

THE CENTRAL BANK
OF THE REPUBLIC OF ARMENIA

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dated May 26, 2017*

Inflation Report

Monetary Policy Program, Q2, 2017



*Status Report on Implementation of the Monetary
Policy Program, Q1, 2017*

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

Under the inflation targeting strategy, the Bank publishes the non-conditional inflation for a 3-year time horizon after each publication, 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 16, 2017, i.e. the day on which the refinancing rate was set, the results of a survey conducted by the Bank and the judgment made pursuant to the information on future developments of the macroeconomic environment.

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

1. EXECUTIVE SUMMARY

The Central Bank has revised the 2017 economic growth forecast upside. In the forecast horizon the economic growth will accelerate, gradually approaching the long-term equilibrium.

Up until the yearend the inflation will continue to expand, shaping within the lower bound of the confidence band, and in the forecast horizon it is expected to stabilize around the target.

The economic activity in the first quarter of 2017 has been strong enough compared with the forecasts, primarily due to higher output in industry and services sectors. Consequently, the Central Bank of the Republic of Armenia (“the Central Bank”) has revised the 2017 economic growth forecast upside. In the forecast horizon the economic growth will accelerate, gradually approaching the long-term equilibrium. In the first quarter of 2017 the deflationary environment largely phased out, and the 12-month inflation rate stood at -0.1% in late March but continued increasing up to 1.2% in April. Up until the yearend the inflation will continue to expand, shaping within the lower bound of the confidence band, and in the forecast horizon it is expected to stabilize around the target.

The economic activity in the first quarter of 2017 significantly exceeded the Central Bank’s predictions as it amounted to **6.6%**, in which case the first quarter’s economic growth was revised upside, in the **5.0-5.4%** range. Expansionary monetary and fiscal policies implemented by the Central Bank and the Government of Armenia in 2015-2016 have contributed to the recovery of domestic demand, which resulted in revised **private consumption and private investment** figures, amounting to 5.0% and 3.7% in real terms (3.0 and 2.0 percentage points higher than previous forecast, accordingly). It should be noted that domestic demand was recovering at a faster pace. In the first quarter of 2017 the **net real export indicator** declined in the light of high real growth in import of goods and services and is an estimated 11.5%, whereas real export of goods and services grew by 1.5%.

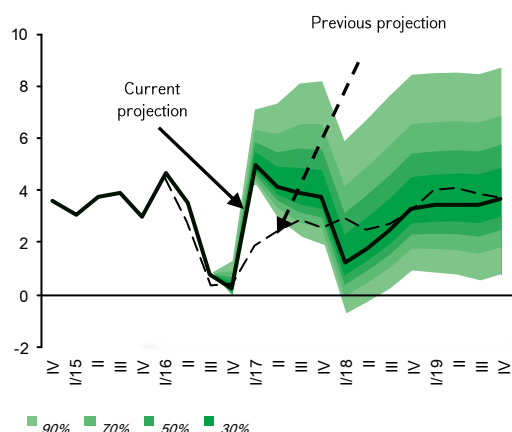
In the first quarter of 2017 the deflationary environment almost phased out, while the **12-month inflation rate** stood at **-0.1%** in late March and it rose up to 1.2% in April. Because inflation was likely to follow somewhat a slower path to target in consideration of lower prices expected for some non-food products compared with the previous forecast as well as reduced gas and electricity tariffs since January and February, accordingly, the Central Bank lowered the refinancing rate by 0.25 pp in February to **6.0%** but left it unchanged in March, since some inflationary risks were beginning to materialize (see details in section “3.1.1. Actual inflation and fulfillment of the inflation target”).

According to the Central Bank forecasts, no significant changes are forecast for global economic growth rates and developments in international commodity markets. However, indicators of remittances of individuals were adjusted upward owing to continued recovery of the Russian economy and revision of the ruble appreciation. In this circumstance, **minor inflationary pressures from the external environment are likely.**

The Central Bank’s estimates of the 2017 economic growth rates were revised upside mostly thanks to much higher economic activity registered in the first quarter of 2017 and materialization of some of the

The economic growth for 2017 is expected within 3.3-4.8%, and the increase is driven solely by domestic demand.

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



risks to growth outlined in the previous monetary policy program. As a result, the **2017 economic growth is expected within 3.3-4.8%**, and the increase is driven solely by domestic demand. What is more, such high growth will offset in part the effect of decline in external demand because of deteriorated net exports. In the structure of domestic demand, private consumption is forecast to grow by 4.3%, private investment, by 6.0%, as well as export and import of goods and services in real terms, within 3.0-5.0% and 4.0-6.0%, respectively. In the meantime, the fiscal policy is predicted to leave a 3.0 pp contractionary impact on aggregate demand during the year, compared to last year (former forecast remained unchanged). This, however, will be adjusted, depending on the pace of implementation of fiscal policy. From the supply perspective, the growth in industry and agriculture will contribute to the economic growth on the whole. The **medium-term forecasts have not been revised**; the economic growth will be in the range of **2.7-4.5%** in 2018, and **3.1-5.2%** in 2019. However, if current high rates of economic growth are maintained, the medium-term forecasts will be revised upward, too.

Thus, **in the forecast horizon up to the second quarter of 2018, the domestic demand's deflationary impact on domestic prices will gradually weaken. Then, up until the end of the forecast horizon, it will turn into that of inflationary, which is in line with the forecast of the previous program.**

According to the Central Bank forecasts, the inflation indicator forecast for end-2017 was revised upside driven by higher-than-expected prices of seasonal products on the one hand and in anticipation of faster recovering prices of non-food products and services during 2017 amid accelerating pace of recovery in aggregate demand on the other. The Central Bank estimates that by the end of the year the **12-month inflation rate** will be within the lower bound of the confidence band and in the rest of forecast horizon it will gradually stabilize around the 4% target.

Given the assessment that current monetary conditions are still stimulating and facilitate the recovery of aggregate demand and help the inflation stabilize around the target, the **Central Bank considers it appropriate to leave monetary conditions unchanged in the second quarter of 2017.**

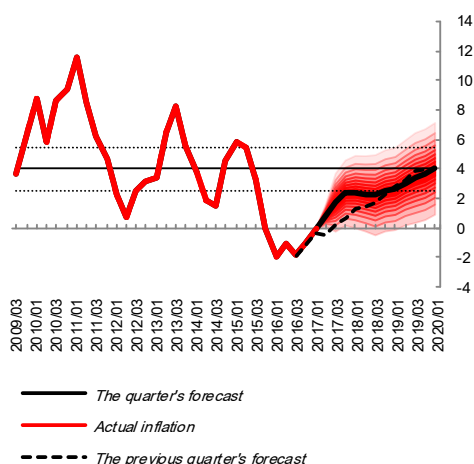
Risks that inflation will deviate from the projected value are generally balanced in both short and medium-term perspectives.

Risks deriving from external and domestic sectors amid gradually rebounding global economy and the aforementioned developments in the domestic sector are generally estimated as balanced as well.

If these risks materialize, the Central Bank will react accordingly by maintaining the inflation target in the medium run.

The Central Bank finds it reasonable to leave monetary conditions unchanged in the second quarter of 2017.

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



2. FORECAST, FORECAST CHANGES AND RISKS

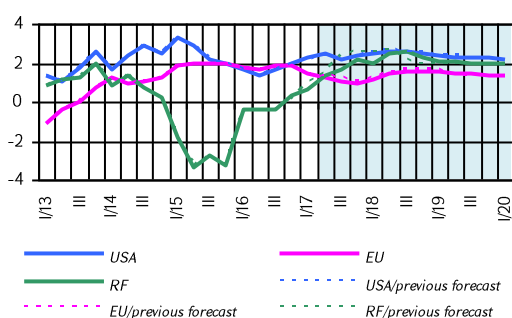
2.1. External environment¹

The world economy is expected to grow more rapidly in 2017. Minor inflationary patterns will be observable in international markets of raw materials and food products in 2017.

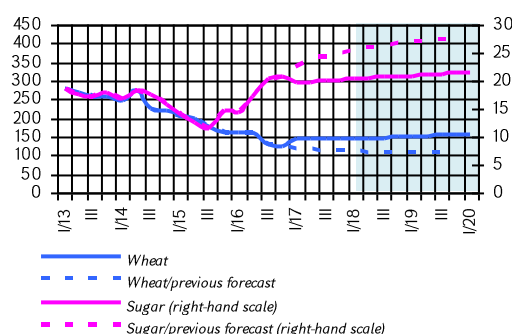
The world economy is expected to grow more rapidly in 2017. In particular, faster economic growth rates are expected in the USA and Russian Federation – principal trade partners to Armenia, and somewhat a slower growth in the Eurozone.

Minor inflationary patterns will be observable this year in international markets of raw materials and food products, except for the copper market which will be highly inflationary. Inflationary trends previously observed in the sugar market will slow down.

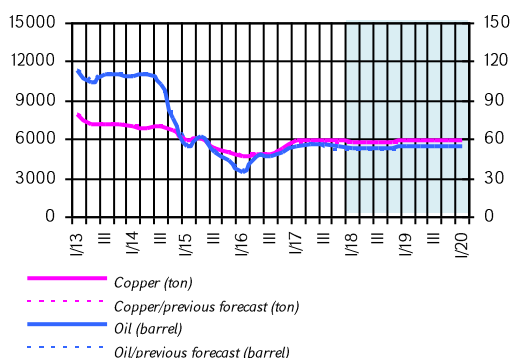
Economic growth in main trade partner countries (%)



Food products (US dollar)



Commodities (US dollar)



Economic growth in the **U.S.A.** is forecast to be 2.4% in 2017 against a former prediction of 2.3% growth, and in the medium-term it is expected to follow a path consistent with previous forecasts².

Economic growth in **Eurozone** in 2017 is predicted to be 1.2% compared to the previous growth forecast of 1.3%. This small revision mainly owes to the domestic demand rebounding at a slower pace. In the medium term, the economic growth will not change, averaging around a 1.4% level.

Economic growth in **Russia** in 2017 is predicted to be 1.6% compared with a previous forecast of 1.8%, which is attributable to lower economic growth reported in the first quarter. The inflation continues trending downward and is expected to reach its target earlier than anticipated, i.e. the second quarter of 2017. In the medium term, the inflation will be around 4%. The Bank of Russia is likely to continue implementing an expansionary monetary policy during 2017 but it will be slightly more expansionary compared with the previous forecast.

According to the IMF April 2017 report “World Economic Outlook”, world economic growth forecast for 2017 is 3.5%, which is 0.1 pp higher than the figure published in the previous report released in January 2017.

A significant recovery in global demand as well as the agreement reached on reducing oil production led international prices **in commodity and food product markets** to restore from their lows observable in 2016. In 2017, international price expectations, as was predicted earlier, shaped relatively high levels for prices of raw materials and certain food products. Risks to the developments in international prices of commodities and food products are positioned upward due to political motives in the USA and the dollar depreciation.

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).

² All forecasts for the external environment are based on the information available as of 25.04.2017.

2.2. Aggregate supply and aggregate demand

Aggregate supply

The Central Bank forecasts of economic growth for 2017 were revised upside mostly due to higher economic activity reported in the first quarter of the year, which in turn is attributable to emergence of risks to added output in services and industry, as had been outlined in previous monetary policy programs. As a result, the 2017 economic growth is estimated in the range of 3.3-4.8%. Medium-term forecasts have not been revised: economic growth in 2018 will be within 2.7-4.5%, in 2019, in the range of 3.1-5.2%. However, if the current high rates of economic growth are maintained, the medium-term forecasts will be revised upward, too. Also, in expectation of the dynamics of economic fundamentals in the domestic and external environment, Armenia's long-term economic growth equilibrium is estimated within 4-5%.

The following developments are expected in the sectors of the domestic economy in the forecast horizon:

For **Industry**, the forecasts were revised considerably upside owing to high economic activity observed in the processing industry since the start of the year and in anticipation of even higher prices of ore and minerals. As a result, in 2017 the value added in industry is forecast to grow in the range of 7.2-8.4%. In 2018-2019 the growth in industry sector will stabilize within 6.0-7.0%, which is close to the previous forecasts.

For **Construction** and **agriculture**, the 2017 forecasts of value added did not change much in comparison with previous forecasts. In particular, the decrease of value added in construction is expected in the range of 1.8-2.5%, and the growth of value added in agriculture, in the range of 3.6-4.4%. In 2018-2019 the growth in these sectors will stabilize within 1.8-2.2% and 4.5-5.6%, respectively, which is close to the previous forecasts.

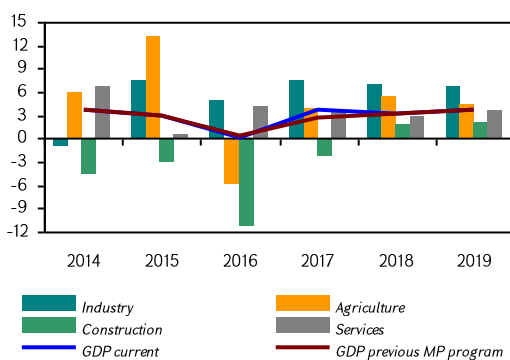
For **Services**, the 2017 value added is estimated in the range of 3.4-4.0%, which is higher compared to the previous forecasts and explained by strong economic activity reported in services in the first quarter of 2017. In 2018-2019, the growth in services is expected to stabilize in the range of 2.8-3.7%, which is in line with previous forecasts.

In the forecast horizon, while risks to the economic growth are dual-sided, **upside risks to the growth prevail**.

Among upside risks, most prominent is the implementation of a number of projects by the Government of Armenia aimed at improving the business climate and promoting export-oriented businesses and how it will affect the economic growth. The domestic economic agents exploring new export markets and creating new products in order to bolster the GDP potential are other positive risks to the growth.

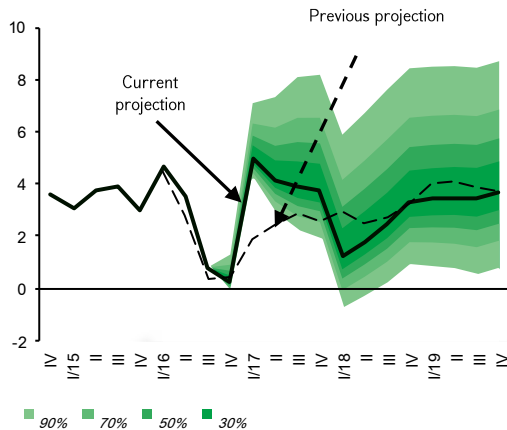
A slower-than-expected recovery of private demand in the medium run is a downside risk. A faster global economic recovery compared to

GDP growth by sectors of economy



the baseline scenario, adverse weather conditions and the pace of pushing ahead with structural reforms for economic growth are dual-sided risks.

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
January-December 2017 / January-December 2016	3.3% - 4.8%	1.8% - 8.2%
January-December 2018 / January-December 2017	2.7% - 4.5%	0.9% - 8.5%
January-December 2019 / January-December 2018	3.1% - 5.2%	0.6% - 9.1%
January-December 2017 / January-December 2016	3.3% - 4.8%	1.8% - 8.2%

Labor market:³ The average nominal wage⁴ forecasts for 2017-2019 were adjusted upside but forecasts for the unemployment rate, downside.

The forecasts of average nominal wage growth in the **private sector** were adjusted 0.4-0.6 pp upside for 2017-2019 due to the revised inflation and economic growth forecasts. Thus, average nominal wage in the private sector is forecast to grow by 4.2% in 2017, 5.2% in 2018 and 6.5% in 2019.

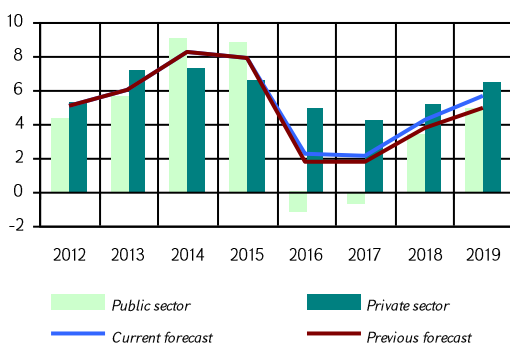
In 2017 the average salary of employees in the **public sector** is predicted to reduce by 0.7% instead of a previous 1% decline forecast. The public sector salary forecasts for 2018-2019 were revised 0.4-0.5 pp upside, which is explained by revision of wage forecasts in the private sector, and amounted to 3.4% and 4.9%, respectively.

On the back of the aforementioned private and public sector wage developments, the **average nominal wage is expected to grow by nearly 2% in 2017, in the range of 4.0-4.4% in 2018, and 5.4-5.8% in 2019.**

In 2017 the unemployment rate forecast was adjusted 0.8 pp downside and is estimated at 17.7%. In 2018 and 2019 the unemployment rate will stand at 17.0-17.3% and 16.7-17.0%, respectively, which is 0.9-1.0 pp lower from the previous forecasts. Revision of the forecasts is due to actual developments as well as adjusted economic growth forecasts.

As a result of the above-mentioned developments, **the wage growth rate will outstrip the productivity growth rate in 2017, driving the consumer market to suffer some 0.3-0.5% of inflationary pressures**, which is slightly higher than the indicator of the previous forecast. Consistent with former projections, the labor market's impact on the inflation is estimated to be neutral in 2018-2019.

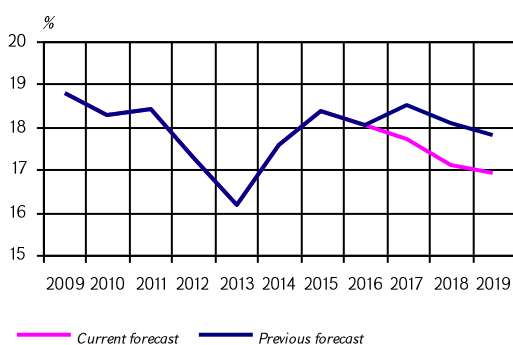
Nominal wage growth, y/y



³ The labor market data for 2017-2019 are the Central Bank projections which are based on the fourth quarter of 2016 data and actual January-February of 2017 figures. The growth indicators presented in this sub-section are relative to the same reference period last year, unless otherwise specified.

⁴ Average nominal wage constitutes a grand sum of salary and salary equivalents (premiums, allowances, bonuses, one-time incentive pays, etc.).

Unemployment rate



Aggregate demand⁵

On the back of growth in remittances from the Russian Federation, as well as the Government of Armenia investment promotion policy and influence from loosened monetary conditions, the private spending is predicted to grow faster in 2017 and amount to 4.4-4.8%, which is 2.6 pp higher than the previous forecasts. In view of the goal of debt sustainability in the medium-term perspective, the budget deficit in 2017 is expected to decrease, which, although set to leave a dampening effect on domestic demand in the short run, will contribute to increasing confidence in the long run, sustainability of public finances and investment and economic activity. The above-described developments in the private and public sectors suggest that the growth of domestic demand in 2017 will be within 3.0-3.4%, which is more than 3.0 pp higher than the previous forecasts. In anticipation of a faster growth, the negative gap of domestic demand in 2017 will shrink considerably compared with previous forecasts and eliminate in early 2018. Consistent with previous forecasts, it is expected that domestic demand will run slightly above the equilibrium in 2018-2019, creating a positive gap.

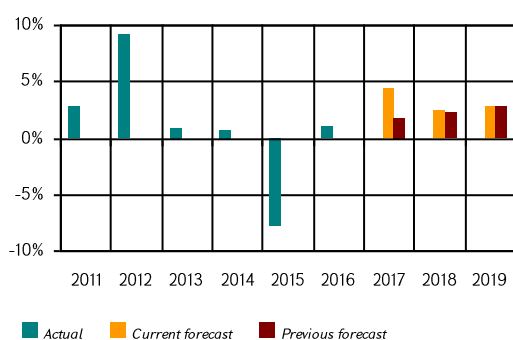
Private sector spending

An anticipated increase in private transfers from the Russian Federation, somewhat higher in comparison with the relevant indicator outlined in the previous monetary policy program, as well as expectation for stronger growth in the domestic economy will bolster real household incomes in 2017. Given these factors, as well as the expected increase in lending in 2017, private consumption growth is expected to be around 2.5 pp higher compared with the previous forecast, amounting to 4.3%. In line with previous forecasts, in 2018-2019 private consumption is expected to increase by 2.2-2.6% and 2.5-2.9%, respectively.

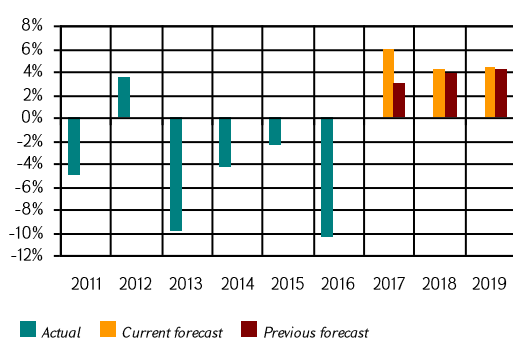
In 2017 investment activity is expected to recover along with about 6% growth of private investment, which is around 3.0 pp higher than the previous forecasts. The revision is driven by new investment projects to be carried out in the field of traditional and alternative energy, agriculture and water management. Consistent with previous forecasts, the growth of private investment in 2018-2019 is expected in the range of 3.9-4.3% and 4.1-4.5%, respectively.

The aforementioned developments with private consumption and investment will result in a 4.6% increase in private spending in 2017, which is 2.6 pp higher than the previous forecast. In 2018-2019 private expenditures will grow by 2.5-2.9% and 2.8-3.2%, respectively, which is consistent with previous projections.

Private consumption



Private investment



⁵ The data of real growth of private consumption, investments, private spending and domestic demand for 2017-2019 are the Central Bank estimates. These actual figures are as of the fourth quarter of 2016 published by the National Statistics Service of Armenia. The real growth indicators represented in this sub-section are relative to the same reference period last year, unless otherwise specified.

The above developments with private expenditures suggest that by the end of 2017 the private spending gap will eliminate. From the first quarter of 2018 to the end of the forecast horizon, the private spending gap is estimated to be positive. So, up until the start of 2018, the **private spending gap will create an average of 0.3-0.5 pp contractionary impact on inflation**, which is smaller from the indicator outlined in previous forecasts. From the second quarter of 2018 to the end of the forecast horizon, **it will turn into inflationary, amounting to 0.5-0.7 pp on average**, which is below the previous forecasts, too.

Current account

In the first quarter of 2017 growth rates in dollar value of export of goods were smaller compared to the previous quarter's forecast, according to Central Bank estimates. This was mainly due to a decrease in item "Products of vegetables origin" and "Precious stones and metals and articles thereof"⁶. Growth of export of alcohol and raw materials remained strong. Growth was also strong in respect of export of services, according to estimates. This was driven by high growth in tourism which offset slower-than-expected growth rates in export of goods. Given these developments with export of commodities as well as downside revisions to the above two items, the 2017 forecasts for growth rates of real export of goods and services were adjusted downward to be in the range of 3.0-5.0%.

Imports have exceeded the expectations. The quarter saw a strong growth of import of goods and services, incurring the effect of restored consumption. Given the actual developments and upside revisions to import in the upcoming quarters, the real growth of import of goods and services in 2017 will be in the range of 4.0-6.0%.

Private transfers of individuals were revised upside and are forecast to be within 14.0-16.0% during 2017. The increase will be determined by continued recovery of the Russian economy and adjustment to the ruble appreciation.

As a result, the 2017 current account deficit-to-GDP ratio will deteriorate in comparison with the previous forecast and run in the range of 1.0-3.0%.

The fiscal sector

The fiscal policy's impact on aggregate demand for 2017 has been estimated, using the indicators of the Republic of Armenia Law on "State Budget 2017" and revenue and expenditure figures⁷ adjusted under selected Government decrees.

⁶ The previous year's unprecedented growth of this item owed to a record growth of sub-item "Other products made of previous metals and metals", which was not reported in the first quarter of 2017.

⁷ The indicators defined under the laws of the state budget are subject to adjustment under selected Government decrees, and are placed at the Government's website://www.e-gov.am.



Relative to the previous monetary policy program, the 2017 tax revenues and selected program expenditures of the state budget have increased by AMD 57.1 billion each. The positive trend of tax collection observed in the first quarter of 2017 is predicted to remain so during the year in anticipation of higher economic growth. The tax-to-GDP ratio⁸ is expected to rise by 1.0 pp whereas the expense-to-GDP ratio to decrease by 1.5 pp against 2016. The budget deficit will reach 2.8% of GDP as planned by the law.

In 2017, relative to 2016, the estimation of the fiscal policy's impact on aggregate demand remained unchanged, 3.0 pp contractionary, against the previous monetary policy program.

In 2017, relative to 2016, the estimation of the fiscal policy's impact on aggregate demand remained unchanged, 3.0 pp contractionary, with the revenues and expenditures leaving 1.2 and 1.8 pp contractionary effects, respectively. It should be noted that such contractionary effects are anticipated in the next two quarters of 2017.

Medium-term fiscal policy impact assessment					
% of GDP	2015	2016	2017	2018	2019
Budget revenues ⁹	22.4	22.4	22.6	23.4	23.5
Budget expenditures	27.2	28.0	25.4	26.0	25.5
Debt interest payment	1.5	1.9	2.2	2.0	2.0
Budget balance	-4.8	-5.6	-2.8	-2.6	-2.0
Primary balance*	-3.3	-3.7	-0.6	0.6	0.0
One-off flows**	-0.6	0.4	-0.1	-0.6	-0.8
Adjusted balance***	-2.7	-4.1	-0.5	0.0	0.8
Cyclical balance****	-0.2	-0.6	-0.2	0.0	0.2
Cyclically adjusted primary balance (structural balance sheet)	-2.5	-3.5	-0.3	0.0	0.6
Fiscal stance*****			-3.2	-0.3	-0.6
* 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 Central Bank 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 Central Bank 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).					

The fiscal policy's forecast horizon is based on the main indicators to underlie the **Republic of Armenia “Medium-Term Public Expenditures Program for 2018-2020”**. In the **medium run**, to achieve a sustainable debt environment as in 2017-2019, as well as in the 2018-2020 programs, the fiscal policy aims at gradual reduction of the deficit. In 2018-2020 the deficit-to-GDP ratio is projected to reach an average 2.3% of GDP, which is higher from the relevant figure of 1.85% outlined in the previous program for 2018-2019. The impact of the fiscal policy on aggregate demand will be contractionary in the medium run and, therefore, non-inflationary.

⁸ The 2017 GDP is the Central Bank estimate.

⁹ State budget indicators are represented excluding the off-budgetary funds.

Summary: from the second quarter of 2017 to the second quarter of 2018 the aggregate demand and labor market developments will create minor deflationary pressures (0.6-0.8 pp on average) in the consumer market, which is smaller than the previous forecast. The combined impact of the fiscal policy, private demand and labor market on domestic prices will be deflationary, 1.0-1.2 pp on average, and net external demand's impact, 0.3-0.5 pp inflationary.

Driven by improving economic conditions in both external and domestic sectors, the aggregate demand will continue recovering with a positive gap. In the outcome, starting from the second quarter of 2018 up until the end of the forecast horizon, the overall aggregate demand and labor market will create an average 0.6-0.8 pp of inflationary impact which is smaller in comparison with the previous forecast.

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

In 2017, relative to the previous forecasts, moderate inflationary pressures from the external sector are likely as the global demand recovers slightly faster and inflationary patterns continue to be seen in international markets of commodities and food products. In the meantime, the risks and uncertainties about the future pace of the world economy as outlined in previous forecasts generally persisted.

With the Russian economy recovering and the ruble appreciating vis-à-vis the US dollar, the first quarter of 2017 saw a strong growth in the ***dollar value of net inflow of private remittances and seasonal worker pays growing strongly*** which is forecast in the range of 14-16% in 2017. Under such conditions, the real private transfers gap in the first quarter of 2017 is estimated as positive, which is higher from previous expectations.

The economic growth rate published for the period January-December 2016 has been **0.2%**, which is in line with previous estimates by the Central Bank. The economic activity indicator in the first quarter of 2017 was 6.6% driven primarily by growth reported in services, trade and industry sectors. In this circumstance, the economic growth forecasts for the first quarter and entire year of 2017 have been revised upside. According to current estimates, the year's economic growth will be in the range of 3.3-4.8%, much above the previous estimates.

It should be noted that the effect of expansionary monetary policy conducted in 2015-2016 further facilitates the recovery of domestic demand. As growth rates in remittances rebound and the services and lending volumes keep on increasing, the estimates of growth rates in private consumption have been revised upside for the first quarter and

entire year of 2017. On the other hand, projections denote a higher growth in investments in 2017 compared to previous forecasts, determined by a number of investment programs in the field of alternative energy, water management and other areas. In this case, the pace at which private spending and domestic demand recovered during the quarter has somewhat accelerated compared to previous forecasts. Note also that real growth of export of goods and services in the first quarter of 2017 has been commensurate with previous forecasts, while the import indicators exceeded the expectations. According to the latest projections, the current account deficit-to-GDP ratio will deteriorate against the previous forecast to be in the range of 1-3% in 2017.

As a result of the aforementioned developments, the **GDP gap is positive** in the first quarter of 2017.

To give the aggregate demand and inflation extra incentives to rebound faster, the Central Bank continued loosening monetary conditions **in the first quarter of 2017** by reducing the refinancing rate in February **by 0.25 pp to 6%**.

Medium-term macroeconomic forecasts by the Central Bank suggest that the dollar value of net inflow of remittances will keep on growing steadily in the period 2017-2019 as the Russian economy slowly recovers. This will gradually neutralize the negative impact of a significant decline in remittances seen in recent years, contributing positively to the GDP gap. On the other hand, the fiscal sector, as previously expected, will leave a contractionary effect on aggregate demand, dampening the positive GDP gap hence the inflation path to recovery. According to current estimates, the Central Bank's policy rate further facilitates the restoration of aggregate demand, helping the inflation return to its target. **Under such circumstances, the Central Bank considers it reasonable to leave monetary conditions unchanged in the second quarter.**

There has been an upward revision to the inflation forecast in relation to the projections outlined in the previous monetary policy program, which is driven by higher-than-expected seasonal product prices and anticipation that prices of non-food products and services would recover quicker in 2017 amid faster restoring demand. By the end of the year, the Central Bank estimates, the 12-month inflation rate will be in the lower bound of the confidence band and in the forecast horizon it is expected to stabilize around 4%.

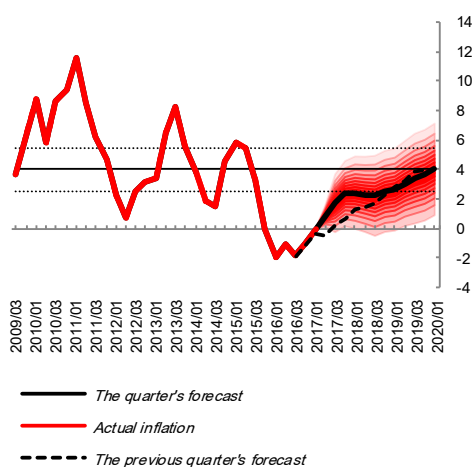
Given the lingering effect of an expansionary monetary policy, the private consumption growth rates further contribute to the recovery of aggregate demand in 2017, stabilizing around the equilibrium in the forecast horizon. At the same time, in case the Government's investment promotion policy and investment project implementation prove effective, high investment activity could be registered in the medium-term perspective, contributing to reducing the negative gap in private spending. In the medium run, the fiscal policy's contractionary effect on aggregate demand will gradually eliminate and the GDP gap, entering a positive territory, will phase out at the end of the forecast horizon, bringing the real sector of the economy into balance.

In such circumstance, the Central Bank estimates, the ***economic growth rates will gradually stabilize within 3.1-5.2% at the end of the forecast horizon.*** This will be largely driven by the tradable sector ***as Armenia's competitiveness rises in an inflation environment which is lower compared with trade partner countries.***

Risks to economic growth are bound upward owing to restored confidence and optimism about the investment environment and economic outlook, which could lead to increased investments along with joint efforts by the Government. Furthermore, a possible upside revision to the economic growth potential depends on the pace of structural and institutional reforms which are aimed at large capital investment and productivity growth.

At the same time, the Central Bank estimates that the monetary policy has contributed to the elimination of deflationary environment and created enough incentives for fulfillment of the inflation target in the forecast horizon in 2017.

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



Period	Inflation interval forecast probability distribution				
	<1.0%	1.0-2.5%	2.5-5.5%	5.5-7.0%	>7.0%
Q2, 2017	65.1%	34.9%	0.0%	0.0%	0.0%
Q3	28.2%	46.8%	25.0%	0.1%	0.0%
Q4	15.9%	38.6%	44.6%	1.0%	0.0%
Q1, 2018	17.2%	35.0%	45.8%	1.9%	0.1%
Q2	20.2%	34.9%	42.9%	1.9%	0.1%
Q3	23.5%	33.7%	40.5%	2.1%	0.2%
Q4	18.6%	31.4%	46.3%	3.3%	0.4%
Q1, 2019	17.0%	30.1%	48.4%	4.0%	0.5%
Q2	12.4%	25.7%	53.9%	6.9%	1.2%
Q3	10.1%	21.9%	55.4%	10.1%	2.6%
Q4	8.3%	19.6%	56.5%	12.1%	3.5%
Q1, 2020	5.7%	15.8%	57.0%	15.8%	5.7%

Risks that inflation will deviate from the projected value are generally balanced in both short and medium-term perspectives.

Risks deriving from external and domestic sectors amid gradually rebounding global economy and the aforementioned developments in the domestic sector are generally estimated as balanced as well.

3. ACTUAL DEVELOPMENTS IN Q1, 2017

3.1. Inflation

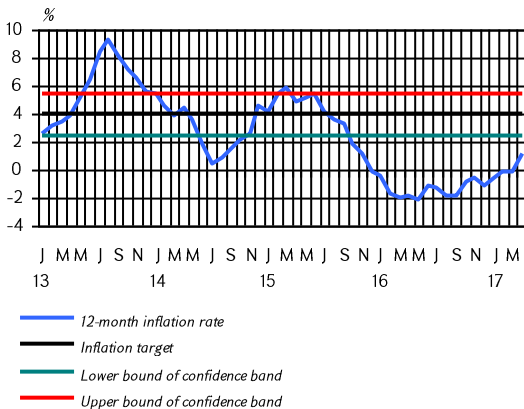
3.1.1. Actual inflation and fulfilment of the inflation target

There was **1.4%** inflation in the first quarter of 2017 instead of projected 1.1%, which was primarily driven, as expected, by a seasonal increase in food prices, with prices of items “fruit” and “vegetable and potato” having risen by 10% and 30.1%, respectively (contribution to the quarter’s inflation: around 2 pp¹⁰). In the first quarter of 2017 the **core inflation rate was 0.3%, commensurate with the projection**, in which case the 12-month rate amounted to -0.9% at the end of March. The latter has largely been driven by increased airfare (11.2% q/q) and increased prices of items “fish products” (13.9% q/q) and “meat products” (0.8% q/q), the impact of which on the inflation has somewhat been offset by decreased prices of items “clothing” (-5.1% q/q) and “footwear” (-7.5% q/q). It should be noted that in recent years deflationary pressures in world markets of raw materials and food products have spilled over to developing countries around the world and especially this region, considerably affecting the formation of low levels of core inflation. Transmission of such deflationary impulses onto the Armenia’s consumer market had been relatively slow, which is why their influence on the level of core inflation continues to be felt. However, these effects are expected to vanish in the near future, which will positively contribute to the restoration of core inflation.

On the back of the aforementioned developments, the deflation environment, as was expected, almost fully phased out in the first quarter of 2017, in which case **the 12-month deflation rate amounted to -0.1% in March instead of the projected -0.4%.**

According to the official statistical data, there was 1% inflation recorded in April, and the 12-month inflation rate reached 1.2%. These figures show that certain inflation risks as outlined in the previous program have materialized, which reflected upside revision to inflation forecasts, on the one hand, and led the inflation to buffer risks to inflation deviation, on the other.

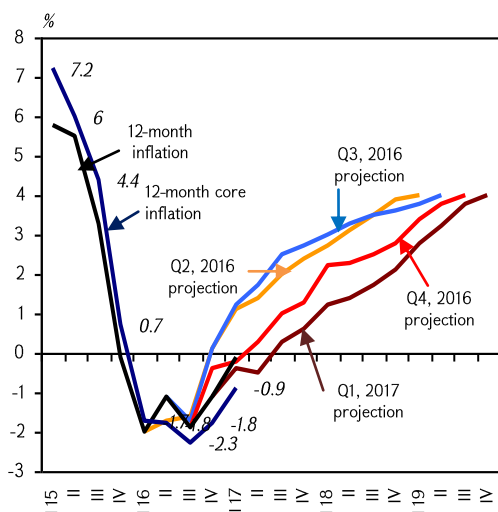
In the first quarter of 2017 the deflationary environment almost phased out



In March of 2017 the 12-month deflation rate amounted to -0.1% instead of the projected -0.4%.

¹⁰ Some statistical discrepancy between the grand sum of certain commodity items' contribution to inflation and the officially published headline inflation can be found due to the characteristics of statistical methodology for inflation calculation.

According to the Central Bank forecasts, the existing deflationary environment will phase out gradually and in the forecast horizon it will stabilize around the 4% target



Price inflation by items as key contributors ¹¹						
Item	December, 2016 (y/y)		March, 2017 (y/y)		Q1, 2017	
	Growth (%)	Contribution (%)	Growth (%)	Contribution (%)	Growth (%)	Contribution (%)
CPI	-1.1		-0.1		1.4	
Food products	-0.2	-0.1	3.3	1.5	4.8	2.2
Bread products						
Meat products	-3.70	-0.40	-0.88	-0.08	-0.15	-0.01
Dairy products	-1.70	-0.20	-0.15	-0.01	0.78	0.07
Fruit	-3.40	-0.10	-2.81	-0.12	-0.15	-0.01
Vegetable and Potato	17.00	0.40	23.75	0.79	10.61	0.35
Eggs	-1.00	-0.10	13.45	0.72	30.11	1.62
Sugar	-0.41	0.00	15.76	0.12	13.93	0.10
Non-food products	6.8	0.1	-1.16	-0.02	-0.63	-0.01
Services	14.6	0.1	14.91	0.13	2.71	0.02

For the previous one-year horizon, which covers a period from second quarter of 2016 to second quarter of 2017, transmitting of the deflationary impact onto the domestic prices from the external sector was still likely, which was only to abolish in the second half of the year, according to Q2, 2016 monetary policy program. At the same time, the fact was that inflation expectations were diminishing relatively fast as a result of consistent monetary policy implemented before. In such a situation, the **Central Bank was planning to continue easing monetary conditions in the upcoming two quarters**, which, coupled with loosened monetary conditions at the beginning of previous year, would lead to the expanding of aggregate demand and help the inflation stabilize around the target in the forecast horizon.

The environment remained mostly deflationary, as was expected, after actual developments in the second and third quarters of 2016. In the period April-September 2016 there has been 4.1% deflation (4.2% in the same reference period last year), leaving the **12-month inflation rate** to fluctuate at -1.9%. The deflation that time has been largely driven by the impact of deflationary patterns in international commodity markets transmitted onto domestic prices, sluggish domestic demand and lower food prices owing to high growth registered in agricultural sector over the same reference period last year.

In response to such inflationary developments, the Central Bank has gradually eased the monetary conditions by lowering the refinancing rate a total of 1.5 pp to **6.75%** at the end of September.

However, expected reduction in gas and electricity tariffs in the first quarter of 2017 and contractionary fiscal policy implementation for 2017 were added to existing deflation risks at the end of the third

¹¹ The y/y data of structural components of food products in the table are calculated by the Central Bank on a basis of information from the National Statistics Service of Armenia, since no such information is officially published by the NSSA due to a new inflation calculation methodology.

quarter, which prompted the Central Bank to make downside adjustment to forecasts for the fourth quarter of 2016 and first quarter of 2017.

As a result of actual inflation developments, the deflationary environment gradually mitigated from the fourth quarter of 2016 to April of 2017, and the **12-month inflation rate** rose to **-0.1%** in March. However, given low economic activity in that period, expected lower prices of some non-food products in comparison with the previous forecast as well as anticipated impact of contractionary fiscal policy planned by the Government for 2017, the Central Bank kept on loosening monetary conditions by reducing the policy rate by 0.75 pp to **6.0%** in late February. In March, the Central Bank left the monetary conditions unchanged, considering the positive developments taking place in external and domestic sectors of the economy and certain inflation risks already exiting at that time.

3.1.2. Import prices and producer prices

Import prices: in the first quarter of 2017 the dollar prices of import of goods and services grew by 1.1% q/q on average. The growth over the same reference period last year amounted to 5.7% y/y.

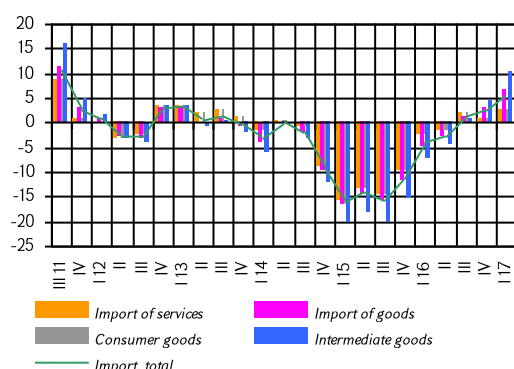
The y/y increase in dollar prices of import was driven by grown prices of goods and services (4.9 pp and 0.6 pp, respectively). The growth of oil and metals prices in the international market has resulted in increased prices of imported raw materials.

Driven by y/y currency appreciation in Russia, the prices of imported consumer goods therefrom have risen. The contribution of price inflation on consumer goods to domestic prices amounted to 0.6 pp.

Producer prices¹²: according to the Central Bank estimates, the GDP deflator in January-March 2017 has increased by about 1.5% in relation to the same period last year, which is in line with previous forecasts. Price developments in different sectors of the economy underlie the estimates, as follows:

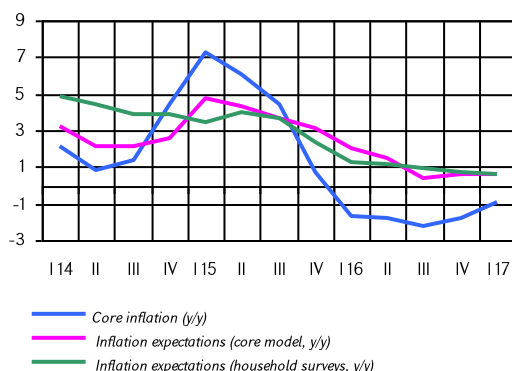
Industry reported 3.1% y/y rise in prices in January-March owing to increased ore and minerals prices in international markets. **Agriculture** posted no significant changes in prices in the same period of time due to weak economic activity persisting in the sector from the previous year. The rapid growth rates notwithstanding, the level of domestic demand is still low in the economy in the period under review, and **Services** reported no essential changes in tariffs, as a result. **Construction** reported a 2.8% y/y price deflation in the first quarter of 2017. This is a result of contracted output and reduced wages in the construction sector, which, in turn, is attributable to supply and demand imbalances in the sector. The price developments in these sectors did not significantly deviate from the Central Bank's estimates.

In the first quarter of 2017 the dollar prices of import of goods and services grew (y/y, %)



¹² The price index change for January-March 2017 is relative to the same reference period last year, unless otherwise specified.

The first quarter of 2017 saw inflation expectations mostly stabilized



3.1.3. Inflation and interest rate expectations

Reduced considerably in 2015-2016, the households' inflation expectations somewhat stabilized in the first quarter of 2017, as was expected, and will recover gradually in an upcoming one-year horizon, anchoring around the inflation target in the forecast horizon. Estimations produced on the Central Bank core model suggest that inflation expectations did not change much this quarter in comparison with the previous quarter (0.6%).

The results of survey conducted by the Central Bank for the first quarter of 2017 about expectations of the households and financial sector with regard to a number of macroeconomic indicators suggest that inflation expectations are further steady. Thus, inflation expectations of the households for an upcoming one-year horizon were anchored around a **0.6%** level of the 12-month inflation rate, against the previous quarter's relevant figure of 0.7%. At the same time, the **average level of the financial system's inflation expectations remained 2.6%** for an upcoming one-year horizon. Commercial banks expected an average **2.2%** of the 12-month inflation rate compared to the previous figure of 2.4%, inflation expectations of credit organizations remained at a **3.0%** level, insurance companies anticipate **2.6%** of inflation on average instead of 2.2% mentioned in the previous survey, and investment companies and funds, **2.1%** compared to the previous figure of 2.3%.

In the financial market, interest rates continued trending downward also in the first quarter of 2017, running very close to the policy rate of the Central Bank. The falling of interest rates was observable in other segments of the financial market, too (see details in section "3.3. Money and financial market developments").

According to the survey results, the financial market's expectations for interest rates followed a downward path this quarter, too. The financial system anticipates a gradual decline in interest rates in all segments, for a one-year perspective.

3.2. Aggregate supply and aggregate demand

3.2.1. Aggregate supply¹³

The **economic growth indicator** for 2016 was **0.2%**, which did not differ substantially from previous Central Bank forecast. Economic activity grew in the first quarter of 2017, significantly exceeding the Central Bank's expectations, and amounted to 6.6%, under which circumstance the estimation of first-quarter economic growth was revised upside, in the range of **5.0-5.4%**.

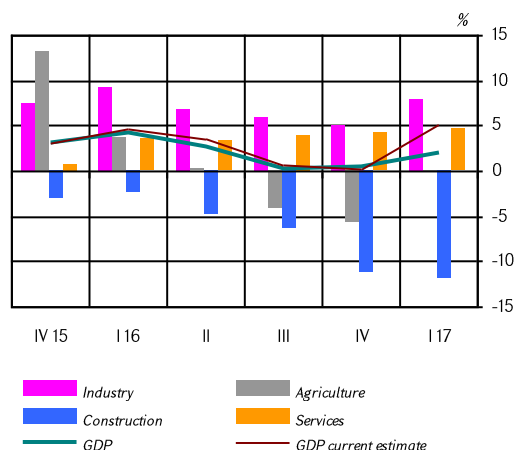
The estimation of economic growth for the first quarter of 2017 was revised upside, in the range of 5.0-5.4%.

¹³ The indicators of y/y real growth of value added in sectors of the economy for January-March 2017 are the Central Bank forecasts, whereas the indicators of sub-sectors represent growth rates in output volumes for January-March 2017, unless otherwise specified.

Export potential and higher-than-expected growth in private spending¹⁴ fuelled, in turn, by a larger amount of remittances from the Russian Federation, were the main drivers to accelerated economic growth in the first quarter.

The growth of value added in **Industry** in the first quarter is estimated within 7.8-8.5% y/y, which is higher than the previous forecast driven by higher prices of ores and minerals in international markets in comparison with previous projections as well as faster economic growth potential. There will be bigger contraction in value added in **Construction** in the reporting period, in anticipation of a lower indicator of construction carried out at the expense of international loans, and is estimated to be within 11.5-12.5%. The value added in gross **Services** is expected to grow even higher in the first quarter and is estimated in the range of 4.4-5.0% y/y, which is explained by stronger-than-anticipated growth in private spending in the economy and the number of people traveling Armenia. Low economic activity observable in **Agriculture** since the second half of 2016 remained so in the beginning of the first quarter of 2017. In this case, the first quarter will see a small decline in value added in agriculture, 0.6-0.2% y/y, which is close to the Central Bank's previous estimates.

GDP and economic sector dynamics



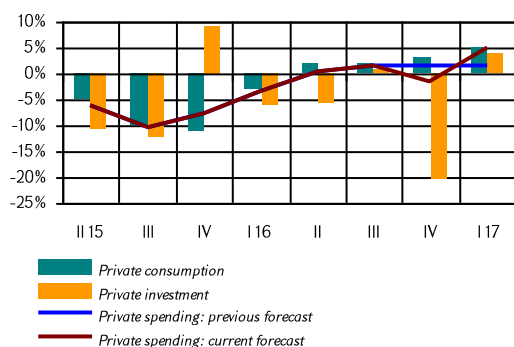
3.2.2. Aggregate demand¹⁵

The growth of private spending in the first quarter of 2017 is estimated at 5.0% – approximately 3 pp higher than the previous forecast – which is attributable to both a larger inflow of private transfers and accelerated economic activity on the whole.

The first quarter saw higher-than-expected investment activity, with private investment estimated to have reached 3.7%, which was around 2 pp above the previous forecast. The revision to growth was determined by higher economic growth and broader inflow of remittances.

The aforementioned developments with private consumption and investment led to an estimated 4.9% growth in private spending in the first quarter of 2017. This is around 3 pp higher in comparison with the previous forecast, and because private spending is slightly above the equilibrium, it created 0.3-0.4 percentage point inflationary pressures in the consumer market instead of previously anticipated deflationary pressures. According to Central Bank estimates, however, high growth in private spending hence inflationary pressures observed in the first quarter are temporary¹⁶.

Private spending, growth y/y, (%)



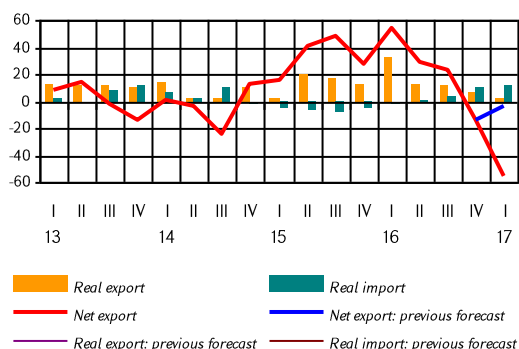
¹⁴ The growth potential of the economy in the first quarter of 2017 is estimated to be around 4.5%, which is higher than the previous quarter by approximately 3.0 percentage points.

¹⁵ The private spending, private consumption and private investment indicators for the first quarter of 2017 are the Central Bank estimates which are based on the actual fourth quarter 2016 data. The growth estimates provided in this sub-section are relative to the same reference period last year, unless otherwise specified.

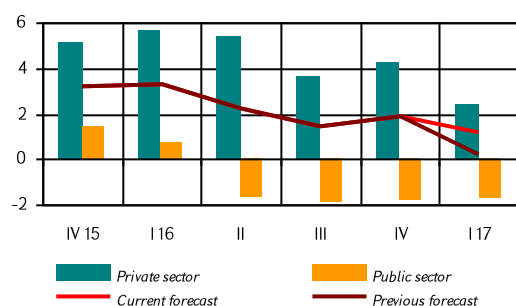
¹⁶ Further developments in private spending and inflationary effects therefrom are presented in more detail in the section of forecasts.

In the first quarter of 2017 the indicator of net export decreased

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

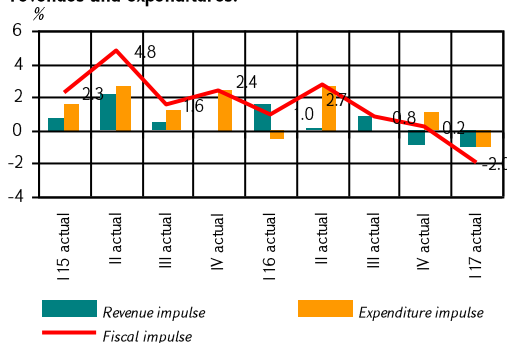


Average wage growth, y/y, (%)

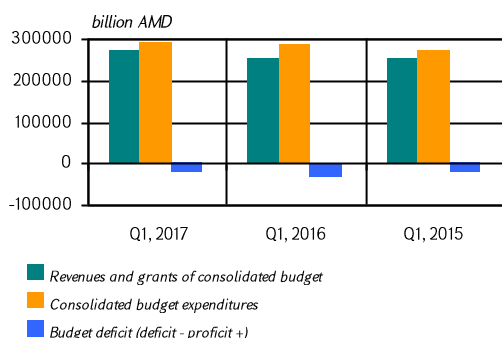


The impact of fiscal policy on aggregate demand is estimated 2.0 pp contractionary for the quarter, which is in line with the figure forecast for the first quarter of 2017.

The contractionary impact of fiscal policy in the first quarter of 2017 is due to the contractionary effect of revenues and expenditures.



Consolidated budget indicators



In the first quarter of 2017 the indicator of net real export fell against the previous forecast amid stronger growth of import of goods and services, according to Central Bank estimates.

In the first quarter of 2017 the growth of net remittances in dollar terms was higher than expected (27.0% y/y), which was primarily attributable to the ruble appreciation that exceeded expectations.

According to Central Bank estimates, in the first quarter of 2017 the indicator of real net export deteriorated against the previous forecast, which was due to more-than-anticipated growth in the import of goods and services. Thus, in the first quarter growth rates of real export of goods and services amounted to 1.5% y/y, while real growth of import of goods and services, 11.5% y/y¹⁷.

3.2.3. Labor market¹⁸

In the first quarter of 2017 the **average nominal wage growth rate** ran above the previous forecasts of the Central Bank, and is an estimated 1.2%.

In the first quarter of 2017 the nominal wage growth in the **private sector** amounted to 2.5%, running 0.4 pp higher from the previous forecasts, reflecting a bolstered economic activity. In the first quarter the decline in growth rate of nominal wages in the **public sector** was 1.8%, which is 0.7 pp higher from the previous forecasts. The deviation is due to the Government's policy for more favorable wage developments in comparison with the Central Bank expectations.

High economic activity recorded in the first quarter of 2017 pointed to the recovering demand for labor. As a result, the first quarter's **unemployment rate** is an estimated 18.3%, running 0.6 pp below the previous forecast. In the first quarter of 2017 the growth rate of wages outpaced the productivity growth and additionally created 0.4-0.5 pp of inflationary effect in the consumer market, which is not that much different from previous estimates.

3.2.4. Fiscal policy¹⁹

In the first quarter of 2017 the Republic of Armenia State Budget was performed with revenues and expenditures having almost proportionally exceeded the Central Bank's estimates²⁰. The fiscal sector's impact on aggregate demand is estimated 2.0 contractionary for the quarter, which is commensurate with the first quarter forecast.

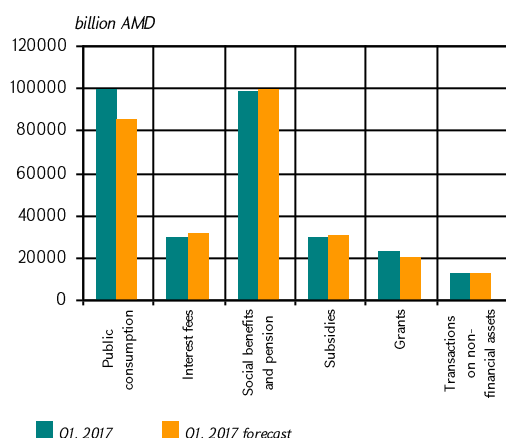
¹⁷ Real export and import growth indicators are the Central Bank estimates.

¹⁸ The labor market data for the first quarter of 2017 are the Central Bank estimates which are based on the fourth quarter 2016 data and actual January-February 2017 figures. The growth indicators provided in this sub-section are relative to the same reference period last year, unless otherwise specified.

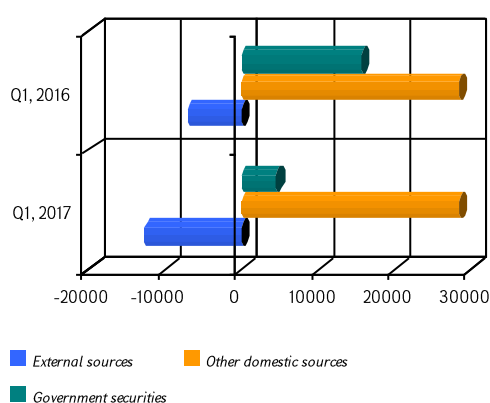
¹⁹ The review of the fiscal sector was done using preliminary actual consolidated budget indicators (local budgets as an estimate) prepared on the basis of preliminary actual indicators of the first quarter of 2017 (PIU funds included), excluding off-budgetary funds. The impact of revenues was calculated in respect of the nominal GDP indicator while the impact of expenditures, in respect of an estimated economic potential.

²⁰ Comparison was made with the Central Bank projections.

Budget expenditures



In the first quarter of 2016 7 budget deficit was financed from domestic sources (billion AMD)



In the first quarter of 2017 consolidated budget revenues grew by 5.5% against the projection, mostly owing to more tax collection (value added tax, environmental taxes, income tax, excise duty and customs duty). As a result, the revenues impulse reached 1.0 contractionary instead of the projected 0.4 contractionary.

In the first quarter of 2017 the expenditures outgrew the Central Bank forecast by around 4%. This quarter saw an 11.5% increase in **public spending** whereas expenditures on item **“Transactions with non-financial assets”** were 1.7% less from the projection. As a result, the expenditures impulse amounted to 1.0 contractionary instead of the projected 1.9 contractionary.

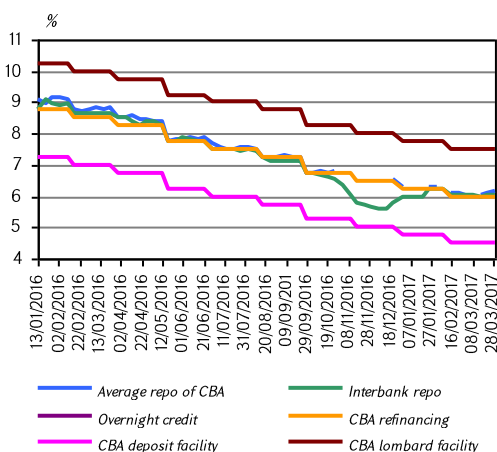
With revenue and expenditure performance described above, in the first quarter of 2017 the state budget generated a deficit of roughly AMD 20.5 billion, which is close to the Central Bank’s projection for the quarter.

Summary: private spending has grown to run slightly above the equilibrium, creating inflationary pressures, amid increased private transfers from the Russian Federation, expansionary monetary policy implementation and high economic activity. Taking also into account the expansionary fiscal policy’s contractionary effect and the labor market’s inflationary pressures, one may conclude that the aggregate demand and labor market are estimated to have jointly created 0.5-0.6 pp of inflationary pressures in the consumer market in the first quarter of 2017. Note, however, that such inflationary pressures are temporary, according to the Central Bank estimates²¹.

3.3. Money and financial market developments

3.3.1. Financial market, money and credit

During the quarter short-term interest rates came closer to the Central Bank’s refinancing rate

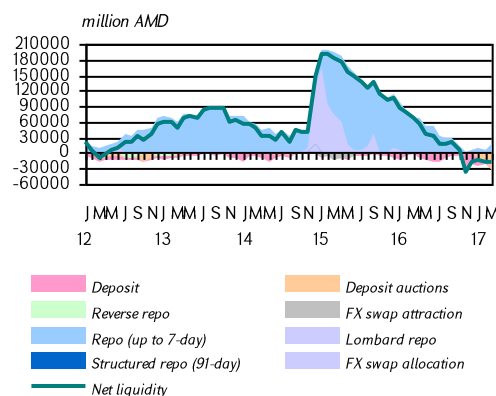


The Board of the Central Bank reduced the refinancing rate by 0.25 pp and then left it unchanged during the first quarter of 2017.

Although certain positive developments resulting from continued easing of monetary conditions by the Central Bank in the last two years were noticeable in the economy this quarter, the forecasts for a slowly recovering inflation prompted the Board to lower the refinancing rate by 0.25 pp in February. In March, the Board considered it reasonable to leave the policy rate unchanged, maintaining that the expansionary policy carried out earlier would continue spilling over to the economy in the course of 2017, while anticipating rapidly rebounding economic activity and inflation (see Box 1).

²¹ Further inflationary effects of aggregate demand and labor market are described in the forecasts section.

Liquidity injection and absorption through the Central Bank operations (average monthly value)



Average quarterly market rates in Armenia

	Q1, 2016	Q2, 2016	Q3, 2016	Q4, 2016	Q1, 2017
Central Bank refinancing rate (end of quarter)	8.25	7.5	6.75	6.25	6.00
Central Bank repo rate	8.92	8.13	7.35	6.54	6.13
Interbank repo rate	8.73	8.01	7.27	6.19	6.06
Short-term treasury bill yield	11.33	10.25	7.87	6.65	7.21
Medium-term notes yield	14.51	13.88	11.36	10.13	9.97
Long-term bonds yield	16.33	16.37	14.16	13.65	13.18

Box 1

The effect of easing monetary conditions on interest rates in the financial market

From August 2015 until the end of the first quarter of 2017 the Central Bank has gradually reduced the policy rate from 10.5% to 6%.

The approach to gradual lowering of the policy rate by the Board was driven by persistently high inflationary expectations²² for a long while after the Russia crisis in 2014 as well as an estimated high probability of additional risks to again having to get the inflation unanchored in case interest rates reduce sharply.

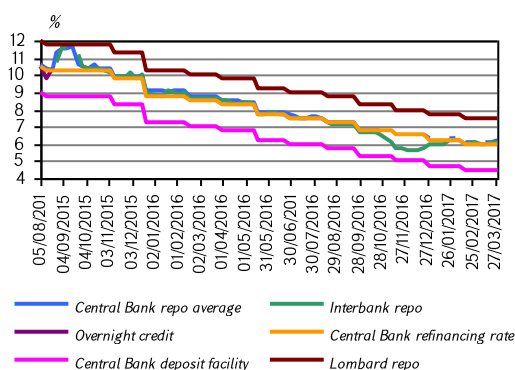
As inflation expectations fall, the Central Bank regularly communicated to the financial market that it would continue easing monetary conditions in the absence of risks and if the situation remains unaffected. At the same time, the Central Bank communicated the reasons why the inflation ran below the target and indicated benefits to slowly reaching the target²³. The implemented policy helped shape a lower level of interest rates in the future owing to the decline in inflationary expectations.

As a result, the approach taken has allowed to reduce inflationary expectations, which was reflected first in the level of first short-term and then long-term interest rates in the financial market, in the level of dollarization and growth rate of cash.

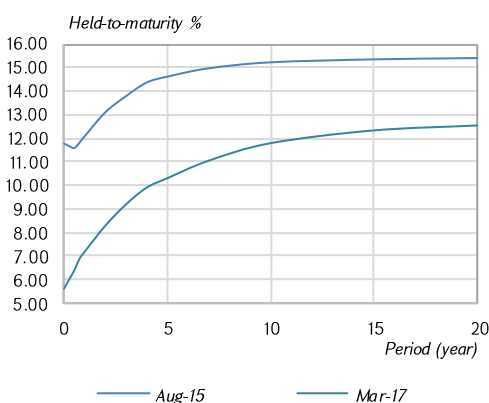
The Central Bank policy rate first affected the interbank rates, a short-term segment of the financial market, and then it spilled over to the government bond market. The impact on long-term interest rates has proved to be gradual.

The policy rate reduction by the Central Bank effectively transmitted to the interbank loan and government bond market, all along the yield curve. Figure 2 shows that the interbank market rate has reacted to the Central Bank policy rate over the entire course of easing of monetary conditions, having reduced by 4.5 pp.

The Central Bank's policy rate impulse transmitted onto the financial market



Held-to-maturity curve



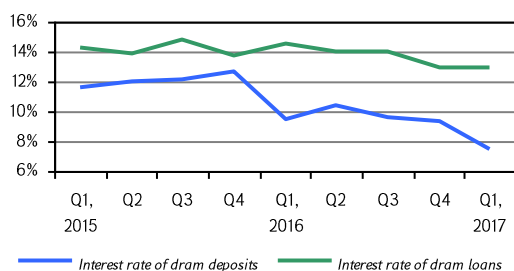
²² It is important to note that anchored inflationary expectations is one precondition for effective transmission of monetary policy, and such expectations may differ significantly from actual inflation. For example, actual inflation in 2015-2016 has been lower from the target, whereas the Central Bank surveys pointed to the fact that perception of the households and companies about inflation had been high.

²³ See "Inflation Report/3-16", <https://www.cba.am/AM/ppperiodicals/Gnach%203-16hay.pdf>, pages 4-10.

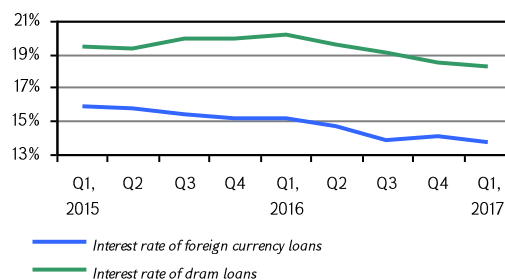
The government bond market yield-to-maturity curve diagram clearly shows the yield curve having shifted in parallel, which means that the Central Bank policy rate cut has transmitted onto both short-term and long-term segments of the curve. The decline in short-term interest rates in that period of time reached nearly 6 percentage points, reflecting a further increase in the short-term stability confidence. Long-term interest rates have fallen by about 3 percentage points, as the long-term inflation expectations of financial market participants have reduced to a lesser extent.

It should be noted, however, that the decline in interest rates on loans and deposits is taking place at a slower pace, which, apart from monetary conditions, depends on the influence of other factors. In particular, the economic developments of 2014 have added to the uncertainty about future revenue growth of businesses, which had a great impact on the creditworthiness of the households. This risk coming from the real sector has decelerated the lenders' propensity to reduce the dram interest rates.

Interest rates of deposits of and loans to legal entities



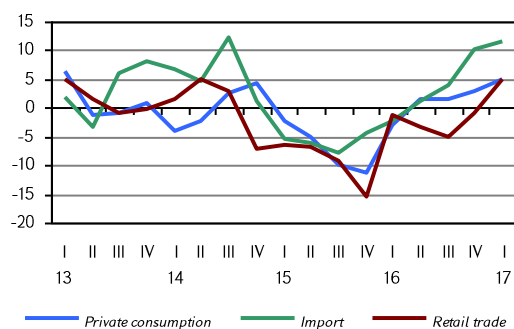
Interest rate of loans to individuals



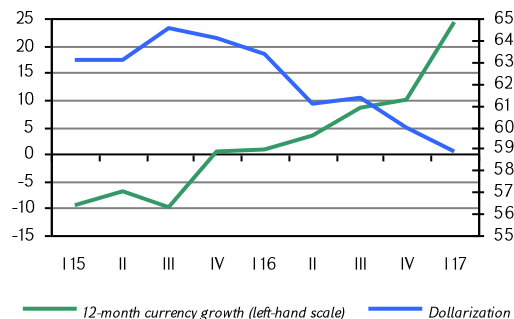
The impact of the Central Bank policy rate on interest rates on foreign currency deposits and loans is much lesser. Interest rates on foreign currency funds, in addition, are affected by more factors such as exchange rate expectations and foreign interest rates. Specifically, the target rate of the US Federal Reserve System, which has been raised by 0.75 percentage point since 2015 and is expected that it will continue to grow slowly in the future.

Also, the falling of interest rates, combined with the stability of the financial markets, has led to reduced dollarization and change in behavior of people to avoid cash, as well as, among other factors, contributed to the recovery of domestic demand.

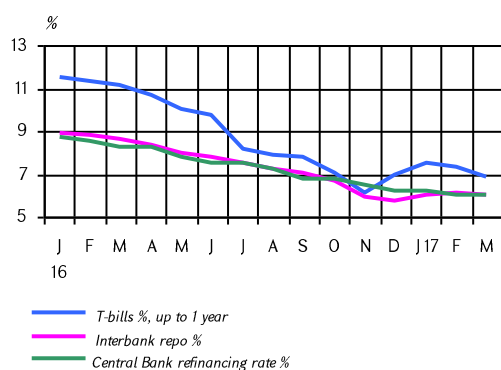
Demand indicators growth, y/y, (%)



Dollarization and currency rates, (%)



Short-term interest rates in the first quarter of 2017



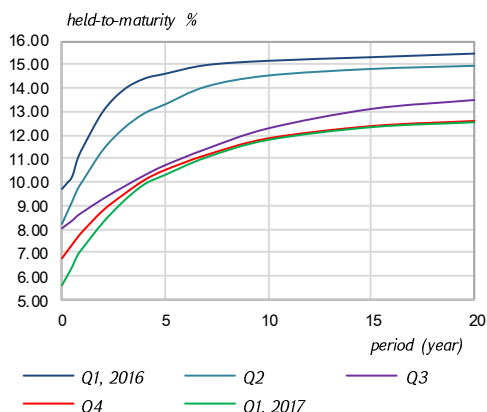
In the first quarter of 2017 short-term market rates approached the Central Bank's policy rate after the Central Bank used an appropriate liquidity management toolkit. So, interbank repo rate stood at 6.03% in March, growing by 0.24 pp against December of 2016, and the average quarterly indicator decreased by 0.13 pp to 6.06%.

Interest rate on up to 14-day interbank repo transactions deviated a mere 0.03% from the refinancing rate of the Central Bank in March²⁴.

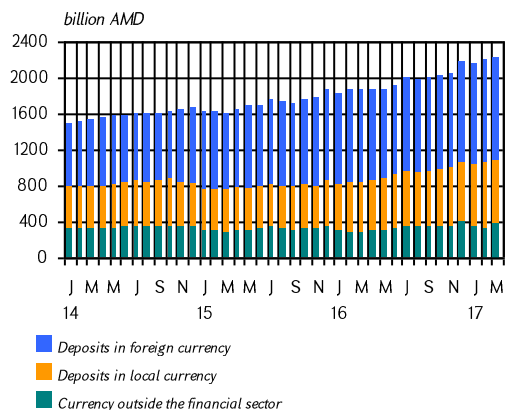
In the financial market, the falling of interest rates affected the government bond market hence the yield curve. At the end of March, compared to the end of December, most prominent was the decline in average yield of up to 1-year maturity bonds, 1.0 pp.

²⁴ Repo transactions with 1-14-day maturities constituted 99% of interbank repo transactions in the first quarter of 2017.

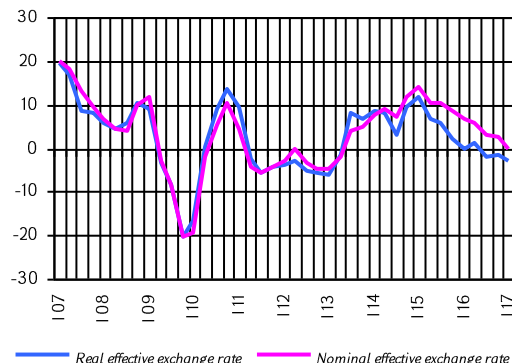
In the first quarter of 2017 the government bond yields declined in the short-term segment of the curve



In the first quarter of 2017 deposits in local currency outgrew deposits in foreign currency



In the first quarter of 2017 the real effective exchange rate depreciated y/y, %



Sustained easing of monetary conditions in previous quarters, falling interest rates in the financial market, competition between banks and other financial institutions and the current level of liquidity all have contributed to continued reduction of interest rates of deposits and loans in the first quarter of 2017.

Falling interest rates of deposits notwithstanding, attracting of deposits continued to grow. Relative stability in financial and currency markets and the decline in inflation expectations during the quarter led to accelerated growth of dram deposits over foreign currency deposits. The dram deposits grew by 4.8%, foreign currency deposits, by 1.9%. This helped reduce the level of dollarization by 1.1 pp, which exceeded the Central Bank forecasts.

The falling of interest rates and easier lending procedures contributed to the growth of lending, as expected; the growth amounted to 1.5% in the quarter mainly owing to dram loans granted to households. The 12-month growth in total lending was 5.3% in March 2017, which exceeded the forecasts by almost 1 pp.

Box 2

Survey on the Terms of Lending by Banks and Credit Organizations in Armenia

According to the results of the first quarter 2017 survey on terms of lending by local banks and credit organizations, there has been further easing of terms in all aspects of lending, including by way of stronger competition between banks and other financial institutions and increased level of liquidity. This not only led to easier terms for loan interest rates but also less strict terms of maturity (i.e. providing the borrowers with extended deadlines). Actual demand for all types of credit has grown.

For the second quarter of 2017 banks and credit organizations anticipate further easing of procedures in provision of all types of credit and a growing demand for loans.

3.3.2. Exchange rate

With the Russian ruble appreciating and euro and Turkish lira depreciating, average weighted nominal exchange rate in currency markets of trade partners to Armenia remained unchanged in the first quarter of 2017. The average nominal exchange rate of the Armenian dram depreciated versus the US dollar by 1.4% during the quarter. To absorb short-term volatilities deriving from balance sheet seasonality, the Central Bank sold nearly USD 15 million in net terms in the foreign exchange market during the first quarter.

In the first quarter of 2017 the nominal effective exchange rate of the Armenian dram depreciated by 1.4% on average. On the other hand, the real effective exchange rate of the Armenian dram appreciated by 1.5% q/q²⁵.

²⁵ The first quarter 2017 indicator of the real exchange rate is the Central Bank estimate.

Compared to the same reference period last year, the real effective exchange rate depreciation has been 3.2%.

Growth y/y, (%)	Q1, 2015	Q2	Q3	Q4	Q1, 2016	Q2	Q3	Q4	Q1, 2017
Real effective exchange rate (+ means appreciation)	11.7	6.7	5.8	2.2	-0.1	1.02	-1.9	-1.3	-3.2
Average inflation in Armenia	5.2	5.1	4.4	1	-1.2	-1.6	-2.2	-0.7	1.5
AMD/USD average nominal exchange rate (+ means appreciation)	-13.9	-13.4	-14.8	-10.1	-2.3	-0.5	0.8	0	0.6
Average weighted inflation in trade partner countries	6.7	7.9	7.5	6.9	5.1	3.1	3.2	3.2	4.4
Trade partners' average weighted nominal exchange rate (+ means appreciation versus the US dollar)	-32.1	-27.2	-29.4	-20.7	-9.1	-6.5	-2.1	-2.7	0.9

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

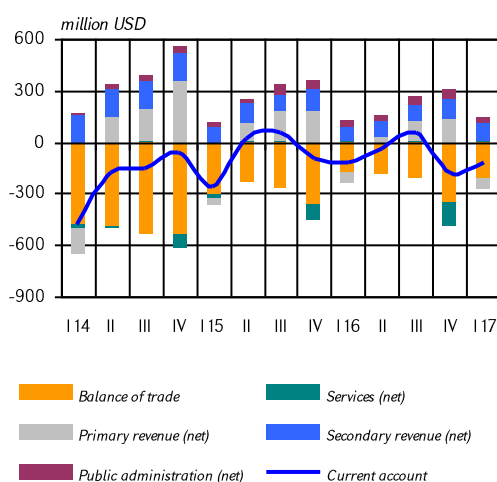
3.4. Balance of payments²⁶

In the first quarter of 2017, the improvement in terms of trade notwithstanding, the trade balance deficit increased due to higher-than-predicted growth of import in dollar terms and real import volumes as a result of stronger economic activity. The increase in dollar value of export was mainly owing to high growth in export prices.

Thus, an 18.0% y/y increase in the dollar value of export²⁷ in the first quarter of 2017 was mainly driven by increased prices of raw materials and the item “Products of prepared food”. The items “Precious metals, metals and articles thereof” and “Produce of vegetable origin” had negative contributions. Note, that the growth of item “Precious metals, metals and articles thereof” deviated by about 5 percentage points from the projection because of missing of sub-item “Other produce of precious metals and metals”.

Import of consumer goods posted high growth in the first quarter of 2017 amid gradually improving domestic demand. Import of raw materials also contributed positively to the imports indicator. As a result, a 19.0% y/y increase in the dollar value of import was recorded during the quarter, which is about 10.0 pp above the forecast. The deviation was mainly due to expecting more favorable developments in the economic activity.

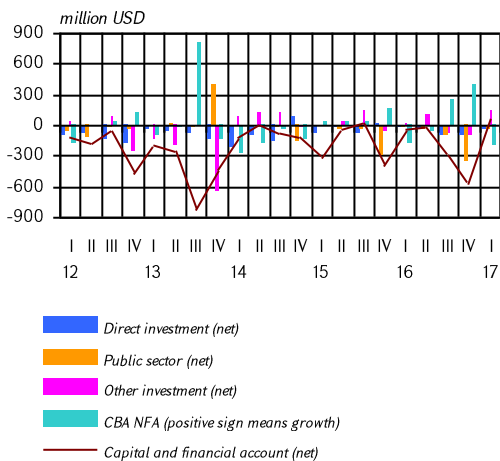
In the first quarter of 2017, relative to the first quarter of 2016, the current account deficit has grown



²⁶ The first quarter 2017 balance of payments will be published at the end of June 2017, according to the timetable. The first quarter 2017 indicators are the Central Bank's forecasts and estimates.

²⁷ The export and import indicators are represented on a balance-of-payments basis, i.e. by credit and debit, respectively.

The decrease in net foreign assets of the Central Bank has been offset by net growth of foreign assets in the private sector



In the first quarter of 2017 the deficit of trade balance²⁸ grew by around USD 38.0 million to USD 214.2 million, as a result of outgrown import. The net inflow of remittances broadened by 27.0% y/y. Actually, the growth has been quite high than the projected growth indicator, which is explained by rapid appreciation of the ruble amid gradually recovering Russian economy. The negative balance on investment income has increased by USD 9.0 million. As a result of the aforementioned developments, the current account deficit widened this quarter to USD 125.0 million relative to the first quarter of the previous year.

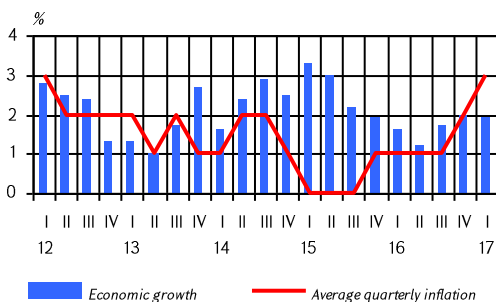
Actual capital and financial account indicators of the first quarter of 2017 will be published at the end of June 2017, according to the timetable.

As current account deficit widened beyond the forecast figure, the decrease of net foreign assets of the Central Bank was higher than projected. This primarily occurred to the expense of a decrease in commercial banks' foreign currency funds with the Central Bank.

3.5. External environment

Main trade partner countries to Armenia saw their economic activity improving further during the first quarter of 2017. In particular, there has been some slowing of economic growth in the USA and the Eurozone but the economic growth rate accelerated in the Russian Federation.

In the first quarter of 2017 the inflation in the USA notably accelerated

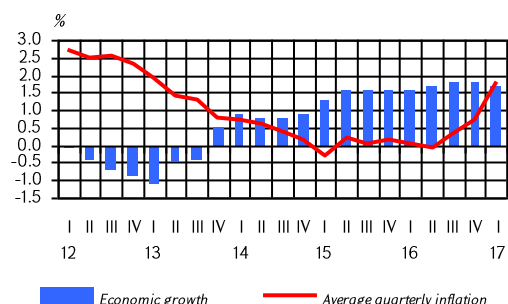


According to preliminary estimates of the Bureau of Economic Analysis of the U.S. Department of Commerce, the y/y economic growth in the **United States** in the first quarter of 2017 was 1.9% against the forecast of 2.2% growth. The deviation occurred mainly in the light of higher expectations for investments and export volumes (previous quarter's y/y growth was 2.0%). The first quarter's inflation rate accelerated noticeably to 2.5%, instead of the projected indicator of 1.9%, and is running above the target. The deviation of inflation from the projected value is due to increased prices of non-food products. The US Federal Reserve System raised the policy rates, as was expected, to 0.75-1.00% in the first quarter of 2017 from 0.5-0.5% in the previous quarter.

According to preliminary estimates provided by the Eurostat, economic growth in the **Eurozone** in the first quarter of 2017 was 1.7% against the forecast 1.4% growth. Higher-than-predicted growth was mostly due to strengthening domestic demand. The average quarterly inflation in the Eurozone in the first quarter of 2017 accelerated,

²⁸ The deficit of trade balance was calculated on a balance-of-payments basis, where export is credit, import debit.

In the first quarter of 2017 the inflation in the Eurozone accelerated



amounting to 1.8% instead of the projected 1.3%. Reported increase in service fees and energy prices largely contributed to the acceleration of inflation. Such acceleration notwithstanding, the inflation is still running below its long-term target. In the first quarter of 2017 the European Central Bank left the policy rates unchanged, as was expected, at the level of 0.0% for refinancing rate and -0.4% for deposit facility rate. At the same time, the ECB continued its asset purchases program in the amount of EUR 80 billion a month.

In the currency market in the first quarter of 2017, the European currency unit, the euro, depreciated against the U.S. dollar by 1.3% q/q (y/y depreciation: 3.3%); the average exchange rate reached 1.065 dollars for one euro instead of forecast value of 1.08 dollars, which has been driven by uncertainties over political future in Europe.

According to preliminary estimates of State Statistics Service of the **Russian Federation**, economy was recovering at a slower pace in the first quarter of 2017; it amounted to 0.5% y/y against the prediction of 0.9% growth. The Russian ruble appreciated during the quarter beyond prediction, reaching 7.4% q/q, explained by a certain rise in international oil prices and a weaker-than-expected effect from a currency intervention program by the Russian Finance Ministry. The ruble's appreciation has been 27.8% over the same quarter last year. In the first quarter of 2017 the inflation further decelerated to 4.5%, instead of the forecast 5.6%, which is determined by fallen prices of food and non-food products and service tariffs. Note, however, that the inflation rate continues running above the 4% target although inflationary expectations subdued to a certain extent. Under such circumstances, the Bank of Russia reduced the policy rate by 0.25 pp to 9.75% in the first quarter of 2017s. It should be mentioned that the Bank of Russia further pursued an interest rate cut policy in April, as was expected.

In the first quarter of 2017 the **price of Brent crude oil** at Intercontinental Exchange rose by 8.2% against the previous quarter, averaging USD 54.0 a barrel. The price increase was quite predictable as OPEC and non-OPEC members had agreed to reduce oil production in the world.

In the first quarter of 2017 the **price of copper** at the London Metal Exchange grew a sizable 10.1% to USD 5840 per ton on average, somewhat at a higher level against the previous quarter, mostly driven by expectations for continued demand in China.

The export price of **hard red wheat** grew during the quarter by 17.1% (y/y price decrease: 11.7%) to USD 3.9 a bushel on average. The wheat prices are also at higher levels due to reduction of output and expectations for somewhat less harvest.

The price index of **unprocessed sugar** at the New York Board-Intercontinental Exchange stood at a lower-than-anticipated level in the first quarter of 2017, driven by sluggish global demand and in expectation of abundant crops in Brazil – a principal producer and exporter.

Summary: inflationary trends observable in the world's commodity and food product markets in the first quarter of 2017 were in line with the previous program's forecasts. However, world copper markets saw higher-than-expected price inflation.

BOARD OF CBA

MINUTES (16.05.2017)

Refinancing Rate of May 16, 2017

The CBA Board Meeting of May 16, 2017 attended by Chairman Arthur Javadyan, Deputy Chairman Nerses Yeritsyan, and Board Members Ashot Mkrtchyan, Arthur Stepanyan, Armenak Darbinyan, Oleg Aghasyan and Arkadi Khachatryan.

The Board meeting opened with presentation of Situation Report as of May 16, 2017. It addressed current developments on inflation, external environment and real, fiscal and monetary sectors of the economy.

There was 1.0% of inflation in April 2017 against 0.3% of deflation recorded in the same month of the previous year, in which case the 12-month inflation rate has increased, reaching 1.2% at the end of the month. Such a high inflation registered in April (average inflation of the same month in the last 6 years has been -0.2%) was mainly due to a 1.8% rise in prices of food products, having contributed to headline inflation by 0.8 pp. The 12-month inflation rate has incurred mostly the influence of supply-side factors, to which the Central Bank normally reacts partially, especially when core inflation continues recovering in line with the expected rates. It was estimated that a faster rebounding of aggregate demand would lead the core inflation to recover rapidly than anticipated, and that the 12-month inflation rate would be within the confidence band during the year. It was also noted that inflation risks were now balanced.

For external sector developments, it was noted that in spite of price deflation in the main food product markets in April (Food and Agriculture Organization's (FAO) Food Price Index of May 4th of 2017 fell in April by 1.8% against the previous month's index, yet it had risen by around 10.0% over the same reference period last year) published on May 4, the food price index in April fell by 1.8% the previous month while over the same period last year increased by 10.0 percent), minor inflationary trends will largely be persisting in short-term and medium-term perspectives, according to the Central Bank estimate.

For developments in the domestic economy, it was admitted that economic activity in the first quarter of the year proved relatively high, which has incurred mostly the effect of high growth reported in industry, services and trade sectors. As a result, the first quarter 2017 economic growth is estimated at 5.0%, which includes both supply and demand components, based on which some of the effects will eliminate starting from the second quarter. However, some of them will remain in the current year, based on which the economic growth forecast for 2017 has been revised upside, 3.3-4.8% from 2.2-3.2% in the previous forecast. At the same time, domestic demand is recovering faster than

expected, influenced by expansionary monetary and fiscal policies conducted in 2015-2016. Rebounding aggregate demand somewhat affected the developments with the current account, leading to the accelerated growth rates in real import of goods and services, as real growth rates in export of goods and services slowed down to a certain extent. In terms of aggregate demand, the Board also highlighted the impact of the fiscal policy to be implemented, which is an estimated 3.1 pp contractionary for 2017, but may be adjusted depending on how the implementation of fiscal policy will unfold. As a result, a positive GDP gap is estimated for the first quarter of 2017, which will be somewhat inflationary on domestic prices.

The Board also discussed the developments in financial market where a further downward trend in interest rates in almost all segments has been observable. It was emphasized that short-term market rates have been very close to the Central Bank's policy rate and have facilitated the transmission of decreasing effect onto long-term interest rates.

Following presentation of the Situation Report and the developments in external and domestic macroeconomic environments, the Board began discussing the monetary policy directions and the interest rate decision-making. Admitting that the current policy rate is still impulsive, the Board decided to leave the refinancing rate unchanged, 6.0%.

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

THE CENTRAL BANK OF THE REPUBLIC OF ARMENIA

BOARD RESOLUTION

Interest rates of operations by the Central Bank in the financial market

By virtue of Article 20 (c) of the Republic of Armenia Law on the Central Bank, the Board of the Central Bank of the Republic of Armenia enacts:

1. Leave the refinancing rate of the Central Bank of the Republic of Armenia unchanged, at 6.0%.
2. To the Financial Department of the Central Bank of the Republic of Armenia to carry out operations in the financial market of the Republic of Armenia, using the interest rates, as follows:
 - 2.1. Lombard facility rate offered by the Central Bank to be 7.5%.
 - 2.2. Deposit facility rate offered by the Central Bank to be 4.5%.
3. This resolution shall take force on the day following the adoption thereof.

Arthur Javadyan,
Chairman of the CBA

PRESS RELEASE

16.05.2017

On a May 16, 2017 meeting, the Board of the Central Bank of Armenia decided to leave the refinancing rate unchanged, at the 6.0% level.

There was 1.0% inflation in April of 2017 compared with 0.3% deflation recorded in the same month of the previous year, which has been mainly attributable to higher levels of prices of agricultural products. In this circumstance, the 12-month inflation rate has expanded and entered a positive territory; it amounted to 1.2% at the end of April, exceeding the Central Bank forecasts. The Board estimates that in the forecast horizon the inflation will continue to recover, stabilizing around the target.

In the external environment, the global economic growth outlook is improving and inflationary patterns in international commodity markets are persisting. However, the Board of the Central Bank expects only moderate inflationary effects from the external sector in the forthcoming months.

The Board notes that growth of economic activity in the first quarter of 2017 was strong enough, largely due to high growth registered in industry, rendered services and trade sectors. At the same time, the expansionary monetary policy implemented in recent years continues contributing to the recovery of domestic demand. As a result, it is expected that inflation will be within the confidence band already in 2017 and will stabilize around the target in the forecast horizon. Also, inflationary risks are estimated to be largely balanced at this point, in which case the Board considers it appropriate to leave the monetary conditions unchanged.

However, should there emerge risks to the inflation deviating from its recovery path, the Central Bank would react by adjusting its monetary policy directions accordingly, while fulfilling the inflation target in the medium run.

Detailed information on setting of the interest rate will be available in Inflation Report (Monetary Policy Program Q2, 2017), to be published by May 26, 2017.

Press Service of the Central Bank of Armenia