

Status report on implementation of the monetary policy program (inflation report) Q1, 2011

2011-05-24

(2011/1) SUMMARY

High inflationary environment in the first quarter of 2011 further depended on an increase of international prices of main food products and raw materials, persistently high prices of agricultural products due to the reported unprecedented downfall in agriculture in the previous year, the second round effects and high inflation expectations in the face of supply shocks. As well as main inflation risks as outlined in the previous monetary policy program showed up during the first quarter. In particular, inflationary

pressures intensified in world markets of raw materials and food products, making the inflationary environment to somehow broaden. The domestic demand slowly recovering has not created additional inflationary pressures yet.

At the end of the first quarter of 2011 the 12-month inflation was 11.5 percent. Price increases of food products made as much as 8.3 pp contribution to headline inflation, of which 5.4 pp fuelled by agro-product price rise and about 2.7 pp by import food products. Price increases in nonfood products and service tariffs made, respectively, 0.6 pp and 2.6 pp contribution to the 12-month inflation.

In the first quarter economic activity slowed down, according to the economic activity indicator (EAI)¹ released by the National Statistics Service of the Republic of Armenia in early 2011, mostly attributable to the February and March EAI having remained unchanged relative to the same period of the previous year. The Central Bank estimations based on the first quarter EAI trends suggest that real GDP growth of the first quarter of 2011 was 2.7 percent, which is determined by added production volumes in industry and services.

In the first quarter the average quarterly unemployment rate reduced, reflecting the growing demand for labor. The growth of average nominal wages in 2010 slightly outpaced the growth of labor productivity, pushing unit labor costs to increase to some extent. As a result, the estimation is that minor inflationary pressures in the economy are

observed.

In the first quarter private sector expenditures grew by around 4 percent relative to the previous year. Public expenditures in real terms reduced by nearly 10 percent, while domestic demand increased by 2 percent relative to the same period of the previous year. Private consumption grew by around 4 percent and private investment by 5 percent

relative to the previous year.

It is estimated 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 first quarter. Under the aforementioned developments, the expenditures in the private sector had a neutral impact on inflation.

In the first quarter the fiscal impulse had 2.1 pp restrictive impact on aggregate demand, hence inflation, instead of the projected neutral. As well as taking into account lagged influence of the expansionary fiscal policy transmitted from the fourth quarter of 2010, the impact of the Q1 2011 fiscal policy on inflation has been neutral, according to the Central Bank estimations.

In light of the above-mentioned developments in domestic demand and labor market, minor inflationary pressures have been observed in the economy during the first 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 first quarter of 2011 current account was adjusted upside relative to the same quarter of the previous year. The real and value growth of export of goods exceeded expectations thanks to positive developments sustained in industry as well as an increase in international metals prices.

Estimations show that real volumes of import of goods reduced substantially in the first quarter since growth rates in import prices speeded up amidst budget constraints of economic agents. At the same time, high growth of transfers was observed in light of world economic growth. In the outcome, current account deficit has reduced by USD 71.1 million y-o-y and amounted to USD 307.3 million.

The above-mentioned trends determined the attainment of the inflation target and monetary policy directions for the first quarter. Though inflationary environment remained affected mainly by supply-side factors while recovering domestic demand and labor

market developments would further create moderate inflationary pressures, the Central Bank embarked on tightening of monetary conditions, seeking to absorb second round effects and have inflation expectations anchored. Starting from February, the Board of the Central Bank has two times raised the refinancing rate, by 0.5 pp each time, to set it at the level of 8.25 percent.

The first quarter of 2011 was prominent in reported divergence with regard to growth rates in foreign currency deposits and lending to economy as they speeded up expectations. Thus, during the quarter foreign currency deposits grew by 7.2 percent and lending to economy by 8.1 percent, as opposed to the projected 1.7 percent and 1.4 percent growth, respectively.