

# Armenia

Country Economic Update  
Winter 2019



**A strong mandate for change  
amid a global slowdown**



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**Macroeconomics,  
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Global Practice

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# **ARMENIA:**

## ***A strong mandate for change amid a global slowdown***

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Country Economic Update

Winter 2019

Government fiscal year:	January 1 – December 31
Currency unit:	Armenian dram (AMD)
Currency equivalents:	Exchange rate effective as of January 25, 2019 US\$1 = 485.8 AMD
Weights and measures:	Metric system

## Abbreviations and acronyms

AMD	Armenian dram
ASA	Air Service Agreement
CAA	Civil Aviation Authority
CBA	Central Bank of Armenia
RPA	Republican Party of Armenia
CEU	Country Economic Update
EEU	Eurasian Economic Union
EU	European Union
IMF	International Monetary Fund
FDI	Foreign direct investment
GoA	Government of Armenia
GDP	Gross Domestic Product
NPL	Nonperforming loan
NSS	National Statistics Service
SCD	Systematic Country Diagnostics
VAT	Value-added tax
WBG	World Bank Group

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## Foreword

*This edition of Armenia's Country Economic Update (CEU) is part of a semi-annual series designed to monitor socio-economic developments in Armenia and contribute to the discussion on economic policies and prospects. It presents a concise analysis of economic, social, and political developments as well as of progress achieved in the implementation of structural reforms since the Summer 2018 edition of the CEU. This edition's authors are Armineh Manookian (Country Economist for Armenia) and Olena Bogdan (Young Professional), with a significant contribution by Evgenij Najdov (Senior Economist for South Caucasus) and support from Artsvi Khachatryan (Consultant). The authors are grateful for the support of, and inputs from, Mercy Miyang Tembon (Regional Director, ECCSC), Sylvie Bossoutrot (Country Manager for Armenia), Genevieve Boyreau (EFI Program Leader for South Caucasus), and Cesar Cancho (Economist). Sarah Nankya Babirye (Program Assistant in Washington, D.C.) and Gayane Davtyan (Program Assistant in Yerevan) provided administrative support. Bronwen Brown edited the text. Vigen Sargsyan (Senior Communications Officer, ECAEC) helped with the report dissemination.*

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## Key Messages

### **The convincing victory of the My Step alliance completed Armenia's political transition.**

The acting Prime Minister, Nikol Pashinyan, secured a landslide victory in snap elections held on December 9, 2018. His My Step alliance won 70.4 percent of the vote, translating into 88 seats in the 132-member Parliament. The Republican Party, a dominant political force since the early 2000s, failed to reach the 5 percent minimum threshold and will remain out of the parliament. Mr. Pashinyan now has the mandate and legislative power to push through the program of economic and rule of law reforms expected by his supporters.

### **Macroeconomic performance has been satisfactory.**

Following an initial spike in early 2018, Armenia's economic performance slowed during the rest of the year, mostly due to weakening external conditions, lower execution of public capital expenditures, production difficulties at two large mining operations, and a poor agriculture harvest. While larger economic disturbances were avoided during the political transition, the associated uncertainty may have weighed on economic sentiments. Nonetheless, real GDP expanded at a strong rate of 6 percent in the first three quarters of 2018 and is estimated to have moderated to about 5.5 percent for the year. Inflationary pressures remained low, with inflation at the lower end of the Central Bank of Armenia's (CBA) inflation target range. The external balances deteriorated as growing exports—particularly textiles, tourism and IT services—were insufficient to offset strong import growth, weaker mining export earnings, and flattening remittances. The overperformance of the fiscal accounts reflected strong revenue collection, sound control over current spending, and underperformance of capital expenditure.

### **Many Armenians continue to live in poverty despite improvements to social indicators.**

Armenia's sound economic growth performance in 2017 and 2018 resulted in a decline in the unemployment rate, which stood at 15.7 percent in mid-2018,<sup>1</sup> its lowest level in a decade. Similarly, while poverty continues to affect a significant proportion of Armenia's population, the poverty rate declined from 29.4 percent in 2016 to 25.7 percent in 2017. This reduction was mostly due to developments in cities other than Yerevan. In Yerevan, the poverty rate eased from 24.9 percent in 2016 to 22.4 percent in 2017.

### **GDP growth is projected to slow to 4.3 percent in 2019.**

Our baseline scenario envisages slower but still robust GDP growth in 2019 amid a supportive macroeconomic environment of low inflation and sustainable public finances. The weakened global and regional growth outlook for 2019 will likely adversely impact Armenia's exports of goods and services. Domestically, growth will benefit from a modest fiscal expansion, continued robust credit growth to households, including for mortgage lending, and improved business sentiments. Following the overperformance in 2018, the 2019 Budget envisages some fiscal expansion, reflecting a medium-term fiscal

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<sup>1</sup> In January 2018, Armstat, Armenia's Statistics Office, revised its labor market statistics methodology. The figures presented use the old methodology to allow for comparisons over time. Labor force statistics using the new methodology are available only since 2017 and show the unemployment rate in the second quarter of 2018 at 20.2 percent.

framework in line with lowering of the government debt to below 50 percent of GDP. Monetary and exchange rate policy will remain focused on maintaining price stability amid a riskier external environment.

**Downside risks to the outlook are significant.**

Externally, rising global trade and political tensions could escalate and cause a slowdown in Armenia's main trading partners. On the domestic front, reforming Armenia's economy will require bold efforts in many areas, which could still face opposition due to vested interests or perceived high costs. At the same time, without such bold reforms, tangible results in creating job opportunities, increasing wages, better addressing the social issues and improving the business environment to be able to attract investment, are unlikely. Failure to produce these results could reignite social and political tensions, fueling economic uncertainty.

## **A. Recent Developments**

### **Political Developments**

**Nikol Pashinyan and his My Step alliance won an overwhelming majority in snap elections.**

Armenia's political landscape underwent enormous change in 2018. A peaceful transition of power took place following the mass-protest and the Spring 2018 Velvet Revolution, with Nikol Pashinyan, the protest leader, assuming the role of Prime Minister and committing to hold snap parliamentary elections within a year. Elections were held on December 9, 2018, and Mr. Pashinyan's My Step alliance won 70.4 percent of the vote (88 seats in the Parliament). Its nearest rival, the moderate Prosperous Armenia party, won just over 8 percent (26 seats). Bright Armenia, a liberal pro-Western party, won about 6 percent of the vote or 18 seats. My Step's overwhelming victory—and Armenia's Constitutional requirement that opposition parties hold at least one-third of parliamentary seats—required that Parliament, a one-chambered legislature, be expanded from 105 to 132 members. The Republican Party, a dominant political force since the early 2000s, won just 4.7 percent of the vote, falling short of the 5 percent threshold for inclusion in Parliament. Another veteran party, Dashnaksutyun, also failed to meet that threshold (with 3.8 percent of the vote). Importantly, the Organization for Security and Cooperation in Europe (OSCE) and the European Union concluded that the elections were well administered, respected fundamental freedoms, and were characterized by genuine competition.

**Election results provide a legal platform for long-needed reforms.**

The election results give the new majority the legislative power to push through its agenda including economic and rule of law reforms, spurring private investment, poverty reduction through job creation and education, and improvements to public expenditure efficiency. Some of the planned reforms are key for the long-term growth of the economy.

**Significant changes to foreign policy are unlikely.**

The incoming Cabinet is expected to confirm its commitment to Armenia's major international engagements. The new government may be tempted to pursue closer ties with the European Union and the United States, largely

focused on promoting economic relations, supporting reform efforts and attracting foreign direct investment (FDI) that could help expand markets and facilitate technology transfer. At the same time, the country plans to maintain close relationships with the Russian Federation and seek to deepen its participation in the Eurasian Economic Union (EEU).

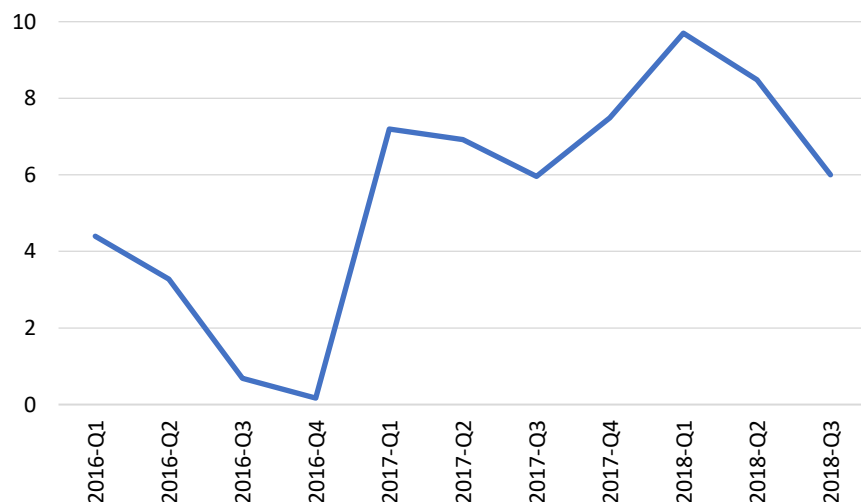
## Economic Growth and Inflation

### Economic growth momentum slowed overall in 2018.

Following an initial burst in early 2018, Armenia's growth slowed in the rest of the year, mostly due to weakening external conditions, lower-than-planned execution of public capital expenditures, production difficulties at two large mining operations, and a weak agriculture harvest. While larger economic disturbances were avoided during the political transition, the associated uncertainty may have weighed on economic sentiments. As a result, real GDP growth slowed from 9.7 percent in the first quarter of 2018 to only 2.7 percent in the third quarter of the year. This deceleration reduced overall GDP growth in the first nine months of the year to 6 percent (Figure 1). All major economic sectors exhibited slowing growth (Figure 2).

High-frequency data suggest some recovery in the final quarter of 2018, mostly due to a stabilizing of industry and services. Still, full-year GDP growth is estimated to have moderated to 5.5 percent. This outcome was above Armenia's historical average growth rate of about 2.5 percent during the past decade and one of the highest among economies in the Europe and Central Asia region.

**Figure 1. Quarterly real GDP growth**  
(Percent, year-to-date, over same period in previous year)



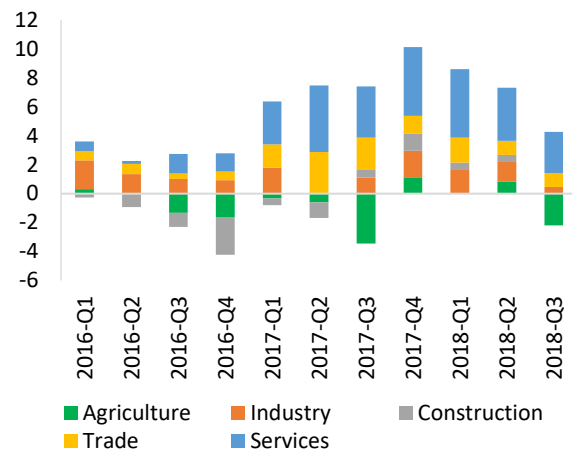
Source: NSS.

<b>Agricultural output has contracted for three consecutive years.</b>	Agricultural production (particularly horticulture) contracted by 2.2 percent year on year in the third quarter of 2018. The sector has now registered negative growth for three consecutive years, reflecting both lower inputs (sawn land area, livestock) and productivity (yields). With 31.6 percent of primary employment in the agriculture sector, it is essential to address the structural issues preventing the expansion of the sector, including land fragmentation and limited adoption of advanced technologies.
<b>Services were the main sectoral driver of growth.</b>	Services (including trade) grew by 9 percent in January-September 2018 and contributed 4.7 percentage points to the total 6 percent growth in this period. Trade and arts, entertainment, and recreation grew fastest (by 11 and 20 percent, respectively). Manufacturing (led by food and cigarette production) experienced double-digit growth of 11 percent year on year. Textiles grew by 38 percent, though from a low base, and made a significant contribution to export growth. Construction activity, while moderating from double-digit growth in late 2017 and early 2018, registered 4.5 percent growth in 2018, higher than the expansion in 2017 (2.2 percent).
<b>Mining sector output contracted for the first time in more than a decade.</b>	Mining output contracted by 7 percent year on year in the first nine months of 2018, and high-frequency data suggest a further contraction in the last quarter of the year. The main cause was the February 2018 suspension of operations at the Teghut copper mine, located in northern Armenia, and the stopping of construction at the Amulsar gold mine, <sup>2</sup> located in the southeast. Importantly, 2018 was the first year since 2005 in which mining output declined.
<b>Slower growth also reflected moderating domestic and external demand.</b>	Following a strong start to 2018, domestic demand moderated, contributing to the growth slowdown throughout the year (Figure 3). Investment's contribution to GDP growth declined—from 12.3 percentage points in the first quarter of 2018 to 4.4 percentage points by the third quarter—reflecting both the suspension of investment activities in the mining sector and slow public capital expenditure execution. Private consumption growth decelerated—rising by 1.2 percent in the third quarter of 2018 compared with 6.8 percent in the same quarter of the previous year—reflecting relatively low real wage growth and stagnant remittances. As a result, its contribution to GDP growth fell to 0.9 percentage points in the third quarter of 2018 (from 5 percentage points a year earlier). Tight control over the budget also resulted in a negative contribution (0.5 percentage points) of government spending to GDP in the third quarter. The contribution of exports to GDP growth in the third quarter stalled, mostly due to falling minerals exports. However, the drag on GDP growth of imports also moderated as the slowdown in domestic demand translated into lower imports.

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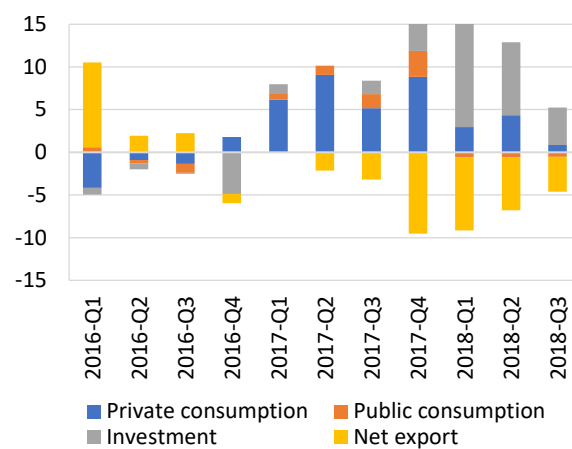
<sup>2</sup> Fully owned by Lydian International, the mine was expected to start operations in 2018. However, the government suspended construction in mid-2018 and is currently awaiting the mine's final environmental impact assessment. A large share of the country's total investment and capital goods imports in 2017 and early 2018 was related to this mine.

**Figure 2. GDP growth by sector**  
(Percent)



Sources: NSS; World Bank staff calculations.

**Figure 3. GDP growth by source of demand**  
(Percent)



Sources: NSS; World Bank staff calculations.

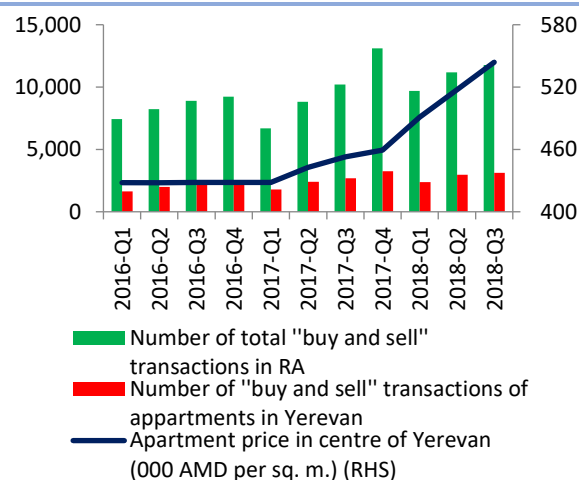
### The real estate market is increasingly dynamic.

Armenia's real estate market, anemic over the last decade, has become more dynamic since mid-2017, reflecting improved economic conditions, more favorable mortgage interest rates, and the introduction of subsidy programs for young families. In the first nine months of 2018, the number of apartments transacted in Yerevan rose by 23 percent year on year, with 17-percent higher prices on average. The total number of real estate transactions across the country rose by 27 percent year on year (Figure 4).

### Inflationary pressures remained subdued.

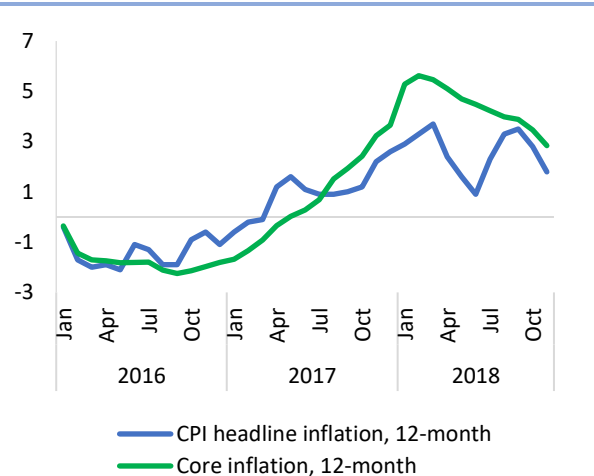
Inflation remains low on account of weak external price pressures and moderating domestic demand. Annual inflation, as measured by the Consumer Price Index (CPI), edged up modestly in the first nine months of 2018, peaking at 3.5 percent in September before declining to 2.8 percent in October and 1.8 percent in November and December (Figure 5). Average annual inflation in 2018 was 2.5 percent, just within the lower end of the central bank's target range of 4 percent (+/-1.5 percent). Rising prices for food products, non-alcoholic beverages, health care, and transportation services drove the acceleration in headline inflation during much of the year. Lower food prices in the fourth quarter were the main driver of the reduction in the headline inflation rate. Core inflation (excluding seasonal products and administratively regulated prices) remained contained at about 3 percent.

**Figure 4. Real estate transactions and price**  
(Percent)



Source: Cadastre Committee.

**Figure 5. CPI headline and core inflation**  
(Percent, year-over-year)



Source: NSS.

## External Sector

### A larger trade deficit caused the current account balance to deteriorate.

In the first three quarters of 2018, the current account deficit widened to 8.1 percent of GDP, compared to 2.4 percent of GDP for full-year 2017 (Figure 6). The deterioration was driven by a larger trade deficit, which increased by 32 percent year on year in 2018, to \$2.6 billion. Goods exports rose by about 8 percent year on year in nominal U.S. dollar terms (1.5 percent in real terms),<sup>3</sup> but imports grew at a much faster rate, rising by 21 percent year on year in nominal terms (15 percent in real terms). At the same time, the services and income accounts registered smaller surpluses compared to the same period of 2017.

### Armenia's merchandise export structure is changing.

Armenia experienced a considerable shift in the structure of its goods exports in 2018. Whereas the share of traditional exports (minerals, particularly copper) diminished as the mining sector contracted, the share of textiles, agriculture, and precious metals (gold and jewelry) increased (Figure 7). Textile exports were up by 65 percent year on year at end-2018, albeit from a small base (6 percent of total exports). At the same time, imports of capital goods (such as transport materials and appliances) increased by about 50 percent, along with double-digit growth rates for all other import categories reflecting a robust expansion of domestic demand (Figure 8).

### More Armenian goods exports went to Eurasian Economic Union markets.

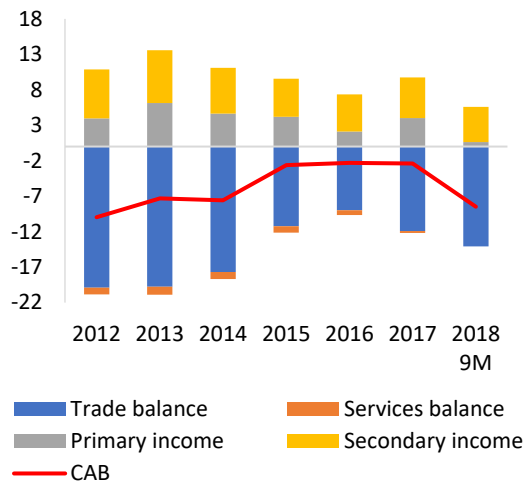
The share of Armenian goods exports sold in the EEU (mostly Russia) increased from 26 percent of total goods exports in 2017 to 29 percent in 2018. Armenian exports to the Islamic Republic of Iran and Iraq also increased, by 12 and 28 percent, respectively. At the same time, the share of imports from EEU economies fell by 3 percentage points, mostly due to lower imports of gas in 2018. Even though imports from Russia increased, imports from other countries—most notably China, Germany and the Islamic Republic of Iran—

<sup>3</sup> World Bank staff calculation. Refers to exports and imports in the January to November 2018 period.

increased faster. In 2018 the European Union (Germany, Bulgaria, and Italy, in particular) accounted for a quarter of Armenia's total trade in goods, and China for 10 percent.

**Figure 6. Current account balance**

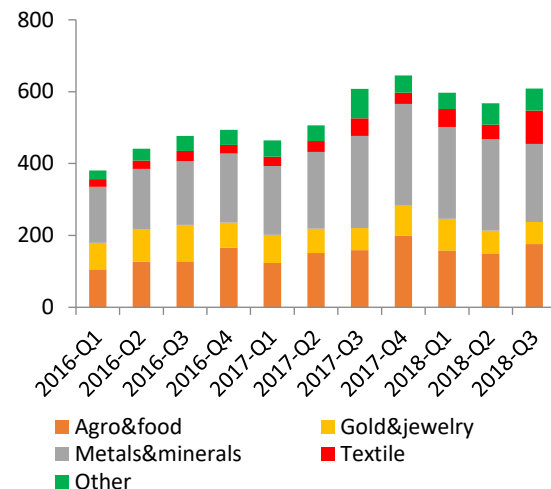
(Percent of GDP)



Sources: CBA; NSS; World Bank staff calculations.

**Figure 7. Exports by commodity groups**

(US\$ million)



Sources: NSS; World Bank staff calculations.

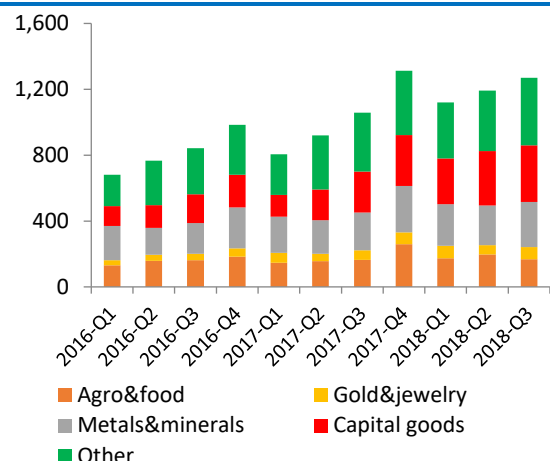
**Net exports of services declined despite robust exports of tourism and IT services.**

The surplus on the services account narrowed significantly in the first three quarters of 2018, falling to \$8 million from \$68 million in the year-earlier period. Tourism, telecom and IT services remained the major positive contributors. Exports of telecommunication and IT services rose by 24 percent in the first nine months of 2018 to \$188 million. Tourism and related services also continued to expand in 2018, with the number of visitors up by 9 percent year on year at end-October (Figure 9). More than a quarter of all tourists came from the European Union, about 20 percent from Russia, and 14 percent from the United States. However, this was offset by a decline in construction activities abroad and higher imports of transport services.

**The income surplus narrowed in 2018.**

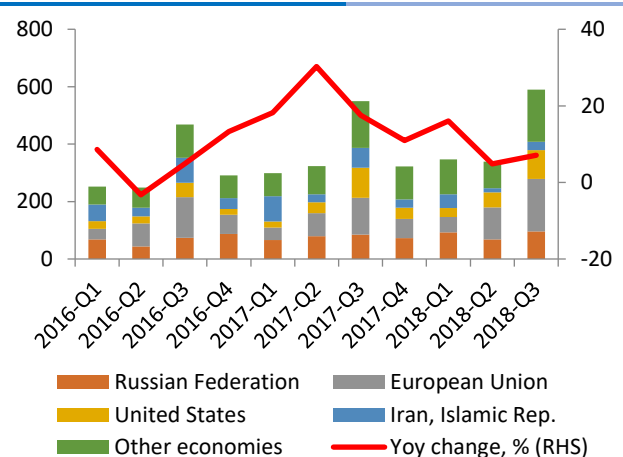
The main drivers of the reduction in the income surplus were reduced remittances, lower transfers to the government, and higher outflows of investment income. Although remittances rose strongly early in the year, a weakening of the Russian ruble resulted in a marked slowdown (in U.S. dollar terms) later in the year. Remittance inflows were flat in the second quarter (compared to the year-earlier period) and declined by 7 percent year on year in the third quarter. There are indications that the decline in remittances was stemmed towards the end of the year as the ruble regained some value. Official transfers also declined in 2018, reflecting a high base of comparison on account of a substantial transfer received in the second quarter of 2017. The deficit on the investment income sub-account widened further as a result of higher interest payments and reinvested earnings.

**Figure 8. Imports by commodity groups**  
(US\$ million)



Sources: NSS; World Bank staff calculations.

**Figure 9. Tourist arrivals, by economy**  
(‘000 persons) (Percent change)



Sources: CBA; World Bank staff calculations.

### Despite a substantial increase, net FDI inflows remain low.

Despite a year-on-year increase of 25 percent in the first nine months of 2018, foreign direct investment (FDI) amounted to only \$177 million or 2.1 percent of GDP (Figure 10). Most FDI continued to flow into the resource sectors. Mining accounted for more than half of total FDI inflows (which originated mainly Germany and Jersey<sup>4</sup>), while the energy sector attracted 10 percent (mostly from Russia). As identified in the previous CEU, key impediments to FDI in Armenia include regulatory obstacles, business environment, and local labor force quality. Political uncertainty may have also deterred foreign investment. On the positive side, reinvested earnings increased considerably in 2018, suggesting positive operating results from existing foreign investors. A lower deficit on the portfolio account, together with higher deposits, partially offset the reduction in loans and helped finance the widening currency account deficit.

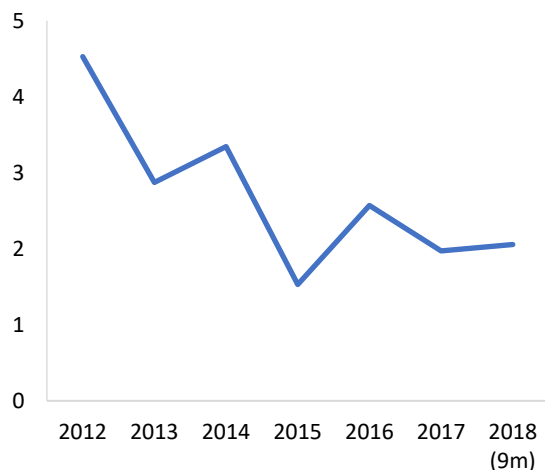
### International reserves saw a modest build-up in late-2018.

Foreign exchange reserves increased towards the end of 2018, and by end-December rose above \$2.2 billion (Figure 11). Still, due to considerably higher imports over the same period, import cover fell to 3.7 months (from about four months at the end of 2017).

<sup>4</sup> Jersey is an island located near the coast of Normandy, France. It is recognized as a leading offshore financial center.

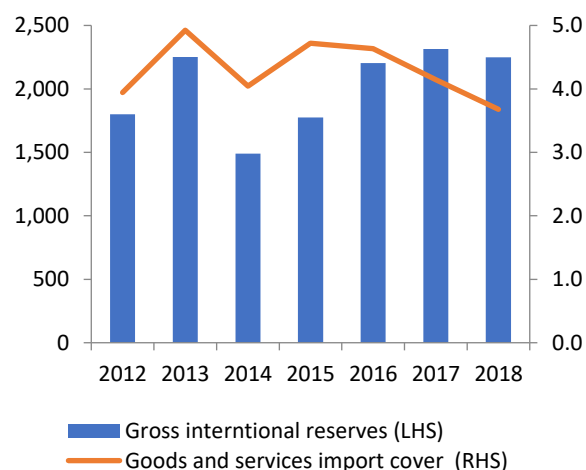


**Figure 10. Net foreign direct investment**  
(Percent of GDP)



Sources: CBA; World Bank staff calculations.

**Figure 11. Gross international reserves**  
(US\$ million) (Months of imports)



Sources: CBA; NSS; World Bank staff calculations.

## Fiscal Policy and Public Debt

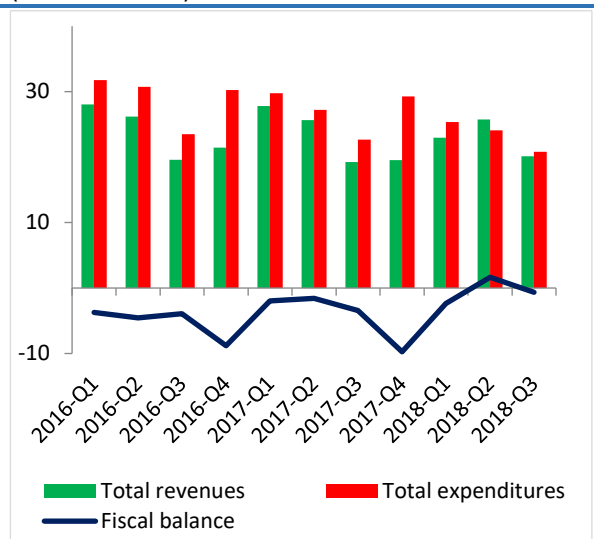
### The fiscal deficit was below target.

After registering a budget deficit of 4.8 percent of GDP in 2017 (one-third of it on account of purchase of military equipment toward the end of the year), the 2018 budget envisaged significant fiscal consolidation with a budget deficit target of 2.6 percent of GDP. However, by the end of November, the deficit stood at only 0.8 percent of estimated GDP (Figure 12). The main reason for the small deficit was a significant under-execution of capital expenditure. Despite accelerating slightly in the last quarter, capital spending fell by 36 percent year on year in 2018, largely due to slower disbursement of externally-financed project loans. Meanwhile, current spending rose by only 2.5 percent year on year, significantly below budgeted levels.

### Improved tax compliance boosted tax revenue in 2018.

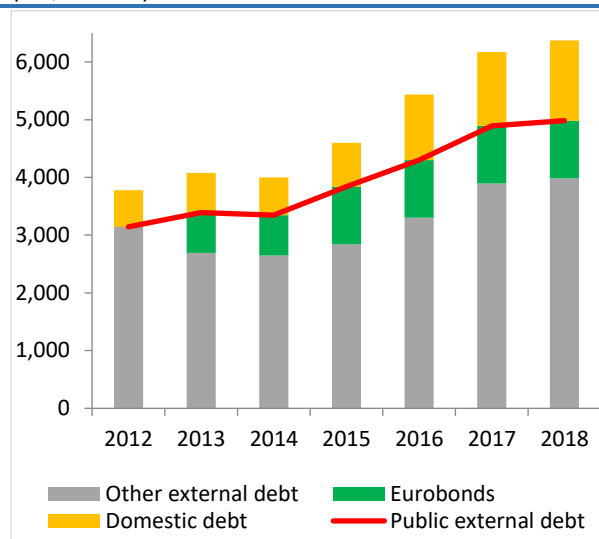
Total revenues reached AMD1,341 billion in 2018, a year-on-year increase of 8.4 percent, reflecting both improved economic activity and a stronger focus on tax compliance. Taxes in the amount of AMD1,258 billion were collected, a 8.6 percent increase compared to a year earlier. This figure probably underestimates the actual improvement in the collection due to the new methodology of administering Value Added Tax (VAT) refunds in 2018. Under this approach, only net VAT revenues (following tax return clearance) are reported to the budget. The authorities also accelerated VAT refunds in 2018 (AMD55 billion in the first three quarters). Profit tax receipts increased by 55 percent while excise tax collections rose by 32 percent.

**Figure 12. Fiscal developments**  
(Percent of GDP)



Sources: MoF; NSS; World Bank staff calculations.

**Figure 13. Public debt\***  
(US\$ million)



Sources: MoF; NSS; World Bank staff calculations.

\*/Excludes Central Bank debt.

**The public debt-to-GDP ratio declined for the first time since 2013.**

The lower budget deficit and slow disbursement on foreign-financed projects helped to stabilize the public debt at \$6.4 billion at the end of 2018 (Figure 13). Of this amount, \$1 billion is associated with two Eurobonds, one issued in 2013 (maturing in 2020, with \$500 million outstanding) and the second in 2015 (maturing in 2025, with \$500m outstanding). In November 2018, the Asian Development Bank (ADB) approved a \$50 million policy-based (budget support) loan as part of an ongoing program of reforms to strengthen public debt and fiscal risk management and develop financial markets in Armenia. The Government debt to GDP ratio is estimated to have fallen from 53.7 percent at end-2017 to about 51 percent of GDP at end-2018, the first decline since 2013.

**The authorities aim to gradually lower Armenia's debt-to-GDP ratio.**

The 2019 State Budget, adopted on December 27, 2018, envisages a fiscal deficit of 2.2 percent of GDP. The budget, which is in line with the revised fiscal rule and medium-term fiscal framework, should contain the government debt-to-GDP ratio to below 50 percent of GDP. The 2019 budget projects an increase in tax collection of 0.4 percentage point of GDP while total spending (as a share of GDP) remains relatively unchanged. Two-thirds of the deficit is to be financed by external sources. Mid-year changes to the budget are expected. Given rising external uncertainty and tightening capital markets, the authorities should ensure that any proposed changes to the budget are within the framework provided by the fiscal rule; this should help re-build buffers and strengthen the prospects for fiscal solvency.

## Social Sector and Labor Markets

### The unemployment rate fell in 2018 but remains high.

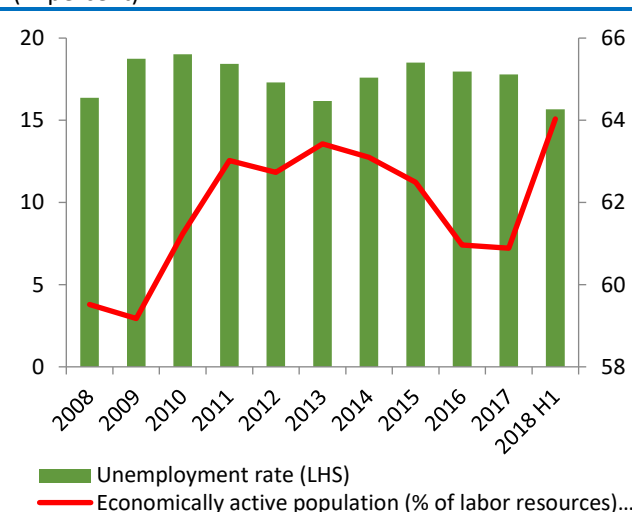
Labor market dynamism accompanied Armenia's stronger economic performance in 2018. After hovering at about 60 percent for two years, the share of the economically active population increased to 64 percent in the second quarter of 2018, the highest rate in a decade. At the same time, the share of the employed population rose to 54 percent at the end of the second quarter of 2018 compared to 50 percent one year earlier, and the unemployment rate fell from 17.8 percent in 2017 to 15.7 percent in the second quarter of 2018,<sup>5</sup> the lowest level since 2008 (Figure 14). However,

Armenia's unemployment rate remains among the highest in the region.

Furthermore, a significant share of the increase in employment is accounted for by people engaged in the production of goods for their own consumption (up by 50 percent) which account for 14 percent of the total employed population (compared to 11 percent in 2017).

Relatively stagnant real wages, which rose by only 1.4 percent in the first eleven months of 2018, also reflect these dynamics.

**Figure 14. Unemployment and labor force participation**  
(In percent)



Sources: NSS; World Bank staff calculations.

### The poverty rate fell in 2017 but was still high compared to peers.

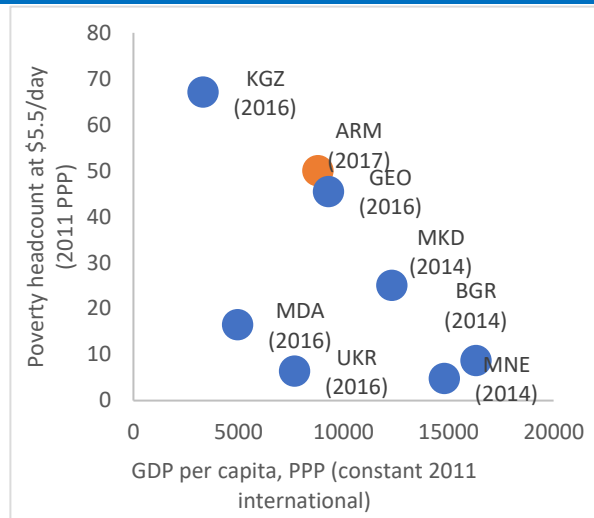
Although improved economic performance and dynamism in the labor market have helped to reduce the poverty rate, poverty continues to affect a substantial proportion of the population. In 2017 (the last year for which poverty data are available), 12.3 percent of the population lived below the lower-middle-income economy poverty line of US\$3.2/day and 50 percent lived below the upper-middle-income economy poverty line of US\$5.5/day.<sup>6</sup> Even though economies

<sup>5</sup> Armstat, Armenia's Statistics Office, revised its labor market statistics methodology in January 2018. The figures presented here use the old methodology, which allows for comparisons over time. Labor force statistics using the new methodology, which are available only since 2017, show the unemployment rate in the second quarter of 2018 at 20.2 percent.

<sup>6</sup> Both measures of poverty are based on the World Bank methodology for international comparisons and are expressed in 2011 purchasing power parity.

such as Ukraine and Moldova have a lower GDP per capita, their poverty rates are significantly below Armenia's (Figure 15).

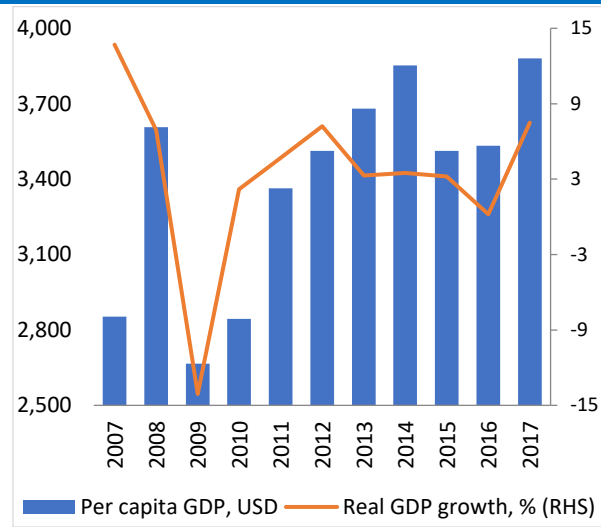
**Figure 15. Poverty rates in Europe and Central Asia (Percent)**



Source: World Development Indicators. Retrieved on December 7, 2018.

Note: The poverty headcount is estimated using upper-middle-income economy poverty line of \$5.5/day PPP 2011.

**Figure 16. Real GDP growth and per capita income (US\$) (In percent)**



Source: NSS.

### The national poverty rate returned to pre-2008 levels in 2017.

The poverty rate (measured using the national poverty line) declined by 3.7 percentage points in 2017, falling to 25.7 percent from 29.4 percent in 2016. This reduction was mostly due to developments in urban areas other than Yerevan, the capital. Urban and rural poverty rates in 2017 were 25 and 26.8 percent, respectively, down from 28.8 and 30.4 percent a year earlier. Among urban areas, the poverty rate was the lowest in Yerevan (at 22.4 percent in 2017). The extreme poverty rate (measured using the food line, approximately \$50 per month) was estimated at 1.4 percent in 2017, only slightly below the 1.6 percent rate registered in 2008. In 2017, economic growth translated into higher consumption levels for those at the bottom 40 percent of the distribution, in contrast to 2011–16 when growth mostly benefited the upper deciles.

## Monetary and Exchange Rate Policies

### The CBA loosened monetary conditions slightly in early 2019.

In late January 2019, the CBA lowered the policy rate by 25 basis points to 5.75 percent, its first cut since February 2017. Similarly, the rates for the deposit and Lombard loan monetary instruments were lowered to 4.25 percent and 7.25 percent, respectively. The reduction reflected the benign external inflationary environment as well as moderating domestic economic activity.

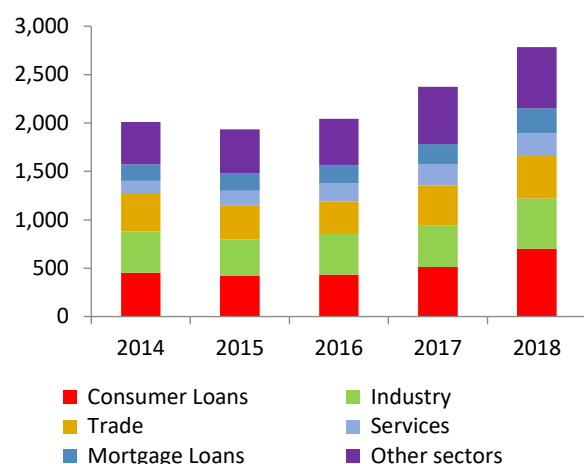
**Broad money growth decelerated in late 2018.**

Supported by a 16 percent increase in dram deposits to commercial banks, broad money expanded by 7.5 percent as of end-2018. Currency in circulation rose by 7.2 percent in 2018 while foreign currency deposits were flat (compared to growth rates of 5-7 percent in early 2018 and double-digit growth during most of 2017) which could signal growing confidence in the domestic currency.

**The loan portfolio of commercial banks grew rapidly.**

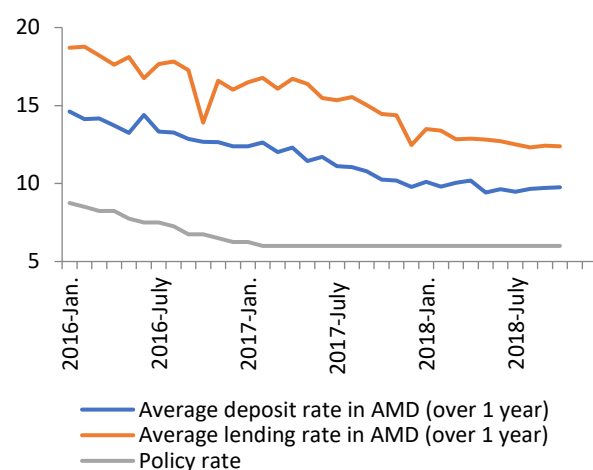
On the assets side, credit growth accelerated in the second half of the year and peaked at 20.5 percent year on year in October 2018, before decelerating to 16.5 percent by end-2018. As a result, credit reached 50 percent of GDP. One-third of the increase was due to the 34 percent increase in consumer loans, followed by an expansion of credit to the industrial sector (Figure 17). Lending to the construction sector rose rapidly in 2018 (by 12 percent), following a 40 percent increase in 2017. Dram-denominated lending grew significantly faster (by 34 percent year on year) than foreign-currency lending (by 5.7 percent).

**Figure 17. Total commercial banks lending to residents, by sector**  
(in billion AMD)



Source: CBA.

**Figure 18. Policy, deposit, and lending rates**  
(Percent)



Sources: CBA; World Bank Staff calculations.

**Interest rates declined modestly.**

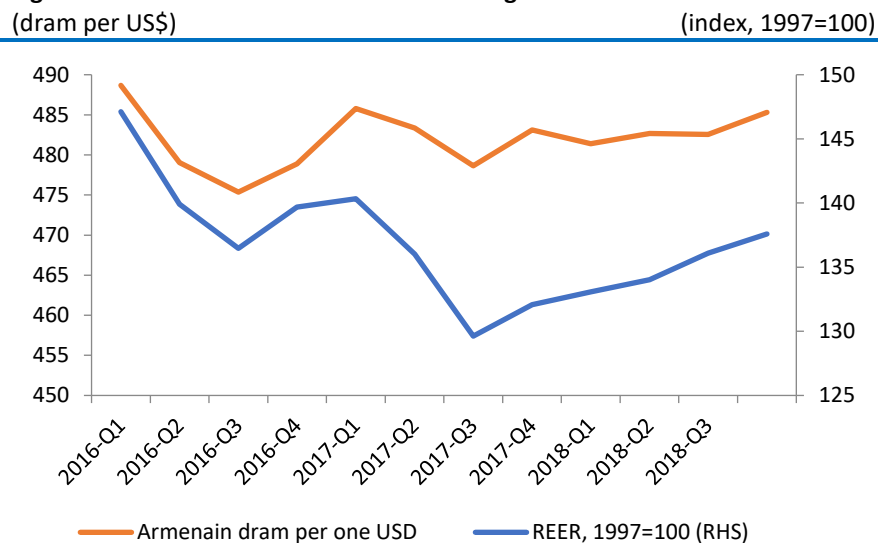
Reflecting more benign macroeconomic conditions and growing competition between banks, interest rates on dram-denominated deposits and loans declined in 2018 (Figure 18). The dram lending rates for more than one-year maturity reached 12.4 percent at end-October, 206 basis points lower than lending rates a year earlier. Changes in foreign currency interest rates were more muted, possibly due to rising U.S. interest rates.

**The exchange rate remained stable, reducing dollarization.**

The Armenian dram remained broadly stable during 2018, despite political developments in April-May and the turmoil later in the year that impacted the currencies of regional economies (notably Russia, the Islamic Republic of Iran and Turkey). The Russian ruble depreciated against the U.S. dollar by about 21 percent year on year in 2018, while the Armenian dram was almost stable in the same period, which led to a real appreciation during the year. The CBA continued to implement a flexible exchange rate policy, with interventions

limited to smoothing out large fluctuations. While the CBA remained a net-purchaser of foreign currency in 2018, the amounts purchased were below levels registered in 2017 (\$44 million net purchases in 2018 compared with \$100 million in 2017). The stable exchange rate and lowered depreciation expectations helped to reduce the dollarization of domestic credit from 62 percent in 2017 to 56 percent at end-2018. Similarly, by end-2018, dram-denominated deposits accounted for 52.8 percent of all deposits in the banking sector, up from 50.2 percent a year earlier.

**Figure 19. Nominal and real effective exchange rate**



Source: CBA.

## Financial Sector

### FSAP reports that Armenia's financial system is stable.

Armenia completed its Financial System Assessment Program (FSAP),<sup>7</sup> jointly with the IMF and the World Bank, in December 2018. According to the report, Armenia's banking sector weathered the 2014 economic slowdown, and financial soundness indicators show signs of improvement. Bank profitability has gradually recovered, although it remains below pre-crisis levels. However, the report highlighted significant risks stemming from a high degree of financial dollarization, including credit risks and limited liquidity cushions in foreign currency in the event of external shocks. Non-performing loans (NPLs), particularly on foreign currency loans could rapidly deteriorate in case of more significant depreciation pressures.

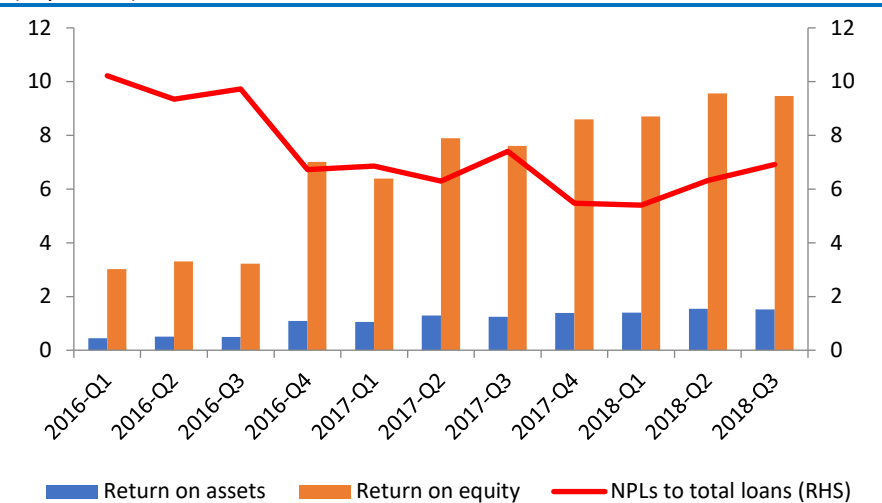
### Capital adequacy levels are healthy, but NPLs must be monitored.

At 17.4 percent at end-November, the capital adequacy ratio stood well above the 12 percent minimum required threshold. The NPL ratio increased to 7.1 percent in October but retreated to 6.9 percent in the following month. While NPLs remain below levels registered after the 2014 economic downturn and a

<sup>7</sup> The Financial Sector Assessment Program (FSAP), established in 1999, is a comprehensive and in-depth assessment of a country's financial sector. The previous report for Armenia was conducted in 2012.

substantial proportion of NPLs is covered by provisions, the recent uptick during a period of high credit growth should be closely monitored (Figure 20). While the sector is profitable overall, profitability levels remain low with return on assets at just 1.5 percent in September.

**Figure 20. Commercial banks' profitability and NPLs**  
(In percent)



Sources: CBA; World Bank staff calculations.

**The expansion of the pension reform to the private sector could drive capital market development.**

Capital markets in Armenia are thin and mostly limited to government bonds and a shallow security exchange market. As of September 2018, 74 securities of 23 issuers were listed in NASDAQ OMX Armenia, including 10 stocks of 10 issuers and 64 bonds of 16 issuers.<sup>8</sup> The government's decision to roll-out the pension reform to include the private sector in July 2018 represents an important step towards capital markets development. As of end-November, the total assets of the pension funds managed by two asset managers (Agricole and C-Quadrat Ampega) reached AMD 152 billion (about \$315 million). Out of total assets, 44 percent were invested domestically in deposits in commercial banks and corporate, mortgage, and international institutions bonds, 30 percent in government bonds and the rest (26 percent) in non-resident banks and investment funds securities. The number of pension fund contributors rose sharply in the second half of 2018, from 200,000 in June to 321,000 at end-November, including 72,000 from the public sector and 249,000 from the private sector.

<sup>8</sup> Three of the issuers have both stock and bond.

## B. Structural Reform Agenda

**A system-wide adjustment is needed to promote competition.**

Investigations and court cases have been opened against officials from the previous administration, and the authorities have announced the recovery of substantial funds from under-reported taxes. While addressing deficiencies in Armenia's tax and customs administration is likely to help in promoting competition, the country's challenges in this area are more profound and will require efforts to open up markets, advance a level playing field, and effectively enforce the Economic Competition Protection law.

**Proposed tax code amendments seek to streamline policy and reduce the tax burden on businesses.**

A recent key reform is the amendment of the Tax Code. The changes are expected to shift the burden of taxation from direct to indirect taxes while streamlining and simplifying Armenia's tax system. The amendments will reduce the number of tax regimes from five to three (regular regime, turnover tax regime, and micro-entrepreneurs) by abolishing the patent fee regime and combining the taxation regime for self-employed and family-entrepreneurs. Also, the draft proposes changes in the tax rates, including lowering the profit tax rates from 20 percent to 18 percent and introducing a flat personal income tax rate of 23 percent at an estimated fiscal cost of about 0.4 percent of GDP. To support microbusinesses, micro-entrepreneurs with an annual turnover of up to AMD 24 million will be exempt from taxation. The amendments also envisage that the threshold for VAT taxation will be preserved at AMD 115 million (relatively high by international comparison). The resulting revenue loss will be offset by higher tax rates on tobacco products and alcoholic beverages; excise taxes on sugary drinks may also be introduced. Furthermore, from 2020 gambling games organizers will be taxed under the general taxation regime. The Ministry of Finance expects that the proposed amendments will have an overall revenue neutral impact.

**The new government has announced an ambitious agenda of public sector reform.**

Reforming Armenia's public sector is critical to improving government effectiveness and controlling corruption. Neighboring Georgia shows that rapid progress is possible. Armenia's new government aims to reform the public sector by reducing the number of ministries and consolidating functions as well as amending civil servant compensation.

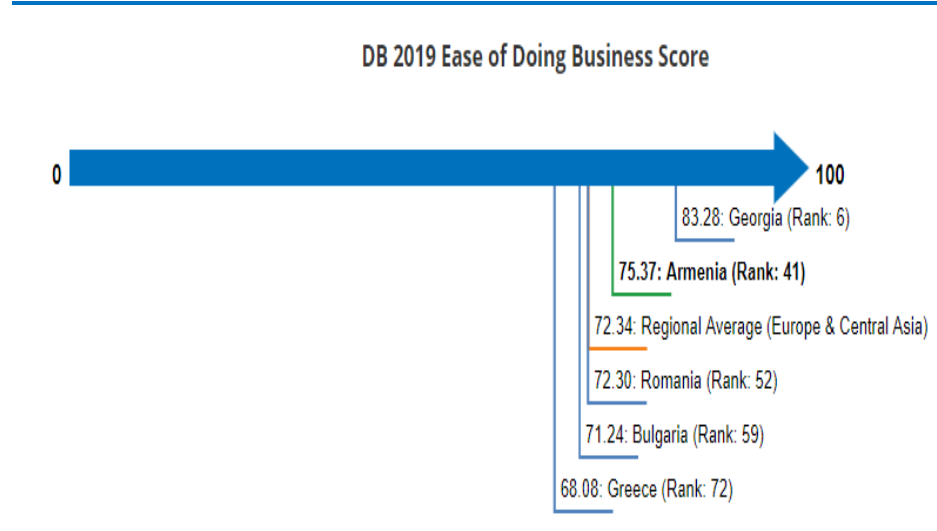
**Armenia rose six positions in the 2019 Doing Business ranking, to 41, its highest position ever.**

In 2017/18, Armenia implemented five key reforms that improved the business regulatory framework. These included: (i) making starting a business easier by allowing voluntary VAT registration at the time of business incorporation; (ii) making getting electricity faster by imposing new deadlines for procedures to obtain a new electrical connection; (iii) strengthening minority investor protections by increasing disclosure of related-party transactions, clarifying ownership and control structures and requiring greater corporate transparency; (iv) making paying taxes easier by introducing administrative measures to ease compliance with corporate income tax, VAT, and labor tax rules; and (v) making enforcing contracts easier by introducing a simplified procedure for small claims and time standards for key court events. The results were positive, with Armenia climbing six positions in the 2019 Doing Business rankings compared to the year before (Figure 21). Additional action is needed



to address cumbersome processes, including dealing with construction permits, paying taxes, and resolving insolvency.

**Figure 21. Ease of doing business score, Armenia and selected peers**  
(on a scale from 0 to 100, 100 is best performing economy)



Source: Doing Business 2019, World Bank.

## C. Economic Outlook and Risks

### Slowing growth and heightened risks are clouding global and regional economic prospects.

International trade and investment have softened, trade tensions have intensified, and some economies are experiencing substantial pressures. Against this less favorable backdrop, global growth is expected to moderate but remain positive. Economic growth in the Europe and Central Asia region is expected to slide to 2.3 percent in 2019, from an estimated 3.1 percent in 2018, and recover to 2.7 percent in 2020.<sup>9</sup> Among Armenia's main trading partners, the outlook is mixed. While output growth in the European Union and Russia is expected to decelerate only slightly, in the Islamic Republic of Iran it is forecast to turn sharply negative. This outlook envisages an orderly tightening of global financial conditions, oil prices averaging \$67 in 2019-21, a gradual slowdown in the Euro Area, and the easing of heightened geopolitical tensions.

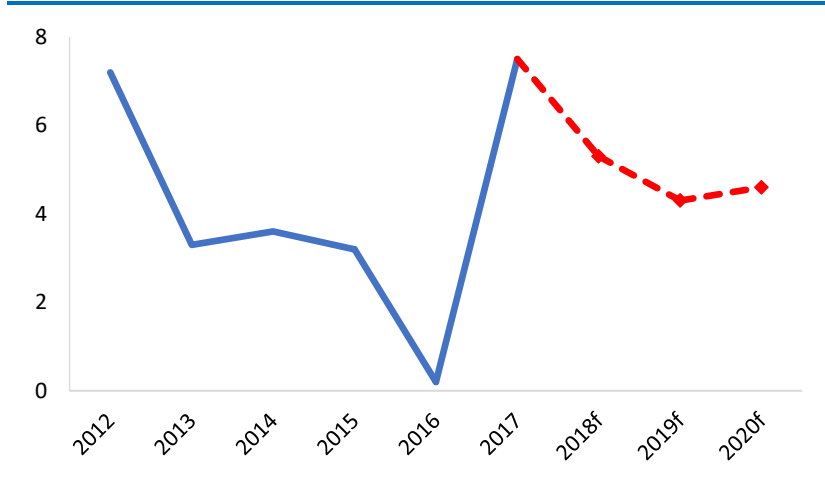
### After moderating further in 2019, GDP growth is expected to begin to recover.

Under the baseline scenario, real GDP growth will slow further in 2019, to 4.3, percent. Growth will be supported domestically by a slightly higher fiscal deficit, strong credit growth from a healthy financial sector, more open markets, and improved business and consumer confidence. Externally, lower but still positive growth in Russia will support remittance inflows, tourism earnings, and goods exports. As the impact of expected reforms takes hold, GDP growth will gradually accelerate over the medium term (Table 1). With growth moderating in 2019, and with envisioned macroeconomic policies, the

<sup>9</sup> A World Bank Group Flagship Report "Global Economic Prospects" January 2019.

inflation rate is expected to remain within the CBA target range (4 percent +/- 1.5 percent).

**Figure 22. Medium-term growth projection, baseline**  
(Percent)



Sources: NSS; World Bank staff projections.

**The current account deficit is forecast to remain wide.**

The current account deficit is estimated to have widened to 8.1 percent of GDP at end-2018, more than double our projection of 3.8 percent of GDP. The deficit will widen further in 2019 and start to narrow only in 2020 and beyond, subject to structural reforms that would yield improved prospects for exports of goods and tourism.

**The fiscal deficit will remain modest, reducing debt levels.**

Fiscal policy, anchored by the fiscal rule, will remain prudent. The 2019 Budget targets a deficit of 2.2 percent of GDP, a slight widening compared to the actual shortfall in 2018 (estimated at 1.9 percent of GDP). Assuming that the fiscal deficit falls to 2 percent of GDP in 2020, the government debt-to-GDP ratio will ease to about 50 percent of GDP. Efforts to improve tax collection should help reverse the declining revenue-to-GDP ratio and create fiscal space for higher capital spending. Stronger government investment—together with the reactivation of several foreign-financed projects that stalled in 2018—will help push associated reforms and promote economic growth.

**Downside risks to the outlook are significant**

Downside risks have increased markedly. Externally, regional currencies could come under renewed pressure, and the tightening of trade restrictions remains possible. The risk of a further escalation of geopolitical tensions also remains high. The realization of these risks could dampen economic prospects in Armenia's main trading partners and reduce metal prices, which would put Armenia's external accounts under pressures and curtail domestic economic growth prospects.

Domestically, reforming Armenia's economy will require bold efforts in many areas which could face opposition due to vested interests or perceived high costs. However, without such bold reforms, tangible results in creating job

opportunities, increasing wages, better addressing social issues and improving the business environment to be able to attract investment, are unlikely. Failure to produce these results could reignite social and political tensions, increasing economic uncertainty.

**Table 1. Baseline scenario: selected macro-fiscal indicators**  
(In percent, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020
Real GDP growth	3.2	0.2	7.5	5.5	4.3	4.6
Consumer price inflation, period average	3.7	-1.4	1.0	2.9	4.0	4.0
Current account balance (percent of GDP)	-2.6	-2.3	-2.4	-8.1	-8.6	-8.0
Overall fiscal deficit (percent of GDP)	-4.8	-5.5	-4.8	-1.9	-2.2	-2.0
Public debt (percent of GDP)*	48.7	56.6	58.9	55.6	56.3	56.0
Government debt (percent of GDP)	44.1	51.9	53.7	50.8	51.1	50.5

Source: World Bank staff calculations based on data published by NSS, CBA, and GEP.

Note: Sums may not add exactly due to rounding.

\*/ Includes government and CBA debt

## Annex 1: Tables

**Table A 1. Selected Macroeconomic and Social Indicators, 2013-20**

	2013	2014	2015	2016	2017	2018	2019	2020
						Est.	Proj.	
(Percent, unless otherwise indicated)								
<b>National Income and Prices</b>								
Nominal GDP (LCU bn)	4,556	4,829	5,044	5,067	5,569	6,065	6,493	7,040
Real GDP growth	3.3	3.6	3.2	0.2	7.5	5.5	4.3	4.6
Private consumption growth	0.9	1.0	-7.8	-1.0	9.4	5.4	6.0	4.9
Gross investment growth	-7.0	-2.2	2.5	-11.4	7.7	10.1	13.4	12.8
Exports of goods & services growth	8.6	6.4	4.9	19.1	18.7	7.2	8.8	9.4
Imports of goods & services growth	-2.1	-1.0	-15.1	7.6	24.6	15.5	12.2	11.4
Gross investment (percent of GDP)	22.3	20.9	20.6	18.2	18.3	19.1	20.7	22.4
Consumer price inflation, year-end	5.6	4.6	-0.1	-1.1	2.6	1.8	4.0	4.0
Consumer price inflation, pa	5.8	3.0	3.7	-1.4	1.0	2.5	4.0	4.0
(Current US\$ millions, unless otherwise indicated)								
<b>External Accounts</b>								
Key commodity exports	1,215	1,257	1,224	1,447	1,791	...	...	...
Metals and minerals	716	688	705	693	970	...	...	...
Prepared food products	310	338	325	417	531	...	...	...
Precious stones and metals	188	230	194	337	290	...	...	...
Merchandise imports	3,832	3,754	2,810	2,835	3,761	4,556	4,909	5,260
Current-account balance	-813	-883	-272	-238	-280	-	-	1,120
as percent of GDP	-7.3	-7.6	-2.6	-2.3	-2.4	-8.1	-8.6	-8.0
Foreign direct investment, net	320	388	162	272	228	287	340	403
Total official international reserves	2,252	1,489	1,775	2,204	2,314	2,249	1,953	2,250
Public external debt, total	3,899	3,785	4,316	4,806	5,495	5,576	5,671	5,905
as percent of GDP	35.1	32.6	40.9	45.6	47.6	44.1	43.6	42.5
(Percent of GDP, unless otherwise indicated)								
<b>Consolidated Fiscal Accounts</b>								
Revenues	24.2	24.4	23.8	23.8	22.9	23.8	24.3	25.2
Expenditures	25.7	26.3	28.6	29.3	27.7	25.4	26.5	27.2
Overall fiscal balance	-1.5	-1.9	-4.8	-5.5	-4.8	-1.9	-2.2	-2.0
Primary fiscal balance	-0.5	-0.6	-3.3	-3.6	-2.6	0.1	0.2	0.0
Public debt and fiscal savings, net	40.9	43.7	48.7	56.6	58.9	55.6	56.3	56.0
(Percent, unless otherwise indicated)								
<b>Monetary Accounts</b>								
Base money growth	6.9	-8.9	4.6	18.0	20.3	...	...	...
Real growth of credit to the private sector	6.1	16.3	-3.0	16.2	7.4	...	...	...
Policy rate (eop)	7.75	8.50	8.75	6.25	6.00	6.00	...	...
(Percent, unless otherwise indicated)								
<b>Social Indicators</b>								
Population, total (millions)	3.017	3.011	2.999	2.986	2.973	2.973	2.974	2.975
Population growth (percent)	-0.32	-0.22	-0.40	-0.42	-0.44	0.02	0.02	0.02
Unemployment rate (percent of labor force)	16.2	17.6	18.5	18.0	17.8	...	...	...
Poverty rate, national (percent of population)	32.0	30.0	29.8	29.4	25.7	...	...	...
International poverty rate (US\$1.9/day 2011 PPP, percent of population)	2.2	2.3	1.9	1.8	1.4	1.3	1.0	0.8

	2013	2014	2015	2016	2017	2018	2019	2020
						Est.	Proj.	
Lower-middle-income poverty rate (US\$3.2 /day 2011 PPP, percent of population)	16.2	16.4	13.5	14.1	12.3	10.1	9.1	8.1
Inequality – Gini coefficient 1/	0.271	0.277	0.279	0.286	0.289	...	...	...
Life expectancy (years)	74.8	75.0	75.0	75.0	75.4	...	...	...

Sources: World Bank staff calculations and estimates based on official data published and provided by the authorities.

1/ The Gini Coefficient is based on consumption.

**Table A 2. Balance of Payments and Official Reserves, 2014–17**

(US\$ millions)

	2014	2015	2016	2017
<b>Current account balance</b>	<b>-882.9</b>	<b>-272.4</b>	<b>-238.1</b>	<b>-279.7</b>
Merchandise trade	-2,055.4	-1,186.4	-944.4	-1,375.4
Exports f.o.b.	1,698.1	1,623.9	1,890.7	2,385.2
Metals and minerals	688.3	704.8	693.4	969.8
Products of prepared food	338.1	325.3	416.6	531.3
Precious stones and metals	230.3	194.0	336.9	289.6
Imports f.o.b.	3,753.6	2,810.3	2,835.1	3,760.7
Services	-113.5	-95.4	-71.4	-27.9
Primary income	541.1	442.9	224.2	463.3
Secondary income	744.9	566.5	553.4	660.3
<b>Capital and financial account balance</b>	<b>259.7</b>	<b>754.7</b>	<b>921.1</b>	<b>809.8</b>
Foreign direct investment	387.9	161.5	271.9	227.5
Portfolio investment	- 38.4	235.0	33.9	86.8
Other investment	- 160.2	292.9	580.4	449.2
Capital transfers	70.4	65.3	34.9	46.3
<b>Errors and omissions</b>	<b>-36.5</b>	<b>-149.3</b>	<b>-228.3</b>	<b>-306.7</b>
<b>Overall external balance</b>	<b>-659.6</b>	<b>332.9</b>	<b>454.6</b>	<b>49.8</b>
Change in FX reserves at Central Bank	659.6	-332.9	-454.6	-49.8
<i>Memorandum items:</i>				
Official reserves, eop	1,489.3	1,775.3	2,204.1	2,314.1
SDR holdings	6.2	2.9	3.5	7.2
Foreign exchange	1,483.2	1,772.4	2,200.6	2,306.9
GDP	11,610	10,553	10,546	11,537
Consumption	11,335	9,624	9,571	10,564
Gross capital formation	2,423	2,188	1,900	2,195
Exports of goods and services	3,316	3,137	3,496	4,305
Imports of goods and services	5,462	4,418	4,511	5,716

Source: World Bank staff calculations based on data published by CBA and NSS.

Note: Sums may not add exactly due to rounding.

**Table A 3. Consolidated Fiscal Accounts, 2014–17**  
(Percent of GDP)

	2014	2015	2016	2017
<b>Revenue and grants</b>	<b>24.4</b>	<b>23.8</b>	<b>23.8</b>	<b>22.9</b>
Tax revenue, of which	22.5	21.6	21.8	21.3
VAT	9.1	8.4	7.7	7.3
Profit tax	2.1	2.1	2.5	1.9
Income tax	6.0	6.2	6.6	6.1
Excise tax	1.0	1.0	1.2	1.5
Non-tax revenue	1.5	1.6	1.4	1.4
Capital revenue				
Grants	0.4	0.6	0.6	0.2
<b>Expenditure and net lending</b>	<b>26.3</b>	<b>28.6</b>	<b>29.3</b>	<b>27.7</b>
General government expenditures	<b>26.3</b>	<b>28.6</b>	<b>29.3</b>	<b>27.7</b>
Current expenses	23.4	25.3	26.2	23.4
Capital expenses and net lending	2.9	3.3	3.1	4.3
<b>Overall fiscal deficit</b>	<b>-1.9</b>	<b>-4.8</b>	<b>-5.5</b>	<b>-4.8</b>
Primary fiscal deficit	-0.6	-3.3	-3.5	-2.6
Deficit financing	1.9	4.8	5.5	4.8
Domestic borrowing, net	1.5	0.2	2.1	1.2
Foreign borrowing, net	0.4	4.6	3.4	3.5
Privatization				

Source: World Bank staff calculations based on data published by NSS and MoF.

Note: Sums may not add exactly due to rounding.

**Armenia**  
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