

**CENTRAL BANK OF
THE REPUBLIC OF ARMENIA**

*Approved under
Central Bank Board Decision No. 136A,
dated 28.08.2020*

**STATUS REPORT ON IMPLEMENTATION OF THE
MONETARY POLICY PROGRAM
(Q3, 2019 - Q2, 2020)**

During the year preceding the third quarter of 2020, the inflationary environment remained low in Armenia. It was mainly attributable to both weak demand and supply factors. Thus, in the second half of 2019, the Government carried out more-than-expected contractionary fiscal policy and the deflationary effects were transmitted from the outside world, which was partially mitigated by a relatively high growth in private consumption. The low inflationary environment in the second half of the year was also driven by influences from a change in competition in certain commodity markets and a structural shift in demand from non-durable consumer goods market to durable consumer goods market. The outbreak of the New coronavirus pandemic in early 2020 and its rapid spread around the world has raised an unprecedented wave of weakening aggregate demand and deflationary patterns. In the meantime, to contain deflationary pressures and make the inflation to approach the target in the 3-year forecast horizon, the Central Bank has increased the amount of stimulus of the monetary policy by reducing the refinancing rate by 1.25 pp, of which 0.75 pp alone in the second quarter of 2020.

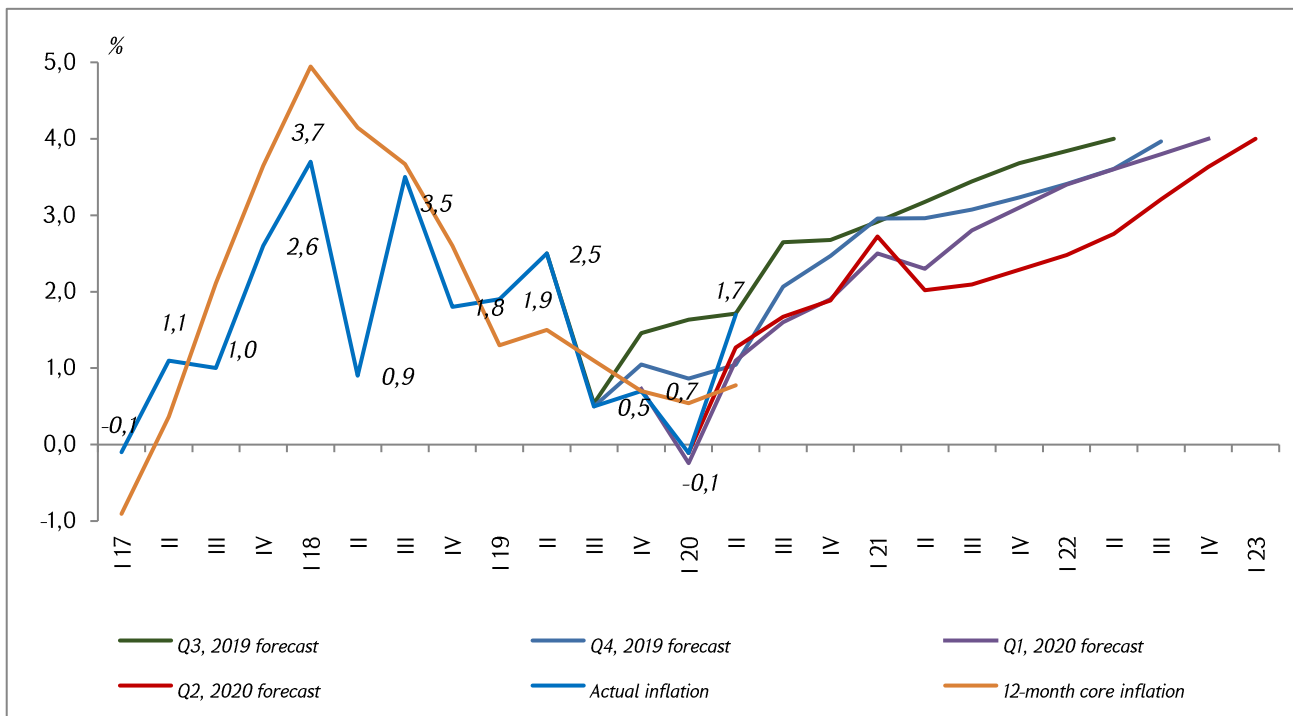
1. MONETARY POLICY IN THE PERIOD UNDER REVIEW

According to the monetary policy program for the third quarter of 2019, for the reporting period the inflationary environment was forecast to be low in anticipation of a weak aggregate demand. The latter, in turn, would be affected by the contractionary fiscal policy to be implemented and the influences transmitted from a low inflationary environment persisted in the outside world. Under these conditions, the Central Bank would continue to pursue a stimulative monetary policy, giving preference to gradual recovery of inflation. With such a policy, the 12-month inflation rate would still be kept low in the short term, and had to approach and stabilize around the 4% target in the medium term.

Driven by deflationary patterns in the reporting period, the inflationary environment proved to be lower than expected, and the 12-month inflation had a downside deviation from the projection path. The deviation was due to both demand and supply factors observable for that period. Thus, the Government's fiscal policy in the second half of 2019 was more contractionary than expected. However, domestic demand in that period grew faster than predicted due to higher growth in private consumption, which in turn was determined by a relatively large increase in consumer loans the financial system provided

to the economy under the stimulative monetary policy. In the second half of 2019, certain supply-side factors that contained the inflation included the impact of low prices in the outside world transmitted onto domestic prices, the increased effectiveness of the use of resources in the non-tradable sector of the economy, and the increasingly competitive commodity markets, which alters the firms' pricing behavior and reduces their markups. Based on this, the Central Bank has revised the quarterly inflation forecasts and the path to recovery.

According to the Central Bank forecasts, a low inflationary environment will persist in the short term and will expand in the medium term, and at the end of the forecast horizon the 12-month inflation will stabilize around the target value



The inflationary developments in the first half of 2020 took place predominantly under the influence of the outbreak of New coronavirus (COVID-19) in a number of countries around the world since the start of the year. Spreading rapidly in Armenia and a great number of countries around the world in the first half of March, the pandemic was reflected first in the simultaneous reduction of aggregate supply and demand, which did not have a significant impact on current inflation developments. In the second quarter, despite the stimulative fiscal policy implemented, under uncertainties caused by the pandemic, a weakening of domestic and external demand was observed, as a result of which the inflationary environment remained low.

In the reporting period, taking into account the low inflationary environment and persistent weak aggregate demand, the Central Bank conducted a stimulative monetary

policy and continued to prioritize the gradual recovery of inflation, since, according to the Central Bank estimation, a low inflation in the current macroeconomic situation was contributing to the anchoring long-term inflation expectations and enhancing public confidence in the monetary policy pursued by the Central Bank. In the course of a one-year period under review, the Central Bank has cut the refinancing rate by a total 1.25 pp, of which 1 percentage point lowered in anticipation of a slow recovery of external and domestic demand under high uncertainty caused by the spread of the pandemic.

At the same time, reacting to the significant increase in demand for dram liquidity, hence a certain rise in interest rates in the government bond market, the Central Bank has, through its main tool, injected a required amount of liquidity into the system, helping short-term interest rates shape around the policy rate of the Central Bank. In the reporting period, the Central Bank repeatedly signaled the financial market that, in view of predicted macroeconomic developments, the monetary conditions will be kept expansionary for as long a period of time as necessary, to fulfil the inflation target in the medium term.

2. INFLATION IN THE PERIOD UNDER REVIEW

In the year following the third quarter of 2019, 12-month inflation remained low and demonstrated certain volatility primarily attributable to agricultural product price changes. Thus, a fall in seasonal food prices in the second half of 2019 and early in 2020 has generally contributed to the inflation negatively, pushing it down to -0.1% y/y in March. In the second quarter of 2020, inflation recovered to a certain extent, which is again a result of the rise in prices of seasonal agricultural products, especially fruits. In the meantime, the 12-month core inflation rate has dropped slightly, to around 0.8% as of June 2020, whereas the rise in regulated service tariffs and seasonal food product prices has been 1.5% and 7.9% y/y, respectively. The price change in seasonal food products was attributable to an increase in prices of items “Vegetables” (4.6%, y/y) and “Fruits” (14.2%, y/y), and as much as 19.2% y/y decrease in prices of item “Eggs”. The core inflation was driven by prices of items “Bread and cereals”, “Alcoholic beverage” and “Tobacco”, having increased, respectively, by 3.49%, 11.98% and 8.78% y/y, by tariffs of items “Outpatient care services”, “Hospital services” and “Education services”, having risen, respectively, by 2.87%, 1.8% and 3.57% y/y, and by prices of items “Meat”, “Sugar” and “Fuel”, having decreased, respectively, by 3.35%, 5.25% and 5.59% y/y. The rise in prices of “Tobacco” and “Alcoholic beverage” continues incurring the inflationary impact of a change in excise duty rates at the beginning of the year. It should be noted that the inflationary impact of a change in customs rates on some goods in the beginning of 2020, as was estimated, amounted to about 0.2 pp.

Table 1

Designation	Weight	12-month inflation	Contribution to y/y inflation
Core inflation	72.7	0.78	0.57
Bread and cereals	7.73	3.49	0.27
Meat	9.58	-3.35	-0.32
Oils and fats	2.37	-0.31	-0.01
Sugar	0.53	-5.25	-0.03
Alcoholic beverage	2.79	11.98	0.33
Tobacco	1.39	8.78	0.12
Clothing	2.45	1.38	0.03
Footwear	1.32	3.12	0.04
Medicines and health products	4.62	1.32	0.06
Fuel	5.29	-5.59	-0.3
Air passenger transportation services	0.48	-13.66	-0.07
Education	3.14	3.57	0.11
Hospital services	2.66	1.80	0.05
Outpatient care services	2.37	2.87	0.07
Seasonal food products	11.47	7.90	0.91
Eggs	1.15	-19.19	-0.22
Fruits	4.19	14.19	0.59
Vegetables	6.13	4.63	0.28
Regulated services	15.88	1.51	0.24