

THE CENTRAL BANK OF THE
REPUBLIC OF ARMENIA

*Approved under the Central Bank Board
Resolution No. 147A, dated August 27, 2018*

Inflation Report

Monetary Policy Program, Q3, 2018



*Status Report on Implementation of the
Monetary Policy Program, Q2, 2018*

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

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

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

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

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

Projections in this report are based on the actual information available by August 14, 2018, i.e. the day on which the refinancing rate was set, the results of a survey conducted by the Bank and the judgment made pursuant to the information on future developments of the macroeconomic environment.

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

Table of Contents

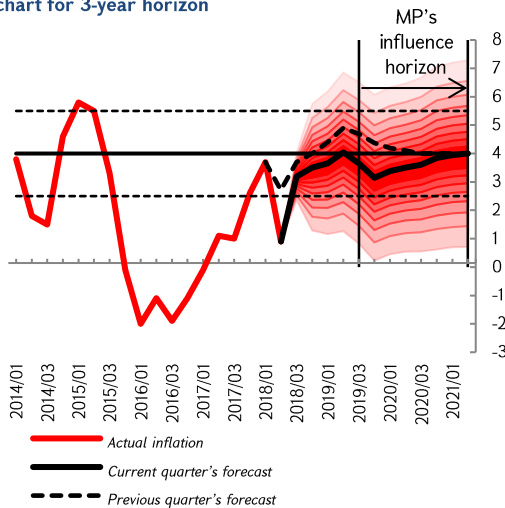
1. Executive summary	4
2. Forecast, forecast changes and risks	5
2.1. External environment	5
2.2. Forecasts	7
2.2.1. Inflation and monetary policy	7
2.2.2. Forecasts	9
<i>Box 1: The medium term state budget developments, by MTEF 2019-2021</i>	10
2.2.3. Comparison with the previous forecast	11
2.2.4. Main assumptions and risks	14
<i>Box 2: The results of survey on the expectations by the households and the financial system</i>	15
3. Actual developments in Q2, 2018	17
3.1. Inflation	17
3.1.1. Fulfilment of the inflation target	17
3.1.2. Prices	18
3.2. Economic developments	19
3.2.1. Economy position	19
3.2.2. The expenditures aspect of the economy	20
3.2.3. The production aspect of the economy	22
3.2.4. Labor market	22
3.3. Financial market developments	23
<i>Box 3: The impact of the political events in the second quarter on the Armenian financial market, and the Central Bank action</i>	24
Annex	
Minutes	25
The CBA Board Decision on interest rates	27
Press release	28
Main macroeconomic indicators	29
Charts	30
Tables	31

1. EXECUTIVE SUMMARY

In the second quarter of 2018, inflation has somewhat slowed down due to the fall in seasonal product prices. It is expected that the 12-month inflation will increase in the second half of 2018, remaining within the confidence band, and it will stabilize around the 4% target in the forecast horizon.

Chart 1

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

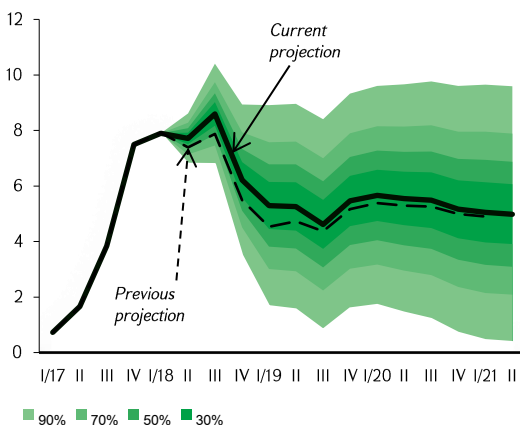


Source: Armenia Statistics Committee,
Central Bank forecast

Economic activity was still high over the first half of 2018, mainly due to strong growth of investments in the private sector. The estimation is that these trends will continue over the short term, on the basis of which the Central Bank has revised the year's economic growth forecast upside. In the mid-term perspective, the growth will approach its long-term equilibrium.

Chart 2

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



Source: Armenia Statistics Committee,
Central Bank forecast

In the second quarter of 2018 inflation slowed down to a certain extent, driven by the fall in prices of seasonal products. However, under current monetary policy, the 12-month inflation rate is expected to increase over the second half of the year, remaining within the confidence band; in the forecast horizon it will stabilize around the 4% target.

Positive developments in the macroeconomic environment carrying on in the short run will largely facilitate the fulfilment of the 12-month inflation target, owing to the effect of persisting expansionary monetary policy and relatively high economic activity, although domestic demand and inflation in the external sector weakened to some extent. The inflation environment remained low in the past period of the year and the 12-month inflation mostly fluctuated within the lower part of the confidence band. The core inflation and short-term inflation expectations have reduced as well, influenced by the change in the supply in some product markets. It is estimated that inflation expectations will also increase and stabilize around the target, as inflation recovers. In view of the actual and predictable macroeconomic developments, in particular, the need to strengthen the domestic demand recovery, the **Board of the Central Bank decided to keep the refinancing rate unchanged, leaving the monetary policy direction expansionary.**

In the light of predicted macroeconomic developments, the Central Bank estimates that maintaining the monetary environment expansionary **in the upcoming period** will be needed, while considering that it will gradually eliminate in the medium run.

High economic activity was persisting over the first half of 2018, mainly due to strong growth of investments in the private sector. The estimation is that these trends will continue over the short term, on the basis of which the Central Bank has revised the year's economic growth forecast upside. In the mid-term perspective, the growth will approach its long-term equilibrium.¹

According to the baseline scenario, mid-term economic growth trends will largely depend on the economy's fundamentals, investment activity and an increase of production capacities in 2017-2018, the pace of Government-led structural reforms, and the anticipated potential of economic growth in partner countries.

Risks to inflation and economic growth **in the short run and medium run** are dual-sided and estimated to be balanced (see subsection 2.2.4 "Main assumptions and risks").

If the event risks deviate from the prediction, the Central Bank will react by adjusting its monetary conditions accordingly.

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

2. FORECAST, FORECAST CHANGES AND RISKS

2.1. External environment

The anticipation is that strengthening of the global economy observable in the first half of 2018 will smoothly continue over the second half of the year. As for principal trade partners to Armenia, relatively strong economic growth rates are expected in the United States, some slowing in high growth rates is anticipated in the Eurozone, while continued recovery will be observable in the Russian economy.

Prices will remain relatively high in the world's raw material and food product markets over 2018 owing to supply factor-associated matters in the light of a sustainable demand.

Economic developments in the external sector: According to preliminary estimates of the Bureau of Economic Analysis of the U.S. Department of Commerce, economic growth in the **United States** in the second quarter of 2018 was 2.8% y/y, with average economic growth projected at 2.8% for 2018, driven by robust domestic demand and increased net export. In the second quarter of 2018 the unemployment rate reduced to 4.0%.

According to preliminary estimates provided by the Eurostat, economic growth in the **Eurozone** in the second quarter of 2018 amounted to 2.1% y/y; that much is predicted for the entire year, mainly owing to the increase in private consumption and a certain positive impact of investment growth. In the second quarter of 2018 the unemployment rate further dropped to 8.4%.

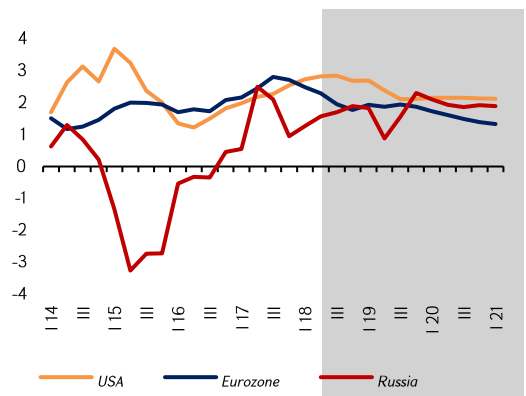
According to preliminary estimates provided by State Statistics Service of the **Russian Federation**, economic growth in the second quarter of 2018 was 1.8% y/y against the previous quarter's 1.3%. The 2018 economic growth is forecast to reach 1.7% – the reported growth of tourism and services during the FIFA World Cup 2018 in Russia contributed positively to the second and third quarters' economic growth in the country. With such economic activity, the unemployment rate continued declining slowly during the second quarter of 2018. In the medium term, notwithstanding some external demand shaped under a depreciated exchange rate, the domestic demand is expected to decline concomitant with implementation of a contractionary fiscal policy under the 2019 program.

Price and financial developments in the external sector: In the second quarter of 2018, the developments in raw material and food product markets unfolded, with prices going slightly upward against the program, except the international copper price, the current level of which was somewhat below the previous forecast.

The global economy strengthened over the first half of 2018 is expected to remain so over the second half of the year. As for principal trade partners to Armenia, relatively strong economic growth rates are expected in the United States, some slowing in high growth rates is anticipated in the Eurozone, while continued recovery will be observable in the Russian economy.

Chart 3

Economic growth in trade partner countries, %



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

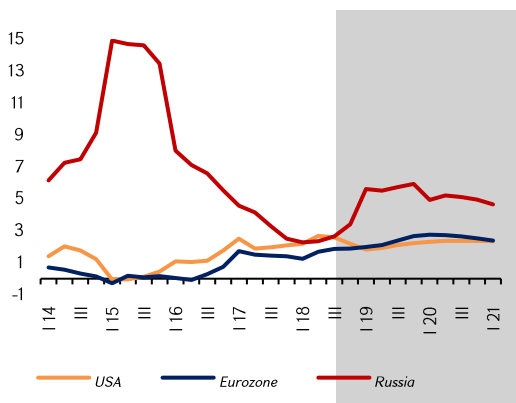
In the United States in the second quarter of 2018, compared to the previous quarter, the average quarterly inflation notably accelerated to 2.7%, running above the US Federal Reserve System's mid-term target. In view of such economic and price developments, the FRS rose the policy rate in the second quarter, as was expected, by another 0.25 pp, setting it in a 1.75-2.00% range. Predictions suggest that the US inflation will remain above its target in 2018 and, taking into account the economic growth trends, the Fed may further pursue a gradually tightening monetary policy to bring the inflation closer to the target. Moreover, the risk to capital outflows from emerging economies and subsequent volatilities in the financial markets will persist in the event the long-term interest rates of US Treasury bonds rise.

In the second quarter of 2018, the average quarterly inflation in the Eurozone accelerated to 1.7%, almost approaching the planned target. In view of such economic developments when inflation needs to be brought closer to the target in the medium term, the European Central Bank will still continue a low interest rate policy, announcing in June about winding-up the asset purchases program at the end of the year. Note that the program will continue usual purchases of EUR 30 billion a month by September, and of EUR 15 billion a month by the end of 2018. In the meanwhile, the ECB has talked about the possibility of leaving interest rates unaffected up until the half of 2019.

In the second quarter of 2018, the average quarterly inflation in the **Russian Federation** somewhat accelerated to 2.4% (2.3% in previous quarter), but was still below its target of 4%. The dropped food prices, the seasonal fruit and vegetable prices in particular, were the main contribution to keeping the inflation low. In view of such conditions as well as growing inflationary expectations due to the rise in petrol prices, in the second quarter the Central Bank of Russia kept the policy rate unchanged, at the level of 7.25%, as was in the previous quarter. Remarkably, the decision on increasing the VAT in Russia, which was announced in June 2018, will have an impact on inflation at the beginning of the next year, while the inflationary expectations it will cause may also affect the current inflation developments. The external demand, expanding as a result of a depreciated exchange rate, will create additional inflation expectations. So, despite the fact that inflation is running below its target, the CBR will continue implementing a moderately contractionary monetary aimed at reducing inflation expectations and anchoring the inflation around the target.

In the second quarter of 2018, the euro exchange rate versus the US dollar depreciated by 3.0% q/q to 1.19 dollars per euro, which was mainly attributable to an approach to conducting different monetary policies in the US and Eurozone. In the second quarter the Russian ruble depreciated by 1.5% to an average RUB 61.9 per dollar, mainly due to US sanctions imposed on Russia in April. Note also that depreciation of the Russian ruble is predicted to continue in the short run on the brink of a new wave of anti-Russian sanctions announced by

Chart 4
Inflation in trade partner countries, %



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

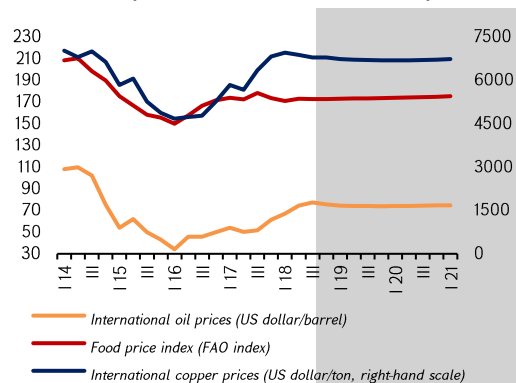
the US in August, on the one hand, and the cautious attitude of investors to developing countries as a result of the Turkey crisis, on the other.

International copper prices posted a decrease and oil prices, a considerable increase, during the second quarter of 2018, and the expectation for the forecast horizon is that the commodity prices will remain as much elevated as they are for now. Specifically, the rise in international oil prices observable in the previous year and over the first half of 2018 will, according to forecasts, continue in the short run too, due to the resumption of US sanctions against Iran, as well as reduced US oil inventories. The drop in international copper prices in the second quarter of 2018 was driven by trade tension, as China reduced the demand. It is expected that in the medium term prices will stabilize around the current. However, trade wars contain significant risks, which may affect the copper prices.

The previous quarter's small slowing of price growth rates in the world food product markets continued over the second quarter of 2018. Specifically, the drop in sugar, vegetable oil and meat product prices in the second quarter has resulted in slower growing food prices, although international dairy and wheat prices have risen. In the second half of 2018, thanks to a relatively good harvest in some of the major sugar exporting countries, a slight decline in sugar prices is expected, whereas international wheat prices are predicted to grow in anticipation of lower crops because of dry weather conditions.

Chart 5

International prices of raw materials and food products



Source: World Bank, FAO, Central Bank forecast

2.2. Forecasts

2.2.1. Inflation and monetary policy

Driven by falling prices of seasonal products, inflation slowed down to some extent in the second quarter of 2018. However, given the current monetary policy conditions, it will continue expanding in the course of 2018, staying within the confidence band, and will stabilize around the target in the forecast horizon.

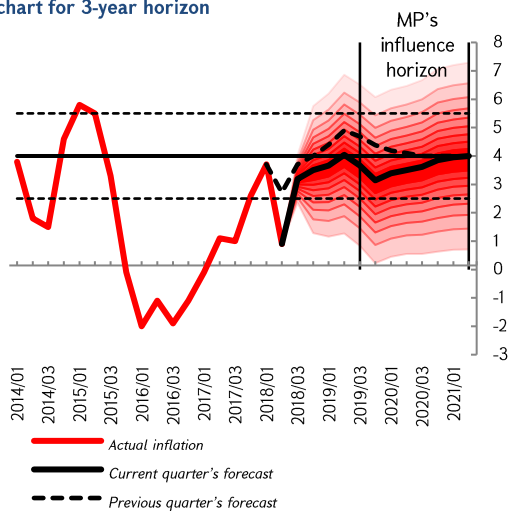
In the second quarter of 2018, core inflation slowed to some extent but was still persisting at a relatively high level. In the coming months it will continue to soften under the influence of supply-side shocks in some product markets² and will come nearer to headline inflation trends. At the same time, the prices of seasonal agricultural products

In the course of 2018, the 12-month inflation will continue to increase, remaining within the confidence band, and in the forecast horizon it will stabilize around the target.

² For example, the influence of currency depreciation in the economies of trade partners to Armenia, of a change in competitive prices and markup prices in certain commodity markets. For more details, see subsection 2.2.4 "Main assumptions and risks".

Chart 6

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



Source: Armenia Statistics Committee,
Central Bank forecast

have begun recovering a little earlier than expected, following the reported decline in the previous quarters, in which circumstance the headline inflation will somehow increase in the course of the year, staying within the lower part of the confidence band.

According to the Central Bank estimates, economic activity slowed down to some extent in the second quarter of 2018 on the back of strong indicators posted in the previous quarter. In the meanwhile, there has been some slowing in the productivity growth rates, and the growth in private demand has slowed down much more as investment growth rates reduced. Also, aggregate demand has incurred the significant contractionary impact of public demand. As a result, the GDP gap is estimated close to zero in the second quarter of 2018. At the same time, demand is expected to weaken gradually due to a notably contractionary effect of the fiscal policy. As the aforementioned developments unfold, aggregate demand will also incur the impact of currency depreciation in partner countries, as a result of which the GDP gap will gradually diminish, entering the negative territory. The latter will have a moderate deflationary effect which, fueled by an expansionary monetary policy, will phase out in the medium-term perspective as the GDP gap closes. In the outcome, inflation will stabilize around the target at the end of the forecast horizon. It is estimated that short-term inflationary expectations of the public have somewhat reduced in the light of inflation developments, particularly in the context of increased competition in a variety of product markets in the second quarter. Nevertheless, these expectations will also stabilize around the target as inflation restores. ***The Board of the Central Bank believes that keeping the policy rate unchanged, while leaving the monetary conditions expansionary, is appropriate for now.***

Table 1

Period	Inflation interval forecast probability distribution				
	<1.0%	1.0-2.5%	2.5-5.5%	5.5-7.0%	>7.0%
Q3 2018	0.0	0.3	99.6	0.1	0.0
Q4	0.2	6.8	73.5	16.0	3.6
Q1 2019	0.0	1.2	52.1	30.2	16.5
Q2	0.1	2.9	54.0	26.5	16.5
Q3	0.5	6.2	59.9	22.7	10.8
Q4	1.5	10.0	61.6	19.6	7.2
Q1 2020	2.2	11.9	62.0	17.9	6.0
Q2	3.1	13.8	62.0	16.2	4.9
Q3	4.0	15.2	60.4	15.5	5.0
Q4	4.6	15.1	57.8	16.2	6.3
Q1 2021	4.6	15.0	57.3	16.4	6.6
Q2	4.7	14.9	56.8	16.7	7.0

2.2.2. Economic activity³

Aggregate demand: High economic activity persisted over the first half of 2018, mostly owing to strong growth of investment in the private sector. Predicted economic growth in 2018 largely depends on the growth of lending to the economy, high investment activity as well as an increase in external demand.

In light of the aforementioned developments, economic growth in 2018 is expected in the range of **5.6-6.9%**. The 3.4% growth in private consumption and as much as 37% growth in investment will make an 8.2 pp contribution to the growth, whereas public spending will leave a 2.6 pp negative impact on the growth. Net export will make a 0.6 pp positive contribution to the 2018 economic growth.

In the medium run, economic growth developments are largely determined by the economy's fundamentals, as well as investment activity in the period 2017-2018. In anticipation of high investment activity, mid-term economic growth forecasts have been revised slightly up. Thus, the 2019 economic growth is estimated in the range of **4.6-6.4%**, that of 2020, in the range of **4.1-6.2%**, and at the end of the forecast horizon it will approach its long run equilibrium. These mid-term growths are largely determined by expanded production capacities, the pace of Government-led structural reforms, and anticipated potential of economic growth in partner countries.

External demand: Sustainable global economic growth notwithstanding, the mining and processing industries' growth rates slowed down in the second quarter of 2018, which was caused by the events in the domestic economy, as, in particular, the operation of Teghut mine was suspended for an indefinite period, and by the temporary effects of political events in April-May. The growth rates of traveling to Armenia have slowed down as well. At the same time, the growth of import of intermediate goods remained robust. Overall, contribution of net export to economic growth is estimated negative.

The forecasts for real growth of export have been revised downside for the second half of 2018 in view of predictions for slower growth in the mining industry. As a result, the real growth of export of goods and services in 2018 will be within 8.0-10.0%. With the domestic demand slackening, including due to the completion of the "Amoulsar" investment project, the real growth of import of goods and services for the second half of the year has had downside forecasts. However, the 2018 annual growth will be in the range of 6.0-8.0%, as imports have posted more than expected growth in real terms in the first half of the year. As a result of these forecasts, net export's negative contribution to the real GDP for the first half will neutralize over the second half.

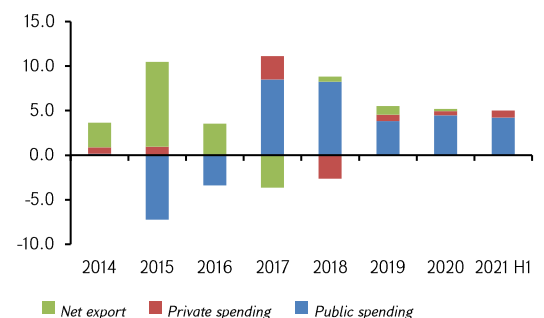
Remittances of individuals in the second quarter of 2018 have been consistent with the forecast, but their growth rates for the next quarters incurred a downward revision in relation to the previous

High economic activity persisted over the first half of 2018 owed mostly to a strong growth of investment in the private sector.

Economic growth in 2018 is expected in the range of 5.6-6.9%.

Chart 7

Demand components contributing to the growth (percentage point)

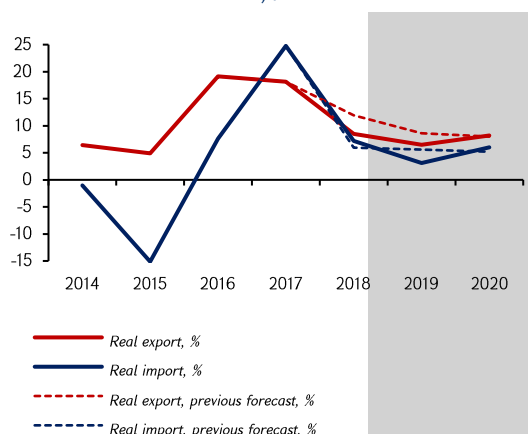


Source: Armenia Statistics Committee,
Central Bank forecast

³ For a detailed account of economic growth forecasts, see the "GDP Projection Probability Distribution", chart 18, table 2.

Chart 8

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



Source: Armenia Statistics Committee,
Central Bank forecast

In 2018, the fiscal policy will have a 1.6 pp of contractionary impact on domestic demand, mostly owing to tightened expenditures.

forecast, due primarily to further depreciated ruble. As a result, the growth of individuals' remittances will be in the range of 5.0-7.0%.

As a result of the aforementioned developments, the current account deficit-to-GDP ratio will somehow increase against the previous forecast and will be within 4.0-5.0%. In the medium run, the ratio will stabilize around an estimated 3.0% equilibrium.

Fiscal policy: The **fiscal policy's impact** on aggregate demand in 2018 has been estimated using the revenue and expenditure indicators determined by the Republic of Armenia Law on "State Budget 2018" and adjusted⁴ under specific Government of Armenia resolutions.

Relative to the previous MP program, the state budget revenue forecasts did not change and are in line with quarterly revenue plans. Lesser public spending during the second quarter made it possible to forecast savings on expenditures for the year, with nearly a 95% performance rate of the annual plan. This will affect the deficit which, the Central Bank estimates show, will make up 1.5% of the GDP instead of 2.7% as provided for by the law. As a result, the fiscal policy will have a 1.6 pp of contractionary impact on domestic demand in 2018, mainly owing to tightened expenditures. Nevertheless, some uncertainties as to which course to opt for collecting revenues and making expenditures persist in the context of further evaluating the pace of the fiscal policy.

According to the Central Bank assessment, the **medium-term impact of fiscal policy** is still uncertain, since the 2019 State Budget indicators may come deviated from the Medium Term Expenditure Framework for 2019-2021, depending on the progress with the 2018 budget performance and the annualized indicators.

Below are the mid-term fiscal trends and scope, as outlined in the Medium Term Expenditure Framework (MTEF) for 2019-2021:

Box 1

The Medium Term State Budget Developments, by MTEF 2019-2021

The medium term fiscal policy framework which is incorporated in the Medium-Term Expenditures Program for 2019-2021 has been developed using an upgraded system for fiscal rules, effective from 2018. In compliance with these rules, a contractionary fiscal policy will be carried out in the forecast medium-term horizon, in view of the need to shape a sustainable fiscal and debt environment. In 2019-2021, an increase in tax revenue relative to the GDP will amount to 0.4 pp on average.

⁴ The indicators set out in the Republic of Armenia laws on the state budget have to be adjusted under separate Government of Armenia resolutions during the year, for which the Government of Armenia has a relevant mandate; these resolutions are published on <https://www.e-gov.am>.

To ensure long-term economic growth, there are plans to decrease the share of current expenditures and increase the share of capital expenditures in the GDP.

As regards the Government debt, the government debt-to-GDP ratio, which exceeded 50% of the GDP in late 2017, amounting to 53.7%, will, according to the fiscal rules, be expected to trim down to be a figure below 50% of the GDP by 2023. So, carrying out a fiscal consolidation and improvement of the debt-to-GDP ratio is intended in the medium-term perspective.

To our opinion, the quantitative criteria established under the fiscal rules are consistent with the long-term objective for public debt sustainability, which, as and when maintained, will contribute to the strengthening of macroeconomic stability and enhancing confidence in economic policy in the country.

Labor market⁵: A notable acceleration in the nominal wage⁶ growth rate in the **private sector** is not anticipated in 2018, so it will hover at 6.5%, reflecting a slower productivity growth rate and declining inflation expectations. In the medium run however, the private sector nominal wage growth will be consistent with economic growth and inflation developments, i.e. its fundamentals. In 2019, the private sector's nominal wage is predicted to increase by 7.5%, and at the end of forecast horizon it will stabilize around 8.5%.

In case of a slowdown in productivity growth, the aforementioned economic growth will be concomitant with increasing employment, and a lower unemployment rate of 16.6% can be expected in 2018 as a result. In the medium term, the unemployment rate will decrease by 0.2-0.3 pp annually, approaching a level of 16% at the end of the forecast horizon.

In 2018, the growth of firms' unit labor costs will accelerate and at the end of the forecast horizon it will stabilize around its fundamental value, i.e. the 4% inflation target.

2.2.3. Comparison with the previous forecast

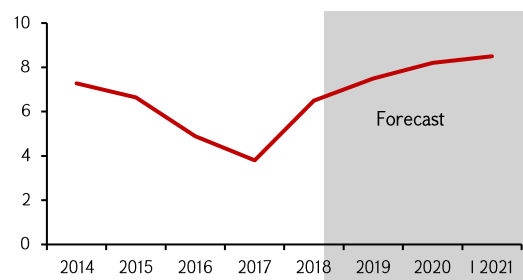
As to developments in the economies of trade partners to Armenia, short-term economic growth indicators in the USA have been adjusted upside relative to the previous forecast, while those

⁵ The labor market data for 2018-2021 are the Central Bank projections which are based on the first quarter of 2018 data and actual January-May 2018 figures. The growth indicators presented in this sub-section are relative to the same reference period last year, unless otherwise specified.

⁶ Starting from January 2018, the National Statistics Service of Armenia began publishing the nominal wage, using data of commercial undertakings with 1 or more employees. Previously, the NSSA published data of commercial undertakings with more than 50 employees. Because the 2017 figures on average monthly wage of commercial undertakings with 1 or more employees are not available for now, the Central Bank will, for its predictions, look to previous methodology of calculating the average salary, in order to maintain comparability. Starting from 2019, the Central Bank will forecast the average nominal wage of commercial undertakings with 1 or more employees in the private sector.

Chart 9

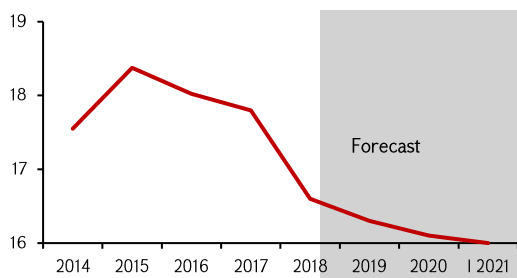
Nominal wage growth in private sector, y/y, %



Source: Armenia Statistics Committee, Central Bank forecast

Chart 10

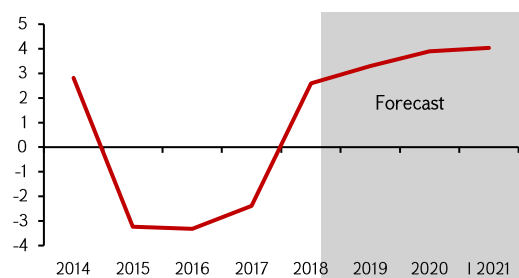
Unemployment rate, %



Source: Armenia Statistics Committee, Central Bank forecast

Chart 11

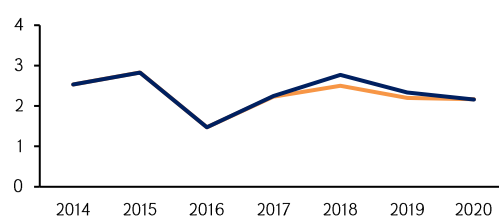
Unit labor costs growth, y/y, %



Source: Armenia Statistics Committee, Central Bank forecast

Chart 12

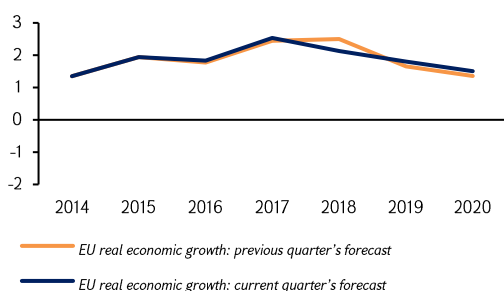
US economic growth forecasts, %



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

Chart 13

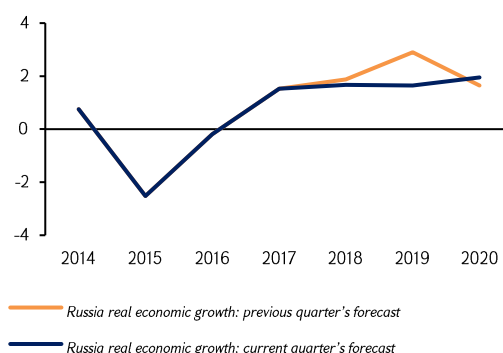
EU economic growth forecasts, %



Source: Eurostat, Central Bank forecast

Chart 14

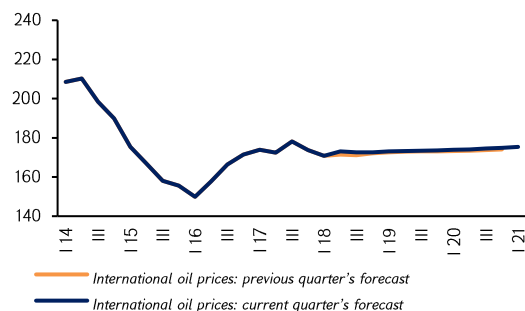
Russia economic growth forecasts, %



Source: Rosstat, Central Bank forecast

Chart 15

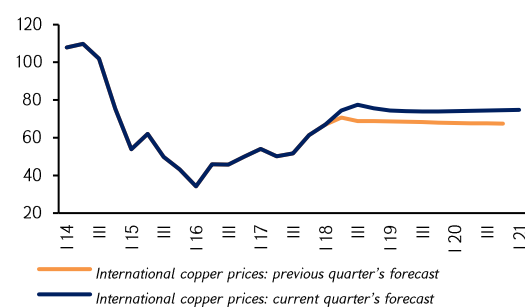
International food price forecasts



Source: World Bank, Central Bank forecast

Chart 16

International copper price forecasts



Source: World Bank, Central Bank forecast

of the Eurozone, downside. Mid-term growth rates will be consistent with the framework of the previous forecast.

The US economic growth forecasts for 2018-2019 have been revised upside, mainly attributable to private consumption and net export, with their more-than-expected growth reported previously, as well as to the positive effect of tax reforms.

The 2018 economic growth forecasts in Eurozone have been adjusted downside primarily due to net export volumes that are anticipated to shrink in the short run.

According to current forecasts, economic growth rate in Russia for 2018-2019 is lower than outlined in the previous forecast, which is explained by the anti-Russian sanctions' negative impact on the economy, on the one hand, and reduction in demand in expectation of a contractionary fiscal policy, on the other.

In the world's commodity markets, higher inflationary patterns are anticipated; in food product markets, prices will shape at the levels forecasted previously.

Specifically, in the world's food product markets the prices will increase in line with the previously predicted dynamics, but in some markets (sugar, wheat) they will shape at the levels slightly lower from previous forecasts, owing to an expected good harvest.

Relative to previous forecasts, international oil prices will rest on a higher level due to expected small US inventories and possible reduction in the supply as a result of the US sanctions on Iran. The world oil demand will further rebound in the meanwhile.

In the medium term, international copper prices will shape at the levels close to the ones outlined in the previous forecast, and in the short run they will rest on lower levels than previously anticipated, driven by expected contraction in demand by China as a result of trade restrictions in the international copper market.

Armenia's economic growth rate has been revised slightly upside relative to previous forecasts, both for 2018 and throughout the forecast horizon.

The economic growth of the recent period is remarkable for revived investment (see subsection 3. 2. 2) and construction (see subsection 3. 2. 3) activity, which has created necessary preconditions for expanding the production capacities of the economy in the medium term. It is therefore expected that throughout the entire forecast horizon the economic growth will be somewhat higher relative to previous predictions. Economic growth will mainly be fueled by the services sector, whereas contribution by agriculture, industry and construction will be relatively small.

There is expectation that the budget's contractionary effect will lead to a negative GDP gap in the short run, which will gradually phase out under the current expansionary monetary environment. In the forecast horizon, the economic growth will be close to its potential value.

Table 2

Real GDP (cumulative) growth projection probability distribution		
Period	30% probability interval	90% probability interval
January-December 2018 / January-December 2017	5.60 - 6.90	3.50 - 8.90
January-December 2019 / January-December 2018	4.60 - 6.40	1.60 - 9.30
January-December 2020 / January-December 2019	4.10 - 6.20	0.70 - 9.60
January-June 2021 / January-June 2020	3.90 - 6.10	0.40 - 9.60

In 2018, the current account deficit-to-GDP ratio will deteriorate in relation to the previous forecast mainly driven by the current account developments in the first half of 2018.

Relative to the previous forecast, the 2018 fiscal sector impact has reduced to an estimated 1.6 pp contractionary from 0.2 pp expansionary. This will be attributable to a neutral effect of revenues, as collection of revenues comes along with high economic growth expected for the year, and a contractionary effect of expenditures, after certain savings on expenditures. It should be noted that the budget impact is rather unclear as to the pace of collecting the revenue and, in particular, making the expenditures.

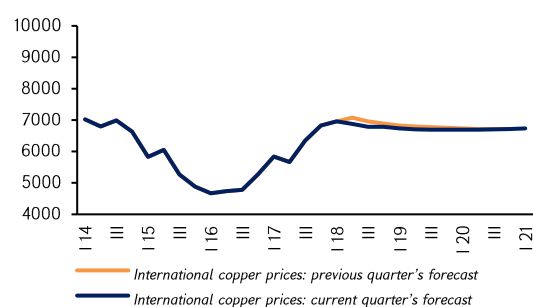
According to the current forecast, the inflation will, in the short term, run below the previous forecasts due to a weaker demand and lower-than-expected actual prices of seasonal agricultural products. Moreover, the supply of some cultivated plants reduced notably in the third quarter, and this started spilling over as inflationary patterns in respective food product markets. In the coming months, as prices of agricultural products recover at a faster rate, the 12-month inflation will gradually accelerate, still fluctuating within the lower part of the confidence band.

The level of core inflation throughout the entire forecast horizon will be lower than outlined in the previous scenario, which is explained by a relatively sluggish environment for aggregate demand. Consequently, fulfilling the inflation target will require keeping the monetary policy moderately expansionary for some time and letting it phase out gradually in the medium run, helping the inflation stabilize around the target (see the Inflation Forecasts Probability Distribution Chart).

Short-term inflation expectations will rest on a level lower than outlined previously and will be driven by how core inflation patterns unfold.

Chart 17

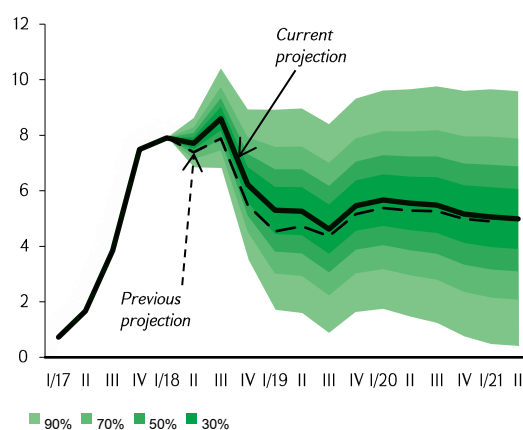
International copper price forecasts



Source: World Bank, Central Bank forecast

Chart 18

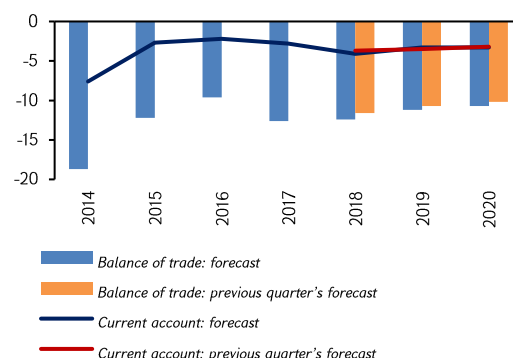
Real GDP (cumulative) growth projection probability distribution chart for 3-year horizon



Source: Armenia Statistics Committee, Central Bank forecast

Chart 19

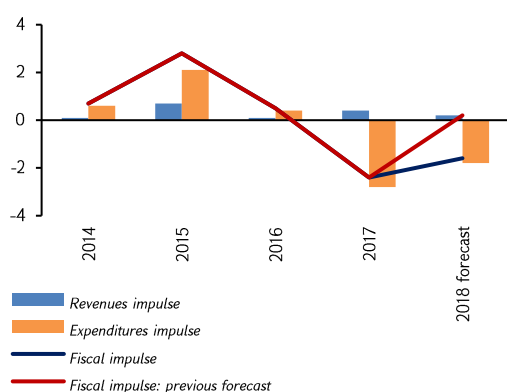
Mid-term current account / GDP forecasts, %



Source: Armenia Statistics Committee, Central Bank forecast

Chart 20

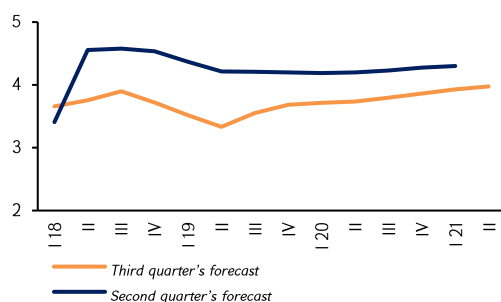
Fiscal impulse forecasts (percentage point)



Source: Central Bank forecast

Chart 21

Short-term core inflation expectation estimations



Source: Central Bank forecast

2.2.4. Main assumptions and risks

This section contains the main assumptions underlying the Monetary Policy Program for the third quarter of 2018 and the risks to implementation of the program, which derive from the external sector developments, the fiscal policy, basic trends and short-term forecasts.

1. The ruble depreciation as a result of sanctions imposed on Russia will generally be a long-term trend which will reflect both slower growth rates in remittances to Armenia from Russia and a real exchange rate coming in most appreciated vis-à-vis the partner countries' currencies. Consequently, it will have a contractionary impact on aggregate demand and inflation in the forecast horizon. It should be noted that the above-mentioned impacts on Armenia's economic growth outlook are estimated not significant.
2. Core inflation actually slowed down in the second quarter reflects the influence of supply-side shocks in some product markets. The depreciation of trade partner currencies, especially the depreciation of the euro, proved an important factor in the falling of prices of import goods, particularly clothing and footwear, which left a considerable impact on the domestic market prices. In some markets, after comparing international and domestic prices of import goods – wheat and fuel in particular, one could see a significant decrease in markup prices, which may seem to also include the deflationary effects of a reduced profit margin as a result of increased competition in these markets. Moreover, in order to assess additional supply-side shocks, a historical analysis of inflation has been carried out for selected goods that contribute to core inflation. As a result, the overall impact of the supply-side shock on prices has been estimated 0.8-0.9 pp negative.
3. The impact of Armenia's state budget now is estimated as contractionary instead of slightly expansionary reported previously, owing to considerable savings on expenditures. The budget impulse for the year is an estimated 1.6 pp negative.
4. The aggregate demand forecasts included possible positive effects of a number of large-scale events (the "La Francophonie Summit 2018", the "Yerevan 2800th Anniversary of Founding", etc.) which will be organized later in the year. According to the estimates, the overall contribution of the above-mentioned measures to the GDP will make up 0.4 pp in the fourth quarter.

Box 2 Chart 22

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

The inflation expectations have reduced to a certain extent, according to the results of the Q2, 2018 survey on selected macroeconomic indicators the Central Bank carries out by way of inquiries among both the households and the companies in the financial sector. Remarkably, in total respondents, the share of the households expecting a high and very high inflation rate for a one-year horizon declined dramatically from about 33% in the previous quarter to almost zero this quarter. However, these figures may have contained the effects of recent political events, so the real impact of pricing and how it has actually affected consumption behavior has supposedly been much more limited.

The **average level of inflation expectations of the financial system** in the upcoming one-year horizon has reduced too, to nearly **3.0%** from **3.5%** reported by the previous survey.

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

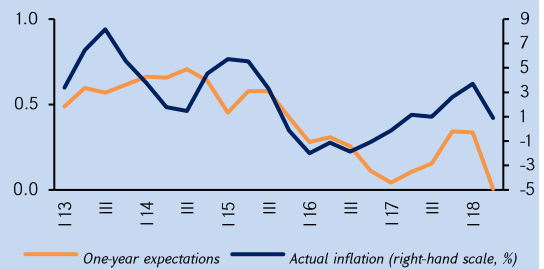
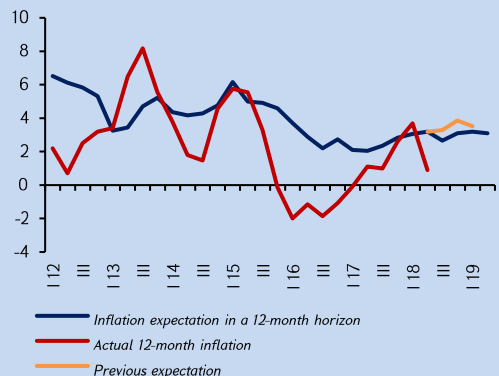


Chart 23

Average level of financial system's inflation expectations, %



Forecast assumptions

Table 3

Main judgments and assumptions	Possible developments if this assumption proves to be correct
In the external sector, economic activity keeps on recovering at steady rates, and prices grow at faster rates	- As economy continues to recover, external demand will be expected to further restore in trade partner countries. In this case, developing countries are expected to gradually tighten their monetary policy conditions. - Depreciation of the Russian ruble will be a long-term trend as a result of anti-Russian sanctions, which will somehow accelerate the rate of inflation in Russia. - As a result of the increase in VAT, inflation expectations are expected to remain unchanged, so no reaction will be expected from the Bank of Russia during that period. - The US sanctions against Iran will continue to keep international oil prices high, while potential trade wars will contribute to maintaining the current levels of international copper prices.
Armenia's risk premium persists at the current level	In the third quarter of 2018, the spread of interest rates of 10-year Eurobonds issued by the Armenian Government will remain at the previous quarter's level, relative to the similar maturity-US assets, amounting to around 3%. Armenia's risk premium is also assessed accordingly.
Fiscal policy conditions	The fiscal sector's impact on aggregate demand is an estimated 1.6 pp contractionary, in 2018.
Action to tackle the growth of GDP potential	Growth of GDP potential will show up mainly in continuous growth of private investment in the tradable sector by increasing output capacities for both goods and services, ensuring an annual 4.5-5.0% growth.

Forecast risks

The main scenario-related risks are determined by both the supply and demand-driven developments in the relevant sectors of the economy.

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

- The budget's contractionary impact persists, as a result of which aggregate demand will have a more deflationary effect on the inflation, necessitating an implementation of additional expansionary monetary policy.
- The actual high growth rates in investment slow down due to the completion of major projects, which will also have an extra deflationary effect.

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

- The short-term inflationary risks, depending on the agricultural product price developments during the year.
- Changes in tax administration, the impact of which on the inflation in the medium run will depend on market participants' repositioning, competition in the markets and, consequently, structural adjustment to markup prices.
- Risks to capital outflow from developing countries if developed countries attempt further tightening of their monetary policy conditions; this will lead to raising the country's risk premium and may, other things equal, create inflationary pressures through exchange rate fluctuations.
- Imposing possibly new sanctions and trade restrictions by the USA on the regional partner countries, which may add to the volatility in currency markets in the region, particularly, Russia's.

Overall, the risks to inflation in the medium run are assessed as balanced, and the 12-month inflation rate is within the confidence band (see the Inflation Forecasts Probability Distribution Chart).

In addition to the above inflation risks, there are some mid-term risks to economic growth potential, which are dual-sided and balanced. Risks, in particular, are associated with:

- Resolving the situation around the Amoulsar mine⁷.
- In the context of long-term economic growth, the future course of structural reforms in the economy and to which extent they will affect the business environment and investment are important.

⁷ The Monetary Policy scenario has been calculated exclusive of the Amoulsar's activity.

3. ACTUAL DEVELOPMENTS IN Q2, 2018

3.1. Inflation

3.1.1. Fulfilment of the inflation target

For the previous one-year horizon, spanning a period from Q3, 2017 to Q3, 2018, the inflation environment would further be expanding in line with anticipated macroeconomic developments and the 12-month inflation rate fluctuating within the confidence band later the year, according to Q3, 2017 Monetary Policy Program. The inflation would have to recover amid expectation of positive developments in the macroeconomic environment in the short run thanks to relatively high activity observable in external and domestic economies at the start of the year and the expansionary monetary policy's lingered impact on inflation. With such a macroeconomic environment and given that the developments would unfold as predicted, the monetary conditions would have to remain expansionary in the near future, facilitating the inflation to stabilize around the target in the forecast horizon.

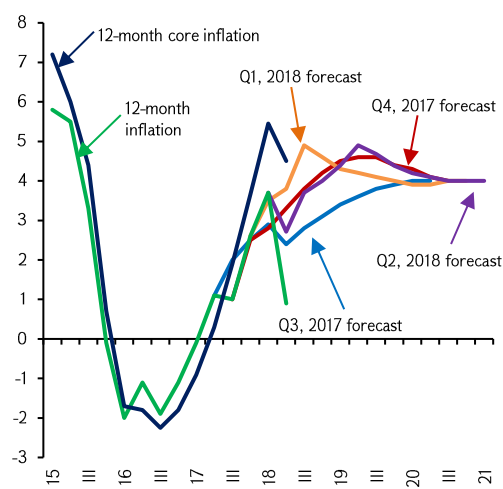
Expected expanding of the inflation environment in the second half of 2017 has somehow deviated from the baseline scenario, as the 12-month growth rates in seasonal agricultural product prices slowed down in the third quarter, leaving the growth almost unchanged over the quarter, fluctuating within 1.0% on average. Moreover, the prices for these products were expected to grow faster and certain inflation risks to accumulate by the end of the year. The anticipated acceleration of inflation materialized in the fourth quarter, when headline inflation increased notably to 2.6% at the end of the year.

In the second half of 2017, core inflation has grown at a faster rate relative to headline inflation, incurring the impact of implemented expansionary monetary policy and of the change in the customs and excise duties that was expected in early 2018. As a result, the 12-month core inflation rate has expanded by 3.4 pp over the half-year and amounted to 3.7% at the end of December. At the same time, additional inflation expectations that were growing even faster among households due to increased prices for some products in food markets in the world have largely contributed to the quarter's high inflation.

In the first quarter of 2018, the 12-month inflation rate increased, in line with expectations, amounting to 3.7% at the end of March, primarily driven by the aforementioned factors. However, the second quarter saw the inflation deviate from the baseline scenario for the previous quarter due to the falling of prices of agricultural products because of an earlier start of seasonality: at the end of June the 12-month inflation rate dropped to 0.9%. The assumption on the back of this occurrence was that the 12-month inflation would be restoring

Chart 24

According to the Central Bank forecasts, the 12-month inflation will continue expanding in the upcoming period and will then stabilize around the target



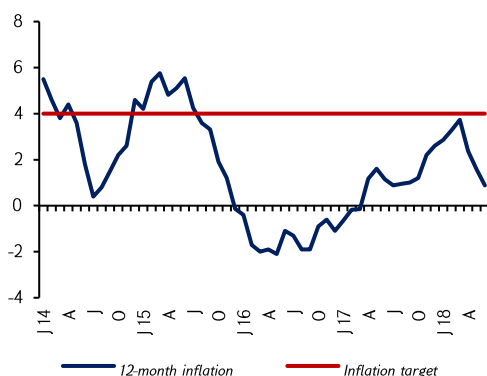
Source: Central Bank forecast

over the upcoming quarters, and it did so, when July inflation developments ended with deflation of 1.2% against that of 2.6% reported in the same month of the previous year, and the 12-month inflation rate reached 2.3%, fluctuating within the lower part of the confidence band.

In view of the macroeconomic situation and inflationary developments described above, the Central Bank had left the monetary conditions unchanged for the previous one-year period, **leaving the refinancing rate at 6%**. The monetary policy conducted previously, the Central Bank reckoned, has proved rather expansionary for the inflation to recover, and such a policy would continue transmitting its impact. Moreover, as the inflation environment somewhat expanded and inflation expectations grew at the end of 2017, keeping an expansionary monetary environment would also justify the need to ensure sustained recovery of demand and implementation of a contractionary fiscal policy. In view of these developments, in June of 2018 the Central Bank fine-tuned the impulse it had signaled to the financial market back in late June of 2017, maintaining that the **need for expansionary monetary conditions weakened in the short run but persisted for the medium run**. Influenced by such a monetary policy, the 12-month inflation rate will grow; in the forecast horizon it will be staying within the confidence band and stabilizing around the target.

Chart 25

In the second quarter of 2018 inflation accelerated



Source: Armenia Statistics Committee,
Central Bank forecast

3.1.2. Prices

Consumer prices: There was **3% deflation** recorded in the second quarter of 2018, largely driven by about 28% decrease in seasonally-sensitive food prices, which has been mostly attributable to as much as 41% price fall in the group **Vegetable**, with nearly 2.3 pp contribution to the quarter's inflation.

Meanwhile, core inflation decelerated to zero from the previous quarter's 1.4%, driven by increased prices in groups **Air transport**, **Footwear**, **Medicine** and **Tobacco** (combined contribution to the quarter's inflation: about 0.23 pp). On the other hand, prices have decreased in groups **Clothes**, **Fuel**, **Wheat**, **Meat products**, **Dairy products**, **Sugar** and **Confectionery**, reducing the headline inflation by nearly 0.35 pp.

With the developments mentioned above, the 12-month inflation rate amounted to 0.9% in June of 2018 instead of the predicted value of 2.7%.

Table 4

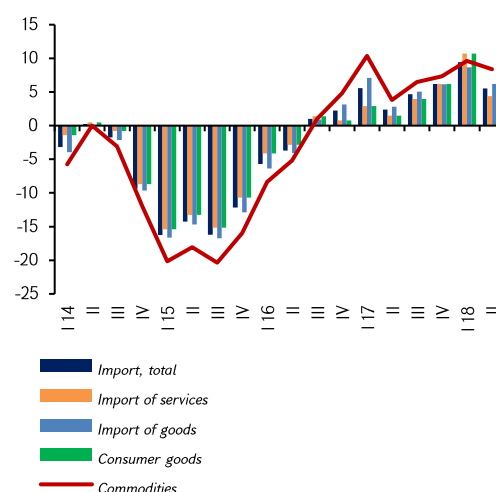
Price inflation by commodity item as key contributors ⁸						
Commodity item	March, 2018 (y/y)		June, 2018 (y/y)		Q2, 2018	
	growth	contribution	growth	contribution	growth	contribution
CPI	3.7		0.9		-2.9	
Food products	4.6	2.1	-1.6	-0.7	-6.7	0.0
Bread products	-1.0	-0.1	-1.05	-0.09	-0.49	-0.04
Meat products	14.7	1.3	9.52	0.92	-1.09	-0.11
Dairy products	6.7	0.3	6.20	0.28	-1.60	-0.07
Oils and fats	17.1	0.5	16.77	0.50	1.63	0.05
Fruit	6.4	0.2	-16.11	-0.45	-0.21	-0.01
Vegetable and Potato	0.0	0.0	-22.60	-1.26	-40.95	-2.29
Fish	12.7	0.1	5.90	0.05	0.09	0.00
Egg	-0.3	0.0	-21.40	-0.29	-24.54	-0.33
Sugar	-9.3	-0.1	-12.60	-0.10	-3.04	-0.02
Non-food products	5.0	1.1	5.3	1.1	0.1	0.0
Services	1.8	0.6	1.4	0.5	0.3	0.1

According to the data issued by the National Statistics Service of Armenia, there was 1.2% deflation in July of 2018, mainly due to decreased prices in groups **Fruit** (-16.6%), **Vegetable** (-11.8%), **Sugar** (-4.76%), **Meat products** (-0.25%), **Dairy products** (-0.51%), **Clothes** (-3.66%), and **Footwear** (-2.92%), with their combined contribution of -1.33 pp to inflation.

Import prices: The dollar prices of import of goods and services to Armenia reduced by 1.6% q/q on average during the second quarter of 2018, with their growth amounting to 5.5% against the same quarter of the previous year. The declined dollar prices of import was attributable to considerable depreciation of exchange rates in the main partner countries, and this has already partly reflected on the prices of goods and services imported from these countries.

Chart 26

In the second quarter of 2018 the growth of dollar prices of import of goods and services slowed down, y/y, %



Source: Central Bank calculations

3.2. Economic developments

3.2.1. Economy position

In the period under review, the GDP gap was estimated to have neared zero. The expansionary monetary policy the Central Bank has been implementing since 2016, the growth in external demand, money transfers and lending all have contributed to the notable contraction of

⁸ In the table the y/y data of structural elements of food products are calculated by the Central Bank on the basis of the National Statistics Service of Armenia data.

the GDP gap. Starting from end-2017, considerable growth of investment has facilitated the shaping of a positive GDP gap, which, as was expected, will have a short-term impact on the GDP cycle component and create prerequisites for increasing the economy's productive capacity in the medium term. As a result, the positive GDP gap which persisted over two quarters is estimated close to zero in the second quarter of 2018, with the impact on inflation being neutral. Thus, the contracted GDP gap mostly owed to the slowing in the growth of domestic demand (see subsection 3.2.2), pointing also to the decelerated core inflation rate in the period under review (see subsection 2.2.1).

3.2.2. The expenditures aspect of the economy

The growth rate of private demand was still high in the second quarter of 2018. With an anticipated 5.8% economic growth, the growth of private spending will amount to 11.5%, which is notably above the previous forecast value driven by the higher-than-expected growth of investment. The growth rate of private spending in the second quarter slowed down compared to the first quarter of 2018.

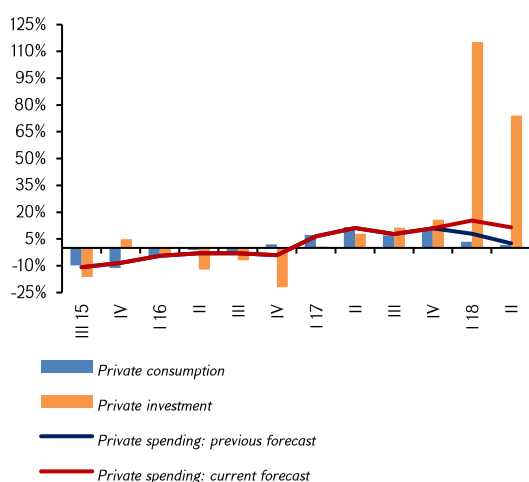
The 11.5% growth of private spending in the second quarter of 2018 is a result of increased private consumption (1.6%) and private investment (about 70%). The private consumption growth rate is still low, as was anticipated. The shrinkage in retail trade turnover points to a sluggish activity in the consumer market in the second quarter. A substantial part of strong investment growth owed to the increased working capital inventories as well as reported high growth in the construction sector and around 70% growth in import of intermediate goods.

The pace of growth of private spending observable since 2017 and persisted over the first half of 2018 was still above its equilibrium, although it decelerated in the second quarter compared to the first quarter. As a result, the gap in private spending has narrowed in the period under review, yet it is estimated slightly positive, with no considerable impact on inflation in the second quarter.

In the second quarter of 2018, according to the Central Bank estimates, net real export affected the GDP growth negatively as a result of faster growth of real import of goods and services over those of export, since domestic demand has posted a growth higher than anticipated. Thus, while the real growth of export of goods and services reached 7.0%, the real growth of import exceeded the expectations, amounting to 11.3%⁹ over the quarter. The growth of domestic demand primarily reflects continued high growth in the import of intermediate goods.

Chart 27

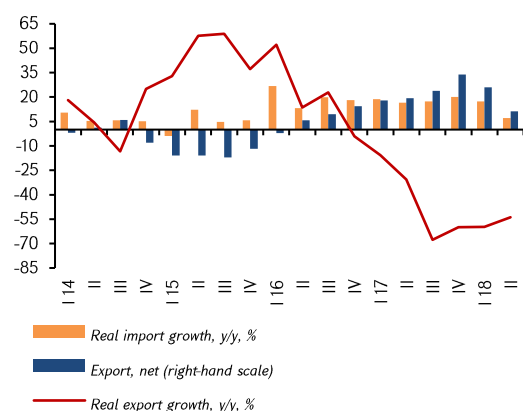
Structure of private spending, y/y, %



Source: Armenia Statistics Committee,
Central Bank estimate

Chart 28

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



Source: Armenia Statistics Committee

⁹ The real export and import growth indicators are the Central Bank estimates.

In the second quarter of 2018, the growth rates in dollar value of net remittances of individuals (seasonal workers' income and personal transfers inclusive) slowed down to an estimated 7.3% y/y, as the ruble exchange rate depreciated versus the US dollar.

The increase in private money transfers notwithstanding, the current account deficit-to-GDP ratio rose in the second quarter of 2018 by about 4 pp as a result of widened trade balance deficit.

Fiscal policy¹⁰: In the second quarter of 2018, the State Budget was performed with actual expenditures and revenues deviated from the Central Bank's projections¹¹. As was outlined in the previous MP program, there were risks to the fiscal policy in connection with collecting of revenue and making of expenditures. The quarter saw over-performed revenues and low performance of expenditures. In the outcome, the fiscal policy impulse on aggregate demand is an estimated 2.9 pp contractionary instead of the predicted 2.7 pp expansionary, for the second quarter.

In the second quarter of 2018, budget revenues made up 103.9% and tax revenues, 103.6%, of the projection. The revenue impulse was 0.3 pp contractionary instead of the forecast 1.5 pp expansionary, which is attributable to the revenue actually more collected than the projection.

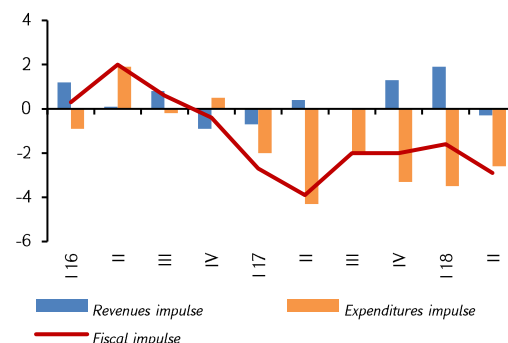
The state budget expenditures constituted 91.2% of the projection by the Central Bank.

In the expenditures structure in the second quarter of 2018, **government consumption** was below the predicted figure by 14%. The expenditures on item **"Transactions with non-financial assets"** amounted to 53% of the projected value, which is explained by low performance of the programs implemented both on the domestic funding and external assistance. For the quarter, the expenditures impulse was 2.6 pp contractionary instead of the forecast 1.2 pp expansionary. The deviation owed to a low expenditures performance, on the one hand, and net lending (about 7.5% of the planned lending was provided based on the quarterly results), on the other.

With revenues and expenditures performance described above, the state budget generated a surplus of AMD 21.5 billion in the second quarter of 2018, instead of the projected AMD 35.0 billion deficit. As a result, the second quarter reported public debt indicators lower than the projected value.

Chart 29

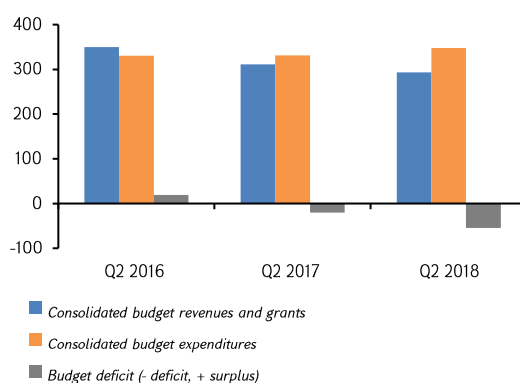
In the second quarter of 2018 the contractionary effect of fiscal policy owed primarily to the contractionary effect of expenditures



Source: Central Bank estimate

Chart 30

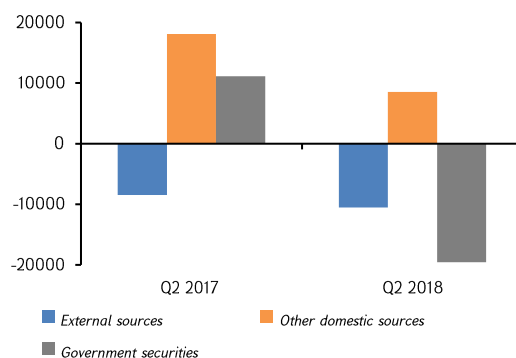
Main indicators of the consolidated budget, billion AMD



Source: Finance Ministry, Central Bank estimate

Chart 31

In the second quarter of 2018 the budget surplus was, along with other domestic sources, used to fund government securities



Source: Finance Ministry

¹⁰ 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 2018, 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.

¹¹ The Q2, 2018 state budget proportion has been viewed as the revenue plan; the expenditure forecast is the Central Bank estimate.

Chart 32
GDP sectoral structure, %

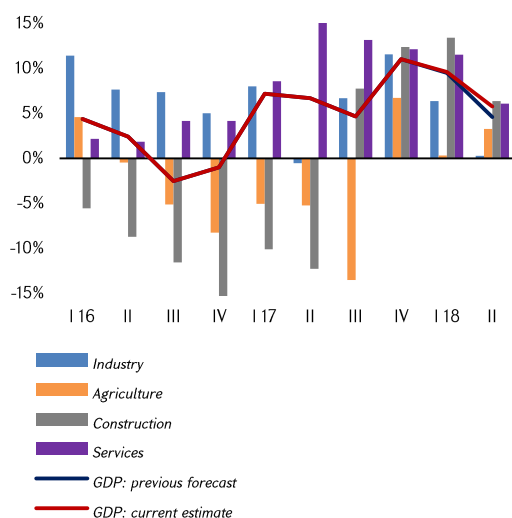


Chart 33
Private nominal wage, y/y, %

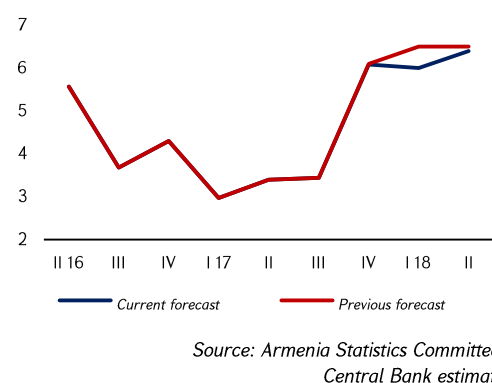
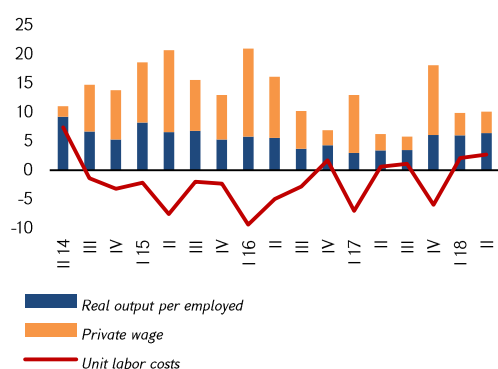


Chart 34
Unit labor costs growth, y/y, %



3.2.3. The production aspect of the economy

The economic activity has somewhat slowed down in April-May 2018, as was expected. Although partly rebounded in June, the economic activity has been generally higher over the second quarter from previous Central Bank forecasts: the GDP growth was an estimated 5.8% instead of the projected 4.6%.

In the period under review, there has been an upside revision in the forecast growth of all sectors of the economy, except the industry sector. Particularly, in the second quarter of 2018 the growth in construction was an estimated 6.4% thanks to invigorated investment activity that time, the services sector reported 6.1% growth while growth in the agriculture sector amounted to 3.3% on the back of favorable developments in plant growing.

The industry sector will only anticipate a moderate 0.3% growth, amid a decline in the mining industry and sluggish activity in the processing industry.

Following strong growth rates observable since the beginning of 2017, the productivity, calculated as real value added per hour worked, has slowed down starting the first quarter of 2018. According to the Central Bank estimates, the productivity growth rate reached 2.2% in the second quarter, and this determines part of the economic growth in the reporting quarter.

3.2.4. Labor market¹²

In the second quarter of 2018, the private sector nominal wage growth rate amounted to 6.4%, which is close to previous forecasts by the Central Bank, and the private sector real wage growth rate reached 4.5%, which is consistent with the economic growth outlook. In the period under review, the productivity has grown by 3.7%¹³, which is lower than the real wage growth rate. In the second quarter of 2018, the labor market created weaker inflationary pressures, as a result.

The unemployment rate is an estimated 16.7% for the second quarter of 2018, which is slightly below the previous forecasts. This is due to the fact that the productivity growth rate has been slower than expected by the Central Bank, and a considerable part of economic growth has been fuelled by grown employment. Relative to the same reference period of 2017, the unemployment rate has declined by 1.1 pp.

¹² The labor market data for the second quarter of 2018 are the Central Bank estimates which are based on the first quarter 2018 data and actual April-May 2018 figures. The growth indicators provided in this subsection are relative to the same reference period last year, unless otherwise specified.

¹³ As a productivity indicator, aggregate real value added output per employed was considered.

In the period under review, unit labor costs of the firms have grown by 2.7%, reflecting the deceleration of output growth rate per unit of labor in relation to private sector wage growth.

3.3. Financial market developments

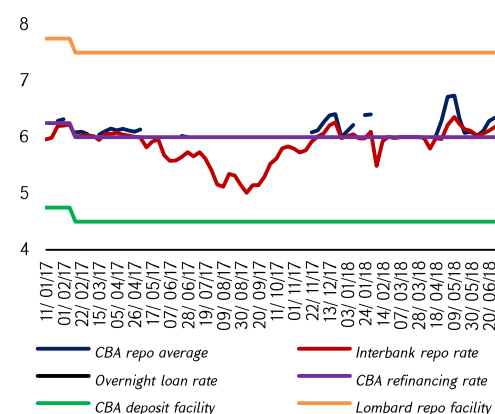
In the second quarter of 2018, the Board of the Central Bank decided to leave the refinancing rate unchanged, at a 6% level.

Small inflation expectations and some slowing in the growth of domestic demand were the primary factors prompting the Board of the Central Bank to decide on leaving the policy rate unchanged. At the same time, the Board reiterated the possibility that expansionary monetary conditions may phase out gradually in future, if the predicted developments unfold and the outlined risks materialize accordingly, anticipating that inflation will stabilize around the target in the medium term.

The refinancing rate was 6% in the second quarter of 2018, as the Board decided to again leave it unchanged.

Chart 35

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



Source: Central Bank

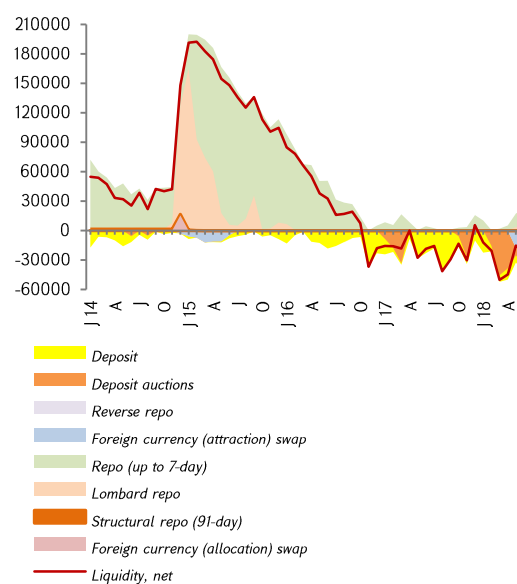
Table 5

Average quarterly interest rates in Armenia's financial market					
Instrument	Q2, 2017	Q3, 2017	Q4, 2017	Q1, 2018	Q2, 2018
Central Bank refinancing rate (end of quarter)	6.00	6.00	6.00	6.00	6.00
Central Bank repo rate	6.05	6.06	6.20	6.20	6.32
Interbank repo rate	5.86	5.31	5.89	5.94	6.09
Short-term treasury bill yield	6.56	6.19	5.93	6.04	6.13
Medium-term notes yield	8.76	8.45	8.03	7.64	8.36
Long-term bonds yield	13.03	10.03	9.90	12.29	9.30

The impact of political events in the country in April-May 2018 on market rates was not significant, as it owed to strong confidence of market participants in the toolkit and policies implemented by the Central Bank to respond to the situation adequately. Notwithstanding a certain increase, short-term interest rates, however, continued shaping around the policy rate of the Central Bank. Thus, the interbank repo (up to 7-day) rate has increased by 0.15 pp against the previous quarter to 6.09%; the average monthly repo rate in June was 6.11%, having grown by 0.18 pp against March.

Chart 36

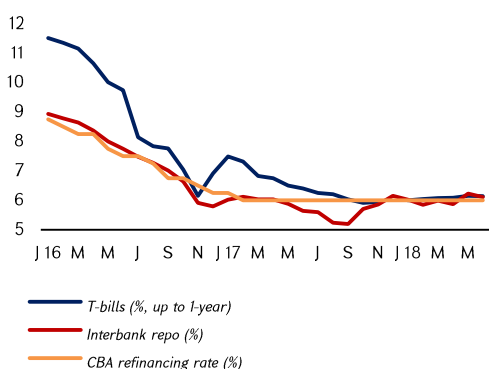
Liquidity injection and absorption through the Central Bank operations (average quarterly inventory), million AMD



Source: Central Bank

Chart 37

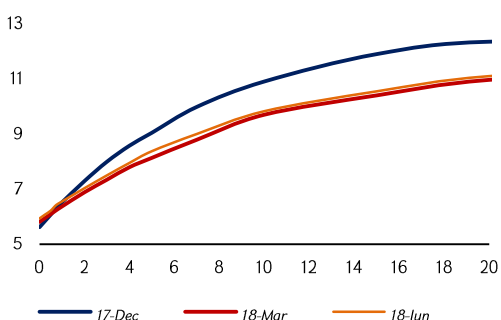
The behavior of short-term interest rates in the second quarter of 2018



Source: Central Bank, Nasdaq OMX Armenia

Chart 38

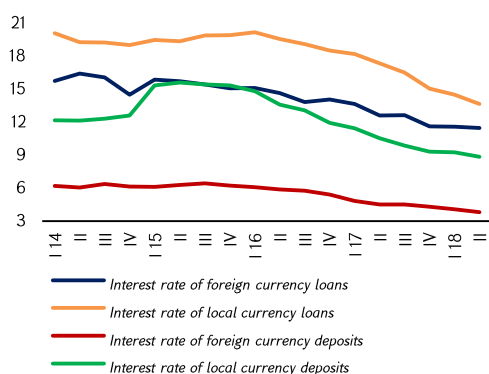
In the second quarter of 2018 yields in the government bond market grew slightly



Source: Central Bank

Chart 39

Interest rates on deposits of and loans to individuals



Source: Central Bank

The impact of the political events in the second quarter on the Armenian financial market, and the Central Bank action

The developments in the financial market could not remain intact as the political events in the second quarter of 2018 (April-May) gripped the country. These events were accompanied by a short-term deposit runoff in the domestic banking system, which resulted in a certain urge for local and foreign currency liquidity with banks. While, in April, the Central Bank was set to use tools to absorb excess liquidity in order to bring short-term interest rates around the policy rate, in late April and throughout May it started injecting a required amount of liquidity in order to soften the tightness the financial market experienced that time in different segments. In the meantime, in view of the temporary nature of demand for foreign currency liquidity, the Central Bank found it appropriate to satisfy it mainly through short-term foreign currency swap transactions, which have now been completed.

The Central Bank statements as well as tools used have not led to significant fluctuations in the dram exchange rate and interest rates in the market at that time, which points to a high level of confidence of market participants to the policy conducted by the Central Bank.

However, a sharp decline in the volumes of transactions in the interbank foreign exchange market because of uncertainties reduced the efficiency for functioning of the market. To re-launch the market mechanism and identify the market price of foreign currency, the Central Bank decided to sell a small amount of foreign currency, which helped the market to refresh and recover to a normal functioning.

Over the quarter, yields of government short-term bonds have demonstrated patterns typical of money market rates. Culminating at the end of the quarter, these yields settled on a slightly higher level than the policy rate of the Central Bank. Overall, yields have only negligibly increased in the government securities market – in June, relative to March, the average quarterly increase along the yield curve has been 0.15 pp.

The expansionary monetary policy pursued by the Central Bank as well as strong capitalization of the banking system in the second quarter of 2018 further contributed to the growth of assets allocated by commercial banks while pushing interest rates down. The growth of lending over the quarter amounted to 5.7%. In particular, dram loans have grown by 8.3% and foreign currency loans, by 3.6%. The 12-month growth of total lending to the economy in June 2018 reached 22.4%. The lending growth was concurrent with reducing interest rates, and this was more expressly demonstrated in dram loans provided to individuals.

BOARD OF THE CBA

MINUTES

(14.08.2018)

The Refinancing Rate

The CBA Board Meeting of August 14, 2018 attended by Chairman Arthur Javadyan, Deputy Chairman Nerses Yeritsyan, and Board Members Ashot Mkrtchyan, Arthur Stepanyan, Armenak Darbinyan and Oleg Aghasyan

The Board meeting opened with presentation of the Situation Report as of August 14, 2018. It addressed current developments on inflation, external environment and real, fiscal and monetary sectors of the economy.

It was recorded that the 12-month inflation increased sharply in July 2018 after the reduction in May-June, amounting to 2.3% at the end of the month. The inflation behaved this way largely due to the change in prices of agricultural products, which, in turn, is explained by earlier demonstrated seasonality for harvest. In other words, as the prices in the groups “Fruit” and “Vegetable” reduced more than expected, the 12-month inflation rate has dropped in May-June by about 1.3 pp from its expected value, which was totally restored in the course of July. It should be noted that over that period, core inflation has gradually decreased, but it still remains at a relatively high level.

Addressing the economic situation, the Board stated that economic activity in the second quarter of 2018 was rather strong as well, although a certain weakening was observed in the meanwhile as the industry growth rates slowed down; in the last month of the quarter however, the economic activity rebounded owing to reported high growth in the processing industry and agriculture sectors. In view of these developments, the Central Bank revised both the second quarter and the end-year forecasts upside. The domestic demand persisted at a relatively high level in the second quarter too, driven largely by unprecedented high growth in private investment, while private consumption growth rates slowed down slightly, incurring the impact of a contractionary fiscal policy. The Board estimates that the latter will persist over the upcoming months, which, coupled with some slowing in high private investment growth rates, will diminish the impact on the domestic demand and prices.

The external sector developments were also addressed at the Board meeting: the global economic growth and the patterns in the world’s major commodity markets continued trending up. Under these conditions, the central banks of the main partner countries keep on tightening their monetary conditions. At the same time, some countries of the region are seeing increased volatilities in the financial markets

under trade restrictions and sanctions imposed by the United States. Nevertheless, the Board considers that it does not contain considerable risks to the Armenian financial market at present; however, if such risks show up, the Central Bank will react accordingly.

The Board referred to the developments in the domestic financial market: it stated that in the second quarter of the year short-term interest rates shaped primarily around the policy rate of the Central Bank, reflecting also the sustainability of the yields in the government bond market.

Following presentation of the Situation Report and the developments in external and domestic macroeconomic environments, the Board began addressing the monetary policy directions and making a decision on the interest rate. The Board considered only one option for setting the refinancing rate, and in expectation of a weak inflationary effect from the external sector in the near future and a non-inflationary (gradually slowing private demand and even a more contractionary fiscal policy) influence which prevails in the Armenian economy, the Board of the Central Bank decided to leave the refinancing rate unchanged, maintaining that the monetary policy should remain expansionary for the time being. In the event predicted macroeconomic developments unfold and existing risks are not materialized, the Board estimates that the expansionary monetary policy will be maintained ***in the near future*** while making sure it will gradually phase out in the medium run. As a result, ***the 12-month inflation rate will fluctuate within the lower part of the confidence band in the upcoming period and will stabilize around the target in the medium run.***

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

THE CENTRAL BANK OF THE REPUBLIC OF ARMENIA

BOARD DECISION

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

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

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

Arthur Javadyan,
Chairman of the Central Bank

August 14, 2018

PRESS RELEASE
14.08.2018

At the August 14th of 2018 meeting, the Board of the Central Bank of Armenia (the CBA) decided to leave the refinancing rate unchanged, at the level of 6.0%.

There was 1.2% deflation in July of 2018 against that of 2.6% reported in the same month of the previous year, and the 12-month inflation rate somewhat increased, amounting to 2.3% at the end of the month. At the same time, core inflation reduced to some extent in July, still persisting at a relatively high level. The Board of the CBA considers that the 12-month inflation rate will approach the target in the upcoming months, fluctuating within the lower part of the confidence band.

In the external sector, trends for improving global economic growth continued and inflationary developments in international commodity markets are in line with such developments. As the Board of the CBA estimates, there has been an increase in financial market volatilities in a number of countries of the region amid the imposed US trade restrictions and sanctions, which currently does not contain significant risks for Armenia's financial markets; yet in the emergence of any risk, the CBA will react adequately.

The Board notes that economic activity in June of 2018 recovered owing to the accelerating growth in the processing industry and agriculture, following the slowdown at the beginning of the second quarter. The Board estimates that aggregate supply will gradually weaken due to the contractionary pace of fiscal policy, which is reflected in the considerable cost savings in relation to the planned ones.

Taking into account the expected developments – a slowdown in domestic demand and weak inflation environment in the outside world – the CBA finds it appropriate to maintain expansionary monetary conditions by leaving the refinancing rate at the current level. At the same time, in view of the anticipated macroeconomic developments and the absence of such risks, keeping the monetary environment expansionary in the forthcoming period too is important in terms of fulfillment of the inflation target, on condition that it gradually eliminates in the medium run. As a result, the expectation is that inflation will remain within the lower part of the confidence band, stabilizing around the 4% target at the end of the forecast horizon.

Should there be risks to economic growth outlook and to the inflation deviating from its recovery path, the CBA will adjust the monetary policy directions accordingly, while ensuring the price stability.

Press Service of the Central Bank of Armenia

MAIN MACROECONOMIC INDICATORS OF ARMENIA

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
	actual	actual	actual	actual	actual	actual	actual	actual	program	program	program
Prices											
Inflation (y/y, end of period, %)	9.4	4.7	3.2	5.6	4.6	-0.1	-1.1	2.6	3.5	3.1	3.8
Consumer price index (y/y, average, %)	8.2	7.7	2.6	5.8	3.0	3.7	-1.4	1.0	2.7	3.5	3.6
Core inflation (y/y, average, %)	7.5	8.6	5.3	5.8	1.9	5.1	-2.0	0.8	4.0	3.6	3.7
Gross product											
GDP (billion Armenian dram)	3690.0	4028.9	4266.5	4555.6	4828.6	5043.6	5067.3	5568.9	6175.3	6775.5	7413.0
GDP (% real growth)	2.2	4.7	7.2	3.3	3.6	3.2	0.2	7.5	6.2	5.5	5.2
Supply											
Industry (% real growth)	9.2	13.6	6.4	6.3	-0.9	6.2	7.7	6.6	4.3	4.7	4.8
Agriculture (% real growth)	-16.0	14.0	9.5	7.6	6.1	13.2	-5.0	-5.3	5.5	4.6	4.5
Construction (% real growth)	3.3	-12.2	4.5	-7.4	-4.5	-3.1	-14.1	2.5	0.3	5.7	4.9
Services (% real growth)	4.1	4.7	6.3	3.1	6.7	1.6	3.2	12.4	7.3	5.9	5.5
Taxes, net (% real growth)	13.4	3.8	9.9	3.6	1.8	-5.1	-4.7	10.1	9.8	6.3	6.0
Demand											
Consumption (% real growth)	3.9	2.6	7.7	1.9	0.7	-6.2	-0.5	9.5	2.3	4.0	3.6
Public consumption (% real growth)	3.9	1.9	-1.4	8.7	3.4	4.7	5.8	11.5	-3.7	3.0	1.3
Private consumption (% real growth)	3.9	2.7	9.1	0.9	1.0	-7.7	-1.2	8.9	3.4	4.2	4.0
Gross investment (% real growth)	0.5	-5.2	0.5	-10.5	-3.0	-1.2	-8.7	13.9	20.1	4.8	8.6
Public investment (% real growth)	-12.7	-6.1	-22.4	-13.8	10.0	13.6	5.0	31.7	-49.9	18.0	15.0
Private investment (% real growth)	2.6	-5.1	3.6	-10.0	-3.7	-3.6	-10.5	11.1	36.9	3.5	7.9
Export of goods and services (% real growth)	20.4	14.5	12.0	8.9	6.4	4.9	19.1	18.2	8.5	6.5	8.2
Import of goods and services (% real growth)	7.2	-0.1	4.7	5.5	-1.0	-15.1	7.6	24.8	7.2	3.1	6.0
External sector											
Balance of trade (million US dollar)	-2065.7	-2109.8	-2111.9	-2196.2	-2055.4	-1186.4	-944.4	-1409.5	-1551.6	-1556.6	-1652.8
Balance of services (million US dollar)	-260.8	-65.8	-101.6	-124.3	-113.0	-94.5	-71.4	-42.9	-41.6	-12.5	2.8
Remittances (million US dollar)	1421.9	1440.4	1539.8	1755.1	1616.1	1082.4	989.6	1128.5	1194.4	1281.5	1374.0
Current account (million US dollar)	-1261.4	-1058.9	-1057.9	-812.9	-883.1	-279.1	-238.1	-328.5	-521.7	-467.8	-505.5
Balance of trade (share in GDP, %)	-22.1	-20.8	-19.9	-19.7	-17.8	-11.3	-8.9	-12.2	-12.1	-11.1	-10.7
Balance of trade (share in GDP, %)	-2.8	-0.7	-1.0	-1.1	-1.0	-0.9	-0.7	-0.4	-0.3	-0.1	0.0
Remittances (share in GDP, %)	15.2	14.2	14.6	15.8	14.0	10.3	9.3	9.8	9.3	9.1	8.9
Current account (share in GDP, %)	-13.5	-10.5	-10.0	-7.3	-7.6	-2.7	-2.2	-2.8	-4.1	-3.3	-3.3
Public sector											
Revenues and grants (billion Armenian dram)	780.4	880.9	946.2	1071.4	1144.8	1167.7	1171.1	1237.2	1304.7	-	-
Tax revenues (billion Armenian dram)	699.4	777.4	878.4	1000.9	1064.1	1067.9	1079.7	1158.1	1252.8	-	-
Expenditures* (billion Armenian dram)	954.3	986.5	1006.1	1142.9	1235.1	1409.0	1449.1	1503.9	1396.5	-	-
Deficit (billion Armenian dram)	-173.9	-105.6	-59.9	-71.5	-90.3	-241.3	-278.0	-266.7	-91.8	-	-
Revenues and grants (share in GDP, %)	22.6	23.3	22.2	23.5	23.7	23.2	23.1	22.2	21.1	-	-
Tax revenues (share in GDP, %)	20.2	20.6	20.6	22.0	22.0	21.2	21.3	20.8	20.3	-	-
Expenditures (share in GDP, %)	27.6	26.1	23.6	25.1	25.6	28.0	28.6	27.0	22.6	-	-
Deficit (share in GDP, %)	-5.0	-2.8	-1.4	-1.6	-1.9	-4.8	-5.5	-4.8	-1.5	-	-
Monetary sector											
Broad money (y/y, end of period, %)	11.8	23.7	19.5	14.8	8.3	10.8	17.5	18.5	-	-	-
Dram broad money (y/y, end of period, %)	15.7	26.4	11.9	14.9	-3.5	5.2	24.8	28.9	-	-	-
Loans to economy (y/y, end of period, %)	26.7	35.3	27.6	12.9	20.8	-3.3	6.0	16.2	-	-	-
USD / AMD (Armenian dram for one US dollar)	373.7	372.4	401.8	409.6	415.9	477.9	480.5	482.7	-	-	-

* The 2017 Expenditures and Deficit include the AMD 82.0 billion-worth Russian Commodity Loan received at the end of the year.

CHARTS

Chart 1	Inflation (12-month) forecast probability distribution chart for 3-year horizon	4
Chart 2	Real GDP (cumulative) growth projection probability distribution chart for 3-year horizon	4
Chart 3	Economic growth in trade partner countries	5
Chart 4	Inflation in trade partner countries	6
Chart 5	International prices of raw materials and food products	7
Chart 6	Inflation (12-month) forecast probability distribution chart for 3-year horizon	8
Chart 7	Demand components contributing to the growth (percentage point)	9
Chart 8	Changes in real export and import of goods and services in the medium term	10
Chart 9	Nominal wage growth in private sector	11
Chart 10	Unemployment rate	11
Chart 11	Unit labor costs growth	11
Chart 12	US economic growth forecasts	11
Chart 13	EU economic growth forecasts	12
Chart 14	Russia economic growth forecasts	12
Chart 15	International food price forecasts	12
Chart 16	International copper price forecasts	12
Chart 17	International copper price forecasts	13
Chart 18	Real GDP (cumulative) growth projection probability distribution chart for 3-year horizon	13
Chart 19	Mid-term current account / GDP forecasts	13
Chart 20	Fiscal impulse forecasts (percentage point)	14
Chart 21	Short-term core inflation expectation estimations	14
Chart 22	Share of households expecting high and too high inflation in a one-year horizon	15
Chart 23	Average level of financial system's inflation expectations	15
Chart 24	According to the Central Bank forecasts, the 12-month inflation will continue expanding in the upcoming period and will then stabilize around the target	17
Chart 25	In the second quarter of 2018 inflation accelerated	18
Chart 26	In the second quarter of 2018 the growth of dollar prices of import of goods and services slowed down	19
Chart 27	Structure of private spending	20
Chart 28	In the second quarter of 2018 net export position deteriorated as import grew at a faster pace	20
Chart 29	In the second quarter of 2018 the contractionary effect of fiscal policy owed primarily to the contractionary effect of expenditures	21
Chart 30	Main indicators of the consolidated budget	21
Chart 31	In the second quarter of 2018 the budget surplus was, along with other domestic sources, used to fund government securities	21
Chart 32	GDP sectoral structure	22
Chart 33	Private nominal wage	22
Chart 34	Unit labor costs growth	22
Chart 35	During the quarter short-term interest rates remained around the Central Bank's policy rate	23
Chart 36	Liquidity injection and absorption through the Central Bank operations (average quarterly inventory)	23
Chart 37	The behavior of short-term interest rates in the second quarter of 2018	24
Chart 38	In the second quarter of 2018 yields in the government bond market grew slightly	24
Chart 39	Interest rates on deposits of and loans to individuals	24

TABLES

Table 1	Inflation interval forecast probability distribution	8
Table 2	Real GDP (cumulative) growth projection probability distribution	13
Table 3	Forecast assumptions	15
Table 4	Price inflation by commodity item as key contributors	19
Table 5	Average quarterly interest rates in Armenia's financial market	23