

THE CENTRAL BANK
OF THE REPUBLIC OF ARMENIA

*Approved under Board of the Central Bank
Resolution No. 268A,
dated November 24, 2017*

Inflation Report

Monetary Policy Program, Q4, 2017



*Status Report on Implementation of the Monetary
Policy Program, Q3, 2017*

The inflation targeting strategy of the Central Bank of Armenia highlights the importance of communicating of the Bank to the general public by publishing, inter alia, quarterly inflation reports.

The first section of the inflation report includes the Monetary Policy Program that provides main directions of the monetary policy in the forecast horizon as well as forecasts of inflation and other macroeconomic indicators. These forecasts are based on the Bank's assessment of the current situation and future assumptions by the Bank, which also include the impact of the Bank operations.

The second section includes status report on implementation of the monetary policy program of the previous quarter, which presents the results of monetary policy implementation and covers the actual developments in the domestic economy.

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.

According to the rule of monetary policy, the policy is aimed at minimizing the deviations between the 4% target and the inflation forecasts. The path to inflation rate shaped as a result of projected policy directions is published as a forecast probability distribution chart for the 12-quarter time horizon.

Projections in this report are based on the actual information available by November 14, 2017, 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 developments of the macroeconomic environment.

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

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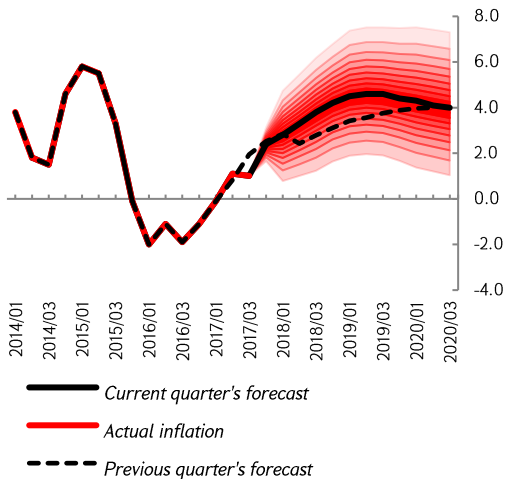
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1. EXECUTIVE SUMMARY

According to the Monetary Policy Program for the fourth quarter of 2017, inflation will continue expanding, stepping in the confidence band in the upcoming months; in the medium-term perspective it will stabilize around the 4% target, influenced by the pace of the monetary policy.

Chart 1

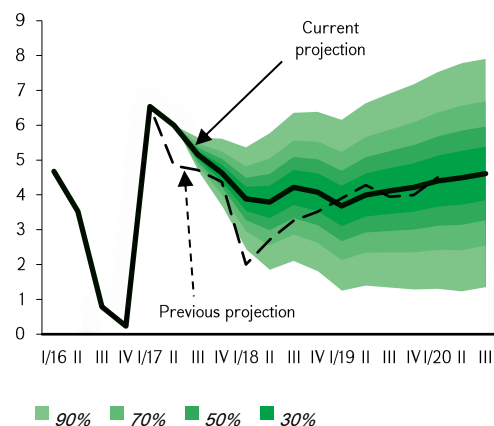
Inflation (12-month) Forecast Probability Distribution Chart for 3-year horizon



As economic activity remained strong in the third quarter of 2017 as well, the Central Bank again revised the 2017 economic growth forecast slightly upside.

Chart 2

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



According to the Q4, 2017 Monetary Policy Program of the Central Bank of Armenia (“the Central Bank”), inflation will continue expanding, stepping in the confidence band in the upcoming months; in the medium-term perspective it will stabilize around the 4% target, influenced by the pace of the monetary policy.

Positive developments in the macroeconomic environment expected in the short run will largely contribute to the recovery of the 12-month inflation rate, owing to still visible influence of expansionary monetary policy implemented by the Central Bank and relatively robust recovery in demand expected both in the external and domestic economic environment. During the year the monetary conditions remained expansionary, making it possible for domestic demand and inflation as well as core inflation to recover. However, **expansionary monetary conditions to phase out gradually will be needed** in the near future in fulfillment of the inflation target in the medium term.

In view of economic activity still high in the third quarter of 2017, the Central Bank has again revised the 2017 economic growth forecast slightly upside. The forecast of aggregate demand has been adjusted upward too, taking into account its rapid recovery in the last nine months of the year, reflecting both expanding core inflation and high growth in imports and services. In the forecast horizon, the economic growth rates will accelerate, gradually approaching the long-term equilibrium.

In the short run, downside risks to inflation somewhat prevail as prices of seasonal agricultural products prices may have restored not adequately. **From 2018 to the end of the forecast horizon**, inflationary risks go upward, largely due to the expansion of the inflation environment in international commodity markets and the pace of recovery in domestic demand.

2. FORECAST, FORECAST CHANGES AND RISKS

2.1. External environment

The global economic growth is accelerating in 2017 after a slowdown last year. This is expected to carry on in the coming years as well. Certain improvement in economic growth rates is expected in the USA, the Eurozone and Russia – principal trade partners Armenia.

In international commodity and food product markets, deflationary patterns have eliminated, while inflationary developments are expectable in 2017 and for the period to come, as the global demand recovers.

Economic developments in the external sector: According to preliminary estimates of the Bureau of Economic Analysis of the U.S. Department of Commerce, economic growth in the **United States** in the third quarter of 2017 was 2.3% y/y in which case average economic growth is projected at 2.2% for 2017. In recent quarters, economic growth was largely driven by increased business investment: in the medium-term, economic growth is expected to stabilize at the 2017 indicator. The current 4.1% unemployment rate is close to the pre-crisis level, so, without further inflationary pressures, the growth of future economic activity will depend largely on productivity growth.

According to preliminary estimates provided by the Eurostat, economic growth in the **Eurozone** in the third quarter of 2017 was 2.5% y/y. The 2017 economic growth in the Eurozone is forecast 1.95%, owing to the improvement of economic growth in almost all member states. Economic growth will continue to be driven by improved business environment and consumer confidence, as well as expansionary monetary policy. Recovering demand, in turn, will also contribute to the further improvement in the labor market conditions.

According to preliminary estimates of State Statistics Service of the **Russian Federation**, economic growth in the third quarter was 1.8% y/y (2.5% in the same period of the previous quarter) and for 2017, according to our forecasts, it will average 1.7%. The labor market conditions continue improving amid growing economic activity, in which circumstance the decline in unemployment in Russia tends to its historical low. The recovery of domestic demand through an expansionary monetary policy implemented by the Bank of Russia will continue fostering the economic growth.

Price and financial developments in the external sector: In the United States in the third quarter of 2017, compared to the previous quarter, the average quarterly inflation has dropped to 1.95%, close to its long-term target. According to forecasts, US inflation will somehow slow in the short-term, and will reach the target during the second quarter of 2018. With economy and prices demonstrating such growth

Following a slowdown last year, the global economic growth is accelerating in 2017. This is expected to carry on in the coming years as well.

In international commodity and food product markets, deflationary patterns have eliminated, while inflationary developments are expectable in 2017 and for the period to come, as the global demand recovers.

Chart 3

Economic growths in trade partner countries, (%)

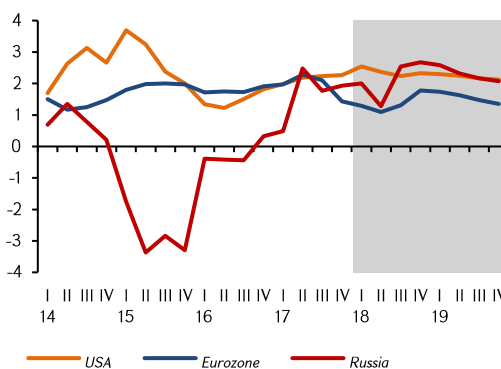
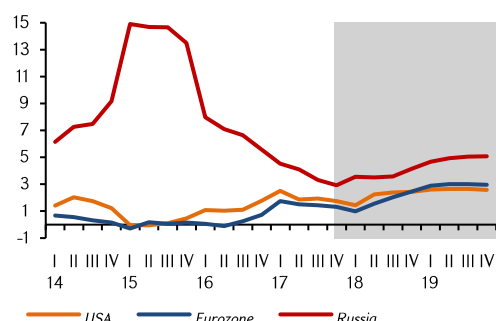


Chart 4

Inflation in trade partner countries, (%)



patterns, the US Federal Reserve System kept its policy rate in the range of 1 to 1.25% in the third quarter and announced about the reduction in the balance sheet since October, which also indicates that the FRS will continue to pursue a gradually tightening monetary policy.

The average quarterly inflation in the Eurozone in the third quarter of 2017 was 1.44%, still running below its target. It is expected to reach its target only in the medium run. In the short-term perspective, lower prices of import goods due to exchange rate appreciation will be an impediment to recovery of inflation. Under these conditions, the European Central Bank will continue to pursue a low interest rate policy, while the asset purchases program will continue up until the end of 2017, involving the same volumes of EUR 60 billion a month, which will however halve to EUR 30 billion in the first half of 2018.

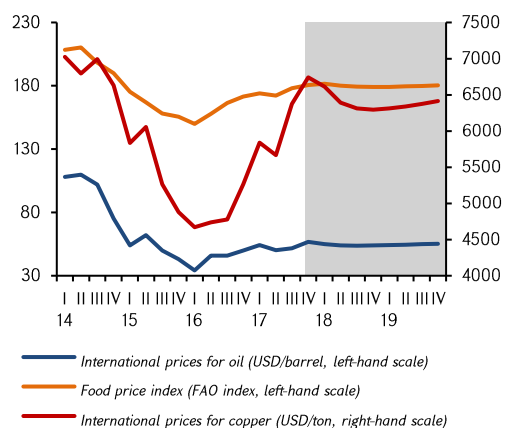
The average quarterly inflation in the **Russian Federation** kept on declining: in the third quarter of 2017 it ran at a 3.3% level – below its target (4%), and the October indicator reached 2.7%. The decline in services prices has largely contributed to the reduction in inflation. In the third quarter of 2017, therefore, the Central Bank of Russia lowered the policy rate by 0.5 pp to 9%; and it is expected that the CBR will further pursue an expansionary policy, as the inflation remains below the target, although inflation expectations are still high.

Relative predictions of economic growth and interest rates across countries leave an impact on how the exchange rates behave. In the third quarter of 2017, the euro appreciated against the US dollar, hitting the maximum value of the past few years, as it amounted to 1.17 dollars per euro. The tendency of the exchange rate reflects strong economic growth in the Eurozone, as well as the US geopolitical tensions and fallouts of the storms on the US economy. The increase in oil prices notwithstanding, the Russian ruble depreciated by 3.2% in the third quarter of 2017, against the previous quarter, to an average RUB 59 per one US dollar. The ruble depreciation was mainly due to the diminishing interest of investors in the currencies of emerging economies. According to forecasts, the euro/US dollar and US dollar/Russian ruble exchange rates will fluctuate at current levels.

The recovery of copper and oil prices, a trend observable since the third quarter of 2017, will continue in the short-term, as well. In the mid-term, the international prices of these commodities will shape at relatively high levels now. In the third quarter of 2017, in particular, international copper prices will continue trending up over the fourth quarter too, driven by the growing industry in China and the US dollar depreciation against the rest of the currencies. In the mid-term perspective, however, the prices will incur adjustment, from currently high levels to the lower ones, due to the expectations for the reduction of production volumes. There is prediction that the rise in international oil prices in the third quarter will continue in the short-term, driven by several factors, such as expectations for an extended term of the deal for OPEC + oil production reduction, expectations for reduction in supply by Iraq in the Middle East.

Chart 5

International prices for raw materials and food products



In the world food product markets, trends of price increases will continue at the end of 2017. In particular, the rise in prices for dairy products has contributed to increased food prices, along with international price of sugar that has stopped declining in previous quarters. However, the current growth in the mid-term will stop due to the fall in dairy product prices, which is, in turn, attributable to the recovering volumes of supply in the market.

Box 1:

International butter price developments

The decrease in milk production in major producer countries (Europe, the United States, New Zealand) and the growth in demand have been the main reason why international prices of butter doubled during this year.

Chart 1 shows that the butter price has risen in several stages, and the beginning of the most recent price-rise was in May 2017 when a bunch of study papers came in with conclusion that butter is not really among harmful foods* as it has been claimed for years after Minnesota University Professor Ancel Keys had his work published in 1961 (also published in the Times magazine), scientifically proving that saturated fat is harmful**. This revealing contributed to the reduction in demand for saturated fat, which led to the drops in international butter prices. The low demand for butter and animal oil continued until the publication of work that denied the hypotheses that using saturated oils was dangerous***, ****. This shored up the demand for butter and, consequently, led to the increase of international prices for butter in 2014. The demand continued growing in line with supply factors which became the major causes of sharp increase in international butter prices in 2017 (Chart 6).

With excess worldwide milk production volumes in 2014-2015, the global milk production shrank in 2016 (Chart 7), which led to the rise in butter prices, from USD 4400 per ton in the beginning of the year to USD 6000 in September. The fall in prices urged the farmers to reduce the number of livestock, while forcing others out of the market, which resulted in the reduction in milk supply worldwide.

Milk production in the world's major exporting countries started to decline early in 2016 (Chart 7), and only in the second quarter of this year the production volumes restored. Despite large quantities of butter consumption, the rebounding butter production will contribute to the stabilization of prices in the butter market.

* "The Big Fat Surprise: Why Butter, Meat, and Cheese Belong in a Healthy Diet", Nina Teicholz, 2014.

** Ancel Keys, Time Magazine, January 13, 1961.

*** "The case for eating steak and cream", The Economist, May 31, 2014.

**** "Ending the war on fat", Bryan Walsh, Time Magazine. June 12, 2014.

Chart 6

International prices for butter

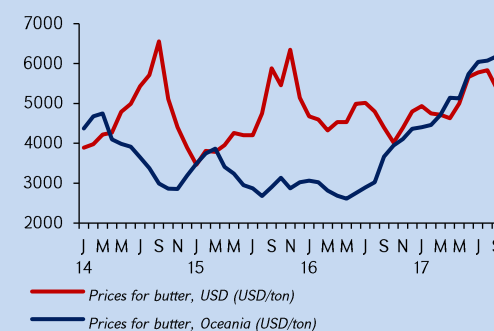
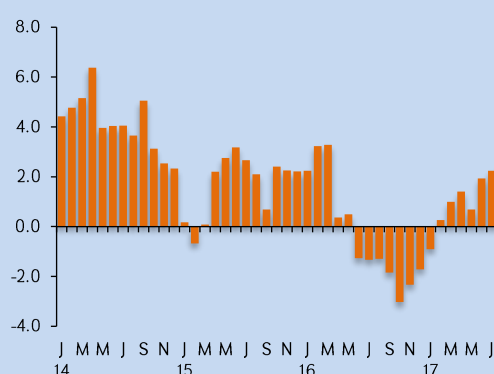


Chart 7

World milk production (y/y change, %)



2.2. Forecasts

2.2.1. Inflation and monetary policy

Inflation will continue rebounding in the medium term, and starting from 2018, it will step in the confidence band, approaching the target.

Inflation will continue rebounding in the medium term; starting from 2018 it will be within the confidence band, approaching the target. At the end of 2018 and during 2019 it will even slightly outstrip the 4% target, stabilizing again at the same level by the end of the forecast horizon.

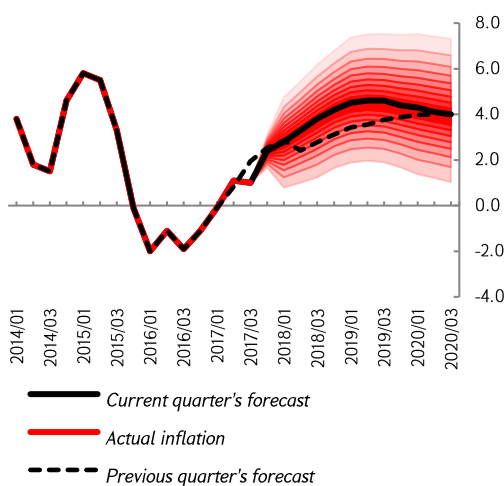
Notwithstanding the smaller-than-expected inflationary effect from commodity groups “Fruits” and “Vegetables”, faster accelerating core inflation rate remains the main factor that determines recovery of inflation. The recovering of core inflation is primarily conditioned by continued strengthening of domestic demand, as well as the inflationary effects coming from commodity markets in the world. It is estimated that in the short-term perspective changes in the customs duty and excise tax rates on certain goods will have a limited inflationary effect¹, which will be temporary and will phase out at the start of 2019. On the other hand, the deflationary effect observed in 2017 as a result of reduced tariffs for regulated services, particularly electricity and gas, will eliminate in early 2018, which will also leave a positive impact on the path to recovery of headline inflation.

With the monetary environment expanding and private remittances from abroad growing, a steady increase in domestic demand has been observed since the beginning of the year, which has also been reflected in increasing imports and core inflation behavior. As these developments are combined with expectations of less contractionary effect from the budget in 2017 and some expansionary impact to be expected in 2018, the GDP gap is predicted to enter a positive territory starting from 2018, which will further contribute to the acceleration of inflation. In the event expansionary monetary conditions phase out in 2019, the GDP gap will gradually come to zero.

As core inflation and demand bounce back, one may see that households' short-term inflationary expectations increase, which are fueled additionally by mass media giving way to various interpretations for high price inflation on some primary consumption goods. Although inflationary expectations are taken into account by the Central Bank in the monetary policy development in any case, regardless of how they arise, it is estimated that the excessive growth of short-term inflationary expectations under the aforementioned factors will be temporary and will then be anchored at the level which is consistent with the actual inflation indicators and objective developments for recovery of demand. The Central Bank believes that monetary conditions are still reasonable to be left unchanged. Nevertheless, the logic of a forward-looking policy tells that a monetary environment that supports the growth of demand needs only to phase out gradually, as a result of

Chart 8

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



¹ The primary general impact of the change in tax and customs duty rates in 2018 is estimated to be 1 pp, of which about 0.4 pp falls on the first quarter of 2018.

which the inflation will slightly exceed the target but will step back around the target, as influenced by the Central Bank action.

Table 1

Period	Inflation interval forecast probability distribution				
	<1.0%	1.0-2.5%	2.5-5.5%	5.5-7.0%	>7.0%
Q4, 2017	0.1	58.6	41.3	0.0	0.0
Q1, 2018	7.3	33.5	58.2	1.0	0.0
Q2	5.2	24.0	66.3	4.2	0.2
Q3	3.8	17.2	67.5	10.2	1.3
Q4	2.0	11.6	65.9	16.9	3.7
Q1, 2019	1.3	8.6	60.4	21.8	7.9
Q2	1.2	7.9	58.9	22.9	9.2
Q3	1.3	8.3	58.8	22.4	9.2
Q4	1.9	9.9	58.5	20.9	8.8
Q1, 2020	3.0	11.9	56.9	19.4	8.8
Q2	3.7	13.2	57.0	18.1	8.0
Q3	4.6	14.6	56.8	16.9	7.2

2.2.2. Economic activity²

Aggregate demand: Continuous monetary expansion by the Central Bank, increased private remittances from Russia and the investment promotion policy of the Armenian Government are the main factors which facilitated a substantial increase of domestic demand in 2017 thus promoting the economic growth. It should also be noted that gradually recovering external demand also contributed to the economic growth expected for the year. These developments with aggregate demand will be persisting to a certain extent also in 2018.

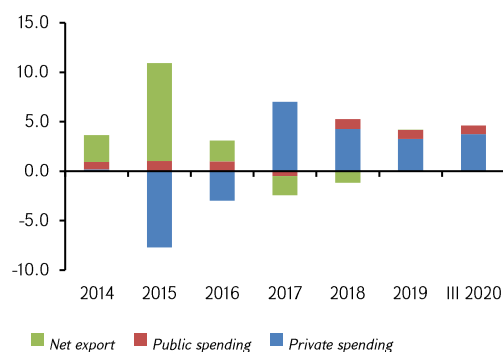
Cyclical effects of expansionary monetary and fiscal policies will gradually weaken over 2019-2020. In this event, the expected economic growth will largely be determined by gradual increase in the level of the economy potential, which will be driven by structural reforms implemented by the Government and the dynamics of economic fundamentals to be shaped in the external sector.

In light of the aforementioned developments, economic growth in 2017 is expected in the range of 4.4-4.9% which will be driven mainly by 7.4% growth in private consumption and 6.0% growth in private investment.

It should also be noted that export of goods and services will also positively affect the economic growth as a result of the increase in incomes in trade partner countries to Armenia as well as export promotion in the domestic economy. Nonetheless, net exports will have a negative impact on economic growth as the growth in consumption

Chart 9

Demand components contributing to the growth, (percentage point)



² For a detailed account of economic growth forecasts, see the GDP projection probability distribution chart.

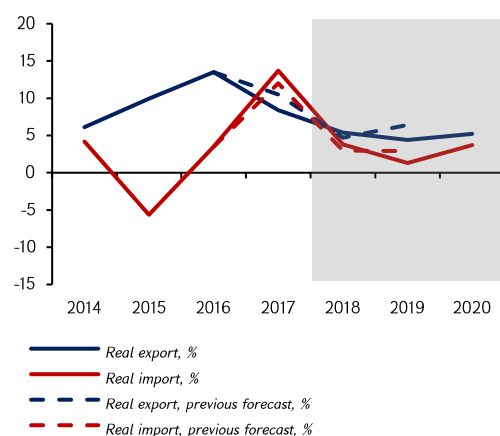
and investment has been concomitant with a significant increase in imports.

An expansionary fiscal policy expected in 2018, a lagged impact of expansionary monetary policy carried out in 2017, as well as acceleration of economic growth in trade partner countries to Armenia will lead to continued strengthening of domestic and external demand, under which circumstance the economic growth will amount to 3.5-4.6%.

There is expectation that economic growth in 2019-2020 will be in the range of 3.5-4.9% and 3.8-5.4%, respectively. Note that the medium-term economic growth above depends on the pace of structural reforms implemented by the Government, the export promotion policy, and economic growth potentials as expected in trade partner countries to Armenia.

Chart 10

Changes in real export and import of goods and services in the medium term, (%)



External demand: As was already mentioned, in 2017 the impact of

net external demand on real GDP is estimated negative, explained by strong growth in real import of goods and services as domestic demand recovered at a rate faster than anticipated. It should be noted that the growth of domestic demand owed to grown import of all commodity groups. The growth of domestic demand has, in addition to other factors, been fueled by high growth of private remittances thanks to rapid recovery of the Russian economy (the growth of private remittances is estimated to be 14.0-16.0% in 2017). The growth in import has exceeded the growth of export and the transfers amid positive developments in the external environment. As a result of these developments, the current account deficit-to-GDP ratio will be in the range of 2.0-3.0%.

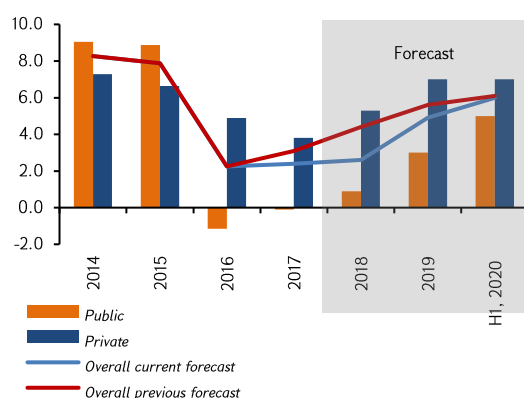
The previous year's negative contribution of net export to real GDP will eliminate somewhat during 2018. This is based on the assumption that significant part of import growth reflects the offset of contracted demand of previous years, and there is no anticipation that such high growth rates would be maintained – these are projected to reach 2.0-4.0%. With the Government programs to carry on as well as identifying new markets, the growth of real export of goods and services will stabilize within 4.0-6.0% in the medium run. Growth of money transfers will be commensurate with the scenario of gradual appreciation of the Russian ruble and economic recovery in this country, in which case net growth will be anticipated between 6.0-8.0%. As a result, following deterioration in 2017, the current account will stabilize around a medium-term equilibrium of 3%.

Fiscal policy: Driven by the actual tax collection and

implementation of tax reforms in 2017, the 2017 tax assessment has been reduced by AMD 50.0 billion. As a result, tax revenues will slightly exceed the figure projected in the 2017 budget. This means that the tax-to-GDP ratio will persist almost at the same level compared to the previous year, 21.2%³, under which the revenue impulse will be smaller, 0.2 pp contractionary.

Chart 11

Nominal wage growth, y/y, (%)



³ The 2017 GDP is the Central Bank forecast.

By the year's results, there will be savings on public expenditures, as was in the previous plan, which are anticipated to the expense of capital expenses mostly funded through external sources. The expenditures estimate will make up 96.8% of the annual figure of adjusted proportions (about AMD 45.0 billion worth savings). As a result, the expenditures-to-GDP ratio will reach 25.6%, dropping by 2.3 pp compared to the previous year, with the expenditures impulse to be 2.7 pp contractionary.

The deficit-to-GDP ratio will amount to 3.3%, reducing by 2.3 pp compared to the same indicator in 2016. The impact of fiscal policy on aggregate demand, driven by the above-mentioned changes, is estimated 2.9 pp contractionary for 2017.

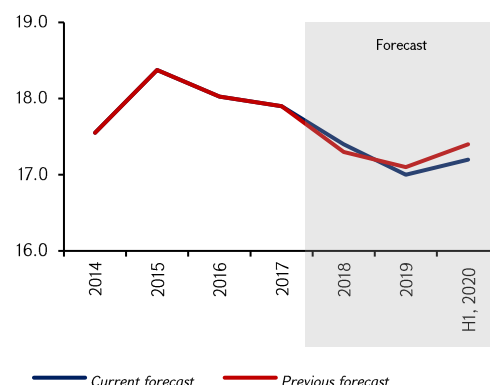
To pursue a sustainable debt environment in the **mid-term perspective**⁴ the fiscal policy will be steered to gradual reduction of deficit (2.4% of GDP, on average). In 2018⁵, relative to the Central Bank estimates for 2017, the deficit-to-GDP ratio is expected to decrease by 0.7 pp. The deficit reduction notwithstanding, the fiscal policy's impact on aggregate demand in 2018 is predicted to be 0.8 pp expansionary in relation to that of 2017. This is due to the extensive effect of expenditures and net lending⁶. In 2019-2020, according to the fiscal impulse assessment, the impact of fiscal policy will be neutral.

Labor market⁷: The developments for nominal wages in the private sector, which tended to accelerate since the beginning of 2017, will play their part in helping the domestic demand to stabilize. The private sector nominal wage growth will keep abreast with economic growth and inflation developments in the medium run.

In the event of such economic growth developments and Government-led investment promotion policy and structural reforms, the rate of unemployment is expected to be 17.9% in 2017, which will gradually decline by 0.3-0.5% annually to reach its mid-term equilibrium at the end of the forecast horizon.

Chart 12

Unemployment rate, (%)



In general, trade partner countries' indicators of economic growth are revised upside compared to the previous forecast.

2.2.3. Comparison with the previous forecast

The indicators of economic growth in trade partner countries to Armenia have been revised generally upward compared to the previous forecast. Particularly, some improvement in economic growth rates in the Eurozone and Russia is expected, and in the

⁴ The forecasts of fiscal policy in the forecast horizon are based on the main indicators of the "State Medium-Term Expenditure Framework of Armenia for 2018-2020".

⁵ Based on the indicators of a draft law on the Republic of Armenia State Budget 2018.

⁶ Net lending provided has an extensive effect but net lending recovered, a restrictive effect. In 2018 and 2019, provision of net lending is envisaged while in 2019 recoveries on net lending are anticipated.

⁷ The labor market data for 2017-2020 are the Central Bank projections which are based on the second quarter of 2017 data and actual January-August 2017 figures. The growth indicators presented in this sub-section are relative to the same reference period last year, unless otherwise specified.

Chart 13

US economic growth forecasts, (%)

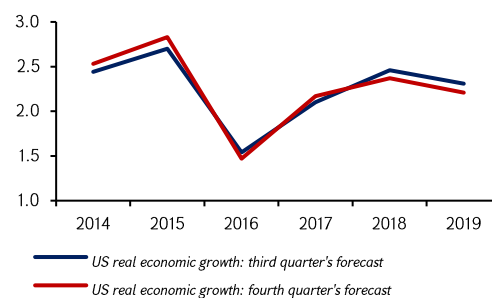
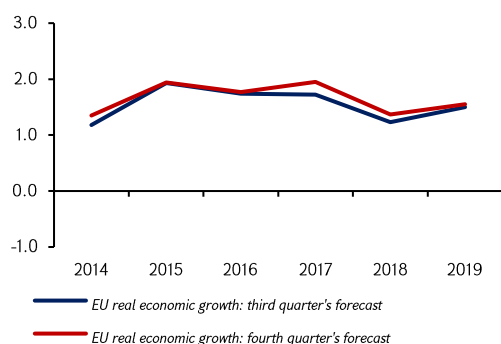


Chart 14

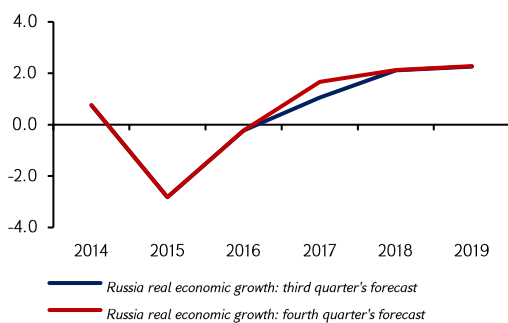
EU economic growth forecasts, (%)



More inflationary developments are expected to be seen in the commodity markets compared to the previous forecasts.

Chart 15

Russia economic growth forecasts, (%)



The economic growth rate in Armenia has been revised upside against the previous forecasts.

Chart 16

International prices for food

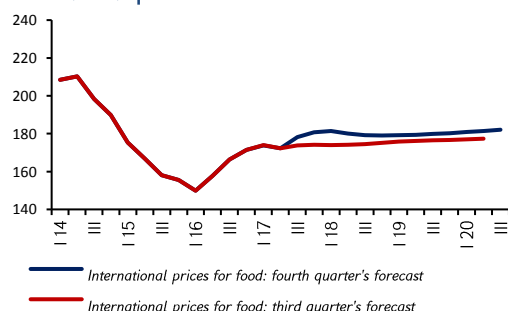
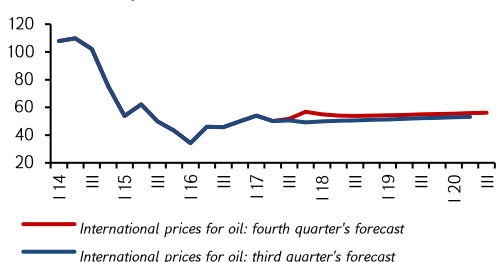


Chart 17

International prices for oil



United States, economic growth has been revised slightly downside in the medium term compared to the previous forecast.

The upward revision of economic growth forecasts in the USA is determined by higher-than-anticipated growth recorded in the previous quarter, while the 0.1 pp downward revision for 2018 and 2019 is mainly due to the expected canceling of the US Tax Reduction Program during in the time of previous forecasts. The 2017 and 2018 upward revision of economic growth forecasts in Eurozone has been driven by both higher-than-expected consumption and investment growth.

The economic growth rates in Russia in 2017, as compared to previous forecasts, have also been revised upwards, largely due to increased inventories.

Inflationary patterns in the commodity markets are more likely to be observed in comparison with previous forecasts.

Particularly, in the global food market, compared to the previous one, a faster price increase is expected despite a minor deflation during October. The revision was mainly conditioned by the temporary increase in prices for dairy products.

Relative to previous forecasts, oil prices will rest on somewhat a higher level in anticipation of an extended term for OPEC + oil production restriction deal and expected reduction in supply volumes by Iraq.

Compared to the previous forecast, copper prices will be set at a higher level, driven by the actual high indicator reported in the third quarter, which was attributable to even higher expectations for demand in China and somewhat limited supply volumes in the copper market.

The economic growth rate in Armenia has been revised upside in relation to previous forecasts.

Driven by actual developments, the expectations for growth in agriculture and construction sectors in 2017 have decrease compared with the previous forecasts. However, certain invigoration in economic activity is expected on the whole, which is primarily conditioned by higher-than-expected growth rates in the services sector.

Actual and expected high growth rates in the services sector are explained totally by an upside revision of growth in private sector spending as well as higher growth recorded in the tourism industry in 2017, with the positive developments in the tourism industry believed to be persisting over 2018, too. Also, taking into account the fiscal policy which is expected to be expansionary in 2018, the year's economic activity is anticipated to be higher than outlined in previous predictions. It should also be noted that economic growth rates expected in 2019-2020 did not change significantly and it is gradually approaching its potential level.

Table 2

<i>Real GDP Growth (Cumulative) Projection Probability Distribution</i>		
Period	30% probability interval	90% probability interval
January-December 2017 / January-December 2016	4.4 - 4.9	3.6 - 5.6
January-December 2018 / January-December 2017	3.5 - 4.6	1.8 - 6.4
January-December 2019 / January-December 2018	3.5 - 4.9	1.3 - 7.2
January-September 2020 / January-September 2019	3.8 - 5.4	1.3 - 7.9

With domestic demand growing persistently, real growth in imports outstripped the expectations in the third quarter of 2017, yet the forecast for real growth of imports has not been revised against the previous program⁸. The growth of remittances in 2017 has been revised slightly upside owing to accelerated recovery of the Russian economy.

The developments with regard to exports proceed in line with the scenario.

In 2018, the current account deficit-to-GDP ratio is expected to somehow decline compared to previous forecasts, mainly attributable to domestic demand which rebounded in 2017 and will stabilize further. Thus, in the medium term, a larger deficit will be expectable in comparison with the previous forecast.

In 2017, relative to the previous forecast, the fiscal sector's impact will be less contractionary owing to downside revision in tax assessment. In 2018 the fiscal policy is estimated to be merely 0.8 pp expansionary against the almost neutral impact envisaged in the previous program⁹. In 2019-2020, the fiscal policy's impact will be neutral, according to fiscal impulse assessment.

Current forecasts suggest that the inflation will recover at a faster pace in comparison with the previous program.

The revision owed primarily to core inflation the expectations for which are much higher than the previous one, which, in turn, is a result of growing domestic demand on the one hand and continued inflationary pressures in global commodity markets on the other. Forecasts for regulated service tariffs did not change much in relation to the previous ones. While actual price inflation on seasonal agricultural products has been below the forecast indicators, it is expected that low indicators of agricultural output will still be

⁸ The 2017 forecast has not been revised as, on the back of strong growth recorded in the third quarter, the National Statistics Service of Armenia had lowered the dollar value of the H1, 2017 imports by nearly USD 66 million (mainly for items "Machinery and equipment" and "Non-precious metals and articles made thereof") on the basis of data available as of October 20, 2017.

⁹ The previous estimation is based on the 2018 indicators of "State Medium-Term Expenditure Framework of Armenia for 2018-2020" and the current estimation on the indicators of a draft law on the Republic of Armenia State Budget 2018.

Chart 18

International prices for copper

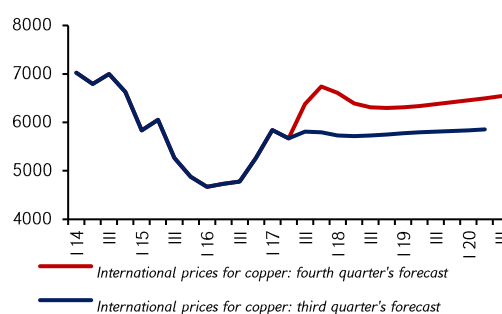
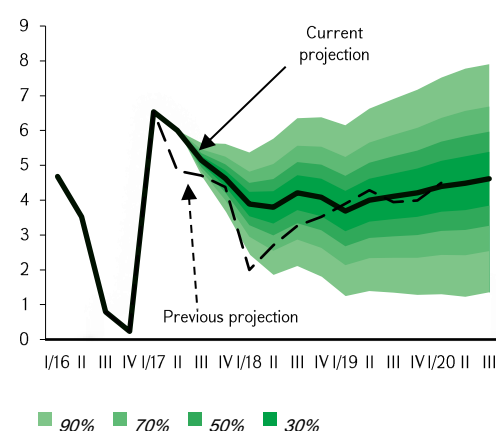


Chart 19

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



According to current forecasts, the recovery of inflation will be faster than envisaged in the previous program.

Chart 20

Mid-term current account / GDP forecasts, (%)

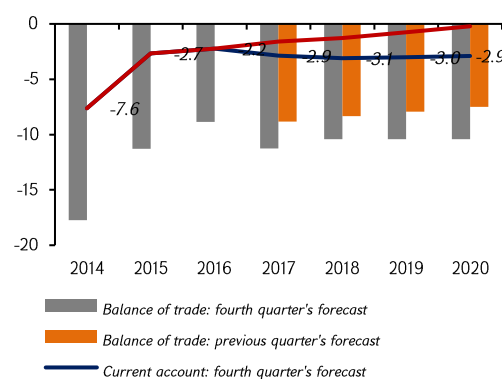
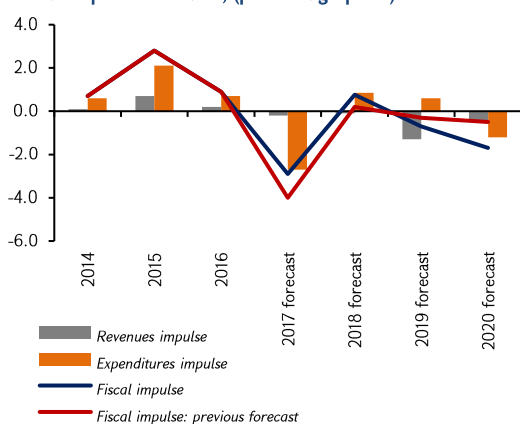


Chart 21

Fiscal impulse forecasts, (percentage point)

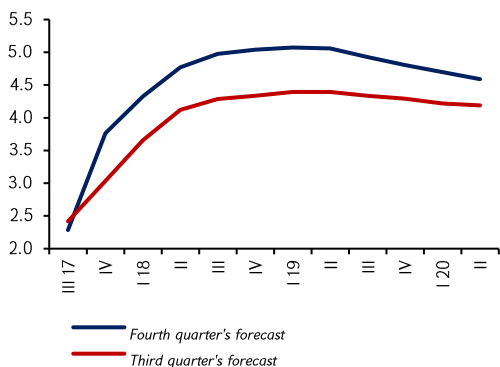


demonstrated through a rise in prices in this group. Consequently, the deviation of the actual inflation rate against the previous program, which is totally due to smaller prices of agricultural products, is temporary and reckoned to gradually eliminate in the upcoming months. Accordingly, almost throughout the entire forecast horizon the inflation will run higher than the previous predictions (see the Inflation Forecasts Probability Distribution Chart).

The short-term inflation expectations have been slightly revised upward compared to previous forecasts, due to predictions for a quicker recovery of core inflation on the one hand, and recent speculations in the media in anticipation of impending inflation of selected food products (meat, butter) and the change in tax and customs duty rates, on the other.

Chart 22

Short-term inflation expectations estimated by Quarterly Projection Model, (%)



2.2.4. Main assumptions and risks

This section presents the main assumptions underlying the Monetary Policy Program for the fourth quarter of 2017 and the risks to implementation of the program, which derive from the external sector developments, the fiscal policy, the trends and short-term forecasts. For the fourth quarter, most relevant are the assumptions and risks underlying short-term inflation forecasts and inflation expectations, which are presented below in more detail.

The short-term inflation forecasts have considered the effects of change in excise tax and customs duty on a bunch of commodities since 2018 (see Box 1). The excise tax rate will change to such commodities as alcoholic beverages, tobacco, petrol, lubricants, compressed natural gas; note that the excise tax rate will change with regard to all commodities but diesel. At the same time, given the inflationary pressures in the meat and butter markets, it was supposed that inflationary patterns would persist with these commodities as the recovery of supply goes on slowly.

Table 3

<i>Impact assessment of excise duty rate change in 2018</i>					
Product type	Weight in the basket	Current excise duty	New excise duty	Change in prices, (%)	Contribution to inflation
Vodka of domestic production	0.5	630	725	6.2	0.03
Vodka produced in other countries	0.5	630	725	3.5	0.02
Cigars with filters, of domestic production	1.0	6325	7275	7.0	0.07
Cigars with filters, produced in other countries	0.7	6325	7275	4.4	0.03
Diesel fuel	0.0	35000	13000	-6.4	0.00
Petrol	0.4	120000	135000 ¹	3.3	0.01
Gas to refill motor vehicles	3.2	8330	25000	10.9	0.35
Lubricants	0.0	400	400	0.0	0.00
Total	6.3				0.51

The direct impact of the change in excise tax rate is estimated 0.5 pp.

As to the EEU membership-driven change in customs duties, an increase in customs duties is anticipated with regard to nearly 30 item names in the consumption basket¹¹, the overall impact of which is estimated to be 0.4 pp. Thus, the direct impact of the aforementioned change is estimated to be 0.92 pp. The overall impact will be up to 1 pp. According to the estimates, a 0.4 pp impact is expected in the first quarter of 2018.

The assumption was that, in addition to the growth determined by recovering core inflation, short-term inflation expectations have revealed some excess growth trends, driven by the media's lively debates and comments about the inflation of a selected list of basic consumption goods. The growth of inflation expectations has started reflecting the indicators of survey on inflation expectations.

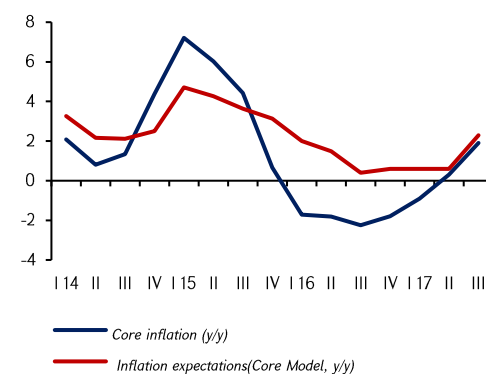
Expectations: According to the Central Bank estimates, the households' inflation expectations in the third quarter have slightly increased, mainly owing to the impact of the rise in international prices for several commodities on domestic prices. Given the developments with core inflation and the households' high inflation expectations, the Central Bank estimates that inflation expectations have increased to 2.3%. In the coming year, they will continue to grow, anchoring around the target in the forecast horizon.

¹ Where the total sum of the excise duty imposed on 1 ton of gasoline and the relevant VAT amount is less than AMD 120,000, that excise duty will be added to the extent that the total sum of excise duty imposed on 1 ton of petrol and the relevant VAT amount equals AMD 135,000.

¹¹ According to the current customs classification of goods within the framework of the Eurasian Economic Union, the customs duty rates on nearly 200 goods will increase in 2018, which will affect about 30 item names in the consumption basket in Armenia.

Chart 23

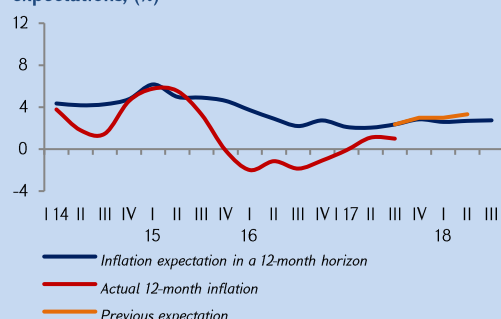
in the third quarter 2017 inflation expectations somewhat increased



The results of survey on the expectations by the households and the financial system

Chart 24

Average level of financial system's inflation expectations, (%)



Household inflation expectations have increased to an average **0.9%**¹² of the 12-month inflation rate, against that of 0.6% reported for the previous quarter.

The inflation expectations have been largely stable, according to the results of the Q3, 2017 survey on selected macroeconomic indicators, conducted by the Central Bank among households and organizations of the financial sector. The **average level of inflation expectations of the financial system** in the upcoming one-year horizon is **2.8%**, according to the current and previous survey.

The results of the third quarter's survey denote that the financial system's expectations for a short-term and long-term average interest rate in a one-year horizon continue trending downward; the expected quarterly levels have been revised downside.

Chart 25

Expectations for interest rates on deposits attracted by the financial system, in one year horizon, (%)

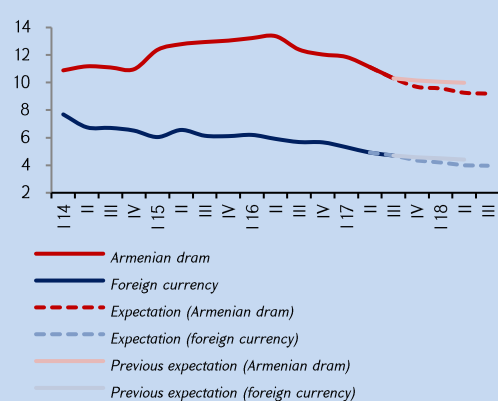
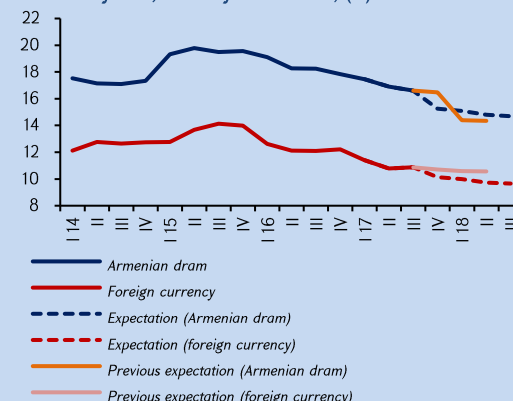


Chart 26

Expectations for interest rates on loans provided by the financial system, in one year horizon, (%)



Forecast assumptions and risks

The main judgments and assumptions underlying the forecasts are presented in Table 4.

Table 4:

Main judgments and assumptions	
Main judgments and assumptions	Possible developments in the event of implementation of this assumption
In the external sector economic growth recovers at steady rates	- Demand will keep on recovering and economy invigorating in trade partner countries. - With demand recovering, accelerated inflation on food and raw materials will continue. - As economy rebounds, gradual monetary tightening is expected in developed countries. Particularly, the US monetary policy rates increase in December 2017; the ECB asset purchasing program reduces in size since January 2018, according to ECB statement.

¹² The methods that are used to figure inflation expectations are purely for statistical purposes, and the results may vary materially from method to method.

In Russia economic activity grows stronger and inflation expectations reduce substantially	• The monetary policy rate reduces even more considerably. • The ruble exchange rate incurs certain appreciation pressures, all else being equal. • Growth of money transfers from Russia.
Tax rates and customs duties change	• Inflation incurs a direct and indirect impact of up to 1 percentage point, with 0.4 pp falling upon the first quarter of 2018.
Inflation expectations grow	• Short-term inflation expectations will persist in line with current growth trends, as core inflation recovers and the media actively invites a debate over inflation on selected goods/products.
Fiscal policy conditions	• Aggregate demand incurs -2.9 contractionary impact in 2017, 0.8 expansionary impact in 2018 and neutral impact in 2019-2020.
Action to tackle the growth of potential GDP ¹³	• The Armenia Government will further push ahead with structural reforms as a result of which investments in the private sector will gradually expand, providing up to 4.5-5% growth annually. • More investment in the private sector and potential GDP growth will largely be reflected in the tradable sector in terms of significant growth in export of both goods and services.

The downside risks to inflation forecast for the fourth quarter of 2017 somewhat prevail as prices of seasonal agricultural products may have recovered not satisfactorily. On the other hand, starting 2018, the risks to inflation go an upside path in the medium run (see the Inflation Forecasts Probability Distribution Chart).

In the medium-term perspective, the prevalence of upside risks to inflation depends on a bunch of key factors and developments taking place in relevant sectors of the economy.

The first group factors are pertinent to the acceleration of economic recovery in the external environment and the impact to be spilled over to the Armenian economy. Specifically, the following key factors can be highlighted:

- Rapider recovery of external demand and inflationary risks resulting therefrom, including faster-than-expected rise in international prices in raw materials and food product markets.
- Risks to capital outflow from developing countries on the back of further tightened monetary policy conditions in developed countries.

If the aforementioned risks materialize, the inflation will incur an added impact of inflationary pressures from the external sector, in which event tightening the monetary conditions relatively quickly would be needed.

The main inflation risks emerging from the developments in the domestic economy pertain to the following factors:

- A lasting growth of demand and, particularly, consumption.

¹³ The results of the Amulsar mine investment program not considered due to the lack of information on the operations dates and extraction volumes.

According to the assumptions underlying the Central Bank forecasts, currently high indicators of rebounding consumption and demand partly owe to the offset for reduced consumption in recent years, so they will have a short-term nature. Nevertheless, there is likelihood that the current level of indicators reflects a steadier growth of demand, in which circumstance further inflationary pressures are possible.

- Acceleration in inflation expectations.

If accelerated short-term inflation expectations, which are fueled by the inflation on selected products, prove to be more lasting, the Central Bank will react to the situation by taking action, while, all else being equal, tightening monetary conditions.

In the forecast horizon, the risks to economic growth are dual-sided and balanced.

The risks to the economic growth include:

- uncertainties over the recovery rate of the global economy,
- possible sudden changes in the capital flight between emerging and developed countries,
- the extent and impact of the Government-led structural reforms and investment promotion policies,
- economic consequences of Amulsar mine operation,
- uncertainties about exploring new export markets and creating new products by businesses.

3. ACTUAL DEVELOPMENTS IN Q3, 2017

3.1. Inflation

3.1.1. Fulfilment of the inflation target

For the previous one-year horizon, which covers a timespan from fourth quarter of 2016 to fourth quarter of 2017, according to Q4, 2016 monetary policy program the deflationary environment was to mitigate notably at the end of the year but was still to linger over the first quarter of 2017, largely due to a planned lowering of gas tariff; then it was supposed to phase out, giving way to the 12-month inflation rate to return to the target over the rest part of forecast horizon.

In such a situation, the deflation risks, the Central Bank reckoned, would generally persist in the medium run, along with the 2017 contractionary fiscal policy factor, so certain easing of monetary conditions in the fourth quarter was still reasonable.

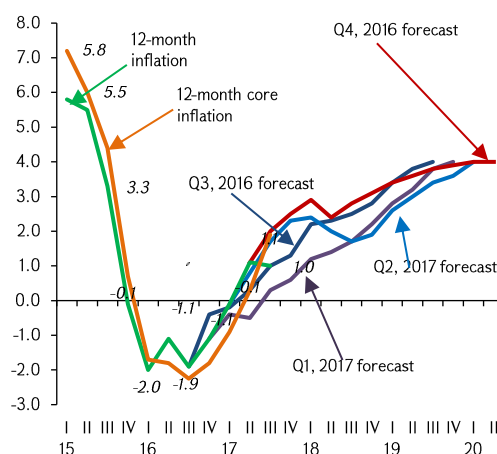
In the fourth quarter of 2016 and the first quarter of 2017, in spite of the deflationary risks, the 12-month inflation rate has notably increased, as was expected, to -0.1% **at the end of March** (year 2016 ended with **-1.1%**). It should be noted that inflationary developments in this period of time have mostly incurred the influence of expansionary monetary policy implemented by the Central Bank.

In consideration of the domestic demand persisted at a low between October 2016 and March 2017, the deflationary effects from the external sector transmitted onto food products and, later on, non-food products, as well as anticipated impact of the Government's contractionary fiscal policy in 2017, the Central Bank continued in the meantime to mitigate the lending terms by reducing the refinancing rate by 0.75 pp to **6.0%** at the end of February.

In the second quarter of 2017 inflation increased considerably, largely due to high levels of prices for agricultural products, and, as a result, **the 12-month inflation rate has entered a positive territory since April**, fluctuating within **1.3%** on average during the quarter. In the meantime, the 12-month core inflation rate has also increased, to 0.3% from the previous quarter's indicator of -0.9% owing to an expansionary monetary policy. The 12-month growth rates in fruit and vegetable prices slowed down in the third quarter; this has halted the recovering of inflation which averaged 1.0%, while the 12-month core inflation rate continued growing at a rapid pace, amounting to 1.9% by the end of the quarter. It should be noted that October saw both headline and core inflation rates increased to 1.2% and 2.4%, respectively, which points to high probability that prices of seasonal agricultural products would rise and more inflation expectations would emerge by the end of the year. At the same time, the inflation expectations of the population are growing faster due to increased prices for some products in the food products markets in the world.

Chart 27

According to the Central Bank forecasts, inflation will gradually approach the 4% target in the forecast horizon



In such a situation, the Central Bank reckons, the monetary policy implemented previously proved rather expansionary for the inflation to recover and would still have its impact transmitted by the end of the year. Therefore, the Central Bank left the monetary conditions unchanged during the second and third quarters, **keeping the refinancing rate at 6%**. In the fourth quarter, as the inflation environment expanded and inflation expectations grew, the Central Bank again left the refinancing rate unchanged, yet the financial market has already been signaled **that stimulating monetary conditions would need to be abolished gradually** in the light of forecast developments. As a result, inflation will continue to grow gradually, shaping within the confidence band in 2017; in the forecast horizon it will stabilize around the target under the influence of the monetary policy.

3.1.2. Prices

Consumer prices: There was **-2.8% inflation** recorded the third quarter of 2017 (against the predicted **-1.8%**), which was totally due to smaller-than-expected inflation on prices of seasonal food products, particularly **fruits**, and **vegetables and potatoes**, -32.4% and -37.6%, respectively (negative contribution to the quarter's inflation: about 3.0 pp). In expectation of the decline in the agriculture sector in 2017 (around -11% y/y in the third quarter), the prediction was that there would be higher inflation on prices of seasonal food products instead of the lower one specific to the third quarter, which did not happen, however. It is worth mentioning that in the third quarter of 2017 the growth rate of core inflation was 1.9%, running above the projected figure. Such a strong growth rate was mainly due to increased prices of **meat products** (2.7% q/q), **dairy products** (1.2% q/q), **oils and fats** (3.1% y/y), **pharmaceuticals** (3.1% q/q) (see Box 3). The rise in prices of item "Oils and Fats" totally owed to the continuous increase in the import prices of butter (9.2% q/q).

With the developments mentioned above, the inflation environment remained unchanged in the third quarter of 2017, in which case the 12-month inflation rate in September amounted to 1.0% instead of projected 2.0%.

Chart 28

Monthly butter price growth index

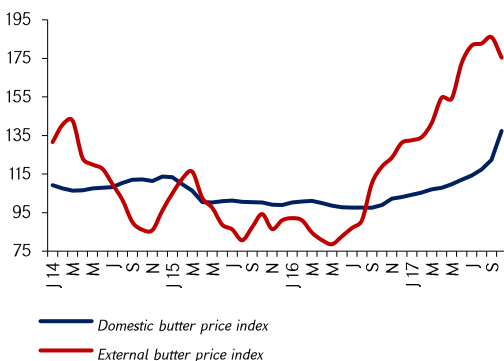


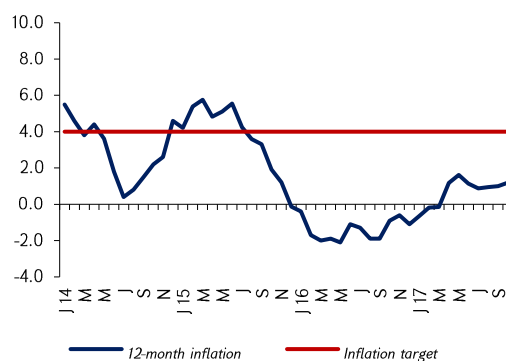
Table 5

Price inflation by commodity item as key contributors ²						
Item	June, 2017 (y/y)		September, 2017 (y/y)		Q3, 2017	
	Growth	Contribution	Growth	Contribution	Growth	Contribution
CPI	1.1		1		0.8	
Food products	4.9	2.3	2.9	1.2	-6.5	-2.7
Bread products	-1.4	-0.1	-1.2	-0.1	0.0	0.0
Meat products	3.4	0.3	6.6	0.6	2.7	0.2
Dairy products	-2.4	-0.1	1.7	0.1	1.2	0.1
Oils and fats	4.0	0.1	7.9	0.2	3.1	0.1
Fruit	13.5	0.5	-0.6	0.0	-32.4	-1.0
Vegetable and Potato	19.2	1.0	7.8	0.4	-37.6	-2.0
Fish	24.2	0.2	27.5	0.2	1.4	0.0
Eggs	23.0	0.3	-8.0	-0.1	-2.9	0.0
Sugar	16.7	0.1	3.4	0.0	-4.8	0.0
Non-food products	-2.9	-0.6	-0.8	-0.2	0.7	0.1
Services	-1.4	-0.5	-0.5	-0.2	0.3	0.1

According to the data issued by the National Statistics Service of Armenia, there was 0.8% inflation in October of 2017, mainly due to increased prices of **vegetables and potatoes** (11.8%), **oils and fats** (5.6%), **meat products** (1.3%), as well as **clothes** (7.7%) and **footwear** (9.6%), (total contribution to inflation: 1.3 pp). Meanwhile, there has been a fall in prices in item **fruits** and air transport services (total contribution to inflation: -0.5 pp). As a result, the 12-month inflation rate has increased to 1.2%.

Chart 29

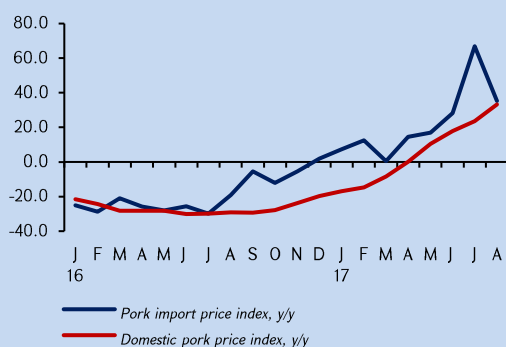
In the third quarter of 2017 the inflation environment remained unchanged



² The y/y data for structural elements of food items in the table are calculated by the Central Bank on the basis of the information from the National Statistics Service of Armenia.

Chart 30

The rise in domestic pork prices has been driven by increased international prices for pork in 2017



What caused the meat price to rise?

High growth of prices of meat products has been attributable to increased volumes of export of large and small cattle as well as a sharp increase in pork prices in international markets during 2017.

Chart 31

The rise in beef prices has been largely driven by a sharp increase in the volume of export of cattle in the third quarter of 2017

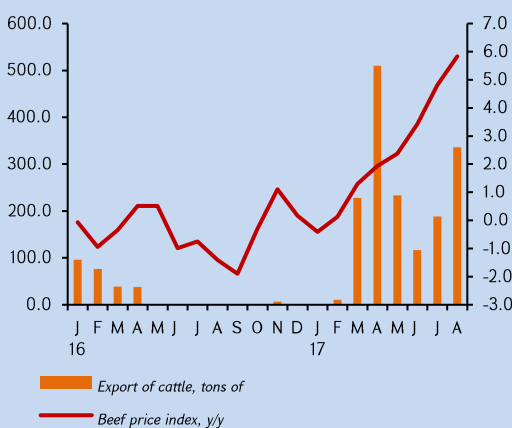


Chart 32

Increased output in the group "meat product" has been mostly determined by grown export of small cattle

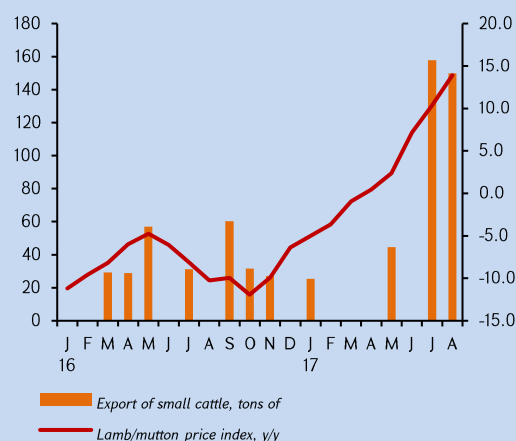
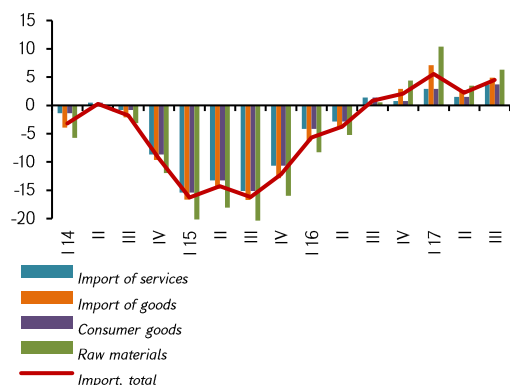


Chart 33

In the third quarter of 2017 the growth of dollar prices of import of goods and services speeded up, (y/y, %)



Import prices: In the third quarter of 2017, the growth of dollar prices of import of goods and services to Armenia accelerated, reaching 2.5% q/q on average, as the global demand rebounded. The growth over the same reference period last year amounted to 4.5% y/y. It is worth mentioning that the prices for butter and pork are quite high amid strengthening demand in the global market (see Boxes 1 and 3). Meanwhile, in the light of economic developments globally, prices in oil, wheat and iron ore markets of the world have also speeded up.

Acceleration of global dollar price growth rates, especially on the back of appreciation of exchange rates in Russia and the European Union, has resulted in increased prices for final consumption goods in Armenia, the impact of which on the overall imports in dollar terms reached 0.6 pp.

3.2. Economic developments

3.2.1. Economy position

Private spending and investment sharply declined in the Armenian economy due to reduction in remittances from Russia between 2015 and 2016. A negative GDP gap has emerged as a result, creating substantial deflationary pressures in the consumer market. To tackle the situation, the Government carried out an expansionary fiscal policy in 2016. At the same time, the Central Bank gradually eased the monetary conditions while carrying on implementing an expansionary monetary policy over 2017. In line with these developments, starting from the third quarter of 2016, the volumes of remittances from Russia gradually recovered.

Driven by the factors mentioned above, a growth of private spending was observable since the beginning of 2017, as the actual GDP gradually approached the potential level, or which is the same, the negative GDP gap reduced, which has been also fueled notably by growth of export of goods and services¹⁵. In spite of significant reduction in the GDP gap, the economy's cyclic stance is estimated still a little negative, in which circumstance minor deflationary pressures were observable in the economy.

3.2.2. The expenditures aspect of the economy

In the third quarter of 2017, demand further restored in the private sector, exceeding the Central Bank's expectations. Specifically, private spending has grown by 7.2%, resulting from 7.8% growth in private consumption and 4% in private investment.

The growth of private consumption and investment in the third quarter has been driven largely by the growth of remittances from Russia, the expansionary monetary policy carried out by the Central Bank, as well as the measures in support of the Government-led investment promotion policy. It should also be noted that contractionary fiscal policy steered to sustainable public debt management has somehow curbed the growth of spending in the private sector in the third quarter.

Continued growth in private spending observable since the beginning of 2017 helped private spending approach its potential level, which has essentially diminished the negative gap in private demand. Nevertheless, private spending kept on making deflationary contribution during the third quarter. However, the extent of such contribution has decreased notably amid rapidly recovered private demand when compared with the previous program.

¹⁵ These positive contributions to the export notwithstanding, net external demand has slowed down the narrowing of the negative GDP gap amid a robust growth of import in 2017.

Chart 34

Private spending dynamics, (y/y growth, %)

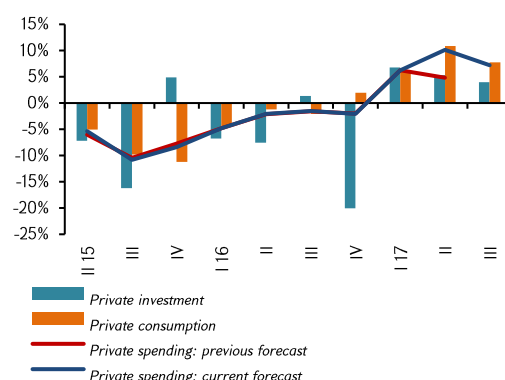


Chart 35

In the third quarter of 2017 the real decline in net exports somewhat slowed down
(net real export (y/y, %), positive sign = improvement)

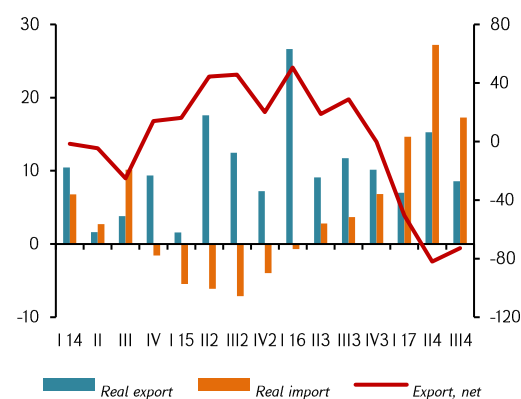


Chart 36

In the third quarter of 2017 the contractionary effect of fiscal policy owed to the contractionary effect of expenditures

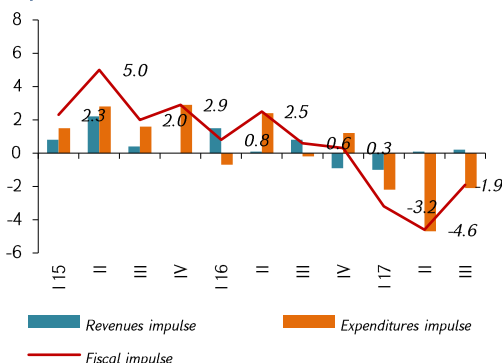


Chart 37

Main consolidated budget indicators (billion AMD)

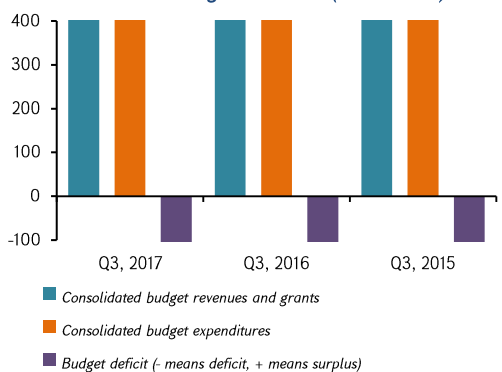
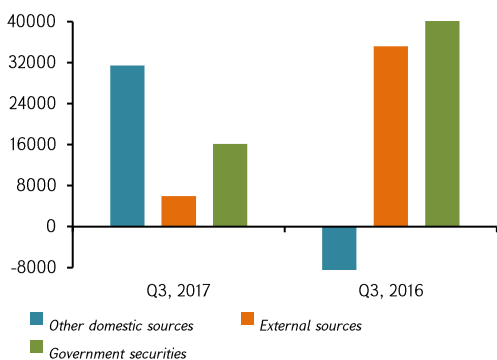


Chart 38

In the third quarter of 2017 the deficit was financed mostly owing to domestic sources (billion AMD)



In the third quarter of 2017, according to the Central Bank estimates, net real export has had a negative impact on the GDP growth as a result of faster growth of real import over export. During the quarter, real growth rates of export of goods and services amounted to 8.6% y/y and real growth rates of import, 17.3% y/y¹⁶.

The growth rates in dollar value of net remittances of individuals (seasonal workers' income and personal transfers inclusive) accelerated to 15.7% y/y in the third quarter of 2017, driven by faster recovering Russian economy.

Fiscal policy¹⁷: In the third quarter of 2017 the State Budget was performed with expenditures in line with but taxes collected below the Central Bank's projections¹⁸. The fiscal sector's impact on aggregate demand was estimated 1.9 pp contractionary for the quarter, against the forecast 3.0 pp contractionary.

In the third quarter, consolidated budget revenues were under-collected by 5.4% against the projection. The revenue impulse reached 0.2 pp expansionary instead of the forecast 0.5 pp contractionary.

In the third quarter of 2017 the budget expenditures were performed in compliance with the projection. **Public spending** exceeded the predicted figure by about 9% whereas expenditures on item **"Transactions with non-financial assets"** were 7% less from the projection. As a result, the expenditures impulse amounted to 2.1 pp contractionary, which is in line with the forecast.

With revenues and expenditures performance described above, in the third quarter of 2017 the state budget generated a deficit of roughly AMD 50.5 billion, which is 65% higher from the Central Bank's projection for the quarter.

3.2.3. The revenues aspect of the economy

Economic activity in January-September 2017 has increased by 5.1%, and the GDP growth in the third quarter is an estimated 4.0%, which is slightly above the Central Bank expectations.

The third quarter's economic growth owed to the industry and services sectors, with their growths of 6.7% and 12.6%, respectively, in the reporting period. Note that the growth of services exceeded the expectations of the Central Bank as both domestic and external demand bounced back rapidly. Steady growth in the industry has, in turn, been driven by further increasing export potential.

Developments in other sectors of the economy had a negative contribution to economic growth in the third quarter: the decline in

¹⁶ Real export and import growth indicators are the Central Bank estimates.

¹⁷ The review of the fiscal sector was done using preliminary actual consolidated budget indicators (local budgets as an estimate) prepared on the basis of preliminary actual indicators of the third quarter of 2017 (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.

¹⁸ The revenue projection was commensurate with quarterly adjusted budget plans.

agriculture and construction observable since the beginning of the year persisted over the third quarter (11% and 6.9%, respectively).

The productivity (real output per hour) reported strong growth rates in early 2017, which in part determined a high level of economic activity. The productivity growth rate in the second quarter was 5.2%, which, according to the estimates, slightly decreased in the third quarter to 4.1%.

3.2.4. Labor market

Average nominal wage in the **private sector** has grown faster since the beginning of 2017, in line with economic growth; it was however slightly slower (4%) in the third quarter from that of outlined in the previous forecasts, due to a lower-than-expected inflation rate. Nevertheless, the growth of private real wage is close to the historical average for recent years. The third quarter saw an estimated -0.6% decline in nominal wage in the **public sector**, which is below the Central Bank expectations. As a result, the **average nominal wage growth rate** in the third quarter of 2017 was slightly adjusted downside against previous forecasts to 2.4%.

In the third quarter of 2017 the **unemployment rate** is an estimated 17.4%, which is not that different from previous predictions.

In the reporting period, unit labor costs of the firms have grown, reflecting the acceleration of private wage growth in relation to output growth rate per unit of labor.

3.3. Financial market developments

3.3.1. Financial markets

The refinancing rate was left unchanged by the Board of Central Bank in the third quarter of 2017.

The Board's decision to leave the policy rate at 6% has been in consideration of macroeconomic developments, both actual and expected, as well as inflation forecasts. It was estimated that the current level of policy rate was stimulating enough and would further facilitate the recovery of the inflation and fulfilment of the target in the forecast horizon.

Chart 39

GDP and economic sector dynamics

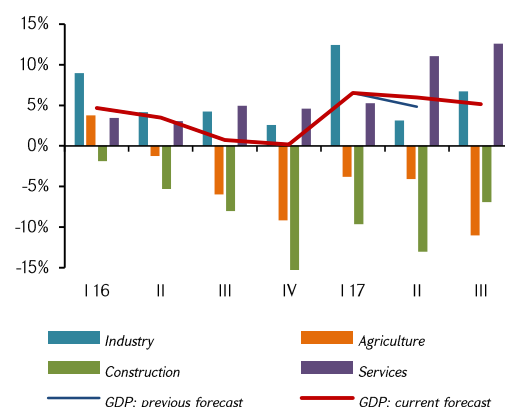


Chart 40

Average wage flows by sector, y/y growth, (%)

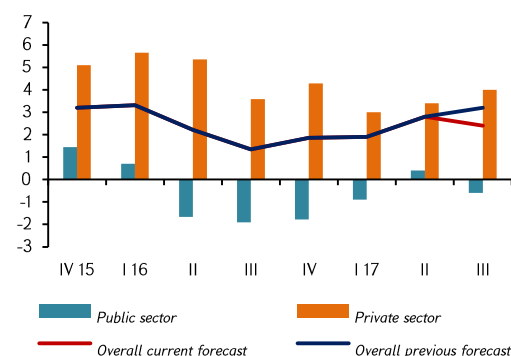


Chart 41

Unit labor costs, y/y growth, (%)

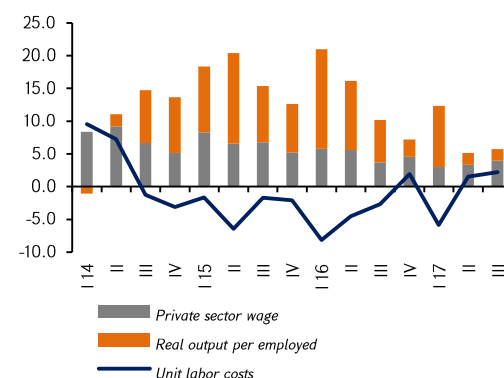


Chart 42

In the third quarter of 2017 short-term interest rates declined, (%)

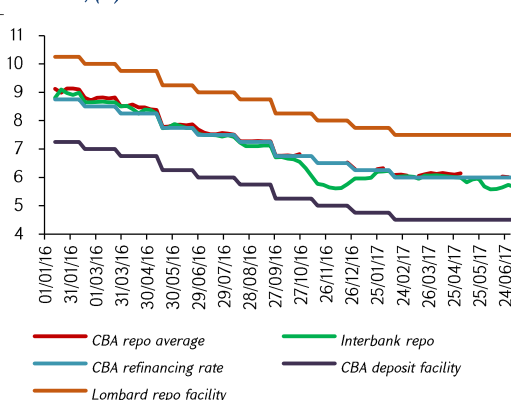


Chart 43

Liquidity injection and absorption through the Central Bank operations (average monthly value, million AMD)

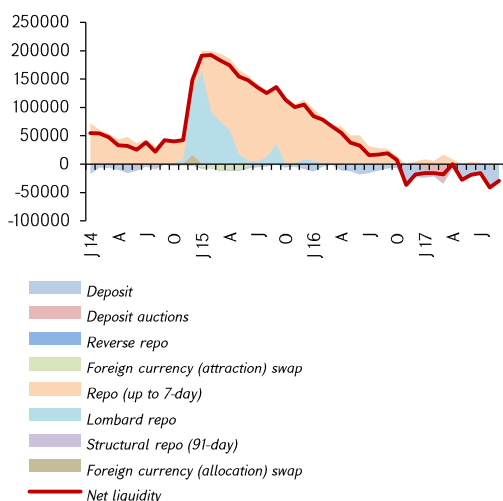


Chart 44

The behavior of short-term interest rates in the third quarter of 2017

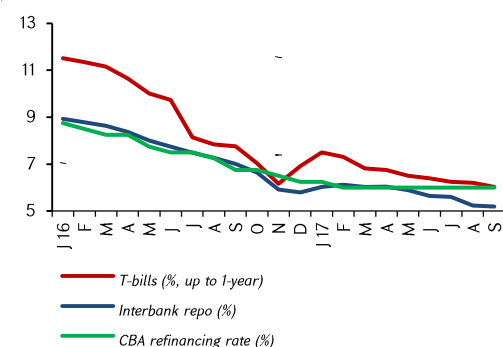


Table 6

Average quarterly interest rates in Armenia's financial market					
Instrument	Q3, 2016	Q4, 2016	Q1, 2017	Q2, 2017	Q3, 2017
Central Bank refinancing rate (end of quarter)	6.75	6.25	6.00	6.00	6.00
Central Bank repo rate	7.35	6.54	6.13	6.05	6.06
Interbank repo rate	7.27	6.19	6.06	5.86	5.33
Short-term treasury bill yield	7.87	6.65	7.21	6.56	6.19
Medium-term notes yield	11.36	10.13	9.97	8.76	8.45
Long-term bonds yield	14.16	13.65	13.18	13.03	10.03

In the financial market, trends of the previous period persisted over the third quarter of 2017: even though there has been strong liquidity in the banking system, the demand for liquidity offered through the Central Bank's repo instrument was rather small, with short-term market rates further trending down. The quarterly interbank repo rate has decreased by 0.53 pp against the previous quarter to 5.33%; the average monthly repo rate in September was 5.19%, dropping by 0.45 pp against June. Interest rates on up to 14-day interbank repo transactions were 0.82 pp smaller from the refinancing rate of the Central Bank in September¹⁹.

Currency Market: In the third quarter of 2017 the Central Bank carried on implementing an expansionary monetary policy, in which framework interbank MM rates went considerably down, whereas interest rates on the US federal funds have risen. Under such conditions, the difference between domestic and foreign market interest rates further narrowed, which in part reflects the reduction of the Country risk premium. During the quarter the Central Bank purchased about USD 99.1 million from the foreign exchange market in order to absorb short-term volatilities caused by the Balance of Payments seasonality. The nominal exchange rate of the Armenian dram against the US dollar was mostly stable, appreciating by about 1%. In the third quarter of 2017, the nominal effective exchange rate of the Armenian dram depreciated by 1.1% amid further appreciating dollar against trade partners' currencies (the euro, in particular).

The expectations of financial market participants were relatively stable during the quarter. At the same time, the high level of excess liquidity and the Central Banks' expansionary policy impact on the government bond market shored up a strong demand for bonds while leading to reduced yields. The bond yields have equally dropped all along the yield curve: in end-September, relative to end-June, the yield curve sloped down by approximately 0.17 pp.

Despite an unchanged level of the Central Bank policy rates since March 2017, the influence of previous expansionary monetary policy by

¹⁹ Repo transactions with 1-14-day maturities constituted 97% of interbank repo transactions in the third quarter of 2017.

the Central Bank lingered on the financial market, contributing to lower interest rates but more funds attracted and allocated by commercial banks, on the one hand, and bolstering competition between financial institutions and facilitating the current liquidity, on the other.

Attraction of deposit continued growing during the quarter.

Reduction of interest rates was concurrent with growing dram and foreign currency deposits, with an 8.0% growth of dram deposits mainly due to more funds attracted from individuals; foreign currency deposits have grown by 3.2%. The level of dollarization decreased by 0.6 pp during the quarter.

As it was anticipated, lending continued to grow amid dropping interest rates, facilitated lending procedures. Over the quarter, the growth of loans to the economy was 3.9%, mainly owing to the loans provided to companies. The 12-month growth of total lending to economy in September 2017 was 12.8%, which is more than Central Bank estimation.

Box 4:

Survey on the Terms of Lending by Banks and Credit Organizations

According to the results of the third quarter 2017 survey on terms of lending by local banks and credit organizations, there has been further easing of terms in respect of all aspects of lending. Stronger competition between banks and other financial institutions as well as an increased level of liquidity, which not only resulted in easier terms for loan interest rates but also less strict terms of maturity (i.e. providing the borrowers with extended deadlines) and fewer non-interest charges, remained decisive factors to easing. Non-interest charges have slightly increased in providing mortgage loans, however. Actual demand for all types of credit has grown.

For the fourth quarter of 2017 banks and credit organizations anticipate further easing in lending procedures and a growing demand for loans. The results of the survey are in line with CBA's assessment of the demand for economic recovery.

Chart 45

In the third quarter of 2017 yields in the government bond market dropped all along the curve

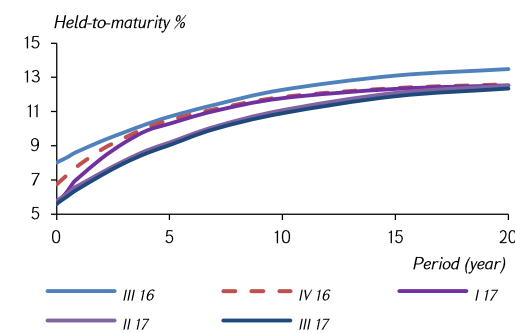


Chart 46

Interest rates on deposits of and loans to companies

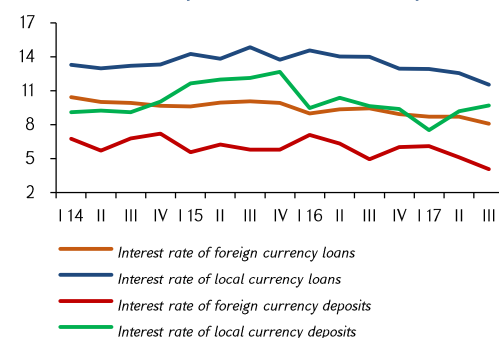


Chart 47

Interest rates on deposits of and loans to individuals

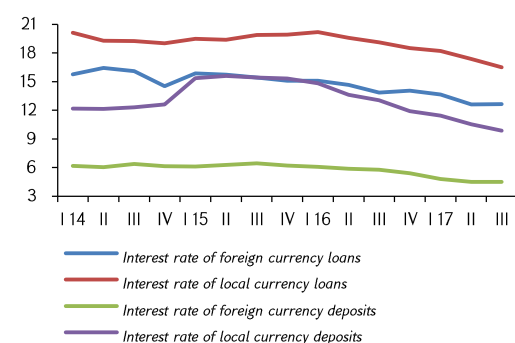
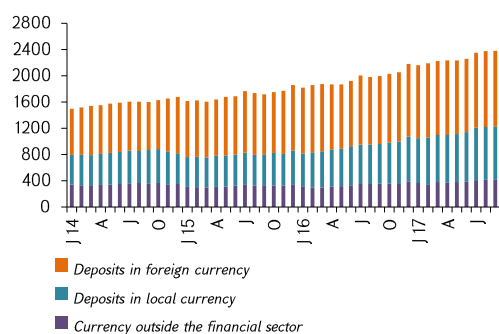


Chart 48

In the third quarter of 2017 the dram deposits outgrew foreign currency deposits (billion AMD)



**BOARD OF THE CBA
MINUTES
(14.11.2017)**

Refinancing Rate of November 14, 2017

**The CBA Board Meeting of November 14, 2017 attended by
Chairman Arthur Javadyan, Deputy Chairmen Nerses Yeritsyan
and Vakhtang Abrahamyan, and Board Members Ashot
Mkrtchyan, Arthur Stepanyan, Armenak Darbinyan,
Oleg Aghasyan and Arkadi Khachatryan.**

The Board meeting opened with presentation of Situation Report as of November 14, 2017. It addressed current developments on inflation, external environment and real, fiscal and monetary sectors of the economy.

Inflation in the third quarter of 2017 was lower than expected, mainly due to lower prices for fruits and vegetables. This effect, the Central Bank estimates, will phase out in the upcoming months, as the volumes of agricultural output are still below the previous year's level. There is expectation that inflation will be within the confidence band by the end of December. In recent months, core inflation has been recovering at a faster pace, incurring the impact of relatively high growth of domestic demand, further fuelled by the expansionary monetary policy implemented by the Central Bank. The high rates with which core inflation recovers points to the grown inflation expectations, with household inflation expectations increasing even faster, which is determined by an increase in prices for some food products in food markets of the world.

The Board addressed the current economic situation, stating that economic activity remained high also in the third quarter of 2017, mainly driven by strong growth registered in the services sector. In view of these developments, the Central Bank again revised the economic growth forecast upside in the Q4, 2017 Monetary Policy Program. High economic activity has been largely attributable to domestic demand that recovered at faster-than-expected rates, which mostly incurred the effect of expansionary monetary policy implementation and of restored growth rates in remittances from abroad. It should be noted that high growth rates in import of goods also persisted in the third quarter, which is another indication of the recovery of domestic demand.

The Board also discussed the external sector developments, which, in line with the scenario, contained trends for improved economic growth, somehow accelerating the external demand growth rates and the rise in prices in the international commodity markets. Following the discussion, the Board concluded that these trends will be maintained in the upcoming months and, consequently, certain inflationary patterns will continue to be observable in the external sector.

The Board looked into the developments in the domestic financial market, admitting that an expansionary monetary policy implemented by the Central Bank has given way for short-term market rates to further decline, fuelled also by a high level of excess liquidity in the banking system. In such a situation, the Central Bank has decided on the right toolkit, in concert with public debt management by the Republic of Armenia Ministry of Finance, in order to absorb the excess liquidity, thus making interest rates to return to the level of the Policy Rate in October-November of 2017.

Following presentation of the Situation Report and the developments in external and domestic macroeconomic environments, the Board began addressing the monetary policy directions and making decision on the interest rate. Two options were on the table – to leave the refinancing rate unchanged and to raise it by 0.25 pp. The Board noted that although inflation expectations and inflation risks came in somewhat intensified, it was still appropriate to keep the policy rate unchanged, leaving it expansive, and to give signal to the financial market about the need for gradual increase in interest rates in the future. As a result, the **12-month inflation rate** will enter the confidence band by the end of the year; it will exceed the 4% target starting from 2018, and only at the end of the forecast horizon will stabilize around the average inflation.

Albeit still low in the short-term, the risks to inflation trend substantially upward in the medium run, and should they materialize, a tougher policy would be required.

The Board approved the decision on interest rates of monetary instruments of the Central Bank and the proposed press release, which are attached hereto.

THE CENTRAL BANK OF THE REPUBLIC OF ARMENIA

BOARD RESOLUTION

Interest rates of operations by the Central Bank in the financial market

By virtue of Article 20 (c) of the Republic of Armenia Law on the Central Bank, the Board of the Central Bank of the Republic of Armenia **enacts:**

1. Leave the refinancing rate of the Central Bank of the Republic of Armenia unchanged, at 6.0%.
2. To the Financial Department of the Central Bank of the Republic of Armenia to carry out operations in the financial market of the Republic of Armenia, using the interest rates, as follows:
 - 2.1. Lombard facility rate offered by the Central Bank to be 7.5%.
 - 2.2. Deposit facility rate offered by the Central Bank to be 4.5%.
3. This resolution shall take force on the day following the adoption thereof.

Arthur Javadyan,
Chairman of the CBA
November 14, 2017

PRESS RELEASE
14.11.2017

At the November 14th of 2017 meeting the Board of the Central Bank of Armenia decided to leave the refinancing rate unchanged, at the 6.0% level.

There was 0.8% inflation in October of 2017 against that of 0.5% registered in the same month of the previous year, and the 12-month inflation rate amounted to 1.2% in the end of the month. Meanwhile, acceleration of the 12-month core inflation, observable in the last months, continues, from 0.7% in July to 2.4% in October. Headline inflation, the CBA Board estimates, remains low owing to slower-than-expected pace in price inflation on fruits and vegetables, the impact of which will, however, phase out in the upcoming months, and the inflation will be within the confidence band.

In the external environment, the global economic growth outlook further followed a positive track while inflationary patterns persisted in world commodity markets. In view of such developments, the CBA Board expects certain inflationary effects from the external sector, as external demand recovers.

The CBA Board notes that based on the results of the first nine months of 2017, compared to the same reference period last year, economic activity remained strong mainly due to high growth in services sector. Domestic demand continues recovering faster than expected, which is attributable to an implemented expansionary monetary policy and somewhat recovered growth in remittances from abroad. Strong growth in imports as well as the way core inflation behaves also points to the recovering domestic demand. In the meantime, inflation expectations of households are growing slightly faster, deriving from the rise in international prices in individual food product markets and supply-driven price increases.

Although certain expanding of the inflation environment and higher inflation expectations are possible, the CBA Board still finds it reasonable to keep monetary conditions expansionary. At the same time, the Board believes that in light of predicted developments **a gradual offsetting of expansionary monetary conditions would be needed** in the near future to fulfil the inflation target in the medium run.

Should there emerge risks to the economic growth outlook and inflation deviating from its recovery path, the Central Bank would react by adjusting its monetary policy directions accordingly, while fulfilling the inflation target in the medium run.

Press Service of the Central Bank of Armenia

MAIN MACROECONOMIC INDICATORS OF ARMENIA

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
	actual	actual	actual	actual	actual	actual	actual	estimate	program	program
Prices										
Inflation (y/y, end of period, %)	9.4	4.7	3.2	5.6	4.6	-0.1	-1.1	2.5	4.2	4.4
Consumer price index (y/y, average, %)	8.2	7.7	2.6	5.8	3.0	3.7	-1.4	1.2	3.3	4.3
Core inflation (y/y, average, %)	7.5	8.6	5.3	5.8	1.9	5.1	-2.0	0.7	4.5	5.4
Gross product										
GDP (billion Armenian dram)	3690.0	4028.9	4266.5	4555.6	4828.6	5043.6	5079.7	5394.6	5784.3	6268.5
GDP (% real growth)	2.2	4.7	7.2	3.3	3.6	3.2	0.2	4.6	4.1	4.2
Supply										
Industry (% real growth)	9.2	13.6	6.4	6.3	-0.9	6.2	5.1	7.5	4.9	6.6
Agriculture (% real growth)	-16.0	14.0	9.5	7.6	6.1	13.2	-5.8	-7.2	6.9	7.4
Construction (% real growth)	3.3	-12.2	4.5	-7.4	-4.5	-3.1	-11.3	-7.2	4.3	3.4
Services (% real growth)	4.1	4.7	6.3	3.1	6.7	1.6	4.1	8.9	3.2	2.4
Taxes, net (% real growth)	13.4	3.8	9.9	3.6	1.8	-5.1	-4.3	6.7	3.4	4.3
Demand										
Consumption (% real growth)	3.9	2.6	7.7	1.9	1.3	-6.4	-0.9	6.6	3.5	2.8
Public consumption (% real growth)	3.9	1.9	-1.4	8.7	3.4	4.5	0.9	2.2	1.0	2.2
Private consumption (% real growth)	3.9	2.7	9.1	0.9	0.6	-7.9	-1.2	7.4	3.6	2.9
Gross investment (% real growth)	0.5	-5.2	0.5	-10.5	-2.6	-1.2	-8.7	2.2	9.9	7.1
Public investment (% real growth)	-12.7	-6.1	-22.4	-13.8	9.3	13.6	5.6	-22.4	31.5	18.0
Private investment (% real growth)	2.6	-5.1	3.6	-10.0	-4.4	-4.2	-10.5	5.9	7.5	4.9
Export of goods and services (% real growth)	20.4	14.5	11.5	8.5	6.1	9.9	13.5	8.4	5.4	4.1
Import of goods and services (% real growth)	7.1	-0.1	4.7	5.5	4.2	-5.6	3.5	13.7	3.8	3.7
External sector										
Balance of trade (million US dollar)	-2065.7	-2109.8	-2111.9	-2196.2	-2055.4	-1186.4	-944.4	-1189.0	-1245.7	-1307.8
Balance of services (million US dollar)	-260.8	-65.8	-101.6	-124.3	-113.0	-94.5	-71.4	-73.6	-55.0	-37.8
Remittances (million US dollar)	1421.9	1440.4	1539.8	1755.1	1616.1	1082.4	989.6	1134.2	1215.7	1304.8
Current account (million US dollar)	-1261.4	-1058.9	-1057.9	-812.9	-883.1	-279.1	-238.1	-254.4	-375.4	-381.0
Balance of trade (share in GDP, %)	-22.1	-20.8	-19.9	-19.7	-17.8	-11.3	-8.9	-10.7	-10.4	-10.4
Balance of trade (share in GDP, %)	-2.8	-0.7	-1.0	-1.1	-1.0	-0.9	-0.7	-0.7	-0.5	-0.3
Remittances (share in GDP, %)	15.2	14.2	14.6	15.8	14.0	10.3	9.3	10.2	10.2	10.4
Current account (share in GDP, %)	-13.5	-10.5	-10.0	-7.3	-7.6	-2.7	-2.2	-2.3	-3.1	-3.0
Public sector										
Revenues and grants (billion Armenian dram)	780.4	880.9	946.2	1071.4	1144.8	1167.7	1171.1	1201.4	1307.3	-
Tax revenues (billion Armenian dram)	699.4	777.4	878.4	1000.9	1064.1	1067.9	1079.7	1146.7	1247.9	-
Expenditures (billion Armenian dram)	954.3	986.5	1006.1	1142.9	1235.1	1409.0	1449.1	1381.9	1464.2	-
Deficit (billion Armenian dram)	-173.9	-105.6	-59.9	-71.5	-90.3	-241.3	-278.0	-180.5	-156.9	-
Revenues and grants (share in GDP, %)	22.6	23.3	22.2	23.5	23.7	23.2	23.1	22.3	22.6	-
Tax revenues (share in GDP, %)	20.2	20.6	20.6	22.0	22.0	21.2	21.3	21.3	21.6	-
Expenditures (share in GDP, %)	27.6	26.1	23.6	25.1	25.6	28.0	28.6	25.6	25.3	-
Deficit (share in GDP, %)	-5.0	-2.8	-1.4	-1.6	-1.9	-4.8	-5.5	-3.3	-2.7	-
Monetary sector										
Broad money (y/y, end of period, %)	11.8	23.7	19.5	14.8	8.3	10.8	17.5	10.9	6.3	-
Dram broad money (y/y, end of period, %)	15.7	26.4	11.9	14.9	-3.5	5.2	24.8	20.0	10.7	-
Loans to economy (y/y, end of period, %)	26.7	35.3	27.6	12.9	20.8	-3.3	6.0	-	-	-
USD / AMD (Armenian dram for one US dollar)	373.7	372.4	401.8	409.6	415.9	477.9	480.5	-	-	-

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