

Key developments and challenges

The global financial crisis has underlined Armenia's economic dependence on the remittance-financed construction sector. To channel remittances and foreign direct investment (FDI) into a broader group of industries, the business environment needs to be improved through better enforcement of anti-competitive measures and a reduction in the administrative burden on small and medium-sized enterprises (SMEs).

High transportation costs and closed borders with Turkey and Azerbaijan emphasise the need to improve the competitiveness of the tradeable sector and to diversify and upgrade regional transport infrastructure.

The switch to a floating exchange rate and subsequent depreciation of the dram has eliminated the exchange rate misalignment and helped to improve export competitiveness. To further contribute to macroeconomic stabilisation the central bank needs to continue providing the banking system with sufficient liquidity support, including through repo instruments with longer maturities.

Country data

| | |
|---|------|
| Population (in millions) | 3.2 |
| Area ('000 sq km) | 29.8 |
| GDP (in billion US\$, 2008) | 11.9 |
| Average transition score (scale: 1 to 4.33) | 3.18 |

Progress in structural reform

Business environment and competition

Remittances from Russia, previously accounting for about 80 per cent of overall remittance inflows, have declined significantly. The construction sector – the main pillar of economic growth – has suffered the most as a consequence and the need for diversification has become even more pressing. Improving the overall business climate can be an effective means of fostering diversification. The 2008/09 Business Environment and Enterprise Performance Survey (BEEPS IV) identified anti-competitive practices, particularly in the informal sector, and taxes as key impediments to the development of SMEs. While competition policy has limited impact on the informal sector, the government has made some progress in 2009 with simplifying the tax code for SMEs. Tax policy changes include the introduction of a threshold below which enterprises need not register for VAT and ongoing administrative reform to reduce delays in VAT refunds.

Infrastructure

In 2009 Armenia made significant progress in expanding and diversifying its energy infrastructure. In May the Iran-Armenia gas pipeline became operational, allowing both countries to start implementing their substantially increased gas-for-electricity swap programme in which Armenia will import Iranian gas and use it to generate electricity and export part of it back to Iran. This is the first of a number of planned joint Iran-Armenian infrastructure projects forming part of a broader diversification strategy to reduce Armenia's dependency on energy and goods transit through Georgia. An agreement was reached with Turkey in March 2009 that provides for Armenia to export 1.5 billion kWh per year once the electricity grid in eastern Turkey has been upgraded.

The inadequate irrigation network has been one of the most acute problems facing Armenian agriculture since the break-up of the Soviet Union, compounded by under-investment in rural infrastructure. With funding from the Millennium Challenge Account and the World Bank, a large-scale reconstruction project of the canal network started in September 2008. Many rural farmers in the intensively cultivated Ararat valley nevertheless remain without access to an efficient irrigation system.

Financial sector

Although the direct impact of the global financial crisis on Armenian banks has been limited to date, greater economic uncertainty has resulted in banks slowing their lending to the private sector. Annual credit growth slowed to 25 per cent in the first quarter of 2009 from 67 per cent a year earlier. New consumer loans in particular have fallen sharply – by more than 40 per cent year on year by the end of the first quarter 2009 – and mortgage lending has come to a near standstill. The government has reacted by establishing a state mortgage fund, which offers funding to commercial banks at an annual interest rate of 9 per cent for on-lending to households.

The switch to a free-floating exchange rate regime in March 2009 went relatively smoothly and did not adversely affect banking sector stability. After a rapid increase in the volume of US dollar deposits in anticipation of the depreciation, this trend levelled off later in 2009 (at around 65 per cent from only 35 per cent in November 2008) partially undermining the authorities' efforts to increase confidence in the Armenian dram. The depreciation, however, did not trigger a significant outflow of deposits. Non-performing loans as a percentage of gross loans increased from 4.4 per cent at the end of 2008 to 7.6 per cent in March 2009 and to 10.2 per cent in June 2009.

Social sector

The sharp slow-down in economic growth has led to a substantial decline in tax revenues, putting pressure on the government's expenditure plans. The government has ring-fenced part of the 2009 budget to keep the existing social safety net in place and to ensure that progress with poverty alleviation will not be reversed. The government has also signed several multilateral and bilateral agreements (including an International Monetary Fund stand-by facility, additional World Bank funding and a large bilateral loan from Russia) that will enable it to spend more on capital investment. This will target new housing projects (especially in the 1988 earthquake zone) and infrastructure, particularly the rehabilitation of rural roads.

Macroeconomic performance

After several years of double-digit economic growth, the global financial crisis hit Armenia in the final quarter of 2008, moderating real GDP growth to 6.8 per cent for 2008 as a whole. Since then, a significant reduction in external demand and dwindling remittances have further constrained growth, with GDP contracting 16.3 per cent (year on year) in the first half of 2009. The non-tradeable sector – particularly services (diamond processing), retail trade and construction – which has been the main driver of growth, was seriously affected by the crisis, with output declining by over 40 per cent in the first five months of 2009. At the same time, the tradeable sector, particularly manufacturing and agriculture, continues to lag behind in terms of productivity levels.

While trade with Iran has intensified in 2009, the continuing closure of the Turkish and Azerbaijani borders remains a major impediment to Armenian trade flows. Falling prices for base metals over the past year have put additional pressure on Armenia's external position. The move towards a flexible exchange rate and the subsequent 22 per cent depreciation in relation to the US dollar by the end of March have boosted the competitiveness of Armenia's exporters.

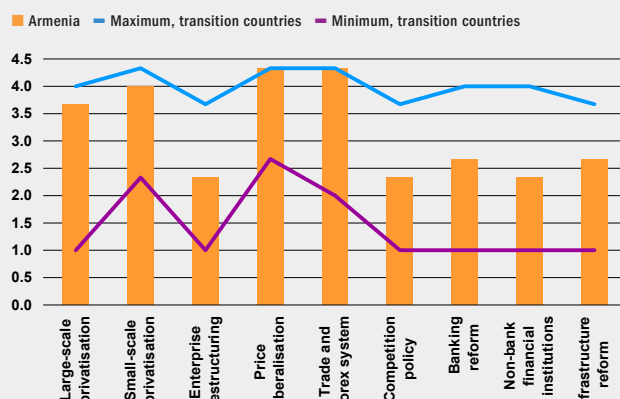
Despite the depreciation, inflation amounted to only 3.5 per cent in August compared with a year earlier and is expected to remain within the central bank's inflation target of 4 per cent (+/- 1.5 per cent) for 2009. Although prices for a number of other imported commodities have fallen, limited competition among commodity importers has meant that only part of these price declines has been passed on to consumers.

Slower growth has resulted in a substantial decline in tax revenues to the government since the beginning of 2009. As a result, the government's expenditure plans have come under pressure and, with the exception of certain categories of social spending, have been either scaled back or postponed. The government was forced to raise the legally allowed maximum budget deficit from 5.0 to 7.5 per cent of GDP for 2009. However, low debt levels and concessional financing terms are helping the country to achieve sustainable medium-term fiscal and external debt.

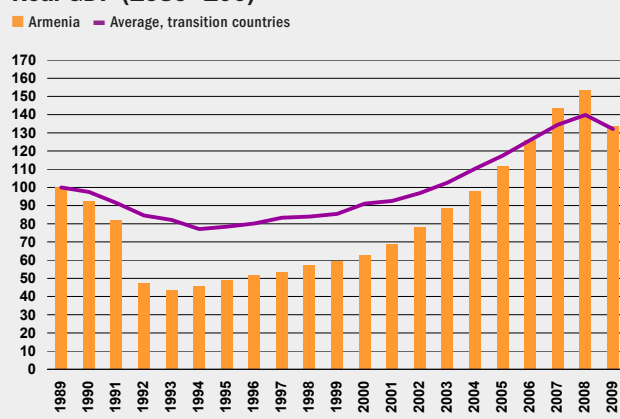
Outlook and risks

Armenia's economy is expected to contract by about 12 per cent in 2009 in the wake of the global economic downturn. However, it is expected to record positive growth in 2010, partly as a result of the significant concessional finance packages from the International Monetary Fund (IMF), the World Bank and Russia. The main risk stems from the possibility of an even more dramatic decline in remittances than already envisaged, combined with a more severe decline in base metal prices and a significant slow-down of FDI. Further improvements in relations with Turkey could, on the other hand, make a significant positive contribution to Armenia's trade balance. Continuing the ambitious pension reform agenda and safeguarding key social expenditure will be the main fiscal challenges in 2010.

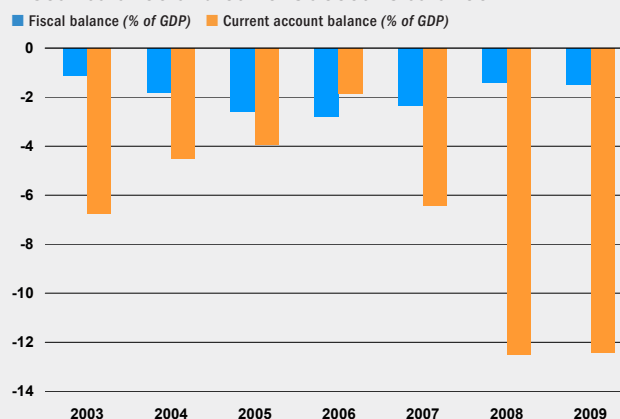
Transition indicators 2009



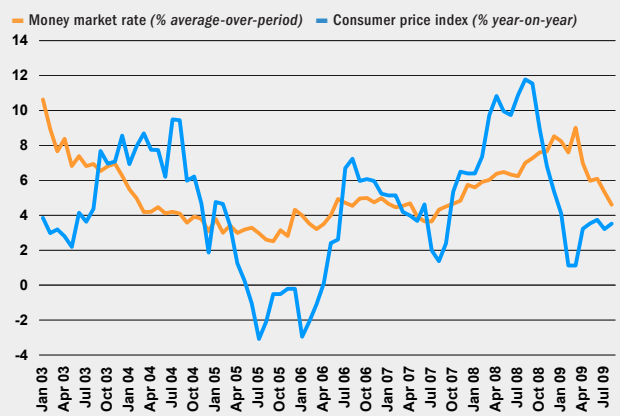
Real GDP (1989=100)



Fiscal balance and current account balance



Interest rates and inflation



| Liberalisation and privatisation | Business environment and competition | Infrastructure | Financial sector | Social reform |
|--|---|--|---|---|
| Current account convertibility - full | Competition office - yes | Telecoms regulatory assessment compliance - medium | Capital adequacy ratio - 12 per cent | Share of population living in poverty - 43.4 per cent (2003) |
| Controls on inward direct investment - no | Quality of insolvency law - medium | Independence of the electricity regulator - partial | Deposit insurance system - yes | Government expenditure on health - 1.5 per cent (2006) |
| Interest rate liberalisation - full | Secured transactions law - under development | Separation of railway infrastructure from operations - no | Private pension funds - no | Government expenditure on education - 2.7 per cent (2006) |
| Exchange rate regime - floating | | Independence of the road directorate - no | | Household expenditure on power and water - 6.8 per cent |
| Wage regulation - no | | | | |
| Tradeability of land - full except foreigners | | | | |

Structural and institutional change indicators

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|--|------------|------------|-------------|-------------|-------------|-------------|------|
| Enterprises | | | | | | | |
| Privatisation revenues (cumulative, in per cent of GDP) ¹ | 10.2 | 10.2 | na | na | na | na | na |
| Private sector share in GDP (in per cent) | 70.0 | 75.0 | 75.0 | 75.0 | 75.0 | 75.0 | 75.0 |
| Private sector share in employment (in per cent) | 76.0 | na | na | na | na | na | na |
| Budgetary subsidies and current transfers (in per cent of GDP) | 0.9 | 1.0 | 0.6 | na | na | na | na |
| Share of industry in total employment (in per cent) | na | na | na | na | na | na | na |
| Change in labour productivity in industry (in per cent) | na | na | na | na | na | na | na |
| Investment/GDP (in per cent) | 24.2 | 22.0 | 23.2 | na | na | na | na |
| <i>EBRD index of small-scale privatisation</i> | 3.7 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| <i>EBRD index of large-scale privatisation</i> | 3.3 | 3.3 | 3.7 | 3.7 | 3.7 | 3.7 | 3.7 |
| <i>EBRD index of enterprise reform</i> | 2.3 | 2.3 | 2.3 | 2.3 | 2.3 | 2.3 | 2.3 |
| Markets and trade | | | | | | | |
| Share of administered prices in CPI (in per cent) | 8.7 | 8.0 | 8.0 | 8.1 | 8.1 | 8.1 | na |
| Number of goods with administered prices in EBRD-15 basket | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | na |
| Share of trade with non-transition countries (in per cent) | 77.0 | 73.6 | 69.3 | 59.5 | 58.2 | na | na |
| Share of trade in GDP (in per cent) | 65.1 | 54.1 | 53.0 | 46.1 | 43.4 | 40.7 | na |
| Tariff revenues (in per cent of imports) | 1.6 | 2.0 | 2.3 | na | na | na | na |
| <i>EBRD index of price liberalisation</i> | 4.3 | 4.3 | 4.3 | 4.3 | 4.3 | 4.3 | 4.3 |
| <i>EBRD index of forex and trade liberalisation</i> | 4.3 | 4.3 | 4.3 | 4.3 | 4.3 | 4.3 | 4.3 |
| <i>EBRD index of competition policy</i> | 2.0 | 2.0 | 2.3 | 2.3 | 2.3 | 2.3 | 2.3 |
| Financial sector | | | | | | | |
| Number of banks (foreign-owned) | 19 (9) | 20 (9) | 21 (9) | 21 (10) | 22 (12) | 22 (12) | na |
| Asset share of state-owned banks (in per cent) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | na |
| Asset share of foreign-owned banks (in per cent) | 51.3 | 56.7 | 48.7 | 45.8 | 49.0 | 50.5 | na |
| Non-performing loans (in per cent of total loans) | 4.9 | 2.1 | 2.1 | 2.6 | 2.5 | 4.4 | na |
| Domestic credit to private sector (in per cent of GDP) | 6.0 | 7.2 | 8.1 | 8.7 | na | na | na |
| Domestic credit to households (in per cent of GDP) | 2.1 | 2.9 | 3.6 | 4.5 | 7.1 | 9.1 | na |
| - Of which mortgage lending (in per cent of GDP) | na | na | 0.5 | 0.9 | 1.7 | 2.3 | na |
| Stock market capitalisation (in per cent of GDP) | 1.0 | 0.5 | 0.9 | 0.8 | 1.0 | 1.4 | na |
| Stock trading volume (in per cent of market capitalisation) | 2.9 | 7.0 | 3.6 | 9.4 | 5.5 | 0.6 | na |
| Eurobond issuance (in per cent of GDP) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | na |
| <i>EBRD index of banking sector reform</i> | 2.3 | 2.3 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 |
| <i>EBRD index of reform of non-bank financial institutions</i> | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.3 | 2.3 |
| Infrastructure | | | | | | | |
| Fixed-line (mobile) penetration rate (per 100 inhabitants) | 18.4 (3.7) | 18.9 (6.6) | 19.4 (10.4) | 19.4 (41.1) | 19.4 (61.1) | 19.4 (61.1) | na |
| Internet users (per 100 inhabitants) | 4.6 | 4.9 | 5.3 | 5.6 | 5.6 | 5.6 | na |
| Railway labour productivity (1989=100) | 23.5 | 29.1 | 26.9 | 27.6 | 34.6 | 31.5 | na |
| Residential electricity tariffs (USc kWh) | 4.3 | 4.6 | 5.4 | 5.9 | 7.1 | 7.9 | na |
| Average collection rate, electricity (in per cent) | 96 | 96 | 102 | 99 | 99 | 101 | na |
| GDP per unit of energy use (PPP in US dollars per kgoe) | 4.7 | 5.0 | 4.9 | na | na | na | na |
| <i>EBRD index of infrastructure reform</i> | 2.3 | 2.3 | 2.3 | 2.3 | 2.3 | 2.7 | 2.7 |
| - <i>Electric power</i> | 3.3 | 3.3 | 3.3 | 3.3 | 3.3 | 3.3 | 3.3 |
| - <i>Railways</i> | 2.0 | 2.0 | 2.0 | 2.0 | 2.0 | 2.3 | 2.3 |
| - <i>Roads</i> | 2.3 | 2.3 | 2.3 | 2.3 | 2.3 | 2.3 | 2.3 |
| - <i>Telecommunications</i> | 2.3 | 2.3 | 2.3 | 2.7 | 2.7 | 3.0 | 3.0 |
| - <i>Water and wastewater</i> | 2.0 | 2.0 | 2.0 | 2.0 | 2.3 | 2.3 | 2.3 |

¹ Privatisation proceeds are in principle to finance fiscal deficits only. The part saved in the Special Privatisation Accounts is not included.

Macroeconomic indicators

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 Estimate | 2009 Projection |
|--|---|---------|---------|---------|----------|------------------|--------------------|
| Output and expenditure | <i>(Percentage change in real terms)</i> | | | | | | |
| GDP | 13.9 | 10.1 | 14.0 | 13.2 | 13.8 | 6.8 | -12.9 |
| Private consumption | 11.5 | 16.3 | 7.6 | 13.3 | 16.1 | 10.6 | na |
| – Public consumption | 21.9 | 17.0 | 21.9 | 13.3 | 24.2 | 13.7 | na |
| – Gross fixed capital formation | 30.0 | 21.9 | 46.8 | 41.2 | 21.3 | na | na |
| – Exports of goods and services | 30.6 | 0.0 | 23.7 | 6.7 | 17.6 | -3.0 | na |
| – Imports of goods and services | 28.1 | -1.1 | 20.6 | 19.4 | 41.5 | 30.3 | na |
| Industrial gross output | 15.3 | 2.1 | 7.5 | -0.9 | 2.6 | 2.0 | na |
| Agricultural gross output | 4.0 | 14.5 | 11.2 | 0.4 | 9.6 | 1.3 | na |
| Employment | <i>(Percentage change)</i> | | | | | | |
| Labour force (end-year) | -0.6 | -0.5 | 0.6 | 0.5 | -8.8 | na | na |
| Employment (end-year) | 0.5 | -4.6 | 2.6 | -0.3 | 0.1 | na | na |
| | <i>(In per cent of labour force)</i> | | | | | | |
| Unemployment (annual average) ¹ | 10.1 | 9.7 | 7.9 | 7.2 | 7.1 | 6.3 | na |
| Prices and wages | <i>(Percentage change)</i> | | | | | | |
| Consumer prices (annual average) | 4.7 | 7.0 | 0.6 | 2.9 | 4.4 | 9.0 | 3.0 |
| Consumer prices (end-year) | 8.6 | 1.9 | -0.2 | 5.2 | 6.6 | 5.2 | 3.7 |
| Producer prices (annual average) | 8.9 | -13.3 | 7.7 | 0.9 | 0.6 | 2.2 | na |
| Producer prices (end-year) | 21.1 | 25.3 | -4.0 | na | na | na | na |
| Gross average monthly earnings in economy (annual average) | 26.7 | 23.7 | 23.9 | 22.9 | 20.9 | 17.6 | na |
| Government sector² | <i>(In per cent of GDP)</i> | | | | | | |
| General government balance | -1.1 | -1.8 | -2.6 | -2.8 | -2.3 | -1.4 | -1.5 |
| General government expenditure | 18.9 | 17.1 | 17.6 | 20.0 | 22.4 | 21.7 | na |
| General government debt | 40.9 | 51.5 | 39.7 | 34.3 | 20.5 | 20.0 | na |
| Monetary sector | <i>(Percentage change)</i> | | | | | | |
| Broad money (M2, end-year) | 10.4 | 22.3 | 27.8 | 32.9 | 42.3 | -1.2 | na |
| Domestic credit (end-year) | -10.1 | 41.2 | 54.6 | 8.7 | 78.4 | na | na |
| | <i>(In per cent of GDP)</i> | | | | | | |
| Broad money (M2, end-year) | 14.4 | 15.0 | 16.3 | 18.3 | 22.0 | 18.7 | na |
| Interest and exchange rates | <i>(In per cent per annum, end-year)</i> | | | | | | |
| Refinancing rate | 7.0 | 3.8 | 3.5 | 4.1 | 4.8 | 4.5 | na |
| Money market rate | 7.5 | 4.2 | 3.2 | na | 5.1 | na | na |
| Deposit rate | 6.9 | 4.9 | 5.8 | na | 6.2 | na | na |
| Lending rate | 20.8 | 18.6 | 18.0 | 16.5 | 17.5 | 16.5 | na |
| | <i>(Drams per US dollar)</i> | | | | | | |
| Exchange rate (end-year) | 566.0 | 486.3 | 450.2 | 363.5 | 304.2 | 299.1 | na |
| Exchange rate (annual average) | 578.8 | 533.5 | 457.8 | 416.0 | 342.1 | 304.1 | na |
| External sector | <i>(In millions of US dollars)</i> | | | | | | |
| Current account | -189.4 | -161.7 | -193.1 | -117.0 | -589.0 | -1,499.0 | -1,229.0 |
| Trade balance | -434.1 | -457.9 | -588.0 | -896.0 | -1,600.0 | -2,649.0 | -2,160.0 |
| – Merchandise exports | 696.1 | 738.3 | 1,005.0 | 1,025.0 | 1,197.0 | 1,118.0 | 815.0 |
| – Merchandise imports | 1,130.2 | 1,196.3 | 1,593.0 | 1,921.0 | 2,797.0 | 3,767.0 | 2,975.0 |
| Foreign direct investment, net | 121.0 | 217.0 | 252.0 | 450.0 | 701.0 | 784.0 | 488.0 |
| Gross reserves, excluding gold (end-year) | 502.0 | 547.8 | 669.5 | 1,071.9 | 1,659.0 | 1,405.0 | na |
| External debt stock | 1,788.1 | 1,868.0 | 1,860.2 | 2,052.7 | 2,200.0 | na | na |
| | <i>(In months of imports of goods and services)</i> | | | | | | |
| Gross reserves, excluding gold (end-year) | 4.3 | 4.3 | 4.0 | 5.1 | 5.5 | 3.6 | na |
| | <i>(In per cent of exports of goods and services)</i> | | | | | | |
| Debt service | 15.6 | 9.7 | 4.6 | 3.9 | 2.9 | na | na |
| Memorandum items | <i>(Denominations as indicated)</i> | | | | | | |
| Population (end-year, million) | 3.2 | 3.2 | 3.2 | 3.2 | 3.2 | 3.2 | na |
| GDP (in billions of drams) | 1,624.6 | 1,907.9 | 2,244.0 | 2,656.0 | 3,149.0 | 3,650.0 | 3,757.0 |
| GDP per capita (in US dollars) | 873.9 | 1,112.8 | 1,510.0 | 1,982.6 | 2,850.0 | 3,707.9 | na |
| Share of industry in GDP (in per cent) | 19.9 | 19.7 | na | na | na | na | na |
| Share of agriculture in GDP (in per cent) | 21.3 | 22.5 | na | na | na | na | na |
| Current account/GDP (in per cent) | -6.7 | -4.5 | -3.9 | -1.8 | -6.4 | -12.5 | -12.4 |
| External debt – reserves (in US\$ million) | 1,286.1 | 1,320.2 | 1,190.7 | 980.7 | 541.0 | na | na |
| External debt/GDP (in per cent) | 63.7 | 52.2 | 38.0 | 32.2 | 23.9 | na | na |
| External debt/exports of goods and services (in per cent) | 197.9 | 189.7 | 139.1 | 135.9 | 123.8 | na | na |

¹ Registered unemployed only.

² Central government account only.