



sharp fall in domestic agricultural production and higher international wheat and other cereal costs led, however, to a spike in headline inflation to 9.4% in December 2010 from a year earlier (Figure 3.1.3), pushing inflation above the upper limit of the central bank's inflation target band (4% +/-1.5%). Average annual inflation was 8.2% for the year. Items keeping food inflation high were dairy, eggs, meat, and grain products, in that order, with price increases ranging from 18.7% to 13.1%. The higher food inflation was offset by moderating nonfood inflation, mainly due to weakening prices in private cars, medicines, garments and knitwear, footwear, detergents, and beauty items.

As inflation picked up, the central bank tightened monetary policy and gradually raised its refinancing rate by 225 basis points in January–May 2010 to 7.25% and kept it there through December. Despite this tightening and measures to de-dollarize the economy, the share of foreign currency loans in banks stayed high, increasing from 51.9% at end-2009 to 57.4% 12 months later, while the share of foreign currency deposits fell from 73.4% to 69.0%.

Broad money supply grew by 11.8% in 2010. Credit to the economy jumped by about 28%, reflecting positive macroeconomic trends and a slight decline in interest rates due to allocation of funds attracted by banks. The contribution of net foreign assets to monetary growth was negative, mainly due to the central bank's interventions, which aimed to smooth large exchange rate movements (Figure 3.1.4).

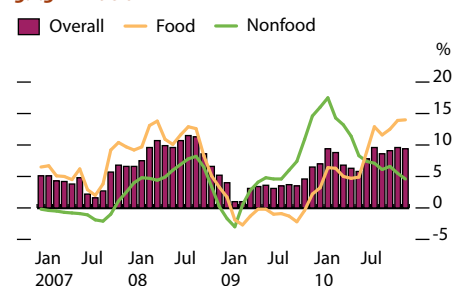
Fiscal policy aimed to continue supporting the recovery while addressing medium-term fiscal and debt vulnerabilities. A 14.5% increase in tax revenue and restrained spending have significantly eased the fiscal imbalance. Improvements in tax and customs administration, progress in introducing an electronic tax-filing system, and strengthened taxpayer services (such as "taxpayer service centers") along with greater economic activity boosted tax receipts. But despite climbing slightly from 16.7% in 2009 to 16.9%, the tax-to-GDP ratio is still low internationally. Total budget revenue rose by 10%, but as a share of GDP declined from 22.9% in 2009 to 22.2% in 2010.

Total expenditure increased by a mere 0.5% from 2009. A budget deficit of 4.9% of GDP recorded in 2010 was well below the 6% of GDP projected by the government in late 2009 and a sizable 7.6% recorded in 2009 (Figure 3.1.5). About 60% of the deficit in 2010 was financed through domestic resources.

Outstanding public external debt climbed quickly to nearly \$3.0 billion in 2009 and rose by another \$300 million in 2010, reaching about 35.1% of GDP (Figure 3.1.6), with about 22.5% coming from central bank borrowing. Domestic public debt edged up to \$428 million in 2010, and is relatively small at 4.5% of GDP. Although the level of total public debt is high, given that most is on concessional terms, debt service is manageable. Debt projections from the International Monetary Fund indicate that the total debt ratio will move up to about 50% of GDP in 2012, reflecting an increase in external borrowing, before declining to 43.5% of GDP in 2013.

While the public finance situation is improving, weaknesses remain in the balance of payments. Exports surged by 46.9%, much of which was generated by export-oriented mining and metallurgy,

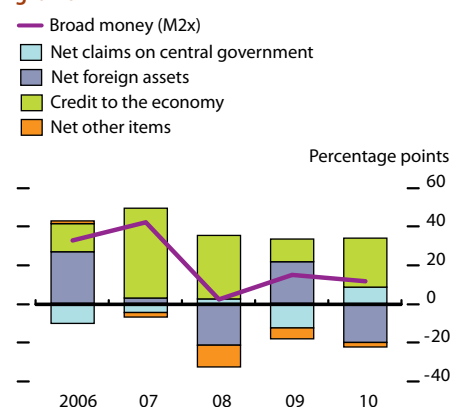
### 3.1.3 Inflation



Source: National Statistical Service of the Republic of Armenia. <http://www.armstat.am> (accessed 1 March 2011).

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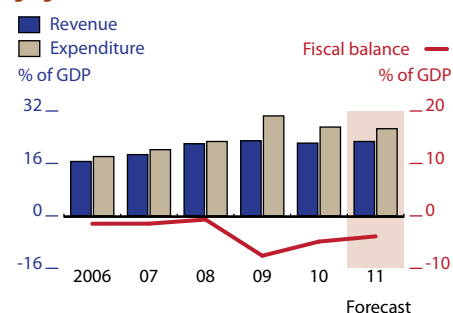
### 3.1.4 Contributions to money supply (M2x) growth



Source: Central Bank of Armenia. <http://www.cba.am> (accessed 1 March 2011).

[Click here for figure data](#)

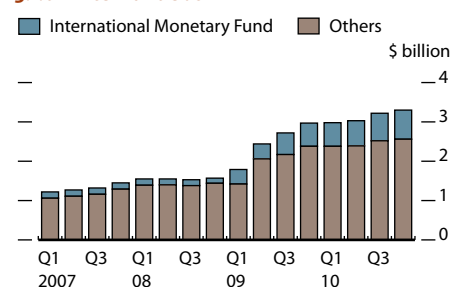
### 3.1.5 Fiscal balance indicators



Source: National Statistical Service of the Republic of Armenia. <http://www.armstat.am> (accessed 1 March 2011).

[Click here for figure data](#)

### 3.1.6 External debt



Source: National Statistical Service of the Republic of Armenia. <http://www.armstat.am> (accessed 1 March 2011).

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primarily due to soaring international prices of copper, molybdenum, and other nonferrous metals (but also due to a better global economic environment). After tumbling by 25.0% in 2009, imports showed growth of 19.8% in 2010, boosted by domestic demand that was lifted by improving investment and rebounding remittances.

The trade deficit pushed out slightly to an estimated \$2.3 billion, but larger remittances and factor income helped narrow the current account deficit to 14.6% of GDP in 2010 from 16.0% (Figure 3.1.7). The large current account gap was financed primarily by donor inflows and foreign direct investment.

The central bank maintains a floating exchange rate regime. Given the large import content of consumption, its interventions in the foreign exchange market aimed to prevent steep fluctuations in the value of the dram while safeguarding reserves. Over the year, the nominal effective exchange rate appreciated by 9.7%, and the real effective exchange rate by 11.4%, reflecting higher inflation in Armenia than in its main trading partners (Figure 3.1.8).

Gross international reserves contracted by about \$150 million to \$1.8 billion at end-December 2010, equivalent to about 5 months of import cover. Three-year arrangements equivalent to \$395 million with the International Monetary Fund were approved in June 2010, following a \$540 million stand-by arrangement approved in March 2009. These arrangements have helped to replenish reserves as the authorities seek to strengthen the external position. Their economic program aims to restore fiscal and external sustainability, preserve financial stability, and support growth and poverty reduction.

## Economic prospects

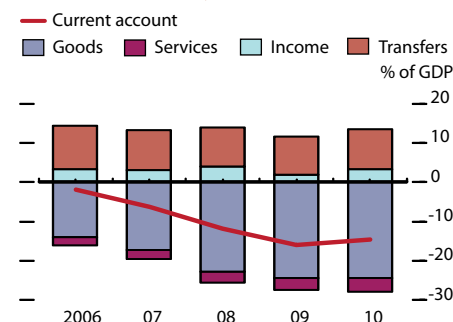
Continued growth in Armenia depends heavily on that in the Russian Federation. Strong performance there will boost foreign direct investment inflows, migrants' remittances, and demand for exports. As a result of improved external conditions—along with a rebound in agriculture, which is expected to grow by 10% this year—GDP is projected to expand by 4.0% in 2011 and 4.5% in 2012.

The government's efforts toward diversifying the economy and stimulating exports will provide additional impetus to growth and should make it less volatile. Investments in large-scale infrastructure, such as highways and rural roads, as well as the water-supply system, will continue to bolster public spending.

Fiscal policy is expected to be gradually tightened in 2011 and 2012 given concerns on the large buildup of external debt. This year's fiscal consolidation should be achieved through stronger revenue collection, stemming from the positive economic outlook and improving tax administration. The 3-year midterm spending program calls for suspension of public sector salary increases up to 2013 and freezing spending on purchases of equipment and property. The government envisages reducing the budget deficit to about 4% in 2011. The priority areas for expenditure include support for social programs and infrastructure.

Due to strengthening domestic activity and fast-rising global

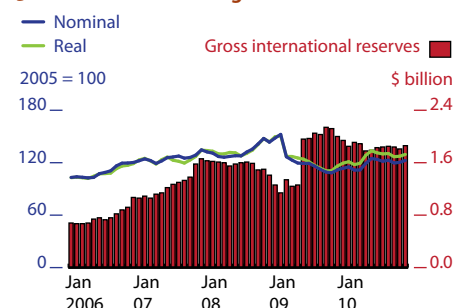
### 3.1.7 Balance-of-payment components



Source: National Statistical Service of the Republic of Armenia. <http://www.armstat.am> (accessed 1 March 2011).

[Click here for figure data](#)

### 3.1.8 Effective exchange rates and reserves



Sources: International Monetary Fund. International Financial Statistics online database; Central Bank of Armenia. <http://www.cba.am> (both accessed 1 March 2011).

[Click here for figure data](#)

### 3.1.1 Selected economic indicators (%)

	2011	2012
GDP growth	4.0	4.5
Inflation	7.5	5.5
Current account balance (share of GDP)	-13.0	-12.3

Source: ADB estimates.

commodity prices, inflation pressures will persist in 2011, though inflation is expected to come down from its 2010 high. Monetary policy is shifting to a tighter stance to combat these pressures: in February this year, the central bank increased the refinancing rate by 0.5 percentage points, to 7.75%. Inflation is forecast at 7.5% in 2011 and 5.5% in 2012.

Recovering remittance inflows and transfers as well as the large infrastructure projects are seen boosting domestic demand for imports, such that they rise by about 12.0% in 2011 and 10.0% in 2012.

Given the expected growth in major trade partners and expected outcomes of the government's export diversification and promotion actions, exports are expected to expand by 15.0% in 2011 and by about 10.0% in 2012. This increase will be backed by strengthening from new investments in chemicals and metallurgy. The trade deficit is seen narrowing moderately. Backed by the robust remittance inflows, the current account deficit is forecast to ease to 13.0% of GDP in 2011 and to 12.3% of GDP in 2012 (Figure 3.1.9).

## Development challenges

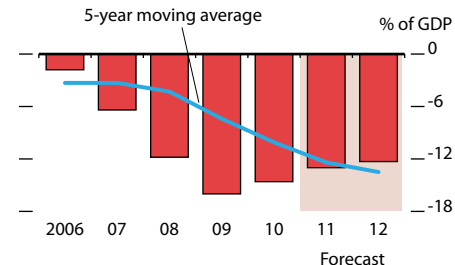
The immediate to midterm macroeconomic challenges include tightening the monetary and fiscal stances, ensuring debt sustainability through concessional financing, and reducing external imbalances.

Fiscal consolidation will require action on both the revenue and expenditure sides. The authorities acknowledge the need for a faster pace of reforms in the areas of tax and customs administration.

Further efforts for better governance will likewise be important to improve social policy, improve the distribution of resources, and reduce poverty. The government is aware of oligopolies in key sectors of the economy that have strong links with entrenched elites. It therefore intends to continue its efforts to reduce corruption, enforce competition, modernize public expenditure management, and strengthen the civil service and judiciary.

For reducing reliance on minerals and metals, which account for the bulk of exports, the government needs urgently to take steps to diversify the industrial base. A one-stop shop for business registration is set to come into effect this year, which should reduce barriers to entry for new businesses.

### 3.1.9 Current account balance



Sources: National Statistical Service of the Republic of Armenia, <http://www.armstat.am> (accessed 1 March 2011); ADB estimates.

[Click here for figure data](#)