Armenia

The global and regional recessions severely battered exports, workers' remittances, and private capital flows, forcing the country into its worst recession since just after independence. To counter the downdraft, the government implemented a wide-ranging anticrisis program. Its measures have maintained financial and external stability, kept inflation in check, and cushioned the adverse impact on the population. With momentum established, the outlook is for recovery with modest but strengthening growth. The medium-term challenges include broadening the production base, strengthening the fiscal position, and improving governance.

Economic performance

The global recession, as well as continued tension between Georgia and the Russian Federation (which disrupted trade routes), stopped the economy dead in its tracks in late 2008 and in 2009 after several years of strong performance.

Fortunately, due to previous significant reforms and prudent macroeconomic policies, the country entered last year with strong economic fundamentals—a small fiscal deficit, moderate inflation, and low external debt—allowing the authorities to respond with a comprehensive anticrisis plan. But GDP still contracted by 14.4%, its worst outturn in 16 years.

The blast of recession was felt from the start of the year, with GDP on a monthly basis hitting double-digit declines by May and bottoming in July. This trend eased throughout the rest of the year (Figure 3.1.1).

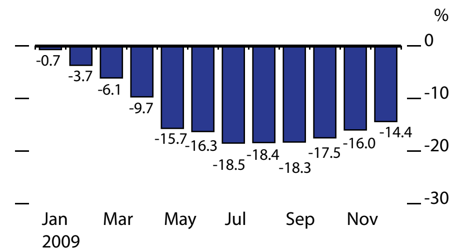
The economic downturn was experienced in all sectors of the economy (Figure 3.1.2). Construction, which had been the main driver of the economy, hemorrhaged with a 42.3% loss of output. The energy sector (electricity and natural gas) ebbed by 14.3%.

Other important industry activities, such as chemical products, building materials, mining and metallurgy, and the diamond-processing trade, all slumped. Agriculture saw no growth: lower animal output was offset by better crops. The services sector grew by a mere 0.7% due to reduced activity in finance, tourism, communications, and transport.

From the demand side, private investment tumbled by 25% as net inflows of remittances, which had driven the housing boom, sank by one-third (Figure 3.1.3) and net foreign direct investment declined by about one-fourth to about $700 million. Private consumption also withered due to the reduced remittance inflows and the economic downturn. Public consumption and investment, however, were bolstered by the anticrisis program.

To stimulate mortgage lending, a National Mortgage Company was

3.1.1 Monthly GDP growth



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 3 March 2010).
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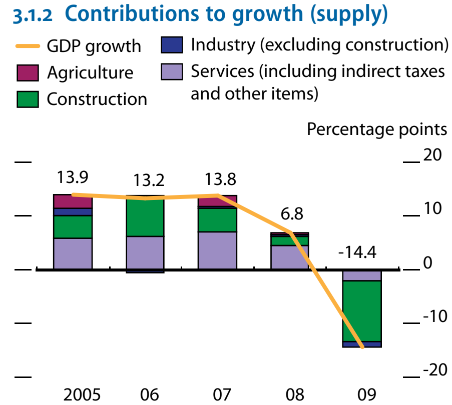
3.1.2 Contributions to growth (supply)



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am; Central Bank of Armenia. http://www.cba.am (both accessed 3 March 2010).
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This chapter was written by Kiyoshi Taniguchi of the Uzbekistan Resident Mission, ADB, Tashkent; and Grigor Gyurjyan of the Armenia Resident Mission, ADB, Yerevan.

established by the Central Bank of Armenia in July 2009. The new body began shoring up the construction sector by providing resources that are more affordable to participating banks and lending organizations.

The earlier, strong inflation pressures had dissipated by the early months of 2009 (Figure 3.1.4). However, the devaluation of the dram by 22% in March and a 40% increase in imported natural gas prices in April, along with rising international prices for oil, commodities, and basic foodstuffs in the second half, sent inflation back upward. Headline inflation hit 6.5% in December, beyond the upper limit of the central bank's inflation target band. In 2009, sugar, fuel, medicine, and household utilities, in that order, recorded the highest price increases (ranging from 34% to 20%). Despite the hike of inflation in the fourth quarter, average inflation was 3.4% for the year.

Monetary policy is underpinned by an inflation targeting framework. The target of 4% ±1.5% for 2009 was difficult to sustain due to the March devaluation and increased utility tariffs in April. Nonetheless, the devaluation and the subsequent program with the International Monetary Fund (IMF) served the economy well by restoring business confidence, reducing concerns about financial stability, and increasing competitiveness of exports.

By February 2009, gross official reserves fell to $1.1 billion or 3.9 months of imports, the lowest level since May 2007. Given the rapidly worsening economic situation, the government formulated an economic recovery program that was supported by an IMF standby arrangement that took effect in early March. From June, reserves started to accumulate as economic activity bottomed, climbing to $2.0 billion (6.6 months of imports) at year-end (Figure 3.1.5).

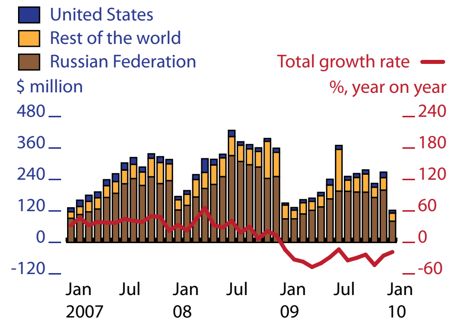
Real and nominal effective exchange rates depreciated throughout 2009. Due to the fear of further dram depreciation, dollarization accelerated: the share of deposits held in foreign currency doubled and that of loans climbed by half, relative to 2008. In such conditions, total lending volumes increased by 17.5% in 2009. The share of nonperforming loans edged down to 4.2% from 4.4% in 2008. Since banks are generally well capitalized, this increase presents no serious concerns.

To stimulate economic activity, the central bank implemented an expansionary monetary policy through quantitative easing and reduction of the refinancing interest rate, which it gradually cut from 7.75% in March to 5.0% at year-end. Money supply grew by 15.1%, reflecting increases in net foreign assets and credit to the economy (Figure 3.1.6).

In a deteriorating economic situation, fiscal policy was relaxed to boost aggregate demand. Public spending on pensions and public servants' salaries was increased by 16.3%, and other social outlays were largely maintained. Tax receipts fell with lower economic activity, helping push out the fiscal deficit to 4.7% of GDP from 0.7% in 2008 (Figure 3.1.7). External resources more than financed the deficit, and even permitted a buildup of government deposits in the banking system.

With budgetary and balance-of-payments financial support from development partners, external debt nearly doubled during 2009 to $3 billion by end-December 2009 (Figure 3.1.8). The public sector debt-to-GDP ratio hit 40.1%, with foreign currency–denominated debt at 34.0%. IMF debt projections indicate that the debt ratio may peak

3.1.3 Sources and growth of remittance inflows



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 3 March 2010).

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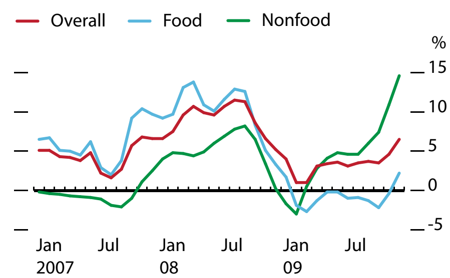
3.1.4 Inflation



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 3 March 2010).

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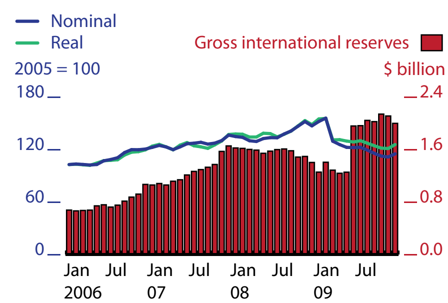
3.1.5 Effective exchange rates and reserves



Sources: International Monetary Fund. International Financial Statistics online database; Central Bank of Armenia. http://www.cba.am (both accessed 3 March 2010).

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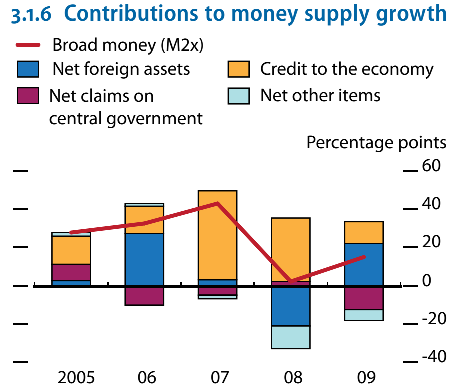
3.1.6 Contributions to money supply growth



Source: Central Bank of Armenia. http://www.cba.am (accessed 3 March 2010).

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at 46.6% in 2011 before falling to under 40% by 2013. While both the government and the IMF regard the debt dynamics as sustainable, these are subject to risks, such as the projected improvement in the fiscal position or in economic growth failing to materialize.

Weak external demand for the main exports and slower than expected benefits of the dram's devaluation resulted in exports falling by 35.0% in 2009. This decline in value terms nevertheless was outweighed by a 25.4% fall in imports due to weak domestic demand that stemmed from lower remittances. Imports suffered in all major categories. For example, precious metals and diamonds (both items for export processing) collapsed by two-thirds and cars and other transport equipment by nearly three-fifths. As a result, the trade deficit narrowed to $2.1 billion in 2009 from $2.7 billion in 2008.

Due to lower remittance inflows and transfers, the current account deficit narrowed slightly to $1.3 billion from $1.4 billion, though it widened in relation to the shrunken GDP, to 15.4% from 11.6% in 2008 (Figure 3.1.9).

In support of its anticrisis program, the government received budgetary support from international financial institutions of nearly $300 million. In addition, it has been using a $500 million loan from the Russian Federation for earthquake zone reconstruction, as well as for support to the banking sector, large commercial firms, and small and medium-sized enterprises. These anticrisis measures stimulated the real sector, and output will further strengthen this year.

Economic prospects

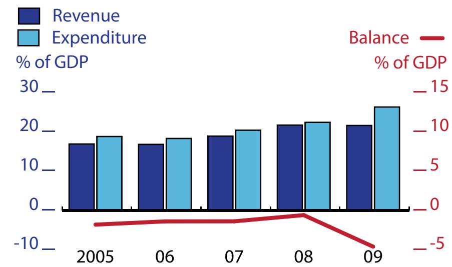
Economic recovery in large part depends on the assumed rebound in the Russian Federation, as resumed remittance inflows from the many Armenian workers there will be necessary for economic expansion. This pickup in remittances, improved external demand, and an increase in capital inflows are the ingredients to bring GDP growth to 1.5% then to 3.0% in the forecast period.

Fiscal policy will be gradually tightened in 2010 due to rising concerns on debt servicing. The fiscal position is expected to remain weak, and the recovery of tax revenue will be gradual. Yet excessive tightening in 2010 would slow the pace of the economic recovery. Still, through budgetary support from development partners as well as external borrowing, the public sector will remain one of the main economic buttresses in 2010–2011.

Inflation will be largely contained to a range of 4.5%–5.0% despite a 17% increase in the import price for natural gas that will push up utility tariffs and be generally passed on in higher transportation and consumer goods prices. Continuing weak demand and monetary policy, directed by the central bank's well-developed inflation-targeting procedures, should be able to keep inflation in check.

Remittance inflows and transfers are projected to grow by around 10%–15% in the forecast period, though they are not expected to recover to precrisis levels. Exports are seen rising by 5.2% in 2010 and then stepping up to 11.8% growth, supported by gradual strengthening in the diamond-processing, chemical, and metallurgy sectors. Import growth

3.1.7 Fiscal balance indicators



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 3 March 2010).

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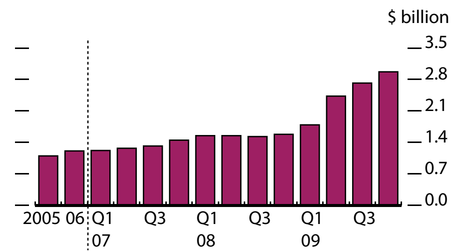
3.1.8 External debt



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 3 March 2010).

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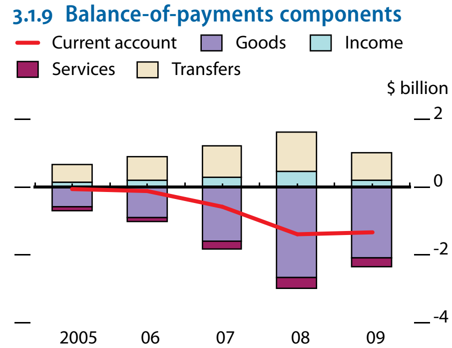
3.1.9 Balance-of-payments components



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 8 March 2010).

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3.1.1 Selected economic indicators (%)

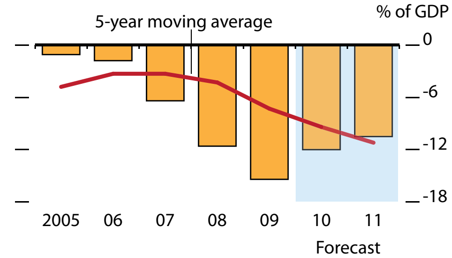
	2010	2011
GDP growth	1.5	3.0
Inflation	4.5	5.0
Current account balance (share of GDP)	-12.0	-10.5

Source: ADB estimates.

is projected to be moderate at 4.7% and then climb to 5.1%, on the net effect of a slow recovery in consumer spending but a faster pickup in investment goods. The current account deficit is expected to moderate to 12.0% of GDP in 2010 and to 10.5% in 2011 (Figure 3.1.10).

Exports of agricultural products will benefit from the early March reopening of the Upper Lars checkpoint at the Russian–Georgian border, which is Armenia's sole overland route to the Russian Federation and thence to Europe.

3.1.10 Current account balance



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 8 March 2010); ADB estimates.

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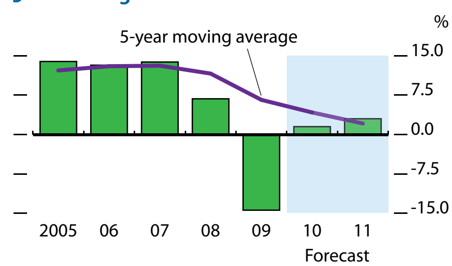
Development challenges

Over the last few years, the economy has generally benefited from greater openness to trade and investment, although the global recession took a heavy toll (Figure 3.1.11). The immediate to medium-term challenges include tightening the fiscal stance, limiting the rising external debt, broadening the production base, and adding trade partners. Establishing stronger trade relationships with European countries, while maintaining ties with traditional trade partners, is a hard juggling act.

The authorities acknowledge the need for a faster pace of reforms in the areas of tax policy and administration, and a more competitive business environment. An action plan with clear milestones will be necessary to implement reforms to improve governance, form an effective incentive structure for fair distribution of resources, and strengthen the antimonopoly policy.

The government recognizes the existence of oligopolies in key sectors of the economy that have strong links with entrenched elites. To reduce such conflicts of interest and to improve the business environment, it will continue its efforts to reduce corruption, modernize public expenditure management, and strengthen the civil service and judiciary.

3.1.11 GDP growth



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