

The Monetary Policy Program of the Republic of Armenia 2006

2006-12-19

2006 Introduction

The Monetary Policy Program has been prepared pursuant to the provisions of the Republic of Armenia Law on the Central Bank. It contains the following sections:

Macroeconomic Environment;

Fiscal Policy;

External Sector;

Directions and Trends of Monetary Policy in 2005

Inflation;

Main Objectives and Directions of Monetary Policy in 2006;

Banking Sector Developments;

Development of Payments and Settlements Relations

The Central Bank of the Republic of Armenia (the CBA) is starting in 2006 to switch to a fully-fledged inflation targeting process. The main principles of this process have their reflection in the Program.

The sections that introduce individual sectors of the economy (except for the section Monetary Policy) provide generalized trends of basic macroeconomic indicators for 2005 and their respective forecasts for 2006. The bases for forecast and methodology are laid down in annexes, by respective areas. The monetary policy is presented in two sections. The first section gives a detailed analysis of the 2005 monetary policy indicators and trends, and reasons of departures of monetary aggregates from the program level as a precondition for a transparent monetary policy. The second section considers the usefulness to shift to a fully-fledged inflation targeting regime from the monetary policy's

current strategy of monetary targeting. The review also includes the 2006 forecasts of basic monetary indicators, the policy directions and the policy toolkit.

As the CBA is planning to launch a fully-fledged inflation targeting regime in 2006, the section Inflation provides a thorough account of forecasts for inflation and how likely will it fluctuate, based on the potential risks expected from different sectors of the economy.

Overall, the macroeconomic environment in 2006 will depict a picture as follows: economic growth will be 10%, according to the CBA forecasts; GDP deflator will beat the average annual consumer price index to 4%.

In the external sector, the share of current account deficit in GDP in 2006 is expected to be 3.8% compared with 3.2% in the year before. This rise will reflect surpassing growth in imports over exports, determined by high growth rates in capital goods in the structure of imports. The state budget deficit in GDP will be 2.7%. Though the deficit is not high, conversion and spending at the CBA of large-scale FX funds (including the Lincy Fund resources) to be disbursed through the budget will, however, draw an essential expansionary impact on monetary aggregates and inflation.

Given these developments in the macroeconomic environment and the need to end the year 2006 with up to 3% inflation target, dram broad money and broad money are forecast to grow by 27.0% and 17.3%, respectively, as opposed to the previous yearend.

The monetary policy will not seek maintaining such growth rates of monetary aggregates. Rather, aggregate demand will be regulated and inflation managed largely through interest rates of the CBA operations.

The inflation forecasts have been carried out using economic and mathematic models developed by the CBA. The inflation model that had been built in the previous year was made better in connection with switching to the inflation targeting strategy. This is based on differentiating goods in the consumer basket by price change patterns, and a choice of macroeconomic indicators to explain such changes. The forecast of inflation by the above methods suggests that reaching up to 3% inflation in the absence of certain risks in individual sectors of the economy is fully realistic.

