

(2012/2) Status report on Implementation of the Monetary Policy Program Q2, 2012. Inflation report

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Executive summary

The monetary policy programs of 2011 predicted that the inflation environment would further ease and inflation would rest within the confidence band, starting from the fourth quarter of 2011. Actual trends were basically in line with the program - the 12-month inflation reached 4.7 percent at the end of 2011 and 2.2 percent at the end of March of 2012.

In the forecast horizon the developments in both external sector and domestic economy do not predict expanding of the inflation environment; in the upcoming months inflation is expected to be in the lower border of the band. However, provided that the monetary conditions are relaxed, inflation may come closer to 4 percent during the year and will be tamed mainly within this interval until the end of forecast horizon.

In 2011 economic growth was 4.7 percent per annum. The Economic Activity Indicator for the first quarter of 2012 released by the National Statistics Service of Armenia points to an enlivened economic activity, which is totally due to increased output volumes in industry and services. According to a baseline scenario, there is much probability that economic growth in 2012 will be in the range 3.5-4.8 percent, attributable to expected faster recovering of external and domestic demand in the light of optimistic world economic growth outlook. Economic growth will continue to be driven mostly by increased value added in industry and services: in 2012 these will be roughly 10.0 percent and 3.5 percent, respectively. The outlined trends of economic growth will persist over forecast horizon while economic growth will stabilize within the 4-5 percent interval.

In the labor market in the first quarter of 2012, average nominal wage grew by 5.5 percent while official unemployment reduced by 0.8 pp and made up 6.2 percent, according to the Central Bank estimates. In the light of expected economic activity, in 2012 the labor market will anticipate 5.3 percent growth of average nominal wages and 0.4 pp reduction of unemployment. Given the baseline scenario-developments with economic growth persist, such growth rates of average nominal wages and reduction of

unemployment will continue in the forecast horizon, too.

Real growth of private spending in the first quarter of 2012 was 2.5 percent, according to the Central Bank estimates. In the light of expected economic activity, 4.6 percent real growth of private spending is anticipated owing to the growth of private consumption and private investment, by 4.3 percent and 5.4 percent, respectively, which are expected to grow somewhat faster in the forecast horizon.

In the first quarter of 2012 the impact of fiscal policy on aggregate demand, hence prices, was 1.5 pp contractionary instead of expected expansionary, according to the fiscal impulse indicator. This was determined mainly by savings on first quarter public expenditures. For 2012, the baseline scenario's estimation is 0.7 pp contractionary impact, owing to neutral impact from expenditures and contractionary impact from revenues. In the forecast horizon the fiscal policy will be steered to an effective debt management and maintaining the debt/GDP ratio up to the 3 percent level, under which circumstance the impact of fiscal policy in forecast horizon is estimated to be non-inflationary.

In the first quarter of 2012, relative to the first quarter of the previous year, current account has improved. The growth of dollar value of export of goods amounted to 31.4 percent y-o-y and that of import of goods, 9.7 percent y-o-y. Y-o-y growth rates in remittances of individuals continued thanks to positive developments in the Russian economy. Over 2012 current account will keep on improving and the current account/GDP ratio will be in 9-11 percent interval, according to baseline scenario. In 2012 dollar value of export of goods and services is expected to grow in the range of 9-11 percent, and that of import, 4-6 percent. Then growth of net inflow of noncommercial transfers of individuals will be in the range of 10-12 percent in 2012.

The current account improvement trends will persist in forecast horizon conditioned by recovering external demand and continued growth rates of domestic industry in the light of further positive developments in world economy. The current account/GDP ratio will be within the 7-9 percent interval, as a result.

Trends of minor price inflation were observed in international food markets in 2012 explained by positive trends in economic activity in some leading economies. Previous estimations of world economic growth rate were revised upside yet economic growth will be at somewhat a lower level in comparison with actual 2011 indicators. The main reason is 0.3 percent economic decline which is anticipated for the European Union and which is due to, among others, persisting uncertainties over debt problems and stricter lending

terms worldwide. In forecast horizon world economic growth will be recovering at moderate rates, and is expected to reach 4.4 percent in 2014. As outlined in the baseline scenario, a minor inflationary environment is anticipated as a result of reducing demand in the main commodities and food markets in the face of expected deceleration of world economic growth rates in 2012. In case of favorable weather, international prices of food products will trend slightly deflationary in forecast horizon although growing world demand for food will offset such falling of prices to some extent, whereas international prices of base metals and oil products will show somewhat an inflationary behavior due to moderate growth of world demand and geopolitical developments.

Main risks to world economic developments in forecast horizon are pertinent to slower-than-forecast growth rates of world economy due to persisting uncertainties over debt problems in Euro-area as well as higher increases in international prices of oil products resulting from geopolitical developments in the Middle East. In this context, more threatening is the risk to financial stability of the European Union. If materialized, it would bring in even more slowing of economic growth rates in both industrialized and emerging countries and significant deflationary pressures in international raw materials markets.

In the first quarter of 2012 the Central Bank further implemented a neutral monetary policy, leaving the refinancing rate unchanged, at 8.0 percent. The financial market responded to the policy more or less in the same neutrality as market interest rates stayed unchanged despite some segments of the market saw both rises and falls.

In forecast horizon in general, economic developments in both external sector and domestic sector do not predict an expansion of the inflation environment. In the upcoming months inflation will rest within the lower border of the confidence band. Under such condition, the Central Bank action will result in easing of monetary conditions, so inflation will come closer to the 4 percent target during the year and will be maintained there up until the end of horizon. Also, in the end of forecast horizon growth rates will remain strong, while dollarization of the economy will keep on reducing and the level of financial intermediation increasing. Persisting recession in the European Union continues to be named the most probable risk to the world economic outlook, and the Central Bank will consider quicker easing of monetary conditions as the most probable alternative to the baseline scenario in trying to minimize the influence of the Europe recession on the Armenian economy.

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