

Annual report 2006

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Introduction

In January 2006, the Central Bank of Armenia made a statement that, operating within the framework Republic of Armenia Law on the Central Bank, the Central Bank of Armenia adopted effective January 1, 2006 a new approach to inflation management by transitioning to an inflation targeting strategy. The earlier-used monetary aggregates targeting strategy had been adopted by the CBA in 1994 on the backdrop of an autonomous monetary policy pursued since the introduction of a national currency in late 1993. The strategy implied setting an ultimate goal, followed by setting an intermediate target, also known as a nominal anchor. The ultimate goal was inflation, and the intermediate target-money supply or broad money, which the CBA managed by means of an operational target-the monetary base. Hence, a monetary base-broad money-inflation chain was operational. Though the CBA had been attaining the inflation targets in recent years, the monetary aggregates targeting strategy encountered problems in the course of its implementation. In the more recent past, the broad money-inflation link had become volatile because of a fluctuating money supply, broad money structural changes in a highly-dollarized environment, and the sizable impact on inflation of non-monetary factors (external shocks and the like). As the primary goal of the CBA is to maintain price stability-defined by the legislature in the Law on the State Budget as a "certain level of inflation" - the CBA, given the weakening of the aforementioned link and the preference for the inflation target, has periodically had to revise its projection of broad money in the implementation of monetary policy. Essentially, the nominal anchor of monetary aggregates was not efficiently serving its purpose, because the legislature's requirement to deliver a certain level of inflation forced the CBA to exercise discretion authority on numerous instances.

Since the transition in 2006 to an inflation targeting strategy, for which the ultimate goal is a targeted level of inflation, and the nominal anchor is the projected level of inflation, the CBA is no longer guided by monetary aggregates. Shortterm interest rate is the operational goal; however, for reasons of financial stability, the CBA will also practice some volume regulation. Using an inflation model to forecast inflation for a future period, the CBA assesses the deviation from the target and aims its policy at eliminating the discrepancy between the target and the projection. The chain now runs from interest rate to projected inflation to inflation. The main advantage of explicit inflation targeting over the previous strategy is that, under the latter, broad money was considered the only

factor driving inflation, whereas the new strategy conceives a broad spectrum of factors probably impacting inflation, including the public's expectations of the future.

Accountability and transparency of the CBA's activities become rather important for implementing an inflation targeting strategy. Hence, the CBA will regularly publish the inflation forecast in the form of Inflation Reports, which, since 2006, have been issued on a quarterly basis (in The Newsletter of the Republic of Armenia Central Bank), covering the policy implementation progress. In this manner, the public can keep up with the CBA's activities and obtain explanation of the policies pursued and the deviations found. This process aims at bolstering public confidence in the CBA and the national currency, increasing dram savings, and improving the effectiveness of monetary policy.

As a result of the monetary policy carried out in line with the new inflation management strategy, annual inflation in 2006 was 5.2%. Inflation was mainly caused by a 6.6% increase in food products prices and a 5.3% increase in service tariffs, which contributed 3.6 and 1.6 percentage points, respectively, to inflation. The increase in food products prices was mainly due to changes in prices of several product groups such as Vegetables, Fruit, and Sugar (contributing 3.3, 1.4, and 0.5 percentage points, respectively), while the increase in service tariffs was mainly due to the "Health Care Services" and "Housing Services and Utilities" groups (contributing 0.9 and 0.3 percentage points, respectively). Economic growth remained buoyant in 2006— coming in at 13.4% at yearend. Growth continued to be fueled mainly by strong real growth of value added in construction and services (annual growth in these sectors was 37.2% and 14%, respectively). These developments, along with the higher growth of tourism and private transfers, caused a marked inflow of foreign currency to the economy, resulting in higher household income. The latter, through a rise in private consumption, generated some inflationary pressure in the consumer market. In two other sectors of the economy—the industry and agriculture—growth slowed down. The decline of annual value added in the industry was mainly due to changes in international markets, while agriculture was negatively affected by adverse weather conditions.

Consequently, annual industrial output declined by 0.9% in real terms in 2006 (compared to a 7.4% growth in 2005), while annual growth of agriculture came in at only 0.4% (compared to 11.2% in 2005). During 2006, domestic demand grew by an annual 13.7%, and private sector expenditures grew by an annual 13.2%. The performance was rather sound in terms of private investment, which grew by an annual 27.9%, mainly on account of Q4 growth. Capital investment growth was mainly expressed in the form of faster construction growth, especially in the housing construction segment.

