



**Central Bank
of Armenia**

Q2 2024

**Executive
Monetary
Policy
Statement**

Published June 11, 2024

A. Executive Monetary Policy Statement

The Board of the CBA today reduced the Refinancing Rate to 8.00%.

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 8.00 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 0.3% in May 2024. Core inflation continued to remain in negative territory, at -0.5% year-over-year in April.

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, but 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. Geopolitical tensions in the Middle East since the beginning of the year, 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 modest demand pressures stemming from fiscal policy continue to persist. The inflationary environment in Armenia continues to remain low, driven by the monetary policy implemented by the CBA in recent years, weak deflationary pressures from the external sector, and somewhat weaker aggregate demand conditions. Further, labor market conditions continue to cool somewhat, reflected in cooling wage growth as well as declining non-traded sticky price inflation and inflation expectations.

In the face of high uncertainty, and given its commitment to achieving the price stability objective, the Board considers multiple scenarios during its deliberations. On the one hand, the Board discussed scenarios where possible underlying developments—including persistently tighter monetary conditions in key trading partner countries, as well as uncertainty related to the country risk premium and neutral interest rates—would require a higher path for the policy rate relative to current market expectations in order to manage risks that threaten the price stability objective. 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—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.

In summary, balancing the aforementioned risks in both directions, the Board of the Central Bank of Armenia finds it appropriate to continue to gradually ease the policy stance. The Board will continue to monitor risk scenarios, and stands ready to take adequate actions to ensure that the price stability objective of 4 percent inflation over the medium-term horizon is met.

Approved by the Board of the Central Bank of Armenia
June 11, 2024

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B. Summary of Economic Conditions

Global Economy

In 2024Q2, economic activity among Armenia's main trading partners has been mixed; however, risks of weaker economic activity going forward continue to persist. Despite an elevated policy rate in recent quarters, the US continues to experience strong growth, spurred by persistently robust consumption and domestic demand conditions. Amid these conditions, headline inflation, sticky prices, and wage growth all remain meaningfully above their target levels, complicating monetary authorities' task of finding a sustainable path back to the inflation target. Moreover, the persistence of these excess demand conditions raises questions about a potentially higher underlying neutral rate in the US, with implications on both the future stance of Fed policy and capital flows to emerging markets. In the Eurozone, economic activity continued to rebound in Q2, driven primarily by services, though risks of economic slowdown still persist, particularly given the structurally weakened position of industry and manufacturing in key economies. 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, despite the tight CBR policy stance. However, the sustained imposition of stricter and more targeted Western sanctions continues to pose risks to the medium-term Russian economic outlook.

The overall inflationary environment in the global economy continues to remain weak, though important 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. Food prices continue to remain below the high levels of the previous two years, though consecutive month-on-month upticks could suggest that further deflation in global food prices may be drawing to a close.

Domestic Demand Conditions

Economic growth in Armenia in Q1 2024 remained well above estimates of long-run sustainable growth (approximately 5%), comprising 9.2% Y-o-Y growth. However, growth in Q2 was primarily concentrated in trade (25.1% Y-o-Y growth), manufacturing (17.3%), and financial services (17.2%) sectors. Economic activity followed a similar pattern in April (Y-o-Y growth of 10.4%), though there was somewhat less sectoral concentration of economic activity than in the first four months of the year. The persistence of above-potential growth, as well as the non-widespread nature of recent growth, poses certain uncertainties regarding the relative position of

aggregate demand versus aggregate supply. On the one hand, growth remained strong and above long-run potential, which could suggest excess demand conditions. On the other hand, the concentrated and non-widespread nature of recent economic growth could speak to weak consumption and suggest a closed, or even negative, output gap.

The robust external demand observed since 2022 has gradually weakened by Q1 2024, as reflected in the stabilization of both real expenses per tourist and tourist arrivals. Meanwhile, considerable uncertainty continues to surround domestic demand conditions. On the one hand, the concentrated nature of recent economic growth would suggest a relatively limited overall income effect; in this context, the modest consumption growth seen in Q1 relative can be interpreted as an indicator of somewhat weaker domestic demand conditions emerging. This argument for weaker domestic consumption is further supported by continued declines in remittances. On the other hand, domestic demand could grow on the back of a reduced debt burden, subsequent potential for credit growth, and previously accumulated savings in the private sector. In this context, depending on how and in which directions savings are used, they could have 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.

The funds attracted and provided by commercial banks continued to grow during Q1 2024, reflecting high economic activity. CBA surveys of commercial banks further attest to sustained high demand for loans. In recent years, the reduction in the debt burden (relative to incomes) serves as a source of uncertainty in terms of the potential for lending to accelerate and generate inflationary pressures.

Labor Market & Inflation

In the context of continued high economic growth, labor demand and wage growth both continued to persist at high levels, with private wage growth standing at 7.3% Y-o-Y in Q1 2024 and 4.5% in April. While the growth in productivity and labor supply observed in prior quarters continue to contribute to a weakening in inflationary pressures stemming from the labor market, overall wage growth still remains elevated relative to measures of headline and underlying inflation. This could serve as a source for sustained inflationary pressures to the broader economy. On the other hand, wage growth has been somewhat concentrated in certain sectors, while other sectors of the economy have seen slower or flat wage growth. This could be interpreted as reflecting a meaningful weakening or neutralization of inflationary pressures stemming from the labor market.

The potential for further increases in labor supply could help ease labor market conditions, moderating any potential inflationary pressures in the medium to long term. In this context, the primary uncertainties relate to the potential for a continued inflow of migrant workers to the Armenian labor market, the rapid integration of forcibly displaced persons from Nagorno-Karabakh in the Armenian labor market, as well as slowing flows of Armenian labor migrants to Russia and their greater participation in the domestic labor market.

The deflationary environment has persisted in Q1 2024, primarily driven by weakened pressures coming from the external sector, the impacts of the CBA's policy stance over the past several quarters, and somewhat weaker aggregate demand conditions. In this context, overall CPI inflation has remained below target since April 2023, standing at 0.3% Y-o-Y in May 2024. Non-Traded Sticky Price Inflation, which captures domestically driven demand dynamics, continued to stabilize, standing at 3.0% Y-o-Y in April 2024. At the same time, inflation for services that are highly exposed to external demand have also continued to soften, reflecting trends of slowing demand. Nevertheless, in this context, there is still considerable uncertainty surrounding household inflation expectations, which continue to remain relatively elevated.

Monetary Policy

Market expectations of the CBA policy rate path have not changed materially 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, partly following trends in emerging countries. However, some uncertainty persists regarding 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.

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 presented in the MPR, where the policy rate path would need to be higher than market expectations, is motivated by the risk of sustained inflationary pressures from the US economy, driven by high domestic demand there, as well as the threat of supply shocks amid global trade and geopolitical risks. Amid persistently elevated demand conditions, a potential upward revision to the neutral rate, and continued negative supply shocks, the Fed would need to maintain a tighter policy stance for longer. The implications on risk premiums in emerging markets, including Armenia, could create preconditions for capital outflows. To guard against the risk of nonlinearities emerging—such as allowing depreciatory or inflationary pressures to result in an upward ratcheting of inflation expectations—the CBA policy rate path would need to adopt a tighter stance relative to current market expectations.

The illustrative Case B scenario presented in the MPR, where the policy rate path would need to be lower than market expectations, is motivated by the risk of a negative demand environment emerging in the domestic economy. Specifically, specific structural features of recent growth poses risks of resulting in relatively weaker longer-term demand fundamentals. Over the medium term, these factors could pose risks of more persistent deflationary forces taking hold. In such a situation, the CBA policy rate would need to follow a sharper and more aggressive downward path than what markets presently expect, in order to stimulate demand and return inflation to the target over the medium horizon.

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.



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