

Inflation report 2016/2 (Monetary Policy Program, Q2, 2016. Status report on implementation of the Monetary Policy Program Q1, 2016)

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Executive summary

Although global economic growth rates remained sluggish, some activity in the Armenian economy was observed in the first quarter of 2016 owing to expansionary policy carried out by the Government of Armenia (the Government) in 2015 and monetary conditions loosened considerably by the Central Bank of Armenia (the CBA) since the second half of the year. Consequently, the CBA has revised the 2016 economic growth projection indicator upside. In the rest part of the forecast horizon growth rates will continue to accelerate, gradually approaching the long-term equilibrium. Deflationary patterns will continue to be seen in the coming months due to the deflationary influence still transmitting from international commodity markets, while in the rest of the forecast horizon the 12-month inflation rate will gradually return to the target.

Private consumption and private investment kept on reducing (estimated at 2% and 5% respectively, in real terms) in the light of noticeable contraction in real disposable household income resulting from shrinkage in money transfers from Russia. However, while the decline in private investment was within expectation, private consumption expenditures reduced less than expected, as economic activity was stronger at that time. This was fueled by expansionary fiscal and monetary policy implementation by the Government and the CBA on the one hand and a relatively high growth observed in the tradable sector of the economy on the other. Good performance in the tradable sector secured rather strong real growth of export of goods and services (estimated at 32.9% y/y) whereas the estimation of import of goods and services decreased by 7.5%, reflecting continuous improvement in the net real export indicator. So, in the first quarter of 2016 the economic activity indicator amounted to 5.6% y/y mainly due to increased output volumes in industry and services sectors, in which case the quarter's economic growth was estimated in the range of 4.8-5.0% y/y.

According to short-term forecasts of the CBA, in 2016 economic growth in the external sector will continue to be slow and no more deflationary developments will be seen in international commodity markets while some price stability will be achieved gradually.

Furthermore, on the premise of slower declining rates in the Russian economy and eliminated expectations for the ruble depreciation, there is anticipation that the decline in seasonal worker income and remittances of individuals will slow down considerably, which will positively affect the level of domestic demand, hence gradual rebounding of private consumption. On the other hand, despite a sizable state budget deficit expected in 2016, the impact of fiscal policy on the domestic demand (calculated over the previous year) is estimated 1.5 contractionary for the year. Private consumption growth is projected at around 1.0% while private investment will grow by about 2.0% primarily thanks to investment to be made in the tradable sector of the economy. The latter, along with high growth in the first quarter, served a basis for giving exports a higher growth forecast. Thus, in 2016 the real growth of export of goods and services is projected in the range of 9.0-11.0%, while the forecast of real import of goods and services will remain at the previous level (6.0-8.0% decrease). In view of these developments, the 2016 economic growth is estimated in the range of 2.7-3.6%.

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, the impact of aggregate demand on domestic prices will be deflationary up until the start of 2017; then it will grow into inflationary by the end of the horizon.

In the first quarter of 2016, the 12-month inflation rate declined faster than expected. Inflation amounted to 0.4% compared to 2.4% recorded in the same period of the previous year, in which case the 12-month inflation rate reached -2.0% at the end of March. A low inflation was primarily driven by prices of agricultural products which had fallen relative to the same period of the previous year and deflationary impacts partly transmitted on to the domestic prices from international commodity markets. Despite a fairly low inflation environment and some moderation of inflationary expectations, inflation expectations are still viewed high according to the CBA estimations, which is why it lowered the refinancing rate in that period gradually by a total 0.5 pp to 8.25% at the end of March. The CBA has always emphasized that in the event inflationary expectations are mitigated and no additional risks are posed to inflation, it will keep on easing monetary conditions gradually and, if necessary, at an abrupt pace (see details in section “3.1.1 Actual inflation and fulfillment of the inflation target”).

Short-term forecasts of the CBA denote that external environment's deflationary impact will be transmitting on to the domestic prices in the coming months, which will phase out in the second half of the year. At the same time, it is estimated that inflation expectations are declining relatively fast thanks to consistent monetary policy implementation. On top of the policy influence, an expected reduction in the natural gas tariff as another factor has been added and is thought to facilitate the reducing of inflation expectations.

The CBA reckons that easing of monetary conditions at a greater pace in the second quarter of 2016 is relevant in the time of low inflation environment and considerable reduction of inflation expectations. This, coupled with monetary conditions loosened at the start of the previous year, will lead to the expanding of aggregate demand and stabilizing of inflation around the target in the forecast horizon.

Risks to inflation deviating from the projected value are estimated as balanced in the short and medium run. Risks deriving from domestic and external sectors mostly persisted in relation to the previous forecast. In particular, the external sector risks are related to capital outflows to the U.S.A. from developing countries and, consequently, higher volatilities of currencies in developing countries, a likely slowdown of global economic growth resulting from structural reformation of the Chinese economy as well as risks related to developments in international prices of raw materials and food products. Risks deriving from the domestic sector are mostly associated with the extent to which external environment's deflationary impact will spill over to the domestic price 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 structural reforms.

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

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