Armenia

The economy grew strongly in 2012. Prudent fiscal and monetary policies helped control inflation, narrow deficits in the budget and current account, and keep the ratio of external public debt to GDP manageable. Growth will likely continue over the medium term if the government implements plans to accelerate structural reform and mobilize revenues essential for prudent social and development expenditures.

Economic performance

Government estimates showed economic growth accelerating to 7.2% in 2012 from 4.7% in 2011, with all supply-side sectors of the economy expanding (Figure 3.1.1).

Industry (excluding construction) grew by 5.7%, reflecting favorable conditions in foreign markets and the government's efforts to stimulate exports. Growth in industry came mainly from mining, beverages, and building materials. Good weather and government programs offering farmers free seed and subsidized fuel, fertilizer, and credit helped agriculture expand by 9.3%. The construction sector, still reeling from the 2009 recession, inched up by a mere 0.5%, mainly reflecting renewed construction in the energy and transport sectors. Services, accounting for 45% of GDP, gained further steam and expanded by 8.4%, with the fastest growth rates in finance, insurance, entertainment, and recreation.

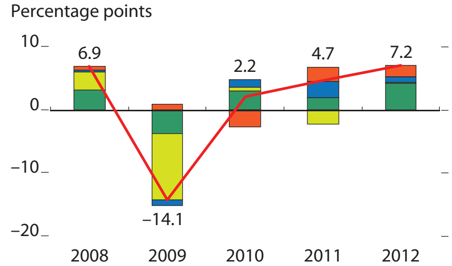
On the demand side, growth was driven mostly by higher private consumption, while total investment and net exports reduced growth. The negative effect of net exports eased somewhat, as exports grew more quickly than imports because of the relatively favorable external environment. Private consumption rose by an estimated 10.1%, fuelled by remittances, continued rapid growth in lending, and moderate growth in domestic earnings. Public consumption was flat in line with the government's conservative fiscal stance. Gross fixed capital formation contracted by 4.2% because of sluggish public and private investment.

Average annual inflation plunged by two-thirds, to 2.6% from 7.7% in 2011, mainly because of smaller price rises for food and services (Figure 3.1.2). Aided by higher food production, favorable global prices, and continued tight monetary conditions, the 12-month inflation rate (comparing December to December) declined to 3.6% in 2012 from 4.7% in 2011, within the central bank's target band of 2.5%–5.5%.

Fiscal policy was generally tight, aimed at gradually shrinking the deficit without derailing economic growth. As expenditures rose less than planned, the budget deficit narrowed to 1.5% in 2012, less than the programmed 2.6% (Figure 3.1.3).

3.1.1 Supply-side contributions to growth

Agriculture
Industry (excluding construction)
Construction
Services (including indirect taxes and other items)
GDP



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am; Central Bank of Armenia. http://www.cba.am (both accessed 12 March 2013).
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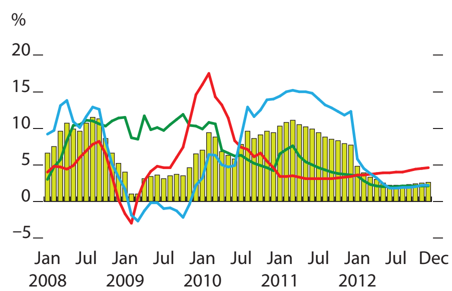
3.1.2 Inflation

Services
Food
Nonfood
Overall



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 12 March 2013).
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This chapter was written by Grigor Gyurjyan of the Armenia Resident Mission, ADB, Yerevan.

Fiscal consolidation combined with economic growth and some improvements in tax collection lifted total government revenue by 6.6% in 2012. Expenditures grew by 1.5% in absolute terms—mostly to cover higher public spending on the social safety net, education, and health, which together claim nearly half of government expenditure—but edged down as a percentage of GDP. Meanwhile, undefined "other expenditures" and outlays for nonfinancial assets declined.

Despite rapid growth, careful debt management, and the government's conservative policy on external borrowing, public debt as a share of GDP expanded from 40.7% in 2011 to 44.1% at the end of 2012, still below the 50% ceiling that would trigger a deficit limit of 3% according to the Public Debt Law (Figure 3.1.4). In nominal terms, public external debt increased by $170 million to $3.7 billion, or 37.7% of GDP. Domestic public debt climbed by $70 million to $630 million, or 6.4% of GDP. Although total public debt is considerable, debt service remains manageable because most debt is on concessional terms.

Having peaked in 2009, the current account deficit again declined to an estimated 10.4% of GDP in 2012 from 10.9% in 2011 (Figure 3.1.5).

Exports surged by an estimated 7.0% to $1.7 billion, benefitting from generally benign global commodity prices, which boosted export values for the mining sector, and the strong performance of the food-processing industry. Imports climbed by 1.7% to $3.7 billion to meet domestic demand that was powered by higher remittances. Despite robust export growth, imports still dwarfed exports. The large trade imbalance was covered by growing remittances and official grants and loans. Net inflows of foreign direct investment, concentrated in mining and telecommunications, remained subdued at an estimated $420 million, down 6% from 2011. Remittance inflows from workers abroad, mainly in the Russian Federation, rose by 8.8% to $1.4 billion, returning to their 2008 peak (Figure 3.1.6).

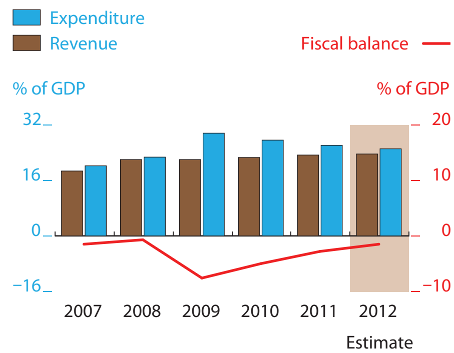
Despite higher domestic demand, the refinancing rate has been kept at 8.0% since September 2011. Pushed by increased lending and a continued buildup in net domestic assets, the money supply (M2) rose by 19.5% in 2012. The central bank's efforts to dampen exchange rate volatility lowered foreign exchange reserves, despite strong remittances, by $108 million to $1.8 billion at the end of December 2012 (Figure 3.1.7).

Over the year, the dram depreciated by 4.4% in nominal effective terms and by 6.7% in real effective terms. While exports benefited from depreciation, they remained constrained by weak productivity and competitiveness and persistently high concentration in mining and metals.

Economic outlook

With the outcome of the February 2013 presidential elections signaling the maintenance of current policies, continued but more moderate growth is expected in 2013 and 2014. Assuming continued structural reform and no further worsening of global economic conditions, GDP growth is projected at 4.5% in 2013 and 4.6% in 2014 (Figure 3.1.8). Growth could be slower if external risks, including a further slowdown of growth in the Russian Federation and possible recession in the euro area, materialize.

3.1.3 Fiscal indicators



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 12 March 2013).
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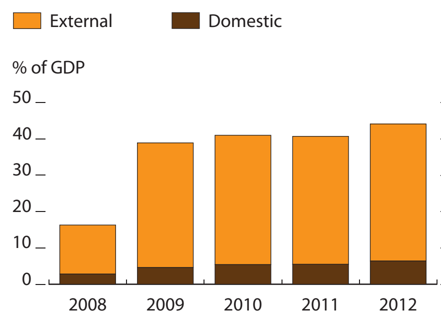
3.1.4 Public debt



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 12 March 2013).
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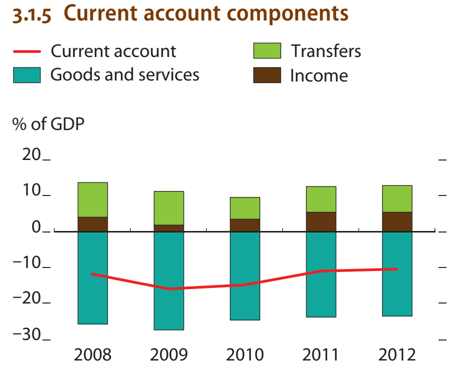
3.1.5 Current account components



Source: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 12 March 2013).
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Agriculture is expected to continue growing as productivity improves and the area under irrigation expands. Industrial expansion, led by mining and food processing, will further buttress growth. Services should also expand as higher remittances drive consumption. Lagging construction growth will be supported by the building of the North–South Road Corridor and other large infrastructure projects. Continued structural and public sector reform aiming to improve the business environment and private sector development could further strengthen the economic outlook and promote growth.

In the short run, service payments on the external debt of the government and central bank are expected to peak in 2013 at $423 million, including both principal and interest. This sum will pose a major drain on financial resources, equal to 15% of the value of exported goods and services, and could put pressure on the overall balance of payments. The government's share of this debt service is $225 million, which will equal 10% of government revenues in 2013, though this burden is projected to ease thereafter.

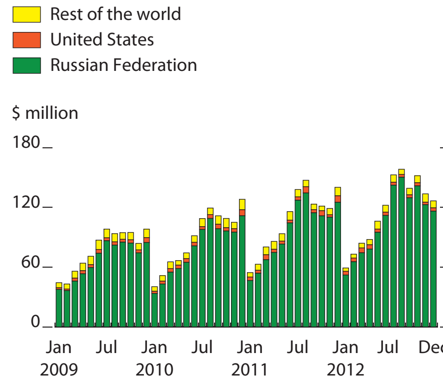
In the long run, the introduction of a mandatory funded pension system in January 2014 is expected to create a pool of long-term assets to help finance investment, which should foster growth and promote job creation. With continued tight monetary conditions and an assumed gradual upswing in agriculture, average annual inflation is projected at 3.6% in 2013 and 3.2% in 2014. During these 2 years, the 12-month inflation rate (December to December) is expected to remain within the central bank's target band of 2.5%–5.5%. Smaller price rises for food will reduce the impact of the higher price for imported natural gas planned in 2013.

The government is likely to maintain its policy of gradual fiscal consolidation, to allay concerns about the buildup of public and external debt. The fiscal deficit is projected to narrow further without constraining economic recovery. The 2013 budget aims for an overall deficit equal to 2.6% of GDP, as was programmed for 2012. The government's medium-term fiscal objective is to narrow this deficit to 2.3% of GDP in 2014 and 2.0% in 2015. Spending will continue to focus on strengthening social infrastructure and the social safety net. Sustained tax and customs reform and efforts to enhance economic competitiveness are expected to raise the tax-to-GDP ratio over time.

Monetary policy is expected to return gradually to a neutral stance over the medium term, to sustain growth while ensuring price stability. However, the financial sector remains highly dollarized in terms of both assets and liabilities, leaving the country vulnerable to exchange rate shocks and making monetary policy less effective. The authorities have discouraged further dollarization by imposing higher risk weights and provisions on foreign currency assets and higher reserve requirements on foreign currency deposits.

The trade deficit is expected to narrow moderately. Assuming no downward pressure on commodity prices, export growth should continue. The government's strategy to diversify exports, approved in 2011, is to develop 11 industrial subsectors selected for their export potential. This strategy is expected to help expand exports by 8.5% in 2013 and 9.0% in 2014, but lower world demand or prices for key commodity exports such as copper and other metals would constrain export growth.

3.1.6 Sources of remittance inflows



Source: Central Bank of Armenia. http://www.cba.am (accessed 12 March 2013).

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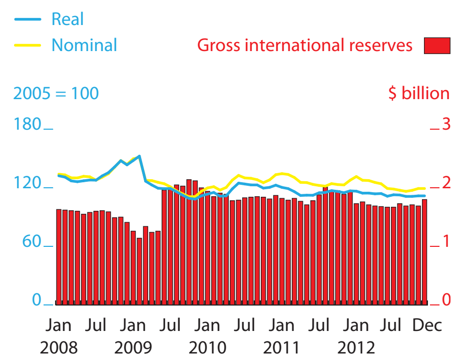
3.1.7 Effective exchange rates and reserves



Source: Central Bank of Armenia. http://www.cba.am (accessed 12 March 2013).

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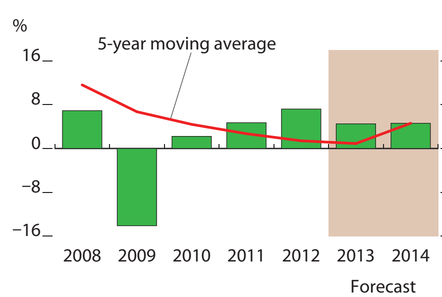
3.1.8 GDP growth



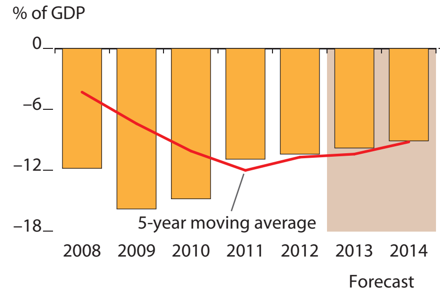
Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 12 March 2013); ADB estimates.

Click here for figure data

Recent trends in domestic demand and investment—and large infrastructure projects that are seen as boosting domestic demand for imports—suggest that imports will grow by 6.5% in 2013 and 5.0% in 2014, which is somewhat less than projected export growth.

Backed by robust remittance inflows, the current account deficit is projected to narrow to 9.8% of GDP in 2013 and 9.1% in 2014 (Figure 3.1.9). Continued loan inflows and a modest rise in foreign direct investment are expected to help finance the current account deficit. Total external debt is expected to rise in the forecast period, but economic expansion will probably mean that external debt declines slightly as a percentage of GDP.

3.1.9 Current account balance



Sources: National Statistical Service of the Republic of Armenia. http://www.armstat.am (accessed 12 March 2013); ADB estimates.

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Policy challenge—promoting poverty reduction

Despite impressive growth, much remains to be done to combat the rise in poverty that occurred after the sharp economic contraction experienced in 2009. Accelerating structural reform to develop the private sector, implement an export-oriented diversification strategy, and mobilize resources for higher outlays on social sectors could enhance growth, thereby facilitating job creation and poverty reduction.

While Armenia scores well in many international comparisons, further improvements in tax collection, contract enforcement, competitiveness, legal and judicial reform, governance, and anti-corruption measures are essential for the economy to achieve and sustain its growth potential. Pursuing structural reform will enhance Armenia's attractiveness to foreign investors and eventually improve the job market and living standards.

Disparity between the capital and the regions in incomes and economic development risks undermining long-term, inclusive growth. Promoting private sector development, especially of small and medium-sized enterprises outside the capital, is critical to narrowing the gap in living standards between the capital and the rest of the country.

Armenia's overreliance on mining and construction are emblematic of the lack of economic diversification that the 2008–2009 global financial crisis revealed as a major vulnerability. Seriously implementing measures to advance the export diversification strategy approved in 2011—and programs designed to build a knowledge-based economy, enhance productivity, and promote technological modernization—can diversify growth, strengthen competitiveness, and eventually stimulate sustainable growth in employment and incomes.

In this regard, government plans to establish an export lending agency and an industrial development fund in 2013 are encouraging, as are its commitments to earnestly enforce a law on free economic zones and a "regulatory guillotine" initiative adopted in 2011 toward eliminating excessive regulation. As evidenced by strong growth in information and communication technology since the early 2000s, investment in infrastructure and technology to support industries with high returns can catalyze economic growth.

Over time, expanding public infrastructure and targeted social spending should promote inclusive economic growth. Financing these outlays without worsening the ratio of public debt to GDP will require further increases in the tax-to-GDP ratio and curbs on other expenditure.

3.1.1 Selected economic indicators (%)

	2013	2014
GDP growth	4.5	4.6
Inflation	3.6	3.2
Current account balance (share of GDP)	−9.8	−9.1

Source: ADB estimates.