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Q3 2010 ACTUAL INDICATORS AND DEVELOPMENTS

In the third quarter of 2010 decrease in agriculture output and steep rise in grain prices in international markets were the main causes for high inflationary environment. These factors reflected the end-quarter inflation indicator as price increases in items “fruit” and “vegetable and potato” contributed as much as 3.3 pp and item “bread products” 1.5 pp to the 8.6 percent of the 12-month inflation.

During the quarter, however, the impact of some factors prevented the creation of higher inflationary environment owing, specifically, to the tightened monetary conditions since the start of the year, including the developments in the foreign exchange market, and recovered domestic demand still not creating inflation.

With these circumstances, inflation in the third quarter amounted to 0.3 percent, and the 12-month inflation indicator reached 8.6 percent, increasing by 2.8 pp against the previous quarter’s indicator. Over the quarter, food prices fell by 0.2 percent (with -0.1 pp contribution to headline inflation), non-food prices remained almost unchanged, while service tariffs rose by 1.1 percent (with 0.3 pp contribution to headline inflation). Whereas in recent years change in prices in items “vegetable and potato” and “fruit” made an average -2.6 pp contribution to the quarter’s inflation, these items in the third quarter of 2010 contributed by 0.1 pp, that is 2.7 pp higher, and which is why the actual indicator deviated from the Q3 projection almost to the same extent.

Over the quarter core inflation amounted to 0.4 percent¹ while the 12-month core inflation has reduced by 0.5 pp against the previous quarter’s indicator to make up around 4.9 percent.

External environment

In the third quarter world output growth rates have somewhat decelerated in both developed and emerging countries. Nevertheless, the main international commodities markets saw prominent inflationary developments in anticipation of concerns with basic crops as well as the US dollar exchange rate depreciation in the end-quarter, affecting developments in the main intermediate goods markets.

In the third quarter international oil prices fell by 3.2 percent q-o-q, with ‘Brent’ averaging around USD 76.4 a barrel, which however is 11.8 percent higher in relation to the relevant indicator of the third quarter of the previous year.

In the third quarter prices of both base metals and precious metals grew. The copper price at the London Metal Exchange has increased by 3.1 percent q-o-q, averaging around USD 7279 per ton (24.0 percent growth y-o-y). Though over the quarter the molybdenum price in international markets fell by around 4.5 percent on average, it is still about 10.2 percent higher from the third quarter’s average of the previous year. Despite somewhat a down-trending character observed for the gold price at the beginning of the quarter, it rose again in September driven by added demand for gold from financial market participants and investors due to the dollar depreciation and increased volatility of exchange rates of other foreign currency assets, and Japanese yen, in particular. In such circumstances average quarterly price of gold has grown by 2.7 percent against the previous quarter to reach USD 1228 per troy oz. (27.9 percent growth y-o-y).

In the third quarter prices of grains in international markets were driven by notable reduction in volumes of expected harvest in the light of unfavorable weather conditions in Russia, Europe and Canada. This is why a deflationary environment observed over previous quarters has turned into an obviously

¹ The core inflation calculation methodology developed by the Central Bank is detailed in the CBA Review (Q1, 2008). The paper regularly publishes core inflation indicators.

inflationary one. So, at the Chicago Board of Trade the grain prices increased by around 34.1 percent against the previous quarter, making up USD 6.5 a bushel on average (14.6 percent growth y-o-y). In expectation of record volumes, the rice price reported 17.3 percent decline in relation to the same period of the previous year, to USD 11.2 per short hundredweight (45.3 kg) (5.2 percent decline q-o-q).

According to international sugar price index released by New York Board of Trade, in the third quarter sugar prices grew by 30.9 percent q-o-q, averaging around 26.5 US cent/pound, which is 24.5 percent higher from the third quarter's indicator of the previous year.

Amid pessimistic expectations about the developments of the US economy as well as announcements by the US Federal Reserve System on applying of quantitative easing, in the third quarter USD depreciated by 1.5 percent against EUR, with the dollar averaging around 1.29 per Euro. (The US dollar still remains appreciated vis-a-vis Euro by around 10.7 percent y-o-y).

In the third quarter, attributable to somewhat slackened world output growth under a partial fiscal consolidation, the monetary policy in the most countries has stayed primarily expansionary. Though some emerging and developed countries decided on the lifting of the policy rates, leading industrialized countries (USA, Euro-area, Japan) also considered a return to the quantitative easing. This is to say that in the third quarter the Fed and the ECB maintained their policy rates at a low level, and the US Federal Reserve System even uttered a consideration to get back to the quantitative easing. It should be noted that the tightening of monetary conditions in emerging countries has been in the form of increased interest rates, stricter reserve requirements (China, India, Turkey) and explicit lending restrictions (China).

So, in the third quarter predicted possible upside risks in the main international commodities markets on a global scale persisted, which remains decisive for the formation of inflation in the domestic economy.

Aggregate Supply²

As a result of continuously slowdown of economic growth rates in the third quarter, in the period January-September of 2010 economic growth has increased by 2.8 percent y-o-y. This was driven by declining of agriculture, second largest branch in GDP, due to unfavorable weather conditions as well as decelerated decline in real GDP observed in the third quarter of the previous year.

In **Industry** the value added has increased by 9.8 percent primarily due to the increased volumes in *metal ore mining* (32.1 percent), *food production* (5.9 percent), *beverage production* (23.4 percent), *building materials production* (17.5 percent), *chemical industry* (32.9 percent) and *jewelry manufacturing* (46.5 percent), which is a result of consistent improvement in external demand as domestic and world economies recover.

Although around 1.9 percent decline was recorded in the generation of *electricity, natural gas, steam* and *high-quality air*, the production of electricity, when expressed in kind, has increased by about 17.1 percent y-o-y, reflecting noticeable growth in export volumes of electricity.

In **Construction** the value added has grown by 5.5 percent. At the same time, reduction in construction volumes financed by *international loans* (-24.8 percent) and *households* (-51.9 percent) totally offset the increase in construction volumes financed by *state budget* (11.4 percent), *local budgets* (48.5 percent), *humanitarian aid* (4.6-fold) and *organizations* (42 percent).

There has been marked growth in construction volumes in *agriculture, processing industry, IT and communications, financial, insurance, healthcare* and *public catering services*.

² The indicators of branches and sub-branches of the economy represent a period spanning January-August of this year relative to January-August of the previous year.

In **Services** the value added has increased by 5.3 percent mainly due to 12.1 percent increase in *wholesale trade turnover* and 0.3 percent increase in *retail trade turnover*. The volume of services delivered has increased by 7.2 percent. Except for services in *healthcare* and *social servicing of the public*, growth was reported in all other areas. Even more so, financial and insurance services reported the largest growth, 18.6 percent and information and communication services, 3.6 percent.

In **Agriculture** the value added has decreased by 17.9 percent y-o-y, almost entirely due to declines in *plant growing* (-29.1 percent) and *animal growing* (-2.2 percent). The decline in volumes of animal production has been totally attributable to 11.2 percent reduction in slaughter animal and poultry and 5 percent reduction in meat production compensated, in part, by 26.4 percent increase in egg production. The decline in plant growing has been attributable mainly to unfavorable weather conditions. In the domestic market demand for agricultural products has been satisfied from hothouse products and imports.

Labor Market⁵

According to the Central Bank estimates, in the third quarter of 2010 the growth of average nominal wages was nearly 7 percent, reflecting an increase in wages in private sector fuelled by bouncing economic activity and some budget-supported organizations. It should be noted that in the third quarter average nominal wages in the private sector grew primarily due to the growth of wages in *industry, service and construction*.

In the time of recovering economy, demand for labor continued to increase, thus pushing the average quarterly unemployment rate downward by 0.1 pp to 6.9 percent. In the third quarter, concurrent with deceleration of economic growth rate, labor productivity decreased by around 1 percent.

As a result of these developments, unit labor costs have increased by around 8 percent, creating slight inflationary pressures in the economy, which are estimated to be 0.5 percent.

Aggregate Demand⁴

According to Central Bank estimates, in the third quarter of 2010 private spending has increased by around 4 percent in real terms due to real growth of private investment and private consumption. As such, growth rates of private investment were faster from those of private consumption, while growth rates of private spending have diminished due to the slowdown of the economic growth.

The growth rate of domestic demand lagged behind that of private spending due to reduced government expenditures, and amounted nearly to 1 percent.

Private investment has grown by around 12 percent, determined by gradually improving domestic and external demand, increased inflow of transfers from abroad and growing optimism among economic agents over future economic conditions. Private consumption has increased by around 1 percent in real terms as a result of slight rise in household incomes and recovering consumer confidence. The growth of private investment and consumption reflects increased volumes of construction financed by organizations as well as of trade turnover⁵.

⁵ The labor market data for the third quarter of 2010 are the Central Bank estimates which are based on actual figures of the second quarter of 2010 and July and August 2010 figures. The growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

⁴ The data on real growth of private sector consumption and investments for the third quarter of 2010 are the Central Bank estimates. Actual preliminary figures of these indicators are as of the second quarter of 2010. The growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

⁵ See sub-section Aggregate supply.

Composite economic indexes computed and published by the Central Bank also point to the aforementioned developments⁶. In the third quarter of 2010 *consumer confidence index* rose by 2.3 percent, *current conditions index*, by 1.3 percent and *future conditions index*, by 3 percent. *Economic activity index* and *business activity index* have increased by 5.8 percent and 4.5 percent, respectively. In the third quarter enterprise willingness to invest increased, as well. The deterioration of these indexes relative to the previous quarter reflects the slowing of the growth rate of private spending, which is associated with deceleration of the economic growth on the whole.

Though private spending has increased over the quarter, it still had a restrictive impact on inflation. According to the Central Bank, the estimated level of real private spending has been below its potential by 1-2 percent. This created deflationary pressures in consumer market, pushing inflation down by 0.4-0.6 pp.

Current account

The deficit of current account remained at a high level over the third quarter of 2010 in the light of international price increases on the basic commodities and developments in domestic economy. The third quarter saw a notable slowing of growth rates of export and import. According to estimations, the growth of export of goods and services in the third quarter amounted to 18.7 percent⁷. The growth of goods and services in real terms has been 6.2 percent y-o-y.

The slowing of growth rates of domestic economy reflected the diminishing growth of import. In the third quarter the growth of import of goods and services⁸ is estimated to have reached 9.3 percent y-o-y. Import of goods has grown by 10.6 percent y-o-y, and real volumes of goods and services have increased by 1.7 percent y-o-y.

Consistent with forecasts, the inflow of non-commercial remittances of individuals through the banking system has increased by 16.8 percent y-o-y, and the outflow, by 6.3 percent y-o-y. As a result, the y-o-y increase of net inflow of non-commercial remittances in the third quarter of 2010 has been 18.7 percent.

Consolidated budget

In the third quarter of 2010 the fiscal policy had somewhat a less expansionary impact on aggregate demand as has been forecast⁹. As such, the revenues impulse has been restrictive and the expenditures impulse less expansionary than forecast. In the outcome, based on calculations, the fiscal sector had a mere 0.8 expansionary impact on aggregate demand instead of the projected 2.1 expansionary.

To sum up, in the third quarter of 2010 the fiscal policy had less expansionary impact on aggregate demand which, however, has not created notable inflationary pressures in the economy under unsatisfactory growth of private spending. Also, taking into account weak inflationary pressures in the labor market, one may conclude that net impact of domestic demand and labor market on inflation in the third quarter has been in the range of 0.2–0.4 percent.

⁶ See http://www.cba.am/CBA_SITE/statistics/complex_index.html?_locale=hy.

⁷ In January-September of 2010, the growth of export of goods (FOB) has been 43.9 percent. The quarterly indicators of export of services are forecasts.

⁸ In January-September of 2010, the growth of import of goods (CIF) has been 19.2 percent. The quarterly indicators of import of services are forecasts.

⁹ The fiscal policy's impact on aggregate demand is estimated through fiscal impulses. According to the current methodology on fiscal impulses, GDP used in the calculation of the revenues impulse comes as nominal GDP whereas GDP used in the calculation of the expenditures impulse comes as estimated potential GDP. The year 2008 is taken as the base year.

Money and credit

Rapid slowing of the 12-month inflation observed during the second quarter of 2010 was followed by accelerating rates of inflation in the third quarter. Already in September, driven primarily by supply-side factors (persistently high level of prices of agricultural goods due to unfavorable weather conditions, rising prices of grains in international markets), inflation reached 8.6 percent, markedly exceeding the upper border of the band. However, according to the Central Bank estimations, since the recovery of the domestic demand was not creating inflationary pressures for the next period and the tightening of monetary conditions from the beginning of the year was further moderating the inflationary environment, the Central Bank has been primarily conservative, keeping away from tightening of monetary conditions. As a result, during the quarter the Central Bank left the refinancing rate unchanged, at a 7.25 percent level.

Under such conditions, interest rates in different sectors of the financial market kept on trending downward. In the third quarter, relative to the second quarter, average market rate fell by 3.0 pp in the repo market and by 2.6 pp in the interbank repo market. In primary market of treasury bills average interest rate fell by 1.8 pp. In the foreign exchange market in the third quarter, relative to the second quarter, the AMDUSD appreciated by 5.2 percent, the AMDEUR appreciated by 3.75 percent and the AMDRUR appreciated by 9.1 percent.

Owing to the monetary policy implementation and anti-dollarization measures, the growth of dram broad money again outpaced broad money during the third quarter, posting, respectively, 3.0 percent and 6.5 percent growths. In the third quarter the level of dollarization declined by 4.1 percent, reflecting the 12.9 percent increase of dram deposits and 1.2 percent decrease of foreign currency deposits (a mere 0.5 percent growth, when the change in exchange rate is excluded). Over the third quarter lending has grown by 6.5 percent, with dram lending increased merely by 2.4 percent and foreign currency lending increased by 10.3 percent (12.1 percent growth, when the impact of the change in exchange rate is excluded).

UPCOMING 12-MONTH PERIOD FORECASTS

External environment¹⁰

According to October forecasts by the IMF, in 2010 the world output growth is expected to reach 4.8 percent, just 0.2 pp higher from the July projection. This is some 1.3 pp above the average indicator recorded in the last five years yet stays below the growth rates observed in the period of economic uprising (2004-2007). The growth rate of 4.3 percent, as projected in July for 2011, was revised a notch down to 4.2. New forecasts denote that economic growth in Euro-area for 2010 is increased to reach 1.7 percent, whereas the US economic recovery rate is reduced noticeably, by around 0.7 pp, to 2.6 percent. Russia's economic growth is also revised downside, by 0.3 pp, to 4.0 percent which is determined by the damage to the agriculture caused by drought. Furthermore, the IMF predicts downside risks to world output perspectives in 2010-2011. This is largely attributable to financial instability risks spreading farther and to the lack of consistent economic policies to enhance domestic and external redistributions of world aggregate demand. Add that quite impressive inflationary pressures would be observed in countries with transition economy and emerging economies in the years ahead. The IMF estimates that inflation in emerging countries is expected to be 6.2 percent in 2010 and 5.2 percent in 2011.

In commodities markets in 2010-2011 prices will persist at a high level, as it is shaped as of the end of the third quarter. The pricing in basic commodities markets will not only be accommodative to the alteration of estimates on world economy and demand dynamics but also will depend on developments in financial markets on the whole. At the same time, developments inherent in individual commodity markets will determine risks to possible high inflationary pressures.

In the period 2010-2011 a limited growth of oil prices is anticipated, which is going to be in the range of USD 80-85 a barrel. This is mostly associated with increased demand for oil products amidst forecasts for high global output and economic recovery in emerging countries, whereas the main risks to rapid price increases are stemming from supply-side factors (investment programs perspectives).

There is expectation that prices of precious metals and base metals will grow moderately. Copper price is expected to reach USD 8000 per ton and gold price to stabilize within USD 1350 per troy oz, which was persistent in the beginning of the fourth quarter.

Prices of grain are expected to maintain at their historically high levels while demonstrating a moderate growth. This is determined by coordinated supply and demand growth expected in the future. According to estimations by the US Department of Agriculture, some 641 million tons of grain harvest is expected for 2010/2011 (roughly 682 million tons was the estimated yield in the previous period 2009/2010). Because an expected consumption is estimated to be around 663 million tons, the world grain stock is predicted to decrease by nearly 22 million tons, to make up 175 million tons. As a result, grain prices in the period 2010-2011 will be within USD 7.5 - 7.8 a bushel.

The price of sugar will also demonstrate upward-trending patterns and in the period 2010-2011 they are expected to remain high at the end-quarter three 2010 levels. This is connected with the exporting difficulties in India and Brazil, which is likely to bring on some tension in respect of satisfying growing world demand for this commodity. There is expectation of a moderate growth of the price of rice which is explained by both huge world demand, despite a predicted record produce of up to 452.5 million tons, and possible reductions in expected crops due to unfavorable weather conditions in the main producer countries (India, in particular).

¹⁰ The forecasts of external sector have been based on the information provided from the IMF, World Bank, The Economist, Global Insight, Financial Times, US Department of Agriculture, РосБизнесКонсалтинг and other sources.

In financial markets in the third quarter of 2010, owing to deterioration of the US economic growth outlook as well as announcements by the US Federal Reserve System to return to applying of quantitative easing, the US dollar incurred depreciation pressures which, logically, affected the behavior of the European currency which, in turn, was fuelled by positive developments of economic recovery in Euro-area. Determined by faster recovery of the US economy over the EU as well as investor propensity for commodity assets in financial market, the Euro exchange rate is expected to depreciate to some extent.

The main issues impeding sustainable growth of world economy and the pace with which it is recovering are pertinent to economic policies designed to reshape external and domestic balances. These issues and policies are momentous especially in developed countries. In this context, fiscal consolidation will remain a top priority. This suggests, inter alia, creating a tight fiscal environment during 2011 which means that the rates of economic recovery will slow down. Sure, in the time of slackening economic growth and tightening fiscal channel, implementation of the monetary policy will carry on in relatively a moderate environment sometimes by the use of non-traditional instruments of the monetary policy.

To sum up, developments in financial markets that contain expectations for world economic recovery will be reflected in international prices of basic commodities which will, in turn, continue creating temperate inflationary pressures in domestic commodities market in Armenia.

Aggregate Supply

Economic growth forecasts have been revised downside, due to implementation of economic growth downside risks as was outlined in projections of the previous quarter. As a result, a relatively smaller economic growth in the range of 2.4 - 2.7 percent is expected in 2010, and some 4 - 5 percent in the period January-September 2011.

Risks to economic growth are dual-sided, and associated with both external and internal factors. However, upside risks are prevailing thanks to the upside risks of indicators projected for all branches of the economy (except for industry).

For **Industry**, forecasts have been revised slightly downside. In particular, the figures of real growth of value added in production of *building materials* were lowered. Similarly, projections for *energy* branch were revised driven by both the aforementioned factor and the nuclear plant lay-off recently. As a result, the value added in industry is expected to grow in the range of 6.5 - 8.5 percent in real terms and 5 - 7 percent over the first nine months of 2011.

Risks deriving from the industry branch are projected downside, reflecting prediction to the slowdown of the global economy.

For **Construction**, forecasts have also been revised downside, based on a less than expected growth of value added in construction in the third quarter as well as somewhat deteriorated expectations among companies active in this branch¹¹. However, no essential changes are expected in construction financed by households.

As a result, the growth of value added in construction is expected to be within 0.5 - 2.5 percent in real terms in 2010 and within 1.5 - 3.5 percent over the first nine months of 2011.

For **Services**, forecasts have been revised slightly downside, due to the revised forecasts of domestic demand that will be affecting the volumes of both trade turnover and other services.

As a result, the real growth of value added in services in 2010 is projected in the range of 4.5 - 6.5 percent and 2.5 - 4 percent over the first nine months of 2011.

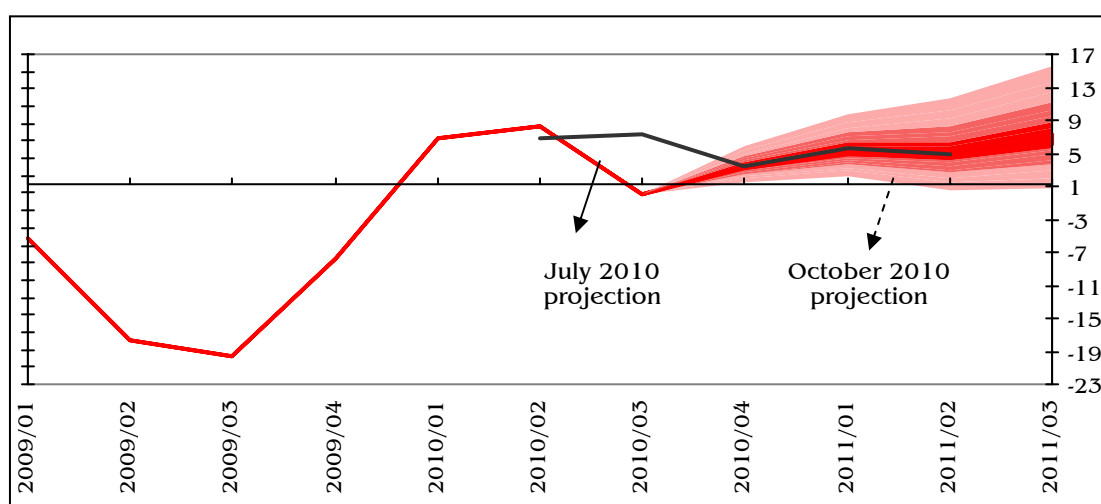
¹¹ See http://www.cba.am/CBA_SITE/statistics/complex_index.html?__locale=hy.

Risks of recording some higher growth rates exist in **Construction** and **Services**, which largely depends on how fast the envisaged large-scale investment programs will be realized.

For **Agriculture**, forecasts have been revised downside due to reported downfall in this branch because of delayed sowing in springtime, postponed harvesting and reduced arable land. So, because plant growing, which makes half of the agricultural capacity, largely depends on weather conditions, the least risky option has been taken in projecting the agricultural growth.

As a result, value added in agriculture is expected to decline within 13 - 16 percent in real terms in 2010 whereas recovery of growth rates up to 7 - 9 percent. However, existing risks are projected upside, associated with the increase of sowing area for wheat, intended investment in the framework of the program 'Rural Capacity Building' and opening up the next year of a free economic zone, in the surroundings of **Zvartnots** airport, for exporting of fresh agricultural produce.

Real GDP Growth Projection Probability Distribution
(quarter over same quarter of previous year)



Economic Growth Projection Probability Distribution

Economic growth interval	Probability of economic growth interval			
	Q4, 2010	Q1, 2011	Q2, 2011	Q3, 2011
< 1%	6.34%	2.85%	9.97%	6.68%
1 - 4%	55.00%	34.61%	31.08%	20.25%
4 - 7%	31.12%	41.75%	31.00%	27.37%
7 - 10%	6.90%	17.32%	17.99%	22.50%
10 - 14%	0.64%	3.35%	7.40%	15.90%
14% <	0.01%	0.10%	0.96%	5.38%

Labor Market¹²

Due to the slowing of economic growth rates, forecasts of demand for labor for the fourth quarter of 2010 and for the period January-September of 2011 have

¹² The labor market data for 2010-2011 are the Central Bank estimates which are based on actual figures of the second quarter of 2010 and July-August of 2010. The growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

been revised downside predicting, in particular, somewhat a lesser level of average nominal wages and a higher level of unemployment in the economy.

In the fourth quarter average nominal wages are expected to increase by nearly 7.5 percent due to continued growth of productivity observable in the private sector since the start of the year and moderate growth of wages in some budget-supported organizations. In this case, the growth of average nominal wages in 2010 will be up to 7 percent.

Over the first nine months of 2011 the growth rate of average nominal wages will increase compared to the respective indicator recorded in the previous year, amounting to around 9 percent. The reduction in the rate of unemployment will notably affect acceleration of the growth rate of wages.

Although economic growth rates slowed down, in the fourth quarter demand for labor will continue to grow because of an increase in output in industry and services, which will reduce the number of the unemployed. Under this circumstance, in the fourth quarter the average level of the officially unemployed will diminish to some extent in relation to the same period of the previous year, reaching 6.8 percent.

In the period January-September of 2011 average unemployment will make up 6.7 percent, reducing by 0.4 pp in relation to the same period of the previous year.

As a result of the above said developments, in the fourth quarter the growth rate of nominal wages will outpace the productivity growth rate, leading to about 6 percent rise in unit labor costs. This will create minor (0.4 percent) inflationary pressures in the economy.

The continuing growth of average nominal wages over productivity in the period January-September of 2011 will lead to about 5 percent rise in unit labor costs, as a result of which inflationary pressures will amount to 0.3 percent.

Aggregate Demand¹³

Private Sector Spending

Estimations of private sector spending for the fourth quarter of 2010 and for the period January-September of 2011 have been revised slightly downside, based on the expected slowdown of the economic growth rates.

According to revised estimations, in the fourth quarter of 2010 private expenditures are expected to grow by about 5 percent, which is determined by both increased private consumption and private investments. Further, private investments will grow by nearly 10 percent, reflecting improved expectations of economic agents¹⁴, growth of remittances from abroad and sustainable recovery of external demand. Estimations suggest that in the fourth quarter private consumption will grow by about 3 percent fuelled by the growing private disposable income and restored consumer confidence. Under such developments, growth rates private consumption and private investment figures will be 3.5 percent and 9.5 percent, respectively.

Over the first nine months of 2011 private spending will keep on growing at a moderate pace, in the circumstances of steadily growing world and domestic economies. The growth of private investments will reach 11 percent, reflecting continuation of the investment process commenced from 2010 and structural shifts in the economy in the form of faster growing *industry* and *service* branches

¹³ The data of real growth of private consumption and investments for 2010-2011 are the Central Bank estimates, and their preliminary actual figures are as of the second quarter of 2010. The real growth indicators represented in this sub-section are relative to the same quarter of the previous year, unless otherwise specified.

¹⁴ Compound economic indices calculated by the Central Bank point to economic agents' optimism for a better economic environment in future.
See http://www.cba.am/CBA_SITE/statistics/complex_index.html?__locale=hy.

in relation to all other branches of the economy. The growth of private consumption will amount to 3.6 percent fuelled by increased disposable household income derived mainly from money remittances from abroad as well as real GDP growth.

In the period from the fourth quarter of 2010 through the third quarter of 2011, the gap between private spending and their potential level (which has been caused by the crisis in 2009) will slowly downsize thanks to slowly growing private spending. It should be noted that in the third quarter of 2011 the private spending gap, though steadily slimming down, will still remain negative. As a result of the above said developments, in the fourth quarter of 2010 private spending will be 1-2 percent below the potential level, creating 0.3 - 0.6 percent deflationary pressures in the consumer market. Over the first nine months of 2011 private spending will be 0 - 1 percent lower from the potential level, thus creating deflationary pressures in the economy, to the extent of 0 - 0.3 percent.

Current Account

Forecasts of current account components of Balance of Payments have incurred certain changes, reflecting continued recovery in global economy and slackened growth rates of the domestic economy.

In the third quarter growth rates of export and import lost their speed, and such deceleration will go on in the fourth quarter as well, primarily in terms of import. So, the fourth quarter forecasts inclusive, the growth of export of goods and services in dollar terms in 2010 will reach 27 percent. The growth of real export of goods and services in 2010 will persist around 7 percent.

Based on downside revised forecasts of the fourth quarter, the growth of import of goods and services in dollar terms will be in the lower floor of the previously predicted range of 12 - 15 percent. This will be determined by the slowing of growth rates of the domestic economy. The forecast of the growth of real import of goods and services for the end-2010 period is estimated to make up 3.0 percent, instead of the previous forecast of 6 - 8 percent.

The growth of non-commercial remittances by individuals in the end-2010 will persist within the previous forecasts, i.e. in the range of 10 - 15 percent. This will be determined mostly by developments in Russian economy.

All aforementioned developments suggest that at the end of 2010 the current account deficit/GDP ratio will be below the 15 percent mark, which is somewhat an improvement against the previous year's 16.2 percent.

No essential changes have been made to the 2011 forecasts, with export and import figures slightly adjusted downside. There is expectation of 5 - 7 percent growth of export of goods and services in dollar terms and 3 - 5 percent increase in real volumes. The latter will largely depend on positive developments in global economy and domestic economy.

The growth of import of goods and services in dollar terms will be within 3 - 5 percent, whereas real import of goods and services are expected to shrink in 2011, especially over the first half of 2011. This will be determined mostly by reducing budget deficit as well as by growing import prices under the budget constrained of economic agents.

The growth of non-commercial remittances of individuals is expected in the range of 9 - 13 percent in 2011, which will be largely depending on economic developments in Russia. New forecasts by the IMF suggest that Russia's economic growth indicator in 2011 will reach 4.3 percent, somewhat higher an indicator from previous forecasts.

As a result of these developments, it is already expected that the current account deficit to GDP ratio in 2011 will improve faster and will be within the range of 11.5 - 13.5 percent.

Consolidated Budget¹⁵

The fiscal policy is forecast to have a less expansionary impact (2.5 pp) on aggregate demand provided that the fiscal sector developments over the first nine months are consistent with the projections and the annual revised state budget is performed adequately. It should be noted that the 2010 fiscal policy was the continuation of an expansionary policy that was called to stimulate domestic demand in the previous year. However, since a general policy was to suppress inflationary environment, the fiscal policy proved less and less expansionary over the quarters owing to overperformance on the budget revenues and some savings on expenditures. Economic recovery tendencies observed since the beginning of the year served a good ground for enhanced tax collection which, coupled with more savings over the planned expenditures, contributed to the reduction of budget deficit.

For 2011, the impact of the fiscal policy on aggregate demand has been assessed based on the figures of the draft law on state budget 2011. The draft law provides for 0.2 pp increase in the tax/GDP ratio and about 7 percent growth on the expenditures part. As a result, the deficit/GDP ratio in 2011 will lessen, too.

On a 12-mnth basis, the fiscal policy's impact on aggregate demand hence inflation is expected to be as little as 1 pp expansionary, which will be attributable mainly to expansionary impact of expenditures.

To sum-up, in the fourth quarter of 2010 the fiscal sector will have a less expansionary impact on aggregate demand, which will not lead to inflationary pressures in the wake of deflationary environment thus fuelled by private spending. Taking also into consideration the weak inflationary pressures from the labor market, one may see that the net impact of domestic demand and labor market on inflation in the fourth quarter of 2010 will be in the range of 0.3 - 0.6 percent.

Over the first nine months of 2011 the fiscal sector will continue to have weak expansionary impact on domestic demand, which will not create significant inflationary pressures in the consumer market because of persistently low level of private spending. Considering also certain inflationary pressures from the labor market one may conclude that the net impact of domestic demand and labor market on inflation will be in the range of 0.2 - 0.5 percent.

Money and Credit

In view of current economic development prospects, the prevalence of supply-side factors over the shaping of inflationary environment as well as the Central Bank judgment that by the end of the forecast horizon inflation will rest within the target band, a conservative monetary policy for the upcoming 12-month period is preferable.

In this context, forecasts of monetary indicators for the upcoming 12-month period subsequent to September 2010 have been based on macroeconomic environment of the previous quarter, projections of macroeconomic developments for the next one year and the fiscal policy scenario developed for that period. Taking also account of possible effect of anti-dollarization measures, the Central Bank predicted a faster growth of dram broad money (17.2 percent) over broad money (15.4 percent) for the upcoming 12-month period. In the meantime monetary base is expected to grow by 8.9 percent. There is

¹⁵ The fiscal sector's impact has been estimated based on preliminary adjusted program of public sector indicators for 2010.

expectation that the dollarization of the economy will further subside, resulting in the faster growth of dram deposits over foreign currency deposits, 23.6 percent versus 13.1 percent, respectively.

Lending to the economy by the financial sector will remain period targeted primarily for small- and medium-size enterprise and mortgage market development projects over the next 12-month. As a result, the economy lending indicator will grow by around 11 percent y-o-y.

In the monetary sector possible risks are pertinent to a greater demand for the dram owing to collaborative action by the Central Bank and the Government to fight dollarization and the GDP demonstrating higher-than-expected growth patterns.

INFLATION FORECASTS AND MONETARY POLICY DIRECTIONS IN THE PROJECTED 12-MONTH PERIOD

Inflation and monetary policy directions have been forecast using the Quarterly Projection Model of the Central Bank based on actual macroeconomic conditions formed in the third quarter of 2010. According to the estimates current inflation had been a result of the impact from supply shocks primarily observed in the third quarter, yet the tightened monetary conditions and moderate rates of aggregate demand recovery remain supportive in easing the inflationary environment.

Forecasts made under initial macroeconomic conditions mentioned above provide for the following macroeconomic developments determining inflation behavior: it is expected that aggregated demand will further be recovering in the forecast horizon yet GDP will remain below the equilibrium as economic growth is still pacing slowly. At the same time, existing negative GDP gap, surpassing growth rates of export over import, state budget deficit reduction and more vibrant inflow of capital will facilitate a faster shrinkage of current account deficit. Given these developments there is expectation that the 12-month inflation will continue settling down until it rests within the target, preferably since the second half of the previous year, when the impact of supply shock finally come to an end.

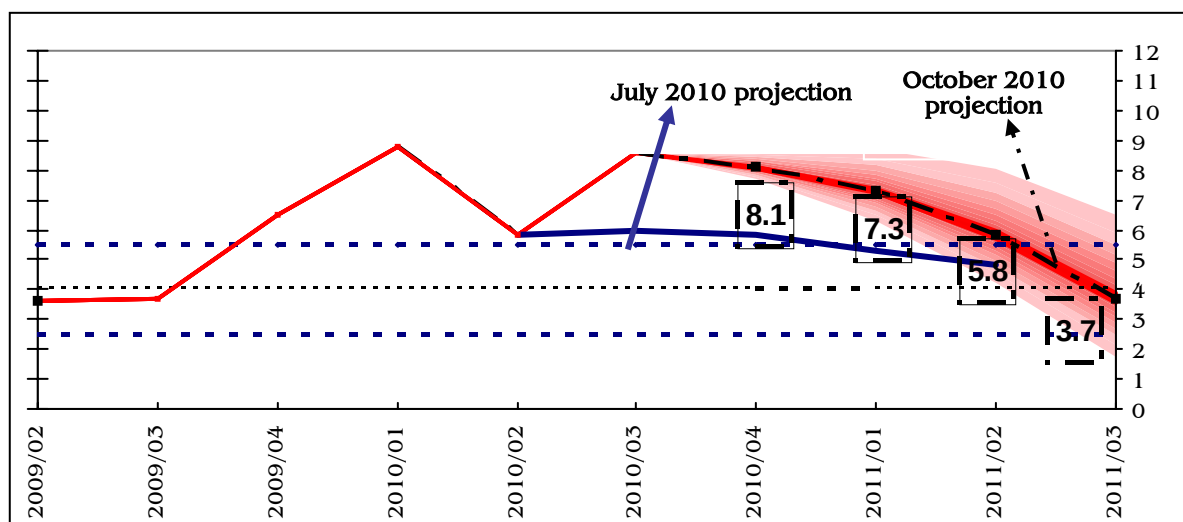
Results derived from an inflation model by the individual commodity groups also point to such change directions for both inflation and inflation environment. So, when considering an unchanged level of interest rates, inflation is forecast to amount to 8.1 percent in end-year, and 3.7 percent y-o-y at the end of the third quarter of 2011.

Meanwhile, in the forecast time horizon there exist risks that the inflation indicator may move both upside and downside the forecast value.

Upside risks are prevailing and associated with: i) the possibility of higher-than-expected international prices of intermediate goods and food products as a result of stimulus-fuelled macroeconomic policies in leading industrialized countries and faster recovering economies of emerging countries, and ii) faster recovery of the domestic demand as well as possible inflationary pressures in the domestic economy to derive from a likely change in administered prices as well as from a legislative initiative mandating a transfer of excise duty and presumptive tax on tobacco onto a general field of taxation.

Downside risks may emerge under influence of faster-than-expected growth rates in agriculture where a favorable price situation may positively contribute to the growth in this branch.

Inflation Projection Probability Distribution Chart (12-month)



Inflation Projection Probability Distribution

Inflation interval	Probability of inflation interval	
	Q4, 2010	Q3, 2011
< 3.0%	0.00%	23.36%
3.0 - 4.0%	0.00%	26.21%
4.0 - 5.5%	0.00%	33.23%
5.5 - 7.5%	0.55%	15.64%
7.5 - 9.5%	99.44%	1.52%
9.5% <	0.00%	0.04%

Taking into account of possible inflation developments, whereby inflation in the forecast horizon will be within the target, a conservative approach of the Central Bank for now is most reasonable. However, depending on how estimated risks would emerge, a revision of the policy rate is not ruled out.