

Status report on implementation of the monetary policy program (Inflation report) Q4, 2010

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2010/4 SUMMARY

High inflationary environment has been the main macroeconomic development over 2010. One factor that contributed to the creation of such an environment was sharp increase of food prices in world markets (in 2010 the World Bank Food Index rose by 25.3 percent), fuelled greatly by price increases on wheat (48.6 percent p.a.) sunflower oil (47.5 percent p.a.) and sugar (42.8 percent p.a.). The other significant factor was the

downfall in agriculture, which led to severe shrinkage of supply and, hence, steep rise in prices of agricultural products. Prices in item «vegetable and potato» have grown by 30.7 percent y-o-y; prices in item «fruit» by 19.0 percent, and item «meat products» by 17.6 percent. Gas and water utility tariffs, increased since April of 2010, was another factor contributing to inflation. At the same time though, a slowly recovering domestic demand

has not added to inflation.

Over 2010 inflation in Armenia has amounted to 9.4 percent, 7.5 pp of which alone fuelled by food price increases (about 5 percent driven by price rise in agricultural products and more than 2 pp by increased import prices). In the period January-December 2010 inflation has been an average 8.2 percent against the same period of the previous year.

Over 2010 economic growth has been 2.6 percent y-o-y. The services and industry branches greatly contributed to the economic growth during the fourth quarter and throughout the year. In the period January-December industry, services and construction reported, respectively, 9.5 percent, 4.6 percent and 3.7 percent y-o-y growth of value added, whereas a severe decline has been recorded in agriculture, 13.4 percent y-o-y.

Over 2010 there was some improvement observed in labor market indicators. Average quarterly unemployment reduced, reflecting the growing demand for labor. The growth of average nominal wages slightly outpaced the growth of labor productivity, pushing unit labor costs to increase to some extent. As a result, minor inflationary pressures (about 0.3

pp) were observed in the economy during the year.

Over 2010 private spending has grown by around 4 percent against the previous year. With a high public spending deflator, government expenditures have reduced by about 3 percent in real terms and the domestic demand has grown by 3 percent in relation to the same period of the previous year, as a result. Private consumption has increased by nearly 6 percent while private investment remained unchanged in relation to the previous year.

Though more private spending was recorded in 2010, it had a restrictive impact on inflation, however. According to the Central Bank estimates, during 2010 real spending by private sector has been below the equilibrium by 0-3 percent, creating 0.2-0.9 pp deflationary pressures in the consumer market.

Over 2010 the impact of fiscal policy on aggregate demand, hence inflation, has been more expansionary than forecasted, with an estimated fiscal impulse indicator reaching 4.5 pp. It was generated as a result of 3.8 percent revenues and 0.7 percent expenditures expansionary impulses.

With the above developments in domestic demand and labor market, slight inflationary pressures were observed during the year, which were in the range of 0.5-0.8 percent, according to the Central Bank estimates.

On the background of developments in global and domestic economies during 2010 the current account deficit has improved. Accelerating growth rates in international metals prices, which surpassed expectations, was one of such developments observed during the fourth quarter of 2010.

This was especially momentous in the dollar growth rates in exports as high growth rates in industry persisted. High growth rates in imports persisted during the first half of the year while these rates had sharply reduced since the second half as growth rates in import prices speeded up amidst budget constraints of economic agents. In the outcome, the current account deficit has reduced to amount to 14.0 percent of GDP compared to 16.2 percent in the previous year.

The above-mentioned trends determined the attainment of the inflation target and monetary policy directions over the year. In the first half of the year, the tightening of monetary conditions (the refinancing rate was lifted by 2.25 pp) and the de-dollarization measures made it possible for the Central Bank to move the 12-month inflation indicator close to the upper border of the target band. Yet the picture changed rapidly in June when

inflation developments suffered the effects of the supply shock, i.e. a steep decline in supply of agricultural products and the resultant price increase as well as sharply grown prices of food products in world markets.

However, considering that the supply factors are not subject to monetary regulation and that demonstration of trends and persistently high prices of agricultural products are thought to be less likely during the next year, the Central Bank conducted primarily an accommodative monetary policy in the second half of the year, withholding from tightening the monetary conditions.

At the end of the year, in the light of accelerating food price growth rates in global markets and possible intensification of the inflationary environment in the future, the necessity of tightening of monetary conditions was overt in the Central Bank statements.

The monetary conditions tightened from the start of the year as well as the measures taken to fight dollarization drove the monetary indicators to show the following patterns: with monetary base stayed almost unchanged, broad money and dram broad money have increased by 11.8 percent and 15.7 percent, respectively. Dram deposits and foreign currency deposits have grown by 29.0 percent and 7.0 percent, respectively. The surpassing growth of dram deposits over foreign currency deposits pushed the level of dollarization down by 4.2 percent during the year. The tightened monetary policy notwithstanding, the year 2010 posted as high as 26.7 percent growth rates in economy lending, which more than doubled the previous year indicator and was primarily due to the use of excess funds on correspondent accounts with the Central Bank and attracted foreign loan resources.