

THE CENTRAL BANK
OF THE REPUBLIC OF ARMENIA

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dated 11.08.2015*

Inflation Report

Monetary Policy Program, Q3, 2015



*Status Report on Implementation of the Monetary Policy
Program, Q2, 2015*

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Since January 2006, the Central Bank of Armenia has moved to a fully-fledged inflation targeting strategy, which highlights the importance of communicating of the Bank to the general public by publishing, inter alia, quarterly inflation reports. First section of the inflation report includes next quarter's monetary policy program that provides new forecasts of inflation and other macroeconomic indicators and main directions of the monetary policy in the forecast horizon. Second section includes status report on implementation of the monetary policy program of the previous quarter, which covers actual economic and monetary developments.

Publishing of inflation forecast and assumptions underlying it makes the monetary policy of the Bank more transparent, understandable and predictable, which considerably increases the public confidence in the Bank. The Bank believes that a clear and trusted monetary policy positively affects the anchoring of inflation expectations and maintaining financial stability in terms of cost reduction.

Starting from the second quarter of 2012, the Bank has been publishing forecasts of non-conditional inflation in a 3-year time horizon, in implementation of the inflation targeting strategy, whereby the monetary policy is steered to minimize any deviations of potential inflation from a 4 % target. Projections in this report are based on the factual information available by August 11, 2015, i.e. the day on which the refinancing rate was set, the results of a survey conducted by the Bank and the judgment made pursuant to the information on future macroeconomic developments.

All inflation reports which have been published to date are available on the Bank's website which also contains monetary policy-related publications.

1. Executive Summary

By the end of 2015, the 12-month inflation rate will be in the lower bound of the confidence band of $4\% \pm 1.5$ pp and will then stabilize around the target at the end of the forecast horizon.

For 2015, economic growth is predicted to be higher in comparison with previous forecast, which is determined by positive developments of economic activity in the first half of the year. In 2016, economic growth rates will remain the same but are expected to accelerate to approach a long-term equilibrium.

Economic growth in the first half of 2015 is estimated in the range of 2.7 - 2.9% y/y.

The 2015 economic growth has been revised upside compared with previous forecast and is estimated in the range of 2.8 - 3.6%.

According to the forecasts of the Central Bank of Armenia (hereinafter “the CBA”), by the end of 2015 the 12-month inflation rate will be in the lower bound of the confidence band of $4\% \pm 1.5$ pp. In the rest part of forecast horizon, it will fluctuate within the confidence band and stabilize around the target at the end of forecast horizon. For 2015, economic growth is predicted to be higher compared with previous forecast, which is due to positive developments of economic activity in the first half of the year. In 2016, economic growth rates will remain at the same level but will accelerate gradually, approaching a long-term equilibrium.

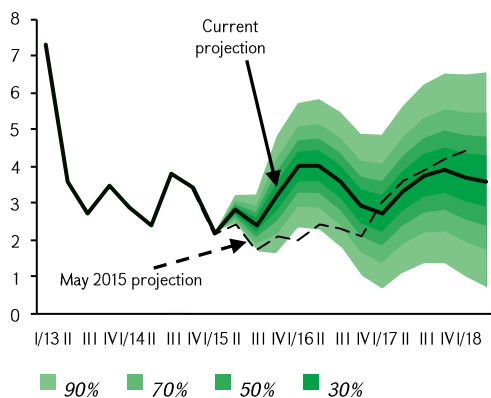
In the first half of 2015, ***the indicator of economic activity was 4.2% y/y***, which exceeded expectations largely due to higher-than-expected output volumes in agriculture and, in part, industry sectors. In terms of demand, the growth of economic activity that time has been driven by more stimulating fiscal policy implemented by the Government and considerable easing of monetary conditions by the CBA early in the year, when lombard repo facility rate was reduced to 12% from 20%. This generally mitigated the impact of the decline in ***private consumption*** and ***private investment***. Note that the slump in private consumption and private investment has been attributable, respectively, to significant reduction in households' disposable income as a result of the decrease in remittances from Russia and weak economic activity in the construction sector and slowed down credit growth. In the second quarter of 2015, the decrease in private consumption costs is estimated to amount to 2.0% and private investments, 7.0%. The second quarter of 2015 saw a sizable reduction of negative balance in net real export thanks to a real growth of export of goods and services by 22.7% y/y, whereas import of goods and services posted a decrease in real terms by 5.9% y/y. As a result, ***economic growth*** in the first half of 2015 is estimated ***in the range of 2.7 - 2.9% y/y***.

According to short-term forecasts of the CBA, in 2015 private consumption and private investment will reduce by 1.6% and 4.0%, respectively. The fiscal impulse, calculated in relation to the previous year, is estimated to be 2.0 - 2.5 expansionary for the year. Given that the National Statistical Service of Armenia recalculated Armenia's foreign trade figures for January-June, which reflect high real growth rates in export and declined rates in import, the export and import forecasts have been revised. Thus, real growth of export of goods and services for 2015 is predicted in the range of 15.0 - 17.0%, while real decrease in import of goods and services, in a 3.0 - 5.0% range. Though the growth in money transfers outstripped expectations in the second quarter, deteriorating situation of the Russian economy, however, required to leaving the forecasts of remittances of individuals unchanged. In 2015, about 25% decrease in remittances in dollar terms (net) is anticipated.

As a result, ***the 2015 economic growth has been revised upside relative to a former forecast and is projected within 2.8 - 3.6%***, which will be mainly driven by macroeconomic and financial stability since the beginning of the year, monetary conditions loosened by the

Economic growth at the end of the forecast horizon will be within 3.5 - 4.5%.

Real GDP Cumulative Growth Projection Probability Distribution Chart for a 3-year horizon

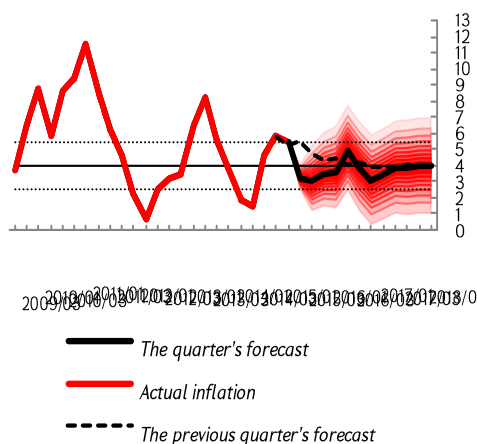


In the forecast horizon, inflationary pressures from the external sector are not likely.

In the second quarter of 2015, the 12-month inflation rate hovered within the upper bound of the confidence band, as was expected, and it reached 5.5% in late June.

In the second quarter, the CBA left monetary conditions unchanged.

Inflation (12-month) Forecast Probability Distribution Chart for a 3-year horizon



CBA in the first half of the year, more stimulating fiscal policy implementation as well as positive developments in agriculture.

In 2016, economic growth rates will persist at the same level. Starting from 2017, the growth rates will speed up, carrying the influence of effective implementation of government program steered to export and investment promotion, gradual improvement in the external economic environment and structural reforms. Driven by these developments, it is expected that ***economic growth at the end of the forecast horizon will be within 3.5 - 4.5%.***

Thus, ***in the forecast horizon***, with stabilizing private demand and mostly a neutral impact of the fiscal policy, the ***impact of the aggregate demand on domestic prices will be neutral.***

In the second quarter of 2015 too, economic activity in ***Armenia's main trade partners*** further demonstrated slow-growth patterns, in which case ***external demand*** remains at a low level. In the second quarter of the year, ***international markets of basic commodities*** continued observing deflationary developments on the back of large volumes of food production, a low level of global demand as well as appreciating US dollar in spite of rise in prices of certain raw materials.

In the medium-term perspective, slowly rebounding growth in economies of Armenia's trade partners, stabilizing prices in commodity and food product markets as well as subsiding volatilities in world financial markets all will transmit positive effects onto the Armenian economy.

So, in the forecast horizon, ***inflationary pressures from the external sector are not anticipated.***

In the second quarter of 2015, ***the 12-month inflation rate*** hovered within the upper bound of the confidence band, as was expected, reaching 5.5% ***in late June***. According to the CBA's short-term forecasts, although upcoming months would see somewhat lower prices of agricultural products relative to the same period last year, owing to positive developments in agriculture, ***the CBA left monetary conditions unchanged in the second quarter*** because the inflationary impact of the electricity price increase possibly since August this year is thought to offset that development (see details in section "3.1.1 Actual inflation and fulfillment of the inflation target").

At the end of the forecast horizon the 12-month inflation rate will stabilize around its target level of 4%. A fairly moderate inflationary environment is anticipated in the second half of 2015 as positive developments in agriculture sector will result in lower year-on-year levels of prices of agricultural products. However, low inflation environment will be offset to a certain extent, as the CBA loosens monetary conditions and the Government implements a stimulating fiscal policy during the year. It should be noted that the inflationary effect that was previously expected to come from electricity price increase since August 1, 2015 is currently out of consideration. However, once actual information on how a mechanism of Government subsidies works and on the results of the audit to be conducted at the "Electric Networks of Armenia" CJSC is available, the CBA will provide estimates of the inflationary effect of this particular change in its next publications. In the meantime, the inflationary effect of possible

In the second half of the year the 12-month inflation rate will reduce and stay in the lower bound of the confidence band. Over the rest part of the forecast horizon, the inflation will fluctuate within the confidence band, expecting to stabilize around the target at the end of the horizon.

In the time of low inflationary environment, easing of monetary conditions in the third quarter of 2015 will be appropriate.

changes in excise duty in 2016 has been considered in inflation forecasts. In the light of these developments, the CBA estimates that in the second half of the year the 12-month inflation rate will reduce and stay in the lower bound of the confidence band. Over the rest part of the forecast horizon, the inflation will fluctuate within the confidence band and is expected to stabilize around the target at the end of the horizon.

The CBA estimates that, in the time of low inflationary environment, easing of monetary conditions in the third quarter of 2015 will be appropriate. Still, there are risks coming from domestic and external economies. If these materialize, the inflation environment may expand while the CBA will possibly adjust its monetary policy directions in order to attain the inflation target in the medium run.

Risks to inflation deviating from the projected value are estimated ***upward*** in both short and medium-term perspectives. ***Risks deriving from the external sector*** are related to economic outlook in both developed and developing countries. In particular, an expected rise in interest rates by the U.S. Federal Reserve System could lead to capital outflows from developing countries to the U.S.A. and provoke higher volatilities of currencies in developing countries. More significant are the risks to the future of Russian economic development. These are attributable to oil prices with their greater-than-expected decline and predicted lower level over the forecast horizon, further depreciation of the Russian ruble against the U.S. dollar, as well as further course of geopolitical developments. A sharp slowdown in Chinese economic growth could also pose risks to the global economic decline and the fall in international prices of commodities and food products. ***Risks deriving from the domestic sector*** are mainly associated with the developments in agriculture, a sector greatly depending on weather conditions, the uncertainty of the impact of increasing electricity prices, as well as the pace at which the domestic demand would recover and the Government-led projects unfold. If the aforementioned risks materialize, the CBA will react accordingly by maintaining the inflation target in the medium run.

2. Forecast, Forecast Changes and Risks

2.1. External environment¹

Main trade partners' economies will further see slow growth rates.

The global economy and economies in Armenia's main trade partners will further see slow growth rates. While this will be noticeable in developing countries, economic activity will tend to improve in developed countries.

In external markets, deflationary patterns will be persisting in the short run, while prices are anticipated to grow modestly in the medium run as global demand rebounds gradually.

In external markets, deflationary patterns will be persisting in the short run due largely to weak global demand and excess supply in individual commodity markets, whereas prices are anticipated to grow moderately in the medium run as the global demand rebounds gradually.

In its *Global Economic Outlook* report², released in July 2015, the IMF has revised economic growth rates downside for both developed and developing countries due mainly to weak economic growth rates in the first quarter and faster-than-expected growth of oil prices in the second quarter of 2015.

The slowing of economic growth in the U.S.A. at the beginning of 2015 is estimated as a temporary phenomenon, and the growth rate is predicted to accelerate during the rest part of the year. Economic growth in 2015 is estimated at around 2.2%; it will speed up in 2016 to reach about 2.7% and will stabilize around its potential indicator of 2.2% over the long-term perspective. Despite persisting deflationary patterns, the U.S. Federal Reserve System is expected to raise the policy rates in autumn of 2015 on the brink of strengthening U.S. economy and labor market conditions.

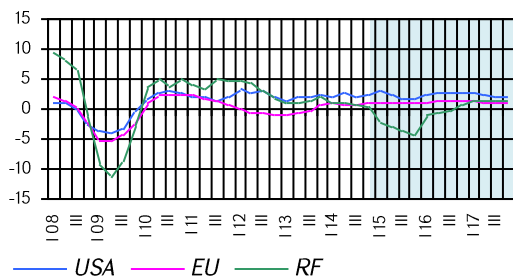
An expected decline in oil prices, exchange rate depreciation and the European Central Bank's extensive asset purchase program will certainly contribute to the acceleration of economic growth in the Eurozone in 2015. Here, economic growth this year is forecast at around 1.0%, while in the forecast horizon it will accelerate, reaching 1.5%. Notwithstanding some inflationary trends observable in the economy, inflation is still below its target level. The expectation is that the ECB will continue its low-interest-rates policy and quantitative easing program up until the end of 2016, which is aimed at restoring economic activity and regulating inflation.

In Russia, economic downturn over the first half of 2015 will continue deteriorating up until yearend, with average annual economic decline estimated at around 3.3%. The economy will further decline up until the end of 2016 as a consequence of lower oil prices and

¹ The forecasts of external sector were based on the information provided from international reputable analytical, research, ratings organizations and financial institutions as well as various news agencies worldwide (including the IMF, World Bank, The Economist, Economist Intelligence Unit, Global Insight, Financial Times, and so on).

² IMF World Economic Outlook (WEO) Update, July 2015.

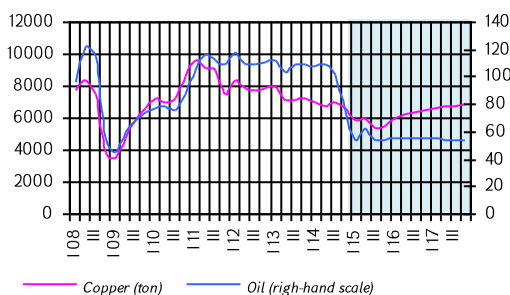
Economic growth in main trade partners (%)



Food products (USD)



Basic commodities (USD)



economic sanctions. Positive growth will only be observable starting from 2017, which will amount to 1.3% at the end of the forecast horizon. Albeit some stabilization, the Russian ruble's exchange rate is predicted to depreciate to a certain extent in the second half of 2015, which is driven by continued decline in oil prices. Inflation will remain high as a result of depreciation, reaching 11.0% later the year. However, the exchange rate may demonstrate somewhat steadier patterns at the end of the forecast horizon due to some stabilization of oil prices and restored capital flows.

In addition, the IMF July 2015 report predicted a 3.3% growth of global economy for 2015 (which is a 0.2% downward revision in comparison with the April release of the report), while global economic growth forecast for 2016 remained unchanged, 3.8%.

With the global demand still sluggish, deflationary trends in world commodity and food product markets will continue up until the end of 2015. However, a stable small growth of prices in the forecast horizon is likely on the back of rebounding global demand. It should be noted that oil prices will be low in the medium run owing to Iran's entry to the oil market, in which case an increase of global oil supply can be expected.

Risks to the developments in global economy have grown in relation to the previous forecast. In particular, risks deriving from persistently low price environment in commodity and food product markets will continue leaving influence on global demand. On the other hand, Iran entering the oil market can mean a significant risk since prices may fall steeply in the short term and persist at a very low level in the medium term. That, in turn, may bring about risks to shaping deflationary environment in other commodity markets, as well. In such circumstances, significant problems may arise in developing countries as economic activity declines. An abrupt slowing of economic growth in China could also pose risks to the global economic slowdown and the fall in international prices of commodities and food products. Risks associated with deepening recession and delayed recovery of the Russian economy will heighten, which will be certainly fuelled by risks to further extending and tightening of economic sanctions. Under these conditions, Russia's economic growth recovery will be put off up until the end of the forecast horizon. In the meantime, the lifting of interest rates by the U.S. Fed contains substantial risks in terms of more capital outflows from developing countries and heightened exchange rate volatility for currencies.

Though risks arising from developments in the world economy and principal partner countries may transit adverse effects onto the Armenian economy at the beginning of forecast horizon, gradual recovery of economic growth in partner countries, stabilization of prices of commodity and food product markets and reduction of volatilities in world financial markets in the medium-term perspective will contribute positively to the domestic economy.

Developments in commodities markets in the forecast horizon

The OPEC July 2015 report of the oil market predicts that the global oil demand will grow in 2015 by 1.28 million b/d and consumption will reach 92.61 million b/d. The report also predicts that oil production outside OPEC will grow in 2015 by 0.86 million b/d, while oil production by OPEC will grow by 0.19 million b/d. At the same time, it is expected that Iran's entry into oil product markets would lead to an additional increase in market supply. In such a circumstance, a low level of oil prices can be anticipated throughout the forecast horizon.

The slowing of economic growth rates in China and increased production in the forecast horizon will determine low rates of inflation in base metals markets. According to World Bank estimates, in 2015 prices of metals will plunge by nearly 17%. Although copper prices have increased owing to seasonal high demand, these are expected to fall in the short run as a result of excess supply in the market.

According to July estimates of the U.S. Department of Agriculture, in the 2015/2016 marketing year some 722.0 million tons of wheat crops is expected. In the 2015/2016 marketing year, the world wheat stock will amount to 219.8 million tons, mainly determined by the growth of China's stocks. In such circumstances, driven by large-scale supply of wheat, international wheat prices are expected to decline in the short term.

World rice production in the 2015/2016 marketing year is estimated to reach 480.3 million tons (an increase of production by nearly 4.0 million tons in comparison with the previous reference period). According to U.S. Department of Agriculture estimates, rice stocks in the 2015/2016 marketing year will total 90.5 million tons, down by 0.9 million tons. The decrease will be explained by reduced stocks in Pakistan, the Philippines and the USA. However, in a short-term perspective, international rice prices are expected to decrease due to a reduction in global demand for rice.

In 2015, international sugar prices will keep on falling due to the expected large-scale production in India and Thailand and in anticipation of heavy crops in Brazil, the world's leading manufacturer and exporter of sugar cane. Appreciating U.S. dollar may also be contributing to price falls.

A slow growth of food prices is anticipated in the medium run as the global demand bounces back.

2.2. Aggregate supply and aggregate demand

Aggregate supply

Economic growth forecasts for 2015 were revised upside, mostly determined by monetary conditions which the CBA loosened in the first half of the year in view of maintaining macroeconomic and financial stability, more stimulating fiscal policy implementation as well as encouraging developments in agriculture. As a result, economic growth in 2015 is anticipated **in the range of 2.8 - 3.6%**³. It should be mentioned however that global economic growth rates remain slow,

*Economic growth in 2015 is predicted to be within
2.8 - 3.6%.*

³ See the 30% range in the Real GDP Growth (Cumulative) Projection Probability Distribution Chart.

Armenia's domestic demand is still sluggish and international ore and mineral prices persist at their low levels.

With domestic demand still weak, economic growth expected in 2015 will be underpinned by net exports which have grown thanks to structural reforms implemented in recent years, favorable developments in agricultural sector as well as Armenian dram's depreciation against the U.S. dollar at the end of 2014.

Anticipated restoring of growth rates in money transfers from Russia, revival of economic activity to some extent in partner countries in 2016 as well as a lagged impact of loosened monetary policy carried out in 2015 all will contribute to the recovery of domestic demand. In this case, economic growth in 2016 is estimated at 2.5 - 3.4%⁴.

Economic growth in 2016 is estimated at 2.5 - 3.4%; starting from 2017, it will speed up to be within 3.5 - 4.5% at the end of the forecast horizon.

Effective implementation of export and investment-oriented program of the Government, improving external economic environment and structural reforms are among key factors that will accelerate the economic growth starting from 2017, amid a steady inflation environment. Based on the above mentioned developments, it is expected that ***economic growth will speed up to be in the range of 3.5 - 4.5%⁵ at the end of the forecast horizon***, which will be driven greatly by the tradable sector.

Given reduced long-term economic growth equilibriums⁶ amidst growing uncertainties associated with economic developments in Armenia's main trade partners, anticipated slowing of foreign capital investment, and weak investment activity persisting in the domestic economy, ***Armenia's long-term economic growth equilibrium is estimated within 4.0 - 5.0%.***

For ***Industry***, the 2015 forecasts of value added have been revised upside, with food processing growth rate adjusted as a result of positive developments in agriculture. Thus, in 2015 value added in industry is predicted to be within 4.0 - 4.5%. It should be noted that exploiting Teghout mine and identifying new export markets has significantly contributed to the progress in industry in the first half of the year. This development is anticipated for the second half of the year, too.

In the ***forecast horizon***, the industry growth will ***stabilize within 4.0 - 5.0%***. This will be underpinned by implementing a handful of investment projects and broadening export capacities as the Government carries out an export-oriented policy.

For ***Construction***, the forecasts of value added have also been revised upside, mainly based on somewhat higher growth rates in the first quarter against forecasts and an expectation that overall economic activity would be stronger during the second half of the year. In view of low investment activity in non-tradable sector of the economy, there is anticipation that volumes of construction funded by organizations would shrink. Note, however, that a moderate growth of 1.0 - 1.5% in total construction is expected during 2015 as a result of construction

⁴ Refer to the same place.

⁵ Refer to the same place.

⁶ See details in section "External environment", chapter "Forecast, Forecast Changes and Risks".

activities for roads, irrigation, water supply and sewage systems, renewable energy and Yerevan underground modernization, which are planned to be carried out using funds of the central and local community budgets and of international organizations.

In the **forecast horizon**, the growth is expected to **stabilize within 1.5 – 2.5%** as the supply and demand imbalance in construction phases out. The growth will be driven mainly by large construction projects designed for infrastructure improvement and investment projects in private sector.

For **Services**, the forecasts of value added have not changed significantly. Real growth of value added of services in 2015 is expected within 1.0 - 1.5%, which is well below the average growth recorded for services in recent years. The slowing in the branch is primarily due to contraction of trade determined by weak demand in the economy. This, however, contributes to the adjustment of existing imbalances in the economy and sustainability of future economic growth. Trade and related services sector contraction notwithstanding, an activity observable in the tourism industry could substantially contribute to an anticipated moderate growth during the year.

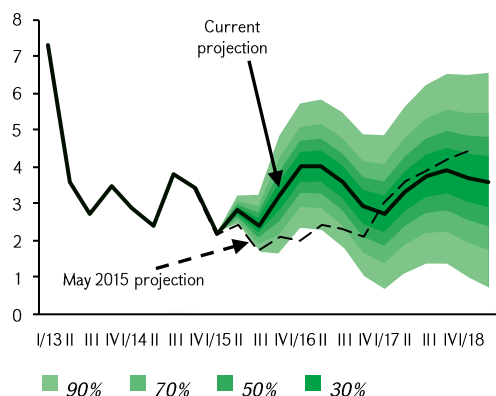
In the **forecast horizon**, growth in services is predicted to speed up and **stabilize around 4.0 - 5.0%** in expectation of gradual recovery of domestic demand and tourism growth.

For **Agriculture**, the forecasts of value added have been revised considerably upside relative to previous predictions. The revision has been based on a higher-than-predicted growth in the second quarter, which is a result of much stronger (above average) performance in plant growing observable in the last few years. There is anticipation that the growth would persist over the second half of the year, too. As a result, the growth of value added in agriculture in 2015 will be within 10.5 - 11.5%.

In the forecast horizon, the growth in agriculture will stabilize in the range of 5.0 - 6.0%. Relatively high growth rates in the medium run will be possible to maintain by using more house farming and refrigerator facilities, arable land, crops and cattle, and engaging extra means of transportation for exports, as a result of consistent complex measures which the Government has taken on in recent years.

In the forecast horizon, risks to the economic growth are dual-sided and balanced. In particular, they depend on how the global economy would develop further and what economic effects could be expected from integration processes in the region, on the one hand, and how long would uncertainties with regard to private spending persist, on the other.

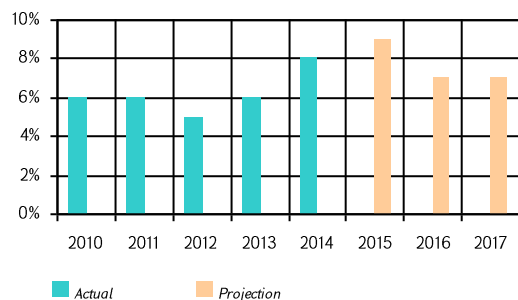
Real GDP Cumulative Growth Projection Probability Distribution Chart for a 3-year horizon



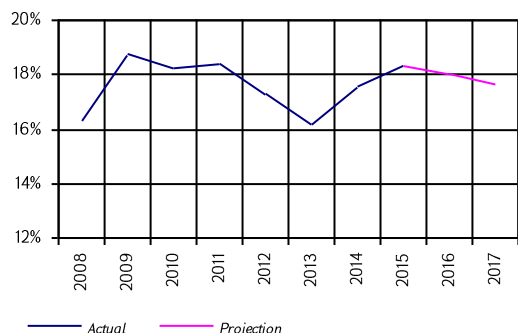
Real GDP Growth (Cumulative) Projection Probability Distribution				
Period	30% probability interval		90% probability interval	
	Minimum	Maximum	Minimum	Maximum
January-December 2015 / January-December 2014	2.8%	3.6%	1.6%	4.8%
January-December 2016 / January-December 2015	2.5%	3.4%	0.9%	4.9%
January-December 2017 / January-December 2016	3.5%	4.5%	1.3%	6.5%

Average nominal wage is expected to grow by 9.4%, 7.1% and nearly 7.0% in 2015, 2016 and 2017, respectively.

Average nominal wage growth, y/y



Unemployment rate



Average unemployment rate in 2015 is expected to amount to 18.3%, while a trend of steadily subduing unemployment rate will be observable in 2016-2017.

Labor market:⁷ Forecasts of labor market indicators for 2015-2017 have improved relative to the previous predictions, reflecting the adjustment in economic growth forecasts. Specifically, in the forecast horizon, average wage is expected to report higher growth rates. Thus, **average nominal wage is expected to grow by 9.4% in 2015, by 7.1% in 2016 and by about 7.0% in 2017.**

The impact of wage increases in the public sector since July of 2014 will phase out in the second half of 2015. As a result, public sector wage growth rates are expected to slow down in the second half of 2015 against the first half of the year, but these will increase at the average growth rate reported for this sector in recent years. As economic activity increases, private sector wages will show slightly faster growth patterns compared with previous forecasts. Note that the minimum wage threshold has risen to AMD 55,000 since July of 2015. As a result, the predicted average wage growth for 2015 is nearly 9.4%.

With an expected economic growth, stabilizing inflation rate and the Government policy which is further aimed at minimum wage increases, the average nominal wage is predicted to grow by 7.0% annually in the period 2016-2017.

Despite acceleration in economic activity, the 2015 unemployment forecast remained almost unchanged in comparison with previous forecast because of increased productivity observed in the economy.

Average unemployment rate in 2015 is expected to amount to 18.3%. In view of faster economic growth, a trend of steadily subduing unemployment rate will be observable in 2016-2017. By the second quarter of 2017, the unemployment rate will be above its equilibrium, reflecting a small negative GDP gap and minor deflationary pressures it will generate in the meantime. By the end of the forecast horizon, the unemployment will approach its equilibrium.

Expected productivity growth in 2015 is consistent with an anticipated rise in wages, and in the forecast horizon the labor market's impact on inflation is estimated to be neutral.

Aggregate demand⁸

In view of persisting decline in remittances from Russia, a trend observable since the start of the year, and weak investment activity in the domestic economy, there is anticipation that private sector spending in Armenia will reduce in 2015 by about 2.1%. However, there will be smaller contraction of private spending in 2015 relative to previous forecasts, owing to an expansionary fiscal policy to be implemented during the year and higher economic activity in comparison with previous forecast.

⁷ The labor market data for the second quarter of 2015 are the CBA estimates which are based on the first quarter of 2015 data and actual April-May 2015 figures. The growth indicators presented in this sub-section are relative to the same reference period last year, unless otherwise specified.

⁸ The data of real growth of private consumption and investments for 2015-2017 are the CBA estimates. These actual figures are as of the first quarter 2015 published by the National Statistical Service of Armenia. The real growth indicators represented in this sub-section are relative to the same reference period last year, unless otherwise specified.

A tight monetary policy in late 2014, carried out to maintain price and financial stability, was replaced by considerable easing of monetary conditions since the start of 2015. This will allow to mitigate an expected decline of the level of private spending in 2015.

In the period 2016-2017, the private spending will bounce back, growing at a moderate rate. The negative impact of private spending on economic growth during this period will alleviate owing to persisting effect from expansionary fiscal policy to be implemented in 2015 and a positive contribution from net exports.

Although such a development with private spending will somewhat negatively affect the economic growth, it will however contribute to a long-term equilibrium and stability of the economy in future.

Final consumption expenditures of households will reduce in 2015 by 1.6% in real terms as a result of considerable reduction in remittances from Russia and anticipated slowing of growth rates of credit to the economy.

Weak investment activity existing and anticipated in the economy in 2015 will lead to around 4.0% reduction in private investment.

Estimates suggest that final consumption expenditures of households will reduce in 2015 by 1.6% in real terms resulting from considerable reduction in remittances from Russia and anticipated slowing of growth rates of credit to the economy. However, the shrinkage of private transfers is estimated to be smaller compared to previous forecasts, which is attributable to higher economic activity to be seen in 2015 and to fiscal and monetary stimuli.

The above factors, as well as current and expected sluggishness in investment activity will lead to about 4.0% reduction in private investment in 2015, which is significantly lower compared to previous forecasts.

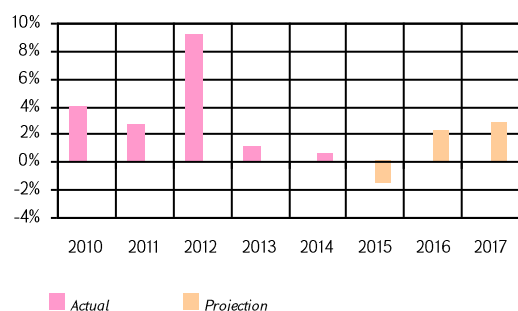
An expected decline in private investment in 2015 will be determined by reduced investment in companies engaged in construction and other non-tradable sectors of the economy, which will outweigh investments in the tradable sector. An expected growth of investments in the tradable sector is due to increased profitability there as a result of the dram exchange rate depreciation in late 2014.

The 2015 expansionary fiscal policy, considerable easing of monetary conditions in the first half of the year will cushion the decline in private consumption and investment in 2015 and even stimulate their growth in 2016-2017. Improving external economic environment and Russia's economic recovery, in particular, may positively contribute to this process. As a result, private consumption is expected to grow in 2016 and 2017 by 2.0% - 2.5% and 2.5% - 3.0%, respectively.

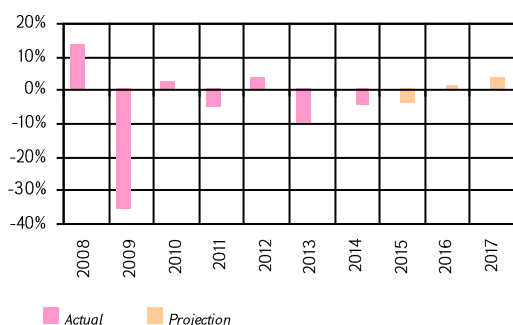
Growth of private investment in 2016-2017 is anticipated within 1.5 - 2.5% and 3.0 - 4.0%, respectively. A moderate growth of investment can be seen owing to expected investment in tradable sector as well as ongoing structural reforms in the Armenian economy. On the back of these developments, investment activity in non-tradable sector is expected to recover in 2016-2017, although rather slowly than it is envisaged in tradable sector.

In view of the aforementioned developments with private consumption and investment, in 2015 private sector expenditures will reduce by 2.1%. Starting from 2016, private spending will gradually recover, growing by 2.0 - 2.5%, and at the end of the forecast horizon it will stabilize within 2.5 - 3.5%. In the outcome, private spending gap for the period 2015 - 2016 is estimated to be still negative despite the

Private consumption growth, y/y



Private investment growth, y/y



fact that the level of private spending rebounds gradually in the forecast horizon.

An expansionary fiscal policy to be implemented in the domestic economy, regular easing of monetary conditions, as well as acceleration of economic growth in Armenia's main trade partners will gradually reduce the negative private spending gap and help these imbalances phase out at the end of the forecast horizon.

From the first quarter of 2015 to the second quarter of 2016, the **private spending will create some 1.6 pp - 1.8 pp of contractionary impact on the inflation**. From the second half of 2016 up to the end of the forecast horizon, the private spending will leave no considerable impact on the inflation.

Current account

The export and import forecasts have been revised on a basis of Armenia's foreign trade figures recalculated by the National Statistical Service of Armenia for January-June. Thus, the first half of 2015 saw high export growth rates in comparison with a decrease in import, in real terms. Given record high growth rates in the first half of the year and positive developments in tradable sector, export growth of goods and services in real terms is predicted in the range of 15.0 - 17.0% for 2015. The operation of Teghout mine, high growth in agriculture and new capacities for exporting agricultural products all will greatly contribute to overall export growth. In 2015, the decline in real import of goods and services will slow down to some extent and stay within a 3.0 - 5.0% range amid accelerating GDP growth. At the same time, car imports are expected to decline considerably this year due to oversupply in that market in recent years. Under such conditions, despite an estimated worsening of terms of trade to a certain extent, there will be significant adjustments to the balance of trade deficit, which will contribute to a significant reduction of the current account deficit.

Although the second quarter saw somewhat slower-than-expected declining rates in money transfers, worsening developments in Russian economy do not allow making revision of the forecasts. Net decrease in the dollar value of remittances of individuals is forecast to be around 25.0% in 2015.

On a basis of these revisions, the Current Account Deficit-to-GDP ratio, which was 7.3%⁹ in 2014, will drop and stay within a 4.0 - 5.0% range in 2015. It is noteworthy that the current account will improve mostly owing to the improvement of the balance of trade, in spite of negative developments with private transfers.

In consideration of a faster current account adjustment primarily resulting from an expansion of tradable sector of the economy and recovery in the rate of remittances, the current account position will continue improving in the medium-term perspective, and the Current Account Deficit-to-GDP ratio will reach a 3.0 - 4.0% range.

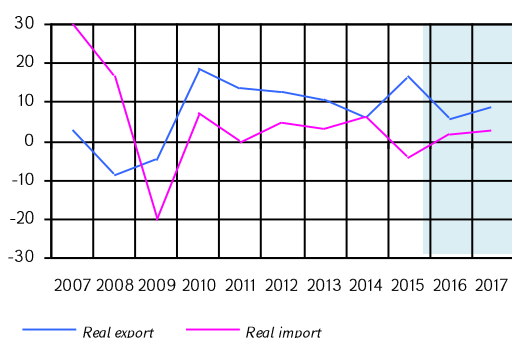
The impact of net external demand is estimated to be 0.1 - 0.2 pp deflationary, which is due to negative GDP gaps in partner countries, particularly Russia. At the same time, high growth of export is

Export growth of goods and services in real terms is predicted to be within 15.0 - 17.0% for 2015.

In 2015, decline in real import of goods and services will slow down to some extent and stay within a 3.0 - 5.0% range.

Net decrease in the dollar value of remittances of individuals is forecast to be roughly 25.0% in 2015.

Real export and real import of goods and services, y/y, %



⁹ The Current Account-to-GDP figures of previous years have been adjusted due to official revisions of export and import of services of current account and of nominal GDP.

demonstrating a trending behavior thanks to Teghout mine operation and new capacities for exporting agricultural products.

The **fiscal policy's impact** on aggregate demand for 2015 has been assessed using the adjusted indicators of the Republic of Armenia Law on State Budget 2015. According to the assessment, the Tax-to-GDP ratio is expected to stay unchanged but the Expenditure-to-GDP ratio to somehow increase in relation to the 2014 indicators, with projected increase of expenditures owing to both current and capital expenditures. As a result, the Deficit-to-GDP ratio in 2015 will be 3.7%, which is higher than the 2.34% figure provided in the law.

In 2015, relative to 2014, the budget revenues are projected to leave a neutral impact and budget expenditures an expansionary impact on aggregate demand. Meanwhile, smaller expansionary effects can be anticipated in the second half of the year unlike the first half, so the estimation of expansionary impact of the fiscal policy on aggregate demand is again in the range of 2 - 2.5 for the year. It is noteworthy that in the second half of the year domestic economic developments will be largely conditional on both a lagged transmission of the fiscal policy's even more expansionary impact in the first half and on how the state budget will be performed in the second half of the year.

The fiscal impulse for 2015 is estimated as expansionary, in the range of 2.0 - 2.5:

Medium-term fiscal policy impact assessment					
% in GDP	2014 ¹⁰	2015	2016	2017	2018
Budget revenues	22.8	24.3	24.6	24.7	24.8
Budget expenditures	24.7	28.0	27.4	26.7	26.5
Debt interest payment	1.3	1.5	1.9	1.9	1.9
Budget balance	-1.9	-3.7	-2.8	-2.0	-1.7
Primary balance*	-0.7	-2.2	-0.9	-0.1	0.1
One-off flows**	-0.6	0.2	-0.7	-0.7	-0.6
Adjusted balance***	-0.1	-2.5	-0.1	0.6	0.7
Cyclical balance****	0.2	-0.2	-0.6	-0.2	-0.1
Cyclically adjusted primary balance (structural balance sheet)	-0.2	-2.2	0.5	0.8	0.8
Fiscal stance*****		2.0	-2.7	-0.3	0.0
* Budget balance less debt interest payments. ** Temporary or one-off budget entries. In this case net lending is considered; the sign "+" means resources allocated and the sign "-" means resources repaid. *** Primary balance sheet adjusted by temporary or one-off entries. **** Central Bank estimate: a part of the budget balance which depends directly on the business cycles. The latter's components depend on the GDP gap and revenues and expenditures elasticity coefficients on GDP gap. ***** Central Bank estimate: y/y change in the structural budget balance that reflects a discretionary nature of the fiscal policy (the positive sign denotes fiscal expansion and the negative sign denotes fiscal contraction).					

The **projections of the fiscal policy in the forecast horizon** are based on underlying macroeconomic indicators in the Republic of Armenia Medium-Term Public Expenditures Program for 2016-2018. **In the medium run** the fiscal policy is steered to reduce the budget deficit in order to achieve a sustainable macroeconomic and debt environment. The fiscal policy's impact is estimated to be contractionary in 2016, neutral in 2017-2018, and generally **non-inflationary** in the medium run.

¹⁰ The 2014 state budget indicators presented here exclude records of off-budgetary funds.

Summary: from the second half of 2015 up to the first half of 2016 the combined impact of the fiscal policy, private demand and labor market on domestic prices will be deflationary, in the range of 0.3 - 0.4 pp, which will be determined by primarily deflationary impact of private spending. Also, given the 0.1 - 0.2 percentage point deflationary impact of net external demand, one may conclude that overall aggregate demand and labor market developments in the above-mentioned period will create an average 0.4 - 0.6 percentage point deflationary pressures in the consumer market.

Starting from the second half of 2016 up until the end of the forecast horizon, the impact of overall aggregate demand and labor market on inflation is estimated to be neutral.

2.3. Inflation forecasts and monetary policy directions in 3-year forecast horizon

In the second quarter of 2015, global economic growth trended at a pace slower than expected. This, coupled with increased supply factors and appreciation of the U.S. dollar, ***has further led to deflationary patterns in basic commodity and food product markets of the world.*** In the meantime, ***commodity markets saw an increase in prices*** as information on the reduction of U.S. oil inventories came in and because of seasonal low demand and expectations for reduced supply in the oil market.

In the forecast horizon, ***global economic growth will continue at a slow pace:*** while trends of improving economic growth will be observable in developed countries, economic growth rates will decelerate in developing countries. In view of geopolitical and domestic economic developments, the Russian economic growth forecast has been revised downside compared to a former one. In particular, a 3.2% economic decline is expected in 2015 (previous forecast: 2.2%), which will continue until end-2016, gradually approaching a 1.3% level in the forecast horizon. ***Risks and uncertainties*** over further development of the global economy ***have become more momentous.*** On the one hand, they are attributable to capital flight to the USA from developing countries in anticipation of interest rate hike by the U.S. Federal Reserve System, which brings in worries of increased investment risks, higher currency volatilities and slowing economic growth there. On the other hand, there are significant risks to how developments will unfold in the Russian economy (continued fall in oil prices and persisting low levels in the forecast horizon, further depreciation of the Russian ruble against the U.S. dollar, as well as extended and tightened economic sanctions). A sharp slowing of Chinese economic growth could also pose risks to the global economic slowdown and the fall in international prices of commodities and food products. Finally, Iran's entry into the oil market can mean a significant risk since prices may fall steeply in the short term and persist at a very low level in the medium term.

With global economy in a sluggish pace and existing excess supply in individual commodity markets, external markets will further see

deflationary patterns in the short run, while a steady low growth is anticipated in the forecast horizon as global demand recovers gradually.

In the second quarter of 2015, economic growth rates in the domestic economy were higher than anticipated due to even more encouraging developments reported in agriculture and, in part, industry. In this case, economic growth in the first half of 2015 is estimated to be ***in the range of 2.7 - 2.9%***, with agriculture and industry as the main drivers.

In the second quarter of 2015, with the Russian ruble appreciating against the US dollar, high declining rates in ***dollar value of net inflow of private remittances and seasonal worker pays decelerated notably***, thus facilitating the contraction of the previous quarter's deep negative gap in real private remittances. However, with lending volumes growing in slow rates and construction activity still sluggish, domestic demand has been fragile during the quarter, as was predicted, reflecting both reduction in private spending and persistently weak investment environment. The slackening of domestic demand was somehow offset as the Government carried out a more expansionary fiscal policy during the quarter while the CBA had taken on a considerable easing of monetary conditions since the start of the year. The quarter saw the foreign demand growing much quicker than expected, reflecting fairly stronger growth of export in real terms amid a decrease in real volumes of import.

The 12-month inflation rate has been at a level which was somewhat higher than anticipated, amounting to 5.5% in late June.

As a result of the above developments, ***the GDP gap is estimated to be less negative in the second quarter compared to a previous forecast***, while ***the 12-month inflation rate*** has been at a level slightly higher than anticipated, reaching ***5.5%*** in late June. It should be noted that lagged effects from exchange rate depreciation observed at the end of the year have phased out in full, and prices of almost all imported food products posted a decline. Furthermore, Armenia's accession to the Eurasian Economic Union since January 1, 2015 was in line with the CBA estimates for the first half of the year, creating just a minor inflationary effect¹¹, without any associated extra inflationary risks in future.

The situation in domestic financial and commodity markets at the end of the year stabilized in the second quarter of 2015 ***after the CBA took action at the start of 2015***. This helped the refinancing rate regain its leading role in the market and made it possible to reduce the spread between the policy rate and short-term market rates. During the quarter, the CBA had its refinancing rate kept at a current level of 10.5% in expectation of stabilizing the 2016 inflation around the target.

Regarding macroeconomic indicators, the CBA revised the 2015 economic growth forecasts upward in consideration of notably loosened monetary conditions and more stimulating fiscal policy implementation in the first half of the year as part of maintaining financial stability, as well as owing to positive developments in agriculture and industry sectors. At the same time, notwithstanding the developments that were even more encouraging during the first half of the year, forecasts for private transfers in dollar value remained unchanged in anticipation of deeper economic downturn in Russia. As a result, ***economic growth in***

¹¹ The Central Bank's Inflation Report, 4th quarter, 2014.

2015 is estimated to be in the range of 2.8 - 3.6%, with agriculture and industry as the main drivers. Influenced by the aforementioned factors, the decline in private spending is predicted to be smaller whereas investment environment will remain sluggish in 2015. This, combined with lagged effects from a more stimulating fiscal policy carried out over the first half of the year and substantial improvement in external demand will lead to a small positive GDP gap.

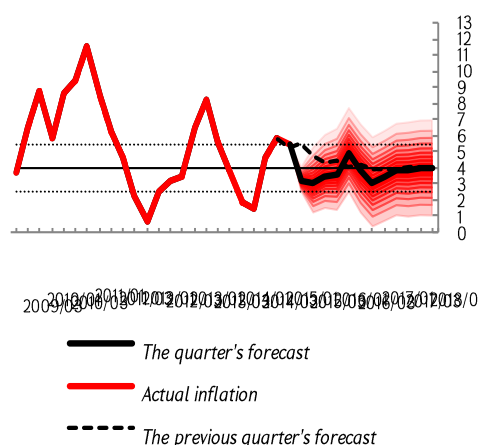
Economic growth in 2015 is estimated to be within a 2.8 - 3.6% range, and agriculture and industry are envisaged as the main driving force.

The 2016 economic growth rates will persist at the previous year's level, which will be determined by a more contractionary fiscal policy implementation instead of an expansionary one carried out in 2015. In the forecast horizon, the growth rates will accelerate owing to gradual recovery of domestic demand, a number of projects the Government plans to carry out in tradable sector, and continued improvement in external economic environment. Influenced by the above developments, the GDP gap will run negative in the first half of 2016 but will, however, adjust to zero in the forecast horizon, as private spending is expected to bounce back and net exports to make a positive contribution. In this case, the anticipation is that **economic growth at the end of the forecast horizon will be within 3.5 - 4.5%**, which will be mostly driven by tradable sector of the economy. It should be noted, however, that economic growth forecasts largely depend on the scale, scope and effectiveness of the Government's projects as well as the developments in external sector.

The 2015 inflationary developments predict low y/y price levels for agricultural products as a result of positive developments in agriculture sector in spite of strong growth rates in export of agricultural products and persisting trends for an upcoming period. A low-inflation environment will in part be offset by the CBA's easing of monetary conditions and more expansionary fiscal policy implementation during the first half of the year. Note, also, that the inflationary effect that was previously expected to generate from electricity price increase since August 1, 2015 is currently out of consideration. However, once actual information on how the mechanism of Government subsidies works and on the results of the audit to be conducted at the "Electric Networks of Armenia" CJSC is available, the CBA will provide estimates of the inflationary effect of this particular change in the next publications. In the meantime, the inflationary effect of possible changes in excise taxes in 2016 has been considered in inflation forecasts. In the light of these developments, the CBA estimates that in the second half of the year the 12-month inflation rate will reduce and stay in the lower bound of the confidence band. In the forecast horizon, the inflation will fluctuate within the confidence band and is expected to stabilize around the target at the end of the horizon.

The CBA estimates that easing of monetary conditions in the third quarter of 2015, combined with monetary conditions already loosened and stimulating fiscal policy implementation since the beginning of the year, will push aggregate demand up and make the inflation rate stabilize around its target in the forecast horizon. In the meantime, risks from domestic and external economies are still persisting. If these materialize, the inflation environment might expand and the CBA would possibly adjust its monetary policy directions in order to fulfil the inflation target in the medium run.

Inflation (12-month) Forecast Probability Distribution Chart for a 3-year horizon



Period	Inflation forecast probability distribution				
	<1.0%	1.0-2.5%	2.5-5.5%	5.5-7.0%	>7.0%
Q3, 2015	0.0%	3.6%	96.1%	0.3%	0.0%
Q4	2.8%	25.4%	67.9%	3.7%	0.2%
Q1, 2016	1.7%	16.2%	71.0%	9.7%	1.3%
Q2	2.3%	15.8%	66.7%	12.4%	2.6%
Q3	0.3%	4.1%	56.3%	27.4%	11.0%
Q4	3.6%	15.4%	63.3%	14.2%	3.3%
Q1, 2017	10.2%	25.3%	56.5%	6.9%	1.1%
Q2	7.1%	20.7%	60.2%	10.0%	1.9%
Q3	4.7%	16.2%	61.3%	14.1%	3.5%
Q4	5.2%	16.4%	60.0%	14.4%	3.9%
Q1, 2018	4.7%	15.4%	59.8%	15.4%	4.4%
Q2	4.8%	15.5%	59.5%	15.5%	4.5%

Risks to inflation deviating from the projected value are estimated primarily **upwards** in both short and medium-term perspectives. **Risks deriving from the external sector** are related to economic outlook in both developed and developing countries. Specifically, an expected rise in interest rates by the U.S. Federal Reserve System could lead to capital outflows from developing countries to the U.S.A. and provoke higher volatilities of currencies in developing countries. More significant are the risks to the future of Russian economic development, as these are attributable to oil prices with their greater-than-expected decline and predicted lower level over the forecast horizon, further depreciation of the Russian ruble against the U.S. dollar, as well as the further course of geopolitical developments. A sharp slowdown in Chinese economic growth could also pose risks to the global economic decline and the fall in international prices of commodities and food products. **Risks deriving from the domestic sector** are mainly associated with the developments in agriculture, a sector greatly depending on weather conditions, the uncertainty of the impact of increasing electricity prices, as well as the pace at which the domestic demand would recover and the Government-led projects unfold. If the aforementioned risks materialize, the CBA will react accordingly by maintaining the inflation target in the medium run.

Predictions for a decline in credit growth rates **remain unchanged in the forecast horizon**. The slowing, as was mentioned in the previous monetary policy program, will be somehow offset by various lending programs under a number of international financial institutions (World Bank, Asian Development Bank, KfW Bank, European Investment Bank) carried out through the Central Bank in cooperation with the Armenian Government, and by low-interest loan projects under a handful of social programs (Housing for Youth, the National Mortgage Company).

In view of maintaining price stability in a longer term perspective, the CBA will react to any shifts in liquidity by using its policy rate, a mechanism of reserve requirement and taking on other macro-prudential measures it will consider appropriate.

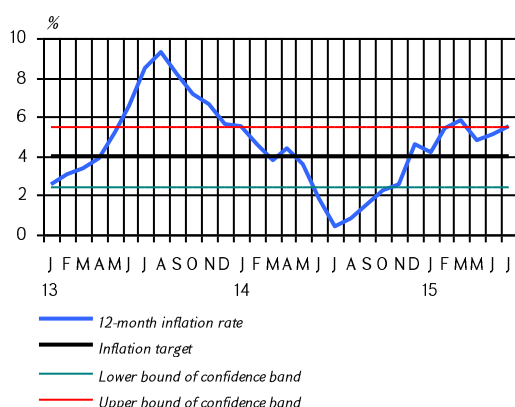
3. Actual Developments in Q2, 2015

3.1. Inflation

3.1.1. Actual inflation and fulfilment of the inflation target

The second quarter of 2015 reported 2.3% deflation, and the 12-month inflation amounted to 5.5% in late June.

Inflation environment in the second quarter of 2015 was somehow moderate



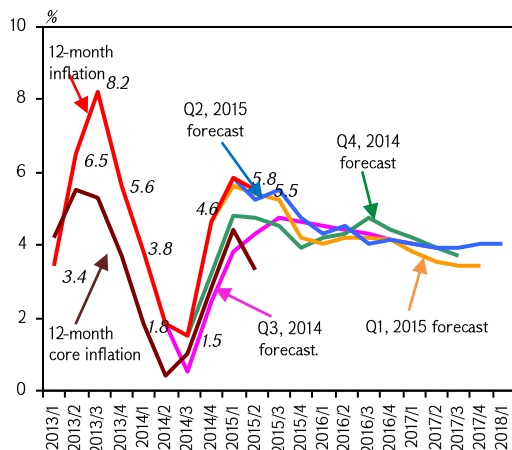
There was a 2.3% deflation recorded in the second quarter of 2015 (2.1% deflation in the same period last year) primarily due to a 5.1% fall in prices of food products (contribution to inflation: -2.5 pp.). Prices of non-food products and services tariffs have increased by 0.5% and 0.3%, respectively, with their total contribution to inflation making up 0.2 pp. Higher than expected price rise in the group “fruit” drove the 12-month inflation rate to be slightly above the predicted level; approaching the upper bound of the confidence band, it amounted to 5.5% in late June.

A decrease in food prices in external markets as well as strong growth in domestic agriculture resulted in deflation in the price structure of food products during the quarter. Almost all groups – “Vegetables and potato”, “Eggs”, “Fats and oils”, “Bread products”, “Dairy products”, “Meat products” and “Sugar” - reported falling prices, with an exception of “Fruits” and “Pastry” which posted 21.7% and 2.0% price increases, respectively.

The 12-month inflation by groups which serve as key contributors						
Group	March 2015 (y/y)		June 2015 (y/y)		Second quarter of 2015	
	Growth (%)	Contribution	Growth (%)	Contribution	Growth (%)	Contribution
CPI	5.8		5.5		-2.3	
Food products	6.8	3.3	5.2	2.5	-5.1	-2.5
Bread products	8.1	0.8	6.2	0.6	-0.7	-0.1
Dairy products	10.8	0.5	4.3	0.2	-3.6	-0.2
Meat products	7.6	0.7	4.1	0.4	-1.9	-0.2
Fruits	21.9	0.7	21.1	0.7	21.7	0.7
Vegetables and potato	-3.2	-0.2	-6.9	-0.4	-40.8	-2.3
Fats and oils	2.7	0.1	-0.9	-0.02	-3.6	-0.1
Egg	2.9	0.05	4.1	0.06	-15.8	-0.2
Sugar	7.7	0.1	3.3	0.03	-5.7	-0.04
Pastry	16.8	0.2	18.2	0.2	2.0	0.03
Non-food products	5.8	1.2	7.0	1.4	0.5	0.1
Services	3.7	1.1	4.1	1.2	0.3	0.1

Non-food price inflation was mainly due to prices in groups “Footwear” and “Medicament” with price growth amounting to 5.6% and 2.7%, respectively. Services reported increased prices of healthcare and long-distance transport fare, by 2.8% and 2.1%, respectively. Fees of recreational services fell by 13.0%.

According to former forecasts of the CBA, the 12-month inflation rate will float in the upper bound of the confidence band until early 2016, and it will stabilize around a 4% target in the rest part of forecast horizon.



In the second quarter of 2015, **core inflation decreased by 0.9%**, in which case the 12-month inflation rate dropped by 1.1 pp to **3.3%** in late June.

For the previous year's short-term horizon that covers a period from **3rd quarter of 2014 up to 3rd quarter of 2015**, the CBA predicted some expansion of the inflation environment owing to **public sector wage increases** since the middle of 2014, **electricity price rise** starting from August 2014 and **introducing of stamps** to a variety of products starting from the fourth quarter. However, because the inflation rate was to persist around the lower bound of the confidence band and no inflationary pressures were expectable from domestic and external economies, **the CBA's intention was to continue easing monetary conditions in the third quarter of 2014** in order to help inflation stabilize around the target in the forecast horizon.

Actual developments showed that the inflation environment was expanding gradually **in the second half of 2014**. This was somewhat higher than expectations determined by escalation in geopolitical issues in the world and, particularly, in the region later the year. In this period of time, **inflation stood at a total of 5.6%** as opposed to **2.8%** recorded in the same period last year, in which case the 12-month inflation had increased to **4.6%** at the end of 2014. Note that nearly 2.0 percentage point increase was recorded in December when the local currency, the dram, incurred a steep depreciation in the foreign exchange market amidst sizable reduction of money transfers from abroad and Russia, a principal trade partner. This event immediately affected the product market while expanding the inflation environment and shaping inflationary expectations.

Given persisting low inflation environment and in anticipation of non-inflationary pressures from the external and domestic sectors in the medium run, the CBA kept on loosening monetary conditions: **in August of 2014** the refinancing rate was lowered by 0.25 pp to **6.75%** and was left at this level by late November.

The CBA responded to the situation intensely: in late November it raised the **Lombard Repo Facility Rate from 8.25 to 21.0%**, followed by a mid-December increase of the **Reserve Requirement Ratio for funds attracted in foreign currency from 12.0 to 24.0%**. Short-term dram market rates reacted to the CBA's tightening of financial conditions in the financial market by rising and staying around the Lombard Repo Facility Rate. This prompted the **Lombard Repo Facility Rate to take the role of financial market's leading interest rate**. In the meantime, to moderate future inflationary pressures and have the inflationary expectations anchored around the target, in late December the CBA raised the Refinancing Rate by 1.75 pp.

Following these actions, the currency and product markets were able to see some signs of stabilization, which is why in late December the CBA lowered the **Reserve Requirement Ratio for funds attracted in foreign currency from 24.0 to 20.0%** and the **Lombard Repo Facility Rate from 21.0 to 20.0%**. A strong response by the CBA at the end of 2014 secured anchoring of inflation expectations **in the first quarter of 2015**, which helped to almost eliminate the tension in the domestic financial and commodity markets. In view of this development, **the CBA loosened monetary conditions considerably**; starting earlier the year the CBA embarked on a phase by phase reduction of **the Lombard Repo Facility Rate from 20% to 12%**.

In the first quarter of 2015, the CBA raised the Refinancing Rate to 10.5% with the aim to retain the monetary position of the Republic of Armenia over a longer run, reflecting upward trends of investment risk and interest rates in developing countries.

These actions not only allowed the CBA to secure the Lombard Repo Facility Rate an accepted 1.5 percentage point spread from the Refinancing Rate but also pushed short-term market rates down.

A zero or weak mechanism of reserve requirement became effective from the first quarter of 2015. This means that the funds borrowed from international financial institutions as well as the 2-year and longer maturity funds borrowed through bonds issued by domestic banks will be subject to reservation at a zero or reduced rate. **Other macro-prudential measures** included mitigating the requirements to resident non-financial corporations and reducing risk weights ascribed to foreign currency loans to borrowers active in export businesses, if they have external credit rating.

In the second quarter of 2015, inflation developments followed mainly a predictable path: there was a 2.3% deflation, in which case the 12-month inflation amounted to **5.5%**, hovering around the upper bound of the confidence band. Although short-term forecasts of the CBA envisaged a lower level of prices of agricultural products against the same reference period last year, which had been attributable to positive developments in agriculture, **the CBA left monetary conditions unchanged in the second quarter,** as the inflationary effect of possible electricity price increase since August would weigh against that development. In case the refinancing rate was to be maintained at its current level, it was reckoned that the 12-month inflation rate would float within the upper bound of the confidence band until the end of the year and stabilize around its target starting from 2016.

3.1.2. Import prices and producer prices

Import prices: in the second quarter of 2015 dollar prices of import of goods and services rose by 3.2% q/q, while declining rates slowed down compared with the same period last year to 13.4% y/y. Overall, an increase in dollar prices of import was due to fairly diminished depreciation pressures of partner countries' currencies. Moreover, in the second quarter the Russian ruble demonstrated appreciation patterns.

The y/y reduction in dollar prices of import was attributable to prices of goods and services having reduced by 10.3 and 3.1 pp, respectively. Also, the y/y decrement in dollar prices of import of goods was driven mainly by a y/y decline in prices of intermediate goods. Of the group of commodities, oil price rose in the second quarter, which, however, is well below the previous year's second quarter level.

The y/y falling in dollar prices of consumer goods was driven by a y/y decrement in dollar prices in the Eurozone, Russia and Turkey. As a result, consumer goods made a 2.8 pp of negative contribution.

Producer prices:¹² in the first half of 2015, all sectors of the economy, with an exception of agriculture, posted increased price

In the second quarter of 2015 dollar prices of import of goods and services declined at a slower pace, (y/y, %)



¹² The price index change as of January-June 2015 is relative to the same reference period last year, unless otherwise specified.

indices. As a result, the growth of GDP deflator in the period January-June has been nearly 3.0%, according to the CBA estimates.

Industry reported price increases of 2.3% y/y over the first half of the year, mainly owing to growths in processing industry (4.8%) and energy and gas production and distribution (6.0%). At the same time, the mining sector saw a 10.4% deflation due to a decline in international prices of mining produce.

Agriculture reported as much as 27.5% y/y reduction in prices¹³ owing to a 61.6% y/y decline in prices in plant growing. In the same period, prices have dropped slightly in animal breeding, by 0.3% y/y.

The price fall in plant growing has been largely driven by decreased prices of fruits and berries (78.9%), potato and gourds and melons (3.0%), and grain (8.8%).

Construction saw a 7.0% y/y price growth in the first half of the year, determined by increased costs in construction works (5.8%), equipment & materials (4.0%) and other expenses (16.5%). Note that the inflation on other expenses is primarily due to a wage growth.

Carriage posted a 2.3% y/y rise in tariffs in the first half of the year, owing to increased fare for railroad transport (12.2%) and truck transportation (1.2%). Note that higher railroad fare is mainly attributable to the energy prices having risen since August 1, 2014.

3.1.3. Inflation and interest rate expectations

The CBA's second quarter 2015 survey on financial sector and household expectations of selected macroeconomic indicators suggests that inflationary expectations for an upcoming one-year horizon remained almost unchanged. Thus, most banks had their expectations of the 12-month inflation rate anchored around the 4.7% level against the 4.8% indicator reported in the previous survey; credit organizations' expectations have averaged 5.8% instead of the previous indicator of 6.0% and households had their expectations around 4.0%.

Expectations of interest rates in the financial market for a one-year horizon remain much the same - a certain rise in interest rates of dram deposits and a downward path for interest rates of foreign currency deposits. In the upcoming one-year horizon, interest rates of dram and foreign currency funds allocated by the financial sector are likely to behave stably.

3.2. Aggregate supply and aggregate demand

3.2.1. Aggregate supply¹⁴

The **economic growth indicator** for the first quarter of 2015 was 2.2% y/y, according to the National Statistical Service of Armenia (previous economic growth forecasts by the CBA: 2.3%).

¹³ Sales prices of producers of agricultural product are presented.

¹⁴ The indicators of real growth of value added in sectors of the economy for January-June 2015 y/y are the CBA forecasts whereas the indicators of sub-sectors represent y/y growth rates in output volumes for January-March 2015, unless otherwise specified.

Economic activity indicator in the first half of 2015 was 4.2% y/y.

Economic growth in the first half of 2015 is estimated within a 2.7-2.9% range.

In the first half of 2015, the economic activity indicator was 4.2% y/y, which exceeded expectations as a result of higher-than anticipated output growth in agriculture and industry sectors.

In the first half of 2015, the economic growth is estimated within a 2.7 - 2.9% range¹⁵.

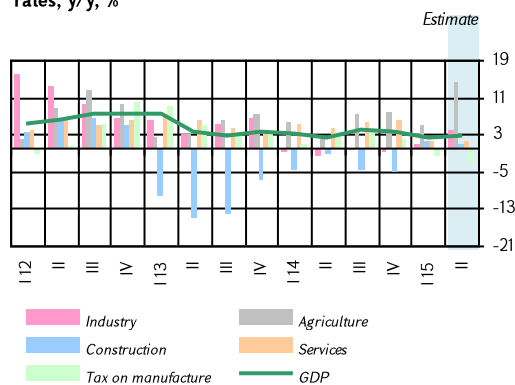
Given an increased output of 5.1% y/y reported in **Industry** in the first half of 2015, the growth of value added is estimated in the range of 3.4 - 4.2% y/y for the first half of the year. This is mainly due to increased production in ore mining (35.5%), metallurgy (6.9%), tobacco production (45.9%), pharmaceuticals (35.4%), chemical products (10.2%) and water supply (9.6%) during the first six months of the year. High growth in ore mining is determined by the start of Teghout mine operation. Notwithstanding growth recorded in the above sectors, a sluggish domestic demand in Russia, a principal trade partner, and the economy of Armenia led to a decline in industrial output in several fields over the first half of the year. In particular, production of food and clothing posted a decrease of 7.7% and 3.4%, respectively, while production of beverage reported a 17.9% decline.

Based on an actually increased output of 0.6% y/y recorded in **Construction** for the period January-June 2015, the growth of value added is estimated within 0.8-1.2% y/y for the same period. Exclusive of reduced volumes of construction financed by organizations (0.6%) and local community budgets (74.9%), all other sources of construction financing posted growths as follows: state budget (4.1%), international credit (7.1%) and households (15%).

In **Services**, the growth of value added in the first half of 2015 is estimated in the range of 1.0 - 1.6%, which is determined by a 3.3% growth in services provided but a 5.1% drop in trade turnover during the same period. Note that the increase in the volume of services provided was driven largely by growth reported in banking services (9.7%), events, leisure and rest (72.9%), information technologies (14.4%), and hotel and accommodation (7.8%). Domestic demand declined as a result of diminishing transfers in the first half of the year affected trade turnover which, in turn, led to reduced output in transport sector. The decline in trade was attributable to the turnover in retail, wholesale and passenger car trade having reduced by 6.4%, 5.1% and 16.1%, respectively. Thus, in January-June 2015 the retail and wholesale trade and motor vehicle trade turnover has decreased by 6.7%, 2.4% and 6.0% respectively, while the decline in transport amounted to 26.4%.

In **Agriculture**, the growth of value added for the first half of 2015 is estimated in the range of 13.7 - 14.5%, which is driven by increased outputs in animal breeding, plant growing and fishing by 4.5%, 38.7% and 29.6%, respectively.

Actual real GDP and economic sector cumulative growth rates, y/y, %

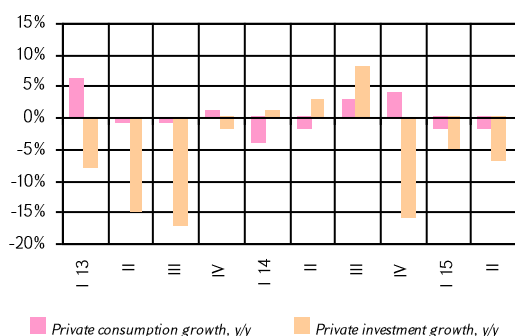


¹⁵ See the 50% range in Real GDP Growth (Cumulative) Projection Probability Distribution Chart.

Reduction in private spending was in line with previous forecasts; it amounted roughly to 2.0%.

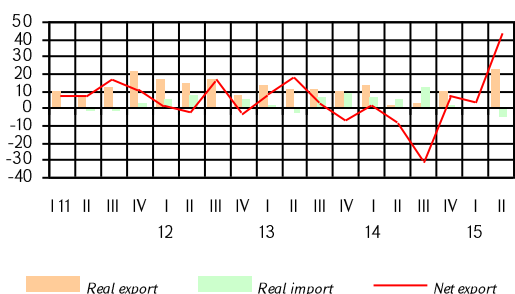
Decline in private investment in the second quarter of 2015 reaches an estimated 7.0% compared to the same reference period last year.

Private consumption and investment growth, y/y



Negative balance of net export contracted considerably in the second quarter of 2015

(net real export, y/y, %, positive sign denotes improvement)



In the second quarter of 2015, growth rates of real export of goods and services reached 22.7% y/y amid a 5.9% y/y decline in real import of goods and services.

3.2.2. Aggregate demand¹⁶

In the second quarter of 2015, reduction in private spending was in line with previous forecasts; it amounted roughly to 2.0%.

Reduced private remittances from Russia have notably diminished the households' disposable income, which, in turn, led to the shrinkage of private spending during the first and second quarters of 2015. It should be noted that expansionary fiscal policy carried out by the Government and easing of monetary conditions by the CBA served a substantial cushion against declining private spending in the economy.

The results of the CBA surveys¹⁷ as well as trade turnover indices, calculated by the National Statistical Service of Armenia, also point to the contracted private consumption. Thus, in the second quarter of 2015 the Consumer Confidence Index was 41.2, which is below its stability range of 45 – 55, reflecting a declined consumer spending in the period under review. In the second quarter, compared to the same reference period last year, trade turnover has shrunk by 6.1%, with a reported decline in wholesale and retail trade as well as motor vehicle trade.

In the second quarter of 2015, the investment climate in the economy was weak – in line with anticipation – with an estimated 7.0% decline in private investment in relation to the same reference period last year. The decline was determined by slow-moving activity in construction, slower growth rates in company lending and a sluggish business environment in general in the period under review.

The results of the CBA's investment survey on Armenian companies point to the decline in investment in the period under review. Thus, only 20% of the companies surveyed invested during the second quarter, which is 4 pp smaller than the indicator reported in the same reference period last year.

With private consumption and investment developments described above, private spending shrank by 2.5% in the second quarter. With public expenditures having increased by around 15%, the domestic demand is estimated to have posted a 1% decline in the period under review, which is smaller in comparison with private spending.

In the light of the aforementioned developments, private spending gap in the second quarter of 2015 is estimated to be negative, as it left **0.9 - 1.1 pp of contractionary impact** on inflation.

According to the CBA estimates, a negative balance of net real export narrowed considerably in the second quarter of 2015. This was due to high real growth in export of goods and services in the face of a real decline in import of goods and services. Thus, growth rates in real export of goods and services¹⁸ amounted to 22.7% y/y amid a 5.9% decline in real volumes of import of goods and services.

¹⁶ The private spending, private consumption and private investment indicators for the second quarter of 2015 are the CBA estimates which are based on the first quarter of 2015 data. The growth estimates provided in this sub-section are relative to the same reference period last year, unless otherwise specified.

¹⁷ <https://www.cba.am/am/SitePages/statsscci.aspx>

¹⁸ Real export and import growth indicators are the CBA estimates.

In the second quarter of 2015, declining rates in net inflow of non-commercial remittances of individuals via the banking system slowed down remarkably against the previous quarter. This was attributable to the Russian ruble which appreciated versus the U.S. dollar in the second quarter of 2015. As a result, in the period under review net inflow of non-commercial remittances of individuals has shrunk by 28.0% y/y.

3.2.3. Labor market¹⁹

In the second quarter of 2015, the **average nominal wage growth rate** was slightly higher relative to former forecasts of the CBA, standing at 11.1%. In the period under review, growth rate in wages of public sector has been slightly faster than wage growth in the private sector.

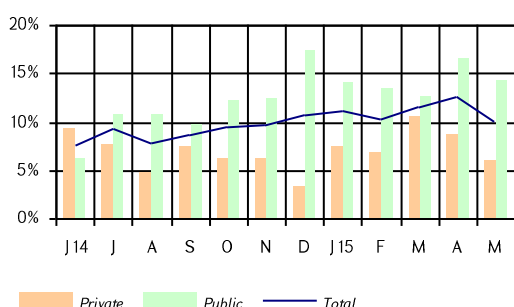
Over the second half of 2014 and the first half of 2015, wage growth in public sector has been higher than average growth rates in recent years after wage increases in some areas of public sector since July of 2014. As a result, the average annual wage growth in public sector in the second quarter of 2015 was 13.7%.

In the second quarter of 2015, the average nominal wage growth rate in private sector somewhat slowed down to 7.3%. The slowing owed to wage increases at private sector firms during the second quarter last year in connection with introduction of a funded pension contributions scheme. Note that over the same reference period of 2014, the average private sector wage had risen by 9.2%.

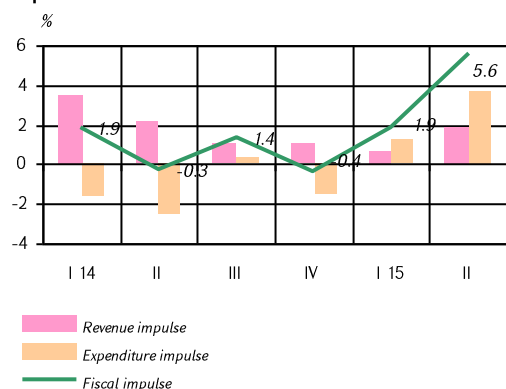
There was a productivity growth reported in the first quarter of 2015 which resulted in reduced labor demand in the economy. Therefore, in spite of accelerated economic activity, the productivity growth facilitated the **unemployment rate** to be consistent with previous forecasts and is an estimated 18.4% in the second quarter of 2015.

In the period under review, the productivity growth has been quicker than the wage growth. As a result, the labor market's impact on inflation in the second quarter of 2015 is estimated as 0.13 pp deflationary.

Nominal wage growth, y/y



Expansionary impact of fiscal policy in the second quarter of 2015 owed primarily to expansionary effect of expenditures.



3.2.4. Fiscal policy²⁰

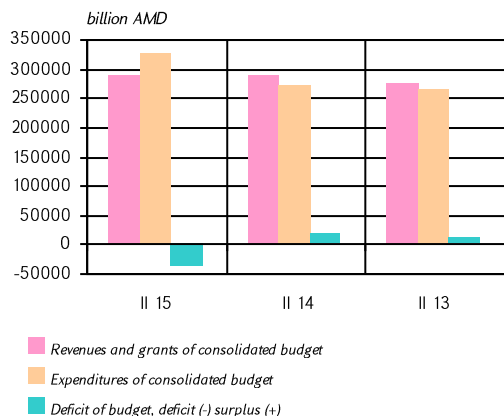
In the second quarter of 2015, Armenia's state budget performed with under-collected revenues and some saving on certain expenditure items. Although revenues were not consistent with the CBA projections either, expenditures were performed proportionately. In the second

¹⁹ The labor market data for the second quarter of 2015 are the CBA estimates which are based on the first quarter of 2015 data and actual April-May 2015 figures. The growth indicators provided in this sub-section are relative to the same reference period last year, unless otherwise specified.

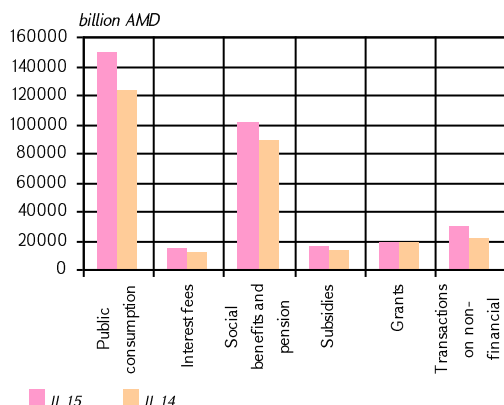
²⁰ The review of the fiscal sector was done using the preliminary actual consolidated budget indicators prepared on the basis of the preliminary actual indicators of the second quarter of 2015 (PIU funds included), excluding off-budgetary funds. The impact of revenues was calculated in respect of the nominal GDP indicator while the impact of expenditures, in respect of an estimated economic potential.

In the second quarter of 2015, the fiscal sector's impact on aggregate demand was 5.6 expansionary instead of an expected 5.0, according to a fiscal impulse indicator.

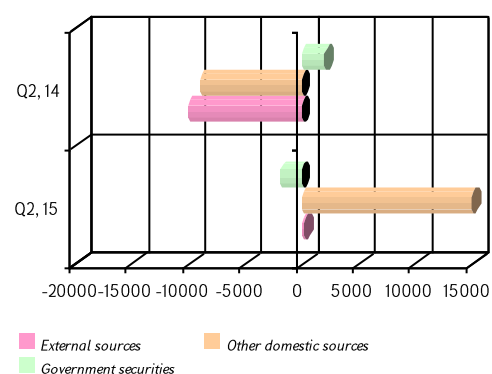
Consolidated budget indicators' dynamics



In the second quarter of 2015, state budget expenditures posted increases on all expenditure items



In the second quarter of 2015, the deficit was financed from domestic sources, specifically the Government's funds with the CBA (billion AMD)



quarter of 2015, the fiscal sector's impact on aggregate demand was 5.6 expansionary instead of an expected 5.0, according to a fiscal impulse indicator. The deviation was mainly due to the revenue impulse, as the actual impulse amounted to 1.9 expansionary instead of 0.7 expansionary that was anticipated after under-collected revenues.

In the second quarter of 2015, relative to the same reference period last year, revenues of consolidated budget have reduced by 0.3%. Meanwhile, tax revenues have decreased by 2.9% y/y. The actual taxes collected during the quarter were AMD 24.1 billion less than adjusted quarterly proportions²¹ and AMD 13.1 billion less than the CBA projections. This is why the revenue impulse totaled 1.9 expansionary instead of projected 0.7 expansionary.

Driven by weakened domestic demand and reduced imports, indirect taxes have decreased by 9.8% in relation to the second quarter of 2014. A direct tax decrease for the same period of time amounted to 0.6%. As a result, the share of indirect taxes in total taxes and duties has shrunk by 3.5 pp to 45.8%. The share of direct taxes has increased by 1 pp to 44.1% and the share of other taxes by 2.5 pp to 9.98%. Other revenues have grown by nearly 53%, outstripping the second quarter's projected figure.

Government spending was slightly lower from the projected figure adjusted for the quarter, making up 97.1% of the projection. Second quarter's expenditures were in line with the CBA projection. There has been roughly 19% increase in consolidated budget expenditures relative to the same reference period last year. Current expenditures have grown by 17.2%; note that the growth has been reported with regard to all items. **Public consumption** has increased by 21.1% compared to the same reference period last year. Expenditures through the item "transactions with non-financial assets" have grown by 44.3% owing to more foreign-funded projects on the one hand and expenditures financed from domestic sources on the other.

With revenues and expenditures figures shown above, the state budget reported a deficit of AMD 36.4 billion for the second quarter of 2015.

On the back of economic activity that was slowed down in relation to the economic growth outlined in the Law on State Budget 2015, the first half of 2015 reported tax revenues underperformed against adjusted projections by almost as much as AMD 23.2 billion. Compared to the same reference period last year, tax revenues have grown by 0.3%. Government spending (including PIU funds) has increased by 15.0% over the same reference period last year.

On a basis of the first six months' results, the state budget ran an AMD 58.1 billion deficit instead of AMD 73.6 billion as was outlined in a projection adjusted for that period of time.

Overall, the fiscal policy's impact on aggregate demand over the first half of the year has been 3.9 expansionary, with expenditures and revenues having generated, respectively, 2.7 and 1.3 expansionary effects.

²¹ The Law on State Budget 2014 has been adjusted on a basis of Government decrees (<https://www.e-gov.am/gov-decrees/>).

Summary: reduced private transfers from Russia as well as sluggish investment activity in the domestic economy cut private spending down in the first half of 2015. However, the contraction of expenditures in private sector has diminished owing to lagged impact of the expansionary monetary and fiscal policies implemented in the course of 2014 and, particularly, new fiscal and monetary stimuli provided to the domestic economy during the first half of 2015, which, in turn, mitigated the domestic economic slowdown and deflationary environment.

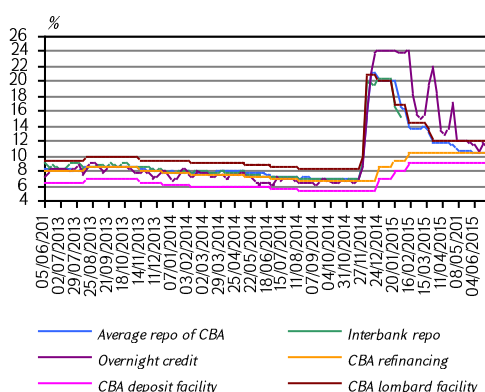
In the second quarter of 2015, private spending gap is estimated to be negative. Given also the behavior of the labor market and public expenditures, it is estimated that the above factors combined created 0.4 - 0.5 pp of deflationary pressures in the consumer market in the second quarter

3.3. Money and financial market developments

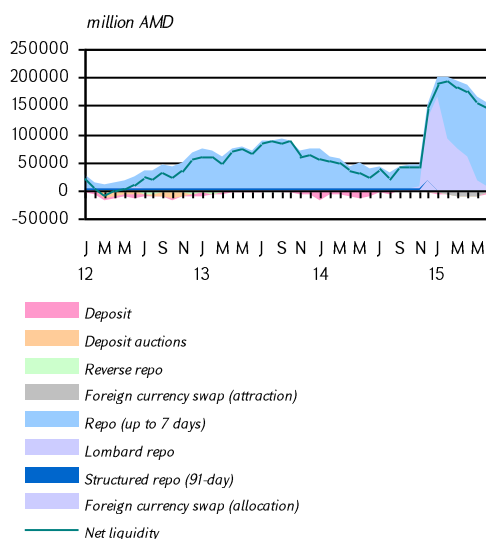
3.3.1. Financial market, money and credit

The CBA action taken on in early 2015 stabilized the financial market in the second quarter of the year as the refinancing rate regained its leading role in the market.

During the quarter, short-term interest rates came in around the CBA's repo rate



Operations carried out by the CBA



Following the CBA's measures taken on in early 2015, the financial market stabilized in the second quarter of the year as the refinancing rate regained its leading role in the market. Board of the CBA kept the refinancing rate at its current level of 10.5% during the quarter, expecting that this would facilitate the 12-month inflation rate to stabilize around the target by the end of the year.

To restore the refinancing rate's leading role in the market, more liquidity was provided through a 7-day repo rate, the main policy instrument of the CBA (that is, liquidity provided through lombard repo facility in exchange of repo agreements) during the second quarter of 2015. This helped the main policy rate come closer to the refinancing rate. As a result, average repo rate in June amounted to 10.55%, having dropped by 2.61 pp relative to March.

Pursuing an increased effectiveness of liquidity management, the CBA again referred to the reserve requirement mechanism: in late June it took a decision that proposed a new approach to keeping reserves for funds against foreign currency attracted by banks. According to the new approach, provisioning against foreign currency on a daily basis will, effective from July 2015, move to an average weekly basis.

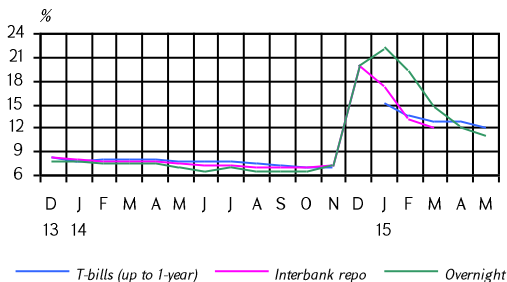
Operations carried out by the Central Bank (average value)						
Period	Repo (up to 7 days)		Funds attracted		Lombard repo	
	Value (million AMD)	Weighted average %	Value (million AMD)	Weighted average %	Value (million AMD)	Weighted average %
Q1, 2013	63652.16	8.09	2518.46	6.50	14.53	9.50
Q2	71467.51	8.19	2712.31	6.50	45.74	9.50
Q3	86238.94	8.42	2712.31	6.75	20.30	9.50
Q4	76070.53	8.31	6035.38	6.71	7.69	10.0
Q1, 2014	58769.52	7.80	8230.77	6.17	297.76	9.05
Q2	41619.24	7.79	9908.46	5.88	41.38	8.75
Q3	37331.05	7.16	3270.00	5.47	16.08	8.43
Q4	34048.94	10.60	1765.67	5.25	41550.14	19.69
Q1, 2015	95454.55	14.25	63.75	8.04	104521.49	16.27
Q2	141919.97	11.02	1857.26	9.00	27967.60	12.00

In the second quarter of 2015, short-term interest rates trended downward as interest rate of the main policy instrument of the CBA fell.

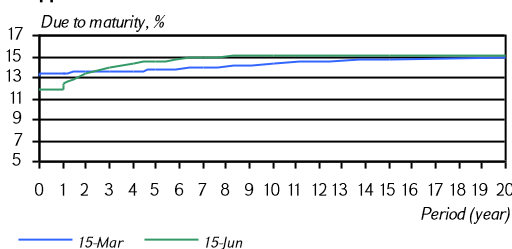
In the financial market in the second quarter of 2015, short-term interest rates trended downward as the policy rate of the CBA decreased. Interest rate of overnight credit reached 11.02% in June after an 8.25 percentage point plunge against March, coming closer to the CBA policy rate. The volume of transactions in the interbank repo market during the quarter has been small, however developments in interbank repo market transactions this quarter and the previous one have been consistent with the CBA's policy: average monthly decline of the interest rate in June against March has been 2.44 pp.

Short-term interest rate dynamics in the second quarter

Box 2



In the T-bills market in the second quarter, interest rates dropped



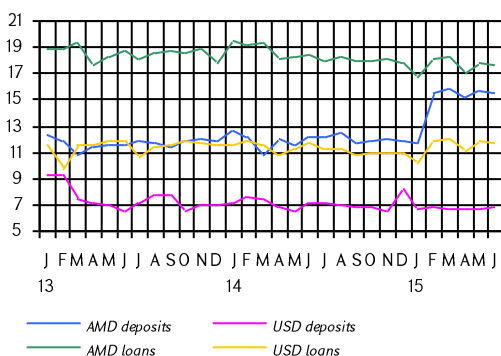
Government securities market

The second quarter of 2015 marked a decrease in interest rates in the government securities market, too. Although yields on short-term bonds were somewhat above the CBA policy rate, the decrease in June has been 1.5 pp relative to March.

The average quarterly yield on short-term T-bills has fallen by 2.1 pp to 12.6% in relation to the previous quarter, whereas the yield on mid-term notes and long-term bonds remained almost unchanged.

A stabilizing financial market, downsizing of market participants' exposure to risks were reflected in a yield curve for government securities primarily through reduced yields in a short-term segment and an up-sloping curve. In late June, compared to March, the yield curve has increased slightly the entire length: the long-term rate reached 15.2%, a 0.3 percentage point increase against March, whereas the long-term and short-term interest rates spread widened in June by 1.7 pp to 3.3 pp.

Interest rates of funds in local currency and foreign currency



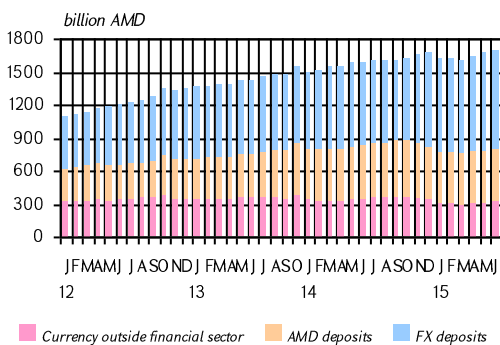
Though tensions in the financial market have eased and the market stabilized, interest rates of deposits and loans were slightly lower during the previous quarter amid current uncertainties and strong demand for dram liquidity in the banking sector.

The decline in short-term interest rates in the second quarter of 2015 was most prominent for dram deposits and loans. Although 1.1 percentage point higher from the first quarter's level, the average interest rate of dram deposits was 15.5% in June, having posted a 0.4 percentage point drop against March. Interest rates of loan facilities have fallen on a quarterly and end-period basis. In the second quarter, compared to the previous one, the average interest rate of dram loans has dipped by 0.1 pp and the average monthly interest rate, by 0.5 pp to 17.7% in June.

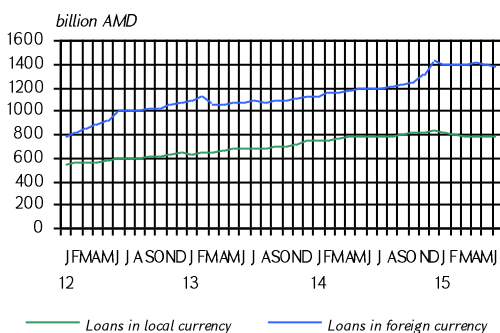
High interest rates of funds attracted during the first quarter of 2015 affected the volume of funds attracted during the second quarter as deposits in dram grew by 3.3%.

The easing of reserve requirement mechanism for long-term foreign currency funds, effective from March 1, 2015, which implies reduced costs in attracting these funds, resulted in a small increase in interest rates of foreign currency deposits in the second quarter of 2015. In June, average interest rate of foreign currency deposits rose by 0.2 pp

In the second quarter, deposits in both foreign currency and local currency grew

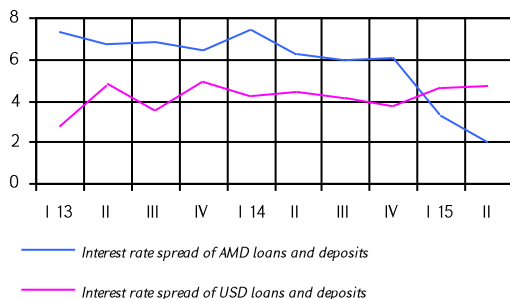


In the second quarter, foreign currency loans again outnumbered local currency loans



The second quarter 2015 dollarization indicator subdued by 0.18% against the relevant indicator reported in previous quarter.

In the second quarter, the spread of interest rates of dram loans and deposits narrowed



to 6.9%, while average quarterly rate remained unchanged, 6.8%, in which case the volume of foreign currency deposits expanded by 4.4%.

In June, relative to March, average monthly interest rates of foreign currency loans have fallen by 0.3 pp to 11.7%, owing primarily to the loans with more than 1-year maturity.

One may conclude that the decline in short-term rates in the financial market and, in part, easing of reserve requirement mechanism for long-term foreign currency funds have pushed interest rates of both local and foreign currency loans down during the second quarter. Overall, in June 2015, compared to the same period last year, the credit growth has been 9.9%.

Box 3

According to Survey on Terms of Lending by Armenian Banks and Credit Organizations for the second quarter of 2015, though the terms and conditions for business and mortgage lending continued to be tight, the tightening of the terms and conditions for consumer credit came at a slower pace during the quarter.

Commercial banks reviewed their risk management policies during the quarter, and this means that easing of lending procedures thus an increased demand for all types of loan products might be anticipated in the third quarter of 2015.

The spread of interest rates of loans and deposits in local currency kept on narrowing during the second quarter of 2015: the average quarterly indicator has reduced by 1.2 pp compared to the previous quarter to 2.1 pp this quarter. The spread of interest rates of loans and deposits in foreign currency has been much the same in relation to the previous quarter.

In the second quarter of 2015, the indicator of dollarization (the Foreign Currency Deposits-to-Broad Money ratio) dropped by 0.18 pp against previous quarter.

Monetary indicators	June 14, 12-month growth	September 14, 12-month growth	December 14, 12-month growth	March 15, 12-month growth	June 15, 12-month growth
Broad money (%)	14.8	9.6	8.3	4.1	6.3
Dram broad money (%)	14.3	14.2	-3.5	-4.4	-4.2
Base money (%)	8.2	-0.5	-0.2	1.6	14.7
Dram base money (%)	4.5	0.6	15.5	19.6	19.6
Currency (%)	-1.2	1.4	-9.4	-9.8	-6.7
Deposits in local currency (%)	28.6	25.3	1.8	-0.5	-2.5
Deposits in foreign currency (%)	15.4	4.7	22.7	13.0	17.9
Dollarization (percentage point)	0.2	-2.2	6.0	4.2	5.2
Money multiplier (percentage point)	0.1	0.2	0.2	0.0	-0.2
Dram multiplier (percentage point)	0.1	0.2	-0.2	-0.3	-0.3

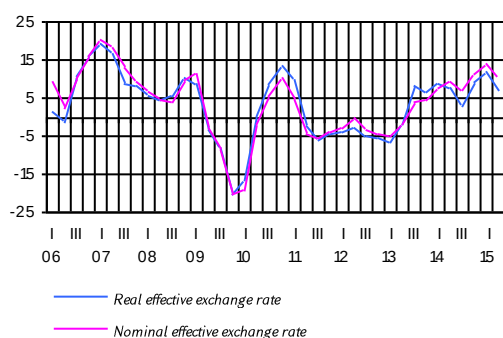
3.3.2. Exchange rate

High depreciation pressures seen in currency markets of partner countries in the previous quarter almost eliminated in the second quarter of 2015. Moreover, the Russian ruble tended to appreciate in the second quarter, making as much as 3.7 pp of impact on quarter-to-quarter appreciation of nominal exchange rates' weighted basket in partner countries. Considerable slowing of the pace with which euro and Ukrainian currency depreciated against the U.S. dollar is noteworthy either. As a result, high depreciation of average nominal exchange rate in partner countries last quarter has turned into quarter-to-quarter appreciation of 1.8% in the second quarter of 2015. With a basket of currencies appreciating in partner countries, the dram's average nominal exchange rate also followed an appreciation path during the second quarter (by 0.2% q/q) in the aftermath of achieved external equilibrium. In the meantime, the CBA has purchased dollars in the amount of nearly USD 25.0 million in the currency market, in order to absorb any short-term volatilities in the foreign exchange market.

Driven by higher appreciation of a currency basket in partner countries, the nominal effective exchange rate of the Armenian dram posted 1.6% q/q depreciation in the second quarter. The real effective exchange rate depreciation²² was 5.9% q/q, which, in addition to the nominal effective exchange rate developments, has been attributable to high weighted inflation in partner countries, in comparison with inflation in Armenia. Note that Ukraine and Russia saw high inflation during the second quarter.

Real effective exchange rate's y/y high appreciation rates in the previous quarter slowed down markedly this quarter to 6.7% y/y. It still incurs the effect of the events taken place in late 2014.

In the second quarter, y/y appreciation of real effective exchange rate slowed down notably (%)



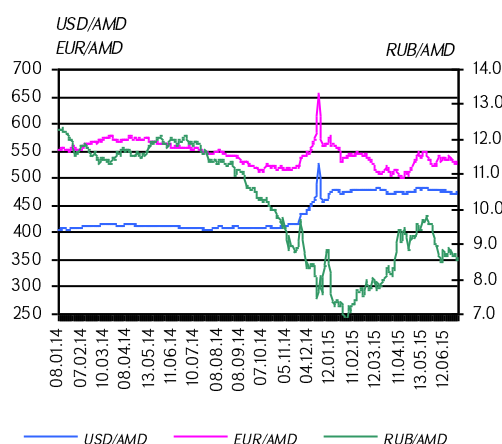
Growth y/y, (%)	Q1, 2013	Q2	Q3	Q4	Q1, 2014	Q2	Q3	Q4	Q1, 2015	Q2
Real effective exchange rate (+ means appreciation)	-6.4	-1.6	7.9	6.8	8.5	7.8	3.1	9.2	11.7	6.7
Average inflation in Armenia	3.0	5.2	8.7	6.4	4.6	3.3	1.0	3.2	5.2	5.1
AMD/USD average nominal exchange rate (+ means appreciation)	-5.1	-3.3	0.5	0.2	-0.4	0.5	0.0	-5.7	-13.9	-13.4
Average weighted inflation in trade partner countries	4.5	4.4	4.3	4.0	3.7	4.4	4.6	5.1	6.7	7.9
Trade partners' average weighted nominal exchange rate (+ means appreciation versus dollar)	-0.4	-1.1	-3.2	-4.3	-8.0	-8.6	-7.0	-18.5	-32.1	-27.2

Real exchange rate appreciation = Inflation in Armenia + Nominal exchange rate appreciation – Trade partners' average weighted inflation – Trade partners' average nominal weighted exchange rate appreciation.

²² The second quarter 2015 indicator of the real exchange rate is the CBA estimate.

Foreign exchange market

Armenian dram exchange rate versus US dollar, Euro and Russian ruble over a year



As of end of the second quarter of 2015, the average market exchange rate of AMD/USD was 472.53, having depreciated by 0.3% relative to the end of previous quarter.

Armenian dram's behavior versus the U.S. dollar, Euro and Russian ruble during the 1st quarter of 2015

Armenian dram's exchange rate movement q/q, Q2, 2015			
Currency pair	Exchange rate as of 31.03.2015 (AMD)	Exchange rate as of 30.06.2015 (AMD)	% (appreciation "+", depreciation "-")
USD/AMD	471.13	472.53	-0.30
EUR/AMD	505.29	528.48	-4.39
RUB/AMD	8.13	8.51	-4.47

Armenian dram's average exchange rate, y/y, Q2, 2015			
Currency pair	Average exchange rate, Q2, 2014	Average exchange rate, Q2, 2015	% (appreciation "+", depreciation "-")
USD/AMD	412.84	476.48	-13.36
EUR/AMD	566.05	526.80	7.45
RUB/AMD	11.81	9.08	30.07

The aggregate volume of U.S. dollar/Armenian dram transactions in the foreign exchange market in the second quarter of 2015 amounted to USD 2.34 billion, which represents a 17.89% decrease in relation to USD 2.85 billion reported in the same reference period last year.

The aggregate volume of Euro/Armenian dram transactions carried out during the quarter reached EUR 226.74 million, up by 0.11% against EUR 223.98 million recorded in the second quarter of 2014.

The aggregate volume of Russian ruble/Armenian dram transactions in the second quarter of 2015 totaled RUB 13.11 billion, which represents a 14.30% increase compared to RUB 11.47 billion recorded in the second quarter of 2014.

3.4. Balance of payments²³

Considerable reduction in deficit of trade balance²⁴ was an important development in the second quarter of 2015. The downsizing of the deficit owed to high growth in export amid shrinking import. High decline rates in remittances by individuals slowed down mainly attributable to the Russian ruble that appreciated against the U.S. dollar during the second quarter.

²³ The second quarter 2015 indicators are the CBA's forecasts and estimates. The BoP historical figures have been revised by the CBA. The main revisions relate to the export of services and import of services.

²⁴ The National Statistical Service of Armenia has recalculated Armenia's foreign trade figures for January-June on a basis of preliminary indicators relating to mutual trade between the countries of the Eurasian Economic Union, collected by customs authorities.

As a result, despite the decline in remittances by individuals, the current account deficit contracted notably during the second quarter, compared to the same reference period last year. Foreign direct investment has been the main contributor to the financing of current account deficit. As a result of the balance of payments developments, the CBA's net foreign assets have increased.

3.4.1. Current account

In the second quarter of 2015, relative to the same reference period last year, the Current Account Deficit-to-GDP ratio has reduced by 2.4 pp, according to estimates. In the second quarter of 2015, relative to the same reference period last year, the current account deficit has decreased by USD 111.0 million to USD 55.5 million.

In the period under review, export of goods has grown by 12.5% y/y but import of goods has reduced by 24.0% y/y.

The second quarter of 2015 reported a positive balance of services, amounting to USD 9.5 million. This was mainly attributable to a well-reduced negative balance of transport services. As a result, the quarter saw an estimated 0.4% y/y increase in export of services and 5.8% y/y decrease in import of services.

In the second quarter of 2015, relative to the same reference period last year, the declining rates in remittances by individuals have considerably decelerated²⁵ which was determined by appreciation of the Russian ruble versus the U.S. dollar in the light of economic developments in Russia. Net inflow of funds through item "Compensation of employees" posted a 27.9% y/y decrease to USD 162.6 million, which outgrew the figure of net outflow through item "Income on investment". As a result, item "Primary income" posted net inflow of USD 28.8 million. Net inflow of private transfers has reduced by 27.8% y/y to USD 116.1 million.

3.4.2. Capital and financial account²⁶

The second quarter of 2015 reported net inflow of funds amounting to USD 96.0 million through the Capital and Financial Account as opposed to the previous year's net outflow of USD 7.2 million. The current account deficit has been financed largely by foreign direct investment. As a result of the balance of payment developments, net foreign assets of the CBA have grown by USD 40.5 million.

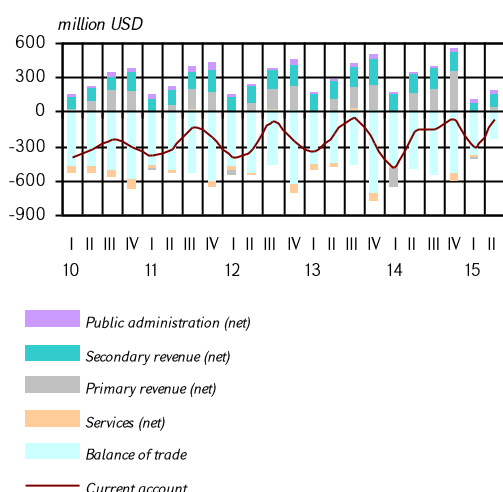
In the second quarter of 2015, capital transfers amounted to USD 13.2 million as compared to USD 23.5 million recorded in the second quarter of 2014.

The net inflow of foreign direct investments this quarter amounted to USD 98.9 million. There has been a USD 14.2 million-worth net inflow of public credit against USD 1.8 million reported in the second quarter of the previous year.

²⁵ There was a 28.0% y/y reduction in net inflow of non-commercial transfers of individuals via the banking system in the second quarter of 2015.

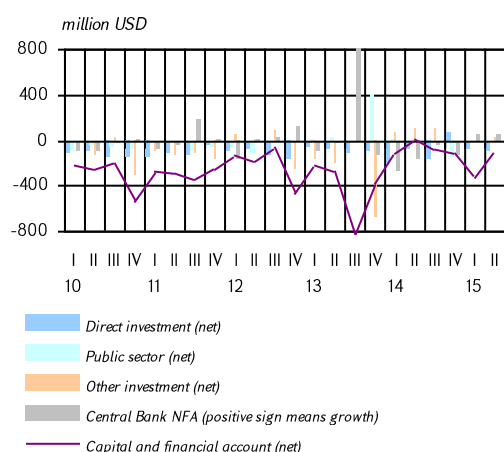
²⁶ The second quarter 2015 capital and financial account indicators are the CBA's forecasts and estimates.

In the second quarter, current account deficit narrowed, y/y



In the second quarter, net y/y inflow of funds through the capital and financial account grew

(+ net credit, - net borrowing)



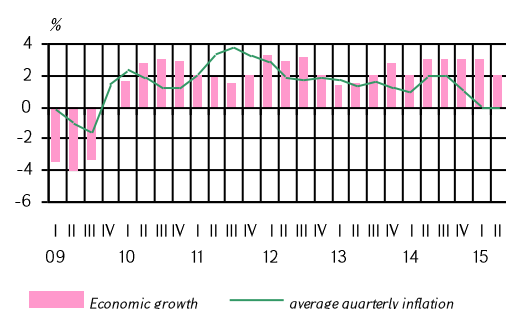
Net foreign assets of the private sector have grown by USD 33.5 million in comparison with a relevant growth figure of USD 95.3 million in the same reference period last year. Net foreign assets of commercial banks have increased by USD 70.4 million in contrast to other private sector's net foreign assets having decreased by USD 36.9 million.

3.5. External environment

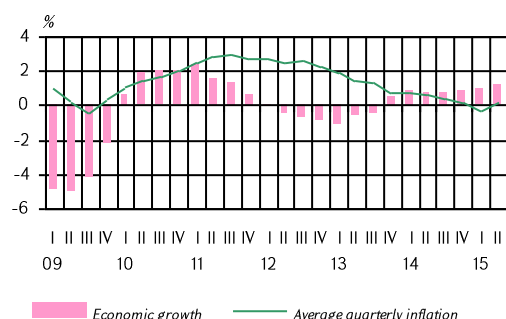
A slow growth of economic activity was observable in Armenia's main trade partner countries during the second quarter.

Economic activity further demonstrated slow-moving growth patterns in Armenia's main trade partner countries during the second quarter of 2015.

The second quarter of 2015 reported deflation in the U.S.A.



Eurozone saw inflation during the second quarter of 2015



According to preliminary estimates of the U.S. Department of Commerce Bureau of Economic Analyses, ***in the United States of America in the second quarter of 2015*** the annualized economic growth was 2.3% q/q against the previous quarter's 0.6% growth (2.3% y/y economic growth was recorded in the second quarter compared to the previous quarter's relevant indicator of 2.9% y/y). The second quarter's growth was fuelled by more private spending, increased exports, as well as added investment and public expenditures. Increased imports made negative contribution to the growth, however. Average quarterly deflation in the U.S.A. in the second quarter of 2015 was 0.04% instead of the previous quarter's deflation of 0.6%. However, inflation remains below its target. The U.S. Federal Reserve System still keeps the policy rates in the range of 0 - 0.25% in order to maintain price stability and sustainable development of the labor market.

In Eurozone in the second quarter of 2015, there was 1.2% economic growth relative to the same reference period last year, according to preliminary estimates provided by the Eurostat. The reporting quarter also saw an average 0.17% inflation y/y as compared to the previous quarter's 0.3% deflation.

In the second quarter, the European Central Bank kept the policy rate at 0.05% and the deposit facility rate at -0.2% levels. In addition to the program for buying asset-backed securities and covered bonds launched in late 2014, the ECB started another program in early 2015 aimed at buying sovereign bonds.

In the currency market in the second quarter, Euro kept on depreciating versus the U.S. dollar. The European currency's depreciation against the US dollar was 1.85% q/q (y/y depreciation: 19.4%), with the average dollar exchange rate reaching 1.10 for one Euro.

In Russian Federation in the second quarter of 2015, there was a 4.6% y/y economic decline, according to the preliminary estimates of the Russian State Statistics Service (previous quarter: 2.2% y/y decline).

With the ruble's exchange rate plunged as much as 50.4% y/y, the economy saw an average 15.8% inflation during the second quarter (previous quarter: 16.2% inflation). Note that the ruble posted a 16.8% appreciation against the previous quarter. In view of persisting risks to significant slowdown in economic growth, the Central Bank of Russia again lowered the policy rate to 11.5% in the second quarter from 14.0% at the end of previous quarter.

In the second quarter of 2015, the **price of Brent crude oil** at Intercontinental Exchange rose by nearly 15.0% against the previous quarter to roughly USD 62.1 a barrel (with 43.4% y/y decrease), following the information on contraction of U.S. inventories, a large seasonal demand and in anticipation of fewer supply in the oil market.

In the second quarter of 2015, the **price of copper** at the London Metal Exchange fell by 10.9% y/y (with 4.41% price rise q/q) to USD 6056 per ton on average. The drop in the price was due to the slowing of demand in China, increased production output, and the effects of appreciating U.S. dollar.

In the second quarter of 2015, export price of **hard red wheat** dropped by 9.5% q/q to USD 5.9 a bushel (with 32.9% decline y/y), according to the U.S. Department of Agriculture data. The price fell during the quarter in anticipation of abundant crops in the world this year.

In the second quarter of 2015, the price index of **unprocessed sugar** at the New York Board-Intercontinental Exchange posted an 11.7% decrease q/q (with 27.9% decline y/y). The price fall is due to higher than expected production in India and Brazil, as well as the depreciation of the currencies of these exporting countries.

In the second quarter of 2015, the price of **rice** at the Chicago Board of Trade fell by 7.3% to USD 10.1 per U.S. hundredweight (45.4 kg) (with 31.8% decline y/y), amid some increase in production volumes as well as slowing demand.

Notwithstanding increased prices of commodities during the second quarter of 2015, food product markets continued seeing deflationary trends, transmitted from previous quarter, owing to large volumes of food production, a low level of global demand as well as appreciating U.S. dollar.

The second quarter saw a rise in commodity prices yet deflationary patterns were further observable in food product markets.

4. Conclusion

In **external sector** in the second quarter of 2015, **external demand** remained sluggish while deflationary patterns were observable in **basic commodity and food product markets of the world**. In the **forecast horizon, considerable inflationary pressures** from the external environment **are not likely**.

In the second quarter of 2015, **growth of economic activity** exceeded expectations owing to higher-than-expected output volumes in agriculture and, in part, in industry sectors. Under this circumstance, **economic growth** in the second quarter of 2015 is estimated **in the range of 2.7 - 2.9% y/y**.

The 2015 economic growth is projected within 2.8 - 3.6%, mainly determined by macroeconomic and financial stability since the beginning of the year, monetary conditions loosened by the CBA in the first half of the year, more stimulating fiscal policy implementation as well as positive developments in agriculture.

In 2016, economic growth rates will persist at the same level. Then, the growth will gradually approach its long-term equilibrium, determined by a bunch of programs the Government plans to carry out in the tradable sector and continued improvement in external economic environment. **In the forecast horizon, the impact of the domestic economy on aggregate demand will be non-inflationary** as a result of stabilizing private demand as well as mostly a neutral impact of the fiscal policy.

In the second quarter of 2015, **the 12-month inflation rate** floated within the upper bound of the confidence band, reaching 5.5% **in late June**.

At the end of the forecast horizon the 12-month inflation rate will stabilize around its target level of 4%. A fairly moderate inflationary environment is anticipated in the second half of 2015 as positive developments in agriculture will result in lower y/y levels of prices of agricultural products. However, low inflation environment will be offset to a certain extent under a lagged effect from loosened monetary conditions and implementation of a stimulating fiscal policy during the year. It should be noted that the inflationary effect that was previously expected to come from electricity price increase since August 1, 2015 is currently out of consideration. However, once actual information on how the mechanism of Government subsidies works and on the results of the audit to be conducted at the “Electric Networks of Armenia” CJSC is available, the CBA will provide estimates of the inflationary effect of this particular change in the next publications. In the meantime, the inflationary effect of possible changes in excise duty in 2016 has been considered in inflation forecasts. In the light of these developments, the CBA estimates that in the second half of the year the 12-month inflation rate will reduce and stay in the lower bound of the confidence band. Over the rest part of the forecast horizon, the inflation will fluctuate within the confidence band and is expected to stabilize around the target at the end of the horizon.

The CBA estimates that, in the time of low inflationary environment, easing of monetary conditions in the third quarter of 2015 will be appropriate. Still, there are risks coming from domestic

and external economies. If these materialize, the inflation environment might expand while the CBA would possibly adjust its monetary policy directions to be steered to fulfilling the inflation target in the medium run.

Risks to inflation deviating from the projected value are estimated ***upward*** in both short and medium-term perspectives. ***Risks deriving from the external sector*** are related to economic outlook in both developed and developing countries. In particular, an expected rise in interest rates by the U.S. Federal Reserve System could lead to capital outflows from developing countries to the U.S.A. and provoke higher volatilities of currencies in developing countries. More significant are the risks to how the Russian economy would develop further, and these are attributable to oil prices with their greater-than-expected decline and predicted lower level over the forecast horizon, further depreciation of the Russian ruble against the U.S. dollar, as well as the further course of geopolitical developments. A sharp slowdown in Chinese economic growth could also pose risks to the global economic decline and the fall in international prices of commodities and food products. ***Risks deriving from the domestic sector*** are mainly associated with the developments in agriculture, a sector greatly depending on climatic conditions, the uncertainty of the impact of increasing electricity prices, as well as the pace at which the domestic demand would recover and the Government-led projects go. If the aforementioned risks materialize, the CBA will react accordingly by maintaining the inflation target in the medium run.