

**CENTRAL BANK OF
THE REPUBLIC OF ARMENIA**

*Approved under
Central Bank Board Decision No. 122A,
dated 31.08.2021*

**STATUS REPORT ON IMPLEMENTATION OF THE
MONETARY POLICY PROGRAM
(Q3, 2020 – Q2, 2021)**

During the reporting period, from the third quarter of 2020 to the third quarter of 2021, the global and, in particular, the Armenian healthcare system and economy continued to face a number of serious challenges. As a result of the large-scale hostilities in Artsakh in the second half of 2020, martial law declared in the country, the outbreak of a new wave of rapidly spreading pandemic and the resulting economic and political uncertainties put Armenia in front of health, social and economic challenges. These challenges latter led to a significant decline in economic activity, considerable weakening of aggregate demand and formation of a low inflationary environment. The Government of the Republic of Armenia and the Central Bank have responded to these developments by implementing expansionary policies aimed at restoring economic activity and aggregate demand, and attaining a target of 4% 12-month inflation in the projected horizon, respectively. Thus, in July-November, the Central Bank continued to increase the expansion, lowering the refinancing rate by 0.25 percentage points in September. By the end of the year, the situation has changed: inflationary environment in the international commodity markets and in the main partner countries of the Republic of Armenia has significantly expanded amid the positive expectations of the widespread coronavirus vaccination since the beginning of 2021 and the consequent recovery of the world economy and foreign demand. From December 2020 to June 2021, given some acceleration of forecasted inflation and inflation expectations due to the expected higher inflationary impacts from the external sector, a number of factors of supply and demand in the Armenian economy and dram devaluation in the Armenian currency market, the Central Bank raised the policy rate by relatively large steps by 2.25 percentage points bringing it to 6.5% as of June. Moreover, even in the case of such an increase, the monetary stance is still maintained as expansionary. During the reporting period, under the influence of the above-mentioned factors, the 12-month inflation showed an upward dynamic, reaching from 1.7% in June 2020 to 6.5% in June 2021.

1. MONETARY POLICY IN THE PERIOD UNDER REVIEW

The monetary policy to be implemented during the reporting period was based on the assumptions that despite the slowdown in the spread of the epidemic in the third quarter of 2020, there was a certain economic recovery, the persisting uncertainties relating to reversing of the pandemic would curb and delay the recovery of external and domestic economic activity and aggregate demand. In light of this situation and the low inflation environment, central banks of the main partner countries of the Republic of Armenia and the Central Bank of Armenia, would continue to pursue an expansionary monetary policy, accompanied by a significantly expansionary fiscal policy pursued by governments. With the expected economic developments, the Central Bank tended to continue easing monetary conditions further, considering that it will be necessary to maintain the expansionary stance in the medium term as well, in order to stabilize the 12-month inflation in the projected horizon around the target 4%.

In the first half of the reporting 12-month horizon, as expected, low inflation environment persisted. Thus, under the martial law declared in the second half of 2020 in Armenia, in the wake of the outbreak of a new wave of coronavirus pandemic, and the high level of uncertainty related to the economic outlook, low economic activity and weak gross demand persisted. In such a situation, the government implemented expansionary fiscal policy aimed at promoting social and economic assistance. However, amid the accumulated great uncertainty, households demonstrated a cautious attitude towards consumption, which has outweighed the expected impact of fiscal expansion, leading to continuing sluggish domestic demand and low inflationary environment.

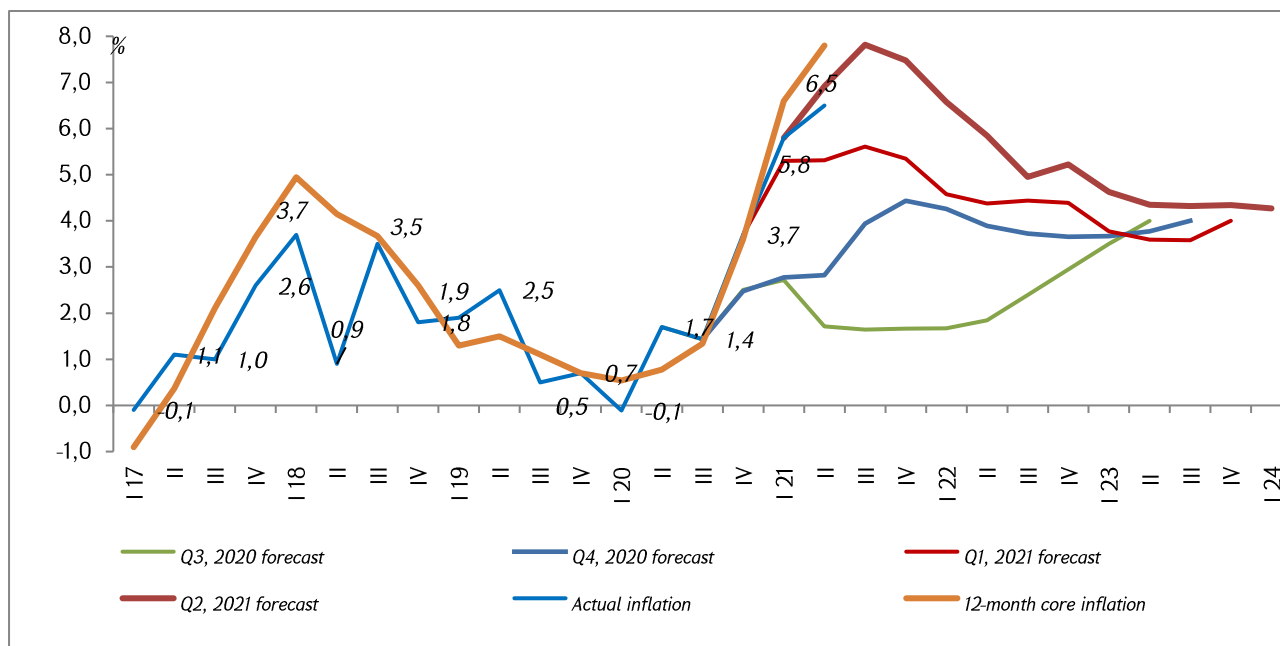
As a consequence of the above-mentioned developments, until December the 12-month inflation was lower than expected, amounting to 1.6% at the end of November, in light of which the Central Bank revised downwards the projected inflation path.

Positive developments in the recovery of global economic activity and external demand in late 2020 due to the expectation of large-scale use of coronavirus vaccines, combined with a number of supply factors (projected low supply of new crops, increase in freight costs, consequences of disruption of production chains) have led to a significant growth in the inflationary environment in international commodity markets. Furthermore, it resulted in a high inflationary environment in the main partner countries of Armenia with ensuing inflationary pressures transferred to its economy through a number of imported food products. In the second quarter of 2021, due to positive developments in remittances and lending to the economy, as well as the prevailing growth of private consumption against capacity expansion opportunities, supply factors of the inflationary impact of international food prices to domestic prices were supplemented by demand factors. The latter is defined as a shock to the rapid recovery of deferred demand, as during the mentioned period, under the acceleration of inflation and inflation expectations, there was a sharp increase of the household's consumption expenditures due to the accumulated savings. Concurrently, in the conditions of martial law and economic-political uncertainties, depreciation of the Armenian dram was observed. Under the impact of the mentioned factors, 12-month inflation in the second half of the reporting period (December 2020 to June 2021) was higher than expected, reaching 6.5% in June. The great uncertainties related to the

economic outlook led to somewhat higher inflation, reflected by the rising dynamics of core inflation. During the mentioned period, the 12-month core inflation grew by more than 6.0 percentage points and made 7.8% in June.

In light of these developments, the projected short-term inflation trajectory to reach the target in the last two quarters of the reporting year was adjusted upwards.

In the first half of the reporting 12-month horizon, as expected, low inflation environment persisted, but in the second half, the 12-month inflation grew rapidly, surpassing the target of 4%



During the reporting period, amid the pandemic and the uncertainties arising from the martial law, a high demand for dram liquidity was observed in the RA financial market. As a result of the Central Bank's operations through its main instrument (7-day repo agreements), short-term market interest rates adequately responded to policy changes and were largely formed around it. During the reporting period of 12 months, given depreciation of the Armenian dram in Armenian foreign exchange market, the Central Bank, adhering to the floating exchange rate policy, took a situational participation in the foreign exchange market in order to ensure sustainability of the financial market.

Taking into account the possible inflationary developments in the existing and expected macroeconomic environment, during the reporting period the Central Bank of Armenia continued to pursue expansionary monetary policy. Moreover, following continuous increase in the amount of monetary expansion in July-November 2020, beginning from December 2020 and until July 2021, monetary expansion was significantly reduced, given the strong inflationary effects transmitted from the external sector and certain acceleration of inflation and inflation expectations under a number of supply and demand factors in the domestic economy. To this end, the Central Bank through comparatively big steps increased the refinancing rate by 2.25 percentage points. At the same time, the Central Bank signaled financial market that it would continue consistent mitigation of the risks of accelerating inflation expectations, without harming the recovery of domestic demand to the extent possible.

2. INFLATION IN THE PERIOD UNDER REVIEW

Inflation has accelerated since the end of 2020, and already in the first half of 2021, as expected, surpassed the target.

The growth of inflation was mainly conditioned by the acceleration of core inflation, which was strongly driven by the rise in prices for imported food and non-food products. The latter, as mentioned above, has been affected by changes in food prices and devaluation of the exchange rate in international markets. Thus, spill-over effects from international markets resulted in a sharp growth in the prices of "Bakery and Cereals", "Oils and Fats" and "Sugar" commodity groups in the domestic economy. The growth of international energy prices affected fuel prices. The 12-month inflation also significantly contributed to the rise in prices for pharmaceuticals, almost entirely due to the high demand during the pandemic. The acceleration of core inflation at the end of 2020 was partly caused by the significant increase in air transport tariffs, which was conditioned by the higher growth of demand of flights compared to the supply after the easing of restrictions on passenger transport applied by some countries to combat the pandemic. The sharp growth of international freight prices is also notable as it had a direct impact on inflation of imported goods (in particular, electrical appliances, clothing and footwear, as well as personal care items).

In the first half of 2021, inflationary trends continued in the main international commodity markets because of the positive expectations of demand recovery and a number of observed supply factors, which also had a direct impact on the increase in inflation of imported food. At the same time, along with the faster-than-expected recovery of demand in the Armenian economy, inflation in the mentioned period accelerated for locally produced goods and services as well, leading to the adjustment of tariffs for a number of services with rigid prices (medical, hairdressing, legal and postal services).

During the year, tariffs for regulated services endured moderate inflationary fluctuations, with 0.3% year-over-year growth in the second quarter of 2021.

Among the factors of supply the high growth of vegetable and egg prices in the seasonal food product group caused by market inherent shocks can also be emphasized. Furthermore, the inflationary effect of the growth of prices of "Tobacco" and "Alcoholic Beverages", in line with the estimates, was affected by inflationary impact of the change in excise tax rates at the beginning of the year.

Inflation has accelerated since the end of 2020, and already in the first half of 2021, as expected, surpassed the target

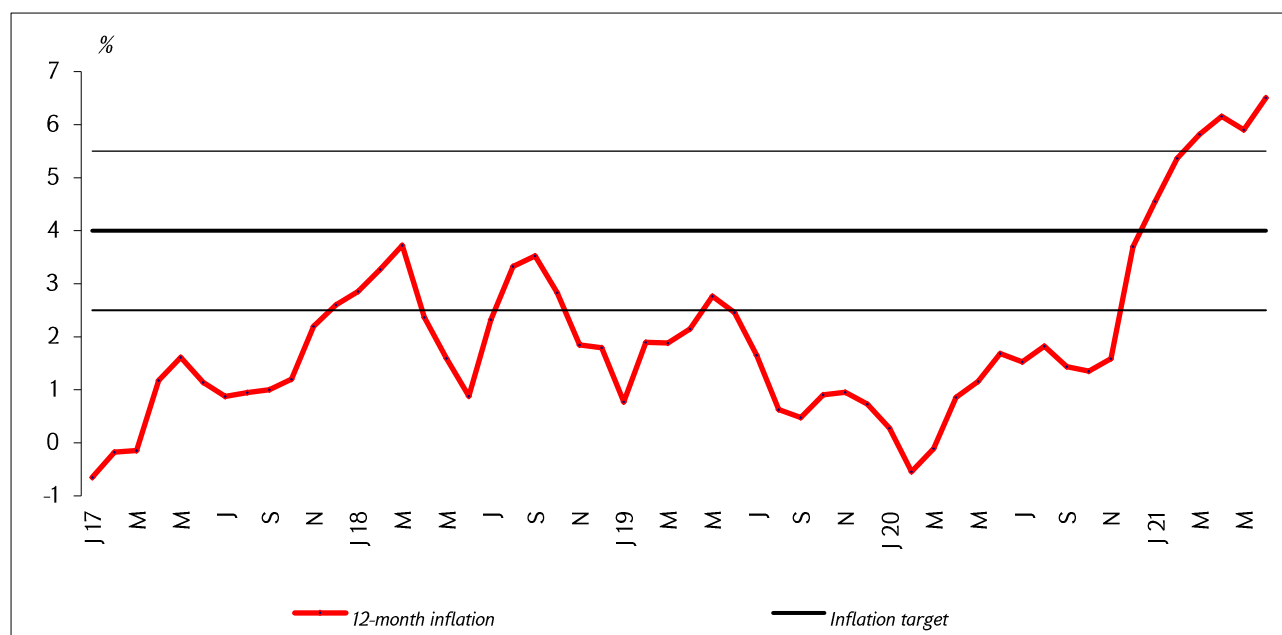


Table 1

Designation	Weight	12-month inflation	Contribution to y/y inflation
Core inflation	74.39	7.83	5.82
Bread and cereals	7.68	8.13	0.62
Meat	9.66	6.56	0.63
Oils and fats	2.25	36.52	0.82
Sugar	0.44	43.17	0.19
Alcoholic beverage	2.87	8.70	0.25
Tobacco	1.59	9.00	0.14
Clothing	2.45	7.05	0.17
Footwear	1.56	5.75	0.09
Medicines and health products	0.52	11.74	0.06
Fuel	3.97	11.11	0.44
Air passenger transportation services	6.01	12.73	0.80
Education	0.56	65.63	0.37
Hospital services	2.94	3.58	0.11
Seasonal food products	9.59	6.98	0.67
Eggs	1.28	41.38	0.53
Fruits	3.65	-9.03	-0.33
Vegetables	4.67	17.52	0.82
Regulated services	15.98	0.31	0.05