

THE CENTRAL BANK
OF THE REPUBLIC OF ARMENIA

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Bank Resolution No. 93A,
dated May 27, 2016

Inflation Report

Monetary Policy Program, Q2, 2016



*Status Report on Implementation of the Monetary Policy
Program, Q1, 2016*

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Starting from January 2006, the Central Bank of Armenia has moved to a fully-fledged inflation targeting strategy, which highlights the importance of communicating of the Bank to the general public by publishing, inter alia, quarterly inflation reports. First section of the inflation report includes next quarter's monetary policy program that provides new forecasts of inflation and other macroeconomic indicators and main directions of the monetary policy in the forecast horizon. Second section includes status report on implementation of the monetary policy program of the previous quarter, which covers actual economic and monetary developments.

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.

Starting from the second quarter of 2012, the CBA has been publishing forecasts of non-conditional inflation in a 3-year time horizon, in implementation of the inflation targeting strategy, whereby the monetary policy is steered to minimize any deviations of potential inflation from a 4 % target.

Projections in this report are based on the factual information available by May 17, 2016, i.e. the day on which the refinancing rate was set, the results of a survey conducted by the CBA 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 monetary policy-related publications.

1. EXECUTIVE SUMMARY

The CBA has revised the 2016 economic growth projection indicator upside. In the rest part of the forecast horizon growth rates will continue to accelerate, gradually approaching the long-term equilibrium.

Deflationary patterns will persist over coming months due to the deflationary influence still transmitting from international commodity markets. In the rest of the forecast horizon the 12-month inflation rate will gradually return to the target.

The first quarter's economic growth is estimated in the range of 4.8-5.0% y/y.

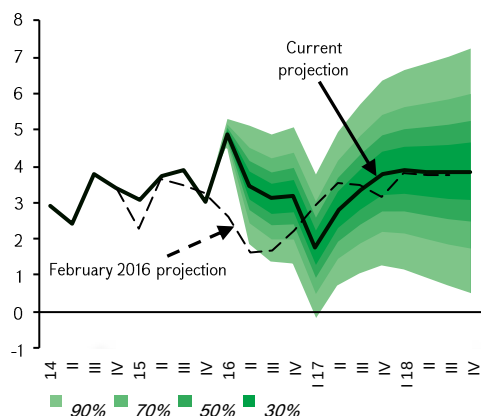
Although global economic growth rates remained sluggish, some activity in the Armenian economy was observed in the first quarter of 2016 owing to expansionary policy carried out by the Government of Armenia (the Government) in 2015 and monetary conditions loosened considerably by the Central Bank of Armenia (the CBA) since the second half of the year. Consequently, the CBA has revised the 2016 economic growth projection indicator upside. In the rest part of the forecast horizon growth rates will continue to accelerate, gradually approaching the long-term equilibrium. Deflationary patterns will continue to be seen in the coming months due to the deflationary influence still transmitting from international commodity markets, while in the rest of the forecast horizon the 12-month inflation rate will gradually return to the target.

*Private consumption and private investment kept on reducing (estimated at 2% and 5% respectively, in real terms) in the light of noticeable contraction in real disposable household income resulting from shrinkage in money transfers from Russia. However, while the decline in private investment was within expectation, private consumption expenditures reduced less than expected, as economic activity was stronger at that time. This was fueled by expansionary fiscal and monetary policy implementation by the Government and the CBA on the one hand and a relatively high growth observed in the tradable sector of the economy on the other. Good performance in the tradable sector secured rather strong real growth of export of goods and services (estimated at 32.9% y/y) whereas the estimation of import of goods and services decreased by 7.5%, reflecting continuous improvement in the net real export indicator. So, in the first quarter of 2016 the **economic activity indicator amounted to 5.6% y/y** mainly due to increased output volumes in industry and services sectors, in which case the quarter's **economic growth was estimated in the range of 4.8-5.0% y/y**.*

According to short-term forecasts of the CBA, in 2016 economic growth in the external sector will continue to be slow and no more deflationary developments will be seen in international commodity markets while some price stability will be achieved gradually. Furthermore, on the premise of slower declining rates in the Russian economy and eliminated expectations for the ruble depreciation, there is anticipation that the decline in seasonal worker income and remittances of individuals will slow down considerably, which will positively affect the level of domestic demand, hence gradual rebounding of private consumption. On the other hand, despite a sizable state budget deficit expected in 2016, the impact of fiscal policy on the domestic demand (calculated over the previous year) is estimated 1.5 contractionary for the year. Private consumption growth is projected at around 1.0% while private investment will grow by about

The 2016 economic growth is estimated in the range of 2.7-3.6%.

Real GDP Cumulative Growth Projection Probability Distribution Chart for a 3-year horizon



The 12-month inflation rate amounted to -2.0% at the end of March.

External environment's deflationary impact will be transmitting onto the domestic prices in the coming months, which will phase out in the second half of the year.

The CBA reckons that easing of monetary conditions at a greater pace in the second quarter of 2016 is reasonable in the time of low inflation environment and considerable reduction of inflation expectations.

2.0% primarily thanks to investment to be made in the tradable sector of the economy. The latter, along with high growth in the first quarter, served a basis for giving exports a higher growth forecast. Thus, in 2016 the real growth of export of goods and services is projected in the range of 9.0-11.0%, while the forecast of real import of goods and services will remain at the previous level (6.0-8.0% decrease). In view of these developments, the **2016 economic growth is estimated in the range of 2.7-3.6%.**

Starting from 2017, the economic growth rates will speed up, carrying the influence of effective implementation of the Government program steered to export and investment promotion, gradual improvement in the external economic environment and structural reforms. Driven by these developments, it is expected that **economic growth at the end of the forecast horizon will be within 3.0-4.5%.**

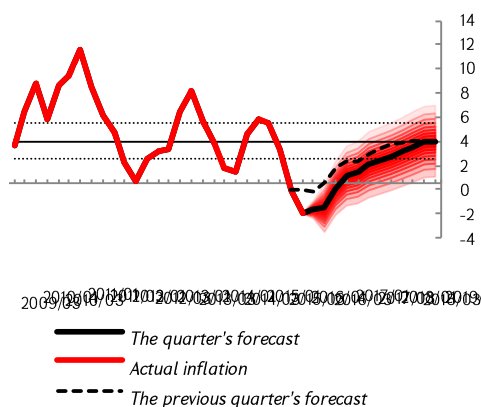
Thus, **in the forecast horizon, the impact of aggregate demand on domestic prices will be deflationary up until the start of 2017; then it will grow into inflationary by the end of the horizon.**

In the first quarter of 2016, the **12-month inflation rate** declined faster than expected. Inflation amounted to 0.4% compared to 2.4% recorded in the same period of the previous year, in which case the 12-month inflation rate reached **-2.0%** at the end of March. A low inflation was primarily driven by prices of agricultural products which had fallen relative to the same period of the previous year and deflationary impacts partly transmitted on to the domestic prices from international commodity markets. Despite a fairly low inflation environment and some moderation of inflationary expectations, inflation expectations are still viewed high according to the CBA estimations, which is why it lowered the refinancing rate in that period gradually by a total 0.5 pp to **8.25%** at the end of March. The CBA has always emphasized that in the event inflationary expectations are mitigated and no additional risks are posed to inflation, it will keep on easing monetary conditions gradually and, if necessary, at an abrupt pace (see details in section "3.1.1 Actual inflation and fulfillment of the inflation target").

Short-term forecasts of the CBA denote that external environment's deflationary impact will be transmitting on to the domestic prices in the coming months, which will phase out in the second half of the year. At the same time, it is estimated that inflation expectations are declining relatively fast thanks to consistent monetary policy implementation. On top of the policy influence, an expected reduction in the natural gas tariff as another factor has been added and is thought to facilitate the reducing of inflation expectations.

The CBA reckons that easing of monetary conditions at a greater pace in the second quarter of 2016 is relevant in the time of low inflation environment and considerable reduction of inflation expectations. This, coupled with monetary conditions loosened at the start of the previous year, will lead to the expanding of aggregate demand and stabilizing of inflation around the target in the forecast horizon.

Inflation (12-month) Forecast Probability Distribution Chart for a 3-year horizon



Risks to inflation deviating from the projected value are estimated as balanced in the short and medium run. Risks deriving from domestic and external sectors mostly persisted in relation to the previous forecast. In particular, the **external sector risks** are related to capital outflows to the U.S.A. from developing countries and, consequently, higher volatilities of currencies in developing countries, a likely slowdown of global economic growth resulting from structural reformation of the Chinese economy as well as risks related to developments in international prices of raw materials and food products. **Risks deriving from the domestic sector** are mostly associated with the extent to which external environment's deflationary impact will spill over to the domestic price developments in agriculture, a sector greatly depending on weather conditions, the pace at which domestic demand and private investments will recover, as well as Government-led structural reforms.

If the aforementioned risks materialize, the CBA will react accordingly by maintaining the inflation target in the medium run.

2. FORECAST, FORECAST CHANGES AND RISKS

2.1. External environment¹

In 2016 trends of slow economic growth will continue to be observable in the global economy and main partner countries to Armenia. In both developed and developing countries in general, no significant change is anticipated in economic growth rates compared to the previous year.

In 2016 trends of slow economic growth will further be observable in the global economy and main partner countries to Armenia. Deflation in international commodity markets has basically abolished yet prices will keep generally low in 2016.

Deflation in international commodity markets has basically abolished yet prices will keep generally low in 2016 because of weak global demand and supply factors in different product markets.

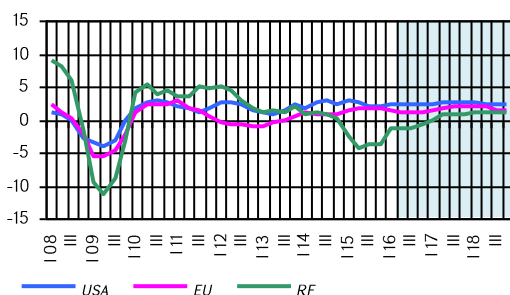
Economic growth in the **U.S.A.** in 2016 is forecast at around 2.3% on average (compared to 2.4% growth reported in the previous year), which will persist in the medium term. With the dollar somewhat losing in value, world oil prices rising in the short-term perspective and taking into account positive developments in the U.S. labor market, the Federal Reserve System is expected to raise interest rates in the second half of 2016 and gradually tighten monetary conditions in the medium run.

Economic growth in **Eurozone** in 2016 is predicted to slow down on average by 1.1% as opposed to 1.5% growth recorded in the previous year. In the medium term, however, the growth rates will speed up to nearly 1.7%. Although high levels of public and private debt, as well as political uncertainties will continue hampering economic growth, in the medium term it will be fostered largely by rebounding external demand and notably expansionary policy by the European Central Bank. Under expected appreciation of the euro exchange rate to a certain extent and persisting weak demand, inflation in Eurozone is still below its target level and may only come up to it at the end of the forecast horizon. With the aim to regulate inflation, the ECB will continue implementing an extremely expansionary monetary policy, setting negative interest rates and carrying out the quantitative easing program up until mid-2017.

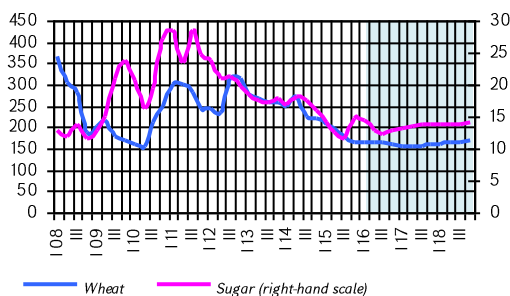
In 2016 economic decline in **Russia** will continue; it will average 1.2% compared to the previous year's decline of 3.8%. The economy will return to positive growth only in the middle of 2017 with the growth indicator to reach 1.3% at the end of the forecast horizon. Low oil prices remain a key factor that determines weak economic activity. However, small increases in oil prices in the short term may secure some appreciation of the Russian ruble, which will help the inflation to slow down to around 6.0% at the end of 2016 and approach the 4%

¹ The forecasts of external sector were based on the information provided from international reputable analytical, research, ratings organizations and financial institutions as well as various news agencies worldwide (including the IMF, the World Bank, The Economist, Economist Intelligence Unit, the Global Insight, the Financial Times, and so on).

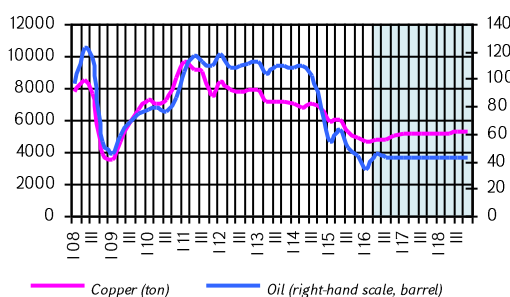
Economic growth in main trade partner countries (%)



Food products (US dollar)



Commodities (US dollar)



medium-term target of the Bank of Russia in the second half of 2017. In this case, however, the Bank of Russia will withhold from reducing the policy rates in the short run due to substantial risks and uncertainties associated with the fiscal policy.

According to the IMF April 2016 report “Global Economic Outlook”, world economic growth in 2016 is predicted to reach 3.2%, which is a 0.2 pp downside revision compared to the previous publication of the report in January.

With the global economy still on a slow-growth track and large volumes of supply in the main markets, prices will keep low in **world commodity and food product markets** during 2016, and only in the medium term perspective some inflationary trends will emerge on the back of somehow rebounding global demand.

Risks to the developments in global economy persisted in general. These include capital flight to the U.S.A. from developing countries and, consequently, higher volatilities in financial markets, a likely slowdown of global economic growth resulting from structural reformation of the Chinese economy, sluggish economic activity in developing countries and Russia and risks associated with geopolitical developments.

Box 1

Developments in commodities markets in the forecast horizon

The April 2016 report of the **oil** market published by OPEC predicts that the global oil demand will grow in 2016 by 1.20 million b/d and consumption will reach 94.18 million b/d. The report also foresees that oil production outside OPEC in 2016 will reduce by 0.73 million b/d to 56.39 million b/d on average. Oil production by OPEC in 2016 will go up by 0.17 million b/d. Though international oil prices will trend slightly upward in the short run on the brink of prediction that excess supply will somehow reduce, prices are nevertheless expected to keep low in the light of still a large volume of supply but relatively weak demand in the oil market.

Prices in world **metals** markets will demonstrate signs of modest growth, mainly reflecting a weak industrial demand in China.

According to the April estimates of the U.S. Department of Agriculture, in the 2015/2016 marketing year some 733.1 million tons of **wheat** crops is expected (1.0 million tons more than in the previous marketing year). According to estimations, world wheat stock will reach a record amount of 239.3 million tons for the 2015/2016 marketing year. The wheat supply that much will determine deflationary patterns to be persisting in the short run. However, trends of weak price growth will be observable in the medium run as some contraction in the production in the next marketing year as well as gradual recovery of the global demand is likely.

According to U.S. Department of Agriculture estimates, world **rice** production in the 2015/2016 marketing year will be 470.6 million tons, and world rice stocks will reach 90.2 million tons, reducing by 13.4 million tons compared to the previous year. Nevertheless, the prices of rice will still keep low in the short run in the light of relatively large supply volumes.

Considerable rise in world **sugar** prices, resulting from delayed sugarcane harvest due to bad weather in late 2015 in Brazil, the world's leading manufacturer and exporter of sugar, will end in 2016. Some drop in sugar prices in the short-term perspective will be observable.

2.2. Aggregate supply and aggregate demand

Aggregate supply

The CBA revised its economic growth forecasts for 2016 upside driven by higher-than-expected output volumes in industry and services sectors in January-March 2016 issue of volumes. As a result, the **2016 economic growth is estimated in the range of 2.7-3.6%**².

The pace at which private transfers from Russia to Armenia were declining is expected to slow down considerably in 2016. Albeit a contracting effect of remittances of individuals on the domestic demand will be seen further, it will be cushioned by the influence of expansionary monetary and fiscal policies conducted in 2015-2016 and a low inflationary environment in the economy. Under such conditions, the **domestic demand is expected to grow by 1.0%**, which will still be smaller from its equilibrium.

Thus, with the domestic demand persisting at a low level, the 2016 economic growth will be underpinned by net exports thanks to recent structural reforms as well as favorable developments in agriculture, industry and services sectors.

Anticipated rebounding of the domestic demand, effective implementation of export and investment promotion policy of the Government, improving external economic environment and structural reforms are among key factors that will accelerate the economic growth, starting from 2017. On the back of the aforementioned developments the **economic growth will speed up and at the end of the forecast horizon the growth indicator will be within 3.0-4.5%**³, which will further be driven greatly by the tradable sector.

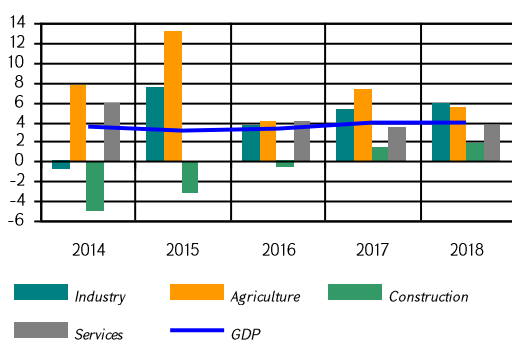
Also, taking into account long-term economic developments anticipated in partner countries to Armenia as well as structural shifts in the domestic economy, **Armenia's long-term economic growth equilibrium is estimated within 4-5%**. It should be noted, however, that estimated long-term GDP growth rate may decelerate if the structural reforms proceed slowly and investment in tradable sector grows unhurriedly. It is worth mentioning that investments in tradable sector will prove rather effective in the forecast horizon, if they come as foreign direct investment or are funded through domestic savings, since investment made at the expense of credit resources in the domestic economy are approaching their efficacy caps.

For **Industry**, the forecasts were revised upside, primarily reflecting higher-than-expected growth in processing industry observed early in the year. As a result, **in 2016 the value added in industry is forecast to grow within 3.2-4.0%**. The expected growth in industry sector during the year will be fueled by continued growth in mining industry, rebounding economic activity in processing industry after the decline reported in 2015, as well as the increase in electricity production.

The 2016 economic growth is estimated in the range of 2.7-3.6%.

Starting from 2017 economic growth will speed up and at the end of the forecast horizon the growth indicator will be within 3.0-4.5%.

GDP growth by economy sector



²See the 30% range in the Real GDP Growth (Cumulative) Projection Probability Distribution Chart.

³See the 30% range in the Real GDP Growth (Cumulative) Projection Probability Distribution Chart.

In the **forecast horizon**, the industry growth **will stabilize within 5.5-6.5%**. This will be underpinned by implementing a handful of investment projects in the private sector, broadening export capacities, exploring new markets and embarking on product development in the context of export-promotion policy of the Government.

For **Construction**, the 2016 forecasts of value added did not change much. In view of low investment activity in non-tradable sector of the economy and reduction in remittances from Russia, there is anticipation that volumes of construction funded by organizations and households will shrink. It should be noted, however, that relatively high investment activity in the tradable sector of the economy and improved lending conditions will cushion the above negative effects on the construction sector. As a result, the change in value added in construction in 2016 will be within -0.8 to -0.4%.

In the **forecast horizon**, the growth is expected to **stabilize in the range of 1.5-2.0%** as the supply and demand imbalance in the construction sector phases out. The growth will be fostered primarily by large construction projects designed for infrastructure improvement and investment projects in the private sector.

For **Services**, the 2016 forecasts of value added were revised upside and estimated within **3.8-4.4%**. The revision is determined by higher-than-expected growth in services provided in the first quarter of 2016 and smaller contraction in trade turnover. With the domestic demand still sluggish, the growth of services in 2016 will be bolstered by increasing volumes of services rendered in connection with export businesses.

In the **forecast horizon**, the growth in services is predicted to **stabilize within 3.0-4.0%** in view of gradually recovering domestic demand and expected tourism growth.

For **Agriculture**, the forecasts of value added did not change much in relation to the previous forecasts and are estimated in the range of **4.0-5.0%**.

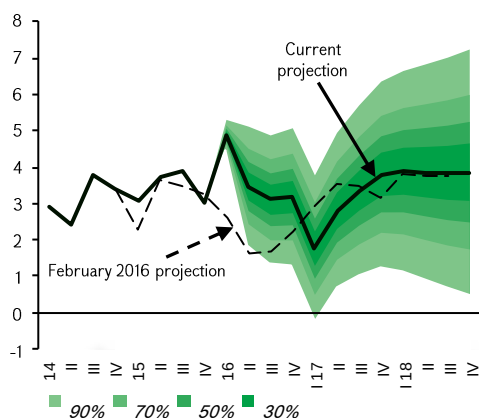
In the forecast horizon, the growth in agriculture will accelerate and stabilize within **5.5-6.5%**. Relatively high growth rates in the medium run will be feasible by using more house farming and refrigerator facilities, arable land, crops and cattle, and engaging extra means of transportation for exports, as a result of complex measures which the Government has consistently taken on in recent years.

In the forecast horizon, risks to the economic growth are dual-sided and balanced. The risks to the economic growth are associated with uncertainties in global and domestic economic environments.

Among upside risks, most prominent are the expanding and using of export potential in certain sectors of the economy amid gradual recovery of global economy and growing competitiveness of Armenia, as well as identifying new export markets.

Downside risks include a notable slowing in agricultural growth rates in 2016 due to less favorable weather in comparison with 2015, as well as the slow pace of structural reforms that promote economic growth.

Real GDP Cumulative Growth Projection Probability Distribution Chart for a 3-year horizon



Real GDP Growth (Cumulative) Projection Probability Distribution				
Period	30% probability interval		90% probability interval	
	Minimum	Maximum	Minimum	Maximum
January-December 2016 / January-December 2015	2.7%	3.6%	1.3%	5.1%
January-December 2017 / January-December 2016	3.2%	4.4%	1.3%	6.3%
January-December 2018 / January-December 2017	3.1%	4.6%	0.5%	7.2%

Labor market:⁴ The 2016-2018 forecasts of labor market indicators remained much the same as no revision of wage growth rate took place. Thus, **average nominal wage is predicted to grow by 3.6% in 2016, by 5.0% in 2017 and by nearly 6.0% in 2018.**

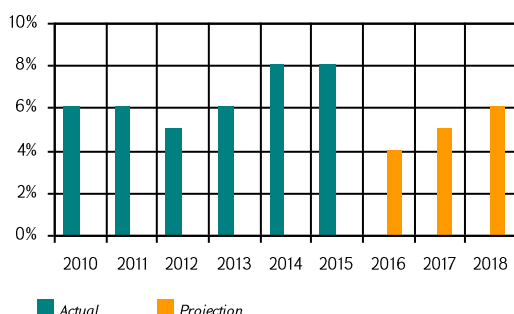
Since October 2015 there has been a slowdown in public sector wage⁵ growth. This will lead to a moderate growth of public sector wage in 2016. While the minimum wage threshold rose to AMD 55,000 in July of 2015, more increases of the threshold are not scheduled for 2016. Although a higher indicator was forecast after the revision of economic growth, the wage growth forecast remained unchanged as a result of a lower inflation environment in 2016; so it is an estimated 3.6%.

On the premise of projected economic growth, fulfillment of the inflation target and continued Government policy⁶ aimed at minimum wage increases starting from 2017, the average annual nominal wage will grow by 5.0% in 2017 and around 6.0% in 2018.

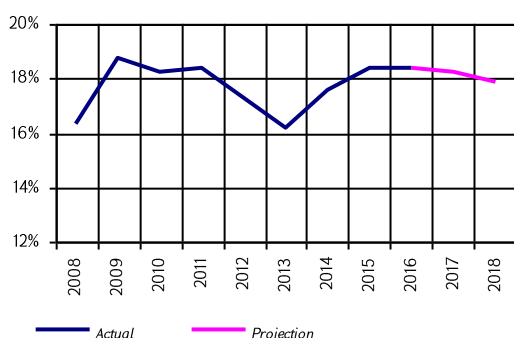
In 2016 the average unemployment rate is expected to reach 18.3%, which is close to the previous forecasts but 0.1 pp below the relevant figure reported in 2015. In 2016 the average unemployment rate will remain high as a result of productivity growth reported in 2015 (not leading to employment growth in the short run, however). The slowing of productivity growth and predicted acceleration of the economic growth will prompt the unemployment rate to subside by around 0.2 pp annually in the period 2017-2018. Up until the second quarter of 2017 the unemployment rate will be above its equilibrium, reflecting the negative GDP gap and deflationary pressures it will have created. By the end of the forecast horizon, the unemployment will approach its equilibrium thanks to the expansionary monetary and fiscal policy implementation by the CBA and the Government.

As a result of the aforementioned developments, the productivity growth expected in 2016 will outweigh an anticipated rise in wages and leave some 0.3-0.4% of deflationary effect on consumer prices during the year. In the forecast horizon, the labor market's impact on the inflation is estimated to be neutral.

Average nominal wage growth, y/y



Unemployment rate



⁴ The labor market data for 2016-2018 are the CBA projections which are based on the fourth quarter of 2015 data and actual January-February of 2016 figures. The growth indicators presented in this sub-section are relative to the same reference period last year, unless otherwise specified.

⁵ Average nominal wage constitutes the grand sum of salary and salary equivalents (premiums, allowances, bonuses, one-time incentive pays, etc.).

⁶ A gradual rise in the minimum wage in the medium run has been outlined in the Republic of Armenia's Medium-Term Public Expenditures Program for 2016-2018.

Aggregate demand⁷

A trend of reducing remittances from Russia will probably continue in 2016. The expected decline, however, will be smaller compared to those reported in 2015 and will amount to 6-8%. The expansionary monetary policy implemented in 2015-2016, an expected low inflation environment in the economy and a large budget deficit for 2015-2016 will significantly soften the negative impact of private remittances on domestic demand in 2016. The rise in disposable income in the economy in 2016 will be driven by positive influence from the growth in the tradable sector. As a result, it is expected that the domestic demand, which posted a decline in 2015, will gradually bounce back in 2016, which will still be below the equilibrium.

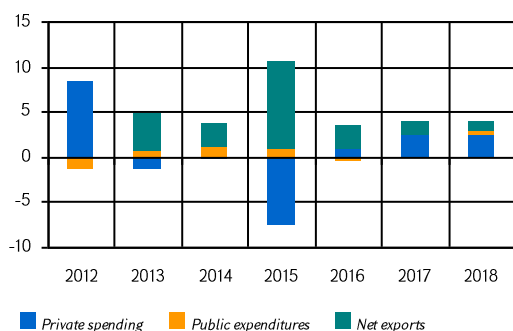
The domestic demand will continue growing and getting closer to its equilibrium in 2017-2018 as economic activity revives in partner countries to Armenia as well as the lagged impact of the above-referred expansionary monetary policy in the Armenian economy persists.

Though weak domestic demand will negatively affect the economic growth at the start of the forecast horizon, it will however facilitate the elimination of imbalances – particularly the closing up of the negative gap between savings and investments – observable in the domestic economy in recent years. This, amid a floating exchange rate regime, boosts up competitiveness of the tradable sector of the Armenian economy, strengthens the macroeconomic stability and provides for long-term, sustainable investment and economic growth prospects.

The domestic economic growth in 2016 will further be achieved by contributing to net exports. Improved competitiveness in recent years determined more rapid rates in productivity growth in the tradable sector of the Armenian economy, which will, in turn, secure growths in agriculture, industry and services sectors in 2016. Given the global demand expands and investments in tradable sector increase in 2017 - 2018, net exports will continue to largely contribute to the economic growth. Furthermore, investments will prove highly effective, if they are funded from domestic savings rather than through foreign debt instruments, or if they come as foreign direct investment.

In the forecast horizon, revenues generated in the tradable sector will, in turn, serve a source to finance gross private expenditures and will promote the recovery of the domestic demand and economic growth on the whole.

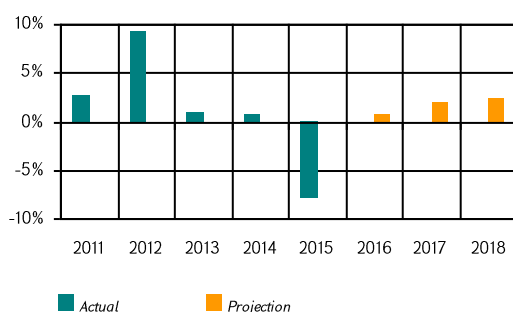
Demand components contributing to the economic growth



⁷ The data of real growth of private consumption and investments for 2016-2018 are the CBA estimates. These actual figures are as of the fourth quarter of 2015 published by the National Statistics Service of Armenia. The real growth indicators represented in this subsection are relative to the same reference period last year, unless otherwise specified.

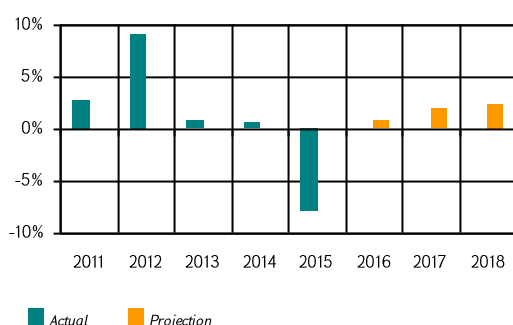
Final consumption expenditures of households will grow in 2016 by about 1%.

Private consumption



There will be a moderate growth of about 2% of gross private investment in the economy in 2016.

Private investment



Private sector spending

The expected shrinkage in private transfers from Russia in 2016 will negatively affect the household incomes. Estimates suggest, however, that final consumption expenditures of households will grow in 2016 by about 1%, which will be underpinned by expansionary monetary policy implementation since 2015, expansionary impact of the fiscal policy in the first half of 2016, a low inflation environment in the economy, as well as positive influences the economic growth will have on disposable income by contributing to net exports. Despite an expected private consumption growth in 2016, estimates suggest that it is still below the equilibrium.

The shrinking of remittances from Russia and weak investment activity persisting in non-tradable sectors of the economy will adversely affect private investment in 2016. On the other hand, a relatively high investment activity in the tradable sector of the economy is possible thanks to an increase in relative competitiveness of the sector, which was reflected in the growth in agriculture, industry and services sectors reported in 2015 and early 2016. These developments, therefore, denote that gross private investment in the economy in 2016 will post a moderate growth of about 2%.

Considerable loosening of monetary conditions in 2015-2016 as well as growing budget deficit at that time have softened the negative impact of decline in private transfers from Russia on private consumption and investment in 2016, but are expected to stimulate their growth in 2017-2018. It should be mentioned, however, that fiscal policy's expansionary impact on aggregate demand will weaken starting from the second half of 2016. In 2017-2018, in view of maintaining the sustainability of public debt, the fiscal policy will have a contractionary effect on aggregate demand. The increase of household incomes, which will be a result of improved economic environment in trade partner countries as well as recovering exports, will help the private sector demand to rebound. It is expected that private consumption will grow by 1.8-2.2% in 2017 and 2.1-2.5% in 2018.

Private investment will grow by 5.0-5.5% in 2017 and 4.0-5.0% in 2018. Expanding of capacities in the tradable sector and continued structural reforms in the domestic economy will bolster a moderate growth in investment. On the back of these developments, a non-tradable sector of the economy – construction and trade sectors in particular – may anticipate a slowly recovering investment activity in 2017-2018, but the growth there is expected to be smaller than in the tradable sectors.

In view of the aforementioned developments with private consumption and investment, in 2016 private sector expenditures will increase by 1.0%. Starting from 2017, private spending will grow faster to amount to 2.4-2.8%, and at the end of the forecast horizon it will stabilize within 2.5-3.0%. In the outcome, private spending gap for the period 2016-2017 is estimated to be negative although the level of private spending is set to rebound gradually in the forecast horizon.

The fiscal and monetary stimulus provided to the economy, resurging investment activity in the domestic economy in 2015-2016, as well as acceleration of economic growth in partner countries to Armenia will gradually reduce the negative private spending gap and help this imbalance phase out at the end of 2017. From end-2017 to the end of the forecast horizon, the private spending gap is estimated to be positive.

From the beginning of 2016 to the end of 2017, the **private spending will create an average 0.9-1.1 pp of contractionary impact on the inflation**. As domestic demand recovers thanks to an expansionary monetary policy, the abovementioned deflationary pressures will gradually vanish. From the fourth quarter of 2017 to the end of the forecast horizon, the impact of private spending will be 1.1-1.3 pp inflationary.

Current account

Export growth in the first quarter of 2016 was unprecedented and has exceeded expectations amid persisting weak demand in the global economy. The volumes of export of alcohol recovered, the export of tobacco remained rather strong and items “Precious stones and metals and articles thereof” and “Textiles” posted rather high growths. At the same time, high rates of growth were further observed in the mining sector, where the impact of the operation of the Teghut mine is still considered. It is noteworthy that despite deteriorated terms of trade, the main focus of economic agents is placed on sustaining the productivity growth, which is reflecting significant improvement in export performance. The latter will be of fundamental importance for positive developments in the current account deficit in spite of expected decline in remittances.

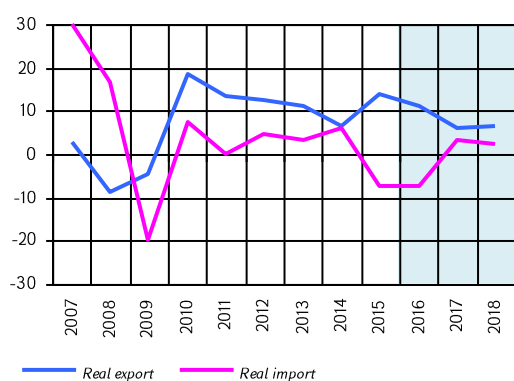
The 2016 forecasts of growth of export of goods and services were revised upside and will be in the range of 9.0-11.0%. The pace of decline in real import of goods and services will remain within 6.0-8.0%, as in the previous forecast.

The pace at which the seasonal workers’ remittances and private transfers contracted will slow down notably owing to the slower pace of decline in the Russian economy and reducing expectations for ruble exchange rate depreciation. As a result, the decrease in dollar value of the seasonal workers’ remittances and private transfers will be in the range of 6-8% instead of previously estimated 9-12%.

Based on the above projections, the current account deficit-to-GDP ratio in 2016 will be in the range of 1.0-2.0%. Given productivity growth in the tradable sector is sustained and remittances and domestic demand recover, the current account deficit-to-GDP ratio will stabilize over the medium run in the range of 2.0-3.0% compared to the previous projection of 3.0-4.0%.

The **fiscal policy’s impact** on overall demand for 2016 was assessed based on revenue and expenditure figures laid down in the Republic of Armenia Law on “State Budget 2016” and its revised program relevant

Real export and real import of goods and services, y/y, %



Notwithstanding an anticipated large budget deficit in 2016, the fiscal impulse indicator is expected to leave 1.5 of contractionary impact on aggregate demand.

to Government decisions⁸. Given the GDP projection by the CBA, the revenue-to-GDP ratio will remain unchanged to the 2015 figures whereas the expenditure-to-GDP ratio will drop by 1.1 pp, mostly at the expense of current costs. The deficit-to-GDP ratio in 2016 will amount to 3.7% of GDP.

Notwithstanding a large budget deficit anticipated in 2016, the revenues are expected to leave a neutral effect and expenditures a contractionary effect on aggregate demand, according to the fiscal impulse indicator. Moreover, contractionary effects are likely for all the quarters. For the year, the contractionary effect may rise up to 1.5.

Projections of the fiscal policy in the forecast horizon are based on the forecasts of main nominal indicators outlined in the Republic of Armenia Law on “State Budget 2016” and the Republic of Armenia “Medium-Term Public Expenditures Program for 2016-2018”. **In the medium run** the fiscal policy is aimed at shaping a budget deficit in line with the sustainability of public debt.

In the structure of public expenditures for 2016-2018, public debt interest payment constitutes an average 1.8% of GDP and the primary deficit-to-GDP ratio (deficit less debt interest payment) will average 0.6% of GDP. The change in primary structural balance (the primary balance adjusted by temporary entries and cyclical effects of GDP) is estimated 1.3 contractionary for 2017 and neutral for 2018.

The fiscal policy’s impact over the medium-term is **non-inflationary**.

Medium-term fiscal policy impact assessment				
% of GDP	2015	2016	2017	2018
Budget revenues ⁹	22.4	22.5	22.9	23.0
Budget expenditures	27.2	26.2	24.8	24.6
Debt interest payment	1.5	1.9	1.8	1.7
Budget balance	-4.8	-3.7	-1.9	-1.6
Primary balance *	-3.3	-1.8	-0.1	0.1
One-off flows **	-0.3	-0.4	-0.6	-0.5
Adjusted balance ***	-3.0	-1.4	0.5	0.6
Cyclical balance ****	-0.3	-0.6	0.0	0.0
Cyclically adjusted primary balance (structural balance sheet)	-2.7	-0.8	0.5	0.6
Fiscal stance *****	2.6	-1.9	-1.3	0.3
* Budget balance less debt interest payments. ** Temporary or one-off budget entries. In this case net lending is considered; the sign “+” means resources allocated and the sign “-” means resources repaid. *** Primary balance sheet adjusted by temporary or one-off entries. **** The CBA estimate: a part of the budget balance which depends directly on the business cycles. The latter’s components depend on the GDP gap and revenues and expenditures elasticity coefficients on GDP gap. ***** The CBA estimate: y/y change in the structural budget balance that reflects a discretionary nature of the fiscal policy (the positive sign denotes fiscal expansion and the negative sign denotes fiscal contraction).				

⁸ The revenue and expenditure indicators as established in the Republic of Armenia Law on State Budget are subject to revision under separate decisions issued by the Government within the scope of Government mandate, and are available at www.e-gov.am.

⁹ The budget indicators are presented here excluding records of off-budgetary funds.

Summary: from the first quarter of 2016 to end-2017 the combined impact of the fiscal policy, private demand and labor market on domestic prices will be deflationary, in the range of 1.4-1.5 pp. This will be determined by predominantly deflationary impact of private spending amid stabilizing inflation expectations. Also, given the 0.3-0.4 pp inflationary impact of net external demand, one may conclude that overall aggregate demand and labor market developments in the above-mentioned period will create an average of 1.2-1.3 pp deflationary pressures in the consumer market.

In the above-mentioned period, as aggregate demand recovers, these deflationary pressures will phase out gradually. Starting from the fourth quarter of 2017 up until the end of the forecast horizon, the overall aggregate demand and labor market will create an inflationary effect, making up 1.7-1.9 pp on average.

2.3. Inflation forecasts and monetary policy directions in 3-year forecast horizon

In the first quarter of 2016 ***trends of slow growth*** were observable in the economies of main trade partners to Armenia, particularly in the U.S.A. and Eurozone, and the global demand remained sluggish. In the meantime, economic decline in Russia was slower (it is an estimated -1.3% for the first quarter of 2016 instead of forecasted -2.5%). Weak global demand, coupled with increased supply factors, ***allowed the deflationary patterns to linger in commodity and food product markets of the world.***

In the forecast horizon, global economic growth will continue at a slow pace. While economic growth rates are predicted to accelerate to some extent in developed countries, sluggish growth rates will be persisting in developing countries. In view of geopolitical and country-specific developments, ***economic decline in Russia will continue over 2016 but will, however, be slower compared to the previous forecast*** (-1.2% instead of -1.8%). The economy will only enter a positive growth territory in mid-2017 and at the end of the forecast horizon the economic growth will be nearly 1.3%. Meanwhile, ***risks and uncertainties*** about further pace of the global economy, pinpointed in the previous forecast, ***will be persisting.*** They are associated with anticipated interest rate increase by the U.S. Federal Reserve System and the consequences it could bring. On the other hand, there are significant risks to how the Russian economy will unfold in the light of geopolitical and in-country economic developments, how the Chinese economy will develop further and what implications there can be for global demand.

With global economy still sluggish and excess supply in individual commodity markets, **international prices will keep at a low level in commodity and food product markets of the world** in the short run. In the forecast horizon, however, international prices of commodities and food products will trend slowly upward as global demand recovers gradually and production volumes shrink.

In the first quarter of 2016 the **domestic economic growth rates were estimated within 4.8-5.0%, well above the expectation**, which is attributable to more positive developments in the tradable sector (industry and services, in particular) of the economy.

As the decline of the Russian economy slowed down, the **dollar value of net inflow of private remittances and seasonal worker pays** also reduced at a slower pace during the quarter, making up - 7.9% y/y. This contributed to the narrowing of the negative gap of real private transfers.

On the back of slower contraction of private transfers, accelerated growth rates in lending and higher economic activity, the first quarter of the year saw a lesser-than-expected reduction in private spending and private investment. **In this circumstance, the pace of decline in domestic demand has slowed down compared to the previous quarter** and is estimated at around 2.1%. Note that such developments with the domestic demand are also attributable to the effect of expansionary monetary and fiscal policies carried out by the CBA and the Government over the previous months, as well as a low inflation environment at the time. Productivity in the tradable sector of the domestic economy grew steadily in line with improving net external demand and notably adjusted negative current account during the quarter. This facilitated real export to post higher than expected growth rates amid contracted real volumes of import.

As a result of these developments, **although the first quarter's negative GDP gap has narrowed in comparison with the previous quarter**, it is nonetheless in a more negative territory, influenced under supply factors. Considering also that deflationary effects from the external sector were further transmitted onto domestic prices, the 12-month core inflation rate fell during the quarter by 2.4 pp, more rapidly than expected, to -1.7% late in March. During the quarter prices of agricultural products rested at a lower level compared to the previous year amid high growth rates in agriculture and weak domestic demand. As a result of these developments, the **12-month inflation declined faster than expected, amounting to -2.0% at the end of the quarter instead of expected -0.9%**.

Despite a low inflation environment but relatively high inflation expectations still influenced by downside price rigidities and a likelihood of increasing dollarization, as well as taking into account an abrupt easing of monetary conditions at the end of the previous year, the **CBA loosened monetary conditions in the first quarter of 2016 by reducing the refinancing rate by 0.25 pp once in February and once in March, setting it at 8.25%**. A low inflation resulting from such a policy contributes to maintaining the purchasing power, reduction of company costs and gradual decline in inflation expectations.

The CBA revised the 2016 economic growth forecasts upside entirely due to even more positive developments in the industry and services sectors. There is anticipation, however, that economic growth rates will slow down to some extent starting from the second quarter, determined by deceleration of high growth rates in productivity which agriculture and mining industry had enjoyed from the start of the previous year. As a result, ***economic growth in 2016 is expected in the range of 2.7-3.6%***, with the tradable sector, particularly agriculture, mining and services, remaining the main drivers to growth.

In consideration of slower rates of decline of the Russian economy and vanishing expectations of the ruble exchange rate depreciation against the U.S. dollar, the 2016 forecasts of the ***dollar value of net inflow of remittances*** were revised notably upside. As a result, considering increased expectations of economic growth and weak inflation environment, the level of private spending for 2016 was revised upside in anticipation of more positive developments with private consumption and private investment. Therefore, the domestic demand, although still weak, is estimated to persist at the previous year's level as opposed to formerly predicted decline. Considerable easing of monetary conditions, expanding of the state budget deficit and a low inflation environment in 2015-2016 will somewhat facilitate the recovery of domestic demand in 2016. In the event productivity growth in the tradable sector remains sustainable, the external demand will be able to improve substantially in 2016, which will be conditioned by high growth rates of real export and reduced volumes of real import. As a result of these developments, the GDP gap, still in a negative territory, will reduce gradually in 2016.

As for prediction of the period ***2017-2019***, the domestic demand will rebound gradually amid improving external economic environment, recovering growth rates in private remittances and implementation of a number of projects by the Government to promote the tradable sector. At the same time, external demand will continue fostering the economic growth. In the outcome, the GDP gap will reduce gradually in 2017, take a positive value since the second half of 2017 and keep fairly positive throughout the forecast horizon. It is expected that ***economic growth will also accelerate throughout the horizon, drifting within 3.0-4.5%***, which will be largely driven by the tradable sector of the economy. The economic growth forecasts, nevertheless, greatly depend on investments in the private sector, the scale, directions and effectiveness of the projects carried out by the Government as well as on how the developments in the external sector will unfold.

The CBA reckons that the external sector's deflationary impact on domestic prices continues in the short run, which will be neutralized in the second half of this year. The CBA also believes that inflation expectations are reducing relatively fast as a result of consistent monetary policy it conducted. On top of the policy influence, an expected reduction in the natural gas tariff as another factor has been added, and its deflationary impact on headline inflation is about -0.6 pp

(direct impact: -0.36 pp)¹⁰, according to the CBA estimates. Under these developments, the deflationary environment will be persisting in the coming months; later it will weaken gradually and the 12-month inflation rate will approach its target in the forecast horizon.

The CBA considers that easing of monetary conditions at a greater pace in the second quarter of 2016 is relevant. This, coupled with monetary conditions loosened at the start of the previous year, will lead to the expanding of aggregate demand and stabilizing of inflation around the target in the forecast horizon.

Period	Inflation interval forecast probability distribution				
	<1.0%	1.0-2.5%	2.5-5.5%	5.5-7.0%	>7.0%
Q2, 2016	99.9%	0.1%	0.0%	0.0%	0.0%
Q3	98.2%	1.6%	0.0%	0.0%	0.2%
Q4	75.1%	21.2%	3.7%	0.0%	0.0%
Q1, 2017	46.9%	35.3%	17.6%	0.2%	0.0%
Q2	40.1%	36.0%	23.5%	0.4%	0.0%
Q3	26.4%	34.3%	37.4%	1.7%	0.1%
Q4	20.6%	32.3%	44.0%	2.9%	0.3%
Q1, 2018	15.8%	29.4%	49.8%	4.4%	0.6%
Q2	11.3%	25.3%	55.2%	7.0%	1.2%
Q3	7.8%	20.5%	58.4%	10.8%	2.5%
Q4	5.1%	16.1%	59.8%	14.7%	4.3%
Q1, 2019	4.8%	15.5%	59.5%	15.5%	4.8%

Risks to inflation deviating from the projected value are estimated as balanced in the short and medium run. Risks deriving from domestic and external sectors mostly persisted in relation to the previous forecast. In particular, the **external sector risks** are related to the flight of capital to the U.S.A. from developing countries and, consequently, higher volatilities of currencies in developing countries, a likely slowdown of global economic growth resulting from structural reformation of the Chinese economy as well as risks related to developments in international prices of raw materials and food products. **Risks deriving from the domestic sector** are mostly associated with the extent to which external sector's deflationary impact will transmit onto the domestic prices developments in agriculture, a sector greatly depending on weather conditions, the pace at which domestic demand and private investments will recover, as well as Government-led structural reforms. If the aforementioned risks materialize, the CBA will react accordingly by maintaining the inflation target in the medium run.

¹⁰ Based on a letter of claim which "Gazprom Armenia" CJSC and "Transgaz" LLC submitted to the Public Services Regulatory Commission for revision of gas prices (http://www.psrc.am/images/News/2016/hayt/Dimum_Gazprom_Armenia.pdf).

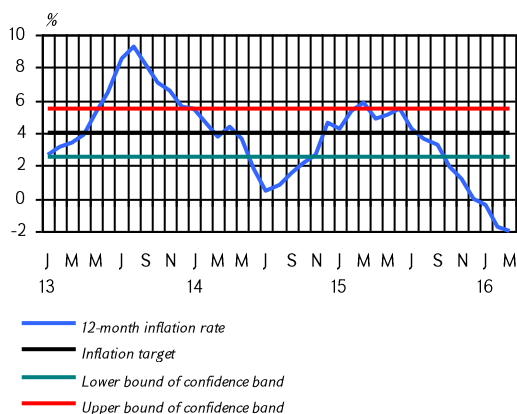
3. Actual developments in Q1, 2016

3.1. Inflation

3.1.1. Actual inflation and fulfilment of the inflation target

In the first quarter of 2016 the 12-month inflation rate declined faster than anticipated, reaching -2.0% at the end of March.

In the first quarter of 2016 the inflationary environment weakened more rapidly than expected



Inflation in the first quarter of 2016 was 0.4% compared to 2.4% in the same reference period last year, under which the **12-month inflation rate** declined faster than anticipated, reaching **-2.0%** at the end of March. The quarter's inflation was driven by 1.3% and 0.5% increases of food prices and service tariffs (total contribution to inflation: 0.7 pp). During the quarter prices of non-food products reduced by 1.3%, with their contribution of -0.3 to inflation. Inflation was low in the first quarter due entirely to prices of agricultural products having reduced y/y and the external sector's deflationary impact partly transmitted onto the domestic prices.

The increase in prices of food products during the quarter was largely attributable to fruit and vegetable and potato prices having risen by 4.6% and 13.5%, respectively (total contribution to inflation: 0.85 pp). The aforementioned prices, however, stood below the previous year's level on the back of strong growth rates in agriculture and weak domestic demand in the economy. Specifically, price decreases were reported in the following groups: "Bread products", "Meat products", "Dairy products", "Fats and Oils" and "Pastry" (total contribution to inflation: -0.38 pp), whereas some price increases were recorded in the following groups: "Egg" and "Sugar" (total contribution to inflation: 0.11 pp).

The group "Services" posted increased tariffs as a result of healthcare, transport, and housing and utility fees having risen by 2.6%, 1.7% and 0.4% q/q, respectively. There was a 1.1% drop in tariffs for communication services.

Price deflation on non-food products was mainly attributable to the prices of import goods, such as garment and knitwear, footwear, household appliances, motor vehicle spare parts, petrol, and detergents, having dropped by 5.0%, 3.9%, 3.0%, 2.0% and 1.3%, respectively.

Inflation by groups serving as key contributors						
Group	December 2015 (y/y)		March 2015 (y/y)		First quarter 2016	
	Growth (%)	Contribution (%)	Growth (%)	Contribution (%)	Growth (%)	Contribution (%)
CPI	-0.1		-2.0		0.4	
Food products	-3.7	-1.81	-5.1	-2.3	1.3	0.6
Bread products	0.4	0.04	-4.1	-0.40	-3.0	-0.29
Meat products	-3.7	-0.35	-5.7	-0.53	-0.9	-0.08
Dairy products	-4.7	-0.22	-5.4	-0.24	-0.1	-0.01
Fats and oils	-7.9	-0.23	-4.7	-0.12	-0.1	0.00
Pastry	11.3	0.15	1.4	0.02	-0.1	0.00
Fruit	-19.5	-0.66	-23.0	-0.61	4.6	0.12
Vegetable and Potato	-4.0	-0.23	-1.0	-0.05	13.5	0.73
Eggs	-20.2	-0.31	-13.9	-0.16	7.4	0.09
Sugar	-10.1	-0.08	-7.9	-0.06	2.5	0.02
Non-food products	3.4	0.70	-1.5	-0.34	-1.3	-0.29
Services	3.2	0.98	2.9	0.93	0.5	0.15

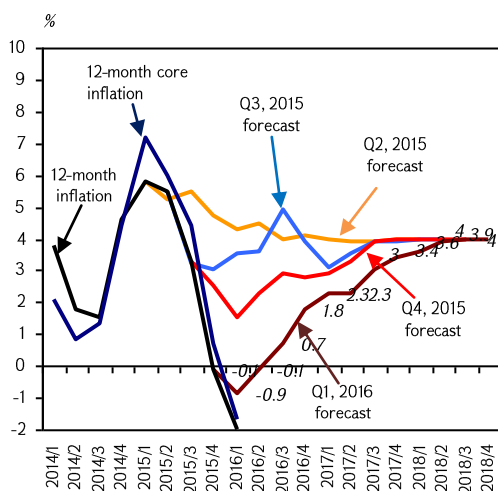
In the first quarter of 2016 core inflation **decreased by 0.7%**, while the 12-month rate fell by 2.4 pp to **0.7%** in late March.

For the previous one-year horizon covering a period from the second quarter 2015 to the second quarter 2016, high inflation environment was forecast to diminish gradually. Influenced by positive developments in agriculture sector that led to higher seasonal decline in food prices and in expectation of weak demand in external and domestic economies, the **12-month inflation rate was to decline gradually**. In this situation the **current level of the refinancing rate was to be maintained**, which would help the 12-month inflation rate stabilize around the target since 2016.

Starting from the second quarter of 2015 the inflation environment gradually eased, as was expected. Positive developments in agriculture resulted in a 4.2% drop in prices in April-September 2015 (food price contribution to inflation: -4.3%), in which case the **12-month inflation rate** had fallen to **3.3%** in end-September from 5.8% in March. Taking into account the low inflation environment and non-inflationary effects from weak demand in external and domestic sectors, as well as existing high inflation expectations (the 12-month core inflation rate was 4.4% during the quarter), the **CBA cut the refinancing rate in August by a total of 0.25 pp to 10.25%**.

In the fourth quarter of 2015 the 12-month inflation rate kept on declining but at a faster pace than expected. This was influenced by further drop in prices in the external sector, which was in part reflected in domestic prices, on the one hand, and the factor of large supply in agriculture, on the other. In addition, this factor has somehow reduced high inflationary expectations. As a result, the fourth quarter saw only 1.9% of inflation compared to 5.4% reported in the same reference period last year, leaving the year to end with the 12-month inflation rate of **-0.1%**.

Inflation environment will gradually expand in the upcoming year and the 12-month inflation rate will approach the lower border of the band and in the rest of the forecast horizon it is expected to stabilize around the 4% target.



In view of end-year developments, the CBA has notably eased monetary conditions in November-December by reducing the refinancing rate by 1.5 pp to **8.75%** at the end of December. It was estimated that inflationary risks arisen from the previous year-end had been largely overcome, and solid easing of monetary conditions made it possible to return to the normal situation that existed before November of 2014.

Trends in international commodity markets were further deflationary and their effect on domestic prices persisted **in the first quarter of 2016**. As well as prices of food products remained at lower levels in relation to the same reference period last year thanks to strong growth in agriculture sector. As a result, inflation amounted to a mere 0.4% in the first quarter compared to around 3.0% inflation on average reported in the last 5 years, in which case the 12-month inflation rate continued reducing to -2.0% in March (contribution of decreased food prices to headline deflation: 2.3 pp).

Despite a low inflation environment, inflation expectations were estimated to be relatively high amid downside price rigidities and a likelihood of increasing dollarization, and an abrupt easing of monetary conditions at the end of the previous year was largely sufficient to neutralize the deflationary pressures during the year. In the first quarter, therefore, the CBA loosened monetary conditions, cutting the refinancing rate in February and March by 0.25 pp each time to **8.25%**. A low inflation resulting from such a policy was to contribute to maintaining the purchasing power, reduction of company costs and gradual decline in inflation expectations. In the outcome, the deflationary environment will gradually ease starting from the second half of the year and the 12-month inflation rate will approach the target in the forecast horizon.

3.1.2. Import prices and producer prices

Import prices: in the first quarter of 2016 the dollar prices of import of goods and services fell by 1.9% q/q along with price decrease in international markets. However, the declining has somewhat slowed down in comparison with the previous reference period to 4.2% y/y.

The y/y reduction in dollar prices of import was attributable to prices of goods and services having fallen by 3.7 and 0.5 pp, respectively. The y/y decrease in dollar prices of import of goods was driven mostly by prices of intermediate goods declined as a result of falling international prices of oil, iron ore, wheat and aluminum, as well as the depreciation of the currencies of the partner countries.

The y/y falling of dollar prices of consumer goods owed mainly to y/y decrease in dollar prices in China, Russia and Turkey. Consumer goods had a 0.5 pp of negative contribution.

In the first quarter of 2016 dollar prices of import of goods and services declined at a slower pace, (y/y, %)



Producer prices¹¹: price developments in different sectors of the economy in the first quarter of 2016 suggest that the GDP deflator remained unchanged in comparison with the same reference period last year.

Industry reported 3.9% y/y drop in prices during the year due to falling prices in mining (17.5%) and processing industry (1.6%). The falling of prices in mining, which saw the highest price decline, was driven by the decrease in prices of non-ferrous metals in the international market.

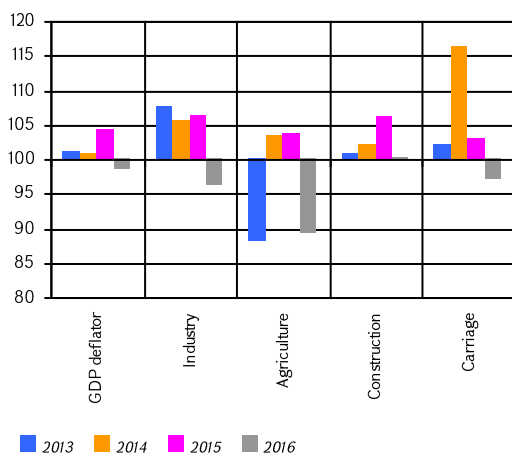
Agriculture saw 10.8% y/y fall in prices¹² during the quarter as a result of decreased prices in animal breeding (22.2%) and plant growing (8.8%).

The price deflation in plant growing was driven mainly by reduced prices of potato and gourds and melons (20.8%), grain crops (2.7%), forage crops (23.6%) and fruit and berries (32.1%). The decline in prices in animal breeding was attributable to reduced prices of milk, dairy products (11.3%), eggs (15.3%) and meat (7%).

Construction posted 0.4% y/y price increase in the first quarter primarily owing to increased costs in construction and assembly works (0.2%) and equipment and materials (0.3%).

Carriage service reported 3% y/y decline in tariffs in the first quarter as a result of reduced fare of railroad transport (3.4%) and motor transport (7.4%). The highest decrease in tariffs recorded in motor transport was mainly driven by fallen prices of petrol and diesel.

In the first quarter of 2016 highest price inflation was seen in construction



3.1.3. Inflation and interest rate expectations

The financial sector survey by the CBA for the first quarter of 2016 denotes that households' inflation expectations for an upcoming one-year horizon have reduced notably, reflecting the fallen prices of goods, net of seasonal agricultural products, and the actual inflation with an abruptly sloped-down path. Estimations produced on a basis of the CBA's core model suggest that inflation expectations reduced faster this quarter than expected, amounting to 2.2%, mainly thanks to the consistent monetary policy carried out by the CBA.

During the quarter, the CBA continued its surveys with the financial sector and households in order to figure out their expectations of selected macroeconomic indicators. The average level of inflation expectations in the financial system is 3.5% in the upcoming one-year horizon compared to the relevant indicator of 4.2% reported in the previous survey. Thus, **commercial banks** had their expectations of the 12-month inflation rate anchored around a **3.3%** level against the average figure of **4.3%** reported in the previous survey; **credit organizations'** expectations have averaged **3.6%** compared to the

According the CBA's core model, inflation expectations reduced faster in the first quarter of 2016 than expected, amounting to 2.2%.

¹¹ The price index change for January-March 2016 is relative to the same reference period last year, unless otherwise specified.

¹² Sales prices of producers of agricultural product are presented.

previous indicator of **4.3%**; households had their inflation expectations of the 12-month inflation rate around a **2.0%** level compared to a relevant indicator of **2.8%** reported in the previous quarter's survey.

In the first quarter of 2016 the interest rate channel again demonstrated how an expansionary monetary policy of the CBA transmitted its impulse on interest rates in the financial market, affecting mostly downward. This in turn reflected the financial market's expectations for interest rates. According to the survey results, the financial system still expects gradual reduction of interest rates on funds attracted and allocated, for a one-year perspective.

3.2. Aggregate supply and aggregate demand

3.2.1. Aggregate supply¹³

The **economic growth indicator** published by the National Statistics Service of Armenia for the fourth quarter of 2015 was 1.1% y/y, in which case the economic growth in January-December has been 3% y/y, which is slightly below the previous forecast of the CBA.

In the first quarter of 2016 the economic activity indicator was 5.6% y/y, which exceeded expectations thanks to higher output volumes in services.

As a result, economic growth in the first quarter of 2016 is estimated in the range of 4.8-5%¹⁴.

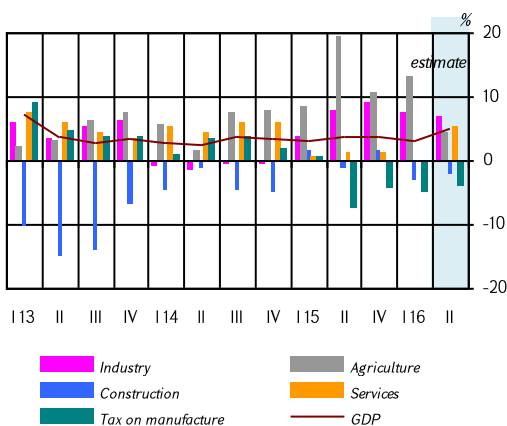
Taking into account an increased output of 8.9% y/y reported in **Industry** in the first quarter of 2016, the growth of value added here for the quarter is estimated within 6.5-7% y/y. This is mainly due to increased output volumes in ore and minerals (27.7%), mining industry (34%), beverage (17.5%), tobacco (51.1%), jewelry crafting (41.7%), furniture (72.6%), clothing (49.2%), chemical products (10%) and water supply and sewage (4.9%). It should be noted that there has been as much as 28% increase in electricity production, as well.

Based on actual output volumes (-2.2%) reported in **Construction** for January-March 2016, the decrease of value added for that period is estimated at 2-2.5% y/y. Save for the volumes of construction financed by local budgets (5.7% growth) and international loans (4.1-fold growth), all other sources of financing reported a decrement, as follows: construction financed by households (-18.5%), state budget (-34.1%), humanitarian aid (-70.8%) and organizations (-24.7%).

The growth of value added in **Services** for the first quarter of 2016 is estimated in the range of 5-5.5% y/y, which is a result of 9.6% growth in services provided but 1.1% contraction in trade. The increment in

The economic growth in the first quarter of 2016 is estimated in the range of 4.8-5%.

Actual real GDP and economy sector cumulative growth rate, y/y



¹³ The indicators of y/y real growth of value added in sectors of the economy for January-March 2016 are the CBA forecasts, whereas the indicators of sub-sectors represent y/y growth rates in output volumes for January-March 2016, unless otherwise specified.

¹⁴ See the 50% range in Real GDP Growth (Cumulative) Projection Probability Distribution Chart.

services provided was fueled by the growth reported in financial and banking services (2.8%), information and communications services (3.1%), events, leisure and rest services (46.1%), real estate services (10.6%) and transportation services (25.7%). High growth in transportation services owed to companies specialized in the carriage of ore and minerals.

The decline in trade resulted from contraction of retail trade and car sales, by 4.8% and 1.3%, respectively.

The growth of value added in **Agriculture** for the first quarter of 2016 is estimated in the range of 4-4.5% y/y, which is a result of increased output in animal breeding, plant growing and fish growing, by 2.9%, 12.4% and 7.5%, respectively. The growth in animal breeding was driven by increased production of milk (2.9%), eggs (9.7%) and livestock and poultry sales (2.7%).

3.2.2. Aggregate demand¹⁵

There was smaller decline in private spending in the first quarter of 2016 compared to previous forecasts, and it is estimated at around 2.0%.

There was smaller decline in private spending in the first quarter of 2016 compared to previous forecasts, and it is estimated at roughly 2.0%. This was due to a smaller-than-expected contraction in trade turnover and much higher economic activity in the first quarter. It is noteworthy that the decline in private consumption in the first quarter of 2016 came in rather decelerated in comparison with the contraction recorded in 2015.

Shrinking of remittances from Russia, a trend observable since end-2014 and persisted over 2015, has negatively affected the households' disposable income, which led to reduced private consumption costs throughout 2015 and in early 2016. It should be noted, however, that the decline in private spending has diminished considerably thanks to a CBA policy steered to ease monetary conditions since 2015, as well as a low inflationary environment.

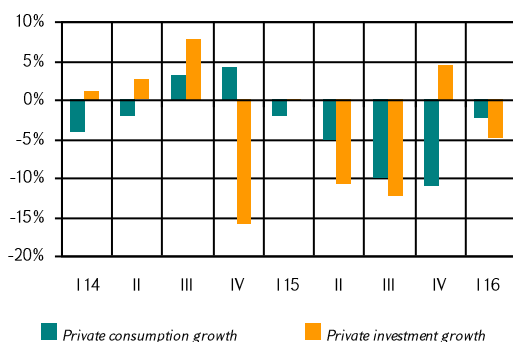
The results of the CBA surveys and trade turnover indices calculated by the National Statistics Service of Armenia also point to the contracted consumption in the private sector. In the first quarter of 2016 the Consumer Confidence Index was 42.3, which is below its stability range of 45-55, reflecting the reduced consumption costs of households in the period under review, and the Current Consumption Index was 33.5. In first quarter of 2016 trade turnover decreased by 1.3% against the same reference period last year.

Investment climate in the economy was weak in the first quarter of 2016, which is in line with forecasts, with private investment having decreased by about 5.0% in relation to the same period of the previous year.

In the first quarter of 2016 the investment climate in the economy was weak – consistent with forecasts– with private investment having decreased by about 5.0% in relation to the same period of the previous year. The decline in private investment was determined by reduced domestic demand and contracted output volumes in construction. As it was outlined in the CBA's previous forecasts, the decline in investment

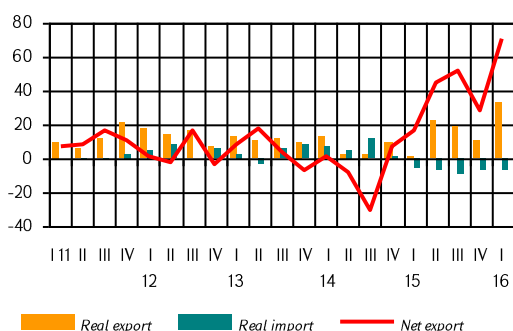
¹⁵ The private spending, private consumption and private investment indicators for the first quarter of 2015 are the CBA estimates which are based on the actual fourth quarter 2015 data. The growth estimates provided in this sub-section are relative to the same reference period last year, unless otherwise specified.

Private consumption and investment growth, y/y

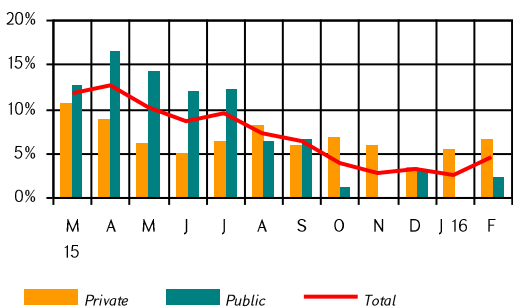


Net real export improved considerably in the first quarter of 2016

(net real export, y/y %, positive sign means improvement)



Nominal wage growth, y/y



had been more pronounced in non-tradable sector of the economy, whereas investment activity was relatively strong in tradable sector.

The results of the CBA surveys on business environment at companies point to the aforementioned developments in investment climate in the period under review. According to the survey results, the business activity indicator in non-tradable construction sector in the first quarter was 37.0, which is below the stability value of 50.0. On the other hand, the business activity indicators in tradable industry and non-trade services sectors were above the stability value of 50.0, amounting to 52.8 and 52.1, respectively.

As a result of private consumption and investment developments described above, private spending contracted by 2.5% in the first quarter. With about 1% decrease in public expenditures, domestic demand is estimated to have posted 2.0% decline, which is smaller in relation to the decrease reported in 2015. The decline in domestic demand in 2015 and the first quarter of 2016 slowed down notably as a result of easing of monetary conditions by the CBA.

In the light of the aforementioned developments, the private spending gap in the first quarter of 2016 is estimated negative, creating **1.8-2.1 pp of deflationary pressures** in the consumer market.

According to the CBA estimates, real net export improved sufficiently in the first quarter, which was determined by a record high growth of real export of goods and services amid reduced real import of goods and services. In the first quarter of 2016 growth rates of real export of goods and services amounted to 32.9% y/y as opposed to 7.5% y/y decline in real import of goods and services¹⁶. Real export growth was mainly due to high growth in export of copper, electricity, tobacco and alcohol.

The pace at which seasonal worker remittances and private transfers narrowed slowed down in the first quarter of 2016, reflecting somewhat a slower decline in Russian economy.

3.2.3. Labor market¹⁷

In the first quarter of 2016 the **average nominal wage growth rate** was consistent with previous forecast of the CBA; it is estimated at 3.5%. In the period under review the private sector wage growth outpaced the public sector wage growth.

The effect of wage increases in some areas of public sector since July of 2014 phased out in the third quarter of 2015. Starting from October, the wage growth in public sector slowed down. As a result, in the first quarter of 2016 the rate of wage growth decelerated against the previous reference period's high base and stood at 1.0%.

In the first quarter of 2016 the private sector's nominal wage growth rate decelerated by 2.0 pp against the relevant indicator of the previous

¹⁶ Real export and import growth indicators are the CBA estimates.

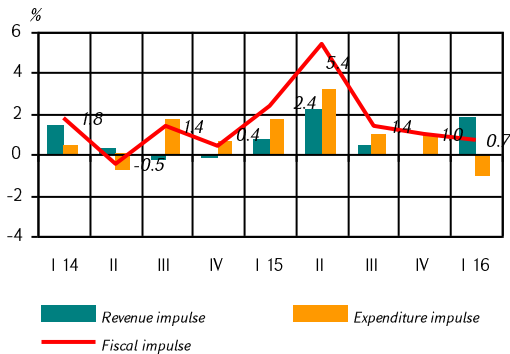
¹⁷ The labor market data for the first quarter of 2016 are the CBA estimates which are based on the fourth quarter 2015 data and actual January-February 2016 figures. The growth indicators provided in this sub-section are relative to the same reference period last year, unless otherwise specified.

reference period to 6.0%, which is conditioned by a deflationary environment in the economy.

The growth of productivity reported in the economy in 2015 persisted over the first quarter of 2016. This resulted in reduced labor demand in the economy. As a result, the **unemployment rate** in the first quarter was in line with previous forecasts and is an estimated 19.3%.

As a result of the aforementioned developments, in the first quarter of 2016 the productivity growth outpaced the wage growth and left a 0.5% of deflationary impact on consumer prices.

In the first quarter of 2016 the fiscal policy had a less expansionary impact compared to the same reference period last year (according to actual data)



In the first quarter the fiscal sector's impact on aggregate demand was 0.7 expansionary instead of the projected neutral, according to the fiscal impulse indicator.

3.2.4. Fiscal policy¹⁸

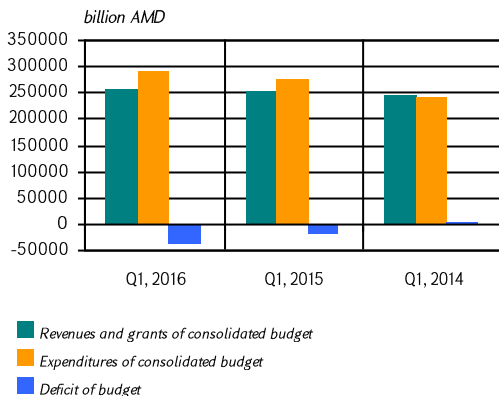
In the first quarter of 2016 the Republic of Armenia State Budget was performed with revenues consistent with the quarter's projections and expenditures having reported savings on some articles. Government spending for the quarter was slightly higher from the figure forecast by the CBA¹⁹, which is why the fiscal sector's impact has been assessed as expansionary instead of the expected neutral. The fiscal sector's impact on aggregate demand amounted to 0.7 expansionary instead of the projected neutral, according to the fiscal impulse indicator. The revenues impact was 1.8 expansionary and the expenditures impact 1.1 contractionary.

In the first quarter of 2016, relative to the same reference period last year, consolidated budget revenues and grants grew by 0.7%; tax and other revenues reduced by 1.6% and grants increased by 3.4-fold; tax revenues and duties of state budget decreased by 0.6% y/y mainly at the expense of value added tax and customs duty. The state budget's quarterly plan was fully performed with regard to taxes and duties. In the first quarter of 2016, relative to the same reference period last year, indirect taxes shrank by 8.3% but direct taxes grew by 10.4% and other tax revenues increased by 12.7%. The share of indirect taxes contracted by 4.7 pp to 48.1% whereas the share of direct taxes grew by 3.7 pp to 42.7% and the share of other taxes, by 1.0 pp to 9.2% in total.

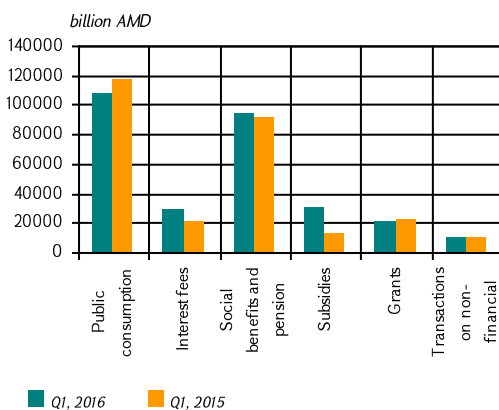
Other revenues decreased by 44.2% against the previous reference period due to reduced interest on loans granted to residents.

Government grants amounted to AMD 8.3 billion. The figure exceeded the first quarter's plan as more has been received under a target PIU grant program, on the one hand, and the AMD 2.0 billion-worth grant projected in the previous year's budget (under the European Neighborhood Policy framework) has been received in the first quarter of 2016, on the other.

Consolidated budget indicators



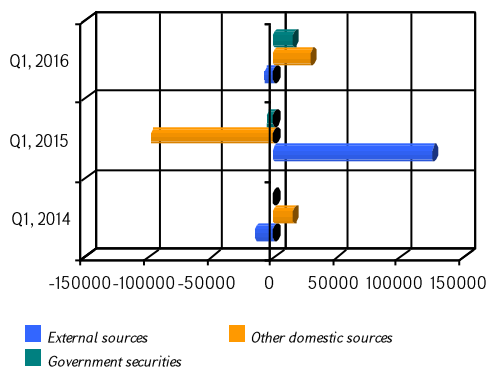
In the first quarter of 2016 budget expenditures posted an increase on current expenditures



¹⁸ The review of the fiscal sector was done using the preliminary actual consolidated budget indicators prepared on the basis of preliminary actual indicators of the first quarter of 2016 (PIU funds included), excluding off-budgetary funds. The impact of revenues was calculated in respect of the nominal GDP indicator while the impact of expenditures, in respect of an estimated economic potential.

¹⁹ Actual public sector indicators were compared with the CBA projections; note that the CBA projections on revenues were in line with quarterly revenue proportions.

In the first quarter of 2016 and of 2015 state budget ran with deficit (billion AMD)



In the first quarter of 2016 actual expenditures amounted to 89.3% of the plan²⁰ adjusted for the quarter. Relative to the CBA projection, expenditures slightly outstripped the forecast, amounting to 101%. Compared to the same period last year, there was a 6.8% increase in consolidated budget expenditures, which was mainly due to the current expenditures. Relative to the same period last year, public consumption has decreased by 8.7%; it stood behind the previous year's figure due to the change in the principle²¹ of financing the preschool and general education establishments. The public debt interest payments outgrew the previous year's relevant indicator by 39.2%, primarily due to increased amount of servicing costs.

Government subsidies exceeded the previous year's relevant indicator by 2.6-fold (AMD 18.3 billion), mostly owing to the changed principle of education financing, as well as increased subsidies to organizations in agricultural and water supply sectors.

In the meantime, expenditures on item ***“Transactions with non-financial assets”*** remained unchanged against the previous year. Expenses financed from external sources grew by 37.5% while expenses financed domestically reduced by about 8%.

With the above revenue and expenditure indicators in the first quarter, the state budget generated a deficit of roughly AMD 37.4 billion as compared to the CBA projection of AMD 41.6 billion (planned deficit adjusted for the quarter: AMD 76.5 billion). The deficit has been entirely financed at the expense of government securities and other domestic sources. Specifically, net proceeds from placement of T-bills in the first quarter amounted to AMD 15.7 billion.

In the first quarter of 2016 the fiscal policy had a minor expansionary impact on aggregate demand.

Summary: reduced private transfers from Russia as well as sluggish investment activity in the domestic economy dampened the spending in the private sector in the first quarter of 2016. However, fiscal stimulus delivered to the economy as well as continued easing of monetary conditions by the CBA during 2015 secured a slower contraction of private spending while softening the domestic economy's slowdown and deflationary environment.

In the first quarter of 2016 the private spending gap is estimated as negative. Given also the inflationary behavior of the fiscal policy but deflationary patterns reported for net exports and labor market, the aggregate demand and labor market are estimated to have jointly created 2.6-2.8 pp of deflationary pressures in the consumer market in the first quarter.

²⁰ The revenue and expenditure indicators as established in the Republic of Armenia Law on State Budget are subject to revision under separate decisions issued by the Government within the scope of Government mandate, and are available at www.e-gov.am.

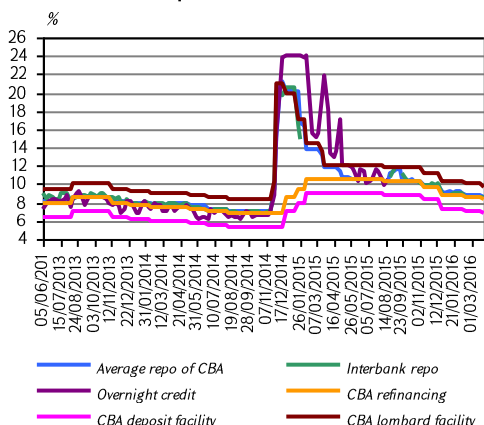
²¹ Last year it was regarded as procurement of contractual services and, starting from 2016, as providing of subsidies to these organizations.

3.3. Money and financial market developments

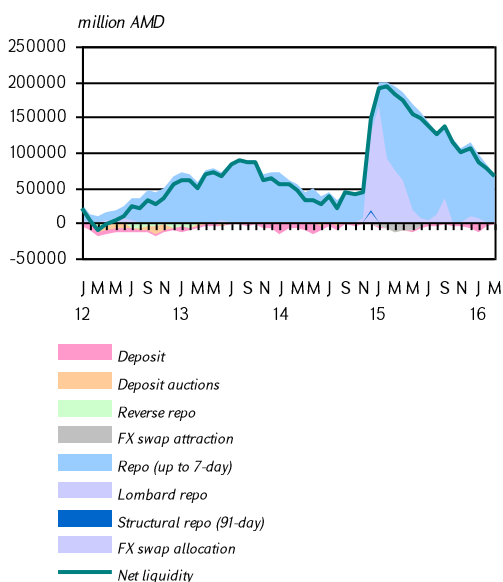
3.3.1. Financial market, money and credit

In the first quarter of 2016 the CBA Board lowered the refinancing rate by 0.25 pp in February and that much in March.

During the quarter short-term interest rates came in around the CBA's repo rate



Liquidity injection and absorption through the CBA operations (monthly average)

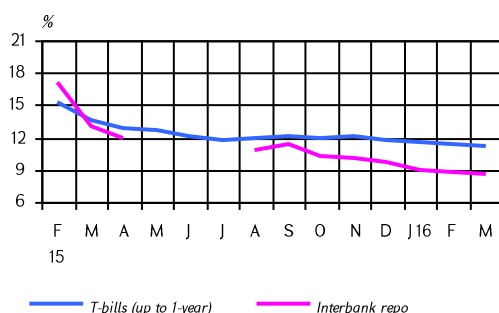


Operations carried out by the Central Bank (average transaction value)

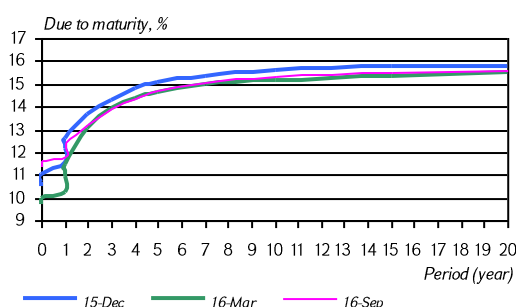
Period	Repo (up to 7 days)		Funds attracted		Lombard repo	
	Value (million AMD)	Weighted average %	Value (million AMD)	Weighted average %	Value (million AMD)	Weighted average %
Q1, 2014	58,769.52	7.80	8,230.77	6.17	297.76	9.05
Q2	41,619.24	7.79	9,908.46	5.88	41.38	8.75
Q3	37,331.05	7.16	3,270.00	5.47	16.08	8.43
Q4	34,048.94	10.60	1,765.67	5.25	41,550.14	19.69
Q1, 2015	95,454.55	14.25	63.75	8.04	104,521.49	16.27
Q2	141,919.97	11.02	1,857.26	9.00	27,967.60	12.00
Q3	119,429.03	10.72	3,639.62	8.95	17,089.82	11.78
Q4	107,621.63	9.97	6,496.15	8.17	4,048.49	11.07
Q1, 2016	78,642.66	8.92	5,687.19	7.22	2,458.35	10.21

In the first quarter of 2016 the interbank repo rate behaved similarly in reacting to the CBA policy signal. In March it averaged 8.64%, reducing by 1.11 pp against December.

Short-term interest rate dynamics in the first quarter of 2016



In the T-bills market in the first quarter of 2016, yields declined along the entire curve



Government securities market

The effect of continuous easing of monetary conditions has passed on to the T-bills market, too. Although interest rates in this market are slightly higher than other money market instruments, the yields on T-bills behaved in line with the policy rate during the first quarter of 2016. The average quarterly rate of return on T-bills reduced by about 0.6 pp against the previous quarter to 11.33%. The same rate of decline was seen in March against December, with the average yield having reached 11.16%.

The falling of interest rates in the financial market led to a changed position of the T-bills yield curve. At the end of March of 2016, relative to previous December, the yields have squeezed along the entire curve, especially in the short-term segment where the yield on T-bills with up to 1-year maturity decreased on average by 1.05 pp and long-term interest rate by 0.3 pp to 15.5%. As a result, the long-term and short-term interest rates spread widened in March by 0.5% to 5.8 pp, owing to a sizable decrease in short-term rates.

Overall, the average rate of return on T-bills with up to 1-year maturity has dropped by about 1.5 pp after reduction of the refinancing rate by 2.0 pp by the CBA in the period from September 2015 up to end-March 2016.

In the first quarter of 2016, relative to the previous quarter, average interest rate of local currency deposits with up to 1-year maturity attracted from legal persons has reduced by 3.8 pp and, by 4.8 pp in March against December, to 8.3%. The average interest rate of local currency deposits with up to 1-year maturity attracted from households has decreased by 0.6 pp. That much was the change in average interest rate in March against December, from 15% to 14.4%. Average quarterly interest rate of local currency deposits with over 1-year maturity attracted from households has dropped by 0.4 pp to 14.2% in March whereas that of attracted from legal persons has grown by 0.8 pp to 8% in March. Gradual reduction of the refinancing rate by the CBA since August of 2015 and increased liquidity are among the factors that facilitated the falling of interest rates of funds attracted by banks.

Notwithstanding the plunge in interest rates of local currency deposits during the quarter, which was most pronounced for funds with up to 1-year maturity, there was as much as 7.1% increase in volume of funds attracted in local currency in the first quarter of 2016. The increase owed entirely to time deposits in dram while the volume of demand deposits reduced during the quarter.

In the first quarter of 2016, relative to the previous quarter, average interest rate of foreign currency deposits with up to 1-year maturity attracted from legal persons has grown by 1.9 pp to 7% in March. The average interest rate of foreign currency deposits with up to 1-year

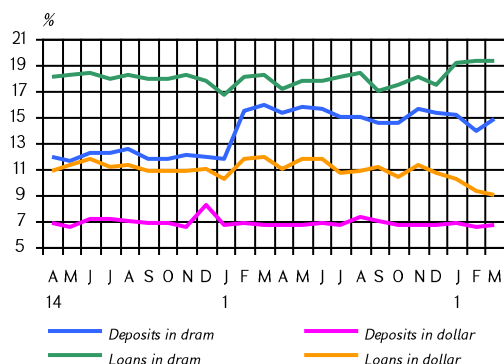
maturity attracted from households has fallen by 0.2 pp to 5.4% in March. Average quarterly interest rate of foreign currency deposits with over 1-year maturity attracted from both legal persons and households has dropped by 0.1 pp to 8% and 7%, respectively, in March. The volume of foreign currency deposits grew by 2.9% during the quarter, with demand and time deposits having almost equally contributed to such growth. The change in the reserve requirement mechanism has fostered the shaping of interest rates of foreign currency funds²².

Generally, financial intermediation in Armenia is influenced by the monetary policy's lagged impact, macro-prudential measures aimed at maintaining financial stability and commercial banks' policies deriving from expectations about developments in the economy. Furthermore, first quarter 2016 surveys about the terms of lending provided by local banks and credit organizations pointed to an increased competition among these banks and credit organizations, facilitation of lending procedures for nearly all types of loan products and some drop in lending rates concomitant with interest rate trends in the financial market. In an environment of high dollarization of liabilities, banks prefer to deepen their intermediation in foreign currency in order to reduce currency risks. **All these factors have influenced the shaping of interest rates and volumes of lending.** The lowering of the policy rate affected the market of up to 1-year maturity loans in local currency provided to households. The average quarterly rate in this segment of the market fell by 0.1 pp and, in March against previous December, by 0.5 pp. The total lending volume in local currency in March of 2016 has increased by 0.6% in comparison with December of 2015.

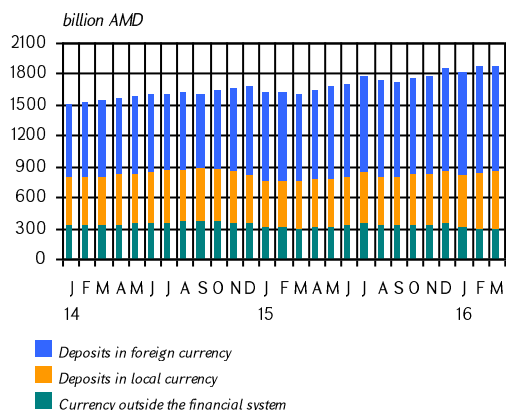
Average quarterly interest rate of foreign currency loans with up to 1-year maturity provided to legal persons has reduced by 1.9 pp. Average quarterly interest rate of loans with over 1-year maturity, which constitutes the largest share in lending to businesses, has shrunk by 0.5 pp. No significant shifts were reported in interest rates of other types of foreign currency loans. The total lending volume grew during the quarter by 2.2%, or 2.9%, if the effect of varying exchange rate is excluded.

Overall, the first quarter of 2016 saw acceleration of credit growth, a trend observable since the previous quarter: as of the end of the first quarter in relation to December 2015 and throughout a 12-month period, the credit growth has been nearly 2%. Most of the growth in lending in the first quarter owed to the loans to enterprises, with foreign currency loans having outgrown local currency loans. In this quarter's lending portfolio foreign currency loans prevailed, constituting roughly 64% in total.

Interest rates of funds in local currency and foreign currency

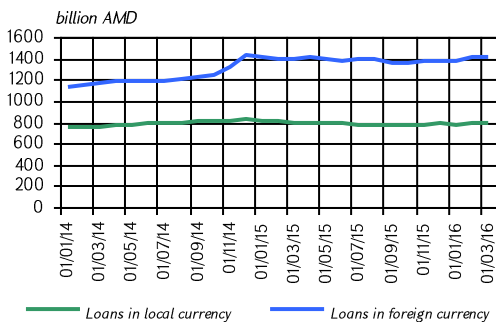


In the first quarter of 2016 deposits in both local and foreign currency grew

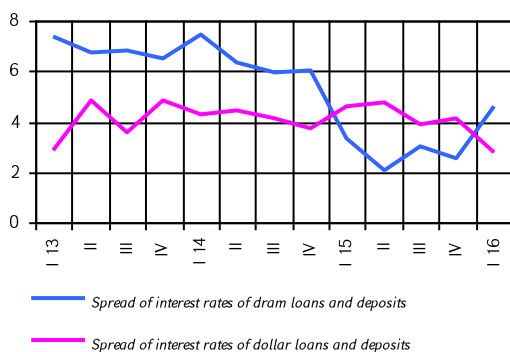


²² The lowering of the reserve requirement ratio for long-term funds in foreign currency has reduced costs to attract deposits in foreign currency. See "Inflation Report", Q1, 2016, Box 3.

In the first quarter of 2016 the foreign currency loans again outgrew the local currency loans



In the fourth quarter of 2015 the spread of interest rates of dram loans and deposits narrowed



Box 3

According to the results of the first quarter 2016 survey on terms of lending by local banks and credit organizations, there has been easing of the terms of lending virtually in all directions. This was set to achieve through increased competition between financial institutions (in a sense that they offer customers various promos), and revised terms in refinancing programs to name a few, which led to the facilitating of requirements to loan interest rates, non-interest payments, maturity and collateral. Demand for business loans remained sluggish. The quarter saw a slackened demand for loans by major companies, which had been identified back in the fourth quarter 2015 survey. Demand for loans by households has grown as the amendment to the Republic of Armenia Law on Income Tax (Article 8.2), providing for a refund of interest payable on the loan servicing, led to an increased demand for mortgage loans.

Ahead of the second quarter of 2016, banks and credit organizations anticipate easing of procedures for all types of credit, along with a growing supply of loans in all directions, and generally positive expectations for credit demand.

Monetary indicators	March 15, 12-month growth	June 15, 12-month growth	September 15, 12-month growth	December 15, 12-month growth	March 16 12-month growth
Broad money (%)	4.1	6.3	7.3	10.8	16.9
Dram broad money (%)	-4.4	-4.2	-8.6	5.2	12.1
Base money (%)	1.6	14.7	22.1	3.9	7.3
Dram base money (%)	19.6	19.6	15.7	-1.6	0.7
Currency (%)	-9.8	-6.7	-10.6	-0.8	0.1
Deposits in local currency (%)	-0.5	-2.5	-7.2	9.6	19.8
Deposits in foreign currency (%)	13.0	17.9	26.2	16.3	21.2
	Mar 15	Jun 15	Sep 15	Dec 15	Mar 16
Dollarization (rate)	51.6	51.2	52.6	52.2	53.4
Money multiplier (rate)	2.02	2.06	1.95	2.01	2.20
Dram multiplier (rate)	1.11	1.15	1.15	1.17	1.24

Ahead of the second quarter of 2016, banks and credit organizations anticipate easing of procedures for all types of credit, along with a growing supply of loans in all directions, and generally positive expectations for credit demand.

3.3.2. Exchange rate

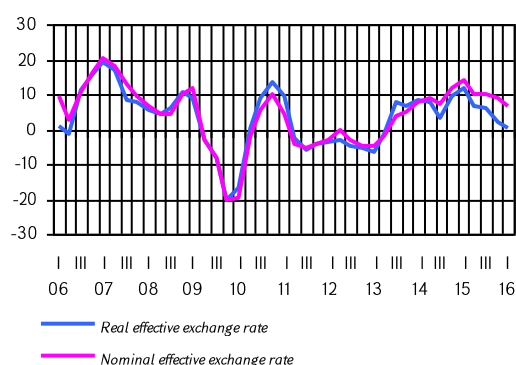
In the first quarter of 2016 trade partner countries saw depreciation pressures in their foreign exchange markets. During the quarter the partner countries' average weighted nominal exchange rate depreciation versus the US dollar was 3.6%, largely driven by depreciated Russian ruble, Ukrainian hryvnia and Chinese yuan (contribution: 2.5, 0.9 and 0.3 pp, respectively). With partner

countries' national currencies depreciating, the average nominal exchange rate of the Armenian dram appreciated versus the US dollar by 2.1% in the first quarter. To absorb short-term volatilities deriving from balance sheet seasonality, the CBA sold nearly USD 94.6 million in net terms in the foreign exchange market.

In the first quarter of 2016 the nominal effective exchange rate of the Armenian dram posted an average 1.5% q/q appreciation amid partner countries' currency depreciation versus the US dollar. In the meantime, the real effective exchange rate has appreciated by 3.6% q/q²³.

In the first quarter, relative to the same reference period last year, the real effective exchange rate has appreciated by 0.2%. It is noteworthy that relatively low inflation in Armenia is a fundamental factor that adds to the attractiveness of the domestic real exchange rate and the country's external competitiveness, as the partner countries' exchange rates depreciation was considerable while that of the Armenian dram a little.

In the first quarter of 2016 the real effective exchange rate depreciated y/y, (%)

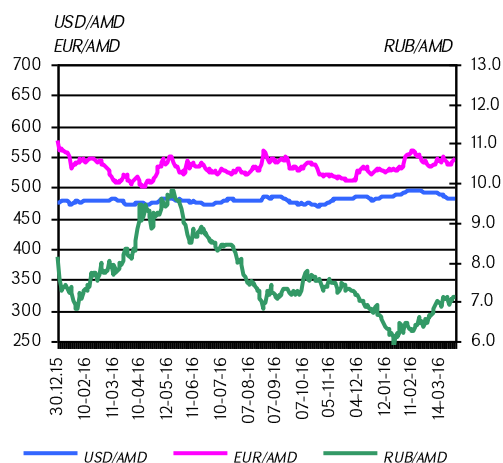


Growth y/y, (%)	Q1, 2014	Q2	Q3	Q4	Q1, 2015	Q2	Q3	Q4	Q1, 2016
Real effective exchange rate (+ means appreciation)	8.5	7.8	3.1	9.2	11.7	6.7	5.8	2.2	0.2
Average inflation in Armenia	4.6	3.3	1.0	3.2	5.2	5.1	4.4	1.0	-1.2
AMD/USD average nominal exchange rate (+ means appreciation)	-0.4	0.5	0.0	-5.7	-13.9	-13.4	-14.8	-10.1	-2.3
Average weighted inflation in trade partner countries	3.7	4.4	4.6	5.1	6.7	7.9	7.5	6.9	4.9
Trade partners' average weighted nominal exchange rate (+ means appreciation versus dollar)	-8.0	-8.6	-7.0	-18.5	-32.1	-27.2	-29.4	-20.7	-9.1

Real exchange rate appreciation = Inflation in Armenia + Nominal exchange rate appreciation – Trade partners' average weighted inflation – Trade partners' average nominal weighted exchange rate appreciation.

Box 4

Armenian dram's exchange rate versus US dollar, Euro and Russian ruble



Foreign exchange market

As of end of the first quarter of 2016 the average market exchange rate of USD/AMD was 480.79, having appreciated by 0.62 relative to the end of the previous quarter.

The table below shows the Armenian dram exchange rate dynamics to the US dollar, the Euro and the Russian ruble during the first quarter of 2016.

The dram's exchange rate: end of Q1, 2016 to end of Q4, 2015			
Currency pair	Exchange rate as of 30.12.2015 (AMD)	Exchange rate as of 31.03.2016 (AMD)	% (appreciation «+», depreciation «-»)
USD/AMD	483.75	480,79	+0,62
EUR/AMD	528.69	546,47	-3,25
RUB/AMD	6.62	7,14	-7,28

²³ The first quarter 2016 indicator of the real exchange rate is the CBA estimate.

The dram's exchange rate: Q1, 2016 to Q1, 2015			
Currency pair	Average exchange rate, Q1, 2015	Average exchange rate, Q1, 2016	% (appreciation «+», depreciation «-»)
USD/AMD	477,26	488,67	-2,33
EUR/AMD	538,40	538,95	-0,10
RUB/AMD	7,61	6,53	+16,54

The aggregate volume of U.S. dollar/Armenian dram transactions in the foreign exchange market in the first quarter of 2016 amounted to USD 1.81 billion, decreasing by 26.12% (AMD 2.45 billion) against the same reference period last year.

The aggregate volume of Euro/Armenian dram transactions carried out during the first quarter reached EUR 165.15 million, which is a 17.18% decrement against EUR 199.42 million reported in the first quarter of 2015.

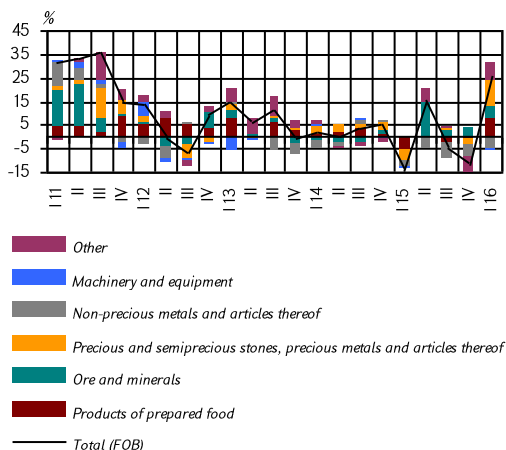
The aggregate volume of Russian ruble/Armenian dram transactions in the first quarter of 2016 totaled RUB 15.73 billion, which represents a 63.85% (RUB 9.60 billion) increase compared to the relevant figure recorded in the first quarter of 2015.

3.4. Balance of payments²⁴

In the first quarter of 2016 the deficit of trade balance began narrowing pretty much faster in comparison with the same quarter last year, in spite of worsening of terms of trade²⁵. Real export volumes are rather high and grow steadily in recent years, reflecting the structural shifts in the economy in benefit of the tradable sector. The decline in seasonal workers' remittances and private transfers has slowed down. As a result, in the first quarter of 2016 the current account ran with a small negative balance, while net external liabilities of the economy reduced.

The dollar value of export of goods posted as much as 26.4% y/y increase in the first quarter of 2016.

Change in dollar value of export of goods, y/y, and main commodity group contribution²⁶



3.4.1. Current account

In the first quarter of 2016, relative to the same reference period last year, the current account deficit-to-GDP ratio has improved by about 12.0 pp, mainly due to substantially adjusted trade balance. The current account deficit has reduced by USD 227.0 million compared to the first quarter of 2015 to USD 28.8million this quarter.²⁶

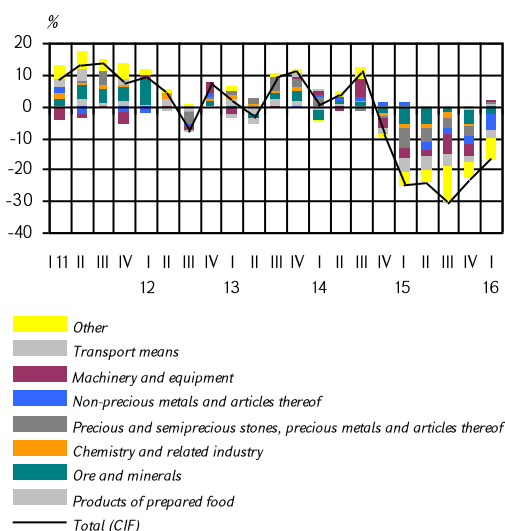
²⁴ The first quarter 2016 balance of payments will be published at the end of June of 2016, according to the timetable. The first quarter 2016 indicators are the CBA's forecasts and estimates.

²⁵ The y/y decrement of dollar prices of export has notably outpaced the y/y falling of dollar prices of import, according to estimates.

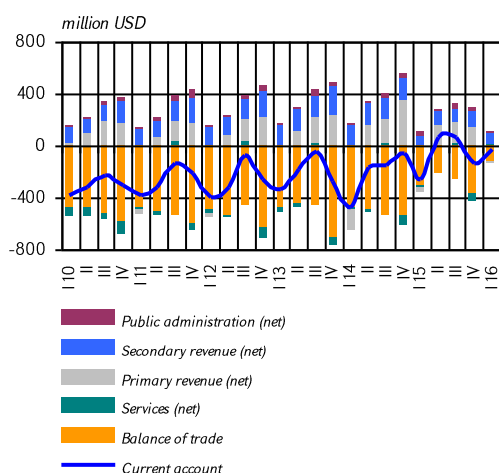
²⁶ Արդյապատեղի և ներմուծման ըստ ապրանքախմբերի ցուցանիշները ներկայացված են համապատասխանաբար ՖՕՔ և ՄԻՖ գներով:

The dollar value of imports of goods has decreased by 15.9% y/y.

Change in dollar value of import of goods, y/y, and main commodity group contribution



In the first quarter of 2016 the current account deficit reduced considerably



The dollar value of export of goods posted as much as 26.4% y/y increase²⁷ in the first quarter notwithstanding a sluggish external demand and falling dollar prices of export. High growth of real export was determined by sustainable productivity growth in the tradable sector. The dollar value of import of goods has decreased by 15.9% y/y due to dropped import prices and continued contraction of volumes.

The trade balance deficit shrank in the first quarter by USD 185.5 million to USD 119.0 million, as a result of high growth of exports and reduced imports.

The increase in the dollar value of export in the first quarter of 2016 was mainly attributable to the growth of export of consumer goods and precious metals. Recovering of export of alcohol, which subsequently followed a stabilization path, and continued strong growth of export of tobacco is worthwhile to mention. The dollar value of export of the group “Non-precious metals and articles thereof” has decreased in comparison with the same period of the previous year mostly because of price developments in international commodity markets, despite high growth in real volumes of export of copper.

The decline in the dollar value of import in the first quarter of 2016 was conditioned by reduced imports of almost all commodity groups, except for the investment goods and group “Precious and semi-precious stones, precious metals and items” which posted a certain growth.

A positive balance of services, amounting to USD 11.0 million, was reported in the first quarter of 2016. This development owed mainly to a notably reduced negative balance of transport services and a positive balance of travel. There is an estimated 7.3% y/y increase in export of services in the first quarter amid 2.1% decrease in import of services.

As the decline of the Russian economy slowed down, the net inflow of private transfers and seasonal worker remittances started shrinking at a slower pace, reaching 7.9% y/y. However, the indicator of total inbound transfers on behalf of individuals executed via banks remained at the previous reference period’s level.

3.4.2. Capital and financial account²⁸

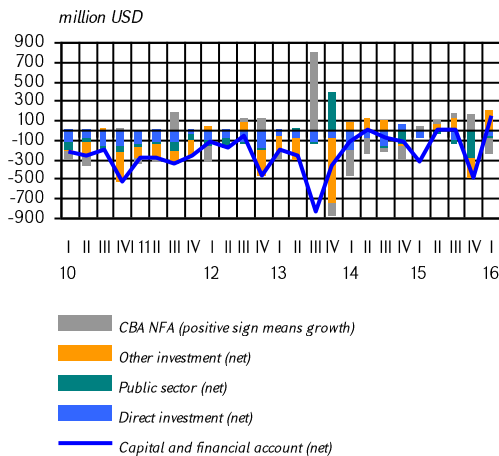
In the first quarter of 2016 net foreign liabilities of the Armenian economy reduced by USD 145.0 million, mainly due to the performance of the private sector.

The net inflow of capital transfers in the first quarter of 2016 amounted to USD 5.4 million, almost the same level as was reported for the previous reference period.

²⁷ The export and import indicators are presented on a basis of the balance of payments, by the use of credit and debit, respectively.

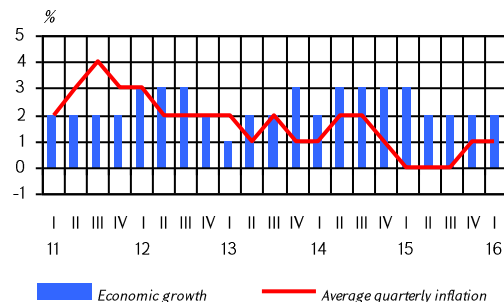
²⁸ The firstquarter 2016 capital and financial account indicators are the CBA’s forecasts and estimates.

In the first quarter of 2016 Armenian economy's net foreign liabilities decreased
(«+» net credit, «-» net borrowing)

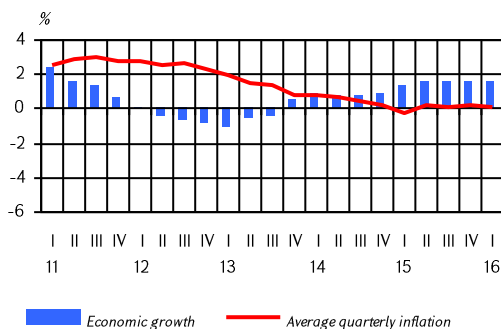


In the first quarter of 2016 trends of slow growth were observable in the economies of main trade partners to Armenia, and economic decline in Russia somewhat decelerated.

In the first quarter of 2016 inflation rate in the USA accelerated



In the first quarter of 2016 inflation rate in the Eurozone again slowed down



Net inflow of foreign direct investment in the first quarter of 2016 was USD 70.5 million, which is a decrease compared to the same quarter last year. There was a net inflow of USD 8.9 million reported for public loans.

In the first quarter net foreign assets of the private sector grew by USD 196.7 million against almost a zero level reported in the first quarter of 2015. Specifically, net foreign assets of commercial banks increased this quarter by USD 70.1 million and net foreign assets of other private sector, by USD 126.7 million.

It is noteworthy that the CBA net foreign assets decreased this quarter by USD 173.7 million, mainly due to a decrease in commercial banks' foreign currency correspondent accounts with the CBA, which resulted in the accumulation of net foreign assets in the private sector.

3.5. External environment

In the first quarter of 2016 trends of slow growth were observable in the economies of main trade partners to Armenia, particularly in the U.S.A. and Eurozone, whereas economic decline in Russia somewhat decelerated.

According to preliminary estimates of the U.S. Department of Commerce Bureau of Economic Analysis, the annualized economic growth in the **United States** has reduced q/q to 0.5% in the first quarter of 2016 against the previous quarter's 1.4% growth, and the y/y economic growth remained 2.0%/y/y (versus the previous quarter's 2.0% y/y). Contracted net exports because of still appreciated exchange rate, reduced private investment have contributed to the slowing of economic growth. Despite the slowdown in aggregate demand, the average quarterly inflation accelerated in the first quarter of 2016 to 1.1% against the previous quarter's respective figure of 0.5%. It still carries the influence of low oil prices. In such circumstances, the US Federal Reserve System refrained from raising policy rates in the first quarter, keeping them in the range of 0.25-0.5% set in the previous quarter.

According to preliminary estimates provided by the Eurostat, economic growth in **Eurozone** in the first quarter of 2016 remained at the same level as in the previous quarter, 1.6% y/y. In Eurozone in the first quarter, the inflation rates decelerated to 0.02% on average against the previous quarter's respective figure of 0.16%. In the first quarter of 2016 the European Central Bank cut the policy rates, setting the refinancing rate at the level of 0.0% and the deposit facility rate at the level of -0.4% against the previous quarter's respective figures of -0.05% and -0.3%. At the same time, the ECB expanded its program on purchase of assets, bringing it to EUR 80 billion a month from the former target of EUR 60 billion and involving new types of assets. The program with new criteria was launched on April of 2016, as was planned.

In the currency market in the first quarter of 2016, euro appreciated against the U.S. dollar by 0.6% q/q (with y/y depreciation of 2.2%); the average exchange rate reached 1.10 dollars for one euro.

According to the preliminary estimates of State Statistics Service of **Russian Federation**, in the first quarter of 2016 economic decline continued, amounting to 1.2% y/y (previous quarter's figure of decline: 3.9% y/y). With international oil prices falling, the Russian ruble continued to depreciate by 13.6% q/q (with y/y depreciation amounting to 18.5%). Under high inflation expectations and uncertainties in connection with the fiscal policy, the Bank of Russia kept the policy rates at an 11.0% level, while the 12-month inflation has reduced considerably to nearly 7.9% on average compared to the previous quarter's respective figure of 13.6%.

In the first quarter of 2016 the **price of Brent crude oil** at Intercontinental Exchange kept on falling sharply – by about 20.9% against the previous quarter – to roughly USD 34.2 a barrel (with 36.6% y/y decrease), driven by persisting huge extraction volumes and a sluggish global demand. It is noteworthy that international oil prices began demonstrating growth trends at the end of the quarter.

In the first quarter of 2016 the **price of copper** at the London Metal Exchange fell by 4.3% q/q (with 19.9% price decrease y/y) to USD 4770 per ton on average, which was driven by continued weak demand in China's economy.

The export price of **hard red wheat** remained low during the first quarter of 2016 thanks to large worldwide production volumes and sizable inventories although a small price increase of 0.2% q/q was seen in the quarter, pushing the price slightly up to USD 4.43 a bushel. However, it is still about 20.7% below the level recorded in the first quarter of 2015.

In the first quarter of 2016 the price index of **unprocessed sugar** at the New York Board-Intercontinental Exchange dropped by 2.5% q/q (with 1.45% increment y/y) after a notable rise in the previous quarter. The price has fallen thanks to resolved problems with harvesting in Brazil, the main producer and exporter.

In the first quarter of 2016 the price of **rice** at the Chicago Board of Trade grew by 2.8% q/q to USD 16.7 per U.S. hundredweight (45.4 kg) (with 9.6% decline y/y), amid some reduction of production volumes in Brazil and Pakistan.

Deflationary trends as well as low prices persisted in the world's commodity and food product markets during the first quarter of 2016.

Deflationary trends as well as low prices persisted in the world's commodity and food product markets in the first quarter of 2016. This has been mostly in line with the previous program's forecasts.

4. CONCLUSION

The **global economy** remained on a slow-growth track during the first quarter of 2016. This will continue up until the end of the year, as deflationary developments come to an end while some stability is achieved in international commodity markets. In the rest part of the forecast horizon, prices of goods in foreign markets will increase gradually due to some recovery in global demand. Therefore, in the **forecast horizon, considerable inflationary pressures** from the external environment **are not likely**.

In the first quarter of 2016 **growth of economic activity** amounted to **5.6%** largely driven by increased output in industry and services sectors. Under this circumstance, **economic growth** is estimated in the range of **2.7-3.6** at the end of 2016 and **3.0-4.5%** at the end of the forecast horizon.

Thus, in the forecast horizon, the impact of aggregate demand on domestic prices will be deflationary up until the start of 2017; then it will grow into inflationary by the end of the horizon.

At the end of March of 2016 the **12-month inflation rate** was **-2.0%**, driven by prices of agricultural products which had fallen relative to the same period of the previous year and deflationary impacts partly transmitted on to the domestic prices from international commodity markets.

At the end of the forecast horizon the 12-month inflation rate will stabilize around the 4% target. External environment's deflationary impact is still transmitting onto the domestic prices **in the second quarter of 2016**, which will phase out in the second half of the year. It is estimated that inflation expectations are declining relatively fast under the influence of consistently implemented monetary policy. On top of the policy influence, expected reduction in the natural gas tariff is another factor which is believed to contribute to the reduction of inflation expectations.

The CBA reckons that easing of monetary conditions at a greater pace in the second quarter of 2016 is relevant in the time of low inflation environment and considerable reduction of inflation expectations. This, coupled with monetary conditions loosened at the start of the previous year, will lead to the expanding of aggregate demand and stabilizing of inflation around the target in the forecast horizon.

Risks to inflation deviating from the projected value are estimated as balanced in the short and medium run. Risks deriving from domestic and external sectors mostly persisted in relation to the previous forecast. In particular, the **external sector risks** are related to capital outflows to the U.S.A. from developing countries and, consequently, higher volatilities of currencies in developing countries, a likely slowdown of global economic growth resulting from restructuring of the Chinese economy as well as risks to international prices of raw materials and food products. **Risks deriving from the domestic sector**

are mostly associated with the extent to which external environment's deflationary impact will spill over to the domestic prices developments in agriculture, a sector greatly depending on weather conditions, the pace at which domestic demand and private investments will recover, as well as Government-led structural reforms.

If the aforementioned risks materialize, the CBA will react accordingly by maintaining the inflation target in the medium run.