

Status Report on Implementation of the Monetary Policy Program Q1, 2010. Inflation Report

2010-05-18

(2010/1) Summary

The main macroeconomic developments in the first quarter of 2010 have been attributable to inflationary pressures which were transmitted from the previous yearend and faster recovering world and domestic economies. Persisted high prices of food and non-food products in global markets due to positively developing world economy, expansionary impact coming from the previous year's implementation of monetary and fiscal policies as part of anti-crisis measures and depreciation episodes of the dram during the quarter driven by adverse expectations have all contributed to the persistence of inflationary environment.

Inflation in the first quarter was 2.9 percent whereas the 12-month inflation indicator has been 8.8 percent, increasing by 2.3 pp in relation to the previous year. Interestingly, the above-mentioned developments were not the only factors contributing to such a high level of inflation but also the low inflation recorded in the first quarter of 2009 which was not typical to that period of time. In the consumer basket, prices of food products have grown by 4.3 percent (with 2.3 pp contribution to inflation), prices of non-food products, by 1.1 percent (with 0.2 pp contribution to inflation), and service fees, by 1.3 percent (with 0.4 pp contribution to inflation). Overall, inflation has been determined by 9.2 percent rise in meat prices (with 0.9 pp contribution to headline inflation), 22.9 percent rise in prices in item " Vegetable and Potato " (with 1.1 pp contribution to headline inflation) and 2.9 percent rise in medical service fees (with 0.3 pp contribution to headline inflation).

The impact of inflationary pressures was also reflected in the behavior of core inflation. In the first quarter of 2010 core inflation was 2.1 percent¹ whereas the 12-month inflation indicator has grown by 1.9 pp in relation to the previous quarter's indicator to amount to nearly 7.1 percent. Notwithstanding these developments, the rate of the 12- month inflation has slowed down considerably at the end of the quarter determined by both previous year's inflation developments and monetary conditions which the Central Bank of Armenia has been tightening since the beginning of the year as well as stabilization patterns which the foreign exchange market started to see in end-March. The first quarter of 2010 saw some 5.5 percent y-o-y economic growth against 6.1 percent y-o-y decline in the previous year. Economy posted growth thanks to improving macroeconomic

environment as a result of recovering world economy as well as expansionary impact transmitted from fiscal and monetary policies implemented in the framework of anti-crisis measures. As such, economic revival has been a result of the growth recorded in all sectors of the economy.

Industry reported growth of value added nearly by 6.1 percent y-o-y; agriculture reported 3.1 percent growth y-o-y; construction reported 9.7 percent growth y-o-y; and services reported 5.1 percent y-o-y. In the first quarter in labor market, nominal wages have grown to some extent. This was driven by the growth of wages in firms in the private sector and somewhat due to several budget-supported organizations. The growth rate of wages has, however, decelerated in comparison with the relevant indicator recorded over the previous quarters of the year. Average quarterly unemployment kept on increasing, still remaining unresponsive to the economic recovery, and, in the first quarter labor productivity has grown instead. As a result, these developments have not led to material changes in unit labor costs, and the labor market's impact on inflation has been neutral. In the first quarter the domestic demand has grown due to increased expenditures in public and private sectors. The growth of domestic demand has been around 4 percent. Public expenditures have increased by about 18 percent in real terms, reflecting Government's goal for spending in more investment projects. In the atmosphere of recovering world and domestic economies, private spending, too, has grown by 2.5 percent. In the structure of private spending, private consumption has increased by nearly 3 percent while the rate of decline in private investments has considerably recovered in relation to the relevant indicator of the previous quarter to amount to around 4 percent.

In the first quarter the impact of private spending on inflation has been restrictive. According to Central Bank estimations, private sector expenditures in real terms have been some 2-3 percent below the natural level, thus creating some 0.6-0.9 percent deflationary pressures in consumer market. In the first quarter of 2010, attributable to state budget's over-performance on the part of revenues and savings on expenditures, the impact of the fiscal sector on aggregate demand and inflation has been less expansionary (see details in the section Aggregate Demand) and amounted to 6.8 pp, according to the calculated fiscal impulse indicator. As such, the revenues impulse has been 3.2 percent expansionary and the expenditures impulse, 3.6 percent expansionary. According to the Central Bank estimates, in the first quarter the combined impact of domestic demand and labor market on prices has been 1.1-1.4 percent inflationary. In the first quarter, with global and domestic economies showing trends of faster recovery, improvement has been seen in respect of the export of goods, which exceeded anticipations. Increase in import, too, pointed to the earlier recovery of the domestic economy. At the same time, growth has been recorded with regard to transfers, reflecting

positive development patterns with which the global economy is evolving. In the first quarter current account deficit has grown by USD 101.5 million y-o-y to USD 349.1 million, and its share in GDP constituted 23.6 percent.

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