

Inflation report 2016/3 (Monetary Policy Program Q3, 2016. Status report on Implementation of the Monetary Policy Program Q2, 2016)

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Executive summary

The economic situation in Armenia and the pace of monetary policy of the Central Bank of Armenia

The policy implemented by the Central Bank of Armenia (the CBA) in the forecast horizon is still incurring the effect of the economic shock in late 2014, and the CBA has from time to time addressed the mechanisms of such effect in its inflation reports. In the last quarter of 2014, a sharp decline in international oil prices and depreciated Russian ruble led to dramatic changes in the behavior of households and companies. With too high expectations for inflation, all businesses attempted to secure themselves by converting the domestic currency into foreign currency and into various consumer goods, even short-term ones. Such behavior reflected all the signs of hyper-inflation the domestic economy had experienced back in 1993. The CBA reacted to this situation by using all of the means in its arsenal to stabilize the situation and safeguard the country from a deep economic crisis. It has therefore been possible for Armenia to avoid heavy financial and economic turmoil, which is still the case in many countries of the region as a consequence of a sharp price-fall in international oil market in 2014. Not only has the CBA been able to ensure macroeconomic stability in 2015, but its policy has contributed to shaping of positive economic growth at a time when the economies of all major partner countries in the region contracted. Moreover, the CBA's actions laid the foundation for eliminating previous economic imbalances and paving the way for long-term sound economic growth.

Regional shocks are not completely waned out yet, and the CBA is doing all to preserve hard-won macroeconomic stability while making sure it is not exposed to risks. This is why the CBA has chosen under its current monetary policy a scenario of gradual elimination of deflation; it is especially true as current deflation is of mostly an imported character, which all the central banks of the world do not practically respond to, allowing the shock of imported deflation to phase out automatically. The CBA presented deflation forecasts in its previous inflation reports, and well aware of deflation as having been imported, it believes that currently low inflation and gradual inflation recovery trajectory are in line

with the long-term price stability objective of the CBA and, therefore, best serve the public interest for several reasons.

It provides stability and predictability for attracting investment. Over the past 7 years, only 2015 saw a significant increase in domestic savings and no more decline in gross investments, which are the cornerstone for long-term economic growth. Still, their level is low. This is attributable to slow pace of structural reforms in recent years as the investments were fully financed through loan resources, which has a significant deterrent effect and may not be sustainable in the long run.

It facilitates elimination of accumulated imbalances in the economy through developed tradable sector, which is reflected in reducing current account deficit and sustainability of foreign debt even in the time of significant drop in remittances from abroad. Moreover, along with the import reduction, all countries in the region faced reduced exports, whereas import reduction in Armenia was almost concurrent with an unchanged level of exports (a significant increase in real exports was recorded under a sharp drop in export prices), which puts Armenia's economy positively apart from other countries in the region and secures an adjustment of external imbalance.

It helps restore enterprise competitiveness, which was disrupted due to the depreciation of the Russian ruble, as companies spend less on imported raw materials, fuel, and food and non-food products. Under an inflation scenario however, companies would incur more wage growth pressures and heavier foreign currency debt burden, leading to a wave of bankruptcies and sharp increase in unemployment, the risks to which have not vanished even today. These costs would definitely outgrow the ones exporters had incurred as a result of less depreciated dram in comparison with the ruble, and it seems to have been largely neutralized in Russia in two consecutive years due to much higher inflation there if compared to Armenia.

It also helps maintain consumers' living standards, as diminishing consumer incomes in a time of sharp decline in remittances would be more painful amid a higher rate of inflation. Low inflation has secured the purchasing power of wages, while real consumption has decreased due to reduced remittances from abroad.

It anchors inflation expectations, which, in addition to macroeconomic stability, also facilitates the transmitting of the effect of expansionary monetary policy on to the real sector and lending. Thus, in a time of high inflation expectations sharp reduction in interest rates comes out through exchange rate depreciation pressures in the currency market and it does not contribute to the real economy lending, as it

happened in the period November 2015 – February 2016. However, the policy of more gradual reduction in interest rates since February gives the economy an impulse about stability of future prices, reflecting declined inflation expectations and lower long-term interest rates. Only such a policy made it possible to gradually restore lending, which, since the end of the first quarter of 2016, is in the positive territory.

It covers adverse shocks while contributing to the improvement of economic fundamentals, which, in the case of new negative external shocks, would keep the country immune to repeating of volatilities in 2014. The risk of these shocks is still estimated to be very high due to geopolitical developments in the region and possible fluctuations in commodity markets on the one hand, and the consequences after the US Federal Reserve System decides to raise the policy rates in the future, on the other.

The CBA believes the monetary policy it conducts best serves the society's interests and is determined to further carry out its primary task of maintaining price stability in Armenia, as entrusted to it by the Constitution and laws of the Republic of Armenia.

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