

THE CENTRAL BANK
OF THE
REPUBLIC OF ARMENIA

*Approved under Board of the Central Bank
Resolution No. 39A,
dated 19.02.2015*

Inflation Report

Monetary Policy Program, Q1, 2015



*Status Report on Implementation
of the Monetary Policy Program
Q4, 2014*

Table of Contents

1. Executive Summary	4
2. Forecast, forecast changes, risks	7
2.1. External environment	7
2.2. Aggregate supply and Aggregate demand	9
2.3. Inflation forecasts and monetary policy directions in 3-year forecast horizon	15
3. Actual Developments in Q3 2014	19
3.1. Inflation	19
3.1.1. Actual inflation and fulfilment of the inflation target	19
3.1.2. Import prices and producer prices	21
3.1.3. Inflation and interest rate expectations	22
3.2. Aggregate supply and Aggregate demand	22
3.2.1. Aggregate supply	22
3.2.2. Aggregate demand	24
3.2.3. Labor market	25
3.2.4. Fiscal policy	26
3.3. Money and financial market developments	27
3.3.1. Financial market, money and credit	27
3.3.2. Exchange rate	31
3.4. Balance of payments	33
3.4.1. Current account	33
3.4.2. Capital and financial account	34
3.5. External environment	34
4. Conclusion	37

Since January 2006, the Central Bank of Armenia has moved to a fully-fledged inflation targeting strategy, which highlights the importance of communicating of the Bank to the general public by publishing, inter alia, quarterly inflation reports. First section of the inflation report includes next quarter's monetary policy program that provides new forecasts of inflation and other macroeconomic indicators and main directions of the monetary policy in the forecast horizon. Second section includes status report on implementation of the monetary policy program of the previous quarter, which covers actual economic and monetary developments.

Publishing of inflation forecast and assumptions underlying it makes the monetary policy of the Bank more transparent, understandable and predictable, which considerably increases the public confidence in the Bank. The Bank believes that a clear and trusted monetary policy positively affects the anchoring of inflation expectations and maintaining financial stability in terms of cost reduction.

Starting from the second quarter of 2012, the Bank has been publishing forecasts of non-conditional inflation in a 3-year time horizon, in implementation of the inflation targeting strategy, whereby the monetary policy is steered to minimize any deviations of potential inflation from a 4 % target. Projections in this report are based on the factual information available by February 10, 2015, i.e. the approval of the refinancing rate, the results of a survey conducted by the Bank and the judgment made pursuant to the information on future macroeconomic developments.

All inflation reports which have been published to date are available on the Bank's website which also contains monetary policy-related publications.

1. Executive summary

The Central Bank predicts that in the course of 2015, the 12-month inflation rate will stay mostly in the upper bound of the confidence band of $4\% \pm 1.5$ pp; later the year it will approach the target and stabilize around over the rest part of the forecast horizon.

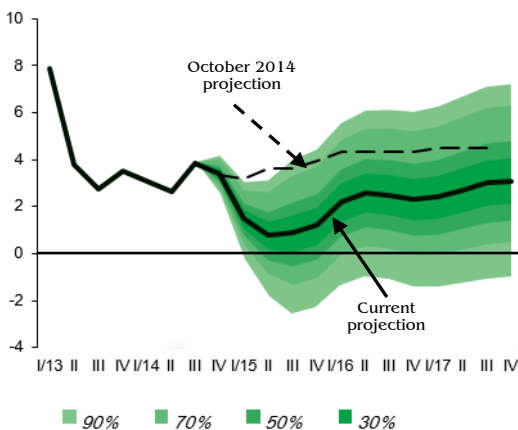
In the time of uncertain economic developments in the external environment, economic growth rates will slow down in 2015 but will speed up over the rest part of the forecast horizon, gradually approaching the long-term equilibrium.

According to the Central Bank forecasts, in the course of 2015 the 12-month inflation rate will stay mostly in the upper bound of the confidence band of $4\% \pm 1.5$ pp; later the year it will approach the target and stabilize around over the rest part of the forecast horizon. In the time of uncertain economic developments in the external environment, economic growth rates will slow down in 2015 but will speed up over the rest part of forecast horizon, gradually approaching the long-term equilibrium.

In the 4th quarter of 2014, the domestic demand remained sluggish attributable to declined *private consumption* and *weak investment activity* mainly due to a significant reduction in remittances from abroad and Russia in particular. It is estimated that in 2014, compared to the last year, private consumption spending will remain unchanged, while private investment will decline by 0.6%. The negative impact of these factors on the aggregate demand was somewhat reduced owing to implemented expansionary fiscal and monetary policies. Sluggish economic growth in terms of supply this quarter was again due to slow growth rates in industry and services, particularly trade volumes, and still negative developments in construction. On the other hand, the developments in agriculture were in line with forecasts. As a result, it is expected that in 2014 the *economic growth will be in the range of 3.2%-3.5%*.

In 2014, the economic growth will be in the range of 3.2%-3.5%.

Real GDP cumulative growth projection probability distribution for a 3-year horizon



The economic growth in 2015 is estimated in the range of 0.4%-2.0% primarily due to resumption of tradable sector of the economy.

According to short-term forecasts, both private consumption and private investment will reduce in 2015. The fiscal impulse (in relation to the previous year) is estimated to be small expansionary during the year. In 2015, the real growth of export of goods and services is expected within 7.0%-9.0% while the decline in import of goods and services in real terms is predicted in the range of 4.0%-6.0%. Moreover, around 30% net reduction in remittances of individuals in dollar terms is anticipated. It should be noted that private remittances¹ in Russian ruble are expected to increase in 2015 but their growth rates are predicted to slow in future. As a result, the *economic growth in 2015 is estimated in the range of 0.4%-2.0%* primarily due to resumption of tradable sector of the economy.

In the forecast horizon, the economic growth will gradually approach its long-term equilibrium, reflecting accelerating net export growth rates and slowly rebounding domestic demand. Thus, *in the forecast horizon*, with stabilizing private demand and mostly a neutral impact of the fiscal policy, the *impact of the aggregate demand on prices will be non-inflationary*.

The economic activity in *Armenia's main trade partner countries* tended to slow down in the 4th quarter of 2014, in which case the *external demand* remained at a low level while more than expected deflationary patterns were observable in *international commodities and food product markets*.

¹ A larger bulk of private remittances of individuals is in Russian ruble. In 2014, the private remittances in Russian ruble grew by 10.3%.

In the forecast horizon, inflationary pressures from the external demand and international markets of basic commodities and food products are not anticipated.

In 2014, the 12-month inflation rate amounted to 4.6%, staying within the confidence band.

In the forecast horizon, in view of rebounding global economy and gradual acceleration of economic growth in Armenia's main trade partner countries, a steady price rise in international commodities and food products markets as well as relative stabilization of exchange rates and expectations of further appreciation will transmit positive effects onto the Armenian economy. Under these conditions, however, ***inflationary pressures*** from the external demand and international markets of basic commodities and food products ***are not likely***.

With the Armenian dram depreciated and the inflation environment expanded on the brink of a steep reduction in foreign currency flows, depreciating Russian ruble and resultant inflationary expectations at the end of the year, the ***12-month inflation rate exceeded expectations in the 4th quarter as in late December it was 4.6%***, still within the confidence band.

Though the inflation was still within the confidence band during the quarter, the dram's exchange rate adjustment as well as persisting economic and geopolitical developments abroad and especially in the region intensified the pressures in the foreign exchange market since the end of November, taking them also to the products market. These markets began to incur temporary instability, in the meanwhile loading significant inflationary potential and creating inflationary expectations.

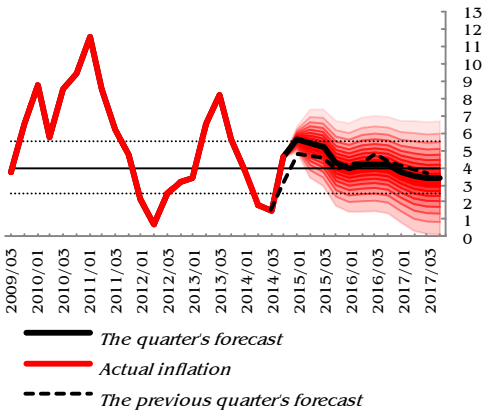
The Central Bank responded to the situation thoroughly. Specifically, in late November the Bank raised the ***Lombard Repo Facility Rate (from 8.25 to 21.0%)***, followed by a mid-December increase of ***the Reserve Requirement Ratio with regard to funds attracted in foreign currency (from 12.0 to 24.0%)***. Note that short-term dram market rates reacted to the Central Bank's tightening of financial conditions in the financial market as they rose and ***stayed in the time around the Lombard Repo Facility Rate***. This can imply that the ***Lombard Repo Facility Rate has taken, since the yearend, the role of financial market's leading interest rate***. Following these actions, the currency and product markets were able to see some signs of stabilization, which is why in late December the Central Bank lowered the ***Reserve Requirement Ratio with regard to funds attracted in foreign currency*** from ***24.0 to 20.0%*** and the ***Lombard Repo Facility Rate*** from ***21.0 to 20.0%***. In early 2015, the Lombard Repo Facility Rate was reduced further to ***14.5%***, which straightforward led short-term dram market rates down.

At the same time, to moderate future inflationary pressures and have the inflationary expectations anchored around the target, in late December the Central Bank raised the Refinancing Rate by 1.75 pp. In early 2015, the Refinancing Rate was further increased to 10.5%, reflecting upward trends of investment risk and interest rates in developing countries over a longer term (see details in section "3.1.1 Actual inflation and fulfillment of the inflation target").

According to the Central Bank forecasts, with a lower base compared to the same period of the previous year as well as

In the 1st quarter of 2015, the Central Bank will continue reducing the Lombard Repo Facility Rate.

Inflation (12-month) forecast probability distribution chart for a 3-year horizon



Armenia's membership to the Eurasia Economic Community from January 2015², ***in the 1st quarter the 12-month inflation rate will increase slightly.*** However, in anticipation of weak demand in external and domestic economies, the inflation will reduce to approach its target at the end of the year.

The Central Bank estimates that, driven by the latest events in the previous year and the geopolitical situation in the region, the developments in product and financial markets of Armenia are gradually playing out as they incur the impact of the Central Bank policy action for the period December 2014 to February 10, 2015. In this circumstance, the ***Central Bank will continue reducing the Lombard Repo Facility Rate during the 1st quarter of 2015.***

As the economy comes back to normal conditions, the Central Bank policy actions will reduce the spread between the Bank's policy and short-term dram market rates, ***reviving the leading role of the Refinancing Rate in the market*** and contributing to the financial market stabilization and fulfillment of the inflation target in the medium term.

Risks to inflation deviating from the projected value are estimated as ***balanced*** in both short and medium-term perspectives. ***External sector risks*** are primarily associated with global economic growth rates bouncing back as well as economic and geopolitical development perspectives in emerging economies, and Russia in particular, and how their potential impact would be spilled over to basic commodities and food product markets. ***Risks deriving from the domestic environment*** are attributable to domestic demand developments, particularly private consumption growth rates, capital investment recovery rates, the Government-led projects, the economic effects from Armenia's membership to the Eurasia Economic Community, and the developments in agriculture sector which is largely reliant on climatic conditions. If such risks materialize, the Central Bank will react accordingly by maintaining the inflation target in the medium haul.

² Detailed information on the impact of Armenia membership to the Eurasia Economic Community on the inflation in 2015-2017 is available in Q4 2014 Inflation Report (section 2.3 "Inflation forecasts and monetary policy directions in 3-year forecast horizon").

2. FORECAST, FORECAST CHANGES, RISKS

2.1. External environment³

The global economy and economic growth rates in Armenia's main trade partner countries are expected to slow down remarkably.

In 2015, the world economic growth and growth rates in economies of Armenia's main trade partner countries are expected to slow down remarkably in comparison with previous forecast, which will be noticeable mostly in developing countries, whereas economic activity in the U.S.A. will accelerate.

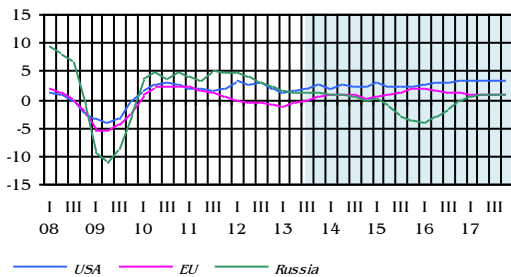
As the economic activity and demand rebound and the inflation rates decline unhurriedly, the **U.S. Federal Reserve System** is expected to raise the policy rates in the midst of 2015. The economic growth in 2015 is estimated to be 2.5%, which will speed up to 3.5% in 2017.

In the **Euro-area**, after slowdown in economic activity in 2014, the growth in 2015 is expected to accelerate to a certain extent, which will be about 1.2%. In 2017, however, i.e. at the end of the forecast horizon, the growth will be around 1.0%. In the face of increasingly deflationary environment, the European Central Bank will continue its low-interest-rates policy. It should be noted that purchases of sovereign bonds in early 2015 (with a monthly purchase volume of EUR 60 billion) came in addition to the program of asset-backed security and covered bond purchases launched in late 2014. This program will carry on by September 2016, resulting in a more expansionary monetary policy with the aim to regulate inflation.

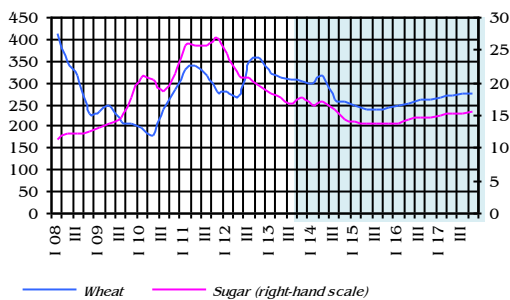
In **Russia**, substantially volatile patterns in economy observed in late 2014 and early 2015 make it to expect economic slowdown in 2015 around 2.0% (later the year, the economic decline is predicted to even deepen to 3.8%). Recession in the economy will continue in 2016 too, and some positive growth in economic activity will only be recorded in 2017, which will amount to nearly 1.0% at the end of the forecast horizon. Driven by the exchange rate depreciation, coupled with geopolitical factors observed in late 2014, the inflation rate is expected to accelerate notably in 2015. The economic decline determined by geopolitical situation and domestic developments will reflect mainly a weak investment climate and will be accompanied by capital outflows. At the same time, the exchange rate depreciation in a long-term perspective will somehow positively influence by improving Russia's external position affected by decreased oil price, restoring the economic growth and retaining the rate of employment.

³ The forecasts of external sector were based on the information provided from international reputable analytical, research, ratings organizations and financial institutions as well as various news agencies worldwide (including the IMF, World Bank, The Economist, Economist Intelligence Unit, Global Insight, Financial Times, and so on).

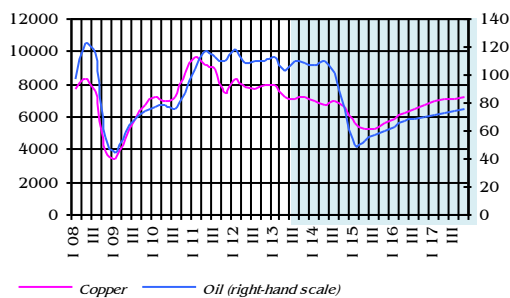
Economic growth in trade partner countries (%)



Food products (USD)



Basic commodities (USD)



In addition, the IMF January 2015 report predicted a 3.5% growth of global economy (with a downside adjustment of 0.3 pp in comparison with previous (October) publication, owing to developing countries).

Uncertainties and risks about a further pace of the global economy **have become more essential** for developing countries. These are attributable to the capital fleeing from developing countries to the developed ones and to deteriorating economic growth prospects as commodity prices fall in international markets. It is noteworthy that escalation of the aforementioned risks was reflected in developing countries as the level of equilibrium interest rates has risen to a certain extent and the economic growth potential reduced. Downside risks to economic growth in Euro-area member states are significant, too, which is due to a slowing pace of structural reforms and geopolitical developments.

With the global economy growing at a slow rate, international markets of **basic commodities and food products** saw some signs of recovery after dramatic deflation recorded in late 2014. In the meantime, individual commodity markets are predicted to develop under the influence of fundamental factors inherent in any such markets. Specifically, risks associated with energy price developments will be determined by geopolitical events, whereas prices of food products will depend on weather conditions.

As the global economy rebounds and economic growth in Armenia's main trade partner countries gradually accelerates in a medium run, a steady price rise in international commodities and food products markets as well as relative stabilization of exchange rates and further appreciation trends will transmit positive effects onto the Armenian economy.

Box 1

Developments in commodities markets in the forecast horizon

The International Energy Agency's February 2015 estimates indicate that in 2015 about 61.9% of global oil demand will be met thanks to oil production by non-OPEC countries (the growth was 2.3% against the previous year), under which circumstance average demand for extraction of oil by OPEC countries will reach 28.9 million b/d. Oil companies are expected to reduce their investments to some extent on the brink of steep deflationary patterns driven by increased oil extraction volumes by the U.S. companies at the end of 2014. However, in the short term the oil supply (mainly by non-OPEC countries) will persist at a high level, which will keep the prices low until mid-2015. In the medium term, however, international oil prices will tend to increase moderately in line with adjusting a market balance between supply and demand, which will also be fuelled by a gradual increase in global demand. It should also be noted that geopolitical risks associated with negotiations with Iran, Islamic groups' actions, as well as the relations between Russia and the West will determine the main developments with energy prices in the medium run.

In the short-term perspective, certain deflationary patterns will be discernable in base metals markets as the global economy grows slowly. Later, in the medium haul, prices of base metals will demonstrate primarily minor inflationary patterns.

According to February estimates of the U.S. Department of Agriculture, in the 2014/2015 marketing year some 725.0 million tons of wheat crops is expected (the volume of crop has increased by about 9 million tons in comparison with the previous year). Furthermore, some growth of stock is expected in the forecast horizon, reflecting faster production rates over consumption (the stock will increase by nearly 10 million tons against the previous year). This will determine the short-term deflationary trends in the international wheat market. In the medium term, however, prices will trend slowly upward, following a steadier path.

In the 2014/2015 marketing year, world production of rice will reach 474.56 million tons (roughly 2.5 million tons less compared to the previous year). On the back of increased consumption however, the world rice stock may decrease by nearly 8.5 million tons in comparison with the previous year. As a result, average international rice price will mostly tend to grow slowly.

In the 2014/2015 marketing year, uncertainties over production of cane crop, fuelled by certain pressures in the cane market in Brazil, will be largely compensated by generous harvest expected in India, Thailand and the EU, as well as Australia and Mexico. As a result, in the medium run international sugar price may trend slightly up. It should be noted that short-term developments in the market will be greatly influenced by expectations about supply, as key producer countries, Brazil in particular, will adjust their estimations of domestic output.

2.2. Aggregate supply and Aggregate demand

Aggregate supply

The Central Bank estimates of economic growth of Armenia for 2014 did not change notably, and are in the range of 3.2%-3.5%. Unfavorable external economic environment due in 2015, particularly an expected economic decline in Russia, Armenia's main trade partner, and low ore mining and metals prices as well as anticipated decrease in domestic demand all **served a basis for adjusting Armenia's 2015 economic growth forecast considerably downside**. It is expected, as a result, that economic growth will slow down against 2014 and will be in the range of 0.4%-2.0% in 2015.

An expansionary fiscal policy to be implemented in 2015, improving external economic environment and exploring new export markets will play a decisive role in restoring the economic growth in the forecast horizon amid a steady inflation environment. Driven by the above mentioned developments, it is expected that economic growth would speed up to a 2.5%-3.5% range in the forecast horizon. The growth anticipated in the tradable sector of the economy is believed to largely contribute to the economic growth in the forecast horizon.

The 2014 economic growth is estimated within 3.2%-3.5%.

In 2015, the economic growth will slow down to be in the range of 0.4%-2.0%.

For **Industry**, the forecasts of value added were revised slightly downside, with ore mining and metallurgy growth rates predicted to slow down due to the falling prices of non-ferrous metals in global markets. Growth rates in production of building materials, beverage and processed food were also revised downside due to the reported slowing in growth rates in construction, external and domestic demand. As a result, in 2015 value added in industry is expected to grow in the range of 1.0%-1.6%. Exploiting Teghout mine and exploring new export markets will significantly contribute to the expected moderate growth in 2015.

In **forecast horizon**, the industry growth will speed up and stabilize within 4.1%-4.6%, and this will be underpinned by implementing a handful of investment projects as well as improved profitability in tradable sub-industries, driven by the exchange rate depreciation.

For **Construction**, the forecasts of value added were revised markedly downside, mostly due to an anticipated reduction in remittances from Russia and expected decline in investment in a number of sectors of the domestic economy, particularly in the non-tradable sector. As a result, value added is expected to decrease in 2015 in the range of 6.3%-7.3%.

In the **forecast horizon**, the growth is expected to stabilize within 0%-0.5% as investment activity and money transfers from Russia rebound.

For **Services**, the forecasts of value added were also revised downside in line with downside adjustment of the forecasts for private spending in the domestic economy, which will leave an influence on both the volumes of trade turnover and other services provided. As a result, real growth of value added in services in 2015 is predicted in the range of 1.6%-2.0%. Note that expected growth of the tourism industry could substantially contribute to an anticipated moderate growth during the year.

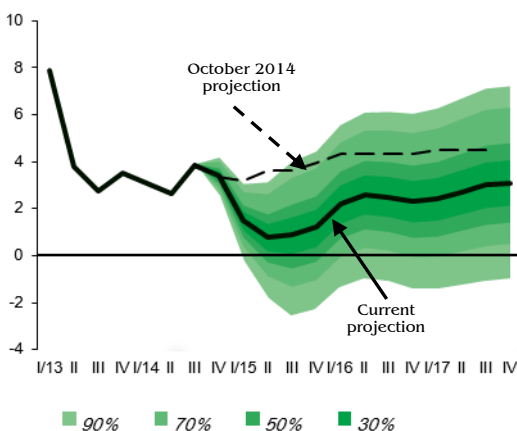
In the **forecast horizon**, growth rates in services will somehow accelerate and stabilize within 2.5%-3.0% as the domestic demand recovers steadily.

For **Agriculture**, the forecasts of value added were revised downside, primarily due to shortage of investment sources for the sector, as well as expected slower economic activity in the processing industry. As a result, the real growth of value added in the sector in 2015 is predicted in the range of 3.5%-4.5%.

In the **forecast horizon**, underlying growth rates will pick up and stabilize within 5.0%-5.5% as accessibility to investment sources recovers, the sector's export promotion policy continues and house farming facilities expand.

In the forecast horizon, risks to the economic growth are dual sided and come in mostly balanced. In particular, further-than-expected decline in private spending is a negative risk to the economic growth in the short term. In the medium term, risks to the economic growth depend on how the global economy would develop further and what economic effects could be expectable from integration processes in the region, on the one hand, and on how investment activity in the tradable sector of the domestic economy would unfold, on the other.

Real GDP cumulative growth projection probability distribution for a 3-year horizon



Real GDP Growth (Cumulative) Projection Probability Distribution				
Period	30% probability interval		90% probability interval	
	Min	Max	Min	Max
January-December 2014 / January-December 2013	3.2%	3.5%	2.7%	3.8%
January-December 2015 / January-December 2014	0.4%	2.0%	-2.3%	4.4%
January-December 2016 / January-December 2015	1.4%	3.2%	-1.4%	6.0%
January-December 2017 / January-December 2016	2.1%	4.1%	-1.0%	7.2%

Labor market:⁴ Forecasts of labor market indicators for 2015-2017 have worsened compared to the previous forecasts, in response to the adjustment of the economic growth forecasts. Specifically, in the forecast horizon average wage is expected to have much slower growth rate and the unemployment rate to be somewhat higher. Thus, average nominal wage is expected to **grow by 6.2% in 2015 and by about 5.0% in the period 2016-2017.**

The nominal wage increase of 8.1% in 2014 is higher than the average wage growth reported in recent years. The wage increase during the year was attributable to the minimum wage threshold increased up to AMD 50,000, the increase in wages in some undertakings in the private sector in the context of the funded pension reform and wage increases in the public sector during the second half of the year.

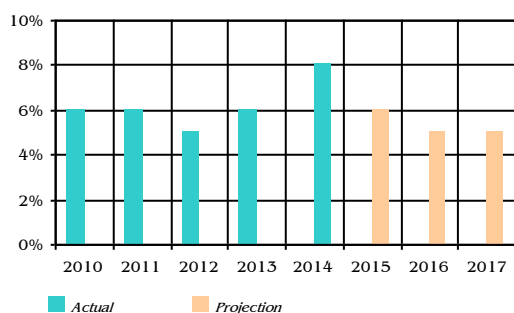
On the back of wage increases in the public sector in the second half of 2014, average wage growth rates are expected to remain strong over the first half of 2015. Starting from the mid-2015, the minimum wage threshold will rise to AMD 55,000.

With the economic growth expected to grow at a slow pace, the stabilizing inflation rate and the Republic of Armenia Government policy further steered to minimum wage increases, the average nominal wage is predicted to grow by about 5% annually in the period 2016-2017.

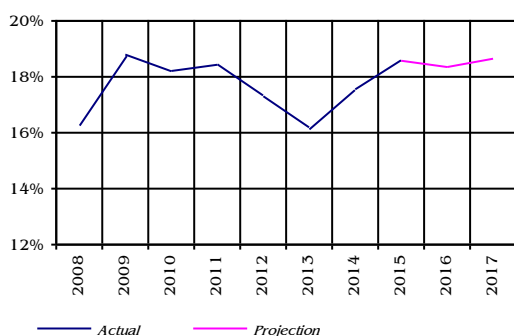
Relatively high growth of wages expected for the first half of 2015 outstrips the productivity growth projected for the aforementioned period, which is determined by existing rigidities in the labor market. In the meantime, these developments are expected to push unit labor costs slightly up, and the consumer market will incur weak inflationary pressures, 0.15 pp - 0.25 pp, from the supply side, which will phase out in the forecast horizon. **Thus, one may conclude that, in the forecast horizon, the inflationary pressures from the labor market are not significant.**

In anticipation of slower economic growth in 2015, the average unemployment rate will amount to 18.5%. In the forecast horizon, the unemployment rate will be above its equilibrium, reflecting a negative GDP gap, and deflationary pressures created by it, in the above-mentioned period.

Average nominal wage growth, y/y



Unemployment rate



⁴ The labor market data for 2014 are the Central Bank estimates which are based on the 3rd quarter of 2014 data and actual September-November 2014 figures. The growth indicators presented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

Aggregate demand⁵

Driven by an anticipated decline in remittances from Russia, a main trading partner, and weak investment activity in the domestic economy, the private sector spending in Armenia is likely to reduce by 5.2% in 2015. However, anticipated slackening of private spending will diminish in 2015 thanks to persisting effect from expansionary monetary and fiscal policies implemented in the previous year and if new fiscal stimuli are provided to the economy during 2015.

A tight monetary policy in late 2014, carried out to maintain price and financial stability, was geared up for considerable easing of monetary conditions in early 2015. This will mitigate tight monetary policy's contractionary effect on private spending in the period 2016-2017.

A tight monetary policy in late 2014, carried out to maintain price and financial stability, was geared up for considerable easing of monetary conditions in early 2015, which will mitigate tight monetary policy's contractionary effect on private spending in the period 2016-2017.

In 2016-2017, the private spending will bounce back, growing at a moderate rate. The negative impact of private spending on economic growth during this period will alleviate owing to persisting effect from expansionary fiscal policy to be implemented in 2015 and a positive contribution from net exports.

Although such a development with private spending will somewhat negatively affect the economic growth, it will however contribute to the equilibrium and stability in the economy in future.

In 2015, the private consumption will decrease by 3.3% and private investment, by 14%.

In 2015, the expenditures of private consumption were revised markedly downside, which was determined by considerable reduction in remittances from Russia and anticipated slowing of growth rates of credit to the economy. Estimates suggest that final consumption expenditures of households will reduce in 2015 by 3.3% in real terms.

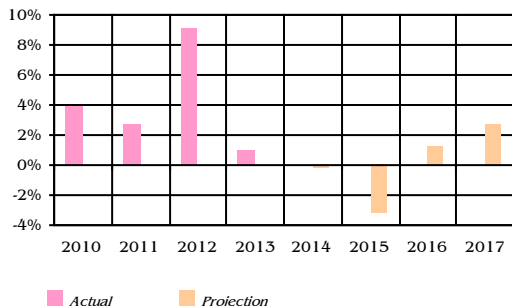
The above factors, as well as current and expected sluggishness in investment activity will lead to around 14% reduction in private investment in 2015, which is significantly lower compared to the previous forecasts. Expected decline in private investment in 2015 will be determined by reduced investment in companies engaged in construction and other non-tradable sectors of the economy, which will outweigh the investments in the tradable sector. The expected growth of investments in the tradable sector, in turn, is linked to increased profitability there as a result of the dram exchange rate depreciation in late 2014.

The 2015 expansionary fiscal policy, gradual easing of monetary conditions in the forecast horizon, lingering effects of monetary incentives provided to the economy during 2014, as well as improving external economic environment and Russia's economic recovery, in particular, will cushion the decline in private consumption and investment in 2015 and even stimulate

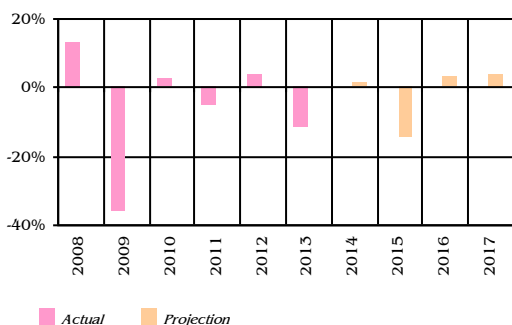
⁵ The data of real growth of private consumption and investments for 2015-2017 are the Central Bank estimates. Actual figures of these data are as of the 3rd quarter 2014 and published by the Republic of Armenia National Statistics Service. The real growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

In 2016-2017, the private consumption is expected to grow by 1%-3% and private investment, by 3%-4%.

Private consumption growth, y/y



Private investment growth, y/y



their growth in 2016-2017. As a result, the private consumption is expected to grow in 2016 and 2017 by 1%-1.5% and 2%-3%, respectively.

The private investment in 2016-2017 is expected to post a 3%-4% growth. There will be more investments owing to the ones expected in the tradable sectors of the economy, for which recent depreciation of the dram exchange rate and resultant structural changes in the economy will be an important incentive. On the back of these developments, recovery in investment activity in the non-tradable sector could be expected in 2016-2017, although rather weaker than in the tradable sector.

In the forecast horizon, Armenia as a Eurasia Economic Community member will benefit from more private investment flowing into its economy as a result of implementation of a variety of projects to be carried out with EEC member countries and a free access to the EEC markets.

In view of the aforementioned developments with private consumption and investment, in 2015 the private sector expenditures will reduce by 5.2%. Starting from 2016, private spending will gradually recover and in the end of the forecast horizon will increase by 2%-3.0%.

The private spending gap in the period 2015-2017 is estimated to be significantly negative, although the private spending growth on the medium-term path is estimated to be lower in relation to former forecasts.

The expansionary fiscal policy to be implemented in the domestic economy, gradual easing of monetary policy, as well as acceleration of economic growth in Armenia's main trading partner countries will gradually reduce the negative private spending gap and help these imbalances phase out in 2017.

From the 1st quarter 2015 to the 2nd quarter 2016, the **private spending will create some 2.9 pp - 3.1 pp of contractionary impact on the inflation.** In the period from the second half of 2016 up to the end of 2017, the private spending will leave no considerable impact on the inflation.

In the light of developments in the global and domestic economy, the deficit of current account will grow, according to the Central Bank estimates. **In 2014, the growth of export and import of goods and services in real terms is estimated around 6%.** Under recent economic developments in Russia when, among others, the country saw a steep depreciation of the ruble in the 4th quarter, remittances of individuals have reduced by an estimated 9.4%. In the 4th quarter alone, the decrease in remittances amounted to 31.2% y/y. On the back of such developments, the Current Account Deficit-to-GDP ratio in 2014 was an estimated 10.7% against the previous year's 8.0%.

The Current Account Deficit-to GDP ratio will reduce in 2015 as global economy grows slowly and there are new forecasts for Russia's economic decline and weakening of the domestic demand. As the Armenian dram depreciated versus the U.S. dollar in late 2014, there is prediction that the export volumes in real terms would grow in 2015 as opposed to the reduction in

import volumes in real terms. The growth of export of goods and services will be fuelled primarily by increased volumes of export of commodities and export of travel services. ***In 2015, the real growth of export of goods and services will be in the range of 7.0%-9.0%.***

As the domestic demand declines, for ***2015 the reduction in import of goods and services in real terms is expected within 4.0%-6.0%.***

As a result, net external demand will leave a 0.5 pp - 0.7 pp of expansionary effect on the inflation.

In consideration of new forecasts for Russia's economic decline as well as the steep depreciation of the ruble exchange rate during the 4th quarter of 2014, the ***dollar value of net remittances of individuals is expected to diminish by around 30.0%***. It should be noted, however, that the ruble remittances of individuals⁶ will grow in 2015, but their growth rates will slow down afterwards.

The aforementioned developments will drive the Current Account Deficit-to-GDP ratio to decrease in comparison with 2014 to be in the range of 8.5%-9.5% in 2015. It is noteworthy that the current account will keep on improving as the trade balance gets a better shape, despite negative developments with private transfers.

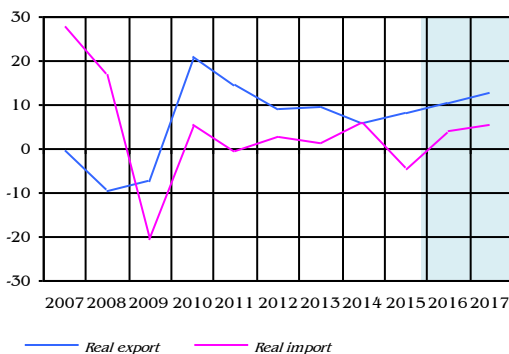
The current account position will continue improving in the medium-term perspective, and the Current Account Deficit-to-GDP ratio will reach a 5.0%-6.0% range.

The ***fiscal policy's impact*** on the aggregate demand for 2015 was assessed using the indicators laid down in the Republic of Armenia Law on State Budget 2015. According to the assessment, the Tax-to-GDP ratio is expected to stay unchanged but the Expenditure-to-GDP ratio⁷ to increase by 1.1 pp in relation to the preliminary indicators of 2014. Moreover, the projected increase of expenditures is due to current expenses. As a result, the Deficit-to-GDP ratio in 2015 will be 2.3%.

In 2015, relative to 2014, the budget revenues are projected to leave a neutral impact and budget expenditures an expansionary impact on the aggregate demand⁸. It is worth mentioning that domestic economic developments will be largely determined by how the state budget will be performed.

The ***projections of the fiscal policy in the forecast horizon*** are based on underlying macroeconomic indicators in the Republic of Armenia Medium-Term Public Expenditures Program, 2015-2017, which is steered to maintaining a budget deficit adequate to sustainable public debt. The fiscal policy's impact in the medium run is estimated to be ***non-inflationary***.

Real export and real import (goods and services), y/y, %



⁶ A larger bulk of private remittances of individuals is in Russian ruble. In 2014, the private remittances in Russian ruble grew by 10.3%.

⁷ The GDP 2015 is the estimation of the Central Bank.

⁸ It is possible for the fiscal policy to have even more expansionary impact as the budget deficit is likely to grow.

Medium-term fiscal policy impact assessment					
% in GDP	2013	2014 ⁹	2015	2016	2017
Budget revenues	24.3	24.3	24.4	23.6	23.7
Budget expenditures	24.5	26.4	26.7	25.4	25.5
Debt interest payment	1.1	1.4	1.5	1.4	1.4
Budget balance	-0.2 ¹⁰	-2.1	-2.3	-1.8	-1.8
Primary balance*	0.9	-0.7	-0.8	-0.4	-0.4
One-off flows**	0.5	-0.7	0.3	0.5	-0.2
Adjusted balance***	0.4	0.0	-1.1	-0.9	-0.2
Cyclical balance****	0.0	0.2	-0.3	-0.2	0.0
Cyclically adjusted primary balance (structural balance sheet)	0.4	-0.2	-0.8	-0.7	-0.2
Fiscal stance*****		0.6	0.6	-0.1	-0.5

* Budget balance less debt interest payments.
** Temporary or one-off budget entries. In this case net credit is considered; the sign "+" means resources allocated and the sign "-" means resources repaid.
*** Primary balance sheet adjusted by temporary or one-off entries.
**** Central Bank estimate: a part of the budget balance which depends directly on the business cycles. The latter's components depend on the GDP gap and revenues and expenditures elasticity coefficients on GDP gap.
***** Central Bank estimate: y/y change in the structural budget balance that reflects a discretionary nature of the fiscal policy (the positive sign denotes fiscal expansion and the negative sign denotes fiscal contraction).

To sum-up, from the 1st quarter 2015 up to the 1st quarter 2016 the combined impact of the fiscal policy sector, private demand and labor market on domestic prices will be deflationary, in the range of 1.9 pp - 2.1 pp, which will be determined by primarily deflationary impact of private spending. Also, given the 0.5-0.7 percentage point inflationary impact of net external demand, one may conclude that the total aggregate demand and labor market developments in the above-mentioned period will create on average 1.3-1.5 percentage point deflationary pressures in the consumer market. Starting from the second half of 2016 up until the end of the forecast horizon, the impact of total aggregate demand and labor market on the inflation is estimated to be neutral.

2.3. Inflation forecasts and monetary policy directions in 3-year forecast horizon

In the 4th quarter of 2014, global economic growth persisted at a slow pace, under which circumstance the world commodity and food product markets saw significant deflationary patterns.

In the 4th quarter of 2014, global economic growth persisted at a slow pace mainly due to the developments in emerging economies, whereas the U.S.A. saw acceleration in their economic activity. This brought about expectations for further interest rate rise by the Federal Reserve System and prompted a capital outflow from developing countries to the U.S.A. thus adding to ***investment risks, slowing economic growth rates and currency devaluation in key developing countries.***

Given the above developments as well as the supply factors and geopolitical issues, the ***basic commodity and food product markets*** are seeing significant deflationary trends contributing, particularly, to adverse economic conditions in Russia and devaluation of currencies of other former Soviet countries.

⁹ The state budget indicators are preliminary and the records of off-budgetary funds are excluded.

¹⁰ The 2013 state budget indicators are represented without off-budgetary funds, and public expenditures are shown as cash flows.

In the forecast horizon, *global economic growth rates are predicted to slow down*, and this will be observed in both developing and developed countries, with the exception of the U.S.A. The developments in the Russian economy with around 2.0% of economic decline anticipated in 2015 are noteworthy. Driven by geopolitical and economic adversities, the slowdown in the Russian economy will carry on throughout 2016, gradually approaching the 1.0% level at the end of the forecast horizon. As global economic growth rates slow down, the *external environment will most likely be non-inflationary*.

The 2014 economic growth is estimated to be in the range of 3.2%-3.5%.

There was some slowing in economic activity during the 4th quarter of 2014 due to lower-than-expected growth in trade volumes. However, the 2014 growth estimation remains almost unchanged: the annual economic growth rate will be **within 3.2%-3.5%**, with agriculture and services sectors remaining the main driving force (their contribution to the growth is 3.2 pp - 3.4 pp).

The impact of developments in global and regional economies had its reflection in the Armenian economy, as reduced flows of foreign currency from the outside world and main trade partners' currency depreciation against the U.S. dollar led to an overvalued Armenian real effective exchange rate, creating depreciation pressures in the domestic foreign exchange market during the 4th quarter of 2014. At the time of significant economic slowdown in Russia and depreciated ruble, the net inflow of private remittances and seasonal worker pays has reduced sharply, resulting in a deep negative gap in remittances. On the back of reduced remittances and weak economic activity, the estimation of private consumption expenditures is notably lower compared to the forecast, under which circumstances the 2014 private consumption expenditures will not change much in relation to the previous year.

Influenced by the above factors, the nominal exchange rate of the Armenian dram reacted in late November to the need to adjust the external equilibrium and achieve new equilibrium for economic fundamentals by posting around 14.0% depreciation in December. The speed at which prices of some products rose because of dram devaluation destabilized the households' inflation expectations, rapidly pushing the demand for goods and foreign currency up and sizably adding to inflationary pressures. This contributed to shaping a positive GDP gap in the 4th quarter, helping the inflation rates recover rather quickly. It should be noted that the year-end inflation was also fuelled by increased prices of a variety of food products, such as dairy products, coffee, tea, cocoa, animal fats and vegetable oils as a result of their labeling during the 4th quarter of 2014.

Prices of some goods increased at a rate that destabilized the households' inflation expectations, rapidly pushing the demand for goods and foreign currency up and sizably adding to inflationary pressures.

To mitigate the inflationary pressures and have the inflation anchored around the target, the Central Bank lifted in late November the Lombard Repo Facility Rate from 8.25 to 21.0% and lifted in mid-December the Reserve Requirement Ratio for funds attracted in foreign currency from 12.0 to 24.0%. As a result, the Lombard Repo Facility Rate has taken, since the yearend, the role of financial market's leading interest rate.

To weather the situation in the domestic financial and commodity markets, including the need to tempering further inflationary pressures and anchoring the inflation expectations around the target, the Central Bank worked out a strong response. Specifically, in late November the Bank raised the *Lombard Repo Facility Rate from 8.25 to 21.0%*; then in mid-December it lifted the *Reserve Requirement Ratio* with regard to funds attracted in foreign currency *from 12.0 to 24.0%*. Note that short-term dram market rates reacted to the Bank's tightening of financial conditions in the financial market by rising

After some signs of stabilization, in late December the Central Bank lowered both the Reserve Requirement Ratio with regard to funds attracted in foreign currency and the Lombard Repo Facility Rate.

and *staying in the time around the Lombard Repo Facility Rate*. In effect, the *Lombard Repo Facility Rate has taken, since the yearend, the role of financial market's leading interest rate*.

Following these actions, the currency and product markets were able to see some signs of stabilization, which is why in late December the Central Bank lowered the **Reserve Requirement Ratio** with regard to funds attracted in foreign currency from **24.0 to 20.0%** and the *Lombard Repo Facility Rate* from **21.0 to 20.0%**. In early 2015, the Lombard Repo Facility Rate was reduced further to **14.5%**, which easily pushed short-term dram market rates down.

At the same time, to moderate future inflationary pressures and have the inflationary expectations anchored around the target, in late December the Central Bank raised the Refinancing Rate by 1.75 pp. In early 2015, the Refinancing Rate was further increased to 10.5%, reflecting upward trends of investment risks and interest rates in developing countries over a longer term.

As for the macroeconomic forecasts of the Central Bank, it should be noted that expected economic decline in Russia and deeper negative effect spillovers onto the domestic economy, as well as low ore mining prices all *served a basis for adjusting Armenia's 2015 economic growth forecast considerably downside*. Therefore, the economic growth is predicted to slow down against 2014 and be in the range of **0.4%-2.0%** in 2015. In the time of sluggish economic activity when the inflow of private remittances is predicted to decrease considerably, the private consumption expenditures, too, will most likely reduce markedly in 2015. Weak investment activity will slacken, reflecting a contraction in investment with companies engaged in construction and non-tradable sector of the economy. This will lead to the shaping of a large negative GDP gap over the first half of 2015, which will diminish gradually thanks to the expansionary fiscal policy expected from the second half of the year, the Government-led projects in the tradable sector, as well as a stage by stage easing of the financial market conditions by the Central Bank. All these measures will facilitate some acceleration of the economic growth in the period 2016-2017 and at the end of the forecast horizon it will be in the range of **2.5%-3.5%**. Yet, economic growth projections in the forecast horizon will largely depend on the size, course and efficiency of the Government's programs. In other words, for a sustainable, long-term economic growth, the programs of the Government need to be tradable sector-oriented thus creating favorable conditions for economic fundamentals and restored external equilibrium.

The economic growth will slow down against 2014 and be in the range of 0.4%-2.0% in 2015.

In the period 2016-2017, the economic growth will accelerate to a certain extent and at the end of the forecast horizon it will be in the range of 2.5%-3.5%.

In the 1st quarter of 2015, the 12-month inflation rate will accelerate but is expected to gradually decline to approach the confidence band amid weak demand in external and domestic economies.

The *inflation developments* suggest that a low base of the same period last year as well as Armenia's membership to the Eurasia Economic Community¹¹ starting from January 2015 will facilitate the *12-month inflation rate to increase*. However, it will gradually decline nearing the confidence band amid weak demand in external and domestic economies.

The Central Bank estimates that, driven by the latest events in the previous year and the geopolitical situation in the region, the developments in product and financial markets of Armenia

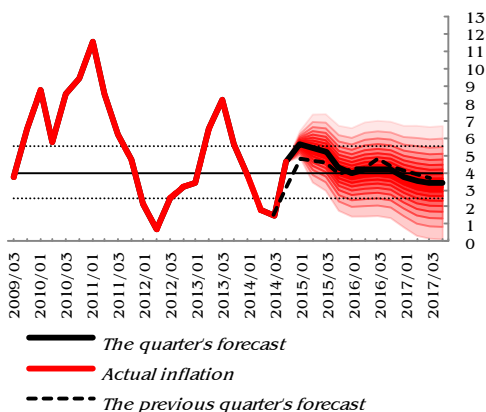
¹¹ Detailed information on the impact of Armenia membership to the Eurasia Economic Community on the inflation in 2015-2017 is available in Q4 2014 Inflation Report (section 2.3 "Inflation forecasts and monetary policy directions in 3-year forecast horizon").

In the 1st quarter of 2015, the Central Bank will continue reducing the Lombard Repo Facility Rate.

are gradually playing out as they incur the impact of the Central Bank policy action for the period December 2014 to February 10, 2015. In this circumstance, the **Central Bank will continue reducing the Lombard Repo Facility Rate during the 1st quarter of 2015.**

As the economy returns to normal conditions, the Central Bank policy actions will reduce the spread between the Bank's policy and short-term dram market rates, **reviving the leading role of the Refinancing Rate in the market** and contributing to the financial market stabilization and fulfillment of the inflation target in the medium term.

Inflation (12-month) forecast probability distribution chart for a 3-year horizon



Period	Inflation forecast probability distribution chart				
	<1.0%	1.0-2.5%	2.5-5.5%	5.5-7.0%	>7.0%
Q1 2015	0.0%	0.0%	37.4%	62.5%	0.1%
Q2	0.0%	0.8%	52.9%	37.3%	9.0%
Q3	0.1%	2.3%	57.5%	31.4%	8.6%
Q4	1.5%	10.8%	67.7%	16.8%	3.3%
Q1 2016	2.7%	14.1%	66.4%	14.1%	2.7%
Q2	2.8%	12.9%	63.1%	16.8%	4.4%
Q3	2.7%	12.4%	62.4%	17.6%	5.0%
Q4	3.2%	13.5%	62.1%	16.6%	4.6%
Q1 2017	6.2%	17.9%	59.4%	13.0%	3.5%
Q2	9.7%	20.3%	54.6%	11.7%	3.6%
Q3	11.2%	21.3%	53.3%	10.9%	3.4%
Q4	11.5%	21.1%	52.7%	11.1%	3.6%

Risks to inflation deviating from the projected central value are estimated as balanced in both short and medium-term perspectives. **Risks deriving from the external sector** are primarily associated with the recovery of world economic growth and economic and geopolitical perspectives in emerging economies (Russia, in particular) and a spillover of their possible effects onto commodities and food product markets. **Risks coming from the domestic economy** are attributable to domestic demand developments, particularly private consumption growth rates, capital investment recovery rates, the Government-led projects, the economic effects from Armenia's membership to the Eurasia Economic Community, and the developments in agriculture sector which is largely reliant on weather conditions. If such risks materialize, the Central Bank will react accordingly by maintaining the inflation target over the medium run.

In the 1st quarter of 2015, credit growth rates will slow down as economic activity declines. However, this will somewhat be compensated by various lending programs as well as a handful of social programs.

In the **forecast horizon**, as the economic activity declines further, there will be less demand for credit resources hence slower credit growth rates. This will somewhat be compensated by various lending programs under a number of international financial institutions (World Bank, Asian Development Bank, KfW Bank, European Investment Bank) carried out through the Central Bank in cooperation with the Armenian Government, and by low-interest loan projects under a handful of social programs (Housing for Youth, the National Mortgage Company). Happily, commercial banks are willing to forgo part of their profits by paying certain costs to leave lending inexpensive. In a longer term, the Central Bank will look to the target level of the policy rate to adequately react to any shifts in liquidity to make sure money supply is consistent with demand.

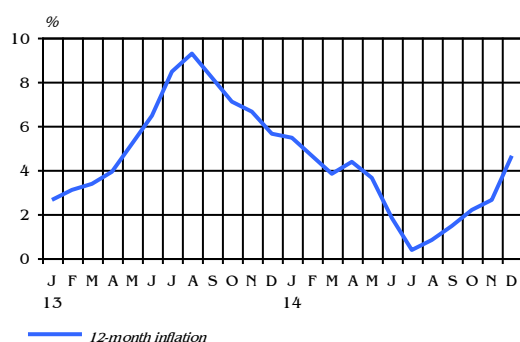
3. ACTUAL DEVELOPMENTS IN Q3 2014

3.1. Inflation

3.1.1. Actual inflation and fulfillment of the inflation target

The 12-month inflation topped the expectations, reaching 4.6% in end-December, stating, however, within the confidence band of 4.0+/-1.5 pp.

Expanding further in Q4 2014, the inflation environment topped expectations in December due to geopolitical and economic developments in the region.



The 4th quarter 2014 monetary policy program predicted that the inflation environment would expand at the end of the year, though it would end up with the 12-month inflation rate below the confidence band.

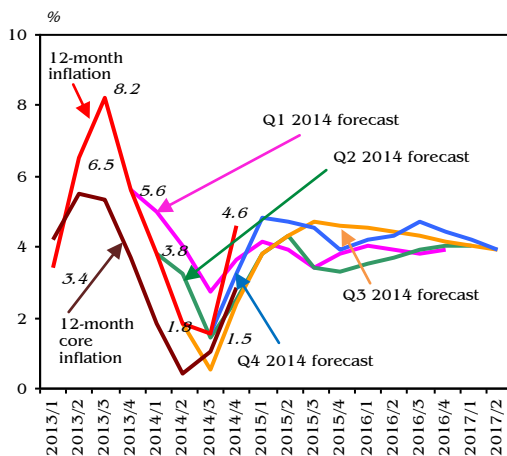
However, as the dram depreciated, the inflation environment expanded and the inflationary expectations were shaped amid dramatic decrease in the foreign currency flows and devaluation of the Russian ruble later the year, the **12-month inflation rate behaved unexpectedly when it reached 4.6% in late December, still within the confidence band of 4.0+/-1.5 pp.** In the reporting quarter, the inflation was 5.4% compared to 2.3% in the same period last year, which was primarily due to a 9.1% increase in food prices with as much as 4.8 pp of contribution to the headline inflation. The yearend's high inflation was a result of increased prices of imported goods, mainly due to an abruptly depreciated dram exchange rate. The prices of bread products, oils and fats and sugar have risen. Note that prices of some food products, such as dairy products, coffee, tea, cocoa have risen as a result of their labeling in November 2014. Price increases on fruits and vegetables as well as egg were mainly of a seasonal nature.

The 12-month inflation by commodity groups as most important contributors						
Commodity group	September 2014 (y/y)		December 2014 (y/y)		Q4 2014	
	Growth	Contribution	Growth	Contribution	Growth	Contribution
CPI	1.5		4.6		5.4	
Food products	1.4	0.8	6.3	3.4	9.1	4.8
Bread products	0.8	0.1	5.9	0.6	5.0	0.5
Dairy products	5.1	0.2	13.1	0.6	8.7	0.4
Meat products	0.6	0.1	3.3	0.3	2.8	0.3
Fruits	5.3	0.2	14.6	0.5	8.2	0.3
Vegetables and potato	1.7	0.1	7.9	0.5	67.3	4.2
Fats and oils	-3.3	-0.1	1.9	0.1	3.1	0.1
Egg	-10.8	-0.1	2.1	0.0	12.6	0.2
Sugar	-6.8	-0.1	6.9	0.1	9.6	0.1
Non-food products	0.9	0.1	1.6	0.3	2.4	0.4
Services	1.8	0.6	3.0	0.9	0.5	0.2

The 4th quarter of 2014 saw **core inflation of about 2.0%**, with the 12-month rate having amounted to **2.8%** in late December.

Arguments and expectations of the Central Bank for a one-year horizon of the previous year, **which covers the year 2014**, pondered that the **inflation would have to continue reducing** to approach the lower bound of the confidence band in the 3rd quarter of 2014 as the impact of energy price increases phased

The Central Bank forecasts of the 12-month inflation rate*



* The low inflationary environment of the past 3 quarters expanded in the 4th quarter of 2014. The Central Bank adjusted the 4th quarter inflation forecast upside whereby the 12-month inflation would step in the confidence band later the year and stay around the 4% target.

out in July 2013. Later in the year, the 12-month inflation rate would have to stabilize within the target due mainly to a lagged effect from loosened monetary conditions and an expansionary fiscal policy implementation and, *in the forecast horizon*, would be staying around the target. In such a situation, *in the 1st quarter of 2014 the Central Bank was planning to continue easing the monetary conditions in response to a sluggish economic activity and moderate inflationary environment, while further monetary policy directions would also be determined by the pace of the fiscal policy implementation.*

The Central Bank was also planning to lower the *dram reserve requirement ratio from 4% to 2%* early in the year, as part of the easing of monetary conditions.

Actual developments showed that over the first three quarters of 2014 the 12-month inflation rate had declined faster than anticipated, mainly reflecting the downside adjustments to demand in both external and domestic sectors. Based on the aforementioned, the Central Bank chose a down-trending path for the inflation in the forecasts for each of the quarters ahead.

In the first three quarters of 2014, there was 0.8% deflation against 3.2% inflation of the same reference period last year. Subdued gradually, the 12-month inflation rate reached 1.5% in late September 2014, stepping below the lower bound of the confidence band. In the first three quarters of 2014, the 12-month inflation continued to decline rapidly due also to sluggish economic growth amidst a low level of investment and slowing private consumption growth rates and a notable decrease in some food prices. In the meantime though, the *12-month core inflation rate* had declined consistently from 3.7% in late 2013 to 1.0% in late September 2014.

In consideration of the effect of energy price inflation on the domestic prices phased out since July of 2014 as well as the expectations of non-inflationary pressures from the external and domestic sectors in the medium run, the Central Bank further loosened the monetary conditions: *in the past nine months of 2014* the refinancing rate was lowered a total of 1.0 pp to 6.75% in late September. Also, the *dram reserve requirement ratio lowered from 4% to 2% in February 2014*, which caused reduction in short-term interest rates in the financial market, was another easing-driven measure. These actions facilitated the falling of short-term financial market rates and are predicted to also foster economic activity in the 4th quarter of 2014 and contribute to the expanding of the inflation environment in the 1st quarter of 2015.

Varied dramatically, the inflationary patterns outstripped the expectations in the 4th quarter of 2014 in the light of escalated geopolitical issues globally and, particularly, at the regional level. On the other hand, the *U.S. economic growth was accelerating and the dollar strengthening* as opposed to other developed and developing countries, which was accompanied by currency depreciation and expanding inflation elsewhere in the world. The effect of these events was first observed in the currency market which reported a steep depreciation of the dram amidst notable reduction of foreign currency transfers from abroad and Russia, the main trade partner to Armenia. This was immediately reflected on the commodity market by

The tension in foreign exchange and commodity markets later the year gave rise to the inflation potential and further inflation expectations, and the Central Bank reacted to the situation by promptly lifting the Lombard Repo Facility Rate and the Reserve Requirement Ratio with regard to funds attracted in foreign currency.

Driven by prudent measures of the Central Bank, as well as when the economy returns to normal, the short-term market rates will reduce gradually to rest around the Refinancing Rate, making it again the leading interest rate in the market.

expanding the inflation environment and creating inflationary expectations. As a result, ***the 12-month inflation rate, expected to amount to 3.2% late in the year, reached 4.6%, staying around the confidence band.***

The Central Bank responded to the situation intensely: in late November the Bank raised the ***Lombard Repo Facility Rate from 8.25 to 21.0%***, followed by a mid-December increase of the ***Reserve Requirement Ratio with regard to funds attracted in foreign currency (from 12.0 to 24.0%)***. The short-term dram market rates reacted to the Bank's tightening of financial conditions in the financial market by rising and staying around the Lombard Repo Facility Rate. As a result, the ***Lombard Repo Facility Rate has taken, since the yearend, the role of financial market's leading interest rate.*** Following these actions, the currency and product markets were able to see some signs of stabilization, which is why in late December the Central Bank lowered the ***Reserve Requirement Ratio with regard to funds attracted in foreign currency from 24.0 to 20.0% and the Lombard Repo Facility Rate from 21.0 to 20.0%***. In early 2015, the Lombard Repo Facility Rate was reduced further to ***14.5%***, which quickly drove short-term dram market rates down.

In the meantime, to moderate future inflationary pressures and have the inflationary expectations anchored around the target, in late December the Central Bank raised the Refinancing Rate by 1.75 pp. In early 2015, the Refinancing Rate was further increased to 10.5%, reflecting upward trends of investment risk and interest rates in developing countries over a longer term.

As the economy returns to normal conditions, the short-term market rates will reduce gradually ***to rest around the Refinancing rate, making it again the leading interest rate in the market.***

3.1.2. Import prices and producer prices

Import prices: in the 4th quarter of 2014, the dollar prices of import of goods and services decreased even faster, by 6.2% q/q, with y/y reduction of 8.9%. The decrement in dollar prices was mainly attributable to the partner countries' currencies having abruptly depreciated against the U.S. dollar during the 4th quarter. Overall, the y/y decrement in dollar prices was driven by 7.0 pp drop in prices of goods and 1.9 pp reduction of service prices (in the 4th quarter, the dollar prices of import of services and import of goods fell by 6.0% q/q and 6.3% q/q, respectively). The decrease in prices of intermediate goods was the main cause for falling dollar prices of import of goods. The quarter saw a decline in prices of all items included in this group.

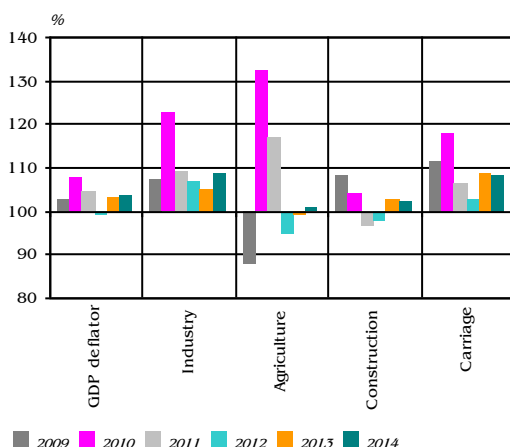
The falling of dollar prices of consumer goods was fuelled by the y/y decrement in dollar prices in Russia, the European Union and Ukraine because of exchange rate depreciation there. As a result, consumer goods had 1.8 pp of negative contribution.

Any deflationary patterns in basic commodity and food product markets in the external sector that could possibly spill over to the relevant markets in Armenia have not been discernable so far.

Producer prices¹²: in the 4th quarter of 2014, all sectors of the economy posted increased price indices, with the GDP

¹²The price index change as of January-December 2014 is relative to the same period of the previous year, unless otherwise specified.

In January-December 2014, the prices were highest in industry and carriage



deflator having reached y/y 103.5 in the period January-December, according to the Central Bank estimates.

Industry posted quarterly price increases of 6% y/y, with the January-December rise having amounted to 8.5% y/y, owing to growths in ore mining (6.6%), processing industry (2.9%) and energy and gas production and distribution (30.4%). Note that the latter is a result of electricity price increase since August 1, 2014.

Agriculture reported a 4% y/y increase in prices¹³ during the 4th quarter, with the January-December price inflation of 0.8%, fuelled by 3.6% y/y price increases in animal breeding. The 4.1% drop of prices in plant growing was due to decreased prices in groups "potato and vegetables" (4.3%), "gourds" (44.4%), and "grains" (11.8%), whereas increased prices in animal breeding were mainly attributable to 10.4% and 7.7% rise in milk and dairy products and egg, respectively.

Construction reported 2.6% y/y price increases during the 4th quarter, with the January-December rise having amounted to 2.1% y/y, mainly attributable to a 13% wage increase in the branch.

Carriage posted 1.6% y/y rise in tariffs during the reporting quarter, with the January-December price increase having amounted to 8% y/y, owing to increased tariffs for railroad transport (14.5%), pipeline transportation (16.9%) and air transport (0.1%). Note that higher pipeline transportation tariffs are mainly due to the increase in energy prices.

3.1.3. Inflation and interest rate expectations

The 4th quarter 2014 surveys of the Central Bank on financial sector and household expectations of selected macroeconomic indicators suggest that inflationary expectations for an upcoming one-year horizon have expanded. Indeed, most banks had their expectations of the 12-month inflation rate anchored around the 5.8% level against an average indicator of 5.0% of the previous survey and credit organizations in the region of 5.4% instead of an average 4.5% level reported formerly.

The results of the survey predict a certain rise in market rates for a one-year horizon, most likely to be seen with regard to interest rates of deposit and loan instruments during the 1st quarter of 2015. Later, the interest rates will follow a steadier path.

3.2. Aggregate supply and Aggregate demand

3.2.1. Aggregate supply¹⁴

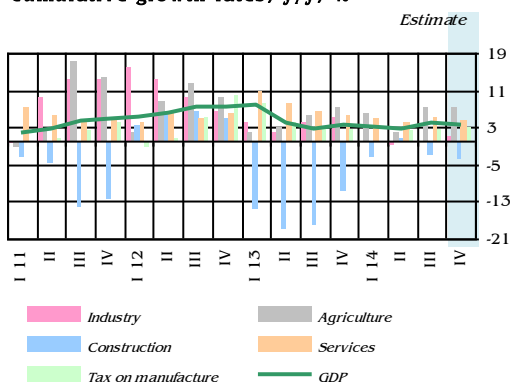
The **economic growth** in the period January-September 2014 has been 3.9% y/y, which is slightly (0.2 pp) higher from the former forecast by the Central Bank.

¹³ Sales prices of producers of agricultural product are presented.

¹⁴ The indicators of real growth of value added in sectors of the economy for January-September 2014 y/y are the Central Bank estimates whereas the indicators of sub-sectors represent y/y growth rates in output volumes for January-September 2014, unless otherwise specified.

The economic growth forecasts for 2014 were much the same: it is expected in the range of 3.2%-3.5%.

Actual real GDP and economic sector cumulative growth rates, y/y, %



In the 4th quarter of 2014, the economic activity slowed down due to reduced trade volumes. Indeed, in the period January-December the economic activity indicator has grown by 3.9% compared to the January-September growth of 4.3% y/y.

The macroeconomic developments were largely in line with the Central Bank forecasts, so the economic growth estimates for 2014 remained unaltered – the growth is expected in the range of 3.2%-3.5%¹⁵.

In **Industry** in 2014, the growth of value added is estimated in the range 0.7-1.2% y/y, mainly due to increased output in *food products* (8.4%)¹⁶, *metallurgy* (10.3%), *tobacco production* (36.5%), and *water supply and sewage* (5%). Acceleration of growth rates in the sector in the 4th quarter is primarily attributable to exploring new export markets and diversified exports. It is worth mentioning that reduced export output to Russia has been offset by strong growth of exports to other world¹⁷.

Based on actual developments in **Construction** reported for 2014, the decline of value added is estimated within 3.5-4.5%. Exclusive of reduced volumes of construction financed by *households* (18.9%), *state budget* (by 13.5%) and *humanitarian aid* (by 23.6%), all other sources of construction financing posted growths, as follows: *organizations* (3.7%), *international credit* (7.5%) and *local community budgets* (61.9%).

In **Services**, the growth of value added in 2014 is estimated in the range of 4.2%-4.7% y/y as a result of volumes of services rendered and trade turnover having increased by 7.8% and 1.6%, respectively. The increase in the volume of services rendered was driven largely by growth in air transport (66.5%), banking services (9%), events, leisure and rest (56%), real estate transactions (9.5%), travel services (9.1%), public catering (9.3%), and information technologies (7.5%), respectively. The trade growth was a result of increased turnover in wholesale trade and passenger car trade, by 5% and 3.9%, respectively. These growths offset the 0.4% decline in retail trade which was determined by reduced real disposable household income as a result of an abruptly narrowed net inflow of private remittances in the 4th quarter.

In **Agriculture**, the growth of value added for 2014 is estimated in the range of 7.3%-7.8% y/y, fostered by increased outputs in animal breeding, plant growing and fishing by 6.9%, 7.8% and 24.6%, respectively. Reported increases in *milk production*, *egg production* and *slaughtered animal and poultry production* by 6.6%, 3.8% and 11.3%, respectively, contributed to the overall growth in *animal breeding*. Similarly, increased production of potato (11%), wheat (7.6%), vegetables (9%), gourds and melons (18.1%) and grapes (8.5%) contributed positively to *plant growing*.

¹⁵ See the 30% probability of Real GDP Growth (Cumulative) Projection Probability Distribution Chart.

¹⁶ Increased output was mainly due to capacity growth in producing meat (13.7%), meat products (15.7%), milk (6.6%), matsoun (33%), sour cream (14.7%), cheese (5.4%), animal fat (2.1-fold), macaroni (9.1%), sugar (28.1%), flour (29.6%), grains (29.7%), confectionery (9.4%), canned food (17.3%) and ice cream (48.8%).

¹⁷ See section 3.4 Balance of payment of this report.

3.2.2. Aggregate demand¹⁸

In the 4th quarter of 2014, the growth of private consumption slowed down and it is estimated that private spending will not change significantly in relation to the previous year.

In the 4th quarter of 2014, the growth of private consumption slowed down to 0.9%, which is somewhat lower from previous forecasts. Under such circumstances, private spending in 2014 will not change significantly in relation to 2013.

Reduced private transfers from Russia adversely affected the level of private consumption by households in the 4th quarter of 2014. This negative impact, however, was somehow diminished thanks to expansionary monetary and fiscal policy implementation. In particular, during the 4th quarter total credit to the economy grew by about 20% y/y and consumer loans, by 23.5% y/y amidst an expansionary monetary policy. The expansionary fiscal impulse amounted to nearly 0.7%.

Further reduction in private remittances from Russia in the 4th quarter of 2014 has significantly diminished the households' disposable income, which, in turn, led to the slowing of the growth rate in private spending on the back of weak growth reported in the 3rd quarter.

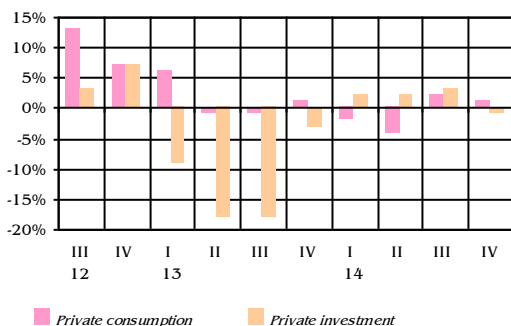
The results of the Central Bank surveys¹⁹ as well as trade turnover and import of goods and services indices, as calculated by the National Statistics Service of Armenia, also point to the above developments with private consumption. Thus, in the 4th quarter of 2014, the Consumer Confidence Index dropped by about 2.0% relative to the same reference period last year and nearly 7.0% compared to the previous quarter. Moreover, the CCI trended down with regard to all components, reflecting a declined consumer spending by households in the reporting period. In the 4th quarter, compared to the same period last year, trade turnover in the economy has decreased by 5.6%, with retail trade having reduced by 7.2% and import of goods and services in dollar terms shrunk by 9.3%.

In the 4th quarter of 2014, the *investment climate* in the economy was weaker than anticipated, under which circumstance the decline in the private investment was an estimated 0.6% in relation to the same period last year. Weak investment climate observable since the start of the year was due to a shrinkage in construction output and sluggish economic activity on the whole. The decrease in remittances from Russia in the 4th quarter led to contracted volumes of household-funded construction, which determined a 0.6% decline in private investment in the same period of time as opposed to the previous quarter's 3.0% increase. The growth of private investment in 2014 is an estimated 1.2%.

With construction output having reduced by 4.3%, the moderate growth in private investment has been due to an increased amount of investment by companies. According to the Central Bank investment surveys²⁰ of Armenian companies, about 50% of companies having invested used the loan funds from local banks as a source of investment in 2014. The expansionary monetary policy of the Central Bank contributed to about 17% growth in credit to companies in various sectors of the economy in 2014.

The growth of private investment in 2014 is an estimated 1.2%.

Private consumption and investment growth, y/y



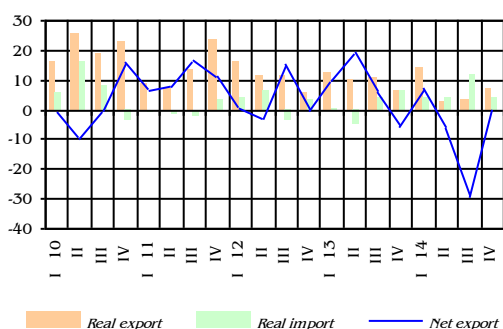
¹⁸ The private spending, private consumption and private investment data for the 4th quarter 2014 are the Central Bank estimates based on actual 3rd quarter 2014 data. Growth estimates in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

¹⁹ See <https://www.cba.am/am/SitePages/statsscci.aspx>.

²⁰ <https://www.cba.am/am/SitePages/statsseabci.aspx>.

Negative balance of net export reduced slightly

(net real exports, y/y, %, positive sign means improvement)



With private consumption and investment developments described above, the growth rate in private spending slowed down to 0.7% in the 4th quarter compared to the previous quarter, which, coupled with a 2.3% increase in public expenditures, pushed the domestic demand up by 1.0% in the reporting period.

The private spending gap in the 4th quarter of 2014 is estimated as negative, which left **1.5 pp - 1.7 pp of contractionary impact** on the inflation.

According to the Central Bank estimates, in the 4th quarter of 2014 the negative balance of net export in real terms somewhat declined in absolute value due to a faster growth of export of goods and services in real terms over the growth of import of goods and services in real terms. The growth rates in export of goods and services in real terms amounted to 7.3% y/y and the growth rates in import of goods and services in real terms, by 3.5% y/y.²¹

In the 4th quarter of 2014, the dollar value of net inflow of non-commercial remittances of individuals via the banking system slowed down by as much as 30.5% y/y (a 10.1% decrease on an annual basis) due to an abrupt depreciation of the Russian ruble against the U.S. dollar.

3.2.3. Labor market²²

In the 4th quarter of 2014, the **average nominal wage growth rate** was in line with the forecast, 9.5%. In the period January-December, the nominal wage has grown by 8.1%. In the meantime, the growth rate in wages of public sector has been slightly faster than the wage growth in the private sector.

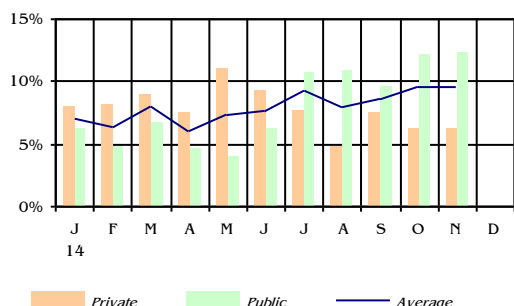
The increase of the wage in some areas of the public sector since July of 2014 pushed the average public sector wage up by 11.3% in the second half of the year, which was a 6 pp increase relative to the first half. As a result, the average annual wage growth was 8.3%.

In the first half of 2014, the average nominal wage growth rate in the private sector was 8.8%. The increase of wages in the private sector in the context of the funded pension reform notably contributed to the nominal wage growth in some companies of the private sector. Note that the minimum wage threshold has been lifted since July 2014.

The aforementioned factors notwithstanding, a relatively weak economic activity persisted over the second half of the year exerted negative pressures on the growth of wages in the private sector (it was 6.5% in the second half of the year). In 2014, the average wage in the private sector rose by 7.6%.

A weak economic activity recorded in 2014 prompted the supply for the labor market to outgrow the demand for that market, with the employment rate posting a small growth of 0.6% against 2.4% growth of economically active population. This trend has been observed since the first quarter and grown deeper in the second half of the year. As a result, in the 4th

Nominal wage growth, y/y



²¹ The real export and import growth indicators are the Central Bank estimates.
²² The labor market data for Q4 2014 are the Central Bank estimates which are based on the 3rd quarter of 2014 data and actual September-November 2014 figures. The growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

quarter of 2014, relative to the same reference period last year, the **unemployment rate** has risen by 1.2 pp to 17.4%. Compared to the previous forecasts, the unemployment rate grew more quickly during the second half and reached 17.5% for the year, which was 1.3 pp higher than the 2013 figure.

In the period under review, there has been a slight increase in productivity in the labor market, while wages have somewhat outgrown the productivity thus adding to unit labor costs in companies. Consequently, increased labor costs have brought in minor inflationary pressures of 0.15 pp - 0.25 pp in the economy over the second half of the year.

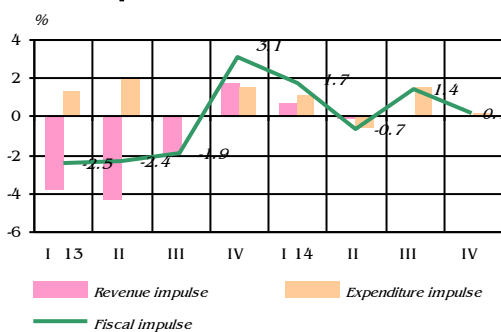
3.2.4. Fiscal policy²⁵

In the 4th quarter of 2014, the State Budget performed with tax revenues under-collected (due to a decline in economic activity) and with more expenditures in comparison with previous quarters. As a result, the fiscal sector's impact on aggregate demand has been neutral instead of projected contractionary: the fiscal impulse indicator was neutral instead of projected 1.2 contractionary mainly due to the deviated revenues impulse. The neutral impact has come with both the revenues and expenditures.

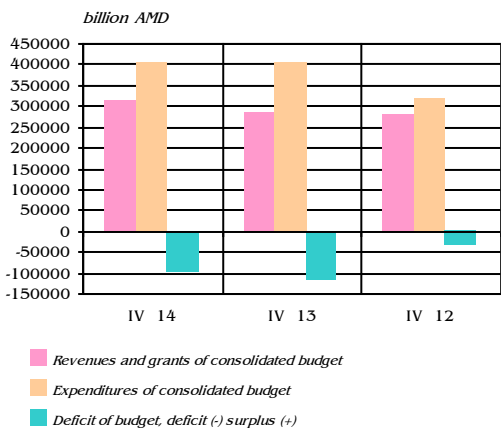
Revenues of the consolidated budget have grown by 10.0% in relation to the 4th quarter of the previous year, with tax revenues having increased by 10.3% y/y. Relative to the 4th quarter of the previous year, indirect tax has grown by 0.2 pp, making up 50.2% of tax revenue, but direct tax has reduced by 4.8 pp to 36.6% of tax revenue. Value added tax has grown by 14% in the indirect tax portfolio but profit tax has reduced by 44.7% in the direct tax portfolio. The y/y increase of indirect tax has been 10.8% and the y/y decrease of direct tax, 2.5%. The share of other tax has grown by 4.6 pp y/y to 13.2% in total tax revenue. As a result, the revenues impulse has been neutral, instead of projected contractionary, which is attributable to tax revenues under-collected as a result of slackened economic activity.

In the 4th quarter of 2014, relative to the 4th quarter last year, total expenditures have grown by 0.8%. However, current expenditures have reduced by 3.7% y/y, with **public consumption** having contracted by 16.4% y/y. The **item "transactions with non-financial assets"** posted a 30.0% increase against the 4th quarter last year. The 4th quarter's spending amounted to roughly 33% of annual expenditures, which exceeded the figure of quarterly planning (part of expenditure savings of previous quarters was used for spending this quarter). The 43.4% y/y growth of capital expenditures funded by external sources has been a remarkable posting in the item "transactions with non-financial assets". In the 4th quarter, public expenditures (including net lending) had a neutral effect on aggregate demand, which is consistent with the projection.

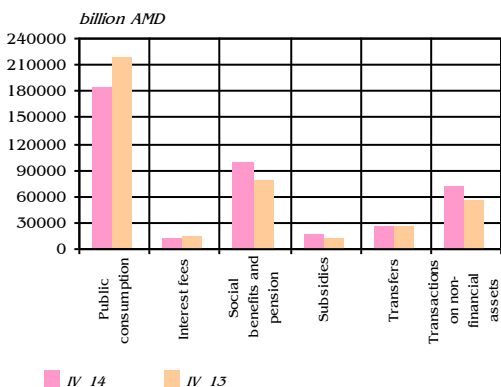
In the 4th quarter, the fiscal policy had a neutral impact



Consolidated budget indicators

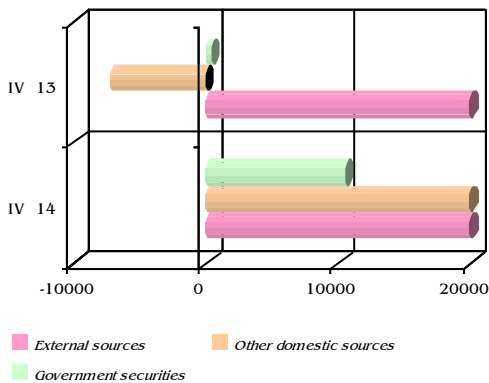


In the 4th quarter, budget expenditures posted a decrease in public consumption and public debt interest



²⁵ The review of the fiscal sector was done using the preliminary actual consolidated budget indicators prepared on the basis of the preliminary actual indicators of the 4th quarter of 2014 (PIU funds included), excluding off-budgetary funds. The impact of revenues was calculated in respect of the nominal GDP indicator while the impact of expenditures in respect of the estimated potential GDP indicator.

The 4th quarter saw the largest budget deficit (billion AMD)



In 2014, the fiscal policy had a 0.65 expansionary impact on the aggregate demand.

With revenues and expenditures figures in the 4th quarter of 2014, the budget reported a deficit of AMD 87.5 billion. Around 40.0% of the deficit has been funded by domestic sources and 60.0%, by external sources.

Based on the results of the *year 2014²⁴*, the state budget generated revenues totaled AMD 1103.4 billion, which is 4.2% less from the adjusted projection²⁵. Tax revenue amounted to AMD 1062.8 billion, which secured the *Tax-to-GDP ratio's 23.4% performance* projected for 2014. Relative to the same reference period of last year, tax revenue has grown by 6.3% or AMD 63.4 billion due mostly to increased value added tax and income tax. Relative to the same reference period last year, public expenditures (PIU funds included) have grown by 7.9%. Based on the results of the year 2014, the state budget deficit totaled AMD 93.2 billion.

Based on the results of the year 2014, the fiscal policy has left a 0.65 expansionary impact on aggregate demand as the revenues created neutral pressures and the expenditures, expansionary pressures.

Summary: reduced private transfers from Russia, declined construction output and sluggish investment activity all exerted negative pressures on spending in the domestic private sector in the 4th quarter of 2014. These pressures, however, have been diminished considerably by expansionary monetary and fiscal policies implemented during the year, which in its turn mitigated the domestic economy's slowdown and the deflationary environment.

In the 4th quarter of 2014, the private spending gap is estimated to be negative. Given also the behavior of the labor market and public expenditures, it is estimated that the above factors combined have created 0.7 pp - 0.8 pp of deflationary pressures in the consumer market in the period under review.

3.3. Money and financial market developments

3.3.1. Financial market, money and credit

In the 4th quarter of 2014, the Central Bank had its monetary policy directions steered for the fulfillment of the inflation target while weathering the tension in the domestic financial and currency markets driven by the global economy and developments at the regional level. The policy adjustment went along with an active use of monetary instruments and frequent public statements.

The fundamentals of the Armenian economy necessitated correction in the exchange rate of the domestic currency, and in

In the 4th quarter, the Central Bank fine-tuned the monetary policy directions aimed at the fulfillment of the inflation target while weathering the tension in the domestic financial and currency markets driven by the global economy and developments in the region. The policy adjustment went in line with an active use of monetary instruments and frequent public statements.

²⁴ Records of off-budgetary funds are excluded.

²⁵ I.e., the quarterly adjusted plans of the Government of Armenia.

Since end-November, the Central Bank has twice increased the Lombard Repo Facility rate up to 21%.

For the first time in recent years, the reserve requirement mechanism was used as a monetary policy instrument to regulate the liquidity by raising the reserve requirement ratio with regard to funds attracted in foreign currency from 12% to 24%.

late November the dram exchange rate was depreciated to adjust. The Central Bank and financial market participants evaluated and the Central Bank announced that the domestic exchange rate had been adjusted and it's been on the path to stabilization. However, deteriorating economic situation in Russia in early December brought in new depreciation pressures and exchange rate volatility. This prompted the Central Bank to issue another statement saying that these phenomena are short-term in nature, and the Central Bank reserves are sufficient to prevent all kinds of artificial exchange rate fluctuations and maintain the financial stability. ***To this end, the Central Bank successfully handled the dram liquidity at the time by raising the Lombard Repo Facility rate a total of two times up to 21%.***

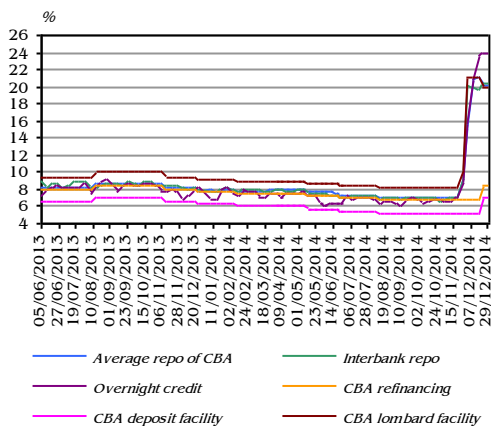
There were further expectations for dram depreciation as pressures coming from the Russian financial market intensified. To handle the situation, smooth out the exchange rate fluctuations and go back to the balance in the foreign exchange market, the Central Bank took a new approach to selling foreign currency through daily currency auctions, using the preannounced highest lots. The information on the results of currency auction was published on a daily basis. In an effort to lessen the impact of the Central Bank on the dram exchange rate, the planned daily intervention volumes were reduced phase by phase to return to an acceptable level for the exchange rate. It should also be noted that, ***for the first time in recent years, the Central Bank used the reserve requirement mechanism as a monetary policy tool for handling the liquidity by raising the reserve requirement ratio for funds attracted in foreign currency from 12% to 24%.*** To satisfy the demand for the U.S. dollar, the Central Bank announced and carried out foreign currency swap attraction and allocation transactions.

These measures brought some stabilization in the currency market, and ***in late December the Board of the Central Bank decided to lower the Reserve Requirement Ratio with regard to funds attracted in foreign currency from 24.0% to 20.0% and the Lombard Repo Facility Rate from 21.0% to 20.0%.*** At the same time, to have the inflationary expectations anchored around the target, the Central Bank lifted the Refinancing Rate by 1.75 pp to 8.5%.

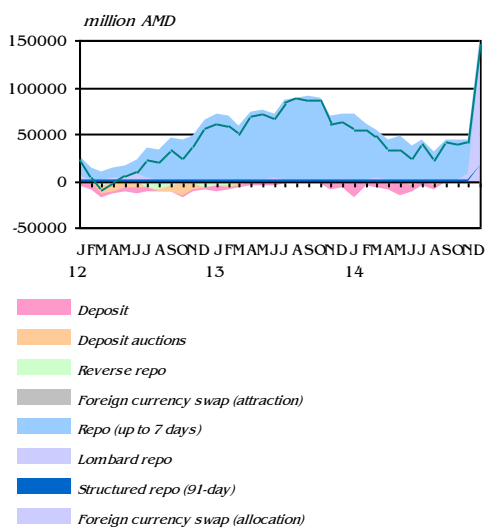
In early 2015, the Lombard Repo Facility Rate was reduced further to 14.5%. Lowered by a total of 5.5 pp, the above policy rate of the Central Bank pushed short-term dram market rates down. In the meantime, basing upon the forecasts of the inflation environment, the Central Bank kept on increasing the Refinancing Rate by a total of 2 pp to 10.5%.

During the quarter, the ***7-day Repo Rate***, the main policy instrument of the Central Bank, trended upward on the back of contracting dram liquidity in the banking sector since late November, drifting around the Lombard Repo Facility Rate. As a result, the average December rate has grown by 13.6 pp against September and amounted to 20.61%. The average quarterly growth of the rate was 3.44 pp.

Short-term interest rates grew during the quarter



Operations carried out by the Central Bank (average monthly volume)

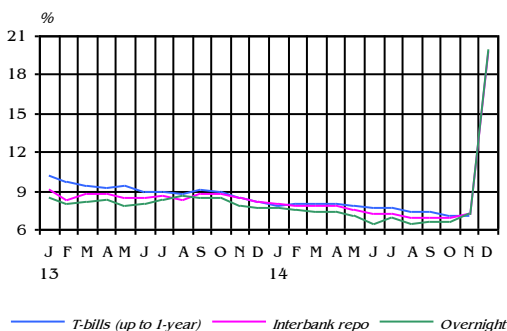


Operations carried out by the Central Bank (average value)						
Period	Repo (up to 7 days)		Funds attracted		Lombard repo	
	Value (million AMD)	Weighted average %	Value (million AMD)	Weighted average %	Value (million AMD)	Weighted average %
Q1 2013	63652.16	8.09	2518.46	6.50	14.53	9.50
Q2	71467.51	8.19	2712.31	6.50	45.74	9.50
Q3	86238.94	8.42	2712.31	6.75	20.30	9.50
Q4	76070.53	8.31	6035.38	6.71	7.69	10.0
Q1 2014	58769.52	7.80	8230.77	6.17	297.76	9.05
Q2	41619.24	7.79	9908.46	5.88	41.38	8.75
Q3	37331.05	7.16	3270.00	5.47	16.08	8.43
Q4	34048.94	10.60	1765.67	5.25	41550.14	19.69

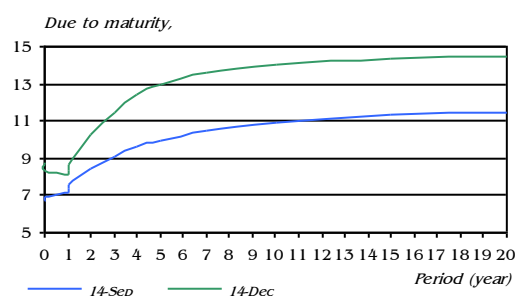
The situation in the financial market in the 4th quarter of 2014 – the depreciated dram exchange rate, raised interest rates of the monetary policy instruments by the Central Bank, reduced liquidity in the banking sector as a result of an adjusted reserve requirement ratio – would have to lead inevitably to an abrupt rise of short-term dram market rates. Thus, the average quarterly overnight loan rate has grown by 1.88 pp to 8.54% in relation to the previous quarter, while the average rate for December amounted to 20.07%. The average quarterly rate in interbank repo market has risen by 1.46 pp against the previous quarter, and the average December rate has grown by 12.94 pp to 19.89% in relation to the average September rate.

During the quarter, short-term interest rates trended upward

Box 2



In the T-bills market in the 4th quarter, interest rates rose



Government securities market

The yields of government bonds reacted to a sharp increase in short-term interest rates in late November of 2014. However, the Armenian Ministry of Finance decided to withhold from placement of short-term bills in December. As a result, the average quarterly yield has dipped by 0.36 pp to 7.09% in relation to the previous quarter. The average yield of mid-term notes and long-term bonds has increased in December by more than 2 pp relative to September.

According to yield to maturity curve, interest rates in the secondary market of government securities have grown all along the curve. In the long-term segment, the interest rate rose in late December by around 3.0 pp to 14.42% against September. The long-term and short-term interest rates spread widened in December by 0.88 pp to 5.64 pp in relation to September.

A sharply increased demand for foreign currency in December of 2014 provoked a change in the structure deposits as part of dram deposits and time deposits in foreign currency was converted into demand deposits in foreign currency.

In December, the average monthly dram deposit rate was 11.9%, up by 0.2 pp compared to September. The average foreign currency deposit rate was 8.2% in December, up by 1.3 pp against September, with average quarterly interest rate having grown by 0.2 pp to 7.2% in relation to the previous quarter. During the quarter, the volume of dram deposits shrank by 7.4%, primarily attributable to dram demand deposits having diminished by 11.3%, whereas dram time deposits decreased by 4.8%. The volume of dram deposits is predicted to recover in 2015 in the event the interest rates of dram deposits rise.

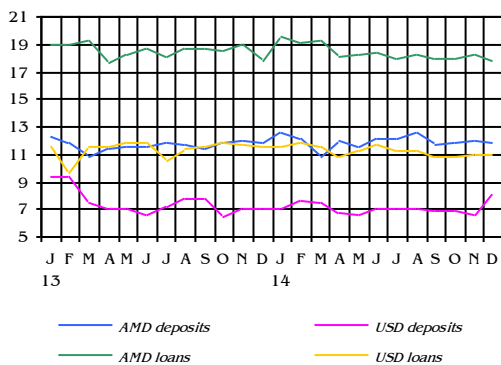
The volume of foreign currency deposits grew by 17.2% during the quarter due primarily to an increased volume of demand deposits. If the exchange rate depreciation in the 4th quarter is excluded, the volumes of deposits remained virtually unchanged – the growth of demand deposits was concomitant with reducing volume of time deposits.

In the period under review, interest rates of dram loans extended to both households and non-financial corporations for a period over 1 year trended downward: the average quarterly interest rate of loans in dram has fallen by 0.1 pp to 18.0% in relation to the previous quarter.

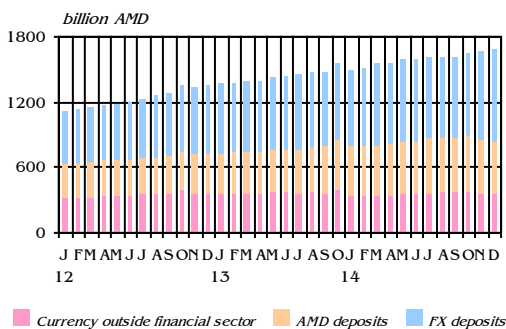
In the 4th quarter of 2014, foreign currency lending rates dropped as well, with average quarterly interest rate having dipped by 0.2 pp to 10.9%.

The value of loans in both foreign currency and local currency has grown by 17.8% and 2.7%, respectively. The loans in foreign currency still prevailed in the total loan portfolio, making up about 60% of it. The growth of total loan value during the quarter was 11.7% (21.0% y/y) or AMD 241.7 billion in absolute terms. Given the exchange rate is constant relative to the 3rd quarter, the value of loans in foreign currency has grown by 1.0% and total lending volumes, by 1.8%. The quarterly growth of loans in dram amounted to 2.73%.

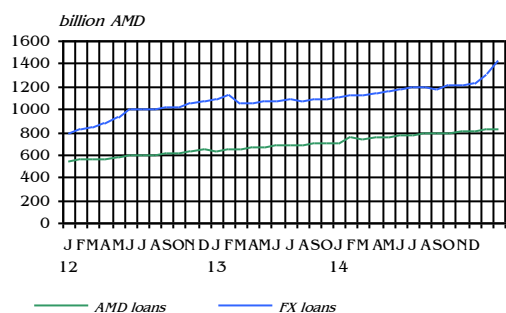
Interest rates of funds in domestic currency and foreign currency



In the 4th quarter, growth of foreign currency deposits outpaced the growth of dram deposits



In the 4th quarter, FX loans again outnumbered in total lending portfolio



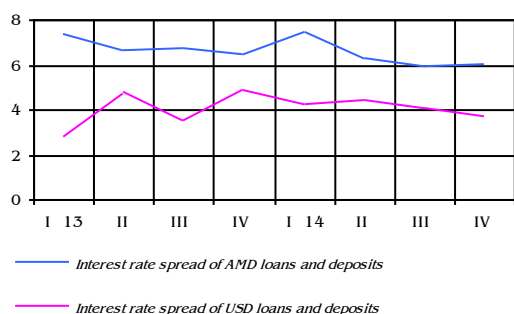
Box 3

The results of Q4 2014 survey on terms of lending by Armenian banks and credit organizations suggest that the terms of lending came in much tightened. The factors in support of the tightening included restricted liquidity, borrower creditworthiness, accessibility to the money markets, slowing of the economic activity.

During the 4th quarter, one could see the demand growing for consumer loans, staying unchanged for mortgage loans and declining for business loans, with the planned low level of capital investment as the principal factor for the decline.

The terms of lending will continue to be tightened during the 4th quarter with regard to all types of loan products. The demand for business loans and consumer loans is expected to somewhat grow while the demand for mortgage loans will be more or less the same.

In the 4th quarter, the spread of interest rates of foreign currency loans and deposits narrowed



The narrowing spread of interest rates of loans and deposits in foreign currency remained a trend during the 4th quarter of 2014. The average quarterly indicator of spread has reduced by 0.4 pp to 3.7% relative to the previous quarter. On the contrary, the spread of interest rates of loans and deposits in the Armenian dram has grown by 0.1 pp to 6.05%. In December, against September, the spread had narrowed by 0.3 pp to 5.9%.

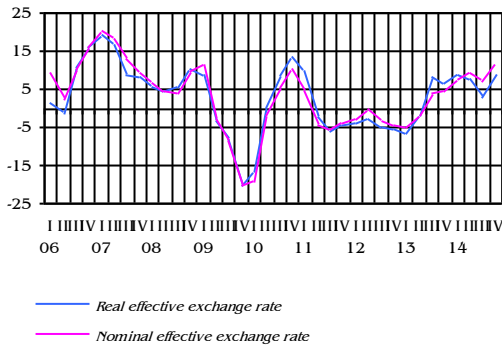
The Armenian dram depreciating during the quarter reflected the indicator of dollarization (the Foreign Currency Deposits-to-Broad Money ratio) which posted a 5.42 pp increase in relation to the previous quarter.

Monetary indicators	March, 12-month growth	June, 12-month growth	September, 12-month growth	December, 12-month growth
Broad money (%)	12.84	14.78	9.64	8.34
Dram broad money (%)	10.92	14.26	14.15	-3.51
Base money (%)	20.84	8.21	-0.52	-0.15
Dram base money (%)	1.67	4.49	0.63	15.65
Currency (%)	-4.49	-1.19	1.44	-9.39
Deposits in local currency (%)	25.27	28.59	25.31	1.37
Deposits in foreign currency (%)	14.95	15.36	4.71	22.74
Dollarization (percentage point)	0.89	0.24	-2.15	6.0
Money multiplier (percentage point)	-0.14	0.13	0.21	0.15
Dram multiplier (percentage point)	0.12	0.12	0.17	-0.22

3.3.2. Exchange rate

In the 4th quarter of 2014, trade partner countries' average nominal weighted exchange rate depreciated even faster against the US dollar. There was 9.9% depreciation q/q, of which 5.6 pp alone was fuelled by the Russian ruble as its average nominal exchange rate had abruptly depreciated by 31.5% relative to the 3rd quarter. Under the currency depreciation pressures in partner countries, the nominal exchange rate of the Armenian dram bore the impact of above-mentioned developments in November, as a result of providing external balance, making it to soon post high depreciation rates in December when the exchange rate plunged by 11.8% against September. Meanwhile, the Central Bank acted as a net seller of foreign currency in the foreign exchange market to finance the current account as well as mitigate depreciation and inflation expectations. Overall, the Central Bank injected around USD 212.5 million in the market during the quarter.

In the 4th quarter, real effective exchange rate appreciated rather quickly, y/y, %



Influenced by dramatic currency depreciation in trade partner countries, the nominal effective exchange rate of the Armenian dram has appreciated by 4.2% q/q and the real effective exchange rate²⁶, by 6.0% q/q during the quarter. The real exchange rate appreciation speeded up to 9.3%, which was largely attributable to the average nominal weighted exchange rate highly depreciated in trade partner countries (the Russian ruble's depreciation is considerable).

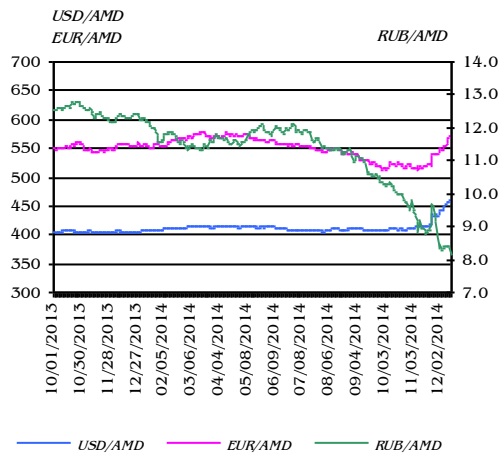
y/y growth, %	Q1, 2013	Q2	Q3	Q4	Q1, 2014	Q2	Q3	Q4
Real effective exchange rate (+ means appreciation)	-6.4	-1.6	7.9	6.8	8.5	7.9	3.1	9.3
Average inflation in Armenia	3.0	5.2	8.7	6.4	4.6	3.3	1.0	3.2
AMD/USD average nominal exchange rate (+ means appreciation)	-5.1	-3.3	0.5	0.2	-0.4	0.5	0.0	-6.0
Average weighted inflation in trade partner countries	4.5	4.4	4.3	4.0	3.7	4.4	4.6	5.1
Trade partner countries' average weighted nominal exchange rate (+ means appreciation versus dollar)	-0.4	-1.1	-3.2	-4.3	-8.0	-8.7	-7.0	-18.7

Real exchange rate appreciation = Inflation in Armenia + Nominal exchange rate appreciation – Trade partner countries' average weighted inflation – Trade partner countries' average nominal weighted exchange rate appreciation.

Box 4

Foreign exchange market

Dram exchange rate versus US dollar, Euro and Russian ruble



As of end Q4 2014, the average market exchange rate of AMD/USD was 474.97, having depreciated by 14.8% against the previous quarter.

The table below shows the Armenian dram's behavior versus the U.S. dollar, Euro and Russian ruble during the 4th quarter of 2014:

The dram exchange rate, q/q			
Currency pair	Exchange rate as of 30.09.2014 (AMD)	Exchange rate as of 30.12.2014 (AMD)	% (appreciation +, depreciation -)
USD/AMD	407.6	474.97	-14.18
EUR/AMD	513.49	577.47	-11.08
RUB/AMD	10.32	8.15	26.63
The dram average exchange rate, y/y			
Currency pair	Average exchange rate, Q4, 2013	Average exchange rate, Q4, 2014	% (appreciation +, depreciation -)
USD/AMD	405.48	431.32	-5.99
EUR/AMD	552.11	538.14	2.60
RUB/AMD	12.46	9.11	36.72

The aggregate volume of U.S. dollar/Armenian dram transactions in the foreign exchange market during the 4th quarter amounted to USD 3.43 billion, which represents a 16.3% increase in relation to USD 2.95 billion reported in the previous quarter.

The aggregate volume of Euro/Armenian dram transactions reached EUR 304.98 million against EUR 276.28 million recorded in the previous quarter.

During the 4th quarter, the Central Bank sold U.S. dollars in the currency market for a total of USD 212.54 million.

²⁶ The 4th quarter 2014 indicator of the real exchange rate is the Central Bank estimate.

3.4. Balance of payments²⁷

In the 4th quarter of 2014, the dollar value of private transfers decreased significantly, which was determined by steep depreciation of the Russian ruble against the U.S. dollar. Consequently, the current account deficit widened despite a decreased trade balance deficit. The current account deficit was financed through net attraction of loans by the public sector, net foreign direct investment and net assets provided by the banking system. Given net accumulation of foreign currency with the non-bank private sector²⁸, the current account financing led to a decrease in net foreign assets of the Central Bank in the 4th quarter.

3.4.1. Current account

In the 4th quarter of 2014, relative to the same quarter last year, the Current Account Deficit-to-GDP ratio has increased by around 4.0 pp and, based on the 2014 estimations, reached 10.7%. In the 4th quarter of 2014, relative to the same reference period, the current account deficit has grown by USD 138.6 million to USD 358.2 million.

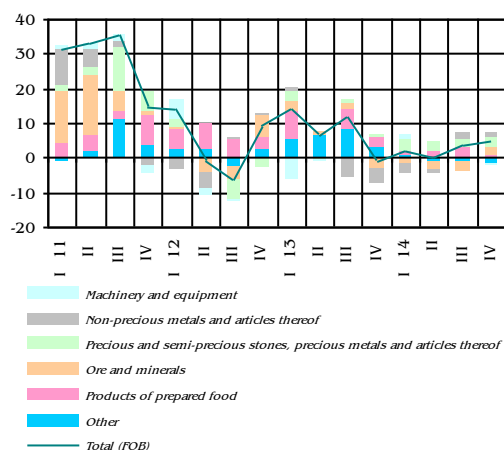
In the 4th quarter of 2014, the dollar value of export of goods grew by 5.7% y/y. Intermediate goods, precious stones and metals, which are largely reliant on price developments in international markets, made a positive contribution to the export growth in contrast to consumer and investment goods which had contributed negatively due to the slowing of economic activity in main trade partner countries.

In the 4th quarter of 2014, the dollar value of import of goods decreased by 9.0% y/y primarily due to a declined values of import of nearly all commodity groups (some small-share commodity groups made a positive contribution, though).

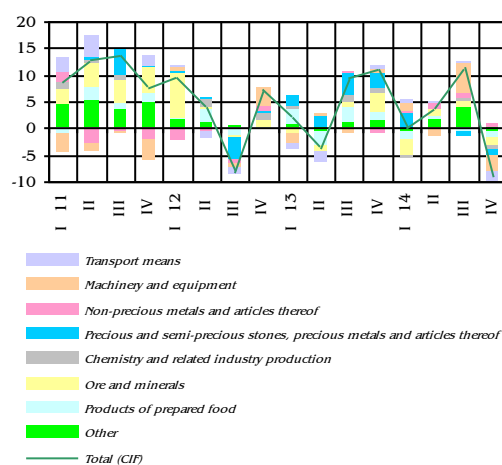
With improved terms of trade³⁰ as well as the real export volumes having outgrown the real import volumes, the trade balance deficit reduced by USD 127.3 million and amounted to USD 573.3 million in the 4th quarter.

In the 4th quarter of 2014, relative to the same quarter last year, the negative balance of services has widened to USD 81.0 million. This was determined mainly by an increased negative balance of travel and contracted positive balance of construction services³¹. The latter reflects the impact of Russia's economic difficulties. As a result, there is an estimated 2.5% y/y decrease in the export of services and 2.2% y/y increase in the import of services for the quarter.

Change in dollar value of export of goods y/y and main commodities contribution, %²⁹



Change in dollar value of import of goods y/y and main commodities contribution, %



²⁷ The 4th quarter 2014 figures are the Central Bank forecasts and estimates.

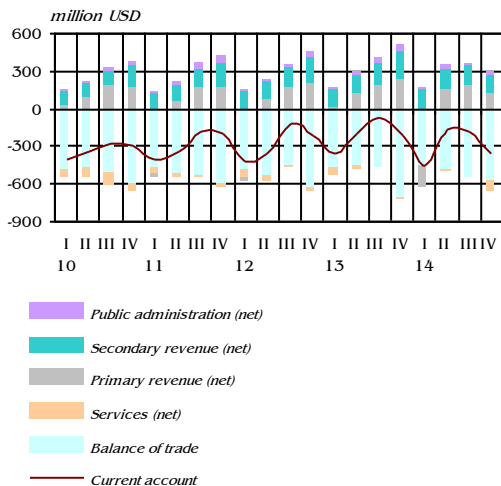
²⁸ Huge amounts of foreign currency purchased by the private sector but undersold in expectations for the dram exchange rate depreciation during the 4th quarter resulted in net accumulation of foreign currency with the sector.

²⁹ The export and import indicators by commodity and by country are in FOB and CIF prices, and export and import of the current account, by credit and debit, respectively.

³⁰ The y/y decrease in dollar prices of import has outpaced the y/y decrease in dollar prices of export.

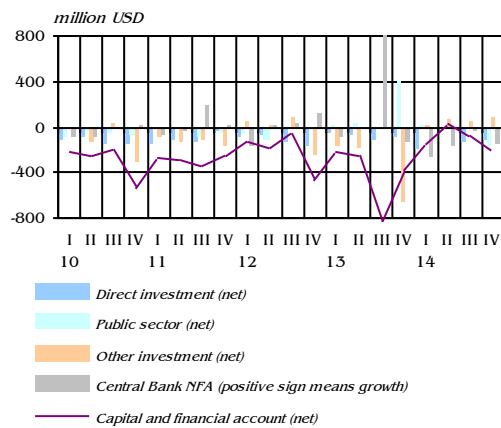
³¹ This includes the dollar value of construction services provided by seasonal workers.

In the 4th quarter, current account deficit grew, y/y



In the 4th quarter, the capital and financial account posted a reduced net inflow of funds

(+ net credit, - net borrowing)



In the 4th quarter of 2014, net remittances of individuals³² reduced notably amidst an abrupt depreciation of the Russian ruble against the U.S. dollar. The net inflow through item "Compensation of employees" posted a 29.1% y/y decrease to USD 276.3 million, which is, however, higher from the figure of net outflow through item "Income on investment". As a result, item "Primary income" posted net inflow of USD 117.6 million. The net inflow of private transfers has reduced by 34.6% y/y to USD 150.9 million.

3.4.2. Capital and financial account³³

The 4th quarter of 2014 reported net inflow of USD 208.6 million worth of funds through the capital and financial account in comparison with net inflow of USD 371.3 million in the same quarter last year. The current account deficit was financed by the public sector loans, foreign direct investment and assets provided by the banking system. With net accumulation of foreign currency with the non-bank private sector, the current account financing diminished net foreign assets of the Central Bank by USD 149.6 million.

In the 4th quarter, capital transfers reduced, amounting to USD 17.8 million (compared to USD 24.8 million recorded in the same reference period last year).

During the quarter, net inflow of foreign direct investment amounted to USD 116.4 million. Net inflow of public loans reached USD 169.0 million compared to net outflow of USD 392.0 million reported for the 4th quarter last year (due to a repaid debt to Russia).

The private sector posted a net outflow of funds or net accumulation of foreign currency funds amounting to USD 87.3 million as opposed to the net inflow of USD 660.0 million recorded in the 4th quarter last year. This includes the commercial banks' posting of net inflow in the amount of USD 94.0 million in contrast to other private sector's net outflow of USD 181.3 million, which reflects the effect of foreign currency assets accumulated with the private sector late in the 4th quarter in anticipation of further dram depreciation driven by external factors.

3.5. External environment

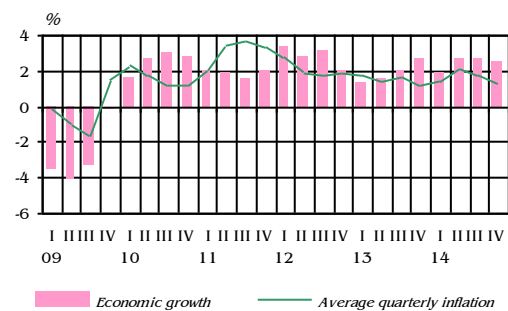
In the 4th quarter of 2014, Armenia's main trade partner countries saw trends of slowing economic activity.

In the 4th quarter of 2014, trends of slowing economic activity were observable in Armenia's main trade partner countries.

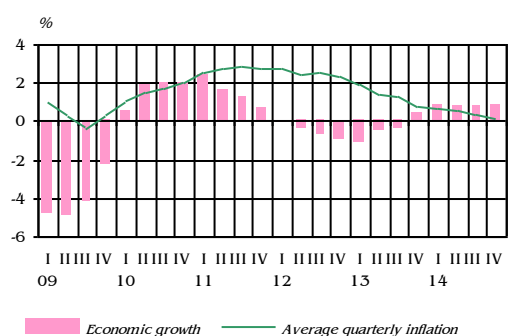
³² The 4th quarter of 2014 saw as much as 30.5% y/y reduction in net inflow of non-commercial transfers of individuals via the banking system.

³³ The 4th quarter 2014 capital and financial account figures are the Central Bank forecasts and estimates.

In the 4th quarter, economic growth in U.S.A. somewhat slowed



In the 4th quarter, economic growth in Euro-area remained slow



According to preliminary estimates of the U.S. Department of Commerce Bureau of Economic Analyses, *in the United States of America in the 4th quarter of 2014* the annualized economic growth was 2.6% q/q (2.5% y/y economic growth in the 4th quarter). Note that the slowing of the growth against the previous quarter (5.0% q/q growth annualized) was driven mostly by grown imports, reduced public expenditures and slowed down investment and exports, which was only partly offset by positive shifts in private spending and private investment in inventories.

In the 4th quarter of 2014, average quarterly inflation in the U.S.A. was 1.3% y/y compared to 1.8% reported in the previous quarter. Later the year, the inflation was 0.8%. As it was scheduled, the quantitative easing program of the U.S. Fed ended in October, while the policy rates were still low, in the range 0-0.25%.

In Euro-area in the 4th quarter of 2014, there was 0.9% economic growth against the same period last year, according to preliminary estimates provided by the Eurostat. During the quarter, the consumer price index posted an average 0.2% y/y rise against the previous quarter's 0.4%. It is noteworthy that by the end of the year the Euro-area saw a 0.2% deflation.

In the 4th quarter of 2014, the European Central Bank kept the policy rate at 0.05% and the deposit facility rate at -0.2% levels. At the same time, the ECB launched the purchases of asset-backed securities and covered bonds in the context of a quantitative easing program.

In the 4th quarter of 2014, Euro depreciated versus the U.S. dollar by 5.7% (y/y depreciation was 8.23%), with the average dollar exchange rate reaching 1.249 for one Euro.

In Russia in the 4th quarter of 2014, economic growth was 0.6% y/y³⁴, according to the preliminary estimates of the Russia State Statistics Service. Based on annual results, positive developments were reported in processing industry (2.5% growth) and agriculture (1.4% growth), whereas construction reported a 5.2% decline. In the meanwhile, private consumption slowed down to 1.5% compared to the previous year's 3.5% growth and aggregate investment kept on reducing to 5.7% against the previous year's decline of 6.6%. Consumer Price Index posted an average 9.6% y/y growth (compared to a 7.7% growth last quarter) on the back of as much as 31.7% y/y depreciation of the ruble in the 4th quarter of 2014. Later the year, the inflation in Russia was 11.4% which expanded in January of 2015, reaching some 15%.

In the 4th quarter of 2014, the *price of Brent crude* at Intercontinental Exchange plunged by as much as 25.6% against the previous quarter, to USD 76.0 a barrel (with 30.5% y/y decrease), amidst increased U.S. extraction volumes and relevant anticipations in the financial markets. Later the year, the international oil price sank to USD 55.3 a barrel.

In the 4th quarter of 2014, the *price of copper* at the London Metal Exchange fell by 5.8% (with 8.3% decline y/y) to USD 6572 per ton on average. The drop in the price was explained by

³⁴ The 4th quarter 2014 data have not been released yet.

More-than-expected deflationary trends were observable in world commodities markets during the 4th quarter, which was determined by the developments typical to individual commodity markets as well as over-reacting to market expectations.

the slowing of demand in China on the one hand and the effects of appreciating U.S. dollar on the other.

In the 4th quarter of 2014, export price of **hard red wheat** dropped by 1.8% q/q to USD 7.0 a bushel (with 16.2% decrease y/y), according to the U.S. Department of Agriculture data. This slight decrease in wheat prices during the quarter in anticipation of abundant crops was primarily attributable to the market which is wary of possible limitations to the exporting of wheat in the light of geopolitical developments in Russia at the end of the year.

In the 4th quarter of 2014, the price index of **unprocessed sugar** at the New York Board-Intercontinental Exchange reported a 0.7% decrease (with 10.6% decline y/y), mostly driven by various expectations in the market for weather conditions and production capacities in Brazils during the quarter. Similarly, the price of **rice** at the Chicago Board of Trade fell by 3.9% to USD 12.4 per U.S. hundredweight (45.4 kg) (with 20.1% decline y/y).

There were even deeper deflationary trends observable in world commodities markets during the 4th quarter, which was determined mainly by the developments typical to individual commodity markets as well as over-reacting to market expectations.

4. CONCLUSION

In the *external sector* in the 4th quarter of 2014, the *external demand* remained sluggish and more-than-expected deflationary patterns were observable in *basic commodity and food markets of the world*. *In the forecast horizon, no considerable inflationary pressures* in basic commodity and food markets of the world *are anticipated*.

In the 4th quarter of 2014, the *economic activity* slowed down as trade volumes shrank, under which circumstance the *economic growth* in 2014 is estimated in the range of *3.2%-3.5%*.

In the forecast horizon, the economic growth will gradually approach its long-term equilibrium as real private consumption growth rates are expected to speed up and private investment to rebound slowly. *In the forecast horizon*, the *impact of the domestic economy on aggregate demand will be non-inflationary* as a result of stabilizing private demand as well as mostly a neutral impact of the fiscal policy.

The Armenian dram exchange rate depreciated and the inflation environment expanded at yearend under influence of an abrupt reduction in foreign currency flows and devaluated Russian ruble drove the *12-month inflation rate up to 4.6% in late December, staying within the confidence band*.

In the forecast horizon, the inflation will stabilize around the 4% target. *According to the Central Bank forecasts*, determined by low base of the same period of the previous year as well as Armenia's membership to the Eurasia Economic Community since January 2015, the *12-month inflation rate will accelerate to a certain extent over the first quarter of the year* but is expected to decline gradually amid a weak demand under developments in external and domestic economies to approach its target at the end of the year.

As the developments in domestic financial and commodity markets, so influenced by end-year events and geopolitical situation in the region, phase out, the *Central Bank will continue to reduce the Lombard Repo Facility Rate during the 1st quarter of 2015 while attempting to steer short-term money market rates*. In consideration of holding the monetary policy position sustainable, the Central Bank raised the Refinancing Rate earlier the year. These actions are intended to reduce the spread between the policy rate and short-term market rates, restoring the leading role of the Refinancing Rate in the market thus contributing to the stabilization of the financial market and fulfillment of the inflation target in the medium run.

Risks to inflation deviating from the projected value are estimated as *balanced* in both short and medium-term perspectives. *External sector risks* are primarily associated with global economic growth rates bouncing back as well as economic and geopolitical developments in emerging economies, and Russia in particular, and how their potential impact would be spilled over to basic commodities and food

product markets. ***Risks deriving from the domestic environment*** are mostly attributable to domestic demand developments, particularly recovering of private consumption and capital investment, the Armenian Government-led programs, the economic effects from Armenia's membership to the Eurasia Economic Community, and the developments in agriculture sector which is largely reliant on climatic conditions. If such risks materialize, the Central Bank will react accordingly by maintaining the inflation target in the ***medium run***.