

Inflation report 2013/1 (Monetary Policy Program Q1 2013, Status report on Implementation of the Monetary Policy Program Q4 2012)

2013-02-19

Executive summary

The potential of economy further trended upward in Armenia in 2012: the sustainable growth potential is an estimated 5.5 percent versus about 4.5 percent estimation of the previous period, according to the Central Bank. Main factors that contributed to the strengthening of economy potential include the share of supply-stimulating loans in total lending volumes (in the period 2009-2012 the share of these loans has grown around 12 pp and amounted to 33.3 percent in 2012) and the share of foreign investment in industry (in the period 2009-2012 the share has almost doubled to 60 percent in 2012).

The results of the Central Bank surveys on investment perspectives of companies point out to an increasing readiness to invest in industry and services. Moreover, the amount of investment in machinery and equipment and other productive capital in these sectors of the economy almost reached the precrisis levels, which may prove an increased productivity of the economy. According to the Central Bank estimates, the productivity factor contribution in 2012 has increased relative to the previous year (see Box 2).

Agriculture posted unusually high output volumes in 2012 as the economy potential grew (in 2012 the growth of value added in agriculture is an estimated 9.5-10 percent), which contributed to as high as around 7.0 percent economic growth during the year, well above the potential. Strong growth in agriculture as well as low levels of food prices (fruit and vegetable prices in particular), fairly below the historic average, contributed to the surplus growth of real private consumption. The Central Bank estimations show that annual growth of real private consumption in 2012 is expected to be 10.5 percent while annual inflation makes up 3.2 percent, staying within the lower bound of the confidence band (with average inflation of 2.6 percent in 2012). Strong growth in real private consumption is considered by the Central Bank as an effect of supply shock which, however, is temporary since large volumes of agricultural output were mainly attributable to favorable weather conditions which may not be the same in the years ahead.

In external sector in 2012 world demand remained sluggish while no inflationary trends

were discernible in the main raw materials and food products in international markets.

In 2012, in view of the dominating effect of the supply shock over the low level of inflation, the Central Bank implemented a neutral monetary policy, leaving the refinancing rate unchanged (see details in section Actual inflation and attainment of target).

In the forecast horizon, as the supply shock wanes out gradually, the surplus growth of real consumption will contract, leading to the stabilization of the economic growth around its equilibrium. Specifically, in 2013 real private consumption growth rates will slow down to 4.6 percent and private investment will rebound from the currently low levels to 5.1 percent growth. Under such conditions, in 2013 economic growth will be about 5.2 percent mainly due to the growth of industry and service sectors (with a total contribution of 3.4 pp).

In the forecast horizon, in expectation of sluggish private demand and an estimated neutral impact of the fiscal policy, one will see a non-inflationary influence on domestic prices from the domestic economy.

In the forecast horizon, no inflationary pressures will be expected from the external sector. Because uncertainties over political solutions to debt problems in industrialized economies are persisting, it is anticipated that world economic growth rates would slowly recover. Given small impact of external demand, international prices of major raw materials and food products will behave relatively steady whilst staying at existing high levels.

In the forecast horizon, inflation will stabilize around its 4 percent target level. Taking into consideration the aforementioned economic developments in external and domestic sectors and the impact of the temporary supply shock, it is predicted that the 12-month inflation would somehow accelerate in the course of the first half of 2013, reaching 4.5 percent at end June.

In the forecast horizon, the Central Bank plans to continue implementing a neutral monetary policy and further leave the refinancing rate unchanged, i.e. at an 8 percent level. A neutral monetary policy involves a refinancing rate compared to an estimated neutral interest rate under which conditions inflation is within the target and GDP at its equilibrium. The neutral interest rate is currently an estimated 8 percent.

In the forecast horizon, the existing risks are estimated as balanced, determined by development prospects for the global and domestic economies. In the event such risks materialize, the Central Bank may consider an adjustment of the policy rate as

appropriate.

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