THE CENTRAL BANK OF THE REPUBLIC OF ARMENIA

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on 24.05.2011

STATUS REPORT ON IMPLEMENTATION OF THE MONETARY POLICY PROGRAM

(Inflation Report)

Q1, 2011

YEREVAN
2011

Table of Contents

1. SUMMARY

ACTUAL INDICATORS AND DEVELOPMENTS IN Q1, 2011

High inflationary environment in the first quarter of 2011 further depended on an increase of international prices of main food products and raw materials, persistently high prices of agricultural products due to the reported unprecedented downfall in agriculture in the previous year, the second round effects and high inflation expectations in the face of supply shocks. As well as main inflation risks as outlined in the previous monetary policy program showed up during the first quarter. In particular, inflationary pressures intensified in world markets of raw materials and food products, making the inflationary environment to somehow broaden. The domestic demand slowly recovering has not created additional inflationary pressures yet.

At the end of the first quarter of 2011 the 12-month inflation was 11.5 percent. Price increases of food products made as much as 8.3 pp contribution to headline inflation, of which 5.4 pp fuelled by agro-product price rise and about 2.7 pp by import food products. Price increases in non-food products and service tariffs made, respectively, 0.6 pp and 2.6 pp contribution to the 12-month inflation.

In the first quarter economic activity slowed down, according to the economic activity indicator (EAI)[1] released by the National Statistics Service of the Republic of Armenia in early 2011, mostly attributable to the February and March EAI having remained unchanged relative to the same period of the previous year. The Central Bank estimations based on the first quarter EAI trends suggest that real GDP growth of the first quarter of 2011 was 2.7 percent, which is determined by added production volumes in industry and services.

In the first quarter the average quarterly unemployment rate reduced, reflecting the growing demand for labor. The growth of average nominal wages in 2010 slightly outpaced the growth of labor productivity, pushing unit labor costs to increase to some extent. As a result, the estimation is that minor inflationary pressures in the economy are observed.

In the first quarter private sector expenditures grew by around 4 percent relative to the previous year. Public expenditures in real terms reduced by nearly 10 percent, while domestic demand increased by 2 percent relative to the same period of the previous year. Private consumption grew by around 4 percent and private investment by 5 percent relative to the previous year.

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

In the first quarter the fiscal impulse had 2.1 pp restrictive impact on aggregate demand, hence inflation, instead of the projected neutral. As well as taking into account lagged influence of the expansionary fiscal policy transmitted from the fourth quarter of 2010, the impact of the Q1 2011 fiscal policy on inflation has been neutral, according to the Central Bank estimations.

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[1] *EAI, unlike the GDP indicator, is calculated based on the volumes of non-value added in outputs of different economic activity segments and does not include net taxes on manufacture and services of financial intermediation that are measured indirectly. More information on this indicator can be found in the press release on "Moving to the Discrete (Net Monthly) Method from the Cumulative Method for Compilation, Survey and Publication of Current Macroeconomic Indicators for a Year", which the National Statistics Service of the Republic of Armenia published in 2011.*

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

On the background of developments in global and domestic economies in the first quarter of 2011 current account was adjusted upside relative to the same quarter of the previous year. The real and value growth of export of goods exceeded expectations thanks to positive developments sustained in industry as well as an increase in international metals prices. Estimations show that real volumes of import of goods reduced substantially in the first quarter since growth rates in import prices speeded up amidst budget constraints of economic agents. At the same time, high growth of transfers was observed in light of world economic growth. In the outcome, current account deficit has reduced by USD 71.1 million y-o-y and amounted to USD 307.3 million.

The above-mentioned trends determined the attainment of the inflation target and monetary policy directions for the first quarter. Though inflationary environment remained affected mainly by supply-side factors while recovering domestic demand and labor market developments would further create moderate inflationary pressures, the Central Bank embarked on tightening of monetary conditions, seeking to absorb second round effects and have inflation expectations anchored. Starting from February, the Board of the Central Bank has two times raised the refinancing rate, by 0.5 pp each time, to set it at the level of 8.25 percent.

The first quarter of 2011 was prominent in reported divergence with regard to growth rates in foreign currency deposits and lending to economy as they speeded up expectations. Thus, during the quarter foreign currency deposits grew by 7.2 percent and lending to economy by 8.1 percent, as opposed to the projected 1.7 percent and 1.4 percent growth, respectively.

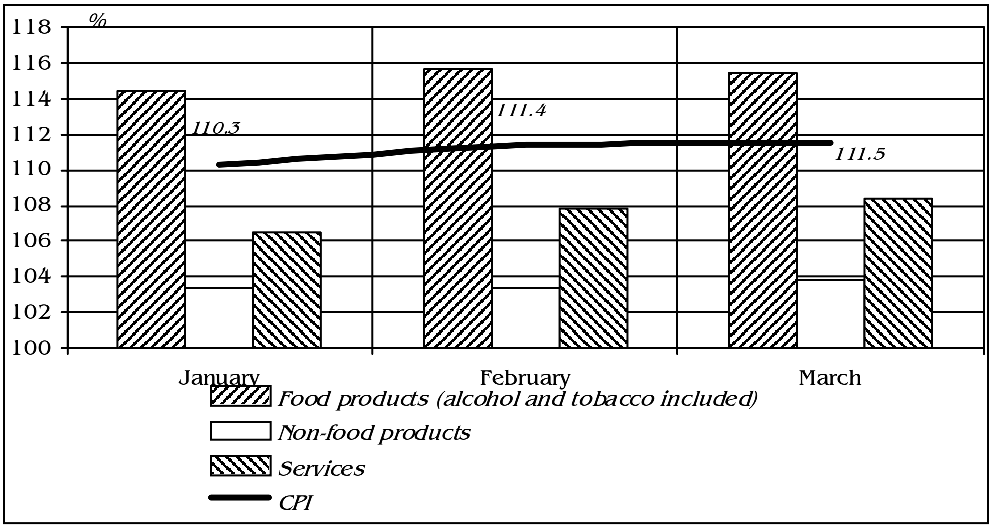
2. INFLATION DEVELOPMENTS

2.1. INFLATION BY GOODS AND SERVICES; CORE INFLATION

In Mach 2011, relative to Mach 2010, inflation was 11.5 percent. Prices rose as follows: food products (alcohol and tobacco included) – 15.5 percent; non-food products – 3.8 percent; and service tariffs – 8.4 percent, all having contributed to inflation by 8.3, 0.6 and 2.6 pp, respectively.

Contribution to inflation, pp	Commodity groups	Price change, %
	Food products	
1.9	Bread products	18.0
1.8	Vegetable and potato	28.6
1.5	Fruit	41.0
1.0	Meat products	9.7
0.9	Dairy products	21.3
0.5	Fats and oils	15.8
0.2	Coffee, tea, cocoa	5.8
0.2	Egg	13.2
0.1	Confectionery	5.8
	Non-food products	
0.3	Personal car and fuel	11.5
0.1	Garment and knitwear	3.4
	Services	
2.0	Residential and public utilities	15.4
0.4	Medical services	11.6
0.2	Transport services	5.1
0.1	Public catering	5.6
-0.1	Communications services	-1.2

CPI in Q1 2011 based on the 12-month results, by main commodities and services



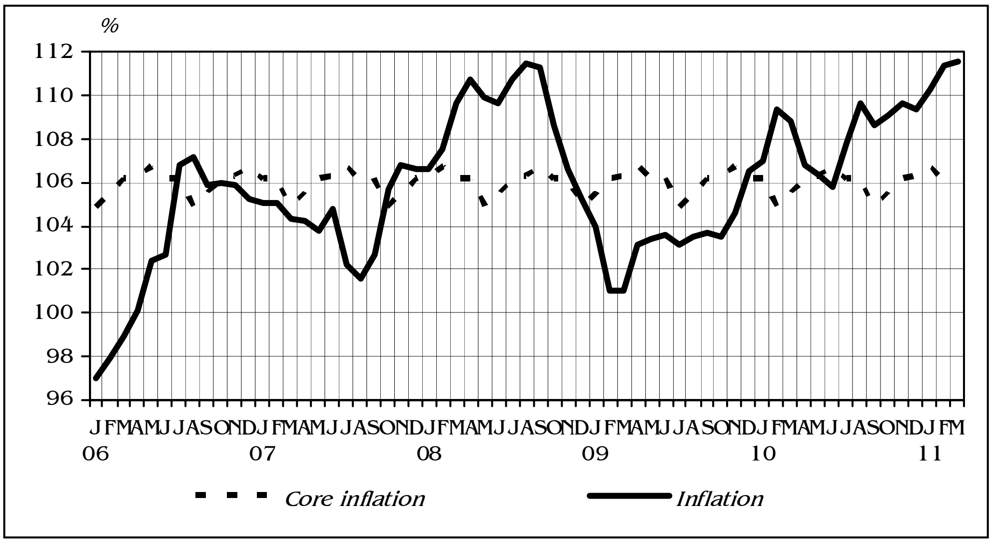
In the first quarter inflation was 5.2 percent compared to the end of the previous quarter. Prices of food products (alcohol and tobacco included) rose by 7.9 percent (with 4.2 pp contribution to inflation), non-food prices by 0.9 percent (with 0.2 pp contribution to inflation), and service tariffs by 2.5 percent (with 0.8 pp contribution to inflation).

In the period January-March of 2011, relative to January-March of 2010, inflation has been 11.1 percent (it was 8.4 percent and 2.0 percent in 2010 and 2009, respectively). This figure of 11.1 percent was due to

15.2 percent price increase of food products, 3.5 percent price increase of non-food products and 7.6 percent rise in service tariffs, all having contributed to headline inflation by 8.2 pp, 0.6 pp and 2.3 pp, respectively.

The 12-month core inflation in the first quarter of 2011 was 6.2 percent. The largest contribution to it came from such items as "beef" (contribution – 0.9 pp), "homemade cheese from cow milk" (0.7 pp), "surgery services at hospitals" (0.4 pp), "chanakh cheese" (0.3 pp), "egg" (0.3 pp), "butter" (0.3 pp), and "air transport fare" (0.3 pp), and some other types of services[2].

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



Statistical review of inflation fluctuations

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

Calculations show that in the period from April 2008 to March 2011 the influence of seasonality component on CPI has been 68.05 percent; the influence of irregularity component, 22.86 percent; and the influence of trend component, 9.09 percent. In comparison with the period from April 2007 to March 2010, influence of seasonality component and irregularity component has decreased by 6.2 percent and 2.7 percent, respectively, whereas influence of trend component has increased by 8.9 pp.

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

- the impact of seasonality component on **price index of food products** was as much as 67.73 percent, although this component's impact had decreased by 14.0 percent compared to the period from April 2007 to March 2010; in the meantime influence of trend component has increased by 14.3 percent;

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

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

- the irregularity component had a substantial impact, 60.95 percent, on **price index of non-food products**, in the period between April 2008 and March 2011; this component's impact had decreased by 2.0 percent compared to the period from April 2007 to March 2010 while impact of seasonality component had increased by 4.6 percent and made up 39.05 percent;
- the seasonality component had 57.63 percent impact on **service tariffs**; the irregularity component's impact was 33.36 percent. Relative to the period between April 2007 and March 2010, the seasonality component's impact had increased by 18.6 percent while the irregularity component's decreased by 12.3 percent.

For the time period from April 2008 to March 2011, the **seasonality component** had the strongest impact on such items as "education services" (88.9 percent), "fruit" (80.7 percent), "vegetable and potato" (72.6 percent), "fats and oils" (59.2 percent) and "footwear" (55.9 percent); the **irregularity component** had the strongest impact on such items as "jewelry items" (78.3 percent), "kitchen utensils" (78.2 percent), "services in culture" (76.5 percent), "meat products" (74.5 percent), "beauty and apparel" (74.5 percent), "public catering" (74.0 percent), "Textiles" (74.0 percent) and "legal and banking services" (72.1 percent); the **trend component**'s impact has been relatively strong on such items as "fuel" (17.5 percent), "other products" (15.4 percent), "non-alcoholic beverage" (12.7 percent), "dairy products" (9.5 percent), "gardening items" (8.2 percent) and "communication services" (7.2 percent).

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

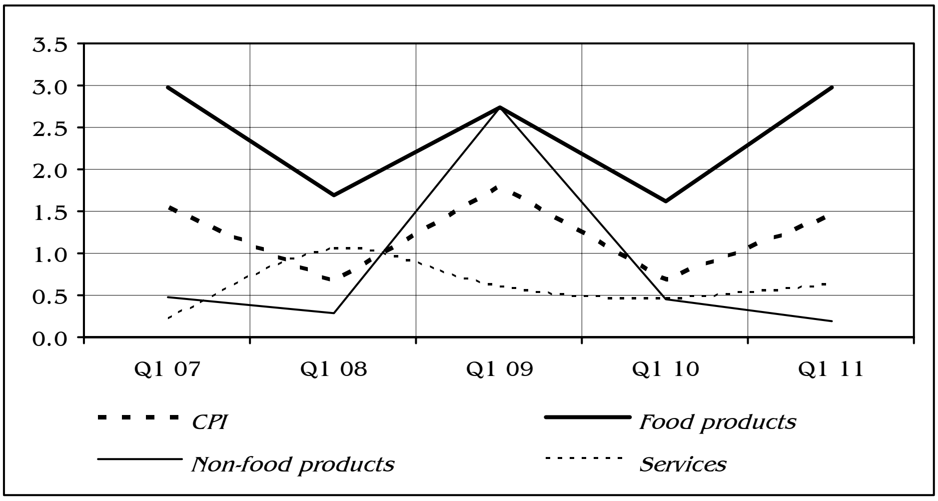
Item	Trend	Seasonality	Irregularity	Total
CPI (relative to previous month)	**9.09**	**68.05**	**22.86**	**100.0**
Food products (alcohol and tobacco included)	**14.30**	**67.73**	**17.97**	**100.0**
Bread products	4.5	37.9	57.6	100.0
Meat products	1.6	23.9	74.5	100.0
Fish products	0.8	35.5	63.6	100.0
Dairy products	9.5	36.6	53.9	100.0
Egg	5.2	50.9	43.9	100.0
Fats and oils	1.0	59.2	39.8	100.0
Fruit	2.8	80.7	16.5	100.0
Vegetable and potato	7.0	72.6	20.4	100.0
Sugar	0.1	51.1	48.8	100.0
Coffee, tea, cocoa	5.4	51.5	43.1	100.0
Confectionery	3.8	37.6	58.6	100.0
Other products	15.4	22.7	62.0	100.0
Non-alcoholic beverage	12.7	25.2	62.1	100.0
Alcohol and tobacco	0.0	45.8	54.2	100.0
Non-food products	**0.00**	**39.05**	**60.95**	**100.0**
Garment and knitwear	0.5	40.2	59.3	100.0
Footwear	1.1	55.9	43.0	100.0
Fuel	17.5	38.6	43.9	100.0
Furniture	4.9	41.2	54.0	100.0
Carpets	0.4	44.1	55.5	100.0
Textiles	5.3	20.7	74.0	100.0
Home appliances	2.3	26.0	71.7	100.0
Kitchen utensils	5.5	16.3	78.2	100.0
Detergents	6.7	38.5	54.7	100.0
Building materials	3.6	39.9	56.4	100.0
Items of gardening	8.2	50.1	41.8	100.0
Medicament	2.0	26.6	71.4	100.0

Personal cars and fuel	0.9	36.4	62.7	100.0
Items of culture	3.9	54.2	41.9	100.0
Stationery	0.8	29.0	70.2	100.0
Beauty and apparel	1.5	24.0	74.5	100.0
Items of jewelry	0.2	21.5	78.3	100.0
Items of personal use	4.1	32.1	63.7	100.0
Services	**9.01**	**57.63**	**33.36**	**100.0**
Household services	0.1	34.2	65.7	100.0
Other services for household	0.1	34.5	65.4	100.0
Residential and public utility services	1.6	49.9	48.5	100.0
Healthcare services	0.0	32.0	68.0	100.0
Transport services	0.0	38.2	61.8	100.0
Communications services	7.2	31.0	61.8	100.0
Culture services	0.9	22.6	76.5	100.0
Educational services	0.0	88.9	11.0	100.0
Leisure and rest services	2.2	44.0	53.8	100.0
Public catering	2.1	23.9	74.0	100.0
Legal and banking services	2.2	25.7	72.1	100.0

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

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

CPI, food, non-food products and services price index variation coefficients in fourth quarters, 2006 - 2010



The table below shows that in Q1 2011, relative to Q1 2010, the CPI variation coefficient has grown to 1.5 percent from 0.7 percent. The food product price and services tariff index variation coefficients have also grown to 3.0 percent and 0.6 percent from 1.6 percent and 0.5 percent, respectively. The non-food product price index variation coefficient has fallen to 0.2 percent from 0.5 percent.

In the first quarter the highest volatility was reported for items "fruit" (14.8 percent versus 5.9 percent in Q1 2010), "vegetable and potato" (12.7 percent versus 14.7 percent in Q1 2010), "egg" (9.4 percent versus 1.7 percent in Q1 2010) and "items of culture" (5.5 percent versus 3.2 percent in Q1 2010).

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

Item	Q1 07	Q1 08	Q1 09	Q1 10	Q1 11
CPI (relative to previous month)	**1.6**	**0.7**	**1.8**	**0.7**	**1.5**
Food products (alcohol and tobacco included)	**3.0**	**1.7**	**2.7**	**1.6**	**3.0**
Bread products	0.1	3.7	2.7	0.2	1.4
Meat products	0.6	0.4	1.0	1.4	2.1
Fish products	6.7	14.9	12.1	3.9	1.1
Dairy products	0.5	0.4	0.1	0.3	0.2
Egg	3.0	2.3	2.1	1.7	9.4
Fats and oils	0.3	4.2	6.5	0.9	0.6
Fruit	9.7	5.7	10.9	5.9	14.8
Vegetable and potato	17.7	17.6	19.4	14.7	12.7
Sugar	1.3	1.4	7.1	3.2	1.1
Coffee, tea, cocoa	0.3	3.2	1.1	0.7	1.1
Confectionery	0.1	0.0	0.2	0.7	0.1
Other products	0.0	0.2	0.5	1.1	0.1
Non-alcoholic beverage	0.1	0.4	0.2	1.1	0.1
Alcohol and tobacco	0.0	0.2	0.4	0.1	0.0
Non-food products	**0.5**	**0.3**	**2.7**	**0.5**	**0.2**
Garment and knitwear	0.2	0.2	0.1	0.3	0.9
Footwear	0.3	0.1	2.0	2.2	1.7
Fuel	0.4	5.8	1.1	1.2	0.3
Furniture	0.1	0.1	0.9	0.5	0.1
Carpets	0.0	1.2	0.1	1.8	2.4
Textiles	1.3	0.7	0.2	0.1	0.6
Home appliances	0.3	0.1	2.3	1.1	0.2
Kitchen utensils	0.3	0.4	1.6	1.5	0.1
Detergents	0.2	1.0	3.1	0.4	0.2
Building materials	0.1	0.7	0.8	0.1	0.1
Items of gardening	0.1	0.1	0.9	0.4	0.1
Medicament	0.2	0.2	4.0	0.1	0.7
Personal cars and fuel	3.0	0.5	8.4	2.7	0.2
Items of culture	2.7	1.5	5.8	3.2	5.5
Stationery	0.2	0.9	0.1	1.4	0.1
Beauty and apparel	0.1	1.5	2.5	0.7	0.0
Items of jewelry	0.4	1.0	10.5	5.1	1.2
Items of personal use	0.1	0.8	0.4	0.0	0.2
Services	**0.2**	**1.0**	**0.6**	**0.5**	**0.6**
Household services	0.5	0.1	0.5	5.6	0.3
Other services for household	0.6	0.2	0.5	6.7	0.3
Residential and public utility services	1.1	0.0	0.2	0.1	0.0
Healthcare services	1.1	3.2	0.7	0.9	2.8
Transport services	0.7	0.4	2.7	0.8	2.3
Communications services	0.0	0.6	0.2	0.0	0.2
Culture services	3.6	2.6	1.8	2.2	0.6
Educational services	0.0	0.1	0.0	0.0	0.1
Leisure and rest services	0.2	0.3	0.2	2.4	2.0
Public catering	0.1	0.5	0.3	0.6	1.1
Legal and banking services	0.0	8.0	0.0	0.0	0.1

2.2. FULFILLMENT OF INFLATION TARGET

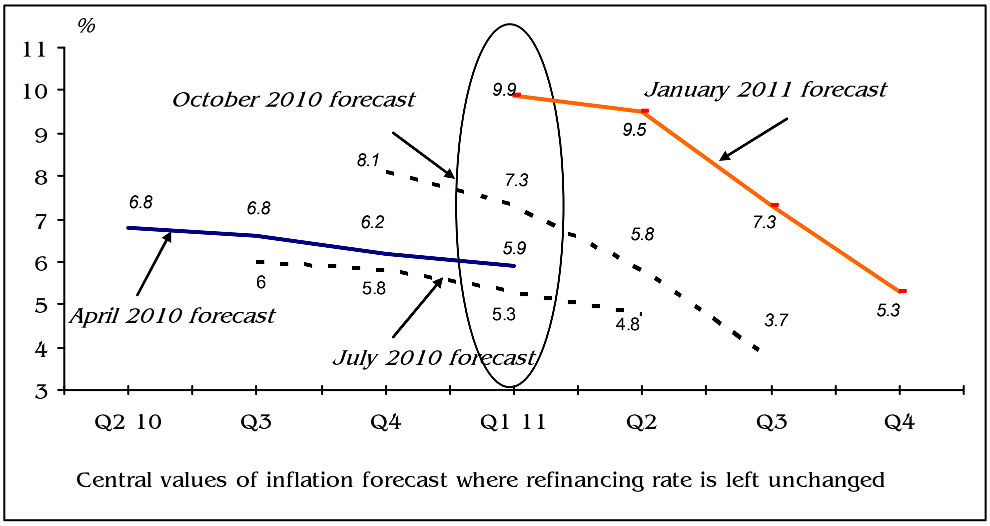
The early 2011 was characterized by high inflation environment which was generated since the second half of the previous year and expanded further. Though inflation was mostly supply shock-driven (price increases in wheat and some food markets and risen prices of agricultural products due to reduced supply in agriculture), second round effects and inflationary expectations showed up as well. External and internal macroeconomic developments projected for the upcoming one-year horizon and expected influence from monetary policy point out that inflationary pressures will loosen starting the second half of 2011 and the 12-month inflation will be closer to the upper border of the band at the end of the year.

The inflationary environment and monetary policy directions in the preceding 12-month period demonstrated the following main developments.

Tasked to eliminate an accelerating potential of inflation and to bring inflation back to the target, the Central Bank had changed, since the beginning of 2010, the direction of monetary policy by tightening monetary conditions. Thus, in order to minimize deviation of inflation from the target, the Central Bank had raised the refinancing rate a total 2.25 pp over the first five months of the year while sharply restricting quantitative easing. At the same time, the Government and the Central Bank further took macro-prudential measures. Concurrently, the Government took an action to restrain inflation by fiscal policy consolidation. In the outcome, the Central Bank succeeded in lowering the 12-month inflation to 5.8 percent at the end of the second quarter from the February peak of 9.4 percent.

Based on the above mentioned semi-annual developments with inflation, in April and July the Central Bank's forecast of the 12-month inflation for the first half of 2011 was relatively low, at 5.9 percent and 5.3 percent levels, respectively.

The 12-month inflation indicator forecast



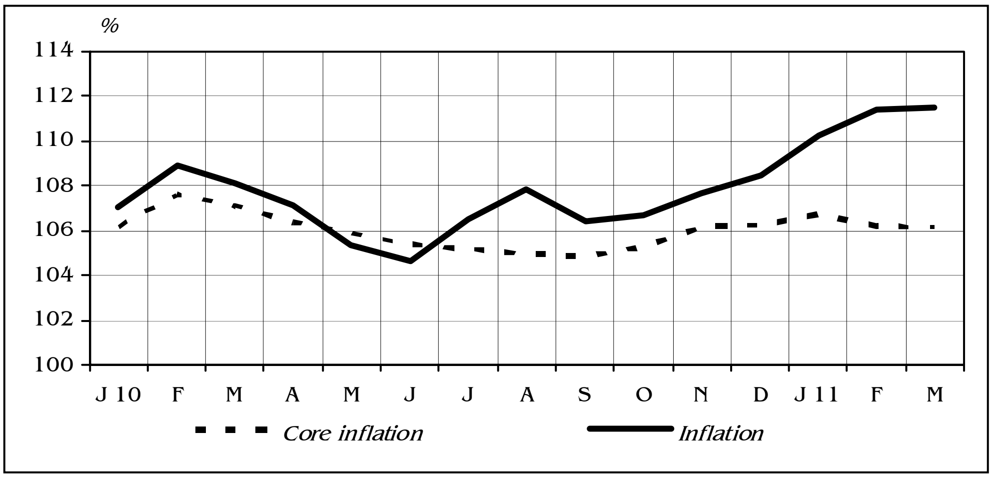
Central values of inflation forecast where refinancing rate is left unchanged

In fact, the influence of factors to ease inflation was expected to carry on over the next quarters as well, under which circumstance a diminishing behavior of inflation would be persisting. What happened in the second six months, however, was the surge of the 12-month inflation affected mostly by supply shocks, i.e. global price increases on food products and domestic agricultural products. In addition, second round effects and inflation expectations showed up at the end of the year in the face of high inflationary environment, which pushed the rate of domestic inflation to accelerate. As a result, 0.2 percent inflation was recorded in the third quarter which is a deflationary period as a rule (since in the last five years the respective deflation indicator has been an average 3.0 percent), while 4.4 percent inflation recorded in the fourth quarter (in the last five years the respective indicator has been an average 3.4 percent).

Under such a high inflationary environment, the Central Bank forecasts made in October 2010 and January 2011 for the first quarter of 2011 were revised upside, to an estimated 7.3 percent and 9.9 percent, respectively. Also, taking into account the impact of supply shock gradually faded off during the year and completely eliminated in the second half as well as the lagged impact of tightened monetary conditions in the first six months of the year, the forecasts however hold the fastest declining trajectory for a one-year horizon, when compared with projections of previous quarters, coming closer to the midpoint of the band at the end of the forecast horizon. Such a high forecast was grounded on the World Bank Food Index having risen to 14 percent y-o-y in September from 5.5 percent y-o-y in August. Yet, until end-December, the WB Food Index had jumped farther, to 25.3 percent y-o-y and to around 35.0 percent in end-March of 2011.

In reality, driven by high price increases of import food products and those of domestic manufacture, the impact of supply shocks caused all forecasts to be exceeded. As a result, 5.2 percent inflation was recorded in the first quarter of 2011, and the 12-month inflation reached 11.5 percent, outgrowing the upper border of the band by 6 pp. Price increases of food products made as much as 8.3 pp contribution to the reported high inflation (5.4 pp driven by price increases of local agro-products and 2.7 pp by price increases of import food products). This was conditioned by both sustained impact of supply shock shown up since the previous year and second round effects of high inflation and inflation expectations. These factors contributed to the creation of a high level of 12-month core inflation, bringing it to 6.2 percent at the end of March.

The 12-month core inflation and headline inflation dynamics



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

From the start of 2011 the Central Bank has gradually tightened the monetary conditions, by raising the refinancing rate by 1.0 pp during the first quarter. This and clear impulses about further change of monetary conditions provide real preconditions for scaling down high inflation and bringing it back to the band possibly at the end of 2011.

3. INFLATION FACTORS

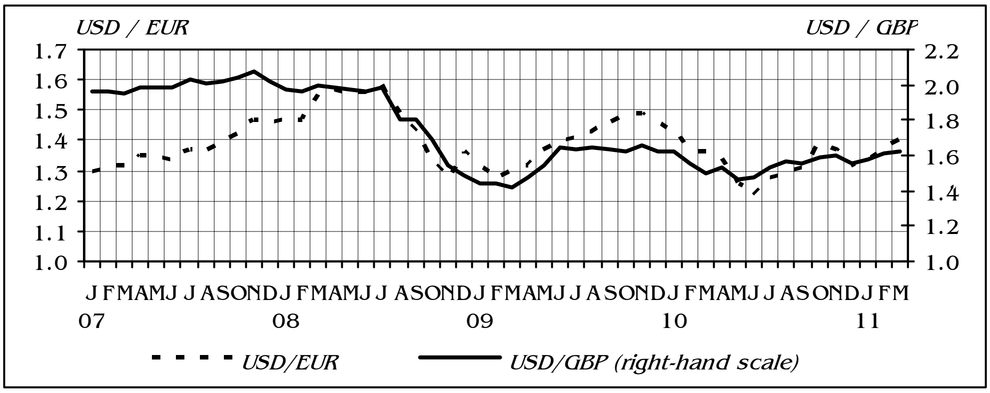
3.1. EXTERNAL ENVIRONMENT

In the first quarter of 2011 world output growth continued decelerating to around 4.2 percent compared to 5.0 percent recorded in the previous year, according to the IMF estimations. So, based on the IMF forecasts made in April 2011, world output growth in 2011 is expected to slow down to 4.4 percent (unchanged relative to the January forecasts). The IMF estimations showed that in 2010 inflation was 6.2 percent in emerging countries and 1.6 percent in developed economies. Inflation in CIS and Georgia reached an average weighted 8.9 percent. World inflation forecasts for 2011 were revised upside: in both developed and emerging countries the rate of inflation will speed up relative to the previous year to reach 2.2 percent and 6.9 percent, respectively. Generally, the world economy is in the territory of sustainable development, and the IMF estimates that existing risks have been reduced substantially yet they remain downside. This is mostly attributable to public balance issues in developed countries, huge capital inflow management issues in emerging countries and developments in world commodity markets and oil market in particular.

The first quarter was remarkable with large price volatilities and new records of price peaks in world commodity markets, determined by geopolitical developments in main oil exporting countries and the Japan disaster.

Driven by inflation expectations expanding farther in the USA and other developed countries amidst price increases of raw materials and food products as well as in the light of geopolitical developments, in the first quarter of 2011 USD versus EUR depreciated by around 0.6 percent q-o-q and reached 1.36 dollar for one euro (dollar's y-o-y appreciation has been 1.3 percent).

In Q1 2011 the US dollar depreciated

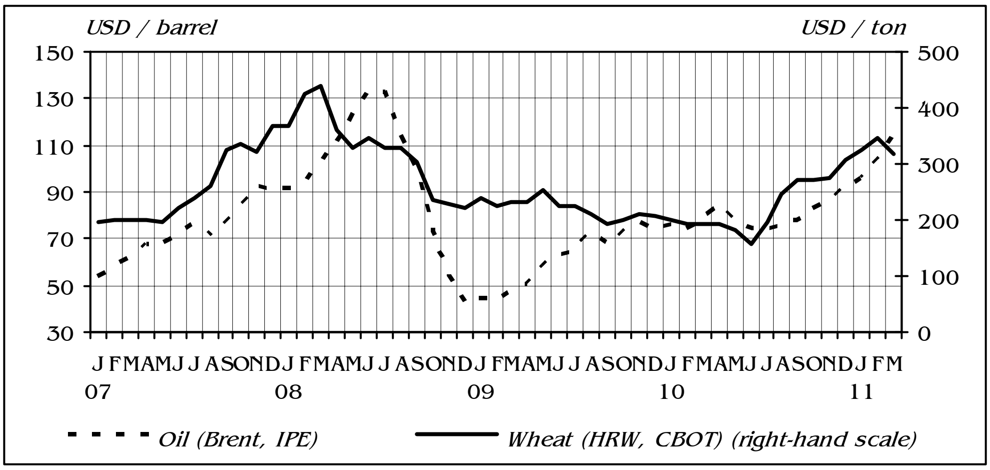


In the first quarter of 2011 international oil prices climbed by 20.9 percent q-o-q, with 'Brent' averaging around USD 104.9 a barrel (y-o-y growth was 36.8 percent). New peaks of prices of both base metals and precious metals were recorded. The copper price at the London Metal Exchange has risen by 11.6 percent q-o-q averaging around USD 9635 per ton (y-o-y growth was 33.2 percent). Average quarterly price of gold has increased by 1.4 percent against the previous quarter to reach USD 1386 per troy oz. (y-o-y growth was 25.0 percent).

International prices of wheat continued rising in the first quarter of 2011 despite some downward trends observed at the end of the quarter. Average quarterly wheat price at the Chicago Board of Trade made up around USD 9.0 a bushel, up by 16.6 percent against the previous quarter's average and up by 69.1 percent compared to the same quarter's average of the previous year. According to April estimates by the US Department of

Agriculture, in the 2010/2011 marketing year some 647 million tons of crops of wheat are expected against the previous year's 683 million. The world wheat demand is forecast to reach around 662 million tons, so the world stock of wheat is predicted to reduce, in relation to the previous year, to amount to 183 million tons.

In world commodity markets in Q1 2011 inflationary trends persisted



The price of rice has grown by 4.2 percent q-o-q and reached USD 14.7 per short hundredweight (45.4 kg), which exceeded the previous year's indicator by 7.1 percent.

The price of sugar has fallen by 2.6 percent q-o-q, with an average quarterly price of USD 34.7 per cent/pound, which is 35.6 percent higher from the first quarter's indicator of the previous year.

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

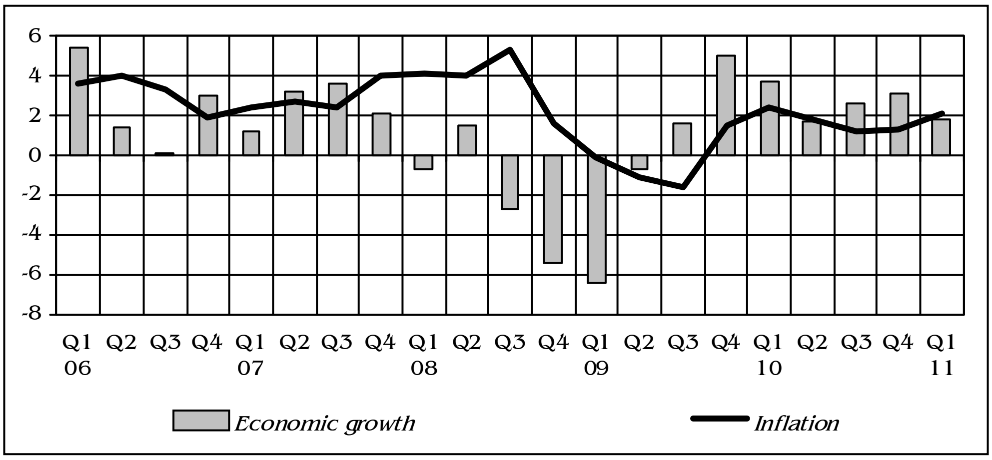
In the ***United States of America*** in the first quarter of 2011 economic growth rates again slowed down. Preliminary estimates by Economic Analyses Bureau of the US Department of Commerce show that in the first quarter the US economy posted an annualized 1.8 percent growth q-o-q against 3.1 percent growth recorded in the fourth quarter of 2010. The growth has been fuelled primarily by consumer spending (with 1.9 pp contribution) and gross private investment (with 1.0 pp contribution). However, net export and public sector contributions were -0.1 pp and -1.1 pp, respectively.

In the first quarter the deficit of net exports in GDP deteriorated noticeably, amounting to 3.8 percent compared to 3.3 percent recorded for the previous quarter. This indicator is considerably higher from the 3.3 percent value recorded for the same period of the previous year. Notwithstanding relatively a slow growth rate of import volumes, the deterioration was determined by a higher growth rate of import value amid import prices grown faster over export prices.

In the first quarter average quarterly inflation in the USA was 2.1 percent y-o-y (1.3 percent in the previous quarter). The inflationary environment was driven mainly by price increases on fuel, energy and food products.

In the first quarter the US Federal Reserve System maintained its prime lending rate in the corridor of 0 - 0.25 percent and carried out the QE2 exercise 2 while believing that global inflationary pressures on the US economy were contemporary.

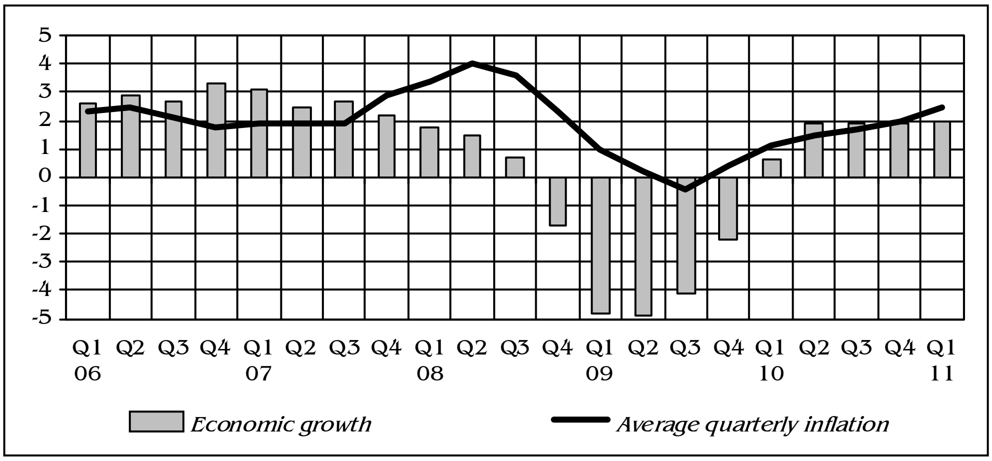
In the USA in Q1 2011 inflation intensified



According to preliminary estimates of the EuroStat, a 0.8 percent economic growth was posted in ***Euro-area*** in the first quarter of 2011. In the meantime, the y-o-y economic growth rates accelerated, making up 2.5 percent (against 0.3 percent and 2.0 percent q-o-q and y-o-y, respectively, in the previous quarter).

In the first quarter the consumer price index rose by an average 2.5 percent y-o-y against 2.0 percent inflation recorded in the previous quarter. Inflation was driven mainly by price increases on fuel, energy and gas, whereas price falls on communications and leisure services made a little downward impact on inflation. In view of inflationary pressures amid price rise in global markets of primary goods, the European Central Bank tightened the monetary conditions, in its April 7 2011 meeting, by raising interest rates by 0.25 pp to set 1.25 percent.

In Q1 2011 inflation accelerated in Euro-area



In the first quarter of 2011 economic growth in ***Russia*** was 4.1 percent, according to preliminary figures of the statistics service.

Growth in industry was 5.9 percent y-o-y compared to 9.5 percent recorded in the same quarter of the previous year. Retail trade posted 4.7 percent growth y-o-y in January-March (2.2 percent in the same quarter of the previous year). Construction reported 1.6 percent growth in January-March.

In the first quarter, in view of the external and domestic developments, current account surplus has decreased by USD 1.5 billion y-o-y and amounted to USD 31.8 billion. The growth of trade balance surplus (by 3.6 percent or USD 1.7 billion) has not been sufficient to compensate negative balance growth on other items, and the current account surplus diminished as a result. Net capital outflow, which was observed since the second half of the previous year, persisted over the first quarter of 2011, reaching USD 15.9 billion (in the first quarter of 2010 net outflow was USD 11.1 billion). Net outflow by banks amounted to USD 7.4 billion and net outflow by other private sector reached USD 8.4 billion. As a result of balance of payments flows, in the first quarter foreign currency reserves of the Central Bank of Russia have increased by USD 10.1 billion and totaled USD 502.5 billion, as of end-April 2011 (net outflow on item *error and omission* was USD 5.8 billion).

In the face of balance of payment flows as well as developments in international financial markets, the Russian Central Bank acted as a net buyer of foreign currency in order to curb the ruble exchange rate appreciation pressures. As a result, the average nominal exchange rate of RUR versus USD appreciated by 4.7 percent q-o-q. In the first quarter the ruble's y-o-y appreciation versus the US dollar was 2.1 percent.

High rates of inflation were observed during the first quarter, with average inflation amounting to 9.5 percent y-o-y against 7.2 percent recorded in the same quarter of the previous year. The highest inflation was in January when it reached 2.4 percent relative to December. Inflation in the first quarter was driven mainly by increased prices of food products and paid service tariffs.

In consideration of high inflation expectations as well as preconditions for capital inflow if international oil prices persist at a high level, the Russian Central Bank raised, in February, the refinancing rate by 0.25 pp and set it at an 8.0 percent level.

Macroeconomic Situation in Neighboring Countries [4]

Turkey: *in the fourth quarter economic growth rates*[5] *accelerated and reached 9.2 percent, following the slowdown in the previous quarter. The recorded figures topped expectations. The acceleration was entirely due to domestic demand with its positive contribution of 14.8 pp. A considerable part of domestic demand was driven by investments. Growth of private investments was unprecedented, 50 percent y-o-y in the fourth quarter, which is the highest growth since 2004. Growth of private consumption grew in relation to the third quarter and made up 9.0 percent y-o-y. External demand had a negative contribution of 5.6 pp. Based on the 2010 results, economic growth reached 8.9 percent.*

Acceleration of economic growth rates was attributable to the processing industry, retail and wholesale trade and agriculture in which growth rates speeded up, respectively, by 11.3 percent, 13.1 percent and 4.3 percent y-o-y. Growth in construction reached 17.5 percent y-o-y.

In the first quarter of 2011 the rate of inflation slowed down to 4.3 percent y-o-y, primarily due to y-o-y deceleration of growth rates in prices of unprocessed food.

Current account deficit deteriorated in the period January-February of 2011 almost twice as much remained a primary concern. This was determined mostly by an unprecedented growth of domestic demand. In January-February current account deficit has deteriorated by USD 6.3 billion and amounted to USD 12.0

[4] *Review of the macroeconomic situation in neighboring countries is important in a sense that, being under the influence of similar economic turbulences, developments in these countries may indirectly influence the Armenian economy. Crises of 1990s showed that indirect influence channels, including common export markets, 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 numerical data of this country are not complete and are issued in such delays when they lose relevance.*

[5] *Official first quarter 2011 figures are missing.*

billion. This was largely due to a USD 6.7 billion increase of trade balance deficit. In January-February growth of export was 22.2 percent or USD 3.8 billion, whereas as much as 47.0 percent or USD 10.5 billion worth of growth was reported for imports. Net inflow of capital amounted to USD 7.8 billion compared to USD 2.8 billion recorded for the same period of the previous year. In the banking sector in the period January-February, net outflow of capital reached USD 4.8 billion, whereas other private sector reported USD 8.5 billion worth net inflow. In the same period of time, net inflow of 'hot money' amounted to USD 3.8 billion against USD 0.3 billion in January-February of the previous year. Inflow of foreign direct investment has increased by 4.0 percent and amounted to USD 1.0 billion. As a result of the balance of payments flows, official reserves of the Central Bank of Turkey have increased by USD 1.2 billion (net inflow on item error and omission was USD 5.5 billion).

The Turkish lira exchange rate trending downward against the US dollar, as observed in November-December of 2010, carried on during the first quarter of 2011, too. This made the exchange rate to depreciate by 8.0 percent q-o-q, while in the first quarter of 2011 the exchange rate y-o-y depreciation was 4.7 percent.

In the first quarter the Central Bank of Turkey further implemented its monetary policy by using multiple tools. In January the Central Bank lowered one-week repo rate by 25 basis points to 6.25 percent. This decision was based on that the economic activity was further recovering amid high growth of domestic demand and that the usage of industrial capacities was still below the pre-crisis levels due to weak external demand. So, the developments with aggregate demand are not creating inflationary pressures. In view of macro-prudential goals, the Central Bank once more raised the reserve requirement in March for tightened monetary conditions, in order to curb second round effects that may derive from price increases of oil and other raw materials during the quarter.

***Azerbaijan:** in the period January-March 2011 real GDP growth rates have decelerated but accelerated in non-oil sector. Real GDP has grown by 1.6 percent, and 5.6 percent in non-oil sector[6]. Nominal GDP has grown by 12.8 percent compared to the previous year, and GDP deflator amounted to 11.0 percent (against 34.3 percent in the same period of the previous year). Industry's contribution to the GDP growth was 55.7 percent; agriculture – 2.7 percent; construction – 5.3 percent; transport and telecommunications – 9.3 percent; wholesale and retail trade – 7.8 percent; social services – 11.5 percent; and net production and import taxes – 7.7 percent[7].*

Relative to December of the previous year, inflation in Azerbaijan was 4.2 percent and average inflation, 9.1 percent y-o-y. Average annual inflation was fuelled by price increases on food products (13.4 percent), non-food products (2.8 percent), and service tariffs (3.1 percent)[8]. Price increases of oil and agro-products in world markets, coupled with a considerable increase of foreign currency inflows and major balance of payment surplus, made inflation expectations more intensified in January and February in 2011. In January inflation was 8.3 percent y-o-y and in February it accelerated to reach 9.3 percent y-o-y. Seeking to maintain price stability, the Central Bank of Azerbaijan raised the refinancing rate, since March 1 2011, by 2.0 percent to 5.0 percent and brought the reserve requirement ratio to 2.0 percent from the former level of 0.5 percent. Note that from November 2010 up to end-March 2011 the Central Bank has raised the refinancing rate by 3.0 percent.

During the first quarter of 2011 trade balance of Azerbaijan run with surplus, reaching USD 3.5 billion. Export has increased by 22.7 percent in relation to the same period of the previous year and totaled USD 5.4 billion; import has increased by 58.3 percent and reached USD 1.9 billion[9]. Crude oil accounted for 86.3 percent of value of Azerbaijani exports in the first quarter of 2011 (it accounted for 81.6 percent in 2009)[10].

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[6] Source: Azerbaijan Central Bank Statistics Bulletin, January-March, 2011, Table 1.1.
[7] Source: http://abc.az/rus/news/53206.html.
[8] Source: Azerbaijan Central Bank Statistics Bulletin, January-March, 2011, Table 1.2.
[9] Source: http://abc.az/rus/news/53367.html.
[10] Source: http://abc.az/rus/news/50908.html.

In January-March 2011, relative to January-March 2010, gross inflow of foreign direct investment has increased by around 10.3 percent to reach USD 595.1 million, with Great Britain as the largest investor (43.1 percent), USA (16.8 percent), Japan (9.7 percent), Norway (5.4 percent), and Turkey (4.8 percent)[11].

In the first quarter of 2011 too, the Central Bank of Azerbaijan implemented a policy to maintain stability of the Manat exchange rate. As a result, in the period January-March manat appreciated vis-a-vis US dollar by a mere 0.66 percent, while the January-March average exchange rate appreciation was 0.99 percent y-o-y[12].

In the period January-March the volumes of loans provided to the economy by banks have decreased by 8.7 percent; the volumes of loans in local currency have reduced by 14.4 percent[13]. In the resident business loan portfolio structure trade & services hold the largest share (26.1 percent), followed by construction (10.2 percent), industry (5.8 percent) and transport and communications (5.4 percent). On the back of this, the volumes of bad loans have grown by around 9.5 percent (USD 59 million) against end of 2010. As of end-March 2011, bad loans constituted 6.5 percent of total economy lending (5.4 percent in the previous yearend)[14].

Though the volume of bank deposits has grown by 5.1 percent, the volume of deposits in local currency has reduced by 5.4 percent. The dollarization of the economy has grown by 5.6 percent and reached 49.6 percent as of end-March 2011, as a result of 18.5 percent increase in the share of deposits in foreign currency[15].

In the period January-March 2011 foreign exchange reserves of the Central Bank of Azerbaijan have increased by 4.85 percent and totaled USD 6.7 billion, as of April 1, 2010[16]. In the meantime state oil fund assets have grown as well to reach USD 25.8 billion, as of April 1, 2011[17].

***Georgia:** in 2010 real GDP growth was 6.4 percent. The nominal GDP has grown by 15.6 percent relative to the previous year. The GDP deflator amounted to 8.7 percent (-2.0 percent was in the same period of the previous year). The largest contribution to GDP growth came from industry (16.9 percent), trade (16.6 percent), public administration (13.0 percent), transport and telecommunications (11.6 percent) and agriculture (8.4 percent). Net taxes on manufacture and import amounted to 13.1 percent of GDP[18].*

In the period January-March 2011 average inflation in Georgia was 13.3 percent y-o-y, and 4.9 percent in relation to December of the previous year. Compared to the previous December, inflation was reported for non-durable goods (6.9 percent) and services (1.1 percent) but deflation was reported for semi-durable goods (2.3 percent) and durable goods (0.3 percent)[19]. Driven by price increases of oil and agricultural products in global markets, inflation reached 12.3 percent in January, exceeding the target set by the National Bank of Georgia. Because the share of food is high enough in the consumer basket and the price increase may trigger high inflation expectations thus adversely affect the medium-term inflation[20], the National Bank raised the refinancing rate, in February 2011, by 0.5 basis points to 8.0 percent. Note that from June 2010 up to February 2011 the National Bank has lifted the refinancing rate by 1.75 percent.

In January-March 2011, relative to January-March 2010, export volumes (FOB) have increased by 35.8 percent and amounted to USD 464 million, and import volumes (CIF) have increased by 37.3 percent and reached USD 1.398 million. As a result of export-import transactions Georgia's trade balance deficit deteriorated by 38.0 percent and totaled USD 934 million.

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[11] Source: http://abc.az/rus/news/53293.html.
[12] Source: http://www.cbar.az/other/azn-rates.
[13] Source: Azerbaijan Central Bank Statistics Bulletin, January-March, 2011, Table 2.6.
[14] Source: Azerbaijan Central Bank Statistics Bulletin, January-March, 2011, Table 2.8.
[15] Source: Azerbaijan Central Bank Statistics Bulletin, January-March, 2011, Table 2.4.
[16] Source: http://www.cbar.az/infoblocks/money_reserve_usd.
[17] Source: http://abc.az/rus/news/main/53269.html.
[18] Source: http://www.nbg.gov.ge/uploads/gdpinglisurad/nominal_gdpqucurrenteng.xls.
[19] Source (here and henceforth): National Bank of Georgia's Monetary and Banking Statistics Bulletin, January-March, 2011.
[20] The National Bank of Georgia has set an inflation target of 6 percent for 2011-2013.

Notwithstanding signs of recovery of the Georgian economy, gross inflow of foreign direct investment further narrowed. During 2010 inflow of FDI reached USD 549 million, which was 17.7 percent reduction y-o-y. Unlike direct investment inflows, in 2010 there was about 12.0 percent growth of inflow of money transfers from abroad. In the period January-March 2011, relative to the same period of the previous year, this figure almost doubled (93.2 percent growth) and reached USD 227.4 million.

With foreign currency inflow reducing, in January-March 2011 the average exchange rate of Georgian lari depreciated vis-a-vis the US dollar by 0.8 percent y-o-y. Relative to end-December of 2010, lari's appreciation was 3.9 percent. To restrain pressures from depreciation of the lari exchange rate, as was observed in January, the National Bank sold USD 30.0 million in the domestic foreign exchange market that month but, in view of the appreciation trend in the period February-March, the National Bank bought USD 40.0 million in March. As a result, net purchase of foreign currency by the National Bank during the first quarter of 2011 amounted to USD 10.0 million.

In January-March 2011 bank lending has grown insignificantly. The volumes of loans in local currency grew by 4.1 percent and loans in foreign currency, by 0.8 percent. As of March 31, 2011, 64.0 percent of total loans provided to resident businesses were in foreign currency. In the resident business portfolio structure, trade held the largest share (51.5 percent), industry (21.6 percent) and construction (10.6 percent). The amount of bad loans has increased by about Lari 14.5 million (USD 8.5 million), constituting 2.9 percent of total lending volumes. The share of deposits attracted by banks has dropped a little, with deposits in local currency reduced by 2.1 percent and deposits in foreign currency, by 1.3 percent. The dollarization in the Georgian economy has subdued by 0.15 percent in relation to December of the previous year; as of March 31, 2011, foreign currency deposits constituted 72.3 percent in total.

In the period January-March 2011, foreign exchange reserves of the National Bank of Georgia have grown by 20.0 percent and amounted to USD 2.72 billion, as of March 31, 2011. This exceeded the figure of USD 453.8 million recorded as of end-2010.

In the period January-March 2011, Georgia's public debt (excluding state guaranties) has increased by around USD 128.5 million and reached USD 4.062 billion (as of December 31, 2010, it was USD 9.665 billion).

3.2. BALANCE OF PAYMENTS [21]

3.2.1. Current Account

On the back of developments in world and domestic economies, in the first quarter of 2011 current account has improved relative to the same quarter of the previous year. Real and value growth of export of goods exceeded expectations, which was determined primarily by sustained positive developments in the Armenian industry as well as increased international metals prices. In the first quarter real volumes of import of goods shrank considerably, according to estimations, which was affected by faster growth rates in import prices amid budget constraints of economic agents. In the meantime, growth rates of transfers speeded up. As a result, the deficit of current account has reduced by USD 71.1 million y-o-y to amount to USD 307.3 million, with its share in GDP having reduced by 7.2 pp.

In the first quarter export and import values have increased by USD 48.8 million (22.2 percent) and USD 39.2 million (5.6 percent) y-o-y, respectively. As a result, the deficit of trade balance has reduced by USD 9.6 million y-o-y and amounted to USD 475.8 million.

Faster rates of growth of export were attributable to the acceleration of growth rates of metals prices and persistently high growth rates in

[21] *Q1 2011 indicators are the Central Bank estimations.*

industry as global economy develops. Growth of export of goods and services in real terms[22] was 6.2 percent y-o-y in the first quarter. Growth of export value[23] was driven mainly by positive contributions from such items as "mineral production" (11.0 pp), "base metals and articles thereof" (8.2 pp) and "products of prepared food" (4.1 pp)[24].

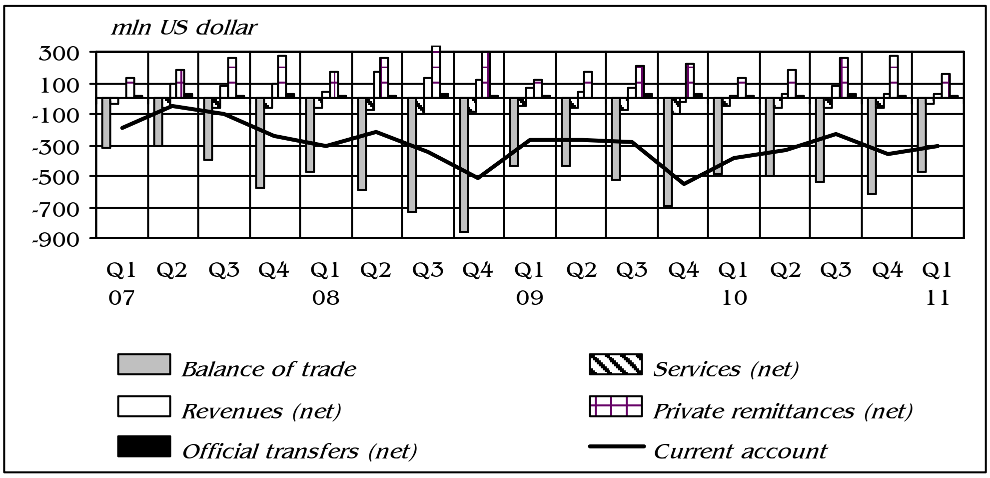
Developments in domestic demand and faster growing import prices reflected the dynamics with import of goods. In the first quarter growth of import of goods in dollar terms was 5.6 percent y-o-y. There was considerable, 15.5 percent, y-o-y decline in real volumes of import of goods and services reported during the first quarter, which was attributable to accelerated growth rates in import prices amidst budget constraints of economic agents.

Import was affected by positive contributions mainly from such items as "mineral production" (2.4 pp), "base metals and articles thereof" (1.7 pp) and "vegetable produce" (2.7 pp), whereas items "machinery and equipment" and "products of prepared food" had negative contributions of 4.9 pp and 1.6 pp, respectively.

This was geographic distribution of external trade: trade balance deficit has increased by USD 17.7 million with the CIS but reduced by USD 11.4 million and USD 3.8 million with the EU states and other countries, respectively. The reduction of trade balance deficit with the EU states was mainly attributable to Bulgaria and the Netherlands, with their trade balance surpluses having grown by USD 15.6 million and USD 11.4 million, respectively. The reduction of trade balance deficit with other countries was due to Brazil, China and Japan, with their trade balance deficits having reduced by USD 10.1 million, USD 3.6 million and USD 2.3 million, respectively.

In the first quarter the deficit of services balance has narrowed by USD 14.5 million y-o-y and amounted to USD 37.1 million. This was determined mainly by reduced deficit of balance of transport services and increased y-o-y surplus of balance of travel. In the first quarter the y-o-y growth of export and import of services reached 16.6 percent and 3.4 percent, respectively.

In Q1 2011 current account deficit has improved y-o-y



In the first quarter the y-o-y growth rates of private remittances have accelerated[25]. This is largely explained by the developments in the Russian

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[22] *Export and import of goods in real terms are the Central Bank estimates.*
[23] *Decreases were reported for export of some items which are negligible by share.*
[24] *Export and import breakdown by sector and geography is presented, respectively, in FOB and CIF prices.*
[25] *Net inflow of non-commercial transfers via the banking system has grown by 25.7 percent y-o-y in the first quarter of 2011.*

economy (in the first quarter of 2011 economic growth in Russia was 4.1 percent y-o-y compared to 2.9 percent recorded in the same quarter of the previous year). In the first quarter net inflow of seasonal worker income has grown by 26.0 percent y-o-y and amounted to USD 110.6 million. This more than offset net outflow in item "income on investment". As a result, item "income" posted net inflow of USD 26.7 million. Net inflow of private transfers has increased by 24.4 percent y-o-y and reached USD 162.1 million.

3.2.2. Capital and Financial Account[26]

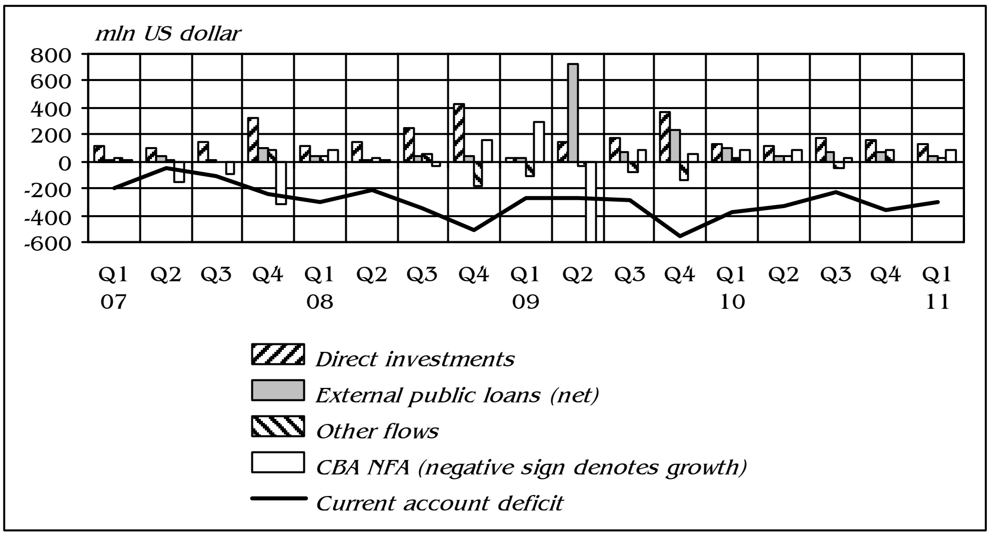
In the first quarter of 2011 the capital and financial account reported net inflow of USD 223.0 million. Almost all items posted net inflow of funds, concomitant with net foreign assets of the Central Bank having reduced by USD 84.3 million. This was in part due to the decrease of foreign currency accounts of commercial banks with the Central Bank.

In the first quarter the inflow of capital transfers amounted to USD 22.5 million (USD 21.3 million in the first quarter of the previous year).

Net inflow of foreign direct investment reached USD 127.1 million, remaining almost unchanged relative to the same quarter of the previous year. Net inflow of public loans amounted to USD 40.8 million against USD 101.0 million recorded in the first quarter of the previous year.

In the first quarter net foreign assets of private sector have decreased by USD 32.6 million. Net foreign assets of private sector (commercial banks excluded) have grown by USD 44.6 million in contrast to USD 77.2 million of decrease in NFA of the banking sector.

In Q1 2011 current account deficit outweighed net inflow on capital and financial account



3.3. INTEREST RATES, EXCHANGE RATE, AND MONETARY DEVELOPMENTS

3.3.1. Interest Rates

In the first quarter of 2011 the Central Bank embarked on gradual tightening of the monetary policy, so the Board of the Bank raised the refinancing rate during the quarter by 1 pp to 8.25 percent from 7.25 percent. Lombard repo rate and deposit facility rate were also lifted by 1 pp each, to reach 11.25 percent and 5.25 percent, respectively.

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

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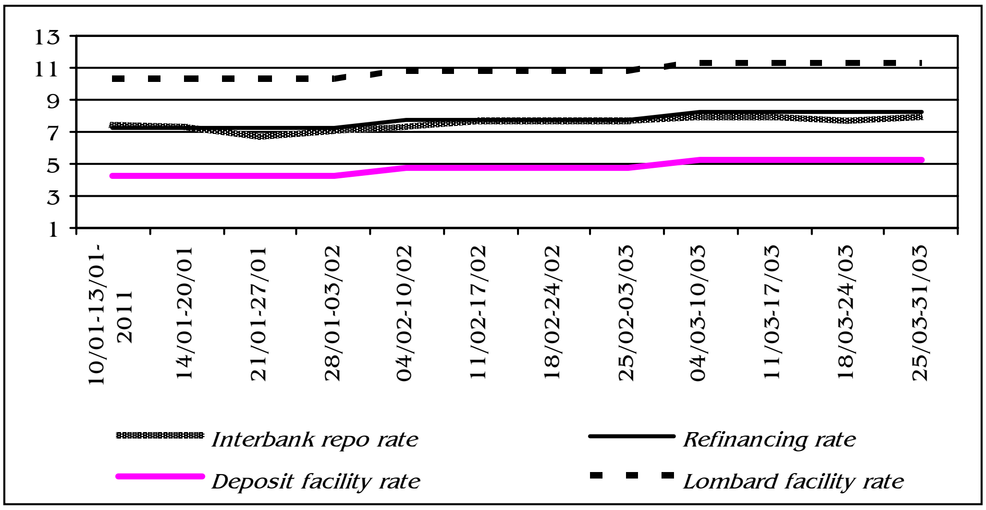
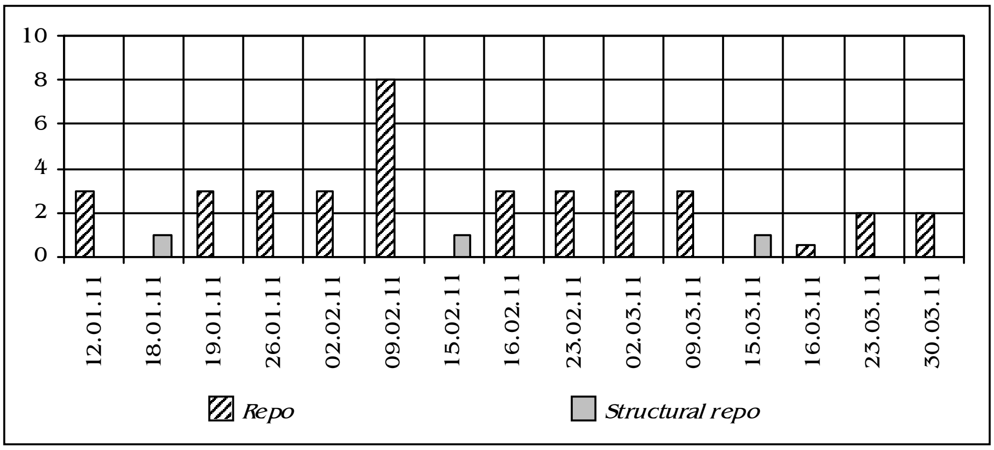
[26] *All indicators pertaining to the Q1 2011 capital and financial account are the Central Bank estimates.*

CBA Refinancing Rate, Standing Facility Rate and Interbank Repo Rate



The Central Bank continued offering, each Wednesday, repo transactions to commercial banks. Average reported weekly volumes of repo operations performed reached AMD 3.0 billion, with an average interest rate of 8.06 percent. In the meantime, the Central Bank further applied an instrument of long-term repo, with a total volume of nearly AMD 3.0 billion, with an average interest rate of 9.12 percent.

CBA repo operations (bln AMD)

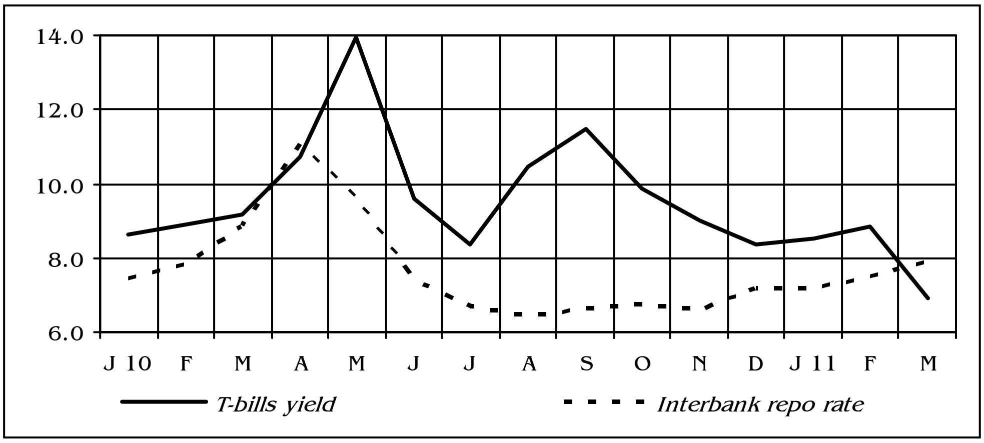


The interbank loan market, i.e. the Overnight Börse, has been active. During the quarter the volume of interbank loans made up AMD 472.0 billion against AMD 347.1 billion recorded in the previous quarter, with an average interest rate having risen by 0.22 pp to 5.09 percent. This was the reason why no lombard repo operations were executed between commercial banks and the Central Bank, whereas the average daily volume of commercial bank deposit with the Central Bank amounted to AMD 9.6 billion (almost the same level of the previous quarter).

In the first quarter the volume of operations performed in the interbank and intrabank repo markets amounted to AMD 206.5 billion, reduced by just AMD 2.3 billion against the previous quarter. In March the interbank repo rate was 8.27 percent, up by 0.43 pp against December of 2010. The share of operations executed between commercial banks in total amounted nearly to 40 percent against 35 percent recorded in the previous quarter. In March, relative to December of 2010, average interbank repo rate has risen by 0.75 pp and amounted to 7.91 percent.

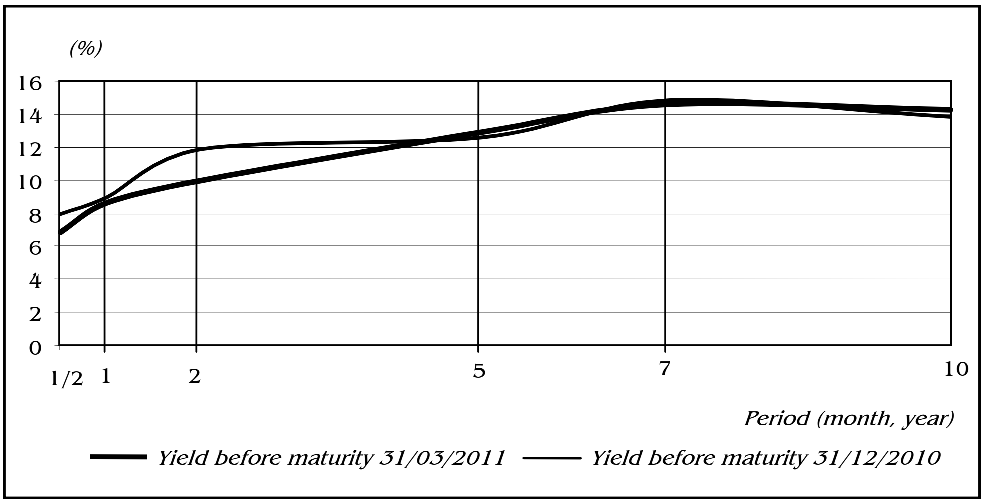
In the first quarter total allocation volume of short-term treasury bills reached AMD 14.0 billion compared to AMD 24.5 billion recorded in the previous quarter. Total amount of short-term treasury bills allocated amounted to AMD 13.9 billion compared to AMD 24.4 billion recorded in the previous quarter. In primary market of government securities interest rates tended to fall, which was more pronounced in the short-term segment. Relative to the previous quarter, average interest rate has dropped by 1.21 pp to 7.90 percent in short-term segment and by 0.68 pp to 13.70 percent in medium-term segment.

T-bills and interbank repo rates



The yield curve analysis shows that in the secondary market of government securities yields have declined mainly in the 6-month – 2-year segments. Most transposition of the curve (93 percent) is driven by a parallel shift in the curve line, which made up 0. 5 pp, owing to declined yields. Convexity of the curve has changed as well, from 0.32 just to 0.41, pointing out to the increased spread of interest rates of long-term and short-term securities.

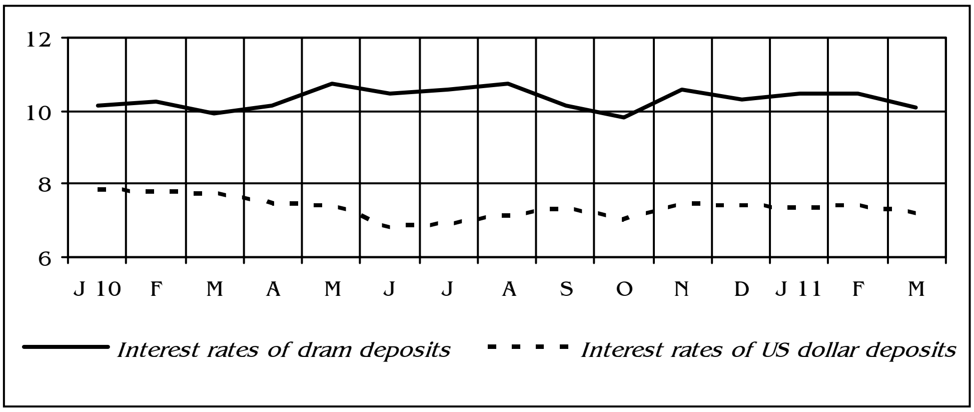
Secondary market posted an interest rate decline in short-term segment



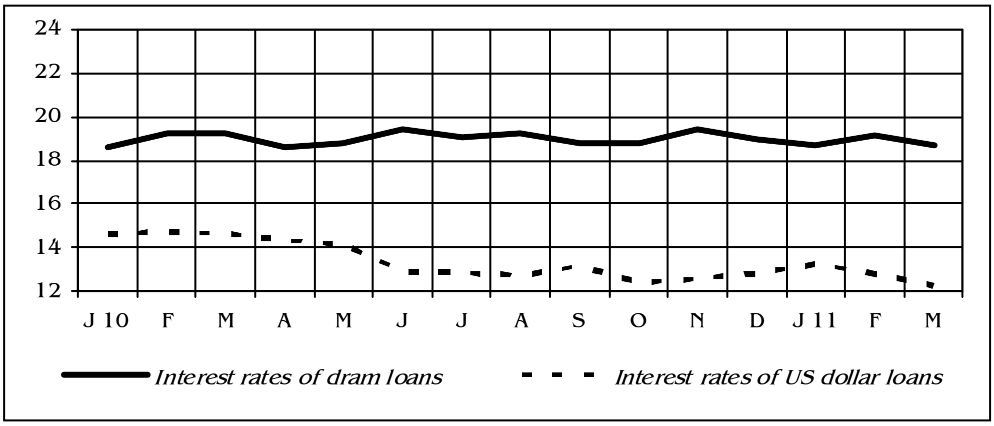
In the first quarter interest rates of loans and deposits in Armenian dram and US dollar trended as follows: average interest rates of dram and dollar deposits were 10.35 percent and 7.33 percent, respectively. Relative to the previous quarter, average interest rate of dram deposits has risen by 0.12 pp, while interest rates of dollar deposits remained almost unchanged. As a result, the spread of interest rates of dram and dollar deposits made up 3.02 pp (2.92 pp in the previous quarter).

In the first quarter average interest rates of dram loans and dollar loans were 18.86 percent and 12.78 percent, respectively. Relative to the previous quarter, average interest rate of dram loans has dropped by 0.18 pp but interest rate of dollar loans risen by 0.16 pp. As a result, the spread of interest rates of dram and dollar loans made up 6.08 pp compared to 6.42 pp recorded in the previous quarter.

Interest rates of deposits attracted by banking sector



Interest rates of loans provided by banking sector

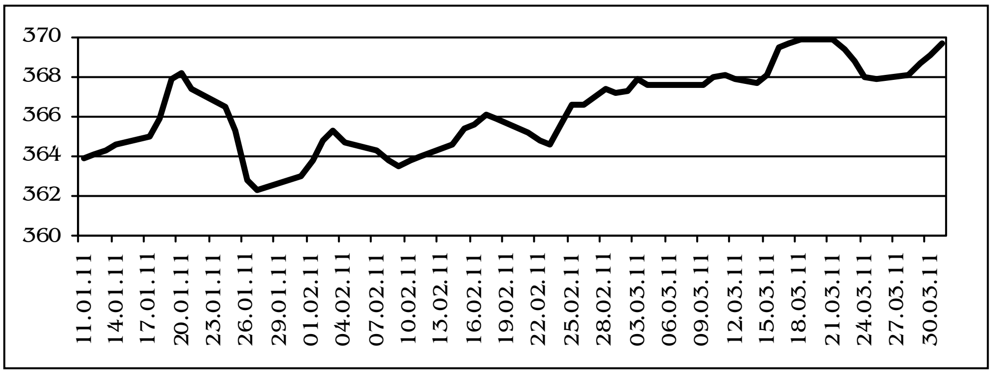


In the first quarter of 2011 the interest rate spread of loans and deposits in Armenian dram made up 8.51 pp, (8.81 pp in the previous quarter) and the interest rate spread of loans and deposits in US dollar reached 5.45 pp (5.31 pp in the previous quarter).

3.3.2. Exchange Rate

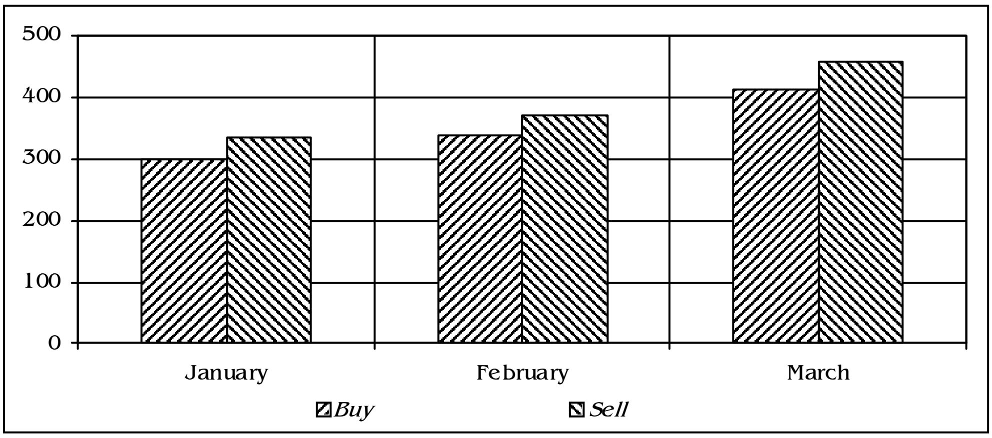
At the end of the first quarter of 2011, relative to the end of the previous quarter, the average AMD/USD exchange rate has depreciated by 1.7 percent to reach dram 369.7 from 363.4 for one dollar. Relative to the same quarter of the previous year, the average quarterly AMD/USD exchange rate has appreciated by 4.9 percent to reach dram 366.1 from 384.1 for one dollar (versus 15.24 percent depreciation recorded in the same quarter of the previous year).

AMD / USD exchange rate



The aggregate volume of interbank market transactions executed during the first quarter amounted to USD 2210 million, which represents 22.23 percent increase in relation to the respective indicator of USD 1808 million recorded in the first quarter of the previous year.

Gross volumes of foreign exchange operations
(mln US dollar)



In the first quarter the aggregate volume of Euro/Dram exchange transactions amounted to EUR 186.1 million, almost the same level recorded in the same quarter of the previous year (EUR 186.2 million).

To handle the dram supply and prevent the dram exchange rate from sharp fluctuations, the Central Bank purchased a total of USD 5.9 million from and sold a total of USD 46.8 million to commercial banks.

In the first quarter the nominal effective exchange rate of the dram depreciated by 2.6 percent q-o-q. This was primarily due to nearly 1.5 percent q-o-q depreciation of average quarterly AMD/USD exchange rate and about 1.2 percent appreciation of partner countries' currencies versus the US dollar.

Relative to the same period of the previous year, the nominal effective exchange rate of the dram has appreciated by around 4.6 percent, mostly driven by around 4.9 percent appreciation of the dram exchange rate and average weighted 0.3 percent y-o-y appreciation of exchange rates in partner countries, the Russian ruble in particular.

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

In the first quarter of 2011 average quarterly inflation in Armenia was 11.8 percent y-o-y[27] whereas average weighted inflation in partner countries was 5.5 percent y-o-y. Weighted average inflation in partner countries was most influenced by inflation in Russia (9.5 percent y-o-y) and Iran (16.0 percent y-o-y), with their contributions of 2.0 pp, 0.9 pp, respectively, as well as by 0.9 pp contribution from Euro-area, which is determined by a large weight of the latter. In the outcome, the CPI-calculated real effective exchange rate has appreciated by 1.2 percent q-o-q under which circumstance there has been a notable 10.5 percent y-o-y appreciation over the first quarter of 2011, which however has diminished against 15.4 percent y-o-y appreciation recorded in the previous quarter.

At the same time, the PPI-calculated real effective exchange rate has depreciated by about 2.3 percent q-o-q. Under such circumstances the y-o-y appreciation amounted to 8.1 percent compared to about 16.2 percent y-o-y appreciation in the previous quarter. This was mainly driven by considerable y-o-y increase of producer prices in dram in Armenia and the

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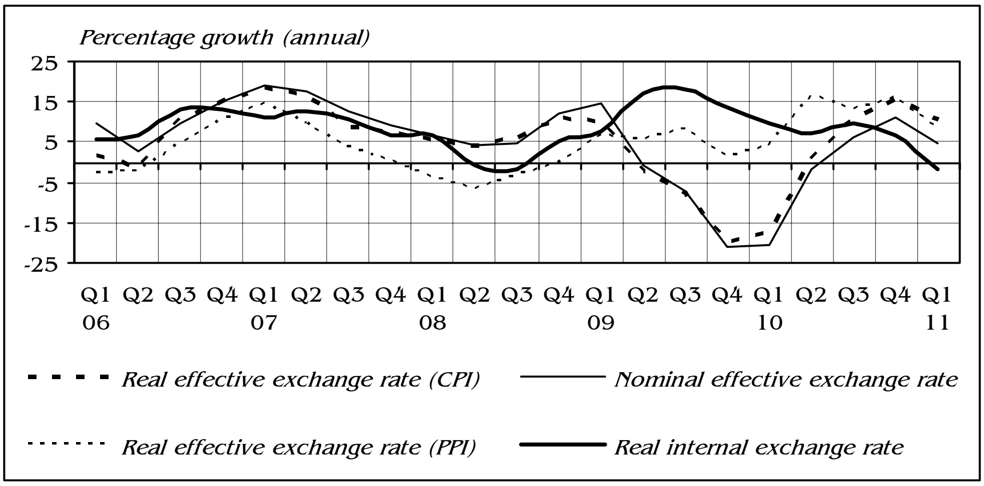
[27] *This indicator makes up 11.1 percent, according to official publications of the National Statistics Service of Armenia, and the difference is the variety of bases on which the indexes were calculated.*

dram exchange rate appreciation, although producer prices in partner countries have risen considerably as well.

In Q1 2011 real exchange rate appreciation slowed down



In the first quarter the internal real exchange rate[28] depreciated by 1.7 percent y-o-y, against the previous quarter's 6.5 percent appreciation, as prices of non-tradable goods grew faster than prices of tradable goods[29].

Prices of non-tradable goods and services have increased by 14.4 percent and prices of tradable goods, by 16.3 percent y-o-y, compared to 17.3 percent and 10.1 percent, respectively, recorded in the previous quarter. The y-o-y growth of prices of tradable goods was attributable to a notable growth of international prices. The y-o-y growth of prices in non-tradable sector was mainly determined by increase in gas service fees since the second quarter of 2010.

3.3.3. Monetary Developments

In view of actual monetary developments in the previous year and forecasts made on an upcoming 12-month horizon, the monetary policy program for Q1 2011 envisaged further tightening of monetary conditions while bringing the reserve requirement ratio up to 75 percent as part of de-dollarization measures (whereby 75 percent of foreign currency funds reserved must be kept in dram instead of the former requirement of 50 percent). Expectedly, this would result in dram deposits growing faster than foreign currency deposits thus pushing dram broad money to outgrow broad money.

As projected in the program, in the first quarter the Central Bank continued tightening monetary conditions by having the refinancing rate raised in January-March for a total of 1.0 pp to 8.25 percent level, in order to absorb second round effects and have inflation expectations anchored.

However, the first quarter was prominent by two main deviations observed with foreign currency deposits and economy lending indicators as these posted faster-than expected growth rates. So, during the quarter FX deposits grew by 7.2 percent or AMD 28.0 billion, of which term deposits made up 6.3 percent or AMD 17.3 billion and demand deposits constituted 9.2 percent or AMD 10.6 billion. As such, demand FX deposits were attracted totally from state enterprises and term FX deposits mostly from households and private companies.

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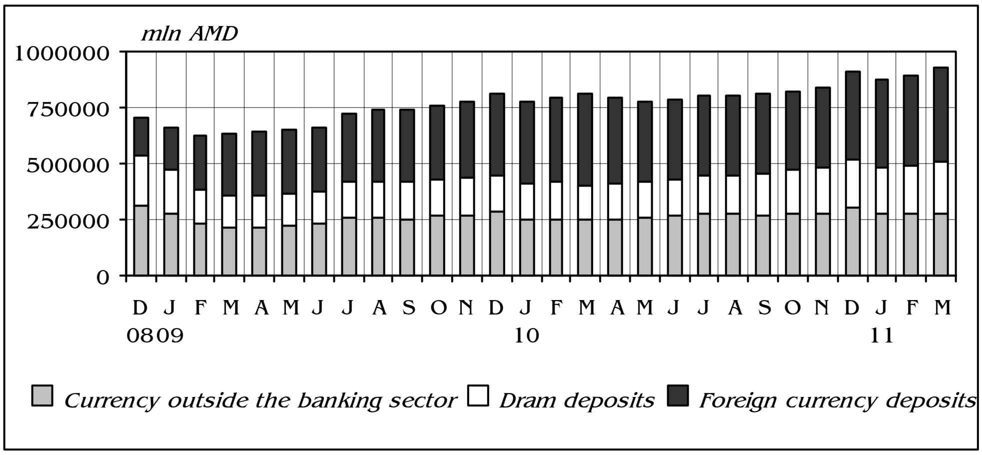
[28] *Internal real exchange rate has been calculated as a ratio of prices of non-tradable goods to prices of tradable goods.*
[29] *Prices of non-tradable and tradable goods have been calculated based on expert judgment over prices of a consumer basket, taking goods and services into relevant categories.*

Dram deposits grew by 5.8 percent or AMD 12.7 billion, primarily owing to term deposits (16.0 percent or AMD 14.3 billion), whereas demand deposits decreased by 1.2 percent or AMD 1.6 billion.

Over the first quarter currency outside the financial system has reduced by 8.6 percent or AMD 26.1 billion which is two and a half times lower from the last two year's average indicator for the respective quarter.

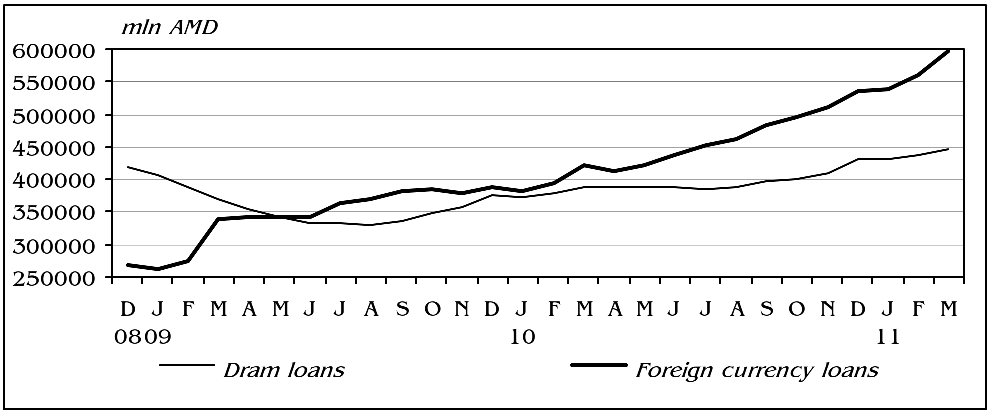
As a result of the aforementioned developments, broad money has increased by 1.6 percent and dram broad money reduced by 2.6 percent.

In Q1 2011 growth rates of foreign currency deposits again accelerated



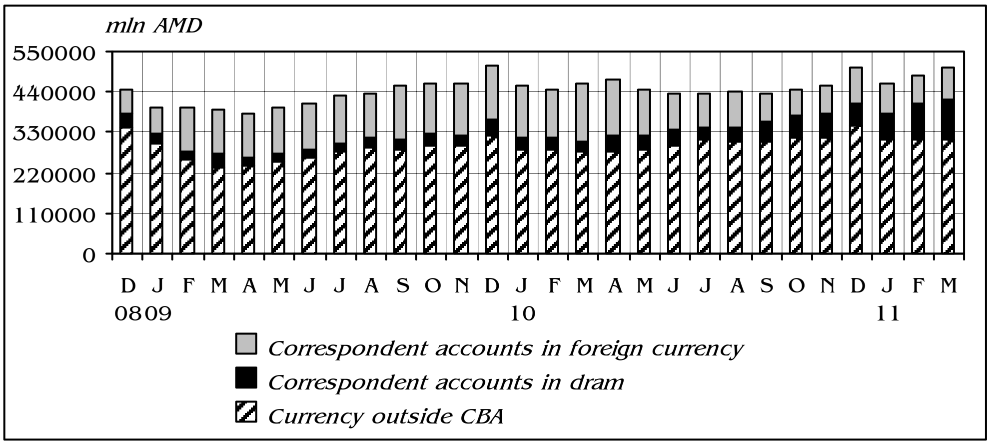
Notwithstanding the gradual tightening of monetary conditions, lending to the economy remained strong during the first quarter, 8.1 percent or AMD 79.5 billion, of which 11.6 percent or AMD 61.9 billion alone extended in foreign currency. Loans in foreign currency were provided to finance business plans. In the meantime, FX loans provided to households have reduced by AMD 8.4 billion. Excess funds of FX correspondent accounts (as a result of 25 percent addition to the reserve requirement ratio) and credit resources attracted from abroad remained the main source for foreign currency lending in this quarter, too. Dram loans have grown by AMD 17.6 billion predominantly owing to consumer loans.

In 2011 growth of foreign currency lending remained strong



Following 10.3 percent reduction in currency outside the Central Bank and 21.7 percent increase of correspondent accounts of commercial banks with the Central Bank, monetary base remained almost unchanged, having reduced a mere 0.2 percent. Moreover, the change introduced to the reserve requirement mechanism made dram funds to increase notably, by AMD 38.5 billion, in the structure of correspondent accounts, which was concurrent with only AMD 6.0 billion of reduction in foreign currency funds. As a result, unlike monetary base, the dram component of it has grown by 1.8 percent over the first quarter.

In Q1 2011 reduction of currency outside CBA was offset by increased dram correspondent accounts

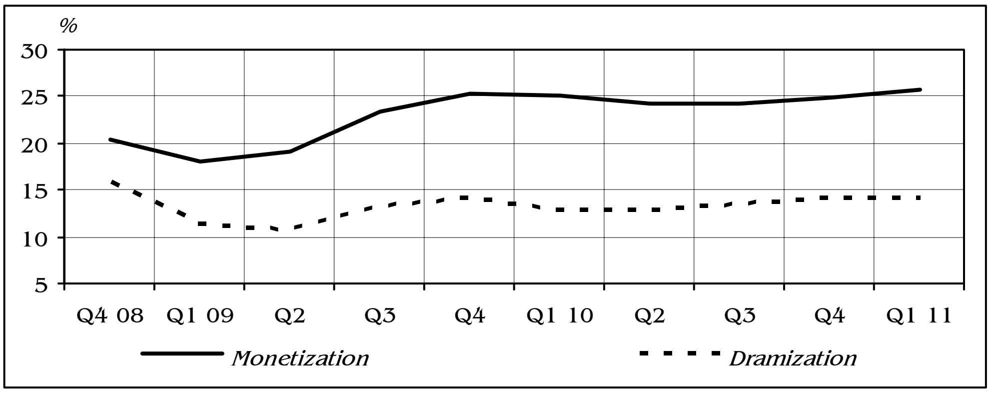


The tightening of monetary conditions and further measures to fight dollarization drove the monetary indicators to demonstrate the following behavior at the end of March of 2011, based on the 12-month period: broad money and dram broad money have grown by 14.0 percent and 26.8 percent, respectively; currency in circulation has increased by 12.5 percent; dram deposits and foreign currency deposits have grown by 49.8 percent and 1.5 percent, respectively; monetary base and lending to the economy have grown by 8.9 percent and 29.3 percent, respectively.

At the end of the first quarter dollarization of the economy (measured as a ratio of foreign currency deposits to broad money) reached 45.1 percent, up by 2.3 pp relative to the same indicator of the previous quarter, which was driven by high growth of FX deposits. Yet there has been a reported 5.5 pp decrease relative to that indicator of the same quarter of the previous year.

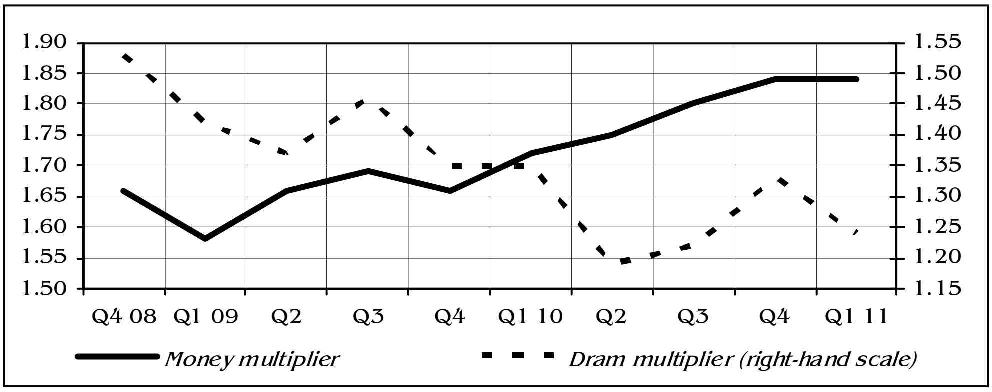
The monetization and dramization ratios, which are measures of financial intermediation, amounted to 25.7 percent and 14.1 percent, respectively, growing by 2.0 percent and 9.1 percent relative to the same indicators of the first quarter of the previous year. High growth of the ratios was determined mainly by the change to the reserve requirement mechanism.

Monetization and dramization ratios



Other indicators of financial intermediation, i.e. money multiplier and dram multiplier performed as follows: money multiplier stayed almost unchanged, at the 1.84 percent level, with y-o-y growth making up 6.5 percent; and dram multiplier fell by 7.8 percent q-o-q and by 8.2 percent y-o-y. The falling of dram multiplier was associated with the change to the reserve requirement mechanism as part of Central Bank action to reduce the level of dollarization in the economy. As a result, foreign currency funds on correspondent accounts of commercial banks with the Central Bank have decreased and dram funds have increased.

Money multiplier and dram multiplier



3.4. AGGREGATE DEMAND AND AGGREGATE SUPPLY

3.4.1. Aggregate Demand

Domestic demand

Private consumption and investments[30]: Over the first quarter of 2010 growth of private spending in real terms was estimated around 4 percent, determined by both real increases in private investments and private consumption. Relative to the previous year, public expenditures have declined by nearly 10 percent in real terms. In the light of the aforementioned developments, domestic demand has grown by around 2 percent.

Growth of private investments was estimated around 5 percent, owing to increased profitability in a number of economic sectors attributable to domestic and external demand growing slowly but steadily. Growing private investments were financed mainly from loans provided to the private sector and in part by own funds generated as a result of economic growth. Note, however, that in the first quarter the developments in construction[31] negatively affected the growth rate of investments by the private sector.

Private consumption in real terms has increased by nearly 4 percent, largely attributable to private sector incomes owing to increased remittances from abroad and reported domestic economic growth. Growth of lending volumes has somewhat contributed to the growth of private spending.

The gap between private spending and their potential, a by-product of the 2009 crisis, was eliminated as a result of sustained growth of private spending during the first quarter. Under the aforementioned developments, the expenditures in the private sector had a neutral impact on inflation.

Public consumption and investments[32]: In the first quarter of 2011 the fiscal policy's impact on aggregate demand, hence prices can be characterized as a policy to curb inflation. This showed up in the form of over-performed revenues and some savings on expenditures[33]. According to

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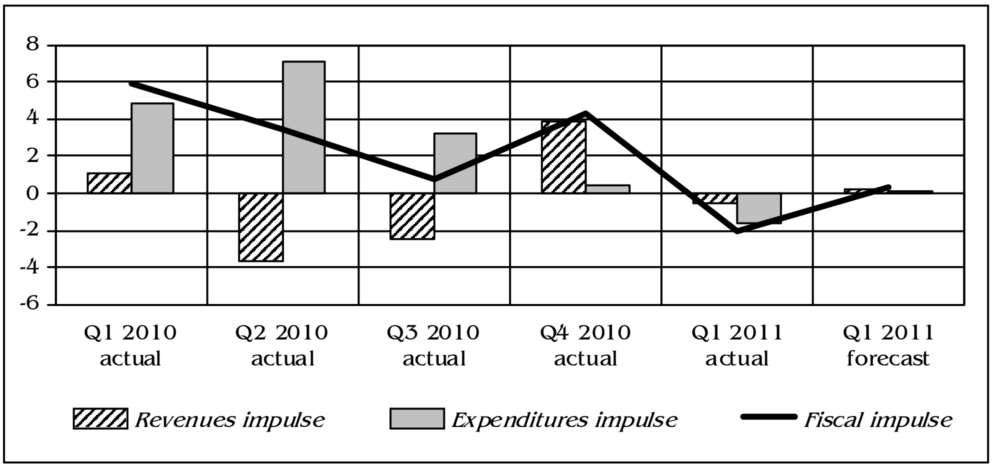
[30] The real growth indicators of private consumption and investments for the first quarter are the Central Bank estimates. The actual figures of these indicators are as of the fourth quarter of 2010. Estimations of real growth presented in this section are relative to the same quarter of the previous year, unless otherwise stated.
[31] See subsection Aggregate supply.
[32] Consolidated budget indicators which were prepared on the basis of preliminary actual data of the first quarter of 2011 (including PIU funds) were used for the review of the fiscal sector. The 2011 fiscal impulse indicators were estimated against base year of 2010 consolidated budget indicators, determined by positive economic recovery trends and the move from an expansionary anti-crisis fiscal policy to a more balanced one. The impact of revenues has been calculated against an estimated nominal GDP indicator and the impact of expenditures has been calculated against an estimated potential GDP indicator.
[33] Comparison of budget revenues, expenditures and deficit indicators was made by weighing their projected levels against quarterly proportions set by the Government (including PIUs) and the Central Bank quarterly forecasts of the state budget.

an estimated fiscal policy impulse, in the first quarter of 2011 the fiscal policy had 2.1 pp of restrictive impact instead of the projected neutral, which was generated in the face of restrictive revenues impulse of 0.5 pp and restrictive expenditures impulse of 1.6 pp. The main deviation of the impulse owed to expenditures as, driven by savings on expenditures, a restrictive impulse came in instead of the neutral. Also, taking into account the lagged impact of the expansionary policy transmitted from the fourth quarter of the previous year, the impact of the first quarter fiscal policy was estimated to be neutral.

In Q1 2011 the fiscal impulse had a restrictive impact



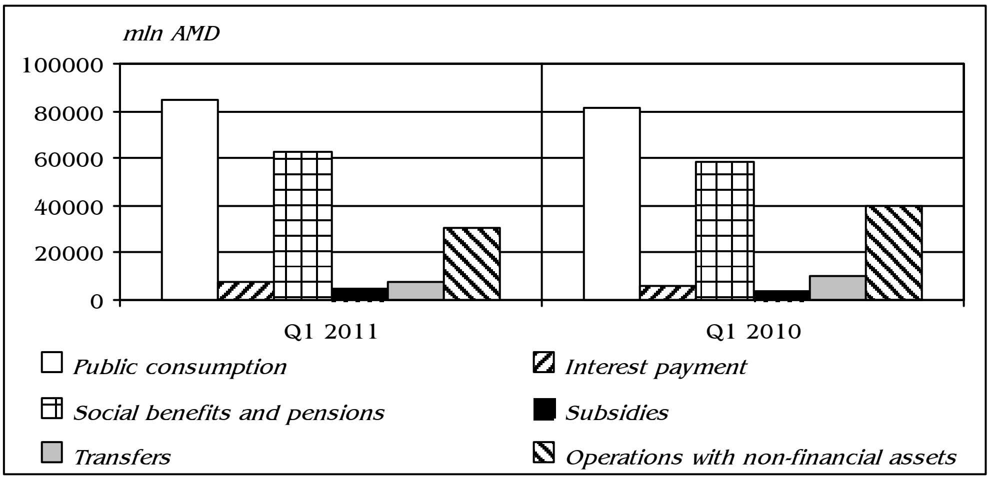
It is noteworthy that in 2011 further trends in economic recovery were observed, which had their positive impact on collection of budget revenues in line with projected proportions and even reflected on some over-performance to the amount of approximately AMD 2.0 billion in the form of social security charges.

Growth of tax revenues of the consolidated budget and social security charges has been 10.8 percent relative to the first quarter of the previous year. In the structure of tax revenues, the share of both indirect taxes and direct taxes has reduced by 2.1 pp and 0.2 pp y-o-y, amounting to 59.5 percent and 28.5 percent, respectively, in total. There has been an increase of 2.4 pp in other taxes, making up 12 percent in total; the y-o-y growth was 37.3 percent. The decline in indirect taxes was mainly due to reduced share of excise duty, which made up 6.4 percent y-o-y. The latter was conditioned by narrowed entries on sub-excise goods imported. The y-o-y growth of indirect taxes was 6.2 percent and direct taxes, 9.2 percent. In the structure of direct taxes, there has been an increase in respect of all taxes, with profit tax having grown by 12.5 percent and income tax having grown by 8.7 percent. Other taxes reported decline of 11.1 percent.

Over the first quarter the state budget expenditures have decreased by around 1.1 percent compared to the same period of the previous year. Current expenditures have grown by 4.9 percent y-o-y, in which public consumption has increased by 4.2 percent y-o-y. Expenditures on item *transactions with non-financial assets* have reduced by 23.6 percent mostly due to expenditures not executed for shortfalls with external grant programs as well as some savings on expenditures intended to be made to the expense of domestic sources.

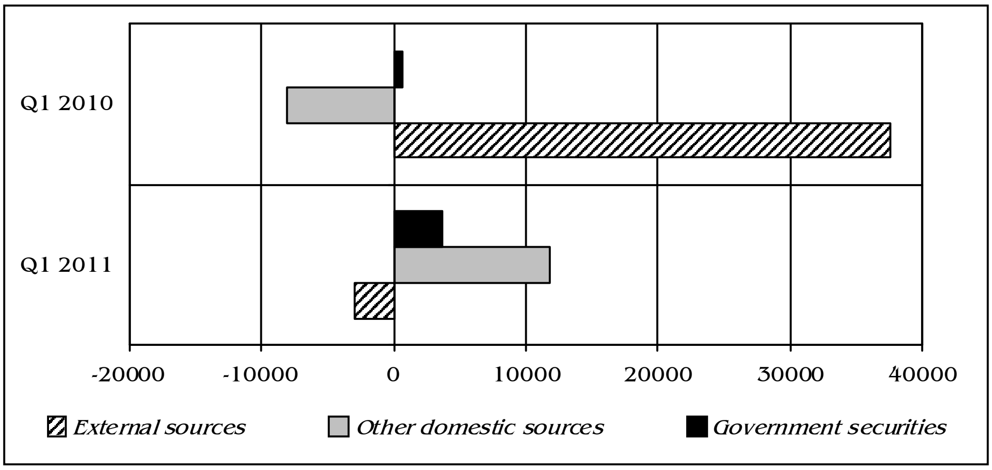
It is noteworthy that in the structure of expenditures on item *transactions with non-financial assets* the share of domestic sources of financing has grown while the share of external sources has reduced, amounting to 56.7 percent and 43.3 percent, compared to the previous year's figures of 35.1 percent and 64.9 percent, respectively.

In Q1 2011 budget expenditures posted cutbacks on capital expenditures



With revenues and expenditures indicators shown above, in the first quarter the budget deficit reached AMD 12.4 billion (making up AMD 8.3 percent of the projected annual deficit). The latter was financed primarily from external sources. In the structure of domestic sources, AMD 3.6 billion was financed from net proceeds on government securities and the rest portion, from funds available with the unified treasury account at the Central Bank.

In Q1 2011 financing from other domestic sources prevailed in the structure of budget deficit financing



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

Indicator	Q1 2010 - Q1 2009	Q1 2011 - Q1 2010
Real GDP	3.4	2.7
Domestic demand	6.1	1.7
Consumption	5.0	2.9
Public	3.0	-3.4
Private	5.3	3.9
Capital investment	15.3	-7.6
Public	11.5	-26.6
Private	-12.3	5.3
Export[34]	12.8	6.2
Import	5.9	-15.5

[34] *This is to mean export (import) of goods and services.*

3.4.2. Aggregate Supply[35]

According to economic activity indicator[36], as released by the National Statistics Service of Armenia in early 2011, economic activity in Armenia slowed down during the first quarter mainly due to the February-March EAI that remained unchanged relative to the same period of the previous year. The GDP growth rate was estimated 2.7 percent for the first quarter, which is determined by an estimated growth of value added in industry and services.

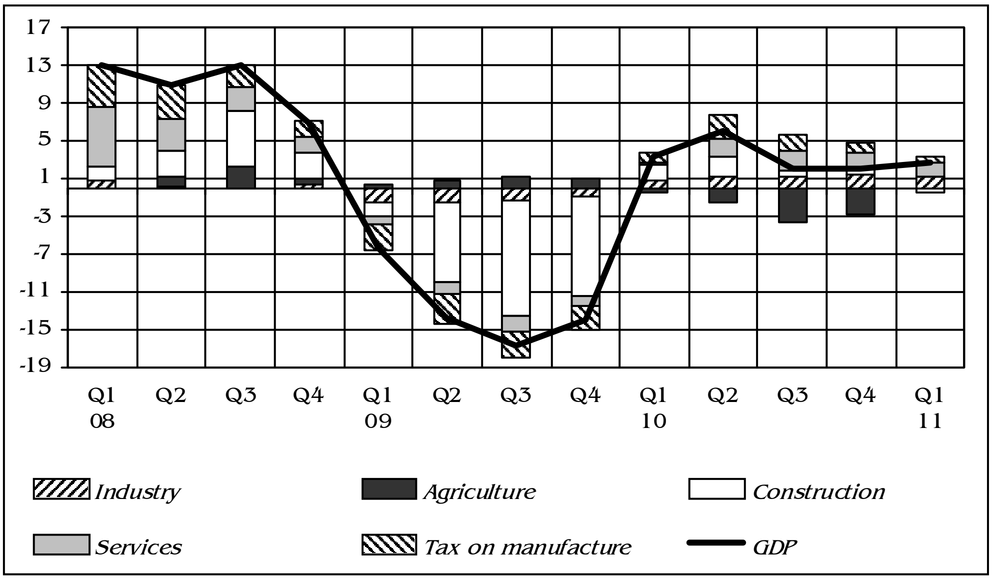
Industry: an estimated indicator of growth of value added was 5.9 percent, mainly owing to increased production volumes in *ore mining* (5.2 percent), *food* (9.3 percent), *beverage* (5.1 percent), *metallurgy and finished articles of metal* (54.7 percent), all as a result of grown external demand driven by recovering world economy. The 13.6 percent increase in electricity production also contributed to the growth of value added.

Construction: value added has reduced by 5.5 percent. The reduction in the volumes of construction financed by international loans was somewhat mitigated by increased volumes of construction financed by *organizations* and funds of *humanitarian aid.*

Services: growth of value added was estimated 2.9 percent, owing to increased volumes in *retail trade* and *wholesale trade* by 6.2 percent and 2.7 percent, respectively. The latter is mainly a result of 2.8 percent growth of retail trade turnover, largely driven by even a higher level of growth recorded in March. In the meantime, areas such as *financial and insurance activities* and *transport* made considerable contribution to the growth of value added of services rendered.

Agriculture: value added has reduced by 1 percent mainly due to decreased output volumes in plant growing. Output volumes in animal growing remained unchanged relative to the previous year explained by increased production of meat and reduced production of egg.

Real GDP growth rate and sector contributions (cumulative)



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

[36] *EAI, unlike the GDP indicator, is calculated based on the volumes of outputs of different economic activity segments rather than the volumes of value added, and it does not include net taxes on manufacture and services of financial intermediation that are measured indirectly. More information on this indicator can be found in the press release on "Moving to the Discrete (Net Monthly) Method from the Cumulative Method for Compilation, Survey and Publication of Current Macroeconomic Indicators for a Year", which the National Statistics Service of the Republic of Armenia published in 2011.*

3.5 LABOR MARKET [37]

In the first quarter of 2011 some growth in nominal wages was observed in the labor market, which was fostered by wage increases in the private sector and a number of budget-supported organizations, as a result of recovering economic activity. The growth rate of nominal wages somewhat exceeded the growth rate of productivity amid economic activity. As a result, in the first quarter of 2011 unit labor costs increased moderately in the economy, creating minor inflationary pressures.

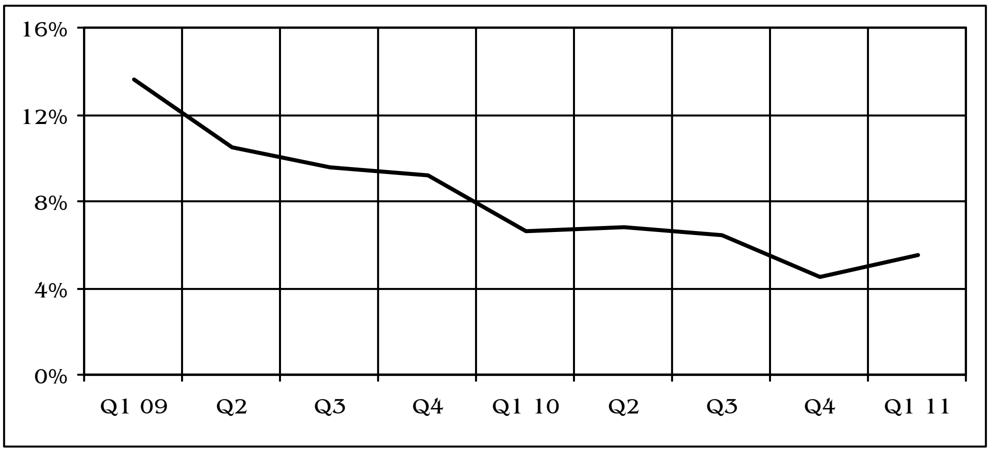
According to the Central Bank estimates, average growth of nominal wages in the economy in the first quarter was around 6 percent, reflecting a moderate growth of wages in private sector and in some budget-supported organizations. In the private sector, growth of nominal wages was largely affected by increased productivity in industry and services as well as the previous year's inflation. Increased nominal wages in healthcare, reflecting the introduction of a single payment window in the healthcare system, also contributed to the overall growth of nominal wages during the first quarter.

In the first quarter of 2011 demand for labor continued increasing mostly due to a reported increase of output in industry and services. As a result, the average number of the employed reached 2.3 percent while the quarterly unemployment rate fell against the same period of the previous year by 0.7 pp and reached 6.6 percent.

In the first quarter, concomitant with economic growth, labor productivity grew by around 2 percent.

As a result of these developments, unit labor costs have increased by around 4 percent, creating minor inflationary pressures in the economy, which amounted to about 0.3 pp.

Average nominal monthly wage growth



3.6. IMPORT PRICES AND PRODUCER PRICES

3.6.1. Import Prices

In the first quarter of 2011 prices of basic food products and intermediate goods in world markets trended up further. According to the Central Bank estimates, the dollar prices of imports have increased by 23.1 percent y-o-y (about 19.0 percent y-o-y increase was recorded in the previous quarter).

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[37] Labor market indicators of the first quarter of 2011 are the Central Bank estimates based on actual figures of January and February and estimated figures of March of 2011. Growth estimations presented in this section are relative to the same quarter of the previous year, unless otherwise specified.

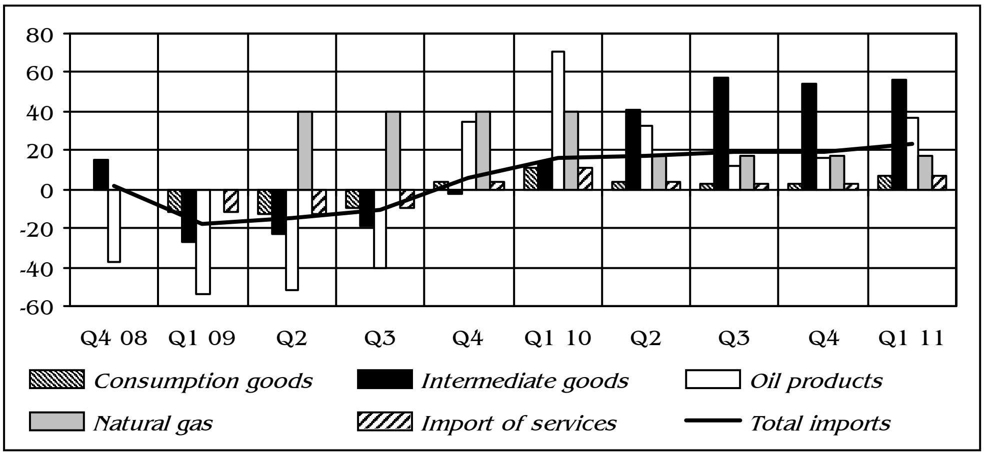
Indicator	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011
Import (total)	16.1	17.5	19.3	19.0	23.1
Import (services)	11.4	4.3	2.7	3.1	7.0
Import (goods)	17.3	21.0	23.8	23.3	27.3
Capital goods[38]	0.0	0.0	0.0	0.0	0.0
Consumption goods	11.4	4.3	2.7	3.1	7.0
Intermediate goods	14.2	40.9	57.8	54.4	57.2
Diamond[38]	0.0	0.0	0.0	0.0	0.0
Oil products	70.4	33.1	11.8	15.8	36.8
Natural gas	40.0	16.9	16.9	16.9	16.9

The y-o-y growth in dollar prices has been attributable to a notable growth of prices of intermediate goods and food products as well as oil products. The price increase of oil products alone has been 20.9 percent q-o-q against the previous quarter's 13.6 percent increase.

The dollar prices of intermediate goods and food products have increased by 57.2 percent y-o-y compared to 54.4 percent y-o-y increase recorded in the previous quarter. Prices of intermediate goods had 17.4 pp of impact on total import prices.

In the first quarter there has been high growth of dollar prices of oil products, 20.9 percent, whereas their y-o-y growth was 36.8 percent (15.8 percent in the previous quarter). As a result, prices of oil products had 2.7 pp of impact on total import prices.

In Q1 2011 prices of import goods were again fuelled by prices of intermediate goods and food products



The increase of dollar prices of imported consumption goods was driven by high inflation recorded in partner countries contribution of 6.1 pp. During the first quarter, in the face of around 0.6 percent appreciation of the partner countries' exchange rates on average, the dollar prices of imported consumption goods have risen by 7.0 percent y-o-y, which had 1.6 pp of impact on total import prices. High inflation recorded in Russia and the ruble appreciation made the strongest contribution, among main partner countries, to total import prices, making up 0.7 pp. Second strongest contribution came from China and Ukraine, making up 0.2 pp each.

Given 23.1 percent y-o-y increase of international prices (dollar import prices) and 4.9 percent y-o-y appreciation of the average nominal AMD/USD exchange rate, the dram prices of imported goods included in the consumption basket have risen by 9.8 percent y-o-y in the first quarter of 2011.

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

3.6.2. Producer Prices [39]

In the first quarter of 2011 all branches of the economy reported an increase of price indexes, and the GDP deflator amounted to 4.6 percent, according to the Central Bank estimations. Relative to the same period of the previous year, the GDP deflator has fallen by 3.4 pp due to the slowing of the growth rate of producer price index.

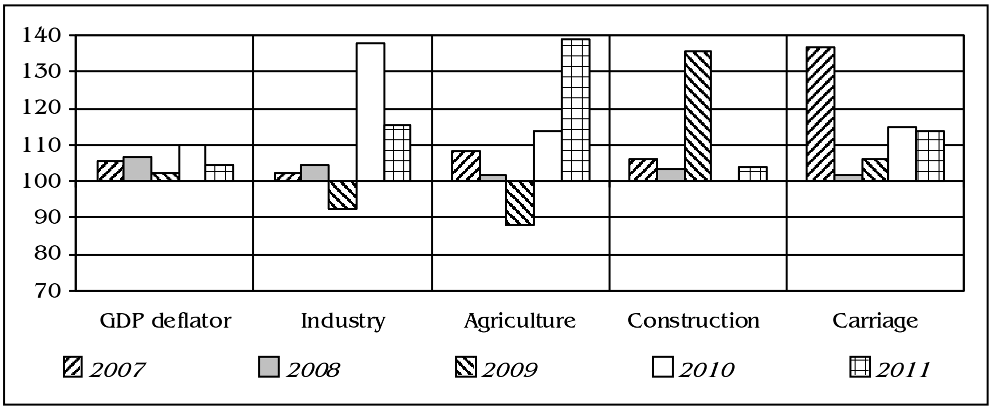
Agriculture posted the highest price increase. Over the first quarter prices have risen by 39.1 percent y-o-y[40].

Industry reported some slowing of growth rate of prices compared to the first quarter of the previous year under which circumstance the price index has grown by 15.7 percent y-o-y (37.7 percent growth in re previous year).

Construction reported the lowest growth of prices 7.3 percent y-o-y growth of prices, making up 3.7 percent y-o-y, but slightly outpacing the previous period's indicator.

Carriage costs have risen by 13.8 percent y-o-y (15 percent growth in the same quarter of the previous year).

In Q1 2011 the highest price increase was recorded in agriculture, the lowest, in construction



3.7. INFLATION EXPECTATIONS

The Central Bank conducted the Q1 2011 survey of inflation expectations among financial organizations, households, and non-financial organizations of real sector.

Based on the results of survey in the financial sector, expectations of high inflation for the upcoming 12-month horizon persisted. The choice of the 5.5-8.5 percent range for the 12-month inflation still prevailed at banks, amounting to 76.2 percent and at credit organizations, amounting to 62.0 percent. As such, expectations of high inflation in the financial sector, credit organizations in particular, were revised upside, reflecting persistently high inflationary environment recently.

Based on the survey results, expectations of high inflation were maintained with households as 69.4 percent of them predicted general price increases (69.6 percent recorded in the previous quarter).

Further, according to the results, banks and credit organizations stick to expectations of stable market interest rates for the upcoming 12-month horizon.

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[39] Price index change in the period January-December of 2010 is relative to the same period of the previous year, unless otherwise specified. Price indexes in branches of the economy represent output price indexes.
[40] Sales prices of producers of agricultural product are presented.