

Inflation report 2017/1 (Monetary Policy Program Q1, 2017. Status report on implementation of the Monetary Policy Program, Q4, 2016)

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Executive summary

The monetary policy the Central Bank of the Republic of Armenia (hereinafter “the Central Bank”) carried out in 2016 was expansionary and aimed at softening the existing deflationary environment, in view of the macroeconomic situation and inflation developments at the time. The consistency by which the Central Bank attempted gradual easing of monetary conditions proved effective since inflation expectations had reduced significantly amid persistently low inflation, domestic demand and inflation recovered to some extent during the year, leading to sustained income purchasing power and restored external competitiveness.

Economic activity growth rates remained slow in the fourth quarter of 2016 mainly due to reduced output in agriculture and mining sectors. In view of such developments, although the Central Bank had revised the 2016 economic growth forecast downward, the 2017 economic growth forecast remained virtually unchanged. Starting from 2017 up until the end of the forecast horizon, however, the growth rates will speed up to gradually approach the long-term equilibrium under the influence of somewhat accelerating global economic growth rates, expected gradual recovery of domestic demand in the economy, as well as a number of export and investment promotion programs and structural reforms by the Government of Armenia. The deflationary patterns observable in the most part of 2016 somehow mitigated in the fourth quarter; at the end of the year the 12-month inflation rate amounted to -1.1%. In anticipation of lower prices of some non-food products and reduction in the electricity tariff since February of 2017, the path to inflation target will be slightly slower compared to the previous prediction. Up until the end of 2017, the deflationary environment will phase out and the 12-month inflation rate will return to the target in the forecast horizon.

In the fourth quarter of 2016 the economic activity continued growing sluggishly due to reduced output of agricultural product and slowing of growth rates in mining sector. The decline in remittances from Russia 2015-2016 has negatively affected the domestic demand, yet expansionary monetary and fiscal policies implemented by the Central Bank

and Government of Armenia in the meanwhile have somewhat neutralized the effect. So, starting from the second quarter of 2016, the domestic demand recovered to some extent, reflecting accelerating growth rates in private consumption that time. As a result, 0.9% growth in real private consumption but 2.5% decrease in real private investment are estimated for the year. In the fourth quarter net real exports continued improving – for 2016 the real growth of export of goods and services is estimated at 14.0% and the real growth of import of goods and services, 1.5%. In the light of such developments, in 2016 the economic growth is estimated in the range of 0.3-0.5%.

There was 2.7% inflation in the fourth quarter of 2016 compared to that of 1.9% observed in the same period of the previous year, in which case the 12-month inflation rate amounted to -1.1% at the end of the year. In view of the deflationary environment to still persist over the coming months, sluggish domestic demand and the inflation expectations further mitigating, the Central Bank kept on loosening monetary conditions in the fourth quarter as well: the refinancing rate was lowered by a total of 0.5 pp (2.5 pp annually) to 6.25% in late December (see details in section “3.1.1. Actual inflation and fulfillment of the inflation target”).

According to the Central Bank forecasts, beginning from 2017, the pace of global economic growth rates will somewhat accelerate while inflationary patterns will continue to be seen in international markets, with the exception of the wheat market. Nevertheless, in the forecast horizon, considerable inflationary pressures from the external environment are not likely.

In 2017 the economic growth rates will speed up, mostly thanks to expected gradual recovery of the domestic demand, effective implementation of a number of programs by the Government of Armenia aimed at export and investment promotion, continued improvement in external economic environment and pushing ahead with structural reforms. In 2017 as a result, the economic growth is expected within 2.2-3.2%. From the demand perspective, this will be fuelled by private consumption (1.7% growth), private investment (3.0% growth) and net exports, with the export growth of goods and services forecasted in the range of 5.0-7.0%, while the growth of imports of goods and services is predicted in the 0-2.0% range. Also, the fiscal policy is expected to have 3.0 contractionary impact on aggregate demand during the year, compared to last year. From the supply perspective, the growth in industry and agriculture will contribute to the economic growth on the whole.

The economic growth rates will further accelerate, to be within 3.2-4.4% in the forecast

horizon.

Thus, in the forecast horizon up to the beginning of 2018, the domestic demand's deflationary impact on domestic prices will gradually weaken but then, up until the end of the forecast horizon, it will turn into that of inflationary.

According to the Central Bank forecasts, in anticipation of lower prices of some non-food products and the electricity tariff cut since February of 2017, the path to inflation target will be slightly slower compared to the previous prediction. Then, the deflationary environment will phase out by the end of the year, and the 12-month inflation rate will return to the target in the forecast horizon.

Given these factors, as well as the fiscal policy to be contractionary in 2017 in comparison with the previous year, the Central Bank finds that easing of monetary conditions in the first quarter of 2017 is still appropriate and possible.

The Central Bank believes that the policy implemented to date has created enough stimuli for neutralizing the deflationary environment in 2017 and fulfilling the inflation target in the forecast horizon, while future possibilities of conventional monetary policy remain limited.

Risks that inflation will deviate from the projected value are estimated to follow a downward path in both short and medium-term perspectives. Risks deriving from external sector have not changed much against the previous prediction and are somewhat inflationary; these are mainly associated with capital outflows from developing countries and, consequently, volatilities in financial markets, and the developments in international prices of raw materials and food products. Risks deriving from the domestic sector are estimated to be deflationary and reflect the extent to which price developments in product markets in the external sector will affect the domestic prices, the pace at which domestic demand and private investments will recover, as well as the Government-led structural reforms. At the same time, dual-sided risks to the developments in agriculture, a sector greatly depending on weather conditions, are possible.

If the aforementioned risks materialize, the Central Bank will react accordingly by maintaining the inflation target in the medium run.

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