EFSD Eurasian Fund for Stabilization and Development

# Republic of Armenia

## Social and economic development in 2020 and medium-term prospective*

March 2021

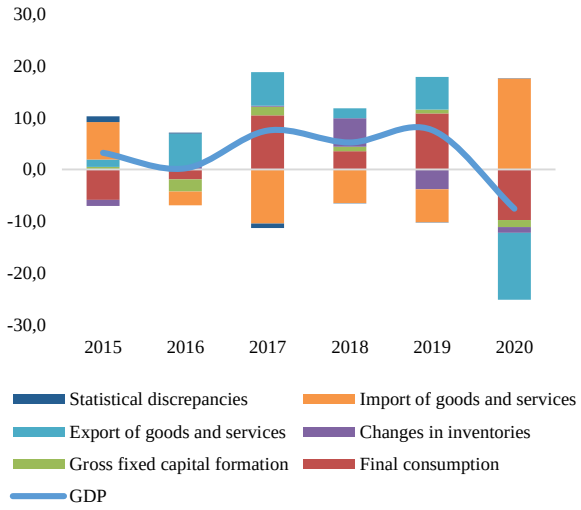
*This Note was prepared by the Financial Credit Project Group, EFSD Project Unit, Eurasian Development Bank, including: Tigran Kostanyan (Acting Director of the Financial Credit Group), Natalia Pisareva (Head of the Budget Sector), Elvira Kurmanalieva (Leading Expert), Pavel Biryukov (Leading Specialist), Anatoly Trifonov (Leading Specialist), Alexandr Yanyshkevich (Leading Specialist), Dinara Sholanova (Senior Specialist). The Group gratefully acknowledges the comments provided by Sergei Ulatov (Advisor to the EFSD Project Unit) and the team of the EFSD Chief Economist. The Note was prepared by Pavel Biryukov.

## REPUBLIC OF ARMENIA: SOCIAL AND ECONOMIC TRENDS IN 2020

### *Real Sector and Labour Market*

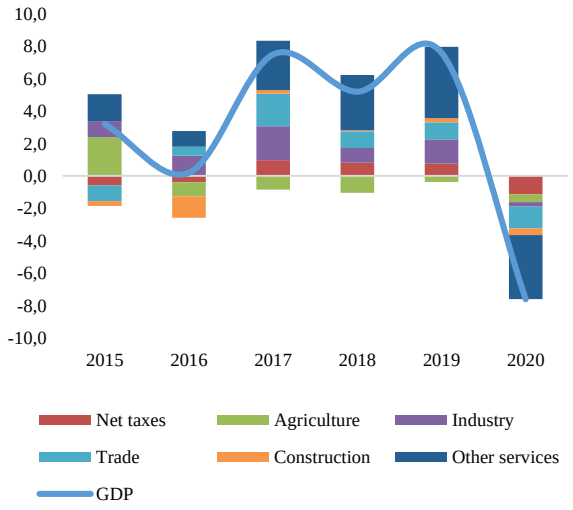
**The COVID-19 pandemic and the Nagorno-Karabakh military conflict had a significant negative impact on the economic activities in the Republic of Armenia.** In 2020, the real GDP dropped by 7.6 percent compared to its growth by 7.6 percent a year earlier (Figure 1). The contribution of final consumption to the GDP growth was negative in the amount of 9.8 p.p. due to lower real wages in certain sectors of the economy, lower inflows of remittances, and propensity to consume because of increased uncertainty. The introduction of restrictive measures in the first half of the year and increased political tensions had additional negative impacts on the evolution of investment demand, resulting in a negative contribution of the gross capital formation of 2.4 p.p. Housing construction, manufacturing, and services experienced the largest drop in investments. The key factors behind the contribution of exports declining by 12.9 p.p. were weaker economic growth in the trading partner countries and AMD real effective exchange rate appreciation by 1.6 percent, as well as a significant decline in tourism exports because of the restrictions related to the lockdown and practically full suspension of air traffic to and from other countries. In terms of sectors, a negative contribution to the GDP growth was recorded in case of all sectors of the economy, particularly in services (-4 p.p.) and trade (-1.3 p.p.) (Figure 2).

**Figure 1.** *Contribution to GDP growth, by expenditure components (p.p., y-o-y)*




*Source: Armstat*

**Figure 2.** *Contribution to GDP growth, by production components (p.p., y-o-y)*




*Source: Armstat*

**The weaker economic activity affected the labour market performance slightly *inter alia* owing to state support of the sectors most affected by the pandemic.** In 2020, the rate of employment growth slowed down to 4.3 percent from 7.5 percent a year earlier. The relative contribution of trade and industry decreased, amounting to 2.5 p.p. compared to 5 p.p. a year earlier. Despite some measures to support employment, there was mounting pressure on the labour market in Armenia due to lower labour migration: according to the Ministry of Internal Affairs of the Russian Federation, the number of labour migrants from the Republic of Armenia went down by 29.6 percent in one year. In 2020, the rate of growth of real wages of employees slowed down by 2.4 percent in contrast to an increase of 4.2 percent a year earlier. At the same time, if there has

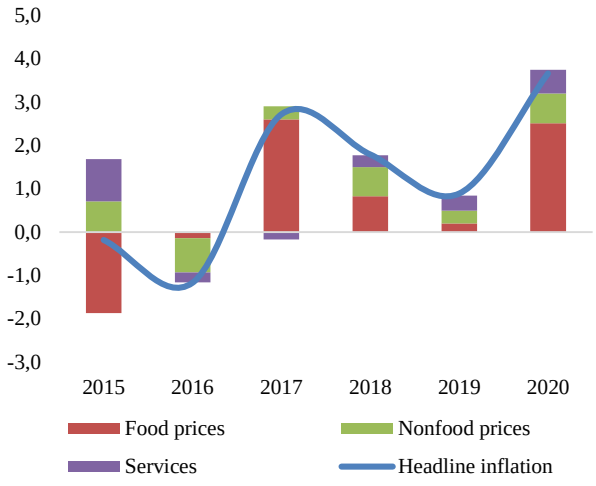
been a slowdown in the trade and service sectors, the contribution of the tradeable sectors will be negative for the year.

### *Inflation and Monetary Policy*

**In 2020, the inflation accelerated because of a rise in world prices in commodity markets and the AMD exchange rate depreciation in the second half of the year** (Figure 3). In December, the 12-month inflation was 3.7 percent compared to 0.9 percent in 2019, mainly due to a higher contribution of prices for food products (2.5 p.p., up from 0.2 p.p.). Under these circumstances, the core inflation rate also accelerated, making 3.7 percent (against 0.7 percent). Amid the acceleration of inflation, the Central Bank of Armenia sharply raised the refinancing rate in December by 100 basis points to 5.25 percent per annum. At the same time, the monetary policy stance remained relatively relaxed compared to the beginning of the year in view of a reduction of the real interest rate. It is worth noting that during the year, due to persistently weak domestic demand, the Central Bank reduced the refinancing rate four times, in aggregate by 125 basis points.

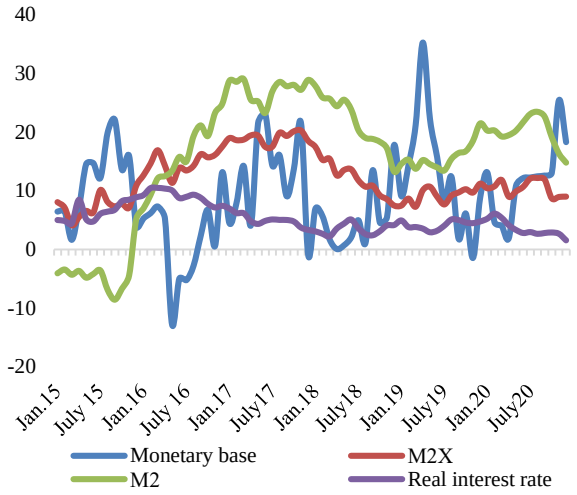
**The imposition of martial law resulted in a slowdown in money supply growth rates**. The broad money supply growth was 9 percent in December compared to 11.2 percent a year earlier (Figure 4). At the same time, until October 2020, the money supply grew at an accelerated pace relative to the previous year, by about 12 percent in annual terms, which was explained by the expansionary monetary policy. However, due to the negative impact of the military operations, the banking system faced a slowdown in its lending and deposit activities at the end of the year. Thus, the growth of local currency deposits slowed down to 9.6 percent (against 28.5 percent), and that of loans to the economy – to 14.3 percent (18.5 percent). The base money growth accelerated to 18.3 percent from 8.8 percent a year earlier. The main driver of the base money growth was the growth of lending to commercial banks. However, the base money growth was partly contained through interventions in the form of foreign exchange sales, which amounted to US $147 million for the year on a net basis. The fact that the rate of base money growth outpaced that of money supply indicates weaker efficiency of the monetary policy credit channel.

**Figure 3.** *Inflation (percent, y-o-y, end of period)*




*Source: CB RA, Armstat*

**Figure 4.** *Monetary indicators (in percent)*




*Source: Armstat*

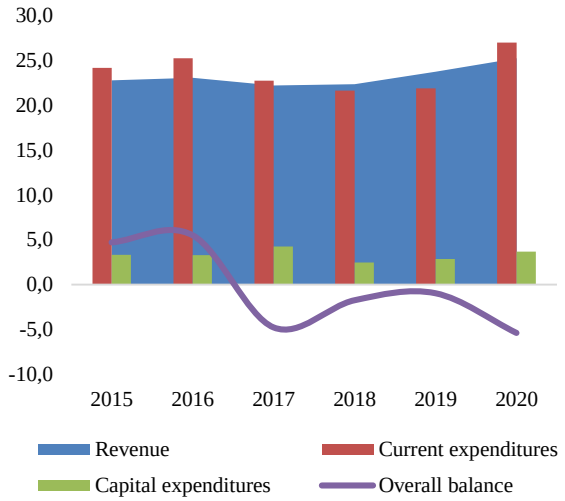
### *Fiscal Sector and Public Debt Sustainability*

**The significant weakening of the economic activity, which resulted in lower tax revenues, and growth of budget expenditures to support households and the economy led to a deterioration of the fiscal position.** In 2020, the budget deficit expanded to 5.4 percent of GDP,

compared with a deficit of 1 percent of GDP a year earlier. The total revenues and grants[1] decreased to 25.2 percent of GDP from 25.8 percent of GDP in 2019 solely due to falling tax revenues. Revenues were lower under all types of taxes, with the most significant decline recorded for the profit tax (-1.2 p.p.), VAT (-0.1 p.p.), and income tax (-0.1 p.p.). At the same time, non-tax revenues increased significantly, mainly due to voluntary transfers and interest incomes (+0.7 p.p.) and grants from international and bilateral donors (+0.7 p.p.). Against this background, the share of tax revenues in the formation of the total revenues and grants decreased over the year from 94 percent to 89 percent. The expenditure part of the budget expanded to 30.6 percent from 24.7 percent of GDP in 2019[2]. Current expenditures showed the most significant growth (+5.1 p.p.) due to increased funding under all expenditure items, including social payments and transfers (+2.8 p.p.) and other expenditures (+1.6 p.p.). The resumption of the implementation of investment projects contributed to an increase in capital spending funding to 3.7 percent of GDP from 2.5 percent of GDP a year earlier.

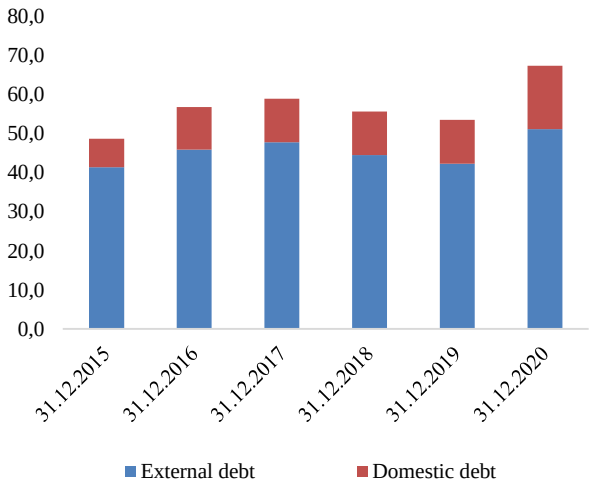
**The budget deficit expanded mainly due to significant growth of the public debt.** In 2020, the public debt amounted to 67.3 percent of GDP, up by 13.9 p.p. since the beginning of the year. The domestic debt increased by 35.8 percent in nominal terms, thus, its share relative to GDP increased by 5 p.p. to 16.2 percent. The foreign debt rose by 14 percent, with its share relative to GDP rising by 8.9 p.p. to 51.2 percent of GDP, *inter alia* due to the AMD depreciation.

**Figure 5.** *State budget (percent of GDP)*




*Source: MF RA*

**Figure 6.** *Public debt (percent of GDP)*




*Source: MF RA*

### *External Sector*

**The declining trade deficit resulted in lower current account deficit.** According to EFSD estimates, the CA deficit amounted to 5 percent of GDP in 2020, compared to 7.2 percent of GDP in 2019 (Figure 7). Lower physical volumes of imports, combined with compressed consumer and investment demand, contributed to lower trade deficit, down to 11.6 percent from 13.4 percent of GDP a year earlier. Imports of durable goods, precious stones and metals—the raw materials for the jewellery industry, which faced lower output and exports in the context of the pandemic—declined the most. Despite an improvement in the terms of trade due to significant

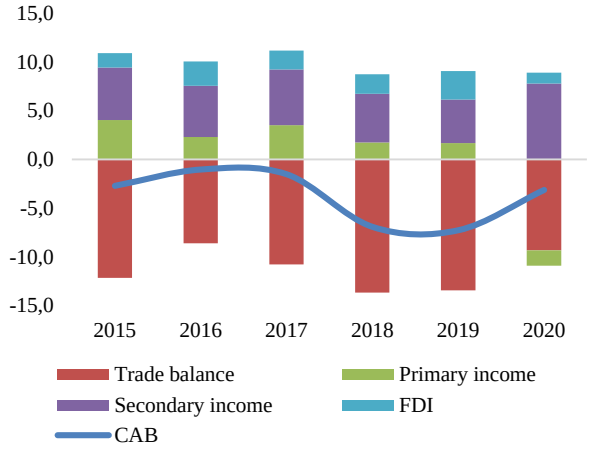
[1] Net of the amount of tax rebates and VAT refunds for exports, which are reflected in tax revenues with a negative sign. As at end-2019, this item was 2.1 percent of GDP, while as at end-2020, it made 0.01 percent of GDP

[2] The highest rate since 2009

acceleration of the export price growth in the second half of the year, exports decreased in value terms because of lower physical volumes of exports of goods and a significant drop in tourism exports. Exports of gems, metals, and finished food fell the most. Despite restrictions on migration flows in 2020, remittances to Armenia decreased by only 6 percent, as a significant decrease in remittances by labour migrants from Russia (-21.9 percent) was offset by a sharp increase in cash inflows from the Armenian diaspora in other countries, in particular from the United States – by 63.3 percent.

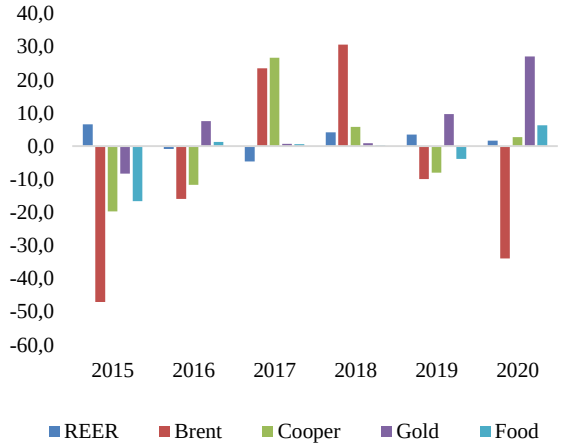
**The CA deficit was financed by inflows of foreign direct investments and a draw down on the gross international reserves (GIR).** The FDI inflows decreased to 1.2 percent in 2020 from 1.9 percent of GDP in the previous year, with the reinvested funds making 50 percent. At the same time, the GIR decreased by US $236 million (-8.3 percent). Despite the decline in reserves in absolute terms, their adequacy in months of imports of goods and services increased, reaching 5.9 months due to a significant decrease in imports in 2020.

**Figure 7.** *Balance of payments (percent, y-o-y)*




*Source: CB RA, EFSD estimations*

**Figure 8.** *Terms of trade (in percent, y-o-y)*



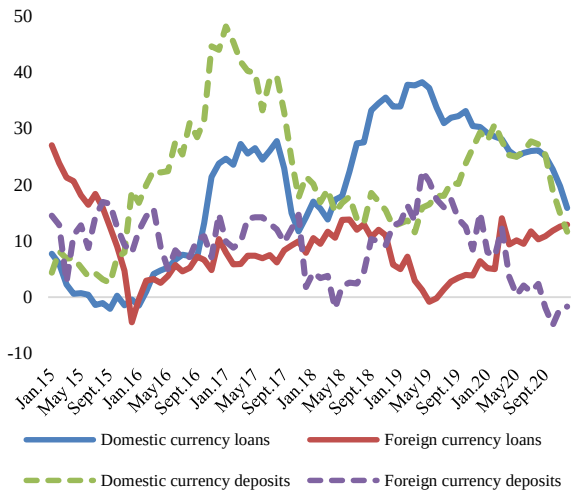

*Source: CA RA, WB*

### *Financial Sector*

**The growth rate of the loan portfolio and the deposit base declined despite the expansionary monetary policy.** The annual growth of the loan portfolio in 2020 decreased from 16.7 percent to 14.5 percent. While in recent years, the key driver of growth was lending to households, including mortgage loans, the main contribution to growth in 2020 was made by legal entities, and that of households decreased from 11.6 p.p. to 4.3 p.p. The demand of households dropped mainly in the part of consumer loans, while mortgage loans remain one of the most dynamically growing areas of lending (contribution to growth of 3.8 p.p.), second only to lending to industry (contribution to growth of 4.7 p.p.). The deposit base growth slowed down even more, from 20.7 percent in 2019 to 3.9 percent in 2020. The key driver of its growth was local currency deposits of households (contribution to growth of 1.7 p.p.).

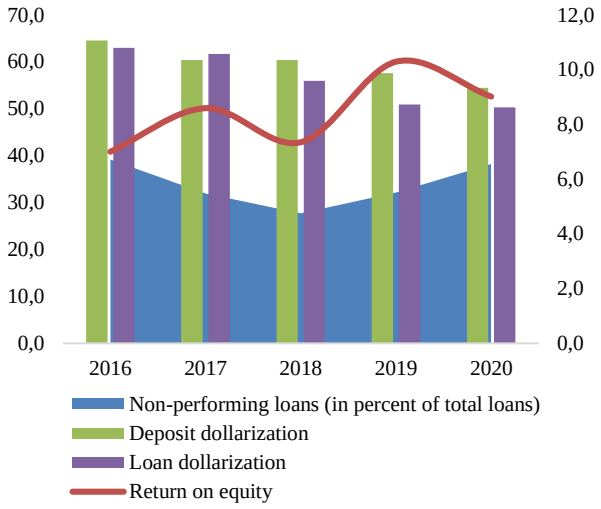
**The performance of the banking system deteriorated somewhat**. Banks faced lower profits in 2020 that led to a decrease in their return on equity (from 10.3 percent to 9 percent) and return on assets (from 1.5 percent to 1.3 percent). The bank capital adequacy ratio fell from 17.6 to 16.9, and the share of bad loans rose from 5.5 percent to 6.6 percent. It should be noted that most of these indicators deteriorated in Q4 2020 because of the outbreak of hostilities. Nevertheless, despite some deterioration in their evolution, the key macroprudential indicators reflect the resilience of the banking system to the crisis developments.

**Figure 9.** *Bank lending (in percent, y-o-y)*




*Source: CA RA*

**Figure 10.** *Banking sector indicators (in percent)*




*Source: CB RA*

### *Medium-Term Prospects*

**Under the baseline scenario, the medium-term recovery of economic activity would be slow due to the continued high uncertainty about further political developments in the country and the consequences of the military operations.** The EFSD Project Unit estimates the GDP growth in 2021 at 2 percent, while this scenario is dominated by downward risks. A key driver of the growth would be consumer activity, supported by a recovery in remittance inflows from Russia, after the restrictive measures are lifted in both countries. At the same time, the investment demand would remain weak, because of continued high uncertainty for doing business amid the political tensions. The recovery of external demand would support exports, however, their growth would be constrained by the factors that slow down the recovery of agriculture, gold and copper mining, *inter alia* in view of the circumstances resulting from the military operations, as well as the weak recovery of tourism exports. Given these circumstances, the baseline scenario assumes that the real GDP would not return to the pre-crisis level before 2023 as the economy adapts to the new conditions.

**The monetary policy is expected to be aimed at keeping the inflation at the targeted level in the medium term.** In 2021, against the backdrop of continued weak economic activity, the monetary policy would remain expansionary. At the same time, as the economic growth recovers, the monetary authorities are expected to gradually reduce the expansionary nature of their monetary policy, which would help the inflation settle at the targeted level of 4 percent in the medium term.

**The need for further support of households and the economy would necessitate persistently high spending and budget deficits**. The baseline scenario assumes that the costs of supporting households, the health sector, and the economy, *inter alia* due to the hostilities, would remain high throughout the forecast period. The average budget deficit would be 4.4 percent of GDP.

Weak economic growth and continued high budget deficit in 2021 would result in an increase in the public debt to 69.2 percent of GDP. The key driver of the debt growth would be the budget deficit explaining 72 percent of the increase. In the medium term, subject to a gradual reduction of the budget deficit and the annual growth of the economy averaging at of 3.5 percent, the public debt would decrease annually by 0.5 p.p. to 67.5 percent of GDP in 2024.

**Amid the recovery developments in the economy, the current account deficit would expand slightly in 2021, amounting to 6.6 percent of GDP.** The volumes of imports exceeding

those of exports will be a key driver of the current account deficit growth. However, the projected recovery of remittance inflows from Russia would have a positive effect on the current account. In future, as exports of goods and services are expected to increase, the CA deficit would decrease to 5.8 percent in 2024. As a result, the reserve adequacy would remain at an acceptable level of about 4 months of imports.

***Risks under the Outlook***

1. **Slower recovery of the economy of trading partner countries, above all that of Russia.**

A slow recovery of the economies of trading partners, *inter alia* because of slower growth of the world economy and commodity prices, would have a deterrent effect on the pace of economic growth recovery in Armenia, working through the channels of trade, investment, and remittances. This would result in a drop in budget revenues, which, along with continued high budget expenditures, would push the budget deficit and its financing needs up.

2. **A deterioration of the epidemic situation in the country (the third wave of the pandemic).**

Uncertainty about the duration of the pandemic and anti-epidemic measures may lead to further weakening of the consumer activity. If maintained for a long time, this situation would pose additional risks to the potential medium-term economic growth.

3. **Mounting domestic political tensions.**

Following the military conflict, the domestic political tensions remain high, which may affect the pace of recovery of the domestic demand and investment activity.

**Table 1. Republic of Armenia: Key macroeconomic indicators and medium-term prospective**

| | Actual | Forecast | | | |
|---|---|---|---|---|---|
| | 2020 | 2021 | 2022 | 2023 | 2024 |
| **National accounts and prices, %** | | | | | |
| Real GDP growth | -7,6 | 2,0 | 3,6 | 4,0 | 4,3 |
| GDP deflator | 1,9 | 3,7 | 3,8 | 3,9 | 3,9 |
| CPI (average, y-o-y) | 1,3 | 3,4 | 3,8 | 4,0 | 4,0 |
| **Money and credit, %** | | | | | |
| Broad money growth | 9,0 | 14,5 | 7,5 | 8 | 8,3 |
| Key interest rate | 5,25 | 5,5 | 5,5 | 5,5 | 5,5 |
| **Public finance (as % of GDP)** | | | | | |
| Revenue and grants | 25,2 | 23,6 | 23,7 | 23,7 | 23,7 |
| Of which: tax revenue | 22,4 | 22,3 | 22,4 | 22,4 | 22,4 |
| Expenditure | 30,6 | 28,3 | 28,2 | 28,1 | 27,8 |
| Balance | -5,4 | -4,7 | -4,5 | -4,4 | -4,2 |
| Public debt | | | | | |
| **External sector (as % of GDP)** | | | | | |
| Current account balance | -5,0 | -6,6 | -6,1 | -5,9 | -5,8 |
| Exports of goods and services | 30,7 | 34,3 | 34 | 34,2 | 33,8 |
| Imports of goods and services | 42,2 | 47,8 | 47,2 | 46,8 | 45,8 |
| Foreign direct investments | 2,3 | 2,4 | 2,4 | 2,0 | 1,8 |
| Gross international reserves, in months of imports of goods and services | 5,9 | 4,5 | 4,0 | 4,0 | 4,0 |

*Sources: Armstat, CBA, MoF RA, EFSD estimations*

**BOX 1. MEDIUM-TERM PRIORITIES OF STRUCTURAL AND INSTITUTIONAL REFORMS IN THE REPUBLIC OF ARMENIA**

**Despite the high rates of economic growth in Armenia before the pandemic, there are significant structural constraints in the economy resulting in high vulnerability of the current growth model to external economic shocks.** The GDP growth acceleration in 2017-2019 to 6.8 percent from 3.5 percent in the previous five-year period was mainly driven by the contribution of domestic demand in the non-tradeable sectors to growth, which led to a lower poverty rate, down to 23.5 percent from 30.7 percent in 2012-2016. However, the weak growth of the tradeable sectors and the small contribution of the poorly diversified exports are explained by the relatively low productivity of the economy, even though it has a substantial share of the private sector. The factors behind the low productivity include a significant share of the shadow sector in the economy against the background of chronically high unemployment, which is structural in its nature. At the same time, the high dependence of the economy on incomes of migrant workers results in its high vulnerability to external shocks. These circumstances, along with infrastructure restrictions, prevent the realisation of the economic potential of the Republic of Armenia and the launch of the creation of competitive jobs.

**Structural and institutional reforms are needed to improve the potential and sustainability of economic growth in the RA**, the main ones including:

(1) Enhanced competitiveness and export capacity.
(2) Improved efficiency of the labour market and reduced informal activity.
(3) The development of the basic and social infrastructure.

**Enhanced competitiveness and export potential can be achieved by improving the productivity in the tradeable sectors,** *inter alia* through private investments, which should be promoted by improving the business environment to support investor confidence. Specific measures in this area can include reducing the barriers to market entry (easing the regulatory burden, facilitating access to finance, improving antitrust laws) and support measures for exporters (strengthening of non-commodity export support mechanisms).

**Better efficiency of the labour market can be achieved through increased labour market participation and the development of the social infrastructure.** The efficiency of the labour market can be improved by changing the composition of demand for labour (stimulating the development of the private sector, facilitating employers' access to skilled labour), and by adjusting the composition of supply in the labour market. The key measures include improving the quality of education services for skilled labour development, including the introduction of re-qualification programmes and the life-long education approach. In addition, improvements in the social infrastructure (better access to social protection services, increased economic opportunities for poor and vulnerable groups) are called for.

**To bridge the infrastructure gaps, best international practices should be introduced, and institutional reforms should be implemented.** The existing level of supply of the basic (logistics, land reclamation, energy supply) and social infrastructure (health, education, and social protection) does not meet the current needs of the economy. To bridge the infrastructure gap, increased funding and institutional changes are needed, which the EFSD will be able to support under a financial credit arrangement. Further consultations with the Government should be held to identify potential areas of cooperation.