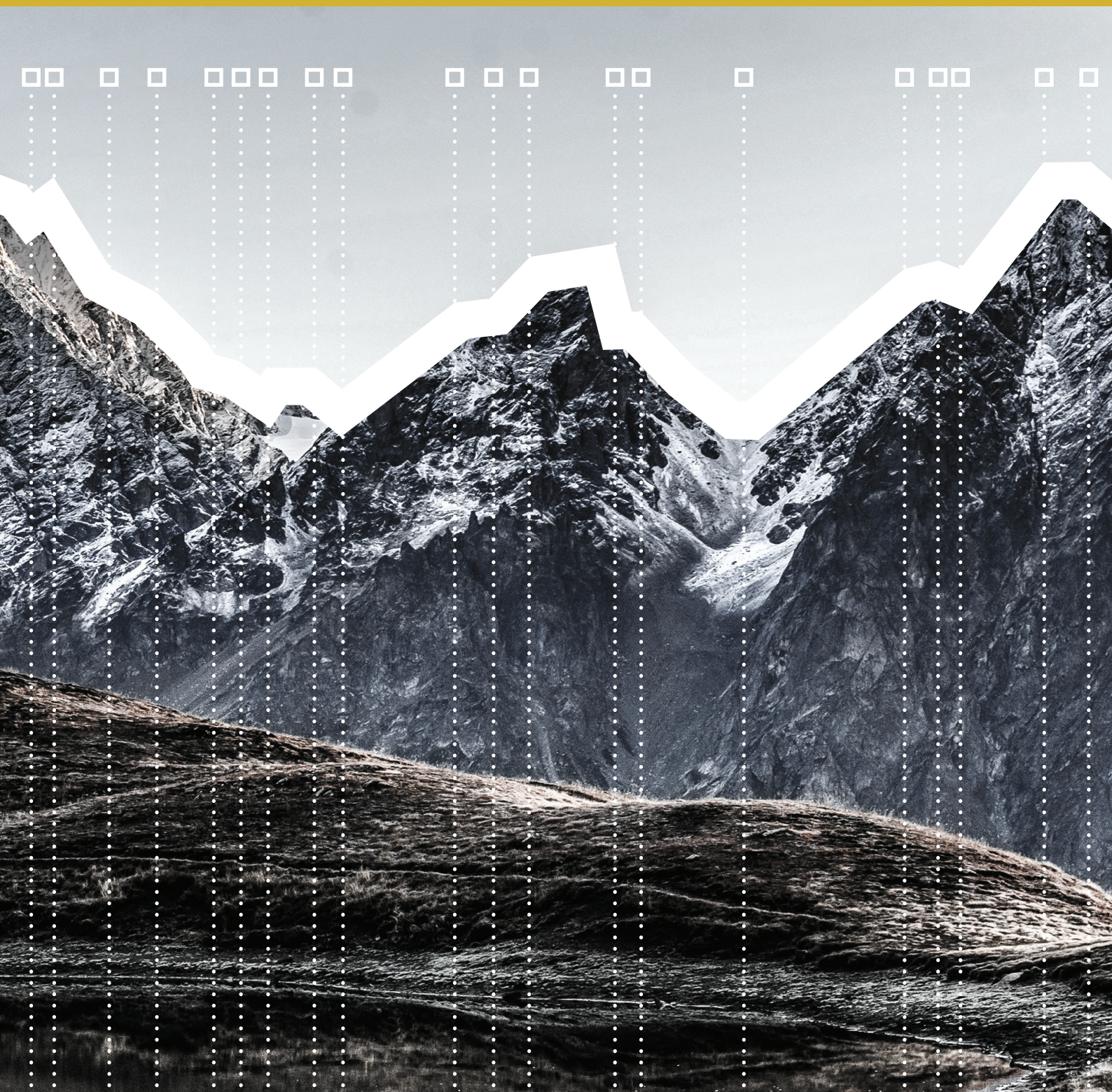




Central Bank of
The Republic of Armenia

Inflation Report

2023 / 2



*Approved
under the Central Bank Board
Resolution No. 92A, dated 27.06.2023*

Inflation Report/2

*Monetary Policy Program,
Q2, 2023*

✦
*Status Report on Implementation of the
Monetary Policy Program,
Q1, 2023*

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 presents the Monetary Policy Program that includes the directions of the monetary policy in the mid-term horizon as well as the scenario of inflation and other macroeconomic indicators under the directions. The latter is one possible scenario under consideration and is based on the Bank's assessment of the current situation and future assumptions, which also include the impact of the Bank operations.

The second section of the report includes the Status Report on implementation of the monetary policy program for the previous one-year period, which presents the results of monetary policy implementation and covers the actual developments in the domestic economy.

Publishing of inflation scenario and the underlying assumptions, along with the inflation target, makes the monetary policy of the Bank more transparent, understandable and predictable, which aims to increase 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 effectively minimizing the deviations between the 4% target and the inflation scenario. 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.

The scenario outlined in this report has been based on the actual information available by June 13, 2023, i.e. the day on which the refinancing rate was set, the results of 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 (www.cba.am) which also contains all press-releases and other monetary policy-related publications.

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1. Executive summary

In the second quarter of 2023, the economic growth rates in the main partner countries to Armenia are still sluggish, which is accompanied by continuous easing of the inflation environment. Nevertheless, in all partner countries, as inflationary pressures derived from labor markets linger, the prices of goods and services that stand out with “sticky” prices still remain high. The central banks of those countries will therefore carry on tightening monetary conditions in the near future. As a result, global demand will continue to weaken, contributing to lower prices in international commodity markets.

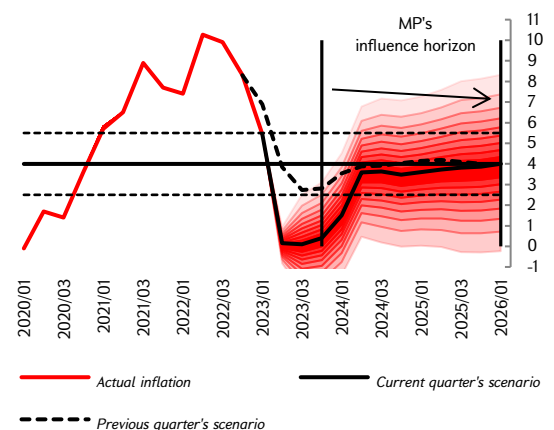
The trends of high economic activity in Armenia are persisting, which is primarily sustained by the positive developments in the construction sector and strong external demand in the services sector. At the same time, continued weakening of the inflationary effects spilling over to the Armenian economy from the world economy, the contractionary monetary policy implemented by the Central Bank of Armenia and the dram appreciation all have resulted in a notable drop in prices of imported food products, which has in turn facilitated a rapid easing of the overall inflation environment. However, determined by high demand and inflation expectations, the inflation of services and some product groups is being adjusted more slowly.

In general, with uncertainties carrying on, the Central Bank of Armenia is striving to reduce the possible risks that arise therefrom by building and discussing different scenarios for the situation development, the one of which is outlined in this monetary policy program.

In the second quarter of 2023, the 12-month inflation declined sharply to 1.3% as of end-May. According to the scenario presented by the Central Bank of Armenia, a certain decrease in the 12-month inflation is expected in the near future, with high demand and inflation expectations persisting in the economy, in which case wages and inflation of a number of services and goods standing out with “most sticky prices” are still at high levels. Based on the above, the Central Bank of Armenia considered it appropriate to loosen the monetary conditions in a relatively small step at this stage, while further committed to eventual controlling of inflation.

In view of the monetary policy implementation and expected macroeconomic developments, the 12-month inflation will remain below the target value in the near future, then will

Chart 1
Inflation (12-month) scenario probability distribution
for a 3-year policy horizon



Source: Armenia Statistics Committee, Central Bank of Armenia scenario

gradually increase and stabilize around the 4% target in the medium term.

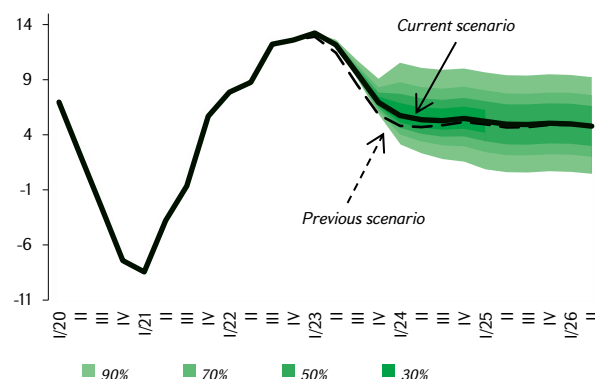
According to the scenario presented by the Central Bank of Armenia, high economic activity will be sustained in the near future, whereas the growth in 2023 is expected to be higher relative to the one outlined in the previous program's scenario.

In the mid-term horizon, as the demand side factors and positive GDP gap seek adjustment, the growth will gradually slow down and stabilize around its long-term sustainable rate of 4.5%.

In the 3-year policy horizon of the outlined scenario, the probability risks of inflation and economic growth deviating from the projection paths are mostly balanced (see subsection 2.2.3). In the case of risks emerging in any direction, the Board of the Central Bank of Armenia will adequately respond and ensure the fulfilment of the price stability objective.

Chart 2

Real GDP growth (cumulative)¹ scenario probability distribution for a 3-year policy horizon



Source: Armenia Statistics Committee, Central Bank of Armenia scenario

¹ Each quarter's growth rate is calculated as the cumulative growth rate of the last four quarters.

2. Scenario presented, scenario changes and risks

2.1. External environment developments

The economic activity in the world and the main partner countries to Armenia in particular, continues demonstrating sluggish rates since the beginning of 2023, and the 12-month inflation slows down considerably largely owing to the continued fall in food and energy prices. In a number of developed economies, however, inflationary pressures deriving from the overheated labor markets are persisting, which helps the prices of goods and services that stand out with mostly “sticky” prices settle at elevated levels. It is estimated, as a result, that the central banks of developed economies will further carry out a contractionary monetary policy, which will be reflected in continued slowing of demand in the global economy and a certain decrease in prices in commodity markets.

In the global economy and Armenia's main partner countries in particular, the economic activity remains sluggish since the start of 2023, with the 12-month inflation slowing down significantly.

The central banks of developed economies will further pursue a contractionary monetary policy, which will be reflected in continued slowdown of economic activity in the world and a certain decrease in prices in commodity markets.

Economic developments in the United States:

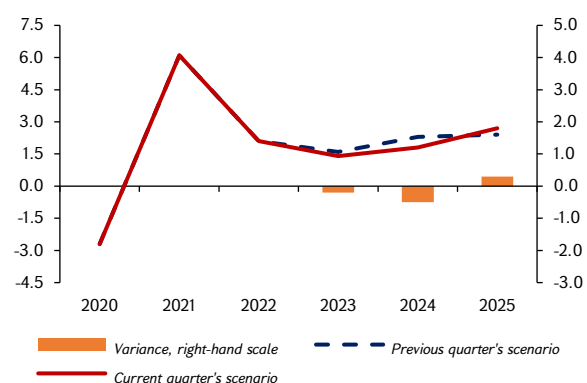
According to the U.S. Bureau of Economic Analysis estimate, in the first quarter of 2023 the US economy posted a growth of 1.6% y/y, which is somewhat lower than the estimate presented in the previous MP program of the Central Bank of Armenia. The growth of private consumption, public expenditures and net exports positively contributed to the first quarter's economic growth, whereas private investment had a negative contribution.

In the course of the last quarters, the terms of lending² by banks in the USA, too, have become tighter enough (see Chart 4). According to the Central Bank of Armenia estimates, the negative impact of tightened terms of lending by banks will be felt starting from the second half of 2023 up until the end of 2024, with a total negative impact of up to 1.0 percentage point on economic growth. As a result, according to the scenario presented in the program, the US economic growth in 2023 will be slightly lower than the estimate in the previous program, around 1.4%. It is estimated that economic growth in the US will remain relatively low in the wake of tight monetary policy and will only approach a long-term sustainable level at the end of the mid-term horizon.

According to the estimates of the Bureau of Economic Analysis of the US Department of Commerce, in the United States in the first quarter, the personal consumption

Chart 3

The USA economic growth scenario (%)



Source: Bureau of Economic Analysis, Central Bank of Armenia scenario

² Senior Loan Officers Opinion Survey (SLOOS):
<https://www.federalreserve.gov/data/sloos/sloos-202304.htm>

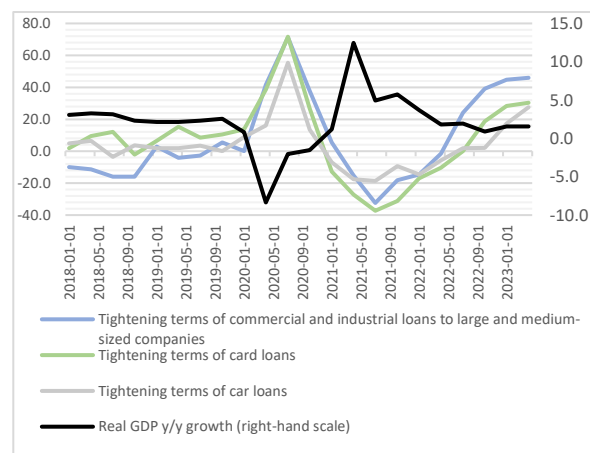
expenditure price index³ slowed at a faster pace than expected under the previous program, falling to 4.9% from 5.7% in the previous quarter, and the annualized rate of consumer price inflation amounted to 5.8% in the first quarter. The slowing of personal consumption expenditures and consumer price inflation in the first quarter was mainly determined by a decrease in energy prices and prices of used cars. It is noteworthy that the second quarter posted a rise in prices in the used car markets due to increased demand. Inflation acceleration was observable in the services sector as well. However, with energy prices decreasing, the US personal consumption expenditure price index continued to slow during the second quarter of 2023, reaching 4.4% y/y in April, while consumer price inflation slowed down to 4.0% in May. However, headline inflation continues to hover above the US Federal Reserve's inflation target, which is fueled by inflation in product groups with relatively more "sticky" prices in the consumer basket. Note that, the fuel and food indicators excluded, there was 0.4% inflation (that of nearly 5% annualized) recorded for the consumer basket in May of 2023, relative to the previous month.

The US labor market continues to be overheated. Unemployment in the first quarter of 2023 remained below the pre-pandemic level, at the rate of 3.5%, while the figure of job vacancies exceeded the number of the unemployed by about 1.5 times. These factors carry on transmitting significant inflationary pressures from the labor market to the economy.

Given the aforementioned developments, it is expected that the US Fed will continue to conduct a contractionary monetary policy, ensuring that the inflation returns to the target at the end of the horizon. However, taking into account the expected effects of tightening of lending terms, the US Fed will envisage a lower path for policy rates compared to previous estimates.

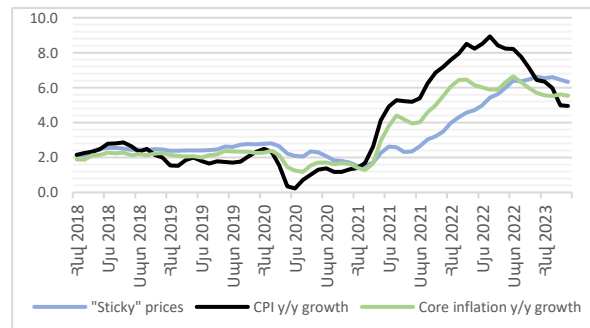
Economic developments in the Eurozone: According to the Eurostat's estimate, in the first quarter of 2023 the Eurozone's economic growth was 1.0% y/y, which is somewhat lower than the estimate of the scenario in the previous program of the Central Bank of Armenia. Reduced private consumption, public expenditures and reserves have had negative contribution to the economic growth, whereas net exports and investment have contributed positively. Given the continuous tightening of

Chart 4
Tightening bank lending terms; lending and real GDP y/y growth



Source: US Federal Reserve System

Chart 5
Inflation and the "sticky" prices, y/y growth, seasonally adjusted (%)



Source: Bureau of Labor Statistics, Federal Reserve Bank of Atlanta

³ The personal consumption expenditure price index target is 2%, which on average is commensurate with consumer price increase of 2.3%.

the monetary conditions, as well as the impact the Eurozone economy experiences because of stern restrictions applied to Russia, the economic growth of the Eurozone in the short and medium term is expected to be close to previous estimates, i.e. at low levels.

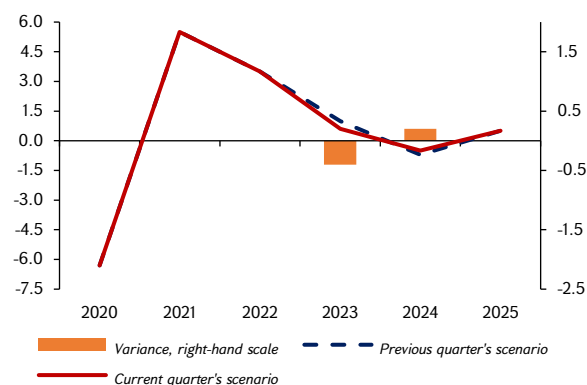
The labor market in the EU continues to operate under conditions of “overheating”. The unemployment has decreased to around 6%, but on the other hand the labor participation rate has grown significantly, surpassing the pre-pandemic indicator. The estimation is that these conditions will still prevail, causing inflationary pressures in individual branches of the economy (especially in the services sector).

The 12-month inflation keeps on decelerating in the Eurozone. Thus, in the first quarter of 2023 the Eurozone economy saw 8.0% y/y inflation against that of 10% in the previous quarter. The slowing of inflation was largely determined by oil and gas prices which came lower in comparison with the same period of the previous year. In the second quarter of 2023, the rate of inflation continued to decelerate, yet it remains considerably above the European Central Bank’s target: in May, it amounted to 6.1% y/y. It should be noted that, unlike headline inflation, core inflation somehow accelerated in the first quarter and started to decelerate in the second quarter only, but at a notably slower pace than headline inflation: in May, the 12-month inflation, excluding energy and food indicators, amounted to 6.9%.

Thus, in view of the aforementioned developments, the anticipation is that the ECB will continue to tighten monetary conditions, while ensuring further easing of the inflation environment and helping the inflation return to the target at the end of the policy horizon.

Economic developments in Russia: According to the estimates of the State Statistical Service of Russia, in the first quarter of 2023 the Russian economy contracted by 1.9% y/y – a more positive result compared to the estimates outlined in the previous program of the Central Bank of Armenia. The contraction of the Russian economy was primarily due to the wholesale and retail trade branches, whereas more positive-than-expected developments in economic growth were mainly attributable to the increased output in the manufacturing industry. It is worth noting that demand in Russia is also recovering faster than expected, which continues to be largely supported by a substantially stimulative fiscal policy and rebounding private consumption.

Chart 6
The EU economic growth scenario (%)



Source: Eurostat, Central Bank of Armenia scenario

According to the Central Bank of Armenia scenario, the economic developments in Russia in 2023 will be more positive compared to the previous program: about 1.2% of economic growth will be recorded during the year. Note also that in the current year and along the entire medium-term horizon, the Russian state budget will perform in deficit (up to 2% of GDP in 2023, and up to 1.4% in 2024)⁴, however, unlike the current year, the fiscal policy's impact on the economy in the upcoming years will be mostly neutral.

As demand recovers at a faster-than-expected rate, rapid reduction of the current account surplus is observable, which, in turn, leads to depreciation of the ruble's nominal exchange rate and adds to inflationary pressures to a certain extent.

In the first quarter of 2023, the 12-month inflation amounted to 8.7%, which is way above the 4% target value; however, the 12-month inflation has significantly reduced since March, embracing the effect of high inflation recorded in March of the previous year. The slowing of inflation continued over the second quarter of 2023 too, making up 2.5% y/y in May. It should be mentioned that despite the decelerated 12-month inflation, the services sector sees inflation shape at a considerably higher level, mainly reflecting the inflationary effects derived from the continuously "heating" labor market, among other factors.

According to the current estimates of the Central Bank of Armenia, to neutralize risks to inflation acceleration and inflation expectations, the Central Bank of Russia will tighten monetary conditions to a certain extent in the short run while ensuring that the inflation approaches the target at the end of the policy horizon.

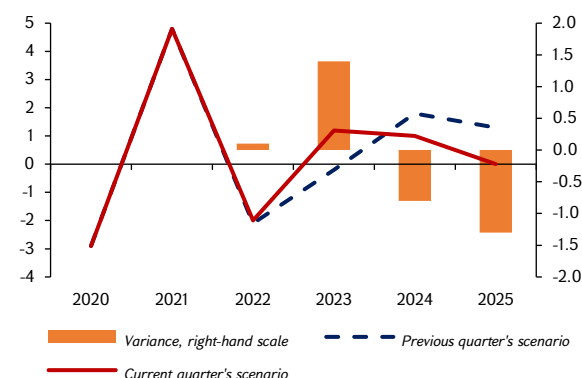
Developments in commodity and food product markets:

As financial conditions tighten up around the globe, price decreases in almost all international commodity markets continued in the course of the first quarter of 2023. As supply chains step into full recovery and global demand continues to slow amid tightening financial and fiscal conditions, there is expectation that real commodity and food product prices will further be adjusted downside, in the medium run approaching the levels driven by long-term fundamentals (see Box 1). As a result, the inflationary effect from commodity markets to the Armenian economy will be weak.

In the international copper market in the first quarter of 2023, relative to the same reference period last year, prices dropped by about 10% y/y, reaching USD 8,900 per ton

Chart 7

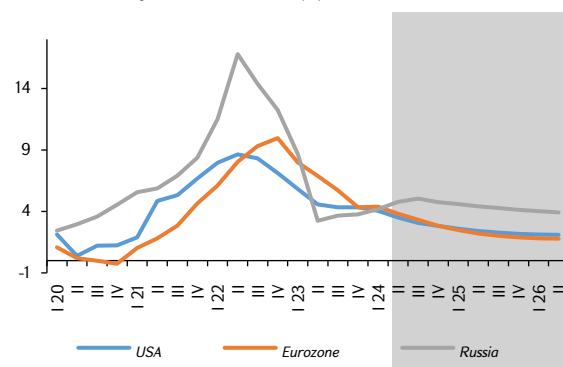
The Russia economic growth scenario (%)



Source: Rosstat, Central Bank of Armenia scenario

Chart 8

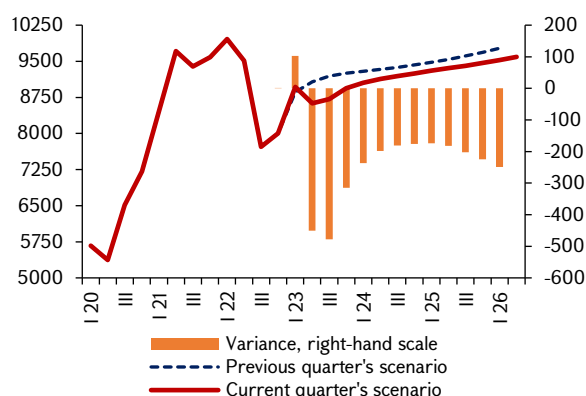
Inflation in partner countries (%)



Source: Bureau of Labor Statistics, Eurostat, Rosstat, Central Bank of Armenia scenario

Chart 9

International copper price scenario



Source: World Bank, Central Bank of Armenia scenario

⁴ Russia Federal Budget, 2023-2025, Ministry of Finance of the Russian Federation.

determined by continued tightening of monetary conditions in the world. Driven by contractionary monetary policy implementation in advanced economies and a faster slowing of demand on the back of tightened global financial conditions, copper prices in the short term were somehow revised downside compared to the previous MP program of the Central Bank of Armenia. In the mid-term perspective, however, international copper prices will increase to a certain extent, approaching the price level of USD 9,500 per ton at the end of the horizon.

The international oil market, too, is incurring the impact of the sluggish global demand. Over the first quarter of 2023 the prices plunged by about 15% y/y, resting at the level of USD 82 per barrel. The international oil prices kept on decreasing in the course of the second quarter as well.

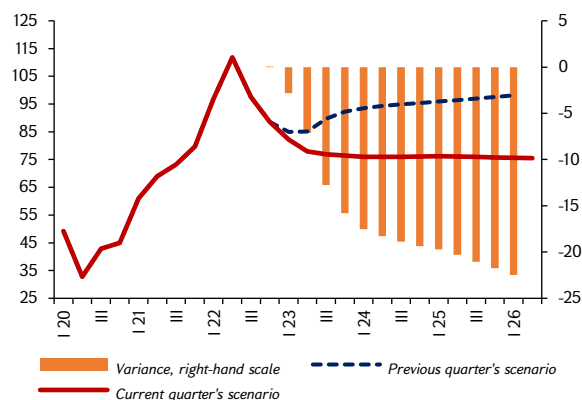
In pursuit of reaching a supply and demand balance and price regulation in the international oil market, in April of 2023 the OPEC+ member countries decided to cut oil production by an extra 1.6 million barrels a day by the end of the year (and then extend it until end-2024 as well), which somewhat mitigated the deflationary risks that derive from the slowing demand.

In view of the developments in oil market, oil prices will shape around USD 75 per barrel at the policy horizon, according to the current scenario by the Central Bank of Armenia.

In food product markets, driven by optimistic expectations for the volume of supply of individual products on the one hand, and globally tightened financial conditions, on the other, the prices of all food product groups, except those of sugar and meat products, posted decreases during the first quarter of 2023, standing somewhat below the previous estimates by the Central Bank of Armenia. Thus, based on the Q1, 2023 results, the prices of items in food basket have dropped by about 11.0% against the respective levels reported for the previous reference period. This was mainly attributable to a considerable plunge in vegetable oil prices by more than 36% y/y, dairy product prices, by nearly 7% y/y, and grain prices, by about 5% y/y. The prices of almost all product groups keep on decreasing in the course of the second quarter, too.

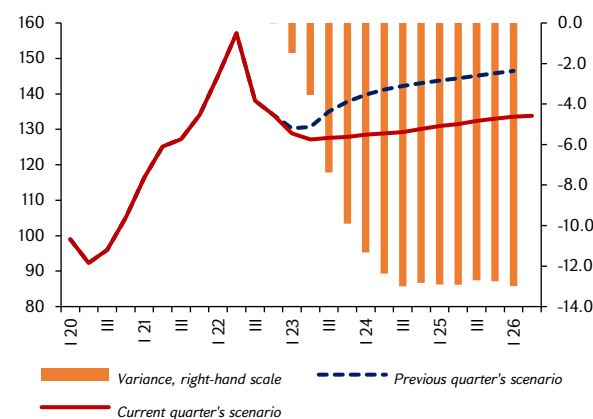
According to the current scenario of the Central Bank of Armenia, as weakening of global demand continues, and conditions of supply in some product groups are favorable, the prices in food product markets will further decrease in the short term; in the medium term the prices will shape at levels below the previous estimates.

Chart 10
International oil price scenario



Source: World Bank, Central Bank of Armenia scenario

Chart 11
International food price scenario



Source: FAO, Central Bank of Armenia scenario

Box 1: The commodity and food product “supercycles”

International commodity and food product prices always stand out with high volatility, which heightened especially at the beginning of the Covid-19 pandemic due to considerably grown uncertainties, significant diseconomic stimulative policies and supply chain disruptions. Naturally, this also leads to an increased price volatility in the consumer basket of countries. The problem is particularly pronounced in such developing open economies (including Armenia), where the share of imported food in the consumer basket is large. These are the main factors which determine a certain increase in volatility in the behavior of inflation in both Armenia and other developing and advanced economies in recent years.

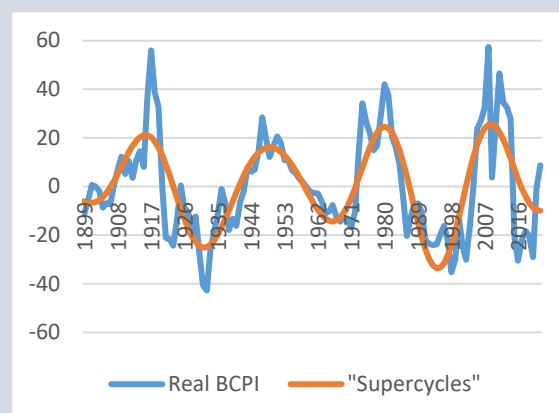
Despite a significant volatility demonstrated in the short run, the real prices of goods in commodity and food markets wade through long periods of growth and decline, which can be called “supercycles”. Interestingly, the real (nominal prices adjusted by the increase in final total basket prices) prices (nominal prices adjusted by headline inflation) of these product groups remain, on average⁵, in a very long time horizon (the last 100-150 years) almost unchanged (see Chart 12⁶), while the cycles have approximately the same duration, 30-35 years. Consequently, according to this estimate, there have been 4 “supercycles” in the last 125 years or so, and at present the markets are in the latter part of the 4th cycle, which means that the markets have passed the price peak and now are close to the long-term sustainable level, with the phase of decline to follow.

The reason that the “supercycles” (phase of growth) emerge is almost always the same: the shaping of a lasting, sustainable, strong global demand, driven mostly by a steep increase in the level of industrialization in a variety of major economies (Erten and Ocampo, 2012), which occurs in the light of commodity supply increases with a substantially slower, gradual, longer-time lag (time-to-build) response⁸.

In the case of such product groups, especially commodities (oil, metals, etc.), the slower response of the supply increases is due to the costs associated with implementing large-scale investments (start-up costs), for the start of which one needs to be sure that the increase in demand is not temporary but it will remain high for a certain long period of time (“insurance” for investment buyback, Majd and Pindyck,

Chart 12

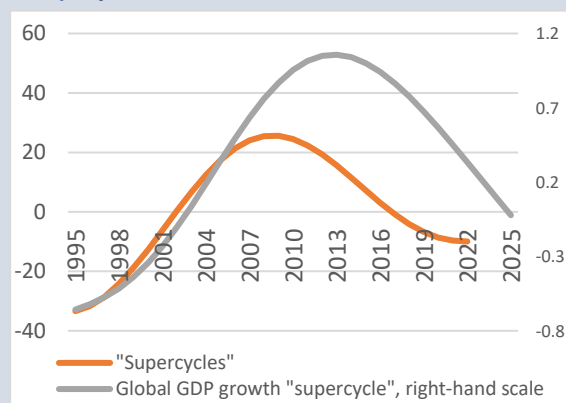
The commodity and food product (BCPI) “supercycles”



Source: Central Bank of Armenia estimate

Chart 13

The relation between commodity and global growth “supercycles”



Source: World Bank, Central Bank of Armenia estimate

⁵ This refers to the movement of general indices containing all basic food products and commodities.

⁶ These estimates were made based on the Bank of Canada research conducted in 2016: <https://www.bankofcanada.ca/wp-content/uploads/2016/11/boc-review-autumn16-buyuksahin.pdf>, using the Colletti (1993) and Christiano and Fitzgerald (2003) methodology.

⁷ BCPI – Bank of Canada Commodity Price Index, which comprises 26 groups of products: <https://www.bankofcanada.ca/rates/price-indexes/bcpi/>.

⁸ A lasted strong industrial growth in the US and other countries in early 19th century; a high growth in defense and military industries in the pre-war period almost all over the world in the 1930s; the start of a steep industrial growth in China in the late 20th century and, in general, a growth of free trade in the world in the wake of increasing globalization. And the “supercycle” of the 1970s is associated with multiple, long-lasting supply chain disruptions caused by geopolitical events.

1987). As a result, noticeable investment to increase supply begins some time (usually several years) after demand increases, while it takes several more years from the start of investment to manufacture or output (Radetzki et al. 2008).

Thus, the growth phase of “supercycles” comes when there is a significant shortage of goods (high demand and a relatively stable supply that grows more slowly at a later point), and the decline phase comes when, on the contrary, there is a surplus of goods (weakening demand and still a rapidly growing supply that slowly needs to be adjusted at a later point).

In this context, when looking at commodity “supercycles”, we notice that, because of deglobalization phenomena (segmentation of countries, “trade wars”, imposing of harsh economic sanctions), persistently high uncertainty over geopolitical developments, and other factors, we currently are in a decline phase of “supercycles”⁹ of global growth (see Chart 13).

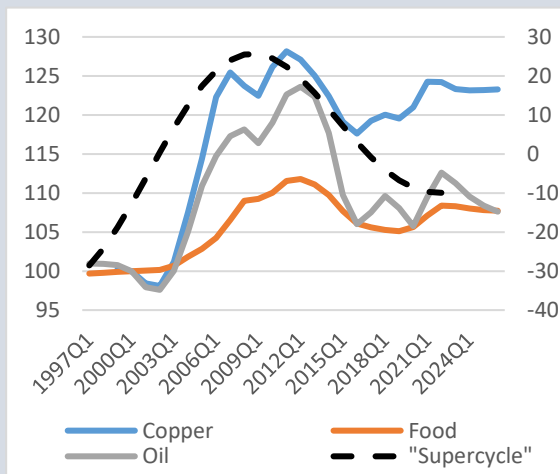
It should also be noted that between 2020-2022, mainly driven by a notable increase in temporary demand (substantially stimulative monetary and fiscal policies almost all over the world), on the one hand, and supply chain disruptions, on the other, the commodity and food product prices have grown significantly, hitting values higher than determined by long-term factors.

Once the influence of the aforementioned factors phase out – supply chains recover considerably, economic policies (specifically the monetary policy) tighten up faster, liquidity decreases and financial conditions get back to ‘normal’ (see Inflation Report for the 1st quarter of 2022, Box 1) – real prices of commodities and food products will continue to be adjusted downside in the upcoming years, approaching long-term “fundamental” levels. As a result, the Central Bank of Armenia estimates of the real price trends of commodities and food products have been reconsidered accordingly (see Chart 14).

⁹ The “supercycles” of global growth are estimated using the same methodology as for commodity and food products.

Chart 14

The Central Bank of Armenia estimates of the mid-term trends for real commodity and food product prices (index, 2000 = 100)



Source: Central Bank of Armenia

2.2. Domestic economy scenario

2.2.1. Inflation and monetary policy

In the second quarter of 2023, the inflationary effects transmitted to the Armenian economy from the external sector are weakening considerably, as economic growth rates remain slow and inflation environment is further easing in Armenia’s main partner countries.

The country risk-premium of the Republic of Armenia has somewhat decreased owing to the sizably reduced debt burden on the back of high economic growth (improved outlook, too) and the dram appreciation in the country. Moreover, with

currently large-scale capital flows, it is estimated that the country risk-premium of Armenia stands slightly below the level determined by fundamental factors.

The trends of high economic activity in Armenia continue. Specifically, a 12.1% increase in economic activity was recorded in April of 2023, which was mainly driven by the positive developments in construction and services (especially IT industry) sectors. Although, it should be noted, the IT industry's contribution to the economic growth will somewhat weaken starting from the second half of this year, the productivity growth in this industry will remain high, helping the economy's potential grow stronger in the medium term compared to previous estimates.

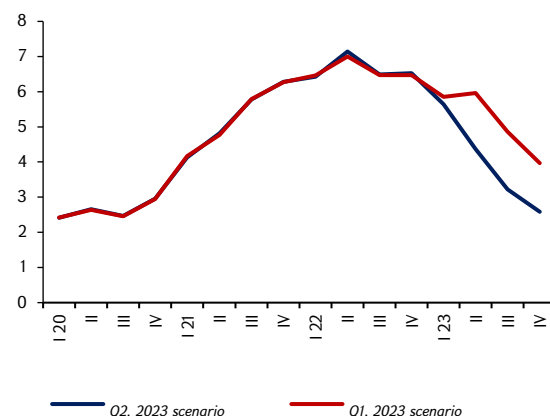
A larger than expected inflow of tourists was observable in the course of the first months of 2023. There is anticipation that rebounding domestic demand will somewhat positively contribute to strong demand reported this year. As a result, the gap in demand, although slightly more positive compared to previous estimates, will close in the near future under the influence of tight monetary and fiscal conditions, prompting the inflation environment to stabilize.

Certain encouraging developments continue to be seen in the labor market; both the number of the working age population and the employed, and the labor force participation rate keep on rising. A steady slowdown in the rate of migration is observable. These shifts also determine a certain increase in the potential growth of the economy. On the other hand, though the 12-month wage growth is still high enough, growth has stabilized in recent months, and risks of inflationary pressures from the labor market have diminished significantly.

In the outcome, driven by weaker inflationary effects transmitted to the domestic economy from the external sector, the contractionary monetary policy implemented by the Central Bank of Armenia, and the appreciation of the dram, the prices of food products (the imported ones, in particular) are reporting a significant drop in Armenia, while the inflation environment continues to ease at a rapid pace. However, in view of high demand and inflation expectations, adjusting of price inflation on services and some goods is taking place more slowly (see Box 3).

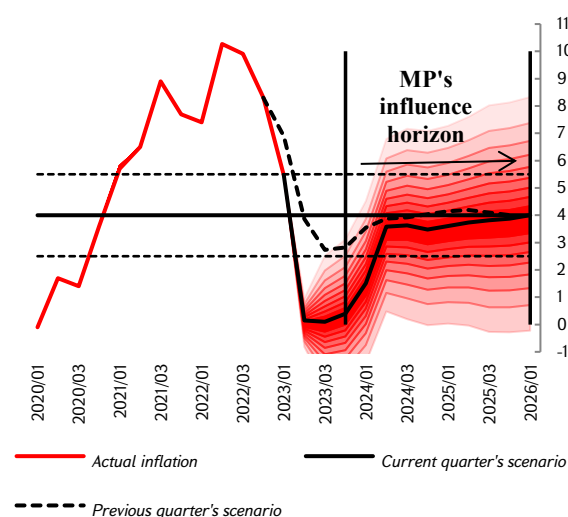
As things currently stand, the Board of the Central Bank of Armenia decided to reduce the policy rate by 0.25 percentage point to 10.5%.

Chart 15
Short-term inflation expectation estimates (%)



Source: Central Bank of Armenia

Chart 16
Inflation (12-month) scenario probability distribution for a 3-year policy horizon



Source: Armenia Statistics Committee, Central Bank of Armenia scenario

In the current situation, the Board of the Central Bank of Armenia decided to reduce the policy rate by 0.25 percentage point.

The monetary stance, it should be noted, remains contractionary, which safeguards the required consistency in an endeavor to handle demand and stabilize inflation expectations. As outlined in the monetary policy scenario, the 12-month inflation will remain below the target in the near future, reaching 0.4% at the end of 2023, then it will gradually increase and stabilize around the 4% target in the medium run. At the same time, the risks to inflation deviating from the projection path are primarily balanced.

The 12-month inflation will persist below the target value in the near future, making up 0.4% at the end of 2023.

Table 1

	Inflation interval forecast probability distribution				
	<1.0%	1.0-2.5%	2.5-5.5%	5.5-7.0%	>7.0%
Q1, 2023	93.8%	6.2%	0.0%	0.0%	0.0%
Q2, 2023	72.6%	22.3%	5.2%	0.0%	0.0%
Q3, 2023	63.5%	26.1%	10.2%	0.1%	0.0%
Q4, 2023	38.0%	32.1%	28.5%	1.4%	0.2%
Q1, 2024	8.5%	19.5%	55.6%	12.5%	4.1%
Q2, 2024	10.3%	18.7%	51.5%	13.6%	6.0%
Q3, 2024	12.0%	19.8%	50.1%	12.6%	5.5%
Q4, 2024	11.4%	18.8%	49.8%	13.5%	6.5%
Q1, 2025	11.5%	17.7%	48.0%	14.6%	8.3%
Q2, 2025	12.7%	16.7%	44.7%	15.1%	10.8%
Q3, 2025	12.6%	16.4%	44.2%	15.3%	11.5%
Q4, 2025	12.0%	15.6%	43.6%	15.9%	12.9%

2.2.2 Economic activity ¹⁰

The economic growth estimate for Armenia has been revised upside compared to the previous scenario of the Central Bank of Armenia.

The economic growth in 2023 will be 6.9% compared to the previous estimate of 5.9%; it will continue to be greatly supported by strong growth currently observable and anticipated in the services and construction sectors.

As for the services sector, high growth is expected in 2023, driven by some growth in output and capacity in the sector (especially the IT branch) and, in particular, the sustained high external demand in the first half of the year, which largely reflects high growth in the accommodation, public catering and

The economic growth estimate has been revised upside relative to the previous Central Bank scenario; In 2023, the economic growth will be 6.9% against the previous estimate of 5.9%.

¹⁰ For a detailed numerical description of the economic growth scenario, see Chart 17, Table 2.

transport branches, and ongoing positive developments in the trade sector.

The growth in the construction sector will be largely determined by further maintaining activity in the construction of residential buildings carried out by firms engaged in the real estate sector, on the one hand, and expanding construction works designed for the operation of the Amulsar mine starting from the second half of 2023.

The contribution of other branches of the economy to the growth will be minor. Specifically, no substantial positive developments are expected in the agriculture sector in comparison with the previous program: the growth will remain low as a result of reduced acreage and further decreasing output in animal breeding. In the meantime, the growth of industry will be positively shored up by the manufacturing industry through minor capacity increases in the wake of sustained external demand.

Over the policy horizon, the GDP and export potential levels are also estimated to be slightly higher, mostly attributable to continued increases of capacities in the IT services and manufacturing sectors. The inflow of capital and labor (mainly from Russia) comprised the main contribution to the said sectors.

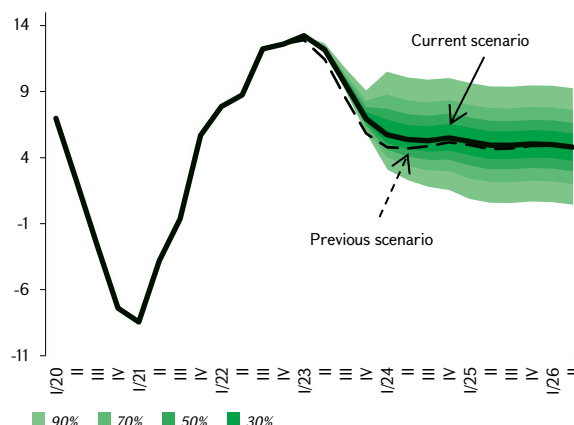
Table 2

Real GDP growth (cumulative) forecast probability distribution		
Period	30% probability distribution	90% probability distribution
January - December 2023 / January - December 2022	6.7 - 7.4	5.7 - 9.1
January - December 2024 / January - December 2023	4.6 - 6.6	1.5 - 10.0
January - December 2025 / January - December 2024	4.0 - 6.1	0.6 - 9.5
January - June 2026 / January - June 2025	3.8 - 5.8	0.4 - 9.2

Domestic demand: Higher economic activity estimated for 2023 will primarily be attributable to bigger growth in private spending. In particular, given the accumulation of savings, mainly in private enterprises, as well as the actual volume of

Chart 17

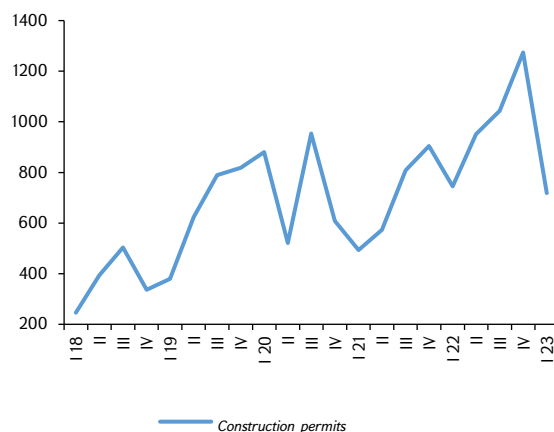
Real GDP growth (cumulative)¹¹ scenario probability distribution for a 3-year policy horizon



Source: Armenia Statistics Committee, Central Bank of Armenia scenario

Chart 18

Construction permits



Source: Armenia Statistics Committee, Central Bank of Armenia

¹¹ Each quarter's growth rate is calculated as the cumulative growth rate of the last four quarters.

current construction, the growth of private investment is expected to accelerate this year.

Although high growth rate of private investment will somewhat weaken in the medium term, it will still persist at an elevated level, contributing to the increase in GDP and export potential. The domestic private consumption growth will continue to remain low relative to economic growth, although its growth rate will accelerate to a certain extent.

External demand: In the course of 2022, the current account deficit reported a considerable decline relative to the previous year, reaching 0.9%. Positive impact spillovers to the Armenian economy from the external sector were recorded during 2022, pointing to the increase in the actual and potential level of export of goods and, particularly, large volumes of export of tourism. At the same time, with economic activity persisting strong, the growth in import of goods and services has been high too, albeit lagging behind the export growth. In 2022, as a result, the impact of external demand on GDP has been positive.

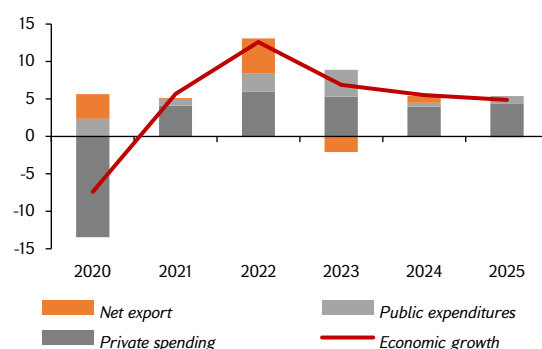
In the course of 2023, the current account deficit-to-GDP ratio will increase against the previous year to amount to 1.7%. In 2023 the growth of export and import of goods and services will somewhat stabilize after a reported high growth in the previous year. Armenia's export opportunities to Russia continue to widen in the light of a certain increase in export potential. In the export of services point of view, the expectation is that high influx of international visitors will carry on. In the meantime, the growth of export of IT services will further be strong although it will somehow be slowing down in the second half this year. As a result, the estimation is that the 2023 growth of real export of goods and services will be high compared to the indicator of the previous scenario, reaching 18.7%. In 2023 the growth of real import of goods and services will also be as high as 22.1% amid a certain domestic demand and investment activity on the back of high income generated during the previous year.

In 2023, the remittances¹² of individuals from both the Russian Federation and the United States will reduce from their highs, partly also incurring the effects of a slowdown in economic activity in partner countries.

In the medium run, gradual adjustment of strong external demand will be reflected in the increase in the current

Chart 19

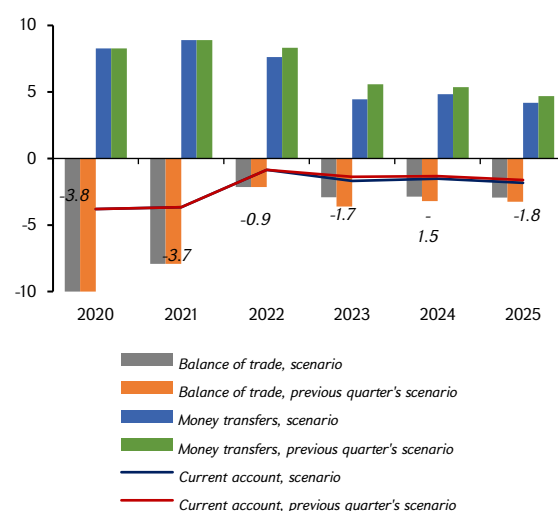
Demand components contributing to the growth (percentage point)



Source: Armenia Statistics Committee, Central Bank of Armenia scenario

Chart 20

Current account/GDP ratio medium-term scenario (%)



Source: Armenia Statistics Committee, Central Bank of Armenia scenario

¹² The official statistics of the 2022 Balance of Payments embraced revisions in order to reflect the incomes the relocants received in the Republic of Armenia, in which case the net income of seasonal workers is revised downward.

account deficit-to-GDP ratio, but it will still be below the estimated equilibrium of 4.0-6.0%. The latter will be determined by positive effects of the export of precious metals starting from 2024 after the Amulsar mine operates.

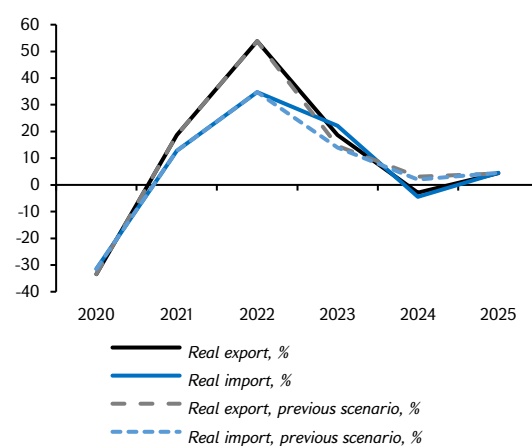
Estimations suggest that in the near future the positive GDP gap will close and economic growth will slow down due to gradual weakening of external demand. However, the mid-term economic growth will be higher relative to the last quarter's estimate, also reflecting the potential GDP growth thanks to more positive developments in the labor market and productivity growth. As a result, at the end of the policy horizon the economic growth will still hover around 5%, pointing to the positive effects of the Amulsar gold mine operation in the medium term, before declining to near a sustainable 4.5% level.

Fiscal policy:¹³ With an estimated high economic growth for 2023, the impact of fiscal policy on aggregate demand is assessed as contractionary. Over the first 5 months of this year, the state budget reported overperformed revenue collection and underperformed expenditures against the 2023 adjusted budget plan. This generated a much smaller deficit of the state budget than projected. However, it should be noted that the overperformed revenue collection is largely attributable to higher-than-expected income tax, which is a result of strong economic growth of the previous year. As to the other taxes, there are small underperformed collections, except for the profit tax, against the plan. Therefore, while growth rates of economic activity, observable since the start of 2023, remain strong and even higher economic growth is anticipated throughout 2023, the tax collection is estimated to be in line with the plan.

Public capital investment is expected to increase significantly this year, leaving a notable impact on economic growth. Though the growth of public investment will remain high in the years to follow, its contribution to the economic growth will yet be much smaller.

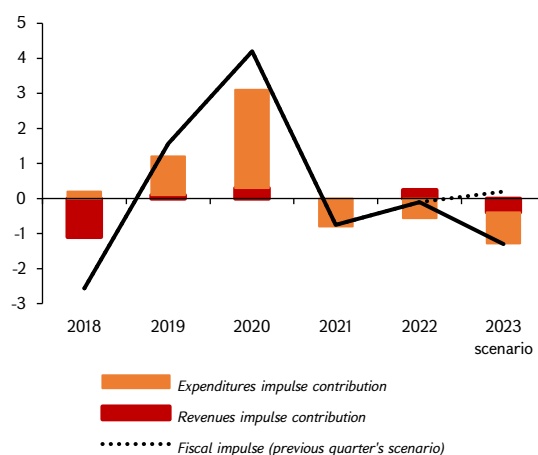
Thus, according to the Central Bank of Armenia's current estimate, in 2023 the tax-to-GDP ratio¹⁴ will amount to 23.7%,

Chart 21
Change in real export and import of goods and services in the medium term (%)



Source: Armenia Statistics Committee, Central Bank of Armenia scenario

Chart 22
Fiscal impulse scenario (percentage point)



Source: Central Bank of Armenia scenario

¹³ The fiscal policy's impact on the 2023 aggregate demand was estimated taking into account the RA Law on the Budget 2023, the "Mid-Term Expenditures Framework, 2024-2026" estimates, the current program (quarterly and annual program as adjusted by respective Government decrees available at the time), current developments and the Central Bank estimations based thereon.

¹⁴ The GDP indicators used in the program are the Central Bank of Armenia estimations.

indicating a slightly slower increase in tax collection relative to the GDP growth.

The state budget expenditures in January-May 2023 were underperformed relative to the projection mainly due to capital expenditures. The pace of spending in recent months has somewhat slowed down, having resulted in an estimated 98% performance of the expenditures plan, or about AMD 57 billion less spending. According to the current Central Bank of Armenia estimate, in 2023 public expenditures will amount to nearly AMD 2.5 trillion and the expenditure-to-GDP ratio, 26.6%, reducing by 1.1 percentage points against the previous estimate.

In the outcome, in 2023 the deficit-to-GDP ratio will be 1.3%, decreasing by 1.0 percentage point relative to 2022.

Thus, with state budget expenditures and revenues adjusted from the flows that have no impact on aggregate demand, the fiscal policy is estimated to have about a 1.3-percentage point more contractionary effect in 2023 relative to 2022. This will be attributable to contractionary impulses of both expenditures and revenues.

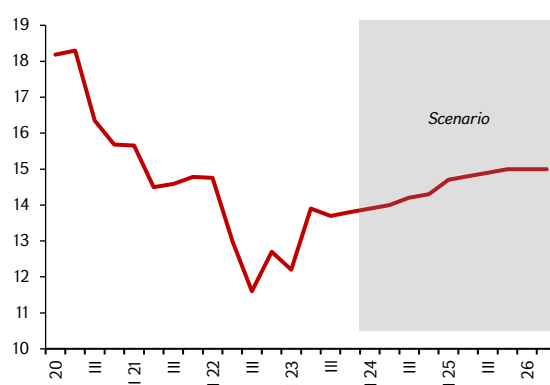
Basing upon the MTEF 2024-2026, the impact of the fiscal policy in the medium term is estimated to be neutral and will depend on a large volume of capital expenditures planned for that period of time and a certain slowing in the GDP growth rate. A gradual reduction of the budget deficit and debt burden is also anticipated thanks to the increase in tax revenues and improvement in the expenditure structure.

Labor market: The unemployment rate in 2023 is expected to reach 13.4%, which is slightly below its long-term sustainable level. This is explained by the employment rate increased amid high demand in the short-term perspective. In the medium term, as a result of some demand and potential growth adjustment, the unemployment rate will stabilize around its estimated fundamental level of about 15%.

In 2023, the private wage growth is still expected to be rather high, around 18.0%, driven by both high demand in the labor market and grown productivity. Note, however, that the growth of private wages has been slowing and turning steadier recently amid weakening inflation and inflation expectations. In the medium term, in view of sustained demand and inflation, the private wage growth is expected to stabilize around the fundamental estimate of 7-8%.

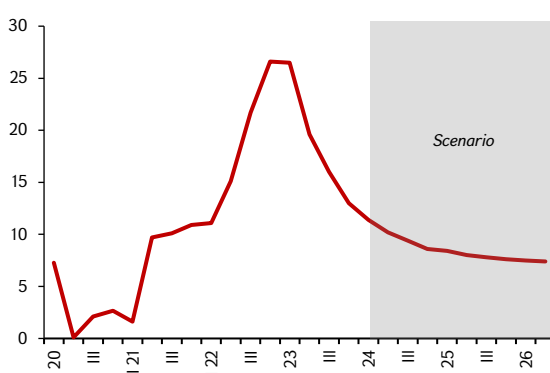
In 2023, relative to 2022, the fiscal policy is estimated to have about a 1.3-percentage point more contractionary effect.

Chart 23
Unemployment rate (%)



Source: Armenia Statistics Committee,
Central Bank of Armenia scenario

Chart 24
Private nominal wage growth y/y (%)



Source: Armenia Statistics Committee,
Central Bank of Armenia scenario

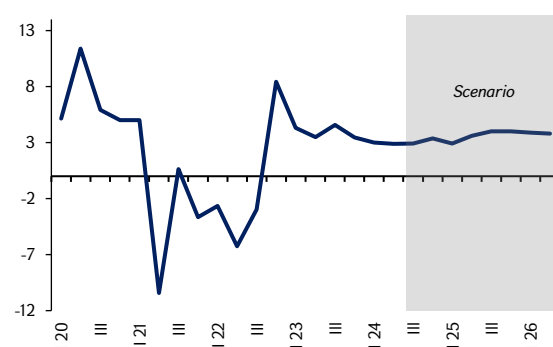
So, in 2023 the inflationary pressures from the labor market will ease to some extent owing to the productivity growth together with even faster private wage growth. In the mid-term perspective, unit labor costs will stabilize around 4%.

2.2.3. Main judgements and risks

This section contains the main judgements and scenario risks underlying the Monetary Policy Program for the second quarter of 2023.

Chart 25

Unit labor costs growth y/y (%)



Source: Armenia Statistics Committee,
Central Bank of Armenia scenario

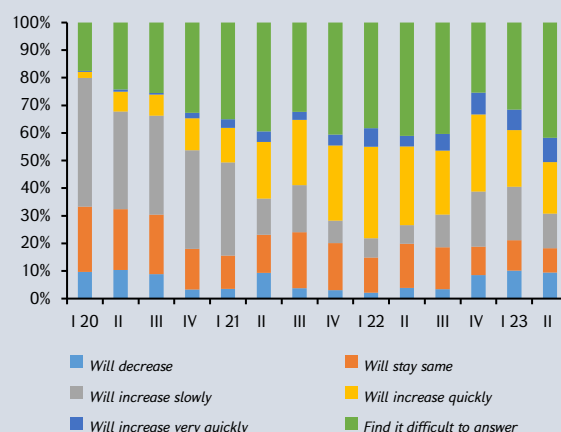
Box 2: The results of survey on the expectations by the households and the financial system

The results of the survey the Central Bank of Armenia conducted among households in connection with their expectations for a bunch of macroeconomic indicators in the second quarter of 2023 show that the uncertainty about inflation has increased. In particular, the share of households expecting high inflation and the share of those expecting low inflation in a one-year horizon has decreased in the structure of respondents.

Interestingly, although the inflation expectations of households have been somehow decreasing recently, these still remain relatively high.

Chart 26

Surveys on households' inflation expectations



Source: Central Bank of Armenia

Table 3 Judgments of the scenario presented

Basic judgments and assumptions	Possible developments, if the assumption mentioned proves correct
The sanctions against Russia will carry on over the entire policy horizon.	✓ The sanctions against Russia will carry on over the entire policy horizon.
The bankruptcies of some banks in the US financial sector recently will not be systemic in	✓ The bankruptcies of some banks in the US financial sector recently will not be systemic in

nature, including as a result of adequate policy measures. Terms of lending tightened by the US banking system will have some negative impact on the real sector in the medium term. The fiscal policy in Russia will be deficit-driven; the recovery of private demand will be faster. As approved by OPEC+ member countries, the agreement to reduce oil production by an extra 1.6 mln/b per day from April of 2023 will be effectively adhered to up until end-2024. As global demand continues to slow and supply chains go full recovery in a time when economic policies tighten up, the real commodity and food product prices will further be adjusted downside, shaping around the fundamentals-driven levels in the medium run.	nature, including as a result of adequate policy measures. ✓ Terms of lending tightened by the US banking system will have some negative impact on the real sector in the medium term. ✓ The fiscal policy in Russia will be deficit-driven; the recovery of private demand will be faster. ✓ As approved by OPEC+ member countries, the agreement to reduce oil production by an extra 1.6 mln/b per day from April of 2023 will be effectively adhered to up until end-2024. ✓ As global demand continues to slow and supply chains go full recovery in a time when economic policies tighten up, the real commodity and food product prices will further be adjusted downside, shaping around the fundamentals-driven levels in the medium run.
The fiscal policy is expected to be contractionary in terms of both expenditures and revenues in 2023.	✓ In 2023, the fiscal policy is estimated to have about 1.3 percentage point contractionary impact (in case that the annual tax revenues plan and as much as 98% of the adjusted expenditures plan are executed) primarily by maintaining the level of expenditures on the back of higher economic growth. In the medium term, according to the estimates in the Mid-Term Expenditures Framework 2024-2026, a minor stimulative effect of the fiscal policy is expected.
Armenia's export opportunities continue to expand given the potential growth in the manufacturing and IT sectors, as well as the persistently high external demand.	✓ Additional positive developments, including by way of some expanding of production capacity, will carry on in the manufacturing sector. ✓ Given a persisting influx of international visitors, positive trends in external demand will continue in the short term. ✓ High growth in Information and Communication sector will be maintained in the short term, which will have between a 1.8-2.0 percentage point positive impact on the GDP potential in 2023.

In the medium-term perspective, the mining sector is expected to make a certain positive contribution to the growth of the GDP potential.	✓ The operation of the Amulsar mine will contribute positively to the Armenia's potential growth between 2023-2025. Specifically, the contribution of Amulsar to accelerating the potential growth will be reflected in strong growth in the construction sector and higher investment activity (about 1.0 percentage point in GDP) in 2023, and in the expanded output and export potential (some additional 2.0 percentage point contribution to the GDP) in 2024 and, to a certain extent, in 2025.
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Scenario risks

Heightened geopolitical uncertainties in the region and much around the globe carry on, creating risks and challenges in terms of balancing the world economy, ensuring normal functionality and full recovery of the international commodity, food and financial markets, and supply chains.

In addition to risks from the outside world, there are also geopolitical risks associated with large-scale military aggression by Azerbaijan. These factors continue to be reflected in wider ranges of uncertainty around central value forecasts for inflation and other key macro indicators (see Charts 1 and 2). Accordingly, as things with high uncertainties stand, only quantitatively the most significant risks that are around the presented scenario are introduced below.

In the aggregate demand point of view, the risks are as follows:

- Labor markets in the US and the Eurozone are operating in an “overheated” environment. The unemployment is at historically low levels, and job creation continues to be strong, especially in the services sector. As these trends carry on, the growth of wages in certain branches may remain high, creating additional inflationary risks. In Russia, too, the labor market is further “warming up”, containing certain risks to accelerating inflation.

- The problems reported in the U.S. banking system may be systemic in nature and have a significant impact on slackening of the global demand.
- The fiscal policy in Russia may be more stimulative than expected, contributing to a more rapid recovery of demand in the economy and an expanding inflation environment.
- In view of the duration and volume of the expected inflow of international visitors, tourists and financial resources in the context of current geopolitical events in the region, the impact of the latter on the Armenian economy mainly creates risks to positive demand.
- In case the security situation in Armenia and/or the region deteriorates, there may be an outflow of foreign visitors and capital, which may have both inflationary (depreciation of the exchange rate) and deflationary (reduction of external demand) effects.
- The possible slowdown of seasonal migration from and remittances to the Republic of Armenia due to currently unfriendly economic environment in the Russian Federation and restrictions on the movement of capital, as well as thanks to improving working conditions in Armenia, creates risks in terms of slowing consumption, on the one hand, and increasing labor supply, on the other.
- In the fiscal policy point of view, the main risks are with regard to contributing to the containment of the inflation environment in the short run in case the capital expenditures, projected at remarkably high targets, are underperformed.
- In an environment of a sizeable positive demand, difficulties in attracting additional labor force and resources may arise, in which case there may be risks to non-linear effects on inflation.
- With inflation indicators staying notably above the target for a long period of time in Armenia, risks to deanchoring of long-term inflation expectations may linger.
- With a high amount of savings accumulated in the private sector, there may be primarily inflationary risks associated with accelerating consumption and investment in the short run.

In the supply point of view, the risks to inflation are as follows:

- The risks to commodity and food product price forecasts are attributable to the speed at which the demand slows in the global economy, the extent of further monetary policy tightening by the US Fed, the speed at which demand recovers in China, as well as to possible disruptions in supply chains and ensuring fundamental supply volumes in international markets in case of even more escalation of the Russian-Ukrainian conflict.
- With geopolitical tensions persisting, there are risks to deglobalization and primarily inflationary risks deriving from it.
- In view of a substantial improvement in the relative conditions of Armenia's labor market (average private sector wages in dollar terms), an inflow of migrant workers may be possible. As well as contributing to some growth of aggregate demand, this will have primarily a deflationary effect as a result of the surpassing growth of aggregate supply.
- In case weather maintains favorable conditions, there are risks to above-average harvest in agriculture, with respective deflationary effects.
- With continued tension on the borders of the Republic of Armenia, high geopolitical and regional uncertainties, there are inflationary risks associated with financial markets' overreaction and the increase in the country risk-premium of the Republic of Armenia.

In the medium-term perspective, the risks to the inflation deviating from the projection path are estimated as balanced and, on the whole, rather big quantitatively (see Chart 1).

In addition to the above-mentioned inflation risks, there are more mid-term risks to potential economic growth that are both dual-sided and balanced. In particular, the risks are related to the domestic and external factors, as follows:

- Uncertainties related to the operation of the Alaverdi copper smelter, which is an upside risk.
- Uncertainties related to the timing of the Amulsar mine operation, the nature and extent of investment, as well as output and export volumes following the operation of the mine, which is both an upside and downside risk.

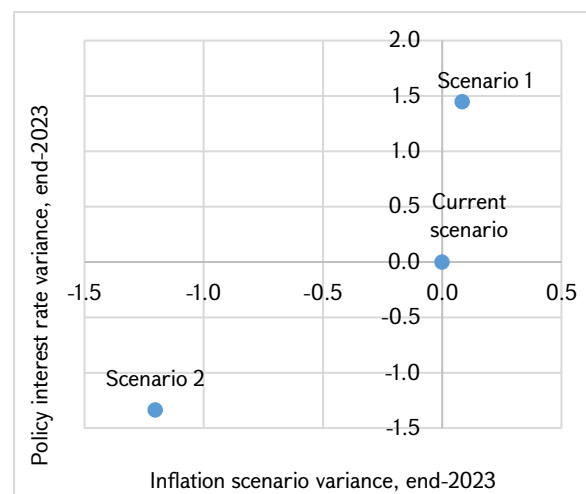
- Difficulties in the activity of companies operating with Russian capital in the Armenian economy, which is a negative risk in terms of the domestic economic growth.
- Both positive and negative risks related to the nature, size, and duration of capital financial flows to the Armenian economy, and to possible transformation of the economy.
- Risks related to the size and effectiveness of capital expenditures (including the economy's ability to absorb them) outlined in the medium-term budget expenditure plan.
- Negative risks related to border tensions and geopolitical and regional uncertainties.
- Mainly positive risks related to acceleration of investment as a result of savings accumulated in the private sector.
- The programs with the EUR 2.6 billion support package intended to be carried out within the framework of the EU Eastern Partnership, which is an upside risk (annual GDP growth of around 0.9-1.0%).

In general, there are major uncertainties about possible geopolitical developments, the speed of recovery of demand in Russia, rearrangements in international supply chains, as well as the continuity of international travel and capital and labor inflows to Armenia and directions of use of large amount of savings accumulated in the real sector of the domestic economy, so which is why the Central Bank of Armenia attempts to reduce the possible risks arising from such uncertainties by building and discussing various scenarios on how the situations would unfold. Specifically, driven by the peculiarities of the current phase, in the context of numerous risks to be possibly materializing, two typical scenarios of economic development assuming a relatively tight or weak monetary policy against the presented scenario were considered in depth, as follows:

- With high inflation environment and demand carrying over a long period of time, inflation expectations continue to remain elevated. Meanwhile, certain behavioral changes observable in product groups that stand out with “sticky” prices (increase in the share of goods posting a price-rise in the group of total services against the median value of a certain long period of time) will persist, helping inflation of services and some goods remain continuously high. Even with the headline inflation drifting below the target, this could lead to deanchored inflation expectations and diminished reputation of the Central Bank, which would

Chart 27

Possible economic development scenarios in the given situation



Source: Central Bank of Armenia scenario

make fulfilment of the inflation target more costly. As a result, the Central Bank will need to look to tighter policy conditions to ensure price stability (scenario 1).

- Although continuously falling prices of imported food products in international markets notably assist the inflation to decline fast, their quick adjustment may substantially contribute to a rapid decline in inflation expectations in the economy. Moreover, some estimates suggest that international deflationary patterns of prices of certain food products are not yet fully reflected in prices in the domestic market. In such a situation, the 12-month inflation will decrease much faster relative to the scenario presented in the current program, facilitating reduction of production costs in other sectors and to further weakening of short-term inflation expectations. In this case, the Central Bank of Armenia will fulfil the inflation target in the medium term by pursuing a softer policy in comparison with the scenario presented (scenario 2).

It is worth mentioning that the options of an appropriate policy response to the scenarios have been considered, which will allow to react upon first substantial signs that these risks are materializing.

3. Actual developments in Q4, 2022

3.1. Inflation

3.1.1. Fulfilment of the inflation target

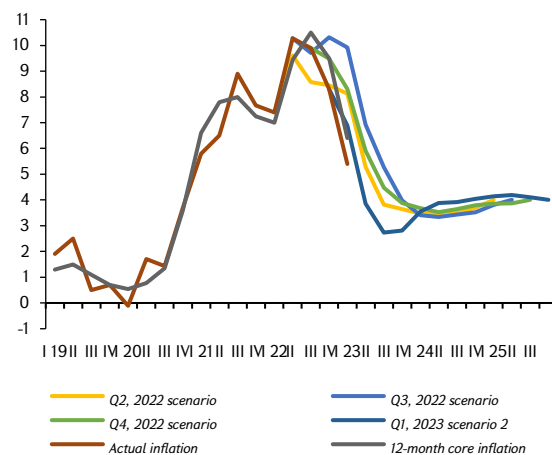
According to the main judgements of the scenario outlined in the monetary policy program for the second quarter of 2022, the inflation environment would have to remain high in the course of the upcoming one year driven by the inflationary effects transmitted from external markets following the escalation of the Russian-Ukrainian conflict, on the one hand, and the strong demand being created in the Armenian economy amid an estimated influx of international visitors and financial resources, on the other. Furthermore, the estimation was that the effects of global inflation patterns, which prevailed in the structure of inflation factors, and external demand would have to weaken during the year if the Armenian dram kept on appreciating, neutralizing the risks to inflation and inflation expectations. As a result, under tightening monetary policy and expected macroeconomic developments, the 12-month inflation would have to gradually decrease in the medium term and stabilize around the 4% target.

In the period under review, the 12-month inflation reduced at a faster-than-expected rate, which was mainly attributable to notable weakening of inflationary effects from the external sector and continued dram exchange rate appreciation. This has been concurrent with a gradual easing of tight monetary conditions by the Central Bank of Armenia. In that situation, in the last two quarters, the projected path of inflation for the short-term perspective has been adjusted downside.

As the actual developments show, following the escalated Russian-Ukrainian conflict and various sanctions imposed on the Russian economy, Armenia has since the second quarter of 2022 seen a large influx of international visitors and financial resources, which was expressed by a considerably accelerated rate of economic activity. Factors of external demand for domestic services have contributed to high economic growth. Positive developments have also been observable in the export sector, the IT and manufacturing industries in particular, pointing to trends in manufacture potential and export growth there. However, continuously growing demand has contributed to the expansion of the overall inflation environment and creation of high inflation expectations. In the period between the third quarter of 2022 and the first quarter of 2023, a certain weakening of the

Chart 28

In the period under review, the 12-month inflation has generally trended down, with the short-term estimate of the last two quarters revised downside



Source: Armenia Statistics Committee,
Central Bank of Armenia

inflationary influence from the external sector has been observable owing to the fall in energy and food prices as a result of the contractionary monetary policy pursued by central banks in the main partner countries of Armenia, as well as the gradual adjustment to supply chain disruptions. As a result, the overall inflation environment in Armenia has eased significantly, but the demand persisting strong further contributed to the growth of wages and prices of individual goods and services. High demand coming from international visitors and significant inflow of financial transfers from abroad in the period under review helped the Armenian dram appreciate notably in the domestic currency market, thus contributing to a certain mitigation of the impact of the aforementioned inflation factors.

Taking into account these developments, the Central Bank of Armenia withheld from the interest rate change in the second quarter of 2022 in expectation of a gradual easing of the inflationary effects as a result of appreciation of the Armenian dram on the back of growing external demand. In the third and fourth quarters, however, despite some weakening of the inflationary effects on the Armenian economy from the external environment, the Central Bank tightened monetary conditions and raised the policy rate each time by 0.75 percentage point in view of growing demand and high inflation expectations in the domestic economy amid continued high influx of international visitors and tourists, and of financial resources.

The first quarter of 2023 posted further deflationary patterns seen on imported food products, but the still high demand fueled price increases in product groups that stand out with “sticky” prices. In such a situation, the Central Bank of Armenia left the policy rate unchanged, keeping monetary conditions relatively tight.

There has been an increase in volatility observed in the Armenian financial market since the end of the first quarter of 2022, following the escalation of the Russian-Ukrainian conflict. Throughout the year the Central Bank of Armenia has been consistent in fulfilling its goal of handling sufficient liquidity in the financial market, which helped the market interest rates shape mainly around the operational goal, i.e. the policy interest rate. In the period under review, the dram had been appreciating as a result of a considerably increased supply of foreign currency and grown demand for the Armenian currency in the financial market. To neutralize short-term disruptions and problems observed in the currency market in the middle of large-scale inflows of foreign currency, the Central Bank of Armenia

arranged a situational intervention in the market, facilitating the normal functioning of the financial market.

To sum up, the 12-month inflation standing high at the beginning of the period under review, has then decreased rapidly to reach 5.4% at the end of March of 2023 thanks to the contractionary monetary policy implementation, the dram appreciation and significantly eased inflationary influence from the external sector. In the meantime, the 12-month core inflation has behaved similarly, amounting to 6.4%. It is estimated that by virtue of the impact of monetary policy implementation, the 12-month inflation rate will further reduce and stabilize around the 4% target in the medium term.

The 12-month inflation standing high at the beginning of the period under review, has then decreased rapidly to reach 5.4% at the end of March of 2023 thanks to the contractionary monetary policy implementation, the dram appreciation and significantly eased inflationary influence from the external sector.

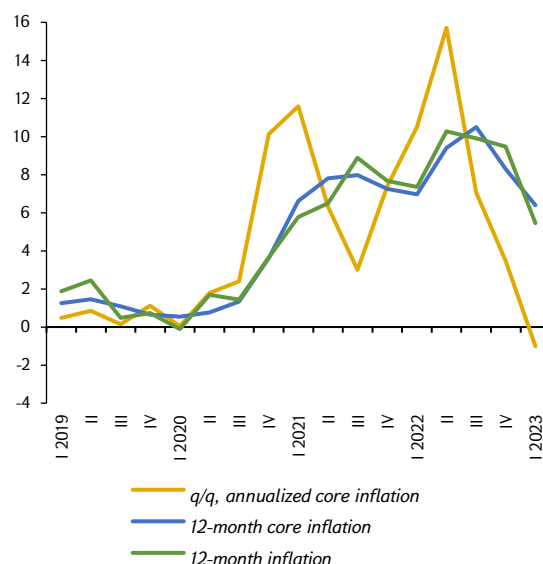
3.2.1. Prices

The inflation environment transmitted from the external sector and fueled by the growing demand in the domestic economy persisted high already in the second quarter of 2022 and demonstrated a trend of some easing since the end of the year only. The latter is expressed in the behavior of individual product groups in the consumer basket.

Thus, following the escalation of the Russian-Ukrainian conflict, a sharp increase in the prices of items “Bread and cereals”, “Meat”, “Dairy products”, “Oils and fats” has been observable in the domestic economy since the end of the first quarter of 2022 on account of the impacts transmitted from international food markets. Increased international energy prices had their spillover effect on the fuel price rise. At the same time, given the large influx of international visitors to the Republic of Armenia, high demand created in the Armenian economy has added to inflationary pressures also in terms of locally manufactured goods and especially services, in which circumstance a number of tariffs for services with “sticky” prices (apartment rent, restaurants and hotels, hairdressing, financial, postal services), on a gradually increasing track throughout the reporting period, have been adjusted. In the fourth quarter of 2022, in expectation of sluggish demand from the world economy and tightening financial conditions, a decrease in prices of some commodities (fuel, sunflower oil, grain, sugar) has been observable in international commodity markets, which was also reflected in the prices of goods imported to the Armenian economy. It should also be noted that the Armenian dram appreciated along with mounting external demand has notably curbed, starting from the third quarter of 2022, the price increases of imported goods. Even though all this was reflected

Chart 29

The inflation environment persisted high, only demonstrating a certain weakening trend since the end of the year



Source: Armenia Statistics Committee,
Central Bank of Armenia

in considerably decreased q/q core inflation trends, the high growth of prices of the key core inflation components – services and a large group of non-food products – continues to significantly contribute to the domestic inflation developments.

Meanwhile, the risen prices of items “Tobacco” and “Alcoholic beverage” out of the core inflation components has incurred, as was estimated, the inflationary impact of the change in excise tax rates early in 2022 and 2023, especially on the part of tobacco products. The creeping inflation in the local market of alcoholic beverages as a result of the relatively reduced export volumes has somewhat contained the inflationary patterns in the overall product group.

In addition to the above-mentioned factors, the inflation accelerated since the start of the period under review has been driven significantly by highly grown prices of seasonal food products. Reduced sown areas pushed vegetable prices up, particularly for certain products, while unfavorable weather conditions had their impact on fruit prices, especially in the second quarter. Starting from the third quarter of 2022, the impact of these factors on inflation has mitigated to some extent.

In the second quarter of 2022 the tariffs of regulated services kept on rising due to the increase in the tariffs of electricity since March, and those of natural gas since April. The secondary inflationary effects of these services were particularly evident in the second half of 2022, and signs of easing were observable only by the end of the period under review.

Table 4: Consumer price inflation by commodity items as key contributors

Commodity item	Weight	12-month inflation: March 2023	Contribution to inflation y/y
Core inflation	73.9	6.4	4.7
Bread and cereals	8.5	6	0.5
Meat	10.6	7.5	0.8
Oils and fats	2.9	-6	-0.2
Sugar	0.5	-10.9	-0.1
Dairy products	4.4	12	0.5
Alcoholic beverage	2.5	7.8	0.2
Tobacco	2	8.8	0.2
Clothing	2.2	6.7	0.2
Footwear	1.2	8.9	0.1
Household appliances	0.6	5.9	0
Fuel	5.4	-2.6	-0.1

Air passenger transportation services	1.1	47.5	0.5
Outpatient care services	2.6	6.6	0.2
Actual rent paid by the tenant for additional accommodation	1.1	33.1	0.4
Restaurants and hotels	1.9	9	0.2
Fees for services of banks, post offices	0.8	21.4	0.2
Imported food products	15.3	3.6	0.6
Seasonal food products	11	1.7	0.2
Eggs	1.6	-1.1	0
Fruits	4.1	8.7	0.4
Vegetables	5.3	-0.7	0
Regulated services	15.1	2	0.3

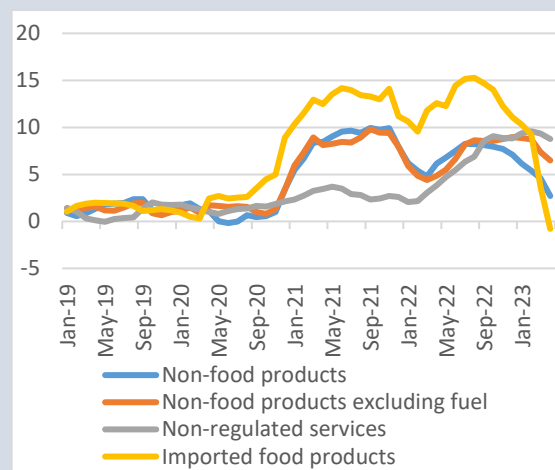
Box 3: Inflation in product groups with «sticky» prices in Armenia

As the inflationary influences from the outside world are weakening, the dram keeps on appreciating and the monetary policy carried out remains contractionary, somehow faster decline in both the 12-month and quarterly inflation rate is observable especially in recent months. It is noteworthy that the core inflation rates, as calculated by the Central Bank of Armenia, have been slowing as well (see Chart 30).

However, when trying to study the developments of individual major elements of inflation, one may notice that the differences observable in the behavior of the said elements of inflation have now become even more divided (see Charts 30 and 31). Specifically, the decline in both headline and core inflation is largely due to lower prices of imported and seasonal food products, which basically reflects the weakening inflationary environment in the global economy and the impact of the strengthening dram.

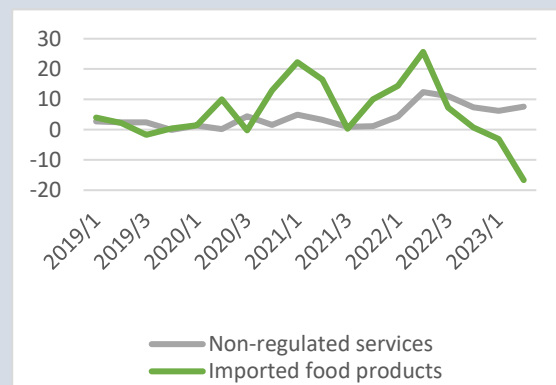
On the other hand, the prices of unregulated services (medical: 12.8% y/y, restaurant and hotel: 7.8% y/y, hairdressing, financial, banking and postal: 22% y/y, legal: 15.9% y/y and other services) remain elevated, both quarterly and annually, mainly driven by persistently strong external demand. The high activity as observable and anticipated in the construction sector further helps the price inflation of non-regulated services and some goods (construction services, furniture, etc.) linger at high levels (see Chart 32).

Chart 30
Dynamics of individual elements of inflation against the respective month of the previous year, %



Source: Armenia Statistics Committee,
Central Bank of Armenia

Chart 31
Dynamics of individual elements of inflation, q/q annualized percentage growth



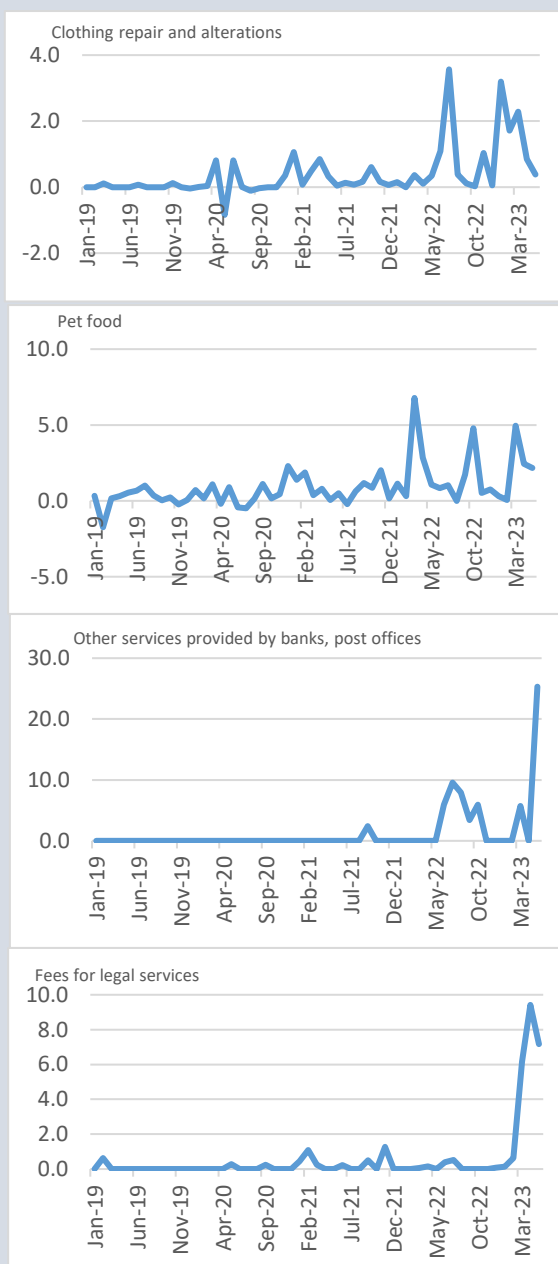
Source: Armenia Statistics Committee,
Central Bank of Armenia

¹⁵ The second quarter of 2023 indicator is an estimate based on actual developments in April-May.

The above product groups, which with some reservations can be characterized as standing out with their “sticky” prices, deserve the monetary policy’s special attention in Armenia, because they best reflect the conditions of demand and inflation expectations in the economy. In this case, despite the fact that since 2023 the share of these product groups in the consumer basket has decreased (so has their impact on overall inflation, accordingly), the importance of these groups remains intact in the monetary policy point of view, since it appears to denote the extent to which inflation is anchored in the economy.

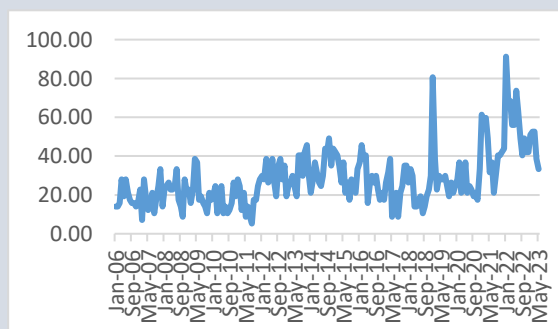
In the course of 2022, it should be mentioned, with external demand persisting high and inflation expectations shaped above targets, an increase in the share of items/goods having pushed the prices up relative to the previous month has been observable in the services group; although that share has somewhat decreased recently, it continues to stand high (see Chart 33).

Chart 32
Percentage change in tariffs of some services with relatively sticky prices against the previous month



Source: Armenia Statistics Committee

Chart 33
The share of those products in the services group, which have pushed prices up against the previous



Source: Armenia Statistics Committee

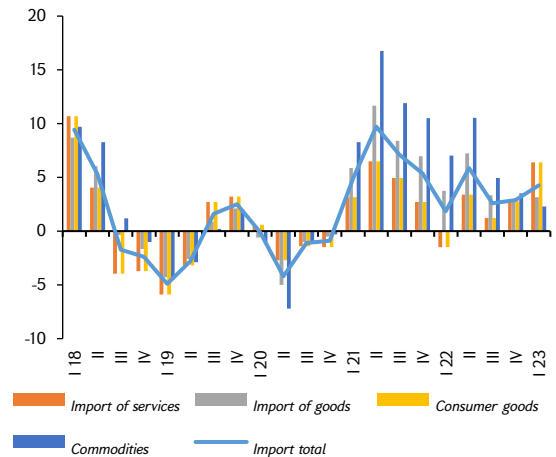
Import prices

While the prices of food products further trended down in the global economy during the first quarter of 2023, this has not yet been reflected in the price dynamics in the main partner countries. As a result, the dollar prices of imports to Armenia have risen. The rise was mainly determined by relatively high prices of final consumption goods, in comparison with just a small increase in those of intermediate consumption goods. Thus, over the first quarter, relative to the previous quarter, the dollar prices of imports to Armenia have grown by 2.3%, in which case the growth was 4.2% y/y compared to the same reference period last year.

Relative to the same reference period last year, the prices of final consumption goods have grown largely thanks to an increase in dollar prices in Russia, Turkey, and the EU countries. In the meanwhile, relative to the previous year, the oil and wheat prices have settled at low levels. The contribution of dollar prices of final consumption goods has been 1.2 percentage points, and the contribution of dollar prices of import of services, 2.1 percentage points positive.

Chart 34

In the first quarter of 2023 the increase in dollar prices of import of goods and services speeded up to a certain extent against the same quarter of the previous year, y/y, %



Source: Central Bank of Armenia

3.2. Economic developments

3.2.1. Economy position

In the period under review, the GDP gap remained high, in a positive territory. In the first quarter of 2023, the economic growth amounted to 12.1% (see section 3.2.3), standing above the estimate of the previous MP program of the Central Bank of Armenia, which is largely due to the increase in potential GDP growth (mainly IT sector). The strong growth of the services sector, fueled by external demand, also kept on contributing to the economic growth. However, the GDP gap has not incurred sizable revision against the previous estimate.

In the period under review, the GDP gap remained high, in a positive territory.

3.2.2. Expenditures aspect of the economy

In terms of demand, primarily private spending and net exports have contributed positively to the economic growth.

In the quarter under review, the growth of private spending was 6.6%, which is in line with the previous estimate of the Central Bank of Armenia. At the same time, bolstered by rather a strong economic growth (see section 3.2.3), remittances, as well as real wages (see section 3.2.2), the private

sector disposable income has increased significantly, pointing to an elevated level of savings. As observed by the Central Bank of Armenia, the increase in savings has been surpassing with businesses which are still prone to rescheduling their investment amid uncertainties about the main drivers to current economic growth (international visitors and financial inflows). Although the volumes of housing construction funded by organizations remain large, the private investment stands relatively at a low level.

In the first quarter of 2023, the external demand developments remained positive, pointing to the high level of real growth of export of goods and services, slightly exceeding the expectations. The real growth of export of goods and services has been close to the expectations. High revenues generated in the domestic economy are not yet reflecting the anticipated increase in the import of tourism. In the meanwhile, with sustained high influx of international visitors, the developments in export of tourism have exceeded the expectations. As a result, in the first quarter of 2023 the growth of real export of goods and services was 72.4% y/y, and the growth of real import of goods and services, 49.1% y/y.

To sum up, it should be noted that the contribution of net real exports to GDP in the course of the first quarter has been unexpectedly more positive.

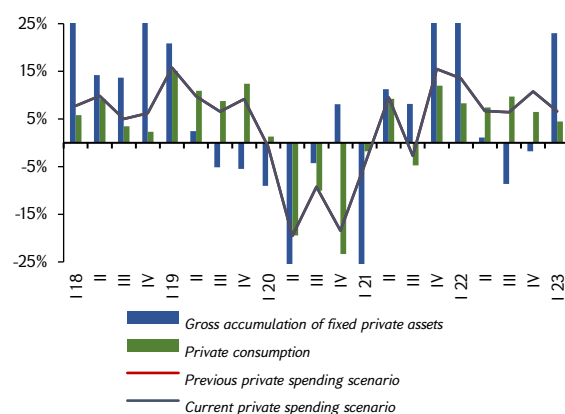
In the first quarter of 2023, the growth of net remittances of individuals (the seasonal worker income and personal transfers inclusive) in dollar terms was 12.3% y/y, according to estimates. This was determined by high growth in nominal dollar incomes generated in the non-tradable sector of the Russian economy.

Fiscal policy¹⁶

In the first quarter of 2023, both revenues and expenditures of the state budget were overperformed against the budget, thus posting deviation from the Central Bank of Armenia estimates. As a result, the fiscal policy's impact on aggregate demand is estimated 0.8 percentage point contractionary.

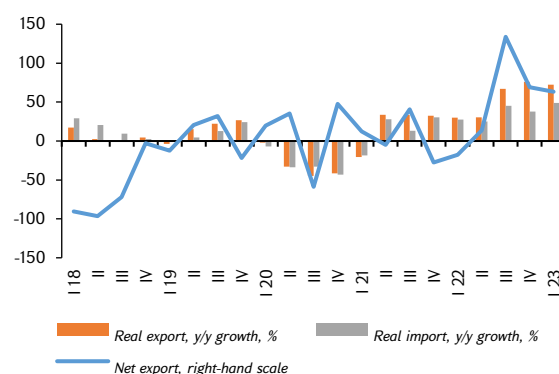
In the first quarter of 2023, the state budget revenues amounted to 98.3% of the adjusted plan, primarily due to lower

Chart 35
The structure of private spending, y/y growth



Source: Armenia Statistics Committee,
Central Bank of Armenia estimate

Chart 36
In the first quarter of 2023 net export position further improved (net real export, y/y %, positive sign means improvement)



Source: Armenia Statistics Committee

The impact of fiscal policy on aggregate demand is estimated 0.8 percentage point contractionary.

¹⁶ The review of the fiscal sector was done using the actual consolidated budget indicators of the first quarter.

tax revenue collection. Other revenues were also overperformed against the plan by about 91.5%. Tax revenues of the Republic of Armenia state budget have fallen short of the projected figure in the light of unexpectedly higher growth reported in the relatively hard-to-tax sectors of the economy. As a result, the revenues impulse has been 0.1 percentage point expansionary.

In the first quarter of 2023, the state budget expenditures amounted to 94.1% of the Central Bank of Armenia estimate. As a result, the expenditures impulse came in more contractionary compared to the previous quarter, making up 1.0 percentage point instead of the previously estimated 0.3 percentage point. In the state budget's expenditures structure, both the expenditures on non-financial assets and current expenditures were underperformed against the Central Bank of Armenia projections.

In the outcome, with the revenues and expenditures dynamics mentioned above, the Republic of Armenia state budget generated an AMD 60.9 billion-worth surplus (budget funds intended as part of domestic sources of financing outgrew the needs) in the first quarter. In the meantime, the surplus of the consolidated budget has amounted to about AMD 75.0 billion.

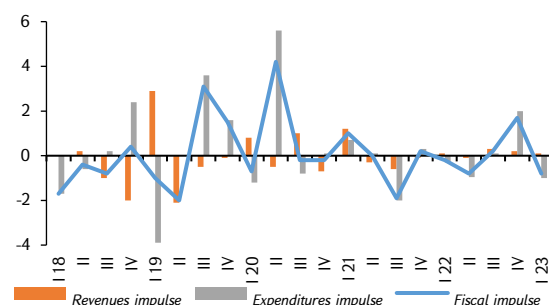
3.2.3. Production aspect of the economy

In the first quarter of 2023, the economic growth was 12.1%, which is above the previous Central Bank of Armenia projections. The services and construction sectors were the main contributors to high economic growth, posting increases by 15.9% (owing to continued positive developments in the IT sector, and sustained high external demand) and by 15.2%, respectively. Construction activity in various sectors of the economy continues, but residential housing funded by the organizations remains the main driver to the construction industry.

The growth in the industry and agriculture sectors has not been prominent. The industry reported a 3.9% growth on account of some increase in manufacturing, while decreases in the mining sector continued during the period under review.

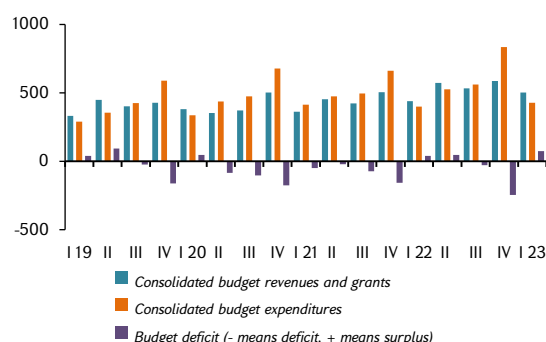
The agriculture sector posted a 0.6% growth, commensurate with the Central Bank of Armenia projections. Sluggish developments in the sector are primarily attributable to a certain decline in animal breeding.

Chart 37
In the first quarter of 2023 the fiscal policy's impact was contractionary relative to the previous quarter



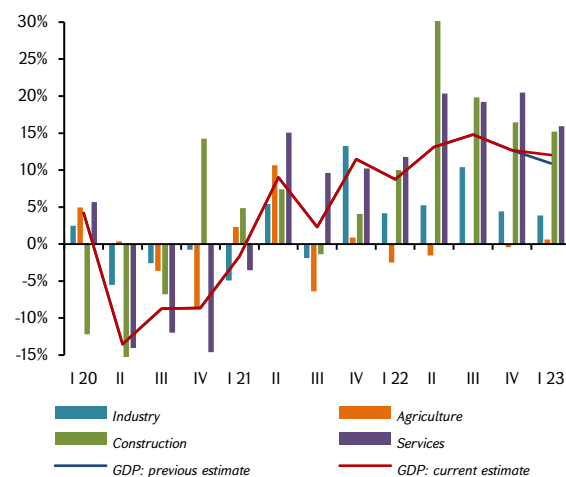
Source: Central Bank of Armenia estimate

Chart 38
In the first quarter of 2023 the state budget generated a surplus (billion of Armenian dram)



Source: Armenia Statistics Committee

Chart 39
The GDP structure by sector, y/y growth, %



Source: Armenia Statistics Committee,

Box 4: Assessment of long-term potential growth of the Armenian economy

Starting from 2020, certain negative factors came in the way of the long-term sustainable potential growth of the Armenian economy, as the Covid-19 pandemic broke out and military offensive began in Artsakh. Thus, households and firms had shortened their planning horizon out of a largely risen uncertainty, as well as certain negative developments seen on the part of the labor force (decrease in the working-age population due to the war, and migration, among others). However, especially in the time following the Russian-Ukraine conflict, the picture has changed quite a bit as certain positive structural shifts are observable in the economy (particularly in terms of labor force and productivity), which are leaving their impact on the long-term potential growth rate.

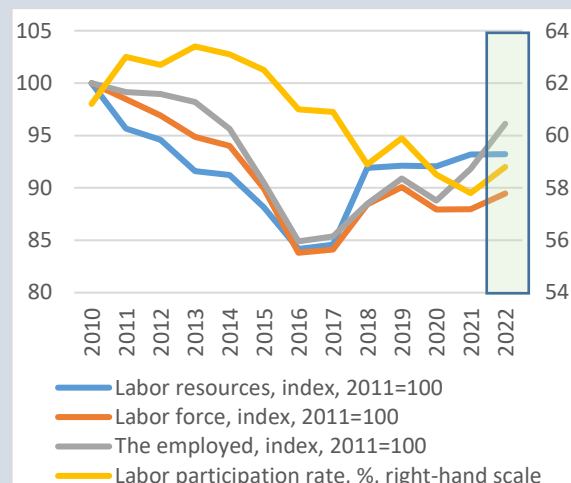
The fundamental factors that determine the long-term trends of potential GDP growth refer to labor force, capital and productivity developments, on the part of which certain changes have been observed in recent years.

Recently, there have been positive changes in the labor market, reflecting trends in increasing of the labor resources and the number of the employed, and growing participation in the labor force (see Chart 40). As high rates of new job openings carry on, there has been a decrease in vacancies. As well as pointing to a better search-matching process and an improved flexibility in the labor market, this helps the natural rate of unemployment subdue to a certain extent (see Chart 41). In addition, the negative balance of the Republic of Armenia border crossings has somewhat reduced (see Chart 42), denoting both a long-term influx of labor resources (both foreigners and Armenia citizens) to Armenia, and a considerable slowing in the rate of migration of Armenia citizens in recent years.

In recent times, the information and communication industry watch their output and export capacity notably increasing, which is largely driven by the inflow of highly qualified labor resources and capital from Russia. As more and more firms have been opening in

Chart 40

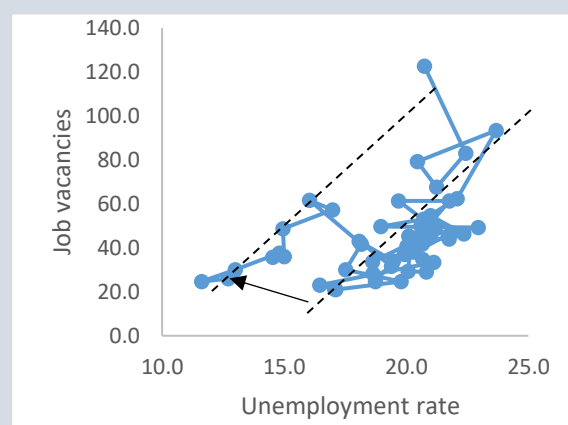
Dynamics of some variables that are specific to Armenia's labor market



Source: Armenia Statistics Committee

Chart 41

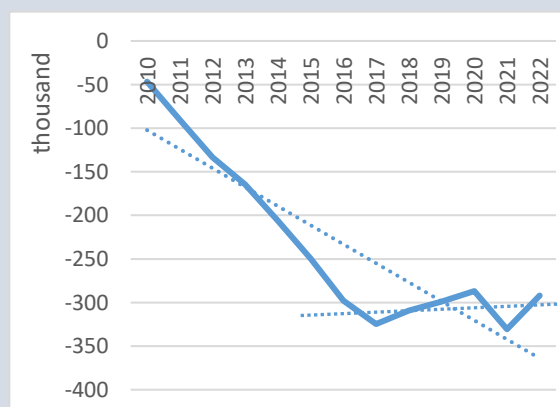
The Beveridge Curve of Armenia's labor market, by workload per job vacancy



Source: Armenia Statistics Committee, Central Bank of Armenia estimate

Chart 42

Balance of the Republic of Armenia border crossings,



Source: Armenia Statistics Committee

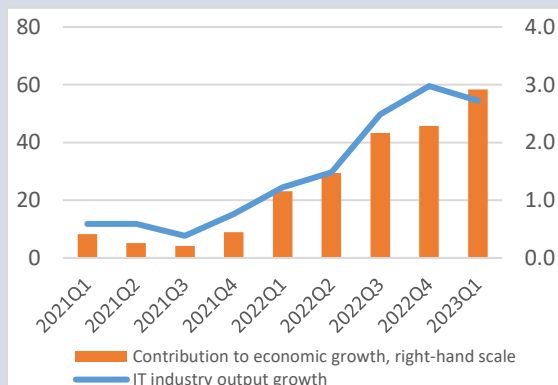
the sector over the last one-year period, the share of the IT sector in GDP has approximately doubled and will make up between 6-7% in 2023, according to the current Central Bank of Armenia estimates. This allows assuming that the growth of the sector's output in the long-term perspective (the IT sector grows on average obviously faster than the overall economy) will contribute much more than before (see Chart 43). Furthermore, the increasing of non-resident workers in the IT sector, with far above average wages and relatively more productivity they demonstrate, will lead to higher competition in the sector (see Chart 44). It is estimated that the productivity and wages of non-resident workers and resident workers in Armenia's IT sector would gradually converge at higher levels in the long run, which also implies that the overall productivity would grow higher in domestic IT sector.

A certain increase in both public and private investment is expected in the short and medium term. Note that, as per the Armenian Government objectives, public investment will grow to around 6% of the GDP in the mid-term perspective. This, as was previously estimated, depending on the effectiveness of implementation of the programs, may bring about 0.3-0.4 percentage point* contribution to the medium-term potential growth. The growth of private investment will be bolstered also by further investments aimed at the Amulsar gold mine operation and once part of the accumulated savings in the private sector is channeled to investment projects financing. It is noteworthy, however, that a particularly higher growth in private investment is not anticipated in the long term, according to current estimates. This primarily explains the fact that the share of private investment in GDP continues to be steady in the range of 13-15%, and construction in the core production capital remains relatively subdued, while strong growth in the construction sector is mainly driven by even a faster growth in housing construction (see Charts 45 and 46).

* Inflation Report for the fourth quarter of 2021, Box 2: "The 2022 impact of public capital investments on the economic growth and GDP potential": https://www.cba.am/Storage/AM/downloads/parberakan/DVQ/Monetary%20overview_IV_2021.pdf.

Chart 43

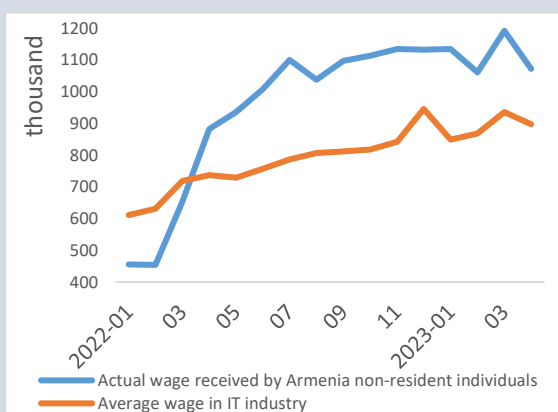
The information and communication industry's output growth and contribution to economic growth



Source: Armenia Statistics Committee

Chart 44

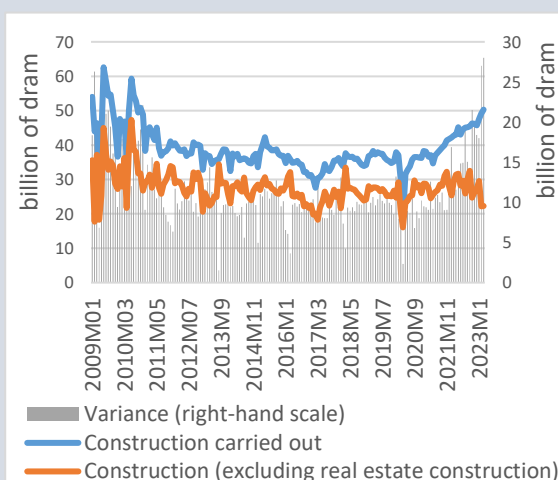
Average wage of registered non-resident employees and Armenia's IT industry wages



Source: Armenia Statistics Committee, Armenia State Revenue Committee

Chart 45

Construction output in real estate sector and other sectors

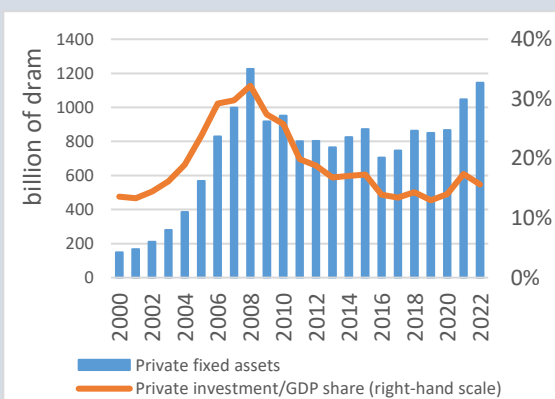


Source: Armenia Statistics Committee

Rounding up this analysis on the three fundamental factors that determine the long-term sustainable potential GDP growth, one may conclude that, in view of mostly positive developments in the labor market and an assessment of higher productivity growth, the long-term sustainable potential growth of the Armenian economy is currently estimated to be 4.5%, about 0.5 percentage point higher from the previous figure of 4.0% (see Chart 47). It is worth noting that in the upcoming years the potential growth of the Armenian economy will be shaping slightly above the long-term sustainable level mainly determined by capital investments pertinent to the Amulsar gold mine operation, as well as the resultant increase in productivity. Then, once these one-off time factors phase out, the potential growth will slow down, stabilizing at the level of 4.5%.

Chart 46

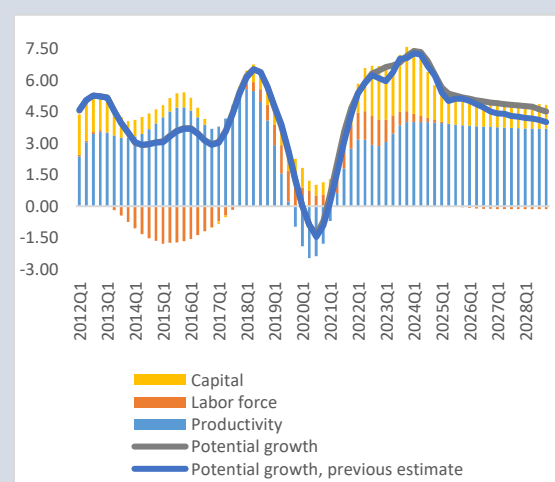
The share of private investment in GDP



Source: Armenia Statistics Committee,
Central Bank of Armenia estimate

Chart 47

The long-term potential GDP growth and its elements



Source: Central Bank of Armenia

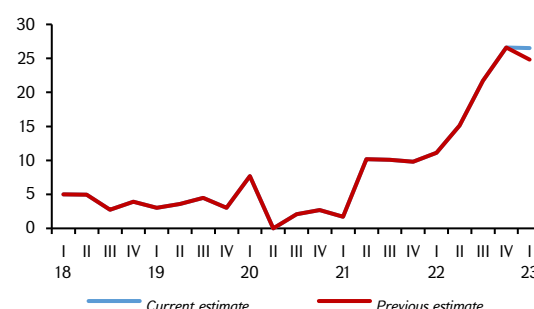
3.2.4. Labor market

In the first quarter of 2023, the unemployment rate is estimated around 12.6%, which is close to the previous Central Bank of Armenia estimate. The decline in the unemployment rate owes to employment that follows a growth path in the context of vibrant activity in various sectors of the economy.

In the first quarter of 2023, the nominal private sector wages grew by 26.5%, higher than the Central Bank of Armenia projection. The wage growth was especially strong in industry of services, reflecting high demand over the respective period of time. The real wage growth in the private sector has also been high – it amounted to around 18% – thanks to some easing of the inflation environment.

Chart 48

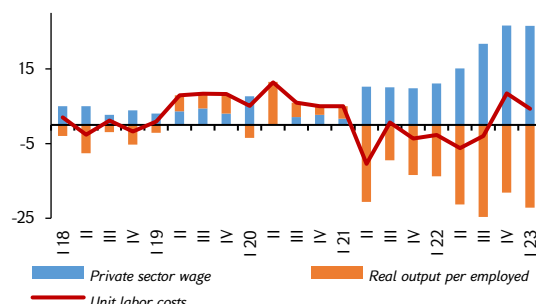
Private nominal wage, y/y growth, %



Source: Armenia Statistics Committee,
Central Bank of Armenia estimate

Thus, high private wage growth and declining unemployment reflect an eminent positive GDP gap in the reporting period. In the first quarter of 2023, minor inflationary pressures from the labor market persisted (with some increase in unit labor costs). However, some downsizing in unit labor costs has been noticeable in relation to the previous quarter. The latter reflects the surpassing growth of the private real wages over compared to the output growth per employee.

Chart 49
Unit labor costs, y/y growth, % ¹⁷



Source: Armenia Statistics Committee,
Central Bank of Armenia estimate

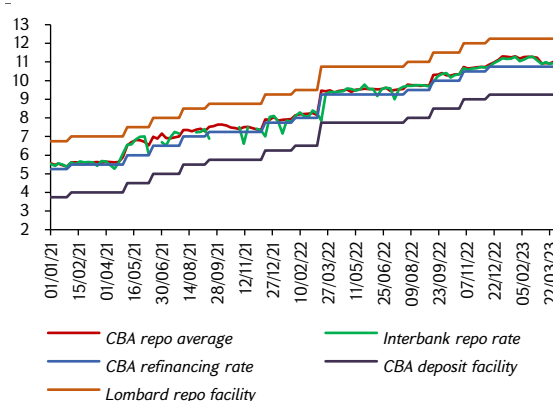
3.3. Financial market developments

In the first quarter of 2023, the Central Bank Board left the refinancing rate unchanged, at 10.75%.

In the first quarter of 2023, the Central Bank Board left the refinancing rate unchanged, at 10.75%.

Weakened inflationary effects transmitted from the international commodity markets amid the slowing growth in the world economy, the contractionary monetary policy by the Central Bank of Armenia and the appreciation of the dram notwithstanding, the persistently strong demand and inflation expectations during the first quarter of 2023 served as a basis for the Central Bank Board to leave the policy interest rate unchanged in February and March. According to the assessment of the Central Bank Board, the sustained high demand and inflationary expectations contributed to the high inflation of some goods and services. The sustained high demand and inflation expectations, the Board reckoned, fueled rapid price increases of certain goods and services. As well as the Board had announced its commitment to taking all required measures to regulate demand, stabilize inflation and neutralize risks of deanchoring of inflation expectations.

Chart 50
During the quarter the short-term interest rates continued shaping around the Central Bank's policy rate



Source: Central Bank of Armenia

Table 5: Average interest rates in Armenia's financial market

	02.02.22-15.03.22	16.03.22-03.05.22	04.05.22-14.06.22	15.06.22-02.08.22	03.08.22-13.09.22	14.09.22-01.11.22	02.11.22-13.12.22	14.12.22-31.01.23	01.02.23-29.03.23
Central Bank refinancing rate	8.00	9.25	9.25	9.25	9.50	10.00	10.50	10.75	10.75
Central Bank repo rate	8.20	9.46	9.51	9.53	9.75	10.32	10.70	11.11	11.12

¹⁷ In unit labor costs the productivity is represented by a negative contribution.

Interbank repo rate (up to 7-day)	8.14	9.39	9,65	9,55	9.67	10.32	10.66	11.11	11.06
Yield of government securities on a yield curve (average indicator)									
Short-term treasury bill (1-year)	9.08	10.13	10.25	10.41	10.46	10.86	11.50	11.67	11.54
Medium-term notes (5-year)	9.93	10.97	10.87	10.98	11.02	11.43	11.83	11.94	11.76
Long-term bonds (30-year)	10.25	11.20	11.26	11.59	11.69	12.04	12.11	12.02	11.85

In the first quarter of 2023, the financial system demonstrated high liquidity and capital levels. The banking system's demand for provision of liquidity through the main instrument of the Central Bank of Armenia kept on decreasing. Short-term interest rates in the dram market came to shape mostly around the policy rate.

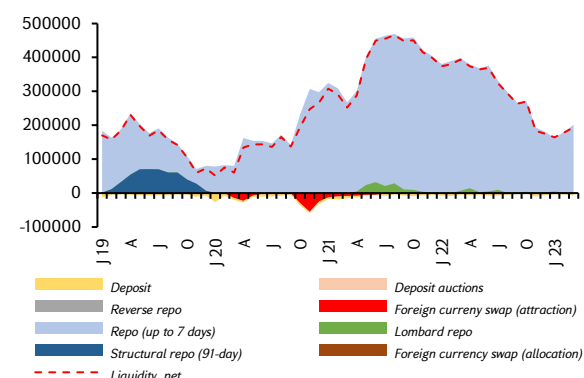
Recently, following the Central Bank of Armenia's contractionary monetary policy, the growth of yields in the government securities market has been prominent in the short-term segment of the market, whereas the reaction of long-term interest rates, in view of expected easing of the inflation environment as a result of the policy pursued by the Central Bank, has been in the direction of a moderate decline. Subsequently, the short- and long-term interest rates spread on the yield curve of government securities has narrowed to around 0.8 percentage point.

In the first quarter of 2023, the funds attracted and provided by commercial banks kept on growing, with only negligible change in interest rates. As of March 2023, based on 12 months' figures, the total amount of lending has grown by 6.4%, and that of consumer and mortgage lending, by 11.3% and 28.6%, respectively.

During the quarter, the amount of deposits attracted by the banks from non-residents stabilized at an elevated level; based on 12 months' figures, in March of 2023 it made up 54.7% of the total portfolio.

Chart 51

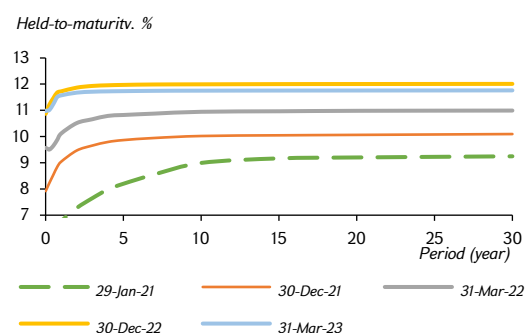
Liquidity injected and absorbed through Central Bank transactions (average monthly inventory, million Armenian dram)



Source: Central Bank of Armenia

Chart 52

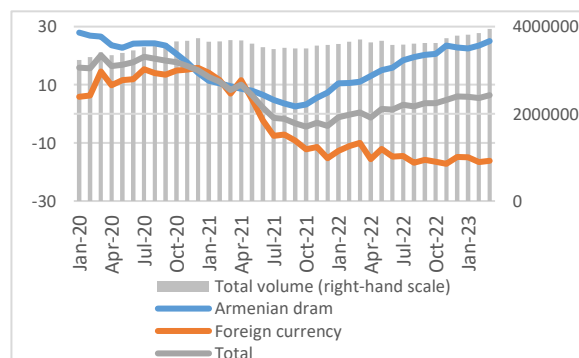
In the first quarter of 2023 the government security yield spreads narrowed in short- and long-term segments



Source: Central Bank of Armenia

Chart 53

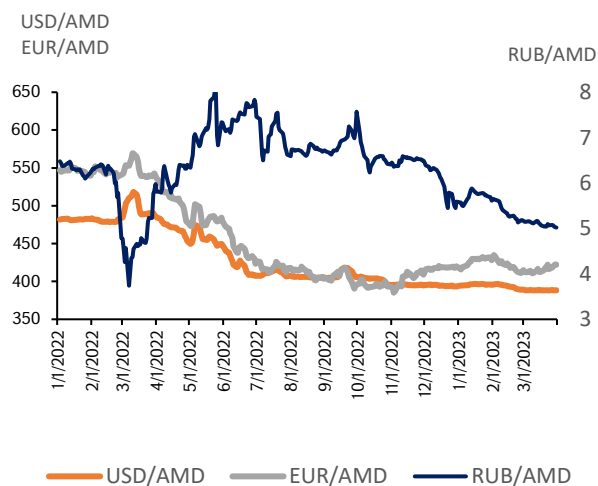
Change in the loans provided by banks (12-month change)



Source: Central Bank of Armenia

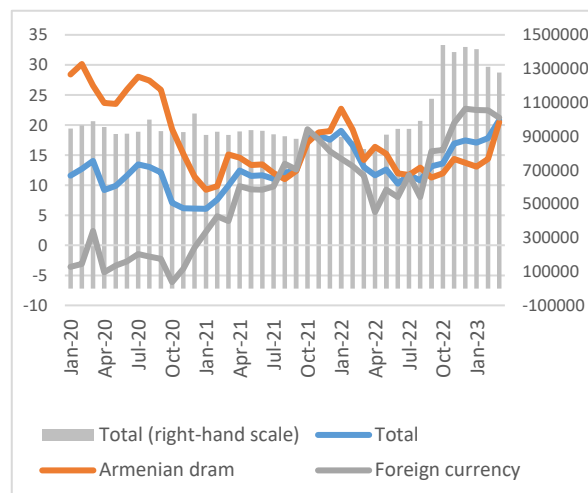
The domestic currency market saw the dram further appreciating on the back of high demand from international visitors, among others, for domestic services. The average quarterly AMD/USD exchange rate has appreciated by 1.26%, and the AMD/RUB exchange rate, by 15.81%. The vast inflow of foreign currency overtook, in some episodes, the absorbing capacity of Armenia's currency market, causing market disruption risks. The Central Bank of Armenia reacted to this through situational intervening in the market in order to purchase foreign currency and help the financial markets get back to normal functioning. The volume of net purchase of US dollars by the Central Bank of Armenia during the first quarter reached USD 191.3 million.

Chart 56
The behavior of currency exchange rates against the Armenian dram



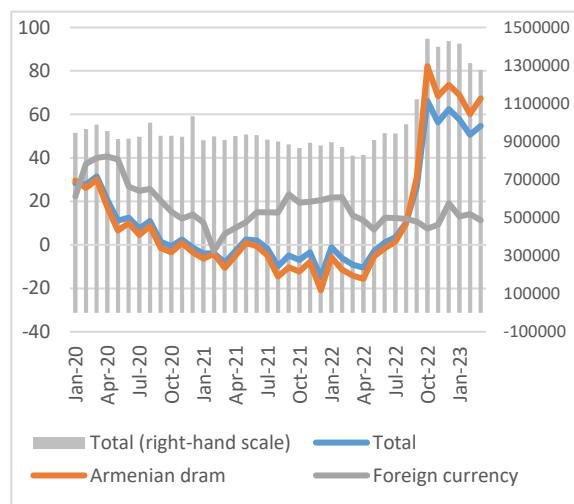
Source: Central Bank of Armenia

Chart 54
Change in the deposits attracted by banks (12-month change)



Source: Central Bank of Armenia

Chart 55
Change in the deposits attracted by banks (12-month change) (non-residents)



Source: Central Bank of Armenia

4. Summing-up

According to the scenario outlined in the Q2, 2023 monetary policy program of the Central Bank of Armenia, the headline inflation will reduce to some extent in the near future, yet the prices of services and a number of goods will further remain elevated, incurring the effects of current high demand and inflation expectations. Considering the aforementioned, the Central Bank of Armenia found it reasonable to cut, in a relatively small step, the policy rate at this stage. Meantime, the Central Bank will be consistent in taking required action to further regulate the demand and stabilize the inflation expectations. In view of the monetary policy the Central Bank of Armenia implements and expected macroeconomic developments, the 12-month inflation will float below the target value; it then will gradually increase and stabilize around the 4% target in the mid-term perspective.

For the 3-year policy horizon as presented in the scenario, the risks of inflation deviating from the projection path are mostly balanced, and in the event any such risks materialize, the Central Bank of Armenia will stand ready to react accordingly to ensure the price stability objective in the medium run.

MINUTES
THE CENTRAL BANK OF ARMENIA BOARD MEETING
(13.06.2023)

On the refinancing rate

**The Central Bank Board Meeting of June 13, 2023 attended by
Governor Martin Galstyan, Deputy Governor Hovhannes
Khachatryan, and Board Members Hasmik Ghahramanyan,
Davit Nahapetyan, Artak Manukyan,
Levon Sahakyan, Narek Ghazaryan**

The meeting of the Board of the Central Bank of Armenia started with presentation of the Situation Report as of June 13, 2023. It addressed the developments on inflation, external environment, and real, fiscal, financial, and monetary sectors of the economy.

Current developments in the external sector were presented. In the second quarter of 2023, it was recorded, the economic growth rates in the world and partner countries to Armenia carry on slow. At the same time, aggregate demand in the USA and the EU countries – among Armenia’s main partners – continues to weaken as a result of contractionary monetary policy and tighter financial conditions, while in Russia it is recovering at a faster-than-expected pace, mainly because of a considerably stimulative fiscal policy implementation. The Board corroborated that in expectation of slowing of the global economic growth rate, on the one hand, and the contractionary monetary policy currently pursued, on the other, all partner countries see their inflation environment softening notably, which also points to certain deflationary pressures in international commodity markets. However, with persistently strong demand and inflationary pressures deriving from the labor market, prices of goods and services that stand out with “sticky” prices still remain high. In this situation, the central banks of the main partner countries to Armenia will continue to conduct contractionary monetary policies in the near future. It is estimated that the continued weakening of demand amid tight financial conditions will contribute to lower prices in commodity markets, as a result of which the inflationary impact of the global

economy on the Armenian economy will keep on weakening significantly.

The Board of the Central Bank discussed the developments in the Armenian economy; in the second quarter of 2023, it was recorded, higher-than-expected economic activity was observable primarily owing to reported high growth in services and construction sectors. Positive factors came on the scene of the growth of economic potential mainly driven by positive changes seen in the labor market and the increased productivity. It was stated that, fueled by the effect of a sustained high external demand and regularly growing income in the economy, the aggregate demand remains strong and continues to be substantially backed by a large inflow of tourists. In the light the above trends, the 2023 economic growth is an estimated 6.9%, which is higher than the previous indicator.

Armenia's financial market developments were addressed; it was noted that although the banking system's demand for providing liquidity through the main Central Bank instrument continued to decrease in the second quarter of 2023, short-term market rates shaped primarily around the policy rate. During the quarter, the sustained high rates of capital influx and tourism growth were also reflected in continued appreciation of the dram in the currency market.

Touching upon the inflation developments, the Board noted that a 1.8% deflation was registered in May 2023, totally driven by a 3.5% fall in prices of food products. The prices of non-food products dropped by 0.9%, whereas service tariffs rose by 0.2% during the month. **As a result, the 12-month inflation continued to decline rapidly to 1.3% at the end of the month. The 12-month core inflation also reduced considerably to 3.1%.** Also, the Board admitted that the overall inflationary environment in Armenia continued easing owing to notably weakened inflationary pressures from the external sector, a contractionary monetary policy implemented by the Central Bank, and the dram appreciation, while also stating that price inflation of services and some goods adjusts more slowly amid high demand and inflation expectations.

Following the discussion of the Situation Report and the macroeconomic developments in external and domestic sectors, the Board proceeded to addressing the macroeconomic scenarios and monetary policy directions, and to making decision on the policy interest rate. The Forecasting Team, in view of the aforementioned macroeconomic situation, apprised the Board of the scenarios describing the monetary risks that

would possibly derive from upcoming economic development outlooks. The members of the Board all agreed that the risks to deanchoring of inflation expectations had been largely offset in an inflationary environment softened in light of weaker inflationary effects transmitted to the domestic economy from the external sector, and the implemented monetary policy. Some members were of the opinion that even though the 12-month inflation would possibly subdue a little in the near future, inflation of a number of goods and services with “sticky” prices was still declining slowly, while demand and inflation expectations persisted high. Moreover, uncertainty over a further path of inflation has grown as inflation declined rapidly. Therefore, even with the 12-month inflation slowing in the short term, future inflation risks were still not fully neutralized, and a more conservative behavior toward changing monetary conditions would need to be demonstrated. In the upcoming period, part of the members of the Board reckoned, inflation expectations might be diminishing commensurate with an inflation environment having eased amid deflationary effects transmitted from the external sector, while the relatively contractionary fiscal and monetary policies would together contribute to the slowing of economic demand, creating risks of maintaining low inflation. Therefore, they further reckoned, loosening monetary conditions in a relatively big step would be more appropriate in terms of managing the risks to deflation and economic slowdown. As a result, the **Board of the Central Bank of Armenia made a decision in a majority of voices to reduce the refinancing rate by 0.25 percentage point.** The Board also endorsed its commitment in taking adequate measures to regulate demand and stabilize inflation expectations. As outlined by the monetary policy scenario, that the 12-month inflation will remain below the target in the near future, then will gradually increase and stabilize around the 4% target in the medium term.

The Board also estimated that the risks of inflation deviating from the projection path are mostly balanced. In the case of risks materializing in any direction, the Board will adequately react and ensure the price stability objective.

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

THE CENTRAL BANK OF THE REPUBLIC OF ARMENIA

BOARD DECISION

ON THE SETTING OF INTEREST RATES OF MONETARY POLICY INSTRUMENTS OF THE CENTRAL BANK OF THE REPUBLIC OF ARMENIA AND THE PRESS RELEASE ON THE REFINANCING RATE

By virtue of Article 2 (3), Article 20 “c” and “e” of the Republic of Armenia Law on the Central Bank, and clauses of the Republic of Armenia Law on Normative Regulations, the Board of the Central Bank of the Republic of Armenia **enacts:**

1. Set the Refinancing rate of the Central Bank of the Republic of Armenia to be 10.5%.
2. Set the Lombard facility rate offered by the Central Bank of the Republic of Armenia to be 12.0%.
3. Set the Deposit facility rate offered by the Central Bank of the Republic of Armenia to be 9.0%:
4. Approve the Press Release on the Refinancing Rate of the Central Bank of the Republic of Armenia (attached).
5. This decision to take effect on the day following its publishing on Internet homepage of the Central Bank of the Republic of Armenia.

Martin Galstyan
the Central Bank of Armenia

Governor of

June 13, 2023

PRESS RELEASE

13.06.2023

At the June 13, 2023 meeting, the Board of the Central Bank of Armenia decided to reduce the refinancing rate by 0.25 percentage point to 10.5%.

In May 2023, the 12-month inflation continued to decrease at a rapid pace; at the end of the month it was 1.3%. The 12-month core inflation also reduced significantly, reaching 3.1%.

In the second quarter of 2023, the rates of economic growth in the world and main partner countries of Armenia remain slow, and the 12-month inflation continues to decrease. However, in all partner countries sticky price inflation of goods and services remains high amid sustained inflationary pressures coming from labor markets. Therefore, the central banks of partner countries will further conduct a contractionary monetary policy in the near term. Continued weakening of demand in the wake of tight financial conditions is contributing to lower prices in commodity markets. As a result, the inflationary effects of the global economy on Armenia's economy keep on weakening considerably.

A higher than expected economic activity is observable in Armenia in the second quarter of 2023, which is mostly driven by strong growth reported in the construction and services sectors. Positive shifts seen in the labor market and the increase in productivity are also leading to a certain acceleration of the potential growth rate of the economy. On the other hand, sustained high external demand and increased income in the economy contribute positively to demand expansion. The inflation environment in Armenia continues to mitigate rapidly owing to the notably weakened inflationary impact from the external sector, the implemented contractionary monetary policy and the appreciation of the dram. However, price inflation of services and some goods is adjusting more slowly in the light of high demand and inflation expectations.

The Board of the Central Bank of Armenia finds it appropriate to reduce the policy rate. The Board will be consistent in taking action to handle demand and stabilize inflation expectations. According to the outlined monetary policy scenario, the 12-month inflation will remain below the target value in the near future and stabilize around the 4% target in the medium term.

The Board of the Central Bank of Armenia estimates that the risks of inflation deviating from the projected path are mostly balanced; in the event these risks materialize in any direction, the Board stands ready to respond accordingly in fulfilment of the price stability objective.

Press Service of the Central Bank of Armenia

Armenia's main macroeconomic indicators according to the Scenario

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Indicators	actual	actual	actual	actual	actual	actual	actual	actual	program	program	program
External sector											
USA economic growth (% , real growth)	2.7	1.7	2.3	2.9	2.3	-2.7	6.1	2.1	1.4	1.8	2.7
EU economic growth (% , real growth)	1.9	1.8	2.7	1.9	1.6	-6.3	5.5	3.5	0.6	-0.5	0.5
Russia economic growth (% , real growth)	-1.9	0.2	1.8	2.8	2.0	-2.9	4.8	-2.2	1.2	1.0	0.0
USA inflation (average, %)	0.1	1.3	2.1	2.4	1.8	1.2	4.7	8.0	4.8	3.4	2.4
EU inflation (average, %)	0.0	0.2	1.5	1.7	1.2	0.3	2.6	8.4	6.3	3.6	2.2
Russia inflation (average, %)	14.4	6.8	3.6	2.8	4.5	3.4	6.7	13.7	4.8	4.7	4.4
Oil price (dollar/barrel)	53.5	45.0	54.6	71.4	64.1	42.5	71.0	98.7	78.4	76.0	76.0
Copper price (dollar/barrel)	5497.4	4867.6	6201.5	6544.7	6024.1	6191.2	9288.1	8956.0	8809.5	9156.0	9383.2
FAO index	93.0	91.9	98.0	95.9	95.1	98.1	125.7	143.6	127.9	129.2	132
Domestic economy											
Prices											
Inflation (y/y, end period, %)	-0.1	-1.1	2.6	1.8	0.7	3.7	7.7	8.3	0.4	3.5	3.9
Consumer price index (y/y, average, %)	3.7	-1.4	1.0	2.5	1.5	1.2	7.2	8.6	2.2	2.8	3.7
Core inflation (y/y, average, %)	5.1	-2.0	0.8	4.0	1.2	1.3	7.2	8.9	3.0	2.1	3.6
Gross product											
GDP (billion of Armenian dram)	5043.6	5067.3	5568.9	6017.0	6543.3	6181.7	6983.0	8496.8	9450.3	10368.3	11311.4
GDO (% , real growth)	3.2	0.2	7.5	5.2	7.6	-7.4	5.7	12.6	6.9	5.5	5.0
Supply											
Industry (% , real growth)	6.2	7.7	11.7	4.9	12.0	-1.7	3.5	6.3	4.6	7.4	6.4
Agriculture (% , real growth)	13.2	-5.0	-5.1	-6.9	-5.8	-4.1	-0.6	-0.7	1.3	2.4	2.8
Construction (% , real growth)	-3.1	-14.1	2.8	0.6	6.5	-6.7	3.1	19.1	15.7	9.8	6.1
Services (% , real growth)	1.6	3.2	10.6	9.1	10.0	-9.7	7.9	18.1	7.8	4.8	4.8
Tax, net (% , real growth)	-5.1	-3.7	9.7	8.0	7.1	-10.0	7.4	8.2	6.5	5.6	5.4
Demand											
Consumption (% , real growth)	-6.0	-2.1	11.6	3.8	11.7	-10.9	4.2	7.7	6.1	4.1	4.6
Public consumption (% , real growth)	4.7	-2.4	-2.1	-3.0	12.9	9.2	8.4	6.5	8.1	2.1	3.5
Private consumption (% , real growth)	-7.5	-2.1	14.0	4.8	11.5	-14.0	3.4	8.0	5.6	4.5	4.8
Gross accumulation of fixed assets* (% , real growth)	2.5	-11.4	9.7	4.8	4.4	-1.5	6.3	9.5	24.1	5.5	8.4
Public investment** (% , real growth)	13.6	5.0	31.7	-37.4	31.1	16.2	-9.9	41.1	54.3	3.5	15.9
Gross accumulation of private fixed assets (% , real growth)	1.2	-13.9	6.2	19.6	-0.5	-5.7	11.2	1.9	15.1	6.4	4.8
Export of goods and services (% , real growth)	4.9	21.3	19.3	5.0	16.0	-33.4	17.1	54.4	18.7	-2.9	4.4
Import of goods and services (% , real growth)	-15.3	6.3	24.6	13.3	11.6	-31.4	12.5	33.8	22.1	-4.5	4.6
Current account											
Balance of trade (million of US dollar)	-1186.4	-976.9	-1400.9	-1724.4	-1727.9	-1382.2	-1504.8	-2016.1	-2088.3	-1899.7	-1953.7
Balance of services (million of US dollar)	-96.4	70.4	159.4	24.7	-66.9	118.0	396.9	1429.4	1384.9	1243.3	1228.2
Money transfers (million of US dollar)	1098.3	1009.4	1179.3	1136.2	1143.8	1046.2	1243.1	1630.5	1075.9	1102.3	1030.4
Current account (million of US dollar)	-284.7	-107.9	-173.9	-875.9	-1002.3	-477.8	-515.1	14.8	-408.3	-348.9	-449.9
Balance of trade (share in GDP, %)	-12.2	-8.6	-10.8	-13.7	-13.1	-10.0	-7.9	-3.0	-2.9	-2.9	-2.9
Balance of services (share in GDP, %)	-0.9	0.7	1.4	0.2	-0.5	0.9	2.8	7.3	5.7	5.5	5.0
Money transfers (share in GDP, %)	10.4	9.5	10.2	9.1	8.4	8.3	8.9	8.3	4.5	4.8	4.2
Current account (share in GDP, %)	-2.7	-1.0	-1.5	-7.0	-7.3	-3.8	-3.7	0.1	-1.7	-1.5	-1.8

Indicators	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
	actual	actual	actual	actual	actual	actual	actual	actual	program	program	program
Public sector***											
Revenues and grants (billion of Armenian dram)	1167.7	1171.1	1237.8	1342	1559.1	1560.4	1683.8	2046	2366.4	2630.4	2968.6
Tax revenue (billion of Armenian dram)	1067.9	1079.7	1158	1258	1464.3	1385.2	1586.9	1926	2248.0	2553.0	2898.0
Expenditures (billion of Armenian dram)	1409	1449.1	1504.8	1447	1623	1894.3	2004.3	2243.5	2541.0	2846.0	3190.0
Deficit (billion of Armenian dram)	-241.3	-278	-267	-105.4	-63.9	-333.9	-320.5	-197.5	-174.6	-215.6	-221.4
Revenues and grants (share in GDP, %)	23.2	23.1	22.2	22.3	23.8	25.2	24.1	24.1	25.0	25.4	26.2
Tax revenue (share in GDP, %)	21.2	21.3	20.8	20.9	22.4	22.4	22.7	22.7	23.8	24.6	25.6
Expenditures (share in GDP, %)	28	28.6	27	24.1	24.8	30.6	28.7	26.4	26.9	27.4	28.2
Deficit (share in GDP, %)	-4.8	-5.5	-4.8	-1.8	-1	-5.4	-4.6	-2.3	-1.8	-2.1	-2.0
Monetary sector											
Broad money (y/y, end period, %)	10.8	17.5	18.5	7.5	11.2	9	13.1	16.1	0	0	0
Dram broad money (y/y, end period, %)	5.2	24.8	28.9	13.2	21.5	14.8	12.8	13.4	0	0	0
Loans to economy (y/y, end period, %)	-3.3	6	16.5	17.2	18.5	14.3	-3.9	4.5	0	0	0
USD/AMD (Armenian dram for one US dollar)	477.9	480.5	482.7	483	480.4	489	503.8	435.7	0	0	0
* From now on the Central Bank will only present the indicator of gross fixed asset accumulation instead of gross accumulation, since the change in tangible working capital inventories is calculated by Armenia's Statistics Committee as a balancing item and it does not show the true level of gross accumulation. See https://www.armstat.am/file/article/sv_04_19a_112.pdf :											
** Actual indicators of public investment are the capital expenditures of the consolidated budget, and the estimates are based on a revised macro-framework, 2023-2025, available at the time.											
*** The 2023 budget indicators are the Central Bank of Armenia estimate. The 2024-2025 indicators are presented from the state Mid-Term Expenditures Framework.											

Yerevan, 2023

