



Central Bank
of Armenia

2025 February
Executive
Monetary
Policy
Statement

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A. Executive Monetary Policy Statement

The Board of the CBA today reduced the Refinancing Rate to 6.75%.

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 6.75 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 3 percent over the medium term.

Annual CPI inflation has continued to remain below the target, registering 1.5% in December 2024. Core inflation has also remained at low levels, at 1% year-over-year in December.

In Q1 2025, risks of slowing economic growth globally and in the key trading partner countries of Armenia continue to persist. Inflation in partner countries has moderately expanded, while the prices of goods and services characterized by sticky prices in key trading partner economies continue to remain significantly above target levels. 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, remain tight. In this context, advanced economy central banks would be expected to continue to gradually ease policy rates at a slower pace, while maintaining a relatively tight stance. Consequently, the external environment would be expected to transmit weak inflationary pressures on the Armenian economy.

In the fourth quarter of 2024 economic activity in Armenia continue to approach its stable, long-term levels. Growth in economic activity has largely been driven by services, construction, 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 conditions. Uncertainty has increased regarding the direction and magnitude of the potential impact of fiscal policy on demand. Labor market conditions continue to cool amid these conditions, as reflected in stabilizing wage growth, non-traded sticky price inflation, and inflationary expectations.

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 uncertainty about the possible expansion of the inflationary environment in the global economy, as well as uncertainty about long-term interest rates. These developments require a tighter policy response compared to market expectations in order to ensure price stability. On the other hand, the Board discussed Case B-type scenarios, including those related to the gradual slowdown of economic growth, weakening demand, and the risks associated with the prolonged maintenance 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.

As a result, 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 3% inflation in the medium term.

Approved by the Board of the Central Bank of Armenia
February 4, 2025

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B. Summary of Economic Conditions

Global Economy

In Q4 2024, economic activity among Armenia's main trading partners has been mixed. High economic activity persists in the US and Russia, driven largely by robust growth in domestic consumption, particularly in the services sector. In China, while economic growth has somewhat accelerated, approaching target levels, the environment of weakening domestic demand persists due to structural challenges. In the Euro Area, economic growth has markedly decelerated following the fading impact of certain short-term factors. Risks of slower economic activity globally remain latent.

Uncertainty regarding economic fundamentals in the United States persists. Despite elevated interest rates in recent quarters, the US continues to experience strong growth, spurred by consistently robust consumption. Thus, in Q4 2024, economic growth has moderated somewhat, forming around 2.3%, but the contribution of private consumption growth was about 2.8 percentage points, indicating the persistence of high domestic demand. Simultaneously financial asset prices remain at high levels, creating risks for further expansion of demand. In this context, headline inflation has somewhat increased, sticky prices and wage growth remain significantly above their target levels. A further escalation of the inflationary environment may also be anticipated as a result of the tightening of external trade policies.

Risks have remained, particularly in the medium term, regarding the potential shift towards a more stimulative fiscal policy stance. This poses an additional challenge for monetary policy, not only due to the short-term inflationary effects but also in the context of its potential impact on the neutral interest rate, especially if a higher debt burden trajectory materializes. These highlight the challenges that monetary authorities face in the "last mile" of bringing inflation back to target and maintaining long-term price stability.

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 times. In this context, the Federal Reserve decided to leave the policy rate unchanged. It should also be noted that financial market expectations regarding the future trajectory of the Federal Reserve's policy rate have significantly increased in recent times. At the same time, uncertainties regarding the long-term neutral interest rate persist, 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 an additional 25 basis points to 2.9% in February 2025. In the Euro Area, both short-term and, particularly, medium-term growth prospects and structure, especially in the industrial sector, continue to remain concerning. Headline

inflation has slightly expanded, yet it remains near the target level, primarily due to the modest inflation of manufacturing goods, 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 policies and notable increases in private expenditures. Labor market tension remains persistent. In this context, 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, particularly the targeting of Russian "shadow trade vessels" by the United States, continue to pose risks to the medium-term Russian economic outlook, especially under conditions of prolonged strict monetary policy.

In the global commodity markets, food prices have stabilized in recent months. Nevertheless, significant uncertainty persists regarding the medium-term developments in commodity markets, particularly in the oil market. In the case of effective targeting of "shadow trading vessels" transporting Russian oil at prices above the cap set by Western countries, global oil supply could be somewhat reduced, leading to inflationary pressures. Conversely, further weakening in global demand may lead to deflationary pressures in commodities.

Domestic Demand Conditions

In Q4 2024, economic growth in Armenia continued to slow, approaching the estimated level of long-term sustainable growth. The sectors of services, construction, and trade continue to remain the major growth drivers. It is worth noting that the weakening of economic activity is largely driven by the reduction in external trade flows. Nevertheless, the structure of growth continues to pose high uncertainty regarding the relative position of aggregate demand versus aggregate supply. An uptick in economic activity is observed in certain "traditional" sectors of the manufacturing industry, such as food and tobacco production. Nevertheless, risks remain regarding the growth prospects of these sectors, driven by slow growth in capacity (including construction in these sectors, the import of investment goods, and employment growth).

The robust external demand observed since 2022 has been gradually weakening, as reflected in the stabilization of both

real expenses per tourist and tourist arrivals. Non-commercial money transfers from Russia to Armenia are also somewhat decreasing. This may be due to the recent narrowing of the wage gap between Armenia and Russia, heightened uncertainty regarding Russia's medium-term economic outlook, and a decline in labor migration to Russia amid stricter migration policies.

Meanwhile, considerable uncertainty continues to surround current domestic demand conditions. The 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. 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. 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, uncertainty regarding the impact of fiscal policy on aggregate demand has increased. This is driven by concerns over revenue underperformance and high current expenditures necessitated by various social support programs. Significant risks remain regarding the underperformance of expenditures, particularly capital expenditures, as well as their structural characteristics, which may result in a restrictive impact on demand.

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 increase of approximately 2 percentage points relative to the same quarter of last year. Considering the uncertainty surrounding the level of unemployment, it is crucial 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. This aligns with the observed outflow of foreign workers and the slowdown in wage growth rates 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 continued to rise, with about 41,200 more individuals

employed compared to the same period of last year. This could suggest that labor conditions are tighter than the household survey indicates. As an alternative interpretation, the growth in registered employees might 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, largely reflecting the high wage increases in the financial sector. However, excluding the financial sector, private sector wage growth remains around 5%, which remains below levels that are consistent with productivity growth and the 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 high unpredictability surrounding Russia's economic growth prospects and the potential decline in the flow of Armenian labor migrants to Russia, as well as the challenges of integrating them into the domestic labor market.

The weak inflationary environment persisted in Q4 2024, primarily driven by moderate deflationary pressures from the external environment, as well as a decline in prices of imported non-food products and domestically produced food items. The deflation of imported non-food products persists, primarily driven by the ongoing decline in producer prices in China's economy. In this context, overall CPI inflation has remained below target since April 2023, standing at 1.5% Y-o-Y in December 2024. Non-Traded Sticky Price Inflation, which captures domestically driven demand dynamics, continued to stabilize, standing at 2.4% Y-o-Y in December 2024. The latter continues to be negatively affected by the inflation of services highly exposed to external demand, including the gradual decrease in hotel service prices and residential rental rates. In this context, households' inflation expectations have moderately decreased approaching target levels. This is supported by both the consistently low inflationary environment in Armenia as well as the results of household surveys.

Monetary Policy

Market expectations regarding the Central Bank of Armenia (CBA) policy rate path have adjusted slightly downward since the latest decision 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 short- and medium-term segments of the yield curve have shifted downward. At the same time, 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 mainly driven by positive developments surrounding the Middle East conflict 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 interest 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's 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. On one hand, the Board has discussed scenarios in which developments necessitate a tighter policy response relative to market expectations to stabilize inflation around the target in the medium term. These scenarios primarily encompass the following risks and uncertainties:

- Risk associated with the U.S. neutral interest rate being higher than market expectations.
- A rapid adjustment in Armenia's country risk premium, as well as an increase in its fundamental level.
- Excessive demand formation in the domestic economy and its sustained persistence.
- In the global economy, the intensification of regional conflicts and the imposition of tangible tariffs by major economies on each other and the external world give rise to risks of an expanded inflationary environment, driven by disruptions in supply chains.
- Risks of a sharp slowdown in global economic growth, largely driven by deep structural challenges in the Chinese and Eurozone economies.
- Risks associated with a gradual slowdown in economic growth, weakening demand, and the prolonged maintenance of a low inflationary environment in the RA.
- Declining seasonal migration from Armenia to Russia, driven by the further narrowing of the wage gap between the two countries and heightened uncertainty regarding Russia's growth outlook.
- Tightening of trade policies among major economies over the medium-term horizon, potentially leading to excess supply of goods and services in international markets and a deflationary environment, along with other risks and uncertainties.

On the other hand, the Board has considered scenarios in which potential economic developments suggest a faster downward trajectory for the policy interest rate compared to market expectations. These scenarios encompass the following risks and uncertainties:

