

# Inflation report 2015/4 (Monetary Policy Program Q4, 2015, Status report on implementation of the Monetary Policy Program, Q3, 2015)

2015-11-20

## EXECUTIVESUMMARY

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  $4\% + 1.5$  pp. In the upcoming months, it will remain at a low level, gradually approaching and stabilizing around the target within forecast horizon. Year 2015 will end with a 3.2 - 3.9% economic growth which will slow down in 2016 mainly due to expected deceleration in growth rates in agriculture and industry sectors. Starting from 2017, concurrent with rebounding domestic demand, economic growth rates will speed up, gradually, approaching a long-term equilibrium.

In the period January-September 2015, economic growth is expected in the range of 3.4 - 3.6%, which exceeds expectations owing to higher-than-expected output volumes in industry and agriculture sectors. Domestic demand has decreased due to noticeable reduction in real disposable household income because of shrinkage in money transfers from Russia, weak activity in construction sector and slowed down lending growth rates. The diminishing of demand in the past nine months has been mitigated as the Government continued implementing expansionary fiscal policy while the CBA had eased monetary conditions considerably since the beginning of the year (lombard repo facility rate was reduced to 12% from 20% and refinancing rate to 9.75% from 10.5%). In the third quarter of 2015, the decrease in private consumption costs is estimated to reach 7.0% and private investment costs, 10.0%. In the third quarter, net exports in real terms continued improving thanks to a real growth of export of goods and services by 21.4% y/y and a real decrease of import of goods and services by 8.5% y/y.

According to short-term forecasts of the CBA, year 2015 will end with private consumption and private investment reducing by 6.0% and 5.0%, respectively. This will be largely determined by around 30% reduction in net money remittances of individuals in dollar terms in the same period. The fiscal impulse, calculated in relation to the previous year, is estimated to be 2.0 - 2.5 expansionary for the year. This is expected to mitigate the reduction of private spending in 2015, concomitant with the easing of

monetary conditions. In 2015, reduction of import of goods and services in real terms will be within 7.0-9.0% as a result of shrinking of domestic demand. Despite persisting weak demand in global economy during the year, the growth of export of good and services in real terms is predicted in the range of 13.0 - 15.0%, which is determined by increased productivity in tradable sector of Armenian economy and excess supply in agriculture and mining sectors. In the outcome, current account will improve notably in 2015 to reach 3.0 - 4.0% of GDP. This development helped the currency market gain its equilibrium. The exchange-rate-driven inflationary expectations are therefore forecast to continue easing, which will facilitate the reducing of inflation net of seasonally adjusted food products and regulated services.

As a result, economic growth in 2015 is estimated to be within 3.2 - 3.9%, which will be driven largely by growth of net exports. Relative to the former forecast, the growth has been revised slightly upside thanks to higher-than-expected growth being reported in industry and services rendered.

In 2016, economic growth rates will slow down. Starting from 2017, the growth rates will speed up, carrying the influence of effective implementation of the 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 3.0 - 4.5%.

Thus, in the forecast horizon, private demand will gradually stabilize and help the economic growth bounce back. However, demand in the private sector will be lower from its equilibrium.

Taking into account the influence of the fiscal policy, domestic demand will retain deflationary pressures in the consumer market in the forecast horizon. In the period 2015 - 2017 however, such deflationary pressures will be eased by inflationary impact of net exports and will phase out at the end of the forecast horizon.

In the third quarter of 2015, economic landscape in Armenia's principal trade partners was as follows: the USA and Eurozone further demonstrated slow-growth patterns, while Russia posted even deeper economic decline. In the third quarter, international markets of basic commodities remained deflationary owing to a low level of global demand as well as expectations about large production volumes.

On the back of low global demand, commodity and food product markets will further demonstrate deflationary patterns in the short run. Then, as the global demand rebounds, some recovering of prices can be anticipated. So, in the forecast horizon inflationary

pressures from the external sector are not anticipated.

At the start of forecast horizon, financial and economic risks which derive from global economy and main trade partners and which are transmitting to the Armenian economy will persist. Such risks will however phase out in the medium run when economic growth in partners' countries recovers, prices in commodity and food product markets stabilize and volatility in world financial markets eliminates.

In the third quarter of 2015, the 12-month inflation rate followed a down-sloping path, consistent with the projection, reaching 3.3% in late September and decreasing further to 1.9% in October . The decrease was almost entirely due to agricultural products that reported lower prices in comparison with the same reference period last year. However, in the face of weak domestic demand and deflationary external environment, prices net of seasonal agricultural products demonstrated downside rigidity, pointing to still high inflationary expectations.

Considering that the inflationary environment is currently low and no inflationary effects from weak external and domestic demand are discernable, the CBA loosened monetary conditions by lowering the refinancing rate by 0.25 pp to 10.25% in August.

According to the CBA estimates, at the end of 2015 the 12-month inflation rate will be at the lower bound of the confidence band; in the upcoming months it will persist at a lower level but is predicted to approach and stabilize around the target in the forecast horizon. As inflationary expectations diminish, the inflation indicator net of agricultural products will subdue as well. The direct impact from electricity tariff increase since August 1 of this year has not been considered in inflation forecasts in view of an announcement by the Government and "Electric Networks of Armenia" CJSC to subsidize the electricity tariff for a particular part of population and small businesses up until August next year as well as any further uncertainties relevant to this development. At the same time, the indirect impact of electricity tariff increase on inflation through an increased cost of a number of goods has been small, i.e. consistent with the CBA projections, and additional inflation risks related thereto are not likely. The inflationary effect of possible changes in excise taxes in 2016 has been considered in inflation forecasts.

The CBA reckons that loosening of monetary conditions in the fourth quarter of 2015, which could otherwise be tougher in the event of less inflationary expectations, will result in expanding of aggregate demand and help the inflation stabilize around the target in the forecast horizon. On November 10, 2015, the CBA cut the refinancing rate by 0.5 pp to 9.75%. In the fourth quarter, the CBA will keep on easing monetary conditions in the event

inflation expectations are anchored and additional inflationary risks from both external and domestic environments are lacking.

Risks to inflation deviating from the projected value are estimated balanced 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, there is risk that 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 pronounced are the risks to the further developments in Russian economy. These are attributable to oil prices with their deeper-than-expected decline and predicted lower level in the forecast horizon, continued depreciation of the Russian ruble, and a 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 dual-sided and mostly associated with the developments in agriculture, a sector greatly depending on weather conditions, the pace at which domestic demand and private investments will recover, as well as Government-led promotion programs. If the aforementioned risks materialize, the CBA will react accordingly by maintaining the inflation target in the medium run.

[Monetary Policy Program Q4, 2015, Status report on implementation of the Monetary Policy Program, Q3, 2015](#)