

THE CENTRAL BANK OF
THE REPUBLIC OF ARMENIA

*Approved under the Central Bank Board
Resolution No. 36A, dated March 26, 2019*

Inflation Report

Monetary Policy Program, Q1, 2019



*Status Report on Implementation of the Monetary
Policy Program, Q4, 2018*

The inflation targeting strategy of the Central Bank of Armenia highlights the importance of communicating of the Bank to the general public by publishing, inter alia, quarterly inflation reports.

The first section of the inflation report includes the Monetary Policy Program that provides main directions of the monetary policy in the forecast horizon as well as forecasts of inflation and other macroeconomic indicators. These forecasts are based on the Bank's assessment of the current situation and future assumptions by the Bank, which also include the impact of the Bank operations.

The second section includes status report on implementation of the monetary policy program of the previous quarter, which presents the results of monetary policy implementation and covers the actual developments in the domestic economy.

Publishing of inflation forecast and assumptions underlying it makes the monetary policy of the Bank more transparent, understandable and predictable, which considerably increases the public confidence in the Bank. The Bank believes that a clear and trusted monetary policy positively affects the anchoring of inflation expectations and maintaining financial stability in terms of cost reduction.

According to the rule of monetary policy, the policy is aimed at minimizing the deviations between the 4% target and the inflation forecasts. The path to inflation rate shaped as a result of projected policy directions is published as a forecast probability distribution chart for the 12-quarter time horizon.

Projections in this report are based on the actual information available by March 12, 2019, i.e. the day on which the refinancing rate was set, the results of a survey conducted by the Bank and the judgment made pursuant to the information on future developments of the macroeconomic environment.

All inflation reports which have been published to date are available on the Bank's website which also contains all press-releases and other monetary policy-related publications.

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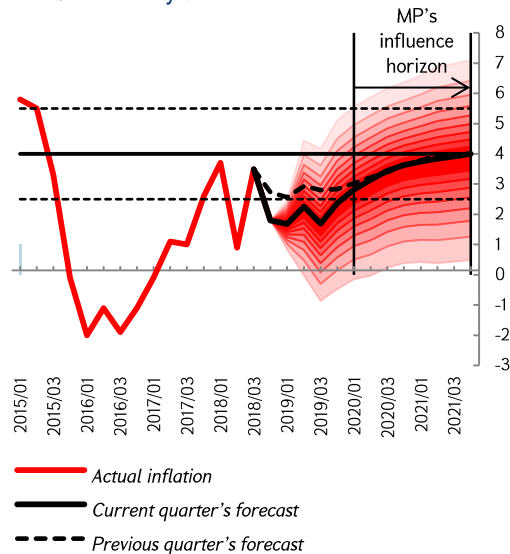
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1. EXECUTIVE SUMMARY

At present, the Central Bank favors the gradual recovery of inflation, estimating that low inflation contributes to anchoring long-term inflation expectations and maintaining the purchasing power of income.

Chart 1

Inflation (12-month) forecast probability distribution for 3-year horizon

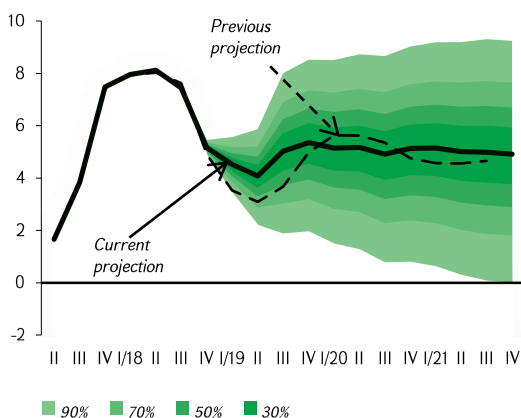


Source: Armenia Statistics Committee,
Central Bank forecast

Economic growth in 2019 will be between 4.6-6.1%, according to Central Bank's short-term forecasts.

Chart 2

Real GDP (cumulative)⁵ growth projection probability distribution for 3-year horizon



Source: Armenia Statistics Committee,
Central Bank forecast

In the forecast horizon, the inflation will shape around the target, according to the Central Bank's Monetary Policy Program, Q1, 2019.

The low inflationary environment of 2018 is persisting in early 2019, and the Central Bank continues to pursue an expansionary monetary policy, under which, as aggregate demand recovers, inflation will stabilize around the 4% target in the medium term.

In the light of monetary policy implementation and expected economic developments, the 12-month inflation will remain low in the forthcoming period, as in this situation the Central Bank opts for inflation to recover gradually and estimates that at present the low inflation contributes to anchoring long-term inflation expectations and maintaining the purchasing power of income.

In terms of ensuring the predicted inflation path, the current policy rate is estimated to be expansionary enough, commensurate with the negative GDP gap, so the Central Bank finds it reasonable to leave the refinancing rate unchanged for the time being; for fulfilment of the inflation target in the medium run the monetary conditions will remain expansionary for a period as longer as required, if macroeconomic developments unfold according to the baseline scenario.

According to Central Bank's short-term forecasts, the 2019 economic growth will be between 4.6-6.1% and will reach its long-term equilibrium in the medium run.

According to the baseline scenario, the 2019 economic growth will mostly be contributed by private spending. Mid-term economic growth will largely owe to the expanding of production capacities, the pace at which the Government will push forward the structural reforms and what economic growth potential can be expected in partner countries.

In the forecast horizon, ***downside risks to inflation and economic growth outlook are still prevailing at present*** and depend on both external and domestic factors (see subsection 2.2.4 "Main assumptions and risks"). In the event these risks materialize, an appropriate monetary policy response will be needed for ensuring price stability in the medium-term perspective.

⁵ The growth rate of each quarter is calculated as the cumulative growth rate for the last four quarters.

2. FORECAST, FORECAST CHANGES AND RISKS

2.1. External environment

The world economic growth slowed down in the latter part of 2018 and this tendency is foreseen to persist over this year and the next one. Economic growth rates, which were high elsewhere in the world's leading countries in 2018, are expected to slow down in the United States, the Eurozone, and Russia – the main trade partners to Armenia.

Economic developments in the external sector: According to preliminary estimates of the Bureau of Economic Analysis of the U.S. Department of Commerce, economic growth in the **United States** in the fourth quarter of 2018 was 3.1% y/y, with average economic growth of 2.9% for 2018, driven by robust domestic consumption indicators. The growth of private investment has slowed down, however. The fourth quarter of 2018 saw the unemployment rate persisting at the previous quarter's level, 3.9%. With such an impetus for economic development and lingered positive effect of the US tax reforms phasing out earlier than predicted, there is anticipation that the economic growth, which was high in 2018, will slow down.

According to preliminary estimates provided by the Eurostat, economic growth rate in the **Eurozone** in the fourth quarter of 2018 decelerated to 1.2% y/y, with the 2018 growth indicator making up 1.8%. The slowdown in the Eurozone's economic growth has been mostly due to low growth rates reported in major member states, particularly Germany and Italy, while high private consumption in individual member states continue contributing positively to the growth. Despite the slowing, in the fourth quarter of 2018 the unemployment rate dropped further to 7.9% thanks to structural changes in the Eurozone's labor market.

According to preliminary estimates by State Statistics Service of the **Russian Federation**, the average economic growth in the fourth quarter of 2018 was 2.3%, owing to strong indicators in construction sector, with its added contribution to GDP estimated to reach some 0.3 pp.

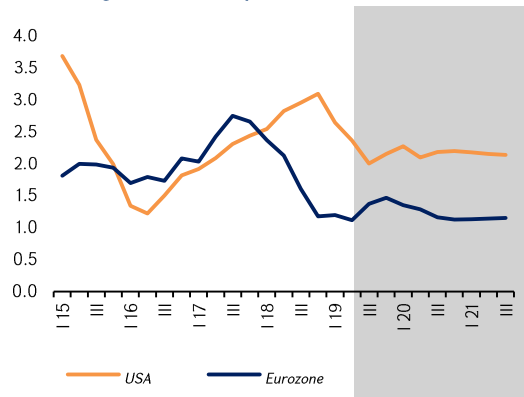
Inflation and financial market developments in the external sector: A minor inflationary environment persisted in the world's commodity and food product markets (in spite of small volumes of production of goods in individual groups) in the fourth quarter of 2018, determined by a sluggish global demand.

In the United States in the fourth quarter of 2018, the average quarterly inflation subdued against that of registered at the start of the

The global economy slowed down in the second half of 2018 and this tendency is expected to further be observable both during this year and the next.

Chart 3

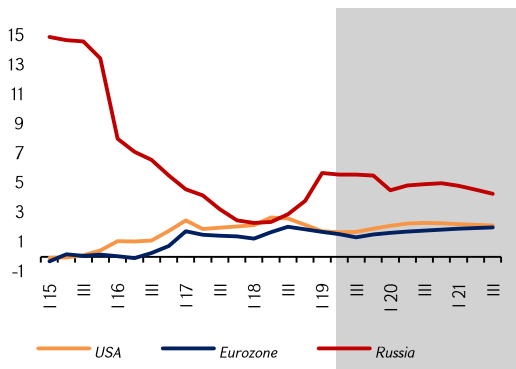
Economic growth in trade partner countries, %



Source: Bureau of Economic Analysis (BEA), Eurostat, Rosstat, Central Bank forecast

Chart 4

Inflation in trade partner countries, %



Source: Bureau of Labor Statistics (BLS), Eurostat, Rosstat, Central Bank forecast

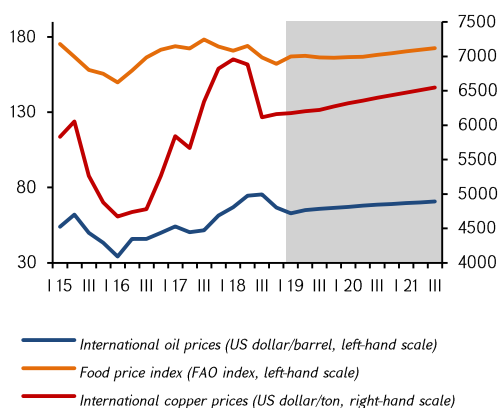
year to 2.2%, shaping around the US Fed's mid-term target. In view of such economic and price developments, the Fed raised the policy rate in the fourth quarter, as was expected, by another 0.25 pp, setting it in a 2.25-2.50% range. The prediction amid slackening aggregate demand is that the US inflation will somewhat decelerate in 2019, running below the target. The inflation behaving so in the time of economic slowdown will prompt the Fed not to hurry with adjusting of its policy rates in 2019.

In the fourth quarter of 2018, the average quarterly inflation in the Eurozone accelerated to 1.9%, standing close to the European Central Bank's target. This has been driven mainly by favorable energy price developments. Core inflation is still running at a low level, however. Even though the ECB wound up the asset purchases program (EUR 15 billion a month) in December, it announced that, in view of slackening demand and decelerating inflation, a low interest rates policy will be pursued at least until the end of 2019, while continuing to carry out long-term repo transactions.

In the fourth quarter of 2018, the average quarterly inflation in the **Russian Federation** accelerated to 3.8% against that of 3.0% in previous quarter. Note that the inflation had already outrun the 4% target by the end of the year, hitting a 5% value in January of 2019. The acceleration of inflation was mainly fueled by increased domestic prices of certain food products, on the one hand, and the depreciated Russian ruble and further inflationary expectations caused by the increase in VAT since January of 2019, on the other. In view of such inflationary patterns, the Central Bank of Russia raised the policy rate in the fourth quarter by another 0.25 pp to 7.75%. Although the anticipation is that the inflation will linger above the target, incurring in part the influence from VAT increase and depreciation of the Russian ruble, the Bank of Russia will most probably withhold from raising the policy rate in the near future and will look to adjusting it only after evaluating the impact of previous tightening policy on the inflation.

Chart 5

International prices of raw materials and food products



Source: World Bank, FAO, Central Bank forecast

In the fourth quarter of 2018, the euro exchange rate versus the US dollar depreciated by 1.9% q/q to 1.14 dollars per euro, attributable to the Eurozone's economic growth slowing faster compared to that of the US. In the fourth quarter of 2018, the Russian ruble depreciated by 1.5% q/q to an average RUB 66.5 per dollar, mainly due to a decrease in international oil prices relative to the previous quarter.

Following the third quarter's steep decline, international copper prices recovered to some extent in the fourth quarter of 2018, whereas oil prices have dropped considerably. Rebounded international copper prices owed to the contraction in production volumes in India and Indonesia as well as expectations of a positive outcome for trade tensions between the USA and China. Notwithstanding the imposed US sanctions on Iran and the decision to cut oil production under the OPEC+ Deal, international oil prices dropped during the fourth quarter of 2018, mainly thanks to grown US shale oil production volumes.

In food product markets in the fourth quarter of 2018, all commodity groups, except the sugar market, have posted a price decline in relation to the previous quarter. Specifically, although fallen considerably, the dairy product and vegetable oil prices began to restore upward already in January of 2019 mainly due to small supply volumes, whereas the rise in sugar prices has been driven by appreciated currency of Brazil, a principal sugar exporter. In a short-term perspective, weak inflationary environment will persist in main food commodity groups, particularly dairy products, vegetable oils and sugar markets, whereas significant price movements in the grain and meat product markets are less likely.

2.2. Forecasts

2.2.1. Inflation and monetary policy

In the first quarter of 2019, the inflation persists at a relatively low level, largely incurring the impact of a sluggish demand which, in turn, is attributable to a tight fiscal policy implementation and slower growth in private spending. This urged the Central Bank to increase, early in the quarter, the monetary stimulus by cutting the refinancing rate by 0.25 pp to 5.75%. As a result, the monetary conditions are rather expansionary now and in the upcoming period may lend to sustained recovery of demand amid anticipated developments in the external sector. The inflation, influenced by these developments, will gradually approach the target and will stabilize around it in the forecast horizon.

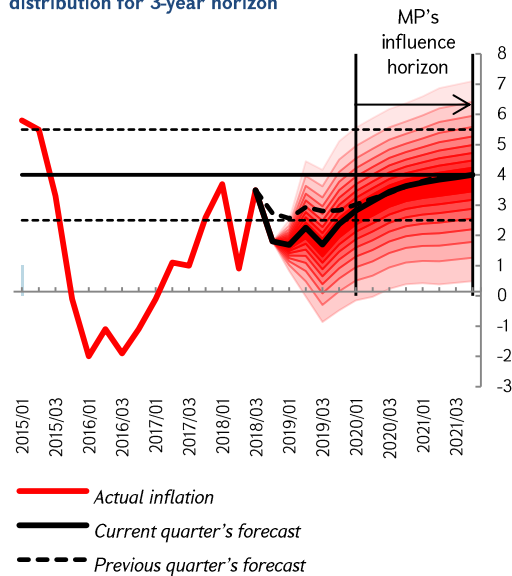
In the first quarter of 2019, the inflation persists at a relatively low level, largely incurring the impact of a weak demand.

In the first quarter of 2019, the Central Bank increased the monetary stimulus by cutting the refinancing rate by 0.25 pp to 5.75%.

In the fourth quarter of 2018, relative to the third quarter, the economic activity indicators have somewhat improved, according to the Central Bank estimates, which is explained mainly by favorable developments in the services and trade sectors. With an overall positive performance of recorded indicators, the level of private spending has not changed substantially, yet there has been a certain shift in demand components as private consumption growth rates speeded up on the back of robust investment growth rates having slowed down. At the same time, aggregate demand remained incurring the significant contractionary impact of public demand, which is attributable to budget revenue's tightening effect. As a result, the GDP gap is estimated markedly negative for the fourth quarter of 2018; there is expectation that it will stay in the negative territory up until the end of 2019 and will only be gradually phasing out to zero in 2020 thanks to the

Chart 6

Inflation (12-month) forecast probability distribution for 3-year horizon



Source: Armenia Statistics Committee,
Central Bank forecast

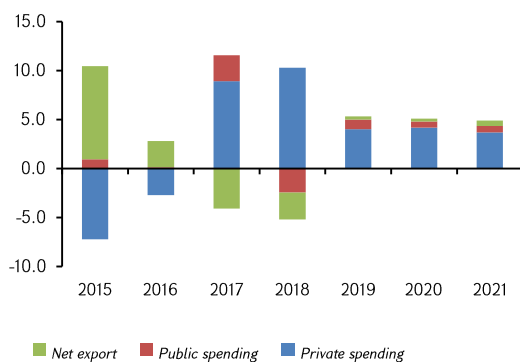
expansionary monetary environment on the one hand, and in the absence of too contractionary fiscal policy impulses, on the other. As the aforementioned developments unfold, aggregate demand will also incur a short-term contractionary impact of exchange rate depreciation in partner countries, which however will weaken gradually as external equilibrium rebounds thanks to Armenia's low inflationary environment. In the outcome, inflation will also stabilize around the target at the end of the forecast horizon. The households' short-term inflation expectations are estimated to follow the inflationary patterns in the light of current inflation developments, including, specifically, certain slowing of the core inflation rate. Nevertheless, these expectations will also stabilize around the target as inflation recovers. On the other hand, long-term inflation expectations also diminish, though remaining relatively high. ***In such a situation, the Board of the Central Bank believes that the policy rate currently is expansionary enough, and abandoning the monetary stimulus in view of upcoming developments will take a slower pace.***

Table 1

Period	Inflation interval forecast probability distribution				
	<1.0%	1.0-2.5%	2.5-5.5%	5.5-7.0%	>7.0%
Q1, 2019	9.6%	85.3%	5.1%	0.0%	0.0%
Q2	18.6%	39.5%	41.2%	0.7%	0.0%
Q3	33.3%	37.5%	28.6%	0.5%	0.0%
Q4	21.9%	32.1%	43.0%	2.7%	0.3%
Q1, 2020	16.3%	28.4%	50.1%	4.6%	0.6%
Q2	14.3%	25.4%	53.1%	6.3%	0.9%
Q3	11.4%	22.6%	56.1%	8.4%	1.5%
Q4	9.9%	20.8%	57.3%	10.0%	2.0%
Q1, 2021	9.4%	19.6%	56.7%	11.6%	2.8%
Q2	9.4%	18.5%	54.9%	13.1%	4.0%
Q3	9.0%	17.8%	54.7%	13.9%	4.6%
Q4	8.5%	17.1%	54.4%	14.8%	5.2%

Chart 7

Demand components contributing to the growth, percentage point



Source: Armenia Statistics Committee,
Central Bank forecast

2.2.2. Economic activity²

Aggregate demand: The 2018 economic activity was mostly driven by robust private spending, which owed primarily to an unprecedented high growth of working capital inventories in private investment. At the end of the year the structure of private spending has changed however, as private consumption paced faster and private investment slowed down. There is prediction that private spending in 2019 will be notably

² For a detailed numeric account of economic growth forecasts, see the "GDP Projection Probability Distribution", chart 18, table 2.

induced by private consumption, with the growth of household loans outpacing those of business loans (see Chart 40). In the outcome, private spending is expected to make a 4.0 pp contribution to the economic growth in 2019, which is a result of 5.1% growth in private consumption and 0.3% growth of private investment.

In the medium run, economic growth developments will largely be determined by economy's fundamentals as well as investment activity. Mid-term private spending forecasts remain principally intact, yet a slightly higher level of private consumption is possible amid some upside revision to the medium-term economic growth forecasts (see Chart 18), which is consistent with services-sector-driven economic growth developments. Private investment will rebound in 2020, with an annual growth rate of about 4.9%. At the end of forecast horizon, the economic growth will stabilize around its long-term equilibrium. It is worth mentioning that the mid-term growths are mostly attributable to the expanding of production capacities, the pace of Government-led structural reforms, and anticipated potential of economic growth in partner countries.

External demand: The growth of income in partner countries, the tourism growth have contributed positively to the 2018 economic growth. However, net export's contribution to the growth is estimated to be negative, as growth in consumption and investment in the domestic economy has been concurrent with a significant increase in import volumes. At the same time, mining sector-specific problems have led to slower export growth rates.

Net export's contribution to the real GDP which was negative in 2018 will somehow abolish during 2019. Previous year's high growth rates in import of investment goods will slow down as some investment programs reached accomplishment. The real growth of import of goods and services in 2019 is expected in the range of 2.0-4.0% and those of export, in the range of 4.0-6.0%. The growth of net inflow of remittances in 2019 will be between 5.0-7.0%, which is consistent with predicted developments in the Russian economy.

As a result of the aforementioned developments, the current account deficit-to-GDP ratio will improve in 2019 as it will be within 6.0-7.0%. In the medium run, bolstered by a faster growth of export, the ratio will stabilize around an estimated 3.0% equilibrium.

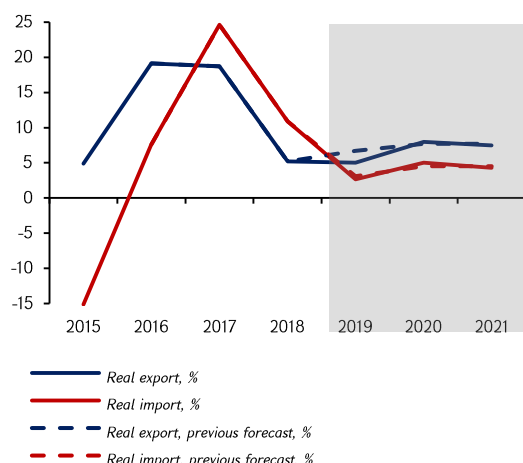
Fiscal policy: The *fiscal policy's impact* on aggregate demand in 2019 was estimated using the revenue and expenditure indicators, so outlined in the Republic of Armenia Law on "State Budget 2019", and the Central Bank estimates.

As regards the taxes, the indicator is planned to be in line with the figure outlined in the law, as a result of which the taxes-to-GDP ratio³ will amount to 21.4%, up by 0.5 pp compared to the previous year.

In 2019, private spending will be spurred up largely by private consumption, which also points to the faster growth of household loans over those of business loans.

Chart 8

Changes in real export and import of goods and services in the medium term, %

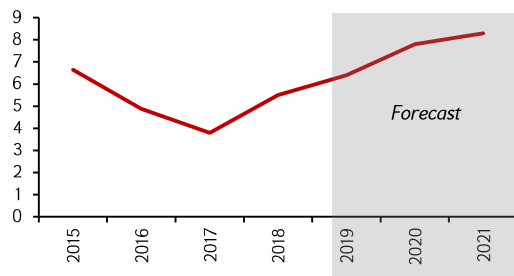


Source: Armenia Statistics Committee,
Central Bank forecast

³ The GDP forecast is the Central Bank estimate.

Chart 9

Nominal wage growth in private sector, y/y, %

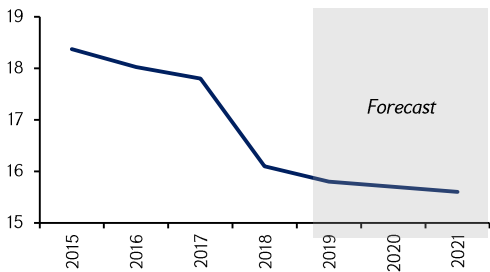


Source: Armenia Statistics Committee,
Central Bank forecast

In 2019, relative to 2018, the fiscal policy's impact on aggregate demand is an estimated 0.4 pp contractionary.

Chart 10

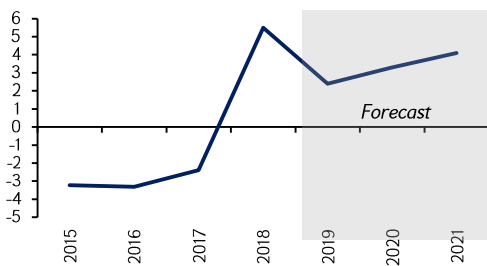
Unemployment rate, %



Source: Armenia Statistics Committee,
Central Bank forecast

Chart 11

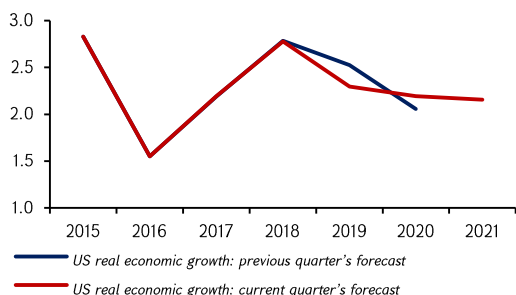
Unit labor costs growth, y/y, %



Source: Armenia Statistics Committee,
Central Bank forecast

Chart 12

US economic growth forecasts, %



Source: Bureau of Economic Analysis (BEA),
Central Bank forecast

Considering the budget performance indicators of previous years, about 2.5% of government's spending (nearly AMD 40.0 billion) is projected to be saved, mainly on the part foreign assistance programs. The expenditure-to-GDP ratio will make up 24.1%, up by 0.6 pp relative to the previous year.

Budget deficit will come smaller than expected owing to performed expenditures: the deficit-to-GDP ratio is an estimated 1.7% for 2019, instead of 2.2% provided for by the law.

Given the tax and expenditure estimates mentioned above and the public expenditure and revenue streams that did not affect aggregate demand, the fiscal policy's impact on aggregate demand will be 0.4 pp contractionary in 2019, which is mostly determined by a contractionary impulse of revenues.

In the context of pursuing a sustainable fiscal and debt environment, the mid-term impact of fiscal policy is estimated slightly contractionary for 2020 and 2021, according to the Medium Term Expenditure Framework for 2019-2021. For the time being, the Central Bank has no other assumptions for mid-term expenditures.

Labor market⁴: In 2019, the economic growth forecast was revised slightly upside owing to the services, a relatively more labor-intensive, limited-productivity sector. It is therefore expected that the growth of private nominal wages will be somewhat lower than predicted previously but demand for labor, higher. As a result, about 6.4% increase in nominal wage⁵ in the **private sector** is anticipated in 2019. In the medium run, the private sector nominal wage growth will be consistent with economic growth and inflation developments, i.e. its fundamentals, and at the end of the forecast horizon it will stabilize around 8.3%.

In light of the aforementioned economic growth, somewhat a lower unemployment rate, 15.9%, can be expected in 2019. In the medium term, the unemployment rate will subside by 0.1-0.2 pp annually, approaching a 15.6% level at the end of the forecast horizon.

In 2019, the growth of firms' unit labor costs will slow to some extent, as productivity growth rate speeds up, and at the end of the forecast horizon it will stabilize around its fundamental value, i.e. the 4% inflation target.

⁴ The labor market data for 2018-2021 are the Central Bank projections which are based on the first, second and third quarter 2018 data and actual October-November 2018 figures. The growth indicators presented in this sub-section are relative to the same reference period last year, unless otherwise specified.

⁵ Starting from January 2018, the Republic of Armenia Statistics Committee began publishing the nominal wage, using data of commercial undertakings with 1 or more employees. Previously, the National Statistics Service of Armenia was publishing data of commercial undertakings with more than 50 employees. Because the 2017 figures on average monthly wage of commercial undertakings with 1 or more employees are not available for now, the Central Bank will, for its predictions, look to previous methodology of calculating the average salary, in order to maintain comparability. Starting from 2019, the Central Bank will forecast the average nominal wage of commercial undertakings with 1 or more employees in the private sector.

2.2.3. Comparison with the previous forecast

Partner countries' short-term economic growth indicators will persist at lower levels compared with the previous quarter's forecasts, though the medium-term growth will be similar to those predicted by the previous scenario.

The US economic growth forecasts for 2019-2020 were also revised slightly downside as the positive effect expected of tax reforms phased out more quickly.

The 2019 economic growth forecasts in Eurozone were adjusted downside due to the expecting of lower economic growth rates in Germany and Italy as well as a certain decline in net exports amid a slackening global demand.

The 2019 forecasts of economic growth in Russia are close to the ones outlined in the previous quarter's scenario. The economy is predicted to slow down to some extent in 2019 following a notable 2.3% growth observable in 2018, since the construction sector had well contributed to the growth that year. It is estimated, however, that the contribution will have a one-time effect. It should be noted that the Russian State Statistical Service has revised the 2016-2018 GDP data for an upward growth.

In the world's basic commodity and food product markets, somewhat a weaker inflationary environment is anticipated, in comparison with the previous forecast, amid a sluggish global demand.

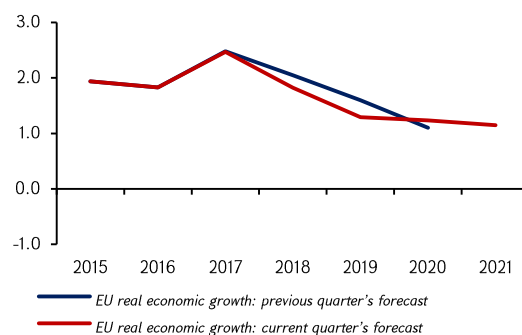
In the world's food product markets, prices are predicted to follow trends close to the previous forecasts; in some markets (vegetable oil, dairy products) they will shape at somehow higher levels in the short term due to expected seasonal shrinking of supply, whereas sugar and wheat prices will further grow (although at a slower pace than forecast previously) as currencies of major exporting countries appreciate against the US dollar and the supply come in smaller volumes.

International oil prices are expected to rest on the level which is below the former forecast but, as previously predicted, will be trending up. In spite of the decision to reduce the supply volumes under OPEC+ Deal as well as Saudi Arabia having announced about reducing production volumes, oil prices will not post a significant increase as they cannot sufficiently challenge downward price movement factors, such as the increase in US production volumes and weakening global demand.

In the short term perspective, international copper prices will shape at the levels lower than outlined in the previous forecast, due to somewhat contracted demand resulting from trade tensions in the international copper market. However, in the mid-term, international copper prices are expected to bounce back as certain projects are intended to implement in infrastructures of China, a principal copper consumer.

Chart 13

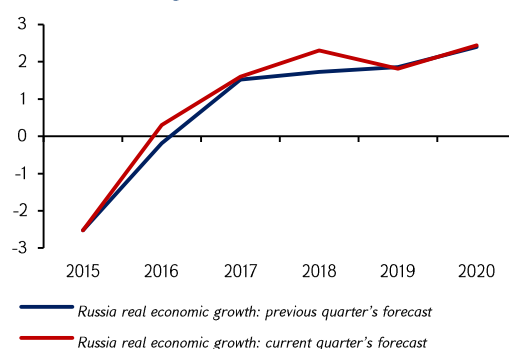
EU economic growth forecasts, %



Source: Eurostat, Central Bank forecast

Chart 14

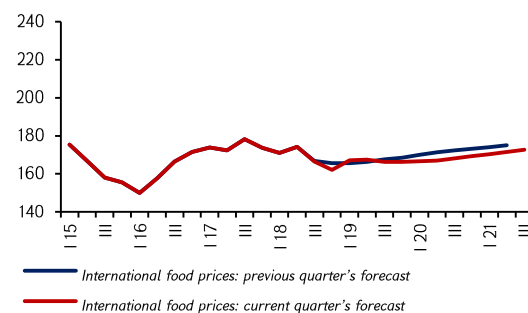
Russia economic growth forecasts, %



Source: Rosstat, Central Bank forecast

Chart 15

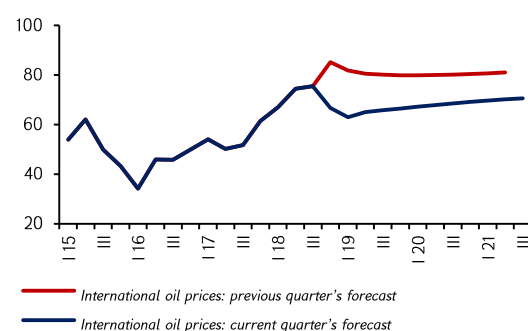
International food price forecasts



Source: FAO, Central Bank forecast

Chart 16

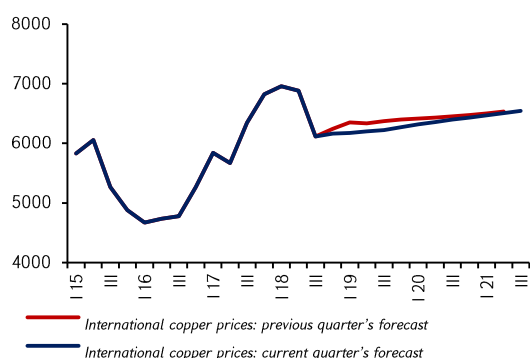
International oil price forecasts



Source: World Bank, Central Bank forecast

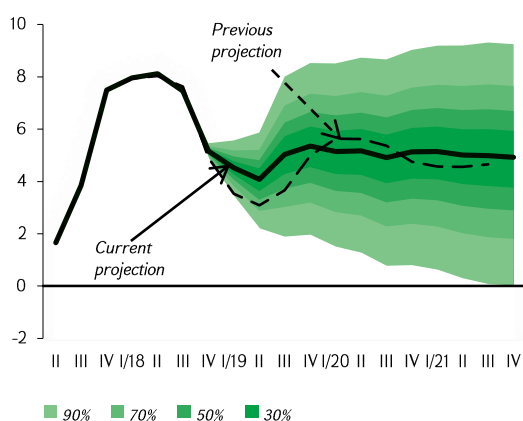
Chart 17

International copper price forecasts



Source: World Bank, Central Bank forecast

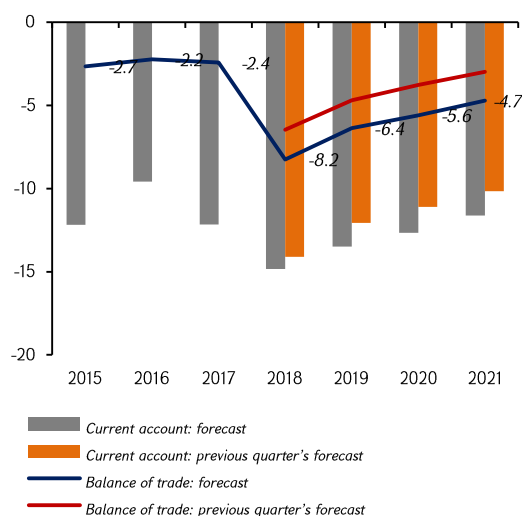
Chart 18

Real GDP (cumulative)⁶ growth projection probability distribution for 3-year horizon

Source: Armenia Statistics Committee, Central Bank forecast

Chart 19

Mid-term current account-to-GDP ratio forecasts, %



Source: Armenia Statistics Committee, Central Bank forecast

Armenia's economic growth rate was revised slightly upside against the previous forecast, for both 2019 and along the forecast horizon.

The economic growth of the recent period marks high activity in services, a labor-intensive sector (see subsection 3. 2. 3) and is concomitant with reducing unemployment (see subsection 3. 2. 4). Furthermore, given the international tourism grows continuously and economic activity of labor resources remains vigorous, there is expectation that economic growth will be slightly higher in 2019 and throughout the forecast horizon; the economic growth will mainly be fueled by the services sector, whereas the industry, agriculture and construction sectors will bring relatively small contributions.

The negative GDP gap induced as a result of contractionary fiscal policy and reduced remittances and net exports in real terms will gradually phase out under the current expansionary monetary environment, and in the forecast horizon the economic growth will approach its potential estimate.

Table 2

Real GDP (cumulative) growth projection probability distribution		
Period	30% probability interval	90% probability interval
January-December 2019 / January-December 2018	4.6 - 6.1	1.9 - 8.5
January-December 2020 / January-December 2019	4.1 - 6.0	0.8 - 9.0
January-December 2021 / January-December 2020	3.8 - 5.9	0.0 - 9.2

In 2019, the current account deficit-to-GDP ratio will run above the previously forecast level, which will mainly be attributable to the deterioration of terms of trade compared to the previous forecast, and the revision to remittances forecasts.

The fiscal sector's impact on aggregate demand is estimated to be 0.4 pp contractionary, relative to the previous forecast of 0.8 pp expansionary (some 2.5% of public expenditures is anticipated to be saved). The fiscal policy will have a neutral effect in case state budget performs in full.

Current forecasts denote that the inflation in the short run will be below the forecast outlined in the previous scenario, which is explained by lower-than-expected prices of meat products, fuel, clothes and footwear. Recovered growth of meat product prices and a slower fall in agricultural goods prices in the first quarter will push the 12-month inflation rate to somehow accelerate.

⁶ The growth rate of each quarter is calculated as the cumulative growth rate for the last four quarters.

In the meanwhile, core inflation too will run slightly below the path outlined in the previous scenario, consistent with a relatively slowly restoring aggregate demand. Consequently, fulfilling the inflation target will require keeping the monetary policy expansionary for some time and letting the 12-month inflation recover gradually, thus helping it stabilize around the target at the end of the forecast horizon (see Chart 1: “Inflation Forecasts Probability Distribution”).

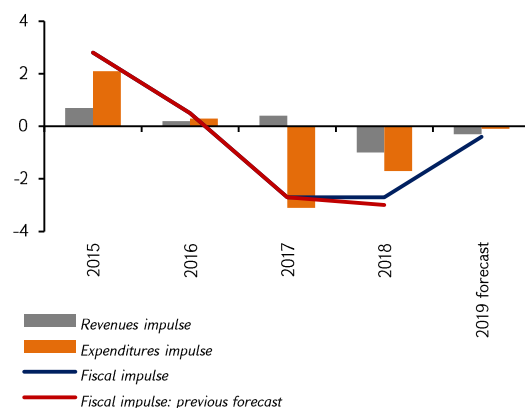
Short-term inflation expectations are going to rest on a level lower than outlined previously and will virtually be driven by how core inflation patterns unfold. However, the Central Bank evaluates, long-term inflation expectations have not reduced enough and their further anchoring will be needed.

2.2.4. Main assumptions and risks

This section contains the main assumptions underlying the Monetary Policy Program for the first quarter of 2019 and the risks to implementation of the program, which derive from the external sector developments, the fiscal policy, current trends and short-term forecasts.

Chart 20

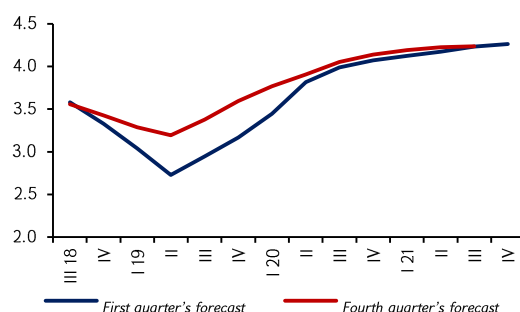
Fiscal impulse forecasts, percentage point



Source: Central Bank forecast

Chart 21

Short-term inflation expectation estimations, %



Source: Central Bank forecast

Box 1:

The results of survey on expectations by the households and the financial system

The inflation expectations did not change notably at the end of the year, according to the results of the Q4, 2018 survey on selected macroeconomic indicators, which the Central Bank carries out by way of inquiries among households and companies in the financial sector. Specifically, the share of the households expecting high and very high inflation rates for a one-year horizon in a total amount of respondents remained almost the same with the previous quarter's level (very close to a zero).

The average level of inflation expectations of the financial system in the upcoming one-year horizon has decreased to about 3.2% from 3.4% reported in the previous survey.

Chart 22

Share of households expecting high and too high inflation in a one-year horizon

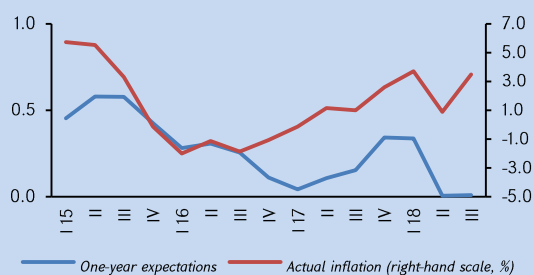
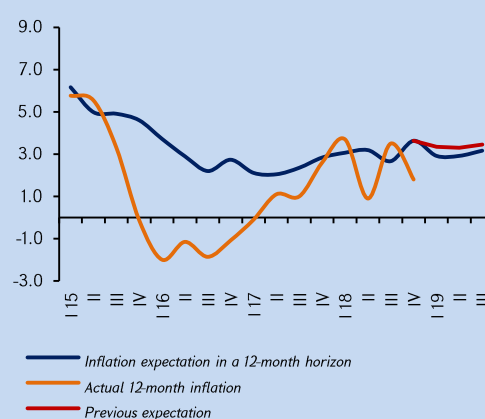


Chart 23

Average level of financial system's inflation expectations, %



Forecast assumptions

Table 3:

Main judgments and assumptions	Possible developments, if this assumption proves correct
Economic growth rates and price growth rates get slower in major partner countries to Armenia	- As global demand weakens, external demand in partner countries will somewhat slow and minor inflation will be observable in raw material and food product markets, in which case monetary conditions in developed countries will be adjusted unhurriedly, at a slower pace. - The US and Eurozone inflation will slow down in the short term due to the decline in international oil prices.
Armenia's risk premium recovers much slower in the medium run	The Armenia government-issued 10-year Eurobond rates spread, relative to the similar-maturity US assets (current risk premium is estimated to be within 3% for Armenia), narrowed considerably, in line with general trends in developing countries, during the first quarter of 2019, and is far below the estimated long-term equilibrium. In expectation of a slower growth, hence more expansionary monetary policies in developed countries, the developing countries' risk premiums will still be persisting at their currently low levels and will then return to their long-term equilibria.
Impact of tax administration in the first quarter of 2019	The aggregate supply and demand forecasts considered how SRC's tax administration has affected performance indicators in services (including trade) and consumption in January-February of 2019, admitting that it prompts the latter to go upward, which is still insignificant in the inflationary pressures point of view.
Private investment grows moderately	A large number of tangible working capital inventories was observable during 2018, with a growth rate of their change slowed down by the end of the year. There is expectation that inventories will not diminish much, and their change growth rate in 2019 will be close to historical average.
There are supply-push inflation shocks	Effects of supply-push shocks on some products were noticeable in the first quarter of 2019 due to changes in the excise tax and customs duties. The aforementioned impact on the 12-month inflation is estimated at about 0.2 pp.
Action that fosters the growth of potential GDP	The fiscal policy's impact on aggregate demand is estimated to be 0.4 pp contractionary in 2019.
Measures to bolstering potential GDP growth	- Armenia's GDP potential will be mainly discernable by increasing output capacities for both goods and services by way of continued growth of private investment in tradable sector of the economy, ensuring an annual 4.5-5.0% growth in the long-term. - The monetary policy scenario did not consider the Amoulsar mine activity; as to the Alaverdi copper smelter, its operating is supposed to resume in the second half of 2019.

Forecast risks

The risks which the baseline scenario has considered are associated with both the supply and demand-driven developments in the relevant sectors of the economy.

In terms of aggregate demand, the main risks are related to the following factors:

- Mainly deflation risks emerge in the short-term perspective that may withhold the demand and, consequently, core inflation to recover at satisfactory rates.
- The budget leaves a bigger contractionary impact over 2019, because of which the aggregate demand will have even more deflationary effect on the inflation, making the expansionary monetary policy more vigorous.
- The growth rates in investment slow down as the change in tangible working capital inventories recovers to normal.
- Economic growth in the global economy and partner countries in particular slows down amid uncertainties and adversities connected with potential US trade policies on possible trade wars with China and the revision to the US customs policy towards the EU, as well as associated with the UK leaving the EU (Brexit).

In terms of supply, the following are risks to the inflation:

- In the short term, prices of meat products may grow faster than expected due to the shortage of livestock.
- There are two-way risks to the impact on inflation (estimated to reach 0.4 pp) due to change in customs duty on some products in 2020.

Overall, the downside risks to inflation deviating from the projection path in the medium run prevail (see Chart 1: “Inflation Forecasts Probability Distribution”).

In addition to the risks to diminishing demand, there are other risks, again dual-sided, associated with potential economic growth, as follows:

- The uncertainties associated with further operating of Amoulsar mine and Alaverdi copper smelter.
- In the context of long-term economic growth estimation, the further course of structural reforms in the economy and to which extent they will affect the business and investment climate.

It should be noted that net impact of the aforementioned risks on the economic growth is trending somehow downward (see Chart 2).

3. ACTUAL DEVELOPMENTS IN Q4, 2018

3.1. Inflation

3.1.1. Fulfilment of the inflation target

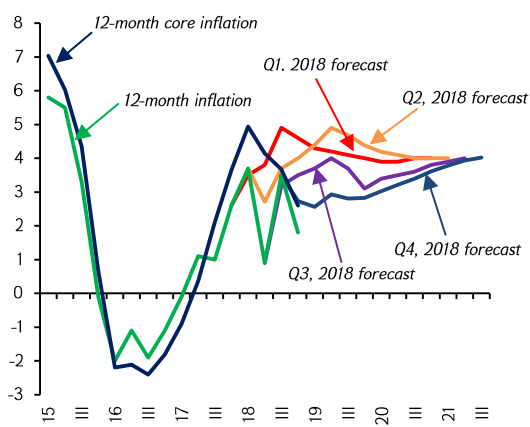
Fulfilment of the inflation target in a preceding 1-year horizon (which covers the entire year 2018) suggested that the inflation environment would further be expanding during the year, mainly driven by inflationary effects transmitting from world commodity markets and invigorated domestic demand thanks to the expansionary monetary policy implemented by the Central Bank, according to Q1, 2018 Monetary Policy Program. The estimation was that altered customs and excise duty rates on certain goods would have a limited inflationary effect in the short run, and additional inflation expectations in end-2017, temporary in nature as they resulted from increased prices on individual products, would be phasing out starting 2018. To ensure the sustainability of demand, the **monetary policy stance would have to remain expansionary**, according to the Program, but in the course of the year, as inflation rebounded, **expansionary monetary environment had to phase out gradually**, fulfilling the mid-term price stability objective.

As actual developments in 2018 showed, the risks have materialized early in the year: the demand, relatively high in the previous year, proved temporary in nature and came somewhat weaker at the start of the year; it further slowed incurring the impact of the Government's contractionary fiscal policy and considerably weakened inflation environment in the outside world. Furthermore, the above developments were reflected in both the core and headline inflation behaviors.

It is worth mentioning that inflation deviated to a certain extent from its gradual-recovery scenario. Thus, in the first quarter of 2018, as expected, the inflation environment expanded, with the 12-month inflation rate risen to 3.7 in March from 2.6% at the beginning of the year. The second and third quarters saw the inflation deviate from its previous quarter's baseline scenario – driven by agricultural product prices that fluctuated because of earlier developed crop seasonality, the 12-month inflation slowed down to 0.9% in end-June but then rebounded to 3.5% in end-September. A contractionary fiscal policy implemented instead of the planned one was another factor that let the inflation run below the anticipation over the mentioned period. This development was further induced by significant weakening of the inflation environment in the external sector in the fourth quarter, again pushing the 12-month inflation down, to 1.8% in end-December.

Chart 24

According to the Central Bank forecasts, the 12-month inflation will expand gradually and will then stabilize around the target



Source: Armenia Statistics Committee,
Central Bank forecast

In the monetary policy impact point of view however, more pronounced is the quarterly behavior of core inflation. It, too, has grown at the beginning of the year influenced by temporary extra household inflation expectations at the end of previous year and expansionary monetary policy implemented by the Central Bank. Later on, when the extra inflation expectations waned out and the said deflationary patterns emerged, core inflation started to decline gradually, as well. As a result, the 12-month core inflation increased to 4.9 at the end of March from 3.6% at the beginning of the year and then dropped to 2.6% at the yearend, pointing to the mitigated inflation expectations.

In view of the actual macroeconomic developments and non-inflationary patterns anticipated from external domestic economies, the **Central Bank has kept monetary conditions expansionary over 2018 by leaving the refinancing rate unchanged, at a 6% level.** Such a monetary policy, the Central Bank reckoned, is rather expansionary (as central banks of the world's leading countries also tightened their monetary conditions during the year) and fosters the growing of domestic demand in the forecast horizon and helps the inflation stabilize around its target.

Remarkably, in the second half of the year the risks to inflation deviating from its projection path were mostly on a downside trend, driven by external factors (lower-than-expected inflation environment and sluggish demand) and domestic factors (weaker-than-expected domestic demand resulting from more contractionary fiscal policy implementation). The inflation environment has considerably mitigated in the face of existing risks as the Central Bank, in pursuit of the inflation targeting in the mid-term perspective, kept the monetary conditions expansionary by leaving the refinancing rate unchanged and opening the stimulus horizon wider.

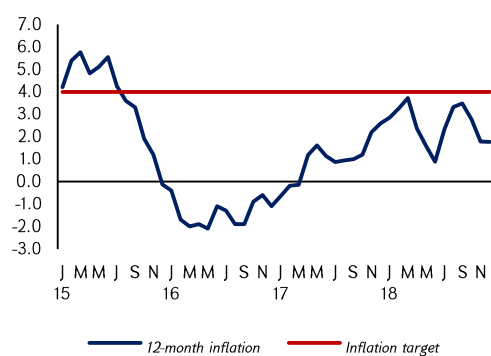
3.1.2. Prices

Consumer prices: There was **2.6% inflation** recorded in the fourth quarter of 2018, largely driven by a 4.9% price rise in commodity group “Food and non-alcoholic beverage” (including “Alcoholic beverage and tobacco”). Similarly, non-food and service tariffs have increased by 1.8% and 0.2%, respectively (contribution to the quarter's headline inflation: close to 0.45 pp). Specifically, price inflation in the group “Food and non-alcoholic beverage” has been fueled by fruit, vegetable and meat product prices grown by 16.8%, 37.4% and 1.7%, respectively (contribution to the quarter's headline inflation: about 2.7 pp).

The quarterly non-food price inflation is almost entirely due to prices in commodity groups “Clothes” and “Footwear” grown by 9.5% and 11.5%, respectively (contribution to the quarter's headline inflation:

Chart 25

In the fourth quarter of 2018 inflation decelerated



Source: Armenia Statistics Committee,
Central Bank forecast

about 0.4 pp). The prices in the group “Fuel” have dropped by 0.6% in the meanwhile.

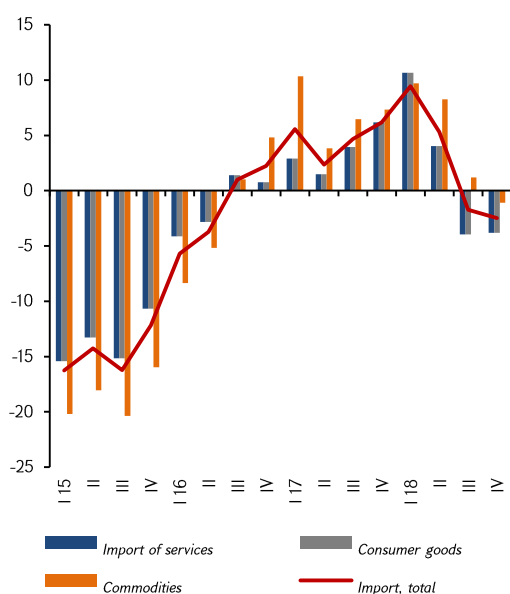
Housing utility tariffs have risen noticeably, by 0.8% (contribution to the quarter’s headline inflation: about 0.1 pp), while air fares and health service fees have fallen to a certain extent, by 0.7% and 0.3%, respectively.

Table 4:

Price inflation by commodity item as key contributors ⁷						
Commodity item	September, 2018 (y/y)		December, 2018 (y/y)		Q4, 2018	
	growth	contribution	growth	contribution	growth	contribution
CPI	3.5		1.8		2.6	
Food and non-alcoholic beverage (including alcoholic beverage and tobacco)	5.3	2.4	1.8	0.83	4.9	2.25
Bread products	-0.2	-0.02	0.7	0.06	0.4	0.04
Meat products	10.8	1.05	8.2	0.79	1.7	0.23
Oils and fats	11.7	0.35	3.1	0.09	-0.1	0
Fruit	0.3	0.01	10	0.28	16.8	0.47
Vegetable and potato	19.2	1.06	-6.3	-0.35	37.4	2.09
Egg	4.3	0.06	-6.5	-0.09	6.9	0.09
Sugar	-15.4	-0.12	-11.7	-0.09	-0.4	0
Tobacco	9.6	0.15	7.9	0.13	0.3	0.0
Non-food products	3.9	0.82	3.2	0.69	1.8	0.38
Services	0.7	0.25	0.8	0.3	0.1	0.03

Chart 26

In the fourth quarter of 2018 the dollar prices of import of goods and services decreased, y/y, %



Source: Central Bank calculations

The 12-month inflation rate amounted to 1.8% in December of 2018, instead of a 2.7% target outlined in the fourth quarter’s MP program, with seasonally-sensitive agricultural product price growth making up -1.6% y/y, regulated services, 0.3%, and core inflation, 2.6%. Note that the core inflation indicator, too, has embraced the effects of some supply-side shocks observable during the year. Specifically, the combined impact of the change in excise tax, customs duty, of the rise in prices of meat products (beef in particular) and of the decline in prices of imported goods on inflation is estimated to be 0.8 pp positive.

According to the official data issued by the Republic of Armenia Statistics Committee, there was 1.8% inflation in January of 2019, mainly due to a 4.6% price increase in group “Food and non-alcohol beverage”, with the 12-month inflation rate having dropped sharply in January to 0.8%.

⁷ In the table the y/y data of structural elements of food products are calculated by the Central Bank using the information provided by the Republic of Armenia Statistics Committee.

Inflation in February of 2019 was 0.6%, largely driven by increased prices in groups “Fruit” and “Vegetable” by 1.7% and 7.4%, respectively (contribution to the overall increase in consumer prices: 0.5 pp). As a result, the 12-month inflation rate rebounded to 1.9% in February.

Import prices: The change of dollar prices of import of goods to Armenia was almost zero in the fourth quarter of 2018. The dollar prices of consumer goods have increased 0.3% q/q and those of import of ore and minerals decreased by 0.7% q/q. The latter decrease was driven by the fall in wheat and oil prices during the quarter. The overall impact of these developments on prices of imported goods to Armenia is almost unchanged compared with the previous quarter. At the same time, the dollar prices of import of goods and services are still lower, by 2.5%, relative to the same quarter of the previous year.

3.2. Economic developments

3.2.1. Economy position

The estimation of the GDP gap is negative in the fourth quarter of 2018. Although higher-than-anticipated economic growth and accelerated private consumption in the fourth quarter of 2018 (see subsections 3.2.2 and 3.2.3) facilitated an upside revision to the GDP gap, it is nevertheless estimated to remain considerably negative due to a number of factors; this is consistent with a low inflation environment in the consumer market and reflects the slowing of the core inflation rate (see section II.2.1). In particular, a contractionary fiscal policy in the fourth quarter of 2018, depreciated exchange rates in the economies of partner countries, the weakening of external demand and less-than-expected remittances in real terms all have contributed to the shaping of a negative GDP gap in spite of the expansionary monetary policy implemented by the Central Bank.

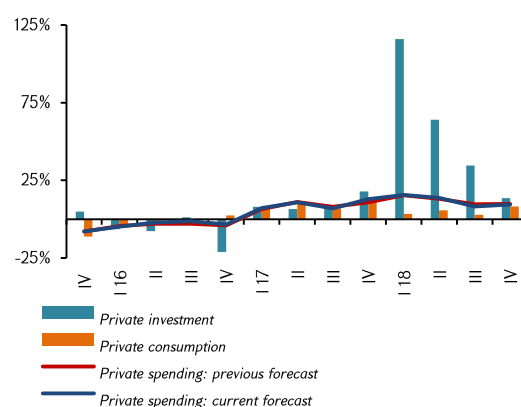
In the fourth quarter of 2018, the GDP gap is estimated as negative.

3.2.2. The expenditures aspect of the economy

The growth rate of private demand persisted high over the fourth quarter of 2018. With a 3.4% economic growth, private spending posted an estimated 9.3% growth in the reporting quarter, which is not a notable deviation from the previous forecast. Compared to the previous estimate, however, the structure of private demand has changed – the growth rate of private consumption accelerated and that of private investment slowed down.

Chart 27

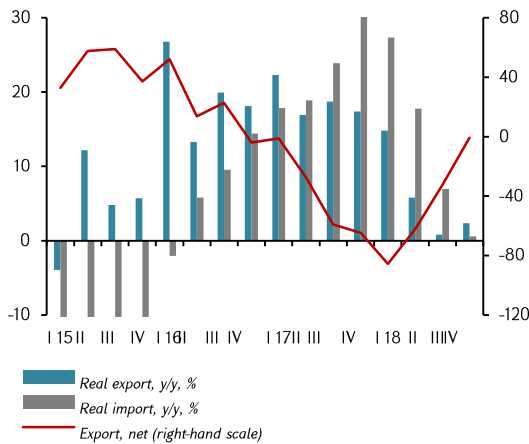
Structure of private spending, y/y, %



Source: Armenia Statistics Committee, Central Bank estimate

Chart 28

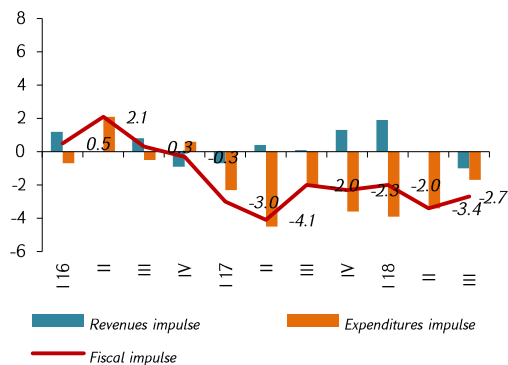
In the fourth quarter of 2018 net export position improved as export grew at a faster pace over import (net real export, y/y, %, positive sign = improvement)



Source: Armenia Statistics Committee

Chart 29

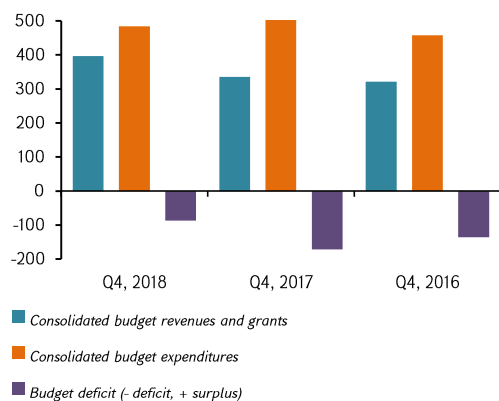
In the fourth quarter of 2018 the contractionary effect of fiscal policy owed primarily to the contractionary effect of revenues



Source: Central Bank estimate

Chart 30

Main indicators of the consolidated budget, billion AMD



Source: Finance Ministry, Central Bank estimate

Remarkably, a 9.3% growth of private spending in the fourth quarter of 2018 owes to an 8.3% increase in private consumption and a 13.5% increase in private investment. In recent quarters, there has been a steady increase in lending to households as compared with the growth of business loans, which is partly attributable to higher consumption and lower investment dynamics. It is worth mentioning that high growth in private investment observable since the beginning of 2018 has been mostly determined by strong growth in tangible working capital inventories which also slowed down in the reporting quarter.

In the fourth quarter of 2018, private consumption is close to its potential value, so significant inflationary or deflationary pressures are not likely.

In the fourth quarter of 2018, the growth of real export and import volumes has slowed down compared to strong growth observable in the beginning of the year, especially on the part of import. The increase in real volumes of export has somewhat exceeded those of import. As a result, the contribution of net real export to the GDP has been almost zero following the negative contributions reported in previous quarters. Thus, in the fourth quarter of 2018 the real growth of export of goods and services amounted to 2.3% y/y, while the real growth of import of goods and services reached 0.6%. It should be noted that the growth of import of goods with their major share in imports structure slowed down in the fourth quarter. The real growth of export and import of goods and services over 2018 has been 5.2% and 10.9%, respectively.

In the fourth quarter of 2018, net remittances of individuals (seasonal workers' income and personal transfers inclusive) in US dollars narrowed to an estimated 7.1% y/y, as the Russian ruble exchange rate continued depreciating versus the US dollar. For 2018, the decrease is an estimated 1.5%.

In the fourth quarter of 2018, the current account deficit-to-GDP ratio dropped by about 0.7 pp, according to estimations, due to shrinking foreign trade balance deficit. As a result, the current account deficit-to-GDP ratio in 2018 is estimated at around 8.2%.

Fiscal policy⁸: In the fourth quarter of 2018, the state budget performed with actual expenditures and revenues deviating from the Central Bank's projections⁹. The quarter saw more revenue collection and more expenditures against the quarterly projections. As a result, the fiscal policy's impact on aggregate demand is an estimated 2.8 pp contractionary instead of the predicted 3.3 pp contractionary, for the fourth quarter.

In the fourth quarter of 2018, budget revenues totaled 103% and tax revenues, 102%, of the projection. Apart from more revenue

⁸ The review of the fiscal sector used preliminary actual consolidated budget indicators (local budgets as an estimate) prepared on the basis of preliminary actual indicators of the fourth quarter of 2018, excluding off-budgetary funds.

⁹ The revenue projection is based on the indicator provided for in the Budget Law 2018; the expenditure projection is the Central Bank estimate.

collection, the unified tax account has increased as well (growing by AMD 16.2 billion over the fourth quarter, it reached almost AMD 48.0 billion at the end of the year), the impact of which has been considered in the revenue impulse. As a result, the revenue impulse was 3.1 pp contractionary, instead of predicted 1.2 pp contractionary.

The state budget expenditures amounted to 106% of the Central Bank projection, pushing the expenditures impulse to report a slightly expansionary impact instead of anticipated contractionary. In the expenditures structure of the budget in the fourth quarter of 2018, **government consumption** was below the predicted figure by nearly 8%. The expenditures on item **“Transactions with non-financial assets”** were 48% more than the projection, which is explained by higher performance of the programs implemented under foreign assistance. For the quarter, the expenditures impulse was 0.3 pp expansionary instead of the forecast 2.1 pp contractionary.

With revenues and expenditures performance described above, the state budget generated a deficit of roughly AMD 87.0 billion in the fourth quarter of 2018, instead of AMD 58.0 billion estimated by the Central Bank.

In 2018, relative to the previous year, the tax-to-GDP ratio has increased by 0.2 pp to 20.9%; the deficit-to-GDP ratio has dropped by 3.1 pp to 1.7%. In view of the annual results, the fiscal policy has had a 2.9 contractionary impact due to both revenues and expenditures impulses.

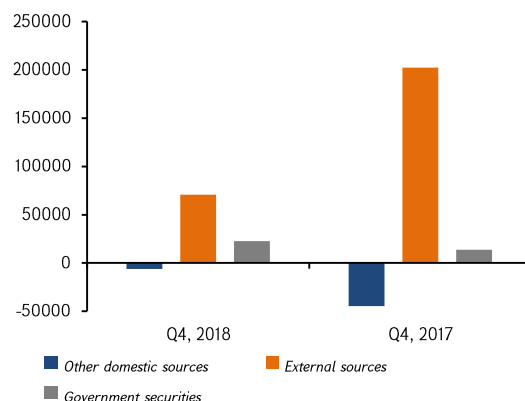
3.2.3. The production aspect of the economy

The economic growth in the fourth quarter of 2018 amounted to 3.4%, higher than forecast by the Central Bank. The deviation was mostly attributable to the services – with more positive developments than anticipated. The sector reported as much as 10.7% growth in the fourth quarter of 2018, driven by strong lending and invigorated international tourism. The industry growth was 1.1%, which remained virtually intact against previous estimation by the Central Bank. Moreover, despite a shrinkage in mining, the growth in manufacturing has been the main contribution to the industry sector. Other sectors of the economy have contributed negatively to economic growth; in the reporting quarter in particular, the decline in agriculture was 13.7% and in construction, 2.7%.

There is anticipation that services will continue to be the main driver to economic growth over the first quarter of 2019, supported by high economic activity indicators for January (with 19.3% growth in trade and 15.6% growth in services). It should be noted that high growth in services can partly be determined by reduction of shadow

Chart 31

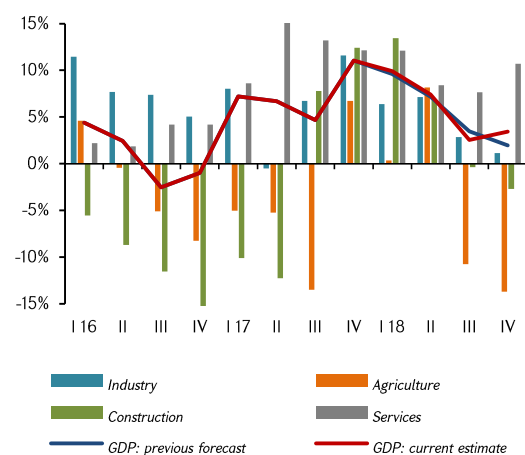
In the fourth quarter of 2018 net sums of foreign funds were used to finance the budget deficit, million AMD



Source: Finance Ministry

Chart 32

GDP sectoral structure, y/y growth, %

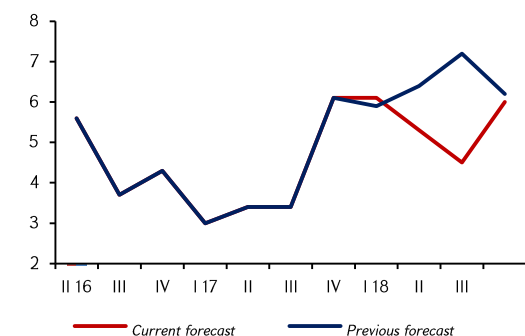


Source: Armenia Statistics Committee, Central Bank estimate

In the fourth quarter of 2018, the economic growth was higher than forecasted by the Central Bank, making up 3.4%.

Chart 33

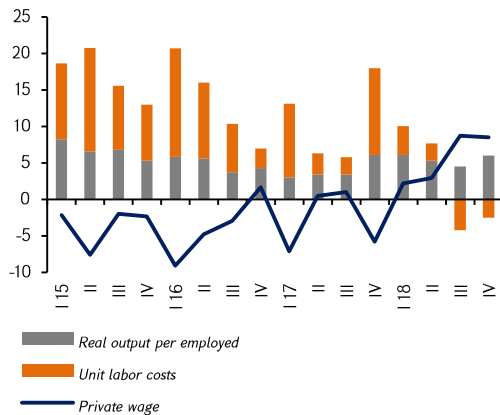
Private nominal wage, y/y growth, %



Source: Armenia Statistics Committee, Central Bank estimate

Chart 34

Unit labor costs, y/y growth, %

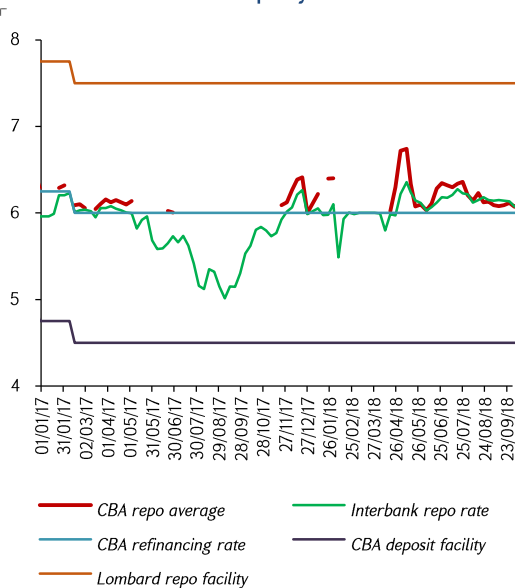


Source: Armenia Statistics Committee,
Central Bank estimate

In the fourth quarter of 2018, the Board of the Central Bank again left the refinancing rate unchanged, at 6%.

Chart 35

During the quarter short-term interest rates remained around the Central Bank's policy rate



Source: Central Bank

economy as a result of tax administration, which has not yet affected the inflationary environment.

In the fourth quarter of 2018, relative to the same reference period last year, the productivity, calculated as real value added per hour worked, has increased by 0.7%, according to the Central Bank estimations. The moderate increase in productivity is consistent with the economic developments described above, as it has been concurrent with the growth in services, a relatively more labor-intensive, limited-productivity sector.

3.2.4. Labor market¹⁰

Economic growth in the fourth quarter came along with a decline in labor productivity¹¹, so the average nominal wage growth in the private sector will possibly be slightly lower than forecasted previously and the demand for labor somewhat higher, as more resources are needed to meet the existing demand amid declining productivity. As a result, in the fourth quarter of 2018 the private sector nominal wage growth was revised some 0.2 pp downward to an estimated 6.0%.

With economic growth and productivity developments mentioned above, the unemployment rate is an estimated 16% in the fourth quarter of 2018, which is 0.2 pp below the indicator outlined in the previous forecast.

In the reporting period, unit labor costs of the firms have grown by 8.5%, with the private sector wage growth rate having accelerated in relation to the output growth rate per unit of labor; weak inflationary pressures from the labor market are likely, as a result.

3.3. Financial market developments

In the fourth quarter of 2018, the Central Bank Board decided to leave the refinancing rate unchanged, at a 6% level.

In November and December, the Central Bank Board preferred to leaving the refinancing rate unaltered, estimating that the policy rate's current level is stimulating enough for the inflation to follow a path to gradual recovery. In view of predicted macroeconomic developments, maintaining monetary conditions expansionary for a longer period has been considered in the context of mid-term price stability, expecting that the inflation will remain low and stabilize around its 4% target at

¹⁰ The labor market data for the fourth quarter 2018 are the Central Bank estimates which are based on the third quarter 2018 data and actual October-November 2018 figures. The growth indicators provided in this subsection are relative to the same reference period last year, unless otherwise specified.

¹¹ The gross real value added per employed has been viewed as the productivity indicator, which posted a 2.5% decrease in the fourth quarter of 2018, according to the Central Bank estimates.

the end of forecast horizon. Looking to the existing inflationary risks, which were mostly on a downside trend, the Board announced that if such risks emerged, the Central Bank would steer the monetary policy direction accordingly, while ensuring price stability.

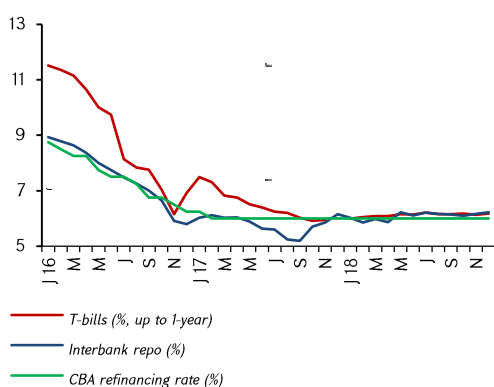
Table 5

Average quarterly interest rates in Armenia's financial market					
Instrument	Q4, 2017	Q1, 2018	Q2, 2018	Q3, 2018	Q4, 2018
Central Bank refinancing rate (end of quarter)	6.00	6.00	6.00	6.00	6.00
Central Bank repo rate	6.20	6.20	6.32	6.17	6.17
Interbank repo rate (up to 7-day)	5.89	5.94	6.09	6.17	6.15
Yield of government securities on a yield curve (as of end-quarter)					
Short-term treasury bill (1-year)	6.25	6.37	6.55	6.70	6.63
Medium-term notes (up to 5 years)	8.41	8.15	8.37	8.60	8.48
Long-term bonds (30-year)	12.27	11.40	11.52	10.54	10.68

The financial market continued performing steadily during the fourth quarter of 2018, with short-term market rates shaped around the policy rate of the Central Bank. To keep short-term interest rates around the refinancing rate, the Central Bank almost entirely satisfied the demand for liquidity during the quarter through its liquidity injection tools. The quarterly interbank repo (up to 7-day) rate was 6.15%.

Chart 37

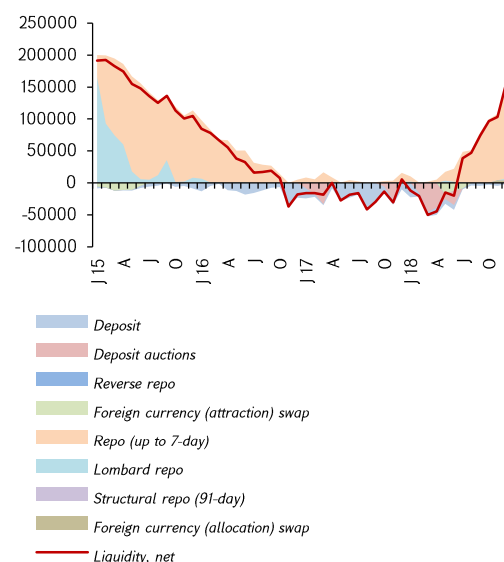
The behavior of short-term interest rates in the fourth quarter of 2018



Source: Central Bank, Nasdaq OMX Armenia

Chart 36

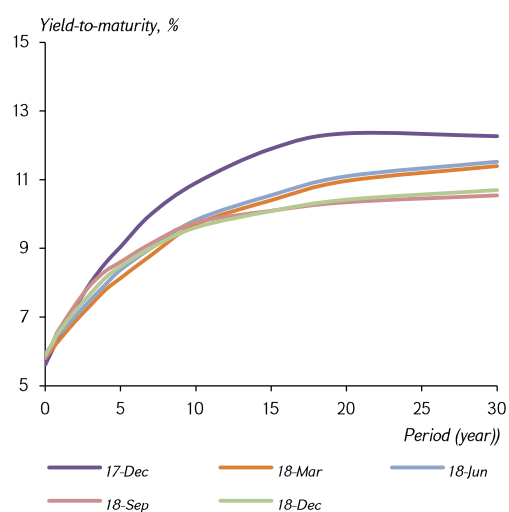
Liquidity injection and absorption through the Central Bank operations (average quarterly inventory), million AMD



Source: Central Bank

Chart 38

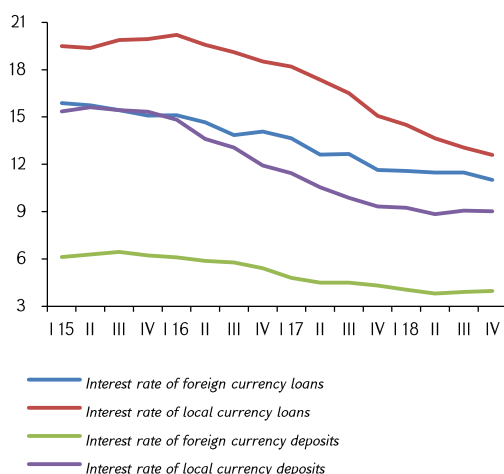
In the fourth quarter of 2018 yields of long-term government securities market did not change much



Source: Central Bank

Chart 39

Interest rates on deposits of and loans to individuals



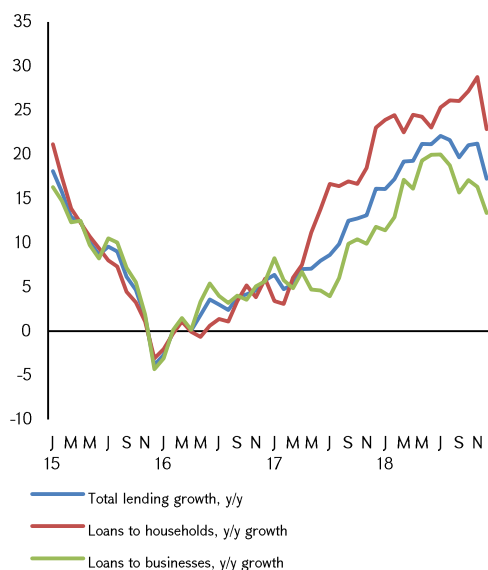
Source: Central Bank

The financial market participants also demonstrated stable expectations over the quarter, with no significant shifts noticeable with regard to the yield of government bonds, as a result. The yields of T-bills have shaped around the Central Bank's policy rate, showing patterns typical of the money market.

With a high level of capitalization of the banking system and expansionary monetary policy pursued by the Central Bank, bank lending tended to grow by volume during the fourth quarter of 2018. Notwithstanding the slowdown in lending to firms, further easing of terms and procedures for loan provision, falling interest rates boosted up the overall lending over the quarter, supported by the growth in consumer and mortgage loans. The quarterly lending growth indicator amounted to 3.7% owing to a 10.5% increase in loans provided in local currency. The 12-month growth of total lending to the economy in December of 2018 reached 17.2%. The falling of interest rates was more expressly demonstrable with local currency loans provided to individuals.

Chart 40

In the fourth quarter of 2018 growth of lending owed to the increased volume of loans to households



Source: Central Bank

BOARD MEETING OF THE CBA

MINUTES (12.03.2019)

On the Refinancing Rate

The CBA Board Meeting of March 12, 2019 attended by Deputy Chairmen Nerses Yeritsyan and Vakhtang Abrahamyan, and Board Members Ashot Mkrtchyan, Arthur Stepanyan, Armenak Darbinyan, Oleg Aghasyan, and Martin Galstyan

The Board meeting opened with presentation of the Situation Report as of March 12, 2019. It addressed the developments on the inflation, external environment and real, fiscal and monetary sectors of the economy.

There was **0.6% inflation in February of 2019, which was totally due to changed prices in commodity group “Food and non-alcoholic beverage”**. In particular, in groups such as “Fruit” and “Vegetable” the prices grew during the month by 1.7% and 7.4%, respectively (with a combined contribution of 0.5 pp to the month’s inflation). In February, non-food prices and service tariffs declined by 0.4% and 0.1%, respectively. As a result, the 12-month inflation rate grew during the month, amounting to 1.9% as opposed to 0.5% deflation registered for the same month of the previous year. Unlike headline inflation, the **12-month core inflation continued reducing during the month, to 1.3% compared with 2.6% recorded for the start of the year**.

Addressing the current economic environment, the Board stated that economic activity **in the fourth quarter of 2018 was higher-than-expected, owing to the growth in services, trade and construction**, as a result of which the year ended with a 5.2% economic growth. From a demand point of view, that was reflected in strong private consumption growth, which was largely driven by grown lending to the economy. At the same time, the **domestic demand growth was somewhat contracted by the impact of the implemented fiscal policy**. These trends persisted in early 2019: in January, relative to the previous period last year, the economic activity indicator has also exceeded the expected level, reaching 6.1%, based on which the CBA made upside revision to the growth forecast for the first quarter, hence for the year.

The Board looked to the latest external sector developments which are pointing to slowdowns in global economic growth, as the global demand slackened. Influenced by the latter, **the inflation environment in the international markets of raw materials and food products has weakened**, except for copper and sugar prices which continue to grow. In this situation, the US Federal Reserve and the European Central Bank stated that, in response to the slowdown in

economic growth and inflation, the former is set to postpone and the latter to get slower with the adjustment of monetary conditions, while the ECB would further be concluding long-term repo agreements. The Central Bank of Russia will keep monetary conditions contractionary, as both inflation and inflation expectations are still high and exceed the target value.

The developments in the domestic financial market were touched upon. The Board admitted that ***interest rates in the financial market dropped in early of the year*** in line with the refinancing rate that was lowered in January, ***helping the interest rates shape around the policy rate.***

Following the discussion of the Situation Report and of the developments in external and domestic macroeconomic environments, the Board began addressing the monetary policy directions and making a decision on the interest rate. The options whether the refinancing rate is to be left unchanged or lowered were considered. In the current situation, gradual recovery of inflation is preferable by the Board since low inflation contributes to anchoring long-term inflation expectations and maintaining the purchasing power of income. Also, in view of the lack of considerable inflationary effects from external and domestic economies in the upcoming period because of persistently weak global and domestic demand, and that the current interest rate is still estimated to be rather expansionary on the back of interest rate rise by major trading partner countries, the Board finds it reasonable to leave the interest rate unchanged. The Board has a consensus that in view of predictable macroeconomic developments, the monetary conditions have to be kept expansionary for as long as required, in fulfillment of the inflation target in the medium run. ***As a result, the expectation is that, in the coming months the inflation will run below the target, stabilizing around the established value later on.***

The Board also referred to existing inflationary risks; these are mostly on a downside path and associated with spillover effects on domestic prices due to more-than-anticipated deflationary environment in the external sector, on the one hand, and weakening of economic activity in Armenia as compared to the baseline scenario, on the other. In the event these risks materialize, an appropriate monetary policy response will follow in order to ensure price stability in the medium-term perspective.

The Board approved the decision on interest rates of monetary instruments of the Central Bank and the proposed press release, which are attached hereto.

BOARD OF THE CENTRAL BANK OF ARMENIA

R E S O L U T I O N

INTEREST RATES OF OPERATIONS BY THE CENTRAL BANK OF THE REPUBLIC OF ARMENIA IN THE FINANCIAL MARKET

By virtue of Article 20 (c) of the Republic of Armenia Law on the Central Bank, the Board of the Central Bank of the Republic of Armenia **e n a c t s**:

1. To leave the refinancing rate of the Central Bank of the Republic of Armenia unchanged, 5.75%.

2. To the Financial Department of the Central Bank of the Republic of Armenia to carry out operations in the financial market of the Republic of Armenia, using the interest rates, as follows:

2.1. Lombard facility rate offered by the Central Bank to be 7.25%.

2.2. Deposit facility rate offered by the Central Bank to be 4.25%.

3. This decision shall take force on the day following the adoption thereof.

Nerses Yeritsyan,
Deputy Chairman of the Central Bank
March 12, 2019

PRESS RELEASE
12.03.2019

In the March 12, 2019 meeting, the Board of the Central Bank of Armenia (CBA) decided to leave the refinancing rate unchanged, at a 5.75% level.

There was 0.6% inflation in February of 2019, compared with 0.5% deflation registered in the same month of 2018, in which case the 12-month inflation rate has increased, amounting to 1.9%. The rise in prices of seasonal products has totally contributed to the month's inflation.

As global economic growth rates are slowing down, the global demand has somewhat weakened, with a low inflation environment persisting in international markets of basic commodities. In the meantime, central banks of leading countries temporarily withheld from adjusting their monetary conditions. In view of these developments, the Board of the CBA considers that no inflationary pressures from the external sector are likely in the upcoming months.

The Board states that, according to Q4, 2018 actual results, the economic activity has been higher than expected, which was driven mainly by the high growth in private consumption. The relatively high economic activity was also observable at the start of 2019; it made up 6.1% in January. It should be noted that at the beginning of the year too, the fiscal policy continues to have a contractionary effect on the domestic demand, which, according to the CBA estimation, will phase out over the first half of the year.

In consideration of the current situation, the Board has a preference for the gradual recovery of inflation, as low inflation contributes to anchoring long-term inflation expectations and maintaining purchasing power of incomes. Taking into account the aforementioned trends, the Board finds it reasonable to keep monetary conditions expansionary, leaving the refinancing rate unchanged. At the same time, in view of the anticipated macroeconomic developments, to leave monetary conditions expansionary for a long period of time will be needed for maintaining price stability in the medium run. As a result, the expectation is that the inflation will be running below the target but later stabilizing around the target value in the coming months.

Risks to fulfillment of the inflation target in the forecast horizon are assessed still downside, due to both external and internal factors. An adequate monetary policy response will come along if such risks emerge, in order to maintain price stability in the medium run.

Press Service of the Central Bank of Armenia

MAIN MACROECONOMIC INDICATORS OF ARMENIA

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
	actual	actual	actual	actual	actual	actual	actual	actual	actual	program	program	program
Prices												
Inflation (y/y, end of period, %)	9.4	4.7	3.2	5.6	4.6	-0.1	-1.1	2.6	1.8	2.4	3.6	4.0
Consumer price index (y/y, average, %)	8.2	7.7	2.6	5.8	3.0	3.7	-1.4	1.0	2.5	1.9	3.1	3.9
Core inflation (y/y, average, %)	7.5	8.6	5.3	5.8	1.9	5.1	-2.0	0.8	4.0	1.6	3.7	4.2
Gross product												
GDP (billion Armenian dram)	3690.0	4028.9	4266.5	4555.6	4828.6	5043.6	5067.3	5568.9	6002.7	6526.4	7133.6	7782.5
GDP (% real growth)	2.2	4.7	7.2	3.3	3.6	3.2	0.2	7.5	5.2	5.4	5.1	4.9
Supply												
Industry (% real growth)	9.2	13.6	6.4	6.3	-0.9	6.2	7.7	6.6	4.1	2.8	4.5	4.9
Agriculture (% real growth)	-16.0	14.0	9.5	7.6	6.1	13.2	-5.0	-5.3	-8.5	1.5	2.4	3.5
Construction (% real growth)	3.3	-12.2	4.5	-7.4	-4.5	-3.1	-14.1	2.5	1.6	3.5	3.1	3.4
Services (% real growth)	4.1	4.7	6.3	3.1	6.7	1.6	3.2	12.4	9.6	7.8	6.2	5.4
Taxes, net (% real growth)	13.4	3.8	9.9	3.6	1.8	-5.1	-4.7	10.1	8.0	4.1	5.4	4.9
Demand												
Consumption (% real growth)	3.9	2.6	7.7	1.9	0.7	-6.2	-0.5	9.5	3.9	4.5	3.8	3.4
Public consumption (% real growth)	3.9	1.9	-1.4	8.7	3.4	4.7	5.8	11.5	-5.8	0.7	1.3	2.2
Private consumption (% real growth)	3.9	2.7	9.1	0.9	1.0	-7.7	-1.2	8.9	5.2	5.1	4.2	3.6
Gross investment (% real growth)	0.5	-5.2	0.5	-10.5	-3.0	-1.2	-8.7	13.9	28.5	3.1	6.3	6.0
Public investment (% real growth)	-12.7	-6.1	-22.4	-13.8	10.0	13.6	5.0	31.7	-38.0	37.4	15.0	12.0
Private investment (% real growth)	2.6	-5.1	3.6	-10.0	-3.7	-3.6	-10.5	11.1	41.0	0.3	4.9	4.9
Export of goods and services (% real growth)	20.4	14.5	12.0	8.9	6.4	4.9	19.1	18.2	5.2	5.0	7.9	7.5
Import of goods and services (% real growth)	7.2	-0.1	4.7	5.5	-1.0	-15.1	7.6	24.8	10.9	2.7	5.0	4.3
External sector												
Balance of trade (million US dollar)	-2065.7	-2109.8	-2111.9	-2196.2	-2055.4	-1186.4	-944.4	-1375.4	-1755.7	-1741.6	-1820.1	-1851.2
Balance of services (million US dollar)	-260.8	-65.8	-101.6	-124.3	-113.0	-94.5	-71.4	-27.9	-86.9	-67.8	-39.2	-25.0
Remittances (million US dollar)	1421.9	1440.4	1539.8	1755.1	1616.1	1082.4	989.6	1128.1	1111.4	1172.2	1289.4	1418.3
Current account (million US dollar)	-1261.4	-1058.9	-1057.9	-812.9	-883.1	-279.1	-238.1	-279.7	-1025.0	-855.5	-822.9	-760.9
Balance of trade (share in GDP, %)	-22.1	-20.8	-19.9	-19.7	-17.8	-11.3	-8.9	-11.9	-14.1	-13.0	-12.4	-11.5
Balance of services (share in GDP, %)	-2.8	-0.7	-1.0	-1.1	-1.0	-0.9	-0.7	-0.2	-0.7	-0.5	-0.3	-0.2
Remittances (share in GDP, %)	15.2	14.2	14.6	15.8	14.0	10.3	9.3	9.8	8.9	8.7	8.8	8.8
Current account (share in GDP, %)	-13.5	-10.5	-10.0	-7.3	-7.6	-2.7	-2.2	-2.4	-8.2	-6.4	-5.6	-4.7
Public sector*												
Revenues and grants (billion Armenian dram)	780.4	880.9	946.2	1071.4	1144.8	1167.7	1171.1	1237.2	1298.4	1462.0	-	-
Tax revenues (billion Armenian dram)	699.4	777.4	878.4	1000.9	1064.1	1067.9	1079.7	1158.1	1255.5	1399.2	-	-
Expenditures (billion Armenian dram)	954.3	986.5	1006.1	1142.9	1235.1	1409.0	1449.1	1503.9	1409.7	1573.3	-	-
Deficit (billion Armenian dram)	-173.9	-105.6	-59.9	-71.5	-90.3	-241.3	-278.0	-266.7	-111.3	-111.3	-	-
Revenues and grants (share in GDP, %)	22.6	23.3	22.2	23.5	23.7	23.2	23.1	22.2	21.6	22.4	-	-
Tax revenues (share in GDP, %)	20.2	20.6	20.6	22.0	22.0	21.2	21.3	20.8	20.9	21.4	-	-
Expenditures (share in GDP, %)	27.6	26.1	23.6	25.1	25.6	28.0	28.6	27.0	23.5	24.1	-	-
Deficit (share in GDP, %)	-5.0	-2.8	-1.4	-1.6	-1.9	-4.8	-5.5	-4.8	-1.9	-1.7	-	-
Monetary sector												
Broad money (y/y, end of period, %)	11.8	23.7	19.5	14.8	8.3	10.8	17.5	18.5	7.4	-	-	-
Dram broad money (y/y, end of period, %)	15.7	26.4	11.9	14.9	-3.5	5.2	24.8	28.9	13.2	-	-	-
Loans to economy (y/y, end of period, %)	26.7	35.3	27.6	12.9	20.8	-3.3	6.0	16.5	17.2	-	-	-
USD / AMD (Armenian dram for one US dollar)	373.7	372.4	401.8	409.6	415.9	477.9	480.5	482.7	483.0	-	-	-

* The 2019 state budget indicators of the Central Bank estimates.

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