

Inflation report 2015/2 (Monetary Policy Program Q2, 2015, Status report on implementation of the Monetary Policy Program Q1, 2015)

2015-05-21

Executive summary

According to the Central Bank forecasts, in the course of 2015 the 12-month inflation rate will be in the upper bound of the confidence band of 4%+1.5 pp; starting from 2016, it will stabilize around the target. Economic growth for 2015 is forecast to be higher relative to the previous projection, which is determined by positive developments in economic activity in the first quarter. In 2016, economic growth rates will remain the same but will speed up later, gradually approaching the longterm equilibrium.

In the 1st quarter of 2015, the domestic demand grew somewhat relative to the projection attributable to lesser declined private consumption. However, investment activity has been consistent with an expected low level mainly due to weaker construction sector activity and slower growth rate in credit to enterprises. It is estimated that in the 1st quarter of 2015, compared to the same reference period last year, private consumption spending will decrease by 1.3% and private investment, by 7.4%. Lagged effect from implemented expansionary fiscal and monetary policies and expansionary impact of the fiscal policy implemented in 1st quarter of 2015 somehow offset the negative impact of these factors on the aggregate demand. Some growth in economic activity in terms of supply this quarter was due to higher-than-expected growth in agricultural output and lesser decline in construction. As a result, the 1st quarter economic growth is estimated in the range of 2.1%-2.5%.

In 2015, both private consumption and private investment will reduce by 2.5% and 8.0%, respectively, according to the Central Bank forecasts. The fiscal impulse [calculated in relation to the previous year] is estimated to be 2.0-2.5 expansionary during the year. Given that the information on the 1st quarter 2015 foreign trade indicators is not complete, forecasts of real growth of export and import of goods and services for 2015 remained unrevised. This means that 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 in the range of 4.0%-6.0%. Moreover, about 25% net reduction in remittances of individuals in dollar terms is anticipated. This is, however, some improvement in relation

to the former forecast, as the Russian ruble started appreciating at higher rates than expected.

As a result, the 2015 economic growth has been revised upside relative to the former forecast to be in the range of 1.6%-2.6%, which will be driven by further maintaining financial stability, loosening monetary conditions in the 1st quarter, more stimulating fiscal policy implementation and positive developments in agriculture.

In the forecast horizon, the 2016 economic growth rates will persist at the same level. Then the economic growth will speed up, owing to a bunch of programs the Government plans to carry out in the tradable sector and reflecting continued improvement in external economic environment, and approach its long-term equilibrium. In view of long-term economic growth equilibriums declining amid growing uncertainties about further economic development in Armenia's main trade partners and slowing foreign capital investment as well as still sluggish domestic economic activity, the Armenian long-term economic growth equilibrium has been revised downside, ranging 4%-5%.

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 domestic prices will be neutral. Economic activity in Armenia's main trade partners further demonstrated slow-growth patterns over the 1st quarter of 2015, in which case the external demand remains at a low level. International commodities and food product markets continue observing deflationary developments, mainly driven by appreciating U.S. dollar as well as expectations of high crops. In the forecast horizon, amid gradually accelerating global economy and rebounding growth in Armenia's main trade partners, 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, significant inflationary pressures from the external sector are not likely.

In the 1st quarter of 2015, the 12-month inflation rate behaved cumulatively, as was expected. As a result, at the end of March the 12-month inflation rate was 5.8%, staying closer to the upper bound of the confidence band.

Despite high 12-month inflation rate, decisive actions of the Central Bank taken on in late 2014 helped to get inflationary expectations anchored as soon as the 1st quarter of 2015, which in turn contributed to the elimination of tension in the domestic financial and commodity markets. This prompted the Central Bank to ease monetary conditions notably during the 1st quarter of 2015 by gradually lowering the Lombard Repo Facility Rate from

20% to 12%. However, in order to maintain Armenia's monetary position in a long-term perspective amid investment risks and growing interest rate trends in developing countries, the Central Bank raised the Refinancing Rate to 10.5% in the 1st quarter of 2015. These actions helped the Lombard Repo Facility Rate to again uphold an accepted 1.5 percentage point spread from the Refinancing Rate and pushed short-term market rates down. A zero or weak mechanism of reserve requirement for long-term funds attracted by banks became effective and some other macro-prudential measures were taken on in the 1st quarter (see details in section "3.1.1 Actual inflation and fulfillment of the inflation target").

In conclusion, the 1st quarter of 2015 saw generally an easing of monetary conditions.

In consideration of possible rise in electricity price in the upcoming period, the prediction is that the 12-month inflation rate would remain in the upper bound of the confidence band but would then reduce gradually fuelled by a greater seasonal drop in food prices owing to positive developments in agriculture as well as expected weak demand in both external and domestic sectors.

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