

# Armenia

Another year of double-digit growth was seen in 2007, with a robust performance in construction, services, and agriculture. Strong remittance inflows, rising incomes, and solid private investment fueled domestic demand. As escalating prices of energy and food imports pushed up inflation, the central bank increased the refinancing rate and allowed the domestic currency to appreciate. The medium-term outlook is bright. Construction and services are expected to continue powering growth, with a strengthening contribution from realized investments in mining. To sustain expansion, the authorities will have to diversify the economic base and continue implementing structural reforms.

## Economic performance

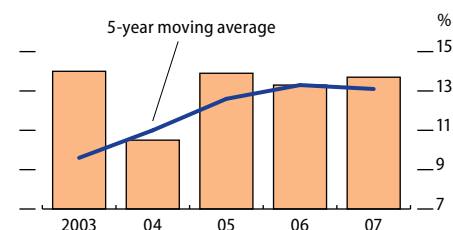
Continuing the double-digit growth trend of the past half decade, GDP grew at an annualized rate of 13.7% in 2007 (Figure 3.1.1). On the aggregate demand side, strong inflows of workers' remittances and higher wages fueled private consumption. Significant private investments were channeled into several industries: real estate, mining, gas supply, and transport and communications. Public investment increased, by over 40%, most of which was directed to developing and rehabilitating public infrastructure. Yet despite strong growth, unemployment stayed high at 6.7%, only a slight improvement from 2006's 7.2%.

Growth in aggregate supply was led by construction, services, and agriculture (Figure 3.1.2). Construction output expanded by 18.4%, largely arising from the building of new homes and offices in Yerevan; expansion of production capacity in mining, metals, and energy; and large-scale construction in transport and communications. Services output grew by 12.5%, underpinned by transport and communications; travel; wholesale and retail trade; and finance. With more favorable weather, agriculture recovered from its poor performance in 2006 to expand by 9.6%, marking a surge in the output of fruit and vegetables, tobacco, and wheat.

Industry (excluding construction) was sluggish in 2007, growing by only 3.2%. Metallurgy expanded by 13.8%, supported by strong demand for copper, molybdenum, and other nonferrous metals. Mining rose by 6.6%, on high demand for construction materials and metal ores. However, processing output (which includes food, tobacco, and beverages) edged up by only 0.5% in the first 10 months of the year. Moreover, manufacturing output of precious metals and stones—mainly diamond processing—continued to tumble (by 47%), reflecting the diminished supply of stones made available to the country. Electricity generation declined by 0.7%.

Inflation (Figure 3.1.3) rose sharply to average 4.4% in 2007. External factors were the major culprits, with steep increases in the prices of energy; other raw materials; and food such as grains, vegetable oil, and

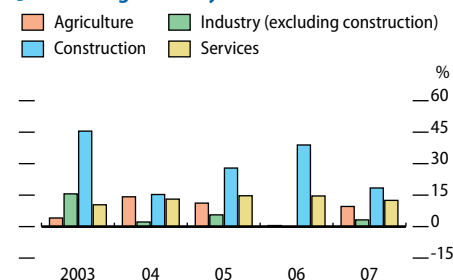
3.1.1 GDP growth



Source: National Statistical Service of the Republic of Armenia, available: <http://www.armstat.am>, downloaded 10 March 2008.

[Click here for figure data](#)

3.1.2 GDP growth by sector



Source: Ministry of Finance and Economy, available: <http://www.mfe.am>, downloaded 10 March 2008.

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butter. Monopolistic or oligopolistic practices of producers and importers of certain products exacerbated the pressure.

Surging monetary aggregates also stoked inflation. The monetary base, for example, leaped by 51% and the money supply (M2) by 63.9%, reflecting unsterilized foreign exchange intervention, dedollarization of cash holdings, and expansion of bank credits. In an attempt to counter inflation pressure, the Central Bank of Armenia raised the refinancing interest rate (its main policy instrument) on several occasions in 2007, from 4.75% to 5.75%. It also allowed the exchange rate to appreciate by 21.6% against the dollar. Some export sectors and remittance-dependent households have suffered from the sharp appreciation.

Fiscal policy has been prudent. Total fiscal revenues (including nontax receipts and grants) came to AMD570.1 billion, and total expenditures to AMD565.9 billion, producing a small budget surplus (Figure 3.1.4). Total revenues rose by 29.1%, mainly on higher tax collection—value-added tax was up by 49.5% and income tax by 31.8%—and reduced official transfers. Fiscal expenditures increased by 17.6%: about 72% of the total was current spending, such as wages, subsidies, interest payments, and goods and services; 25% was on public capital outlays; and the rest was for lending.

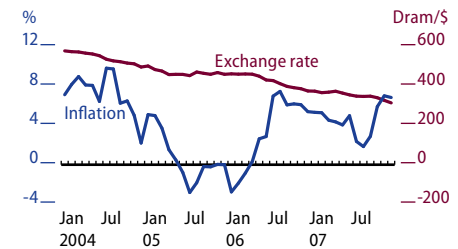
Although the tax-to-GDP ratio climbed to 18.2% in 2007 from 16.6% in 2006, it remains low because of widespread tax evasion, weakness in tax administration, excessive exemptions that limit the tax base, and heavy reliance on indirect taxes (which constitute about 60% of total tax receipts). Consequently, the major contributors to economic growth—construction, services, and agriculture—have largely escaped the tax net. Lack of buoyancy in the services tax stems from the fact that it is specific rather than ad valorem. Agriculture will not be taxable until 2009, in accordance with an agreement with the World Trade Organization. Foreign and joint-venture companies are the top taxpayers; many large domestic enterprises do not pay tax.

The total value of goods exported (customs data) was \$1.2 billion in 2007, up by 16.7% relative to the previous year. The major commodities include precious stones and metals, base metals and mineral products, and prepared foodstuffs. Armenia is currently pursuing a diversification strategy to expand its narrow export structure. Exports of precious stones, such as polished diamonds, used to account for more than 50% of total export income, but exports of base metals have recently become a leading income earner. Base metals accounted for 33.7% of total export receipts in 2007 (up from 28.5% in 2006), while precious stones and metals amounted to 18.5% of the total (falling from 30.6% in 2006).

Goods imports surged by 49.7%, to \$3.3 billion in 2007. New construction projects boosted spending on imports of building materials, and machinery and equipment also grew rapidly. Higher incomes and remittances raised imports of consumer goods, while sharp increases in prices of energy and commodities, especially grains, pushed up “other imports” and the total value of imports (Figure 3.1.5). The trade deficit in 2007 came in at \$2.1 billion.

A services trade deficit of \$137.2 million was recorded in the first 9 months of 2007 and is estimated at about \$180 million for the year. Although remittances helped offset a widening trade gap, a current account deficit of \$436 million (4.7% of GDP) is estimated for the year

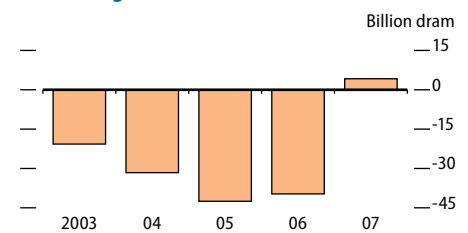
### 3.1.3 Inflation and exchange rate



Sources: International Monetary Fund, *International Financial Statistics* online database; Ministry of Finance and Economy, available: <http://www.mfe.am>; both downloaded 10 March 2008.

[Click here for figure data](#)

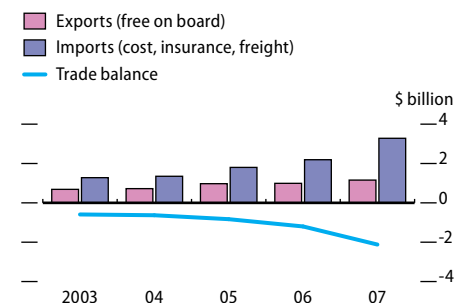
### 3.1.4 Budget balance



Source: Ministry of Finance and Economy, available: <http://www.mfe.am>, downloaded 11 March 2008.

[Click here for figure data](#)

### 3.1.5 Merchandise trade balance



Source: National Statistical Service of the Republic of Armenia, *Socio-economic Situation of the Republic of Armenia*, various issues.

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(Figure 3.1.6). The current account deficit was financed by foreign direct investment (FDI) of \$354.5 million in the first 9 months of 2007 and by external borrowings. Gross official international reserves jumped to \$1.7 billion in 2007 (up by 55%), equivalent to more than 5 months of imports of goods and services.

External debt amounted to \$1.4 billion at end-2007 (a 12.8% rise compared with 2006). Continued official emphasis on a sustainable debt-management policy has seen a notable reduction in external public debt as a share of GDP in recent years. It was 14.8% of GDP in 2007, with most of the outstanding debt contracted on concessional terms (Figure 3.1.7).

The Government has made solid progress in improving the general business environment. As demonstrated in the *Doing Business* survey for 2008, the country's ranking climbed to 39 in 2007 (out of 178 countries and areas), from 46 in 2006. However, much remains to be done to move toward international best practice, particularly in the areas of payment of taxes (the ranking declined to 143 from 137), and to a lesser extent, investor protection (which weakened to 83 from 81) and enforcement of contracts (which remained at 64).

In addition, further reform is needed to enhance competition in domestic markets, in order to improve efficiency and to limit inflation pressure. A recent comprehensive study on the economy by the World Bank noted that some sectors are being controlled by a few incumbents, which either singly or in cartels dominate the distribution of particular products. Further reform is also required to strengthen the rule of law and to improve the judicial system.

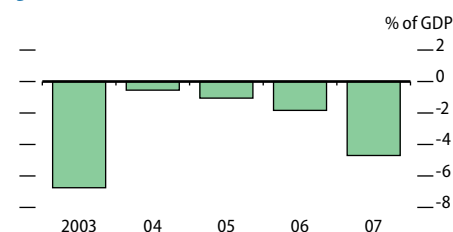
The Government has acknowledged this. It adopted an anticorruption strategy and action plan in 2003, as well as an action plan for public sector management reform, which aims to improve accountability and provide civil society a greater voice. A second anticorruption strategy is now being prepared. The Government is also planning to create an electronic procurement system. The intention is to help improve transparency and reduce corruption.

## Economic prospects

As the economy is small and open, developments internationally—especially in the Russian Federation—have a significant impact on performance. It is expected that high energy prices will continue to exert pressure on inflation over the forecast period, and that large inflows of remittances will continue because the Russian economy (the source of 75–80% of Armenia's remittances) will remain robust. The central bank has kept the same inflation target for 2008 and has committed to tightening monetary policy if inflation pressure accelerates. Fiscal policy will be expansionary this year relative to last year. The authorities are determined to maintain a flexible exchange rate policy and the dram is likely to continue appreciating against the dollar.

The economic outlook is positive. In 2008, construction and services (in particular, transportation and communications, and wholesale and retail trade) are expected to continue driving growth. Moreover, production in mining—especially copper and molybdenum—is forecast to expand as recent investments in the sector begin to pay off. On the

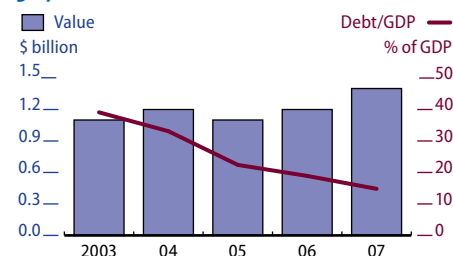
### 3.1.6 Current account balance



Sources: Ministry of Finance and Economy, available: <http://www.mfe.am>, downloaded 11 March 2008; staff estimates.

[Click here for figure data](#)

### 3.1.7 External debt



Sources: Ministry of Finance and Economy, available: <http://www.mfe.am>; National Statistical Service of the Republic of Armenia, available: <http://www.armstat.am>; both downloaded 4 February 2008; staff estimates.

[Click here for figure data](#)

### 3.1.1 Selected economic indicators

	2008	2009
GDP growth	10.0	8.0
Inflation	5.5	5.0
Current account balance (% of GDP)	-4.5	-4.9

Source: Staff estimates.

demand side, remittance inflows and higher disposable incomes, in part boosted by a steep rise in pensions and minimum wages that came into effect on 1 January this year, will continue to fuel consumption spending and imports. GDP is projected to grow at 10.0% in 2008 and 8.0% in 2009.

Parliament approved the state budget for 2008. Fiscal revenues are expected to reach AMD746 billion (25.8% of GDP), and fiscal expenditures AMD822 billion (28.4% of GDP), with a budget deficit of AMD76 billion (in contrast to a surplus of AMD4.2 billion in 2007). Major spending items are the increase in pensions (from AMD11,500 to AMD20,000 a month) and minimum wages (from AMD20,000 to AMD25,000 a month).

Increased private and public consumption expenditures, combined with external price pressures, will result in a pickup in inflation to 5.5% in 2008. The authorities' commitment to tightening monetary policy and some likely exchange rate appreciation will help curb inflation pressure. The potential hike in the price of gas resulting from the elimination of the gas subsidy by end-2008 will impact on inflation in 2009, though softer prices for imports of foodstuffs and petroleum may allow inflation to ease to 5.0% in 2009.

The trade deficit is expected to widen in the forecast period because of persistent expansion in imports to support higher construction and investment activity, as well as high volumes of food imports. The narrow export structure means that exports are susceptible to changes in international prices and demand. Mining and metallurgy exports are forecast to be robust because of new investment. Increased net income from abroad, along with larger workers' remittances and other transfers, are expected to partly offset the enlarged trade deficit. The current account deficit is projected to be around 4.5% of GDP in 2008 and 4.9% in 2009. Inflows of capital grants, FDI, and foreign development assistance are likely to fully finance the larger current deficit and provide for a continued increase in official reserves.

There are a range of risks to the medium-term outlook. Due to the openness of the economy, external factors will play a prominent role. A marked slowdown of the Russian economy could reduce remittances, trade, and FDI. A substantial downturn in global demand for commodities would also have an important adverse effect. On the domestic front, a downturn of the real estate market would also have a significant impact on growth. In addition, further appreciation of the dram may make it hard to sustain export growth.

## Development challenges

The economic base is narrow, and the Government recognizes that in order to achieve a more diversified and sustainable growth path it needs to capture other production activities in the value chain, broaden its sources of energy supply, and develop new areas, such as information technology. It also needs to push through further institutional reforms in the areas of tax administration and collection, customs, the judiciary, and competition policy.