

Inflation report 2015/3 (Monetary Policy Program Q3, 2015. Status report on implementation of the Monetary Policy Program Q2, 2015)

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Executive summary

According to the forecasts of the Central Bank of Armenia (hereinafter “the CBA”), by the end of 2015 the 12-month inflation rate will be in the lower bound of the confidence band of $4\% \pm 1.5$ pp. In the rest part of forecast horizon, it will fluctuate within the confidence band and stabilize around the target at the end of forecast horizon. For 2015, economic growth is predicted to be higher compared with previous forecast, which is due to positive developments of economic activity in the first half of the year. In 2016, economic growth rates will remain at the same level but will accelerate gradually, approaching a long-term equilibrium.

In the first half of 2015, the indicator of economic activity was 4.2% y/y, which exceeded expectations largely due to higher-than-expected output volumes in agriculture and, in part, industry sectors. In terms of demand, the growth of economic activity that time has been driven by more stimulating fiscal policy implemented by the Government and considerable easing of monetary conditions by the CBA early in the year, when lombard repo facility rate was reduced to 12% from 20%. This generally mitigated the impact of the decline in private consumption and private investment. Note that the slump in private consumption and private investment has been attributable, respectively, to significant reduction in households’ disposable income as a result of the decrease in remittances from Russia and weak economic activity in the construction sector and slowed down credit growth. In the second quarter of 2015, the decrease in private consumption costs is estimated to amount to 2.0% and private investments, 7.0%. The second quarter of 2015 saw a sizable reduction of negative balance in net real export thanks to a real growth of export of goods and services by 22.7% y/y, whereas import of goods and services posted a decrease in real terms by 5.9% y/y. As a result, economic growth in the first half of 2015 is estimated in the range of 2.7 - 2.9% y/y

According to short-term forecasts of the CBA, in 2015 private consumption and private investment will reduce by 1.6% and 4.0%, respectively. The fiscal impulse, calculated in relation to the previous year, is estimated to be 2.0 - 2.5 expansionary for the year. Given

that the National Statistical Service of Armenia recalculated Armenia's foreign trade figures for January-June, which reflect high real growth rates in export and declined rates in import, the export and import forecasts have been revised. Thus, real growth of export of goods and services for 2015 is predicted in the range of 15.0 - 17.0%, while real decrease in import of goods and services, in a 3.0 - 5.0% range. Though the growth in money transfers outstripped expectations in the second quarter, deteriorating situation of the Russian economy, however, required to leaving the forecasts of remittances of individuals unchanged. In 2015, about 25% decrease in remittances in dollar terms (net) is anticipated.

As a result, the 2015 economic growth has been revised upside relative to a former forecast and is projected within 2.8 - 3.6%, which will be mainly driven by macroeconomic and financial stability since the beginning of the year, monetary conditions loosened by the CBA in the first half of the year, more stimulating fiscal policy implementation as well as positive developments in agriculture.

In 2016, economic growth rates will persist at the same level. Starting from 2017, the growth rates will speed up, carrying the influence of effective implementation of 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 3.5 - 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.

In the second quarter of 2015 too, economic activity in Armenia's main trade partners further demonstrated slow-growth patterns, in which case external demand remains at a low level. In the second quarter of the year, international markets of basic commodities continued observing deflationary developments on the back of large volumes of food production, a low level of global demand as well as appreciating US dollar in spite of rise in prices of certain raw materials.

In the medium-term perspective, slowly rebounding growth in economies of Armenia's trade partners, stabilizing prices in commodity and food product markets as well as subsiding volatilities in world financial markets all will transmit positive effects onto the Armenian economy.

So, in the forecast horizon, inflationary pressures from the external sector are not anticipated.

In the second quarter of 2015, the 12-month inflation rate hovered within the upper bound of the confidence band, as was expected, reaching 5.5% in late June. According to the CBA's short-term forecasts, although upcoming months would see somewhat lower prices of agricultural products relative to the same period last year, owing to positive developments in agriculture, the CBA left monetary conditions unchanged in the second quarter because the inflationary impact of the electricity price increase possibly since August this year is thought to offset that development (see details in section "3.1.1 Actual inflation and fulfillment of the inflation target").

At the end of the forecast horizon the 12-month inflation rate will stabilize around its target level of 4%. A fairly moderate inflationary environment is anticipated in the second half of 2015 as positive developments in agriculture sector will result in lower year-on-year levels of prices of agricultural products. However, low inflation environment will be offset to a certain extent, as the CBA loosens monetary conditions and the Government implements a stimulating fiscal policy during the year. It should be noted that the inflationary effect that was previously expected to come from electricity price increase since August 1, 2015 is currently out of consideration. However, once actual information on how a mechanism of Government subsidies works and on the results of the audit to be conducted at the "Electric Networks of Armenia" CJSC is available, the CBA will provide estimates of the inflationary effect of this particular change in its next publications. In the meantime, the inflationary effect of possible changes in excise duty in 2016 has been considered in inflation forecasts. In the light of these developments, the CBA estimates that in the second half of the year the 12-month inflation rate will reduce and stay in the lower bound of the confidence band. Over the rest part of the forecast horizon, the inflation will fluctuate within the confidence band and is expected to stabilize around the target at the end of the horizon.

The CBA estimates that, in the time of low inflationary environment, easing of monetary conditions in the third quarter of 2015 will be appropriate. Still, there are risks coming from domestic and external economies. If these materialize, the inflation environment may expand while the CBA will possibly adjust its monetary policy directions in order to attain the inflation target in the medium run.

Risks to inflation deviating from the projected value are estimated upward in both short and medium-term perspectives. Risks deriving from the external sector are related to economic outlook in both developed and developing countries. In particular, an expected

rise in interest rates by the U.S. Federal Reserve System could lead to capital outflows from developing countries to the U.S.A. and provoke higher volatilities of currencies in developing countries. More significant are the risks to the future of Russian economic development. These are attributable to oil prices with their greater-than-expected decline and predicted lower level over the forecast horizon, further depreciation of the Russian ruble against the U.S. dollar, as well as further course of geopolitical developments. A sharp slowdown in Chinese economic growth could also pose risks to the global economic decline and the fall in international prices of commodities and food products. Risks deriving from the domestic sector are mainly associated with the developments in agriculture, a sector greatly depending on weather conditions, the uncertainty of the impact of increasing electricity prices, as well as the pace at which the domestic demand would recover and the Government-led projects unfold. If the aforementioned risks materialize, the CBA will react accordingly by maintaining the inflation target in the medium run.

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