



Central Bank
of Armenia

Q3 2024

**Executive
Monetary
Policy
Statement**

Published September 10, 2024

A. Executive Monetary Policy Statement

The Board of the CBA today reduced the Refinancing Rate to 7.50%.

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 7.50 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 1.3% in August 2024. Core inflation has also remained at low levels, at 0.3% year-over-year in July.

In Q3 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 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, recent slowing in key trading partner countries' labor markets could point to some softening in demand conditions. In this context, key trading partner central banks would be expected to begin to gradually ease the policy rate in the near term, while still maintaining a relatively tight stance. Consequently, weak deflationary effects from the external sector on the Armenian economy continue to persist.

Economic activity in Armenia remained robust in the third quarter, continuing to be largely driven by meaningful growth in construction and trade. 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 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, as reflected in the cooling pace of wage growth, and stabilizing non-traded sticky price inflation.

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 uncertainty about the country risk premium and the neutral interest rate. On the other hand, the Board discussed scenarios where potential economic developments—including the risk of cooling labor market conditions driving a weak demand environment—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
September 10, 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 Q3 2024, economic activity among Armenia's main trading partners has been mixed; however, risks of weaker economic activity going forward continue to persist. Uncertainty continues to surround economic fundamentals in the US. On the one hand, 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 inflation has slowed, sticky prices and wage growth still remain uncomfortably above their target levels, demonstrating the challenges that monetary authorities face in the "last mile." On the other hand, continued tightening of financial conditions, and the gradual depletion of excess savings, poses risks of a quick deceleration of consumption moving forward. Further, in the context of the Fed's dual mandate, risks of weakening labor market conditions imply a greater degree of readiness by the Fed to begin the loosening cycle. Looking ahead, the key uncertainty relates to the pace and magnitude of future policy easing, given financial sector vulnerabilities and still-strong consumption and demand conditions. The latter additionally 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 H1 2024, 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 in July, 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 inflationary environment in global commodity markets continues to remain weak, 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 growth in Armenia in Q2 2024 remained above estimates of long-run sustainable growth (approximately 5%), comprising 6.4% Y-o-Y growth. Growth was primarily driven by construction, trade, and financial services. Additionally, previous quarters' economic growth figures downward were revised downwards, owing to a reevaluation of value added within the manufacturing sector. 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 in the economy.

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.

In the wake of weakening global demand for IT services in recent months, production and exports in this sector have continued to decline, while some modest outflows of foreign, relatively high-skilled IT workers have been observed. Nevertheless, exports of other, "traditional" product groups—e.g. brandy, cigarettes, mineral water, and so on—remain at stable levels.

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 points to strong domestic 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 eased somewhat. 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); the future utilization of accumulated savings in the private sector; slowing wage growth; and geopolitical and regional uncertainties. 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 modest demand pressures stemming from fiscal policy continue to persist. This is driven by risks of revenue underperformance, as well as high current expenditures given 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 Q2 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, given that the uptick in unemployment has been driven by increases in the number of unemployed rather than increases in labor supply. 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 July, standing at 4.1% 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 1.3% Y-o-Y in August 2024. Non-Traded Sticky Price Inflation, which captures domestically driven demand dynamics, continued to stabilize, standing at 2.4% Y-o-Y in July 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, high uncertainty still surrounds household inflation expectations.

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.

Monetary Policy

Market expectations of the CBA policy rate path have adjusted very slightly downward since the latest decisions, and continue to reflect expectations of a gradual reduction in the policy rate over the next eight decisions. Since the CBA's latest policy rate decisions, the short part of the yield curve has slightly shifted downward, while the long part of the curve remained stable. At the same time, according to CBA estimates, it is likely that, besides market expectations about the future policy rate, the yield curve also reflects certain other risk factors.

The country risk premium continues to remain at relatively low levels since the beginning of the year, with some upward revisions over the last weeks, while the perceived riskiness of emerging countries overall continues to decline. 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.

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 assumption that the country risk premium of Armenia sits somewhat lower than its fundamental level. There thus would be risks of a quick adjustment to its long run sustainable level because of continuous regional tensions and uncertainties regarding geopolitical developments. In the event of a quick adjustment of the country risk premium, there could also emerge risks of increased volatility in financial markets and de-anchoring of inflation expectations. In this context, the CBA policy rate path would need to adopt a tighter stance relative to current market expectations in order to reflect the elevated country risk premium and neutral interest rate and guard against these adverse outcomes.

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, the increase in the unemployment rate and cooling private wage growth, as well as the weak inflationary environment, poses risks of relatively weaker longer-term demand conditions emerging. 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.

