REPUBLIC OF ARMENIA

Social and Economic Development in the first half of 2022*

October 2022

*This Note was prepared by the Financial Credit Project Group, EFSD Project Unit, Eurasian Development Bank, including: Tigran Kostanyan (Director of the Financial Credit Project Group), Dinara Sholanova (Leading Specialist), Natalia Pisareva (Head of the Budget Sector), Alexandr Yanushkevich (Chief Specialist), Elvira Kurmanalieva (Leading Expert), Evgeny Zhevnov (Chief Specialist), Liana Harutyunyan (Leading 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.

October 2022

REPUBLIC OF ARMENIA
H1 2022

LIST OF ABBREVIATIONS

Armstat – Statistical Committee of the Republic of Armenia
CA – current account of the balance of payments
CBA – Central Bank of the Republic of Armenia
EAEU – Eurasian Economic Union
EFSD Project Unit – Project Unit of the Eurasian Fund for Stabilization and Development
FDI – foreign direct investment
GDP – gross domestic product
GIR – gross international reserves
ILO – International Labour Organisation
MF RA – Ministry of Finance of the Republic of Armenia
RA – Republic of Armenia
RF – Russian Federation
US – United States of America
VAT – value added tax

In H1 2022, the economic growth in the Republic of Armenia accelerated significantly, driven by both external and domestic demand. The imposition of sanctions against Russia had a substantial positive effect on the economy of the Republic of Armenia through an influx of tourists, expansion of exports of goods, as well as two-fold growth of remittances.
Inflation accelerated significantly, driven by high prices on international commodity markets, as well as stronger domestic demand. Under those conditions, the Central Bank of Armenia tightened the monetary conditions further by raising the refinancing rate on two occasions. The fiscal position improved significantly against the background of high rates of economic growth, as well as actual budget expenditures falling short of budgeted amounts.

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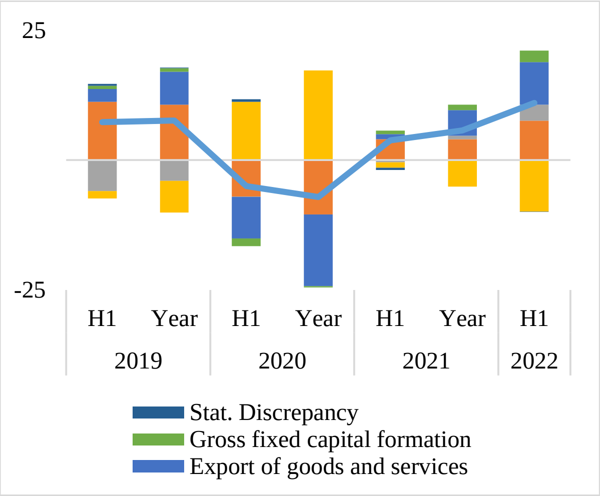
Real Sector and Labour Market

Stronger external and domestic demand contributed to significant acceleration of economic activity in the Republic of Armenia (RA) in H1 2022. In January–June, the real GDP grew by 11% compared to an increase of 3.8% in the corresponding period of the previous year. The imposition of sanctions against the Russian Federation (RF) had a positive effect on the RA economy through an influx of tourists, partial relocation of Russian businesses (in particular in the IT sector), as well as substitution and re-export of goods subject to a ban on import to the RF. Those factors supported a substantial increase in the contribution of exports of goods and services (8.2 p.p.). Consumer demand (a contribution of 7.6 p.p.) was supported by a twofold increase in the inflow of remittances, growth of salaries and wages in the private sector, and spending of household savings. Against the background of an expansion of mortgage lending, housing construction was a driver of investment demand (a contribution of 5.2 p.p.). Investment also increased in the transport and the information and communication sectors. It should be noted that the sources of investment financing in the reporting period were own funds of entities and credit to the economy, while a year earlier it was the state budget.

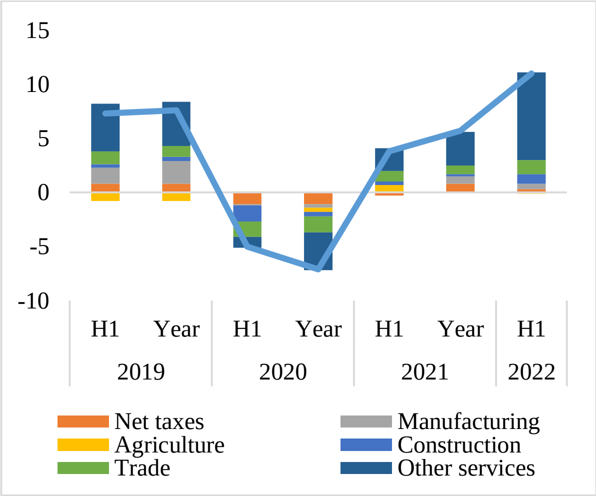
In terms of sectors, a positive effect on the GDP was generated by all sectors of the economy, except for agriculture. The largest growth was registered for the trade and the services sectors, with a combined contribution of 9.4 p.p. The production of the manufacturing industry increased due to stronger domestic and external demand (a contribution of 1.3 p.p.). The largest increase was noted in the production of food products, non-metallic mineral products, non-ferrous metals, and jewellery. The mining industry, however, showed a negative trend in the context of the suspension of work at the Teghut mine.

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

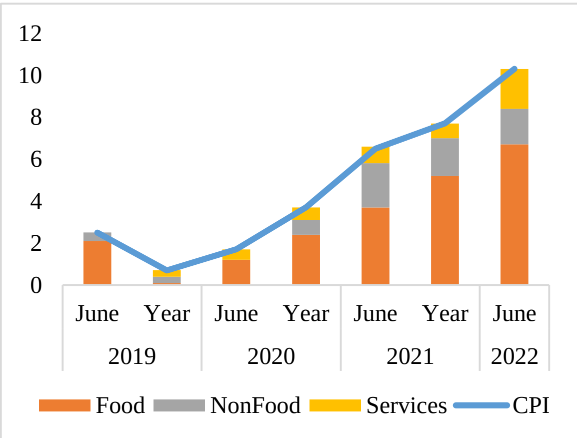
The acceleration of the economic activity had a beneficial effect on the performance of the labour market. In the first half of the year, the number of employed persons increased by 3.3%, which resulted in a lower unemployment rate (calculated based on the ILO methodology) down from 16.7% to 14.8%. The growth rate of nominal wages accelerated from 5.4% to 11.3%, mainly due to the services sector. There were high rates of wage growth registered in the information and communication, wholesale and retail trade, financial, and insurance sectors. Amid the accelerated inflation, the economy-wide real wages grew by 3% – they increased by 4.7% in the private sector and decreased by 3.3% in the public sector.

Inflation and Monetary Policy

In H1 2022, the inflationary pressure remained high due to high prices on international commodity markets, as well as high domestic demand. In June, the 12-month inflation accelerated to 10.3% (compared to an increase of 6.5% a year earlier), remaining above the upper boundary of the target (4±1.5%) set by the Central Bank of the Republic of Armenia (CBA). The acceleration of inflation was driven by growth of prices for food products and services, whose contribution to the consumer price index amounted to 6.7 p.p. (against 3.7 p.p. a year earlier) and 1.9 p.p. (0.7 p.p.), respectively. It was accompanied by appreciation of the Armenian dram by 6.2% over 12 months that led to a lower contribution of prices for non-food products, down to 1.7 p.p. (against 2.1 p.p.). In the context of high domestic demand, the core inflation also accelerated, amounting to 9.4% compared to an increase of 7.8% a year earlier. In view of the persistent inflationary pressure[1], the CBA tightened the monetary conditions further, raising the refinancing rate on two occasions, by a total of 150 basis points to 9.25% per annum.

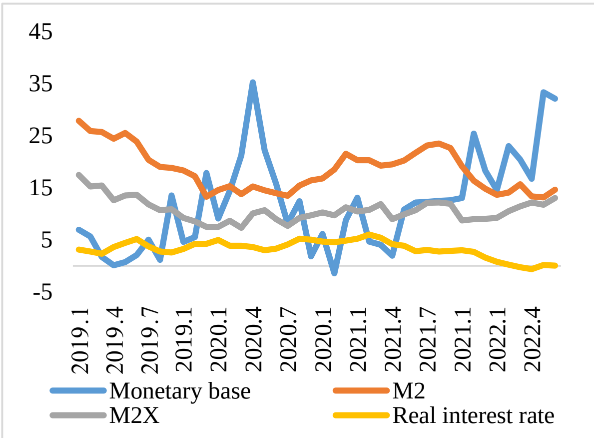
In the environment of the tight monetary conditions, the money supply growth rate slowed down from 13% to 9.2%, despite the accelerated economic activity. The main contributors to the broad money growth were dram term and demand deposits, with the total contribution of 7.3 p.p. (against 5.5 p.p. a year earlier). The decline of the contribution of cash in circulation by 0.4 p.p. (against an increase of 3.7 p.p. a year earlier) had a negative impact. A revaluation of foreign currency assets, as well as growth of Government deposits, led to a slowdown in the base money growth rate to 1.2% (against 32.1% a year earlier). As a result of significant exchange rate appreciation, the contribution of net foreign assets in the dram equivalent was negative at 12.3 p.p. (against an increase of 20.5 p.p. a year earlier) and became the key factor of reserve money growth deceleration[2]. Another constraint was the growth of Government deposits, driven by a budget surplus in the reporting period.

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



Source: Armstat, CBA

Figure 4. *Monetary indicators (in %)*



Source: Armstat, CBA

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[1] The second increase of the interest rate in the reporting period occurred in March 2022 in response to heightened inflationary pressure due to the start of the special military operation in Ukraine.

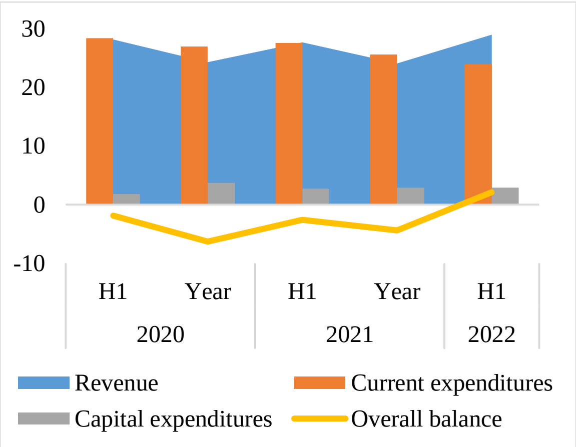
[2] According to the EFSD Project Unit, the net foreign assets increased by 1.3%, leaving the currency revaluation aside.

Budget Sector and Public Debt

High rates of economic growth, as well as actual budget expenditures falling short of budgeted amounts, contributed to a significant improvement in the fiscal position. In the first half of the year, the state budget was executed with a surplus of 2.1% of GDP, against a deficit of 2.6% of GDP a year earlier. Budget revenues increased by 1.3 p.p. to 29% of GDP, which was mainly due to an increase in tax revenues by 1.1 p.p. to 27.4% of GDP. Compared to the first half of last year, there was growth of almost all types of taxes, except for customs duties in the framework of their distribution between the budgets of the EAEU countries, due to lower imports to the RF. The largest increases were recorded for the profit tax (49.4%), charges for subsoil use (55.7%), and the VAT (18.8%). The VAT revenues increased owing to both imported goods and goods produced domestically. The level of budget expenditures declined by 3.4 p.p. to 26.9% of GDP due to cuts across all items of current expenditures. The most significant decrease occurred in social payments (-1.9 p.p.), goods and services (-0.4 p.p.), and transfers (-0.3 p.p.). Along with the implementation of plans for gradual fiscal consolidation in the medium term, the sharp decline of expenditures is also explained by a significant deviation of actual financing from the plan approved in the Budget Law – the actual current expenditures fell short of budgeted amounts by 10.3% and the capital expenditures – by 41.8%. Notably, salaries and wages, and purchases of goods and services (including other expenditures) accounted for almost half of the shortfall of current expenditures.

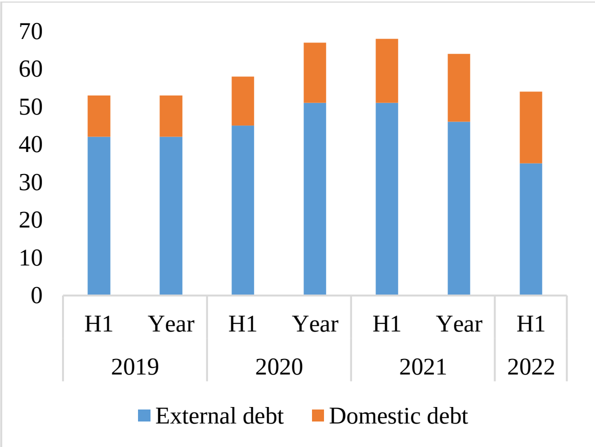
The exchange rate appreciated against the background of high economic growth and a budget surplus, resulting in a significant reduction of the public debt level. In the first half of the year, the public debt fell by 9.4 p.p. compared to the beginning of the year, amounting to 54% of GDP. Due to the exchange rate appreciation (by 12.8% since the beginning of the year), the external debt fell by 10.4 p.p. to 35.3% of GDP. The domestic debt, however, increased by 1 p.p. in the reporting period to 18.7% of GDP. As a result, the composition of the public debt changed: the share of external debt in the total public debt fell to 65%, and that of domestic debt increased to 35%, which is generally in line with the Government's strategy of public debt management in terms of changing its composition with a greater focus on domestic borrowing. Additional contributors to the lower public debt level included high economic activity and a budget surplus.

Figure 5. *State budget (in % of GDP)*



Source: MF RA

Figure 6. *Public debt (in % of GDP)*



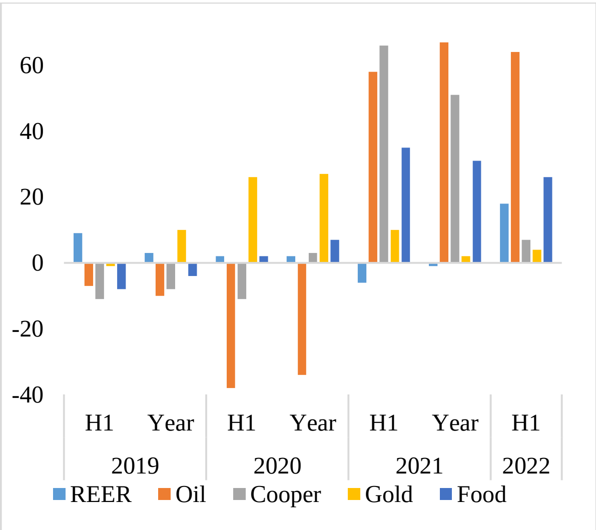
Source: MF RA

External Sector

The growth of imports outpaced that of exports, resulting in a higher current account (CA) deficit, despite a substantial inflow of remittances. According to the EFSD Project Unit, the CA deficit amounted to 2.5% of GDP in H1 2022 compared to 1% of GDP a year earlier. Exports of goods increased by 36.3% in value terms, which was facilitated by stronger external demand, high world prices for metals, as well as an additional increase in exports of goods to the RF market due to sanctions imposed by Western countries against Russia. The largest contribution to the export growth was made by precious stones (11.9 p.p.), finished food products (6.7 p.p.), base metals (5.4 p.p.), machinery and equipment (3.2 p.p.), and mineral products (1.6 p.p.). In addition, a significant influx of tourists, mainly from Russia, as well as re-export of goods to the RF, facilitated a higher contribution of exports of services. Stronger consumer and investment demand led to a significant increase in imports of goods, which increased by 48.7% in value terms. The largest contribution to the growth of imports was made by mineral products (6.9 p.p.), machinery and equipment (6.6 p.p.), vehicles (6.2 p.p.), precious stones and metals (5.4 p.p.), and base metals (4.4 p.p.). The inflow of remittances almost doubled in H1 2022 (up by 97% against 32.5% a year earlier). The sharp increase in remittances was a result of Russian citizens arriving in Armenia for temporary residence or for transit purposes.

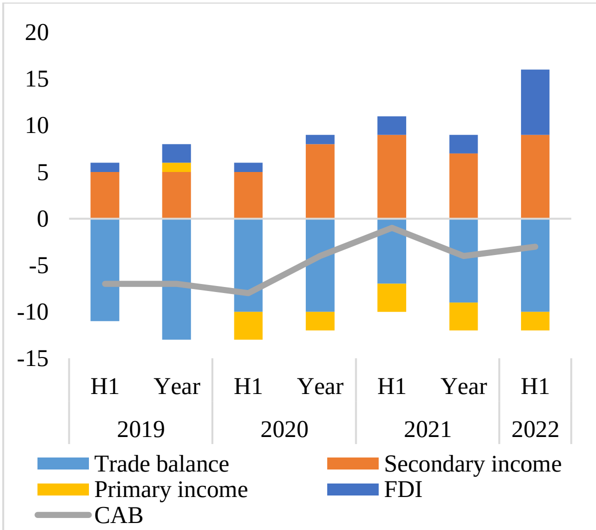
The CA deficit was financed with net inflows under the financial account, which led to an increase in the gross international reserves (GIR). In H1 2022, the growth of foreign direct investment (FDI) was almost five times higher compared to the previous year, with Russia being the main origin country. In the context of a significant inflow of foreign exchange, the CBA made interventions to buy foreign currency, totalling US $167 million. As a result of the CBA's interventions, the GIR went up to US $3.4 billion, which is equivalent to 5.6 months of imports of goods and services.

Figure 7. *Terms of trade (in %, y-o-y)*



Source: World Bank, Armstat, CBA

Figure 8. *Balance of payments (in % of GDP)*



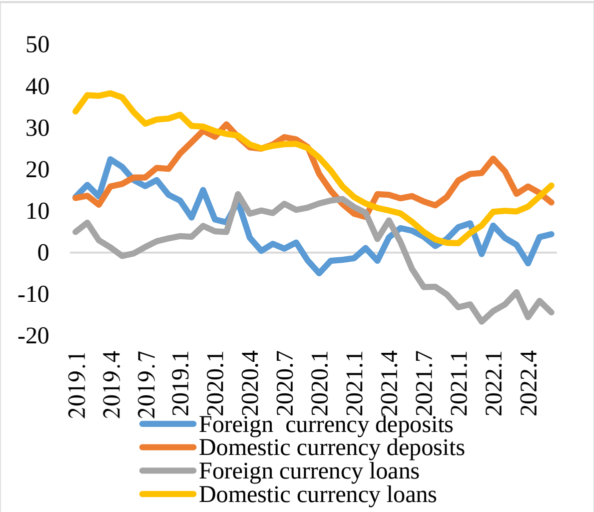
Source: CBA, Armstat

Financial Sector

Banks' lending hardly changed against the background of a slowdown in money supply growth. During the period of 12 months, the total stock of loans provided by commercial banks increased by 1.7% compared to 1.8% growth a year earlier. The key factor determining that weak trend was a reduction of foreign currency loans by 14.4% (against a decrease of 3.9% a year earlier) due to the effect of currency revaluation as a result of significant appreciation of the Armenian dram. Setting that factor aside, there was a slight increase in loans in foreign currency. The growth of loans in local currency, on the contrary, accelerated substantially, amounting to 16.1% (against an increase of 7.4% a year earlier). In terms of sectors, the growth of dram loans was driven by mortgage loans (4.8 p.p.), loans for construction purposes (0.7 p.p.), and loans to agriculture (1 p.p.). The decrease in foreign currency loans contributed to lower dollarization of the loan portfolio, down from 47.1% to 39.7%. Against the background of rising interest rates in the economy, the deposit base continued to grow at a high rate (an increase of 8% against 9.1% a year earlier). Its growth was driven by deposits of residents (an increase of 10.3% against 11.6% a year earlier), including both households and enterprises (contributions of 4.5 p.p. and 2.3 p.p., respectively). In terms of the currency composition, the contribution of dram deposits amounted to 6.9 p.p., and that of foreign currency deposits – to 3.4 p.p. The growth of deposits in local currency outpaced that of foreign currency deposits, resulting in lower dollarization of deposits, down from 52.1% to 50.4%.

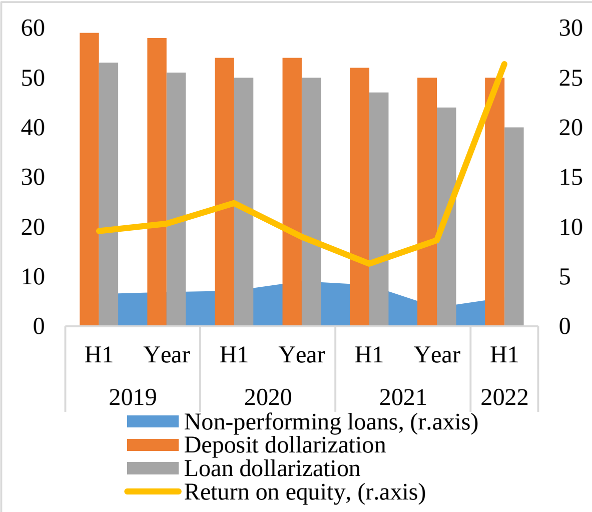
The financial soundness indicators of the banking system improved considerably. During the period of 12 months, the return on equity increased from 6.3% to 26.3%, and the return on assets – from 0.8% to 3.75%. Higher profits and improved asset quality contributed to an increase in the capital adequacy ratio from 17% to 18.6%. At the same time, the quality of the loan portfolio improved owing to a significant reduction in the share of bad debts from 4.1% to 2.9%. The latter is due to a write-off of non-performing loans to households and enterprises, noted since the second half of the previous year, as well as a change in the methodology for classifying loans as non-performing.

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



Source: CBA

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



Source: CBA

Medium-Term Outlook

According to the current estimates of the EFSD Project Unit, the economic growth rate in Armenia may accelerate to 10.5% in 2022 compared to 5.7% in 2021, as a result of a significant increase in both external and domestic demand. The imposition of sanctions against Russia would have a positive effect on the Armenian economy through an increase in exports of goods and services. Consumer demand would be supported by higher remittances, growth of salaries and wages in the private sector, as well as spending of household savings. Capital investment would also make a positive contribution to the economic growth, mainly due to the growth of housing construction. In the medium term, the economic growth rates would be around its long-term potential level, estimated at 4%[3]. High global prices on commodities, especially copper, as well as the expected global economic recovery in 2024, would support exports of goods and services. The gross capital formation due to the projected increase in public investment, in accordance with the Government's plans to raise its share to 6% of GDP in the medium term, as well as improved investment activity in the private sector, would have a positive effect on the economic growth.

Inflationary pressures associated with high prices on international commodity markets, as well as high domestic demand, would persist in 2022. According to the EFSD Project Unit, consumer inflation may accelerate to 8.1% (y-o-y) at the end of the year, remaining above the upper boundary of the CBA's target. However, the exchange rate appreciation caused by a significant inflow of foreign exchange would have a curbing effect on the evolution of inflation. The inflationary pressure generated by domestic demand would weaken in the medium term, making it possible to ease the monetary conditions. At the same time, it is expected that monetary policy would be aimed at bringing the inflation back to the targeted interval (4±1.5%) in the medium term.

High economic growth rates would lead to an increase in tax revenues, which, along with lower current expenditures, would ensure a reduction in the budget deficit in 2022. According to the current estimates of the EFSD Project Unit, the budget deficit may be at the level of 1.3% of GDP, which is significantly below the indicator approved by the 2022 Budget Law (3% of GDP). In the medium term, fiscal policy will be aimed at reducing the debt pressure and maintaining the debt – which exceeded the maximum threshold of 60% of GDP in 2021 – on a sustainable path. Along with the projected decline in current expenditures, the annual increase in tax revenues (by about 0.4 p.p. per year) due to the expected improvement in tax administration would contribute to a lower budget deficit. Therefore, the budget deficit is currently estimated to average 2% of GDP over the forecast period.

The stability of the balance of payments would decrease slightly as the current account deficit grows. In 2022, the CA deficit would expand to 4.5% of GDP (against 3.7% of GDP in 2021), due to the projected deterioration in the trade balance. In the medium term, an increase in investment demand, driven by public and private investment, would lead to a gradual increase in the current account deficit to an average of 5.2% of GDP. At the same time, the FDI inflow would remain at a relatively low level, and the adequacy of the international reserves would fall, as a result of a recovery in imports of goods and services, to 4.0 months of imports in 2024–2025 compared to 6.4 months in 2021.

[3] According to the CBA

Table 1. Armenia: Key macroeconomic indicators

	2021 Actual	2022 Forecast	2023 Forecast	2024 Forecast	2025 Forecast
National accounts and prices (in %)					
Real GDP growth	5.7	10.5	4.2	4.0	4.0
CPI (average)	7.2	8.1	5.6	3.7	4.0
Money and credit (end of period)					
Broad money, percentage change	13.1	19.4	9.4	8.3	8.1
Refinancing rate, %	7.75	9.50	6.5	4.5	4.5
Public finance (in % of GDP)					
Revenues and grants	24.1	25.0	24.9	25.1	25.4
of which tax revenues	22.7	23.5	24.0	24.4	24.8
Budget expenditures	28.7	26.3	27.0	27.0	27.1
Current expenditures	25.6	22.1	21.8	21.7	21.6
Capital expenditures	3.1	4.2	5.1	5.3	5.6
Budget balance (“-” deficit/“+” surplus)	-4.6	-1.3	-2.1	-1.8	-1.7
External sector (in % of GDP)					
Current account	-3.7	-4.5	-4.9	-5.3	-5.5
Export of goods and services	35.2	37.3	41.1	41.6	42.0
Import of goods and services	43.5	46.2	49.8	50.1	50.5
Foreign direct investment	2.7	4.0	2.7	2.7	2.7
Gross reserves, in months of imports of goods and services	6.4	4.5	4.2	4.0	4.0

Source: national agencies and EFSD estimates

ANALYSIS OF FISCAL POLICY OF THE REPUBLIC OF ARMENIA DURING CRISES

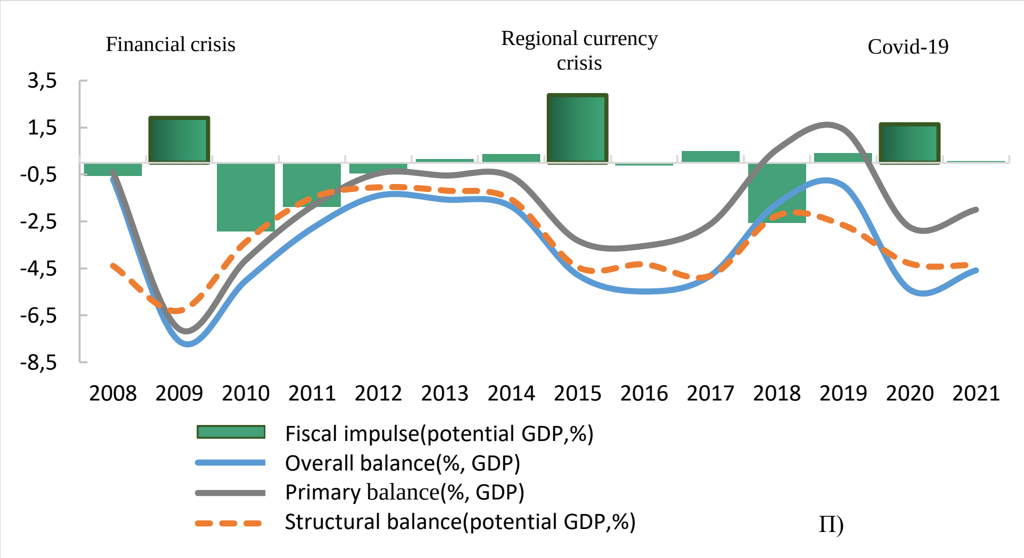
Over the past two decades, the Republic of Armenia has passed through three economic crises. The Government resorted to fiscal stimuli to respond to the crises, which led to a significant increase in the budget deficit and public debt and a substantial contraction of space for pursuing countercyclical fiscal policy.

In terms of responding to changes in the cycle, Armenia's fiscal policy was both pro-cyclical and countercyclical. The pro-cyclical nature of Armenia's fiscal policy was clearly evident until the 2008–2009 Global Financial Crisis, when, against the background of a long period of double-digit economic growth, the Government maintained a primary budget deficit, contributing to overheating of the economy.

During the crisis years, amid declining economic growth, the Government pursued countercyclical policy by significantly expanding its expenditures – and, thus, the budget deficit – in order to stabilise the economy. The budget deficit increased in the crisis years that was to a great degree driven by an expansion of budget expenditures based on discretionary decisions of the Government and – to a lesser extent – was related to tax revenue regulation.

Estimates of the structural budget balance and the fiscal impulse validate the important countercyclical nature of Armenia's fiscal policy during crisis periods (Figure 1).

Figure 1. Structural Budget Balance and Fiscal Impulse



Source: MF RA, Armstat, EFSD estimates

In 2009, as a result of the Global Financial Crisis, the RA budget deficit expanded to 7.5% of GDP against 1.3% of GDP on average for 2002–2008 (Figure 2). Budget expenditures increased by 6.9 p.p. to 29.6% of GDP. At that time, the Government had to expand its capital expenditures by 4.1 p.p. (Figure 3) in order to offset the decline in private investment, which had grown explosively in the early 2000s mainly due to the growth of the construction sector.

The countercyclical policy followed by the Government supported the economy and facilitated gradual reduction of the negative output gap, while leading to a sharp increase in the public debt – from 16.4% of GDP in 2008 (US $1,906 million) to 40.6% of GDP in 2009 (US $3,376 million) (Figure 2). It should be noted that the Global Financial Crisis led to a contraction of Armenia's real GDP by 14.1% in 2009, putting an end to the period of double-digit economic growth in the country, driven by the non-tradeable sector fuelled by sizeable remittances from the RF, high commodity prices, as well as FDI inflows.

In 2015 and 2016, under the impact of the regional currency crisis, the country's economic growth rates slowed down to 3.2% and 0.2%, respectively, compared to the average growth of 4.2% in 2010–2014.

The expansion of the budget deficit to 4.8% and 5.5% of GDP in 2015 and 2016, respectively, was financed with external borrowings and made it possible to prevent a deeper contraction in the economy and maintain positive growth rates (Figure 2). However, it led to the public debt increasing to 56.7% of GDP as at end-2015, beyond the threshold allowed by the fiscal rule.

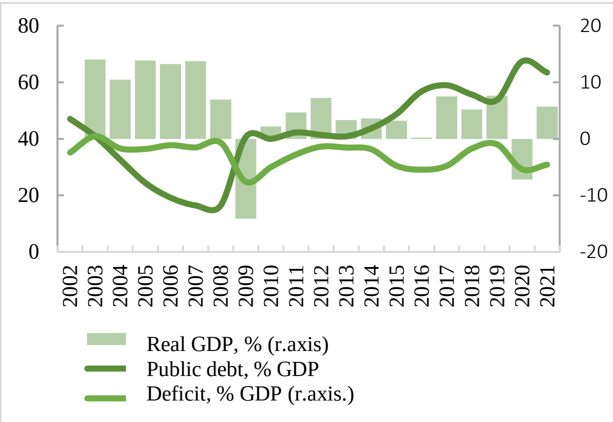
As the level of debt of 50% of GDP was exceeded in 2016, the fiscal rule required adjustments to the 2017 budget, namely, limiting the budget deficit to 3% of the average GDP over the previous three years, despite the fact that the economic growth remained weak. Under those conditions, the applicable fiscal rule did not allow for counter-cyclical policy. Subsequently, with support of the IMF, the fiscal rule was amended, making Armenia's fiscal policy more flexible. Specifically,

The fiscal rule includes an algorithm of action of the RA Government if the public debt exceeds a certain threshold (40%, 50%, 60% of GDP):

- ✓ If the debt exceeds 40% of GDP, capital expenditures should be no less than the budget deficit;
- ✓ If the debt exceeds 50% of GDP, capital expenditures should not be less than the budget deficit; the increase in current primary expenditures should be limited to the average nominal GDP growth over the previous 7 years;
- ✓ If the debt exceeds 60% of GDP, capital expenditures should not be less than the budget deficit; the increase in current primary expenditures should be limited to the average nominal GDP growth over the previous 7 years, reduced by 0.5 p.p.; the total amount of current expenditures should be limited to tax revenues.

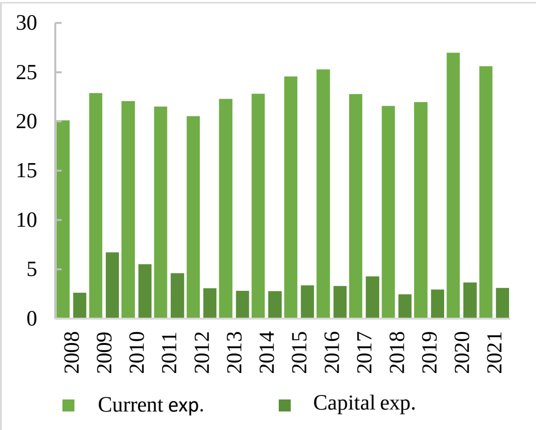
At the same time, restrictions do not apply to exceptional cases (natural disasters, wars, and negative economic shocks).

Figure 2. Public debt, budget deficit, and economic growth, in % of GDP



Source: MF RA, Armstat, EFSD estimates

Figure 3. Current and capital expenditures of the budget, in % of GDP



Source: MF RA, Armstat, EFSD estimates

EFSD
EURASIAN FUND FOR STABILIZATION AND DEVELOPMENT

REPUBLIC OF ARMENIA
H1 2022

In 2020, the RA economy was negatively affected by a double shock associated with the spread of the COVID-19 pandemic and the escalation of the military conflict in Nagorno-Karabakh. According to the fiscal rule, the 2020 crisis was recognised as an exceptional case – which made it possible to pursue fiscal policy without taking into account the requirements of the fiscal rule – and the Government was able to respond to it quite promptly. In order to mitigate the economic and social consequences of the pandemic, a comprehensive package of fiscal, monetary, and financial measures totalling AMD 215 billion (US $430 million), or 3.4% of GDP, was developed.

An additional increase in spending by AMD 40 billion (US $80 million) due to the military operations in Nagorno-Karabakh led to a higher budget deficit, up to 5.4% of GDP compared to 1% of GDP in 2019. Current expenditures, the main contributor to the expanding deficit, increased by 5.8 p.p. to 30.6% of GDP and were mainly used for lump-sum payments to vulnerable segments of the population, direct subsidies for salaries and wages, and the provision of liquidity to enterprises. Capital expenditures increased by 0.7 p.p. to 3.7% of GDP, driven mainly by the costs associated with the military operations in Nagorno-Karabakh. As a result, the public debt increased to 67.4% of GDP in 2020, exceeding the maximum threshold, set by the fiscal rule, by a large margin.

The crisis response measures implemented by the Government in 2009, 2015, and 2020 helped stabilise the economy and gradually close the negative output gap. However, the expansionary fiscal policies significantly narrowed the space for applying countercyclical fiscal policy in the event of new crises.

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