



Central Bank
of Armenia

2024 Q4

**Executive
Monetary
Policy
Statement**

Published December 10, 2024

A. Executive Monetary Policy Statement

The Board of the CBA today reduced the Refinancing Rate to 7%.

At its meeting today, the Board of the Central Bank of Armenia decided to decrease the key policy rate (refinancing rate) by 0.25 percentage points, setting it at 7 percent. The Board agrees that a lower refinancing rate is necessary to continue to meet its price stability objective of ensuring an inflation rate of 4 percent over the medium term.

Annual CPI inflation has continued to remain below the target, registering 1.4% in November 2024. Core inflation has also remained at low levels, at 0.6% year-over-year in October.

In Q4 2024, risks of slowing economic growth globally and in the key trading partner countries of Armenia continue to persist. Global inflation continues to slow; however, the prices of goods and services characterized by sticky prices in key trading partner economies continue to remain relatively elevated. Persistent geopolitical uncertainties, as well as growing tensions in international trade relations, continue to create risks for future growth in global commodity prices and potential disruptions in global supply chains. At the same time, labor market conditions in key trading partner countries, particularly the United States, despite some recent easing, labor market conditions remain tight. Conversely, uncertainty about the scale of impacts of fiscal policy on aggregate demand conditions in US, also the resulting long-term interest rates, has significantly risen. In this context, advanced economy central banks would be expected to continue to gradually ease policy rates in the near term, while still maintaining a relatively tight stance. Consequently, the external environment would be expected to transmit weak inflationary pressures on the Armenian economy.

Economic activity in Armenia continue to approach its stable, long-term growth levels. Growth in economic activity has largely been driven by meaningful growth in construction, services, and trade. These dynamics continue to be impacted by certain short-term factors, posing significant uncertainty with respect to the sustainability of economic growth and its long-term outlook, as well as the future trajectory of domestic demand and consumption conditions. In this context, external demand for domestic services continues to be adjusted. Labor market conditions continue to somewhat cool amid these conditions, as reflected in stabilizing wage growth, non-traded sticky price inflation, and inflationary expectations. At the same time, risks for additional demand pressures stemming from fiscal policy persist.

In order to manage possible risks stemming from conditions of high uncertainty, the Board considers multiple scenarios during its deliberations. On the one hand, the Board discussed scenarios where possible underlying developments would require a higher path for the policy rate relative to current market expectations. These Case A-type scenarios include those related to uncertainty about the formation and prolonged persistence of excess demand in the domestic economy, and the long-term interest rate. These developments require a policy response that is more stringent compared to market expectations in order to manage the risks of ensuring price stability. On the other hand, the Board discussed Case B-type scenarios, including those related to the gradual slowdown of the construction sector, weakening demand, and the risks associated with the prolonged sustaining of a low inflation environment. This would imply a more rapid and aggressive downward path for the policy rate than what is currently priced in markets in order to sustainably stabilize inflation at the target in the medium-term horizon.

While the Board believes that though there is a greater likelihood of Case B-type scenarios materializing, it emphasizes the importance of minimizing the losses that could stem from the Case A-type risks. The Board thus finds it appropriate to continue to gradually ease the policy stance. The Board resolutely affirms its commitment to adopting the appropriate policy actions and strategy to ensure the price stability objective of 4% inflation in the medium term.

Approved by the Board of the Central Bank of Armenia
December 10, 2024

Governor
Martin Galstyan

Deputy Governor
Armen Nurbekyan
Hovhannes Khachatryan

Board Members
Hasmik Ghahramanyan
Artak Manukyan
Levon Sahakyan
Narek Ghazaryan

B. Summary of Economic Conditions

Global Economy

In Q4 2024, economic activity among Armenia's main trading partners has been mixed. On one hand, high economic activity persists in the US and Russia, driven largely by robust growth in domestic consumption, particularly in the services sector. On the other hand, activity in the China has slowed due to weakening domestic demand. In the Euro Area, economic growth, has slightly accelerated but remains low. Risks of slower economic activity globally remain latent.

Uncertainty regarding economic fundamentals in the United States persists. Despite elevated market interest rates over the recent quarters, the US continues to experience strong growth, spurred by consistently robust consumption and domestic demand conditions. In Q3 2024, economic growth stood at approximately 2.8%, with the expansion in gross consumption contributing around 2.5 p.p. to this growth. At the same time, financial asset prices rise, posing risks of consumption remaining at elevated levels. In this context, while overall inflation is gradually nearing target levels, sticky prices and wage growth remain significantly above their target levels. These highlight the challenges that monetary authorities face in the "last mile" of bringing inflation back to target and maintaining long-term price stability.

Risks of a more expansionary fiscal policy stance in the US have notably increased, particularly in the medium term. This poses an additional challenge for monetary policy both in terms of short-term inflationary effects as well as its potential impact on the neutral interest rate, especially if a substantially higher debt burden materializes.

On the other hand, continued tightening of financial conditions and the lending environment poses risks of further, undesirable weakening in the labor market. However, it is important to note that these risks have somewhat eased in recent months. Looking ahead, the key uncertainty relates to the pace and magnitude of future policy easing, considering the potential for a rapid adjustment of the economy and still-strong consumption and demand conditions. The latter additionally raises questions about a potentially higher underlying neutral rate in the US, which would have implications on both the future stance of Fed policy and capital flows to emerging markets.

In the Euro Area, the European Central Bank (ECB) cut interest rates by 25 basis points in October 2024, marking the third decrease this year. While growth in the services sector—fueled by increased external demand—has contributed to a modest rebound in economic activity over the course of 2024, concerns regarding growth prospects and structural challenges in manufacturing sector persist. Declines in overall inflation are driven by a reduction in goods price inflation, while services inflation remains elevated, highlighting a growing divergence between these two sectors of the

economy. This poses significant challenges for the pace of policy adjustments and the pursuit of long-term price stability.

Risks associated with persistently weak domestic demand in the Euro Area and China continue to remain key sources of uncertainty driving a weaker global economic outlook.

Meanwhile, Russia has maintained robust growth and strong domestic demand, supported by expansionary fiscal policy and notable increases in private expenditures. In this environment, intensified competition for labor between the defense industry and the private sector amid tight labor market conditions may heighten inflationary risks. Despite the significant tightening of policy conditions by the Central Bank of Russia, no significant progress has yet been observed in controlling inflation. Additionally, the sustained imposition of stricter and more targeted Western sanctions, as well as the monetary policy tightening, pose risks to the medium-term Russian economic outlook.

In the global commodity markets, food prices experienced a solid increase in November, primarily driven by adverse weather conditions, exceeding 2023 levels. Nevertheless, considerable uncertainty remains regarding the medium-term outlook for commodity markets. Heightened geopolitical tensions in the Middle East continue to threaten both higher and more volatile energy prices as well as potential disruptions to global supply chains. Conversely, further weakening in global demand may lead to deflationary pressures in commodities.

Domestic Demand Conditions

In Q3 2024, economic growth in Armenia continued to slow somewhat, approaching the estimated level of long-term sustainable growth at 5.2% Y-o-Y. The construction, trade, and services sectors remain the major growth drivers, though growth in recent months has been somewhat less concentrated in specific sectors compared to previous quarters. Nevertheless, the structure of growth continues to pose high uncertainty regarding the relative position of aggregate demand versus aggregate supply.

The robust external demand observed since 2022 has been gradually weakening in 2024, as reflected in the stabilization of both real expenses per tourist and tourist arrivals. Exports of other, "traditional" product groups—e.g., brandy, cigarettes, mineral water, and so on—remain stable and show modest signs of expansion. Nevertheless, risks remain regarding the growth prospects of these sectors, driven by slow growth in capacity including construction in these sectors, investment goods imports and employment growth.

Meanwhile, considerable uncertainty continues to surround current domestic demand conditions. On the one hand, strong growth in retail trade, consumer credit, domestic tourism, and other services suggest robust domestic demand. In this context, consumer credit rates remain high, reflecting strong demand. Under these conditions market interest rates on loans remain elevated reflecting high demand. On the other hand, recent economic growth has been fairly concentrated in certain sectors, remittances have continued to decline, and labor market conditions have somewhat eased. These factors, coupled with the overall weak inflationary environment for several successive quarters, could point to weaker demand conditions in the economy.

Uncertainties also surround the outlook and future trajectory of domestic demand conditions. Key uncertainties relate to the reduced debt burden (given higher incomes) and the future utilization of accumulated savings in the private sector. For example, depending on how and in which direction savings are spent (consumption vs. investment), this could have different implications on the relationship between aggregate demand and aggregate supply in the economy.

Additionally, risks for demand pressures stemming from fiscal policy remain. This is driven by concerns over revenue underperformance and high current expenditures necessitated by various social support programs.

Labor Market & Inflation

Labor market data has offered mixed signals in recent months. The household survey-based unemployment rate in Q2 2024 stands at 13.8%, representing an increase of approximately 2 percentage points relative to the same quarter of last year. Considering the uncertainty surrounding the level of unemployment, it is important to monitor potential development scenarios and their implications.

On the one hand, this trend could signal weakening demand conditions across the economy. The increase in the unemployment rate has not been driven by a significant rise in labor supply compared to the previous year, but rather by a decrease in the number of employed persons—approximately 20 thousand. This aligns with the observed some outflow of foreign workers, such as Indian citizens, over the course of this year.

On the other hand, data from the State Revenue Committee indicates that the total number of registered employees has risen, with about 34 thousand more employed compared to the same period of last year. This could suggest that labor conditions are tighter than what the household survey suggests. Alternatively, the growth in registered employees might also reflect a gradual decline in the shadow labor market in favor of formal employment.

In recent months, some acceleration has been observed in private sector wage growth. However, it remains below levels

consistent with productivity growth and inflation target. In the medium and long term, a potential increase in labor supply could contribute to further easing of labor market conditions and labor market-driven inflationary pressures. The main uncertainty is tied to the Russia's economic growth prospects and the potential decline in the flow of Armenian labor migrants to Russia amid the current depreciation of the ruble, as well as the challenges of integrating them into the domestic labor market.

The weak inflationary environment has persisted in Q4 2024, primarily driven by moderate deflationary pressures coming from the external environment as well as weakening of external demand for certain domestic services. In this context, overall CPI inflation has remained below target since April 2023, standing at 1.4% Y-o-Y in November 2024. Non-Traded Sticky Price Inflation, which captures domestically driven demand dynamics, continued to stabilize, standing at 2.5% Y-o-Y in October 2024. The recent increase in international food prices has not been yet fully transmitted into domestic prices. On the other hand, the deflation of imported non-food products persists, primarily driven by the ongoing decline in producer prices in China's economy. Further, inflation in services highly exposed to external demand has continued to decline, reflecting trends of slowing demand. In this context, households' inflation expectations have moderately decreased, approaching the target.

Monetary Policy

Market expectations regarding the CBA policy rate path have adjusted very slightly downwards since the latest decisions, and continue to reflect expectations of a gradual reduction in the policy rate over the next eight decisions. Following the CBA's recent policy rate announcements, the yield curve have shifted slightly upward. This may be attributed to various factors, including short-term influences, the faster-than-expected growth in domestic public debt levels, sustained strong demand for lending as an alternative investment, and more gradual-than-anticipated rate reductions in the global economy, particularly in the United States, among other factors. Additionally, according to CBA estimates, the yield curve likely incorporates not only market expectations about the future policy rate but also various other risk factors.

Armenia's country risk premium has moderately declined in recent months and remains significantly below the long-term stable level determined by the country's fundamentals. However, it still reflects uncertainties related to debt sustainability, geopolitical tensions, including border issues, and regional developments. In this context, an upward reappraisal of the country risk premium could pose risks regarding the reassessment of neutral rates, which, all else being equal, would primarily carry inflationary risks in a more accommodative monetary policy environment. At the same time, macroeconomic stability in Armenia and strong economic growth can serve as important preconditions for a

potential reassessment of the country risk profile with impacts on the neutral rate.

Considering the persistence of numerous types of uncertainty, the CBA builds and evaluates several different scenarios for future economic developments in order to manage possible risks stemming from these key areas of uncertainty. The illustrative Case A scenario outlined in the Monetary Policy Report, which necessitates a policy rate path higher than market expectations, is grounded in the assumption that continued above-potential, demand-driven growth indicates the persistence of excess demand conditions in Armenia. On the other hand, the high savings accumulated in the private sector, the strong credit expansion and expected high demand for loans, and the increase in income derived from positive developments in exports may further contribute to the acceleration of private expenditure growth in the near future. In addition to these factors, the formation of a more expansionary fiscal policy poses another tangible risk to the expansion of domestic demand. Moreover, a faster-than-expected increase in the debt burden could pose certain upward risks to the country risk premium and, consequently, result in an upward revision of the neutral interest rate. In this scenario, the CBA policy rate path would need to adopt a

tighter stance relative to market expectations in order to ensure price stability in the medium-term horizon.

The illustrative Case B scenario outlined in the Monetary Policy Report, which assumes a lower policy interest rate path compared to market expectations, reflects risks of oversupply conditions in the real estate market resulting in a gradual price adjustment in the economy. This could result in both a slowdown in construction and a decrease in real estate prices and rents, potentially having a significant negative impact on domestic demand and the inflationary environment. Presently, certain initial signs of slowing real estate activity have been observed, particularly considering slowing construction activity in Yerevan. In such a situation, the Central Bank would adopt a looser policy interest rate path compared to market expectations, with the aim of stimulating demand and bringing inflation to the target in the medium term.

In the context of the latent risks and uncertainties in the current period, the CBA builds and discusses various scenarios, summarized in the Taxonomy of Scenarios, with the aim of managing possible risks and assessing sources of uncertainty. At the same time, the MPR includes a deeper dive into two illustrative scenarios, which reflect illustrative future paths of the economy that would require either a higher path for the policy rate (Case A) or a lower path of the policy rate (Case B) relative to current market expectations. These illustrative scenarios do not represent a most-likely future, assign weight or probability to outcomes, or include all possible risks and uncertainties.

