THE CENTRAL BANK OF THE REPUBLIC OF ARMENIA

Approved under
the Central Bank Board
Resolution No. 107 A,
18/05/2010

STATUS REPORT ON IMPLEMENTATION OF THE MONETARY POLICY PROGRAM

(Inflation Report)

Q1, 2010

YEREVAN
2010

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1. SUMMARY

The main macroeconomic developments in the first quarter of 2010 have been attributable to inflationary pressures which were transmitted from the previous yearend and faster recovering world and domestic economies. Persisted high prices of food and non-food products in global markets due to positively developing world economy, expansionary impact coming from the previous year's implementation of monetary and fiscal policies as part of anti-crisis measures and depreciation episodes of the dram during the quarter driven by adverse expectations have all contributed to the persistence of inflationary environment.

Inflation in the first quarter was 2.9 percent whereas the 12-month inflation indicator has been 8.8 percent, increasing by 2.3 pp in relation to the previous year. Interestingly, the above-mentioned developments were not the only factors contributing to such a high level of inflation but also the low inflation recorded in the first quarter of 2009 which was not typical to that period of time. In the consumer basket, prices of food products have grown by 4.3 percent (with 2.3 pp contribution to inflation), prices of non-food products, by 1.1 percent (with 0.2 pp contribution to inflation), and service fees, by 1.3 percent (with 0.4 pp contribution to inflation). Overall, inflation has been determined by 9.2 percent rise in meat prices (with 0.9 pp contribution to headline inflation), 22.9 percent rise in prices in item "Vegetable and Potato" (with 1.1 pp contribution to headline inflation) and 2.9 percent rise in medical service fees (with 0.3 pp contribution to headline inflation).

The impact of inflationary pressures was also reflected in the behavior of core inflation. In the first quarter of 2010 core inflation was 2.1 percent[1] whereas the 12-month inflation indicator has grown by 1.9 pp in relation to the previous quarter's indicator to amount to nearly 7.1 percent.

Notwithstanding these developments, the rate of the 12-month inflation has slowed down considerably at the end of the quarter determined by both previous year's inflation developments and monetary conditions which the Central Bank of Armenia has been tightening since the beginning of the year as well as stabilization patterns which the foreign exchange market started to see in end-March.

The first quarter of 2010 saw some 5.5 percent y-o-y[2] economic growth against 6.1 percent y-o-y decline in the previous year. Economy posted growth thanks to improving macroeconomic environment as a result of recovering world economy as well as expansionary impact transmitted from fiscal and monetary policies implemented in the framework of anti-crisis measures. As such, economic revival has been a result of the growth recorded in all sectors of the economy.

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[1] *The core inflation calculation methodology developed by the Central Bank is detailed in the CBA Review (Q1, 2008), and core inflation indicators are regularly published in that paper.*
[2] *Y-o-y = year-on-year in relation to the same period of the previous year.*

Industry reported growth of value added nearly by 6.1 percent y-o-y; agriculture reported 3.1 percent growth y-o-y; construction reported 9.7 percent growth y-o-y; and services reported 5.1 percent y-o-y.

In the first quarter in labor market, nominal wages have grown to some extent. This was driven by the growth of wages in firms in the private sector and somewhat due to several budget-supported organizations. The growth rate of wages has, however, decelerated in comparison with the relevant indicator recorded over the previous quarters of the year. Average quarterly unemployment kept on increasing, still remaining unresponsive to the economic recovery, and, in the first quarter labor productivity has grown instead. As a result, these developments have not led to material changes in unit labor costs, and the labor market's impact on inflation has been neutral.

In the first quarter the domestic demand has grown due to increased expenditures in public and private sectors. The growth of domestic demand has been around 4 percent. Public expenditures have increased by about 18 percent in real terms, reflecting Government's goal for spending in more investment projects. In the atmosphere of recovering world and domestic economies, private spending, too, has grown by 2.5 percent. In the structure of private spending, private consumption has increased by nearly 3 percent while the rate of decline in private investments has considerably recovered in relation to the relevant indicator of the previous quarter to amount to around 4 percent.

In the first quarter the impact of private spending on inflation has been restrictive. According to Central Bank estimations, private sector expenditures in real terms have been some 2-3 percent below the natural level, thus creating some 0.6-0.9 percent deflationary pressures in consumer market.

In the first quarter of 2010, attributable to state budget's over-performance on the part of revenues and savings on expenditures[3], the impact of the fiscal sector on aggregate demand and inflation has been less expansionary (see details in the section *Aggregate Demand*) and amounted to 6.8 pp, according to the calculated fiscal impulse indicator. As such, the revenues impulse has been 3.2 percent expansionary and the expenditures impulse, 3.6 percent expansionary.

According to the Central Bank estimates, in the first quarter the combined impact of domestic demand and labor market on prices has been 1.1-1.4 percent inflationary.

In the first quarter, with global and domestic economies showing trends of faster recovery, improvement has been seen in respect of the export of goods, which exceeded anticipations. Increase in import, too, pointed to the earlier recovery of the domestic economy. At the same time,

[3] *Comparison with program levels of budget revenues and budget expenditures has been made by matching preliminary actual figures thereof with quarterly proportions (project implementation units, PIU, included) set by the Government.*

growth has been recorded with regard to transfers, reflecting positive development patterns with which the global economy is evolving. In the first quarter current account deficit has grown by USD 101.5 million y-o-y to USD 349.1 million, and its share in GDP constituted 23.6 percent.

At the beginning of the year monetary aggregates demonstrated patterns of quarterly reductions driven by the seasonal passiveness of the economy and, therefore, slowing demand for money, which is typical to the first quarter of the year, as well as implementation of monetary policy in line with projected directions. Dram broad money has reduced by 11.1 percent due to 12.4 percent reduction in currency in circulation and 8.8 percent reduction in dram deposits. Driven by still a high dollarization rate in the economy foreign currency deposits repeated the patterns demonstrated over the previous two quarters, having grown by 13 percent q-o-q[4]. Driven by the above-mentioned developments with broad money components, broad money has reduced by 0.3 percent q-o-q.

In the first quarter trends of active lending to the economy persisted under which circumstance the volumes of lending have increased by 5.9 percent q-o-q. However, unlike the previous quarter, foreign currency deposits have grown at a faster rate.

In the first quarter the banking sector saw excess liquidity reducing, as the Central Bank tightened monetary conditions. This has brought interest rates up in secondary markets of repo operations and government securities.

The aforementioned developments have steered the fulfillment of the inflation target and the monetary policy directions during the quarter. On the whole, with faster recovering economy and persisting inflationary environment, the Central Bank moved to a policy of gradual tightening of monetary conditions by refocusing on price stability. During the quarter refinancing rate has been lifted a total of one-and-half pp (0.5 pp each month), with the goal to create real positive interest rates and downscale inflation deviations from the target in a forecast time horizon, in line with inflation developments. Also, trends with base money and liquidity management issues have remained at the Central Bank’s focus. Consistent with projected directions, in implementation of the monetary policy, the 12-month inflation rate has been tending down since March.

[4] *Q-o-q = quarter-on-quarter in relation to the same period of the previous year.*

2. INFLATION DEVELOPMENTS

2.1. INFLATION BY GOODS AND SERVICES; CORE INFLATION

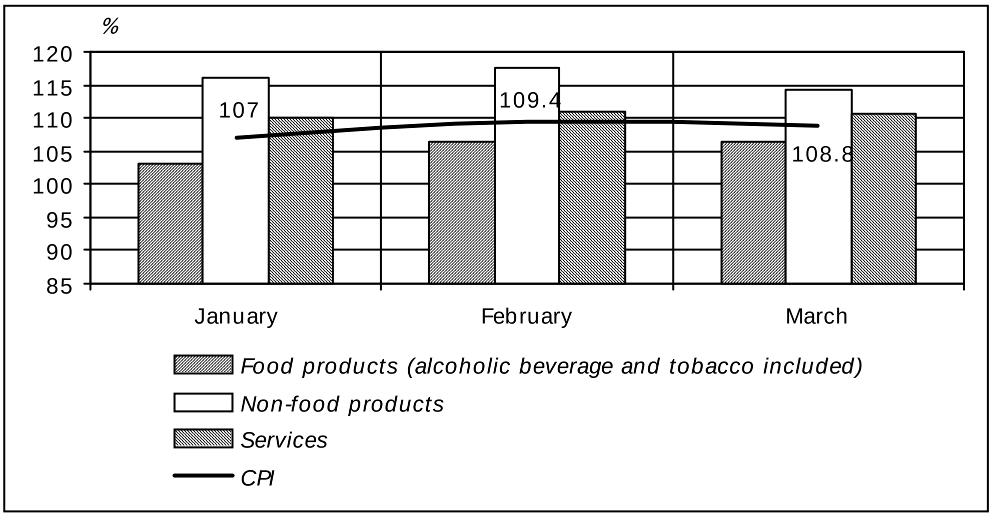
In March of 2010 inflation was 8.8 percent against March of 2009. Prices have increased as follows: food products (alcohol and tobacco included) – 6.3 percent; non-food products – 14.3 percent; and service tariffs – 10.6 percent, all having contributed to inflation by 3.4, 2.31 and 3.17 pp, respectively.

Price increase of food products (alcohol and tobacco included) by 6.3 percent was mainly due to price increases in the following items: "Meat products" (14.1 percent), "Vegetable and potato" (11.7 percent), "Sugar" (28.4 percent)", "Fruit" (12.0 percent), "Fish" (47.0 percent) and "Fats and Oils" (5.8 percent), all having contributed to inflation by 1.3, 0.6, 0.4, 0.3, 0.2 and 0.2 pp, respectively. Whereas in item "Egg" price decrease of 8.6 percent has eased the inflation indicator by 0.2 pp.

Price increase of non-food products by 14.3 percent was mainly due to price increases in the following items: "Personal usage cars and petrol" (30.5 percent), "Medicament" (20.7 percent), "Garment and knitwear" (10.6 percent), "Footwear" (9.9 percent), "Detergents" (12.4 percent), and "Beauty items" (12.3 percent), all having contributed to inflation by 1.0, 0.3, 0.3, 0.2 and 0.2 pp, respectively.

Price increase of 10.6 percent in the group "Services" was due to increased tariffs in the following items: "Household utility services" (18.9 percent), "Medical services" (8.5 percent), "Transport" (10.4 percent), "Education system services" (7.4 percent), and "Other household services" (23.7 percent), all having contributed to inflation of the group by 1.4, 0.8, 0.4, 0.3 and 0.2 pp, respectively.

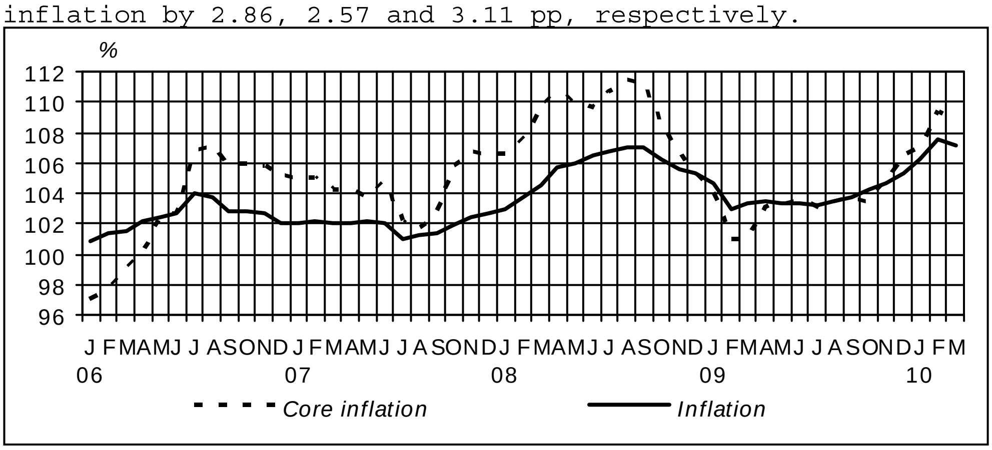
The 12-month CPI in Q1 2010 by the main items of goods and services



In the first quarter of 2010 inflation was 2.9 percent against December of 2009 and versus 0.7 percent inflation recorded in the first quarter of the previous year and 4.8 percent inflation recorded in the same period of 2008. Prices of food products have increased by 4.3 percent, non-food products, by 1.1 percent and service fees, by 1.3 percent, all having contributed to inflation by 2.3, 0.2 and 0.4 pp, respectively.

Inflation in the first quarter of 2010 was 8.4 percent against the same period of the previous year; in 2009 and 2008, these indicators were 2.0 percent and 7.9 percent, respectively. Inflation of 8.4 percent has been determined by 5.3 percent increase in prices of food products; 15.9 percent increase in prices of non-food products, and 10.4 percent rise in service fees, all of which have contributed to inflation by 2.86, 2.57 and 3.11 pp, respectively.

Inflation and core inflation, 2006-2010 (to the same month of previous year, %)



Core inflation in March of 2010, versus the previous year's March, was 7.14 percent. Price increases on food products made 2.4 pp contribution; non-food products, 2.5 pp contribution; and service tariffs, 2.2 pp contribution to core inflation. Prominent were contributions to core inflation by the following items: "Petrol" (137.6 percent, with 1.2 pp contribution), "Beef" (123.7 percent, with 1.1 pp contribution), "Air fare" (127.7 percent, with 0.5 pp contribution), "Surgical services at hospitals" (106.8 percent, with 0.4 pp contribution), "Sugar" (118.9 percent, with 0.3 pp contribution), "Whitefish fresh" (154.9 percent, with 0.3 pp contribution), "Higher education services - tuition fee for baccalaureate" (108.1 percent, with 0.2 pp contribution), and "Health and resort centers with lodgment, treatment and service facilities" (116.9 percent, with 0.2 pp contribution).

The table below shows [the difference of] indicators of 8.8 percent inflation and 7.1 percent core inflation, as recorded in March of 2010 in relation to March of 2009.

Contribution to inflation	**10 items most contributed to inflation in March 2010 in relation to March 2009**	**Contribution to core inflation**	**10 items most contributed to core inflation in March 2010 in relation to March 2009**
1.13	services to households on sales of electricity		
0.98	petrol	1.20	petrol
0.88	beef	1.08	beef
0.39	air fare	0.47	air fare
0.29	surgical services at hospitals	0.36	surgical services at hospitals
0.41	sugar	0.33	sugar

0.21	whitefish fresh	0.26	whitefish fresh
0.20	higher education services - tuition fee for baccalaureate	0.25	higher education services - tuition fee for baccalaureate
0.29	onion		
0.26	haricot bean		
		0.18	health and resort centers services
		0.18	vitamin C
		0.14	household appliance hire services

According to a current core inflation calculation methodology, which is commonly known as a 'Seasonal exclude and external shock adjustment' method, item *changed tariffs of services to households on sales of electricity* from administered services and item *increased prices of onion and haricot bean* from seasonal products have been excluded from the list of 10 items, chosen to have most contributed to inflation, and therefore excluded from the calculation of core inflation, as well as item *changed prices of sugar* has been adjusted. Dissimilar contributions of the same items as shown in the table (an example is *petrol* having made 0.98 pp contribution to inflation but 1.20 pp contribution to core inflation) are explained by different baskets which serve a basis for calculation of inflation and core inflation (the core inflation basket constitutes 81.4 percent of the consumer price basket).

Statistical review of inflation fluctuations

In order to review the changes in Consumer Price Index and in price indexes of individual items included in consumer basket, as well as to discover the factors determining their fluctuations, the influence of three components (trend, seasonal and irregular components) used in Statistics theory has been identified and assessed for the time period from April of 2007 to March of 2010*.

Calculations show that in the period from April of 2007 to March of 2010 the influence of seasonal component on CPI has been 74.3 percent; the influence of irregular component, 25.6 percent; and the influence of trend component, a mere 0.2 percent. In comparison with the period from April of 2006 to March of 2009, the influence of seasonal component and trend component on CPI has increased by 5.6 pp and 0.2 pp, respectively, while the influence of irregular component has reduced by 5.8 pp.

Share of components causing fluctuations in monthly price indexes (April of 2007 to March of 2010) (%)

Item	Trend component	Seasonal component	Irregular component	Total
CPI	0.2	74.3	25.6	100.0
1. Bread products	15.6	28.2	56.2	100.0
2. Meat products	11.1	16.8	72.1	100.0
3. Fish products	0.1	39.3	60.6	100.0
4. Dairy products and oils	5.0	46.7	48.3	100.0

5. Fruit and vegetable	1.3	90.6	8.1	100.0
6. Other food products	6.9	63.6	29.4	100.0
7. Non-alcoholic beverage	5.8	24.2	70.0	100.0
8. Alcoholic beverage and tobacco	7.2	36.0	56.8	100.0
9. Garment and footwear	6.8	43.7	49.5	100.0
10. Rent, electricity, and fuel	3.8	33.5	62.7	100.0
11. Home appliances	7.9	17.7	74.4	100.0
12. Health services and medication	1.1	39.1	59.9	100.0
13. Transport and communications	0.6	44.1	55.3	100.0
14. Leisure and items of cultural products and services	0.9	86.0	13.1	100.0
15. Other goods and services	1.7	30.9	67.4	100.0

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

The influence of the three components has changed as follows:

- the seasonality component had stronger impact on such items as "Fruit and vegetable" (90.6 percent), "Leisure and items of cultural products and services" (86.0 percent), "Other food products" (63.6 percent), "Dairy products and oils" (46.7 percent), "Transport and communications" (44.1 percent), "Garment and footwear" (43.7 percent), and "Fish products" (39.3 percent);
- the irregular component had stronger impact on such items as "Home appliances" (74.4 percent), "Meat products" (72.1 percent), "Non-alcoholic beverage" (70.0 percent), "Other goods and services" (67.4 percent) "Rent, electricity, and fuel" (62.7 percent), "Fish products" (60.6 percent), and "Health services and medication" (59.9 percent);
- the trend component had stronger impact on such items as "Bread products" (15.6 percent), "Meat products" (11.1 percent), "Home appliances" (7.9 percent), "Alcoholic beverage and tobacco" (7.2 percent), "Other food products" (6.9 percent), "Garment and footwear" (6.8 percent), and "Non-alcoholic beverage" (5.8 percent).

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

Monthly price index variation coefficients, 2008, 2009 and Q1, 2010 (%)

Item	2008	2009	2010
CPI	0.7	1.8	0.7
1. Bread products	3.7	2.7	0.2
2. Meat products	0.4	1.0	1.4
3. Fish products	14.9	12.1	3.9
4. Dairy products and oils	1.9	3.1	0.5
5. Fruit and vegetable	13.6	16.4	11.6
6. Other food products	1.4	1.7	0.8
7. Non-alcoholic beverage	0.4	0.2	1.1
8. Alcoholic beverage and tobacco	0.2	0.4	0.1
9. Garment and footwear	0.1	0.9	0.8
10. Rent, electricity, and fuel	0.0	0.2	0.1
11. Home appliances	0.2	1.4	1.0
12. Health services and medication	2.8	1.2	0.7
13. Transport and communications	0.1	1.9	0.5
14. Leisure and items of cultural products and services	0.1	0.1	0.5
15. Other goods and services	1.9	0.3	0.5

Items "Fish products" and "Fruit and vegetable" in which volatility has been the strongest have reported lesser variances in the first quarter of 2010, down to 3.9 percent and 11.6 percent, respectively.

2.2. FULFILLMENT OF INFLATION TARGET

According to the results of the first quarter of 2010, the 12-month inflation has been 8.8 percent, some 3.3 pp above the upper border of the target. Such a high level of inflation has been a result of baseline effect driven by much lower inflation recorded in the first quarter of the previous year, on the one hand, and domestic high inflation fuelled by more-than-expected growth of international prices of raw materials and certain food products and impact of lagged transmission of expansionary fiscal and monetary policies since the mid of the previous year, on the other hand.

The inflationary environment and monetary policy directions in the preceding 12-month period have been characterized by the following developments: notwithstanding low inflation in domestic economy (merely 1.0 percent y-o-y in end-March of 2009) influenced by worsened global economic crisis and deflationary environment created in international markets, the quarterly monetary policy programs in 2009 provided for quite high forecasts of inflation for the first quarter of 2010 These, save for baseline effect, included such inflation effects as sharp depreciation of the dram in early March, increased public utility service fees from April 1 and the expected impact of expansionary fiscal policy during the year. In this context, however, forecasts made in the first half of 2009 were suggesting that the 12-month inflation of the first quarter of 2010 would not outstrip the upper border of the target, making up 5.2 percent (see Appendix 1).

In reality, starting from April up to the end of 2009, in the times of worsened global economic crisis and steep downfall of domestic demand the impact of the above-mentioned inflation factors has been moderate. This allowed the Central Bank implementing more expansionary monetary policy aimed at stimulating economic activity while maintaining price stability. The Central Bank lowered the refinancing rate during the second and third quarters from 7.75 percent in end-March to 5.0 percent in end-September. In the meantime, the Central Bank carried out a policy of quantitative easing, involving long-term repo transactions, active participation in secondary markets of government securities and pouring huge amounts of dram resources into the banking sector through credit programs under a coordinated policy action with the Government. In the outcome, determined by continued import price adjustments as well as direct and indirect impact of increased public utility service fees, inflation has somewhat intensified in the period starting from the second quarter up until December, amounting to 3.6 percent y-o-y in end-June, 3.7 percent in end-September and 4.6 percent in end-November. The December’s 2 percent inflation primarily contributed by seasonal price increases on several agricultural products (a total of 1.4 pp contribution) pushed end-year inflation to exceed the upper border of the target, making up 6.5 percent.

In the fourth quarter of 2009 there was somewhat a different picture: with external and domestic economies demonstrating patterns of stability and activation, inflationary risks started to emerge in international markets. This brought in a necessity to revise inflation forecasts for the 12-month time horizon. Considering the 12-month inflation developments in the previous period as well as in expectation of external and domestic inflationary pressures, in the fourth quarter of 2009 the Central Bank adjusted Q1 2010 inflation upside, projecting a 6.5 percent level (see Appendix 1). In such a situation the Central Bank left the refinancing rate unchanged, at 5.0 percent, while remaining committed to a policy of quantitative easing in order to stimulate economic activity and maintain price stability.

Most recent forecast for the first quarter of 2010 included the impact of intensifying inflationary pressures driven by faster-than-anticipated price increases on raw materials and basic foodstuff in international markets as well as baseline effect of considerably low inflation recorded in the first quarter of the previous year – what they arrived in was a forecast as high as 8.6 percent y-o-y (see Appendix 1). Therefore, the Central Bank had its monetary policy re-steered by tightening monetary conditions in order to eliminate high inflation potential, which was observable back in end-2009 and which is persisting in 2010, and to bring inflation back to the target. To this effect, the Central Bank has raised the refinancing rate by a total of 1.5 pp during the first quarter of 2010 while abruptly restricting the policy of quantitative easing.

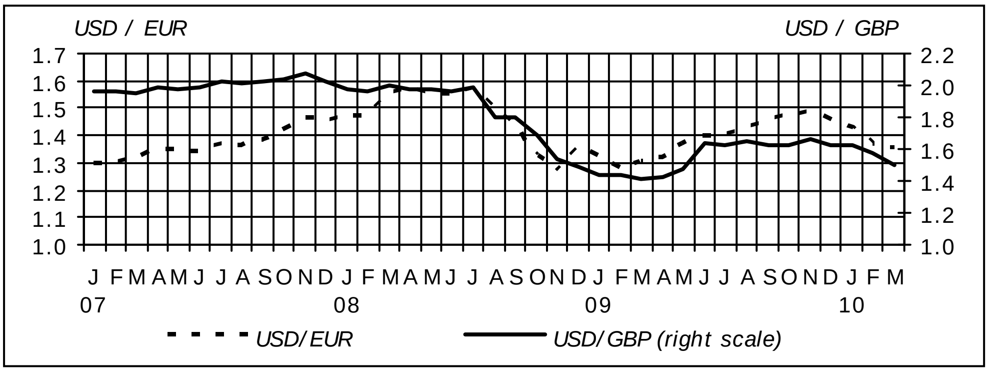
3. INFLATION FACTORS

3.1. EXTERNAL ENVIRONMENT

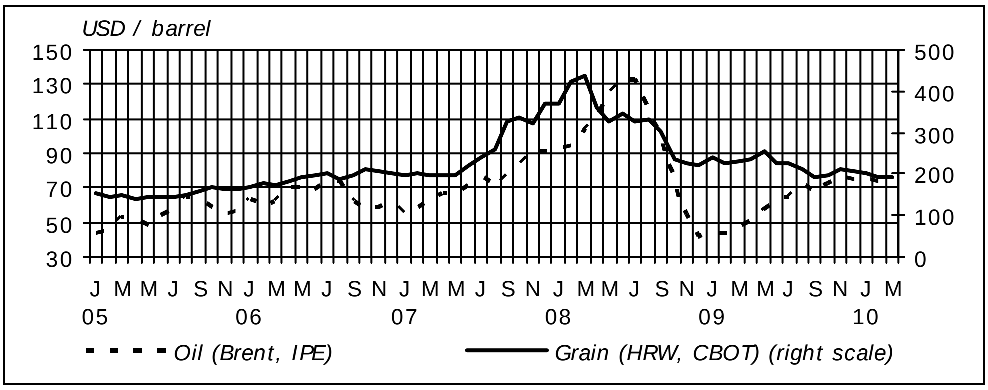
In the first quarter of 2010 trends of recovery of the world economy have become evident, which explains international institutions' approach in revising global economic growth outlook. According to new forecasts by the IMF, in 2010 the world economy will recover at faster rates, to reach 4.25 percent, which is some 0.35 percent more than the previous forecast.. Though, given the stabilization trends, the US Federal Reserve System has somewhat altered its tools for bank lending, industrialized countries continued implementing expansionary fiscal and monetary policies owing to high unemployment in the USA and Euro-zone, having in mind financial stability. Also, the first quarter of 2010 was momentous by aggravation in structural disproportions of economic development in Euro-zone (e.g. debt issues harassing Greece) which may put the EU economic recovery at risk in future.

In the first quarter prices in global commodity markets persisted mostly at levels that were seen in the end of the previous year. Because of fears among financial market participants about future service of the Greek debt Euro depreciated versus the US dollar in the first quarter by about 6.3 percent, with an average exchange rate of 1.38 dollar for euro (euro appreciation has been 6.6 percent y-o-y).

US dollar depreciation versus euro in the first quarter



In commodities markets in the first quarter, prices have stabilized



In the first quarter of 2010 oil prices have grown by 2.2 percent q-o-q, with 'Brent' reaching an average USD 77 a barrel (with 70.4 percent growth y-o-y). The prices of industrial metals have grown, too. In particular, copper prices have increased by around 9 percent compared with the previous quarter to amount to USD 7250 per ton on average. There has been over twice as much increase y-o-y.

In the first quarter grain prices tended to fall by an average 15.6 percent y-o-y, fluctuating in the corridor of USD 5.2 - 5.5 a bushel, dropping by about 5 percent q-o-q. As estimated by the US Department of Agriculture, in the 2009/2010 marketing year some 678 million tons of crops of grain are expected in comparison with the previous year's 683 million tons. Since the expected volume of the crops in 2010 will again exceed the estimated consumption, the world stocks of grain will slightly increase this year, too, reaching 196.8 million tons. The most impressive increase is expected in Kazakhstan, from 12.6 million tons to 17.0 million tons, while the most declines are expected in Ukraine, from 26 million tons to 20.9 million tons and in Russia, from 63.7 million tons to 61.7 million tons.

Continued growth of sugar prices observable since the end-2008 has been interrupted with about 5.2 percent decline in the first quarter of 2010, making the average price to amount to USD 25.6 cent/pound, which represented as much as 87.8 percent increase in relation to the average indicator recorded in the same period of the previous year.

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

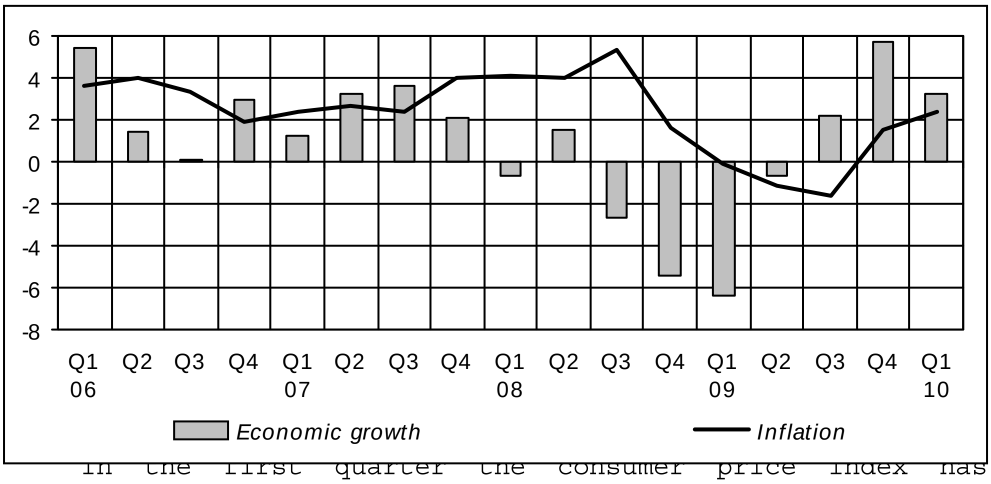
In the first quarter of 2010 trends of recovery, which the US economy started to see from the middle of the previous year, continued. Preliminary estimates suggest that in the first quarter the economy of **United States of America** posted an annualized 3.2 percent growth q-o-q against 5.6 percent growth recorded in the previous quarter. The main contribution to the growth has come from increased consumer expenditures (with 2.6 pp contribution) and private investments (with 1.7 pp contribution), while contributions from net exports and public sector have been -0.61 pp and -0.37 pp, respectively.

In the first quarter the deficit of net exports in GDP has increased to 3.5 percent in relation to 2.7 recorded for the same period of the previous year, which was driven mostly by faster growing imports over exports in terms of value, whereas in that period of time growth rates of exports in real terms have considerably exceeded those of imports.

In the first quarter some 2.4 percent y-o-y inflation was recorded in the US (1.5 percent in the previous quarter). This has been attributable to fast growing prices of food products and fuel. In the first quarter when trends of stabilization of the economy were more evident, the US Federal Reserve System introduced some changes to its instruments of bank lending by lifting prime lending rate by 0.25 pp up to 0.75 percent. Nonetheless for now, the Fed keeps the target rate within the corridor of 0-0.25 percent.

According to the EuroStat data in the fourth quarter of 2009 no economic growth has been posted in **Euro-zone** in relation to the previous quarter – economic decline has been 2.2 percent y-o-y (0.4 percent and -4.1 percent q-o-q and y-o-y, respectively, in the previous quarter).

In the first quarter the level of prices in USA increased



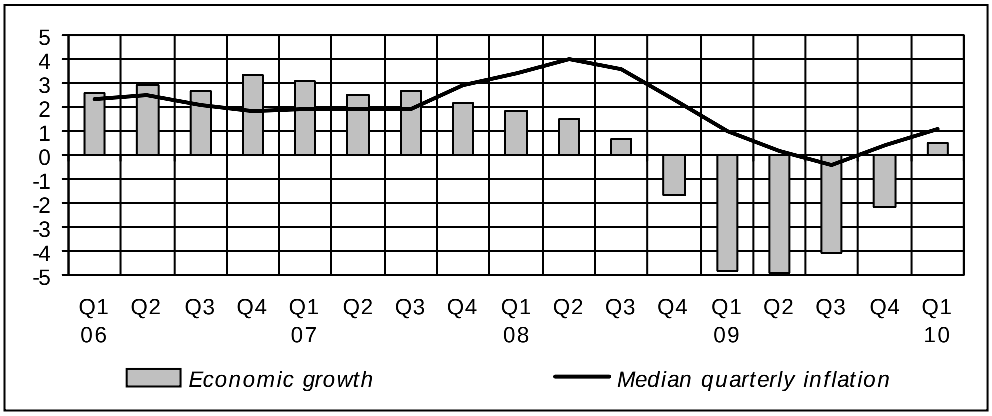
In the first quarter the consumer price index has increased by 1.1 percent y-o-y against 0.4 percent inflation recorded in the previous quarter. During the quarter the European Central Bank kept interest rates at the same, 1.0 percent, whilst maintaining a policy of quantitative easing.

Trends of recovery of the economy in **Russia** persisted in the first quarter as GDP reported 2.9 percent growth y-o-y, according to preliminary estimations by Federal Service of State Statistics. However, talking of stability of the economy is early in spite of the signs of revival, since investment and consumer demand is not signaling patterns of stability yet.

Growth in industry in the first quarter reached 5.8 percent against 14.3 percent decline recorded for the same period of the previous year. Retail trade sector posted 1.3 percent growth y-o-y, whereas construction reported 8.1 percent decline y-o-y.

In view of the said developments as well as faster recovery rates of world output, the IMF revised Russia's growth indicator for 2010 upside to have reached an estimated 4 percent which is 0.4 pp above the previous projections. Nonetheless, the latter incurs, by and large, the base effect and the turnover of investment cycle, while domestic demand will still remain weak.

In Euro-zone inflation persisted



In the first quarter, with faster recovering global economy and persisting high prices of oil in international markets, the economy posted marked growth of current account surplus amidst net outflow of capital and financial assets. Current account surplus has increased by USD 24.2 billion to USD 33.9 billion. Net outflow of funds via the capital and financial account reached USD 5.4 billion against net outflow of USD 32.6 billion recorded in the same quarter of the previous year. Banking sector reported net inflow of funds but other private sector reported net outflow of funds. With these balance of payments flows, in the first quarter foreign currency reserves of the Central Bank of Russia have increased by USD 16.6 billion and amounted to USD 447 billion as of April 1, 2010.

With the balance of payments surplus, the nominal exchange rate of Russian ruble vs. US dollar remained almost at the same level in relation to the average indicator recorded in the fourth quarter of 2009 and made up 29.9 ruble for one US dollar. The average nominal exchange rate of Russian ruble vs. US dollar has appreciated by 12 percent in relation to the average indicator of the first quarter of the previous year. In the foreign exchange market in the first quarter the Russian Central Bank has acted as net buyer.

Favorable developments with consumer price index continued during the first quarter as some 7.2 percent y-o-y inflation was recorded in comparison with the previous quarter's 11.5 percent. However, the Central Bank of Russia does not rule out CPI growth in the second half of 2010 albeit that may be somewhat determined by base effect.

Declining rates of inflation created those main conditions under which Bank of Russia has two times lowered the refinancing rate during the quarter, having set it at the level of 8.25 percent as of March 29, 2010. The Bank further lowered the refinancing rate on April 30 by 0.25 pp. This move was aimed at increasing accessibility to credit resources and stimulating demand.

However for the first time in the course of the last six months, the Central Bank of Russia had announced about the nearing of the phase of interest rate cuts, and tightening of monetary conditions may soon happen.

Macroeconomic Situation in Neighboring Countries [5]

Turkey: *first time in the fourth quarter of 2009 after economic downfall in the preceding four quarters in a row, the Turkish economy recorded some 6 percent real GDP growth y-o-y,*

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

although the latter incurs, in part, base effect of the previous fourth quarter's decline. Trends of economic recovery, however, are becoming evident. Based on the 2009 results, the GDP decline has been 4.7 percent. On the demand side, private consumption (with 3.3 pp positive contribution) and public expenditures (with 2.3 pp positive contribution) remain the central drivers of the economic growth. Overall, domestic demand and stocks have positively contributed to the growth by 4.5 pp and 2.5 pp, respectively, in contrast to net external demand's 1 pp negative contribution.

The highest growth has been in processing industry and wholesale and retail trade sub-sectors which reported, respectively, 12.8 percent and 10.3 percent growth y-o-y, whereas construction sub-sector reported 6.6 percent decline y-o-y.

In the period January-February 2010, current account deficit has increased substantially to amount to USD 5.57 billion in comparison with USD 801 million recorded for the same period of the previous year. This has been largely attributable to the deteriorated balance of trade deficit. In the period January-February export of goods has reduced by 0.7 percent to amount to USD 17.2 billion whereas import has increased by 27.1 percent and amounted to USD 22.1 billion. The increase of import was determined by added imports with regard to nearly all sub-items, which is signaling revitalization of consumption and investments. In the period January-February capital and financial account posted some USD 2.2 billion-worth net inflow versus the previous year's USD 2.05 billion-worth net outflow.

In the period January-February net inflow of foreign direct investment has been USD 652 million, which represented 55.8 percent shrinkage. Some USD 214 million-worth net outflow was posted with regard to portfolio investment against net outflow of USD 2.7 billion recorded in January-February of the previous year. Item 'Other investment' posted net inflow of USD 1.76 billion; banking sector's net foreign assets have reduced by USD 2.6 billion in comparison with USD 1.19 billion growth of net foreign assets of other private sector (excluding banks).

As a result of these flows, official reserves of the Central Bank of Turkey have reduced by USD 973 million (item 'Errors and omissions' posted net inflow of USD 2.4 billion).

In the first quarter the Turkish lira depreciated versus the US dollar, with an average nominal exchange rate of lira having depreciated by 13 percent in relation to the average indicator of the previous quarter, whereas average appreciation has been 9.0 percent against the first quarter of the previous year.

Price growth which started accelerating since the fourth quarter of the previous year persisted during the first quarter of 2010 when some 9.3 percent y-o-y inflation was recorded against the previous quarter's 5.7 percent. The main cause for price growth has been attributable to tax increases on some goods as well as high growth of prices of unprocessed food. Such price behavior affected [although temporarily] expectations contrariwise. So, considering the above developments, the Central Bank of Turkey decided on implementing a more cautious policy. At the same time, in consideration of normalization in money and credit markets, the Monetary Committee decided to gradually withdraw from liquidity injecting measures, a policy which was exercised during the crisis times. Therefore, during the quarter the Central Bank left the policy rate unchanged, at 6.5 percent.

Azerbaijan: *economy of this country maintained real GDP growth rates in 2010, too, thanks to extraction of oil, natural gas and other carbohydrate resources. The GDP growth has been 5.4 percent,* *of which 4.3 percent in the non-oil sector*[6]*. The nominal GDP has grown by 41.5 percent in relation to the same period of the previous year and the GDP deflator amounted to +34.3 percent against -28.5 percent in the same period of the previous year. Industry's contribution to the GDP growth has been 59.5 percent; agriculture – 1.8 percent; construction – 6.8 percent; transport and communications – 8.6 percent; wholesale and retail trade – 6.7 percent; social services – 10.4 percent; and net taxes on manufacture and imports – 6.2 percent*[7]*.*

In Azerbaijan in the period January-March of 2010, inflation has been 2.9 percent against December of the previous year and 3.8 percent against the period January-March of the previous year. Average annual inflation has been determined by price decreases on food products, by 2.5 percent, whereas inflation on non-food products and services has been 1.6 percent and 8.5 percent, respectively[8]*. In the period mentioned, household incomes have increased in relation to the same period of the previous year by 6.5 percent, as well as average monthly wages have grown by 4.1 percent to make up USD 380 (Manat 304.0)*[9]*.*

In the first quarter the trade balance has been running with surplus, amounting to about USD 3.3 billion. Exports have increased in relation to the same period of the previous year by 81.7 percent and totaled USD 4.5 billion whereas imports have decreased by 12.6 percent to USD 1.2 billion[10]*. Crude oil accounted for 84.6 percent of value of Azerbaijani exports in the period January-March of 2010*[11]*.*

In January-March of 2010 inflow of foreign direct investment has increased considerably, nearly by 67.4 percent, in relation to the same period of the previous year. Inflow of FDI amounted to around USD 406 million in which leaders are Great Britain (50.1 percent), USA (18.0 percent), Japan (9.4 percent), Norway (5.9 percent), Turkey (4.7 percent), Korea (2.0 percent), Russia (0.5 percent) and Saudi Arabia (0.4 percent)[12]*.*

In 2010 too, the Central Bank of Azerbaijan implemented a policy to maintain stability of manat exchange rate. As a result, in the period January-March manat has depreciated vis-à-vis US dollar by a mere 0.04 percent, while the January-March average exchange rate appreciation has been 0.21 percent y-o-y[13]*.*

Relative to the end of December of 2009, economy lending has grown merely by 0.9 percent, yet non-performing loans have increased at the same time by 17.4 percent[14]*. Foreign currency deposits have increased notably – this is when total volume of bank deposits has grown by 1.6 percent in which growth of foreign currency deposits has been 8.3 percent. The share of foreign currency deposits in total has grown and amounted to USD 57.1 percent, as of end-March, 2010*[15]*.*

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[6] *Source: Azerbaijan Central Bank Statistics Bulletin, January-March, 2010, Table 1.1.*

[7] *Source: http://abc.az/rus/news/44219.html.*

[8] *Source: Azerbaijan Statistics Committee, http://www.azstat.org/sdds/en/P_I/I_C_P.shtml, http://www.cbar.az/assets/93/1_2_eng.pdf.*

[9] *Source: Azerbaijan Central Bank Statistics Bulletin, January-March, 2010, Table 1.1.*

[10] *Source: http://abc.az/rus/news/44269.html.*

[11] *Source: http://abc.az/rus/news/44318.html.*

[12] *Source: http://abc.az/rus/news/main/44405.html.*

[13] *Source: http://www.cbar.az/other/azn-rates?act=betweenForm&from%5Bday%5D=1&from%5Bmonth%5D=1&from%5Byear%5D=2010&to%5Bday%5D=31&to%5Bmonth%5D=3&to%5Byear%5D=2010&rateID=usd.*

[14] *Source: Azerbaijan Central Bank Statistics Bulletin, January-March, 2010, Table 2.8.*

[15] *Source: Azerbaijan Central Bank Statistics Bulletin, January-March, 2010, Table 2.4.*

In the period January-March of 2010 foreign exchange reserves of the Central Bank of Azerbaijan have increased by 6.7 percent to amount to USD 5.51 billion, as of March 31, 2010[16]*.*

Georgia: *since the second quarter of 2008, the country had been posting economic decline. In 2009 the economic decline has been 3.9 percent*[17]*. During that period, in the GDP structure the largest growth has been reported for public administration (13.7 percent), trade sector (12.4 percent), agriculture (8.3 percent), processing industry (7.3 percent), and transport (6.6 percent)*[18]*.*

In the period January-March of 2010 average inflation in Georgia has been 4.7 percent in relation to the same period of the previous year, and 2.4 percent in relation to December of the previous year. Moreover, compared to the previous December, some 2.8 percent deflation was reported for semi-durable goods but inflation was reported for durable and non-durable goods and services, by 3.6 percent, 2.0 percent and 0.5 percent, respectively[19]*. For the period 2010-2012 the National Bank of Georgia set a 6 percent inflation target.*

As a result of export-import transactions carried out in the period January-March of 2010 Georgia's trade balance deficit has improved by 8.8 percent in relation to the same period of the previous year and amounted to USD 680.6 million. The improvement was determined by as much as 55.0 percent increase of exports (FOB) and just 5.7 percent increase of imports (CIF) in relation to the previous year[20]*.*

There have been substantial decreases reported for inflow of foreign direct investment and inflow of gross portfolio investment. The inflow of FDI to Georgia in 2009 amounted to USD 763.7 million (representing more than 2.0-fold decrease y-o-y) and the inflow of gross portfolio investment amounted to USD 6.2 million (representing more than 100-fold decrease y-o-y)[21]*. Unlike direct and portfolio investment inflows, there has been about 22 percent growth reported for the inflow of money transfers from abroad in relation to January-March of 2009: in the first quarter of 2010 this indicator was USD 199.5 million*[22]*.*

With foreign currency inflow narrowing, in the period January-March of 2010 the average exchange rate of lari has depreciated vis-à-vis the US dollar by 2.9 percent y-o-y. Relative to the end-December of 2009, depreciation of lari has been 3.6 percent[23]*. Furthermore, the National Bank's intervention in domestic foreign exchange market has only been in the form of net sales of foreign currency: in the first quarter of 2010 there have been sales of USD 124.2 million in comparison with sales of USD 141.6 million in the first quarter of 2009*[24]*.*

In the first quarter the volumes of bank lending kept on narrowing: loans in national currency have reduced by 8.9 percent

[16] *Source: http://www.cbar.az/infoblocks/money_reserve_usd.*
[17] *Source: National Bank of Georgia, "Monetary and Banking Statistics Bulletin", January-March, 2010, Table 1.1. Indicators on GDP and its components will be published on June 30, 2010.*
[18] *Source: http://www.nbg.gov.ge/uploads/gdpinglisurad/nominal_gdp_anncurrenteng.xls.*
[19] *Source: National Bank of Georgia, "Monetary and Banking Statistics Bulletin", January-March, 2010, Table 1.1.*
[20] *Source: National Bank of Georgia, "Monetary and Banking Statistics Bulletin", January-March, 2010, Table 5.4.*
[21] *Source: National Bank of Georgia, "Monetary and Banking Statistics Bulletin", January-March, 2010, Table 5.3.*
[22] *Source: National Bank of Georgia, "Monetary and Banking Statistics Bulletin", January-March, 2010, Table 5.8.*
[23] *Source: National Bank of Georgia, "Monetary and Banking Statistics Bulletin", January-March, 2010, Tables 1.1 and 4.7.*
[24] *Source: National Bank of Georgia, "Monetary and Banking Statistics Bulletin", January-March, 2010, Table 4.5.*

and loans in foreign currency, by 0.8 percent. Under such conditions the volumes of bad loans have increased by around Lari 10.1 million (USD 5.8 million)[25]. The share of deposits attracted by banks has increased, with deposits in national currency, by 13.8 percent. Though in the period January-March foreign currency deposits have grown by 2.1 percent, the level of dollarization of the economy is still high: as of March 31, 2010, the share of foreign currency deposits has constituted 71.3 percent in total deposits[26].

In the period January-March of 2010 foreign exchange reserves of the National Bank of Georgia have grown by about 4.2 percent and amounted to USD 2.2 billion, as of March 31, 2010[27]. In the same period of time, Georgia's foreign debt has increased by around USD 146.0 million and totaled over USD 3.5 billion, as of March 31, 2010, compared to USD 2.8 billion recorded as of March 31, 2009[28]. The increase of foreign debt after March of 2009 has been attributable to the loans attracted from international financial organizations and sale of USD 500 million-worth government securities at the London Stock-Exchange in October of 2009[29].

3.2. BALANCE OF PAYMENTS[30]

3.2.1. Current account

With the world economy and domestic economy demonstrating faster recovery rates in the first quarter of 2010, there have been positive developments on export of goods, which exceeded expectations. Early recovery of the domestic economy has been seen in the form of increased imports, as well. There has been reported increase of transfers. As a result, the deficit of current account has increased by USD 101.5 million y-o-y and amounted to USD 349.1 million, with its share constituting 23.6 percent of GDP.

In the first quarter the deficit of trade balance has increased by USD 66 million and amounted to USD 494.6 million. The y-o-y increases in export and import have been 56.9 percent and 25.1 percent, respectively. The increase of the trade balance deficit has been attributable to faster growing imports over exports.

The growth of exports has been largely attributable to high international prices of metals fuelled by growing world demand. The Government support to major export-oriented firms in the framework of relevant programs launched since the second quarter of the previous year has contributed to such growth. In the first quarter exports of goods and services in real terms[31] have increased by 7.9 percent y-o-y. Items such as "Mineral production", "Base metals and articles thereof", "Products of prepared food" and "Precious and semi-precious stones, precious metals and articles thereof", have been the main contribution (by 31.7 pp, 22.1 pp, 5.2 pp

[25] Source: National Bank of Georgia, "Monetary and Banking Statistics Bulletin", January-March, 2010, Table 3.5.
[26] Source: National Bank of Georgia, "Monetary and Banking Statistics Bulletin", January-March, 2010, Table 3.15.
[27] Source: http://www.nbg.gov.ge/uploads/templatesection_ieng.xls.
[28] Source: Georgian Business Consulting, April 20, 2010, www.gbc.ge.
[29] Source: Georgian Business Consulting, October 9, 2009, www.gbc.ge.
[30] Q1, 2009 indicators are the Central Bank estimations.
[31] Export and import of goods in real terms are the Central Bank estimations.

and 2.6 pp, respectively) to the increase in exports in dollar terms[32].

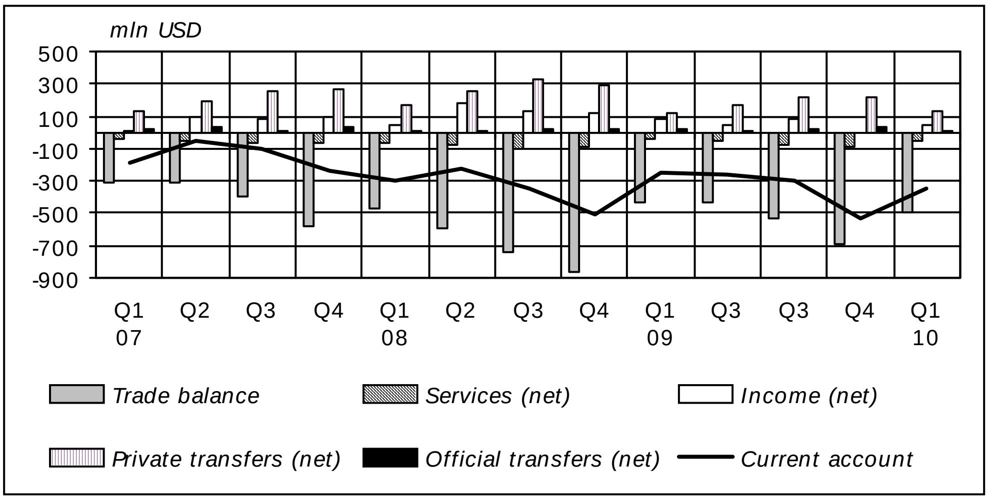
The early recovery of the domestic economy coupled with y-o-y increase of import prices explained the growth of import of goods. This has been largely attributable to intermediate goods and fuel. Items such as "Machinery and equipment", "Mineral production", "Precious and semi-precious stones, precious metals and articles thereof" and "Base metals and articles thereof" have contributed positively, by 8.2 pp, 6.8 pp, 3.5 pp and 0.8 pp, respectively. Import of goods and services in real terms has increased by 8.5 percent y-o-y.

In terms of geographic distribution of external trade the deficit of trade balance with the EU states remained at the level similar to the one recorded in the first quarter of the previous year. There has been a surplus of trade balance with Bulgaria in the first quarter of 2010 in contrast to the deficit in the previous year. The surplus of trade balance with the Netherlands has increased and the deficit of trade balance with Germany has decreased.

The increase of trade balance deficit has been attributable to the increase of the deficit of trade balances with CIS, China, Turkey and Iran, by USD 17.9 million, USD 23.7 million, USD 10.3 million and USD 18.1 million, respectively.

The increase of trade balance deficit has led to the increase of the balance of services deficit: in the first quarter it has grown by 12.5 percent y-o-y and amounted to USD 52 million mostly due to increased deficit of balance of transport services deficit. Export and import of travel services reported year-on-year growth. As a result, in the first quarter export of services has increased by 14.7 percent y-o-y and import of services, by 14 percent y-o-y.

In the first quarter current account deficit increased in relation to previous period



In the first quarter of 2010 there has been a positive shift in private remittances[33]. This depended primarily on

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[32] *Decreases have been reported for export of some items which are negligible by weight.*

[33] *In the first quarter of 2010 net non-commercial transfers via the banking system have grown by 9.6 percent y-o-y. As such, inflow of non-commercial*

positive developments in the Russian economy[34]. According to most recent forecasts by the IMF, economic growth indicator in Russia in 2010 is estimated to reach 4 percent, which is above the previous forecasts. In the first quarter net inflow of seasonal worker income has grown by 9.7 percent y-o-y and amounted to USD 103.3 million while item "Income on investment" reported net outflow of USD 53 million. In the outcome, item "Income" reported net inflow amounting to USD 50.4 million. In the first quarter of 2010 private transfers have grown by 10 percent y-o-y.

3.2.2. Capital and financial account

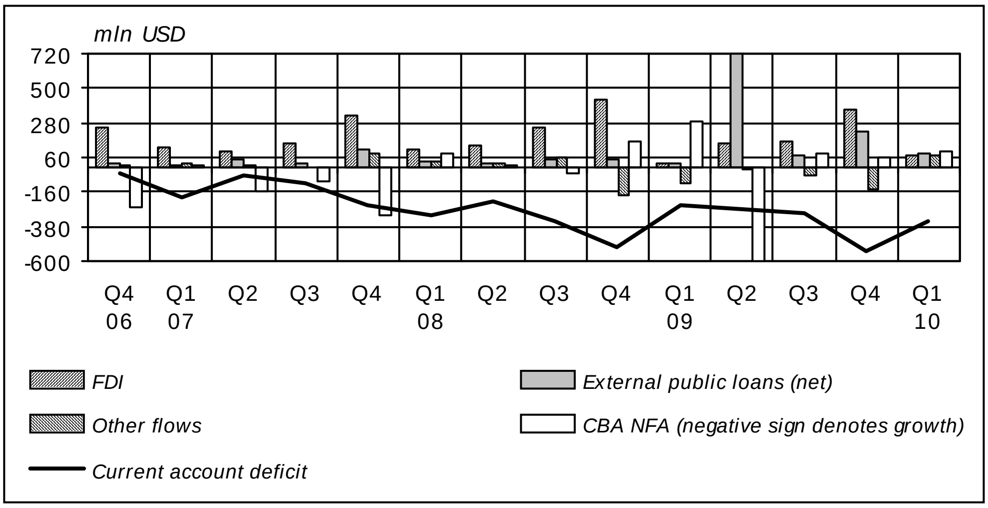
In the first quarter of 2010 the capital and financial account posted net inflow amounting to USD 250.6 million as opposed to net outflow recorded in the first quarter of the previous year. Almost all items posted net inflow of funds, which has not nevertheless been sufficient to finance current account deficit. As a result, net foreign assets of the Central Bank have reduced by USD 96.8 million.

Individual items of the capital and financial account reported flows, as follows: inflow of capital transfers reached USD 22 million (USD 16.5 million in the first quarter of the previous year) and net inflow of public loans amounted to USD 90.9 million.

Net inflow of foreign direct investment has been USD 71.2 million compared to USD 17 million recorded in the first quarter of the previous year.

Item "Other investment"[35] reported net inflow of USD 66.5 million. Net foreign assets of private sector (commercial banks excluded) have decreased by USD 118.8 million in contrast to USD a 52.3 million increase of net foreign assets of the banking sector.

In the first quarter current account deficit outweighed net inflow on capital and financial account



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transfers has increased by 10.7 percent y-o-y and outflow of non-commercial transfers, by 14.7 percent y-o-y.

[34] The main portion of private remittances comes from Russia.

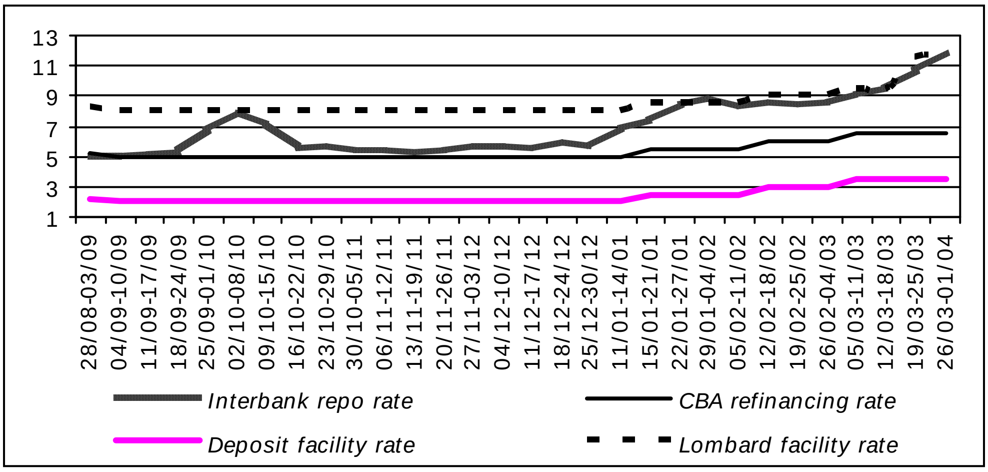
[35] This item covers net foreign assets of the banking sector and other private sector.

3.3. INTEREST RATES, EXCHANGE RATE AND MONETARY DEVELOPMENTS

3.3.1. Interest rates

In the first quarter of 2010, intensification of inflationary pressures [attributable to the rise in international prices of raw materials and basic food products] transmitted from the external environment amid recovering world economy, as well as slowly rebounding aggregate demand boosted by implementation of expansionary fiscal policy have led to the creation of a high inflationary environment. The Central Bank has, therefore, embarked on step-by-step tightening of monetary policy conditions, and during the first quarter the Board of the Central Bank raised the refinancing rate, then 5.0 percent, by 1.5 pp to 6.5 percent.

Interest rate of Central Bank operations and market repo operations

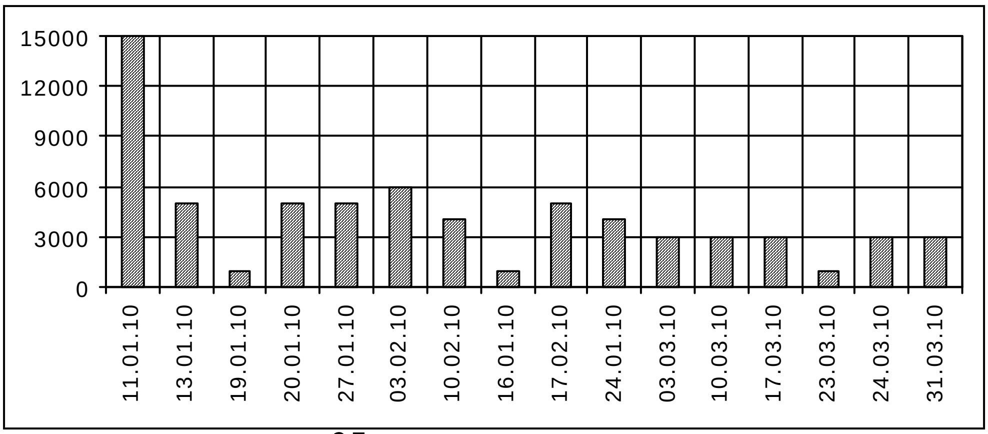


** Until 2010 this instrument was called Lombard facility.*

In the first quarter the banking sector saw excess liquidity diminishing, which affected the Central Bank operations. In particular, average daily volumes of Lombard repo operations performed by commercial banks with the Central Bank have reduced to AMD 4.7 billion.

During the quarter the Central Bank continued offering commercial banks to enter into repo transactions each Wednesday. As a result, average weekly volumes of repo operations performed have amounted to AMD 3.5 billion (AMD 5.7 billion in the previous quarter). In the meantime, the Central Bank further resorted to using the long-term repos, with a total volume of AMD 1.0 billion at the end of the quarter (AMD 1.0 billion in the previous quarter).

Central Bank repo operations in the first quarter (million AMD)

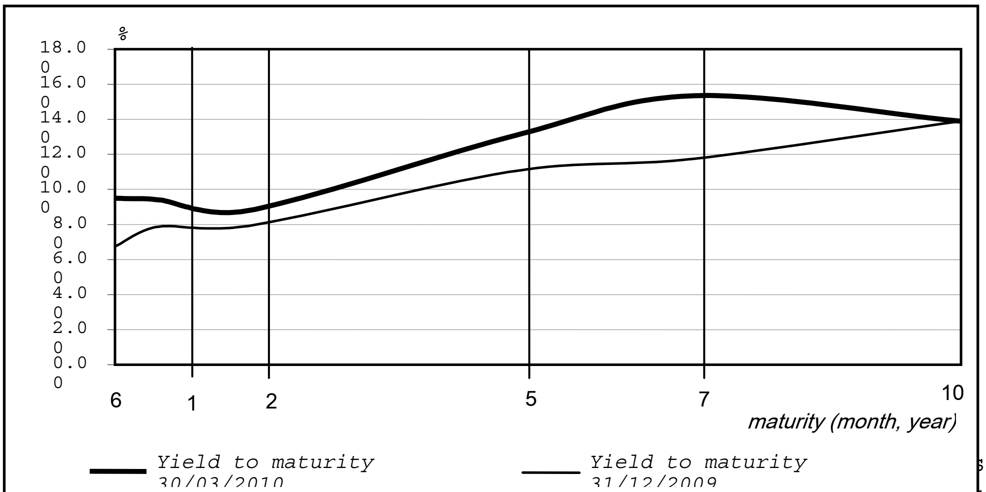


In the first quarter, average daily volume of deposit invested by commercial banks with the Central Bank amounted to AMD 1.4 billion compared to AMD 4.5 billion in the previous quarter.

The volume of operations performed in the interbank and intrabank repo market during the first quarter of 2010 amounted to AMD 193.2 billion, up by AMD 46.3 billion in relation to the previous quarter. The market repo rate was 10.0 percent in March against 5.79 percent in December of 2009. The share of operations between commercial banks in total constituted 36.4 percent in the first quarter of 2010, and 41.4 percent in the previous quarter.

In the first quarter the issue volumes of short-term treasury bills have amounted to AMD 10 billion. The total volume of short-term treasury bills allocated has been AMD 8.5 billion against AMD 9.9 billion recorded in the previous quarter.

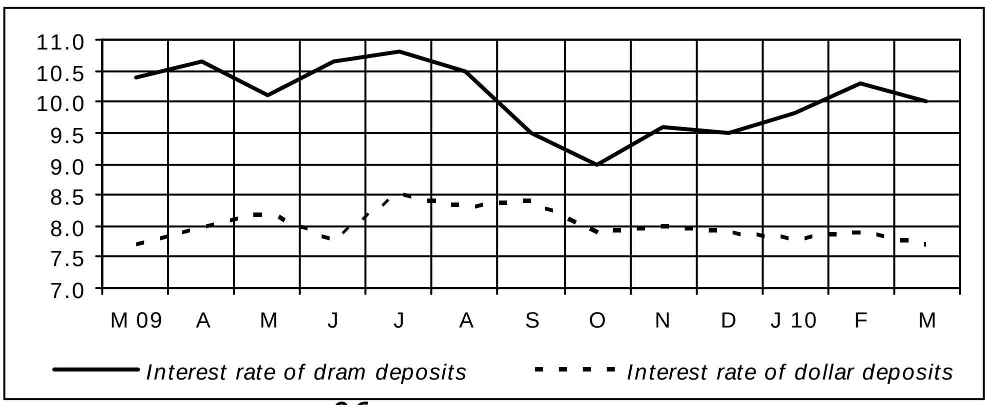
In the secondary market interest rates have increased



of short-term treasury bills have reduced by 0.24 pp to 9.15 percent. Interest rates of medium-term treasury bills have remained unchanged, at 13.36 percent, and interest rates of long-term treasury bills have amounted to 15.92 percent.

The yield curve analysis shows that in the secondary market of government securities yields have grown by around 1.8 pp on average. Convexity of the curve has changed slightly (from 0.37 to 0.32), which points to the narrowed spread between interest rates of long-term and short-term treasury bills.

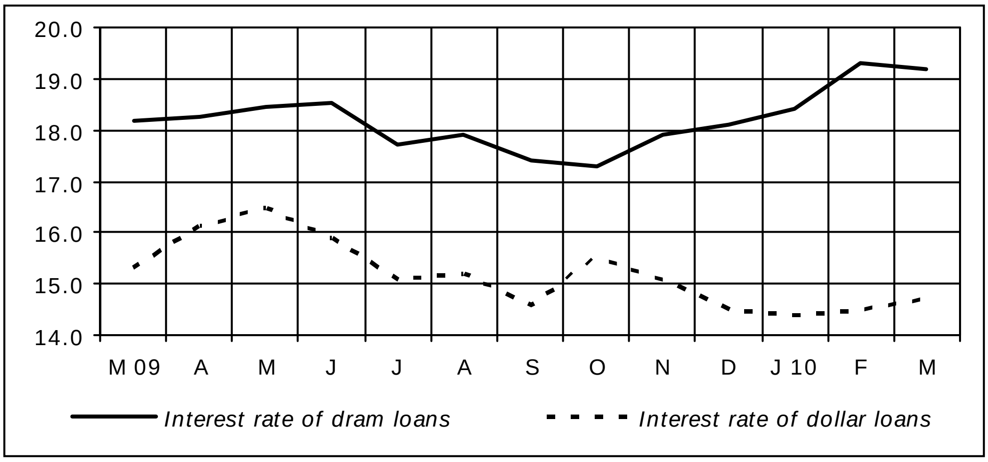
Interest rates of deposits attracted by the banking sector



Interest rates of loans and deposits in Armenian dram and US dollar trended as follows: in March interest rates of dram and dollar deposits made up 10.0 percent and 7.7 percent, respectively. Relative to December of 2009, interest rates of dram deposits have grown by 0.5 pp but interest rates of dollar deposits remained almost unchanged. As a result, the spread of interest rates of dram and dollar deposits has been 2.3 pp against 1.6 pp recorded in December.

In March of 2010 interest rates of dram loans made up 19.2 percent, and dollar loans, 14.7 percent. Relative to December of 2009, interest rates of dram loans have grown by 1.1 pp whereas interest rates of dollar loans remained almost unchanged. As a result, in March the spread of interest rates of dram and dollar loans has been 4.5 pp compared to 3.6 pp recorded in December.

Interest rates of loans provided by the banking sector



In March of 2010 the interest rate spread of loans and deposits in Armenian dram made up 9.2 pp, (8.6 pp in December of 2009), growing by 0.6 pp, and the interest rate spread of loans and deposits in US dollar made up 7.0 pp (6.6 pp in December of 2009), growing by 0.4 pp.

3.3.2. Exchange rate

At the end of the first quarter of 2010, relative to the end of the previous quarter, the Dram has depreciated versus the US dollar by 5.65 percent to 400.50 from 377.89 for one dollar. Whereas in the first quarter, relative to the first quarter of the previous year, the average exchange rate depreciation has been 15.24 percent to 384.08 from 325.56 for one dollar. The same indicator in the previous year was 5.38 percent.

The aggregate volume of interbank market transactions carried out during the quarter amounted to USD 1807.8 million[36], which is 64.83 percent reduction in relation to the volumes of the first quarter of the previous year (USD 2818.9 million).

The volumes of transactions in the EUR/AMD exchange market have decreased, too, with an aggregate volume reaching

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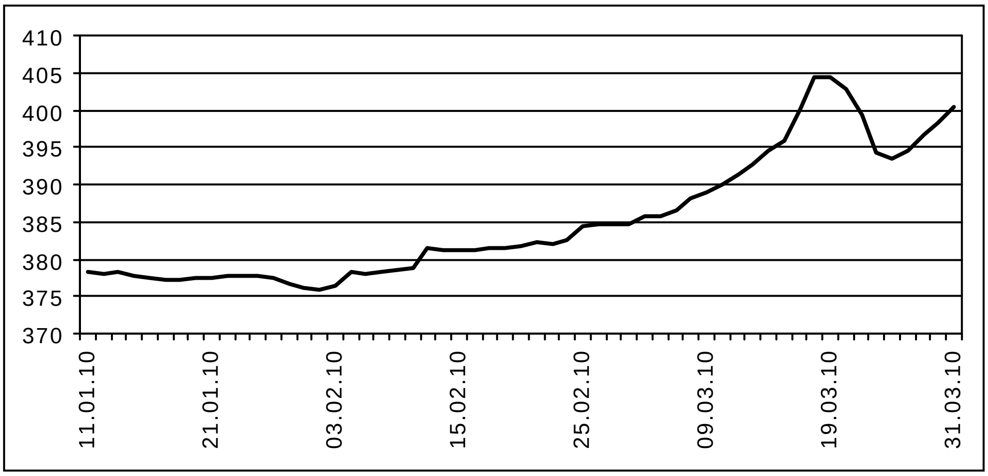
[36] *This amount includes trades executed at the stock exchange, totaling USD 308.488.*

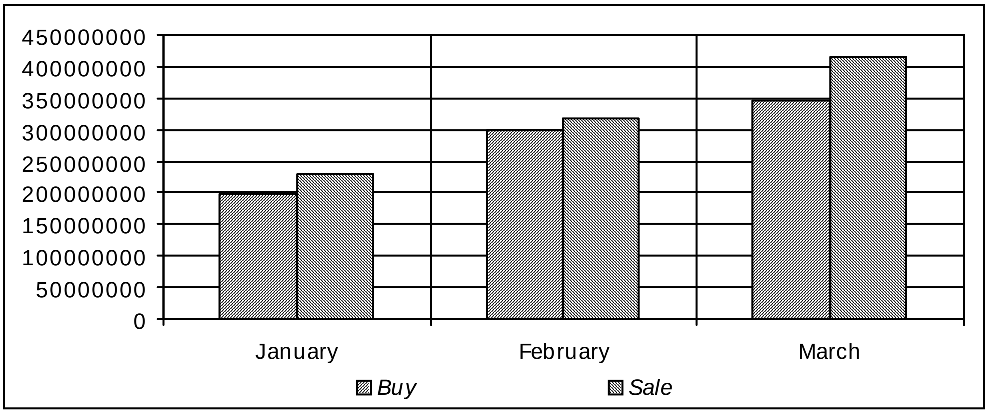
EUR 186.227 million, which is 44.3 percent reduction compared to the volumes of the first quarter of the previous year.

In the first quarter the Central Bank purchased a total of USD 13.10 million and sold a total of USD 138.24 million from/to commercial banks to handle the dram supply and moderate volatilities in the dram exchange rate.

Dram exchange rate versus US dollar in the first quarter



Operations carried out in foreign exchange market (million USD)

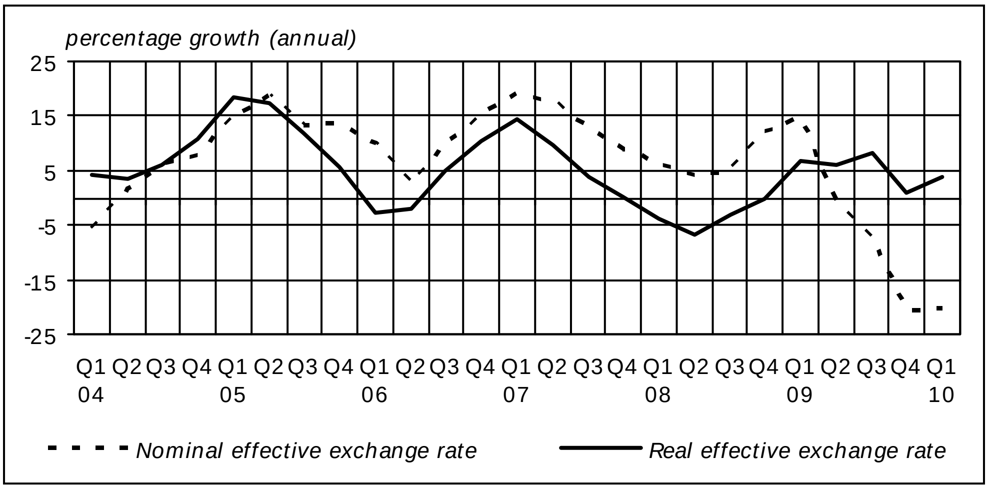


In the first quarter of 2010 a negligible (0.1 percent) q-o-q appreciation of the dram exchange rate versus the US dollar and about 3.2 percent average weighted depreciation of partner countries' exchange rates versus the US dollar have resulted in 3.3 percent q-o-q appreciation of the dram nominal effective exchange rate. However, persisted high deprecation of the dram exchange rate versus the US dollar y-o-y as well as average weighted appreciation of partner countries' exchange rates versus the US dollar y-o-y determine a high level of deprecation (20.3 percent) of the nominal effective exchange rate y-o-y.

In the first quarter of 2010 the average quarterly inflation has been 8.5 percent y-o-y in Armenia and the average weighted inflation has been 4.2 percent y-o-y in partner countries. The weighted average inflation in partner countries has been most influenced by inflation in Russia and Ukraine, by 1.5 and 0.9 pp, respectively. As a result, in the first quarter, coupled with y-o-y depreciation of the nominal exchange rate, the real effective exchange rate has depreciated by 17.1 percent y-o-y (20.1 percent in the previous quarter). For comparison, the real exchange rate calculated by producer prices has, in the meantime, appreciated by 3.7 percent y-o-y (about 1 percent in the previous quarter). This is attributable to producers which had the dram prices adjusted due to depreciation of the exchange rate.

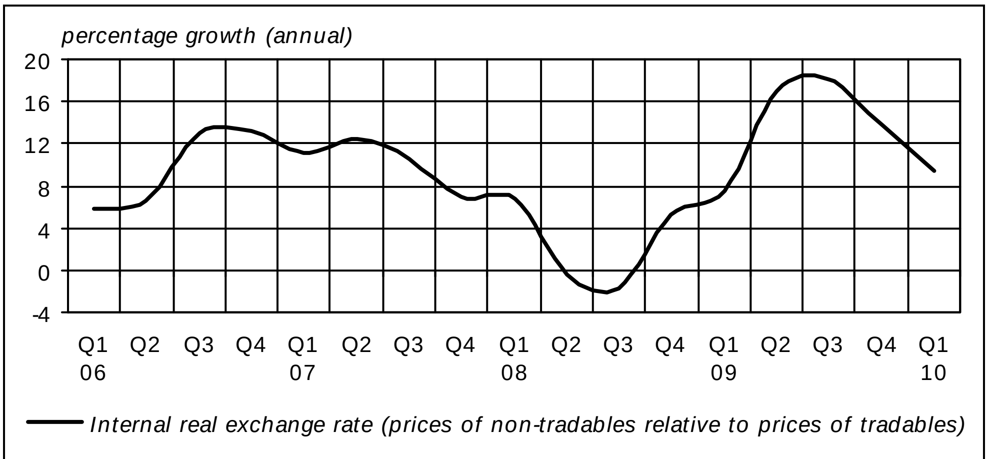
In the first quarter of 2010 the domestic real exchange rate has appreciated by 9.5 percent y-o-y (13.7 percent in the previous quarter), which is a result of faster growth of prices in non-tradable sector over prices in tradable sector.

In the first quarter real and nominal exchange rates have appreciated q-o-q



In the first quarter prices of non-tradable goods and services have increased by 17.8 percent y-o-y, and prices of tradable goods have increased by 7.5 percent compared to 16.2 percent and 2.1 percent, respectively, recorded in the previous quarter. The y-o-y growth of prices of tradable goods has been due to y-o-y depreciation of the dram nominal exchange rate and annualized growth of international prices. Growth of prices in non-tradable sector has been largely determined by y-o-y increase in gas and electricity fees.

In the first quarter domestic real exchange rate appreciated at slower pace



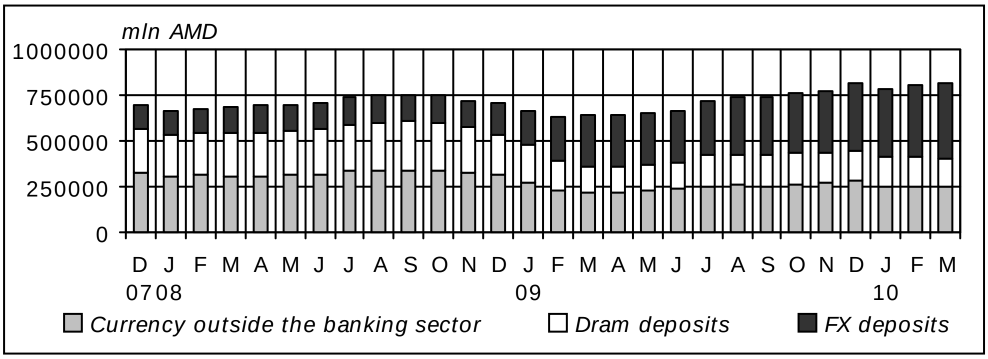
3.3.3. Monetary developments[37]

The year 2010 started with trends of stabilizing macroeconomic developments and relevant inflationary environment which was determined by high inflationary pressures [in the form of increased international prices of raw materials and certain food products] and influence of extremely expansionary fiscal and monetary policies implemented since the second half of 2009.

Therefore, the 2010 Monetary Policy Program outlined a strategy for tightening monetary conditions during the year, which means to lift refinancing rate and restrict liquidity injection operations.

At the start of the year, in implementation of monetary policy directions, monetary aggregates demonstrated quarterly decreases affected by decline in demand for money which is typical to the time when economy is in seasonal inactivity. Thus, dram broad money has reduced by 11.1 percent due to the decrease of currency in circulation, by 12.4 percent, and dram deposits, by 8.8 percent. Because these indicators suffered large quarterly reductions their 12-month growth rates have lagged expectations substantially - dram broad money has grown by 12.0 percent, currency in circulation, by 16.6 percent and dram deposits, by 5.5 percent.

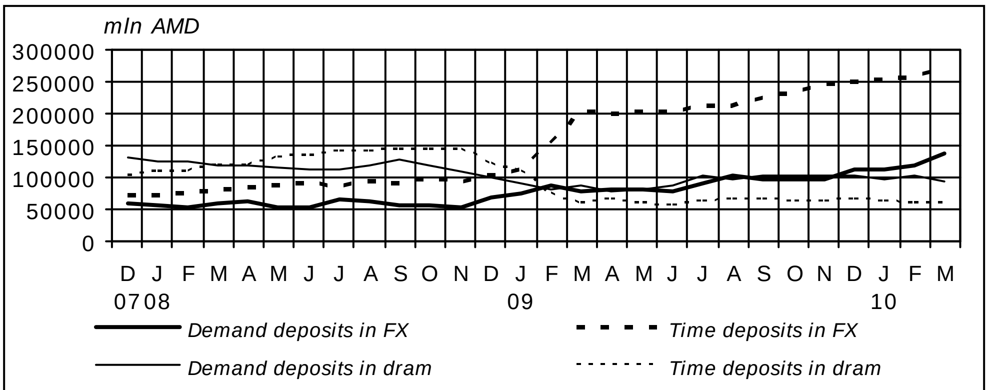
In the first quarter, currency substitution was observed as dram broad money suffered vast reductions while foreign currency deposits reported considerable increases



In the reporting period foreign currency deposits demonstrated behavior similar to the performance in preceding two quarters, growing by 13 percent q-o-q, and this points to the persisting dollarization of the economy. The 12-month indicator of foreign currency deposits having outstripped the projection by 46.9 percent is another evidence of dollarization.

Foreign currency deposits have grown due to demand deposits, having grown by 21.2 percent (AMD 24.2 billion) and time deposits, having grown by 9.2 percent (AMD 23.0 billion). Based on annualized results, these two indicators have performed similarly, with demand deposits having grown by 77.4 percent (AMD 60.3 billion) and time deposits having grown by 35.1 percent (AMD 71.0 billion).

In the first quarter foreign currency deposits continued growing rapidly



Starting from the third quarter of 2008, the Inflation Report covers summary balance sheet indicators of depositary institutions, i.e. the Central Bank, commercial banks and credit organizations.

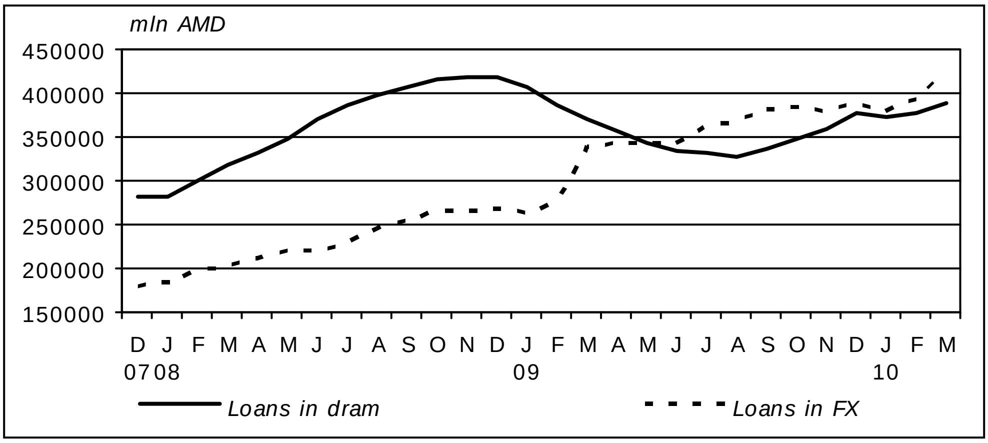
There is an opposite picture for quarterly and annual trends in the portfolio of time deposits in dram. While dram deposits have decreased driven by 11.0 percent (AMD 11.4 billion) reduction of demand deposits and 5.4 percent reduction (AMD 3.4 billion) of time deposits due to seasonal decline in demand for dram in the first quarter, on annualized terms, however, these have grown by 6.7 percent (AMD 5.8 billion) and by 3.6 percent (AMD 2.1 billion), respectively.

As a result of flows of the above components, broad money has decreased by 0.3 percent q-o-q but increased by 27.3 percent y-o-y.

By supply-side factors, quarterly decrease of broad money has been totally due to net foreign assets of depositary institutions, with 9.6 percent (AMD 34.1 billion) decrease, while net domestic assets have grown in this period of time by 6.9 percent (AMD 31.4 billion).

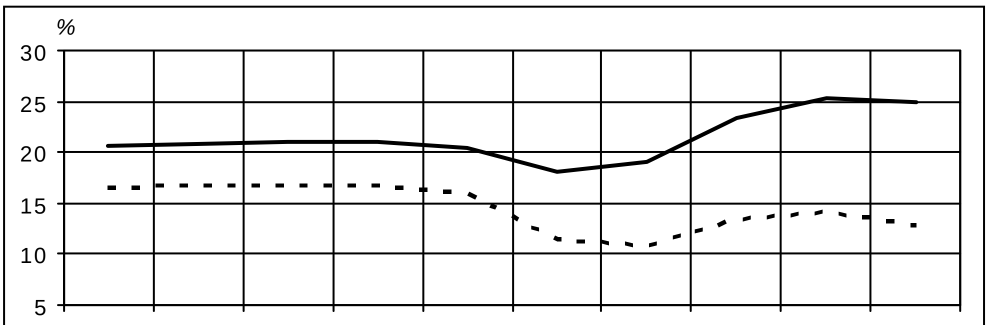
In the first quarter the economy lending kept on spurring up, demonstrating growth by 5.9 percent q-o-q and 14.3 percent y-o-y. Economy's dollarization has been seen also in lending in foreign currency as foreign currency loans reported larger growths in both quarterly and 12-month terms, by 8.6 percent and 24.8 percent, respectively, which had been concurrent with the growth of dram loans by 2.9 percent and 4.9 percent, respectively. Under these conditions, the share of foreign currency loans in total lending kept on growing. In March of 2010, the dram loans to foreign currency loans ratio was 48/52 versus 49/51 recorded as of the end of the previous year and 52/48 in March of the previous year.

In the first quarter the share of foreign currency loans in total lending kept on growing



As of the end of the first quarter dollarization of the economy (measured as a ratio of foreign currency deposits to broad money) has been 50.6 percent, representing more than 13 percent increase in relation to the previous quarter and 15.3 percent increase in relation to the respective indicator of the previous year.

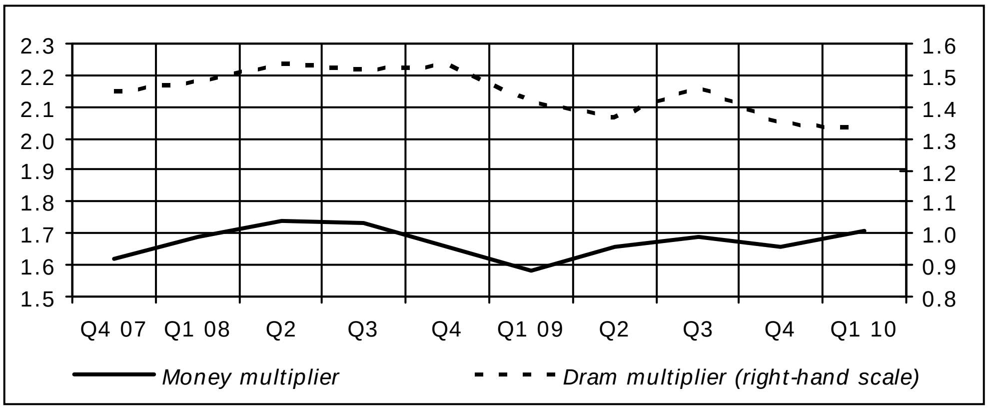
In the first quarter the dramization ratio tended to decline faster in relation to the monetization ratio



Based on quarterly results, the monetization and dramization ratios (described as indicators of financial intermediation) reached 25.0 percent and 12.9 percent, respectively, representing 38.3 percent and 12.7 percent increase in relation to respective indicators of the previous year.

The other indicators of financial intermediation, i.e. money and dram multipliers, have reported, respectively, 2.9 percent increase and 1.9 percent decrease. The picture is the same in terms of the 12-month period where money multiplier has grown by 7.7 percent and dram multiplier has fallen by 6.5 percent.

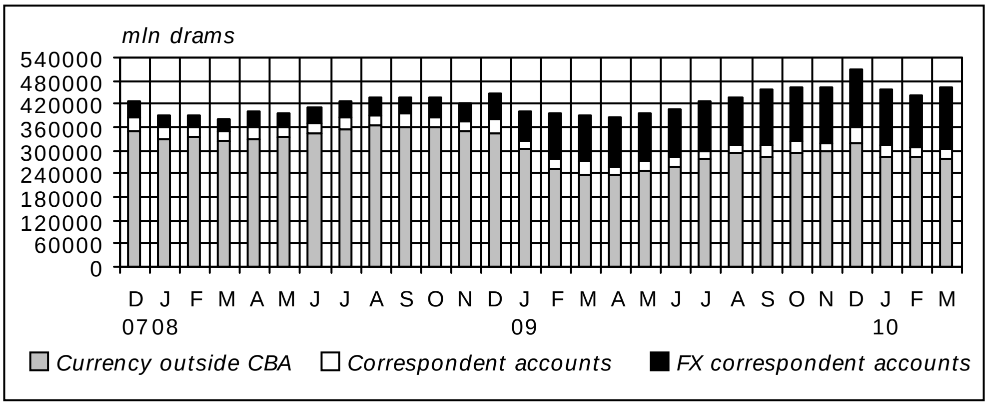
The money and dram multipliers



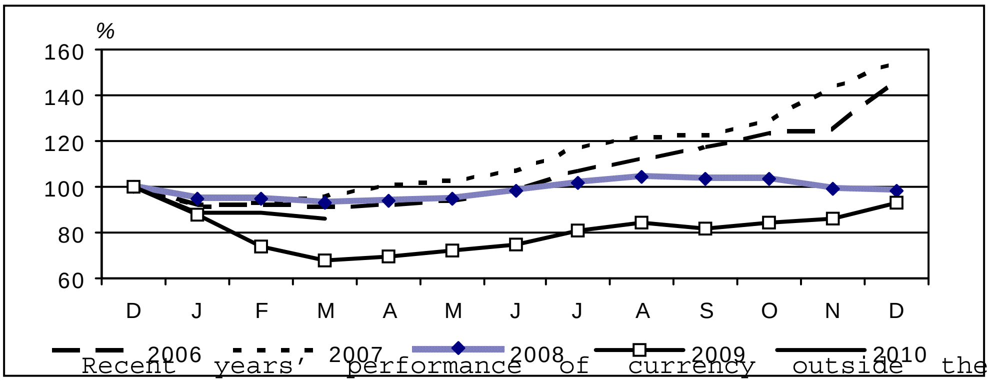
Base money

In the first quarter there has been a considerable decline in money supply affected by tightened monetary conditions as well as factors responsible for seasonal decline in demand for money which is typical to the beginning of the year. As of the end of March, base money had reduced by 9.1 percent in relation to the start of the year, totally due to 13.8 percent reduction of currency outside the Central Bank.

Base money by components



In the first quarter currency outside the Central Bank behaved its regular way



Recent years' performance of currency outside the Central Bank shows that, except when currency outside the Central Bank had been reducing at much faster rates due to precipitance to convert drams into dollars because of steep depreciation of the dram at the beginning of the previous year, currency in circulation behaved as regular at the beginning of this year as in the first quarters of 2006-2008.

3.4. AGGREGATE DEMAND AND AGGREGATE SUPPLY

3.4.1. Aggregate demand

Domestic demand

Private consumption and investments[38]***:*** In the first quarter of 2010 the economy saw the domestic demand growing, owing to the increase of public expenditures and private spending amid recovery of the world and domestic economies.

In the first quarter the domestic demand has grown by around 4 percent in real terms. Real growth of public expenditures has been 18.4 percent in relation to the same quarter of the previous year, reflecting notable increment of public investments during the quarter.

Private spending has grown by 2.5 percent in real terms. In the portfolio of private spending growth of private consumption has been around 3 percent which is determined by increased private disposable income and restored consumer confidence as a result of activation of the economy. Decline in private investments has been nearly 4 percent in relation to the same period of the previous year. The declining rates in private investments have slowed down in comparison with those of reported during the previous year, reflecting improvement in expectations about the future businesses environment.

Composite economic indexes calculated by the Central Bank for 2010 have been consistent with the above developments[39]. In the first quarter of 2010 economic activity index, EAI, has risen by about 20 percent and consumer confidence index, CCI, by 1.5 percent. As such, major household purchases indicator has recovered by 1.8 percent and the indicator reflecting enterprise willingness to invest, by 2.3 pp upward.

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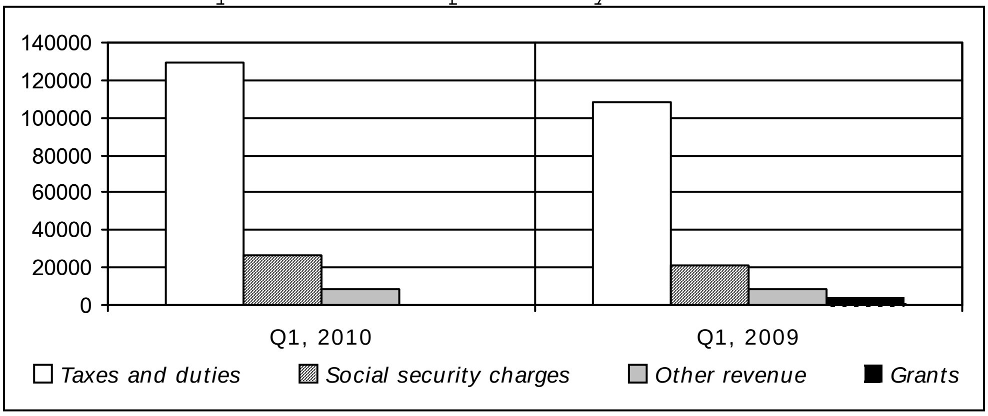
[38] The real growth indicators of private consumption and investments for the first quarter are the Central Bank estimations. The actual figures of these indicators are as of the fourth quarter of 2009. Estimations of real growth presented in this section are relative to the same quarter of the previous year, unless otherwise stated.
[39] See http://www.cba.am/CBA_SITE/statistics/complex_index.html?__locale=hy.

In the first quarter private sector expenditures have had a restrictive impact on inflation. According to the Central Bank, the estimated level of real private expenditures has been below its equilibrium by 2-3 percent, which exerted some 0.6-0.9 percent deflationary pressures in the consumer market.

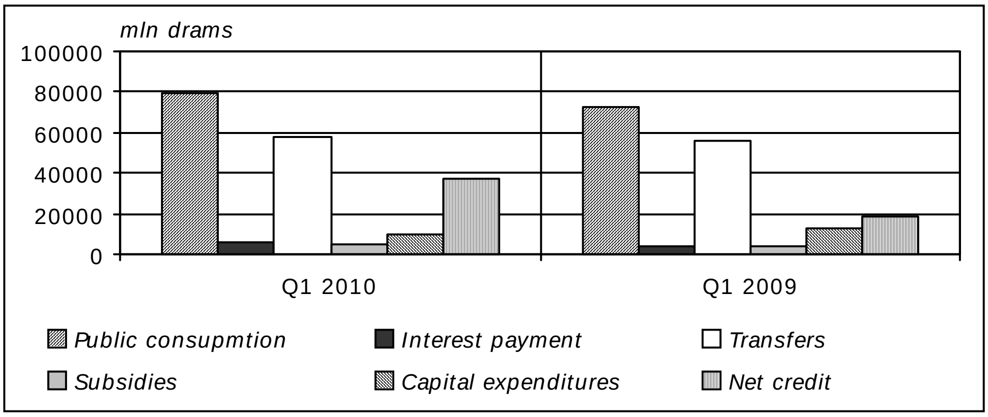
Public consumption and investments[40]***:*** In the first quarter of 2010 positive trends of economic recovery have had their impact on collection of budget revenues. As a result, budget revenues have notably outweighed quarterly proportions determined by the Government. Growth of tax revenues has been 19.2 percent and growth of mandatory social security charges, by around 22 percent, in relation to the respective indicator of the first quarter of the previous year.

In the first quarter State Budget reported growth of revenues



In the tax revenues structure of the budget growth of indirect taxes has been 20 percent y-o-y which was largely due to increased amount of value added tax. Growth of direct taxes has been 25 percent y-o-y explained by increased amount of income tax and profit tax.

In the first quarter expenditures in the consolidated budget reported declines on transfers only



[40] *Consolidated budget indicators prepared based on preliminary actual data of the first quarter of 2010 (including PIU funds) have been used for the review of the fiscal sector. The 2010 fiscal impulse indicators have been estimated against 2008 consolidated budget indicators (with 2008 treated as a base year), since the fiscal policy in 2009 has been prominent in increased amounts of public expenditures and net domestic lending as part of implementation of anti-crisis measures year. The impact of revenues has been calculated against estimated nominal GDP indicator and the impact of expenditures has been calculated against estimated potential GDP indicator. Net economy lending has been included in public expenditures to evaluate the impact on the aggregate demand.*

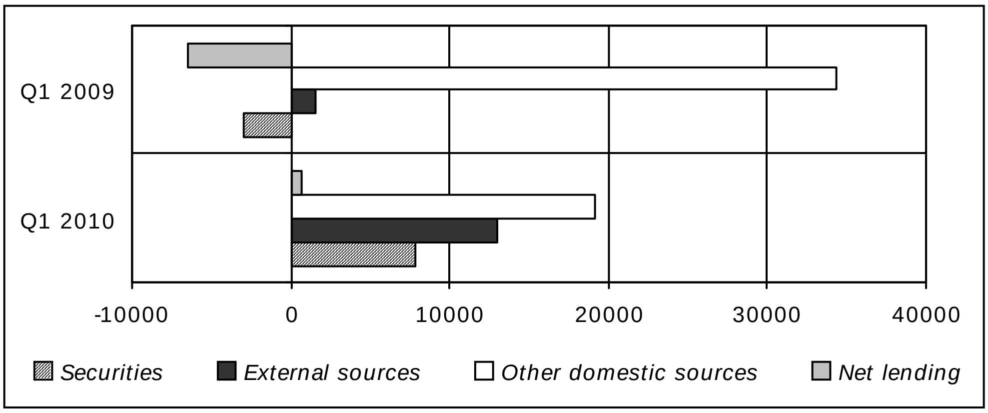
In the first quarter the Republic of Armenia budget expenditures have increased by about 16.5 percent in relation to the respective indicator of the first quarter of the previous year. Current expenditures have increased by 6 percent and expenditures in item *Transactions with non-financial assets*, by 97 percent. In current expenditures, public consumption has grown by nearly 11 percent y-o-y and allowances and pensions, by 5 percent y-o-y.

Expenditures in item *Transactions with non-financial assets (capital expenditures)* have increased notably due to external financing received through PIUs. The share of expenditures disbursed from sources of domestic financing amounted to 35 percent, and the share of external financing amounted to 65 percent (45 percent and 55 percent, respectively, in the previous year).

In the first quarter of 2010 budget deficit amounted to AMD 30 billion 42 percent of which has been financed from external sources and 58 percent, from domestic sources.

To sum up, in the first quarter of 2010 the fiscal policy's impact on aggregate demand and inflation has been less expansionary thanks to over-performance on the part of revenues and some savings on expenditures. According to estimated fiscal impulses, impact has been 6.8 percent expansionary, fuelled by expansionary revenues and expenditures impulses.

Attributable to faster growth rates of GDP over revenues, the revenues impulse is estimated to have been 3.2

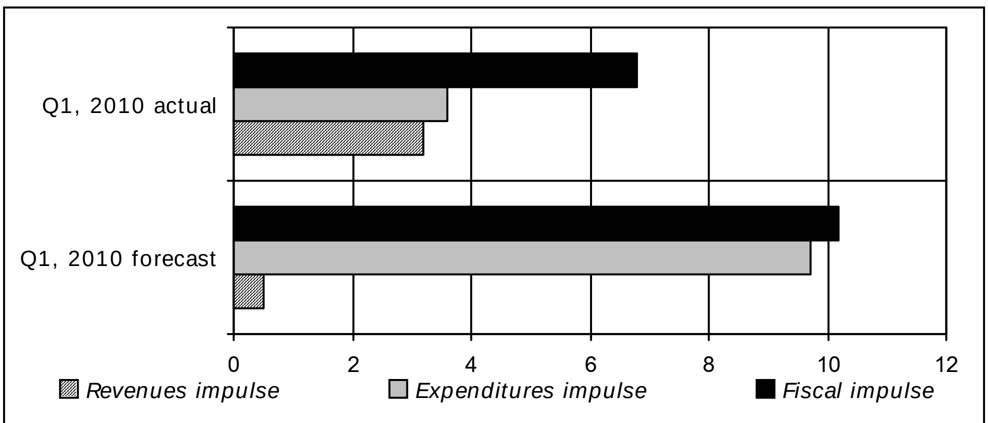


pp expansionary in terms of impact on aggregate demand.

In the first quarter external financing prevailed in the sources of deficit financing

Given 26 percent increase of expenditures in relation to the same period of the base year as well as estimated level of potential GDP which the Central Bank adjusted upside based on actually high GDP level, the impact of expenditures on aggregate demand has been estimated 3.6 pp expansionary.

In the first quarter expansionary impact of the fiscal impulse has been somewhat lesser



Main macroeconomic indicators in Q1, 2009 and Q1, 2010 (in real terms)

Item	Q1, 2009-Q1, 2008	Q1, 2010-Q1, 2009
Real GDP	-6.1	5.5
Domestic demand	-8	4.2
Consumption	-3..9	2.2
Public	-7.4	-3.9
Private	-3,5	3.1
Capital investment	-32..5	22.2
Public	10..3	108.6
Private	-39.7	-4.1
Export[41]	-9.3	7.8
Import	-9.1	8.3

3.4.2. Aggregate supply[42]

With macroeconomic environment improving as the world economy recovers and impacts of expansionary fiscal and monetary policies implemented in the framework of anti-crisis measures are transmitting, the first quarter of 2010 reported y-o-y 5.5 percent economic growth against y-o-y 6.1 percent economic decline recorded in the same period of the previous year. Economic revival is a result of growth recorded with regard to all branches of the economy.

Industry reported about 6.1 percent y-o-y growth in value added in the first quarter (compared to 8.8 percent decline recorded for the same period of the previous year) mainly due to the growth recorded in *metal ore mining* and *production of building materials*, by 54 percent and 53.2 percent, respectively. Particularly, in the sub-branch of metal ore mining growth has been a result of consistent improvement in this sub-branch of industry in the framework of anti-crisis measures as well as a boost by external demand and increased export volumes. Increased production of building materials has been attributable to revitalization in this sub-branch.

Contribution to the growth in industry has come from *food production* (2.6 percent), *beverage*[43] *production* (5.4 percent), *items of jewelry* (37.9 percent), *finished articles of metal* (27.2 percent), *general manufacture* and *chemical production* (3.2-fold), driven by gradually recovering world economy and domestic economy.

There has been around 9.6 percent y-o-y decline recorded in *supply of electricity, gas, steam and pure air* whereas, when expressed in kind, about 9.8 percent y-o-y growth has been recorded for electricity production, which made it possible to notably increase export of electricity.

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[41] *This is pertinent to the export and import of goods and serv ices.*
[42] *Growth of value added of branches of the economy and real GDP has been calculated using data which the National Statistics Service of Armenia adjusted in 2009, and it represents January-March of 2010 in relation to the same period of the previous year.*
[43] *Increased production of beverage has been fuelled by growth in production volumes in brandy (17.5 percent), wine (21.3 percent), beer (58.9 percent), champagne (29.4 percent), and natural juice (87.9 percent).*

Construction reported 9.7 percent y-o-y growth in value added against 18.8 percent decline recorded for the same period of the previous year. Growth has been fuelled by increased volumes of construction in *energy* (61.9 percent), *agriculture* (4.5-fold), *financial and insurance activity* (2.7-fold), *trade* (50.5 percent), and *healthcare sector* (10.3-fold).

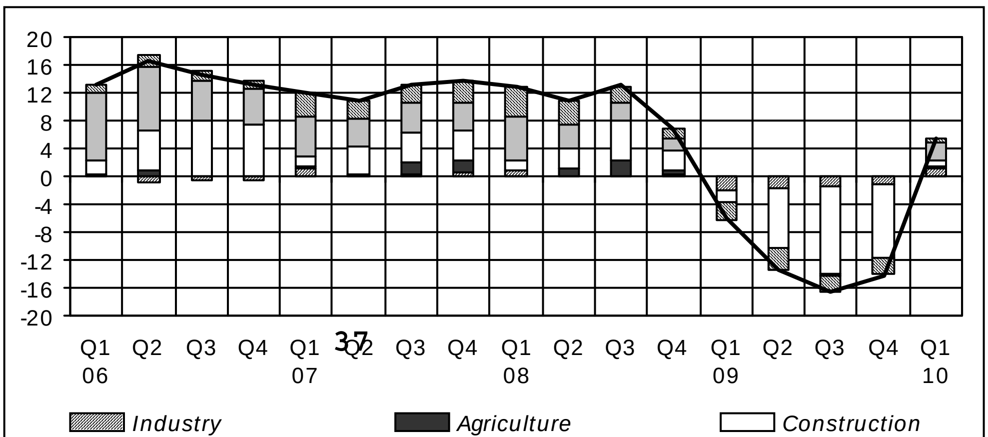
Notwithstanding somewhat slowing decline in the construction sub-branch, volumes of *construction financed by households and private organizations* keep on reducing, to have amounted to 51.7 percent and 36.7 percent, respectively, in the period January-March. Growth has been relatively high in construction financed by *international loans* (2.2-fold) and *state budget funds* (2.7-fold).

Agriculture reported 3.1 percent y-o-y growth in value added in the first quarter of 2010 compared to some 0.9 percent decline recorded for the same period of the previous year. Growth recorded in the period under review has been driven by increases in *plant growing* (30 percent), *animal growing* (2.2 percent), and *fishing* (0.9 percent). Increased volumes in animal growing has been totally due to 28.9 percent increment in egg production which fully offset the declines recorded in *slaughter animal and poultry* (1.6 percent) and *milk production* (7.2 percent). Increased production in plant growing has been mostly attributable to augmented volumes of *bedded plants* and *spring sowing*.

Services reported 5.1 percent y-o-y growth in value added for the quarter against 0.1 percent growth recorded in the first quarter of 2009. Growth has been driven by *retail trade* (1 percent), (this has been a result of 11.8 percent increase in turnover at trade stalls, and *wholesale trade* (3.7 percent). In the meantime the volume of services has increased by 6.2 percent. Save for services in *culture* and *transport*, growth has been reported for services in all other areas, with services in *financial and insurance activities* (23.2 percent) and *real estate transactions* (17.9 percent) having reported the fastest growth.

Composite Economic Indexes[44] that are calculated on a basis of quarterly queries from/at non-banks, non-financial organizations and households and on how they are progressing points additionally to the economic activity. In particular in the first quarter of 2010, *economic activity index* has climbed up by 20.2 percent y-o-y, boosted largely by industry and service, while *business activity index* has risen by 37.3 percent y-o-y. Improvement in business environment has been observable in all branches of the economy, with industry having boasted most prominent change in business activity.

Real GDP growth rate (cumulative) and sector contributions



3.5. LABOR MARKET[45]

In the first quarter of 2010 there has been some growth in nominal wages observed in the labor market, which was fostered by wage increases in private sector and budget-supported organizations as a result of economic activity. The unemployment rate has responded to the economic recovery with a certain time-lag and showed some increase. Labor productivity has increased and, with a moderate rise in wages, resulted in a slight increase in unit labor costs. These developments demonstrated that the labor market's impact on inflation has been neutral.

According to the Central Bank estimations, the average growth of nominal wages in the economy in the first quarter has been nearly 5 percent. Wages have notably increased in industry, construction and services but considerable slowing of growth rates of wages in relation to respective indicators of the previous year have been seen in healthcare and education.

In spite of economic activity, in the first quarter employment indicators kept on deteriorating, which was observable from the start of the previous year. The average quarterly unemployment rate has risen by 0.7 pp to 7.3 percent. In 2010 the number of officially unemployed has increased by 10.8 percent and the number of employed reduced by 0.2 percent.

During the quarter the growth of labor productivity has improved by around 6 percent as the economy continued recovering while unemployment remained persisting.

As a result of these developments, unit labor costs have not changed much, so the labor market's impact of the price level has been neutral.

3.6. IMPORT PRICES AND PRODUCER PRICES

3.6.1. Import prices

In world commodities markets in the first quarter of 2010 prices persisted mainly at the previous year's levels. This was attributable to both intermediate goods and basic food. Though at the start of 2010 the world economy was recovering at faster rates than anticipated, this has been prominent in financial markets and seems not to have affected commodity prices again and definitely.

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[45] *The first quarter of 2010 labor market data are the Central Bank estimations which are based on actual figures for January and February and estimated figures for March. Growth estimations presented in this section are relative to the same quarter of the previous year, unless otherwise specified.*

According to the Central Bank estimations, in the first quarter dollar prices of imports have increased by 13.1 percent y-o-y (nearly 5.4 percent increase y-o-y in the previous quarter).

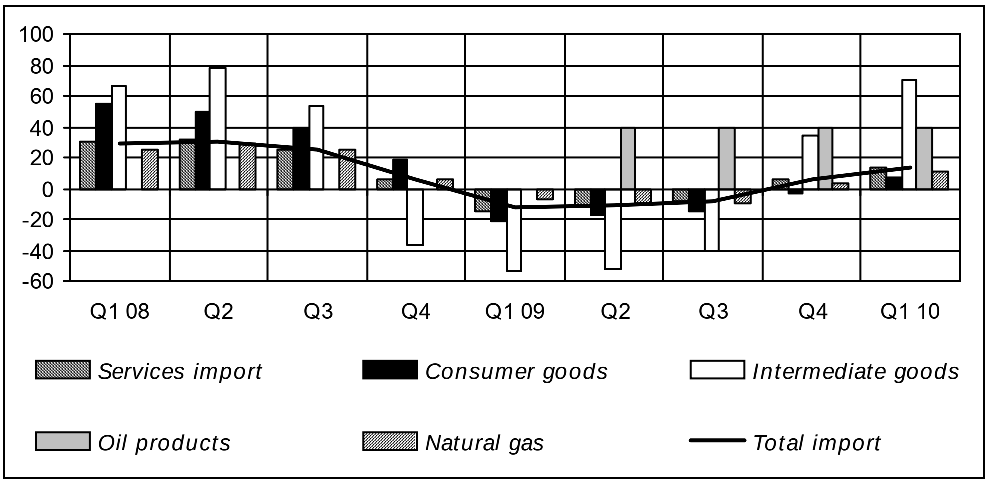
Item	Q1, 09	Q2, 09	Q3, 09	Q4, 09	Q1, 10
Import (total)	-12.7	-10.6	-8.3	5.4	13.1
Import (services)	-7.4	-10.0	-9.2	3.1	10.7
Import (goods)	-14.4	-10.8	-8.0	6.1	13.9
Capital goods[46]	0.0	0.0	0.0	0.0	0.0
Consumption goods	-7.4	-10.0	-9.2	3.1	10.7
Intermediate goods	-21.1	-17.7	-15.1	-3.7	7.4
Diamond[46]	0.0	0.0	0.0	0.0	0.0
Oil products	-53.5	-51.7	-40.9	34.2	70.4
Natural gas	0.0	40.0	40.0	40.0	40.0

The y-o-y growth in dollar prices has been attributable to very low prices recorded in the same quarter of the previous year and little growth of prices of intermediate goods and oil products in particular.

Prices of intermediate goods have increased by 7.4 percent y-o-y compared to some 3.7 percent y-o-y decrease in the previous quarter. Though in the period under review prices of grain have fallen, prices of metals have increased thus resulting in y-o-y increase of prices of intermediate goods. The impact of prices of intermediate goods on total prices has been 2.0 percent.

In the first quarter dollar prices of oil products have somewhat risen. However, these prices reported some 70.4 percent rise y-o-y (34.2 percent in the previous quarter) owing to high growth in the previous quarters amidst optimistic expectations for the world economic recovery, as well as the fact that these were at low levels in the same quarter of the previous year. As a result, in the period under review prices of oil products have created 4.5 pp impact on general import prices.

In the first quarter import prices have considerably outstripped the price level recorded for the previous period



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

In the first quarter prices of consumption goods have increased by 10.7 percent y-o-y, creating 2.0 pp impact on general import prices. On the whole, growth of prices of consumption goods has been determined by strong appreciation of exchange rates (5.7 pp) and high inflation (4.1 pp) in partner countries. Appreciation of the ruble and high inflation recorded in Russia has created 1.0 pp impact on general import prices.

Given 13.1 percent y-o-y rise in international prices and 15.3 percent y-o-y deprecation of average nominal AMD/USD exchange rate, dram prices of imported goods included in the consumer basket have increased by 9.2 percent y-o-y.

3.6.2. Producer prices[47]

In the first quarter of 2010 all branches of the economy have reported rise in price indexes, and the GDP deflator reached 110.2 as a result, outstripping the previous year's respective indicator by 8.1 pp.

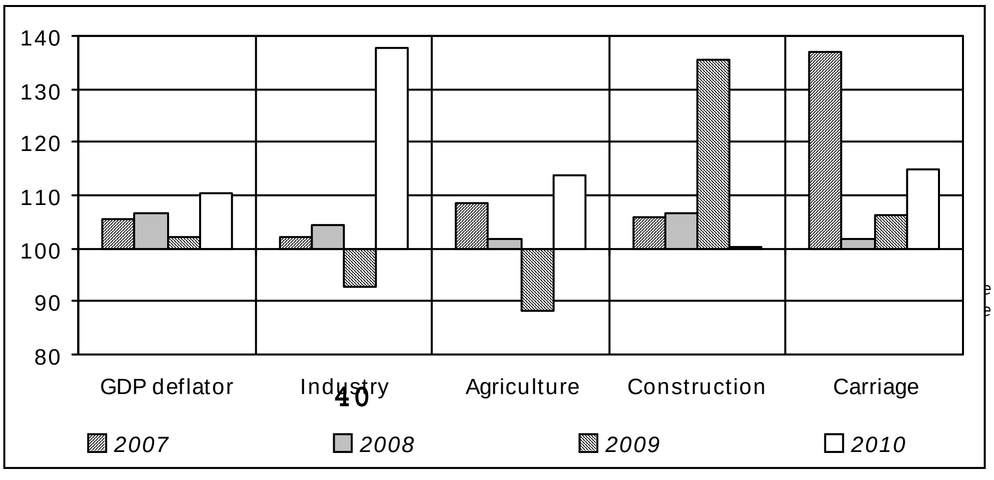
The largest price increase of 37.7 percent has been reported with regard to *producer price index* which was driven by growths recorded in *mineral production* (96.4 percent y-o-y), *electricity, gas and water production and supply* (24.7 percent y-o-y), and *processing industry* (28.8 percent y-o-y). The increase of producer price index in mineral production has been attributable to high prices of nonferrous metals which world markets recorded during the quarter.

In the first quarter **Agriculture** reported price increases, too, (13.6 percent y-o-y), determined by 17.4 percent growth of prices in animal growing. Items "Meat products" and "Milk and dairy products" have reported notable increases on purveyor prices, by 23.8 percent and 3.9 percent, respectively.

Price increases in **Capital Construction** have been merely 0.1 percent which was driven by some revival in the construction sub-branch.

Carriage costs have increased by 15 percent y-o-y owing to the rise in *railway carriage costs* (5 percent y-o-y), *air transportation costs* (23.4 percent y-o-y), *truck transportation costs* (7.9 percent y-o-y), and pipeline transportation costs (19.5 percent y-o-y, since gas tariffs have risen, effective April 1 2009 to USD 154 from USD 110).

In the first quarter the highest price index was recorded in industry and the lowest, in construction



3.7. Inflation expectations

The Central Bank has surveyed inflation expectations of financial organizations, households, and non-financial organizations of real sector for the first quarter of 2010. This was done when the 12-month inflation has been so high, along with intensive inflation environment and expectations, explained by baseline effect of unusually low inflation recorded for the same period of the previous year.

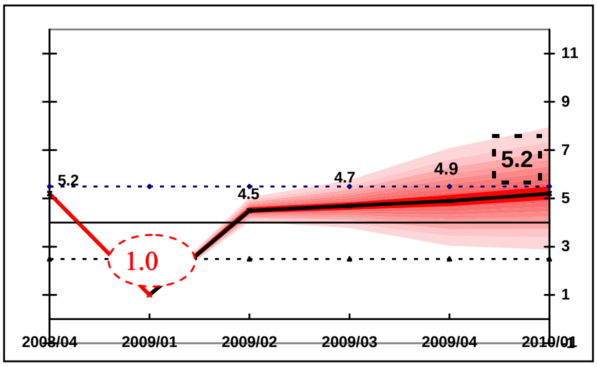
Therefore, it comes as no surprise that inflation expectations in the financial sector for the upcoming 12-month horizon are set mainly upside compared to the results of previous quarter's survey. Banks and credit organizations pointed primarily to the range of 5.5-8.5 percent for the 12-month inflation. This means that the financial sector is more expectant of high inflationary environment, which outstrips the target band set by the Central Bank. However, in consideration of the trends that inflation would be subsiding at some later point during the year once baseline effect is knocked down and monetary conditions are tightened by the Central Bank, the financial sector is likely to adjust its inflation expectations downside.

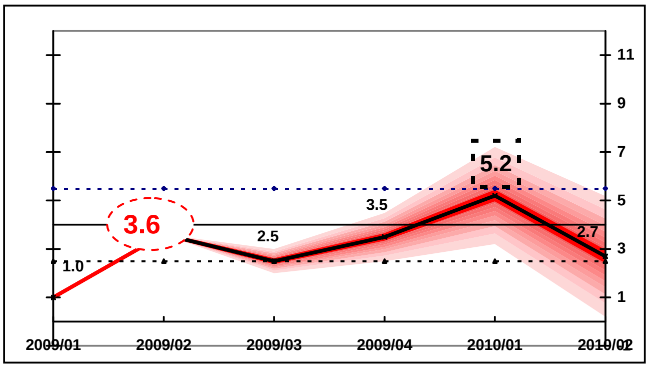
Expectations of households and non-financial organizations of real sector concerning future prices of food products are set to upside growth, too. Based on the results of the first quarter's survey, 69.5 percent of respondents expect high inflation versus 35.0 percent and 59.4 percent in the previous two quarters, while 28 percent expect a stable level of prices compared to 59.7 and 36.9 percent in the previous quarters.

Based on the results of survey, banks and credit organizations expect mostly stable market interest rates for the upcoming one-year horizon. Some banks however expect slight growth of interest rates of dram funds attracted and allocated, while expectation for interest rates of foreign currency funds attracted and allocated are somewhat downside.

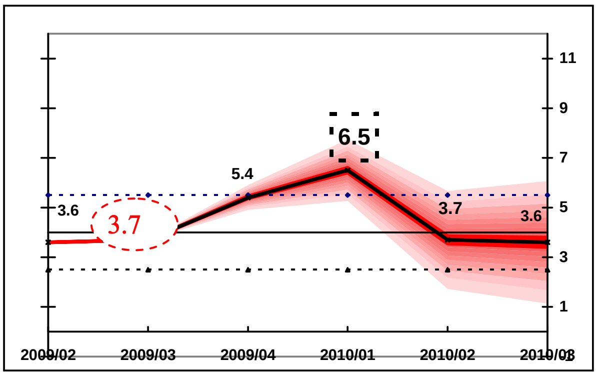
Appendix 1: Inflation forecasts made from April 2009 to January 2010 for Q1, 2010

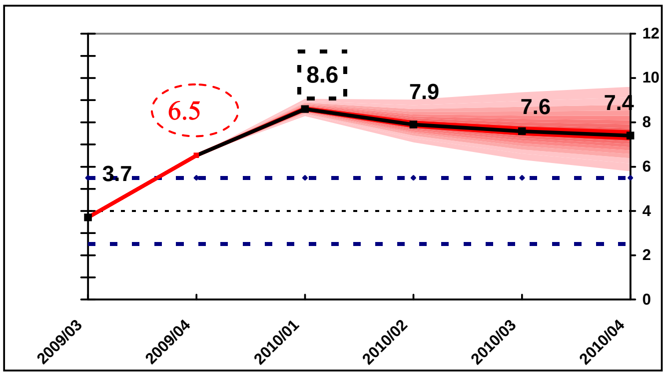
Inflation forecast in April 2009 Inflation forecast in July 2009





Inflation forecast in October 2009 Inflation forecast in January 2010





- actual inflation at the time of forecast

- inflation forecast for Q1, 2010