

Inflation report 2016/1 (Monetary Policy Program Q1, 2016, Status Report on Implementation of the Monetary Policy Program, Q4, 2015)

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Executive summary

In the time of unfavorable economic developments in the main partner countries on the Armenian economy and inexorable influence of deflationary trends in international markets of commodities and food products, the economic growth in 2016 will remain weak. The 12-month inflation rate, although low at the beginning of the year, will tend to expand. Starting from 2017, the economic growth will accelerate to gradually approach the long-term equilibrium and inflation will continue to expand, stabilizing around the 4% target.

In 2015 private consumption and private investment reduced (estimated to be around 8% each) due to noticeable reduction in real disposable household income because of shrinkage in money transfers from Russia, an overall low level of business activity and slowed down lending growth rates. The negative impact of the reduction on economic growth was largely mitigated as the Republic of Armenia Government (hereinafter “the Government”) continued implementing expansionary fiscal policy while the Central Bank of Armenia (hereinafter “the CBA”) eased monetary conditions considerably. Low domestic demand prompted the import of goods and services to decrease by around 7.0% in real terms in 2015, which went along with 14.0% y/y real growth of the export of goods and services, leading to improved real net exports. As a result of these developments, the economic activity indicator in 2015 reached y/y 3.1% mainly due to increased output volumes in agriculture and mining sectors, in which case the economic growth is estimated in the range of 3.1-3.3% y/y.

According to short-term forecasts of the CBA, the external sector will further see a slow pace of economic growth and deflationary environment. Fresh forecasts of decline in the Russian economy and the ruble devaluation are signaling that the dollar value of remittances of individuals would decrease even more (9.0-12.0%) during the year compared to the previous prediction, which will contribute to the low level of domestic demand, hence the shrinking of private consumption. The impact of fiscal policy on the domestic demand (calculated over the previous year) is estimated 1.4 contractionary for

the year, although the deficit-to-GDP ratio is higher from the past 5-year average, standing at 3.5% against 2.4%. In this case, private consumption will fall by 1.3%, while private investment will remain at the 2015 level. Driven by weak demand, the real import of goods and services will continue to decline by 6.0-8.0% in 2016 while the real growth of export of goods and services is forecast within 2.0-4.0% owing to expected moderate growth in industry and agriculture sectors. In view of these developments, the 2016 economic growth is estimated in the range of 1.5-2.6%.

Starting from 2017, the economic growth rates will speed up, carrying the influence of effective implementation of the Government program steered to export and investment promotion, gradual improvement in the external economic environment and structural reforms. Driven by these developments, it is expected that economic growth at the end of the forecast horizon will be within 3.0-4.5%.

Thus, in the forecast horizon, on the back of stabilizing private demand and contractionary effect of the fiscal policy, the impact of aggregate demand on domestic prices will be somewhat deflationary and is expected to phase out at the end of horizon.

In the course of actual developments in 2015, the 12-month inflation rate fluctuated mainly within the confidence band, and it only stepped below the band at the end of the year, as a result of sharper falling. The year ended with an inflation indicator of -0.1%, which was determined by persistently low domestic and external demand, a large supply of agricultural products, as well as the fact that falling prices in external sector during 2015 had already partly reflected the domestic price reduction at the end of the year. In this situation, the CBA kept on easing monetary conditions in November-December by reducing the refinancing rate by 1.5 pp to 8.75% later the year. It was estimated that inflationary risks arisen from the previous year-end had been largely overcome, and abruptly eased monetary conditions made it possible to return to the normal situation that existed before November of 2014 (see details in section “3.1.1 Actual inflation and fulfillment of the inflation target”).

A low deflationary environment will be maintained over the first half of 2016 as significant inflationary pressures from the domestic economy and external sector in the short run are not expected. Note that the inflationary effect from the change in the excise duty scheduled for May 2016 has been considered in inflation forecasts. The CBA, therefore, estimates that at the yearend the 12-month inflation rate will be at the lower bound of the confidence band; in the upcoming months, influenced by expansionary monetary policy implementation, it will expand gradually to approach and stabilize around the target in the

forecast horizon.

The CBA believes that further easing of monetary conditions in the first quarter of 2016 is relevant in such a low inflationary environment. This, coupled with loosened monetary conditions early in the year, will lead to the expanding of the aggregate demand and fulfillment of the inflation target in the forecast horizon. Moreover, gradual loosening of monetary conditions is important on the premise of relatively high inflation expectations¹ and the risk to downside price rigidity and increasing dollarization. That said, in the time of a low inflationary environment and the lack of notable inflationary risks, the CBA refrains from more robust loosening of monetary conditions and rapid recovery of the 12-month inflation rate, taking into account still relatively high inflation expectations and the consideration that low inflation would somewhat cushion the decline in domestic demand, contribute to maintaining the purchasing power of incomes and restore the external competitiveness, which was damaged as a result of significant depreciation of partner countries' currencies. In addition, reducing and anchoring inflation expectations are only possible through a low inflation.

Risks to inflation deviating from the projected value are estimated to be downside in the short run and balanced in the medium run. The downside risks are mainly attributable to the falling prices of commodities and food products in international markets and a spillover of greater impact of such price reduction on domestic prices as well as to the developments in prices of agricultural products. In the medium-term perspective, the risks deriving from domestic and external sectors are mostly persisting relative to the previous forecast. In particular, the external sector risks are related to the global economic decline and drop in international prices of commodities and food products driven by capital outflows from developing countries to the U.S.A., higher volatilities of currencies in developing countries and a sharp slowdown in Chinese economic growth. Risks deriving from the domestic sector are mostly associated with the developments in agriculture, a sector greatly depending on weather conditions, the pace at which domestic demand and private investments will recover, as well as Government-led promotion programs. If the aforementioned risks materialize, the CBA will react accordingly by maintaining the inflation target in the medium run.

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