THE CENTRAL BANK OF THE REPUBLIC OF ARMENIA

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STATUS REPORT ON IMPLEMENTATION OF THE MONETARY POLICY PROGRAM

(Inflation Report)

Q2, 2011

YEREVAN
2011

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1. SUMMARY

ACTUAL INDICATORS AND DEVELOPMENTS IN Q2, 2011

The second quarter of 2011 was momentous for a moderated inflationary environment, which was fostered by both domestic developments, including the tightening of monetary conditions since the start of the year, and developments of the external sector. Prices of food products and raw materials tended to somewhat stabilize (and prices of some commodities even went down) at the beginning of the quarter after fluctuations observed in global markets. In the meantime, conditioned by slowly recovering domestic demand, influence of implemented restrictive fiscal and monetary policies and increased supply of agricultural products, no inflationary pressures from domestic environment were shown up.

At the end of the second quarter the 12-month inflation was 8.5 percent, reducing by around 3 pp relative to the previous quarter's indicator. Price increases of food products made as much as 7.3 pp contribution to headline inflation, of which 4.2 pp fuelled by price increase of agricultural products and about 3 pp by import food products. Price increases in non-food products and service tariffs made, respectively, 0.5 pp and 0.8 pp contribution to the 12-month inflation.

In view of higher-than-expected economic activity in industry and services the second quarter of 2011 (in January-June EAI growth was 4.5 percent y-o-y), somewhat a higher economic growth, 3.9 – 5 percent y-o-y, will be expected in the period January-June 2011, according to the Central Bank estimations[1]. The growth will be fuelled mainly by around 15 percent and 4.2 percent y-o-y increases expected in industry and services, respectively.

In the second quarter the average quarterly unemployment rate reduced, reflecting the growing demand for labor. At the same time, the growth of average nominal wages was consistent with the growth of labor productivity. As a result, no significant changes in the structure of unit labor costs were seen, so one may affirm that the impact of the change in unit labor costs on inflation in the second quarter was neutral.

In the second quarter private sector expenditures grew by around 6 percent relative to the previous year. Public expenditures in real terms reduced by nearly 9 percent, while domestic demand increased by 4 percent relative to the same period of the previous year. Private consumption grew by around 7 percent and private investment by 2.5 percent relative to the previous year.

Estimations suggest that the gap between private spending and their potential, a by-product of the 2009 crisis, was eliminated as a result of added private spending during the second quarter. Under the aforementioned developments, the expenditures in the private sector had a neutral impact on inflation.

In the second quarter the fiscal impulse had 3.1 pp restrictive impact on aggregate demand, hence inflation, instead of the projected neutral. This is determined by 1.3 pp expansionary impulse from revenues and -4.4 pp restrictive impulse from expenditures.

Partly offsetting the end-year 2010 expansionary impact, the fiscal policy of the first quarter of 2011 has had a restrictive impact on aggregate demand, too.

In light of the above-mentioned developments in domestic demand and labor market, some deflationary pressures were observed in the economy during the second quarter of 2011, which were in the range of 0.4-0.6 pp, according to the Central Bank estimates.

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[1] *See the 90 percent probability interval of the Real GDP Growth (Cumulative) Projection Probability Distribution Chart in the Monetary Policy Program, Q3, 2011.*

On the background of developments in global and domestic economies in the second quarter of 2011 current account has improved. With sustained high levels of metals prices in global markets, the growth of exports exceeded expectations. As well as the growth of imports topped the expectations mostly due to faster growth of private consumption. Estimations show that real volumes of import of goods reduced in the light of prices having been consistent with the forecast. At the same time, the growth of transfers remained strong in the face of global economic growth. As a result of the aforementioned developments, in the second quarter the current account deficit reduced by USD 50.6 million y-o-y and amounted to USD 317.0 million. In the first half of 2011 the share of current account deficit in GDP has improved, making up 19.0 percent (23.3 percent in the first half of the previous year).

The above-mentioned trends determined the attainment of the inflation target and monetary policy directions for the second quarter. At the beginning of the quarter the Central Bank carried on tightening, perhaps at a slower pace, monetary conditions in the face of risks in the external sector and fears that in the forecast time horizon inflation would yet overstep the target. Already in the period May-June trends of a stabilizing and even moderating inflationary environment were evident. Also, the combination of lifting refinancing rate and liquidity management clearly benefited other interest rates in the financial sector. This drove to anticipate trends for faster reducing inflation rate. So, starting from May, the Central Bank stopped tightening monetary conditions, implementing a neutral monetary policy instead.

In the second quarter monetary policy developments were mainly consistent with the scenario. Broad money grew by 4.5 percent, dram broad money, by 6.5 percent, and monetary base, by 2.7 percent. Despite gradual tightening of monetary conditions since the start of the year in the second quarter growth of lending volumes remained strong, 8.7 percent. With dram and foreign currency loans holding almost the same growth rate of 8.7 percent, loans in foreign currency still prevail in absolute value.

2. INFLATION DEVELOPMENTS

2.1. INFLATION BY GOODS AND SERVICES; CORE INFLATION

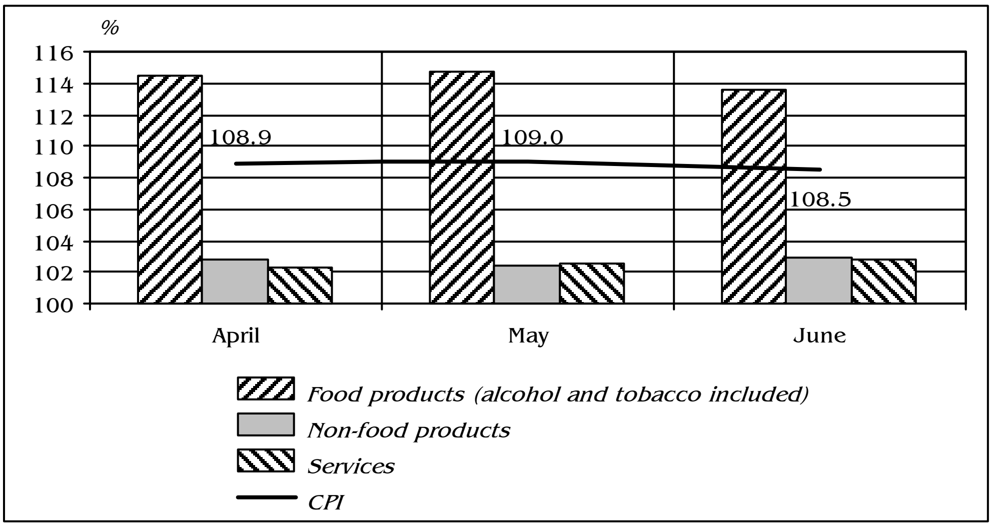
In June 2011, relative to June 2010, inflation was 8.5 percent. Prices rose as follows: food products (alcohol and tobacco included) by 13.6 percent; non-food products by 2.9 percent; and service tariffs by 2.8 percent, all having contributed to inflation by 7.3, 0.4 and 0.8 pp, respectively.

Table 1

Main Contributions to Inflation

Contribution to inflation, pp	Commodity groups	Price change, %
	Food products	
1.8	Bread products	16.8
1.1	Fruit	29.7
0.9	Dairy products	22.1
0.9	Meat products	9.0
0.9	Vegetable and potato	14.6
0.6	Fats and oils	19.9
0.4	Egg	31.3
0.4	Coffee, tea, cocoa	11.3
0.1	Sugar	13.6
	Non-food products	
0.3	Personal car and fuel	13.2
0.1	Garment and knitwear	3.2
	Services	
0.5	Medical services	12.5
0.4	Transport services	12.7
0.1	Public catering	6.5
0.1	Household services	4.4
-0.1	Communications services	-1.1
-0.1	Residential and public utilities	-0.7

CPI in Q2 2011 based on the 12-month results, by main commodities and services

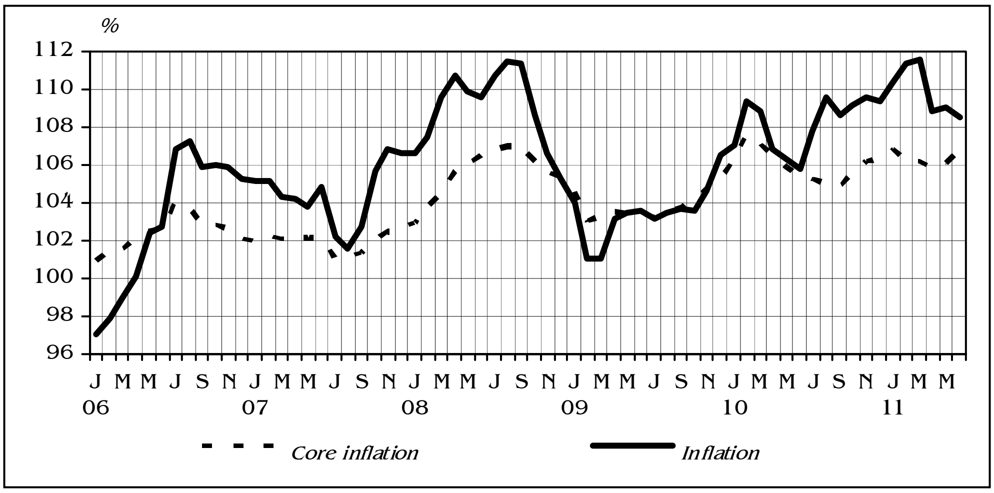


In the second quarter consumer price index reduced by 1.6 percent compared to the end of the previous quarter; prices of food products decreased by 3.1 percent (with -1.66 pp contribution to inflation), service tariffs by 0.04 percent (with -0.01 pp contribution to inflation), while non-food prices rose by 1.2 percent (with 0.18 pp contribution to inflation).

In the period January-June of 2011, relative to January-June of 2010, inflation has been 9.9 percent (it was 7.3 percent and 2.7 percent in 2010 and 2009, respectively). This figure of 9.9 percent was due to 14.8 percent price increase of food products, 3.1 percent price increase of non-food products and 5.0 percent rise in service tariffs, all having contributed to headline inflation by 7.9 pp, 0.5 pp and 1.5 pp, respectively.

The 12-month core inflation in the second quarter of 2011 was 6.72 percent. The largest contribution to it came from such items as "beef" (contribution – 0.8 pp), "homemade cheese from cow milk" (0.7 pp), "egg" (0.6 pp), "air transport fare" (0.6 pp), "surgery services at hospitals" (0.4 pp), "butter" (0.4 pp), "Chanakh cheese" (0.3 pp), "petrol" (0.3 pp), "sugar" (0.2 pp), "Lori cheese" (0.2 pp), and "sunflower seeds oil" (0.2 pp) [2].

Inflation and core inflation, 2006-2011 (%, relative to the same month of previous year)



Statistical review of inflation fluctuations

In order to review the changes in Consumer Price Index and in price indexes of individual items included in consumer basket, as well as to discover the factors determining their fluctuations, the influence of three components (trend, seasonality and irregularity components) used in Statistics theory has been identified and assessed for the time period from July 2008 to June 2011[3].

Calculations show that in the period from July 2008 to June 2011 the influence of seasonality component on CPI has been 60.6 percent; the influence of irregularity component, 35.8 percent; and the influence of trend component, 3.6 percent. In comparison with the period from July 2007 to June 2010, the influence of seasonality component has decreased by 15.7 percent, whereas the influence of irregularity component and trend component has increased by 12.4 percent and 3.3 percent.

For the time period from July 2008 to June 2011, the influence of the three components has changed as follows:

- the influence of seasonality component on ***price index of food products*** was 69.5 percent, although this component's impact had decreased by 13.0 percent compared to the period from July 2007 to June 2010; in the meantime the influence of irregularity component and trend component has increased by 7.4 percent and 5.5 percent, respectively;

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[2] The detailed methodology of calculation of core inflation is provided in the periodical paper "CBA Review" (Q1, 2008) and an analytical paper "Inflation in the Republic of Armenia: 'Seasonal Exclude and External Shock Adjustment' method.

[3] The methodology of calculation is provided in the paper "Inflation in the Republic of Armenia, 2nd half of 1999".

- the irregularity component had 64.7 percent impact on ***price index of non-food products*** in the period from July 2008 to June 2011 (this component's impact had decreased by 4.2 percent compared to the period from July 2007 to June 2010); the impact of seasonality component has increased by 7.0 percent and reached 35.1 percent;
- the seasonality component and irregularity component had roughly the same amount of impact on ***service tariffs***, making up 43.2 percent and 46.5 percent, respectively; the seasonality component's impact has decreased by 16.9 percent and the irregularity component's has grown by 12.2 percent relative to the period between July 2007 and June 2010.

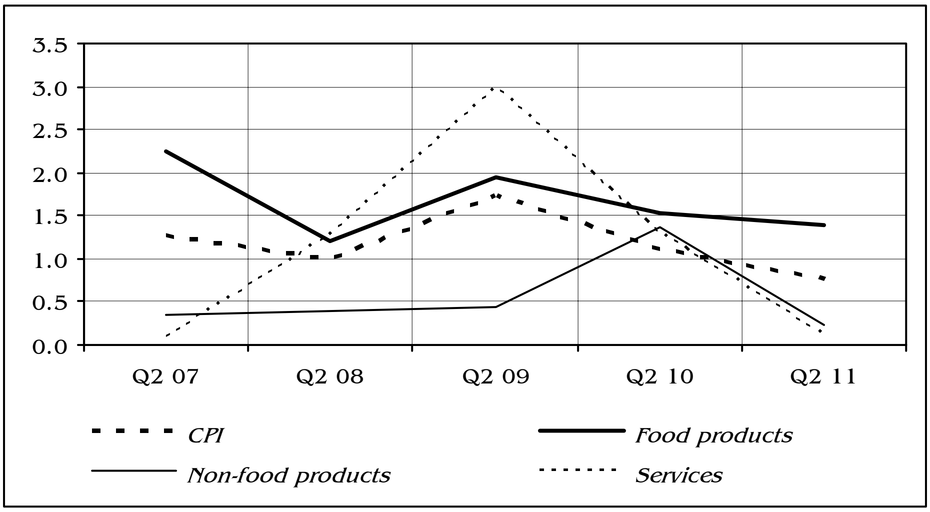
For the time period from July 2008 to June 2011, the ***seasonality component*** had the strongest impact on such items as "vegetable and potato" (82.0 percent), "fruit" (72.6 percent), "education services" (66.1 percent), "footwear" (58.3 percent), "items of culture" (58.2 percent), "Residential and public utility services" (57.8 percent), and "fats and oils" (56.0 percent); the ***irregularity component*** had the strongest impact on such items as "kitchen utensils" (84.4 percent), "jewelry items" (80.0 percent), "textiles" (74.0 percent) "services in culture" (72.8 percent), "legal and banking services" (72.4 percent), "public catering" (72.4 percent), "household services" (71.3 percent), and "other services for household" (71.1 percent); the ***trend component's*** impact has been relatively strong on such items as "bread products" (18.7 percent), "vegetable and potato" (16.1 percent), "gardening items" (12.9 percent), "beauty and apparel" (11.4 percent), "fats and oils" (8.7 percent), and "stationery" (8.1 percent).

Share of components causing fluctuations in monthly price indexes (July 2008 – June 2011), %

Item	Trend	Seasonality	Irregularity	Total
CPI (relative to previous month)				
Food products (alcohol and tobacco included)	**3.6**	**60.6**	**35.8**	**100.0**
Bread products	5.7	69.5	24.8	100.0
Meat products	18.7	29.5	51.8	100.0
Fish products	4.0	27.6	68.4	100.0
Dairy products	2.0	34.4	63.6	100.0
Egg	4.9	40.8	54.3	100.0
Fats and oils	3.2	53.2	43.6	100.0
Fruit	2.0	72.6	25.4	100.0
Vegetable and potato	16.2	82.0	1.8	100.0
Sugar	0.2	54.7	45.1	100.0
Coffee, tea, cocoa	4.1	30.9	65.0	100.0
Confectionery	1.2	38.6	60.2	100.0
Other products	7.6	31.4	61.0	100.0
Non-alcoholic beverage	0.1	34.6	65.3	100.0
Alcohol and tobacco	0.6	40.5	58.9	100.0
Non-food products	**0.3**	**35.1**	**64.6**	**100.0**
Garment and knitwear	3.1	40.2	56.7	100.0
Footwear	0.0	58.3	41.7	100.0
Fuel	4.6	41.4	54.0	100.0
Furniture	2.3	52.8	44.9	100.0
Carpets	0.9	42.2	56.9	100.0
Textiles	0.0	26.0	74.0	100.0
Home appliances	3.6	31.7	64.7	100.0
Kitchen utensils	4.3	11.3	84.4	100.0
Detergents	6.6	34.5	58.9	100.0
Building materials	4.4	31.4	64.2	100.0
Items of gardening	12.9	46.2	40.9	100.0

Medicament	6.0	32.6	61.4	100.0
Personal cars and fuel	7.4	28.8	63.8	100.0
Items of culture	1.2	58.2	40.6	100.0
Stationery	8.2	24.6	67.2	100.0
Beauty and apparel	11.4	17.8	70.8	100.0
Items of jewelry	0.3	19.7	80.0	100.0
Items of personal use	4.3	25.1	70.6	100.0
Services	**10.3**	**43.2**	**46.5**	**100.0**
Household services	0.0	28.7	71.3	100.0
Other services for household	0.0	28.9	71.1	100.0
Residential and public utility services	1.5	57.8	40.7	100.0
Healthcare services	1.4	31.9	66.7	100.0
Transport services	0.3	30.3	69.4	100.0
Communications services	6.4	32.2	61.4	100.0
Culture services	6.5	20.7	72.8	100.0
Educational services	4.3	66.1	29.6	100.0
Leisure and rest services	3.6	45.5	50.9	100.0
Public catering	1.7	25.9	72.4	100.0
Legal and banking services	0.3	27.3	72.4	100.0

CPI, food, non-food products and services price index variation coefficients in second quarters 2007- 2011



The consumer price index volatility was reviewed also by means of monthly price index variation coefficients defined for each commodity group.

The chart shows that the CPI and food price index volatility dynamics are very similar.

The table below shows that in Q2 2011, relative to Q2 2010, the CPI variation coefficient has dropped to 0.8 percent from 1.1 percent. The food product price index variation coefficient has reduced by 0.1 percent; the non-food product price index and service tariff index variation coefficients have fallen by 1.2 percent each.

In the second quarter the highest volatility was reported for items "vegetable and potato" (14.3 percent versus 9.4 percent in Q2 2010), "leisure and rest services" (4.3 percent versus 1.1 percent), "educational services" (3.8 percent versus 0.0 percent), "fruit" (3.2 percent versus 11.2 percent).

Monthly price index variation coefficients in second quarters, 2007-2011, %

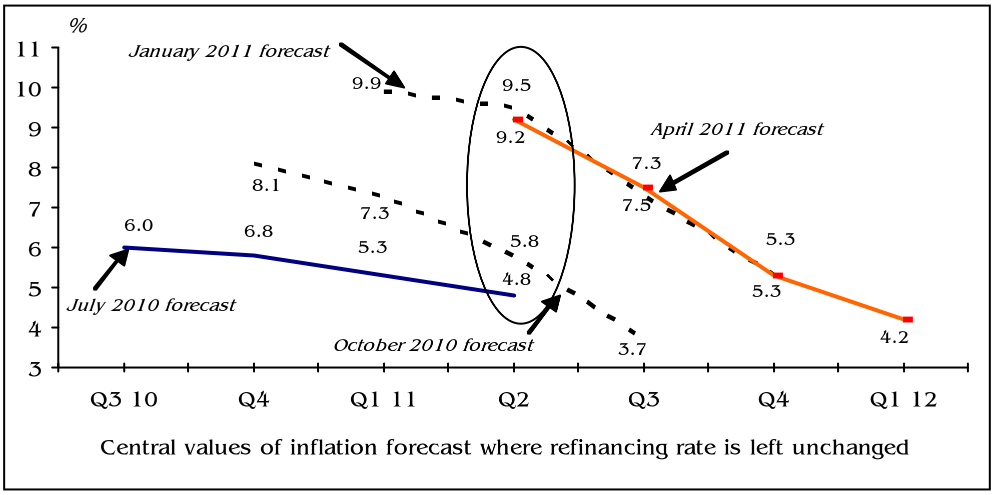
	Q2 2007	Q2 2008	Q2 2009	Q2 2010	Q2 2011
CPI (relative to previous month)	**1.3**	**1.0**	**1.7**	**1.1**	**0.8**
Food products (alcohol and tobacco included)	**2.3**	**1.2**	**1.9**	**1.5**	**1.4**
Bread products	4.2	2.4	1.6	0.5	0.1
Meat products	0.5	0.8	0.2	1.1	1.2
Fish products	7.0	2.5	15.0	4.5	0.4
Dairy products	0.2	0.1	0.3	0.2	0.6
Egg	2.8	2.7	3.9	3.8	0.2
Fats and oils	0.1	2.1	2.4	1.8	1.3
Fruit	7.9	10.7	13.1	11.2	3.2
Vegetable and potato	17.0	4.9	9.3	9.4	14.3
Sugar	1.3	0.9	1.0	4.7	2.0
Coffee, tea, cocoa	0.2	1.8	1.7	0.1	2.3
Confectionery	0.0	0.2	0.5	1.0	0.1
Other products	0.0	3.7	0.3	0.6	0.1
Non-alcoholic beverage	0.1	2.6	0.0	0.2	0.1
Alcohol and tobacco	0.0	0.2	0.2	0.3	0.0
Non-food products	**0.3**	**0.4**	**0.4**	**1.4**	**0.2**
Garment and knitwear	0.1	0.3	0.6	0.6	0.3
Footwear	1.4	0.9	0.2	3.0	1.6
Fuel	0.2	1.7	0.8	0.1	0.5
Furniture	0.1	0.1	1.2	0.4	0.5
Carpets	0.0	0.0	0.7	1.0	2.0
Textiles	0.1	0.1	0.1	0.3	0.9
Home appliances	0.4	0.4	1.1	0.1	0.4
Kitchen utensils	0.4	0.1	0.4	0.2	0.3
Detergents	0.1	0.8	1.1	0.4	0.4
Building materials	0.1	1.0	2.6	1.2	0.4
Items of gardening	0.4	0.8	0.7	0.8	0.7
Medicament	0.1	0.4	4.7	0.7	0.2
Personal cars and fuel	0.9	1.7	2.0	3.7	1.4
Items of culture	1.5	0.9	3.8	0.8	1.6
Stationery	0.0	0.1	0.5	0.2	0.5
Beauty and apparel	0.3	0.2	1.6	0.4	0.8
Items of jewelry	0.3	3.5	1.1	0.4	3.1
Items of personal use	0.0	1.2	0.9	0.3	0.2
Services	**0.1**	**1.3**	**3.0**	**1.3**	**0.1**
Household services	0.3	0.9	2.7	0.2	1.1
Other services for household	0.4	1.1	3.2	0.2	1.3
Residential and public utility services	0.0	4.3	9.9	5.1	0.3
Healthcare services	0.1	2.8	0.6	0.4	0.8
Transport services	0.4	2.5	4.7	1.0	1.6
Communications services	0.0	0.2	0.7	0.1	0.2
Culture services	0.5	2.7	2.6	0.1	0.9
Educational services	0.0	0.1	0.0	0.0	3.8
Leisure and rest services	0.4	0.0	3.4	1.1	4.3
Public catering	0.1	1.6	0.4	0.1	0.3
Legal and banking services	0.0	0.6	0.1	1.2	0.4

2.2. FULFILLMENT OF INFLATION TARGET

Inflation environment in the second quarter of 2011 was somewhat moderate due largely to tightened monetary conditions, lagged impact of the change in reserve requirement, easing of pressures transmitted onto the Armenian economy from the external sector, a restrictive nature of fiscal policy and expected price falls in agriculture amid increasing output volumes of domestic products of that sector. However, in the face of non-inflationary impulses, the 12-month inflation was supposed to persist at high levels, containing high price growth of agricultural products transmitted from 2010, price growth of primary food products in world markets, second-round effects of persistently high inflation and inflationary expectations. External and internal macroeconomic developments projected for the upcoming one-year horizon and expected influence from monetary policy point out that inflationary pressures will loosen starting the second half of 2011 and the 12-month inflation will only come closer to the upper border of the band at the end of the year.

The inflation environment and monetary policy directions during the previous 12-month horizon were characterized by the following trends. Given the diminishing behavior of inflation in first half of 2010, in July and October the Central Bank projected, respectively, 4.8 percent and 5.8 percent levels of the 12-month inflation for the second half of 2011.

The 12-month inflation indicator forecast



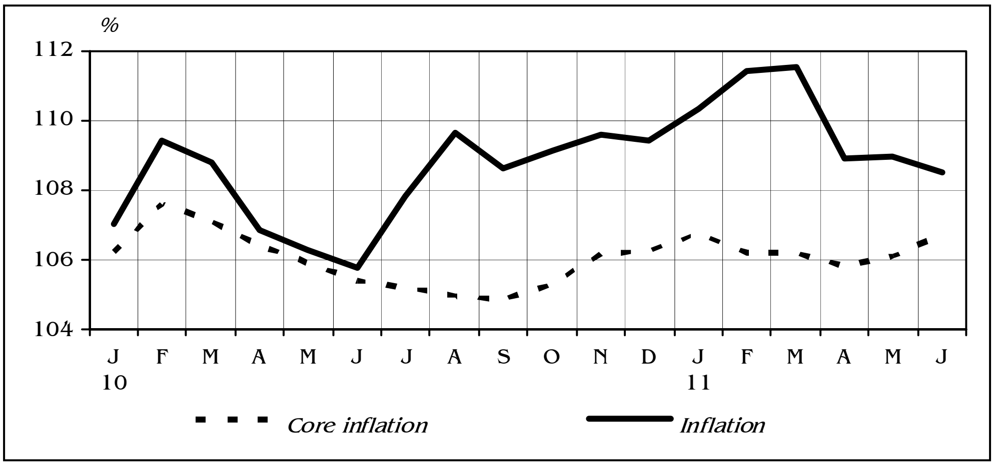
What happened in the second six months, however, was the surge of the 12-month inflation affected mostly by supply shocks, i.e. global price increases on food products and domestic agricultural products. In addition, second-round effects and inflationary expectations showed up at the end of the year in the face of high inflationary environment, which pushed the rate of domestic inflation to accelerate. As a result, 0.2 percent inflation was recorded in the third quarter which is a deflationary period as a rule (since in the last five years the respective deflation indicator has been an average 3.0 percent); in the fourth quarter it reached 4.4 percent (3.4 percent on average in the last five years), while the 12-month inflation ended up with 9.4 percent level.

Notwithstanding high inflationary environment, in the second half of 2010 the Central Bank found it reasonable to withhold from changing monetary conditions in the times when the inflationary environment was driven primarily by supply-side factors. As well as some other factors to ease inflation (i.e. tightened monetary conditions since the start of the year, developments in the foreign exchange market, slowly recovering domestic demand still aversive to creating inflationary pressures) were considered. As a result, in the period June-December the Central Bank left the refinancing rate unchanged, at the 7.25 percent level. However, in the face of intensifying inflationary environment, in the last months of the year the Central Bank made it clear in its statements that tightening the monetary conditions might be necessary.

In early 2011 high inflationary environment persisted, and the Central Bank made another upside revision to its January and April 2011 forecasts for the second half of 2011, to an estimated 9.5 percent and 9.2 percent, respectively. Also, taking into account the impact of supply shock gradually faded off during the year and completely eliminated in the second half as well as the lagged impact of tightened monetary conditions in the first six months of the year, the forecasts however hold the fastest declining trajectory for a one-year horizon, when compared with projections of previous quarters. These forecasts were also based on the World Bank Food Index having increased to 14.0 percent y-o-y in September from 5.5 percent y-o-y in August. Yet, until end-December, the WB Food Index had jumped farther, to 25.3 percent y-o-y and to around 35.0 percent in end-March of 2011.

High price increases of import food products and those of domestic manufacture driven by the impact of supply shocks and second-round effects of high inflation and inflationary expectations caused the first quarter forecasts to be exceeded. As a result, 5.2 percent inflation was recorded in the first quarter of 2011, and the 12-month inflation reached 11.5 percent, outgrowing the upper border of the band by 6.0 pp. Price increases of food products made as much as 8.3 pp contribution to the reported high inflation (5.4 pp driven by price increases of local agro-products and 2.7 pp by price increases of import food products). These factors contributed to the creation of a high level of 12-month core inflation, bringing it to 6.2 percent at the end of March.

The 12-month core inflation and headline inflation dynamics



In the second quarter inflationary environment was somewhat moderate and prices in global commodities and raw materials markets relatively stable. This was concomitant with non-inflationary developments in the domestic economy, reflecting neutral impact of labor market and private expenditures on prices and a restrictive nature of the fiscal policy. As a result, during the second quarter the 12-month inflation subsided by 3.0 pp to 8.5 percent in end-June. However, the 12-month core inflation remained high, 6.7 percent, which is largely an outcome of base effect of the lower indicator of the previous period.

Since the start of 2011 the Central Bank has gradually tightened the monetary conditions by raising the refinancing rate by 1.25 pp in the period January-April. In view of actual moderation of the inflationary environment and in anticipation of price falls in domestic agricultural products due to their increased supply in the sector compared with the previous year, the

Central Bank estimated that the likelihood of further expansion of the inflationary environment is very little and that interest rates in financial market can be used to restrain existing inflationary environment, as a result of which inflation in the forecast time horizon will most likely be in the range of 4%$\pm$1.5.

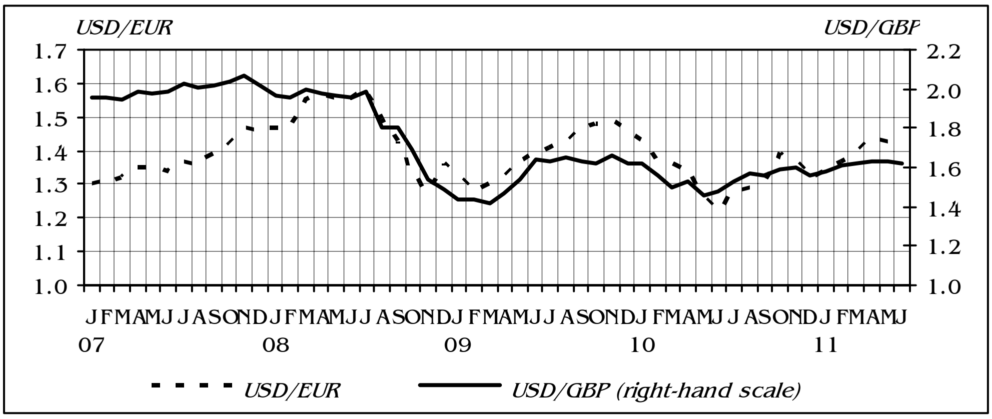
3. INFLATION FACTORS

3.1. EXTERNAL ENVIRONMENT

In the second quarter of 2011 world output growth continued slowing down to an average 4.1 percent in the first half of 2011, according to preliminary IMF estimations. Based on the IMF forecasts made in June 2011, world output growth in 2011 is expected to reach 4.3 percent (0.1 pp lower relative to the April forecasts). Economic growth in 2011 is expected to be 2.2 percent in developed countries (0.2 pp lower relative to the April forecasts) and 6.6 percent in emerging countries (0.1 pp higher relative to the April forecasts). Preliminary IMF estimations showed that in the first half of 2011 inflation speeded up in both developed and emerging economies, fueled by price increases of primary goods in world markets, reaching 2.5 percent and 6.5 percent, respectively. Further IMF forecasts suggest that it will persist at a high level, reaching 2.6 percent in developed countries (0.4 pp higher from the April forecast) and 6.9 percent in emerging countries (unchanged relative to the April forecast). In spite of expected increase in growth rates of world economy for the second half of 2011, risks to the slowdown of the global economy persist, however. These are associated with imbalances (and escalation of problems driven from such imbalances) in financial and fiscal sectors in developed countries and the signs of 'overheating' of the economies in emerging countries as well as developments in global commodities markets (risks deriving from the commodities markets have reduced to some extent yet they remain).

The second quarter was remarkable with more price volatilities in world commodities markets. Prices rose considerably in April but tended to reduce and stabilize in May and June mainly due to some slowing of the world economic activity. During the quarter, stabilization trends of prices were seen in both raw materials and food products markets.

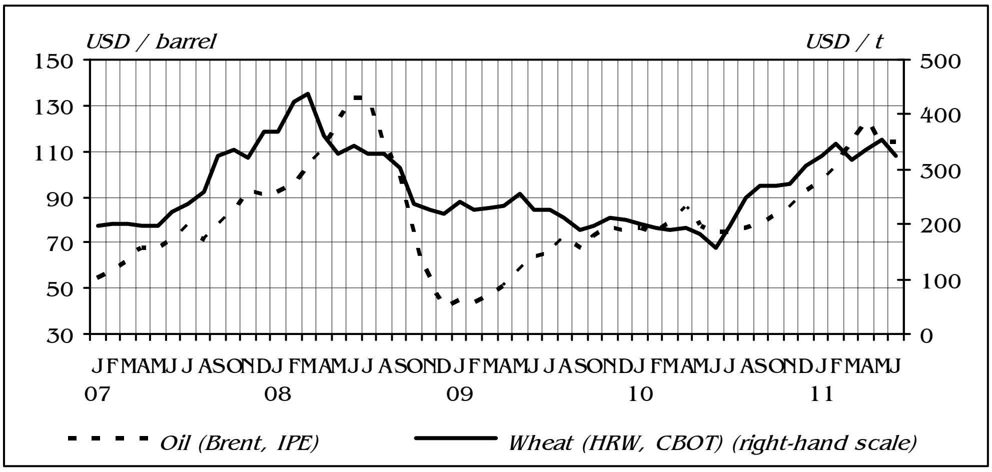
In Q2 2011 the US dollar depreciated



Driven by escalated debt issues in Euro-area as well as more pessimistic expectations regarding economic developments in the USA, the US dollar and Euro exchange rates demonstrated large volatilities in financial markets in the second quarter. So, USD versus EUR depreciated on average by 5.1 percent q-o-q and reached 1.44 dollar for one euro (dollar's y-o-y depreciation was 11.6 percent).

In the second quarter international oil prices increased by 11.6 percent q-o-q, with 'Brent' averaging around USD 117.1 a barrel (y-o-y growth was 48.8 percent). Prices of base metals went down on the whole, reflecting some slowing of the world economic growth rates, whereas prices of precious metals remained at quite high levels. In the second quarter the copper price at the London Metal Exchange fell by 4.8 percent q-o-q averaging around USD 9178 per ton (y-o-y growth was 30.6 percent). Average quarterly gold price rose by 8.9 percent against the previous quarter to reach USD 1509 per troy oz. (y-o-y growth was 26.2 percent).

In world commodity markets in Q2 2011 prices tended to stabilize



Prices of food products generally stabilized during the second quarter. Average quarterly wheat price at the Chicago Board of Trade reached USD 8.8 a bushel, up by 2.6 percent against the previous quarter's average and up by 91.1 percent compared to the same quarter's average of the previous year. According to July estimates by the US Department of Agriculture, in the 2011/2012 marketing year some 662 million tons of crops of wheat are expected against the previous year's 648 million (increase – 2.2 percent). Given a projected world demand of 670 million tons, the world wheat stock is predicted to reduce, in relation to the previous year's 190 million tons, to amount to 182 million tons.

In the second quarter the price of rice grew by 1.7 percent q-o-q and reached USD 14.9 per short hundredweight (45.4 kg), which exceeded the previous year's indicator by 27.1 percent.

The price of sugar went down by 17.5 percent q-o-q, with an average quarterly price of USD 29.7 per cent/pound, which is 41.1 percent higher from the second quarter's indicator of the previous year.

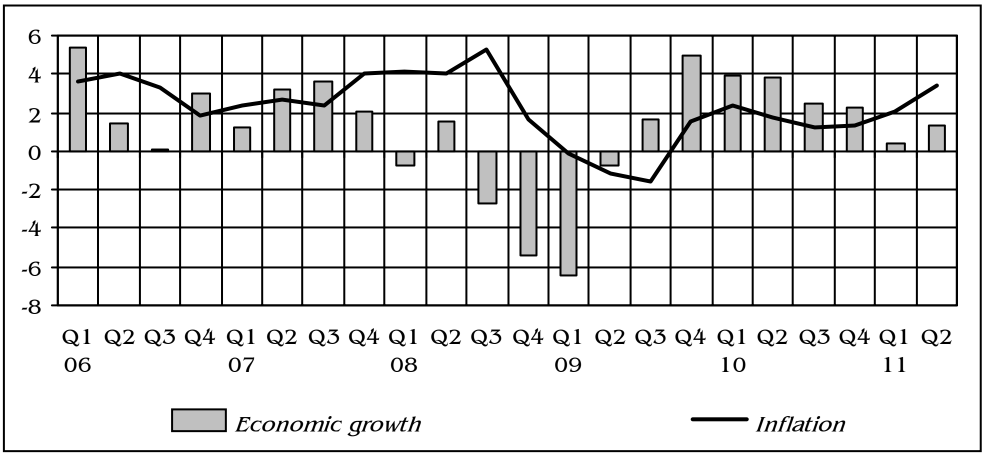
Below is the review of economic developments in the USA, Euro-area and Russia, which make the largest share in the global economy and which are the main partners to Armenia. The review of economic developments of countries neighboring Armenia will follow.

In the ***United States of America*** in the second quarter of 2011 economic growth rates somewhat recovered yet remained modest. Preliminary estimates by Economic Analyses Bureau of the US Department of Commerce show that in the second quarter the US economy posted an annualized 1.3 percent growth q-o-q compared to 0.4 percent growth recorded in the previous quarter. The growth was fuelled primarily by gross private investment (with 0.87 pp contribution), net export (with 0.58 pp contribution) and consumer spending (with 0.07 pp contribution). However, declined public sector expenditures and investment made -0.23 contribution to the economic growth.

In the second quarter the deficit of net exports in GDP continued to deteriorate, amounting to 3.9 percent compared to 3.8 percent recorded in the previous quarter. This indicator is considerably higher from the 3.7 percent value recorded for the same period of the previous year. Notwithstanding relatively a slow growth rate of import volumes, the deterioration was determined by persisted higher growth rate of import value amid higher base value of imports over exports.

In the second quarter average quarterly inflation in the USA was 3.4 percent y-o-y (2.1 percent y-o-y in the previous quarter). The inflationary environment was driven mainly by price increases on vehicles, motor cars, garment, some services and food products.

In the USA in Q2 2011 inflation accelerated

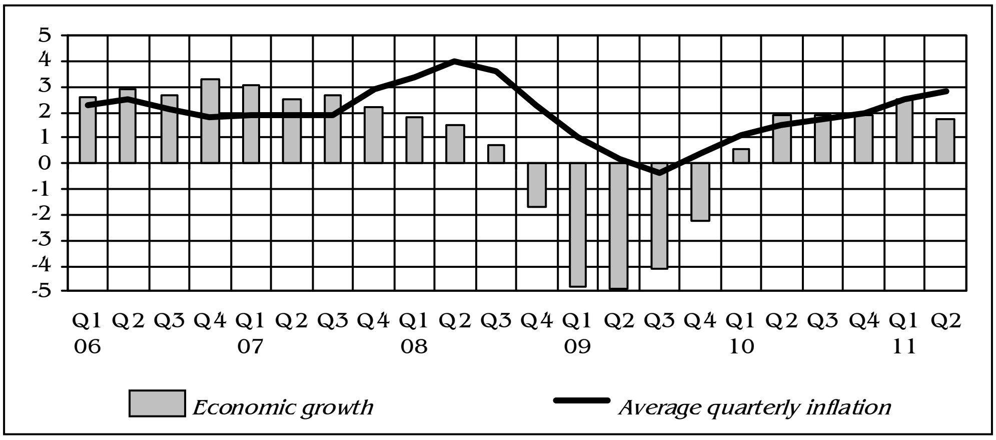


In the second quarter the US Federal Reserve System maintained its prime lending rate in the corridor 0 - 0.25 percent while carrying out the QE2 exercise. While the end of the QE2 policy of the US Fed at the end of the quarter *per se* means tightening of monetary conditions, the Fed may be expected to put off raising policy rates up until 2013 due to relatively moderate developments in the US economy.

According to preliminary estimates of the EuroStat, a q-o-q 0.2 percent economic growth was posted in ***Euro-area*** in the second quarter of 2011. In the meantime, the y-o-y economic growth rates slowed down to 1.7 percent (against 0.8 percent and 2.5 percent q-o-q and y-o-y, respectively, in the previous quarter).

In the second quarter the consumer price index rose an average by 2.8 percent y-o-y against 2.5 percent inflation recorded in the previous quarter. Inflation was driven mainly by price increases on fuel, energy and gas, whereas price falls on communications, rental services and garment made a little downward impact on inflation. In view of increased inflationary pressures amid price rise in global food markets the European Central Bank tightened the monetary conditions by raising interest rates by 0.25 pp first time in early April and another 0.25 pp in July to have set it at the 1.25 percent level.

In Q2 2011 inflation further accelerated in Euro-area



Economic trends were generally positive in ***Russia*** as economic growth continued recovering. As estimated by the Ministry of Economic Developments, economic growth was 3.7 percent y-o-y. For the first six months of 2011 the country posted 3.9 percent economic growth, and 4.5 percent was estimated for the second half of 2011. Growth in industry was 4.8 percent y-o-y compared to 10.9 percent recorded in the same quarter of the previous year. Retail trade posted 5.2 percent growth y-o-y in January-

May (4.0 percent in January-May of the previous year). Construction reported 1.2 percent growth in the first half of the year.

In the second quarter inflation pressures remained high despite tightened monetary conditions in February-April. Average inflation reached 9.56 percent y-o-y against 9.59 percent recorded in the first quarter. It should be noted, however, that in June inflation was low, 0.2 percent, actually the lowest since the start of the year. Inflation rates are expected to slow down during the second half of 2011.

In the second quarter, in view of growing oil prices as well as developments in domestic economy, current account surplus has increased by USD 6.6 billion y-o-y and amounted to USD 25.2 billion. The growth of trade balance surplus (by USD 12.7 billion) promoted an increase of current account surplus. Net capital outflow persisted during the quarter: it reached USD 11.6 billion as opposed to the previous year's net inflow of USD 8.6 billion. Net outflow by banks amounted to USD 4.3 billion and net outflow by other private sector reached USD 4.8 billion. Current account surplus notably exceeded the net outflow of capital. As a result, in the second quarter foreign currency reserves of the Central Bank of Russia have increased by USD 12.9 billion and totaled USD 524.5 billion, as of end-June 2011 (net outflow on item *error and omission* was USD 0.8 billion).

In the face of balance of payment flows as well as developments in international financial markets, the Russian Central Bank remained a net buyer of foreign currency during the second quarter in order to curb the ruble exchange rate appreciation pressures. As a result, the average nominal exchange rate of RUB versus USD appreciated by 4.4 percent q-o-q and the ruble's y-o-y average appreciation versus the US dollar was 7.5 percent.

The Russian Central Bank decided to raise, from May 3, the refinancing rate by 0.25 pp, setting it at the level of 8.25 percent. The decision came in consideration of persisting high inflationary expectations (which is above the inflation benchmark) and somewhat an ambiguous impact on the Russian economy coming from global financial and commodities markets.

Macroeconomic Situation in Neighboring Countries [4]

Turkey: *in the first quarter of 2011 this country posted as high as 11.0 percent economic growth. Economic activity remains strong due to boosted domestic demand of the private sector although net external demand made a negative contribution. As such, net external demand and inventories made, respectively, 5.5 pp and 0.3 pp of negative contribution to the GDP. A considerable part of domestic demand was fuelled by high growth of private consumption and private investments, which amounted to 12.1 percent and 38.3 percent y-o-y, respectively, in the first quarter. The combined contribution of the latter to the economic growth was 16.0 pp.*

The following developments were seen in economy's sectors: processing industry and mining industry posted, respectively, 12.3 percent and 10.9 percent y-o-y growth; growth rates in retail and wholesale trade accelerated and reached

[4] *Review of the macroeconomic situation in neighboring countries is important in a sense that, being under the influence of similar economic turbulences, developments in these countries may indirectly influence the Armenian economy. Crises of 1990s showed that indirect influence channels, including common export markets, the same lending organizations or countries, investors, etc, from the regional standpoint are becoming increasingly influential on economic developments of countries. Therefore countries periodically monitor macroeconomic developments not only in partner countries but also neighboring countries in the Region. Note that Iran is not included in the selection because numerical data of this country are not complete and are issued in such delays when they lose relevance.*

17.2 percent; in construction sector growth was 14.8 percent y-o-y. As for further developments, economic activity is estimated to slow down due to weak external demand and lagged influences of restrictive policies.

Widening current account deficit remains one of the primary problems, driven by persistently high growth of domestic demand. In January-May of 2011 current account deficit has almost doubled, amounting to USD 37.3 billion. This was largely due to a USD 20.5 billion increase of trade balance deficit. In January-May growth of export was 18.6 percent y-o-y and import, by 45.5 percent.

Net inflow of capital amounted to USD 37.9 billion, exceeding current account deficit (in the same period of the previous year USD 23.2 billion worth of net inflow was recorded). In the period January-May net inflow of 'hot money' was USD 14.8 billion compared to USD 7.5 billion net inflow recorded in the same period of the previous year. Inflow of foreign direct investment has increased by USD 3.0 billion and amounted to USD 5.6 billion. As a result of the balance of payments flows, official reserves of the Central Bank of Turkey have increased by USD 9.1 billion (net inflow on item error and omission was USD 8.4 billion).

Following April 2011 appreciation, the Turkish lira depreciated versus the US dollar. Nevertheless, the average second quarter exchange rate remains somewhat appreciated relative to the average exchange rate reported in the first quarter. The y-o-y depreciation of the lira exchange rate was 1.6 percent.

In the second quarter of 2011 consumer prices grew faster, with an average inflation rate making up 5.9 percent y-o-y against 4.3 percent y-o-y recorded in the previous quarter. Such inflation developments were mainly attributable to lagged influence of import prices as well as increased food prices. Also, it should be mentioned that inflation tempered in a volatile manner during the quarter.

In the second quarter the Central Bank of Turkey continued implementing monetary policy mix. On April 21, 2011, the Central Bank raised the reserve requirement ratio (yet left the refinancing rate unchanged) in order to restrain risks by rebalancing the external and domestic demand imbalances and inflow of short-term capital. Note that the reserve requirement ratio was most raised for short-term deposits.

***Azerbaijan:** in the period January-June 2011 real GDP growth rates have decelerated on the whole but accelerated in non-oil sector. Real GDP has grown by 0.9 percent, and 7.2 percent in non-oil sector[5]. Nominal GDP has grown by 13.47 and GDP deflator amounted to 12.5 percent against 25.2 percent in the same period of the previous year. Industry's contribution to the GDP growth was 54.7 percent; agriculture – 4.6 percent; construction – 6.9 percent; transport and telecommunications – 7.9 percent; wholesale and retail trade – 7.4 percent; social services – 11.4 percent; and net production and import taxes – 7.1 percent[6].*

Relative to December of the previous year, inflation in Azerbaijan in the first half of 2011 was 2.5 percent; average inflation amounted to 8.8 percent relative to the same period of the previous year. Average annual inflation was fuelled by price increases on food products (12.3 percent), non-food products (2.9 percent), and service tariffs (4.3 percent)[7].

During the first half of 2011 trade balance of Azerbaijan run with surplus, reaching USD 8.8 billion. Export has increased by 27.8 percent in relation to the same period of the previous year and totaled USD 13.1 billion; import has increased by 49.72 percent and reached USD 4.3 billion[8]. Crude oil accounted for 85.74 percent of value of Azerbaijani exports during the first half of 2011 (it accounted for 86.53 percent in 2010)[9].

In January-June 2011, relative to January-June 2010, gross inflow of foreign direct investment has increased by around 50.5 percent to reach USD 1547.0 million (Manat 1218.8 million), with Great Britain as the largest investor (51.2

[5] Source: Azerbaijan Central Bank Statistics Bulletin, January-June, 2011, Table 1.1.
[6] Source: http://abc.az/rus/news/56036.html.
[7] Source: Azerbaijan Central Bank Statistics Bulletin, January-June, 2011, Table 1.2, http://www.azstat.org/sdds/az/P_I/I_Q_I.shtml.
[8] Source: http://abc.az/rus/news/53367.html: http://www.azstat.org/sdds/az/F_T/x_tic01.shtml.
[9] Source: http://abc.az/rus/news/56116.html.

percent), USA (13.7 percent), Japan (8.3 percent), Norway (4.7 percent), and Turkey (3.9 percent)[10].

In the first quarter of 2011 too, the Central Bank of Azerbaijan implemented a policy to maintain stability of the manat exchange rate. As a result, in the period January-June manat appreciated versus the US dollar by a mere 1.42 percent, and the January-June average exchange rate appreciation was 1.35 percent y-o-y[11].

In the period January-June the volumes of loans provided to the economy by banks have decreased by 2.3 percent; the volumes of loans in local currency have reduced by 5.6 percent[12]. In the resident business loan portfolio structure trade & services hold the largest share (27.3 percent), followed by construction (7.8 percent), industry (5.9 percent) and transport and communications (5.2 percent). On the back of this, the volumes of bad loans have grown by around 13.2 percent (USD 82 million) against end-2010. As of end-June 2011, bad loans constituted 6.2 percent of total economy lending (5.4 percent in end-2010)[13].

Though the volumes of bank deposits have grown by 9.6 percent, the volumes of deposits in local currency have increased merely by 1.5 percent. The dollarization of the economy has grown by 4.2 percent and reached 48.1 percent as of end-June 2011, as a result of 20.1 percent increase in the share of deposits in foreign currency[14].

In the first half of 2011 foreign exchange reserves of the Central Bank of Azerbaijan have increased by USD 539.8 million (8.4 percent) and totaled USD 6947.5 million, as of July 1, 2011[15]. In the meantime state oil fund assets have grown by USD 7.5 billion (33.3 percent) and reached USD 30.3 billion, as of July 1, 2011[16].

Georgia: *in the first quarter of 2011 real GDP growth was 5.8 percent. The nominal GDP has grown by 20.0 percent relative to the previous year. The GDP deflator amounted to 13.4 percent against 4.1 percent recorded in the same period of the previous year. The largest contribution to GDP growth came from industry (18.8 percent), trade (17.1 percent), transport and telecommunications (12.1 percent), public administration (10.6 percent), and agriculture (9.4 percent). Net taxes on manufacture and import constituted 15.7 percent of GDP[17].*

In the period January-June 2011 average inflation in Georgia was 11.3 percent y-o-y, and 0.9 percent relative to December of the previous year. Compared to the previous December, inflation was reported for non-durable goods (1.4 percent) and services (0.8 percent) but deflation was reported for semi-durable goods (3.1 percent) and durable goods (2.2 percent)[18].

In January-June 2011, relative to January-June 2010, export volumes (FOB) have increased by 44.0 percent and amounted to USD 1037 million, and import volumes (CIF) have increased by 35.8 percent and reached USD 3079 million. As a result of export-import transactions Georgia's trade balance deficit deteriorated by 31.9 percent, reaching USD 2042 million[19].

Gross inflow of foreign direct investment started to grow, reflecting further recovery of the Georgian economy. In the first quarter of 2011 inflow of FDI reached USD 173.7 million, which represents more than a 2.3-fold increase y-o-y. In the FDI structure, the largest investors are: Cyprus (23.8 percent), Great Britain (16.5 percent), Netherlands (14.5 percent), Russia (11.4 percent), British Virgin

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[10] Source: http://abc.az/rus/news/56054.html.
[11] Source: http://www.cbar.az/other/azn-rates.
[12] Source: Azerbaijan Central Bank Statistics Bulletin, January-June, 2011, Table 2.7.
[13] Source: Azerbaijan Central Bank Statistics Bulletin, January-June, 2011, Table 2.9.
[14] Source: Azerbaijan Central Bank Statistics Bulletin, January-June, 2011, Table 2.4.
[15] Source: http://www.cbar.az/releases/2011/07/11/20110711-01/?nocache=11021310.
[16] Source: http://abc.az/rus/news/main/56246.html.
[17] Source: http://geostat.ge/cms/site_images/_files/english/nad/GDP_2011Q1(press-release)Eng.pdf.
[18] Source: National Bank of Georgia's Monetary and Banking Statistics Bulletin, January-June, 2011, Table 1.1.
[19] Source: http://geostat.ge/cms/site_images/_files/english/bop/External%20Trade%20of%20Georgia.%20in%20January-June%202011-Eng.pd.f

Islands (11.3 percent) and Turkey (8.0 percent)[20]. Moreover, in the period January-June 2011, relative to the same period of the previous year, inflow of money transfers from abroad has increased by 22.1 percent and reached USD 509.5 million.

With such foreign currency inflow dynamics, in January-June 2011 the average exchange rate of Georgian lari appreciated versus the US dollar by 2.7 percent y-o-y. Relative to end-December of 2010, lari's appreciation was 6.4 percent. To avoid pressures from appreciation of the lari exchange rate, the National Bank purchased USD 45.0 million, net, in the domestic foreign exchange market during the first half of 2011.

In January-June 2011 bank lending has grown by 10.2 percent. The volumes of loans in local currency have increased by 17.7 percent and loans in foreign currency, by 7.5 percent. In the total economy lending structure, resident business portfolio constituted 59.8 percent, including trade (51.6 percent), industry (19.4 percent) and construction (11.2 percent). Bad loans constituted 2.44 percent of total lending volumes, as of June 30, 2011.

In January-June 2011 the volume of deposits attracted by banks has increased by 2.0 percent, with deposits in local currency grown by 9.5 percent but deposits in foreign currency reduced by 0.8 percent. The dollarization in the Georgian economy has subdued by 2.03 percent relative to December of the previous year; as of June 30, 2011, foreign currency deposits constituted 70.1 percent in total.

In the period January-June 2011, foreign exchange reserves of the National Bank of Georgia have grown by 21.9 percent and amounted to USD 2.76 billion, as of June 30, 2011. This represents a USD 495.3 million excess in relation to the relevant figure recorded as of end-2010.

In the period January-June 2011, Georgia's public debt (excluding state guaranties) has increased by around USD 117 million and reached USD 4.182 billion, as of June 30, 2011[21].

3.2. BALANCE OF PAYMENTS[22]

3.2.1. Current Account

The developments in world and domestic economies during the second quarter of 2011 drove the current account to improve. With persistently high metals prices, the growth of export exceeded expectations. The growth of import topped expectations, too, which was mainly due to faster growing private consumption. Real volumes of import of goods have reduced, according to estimations, although price indicators are in line with forecasts. In the meantime, world economic growth promoted continued growth of transfers. As a result of these developments, the deficit of current account reduced in the second quarter by USD 50.6 million y-o-y and amounted to USD 317.0 million. In the first half of 2011 the share of current account in GDP has improved, reaching 19.0 percent (23.3 percent in the same period of the previous year)[23].

The growth of export and import[24] of goods in dollar terms has increased, respectively, by USD 80.6 million (27.3 percent y-o-y) and USD 105.0 million (13.6 percent y-o-y). As a result, trade balance deficit has increased by USD 24.5 million y-o-y and totaled USD 500.0 million.

The growth of export was conditioned by faster growing domestic industry as well as persistently high international metals prices. As a result of these developments, the y-o-y growth of export of goods and services in dollar terms made up 21.7 percent and the growth of volumes[25] of export of goods and services, 10.0 percent y-o-y. The growth of export in dollar

[20] Source: http://geostat.ge/cms/site_images/_files/english/bop/FDI_2011Q1-Eng.pdf.
[21] Source: http://www.mof.ge/en/external_relations/external_debt_statistics.
[22] Q2 2011 indicators are the Central Bank forecasts.
[23] The H1 2011 current account deficit in GDP is usually large due to relatively lower indicator of GDP in the first half of the year relative to the annual cumulative value of the GDP..
[24] Note, also, that customs clearance of motor vehicles with Georgian number-plates, which took place in March-April, had an episodic influence on the import indicator.
[25] Volumes of export and import of goods are the Central Bank estimations.

terms[26] was driven mainly by positive contributions from such items as "mineral production" (17.3 pp), "base metals and articles thereof" (5.1 pp) and "products of prepared food" (4.5 pp)[27].

Positive developments in domestic demand and growth of import prices reflected the dynamics with import of goods as the y-o-y growth of import of goods and services in dollar terms made up 12.9 percent in the second quarter. Volumes have reduced by 3.8 percent y-o-y, which is driven by the influence of the increase of import prices amidst budget constraints of economic agents.

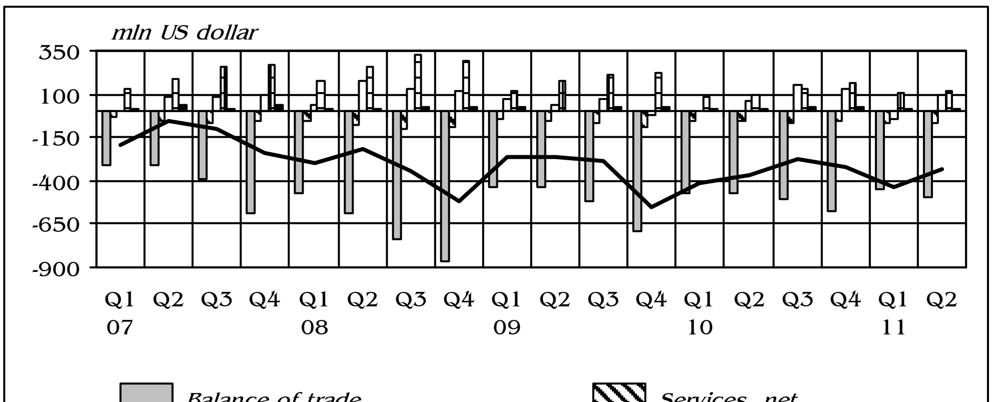
Import was affected by positive contributions mainly from such items as "mineral production" (4.5 pp), "transport means" (4.0 pp) and "products of prepared food" (2.2 pp), whereas items "base metals and articles thereof" and "machinery and equipment" had negative contributions of 2.9 pp and 1.4 pp, respectively.

Re: *geographic distribution of external trade*: trade balance deficit has increased by USD 13.2 million with the CIS and by USD 45.3 million with the EU states. The increase of trade balance deficit with the EU states was primarily due to larger trade balance deficit with Italy. Some surplus was reported with Iran, among others, compared to a USD 21.3 million deficit recorded in the second quarter of the previous year. Trade balance deficits with Switzerland and USA were reduced by USD 19.3 million and USD 3.5 million, respectively, whereas the deficit with Brazil and Turkey increased by USD 12.0 million and USD 7.0 million, respectively.

In the second quarter the deficit of services balance grew by USD 3.7 million y-o-y and amounted to USD 64.0 million. This was determined mainly by increased deficit of balance of transport services and balance of travel. In the second quarter the y-o-y growth of export and import of services reached 12.2 percent and 10.7 percent, respectively.

In the second quarter the y-o-y growth rates of private remittances remained strong. This is largely explained by the developments in the Russian economy (in the second quarter of 2011 economic growth in Russia was 3.7 percent, according to preliminary estimations). Net inflow of non-commercial transfers of individuals via banks has grown by 27.0 percent y-o-y. Also, net inflow of seasonal worker income has grown by 27.0 percent y-o-y and amounted to USD 201.3 million. This more than offset net outflow in item "income on investment". As a result, item "income" posted net inflow of USD 100.7 million. Net inflow of private transfers has increased by 27.2 percent y-o-y and reached USD 120.1 million.

In Q2 2011 current account improved



[26] *Export of some commodity groups that hold a tiny share has reduced.*
[27] *Export and import breakdown by sector and geography is presented, respectively, in FOB and CIF prices.*

3.2.2. Capital and Financial Account[28]

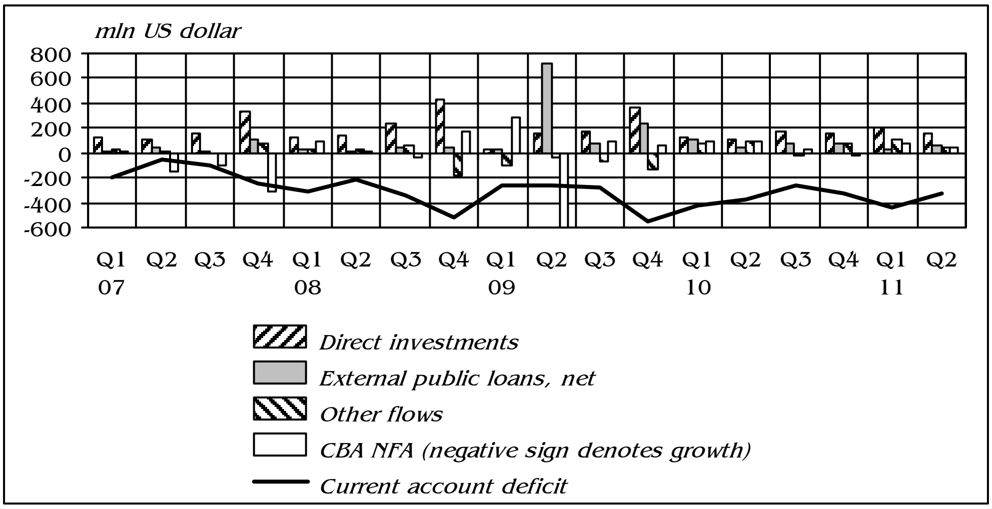
In the second quarter of 2011 the capital and financial account reported net inflow of USD 279.2 million, which is USD 15.0 million more from the relevant indicator recorded in the same period of previous year. All items posted net inflow of funds, which was not sufficient, however, to finance current account deficit. As a result, net foreign assets of the Central Bank have reduced by USD 48.4 million. This was in part due to the decrease of foreign currency accounts of commercial banks with the Central Bank.

In the second quarter the inflow of capital transfers amounted to USD 25.2 million (USD 24.3 million in the second quarter of the previous year).

Net inflow of foreign direct investment has grown by USD 41.6 million and reached USD 150.0 million; net inflow of public loans has grown by USD 10.9 million and amounted to USD 57.5 million.

Net foreign assets of private sector have decreased by USD 46.5 million. Net foreign assets of other private sector (commercial banks excluded) have reduced by USD 16.5 million and net foreign assets of the banking sector, by USD 30.0 million.

In Q2 2011 current account deficit outweighed net inflow on capital and financial account



3.3. INTEREST RATES, EXCHANGE RATE, AND MONETARY DEVELOPMENTS

3.3.1. Interest Rates

In early second quarter of 2011 the Central Bank continued tightening monetary conditions, so the Board of the Bank raised the refinancing rate by 0.25 pp to 8.50 percent from 8.25 percent. Lombard repo rate and deposit facility rate were also lifted by 0.25 pp each, to 11.50 percent and 5.50 percent, respectively.

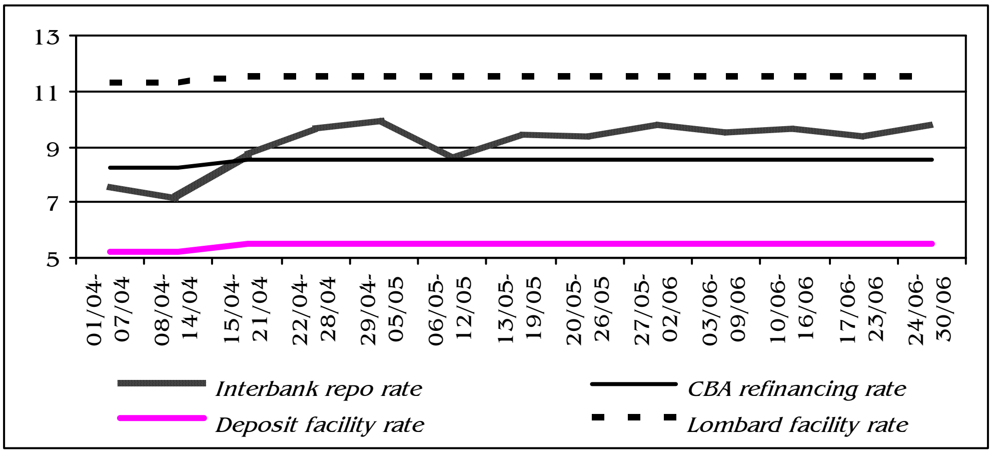
The above factors had their impact on interest rates of the Central Bank operations and interest rates of funds attracted and allocated by commercial banks.

The Central Bank continued offering, each Wednesday, repo transactions to commercial banks. Average reported weekly volumes of repo operations performed reached AMD 4.5 billion, with an average interest rate of 10.63 percent (AMD 3.0 billion and 8.06 percent in the previous quarter). In the meantime, the Central Bank further applied an instrument of long-term repo, with a total volume of nearly AMD 1.5 billion and an average interest rate of 10.11 percent (AMD 3.0 billion and 9.12 percent in the previous quarter). In the second quarter the Central Bank entered into reverse repo transactions, with aggregate volumes of nearly AMD 31.3 billion and average weighted interest rate of 8.46 percent. A fine

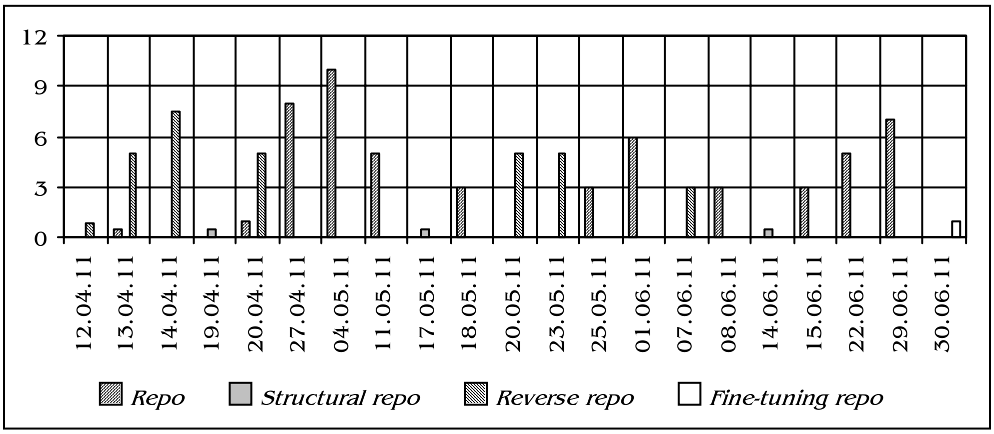
[28] *All indicators pertaining to the Q2 2011 capital and financial account are the Central Bank estimates.*

tuning instrument of around AMD 1.0 billion, with interest rate of 11.25 percent, was applied (for 6 days), as well.

CBA Refinancing Rate, Standing Facility Rate and Interbank Repo Rate



CBA repo operations (bln AMD)



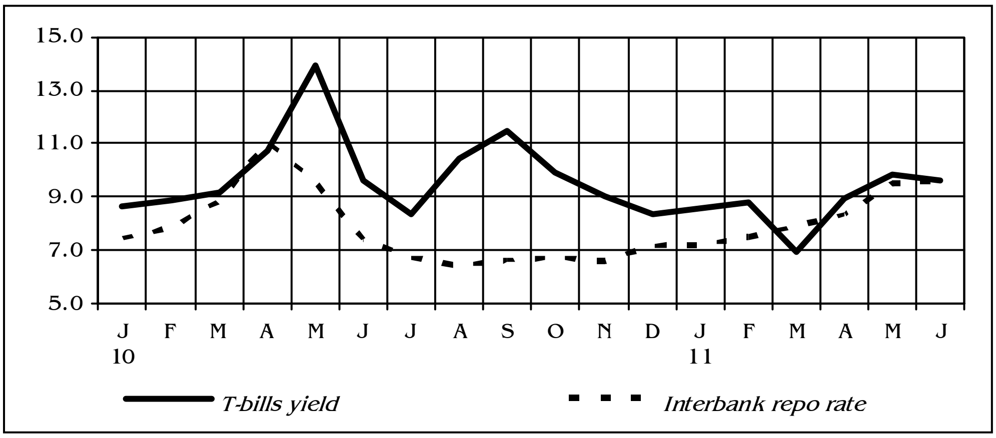
In the meantime, commercial banks used standing facilities. Lombard repo operations with a total volume of AMD 122.9 billion were concluded with the Central Bank, while aggregate volume of funds deposited with the Central Bank amounted to AMD 253.5 billion (AMD 490.8 billion in the previous quarter).

The interbank loan market, i.e. the Overnight Bцrse, has been active. During the quarter the volume of interbank loans was nearly AMD 688.4 billion against AMD 472.0 billion recorded in the previous quarter, with an average interest rate having risen by 3.12 pp to 8.21 percent.

In the second quarter aggregate volume of operations performed in the interbank and intrabank repo markets amounted to AMD 302.2 billion, up by AMD 95.6 billion against the previous quarter. The average market repo rate was 9.95 percent, up by 1.79 pp against the previous quarter. The share of operations executed between commercial banks in total has reduced 38 percent from 40 percent recorded in the previous quarter. Average interbank repo rate has risen by 1.59 pp relative to the previous quarter and amounted to 9.19 percent.

In the second quarter total issue volume of short-term treasury bills reached AMD 14.0 billion (that much in the previous quarter). Total amount of short-term treasury bills allocated was AMD 11.7 billion compared to AMD 13.9 billion recorded in the previous quarter. In primary market of government securities interest rates tended to rise, which was more pronounced in the short-term segment. Relative to the previous quarter, average interest rate has risen by 1.47 pp to 9.37 percent in short-term segment and by 0.16 pp to 13.85 percent in medium-term segment.

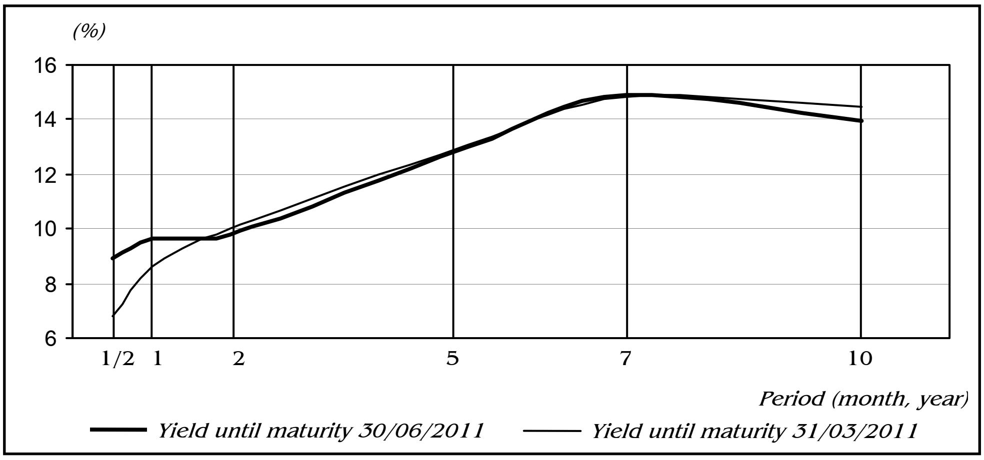
T-bills and Interbank Repo rates



The yield curve analysis shows that in the secondary market of government securities yields have increased mainly in the 1-year segment. Most transposition of the curve (92.5 percent) is driven by a parallel shift in the curve line, which made up 0.4 pp, owing to increased yields. Convexity of the curve has changed as well, from 0.41 to 0.31, pointing out to the decreased spread of interest rates of long-term and short-term securities.

In the second quarter interest rates of loans and deposits in Armenian dram and US dollar trended as follows: average interest rates of dram and dollar deposits were 10.18 percent and 7.30 percent, respectively. Relative to the previous quarter, average interest rate of dram deposits has dropped by 0.17 pp, while interest rates of dollar deposits remained almost unchanged. Even more so, the drop in interest rates of dram deposits took place at the beginning of the quarter but again rose gradually afterwards. As a result, the average weighted interest rate in June rose by 0.25 pp and made up 10.35 percent. The spread of interest rates of dram and dollar deposits made up 2.88 pp (3.02 pp in the previous quarter).

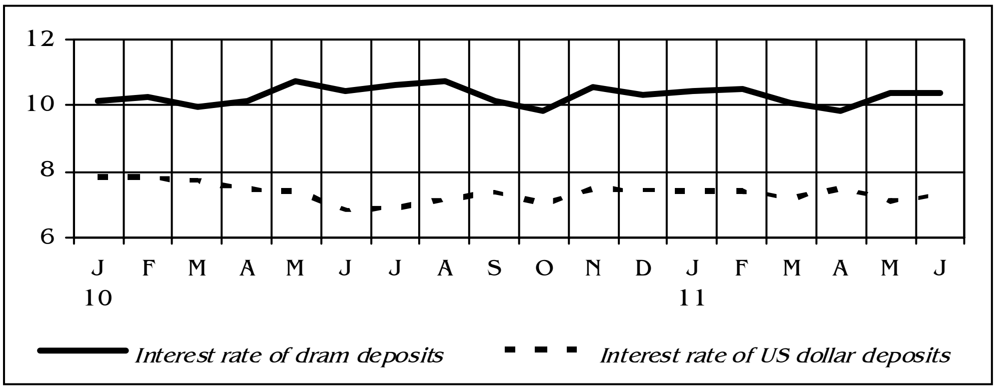
Secondary market reported an interest rate rise in short-term segment



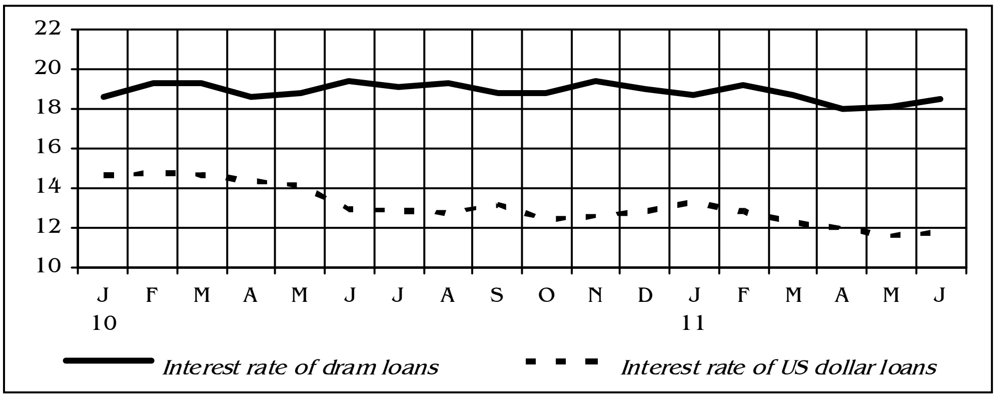
In the second quarter average interest rates of dram loans and dollar loans were 18.19 percent and 11.77 percent, respectively. Relative to the previous quarter, average interest rate of dram loans has dropped by 0.67 pp and interest rate of dollar loans, by 1.01 pp. As a result, the spread of interest rates of dram and dollar loans made up 6.42 pp compared to 6.08 pp recorded in the previous quarter.

In the second quarter the interest rate spread of loans and deposits in Armenian dram made up 8.01 pp, (8.51 pp in the previous quarter) and the interest rate spread of loans and deposits in US dollar reached 4.47 pp (5.45 pp in the previous quarter).

Interest rates of deposits attracted by banking sector



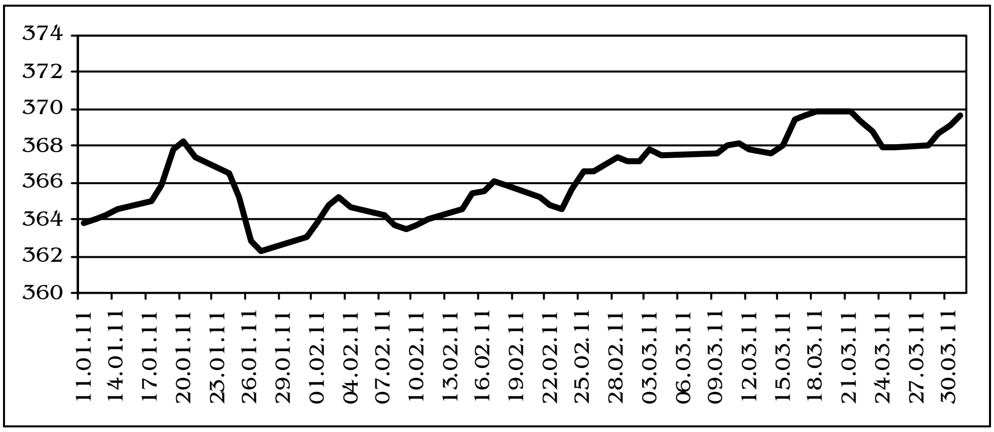
Interest rates of loans provided by banking sector



3.3.2. Exchange Rate

At the end of the second quarter of 2011, relative to the end of the previous quarter, the average AMD/USD exchange rate has appreciated by 0.22 percent to reach dram 368.86 from 369.68 for one dollar. Relative to the same quarter of the previous year, the average quarterly AMD/USD exchange rate has appreciated by 2.71 percent to reach dram 374.18 from 384.33 for one dollar.

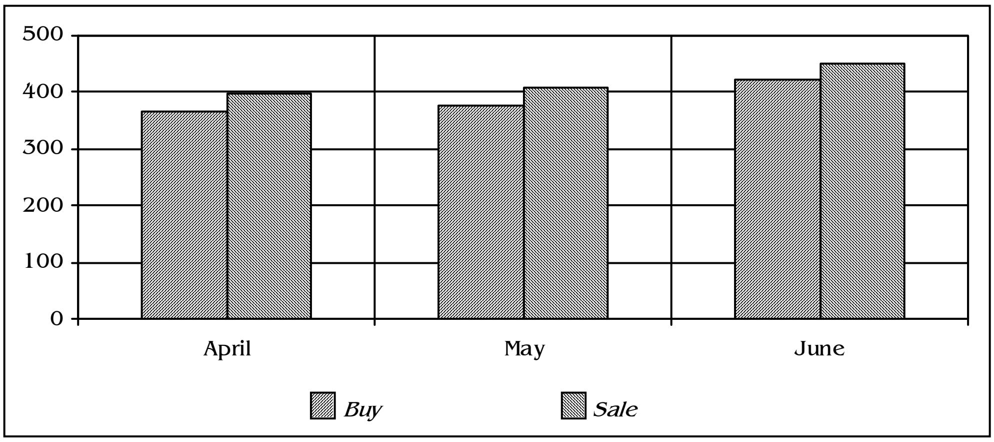
AMD / USD exchange rate



The aggregate volume of interbank market transactions executed during the second quarter amounted to USD 2417.56 million, which represents 29.23 percent increase in relation to the respective indicator of USD 1870.7 million recorded in the second quarter of the previous year.

In the second quarter the aggregate volume of Euro/Dram exchange transactions amounted to EUR 206.85 million, up by 11.2 percent compared to the second quarter of the previous year.

Gross volumes of foreign exchange operations (mln US dollar)



To handle the dram supply and prevent the dram exchange rate from sharp fluctuations, the Central Bank purchased a total of USD 3.65 million from and sold a total of USD 46.38 million to commercial banks during the second quarter.

In the second quarter the nominal effective exchange rate of the dram depreciated by 5.3 percent q-o-q. This was primarily due to nearly 2.2 percent q-o-q depreciation of average quarterly AMD/USD exchange rate and about 3.2 percent appreciation of partner countries' currencies versus the US dollar.

Relative to the same period of the previous year, the nominal effective exchange rate of the dram has depreciated by around 4.9 percent, which was driven by average weighted 7.3 percent appreciation of exchange rates in partner countries, mostly owing to the appreciation of Euro and Russian ruble. At the same time, the Armenian dram has appreciated by 2.7 percent.

During the quarter, both real external exchange rates calculated by CPI (consumer price index) and PPI (producer price index) and real internal exchange rate depreciated.

In the second quarter of 2011 average quarterly inflation in Armenia was 9.2 percent y-o-y[29] whereas average weighted inflation in partner countries was 6.2 percent y-o-y. Weighted average inflation in partner countries was most influenced by inflation in Russia (9.5 percent y-o-y) and Iran (19.6 percent y-o-y), with their contributions of 2.0 pp, 1.1 pp, respectively, as well as by 1.0 pp contribution from Euro-area, which is determined by a large weight of the latter. In the outcome, the CPI-calculated real effective exchange rate has depreciated by 6.8 percent q-o-q under which circumstance there has been 2.5 percent y-o-y depreciation over the second quarter of 2011 (10.3 percent appreciation in the previous quarter).

At the same time, the PPI-calculated real effective exchange rate has depreciated by about 8.0 percent q-o-q. Under such circumstances the y-o-y depreciation made up 8.0 percent as opposed to about 6.3 percent y-o-y appreciation in the previous quarter. This was mainly driven by the dram exchange rate depreciation and appreciation of exchange rates in partner countries and considerable increase of producer prices in partner countries.

In the second quarter the internal real exchange rate[30] appreciated by 4.8 percent y-o-y, against the previous quarter's 7.9 percent appreciation,

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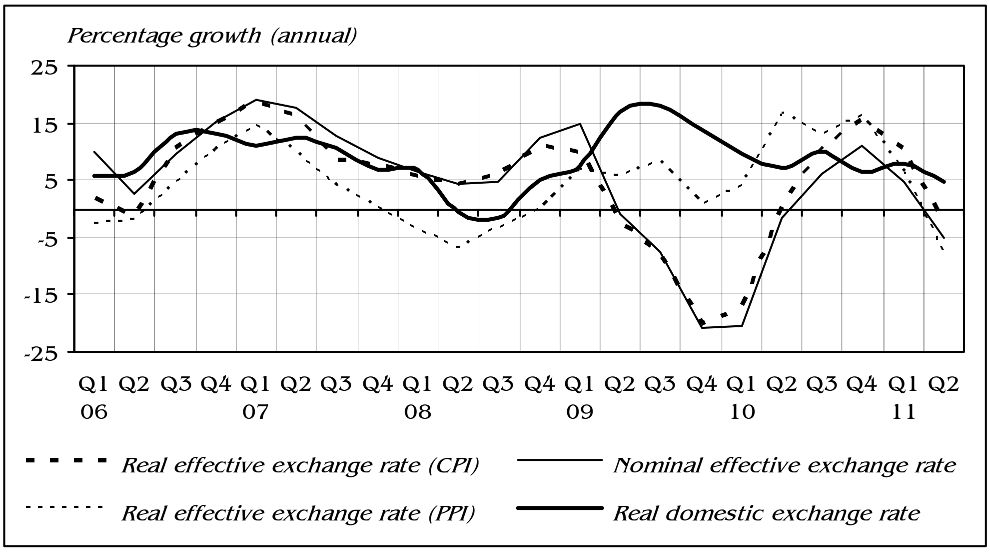
[29] This indicator makes up 8.8 percent, according to official publications of the National Statistics Service of Armenia, and the difference is the variety of bases on which the indexes were calculated.
[30] Internal real exchange rate is calculated as a ratio of prices of non-tradable goods to prices of tradable goods.

as prices of non-tradable goods grew faster than prices of tradable goods[31]. The internal real exchange rate has depreciated by 2.8 percent q-o-q.

In Q2 2011 real exchange rate depreciated



Prices of non-tradable goods and services have increased by 15.5 percent and prices of tradable goods, by 10.3 percent y-o-y, compared to 19.8 percent and 11.0 percent, respectively, recorded in the previous quarter. The y-o-y growth of prices of tradable goods was attributable to persistently high levels of international prices. The y-o-y growth of prices in non-tradable sector was mainly determined by increase of fees of medical services.

3.3.3. Monetary Developments

In view of actual monetary developments in the first quarter of 2011 and forecasts made on an upcoming 12-month horizon, the downsloping trajectory of inflation in particular, the monetary policy program for Q2 2011 envisaged somewhat a moderated scenario. In this context, the tightening of monetary conditions was only considered if upside risks to inflation forecasts were to show up.

Actually, to absorb second round effects of the 2010 high inflation and get inflationary expectations anchored, back in April the Central Bank continued tightening monetary conditions by raising the refinancing rate by 0.25 pp to 8.5 percent. Then, in May-June, the Board of the Central Bank had a consensus that there was very little likelihood of further expanding of the inflationary environment and that formed interest rates[32] in the financial market would further ease inflation environment . As a result inflation in the forecast time horizon would be in the range of 4%±1.5. This is why, for that period of time, the Central Bank left the refinancing rate unchanged.

In the second quarter the monetary developments were mainly consistent with the scenario. Foreign currency deposits grew by 2.0 percent or AMD 8.3 billion, with term deposits making up the whole part of it – AMD 14.8 billion or 5.1 percent, whereas demand foreign currency deposits declined by around AMD 6.5 billion or 5.2 percent.

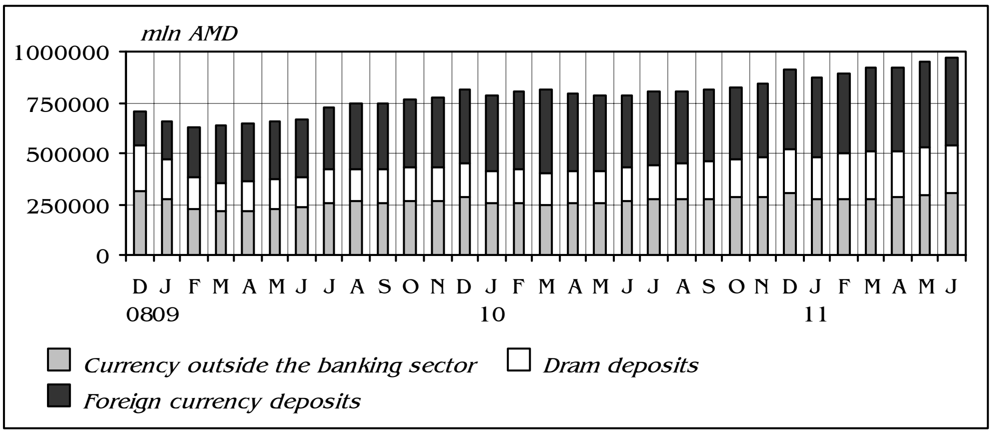
[31] Prices of non-tradable and tradable goods were calculated based on expert judgment over prices of a consumer basket, taking goods and services into relevant categories.
[32] In spite of an unchanged level of the refinancing rate, the dram market in the second quarter of 2011 responded to the 1.25 pp rise in interest rates in February-April by somewhat a stronger increase of interest rates, thus mitigating the inflationary environment of the upcoming period.

Dram deposits grew by 4.1 percent or AMD 9.5 billion, again primarily owing to term deposits (7.3 percent or AMD 7.6 billion), and demand deposits increased by 1.5 percent or AMD 1.9 billion. In the second quarter the dram funds were attracted from households.

Over the quarter currency outside the financial system has grown by 8.5 percent or AMD 23.6 billion which is almost in line with the relevant indicator recorded in the last two years.

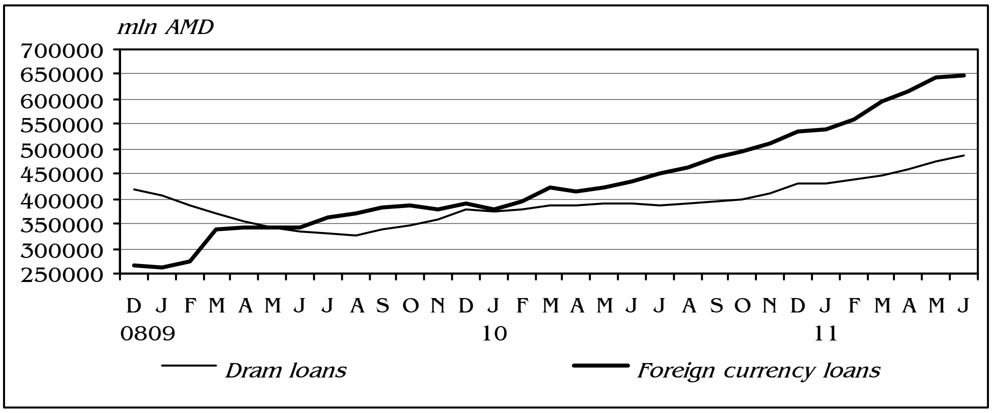
As a result of the aforementioned developments, broad money has increased by 4.5 percent and dram broad money, by 6.5 percent.

In Q2 2011 growth rates of foreign currency deposits kept on slowing down



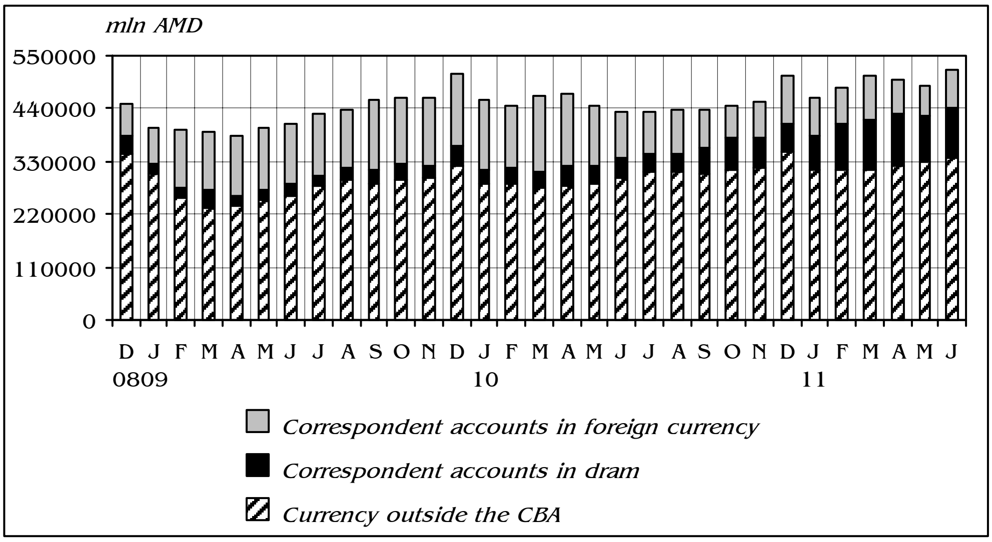
Notwithstanding the gradual tightening of monetary conditions since the beginning of the year, lending to the economy remained strong during the second quarter, 8.7 percent or AMD 92.6 billion, with dram and foreign currency loans almost identical by growth rate. However, in absolute terms, foreign currency loans still prevailed, reaching AMD 54.3 billion. Loans in foreign currency were provided to finance business projects. In the meantime, foreign currency loans provided to companies with state participation have reduced by more than AMD 13.0 billion. Credit resources attracted from abroad and excess funds of FX correspondent accounts remained the main source for foreign currency lending in this quarter, too. Dram loans have grown by AMD 38.3 billion, predominantly owing to consumer loans.

In Q2 2011 high growth rates of foreign currency deposits persisted



In the second quarter the growth of monetary base was 2.7 percent totally owing to 8.5 percent increase of currency outside the Central Bank. Meanwhile, funds on correspondent accounts of commercial banks with the Central Bank have reduced by 6.6 percent, attributable to tantamount reduction of the funds on correspondent accounts both in dram and foreign currency. In the outcome, As a result, the dram component of monetary base has grown by 5.6 percent, consistent with the growth of monetary base.

In Q2 2011 growth of monetary base was totally due to increased currency outside the CBA

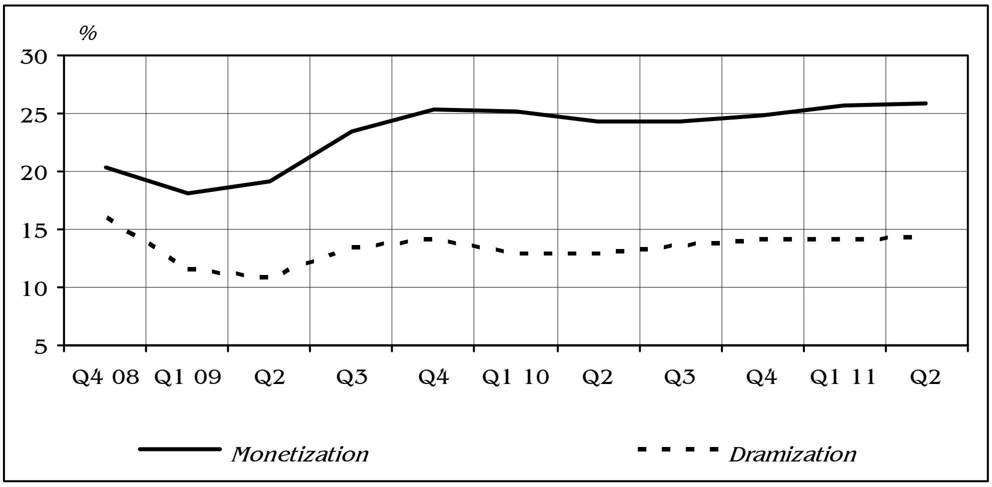


The lagged influence of tightening of monetary conditions and further measures to fight dollarization drove the monetary indicators to demonstrate the following behavior at the end of June of 2011: based on the 12-month period broad money and dram broad money have grown by 23.0 percent and 25.9 percent, respectively; currency in circulation has increased by 13.9 percent; dram deposits and foreign currency deposits have grown by 45.2 percent and 19.5 percent, respectively; monetary base and lending to the economy have grown by 19.7 percent and 37.8 percent, respectively.

At the end of the second quarter dollarization of the economy (measured as a ratio of foreign currency deposits to broad money) reached 44.0 percent, down by 1.1 pp relative to the same indicator of the previous quarter, which was driven by somewhat a slower growth of FX deposits. There has also been a reported 1.3 pp decrease relative to that indicator of the same quarter of the previous year.

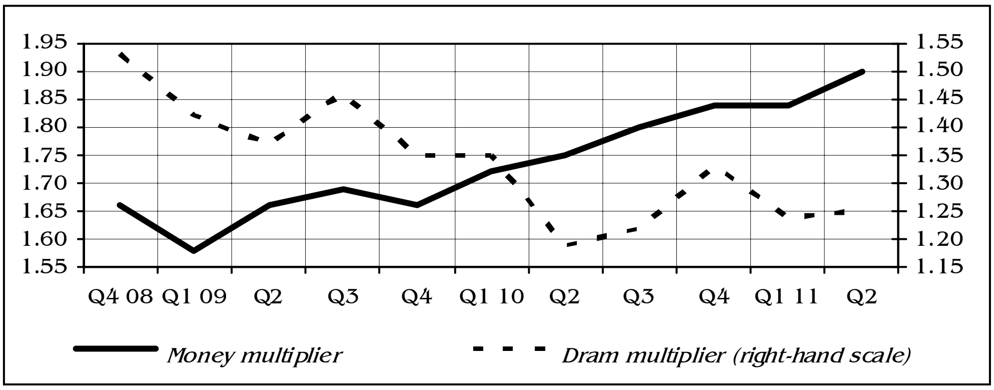
The monetization and dramization ratios, which are measures of financial intermediation, amounted to 25.8 percent and 14.3 percent, respectively, growing by 7.6 percent and 12.3 percent relative to the same indicators of the second quarter of the previous year.

Monetization and dramization ratios



Other indicators of financial intermediation, i.e. money multiplier and dram multiplier performed as follows: money multiplier has grown by 3.4 percent, reaching 1.9 in end-June, with its y-o-y growth making up 8.6 percent; and dram multiplier has grown by 1.4 percent q-o-q and by 5.9 percent y-o-y.

Money multiplier and dram multiplier



3.4. AGGREGATE DEMAND AND AGGREGATE SUPPLY

3.4.1. Aggregate Demand

Domestic demand

Private consumption and investments[33]: In the second quarter of 2011 growth of private spending in real terms was estimated to reach 6 percent, determined by both real increases in private investments and private consumption. In the meantime, public expenditures have declined by nearly 9 percent. In the light of the aforementioned developments, domestic demand has grown by 4 percent.

Growth of private investments was estimated to reach 3 percent, owing to increased profitability in a number of economic sectors attributable to domestic and external demand growing slowly but steadily. Growing private investments were financed mainly from loans provided to the private sector and in part by own funds generated as a result of economic growth.

Private consumption in real terms has increased by nearly 7 percent, largely attributable to private sector incomes owing to increased remittances from abroad and reported domestic economic growth. Growth of lending volumes has somewhat contributed to the growth of private spending. The moderate growth of private investments and consumption reflects increased volumes of construction financed by organization and of trade turnover.

Composite economic indices[34] as calculated and published by the Central Bank point out to the above developments with private consumption and investments. In the second quarter the consumer confidence index rose by 4.3 percent and the economic activity index, by 6 percent, relative to the same period of the previous year.

In the second quarter of 2011, continued growth of private spending resulted in neutralization of the gap between private spending and their potential level, which was caused by the crisis in 2009. As a result of the aforementioned developments, private spending had no impact on inflation.

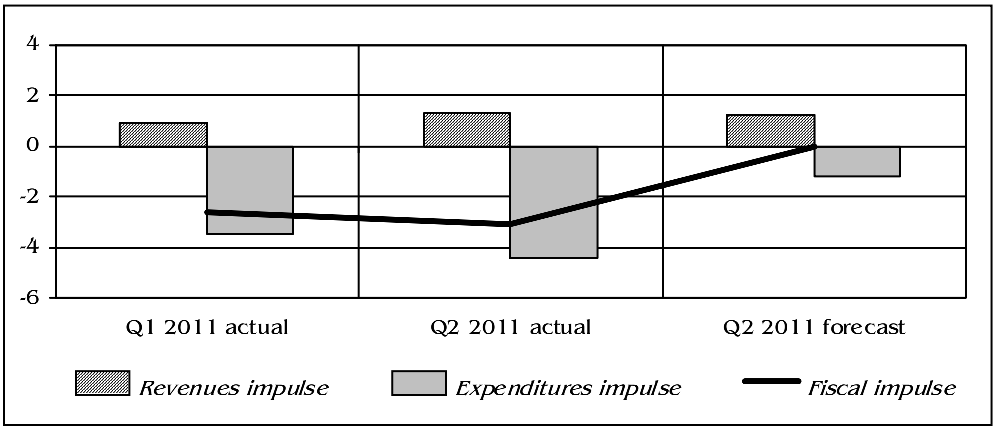
Public consumption and investments[35]***:*** In the second quarter of 2011 the fiscal policy's impact on aggregate demand, hence prices can be seen

[33] *The real growth indicators of private consumption and investments for the second quarter are the Central Bank estimates. The actual figures of these indicators are as of the first quarter of 2011. Estimations of real growth presented in this section are relative to the same quarter of the previous year, unless otherwise stated.*
[34] *See http://www.cba.am/am/SitePages/statsscci.aspx.*
[35] *Consolidated budget indicators which were prepared on the basis of preliminary actual data of the second quarter of 2011 (including PIU funds) were used for the review of the fiscal sector. The 2011 fiscal impulse indicators were estimated against base year of 2010 consolidated budget indicators, determined by positive economic recovery trends and the move from an expansionary anti-crisis fiscal policy to a more balanced one. The impact of revenues has been calculated against an estimated nominal GDP indicator and the impact of expenditures has been calculated against an estimated potential GDP indicator.*

as continuation of the policy to curb inflation. This especially showed up in the form of savings on expenditures[36]. According to an estimated fiscal policy impulse, in the second quarter of 2011 the fiscal policy had 3.1 pp of restrictive impact instead of the projected neutral, which was generated in the face of expansionary revenues impulse of 1.3 pp and restrictive expenditures impulse of 4.3 pp. The main deviation of the impulse was due to expenditures as, driven by savings on expenditures, the restrictive influence came in somewhat a greater amount.

It is noteworthy that in the second quarter of 2011 further trends in economic recovery were observed, which had their positive impact on collection of budget revenues in line with projected proportions. The only deviation came in on the part of grants due to non-disbursement of around AMD 7 billion EU grant expected as part of budget assistance program.

In Q2 2011 the fiscal impulse had a restrictive impact



The growth of tax revenues of the consolidated budget and social security charges has been 9.5 percent relative to the second quarter of the previous year. In the structure of tax revenues, the share of indirect taxes has reduced and the share of direct taxes has increased by 4.7 pp and 4.5 pp y-o-y, amounting to 57.4 percent and 32.7 percent, respectively, in total. There has been a reported decrease of 0.4 pp in other taxes, making up 9.8 percent in total. The decline in indirect taxes was mainly due to reduced share of excise duty, which amounted to 25.2 percent y-o-y. The latter was conditioned by narrowed entries on sub-excise goods imported. The y-o-y growth of indirect taxes was 2.4 percent and direct taxes, 27.1 percent. In the structure of direct taxes, there has been an increase in respect of all taxes, with profit tax having grown by 43.2 percent and income tax having grown by 8.5 percent. Other revenues reported decline of 15.0 percent.

In the second quarter the state budget expenditures have grown by 0.6 percent relative to the second quarter of the previous year. Current expenditures have grown by 6.8 percent y-o-y, in which public consumption has increased by 4.7 percent y-o-y. Expenditures on item *transactions with non-financial assets* have reduced by 24.2 percent mostly due to expenditures not executed for shortfalls with external grant programs as well as some savings on expenditures intended to be made to the expense of domestic sources.

It is noteworthy that in the structure of expenditures on item *transactions with non-financial assets* the share of domestic sources of financing has grown notably while the share of external sources has reduced, amounting to 71.9 percent and 28.1 percent, compared to the previous year's figures of 59.4 percent and 40.6 percent, respectively.

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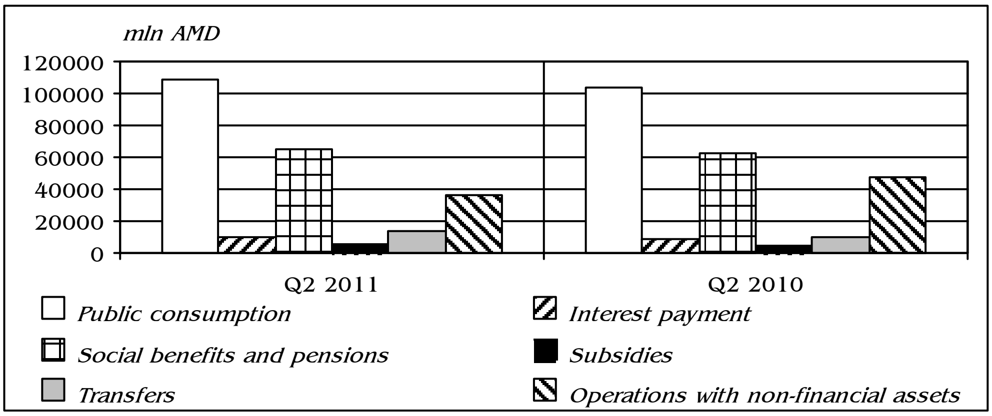
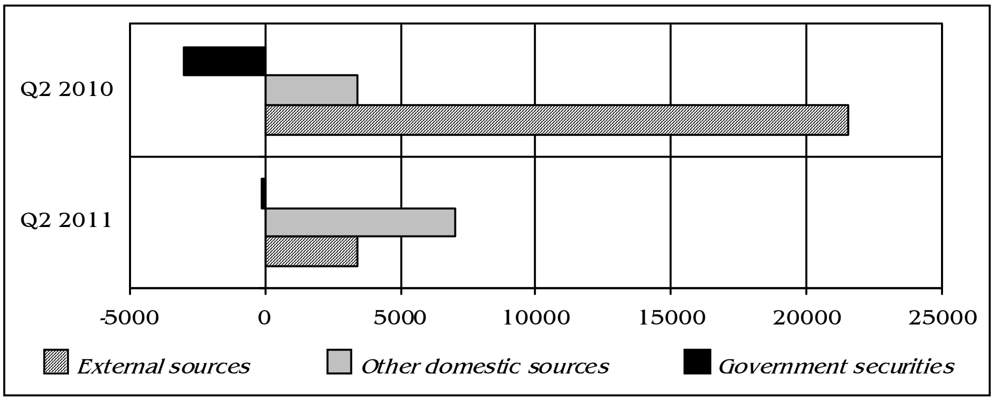
[36] Actual preliminary indicators of budget revenues, expenditures and deficit were compared with quarterly proportions set by the Government (including PIUs).

In Q2 2011 budget expenditures posted cutbacks on capital expenditures



With revenues and expenditures indicators shown above, in the second quarter the budget deficit reached AMD 10.4 billion, making up 28 percent of the projected annual deficit. The latter was financed primarily from domestic sources (66.3 percent) and from external sources (33.7 percent). The structure of domestic sources mainly included funds on Unified Treasury Account with the Central Bank. The structure of external sources included the credit disbursed from the World Bank, amounting to AMD 8.9 billion.

In Q2 2011 financing from other domestic sources prevailed in the structure of budget deficit financing



Based on the results of the first half of 2011, it should be noted that state budget revenues were performed in line with projected proportions. Relative to the same period of the previous year, revenues have grown by 9 percent or AMD 32.9 billion. Public expenditures have reduced by around 1.0 percent y-o-y (PIU funds included). The budget deficit reached AMD 22.0 billion or about 14.8 percent of annual program.

The fiscal policy implemented during the first half of the year had a restrictive impact of aggregate demand, while partly neutralizing end-year expansionary influence.

Table 2

Main macroeconomic indicators in second quarters, 2010-2011 (in real terms)

Indicator	Q2 2010 - Q2 2009	Q2 2011 - Q2 2010
Real GDP	8.2	5.6
Domestic demand	7.3	4.0
Consumption	4.2	5.8
Public	7.4	-2.1
Private	3.5	7.2
Capital investment	21.4	-2.9
Public	0.1	-27.2
Private	27.5	2.5
Export[37]		10.0
Private		-3.8

[37] *This is pertinent to export and import of goods and services.*

3.4.2. Aggregate Supply[38]

Before taking review of the developments in real sector of the economy in the first half of 2011, note that the National Statistics Service of Armenia has changed the economic growth calculation methodology, so the y-o-y GDP growth in the first quarter reached 1.2 percent[39], according to the new methodology.

Considering higher-than-expected economic activity in industry and services during the second quarter (EAI January-June growth – 4.5 percent y-o-y), the Central Bank estimates that there will be somewhat a higher economic growth of 3.9 – 5 percent y-o-y[40] in the period January-June of 2011.

Industry: an estimated indicator of growth of value added was around 15 percent y-o-y mainly due to the increased volumes in *metal ore mining* (13.9 percent), *food production* (18 percent), *beverage production* (11.1 percent), *metallurgy* (15.6 percent) and *items of finished metal manufactures* (65.5 percent), which is a result of consistent improvement in external demand as domestic and world economies recover. Unprecedented growth in electricity and gas production volumes (22.6 percent), driven by increased electricity exports to Iran, further contributed to the growth of value added.

Construction: about 4.6 percent y-o-y contraction of value added was estimated. The reduction in construction volumes financed by *international loans* (70.3 percent reduction), *organizations* (9.8 percent reduction) and *households* (6.1 percent reduction) was somehow offset by increased volumes owing to *state budget* (6.5 percent growth), *local budgets* (2.4-fold growth) and *humanitarian aid* (55.2 percent growth).

The remarkable reduction in volumes of construction financed by international loans is explained by the fact that most part of construction under such programs as 'Improving Rural Area Road Segments', 'Rehabilitating Irrigation System' and 'Improving Vital Roads' had been completed and some other construction works (Yerevan Heat Station Block-5 in the main) financed by the Bank of Japan Loan accomplished.

Services: growth of value added was estimated around 4.2 percent, primarily as a result of increased *retail trade turnover* and *wholesale trade turnover* by 2.5 percent and 3.3 percent, respectively. At the same time, the volume of services rendered has increased by 6.3 percent, with *financial* and *insurance* (25.1 percent), *transport* (3.1 percent) and *education* (7.5 percent) having largely contributed to the growth of value added in Services.

Agriculture: the growth of value added was estimated to remain almost unchanged, driven by 17.6 percent growth in plant growing in spite of 2 percent decline recorded in animal breeding. The decline in animal breeding was conditioned entirely by 24.3 percent reduction in egg production volumes which, however, was partly offset by growth in milk production (0.7 percent) and slaughter animal and poultry (4 percent).

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[38] *Indicators of sectors of the economy represent the value added which the Central Bank estimated based on sector output volumes as released by the National Statistics Service of Armenia for the period January-June of 2011. Indicators of sub-sectors of the economy denote the change in output volumes as released by the National Statistics Service of Armenia for the period January-June of 2011, relative to the same period of the previous year.*

[39] *The economic growth indicator of 2.7 percent was reached on a basis of the former calculation methodology, which is in line with the Central Bank estimates.*

[40] *See the 90 percent probability interval of the Real GDP Growth (Cumulative) Projection Probability Distribution Chart in the paper Monetary Policy Program, Q3, 2011.*

3.5 LABOR MARKET [41]

In the second quarter of 2011 some growth in nominal wages was observed in the labor market, which was fostered by wage increases in the private sector and a number of budget-supported organizations, as a result of recovering economic activity. The growth rate of nominal wages in the economy was consistent with the growth rate of productivity amid buoyant economic activity. In view of the aforementioned developments, unit labor costs have not changed notably, so the changed unit labor costs had an estimated neutral impact on inflation.

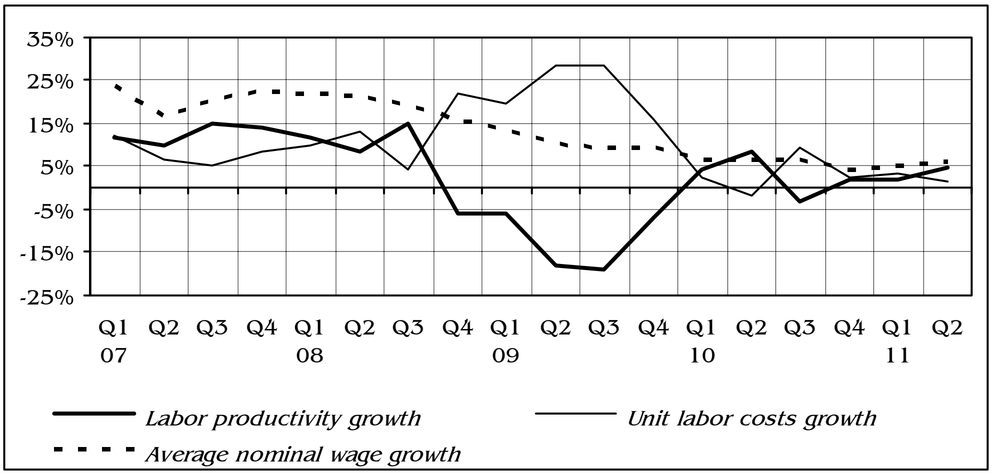
In the second quarter of 2011 the growth of average nominal wages was estimated around 6 percent, reflecting wage increase in private sector as well as moderate increase of wages in some budget-supported organizations. It should be noted that increased productivity in industry and services, growing demand for labor as well as inflation recorded in the previous year had a significant impact on the growth of nominal wages in the private sector. Increased nominal wages in healthcare, reflecting the introduction of a single payment window in the healthcare system, also contributed to the overall growth of nominal wages during the second quarter.

In the second quarter demand for labor continued increasing mostly due to a reported increase of output in industry and services. As a result, the average number of the employed reached 1.3 percent while the quarterly unemployment rate fell against the same period of the previous year by 0.9 pp and reached 6.2 percent.

In the second quarter, concomitant with economic growth, labor productivity grew by around 5 percent.

As a result of these developments, unit labor costs have not changed notably but rather had an estimated neutral impact on inflation.

Labor market developments



3.6. IMPORT PRICES AND PRODUCER PRICES

3.6.1. Import Prices

In the second quarter of 2011 prices of basic food products and intermediate goods in world markets tended to fall and stabilize. According to the Central Bank estimates, the dollar prices of import have increased by 17.4 percent y-o-y (about 22.9 percent y-o-y increase in the previous quarter).

[41] Labor market indicators of the second quarter of 2011 are the Central Bank estimates based on actual figures of April and May and estimated figures of June of 2011. Growth estimations presented in this section are relative to the same quarter of the previous year, unless otherwise specified.

Table 3

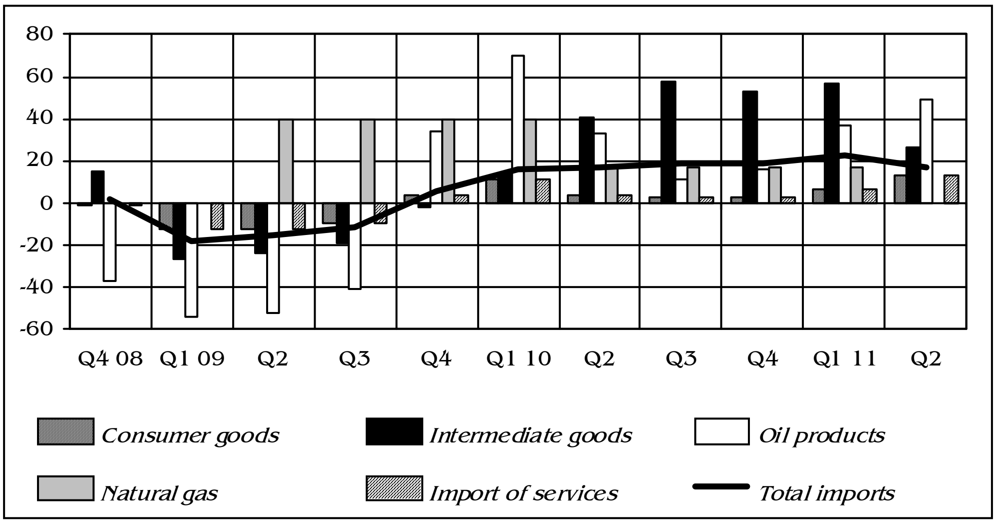
Indicator	Q2 2010	Q3 2010	Q4 2010	Q1 2011	Q2 2011
Import (total)	17.5	19.3	18.7	22.9	17.4
Import (services)	4.3	2.7	3.1	6.9	13.6
Import (goods)	21.0	23.8	22.8	27.2	18.4
Capital goods[42]	0.0	0.0	0.0	0.0	0.0
Consumption goods	4.3	2.7	3.1	6.9	13.6
Intermediate goods	40.9	57.8	52.8	56.3	26.2
Diamond[42]	0.0	0.0	0.0	0.0	0.0
Oil products	33.1	11.8	15.8	36.8	48.8
Natural gas	16.9	16.9	16.9	16.9	0.0

The y-o-y growth of dollar prices this quarter was attributable to persistently high prices of intermediate goods and food products as well as oil products. The price increase of oil products alone was 11.6 percent q-o-q.

The dollar prices of intermediate goods and food products have increased by 26.2 percent y-o-y compared to 56.3 percent y-o-y increase recorded in the previous quarter. Prices of intermediate goods had 8.0 pp of impact on total import prices.

In the second quarter there has been high growth of dollar prices of oil products, 11.6 percent, whereas their y-o-y growth was 48.8 percent (36.8 percent growth in the previous quarter). As a result, prices of oil products had 3.6 pp of impact on total import prices.

In Q2 2011 prices of import goods tended to fall and stabilize



The increase of dollar prices of imported consumption goods was driven by high exchange rate appreciation (6.4 percent) and high inflation (6.6 percent) recorded in partner countries. Under such conditions, in the second quarter of 2011 the dollar prices of imported consumption goods rose by 13.6 percent y-o-y, which had 3.2 pp of impact on total import prices. The Russian ruble and Euro exchange rates appreciation ensured the strongest contribution, among main partner countries, to total import prices, making up 1.0 pp each.

Given 17.4 percent y-o-y increase of international prices (dollar import prices) and 2.7 percent y-o-y depreciation of the average nominal AMD/USD exchange rate, the dram prices of imported goods included in the consumption basket have risen by 10.0 percent y-o-y over the second quarter.

[42] *The lack of estimates on prices of capital goods and diamond is due to their sharp volatility. Therefore a change in these prices is estimated to be zero.*

3.6.2. Producer Prices [43]

In the second quarter of 2011 all branches of the economy (except construction) reported an increase of price indexes, the GDP deflator having been around 108 percent in the period January-June of 2011.

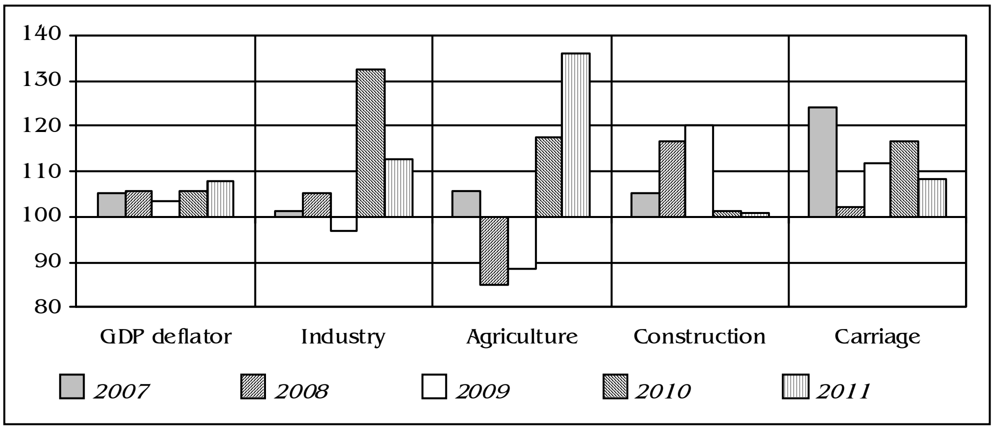
Industry reported the highest price increases, with quarterly growth having reached 9.7 percent y-o-y. In the period January-June the growth has been 12.6 percent y-o-y mainly due to the increased volumes reported in *metal ore mining* (7.9 percent), *processing industry* (10.8 percent) and *energy and gas production and distribution* (21.4 percent), which is a result of persistently high international prices of non-ferrous metals (compared to the prices recorded in the previous period of January-June), consistent improvement in external and domestic demand as well as higher tariffs on electricity producers.

Agriculture posted 34.1 percent y-o-y growth of prices[44], and in the period January-June the growth has been 35.9 percent y-o-y. Driven by unfavorable weather, plant growing reported 71.3 percent price increases, greatly contributed by potato and melons and gourds prices (93.3 percent growth) and grains (66.7 percent growth). Animal breeding reported 29.7 percent price increases due to contracted production volumes and price increases on meat (30.2 percent) and milk and dairy products (3.7 percent).

Construction reported deflation, 1.7 percent y-o-y, under which condition the growth in the period January-June has been 1 percent y-o-y due to wage growth fostered by increasing demand for labor in the branch since the beginning of the year.

Carriage costs have risen by 3.8 percent y-o-y, with the January-June growth having reached 8.5 percent driven by increased tariffs on *railroad transport* (7.2 percent), *motor transport* (3.6 percent) and *pipeline transportation* (15.3 percent). The increase of the pipeline transportation tariffs was attributable to gas tariffs which have risen since April 1 of 2010.

In January-June 2011 the highest price increases were recorded in agriculture and industry



3.7 INFLATION EXPECTATIONS

The Central Bank conducted the Q2 2011 survey of inflationary expectations among financial organizations, households, and non-financial organizations of real sector.

Expectations of high inflation for the upcoming 12-month horizon persisted in spite of a moderated inflation environment. The majority of banks and credit organizations (66.7 percent and 54.8 percent,

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[43] The National Statistics Service of the Republic of Armenia has been publishing an economic activity indicator (EAI) since the start of 2011. The section Prices and Tariffs includes brief information on price change. Recently, the price change has been presented as per economic branch (with no detailed information though), which was used by the Central Bank to estimate total GDP deflator indicator.

[44] Sales prices of producers of agricultural product are presented.

respectively) have further chosen the 5.5 - 8.5 percent range for the 12-month inflation. Nevertheless, the share of respondents with somewhat lower inflationary expectations has grown to some extent.

The results of the survey show that inflationary expectations of households have reduced notably to make up 43.3 percent in the second quarter from 69.4 percent in the first. At the same time though, there has been more uncertainty with regard to inflationary expectations.

Further, according to the results, banks and credit organizations will be sticking to expectations of stable market interest rates for the upcoming 12-month horizon. Some fall in interest rates is anticipated in the government bonds market.