-March, and 15.3% Y-o-Y in March alone. Growth continues to be driven by strong activity in the trade and construction sectors. In recent months, the structure of economic growth has shifted somewhat. Specifically, manufacturing output and exports have grown, primarily driven by sharp growth in jewelry production. The latter could pose risks for sustained high economic growth in the future. At the same time, the structure of growth and concentration in some subsectors continue to raise questions about the sustainability of similarly high growth going forward. Information and Communication services experienced a slowdown in output in Q1 2024, as well as a relative stabilization of both wages and employment. Given its role in driving potential output and export capacities, an adverse adjustment to the tech outlook could have medium-term implications. However, there are no clear signs as of yet of a widespread contraction.

External demand for domestic services has slowed, reflected in both declining inflows of international tourists as well as per capita tourist expenditures. Domestic demand continues to remain at relatively high levels. Notably, accelerated growth in investments has contributed meaningfully to growth in domestic demand; in the short term, this can have some inflationary effects, though in the medium term, growth in investments can create preconditions for growth in the productive capacities of the economy. Growth in private consumption has also contributed significantly to economic growth but remains relatively subdued compared to overall income growth, as reflected in the fact that private savings continue to remain at high levels. The latter serves as a meaningful source of uncertainty, particularly from the perspective of how and in which directions accumulated private savings may be used, as well as the potential for this to contribute to future acceleration in consumption. At the same time, risks for additional demand pressures stemming from fiscal policy continue to persist. The funds attracted and provided by commercial banks continued to grow during Q1 2024, reflecting high economic activity. CBA surveys of commercial banks further attest to sustained high demand for loans. In recent years, the reduction in the debt burden (relative to incomes) serves as a source of uncertainty in terms of the potential for lending to accelerate and generate inflationary pressures. Despite uncertainty, imbalances between aggregate demand and supply in the economy have continued to gradually recede.

Labor Market & Inflation

In the context of continued strong growth, labor demand and wage growth both continued to persist at high levels, with private wage growth standing at 8.5% Y-o-Y in February 2024. Nevertheless, the growth in productivity and labor supply observed in prior quarters has contributed to a weakening in inflationary pressures stemming from the labor market. The potential for further increases in labor supply could help ease labor market conditions, potentially moderating inflationary pressures in the medium to long term. In this context, the primary uncertainties relate to the potential for a continued inflow of migrant workers to the Armenian labor market, the rapid integration of forcibly displaced persons from Nagorno-Karabakh in the Armenian labor market, as well as slowing flows of Armenian labor migrants to Russia and their greater participation in the domestic labor market.

The inflationary environment has continued to soften, primarily driven by weakened pressures coming from the external sector and the impacts of the CBA's policy stance over the past several quarters. In this context, overall CPI inflation has remained below target since April 2023, standing at -1.2% Y-o-Y in March 2024. Non-Traded Sticky Price Inflation, which captures domestically driven demand dynamics, continued to gradually decline, standing at 2.4% Y-o-Y in March 2024. At the same time, inflation for services that are highly exposed to external demand have also continued to soften, reflecting trends of slowing demand.

Monetary Policy

Market expectations of the CBA policy rate path have not changed materially since the last decision and continue to reflect expectations of a gradual reduction in the policy rate through the end of the current year. Since the CBA's previous policy rate decision, the yield curve has shifted downward, while yield curve-implied expectations of the policy rate for the next one year remain relatively elevated in comparison to survey-based measures of policy rate expectations. This suggests the potential for an alternative interpretation of market participants' outlook for the economy and future directions of monetary policy.

The country risk premium continues to remain at relatively low levels, partly following trends in emerging countries. However, some uncertainty persists regarding tensions on the state border, regional geopolitical developments, and other factors; in this context, an upward reappraisal of the country risk premium could pose inflationary risks. At the same time, macroeconomic stability in Armenia and high economic growth can serve as important preconditions for a potential reassessment of the country risk profile.

Considering the persistence of numerous types of uncertainty, the CBA builds and evaluates several different scenarios for future economic developments in order to manage possible risks stemming from these key areas of uncertainty. On the one hand, the Board has evaluated scenarios where underlying developments would require a tighter policy stance relative to current market expectations in order to contain excess demand, anchor inflation expectations to the target and guarantee the price stability objective. These types of scenarios are primarily related to the potential for a "higher for longer" interest rate environment in the United States, with implications on both capital flows and the medium-term neutral rate in Armenia; worsening geopolitical tensions, both globally and regionally; uncertainty about the country risk premium in the context of the fiscal deficit and geopolitical tensions; restructuring of global supply chains; high inflation expectations; as well as other risks and uncertainties. On the other hand, the Board also evaluated scenarios where underlying developments would require the policy rate to follow a more rapid and aggressive downward path than what is currently priced in markets in order to sustainably bring inflation back to target in the medium-term horizon. These types of scenarios include the risk for much weaker aggregate demand conditions; concerns about potential adverse developments in the real estate sector; continued growth in domestic labor supply; accelerating growth in investments, supported by the utilization of large accumulated savings in the real sector of the economy; the potential for a sharp slowdown in global demand; as well as other risks and uncertainties. Given the discussion of these and other scenarios in the context of the existing uncertainties, the Board of the CBA emphasizes the importance of utilizing a prudent risk management approach to ensuring the price stability objective that seeks to minimize the losses that could stem from these scenarios materializing.

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