

THE REPUBLIC OF ARMENIA CENTRAL BANK

*Approved by
the Board of
Central Bank Resolution
No. 66A, 27.03.2009*

**The Monetary
Policy Program
of the Republic of Armenia,
Q1 2009
(adjusted program)**

Forecasts for 2009 (adjusted forecasts)

External environment¹

In March 2009, with the world economic crisis persisting, the IMF and the World Bank revised the indicator of economic growth as they predicted decline instead of 0.5 percent growth, first time ever in the period after the end of WW2. Considerable decline in external demand, unfavorable terms of trade and slackening financial inflow will continue affecting the Armenian economy adversely. The reduction in world demand will also keep international prices at lower levels throughout the year 2009. External developments remain too uncertain to be predicted as crisis is deep on a global scale and the period within which the world economy would recover is uncertain, too.

As for the goods markets, despite some price growth trends observed in the end of the first quarter of 2009, it is expected that, as it was the case with previous estimations, international prices of energy resources and industry metals would remain at relatively lower levels until signs for the recovery of the world economic growth emerged, which is expected to the end of 2009 only.

Prices in food markets, grain market in particular, will also keep on a low level but future developments will mainly depend on the expectation of the grain crops in the 2009/2010 marketing year.

Generally, in spite of high degree of uncertainty in further developments, it is expected that, with the world demand reducing, low levels of international prices would persist during 2009.

Aggregate supply

The forecasts for the economy sectors have been adjusted toward decrease, due to pronounced reduction in world demand and deceleration in the growth of the inflow of capital observed since the end of 2008. As a result, the GDP in real terms in 2009 will decline by around 3 percent².

The economic growth risks are dual and associated with both exogenous and endogenous factors. The reason for the risks of economic growth set toward decrease lies in more-than-expected decline of the domestic demand due to the persistence in reduction of world demand. The risks of economic growth set toward increase are associated with the pace with which some large programs of the Government of the Republic of Armenia, particularly the promotion of small and medium size enterprises, support to financing initiatives in the tradable sector, residential housing in the recovery zone, road construction, and investments in infrastructures, would be implemented.

The trend of decrease recorded in **Construction** in the last quarter of 2008 will be persisting in 2009, due to continuous put-off of investment programs in industry and service branches as well as expected declines in growth rates in residential housing. In the same time, volumes of construction in sectors such as communications and transport, agriculture, energy and utility services are expected to increase. As a result, the value added in construction is forecasted to decrease in 2009 by 11-15 percent in real terms.

Growth indicators in **Services** have also been adjusted toward decrease owing to adjustment in indicators expected with regard to private and public consumption, which will affect both volumes of trade turnover and other services rendered. The trends of

¹ The information provided from sources such as *The Economist*, *Global Insight*, *The Financial Times*, *US Department of Agriculture*, *РосБизнесКонсалтинг* and others has served a ground for the forecasts of the external sector.

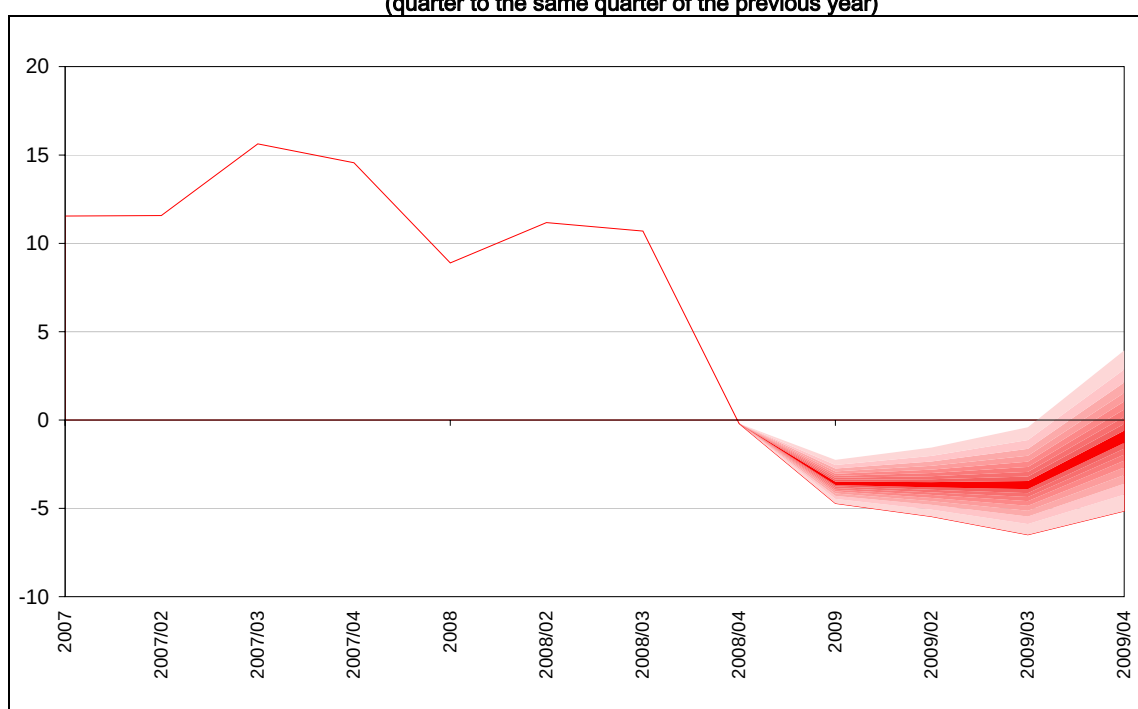
² The central GDP forecast value for 2009 makes up 2.9 percent reduction.

deceleration of the growth rate in retail trade recorded seen in the last two months of 2008 will be shown up in 2009, too. As a result, the value added in services is forecasted in the range of 0-4 percent in real terms in 2009.

In **Industry** the forecasts for 2009 have been adjusted towards some decrease, and the value added is expected to decline by 1-5 percent, as a result. The drop of the projected indicators was attributable to continuous slowing of the growth rate in mining industry since Q4 2008, and in expected decline in production output in chemical industry and metallurgy, hence the need to adjust growth rate in the energy branch, due to the reduction in world demand. However, energy and food branches will report growth, contributing to overall industry.

In **Agriculture** the forecasts have not been adjusted: some 3-5 percent real growth is expected owing to increases in orchards and arable land as well as animal headcount.

**Real GDP growth forecast distribution fan chart
(quarter to the same quarter of the previous year)**



Economic growth forecast distribution fan chart 2009

Interval	Likelihood of economic growth in any given interval			
	Q1 2009	Q2 2009	Q3 2009	Q4 2009
< -7%	0.00%	0.02%	1.32%	0.92%
-7 - -5%	0.40%	7.61%	16.84%	4.51%
-5 - -3%	74.90%	65.87%	47.73%	14.69%
-3 - -1%	26.24%	27.49%	30.50%	26.52%
-1 - 1%	0.05%	0.64%	5.23%	27.29%
1 - 3%	0.00%	0.00%	0.24%	17.78%
3 - 5%	0.00%	0.00%	0.00%	7.53%
> 5%	0.00%	0.00%	0.00%	2.47%

Aggregate demand

The impact of world financial and economic crisis on Armenia's economy in 2009 will be seen in the form of reduction of aggregate demand, which will be determined mostly by the decline in domestic demand. Private sector expenditures will reduce notably whereas public sector spending will increase to some extent in order to ease the consequences of the world economic downturn and regain step-by-step the economic activity in the private sector.

Estimation of real growth of *private sector expenditures* have been adjusted toward decrease on the part of both private consumption and private investments. The revision of assessment for growth rates were driven by expectations for a considerable drop in a number of indicators, due to the deterioration of the world economic situation, such as household income, wage and current transfers, as well as reduction in the inflow of capital transfers and other external financial flows, exiting uncertainties and adverse expectations in the investment climate under the slowing trends of the global demand.

According to estimations, private consumption is expected to drop by 5-6 percent in real terms in 2009, while private investments will reduce by 5.6-6.5 percent in real term.

According to estimations made to measure the deviation from the equilibrium of private expenditures there will be about 5-7 percent negative gap in the respective figure, explained by negative gaps expected with regard to consumption and investments. So, during the year private expenditures will create deflationary pressures in the consumer market, pushing inflation down by 1.5-2.1 percentage points.

In *Fiscal sector* the main benchmark for the execution of programs for 2009 is to ensure 17.4 percent tax revenues indicator in GDP (some 0.4 percentage point increase in relation to the figure in 2008) and to execute public expenditures in implementation of the projection. In the first six months of the year, due to the decline in economic activity, the indicator of budget revenues may be somewhat lower than anticipated, under which condition the Government will have to announce about moving certain expenditures items on to the second half of the year.

In anticipation to moderate the impact of the global crisis on the Armenian economy, the role of public sector will be enhanced as the Government carries on implementing anti-crisis measures and thus stimulating the domestic demand. In particular, the Government's programs will spearhead the promotion of small and medium size businesses, support the tradable sector and increase public expenditures in the non-tradable sector.

So, as a result of the aforementioned, the fiscal policy will have some 2 percent expansionary impact on the aggregate demand. However, depending on the volumes to which the Government has actually carried out the programs which it announced, the stimulation of the domestic demand may be either larger or smaller, reflecting accordingly in the developments of private sector spending in this year and the next one.

To sum up the developments in real and fiscal sectors of the economy, let us note that the level of domestic demand throughout 2009 will be considerably below the equilibrium, creating deflationary pressures in the economy.

With uncertainties in determining the duration in which the adversities in external environment would be overcome, the main items of **current account of the balance of payments** have been forecasted. In doing so, current developments in the domestic economy as well as appropriate measures launched by the Government were taken into consideration. The decline in external demand which will be reflected in persisted low price levels for industry metals, will be playing an important role in reducing of annual export volumes in 2009. On the other hand, the revision of real exchange rate and its

coming back to the equilibrium as a consequence of depreciation of the nominal exchange rate of the Armenian dram, will be material in terms of contribution to the external equilibrium and stimulation of both exports and production of import substitutes. This in turn will serve a ground for the creation of more jobs and further economic growth. Government programs launched to support some export-oriented businesses will, in addition to the revision of the real exchange rate, positively affect export volumes. As a result, some 25-30 percent decrease of volumes in export of goods and services is expected in 2009, which is almost entirely explained by reduced export prices. Whereas the decrease of real volumes of export of goods and services is measured to be 1-3 percent.

The decrease of volumes of import of goods and services in dollar terms is expected to be 30-35 percent in 2009. It, too, will be determined by the real exchange rate revision as well as reduction in incomes in domestic economy. As a result, some 25-30 percent decrease of volumes in import of goods and services is expected.

As regards non-commercial remittances by natural persons using the banking system, although the respective indicator has dropped by 31.4 percent in the period January-February of 2009, net inflow of total remittances of natural persons (including commercial transfers) has grown in the mentioned time by 63.8 percent (net inflow has been USD 83.1 million). In the period January-February, the inflow of total remittances of natural persons has decreased by 19.5 percent, with 46.0 percent reduction in outflow³.

However, much slower decline (in the range of 10-15 percent) in commercial and non-commercial remittances by natural persons is expected in 2009, compared to the decrease of **net non-commercial remittances** (the decline in the range of 30-35 percent), which is mainly attributable to a considerable reduction in outflow of transfers. Current unfavorable developments in Russia, which hold no promise of positive prospects for at least until the yearend, will determine the decline in net transfers.

As a result, the current account deficit to GDP ratio, unlike the former pessimistic scenario, will be in a relatively lower interval of 8-10 percent.

Labor market

The estimations of labor market indicators for 2009 have been adjusted toward decrease. The main reason for revision lies in expectations for a considerable decline in aggregate demand, including the demand for labor force, in the economy due to the world financial and economic crisis, as well as the growth of supply of labor force due to reduced outflow of migrant workers.

According to revised estimations, the average nominal wage in the economy will reduce by around 2 percent in 2009. In private sector, the nominal wage will reduce by more than 7 percent attributable to both a decline in productivity and considerable growth of supply of labor force in the economy. Certain growth of wage, however, will be seen in budgetary organizations.

According to estimations, there will be some deflationary pressures in the labor market in 2009 as unit labor costs in private sector will decline notably.

The growth rates of monetary indicators for 2009 have been adjusted mainly toward decrease. It is expected that at the end of December 2009 the increase of broad money will be 9-12 percent, and that of the monetary base, by 2-5 percent.

³ In the monetary policy point of view the behavior of commercial and non-commercial remittances by natural persons is important as separation of these transfers through the banking system into commercial and non-commercial part is conventional and is made based on the declared purpose of the transfer.

Unlike the decrease recorded previously, money multiplier is expected to increase in 2009 by 7-10 percent annually, owing to the growth of financial intermediation. These developments will be determined mostly by small and medium size enterprise lending through the mediation of the banking system based on the Government programs as well as a large deficit budget expected in 2009. Under these conditions the monetization of economy will increase as well by 9-11 percent annually against 11.8 percent decrease recorded in 2008.

Inflation forecasts

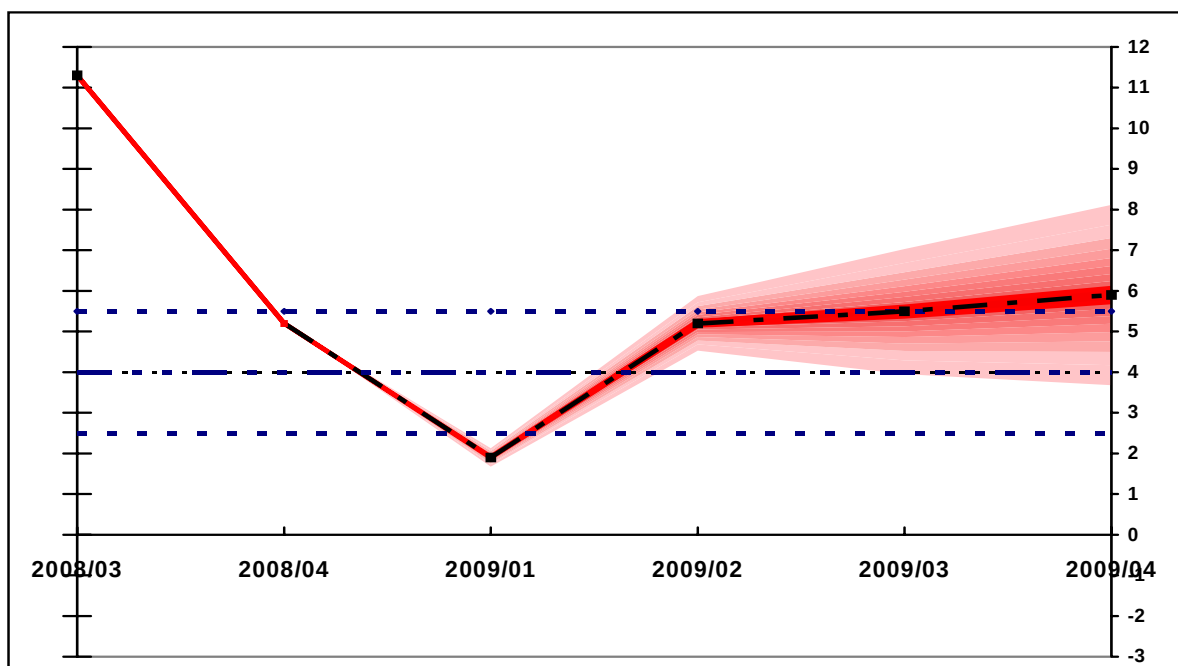
Based on the results of the Model of Inflation by Goods, given the interest rates remain unchanged, the central forecast of the value of inflation at the end of the second quarter of 2009 will be 5.2 percent, and 5.9 percent at the end of the year.

The main assumptions outlined in the baseline scenario as follows:

- Direct influence of increase of gas, electric energy and water tariffs, starting April 1 2009, as well as indirect increase of prices of other goods through their cost price;
- Increase of domestic prices of import goods starting March 2009, due to the depreciation of Armenian dram;
- The fiscal policy's expansionary impact on domestic demand and inflation, as a result of the Government-initiated programs.

Risks: In view of further developments, risks that the inflation indicator would deviate from the projection toward both decrease and increase are possible. In particular, more-than-expected decrease of aggregate demand in the economy due to the world economic crisis is the main deflationary risk. At the same time, in line with the recovery of the world economy, inflationary risks may be possible owing to upward trends for international price increases since the second half of 2009 and depending on the pace at which the Government-initiated programs would carry on.

Inflation forecast distribution fan chart



Inflation forecast distribution fan chart 2009

Inflation interval	Likelihood of inflation in any given interval	
	Q2 2009	Q4 2009
2.0 - 3.0%	0.04%	1.2%
3.0 - 4.0%	2.8 %	4.1%
4.0 - 4.5%	14.3%	7.5%
4.5 - 5.0%	16.9%	10.9%
5.0 - 5.5%	47.5%	14.2%
5.5 - 6.5%	18.4%	31.4%
6.5 - 7.5%	0.02%	22.7%
7.5 - 8.5%	0.0%	6.9%
> 8.5%	0.0%	0.9%

Directions of the monetary policy in the 12-month horizon

The Central Bank estimates that inflation will grow in 2009 but, in the end of the second quarter, it will not outstrip the upper border of the target . Such development is expected due to appreciation of the local currency as a result of restriction of the Central Bank interventions in the foreign exchange market since March of 2009 as well as because of further demonstration of inflation risks, as had been outlined in the previous monetary policy program, namely increased gas prices, starting April 1, for end-users. However, further external developments and the volumes with which the Government-announced programs are being realized will determine the future inflation behavior. Under such conditions, inflation is likely to somewhat exceed the upper border of the target in the yearend. In the meantime in the forecast period, factors curbing the inflation will include persisting external deflationary environment and considerably slowing domestic demand due to the word economic crisis. Though the Central Bank had raised the refinancing rate by 1.0 percentage point in early March, the dram's appreciation resulted in considerable loosening of the monetary conditions.

In consideration of the aforementioned, as well as acceleration of the rates of inflation and current estimation of expected developments in the economy during the year, further interest rate adjustment will depend on a prudent combination to halt inflation from being deviated from its target and to tackle solutions that contribute to economic growth. Important is the consideration that high interest rates of dram-denominated assets promotes the growth of demand therefor and restricts the outflow of capital, while enhancing the confidence in the financial sector.