Armenia:
Looking for More Dynamism



THE WORLD BANK

Armenia Economic Report No.5
Spring 2014

Armenia:
Looking for More Dynamism

Armenia Economic Report No.5
Spring 2014

THE WORLD BANK
Washington, D.C.

Government Fiscal Year:	January 1–December 31
Currency Equivalents:	Exchange rate effective as of March 11, 2014
	Currency Unit = AMD
	USD 1.00 = 414
Weights and Measures:	Metric System

Abbreviations

ADS	Armenia Development Strategy
AMD	Armenian Dram
CAD	Current Account Deficit
CBA	Central Bank of Armenia
CPI	Consumer Price Index
DB	Doing Business
DCFTA	Deep and Comprehensive Free Trade Agreement
ECU	Eurasian Customs Union
EU	European Union
FDI	Foreign Direct Investment
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
IMF	International Monitory Fund
MTEF	Medium-Term Expenditure Framework
NSS	National Statistics Service
OSCE	Organization for Security and Co-operation in Europe
TFP	Total Factor Productivity
WTO	World Trade Organization
VAT	Value Added Tax

Cover photo credits by Ulrich Bartsch (clockwise): the Geghard Monastery, Northern Avenue (Yerevan), Kechut Reservoir.

Contents

List of Figures

List of Tables

Acknowledgments

This issue of the *Armenia Economic Report* was prepared by the World Bank economic team working on Armenia—Ulrich Bartsch (Senior Country Economist), Gohar Gyulumyan (Senior Economist), and Tigran Kostanyan (Economist). The team appreciates valuable inputs from Edgar Karapetyan, Nvard Manasian, Armenia poverty team, and Megumi Kubota on regulatory reform, political developments, simulations of poverty impact of utility tariff increase, and assumptions about short-term global macroeconomic risks.

Authors are grateful to Ivailo V. Izvorski (Sector Manager) and Rashmi Shankar (Lead Economist for South Caucasus and PREM Sector Leader) for guidance and useful comments.

Overview

A decline in construction contributed to a significant weakening of economic growth in Armenia in 2013. Overall GDP growth was 3.5 percent in 2013 down from 7.2 percent in 2012. Construction sector value-added declined by 11.2 percent in 2013, partly because of delays in the implementation of the North-South transport corridor. The decline of the construction sector offset a dynamic expansion of industry, agriculture and services. Inflation spiked up to 9.2 percent in August 2013 in the wake of energy price increases, but the 12-month inflation rate declined to 5.6 percent in December 2013 because of lower food prices. It still exceeded slightly the upper bound of the Central Bank of Armenia's inflation target band of 2.5–5.5 percent.

The volume of merchandise exports rose by 7.2 percent, and net remittances exceeded $1.5 billion, a 15-percent increase over 2012. Most of the higher remittances came from Russia despite the slowdown in economic growth in that country. After the successful issue of Eurobonds, the Armenian government repaid its outstanding debt to Russia, thus alleviating medium-term pressures on its external and fiscal accounts.

For a third year in a row, the execution of public capital spending was lower than budgeted. Tax revenues were in line with the budget because of improved tax administration, policy measures that expanded the tax base, and a one-off license fee paid by the fourth mobile phone operator.

Given the expected uptick in the global economy in 2014, we project growth to recover to 5 percent per year over the medium term led by manufacturing on the supply side and fixed investment on the demand side. However, to achieve higher growth of 6–8 percent a year in line with the goal set out in the Armenia Development Strategy (ADS), the government needs to accelerate productivity-enhancing structural reforms.

Armenia needs to further improve the business environment and competitiveness, and facilitate FDI and exports to create well-paying jobs. The recent World Bank report "Back to Work: Growing with Jobs in Europe and Central Asia" highlights the importance of young, exporting firms for job creation. It shows that the bulk of new jobs in most countries are created by a small group of fast-growing companies. Foreign firms and firms that are connected to global supply chains are likely to be among these fast-growing firms. Therefore jobs will be created as a result of fostering entrepreneurship and of the entry of new firms into the market.

Some employees objected to the introduction of the new, funded pension system, and opposition parties appealed against some legal provisions in court. The Constitutional Court temporarily suspended some provisions of the law on pensions. Opposition parties also proposed establishing an *ad hoc* commission to investigate the recent gas agreement with Russia, and discussions with the ruling party are ongoing.

The government's medium-term reform agenda—supported by the ongoing Development Policy Operation supported by the World Bank—reflects these priorities. It includes critical reforms to the business climate and public administration aimed at strengthening competitiveness and increasing public sector efficiency. These reforms are expected to create jobs by reducing the costs of doing business for firms, expanding access to credit to SMEs, and increasing opportunities for employment and job creation through increased trade and connectivity. The public administration reforms, which aim to strengthen resource management and policy formulation, will also facilitate more inclusive access to services as a result of more efficient use of resources and a sounder policy formulation framework. The government plans to call a Consultative Group Meeting to seek donors' support for upgrading the country's competitiveness and addressing the country's job creation agenda.

This page is intentionally blank.

A. Recent Political Developments

The Constitutional Court suspended some provisions of the law on the new, funded pension system pending a detailed inquiry into the constitutionality of eight articles of the law. The new system requires that monthly contributions equal to 10 percent of employees' gross salaries should be made to individual pension accounts, equally split between the employees and the state budget for salaries up to a certain level.[1] The contributions from the state budget, however, are capped at about $60 per month to limit subsidies to better-paid employees and to protect the budget. High earners, such as employees of IT companies and in the financial sector, will therefore be required to contribute more than 5 percent of their salaries to their pension funds under the new law. They have reacted by arguing the legislation to be revised and have organized protests and strikes against the law. A legal challenge has been mounted by the opposition parties, and, following the temporary suspension of some provisions, a court ruling is expected by the end of March 2014.

The parliamentary majority voted down a proposal by opposition parties to set up an *ad hoc* commission to investigate the recent gas agreement with Russia. The proposal was put forward by four parliamentary fractions—Prosperous Armenia, Dashnaktsutyun, Armenian National Congress, and Heritage. The shares were sold for $155 million and the sales proceeds transferred to Gazprom as partial repayment of a $300 million debt accumulated over a period between 2011 and 2013 when gas tariffs were not adjusted for increases in the import price of gas. The remainder of the debt was written off by the Russians. An agreement to sell the government's remaining 20 percent share in the ArmRosGazProm (ARGP) to Gazprom (Russia) was concluded on January 16, 2014. On February 17th the ruling party came up with its own proposal on the commission, but the opposition has not yet come up with its conclusion.

The government plans to call a Consultative Group Meeting to seek donors' support to upgrade the country's competitiveness and address the country's job creation agenda. The conference will take place in June 2014 in Yerevan. It will be hosted by the Government of Armenia and will be co-organized by the Ministry of Finance of the Russian Federation, the World Bank Group, and the Asian Development Bank. The key objective of the conference is to reach a common understanding of the challenges facing Armenia in the aftermath of the recent economic crisis, the government's strategic priorities and the reform agenda, the regional integration challenges and priorities, and the country's fiscal context, financing challenges, and need for external support.

In December 2013 the President signed a roadmap to guide Armenia joining the Russia-led Eurasia Customs Union. In January, 2014 the government approved a timetable of measures to be implemented as part of Armenia's process of joining the trade bloc. The roadmap was approved by the Government of Armenia and published on its website. The document lays out 262 steps, of which 150 should be accomplished before Armenia officially joins the ECU.

1 For salaries up to AMD500,000 per month, the contributions made by an employee and the state budget are equal—5 percent each. However, for higher salaries, the share contributed by an employee increases. For example, for a monthly salary of AMD1 million, the employee's contribution would be 7.5 percent, and for AMD1.5 million, it would be 8.3 percent.

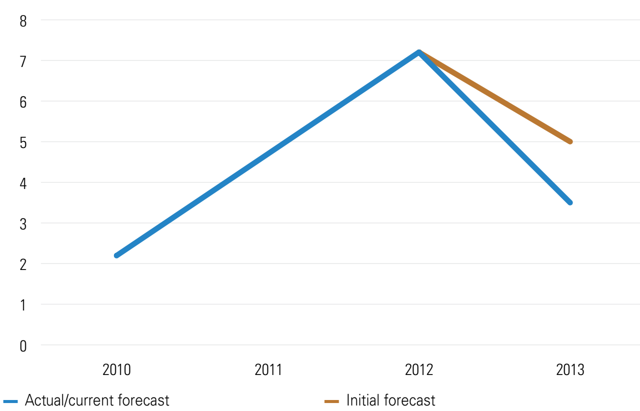
B. Recent Economic Developments

Economic Growth and Domestic Demand

Weaker construction activity slowed GDP growth significantly in 2013. GDP expanded by 5.2 percent in the fourth quarter of 2013 (year-on-year), as compared to 6.2 percent for the same quarter of 2012. Growth for 2013 a whole was 3.5 percent. Agriculture and manufacturing both demonstrated robust growth rates. Value-added in the mining sector increased by 4.9 percent in 2013 despite a 14 percent decline in copper prices. However, due to its small share in GDP, mining contributed only 0.1 percentage points to real GDP growth. In the services

Figure 1. Growth will be lower than forecast…

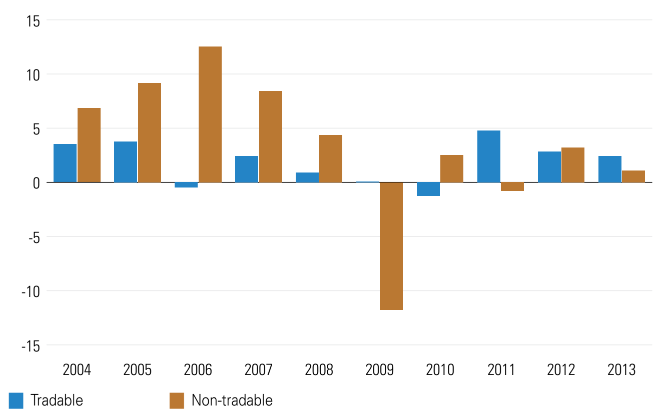
real GDP growth, percent



Source: National Statistics Service (NSS) and Bank staff calculations.

Figure 2. …though the role of the tradable sector has increased driven by agriculture and manufacturing

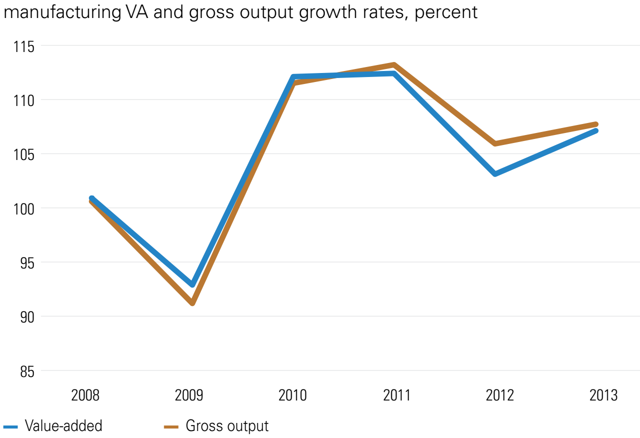
contribution of tradable and non-tradable sector to growth, percentage points



Source: NSS data and Bank staff calculations.

Figure 3. …manufacturing will become more productive as the growth rates of value-added and gross output converge

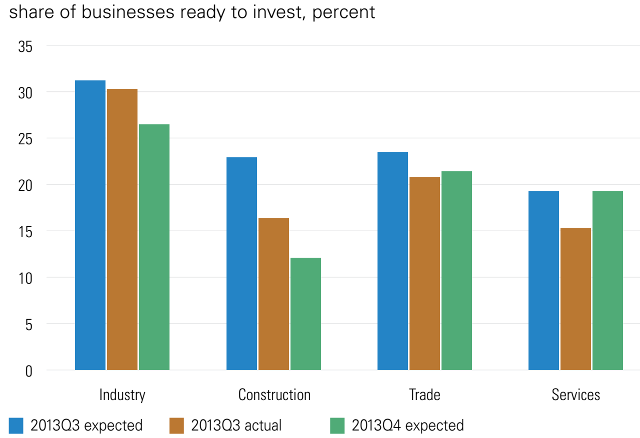
manufacturing VA and gross output growth rates, percent



Source: NSS and IMF data and Bank staff calculations.

Figure 4. …but construction is likely to remain a hurdle to growth

share of businesses ready to invest, percent



Source: Central Bank (CBA).

sector, the highest contributors to growth were financial sector, telecommunications, and real estate. However, construction declined by 11.2 percent and curtailed the growth by 1.4 percentage points.

The contribution of agriculture and manufacturing to growth increased in 2013. The recovery of agriculture and, to a lesser extent, manufacturing pushed up the contribution of the tradable sector to 68 percent in 2013.[2] Growth in manufacturing output was converging with the growth in manufacturing value-added during 2013. Growth in manufacturing value-added reached 7.1 percent for 2013 as a whole, while the growth in manufacturing output (including intermediate consumption) was 7.7 percent. The difference in the growth rates of manufacturing value-added and gross output was as big as 2.8 percentage points in 2012.

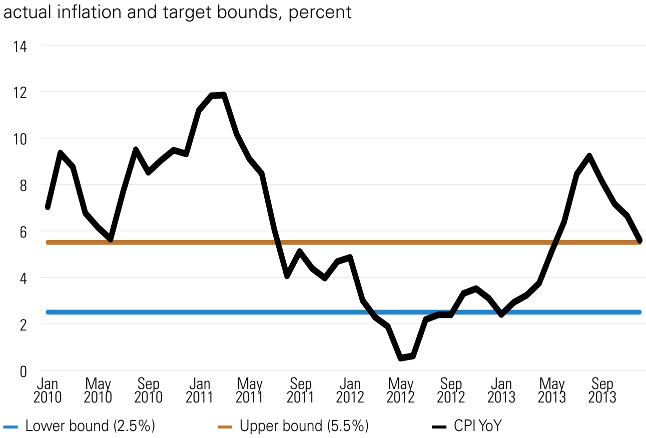
Consumption and investment both remained subdued. Despite high growth in consumer lending and remittances, private consumption grew by only 1.9 percent in January to September (year-on-year), reaching 93.3 percent of GDP. At the same time, private fixed investment in the third quarter was lower than expected. Central Bank of Armenia (CBA) surveys have shown that high expectations for investments in the third quarter did not materialize as actual investments were lower than expected for all of the sectors surveyed. Most importantly, construction most probably contracted further in the fourth quarter of 2013, as very few businesses surveyed intended to invest in construction.

Inflation

Inflation returned close to the target range after the upsurge in August, mainly aided by lower food prices. Twelve-month inflation slowed to 5.6 percent by December, just about the central bank's 2.5–5.5 percent target range. An increase in utility tariffs (gas and electricity) on July 1, 2013 pushed up the contribution of services to CPI inflation to 3.1 percentage points in the second half of the year from less than 1 percentage point in the first half. Monetary policy managed to contain second-round inflationary effects as the contribution of non-food items declined to 0.5 to 0.6 percentage points in the last quarter, down from the 0.9 percentage

Figure 5. Inflation is back to the target range after the surge in the summer

actual inflation and target bounds, percent



Source: NSS.

Figure 6. Core inflation remains low, indicating that second-round effects have not materialized

actual and core inflation, percent

Source: NSS, CBA.

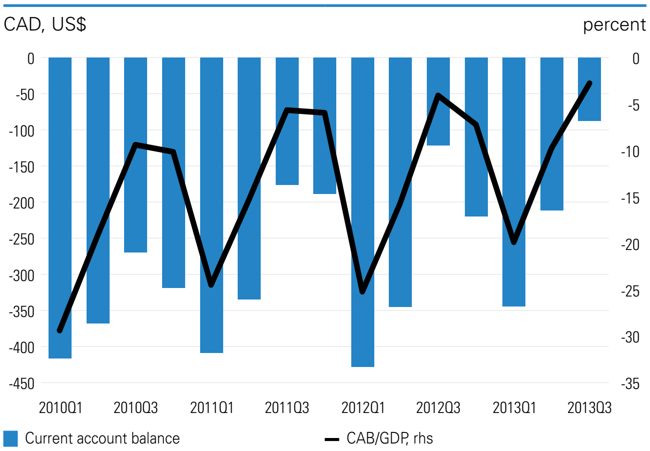
2 For the analysis in this section, tradable branches comprise industry and agriculture and the non-tradable branches comprise construction and services.

points registered in the first quarter. Core inflation, excluding prices for food and fuel, remained below headline inflation in the second half of the year. In the absence of major price shocks, inflation will return to the target by mid-2014 when the effects of the utility tariff adjustment will have been absorbed.

External Accounts

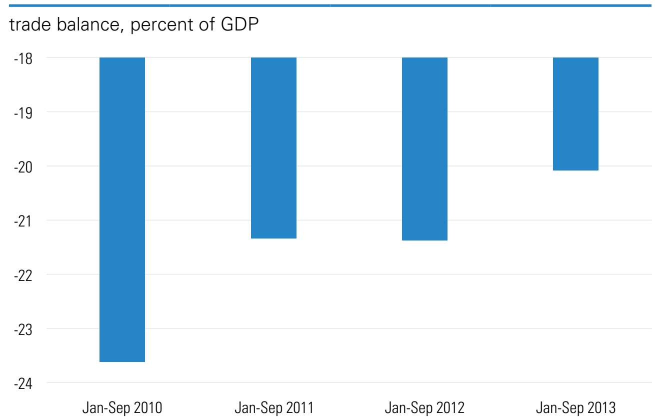
The current account deficit (CAD) improved during January–September of 2013. The current account deficit declined to about 9 percent of GDP compared with 13 percent registered in the first nine months of 2012. The improvement was supported by a 9.2 percent increase in exports and a 15.0 percent rise in remittances, which so far have remained unaffected by the deteriorating macroeconomic developments in Russia. Imports grew by only 2 percent mainly as a result of higher imports of precious metals and stones. This may reflect imports of diamonds for further processing and re-export. However, there is no evidence of a commensurate increase

Figure 7. The CAD continued to improve both in nominal terms and as share of GDP



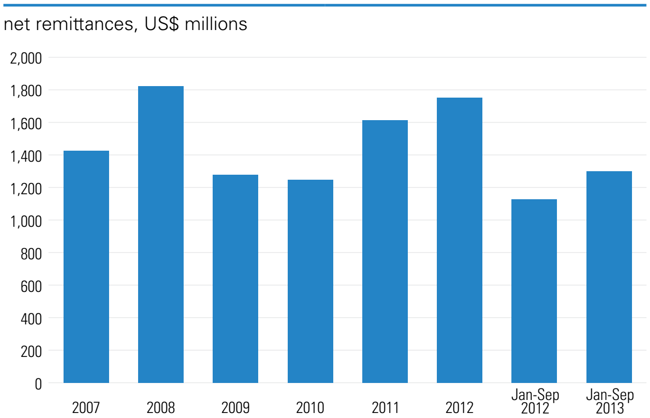
Source: NSS data and Bank staff calculations.

Figure 8. …due to positive developments in the trade balance



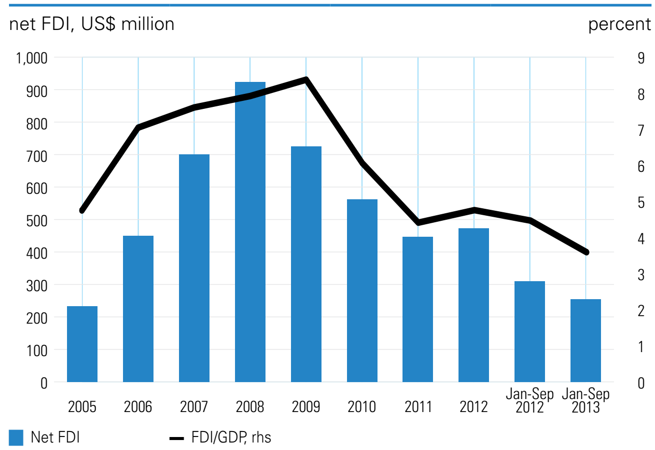
Source: NSS data and Bank staff calculations.

Figure 9. …and the robust recovery of remittances



Source: NSS data and Bank staff calculations.

Figure 10. …while FDI remained depressed



Source: NSS data and Bank staff calculations.

in exports so far. Exports of processed food were the main driver of export growth, while metallic and mining products contributed marginally.

Inflows of foreign direct investment (FDI) remained volatile and lower than during the global financial crisis of 2008–09. In the first nine months of 2013, inflows of FDI amounted to 3.6 percent of GDP or almost 20 percent less than in the same period of 2012. Telecom companies attracted one-third of the FDI in the real sector of the economy. About one-half of FDI came from companies in Russia and France, which are active in the telecom sector in Armenia. The mining sector attracted about 14 percent of FDI inflows.

The stock of external public debt increased by 17 percent from January to September of 2013 and reached $7.8 billion. Commercial banks attracted short-term debt of about $89 million, mainly through non-resident deposits. Other corporations contracted long-term debt in the amount of $417 million. During 2013 as a whole, the government's long-term debt increased by $251 million, reflecting among other factors the issuing of Eurobonds and the repayment of outstanding Russian debt. The Central Bank repaid $86 million of its long-term debt, mainly to the IMF. By the end of December, 2013, the country's public debt amounted to $4.6 billion, almost 82 percent of which was the country's liability to international financial institutions. Its main multilateral creditors are the World Bank and the IMF, which account for 40 percent and 18 percent shares of Armenia's external debt respectively. According to preliminary information, public debt remained at about 44 percent of GDP in 2013.

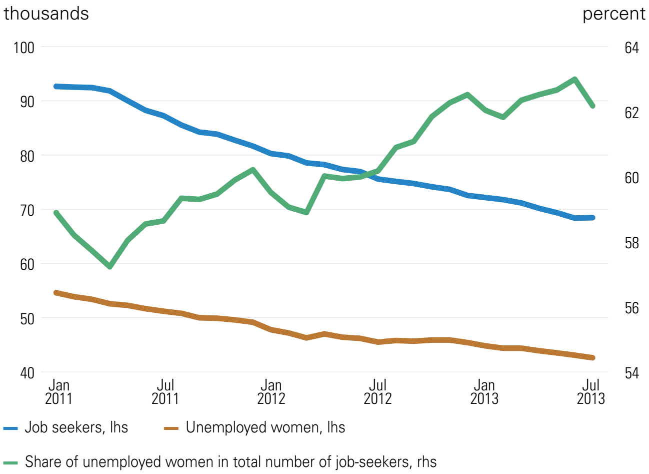
The issuing of Eurobonds has affected the debt structure for 2013 and onwards. The country's timely entry into international capital markets secured favorable terms for the Eurobonds (6.25 percent tenor, seven-year maturity with a bullet payment in 2020), which will serve as a benchmark for commercial borrowers. The government raised $700 million from 190 investors, mainly fund managers, after building a large, high-quality $2.7 billion order book. The transaction raised the visibility and profile of the country. The proceeds of the bond sale were used to repay the LIBOR-linked Russian debt, although the Russian debt carried a lower interest rate at the time. This will mitigate pressures on the fiscal accounts when the LIBOR recovers and will increase the accuracy of interest payment forecasts. The issuing of Eurobonds will also reduce the pressure on the domestic T-bills market as a source of deficit financing.

Employment and the Labor Market

Armenia has high structural unemployment despite healthy economic growth and gender disparities in the labor market are acute. The level of unemployment in September 2013 was 15.4 percent, down from 17.3 percent in 2012. In December 2013 the total number of officially registered job-seekers declined by 10.2 percent to 65,200 people from a year earlier. However, around 72 percent of them were women and their share increased over time. Among the job-seekers, the job placement ratio also favors men with 0.26 versus 0.17 for women.

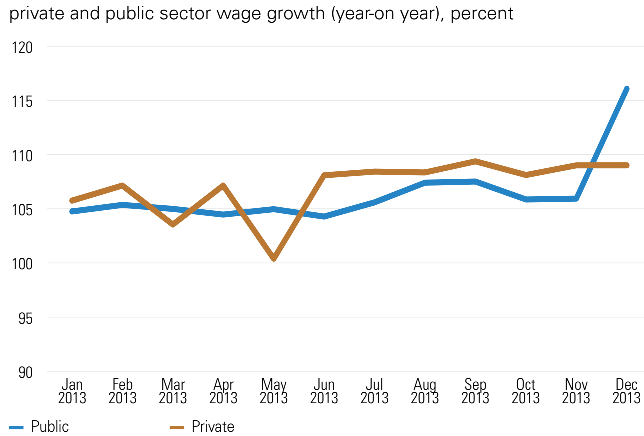
The gap between private and public wages remained stable in 2013. Average wages in the private sector exceeded those in the public sector by around 32 percent. In 2013 average annual monthly wages grew by 1.0 percent per month, driven equally by private and public sector wages, which grew at roughly the same rate. There was no change in remuneration policy for public servants, and the wage growth is a reflection of the

Figure 11. Gender disparities in the labor market remain



Source: NSS data and Bank staff calculations.

Figure 12. Private sector wage growth stabilized, while the spike in public sector pay reflects end-of-year bonus payments



Source: NSS data and Bank staff calculations.

transition of workers between pay levels due to their years of service (in other words, ordinary incremental increases).

Poverty

Subdued growth and the increase of utility tariffs are likely to have resulted in an increase in poverty in 2013. Following the tariff increases, the share of the energy bill in total household consumption expenditures rose to 9.8 percent on average from 8.8 percent prior to the increases. This estimate is coming from our simulations based on the latest available household data from 2011. The simulations show a likely increase in the poverty headcount of about 2.8 percentage points from the baseline of 2011, which would have more than offset the poverty reduction of 2012. However, the government is mitigating some of the impact with "lifeline" tariffs, i.e. lower gas and electricity prices for the poorest.

The headcount of people living in poverty declined in 2012, but inequality marginally worsened. In 2012, poverty rates declined from the previous year but were still higher than in the pre-crisis period. The poverty headcount index declined to 32.4 percent in 2012, down from 35.0 percent a year before.[3] During the same period, extreme poverty declined from 3.7 to 2.8 percent. However, 95 percent confidence intervals for poverty and extreme poverty are wide enough to state that the progress in poverty reduction was marginal at best. Poverty was still almost 5 percentage points higher in 2012 than in 2008. Extreme poverty was also higher than in 2008 although to a lesser extent, i.e. 1.2 percentage points higher on average (in both rural and urban areas). Inequality as measured by the Gini coefficient for income and consumption was higher than before the global crisis and deteriorated marginally in 2012 compared with 2011. Table 1 below summarizes key indicators of poverty and inequality.

3 Measured according to the national poverty lines for general and extreme poverty.

Price increases for the products consumed by poorer population groups played a significant role in shaping poverty trends. The overall price increase (measured as a chained index of 12-month CPI inflation) for 2008–12 was 25.9 percent. However, the prices of products that make up the consumption basket of the poor increased at higher rates. The increase in the average cost of the basket of extremely poor households was 28.3 percent during the same period, and the cost of the basket consumed by the average poor household increased by 26.7 percent, reflecting a relatively lower inflation rate of services. A higher increase in the cost of food explains the higher increase in extreme poverty between 2008 and 2012 because poorer households spent a higher share of their consumption budget on food.

Table 1. Key indicators of poverty and inequality, 2008 and 2011–2012

percent

	2008	2011	2012
Poverty	27.6	35	32.4
Extreme poverty	1.6	3.7	2.8
Gini			
by income	0.339	0.371	0.372
by consumption	0.242	0.267	0.269

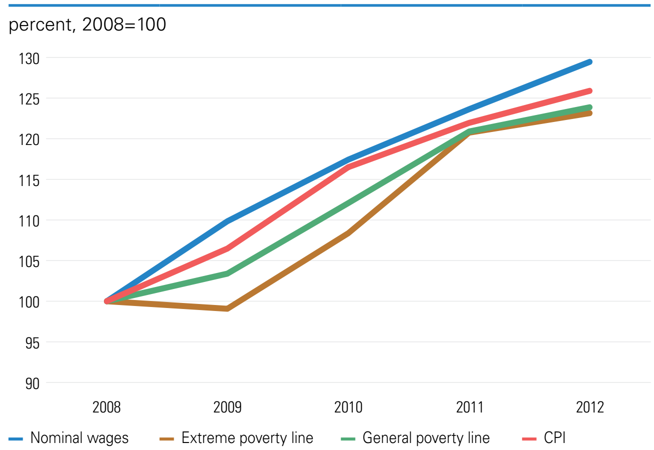
Source: National Statistical Service (NSS).

Between 2011 and 2012, economic growth was the major driver of poverty reduction, while the role played by social transfers was less significant. Elasticities of poverty level to GDP (in levels) were negative unitary in Yerevan and rural areas. Other cities (excluding Yerevan) benefited from growth even more, as the elasticity was 10 percent higher. Surprisingly, poverty reduction in rural areas appeared to be more responsive to overall economic growth than to real growth in agriculture, with the elasticity of poverty reduction over agricultural value-added growth being only -0.8. This reflects internal migration from rural to urban areas to take advantage of greater opportunities to earn labor income in cities.

The labor market has not yet fully recovered from the global crisis, and employment is not a sufficient safeguard against poverty. Although nominal wages grew faster than poverty rates, the poverty rate among the employed population grew to 26.1 percent in 2012 from 22.2 in 2008. Poverty lines (extreme and general)[4] increased by around 23 to 24 percent between 2008 and 2012, which is lower than overall price dynamics (as measured by the CPI) (see Figure 13).

The pension system is the most important of Armenia's social safety net programs. In the absence of pensions, poverty would be 12.6 percentage points higher, out of which 11.3 percentage points would come from an increase in extreme poverty. The family benefit system is the second largest program, but its impact on poverty is much more limited—around 2.6 percentage points. Other types of social assistance (such as unemployment benefits and cash transfers) have a marginal impact on poverty—around 0.2 percentage points. However, in 2012 the role of all types of social assistance (or income redistribution) in reducing poverty declined compared with 2010.

Figure 13. Dynamics of poverty lines and nominal wages



Source: NSS and Bank staff calculations.

4 Costs of food and overall poverty baskets, respectively.

This reconfirms the point that, in relative terms, the role of the primary distribution of income in poverty reduction increased over the reported period.

Table 2. Impact of social safety nets on poverty

percentage points contributed to poverty reduction

	2010		2012	
	Poverty	Extreme Poverty	Poverty	Extreme Poverty
Pensions	16.1	14.3	11.3	12.6
Social benefits	3.6	3.8	1.3	2.8
o/w Family benefits	3	3.5	1.2	2.6

Source: NSS and Bank staff calculations.

Reducing poverty through perfectly targeted re-distribution of income would require substantial fiscal efforts. The poverty gap of 5.6 percent indicates that, if the country were to mobilize resources equivalent to 5.6 percent of poverty line for each individual (both poor and non-poor) and if these resources were accurately allocated to the poor, poverty would theoretically be eliminated. The amount of resources needed to eliminate poverty is around AMD70–75 billion or 1.7 to 1.9 percent of GDP. The theoretical cost of eliminating extreme poverty is much lower—AMD2 billion or 0.1 percent of GDP.

The regional profile of poverty has remained relatively stable over time, as small cities have accommodated the bulk of the increase in poverty. Yerevan and the mostly urban Syunik region had the same poverty rate of 25.6 percent, which was among the lowest in 2012. The lowest poverty was recorded in Vayots Dzor—one of the touristic, wine-making regions of Armenia. Lower levels of poverty are expected in the capital city, which accounts for almost 60 percent of the country's economic activity, and in Syunik, which is the center of the mining industry, while the economic potential of Vayots Dzor requires additional analysis.

C. Economic and Structural Policies

Fiscal Policy

Higher taxes and lower expenditures suppressed demand in 2013, and the fiscal deficit was estimated to decline to 1 percent of GDP in 2013 from 1.5 percent in 2012. According to preliminary estimates, the fiscal deficit is likely to have declined to 1 percent of GDP in 2013 from 1.5 percent in 2012. The deficit was below the budget target of 2.8 percent and was much lower than 7.6 percent recorded in 2009 due to fiscal expansion in the wake of the global crisis. Fiscal consolidation was achieved through expenditure compression and higher revenue, although the latter was mostly due to a one-off payment of a $15 million license fee by Armenia's fourth mobile phone operator. Reflecting the transfer of the sales proceeds for the government's share of ArmRusGazProm (ARGP) in the fiscal accounts may result in a higher deficit, but this should not be treated as fiscal expansion as it was a debt-for-equity swap.

The one-off license fee received from Armenia's fourth mobile phone operator contributed to an increase in revenues. Revenues increased to 22.8 percent of GDP for 2013 as a whole, compared with 21.4 percent in 2012. Tax revenues were higher than expected as a result of improved tax administration and policy measures aimed at expanding the tax base (including the expansion of income tax to military personnel and a revised royalty regime for metallic minerals) as well as the one-off license fee payment, which amounted to about 0.15 percentage points of GDP. Almost one-third of the increase came from lower-than-expected nominal GDP (due to weaker growth) as the State Revenue Committee closely follows nominal targets for tax collection. Only slightly more than 50 percent of the initially expected official grants materialized. On the expenditure side, under-execution of the capital budget continued, while priority social spending was maintained. Capital

Box 1. The Sustainability of Gas Tariffs

In mid-May, 2013, ARGP—the monopoly gas importer and distributor—approached the Public Services Regulatory Commission (PSRC) with a request to increase gas tariffs to reflect an expected increase in the border price of gas. At the time, it was reported that Gazprom's price to Armenia would increase by 50 percent from $180 to $270 per thousand cubic meters (tcm). The new tariffs, however, were set at about 70 percent of the levels requested by ARGP. The authorities announced that the lower price for gas was the outcome of Armenia's commitment to join the Eurasian Customs Union (ECU), as the gas supplied by Russia to ECU member countries is exempt from the export duty of 30 percent charged to other countries.

However, the political nature of the gas deal on both import price and end-user tariffs raises questions about the long-term sustainability of tariffs. First, there is an inconsistency in the explanation of how they are calculated. If the price of $270 per tcm is inclusive of export duty, the price after being exempted from it should be $208 per tcm, not $189 as communicated by the authorities.[1] Second, the PSRC substantially revised the financial indicators provided by the ARGP to calculate the new tariffs, allowing higher depreciation and fixing lower operating and maintenance costs and profit margins. It also applied a more appreciated exchange rate. The result of these adjustments was that the margin for the operating and maintenance costs and profits of ARGP declined by around 34 percent compared to their proposal.

[1/] Export duty is calculated *ad valorem*. A final price of $270 implies a tax of 0.3/1.3=23.08 percent of $270, hence the amount of export duty is $270*0.23=$62.3 and $207.7+$62.3=$270.

spending was lower than the revised budget plan due to delays in the implementation of the North-South corridor project.

Fiscal accounts will deteriorate as the deal on ArmRusGazProm (ARGP) is reflected in the budget for 2013. The government fixed a five-year agreement with its Russian counterparts to secure the price for imported gas at the level of Russian domestic prices adjusted for transportation costs. The agreement also involved the sale of the government's remaining 20 percent stake in ARGP to Gazprom for approximately $155 million to write off the debt accumulated by ARGP during 2012–13 when it suffered losses from tariffs that had not been adjusted for the higher import price of gas. Once this transaction is reflected in the 2013 budget the deficit will increase by 1.5 percentage points of GDP.

The government continued its efforts to improve tax and customs administration and reduce the burden of taxes on businesses. Nearly half of all tax returns are now filed electronically, and 95 percent of invoices are now sent in electronic form. Better tax administration and risk assessment has also made it possible to significantly reduce the number of audits carried out by the tax authorities. To simplify compliance for small entrepreneurs, a turnover tax was introduced for entities with a turnover of up to AMD58.35 million.

Monetary and Exchange Rate Policies

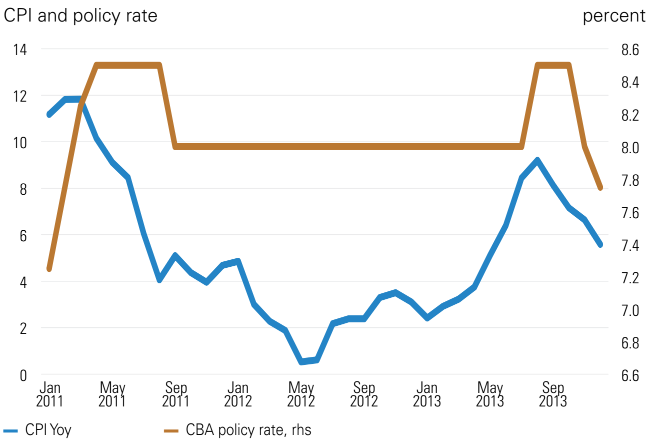
A moderation of inflationary pressures in the last quarter of 2013 allowed the CBA to reduce its policy rate. In mid-November, the CBA reduced the policy rate by 50 basis points back down to 8 percent, which was the level that it maintained between September 2011 and August 2013. Continuing improvement in the inflationary environment with the stabilization of non-food prices and utility tariffs allowed for further reductions in the policy rate at the end of December and in mid-February by 25 basis points each. This monetary loosening was aimed at stimulating consumption as a tight fiscal policy suppresses aggregate demand by reducing capital spending. However, this policy stance only became possible by the end of the year as the CBA had previously kept the policy rate high to prevent second-round inflationary effects.

The level of non-performing loans increased as credit to the private sector expanded. Lending by commercial banks to the private sector expanded by 7.6 percent in line with the CBA's expansionary monetary stance. However, the credit expansion boosted private consumption rather than business investments, as households absorbed 5.3 percentage points out of the growth of lending to residents. Weak growth and low investment opportunities affected the quality of the loan portfolio of commercial banks as the share of non-performing loans increased from 6.4 to 8.1 percent between January and November of 2013.

Favorable developments in the balance of payments allowed the CBA to accumulate reserves. In the reporting period, the CBA intervened in the foreign exchange market mainly to buy currency, as large inflows of foreign currency from high exports, tourism, and remittances actually put some appreciation pressures on the dram. Net purchases of foreign exchange totaled $53.5 million for 2013 as a whole and contributed to an accumulation of international reserves, which reached $2,253 million in end-2013, equivalent to 5.2 months of 2014's imports of goods and services. This monetary expansion through currency interventions was in line with the CBA's expansionary policy as manifested by its policy rate decreases. The accumulation of reserves was also aided by the disbursement of the World Bank's first Development Policy Operation and a few smaller programs, financed by the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), and the Asian Development Bank (ABD).

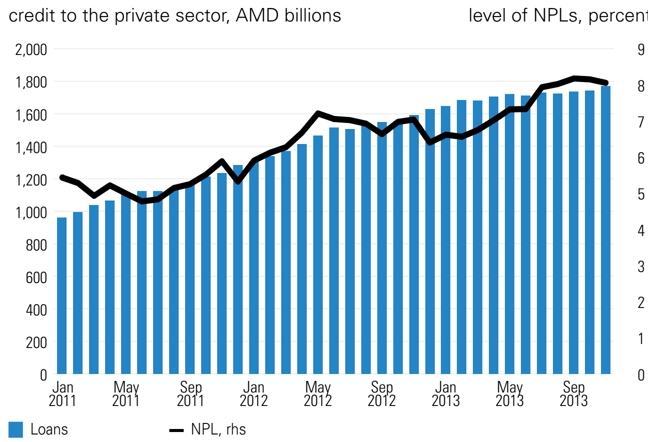
Eurobonds and the first Armenian Dram denominated bonds issued by the International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD) are traded on the NASDAQ-OMX Armenia. Apart from being another investment alternative in the Armenian capital market, the appearance of Eurobonds in the local capital market will enable commercial banks to restructure their credit portfolios by shifting from solely AMD-denominated claims to the government to a currency mix. This will free up additional resources in local currency, which can be used to provide credit to the private sector, thus hedging the latter from exchange rate risks. In their turn, the IFC and the EBRD issued AMD-denominated bonds to strengthen Armenia's capital markets and boost lending to the private sector. The bonds were listed on the NASDAQ OMX Armenia on February 7, 2014 and became available for trading from February 12, 2014.

Figure 14. The CBA lowered the policy rate as inflationary pressure moderated



Source: NSS data and Bank staff calculations.

Figure 15. Credit to the private sector expanded as did the rate of non-performing loans



Source: CBA and Bank staff calculations.

Structural Reforms

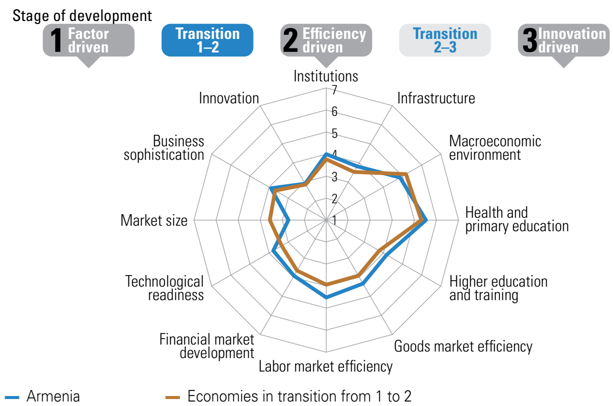
Armenia improved its rating on the World Bank's Doing Business index by three places in 2013 and was ranked 37th among 189 countries. The notable rise of nine positions came in the category of "Paying Taxes," while in the categories of "Enforcing Contracts" and "Starting a Business" Armenia improved by 5 and 4 positions respectively. The government had made paying taxes easier by merging employee and employer social contributions and the individual income tax into a single unified income tax, and starting a business had become easier because of the elimination of company registration fees. The Doing Business report ranked Armenia fifth in the world with regard to property registration, as the regulations specify that property registration in Armenia can be completed in only three steps taking just seven days in total.

Armenia's ranking on the World Economic Forum's Global Competitiveness Index (GCI) also improved by three places as it moved up to 79th place out of 148 countries in 2013–14. The largest improvement came in the category of "Technological Readiness" (up by 20 places), followed by "Improvement in Macroeconomic Environment" and "Goods Market Efficiency" (up by 19 and 14 places respectively). The country's improved in the categories of "Institutions" and "Business Sophistication" by five or six places. Armenia's lowest score came on "the size of the market" (where it ranked 117th, a decline of two positions compared to the GCI of 2012–2013), while in the innovation category, it rose by two positions and is now in 105th place. It received the highest GCI scores for "Health and Primary Education" (5.5), "Macroeconomic Environment" (4.9), and "Labor Market Efficiency" (4.5).

Ongoing business inspections reforms are helping to improve the overall business climate in Armenia. The previous series of Development Policy Operations (DPO) supported by the World Bank introduced risk-based principles in the Law on Inspection, and the government has also introduced risk-based inspection practices in a majority of agencies. To reduce apparent overlaps between agencies, the government embarked on a program of consolidation of inspection agencies with the aim of reducing them by half (there were 18 in 2012). In 2013, the government merged the Labor and the Anti-Epidemiology inspectorates into a single inspection agency. The merger was the first step in what will be a more substantial consolidation later on when a new legal framework is put in place.

Figure 16. Armenia's performance in the 12 categories of the Global Competitiveness Index 2013–2014

score against the average scores for all economies in transition



Source: World Economic Forum.

The government is implementing a cross-governmental regulatory reform to improve the business climate and increase competitiveness. The reform is being conducted according to the guillotine methodology and will draw from international experience in reviewing of Armenia's 3,000 rules and regulations. The reform involves 17 ministries and 10 regulatory bodies at the national level in Armenia. By mid-2013, the National Center for Legislative Regulation had reviewed more than 1,000 legal acts from nine sectors, including tax, customs, entrepreneurship, social issues, public utilities, transport, and health. Of these 1,000 regulations, 400 were amended or abolished, bringing total compliance costs down by 58 percent.

The government has started re-structuring the institutional setup for the oversight of the aviation sector. On December 12, 2013 the government issued a decree to enable the Ministry of Economy to begin liberalizing the aviation sector and promoting an "open skies" policy. Reforms in the sector are already showing some progress. After Armenia's decision to liberalize the sector in mid-2013, the government has already signed "open skies" agreements with Russia and the United Arab Emirates, while a few others (namely, with Ukraine, Iraq, Kuwait, and Turkmenistan) are underway.

The Government of Armenia needs to further improve the country's business environment, increase its competitiveness, and stimulate businesses to create well-paying jobs. The recent World Bank report "Back to Work: Growing with Jobs in Europe and Central Asia" highlights the important role played by young, exporting firms in job creation. It shows that the bulk of new jobs in most countries are created by a small group of fast-growing companies. While many of them are in the construction and modern services sectors, because these are fastest-growing sectors in most countries, they exist also in other sectors, even in sectors which are declining overall. Foreign firms and firms that are connected to global supply chains often predominate among fast-growing firms. Therefore jobs will be created as a result of fostering entrepreneurship and the entry of new firms into the market, promoting exports, and attracting FDI.

The government's medium-term reform agenda—supported by the World Bank's new Development Policy Operation—reflects these priorities. It includes critical reforms to the business climate and public administration aimed at strengthening competitiveness and public sector efficiency. These are expected to contribute to job creation by reducing the costs of doing business for firms, expanding access to credit for SMEs, and increasing opportunities for employment and job creation through increased trade and connectivity within and outside Armenian borders. Public administration reforms supported under the operation will also contribute to more inclusive access to services as a result of a more efficient use of resources and a sounder policy formulation framework.

Armenia is aiming to implement joint border controls with Georgia. A bilateral agreement on the "Joint Use of Land Border Checkpoints" signed between Armenia and Georgia in 2010 calls for the harmonization of clearance procedures and documents and the electronic transmission of data between the two administrations. It provides an excellent starting point for true joint border controls consistent with relevant provisions of the UN Convention on the Harmonization of Frontier Controls (UNECE) of 1982 and with the Armenia-Georgia free trade agreement (FTA). The European Investment Bank is funding infrastructure improvements to Armenia's three border crossings with Georgia.

D. Outlook and Risks

External Economic Environment

Cyclical factors have played a large role in developing countries' GDP growth during both the pre-crisis and post-crisis periods. According to the World Bank's latest Global Economic Prospects (GEP) report, decomposition of the sources of developing countries' growth suggests that most of the slowdown between the pre-crisis (2003–07) and post-crisis (2010–13) periods can be attributed to cyclical factors rather than to any significant slowing in potential growth.[5] Overall, developing country growth has slowed by 2.4 percentage points, and 80 percent of the slowdown was due to cyclical factors, with the rest reflecting weaker productivity or potential growth. Potential growth shows a more pronounced slowdown in the ECA region than in other regions because the global crisis led to steep contractions in investment. Lower potential growth accounted for half of the 3.4 percentage point growth deceleration between the pre-crisis and post-crisis periods. In Armenia, growth decelerated by 8.8 percentage points to 4.3 percent, which is even below the newly estimated potential growth rate, indicating the greater role played by the cyclical factor.

Tapering of quantitative easing may put additional hurdles in the way of capital flows to developing countries. Before the US Federal Reserve Board's announcement that it was tapering off its quantitative easing, investors were putting their money into riskier higher-yielding assets, including developing country bonds and equities. To a certain extent, this also helped Armenia to secure favorable terms for its first issue of Eurobonds in September 2013. However, when yields on 10-year U.S. Treasury bills nearly doubled during the summer of 2013, investors quite naturally decided to rebalance their portfolios towards now higher-yielding US bonds. This portfolio adjustment caused a temporary but significant diversion of capital flows from developing countries to the United States. Capital flows to developing countries are now projected to decline by about 0.6 percent of developing country GDP by 2016. However, the impact on developing countries is likely to be felt mostly by middle-income countries with deeper financial markets and domestic imbalances. Overall, in net terms, developing countries gain as tailwinds from strengthening global trade offset headwinds from tighter global financial conditions.

The effect of counter-crisis policies was limited as programs to stimulate aggregate demand produced larger deficits and debt rather than addressing the underlying weaknesses. Developing countries responded to the global financial crisis by deploying fiscal and monetary stimuli. However, growth dynamics in developing countries over the past several years have been heavily influenced by capacity constraints. Among several large middle-income countries, capacity constraints appear to have stymied the efforts of policymakers to boost GDP growth through fiscal and monetary expansion. Instead, these efforts resulted in increased fiscal deficits, larger current account deficits, and higher inflation rather than faster growth. In the longer term, in most developing countries greater growth will have to come from supply-side reforms that increase the underlying growth potential. The most appropriate policy responses will vary from country to country but may include a loosening of monetary policy to support growth, the prudent management of exchange rates, and the use of macro-prudential regulations. These measures may need to be supplemented by policy reforms to boost

5 This section is based on the analysis in the latest issue of the Global Economic Prospects report of January 2014 (http://www.worldbank.org/en/publication/global-economic-prospects).

investor and market confidence in order to attract domestic and foreign investments. The implementation of a sound reform agenda is particularly important in the context of Armenia, as monetary policy cannot address the supply-side weaknesses of the economy but only contribute to the further expansion of demand and the accumulation of external deficits.

In the medium term, high-income economies will push global demand up as their growth increases. High-income economies seem to have finally overcome the extreme weakness of recent years, which has contributed to a projected acceleration in global growth from 2.4 percent in 2013 to 3.2–3.5 percent during 2014–2016. Among the three major high-income economies (the United States, the Euro area, and Japan), the recovery is the most advanced in the United States. The pace of recovery in Europe is projected to be slower, reflecting the long and deep adjustments in the private sector balance sheet. However, the growth in the EU will be led by Germany, which is the main destination of Armenian metals exports. Overall, recovery in EU demand contributed to growth in the developing Europe and Central Asia region, which has strengthened from 2.0 percent in 2012 to 3.4 percent in 2013. Along with the recovery of the global economy, the composition of demand will change back from government spending to investment goods. As high-income import demand around the world recovers (it is projected to rise from 2.4 percent in 2013 to 4.2 percent by 2016), global trade is expected to accelerate, rising from 3.1 percent in 2013 to 4.6 percent in 2014 and to 5.1 percent in 2016. This should help to offset any negative impact of higher interest rates and weaker capital flows to developing countries.

Growth in the Commonwealth of Independent States (CIS) is projected to pick up from an estimated 3.5 percent in 2013 to 4.1 percent in 2016. Among resource-rich CIS countries, this increase will be supported by the expected advent of new export capacity following years of investment in the energy sectors. The strengthening of the global economy should be supportive of increased energy demand. Oil prices are projected to remain stable in nominal terms through 2014 (at $105.70 a barrel) before declining marginally in 2015 and 2016. Among non-energy-producing CIS countries, the improving outlook will be supported by an increase in remittances and exports as the global economy strengthens. Remittances are projected to increase by 10.3 percent in 2014 as a result of the economic recovery of the Euro area and strengthening growth in Russia (from 1.3 percent in 2013 to 2.7 percent in 2014–16), which is the main destination for Armenian migrants. On the downside, weaker metal and agricultural prices are likely to keep down export revenues and government spending.

Global price developments are not in Armenia's favor. The real prices of internationally traded food and metal commodities, denominated in U.S. dollars, declined by 13 and 30 percent respectively between their peaks in early 2011 and November 2013, boosting the incomes of commodity importers but hurting exporters. The decline in metals prices has been steady throughout this period, reflecting both moderate demand growth in China and a strong supply response to earlier price increases. Long-term investment in new mines has increased five-fold over the past few years. In contrast to metals prices, much of the decline in food prices has occurred more recently. Good harvest prospects led to a drop in food prices in general, while wheat prices have not eased nearly as much, and stocks are relatively low. In metal markets, Armenia's prospects hinge on China, which accounts for 45 percent of global metals consumption. If robust supply trends continue and Chinese demand falls, the sharp fall in prices over the past two years could continue. Overall, in the medium term, price dynamics in global markets may cause a negative terms-of-trade shock for Armenia and hurt the country's export and fiscal revenues. In addition to affecting macroeconomic performance in 2013, continued price declines in the second half of 2013 will hamper growth in 2014.

Box 2. Potential Gains and Losses from Armenia's Accession to the Eurasian Customs Union

Responding to a request from the government, the World Bank conducted a preliminary analysis to identify potential gains and losses from Armenia's accession to the Eurasian Customs Union (ECU). In this analysis, the Bank estimated the trade impact on the basis of a simple partial equilibrium framework, which simulates the impact on trade creation and trade diversion of membership of the ECU.

The analysis showed that current import tariffs in Armenia are likely to increase as a result of joining the ECU and adopting the common ECU external tariff. As a result of increases in import tariffs, trade flows to Armenia from third countries could be expected to decline by $110.6 million (or 1 percent of GDP). Only a small part of this decrease in trade with third countries would be compensated for by an increase in the intra-ECU trade, while some could be substituted by an increase in domestic production. Armenian consumers would suffer a small welfare loss from having to pay higher prices. However, it remains to be seen whether Armenia would have to increase its external tariffs to the levels now prevailing in the ECU because Russia committed to lowering its external tariffs when it joined the World Trade Organization (WTO) in 2012. A transition clause might allow Armenia to maintain lower tariffs while other ECU members are reducing theirs.

The potential benefits from the accession would materialize in the longer run. Opportunities may arise as a result of Armenia having a more liberal trade regime in services than the other ECU member countries. In theory, the country could become an attractive market for investors interested in providing services to the ECU depending on the approach that will be taken by the other ECU member countries to integrate all service sector regulations. Looking beyond the trade impact, another benefit to Armenia from joining the ECU would be having favorable access to natural gas from Russia. Whether these or other non-trade benefits from joining the ECU would exceed the downside of the displacement of imports from more efficient producers to higher-priced and lower-quality products from Russia will require further research and analysis.

Source: Estimating Possible Impacts of Armenia's Accession to the Eurasian Customs Union, World Bank, 2013.

Armenia's Outlook

Armenia has the potential to benefit from an increase in external demand to the extent that its trade links with the Euro area permit. The projected fiscal expansion will support domestic demand in 2014, but beyond that the private sector will have to drive growth. Armenia will continue to face considerable risks, including prolonged weakness in the Euro area and in Russia (although by the same token, stronger than expected growth would be an upside), a disorderly adjustment of economy to higher global interest rates, and further sharp declines in metal prices.

A gradual recovery of the global economy should help to increase real GDP growth in Armenia in the medium term. GDP growth is projected to increase to around 5.0–5.5 percent between 2014 and 2017. This growth projection is based on stable private savings and investment, a slow increase in the share of the population that is active in the labor market, and trend growth in total factor productivity (TFP). The macroeconomic framework of the Armenian Development Strategy (ADS), which envisages economic growth of 6 to 7 percent per annum and a doubling of GDP in real terms by 2025, seems to be overly optimistic as post-crisis recovery is slow and susceptible to shocks.

With the outlook for construction being modest and the agriculture sector's return to trend, the main drivers of growth will have to be industry and modern services competing in international markets. Within industry, the manufacturing sector is the most likely sector to create employment. Labor productivity is significantly higher in manufacturing than in, for example, agriculture, and its production technology is more labor-intensive than that of heavy industry and modern services. The manufacturing sector is therefore appropriately targeted in the ADS as the sector in which high quality, decently paid jobs will be created. Higher productivity in this context means higher growth and faster poverty reduction.

Manufacturing and services will drive medium-term growth, while construction is the riskiest sector. The contribution of manufacturing and services to economic growth is projected to increase from 50 percent to around 60 percent. This assumption is consistent with recent trends and the government's economic policy stance, which aims to expand the tradable sectors of the economy. While the growth of agriculture is forecast to equal its 10-year average of 5 to 6 percent per annum, the volatility of the construction sector presents key risks to this growth as it has declined in real terms every second year after the crisis. After declining by 47 percent during 2009–2011, construction grew marginally in 2012, which seemed to indicate that the crisis in that sector had bottomed out. However, preliminary data suggest that it may have declined again by about 11 percent in 2013.

The current account deficit is expected to improve as a result of growing remittances and structural shifts in the economy. Policies geared to industrial development and export promotion should lead to faster growth in the tradable sectors. Together with continuing growth in remittance inflows, this will support a reduction to single digits in the current account deficit as a percentage of GDP. The macroeconomic framework also takes into account a gradual depreciation of the exchange rate to support an improvement in the current account balance. This would require vigilance by the CBA to maintain an adequate level of foreign exchange reserves and to manage domestic liquidity.

Moderation in growth will ease domestic pressures on inflation as international food prices are likely to remain low, gas prices to remain stable thanks to the agreement with Russia, and depreciation pressure to abate because of the lower current account deficit. As a result, in the medium term, inflation is expected to stabilize around the CBA's target of 4 percent aided by a lower than expected pass-through impact. The CBA's monetary policy stance is consistent with these trends as it lowered its policy interest rate to stimulate demand.

Fiscal Policy

The government's draft budget for 2014 foresees higher revenue and a slight recovery in capital spending. The budget assumes GDP growth of 5.2 percent in 2014 compared with the 6.4 percent envisaged in the Armenia Development Strategy and our forecast of 5 percent. In light of the lower outturn of growth estimated for 2013, the nominal targets set in the Law on the Budget for 2014 imply taxes (net of VAT refunds) of 23.3 percent of GDP and an overall deficit of 2.4 percent of GDP. Capital spending will largely increase to its 2012 level after declining substantially in 2013. The budget envisages a salary increase for public servants from July 1, 2014 of about 0.3 percent of GDP. However, planned reforms to the public sector wage scale and some possible downsizing are expected to lead to a decrease of the public wage bill as a share of GDP.

During 2014–15, the government will be taking some measures aimed at reducing the stock of tax credits. The current large stocks of accumulated tax credits (on order of 5 percent of GDP) are widely perceived to be an impediment to effective business as they lock up working capital that could otherwise be used for expanding businesses. On the other hand, tax credits address short-term pressures on fiscal accounts but undermine fiscal sustainability in the longer run as they are eventually subtracted from future taxes. From this point of view, this seems an opportune time to gradually reduce the stock of tax credits because tax revenues have grown by a healthy amount over recent years. In 2014–15, the government therefore aims to maintain the tax-to-GDP ratio constant while at the same time decreasing the stock of tax credits by an amount similar to the usual tax increase. In other words, tax administration will continue to be improved, but the gains will materialize not as higher taxes (as would usually be the case) but as a lower stock of tax credits.

Strengthening of social safety nets will remain on the government's agenda. The government has expanded the coverage of the health benefits package for poor and vulnerable families under the Family Benefits Program. The 2014 state budget for healthcare was increased by 13 percent and the threshold for the health benefit (an exemption from patient co-payments) was revised to be the same as the eligibility for the Family Benefits Program. This will make an additional 270,000 people eligible for the free health benefits over and above the current 124,000 beneficiaries. On January 30, 2014 the government adopted a decree on the modalities for the Family Benefits Program to fill the legal gap between the new law on state benefits and the old regulations on benefit distribution mechanisms. The government, however, plans to continue reforms to align different types of benefits with relevant stakeholders, as well as to set up social assistance programs for those whose incomes are above the eligibility threshold for the Family Benefits Program.

Table 3. Key fiscal indicators 2012–2014

percent of GDP

	2012	2013		2014
	Actual	Budget	Estimate	Budget
Overall Balance	*-1.5*	*-2.6*	*-1.0*	*-2.4*
Primary balance	-0.5	-1.5	0.1	-1.0
Total Revenues and grants	*23.1*	*22.2*	*24.4*	*24.3*
Tax revenues	21.4	21.3	22.8	23.5
Non-tax revenues	1.2	0.5	1.3	0.4
Grants	0.5	0.4	0.2	0.4
Expenditures	*24.6*	*24.8*	*25.4*	*26.7*
Current expenditures	21.3	20.5	22.4	23.4
Wages and compensation	2.2	2.0	2.4	2.3
Goods and services	8.2	8.6	9.0	9.2
Interest payments	1.0	1.2	1.1	1.4
Current transfers	9.4	8.4	9.3	9.9
Pensions	4.9	4.4	4.7	5.3
Social assistance	4.5	4.0	4.6	4.6
Capital expenditures	3.3	4.4	3.1	3.3
General Government Deficit Financing	1.5	2.6	1.0	2.4
External (net)	1.4	1.4	1.5	0.2
Domestic (net)	0.1	1.2	-0.5	2.2
Functional classification				
General services	3.4	4.1	4.5	4.2
Defence	3.8	4.0	4.3	4.3
Public order and safety	1.9	1.6	2.2	1.8
Economic affairs	1.8	2.9	3.2	2.4
Health	1.6	1.6	1.7	1.8
Education	2.6	2.4	2.5	2.8
Cultural, sports, recreational, religious	0.6	0.4	0.4	0.5
Social Protection	7.3	6.7	7.2	7.9

Source: Armenian authorities and Bank staff calculations.

Risks

The global economy remains exposed to significant challenges despite a brighter outlook. Weaker economic activity compared with pre-crisis years, burdensome debt levels, and risks of crisis fatigue and improving economic conditions may slow the pace of reforms. In Europe, a return to growth is not yet a signal of a return to health. Although labor markets are showing signs of stabilizing, long-term and youth unemployment remain endemic, spreading concerns that extended joblessness may have made many of the unemployed permanently unemployable. CIS countries are exposed to fluctuations in commodity prices and the slowdown in Russia, although remittances to the region have held up so far. Non-energy commodity exporters have suffered a negative terms of trade shock as a result of sharp declines in metal and agricultural commodity prices.

The global outlook is subject to downside risks. Although the main tail risks of the past five years have subsided, the underlying challenges that underpinned them—though less acute—remain. A sharper than expected slowdown in Russia would be a key downside risk for Armenia, as it heavily depends on Russia for import demand, remittances, and foreign investment. Protracted recession in the Euro area is another downside risk, as the EU accounts for one-third of Armenia's merchandise exports. Full recovery of the banking sector in Europe will take more time and considerable effort. In addition, slower than projected growth in China, perhaps provoked by a quicker than anticipated decline in investment, could slow global growth by as much as 0.3 percent but with more marked effects on regional industrial commodity producers such as Armenia.

Further tightening of global financial conditions is a downside risk for Armenia as a newcomer to international capital markets. Over the medium term, the gradual return of long-term interest rates to more sustainable levels in both high-income and developing countries should help to reduce the excesses and vulnerabilities that can accumulate in a persistently low interest rate environment. In the near term, however, the transition to higher global interest rates could be volatile. According to the estimates provided in the recent issue of the World Bank's Global Economic Prospects Report (GEP), if long-term interest rates increase by 100 basis points, capital inflows could decline by as much as 50 percent for several quarters (and by 80 percent in the less likely but more acute scenario of a sudden 200 basis point increase).

While we concur with the projected economic growth of 5 percent per year over the medium term, we suggest more caution for 2014, due to the downside risks from a protracted weakening of the Russian economy. The ongoing crisis in Ukraine and the depreciation of the Russian ruble may have negative consequences for Armenia's economy, ranging from lower demand for exports to the impact of a weak ruble on dollar-denominated remittances sent home by Armenian migrant workers in Russia.

High levels of private or short-term debt or a deterioration in the quality of banks' loan portfolios are additional challenges. Particularly high debt levels increase a country's susceptibility to changes in external financing conditions and currency mismatch. However, we assess this risk as low because private debt accounts for around 40 percent of total external debt and because the share of short-term external debt declined to 12 percent from a pre-crisis level of 19 percent, while public debt is largely concessional. The level of non-performing loans (NPLs) has been increasing since the end of 2012. However, the share of NPLs is still low, and the CBA does not require commercial banks to take additional steps to restructure their debt holdings.

On the upside, stronger growth than envisaged in the baseline could provide an additional boost to developing countries. A stronger than anticipated recovery in high-income economies could provide considerable support to external demand in the ECA region, helping to offset downward adjustments in domestic demand triggered by rising global interest rates. The estimated output gap in Russia is negative, and it was widening between 2010 and 2013. Closing the output gap in Russia will increase remittances, which are correlated with Russia's GDP growth and are around four times larger than Armenia's exports to Russia. Declining global food prices should also reduce inflation pressures and food import costs, although they are a negative development for food exporters.

Table 4. Comparison of the baseline and alternative scenarios for 2014

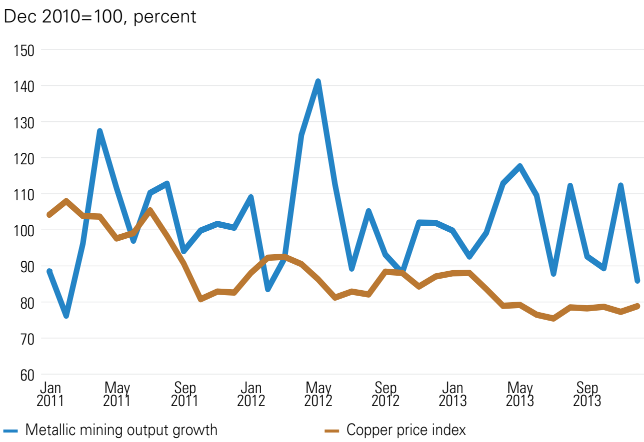
in percent of GDP, unless otherwise specified

	2010	2011	2012	2013 Est.	2014	
					Baseline	Alternative
National income and prices						
Real GDP (percent change)	2.2	4.7	7.2	3.5	5.0	4.5
Gross domestic product (in millions of U.S. dollars)	9,260	10,142	9,951	10,417	11,290	11,155
Gross national income per capita, Atlas method (in U.S. dollars)	3,310	3,470	3,760	3,880	4,030	3,970
Consumer price index (percent change)	8.1	7.5	2.5	5.7	3.4	2.0
Investment and saving						
Investment	32.9	27.3	23.8	22.4	23.0	21.3
Public	5.5	4.7	3.3	3.1	3.3	3.4
Private	27.3	22.6	20.4	19.3	19.6	17.9
National savings	18.1	16.3	12.6	12.8	14.7	12.9
Domestic savings	8.4	3.7	-1.0	-0.7	1.1	0.4
Government operations						
Revenue and grants	21.9	22.7	23.1	24.4	24.1	24.1
Of which: tax revenue	19.5	20.0	21.4	22.8	23.3	23.3
Grants	0.9	1.6	0.5	0.2	0.4	0.4
Expenditures	26.9	25.5	24.6	25.4	26.5	26.9
Current expenditures	21.4	20.9	21.3	22.4	23.2	23.5
Of which: interest payments	0.9	0.9	1.0	1.1	1.4	1.4
Capital expenditures	5.5	4.7	3.3	3.1	3.3	3.4
Overall balance	-5.0	-2.8	-1.5	-1.0	-2.4	-2.7
Primary balance	-4.1	-1.9	-0.5	0.1	-1.0	-1.3
External sector						
Exports of goods and services	20.9	23.7	24.5	24.8	24.1	23.2
Imports of goods and services	-45.5	-47.3	-49.3	-48.0	-46.0	-44.0
Net remittances	13.5	15.9	17.6	16.8	16.7	15.6
Current account	-14.8	-10.9	-11.2	-9.6	-8.2	-8.4
Foreign direct investments, net	6.1	4.4	4.8	3.8	4.3	3.1
Change in gross international reserves (in millions of US dollars)	111.5	-132.9	48.3	-453.6	5.0	124.0
Public debt	**40.9**	**40.9**	**44.4**	**44.4**	**42.7**	**43.2**

Source: Armenian authorities and Bank staff calculations..

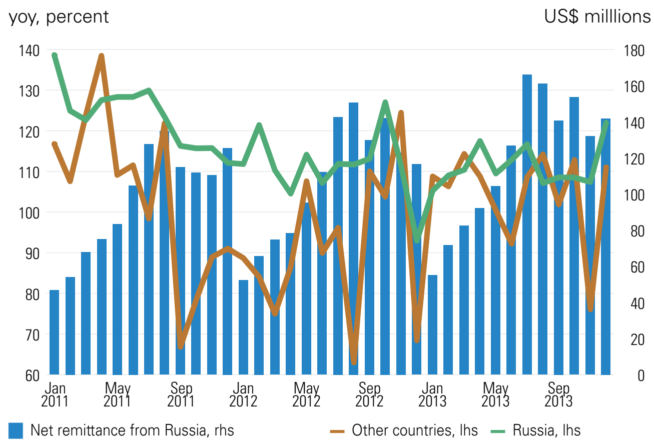
We stress-tested the macroeconomic framework for 2014 to identify possible effects of any downside shocks on the Armenian economy. Our assumptions on possible shocks are consistent with those used in the latest Global Economic Prospects (GEP) report. In particular, for 2014 we assumed 0 percent growth in remittances, a 10 percent decline in FDI inflows, a 20 percent decline in oil prices, 0.5 percent economic growth in Russia, and 0.4 percent economic contraction in the Euro area. Apart from any direct impact (for example, on the balance of payments), these shocks will also have secondary effects on the macroeconomic framework. The decline of oil prices will improve terms of trade and contribute to lower inflation (the share of oil products in the consumer price index basket is 7.6 percent). Trade will be affected by growth in Armenia's partner countries (Russia and the EU). Lower imports will be more than offset by lower exports and remittances, and the current account will widen. Assuming no short-term changes in productivity (and thus, in the ICOR[6]), lower investments will push the growth rate down to 4.5 percent. The fiscal deficit will widen to 2.7 percent of GDP due to lower

Figure 17. Metallic mining output grew despite deceleration of international prices for copper



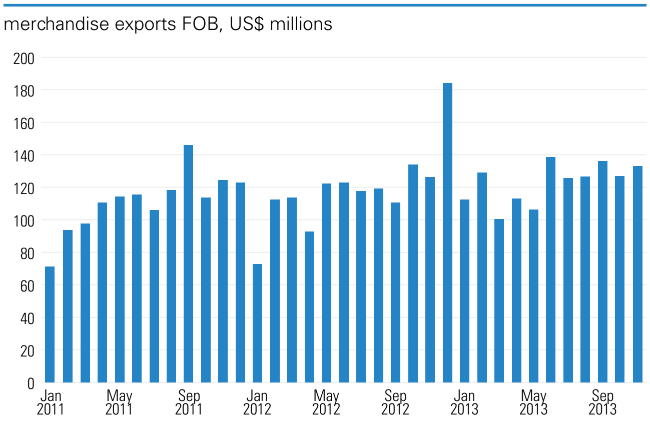
Source: NSS, IMF and Bank staff calculations.

Figure 18. Despite deceleration of economic growth, remittances from Russia are growing at higher rates



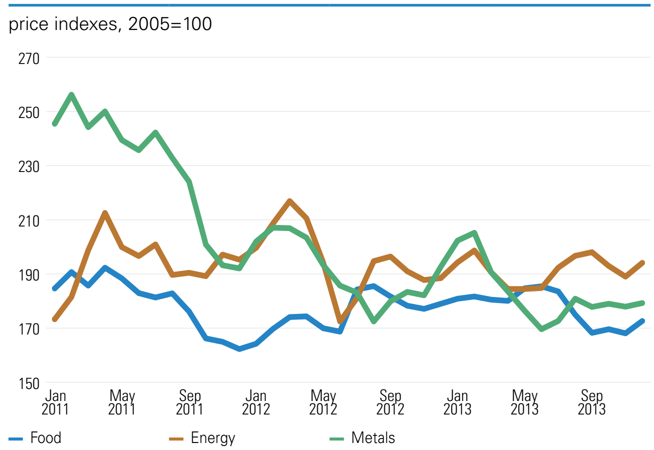
Source: CBA and Bank staff calculations.

Figure 19. Merchandise exports from Armenia remain stable despite slower growth in main trading partners



Source: NSS and Bank staff calculations.

Figure 20. Increase of energy prices and low prices for metals and food may trigger a negative ToT shock



Source: IMF.

6 The incremental capital output ratio (ICOR) measures the marginal amount of investment capital necessary for an entity to generate the next unit of production. Overall, a higher ICOR value is not preferred because it indicates that the entity's production is inefficient.

nominal revenues, while nominal expenditures will remain the same as in the baseline (no cuts in the budget).[7] Table 4 below summarizes key macroeconomic indicators under the baseline and alternative scenarios.

The baseline scenario of the government's medium-term expenditure framework (MTEF) is largely consistent with the GEP report. The baseline scenario is built on the assumption of continued economic recovery in Armenia's major trading partners—Russia, the United States, and the Eurozone—which would support Armenian exports and remittance inflows. The domestic factors underpinning the baseline scenario include the implementation of initiatives following Armenia's export-led industrial development strategy, further improvement of the business environment, and the reduction in the stock of tax credits. The upside risks largely pertain to the pace and success of reforms, while the downside risks relate to developments in the global economy. Thus, the baseline scenario also assumes price stability in global markets, while there is a risk of a negative terms-of-trade shock.

The proper identification of risks and how they are likely to affect the economy, the government's sound policy framework, and the donors' support are all likely to mitigate the impact of any external shock. First of all, the way in which downside risks are likely to impact the economy are different from those identified in the MTEF. Armenia's exports expanded despite lower than expected growth in its partner countries. Also, the deceleration of economic activity in Russia did not negatively affect remittance inflows to Armenia. Inflation returned to a level close to the target (upper bound) by the end of 2013 despite pressure from increased utility tariffs. The government is rebuilding macroeconomic buffers to cushion the economy against any possible external shocks. It has reduced the fiscal deficit significantly since the global financial crisis, and its MTEF envisages reducing the public debt-to-GDP ratio over time. The CBA's flexible inflation targeting regime and the flexible exchange rate are well suited to responding to external shocks, and the level of foreign exchange reserves will be kept at a comfortable level.

7 The SRC will fail to meet nominal target in lower growth environment, unless increase fiscal efforts (share of taxes in GDP)

Appendix

Appendix 1. Economic and Social Indicators—Armenia 2008–2015

Selected indicators	2008	2009	2010	2011	2012	2013e	2014f	2015f
Income and Economic Growth (in percent of GDP unless indicated otherwise)								
GDP growth (percent change)	6.9	-14.1	2.2	4.7	7.2	3.5	5.0	5.0
GDP per capita ($)	3,927	2,907	3,107	3,397	3,331	3,487	3,752	4,110
Private Consumption growth (percent change)	4.5	-5.7	4.6	7.8	9.2	-0.6	2.2	1.5
Gross domestic investment (percent of GDP)	40.9	34.7	32.9	27.3	23.8	22.4	23.1	24.8
Public	5.1	7.0	5.5	4.7	3.3	3.1	3.3	5.0
Private	35.8	27.6	27.3	22.6	20.4	19.3	19.8	19.8
Gross national savings (percent of of GDP)	29.1	18.5	18.1	16.3	12.6	12.8	14.8	17.2
Money and Prices								
Consumer price inflation (percent change, year-end)	5.2	6.5	9.3	4.7	3.1	5.6	2.9	4.0
Consumer price inflation (percent change, annual average)	9.0	3.4	8.1	7.5	2.5	5.7	2.3	4.0
Nominal Exchange Rate (End of period)	307	378	363	386	404	406	408	410
Real Exchange Rate Index (1997=100)	85.2	90.7	90.2	91.1	92.9	,,	,,	,,
Fiscal[a] (in percent of GDP unless indicated otherwise)								
Revenues	21.4	21.5	21.9	22.7	23.1	24.4	24.3	25.2
Expenditures	22.1	29.1	26.9	25.5	24.6	25.4	26.7	27.3
Current	16.0	15.9	16.8	16.0	15.8	19.5	22.4	21.4
Capital	5.1	7.0	5.5	4.7	3.3	3.1	3.3	5.0
Fiscal balance before grants	-1.1	-8.3	-5.9	-4.4	-2.0	-1.2	-2.9	-2.4
Fiscal balance after grants	-0.7	-7.6	-5.0	-2.8	-1.5	-1.0	-2.4	-2.1
External debt (current $ million)	3,052	4,667	5,659	6,496	6,689	6,697	6,626	6,665
External public debt	13.5	34.3	35.6	35.2	37.6	37.5	35.6	34.0
Total public debt	16.3	38.9	41.1	40.7	44.4	44.4	42.9	41.5
External debt service ratio (percent of revenues)	2.2	4.0	4.4	4.6	10.5	33.5	10.0	6.0
External Accounts (in millions of $ unless indicated otherwise)								
Export growth (percent change, constant prices)	-13.1	-10.4	26.5	14.9	5.1	5.6	5.1	6.1
Import growth (percent change, constant prices)	7.3	-19.2	12.8	-2.3	3.8	2.1	5.0	5.0
Merchandise exports	1,112	749	1,175	1,580	1,619	1,737	1,826	1,946
Merchandise imports	-3,776	-2,830	-3,208	-3,658	-3,738	-3,827	-4,019	-4,219
Services, net	-327	-268	-242	-312	-348	-319	-277	-232
Workers' remittances, net	1,823	1,280	1,248	1,615	1,753	1,747	1,876	1,911
Current account balance after grants	-1,382	-1,369	-1,373	-1,108	-1,115	-1,005	-935	-936
as percent of GDP	-11.8	-15.8	-14.8	-10.9	-11.2	-9.6	-8.3	-7.6
Foreign Direct Investment, net (current $ millions)	925	725	562	447	474	391	483	538
Population, Employment and Poverty								
Population (millions)	2.97	2.97	2.98	2.99	2.99	2.99	2.99	3.00
Population growth (percent change)	0.2	0.2	0.2	0.2	0.0	0.0	0.0	0.3
Unemployment rate	16.4	18.7	19.0	18.4	17.3	,,	,,	,,

Poverty headcount (percent of the population)								
At national poverty line	27.6	34.1	35.8	35.0	32.4	,,	,,	,,
At $1.25 a day (PPP)[b]	0.2	0.2	0.5	0.3	0.2	,,	,,	,,
At $2.5 a day (PPP)[b]	12.1	17.4	19.7	17.5	12.2	,,	,,	,,
Gini coefficient (income)	33.9	35.5	36.2	37.1	37.2	,,	,,	,,
Life expectancy (years)	73.5	73.9	74.1	71.0	,,	,,	,,	,,
Other								
GDP (billions of local currency units)	3,568	3,142	3,460	3,778	3,998	4,267	4,559	5,034
GDP (current $, millions)	11,662	8,648	9,260	10,142	9,951	10,417	11,212	12,316
Doing Business Rank	,,	,,	,,	,,	50	40	37	,,
Human Development Index ranking	,,	,,	,,	,,	,,	,,	,,	,,
CPIA (overall rating)	4.4	4.2	4.1	4.1	4.1	,,	,,	,,
Economic Management	5.5	5.0	4.7	4.7	4.7	,,	,,	,,
Structural Policies	4.2	4.2	4.0	4.0	4.2	,,	,,	,,
Social Inclusion and Equity Policies	4.1	4.1	4.1	4.0	4.0	,,	,,	,,
Public Sector Management and Institutions	3.7	3.7	3.7	3.6	3.7	,,	,,	,,

".." indicates data not available

a Consolidated central government

b $1=AMD196.19 (according to PPP valuation of 2005)

This page is intentionally blank.

This page is intentionally blank.

THE WORLD BANK