EFSD Eurasian Fund for Stabilization and Development

Republic of Armenia

Social and Economic Development in 2021

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EXECUTIVE SUMMARY

In 2021, due to an improvement in both internal and external demand, the economy of the Republic of Armenia demonstrated high recovery growth of 5.7%. As a result of continued price growth in world food markets, as well as a rapid recovery in the domestic demand, inflation accelerated to 7.1%, exceeding the target of the Central Bank. Against the background of mounting inflation risks, the monetary conditions tightened. The fiscal position improved due to the fiscal policy getting less expansionary, which was consistent with the Government's plans for smooth consolidation. Improved terms of trade, stronger external demand, and a recovery in remittances contributed to a lower current account deficit, down to 1.3% of GDP, which was financed with net inflows under the financial account.

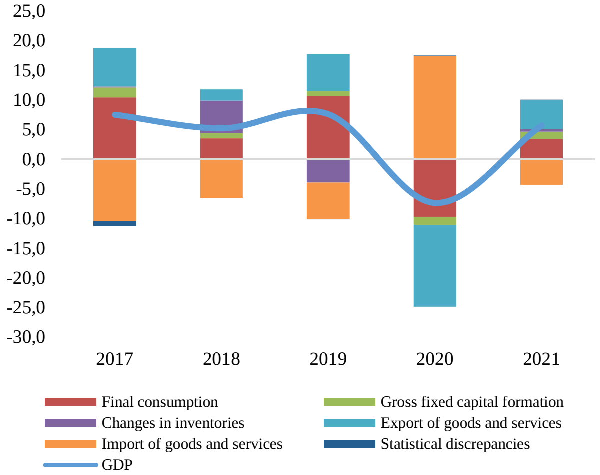
SOCIAL AND ECONOMIC DEVELOPMENT IN 2021

Real Sector and Labour Market

In 2021, the real GDP grew by 5.7% compared to its contraction by 7.6% a year earlier (Figure 1). As a result of a rapid recovery of external demand and international tourism, the key driver of economic growth was export of goods and services, which contributed 4.9 p.p. to the GDP growth. The contribution of consumption amounted to 3.4 p.p., which was facilitated by materialising delayed demand, higher inflows of remittances due to a recovery of migration flows, as well as real wages growth in the private sector. The recovery of the economic activity was supported by stronger investment demand, which contributed 1.7 p.p. A year earlier, investments were supported by budget expenditures financed with international loans, while in 2021, the investment activity growth was driven by the funds of households and enterprises.

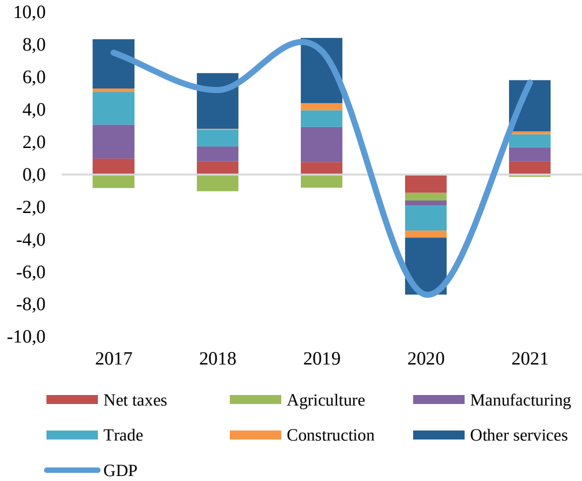
In terms of sectors, all sectors of the economy, except for agriculture, contributed positively to the GDP growth (Figure 2). A recovery in consumer demand led to a higher contribution of trade and other services (4 p.p.). The main drivers of industrial production growth, which contributed 0.8 p.p., included an increase in the production of electricity, food, and non-metallic mineral products. The reinvigoration of the private sector facilitated a greater contribution of construction (0.2 p.p.), driven by the transport sector and housing construction.

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 recovery of the economic activity had a beneficial effect on the performance of the labour market. In 2021, employment increased by 4.1%, which, in the face of lower supply of labour due to a recovery of migration flows, led to a lower unemployment rate, down from 18.4% to 15.5% according to the ILO methodology. The growth rate of nominal wages accelerated to 7.6% from 3.9% a year earlier, mainly owing to the services sector. High growth rates of wages were registered in the transport sector, in the field of information and communication, as well as in tourism. However, as a result of the accelerated inflation, economy-wide real wages grew only by 0.3%. In particular, they increased by 1.1% in the private sector, and decreased by 1.9% in the public sector.

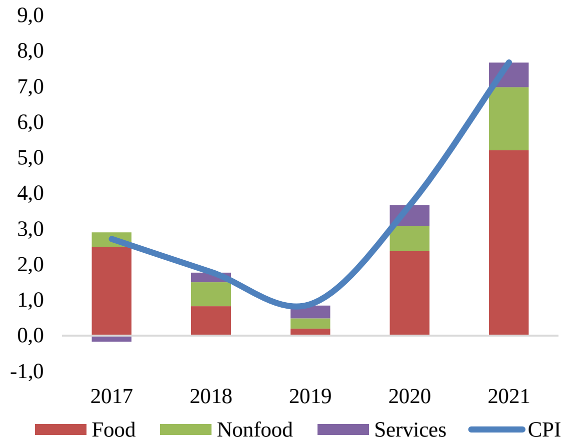
Inflation and Monetary Policy

High global prices for food and commodities, as well as a rapid recovery of the domestic demand, generated significant inflationary pressures in 2021 (Figure 3). The 12-

month inflation accelerated in December to 7.1% compared to 3.7% a year earlier, going beyond the upper band of the Central Bank's target (4±1.5%). The key driver of the accelerating inflation was a sharp rise in food prices, whose contribution to the consumer price index amounted to 5.2 p.p. (2.4 p.p. a year earlier). The prices for other key items of the consumer basket also accelerated: the contribution of prices for non-food items and services amounted to 1.8 p.p. (0.7 p.p.) and 0.7 p.p. (0.6 p.p.), respectively. With the rapid recovery of the domestic demand, the core inflation also accelerated, reaching 7.3% in December, compared to 3.6% a year earlier. Taking into account the mounting inflation risks, the Central Bank of Armenia raised the refinancing rate on six occasions in 2021, by 250 basis points in total, up to 7.75% per annum.

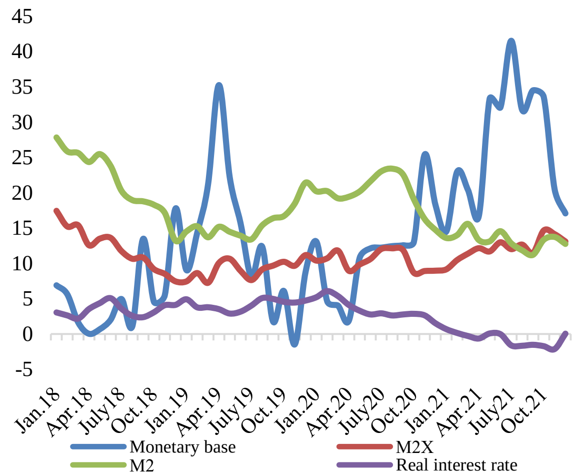
Extensive purchases of government securities by banks pushed the money supply growth. In 2021, the growth rate of broad money supply accelerated from 9% to 13.1%. While a year earlier, the main driver of the broad money supply growth was credit to the economy against the background of expansive monetary policies, in 2021, it was net credit to the Government (17.1 p.p.). The trend is explained by the fact that, in the face of persistent uncertainty, commercial banks opted to invest in less risky assets. Credit to the economy made a negative contribution to the broad money supply growth (-5 p.p.). The key driver of base money growth of 17.1% was credit of the Central Bank of the Republic of Armenia to commercial banks (14.6 p.p.), which was mainly used to purchase Government bonds.

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



Source: CB RA, Armstat

Figure 4. *Monetary indicators (in %)*



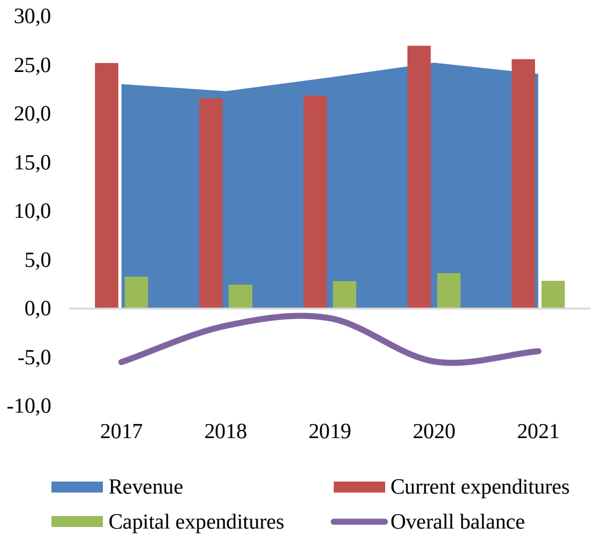
Source: CB RA

Budget Sector and Public Debt

Less expansionary fiscal policy resulted in an improvement of the fiscal position. In 2021, the state budget was executed with a deficit of 4.4% of GDP against a deficit of 5.4% a year earlier. Budget revenues increased in nominal terms by 7.9%, reaching 24.1% of GDP, which is fully explained by an increase in tax revenues by 14.6% against the background of lower non-tax revenues and grants. In the context of a rapid recovery of the economic activity, the largest increase was recorded for the value added tax (17.9%) due to higher revenues from both imported goods and goods produced domestically. More dynamic foreign trade contributed to an increase in customs duties (24.3%). In addition, revenues from other taxes and social payments almost doubled. A negative impact was created by lower excise tax revenues (-8.4%) from excisable goods produced in the country, which was attributable to lower output of tobacco products. Moreover, the tax legislation of the Republic of Armenia was amended in the part of income taxes, with the personal income tax rate reduced,[1] that led to a slowdown in the growth of personal income tax revenues. The level of budget spending was reduced by 2.2 p.p. (to 28.5% of GDP), which is consistent with the Government's plans for a smooth consolidation. Current expenditures decreased by 1.4 p.p. (to 25.6% of GDP) due to cuts under all items of this group. Capital expenditures fell to 2.9% of GDP from 3.7% a year earlier.

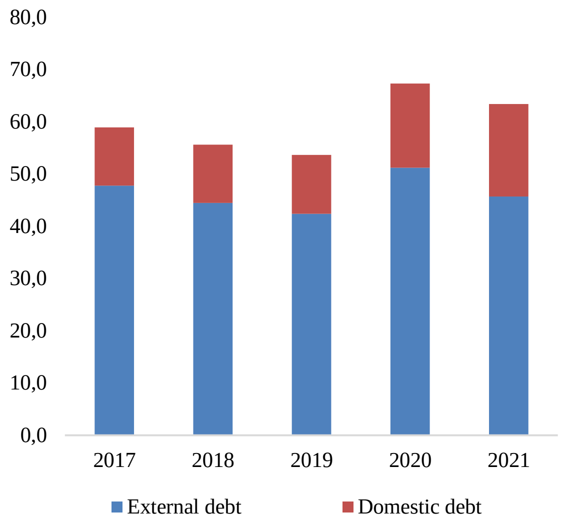
Accelerated economic growth, a lower budget deficit, and exchange rate appreciation contributed to a reduction of the public debt. In 2021, the public debt fell by 3.9 p.p., amounting to 63.4% of GDP. The external debt decreased by 5.6 p.p. to 45.7% of GDP. The domestic debt, however, increased by 1.6 p.p. to 17.7% of GDP, which is in line with the principles of the Government's public debt management strategy in terms of changing its composition in favour of domestic borrowings.

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



Source: MF RA

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



Source: MF RA

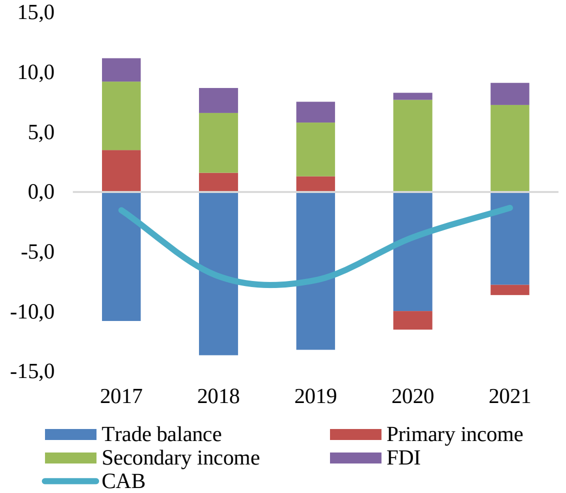
External Sector

Stronger external demand, higher world prices for metals, as well as a recovery of migration flows had a significant positive effect on the path of the current account. According to the EFSD Project Unit, the current account deficit decreased to 1.3% of GDP in 2021 compared to a deficit of 3.8% of GDP a year earlier (Figure 7). The growth of exports outpaced the recovery of imports that led to a lower trade deficit. In particular, the value of exports increased by 19.1%, that was facilitated by higher export volumes and improved terms of trade as a result of a significant increase in prices for major exports, especially copper. Exports were further supported by the real effective exchange rate depreciation by 1.4% against its appreciation by 1.7% a year earlier. The largest contribution to export growth was made by mineral products (6.6 p.p.), base metals (5.3 p.p.), food products (5.5 p.p.), and textiles (2 p.p.). The value of imports increased by 16.9% mainly due to higher imports of mineral products (4.2 p.p.), investment goods (2.8 p.p.), and precious and semiprecious stones (2.3 p.p.). Remittances grew by 5.7% compared to a 7.9% decrease a year earlier. However, the main contribution (7.1 p.p. compared to 3.1 p.p. a year earlier) was made by an increase in the inflow of remittances from other countries, while the contribution of remittances from Russia continued to decline for a second consecutive year (-1.4 p.p. compared to -11 p.p. a year earlier).

[1] From 1 January 2020, the high and progressive personal income tax rates (23, 28, 36%) were replaced with a single 23% rate, which will be gradually reduced by 1% per annum until 2023, reaching 20% on 1 January 2023.

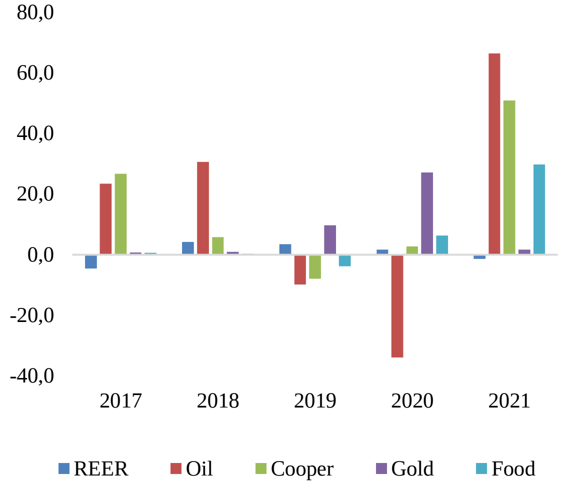
The current account deficit was financed by net inflows under the financial account. The main source of inflows was a 10-year Eurobond issue in an amount of US $750 million, offered in February 2021. In addition, there was an increase in inflows of foreign direct investments that consisted almost entirely of reinvested incomes. In 2021, the level of gross international reserves increased to US $3.2 billion that is equivalent to 6.6 months of imports of goods and services.

Figure 5. *Balance of payments (in %, y-o-y)*



Source: CB RA, EFSD estimates

Figure 6. *Terms of trade (in %, y-o-y)*



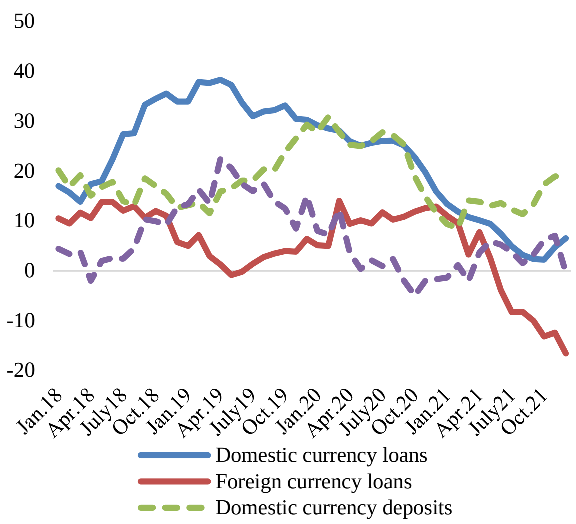
Source: CB RA, World Bank

Financial Sector

The growth rate of bank lending slowed down against the background of persistent uncertainty and tightening monetary conditions. During the period of 12 months, the total stock of loans from commercial banks dropped by 5.1% compared to 14.4% growth in the previous year. The main driver of the reduction of the loan portfolio were loans to private enterprises denominated in foreign currency, whose contribution decreased by 4.7 p.p. against their growth by 6.5 p.p. a year earlier. At the same time, against the background of tightening monetary conditions, the contribution of loans in the local currency dropped to 3.2 p.p. from 7.8 p.p. a year earlier owing to both loans to enterprises and those to private individuals. The dollarisation of the loan portfolio decreased from 50.3% to 44.2%. As a result of increasing interest rates in the economy, the growth rate of the deposit base accelerated from 3.9% to 8.5%. The main drivers of growth were deposits of households and enterprises in the local currency, whose total contribution amounted to 8.7 p.p. Foreign currency deposits declined by 0.2 p.p. due to an outflow of deposits of non-residents (-4.2 p.p.). As a result, the dollarisation of deposits decreased from 54.5% to 50%.

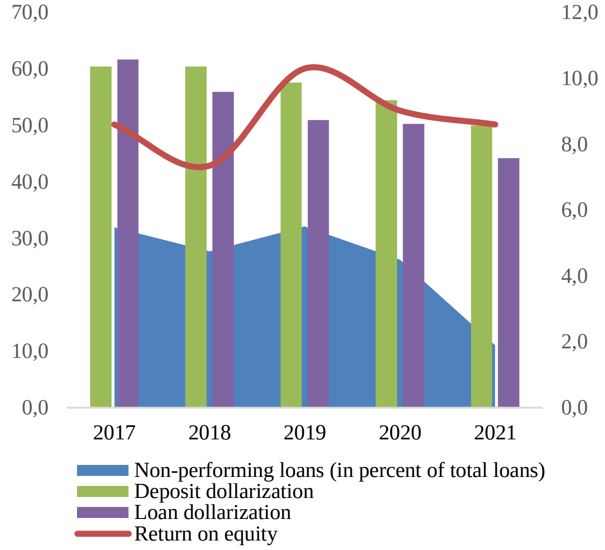
Banks continue to have a relatively high level of capital adequacy, despite a slight deterioration in their financial performance. The weaker credit activity led to a slight deterioration in the financial performance of banks, with the return on equity decreasing from 9% to 8.6%, and the return on assets – from 1.3% to 1.1%. However, the lower profits and poorer asset quality did not affect their capital adequacy that increased to 17.2% in December 2021 compared to 16.9% in December 2020.

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



Source: CB RA

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



Source: CB RA

ANNEX

Contingent Liabilities in the Republic of Armenia

In the framework of developing its budget support programmes, the EFSD performs an assessment of the public debt and fiscal deficit of the borrowing countries in their broad definitions. This approach helps include in the calculation the risks associated with the materialising of contingent liabilities formed with various debt instruments, as well as their potential impact on the country's budget and the level of its public debt.

It should be noted that, in Armenia, the official definition of the state debt is quite broad, since, in addition to the debt of the Government itself, it includes government guarantees, which is not typical of all EFSD recipient countries. Nevertheless, the calculation of the augmented balance of the state budget is justified by the fact that it ensures a more comprehensive assessment of the scale of fiscal risks created, in the case of Armenia, through the provision of budget loans, in particular loans issued under sub-loan agreements, as well as government guarantees.

Historically, the stock of government guarantees in Armenia has not been high, and, thus, has not posed significant risks for the country's fiscal and debt sustainability. The size of guarantees issued annually is regulated by the Law "On the Budget System of the Republic of Armenia" and should not exceed 10% of the tax revenues of the previous year. At the same time, the guarantees are mainly provided for external loans mobilised by the Central Bank of the Republic of Armenia under development programmes. In 2021, the stock of guarantees issued amounted to 0.8% of GDP, and over the past few years it has not exceeded 1.5% of GDP.

Loans provided under sub-loan agreements represent a higher risk. This is due to both the significant volume of loans issued and the precarious financial situation of the beneficiary enterprises. Despite the fact that these loans are included in the calculation of the debt, they may create a significant burden on the budget if the borrowers fail to repay their obligations to the Government. A paper prepared by the EFSD Project Unit in 2021[2] highlights the fact that, if the financial situation of these enterprises worsens, the Government will have to support them. This, in turn, can lead to an increase in the country's financing needs and the level of the public debt. As at end-2021, the outstanding stock of sub-loans amounted to 4.9% of GDP, compared to 6.6% of GDP on average over the past five years. A noticeable decrease in their level compared to 2016, when they amounted to 9.5% of GDP, indicates stronger payment discipline of enterprises and, thus, a lower risk of default on their obligations to the Government.

In its report on the fiscal transparency evolution in Armenia, the International Monetary Fund outlined a wider list of fiscal risks present in the country[3], including state-owned enterprises in the financial sector and public private partnerships. At that time, the IMF assessed the total impact of all those risks materialising at 70% of GDP. However, the report emphasises that the fragmented and insufficiently structured data on fiscal risks make it difficult to regularly analyse and assess the cumulative impact of the risks on the country's fiscal position.

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[2] Total Debt is So Much More Than Just Sovereign Debt. Contingent Liabilities in Armenia, Belarus, Kyrgyz Republic, and Tajikistan. EFSD Working Paper WP/21/2, 2021

[3] Republic of Armenia: Fiscal Transparency Evaluation, IMF, 2019