

THE CENTRAL BANK
OF THE
REPUBLIC OF ARMENIA

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Resolution No. 325A,
dated 20.11.2014*

Inflation Report

Monetary Policy Program, Q4, 2014



*Status report on implementation
of the Monetary Policy Program
Q3, 2014*

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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 November 11, 2014, i.e. the approval of the refinancing rate, 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

According to the Central Bank forecasts, in the short run the 12-month inflation rate will gradually approach the target and stabilize around it; in 2015 and the rest part of the forecast horizon, it will stay within the confidence band.

In the time of uncertainties over economic developments in external and domestic sectors, the economic growth in the forecast horizon will rebound at a slow pace and will gradually approach its long-term equilibrium throughout the horizon.

According to the Central Bank forecasts, in the short run the 12-month inflation rate will gradually approach the target and stabilize around it. In 2015 and the rest part of the forecast horizon, the 12-month inflation rate will stay within the confidence band of $4\% \pm 1.5$ pp. In the time of uncertainties over economic developments in external and domestic sectors, the economic growth in the forecast horizon will rebound at a slow pace and will gradually approach its long-term equilibrium throughout the horizon.

In the 3rd quarter of 2014, *the economic environment somewhat expanded* yet economic growth remained sluggish. Declined private consumption and weak investment activity pointed to the low level of domestic demand this quarter. In particular, in the 3rd quarter the decline in private consumption was an estimated 1.0% y/y and the growth in private investment, 2.0% y/y. The weak demand reflected slow growth rates in industry and services output volumes and still negative developments in construction. On the other hand, higher-than-expected output growth was reported in agriculture, which helped to add to the economic activity during the quarter. As a result, it is expected that economic growth in the 3rd quarter would be in the range **3.5-3.8% y/y**.

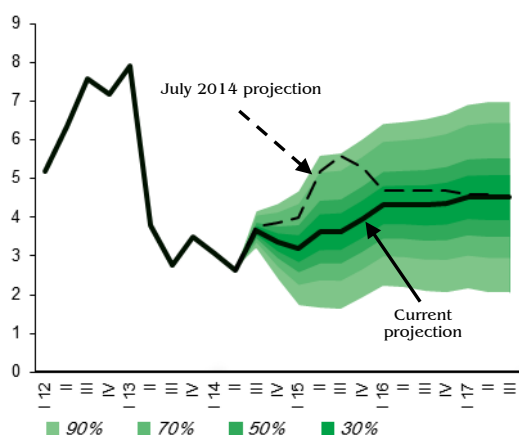
According to short-term forecasts, private consumption growth rates will keep on decelerating whilst a stable investment environment can be expected, under which circumstance the private consumption will reduce by 1.7% but the private investment grow by 1.4% in 2014. In anticipation of expansionary fiscal policy during the year, the fiscal impulse is small expansionary (in relation to the previous year). Based on the 2014 results, the real growth of export and import of goods and services will stabilize around 6.0%, while a net 3% decline in remittances of individuals is anticipated. As a result, *the economic growth in 2014 is estimated in the range 3.1-3.6%* primarily due to the growth in the agriculture and service sectors (a total contribution of 3.0-3.3 pp).

In the forecast horizon the economic growth will gradually approach its long-term equilibrium, reflecting accelerating private consumption growth rates and slowly rebounding private investment.

Thus, *in the forecast horizon*, with stabilizing private demand as well as mostly a neutral impact of the fiscal policy, *the impact of the domestic economy on aggregate demand is expected to be non-inflationary*.

In the *external sector* in the 3rd quarter of 2014, geopolitical developments led to more uncertainties, and the external demand remained sluggish. In such a situation, the deflationary patterns prevailed in *international markets of basic commodities and food products*.

Real GDP cumulative growth projection probability distribution for 3-year horizon



In the forecast horizon, with stabilizing private demand as well as mostly a neutral impact of the fiscal policy, the impact of the domestic economy on aggregate demand is expected to be non-inflationary.

In the forecast horizon, inflationary pressures from both the external demand and international markets of basic commodities and food products are not likely.

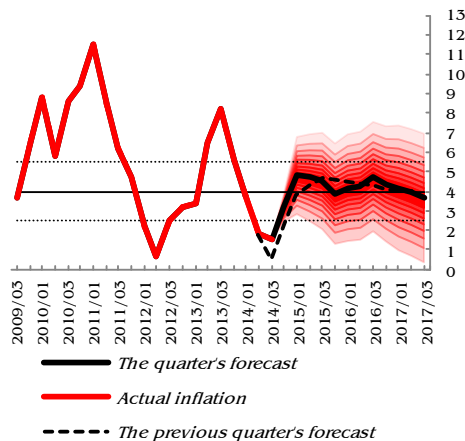
*In the forecast horizon, global economic growth rates will continue to recover at a slow pace, under which conditions ***inflationary pressures*** from both the external demand and international markets of basic commodities and food products ***are not likely***.*

In the 3rd quarter of 2014, ***the 12-month inflation rate*** further trended down to 0.4% in July but began increasing gradually during the next two months. As a result, ***in late September the 12-month inflation rate was 1.5%***, still below the lower bound of the confidence band. In the 3rd quarter, core inflation also demonstrated a changed pattern as its 12-month indicator rose by 0.46 pp to 1.0% in late September.

In the 3rd quarter of 2014, the Central Bank reduced the refinancing rate by 0.25 pp to 6.75% in late September (see details in section 3.1.1 Actual inflation and fulfilment of the inflation target).

In spite of expected low demand in both external and domestic economies, the ***Central Bank predicts*** rebounded inflation rates in the short run as a result of ***stamp duty introduced*** to a variety of goods starting from the 4th quarter of 2014 as well as ***Armenia's membership to the Eurasia Economic Community due on January 2015***. Under these conditions, the easing of monetary conditions to date is believed to be enough for the fulfilment of the inflation target in the short run.

Inflation (12-month) forecast probability distribution chart for the 3-year horizon



Risks to inflation deviating from the ***projected value*** are estimated as ***balanced*** in both short and medium-term perspectives. ***External sector risks*** are primarily associated with global economic growth rates bouncing back as well as economic and geopolitical development perspectives in emerging economies, and Russia in particular, and how their potential impact would be spilled over to basic commodities and food product markets. ***Risks deriving from the domestic environment*** are attributable to domestic demand developments, particularly private consumption growth rates, capital investment recovery rates, the economic effects from Armenia's membership to the Eurasia Economic Community, the inflationary effects of the stamp duty and the developments in agriculture sector which is largely reliant on climatic conditions.

If such risks materialize, the Central Bank will react accordingly by maintaining the inflation target in the medium run.

2. FORECAST, FORECAST CHANGES, RISKS

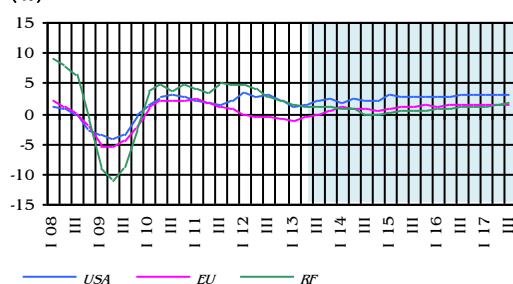
2.1. External environment¹

The global economic growth slowing will lead to a certain deflationary environment in the external sector.

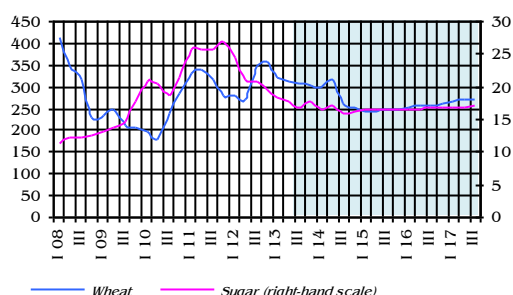
The global economic growth slowing will lead to a certain deflationary environment in the external sector.

In 2014, world economic growth and the growth rates in Armenia's trade partners' economies are expected to slow down to a certain extent in comparison with the previous forecast, which will be noticeable in both emerging and developed countries.

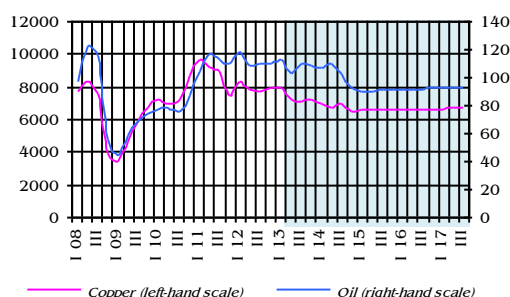
Economic growth in trade partner countries (%)



Food products (USD)



Basic commodities (USD)



After the end of the quantitative easing program of the *U.S. Federal Reserve System* in October 2014, interest rates are only expected to rise in early 2016. The economic growth in 2014 is estimated around 2.2%, to reach roughly 3% in 2017.

In the *Euro-area*, economic recovery observed since late 2013 will start slowing down, with the economic growth making up 0.7% in 2014 and reaching some 1.4% in 2017, i.e. the end of the forecast horizon. In light of a weak inflationary environment, the European Central Bank will continue its low-interest-rates policy. In the 4th quarter, the program to purchase asset-backed securities and secured bonds will commence and last up until June 2016, which will make the monetary policy more expansionary in nature.

In *Russia*, economic activity is expected to be low, with the level of inflation to increase throughout the forecast horizon. Continued slowing of economic growth rates due to geopolitical and domestic developments will mainly be reflecting a weak investment activity, accompanied by capital flight. The growth rate in 2014 is estimated to be approximately 0.4%. In medium term too, the economic growth will be humble, reaching 1.5% in 2017.

In the October 2014 report, the IMF predicted a 3.3% world economic growth indicator for 2014 (with downside adjustment of 0.1 pp). The adjustment was made owing to developing countries.

Uncertainties and risks about the further pace of the global economy *are more essential* for developing countries. Such uncertainties are associated with capital flight to developed countries and a resultant slowing of economic activity. Downside risks to the economic growth in the Euro-area due to insufficient structural improvements and geopolitical developments in EU member states are also remarkable.

With the global economy slowing down, no inflationary trends will be observable in the world's *basic commodity and food*

¹ The forecasts of external sector have been 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).

product markets. In the meantime, individual commodity markets are predicted to develop under the influence of fundamental factors inherent in any such markets. Risks associated with energy price developments will be determined by geopolitical events, whereas prices of food products will depend on weather conditions.

Box 1

Developments in commodities markets in the forecast horizon

According to International Energy Agency's October estimates, in 2014 nearly 60.9% of global oil demand will be met by producing oil by non-OPEC countries (the growth was 3.1% against the previous year), under which circumstance average demand for extraction of oil by OPEC countries will reach 29.7 million b/d. In the short-term perspective, international oil prices are expected to fall as short-term adjustment of supply will be anticipated. Afterwards, as the world economic activity rebounds in the medium run, oil prices will tend to increase moderately although geopolitical developments are such that inflationary risks will persist in the global market of energy resources.

In the short-term perspective, certain deflationary patterns will be discernable in base metals markets as the global economy grows slowly. Later, in the medium run, prices of base metals will stabilize and even demonstrate minor inflationary patterns.

According to October estimates of the U.S. Department of Agriculture, in the 2014/2015 marketing year some 721.1 million tons of wheat crops is expected (the volume of crop has reduced by about 6 million tons in comparison with the previous year). Furthermore, some growth of stock is expected in the forecast horizon, reflecting faster production rates over consumption (the stock will increase by nearly 7 million tons against the previous year). Notwithstanding short-term deflationary patterns, average international wheat price will follow a steady path in the medium run.

In the 2014/2015 marketing year, world production of rice will reach approximately 475.48 million tons (roughly 1 million ton more compared to the previous year). On the back of increased consumption however, the world rice stock may somewhat decrease by nearly 6.2 million tons in comparison with the previous year. As a result, average international rice price will mostly behave stably.

Predictable reduction of cane crop in Brazil in the 2014/2015 marketing year will be largely compensated by generous harvest expected in the EU, Australia and Mexico. As a result, in the medium run international sugar price may trend slightly up. It should be noted that short-term developments in the market will be greatly influenced by expectations about supply, as key industrial countries will adjust their estimations of domestic output.

2.2. Aggregate supply and Aggregate demand

Aggregate supply

Economic growth forecasts were revised downside to amount to 3.1-3.6%.

Further adversities due to negative economic developments in Armenia's trade and investment partner countries, a slow pace of implementation of some major construction projects and a weaker-than-anticipated expansionary fiscal policy implementation all prompted to **revise economic growth**

forecasts downside. As a result, the economic growth in 2014 is expected in the range 3.1-3.6%².

The level of potential economic growth was adjusted downside as well. This was mostly influenced by the declined levels of potential economic growth in main trade partner countries as a result of growing uncertainties over future economic developments there and diminishing foreign capital investment the Armenian economy looks ahead to, on the one hand, and persisting weak investment activity in the domestic economy, on the other. In the forecast horizon, the economic growth is expected to approach gradually its long-term equilibrium, 5-6%.

For **Industry**, the forecasts were revised downside, with ore mining and metallurgy growth rates predicted to slow down due to the falling prices of non-ferrous metals in global markets. Growth rates in production of building materials, processed food and beverage were also revised downside due to the reported slowing in growth rates in construction, external and domestic demand. As a result, in 2014 value added in industry is expected to grow in the range 0.7-1.3%.

In **forecast horizon**, the industry growth will stabilize within 4.8-5.3%, and this development will be supported by implementation of a handful of major projects.

For **Construction**, forecasts of value added were revised downside, mainly due to lower-than-expected activity in the sector and a slow pace of implementation of construction programs during the 3rd quarter. As a result, value added is expected to decrease in 2014 in the range 3-3.5%.

In the **forecast horizon**, the growth is expected to stabilize within 0-1% as the supply and demand disequilibrium in construction phases out.

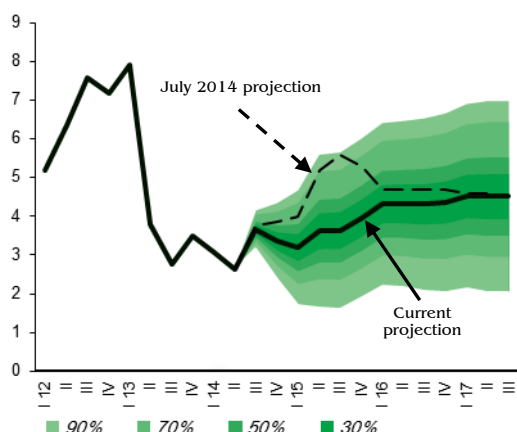
For **Services**, the forecasts were also revised downside in line with downside adjustment of the forecasts for domestic demand, which will leave an influence on both the volumes of trade turnover and other services provided. As a result, real growth of value added in services is predicted in the range 4.2-4.7% for 2014.

In the **forecast horizon**, growth rates in services will stabilize within 5.3-5.8%, broadly in line with the medium-term domestic demand forecasts.

For **Agriculture**, the forecasts were revised upside, supported by actually encouraging developments in the sector on the whole and expanded greenhouse facilities, in particular. As a result, the real growth of value added in the sector in 2014 is predicted in the range 6-6.5%.

² See the 30% interval in the Real GDP Growth (Cumulative) Projection Probability Distribution Chart in this report.

Real GDP cumulative growth projection probability distribution for 3-year horizon



In the *forecast horizon*, underlying growth rates in agriculture will persist within 5.2-5.8%.

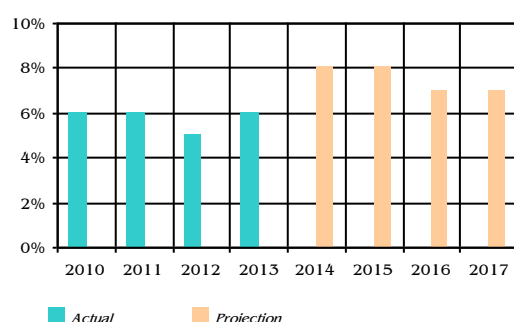
In the forecast horizon, risks to the economic growth are dual sided and depend on how the global economy would develop further and what economic effects could be expectable from integration processes in the region, on the one hand, and on existing uncertainties over private spending, on the other.

Real GDP Growth (Cumulative) Projection Probability Distribution				
Period	30% probability interval		90% probability interval	
	Min	Max	Min	Max
January-December 2014 / January-December 2013	3.1%	3.6%	2.4%	4.3%
January-December 2015 / January-December 2014	3.5%	4.4%	1.9%	6%
January-December 2016 / January-December 2015	3.8%	4.9%	2.1%	6.7%

Labor market:³ Forecasts of labor market indicators for 2014-2017 have worsened compared to the previous forecasts, in response to the adjustment of the economic growth forecasts and slower-than-expected growth rates in wages in the public sector. Specifically, in the forecast horizon average wage is expected to have much slower growth rate and the unemployment rate to be somewhat higher.

Thus, average nominal wage in the economy is expected to grow **by 8.2% in 2014, by 8% in 2015 and by around 7% in the period 2016-2017.**

Average nominal wage growth, y/y



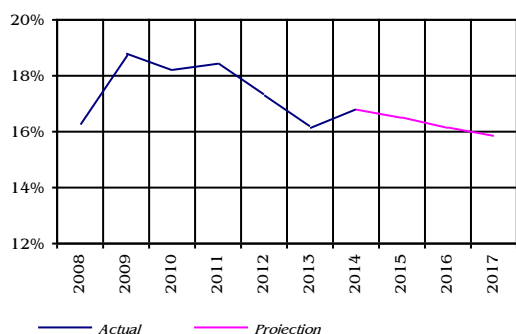
The nominal wage increase expected in 2014 is higher than the average wage growth reported in recent years. The wage increase during the year was fuelled by the rising of minimum wage threshold up to AMD 50,000, some rise in wages in the private sector in the context of the funded pension reform and wage increases in the public sector taken place primarily in the 3rd quarter of the year. On the back of wage increases in the public sector during the quarter, average wage growth rates are expected to remain strong over the first half of 2015. In anticipation of subsequent rising of the minimum wages in 2015, the expected wage increase during the year will continue to be higher from the post-crisis average wage growth rate.

With an economic growth expected to accelerate, an inflation rate stabilizing and the government policy further steered to wage increases, average nominal wage is predicted to grow by about 7% in 2016-2017.

Relatively high growth of wages expected for the period from the second half of 2014 through the first half of 2015 outstrips the productivity growth projected for the aforementioned period. These developments are expected to push unit labor costs

³ The labor market data for 2014 are the Central Bank estimates which are based on the 2nd quarter of 2014 data and actual July-August 2014 figures. The growth indicators presented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

Unemployment rate



slightly up at the end of 2014 and over the first half of 2015, and the consumer market will incur weak inflationary pressures, 0.2 pp, from the supply side, which will phase out in the forecast horizon.

In anticipation of relatively slow economic growth in 2014, average unemployment rate will amount to 16.8%, up by 0.6 pp in comparison with the previous year. In the period **2015-2017** however, the GDP gap, currently estimated to be negative, will vanish as economic growth rates accelerate. As a result, the unemployment rate will subside gradually.

Aggregate demand⁴

The slowing of economic growth in Armenia's main trade partner countries, persisting weak investment activity in the domestic economy and lesser than planned public expenditures resulted in an estimated 1.4% decline in gross domestic spending in 2014. However, expansionary monetary and fiscal policies implemented during 2014 as well as anticipated acceleration of economic growth in main trade partner countries will prompt the aggregate domestic demand to recover gradually in the period 2015-2017 and is predicted to grow by 3.5-4.0% in the end of the forecast horizon.

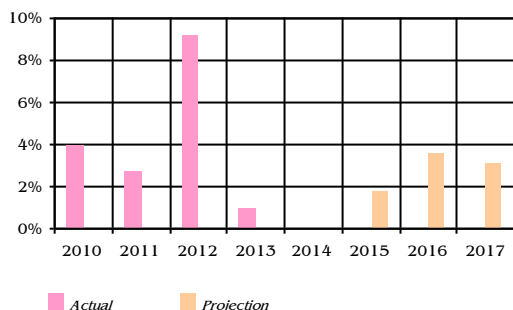
In the 3rd quarter of 2014, private spending was considerably lower from the forecasts, which was determined by slowing remittances from Russia as well as weaker-than-expected activity in domestic economy on the whole. According to the Central Bank estimates, private spending will keep on reducing over the second half of the year and the reduction will be an estimated 1.7% for 2014.

With expansionary monetary and fiscal policies implemented during 2014 and economic growth expected to speed up in main trade partner countries, domestic private consumption is predicted to bounce back gradually in the period 2015-2017 and the growth in the meantime will amount to 3.0-3.5%, alas still much lower from the growth rate outlined in former forecasts.

It should be noted that there are significant risks in the forecast horizon, which could adversely affect expected private consumption growth rates. These risks are first and foremost attributable to less-than-expected amount of remittances from Russia and overall economic activity rebounding at a slower pace.

In 2014, **investment activity** in the economy was sluggish, as was anticipated, reflecting a 2.6% contraction in output in construction in the period January-September⁵.

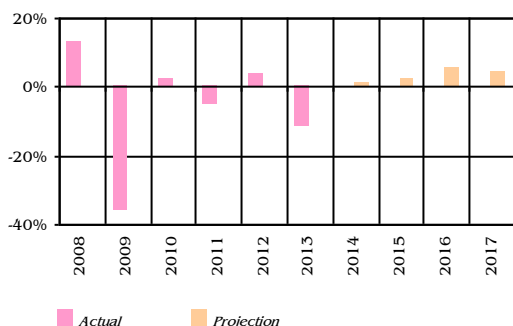
Private consumption growth, y/y



⁴ The data of real growth of private consumption and investments for 2014-2017 are the Central Bank estimates. Actual figures of these data are as of the 2nd quarter 2014 and published by the Republic of Armenia National Statistics Service. The real growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

⁵ See <http://armstat.am/file/doc/99488458.pdf>.

Private investment growth, y/y



Under these conditions, the forecasts of private investment for **2014-2017** are much the same: private investment **in 2014** will only post a minor growth of 1.4% compared to the previous year, which is notably lower from the average historic indicator recorded in the Armenian economy. **In 2015-2017**, private investment will grow to some extent (by 3.-5% annually) as construction activity will stabilize and some private sector projects will be implemented. Note that the investment recovery process could be boosted up by gradually increasing gross national savings as a result of the launch of the funded pension contribution scheme.

With the planned membership to the Eurasia Economic Community, Armenia could see more private investment flowing into its economy for implementation of a variety of projects to be carried out in cooperation with EEC member countries.

In view of the aforementioned developments with private consumption and investment, in 2014 the private sector expenditures will reduce by 1.2%. Starting from 2015, private spending will gradually recover and in the end of the forecast horizon will report some 3.5-4.0% growth, which is still below the former forecasts.

The private spending gap in the period 2014-2015 is estimated to be significantly negative. However, it will narrow gradually and will wane out to zero starting from early 2016 up until 2017 as a result of expansionary monetary and fiscal policy implementation in the domestic economy and acceleration of economic growth in main trade partner countries.

Starting from the 4th quarter 2014 to the 4th quarter 2015 therefore, the private spending will create an average 1.6-1.7 pp of contractionary impact on the inflation. In the period 2016-2017, the private spending will leave no considerable impact on the inflation.

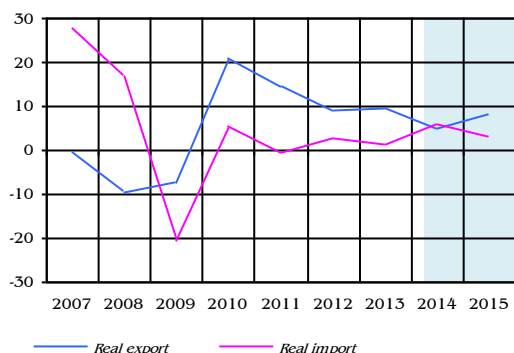
In view of uneven recovery of the global economy and expected developments in the domestic economy, the deficit of current account will reduce in the 4th quarter against the 4th quarter last year. It is estimated that at the end of 2014 the growth of export and import of goods and services in real terms will stabilize around 6% whereas remittances of individuals will reduce by roughly 3%. On the back of such developments, the Current Account Deficit / GDP ratio will be around an estimated 10.0%⁶ against the previous year's 8.0%.

The Current Account Deficit / GDP ratio will reduce in 2015 as global economy grows and domestic economic activity bounces back. The growth of export in real terms is predicted to be faster over the growth of import in real terms. The export growth will be fuelled primarily by increased volumes of export

⁶ The temporary deterioration of the current account deficit resulted from a one-off major transaction in the 1st quarter 2014, which was posted in sub-item "reinvested income" of item "initial income".

of goods of processing industry and agricultural products. As a result, in 2015 the real growth of export of goods and services will be in the range 7.0-9.0% and the real growth of import of goods and services will slow down to some extent to 2.5-4.5%.

Real export and real import (goods and services), y/y, %



In consideration of the 2015 developments in the Russian economy, including base effects of the ruble's depreciation in the second half of 2014, it is predicted that the dollar value of remittances of individuals will persist at the previous year's level.

The aforementioned adjustments will drive the Current Account Deficit / GDP ratio to decrease to the range 7.0-8.0% in 2015.

The current account will keep on improving in the medium-term perspective as the Current Account Deficit / GDP ratio will reduce to 5.0-6.0%.

In view of ***State Budget*** performance for the last 9 months of 2014, which reported revenues underperformed against the quarterly projections and some expenditure savings (see Section "Actual fiscal policy developments"), the annual plan was adjusted to provide for savings of nearly 5.2%⁷ of annual public expenditures and underperformed revenues to the extent of 2.8% of the annual plan. In 2014, the Tax/GDP ratio is expected to have a 0.4% increase and the Expenditures/GDP ratio to post about a 1.7 pp increase⁸ in relation to previous year's actual indicators. The planned increase of expenditures is primarily due to current expenditures. ***As the above developments suggest, in 2014 the deficit is expected to be lower than the level stipulated by the Law on State Budget 2014.***

In 2014, relative to 2013, the fiscal policy's impact on aggregate demand is expected to leave a little more (0.5 pp) expansionary impact instead of 0.3 pp expansionary impact, as was outlined in the 3rd quarter's monetary policy program. Due to a revised assessment of the economic growth, there will be an estimated 0.2 pp contractionary impact of revenues and 0.7 pp expansionary impact of expenditures.

The ***fiscal policy's impact in the forecast horizon*** was estimated using the macroeconomic indicators underlying the Republic of Armenia Medium-Term Public Expenditures Program, 2015-2017, which is steered to an effective debt management and a Deficit/GDP ratio to be maintained on average at the 1.9% level in the medium run. For 2015, the fiscal policy's impact is estimated to be minor, 0.4 pp expansionary, and for 2016 and 2017, almost a neutral impact. In the outcome, ***the impact of fiscal policy in the medium run is estimated to be non-inflationary.***

⁷ A Central Bank estimate.

⁸ Expenditures are represented as cash flows.

Medium-term fiscal policy impact assessment					
% in GDP	2013	2014	2015	2016	2017
Budget revenues	24.3	24.7	24.3	23.6	23.7
Budget expenditures	24.5	26.2	26.7	25.4	25.5
Debt interest payment	1.1	1.4	1.5	1.4	1.4
Budget balance	-0.2 ⁹	-1.4 ¹⁰	-2.3	-1.8	-1.8
Primary balance*	0.9	0.0	-0.8	-0.4	-0.4
One-off flows**	0.5	0.1	-0.4	-0.4	-0.4
Adjusted balance***	0.4	-0.1	-0.4	0.0	0.0
Cyclical balance****	-0.3	-0.3	-0.2	-0.1	0.0
Cyclically adjusted primary balance (structural balance sheet)	0.7	0.2	-0.2	0.1	0.0
Fiscal stance*****		0.5	0.4	-0.3	0.1
* Budget balance minus debt interest payments. ** Temporary or one-off budget entries. In this case net credit is considered; the sign "+" means resources allocated and the sign "-" means resources repaid. *** Primary balance sheet adjusted by 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).					

To sum-up, the combined impact of the fiscal sector, private demand and labor market on domestic prices for the period from the 4th quarter 2014 up until late 2015 will be deflationary, 1.2-1.5 pp, which will phase out in early 2016. In the period 2016-2017, the impact of domestic demand and labor market on the inflation is estimated to be neutral.

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

In the external sector, economic activity slowed down to a certain extent. This, coupled with supply factors, has brought in more than expected deflationary patterns in commodities and food product markets.

In the forecast horizon, global economy will recover at a slower pace than expected, and this will be observed in both developing and developed countries, except for the U.S.A. In the meanwhile, uncertainties about economic prospects in main trade partner countries as well as commodities markets will persist amidst geopolitical developments.

With the global economy recovering at a slower pace, inflationary pressures ***in the world's main commodity and food product markets*** will not be expected. However, individual product markets may run into certain supply-driven issues attributable primarily to geopolitical, climatic and other events.

⁹ The 2013 state budget indicators are represented without off-budgetary funds, and public expenditures are shown as cash flows.

¹⁰ The 2014 state budget deficit indicator is the Central Bank estimate, whereby tax revenues and public expenditures are expected to be, respectively, 2.8% and 5.2% below from the figures projected in the State Budget Law 2014 due to the first nine months' savings, underperformed revenues and taking into account the previous years' trends of budget performance.

In the 3rd quarter of 2014, economic activity grew to some extent, though growth rates were recovering at a slower pace.

Economic growth in the period January-September will be in the range 3.5-3.8%.

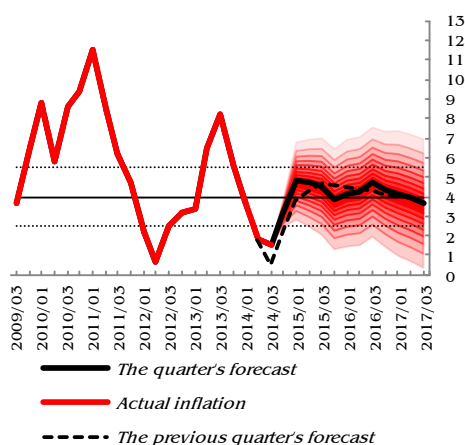
In the 3rd quarter of 2014, economic activity grew to some extent, with growth rates recovering at the rate slower than expected. This was due to the developments in all sectors of the economy, except for agriculture which reported higher-than-expected growth rates. As a result, economic growth in the period January-September will be in the range **3.5-3.8%**, with agriculture and services as the main driver to the economic growth.

The slowing of economic activity in Russia, the main trading and investment partner, and the ruble sliding against the U.S. dollar led to the narrowed inflow of private remittances of individuals and seasonal worker income during the quarter, which reaches an estimated 7.8% y/y. Declined private transfers, combined with sluggish economic activity and mounting debt burden of households, has brought in a considerably lower level of private consumption.

Economic growth in 2014 is estimated in the range 3.1-3.6%.

The level of potential economic growth in Armenia was adjusted downside mainly due to a weak investment activity in the domestic economy as well as declined levels of potential economic growth in main trade partner countries. Given more expansionary fiscal policy implementation (1.0 pp expansionary instead of neutral) during the quarter, the negative GDP gap proved smaller in the 3rd quarter of 2014 thus facilitating the inflation rates to rebound faster: *in September the 12-month inflation rate was 1.5% y/y.*

Inflation (12-month) forecast probability distribution chart for the 3-year horizon



Inflation will continue to rise during the 4th quarter, as the refinancing rate persists at the current level, and will reach its target, making up 3.2% at the end of the year. In 2015 and the rest part of the forecast horizon, the inflation will be close to the target, varying within the confidence band.

Actual developments in the domestic economy, a slow pace of implementation of planned construction projects and negative developments spilled over from Russia all have prompted to revise **Armenia's economic growth downside in 2014**, which is estimated to be in the range **3.1-3.6%**. Agriculture and services sectors will remain the main driver to the economic growth, with an estimated contribution of 3.0-3.3 pp.

According to the Central Bank forecasts, in spite of expected low demand in both external and domestic economies, the inflation rates are predicted to rebound as a result of **labels introduced** to a variety of goods (making up 12% of the consumer basket) starting from the 4th quarter of 2014 as well as **Armenia's membership to the Eurasia Economic Community due on January 2015 (primary influence on the inflation in the period 2015-2017 is estimated at most 0.4 pp)¹¹**. Under these conditions, the easing of monetary conditions to date is believed to be enough for the attainment of the inflation target in the short run.

The Board of the Central Bank estimates that the inflation will continue to rise during the 4th quarter, **as the refinancing rate persists at the current level**, and will reach its target, making up **3.2% at the end of the year**. In 2015 and the rest part of the forecast horizon, the inflation will be close to the target, varying within the confidence band.

¹¹ See details in Box 2 of this report.

Period	Inflation forecast probability distribution chart				
	<1.0%	1.0-2.5%	2.5-5.5%	5.5-7.0%	>7.0%
Q3 2014	0.0	4.6	94.0	1.4	0.0
Q4	0.1	2.7	69.2	24.7	3.3
Q1 2015	0.3	4.9	67.3	23.1	4.4
Q2	0.9	7.9	65.4	20.8	4.9
Q3	3.3	15.7	66.2	12.6	2.2
Q4	2.8	12.8	63.1	16.9	4.5
Q1 2016	2.5	11.9	62.1	18.1	5.3
Q2	1.4	7.9	57.8	23.6	9.2
Q3	3.0	11.8	58.8	19.4	7.1
Q4	5.1	14.4	55.9	17.4	7.2
Q1 2017	6.8	16.5	55.3	15.3	6.0
Q2	9.3	19.0	54.0	13.1	4.7

Risks to inflation deviating from the projected central value are estimated as balanced in both short and medium-term perspectives. ***Risks deriving from the external sector*** are primarily associated with the recovery of world economic growth and economic and geopolitical perspectives in emerging economies (Russia, in particular) and a spillover of their possible effects onto commodities and food product markets. ***Risks coming from the domestic economy*** are attributable to domestic demand developments, particularly private consumption growth rates, capital investment recovery rates, the economic effects from Armenia's membership to the Eurasia Economic Community, the inflationary effects of the labeling and the developments in agriculture sector which is largely reliant on climatic conditions.

If such risks materialize, the Central Bank will react accordingly by maintaining the inflation target over the medium run.

In the ***forecast horizon***, credit growth rates will remain at a steady level due mainly to gradually recovering and stabilizing aggregate demand. The Central Bank will look to the target level of the policy rate to adequately react to any shifts in liquidity to make sure money supply is consistent with the demand.

Box 2

Impact of Armenia membership to the Eurasia Economic Community on the inflation in 2015-2017

Starting from January 1, 2015, Armenia will join the Eurasia Economic Community (EEC). This means that current customs duties applied to imported goods will be aligned to the ones applicable in the EEC, which might lead to some expanding of the inflation environment. Furthermore, new customs duties might influence the inflation rate through both primary and second-round effects. The estimations for the 2015-2017 developments are presented below.

To measure the possible first-round effect on the inflation after Armenia joins the EEC, all import goods to which new customs duties will apply were sorted out in the domestic consumer basket in the first place. The share of these goods in the domestic consumer basket is roughly 30.0%, if we ignore the customs exemptions applied to a bunch of goods for the years ahead as a result of the Armenian Government's negotiations. Since customs exemptions were applied to a number of import goods (such as grain, rice, sugar, certain types of oils and fats, petrol, motor vehicles, some medications as well as a variety of detergents – liquid soap, soap, washing powder, dishwasher liquids) of the consumer basket, which implies that the new rates will only be effective a few years later, it is estimated that the change in the rates will influence 15.0% of the goods in the consumer basket in 2015-2017, which makes almost half of the goods preliminarily listed for the consumer basket. The list of main import goods in the consumer basket for which a new set of tariffs will apply starting from 2015 includes lentils, peas (the current duty of 10.0% will rise to 15.0%), chicken thighs (10.0% to be 25.0%), canned beef stew (10.0% to be 23.3%), condensed milk (10.0% to be 22.5%), corn oil (10.0% to be 15.0%), tea (10.0% to be 17.5%, 18.0% or 18.1%, depending on the type), tobacco (10.0% to be 23.3% or 27.5%, depending on the type), raw material of tobacco (0% to be 5.0%), which could affect the price of locally produced cigarettes, perfume (0% to be 12.9%), toilet paper (0% to be 18.5%) and some other products (source: <http://www.mineconomy.am/uploads/20143001103804709.pdf>).

Given the change in tariffs on each of import goods as well as the share of non-EEC countries in Armenia's import structure, the possible price change has been calculated as a product of the two factors mentioned above. The weight of import goods in the consumer basket was used to measure the contribution each of them will make to the headline inflation as a product of the weight and expected change in price of any particular product. Then, the total sum of contributions of import goods was used to assess the primary impact of revised customs duties on the inflation. So, **the primary impact of Armenia's membership to EEC on the inflation for 2015 is estimated at most 0.4 pp.** Exclusive of customs exemptions, this estimation would vary within 1.0-1.5%.

The increased customs duties may expand the inflation environment not only through the primary but also second-round effects since consumers would gradually substitute the import goods for domestic goods in consideration of relative advantage of domestic prices. At this moment however, making a clear judgment on the second-round effects is quite difficult as it depends on several factors, such as substitution of goods imported from non-EEC countries for domestic products and goods imported from the EEC countries, an individual product market structure, price setting mechanisms, and etc. Currently, the second-round impact of the change in customs duties on the inflation is estimated to be negligible. The Central Bank will further be consistent in giving more accurate assessments to future developments and communicating these assessments to the general public.

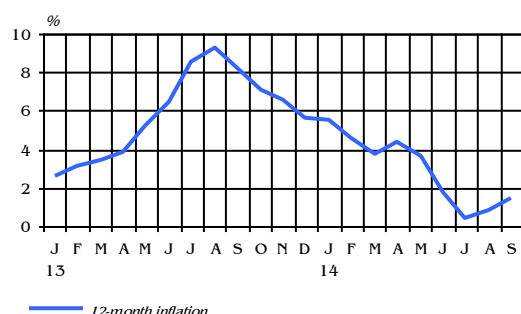
3. ACTUAL DEVELOPMENTS IN Q3 2014

3.1. Inflation

3.1.1. Actual inflation and fulfilment of the inflation target

At the end of September, the 12-month inflation rate was 1.5%.

In the opening month of the 3rd quarter, the 12-month inflation rate kept on falling but started to increase gradually in the next two months, yet it was below the lower bound of the confidence band



In the opening month of the 3rd quarter of 2014, as was expected, the 12-month inflation rate kept on falling to 0.4% in July but started to increase gradually in the next two months. The quarter saw 0.2% inflation, and ***the 12-month inflation rate amounted to 1.5% in late September***, which was still below the lower bound of the confidence band. The reporting quarter's inflation was fuelled by the shift in service tariffs, particularly the electricity price change with its 0.8 pp contribution. In the 3rd quarter, however, food prices posted a 1.2% decrease with their -0.6 pp contribution to headline inflation. Specifically, prices in item 'fruits' and 'vegetable and potato' have dropped notably, by 15.9% and 14.6%, respectively, with a total -1.5 pp contribution to inflation. On the other hand, in the 3rd quarter egg prices rose by 10.2%, making 0.1 pp contribution to inflation.

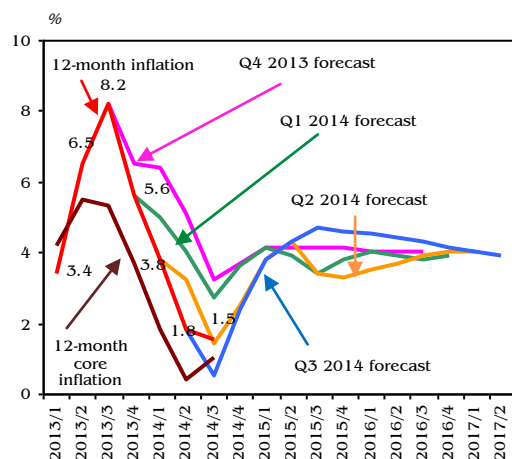
12-month inflation by commodity group as main contributors						
Commodity group	June 2014 (y/y)		September 2014 (y/y)		Q3, 2014	
	Growth	Contribution	Growth	Contribution	Growth	Contribution
CPI	1.8		1.5		0.2	
Food products	-0.7	-0.4	1.4	0.8	-1.2	-0.6
bread products	0.9	0.1	0.8	0.1	0.2	0.0
dairy products	6.9	0.3	5.1	0.2	-1.0	0.0
meat products	-0.8	-0.1	0.6	0.1	1.9	0.2
fruit	-2.1	-0.1	5.3	0.2	-15.9	-0.6
vegetables and potato	-13.7	-0.9	1.7	0.1	-14.6	-0.9
fats and oils	-5.6	-0.2	-3.3	-0.1	3.3	0.1
egg	-10.5	-0.1	-10.8	-0.1	10.2	0.1
sugar	-13.1	-0.1	-6.8	-0.1	-0.1	0.0
confectionery	4.2	0.1	5.4	0.1	3.4	0.1
Non-food products	1.3	0.2	0.9	0.1	0.4	0.1
Services	6.8	2.0	1.8	0.6	2.5	0.8

In the 3rd quarter of 2014, ***the 12-month core inflation*** expanded by around 0.6 pp after a yearlong down-trending path to 1.0% in late September.

At the start of short-term horizon of the previous year, *i.e. the 4th quarter of 2013*, the inflation environment was expected to come down rapidly owing to weak demand and contractionary monetary policy of the Central Bank that time, under which circumstances however the 12-month inflation rate would have to run above the upper bound of the confidence band later the year but keep on falling in the course of the first half of 2014 to return to the target. In such a situation in the 4th quarter of 2013, the ***Central Bank was planning to ease the monetary conditions which would be appropriate for a weak economic activity and moderate inflationary environment, while further***

monetary policy directions would also be determined by the pace of the fiscal policy.

The Central Bank predicts that in the upcoming 3-year horizon the inflation environment would expand until the first half of 2015 then it would stabilize around its 4% target



In the past nine months of 2014 the refinancing rate was lowered a total of 1.0 pp to 6.75% in late September.

However, the inflation developments showed that not only in the 4th quarter of 2013 but also throughout the three quarters of 2014 the 12-month inflation rate has declined faster than anticipated, primarily reflecting the downside adjustments to demand in both external and domestic sectors. Based on the aforementioned, the Central Bank chose a down-trending path for inflation in each of its forecast for the quarters ahead.

Actually, determined by tightened monetary conditions in an earlier period as well as smaller seasonal increase of prices of some products, at the end of 2013 the 12-month inflation rate was near the upper bound of the confidence band, amounting to 5.6%. In view of a moderate inflation environment and anchored inflationary expectations, the *Central Bank gradually loosened the monetary conditions in the 4th quarter of 2013* by cutting the refinancing rate by 0.75 pp to **7.75%** at the end of the year.

In the first three quarters of 2014, the *12-month inflation continued to decline rapidly* which was largely attributable to *sluggish economic growth* amidst a low level of investment and slowing private consumption growth rates and a *notable decrease in some food prices*. *In the first three quarters of 2014, there was 0.8% deflation against 3.2% inflation* of the same reference period last year. So, in late September of 2014 the 12-month inflation rate declined to **1.5%** stepping below the lower bound of the confidence band. In the meantime though, the *12-month core inflation rate* declined consistently from **3.7%** in late 2013 to **1.0%** in late September of 2014.

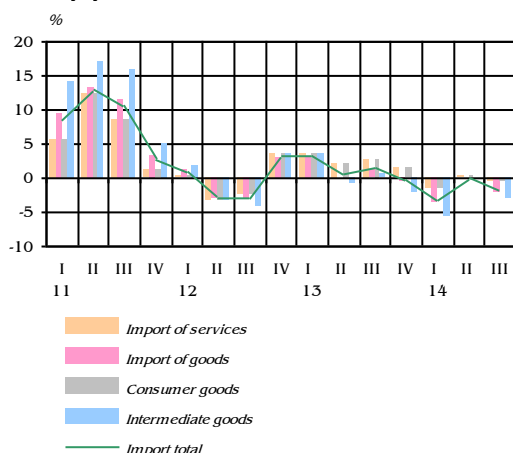
In consideration of phased out effect of the 2013 energy price increases on the domestic prices as well as expectations of non-inflationary pressures from the external and domestic sectors in the medium run, the Central Bank further loosened the monetary conditions: *in the past nine months of 2014* the refinancing rate was lowered a total of 1.0 pp to **6.75%** in late September.

In the past one-year period, the *dram reserve requirement ratio lowered from 4% to 2% effective February 2014*, which caused reduction in short-term interest rates in the financial market, was another easing-driven measure.

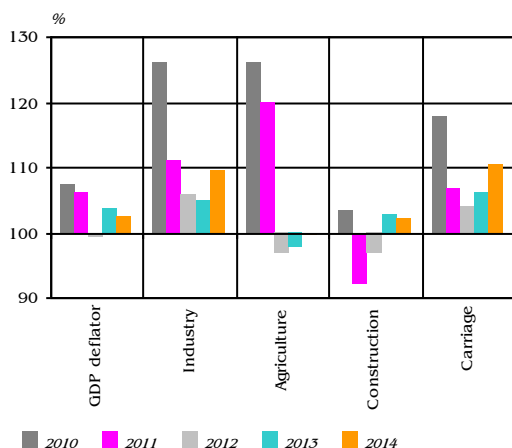
3.1.2. Import prices and producer prices

Import prices: in the 3rd quarter of 2014, the dollar prices of import of goods and services decreased by 1.9% q/q, with y/y reduction of 1.7%. This y/y decrement in dollar prices was driven by 1.5 pp drop in prices of goods and 0.2 pp reduction of service prices (in the 3rd quarter, the dollar prices of import of services and import of goods fell by 1.7% q/q and 2.1% q/q, respectively). The decrease in prices of intermediate goods, which was mostly driven by reduced prices of iron, oil and

In the 2nd quarter, the dollar prices of import of goods and services declined by 1.7% y/y



In January-June 2014, the prices were highest in carriage and industry



wheat, was the main cause for falling dollar prices of import of goods. In the meanwhile though, the third quarter saw a rise in aluminum and sugar prices. The y/y decrease in dollar prices of consumer goods in Ukraine and Russia has been offset by the y/y dollar price increases reported in China and Korea. As a result, consumer prices made as little as 0.1 pp negative contribution.

Producer prices¹²: in the 3rd quarter of 2014, all sectors of the economy, except for agriculture, posted increased price indices, with the GDP deflator in the period January-September having amounted to 102.3 y/y.

Industry posted a quarterly price rise of 10.7% y/y, with the January-September increase having amounted to 9.4% y/y, owing to growths in *ore mining* (6.7%), *processing industry* (2.3%) and *energy and gas production and distribution* (39.6%). Note that the latter is a result of electricity price increase since August 1, 2014.

Agriculture reported 3.6% y/y decrease in prices¹³ during the 3rd quarter, with the January-September price falling of 0.6% y/y, driven by 6.9% y/y reduction in prices in *plant growing* and 2.7% and 3.1% y/y price increases in *animal breeding*. The price drop in plant growing is due to decreased prices in groups "potato and vegetables" (9.1%), "gourds" (44.4%), "grains" (14.1%), whereas increased prices in animal breeding were mainly attributable to 10.7% and 9% rise in *milk and dairy products* and *egg*, respectively.

Construction reported 2.8% y/y price increase during the 3rd quarter, with the January-September price rise of 2% y/y, mainly attributable to the wage increases in the branch.

Carriage reported 1.1% y/y rise in prices in the 3rd quarter, with the January-September price rise having amounted to 10.3% y/y, owing to increased tariffs for *railroad transport* (13%), *pipeline transportation* (23.9%) and *air transport* (0.1%). Note that much higher rates in pipeline transportation are mainly due to the increase in energy prices.

3.1.3. Inflation and interest rate expectations

The results of the 3rd quarter 2014 surveys of the Central Bank on financial sector and household expectations of selected macroeconomic indicators suggest that inflationary expectations for an upcoming one-year horizon have not changed much but remained in the 4,5-5,0% range, indeed. Thus, most banks anchored their expectations of the 12-month inflation rate around a 5% range and credit organizations in the region of 4.5%. The results of the survey show that households' inflationary expectations again moved downward, to an average

¹² The price index change as of January-September 2014 is relative to the same period of the previous year, unless otherwise specified.

¹³ Sales prices of producers of agricultural product are presented.

4.0% inflation for the 3rd quarter of 2015 versus 4.6% reported by the previous survey.

According to the survey results, expectations of market rates for a one-year horizon moved slightly downside.

3.2. Aggregate supply and Aggregate demand

3.2.1. Aggregate supply¹⁴

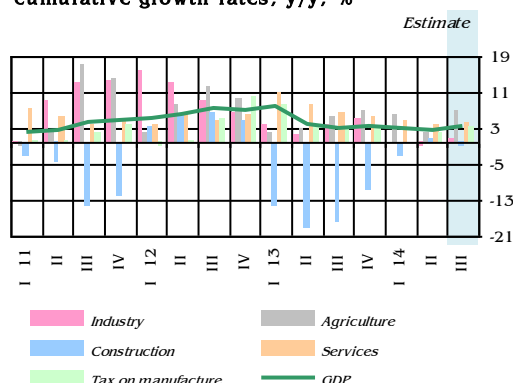
The **economic growth indicator** published for the 2nd quarter of 2014 was 2.3% y/y, with the GDP growth of 2.6% y/y in the period January-September. The economic growth indicator 0.9 pp lower from the Central Bank forecast was a result of faster growing intermediate expenditures over output growth. The latter was more pronounced in industry when value added reported 0.8% y/y decline instead of an anticipated 1.2-1.7% growth for the first half of the year.

The economic activity accelerated in the 3rd quarter, with the activity indicator having grown by 4.3% in the course of the past nine months against 3.4% y/y recorded in the period January-September.

Economic growth for the first nine months of 2014 will be expected in the range 3.5-3.8%.

Thus, taking into account a lower-than-expected output growth in industry and services and negative developments in construction in the 3rd quarter of 2014, the economic growth estimates were revised somewhat downside. As a result, the economic growth for the first nine months of 2014 will be expected in the range 3.5-3.8%¹⁵.

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



In **Industry** in the first nine months of 2014, the growth of value added is estimated in the range 0.5-1% y/y, mainly due to increased output in *food products* (6.9%)¹⁶, *metallurgy* (11.2%), *tobacco production* (26.3%), *beverage* (1.2%)¹⁷ and *water supply and sewage* (4.6%). A reduced growth rate in the sector is primarily a result of slowdown in domestic and external demand.

In view of actual developments in **Construction** reported for the first nine months of 2014, the decline of value added is estimated within 0.4-0.9% y/y. Exclusive of reduced volumes of construction financed by *households* (by 23.7%), *state budget* (by 1.5%) and *humanitarian aid* (by 32.7%), all other sources of construction financing posted growths, as follows: *organizations*

¹⁴ The indicators of real growth of value added in sectors of the economy for January-September 2014 y/y are the Central Bank estimates whereas the indicators of sub-sectors represent y/y growth rates in output volumes for January-September 2014, unless otherwise specified.

¹⁵ See the 30% probability of Real GDP Growth (Cumulative) Projection Probability Distribution Chart.

¹⁶ Increased output was mainly due to capacity growth in producing meat (13.3%), meat products (18.9%), meat prepacks (18.2%), milk (5.9%), matsoun (17.7%), cheese (6.2%), animal fat (2.2-fold), macaroni (18.7%), sugar (2.3%), flour (48.3%), grains (34.9%), confectionery (9.1%), canned food (4.2%) and ice cream (48.8%).

¹⁷ Increased output was mainly due to capacity growth in producing champagne (26.8%), beer (37.2%), non-alcoholic beverage (35.7%), natural juice (14.5%), mineral water (51.6%) and spring water (48.7%).

(by 1.7%), *international credit* (by 32.3%) and *local community budgets* (by 78.8%).

In **Services**, the growth of value added in the period January-September is estimated in the range 3.9-4.4% y/y as a result of volumes of services rendered and trade turnover having increased by 6.8% and 5.2%, respectively. The increase in the volume of services rendered was driven largely by growth in air transport (about 1.34-fold), banking services (0.6%), events, leisure and rest (47.4%), real estate transactions (10.8%), travel services (14.5%), public catering (12.9%), information technologies (3.8%) and healthcare (2.7%), respectively. The trade growth was a result of increased turnover in retail, wholesale and passenger car trade, by 3.2%, 9.1% and 2.4%, respectively.

In **Agriculture**, the growth of value added for the first three quarters of 2014 is estimated in the range 6.6-7.1% y/y, due to increased outputs in animal breeding, plant growing and fishing by 5.7%, 7.5% and 22.5%, respectively. Reported increases in *milk production*, *egg production* and *slaughtered animal and poultry production* by 6%, 3% and 10.7%, respectively, contributed to the overall growth in *animal breeding*. Similarly, increased production of potato (4.3%), wheat (4.2%), vegetables (21.4%), gourds and melons (24.5%) and grapes (29.2%) contributed positively to *plant growing*.

3.2.2. Aggregate demand¹⁸

Private consumption in the 3rd quarter of 2014 was remarkably lower from the projections, with an estimated decline of 1.0% during the quarter.

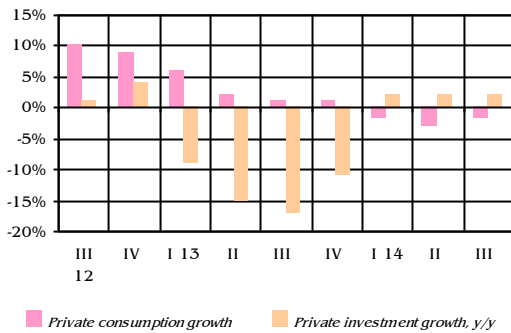
Reduced private transfers from Russia, an overall sluggish economic activity and increasing debt burden of households are those principal factors which have adversely affected the level of private consumption in the 3rd quarter. It should be noted, however, that the negative impact of the above-mentioned factors somehow diminished thanks to expansionary monetary and fiscal policy implementation. In particular, during the 3rd quarter total credit to the economy grew by about 12% y/y and consumer loans, by 22% y/y as part of an expansionary monetary policy.

The results of the Central Bank surveys¹⁹ also point to the above developments with private consumption. Thus, in the 3rd quarter of 2014, relative to the same reference period last year, the indices of households' estimation of overall domestic economic situation and major private spending have dropped by 13% and 0.8%, respectively, reflecting reduced expenditures of households in the reporting period.

¹⁸ The private spending, private consumption and private investment data for the 3rd quarter of 2014 are the Central Bank estimates based on actual 2nd quarter of 2014 data. Growth estimates in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

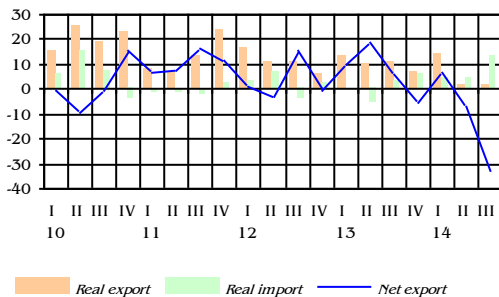
¹⁹ See <https://www.cba.am/am/SitePages/statsscci.aspx>.

Private consumption and investment growth, y/y



In the 3rd quarter, negative balance of net export grew

(net real exports, y/y, %, positive sign means improvement)



In the 3rd quarter of 2014, the investment climate in the economy was weak, in line with the forecast, so the private investment growth was an estimated 2.0% in relation to the same period last year. Weak investment climate observable since the start of the year was due to a decline in construction and sluggish economic activity on the whole.

The results of the Central Bank investment surveys²⁰ of Armenian companies point to a low investment activity during the 3rd quarter. The share of the companies having invested was much the same, 21% of respondents of the survey, in relation to the previous reference period. This is much below the average historical indicator.

According to the survey, the number of investor companies is relatively large in industry and services sectors, whereas the number of companies investing in construction and trade trended downward.

In the 3rd quarter of 2014, **private spending** posted 0.6% decline in relation to the 3rd quarter of the previous year.

On the back of the aforementioned developments with private consumption and investment, the private spending gap in the 3rd quarter of 2014 is estimated largely negative, leaving 1.8-2.0 pp of contractionary impact on the inflation.

According to the Central Bank estimates, in the 3rd quarter of 2014 the negative balance of net export in real terms deteriorated. Thus, the growth rates of export of goods and services in real terms amounted to 2.2% y/y and the growth rates²¹ of import of goods and services in real terms reached 13.0% y/y²². Despite a sluggish external demand, the export developments created inflationary pressures driven by extra export volumes of agricultural product.

In the 3rd quarter of 2014, growth rates of net inflow of non-commercial remittances of individuals via the banking system slowed down by 6.9% y/y due to a low economic growth in Russia and depreciating ruble²³.

3.2.3. Labor market²⁴

In the 3rd quarter of 2014, the **average nominal wage growth rate** was slower than forecasted and amounted to 8.8%. The slowing was attributable to a slower wage growth in the public

²⁰ <https://www.cba.am/am/SitePages/statsseabci.aspx>.

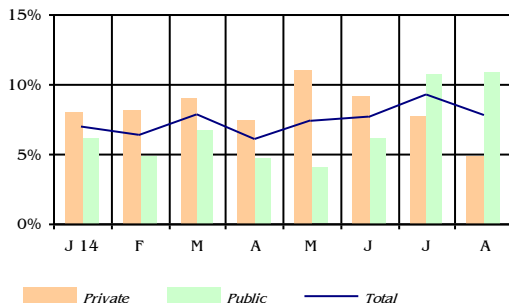
²¹ The real export and import growth indicators are the Central Bank estimates.

²² High growth in import was in part due to a one-off transaction of importing of a bulk of machinery and equipment.

²³ In the period January-September 2014, the inflow of non-commercial remittances of individuals through the banking system has increased by 0.4%. If the ruble's depreciation against the dollar was excluded (depreciation relative to the previous January-September period has been roughly 11.0%), the inflow of the above mentioned non-commercial remittances would have grown by 8.0%.

²⁴ The labor market data for 2014 are the Central Bank estimates which are based on the 2nd quarter of 2014 data and actual July-August 2014 figures. The growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

Nominal wage growth



sector against the previous forecasts. The increase of the wage in some areas of the public sector in July of 2014 pushed the average wage growth up by 11% in the 3rd quarter, which represented a 6 pp increase of the growth rate in comparison with the 2nd quarter.

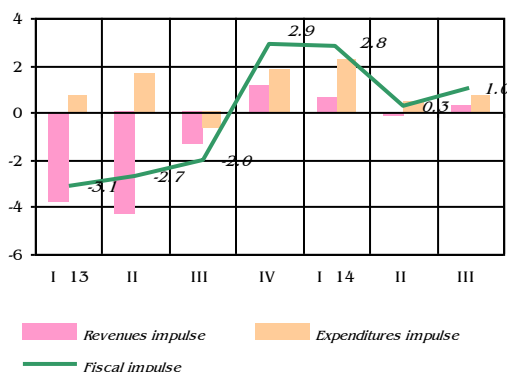
In the 3rd quarter of 2014, the private sector wage growth was an estimated 6.5%. The increase of the minimum salary threshold as well as certain rise in wages in the private sector in the context of the funded pension reform notably contributed to the nominal wage increases in the private sector. The aforementioned factors notwithstanding, a relatively weak economic activity in the 3rd quarter exerted negative pressures on the wage in the private sector.

A weak economic activity recorded in 2014 prompted the supply for the labor market to outgrow the demand for the labor market, with the employment rate posting a small growth of 0.2% in comparison with 1.2% growth of economically active population. As a result, in the 3rd quarter of 2014, relative to the same period of the previous year, the **unemployment rate** has increased by 0.6 pp to 16.0%. During the quarter the unemployment rate grew faster-than-forecasted, which was determined by weak economic activity.

In the 3rd quarter of 2014, the labor market saw a slight increase in productivity, while the wages have somewhat outgrown the productivity and thus added to unit labor costs in companies. Consequently, increased labor costs have brought in minor inflationary pressures of 0.1-0.2 pp in the economy.

3.2.4 Fiscal policy²⁵

In the 3rd quarter, expansionary impact of the fiscal policy is attributable to expenditures with their expansionary effect



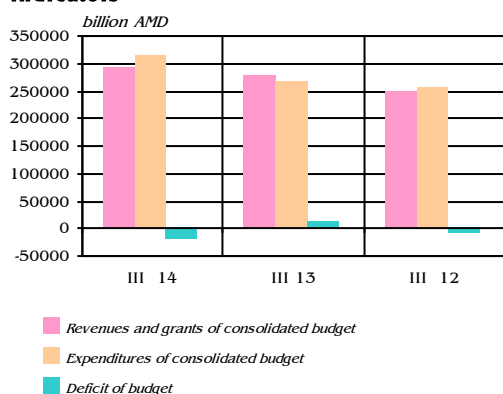
In the 3rd quarter of 2014, the State Budget generated revenue underperformed against the quarterly projections and the Central Bank forecasts but reported considerable expenditures savings on certain items. According to the fiscal impulse indicator, the fiscal sector's impact on aggregate demand was 1.0 expansionary in the 3rd quarter, instead of an expected neutral. The deviation is largely due to the revenues impulse which came in 0.3 expansionary instead of an expected 0.6 contractionary due to underperformed revenues.

Revenues and grants of the consolidated budget have grown by 4.7% in relation to the 3rd quarter of the previous year, with tax revenues having increased by 6.4% y/y. Nevertheless, actual taxes collected during the quarter were AMD 17.3 billion less than the adjusted quarterly plan²⁶. As a result, the revenues impulse proved expansionary instead of projected contractionary.

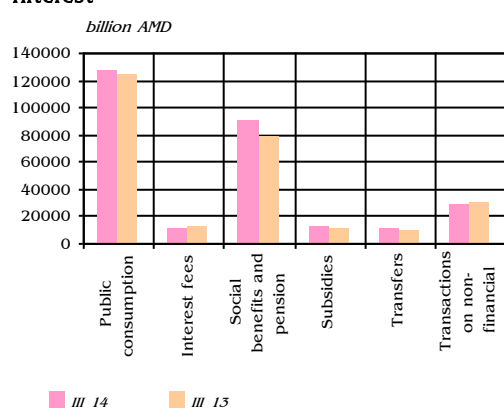
²⁵ The review of the fiscal sector was done using the preliminary actual consolidated budget indicators prepared on the basis of the preliminary actual indicators of the 3rd quarter of 2014 (PIU funds included), excluding off-budgetary funds. The impact of revenues was calculated in respect of the nominal GDP indicator while the impact of expenditures in respect of the estimated potential GDP indicator.

²⁶ The State Budget Law 2014 was adjusted under the Republic of Armenia Government resolutions (<https://www.e-gov.am/gov-decrees/>).

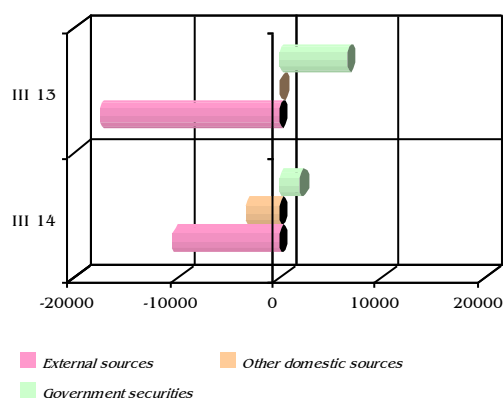
Performance of main consolidated budget indicators



During the quarter, all expenditure items posted increases, except for public debt interest



In the 3rd quarter of 2014, unlike the same period last year, the budget generated a deficit (bln AMD)



Relative to the 3rd quarter of the previous year, the growth of indirect taxes has been an estimated 9.5% and the direct taxes, 1.0%. The share of indirect taxes rose by 1.5 pp to 52.9% of tax revenues but the share of direct taxes shrank by 2.0 pp to 37.3%. The share of other taxes grew by 0.5 pp to 9.8% in total.

Other revenues have reduced by 5.4% y/y but exceeded the 3rd quarter program indicator by nearly 1.5-fold.

Public expenditures reported reduced performance against both an adjusted quarterly plan and the Central Bank forecast, as they amounted to 89.2% and 95.8%, respectively. However, compared to the same period last year, the expenditures of the consolidated budget have grown by about 17.2%. Furthermore, expenditures have grown due to current expenditures and item "transactions with non-financial assets", amounting to 18.7% and 6.1%, respectively. All current expenditure items, except for the item "debt interest payment", posted increases, with **public consumption** having increased by 13% compared to the previous reference period. The increase in item **"transactions with non-financial assets"** was due to increased spending from domestic sources. However, expenditures financed by external sources have reduced by 10%.

In the 3rd quarter of 2014, with revenues and expenditures figures shown above, the budget reported a deficit of AMD 20.6 billion instead of a deficit of AMD 38.7 billion as was projected under the program adjusted for the quarter.

Based on the results of the past nine months of 2014, the revenues and grants of the budget amounted to AMD 803.3 billion, which secured a 96.1% performance of the 9-month program of the Government. Relative to the same period of the previous year, tax revenues have grown by 4.9% or AMD 36.6 billion due mostly to increased value added tax and income tax. Relative to the same period of the previous year, public expenditures (PIU funds included) have grown by 12% to AMD 808.9 billion.

As a result of the past nine months of 2014, the budget deficit totaled AMD 5.6 billion instead of the envisaged AMD 91.3 billion.

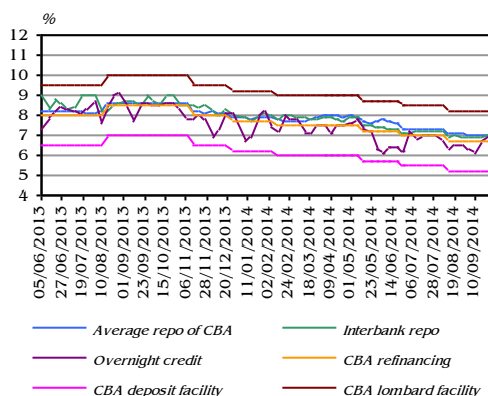
Overall, the fiscal policy's impact on the aggregate demand has been 1.2 expansionary as both the expenditures and revenues generated expansionary pressures.

3.3. Money and financial market developments

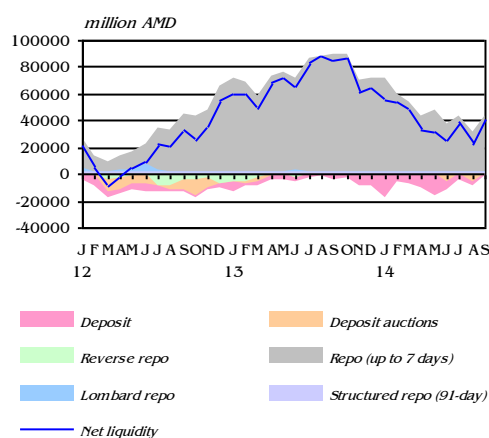
3.3.1. Financial market, money and credit

In the 3rd quarter of 2014, the Central Bank reduced the refinancing rate by 0.25 pp to 6.75% as part of further easing of monetary conditions, a policy measure since November of 2013. The decision was based on the consideration that the inflation and growth still lag behind the desired levels in spite of forecasts in favor of rebounding and stabilizing inflation and economic growth rates.

Short-term interest rates dropped during the quarter



Operations carried out by the Central Bank (average monthly volume)

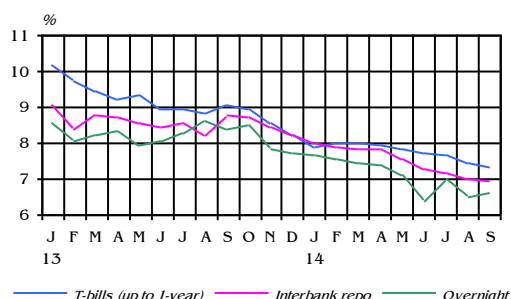


During the quarter, the 7-day repo rate, the main policy instrument of the Central Bank, trended in line with the refinancing rate: the average rate for September, which was 0.56 pp lower from June average, reached 7.01% and the quarterly average indicator dropped by 0.63 pp to 7.16%.

Operations carried out by the Central Bank						
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

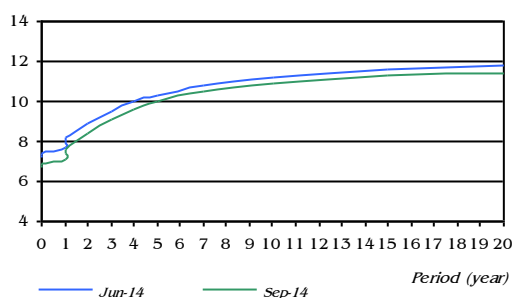
In the 3rd quarter of 2014, short-term interest rates of the financial market further trended downward, concurrent with the refinancing rate. Relative to the previous quarter, the average quarterly overnight interest rate has fallen by 0.37 pp. Despite a slight rise at the beginning of the quarter in part due to a reduced volume of overnight credit resources, the interest rates began stabilizing around 6.5% level the next months as the said volume restored. Relative to the previous quarter, the market repo rate has reduced by 0.53 pp; the average September rate has fallen relative to the average June rate by 0.32 pp to 6.95%. In the T-bills market too, the rates have trended down.

During the quarter, short-term interest rates trended down as the Central Bank cut the refinancing rate



In the T-bills market in the 3rd quarter, interest rates dropped

Up to maturity,



Box 3

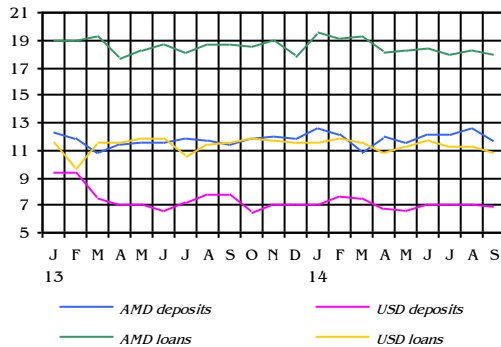
Government securities market

Interest rates in the government securities market reacted to the Central Bank policy rate change adequately. In the primary market, the average quarterly rate of up to 1-year T-bills kept on falling by 0.38 pp to 7.45%. In September, average yield of interest rates was 7.34%, which represented a 0.39 pp reduction compared to June average.

According to yield to maturity curve, interest rates in the secondary market of T-bills have reduced all along the curve. In the long-term segment, the interest rate dropped by 0.3 pp to 11.45% in end-September. The long-term and short-term interest rates spread rose by 0.22 pp to 4.76 pp in September.

Continued loosening of monetary conditions resulted in the reduction of overall credit rates, as well. Note that although increasing competition between banks contributed to reduced interest rates of loans, interest rates of deposits attracted grew during the quarter as a matter of fact.

Dynamica of interest rates of funds in local currency and foreign currency

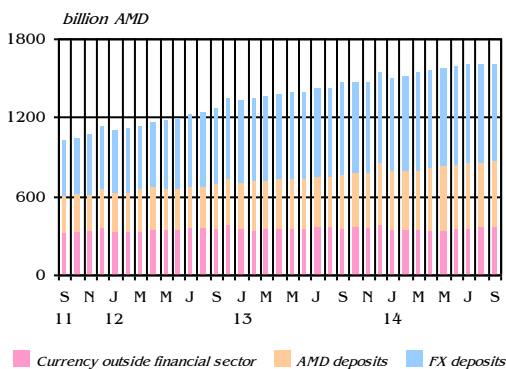


Average quarterly dram deposit rate has risen by 0.2 pp against the previous quarter and amounted to 12.1%. During the quarter, the volume of dram deposits grew by 4.0%, mostly owing to dram demand and term deposits having grown by 5.1% and 3.2%, respectively.

In the 3rd quarter of 2014, like in the previous quarter, interest rates of dram loans reduced in part due to fallen interest rates of consumer loans. As a result, average quarterly dram loan interest rate has fallen by 0.1 pp against the previous quarter to 18.1%.

In the 3rd quarter of 2014, foreign currency lending rates dropped as well, with average quarterly interest rate having reduced by about 0.2 pp to 11.1%. It is worth mentioning that interest rates of mortgage loans to individuals have reduced considerably.

In the 3rd quarter, growth of AMD deposits outpaced that of FX deposits

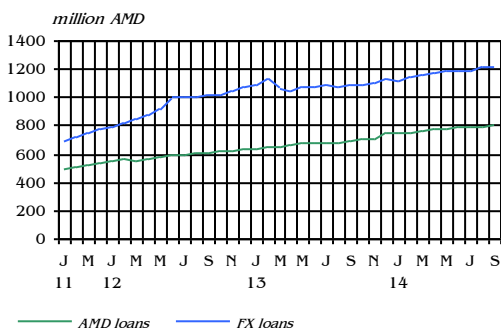


The results of surveys on “Terms of Lending Provided by the Republic of Armenia Banks and Credit Organizations” also point to the downward trend of interest rates of loans to businesses as well as mortgage loans.

In the lending structure by currency, the shares of foreign currency loans and dram loans were nearly the same, 2.2% and 2.3%, respectively, yet in total lending, the foreign currency loans still prevail (59%). During the quarter, the total credit growth amounted to 2.4 % (with y/y growth of 14.3%), and to AMD 48.7 billion, in absolute terms.

In the 3rd quarter, interest rates of foreign currency deposits grew by 0.2 pp against the previous quarter’s average and reached 7.0%. The volume of foreign currency deposits decreased by 2.9% during the quarter primarily attributable to reduced volume of demand deposits.

In the 3rd quarter, FX loans again outnumbered in total lending portfolio



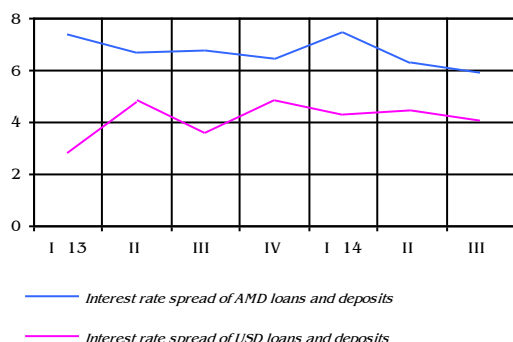
Box 4

As the results of the 3rd quarter 2014 survey on terms of lending provided by Armenian banks and credit organizations show, there has been further easing of the terms of lending to businesses and the terms of consumer and mortgage loans for households. Easing of the terms of SME loans came in somewhat a slower pace due to restricted liquidity and accessibility to the money markets on the one hand and expectations of the slowing of economic activity, on the other. The terms of SME loans (mostly on the part of interest rate) were further eased along with better terms of loans to households, providing for easier review of interest rate, collateral requirements, loan to value ratio and borrower creditworthiness.

Demand has increased for consumer loans, remained unchanged for SME loans but declined for mortgage loans. Factors for a declined demand included reduced savings of households and plunged consumer confidence.

Easing of terms of all types of loan products and lending procedures will carry on during the 4th quarter of 2014, as demand for all types of loan products is expected to grow.

In the 3rd quarter, the spread of interest rates of foreign currency loans and deposits narrowed

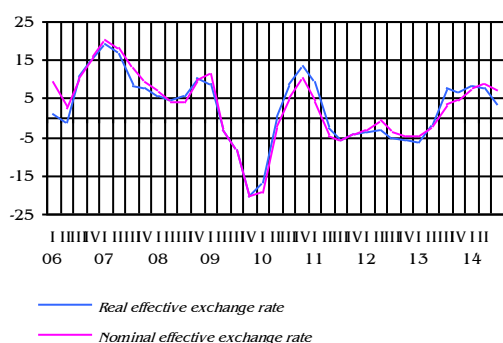


The 3rd quarter of 2014 marked a trend of further narrowing spread of interest rates of loans and deposits in both dram and foreign currency. The spread has reduced by 0.4 pp to 5.9% for dram loans and deposits, and the spread of foreign currency loans and deposits narrowed by 0.3 pp. Note that in September, against June, the spread of foreign currency loans and deposits has reduced by 0.7 pp to 3.9%.

During the quarter, the dollarization (a ratio of foreign currency deposits to broad money) continued to subdue, posting a further 1.7 pp reduction against the previous quarter.

Monetary indicators	12-month inflation		
	March	June	September
Broad money (%)	12.84	14.78	9.64
Dram broad money (%)	10.92	14.26	14.15
Base money (%)	20.84	8.21	-0.52
Dram base money (%)	1.67	4.49	0.63
Currency (%)	-4.49	-1.19	1.44
AMD deposits (%)	25.27	28.59	25.31
FX deposits (%)	14.95	15.36	4.71
Dollarization (percentage point)	0.89	0.24	-2.15
Money multiplier (percentage point)	-0.14	0.13	0.21
Dram multiplier (percentage point)	0.12	0.12	0.17

In the 3rd quarter, real effective exchange rate appreciated at quite a slow pace, %



3.3.2. Exchange rate

In the 3rd quarter of 2014, trade partners' average nominal weighted exchange rate kept on depreciating versus the U.S. dollar by 2.9% q/q. This was driven primarily by high currency depreciation rates in the euro-area as well as Russia and Ukraine. Conversely, during the quarter the nominal exchange rate of the Armenian dram appreciated by 1.1% q/q versus the U.S. dollar, reflecting high seasonal demand. At the time, the Central Bank acted as a net buyer of foreign currency in the foreign exchange market to smooth out sharp currency fluctuations.

y/y growth, %	Q1, 2013	Q2	Q3	Q4	Q1, 2014	Q2	Q3
Real effective exchange rate (+ means appreciation)	-6.4	-1.6	7.9	6.8	8.5	7.9	3.1
Average inflation in Armenia	3.0	5.2	8.7	6.4	4.6	3.3	1.0
AMD/USD average nominal exchange rate (+ means appreciation)	-5.1	-3.3	0.5	0.2	-0.4	0.5	0.0
Average weighted inflation in trade partner countries	4.5	4.4	4.3	4.0	3.7	4.4	4.6
Partner countries' average weighted nominal exchange rate (+ means appreciation versus dollar)	-6.4	-1.6	7.9	6.8	8.5	7.9	3.1

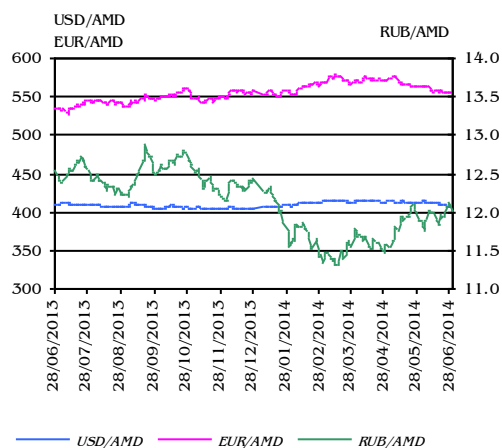
Real exchange rate appreciation = Inflation in Armenia + Nominal exchange rate appreciation – Partner countries' average weighted inflation – Partner countries' average weighted nominal exchange rate appreciation

As a result of the aforementioned developments, during the quarter the nominal effective exchange rate of the Armenian dram appreciated by 4.0% q/q and the real effective exchange rate²⁷, by 1.3% q/q. It should be mentioned that the real exchange rate appreciation slowed down by 3.1% compared to the 3rd quarter of the previous year, which was largely attributable to the low 12-month inflation rate in Armenia.

Box 5

Foreign exchange market

Dram exchange rate versus US dollar, Euro and Russian ruble in a year



At the end of the 3rd quarter of 2014, the average market exchange rate of AMD/USD was 407.6. During the quarter, the dram's depreciation was a mere 0.08%.

The table below shows the dram's behavior versus the U.S. dollar, Euro and Russian ruble:

Dram exchange rate dynamics (end Q3 2014 to end Q2 2014)			
Currency pair	Exchange rate as of 30.06.2014 (AMD)	Exchange rate as of 30.09.2014 (AMD)	% (appreciation "+", depreciation "-")
USD/AMD	407.28	407.6	-0.08
EUR/AMD	556.06	513.49	8.29
RUB/AMD	11.99	10.32	16.18
Dram exchange rate dynamics (end Q3 2014 to end Q3 2013)			
Currency pair	Average exchange rate, Q3, 2013	Average exchange rate, Q3, 2014	% (appreciation "+", depreciation "-")
USD/AMD	408.65	408.47	0.04
EUR/AMD	541.65	541.37	0.05
RUB/AMD	12.47	11.27	10.65

The aggregate volume of U.S. dollar/Armenian dram transactions in the foreign exchange market during the 3rd quarter amounted to USD 2.95 billion, which represents a 3.5% increase in relation to the figure reported in previous reference period (AMD 2.5 billion).

The aggregate volume of Euro/Armenian dram exchange transactions reached EUR 276.28 million against EUR 225.98 million recorded in the previous quarter.

During the 3rd quarter, the Central Bank bought U.S. dollars in the currency market for a total of USD 18.25 million.

²⁷ The 3rd quarter 2014 indicator of the real exchange rate is the Central Bank estimate.

3.4. Balance of payments²⁸

In the 3rd quarter of 2014, the current account deficit deteriorated mainly to an increased balance of trade deficit and reduced private remittances. The net inflow of funds through the capital and financial account recovered (a net outflow of the funds was recorded in the previous quarter). In the 3rd quarter of 2014, net foreign assets of the Central Bank decreased mainly as a result of foreign debt servicing.

3.4.1. Current account

In the 3rd quarter of 2014, according to the estimations, the Current Account Deficit / GDP ratio grew by 1.5 pp against the same quarter last year. Compared to the 3rd quarter of 2013, the current account deficit has increased by USD 191.6 million and amounted to USD 256.8 million.

In the 3rd quarter of 2014, the dollar value of export of goods grew by 3.9% y/y.

Consumer goods, precious stones and metals made a positive contribution to the export growth during the quarter in contrast to raw materials (intermediate goods) and other items with their negative contributions.

In the 3rd quarter of 2014, the dollar value of import of goods grew by 11.6% y/y.

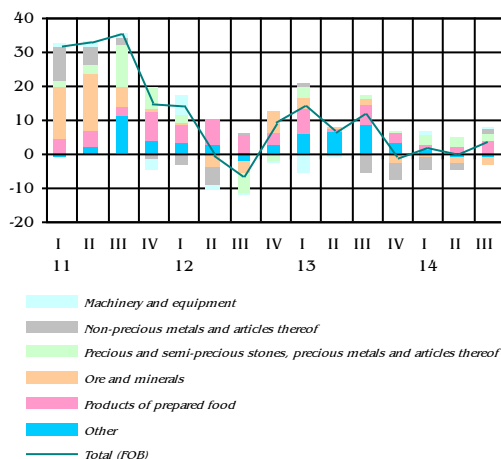
Raw materials (intermediate goods) and investment goods greatly contributed to the growth of import during the 3rd quarter, whereas consumer goods, precious stones and metals made small negative contributions to the import.

Although the terms of trade improved, the deficit of trade balance in the 3rd quarter grew by USD 87.4 million to USD 556.5 million.

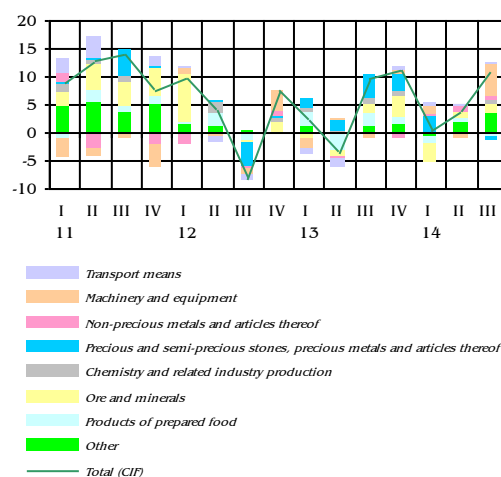
In the 3rd quarter of 2014, the export and import of services posted an estimated 6.7% y/y and 10.3% y/y growth, respectively. The deficit of balance of transport services widened as a result of an increased deficit of trade balance. The dollar value of export of construction services diminished during the quarter³⁰.

In the 3rd quarter of 2014, net remittances of individuals reduced amidst economic difficulties in Russia and the ruble depreciating against the U.S. dollar. During the quarter, net inflow of item "employee remuneration" posted a 6.6% y/y decrease to USD 313.4 million, which is higher from the figure

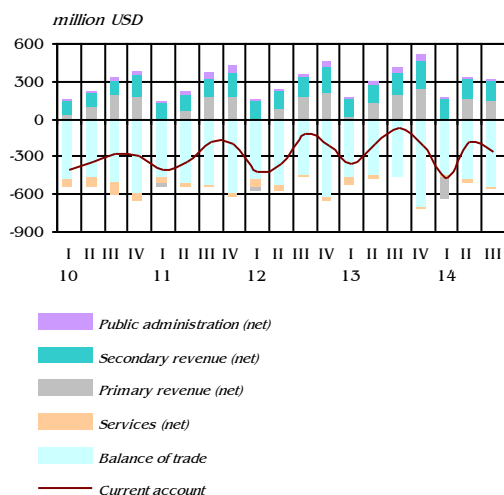
Change in dollar value of export of goods y/y and main commodities contribution, %²⁹



Change in dollar value of import of goods y/y and main commodities contribution, %



In the 3rd quarter, current account deficit grew, y/y



²⁸ From now on, the balance of payments figures will be presented according to the new balance of payments methodology (BPM6). The 3rd quarter 2014 figures are the Central Bank forecasts and estimates.

²⁹ Export and import indicators by commodity and by country are in FOB and CIF prices, and export and import of the current account, by debit and credit, respectively.

³⁰ This includes the dollar value of construction services provided by seasonal workers.

of net outflow in item “income on investment”. As a result, item “initial income” posted net inflow of USD 144.5 million. The net inflow of private transfers has reduced by 10.1% y/y to USD 155.7 million.

3.4.2. Capital and financial account³¹

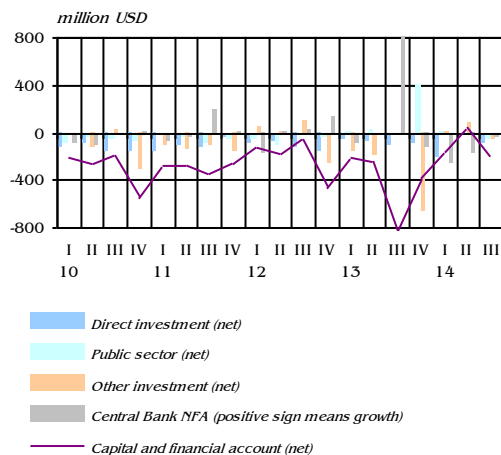
The 3rd quarter of 2014 saw net inflow of funds of USD 215.8 million through the capital and financial account in contrast to the net outflow of funds recorded in the previous quarter. The current account was financed mostly by foreign investment, bank and public loans. During the quarter, net foreign assets of the Central Bank reduced by USD 40.9 million mainly to the expense of foreign debt servicing.

The 3rd quarter marked a stable inflow of capital transfers amounting to USD 18.8 million (USD 19.5 million was recorded in the same reference period last year).

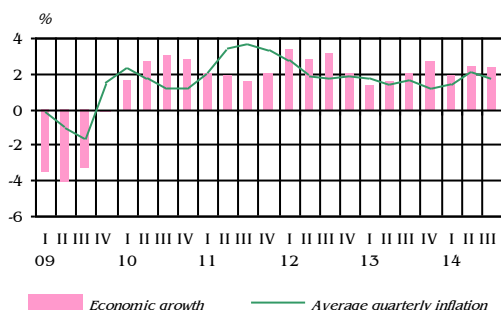
The net inflow of foreign direct investment during the quarter narrowed to USD 97.7 million. The net inflow of public loans amounted to USD 57.0 million compared to the previous year’s respective figure of USD 20.3 million reported for the 3rd quarter.

In the 3rd quarter, the net inflow of funds through commercial banks reached USD 72.0 million; the net outflow through other private sector amounted to 10.8 million. As a result, item “other investment” posted a net inflow of USD 61.2 million.

In the 3rd quarter, the capital and financial account posted a net inflow of funds (+ net credit, - net borrowing)



In the 3rd quarter, economic growth in U.S.A. remained strong



3.5. External environment

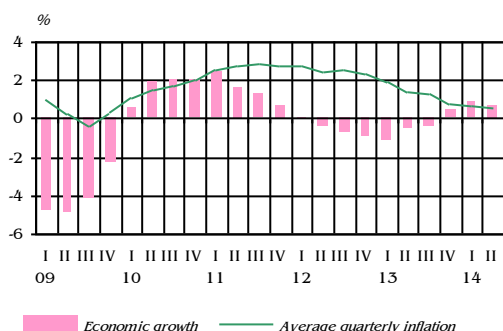
In the 3rd quarter of 2014, save for the U.S.A., trends of slowing economic activity were observable in Armenia’s main trade partners.

According to preliminary estimates of the U.S. Department of Commerce Bureau of Economic Analyses, in the 3rd quarter of 2014 the annualized economic growth in the United States of America was 3.5% q/q (2.3% y/y economic growth reported in the 3rd quarter). Almost all components, i.e. private expenditures, gross investment and government spending as well as net export (owing to increased exports and reduced imports) all contributed to the growth positively.

In the 3rd quarter of 2014, average quarterly inflation in the U.S.A. was 1.8% y/y compared to 2.1% reported in the previous quarter. As it was scheduled, the quantitative easing program of the U.S. Fed ended in October, while the policy rates were again low, in the 0-0.25% range.

³¹ The 3rd quarter of 2014 capital and financial account figures are the Central Bank forecasts and estimates.

In the 3rd quarter, economic growth in Euro-area further slowed down



In Euro-area in the 3rd quarter of 2014, there was 0.8% economic growth against the same period of the previous year, according to preliminary estimates provided by the Eurostat. During the quarter, the consumer price index posted an average 0.3% growth y/y against the previous quarter's 0.6%.

In the 3rd quarter of 2014, the European Central Bank cut the policy rate to 0.05% in the meanwhile setting a -0.2% rate for the deposit facility.

In the 3rd quarter of 2014, Euro depreciated versus the U.S. dollar by 3.4% (y/y appreciation was 0.05%), with the average dollar exchange rate reaching 1.325 for one Euro.

In the 3rd quarter of 2014, economic growth in Russia was 0.7% y/y, according to the preliminary estimates of the Russia State Statistics Service. Specifically, industry posted some 1.5% growth compared to the previous quarter's 1.8% growth. Growth rates in retail trade and agriculture were 1.4% y/y and 11% y/y, respectively. In the meanwhile though, construction reported a 4.1% y/y decline. Consumer Price Index posted an average 7.7% y/y growth against the previous quarter's 7.6%.

In the 3rd quarter of 2014, the *price of Brent crude* at Intercontinental Exchange fell by 6.8% against the previous quarter, reaching USD 102.1 a barrel (with 7.2% y/y decrease). During the quarter, the *price of copper* at the London Metal Exchange grew by 3.2% to USD 6978 per ton (with 1.8% decline y/y).

In the 3rd quarter of 2014, export price of *hard red wheat* plunged by 19% q/q to USD 7.1 a bushel (with 14.8% decrease y/y), according to the U.S. Department of Agriculture data. The decrease of wheat prices during the quarter was in part a result of technical adjustment after a previous price rise as well as expectations for abundant crops.

During the quarter, the price index of *unprocessed sugar* at the New York Board-Intercontinental Exchange reported a 7.7% decrease (with 4.7% decline y/y) driven by strengthening U.S. dollar especially against the Brazilian currency as well as expectations for supply in the market. Similarly, the price of *rice* at the Chicago Board of Trade fell by 12.9% to USD 12.9 per U.S. hundredweight (45.4 kg) (with 17.1% decline y/y).

The world commodities markets saw even deeper deflationary patterns during the 3rd quarter, which was determined by weaker-than-anticipated global economic activity and changes in the geopolitical landscape.

4. CONCLUSION

In the 3rd quarter of 2014, global demand in *external sector* remained sluggish and mostly deflationary patterns were observable in basic commodity and food markets. In the *forecast horizon* the global economic growth rates are expected to rebound slowly, so *inflationary pressures* in basic commodity and food markets of the world *are not anticipated*.

In the 3rd quarter of 2014, the domestic economic activity revived to some extent and the inflation environment expanded. Under such conditions, *economic growth* was estimated in the range *3.5-3.8%*, with the *12-month inflation rate* reached 0.4% in late July and amounted to *1.5%* at the end of September, i.e. still below the lower bound of the confidence band.

In the forecast horizon, real private consumption growth rates are expected to stabilize and private investment to rebound slowly. Under such circumstances, economic growth will approach its equilibrium. In 2015, after the deflationary influence phases out, the *impact of the domestic economy on aggregate demand is expected to be non-inflationary* as a result of stabilizing private demand as well as mostly a neutral impact of the fiscal policy.

According to the Central Bank forecasts, in spite of expected low demand in both external and domestic economies, the inflation rates are expected to rebound as a result of *stamp duty introduced* to a variety of goods starting from the 4th quarter of 2014 as well as *Armenia's membership to the Eurasia Economic Community due on January 2015*. Under these conditions, the easing of monetary conditions to date is believed to be enough for the attainment of the inflation target in the short run.

Risks to inflation deviating from the projected value are estimated as *balanced* in both short and medium-term perspectives. *External sector risks* are primarily associated with global economic growth rates bouncing back as well as economic and geopolitical developments in emerging economies, and Russia in particular, and how their potential impact would be spilled over to basic commodities and food product markets. *Risks deriving from the domestic environment* are attributable to domestic demand developments, particularly private consumption growth rates, capital investment recovery rates, the economic effects from Armenia's membership to the Eurasia Economic Community, the inflationary effects of the stamp duty and the developments in agriculture sector which is largely reliant on climatic conditions. If such risks materialize, the Central Bank will react accordingly by maintaining the inflation target in the *medium run*.