

# Inflation report 2016/4 (Monetary Policy Program Q4, 2016. Status report on implementation of the Monetary Policy Program Q3, 2016)

2016-11-25

## Executive summary

Notwithstanding continued sluggishness in global economic growth rates, main trade partner countries to Armenia saw their economic activity further accelerating in the third quarter of 2016, reflecting an increased external demand for export goods from the Republic of Armenia and positive developments in Armenia's tradable sector of the economy. Yet, the economic growth reported for the first half of the year was considerably lower than expected in the third quarter. Also, trade turnover volumes remained low and risks to reduced output in agriculture and mining materialized during the quarter. In view of such developments, the Central Bank of Armenia (the CBA) has revised the 2016 economic growth forecast downward. In the rest of the forecast horizon, however, the growth rates will speed up to gradually approach the long-term equilibrium. In the course of the past nine months deflationary patterns have prevailed – the 12-month inflation rate fluctuated around an average value of -1.7%. In the coming months, the deflationary environment will persist due to low economic activity and expected gas and electricity tariff reduction in the first quarter of 2017. In the rest of the forecast horizon the 12-month inflation rate will gradually return to the target.

Sharply deteriorated economic activity in the third quarter of 2016 was mainly determined by supply factors, particularly slower growth rates in agriculture and industry sectors, while domestic demand continued to remain weak. Driven by more-than-expected contraction in trade volumes, lower economic activity and construction still at a decline, about 2% growth of real private consumption but 1.0% decrease in real private investment are estimated for the third quarter of 2016. The adverse effect of low economic activity was in part cushioned by expansionary fiscal and monetary policy implementation by the CBA and the Government of Armenia since early 2015 to date on the one hand, and relatively sizable investment in the tradable sector, on the other. Influenced by the latter, net real exports kept on improving this quarter, too: in the third quarter real growth of export of goods and services is estimated at 10.5% y/y and real growth of import of goods and services, merely 3.1%. So, based on the past nine months' results, the economic activity indicator amounted to 1.6% y/y, in which case the January-

September economic growth is estimated in the range of 1.3-1.5% y/y.

There was 2.7% deflation in the third quarter of 2016 compared to that of 1.9% in the same period of the previous year, in which case the 12-month inflation rate reached -1.9% at the end of September. In view of the inflation environment to persist at a low level in the upcoming months, sluggish domestic demand and the inflation expectations further mitigating, the CBA continued to loosen monetary conditions in the third quarter as well: the refinancing rate was lowered by a total of 0.75 pp to 6.75% in late September (see details in section “3.1.1. Actual inflation and fulfillment of the inflation target”).

According to the CBA forecasts, in the external sector in 2016 slow economic growth rates will continue and mainly weak inflationary developments will be seen in international commodity markets. As the Russian economy declines at a slower pace there will be much less narrowing of inflow of seasonal work income and private transfers, but its impact on the recovering of domestic demand thus private consumption will be largely offset by an anticipated low domestic economic growth effect. In this circumstance, private consumption will grow by about 0.8% but private investment shrink by nearly 3.5%, according to the 2016 forecast. The consumption growth will be sustained thanks to an expansionary monetary policy conducted since 2015, fiscal stimulus provided by the Government of Armenia in 2016 and the currently deflationary environment in the economy. The decline in investment will be attributable to low activity in the construction sector. In the light of these developments, the 2016 economic growth is estimated to be within 1.3-1.8%. It will be fuelled primarily by net exports as economic activity accelerates in main partner countries on the one hand, and external demand brings in positive developments in the tradable sector, on the other, which was in turn fostered by a consistent monetary policy by the CBA and risen competitiveness of firms that benefited a lower inflation compared with trade partner countries.

In 2017 the economic growth rates will speed up, bearing the influence of effective implementation of the Government of Armenia program, steered to gradual recovery of domestic demand and export and investment promotion, and the effect of continued improvement in 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 2.8-4.3%.

Thus, in the forecast horizon up until the second quarter of 2018, the impact of domestic demand on prices will be deflationary; then in the end of the forecast horizon it will turn into that of inflationary.

According to the CBA forecasts, the deflationary environment is expected to mitigate significantly at the end of the year. The first quarter 2017 inflation forecasts took into account the factor of lowering of gas price (see details in section “2.3. Inflation forecasts and monetary policy directions in 3-year forecast horizon”). On the back of these developments, the CBA estimates that the deflationary environment will still be maintained in the first quarter of 2017, then it will generally phase out, and the 12-month inflation rate will return to target in the forecast horizon.

As a result, the CBA believes that medium-term deflation risks largely persist, and the 2017 fiscal policy factor has now been added to them. So, further easing of monetary conditions to some extent by the CBA in the fourth quarter of 2016 is relevant.

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 are somewhat inflationary and pertinent to capital outflows from developing countries and, consequently, volatilities in financial markets, the processes in the European Union, 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 estimated to be deflationary, with the 2017 fiscal policy factor and possible reduction of electricity tariff in the first quarter the same year now added to the existing ones. Risks outlined in the previous forecast carry on and are associated with the extent to which external environment’s deflationary impact will spill over to the domestic prices, developments in agriculture, a sector greatly depending on weather conditions, the pace at which domestic demand and private investments will recover, as well as the 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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