

Inflation report 2015/1 (Monetary Policy Program Q1, 2015, Status Report on Implementation of the Monetary Policy Program Q4, 2014)

2015-02-19

Executive summary

According to the Central Bank forecasts, in the course of 2015 the 12-month inflation rate will stay mostly in the upper bound of the confidence band of 4%+1.5 pp; later the year it will approach the target and stabilize around over the rest part of the forecast horizon. In the time of uncertain economic developments in the external environment, economic growth rates will slow down in 2015 but will speed up over the rest part of forecast horizon, gradually approaching the long-term equilibrium.

In the 4th quarter of 2014, the domestic demand remained sluggish attributable to declined private consumption and weak investment activity mainly due to a significant reduction in remittances from abroad and Russia in particular. It is estimated that in 2014, compared to the last year, private consumption spending will remain unchanged, while private investment will decline by 0.6%. The negative impact of these factors on the aggregate demand was somewhat reduced owing to implemented expansionary fiscal and monetary policies. Sluggish economic growth in terms of supply this quarter was again due to slow growth rates in industry and services, particularly trade volumes, and still negative developments in construction. On the other hand, the developments in agriculture were in line with forecasts. As a result, it is expected that in 2014 the economic growth will be in the range of 3.2%-3.5%.

According to short-term forecasts, both private consumption and private investment will reduce in 2015. The fiscal impulse [in relation to the previous year] is estimated to be small expansionary during the year. In 2015, the real growth of export of goods and services is expected within 7.0%-9.0% while the decline in import of goods and services in real terms is predicted in the range of 4.0%-6.0%. Moreover, around 30% net reduction in remittances of individuals in dollar terms is anticipated. It should be noted that private remittances¹ in Russian ruble are expected to increase in 2015 but their growth rates are predicted to slow in future. As a result, the economic growth in 2015 is estimated in the range of 0.4%-2.0% primarily due to resumption of tradable sector of the economy.

In the forecast horizon, the economic growth will gradually approach its long-term equilibrium, reflecting accelerating net export growth rates and slowly rebounding domestic demand. Thus, in the forecast horizon, with stabilizing private demand and mostly a neutral impact of the fiscal policy, the impact of the aggregate demand on prices will be non-inflationary.

The economic activity in Armenia's main trade partner countries tended to slow down in the 4th quarter of 2014, in which case the external demand remained at a low level while more than expected deflationary patterns were observable in international commodities and food product markets.

In the forecast horizon, in view of rebounding global economy and gradual acceleration of economic growth in Armenia's main trade partner countries, a steady price rise in international commodities and food products markets as well as relative stabilization of exchange rates and expectations of further appreciation will transmit positive effects onto the Armenian economy. Under these conditions, however, inflationary pressures from the external demand and international markets of basic commodities and food products are not likely.

With the Armenian dram depreciated and the inflation environment expanded on the brink of a steep reduction in foreign currency flows, depreciating Russian ruble and resultant inflationary expectations at the end of the year, the 12-month inflation rate exceeded expectations in the 4th quarter as in late December it was 4.6%, still within the confidence band.

Though the inflation was still within the confidence band during the quarter, the dram's exchange rate adjustment as well as persisting economic and geopolitical developments abroad and especially in the region intensified the pressures in the foreign exchange market since the end of November, taking them also to the products market. These markets began to incur temporary instability, in the meanwhile loading significant inflationary potential and creating inflationary expectations.

The Central Bank responded to the situation thoroughly. Specifically, in late November the Bank raised the Lombard Repo Facility Rate (from 8.25 to 21.0%), followed by a midDecember increase of the Reserve Requirement Ratio with regard to funds attracted in foreign currency (from 12.0 to 24.0%). Note that short-term dram market rates reacted to the Central Bank's tightening of financial conditions in the financial market as they rose and stayed in the time around the Lombard Repo Facility Rate. This can imply that the Lombard Repo Facility Rate has taken, since the yearend, the role of financial market's

leading interest rate. Following these actions, the currency and product markets were able to see some signs of stabilization, which is why in late December the Central Bank lowered the Reserve Requirement Ratio with regard to funds attracted in foreign currency from 24.0 to 20.0% and the Lombard Repo Facility Rate from 21.0 to 20.0%. In early 2015, the Lombard Repo Facility Rate was reduced further to 14.5%, which straightforward led short-term dram market rates down.

At the same time, to moderate future inflationary pressures and have the inflationary expectations anchored around the target, in late December the Central Bank raised the Refinancing Rate by 1.75 pp. In early 2015, the Refinancing Rate was further increased to 10.5%, reflecting upward trends of investment risk and interest rates in developing countries over a longer term (see details in section "3.1.1 Actual inflation and fulfillment of the inflation target").

According to the Central Bank forecasts, with a lower base compared to the same period of the previous year as well Armenia's membership to the Eurasia Economic Community from January 2015², in the 1st quarter the 12-month inflation rate will increase slightly. However, in anticipation of weak demand in external and domestic economies, the inflation will reduce to approach its target at the end of the year.

The Central Bank estimates that, driven by the latest events in the previous year and the geopolitical situation in the region, the developments in product and financial markets of Armenia are gradually playing out as they incur the impact of the Central Bank policy action for the period December 2014 to February 10, 2015. In this circumstance, the Central Bank will continue reducing the Lombard Repo Facility Rate during the 1st quarter of 2015.

As the economy comes back to normal conditions, the Central Bank policy actions will reduce the spread between the Bank's policy and short-term dram market rates, reviving the leading role of the Refinancing Rate in the market and contributing to the financial market stabilization and fulfillment of the inflation target in the medium term. Risks to inflation deviating from the projected value are estimated as balanced in both short and medium-term perspectives. External sector risks are primarily associated with global economic growth rates bouncing back as well as economic and geopolitical development perspectives in emerging economies, and Russia in particular, and how their potential impact would be spilled over to basic commodities and food product markets. Risks deriving from the domestic environment are attributable to domestic demand developments, particularly private consumption growth rates, capital investment recovery rates, the Government-led projects, the economic effects from Armenia's membership to

the Eurasia Economic Community, and the developments in agriculture sector which is largely reliant on climatic conditions. If such risks materialize, the Central Bank will react accordingly by maintaining the inflation target in the medium haul.

[Inflation report \(Monetary Policy Program Q1, 2015, Status Report on Implementation of the Monetary Policy Program Q4, 2014\)](#)