

Inflation report 2013/2 (Monetary Policy Program Q2 2013, Status report on Implementation of the Monetary Policy Program Q1 2013)

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Executive summary

The potential of economy further trended upward in Armenia in the first quarter of 2013, reflecting persistently strong economic activity, under which circumstance the growth is expected in the range of 7.4-7.7 percent in the first quarter of 2013. Strong growths in industry and services remain an important contribution to the strengthening of economy potential. The Central Bank intended to adjust the growth potential estimation upside. However, taking into consideration the influence of heavy hails in May and possible rise in energy tariffs starting from the third quarter, the economic growth potential in forecast horizon is estimated to have been at the 5.5 percent level as provided for in the previous quarter's program.

The beginning of the year was marked with persistently strong private consumption growth rates: it is an estimated 6.9 percent which is however some slowing compared to the indicator reported for the last quarter of the previous year.

In the forecast horizon, excess growth of real consumption will further reduce as the supply shock in agriculture observed in the previous year gradually wanes out, driving the economic growth indicator to stabilize around its equilibrium. In particular, in 2013 the real consumption growth rates will slow down to 5 percent while private investment will report some increase of 5.3 percent. In 2013 there will be an average 5.6 percent economic growth mainly owing to increased output in industry and service (with a combined contribution of 3.8 pp).

In the forecast horizon, domestic prices will feel deflationary pressures as the private demand weakens and the fiscal policy implementation remains an estimated neutral.

In external sector in the first quarter of 2013 world demand remained sluggish primarily due to the problems in Armenia's main trade partners in EU countries as well as slower-thanexpected growth in the Russian economy. In such conditions no inflationary trends were observable in basic food and raw material markets of the world. Moreover, at the

end of the first quarter some markets started to see deflationary patterns.

In the forecast horizon, no inflationary pressures will be seen in the external sector. Because uncertainties over political solutions to debt problems in industrialized economies are persisting, it is anticipated that world economic growth rates will 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 light of the aforementioned developments in external and domestic economies, in the first quarter of 2013 the 12-month inflation behaved relatively steadily, as was expected, reaching 3.4 percent at the end of March thus staying in the lower bound of the band.

In the first quarter of 2013, in view of the influence of waned out supply shock over the inflation environment as well as the lack of inflationary pressures from external sector and domestic economy, the Central Bank continued implementing a neutral monetary policy, leaving the refinancing rate unchanged (see details in section 3.1. Actual inflation and attainment of target).

In the forecast horizon, the inflation will stabilize around the target 4 percent level. In view of the aforementioned developments in external and domestic sectors as well as the influence of the temporary supply shock waned out, it is predicted that the 12-month inflation will pace slightly faster, staying within the upper bound of the band at the end of June. The inflation environment will expand influenced by the possible price increases on agricultural products due to heavy hails in May and probable rise in energy resources starting from the third quarter of 2013. As a result, starting from the third quarter, the inflation indicator will step above its target and stay within an 8 percent level in the course of the upcoming one year. In the event the decision on revised tariffs of energy resources is final, the Central Bank will adjust the current directions of the monetary policy by raising the refinancing rate in order to mitigate high inflation and its second-round effects and to anchor inflation expectations. Once inflation expectations are neutralized, the Central Bank will look to readjust its policy by lowering the refinancing rate accordingly. As a result of such action the 12-month inflation is anticipated to subside and enter the confidence band already starting from the third quarter of 2014.

In the forecast horizon, the existing risks are estimated as balanced, determined by development prospects for the global and domestic economies.

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