



Central Bank
of Armenia

July 2024

**Executive
Monetary
Policy
Statement**

Published July 30, 2024

A. Executive Monetary Policy Statement

The Board of the CBA today reduced the Refinancing Rate to 7.75%.

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 7.75 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 at low levels well below the target, registering 0.8% in June 2024. Core inflation remained unchanged, standing at 0.0% year-over-year in June.

In the second quarter of 2024, risks of slowing economic growth globally and in the key trading partner countries of Armenia continue to persist. Global inflation continues to decline. However, sticky prices continue to remain relatively elevated in key trading partner economies. At the same time, overheated labor market conditions continue to contribute to sustained high demand conditions in key trading partner economies. 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. In this context, it is likely that key trading partner central banks, and in particular the US Fed, would maintain tight monetary conditions for longer. Consequently, weak deflationary effects from the external sector on the Armenian economy would persist.

Economic activity in Armenia remained robust in the second quarter, continuing to be largely driven by meaningful growth in the construction, trade, and industry sectors. The latter continues 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 strength of domestic demand and consumption conditions. External demand for domestic services continues to slow relative to 2023. At the same time, risks for demand pressures stemming from fiscal policy continue to persist. Further, labor market conditions continue to cool, reflected in the cooling pace of wage growth. Non-traded sticky price inflation and inflation expectations continue to decline.

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. This includes scenarios related to persistently tighter monetary conditions in key trading partner countries, as well as uncertainty related to the country risk premium and neutral interest rates stemming from both global and fiscal policy-related considerations. On the other hand, the Board discussed scenarios where potential economic developments—including the risk of weaker demand conditions emerging, given certain structural features of economic growth and cooling labor market conditions—would cause inflation to persistently remain at a low level. 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 bring inflation back to target in the medium-term horizon.

Seeking to minimize the losses that could stem from these and other scenarios materializing, and balancing the aforementioned risks in both directions, the Board 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
July 30, 2024

Governor
Martin Galstyan

Deputy Governor
Armen Nurbekyan

Board Members
Hasmik Ghahramanyan
Davit Nahapetyan
Levon Sahakyan
Narek Ghazaryan

B. Summary of Economic Conditions

Global Economy

In 2024Q2, economic developments among Armenia's main trading partners has been mixed. However, risks of weaker growth in certain economies continue to persist going forward. Despite an elevated policy rate in recent quarters, the US continues to experience strong growth, spurred by persistently robust consumption and domestic demand conditions. While headline inflation, sticky prices, and wage growth all continue to slow, they still remain uncomfortably above their target levels. This demonstrates the challenges that monetary authorities face in the "last mile," where it is proving to be difficult to find a sustainable path back to the inflation target. On the other hand, continued tightening of financial conditions, and the gradual depletion of excess savings, poses risks of quick deceleration of consumption moving forward. Regardless, the persistence of overall excess demand conditions raises questions about a potentially higher underlying neutral rate in the US. This would have implications on both the future stance of Fed policy and capital flows to emerging markets.

In the Eurozone, the ECB cut interest rates by 25 basis points in June, and kept the policy rate unchanged in July. However, there are only few clear signs that the inflationary environment has fully abated. On the other hand, while growth in the services sector contributed to rebounding economic activity in Q2, risks of economic slowdown still persist. The structurally weakened position of industry and manufacturing in key Eurozone economies remains a cause for concern. These risks, as well as concerns related to the stability of the real estate market and financial system in China, continue to remain key sources of uncertainty driving a weaker global economic outlook.

Meanwhile, the Russian economy continued to experience high growth and strong domestic demand conditions. Amid these conditions, the CBR increased policy rates by 200 basis points on July 26th, with the potential of future rate increases. At the same time, the sustained imposition of stricter and more targeted Western sanctions continues to pose risks to the medium-term Russian economic outlook.

The overall weak inflationary environment in global commodity markets continues to persist, though upside risks exist. Heightened geopolitical tensions in the Middle East, which show few signs of easing, continue to threaten both higher and more volatile energy prices as well as potential disruptions to global supply chains. At the same time, food prices continue to remain below the high levels of the previous two years.

Domestic Demand Conditions

Economic activity in Armenia in Q2 2024 remained well above estimates of long-run sustainable growth (approximately 5%), comprising 10.4% Y-o-Y growth in January-June, and 7.1% in June alone. Growth in activity in Q2 continued to be primarily driven by trade and construction. However, growth was somewhat more widespread across sectors in Q2 compared to the beginning of the year. The persistence of above-potential growth, as well as the still somewhat concentrated nature of recent growth, poses uncertainties regarding the relative position of aggregate demand versus aggregate supply.

The robust external demand observed since 2022 has gradually weakened through Q2 2024, as reflected in the stabilization of tourist arrivals and declining real expenses per tourist. Exports of IT services have continued to decline in the face of weakening global demand, similar to declines in overall sectoral output. Meanwhile, exports of traditional goods (e.g. brandy, tobacco, mineral water, etc.) continue to remain at stable levels.

Considerable uncertainty continues to surround domestic demand conditions. On the one hand, high growth in retail trade, consumer loans, domestic tourism, and services suggest that domestic demand remains quite strong. In the context of still-high demand, interest rates for consumer loans continue to remain elevated. On the other hand, several other factors suggest that weaker demand conditions could be emerging. This includes the characteristics of recent economic and income growth; the steady decline in remittances; cooling labor market conditions; as well as the persistently weak inflationary environment. Another source of uncertainty about how demand conditions might develop in the near and medium term relates to, on the one hand, the declining private debt burden (relative to income growth) in recent years and the directions in which accumulated savings might be used; and, on the other hand, relatively tight lending conditions in the business sector. Depending on how and in which directions these savings are used, and how credit conditions evolve, there would be different implications on the relationship between aggregate demand and aggregate supply in the economy. Additionally, risks for modest demand pressures stemming from fiscal policy continue to persist. This is driven by risks of revenue underperformance, as well as high current expenditures driven by the imperative for various social support programs.

Labor Market & Inflation

The labor market has continued to cool in recent months. The household survey-based unemployment rate in Q1 2024 increased to 15.5%. Considering uncertainty surrounding the level of unemployment, it is important to continue to monitor potential development scenarios and their consequences. On the one hand, the increase in the unemployment rate could reflect arguments for weakening demand conditions across the economy. On the other hand, the total number of registered employees, per State Revenue Committee data, continued to increase. This could suggest that labor conditions are tighter than what the household survey suggests. Alternatively, the growth in registered employees could reflect gradual, structural declines in the shadow labor market in favor of formal employment.

Slowing wage growth in recent months could support arguments of cooling labor market conditions and weakening inflationary pressures from the labor market. Wage growth continued to decline in May, standing at 5.4% Y-o-Y. Moreover, wage growth has been somewhat concentrated in certain sectors, while other sectors of the economy have seen slower or flat wage growth.

Looking ahead, on the one hand, there is potential for labor force participation and supply to increase at a more meaningful pace. This could be supported by the possible weakening seasonal emigration of Armenian workers as well as a more rapid integration of forcibly displaced Nagorno-Karabakh Armenians into the labor market. Such a scenario would moderate inflationary pressures from the labor market in the medium to long term and contribute positively to potential GDP. On the other hand, the number of foreign citizens employed in Armenia has declined somewhat in recent months. If this trend were to accelerate, this could have negative impacts on both labor supply and potential GDP.

The weak inflationary environment has persisted in Q2 2024, primarily driven by weakened pressures coming from the external sector and somewhat weaker aggregate demand conditions. In this context, overall CPI inflation has remained below target since April 2023, standing at 0.8% Y-o-Y in June 2024. Non-Traded Sticky Price Inflation, which captures domestically driven demand dynamics, continued to stabilize, standing at 2.3% Y-o-Y in June 2024. At the same time, weak inflationary pressures in the services that are highly exposed to external demand continue to reflect trends of slowing demand. Nevertheless, considerable uncertainty still surrounds household inflation expectations.

Monetary Policy

Market expectations of the CBA policy rate path have adjusted very slightly downward since the last decision, and continue to reflect expectations of a gradual reduction in the policy rate over the next eight decisions. Since the CBA's previous policy rate decision, the yield curve has slightly shifted downward. However, the downward shift likely does not fully reflect market expectations about the policy rate path, suggesting the sustained presence of certain risk factors.

The country risk premium continues to remain at relatively low levels, but has declined less than in emerging countries overall. This could reflect both country-specific and regional uncertainties, including tensions on the state border, regional geopolitical developments, and other factors. In this context, an upward reappraisal of the country risk premium could pose inflationary risks. At the same time, macroeconomic stability in Armenia and high economic growth can serve as important preconditions for a potential reassessment of the country risk profile.

In order to prudently manage possible risks stemming from numerous types of uncertainty, the CBA builds and evaluates several different scenarios for future economic developments. On the one hand, the Board has evaluated scenarios (Case A-type) where underlying developments would require a tighter policy stance relative to current market expectations. These types of scenarios are primarily related to the potential for a "higher for longer" interest rate environment in the United States, with implications on both capital flows to emerging countries (including Armenia) and the medium-term neutral rate in Armenia; worsening geopolitical tensions, both globally and regionally; uncertainty about the country risk premium in the context of the fiscal deficit and geopolitical tensions; sustained excess demand conditions and high inflation expectations; as well as other risks and uncertainties.

On the other hand, the Board also evaluated scenarios (Case B-type) where underlying developments would require the policy rate to follow a more rapid downward path than what is currently priced in markets in order to sustainably bring inflation back to target in the medium-term horizon. These types of scenarios include the risk for much weaker aggregate demand conditions; risks of low inflation expectations forming, given over one year of below-target inflation; concerns about vulnerabilities in the real estate sector; accelerating growth in investments, supported by the utilization of large accumulated savings in the real sector of the economy; the potential for a sharp slowdown in global demand; as well as other risks and uncertainties.

In the context of its risk management framework, and amid significant uncertainty, the Board of the CBA emphasizes the importance of minimizing the losses that could stem from these and other scenarios materializing. The Board resolutely affirms its commitment to adopting the appropriate policy actions and strategy to ensure price stability.

