CENTRAL BANK OF ARMENIA

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In the first quarter of 2010 inflationary environment carried on as the global economy continued to see positive developments in the form of persisting high prices of food and non-food products in international markets, expansionary impact of monetary and fiscal policies is being transmitted on from previous year in the framework of anti-crisis measures and because of depreciation of the dram fuelled by negative expectations. Inflation was 2.9 percent, whereas the 12-month inflation indicator reached 8.8 percent, adding up by 2.3 pp against the previous year's indicator. Interestingly, the above-noted inflation factors were not the only contribution to such a high level of inflation but also the low inflation recorded in the first quarter of the previous year, which was not typical to that period of time. Over the first quarter prices of consumption basket food have risen by 4.3 percent (with 2.3 pp contribution to headline inflation), prices of non-food products, by 1.1 percent (with 0.2 pp contribution to inflation), and service fees, by 1.3 percent (with 0.4 pp contribution to inflation). Inflation was fuelled largely by increased prices in meat products, by 9.2 percent (with 0.9 pp contribution to headline inflation), item "Vegetable and Potato", by 22.9 percent (with 1.1 pp contribution to headline inflation) and medical service fees, by 2.9 percent (with 0.3 pp contribution to headline inflation).

During the quarter, the impact of inflationary pressures began to be felt in the behavior of core inflation as well: it reached 2.1 percent[1] in the fourth quarter, while the 12-month core inflation has grown by 1.9 pp against the previous quarter and made up around 7.1 percent.

External environment

At the start of 2010 the global economic recovery was 'endorsed' by the IMF and World Bank as both institutions revised their predictions over world economic outlook for 2010 toward an upside direction. Such prospects of market participants at the end of 2009 and the start of 2010 were already reflected in financial markets and, therefore, were not unexpected at all. Nevertheless, one should not forget taking heed of issues that put the pace of economic recovery at risk, due to still huge amounts of public and corporate debt (a glimmering example is Greece), persistently high unemployment as well as uncertainty about the timing (and consequences) of surrender of expansionary monetary and fiscal policies.

In the first quarter international oil prices reported 2.2 percent growth q-o-q, with Brent crude oil having averaged around USD 77 a barrel (with y-o-y increase of 70.4 percent).

Base and precious metals prices, too, have grown relative to the previous quarter: in the first quarter the copper price at the London Metal Exchange rose nearly by 9 percent, having averaged around USD 7250 per ton, whereas its y-o-y price has more than doubled. In the first quarter the gold price grew merely by 0.8 percent, having averaged around USD 1110.1, with its y-o-y increase of 22.2 percent). It is noteworthy that in the first quarter international prices of molybdenum rose by more than 30 percent, with y-o-y increase of 61.3 percent.

Grain prices have demonstrated downward trends: at the Chicago Board of Trade the prices fell nearly by 5 percent in the first quarter and have averaged around USD 5.2 a bushel (with y-o-y decrease of 15.6 percent). Rice prices reached USD 13.8 per short hundredweight (45.3 kg), having reduced by 7.5 percent q-o-q (with y-o-y growth of 8.3 percent).

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[1] *The core inflation calculation methodology developed by the Central Bank is detailed in the CBA Review (Q1, 2008). The paper regularly publishes core inflation indicators.*

Steep rise in prices observed in end-2009 in other food product markets – sugar and butter in particular – moderated considerably. According to New York Board of Trade-released international sugar price index, continued rise in sugar price since the end of 2008 had only stopped in the first quarter of 2010, marked with some 5.2 percent drop, having pushed the sugar price down to USD 25.6 per cent/pound (representing 28.3 percent increase in relation to the average figure recorded for the same quarter a year earlier). Though posting some 9 percent rise in the first quarter of 2010 (y-o-y growth of 51.6 percent), the price of New Zealand butter is nonetheless about 5 percent below the previous December's record high level.

Because of fears among financial market participants that they are faced with the prospect of the Greek debt service, in the first quarter the euro exchange rate depreciated vis-a-vis the US dollar by about 6.3 percent, with the dollar having made up 1.38 for one euro (with the euro's y-o-y appreciation of 6.6 percent).

On the front of downsizing public stimulus, in the first quarter the US Federal Reserve System introduced some alterations in its bank lending instruments, and lifting the Prime Rate by 0.25 pp up to 0.75 percent level was part of the alteration strategy. However, the Fed still would not mind keeping the target rate in the range of 0-0.25 percent. Over the quarter, the European Central Bank also remained committed to implementing expansionary monetary policy in order to contribute to the liquidity and economic growth, while keeping up to the 1.00 percent level of the rate. Relentless unemployment in the US and Euro-area remains one reason for maintaining stimuli, which is why quick abandoning expansionary fiscal and monetary policies may materially undermine recovery of the economy.

On the other hand, in countries where economic recovery is progressing faster, attended by risks of accelerated inflation, monetary authorities are looking to implementing somewhat stricter policy. Thus, over the quarter Australia, Malaysia and India have tightened their monetary conditions, and Norway and Israel had even lifted policy rates yet at the end of the previous year.

Aggregate Supply [2]

As macroeconomic environment slowly is getting back on track, so was economic growth in March, with y-o-y 5.85 percent growth in the period January-March against y-o-y 6.1 percent downfall recorded for the same period a year earlier. Furthermore, economic revival was fuelled by the growth posted in all sectors of the economy.

In the **Industry** sector the output volumes have increased considerably, by 10.4 percent, and the value added has grown by around 6.1 percent, primarily due to the increased volumes in *metal ore mining* and *metallurgy* (46.1 percent and 6.7 percent, respectively). This has been a result of consistent improvement in this branch of industry in the framework of anti-crisis measures implemented by the Government as well as a boost by external demand and increased exports volumes.

In the meantime, *chemical industry* and *production of building materials* have reported 3.1-fold and about 2-fold increases, respectively, which is a result of both increased construction volumes and slowly recovering external demand.

The generation of *electricity* and *natural gas*, however, has shrunk by some 9.8 percent, whereas *water supply and waste management* posted 7.7 percent growth.

In the **Construction** sector the value added has grown by 9.7 percent. Notable growth of construction has been reported in areas such as *energy, agriculture, financial* and *insurance services, healthcare* and *community social services.*

[2] *The indicators of sub-branches of the economy represent a period spanning from January to February.*

It should be noted, however, that construction volumes financed by *households* and *private firms* are still subsiding, having made up 73.2 percent and 33.9 percent, respectively, in the period January-December. Construction volumes have been relatively high when supported by *international loans* (15.3-fold increase) and *state budget* (4-fold increase).

In the **Services** sector the value added has grown by 5.1 percent primarily due to 0.6 percent increase in *retail trade turnover.* Growth was recorded also in areas such as education and information and communications, while other services remained within the levels recorded for the period January-February of the previous year.

In the **Agriculture** sector the value added has increased by 3.1 percent due to the growth in plant growing, animal growing and fishing, by 10.6 percent, 2.6 percent and 3.3 percent, respectively. The increased volumes of animal production has been totally due to 23.3 percent increase of egg production that completely compensated declines in meat and milk production, by 2.5 percent and 3.8 percent, respectively.

Labor Market [3]

According to the Central bank estimates, in the first quarter of 2010 average nominal wages have grown by around 5 percent due to increased wages in private sector and some budget-supported organizations, driven by economic activity. It should be noted that in the forts quarter the growth rate of average nominal wages has been slower in relation to that of recorded for the previous year.

The average quarterly unemployment rate has grown by 0.7 pp to make up 7.3 percent. Over the quarter the labor productivity has increased by more than 6 percent.

As a result of these developments, there have been no material changes to unit labor costs in the economy, so the labor market's impact on prices has been neutral.

Aggregate Demand [4]

According to revised Central Bank estimates, in the first quarter of 2010 private spending has increased by around 2 percent in real terms due to increased private consumption and considerable slowing of declining rates in private investments.

Although private spending has increased over the first quarter, it however had a restrictive impact on inflation. According to the Central Bank, the estimated level of real private spending has been below its potential by some 2-3 percent. This has created deflationary pressures in consumer market, pushing inflation down by 0.6-0.9 pp.

Given positive developments observable in the world economy in the first quarter of 2010, export of goods and services[5] is estimated to have grown by 38.0 percent y-o-y, which is well above expectations. The growth of export was fuelled by high y-o-y increase of metals prices as a result of growing world demand. The growth was driven also by Government programs in promotion of

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[3] The labor market data for the fourth quarter of 2009 are the Central Bank estimates which are based on actual figures of the fourth quarter of 2009 and actual figures of January and February of 2010. The growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

[4] The data on real growth of private sector consumption and investments for the first quarter are the Central Bank estimates. Actual preliminary figures of these indicators are as of the fourth quarter of 2009. The growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

[5] In January-March of 2010, the growth of export of goods (FOB) has been 60.9 percent. The quarterly indicators of export of services are forecasts.

[6] In January-March of 2010, the growth of import of goods (CIF) has been 23.1 percent. The quarterly indicators of import of services are forecasts.

large export-oriented projects, which have started from the second quarter of the previous year. In the reporting period export of goods and services in real terms has increased by 7.9 percent y-o-y.

In the first quarter of 2010 import of goods and services[6] has grown by 22.7 percent y-o-y, in which the growth of import of goods has been 25.1 percent y-o-y. This was determined mainly by increased imports of investment goods and fuel. The real volumes of import of goods and services have increased by 8.5 percent y-o-y.

The y-o-y increase of net inflow of non-commercial remittances of individuals through the banking system in the first quarter of 2010 has been 9.6 percent, which is consistent with the latest forecasts. The inflow of non-commercial remittances in the same period of time has increased by 10.7 percent y-o-y, and the outflow, by 14.7 percent y-o-y. This was primarily due to developments in Russian economy. According to recent estimations by the IMF, Russia's economic growth in 2010 will reach 4.0 percent, which is above previously made forecasts.

Consolidated budget [7]

In the first quarter of 2010, thanks to over-performance on revenues[8] and savings on expenditures, the fiscal policy's impact on aggregate demand and inflation has been less expansionary than projected. Over the quarter, budget revenues exceeded the projected level by around AMD 14 billion. In the meantime, tax revenues and social security charges have increased in relation to the previous year. Given over-performed revenues and actual GDP growth, the revenue impulse has made up 3.2 pp expansionary (the GDP growth rate exceeded that of revenues).

Savings on expenditures reached about AMD 13 billion mostly owing to current expenditures. Despite such savings, government expenditures have increased in relation to the same quarter of the previous year. As a result, the expenditures impact has made up 3.6 pp[9] expansionary.

So, driven by the above developments with budget revenues and expenditures over the quarter, the budget deficit has been considerably below the projection. The fiscal impulse indicator, too, has been below the projection, making up 6.8 percent expansionary.

To sum up, in the first quarter of 2010 the economy saw inflationary pressures driven by expansionary influence coming from the fiscal sector. These pressures also contained the effects of expansionary fiscal policy implemented in 2009. The inflationary pressures outweighed the deflationary pressures fuelled by private spending. Thus, taking into account the labor market's neutral impact on inflation, the influence of the above-said factors for the first quarter of 2010 is estimated in the range of 1.1 percent – 1.4 percent.

Money and credit

In the first quarter of 2010 the Central Bank carried on implementing tight monetary policy amid high inflationary environment. This reflected, particularly,

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[6] In January-March of 2010, the growth of import of goods (CIF) has been 23.1 percent. The quarterly indicators of import of services are forecasts.

[7] The analysis of the fiscal sector was made based on Q1 2010 preliminary actual indicators, including expenditures executed from PIU funds. In 2010 the fiscal impulse indicators were estimated relative to the 2008 consolidated budget indicators (taking the year 2008 as a baseline year), since the fiscal policy implemented in 2009 has incurred somewhat different influence, reflecting increased government expenditures and net lending to the economy, as part of anti-crisis measures launched by the Republic of Armenia Government. It should be noted that the revenues impact has been calculated relative to estimated nominal GDP indicator and the expenditures impact, relative to estimated potential GDP indicator.

[8] The projected indicators of budget revenues, expenditures and deficit were put in comparison by matching their preliminary actual figures up to quarterly proportions (PIU funds included) set out by the Republic of Armenia Government.

[9] The calculation of the expenditures impulse included net lending.

the tightening of the Central Bank's operational target, i.e. the Refinancing Rate, which was lifted by 1.5 pp during the quarter[10].

The following trends were observed in financial market during the first quarter: in repo and secondary markets of government securities interest rates rose by 3-4 pp; in primary market of government bonds, however, interest rates remained almost unchanged as allocation volumes shrank. Despite regular patterns of dram depreciation during the quarter the average AMD/USD exchange rate remained almost unchanged in relation to the previous quarter. In the meantime, the dram's nominal effective exchange rate has appreciated by 3.3 percent, which was driven by euro's and ruble's depreciation vis-a-vis the dram.

The monetary environment of the past quarter contained the effect of both monetary conditions which the Central Bank had tightened and the declining-money-demand factor, typical to seasonal economic inactivity. This has led to quarterly decrement in base money and monetary aggregates right in the beginning of the year. This has been most pronounced in the behavior of dram aggregates which maintained the trend of slowing rates of dramization observable from the previous year. Thus, dram broad money has decreased by 11.1 percent; in which currency in circulation has shrunk by 12.4 percent, dram deposits, by 8.8 percent, base money, by 9.1 percent. Over the quarter high dollarization rates have persisted, driving foreign currency deposits up by 13.0 percent.

The economy lending has increased by 5.9 percent, markedly outstripping the previous year's respective indicator (3.8 percent). Without account of the exchange rate's influence, growth of lending in the first quarter will be 3.4 percent in comparison with the 5.2 percent decline recorded in the first quarter of the previous year, which is pointing to certain revival of this segment of the financial market.

Regarding the 12-month growth of monetary aggregates, less than projected growth has been reported on dram broad money and base money, based on the results of the first quarter, by 12.0 percent and 21.9 percent, respectively. Beyond expectations were indicators of FX deposits and economy lending as these indicators had increased by 46.9 percent and 15.6 percent, respectively. Notwithstanding, in the loan portfolio lending in dram remained weak, whereas lending in foreign currency accounted for the largest part of growth on both quarterly and annual bases.

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[10] The Refinancing Rate was lifted by another 0.5 pp under the Central Bank Board Resolution of April 13, 2010.

UPCOMING 12-MONTH PERIOD FORECASTS

External environment [11]

According to new forecasts by the IMF, in 2010 the world economy will recover at some faster rates, 4.25 percent, instead of the previously projected 3.9 percent. While developed countries will remain the main driver for recovery, economic recovery in other parts of the world will progress differently. The start of the US recovery is most promising. Among developing countries, Asia will steer the recovery, whereas recovery in some European and CIS countries will be somewhat lagged. In China, high economic growth will persist and economic growth rates in Russia will be above from previous projections.

In commodities markets in 2010 and in early 2011, driven by fast recovery rates of the global economy and especially the developing economies, possible inflationary pressures will be tempered by the use of untapped possibilities, accumulated resources as well as by added supply. As a result, in the mentioned period of time price levels created at the start of 2010 will be maintained.

Thus, over 2010 and in early 2011 international oil prices are expected to grow to some extent, to USD 80-85 a barrel. At the same time, prices of precious metals and base metals are expected to remain within the current levels, with the copper price to be in the range of USD 7800 per ton and the gold price to be around USD 1100 per troy oz.

Prices of grain are expected to maintain at current levels, owing to the expectations for more harvest for the 2009/2010 marketing year. As estimated by the US Department of Agriculture, some 678 million tons of grain stock is expected for 2009/2010 (about 674 million tons was the expectation in the end of the previous year). Under such circumstances the volumes this year will again exceed the projected consumption, and the grain stock will increase somewhat, to amount to 196.8 tons. Given the expected recovery of world output, a relatively low level of prices created in the first quarter will also persist in sugar market over 2010.

In financial markets the US dollar's exchange rate may principally appreciate versus euro, explained by faster recovering US economy in relation to the European Union. However, the resolution of the Greek debt crisis may somehow reduce intensity of expectations for the euro's depreciation.

As for the countries' schedule for 'exit strategy', the leading countries will, along with taking fiscal consolidation measures, keep up with supporting monetary environment even if they are expected to abandon quantitative easing mechanisms. Tighter monetary conditions will be established in developing countries and in some developed ones which, as they post relatively faster recovery rates, have already announced plans calling for stricter policies.

To sum up, faster recovery rates in the forecasted time horizon will ease possible inflationary pressures determined by the use of untapped possibilities and accumulated resources. The latter will maintain moderate inflationary pressures in the domestic market.

Aggregate Supply [12]

Economic growth forecasts have been revised upside, owing to faster rebounding world demand, transmitted effect of expansionary fiscal and monetary policies implemented as part of anti-crisis measures and gradually improving attractiveness of investment environment fuelled by economic agents' positive expectations for a better economic outlook. As a result, a relatively high, some 3-4 percent, economic growth is expected in 2010.

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[11] The forecasts of external sector have been based on the information provided from the IMF, World Bank, The Economist, Global Insight, Financial Times, US Department of Agriculture, РосБизнесконсалтинг and other sources.

[12] Growth of value added of branches of the economy and, correspondingly, value added of real GDP growth have been forecasted using respective preliminary actual figures for 2009.

Economic growth risks are dual-sided and associated with both external and internal factors. However, upside risks are prevailing depending on both further global economic growth outlook and higher-than-expected growth of domestic demand as well as realization of large-scale projects in transport, energy and other infrastructures.

For the **Industry** sector, forecasts have been revised upside. Thus, real growth of value added is expected for *metal ore mining* and *metallurgy* (owing to expectations for persisting high level of prices of non-ferrous metals in international markets); for *food* and *drinks* production (owing to expected increases in food reprocessing and brandy production driven by recovering world demand); and for production of *building materials* and *diamond* industry. Naturally, forecasts for *energy* branch have been revised too. As a result, the value added in industry is expected to grow by 5-7 percent in real terms.

Risks deriving from the industry branch are expected to surpass projections upside and are determined by the restart of investment projects that were stopped due to the global economic downturn as well as new programs to be approved for realization in a number of industry sub-branches.

For the **Construction** sector, forecasts have been revised upside, determined by expected inflow of capital and improved expectations of firms in this sector[13]. However, no essential changes are expected in construction financed by households.

Figures of real growth of value added in transport, mining and processing industry and energy reported increases.

As a result, the value added in construction is expected to grow by 1-3 percent in real terms.

For the **Services** sector, forecasts have been revised upside, too, due to the revised forecasts of domestic demand that will be affecting the volumes of both trade turnover and other services.

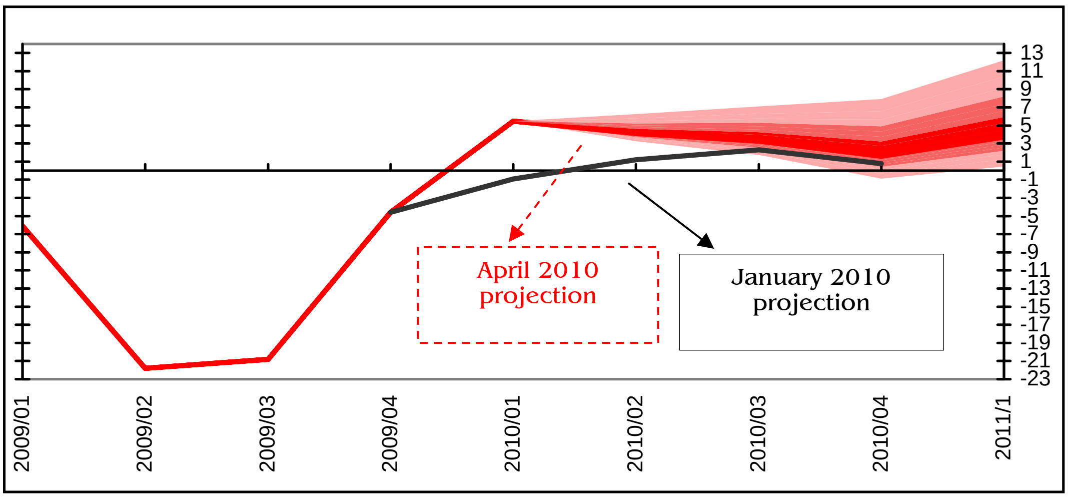
As a result, the value added in services over 2010 is projected in the range of 2.5-4.5 percent in real terms.

Risks of recording some higher growth rates exist in **Construction** and **Services**, which is attributable to increased population incomes and planned realization of investment programs.

For the **Agriculture** sector, forecasts have not been revised, and some 2-4 percent real growth is expected. However, risks existing in the branch are forecast to surpass projections owing to some rise in animal headcount, increased crops and more sowing lands.

It is expected that the above-mentioned trends in the sectors of the economy would persist in the first quarter of 2011, too.

Real GDP Growth Projection Probability Distribution
(quarter over same quarter of previous year)



[13] See http://www.cba.am/CBA_SITE/statistics/complex_index.html?__locale=hy.

Economic Growth Projection Probability Distribution

Economic growth interval	Probability of economic growth interval			
	Q2, 2010	Q3, 2010	Q4, 2010	Q1, 2011
< 0%	0.00%	0.01%	5.83%	1.74%
0 - 3%	0.32%	15.73%	33.15%	17.41%
3 - 6%	48.63%	52.35%	31.49%	32.56%
6 - 8%	28.63%	20.37%	13.96%	18.60%
8 - 10%	14.98%	8.54%	8.31%	13.54%
10 - 12%	5.60%	2.46%	4.19%	8.41%
12 - 14%	1.49%	0.48%	1.79%	4.45%
14 - 16%	0.28%	0.07%	0.64%	2.01%
16 - 18%	0.04%	0.01%	0.20%	0.79%
18 - 20%	0.00%	0.00%	0.05%	0.25%
20 - 22%	0.00%	0.00%	0.01%	0.07%
22% <	0.00%	0.00%	0.00%	0.02%

Labor Market [14]

The 2010 estimates of labor market indicators have been revised to some extent. In particular, about 7 percent growth of average nominal wages in the economy is expected due to i) an increase in nominal wages in the private sector driven by economic activity and ii) a moderate growth of salaries in some budget-supported organizations. In the first quarter of 2011 average nominal wages are expected to grow at somewhat higher pace in relation to the previous year.

Notwithstanding expected economic recovery, the average level of unemployment will respond to the economic activity at a certain time lag and will reach 7.3 percent, representing some 0.4 pp increase in relation to 2009. The average rate of unemployment in the first quarter of 2011 will reach 7 percent, down by 0.3 pp in relation to the same period of 2010.

In 2010 developments in the labor market will create inflationary pressures in the consumer market (about 0.4 percent), since some 2 percent increase of unit labor costs will be recorded in the private sector. It should be noted, however, that inflationary pressures in the labor market will be notable weaker in comparison with the 2009 indicator. In the first quarter of 2011 moderate inflationary pressures in the labor market will carry on at 0.7 percent as average wages will grow faster than labor productivity.

Aggregate Demand [15]

Private Sector Spending

Estimations of private sector spending for 2010 have been revised upside. The revision has been based on consideration of quick recovery of both global and domestic economic environment.

According to revised estimations, private expenditures will grow in 2010 determined by both increased private consumption and private investments.

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[14] The labor market data for 2010-2011 are the Central Bank estimates which are based on actual figures of the fourth quarter of 2009 and January and February of 2011. The growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

[15] The data of real growth of private consumption and investments for 2010-2011 are the Central Bank estimates, and their preliminary actual figures are as of the fourth quarter of 2009. The real growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

Private investments will grow by 11.8 percent, reflecting improved expectations of economic agents for future economic environment[16], growth of inbound remittances and gradually rebounding domestic and external demand. Estimations suggest that private consumption will grow over the year by 3.7 percent depending on the increment of private disposable income and restored consumer confidence. In the first quarter of 2011 private spending will keep on trending upward.

In the course of 2010, rising real private expenditures will contribute to the narrowing of the gap between private spending and its potential level which was generated in 2009 due to then crisis. In the first quarter of 2011 private spending is estimated to come up to its potential level thus reducing the effect of the gap to its minimum. As a result of the above said developments, private spending in 2010 will exert 0.3-0.6 percent deflationary pressures on the consumer market. Over the first quarter of 2011, however, the impact of private spending on prices will be neutral.

Current Account

Forecasts of current account components of Balance of Payments have been adjusted considerably due to the trends denoting faster recovery of the global and domestic economies and their subsequent growth.

Taking into account high growth of exports recorded in the first quarter, persistently high prices of metals and support on the part of the Government in encouraging export-oriented industries, export of goods and services in dollar terms in 2010 will grow by 25-30 percent. Growth of export of goods and services in real terms in 2010 will be in the range of 4-6 percent. It should be noted that risks associated with exports can be upside and downside, depending on how the global economic environment will evolve and how quickly the domestic economy will soak up investment resources and re-orient its industries to exports.

Forecasts of import of goods and services have been revised upside. The latter will depend largely on how fast the domestic economy will grow and how quickly the investment environment will recover. As a result, over 2010 import of good and services in dollar terms will grow in the range of 12-15 percent, whereas the growth of import of good and services in real terms will be in the range of 4-6 percent. Risks associated with imports are estimated to have been upside, conditional on realization of investment projects and whether how quickly these projects will be implemented.

In 2010 the growth of non-commercial remittances by individuals are expected to be in the range of 10-15 percent, mainly owing to new optimism with regard to the Russian economy (new forecasts by the IMF suggest that the Russia's economic growth indicator in 2010 will reach 4 percent, which is 0.4 pp higher from the previous forecasts).

As a result of these developments, the current account deficit to GDP ratio in 2010 will remain close to the level recorded in the previous year, being in the corridor of 14-16 percent. Risks associated with the current account deficit can be upside and downside, too, which depends on how the balance of trade will develop.

It is expected that the above-said developments in current account will keep up with similar patterns also for the earlier part of 2011.

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[16] Compound economic indices calculated by the Central Bank point to economic agents' optimism for a better economic environment in future.
See http://www.cba.am/CBA_SITE/statistics/complex_index.html?__locale=hy.

Consolidated Budget [17]

The fiscal policy in 2010, which is continuation of anti-cyclic expansionary policy carried out in 2009 and which is tended to recover the economy by stimulating domestic demand, will come up with less expansionary impact. The latter largely depends on expected over-performance on revenues and some savings of expenditures on an annual basis if positive trends in actual budget performance for the first quarter are maintained. It should be noted that the main benchmark of government expenditures is to reach a 17.7 percent indicator for tax revenues in GDP. As a result, the annual level of deficit/GDP ratio will report considerable reduction in relation to the projected level set out by the law.

So, as a result of the above-said developments with revenues and expenditures performance, the fiscal policy's impact on aggregate demand will reduce substantially, making up 3.5-4 percent expansionary, and will reflect expansionary effect of expenditures and slightly restrictive effect of revenues. Furthermore, in the first half of the year a grater expansionary impulse of public expenditures is anticipated, which will be attributable to more expenditures relative to the same period of the base year.

In the first quarter of 2011, the Central Bank estimates, the fiscal policy is to have a neutral impact.

To sum-up, over 2010 expansionary effects from the previous year's fiscal sector will continue to be felt in the economy, and the resulting inflationary pressures will outweigh deflationary pressures because of reduced private spending. As a result, given the developments with the domestic demand, inflation will grow by 0.5-0.8 pp. In consideration of some 0.4 pp inflationary pressures expected from the labor market, one may see that the demand-pull inflation and the one spilled over from the labor market in 2010 will be in the range of 0.9-1.2 percent. In the first quarter of 2011 inflationary pressures in consumer market will reduce up to 0.7 percent.

Money and Credit

Forecasts of monetary indicators for the upcoming 12-month period subsequent to March of 2010 have been based on monetary environment of the previous quarter, projections of macroeconomic developments for the next one year and the expansionary fiscal policy scenario developed for that period. According to projections, the Central Bank will continue implementing a policy to eliminate persistently high inflationary potential and bring inflation back to the target bound. The Central Bank estimates that over this period of time average quarterly growth of both broad money and base money will be 3-4 percent in comparison with 6.4 percent and 4.8 percent, respectively, recorded in the previous year with regard to these indicators. Further, in consideration of the effect of de-dollarization measures taken by the Central Bank in collaboration with the Government, the average quarterly growth rates of broad money are expected to quicken more than twice as much relative to the previous year, to reach about 8 percent against 3.2 percent, whereas growth rates of foreign currency deposits are expected to slow down notably, to 2.0 from the previous year's 10 percent.

The economy lending by the financial sector will largely remain the same in terms of directional use of loans. This means that small- and medium-size

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[17] *The fiscal sector's impact has been estimated based on preliminary adjusted program of public sector indicators for 2010.*

enterprise development projects will carry on as well as loans will continue to be made to further revive the mortgage market. As a result, the economy lending indicator will grow by nearly 3 percent on an average quarterly basis, keeping up with the previous year's growth rates.

It should be noted that possible risks in the monetary sector are towards higher growth rates, which is determined by a greater demand for the dram as large-scale action is planned this year to fight dollarization as well as positive macroeconomic trends already demonstrated. This will result in surpassed expectations for the dram components of monetary aggregates and higher-than-anticipated growth rates in lending if economic growth outstrips the projections.

INFLATION FORECASTS AND MONETARY POLICY DIRECTIONS IN THE PROJECTED 12-MONTH PERIOD

Inflation and monetary policy directions have been forecasted through the Quarterly Projection Model used by the Central Bank based on actual macroeconomic conditions created in the first quarter of 2010. Thus, factors that determined the first quarter's inflationary environment included persistently high prices of food and non-food products in international markets under positive developments in the global economy, quicker-than-estimated recovery of aggregate demand and repeated depreciation of the dram during the quarter fuelled by negative expectations.

Quick recovery of aggregate demand and notable reduction of adverse deviation of GDP from its equilibrium remained to be fuelled by expansionary impact of monetary and fiscal policies transmitted on from previous year in the framework of anti-crisis measures as well as continued using of some anti-crisis stimuli in the form of refinanced large state budget deficit and loan portfolios of commercial banks and real refinancing rate spread being still negative.

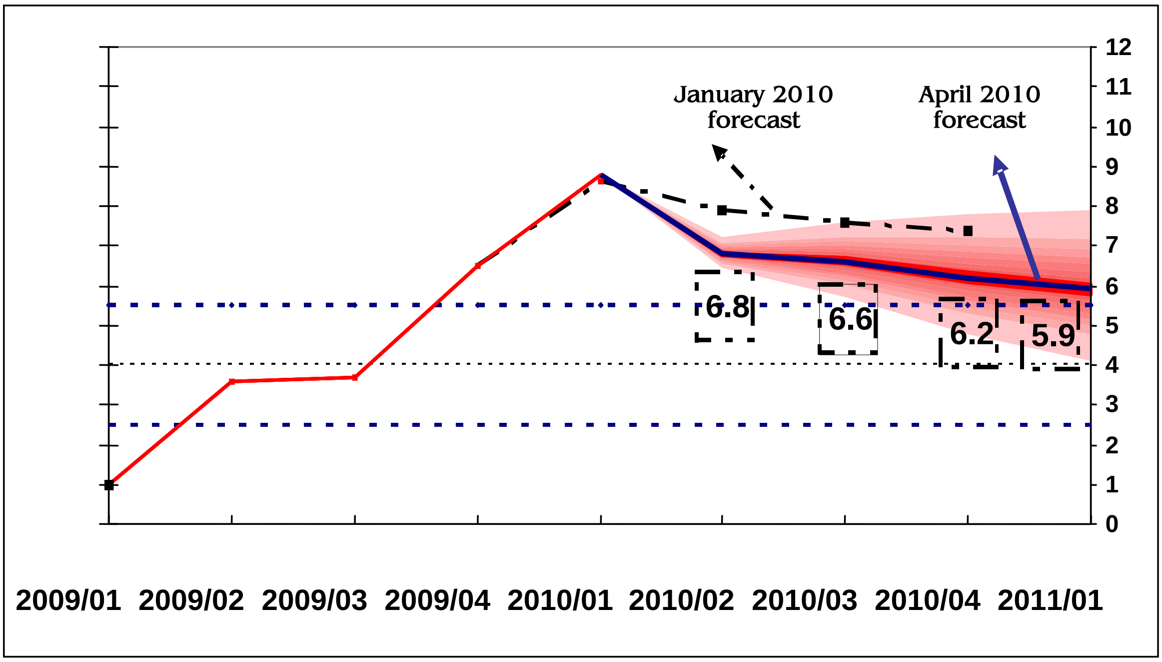
Faster growth of private remittances has also contributed to positive developments in aggregate demand under which circumstance the latter's adverse deviation fro the equilibrium has been reduced substantially. At the same time, already at the end of the quarter the declining rates of the 12-month inflation accelerated, while certain stabilization patterns began to be seen in the foreign exchange market under gradually tightening monetary conditions, rising interest rates in the banking market and somewhat stricter handling of money supply.

Forecasts made under preliminary macroeconomic conditions referred above suggest that the inflation environment in the forecasted 12-month period will persist under influence of positive trends of recovery of the global economy, increased main public utility fees since April 2010 and still rebounding aggregate demand, although the 12-month inflation deceleration trends will carry on.

In view of the influence of stricter monetary conditions applied since the beginning of the year on future behavior of inflation, the inflation forecasts for the 12-month time horizon have been revised downside (see the Chart below). Thus, based on the results of inflation model by separate commodity groups, under the assumption of unchanged interest rates and considering the effect from the rise in prices of other goods due to an increase in gas and water tariffs directly and through cost price increase (with around 1.0 pp contribution to headline inflation), inflation is expected to reach 6.2 percent at the end of the year and 5.9 percent at the end of the first quarter of 2011.

Risks to the inflation deviation from the forecast value are somewhat upside, owing to faster-than-predicted growth of domestic demand and international prices of raw materials and food products, which is driven by faster recovery trends in global economy. In the meantime, depending on the extent of the agricultural output, risks are both downside and upside the forecasted inflation indicator.

Inflation Projection Probability Distribution Chart (12-month)



Inflation Projection Probability Distribution

Inflation interval	Probability of inflation interval	
	Q4, 2010	Q1, 2011
< 3.0%	0.01%	0.38%
3.0-4.0%	0.5%	3.5%
4.0-5.5%	19.5%	29.9%
5.5-6.5%	40.0%	33.5%
6.5-8.0%	36.6%	28.3%
8.0-9.0%	3.2%	3.9%
9.0-10.0%	0.18%	0.5%
10.0% <	0.01%	0.02%

So, consistent with expected developments in inflation, further tightening of monetary conditions should be continued in order to create real positive interest rates which need to be maintained for the whole period under forecast. For curbing of inflation, taking further anti-crisis measures, namely reducing budget deficit by keeping up with current performance of tax collection and saving of budget resources, is important. Combined action by the Central Bank and the Government to achieve the said objective will create real prerequisites for accelerating the decline of inflation and bringing it back to the target bound as soon as possible.

Yerevan - 0010, V. Sargsyan 6. http:// www.cba.am