

Armenia

Largely on account of the rapidly growing nontradable sectors of construction and services, the economy continued to grow beyond expectations, at 13.4% in 2006. The fiscal deficit was kept in check through expenditure rationalization and tax reforms. Higher remittances, public spending, and private investment supported growth in domestic demand. Rising fuel prices and a poor agricultural harvest put some pressure on prices, but inflation remained generally contained. A moderate deceleration is expected in 2007–2008 as production capacity limits are reached and the pace of growth in construction and services eases. Prospects are promising, but structural reforms have to continue, parliamentary and presidential elections must be seen to be democratic, and regional conflicts need to be resolved to allow closed trade routes to open.

Economic performance

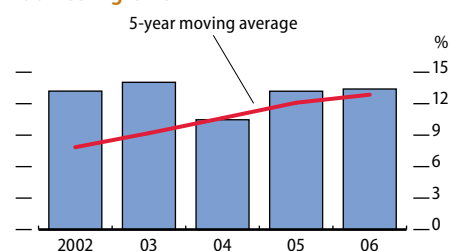
The economy showed substantial resilience as GDP grew by 13.4% in 2006, against the 11.0% projected in the 2006 budget program, continuing the double-digit growth trend of the past half decade (Figure 2.1.1). On the supply side, the main contributions came from rapid growth (37.1%) in industrial construction (for roads, mining, and energy infrastructure) and residential construction; services (20.2%); and retail trade (10.5%) (Figure 2.1.2). The share of construction in GDP now exceeds 20%.

GDP expansion would have been higher still but for the poor performance of manufacturing and agriculture. Manufacturing activity declined mainly due to disruptions in the external supply of raw diamonds for processing, but also due to low growth rates of jewelry, light industry, and chemicals, all reflecting low external demand. A narrow manufacturing production base remains a structural weakness and a constraint to sustaining high growth. Agriculture posted low growth of 0.4% on account of a poor harvest. On the demand side, government consumption and investment supported higher social and capital spending. Rapidly rising wages and remittance inflows bolstered private consumption.

The expansion in services and construction activities continued to help bring down the official level of unemployment from 8.1% in 2005 to 7.4% in 2006. Average monthly nominal wages rose by 23.5% in 2006, boosted by strong growth in public and private sector wages. Revised official estimates put poverty in 2004 at 35%, lower than the previous estimate of 39%. Sustained economic reforms, strong growth, and single-digit inflation reduced poverty further to 30% in 2005. Per capita GDP in US dollars has tripled since 2000, reaching almost \$2,000 in 2006 compared with \$1,524 in 2005, partly on account of the dram's appreciation (Figure 2.1.3).

Year-on-year inflation accelerated to 6.8% in July, reflecting a poor agricultural harvest, higher telecoms and other utilities tariffs, rises in import prices of energy and raw materials, as well as accelerated

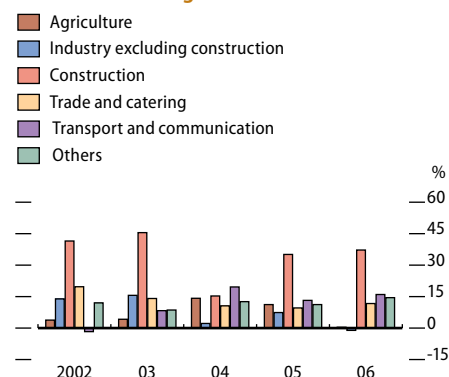
2.1.1 GDP growth



Source: National Statistical Service of the Republic of Armenia, available: <http://www.armstat.am>, downloaded 9 January 2007.

[Click here for figure data](#)

2.1.2 Sector GDP growth



Source: Ministry of Finance and Economy, available: <http://www.mfe.gov.am>, downloaded 12 March 2007.

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monetary growth (Figure 2.1.4) (due to sustained inflows of foreign exchange and limited ability to sterilize their impact). But inflation moderated to 5.2% by end-2006 on account of seasonal fluctuations in food prices and drops in sugar, gasoline, and diesel prices. Given deflation in the first quarter (Figure 2.1.5), average inflation for the year came in at 2.9%, just below the targeted 3.0%. In early 2006, the Central Bank of Armenia began a switch to a policy of inflation targeting from monetary targeting. It now issues regular inflation reports and is using a quarterly model for forecasting; it will shift to full-fledged inflation targeting over the medium term. The authorities will use short-term interest rates, central bank bonds, and monetary aggregates as control mechanisms.

The Government has pursued prudent fiscal policies and is now shifting its focus from expenditure contraction to revenue generation. The fiscal deficit continued its sustained reduction from over 5% of GDP in 1999 to 1.9% in 2005, falling to 0.6% of GDP in 2006 (Figure 2.1.6), well below the budgeted 2.9%. Lower than programmed budget expenditures and higher than expected GDP growth that helped boost tax receipts contributed to this outcome.

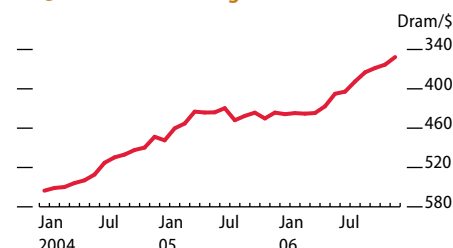
Although nominal tax revenues have been rising gradually, the tax-to-GDP ratio remains essentially stable (at about 14% of GDP) because of widespread tax evasion, weakness in tax administration, excessive exemptions that limit the tax base, and heavy reliance on indirect taxes (about 60% of total tax revenues). Consequently, the major contributors to economic growth—construction, services, and agriculture—have largely escaped the tax net. Lack of buoyancy in the services tax is partly because it is specific rather than ad valorem. Agriculture is not taxable until 2009, in accordance with an agreement with the World Trade Organization. According to the World Bank's *Doing Business 2007*, foreign and joint-venture companies form the top taxpayers while many large domestic enterprises avoid the tax net.

In 2006, the Government implemented several measures to boost tax revenues to finance higher spending in infrastructure and social services in line with commitments made in its poverty reduction strategy paper (PRSP). These included moves to broaden the tax base by reducing exemptions and loopholes and to improve the efficiency of tax administration. The State Tax Service amended the law to tax property above a threshold limit. The authorities prepared a draft bill to tax construction projects. With improved collection from value-added, income, and profit taxes, tax receipts improved marginally to an estimated 14.4% of GDP in 2006 from 14.3% the year before.

Recognizing that reducing the size of the shadow economy is vital to improve compliance, the parliament approved a financial disclosure bill making income and property declaration mandatory for citizens earning more than \$19,000 per year, an amount that is more than 10 times the official average salary. The law is expected to come into force in 2008. The Tax Inspection Unit published the list of the 1,000 largest taxpayers. The Government envisages lowering dependence on external grants and meeting the budget targets through internally collected revenues to enhance sustainability of its resources.

Imports showed robust 21.8% growth in 2006, largely owing to a pickup in capital goods and mineral products, which reflected the

2.1.3 Nominal exchange rate



Source: Central Bank of Armenia, available: <http://www.cba.am>, downloaded 21 February 2007.

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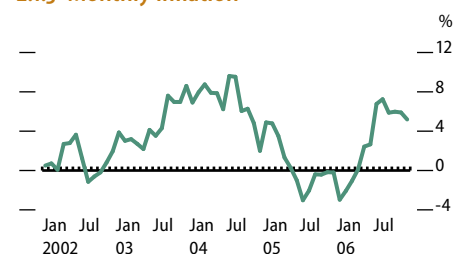
2.1.4 Money supply (M2x) growth



Sources: International Monetary Fund, *International Financial Statistics* online database; Central Bank of Armenia, available: <http://www.cba.am>; both downloaded 10 March 2007.

[Click here for figure data](#)

2.1.5 Monthly inflation



Sources: International Monetary Fund, *International Financial Statistics* online database; National Statistical Service of the Republic of Armenia, available: <http://www.armstat.am>; both downloaded 10 March 2007.

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expansion in construction and investment activity as well as higher commodity prices. Exports, though, achieved only low 3.1% growth, mainly because of a fall in base-metal exports (as modernization programs restricted activity), a drop in the diamond-processing trade (amid supply disruptions and stiffer competition from other countries), and stagnant foodstuff exports. The upshot was a widening of the trade deficit to \$1,190 million or 18.6% of GDP (Figure 2.1.7). Considerable inflows of transfers and income from abroad helped narrow the current account deficit to about 5% of GDP. Gross official international reserves increased by \$402 million in 2006 and stood at about 5 months of imports of goods and services.

Continued official emphasis on a sustainable debt-management policy has seen a marked reduction in external public debt as share of GDP in recent years. It remained at 20.5% of GDP in 2006 (Figure 2.1.8), while the debt service ratio was only 4.2%, as essentially all outstanding debt is on concessional terms.

In 2006, Armenia received an international credit rating for the first time. Moody's assigned a BA2 grade of foreign and local currency rating which signifies a medium level of creditworthiness and a stable outlook. Fitch's assigned a lower BB- sovereign credit rating indicating a relatively high risk of doing business, as the economy remains vulnerable to shocks due to its high degree of dollarization, underdeveloped financial services, low value-added economic activity, as well as the Nagorno-Karabakh conflict.

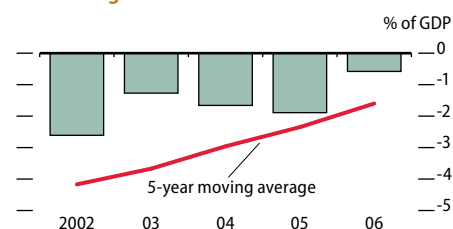
The banking sector has improved but the nonbank financial services market needs attention. The diaspora seems keen to maintain the significant flow of investment spending seen in the last several years. But owing to continuing weaknesses in business procedures, foreign direct investment (FDI) not only fell from 5.1% of GDP in 2005 to an estimated 3.1% in 2006, it has become lower than the mean levels of neighboring countries. Higher inflows of FDI, especially into the tradable sector, would support greater export volumes as well as upward labor mobility and international integration. Further efforts are needed to address corruption and other weaknesses (Box 2.1.1).

Economic prospects

Robust economic growth of the first few years of this century is providing the necessary support for building a coherent macroeconomic policy framework and pushing through wide-ranging structural reforms. It is expected that the PRSP update for 2007 and the recently released Medium-Term Expenditure Framework 2007–2009 (MTEF) will guide economic policy making in the coming years.

The average exchange rate is assumed to be stable in 2007–2008. The narrow export base will keep exports susceptible to changes in international prices. The general parliamentary election in May 2007 and presidential election in early 2008 are not expected to adversely influence the pace of economic reforms. Major bilateral donors, however, have stressed that proper conduct of the elections is an important concern. Prospect for securing an agreement with Azerbaijan in the long-standing dispute over Nagorno-Karabakh remain gloomy.

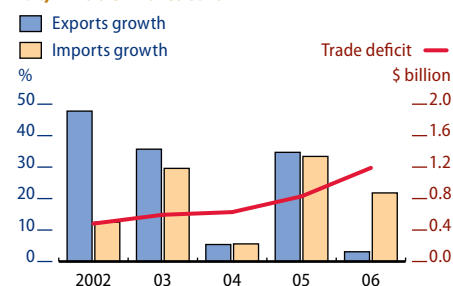
2.1.6 Budget balance



Source: National Statistical Service of the Republic of Armenia, available: <http://www.armstat.am>, downloaded 10 March 2007.

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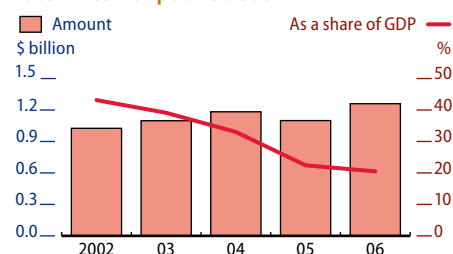
2.1.7 Trade indicators



Source: Ministry of Finance and Economy, available: <http://www.mfe.gov.am>, downloaded 12 March 2007.

[Click here for figure data](#)

2.1.8 External public debt



Source: National Statistical Service of the Republic of Armenia, available: <http://www.armstat.am>, downloaded 12 March 2007.

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2.1.1 Selected economic indicators

	2007	2008
GDP growth	10.0	9.0
Inflation	4.0	4.0
Current account balance (% of GDP)	-5.0	-5.0

Source: Staff estimates.

The economic outlook is positive. However, growth momentum is expected to moderate, to 10% in 2007 and 9% in 2008, as a result of a high base and a deceleration in growth that has already begun in construction, services, and retail trade. The central bank forecasts falls in the growth rates of construction to 12.9% and services to 11.3% this year, and these declines are unlikely to be offset by higher production in agriculture and industry. However, output in these two sectors is set to rise on account of planned investments in irrigation, transport and communications, energy, mining, metallurgy, machine building, and chemicals, boosted by greater availability of private credit and external assistance. Higher public and private wages together with rising remittances will continue to support high growth in consumption spending.

Some inflationary pressures will result from growing domestic demand. Against this, the central bank's monetary program has set a 4.0% annual inflation target, which should be achievable if there is adherence to budgetary targets for financing, some recovery in the agriculture sector, and easing in international prices pressures. Further appreciation of the dram could damp inflationary pressures, though this outcome has not been assumed in the forecast.

Trade deficits will remain large in the forecast period as there will only be a slight improvement in export growth in the face of a continued rapid expansion in imports to support higher construction and investment activity as well as the necessary high volumes of food imports. Sugar importers will have to deal with higher world price while oil importers would benefit from the easing pressure of world prices.

The narrow base of the export basket will keep exports susceptible to changes in international prices. In particular, exporters will face mixed trends in global commodity prices as metal prices are expected to rise and the price of diamonds to fall. Export growth is limited because little relief appears in sight to end the structural problems in the diamond-processing sector and the narrow manufacturing base, though mining and metallurgy exports are expected to accelerate because of new investment.

If the trends of the last few years are maintained, increases in net income from abroad and large foreign transfers are expected to partly offset the trade deficit and contain the current account deficit at about 5% of GDP over the forecast period. Inflows of capital grants, FDI, and foreign development assistance are expected to be sufficient to allow a moderate increase in official reserves.

Fiscal deficits will widen from levels of the past few years to accommodate a rapid rise in defense spending and commitments to higher social and capital spending under the PRSP. This is also reflected in the MTEF. Based on a 9% assumed increase in GDP, the parliament has approved a 16% increase in 2007's budget spending, which includes a 40% rise in the military budget. More than one third of expenditures are earmarked for education, health care, social security, and other public services, with the average monthly wage of civil servants rising by 20% and full-time schoolteachers' salaries by 27%.

The proposed public investment program under MTEF will help streamline investment spending. Higher revenue collection through tax reforms and improvements in tax administration are expected to raise the

2.1.1 Poverty and corruption

The most important development challenges are high levels of poverty, especially in rural areas, and of corruption. Weak investment and productivity increases have led to low farm incomes and a high poverty risk in agriculture. With limited nonfarm employment opportunities, any trickle-down of economic growth to rural households through job hires and self-employment has been minimal.

The official unemployment figures mask the real situation as survey-based sources place unofficial estimates of national unemployment at 20–30%. This is largely due to low overall productivity and returns from farming activity, low growth in the off-farm rural sector, a dearth of well-paying jobs for the educated unemployed, and limited access and high cost of finance for rural enterprises. The public benefits and private transfers forming the bulk of rural households' income are inadequate. Lack of basic infrastructure and effective public services delivery are binding constraints.

Corruption is pervasive, especially in the public sector, and is encouraged by ineffective systems of accountability and weak tax administration in the civil service and the State Tax Service. It is manifested in bribery, tax evasion, and underreported profits. This has led to lower receipts from value-added, income, and profit taxes than in its neighbors, even with similar tax rates. Another stimulus is the stark disparity in wages between the public and private sectors, which too often encourages "inducements."

To its credit, the Government is improving tax administration and is considering performance-based pay system to retain high-quality staff in the civil service, and has signed up to various international anticorruption schemes. But the absence of legal sanctions against corrupt officials has left the public skeptical about the Government's capacity to curtail corruption. Deeper institutional reforms are key to moving forward.

tax-to-GDP ratio by about 1 percentage point, but this may not match the additional resource requirements. The budget deficit is targeted at 2.3% of GDP in 2007. This would be largely financed by external assistance and grants with a need for moderate deficit financing.

Until its initiatives generate adequate revenues, the Government will need alternative sources of financing to meet its rising spending commitments. While it is currently maintaining a zero limit on contracting new nonconcessional debt, robust economic growth and improved creditworthiness have strengthened its capacity for such borrowing. Its ability to repay external public debt is strong, as reflected in low and falling levels of the debt-to-GDP ratio and the debt service-to-exports ratio as well as in rapidly rising per capita incomes.

This observation is consistent with the positive results of the Government's debt-sustainability analysis. Improvements in sovereign credit ratings will promote Armenia's foreign partnerships and attract investment in large-scale projects. A favorable macroeconomic outlook and emerging investment opportunities bode well for the Government to borrow on nonconcessional terms.

The medium-term outlook clearly faces risks, among which external factors loom large. For example, heavy dependence on remittance flows, a limited export base, and a highly dollarized economy make Armenia vulnerable to shocks from external demand, international prices, and exchange rate fluctuations. Further appreciation of the dram poses difficult challenges for monetary management and, if sustained, could cause "Dutch disease," impinging on the international competitiveness of exports and import-competing goods. (These issues are discussed further in Box 2.1.2.)

The Russian Federation is the largest trading partner and a leading investor in energy. A 2006 bilateral agreement allows Armenia to pay the Russian company Gazprom a highly discounted price of \$56 per 1,000 cubic meters of gas until end-2008, a trade-off for the sale of a power plant to Gazprom. However, the start of 2009 may bring with it considerably higher gas prices. The Government has, though, incorporated the impact of such a possible rise in designing the targets in its 2007 budget.

2.1.2 Dynamics of the dram-dollar exchange rate

Armenia is a highly dollarized economy. An estimated \$1 billion is held in US currency notes by residents—about 16% of GDP and three times the value of dram notes in circulation. Close to 65% of bank deposits and 70% of bank loans are denominated in US dollars. Over 90% of total public debt (domestic and external) is denominated in foreign currency, increasing the vulnerability of public sector balance to exchange rate shocks.

Strengthening capital and financial accounts and rapidly growing remittances and foreign investments in real estate continue to fuel appreciation of the dram in a freely floating exchange rate regime. The dram has registered a substantial nominal appreciation in its dollar value since January 2004, rising by 15% in January–September 2006 alone. This has had a significant impact on trade and inflation.

A new law requiring certain transactions to be conducted only in local currency as part of the Government's drive toward dedollarization has led to an increase in the demand for dram, as has its recent marked appreciation. Given large foreign investment flows into real estate, a proposal to tax construction projects is expected to reduce the upward pressure on the currency.

The Central Bank of Armenia has been carrying out sterilization interventions since June 2006 to moderate short-term fluctuations in the exchange rate without trying to fix its level. The central bank's approach is to keep inflation low and the exchange rate floating without a predetermined path for the dram, which moves according to market forces.

International Monetary Fund estimates show that the real exchange rate against the dollar is now close to its market equilibrium level.