Inflation report 2014/4 (Monetary Policy Program Q4 2014, Status report on Implementation of the Monetary Policy Program Q3 2014)

2014-11-20

Executive summary

According to the Central Bank forecasts, in the short run the 12-month inflation rate will gradually approach the target and stabilize around it. In 2015 and the rest part of the forecast horizon, the 12-month inflation rate will stay within the confidence band of 4%±1.5 pp. In the time of uncertainties over economic developments in external and domestic sectors, the economic growth in the forecast horizon will rebound at a slow pace and will gradually approach its long-term equilibrium throughout the horizon.

In the 3rd quarter of 2014, the economic environment somewhat expanded yet economic growth remained sluggish. Declined private consumption and weak investment activity pointed to the low level of domestic demand this quarter. In particular, in the 3rd quarter the decline in private consumption was an estimated 1.0% y/y and the growth in private investment, 2.0% y/y. The weak demand reflected slow growth rates in industry and services output volumes and still negative developments in construction. On the other hand, higher-than-expected output growth was reported in agriculture, which helped to add to the economic activity during the quarter. As a result, it is expected that economic growth in the 3rd quarter would be in the range 3.5-3.8% y/y.

According to short-term forecasts, private consumption growth rates will keep on decelerating whilst a stable investment environment can be expected, under which circumstance the private consumption will reduce by 1.7% but the private investment grow by 1.4% in 2014. In anticipation of expansionary fiscal policy during the year, the fiscal impulse is small expansionary [in relation to the previous year]. Based on the 2014 results, the real growth of export and import of goods and services will stabilize around 6.0%, while a net 3% decline in remittances of individuals is anticipated. As a result, the economic growth in 2014 is estimated in the range 3.1-3.6% primarily due to the growth in the agriculture and service sectors (a total contribution of 3.0-3.3 pp).

In the forecast horizon the economic growth will gradually approach its long-term equilibrium, reflecting accelerating private consumption growth rates and slowly

rebounding private investment.

Thus, in the forecast horizon, with stabilizing private demand as well as mostly a neutral impact of the fiscal policy, the impact of the domestic economy on aggregate demand is expected to be non-inflationary.

In the external sector in the 3rd quarter of 2014, geopolitical developments led to more uncertainties, and the external demand remained sluggish. In such a situation, the deflationary patterns prevailed in international markets of basic commodities and food products.

In the forecast horizon, global economic growth rates will continue to recover at a slow pace, under which conditions inflationary pressures from both the external demand and international markets of basic commodities and food products are not likely.

In the 3rd quarter of 2014, the 12-month inflation rate further trended down to 0.4% in July but began increasing gradually during the next two months. As a result, in late September the 12-month inflation rate was 1.5%, still below the lower bound of the confidence band. In the 3rd quarter, core inflation also demonstrated a changed pattern as its 12-month indicator rose by 0.46 pp to 1.0% in late September.

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In spite of expected low demand in both external and domestic economies, the Central Bank predicts rebounded inflation rates in the short run as a result of stamp duty introduced to a variety of goods starting from the 4th quarter of 2014 as well as Armenia's membership to the Eurasia Economic Community due on January 2015. Under these conditions, the easing of monetary conditions to date is believed to be enough for the fulfilment of the inflation target in the short run.

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 economic effects from Armenia's membership to the Eurasia Economic Community, the inflationary effects of the stamp duty 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 run.

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