

THE CENTRAL BANK OF
THE REPUBLIC OF ARMENIA

*Approved under the Central Bank Board
Resolution No. 134A, dated September 24, 2019*

Inflation Report

Monetary Policy Program, Q3, 2019



*Status Report on Implementation of the Monetary
Policy Program, Q2, 2019*

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

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

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

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

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

Projections in this report are based on the actual information available by September 10, 2019, i.e. the day on which the refinancing rate was set, the results of a survey conducted by the Bank and the judgment made pursuant to the information on future developments of the macroeconomic environment.

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

Table of Contents

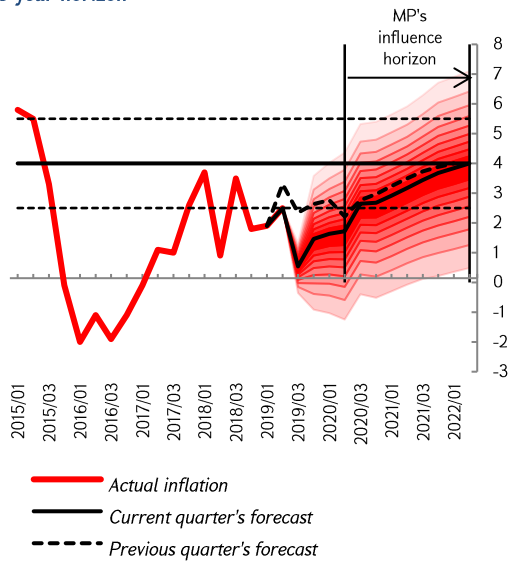
1. Executive summary	4
2. Forecast, forecast changes and risks	5
2.1. External environment	5
<i>Box 1: The uncertainties in the world economy have grown</i>	<i>6</i>
2.2. Forecasts	9
2.2.1. Inflation and monetary policy	9
2.2.2. Economic activity	11
2.2.3. Comparison with the previous forecast	13
2.2.4. Main assumptions and risks	16
<i>Box 2: The results of survey on the expectations by the households and the financial system</i>	<i>16</i>
<i>Box 3: Long-term sustainable GDP</i>	<i>19</i>
3. Actual developments in Q2, 2019	20
3.1. Inflation	20
3.1.1. Fulfilment of the inflation target	20
3.1.2. Prices	21
3.2. Economic developments	22
3.2.1. Economy position	22
3.2.2. The expenditures aspect of the economy	23
3.2.3. The production aspect of the economy	24
3.2.4. Labor market	25
3.3. Financial market developments	25
Annex	
Minutes	28
The CBA Board Decision on interest rates	30
Press release	31
Main macroeconomic indicators	32
Charts	33
Tables	34

1. EXECUTIVE SUMMARY

The inflation environment remained low in the third quarter of 2019 due to some external and domestic factors, under which circumstance the Central Bank further pursued an expansionary monetary policy.

Chart 1

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

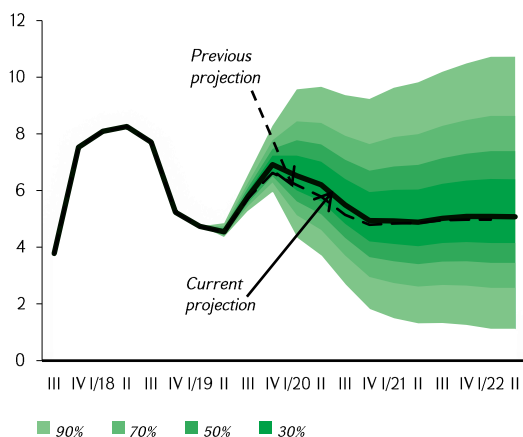


Source: Armenia Statistics Committee,
Central Bank forecast

Economic activity remains strong over the third quarter of 2019, too. This trend is estimated to be persisting in the short-term, under which circumstance the 2019 economic growth forecast has been revised upside by an average 6.9%.

Chart 2

Real GDP (cumulative)¹ growth projection probability distribution for 3-year horizon



Source: Armenia Statistics Committee,
Central Bank forecast

The inflation environment in the third quarter of 2019 was weak, influenced by some external and domestic factors, and the Central Bank of the Republic of Armenia (the Central Bank) continued pursuing an expansionary monetary policy. The Central Bank estimates that at present the low inflation contributes to anchoring long-term inflation expectations and maintaining the purchasing power of income, so a policy steered to the gradual recovery of inflation is still preferable. As a result, the inflation will still be running below the target in the upcoming months and stabilize around it in the medium run.

According to the third quarter 2019 MP program, in the short term perspective the main factor contributing to the low inflation remains a sluggish aggregate demand which, in turn, incurs the impact of subsiding inflationary environment in the external sector and the Government's contractionary fiscal policy. While the fiscal policy's contractionary impact on aggregate demand is expected to weaken by the end of the year, it will remain so throughout the year. At the same time, amid increasing uncertainties of trade wars in the external sector, certain deflationary patterns are observable in major international commodity markets. For a secured path to forecast inflation, the **Central Bank's Board finds it reasonable to add to the monetary stimulus and predicts that** in view of anticipated macroeconomic developments it will keep the monetary stance expansionary in the medium run as well.

The economic activity remains strong over the third quarter of 2019, too. As this trend is estimated to be persisting in the short run, the 2019 economic growth forecast has been revised upside by an average 6.9%; in the mid-term perspective it will approach its long-term equilibrium.

The baseline scenario suggests that the 2019 economic growth will mostly be fueled by growth in the services and, partly, industry sectors, accompanied by persistently high private consumption growth. Mid-term economic growth will largely be determined by expanding of production capacities, the pace at which the Government will push forward the structural reforms and what economic growth potential can be expected in partner countries.

¹ The growth rate of each quarter is calculated as the cumulative growth rate for the last four quarters.

In the forecast horizon, downside risks to the inflation path and slightly upside risks to the economic growth outlook prevail (see subsection 2.2.4 “Main assumptions and risks”). If predicted macroeconomic developments unfold and these risks materialize, the Central Bank will adjust the monetary conditions accordingly, while fulfilling the goal of price stability.

2. FORECAST, FORECAST CHANGES AND RISKS

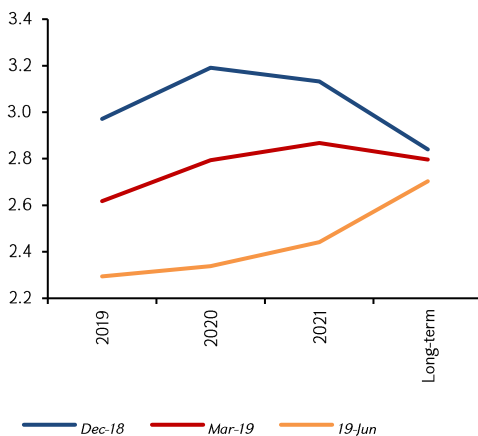
2.1. External environment

The global economy further slowed down in the first half of 2019 and this tendency is expected to be observable up until the end of the year.

The slowing of global economic growth continued in the first half of 2019 and it is predicted to persist up until the yearend. In particular, in the second half of 2019 slow economic growth rates are expected in the United States, the Eurozone and Russia – the main trade partners to Armenia.

Chart 3

FRS's interest rate path according to the FRS Board
(average weighted values, %)



Source: US Federal Reserve System

Economic developments and inflation in the United States:

According to the “second” estimate by the U.S. Bureau of Economic Analysis, driven mainly by a shift in private consumption, economic growth in the USA in the second quarter of 2019 was 2.3% y/y, with average economic growth predicted to be 2.3% for 2019. The unemployment rate in the second quarter of 2019 remained low, 3.7%. The economic growth rate is predicted to slow down to some extent over the next quarters as investments are anticipated to contract under the influence of a trade war between the United States and China.

In the USA in the second quarter of 2019, the average quarterly personal consumption expenditure price index² has decreased relative to that of high figure reported in the previous year, to 1.4%, shaping below the US Federal Reserve’s medium-term target. Taking into account actual growth developments and further uncertainties that may arise from the trade war (see Box 1) and in view of actual low inflation, the Fed cut the policy rate in July 2019 by 0.25 pp, setting it in a 2.00–2.25% range. Given that markets’ expectations of economic growth are pessimistic too and that the inflation is running below the target (it amounted to 1.4% in July), easing of monetary policy conditions by the Fed is anticipated in both short and medium run.

² The personal consumption expenditure price index target is 2%, which on average is commensurate with headline inflation of 2.4%.

Box 1:

The uncertainties in the world economy have grown

Uncertainties in the global economy, the main source of which is an ongoing US-China trade war, keep on growing day after day. The problem is not just the increase in customs duties individual sectors of the US or Chinese economy are suffering most from, but the fact that these uncertainties call into question the further course of global economic relations that have led to a decline in investment and household consumption levels in the United States and China, on the one hand, and in their trade partner countries, on the other.

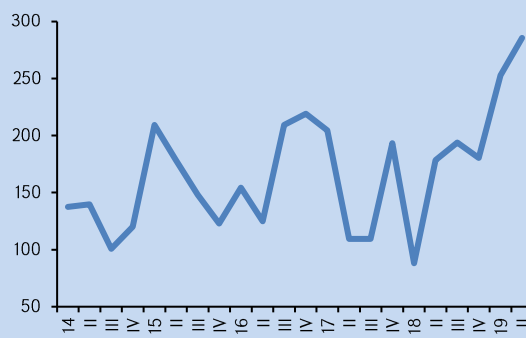
Existing economic uncertainties and rising trade tensions have caused global trade volumes to decline, since the more the economic uncertainties deter investment, the so more can they negatively affect trade because of capital goods being largely imported. For this reason, the world trade policy uncertainty index has risen sharply after having been stable at low levels for many years. This rising of the index started in the second quarter of 2018 when rumors of ascending US and Chinese customs duties began circulating. As these uncertainties are mounting, the world economic growth may slow down: according to IMF estimates, basing upon the first quarter 2019 data, growing trade uncertainties may trim down the 2019 world economic growth by 0.75 pp³.

The purchasing manager index, PMI, in the manufacturing has also suffered the negative influence of trade policy uncertainties. This, coupled with the business sentiment index, has been steadily declining due to cuts or delays in investment into the business, which in turn is explained by a high degree of uncertainties.

Thus, the rise in uncertainties affects various sectors of the economy through a contraction in trade and capital investment, which leaves a negative impact on the world economy.

Chart 4

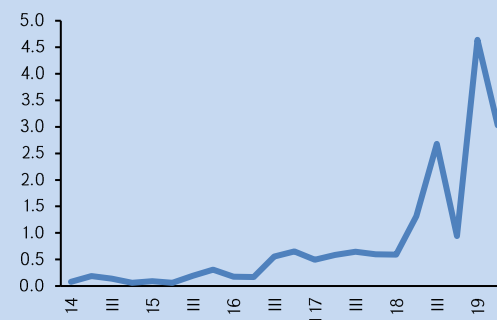
The world uncertainty index



Source: Economic Policy Uncertainties

Chart 5

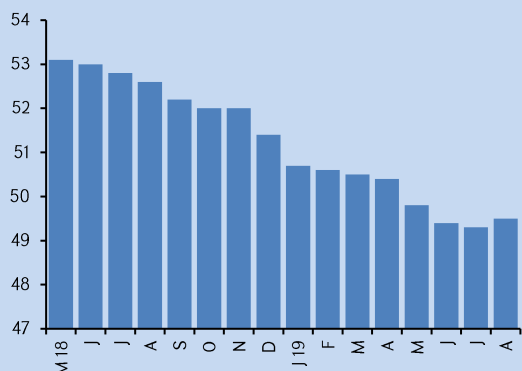
The world trade uncertainty index



Source: Economic Policy Uncertainties

Chart 6

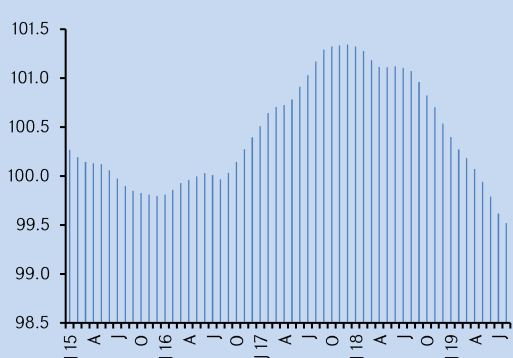
The world purchasing managers' index, PMI



Source: IHS Markit

Chart 7

The business sentiment index



Source: ECD Statistics

³ "World Economic Outlook", IMF, July 2019.

Economic developments and inflation in the Eurozone:

According to preliminary estimates provided by the Eurostat, economic growth in the Eurozone in the second quarter of 2019 was 1.1% y/y, with an average growth indicator of 1.1% estimated for 2019. Of member states, Spain, France and Portugal have contributed positively, whereas Germany, with its economic growth slowed mainly due to a reduction in export volumes, has contributed negatively, to the Eurozone's economic growth. The unemployment rate in the Eurozone continued to decline, to 7.5% in June.

In the Eurozone in the second quarter of 2019, the average quarterly inflation persisted at a 1.4% level, still running below the European Central Bank's target. The low inflation owed primarily to oil prices and service tariffs while core inflation continued to decline due to low service tariffs. To steer low inflation to its target, amid a sluggish economic growth, the ECB has announced that it will continue to pursue a low interest rate policy at least by mid-2020 and, if necessary, will resume the program of quantitative easing through purchases of assets.

Economic developments and inflation in Russia:

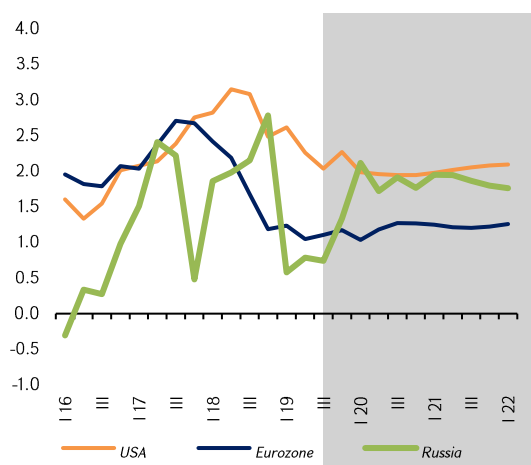
According to preliminary estimates by State Statistics Service of the Russian Federation, the average economic growth in the second quarter of 2019 somewhat accelerated to 0.9% y/y. In consideration of the actual data of the first and second quarters, the average economic growth is estimated to be 1.0% for 2019. The second quarter's indicator was mainly driven by somehow improved investment climate in Russia and a positive contribution coming from net exports. With such economic activity, Russia's unemployment rate dropped to 4.5% in the second quarter, creating no extra inflationary pressures.

In the second quarter of 2019 the average quarterly inflation in Russia decelerated to 5.0% from that of 5.1% reported in the previous quarter, which still runs above its target. However, it keeps on reducing (it dropped to 4.6% in July), driven by weak domestic demand and retreating impact of the VAT increase effected since the beginning of the year. With inflation declining smoothly, the Bank of Russia cut the policy rate in the second quarter of 2019 by 0.25 pp to 7.5%, followed by a decision to reduce it further by 0.25 pp in July. As both inflation and inflation expectations are set to decline, the Bank of Russia is expected to continue pursuing an expansionary monetary policy in the future.

Developments in world commodity and food product markets:

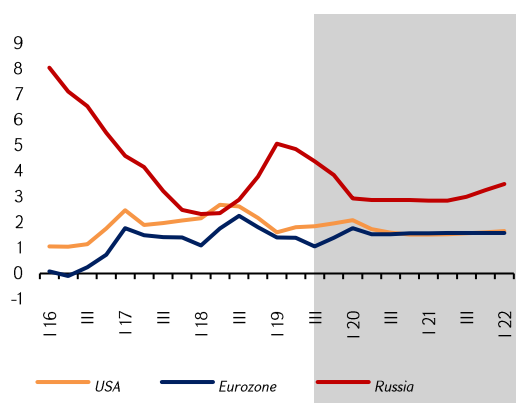
In the second quarter of 2019 weak global demand continued to contribute to lower prices in commodity and food product markets in comparison with the previous year.

Chart 8
Economic growth in trade partner countries, (%)



Source: Bureau of Economic Analysis (BEA), Eurostat, Rosstat, Central Bank forecast

Chart 9
Inflation in trade partner countries, (%)



Source: Bureau of Labor Statistics (BLS), Eurostat, Rosstat, Central Bank forecast

In the second quarter of 2019 the prices in world commodity and food product markets further dropped relative to the previous year, on the back of a sluggish global demand.

In the second quarter of 2019 the euro exchange rate versus the US dollar depreciated by 1.05% q/q to 1.123 dollars per euro while the Russian ruble appreciated by 1.9% q/q to an average RUB 64.5 per dollar.

In the second quarter of 2019 international copper prices decreased slightly compared to the previous quarter, which was driven by a resumed trade war between the United States and China, and it is expected that a relatively low level of copper prices will still be lingering over a short run. International oil prices proved more volatile compared to the previous quarter, shaping at lower levels. The fall in prices largely owed to the weakening of world demand amid the US-China trade war. And, on the contrary, the political turbulence between the US and Iran pushed the prices up. In the short term, international oil prices are expected to remain at low levels.

In food product markets in the second quarter of 2019, wheat and dairy product markets posted price decreases in relation to the previous quarter whereas prices somehow grew in sugar, meat product and vegetable oil markets. The decline in dairy and wheat prices has been driven by large supply volumes; sugar prices have increased thanks to the currency appreciation in Brazil, a principal sugar exporter, while the rise in meat prices was further determined by a limited supply in that market. In a short-term perspective, weak inflationary environment will persist in food markets, the meat market in particular.

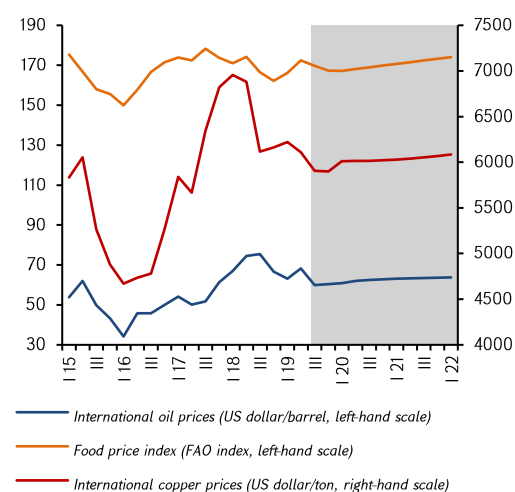
2.2. Forecasts

2.2.1. Inflation and monetary policy

In the current quarter the inflation persists at a relatively low level. The Central Bank estimates that the monetary conditions need to be more stimulative in light of persisting deflationary environment in the external sector, on the one hand, and current budgetary developments in the domestic economy, on the other. As a result, the inflation, still running below its target over the upcoming months, will stabilize around it in the medium run.

As current indicators point out, high growth rates in economic activity are persisting. In the third quarter of the year, economic activity remains strong mainly thanks to the growth in services and

Chart 10
International prices of raw materials and food products

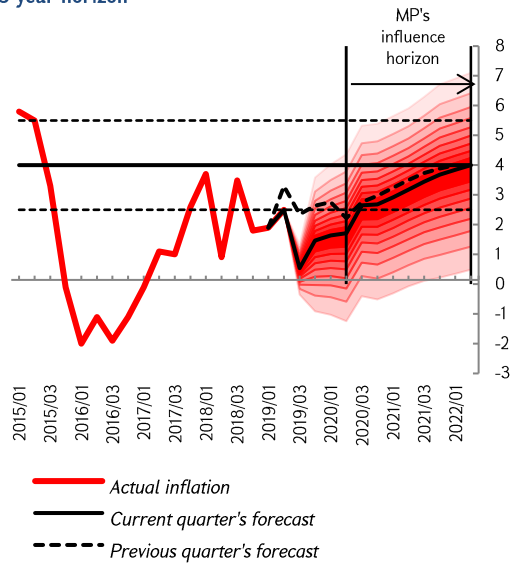


Source: World Bank, FAO, Central Bank forecast

The Central Bank reckons that the monetary conditions need to be more stimulative in the context of persisting deflationary environment in the external sector and current budgetary developments.

Chart 1

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



Source: Armenia Statistics Committee,
Central Bank forecast

manufacturing in terms of supply and increased private consumption in terms of demand. Aggregate demand further incurs the contractionary impact of public demand as well. As a result, the GDP gap is estimated still negative for the third quarter of 2019, which, however, is lower than the second quarter estimate. There is expectation that the budget will have an expansionary impact on aggregate demand at the end of 2019, absorbing contractionary effects observable early in the year; as a result, it will be somewhat contractionary for the year. In view of such developments, the GDP gap will still be in the negative territory and will only be gradually phasing out to zero in 2020 thanks to an increasingly expansionary monetary environment, gradually stabilizing economy in the external sector and the neutral impact of fiscal policy in 2020. As the aforementioned developments unfold, inflation will still float at a low level in the upcoming months and will only stabilize around the target at the end of the forecast horizon. Short-term inflation expectations of the public are estimated virtually intact on the back of current developments in inflation and core inflation in particular, and will continue to follow the inflation trends. Nevertheless, these will also stabilize around the target, as inflation rebounds. The Central Bank still prefers an inflation recovering gradually to an inflation that needs extensive stimulation, since the former scenario contributes to anchoring long-term inflation expectations and maintaining the purchasing power of income. **As things currently stand, the Central Bank's Board finds it reasonable to add to the monetary stimulus by reducing the refinancing rate.** At the same time, in anticipation of macroeconomic developments, an expansionary monetary stance needs to be maintained over a medium run, too.

Table 1

Period	Inflation interval forecast probability distribution				
	<1.0%	1.0-2.5%	2.5-5.5%	5.5-7.0%	>7.0%
Q3 19	83.9%	16.1%	0.0%	0.0%	0.0%
Q4	39.5%	40.6%	19.8%	0.1%	0.0%
Q1 20	36.7%	37.3%	25.7%	0.4%	0.0%
Q2	36.5%	33.9%	28.7%	0.8%	0.1%
Q3	19.9%	29.9%	46.4%	3.4%	0.4%
Q4	20.9%	29.2%	45.9%	3.6%	0.4%
Q1 21	17.8%	27.3%	49.5%	4.8%	0.6%
Q2	14.7%	25.1%	52.8%	6.4%	1.0%
Q3	12.3%	22.3%	54.6%	9.0%	1.8%
Q4	10.8%	19.8%	54.3%	11.8%	3.3%
Q1 22	9.6%	18.5%	54.5%	13.2%	4.2%
Q2	8.5%	17.1%	54.4%	14.8%	5.2%

2.2.2. Economic activity⁴

Aggregate demand: Economic growth has been rather high since the start of 2019, which was greatly fuelled by domestic demand and, particularly, vigorous private spending. The households' consumer preference has grown significantly in light of positive expectations, which has led to an increase in demand for consumer loans, according to the Central Bank estimates. As a result, increased private spending owed primarily to a rather high growth in private consumption, which in turn has largely been financed by credit resources. Given a somewhat torpid nature of consumption as well as currently robust lending to households, private consumption in 2019 is anticipated to grow farther. On the contrary, the growth of gross private fixed asset accumulation has slowed down since the start of the year. Taking into account the currently moderate growth of business lending and construction and that the import of investment goods has been slower in comparison with the last year's high growth, a considerable acceleration of the growth of gross private fixed asset accumulation over 2019 is not likely. In the outcome, in 2019 private consumption will grow by 13.5%, gross private fixed asset accumulation, by 5.6%, and private spending, by 12.3%.

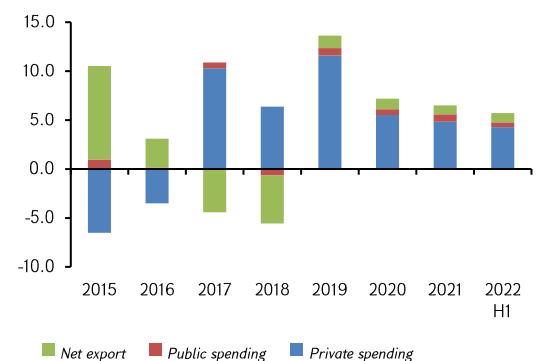
The mid-term forecasts do not vary much from previous Central Bank estimates; private spending will remain a key contributing factor, but it is expected that public spending and net exports will bring their positive contribution as well. Moreover, a slightly higher contribution from net exports is possible amid an upward revision of the industry's growth rate. The mid-term growth depends on the expanding of production capacities in the economy, the pace of structural reforms led by the Government, the economic growth potential in partner countries to Armenia, and positive developments and expanding possibilities in the tradable sector of the economy and, in the long run, also on demography-related factors (see Box 3).

External demand: The previous year's negative contribution of net export to real GDP will retract during 2019. Forecast revisions for the second half of the year mainly relate to the export and private remittances. The real growth of export of goods and services in 2019 is predicted in the range of 5.0-7.0%, given that the mining industry rebounds (including reopening of the Teghut mine) and such recovery patterns stay healthy.

The real growth of import of goods and services remained almost unchanged in the second half 2019, and its growth rates are expected within 1.0-3.0% for 2019.

Chart 12

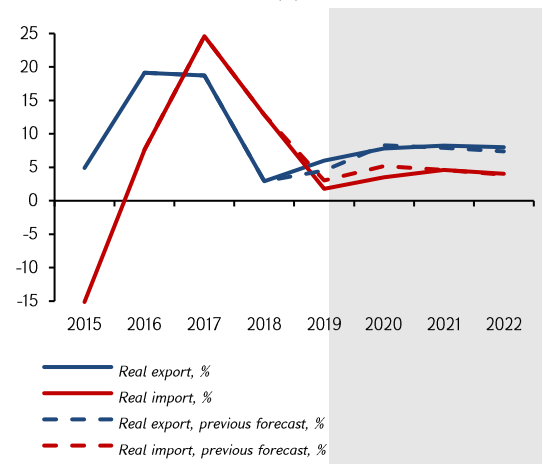
Demand components contributing⁵ to the growth (percentage point)



Source: Armenia Statistics Committee, Central Bank forecast

Chart 13

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



Source: Armenia Statistics Committee, Central Bank forecast

⁴ For a detailed economic growth forecasts, see the "GDP Projection Probability Distribution", chart 23, table 2.

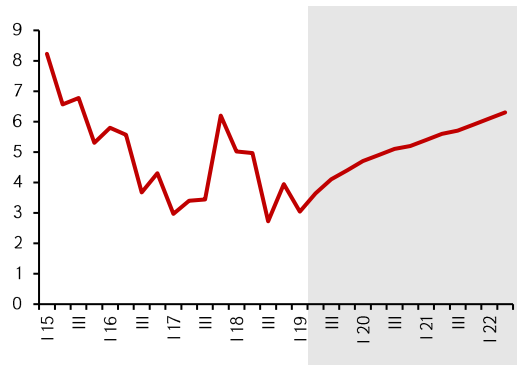
⁵ The change in tangible working capital inventories is not included in demand, so economic growths calculated by supply and demand may vary from each other.

The growth of net inflow of remittances in the second half of 2019 was revised downside due mainly to the slowing of the growth in construction and trade sectors of the Russian economy. If the developments unfold this way, the growth of net inflow of private remittances will be in the range of 1.0-3.0%.

As a result of the aforementioned developments, the current account deficit-to-GDP ratio⁶ in 2019 will persist within the previous forecast of 7.0-8.0%. In the medium run, if bolstered by a faster growth of export, the ratio will stabilize within its estimated equilibrium of 3.0-5.0%.

Chart 14

Nominal wage growth in private sector, y/y (%)

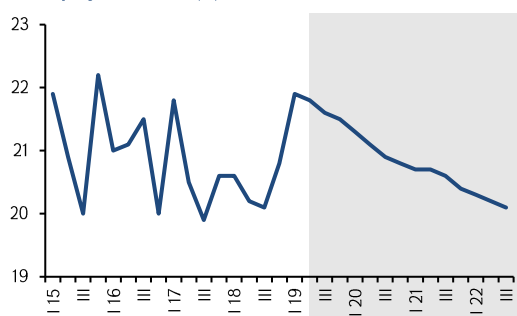


Source: Armenia Statistics Committee,
Central Bank forecast

In 2019, relative to 2018, the fiscal policy's impulse on aggregate demand is an estimated 0.5 pp contractionary.

Chart 15

Unemployment rate, (%)



Source: Armenia Statistics Committee,
Central Bank forecast

Fiscal policy: The **fiscal policy's impact** on aggregate demand in 2019 was estimated using the revenue and expenditure indicators, so outlined in the Republic of Armenia Law on "State Budget 2019" and adjusted⁷ under individual decrees of the Government.

Tax revenues are projected to outperform the relevant budget law indicator by some AMD 62.0 billion, in which case the tax-to-GDP ratio will amount to 22.2%, up by 1.3 pp compared to the previous year. In the meantime, the Government has decided to refund the economic agents as much as AMD 56 billion⁸ as a VAT debit balance that had accrued by July 1, 2017, in which event the tax-to-GDP ratio⁹ will reach 21.4%, up merely by 0.5 pp against the previous year.

As to public expenditures, given the first half's budget performance (expenditures totaled 79.8% of the adjusted plan), the amount of saving on annual expenditures (estimated to be 5.1% of the adjusted plan or nearly AMD 84.0 billion) has grown relative to the previous plan. The previous plan also envisaged an extra spending commensurate with AMD 62.0 billion-worth revenues outperformed, which will not happen if the above revenues are returned. The expenditure-to-GDP ratio will make up 23.7%, up by 0.2 pp relative to the previous year.

According to a preliminary assessment by the Ministry of Finance and the Central Bank, the budget deficit-to-GDP ratio in 2019 will amount to 1.5% (or 0.6%, if the abovementioned VAT refund is excluded) instead of 2.2% projected under the law.

Considering the above tax and expenditure estimates, and in view of the public expenditure and revenue, net of one-off streams and external payments, the 2019 fiscal policy's impulse on aggregate demand is minor, 0.5 pp contractionary, compared to that of 2018.

⁶ It should be noted that the current account statistics may have been flawed with some underestimations in connection with the exports by natural persons from Armenia to other countries of the Eurasian Economic Union; in the event these are included, the 2019-2022 forecasts of current account deficit will be smaller.

⁷ The indicators set by the laws on "State Budget of the Republic of Armenia" are allowed to be adjusted during the year under certain Government resolutions which are posted at: <https://www.e-gov.am>.

⁸ This will practically happen after the relevant law is passed by the National Assembly of Armenia.

⁹ The GDP forecast is the Central Bank estimate.

Overall, in the first half of the year the budget has incurred about 4.5 pp contractionary impact which will weaken largely owing to an anticipated AMD 56.0 billion-worth tax refund. Exclusive of the tax refund, the fiscal policy's contractionary impact will run above 1.0 percentage point for the year, which will be primarily attributable to a contractionary impact of revenues.

Consistent with the monetary policy rule and pursuing a sustainable fiscal and debt environment, the mid-term impact of fiscal policy is estimated to be neutral, according to the Medium Term Expenditure Framework for 2020-2022. Although assessed as neutral for 2020 by the Central Bank (preparing of the 2020 budget is underway), the fiscal policy's impact could also possibly be somewhat expansionary, judging by the MTEF directions.

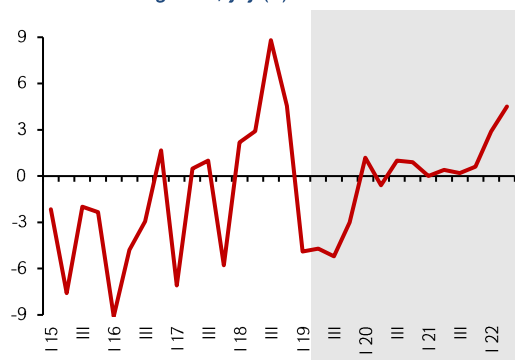
Labor market¹⁰: The growth rate of the private sector nominal wages will persist at the current level, 3.8%, in 2019. In the medium run, the private sector nominal wage growth will be in line with its fundamentals, i.e. the economic growth and inflation developments. So, in 2020 the growth of private sector nominal wages is predicted to reach 5.0%, and at the end of the forecast horizon it will stabilize around 5.7%.

Such developments in economic growth, including accelerated productivity growth rates, have been accompanied by an increase in the labor supply, which will keep unemployment at around 21.7% in 2019. The unemployment rate will subside by about 0.1-0.2 pp annually over a medium-term perspective, approaching a 20% level at the end of the forecast horizon.

In 2019, as productivity growth rate speeds up, the growth of firms' unit labor costs will be contained; at the end of the forecast horizon, as inflation recovers, it will stabilize around its fundamental value, i.e. the 4% inflation target.

Chart 16

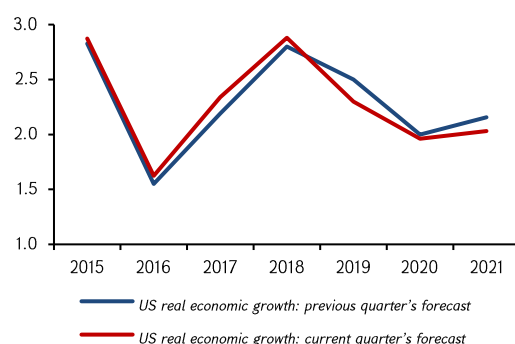
Unit labor costs growth, y/y (%)



Source: Armenia Statistics Committee, Central Bank forecast

Chart 17

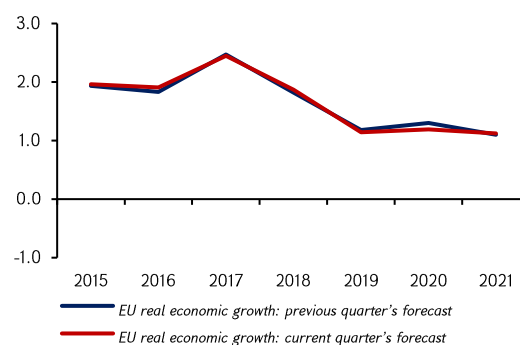
US economic growth forecasts, (%)



Source: Bureau of Economic Analysis (BEA), Central Bank forecast

Chart 18

EU economic growth forecasts, (%)



Source: Eurostat, Central Bank forecast

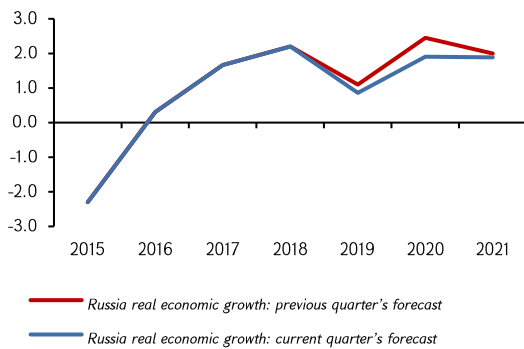
2.2.3. Comparison with the previous forecast

As investments slow down and external demand slackens amid increasing uncertainties resulting from US-China trade wars, short and medium-term economic growth indicators of partner countries to Armenia are predicted to run at levels below previous forecasts (see Box 1).

¹⁰ The labor market data for second quarters of 2019-2022 are the Central Bank projections which are based on the actual second quarter 2019 data. The growth indicators presented in this sub-section are relative to the same reference period last year, unless otherwise specified.

Chart 19

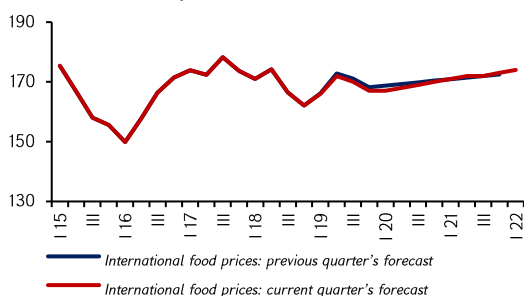
Russia economic growth forecasts, (%)



Source: Rosstat, Central Bank forecast

Chart 20

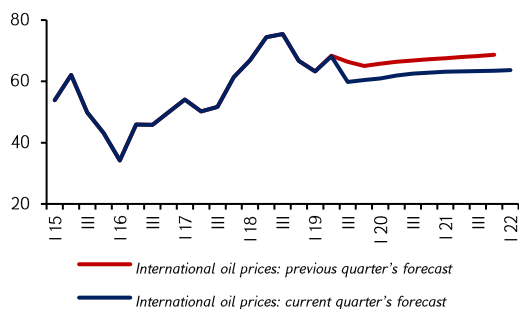
International food price forecasts



Source: FAO, Central Bank forecast

Chart 21

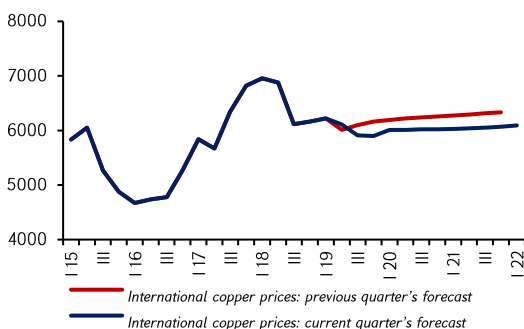
International oil price forecasts



Source: World Bank, Central Bank forecast

Chart 22

International copper price forecasts



Source: World Bank, Central Bank forecast

In the course of the second quarter of 2019, the US Bureau of Economic Analysis has revised economic growth indicators since 2014 which determines the difference in the historical segment for previous and current quarter forecasts. In the forecast segment, the US economic growth in 2019 will be slightly lower than projected in the previous quarter due to both the first quarter's strong indicator revised downside and an expected decline in external demand and investment because of trade wars. The latter also explains the downward revision of mid-term indicators.

The 2019 economic growth forecasts in Eurozone are close to the previous quarter's forecasts. In the medium term, however, the economic growth will be smaller due to the slowdown in the economies of major EU member states.

The current forecasts of economic growth in Russia in short and medium-term perspectives are somewhat below the previous quarter's forecasts. The slowing of the economy will be largely conditioned a weak external demand.

In the world's basic commodity and food product markets, even a weaker inflationary environment is anticipated, in comparison with the previous forecast, amid a persistently sluggish global demand.

In the world's food product markets in 2019 and over a medium run, inflation is predicted to be close to the previous forecast.

International oil prices are now expected at levels, much lower than forecast previously, in both short and medium-term perspectives, as global demand will remain sluggish throughout the forecast horizon.

International copper prices will shape at a level lower than outlined in the previous forecast, due to somewhat contracted demand because of the US-China trade wars.

For 2019, Armenia's economic growth rate was revised upside against the previous forecast; it remains much the same for the forecast horizon, however.

The 2019 economic growth forecast was revised slightly upside compared to the previous one and is an estimated 6.9%. The revision primarily owed to the accelerated economic growth in the mining sector, which was viewed as an alternative scenario¹¹ in previous forecasts of the Central Bank. The forecasts of the agricultural sector, on the contrary, were revised downside thus offsetting the growth of industry to a certain extent, and still the economic growth will be above the previous forecasts. Note that strong indicators of economic growth observable early in the year (see subsection 3. 2. 3) have been driven primarily by high activity in services and industry and coupled with two-digit consumption growth (see subsection 3. 2. 2). In the medium-term, economic growth estimates did not change notably and make up 5.0%;

¹¹ It mainly refers to the reopening of the Teghut mine.

the long-term growth which the economy needs to converge to in a 5- and more year horizon, is also estimated to be around 5.0% instead of the previously projected 4.5-5.0% range (see Box 2). In the medium term, services and industry will be the main drivers to the economic growth.

Facilitated by currently an expansionary monetary policy and in view of a stimulative effect of state budget expected from the second half of the year, the negative GDP gap will gradually phase out, and in the forecast horizon the economic growth will come closer to its mid-term potential.

Table 2

<i>Real GDP (cumulative) growth projection probability distribution</i>		
Period	30% probability interval	90% probability interval
January-December 2019 / January-December 2018	6.7-7.2	5.9-8.3
January-December 2020 / January-December 2019	4.2-5.9	1.8-9.2
January-December 2021 / January-December 2020	4.2-6.4	1.2-10.5
January-June 2022 / January-June 2021	4.1-6.4	1.1-10.7

In 2019 the current account deficit-to-GDP ratio will stay within the boundaries of previous forecast.

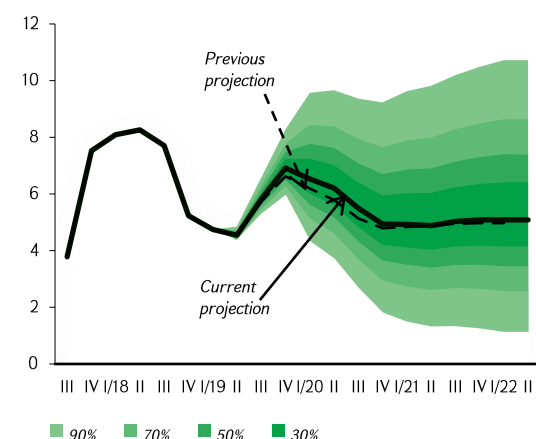
The fiscal sector's impact on aggregate demand will be up to 0.5 pp contractionary instead of an estimated neutral under the previous forecast (in light of anticipated 5.1% saving on public expenditures and AMD 56.0 billion-worth VAT debit balance refund in favor of economic agents).

Current forecasts suggest that the inflation in the short run will be below previous forecasts. While this is explained by a smaller-than-expected seasonal rise in prices of some agricultural goods, vegetables in particular, there is anticipation that it will be temporary and that by the end of the year the prices of seasonal goods prices will somehow recover.

In the meanwhile, core inflation will run at a slightly lower level than expected, driven mainly by deflationary developments in foreign markets. Consequently, in pursuit of the inflation target, the monetary policy stance needs to be even more expansionary, giving the aggregate demand an extra impetus to rebound and helping the inflation stabilize around the target at the end of the forecast horizon (see Chart “Inflation Forecasts Probability Distribution”).

Chart 23

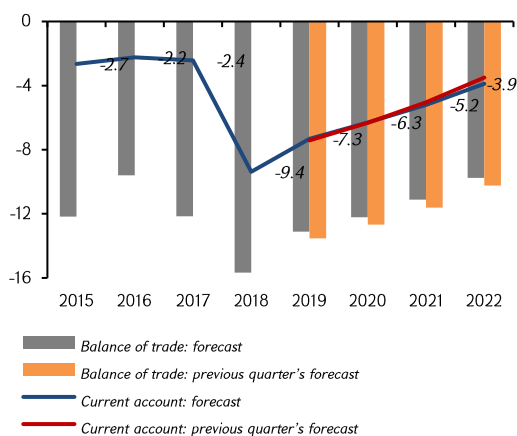
Real GDP (cumulative)¹² growth projection probability distribution for 3-year horizon



Source: Armenia Statistics Committee, Central Bank forecast

Chart 24

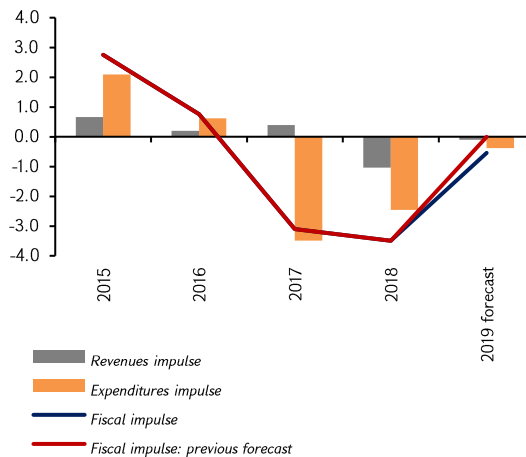
Mid-term current account-to-GDP ratio forecasts, (%)



Source: Armenia Statistics Committee, Central Bank forecast

Chart 25

Fiscal impulse forecast, (percentage point)

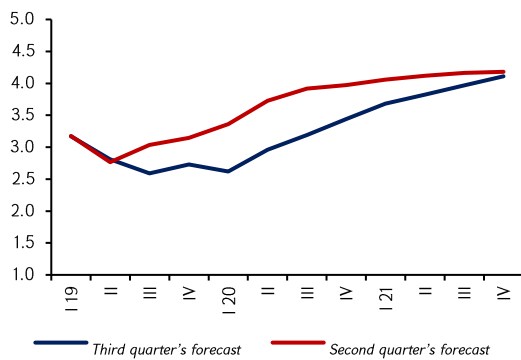


Source: Central Bank estimation

¹² The growth rate of each quarter is calculated as the cumulative growth rate for the last four quarters.

Chart 26

Short-term inflation expectation estimations, (%)



Source: Central Bank estimation

Short-term inflation expectations will in the near future linger around the value slightly lower than forecasted previously, reflecting, in fact, relatively steady core inflation rates at present and how slowly it might recover later on.

2.2.4. Main assumptions and risks

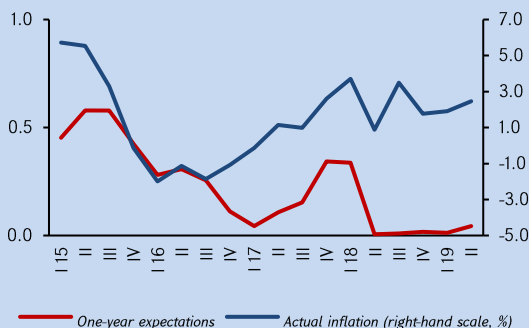
This section contains the main assumptions underlying the Monetary Policy Program for the third quarter of 2019 and the risks to implementation of the program, which derive from the external sector developments, the fiscal policy implementation, current trends and short-term forecasts.

Box 2:

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

Chart 27

Share of households expecting high and too high inflation in a one-year horizon



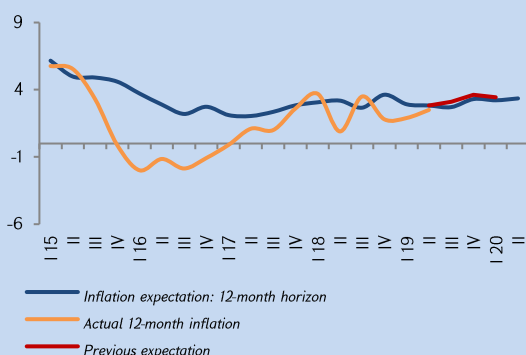
Source: Armenia Statistics Committee, Central Bank surveys

The second quarter 2019 survey on selected macroeconomic indicators which the Central Bank carries out each quarter by way of inquiries among households and companies in the financial sector denote that inflation expectations proved steady over the reporting quarter, with no noticeable changes relative to the previous quarter's figures. Specifically, the share of households expecting high and very high inflation rates for a one-year horizon in a total respondent base continues to be too small.

Inflation expectations of the financial system in the upcoming one-year horizon were generally of the same patterns when compared to the previous survey, with a slight movement downward: the average level of the financial system's inflation expectations in a one-year horizon amounted to **3.1%**.

Chart 28

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



Source: Central Bank surveys

Forecast assumptions

Table 3

Main judgments and assumptions	Possible developments, if this assumption proves correct
Economic growth rates slow in main partner countries to Armenia due to a sluggish global demand	- Inflation running below target values and economic growth slowing on the back of a sluggish global demand will facilitate loosening of monetary conditions in partner countries. - International commodity prices will settle on lower levels as global demand slackens.
The uncertainties caused by trade wars will lead to contraction in US investment	The impact of the decline in investment on the US GDP potential is estimated to be -0.15 pp, which will have an almost identical effect on the US neutral interest rate.
The increase in sovereign rating of Armenia lowers the country's long-term risk premium by 0.5 pp and helps it recovers much slower in the medium run	The Government of Armenia 10-year Eurobond rates spread, relative to a similar-maturity US assets, will still be within a current 2.5% range in the upcoming quarters. Armenia's current risk premium is estimated accordingly, while the return to the long-term sustainable level will occur at a relatively slow pace.
Supply-side inflation shocks come along	Effective January 1, 2020, a change in customs and excise duty for some products are expected as a result of the EAEU membership. The impact of the change on inflation will mainly be discernable in the coming year and is estimated to reach 0.5 pp.
More saving on public expenditures and tax refunds: a 5.1 % saving (nearly AMD 84.0 billion) of the adjusted plan on public expenditures and AMD 56.0 billion-worth VAT debit balance refund to businesses ¹³ .	The fiscal policy's impact on aggregate demand is estimated 0.5 pp contractionary for the year.
Measures to bolstering potential GDP growth	- Armenia's GDP potential will materialize mainly by increasing output capacities for both goods and services as a result of continued growth of private investment in the tradable sector of the economy, which will make up 5.0% as resources grow and productivity bolsters in the long run (see Box 2). - The monetary policy scenario did not consider the activities of Amulsar mine and Alaverdi copper smelter. Their potential impact is considered in the framework of forecast risks. The direct impact of the Amulsar mine on GDP will be 1.0-1.6% and, with indirect impacts, its contribution will be even higher, according to Central Bank estimates.

Forecast risks

The risks considered under the baseline scenario are associated with both the supply and demand-driven developments in the relevant sectors of the economy.

¹³ The relevant Government decree has been adopted and its legislative arrangement is underway.

In terms of aggregate demand, the main risks are attributable to the following factors:

- Mostly short-term deflationary risks may arise in connection with insufficient rates at which demand and, consequently, core inflation recovers.
- The budget leaves bigger contractionary impact during 2019 (as a result of which aggregate demand will have even more deflationary effect on the inflation, calling for implementing a more stimulative monetary policy).

The baseline scenario assumes that businesses would benefit AMD 56.0 billion-worth tax refunds in the fourth quarter, and if this doesn't happen, taxes will have a greater contractionary impact throughout the year. The impact of expenditures may be even more contractionary if foreign loan and grant resources are underused.

Should these risks materialize, the estimated impact of the budget would be more than one percentage point contractionary for the year. The impact of the 2020 fiscal policy may change into somewhat expansionary in relation to a primarily contractionary budget in 2019 against that of the neutral projected in the baseline scenario.

Overall, downside risks to the inflation deviating from its path in the medium term prevail (see Chart 1 “Inflation Forecasts Probability Distribution”).

In terms of supply, the following are risks to the inflation:

- In the short run, seasonal agro-product prices may recover at a slower pace than expected, if the existing uncertainties around large export companies continue.
- Risks coming from the external environment are mostly deflationary as global demand continues growing at a pace slower than anticipated.
- Risks to the inflation are double-sided and relate to the change in customs and excise duty on some products (estimated to each 0.5 pp) to be effective from 2020.

In addition to the risks mentioned above, there are mid-term risks (which are double-sided but upside risks prevail, however) associated with potential economic growth, as follows:

- The uncertainties associated with further operating of Amulsar mine and Alaverdi copper smelter.
- In the context of longer-term economic growth, the further course of structural reforms in the economy and to which extent they will affect the business and investment climate.

Box 3:

Long-term sustainable GDP

Long-term sustainable GDP growth (potential) has been adjusted slightly upward and, as estimated by the Central Bank, currently stands at around 5.0% per annum compared to previously estimated 4.5% - 5.0%.

The long-term (potential) level of GDP¹⁴ is determined by supply factors and depends on the number of resources - labor and capital - available in the economy, as well as their productivity level. The labor supply forecast slightly revised upside underlies the above revaluation of potential GDP.

The labor supply depends heavily on how often people move. In recent years, the working-age population has been declining due to population emigration, which places a negative influence on potential GDP growth. Starting from 2018 however, the net emigration dynamics has changed, as evidenced by the international passenger flow charts¹⁵. As shown in the chart, during 2018 (for the first time since 2007) net border crossings entered a positive value, amounting to 15.3 thousand people. Positive trends continued in 2019 as well. Net border crossings in January-June of this year made up -2.3 thousand people instead of -6.1 thousand reported for the same period of the previous year.

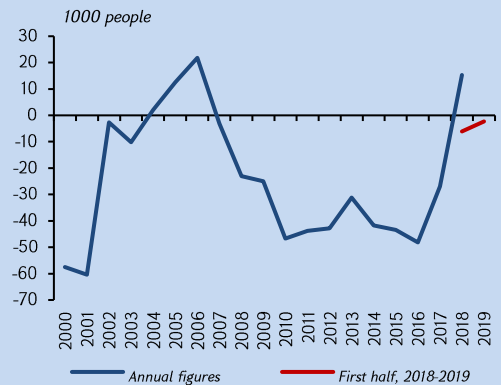
The positive value of border crossings is also consistent with labor market indicators, calculated by the Statistics Committee, in particular with slightly more positive patterns in labor resources and labor supply.¹⁶

The revised estimates of potential GDP are based on the assumption that labor supply in the long run will have a moderate positive contribution to the economic growth while the capital and productivity growth will be the same.

It should also be noted that medium and long-term growth may vary due to an influence of temporary factors like temporary productivity growth, slowing investment, varying potential in agriculture depending on weather conditions, and so on. In the long run (at least a 5-year horizon), all variables are assumed to be steady.

Chart 29

Dynamics of the difference between arriving in and departing from Armenia



Source: Armenia TAD Ministry's Migration Service

Chart 30

Labor supply by a new Statistics Service methodology (grand sum of the employed and the unemployed)



Source: Armenia Statistics Committee

¹⁴ For more details on potential GDP, see Inflation Report, Q4 2018:

https://www.cba.am/AM/ppperiodicals/gnach_IV_18.rar

¹⁵ The data is from the RA Territorial Administration and Development Ministry's Migration Service website: http://www.smsmta.am/?menu_id=18

¹⁶ See https://www.armstat.am/file/article/sv_06_19a_141.pdf and https://www.armstat.am/file/article/sv_02_19a_141.pdf.

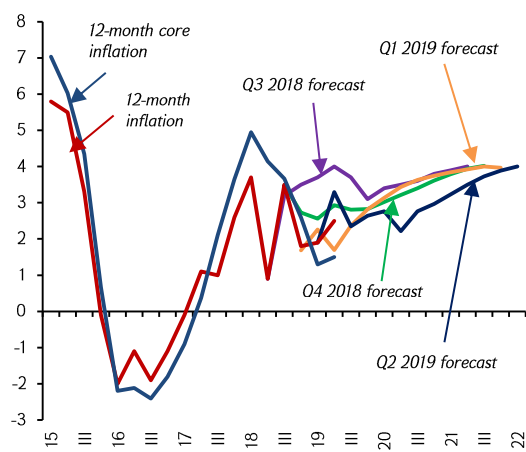
3. ACTUAL DEVELOPMENTS IN Q2, 2019

3.1. Inflation

3.1.1. Fulfilment of the inflation target

Chart 31

According to the Central Bank forecasts, in the near future the 12-month inflation will run below the target value but it will expand and stabilize around the target at the end of the forecast horizon



Source: Armenia Statistics Committee, Central Bank

To bring low inflation to the target value, the Central Bank's policy has been expansionary over the past 1-year horizon, while letting the inflation recover gradually.

The monetary policy program for the third quarter of 2018 predicted that the inflation environment, low at the time, was set to expand gradually over an upcoming 1-year horizon. The expanding had to be fuelled by positive developments in the macro-environment thanks to a stimulative direction of the monetary policy and relatively high economic activity, although risks to weakening domestic demand and inflationary environment in the external sector were already discernable. According to the program, to facilitate a sustained growth of domestic demand, the monetary policy's stance had to further be expansionary and it would only phase out later on, concurrent with recovering inflation, while ensuring price stability.

Actual inflation developments in the meantime have deviated from the scenario to a certain extent, as the contractionary fiscal policy of the time prompted the domestic demand to slacken also amid slowing global economic and demand growth rates. The impact of these developments was especially noticeable in the behavior of the 12-month core inflation as it followed a downward path from 4.1% in end-June 2018 to 1.5% in end-June 2019. On the other hand, prices of agricultural products have proved too volatile as the sector faced earlier seasonality, causing the 12-month headline inflation to float within 0.9-3.5% that time, as a result.

To bring low inflation to a target value, the **Central Bank had pursued, over the past one-year horizon, an expansionary monetary policy, while favoring a gradual recovery of inflation**, since low inflation of that time contributed to anchoring long-term inflation expectations and maintaining the purchasing power of income. Also, as considerable inflationary effects from external and domestic economies were lacking because of persistently weak global and domestic demand, and that monetary conditions at the time were estimated rather expansionary, the Central Bank had left the refinancing rate unchanged in the second half of 2018. In view of continued slowing in global economic growth and anticipated weakening of the inflation environment in world commodity markets, the Central Bank added to the monetary stimulus by cutting the refinancing rate by 0.25 pp to 5.75% in January 2019. In the period

February-June however, the policy rate stayed intact since the amount of stimulus was estimated satisfactory in light of expected expansionary fiscal policy. In the meanwhile, the Central Bank had signaled the financial market about that the monetary conditions would remain expansionary for as long a period as required, in fulfillment of the inflation target in the medium run.

3.1.2. Prices

Consumer prices: The 12-month inflation remained low in the second quarter of 2019, 2.5% as of June, mainly driven by a 16.9% y/y rise in seasonal prices of food products. In the meantime the 12-month core inflation has been 1.5%, while regulated service tariffs remained almost unchanged for a preceding one-year horizon.

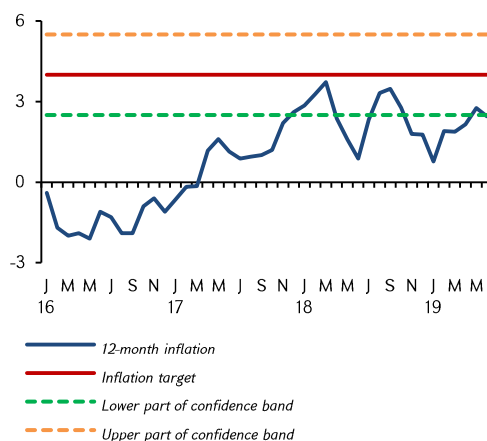
The y/y increase in seasonal prices of food products was a result of 8.6%, 19.1% and 37.6% growths reported for items “Fruit”, “Vegetable and potato” and “Egg”, respectively (combined contribution to y/y inflation: around 1.8 pp).

The y/y increase in core inflation rate was mainly driven by 4.5%, 3.1%, 6.3% growths reported for items “Bread products and wheat”, “Meat”, “Tobacco” as well as by 4.3%, 6.8% and 4.1% growths reported for non-food items “Clothes”, “Footwear” and “Fuel”, respectively (combined contribution to y/y core inflation: about 1.6 pp and to y/y headline inflation: 1.2 pp). At the same time, the decline in dairy product, oil and fat, and sugar prices in international markets has pushed the domestic prices of these products down by 2.1%, 3.1% and 8.4% y/y, respectively.

In the past one-year horizon, inflation has been largely in line with demand developments, although it had to endure a certain amount of supply-side impact of individual products. Particularly, supply factors brought about an increase in the price of beef (due to reduced headcount) in the third quarter of 2018 and an increase in flour and bread prices (amid the developments in the world markets) starting from the fourth quarter, with their combined inflation impact estimated to reach 0.4 pp. Note that the inflation impact of the change in customs duty on some commodity groups is estimated at about 0.3 pp in the first quarter of 2019, which is mainly due to the increase in poultry prices.

Chart 32

A low inflation environment persisted over the last one-year horizon, with the 12-month inflation drifting around the lower part of confidence band



Source: Armenia Statistics Committee

Table 4

Price inflation by commodity items as key contributors ¹⁷			
Commodity item	Weights	June 2019 (y/y)	
		growth	contribution
Consumer price index		2.70	
<i>including:</i>			
Core inflation	72.70	1.50	1.10
Bread products and grains	8.99	4.48	0.40
Meat	9.87	3.11	0.31
Dairy products	4.36	-2.12	-0.09
Fats and oils	2.77	-3.08	-0.09
Sugar	0.60	-8.43	-0.05
Alcoholic drinks	1.73	2.55	0.04
Tobacco	1.77	6.33	0.11
Clothes	2.58	4.28	0.11
Footwear	1.52	6.85	0.10
Fuel	5.20	4.08	0.21
Seasonally sensitive goods	10.50	16.90	1.80
Egg	1.44	37.51	0.54
Fruit	3.35	8.65	0.29
Vegetable	5.74	19.05	1.09
Regulated services	16.70	-0.10	0.00

Chart 33

In the second quarter of 2019 the dollar prices of import of goods and services remain low compared to those of the same quarter of the previous year, y/y, %



Source: Central Bank calculations

Import prices: In the second quarter of 2019 the dollar prices of import of goods and services to Armenia posted almost a zero growth relative to the previous quarter. As to the change in dollar prices of import relative to the second quarter of the previous year, the decrease has been 3.0% y/y and owed mainly to y/y depreciation of nominal exchange rates in trade partner countries. The y/y decline in oil, aluminum and wheat prices contributed to the falling of prices of intermediate goods.

3.2. Economic developments

3.2.1. Economy position

The estimation of the GDP gap in the reporting quarter of 2019 is negative, but it has somehow contracted in relation to the previous quarter. Although economic growth in the second quarter of 2019 (see subsections 3.2.2 and 3.2.3) came along with both supply

In the reporting quarter, the GDP gap is estimated negative but this has contracted slightly compared to the previous quarter, however.

¹⁷ Items' 12-month contributions are calculated by the Central Bank using the weights of these items published by the Republic of Armenia Statistics Committee and the product of the 12-month growth rates.

and demand factors, thanks to which the negative GDP gap was estimated to be smaller than in the previous quarter, it is still negative and consistent with a weak inflationary environment in the reporting quarter (see subsection 2.2.1). In particular, persistent contractionary fiscal policy in the second quarter of 2019, depreciated exchange rates in trade partner countries, the slowing of economic growth in principal trade partner countries, the low level of remittances in real terms all have contributed to the shaping of a negative GDP gap.

3.2.2. The expenditures aspect of the economy

The economic growth in the second quarter of 2019 was largely driven by domestic demand that has increased mostly thanks to strong growth in private spending. According to the Central Bank estimates, the household propensity to consumption has notably grown on the back of positive expectations, which led to a significant increase in demand for consumer loans. As a result, the growth of private consumption, largely financed to the expense of credit resources, proved rather high compared to previous forecasts, making up 14.4%. In the reporting quarter, remittances from abroad have reduced as well. Unlike private consumption, gross accumulation of private fixed assets had a modest increase of 0.9% – below the Central Bank’s previous forecasts – due to a reduced demand for business lending and slowed import of investment goods in the reporting quarter. Thus, with a 6.5% economic growth, private spending posted a 12.5% increase in the second quarter, which is generally above the previous estimates, owing to rather strong private consumption.

Notwithstanding the second quarter’s marked private consumption growth, it still has a little effect on inflation, according to the Central Bank estimates, determined by peculiarities in the consumption structure.

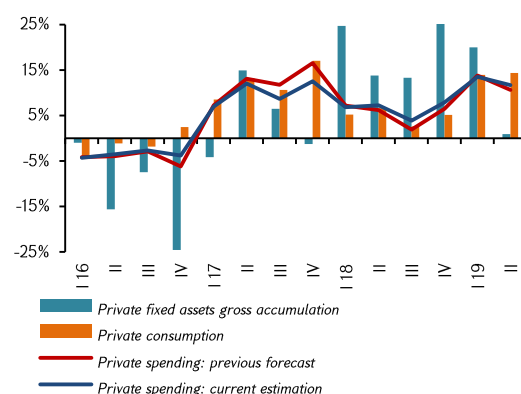
The second quarter of 2019 saw the real export and import volumes reporting y/y increases as opposed to y/y decreases registered in the previous quarter. The real export volumes have grown faster than those of import. As a result, net real export’s contribution to the GDP was positive. Thus, the real growth of export of goods and services and import of goods and services in the second quarter of 2019 amounted to 8.8% and 4.9% y/y, respectively. It is worth mentioning that the mining sector’s recovery during the second quarter was observable as the Teghut mine reopened. Contribution to the export growth from exporting of gold was sizable, too.

In the second quarter of 2019 net remittances of individuals (seasonal workers’ income and personal transfers inclusive) in US

The household propensity to consume has notably grown on the back of positive expectations, and this has led to a significant increase in demand for consumer loans, according to the Central Bank estimates.

Chart 34

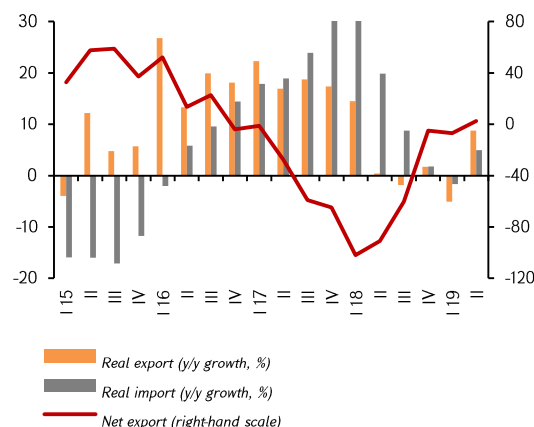
Structure of private spending, (y/y growth)



Source: Armenia Statistics Committee, Central Bank estimate

Chart 35

In the second quarter of 2019 net export position improved as export increased at a faster pace over import (net real export, y/y, %, positive sign = improvement)

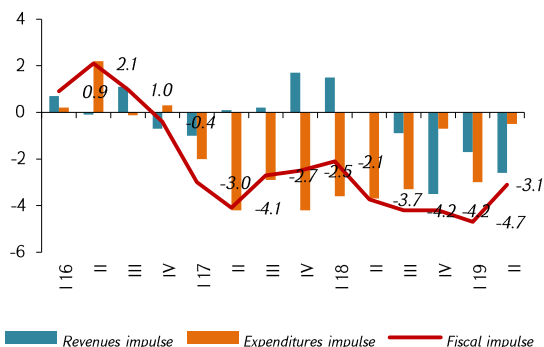


Source: Armenia Statistics Committee

The fiscal policy's impact on aggregate demand is an estimated 3.1 pp contractionary instead of the forecast 1.0 pp contractionary, for the second quarter.

Chart 36

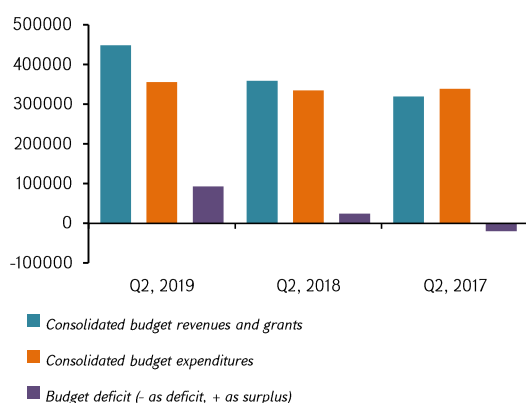
In the second quarter of 2019 the contractionary effect of fiscal policy owes mostly to the contractionary effect of revenues



Source: Central Bank estimate

Chart 37

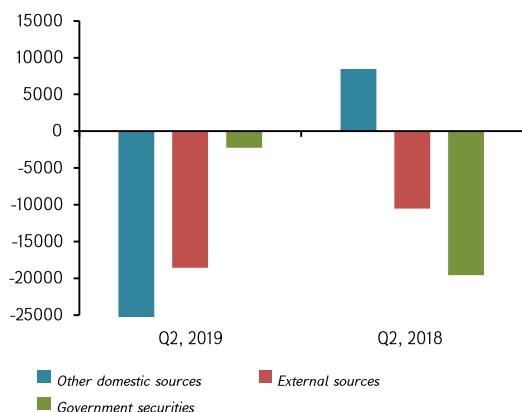
Main indicators of the consolidated budget (billion AMD)



Source: Armenia Statistics Committee

Chart 38

In the second quarter of 2019 state budget generated a surplus as funds in other domestic sources have increased thanks to lower performance of expenditures over revenues (million AMD)



Source: Armenia Statistics Committee

dollars narrowed to 3.1% y/y, according to the Central Bank estimates, as the Russian ruble continued depreciating versus the US dollar and growth in construction and trade sectors slowed down in Russia.

In the second quarter of 2019 the current account deficit-to-GDP ratio dropped by about 1.0 pp, according to the Central Bank estimates, due to a faster growing GDP.

Fiscal policy¹⁸: In the second quarter of 2019 the state budget performed with actual expenditures and revenues deviating from the Central Bank's projections¹⁹.

The quarter saw more revenue collected and less expenditures made against the quarter's plan. As a result, the fiscal policy's impact on aggregate demand in the second quarter of 2019 is an estimated 3.1 pp contractionary instead of the forecast 1.0 pp contractionary.

In the second quarter of 2019 actual budget revenues outstripped the projection by 7.0%, and tax revenues, by 6.2%. As a result, the revenue impulse amounted to 2.6 pp contractionary, instead of predicted 1.9 pp contractionary.

State budget expenditures made up 93.5% of the Central Bank projection, so the expenditures impulse had contractionary rather than expansionary effect. In the budget's expenditures structure, **government consumption** reached 86.5% of the projected indicator. **Expenditures on non-financial assets** amounted to 73.1% of the projection, which is explained by lower performance of both foreign assistance and domestically-funded programs. For the quarter, the expenditures impulse was 0.5 pp contractionary instead of the forecast 0.9 pp expansionary.

With revenues and expenditures performance described above, the state budget generated a surplus of AMD 87.0 billion in the second quarter of 2019, against that of AMD 35.4 billion projected by the Central Bank.

3.2.3. The production aspect of the economy

The GDP growth amounted to 6.5% in the second quarter of 2019, which is consistent with the Central Bank's previous estimates. Deviations were observable at the sectoral level of GDP, however. In particular, the decline in agriculture reached 10.1%, which is rather lower than projected previously and explained by contracted output in both plant growing and animal breeding sectors. On the contrary,

¹⁸ The review of the fiscal sector used actual consolidated budget indicators of the second quarter of 2019, excluding off-budgetary funds.

¹⁹ The revenue projection was based on the adjusted quarterly plan outlined in the Budget Law 2019 as well as the information on AMD 62.0 billion more collected tax for the year (RA Prime Minister's speech); the expenditure projection is the Central Bank estimate.

industry reported as much as 10.0% growth – well above previous estimations. The deviation owed to the acceleration in the mining sector, which the Central Bank had factored in as an alternative scenario²⁰. No significant deviations were observable in services and construction sectors, with their growths amounting to 9.4% and 0.9%, respectively.

There is anticipation that services and industry will remain a key driver to economic growth over the third quarter of 2019, and high economic activity in July, supported by growths in trade (9.1%), services (14.9%), and industry (16.1%) point to this statement.

In the second quarter of 2019, the productivity, calculated as real value added per hour worked, grew by 6.2%, according to the Central Bank estimates, which mostly explains the high economic growth.

3.2.4. Labor market²¹

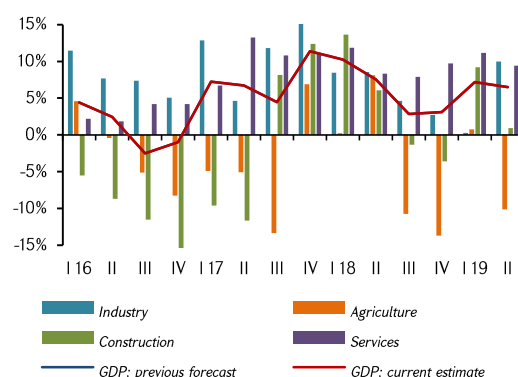
In the second quarter of 2019, the private sector's nominal wage growth rate amounted to 3.6% – somewhat below previous forecasts by the Central Bank – and the private sector's real wage growth rate reached about 1.2%. The real wage growth rate stood behind the productivity growth rate²² due to existing rigidities in the labor market. The productivity outpacing the real wage growth, on the one hand, and increased labor supply (see Box 3), on the other, have triggered a certain rise in unemployment. As a result, the reporting quarter saw company unit labor costs reduced by 4.7%, reflecting the accelerating of output growth over private wage growth per unit of labor.

The unemployment rate in the second quarter of 2019 is an estimated 21.8%²³. This explains the fact that economic growth largely owed to the productivity growth, while the growth of labor supply has been faster over that of the employment.

3.3. Financial market developments

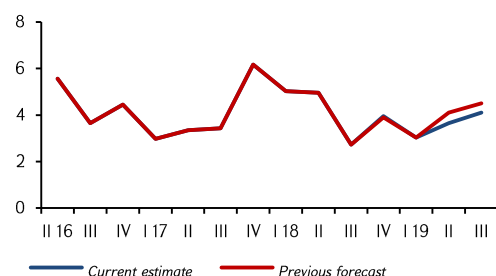
In the second quarter of 2019, the Board of the Central Bank left the refinancing rate unchanged, at 5.75%.

Chart 39
GDP structure by sector, (y/y growth, %)



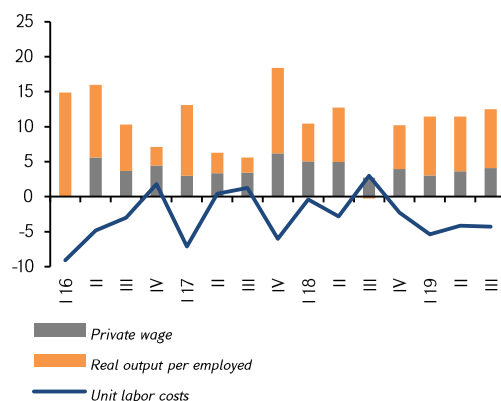
Source: Armenia Statistics Committee,
Central Bank estimate

Chart 40
Private nominal wage, (y/y growth, %)



Source: Armenia Statistics Committee,
Central Bank estimate

Chart 41
Unit labor costs, (y/y growth, %)



Source: Armenia Statistics Committee,
Central Bank estimate

The refinancing rate remained unchanged, 5.75%, in the second quarter of 2019.

²⁰ Mainly referred to the reopening of the Teghut mine.

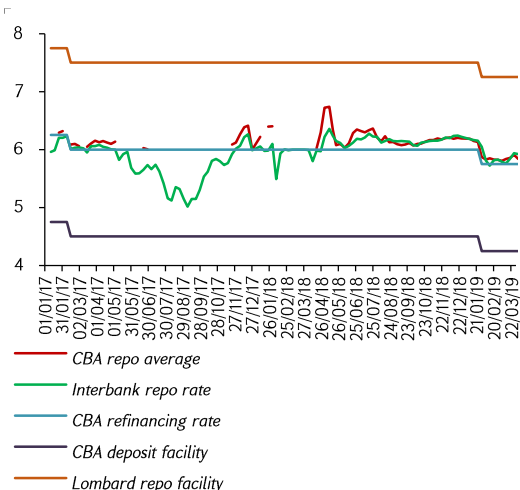
²¹ The labor market data for the third quarter 2019 are the Central Bank estimates which are based on actual second quarter 2019 figures. The growth indicators provided in this subsection are relative to the same reference period last year, unless otherwise specified.

²² The gross real value added per employed has been viewed as the productivity indicator.

²³ Calculation of the unemployment uses, starting from the second quarter of 2019, a new methodology whereby the unemployed includes a producer making goods intended for personal consumption.

Chart 42

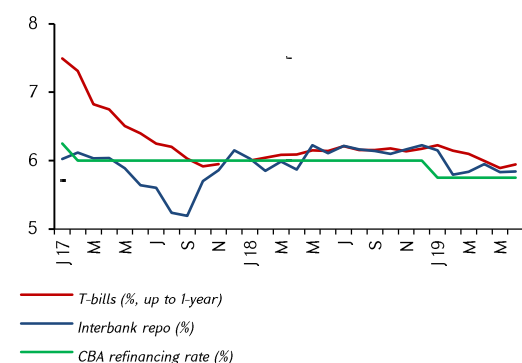
During the quarter short-term interest rates continued shaping around the Central Bank's policy rate



Source: Central Bank

Chart 43

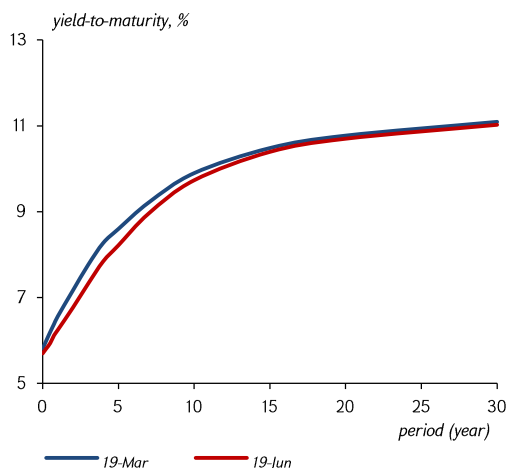
The behavior of short-term interest rates in the second quarter of 2019



Source: Central Bank, Armenia Stock Exchange

Chart 44

In the second quarter of 2019, yields in the government securities market narrowed along the entire curve



Source: Central Bank

The decision was made considering the lack of significant inflationary effects from the external sector and domestic economy, on the other hand, and favoring gradual recovery of the low inflation, on the other, which, according to the Central Bank, contributes to anchoring long-term inflation expectations and maintaining purchasing power of income. In the meanwhile, the Central Bank has signaled the financial market participants that, in view of predicted macroeconomic developments, the monetary conditions would remain expansionary also in the medium run.

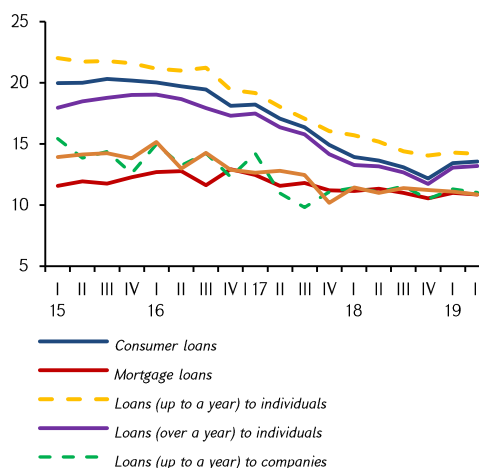
Table 5

Average quarterly interest rates in Armenia's financial market					
Instrument	Q2 18	Q3 18	Q4 18	Q1 19	Q2 19
Central Bank refinancing rate (end of quarter)	6.00	6.00	6.00	5.75	5.75
Central Bank repo rate	6.32	6.17	6.17	5.94	5.86
Interbank repo rate (up to 7-day)	6.09	6.17	6.15	5.94	5.86
Yield of government securities on a yield curve (as of end-quarter)					
Short-term treasury bill (1-year)	6.55	6.70	6.63	6.57	6.36
Medium-term notes (up to 5 years)	8.37	8.60	8.48	8.65	8.39
Long-term bonds (30-year)	11.52	10.54	10.68	11.05	11.13

In the second quarter of 2019 short-term money market rates dropped to a certain extent, coming closer to the policy rate of the Central Bank. The quarterly interbank repo (up to 7-day) rate fell to 5.86%. In addition to the main policy instrument, the Central Bank has used a 91-day repo tool over the quarter, with its quarterly rate amounting to 5.86% as well.

Chart 45

Dynamics of interest rates on dram loans



Source: Central Bank

In the government securities market, yields on short-term bonds narrowed during the quarter, demonstrating patterns typical of the money market. The yields on bonds have reduced along the entire yield curve.

In the second quarter of 2019 too, the stimulative monetary policy of the Central Bank and adequately capitalized domestic financial system kept on fostering the growth of funds financial companies provide. The interest rates on loans to legal entities have fallen in light of expectations steered to heightened economic activity, while the interest rates on dram loans to individuals have slightly increased as a result of high demand for consumer loans. Overall, the growth in lending still persists at a high level: the 12-month growth of total lending in June 2019 was 13.1%, mainly owing to the increase in consumer and mortgage loans.

BOARD MEETING OF THE CBA

MINUTES (10.09.2019)

On the Refinancing Rate

The CBA Board Meeting of September 10, 2019 attended by Governor Arthur Javadyan, Deputy Governors Nerses Yeritsyan and Vakhtang Abrahamyan, and Board Members Arthur Stepanyan, Armenak Darbinyan and Martin Galstyan

The Board meeting opened with presentation of the Situation Report as of September 10, 2019. It addressed current developments on inflation, external environment and real, fiscal and monetary sectors of the economy.

There was 0.4% deflation in August 2019 as opposed to 0.6% inflation registered in the same month last year. This was determined by a deeper seasonal decline in prices of agricultural products. In particular, relatively profound decreases were reported for prices in items “Vegetable” and “Fruit”, by 8.7% and 2.7%, respectively (combined contribution to inflation: -0.6 pp), in line with prices in items “Dairy products, cheese and egg” and “Fats and oils” having dropped by 0.8% and 0.7%, respectively. As a result, the 12-month inflation declined in August, reaching 0.6% at the end of the month. During the month, ***the 12-month core inflation rate*** behaved steadily, ***remaining at a 1.5% level.***

Addressing the current economic situation, the Board stated that ***economic activity remained strong over the third quarter of 2019*** owing to the growth in services and manufacturing. Domestic demand too remains high thanks to the increase in private consumption, which was driven by the growth of lending to the economy and reduction of savings to a certain extent. At the same time, domestic demand continued to be contained during the third quarter as a result of the implemented fiscal policy.

Developments in the external sector were presented at the Board meeting, with reference to uncertainties increasing amid escalated trade wars which are leading to a significant slowdown in global economic and demand growth rates. This comes also in line with continued weakening of the inflationary environment in world's commodity markets. In such a circumstance, in view of persistently sluggish demand in the external and domestic sectors, central banks of main trade partner countries to Armenia will continue pursuing a stimulative monetary policy in order to fulfil their inflation targets.

The Board talked about the developments in the domestic financial market, stating that in the third quarter ***short-term market rates***

have shown mostly a stable behavior and fluctuated around the policy rate of the Central Bank.

Following presentation of the Situation Report and the developments in external and domestic macroeconomic environments, the Board began addressing the monetary policy directions and making decision on the interest rate. As things stand currently, preferring a gradual recovery of inflation and considering the deflationary effects anticipated from external and domestic economies, the Board of the Central Bank ***found it appropriate to increase the monetary stimulus by 0.25 percentage points.*** Given the predictable macroeconomic developments, the Board estimates that expansionary monetary conditions have to be kept over a medium term, in fulfillment of the inflation target. As a result, the expectation is that the inflation will run below the target in the coming months but will later stabilize around it. At the same time, the Board referred to the currently running discussions on the need for some macro-prudential measures to be taken in the near future; taking of the abovementioned measures will be aimed at creating a favorable financial environment for the development of economic potential.

The Board also looked to current inflation risks. These risks, still on a downward path, depend on how the developments in the external environment unfold, and if they materialize, an appropriate monetary policy response of the Central Bank will come along to ensure price stability in the medium term.

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

Board of the Central Bank of Armenia

RESOLUTION

Interest Rates of Operations by the Central Bank of the Republic of Armenia in the Financial Market

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

1. To reduce the refinancing rate of the Central Bank of the Republic of Armenia by 0.25 pp to 5.5%.
2. To the Financial Department of the Central Bank of the Republic of Armenia to carry out operations in the financial market of the Republic of Armenia, using the interest rates, as follows:
 - 2.1. Lombard facility rate offered by the Central Bank to be 7.0%.
 - 2.2. Deposit facility rate offered by the Central Bank to be 4.0%.
3. This decision shall take force on the day following the adoption thereof.

Arthur Javadyan,
Governor of the Central Bank

September 10, 2019
c. Yerevan

PRESS RELEASE
10.09.2019

In the September 10, 2019 meeting the Board of the Central Bank of Armenia decided to reduce the refinancing rate by 0.25 pp to 5.5%.

There was 0.4% deflation in August of 2019 as opposed to 0.6% inflation registered in the same period of the previous year, which continued to be largely driven by a deeper seasonal decline in prices of agricultural products. As a result, the 12-month inflation rate further reduced, reaching 0.6% at the end of the month. Unlike headline inflation, core inflation has been relatively stable in recent months, fluctuating around 1.5%.

In the external sector, trends of notable slowdown in economic growth, demand and inflation are observable amid increasing uncertainty over global economic outlook, and these trends are also evident in international commodity markets. Based on the aforementioned, the Board of the Central Bank estimates that it generally anticipates deflationary pressures from the external sector.

The Board states that economic activity in Armenia remained high in the third quarter, which is mainly driven by the growths in services and manufacturing in terms of supply and the growth of private consumption in terms of demand. In the meantime, the fiscal policy is further having a contractionary impact on aggregate demand.

Given the deflationary environment in the external sector and the stance of the fiscal policy, and in view of further preference to a gradual recovery of inflation, the Board of the Central Bank finds it reasonable to add to the monetary stimulus by reducing the refinancing rate, as well as is considering measures for directing financial resources to the development of the economy's potential. The Board also finds that in view of anticipated macroeconomic developments, keeping the policy expansionary in the near future will be needed in order to fulfil the mid-term inflation target. As a result, the expectation is that the inflation will run below the target in the coming months but will stabilize around the target in the medium run.

At present, downside risks to inflation deviating from the projection path are prevailing and mainly depend on the developments in the external sector. In the event such risks emerge, the Central Bank will respond adequately while maintaining price stability in the medium run.

Press Service of the Central Bank of Armenia

MAIN MACROECONOMIC INDICATORS OF ARMENIA

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
	actual	actual	actual	actual	actual	actual	actual	actual	actual	program	program	program
Prices												
Inflation (y/y, end of period, %)	9.4	4.7	3.2	5.6	4.6	-0.1	-1.1	2.6	1.8	1.5	2.7	3.7
Consumer price index (y/y, average, %)	8.2	7.7	2.6	5.8	3.0	3.7	-1.4	1.0	2.5	1.5	2.0	3.5
Core inflation (y/y, average, %)	7.5	8.6	5.3	5.8	1.9	5.1	-2.0	0.8	4.0	1.3	2.5	3.5
Gross product												
GDP (billion Armenian dram)	3690.0	4028.9	4266.5	4555.6	4828.6	5043.6	5067.3	5568.9	6002.7	6580.9	7048.3	7644.8
GDP (% , real growth)	2.2	4.7	7.2	3.3	3.6	3.2	0.2	7.5	5.2	6.9	4.9	5.1
Supply												
Industry (% , real growth)	9.2	13.6	6.4	6.3	-0.9	6.2	7.7	11.7	5.8	9.2	5.9	5.6
Agriculture (% , real growth)	-16.0	14.0	9.5	7.6	6.1	13.2	-5.0	-5.1	-8.5	-3.8	1.2	2.2
Construction (% , real growth)	3.3	-12.2	4.5	-7.4	-4.5	-3.1	-14.1	2.8	0.8	2.8	2.9	3.8
Services (% , real growth)	4.1	4.7	6.3	3.1	6.7	1.6	3.2	10.6	9.3	9.6	5.9	5.7
Taxes, net (% , real growth)	13.4	3.8	9.9	3.6	1.8	-5.1	-4.7	9.7	8.0	6.5	5.0	5.4
Demand												
Consumption (% , real growth)	3.9	2.6	7.7	1.9	0.7	-6.2	-0.5	10.5	5.1	11.9	4.4	4.2
Public consumption (% , real growth)	3.9	1.9	-1.4	8.7	3.4	4.7	5.8	-3.9	7.6	2.2	-4.1	2.4
Private consumption (% , real growth)	3.9	2.7	9.1	0.9	1.0	-7.7	-1.2	12.7	4.7	13.5	5.7	4.7
Gross accumulation of fixed assets* (% , real growth)	-2.9	-11.7	-1.9	-8.3	-2.2	2.5	-11.4	9.7	4.5	8.1	10.1	6.5
Public investment** (% , real growth)	-12.7	-6.1	-22.4	-13.8	10.0	13.6	5.0	31.7	-38.0	21.5	41.0	13.7
Gross accumulation of private fixed assets (% , real growth)	-1.5	-12.4	0.9	-7.8	-3.4	1.2	-13.9	6.2	12.8	5.6	4.3	4.7
Export of goods and services (% , real growth)	20.4	14.5	12.0	8.9	6.4	4.9	19.1	18.7	4.6	6.0	7.6	8.2
Import of goods and services (% , real growth)	7.2	-0.1	4.7	5.5	-1.0	-15.1	7.6	24.6	12.7	2.0	3.2	4.3
External sector												
Balance of trade (million US dollar)	-2065.7	-2109.8	-2111.9	-2196.2	-2055.4	-1186.4	-944.4	-1376.1	-1789.1	-1696.4	-1734.4	-1731.5
Balance of services (million US dollar)	-260.8	-65.8	-101.6	-124.3	-113.0	-94.5	-71.4	-35.6	-157.8	-99.7	-59.8	-39.1
Remittances (million US dollar)	1421.9	1440.4	1539.8	1755.1	1616.1	1082.4	989.6	1179.3	1136.2	1155.1	1240.5	1314.9
Current account (million US dollar)	-1261.4	-1058.9	-1057.9	-812.9	-883.1	-279.1	-238.1	-344.4	-1165.3	-1002.5	-926.3	-828.2
Balance of trade (share in GDP, %)	-22.1	-20.8	-19.9	-19.7	-17.8	-11.3	-8.9	-12.2	-15.7	-13.1	-12.2	-11.1
Balance of services (share in GDP, %)	-2.8	-0.7	-1.0	-1.1	-1.0	-0.9	-0.7	-0.3	-1.3	-0.7	-0.4	-0.2
Remittances (share in GDP, %)	15.2	14.2	14.6	15.8	14.0	10.3	9.3	10.2	9.1	8.4	8.4	8.3
Current account (share in GDP, %)	-13.5	-10.5	-10.0	-7.3	-7.6	-2.7	-2.2	-3.0	-9.4	-7.3	-6.3	-5.2
Public sector***												
Revenues and grants (billion Armenian dram)	780.4	880.9	946.2	1071.4	1144.8	1167.7	1171.1	1237.2	1341.7	1458.1	-	-
Tax revenues (billion Armenian dram)	699.4	777.4	878.4	1000.9	1064.1	1067.9	1079.7	1158.1	1258.1	1405.8	-	-
Expenditures* (billion Armenian dram)	954.3	986.5	1006.1	1142.9	1235.1	1409.0	1449.1	1503.9	1447.1	1558.3	-	-
Deficit (billion Armenian dram)	-173.9	-105.6	-59.9	-71.5	-90.3	-241.3	-278.0	-266.7	-105.4	-100.2	-	-
Revenues and grants (share in GDP, %)	22.6	23.3	22.2	23.5	23.7	23.2	23.1	22.2	22.4	22.2	-	-
Tax revenues (share in GDP, %)	20.2	20.6	20.6	22.0	22.0	21.2	21.3	20.8	21.0	21.4	-	-
Expenditures (share in GDP, %)	27.6	26.1	23.6	25.1	25.6	28.0	28.6	27.0	24.1	23.7	-	-
Deficit (share in GDP, %)	-5.0	-2.8	-1.4	-1.6	-1.9	-4.8	-5.5	-4.8	-1.8	-1.5	-	-
Monetary sector												
Broad money (y/y, end of period, %)	11.8	23.7	19.5	14.8	8.3	10.8	17.5	18.5	7.4	-	-	-
Dram broad money (y/y, end of period, %)	15.7	26.4	11.9	14.9	-3.5	5.2	24.8	28.9	13.2	-	-	-
Loans to economy (y/y, end of period, %)	26.7	35.3	27.6	12.9	20.8	-3.3	6.0	16.5	17.2	-	-	-
USD / AMD (Armenian dram for one US dollar)	373.7	372.4	401.8	409.6	415.9	477.9	480.5	482.7	483.0	-	-	-

* 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 considered 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 forecasts are based on the Mid-Term Expenditures Framework, 2019-2021.

*** The 2019 budget indicators are the Central Bank estimates.

CHARTS

Chart 1	Inflation (12-month) forecast probability distribution for 3-year horizon	4
Chart 2	Real GDP (cumulative) growth projection probability distribution for 3-year horizon	4
Chart 3	FRS's interest rate path according to the FRS Board	6
Chart 4	The world uncertainty index	7
Chart 5	The world trade uncertainty index	7
Chart 6	The world purchasing managers' index, PMI	7
Chart 7	The business sentiment index	7
Chart 8	Economic growth in trade partner countries	8
Chart 9	Inflation in trade partner countries	8
Chart 10	International prices of raw materials and food products	9
Chart 11	Inflation (12-month) forecast probability distribution for 3-year horizon	10
Chart 12	Demand components contributing to the growth	11
Chart 13	Changes in real export and import of goods and services in the medium term	11
Chart 14	Nominal wage growth in private sector, y/y, %	12
Chart 15	Unemployment rate	12
Chart 16	Unit labor costs growth, y/y, %	13
Chart 17	US economic growth forecasts	13
Chart 18	EU economic growth forecasts	13
Chart 19	Russia economic growth forecasts	14
Chart 20	International food price forecasts	14
Chart 21	International oil price forecasts	14
Chart 22	International copper price forecasts	14
Chart 23	Real GDP (cumulative) growth projection probability distribution for 3-year horizon	15
Chart 24	Mid-term current account-to-GDP ratio forecasts	15
Chart 25	Fiscal impulse forecasts	15
Chart 26	Short-term inflation expectation estimations	16
Chart 27	Share of households expecting high and too high inflation in a one-year horizon	16
Chart 28	Average level of financial system's inflation expectations	16
Chart 29	Dynamics of the difference between arriving in and departing from Armenia	19
Chart 30	Labor supply by a new Statistics Service methodology (grand sum of the employed and the unemployed)	19
Chart 31	According to the Central Bank forecasts, in the near future the 12-month inflation will run below the target value but it will expand and stabilize around the target at the end of the forecast horizon	20
Chart 32	A low inflation environment persisted over the last one-year horizon, with the 12-month inflation drifting around the lower part of confidence band	21
Chart 33	In the second quarter of 2019 the dollar prices of import of goods and services remain low compared to those of the same quarter of the previous year	22
Chart 34	Structure of private spending	23
Chart 35	In the second quarter of 2019 net export position improved as export increased at a faster pace over import	23
Chart 36	In the second quarter of 2019 the contractionary effect of fiscal policy owes mostly to the contractionary effect of revenues	24
Chart 37	Main indicators of the consolidated budget	24

Chart 38	In the second quarter of 2019 state budget generated a surplus as funds in other domestic sources have increased thanks to lower performance of expenditures over revenues	24
Chart 39	GDP structure by sector	25
Chart 40	Private nominal wage	25
Chart 41	Unit labor costs	25
Chart 42	During the quarter short-term interest rates continued shaping around the Central Bank's policy rate	26
Chart 43	The behavior of short-term interest rates in the second quarter of 2019	26
Chart 44	In the second quarter of 2019, yields in the government securities market narrowed along the entire curve	26
Chart 45	Dynamics of interest rates on dram loans	26

TABLES

Table 1	Inflation interval forecast probability distribution	10
Table 2	Real GDP (cumulative) growth projection probability distribution	15
Table 3	Forecast judgments	17
Table 4	Price inflation by commodity items as key contributors	22
Table 5	Average quarterly interest rates in Armenia's financial market	26