THE CENTRAL BANK
OF THE
REPUBLIC OF ARMENIA

Approved under Board of the Central Bank
Resolution No. 131A,
dated 20.05.2014

Inflation Report

Monetary Policy Program, Q2, 2014

✦

Status report on implementation
of the Monetary Policy Program
Q1, 2014

Table of Contents

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

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

Starting from the second quarter of 2012, the Bank has been publishing forecasts of non-conditional inflation in a 3-year time horizon, in implementation of the inflation targeting strategy, whereby the monetary policy is steered to minimize any deviations of potential inflation from a 4 % target. Projections in this report are based on the factual information available by May 13th, 2014, i.e. the approval of the refinancing rate, the results of a survey conducted by the Bank and the judgment made pursuant to the information on future macroeconomic developments.

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

1. EXECUTIVE SUMMARY

The 12-month inflation will keep on reducing to the lower bound of the confidence band in Q3, 2014 but will come closer to the target in Q2, 2015 and stay around in the rest part of forecast horizon.

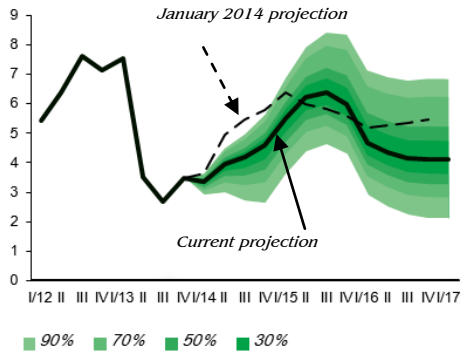
The economic growth will speed up in the period 2014-2015 and will stabilize around its potential in the rest part of forecast horizon.

The Central Bank forecasts suggest the 12-month inflation will keep on reducing to the lower bound of the confidence band in Q3, 2014 but will come closer to the target in Q2, 2015 and stay around in the rest part of forecast horizon. The economic growth will speed up in 2014-2015 and stabilize around its potential in the rest part of forecast horizon.

In Q1, 2014, ***the economic environment remained sluggish*** due to the slow pace with which construction was recovering as well as modest growth of industrial output. Slow private consumption growth rates and weak investment activity observable since the previous year also contributed to such an environment: in Q1, 2014 private consumption growth is estimated 1.8% y/y, while private investment has declined by 4.5% y/y. As a result, it is expected that economic growth in the first quarter would range ***3.2-3.5% y/y.***

According to short-term forecasts, private consumption growth rates will accelerate, with a stable investment environment; so in 2014, private consumption will grow by 4.6% and private investment will persist almost at the same level. In anticipation of expansionary fiscal policy during the year, the fiscal impulse will leave some 0.7 pp of expansionary impact. Based on the 2014 results, the real growth of export of goods and services will be in the range of 5.5-7.5%, the real growth of import within 1.5-3.5% and the growth rate of remittances of individuals within 4.5-6.5%. As a result, ***economic growth in 2014 is estimated in the range 4.1-4.8%,*** due mainly to good performance in the agriculture and service sectors (a total contribution of 3.0 pp).

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



In the forecast horizon the economic growth will stabilize around its potential, reflecting steady private consumption growth rates and slowly rebounding private investment. Thus, ***in the forecast horizon,*** stabilizing private demand as well as neutral impact of the fiscal policy is expected to create ***non-inflationary effect on domestic demand.***

In Q1, 2014, ***external demand*** remained sluggish: ***Armenia's main trade partners, other than the Euro-area, reported trends of slowing economic activity.*** In such a situation, deflationary patterns prevailed in ***international markets of basic commodities and food products.***

In the forecast horizon, a slow pace of recovery in global economic growth rates is anticipated, under which conditions notable inflationary pressures are not likely to come from international markets of basic commodities and food products.

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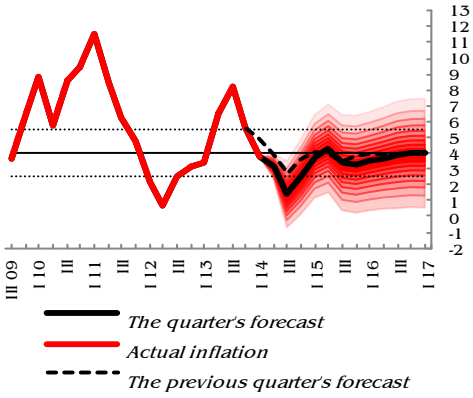
In Q1, 2014, the ***12-month inflation*** trended down – from 5.6% in late 2013 to ***3.8%*** in end-March 2014, approaching the upper bound of the band. In the first quarter, core inflation also demonstrated a downward trend, with its 12-month indicator

dropped to 1.8% in end-March from 3.7% reported in early of the year.

In Q1, 2014, the Central Bank ***further eased the monetary conditions*** by cutting the refinancing rate further (0.25 pp) to 7.5% in end-March (see details in section 3.1.1 Actual inflation and attainment of target). The dram reserve requirement ratio, lowered from 4% to 2% since February 2014, was another step of easing.

In Q2, 2014, the Central Bank will continue easing the monetary conditions.

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



According to the Central Bank estimation, the 12-month inflation in 2014 will be within 2.5-5.5%.

In 2014, inflation will continue to decline at a rate faster than expected, according to the Central Bank projections, and in the third quarter it will be closer to the lower bound of the band as the effect of energy prices risen in July of 2013 phases out. ***In Q2, 2014, the Central Bank will further loosen the monetary conditions***. This, coupled with the easing of monetary conditions to date and an expansionary fiscal policy anticipated during the year, will stimulate aggregate demand and push inflation rates to rebound. As a result, the economic activity will somewhat revive whilst facilitating the inflation to stabilize around its target over the forecast horizon.

According to the Central Bank estimation, ***the 12-month inflation in 2014 will be within 2.5-5.5%.***

Risks to inflation deviating from the ***projected value*** are estimated as ***balanced*** in both short and medium-term perspectives. The primary risks are associated with the development perspectives in emerging economies and domestic demand. If such risks materialize, the Central Bank will react accordingly by maintaining the inflation target in the medium run.

2. FORECAST, FORECAST CHANGES, RISKS

2.1. External environment[1]

The global economy rebounding will create minor inflationary pressures in the external sector in the forecast horizon.

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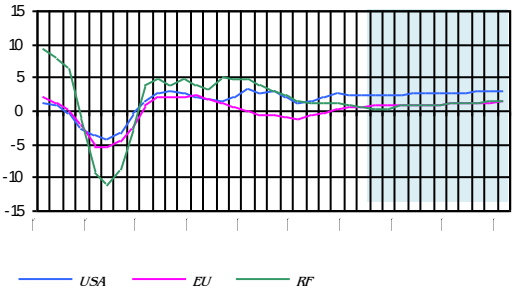
In an April 2014 report, the IMF readjusted world growth outlook indicator slightly downside, predicting economic growth of 3.6% for 2014 (with downside adjustment of 0.1 pp). The adjustment was made owing to developing countries.

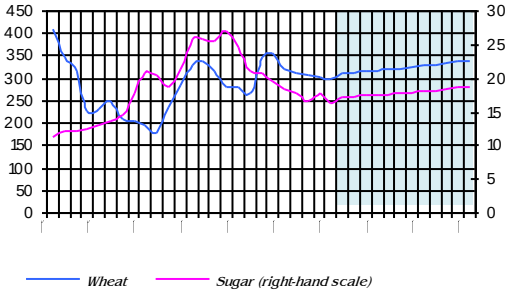
Economic growth in trade partner countries (%)



The U.S. Federal Reserve System is expected to end the quantitative easing program during 2014 yet it will continue implementing a low-interest-rates policy over the forecast horizon. In the meantime, less gloomy uncertainties associated with the fiscal policy will accelerate economic growth rates. Economic growth is estimated to be near 2.5% in 2014 and about 3% in 2017.

In the Euro-area, economic recovery will carry on over 2014 too, with the economic growth to reach 1.5% in early 2017. In pursuit of economic stimulation, the European Central Bank will continue a low-interest-rates policy.

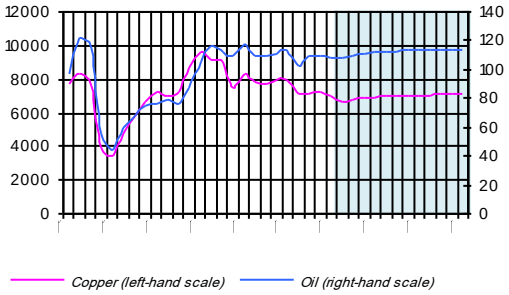
Food products (USD)



The forecast of economic growth in Russia in a medium-term perspective was again revised downside due to geopolitical clashes with Ukraine. The slowing of economic growth rates is mainly attributable to a weak investment activity and capital flight. The economic growth rate is estimated to reach 0.6% in 2014 and 1.5% in 2017.

Uncertainties and risks about the further pace of global economy ***are more essential*** for developing countries. Such uncertainties are associated with capital flight and a resultant slowing of economic activity in such countries.

Basic commodities (USD)



The global economy will further be sluggish as no significant inflationary trends will be observable in the world's ***basic commodity and food product markets.*** In the meantime, individual commodity markets are predicted to develop under the influence of fundamental factors inherent in any such markets. Risks associated with energy price developments will be determined by geopolitical events, whereas prices of food products will depend on weather conditions.

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[1] *The forecasts of external sector have been based on the information provided from the IMF, World Bank, The Economist, Global Insight, Financial Times, US Department of Agriculture, Economist Intelligence Unit, International Grain Council, International Energy Agency, Barclays Capital, РосБизнесКонсалтинг and other sources.*

Box 1

Developments in commodities markets in the forecast horizon

According to International Energy Agency's April estimates, in 2014 about 60% of global oil demand will be met by producing oil by non-OPEC countries (the growth was 2.7% against the previous year), under which circumstance average demand for extraction of oil by OPEC countries will reach 36.5 million b/d. In the forecast horizon, international oil prices are expected to grow moderately as world economic activity rebounds. Though risks due to geopolitical developments have reduced to some extent, the global market of energy resources will however see inflationary risks.

In 2014-2017, moderate inflationary patterns will be discernable in base metals markets, as the global economy further recovers.

According to May estimates of the U.S. Department of Agriculture, in the 2014/2015 marketing year some 697 million tons of wheat crops is expected (the volume of crop has reduced by about 17 million tons in comparison with the previous year). Furthermore, some growth of stock is expected in the forecast horizon, reflecting faster production rates over consumption (the stock will increase by nearly 1 million ton compared to the previous year). As a result, average international wheat price will follow a steady path in the medium run.

In the 2014/2015 marketing year, world production of rice will amount to 480.7 million tons (about 4.6 million tons more compared to the previous year). On the back of increased consumption however, the world rice stock may come in at somewhat reduced volumes (roughly 1.5 million tons less in comparison with the previous year). Average international rice price will mostly behave stably, as a result.

International sugar price may stably trend slightly up in medium run.

2.2. Aggregate supply and Aggregate demand

Aggregate supply

The ***economic growth forecasts were revised downside*** based on a slower economic growth rates in anticipation of pessimistic economic growth prospects in Russia, Armenia's main trade and investment partner, a weaker-than-anticipated expansionary fiscal policy implementation and a revision in the timing for exploitation of Teghout mine[2].

Economic growth in 2014 is expected in the range 4.1-4.8%.

As a result, economic growth in 2014 is expected in the range 4.1-4.8%[3]. Furthermore, projected economic growth trends will continue in the forecast horizon, and the economic growth is expected to stabilize around its potential.

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[2] According to information from the company Vallex Group, they will be expected to start the mine by the end of the year.
[3] See the 30 % interval in the Real GDP Growth (Cumulative) Projection Probability Distribution Chart in this paper.

For ***Industry***, the forecasts were revised downside, with ore mining and metallurgy predicted to reduce due to the falling prices of non-ferrous metals in global markets as well as readjusted timing for exploitation of Teghout mine. Growth rates in production of building materials, processed food and beverage were also revised downside due to the reported slowing in growth rates in construction, external and domestic demand. As a result, value added in industry is expected to reduce to the range 3.7-5.2% in 2014.

In ***forecast horizon***, the industry growth will stabilize in the range of 5.7-6.3% and will be closer to its long-term equilibrium.

For ***Construction***, the growth of value added in 2014 was revised downside, mainly due to lower-than-expected activity in the branch reported in the first quarter. As a result, value added is expected to grow in the range 2.5-4.5% in 2014, mainly driven by construction activities in such infrastructures as roads, irrigation systems, water and sewage, the country's northern terminals and Yerevan underground, which will be funded by central and local government budgets as well as resources of international organizations.

In the ***forecast horizon***, the growth is expected to stabilize within 1-2% as the supply and demand disequilibrium in construction phases out.

For ***Services***, value added is expected to reduce, with the downside prediction in the range of 4.2-5.7% for 2014, caused mainly by revised forecasts of the domestic demand which is expected to affect the volumes of trade turnover and the volumes of other services.

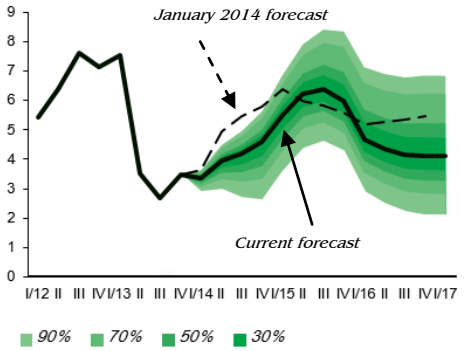
In the ***forecast horizon***, growth rates in services will stabilize within 4.5-5%, broadly in line with the medium-term domestic demand forecasts.

For ***Agriculture***, the forecasts did not change as current developments in the branch are still in line with forecasts of value added under the least risky scenario. The real growth of value added in 2014 is predicted in the range of 4.5-6.5%, driven by expected increases in plant and animal growing fuelled by public and private sector investment in house farming, sowing areas and more harvesting and grown headcount in recent years.

In the ***forecast horizon***, underlying growth rates in agriculture will persist within 5-6.5%.

In the forecast horizon, risks to the economic growth under the baseline scenario are dual sided and depend on how external and domestic economies would perform further. Moreover, ***in the course of 2014***, downside risks will somehow prevail as the fiscal policy will be less expansionary than programmed while private investment will rebound at a slower

Real GDP growth (cumulative) forecast probability distribution chart for 3-year horizon



pace compared to the post-crisis period. In the period 2015-2016, attributable to higher-than-expected risks to private investment growth, risks to accelerated economic growth will be prevailing. Moreover, growth of investment will be expected in the form of increased gross domestic savings, once the funded pension contribution scheme starts, and in the event Armenia joins the Eurasia Customs Union.

Real GDP growth (cumulative) forecast probability distribution chart for 3-year horizon				
Period	30% probability distribution		90% probability distribution	
	min	max	min	max
January-December 2014 / January-December 2013	4.1%	4.8%	2.6%	5.6%
January-December 2015/ January-December 2014	5.6%	6.6%	4.3%	8.4%
January-December 2016 / January-December 2015	3.6%	4.8%	2.1%	6.9%

Labor market:[4] Forecasts of labor market indicators for 2014-2016 were revised slightly in response to the adjustment made in economic growth forecasts. Specifically, compared with previous forecasts, average wage is expected to have somewhat slower growth rates and the unemployment rate to reduce unhurriedly.

In 2014, average nominal wage in the economy is expected to grow by nearly 11% against 6.5% growth reported in 2013.

In 2014, ***average nominal wage is expected to grow by nearly 11% compared to 6.0% growth recorded in 2013.*** The wage increase during the year will be attributable to the rising of minimum wage threshold and sizable wage increases in the public sector most likely to happen in the second half of the year. Note that wages increases in the public sector will possibly trigger some rise in wages in the private sector, reflecting the wage competition across segments between the public and private sectors. In the second half of the year, some minor inflationary pressures (about 0.2 pp) will be observable in the consumer market due to added unit labor costs in the private sector companies. Such pressures will vanish in the mid-2015, however.

In 2014, average unemployment rate is expected to reach 15.8%, reducing by 0.3 pp in comparison with the previous year.

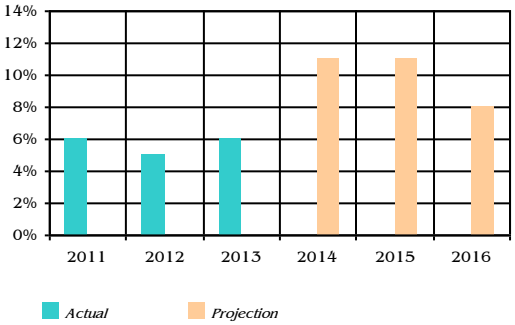
In the light of economic growth anticipated in 2014, average unemployment rate will reach 15.8%, according to Central Bank estimates, representing some 0.3 pp of reduction in comparison with the previous year. The unemployment will further trend downward steadily in the period ***2015-2016.***

In 2015-2016, nominal wages will keep on increasing at a faster rate in relation to 2013, on the back of anticipated economic growth, inflation, reducing unemployment and the Government's policy further steered to foster wage growth. Note

[4] *The labor market data for 2013 are the Central Bank estimates which are based on Q2, 2013 data and actual July-August figures. The growth indicators presented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.*

that the effect of sizable wage increment in the public sector in the second half of 2014 will be persisting in the course of the first half of 2015, which will lead to maintaining high gross wage growth rates for that period.

Average nominal wage growth, y/y



In the second half of 2014, the wage increase in the public sector and an increased minimum salary threshold will slightly speed up the growth rate in wage in the private sector; this will lead to increased costs companies in the private sector will have to incur. As a result, the consumer market will be going to feel minor inflationary pressures, to the extent of 0.2 pp, which will phase out in the first half of 2015. In the forecast horizon, inflationary pressures from the labor market are not anticipated[5].

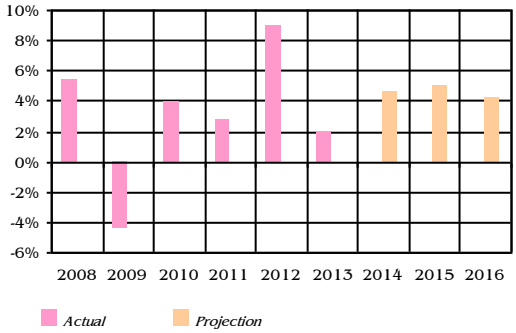
Aggregate demand[6]

Expansionary fiscal policy and monetary policy implementation will push aggregate demand to grow at a rate above average (5%) in the period from the middle of 2014 through late 2015. However, starting from the end-2015, in the event the impact of the fiscal policy weakens, aggregate demand will grow at a slower but steadier pace, in line with the economic growth rates.

In anticipation of a slowdown in the Russian economy, growth rate in ***private consumption*** for 2014 was revised downside to an estimated 4.6%. Despite the revision, the 2014 private consumption growth is expected to be significantly above the 1.8% growth recorded in 2013.

High inflation driven by increased energy prices as well as the slowing of credit growth rates are among factors that determined the sluggish real private consumption growth rates in the second half of 2013 and early 2014.

Private consumption growth, y/y



With the negative impact of increased energy prices phasing out, expansionary fiscal and monetary policies will speed up the pace of private consumption growth already in the second quarter of 2014.

A significant increase in wage in the public sector expected in the second half of 2014 will contribute to the growth of disposable income of households. The increase in disposable income will, starting from the second quarter of 2014, drive private consumption to grow even faster; in early 2015 it will persist at the high level and gradually stabilize around 4.0% in 2015-2016.

In Q1, 2014, ***investment activity*** in the economy was sluggish, as was anticipated, reflecting contracted output in

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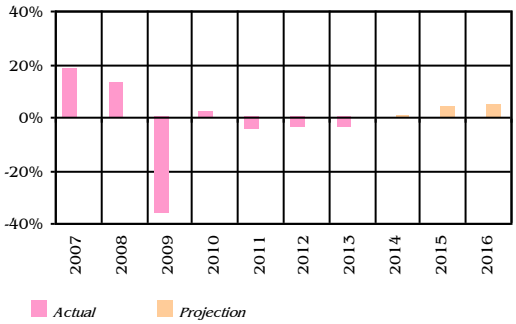
[5] The wage increase in the medium run will also lead to demand-pull inflation (see details in the section "Aggregate demand").
[6] The data of real growth of private consumption and investments for 2014 are the Central Bank estimates. Actual figures of these data are as of Q4, 2013 and published by the Republic of Armenia National Statistics Service. The real growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

construction in the period January-March[7] as well as the Central Bank surveys on investment[8].

There is anticipation that investment activity will improve to some extent during 2014, as the economic growth revives. But because investment activity for the year is estimated to be meek, private investment ***in 2014*** will not change significantly compared to the previous year. ***In 2015-2016*** private investment will post a very moderate growth of 3-4%, as economic activity in construction recovers and some private sector projects will be implemented. Risks to upside growth of investment in the economy prevail, and the launch of a funded pension contribution scheme could considerably increase gross domestic savings hence private investment.

Private investment growth, y/y



In view of the developments with private consumption and investment mentioned above, in 2014 growth rates in private spending will accelerate and stabilize around 4.0% in the end of ***forecast horizon***. As a result, the private spending gap will persist over 2014 and will wane out to zero late in the year. The private spending growth rate accelerated under the lagged influence of fiscal and monetary policy implementation will result in a small positive private spending gap in 2015 and will gradually return to zero in the forecast horizon.

In 2014, therefore, the private spending will create 1.1-1.2 pp of contractionary impact on inflation. Starting from the second half of 2014, deflationary pressures of private spending will weaken and eventually phase out late in early 2015. During 2015, the impact of private spending on inflation will be inflationary, 0.3-0.4 pp, which will phase out in the period 2015-2016.

The 2014 forecasts of individual items of the current account came with further adjustments as global and domestic economic growths were revised downside. As a result, it is expected that the Current Account Deficit / GDP ratio will decrease compared to the same period last year.

The 2014 real export of goods and services growth indicator was revised downside in response to downward forecasts for global economy as well as adjusted timing for exploitation of Teghout mine, and it is expected in the range 5.5-7.5%.

The 2014 real import of goods and services growth indicator was also revised downside and is estimated to be within 2.0-4.0%, mainly due to downward revision of the domestic economic growth rates.

In 2014, the growth rate of private remittances of individuals will slow down primarily in response to new forecasts about the Russian economy. The growth will be in the range of 4.5-6.5%.

All above-mentioned developments denote that Current Account Deficit/GDP ratio will range within 7.5-8.5% in 2014 and will keep on reducing to 5.0-6.0% in the medium run.

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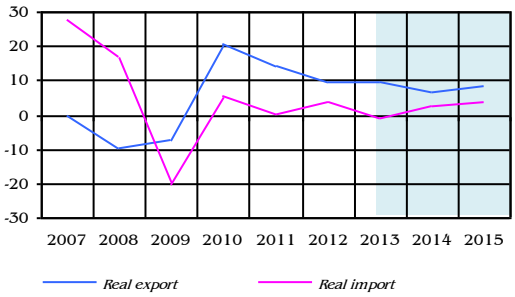
[7] *See http://armstat.am/file/doc/99482078.pdf.*
[8] *See https://www.cba.am/AM/Economic%20Activity%20and%20Business%20Climate% 20Indices/BAI,BCI_full_1.2013.pdf.*

Real export and import, (y/y, %)



In view of the Q1, 2014 ***State Budget*** performance, which generated revenue in line with projections and saved some expenditures (see Section "Actual fiscal policy developments"), the year's plan was adjusted to provide for savings that would reach some 2.4%[9] of annual public expenditures. In 2014, the Tax/GDP ratio is expected to have almost zero growth and the Expenditures/GDP ratio to post nearly 1.6% increase[10] in relation to previous year's actual indicators. The planned increase of expenditures is due to faster growing capital costs and current expenditures. ***In 2014, the deficit is expected to be lower than the level stipulated by law.***

In 2014, aggregate demand is expected to incur as small as 0.7 expansionary impact of the fiscal policy, which will be determined by neutral impact of revenues and 0.7 expansionary impact of expenditures. Further, the second and third quarters were estimated to see, respectively, 2.9 and 1.5 expansionary impacts and the fourth quarter, some 2.7 contractionary impact.

The ***fiscal policy's impact was estimated*** using the macro-prudential indicators underlying the Republic of Armenia Medium-Term Public Expenditures Program, 2015-2016, which is steered to Government Medium-Term Expenditures Program, 2015-2017, which aims to an effective debt management and maintaining the Deficit/GDP ratio at the 1.9% level on average in the medium run. In the outcome, ***the impact of fiscal policy in 2015 is estimated to be minor inflationary relative to the 2014 (adjusted) forecast and non-inflationary in 2016, 2017.***

Estimated medium-term impact of fiscal policy					
% in GDP	2013	2014	2015	2016	2017
Budget revenues	24.3	24.5	24.3	24.1	24.3
Budget expenditures	24.5	26.1	26.3	25.9	26.1
Debt interest payment	1.09	1.36	1.07	1.06	1.06
Budget balance	-0.2[11]	-1.6[12]	-2.0	-1.8	-1.8
Primary balance*	0.9	0.7	-0.9	-0.8	-0.7
One-off flows**	0.5	-0.2	-0.3	-0.4	-0.4
Adjusted balance***	0.5	0.0	-0.6	-0.4	-0.3
Cyclical balance****	-0.5	-0.3	0.1	0.0	0.0
Cyclically adjusted primary balance (structural balance sheet)	1.0	0.3	-0.7	-0.4	-0.3
Fiscal stance*****	-0.9	0.7	1.0	-0.3	-0.1

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

[9] *This is the Central Bank estimate.*
[10] *The 2013 public expenditures are reflected as cash flows.*
[11] *The 2013 budget figures are exclusive of extra-budgetary funds and government expenditures are reflected as cash flows.*
[12] *The 2014 budget figure is a Central Bank estimate in which budget revenues are expected to be scheduled in accordance with the projection whereas government expenditures are 2.4% less the projection (due to cost savings of the first quarter and in view of government expenditures performance trends of previous years).*

To sum-up, the combined impact of the fiscal sector, private demand and labor market on domestic prices in 2014 will be deflationary, 0.8-0.9 pp, which will phase out early in 2015. In the course of 2015, the combined impact of the aforementioned factors is estimated to be minor inflationary, 0.4-0.5 pp, driven by an expansionary fiscal policy since 2014 and expected above-average increases of wages. Starting late in 2015, the impact of domestic demand and labor market on inflation is estimated neutral.

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

In the forecast horizon, ***economic growth in developed countries will continue to slowly recover, while developing countries will continue to face uncertainties associated with economic issues.*** Russia's economic development prospects are worth mentioning as medium-term economic growth was revised substantially downside mainly due to the slowing in investment and a resultant decline in economic activity in other sectors.

In the first quarter, no inflationary pressures were observable in the world's main commodity and food product markets.

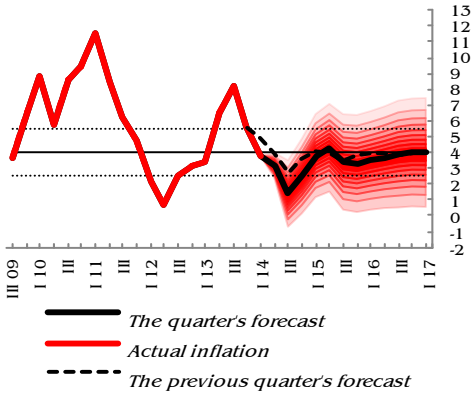
With the global economy recovering at a slow pace, demand-side inflationary pressures ***are not observable in the world's main commodity and food product markets.*** However, individual product markets may run into certain supply-driven issues attributable primarily to geopolitical, climatic and other events.

In Q1, 2014, economic activity remained sluggish, mostly in line with the forecasts, due to the slow recovery in construction sector activity and lower growth in industry sector. A slow private consumption growth rate observable since the previous year as well as weak investment activity persisted. In the meanwhile, driven by a considerable decline in Russia's economic activity, external demand came out weaker during the quarter than anticipated. So, despite some narrowing compared to the previous quarter, the negative GDP gap was somehow bigger than expected and, therefore, it rapidly pushed the inflation rate down to 3.8%, coming up to the target.

In 2014, economic growth in Armenia will seem to be slower than expected, in the range of 4.1-4.8%.

The Central Bank's forecasts suggest that with Russia's economic growth prospects seen in the light of pessimistic expectations and given less expansionary fiscal policy, economic growth in Armenia in 2014 will be slower than expected, in the range of 4.1-4.8%.

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



Period	Inflation forecast probability distribution chart				
	<1.0%	1.0-2.5%	2.5-5.5%	5.5-7.0%	>7.0%
II 2014	0.0%	7.2%	92.8%	0.0%	0.0%
III	37.7%	42.8%	19.4%	0.1%	0.0%
IV	14.9%	35.1%	48.1%	1.8%	0.1%
I 2015	4.0%	16.8%	64.8%	12.1%	2.3%
II	2.5%	11.8%	61.8%	18.4%	5.5%
III	9.6%	21.6%	56.1%	10.2%	2.5%
IV	10.9%	22.5%	54.6%	9.6%	2.4%
I 2016	9.4%	20.5%	55.4%	11.4%	3.3%
II	8.4%	18.6%	55.1%	13.3%	4.6%
III	8.0%	16.9%	53.3%	15.2%	6.6%
IV	7.5%	16.1%	52.9%	16.1%	7.5%
I 2017	7.7%	16.1%	52.5%	16.1%	7.7%

Under weaker economic conditions, ***inflation will continue to decline faster than expected***, resting at the lower bound of the confidence band in the third quarter of the year, as the impact of the July 2013 rise in energy prices phases out. ***In Q2, 2014, the Bank will continue to loosen monetary conditions***. This, coupled with the easing of monetary conditions to date and an expansionary fiscal policy anticipated during the year, will lead to the expanded aggregate demand and rebounded inflation rates. As a result, economic activity will be somewhat livelier in the upcoming period, allowing the inflation to stabilize around its target in the medium run.

During 2014, the 12-month inflation will be primarily in the range 2.5-5.5%.

All the aforementioned factors suggest that in the course of 2014, ***the 12-month inflation will be primarily in the range 2.5-5.5%***.

Risks to inflation deviating from the projected value are estimated as balanced in both short and medium-term perspectives. The primary risks are associated with the development perspectives in emerging economies (Russia, in particular) and a spillover of their possible effects into commodities and food product markets. The risks deriving from the domestic economy are associated with the developments in domestic demand and, in particular, how quickly capital investment would recover and how effectively the state budget will perform, as well as with the developments in agriculture as a sector depending on weather conditions. If such risks materialize, the Bank will react accordingly by maintaining the inflation target in the medium run.

In the ***forecast horizon***, credit growth rates will remain the same. The Bank will look to the target level of the policy rate to adequately react to the change in liquidity demand in order to make sure money supply is consistent with the demand.

3. ACTUAL DEVELOPMENTS IN Q1 2014

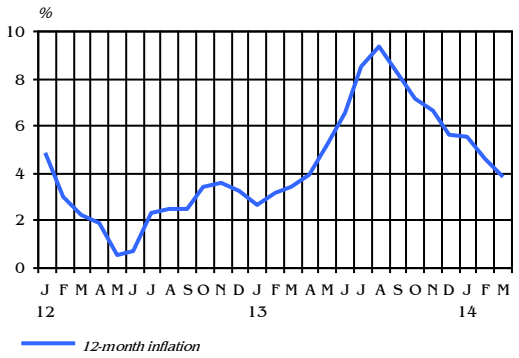
3.1. Inflation

3.1.1. Actual inflation and attainment of target

The 12-month inflation was 3.8% in the first quarter.

In the first quarter, the 12-month inflation rate fell, resting near the target in late March, which was in line with the Q1, 2014 monetary policy program forecasts. In the first quarter, inflation was 1.2% compared to 2.9% recorded in the same period of the previous year. As a result, ***the 12-month inflation rate has rested at the 3.8% level.*** The quarter's inflation was exclusively fuelled by food price increases (a total of 2.3% or 1.2 p of contribution), with prices in item 'vegetable and potato' having risen by 22.6% and made 1.4 pp of contribution to headline inflation. Contrary to the increases, prices in items 'meat products' and 'fats and oils' posted drops by 2.8% and 4.2%, respectively, and had a total -0.4 pp of contribution to headline inflation.

In Q1 2014 inflation environment moderated furher, with the 12-month inflation closer to its target



12-month inflation by commodity group as main contributors						
Commodity group	December 2013, y/y		March 2014, y/y		Q1, 2014	
	Growth	Contribution	Growth	Contribution	Growth	Contribution
CPI	**5.6**		**3.8**		**1.2**	
Food products	**4.0**	**2.1**	**1.7**	**0.9**	**2.3**	**1.3**
bread products	1.6	0.2	0.3	0.0	-0.4	0.0
dairy products	10.9	0.5	10.0	0.4	2.8	0.1
meat products	2.3	0.2	-1.4	-0.1	-2.8	-0.3
fruits	0.9	0.0	-8.4	-0.3	2.9	0.1
vegetables and potato	1.7	0.1	3.6	0.2	22.5	1.4
fats and oils	3.3	0.1	-3.7	-0.1	-4.2	-0.1
eggs	24.6	0.3	8.5	0.1	-1.3	0.0
Non-food products	**3.5**	**0.5**	**2.4**	**0.3**	**-0.6**	**-0.1**
Services	**9.7**	**3.0**	**8.6**	**2.6**	**0.1**	**0.0**

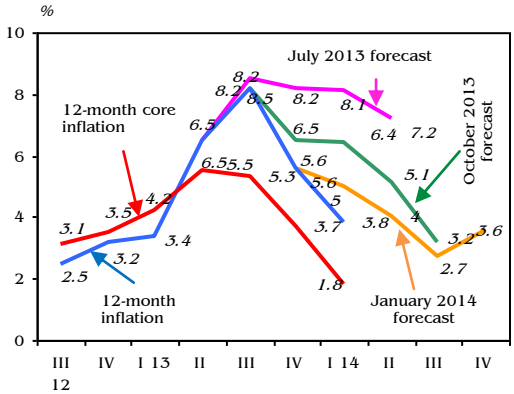
In the first quarter, the 12-month core inflation continued trending downward.

In Q1, 2014, ***the 12-month core inflation*** also followed a down-trending path, from 3.7% in end-year to 1.8% in late March of 2014.

Below are the arguments and expectations which were used to predict inflation and attain the inflation target in a previous one-year horizon, as well as significant deviations in that period, which necessitated further adjustments in forecasts. Notwithstanding a low inflationary environment ***in Q2, 2013*** (i.e. the start of the previous one-year horizon), ***a phased out supply shock in agriculture, possible price increases on agro-products as a consequence of hailstorms in May and likely revision of energy prices since the third quarter*** portended considerable expansion of the inflation environment and increase in the 12-month inflation rate. Furthermore, the 12-month inflation was

meant to exceed the upper bound of the target starting Q3, 2013. In view of a final decision to revise energy prices in order to moderate inflation and its second-round effects and to anchor inflationary expectations, the Bank envisaged to adjust monetary policy directions by raising the refinancing rate. Once inflationary expectations were phased out, the Bank would restart a stimulating policy by cutting the refinancing rate. The aforementioned factors would drive ***the 12-month inflation rate to reduce and enter the confidence band since the third quarter of 2014.***

According to Bank forecasts, as the effect of energy prices phases out, the 12-month inflation will be close to the lower bound of the band late in Q3, 2014, then it will stabilize around the target.



The developments in agriculture (hailstorms, a partially delayed vegetation period), increased prices of some services and increased energy prices did contribute to the expanding of the inflation environment in the period April-August: the economy saw 0.5% inflation against 5.1% deflation recorded in the same period of the previous year, which drove the 12-month inflation rate to reach a two-year peak of 9.3% in late August (contributions of increased energy prices, food prices and some service prices were nearly 3.0pp, 0.7 pp and 0.7pp, respectively).

These factors have prompted the Bank to ***adjust the inflation forecasts upside*** in April and June: by the second half of 2014, the 12-month inflation rate will exceed an 8% level then it will decline to enter the confidence band and will rest within a 4% target in the medium run.

The Bank reacted to the aforementioned inflation developments until August ***by leaving the policy rate unchanged, at an 8% level. Notwithstanding acceleration of inflation in the period May-July of 2013, the Bank carried on implementing a neutral monetary policy,*** maintaining the point that the inflation would return its target value in the medium run as core inflation rested at a low level and inflation expectations remained anchored.

In ***August,*** the Bank raised the refinancing rate by 0.5 pp to 8.5% which was maintained over September, too. This was the Bank's response to the continuous expanding of the inflation environment (the 12-month core inflation also expanded to 5.7% in end-August from 3.5% late in the previous year) and elevated inflation expectations in a short-term perspective. ***Keeping real interest rates positive*** was aimed at anchoring inflation expectations resulted from domestic developments and easing second-round effects from the increase of energy prices.

Staring from ***September,*** the inflation environment gradually eased, attributable to economic growth persisting at low levels amid sluggish investment and slowing private consumption growth rates, to tightened monetary policy as well as little seasonal rise in prices of some food products. ***In the period September 2013 to March 2014, there was only 3.2% of inflation compared to 8.7% in the same period of the previous year,*** and the 12-month inflation rate in late March fell to 3.8%, nearing the target. Further, over the same period of time, the

12-month core inflation has subdued by 4 pp to 1.8% in late March of 2014.

In the period September 2013 to March 2014, the Bank gradually lowered the refinancing rate a total of 1.0 pp to 7.5% in late March.

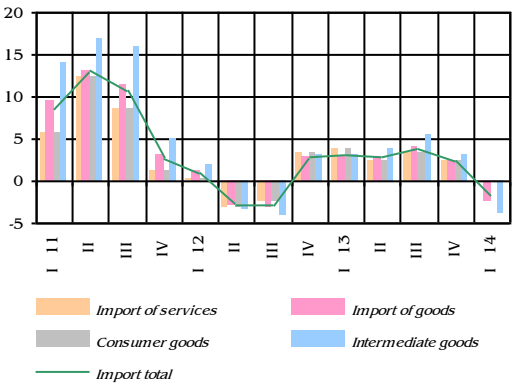
With an inflation environment even more moderate than expected, the effect of energy price increases on domestic prices phased out as well as in view of expectations of non-inflationary impact from external and domestic environment in the medium run, the Bank gradually loosened the monetary conditions by cutting the refinancing rate a total of 1.0 pp to 7.5% in end-March. The dram reserve requirement ratio, lowered from 4% to 2% since February 2014, was another action to easing.

The dram reserve requirement ratio was lowered from 4% to 2% since February 2014.

3.1.2. Import prices and producer prices

Import prices: the first quarter of 2014 saw dollar prices of import of goods and services decreasing. Price drops were reported with regard to both consumer and intermediate goods. The rise in gold, molybdenum and aluminum prices was an exception, although the average price of these commodities is still low enough compared with the previous year's 1st quarter average. As a result, the dollar prices of total imports have decreased by 2.7% q/q, with an annual decline 1.9% compared to 2.4% y/y growth in the previous quarter.

In the 1st quarter, dollar prices of import of goods and services slowed down, y/y, %

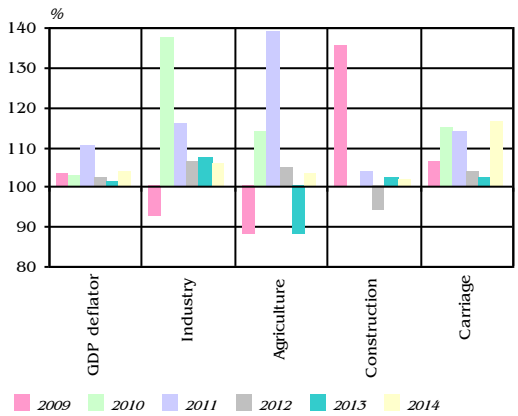


Dollar prices of intermediate consumption goods have decreased mainly due negative contributions from natural gas, iron and gold prices, by 0.9, 0.4 and 0.2 pp, respectively. The y/y decrease of dollar prices of consumer goods was conditioned with y/y decline in dollar prices Turkey, Russia and Ukraine, which offset the y/y increase in dollar prices in Euro-area, China and Belarus.

Producer prices[13]***:*** in the 1st quarter of 2014, almost all sectors of the economy posted increased price indices, and the GDP deflator in the period January-March has been an estimated 103.7 y/y.

Industry posted a quarterly growth of 5.5% y/y, which is a result of 42.6% more *energy and gas production and distribution* owing to energy price rise since July of 2013. Meantime, *ore mining, water supply and sewage, waste recycling and processing industry* posted price drops by 5.4%, 0.7% and 0.6%, respectively.

In the 1st quarter, prices were highest in Carriage subsector



Agriculture reported 3.4% y/y increase in prices[14] during the quarter owing to 23.5% y/y rise in prices in *plant growing* and 0.3% y/y drop in prices in *animal breeding*, respectively. The increase in prices in plant growing was driven by 32.6%, 0.4% and 1.1% increment in prices of "potato and vegetables", "fodder" and "berries", respectively. The price decrease in animal breeding was mainly attributable to a 5.1% drop in meat price.

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[13] *The price index change as presented here is relative to the same period of the previous year unless otherwise specified.*
[14] *Sales prices of producers of agricultural product are presented.*

Construction reported 1.9% y/y growth of prices in the 1st quarter, mainly attributable to the wage increment in the branch.

Carriage reported 16.1% y/y rise in prices in the 1st quarter, owing to risen tariffs on *railroad transport* (13%), *air transport* (0.1%), *truck transport* (0.7%) and *pipeline transportation* (40.8%). Note that much higher rates in pipeline transportation are mainly due to the increase in energy prices.

3.1.3. Inflation and interest rate expectations

The results of the 1st quarter 2014 surveys of expectations organizations in the financial sector and households have about selected macroeconomic indicators suggest that inflationary expectations in the financial system followed a down-sloping path. Indeed, such a development is consistent with gradually moderating inflation environment. Based on the 1st quarter results, most banks anchored their expectations of the 12-month inflation around 4.7% range; credit organizations in the region of 4.2%. Households' inflationary expectations did not change much as they are maintained at a 4.9% level.

According to the survey results, banks and credit organizations will anticipate some alteration in market rates for the upcoming one-year horizon, which is primarily due to the change in reserve requirement ratio. This means expectations of interest rates of dram resources both attracted and allocated would go an upward trend, while interest rates of foreign currency funds a downward path.

3.2. Aggregate supply and Aggregate demand

3.2.1. Aggregate supply[15]

In the first quarter, economic activity is still sluggish, 3.3% y/y.

The indicator of ***economic growth*** published by the National Statistics Service of Armenia for the 4th quarter of 2014 was 5.1% y/y, with the January-December growth having amounted to 3.5% y/y. The acceleration of economic growth in the 4th quarter relative to the previous quarter has been mainly a result of reported growth in industry, faster growth rates in agriculture as well as somewhat a slower decline in construction.

Economic activity in the 1st quarter of 2014 is still estimated to be slow, 3.3% y/y, which is in line with the forecasts. The sluggishness is in part due to weaker growth of the global economy, declined investments in the domestic economy and a weaker aggregate demand as a result of increased energy prices.

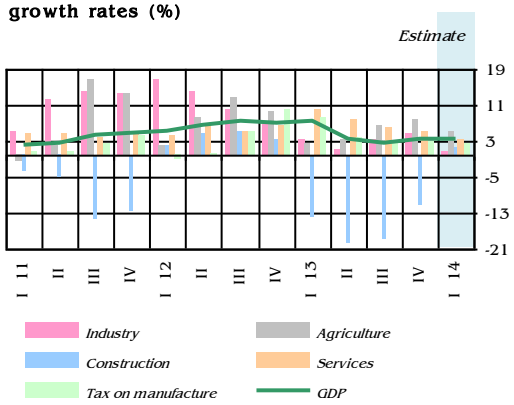
[15] *The indicators of real growth of value added in branches of the economy for the first quarter of 2014 are the Bank's estimates whereas the indicators of sub-branches represent y/y growth rates in output volumes for January-March, unless otherwise specified.*

It is estimated that economic growth in the 1st quarter of 2014 will be in the range 3.2-3.5%[16].

In ***Industry*** in the 1st quarter of 2014, the growth of value added is estimated in the range 0.8-1.3% y/y, mainly due to the increased volumes in *metallurgy* (6.3%), *tobacco production* (2.3%), *pharmaceuticals* (11.5%) and *water supply and sewage* (3%).

In view of actual output growth of 0.7% reported in the 1st quarter of 2014, the growth of value added in ***Construction*** for the same period of time is estimated within 1-1.5% y/y. Note that an increased volume of construction financed by *organizations* (14.2%) has offset the slump in construction financed by *households* (6.5% growth), *international credit* (25.4%), *state budget* (11.4%), *humanitarian aid* (28.7%) and *local community budgets* (19.5%).

Actual real GDP growth and economic sector growth rates (%)



In ***Services***, the growth of value added is estimated in the region 3.2-3.7% y/y as a result of volumes of services rendered and trade turnover having increased by 3.5% and 4.5%, respectively. The increase in the volume of services rendered was driven by growth recorded in information & communication (0.9%), financial and insurance activity (3.4%), events, leisure and rest (22.1%), healthcare (5%) and real estate transactions (17.6%). The growth of trade was totally due to retail trade and wholesale trade, having increased by 1.6% and 11.9%, respectively.

In ***Agriculture***, the growth of value added is estimated in the range 5.0-5.5% y/y, due to increased outputs in animal breeding, fishing and plant growing by 4.7%, 18.6% and 19%, respectively. Reported 5.9% and 4.6% increases in *milk production* and *slaughtered animal and poultry production* have totally contributed to the overall growth in *animal breeding*.

3.2.2. Aggregate demand[17]

In the first quarter, private consumption growth is an estimated 1.8%.

In the 1st quarter of 2014, growth rate in ***private consumption*** remained slow, 1.8%, primarily due to persisted negative influence that came from increased gas and electricity tariffs. Unsurprisingly, an expanded inflationary environment fuelled by higher gas and electricity prices has negatively affected real income in the economy and caused private spending to shrink.

The Consumer Confidence Index[18] calculated by the Bank points to the above developments with private spending. In the 1st quarter of 2014, relative to the same period of the previous year, the CCI has dropped by 7.5% to 40.8, showing a further tendency of decline during the quarter.

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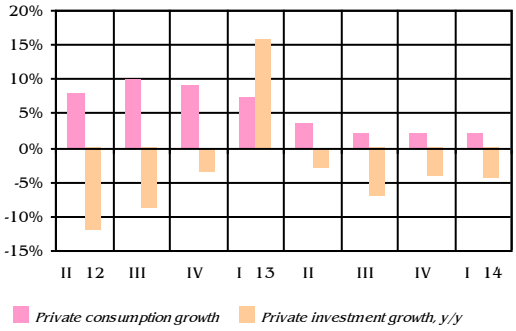
[16] See Real GDP Growth (Cumulative) Projection Probability Distribution Chart.
[17] The private spending, private consumption and private investment data for the 1st quarter of 2014 are the Bank's estimates based on actual 4th quarter of 2013 data. Growth estimates in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.
[18] See https://www.cba.am/am/SitePages/statsscci.aspx.

In the first quarter, private investment contracted by 4.5%.

Private consumption and investment growth, y/y



In the 1st quarter of 2014, the ***investment climate*** came in somewhat weaker, much in line with the forecast, reflecting persisted decline in construction as well as slower-than-expected economic activity in the same period of time. In the 1st quarter, investment contracted by 4.5%.

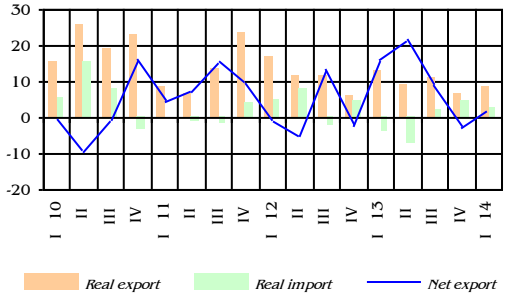
The results of the Central Bank surveys[19] of Armenian companies point to the low investment activity during the 1st quarter.

In the 1sth quarter of 2014, 18% of the companies surveyed invested in industry; this is 1 pp lower from the figure recorded in the same period of the previous year. According to the survey, the share of companies which invested has shrunk in industry, construction and trade.

In the face of still slow private consumption growth rates and contracted investment, ***private spending*** has grown merely by 1.2% in relation to the 1st quarter of the previous year, which has expanded the domestic demand by 1.0% amid 0.8% increase in government spending.

On the back of the aforementioned developments with private consumption and investment, the private spending gap in the 1st quarter of 2014 is estimated largely negative, with a 1.1-1.2 pp of contractionary impact on the inflation.

In the 1st quarter, negative balance in net export shrank
(net real exports, y/y, %, positive sign means improvement)



In the 1st quarter of 2014, the growth rates of export of goods and services in real terms outpaced those of import and amounted to 8.2% y/y. The growth rates of import of goods and services in real terms decelerated to 3.0% y/y[20].

In the 1st quarter of 2014, growth rates of net inflow of non-commercial remittances of individuals via the banking system slowed down to 6.0% y/y.

3.2.3. Labor market[21]

In the first quarter, the growth of nominal wage is an estimated 7.0%.

The developments in the period January-February of 2014 suggest that the ***growth rate in nominal wage*** in the 1st quarter was consistent with previous forecasts and is estimated in the range of 7.0%.

Moreover, the private sector reported wage growth pacing much higher compared to the wage growth in the public sector. In the 1st quarter, the private sector wage growth is an estimated 8.3%, and in the public sector, 5.4%. The increase of the minimum salary threshold as well as continued reduction in the unemployment rate contributed to the nominal wage increases in the private sector.

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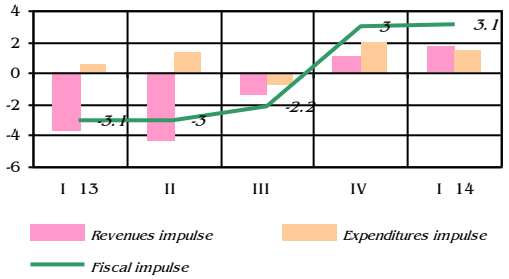
[19] *See https://www.cba.am/am/SitePages/statsseabci.aspx.*
[20] *The real export and import growth indicators are the Bank's estimates.*
[21] *The labor market data for 2014 are the Bank estimates which are based on the 4th quarter of 2013 data and actual January-February 2014 figures. The growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.*

In the first quarter, the unemployment rate is an estimated 17.1% y/y.

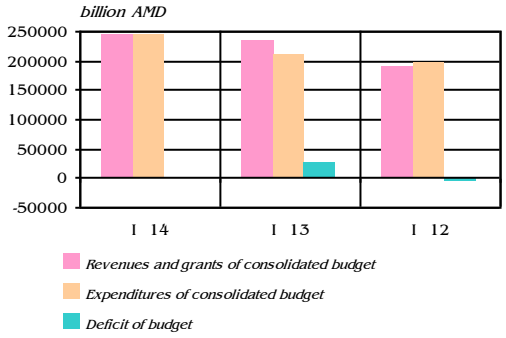
In the 1st quarter of 2014, the ***unemployment rate*** grew to some extent to 17.1%, which is attributable to relatively slow rates of economic growth in the first quarter.

Significant imbalances in the economy were not observed during the 1st quarter, and the impact of the labor market on inflation has been neutral, as a result.

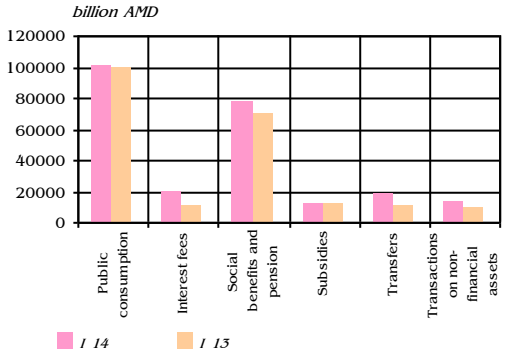
In the 1st quarter, expansionary impact of the fiscal policy is attributable to revenues and expenditures both carrying expansionary effects



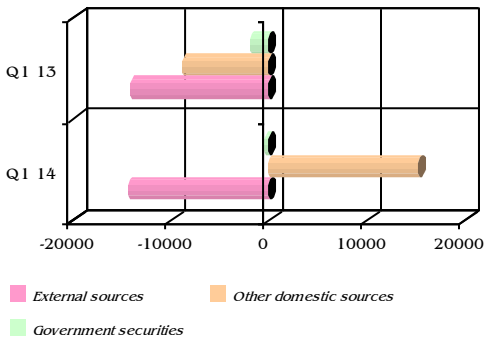
Performance of main indicators of the consolidated budget



In the 1st quarter, all expenditures items of the budget posted increases



In the 1st quarter, budget reported a small deficit (billion AMD)



3.2.4. Fiscal policy[22]

In the 1st quarter of 2014, State Budget generated revenue in line with projections and saved on certain expenditures items. The fiscal sector left somewhat a smaller, 3.1 expansionary, impact on aggregate demand than it would if the expenditures were in line with the projections. The revenues impact was 1.7 expansionary and the expenditures impact, 1.4 expansionary.

Revenues of the consolidated budget have grown by 3.3% or AMD 8.0 billion in relation to the 1st quarter of the previous year, with some tax revenues and other proceeds having been the biggest contribution to the growth. Relative to the 1st quarter of the previous year, the growth of tax revenues was an estimated 1.7%, which fully covered the quarterly program. Relative to the 1st quarter of the previous year, the share of indirect tax has shrunk by 0.7 pp to 51% of tax revenues but the share of direct tax remained the same, 39% of tax revenues.

Other revenues exceeded the first quarter program indicator by nearly 2.4-fold[23], reporting a 72.5% growth.

Public expenditures reported reduced performance as only 84.5% of the expenditures were executed for the quarter. However, compared to the same period last year, there was an estimated 14.8% growth recorded in the consolidated budget expenditures. Furthermore, current and capital expenditures grew by 13.2% and 53.7%, respectively. Almost all current expenditure items posted increases, with **public consumption** having increased by 1.2% compared to the previous reference period. C**apital expenditures (item "transactions with non-financial assets")** also posted increases owing to programs which receive financing from both external and domestic sources.

In the 1st quarter of 2014, with revenues and expenditures figures shown above, the consolidated budget posted a deficit of only AMD 0.5 billion instead of AMD 42.7 billion as was projected under the program adjusted for the quarter. The deficit has been financed totally by domestic sources.

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[22] Consolidated budget indicators which were prepared on the basis of preliminary actual data of the 1st quarter of 2014 (PIU funds included) were used for the review of the fiscal sector. The impact of revenues was calculated in respect of the nominal GDP indicator while the impact of expenditures in respect of the estimated potential GDP indicator.

[23] Due to the proceeds received from granting permission to the use of radio frequencies.

3.3. Money and financial market developments

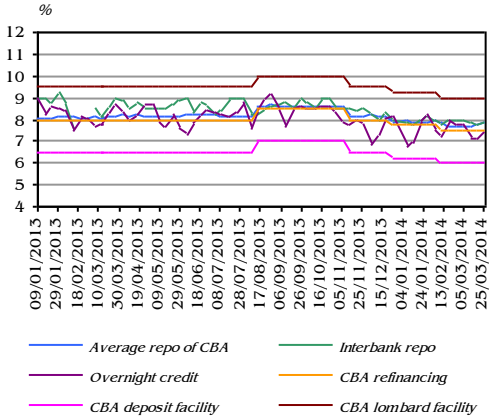
3.3.1. Financial market, money and credit

In the first quarter, Board of the Bank continued easing monetary conditions by cutting the interest rate another 0.25 pp in February to 7.5%.

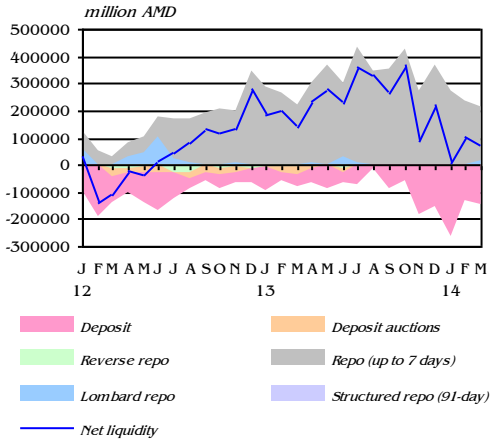
In the 1st quarter of 2014, with the inflation declining more rapidly than expected and the economic growth slowing, the Bank continued loosening the monetary conditions by cutting the interest rate another 0.25 pp in February to 7.5%. Persisting uncertainties at the time prompted the Bank to give the financial market an impulse of possible policy interest rate adjustment, which will provide the medium-term inflation target.

During the quarter, the Bank also reduced the interest rate of ***its main instrument*** by 0.25 pp. Average quarterly rate has dropped by 0.5 pp compared to the previous quarter's average.

Short-term interest rates dropped during the quarter



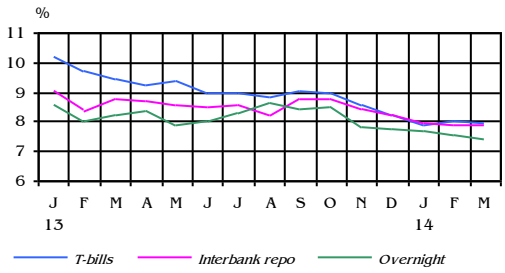
Operations carried out by the Central Bank



Operations carried out by the Central Bank						
Period	Repo (up to 7 days)		Funds attracted		Lombard repo	
	Value (million AMD)	Weighted average %	Value (million AMD)	Weighted average %	Value (million AMD)	Weighted average %
I 2013	763,825.90	8.09	163,700	6.50	944.60	9.50
II	929,077.62	8.19	176,300	6.50	38,652.30	9.50
III	1,121,106.19	8.42	176,300	6.75	5,278.56	9.50
IV	1,064,987.41	8.31	392,300	6.71	500.00	10.0
I 2014	705,234.27	7.80	535,000	6.17	19,354.29	9.05

In the 1st quarter of 2014, ***short-term interest rates of the financial market further trended downward*** as the Bank reduced the policy rate and the dram reserve requirement ratio to 2% from a former 4% level. The average quarterly overnight loan interest rate has dropped by 0.47 pp in relation to the previous quarter; relative to December average, it has fallen by another 0.3 pp to 7.44% in late March. Relative to previous quarter, the market repo rate has reduced by 0.6 pp and another 0.34 pp to 7.86%. In the T-bills market, the rates followed a similar down-trending path amidst the influence of the Bank's policy impulse as well as the Ministry of Finance public debt management policy's.

During the quarter, short-term interest rates trended down as the Bank cut the refinancing rate



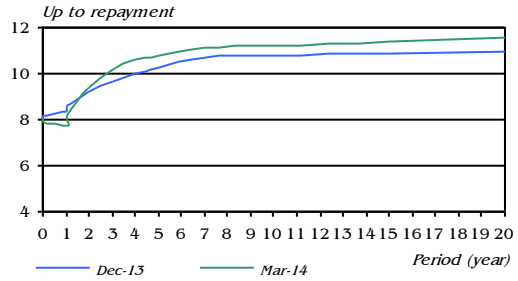
Box 2

Government securities market

T-bill rates reacted to the change of the Refinancing Rate. The Ministry of Finance public debt management policy has also contributed to the downward trend in T-bill rates. As a result, the average quarterly rate of up to 1-year bills was 7.98% in March and in the first quarter; this is 0.24 pp below the December figure and 0.68 pp less than the average figure of the previous quarter.

Change in the policy rate in the secondary market was most pronounced in the short-term segment; yields of government bonds

In the T-bills market in the 1st quarter, medium and long-term rates grew

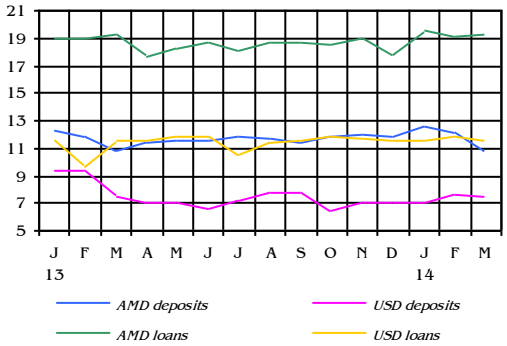


have narrowed in the up to 1 year maturity segment but slightly grown in the mid-term and long-term segments. This is in part explained by the previous quarter's state debt management policy resulted in a sharp decline in interest rates, which could not be continuous and had to be revised upside. As a result, the long-term interest rate of the yield to maturity curve grew 0.65 pp to 11.6%. The long-term and short-term interest rate spread was 3.48 pp in March, up by 0.5 pp in relation to December.

Relaxed monetary conditions as well as an altered reserve requirement ratio, which was to give the banking sector more than AMD 10 billion of extra liquidity, have not yet affected interest rates of dram loans and deposits over the 1st quarter of 2014. Variation in interest rates and volumes of loans and deposits were mainly due to changed volume and currency structure of deposits and loans. Average quarterly dram deposit rate has not changed compared to the previous quarter and stood at 11.9%. The volume of dram deposits remained virtually unchanged: the decrease in dram demand deposits was offset by the increase in dram time deposits.

The first quarter saw a rise in interest rates of dram credit, which was determined by an increase share of consumer loans in total lending. The average quarterly dram loan interest rate has grown by 0.9 pp relative to the previous quarter to 19.3%. The credit growth during the quarter was an estimated 2.6% (13.02% growth y/y), and to AMD 48.9 billion in absolute terms.

Dynamics of interest rates of funds in AMD and foreign currency

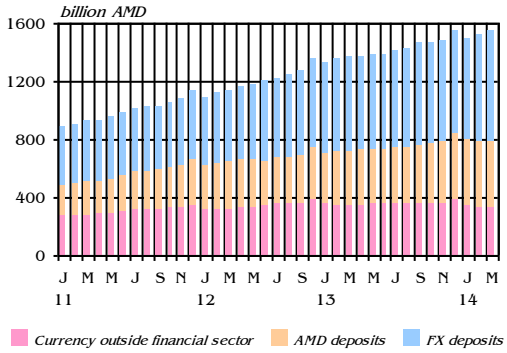


In the 1st quarter, foreign currency lending rates remained virtually unchanged, 11.6%. The growth of credit in foreign currency, which was an estimated 3.2%, has outpaced the growth of credit in dram.

During the quarter, interest rates of foreign currency deposits grew by 0.6 pp to 7.4% while volumes increased by 7.2% owing to resources attracted from companies.

Credit volumes and interest rate behavior have been congruent with the results of survey on the terms of lending provided by banks and credit organizations functioning in Armenia.

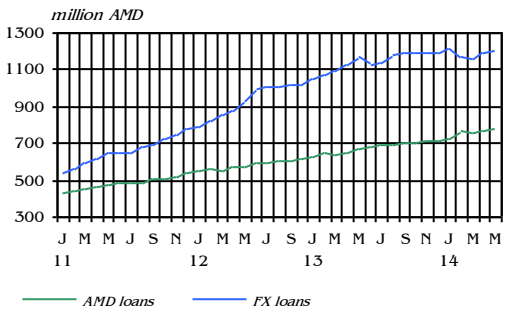
In the 1st quarter, FX deposits grew while AMD deposits were much at the same level



Box 3

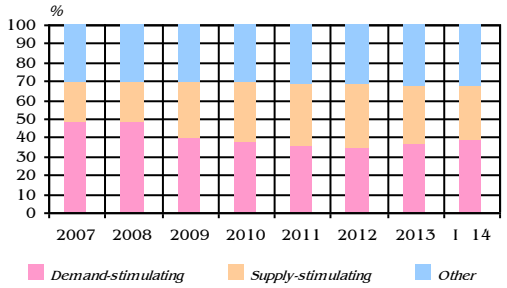
The results of the 1st quarter 2014 survey on terms of lending provided by Armenian banks and credit organizations show there has been further easing of the terms of lending to businesses and the terms of consumer credit. Further easing is applied to the terms of mortgage lending. Easing of terms as to consumer loans involved aspects regarding collateral requirements, a loan to value ratio and review of creditworthiness. Demand has increased for business loans but declined for consumer and mortgage loans. The client's

In the 1st quarter, FX loans outnumber AMD loans in total lending



The share of demand-stimulating loans has increased in total lending portfolio.

Credit to the economy



reduced income and a grown share of other expenses in total spending were among factors resulting in a decline in demand. Easing of terms of household lending will carry on during the 2nd quarter of 2014. The procedures and conditions for business loans are expected to see simplification primarily in lending to small and medium-sized enterprises. There will possibly be an increased demand for all types of credit.

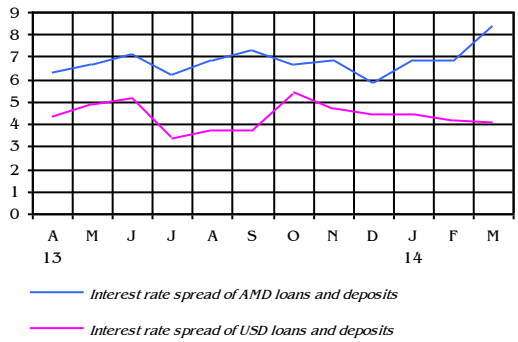
The share of demand-stimulating loans[24] continued increasing in total lending portfolio.

The 1st quarter of 2014 saw further narrowing of the spread of interest rates of foreign currency loans and deposits. The spread of interest rates of dram loans and deposits grew 0.9 pp to make up 7.4 pp whereas the spread of interest rates of foreign currency loans and deposits narrowed 0.6 pp to 4.3 pp.

In the 1st quarter of 2014, the growth of foreign currency deposits (with an almost unchanged level of dram deposits) reflected the change in the rate of dollarization (foreign currency deposits to broad money ratio) as it grew by 3.5 pp. Performance of the indicator of lending in foreign currency, with growth rates outpacing those of dram credit also points to the increased dollarization.

Box 4

In the 1st quarter, the spread of interest rates of FX loans and deposits narrowed



On the back of the developments in the financial market and financial sector on the whole, broad money remained virtually unchanged, AMD 1.539 trillion while dram broad money reported a 6.7% decrease to AMD 791 billion.

The annual performance of monetary indicators was as follows: dram deposits have grown by 25.3%, foreign currency deposits, by 14.95% (16.4%, if the impact of change in foreign exchange rate is excluded), which pushed the dollarization up by 0.9 pp. Currency outside the financial sector has reduced by 4.5%. The 12-month growth rates in broad money and dram broad money were 12.8% and 10.9%, respectively. In the meantime, base money has increased by 20.8% and dram base money, by 1.7%. In the 1st quarter of 2014, the money and dram multipliers were 1.97 and 1.39 compared to 2.11 and 1.27 reported for the same period of the previous year.

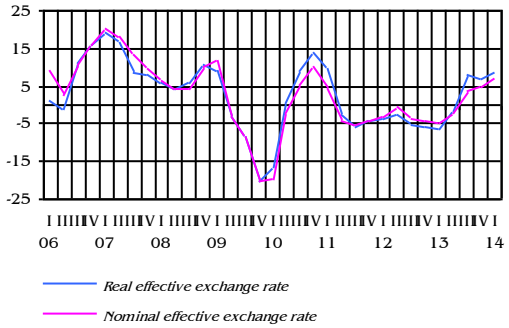
3.3.2. Exchange rate

In the 1st quarter of 2014, trade partners' average weighted exchange rate depreciated steeply by 2.8% q/q, primarily driven by national currency depreciation reported in Russia, Ukraine and Turkey. Over the quarter, the dram's nominal exchange rate tended to depreciate, either. In the meantime, the Bank acted as a net seller of foreign currency in the foreign exchange market to smooth out sharp currency fluctuations.

So, in the 1st quarter the dram's average nominal exchange rate depreciated by 1.3% q/q versus the US dollar, with the real exchange rate[25] having appreciated by 3.4%. Relative to the

[24] *These are consumer, mortgage and construction loans, which were conventionally taken from the overall lending portfolio.*
[25] *The Q1, 2014 real exchange rate indicator is the Bank's estimate.*

In the 1st quarter, real effective exchange rate appreciated faster, y/y, %



same period of the previous year, the real exchange rate posted strong appreciation of 8.5% y/y, about 8.0 pp of which was driven by high y/y depreciation of average weighted exchange rates in trade partners. The latter incurs the impact of depreciation of Iranian rial back in the 3rd quarter of the previous year, which is expected to neutralize already in the 2nd half of 2014.

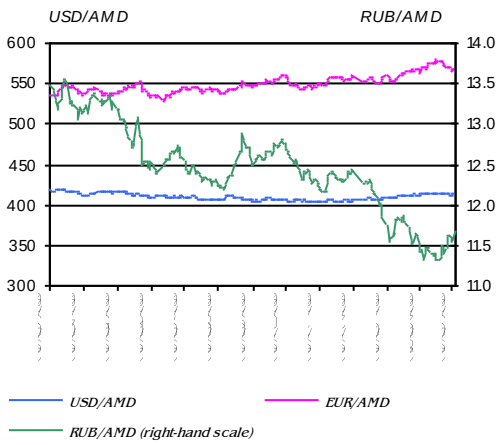
y/y growth, %	Q1 13	Q2 13	Q3 13	Q4 13	Q1 14
Real effective exchange rate (+ means appreciation)	-6.4	-1.6	7.9	6.8	8.5
Average inflation in Armenia	3.0	5.2	8.7	6.4	4.6
AMD/USD average nominal exchange rate (+ means appreciation)	-5.1	-3.3	0.5	0.2	-0.4
Average weighted inflation in trade partner countries	4.5	4.4	4.3	4.0	3.6
Partner countries' average weighted nominal exchange rate (+ means appreciation versus dollar)	-0.4	-1.1	-3.2	-4.3	-8.0

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

Box 5

Exchange rate

Dram exchange rate versus US dollar, Euro and Russian ruble in a year



At the end of the 1st quarter of 2014, relative to the end of the previous quarter, the average market exchange rate of the Armenian dram versus the U.S. dollar has appreciated by 1.86% to 413.31 drams for one dollar.

The table below shows the dram's behavior versus the U.S. dollar, Euro and Russian ruble:

Dram exchange rate dynamics q/q in the 1st quarter of 2014			
Currency pair	Exchange rate as of 30.12.2013 (AMD)	Exchange rate as of 31.03.2014 (AMD)	% (appreciation "+", depreciation "-")
USD/AMD	405.64	413.31	-1.86
EUR/AMD	559.54	569.91	-1.82
RUB/AMD	12.44	11.69	+6.42
Dram exchange rate dynamics y/y in the 1st quarter of 2014			
Currency pair	Average exchange rate, Q1, 2013	Average exchange rate, Q1, 201	% (appreciation "+", depreciation "-")
USD/AMD	409.47	411.05	-0.38
EUR/AMD	541.01	562.93	-3.89
RUB/AMD	13.47	11.72	+14.93

The aggregate volume of U.S. dollar/Armenian dram transactions in the foreign exchange market during the 1st quarter amounted to USD 2.3 billion, which represents an 11.5% decrease in relation to the figure reported in previous reference period (AMD 2.6 billion).

The aggregate volume of Euro/Armenian dram exchange transactions reached EUR 192.7 million against EUR 231.8 million recorded in the 1st quarter of 2013.

To tackle the dram exchange rate volatility against the U.S. dollar in the market in the 1st quarter of 2013, the Bank sold USD 132.9 million worth of dollar resources.

3.4. Balance of payments[26]

In the 1st quarter of 2014, the current account deficit contracted y/y, mostly attributable to the reduced balance of trade deficit as well as increased private transfers. During the quarter, net inflow through the capital and financial account shrank notably primarily as a result of narrowed net inflow of items "Other investment".

Box 6

Database design according to approaches to compilation of the IMF Balance of Payments Manual (6th edition)[1]

In 2009, the IMF released a new compilation of Balance of Payments Manual (6th edition). The main goals for the change to the manual were to present and clarify the concepts, definitions, classifications and common approaches related to the balance of payments and international investment position, to provide a clearer explanation of how booking of some transactions are maintained and matched with other sector statistics.

Since 2011, the Bank compiles the Republic of Armenia Balance of Payments according to requirements set forth in the IMF balance of payments manual 6th edition (BPM-6) while maintaining the practice of publishing the data based on the old manual. Starting 2014, the balance of payments will only be publishable according to the BPM-6 Principles.

The main differences between the old and new manuals are presented below:

Classification: *there has been a change to the structure of the balance of payments only; it now consists of 3 parts instead of the former 2. The capital account is treated as a separate part. The current account is now composed of 3 sub-items: i) goods and services (formerly, they were separate items), ii) initial income (formerly, income) and iii) secondary income (formerly, current transfers).*

Classification in the financial account: *items "SDR allocations", "Insurance and pension schemes" have been added. A former classification "Other items" which applies to all non-bank private sector is now separated into two parts – "Non-bank financial companies" and "Other sectors".*

There has been a change to the procedure on how assets and liabilities are shown in the financial account. The terms "Net purchase of assets" and "Net assumption of liabilities" were introduced. The positive net change means increment in assets or liabilities while the negative change means decrement in assets or liabilities. That is to say the financial account balance is now equal to the current and capital account balance, using the same sign (formerly, an opposite sign).

Methodology: *items "Goods" and "Capital transfers" will no longer include private property of persons who have changed their residency ("Migrant transfers"). Client's product re-processing services will be included at the cost of processing in services "Re-processing of material resources" rather than goods as import and export.*

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[26] *Now and on, the balance of payments figures will be presented according to the new balance of payments methodology (BPM6). The Q1, 2014 figures are the Bank's forecasts and estimates.*

The table below shows the 2013 Balance of Payments according to BPM5 and BPM6 principles:

	BPM5	BPM6
Current Account	- 1,093.0	- 1,098.7
Products and Services	- 2,459.2	- 2,464.9
Products	- 2,344.7	- 2,352.9
Services	- 114.5	- 112.1
Initial income	540.9	540.8
Secondary income	825.4	825.4
Capital account	73.9	77.0
Financial account	951.4	- 947.6
Direct investment	353.5	- 353.5
Portfolio investment	689.1	- 689.1
Financial derivatives	0.6	- 0.6
Other investment	378.8	- 375.0
Reserve assets	- 470.6	470.6
Net errors and omissions	67.7	74.2

[1] See the changes in more detail at: https://www.cba.am/Storage/AM/downloads/stat_data_arm/Notice%20on%20revision.doc

3.4.1. Current account

In the 1st quarter of 2014, relative to the 1st quarter of 2013, the Current Account Deficit/GDP ratio has fallen by an estimated 3.7 pp and current account deficit decreased by USD 41.7 million to USD 347.3 million.

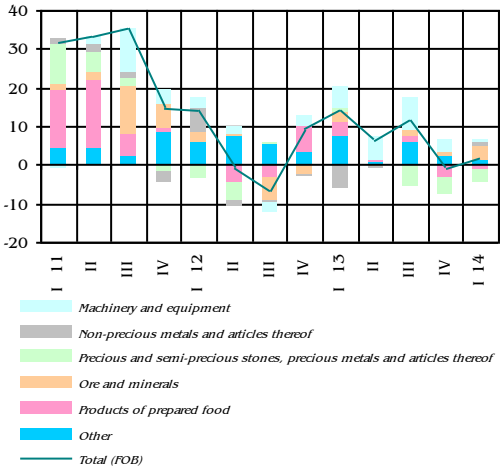
Though the 1st quarter of 2014 posted relatively strong growth of export of goods in real terms, the y/y growth of dollar value of export of goods reached 2.4% amidst the falling of export prices.

In the 1st quarter, the y/y growth of dollar value of export was mainly due to items "precious and semiprecious stones, precious metals and articles made thereof", "textiles", "products of prepared food" with their positive contributions of 3.4 pp, 1.3 pp and 1.2 pp, respectively. Items "non-precious metals and articles made thereof" and "ore and minerals" had 3.4 pp and 1.3 pp of negative contribution.

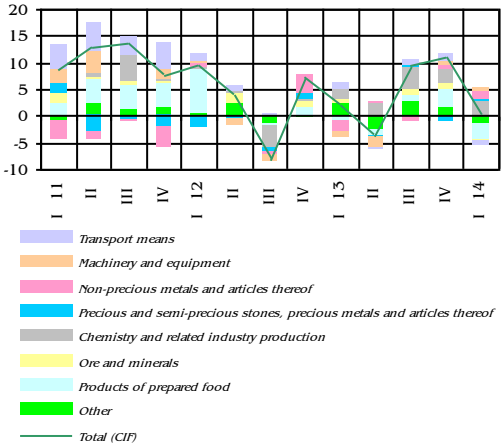
In the 1st quarter, the real growth rates in import of goods were slower, as domestic economy activity was sluggish. With the dollar prices of import falling, the dollar value of import of goods grew merely by 0.5% y/y.

In the 1st quarter of 2014, the import of goods reported the following trends: items "ore and minerals", "products of prepared food" and "products of vegetable origin" made negative contributions of 3.1 pp, 1.4 pp and 1.3 pp,

Change in export y/y and main commodities contribution, % [27]

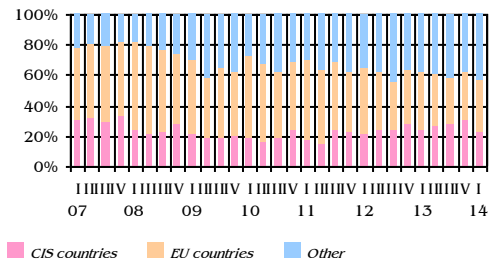


Change in import y/y and main commodities contribution, %

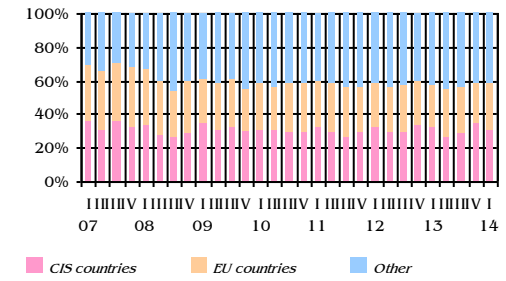


[27] Export and import indicators by commodity and by country are in FOB and CIF prices, and export and import of the current account, by debit and credit, respectively.

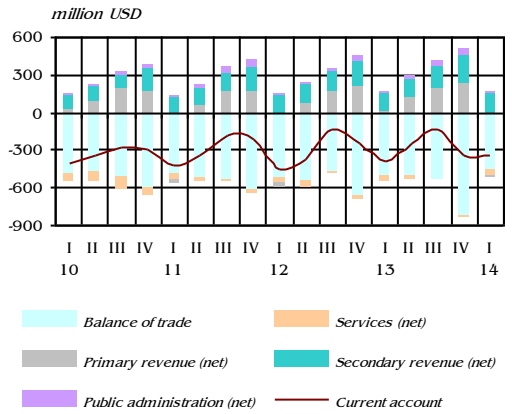
Exports by country group



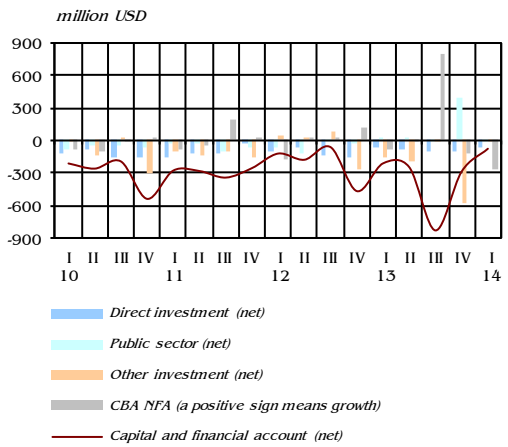
Imports by country group



In the 1st quarter, current account deficit shrank



In Q1, 2014, net inflow through the capital and financial account narrowed
(+ net credit - net borrowing)



respectively. Items "precious and semiprecious stones, precious metals and articles made thereof" and "machinery and equipment" contributed positively[28] by 2.9 pp and 1.3 pp, respectively.

In the 1st quarter of 2014, the deficit of trade balance shrank by USD 49.5 million to USD 454.7 million in spite of deteriorated terms of trade.

In the 1st quarter, the deficit of balance of services narrowed by USD 3.8 million y/y to USD 48.3 million. The y/y growth of export and import of services was 6.0 and 3.1%, respectively.

In the 1st quarter, the y/y growth rates in remittances of individuals[29] slowed down. During the quarter, net inflow of item "employee remuneration" posted an increase of 5.5% y/y and amounted to USD 106.8 million, which is somewhat lower from the net outflow figure in item "income on investment". As a result, item "initial income" posted net outflow of USD 8.7 million. Net inflow of item "secondary income" (save for public administration) grew by 5.6% y/y and amounted to USD 153.1 million.

3.4.2. Capital and financial account[30]

In the 1st quarter of 2014, net inflow through the capital and financial account reduced to USD 79.0 million. The decrease was primarily attributable to the narrowed net inflow of funds through item "other investment". As a result of balance of payments flows, the Bank's net foreign assets have decreased by USD 268.3 million.

Net inflow of capital transfers in the 1st quarter amounted to USD 10.5 million compared to USD 13.1 million reported in the same period of the previous year.

In the 1st quarter of 2014, net inflow of foreign direct investment remained virtually the same in relation to the previous reference period, USD 62.8 million. There was net inflow of USD 18.8 million posted on the part of public credit, compared to net outflow of USD 5.0 million reported in the 1st quarter of the previous year.

Net inflow through item "other investment" amounted to USD 8.4 million compared to the previous year's net inflow of USD 158.6 million. Net foreign assets of commercial banks have increased by USD 140.0 million and net foreign assets of item "other private sector" decreased by USD 148.4 million.

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[28] *Some other items, which hold a small share in total, have contributed positively, as well.*
[29] *The 1st quarter of 2014 posted y/y 6% growth of net inflow of non-commercial transfers of individuals via the banking system.*
[30] *The Q1, 2014 capital and financial account figures are the Bank's forecasts and estimates.*

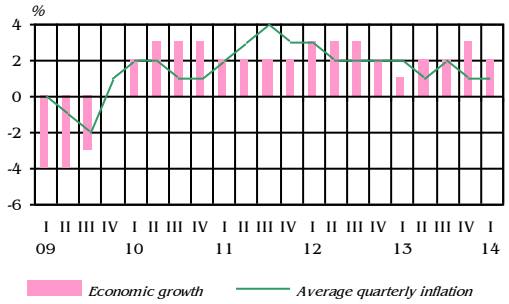
3.5. External environment

In the 1st quarter of 2014, save for Euro-area, some slowing of economic activity was observable in Armenia's main trade partners.

In the 1st quarter of 2014, save for Euro-area, some slowing of economic activity was observable in Armenia's main trade partners.

According to preliminary estimates of the U.S. Department of Commerce Bureau of Economic Analyses, in the 1st quarter of 2014 the annualized economic growth in the ***United States of America*** was 0.1% q/q (2.3% y/y economic growth was reported in the 1st quarter). Private spending contributed to the growth positively but government spending, investment and net exports made a negative contribution. Note that the first quarter's U.S. economic growth slowdown is a result of adverse weather conditions hence is short-term in nature. **In the 1st quarter of 2014**, average quarterly inflation in the U.S.A. was 1.4% y/y compared to 1.2% reported in the previous quarter. In the meantime, the U.S. Fed has reduced the monthly volume of purchase of securities by roughly USD 15 billion.

In the 1st quarter, economic growth in U.S.A. slowed down

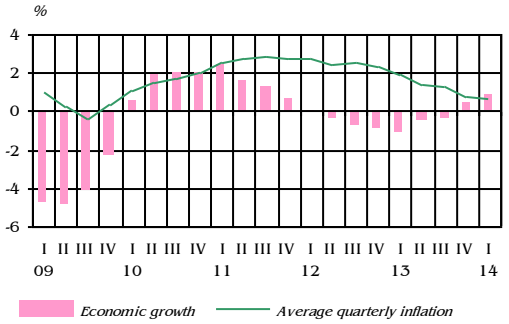


In Euro-area in the 1st quarter of 2014, there was 0.9% percent economic growth against the same period of the previous year, according to preliminary estimates provided by the Eurostat. During the quarter, consumer price index posted an average 0.7% growth y/y against the previous quarter's 0.8%.

In the 1st quarter of 2014, the European Central Bank left the policy rate unchanged, 0.25%.

In the 1st quarter of 2014, Euro appreciated versus the U.S. dollar by 0.6%, with the average dollar exchange rate reaching 1.37 for one Euro (y/y appreciation was 3.7%).

In the 1st quarter, economci growth in Euro-area accelerated



In the 1st quarter of 2014, economic growth in Russia was 0.9% y/y, according to the preliminary estimates of the Russia State Statistics Service. Specifically, industry posted some 1.1% growth compared to the previous quarter's 1.4% growth. Growth rates in retail trade and agriculture were 3.5% y/y and 1.1% y/y, respectively. In the meanwhile though, construction reported 3.6% decline. Consumer prices persisted at the previous quarter's level, 6.4% y/y.

In the 1st quarter of 2014, the ***price of Brent crude*** at Intercontinental Exchange fell by 1.4% against the previous quarter, reaching USD 108 a barrel (with 4.4% decline y/y).

The ***price of copper*** at the London Metal Exchange has dropped by 2.3% to USD 7001 per ton (with 12% decline y/y).

Export price of ***hard red wheat*** has fallen by 2.3% q/q to USD 8.1 a bushel (with 7.6% decline y/y), according to the U.S. Department of Agriculture data.

The price index of ***unprocessed sugar*** at the New York Board-Intercontinental Exchange posted a 7.3% decrease (with 10.8% decline y/y).

The price of ***rice*** at the Chicago Board of Trade has reduced by 0.7% to USD 15.4 per U.S. hundredweight (45.4 kg) (with 0.6% decline y/y).

The first quarter of 2014 saw mainly deflationary trends in basic commodity and food markets.

Mainly deflationary trends were observable in basic commodity and food markets in the 1st quarter of 2014.

4. CONCLUSION

In the 1st quarter of 2014, global demand in ***external sector*** remained sluggish and mostly deflationary trends were observable in basic commodity and food markets. In the ***forecast horizon*** the global economic growth rates are expected to rebound slowly, so in the ***forecast horizon non-inflationary influence*** will be expected from the external sector.

In the 1st quarter of 2014, economic activity was further slow-moving and the inflation environment moderate. Under such conditions, ***economic growth*** was estimated in the range 3.2-3.5%, while the ***12-month inflation*** reached ***3.8%,*** resting near the target.

In the forecast horizon, real private consumption growth rates are expected to stabilize and private investment to rebound slowly. Under such circumstances, economic growth will be in the range 4-4.5%. Revived private demand and overall neutral fiscal policy will make sure that the inflation environment ***will not expand in the forecast horizon.***

In the ***forecast horizon,*** inflation will stabilize around the target level of 4 percent. However, weak economic activity may promote the inflation to ***subdue at the rates faster than expected,*** bringing it to the lower bound of the band. ***In the 2nd quarter of 2014, the Bank will continue loosening monetary conditions in response to the slowing economic activity and mitigating inflationary environment. However, further directions of the monetary policy will depend on how risks to external and domestic economic developments will show up.***

Risks to inflation deviating from the projection value are estimated as ***balanced*** in both short and medium-term perspectives. The primary risks are associated with the development perspectives in emerging economies and the change in domestic demand. If such risks materialize, the Bank will react with an adequate policy while maintaining the inflation figure in the ***forecast horizon.***

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