
Armenia Cbank To Pursue Stringent Monpol In Face of Inflation

By David Barwick
The Main Wire - 29/2/2008

The Central Bank of Armenia expects to face high inflationary pressures at least through 2008 and will pursue "more stringent" monetary policy to ward off second-round effects and return CPI to its definition of price stability, Chairman Tigran Sargsyan said Tuesday.

Speaking to Market News International in an interview, Sargsyan asserted that the recent increase from 3% to 4% of the midpoint of the bank's inflation target has not affected expectations. He defended hiking the target, but suggested that returning to a target of 3% would be possible as of 2011.

Despite wage growth averaging 20% annually in recent years, compared with price increases of 3-4%, second-round effects have not posed a problem thus far, thanks in large part to the inflation- dampening effect of productivity gains, according to Sargsyan.

"Whether such a spiral is looming somewhere in the future is something we have to be very cautious about, which is why I say up front that we're going to pursue ever-more-stringent monetary policies to preclude second-round inflation effects," he said.

The bank missed its inflation target last year due to exogenous shocks that propelled consumer price growth to 5% on commodities, notably wheat, he explained. "We are attempting to raise interest rates to keep the target within reach, and by the end of the year that should get us back to the same corridor," he said, implying CPI for 2008 of "5.5% at most."

At the same time, "it goes without saying that we cannot withstand serious price shocks and would not even aspire to. What we would do is try to explain them to the market participants so that our policies enjoy their trust," he said.

"I have looked at today's global market data, and they do not appease our concerns in any way," he continued, citing wheat futures and fuel prices. "We will be pursued by inflationary pressures throughout the year. We haven't received any hopeful signals yet."

The domestic agricultural sector could yet post a substantial gain in production, which would mitigate inflation a bit, Sargsyan said. "But at this point in time, the mood within the Armenian monetary authority is that we intend to carry on stringent policies."

Sargsyan ruled out any further near-term change in the bank's inflation target, the last hike of which met with international criticism. "If, hypothetically, there are exogenous shocks that result in higher inflation, what we will do is come up with explanations for market participants," he said. "We are responsible for inflation caused by monetary factors."

He dismissed the complaints about the hike in the target, saying the bank is "never short of criticism," be it for high inflation, the appreciation of the country's currency, the dram, or low financial intermediation.

The combined impact of currently high inflationary pressures, rapid wage growth and an expected "drastic" increase in national social expenditures

suggest it would be "more reasonable to aim for 4% inflation the next three years and thereafter to aim for 3% again," he said.

The increase in the target had no effect on market expectations, Sargsyan maintained. The bank's surveys continue to show that, as in Europe, Armenian consumers perceive inflation to be well in excess of actual CPI, with banks and other companies exhibiting views more in line with those of monetary authorities.

The appreciation of the dram over recent years "has restrained inflation substantially in this country," Sargsyan said. "Because we have stayed faithful to the floating exchange, as opposed to our neighbors, who have been playing with both inflation and exchange and failed at both," he explained.

Asked if he expected the dram to continue dampening inflation, he replied, "We are not going to modify the foundation of our policies."

We only intervene in the forex market to mitigate significant fluctuations that may agitate the market."

The last such occasion was to stem a "surge of panic" on the last weekend of November 2007. The fears at the time were "absolutely groundless," Sargsyan said, and mainly reflected the still-immature nature of a market with very few institutional investors.

Sargsyan rejected what he called "the spearhead of criticism we're under" for the dram's strength. Taking into account its real, trade-weighted exchange rate rather than simply considering nominal exchange rates reveals a far better-looking situation in which "export growth rates have not suffered; on the contrary, they have increased," he stressed.

Asked if the dram reflects Armenian economic fundamentals, Sargsyan merely noted that half of the currency's appreciation since 2003 reflects private remittances from Armenians abroad, with another third due to foreign direct investment and the balance caused by improving terms of trade and productivity gains.

Remittance flows will shrink as Armenia's standard of living increases, he continued, observing that some repatriation of jobs, notably in the construction sector, has already occurred.

"At the end of the day the dram's rate is determined by the market," he added.

After averaging some 13% over the last five years, Armenian growth should remain broad-based but cool to 10-11% this year and next, he said.

"I don't think growth of 10% will be undermined," Sargsyan affirmed,

Downside risks to growth include the possibility that the current global crisis could eventually affect private remittances; interfere with large-scale projects currently envisioned in transportation, mining, energy and agriculture; or dissuade Russian, European and American private investors if those economies suffer, Sargsyan said.

The indirect impact of U.S. sub-prime woes depends on subsequent developments in global capital markets

The direct impact of the sub-prime crisis on Armenia "will be negligible if anything," he said, given that Armenian commercial banks only have 0.1% of their holdings in anything other than government paper of one kind or

another, essentially rendering them "immune" to the crisis. "So there will be no direct impact," he said.

Although the current weakness of the U.S. dollar is worrisome for the central bank from the perspectives of the domestic macroeconomy, forex reserve policy and international commodity prices, Sargsyan expressed confidence in the dollar and the U.S. economy.

"For the next 15 years, the U.S. economy will not be seriously challenged and will emerge stronger from the current tribulations," he predicted. "The dollar will maintain its dominance, backed by the dominance of the U.S. economy."

China and India will become major producers of machinery and finished goods, Russia will seek a niche between Europe and China, the U.S.

economy will be increasingly based on knowledge and technology, while "Europe will attempt to catch up with the States, never really making it," he said.

European Monetary Union is a "quite remarkable experiment" that has so far had "significant successes," he allowed, but it is also fraught with risks related to the lack of a corresponding governance system and cultural or philosophical differences.

Although Armenia is well-positioned to attain levels of productivity similar to those of Europe in a decade or so, Sargsyan said, introducing the euro here "is a much more far-away issue; it's not even an objective yet.

Armenia is currently trying hard to pattern its economic structures on European legislation, he noted, and to this end it "carefully looks at all the European directives."

"I think that in the next five years the environment here will be dramatically qualitatively changed and far less divergent from Europe than it is now," he predicted
