THE CENTRAL BANK OF
THE REPUBLIC OF ARMENIA

Approved under the Central Bank Board Resolution No. 85A, dated June 21, 2019

Inflation Report

Monetary Policy Program, Q2, 2019

Status Report on Implementation of the Monetary Policy Program, Q1, 2019

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 June 11, 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 (www.cba.am) which also contains all press-releases and other monetary policy-related publications.

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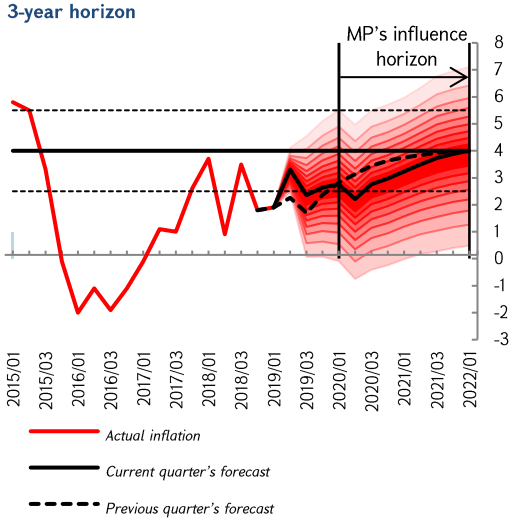
The inflation environment remained low in the second quarter of 2019 too, under which circumstance the Central Bank further pursued an expansionary monetary policy.

Chart 1

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

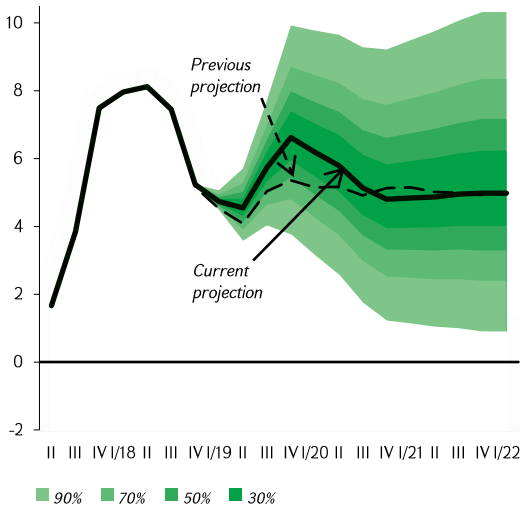


Source: Armenia Statistics Committee, Central Bank forecas

With high economic activity in the first quarter of 2019, the economic growth has surpassed the expected indicator, amounting to 7.1%, which continues to be largely driven by strong private consumption growth.

Chart 2

Real GDP (cumulative)[1] growth projection probability distribution for 3-year horizon



Source: Armenia Statistics Service, Central Bank forecast

The inflation environment remained low in the second quarter of 2019 too, and the Central Bank of the Republic of Armenia (the Central Bank) continued implementing an expansionary monetary policy. With aggregate demand set to recovery, inflation will stabilize around the 4% target in the medium run, as a result.

According to the second quarter 2019 forecasts, the 12-month inflation rate will float in the lower part of the confidence band in the upcoming year. The Central Bank estimates that at present the low inflation contributes to anchoring long-term inflation expectations and maintaining the purchasing power of income, and a policy steered to the gradual recovery of inflation is still preferable.

In the short term, the main factor determining low inflation remains weak aggregate demand which, in its turn, has incurred the impact of the Government's contractionary fiscal policy and of the low inflationary environment persisting in the external sector. True, the fiscal policy is expected to give aggregate demand an extensive stimulus over the second half of 2019, but this will only absorb the contractionary effect it had in first half, turning into a neutral for the year. In such macroeconomic and low inflationary environment, the current policy rate is estimated to be expansionary enough, commensurate with the negative GDP gap, ***so the Board of the Central Bank finds it reasonable to leave the refinancing rate unchanged for the time being***. In view of predicted macroeconomic developments, the Central Bank will keep monetary conditions expansionary for as long a period as required, in fulfillment of the inflation target in the medium run.

With increased economic activity observed in the first quarter of 2019, the economic growth surpassed the expected figure, making up 7.1%, which continues to be driven primarily by high growth in private consumption. These trends are estimated to persist in the short term, under which the 2019 economic growth forecast has been revised upside, in the range of 5.9-7.4%, and in the mid-term perspective it will approach its long-term equilibrium.

The 2019 economic growth will mostly be fueled by growth in the services and, in part, industry sectors, accompanied by persistently high private consumption growth. Mid-term economic growth will largely owe to the expanding of production capacities, the pace at

[1] *The growth rate of each quarter is calculated as the cumulative growth rate for the last four quarters.*

which the Government will push forward the structural reforms and what economic growth potential can be expected in partner countries.

In the forecast horizon, risks to inflation deviating from projection are on a downside and to economic growth outlook on an upside path, depending on both external and domestic factors (see subsection 2.2.4 "Main assumptions and risks"). If predicted macroeconomic developments unfold and these risks materialize, the Central Bank will adjust the monetary conditions accordingly, while fulfilling the goal of price stability.

In the forecast horizon, downside risks to inflation and somewhat upside risks to economic growth outlook are prevailing.

2. FORECAST, FORECAST CHANGES AND RISKS

2.1. External environment

The global economy further slowed down in early 2019 and this tendency is expected to be observable up until the end of the year.

The world economic growth continued slowing in early 2019 and this tendency is predicted to persist up until the end of the year. In particular, in the first half of 2019 economic growth rates are expected to slow down in the United States, the Eurozone and Russia – the main trade partners to Armenia.

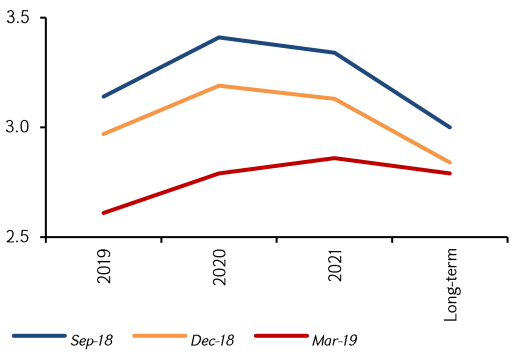
Economic developments and inflation in the United States: According to the U.S. Bureau of Economic Analysis 2nd quarter estimates, driven mainly by net exports and domestic consumption, economic growth in the USA in the first quarter of 2019 was 3.1% y/y, with average economic growth predicted to be 2.45% for 2019. The unemployment rate in the first quarter of 2019 somewhat subdued to 3.8% compared to the previous quarter. A robust first quarter growth notwithstanding, the US economic growth rate is predicted to slow down over the next quarters on the brink of a new wave of trade war between the United States and China; if this intensifies, the slowing of growth will come along with phasing out positive impact of US tax reforms on the economy.

The average quarterly personal consumption expenditure price index in the first quarter of 2019 decreased, relative to that of high figure reported in the previous year, to 1.4% shaping below the US Federal Reserve's medium-term target. In view of higher-than-anticipated economic growth and such price developments, the Fed kept the policy rate in the first quarter, as was expected, within a 2.25-2.50% range.

Given that markets' expectations of economic growth are quite pessimistic and that both the PCE price index and headline inflation are running below the benchmark[2], which amounted, respectively, to 1.5% and 1.9% in April, the Fed no longer expects to tighten monetary policy conditions during 2019, while the mid-term path of the policy rate has been adjusted significantly.

Chart 3

FRS's interest rate path according to the FRS Board ***(average weighted values, %)***



[2] *The personal consumption expenditure price index amounts to 2%, which on average is commensurate with headline inflation of 2.4%.*

Box 1:

Expectations about the US economic outlook

The US Purchasing Managers' Index (PMI) – an index of the prevailing direction of economic trends in the manufacturing and service sectors – has been falling observable from the end of the previous year. As one of the most comprehensive indexes, the purpose of the PMI is to provide information about current and future business conditions, and while the PMI was almost 61 in August 2018, it dropped to 53 in April 2019.

The pessimistic expectations about the US economic growth played out in their most when businesses saw inverted yield curves. Normally, the yield curve is up-sloped[3], i.e. the yield of long-term securities is higher than the yield of short-term securities. Sometimes, however, the opposite happens, when short-term securities have a higher yield than those of long-term, which usually points to high demand, high inflation, and hence high interest rates at present in order to reduce demand and curb inflation in future. And conversely, the inverted or down-sloped yield curve is likely to press on when the economy is in a recession, which means that the interest rates are to trend lower in the long run. In the USA, long-term and short-term bonds are the 10-year and 3-month US Treasuries with their yield spreads having become negative in the recent period. Because, historically, inversions of the yield curve have preceded many of the U.S. recessions, the financial markets have generated concerns over interest rates and the future course of the economy on the whole.

Chart 4

The market's expectations are pessimistic

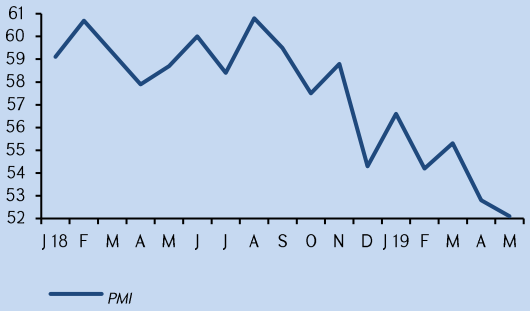
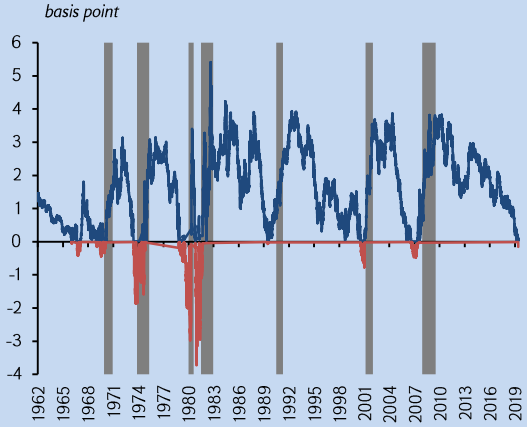


Chart 5

The 10-year and 3-month US Treasuries yield spreads and US economic recessions



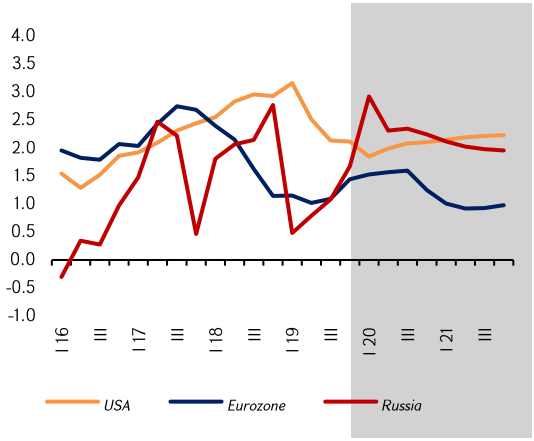
Source: Federal Reserve Bank of St. Louis

Economic developments and inflation in the Eurozone: According to preliminary estimates provided by the Eurostat, economic growth in the Eurozone in the first quarter of 2019 somehow accelerated to 1.2% y/y, but for the next quarters of 2019 the growth rate is projected to persist at low – in 2019 it will average 1.15%. The Eurozone's economic growth was attributable to Spain and France, with

[3] *Each point of the yield curve indicates the level of market interest rates of any financial instrument, say government bond, with maturity commensurate with that point. The market interest rates with different maturities point to expectations for short-term interest rates, as well as future uncertainty. Normally, the future is less certain that the present, and long-term interest rates are higher than short-term interest rates owing to the risk of uncertainty. This is why the yield curve normally looks up-sloped. The yield curve sloped down is a sign of expectations for a lowering policy rate, with uncertainties in the future.*

Chart 6

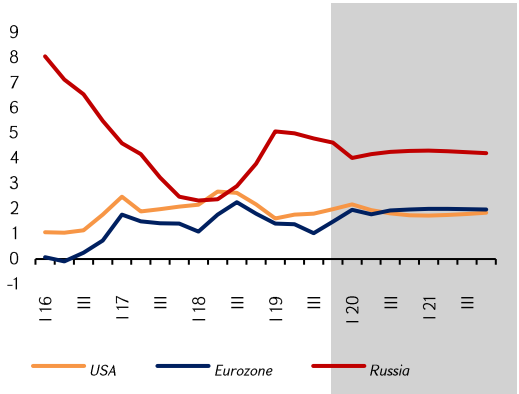
Economic growth in trade partner countries, (%)



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

Chart 7

Inflation in trade partner countries, (%)



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

In the first quarter of 2019, the prices in world commodity and food product markets have fallen relative to the previous year on the back of a sluggish global demand.

their relatively high indicators, as well as Italy as the country got rid of the recession and even posted a positive economic growth. The unemployment rate in the Eurozone continued to fall, but at a slower pace, making up 7.7% in March.

In the Eurozone in the first quarter of 2019 the average quarterly inflation slowed down to 1.4%, running below the European Central Bank's target. The low inflation owed primarily to prices of food products and service tariffs. Note that core inflation has receded over the quarter, mainly thanks to travel industry and the prices of the "Clothing and footwear" group. As a low inflationary environment lingers, the ECB is supposed to pursue a low interest rates policy at least up until 2020.

Economic developments and inflation in Russia: According to preliminary estimates by State Statistics Service of the Russian Federation, the average economic growth in the first quarter of 2019 was 0.5% y/y, with an estimated average economic growth of 1.05% for 2019. The low figure reported in the first quarter was mostly due to private consumption contracted because of small volumes of Russia's trade turnover and an increased VAT. According to the Bank of Russia estimates, in view of such economic activity, the unemployment did not cause additional inflationary pressures but remained instead around its fundamental value.

In the first quarter of 2019 the average quarterly inflation in Russia accelerated to 5.1%, compared to that of 3.8% reported in the previous quarter, running above its target. The maximum value was in March when it hit 5.3%, and since April it has been retreating smoothly, which indicates that the effect of VAT increase early in the year is gradually weakening. The inflation is expected to continue reducing in the near future, and by the end of the year it will reach its target of 4%. With inflation expanding at a slower pace than expected, in the first quarter of 2019 the Bank of Russia kept the policy rate at what it has been set previously: 7.75%. Taking this into account, there is anticipation that the Bank of Russia will implement a more expansionary monetary policy in the future as inflation expectations which are currently high have started to diminish.

Developments in world commodity and food product markets: In the first quarter of 2019 the prices in commodity and food product markets of the world decreased in comparison with the previous year on the back of a sluggish global demand.

In the first quarter of 2019 the euro exchange rate versus the US dollar depreciated by 0.4% q/q to 1.135 dollars per euro while the Russian ruble appreciated by 1.14% q/q to an average RUB 65.7 per dollar.

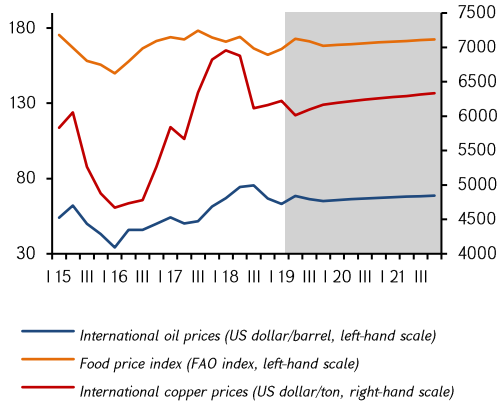
In the first quarter of 2019, as in the previous quarter, international copper prices recovered to some extent, however the recent wave of

trade wars between the United States and China has directly affected the falling of copper prices and it is expected that they will remain low in the short term. Demonstrating patterns of volatility, international oil prices have again dropped in comparison with the previous quarter. Notwithstanding the US sanctions on Iran and the decision to cut oil production under the OPEC+ Deal, international oil prices decreased during the first quarter of 2019 in expectation that the demand would shrink amid trade wars between the USA and China. The increase in oil prices in April, which was due to US sanctions on oil extracted by Venezuela and Iran, ceased in May and began to decline owing to the historically high figure of oil inventories in the United States. However, international oil prices are predicted to recover in the short term.

In food product markets in the first quarter of 2019, all commodity groups, except wheat, posted a certain price rise in relation to the previous quarter. Specifically, the dairy and meat product prices have grown mainly due to a limited supply volumes. Although the rise in sugar prices has been driven by appreciated currency of Brazil, a principal sugar exporter, the growth halted in April in the light of expectations of abundant harvest. In a short-term perspective, weak inflationary environment will persist in food commodity groups, the dairy products in particular.

Chart 8

International prices of raw materials and food products



Source: World Bank, FAO, Central Bank forecast

2.2. Forecasts

2.2.1. Inflation and monetary policy

In the current quarter the inflation persists at a relatively low level. The Central Bank estimates that the monetary conditions are rather expansionary now and in the upcoming period may lend to a sustained recovery of demand amid anticipated developments in the external sector. The inflation which will still be running below its target over the upcoming months will stabilize around it in the medium run, as a result.

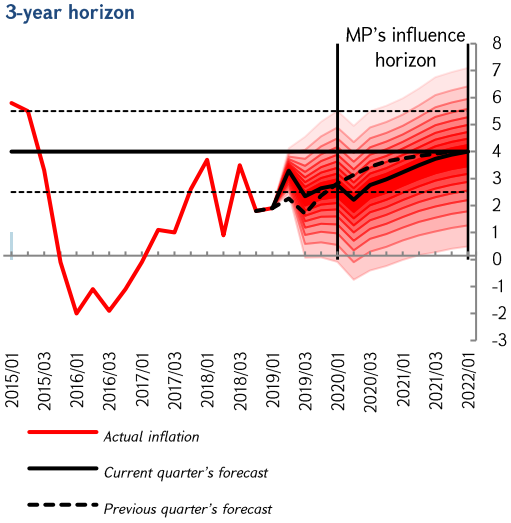
As current figures point out, the economic activity remains strong. In the first quarter of the year, the indicator of economic growth surpassed the expected figure thanks to robust private consumption. From the start of the year, aggregate demand further incurred the considerable contractionary impact of public demand, which is mainly attributable to budget revenue's tightening effect. As a result, the GDP gap is estimated negative for the first and second quarters of 2019.

There is expectation that the budget will leave a considerably expansionary impact on aggregate demand in the second half of the year and will in the meantime absorb contractionary effects observable early in the year; as a result, it will be neutral for the year. In view of such developments, the GDP gap will still be in the negative territory and will only be gradually phasing out to zero in 2020 thanks to the 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, inflation will still float at a low level in the upcoming months and will only stabilize around the target at the end of the forecast horizon. Even though more or less the same, the households' short-term inflation expectations are estimated to also stabilize around the target, as inflation rebounds. On the other hand, long-term inflation expectations diminish too, and yet remaining relatively high. Therefore, the scenario of 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.

As a result, the Board of the Central Bank believes that the current policy rate is expansionary enough, so it needs to be left unchanged. At the same time, in view of predictable macroeconomic developments, the monetary conditions have to remain expansionary for a longer period to give aggregate demand more sustainable stimulus to grow.

Chart 9

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



Source: Armenia Statistics Committee, Central Bank forecas

Table 1

Period	Inflation interval forecast probability distribution				
	<1.0%	1.0-2.5%	2.5-5.5%	5.5-7.0%	>7.0%
Q2, 2019	0.0%	6.4%	93.6%	0.0%	0.0%
Q3	16.8%	38.5%	43.7%	0.9%	0.0%
Q4	14.9%	32.4%	49.9%	2.6%	0.2%
Q1, 2020	15.8%	29.1%	50.2%	4.4%	0.5%
Q2	26.0%	32.5%	39.2%	2.1%	0.2%
Q3	19.4%	28.5%	47.5%	4.1%	0.5%
Q4	16.9%	26.8%	50.4%	5.2%	0.7%
Q1, 2021	14.0%	24.5%	53.5%	6.8%	1.1%
Q2	11.7%	21.8%	55.1%	9.4%	2.0%
Q3	10.4%	19.4%	54.5%	12.2%	3.5%
Q4	9.2%	18.1%	54.6%	13.6%	4.4%
Q1, 2022	8.5%	17.1%	54.4%	14.8%	5.2%

2.2.2. Economic activity[4]

Aggregate demand: Economic growth has been rather high since the start of 2019, which was greatly driven by domestic demand and, particularly, vigorous private spending in terms of both increased consumption and accumulated fixed assets. Taking into account a somewhat persistent nature of consumption, as well as persistently high rates of lending to households, there is anticipation that that the growth of private consumption in 2019 will reach 10.0%, which will become the key driver to private spending[5]. The growth of gross private fixed asset accumulation is estimated to be 13.7% for 2019, in which case the growth of private spending will make up 10.6%.

The mid-term economic growth largely depends on the expanding of production capacities and particularly those in tradable sector of the economy, the pace of structural reforms led by the Government, and the economic growth potential in partner countries to Armenia. On the part of demand, economic growth will primarily be driven by an increase in private spending and, partly by the growth of public spending and net exports; note that the positive impact of net exports will begin increasing gradually. The mid-term forecasts do not significantly differ from the ones made by the Central Bank previously.

External demand: The previous year's negative contribution of net export to real GDP will somehow abolish during 2019. The real growth of export of goods and services will be in the range of 4.0-6.0%, taking into account the forecasts for industry's rebounding.

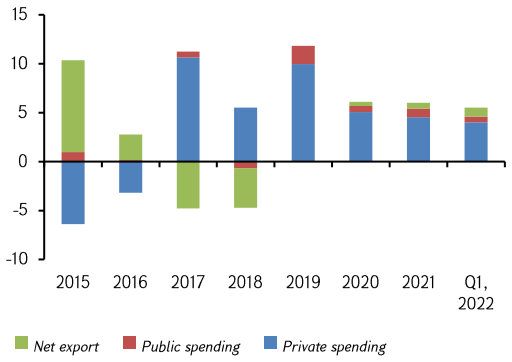
According to estimates, the real growth of import of goods and services will speed up in the second quarter of 2019 as the economic activity gains considerable momentum. In the event such development patterns persist, the 2019 forecasts of real growth of import of goods and services will be in the range of 2.0-4.0%.

The growth of net inflow of remittances in 2019 is expected to be between 5.0-7.0%, which is consistent with predicted developments in the Russian economy.

A rather high economic growth was observable since early 2019, driven largely by domestic demand and, in particular, private spending, both in terms of increased consumption and accumulated fixed assets.

Chart 10

Demand components contributing to the growth (percentage point)

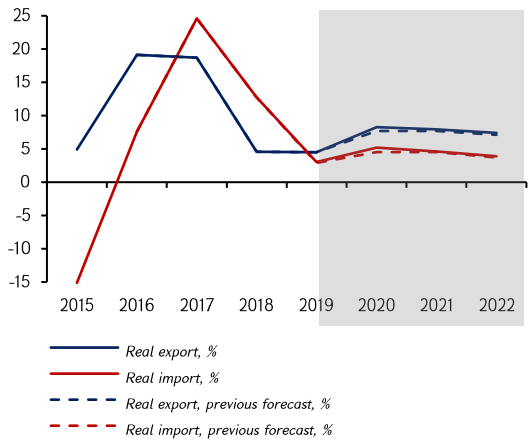


Source: Armenia Statistics Committee, Central Bank forecast

The previous year's negative contribution of net export to real GDP will phase out to a certain extent during 2019.

Chart 11

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



Source: Armenia Statistics Committee, Central Bank forecast

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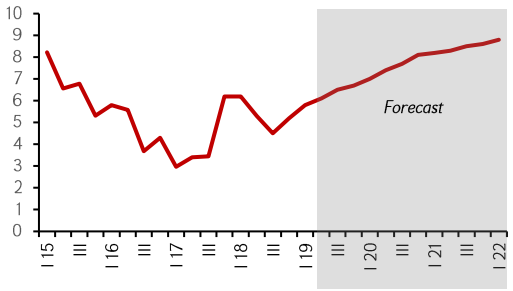
[4] For a detailed economic growth forecasts, see the "GDP Projection Probability Distribution", chart 18, table 2.

[5] It should be noted that, from now on, the Central Bank estimations of capital expenditures will not include the change in tangible working capital inventories, and only the indicator of gross private fixed asset accumulation will be viewed instead of the private investment component, since the change in inventories is considered by Statistics Committee of the Republic of Armenia as a balancing item and does not show the true level of investment.
See https://www.armstat.am/file/article/sv_04_19a_112.pdf

Chart 12

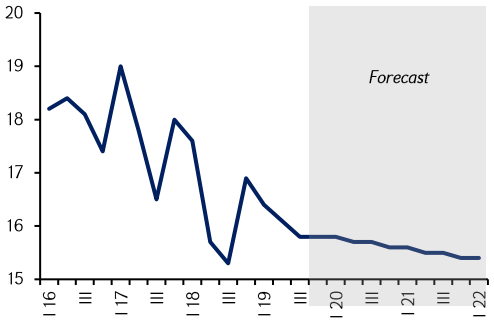
Nominal wage growth in private sector, y/y (%)



Source: Armenia Statistics Committee, Central Bank forecast

Chart 13

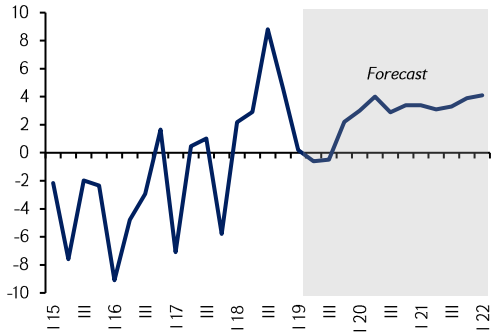
Unemployment rate, (%)



Source: Armenia Statistics Committee, Central Bank forecast

Chart 14

Unit labor costs growth, 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 neutral.

As a result of the aforementioned developments, the current account deficit-to-GDP ratio[6] in 2019 will run within 7.0-8.0%. In the medium run (end of 2022), bolstered by a faster growth of export, the ratio will gradually approach its estimated equilibrium of 3.0%.

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 adjusted[7] under certain resolutions of the Government.

Tax revenues are projected to outperform the relevant budget law indicator by some AMD 62.0 billion, with nearly 62% of revenue having been collected in the period January-May. Based on then year's results, the taxes-to-GDP ratio[8] will amount to 22.1%, up by 1.2 pp compared to the previous year.

An estimated figure of savings of about 2.5% of annual expenditures outlined in the previous MP program (approximately AMD 40.0 billion) remains actual and is based on the previous year's budget performance indicators. Extra expenditures commensurate with at least AMD 62 billion-worth of outperformed revenues are projected and where part of these expenditures are to be directed to has been announced[9]. The other part will be spent on capital expenditures aimed for further economic growth. The expenditure-to-GDP ratio will reach 24.8% as of the end of the year, which will represent a 1.3 pp increase compared to the previous year.

The budget deficit-to-GDP ratio is estimated to be 1.8% for 2019, instead of 2.2% projected under the law.

With the above tax and expenditure estimates as well as the public expenditure and revenue net of one-off streams and external payments, the fiscal policy's impact on aggregate demand will be neutral in 2019.

In the context of pursuing a sustainable fiscal and debt environment, the estimation of the mid-term impact of fiscal policy remains slightly contractionary for 2020 and 2021, according to the Medium Term Expenditure Framework for 2019-2021.

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[6] *It should be noted that the 2018 current account statistics may have been flawed with some underestimations in connection with the exports by natural persons from Armenia to other countries of the Eurasian Economic Union; in the event these are included, the 2019-2022 forecasts of current account deficit will be smaller.*

[7] *The indicators set by the laws on "State Budget of the Republic of Armenia" are allowed to be adjusted during the year under certain Government resolutions which are posted at: https://www.e-gov.am.*

[8] *The GDP forecast is the Central Bank estimate.*

[9] *As referred to in the Prime Minister's speech.*

***Labor market*[10]:** In 2019 the private sector nominal wages are expected to grow by 6.3%, which is consistent with economic growth developments mentioned above. In the medium run, the private sector nominal wage growth will be in line with economic growth and inflation developments, i.e. its fundamentals. Thus, the growth of private sector nominal wages is predicted to reach 7.7%, and at the end of the forecast horizon it will stabilize around 8.2%.

Somewhat a lower unemployment rate, 15.9%, can be expected in 2019 in light of an economic growth revised upside and a faster productivity growth rate. As structural unemployment retreats gradually, the unemployment rate will subdue by about 0.1-0.2 pp annually over the medium-term perspective, approaching a 15.5% level at the end of the forecast horizon.

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

2.2.3. Comparison with the previous forecast

The partner countries' short-term economic growth indicators will persist at lower levels compared with previous forecasts, although the medium-term growth indicators, except those of the US, will be close to the ones predicted under the previous scenario.

The US economic growth forecasts for 2019 will slightly exceed the previous quarter's forecasts, which is mostly attributable to the very strong indicator reported in the first quarter. The 2020 indicator was revised downward to some extent as the external demand is anticipated to contract due to trade wars.

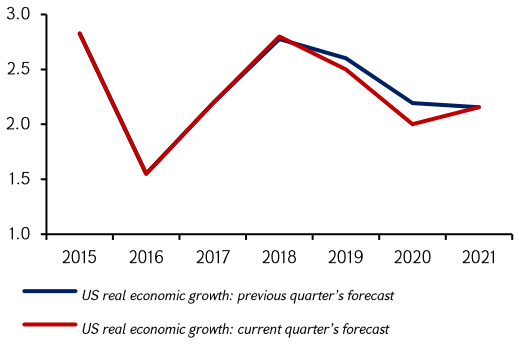
The 2019 economic growth forecasts in Eurozone were adjusted downside due to the expecting of somehow sluggish economic recovery in major EU member states.

The current forecasts of economic growth in Russia for 2019 are below the previous quarter's forecasts. Again, the economy is predicted to slow down during 2019 but, given the too modest growth in the first quarter, the slowdown will be more noticeable compared to the previous scenario.

[10] *The labor market data for first quarters of 2019-2022 are the Central Bank projections which are based on the actual first quarter 2019 data. The growth indicators presented in this sub-section are relative to the same reference period last year, unless otherwise specified.*

Chart 15

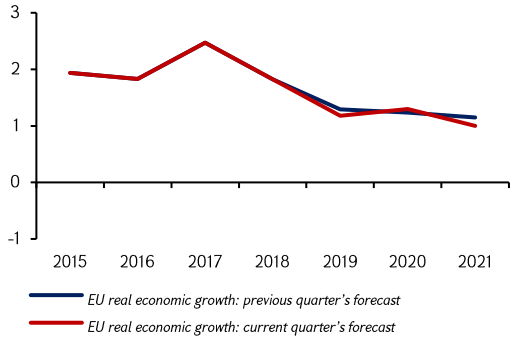
US economic growth forecasts, (%)



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

Chart 16

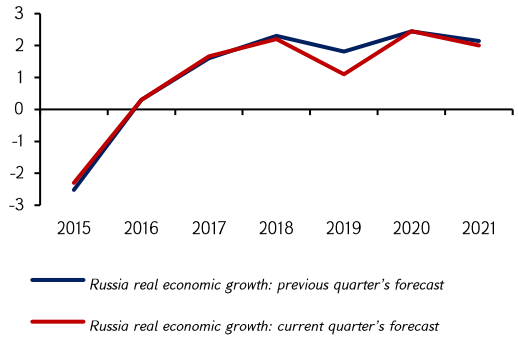
EU economic growth forecasts, (%)



Source: Eurostat, Central Bank forecast

Chart 17

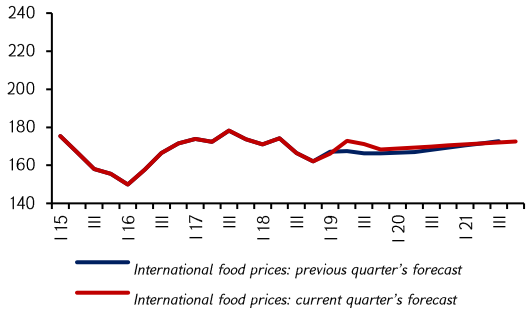
Russia economic growth forecasts, (%)



Source: Rosstat, Central Bank forecast

Chart 18

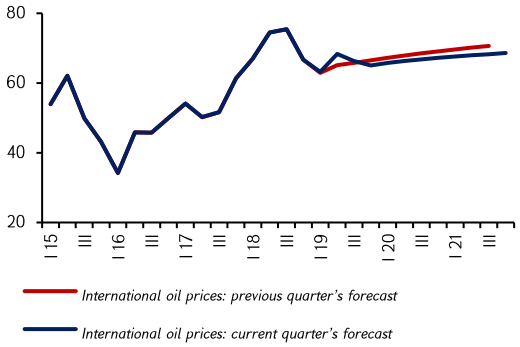
International food price forecasts



Source: FAO, Central Bank forecast

Chart 19

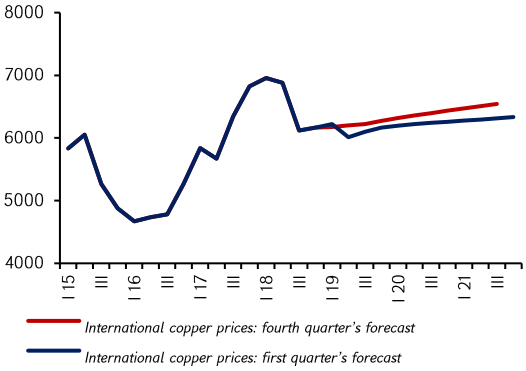
International oil price forecasts



Source: World Bank, Central Bank forecast

Chart 20

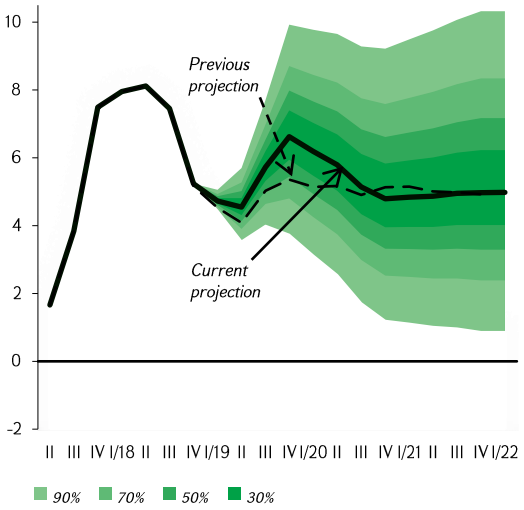
International copper price forecasts



Source: World Bank, Central Bank forecast

Chart 21

Real GDP (cumulative)[12] growth projection probability distribution for 3-year horizon



Source: Armenia Statistics Service, Central Bank forecast

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

In the world's food product markets in 2019, inflation is predicted to be slightly above from previous forecasts as prices in individual product markets – dairy and meat product markets in particular – will shape at somehow higher levels in the short term due to expected shrinking of supply (which will be of a seasonal nature for dairy products).

International oil prices are expected to rest on the level somewhat below the former forecast but will be trending up, although at a slower pace than forecasted previously. In spite of the decision to reduce the supply volumes under OPEC+ Deal as well as the sanctions imposed on the Venezuelan and Iranian oil, the prices will fall from the current level owing to large US oil inventories and the expected reduction in demand due to escalated trade wars.

International copper prices will shape at the levels lower than outlined in the previous forecast, due to somewhat contracted demand resulting from trade wars between the USA and China.

For 2019, Armenia's economic growth rate was revised slightly upside against the previous forecast; it remains much the same for the forecast horizon, however.

The economic growth since the start of the year came with rather strong indicators (see subsection 3. 2. 3) driven primarily by high activity in services and coupled with two-digit consumption growth (see subsection 3. 2. 2). Given some persistence of consumption and that international tourism grows continuously (it reached 5.2% in the first quarter of 2019) there is expectation that the growth in services in 2019 will be higher from the previous estimate. The industry's rate of growth was revised slightly upside too, owing to investment activity observable in this sector recently[11]. As a result, economic growth in 2019 will be higher than estimated previously (see Chart 18). The mid-term economic growth estimates did not change notably, with the services and industry sectors being the key driver to the growth.

Facilitated by an expansionary monetary policy and in view of a stimulative effect of state budget which is expected from the second half of the year, the negative GDP gap will gradually phase out, and in the forecast horizon the economic growth will approach its mid-term potential.

[11] *See: https://www.armstat.am/file/article/sv_04_19a_420.pdf*

[12] *The growth rate of each quarter is calculated as the cumulative growth rate for the last four quarters.*

Table 2

Real GDP (cumulative) growth projection probability distribution		
Period	30% probability interval	90% probability interval
January-December 2019 / January-December 2018	5.9-7.4	3.7-9.9
January-December 2020 / January-December 2019	4.0-5.8	1.2-9.2
January-December 2021 / January-December 2020	4.0-6.2	0.9-10.3
January-December 2022 / January-December 2021	4.0-6.2	0.9-10.3

In 2019, the current account deficit-to-GDP ratio will run above the previous forecast, which will be mostly attributable to the negative balance of investment income revised upside.

The fiscal sector's impact on aggregate demand will be neutral compared to that of 0.4 pp contractionary outlined in the previous forecast; some 2.5% of saving of public expenditures is anticipated along with at least AMD 62.0 billion-worth of overperformed revenues and, accordingly, public spending channeled to increase salaries of the military and teachers on the one hand, and to fund road construction and make other capital expenditures on the other.

Current forecasts suggest that the inflation in the short run will be above the previous forecasts, which is explained by higher-than-expected prices of agricultural goods, vegetables in particular. The latter is mainly conditioned by the shift in the agricultural season and, therefore, will only leave a temporary effect.

In the meanwhile, core inflation will run in line with the path outlined in the previous scenario, consistent with aggregate demand developments. Consequently, in pursuit of the inflation target, the monetary policy stance still needs to be expansionary which will help the inflation stabilize around the target at the end of the forecast horizon (see Chart 1: "Inflation Forecasts Probability Distribution").

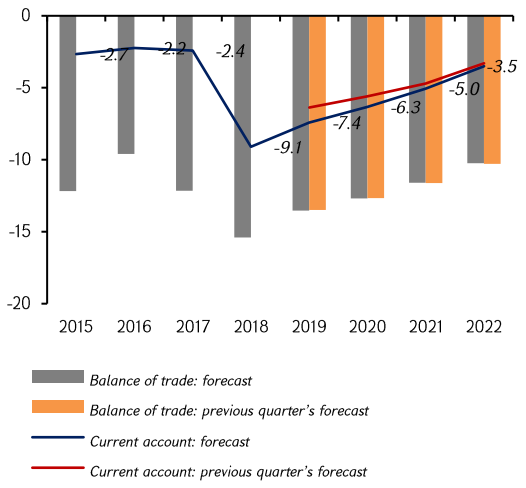
Short-term inflation expectations are almost in line with the ones outlined in the previous scenario and virtually depend on how core inflation patterns will unfold.

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 22

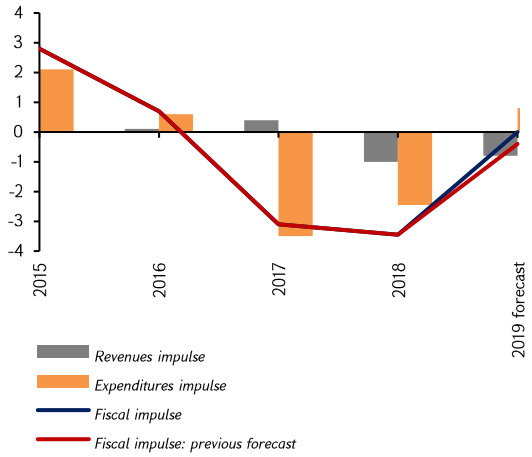
Mid-term current account-to-GDP ratio forecasts, (%)



Source: Armenia Statistics Committee, Central Bank forecast

Chart 23

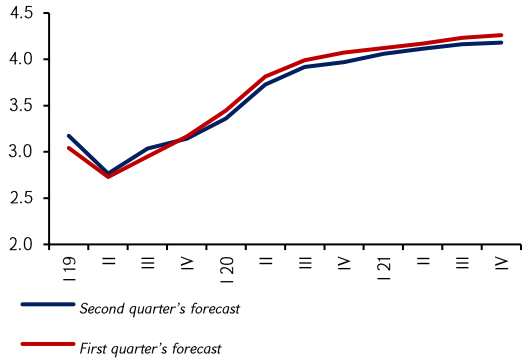
Fiscal impulse forecasts, *(percentage point)*



Source: Central Bank forecast

Chart 24

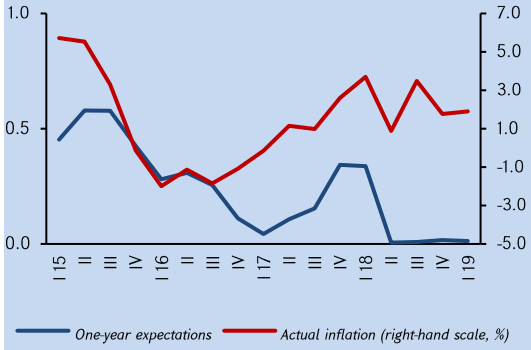
Short-term inflation expectation estimations, (%)



Source: Central Bank forecast

Chart 25

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



Source: Armenia Statistics Committee, Central Bank surveys

Chart 26

Dollarization in Armenia (residents' foreign currency deposits relative to residents' total deposits)

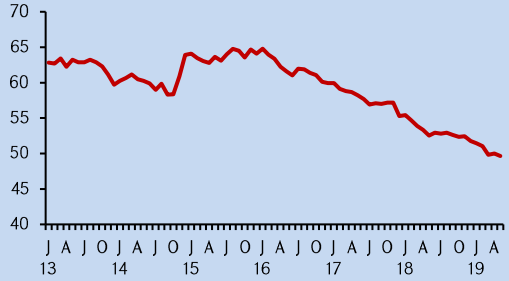
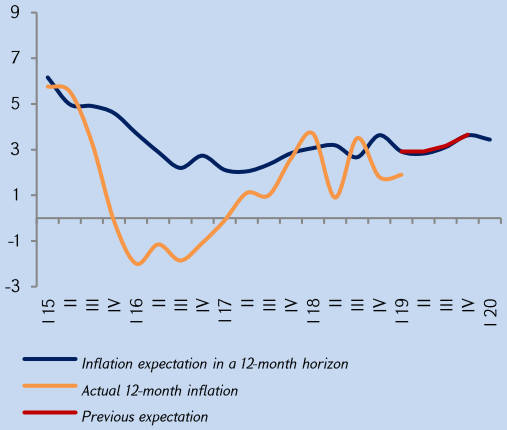


Chart 27

Average level of financial system's inflation expectations, (%)



Source: Central Bank surveys

Box 2:

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 Q1, 2019 survey on selected macroeconomic indicators, which the Central Bank carries out each quarter by way of inquiries among households and companies in the financial sector. Specifically, the share of households expecting high and very high inflation rates for a one-year horizon in a total respondents remained almost the same with the previous quarter's level (very close to a zero).

Meanwhile, the dollarization continues to decline, which points to the long-term inflation expectations following a downward path and approaching the target level.

*The **average level of inflation expectations of the financial system** in the upcoming one-year horizon has been somewhat steady in relation to the previous survey, remaining **3.2%**.*

Forecast assumptions

Table 3

Main judgments and assumptions	Possible developments, if this assumption proves correct
Economic growth rates slow in principal partner countries to Armenia	• As weakening of global demand lingers for a longer while, external demand in partner countries will slow, in which case loosening of monetary conditions in these countries is likely. • International copper prices will settle on lower levels due to escalation of trade wars.
Armenia's risk premium recovers much slower in the medium run	• The Government of Armenia 10-year Eurobond rates spread, relative to a similar-maturity US assets, will still be within a current 2.5% range in the upcoming quarters. Armenia's current risk premium is estimated accordingly.
The 2019 fiscal policy leaves a neutral impact on aggregate demand	• The fiscal policy's impact is estimated neutral in view of overly collected revenues by now and an expected AMD 62 billion-worth of revenue overperformance by annual results as well as channeling that revenue entirely into making expenditures[13].
Measures to bolstering potential GDP growth	• Armenia's GDP potential will be 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 activities of Amulsar mine, Teghut mine and Alaverdi copper smelter. Their potential impact is considered in the framework of forecast risks.

Forecast risks

The risks considered under the baseline scenario 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 attributable to the following factors:

- Mostly short-term deflationary risks may arise in connection with insufficient rates at which demand and, consequently, core inflation recovers.
- The budget leaves a bigger contractionary impact during 2019, as a result of which the aggregate demand will have even more deflationary effect on the inflation, calling for implementing a more vigorous expansionary monetary policy.

  Actual budget expenditures made for 5 months of 2019 (savings of expenditures, underfunding of capital programs in

[13] *According to Prime Minister's discussion of issues relating to allotting of extra budgetary funds.*

particular) against the baseline scenario implies certain risks to the performing of public expenditures fully. In the event savings of public expenditures reach 4% and half of AMD 62 billion-worth of collected revenues are expended (although spending direction is not clear yet), the fiscal policy will have a contractionary impact in the third and fourth quarters instead of the contractionary projected under the baseline scenario. Given this, the contractionary impact is estimated more than 1.0 pp for the year.

Overall, downside risks to the inflation deviating from its path in the medium term prevail (see Chart 1).

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 a possible shortage of livestock. On the other hand, second-round effects may play out vibrantly a as a result of the change in gas price for cars.
- There are risks to the impact on inflation (an estimated 0.3 pp) due to change in customs duty on some products in 2020.

In addition to the risks mentioned above, there are mid-term risks (which are dual-sided but upside risks prevail, however) associated with potential economic growth, as follows:

- The uncertainties associated with further operating of Amulsar mine and Alaverdi copper smelter (see Box 3).
- 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.

Box 3:

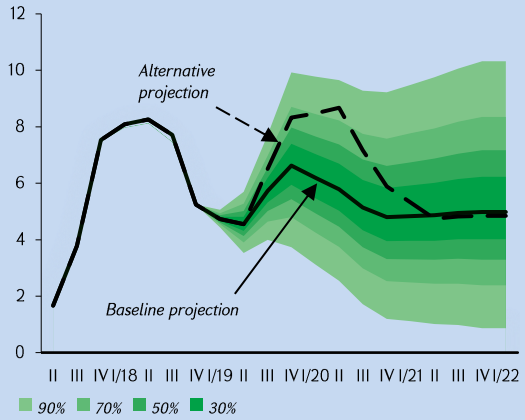
Possible developments in mining and metallurgy branches

The results of operation of Amulsar mine, Teghut mine and Alaverdi copper smelter are not incorporated in the MP program as the information the Central Bank had at the time of preparing the program was not enough to make judgments about their further activities. However, given the potentially large output volumes of these enterprises, the Central Bank has measured the impact these companies would directly have on economic growth and exports, if operated at full capacity, based on a number of publications and calculations. Thus, Amulsar mine is expected to export USD 286 million-worth of gold annually[14] while the figures of actual output from Teghut mine and Alaverdi copper smelter based on the 2017 activities are assessed to amount to AMD 70.1 billion and AMD 34.7 billion, respectively[15]. There is a chart of economic growth probability distribution which has two scenarios (baseline and alternative) on the premise that the three companies start operating from the third quarter of 2019.

It should be noted that the GDP gap, which is the difference between the actual and potential GDP[17] and denotes if the demand is weak or strong, is important in the monetary policy point of view. According to the Central Bank estimations, if the above risks materialize, no significant changes in the GDP gap will take place, since these lead to both the GDP growth and potential GDP growth at the same time[18].

Chart 28

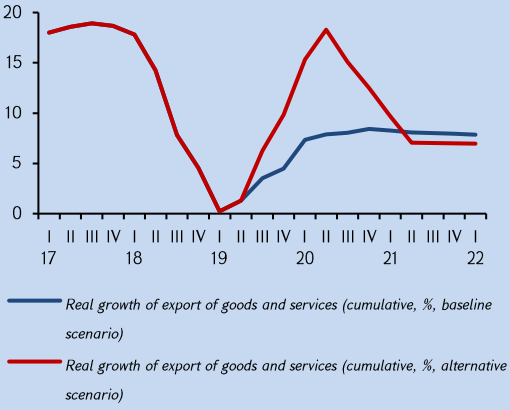
Real GDP (cumulative)[1] growth projection probability distribution for 3-year horizon (baseline and alternative scenarios)



Source: Armenia Statistics Committee, Central Bank

Chart 29

Real (cumulative) growth of export of goods and services



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[14] *See https://www.lydianarmenia.am/images/Socio-economic_study_Executive_Summary_ARM.pdf*

[15] *The figures of output volumes of "Teghut" CJSC and "ACP" CJSC (Alaverdi copper smelting factory) are shown in the Lori governor report for 2017 as a percentage in total industrial production of the region (making up 47.9% and 23.7%, respectively), which were used for calculations. See http://lori.mtad.am/files/docs/30794.pdf*

[16] *The growth rate of each quarter is calculated as the cumulative growth rate for the last four quarters.*

[17] *See more of the potential GDP in the MP program for the fourth quarter of 2018.*

[18] *Some very small short-term effects were not factored in for the sake of simplicity.*

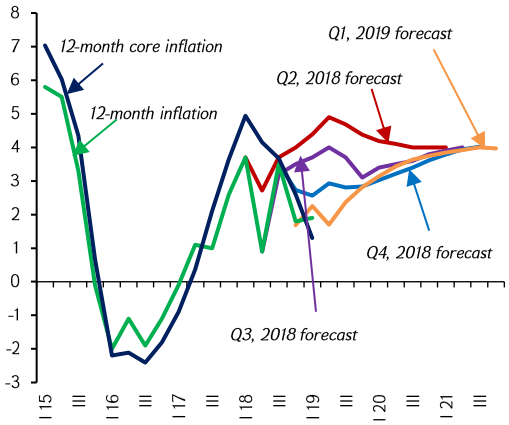
3. ACTUAL DEVELOPMENTS IN Q1, 2019

3.1. Inflation

3.1.1. Fulfilment of the inflation target

Chart 30

According to the Central Bank forecasts, in the upcoming year the 12-month inflation will expand and drift within a lower part of confidence band; in the end of forecast horizon it will stabilize around the target



Source: Armenia Statistics Committee, Central Bank forecast

For a 1-year horizon preceding the second quarter of 2019, the inflation environment, low at the time, was to expand gradually according to Q2, 2018 MP program, which would be fuelled by positive developments thanks to an expansionary monetary policy and in anticipation of effects from continued recovery in demand in the external sector. To facilitate a sustained recovery of domestic demand, an expansionary stance of the monetary policy was still needed, which would only phase out in concurrence with restoring inflation, while fulfilling the goal of price stability.

Actual inflation developments of the time have somewhat deviated from the scenario, as the implemented fiscal policy following the political events in Armenia since the second quarter of 2018 proved more contractionary, causing domestic demand to slacken. In the second half of the year, the global economy and demand growth rates slowed down as well. The impact of these developments was especially noticeable in the behavior of the 12-month core inflation which has gradually subdued in the last 1-year period to 1.3% at the end of March from 4.9% reported as of end-March of the previous year. Unlike core inflation, headline inflation behaved too volatile, especially in the second and third quarters of 2018 when earlier seasonality of harvest pushed agricultural prices first down and then up, causing the 12-month inflation rate to plunge to 0.9% in end-June and recover to about 3.5% at the end of September. In the fourth quarter, induced by the contractionary impulse of the fiscal policy and the deflationary effects transmitted from the external sector, ***the 12-month inflation has decreased to 1.8% at the end of the year***, which persisted with some stability patterns over the first quarter of 2019 too.

Note that the Central Bank has for a while favored a policy of gradual recovery of inflation, since low inflation contributes to anchoring long-term inflation expectations and maintaining the purchasing power of income. Also, as no considerable inflationary effects were observable from external and domestic economies in the upcoming period because of persistently weak global and domestic

demand, and that the current interest rate was estimated to be expansionary enough on the back of interest rate rise by major trading partner countries, the ***Central Bank has left the refinancing rate unchanged in April-December 2018.*** In view of continued slowing in global economic growth and anticipated weakening of the inflation environment in world commodity markets, considering that the monetary stimulus needed a slight boost-up, the Central Bank cut the refinancing rate by 0.25 pp to 5.75% in January 2019 but left it unchanged in March and April however, reckoning that the amount of stimulus was satisfactory. In the meanwhile, the Central Bank has signaled the financial market that the monetary conditions will remain expansionary for as long a period as required.

3.1.2. Prices

Consumer prices: There was 2.6% inflation recorded in the first quarter of 2019, with the 12-month inflation remaining low (1.9% y/y as of the end of March 2019). In the same period of time, the 12-month price inflation in food products and non-alcoholic beverage (alcoholic beverage and tobacco inclusive), non-food products and service tariffs has been 3.5%, 0.9% and 0.1%, respectively.

Inflation in the first quarter of 2019 was 2.6%, with the 12-month inflation still at a low level, making up 1.9% y/y as of March 2019.

Specifically, price inflation in the group "Food and non-alcoholic beverage (alcoholic beverage and tobacco inclusive)" was fueled by vegetable and potato, fruit, bread, meat, and tobacco prices having risen by 8.2%, 3.3%, 3.8%, 3.6% and 9.7%, respectively (combined contribution to the 12-month inflation: about 1.5 pp).

In the group "Non-food products", the clothes, footwear and pharmaceuticals prices posted a slight increase in March 2019, by 2.8%, 3.6% and 1.1%, respectively, compared to the same period last year (combined contribution to the 12-month inflation: about 0.2 pp).

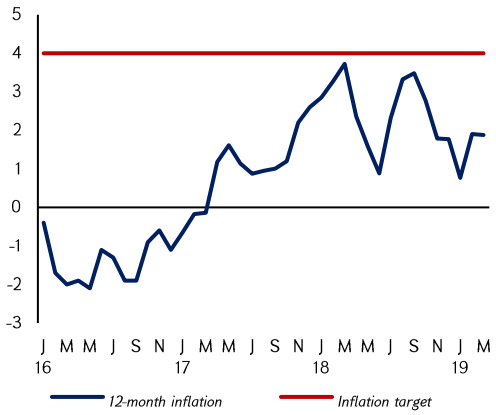
The growth in service tariffs owed to the increased prices for ambulatory services, education services, as well as restaurants and hotel services, by 2.2%, 1.2% and 2.7% respectively (combined contribution to the 12-month inflation: about 0.1 pp).

Caused by the developments mentioned above, the 12-month core inflation's March 2018 indicator has dropped throughout the year to 1.3% as of March 2019.

The 12-month rate of tariffs for regulated services has dropped slightly due to a 0.2% decrease in housing utility fees tariffs and amounted to -0.1%. The 12-month rate of prices of seasonally-sensitive

Chart 31

A low inflation environment persisted over the last one-year horizon, with the 12-month inflation drifting around the lower part of confidence band



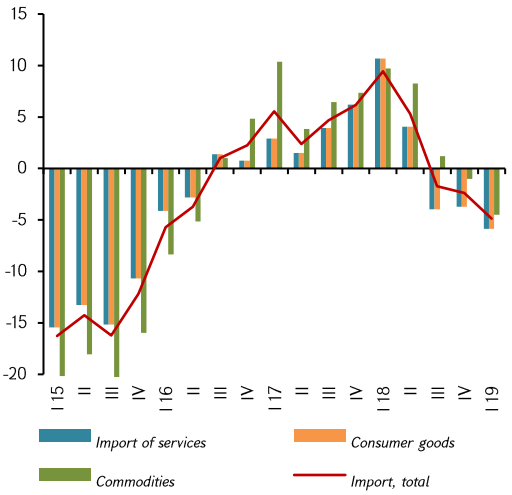
Source: Armenia Statistics Committee

goods amounted to 6.5% due to the growth of vegetable, fruit and egg prices by 8.2%, 3.3% and 5.5%, respectively (combined contribution to the 12-month inflation: about 0.7 pp).

In the past year, inflation has been largely in line with demand developments, although it had to endure a certain amount of impact from the supply of individual products. Particularly, supply factors resulted in a change in the price of beef (due to an altered headcount) in the third quarter of 2018 and a change in flour and bread prices (amid the developments in the world markets) starting from the fourth quarter, with their combined inflation impact estimated to reach 0.4 pp. The inflation impact of the change in customs duty on some commodity groups is estimated at about 0.3 pp in the first quarter of 2019, which is mainly due to the increase in poultry prices.

Chart 32

In the first quarter of 2019 the dollar prices of import of goods and services remained low compared to those of the same quarter of the previous year (y/y, %)



Source: Central Bank estimate

Table 4

Price inflation by commodity item as key contributors[19]				
	March 2019 (y/y)		Q1, 2019 (q/q)	
Commodity item	**growth**	**contribution**	**growth**	**contribution**
CPI	**1.9**		**2.6**	
Food and non-alcoholic beverage (including alcoholic beverage and tobacco)	**3.5**	**1.62**	**5.8**	**2.65**
Bread products	3.8	0.33	2.8	0.25
Meat products	3.6	0.35	-1.5	-0.15
Oils and fats	0.5	0.01	-1.3	-0.03
Fruit	3.3	0.11	9.6	0.32
Vegetable and potato	8.2	0.47	38.9	2.23
Dairy products, cheese and egg	-0.7	-0.04	-0.3	-0.01
Sugar	-11.8	-0.07	-0.9	-0.01
Tobacco	9.7	0.17	1.7	0.03
Non-food products	**0.9**	**0.19**	**-0.4**	**-0.1**
Services	**0.1**	**0.04**	**0.1**	**0.02**

[19] *In the table, the y/y data of structural elements of food products are calculated by the Central Bank using the information provided from the Republic of Armenia Statistics Committee.*

Import prices: The dollar prices of import of goods and services to Armenia increased by 1.2% q/q in the first quarter of 2019. It should be noted however that the dollar prices of import have reduced by 4.9% y/y, relative to the first quarter of 2018, driven mostly by y/y depreciation of nominal exchange rates in trade partner countries. The y/y reduction in prices of intermediate goods owed to the falling in oil and aluminum prices.

3.2. Economic developments

3.2.1. Economy position

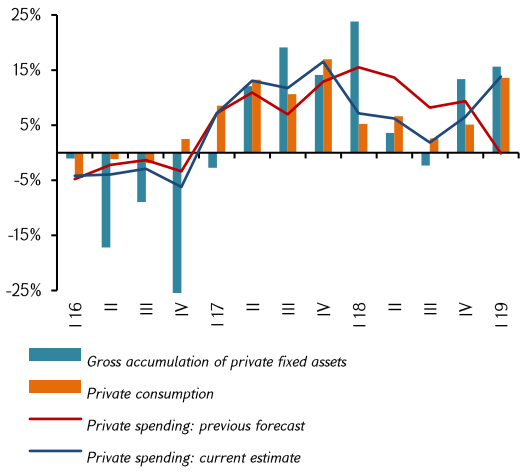
The estimation of the GDP gap in the first quarter of 2019 is negative. Although higher-than-anticipated economic growth and accelerated private consumption in the first quarter (see subsections 3.2.2 and 3.2.3) helped revise the negative GDP gap upside, it is still estimated as negative due to a number of factors, which is consistent with a low inflation environment observable in the consumer market (see section 2.2.1). In particular, even more contractionary fiscal policy in the first quarter of 2019, depreciated exchange rates in trade partner countries, the slowing of economic growth in principal trade partner countries, the low level of remittances in real terms all have contributed to the shaping of a negative GDP gap. It should be noted that high economic growth is somehow attributable to the structural changes and increased competition, which, coupled with supply-side factors, positively affects economic activity. However, the impact on inflation is limited relative to the circumstance when economic growth is driven by the increase in demand factors.

3.2.2. The expenditures aspect of the economy

The growth rate of private demand was still high over the first quarter of 2019 thanks to double-digit growth reported for both private consumption and gross accumulation of private fixed assets[20]. Such a high growth in private consumption over the quarter amid a narrowing inflow of remittances is largely determined by strong growth in lending to households, facilitated by continued expansionary monetary policy pursued in recent years. Thus, with a 7.1% economic growth reported

Chart 33

Structure of private spending, *(y/y growth)*



Source: Armenia Statistics Committee, Central Bank estimate

[20] *This indicator calculated by the Central Bank shows the difference between gross accumulation of total fixed assets and public investment. To produce real growth rates, the gross fixed asset accumulation deflator has been used.*

in the reporting period, private spending[21] has grown by 13.8% owing to private consumption and gross accumulation of private fixed assets (with their growths of 13.6% and 15.6%, respectively), which is significantly higher than the previous forecast.

In the first quarter of 2019 the estimate of private consumption is above its potential value, so minor inflationary pressures are likely.

In the first quarter of 2019 the real export and import volumes contracted relative to the first quarter of the previous year. The real export volumes have reduced faster than those of import. As a result, the contribution of net real export to the GDP proved negative. Thus, in the first quarter of 2019 the real export and import of goods and services declined by 4.3% and 0.1% y/y, respectively.

In the first quarter of 2019 net remittances of individuals (seasonal workers' income and personal transfers inclusive) in US dollars narrowed to an estimated 5.7% y/y, as the Russian ruble exchange rate continued depreciating versus the US dollar.

In the first quarter of 2019 the current account deficit-to-GDP ratio dropped by about 0.4 pp, according to estimations, due to a faster growing GDP.

Chart 34

In the first quarter of 2019 net export position weakened as export decreased at a faster pace over import (*net real export, y/y, %, positive sign = improvement)*

Source: Armenia Statistics Committee

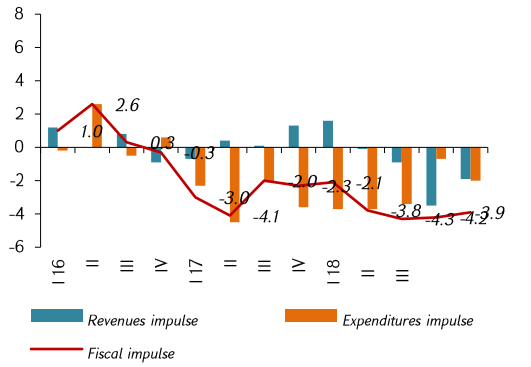
Fiscal policy[22]: In the first quarter of 2019 the state budget performed with actual expenditures and revenues deviating from the Central Bank's projections[23]. The quarter saw more revenue collected and less expenditures made against the quarter's plan. As a result, the fiscal policy's impact on aggregate demand is an estimated 3.9 pp contractionary instead of the predicted 2.0 pp contractionary, for the first quarter.

In the first quarter of 2019 actual budget revenues exceeded the projection by 3.3%, and tax revenues, by 4.6%. As a result, the revenue impulse amounted to 1.9 pp contractionary, instead of predicted 1.6 pp contractionary.

The state budget expenditures reached 92.3% of the Central Bank projection, making the expenditures impulse even more contractionary than predicted. In the expenditures structure of the budget in the first quarter of 2019, ***government consumption*** made up nearly 95% of

Chart 35

In the first quarter of 2019 the contractionary effect of fiscal policy owed to the contractionary effect of both revenues and expenditures



Source: Central Bank estimate

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[21] Note that the Central Bank used to present the indicator of private investment that incorporated the change in tangible working capital inventories, but because the Statistics Committee of the Republic of Armenia viewed it as a balancing item and because it does not show the true level of investment, the Central Bank has only considered the indicator of gross private fixed asset accumulation, which is not compatible with previously provided estimations of private investment capital. See https://www.armstat.am/file/article/sv_04_19a_112.pdf

[22] The review of the fiscal sector used actual consolidated budget indicators of the first quarter of 2019, excluding off-budgetary funds.

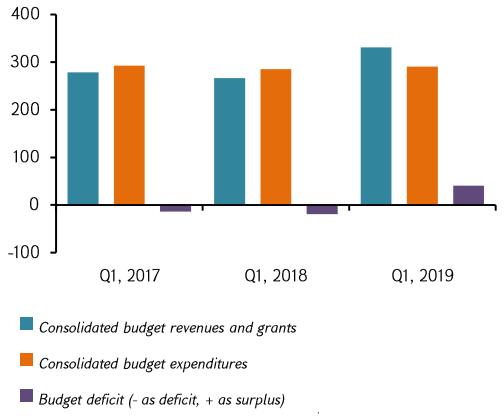
[23] The revenue projection was based on the quarterly indicator as outlined in the Budget Law 2019; the expenditure projection is the Central Bank estimate.

the projected indicator. The expenditures on item ***"Transactions with non-financial assets"*** amounted to 28% of the projection, which is explained by lower performance of both foreign assistance and domestically-funded programs. For the quarter, the expenditures impulse amounted to 2.0 pp contractionary instead of the forecast 0.4 pp contractionary.

With revenues and expenditures performance described above, the state budget generated a surplus of AMD 31.2 billion in the first quarter of 2019, as opposed to AMD 17.5 billion-worth of deficit estimated by the Central Bank.

Chart 36

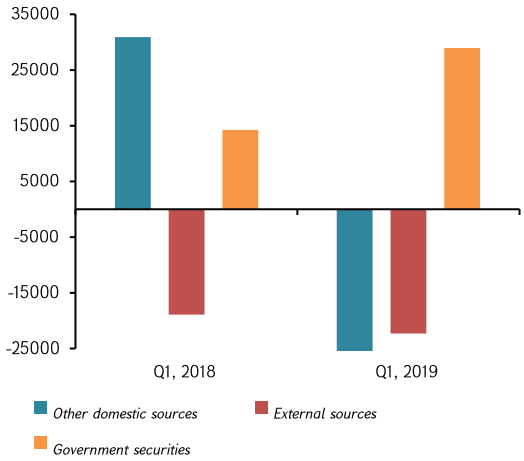
Main indicators of the consolidated budget *(billion AMD)*



Source: Armenia Statistics Committee

Chart 37

In the first quarter of 2019 budget generated a surplus thanks to lower performance of expenditures over revenues *(million AMD)*



Source: Armenia Statistics Committee

3.2.3. The production aspect of the economy

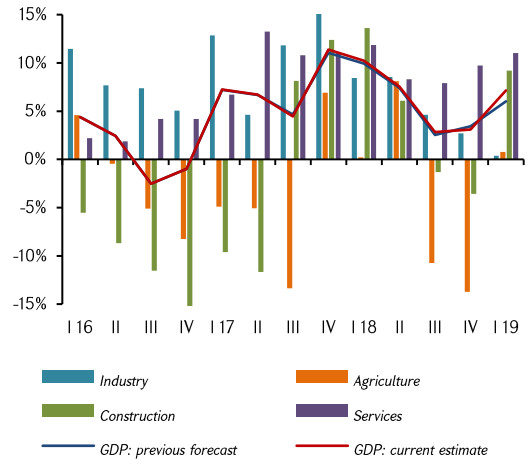
With economic growth of 6.5% in the first quarter of 2019, the GDP growth amounted to 7.1% instead of previous estimation of 6.0%. The deviation owed primarily to the value added having increased faster over output. The growth was largely driven by the services sector which reported as much as 11.0% in the first quarter and stays not that different from previous estimates. Slightly lower than the previous forecasts, the construction growth of 9.2% came amid the slowing of growth rates in the sector in March, but it should be noted that household-funded and company-funded construction is rather strong, which points to positive expectations and continued vibrant growth in the sector. The industry growth amounted to 0.4%, which is somewhat higher from the previous forecasts and attributable to more-than-anticipated positive developments in the processing industry. The agriculture sector reported a 0.8% growth rate, which does not essentially deviate from previous estimation of the Central Bank.

There is anticipation that services will further remain the key driver to economic growth over the second quarter of 2019, as well as some reviving is expected in the industry, supported by high economic activity indicators in April. In particular, the growth in the trade branch amounted to 9.0%, in services, 16.2%, in industry, 13.2%.

In the first quarter of 2019, relative to the same reference period last year, the productivity, calculated as real value added per hour worked, has increased by 2.2%, according to the Central Bank estimations.

Chart 38

GDP structure by sector *(y/y growth, %)*



Source: Armenia Statistics Committee, Central Bank estimate

3.2.4. Labor market[24]

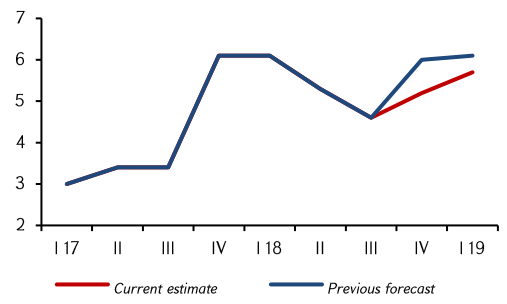
Economic growth in the first quarter of 2019 came along with a 5.5% increase in labor productivity[25]. This positively affected the private sector nominal wage growth rate, which is an estimated 5.8% for organizations with more than 1 employee. As a result, low inflation has pushed real wage growth up in the private sector.

With economic growth and productivity developments mentioned above, the unemployment rate is an estimated 16.5% for the first quarter of 2019 compared to that of 17.6% reported in the same quarter of the previous year.

In the reporting period, unit labor costs of the firms remained unchanged, with the private sector wage growth rate pacing in line with the output growth rate per unit of labor. This means that inflationary pressures from the labor market are not likely.

Chart 39

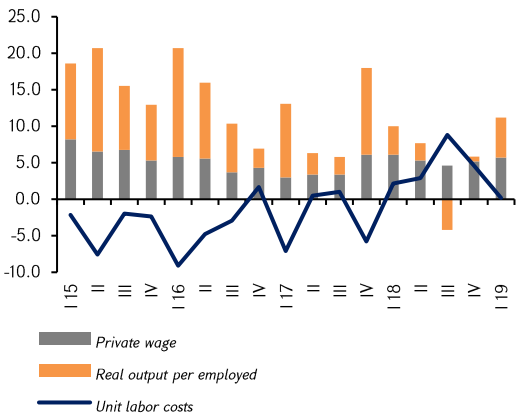
Private nominal wage *(y/y growth, %)*



Source: Armenia Statistics Committee, Central Bank estimate

Chart 40

Unit labor costs *(y/y growth, %)*



Source: Armenia Statistics Committee, Central Bank estimate

3.3. Financial market developments

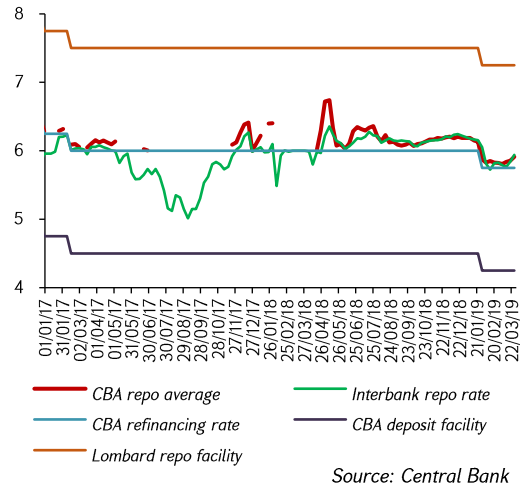
In the first quarter of 2019 the Central Bank Board cut the refinancing rate by 0.25 pp to 5.75%.

In the first quarter of 2019 the Board of the Central Bank cut the refinancing rate by 0.25 pp to 5.75%.

There was a need to slightly increase the amount of monetary stimulus in January, taking into account how continued slowing in global economic growth rates and anticipated weakening of the inflation environment in world's commodity markets would possibly influence aggregate demand and domestic prices. Later, the Central Bank left the policy rate unchanged, assessing it was expansionary enough. In the meanwhile, the Central Bank has signaled the financial market that the monetary conditions will remain expansionary for as long a period as required.

Chart 41

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



Source: Central Bank

[24] *The labor market data for the first quarter 2019 are the Central Bank estimates which are based on the fourth quarter 2018 data and actual January-February 2019 figures. The growth indicators provided in this subsection are relative to the same reference period last year, unless otherwise specified.*

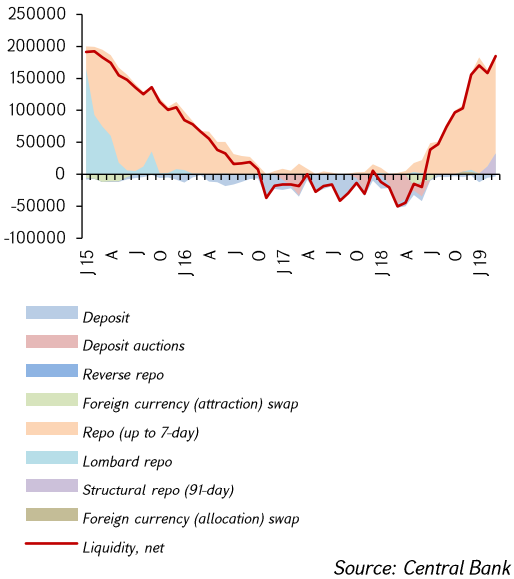
[25] *The gross real value added per employed has been viewed as the productivity indicator.*

Table 5

Average quarterly interest rates in Armenia's financial market					
Instrument	Q1, 18	Q2, 18	Q3, 18	Q4, 18	Q1, 19
Central Bank refinancing rate (end of quarter)	6.00	6.00	6.00	6.00	5.75
Central Bank repo rate	6.20	6.32	6.17	6.17	5.94
Interbank repo rate (up to 7-day)	5.94	6.09	6.17	6.15	5.94
Yield of government securities on a yield curve (as of end-quarter)					
Short-term treasury bill (1-year)	6.37	6.55	6.70	6.63	6.57
Medium-term notes (up to 5 years)	8.15	8.37	8.60	8.48	8.65
Long-term bonds (30-year)	11.40	11.52	10.54	10.68	11.05

Chart 42

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



Source: Central Bank

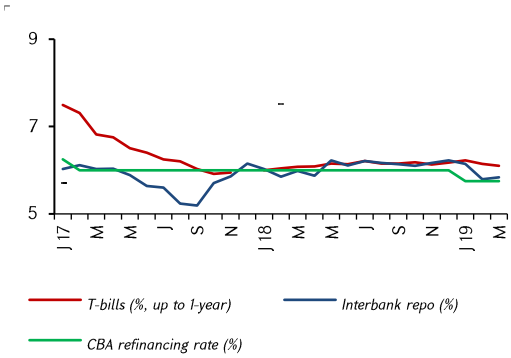
Following a downward path along with refinancing rate cuts, short-term money market rates persisted around the policy rate of the Central Bank over the first quarter of 2019. The quarterly interbank repo (up to 7-day) rate has dropped to 5.94%. In addition to the main policy instrument, the Central Bank has used a 91-day repo tool over the quarter, with a view to placing part of the 7-day liquidity onto a relatively long-term segment while evaluating the liquidity price for that period. As a result, as of end-quarter the 91-day repo tool had an AMD 40.0 billion-worth inventory, with an average interest rate of 5.9%.

In the government securities market during the quarter, short-term bonds further demonstrated patterns typical of the money market: mirroring the refinancing rate cuts, the T-bill yields in the primary market have gradually reduced, and as government bond yield curve showed, in end-March the yield on short-term bonds was close to the Central Bank's refinancing rate. Unlike the short-term segment on the curve, long-term bond yields posted some 0.5 pp increase early in the quarter following revision to investment policy by financial market participants. At some point later, the increase was partially offset however, as the Central Bank trimmed down the refinancing rate.

In recent years loan interest rates incurred not only the influence of the monetary policy pursued by the Central Bank and declining inflationary expectations but the rather high level of capital in the banking system. The capital adequacy currently running above the required minimum threshold indicates that there is enough capital and liquidity in the banking system to sustain further growth in lending. However, the lending growth will trend up and interest rates down

Chart 43

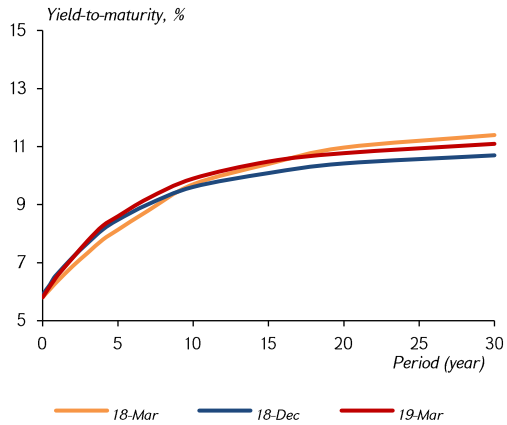
The behavior of short-term interest rates in the first quarter of 2019



Source: Central Bank, Armenia Stock Exchange

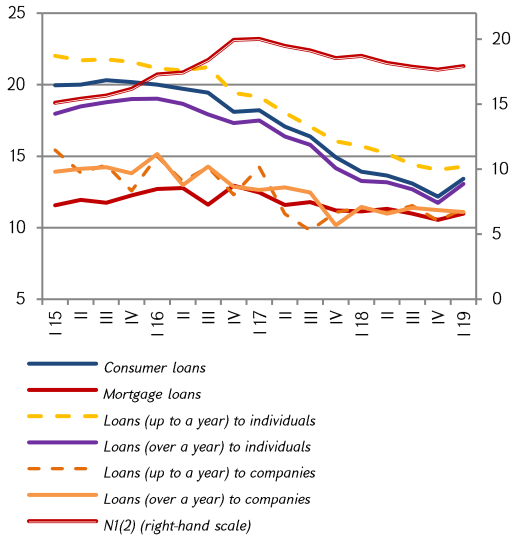
Chart 44

In the first quarter of 2019 yields in government securities market remained almost the same in the short-term segment



Source: Central Bank

Chart 45
Interest rates of loans and the capital adequacy standard



Source: Central Bank

primarily on the premise that the fundamentals in the real sector of the economy – potential for economic growth, economy's exposure to risks, household appetite for credit – unfold. Anyway, the level of loan interest rates now is estimated commensurate with the current expansionary monetary policy.

BOARD MEETING OF THE CBA

MINUTES

(11.06.2019)

On the Refinancing Rate

The CBA Board Meeting of June 11, 2019 attended by Governor Arthur Javadyan, Deputy Governors Nerses Yeritsyan and Vakhtang Abrahamyan, and Board Members Arthur Stepanyan, Armenak Darbinyan and Oleg Aghasyan

The Board meeting opened with presentation of the Situation Report as of June 11, 2019. It addressed current developments on inflation, external environment and real, fiscal and monetary sectors of the economy.

There was 0.4% deflation registered in May 2019 which was mainly due to a seasonal decline in prices of the group "Food product and non-alcohol beverage" (1.5%) and, particularly, of the group "Vegetable" (7.8%). The prices of non-food products and service tariffs grew during the month by 0.5% and 0.1%, respectively. As a result, compared to a 1.0% deflation in the same month of the previous year, the 12-month inflation in May has increased, amounting to 2.8%. During the month, ***the 12-month core inflation rate*** has slightly grown too, ***reaching 1.4%***.

Addressing the current economic situation, the Board stated that ***economic activity over the past period of 2019 has persisted at a rather high level too, with the first quarter's economic growth having exceeded the expectations***. The registered high indicator largely owed to the growth in the services sector, which was accompanied by persistently high growth in private consumption. At the same time, domestic demand continued to be curbed during the second quarter as a result of the implemented fiscal policy, but a certain stimulus for demand might be expected over the second half of the year due to the increase in state budget expenditures, as a result of which the fiscal impulse will be neutral on an annual basis. It should be noted that, in light of economic activity remaining strong, the Central Bank has revised the year's economic growth forecast upside in the Monetary Policy Program for the second quarter of 2019.

Trends in the external sector were discussed at the Board's meeting, according to which the slowing of global economic and demand growth rates continues, which comes in line with further uncertainties associated with the escalation of trade wars. The latter reflected the deterioration of economic growth outlooks of major trade partner countries to Armenia, which implies that they will pursue a

more moderate monetary policy in future. In the meantime, in the international markets of basic commodities and food products, despite the rise in prices for some commodities, the inflationary environment remains low.

The Board talked about the developments in the domestic financial market, stating that in the second quarter too ***financial market interest rates were fluctuating around the policy rate of the Central Bank***.

Following presentation of the Situation Report and the developments in external and domestic macroeconomic environments, the Board began addressing the monetary policy directions and making decision on the interest rate. The Board estimates that, in the current situation, low inflation contributes to anchoring long-term inflation expectations and maintaining the purchasing power of income, and since gradual recovery of inflation is preferable for now and in view of the inflationary effects expected of both the external sector and domestic economy in the near future, ***leaving the refinancing rate unchanged is appropriate***. The Board has a consensus that given the predictable macroeconomic developments, the monetary conditions have to be kept expansionary for as long as needed for fulfillment of the inflation target in the medium run. As a result, the expectation is that the inflation will run below the target in the coming months but will be stabilizing around it later on.

The Board also touched upon current inflation risks which are associated with global economic development uncertainties and a possibly more contractionary pace of the fiscal policy. If these risks materialize, an appropriate monetary policy response will be needed to ensure price stability in the medium term.

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 ***enacts:***

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.

Arthur Javadyan,

Governor of the Central Bank

June 11, 2019

c. Yerevan

PRESS RELEASE
11.06.2019

In the June 11, 2019 meeting, the Board of the Central Bank of Armenia decided to leave the refinancing rate unchanged, at a 5.75% level.

There was 0.4% deflation in May of 2019 compared with that of 1.0% recorded in the same period of the previous year, in which case the 12-month inflation has increased, amounting to 2.8% at the end of the month, determined by a seasonal rise in prices of some agricultural products.

In the external sector, trade wars gaining more tension have considerably added to uncertainties over global economic development, which have touched on trends in both financial and raw commodity markets. In addition, the US economic growth outlooks have deteriorated notably considerably, with the Federal Reserve System expected to make a much milder monetary policy in the future. Although some short-term inflationary trends are observable in the main food commodity markets, the Board of the Central Bank considers that, generally, significant inflationary pressures from the external sector are not likely.

The Board states that growth rates of economic activity remain strong, and the economic growth registered in the first quarter of 2019 has outpaced the expected indicator, with high private consumption growth still as the main driver to it. The impact of fiscal policy carried out over the first half of the year on the domestic demand is estimated as neutral. There is anticipation that in the second half of the year it will be notably expansionary and, consequently, the fiscal policy will have a neutral impact, according to the year's results.

The Board believes that the currently low inflation contributes to the anchoring of long-term inflation expectations and maintaining of purchasing power of incomes. At present, the Board prefers to letting the inflation recover gradually and finds it reasonable to keep monetary conditions expansionary by leaving the refinancing rate unchanged. At the same time, in view of the anticipated macroeconomic developments, to leave the policy's stance expansionary for a long period of time will be needed in fulfillment of the mid-term inflation target. As a result, the expectation is that the inflation will run below the target in the coming months but will stabilizing around the target in the medium run.

It should be noted that risks to inflation deviating from the projection path, which is associated with global economic development uncertainties and the pace of a possibly more contractionary fiscal policy, are still persisting. The Central Bank will respond to the emergence of any of such risks and developments adequately while maintaining 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	2.6	3.0	3.9
Consumer price index *(y/y, average, %)*	8.2	7.7	2.6	5.8	3.0	3.7	-1.4	1.0	2.5	2.4	2.6	3.4
Core inflation *(y/y, average, %)*	7.5	8.6	5.3	5.8	1.9	5.1	-2.0	0.8	4.0	1.9	3.9	4.0
Gross product												
GDP *(billion Armenian dram)*	3690.0	4028.9	4266.5	4555.6	4828.6	5043.6	5067.3	5568.9	6002.7	6620.5	7215.8	7879.7
GDP *(%, real growth)*	2.2	4.7	7.2	3.3	3.6	3.2	0.2	7.5	5.2	6.6	4.8	5.0
Supply												
Industry *(%, real growth)*	9.2	13.6	6.4	6.3	-0.9	6.2	7.7	11.7	5.8	5.1	4.9	5.3
Agriculture *(%, real growth)*	-16.0	14.0	9.5	7.6	6.1	13.2	-5.0	-5.1	-8.5	1.6	2.5	3.5
Construction *(%, real growth)*	3.3	-12.2	4.5	-7.4	-4.5	-3.1	-14.1	2.8	0.8	3.2	3.3	3.6
Services *(%, real growth)*	4.1	4.7	6.3	3.1	6.7	1.6	3.2	10.6	9.3	9.1	5.4	5.5
Taxes, net *(%, real growth)*	13.4	3.8	9.9	3.6	1.8	-5.1	-4.7	9.7	8.0	6.2	5.4	5.2
Demand												
Consumption *(%, real growth)*	3.9	2.6	7.7	1.9	0.7	-6.2	-0.5	10.5	5.1	9.8	4.7	4.3
Public consumption *(%,real growth)*	3.9	1.9	-1.4	8.7	3.4	4.7	5.8	-3.9	7.6	8.2	1.3	3.8
Private consumption *(%,real growth)*	3.9	2.7	9.1	0.9	1.0	-7.7	-1.2	12.7	4.7	10.0	5.2	4.4
Gross investment *(%,real growth)*	-2.9	-11.7	-1.9	-8.3	-2.2	2.5	-11.4	9.7	4.5	15.7	6.5	6.8
Public investment *(%,real growth)*	-12.7	-6.1	-22.4	-13.8	10.0	13.6	5.0	31.7	-38.0	34.9	15.0	12.0
Private investment *(%,real growth)*	-1.5	-12.4	0.9	-7.8	-3.4	1.2	-13.9	6.2	12.8	13.7	4.8	5.7
Export of goods and services *(%,real growth)*	20.4	14.5	12.0	8.9	6.4	4.9	19.1	18.7	4.6	4.5	8.3	7.9
Import of goods and services *(%, real growth)*	7.2	-0.1	4.7	5.5	-1.0	-15.1	7.6	24.6	12.7	3.0	5.2	4.6
External sector												
Balance of trade *(million US dollar)*	-2065.7	-2109.8	-2111.9	-2196.2	-2055.4	-1186.4	-944.4	-1375.4	-1766.0	-1774.5	-1846.5	-1880.2
Balance of services *(million US dollar)*	-260.8	-65.8	-101.6	-124.3	-113.0	-94.5	-71.4	-27.9	-147.8	-82.5	-55.6	-35.4
Remittances *(million US dollar)*	1421.9	1440.4	1539.8	1755.1	1616.1	1082.4	989.6	1128.1	1118.5	1177.7	1295.5	1425.0
Current account *(million US dollar)*	-1261.4	-1058.9	-1057.9	-812.9	-883.1	-279.1	-238.1	-279.7	-1130.6	-1017.3	-949.5	-833.5
Balance of trade *(share in GDP, %)*	-22.1	-20.8	-19.9	-19.7	-17.8	-11.3	-8.9	-11.9	-14.2	-12.9	-12.3	-11.4
Balance of services *(share in GDP, %)*	-2.8	-0.7	-1.0	-1.1	-1.0	-0.9	-0.7	-0.2	-1.2	-0.6	-0.4	-0.2
Remittances *(share in GDP, %)*	15.2	14.2	14.6	15.8	14.0	10.3	9.3	9.8	9.0	8.6	8.6	8.6
Current account *(share in GDP, %)*	-13.5	-10.5	-10.0	-7.3	-7.6	-2.7	-2.2	-2.4	-9.1	-7.4	-6.3	-5.0
Public sector*												
Revenues and grants *(billion Armenian dram)*	780.4	880.9	946.2	1071.4	1144.8	1167.7	1171.1	1237.2	1341.7	1518.7	-	-
Tax revenues *(billion Armenian dram)*	699.4	777.4	878.4	1000.9	1064.1	1067.9	1079.7	1158.1	1258.1	1463.9	-	-
Expenditures* *(billion Armenian dram)*	954.3	986.5	1006.1	1142.9	1235.1	1409.0	1449.1	1503.9	1447.1	1640.9	-	-
Deficit *(billion Armenian dram)*	-173.9	-105.6	-59.9	-71.5	-90.3	-241.3	-278.0	-266.7	-105.4	-122.2	-	-
Revenues and grants *(share in GDP, %)*	22.6	23.3	22.2	23.5	23.7	23.2	23.1	22.2	22.4	22.9	-	-
Tax revenues *(share in GDP, %)*	20.2	20.6	20.6	22.0	22.0	21.2	21.3	20.8	21.0	22.1	-	-
Expenditures *(share in GDP, %)*	27.6	26.1	23.6	25.1	25.6	28.0	28.6	27.0	24.1	24.8	-	-
Deficit *(share in GDP, %)*	-5.0	-2.8	-1.4	-1.6	-1.9	-4.8	-5.5	-4.8	-1.8	-1.8	-	-
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 budget indicators are the Central Bank estimates.*

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