THE CENTRAL BANK
OF THE REPUBLIC OF ARMENIA

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dated August 26, 2016

Inflation Report

Monetary Policy Program, Q3, 2016

Status Report on Implementation of the Monetary Policy Program, Q2, 2016

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The Central Bank of Armenia has, starting from January 2006, 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 August 16, 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 economic situation in Armenia and the pace of monetary policy of the Central Bank of Armenia

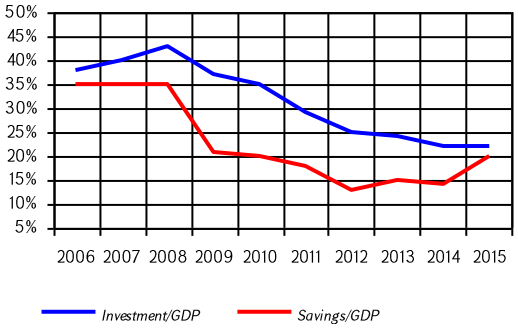
The policy implemented by the Central Bank of Armenia (the CBA) in the forecast horizon is still incurring the effect of the economic shock in late 2014, and the CBA has from time to time addressed the mechanisms of such effect in its inflation reports. In the last quarter of 2014, a sharp decline in international oil prices and depreciated Russian ruble led to dramatic changes in the behavior of households and companies. With too high expectations for inflation, all businesses attempted to secure themselves by converting the domestic currency into foreign currency and into various consumer goods, even short-term ones. Such behavior reflected all the signs of hyper-inflation the domestic economy had experienced back in 1993. The CBA reacted to this situation by using all of the means in its arsenal to stabilize the situation and safeguard the country from a deep economic crisis. It has therefore been possible for Armenia to avoid heavy financial and economic turmoil, which is still the case in many countries of the region as a consequence of a sharp price-fall in international oil market in 2014. Not only has the CBA been able to ensure macroeconomic stability in 2015, but its policy has contributed to shaping of positive economic growth at a time when the economies of all major partner countries in the region contracted. Moreover, the CBA's actions laid the foundation for eliminating previous economic imbalances and paving the way for long-term sound economic growth.

Regional shocks are not completely waned out yet, and the CBA is doing all to preserve hard-won macroeconomic stability while making sure it is not exposed to risks. This is why the CBA has chosen under its current monetary policy a scenario of **gradual** elimination of deflation; it is especially true as current deflation is of mostly an imported character, which all the central banks of the world do not practically respond to, allowing the shock of imported deflation to phase out automatically. The CBA presented deflation forecasts in its previous inflation reports, and well aware of deflation as having been imported, it believes that currently low inflation and gradual inflation recovery trajectory are in line with the long-term price stability objective of the CBA and, therefore, best serve the public interest for several reasons:

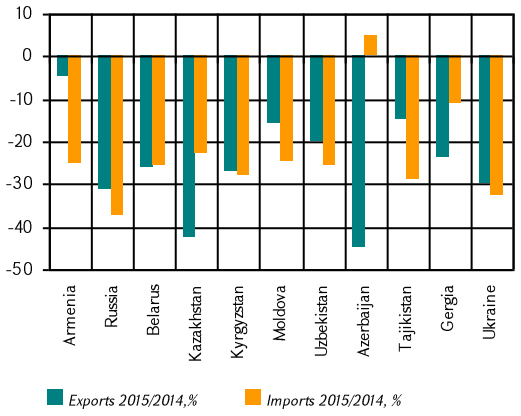
1. It provides stability and predictability for attracting investment. Over the past 7 years, only 2015 saw a significant increase in domestic savings and no more decline in gross investments, which are the cornerstone for long-term economic growth.

Still, their level is low. This is attributable to slow pace of structural reforms in recent years as the investments were fully financed through loan resources, which has a significant deterrent effect and may not be sustainable in the long run.

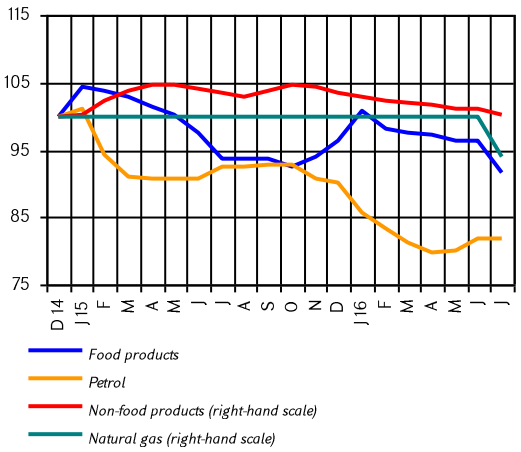
Savings and investments in relation to GDP



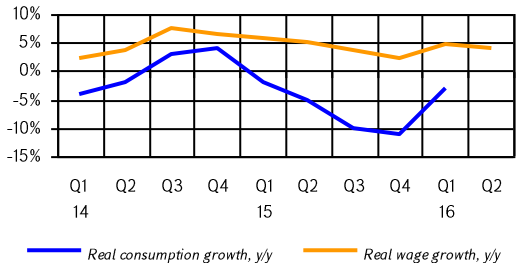
Change in foreign trade in CIS countries, Georgia and Ukraine in 2015



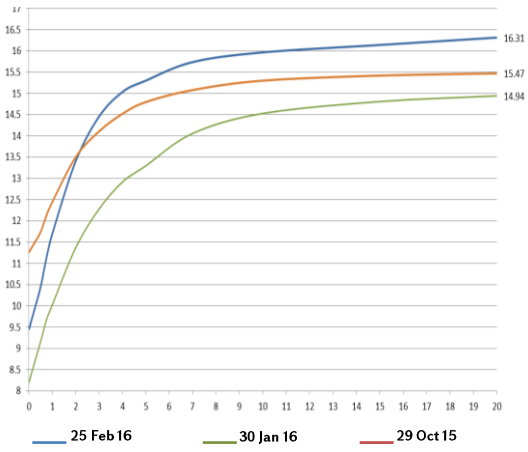
Price dynamics in Armenia, 2015 – 2016



Real wage and real consumption growth, 2014 – 2016



Change in T-bills yield curve before maturity, after October 2015



2. It facilitates elimination of accumulated imbalances in the economy through developed tradable sector, which is reflected in reducing current account deficit and sustainability of foreign debt even in the time of significant drop in remittances from abroad. Moreover, along with the import reduction, all countries in the region faced reduced exports, whereas import reduction in Armenia was almost concurrent with an unchanged level of exports (a significant increase in real exports was recorded under a sharp drop in export prices), which puts Armenia's economy positively apart from other countries in the region and secures an adjustment of external imbalance.

3. It helps restore enterprise competitiveness, which was disrupted due to the depreciation of the Russian ruble, as companies spend less on imported raw materials, fuel, and food and non-food products. Under an inflation scenario however, companies would incur more wage growth pressures and heavier foreign currency debt burden, leading to a wave of bankruptcies and sharp increase in unemployment, the risks to which have not vanished even today. These costs would definitely outgrow the ones exporters had incurred as a result of less depreciated dram in comparison with the ruble, and it seems to have been largely neutralized in Russia in two consecutive years due to much higher inflation there if compared to Armenia.

4. It also helps maintain consumers' living standards, as diminishing consumer incomes in a time of sharp decline in remittances would be more painful amid a higher rate of inflation. Low inflation has secured the purchasing power of wages, while real consumption has decreased due to reduced remittances from abroad.

5. It anchors inflation expectations, which, in addition to macroeconomic stability, also facilitates the transmitting of the effect of expansionary monetary policy on to the real sector and lending. Thus, in a time of high inflation expectations sharp reduction in interest rates comes out through exchange rate depreciation pressures in the currency market and it does not contribute to the real economy lending, as it happened in the period November 2015 – February 2016. However, the policy of more gradual reduction in interest rates since February gives the economy an impulse about stability of future prices, reflecting declined inflation expectations and lower long-term interest rates. Only such a policy made it possible to gradually restore lending, which, since the end of the first quarter of 2016, is in the positive territory.

6. It covers adverse shocks while contributing to the improvement of economic fundamentals, which, in the case of new negative external shocks, would keep the country immune to repeating of volatilities in 2014. The risk of these shocks is still estimated to be very high due to geopolitical developments in the region and possible fluctuations in commodity markets on the one hand, and the consequences after the US Federal Reserve System decides to raise the policy rates in the future, on the other.

The CBA believes the monetary policy it conducts best serves the society's interests and is determined to further carry out its primary task of maintaining price stability in Armenia, as entrusted to it by the Constitution and laws of the Republic of Armenia.

Economic situation in the second quarter of 2016 and the forecasts

In view of developments consistent with the program, the CBA kept the 2016 growth forecast within the previous quarter's range. In the rest of the forecast horizon the growth rates will speed up, 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.

Notwithstanding continued sluggishness in global economic growth rates, the first half of 2016, as was expected, reported accelerated economic activity in the main partner countries and high growth in Armenia's tradable sector of the economy, the industry sector in particular. In view of developments consistent with the program, the CBA kept the 2016 growth forecast within the previous quarter's range. In the rest of the forecast horizon growth rates will speed up, 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 some commodity markets of the world, while in the rest of the forecast horizon the 12-month inflation rate will gradually return to the target.

In the second quarter of 2016, driven by smaller-than-expected contraction in trade volumes and higher economic activity, the decline in private consumption in real terms turned into a growth mode. The investment environment, however, remains weak mainly due to still a sluggish domestic demand and low activity in the construction sector. For the second quarter the growth of ***private consumption*** and ***private investment*** are estimated at 1% and 3%, respectively, thanks to expansionary fiscal and monetary policy implementation by the CBA and the Government since early 2015 to date, on the one hand, and relatively sizable investment in the tradable sector, on the other. The investment, in turn, accelerated growth rates in the tradable sector and facilitated improvement in net exports: in the second quarter real growth of export of goods and services is estimated at 13.2% y/y and real growth of import of goods and services, merely 0.4%. So, based on the first half of 2016 results, the ***economic activity indicator amounted to 4.7% y/y*** mainly due to increased output volumes in industry and services sectors, in which case the semester's ***economic growth is estimated in the range of 3.9-4.1% y/y***.

The second quarter's economic growth is estimated in the range of 3.9-4.1% y/y.

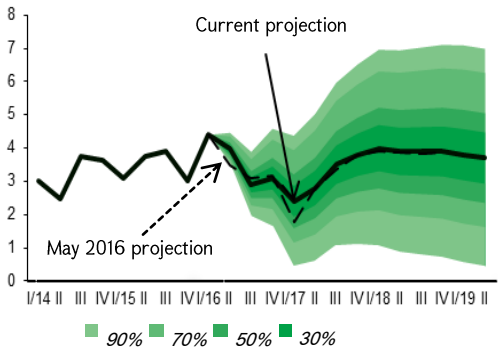
According to short-term forecasts of the CBA, in 2016 economic growth in the external sector will continue to be slow, while a low-price environment in international commodity markets will be persisting in spite of abolishing of deflationary patterns and achieving of some stability. Furthermore, on the premise of slower decline in the Russian

economy, there is anticipation that the decline in seasonal worker income and remittances of individuals will slow down either, 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 0.4-0.6 contractionary for the year, which will fall primarily upon the second half of the year. In 2016 private consumption growth is projected at around 1.5% and private investment, nearly 2.0%, which will be primarily a result of expansionary fiscal policy carried out since 2015, a low inflation environment as well as investment to be made in the tradable sector of the economy. On the back of high export growth registered in the first half and expected investments there, the export forecast has again been adjusted upside – to higher growth. Thus, in 2016 the real growth of export of goods and services is projected in the range of 11.0-13.0%, whereas the real import of goods and services will contract by 1.5-3.5% (see details in subsection "Current account" of section "2.2. Aggregate supply and aggregate demand"). In view of these developments, the ***2016 economic growth is estimated in the range of 2.8-3.4%***.

The 2016 economic growth is estimated in the range of 2.8-3.4%.

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

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



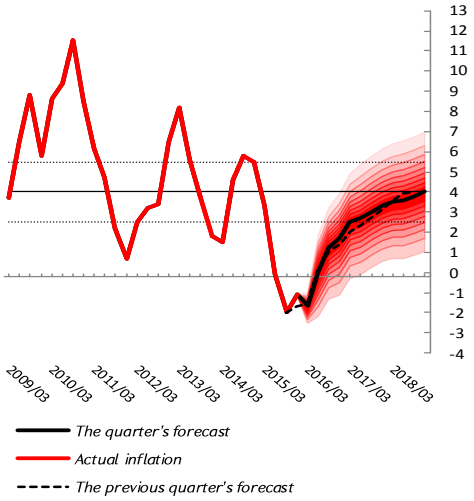
There was 1.4% deflation in the second quarter of 2016 compared to 2.3% recorded in the same period of the previous year, in which case the ***12-month inflation rate*** reached **-1.1%** at the end of June. In view of the inflation environment that will still be persisting at a low level in the upcoming months and inflation expectations further mitigating, the CBA continued to loosen monetary conditions in the second quarter: the refinancing rate was lowered by a total of 0.75 pp to 7.5% in late June (see details in section "3.1.1. Actual inflation and fulfillment of the inflation target").

The 12-month inflation rate reached -1.1% at the end of June.

Consistent with short-term forecasts of the CBA, in consideration of the international commodity markets' deflationary impact still transmitting on to the domestic prices, and a persistently weak domestic demand, the forecasts of core inflation were revised downside. There is however anticipation that regulated service tariffs would increase to some extent, as subsidizing of electricity price by the Government and "Electric Networks of Armenia" CJSC in benefit for some households and small businesses ended on August 1, 2016, which will be partially offset by reduction of the electricity tariff for consumers. In view of the above developments, the CBA estimates that the deflationary environment will be maintained in the third quarter and then it will gradually decrease; in the forecast horizon, the 12-month inflation rate will gradually return to the target.

The CBA finds it reasonable to continue easing monetary conditions in the third quarter of 2016.

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



The CBA finds it reasonable to continue easing monetary conditions in the third quarter of 2016, which will lead to further expanding of aggregate demand, gradually phasing out deflation environment and stabilizing of inflation around the target in the forecast horizon. The CBA considers an increase of the 12-month inflation rate the most efficient path since low inflation environment sustains the purchasing power of incomes, reduction of company costs and anchoring of inflation expectations. Otherwise, abruptly loosened monetary conditions in pursuit of rapid achievement of the inflation target will cause great volatility in the financial market, because refinancing rate sharply lowered today will lead to an equally sharp rise tomorrow when a significant inflationary potential generates.

Risks that inflation will deviate from the projected value are estimated to follow a downward path in the short run and to be balanced in the medium run. Risks deriving from external and domestic sectors mostly persisted in relation to the previous forecast. In particular, the ***external sector risks*** are related to capital outflows from developing countries and, consequently, volatilities in financial markets, the processes in the European Union, 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 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.

2. FORECAST, FORECAST CHANGES AND RISKS

2.1. External environment[1]

In 2016 trends of slow economic growth will continue to be seen in the global economy and main partner countries to Armenia. Deflationary trends in international markets of raw materials and food products ended in general, while developments in some food product markets are already inflationary.

In 2016 trends of slow economic growth will continue to be observable in the global economy and main partner countries to Armenia.

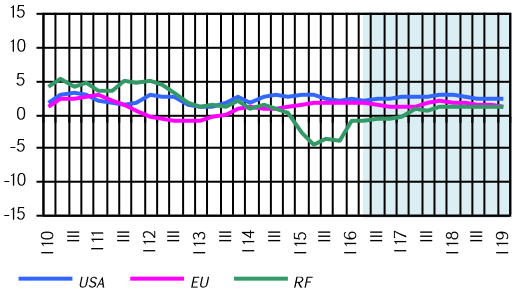
Deflationary trends in international markets of raw materials and food products ended in general, while some food product markets started to see inflationary developments.

Economic growth in the ***U.S.A.*** in 2016 is forecast at 2.1% compared to 2.3% growth reported in the previous prediction. The economic growth rate in the medium-term is expected to accelerate to 2.4%[2]. Despite continued improvement in the labor market and a low rate of unemployment, the US inflation is below the target, and the raising of policy rates by the US Federal Reserve System is expected in the second half of 2016. Then, in the medium term, the Fed will be gradually tightening its monetary policy.

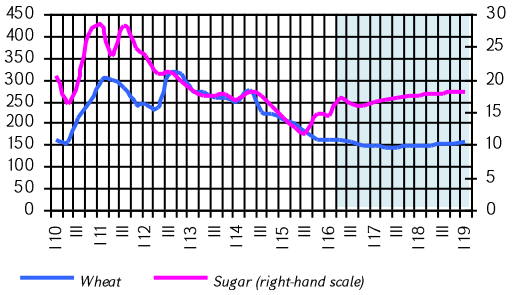
Economic growth in ***Eurozone*** in 2016 is predicted to be 1.3% mainly due to high economic growth recorded in the first half of the year. In the latter part of the year, however, economic activity is expected to slow to a certain extent in connection with the Great Britain leaving the European Union (see details in Box 2). However, in the medium term there will be an acceleration in economic growth, averaging around 1.5%. Notwithstanding persisting political uncertainties in the medium run, the European Central Bank's expansionary monetary policy continues to sustain economic activity. Although the euro's exchange rate remains depreciated against the US dollar, the Eurozone inflation runs below the target as far as commodity prices are lower. It is expected that inflation will approach the target only at the end of the forecast horizon, which will be greatly fostered by the ECB's expansionary policy, under which the quantitative easing exercise will continue up until the first half of 2017.

Economic decline in ***Russia*** is anticipated to slow down in 2016 to around 0.8% compared to the previous prediction's decline of 1.2%. The economy will return to positive growth only in the middle of 2017 with the medium-term growth indicator to reach 1.1%. International oil

Economic growth in main trade partner countries (%)



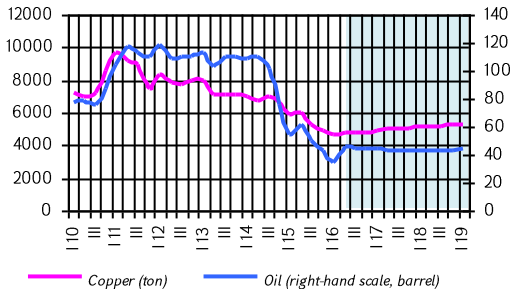
Food products (US dollar)



[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 25.07.2016.*

Commodities (US dollar)



prices persisting at low levels and slackening domestic demand are hampering the economic growth to rebound fast. On the other hand, weak domestic demand and slowing inflation expectations contribute to the reduction of inflation; it is expected that later this year it will be around 5.6% and will approach the 4% target in the second half of 2017. In view of such inflation developments and fewer inflationary risks, the Bank of Russia will keep on adjusting the policy rates downward.

According to the IMF July 2016 report "Global Economic Outlook", world economic growth in 2016 is predicted to reach 3.1%, which is a 0.1 pp downside revision compared to the previous publication of the report in April.

The prediction is that prices will keep low in ***world commodity and food product markets*** during 2016, and in the medium term perspective some inflationary trends will emerge on the back of rebounding global demand and somewhat contracting supply.

Risks to the developments in global economy will persist in general. More prominent risks include capital flight to the U.S.A. from developing countries and, consequently, further volatilities in financial markets (including owing to the processes in the European Union (see Box 2), a likely slowdown of global economic growth resulting from structural reformation of the Chinese economy, continued sluggishness in economic activity in developing countries and Russia as well as the risks associated with geopolitical developments.

Box 1

Developments in commodities markets in the forecast horizon

*The August 2016 report of the **oil** market published by OPEC predicts that the global oil demand will grow in 2016 by 1.22 million b/d and consumption will reach 94.26 million b/d. The report also foresees that oil production outside OPEC in 2016 will reduce by 0.79 million b/d to 56.13 million b/d on average. Oil production by OPEC in 2016 will go up by 0.16 million b/d. In spite of prediction that the oil demand will somewhat increase, international oil prices will trend slightly downward in the short run from high levels recorded in recent months. In the medium run however, prices are 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 continue demonstrating signs of modest growth, mostly reflecting somewhat added industry volumes in China. In 2016 world copper markets anticipate certain recovery of demand in three major copper consumers – China, the European Union and the U.S.A. There are certain risks in the copper market due to uncertainties about how the producers will agree upon setting limits on the production volumes, since the decision to reduce production volumes by key copper mining companies in China earlier this year after a rise in copper prices has been postponed.*

*According to the July estimates of the U.S. Department of Agriculture, in the 2016/2017 marketing year some 738.5 million tons of **wheat** crops is expected. According to estimations, despite the reduction of 4.1 million tons, world wheat stock will reach a record amount of 253.7 million tons for the 2016/2017 marketing year. The wheat supply with such volumes will determine minor 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 2016/2017 marketing year will be 481.2 million tons, and world rice stocks will reach 107.3 million tons, growing by 0.4 million tons compared to the previous estimation. World rice consumption has decreased by 1.8 million tons for the 2016/2017 marketing year to 478.8 million tons, mainly due to a decline in consumption in India. Nevertheless, the prices of rice will still keep low in the short run in the light of shortened demand and relatively large supply volumes.*

*Considerable rise in world **sugar** prices, resulting from reduced sugarcane harvest due to bad weather in Brazil and India, the world's leading manufacturers and exporters of sugar, will be observable in the short-term perspective.*

Box 2

Great Britain exiting the European Union

In the June 23rd referendum UK citizens voted in favor of leaving the European Union (51.9% versus 48.1%). The issue of migrants was the key argument that was used during the campaign to vote against EU migrant policies. Following the referendum David Cameron, the British Prime Minister and an EU advocate, appeared with a statement on stepping down as prime minister, and soon Theresa May, another member of the Conservative Party, took over as the new prime minister.

The legal framework for exiting the EU has been defined by Article 50 of the Lisbon Treaty, which says that each country can apply for termination of the EU membership. Therefore, the issue of termination of the EU membership cannot be on the agenda, unless Article 50 of the Treaty has been enforced. The problem is that it is up to the EU Member States to officially commence the process of leaving the EU and that Member State shall cease to be a member only 2 years after the enforcement of Article 50.

The British withdrawal from the EU shall mean inking more than 50 new trade agreements, which is, above all, time consuming. During that period of time trade with non-EU countries will be implemented by the rules of the World Trade Organization. The issue on how the UK-based financial institutions will proceed with their business after Britain leaves the EU single market is important.

All this points to the argumentation that economic consequences associated with the outcome of the UK referendum will become more visible in the long-term perspective, although some short-term volatility is inevitable.

Thus, the British pound reacted to the referendum results instantly as it lost roughly 10% of its value against the U.S. dollar over the short period of time. At the same time, the euro depreciated by nearly 1.9% against the dollar. What is noteworthy is that the event came in as a surprise to the international financial markets, leading to heightened volatility and, in some developing countries, to exchange rate depreciation and slump in stock indices. This development, however, was only limited to the countries with their main export destination to the EU countries and the UK (Eichengreen, Gupta, Ospino (2016)).

It should be noted that fluctuations in the financial markets were largely short-term in nature, although these expressed the fact that this process has added significant uncertainties to the global economic outlook, economic development and economic policies of the countries involved. Therefore, in the medium term, the impact of the referendum outcome on the instability of the financial markets will weaken but will be more significant for real activity indicators of the British economy – most impact will be incurred by the labor market and capital investment in businesses. It should be noted that, as there are much uncertainties going along with the process, a likely slowdown in investment will, naturally, have an impact on economic growth

prospects. The impact of this process on the EU economic development is important in a sense that there are countries included in the EU that are main partner countries to Armenia. Note that, in the time of present uncertainties, the negative impact on the sustainable long-term EU economic growth equilibrium is estimated to be 0.1 percentage point. In such circumstances, the European Central Bank, and the Bank of England in particular, are very much likely to embark on more stimulating measures. These, specifically, included the Bank of England's cutting of the refinancing rates from 0.5% to historically low levels of 0.25% and proceeding with the program on quantitative easing. It is noteworthy that in the current situation the exchange rate depreciation may bring in some additional impetus for rebounding of demand and inflation.

The uncertainties related to the Brexit will be persisting a couple of years, and impacts on the global economy will only emerge in the medium run.

2.2. Aggregate supply and aggregate demand

Aggregate supply

The 2016 economic growth is estimated in the range of 2.8-3.4%.

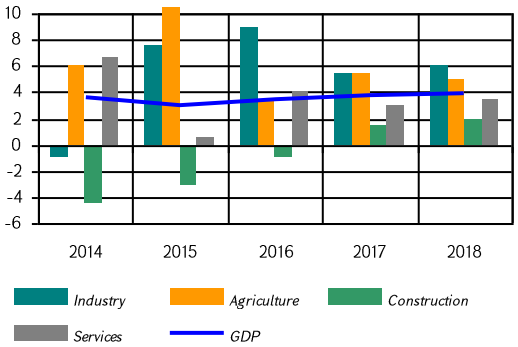
The CBA economic growth forecasts for 2016 remained much the same as macroeconomic developments were generally in line with the previous forecasts. As a result, the ***2016 economic growth is estimated in the range of 2.8-3.4%***[3].

Though the narrowing of private transfers from Russia to Armenia is expected to slow down considerably in 2016, the effect of contracting remittances of individuals on the domestic demand will be seen further. This will, however, 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 0.6%,*** 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 higher economic activity in the main partner countries and, amid a healthy external demand, positive developments in the tradable sector, greatly assisted by the ***CBA's consistent monetary policy***.

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 in the forecast horizon. ***At the end of the forecast horizon the growth indicator will be within 3-4.5%***[4], which will be driven by a

GDP growth by sectors of economy



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

number of investment projects in the private sector, including the Amulsar mine operation, broadening export capacities in the context of export-promotion policy of the Government, identifying new export markets and embarking on product development.

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 both estimated long-term GDP growth rate and medium-term forecast of the economic growth rate may decelerate if the structural reforms are pushed ahead slowly and investment in the tradable sector grows insufficiently. It is worth mentioning that investments in the 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.

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

For ***Industry,*** the forecasts were revised upside, primarily reflecting higher-than-expected growth in food, beverages, tobacco and electricity productions observed early in the year. As a result, ***in 2016 the value added in industry is forecast to grow within 7.9-8.7%.*** 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.

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 and broadening export capacities in the context of export-promotion policy of the Government.

For ***Construction,*** the 2016 forecasts of value added did not change much. Note that the decline in volumes of construction funded from state and municipal budgets will be cushioned by an increase in volumes of construction financed through international credits on the one hand and, on the other hand, an increase in volumes of construction financed by companies and households, if relatively high investment activity in the tradable sector of the economy persists and lending conditions further improve. As a result, the change in value added in construction in 2016 will be ***from -1.3 to -0.5%.***

In the ***forecast horizon,*** the growth is expected to ***stabilize in the range of 1.5-2%*** 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 did not change much either, and are estimated within ***3.8-4.4%.*** With the domestic

demand still sluggish yet set to improve gradually, the growth of services in 2016 will be bolstered by increasing volumes of services rendered in connection with export businesses and recovering growth of trade volumes in the latter half of the year.

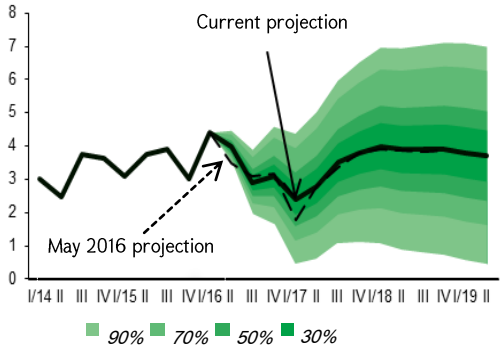
In the ***forecast horizon***, the growth in services is predicted to ***stabilize within 3-4%*** in view of gradually recovering domestic demand and expected tourism growth.

For ***Agriculture***, the forecasts of value added were revised downside in relation to the previous forecasts in consideration of negative developments anticipated in planting caused by hail in July. The growth in the sector in 2016 is estimated in the range of ***1-1.8%***.

In the forecast horizon, the growth in agriculture will accelerate to 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, in the context of broader policy measures the Government has consistently been taking for the sector in recent years.

In the forecast horizon risks to the economic growth are dual-sided and balanced.

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



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.

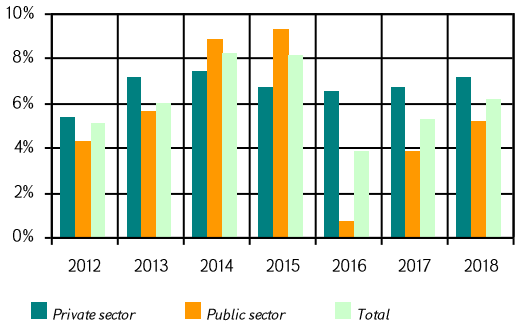
Downside risks include slower-than-expected recovery of private demand in 2016 and a lingering pace of pushing ahead with structural reforms for economic growth.

Real GDP Growth (Cumulative) Projection Probability Distribution				
Period	30% probability interval		90% probability interval	
	Min	Max	Min	Max
January-December 2016 / January-December 2015	2.8%	3.4%	1.8%	4.6%
January-December 2017 / January-December 2016	3.2%	4.4%	1.1%	6.5%
January-December 2018 / January-December 2017	3.1%	4.7%	0.7%	7.1%

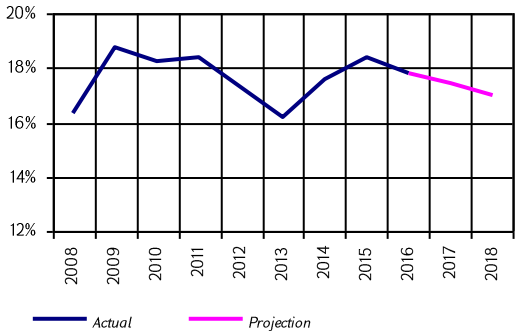
Labor market:[5] The 2016-2018 forecasts of labor market indicators remained much the same, whereas the forecast for the unemployment rate was adjusted slightly downside in the light of current and projected developments.

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

Average nominal wage growth, y/y



Unemployment rate



The productivity growth in the labor market is still strong in 2016, so an average 6.5% increase in nominal wages is expected in the private sector during the year[6]. Note that while the minimum wage threshold rose to AMD 55,000 in July of 2015, more increases of the threshold are not scheduled in 2016. On the premise of projected economic growth, fulfillment of the inflation target and continued Government policy[7] aimed at minimum wage increases starting from 2017, the average annual nominal wage in the private sector will grow by 6.6-6.8% in 2017 and nearly 7% in 2018.

Since October 2015 there has been a slowdown in public sector wage[8] growth, and although this unfavorable development persisted and even deepened during the first half of 2016, some 0.7% growth of average public sector wage will be reported for 2016. Revived economic activity, as well as inter-branch competition in the labor market for private and public sector wages will lead wages in the public sector to grow in the range of 3.6-4.0% in 2017 and 5.0-5.4% in 2018. Thus, average nominal wage is expected to grow by 3.6% in 2016, by 5.1-5.5% in 2017 and by nearly 6% in 2018, which is not much different from previous forecasts.

In 2016 the unemployment rate is expected at 17.8% on average, which is below the previous forecasts. Relative to 2015, the expected unemployment rate will reduce by 0.6 pp. In 2016 the average unemployment rate will still run high as a result of productivity growth reported in 2015 (not leading to employment growth in the short run, however). Beginning the first quarter of 2016 the productivity growth started to slow, pointing to a faster growth rate in average hours worked per week. The slowing of productivity growth and anticipated economic growth will prompt the unemployment rate to subdue by around 0.4 pp annually in the period 2017-2018. Up until the first half 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 as a result of the expansionary monetary and fiscal policy implementation by the CBA and the Government and restructuring of the economy.

On the back 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 pressures in the consumer market. In the forecast horizon, the labor market's impact on the inflation is estimated to be neutral.

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[6] Forecasts of private and public sector wages will, from now on, be published along with the average nominal wage forecast by the CBA.

[7] 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.

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

Aggregate demand[9]

The trend of declining remittances from Russia, a principal trade partner, will probably continue in 2016. The expected decline, however, will be smaller compared to that of reported in 2015 and will amount to 6-8%. The expansionary monetary policy implemented in 2015-2016, a low inflation environment in the economy and 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, the domestic demand, which posted a decline in 2015, is expected to gradually bounce back in 2016. In the period mentioned the domestic demand will still be below the equilibrium, however.

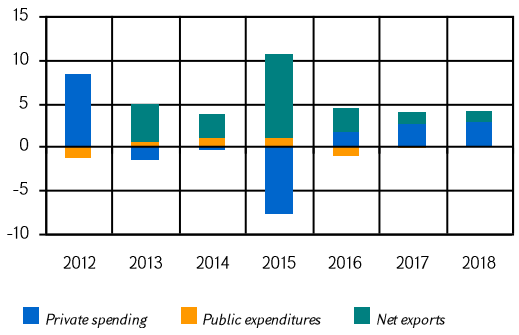
The domestic demand will continue growing and getting closer to its equilibrium in 2017-2018 as economic activity revives in partner countries to Armenia as well as the lagged impact of the above-referred expansionary monetary policy in the Armenian economy persists.

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 decreasing of the negative gap between savings and investments – observable in the domestic economy in recent years. This, along with 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 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 the 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, since financing through loans increases companies' susceptibility to risk.

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

Demand components contributing to the economic growth

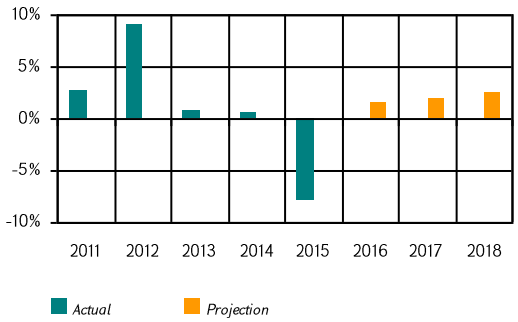


[9] *The data of real growth of private consumption and investments for 2016-2018 are the CBA estimates. These actual figures are as of the first quarter of 2015 published by the National Statistics Service of Armenia.The real growth indicators represented in this sub-section are relative to the same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

Private sector spending

Final consumption expenditures of households are expected to grow in 2016 by around 1.5%.

Private consumption



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

An anticipated shrinkage in private transfers from Russia in 2016 will negatively affect the household incomes. The expectation, however, is that final consumption expenditures of households will grow in 2016 by around 1.5% (the change is not significant compared to the previous forecast), 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.

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 the first half of 2016. These developments, therefore, denote that gross private investment in the economy in 2016 will post a moderate growth of about 2%, which is not that much different from previous projections.

Considerable easing of monetary conditions in 2015-2016 and growing budget deficit are among the factors which not only 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 latter 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 and recovering exports, will also help the private sector demand to rebound. It is expected that private consumption will grow by 1.8-2.2% in 2017 and 2.3-2.7% in 2018.

Given the incentives described above work, private investment is predicted to grow by 4.0-4.5% in 2017 and 4.5-5.0% in 2018. Expanding of capacities in the tradable sector and continued structural reforms in the domestic economy will also contribute to 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 sector.

In view of the aforementioned developments with private consumption and investment, in 2016 private sector expenditures will increase by 1.5%. Starting from 2017, private spending will grow faster to be within 2.2-2.6%, and at the end of the forecast horizon it will stabilize in the range of 2.7-3.1%. 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 second half of 2016 to the end of 2017, the ***private spending will create an average 0.6-0.8 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 end-2017 to the end of the forecast horizon, the impact of private spending will be 0.7-0.9 pp inflationary.

Current account

With a persistently weak demand in the global economy, positive developments for exports continued and even exceeded the expectations in the second quarter of 2016. The growth was fuelled mostly by recovered export of brandy and high growth in items such as "Tobacco", "Precious stones and metals and articles thereof" and "Textiles". As for imports, foreign trade indicators were recalculated by the National Statistics Service of Armenia. The main recalculations pertain to the dollar value of imports, based on which the 2016 forecasts for imports were adjusted upside. In consideration of such revisions, the CBA has changed its import and current account estimations.

Box 3

The revision of Armenia's foreign trade indicators

In recent months, publications of the National Statistics Service of Armenia came in with revised foreign trade indicators. The matter is that companies engaged in trade business with countries of the Eurasian Economic Union made corrections in their reports and, in some cases, submitted those reports with delays. Lots of revisions were made using operational data published as of May 20, 2016. Regular revisions were also carried out using the operational data published in the next few months. According to the operational data, the value of import in January-March amounted to USD 621.1 million and, after the July 20, 2016 revision, USD 683.7 million. Revisions were made in respect of all the commodity groups, while much broader revisions were made in items such as "Non-precious metals and articles thereof", "Products of vegetables origin", "Machinery and equipment" and "Products of prepared food".

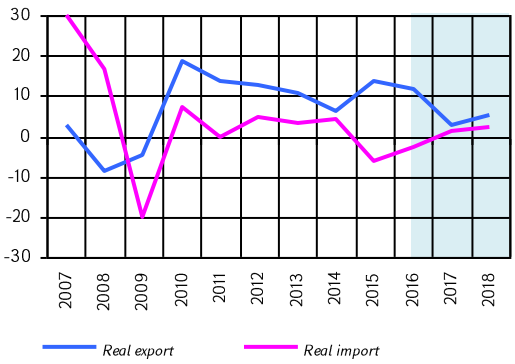
The statistical revisions described above urged the CBA to reconsider its 2016 import forecasts accordingly. The forecasts of the report for the second quarter of 2016 were made using actual data as of May 17, 2016. According to these data, the decrease in the dollar value of imports in the first quarter of 2016 was 15.9% y/y, based on which the real decrease in volume of goods and services for 2016 is predicted within 6-8%. After revision, the nominal decline in import of goods in the first quarter amounted to 6.9%. The forecast of real decrease in volume of goods and services for 2016 was revised and will be in the range of 1.5-3.5%.

The 2016 forecasts of growth of real export of goods and services were adjusted upside (the growth rate will be in the range 11.0-13.0%) in view of the favorable developments in the first half of the year and continued productivity growth in the tradable sector. Unlike high rates of decline predicted for the previous quarter, new forecasts suggest that the real imports will decline at lower rates, within 1.5-3.5%, which will be determined by revised import statistics.

The forecasts for remittances remained the same in relation to the previous ones, which means that the narrowing of net inflow of remittances will be in the range of 6.0-8.0%, in light of new forecasts for the Russian economy and expectations for the ruble's exchange rate.

Based on the above projections and actual revisions, the current account deficit-to-GDP ratio will get higher against the previous forecast and run in the range of 2.0-3.0% for 2016. Given productivity growth in the tradable sector is persistent while 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%.

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



The CBA estimated the ***fiscal policy's impact*** on overall demand for 2016 using a/ the revenue and expenditure figures as established by the Republic of Armenia Law on "State Budget 2016" and adjusted under relevant Government decisions[10] and b/ the main indicators of the Republic of Armenia Law on "State Budget 2016" as outlined in the Republic of Armenia "Medium-Term Public Expenditures Program for 2017-2019". In 2016, relative to 2015, the revenue-to-GDP ratio is expected to decrease by 0.9 pp, the tax-to-GDP ratio to drop by 0.6 pp and the expenditure-to-GDP ratio to reduce by 1.5 pp, at the expense of both current costs and capital expenditures. According to estimates, the deficit-to-GDP ratio will be higher in 2016, amounting to 4.1% instead of 3.5%, as prescribed by law.

Notwithstanding an anticipated large budget deficit in 2016, the revenues are expected to leave an expansionary effect and expenditures a contractionary effect on aggregate demand, according to the fiscal impulse indicator. Moreover, contractionary effects are likely for the third and fourth quarters. For the year, the contractionary effect will be within 0.4-0.6.

For 2016 the fiscal impulse is estimated 0.4–0.6 contractionary.

Projections of the fiscal policy in the forecast horizon are based on the main macroeconomic indicators outlined in the Republic of Armenia "Medium-Term Public Expenditures Program for 2017-2019". ***In the medium run,*** in pursuit of gradual reduction of the deficit for fiscal and public debt sustainability, the fiscal policy will have a contractionary effect on aggregate demand.

[10] The revenue and expenditure indicators as established in the Republic of Armenia Law on State Budget are subject to revision during the year under relevant decisions issued by the Government, which are available at www.e-gov.am.

In the structure of public expenditures for 2017-2019, public debt interest payment constitutes an average 2% of GDP and the primary deficit-to-GDP ratio (deficit less debt interest payment[11]) will average -0.8% of GDP in 2017, will be around zero in 2018 and will reach 0.3% in 2019. The change in primary structural balance (the primary balance adjusted by temporary entries and cyclical effects of GDP), which is the effect of the Government's fiscal policy, is estimated to be neutral in 2017-2019, reaching 0.9 on average.

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

Medium-term fiscal policy impact assessment					
% of GDP	2015	2016	2017	2018	2019
Budget revenues [12]	22.4	21.6	21.6	21.7	21.8
Budget expenditures	27.2	25.7	24.3	23.7	23.5
Debt interest payment	1.5	1.9	1.9	2.0	2.0
Budget balance	-4.8	-4.1	-2.8	-2.0	-1.7
Primary balance *	-3.3	-2.2	-0.8	0.0	0.3
One-off flows **	-0.6	0.0	0.0	-0.6	-0.8
Adjusted balance ***	-2.7	-2.2	-0.8	0.6	1.1
Cyclical balance ****	-0.0	0.0	0.1	0.5	0.5
Cyclically adjusted primary balance (structural balance sheet)	-2.7	-2.2	-0.9	0.1	0.6
Fiscal stance *****		-0.5	-1.2	-1.0	-0.5

** 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).*

Summary: from the second half 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 1.2-1.4 pp. This will be determined by predominantly deflationary impact of private spending amid stabilizing inflation expectations. Also, given the 0.2-0.3 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 0.9-1.1 pp of deflationary pressures in the consumer market.

In the above-mentioned period, as aggregate demand recovers on the premise of easing monetary conditions, 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 inflationary effect, making up 1.6-1.8 pp on average.

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[11] Sign "–" denotes deficit, sign "+", surplus.
[12] The state budget indicators presented here exclude records of off-budgetary funds.

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

With the global demand staying weak, the second quarter of 2016 reported ***some acceleration in economic activity in the main partner countries to Armenia,*** except the U.S.A. where economic growth rates have slowed down. Economic decline in Russia was slower than anticipated (it is an estimated -0.6% for the second quarter of 2016 instead of projected -1.3%). In the meantime, ***a relative stability persisted in commodity and food product markets of the world*** in the face of reduced supply factors, although some inflationary patterns were observable in respect of a number of food products.

In the forecast horizon global economic growth will continue at a slow pace. While economic growth rates are predicted to somehow accelerate in developing countries, growth rates will remain sluggish in developed countries. In view of geopolitical and country-specific developments, ***economic decline in Russia will continue over 2016 but will be slower compared to the previous forecast*** (0.8% decline against that of previously forecasted 1.2%). 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 1.1%. In the meantime, risks and uncertainties about further pace of the global economy, pinpointed in the previous forecast, will be encumbered with how the developments will unfold in the European Union in connection with Brexit.

Given the relative stability in international markets of commodities and food products the inflation environment ***will remain low*** in selected product markets in the short run due to supply factors. In the forecast horizon, however, international prices of commodities and food products will trend slowly upward as global demand recovers gradually and production volumes reduce.

In the second quarter of 2016 the ***domestic economic growth rates are estimated to outstrip the expectation,*** owing to more positive developments in the tradable sector (industry and agriculture, in particular) of the economy. In this case, the economic growth in the first half of 2016 will be in the range of ***3.9-4.1%,*** with agriculture and industry as the main driving force to the growth.

Notwithstanding a slower pace of decline observed in the Russian economy, the ***dollar value of net inflow of private remittances and seasonal worker pays*** has decreased faster than anticipated for the quarter, amounting to -21.3% y/y. This has contributed to the further narrowing of the negative gap of real private transfers. On the back of continued shrinking of private transfers, the second quarter of 2016 saw a moderate growth in private consumption instead of anticipated decline, which was underpinned by monetary conditions the CBA had continuously eased since the beginning of the previous year and low

inflationary environment in the economy amid growing economic activity and acceleration of the growth rate in lending. In the meantime, investment activity has been weak, as was anticipated, in which case private spending and domestic demand recovered at a faster rate than expected. Note that upside revision of the actual volumes of import by the National Statistics Service of Armenia, which is consistent with a more rapid recovery of domestic demand, prompted the CBA to worsen its estimates of the current account for the quarter amid a narrowing inflow of private transfers. However, net external demand kept on improving in the course of high real growth in exports.

As a result of these developments ***the second quarter's negative GDP gap has narrowed in comparison with the previous quarter and is estimated to be less negative than expected.*** With a domestic demand still sluggish and deflationary effects further transmitting onto domestic prices from international commodity markets, the ***core inflation rate fell somewhat faster during the quarter than expected,*** in which case the 12-month indicator remained almost unchanged, amounting to ***-1.8%*** in late June. The price drop during the quarter was modest compared to the forecast, mainly due to a lesser seasonal falling of prices of agricultural products, which, instead, was observable in relatively deep deflationary developments in July. About 6.0% decrease in natural gas tariff, with its direct deflationary impact of -0.36 pp, has also contributed to the above price deflation. As a result, the ***12-month deflation rate*** declined in June more rapidly than expected, reaching **1.1%**, but in July it came close to the forecasts, reducing to a **1.3%** level.

In view of the inflation environment, low at the time and expected to remain such in an upcoming period, and relatively stabilizing inflation expectations, the ***CBA kept on easing monetary conditions in the second quarter by cutting the refinancing rate*** in May and June ***for a total of 0.75 pp to 7.5%*** in late June. Consistent monetary policy conducted by the CBA has softened inflation expectations, in which circumstance long-term market rates have fallen as much as possible thus helping private consumption and domestic demand to recover gradually.

The 2016 forecast of economic growth as part of macroeconomic forecasts by the CBA remained almost unchanged compared to the previous one, as macroeconomic developments were generally in line with projections. The ***economic growth in 2016 is expected in the range of 2.8-3.4%,*** with the tradable sector (particularly mining and services) as the main driver to growth, largely incurring the impact of loosened monetary conditions since the beginning of the previous year.

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 ***dollar value of net inflow of remittances will reduce at a slower pace*** in 2016, generally in line with previous forecasts. Also, given a weak inflation environment, the level of private spending in 2016 will somewhat recover, not varying significantly from

previous forecasts. Moreover, in the event private investment grows moderately, private consumption will gradually increase, staying within the forecast. In this circumstance, domestic demand, persisting at a low level, will recover gradually in 2016 but will still run below its equilibrium.

Considerable easing of monetary conditions, expanding of 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 can improve in 2016. This development is possible if supported by strong growth rates of real export, an upward revision of real volumes of import and currently anticipated zero growth for imports instead of previously expected decline. However, with a projected decline in remittances in 2016, the current account deficit in GDP will increase against previous prediction to be in the range of 2-3%. As a result of these developments, the GDP gap, still in a negative territory, will reduce gradually in 2016.

The prediction of the period ***2017-2019*** is that 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. In the meantime, external demand will continue fostering the economic growth. In the course of 2017 the negative GDP gap will reduce further, 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, with the indicator drifting within 3.0-4.5%***. This will be largely driven by the tradable sector ***for which consistent monetary policy implementation by the CBA has created favorable conditions***. 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 2016 inflation forecasts are generally in line with the estimations outlined in the previous program, although some revisions in respect of certain commodities had been inevitable. Specifically, considering the international commodity markets' deflationary impact still transmitting onto the domestic prices and that the domestic demand is persistently weak, the forecasts of core inflation were revised downside. There is however anticipation that regulated service tariffs will somewhat increase in view of Dram 2.58 reduction[13] of electricity price for consumers by the Public Services Regulatory Commission, effective from August 1st, and a government decision to end the subsidizing of electricity price by the Government and "Electric

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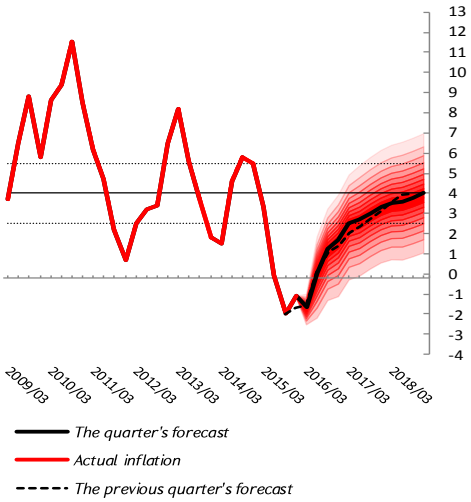
[13] Based on the PSRC's Decision of 24th June 2016 on the reduction of electricity tariffs for the consumers (http://www.psrc.am/am/announcements/ press-release / 2273-2016-06-24-08 -11-08).

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



Networks of Armenia" CJSC in benefit for some households and small businesses[14]. The combined effect of these factors on inflation is roughly 0.3 pp, according to the CBA estimation. In view of the above developments, the CBA estimates that the deflationary environment will be maintained in the third quarter, reaching -1.7% in late September; then it will gradually decrease. In the forecast horizon, the 12-month inflation rate will gradually return to the target.

The CBA considers that further easing of monetary conditions in the second quarter of 2016 is relevant. This would lead to a further expanding aggregate demand, gradually phasing out deflationary environment and inflation stabilizing 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%
Q3, 2016	99.8%	0.2%	0.0%	0.0%	0.0%
Q4	83.1%	15.8%	1.0%	0.0%	0.0%
Q1, 2017	49.7%	37.5%	12.8%	0.0%	0.0%
Q2	38.4%	37.4%	24.0%	0.2%	0.0%
Q3	20.2%	33.4%	44.6%	1.7%	0.1%
Q4	16.4%	30.2%	49.3%	3.7%	0.4%
Q1, 2018	11.7%	26.4%	55.2%	6.0%	0.8%
Q2	8.5%	22.7%	58.7%	8.6%	1.6%
Q3	7.1%	20.3%	59.8%	10.6%	2.3%
Q4	7.1%	19.5%	58.9%	11.6%	2.8%
Q1, 2019	5.9%	17.6%	59.5%	13.3%	3.6%
Q2	4.8%	15.5%	59.5%	15.5%	4.8%

Risks that inflation will deviate from the projected value are estimated to be downward in the short run and balanced in the medium run. Risks deriving from external and domestic sectors mostly persisted in relation to the previous forecast. In particular, the ***external sector risks*** are related to capital outflows from developing countries and, consequently, volatilities in financial markets, the processes in the European Union, a likely slowdown of global economic growth resulting from restructuring 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 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.

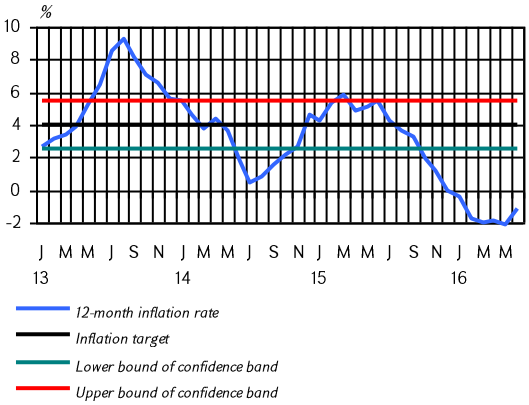
[14] *Based on a Government Decree No. 1269 of October 29th 2015 (https://www.e-gov.am/gov-decrees/item/26490/).*

3. ACTUAL DEVELOPMENTS IN Q2, 2016

3.1. Inflation

3.1.1. Actual inflation and fulfilment of the inflation target

In the second quarter of 2016 the deflationary environment persisted



The 12-month deflation rate declined in June to 1.1%.

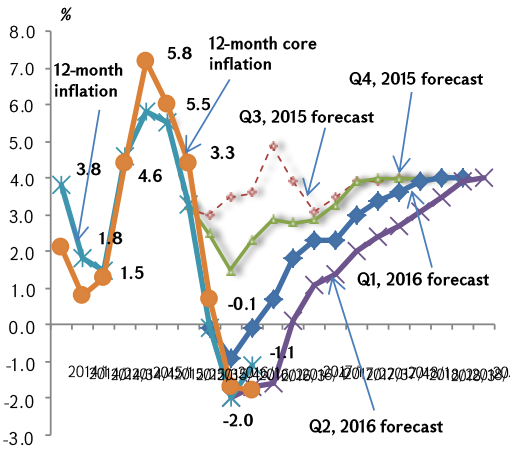
International commodity markets' deflationary impact transmitted onto domestic prices, weak domestic demand and favorable developments in the agricultural sector all have led to a 1.4% deflation recorded in the second quarter of 2016. The deflation was mainly attributable to the prices of food products, decreased by 2.4%, and prices of non-food products and service tariffs, fallen by 0.8% and 0.5%, respectively. The quarter's price deflation was weaker than forecast, due to smaller decline in prices of seasonal agricultural products, as opposed to relatively deep deflationary patterns observed in July. As a result, in June the ***12-month deflation rate*** declined rapidly than expected, reaching ***1.1%,*** but in July it run close to the forecasts, falling to ***1.3%,*** which has also been driven by around 6.0% decrease in natural gas price (contribution to inflation: -0.36 pp). In the second quarter, however, in view of external and domestic factors described above, the ***core inflation rate fell slightly faster, by 0.5%, than anticipated,*** while the 12-month indicator remained almost unchanged, amounting to ***-1.8%*** at the end of June.

The deflationary effects of the external environment on the one hand and a sluggish domestic demand on the other continued determining the price developments for imported non-food products, particularly textiles and clothing, footwear, detergents and cosmetics, during the second quarter. The decrease in service tariffs was mainly attributable to recreational and housing & utility services fees having dropped by 6.6% and 1.7%, respectively (combined contribution to inflation: -0.25 pp), which was somewhat offset by a 10.5% increase in air transport fare (contribution to inflation: 0.09 pp).

(%)

Inflation by groups serving as key contributors						
Group	March 2016 *(y/y)*		June 2016 *(y/y)*		Second quarter 2016	
	Growth	Contribution	Growth	Contribution	Growth	Contribution
CPI	**-2.0**		**-1.1**		**-1.4**	
Food products	**-5.1**	**-2.3**	**-2.5**	**-1.3**	**-2.4**	**-1.1**
Bread products	-4.1	-0.40	-3.2	-0.3	0.2	0.02
Meat products	-5.7	-0.53	-4.5	-0.5	-0.7	-0.1
Dairy products	-5.4	-0.24	-3.8	-0.2	-2.0	-0.1
Fats and oils	-4.7	-0.12	-2.7	-0.1	-1.5	-0.04
Fruit	-23.0	-0.61	-12.7	-0.5	37.9	1.0
Vegetable and Potato	-1.0	-0.05	21.4	1.3	-27.4	-1.5
Eggs	-13.9	-0.16	-21.5	-0.3	-23.2	-0.3
Non-food products	**-1.5**	**-0.34**	**-2.8**	**-0.43**	**-0.8**	**-0.19**
Services	**2.9**	**0.93**	**2.1**	**0.64**	**-0.5**	**-0.15**

The inflation environment will expand gradually in the upcoming year and the 12-month inflation rate will stabilize around the 4% target in the rest of the forecast horizon



For the previous one-year horizon which takes a timespan between Q3, 2015 and Q3, 2016, high inflation environment was forecast to diminish gradually, as positive developments in the agriculture sector were to lead to lower prices of food products compared to the same reference period of the previous year. Moreover, easing of the inflation environment was to be partly offset by monetary conditions which the CBA had loosened back in the first half of 2015 and the lagged impact of more expansionary fiscal policy. In this situation, the CBA considered ***further easing of monetary conditions*** in the latter half of 2015, which would help the 12-month inflation rate stabilize around the target in the forecast horizon.

Actual developments drove the inflation environment to further soften in the second half of 2015. Moreover, a 1.9% price deflation recorded in the third quarter of 2015 was determined by relatively high growth rates in agriculture (food product contribution to headline inflation: -1.9%), in which case the ***12-month inflation rate*** had slowed down to ***3.3%*** at the end of September from 5.5% reported in late June. Notwithstanding a low inflation environment and non-inflationary effects anticipated from a sluggish external and domestic demand, the inflation expectations were estimated to be high in the third quarter (the 12-month core inflation rate was 4.4%), which is why the ***CBA lowered the refinancing rate during the quarter only by 0.25 pp to 10.25%***.

In the fourth quarter of 2015 high inflation expectations subsided under influence of falling prices in the external sector, which was in part reflected in domestic prices and the factor of large supply in agriculture. 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%***.

In view of such inflation developments, the CBA 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 abrupt 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 late March (contribution of decreased food prices to headline deflation: 2.3 pp).

In the second quarter of 2016 a relative stability was achieved in commodity markets of the world, although deflationary patterns were still observable in respect of certain products. Influenced by

expansionary policy implementation by the CBA and the Government, the domestic economy saw aggregate demand bouncing back at much faster rates, reflecting the import of goods and lending to the economy and the growth reported in the tradable sector of the economy.

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 quite enough to neutralize the deflationary pressures during the year. In the first quarter of 2016, therefore, the CBA loosened monetary conditions, cutting the refinancing rate each by 0.25 pp in February and March 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.

The economic and inflationary developments in the second quarter of 2016 showed that consistent monetary policy of the CBA has gradually eased inflation expectations, and anticipated reduction in natural gas price since the second half of the year has reinforced such expectations. Taking into account the current situation and relatively stabilizing inflation expectations, the CBA cut the refinancing rate in the second quarter by 0.75 pp to **7.5%** in late June. 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.

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

3.1.2. Import prices and producer prices

Import prices: in the second quarter of 2016 the dollar prices of import of goods and services grew by 4.9% q/q. However, the declining has somewhat slowed down in comparison with the previous reference period to 2.7% y/y.

The y/y decrease in dollar prices of import was driven by prices of goods and services, which have fallen by 2.3 and 0.4 pp, respectively. The y/y decline in dollar prices of import of goods was determined by prices of intermediate goods having reduced y/y as a result of falling international oil and gas prices, 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 and Russia. Consumer goods had a 0.3 pp of negative contribution.

Producer prices[15]***:*** price indexes in all sectors of the economy reported decreases in the second quarter of 2016, and the GDP deflator in January-June has been around 99.5 y/y, according to CBA estimates.

Industry reported 0.8% y/y drop in prices in the second quarter, with the January-June decline having reached 2.4%. The price reduction owed to falling prices in mining (8.3%), processing industry (1.2%) and

[15] *The price index change for January-June 2016 is relative to the same reference period last year, unless otherwise specified.*

energy, gas production and distribution (3.2%). 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 posted a 1.4% y/y growth in prices[16] during the quarter, with the January-June price deflation having amounted to 2.6% y/y as a result of reduced prices in plant growing (15.5%) and animal breeding (9%). The fall in prices is due to the decrease in international food prices and weak domestic demand.

The price deflation in plant growing was mainly driven by reduced prices of potato and gourds and melons (12.6%), grain crops (3.7%), forage crops (29.2%) and fruit and berries (28.8%). The decline in prices in animal breeding was attributable to reduced prices of milk, dairy products (10.3%), eggs (14.5%) and meat (7.6%).

Construction posted a 2.7% y/y price decrease during the quarter, with the January-June price deflation having reached 1.2% y/y, primarily due to reduced costs in construction and assembly works (1.5%), equipment and materials (0.7%) and other expenditures (0.5%). The price deflation on item "other expenditures" is mostly a result of reduced wages in the construction sector. Furthermore, the deflation in the sector owed to shrinking construction volumes amid sluggish economic activity.

Carriage service reported a 2.3% y/y drop in tariffs during the quarter, with the January-June deflation having amounted to 2.2% y/y, as a result of reduced fare of railroad transport (2.7%) and motor transport (5.4%). The highest decrease in tariffs recorded in motor transport was mainly driven by fallen prices of petrol and diesel.

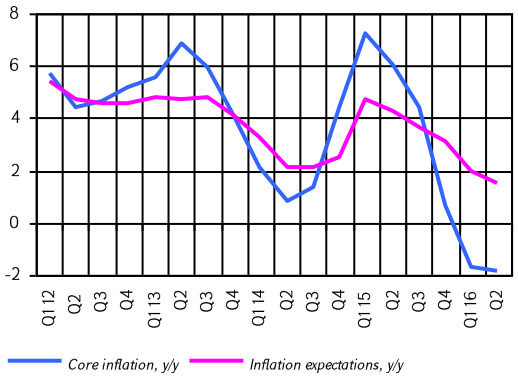
3.1.3. Inflation and interest rate expectations

The financial sector survey by the CBA for the second quarter of 2016 shows that households' inflation expectations for an upcoming one-year horizon have reduced notably as the prices of goods, net of seasonal agricultural products, followed a path that further sloped down. Estimations produced on the CBA's core model suggest that inflation expectations reduced faster this quarter than expected, amounting to 1.5%, mainly thanks to the consistent monetary policy carried out by the CBA.

In the second quarter of 2016 the CBA continued its surveys with the financial sector and households to figure out what are their expectations of a selected number of macroeconomic indicators. The results of the survey point to the easing of inflationary expectations this quarter; the average level of inflation expectations in the financial system is 3.0% for the upcoming one-year horizon compared to the relevant indicator of 3.5% reported in the previous survey. Thus, ***commercial banks*** have their expectations of the 12-month inflation

[16] *Here sales prices of producers of agricultural product are presented.*

Inflationary expectations diminished



rate anchored around a ***2.5%*** level against the average figure of ***3.3%*** reported in the previous survey; ***credit organizations'*** expectations have averaged ***3.3%*** compared to the previous indicator of ***3.6%;*** and households had their inflation expectations of the 12-month inflation rate around a ***1.2%*** level against that of ***2.0%*** reported in the previous quarter's survey.

In the second quarter too, loosened monetary conditions had their impulse passed onto interest rates of the financial market, as almost all funds, both attracted and allocated, and maturities posted fallen interest rates. In the government bond market, yields have declined all along the curve (see details in section "3.3. Money and financial market developments").

This trend in turn reflected the financial market's expectations for interest rates. According to the survey results, still anticipating that interest rates on funds attracted and allocated would drop gradually in a one-year perspective, the financial system incurs most of the influence from considerable easing of inflationary expectations.

3.2. Aggregate supply and aggregate demand

3.2.1. Aggregate supply[17]

The economic growth indicator for the first quarter of 2016 was 4.4% y/y.

The ***economic growth indicator*** published by the National Statistics Service of Armenia for the first quarter of 2016 was 4.4% y/y, which is 0.5 pp smaller from the most probable value of the CBA forecast.

Albeit somewhat slowed down in the second quarter of 2016, the Economic Activity Indicator nevertheless remained strong. As a result, the economic activity over the first half of 2016 amounted to 4.7% y/y compared to 5.4% recorded in January-March.

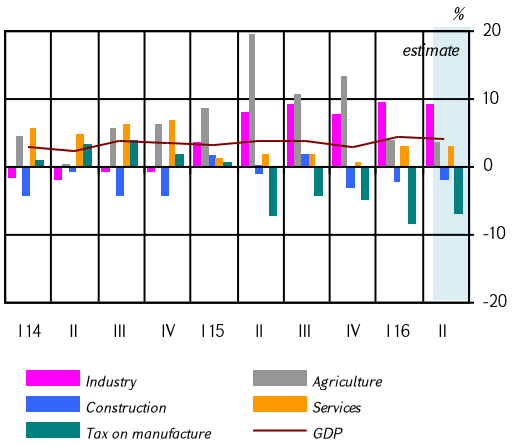
In the first half of 2016 economic growth will be in the range of 3.9-4.1%.

Given the higher-than-expected output growth in the industry and agriculture sectors in the second quarter of 2016, economic growth estimates were revised upward. As a result, economic growth in the first half of 2016 is estimated in the range of 3.9-4.1%[18].

Taking into account an increased output of 8.9% y/y reported in ***Industry*** in January-June 2016, the growth of value added there for the

[17] *The indicators of y/y real growth of value added in sectors of the economy for January-June 2016 are the CBA forecasts, whereas the indicators of sub-sectors represent y/y growth rates in output volumes for January-June 2016, unless otherwise specified.*
[18] *See the 30% range in Real GDP Growth (Cumulative) Projection Probability Distribution Chart.*

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



first half of the year is estimated within 8.8-9.3% y/y. This is mainly due to increased outputs in mining industry (18.8%), food production[19] (5.4%), beverage production[20] (14.9%), tobacco production (21.1%), jewelry crafting (2.7-fold), clothing (37.5%), and manufacturing and waste management (22.7%). As well as positive developments in the industry sector a strong growth of 15.8% has been recorded in terms of electricity generation, transmission and distribution. The high growth in industrial output owed to external demand recovering amid growing economic activity in partner countries.

In view of an actual decrease in output volumes (7.8% y/y) reported in ***Construction*** for January-June 2016, the decline of value added for that period is estimated within 2-2.5% y/y. Save for the volumes of construction financed by local budgets (2.7% growth) and international loans (75.5% growth), all other sources of financing reported a decrement: construction financed by households (-9%), by state budget (-30.1%), by humanitarian aid (-25.7%) and by organizations (-15%). The disequilibrium between supply and demand in the construction sector persisted.

The growth of value added in ***Services*** for the first half of 2016 is estimated in the range of 2.6-3.1% y/y, which is driven by an 8.3% increase in services provided and 0.3% contraction in trade volumes. The increment in services provided owed to the growth in financial and insurance industry services (2.2%), education services (5%), events, leisure and rest services (40.5%), real estate services (5.2%), healthcare services (1.4%) and transportation services (22.8%). High growth reported in transportation services was attributable to companies specialized in the carriage of ore and minerals.

The decline in trade depended on a 4.3% contraction in retail trade turnover, which has been a result of a weak domestic demand in the reporting period.

Given the output growth of 3.2% y/y in ***Agriculture*** recorded the first half of 2016, the growth of value added in the sector in January-June 2016 is estimated within 3.3-3.8% y/y, which is a result of increased output in plant growing, animal breeding and fish growing, by 2.2%, 3.8% and 2.3%, respectively. The growth in animal breeding was driven by increased production of milk (3.4%), eggs (6.5%) and livestock and poultry sales (3.3%); the growth in plant growing was attributable to greater volumes of production of vegetables (9.9%) and potato (0.3%). Modest growth in the agricultural sector has been mostly a result of relatively unfavorable weather conditions this year in comparison with the previous year.

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[19] Food production has grown owing to increased volumes of output in meat (2%), meat products (9.4%), meat prepacks (19.6%), milk (2.7%), cheese (7.4%), sour cream (3.1%) and canned food (46.1%), as expressed in kind.

[20] Beverage production has grown thanks to increased volumes of output in brandy (34.5%), whiskey (2.6-fold), wine (10.8%), champagne (15.1%) and spring water (2.1%), as expressed in kind.

3.2.2. Aggregate demand[21]

In the second quarter of 2016 private spending is estimated to be higher compared to the previous forecast as it has grown by around 1% relative to the same reference period last year.

In the second quarter of 2016 private spending is estimated to be higher compared to the previous forecast as it has grown by around 1% relative to the same reference period last year. This is due to lesser shrinking of trade turnover and much higher economic activity in the second quarter.

A narrowing inflow 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 above-described developments contributed to a moderate increase in private consumption in the second quarter, yet private consumption is at a lower level than it should because of deep downturns recorded in the previous quarters.

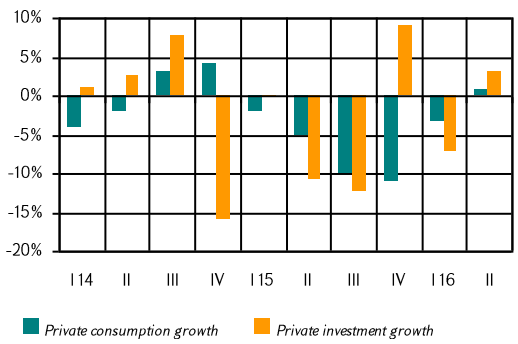
The surveys conducted by the CBA and trade turnover indices calculated by the National Statistics Service of Armenia for the second quarter of 2016 are indicative of contracted consumption in the private sector: the Consumer Confidence Index was 42.6 this quarter, which is below its stability range of 45-55 and points to a low level of final consumption costs of households. Then again, the CCI has increased by 3.6% relative to the same reference period last year, which in turn indicates that private consumption is slowly rebounding in the reporting period from low levels. In the second quarter, compared to the same period of the previous year, a small increase of 0.5% was seen in trade turnover.

In the second quarter of 2016 the investment climate in the economy was weak – consistent with forecasts – with private investment having only grown by 3% in relation to the same period of the previous year.

In the second quarter of 2016 the investment climate in the economy was weak – consistent with forecasts – with private investment having only grown by 3% in relation to the same period of the previous year. Sluggish investment climate in the reporting period was determined by an inadequate level of domestic demand and persistently low construction activity. As it was outlined in the CBA's previous forecasts, the decline in investment has been more pronounced in non-tradable sector of the economy, whereas investment activity has been relatively strong in the tradable sector.

The CBA surveys on business environment conducted at companies point to the aforementioned developments in investment climate in the reporting period. According to the survey results, in the second quarter of 2016 the Business Activity Indicator in construction as a non-tradable sector was 39.0, which is below its stability value of 50. On the other hand, the BAIs in industry as a tradable sector and services provided amounted to, respectively, 53.7 and 51.1, running above the stability value of 50.

Private consumption and investment growth, y/y

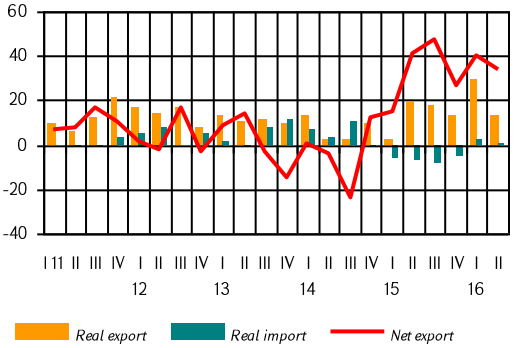


[21] *The private spending, private consumption and private investment indicators for the second quarter of 2016 are the CBA estimates which are based on the actual fourth quarter 2015 data. The growth estimates provided in this sub-section are relative to the same reference period last year, unless otherwise specified.*

The aforementioned developments with regard to private consumption and investment suggest that the growth of private spending in the second quarter is estimated at around 1%. With an unchanged level of public spending, the domestic demand somewhat grew in the reporting period. As remittances from Russia continued reducing, easing of monetary conditions by the CBA as well as existing low inflationary environment in the economy have substantially contributed to the growth of domestic demand.

Despite a recorded growth, the private spending gap in the second quarter of 2016 is estimated as negative, which created ***1.7-1.9 pp of deflationary pressures*** in the consumer market.

In the second quarter of 2016 net real export improved
(net real export, y/y %, positive sign means improvement)

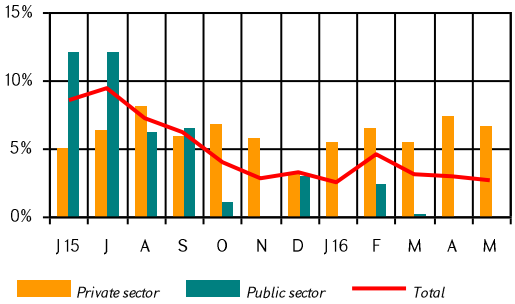


According to the CBA estimates, real net export continued improving at higher rates in the second quarter, which was determined by strong growth of real export of goods and services at the time of almost a zero growth of real import of goods and services. In the second quarter of 2016 growth rates of real export of goods and services amounted to 13.2% y/y compared with 0.4% y/y growth in real import of goods and services[22]. High growth of real export was mainly due to growing export volumes of copper, tobacco and alcohol.

The second quarter of 2016 saw the inflow of remittances narrowing at a faster rate, which was attributable to the Russian ruble with still high depreciation rates in comparison with the same reference period of the previous year.

3.2.3. Labor market[23]

Nominal wage growth, y/y



In the second quarter of 2016 the ***average nominal wage growth rate*** was slightly below the previous forecast of the CBA, and is estimated at 2.7%. In the period under review the private sector wage growth outpaced the public sector wage growth. The deviation from the previous forecast is due to more-than-expected decline in average wage in the public sector.

The effect of wage increases in some parts of public sector since July of 2014 phased out in the third quarter of 2015 and, starting from October, the wage growth in public sector slowed down. This trend was observable over the first quarter of 2016 too. As for the second quarter of 2016, the rate of wage growth decelerated against the previous reference period's high base, reaching -2.0%.

In the second quarter of 2016 the private sector's nominal wage growth rate accelerated by 7.0 pp against the relevant indicator of the previous reference period. The second quarter's rate of growth was somewhat higher compared to the first quarter, which was determined by accelerated economic activity. With a 1.4% deflation in the reporting period, real wages in the private sector posted over an 8% rise.

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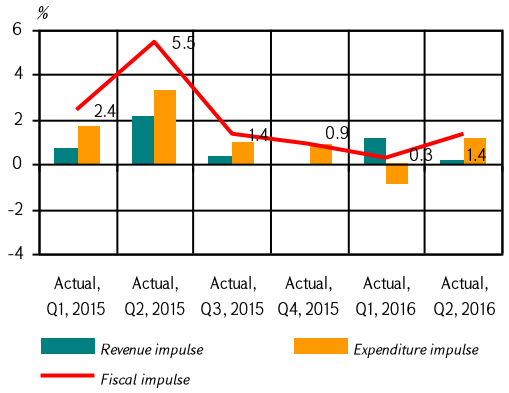
[22] Real export and import growth indicators are the CBA estimates.

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

The growth of productivity reported in the economy in 2015 persisted over the second quarter of 2016. This resulted in reduced labor demand in the economy. Beginning the first quarter of 2016, the productivity growth started to slow, pointing to a faster growth rate in average hours worked per week. As a result, the ***unemployment rate*** in the second quarter was slightly below the previous forecasts and is an estimated 17.8%.

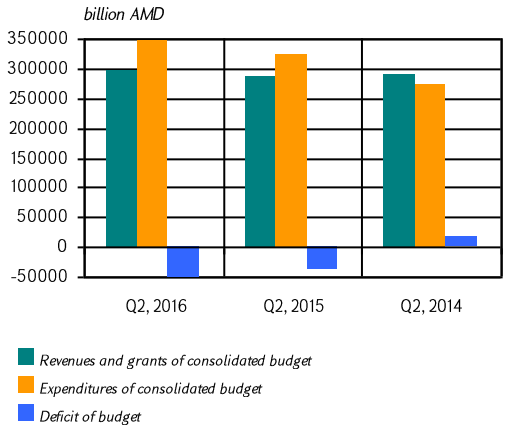
The slowing of productivity notwithstanding, it still outweighed the growth rate in wages in the second quarter of 2016. As a result, this has created 0.4% of deflationary pressures in the consumer market.

The expansionary impact of fiscal policy in the second quarter was mainly due to an expansionary effect of expenditures



Based on the nominal GDP indicator for the second quarter, the fiscal sector's impact on aggregate demand was estimated 1.4 expansionary instead of the projection of 1.5 contractionary.

Consolidated budget indicators



3.2.4. Fiscal policy[24]

In the second quarter of 2016 the Republic of Armenia State Budget was performed with revenues falling short of the CBA's estimates[25]; expenditures posting some savings and net lending in excess of the projected value. In view of such developments described above and the nominal GDP indicator for the second quarter, the fiscal sector's impact on aggregate demand was estimated 1.4 expansionary instead of the projection of 1.5 contractionary. The revenues impulse was 0.2 expansionary instead of the forecast 0.8 contractionary, due to under-collected tax amounting to almost AMD 17.1 billion. The expenditures impulse was 1.2 expansionary instead of the forecast 0.7 contractionary, due to deviated indicator of net lending, since a credit of AMD 16.0 billion had been provided instead of projected repayment of AMD 1.1 billion, and cost savings of about AMD 5.0 billion.

Funds saved on government spending (both current and capital expenditures) in relation to the quarterly plans of 2016 amounted to roughly AMD 17.0 billion.

In the second quarter of 2016, relative to the same reference period last year, consolidated budget revenues and grants have grown by 3.3%; tax revenues have grown by 5.0% but other revenues and grants reduced. The share of indirect tax in total taxes and duties has reduced by 3.4% relative to the second quarter of 2015, as a result of decreased value added tax and customs duty (because of import reduction y/y). The share of direct tax has grown in the same period of time by 11.6%, with all direct taxes having posted increases.

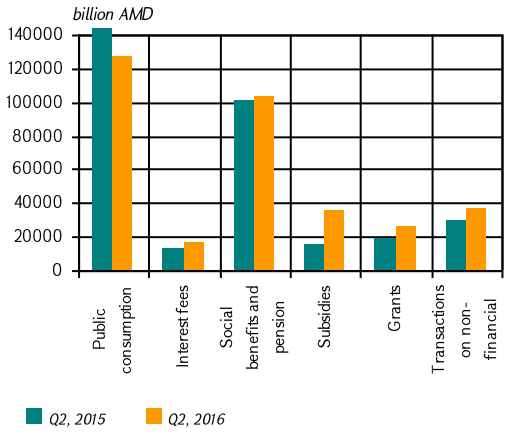
In the second quarter of 2016 actual expenditures amounted to 95.2% of the plan[26] adjusted for the quarter. There were some savings on expenditures as the latter constituted 98.5% of the CBA projection. Compared to the same period last year, there has been about 7%

[24] 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 second 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.

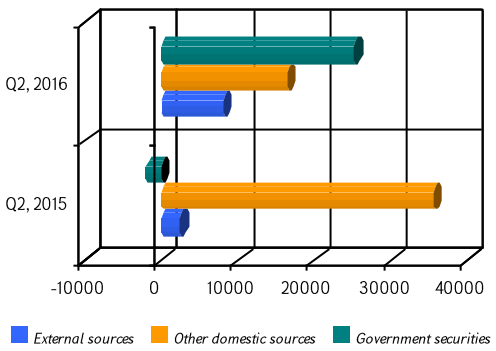
[25] Actual public sector indicators were compared with the CBA projections; note that the CBA projections on revenues were in line with quarterly revenue proportions.

[26] The revenue and expenditure indicators as established in the Republic of Armenia Law on State Budget are subject to revision during the year under relevant decisions issued by the Government, and are available at www.e-gov.am.

Budget expenditures



In the second quarter of 2016 budget deficit was financed mostly at the expense of domestic resources
(AMD billion)



increase in consolidated budget expenditures, owing to both current and capital expenditures. Relative to the same period of the previous year, the share of ***public consumption*** in current expenditures has decreased by 12.3% owing to a change in the method by which preschool and general education establishments are financed (last year it was viewed as procurement of contractual services and, starting from 2016, as providing subsidies to these organizations). The public debt interest payments outgrew the previous year's relevant indicator by 24.8%, primarily due to increased amount of servicing costs.

Government subsidies exceeded the previous year's relevant indicator 2.3-fold (AMD 20.2 billion), mostly owing to the changed principle of education financing, as well as increased subsidies to organizations in agricultural and water supply sectors.

The expenditures on *item* ***"Transactions with non-financial assets"*** have increased by about 28% relative to the same reference period last year.

With revenue and expenditure performance described above, in the second quarter of 2016 the state budget generated a deficit of roughly AMD 49.5 billion as compared to the CBA projection of AMD 39.0 billion (the planned deficit adjusted for the quarter: AMD 41.6 billion). The deficit has been financed by domestic sources (83.4%) and external sources (16.6%). Specifically, net proceeds from placement of T-bills in the second quarter amounted to AMD 25.3 billion.

In the second quarter of 2016 the fiscal policy had 1.4 of expansionary impact on the aggregate demand.

In the first half of 2016, relative to the first half of 2015, the state budget revenues and grants have grown by 2.1%. Tax revenue has increased by 2.2% or AMD 11.1 billion against the same reference period last year; the increment has been due to more entries of profit tax, income tax, excise duty and other taxes, and a reduced amount of value added tax and customs duty.

Government expenditures (including PIU funds) have increased by 6.5% against the same reference period last year.

According to semiannual results, the state budget run with a deficit of about AMD 86.0 billion instead of AMD 118.1 billion as was envisaged in the program adjusted for the first half of 2016.

Overall, the fiscal policy conducted over the first half of 2016 has left 1.0 of expansionary impact on aggregate demand, primarily owing to the expansionary effect of the revenues.

Summary: reduced private transfers from Russia as well as sluggish investment activity in the domestic economy dampened spending in the private sector in the second quarter of 2016. However, fiscal stimulus delivered to the economy and 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.

The private spending gap in the second quarter of 2016 is estimated as negative. Given the fiscal policy's inflationary

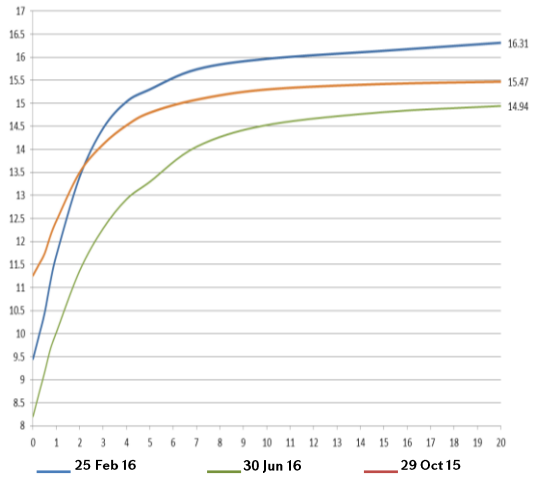
behavior, neutral performance of net exports and deflationary patterns reported for the labor market, the aggregate demand and labor market are estimated to have jointly created 1.9-2.1 pp of deflationary pressures in the consumer market during the second quarter.

3.3. Money and financial market developments

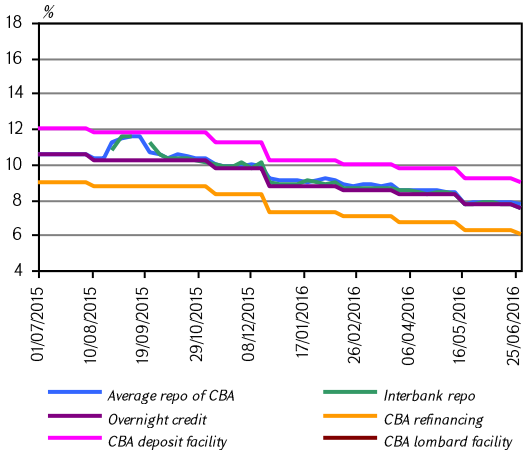
3.3.1. Financial market, money and credit

In the second quarter of 2016 the CBA Board reduced the refinancing rate twice (in May and June) by a total of 0.75 pp.

Yield curve, due to maturity



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



In the second quarter of 2016 the CBA Board cut the refinancing rate twice (in May and June) by a total of 0.75 pp.

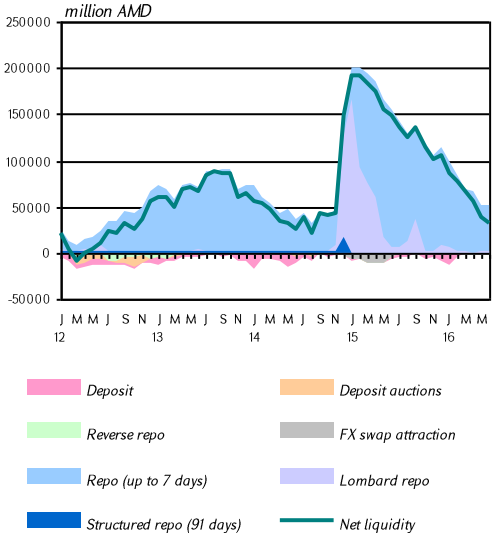
Back in May of 2016 the CBA Board assessed that inflation expectations had reduced as a result of consistent monetary policy implementation, forecasts of a low rate of inflation remained intact at the support of relevant trends in both the domestic and external environment and the natural gas price was supposed to drop in July. All these factors allowed the CBA Board to loosen monetary conditions in a broader stride: at the end of May it cut the refinancing rate by 0.5 pp to 7.75%, looking to further ease monetary conditions in the event additional risks in external and domestic sectors lack.

The CBA continued easing the monetary conditions in June, considering its forecasts for low inflation in the coming months. In the case of 0.25 pp cutting of the refinancing rate, the CBA Board expected that the deflationary environment would phase out gradually and the 12-month inflation rate return to the target at the end of the forecast horizon. In the meantime the CBA Board has signaled the domestic financial market of its intention to adjust the monetary policy directions in future as developments in the economic landscape unfold.

Short-term interest rates in the domestic financial market immediately reacted to the easing of monetary conditions. So did long-term interest rates at a certain time lag, however. Because inflation expectations were still elevated, gradually loosened monetary conditions had not influenced the long-term interest rates in the period November 2015 – February 2016. Yet, by the end of the first quarter, one could see a significant lowering in inflation expectations, which reflected the long-term yield curve thus leading to decreases all along the curve.

Average quarterly rate of 7-day repurchase agreements concluded by the CBA fell by 0.75 pp against the previous quarter to 8.13%; in June the average interest rate decreased by 0.93 pp against March to 7.80%.

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

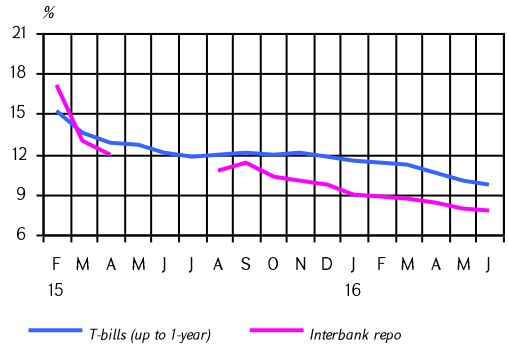


Operations carried out by the Central Bank (average transaction value)						
Period	Repo (up to 7 days)		Funds attracted		Lombard repo	
	Value (million AMD)	Weighted average %	Value (million AMD)	Weighted average %	Value (million AMD)	Weighted average %
Q1, 2014	58,769.52	7.80	8,230.77	6.17	297.76	9.05
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
Q2	54622.40	8.13	14056.0	6.46	677.46	9.31

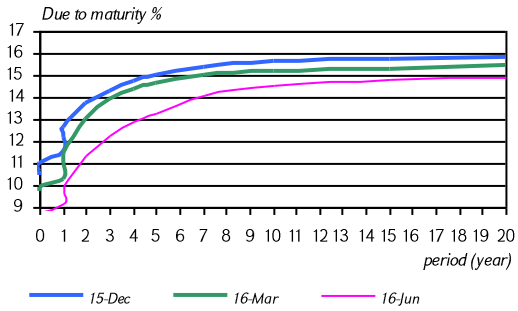
In the second quarter the interbank repo rate behaved similarly in reacting to the CBA policy signal: it averaged 7.75% in June, dropping by 0.89 pp against March.

Box 4

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



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



Government securities market

Continued easing of monetary conditions by the CBA induced a greater effect in the T-bills market in the second quarter of 2016. The decline in short-term bond yields was considerable: because T-bills' yields were slightly higher than those of other money market instruments, the average quarterly yield has fallen by 1.08 pp against the previous quarter to 10.25%, and the average monthly yield slumped by 1.42 pp against March to 9.74% in June.

The financial market participants' expectations that interest rates tend to fall were reflected in government securities yield curve. This led to a changed position of the T-bills' yield curve during the second quarter. The yields came in squeezed along the entire curve, especially in the short-term and medium-term segments, reducing by 1.3 pp and 1.5 pp, respectively. In the long-term segments yields have narrowed by 0.6 pp to 14.9%. As a result, the long-term and short-term interest rate spread widened in June by 0.9% to 6.7 pp, owing to a sizable reduction in short-term rates.

The CBA policy conducted in the second quarter, weakening inflation expectations as well as liquidity offered as a result of paid-in bank capital have led to the falling of interest rates on funds borrowed and attracted by banks.

Interest rate on deposits in local currency	Q1, 2016	Q2, 2016	Change
Up to 1 year			
Non-financial corporations	9.20	9.04	-0.16
Households	14.78	13.58	-1.20
Over 1 year			
Non-financial corporations	13.65	13.64	-0.01
Households	14.7	13.56	-1.14
Interest rate on loans in local currency	**Q1, 2016**	**Q2, 2016**	**Change**
Up to 1 year			
Non-financial corporations	**14.22**	13.73	-0.49
Households	**21.62**	21.44	-0.18
Over 1 year			
Non-financial corporations	15.31	14.15	-1.16
Households	19.28	18.63	-0.65

Despite a decline in interest rates on local currency deposits during the second quarter, the amount of dram deposits grew by 7.7%, mainly thanks to time deposits.

Interest rate on deposits in foreign currency	Q1, 2016	Q2, 2016	Change
Up to 1 year			
Non-financial corporations	7.03	4.92	-2.11
Households	5.58	5.4	-0.18
Over 1 year			
Non-financial corporations	8.17	7.94	-0.23
Households	7.16	6.65	-0.51
Interest rate on deposits in foreign currency	**Q1, 2016**	**Q2, 2016**	**Change**
Up to 1 year			
Non-financial corporations	8.01	8.5	0.49
Households	14.75	14.52	-0.23
Over 1 year			
Non-financial corporations	9.43	9.75	0.32
Households	15.32	14.29	-1.03

The amount of both demand and time deposits in foreign currency decreased during the second quarter along with the reduction of interest rates.

Continued easing of monetary conditions by the CBA which led to the falling of interest rates in the financial market, including interest rates on funds attracted by banks, has affected interest rates in the credit market through the transmission mechanism.

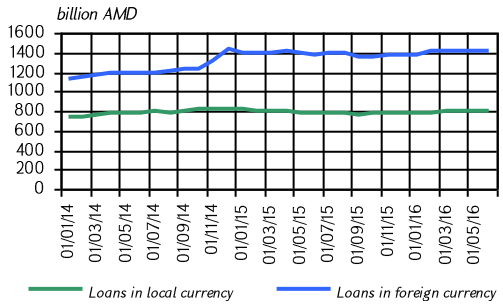
In June the total amount of dram loans grew by 1.8% compared to March of 2016.

The total lending volume grew during the quarter by 0.6% or 1.5%, if the effect of varying exchange rate is excluded.

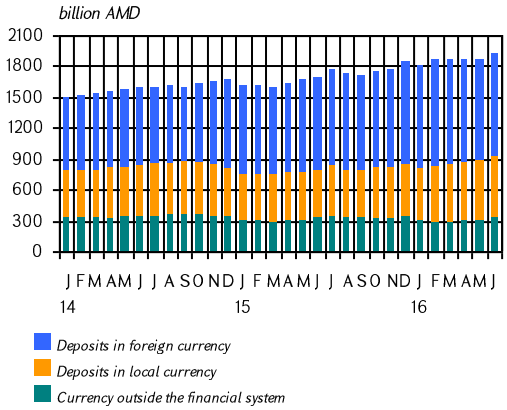
Interest rate on mortgage loans to households	Q1, 2016	Q2, 2016	Change
Armenian dram	12.76	12.55	-0.21
US dollar	12.73	12.54	-0.19
Interest rate on consumer loans			
Armenian dram	20.34	19.84	-0.5
US dollar	15.48	15	-0.48

Overall, the second quarter of 2016 saw acceleration of credit growth, a trend observable since the previous two quarters: as of end-June the credit growth has been 1.1% and for the last 12 months, 3.8%. Most of the growth in lending in the second quarter owed to the loans to enterprises. The structure of this quarter's lending portfolio shows that foreign currency loans again outgrew local currency loans, constituting roughly 64% in total. Also, the terms of lending were facilitated in the second quarter, which means a further easing of monetary conditions.

In the second quarter of 2016 foreign currency loans outweighed local currency loans in total lending



In the second quarter of 2016 deposits in local currency grew



Box 5

According to the results of the second quarter 2016 survey on terms of lending by local banks and credit organizations, there has been easing of loan terms virtually in all aspects of lending. This was set to achieve through revised terms in refinancing programs and increased competition between financial institutions to name a few, which led to less strict requirements to loan interest rates, non-interest payments, maturity and collateral. Demand for SME loans has grown but demand for loans by major companies slackened, which will also be expectable next quarter. Demand for loans by households has grown.

For the third 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, except for loans to large enterprises.

Monetary indicators	**June 15, 12-month growth**	**September 15, 12-month growth**	**December 15, 12-month growth**	**March 16 12-month growth**	**June 16, 12-month growth**
Broad money (%)	6.3	7.3	10.8	16.9	13.9
Dram broad money (%)	-4.2	-8.6	5.2	12.1	15.8
Base money (%)	14.7	22.1	3.9	7.3	-5.0
Dram base money (%)	19.6	15.6	-1.6	0.8	-3.6
Currency (%)	-6.7	-10.6	-0.8	0.1	2.3
Deposits in local currency (%)	-2.5	-7.2	9.6	19.8	24.9
Deposits in foreign currency (%)	17.9	26.2	16.3	21.2	12.2
	Jun 15	**Sep 15**	**Dec 15**	**Mar 16**	**Jun 16**
Dollarization (rate)	51.2	52.6	52.2	53.4	50.5
Money multiplier (rate)	2.06	1.95	2.01	2.20	2.47
Dram multiplier (rate)	1.15	1.15	1.17	1.24	1.39

In the second quarter of 2016 the indicator of dollarization (foreign currency deposits-to-broad money ratio) reduced by 2.9 pp against the previous quarter.

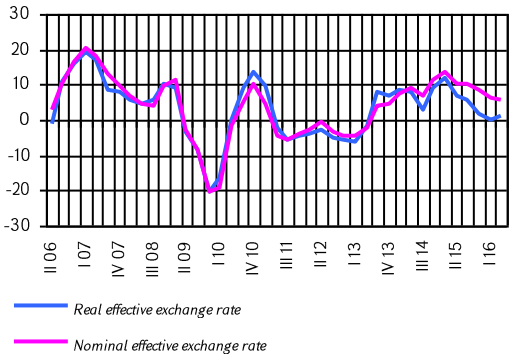
3.3.2. Exchange rate

In the second quarter of 2016 partner countries to Armenia saw appreciation pressures in their foreign exchange markets. During the quarter the partner countries' average weighted nominal exchange rate appreciated versus the US dollar by 4.2%, which was largely driven by appreciated Russian ruble, euro and Georgian lari (contribution: 2.5, 0.8 and 0.3 pp, respectively). With partner countries' national currencies appreciating, the average nominal exchange rate of the Armenian dram also appreciated versus the US dollar by 2% in the second quarter. To absorb short-term volatilities deriving from balance sheet seasonality, the CBA bought nearly USD 52.6 million in net terms in the foreign exchange market.

In the second quarter of 2016 the nominal effective exchange rate of the Armenian dram depreciated by 2.23% q/q as the partner countries' currency basket posted a rapider appreciation versus the US dollar. In the meantime, the real effective exchange rate has depreciated by 4.6% q/q[27].

Compared to the same reference period last year, the real effective exchange rate remained slightly appreciated, nearly 1.3%.

In the second quarter of 2016 the real effective exchange rate appreciated y/y, %



Growth y/y, (%)	Q2, 2014	Q3	Q4	Q1, 2015	Q2	Q3	Q4	Q1, 2016	Q2
Real effective exchange rate (+ means appreciation)	7.8	3.1	9.2	11.7	6.7	5.8	2.2	-0.1	1.3
Average inflation in Armenia	3.3	1.0	3.2	5.2	5.1	4.4	1	-1.2	-1.6
AMD/USD average nominal exchange rate (+ means appreciation)	0.5	0.0	-5.7	-13.9	-13.4	-14.8	-10.1	-2.3	-0.5
Average weighted inflation in trade partner countries	4.4	4.6	5.1	6.7	7.9	7.5	6.9	-5.1	-2.8
Trade partners' average weighted nominal exchange rate (+ means appreciation versus dollar)	-8.6	-7.0	-18.5	-32.1	-27.2	-29.4	-20.7	-9.1	-6.5

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 6

Foreign exchange market

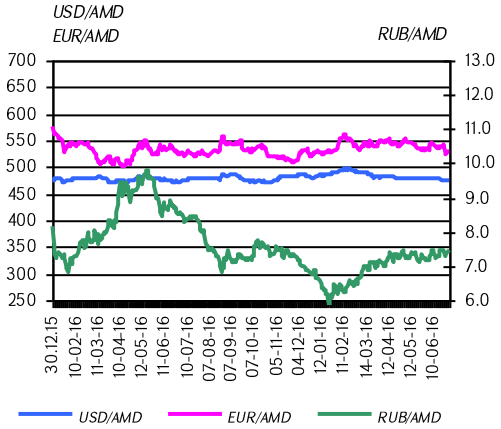
As of end of the second quarter of 2016 the average USD/AMD was 476.68, appreciated by 0.86 relative to the end of the previous quarter.

The dram's exchange rate: end of Q2, 2016 to end of Q1, 2016

Currency pair	Exchange rate as of 31.03.2016 (AMD)	Exchange rate as of 30.06.2016 (AMD)	% (appreciation «+», depreciation «-»)
USD/AMD	480.79	476.68	+0.86
EUR/AMD	546.47	530.45	+3.02
RUB/AMD	7.14	7.44	-4.03

[27] *The second quarter 2016 indicator of the real exchange rate is the CBA estimate.*

Armenian dram's exchange rate versus US dollar, Euro and Russian ruble over a one-year period



The dram's average exchange rate: Q1, 2016 to Q1, 2015			
Currency pair	Average exchange rate, Q2, 2015	Average exchange rate, Q2, 2016	% (appreciation «+», depreciation «-»)
USD/AMD	476.48	479.06	-0.54
EUR/AMD	526.80	541.07	-2.64
RUB/AMD	9.08	7.28	+24.73

The aggregate volume of U.S. dollar/Armenian dram transactions in the foreign exchange market in the second quarter of 2016 amounted to USD 2.06 billion, decreasing by 11.97% (AMD 2.34 billion) against the same reference period last year.

The aggregate volume of Euro/Armenian dram transactions carried out during the second quarter reached EUR 253.46 million, which is an 11.78% increase against EUR 226.74 million reported in the second quarter of 2015.

The aggregate volume of Russian ruble/Armenian dram transactions in the second quarter of 2016 totaled RUB 16.94 billion, which represents a 29.21% (RUB 13.11 billion) increment compared to the relevant figure recorded in the second quarter of 2015.

3.4. Balance of payments[28]

In the second quarter of 2016 the deficit of trade balance tended to narrow further in the light of somehow recovering external demand and continued growth of productivity in the tradable sector of the domestic economy.

Thus, an 8.0% y/y increase in the dollar value of export[29] in the second quarter of 2016 was mainly due to the grown export of consumer goods and precious metals. The y/y decline in the dollar value of export of non-precious metals, in spite of high growth in export volumes, was primarily attributable to prices still at lower levels in international metals markets relative to the second quarter of the previous year.

Trends of recovering imports of consumer and investment goods amid gradually improving domestic demand were observable in second quarter of 2016. However, the level of import of investment goods is still below the relevant indicator reported for the second quarter of 2015 because of persisting weak investment climate. The second quarter of 2016 saw a slight decrease of 2.4% y/y in the dollar value of import.

In the second quarter of 2016 the deficit of trade balance[30] shrank by USD 51.2 million to USD 185.5 million as a result of grown exports

[28] *The second quarter 2016 balance of payments will be published at the end of September of 2016, according to the timetable. The second quarter 2016 indicators are the CBA's forecasts and estimates.*

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

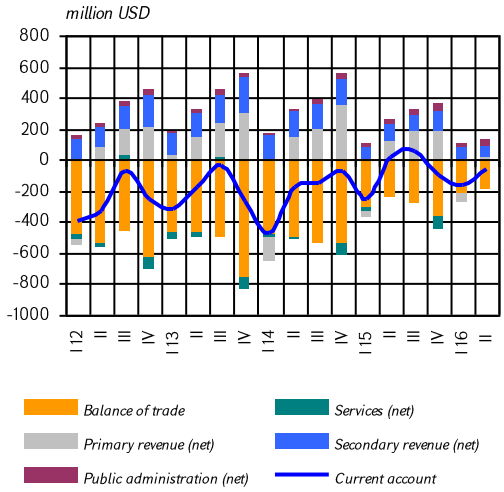
[30] *The deficit of trade balance has been calculated on a balance-of-payments basis, where export is credit, import debit.*

and reduced imports. Remittances kept on declining at a faster rate this quarter due to the depreciation of the ruble against the same reference period last year. It is noteworthy that financial performance of foreign investors has improved in relation to the previous reference period on the back of healthier economic conditions. Better financial results are reflected in a reinvested income, unlike the previous year's second quarter, creating a current account deficit. As a result, the current account posted a negative balance of USD 58.6 million in the second quarter of 2016 (a surplus of USD 19.2 million in the second quarter of 2015). In January-June, the current account deficit-to-GDP ratio has improved by 0.4 pp.

In the second quarter of 2016 a low level of current account deficit was mainly financed by foreign direct investment, as opposed to net foreign assets accumulated with the private sector.

Net demand for foreign currency generated as a result of the aforementioned developments with the balance of payments drove the CBA net foreign assets to decrease by USD 75.9 million. However, net buying volume of FX assets was smaller than the said decrease of commercial banks' FX correspondent accounts with the CBA and the volume of external debt servicing.

In the second quarter of 2016 the current account run with a deficit relative to the second quarter of 2015



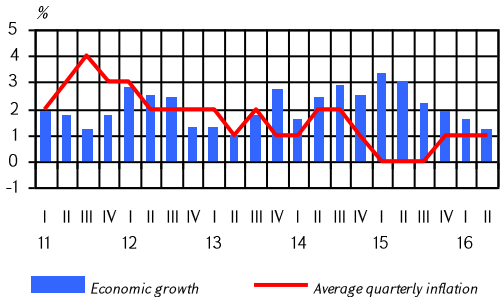
3.5. External environment

In the second quarter of 2016 slower growth rates were observable in the U.S.A. but quicker growth in the Eurozone, whereas economic decline in Russia somewhat decelerated.

In the second quarter of 2016 growth rates were slower in the USA but faster in the Eurozone; in the meantime economic decline in Russia somewhat decelerated.

According to preliminary estimates of the Bureau of Economic Analysis of the U.S. Department of Commerce, the annualized economic growth in the ***United States*** in the second quarter of 2016 was 1.2% q/q compared to the previous quarter's 0.8% growth, and the economic growth was 1.2% y/y against the previous quarter's 1.6% growth[31]. Contracted net exports because of appreciated dollar as well as reduced investment have contributed to the slowing of economic growth. The average quarterly rate of inflation persisted almost at the same level, 1.0%, in comparison with the relevant indicator of 1.1% reported in the previous quarter. Inflation remains below its medium-term target mainly due to lower prices of oil products and import goods. In such circumstances, in the second quarter the US Federal Reserve System kept the policy rates in the range of 0.25-0.5%.

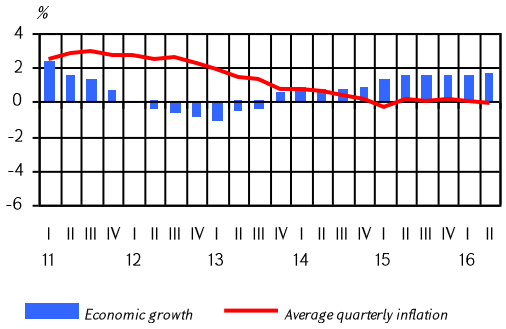
In the second quarter of 2016 economic growth in the USA slowed down



According to preliminary estimates provided by the Eurostat, economic growth in the ***Eurozone*** in the second quarter of 2016 speeded up to 1.7% y/y from 1.6% y/y recorded in the previous quarter.

[31] *The publication of the Bureau of Economic Analysis of the U.S. Department of Commerce included a review of the historical series of economic growth.*

In the second quarter of 2016 economic growth in the Eurozone accelerated



The strengthening of domestic demand is a key stimulus to such economic growth. Despite some recovery in demand, the inflation rate decelerated in the second quarter to -0.1% from the previous quarter's respective figure of 0.02%, which still carries the influence of low oil prices. In the second quarter the European Central Bank kept the policy rates 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 at the amount of EUR 80 billion a month.

In the currency market in the second quarter of 2016, euro's appreciation against the U.S. dollar was 2.5% q/q (with y/y appreciation of 2.2%); the average exchange rate reached 1.13 dollars for one euro.

According to the preliminary estimates of State Statistics Service of ***Russian Federation,*** economic decline in the second quarter of 2016 was 0.6% (previous quarter's figure of decline: 1.2%). With international oil prices posting some rise, the Russian ruble appreciated during the second quarter by 13.8% q/q (with y/y depreciation amounting to 20.1%). Under such circumstances as well as reducing inflation expectations, the Bank of Russia cut the policy rates by 0.5 pp to 10.5% in the second quarter, with the 12-month inflation rate having subdued to 7.1% from the previous quarter's respective figure of 7.9%.

In the second quarter of 2016 the ***price of Brent crude oil*** at Intercontinental Exchange grew against the previous quarter by about 34.2% to USD 45.9 a barrel on average (with 28.6% y/y decrease). The rise in oil prices was mainly due to seasonal increase in demand, decline in production volumes in some oil-producing countries and depreciation of the U.S. dollar, but it should be noted that international oil prices trended somewhat downward at the end of the quarter.

In the second quarter of 2016 the ***price of copper*** at the London Metal Exchange grew by 1.4% q/q against the previous quarter (with 21.8% price decrease y/y), which was mostly determined by some contraction in the volumes of supply by major copper producers in China early in the quarter.

The export price of ***hard red wheat*** followed a downward path during the second quarter too, owing to large worldwide production volumes and sizable inventories. This quarter, the wheat price fell by 2.1% against the previous quarter (with 18.9% decrease y/y) to USD 4.3 a bushel on average.

In the second quarter of 2016 the price index of ***unprocessed sugar*** at the New York Board-Intercontinental Exchange grew considerably, which was driven by expected contraction in the amount of harvest in Brazil and India, main producer and exporter countries. As a result, price growth of sugar was 19% q/q and 35.5% y/y.

In the second quarter of 2016 the price of ***rice*** at the Chicago Board of Trade kept on growing on the back of persistently low production volumes; the price rose by 8.9% to USD 18.2 per U.S. hundredweight (45.4 kg), with the y/y growth reaching 4.9%.

Summary: inflationary trends observable in the world's commodity and food product markets in the second quarter of 2016 were mostly in line with the previous program's forecasts, although food products reported somewhat higher-than-expected price growth.

4. CONCLUSION

The ***global economy*** remained on a slow-growth track in the second quarter of 2016, too. This will continue up until the end of the year. Deflationary developments have generally suspended and some stability is achieved in international commodity markets. A low-price environment will be persisting in these markets in the short run, however. 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 second quarter of 2016 ***growth of economic activity*** amounted to ***4.7%*** largely driven by increased output in industry and services sectors. Under this circumstance, ***economic growth*** is estimated in the range of ***2.8-3.4*** at the end of 2016 and ***3.0-4.5%*** at the end of the forecast horizon.

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

At the end of June of 2016 the ***12-month inflation rate*** was ***-1.1%,*** driven by lower seasonal prices of agricultural products.

At the end of the forecast horizon the 12-month inflation rate will stabilize around the 4% target. The CBA estimates that deflationary environment will persist in the third quarter of 2016 but will gradually reduce thereafter; in the forecast horizon the 12-month inflation rate will gradually return to the target.

In this case, the ***CBA finds it reasonable to continue easing monetary conditions in the second quarter of 2016*** in order to contribute to further expanding of aggregate demand. In doing so, the CBA will also assist the deflation environment to phase out gradually and the inflation to stabilize around the target in the forecast horizon.

Risks that inflation will deviate from the projected value are estimated downside in the short run and balanced in the medium run. Risks deriving from external and domestic sectors mostly persisted in relation to the previous forecast. In particular, the ***external sector risks*** are related to capital outflows from developing countries and, consequently, volatilities in financial markets, the processes in the European Union, a likely slowdown of global economic growth resulting from structural shifts in 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 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.