

THE CENTRAL BANK
OF THE
REPUBLIC OF ARMENIA

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Resolution No. 262 A,
dated 19.11.2013*

Inflation Report

Monetary Policy Program, Q4, 2013

+

*Status report on implementation
of the Monetary Policy Program
Q3, 2013*

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Since January 2006 the Central Bank of Armenia has moved to a fully-fledged inflation targeting strategy whereby the monetary policy was steered to minimize any deviations of potential inflation from a 4 % target.

Each quarter, the monetary policy programs of the Bank used to present inflation forecast for the upcoming 12-month period under the assumption of unchanged interest rates as well as forecasts of the response of the policy rate. The programs included a blueprint for monetary policy directions.

The forecasting and policy analyses capacities of the Bank have considerably improved recently as the quarterly projections model became a more sophisticated one while the list of short-term models designed to forecast different suites of macroeconomic indicators expanded. Not only the Bank is now able to present inflation forecasts for upcoming 12-months but also it can provide medium-term conditional inflation forecasts.

Starting from Q2, 2012, the Bank has expanded inflation forecasts for a longer time horizon of 3 years instead of previously applied 1-year and publishes non-conditional inflation instead of conditional.

In consideration of best international experience, public surveys as well as seeking to raise public awareness the Bank approves and publishes, starting from the second quarter of 2012, Status Report on Implementation of Monetary Policy of the previous quarter and Monetary Policy Program of the next quarter in a single paper.

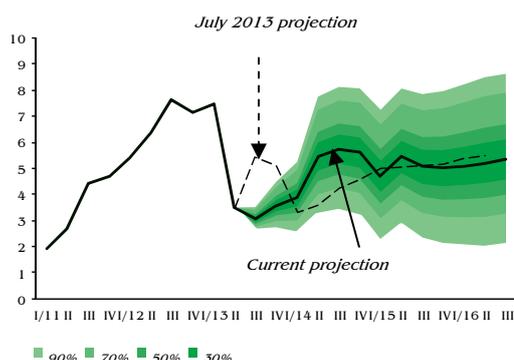
1. EXECUTIVE SUMMARY ¹

According to the Central Bank forecasts, in the course of the next 3 years the 12-month inflation would decline continuously and rest around the target while the economic growth would speed up in 2014 and stabilize around its long-term equilibrium.

In the 3rd quarter of 2013 the developments of the domestic economy marked slowing in economic growth rates and high inflationary environment.

Economic growth will reach 3.4-3.8% mostly driven by growths in agriculture and services (a total of roughly 3.8 pp of contribution).

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



In the forecast horizon the economic growth will stabilize within 4.6-6.0% and rest around its long-term equilibrium.

The Central Bank forecasts suggest that in the course of the next 3 years the 12-month inflation would decline continuously and rest around the target while the economic growth would speed up in 2014 and stabilize around its long-term equilibrium. Yet in the 3rd quarter of 2013 the developments of the domestic economy marked **slowing in economic growth rates and high inflationary environment**. This was mainly determined by reduced private and public investment primarily due to contracted construction volumes as well as the fiscal policy implemented since the beginning of the year, whilst direct and second-round effects of energy price increases contributed to high inflation (a total of 3.0 pp of contribution). Based on the 3rd quarter results, **the 12-month inflation was 8.2%** whereas the core inflation indicator was close to the upper bound of the confidence band, making up 5.3%.

Private consumption growth rates slowed down in the 3rd quarter amid high inflation and sluggish economic activity, under which conditions the private consumption growth for the period January-September is estimated 2.5% y/y. In the 3rd quarter private investment declined further than anticipated, with an estimated 9% y/y for the period January-September, which was primarily due to diminished value added in construction.

According to short-term forecasts, the private consumption in 2013 will grow by 2.7%, private investment growth rates will slow down to 7.0% and, based on the year's results, the fiscal policy will leave around 1.0 pp of contractionary impact. In 2013 the real growth of export of goods and services will be in the range of 7.0-9.0%; the real growth of import within 0.-1.0%. In the outcome, the economic growth will reach 3.4-3.8% mainly attributable to the growths in agriculture and services (a total of roughly 3.8 pp of contribution). In view of the expansionary fiscal policy to be implemented in 2014, the economic growth rates are expected to accelerate especially in that period. **In the forecast horizon** the economic growth will stabilize within 4.6-6.0% and rest around its long-term equilibrium, reflecting stabilization of private consumption growth rates and slow pace of recovering of private investment.

Thus, some recovery of private demand as well as expansionary effect of the fiscal policy **in the forecast horizon will create a minor inflationary effect on domestic demand**.

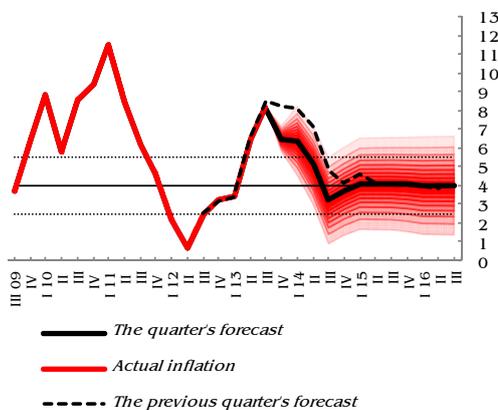
In the external sector external demand remained sluggish in the 3rd quarter, chiefly due to economic developments in Russian economy. No significant inflationary patterns were observable in **international markets of basic commodities and food products**.

¹ The monetary policy program was prepared using basic preliminary macroeconomic indicators that describe the socio-economic situation of Armenia for the period January-September 2013, as provided by the Republic of Armenia National Statistics Service (as of October 31, 2013).

In the forecast horizon a slow pace of recovery in global economic growth rates is anticipated, under which conditions a steady low inflationary environment will be discernable in international markets of basic commodities and food products.

In the 3rd quarter, attributable to direct and second-round effects of increased energy prices, the 12-month inflation continued trending upward, making up 8.2% in end-September.

Inflation forecast probability distribution chart (12-month)



In the 4th quarter of 2013 the Central Bank will loosen the monetary conditions to reach concurrence with the slowing of economic activity and mitigation of inflationary environment, whilst further directions of monetary policy to be carried out by the Central Bank will determine the pace of the fiscal policy, either.

In the forecast horizon a slow pace of recovery in global economic growth rates is anticipated, under which conditions a steady low inflationary environment will be discernable in international markets of basic commodities and food products.

In the 3rd quarter, attributable to direct and indirect effects of increased energy prices, **the 12-month inflation** continued trending upward, making up 8.2% in end-September. To anchor inflation expectations and mitigate second-round effects of increased energy prices, the Central Bank tightened the **monetary conditions** in August by raising the refinancing rate by 0.5 pp to 8.5% (see details in section 3.1.1 Actual inflation and attainment of target).

However, further slowing of domestic demand as well as the Central Bank activity will provide for a lower inflation environment in the 4th quarter, under which circumstance inflation will reduce faster than anticipated. According to the Central Bank projections, in end 2013 inflation will decrease to 7.0% y/y which is still above the upper bound of the confidence band. Inflation, however, will keep on subsiding in the course of the first half of 2014 as well to return the target in the second half. In the 4th quarter of 2013 the **Central Bank will loosen the monetary conditions to be consistent with the slowing of economic activity and mitigation of inflationary environment, whilst further directions of monetary policy to be carried out by the Central Bank will determine the pace of the fiscal policy, either.**

Risks to deviation of inflation from the projected value are estimated as balanced in both short and medium-term perspectives. The primary risks are associated with the pace of recovery of global economy and the developments in the domestic economy. If such risks materialize, the Central Bank will react accordingly by maintaining the inflation target over the medium-term perspective.

2. FORECAST, FORECAST CHANGES, RISKS

2.1. External environment ²

A steady low inflationary environment will be observable in the external sector amidst slowly recovering global economy.

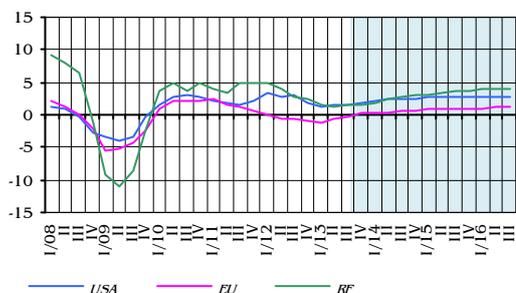
With slowly recovering global economy, a steady low inflationary environment will be observable in the external sector.

In October 2013 the IMF readjusted world growth outlook indicator downside, predicting economic growths of 2.9% and 3.6% for 2013 and 2014, respectively (the downside revisions were totally due to developing countries and amounted to 0.3 and 0.2 %age points for 2013 and 2014, accordingly).

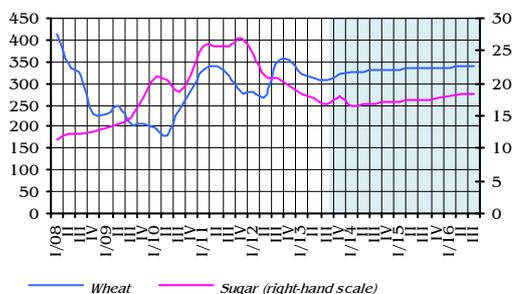
In the *U.S.A.* the Federal Reserve System will continue implementing a low-interest-rates policy during 2014, too, in spite of possible reduction in the indicators in the program of quantitative easing. It is anticipated that economic growth rates would also speed up during 2014, to reach 2.7% in 2016.

In the *Euro-area*, economic recovery will resume from 2014, with the economic growth to reach 1.2% in the second half of 2016. In pursuit of economic stimulation, the European Central Bank will continue a low-interest-rates policy.

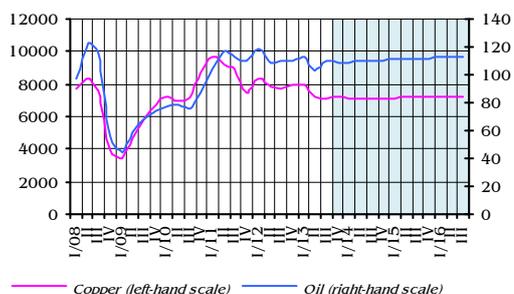
Economic growth in partner countries (%)



Food products (US dollar)



Raw materials (US dollar)



The forecast of economic growth in *Russia* for 2013 was revised downside to 1.4%, due to the slowing in investment and a sluggish external environment. Economic activity is expected to rebound from 2014, with an economic growth to make up 4% in end 2016. The inflation indicator will be within 7 % in 2013.

There are *uncertainties and risks* about the further pace of global economy and *these are more essential* for developing countries.

In the face of expected sluggishness in world economic recovery no significant inflationary trends will be observed 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 resource price developments will be determined by geopolitical events, the performance of metals prices will be influenced by world economic growth outlook whereas prices of food products will depend exclusively on weather conditions.

² 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.

Developments in commodities markets in the forecast horizon

In 2014 about 61.2% of global demand for oil will be met by producing oil by non-OPEC countries (the growth was 3.3% against the previous year), under which circumstance average demand for extraction of oil by OPEC countries will reach 35.7 million b/d. In the period 2013-2016 international oil prices are expected to grow moderately as world economic activity rebounds. However, the global market of energy resources will possibly see inflation risks due to geopolitical developments.

In 2013-2016 moderate inflationary patterns will be discernable in base metals markets, as the recovery of global economy is back on track. In the forecast horizon, however, international markets of base metals will function under serious uncertainties.

According to November estimations of the U.S. Department of Agriculture, in the marketing year 2013/2014 some 706.4 million tons of wheat crops is expected (the volume of crop has increased by about 51.2 million tons in comparison with the previous year). In spite of inflation in early 4th quarter of 2013, which is driven by less crop expectations in Argentina and Black Sea Region, average international wheat price will trend steady in the medium run.

In marketing year 2013/2014 world production of rice will again be impressive, 476.8 million tons. On the back of anticipated 474.6 million tons of rice, the world rice stock will reach 107.4 million tons for the marketing year 2013/2014. Average international rice price will mainly behave stably, as a result.

In early 4th quarter of 2013 the prices of sugar rose to some extent due to fire in port area in Brazil's Santos in October this year. Nevertheless, the price level will come back to where it was previously, thanks to anticipation of rich crops in the marketing year 2013/2014. It is expected that average international sugar price will be mainly stable in the medium run.

2.2. Aggregate supply and Aggregate demand**Aggregate supply**

Under the conditions of current macroeconomic developments³ and a slow pace of recovery in global economy⁴ as well as deteriorating expectations of economic agents over future economic situation⁵, the economic growth forecasts under the baseline scenario were revised downside. As a result, economic growth will be in the range of 3.4-3.8% and **in the forecast horizon** it will stabilize within 4.6-6%⁶.

In 2013, economic growth will be in the range of 3.4-3.8% and in the forecast horizon it will stabilize within 4.6-6%, closer to its long-term equilibrium.

³ See details in sections of Aggregate supply and aggregate demand.

⁴ See details in External sector of this section.

⁵ See Economic Activity and Business Climate Indicators, Q3, 2013, p. 4, <http://www.cba.am>.

⁶ See the 30 % interval in the Real GDP Growth (Cumulative) Projection Probability Distribution Chart in this paper.

The following developments are expected in the sectors of the economy:

For **Industry** the forecasts were revised downside, owing to the developments in the branch reported for the first nine months of 2013 and expected slowing in both the external and domestic demand. The growth of industry will be driven by such sub-industries as *ore mining, metallurgy, food and beverage, diamond processing* and *pharmaceuticals*. As a result, in 2013 value added is expected to post **3-4% real growth y/y**.

In 2013 value added is expected to post 3-4% real growth y/y. 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.

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. In the medium run, the growth rate may speed up depending on the increase of production capacities of enterprises in response to the investment made in the last 3 years, continued export-oriented policy of the Government as well as exploitation of Tegment mine.

For **Construction** the forecasts of value added were revised downside because of the reported double-digit decline in value added in the branch earlier the year, somewhat deteriorated expectations among construction companies⁷ and delays in implementing a major road construction project. As a result, in 2013 value added is expected to decline by **11-13% y/y**.

In the forecast horizon the growth will stabilize within 0-3%. In construction in 2013, the value added is expected to decline by 11-13% y/y.

In the forecast horizon, the growth is expected **to stabilize in the region 0-3%** which will be explained by gradually phasing out disequilibrium between the supply and demand in construction thanks to major construction projects aimed at infrastructure improvement.

For **Services** the forecasts were left unchanged: as a result, the **real growth** of value added of services is forecasted to be in the range of **6-7% y/y** for 2013.

In 2013 the real growth of value added of services is forecast in the range of 6-7% y/y. In the forecast horizon the growth in services will stabilize in the range of 5.8-6%.

In the forecast horizon the growth in services will stabilize in the range of 5.8-6%, staying consistent with the medium-term projections for domestic demand.

For **Agriculture** the forecasts of value added were revised upside thanks to favorable weather and increased sowing area and greenhouse capacities. As a result, the real growth of value added is expected within **5.5-6.5%** for 2013.

In 2013 the real growth of value added is expected within 5.5-6.5%. In the forecast horizon the growth in agriculture will stabilize in the region of 5-6.5%.

In the forecast horizon the growth in agriculture will stabilize in the region of 5-6.5%. In the medium run maintaining steadier growth rates will be determined by increased greenhouse production capacities, expanding of sowing areas, more harvesting and grown headcount as part of consistent implementation of the policy of the Government to boost up agriculture.

Under the baseline scenario risks in agriculture are dual sided and depend on how the external and domestic economies will develop.

⁷ See *Economic Activity and Business Climate Indicators, Q3, 2013, p. 4*, <http://www.cba.am>.

Real GDP Growth (Cumulative) Projection Probability Distribution				
Period	90% probability interval		50% probability interval	
	Min	Max	Min	Max
January-December 2013 / January-December 2012	2.6%	4.5%	3.4%	3.8%
January-December 2014 / January-December 2013	5%	6.2%	3.1%	8.1%
January-December 2015 / January-December 2014	4.3%	5.7%	2%	8%

Labor market⁸: the 2013 forecasts of labor market indicators hence unemployment were revised slightly downside, according to the baseline scenario. This was based on somewhat a slower-than-expected economic activity in relation to previous forecasts.

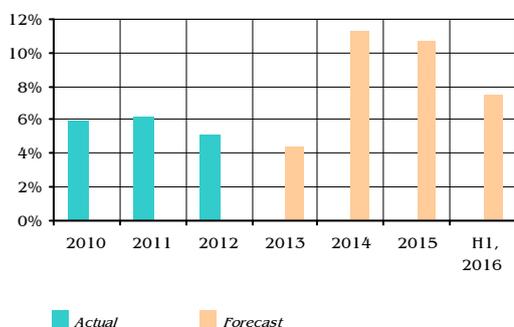
In spite of slower-than-anticipated economic activity, the 2013 forecasts of nominal wage were left virtually unchanged, which is explained by somewhat higher-than-expected increase in wages in July-August. Given the economic growth and inflation developments follow a path as projected in the baseline scenario and the Government keeps to implementing a policy steered to stimulate wage increases, the growth rates in nominal wage will speed up and the unemployment will decline in the *medium-run*.

In 2013 average nominal wage is expected to grow by 4.4% mainly due to the increase in wage in private sector amidst a slight rise in wage in public sector.

In particular, in 2013 *average nominal wage is expected to grow by 4.4%* due mostly to the increase in wage in the private sector on the back of a slight increase in wage in the public sector. In the 4th quarter, moderate growth in productivity in the private sector and the rise of minimum salary from AMD 35,000 to AMD 45,000 in early 3rd quarter will contribute to the growth of wages in the private sector.

In view of economic growth expected to be slower in relation to previous projections, the unemployment rate is likely to reduce at a slower pace. According to Central Bank estimates, the average unemployment rate in 2013 will reduce by 1.5 pp compared to the previous year, to 15.8%.

Average nominal wage growth, y/y



The level of unemployment will keep on subsiding *in the medium-run*.

There are expectations that in 2014 the minimum wage threshold will rise and the wage in the public sector will increase considerably concomitant with the economic growth, inflation and subsiding unemployment. These developments will lead to a sizable wage increment in the economy *in the medium run*. Note that the wage increase in the public sector will possibly trigger some rise in wage in the private sector, reflecting the wage race by segment between the public and private sectors. As a result, some minor inflationary patterns will be observable in the consumer market in the medium run.

⁸ 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.

Under the aforementioned developments, significant imbalances that would affect inflation in the labor market in 2013 are not expected. In the medium run, driven by the wage increase in the public sector, the growth rate in wage in the private sector will be somewhat faster; 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 0.2-0.3 pp⁹.

Aggregate demand¹⁰

Relative to previous forecasts, the estimations of aggregate demand for 2013 were revised downside mainly in consideration of slower growth rates in private spending. In a medium-term perspective, determined by an expansionary fiscal policy implementation, there are even higher expectations for the growth of aggregate demand. In the closing of the forecast horizon, expectations for growth rates in aggregate demand did not change much, though.

Relative to previous forecasts, the estimation of growth rate in *private consumption* for 2013 was revised downside, to 2.7%.

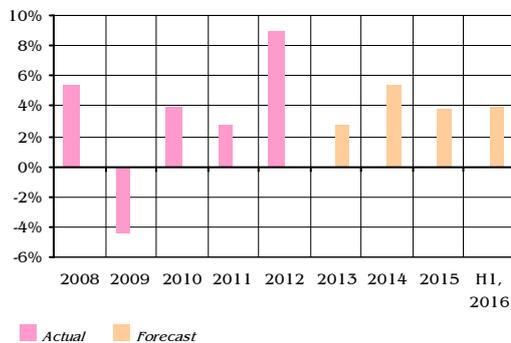
The decline in agricultural output, contraction of volumes of credit to the economy against 2012, as well as the rise in energy prices will lead to slower growth rates in private consumption at the end of 2013 and in early 2014.

In line with economic developments under the baseline scenario, a significant increase in wage in the public sector and pensions is expected in 2014, which will contribute to the growth of disposable income of households. Driven by such an increase in disposable income, the private consumption growth rates will accelerate considerably to gradually stabilize around 4.0% in 2015-2016.

In the 3rd quarter of 2013 investment activity in the economy was somewhat weaker than anticipated, reflecting some contraction in the output volumes in construction in the period July-September as well as the Central Bank surveys on investment¹¹. In consideration of further drop in comparison with the Central Bank estimations of private investment activity in the 3rd quarter, the forecasts of **private investment for 2013** were revised downside. In particular, it is expected that private investment will decline in 2013 by around 7.0% instead of 1% growth as was expected according to the previous forecasts.

The estimation of growth rate in private consumption for 2013 is 2.7%.

Private consumption growth, y/y



It is expected that private investment in 2013 would decrease by around 7.0%.

Private investment growth, y/y



⁹ The wage increase in the medium run will also lead to demand-pull inflation (see details in the section "Aggregate demand").

¹⁰ The data of real growth of private consumption and investments for 2013 are the Central Bank estimates. Actual figures of these data are as of the first quarter of 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.

¹¹ See <https://www.cba.am/AM/Economic%20Activity%20and%20Business%20Climate%20Indices/BAI,%20BCI2013.2.pdf>

In the medium-term perspective the private investment will recover slowly as economic activity in construction recovers. The introduction of the new pension scheme in 2014 will somewhat stimulate savings in the economy hence investment.

However, actual developments with private investment in 2013 provide for a slower recovery in private investment compared to previous forecasts over the medium run.

In view of the developments with private consumption and investment mentioned above, the growth rates of private spending will persist at relatively low levels *at the end of 2013 and early 2014*. Starting from the second half of 2014 the growth rates in private spending will accelerate and will stabilize around 4.5-5% at the end of the forecast horizon. As a result, the private spending gap is estimated to be negative at the beginning of horizon, which will turn to positive in the mid of 2014 and eventually wane out to zero at the end of horizon.

In line with growing public sector wage and pension, the growth rates in private spending will accelerate starting from the second half of 2014 and will stabilize around 4.5-5% at the end of the forecast horizon.

In the period from end-2013 to the first half of 2014, the private spending will create 0.9-1.0 pp of contractionary impact on inflation. In consideration of the increased public expenditures mentioned above, the private spending will create some 0.4-0.5 pp of inflationary pressures in the consumer market; such pressures are expected phase out to zero in the second half of 2015 and at the end of the horizon the impact of private spending on inflation will be neutral.

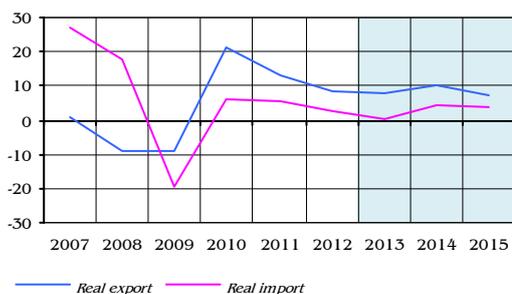
External demand: in the face of somewhat weaker global economic recovery and expected developments in the domestic economy, the current account deficit will keep on reducing during the 4th quarter of 2013, too. The year 2013 will end with real volumes of export outstripping those of import under which circumstance the dollar value of trade balance deficit will decrease in spite of an estimated deterioration of terms of trade. Based on the 2013 results, the real growth of export of goods and services will be within 7.0-9.0% and the real growth of import of goods and services, 0-1.0%. The growth rates in private remittances of individuals in 2013 will be within 9.0-11.0%.

The Current Account Deficit/GDP ratio is forecast within 7.0-8.0% in 2013 from 11.3% reported in 2012. The growth rates in remittances of individuals in 2013 will be within 9.0-11.0%.

All above-mentioned developments denote that the Current Account Deficit/GDP ratio will reduce to 7.0-8.0% in 2013 from 11.3% reported in 2012.

With a sluggish global economic recovery, brisker domestic economic activity and expansionary fiscal policy implementation, the current account improvement will be postponed, and in 2014 the Current Account Deficit/GDP ratio will persist at the 2013 level. The real export growth rate will continue to be faster over that of import. Despite a slow recovery of the global economy, the growth in exports of goods and services is expected in the range 9.0-11.0% amid expected strong growth in industry. The real growth rates in import of goods and services are expected to accelerate in 2014, in the range of 3.0-5.0% amidst faster growth rates in domestic economy and expansionary fiscal policy.

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



In 2013 the Tax/GDP ratio is expected to grow by more than 1.0 pp and the Expense/GDP ratio to drop by 0.5 pp. The Deficit/GDP ratio in 2013 is expected to reach 0.4%.

The 2014 Deficit/GDP ratio is expected to reach 2.3%. In the outcome, the fiscal policy will have 2.0 pp of expansionary impact.

The growth rate of remittances of individuals will persist within 8.0-10.0% in 2014.

All aforementioned adjustments suggest that the Current Account Deficit/GDP ratio in 2014 will persist within 7.0-8.0%.

In the medium run the current account balance will keep on improving, and the Current Account Deficit/GDP ratio will be in the range 5.0-6.0%.

In view of the state budget performance for the first nine months of 2013 which was consistent with the projections (see section "Actual developments in fiscal policy"), an annual plan of around 7.0% costs savings was considered realistic¹². *In 2013 the Tax/GDP ratio is expected to grow by more than 1.0 pp and the Expense/GDP ratio to drop by 0.5 pp*, in relation to the respective ratios reported in the previous year. A slow process of construction of the North-South Road was the main reason for reduction in expense.

In the 4th quarter of 2013 the fiscal policy is expected to be expansionary which will be determined primarily by an expansionary impact of expenditures. Yet, based on the year's results, the fiscal policy will have a **contractionary impact**, a byproduct of contractionary revenue policy carried out in the course of the first three quarters of the year. These developments suggest that the Deficit/GDP ratio in 2013 will possibly be around 0.4%¹³.

The **fiscal policy's impact on aggregate demand was estimated** using main indicators as outlined in the Republic of Armenia draft law on the budget 2014, which is aimed for a zero growth for the Tax/GDP ratio and 2.0 pp of growth for the Expense/GDP ratio. The raise in the latter ratio is driven by the planned increases of pension, wage of power enforcement authorities since the start of the year and, effective July 1st, wage of public servants. **The 2014 Deficit/GDP ratio is expected to reach 2.3%**. In the outcome, the fiscal policy will have 2.0 pp of expansionary impact which will contribute to a positive GDP gap since the second half of the year, creating inflationary pressures.

The **fiscal policy in forecast horizon** will be based on the main indicators as outlined in the Republic of Armenia Medium-Term Public Expenditures Program, 2014-2016, which is steered to provide for deficit adequate to public debt sustainability in the medium run. The impact of fiscal policy in the medium run is estimated to be non-inflationary, as a result.

The fiscal sector's medium-term impact estimation according to macroeconomic indicators underlying the Republic of Armenia Draft Law on Budget 2014 and the Medium-Term Public Expenditures Program, 2014-2016, prepared by the Republic of Armenia Ministry of Finance, is expansionary for 2014 and neutral for 2015 and 2016.

¹² The Central Bank estimate.

¹³ The Central Bank estimate.

	2012	2013	2014	2015	2016
Budget revenues	23.7	24.3	24.0	23.6	23.9
Budget expenditures	25.2	24.7	26.4	25.6	25.9
Debt interest payment	1.01	1.21	1.19	1.17	1.18
Budget balance ¹⁴	-1.5	-0.4 ¹⁵	-2.3	-2.0	-2.0
Primary balance*	-0.5	0.8	-1.1	-0.8	-0.8
One-off flows**	-0.3	-0.2	-0.2	-0.4	-0.3
Adjusted balance***	-0.2	1.0	-0.9	-0.4	-0.5
Cyclical balance****	0.3	0.0	0.1	0.0	0.0
Cyclically adjusted primary balance (structural balance sheet)	-0.5	1.0	-1.0	-0.4	-0.5
Fiscal stance*****			2.0	-0.6	0.1

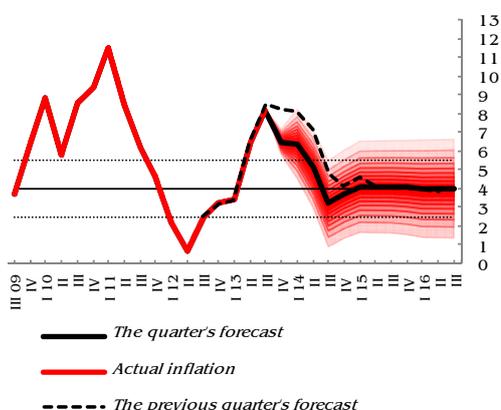
* Budget balance minus debt interest payments.
** Temporary or one-off budget entries. In this case net lending is considered; the sign "+" means resources allocated and the sign "-" means resources repaid.
*** Primary balance sheet adjusted by one-off entries.
**** Central Bank estimate: a part of the 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).

To sum-up, the combined impact of the fiscal sector, private demand and labor market on domestic prices for the period from end-2013 up to the first half of 2014 will be deflationary, 0.3-0.4 pp; from H2 2014 up to H1 2015 the combined impact of the aforementioned factors is estimated to be inflationary, with an average annual effect of 0.8-0.9 pp, driven especially by an expansionary fiscal policy. At the end of the horizon the impact of domestic demand and labor market on inflation is estimated as neutral.

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

Forecast of the main quarterly macroeconomic indicators and estimation of the monetary policy directions were based on the actual macroeconomic environment of the 3rd and 4th quarters of 2013 and all available information on the future developments.

Inflation forecast probability distribution chart (12-month)



	Inflation Forecast Probability Distribution Chart				
	< 2.5%	2.5 - 5.5%	5.5 - 7.0%	7.5 - 9.0%	> 9.0%
QIV, 2013	0.0%	0.9%	98.3%	0.9%	0.0%
QI, 2014	0.0%	21.1%	62.6%	15.3%	1.0%
QII	2.0%	60.5%	34.7%	2.7%	0.1%
QIII	30.9%	64.1%	4.9%	0.1%	0.0%
QIV	20.1%	69.5%	10.0%	0.4%	0.0%
QI, 2015	14.0%	68.8%	16.1%	1.0%	0.0%
QII	14.1%	68.5%	16.2%	1.1%	0.1%
QIII	14.3%	68.2%	16.4%	1.1%	0.1%
QIV	15.3%	67.3%	16.2%	1.2%	0.1%
QI, 2016	17.2%	65.8%	15.7%	1.3%	0.1%
QII	17.3%	65.5%	15.9%	1.3%	0.1%
QIII	17.4%	65.1%	16.0%	1.3%	0.1%

¹⁴ The budget balance sheet contains the pension system costs disburseable starting from 2014 (5%, with the share making up an average 0.49% of GDP for 2014-2016).

¹⁵ The 2013 state budget deficit figure is the Central Bank estimate, which suggests a performance of the budget on the part of revenues and savings on the part of public expenditures, making up 7.0%, primarily due to shortfalls on PIU funds from external sources.

In the face of persisting uncertainties over debt problems and geo-politics in the world, in the *forecast horizon the global economy* is predicted to recover at a slow pace. Under such conditions, demand driven inflationary pressures from the *main commodity and food product markets* are not likely to appear. However, individual product markets may run into certain supply-driven problems attributable primarily to geopolitical, climatic and other events.

In the 3rd quarter the developments in the domestic economy are characterized by *more-than-expected slowing of economic activity* due to the change in domestic demand. The domestic demand contracted due to reduced private and public investment largely because of low construction volumes and a fiscal policy. And, despite the external demand exceeded expectations and led to a rise in prices of individual commodities markets, it however did not offset the weakening of domestic demand. As a result, as of the 3rd quarter, the GDP gap is estimated to be slightly negative, which is expected to contribute to more-than-expected reduction in the core inflation rate in the 4th quarter. Given food prices and other administrative prices grow as projected, the inflationary pressures will also weaken significantly, which moderates concerns over more inflationary expectations in the time ahead.

In the upcoming quarters the actual GDP would still be below the potential level, and restrained consumption in wintertime, driven by increased utility costs, would also contribute to it.

It is predicted that in the upcoming quarters the actual GDP would still be below the potential level, and restrained consumption in wintertime, driven by increased utility costs, would also contribute to it. However, in the 4th quarter of 2013 and during the upcoming year, the fiscal policy would facilitate the recovery of aggregate demand through increases of wage in the public sector starting, particularly, the mid of the next year, and even would create a positive GDP gap in the second half of 2014.

In the 4th quarter of 2013 and during the upcoming year, the fiscal policy steered to increase the budget deficit would facilitate the recovery of aggregate demand.

The inflation is declining gradually, as was expected, and it will return its target in 2014¹⁶. Note, also, that the decrease in inflation in the short run was faster than predicted as economic growth slowed further than anticipated. So, further slowing of domestic demand as well as the Central Bank activity resulted in a lower inflation environment in the 4th quarter, under which circumstance inflation will reduce faster than anticipated. According to the Central Bank projections, at the end of 2013 inflation will decrease to 6.5-7.0% y/y and will keep on subsiding in the course of the first half of 2014 as well to return the target in the second half.

According to the Central Bank forecasts, at the end of 2013 inflation will subdue to 6.5-7.0% y/y and will keep on reducing over the first half of 2014 to return to its target.

Loosening monetary conditions is consistent with the slowing of economic activity and mitigated inflationary environment. Further directions of the monetary policy will be also determined by the pace of the fiscal policy. According to the Central Bank estimations, the GDP growth in 2013 will be in the range 3.4-3.8%, returning to the 4.6-6.0% interval in the medium-term perspective.

¹⁶ See this section "Inflation forecasts and monetary policy directions in 3-year forecast horizon".

In the forecast horizon the lending growth rates are expected to slow down to some extent. However, in absolute terms, lending will remain strong, providing for money supply adequate to demand for money.

In the forecast horizon the lending growth rates are expected to slow down to some extent. However, in absolute terms, lending will remain strong, providing for money supply adequate to demand for money, which will be fostered by the Central Bank's response to the liquidity demand.

3. ACTUAL DEVELOPMENTS IN Q3 2013

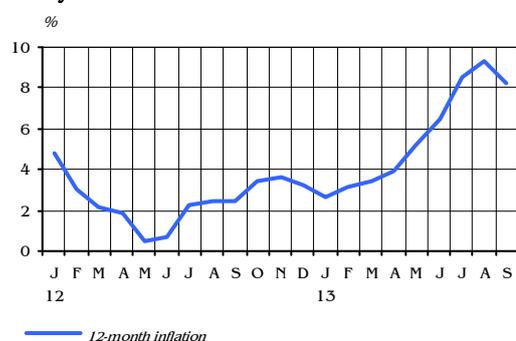
3.1. Inflation

3.1.1. Actual inflation and attainment of target

In the 3rd quarter of 2013 the inflation environment was expected to expand substantially as the baseline scenario of the Q3, 2013 monetary policy program considered the effect of energy prices, increased since July, on domestic prices as well as inflation expectations of economic agents. In the outcome, the 12-month inflation was expected to expand up to 8.5% in the 3rd quarter and return its target during 2014.

The 12-month inflation kept on expanding from 6.5% in end-June up to 8.2%, largely fuelled by the direct and second-round effects of energy prices, increased since July.

In Q3, 2013 inflation further expanded, which led the 12-month inflation to post the highest value (9.3% in August) in the last two years



Based on the actual results, the 3rd quarter reported 0.5% inflation compared to 1.1% deflation recorded in the same period of the previous year. This was fuelled largely by the direct (2.5 pp) and indirect (roughly 0.5 pp) effects of energy price increase since July. The seasonality of food price change persisted owing to price drops in items such as 'fruit' and 'vegetable and potato' which moderated the inflationary effect by 1.8 pp. As a result, the 12-month inflation kept on increasing during the 3rd quarter from 6.5% in end-June up to 8.2%.

Commodity group	Inflation by main commodity groups					
	June 2013 (y/y)		September 2013 (y/y)		3rd quarter 2013	
	Growth	Contribution	Growth	Contribution	Growth	Contribution
CPI	6.5		8.2		0.5	
Food products	8.7	4.7	8.0	4.3	-3.2	-1.8
bread products	10.4	1.1	6.1	0.6	0.4	0.0
dairy products	10.1	0.4	12.2	0.5	0.6	0.0
meat products	4.2	0.4	4.0	0.4	0.5	0.1
fruit	18.4	0.7	20.6	0.8	-21.8	-0.8
vegetable and potato	17.9	1.1	12.4	0.8	-27.5	-1.7
fats and oils	10.2	0.3	12.5	0.4	0.9	0.0
egg	18.8	0.3	38.6	0.5	10.6	0.1
Non-food products	4.8	0.8	3.4	0.5	0.7	0.1
Services	3.4	1.0	10.9	3.4	7.5	2.2

In the 3rd quarter the 12-month core inflation was relatively steady, making up 5.3% in end-September.

Below are the arguments and expectations which were used to predict inflation in a previous one-year horizon, as well as significant deviations in that period, which necessitated further adjustments in forecasts. In consideration of a low inflationary environment in the beginning of the previous one-year (*i.e. the start of the 4th quarter of 2012*), which was shaped due to the supply shock as a result of increased output in agriculture, and the expected spillover of the inflationary effect from the external sector and because a low inflationary environment as this

suggested a moderately expanding inflation environment and gradually increasing 12-month inflation rate, the Central Bank envisaged to implement *a neutral monetary policy*¹⁷. Certain price stability achieved in end-2012 would be maintained over 2013 driven by non-inflationary expectations from the domestic and external economies. In such a case, *the 12-month inflation* would accelerate in the first half of 2013 and later on *stabilize around the target*.

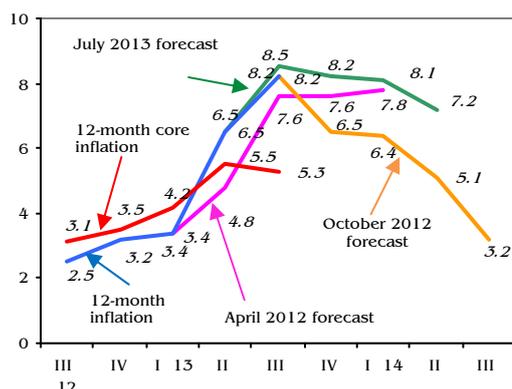
In fact, as was expected, the inflationary environment had expanded gradually in the period from October 2012 to April 2013 (*with the 12-month inflation rising from 2.5% in end-September to 3.9% in April*, nearing the target).

The inflation forecasts made in April and July were revised upside taking into account due to such events as heavy hails, partly postponed vegetation period in agriculture and price increases on some services as well as possible revision of energy prices starting from the 3rd quarter.

However, the situation changed significantly in May as the economy had a considerable amount of inflation potential primarily due to such events as *heavy hails, partly postponed vegetation period in agriculture and price increases on some services* as well as *possible revision of energy prices* starting from the 3rd quarter.

The inflation forecasts made in April and July were revised upside: up until the second half of 2014 the inflation rate will vary within an 8.0% level then it will decline to enter the confidence band and will rest within the 4% target in the medium run.

Inflation environment considerably expanded in 2nd and 3rd quarters of 2013 and existing inflation expectations prompted to revise short-term 12-month inflation forecasts upside



The Central Bank reacted to the aforementioned inflation developments in a one-year horizon preceding the 3rd quarter of 2013 by leaving the policy rate unchanged, at an 8% level, up until August of this year. In August, the refinancing rate rose to 8.5%.

The *actual results of the 2nd and 3rd quarters* show that the 12-month inflation has increased by 4.8 pp to 8.2% in mid-September¹⁸, which is the upper bound of the confidence band if direct and second-round effects of risen energy prices are excluded.

The Central Bank reacted to the aforementioned inflation developments in a one-year horizon preceding the 3rd quarter of 2013 *by leaving the policy rate unchanged, at an 8% level* up until August of this year. Anticipated abolishing of the effect of seasonal price drop in agricultural products in summer of 2012 on general prices as well as the 12-month inflation starting to demonstrate expanding patterns was the underlying argument.

Acceleration of inflation in the period May-July of this year notwithstanding, the Central 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 Central 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 has also expanded to 5.3% in end-September from 3.1% from the same period of 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

¹⁷ A neutral monetary policy involves a policy rate matched with an estimated neutral interest rate under which condition the inflation is within the target and GDP in equilibrium. Currently, the neutral interest rate is estimated around 8%.

¹⁸ Based on the 3rd quarter results, the 12-month inflation was 5.3%.

domestic developments and easing second-round effects from the increase of energy prices.

3.1.2. Import prices and producer prices

Import prices: the q/q growth rates of dollar prices of import of goods and services were near to zero in the 3rd quarter in the light of developments in global economy as well as the US dollar's depreciation versus euro. However, the y/y growth rates of dollar prices of import of goods and services speeded up to some extent, reaching 2.6% in the 3rd quarter compared to 1.3% y/y in the 2nd quarter, according to the Central Bank estimations.

The y/y growth of import prices was mainly attributable to accelerated y/y growth rates in goods prices, which is mainly driven by the increase in prices of commodities, with the iron price increase outpacing the effect of falling of prices of other commodities such as gold, wheat, sugar.

In the 3rd quarter of 2013 the y/y growth rates in dram prices of imported goods included in consumer basket slowed down to an average 6.0% y/y as the dollar prices of import goods rose by 2.6% y/y and the average nominal AMD/USD exchange rate appreciated by 0.5% y/y.

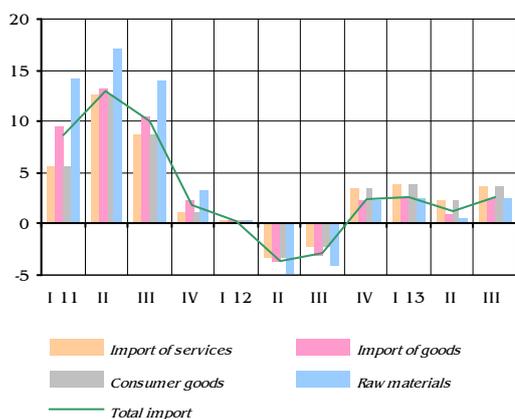
Producer prices¹⁹: in the 3rd quarter of 2013 almost all sectors of the economy posted increased price indices; the GDP deflator in the period January-September has been 103.5 y/y, according to the Central Bank estimates.

Industry posted a quarterly growth of 4.7% y/y, with the January-September growth having amounted to 4.8% y/y, owing to increased prices in *processing industry* (5.3%) and *energy and gas production and distribution* (14.3%). The latter is a result of continued recovery in the global and domestic demand and energy price rise since July of 2013.

Agriculture reported 2.5% y/y increase in prices²⁰ during the 3rd quarter in spite of the 2.3% y/y decline in the period January-September due to 0.5% y/y rise in prices in *plant growing* and 6.4% y/y drop in prices in *animal breeding*, respectively. The small increase in prices in plant growing was driven by 8.9% and 80% increment in prices of 'potato' and 'melons and gourds' in contrast to 13.1% and 16.8% decline in prices of 'fodder crops' and 'fruit, vegetables, berries', respectively. The reported price decrease in animal breeding is attributable to meat and milk and dairy products, having reduced by 7.1% y/y and 0.4% y/y, respectively.

Construction reported 2.7% y/y growth of prices in the 3rd quarter, with the January-September price increase having reached 2.5% y/y, mainly attributable to the wage increment and price increases in the branch.

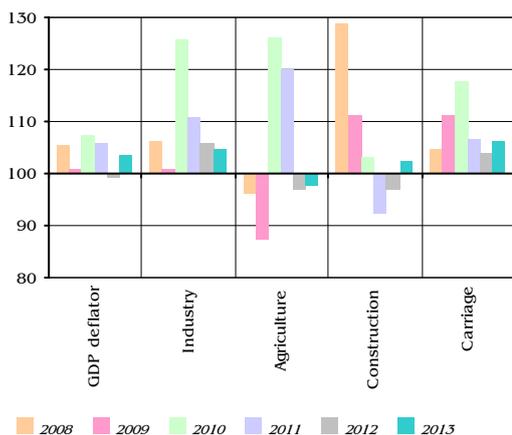
In Q3, 2013 growth rates in prices of import goods speeded up y/y (%)



¹⁹ The price index change as presented here is relative to the same period of the previous year unless otherwise specified.

²⁰ Sales prices of producers of agricultural product are presented.

In January-September 2013 the highest prices were posted in carriage and industry



Carriage reported 14.4% y/y rise in prices in the 3rd quarter, with the January-September price increase having reached 6% y/y, owing to risen tariffs on *railroad transport* (0.4%), *air transport* (4%), *truck transport* (2.3%) and *pipeline transportation* (13.6%). Note that the pipeline transportation rates, as high as these, are mainly due to the increase in energy prices.

3.1.3. Inflation and interest rate expectations

In the 3rd quarter of 2013 the Central Bank continued its regular surveys on what kind of expectations organizations in the financial sector and households have about selected macroeconomic indicators.

It is noteworthy that albeit the inflationary environment expanded further in the 3rd quarter and the 12-month inflation posted an elevated level, inflationary expectations in the financial system were relatively stable according to recent survey results. Also, the impact of possible energy price rise had already been reflected in previous surveys, which is why inflationary expectations in the financial system turned to be stronger. Based on the 3rd quarter results, most banks anchored their expectations of the 12-month inflation around 5.6% range, which is much the same in comparison with the previous quarter's choice as well as the upper bound of the confidence band. Credit organizations had somewhat lower expectations as they chose a 4.0% range for the 12-month inflation figure against their previous expectation of 4.8% range. The 3rd quarter survey results suggest that households' inflationary expectations have moved upward as they chose a 5.2% range compared to the previous quarter's 4.7% for the 12-month inflation.

According to the survey results, banks and credit organizations will further anticipate stable market interest rates for the upcoming one-year horizon; some rise in interest rates of dram deposits and loans is anticipated, however.

3.2. Aggregate supply and Aggregate demand

3.2.1. Aggregate supply²¹

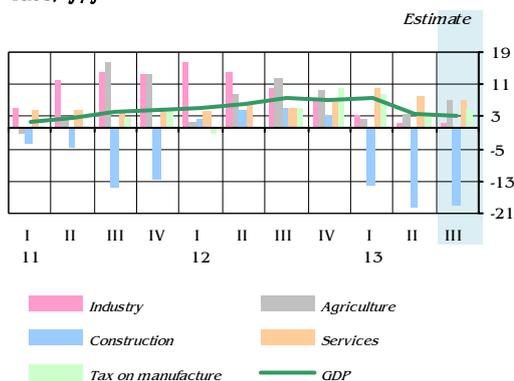
The indicator of *economic growth* published by the National Statistics Service of Armenia for the 2nd quarter of 2013 was merely 0.6% y/y, with the January-June growth having amounted to 3.5% y/y. The reduction of economic growth rates in the first half against the 1st quarter's 7.5% growth was mainly a result of the further slump in construction, slow growth rates in services

²¹ The indicators of real growth of value added in branches of the economy for the first three quarters of 2013 are the Central Bank estimates whereas the indicators of sub-branches represent y/y growth rates in output volumes for January-September, unless otherwise specified.

Economic activity indicator in the period January-September has been 3.2% y/y against 4.4% y/y recorded for the period January-June.

The economic growth in the period January-September 2013 is expected within a 2.9-3.2% range.

Actual real GDP and economy sector growth rate, y/y



and agriculture sectors, which is somewhat mitigated by accelerating growth in agriculture.

Amidst slowing economic activity in the 3rd quarter of 2013, Economic Activity Indicator in the period January-September has been 3.2% y/y against 4.4% y/y recorded for the period January-June.

Taking into account the effect of tightened tax administration, suspended road infrastructure project as well as expected slow-down in domestic demand growth rates on the economic activity, economic growth forecasts under the baseline scenario were revised downside. As a result, economic growth in the period January-September 2013 is expected to be within the range of 2.9-3.2%.

In view of high output growth of 7% in **Industry** in the first 3 quarters of 2013, the growth of value added is estimated in the range of 3-4% y/y for the same reference period mainly due to the increased volumes in *metal ore mining* (10.1%), *food production*²² (2.6%), *metallurgy* (8.8%), *beverage production*²³ (17.7%), and *tobacco production* (60.7%), which is a result of consistent improvement in external demand as domestic and world economies recover.

In consideration of 9.2% decline in **Construction** in the first nine months of 2013, the decrease of value added for the same period of time is estimated within 18-20% y/y. Note that there has been a slump in sources of construction financing with exception of such sources as *households* (19.4% growth) and *humanitarian aid* (10.1%). In particular, decline was posted in regard to construction financed by organizations (-17.2%), international loans (-33.5%), state budget (-11.7%) and local communities (-13.1%).

In **Services** the growth of value added for the first 3 quarters of 2013 is estimated in the region 6.7-7.2% y/y as a result of volumes of services rendered and trade turnover having increased by 2.8% and 2.1%, respectively. The increase in the volume of services rendered was driven by growth recorded in information & communication (9.7%), financial and insurance activity (7.3%), events, leisure and rest (16.2%), public catering (19.7%) and healthcare (13.1%). The growth of trade was totally due to retail trade and wholesale trade, having increased by 1.8% and 4.7%, respectively.

In **Agriculture** the growth of value added for the first 3 quarters of 2013 is estimated in the range of 6.5-7.5% y-o-y, owing to increased outputs in animal breeding, fishing and plant growing by 2.7%, 31.8% and 7%, respectively. Reported 5.4% and 14% increases in milk production and slaughtered animal and poultry production, respectively, have mainly contributed to the overall growth in *animal breeding*.

²² Growth in food production was mainly owing to increased production volumes of vegetable oil (a 2.3-fold increase), macaroni (16.9%), canned food (9.6%), confectionery (15.5%), curd (17%), yogurt (13.9%), milk (4.6%), sour cream (12.4%) and ice-cream (13%).

²³ Growth in beverage production was mainly owing to increased production volumes of champagne (55.6%), beer (35.3%), brandy (7.4%), natural juice (19.2%), spring water (33.4%) and non-alcoholic beverage (40%).

3.2.2. Aggregate demand²⁴

A trend of slowing growth rate in private consumption in the 3rd quarter of 2013 against the previous year's strong growth was something that the Central Bank well forecasted. Note, however, that the third quarter's slowing of consumption was greater than expected.

In the 3rd quarter private consumption grew by 1.3%, with an estimated private consumption growth indicator having reached 2.5% for the period January-September.

In the 3rd quarter private consumption grew by 1.3%, with an estimated private consumption growth indicator having reached 2.5% for the period January-September.

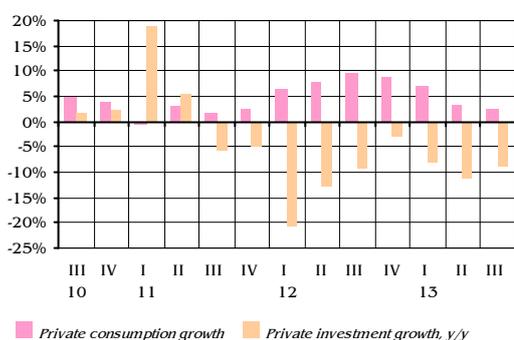
A slowing private consumption was in part a result of gradually phased out economic effects of strong growth in agriculture in 2012, a sluggish credit growth and high inflation recorded in the 3rd quarter of this year.

A Consumer Confidence Index²⁵ as calculated by the Central Bank points to the above developments with private spending. In the 3rd quarter of 2013, relative to the same period of the previous year, the CCI has dropped by 9.9% to 41.9, showing a further tendency of decline.

In the 3rd quarter of 2013 the investment climate was somewhat weaker than expected, reflecting persisted decline in construction during the third quarter as well as slower-than-expected economic activity in the same period of time. In the outcome, in the 3rd quarter investment reduced by 6.8%, while the decline in investment in the period January-September has been an estimated 9.0%.

In the 3rd quarter investment shrank by 6.8%, while the decline in investment in the period January-September has been an estimated 9.0%.

Private consumption and investment growth, y/y



The results of the Central Bank surveys²⁶ of Armenian companies point to the low investment activity during the 3rd quarter.

In the 3rd quarter of 2013, 21% of the companies surveyed invested in industry; this is 5 percentage points higher than the figure recorded in the same period of the previous year. The share of companies having invested in the total survey has shrunk in all sectors of the economy. Credit provided by local banks to companies continued to be an important source of investment financing during the first half of 2013.

In the face of slower private consumption growth rates and contraction in investment, private spending has declined by 0.6% in relation to the 3rd quarter of 2012, which has resulted in 0.6% shrinkage of the domestic demand amid 0.4% decrease in government spending.

On the back of the aforementioned developments with private consumption and investment, the private spending gap in the 3rd quarter of 2013 is estimated negative, with a 0.4-0.5 pp of contractionary impact on the inflation.

In the 3rd quarter of 2013 the growth rates of export of goods and services in real terms amounted to 8.2% y/y; the volume of import of goods and services in real terms has grown by 5.7% y/y. The growth rates of net inflow of non-commercial remittances of individuals somewhat persisted, amounting to 10.6% y/y.

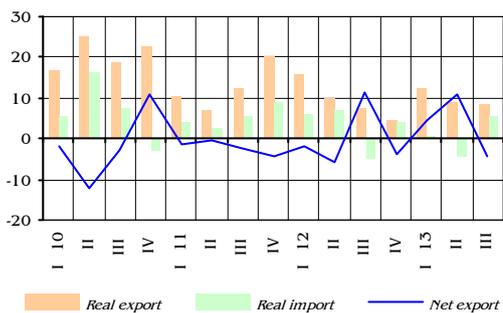
²⁴ The private spending, private consumption and private investment data for the 3rd quarter of 2013 are the Central Bank estimates based on actual 3rd quarter of 2013 data. Growth estimates in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

²⁵ See <https://www.cba.am/am/SitePages/statsscci.aspx>.

²⁶ See <https://www.cba.am/am/SitePages/statsseabci.aspx>.

Net export's negative balance widened in Q3, 2013

(net real export, y/y, %, positive sign denotes improvement)



In the 3rd quarter of 2013 the growth rates of export of goods and services in real terms remained comfortably strong, amounting to 8.2% y/y, which was attributable the developments amidst weak external demand. The volume of import of goods and services in real terms²⁷ has grown by 5.7% y/y, reflecting the base effect of decline reported in the previous year's third quarter.

In the 3rd quarter of 2013 the growth rates of net inflow of non-commercial remittances of individuals somewhat persisted, amounting to 10.6% y/y.

3.2.3. Labor market²⁸

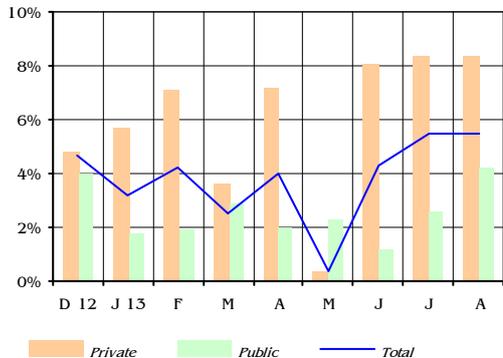
The developments in the period July-August of 2013 suggest that the growth rate in nominal wage in the 3rd quarter was consistent with previous forecasts and was estimated to be 5.5%, with an average nominal wage growth having been estimated to be 4.0% in the period January-September. Moreover, the private sector wage growth in the public sector was quite high compared to the wage in the public sector. In the 3rd quarter of 2013 the private sector wage growth is estimated at 8.5%, and 3.4% in the public sector.

The increase of the minimum salary threshold as well as continued reduction in the unemployment rate in the 3rd quarter of 2013 largely contributed to the nominal wage increases in the private sector.

In the 3rd quarter of 2013 the average unemployment rate subdued somewhat sluggishly than projected (a total of 0.6 pp to 15.4%), which was determined by lower-than-expected economic activity reported in the 2nd and 3rd quarters of the year. In the period January-September 2013 the average unemployment rate has amounted to 16.2%, declining 1.7 pp compared to the same period of the previous year.

Significant imbalances in the economy were not observed during the 3rd quarter of 2013, and the impact of the labor market on inflation has been neutral, as a result.

Nominal wage growth, y/y



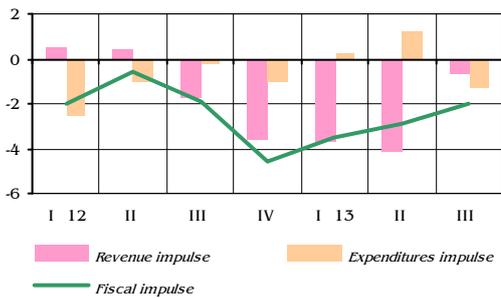
The fiscal impulse was 2.0 contractionary instead of the neutral as was projected for the quarter.

3.2.4. Fiscal policy²⁹

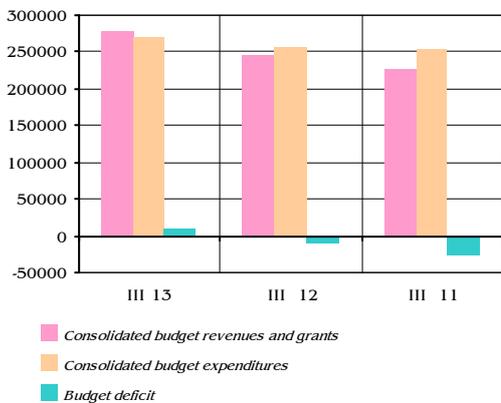
In the 3rd quarter of 2013 the state budget performance was in line with some savings and revenue plans assigned for the quarter. The fiscal sector further had a contractionary impact on aggregate demand: the fiscal impulse was 2.0 contractionary

²⁷ The real export and import growth indicators are the Central Bank's estimates.
²⁸ The labor market data for 2013 are the Central Bank estimates which are based on the 2nd quarter data and actual July-August 2013 figures. The growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.
²⁹ Consolidated budget indicators which were prepared on the basis of preliminary actual data of the 3rd quarter of 2013 (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. The actual developments were matched with the adjusted state budget plans.

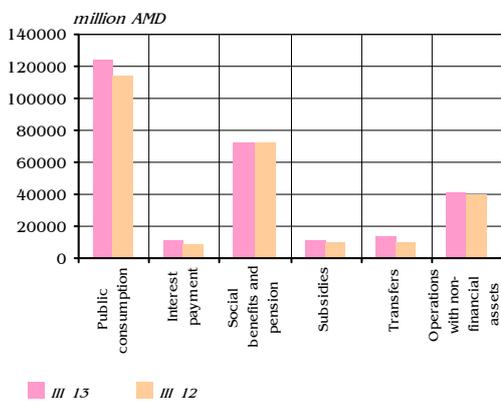
In Q3, 2013 the fiscal policy's contractionary impact was determined mostly by contractionary impact of expenditures



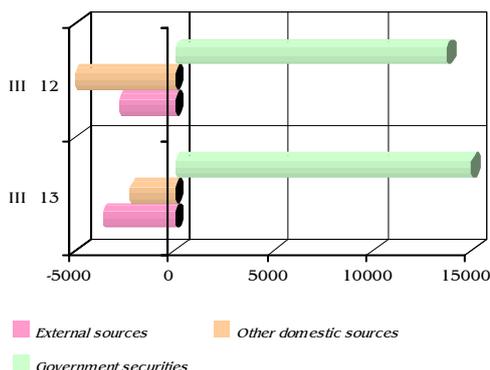
Main consolidated budget indicators in third quarters 2011-2013: for the first time in recent years, the third quarter budget runs with surplus



In Q3, 2013 almost all expenditures items of the budget posted increment



In Q3, 2013 the budget posted a surplus



instead of the neutral as was projected for the quarter. This is mainly explained by the deviation³⁰ reported with regard to the quarterly expenditures performance, whereby some 1.3 of contractionary impact was reported instead of the projected 0.4 expansionary. The revenues impact reached 0.7 contractionary against the projection of 0.3 contractionary.

Revenues of the consolidated budget have grown by 13% in relation to the 3rd quarter of the previous year, mostly owing to increased tax revenues. In the structure of taxes and duties the share of indirect tax has shrunk by 5 pp to 50% of tax revenues but the share of direct tax has risen to 39% of tax revenues. In the structure of direct taxes, the income tax³¹ has grown by 24.2%. As a result, the growth rate of direct tax (21%) has outpaced the growth rate of indirect tax (3%).

Despite low performance on public expenditures during the 3rd quarter (nearly 85.3% against the plan), almost all items have posted increases when compared with the previous reference period. In the 3rd quarter of 2013 expenditures of the consolidated budget grew by 6.6% against the same period of the previous year. Current expenditures have grown by 7.1% y/y and capital expenditures (*item transactions with non-financial assets*) by 3.7% y/y. In the structure of current expenditures, public consumption has increased by 8.5% y/y. The deviation from quarterly plans is mainly attributable to savings on some expenditures items and a slow pace of projects financed through external sources (the "North-South Highway Investment Project", in particular).

In the 3rd quarter of 2013, with revenues and expenditures figures shown above, the consolidated budget generated a surplus of AMD 9.4 billion, in lieu of an estimated deficit of AMD 30.1 billion for the quarter.

Based on the first 3 quarters' results, the state budget generated revenues of AMD 757.5 billion which secured the first nine months' performance of the budget. Relative to the 3rd quarter of the previous year, the growth of tax revenues has been 18.2%, or AMD 113.8 billion, which is largely due to increased value added tax, customs duty, and environmental and natural resources fees. The growth of public expenditures (PIUs included) over the same period of the previous year has been 7.3%.

The results of the first 3 quarters of 2013 show the state budget has generated a surplus of AMD 39.2 billion in lieu of an estimated AMD 76.9 billion deficit, and the fiscal policy has had 2.6 of contractionary impact on the aggregate demand, mostly driven by contractionary impact of revenues.

³⁰ The "North-South Highway Investment Project" encountered considerable shortfalls due to sluggish implementation of the project.

³¹ An income tax has been introduced that replaced the former income tax and social security fees, as part of the legislative amendment effective from 2013.

3.3. Money and financial market developments

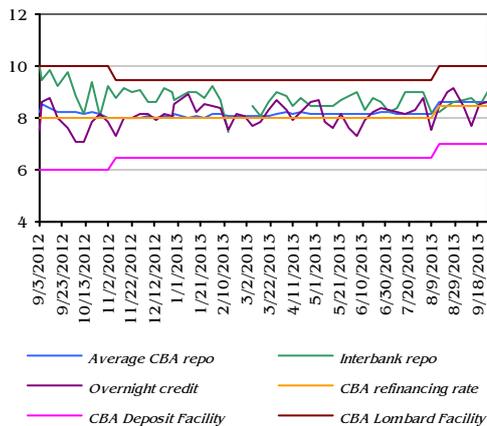
3.3.1. Financial market, money and credit

In the 3rd quarter of 2013 the Central Bank raised the refinancing rate by 0.5 pp to 8.5%. The Bank's decision pursued a goal of making sure inflation expectations resulted from domestic developments are anchored and second-round effects from the increase of energy prices are mitigated, while attaching importance to keeping the real interest rates positive.

In the 3rd quarter of 2013 the Central Bank raised the refinancing rate by 0.5 pp to 8.5%. The Bank's decision pursued a goal of anchoring inflation expectations resulted from domestic developments and mitigating second-round effects from the increase of energy prices, while attaching importance to keeping the real interest rates positive. In the meantime, the Board of the Central Bank had sent an impulse to the financial market that it would react by easing monetary conditions, if inflation declined gradually and economy slowed down.

In the 3rd quarter of 2013, interest rate of repo agreements, the main policy instrument of the Central Bank, has risen in relation to the 2nd quarter and amounted to 8.6%, close to the Refinancing Rate. The average interest rate in September was 8.6%, increasing by 0.4 pp against June. Despite the interest rate rise, the volumes of repo operations carried out by the Central Bank have increased by nearly AMD 190 million.

During the quarter, short-term interest rates rose

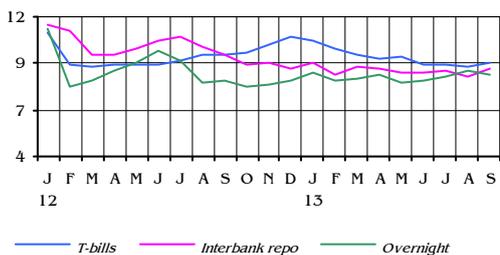


Period	Repo (up to 7 days)		Funds attracted		Lombard repo	
	Value (million Dram)	%	Value (million Dram)	%	Value (million Dram)	%
QI 2012	151932.32	11.15	387600	5.00	59093.88	11.00
QII	185000.00	10.29	317950	5.05	179437.37	10.77
QIII	488921.68	9.03	158200	5.51	32524.98	10.50
QIV	741880.51	8.09	140150	6.22	5631.79	9.50
QI 2013	763825.90	8.09	163700	6.50	944.60	9.50
QII	929077.62	8.19	176300	6.50	38652.30	9.5
QIII	1121106.19	8.42	176300	6.75	5278.56	9.5

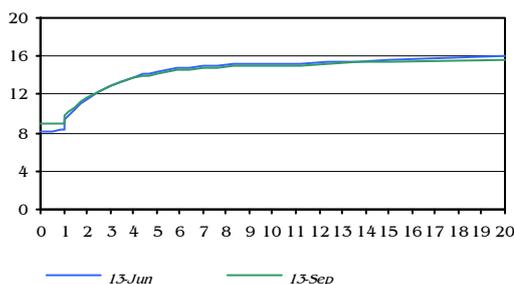
In the 3rd quarter of 2013, the change in Refinancing Rate of the Central Bank was most eminent in the short-term segment of the financial market.

In the 3rd quarter of 2013, the change in Refinancing Rate of the Central Bank was most eminent in the short-term segment of the financial market. The Refinancing Rate's 0.5 pp rise in mid-August was concurrent with the increase of long-term interest rates. As a result, the average quarterly overnight loan interest rate has grown by 0.33 pp in relation to the previous quarter; relative to June, it has grown by 0.37 pp to 8.4% in September. In September, relative to June, the interbank repo rate has grown an average by 0.3 pp to 8.76% (in average quarterly indicators the growth has reflected feebly). A similar behavior was demonstrated in the T-bills market.

During the quarter, short-term interest rates trended up amid rise of the CBA refinancing rate



In the 3rd quarter of 2013 interest rates rose in the government securities market*



* In July 2013 a new methodology that builds yield curves on Armenian government bonds and calculates the curve parameters was introduced. See www.cba.am.

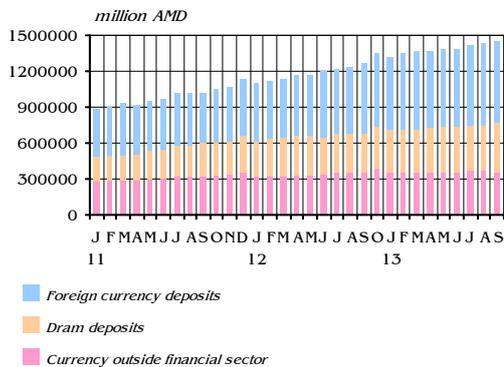
Government securities market

Box 2

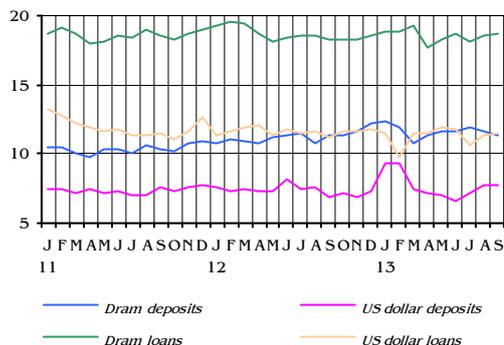
Interest rates of T-bills reacted to the August change of the Refinancing Rate in September. As a result, the downward trend in interest rates, observable since the beginning of the year up until August, has pushed the average quarterly yield figure down by 0.23 pp to 8.96% against the previous quarter. In September, relative to June, the average interest rate has grown by a mere 0.1 pp to 9.05%.

The rise of the policy rate was reflected in the level of yield curve. The yield curve analysis shows that in the secondary market the yields sloped up mainly in the short-term segment. The concavity has dropped by 2.3 to 6.4, which points to the reduced spread of long and short-term interest rates.

In Q3, 2013 the growth rate in foreign currency deposits outgrew that of dram deposits



In Q3, 2013 the average spread of interest rates on FX loans and deposits narrowed



The 3rd quarter saw credit growth rates slowing further as economic activity slowed down.

In the banking sector in the 3rd quarter of 2013, average monthly interest rates of deposits in Armenian dram grew to some extent. Relative to the previous quarter, the average quarterly indicator has risen by nearly 0.2 pp to 11.7%. The volume of dram deposits has increased by 6.7%, owing almost totally to the growth of term deposits in Armenian dram. During the quarter interest rates of foreign currency deposits grew by 0.7 pp to 7.6%, and the volume of foreign currency deposits has increased by 7.0% (8.2%, if the impact of change in the exchange rate is excluded), mainly owing to term deposits attracted from households.

The growth of foreign currency deposits was reflected in the dollarization of the economy. In the 3rd quarter of 2013 the dollarization (measured as a ratio of foreign currency deposits to broad money) grew by 0.7 pp.

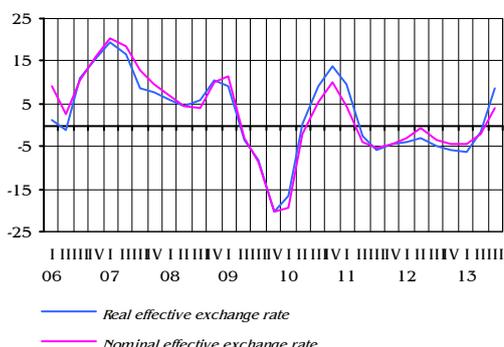
In the 3rd quarter the change in Refinancing Rate affected interest rates of loans differently. Driven by structural shifts in the volumes of credit, the dram and foreign currency loans had varying interest rates. Specifically, on the back of growing demand for consumer credit the average quarterly level of interest rates of dram loans has risen by 0.3 pp to 18.5%.

In the 3rd quarter of 2013 interest rates of foreign currency loans fell, on the contrary. The average quarterly interest rate of foreign currency loans has dropped by 0.5 pp against the previous quarter and amounted to 11.2% in the 3rd quarter. As shown by the 3rd quarter 2013 survey results, the shrinking demand for business and mortgage loans could lead to an interest rate drop.

A narrowing trend in respect of interest rate spread between loans and deposits discernible in recent years persisted during the 3rd quarter. However, as a result of shifts in the lending structure (e.g. increased demand for consumer loans in Armenian dram and reduced demand for foreign currency loans) the interest rate spread between loans and deposits in Armenian dram has not change much in relation to the previous quarter whereas the interest rate spread between loans and deposits in foreign currency has shrunk considerably to 3.7 pp in September from 5.2 pp in June.

The 3rd quarter saw credit growth rates slowing further as economic activity slowed down (which was outlined in the Q3, 2013 survey on terms of lending provided by Armenian banks and credit organizations). The volume of credit has increased by 2.2% (16.7% growth y/y) or AMD 39.7 billion in absolute terms against AMD 38.1 billion reported in the previous quarter. There were changes reported in the structure of currency of lending. In the structure of credit, the volume of dram loans has grown by 2.33% and foreign currency loans, by 0.77% (1.88%, if the impact of the change in exchange rate is excluded). The aforementioned developments are attributable to the contracted demand for business and mortgage loans, according to the Q3, 2013 survey on terms of lending provided by Armenian banks and credit organizations.

In Q3, 2013 real effective exchange rate posted high appreciation rates y/y

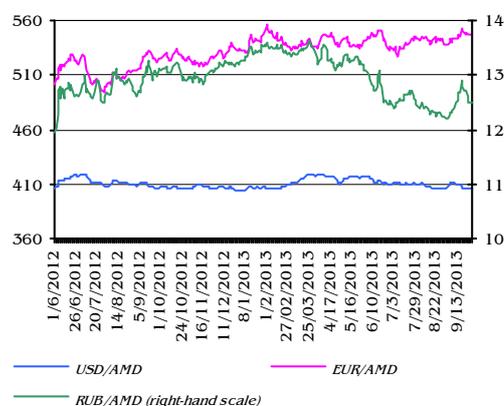


The real effective exchange rate posted high appreciation rates y/y during the 3rd quarter of 2013								
y/y growth, %	QI 12	QII 12	QIII 12	QIV 12	2012	QI 13	QII 13	QIII 13
Real effective exchange rate (+ means appreciation)	-3.8	-2.9	-5.1	-5.7	-4.4	-6.4	-1.6	8.7
Average inflation in Armenia	3.5	1.0	2.4	3.4	2.5	3.0	5.2	8.6
AMD/USD average nominal exchange rate (+ means appreciation)	-5.7	-6.8	-10.2	-6.3	-7.3	-5.1	-3.3	0.5
Average weighted inflation in trade partner countries	4.0	3.5	4.1	4.3	4.0	4.5	4.4	3.6
Partner countries' average weighted nominal exchange rate (+ means appreciation versus dollar)	-2.9	-6.9	-7.6	-1.7	-4.7	-0.4	-1.1	-3.3

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

The above developments denote that in the 3rd quarter of 2013 the dram's nominal exchange rate appreciated by 1.5% q/q, with the real exchange rate appreciation³² having amounted to 6.7% in relation to the 2nd quarter. As for the change in relation to the same period of the previous year, the real exchange rate has posted strong appreciation rates, making up 8.7% y/y, which was also driven by high y/y inflation in Armenia along with high y/y depreciation of the Iranian rial.

The dram's exchange rate dynamics to the US dollar, Euro and Russian ruble over one year



Box 5

Exchange rate

At the end of the 3rd quarter of 2013, 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 1.14% to 405.29 drams for one dollar.

Let's have a look at the table below to see the dram's behavior versus the U.S. dollar, Euro and Russian ruble:

Dram exchange rate dynamics, q/q, 2013			
Currency pair	Exchange rate as of 30.06.2013 (AMD)	Exchange rate as of 30.09.2013 (AMD)	%, (appreciation +, depreciation -)
USD/AMD	409.90	405.29	+1.14
EUR/AMD	535.25	546.82	-2.12
RUB/AMD	12.53	12.51	+0.16
Average dram exchange rate dynamics in Q2, 2013, y/y			
Currency pair	Average quarterly exchange rate in Q2, 2012	Average quarterly exchange rate in Q2, 2013	%, (appreciation +, depreciation -)
USD/AMD	410.66	408.65	+0.49
EUR/AMD	513.56	541.65	-5.19
RUB/AMD	12.85	12.47	+3.05

The aggregate volume of U.S. dollar/Armenian dram transactions in the foreign exchange market during the 3rd quarter amounted to USD 2.5 billion, which represents 8.7% increase in relation to the previous quarter (USD 2.3 billion).

The aggregate volume of Euro/Armenian dram exchange transactions reached EUR 252.4 million against EUR 225.8 million recorded in the previous quarter.

To tackle the dram exchange rate volatility against the U.S. dollar in the market in the 3rd quarter of 2013, the Central Bank bought dollar resources of USD 59.05 million.

³² The Q3, 2013 real exchange rate indicator is the Central Bank estimate.

3.4. Balance of payments³⁵

The 3rd quarter of 2013 saw the current account deficit narrowing further amidst a slight growth in the domestic economy and strong growth rates in private transfers. The third quarter was marked with the Government having allocated Eurobonds, which helped post net inflow through the capital and financial account. The balance of payments developments resulted in the increase of the Central Bank net foreign assets.

3.4.1. Current account

In the 3rd quarter of 2013, relative to the 3rd quarter of 2012, the Current Account Deficit/GDP ratio has reduced by an estimated 1.0 pp to (by USD 22.8 million) to USD 99.0 million, amidst sluggish global economy and slowly growing domestic economy.

Real export of goods remained strong in spite of weak external demand, and such increment was fuelled by positive developments in domestic processing industry. With export prices having reduced y/y, the dollar value of export of goods grew in the 3rd quarter by 6.5% y/y.

The y/y growth of dollar value of export in the 3rd quarter was mainly due to items “products of prepared food”, “livestock and products of animal origin” and “ore and minerals”, with their positive contribution of 5.9 pp, 2.5 pp and 1.6 pp, respectively. Item “non-precious metals and articles made thereof” has made some 5.6 pp of negative contribution.

Despite weak growth of the domestic economy the real volumes of import of goods posted an increase in the 3rd quarter of 2013 amidst an appreciating real effective exchange rate. The growth of dollar value of import fuelled by the y/y growth of dollar prices of import amounted to 9.3% y/y in the 3rd quarter of 2013.

The y/y growth of dollar value of import in the 3rd quarter of 2013 was mainly due to items “products of prepared food” and “precious and semiprecious stones, precious metals and articles made thereof”, with their positive contributions making up 2.6 pp and 4.3 pp, respectively.

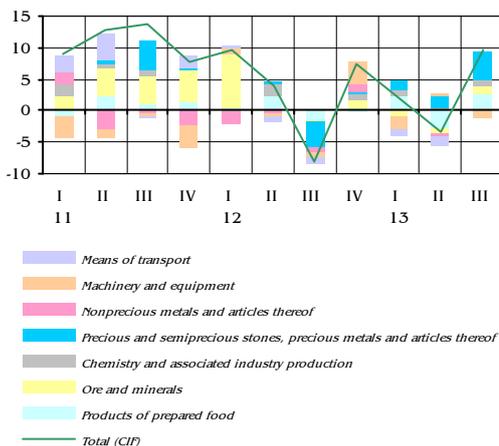
In the 3rd quarter of 2013 the deficit of trade balance grew by USD 54.0 million y/y and totaled USD 514.0 million as a result of developments of real volumes of export and import and deteriorated terms of trade.

The deficit of services balance has grown; in the 3rd quarter of 2013 it reached USD 81.8 million. The y/y growth of export and import of services in the 3rd quarter of 2013 was 6.4 and 6.5%, respectively.

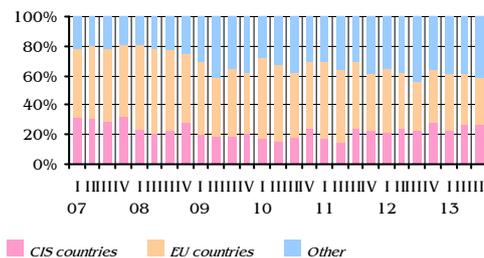
Export growth y/y and main commodity groups having contributed to it³⁴



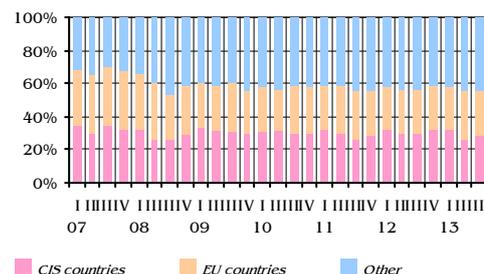
Import growth y/y and main commodity groups having contributed to it



Structure of export, by country group



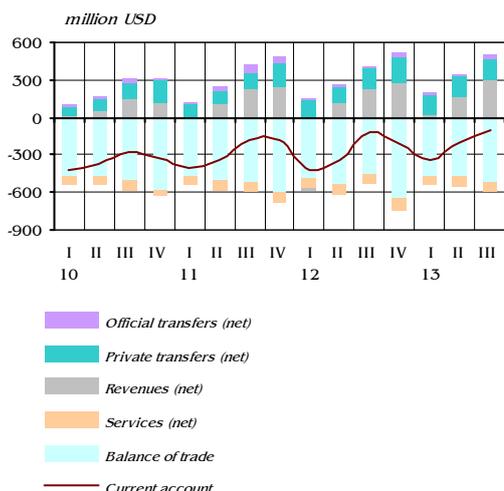
Structure of import, by country group



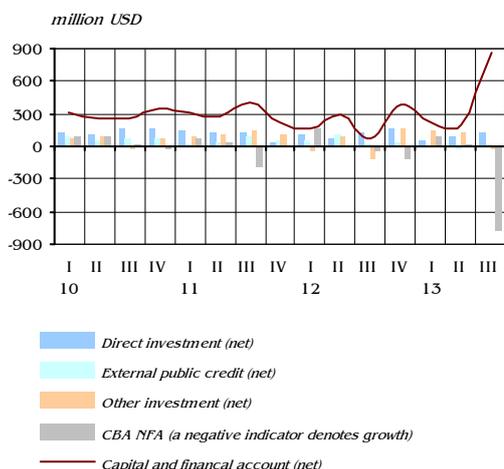
³⁵ The Q3, 2013 indicators are the Central Bank forecasts and estimates.

³⁴ There were adjustments made to Armenia's foreign trade information databanks of 2012 (by month) and for the period January-March 2013, the National Statistics Service of Armenia.

In Q3, 2013 current account deficit kept on decreasing

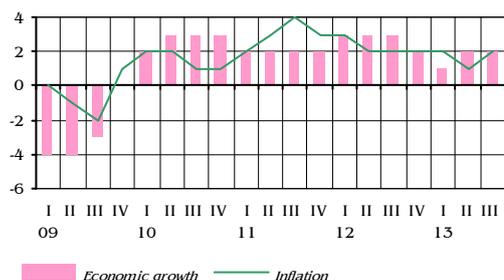


In Q3, 2013 the capital and financial account posted large volumes of net inflow of funds



In the 3rd quarter of 2013 economic recovery trends were observable in the main trade partners to Armenia.

In Q3, 2013 economic activity in USA accelerated to some extent



In the 3rd quarter of 2013 the y/y growth rates in remittances³⁵ of individuals remained as strong as were reported in the previous quarter. During the quarter net inflow of seasonal worker income has grown by 13.9% y/y and amounted to USD 404.9 million, which is way above the net outflow figure in item “income on investment”. As a result, item “income” posted net inflow of USD 289.3 million. In the 3rd quarter of 2013 net inflow of current transfers grew by 15.3% y/y and reached USD 176.5 million.

3.4.2. Capital and financial account³⁶

The third quarter was marked with the Government having allocated Eurobonds, which resulted in huge net inflow of funds in the amount of USD 862.8 million through the capital and financial account. The balance of payment developments in the 3rd quarter resulted in increment of NFA of the Central Bank by around USD 764.0 million³⁷.

The net inflow of capital transfers in 2013 amounted to USD 35.3 million compared to USD 31.3 million in the previous year.

In the 3rd quarter of 2013 the figure of net inflow of foreign direct investment was USD 133.3 million, much the same as in the 3rd quarter of the previous year. The placement of Eurobonds pushed the Government’s portfolio liabilities up by USD 689.7 million. Net inflow of public loans was USD 14.2 million against net inflow of USD 19.7 million recorded in the 3rd quarter of the previous year.

Net outflow through item “other investment” amounted to USD 9.6 million, with net foreign assets of commercial banks having reduced by USD 83.4 million. Net foreign assets of item “other private sector” have increased by USD 93.0 million.

3.5. External environment

In the 3rd quarter of 2013 economic recovery trends were observable in the main trade partners to Armenia.

According to preliminary estimates of the U.S. Department of Commerce Bureau of Economic Analyses, in the 3rd quarter of 2013 the annualized economic q/q growth in the **United States of America** was 2.8% (1.6% of y/y economic growth in the 3rd quarter) against the previous quarter’s 2.5% growth. All components contributed to the growth positively.

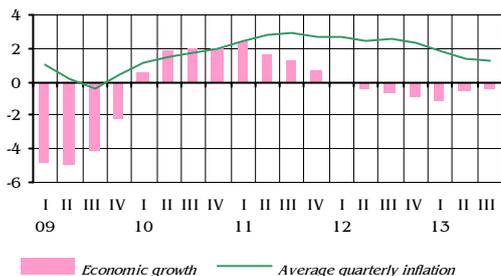
In the 3rd quarter average quarterly inflation was 1.6% y/y compared to 1.4% reported in the previous quarter.

³⁵ The 3rd quarter of 2013 reported a 10.6% y/y growth of net inflow of non-commercial remittances by individuals via the banking system.

³⁶ The Q3, 2013 capital and financial account figures are the Central Bank forecasts and estimates.

³⁷ Around USD 480.0 million worth of funds were repaid on the Russian Loan in early 4th quarter, and the NFA of the Central Bank will be decreasing that much in the 4th quarter.

In Q3, 2013 economic decline in Euro-area slowed down



In **Euro-area** in the 3rd quarter of 2013 there was 0.4% percent decline against the same period of the previous year, according to preliminary estimates provided by the Eurostat.

In the 3rd quarter of 2013 consumer price index in Euro-area grew an average 1.3% y/y against 1.4% recorded in the previous quarter

In the 3rd quarter of 2013, the European Central Bank left the policy rate unchanged (0.5%).

In the 3rd quarter of 2013 Euro appreciated versus the U.S. dollar by 1.3%, with the average dollar exchange rate making up 1.32 for one Euro (y/y appreciation of 5.9%).

In the 3rd quarter of 2013 economic growth in **Russia** reached 1.2% y/y, according to the preliminary estimates of the Russia State Statistics Service. Specifically, industry posted a zero growth compared to the previous quarter's 0.3%; growth rates in retail trade and agriculture were 3.8% y/y and 1.6% y/y, respectively. In the meantime, construction sector reported a zero growth against the 3.6% y/y decline reported in the previous quarter.

The rate of inflation during the quarter decelerated to some extent. The consumer price increase was 6.4% y/y compared to 7.2% rise in the 2nd quarter. In the 3rd quarter of 2013 the Russian Central Bank left the refinancing rate unchanged, at an 8.25% level, following the increase in September of 2012.

In the 3rd quarter of 2013 the **price of Brent crude** at Intercontinental Exchange grew by 7% against the previous quarter, reaching USD 110 a barrel (with 0.5% rise y/y).

The **price of copper** at the London Metal Exchange has fallen by 1.2% to USD 7105 per ton (with 8.1% decline y/y).

Export price of **hard red wheat** has dropped by 2.7% q/q to USD 8.3 a bushel (with 12.5% 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 has dropped by 2.6%, with an estimated 17% reduction against the 3rd quarter of the previous year.

The price of **rice** at the Chicago Board of Trade has risen by 0.1% to USD 15.6 per U.S. hundredweight (45.4 kg) (with 0.8% growth y/y).

The international oil price demonstrated some upward trends as the global demand recovered. Although certain inflationary trends were discernable in some food markets at the end of the 3rd quarter, food products followed primarily deflationary patterns.

The international oil price demonstrated some upward trends as the global demand recovered. Although certain inflationary trends were discernable in some food markets at the end of the 3rd quarter, food products followed chiefly deflationary patterns.

4. CONCLUSION

In the 3rd quarter of 2013 global demand in *external sector* remained sluggish and no considerable inflationary trends were observable in basic commodity and food markets. In the *forecast horizon* the global economic growth rates are expected to rebound slowly. On the back of a sluggish global demand, international prices of basic raw material and food products are going to perform relatively steady. In the *forecast horizon* therefore primarily a *steady low inflationary influence* will be expected from the external sector.

In the 3rd quarter of 2013 the developments in the domestic economy were characterized by slowing economic growth rates and an expanded inflationary environment. Based on the third quarter results, the *economic growth* is expected in the range *2.9-3.2% y/y*. In end-September of 2013 the *12-month inflation* reached 8.2% y/y. The high inflation was driven mostly by energy price increases as was outlined in the monetary policy program.

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 come closer to its equilibrium. Moreover, in 2014 an expansionary fiscal policy is expected to replace the contractionary fiscal policy of 2013. This would significantly contribute to the acceleration of economic growth and creation of some inflationary pressures. **In the forecast horizon, a weak inflationary impact** on domestic prices is anticipated from the Armenian economy as private demand rebounds and the Central Bank implements a neutral fiscal policy **in the medium run**.

In the **forecast horizon** inflation will stabilize around the target level of 4 percent. The inflation environment now high will be going to subdue in the 4th quarter, which will be driven by more-than-anticipated weakening of the domestic demand and influenced by the Central Bank action. The inflation will keep on subsiding over the first half of 2014 too, falling back to the target. Under such circumstance, the Central Bank will ease the monetary conditions in the 4th quarter of 2014, which will be adequate to the slowing of economic activity and moderated inflation environment. **The directions of the monetary policy to be implemented by the Central Bank will also depend on how the fiscal policy will progress.**

In the 4th quarter of 2013 the Central Bank will ease the monetary conditions adequate to the slowing of economic activity and moderated inflation environment. The directions of the monetary policy to be implemented by the Central Bank will also depend on how the fiscal policy will progress.

The risks that inflation would deviate from **the forecast value** are estimated as balanced in both short and medium-term perspectives. The main risks are associated with the pace at which the global economy would recover and the domestic demand would develop. If such risks materialize, the Central Bank will respond accordingly, making sure the inflation target is attained in the medium run.