Armenia

The economy had mixed results in 2013, as slower growth and higher inflation accompanied the marked narrowing of fiscal and current account deficits. The outlook is for higher growth, lower inflation, and further improvements in fiscal and external positions. Despite progress in structural reform and an improved business environment, high unemployment remains a challenge.

Economic performance

Growth slowed to 3.5% in 2013 from 7.2% in 2012. On the supply side, industrial growth decelerated to 4.9% in 2013 from 7.0% in 2012, reflecting the adverse effects of steep price increases for electricity and imported gas in July 2013, partly offset by government efforts to stimulate export-oriented industries. Industrial growth came mainly from higher output in mining, quarrying, and the production of pharmaceuticals, food, and beverages (Figure 3.1.1).

Growth in agriculture moderated to 8.1% in 2013 from 9.5% in 2012, mainly because a severe hailstorm hit several regions of the country in May–June 2013 and slowed growth over the rest of the year. Agricultural growth was driven by state assistance programs, including free seed distribution and subsidies to farmers for fuel and fertilizer. Construction fell by 11.2%, reversing 3.3% growth in 2012. The decline came from lower demand and investment in construction and delays in large public infrastructure projects. Despite some moderation in the second and third quarters, services (accounting for about 45% of GDP) expanded by 5.9%, as compared with 7.0% in 2012. Growth was driven mainly by increases in trade, information and communication, finance, insurance, food service, and recreation.

On the demand side, consumption was the main driver of economic growth in 2013, as in the previous year. Growth in private consumption slowed to an estimated 2.8% in 2013 from 9.1% in 2012, as higher inflation reduced real income, despite continuing increases in workers’ remittances and bank credit. But public consumption jumped by an estimated 12.7%, versus a 0.2% decline in 2012, reflecting higher government spending. Gross fixed capital formation dropped by 4.9%, compounding the 1.8% decline in 2012 and reflecting sluggish public and private investment. The negative impact of net foreign trade and services eased somewhat in 2013, as a relatively favorable external environment helped exports grow more quickly than imports.

Average annual inflation more than doubled to 5.8% in 2013 from 2.6% in 2012, largely reflecting rising energy prices and lagged effects from severe storms in the second quarter (Figure 3.1.2). However, the 12-month inflation rate, which peaked at 9.2% in August, declined

3.1.1 Supply-side contributions to growth

<table>
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<tr>
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</tr>
<tr>
<td>Industry (excluding construction)</td>
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<tr>
<td>Services (including indirect taxes &amp; other items)</td>
<td>-</td>
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<td>-</td>
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<tr>
<td>Construction</td>
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<td>Gross domestic product</td>
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</tbody>
</table>


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3.1.2 Inflation

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This chapter was written by Grigor Gyurjian of the Armenia Resident Mission, ADB, Yerevan.
gradually to 5.6% in December, slightly above the Central Bank of Armenia (CBA) target band of 4% ±1.5 percentage points.

Rising inflation prompted the CBA to raise its refinancing rate to 8.5% in August 2013 from the 8.0% set in September 2011. With inflation slowed, the CBA then bolstered economic activity by lowering the rate to 7.5% in three steps from November 2013 to February 2014. Broad money supply rose by 14.8% during 2013, reflecting a significant buildup in CBA net foreign assets and continued credit growth. Credit to the private sector rose by 11.9% in 2013, versus 26.5% in 2012, mainly for personal loans and lending to retailers and wholesalers.

The government continued its policy of fiscal consolidation, aiming to stabilize the ratio of public debt to GDP. The fiscal deficit declined to 0.4% of GDP in 2013, well below the target of 2.6% (Figure 3.1.3).

Higher tax collection and some improvement in revenue administration lifted government revenues including grants by nearly 13% in 2013, to 25.0% of GDP from 23.7% in 2012. Government expenditure, while rising by 7.6%, remained 6% below the budget (equal to 25.4% of GDP), mainly because of delays in public investment projects. Total public debt declined to 43.6% of GDP at the end of 2013 from 44.1% a year earlier (Figure 3.1.4). External public debt dropped to 37.1% of GDP in 2013 from 37.7% in 2012, while domestic public debt increased by 0.1 percentage points to 6.5% of GDP.

The successful placement in September 2013 of Armenia’s first eurobond ($700 million in 7-year bonds with a yield of 6.25%) enabled the government to repay early a $500 million loan to support its 2009 anti-crisis program, which the Russian Federation had granted with 15-year maturity and an interest rate 3% above the London interbank offered rate (LIBOR).

Continuing large inflows of transfers and income from abroad helped narrow the current account deficit to an estimated 9.5% of GDP in 2013 (Figure 3.1.5). In volume terms, the trade deficit narrowed in 2013, as exports expanded more quickly than imports. Export growth accelerated to an estimated 8.5% in 2013 from 2.5% in 2012, driven largely by higher mineral and processed food exports. Merchandise imports grew by 2.5% in 2013, versus 2.2% in 2012, mainly reflecting slack domestic demand. Remittance inflows from workers abroad, primarily in the Russian Federation, rose by 10.8% to $1.5 billion in 2013 (Figure 3.1.6).

Inflows of foreign direct investment (FDI), concentrated in mining and energy, fell by 9.2% to an estimated $430 million during 2013. Gross international reserves jumped by 25.2% in the year to the end of 2013, to $2.3 billion, reflecting the eurobond issue and CBA purchases of US dollars (Figure 3.1.7). During 2013, the Armenian dram depreciated by 0.7% in nominal effective terms and appreciated by 5.7% in real effective terms, as inflation exceeded that of its main trading partners.

**Economic prospects**

Growth is expected to accelerate to 4.6% in 2014 and 5.0% in 2015, with both projections subject to upside and downside risks (Figure 3.1.8).

The pace of future growth depends on Armenia’s accession to the customs union and common economic space of the Russian Federation,
Kazakhstan, and Belarus in 2015; accession was announced in September 2013, but the full implications will depend on the final agreements to be signed in mid-2014. While Armenia may benefit in the long run from higher trade in the enlarged market, lower nontariff trade barriers, more efficient flows of labor and capital, and potentially greater FDI, it remains to be seen how terms-of-trade changes will affect trade with countries outside the union.

Also likely to promote growth are domestic factors such as continued reforms to taxation, customs duties, and the business environment, along with air space liberalization introduced in 2013.

Agriculture is expected to continue expanding, reflecting the implementation of state assistance programs designed to improve productivity and efficiency. Industrial expansion is expected to accelerate, benefitting from the government’s export-led industrial development strategy approved in 2012, which targets 11 subsectors with export potential. Intergovernmental agreements between Armenia and the Russian Federation signed in December 2013 to exempt imported gas, raw oil, and diamonds from customs fees could provide additional support to industrial growth. Services should also expand, driven largely by increases in civil service salaries in January and July 2014 and remittance-based consumption spending. Construction is expected to rise, primarily on investments associated with the North–South Road Corridor project.

On the demand side, the main contributor to growth will be consumption, fueled by rising salaries, remittances, and public spending. Significant increases in public sector salaries and pensions in 2014, and continuing impacts from energy price increases in July 2013, will likely keep average annual inflation high at 4.5% in 2014 before it eases to 4.0% in 2015. However, the 12-month inflation rate (December over December) is expected to remain within the CBA’s target band of 4% ±1.5 percentage points. Slower demand growth and lower food inflation, from better harvests, are seen as offsetting other price increases. Monetary policy is expected to be broadly accommodative to support growth.

Fiscal policy is likely to remain relatively tight during 2014 and 2015, given the vulnerability of public debt to shocks. The 2014 budget aims for a deficit that is just over 2.3% of GDP, with higher capital spending and wage and pension increases. The government’s medium-term fiscal objective is to trim this deficit to 2.3% of GDP in 2015 and 2.0% in 2016. The current account deficit is projected to narrow slightly to 8.7% in 2014 and 8.0% in 2015, reflecting further shrinkage in the trade deficit and increases in workers’ remittances (Figure 3.1.9). Exports are projected to grow by 6.2% in 2014 and 6.5% in 2015, benefitting from the government’s export-led industrial strategy, assuming no downward pressure on prices for nonferrous metals. Imports are projected to rise by 3.5% in 2014 and 4.3% in 2015 as domestic demand expands.

The policy of air space liberalization may well become important for expanding service exports. Further declines in the current account deficit will also require follow-through on reforms to the business environment, which would improve competitiveness and attract more FDI.

The stock of public debt will continue rising, albeit at a slower pace and in line with the government’s strategy to reduce the external...
share of public debt. While Armenia’s graduation from eligibility for concessional financing from the International Monetary Fund in April 2013 and the World Bank in July 2014 will raise the cost of external borrowing, the eurobond issuance in September 2013 helped the government lengthen its debt profile and lower the average rate on government securities. Higher economic growth should put the ratio of public debt to GDP on a steady downward path, at least through 2015.

**Policy challenge—high unemployment**

Economic growth has had limited impact thus far on Armenia’s high unemployment. Despite some reduction during the past 4 years, the persistently high unemployment rate, estimated at 16.8% in 2013, hinders poverty reduction. A shrinking workforce (caused by outward migration), outmoded worker skills, and market distortions created by a large informal sector continue to undermine Armenia’s growth potential. Addressing these weaknesses would reduce unemployment, narrow income disparity, reduce poverty, and promote more inclusive growth.

The government recognizes the need to foster private sector development in order to create more jobs. Expanding employment by creating high-quality and highly productive jobs is an objective of the government’s Armenia Development Strategy 2025. Achieving this is seen to depend mainly on employment growth, human capital development, an improved social protection system, and better public administration and governance.

Employment is still concentrated in sectors with low productivity, as measured by the value added per employee. As a few export-oriented industries—such as mining, diamond processing, and sectors with some foreign ownership, notably financial intermediation and information technology—generate higher GDP per worker, the government’s export-oriented industrial development strategy is seen as a way to boost employment and productivity over the medium term.

Improving the business climate to attract more FDI is also critical for boosting employment. Weak foreign investment has hindered the economy’s structural transformation. The government has begun extensive reforms to improve the efficiency of public services, streamline operating procedures, and reform tax and customs administration.

Because much unemployment is rooted in outmoded skills and therefore structural in nature, more active labor market policies and better-targeted education and training would complement these programs.

Wide-ranging reforms have been implemented throughout the education system since the 2000s. Advancing these reforms and ensuring that academic and training courses match labor market needs would help alleviate unemployment, create better-paying jobs, and promote further economic growth. The government has adopted a new approach for 2014 that aims to reform labor market policies by eliminating unemployment benefits and less effective programs and focusing resources on better services for job seekers. These policies will receive support from new social programs to be introduced in 2014, such as educational support for the young from vulnerable families and mortgage assistance for civil servants.