Armenia

Armenia's recovery continued in 2011, bolstered by buoyant growth in industry and agriculture. Prudent fiscal and monetary policies helped control inflation and lower the budget deficit, although public debt remained high in 2011, leaving little room for fiscal maneuver. The external accounts generally improved. Economic growth will continue in 2012 and 2013—but with downside risks—and over the medium term, continued and faster structural reforms are needed to support growth.

Economic performance

After modest growth of 2.1% in 2010, economic recovery continued in 2011, with growth estimated at 4.5%. On the supply side, industry, agriculture, and services were responsible for the stronger performance, as construction declined (Figure 3.1.1).

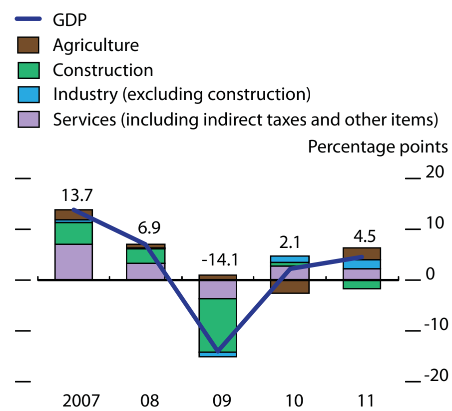
Industry (excluding construction) was the driving force, growing by an estimated 12.3%, including 12.2% in mining and quarrying and more than 16% in food processing. Agriculture expanded by an estimated 12.6%, rebounding from a 15.7% decline in 2010 that greatly impeded the country's recovery from the 2009 recession. Agriculture was a major focus of government policy and benefited from interest rate subsidies and free seed distribution programs. Construction, largely household-financed and that had been the main driver before the crisis, remained weak, contracting by about 10% despite a recovery in remittances. As overall activity accelerated, services expanded by 5.8%, with the fastest growth in health and social work activities, entertainment and recreation.

On the demand side, net exports and consumption underpinned the recovery, while total investment detracted from growth. Net exports improved by 17%, reflecting the favorable external environment, and private consumption rose by an estimated 2.3%, on higher domestic bank lending and sustained remittance inflows. Total investment fell by 4.1%, marking sluggish private investment and restraints on public capital spending.

Average annual inflation decreased to 7.7% from 8.2% in 2010 (Figure 3.1.2). Monetary tightening and a slowdown in nonfood prices offset rapid increases in food prices, helping bring inflation closer to the central bank's target band of 4% +/-1.5%. In December 2011, year-on-year inflation was 4.7%, half the previous year's rate. The central bank raised the refinancing rate by 125 basis points in three steps in February–April to 8.5% and kept it steady until September, when it was cut by 50 basis points to 8.0%, owing to diminishing inflation pressures.

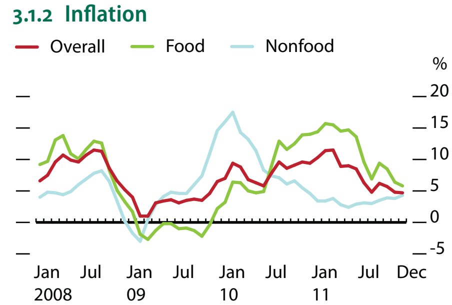
Propelled by increased credit activity and a continued buildup in net domestic assets, broad money (M2X) growth doubled to 23.7% in 2011. However, net foreign assets declined, reflecting the central bank's sales

3.1.1 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 15 March 2012).

3.1.2 Inflation



Sources: CEIC Data Company; National Statistical Service of the Republic of Armenia. http://www.armstat.am (both accessed 15 March 2012).

This chapter was written by Grigor Gyurjyan of the Armenia Resident Mission, ADB, Yerevan.

of foreign exchange in an attempt to limit depreciation and to smooth large fluctuations.

In 2011, the government continued to pursue a prudent fiscal policy, with the aim of gradually reducing the budget deficit and achieving macroeconomic stability. The overall budget deficit is estimated to have narrowed to 3.3% of GDP from 5.0% in 2010, surpassing the official target of 3.9% (Figure 3.1.3). Fiscal consolidation efforts, combined with the impact on revenues of economic expansion and some improvements in tax and customs administration, raised general government revenue to 23.6% of GDP from 22.3% in 2010. Restrained capital spending enabled total outlays to fall to 26.9% of GDP from 27.3% in 2010.

The ratio of central government debt to GDP rose slightly to an estimated 43% at end-2011 from 39.2% the previous year, still within the 50% ceiling stipulated by the Public Debt Law. About 86% of all public debt is external, with domestic debt held mainly by banks.

The balance of payments generally improved, and the current account deficit narrowed to an estimated 12.4% of GDP from 14.7% in 2010 (Figure 3.1.4). Exports surged by an estimated 20.0% to $1.4 billion, benefitting from generally favorable global commodity prices that boosted export values of copper, molybdenum, and other metal concentrates from mining. Imports climbed by an estimated 8.8% to $3.5 billion, boosted by domestic demand that reflected a gradual recovery in foreign direct investment (FDI) and a rebound in remittances.

The large current account gap was financed primarily by donor inflows and FDI. Remittances from workers abroad rose by 20% to $1.3 billion, slightly below their 2008 peak of $1.4 billion; most remittances came from the Russian Federation. Net FDI rose by 15.7% to an estimated $650 million, and most investments were directed to mining, telecommunications, and energy. The Russian Federation accounted for nearly half all investment. Strong export growth, successive releases of funds from Armenia's arrangement with the International Monetary Fund (IMF) initiated in 2010, and a rise in remittances lifted foreign reserves to $1.96 billion by December, equivalent to about 5.2 months of imports.

In 2011 the nominal effective exchange rate depreciated by 1.2% and the real effective exchange rate by 2.2%, though the full potential of exports remained constrained by low competitiveness and high concentration in mining (Figure 3.1.5).

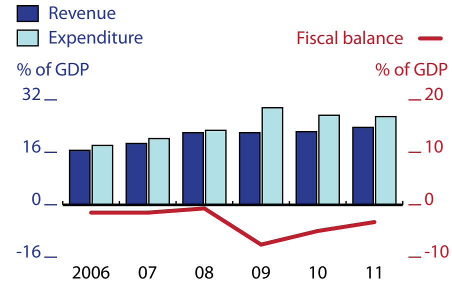
The government continued implementing economic reforms to improve the business environment, streamlining the permit process and making more use of electronic services and one-stop shops for investors. Armenia improved in five of the 10 areas in the World Bank's *Doing Business* 2012 survey and was among the top 10 reformers worldwide, rising six places to 55.

Economic outlook

Armenia's economic recovery is expected to continue in 2012 and 2013, though a shade less quickly than in 2011 (Figure 3.1.6).

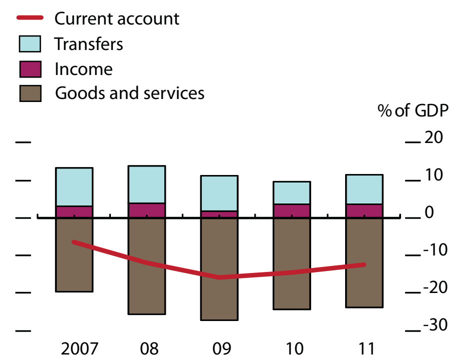
Weak economic prospects in Europe (which accounts for about 60% of Armenia's exports) and their possible spillover to the Russian Federation (80% of remittances, Figure 3.1.7) pose major risks to economic growth.

3.1.3 Fiscal balance



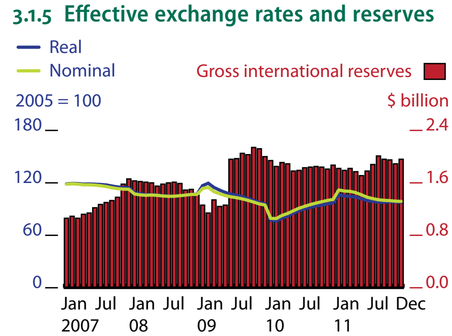
Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 12 March 2012).

3.1.4 Current account components



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 1 March 2012).

3.1.5 Effective exchange rates and reserves



Source: Central Bank of Armenia. http://www.cba.am (both accessed 15 March 2012).

However, structural policy reforms under way, such as an electronic listing of properties and property values as well as electronic facilities to issue construction permits, will help improve the investment climate.

On the supply side, agriculture is expected to continue to grow, but moderately, mainly reflecting government support and assuming continued normal weather conditions. The forecast increases in mining and food processing will contribute to overall industry growth. A moderate rise in construction is foreseen, mostly owing to large infrastructure projects, but no major changes are expected in household-financed construction. On the demand side, remittance-backed consumption is expected to be the growth driver, aided by a modest recovery in public investment spending.

Planned reforms will provide additional impetus to growth and should make it less volatile. Laws on free economic zones, an export-led strategy, and a "regulatory guillotine" initiative aimed at eliminating excessive regulation—all adopted in 2011—may lay the favorable groundwork for attracting investment and diversifying the country's industrial base. Early in 2012, approving the first applications from the Russian Federation, the government authorized the creation of two economic zones, one for agricultural exports and one for high-tech goods.

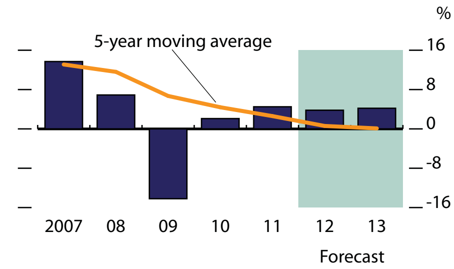
Fiscal consolidation is set to continue in 2012 and 2013, given concerns about the buildup of public and external debt. The government's medium-term fiscal objective is to reduce the budget deficit to 3.1% of GDP in 2012 and 2.0% in 2013. Although a pronounced global slowdown could reduce revenue, sustained reforms in tax, customs, and economic competition are expected to raise the tax-to-GDP ratio. They include a strong tax package adopted in 2011 that raised excises on liquor, luxury vehicles, and engine oil, the marginal rate on high-income taxpayers, and higher tax rates on gambling facilities and restaurants. Good revenue performance would enable the government to increase social security benefits and pensions, while reducing the overall budget deficit.

Average annual inflation is forecast to diminish to 4.1% in 2012 and rise slightly to 4.5% in 2013, as continued domestic support returns agricultural production to normal patterns and global food prices moderate and then pick up a little. Tight monetary policy will also help contain inflation. The 12-month (December–December) rate is expected to remain in the target band in the forecast period.

The external public debt-to-GDP ratio is set to rise in the forecast period (Figure 3.1.8), limiting the space for new borrowing. Still, the IMF, in its latest (December 2011) debt sustainability analysis, viewed external public debt as sustainable and the risk of debt distress as low, even after applying stress tests. The IMF judged that the 3% structural deficit target would maintain the debt ratio at current levels past 2016 without large shocks (although history suggests considerable likelihood of shocks occurring).

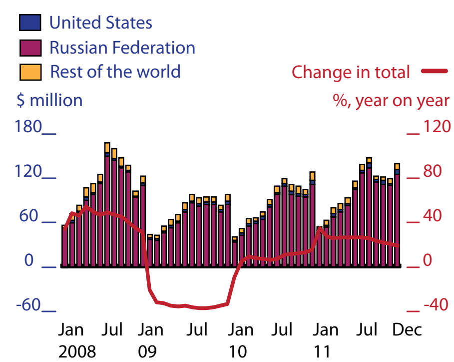
Lower world demand and a fall in prices for key commodity exports, such as copper and other metals, could harm export earnings. However, given the expected outcomes of the government's export diversification strategy—approved in 2011 and targeted at developing 11 industrial branches with export potential, including pharmaceuticals, engineering, and brandy production—exports are projected to expand by 8.0% in 2012 and by about 11.0% in 2013 on top of the large growth

3.1.6 GDP growth



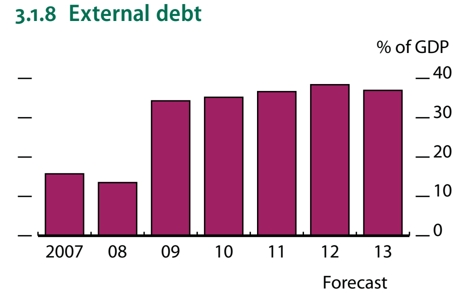
Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 15 March 2012); ADB estimates.

3.1.7 Sources of remittance inflows



Source: Central Bank of Armenia. http://www.cba.am (accessed 16 March 2012).

3.1.8 External debt



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 12 March 2012).

in 2011. Given recent trends in remittances and investments, imports are likely to continue to grow by about 4.5% in 2012 and 6.0% in 2013. The large infrastructure projects will likely boost domestic demand for imports. The recently adopted mining code, which reset mining royalties consistent with international best practices, is expected to attract further investment in the sector.

The current account deficit is forecast to widen to 11.2% of GDP in 2012 and then shrink to 10.0% of GDP in 2013, reflecting projections for gradual export diversification and continued strong remittances. Loan inflows and a modest rise in FDI are expected to help finance the current account deficit (Figure 3.1.9).

3.1.1 Selected economic indicators (%)

	2012	2013
GDP growth	3.8	4.2
Inflation	4.1	4.5
Current account balance (share of GDP)	-11.2	-10.0

Source: ADB estimates.

Policy challenge highlights

Continued reforms in tax and customs and in the business environment are needed to sustain economic growth and diversify the economic base from traditional overreliance on mining and construction, although the impact of reforms may take a considerable time.

The government has committed to accelerate these reforms. Despite the toughening of antitrust legislation, conditions for competitiveness remain unequal across firms of different sizes. Monopolistic practices of producers and importers of certain products distort prices and contribute to inflation. Corruption and inefficient state governance are still serious obstacles to reform.

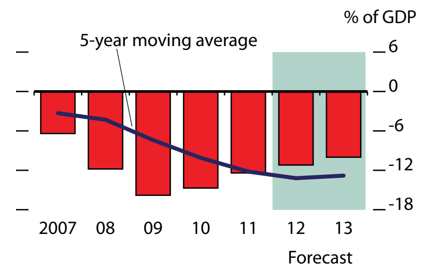
Further improvements to the business environment, especially in paying taxes, enforcing contracts, and trading across borders, are a priority for the government. Moreover, slow progress in legal reform has hindered the effectiveness of new laws. Thus the government is implementing an action plan on doing business that encompasses some 50 activities, including reducing the cost of company registration and the steps to resolve contractual disputes, and, for small and medium-sized enterprises, simplifying tax payments and allowing electronic payment of customs duties.

More effort to strengthen governance will likewise be important to improve social policy, improve the distribution of resources, and reduce the recent crisis-related increase in poverty. Private sector development, especially through promoting small and medium-sized enterprises outside the capital, is critical in reducing the gap in living standards between the capital and the regions.

Despite the monetary tightening and the central bank's policies to contain dollarization of the economy, foreign currency loans and deposits continue to be dominant (60% and 70%, respectively), increasing the country's vulnerability to exchange rate shocks and making monetary policy less effective.

Additional spending on roads, urban infrastructure, and water services is crucial for inclusive growth over the longer term. Financing such spending without increasing the already high public debt-to-GDP ratio will require further increases in the tax-to-GDP ratio and reductions in public debt. Closer public–private partnership in infrastructure could also help reduce the burden on government finances and meet burgeoning infrastructure needs.

3.1.9 Current account balance



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 12 March 2012); ADB estimates.