# (2011/2) The Monetary Policy Programm of the Republic of Armenia Q2, 2011. Inflation report

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Summary

The second quarter of 2011 was momentous for a moderated inflationary environment, which was fostered by both domestic developments, including the tightening of monetary conditions since the start of the year, and developments of the external sector. Prices of food products and raw materials tended to somewhat stabilize [and prices of some commodities even went down] at the beginning of the quarter after fluctuations observed in global markets. In the meantime, conditioned by slowly recovering domestic demand, influence of implemented restrictive fiscal and monetary policies and increased supply of agricultural products, no inflationary pressures from domestic environment were shown up. At the end of the second quarter the 12-month inflation was 8.5 percent, reducing by around 3 pp relative to the previous quarterís indicator. Price increases of food products made as much as 7.3 pp contribution to headline inflation, of which 4.2 pp fuelled by price increase of agricultural products and about 3 pp by import food products. Price increases in non-food products and service tariffs made, respectively, 0.5 pp and 0.8 pp contribution to the 12-month inflation. In view of higher-than-expected economic activity in industry and services the second quarter of 2011 (in January-June EAI growth was 4.5 percent y-o-y), somewhat a higher economic growth, 3.9 - 5 percent y-o-y, will be expected in the period January-June 2011, according to the Central Bank estimations. The growth will be fuelled mainly by around 15 percent and 4.2 percent y-o-y increases expected in industry and services, respectively.

In the second quarter the average quarterly unemployment rate reduced, reflecting the growing demand for labor. At the same time, the growth of average nominal wages was consistent with the growth of labor productivity. As a result, no significant changes in the structure of unit labor costs were seen, so one may affirm that the impact of the change in unit labor costs on inflation in the second quarter was neutral. In the second quarter private sector expenditures grew by around 6 percent relative to the previous year. Public expenditures in real terms reduced by nearly 9 percent, while domestic demand increased by 4 percent relative to the same period of the previous year. Private consumption grew by around 7 percent and private investment by 2.5 percent relative to the previous year.

Estimations suggest that the gap between private spending and their potential, a by-

product of the 2009 crisis, was eliminated as a result of added private spending during the second quarter. Under the aforementioned developments, the expenditures in the private sector had a neutral impact on inflation. In the second quarter the fiscal impulse had 3.1 pp restrictive impact on aggregate demand, hence inflation, instead of the projected neutral. This is determined by 1.3 pp expansionary impulse from revenues and -4.4 pp restrictive impulse from expenditures. Partly offsetting the end-year 2010 expansionary impact, the fiscal policy of the first quarter of 2011 has had a restrictive impact on aggregate demand, too.

In light of the above-mentioned developments in domestic demand and labor market, some deflationary pressures were observed in the economy during the second quarter of 2011, which were in the range of 0.4-0.6 pp, according to the Central Bank estimates.

*On the background of developments in global and domestic economies in the second quarter of 2011 current account has improved. With sustained high levels of metals prices in global markets, the growth of exports exceeded expectations. As well as the growth of imports topped the expectations mostly due to faster growth of private consumption. Estimations show that real volumes of import of goods reduced in the light of prices having been consistent with the forecast. At the same time, the growth of transfers remained strong in the face of global economic growth. As a result of the aforementioned developments, in the second quarter the current account deficit reduced by USD 50.6 million y-o-y and amounted to USD 317.0 million. In the first half of 2011 the share of current account deficit in GDP has improved, making up 19.0 percent (23.3 percent in the first half of the previous year). The above-mentioned trends determined the attainment of the inflation target and monetary policy directions for the second quarter. At the beginning of the quarter the Central Bank carried on tightening, perhaps at a slower pace, monetary conditions in the face of risks in the external sector and fears that in the forecast time horizon inflation would yet overstep the target. Already in the period May-June trends of a stabilizing and even moderating inflationary environment were evident. Also, the combination of lifting refinancing rate and liquidity management clearly benefited other interest rates in the financial sector.*

*This drove to anticipate trends for faster reducing inflation rate. So, starting from May, the Central Bank stopped tightening monetary conditions, implementing a neutral monetary policy instead. In the second quarter monetary policy developments were mainly consistent with the scenario. Broad money grew by 4.5 percent, dram broad money, by 6.5 percent, and monetary base, by 2.7 percent. Despite gradual tightening of monetary conditions since the start of the year in the second quarter growth of lending volumes remained strong, 8.7 percent. With dram and foreign currency loans holding almost the*

*same growth rate of 8.7 percent, loans in foreign currency still prevail in absolute value.*

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