



ARMENIA

Highlights

- **The economy has sustained moderate positive growth despite external economic challenges.** GDP growth in 2014 and early 2015 was maintained at close to the 2013 level despite spillovers from the recession in Russia, slow growth in Europe, the adjustment of regional currencies, the decline in remittances and lower copper prices.
- **Armenia progressed with reforms although challenges remain.** Macroeconomic management has been sound and policy mistakes have been avoided; the pace of diversification of the economic base has been slower despite improvements in the business climate.
- **Armenia officially joined the Eurasian Economic Union (EEU) in January 2015.** Membership entails gradual adoption of a common tariff system with other EEU members.

Key priorities for 2016

- **Further action is needed to improve the business environment.** Structural reforms, including a level playing field to foster competitiveness and diversification, streamlined regulations and enhanced cross-border regional connectivity, are critical for increasing potential growth rates.
- **Continued responsible macroeconomic policies are needed to enhance the economy's resilience to external shocks.** Additional measures are needed to preserve economic stability and attract investments including: an improved tax administration, combined with continued prudent monetary, financial sector and public debt management policies.
- **Improved access to finance, local capital market development and de-dollarisation continue to be important priorities.** The local capital market development momentum needs to be sustained to broaden access to finance and contain adverse balance sheet effects from currency movements.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	4.7	7.2	3.3	3.5	2.3
Inflation (average)	7.7	2.6	5.8	3.0	4.3
Government balance/GDP	-2.9	-1.6	-1.6	-1.9	-4.0
Current account balance/GDP	-11.1	-11.1	-7.6	-7.3	-5.9
Net FDI/GDP [neg. sign = inflows]	-4.3	-4.7	-4.6	-3.3	-4.1
External debt/GDP	71.5	74.9	78.5	73.3	n.a.
Gross reserves/GDP	19.1	18.1	20.2	12.8	n.a.
Credit to private sector/GDP	33.6	40.1	39.5	45.2	n.a.

Macroeconomic performance

Armenia's real GDP is estimated to have grown by 3.5 per cent in 2014 after 3.3 per cent growth in 2013. Growth in 2014 was driven by household and government consumption (year-on-year real growth of 1.1 per cent) and an improvement in net exports. In contrast, gross capital formation is estimated to have decreased by 2.6 per cent in real terms in 2014. The mining and quarrying and construction sectors experienced negative real growth in 2014, but real growth in agriculture, manufacturing and trade was positive. In the first half of 2015, Armenia's economy is estimated to have grown by 4.0 per cent in real terms, mainly driven by the positive contribution of agriculture (15.5 per cent growth in the first half of 2015) and mining (46.0 per cent growth in the first half of 2015). Year-on-year inflation has increased slightly from 3.0 per cent in 2014 to 5.5 per cent year-on-year in June 2015, but moderated again to 3.6 per cent year-on-year in August 2015. The central bank refinancing rate increased several times from 6.75 per cent in August 2014 to reach 10.50 per cent from mid-February until 11 August 2015, when the rate was cut to 10.25 per cent.

The exchange rate stabilised in 2015 amid tight monetary conditions, after significant depreciation pressure at the end of 2014. The Armenian dram depreciated against the US dollar by approximately 20 per cent in one month between mid-November and mid-December 2014, before regaining almost half of the lost ground by the end of the year. In the first eight months of 2015, the dram-US dollar exchange rate was predominantly stable on the back of large central bank interventions early in the year and, more recently, favourable net foreign exchange inflows due to the large adjustment of the current account balance supported by an increase in exports to new markets, tourism gains and a large reduction in imports. In the same period in 2015, the dram appreciated by approximately 4 per cent against the euro and by approximately 5 per cent against the Russian rouble. Real and nominal effective exchange rates appreciated in the first quarter of 2015 and then declined by mid-2015, stabilising at levels somewhat higher than in mid-2014. Gross international reserves were on a downward path for most of 2014, declining from US\$ 2.11 billion in January 2014 to US\$ 1.26 billion in February 2015 and then rebounding to US\$ 1.63 billion by September 2015 (more than three months of import coverage). The abatement of pressures on international reserves and the exchange rate stabilisation in the first half of 2015 were due, among other things, to the rally in the Russian rouble and the issuance of a sovereign Eurobond in March 2015.

Public finances remained sound, although fiscal space is limited. The budget deficit is estimated at approximately 2.0 per cent of GDP in 2014 and the public debt-to-GDP ratio is estimated at 44.4 per cent in the first half of 2015. In 2015, the budget deficit is expected to increase to between 3.0 and 4.0 per cent of GDP (up from the 2.3 per cent of GDP envisaged in the 2015 budget) on account of higher capital expenditure and revenue shortfall.

The short-term outlook depends on a combination of domestic and external factors. The positive contribution of agriculture and mining would continue for the rest of the year. On the other hand, Armenia is not immune to the regional economic slow-down. Remittances were down by 27.8 per cent year-on-year in the first eight months of 2015, including remittances from Russia which were down by 40.2 per cent year-on-year for the same period. Consumption decreased by 1.6 per cent year-on-year in real terms in the first half of 2015, imports decreased by 26.3 per cent in the first eight months of 2015, credit growth in the same period was negative (4.5 per cent year-on-year contraction).

Major structural reform developments

Structural reforms progressed, although challenges remain. The second, four-year phase of the inspection system reforms started in 2014, aimed at improving the institutional structure of the inspection system, and has materialised in the approval of a new Law on Inspection Bodies and a new concept on the optimisation of the inspection system of Armenia. Implementation of the regulatory guillotine approach is ongoing. Cost reductions are targeted through measures in tax and customs administration, patents and government processes, which were approved in March 2015. The government initiated preparation of a new tax code to reduce tax privileges and high

tax compliance costs and to redesign the tax system to foster growth. In October 2015, the draft tax code was discussed at the cabinet and it is expected to be presented for public discussion, with submission to the parliament in 2016. Some 15 bilateral aviation agreements, including the Common Aviation Area Agreement with the European Union (EU), are being negotiated and can attract European low-cost carriers, boosting the hospitality industry and tourism revenues. Armenia's achievements and weaknesses in the business environment are reflected in the World Bank's *Doing Business 2016* report where it ranks 35th out of 189 economies, with lower scores in getting electricity, dealing with construction permits and resolving insolvency.

In January 2015, Armenia became the fourth member of the EEU. This membership is expected to increase Armenia's dependency on the Russian economy, which entered recession in 2015. Armenia will need to increase its import tariffs from the current level of 2.4 per cent to the EEU's average external tariff rate with the European Union of 9.0 per cent (Armenia was granted a temporary waiver, allowing it to apply its current, low tariff on 800 goods in the transition period). EEU membership qualifies Armenia to receive approximately 1 per cent of customs duties from goods imported to the EEU territory. Empirical evidence on the economic implications of EEU membership is still inconclusive. The EU and Armenia recently completed a joint scoping exercise which is expected to lead to negotiations on a new overarching agreement between the two, compatible with Armenia's EEU membership obligations.

New deals in the energy sector have been agreed. In August 2015, US energy company ContourGlobal announced the completion of its acquisition of Armenia's Vorotan Hydropower Cascade, paying US\$ 180 million and pledging to invest more than US\$ 50 million over the next six years in modernisation. The International Finance Corporation acquired a 20 per cent stake in the project. The deal represents the first large US investment in Armenia's energy sector and the largest US investment in the country overall. In April 2015, Gazprom was reported to have announced that Armenia would pay US\$ 165 per 1,000 cubic metres of gas instead of US\$ 190 per 1,000 cubic metres. The reduction in gas price was reportedly offered in the framework of cooperation under the EEU. In August 2015, the Iranian Export Development Bank and Armenia signed an agreement to construct a third power transmission line between the two countries which will reportedly lead to a surge in Armenian energy exports to Iran and a corresponding increase in Iranian gas deliveries to Armenia, as the electricity is largely generated by the Iranian natural gas-fired Armenian thermal power plants. In February 2015, Russia agreed to extend a concessional loan and grant of US\$ 300 million to extend the service life of the Metsamor nuclear power plant, with the start of reconstruction expected in 2017.

Implementation of the North-South road corridor investment programme is under way. The programme is funded by the Asian Development Bank, the European Investment Bank and the Eurasian Development Bank. It aims to develop a national and regional transit, and to enhance trade flows and market accessibility. The road corridor is expected to consist of existing and planned road sections which would collectively stretch from Armenia's borders with Georgia in the north to the border with Iran in the south.

Electricity tariffs have been increased, sparking public demonstrations. The protests followed the approval by the Armenian Public Services Regulatory Commission of a daytime electricity tariff increase for households of approximately 17 per cent, effective from 1 August 2015. The government announced an independent audit of the tariff hike and of the electricity company Electric Networks of Armenia (ENA). It also pledged to bear the full cost of the tariff increase before the conclusion of the audits, expected to be finished by the end of 2015. The subsidisation plan only applies to households and small and medium-sized enterprises. In August 2015, the government announced provisional plans to subsidise the tariff increase from proceeds of the privatisation of the Vorotan Hydro Cascade, one of Armenia's largest power-generating facilities accounting for approximately 15 per cent of Armenia's power generation capacity. More recently, it was announced that Russian energy holding Inter RAO would sell the ENA to the Tashir Group, owned by an Armenian businessman.

Domestic capital markets continue to be developed. In light of the high dollarisation of the system, the EBRD has continued its efforts to work with the Armenian authorities to develop domestic capital markets in the country. In January 2015, the EBRD placed its second dram-denominated bond for a total amount of 2 billion drams (approximately US\$ 4 million) on the Armenian stock exchange.

The banking system was affected by the slowing economy but remains well managed and adequately capitalised. Total loans of the banking system increased from 39 per cent of GDP in 2013 to 45 per cent of GDP in 2014, partly reflecting the valuation effects of depreciation. In the first half of 2015, the stock of commercial bank loans declined by up to 5 per cent. The Armenian banking system recorded losses in the first half of 2015. The system-wide capital adequacy ratio stood at 15.4 per cent in August 2015, up from 14.5 per cent at the end of December 2014. As of September 2015, 65.6 per cent of loans and 70.1 per cent of deposits were dollarised, up from 62.4 and 67.3 per cent in September 2014. In January 2015, the Central Bank of Armenia increased minimum capital requirements from AMD 5 billion to 30 billion (approximately US\$ 10 million to US\$ 60 million, respectively) by 2017 to increase buffers and efficiency. Discussions of new funding and acquisitions are under way.