

## **Interactions between high inflation control, price stabilization and inflation risk management in the context of progressive development of the real sector**

### ***Introduction***

Analysis and description of the situation. This research aims to highlight the real causes of uncontrollable inflation, inflationary risks and, due to them, unemployment, population, decline in purchasing power and high level of poverty, and based on the results of the research, to present proposals for the improvement of the situation. The change we foresee is the presentation of proposals to the executive power, raising the level of awareness of the issues and risks among the population, and possible positive changes in consumer behavior. The period of implementation of the project is chosen taking into account the period of economic and business activity in the country, which includes the period from the last months of summer to autumn, which allows for a more realistic assessment of economic risks and current trends in the economy, as well as to identify external and internal economic sources of risks and their possible impact on the threat management process. The basis of the development of the project is the fact that a contradictory situation has been created in Armenia. In particular, 2022 a fairly high level of the economic activity index was recorded, 14.2 percent ([www.armstat.am, sv\\_12\\_22a\\_03.pdf](http://www.armstat.am/sv_12_22a_03.pdf)), which should have led to a reduction in unemployment and poverty, however unemployment in Armenia is the highest in EAEU. it was 3.6% of the working population (49,600 people). In Kyrgyzstan, this figure was 2.9% (76,400 people), in Kazakhstan - 2.4% (221,900 people), in Russia - 0.7% (556,400 people), and in Belarus - 0.1% (5,800 people) - <https://armeniasputnik.am/20230115/hajastanum-grancvel-e-gvortsazrkutjan-amenabardzr-makardaky-eatmum-53793898.html>, according to the World Bank, the poverty level in Armenia was 41.8 percent. Only in January of this year, 10.5 percent economic growth was registered in Armenia / [https://www.armstat.am/file/article/sv\\_01\\_23a\\_03.pdf/](https://www.armstat.am/file/article/sv_01_23a_03.pdf/), at the same time, more than 20 thousand jobs were closed in January. <https://168.am/2023/03/27/1851396.html>

Moreover, it is important to pay special attention to the gender sensitivity of the topic, taking into account the fact that 571 people from the group of employed poor formed as a result of high inflation do not have primary education and are illiterate at the same time, making 0.3% of the employed poor, and poor women with this indicator are 2.6 even surpassed men. 17.3% of the employed poor had higher education, and

52% were women and 48% were men. <https://library.fes.de/pdf-files/bueros/georgien/17944-20210722.pdf> page 21

A realistic brief analysis of the situation proves that it is necessary to find out these discrepancies and their causes between the economic indicators, as well as to identify the risks that threaten the life of the population in the conditions of continued inflation.

The following types of activities were performed during the research project:

- the real reasons for the "jump" in the prices of consumer goods and services in the world and in the region were studied and diagnosed;
- the peculiarities of the structure of the consumer goods price index in Armenia, the factors causing high inflation were revealed;
- the institutional foundations of controlling high inflation, stabilizing prices and managing inflationary risks were presented according to the degrees of responsibility of state structures (CBA of the Republic of Armenia, Ministry of Economy of the Republic of Armenia, Ministry of Finance of the Republic of Armenia, State Committee on Protecting Competition of the Republic of Armenia, other structures),
- forecasts due to the interdependence of inflation and economic growth were made;
- practical proposals aimed at predicting and controlling high rates of inflation, ensuring price stabilization, and managing inflationary risks were developed.

### ***The real reasons for the "jump" in the prices of consumer goods and services in the world and in the region. diagnosis***

Both during the outbreak of pandemic and in the years that followed, there was a certain disruption of the balance of market forces, which led to many economic risks: the loss of the purchasing power of the local currency was manifested by difficult-to-manage inflationary processes, accompanied by sharp changes in the prices of goods and services, an increase in unemployment and an increase in the level of poverty.

Accordingly, gender sensitivity in this issue is reflected by the existence of the following problems.

According to RA Statistic Committee, 41 percent of those employed in the labor market are women. And, in general, around 51 percent of working women are considered to be out of the labor force. There is a fairly high gender gap, especially in the reproductive age group, the gender gap in the 25-49 age group of the population outside the labor force is 67 percent, and in the same age group of labor force participation, the gender gap is about 41 percent. / <https://point33.am/women-labor-market/>. All this could not leave its impact on the development of the real sector of the economy. As a result, the indicator of economic

activity decreased significantly in almost all branches and sub-sectors of the real sector of the economy. Although the health care system managed to prevent some of the damage caused by the pandemic, its impact on the economy continues to this day. Last year, 2022, was also added to it. The war unleashed by Russia against Ukraine, as a result of which almost 250 thousands of refugees arrived in Armenia from both Russia and Ukraine, and the sharp increase in domestic demand, in turn, led to a more than twenty percent revaluation of the Armenian dram and an almost uncontrollable increase in the prices of consumer goods. It is noteworthy that similar processes, in particular, a significant increase in the prices of basic life support products were also recorded in different countries of the world, which proves that we are dealing with a serious economic threat of a widespread nature. For this very reason, it is important to investigate the real causes of high inflation and the possibilities of its containment, which is aimed at price stabilization and effective management of inflationary risks. Moreover, we observed the important interactions between them, which are of particular importance in the progressive development of the real sector. The pandemic had many negative consequences, one of which is the sharp acceleration of price growth in both developed and developing countries. Acceleration of inflation was particularly strong in 2021 and has so far shown no significant slowing trends, despite the response of macroeconomic policies. Fighting current inflation is difficult because inflation is influenced by many factors from both the supply and demand sides. The IMF also emphasizes the factors affecting inflation in 2022. A report published in January cited rising energy and food prices as the main causes of accelerating inflation, as well as other factors (including supply chain disruptions, congested ports, land restrictions, as well as increased demand for some commodities) that were of varying importance depending on countries and regions. In developed countries, energy prices have been most significant, almost doubling in the past year, causing higher inflation, especially in Europe. Food prices rose by around 23.5%, also contributing significantly to inflation. The sharp increases in the prices of the latter, as well as energy carriers, are explained in 2020-2021 in the conditions of co-epidemic restrictions and the problems created as a result of which have not yet been eliminated with a sharp rise in global demand. Inflation dynamics in developing countries have been significantly driven by higher import prices, while disruptions in supply chains and other similar factors have also played an important role<sup>1</sup>. At the same time, the exchange rate fluctuations in developing countries counteracted inflation because in 2020 mainly devaluation took place, compared to which in 2021 the exchange rates of developing countries were appreciated.

The increase in demand was also a significant factor in the acceleration of inflation, which in turn is explained by the significant size of the fiscal packages aimed at mitigating the negative consequences of the pandemic. The latter reached unprecedented volumes in 2020-2021, especially in developed countries.

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<sup>1</sup> IMF World Economic Outlook, January 2022 Update. Rising Caseloads, A Disrupted Recovery, and Higher Inflation.

However, a study of data from more than 50 countries shows no significant correlation between the size of fiscal packages and the rate of inflation<sup>2</sup>. This allows us to conclude that the effect of increased deposit supply as a result of the fiscal packages on global inflation was not significant. The source of information on fiscal packages is the IMF database, and on inflation, the statistical services of the respective countries. Both fiscal packages and inflation data refer to 2020 from the beginning to 2021 at the end of the period. According to the RA Central Bank, the acceleration of inflation in Armenia was due to supply factors, including the increase in prices in international commodity markets and their transfer to the RA economy, as well as the 2021 with the effects of exchange rate devaluation in the first half<sup>3</sup>. Until 2021 The role of demand factors in the acceleration of inflation at the end of the year has increased due to the acceleration of external demand and the continued high indicators of money transfers from abroad to Armenia. Under these conditions, the Central Bank continued the policy of increasing the interest rate, increasing it to 8.0% at the end of the year. 2019 compared to the end of 2021 at the end of the year, the inflation recorded in RA was lower than the comparable indicators as well as those recorded in the countries of the region, amounting to around 11.8%. In the same period, 2020-2021, RA recorded almost the slowest economic growth among the same countries, as a result of which RA's real production did not recover and did not even equal 2019 level<sup>4</sup>. Among the observed countries, such a situation occurred only in Kyrgyzstan, while in all other countries in 2021 the actual result exceeded the level of 2019. According to IMF forecasts made before the start of the Russian-Ukrainian conflict, it was expected that the high rate of inflation will continue in 2022, being on average 5.9% in developing countries and 3.9% in developed countries, and then the rate of inflation will start to slow down from 2023<sup>5</sup>. However, in 2022 In the IMF report published in April, the inflation forecasts have been significantly revised upwards, and now in developing countries in 2023 8.7% inflation is predicted, and 5.7% in developed countries<sup>6</sup>. This revision is mainly due to the intensification of factors accelerating inflation as a result of the Russian-Ukrainian conflict. In particular, as a result of the war, the increase in the prices of food and energy carriers has accelerated (since Russia and Ukraine have a significant role in the world markets of these products), and new reasons have been created for disruptions in supply chains. In these conditions, the expectations of the IMF regarding the following years have also changed. In the January forecasts, the IMF expected a slowdown in inflation from 2023, and now the uncertainty of the forecast has significantly increased and there are risks of further acceleration of price growth. Such rates of inflation in world markets for countries with a developing and open economy like RA contain not only risks of domestic inflation

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2 The list of countries includes both developing (Armenia, countries of the region and EAEU, as well as developing countries of Eastern Europe) and developed countries (USA, Western European countries and other developed countries).

3 Inflation Report (Monetary Policy Program, 2nd Quarter 2021, Implementation Report of Monetary Policy Program 1st Quarter 2021), RA Central Bank, 28.06.2021.

4 Inflation Report (Monetary Policy Program, 4th Quarter 2021, Implementation Report of Monetary Policy Program 3rd Quarter 2021), RA Central Bank, 27.12.2021.

5 IMF World Economic Outlook, January 2022 Update. Rising Caseloads, A Disrupted Recovery, and Higher Inflation.

6 IMF World Economic Outlook: War Sets Back the Global Recovery, April, 2022.

(inflation of imported goods), but are also dangerous from the point of view of general financial stability. The point is that in response to inflation in developed countries, monetary policy authorities (especially the US Federal Reserve System and the EU Central Bank) raise the interest rate on the one hand, and on the other hand reduce the liquidity provided to the economy by reducing the volume of bond purchases. In this case, the risk increases that large investors will prefer less risky assets (such as US and EU bonds) in the structure of their portfolios, increasing the interest rate by selling risky assets.

Under these circumstances, to avoid capital outflows, central banks in developing countries would also have to raise interest rates, which would cause interest rates on the country's government bonds, as well as private sector debt, to rise to a greater extent than US interest rate increases and increasing the sovereign risk premium of developing countries. This means that, for example, in the RA economy, the costs of refinancing the external debt of both private and public sectors will increase, increasing the debt service burden. In an economy like RA, where the gross external debt (private and state) in 2021 reached 95.1% of GDP as of late, the rise of interest rates could be a serious threat. However, even rising interest rates may not be enough to prevent capital flight. At the same time, an aggressive increase in interest rates could have severe consequences for the economy without fully neutralizing inflationary expectations. This is because a significant amount of inflation is driven by supply factors. Curtailment of demand will not contribute to the neutralization of the latter, but instead will lead to a slowdown in economic activity. Under these circumstances, it is necessary to implement targeted fiscal and structural policy measures to address supply-side problems and repair disruptions in supply chains<sup>7</sup>.

### ***Peculiarities of prices of consumer goods in Armenia, factors causing high inflation***

According to official statistics, in 2021 in December, the price level was on average 7.7% higher than in the same month of the previous year. However, the growth rate of prices in the consumer basket differed significantly by product type. Inflation was mainly caused by a 12.9% increase in the prices of the "food and non-alcoholic beverages" product group, which provided 4.8 percentage points of the 7.7% inflation. The 8.0% inflation of the "non-food products" product group significantly contributed to inflation by about 1.8 percentage points, while the prices of services and "alcoholic beverages, tobacco products" product groups increased by 1.9% and 9.2%, respectively, contributing to the 12-month inflation by about 0.7 and 0.4 percent point. The prices of goods included in the food and non-alcoholic beverages category, the largest contributor to price growth, generally increased at a much higher rate than general inflation. In particular, the prices of vegetables increased significantly by around 40%, contributing to the general inflation by 1.9 percentage points, in which the prices of potatoes increased by around 76.1%. The prices

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<sup>7</sup> 7 Joseph E. Stiglitz, A Balanced Response to Inflation, Project Syndicate, February 2022.

of bakery products, dairy products and edible oils also increased by more than 10%, while the prices of fish and seafood increased by around 31.4%. The latter are primary consumption goods and their price increase directly affects the living standard of the population. The increase in the prices of non-food products was mainly caused by the increase in the prices of fuels (including gasoline) and medical and pharmaceutical products, and the increase in the rates of international air transport services, ambulatory and medical services had its direct impact on the inflation recorded in terms of services.

Studying general inflation indicators is quite important, but the increase in average prices of all products included in the consumer basket does not provide a complete picture of the effects of inflation on different social groups of the population. For this reason, the structure of income and expenses of the population was studied, which allowed to identify the effects of inflation on the rate of income growth for different social groups of the population, on the one hand, and on the other hand, the increase in expenses under the conditions of acceleration of inflation. Almost half of the monetary income of households is the salary, the weight of which in the total income in 2020 was 50% in 2019 increasing by 2.0 percentage points compared to Population in 2022 state pensions and allowances, as well as income from self-employment, played a significant role in the income structure, their weights were 17% and 15%, respectively. The weight of remittances decreased by 7%, which is due to the reduction in the number of people leaving for work abroad in the conditions of the pandemic. Taking into account the differences in the weights of the above-mentioned three components: pensions, wages and transfers in the incomes of the population in different social groups, their changes also changed the upper and lower deciles to a different extent of the incomes of those in the groups. Thus, the nominal incomes of those in the lowest decile increased by 4.2% under the influence of the aforementioned components, while the increase for the highest decile group was 8.6%. In real terms, the picture is more problematic, as the incomes of the population in the lowest decile decreased by around 1.4%, while those in the highest group increased by around 2.3%. It turns out that in 2021 the living standards of the socially vulnerable class have decreased, and those with high incomes have increased, as a result of which income inequality has increased.

According to the estimates, the value of the basket of food products increased by 11.7% on average, while the incomes of the socially disadvantaged population increased by only 4.2%. Moreover, the 11.7% increase is mainly due to the increase in the prices of such products as bread and bakery products, fruits and vegetables, edible oils and meat, which are basic necessities. That is, the increase in the prices of these goods, in the conditions of inadequate growth of incomes, push other expenses out of the population's expenditure structure, thus reducing their well-being. The analysis shows the impact of the average increase in consumer prices on the change in the income of the population. However, the prices of a number of primary consumer goods increased at a much higher rate than average inflation. Moreover,

these products have a greater weight in the consumer spending of the low-income population. In particular, about 52% of the consumption expenditure of the population in the lowest decile group of expenditures is directed to the purchase of food, while in the highest decile, this weight is 33%. Taking into account the differences in the price increases of various products, the Central Bank of Armenia also calculated the consumer price increases for different decile groups of the population. According to these estimates, inflation for households in the lowest group in 2021 was around 8.5%, while inflation for those in the highest decile was 6.1%. As already mentioned, the differences in inflation are due to the fact that in the structure of expenses of low-income earners, the weights of those products, which have recorded the highest price increase, are large. As a result, inflation has had a greater impact on the low-income population, significantly reducing their living standards and increasing social inequality<sup>8</sup>.

It is important to take into account the fact that inflation, being in 2020-2022 as a result of the negative phenomena occurring both in RA and in the world economy, significantly worsened the social condition of the population and increased inequality. In 2022-2023, however, the situation worsened from the point of view of external shocks, as the Russian-Ukrainian conflict that started in February is already having negative economic consequences. The latter are manifested both in the world economy and in the countries with significant connections with the Russian Federation, including the Republic of Armenia. The deterioration of the economic situation in Russia also spread to Armenia through various transmission channels. The channels of this transfer are, in particular, foreign trade (the export of goods to the Russian Federation made up 28% of the total RA exports in 2021, and the imports from the Russian Federation made up 33% of the RA imports), money transfers (in 2021 they made up the total to the RA about 53% of the net inflow of remittances), foreign investments (about 40% of foreign investments in RA in 2021) and tourism (about 40% of tourists in 2021 came from the Russian Federation). In addition to these transmission channels, there may also be indirect effects on Armenia's economy. In particular, as a result of the Russian-Ukrainian war, the international prices of food products and energy sources have sharply accelerated, which has a significant impact on world inflation, therefore it has also led to an increase in the prices of goods imported to Armenia. As a result of these connections and developments, the increase in the prices of imported goods, the revaluation of the Armenian dram, as well as the increases in the prices of apartments and services in the domestic market can be distinguished from the factors of the acceleration of inflation in RA. Acceleration of inflation in international markets, including in RA's trade partner countries, has led to an increase in the prices of goods imported to RA, and therefore also to an acceleration of general inflation. In this regard, the situation is somewhat mitigated by the fact that the price of gas imports is fixed and market factors do not affect it. However, an increase in the price of gas is

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<sup>8</sup> Causes of CPI increase, RA CBA, 2022, available at: <https://www.luys.am/img/artpic/small/7eb82e03aa3ebba64cf604-INFLATION.pdf>

also expected. A devaluation of the Armenian drams was already observed in March, after a sharp devaluation of the Russian ruble. However, at the end of March, the Armenian dram stabilized, returning to the pre-war level, on the one hand, due to the sharp increase in the interest rate of the Central Bank of Armenia, and on the other hand, due to the factors of the appreciation of the Russian ruble. Moreover, since April, the dram has started to appreciate being more valuable than it was before the conflict and passing the limit of 20 percent for the year.

However, the devaluation of the Armenian dram is not based on fundamental factors (increasing the potential of the Armenian economy or improving the trade balance), but temporary factors (temporary inflow of foreign currency to Armenia, including at the expense of money brought by foreign citizens who arrived in Armenia). These factors are not stable, therefore the risk of dram devaluation is still present, and in case of further weakening of the positions of the Russian ruble, as well as in case of deterioration of the RA economic environment, the RA dram may depreciate, leading to the acceleration of inflation. Due to the sanctions imposed on Russia, many Russian citizens, as well as a number of businessmen, moved to Armenia. According to information circulating in the press (official information is not available) in 2022 from the end of February to the end of October, 2023 around 250,000 Russian citizens arrived in Armenia. Those flows have caused significant pressure on the RA real estate market, leading to a sharp increase in rents. These trends have received a certain continuation, especially in September - October, 2023 as a result of the forced deportation of 120,000 Armenians from Artsakh. In addition, citizens arriving in RA have significantly increased the demand for services in RA, which is also a factor accelerating inflation. Quantifying the aforementioned factors is quite difficult, as their future trends and potential volumes are uncertain. In particular, it is uncertain how long the Russian-Ukrainian conflict will last and how much more energy and food prices will rise. In addition, it is uncertain how many citizens and businessmen will arrive in RA from Russia. However, based on the events that have already taken place, it can be noted that the acceleration of inflation is inevitable. 2022 the acceleration of inflation in the conditions of a sharp increase in the Central Bank interest rate already speaks of it. As in 2020-2021, the acceleration of inflation in 2022 also had a negative impact on the social inequality of the population. In particular, the increase in food prices has led to a further decrease in the living standards of the low-income population, since the weight of food in their consumption expenditure is greater. On the other hand, a significant increase in the demand for real estate will lead to an increase in the income of property owners (who are mainly the population in the upper social group). Meanwhile, there will be no significant change in income for wage earners and the socially disadvantaged, and inflation will reduce their real incomes and thus their living standards.



***Institutional foundations of high inflation control, price stabilization and inflation risk management and evaluation of the degrees of responsibility of state structures (CBA of the Republic of Armenia, Ministry of Finance of the Republic of Armenia, Ministry of Economy of the Republic of Armenia, Ministry of Finance of the Republic of Armenia, State Security Council of the Republic of Armenia, other structures)***

It is obvious that inflation is a negative phenomenon and sustainable economic development can be ensured only under conditions of low and stable inflation. This is mainly due to the implementation of inflation targeting policies by central banks, which was first implemented in New Zealand in 1990 and has spread to many developed and developing countries. The Central Bank of Armenia has started implementing inflation targeting policy since 2006. Inflation usually affects macroeconomic indicators in different directions, which can often counteract each other. That is, on the one hand, inflation can have positive effects, on the other hand, negative effects. Professional literature notes that extremely low inflation (close to zero or below zero) can also have a negative impact on the economy, mainly due to the difficulty of downward adjustment of wages and the zero bound on the nominal interest rate (central banks are limited to interest rates close to or above zero under conditions of being down). For this reason, central banks generally target an inflation rate above zero, generally between 2 and 5%. Inflation higher than that, however, begins to negatively affect the economy<sup>9</sup>. Studies show that an inflation rate of up to 10% can lead to a 6.8% reduction in the annual volume of real GDP<sup>10</sup>.

There is also a negative relationship between inflation and technological development: the acceleration of the rate of inflation leads to the reduction of investments in the direction of research and development, which in turn negatively affects the development of the country's economic potential. In addition to the above, the tightening of monetary conditions (including the increase of interest rates) in the conditions of inflation, which is carried out by central banks that have adopted an inflation targeting policy (including in Armenia), also has a negative impact on the economy<sup>11</sup>. By the way, in 2021 interest rates have increased not only in developing but also in developed countries<sup>12</sup>. After recording a relatively low inflation environment in Armenia in recent years, price growth has started to accelerate in December, 2020 when

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9 Akerlof, George A., William T. Dickens, and George L. Perry "The Macroeconomics of Low Inflation." *Brookings Papers on Economic Activity* 1 (1996): 1-76. Fortin, Pierre. "The Great Canadian Slump." *Canadian Journal of Economics* 29 (November 1996): 761-787.

10 Ashraf Q., Gershman B., Howitt P. "How Inflation Affects Macroeconomic Performance: An Agent-Based Computational Investigation", June 2013.

11 Rocha L.A., Cardenas L.Q., Reis F.A., Silva N.G. "Inflation and innovation value: How inflation affects innovation and the value strategy across firms", *Estudios Económicos*, vol. XXXVIII, no. 76, pp. 147-195, 2021.

12 In the absence of a response from the Central Bank of Armenia, the increase in prices may be much higher, leading to an even worse economic situation. Therefore, the mentioned does not mean that the Central Bank should not react, but it is only recorded that the fight against inflation is also "costly" in terms of macroeconomic indicators.

12-month inflation reached 3.7%, after 1.6% in November of the same year. The Central Bank of Armenia, reacting to the expected increase (at the time of the reaction, the inflation index had not yet been published), sharply increased the interest rate by around 1.0 percentage points. Then, in 2021 during this period, the rate of inflation gradually accelerated, and the Central Bank of Armenia continued to increase the interest rate, bringing it to 7.75% at the end of the year, which is about 1.8 times higher than in November, 2020 rate. The interest rate hike continued into 2022, reaching 9.25% in March. 2023 On August 1, a meeting of the Board of the Central Bank of RA took place, during which it was decided to set the refinancing rate at 10.25%<sup>13</sup>. The increase in the interest rate of the Central Bank of Armenia's operations in the financial market had an immediate effect on the interest rate of short-term government bonds (SGB), which began to respond from December, 2020 increasing by 0.2 percentage points, and in 2021 increased by 0.8 percentage points in January. In March 2022, the interest rate of SGBs will be the same as in 2019 compared to the end, it increased by 4.4 percentage points, in the conditions of the increase of the Central Bank interest rate by 3.75 percentage points. It is noteworthy that the change in the Central Bank interest rate did not have the same effect on other interest rates of the financial market, especially on loans and deposits. Thus, in 2022 in March, the average interest rate of dram loans (with a term of up to 1 year) was around 12.5%, in 2019 increasing by about 1.0 percentage points compared to December. The interest rate on short-term deposits increased by around 0.8 percentage points during the same period. However, during the same period, the volume of loans decreased (mainly due to the decrease in loans to legal entities), which was due not only to the increase in interest rates, but also to such factors as the high level of uncertainty in the economy, the sharp increase in non-performing loans, etc.

### ***Regarding the issues related to the RA Ministry of Economy***

The 2020-2023 Artsakh war, its consequences and the coronavirus epidemic had already significantly increased the uncertainty regarding the further development of the RA economy, and the inflation, which is accelerating every month, has aggravated it even more. Under these conditions, businessmen avoid making large-scale investments, postponing their plans, and consumers, on the one hand, increase demand for primary consumption goods (leading to faster inflation), on the other hand, increase savings, due to which consumption volumes decrease compared to disposable income. As a result, the weight of savings in disposable income reached 15.6% compared to 9.3% in 2019. An increase in savings should lead to an increase in investment, but due to the increase in uncertainty in the economy due to inflation and other factors, this does not happen. In 2021 investments (gross accumulation of fixed assets) increased by 7.7% after falling to 8.6% in 2020. It turns out that the real volume of investment did not recover in 2021 in the case of high savings growth. The latter indicates uncertainties and low attractiveness of the investment

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13 [https://www.cba.am/AM/News/Pages/news\\_02-05-2023\\_1.aspx#sthash.upap3Dq6.dpbs](https://www.cba.am/AM/News/Pages/news_02-05-2023_1.aspx#sthash.upap3Dq6.dpbs)

environment in the economy. The 10.9% decrease in loans to legal entities also speaks of the low level of investment activity.

### ***Regarding the issues related to the RA State Revenue Committee***

Inflation naturally has a significant impact on fiscal indicators, but in 2020-2023 negative effects were counterbalanced by positive effects. Thus, as a result of inflation, more tax revenues were collected by around 110.8 billion drams (1.6% of GDP), and the amount of expenses incurred as a result of inflation was around 135.4 billion drams (1.9% of GDP). As a result, the deficit of the state budget increased by 24.6 billion drams (0.3% of the GDP), which, naturally, increased the amount of borrowing by the government to finance the budget. At the same time, as a result of accelerating the growth of the GDP deflator (gross domestic product price growth), nominal GDP growth was recorded which positively affected the government debt/GDP ratio. As a result of these factors, the debt-to-GDP ratio was about 4.2 percentage points lower than it would have been in the absence of inflation. In other words, in the absence of inflation, the debt/GDP ratio would not decrease. In the conditions of inflation, the growth of the real income of the population was almost zero. 2021 during the period, the average price increase was 7.2%, and the average nominal salary increased by 7.6%. As a result, the increase in wages was almost completely neutralized by the increase in prices, as a result of which the average increase in real wages was only 0.4%. By the same logic, the increases in pensions and allowances have also become insignificant in the conditions of inflation.

Returning to the regulatory and control functions of the state, it is necessary to refer to such important instruments for influencing inflation through the competitiveness of the economy as customs, tax and monetary levers.

Despite the fact that every year attempts are made to improve the country's tax system and the mechanisms used, it is still premature to describe them as effective. The "tough" administration, on the one hand, aims to reduce the shadow economy on the other hand such a policy is conducted with some reservations, giving "privileges" to some businessmen who are already in a good condition. As for the real tax benefits, they are legally and legally unacceptable for now. In other words, there is no targeted and differentiated tax policy aimed at developing this or that sector or area. As a result, small and medium-sized enterprises are closed, the share of the shadow economy increases, as a result, the volume of state revenues decreases, and in order for it to be sufficient to cover the expenses of the state budget, the tax burden can increase endlessly, which is increasingly concentrated on a smaller number of entrepreneurs on the shoulders. Additional taxes, in turn, increase the cost of goods and services and contribute to high rates of inflation.

Among the real causes of inflationary pressures, we can also mention smuggling, ineffective customs policy, as well as the low level of efficiency of the fiscal policy aimed at revenue collection. According to some experts, the form of added value, its calculation, and the working mechanism of document circulation also contain inflationary risks.

### ***Regarding the issues related to the RA Ministry of Finance***

It is obvious that inflation is usually accompanied by a devaluation of the national currency. In our case, the opposite happened: high inflation was accompanied by a more than 20 percent revaluation of the Armenian dram, which could not but affect, for example, the RA state debt, debt / GDP ratio, especially external and internal debt servicing processes. In particular, in the conditions of the devalued dram, the Ministry of Finance of the Republic of Armenia was given the opportunity to nominally service a smaller volume of external state debt, expressed in the Armenian dram, converted into foreign currency.

In sum, we can note that in 2020-2021 inflation had significant negative effects on the macroeconomic developments of Armenia. In the conditions of accelerating inflation, uncertainties increased, and the growth of investments was not enough to restore their real volume and real GDP. Also, in the conditions of the acceleration of the rate of inflation, the increase in the real wages of employees in 2022 was almost zero, as a result of which no significant improvement in the living standard of the population took place. Instead, inflation has helped the collection of tax revenues, which the government plans for 2022 presented in the performance report as tax overspending at the expense of administration, on the other hand, it helped ensure a reduction in the debt/GDP ratio<sup>14</sup>.

### ***Regarding the issues related to the RA Competition Protection Commission***

Although in general, Armenia is ranked among the countries with a liberal economy in international reports, it is obvious that there are outwardly invisible barriers in the markets of a number of products, which close the entry of potential competitors to the said market. The limitation of various product markets or their almost closed status is among the internal - subordinate factors contributing to the high level of inflation. The Government of RA and the Central Bank have recorded on different occasions that there are those who have a dominant position in the domestic market and perform price manipulations. The devaluation of the Armenian dram and the high level of prices, including the majority of imported goods, on the one hand, is due to the desire of importers to ensure extra profits not only in foreign currency, but also in Armenian dram, on the other hand, it indicates a high level of concentration in the RA economy, which is an important precondition for the dominant or for the abuse of their position in the

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<sup>14</sup> Causes of CPI increase, RA CBA, 2022, available at:  
<https://www.luys.am/img/artpic/small/7eb82e03aa3ebba64cf604-INFLATION.pdf>

domestic market by entities with a monopoly position through anti-competitive agreements or other methods. This is evidenced by the official data published by the RA Competition Protection Commission.

Due to the low level of effectiveness of the economic competition protection system and the prevalence of corruption, a significant part of Armenia's economy, according to local and international experts, has turned into a semi-monopoly system, which inevitably hinders the establishment of a socially oriented competitive national economy.

The analysis of the situation in the centralized commercial markets of agricultural products operating in Yerevan deserves special attention. The prices of fruits and vegetables offered in the so-called "night" wholesale markets are significantly lower than the unified-monopoly prices imposed on consumers after only 3-4 hours. Of course, we are not talking about the classical notions of the profit norm. Their difference is usually 75-100, and in some cases up to 200 percent or more. It is obvious that under these conditions it is inappropriate to touch the idea of healthy competition or to look for any objective reason. In fact, the entire batch of products is almost forcibly "purchased" from the producers of agricultural products by just a few individuals, the group rulers, they are appointed by administrative order and the consumer is dictated to at unjustified high prices. It is customary to say that the prices dictated by them in the early morning determine the entire trade, and on that day the light seems to open not for the peasant, but for the ruler of the group. Such a phenomenon is even incomparable with the economic administration operating under socialism. It can be more accurately assessed as the arbitrary behavior of the mercantile-usurer elite operating under feudalism, and in today's language, an economic crime that clearly violates the state's regulatory and control functions and weakens the economic and social foundations of statehood.

People often think of inflation as just one phenomenon, when in fact it is the result of several phenomena. For example, inflation can be recorded both when there is a shortage of goods (that is, in the case of an excess of aggregate demand compared to the actual volume of production), and when underutilization of a number of production resources increases production costs and the existing price level. Under the conditions, an increase in the cost required for a unit of output reduces its supply by the producer. It is natural that in both cases the expectations of consumers change, their psychology, and naturally also their behavior. This phenomenon is not at all unique in our country. Sometimes it is enough to spread even unsubstantiated information or rumors about a possible increase in the price of this or that product, and a much greater demand for the same product may arise, which is a good opportunity for some entrepreneurs and traders to raise prices dramatically. Accordingly, the studies conducted by us prove that the disappearance of only 6-7 percent of goods intended for consumption in Armenia can cause not only normal inflation, but also panic. Consumers are trying to stockpile larger quantities of such goods, further reducing the amount of goods in circulation and exacerbating price volatility.

### ***Regarding the issues related to the RA CBA***

Issues of lending to the real sector of the economy play no less important role in the current level of inflation. This also indicates the participation of the banking system in the development of the production sector of the economy. At the same time, it is necessary to find out whether the provided loans will contribute to inflation or deflation.

The currency policy of the country is not an exception among the internal causes of inflation. A devaluation of the national currency can generally help to increase the competitiveness of the economy and boost exports, but in the longer term it can have a negative impact on prices and lead to inflation. On the other hand, large volumes of exports ensure a large inflow of foreign currency, which inevitably affects the exchange rate level, increasing the purchasing power and therefore the value of the national currency. In fact, fixing any level of the exchange rate becomes a serious problem. Periods of dram devaluation / hyperinflation / and dram overvaluation can be considered in our country in 1994 and in 2008 respectively. During 1994, the dram depreciated by 3162%. The Central Bank of RA jointly with the government embarked on the implementation of IMF and World Bank credit programs. Naturally, the most important thing for the Central Bank was the choice of the right monetary strategy, that is, the Central Bank had to choose only two of the three policy objectives in the medium term (fixing the exchange rate or ensuring a narrow corridor of the latter, prices or an independent monetary policy, and therefore the choice of the right strategy derived from it and capital liquidity). In the case of an independent monetary policy strategy, the exchange rate should be allowed to float under conditions of free capital flow. At the same time, it should be noted that the reasons for dram devaluation and rapid price increase can be the incorrect money circulation and monetary policy, the existence of external and internal debts of the state, non-productive expenses, etc. From time to time, the depreciation of a country's currency can make local goods cheaper for foreigners, and its appreciation makes goods more expensive in foreign markets. When a country's currency depreciates, exports become cheaper, and imports from abroad become more expensive for residents. The increase in the exchange rate of the national currency has the opposite effect: foreigners pay more for a country's goods, and local consumers pay less for imported goods. In other words, the appreciation of the national currency increases its export price and lowers its import price. Otherwise, the devaluation of the national currency lowers the price of the country's exports, increasing the competitiveness of domestic goods and raising the prices of imported goods. Studies show that a deep crisis has taken place in those countries where they tried to ensure the three goals at the same time (Brazil, Argentina, Russia). Among other reasons in the external arena, one can also mention the increase in oil prices, the increase in demand for food, the lowest level of grain stocks recorded in the last three decades and the highest level of their prices, the increase in the cost of

food production, the key role of trade unions in developed countries, which limits the possibilities of the market mechanism to form an acceptable wage level for the economy, as well as the fact that in the world market, not so much individual selling companies, but political and economic monopolies, often agree to dictate prices, part of the agricultural products are already used to obtain biofuel /sugar cane, corn, other crops/, in many countries of the world, in the conditions of financial and economic crisis and inter-ethnic conflicts, the military expenses, maintenance expenses of the state apparatus are increasing, which require additional money supply, and the latter does not correspond to the mass of goods in circulation.

***Forecasts of high rates of inflation and practical recommendations aimed at curbing, ensuring price stabilization, and managing inflationary risks***

In our opinion, inflation trends are largely determined by economic developments, and more specifically, they are expressed and evaluated by indicators of economic activity. In particular, the mentioned indicator has recently recorded growth trends therefore it is not difficult to predict that some trends of 2022 may continue until 2023. Taking into account the current trends, one can predict a further increase in business activity, which this time may be below nine percent, if there are no external contributing factors and preconditions. Our forecasts are somewhat different from the forecasts of influential international organizations in terms of numbers, but they coincide with the forecasts of positive trends.

Acknowledging that inflation is actually the result of many accumulated problems, it is necessary to address the most important ones and direct professional resources to their solution. There is a point of view that part of the inflation is a result of the EAEU membership of Armenia. The CBA of RA has clearly formulated the extent of the impact caused by the changes in excise, customs duties and indirect factors in the EAEU, which does not even reach one percentage point. At the same time, in 2023 The estimated four percent inflation for And those products, which are only around a dozen and which are consumed by all classes of the population, have increased in price even in double digits during the last year and this year. Moreover, the main consumer of these ten product groups is the poor class, which makes up more than half of our population (according to official statistics, about a third of the population, adding to it the number of the working poor, whose minimum wage does not allow them to overcome the poverty line).

The next important problem is the making of excessive profits by some businessmen. In particular, some food importers have profit margins that are included in the prices of goods delivered to the consumer gaining extra profits from fewer locally produced products.

A clear agrarian policy aimed at the country's food security and efficient agriculture is almost absent. Strict discipline, responsibility to influence the price level of essential commodities through teamwork is also required.

### ***Conclusions and recommendations***

Thus, it is necessary to develop options for mitigating the effects of inflation for those socially important products that have become more expensive as a result of changes in tax or other laws. First of all, for important agricultural products, it is important to develop an agrarian policy and a road map of complex measures aimed at the development of local production and the substitution of imported products, which will make it possible to ensure the most affordable level of prices while encouraging local production. Relevant government departments should monitor the compressed gas, gasoline and diesel fuel markets and report the identified problems to the State Commission of Economic Competition for action. In cases of unjustified price increases in highly concentrated commodity markets, the Commission should study pricing in grain, flour and other markets and present clear recommendations in case of problems.

The RA Central Bank, using indirect monetary policy tools, reduces inflationary risks, but ensuring a stable price level requires teamwork with RA Ministry of Economy, RA Ministry of Finance, RA State Revenue Committee, RA Economic Competition Commission and other bodies.

It is necessary to take the ten groups of basic necessities under special control in order to mitigate their inflationary risks for the socially vulnerable classes.

1. vegetables,
2. fruit
3. leguminous crops,
4. vegetable oil,
5. egg,
6. milk,
7. meat: beef, pork, sheep and goat, poultry
8. wheat,
9. potatoes,
10. sugar



Our studies prove that Armenia can and should be a self-sufficient country providing local consumption with local production for the majority of the mentioned product groups. It is also important to gradually raise the minimum wage and pensions to the level of the food basket.

The most important issue, in our opinion, is maintaining the achieved level of business activity growth. To improve long-term economic growth prospects, the government and the private sector must pay more attention to building a resilient business environment, effective economic diversification, and improving governance. And this, in turn, requires close cooperation with the expert community.

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