

YEREVAN 2014

MACROECONOMIC
OVERVIEW OF ARMENIA



MACROECONOMIC OVERVIEW

In the early 1990s, a sharp boost of unemployment, reduction of real wages, shrinkage of tax-base, persistent cash shortages of GoA (Government of Armenia) generating large external and domestic expenditure arrears, were the factors resulting in a crucial decline in living standards and rising poverty levels that caused a large migration. Reforms initiated in the second half of the 1990-s attempted to revitalize the economy. As a result, the economy rebounded at the end of century. However, it was clear that a number of imbalances still constrained the economic growth. The start of the new century was notable for Armenia because of renewed stabilization and reform efforts. Comprehensive reforms were introduced in fiscal, banking and energy sectors and later aligned with the Poverty Reduction Strategy Program (PRSP), adopted by the Government in August 2003. As a result, the country outperformed other low-income countries and, in 2004, moved from the class of “low income” countries to the class of “middle income” countries.

Due to the crisis of 2008-2009, the country’s economy has shrunk, poverty and unemployment have risen, and there was a feeling of uncertainty about what to expect and how to move ahead. This was especially because of the common misbehavior that crisis is born and went from the most developed economies with long devotion to market economy, restraints on the public sector, greater efficiency of the private sector, and strong systems of social protection.

Due to the world financial and economic crisis which hit Armenia in 2008 (Q3), the economic contraction in 2009 reached 14.2% of GDP. The strong impact on the economy was due to the dependence on remittances as well as on foreign investments in the construction sector. Following the more than one year-long severe economic contraction, the real GDP turned to a growth path again already from the beginning of 2010, when real growth of 2.1% was recorded. Real GDP expanded by 4.7 per cent in 2011, and growth reached 7.2% in 2012. Growth was driven by industry and manufacturing with double digit growth rates, and a stabilization of the services and trade sectors. High prices for base metals have supported growth in the mining sector. The mining sector grew by 22.5 per cent in real terms in 2011 and by 15.5 per cent in 2012. Agriculture recovered robustly after a 16 per cent slump in 2010, with growth of 14 and 8 per cent in 2011 and 2012, respectively. Recent inflation dynamics followed developments in agricultural production. When agriculture contracted by 16.2 per cent in real terms in 2010, inflation soared to double-digits in early 2011. However, in 2013 the real growth rate of GDP decreased up to 3.5%, which made the GoA to rethink and revise its economic policies coinciding with external challenges (e.g. Customs Union membership). After accelerating to over 7 percent in 2012, led by agriculture, agro-processing, mining, and services, growth slowed to just over 3 percent in 2013, with the trade and services sectors slowing and construction again declining. A deceleration in the global and regional economy, energy price hikes, a tight fiscal position, and a slowing of credit growth were contributing factors.

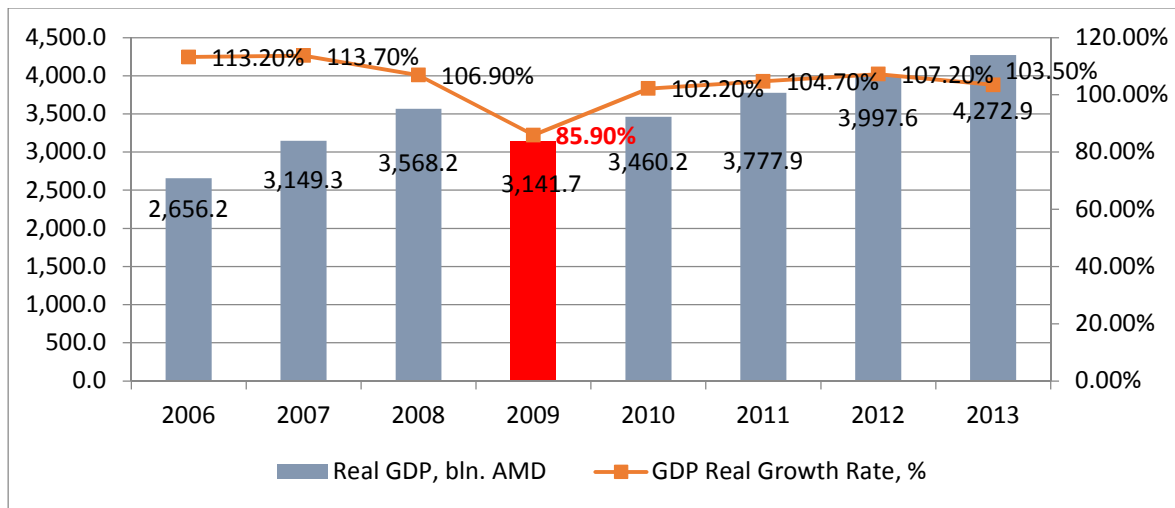
The economic growth in Armenia has peculiarities that can be considered as sources of vulnerability of economic performance during shocks. The Armenian economy is described as:

- I. narrowly based;
- II. lowly diversified by sectors;

- III. microeconomic biases with low share of small and medium-size enterprises, which would facilitate the entry of new firms and the growth of small enterprises and consequently contribute to faster job creation, employment growth and unemployment reduction;
- IV. one in which remittances play an important role in economy and mitigate the impact of the transition on the welfare of households; and
- V. an economy in which the share of informal sector is large – according to different analysts' estimates the shadow economy in 2013 is equivalent to about 35-40% of total GDP.

The socio-economic developments in Armenia during last 10 years can be divided to 3 main time periods by phases. First phase is from 2002 to September 2008, when the economy was characterized by two digit GDP growth. Annual average economic growth rate for 2002-2007 and also for the 9 months of 2008 comprised 13.1%. Since the 4th quarter of 2008 to the end of 2009, Armenian economy entered the phase of decline conditioned by global economic crisis. Particularly, GDP decline by 14.1% was registered in 2009. The period since 2010 can be characterized as phase of moderate growth of the economy. Particularly, in 2010 real growth of GDP was 2.2%, in 2011 – 4.7%, in 2012 – 7.2% and in 2013 – 3.5%.

Figure 1 Nominal GDP Dynamics in Armenia, 2006-2013, billion AMD¹

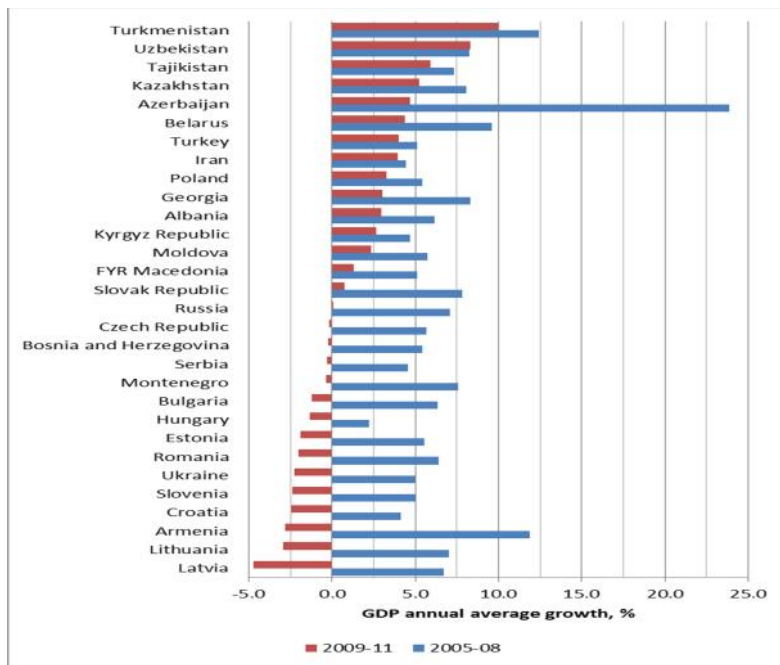


Comparison of economic development of Armenia with the countries in the region² shows that Armenia's average annual economic growth indicator in pre-crisis period (2005-2008) was in top 3, while in 2009-2011 – it has one of the lowest indicators of growth, due to 14.1% decline in 2009. Anyway taking into account the developments in the economy as well as forecasts on 2014-2016 from international organization (IMF, WB), Armenia will overcome majority of the countries by GDP growth rates.

¹ Source: National Statistical Service of Armenia

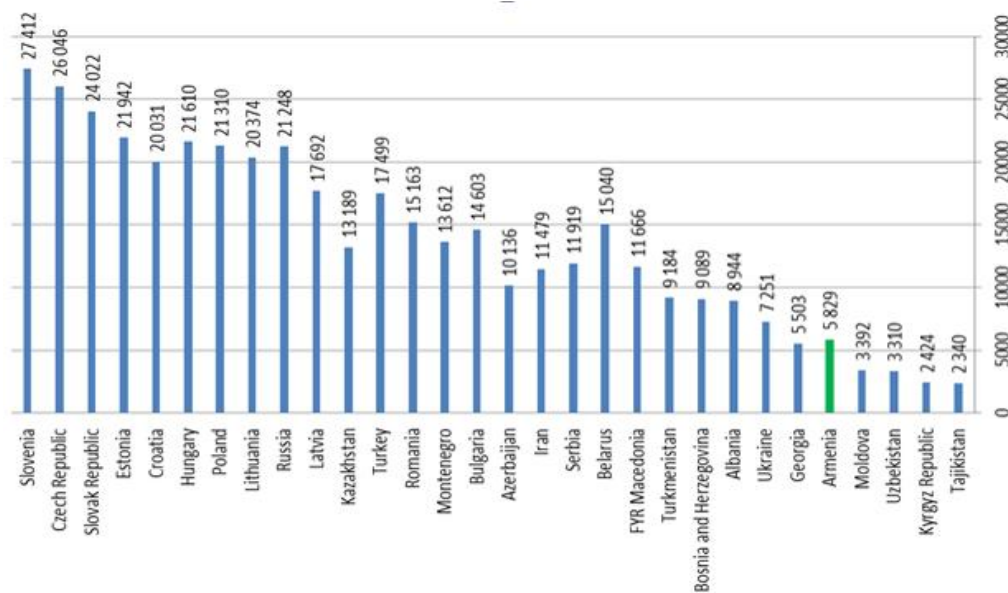
² 30 countries from East-Europe, CIS regions and Georgia, Turkey, Iran

Figure 2 Average Annual GDP Growth in Pre-crisis and after Periods by Countries³



Nominal GDP per capita for Armenia in 2013 is estimated at 3,449 USD, which is still lower than the same indicator of 2008 (USD 3,606). GDP per capita estimated according purchasing power parity (PPP) is the most relevant indicator while comparing indicators of per capita GDP between countries, as it takes into account general price level within the countries. Comparison of per capita GDP (PPP) with the countries in the region shows that Armenia's indicator is below the middle.

Figure 3 GDP per capita, PPP, USD, 2012⁴



³ Source: IMF (World Economic Outlook database, April 2012)

⁴ Source: World Bank (World Development Indicators database, September 2013) countries are listed according to GDP per capita, PPP.

Before World Economic Crisis, the structure of economic output of Armenia was rather balanced with slight domination of domestic trade and construction sectors. After 2009 the economic output structure of Armenia has been changed. The share of construction sector decreased from 18% to 7.4%. Instead, the share of domestic trade drastically increased up to 39% in 2013. The share of industry was also increased from 16.05% in 2009 to 20.83% in 2013. If analyzing the dynamics of agricultural sector output, one may find that it recorded more than 65% overall growth in 2013 compared with the same indicator of 2009.

Table 1 Economic Output of Armenia by Major Sectors, billion AMD⁵

Economic Sectors	2006	2007	2008	2009	2010	2011	2012	2013
Industry	644	716	751	664	824	992	1,120	1,241
Agriculture	556	634	637	556	638	825	840	919
Construction	623	667	842	576	580	481	470	442
Domestic Trade	1,086	1,422	1,677	1,573	1,810	2,050	2,196	2,331
Services	479	543	732	769	789	872	973	1,023

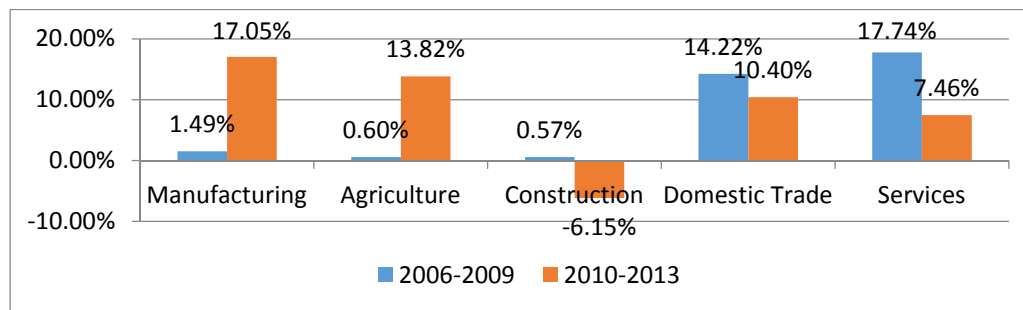
A slight increase of share of services sector was also registered. If before Crisis the share of service sector was about 14-15% than in post-crisis period this indicator reached up to 17%. Even more, during the crisis year – 2009, the share of services reached to its historical maximum – 18.58%. This was mainly thanks to the fact that in the crisis period service industry recorded slight growth in monetary terms, while all other sectors of economy recorded declines.

Table 2 Structure of Economic Output of Armenia

	2006	2007	2008	2009	2010	2011	2012	2013
Industry	19.00%	17.98%	16.19%	16.05%	17.76%	19.00%	20.01%	20.83%
Agriculture	16.41%	15.92%	13.74%	13.43%	13.74%	15.81%	15.01%	15.42%
Construction	18.40%	16.76%	18.16%	13.91%	12.49%	9.21%	8.39%	7.43%
Domestic Trade	32.05%	35.71%	36.14%	38.02%	39.01%	39.26%	39.21%	39.14%
Services	14.14%	13.63%	15.77%	18.58%	17.00%	16.71%	17.37%	17.17%
Total Economic Output	100%	100%	100%	100%	100%	100%	100%	100%

The official statistics proves (also taking into consideration GoA priorities asserted) that the structure of economic output will be changed in favor of Industry and agricultural sectors. In that, Government priorities emphasize the role of export oriented manufacturing sectors and high value added agricultural sub-sectors.

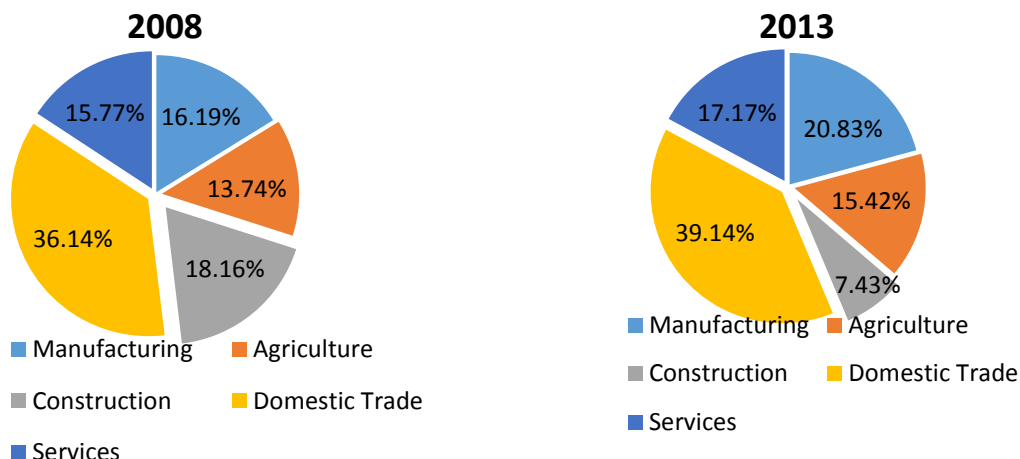
Figure 4 Average Growth Rates of Major Sectors of Economy of Armenia, pre- and post-crisis periods



⁵ Source: National Statistical Service of Armenia

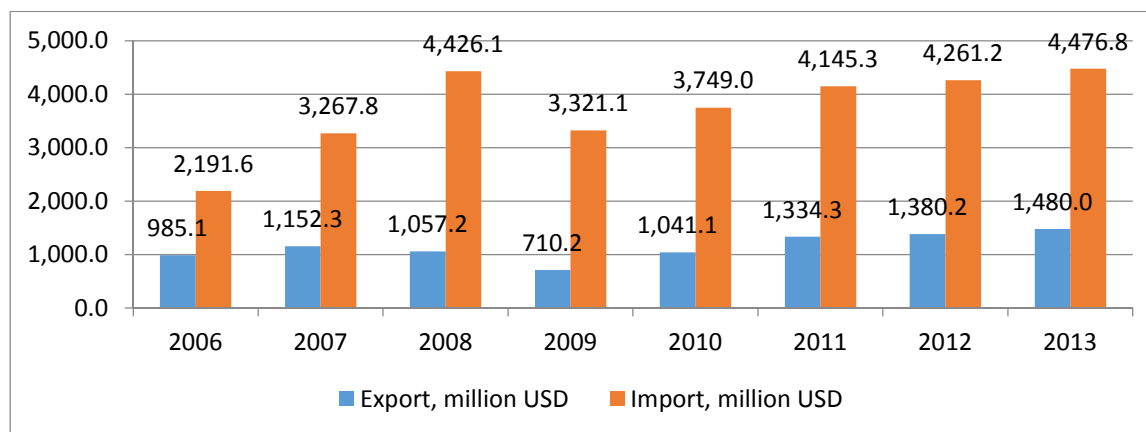
The abovementioned chart shows the differences of average annual growth rates of major economic sectors in pre-crisis and post-crisis periods. It is evident that Industry and agriculture sectors are champions. One may conclude that GoA's efforts on boosting Industry and agricultural sectors were targeted and ensured expected results. The negative impact of the Crisis was significantly visible on Construction sector.

Figure 5 Comparison of Structure of Economic Output of 2008 and 2013 by Major Sectors of Economy of Armenia⁶



Armenia is a small open economy in transition, the economy has large share of private consumption and import. The developments during the global economic crisis brought to increase in private consumption instead of capital formation and also financed by increase in imports.

Figure 6 Export and Import Dynamics of Armenia, 2006-2013, million USD⁷

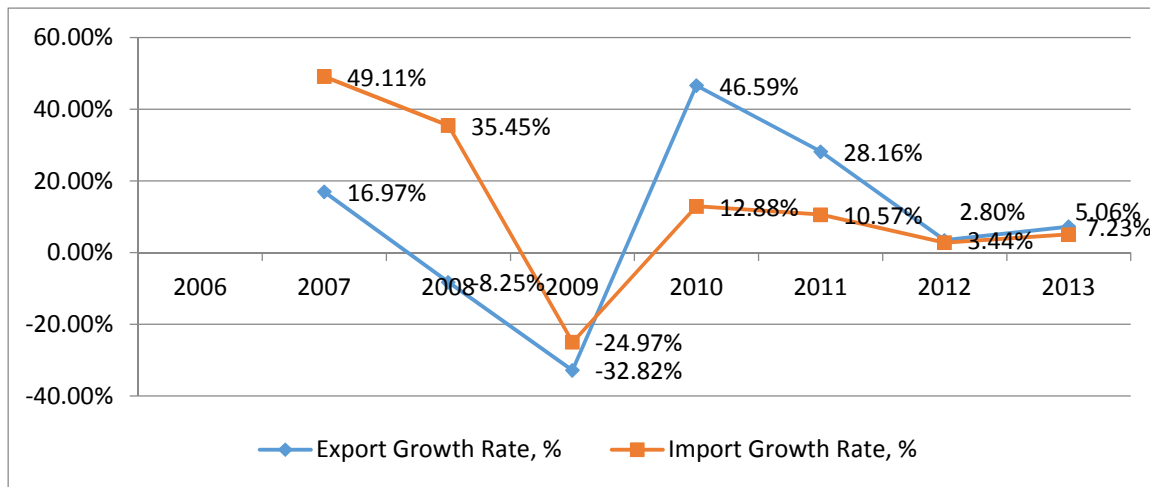


However, it is worth to mention that growth rate of export (21.3% in average) is higher than growth rate of import (7.8 % in average) starting from 2009, which is a positive trend for the economy. However, in 2013 the growth rate of export sharply decreased. If in 2010 the export growth rate was about 47%, then in 2013 the export growth rate was 7.2%. This negative dynamics is very urgent signal for the Government to revise the export development and promotion strategy.

⁶ Source: National Statistical Service of Armenia

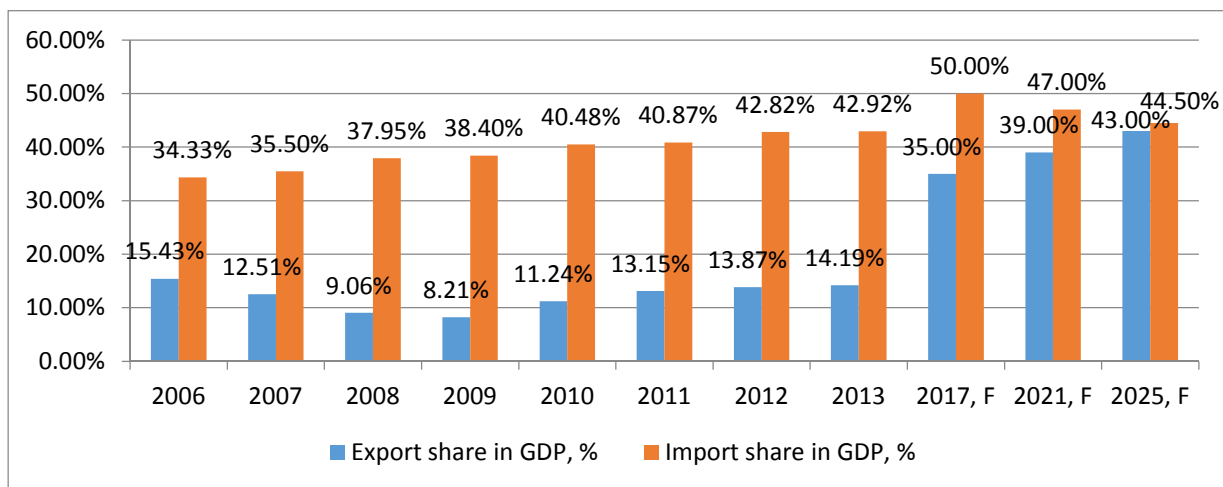
⁷ Source: National Statistical Service of Armenia

Figure 7 Foreign Trade Growth Rates, million USD⁸



According to “Prospective Strategic Development Plan of GoA, 2013-2025”, it is envisaged that Government’s efforts should be mainly concentrated on export promotion and development, the expected results of which will be substantial boost of share of foreign trade in GDP, with special emphasis on increase of export share. The figure below presents forecasts of dynamics of foreign trade share in GDP. According to GoA plans, the share of foreign trade in GDP will reach up to 87.5%, where the share of Export in GDP will be 43% and the share of Import – 44.5%.

Figure 8 Export and Import Share in GDP, 2006-2013⁹



Based on historical data analysis of foreign trade of Armenia, one may conclude that in post-crisis period along with the dynamical increase of export volumes, the structure of export has been also changed in favor of food products export. If in 2006 the share of food products in total export was 12.49%, then in 2013 the same indicator was more than 28%. It is envisaged that this trend will continue for the next decade.

⁸ Source: National Statistical Service of Armenia

⁹ Source: National Statistical Service of Armenia

Table 3 Foreign Trade of Food Products of Armenia, 2006-2013, million USD¹⁰

	2006	2007	2008	2009	2010	2011	2012	2013
Export of Products (in FOB Prices)	985	1,152	1,057	710	1,041	1,334	1,380	1,480
of which Food Products	123	170	200	135	171	237	322	415
Share of Food Products in Export, %	12.49%	14.76%	18.92%	19.01%	16.43%	17.77%	23.33%	28.04%
Import of Products (in CIF Prices)	2,192	3,268	4,426	3,321	3,749	4,145	4,261	4,477
of which Food Products	344	538	761	612	674	781	811	847
Share of Food Products in Import, %	15.69%	16.46%	17.19%	18.43%	17.98%	18.84%	19.03%	18.92%

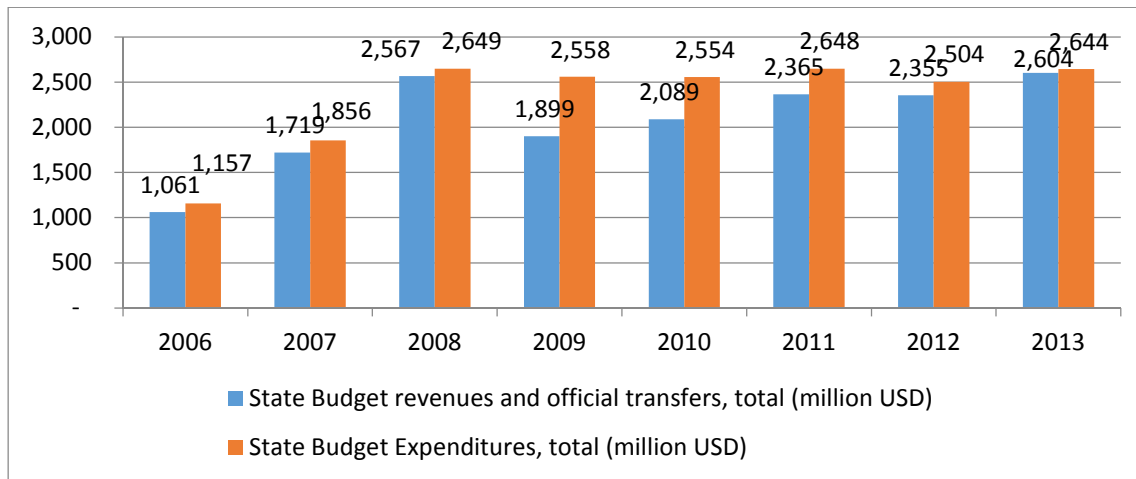
The Armenian public finance management system (state budget management) has made considerable progress in the last decade. The main progress has been noticed in the budget legislative framework, budget planning, policy development, treasury legislation and the treasury system management. Modern challenges rest on achieving a consistent framework for public sector financial management, enhancing accountability and increasing the effectiveness of public spending. The MTEF (mid-term expenditure framework) and PRSP (Poverty reduction strategy paper) processes, which have been in place since 2003, have strengthened the allocation of budget expenditure to the social sectors. The Government has steadily increased the level of financing for health, education and social protection throughout the last decade. These increased allocations resulted in substantial increases in average salary for teachers, the average size of the family poverty benefits, and average pensions. The SDP (PRSP-2), approved in Oct. 2009, reinforces Armenia's poverty reduction priorities and the policy of increasing social sector expenditures. The recent economic crisis had serious fiscal implications. On the one hand, it had negative implications on the tax revenue collection and on the other hand it puts an additional pressure on public spending. Key sectors of the economy, as well as the poor and vulnerable population, were in need of additional government support. The Government has initiated large interventions to mitigate the economic and social implications of the global crisis on Armenia. In 2010, as the country left the crisis behind, the Government terminated successfully the temporary support to the real sector but protected public spending for the socially vulnerable.

Despite the fact that the severe economic crisis of 2009 led to the temporary suspension of the MTEF it has been reintroduced in early 2010 through the government approval of the MTEF for 2011-2013 and later 2012-2014 and 2013-2015. According to Mid-term Expenditure Framework (MTEF), 2014-2016, of the Government of Armenia, over the coming years, the volume of expenditures will continue to exceed that of revenues within the structure of the state budget; meanwhile the budget deficit will be financed from both internal and external sources. The major part of the state budget deficit financing will be covered by borrowings, while the general part of external borrowings will be of a targeted nature and will be forwarded to financing of investment programs in the social sectors and public infrastructures. The ratio of the state budget deficit to GDP will gradually decrease.

According to MTEF 2014-2016 of GoA, the state budget revenues and expenditures will increase up to 32% by the end of 2016 (compared to 2013 figures). In that, the share of state budget expenditures in Agriculture will remain approximately at the same level – 0.9% of state budget expenditures.

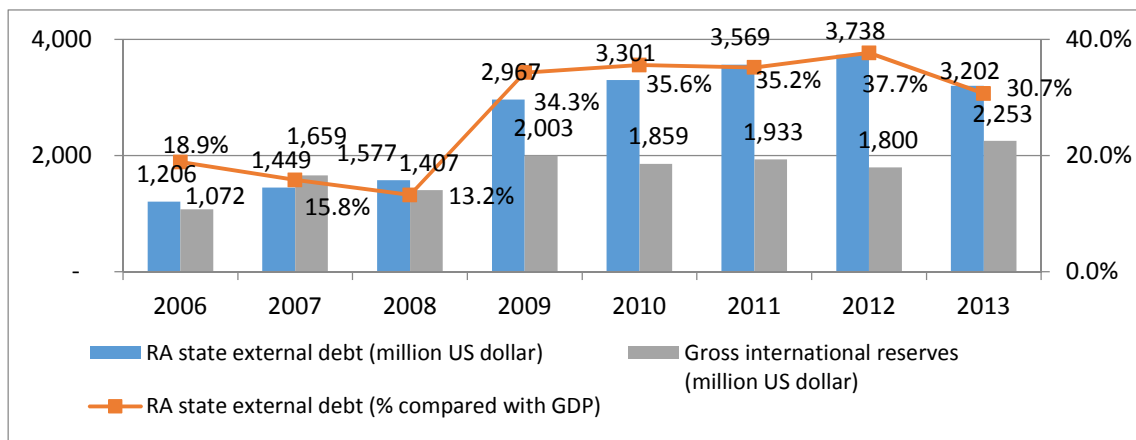
¹⁰ Source: National Statistical Service of Armenia

Figure 9 RA State Budget Revenues, Expenditures and Deficit Dynamics, 2006-2013 mln. USD¹¹



During and after the crisis, the CBA drew down its reserves to provide FX market support and smooth volatility, but the CBA was able to rebuild buffers in 2013 with the Eurobond issuance and net purchases on the domestic FX market. The external current account deficit and high dollarization in the financial system remain sources of vulnerability. Reserves of the Central Bank of Armenia are assessed as healthy and were boosted by proceeds from the September 2013 Eurobond and foreign exchange (FX) market purchases in 2013; however, reserves are expected to decline in 2014, due in part to payments to the IMF. The reduction of the external current account deficit has been supported by the significant fiscal adjustment, which has reflected capital underspendings in recent years. Further external adjustment will need to be driven by the private sector, although stepped-up private investment is also required. While structural reforms advanced under the Fund-supported program, private and foreign investment has not picked up strongly, and further business environment improvements targeting improved competition, competitiveness, connectivity, and regional integration would help shift private activity from consumption to investment.

Figure 10 External Debt and International Reserves of Armenia, 2006-2013 mln. USD

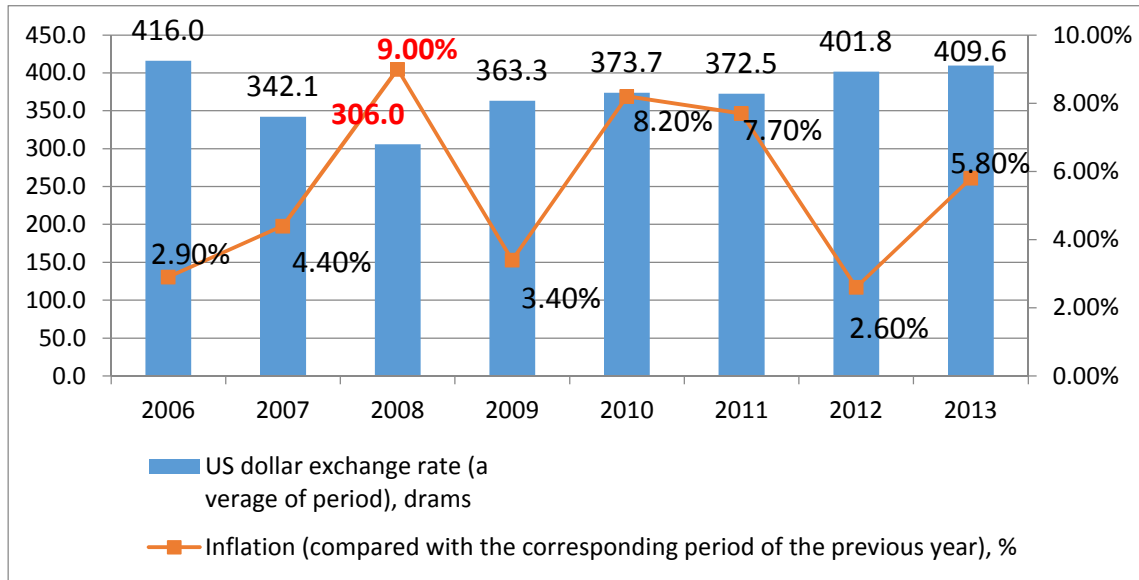


Since January 2006 the Central Bank of Armenia has moved to a fully-fledged inflation targeting strategy whereby the monetary policy was steered to minimize any deviations of potential inflation from the 4 percent

¹¹ Source: National Statistical Service of Armenia

target. Starting from Q2, 2012, the Bank has expanded inflation forecasts for a longer time horizon of 3 years instead of previously applied 1-year and publishes non-conditional inflation instead of conditional.

Figure 11 Inflation and Foreign Exchange Rate Dynamics in Armenia, 2006-2013¹²



A deceleration in the global and regional economy, energy price hikes, a tight fiscal position, and a slowing of credit growth were contributing factors. Higher food prices and energy tariff increases in July drove headline inflation (y-o-y) to 9.3 percent in August, well above the target band of the Central Bank of Armenia (CBA) of 4±1.5 percent. Inflation subsequently declined to 5.8 percent at end-year (see above-mentioned figure). The CBA increased its policy rate by 0.5 percentage point to 8.5 percent in August 2013, the first change in nearly two years, in order to mitigate possible second-round effects associated with the increase of food, gas, and electricity prices. As inflation was declining rapidly and activity was weaker than expected, the CBA reversed its move in November and cut the policy rate to 7.75 percent in December.

The main impact of the July of 2013 electricity and gas tariff increases on inflation was absorbed in 2013, and demand pressures remain moderate due to the gradual growth recovery. Food inflation pressures—which in Armenia are highly linked to movements in international commodity prices—are expected to moderate in 2014, but remain a source of risk given the large food component in Armenia’s consumption basket.

¹² Source: National Statistical Service of Armenia

ECONOMY

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Domestic Trade	32.05%	35.71%	36.14%	38.02%	39.01%	39.26%	39.21%	39.14%
Services	14.14%	13.63%	15.77%	18.58%	17.00%	16.71%	17.37%	17.17%
Total Economic Output	100%	100%	100%	100%	100%	100%	100%	100%

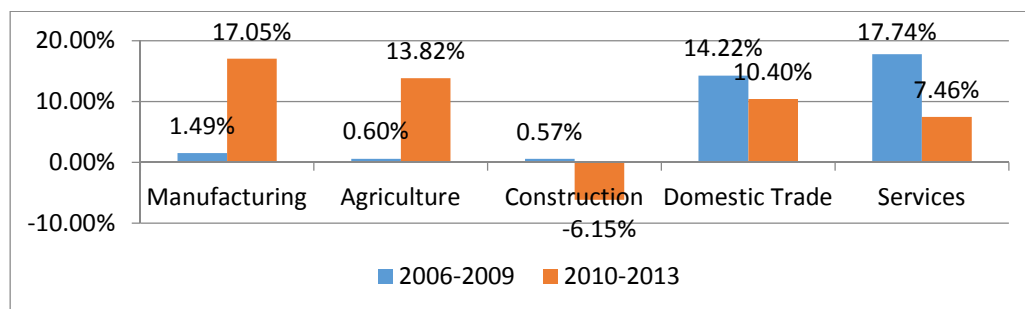
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Figure 12 Average Growth Rates of Major Sectors of Economy of Armenia, pre- and post-crisis periods¹⁵

¹³ Source: National Statistical Service of Armenia

¹⁴ Source: National Statistical Service of Armenia

¹⁵ Source: National Statistical Service of Armenia



According to “Armenia Development Strategy for 2014-2025” the share of Industrial sector in GDP will reach up to 21.2% (17% in 2013) and value-added in Industrial sector will reach up to AMD 3 trillion (AMD 741.6 billion in 2013) by 2025. Agricultural sector will continue steady growth and will value added of agricultural sector will reach up to AMD 2 trillion (AMD 819 billion in 2013), however its share in GDP will decrease from 19.2% in 2013 to 14.6% in 2025. These forecasts of the development of economic sector were made with consideration for certain sectoral changes to the economy. In 2014-2025, the increase in the share of export sectors – industry, as well as agriculture, which began after the crisis, will continue. Before the crisis, economic growth was led by construction and services sectors, where the increase in supply was mainly a reflection of that demand formed in the economy, while the increase in productivity of the economic sectors is limited in the long run. Instead of that, export sectors of the economy are forced to work with higher productivity in order to be competitive, and consequently are more promising to ensure long-term economic growth.

Table 6 Development of Economy by Sectors (GDP by Sector), billion AMD¹⁶

Indicators	2011	2012	2013	2014	2017	2021	2025
	Actual	Actual	Actual	Forecast			
Industry	648	688	742	829	1,161	1,861	2,979
Agriculture	768	764	819	889	1,117	1,525	2,047
Construction	491	489	439	485	645	958	1,441
Services	1,459	1,599	1,762	1,941	2,582	3,902	5,946
Net indirect taxes	412	458	512	555	727	1,105	1,632
Gross domestic product	3,778	3,998	4,273	4,700	6,232	9,350	14,045

The abovementioned forecasts of GoA shows that Government efforts will be mainly concentrated on industrial and services and agricultural sectors development. In that, the development of Industrial sector will be supported by the development of food industry with its export-oriented directions, where the role of agricultural will be substantially high. It is forecasted that value-added in Industry will reach up to AMD 3,000 billion in 2025. If comparing this indicator with the actual figure of 2013, one may conclude that this figure will be quadrupled, which means that the role of industrial sector will be strengthened and will support the development of agricultural sector together with service industry.

Table 7 Development of Economy by Sectors (GDP structure by Sector), %¹⁷

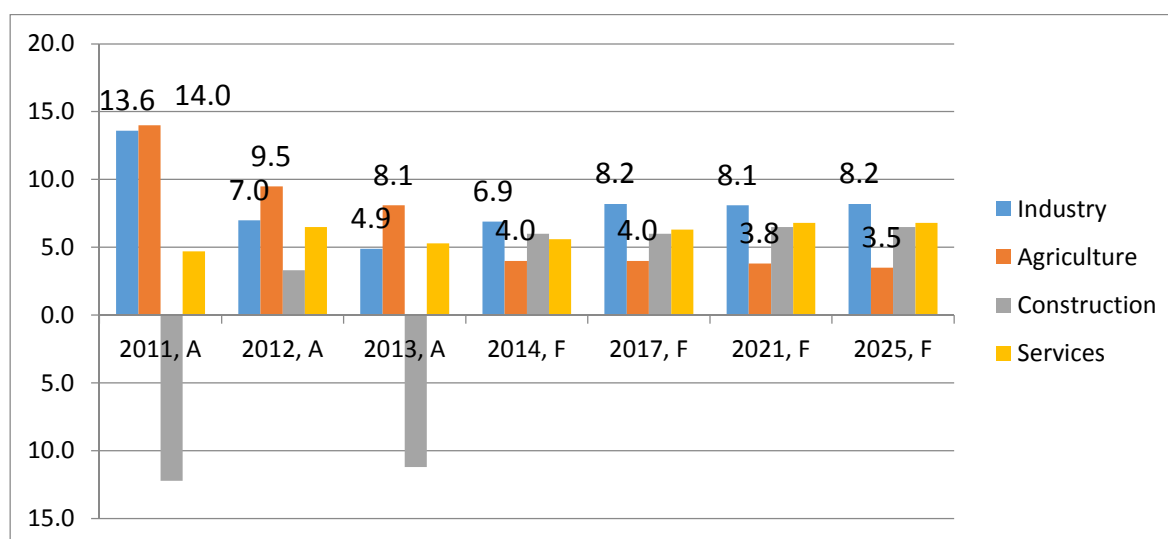
¹⁶ Source: “Armenia Development Strategy for 2014-2025”

¹⁷ Source: “Armenia Development Strategy for 2014-2025”

Indicators	2011	2012	2013	2014	2017	2021	2025
	Actual	Actual	Actual	Forecast			
Industry	17.1	17.2	17.4	17.6	18.6	19.9	21.2
Agriculture	20.3	19.1	19.2	18.9	17.9	16.3	14.6
Construction	13.0	12.2	10.3	10.3	10.4	10.2	10.3
Services	38.6	40.0	41.3	41.3	41.4	41.7	42.3
Net indirect taxes	10.9	11.5	11.9	11.8	11.7	11.8	11.6
Gross domestic product	100	100	100	100	100	100	100

Industry together with Agriculture will remain the major sources of economic growth of Armenia for the next 10-11 years. As forecasted in the “Armenia Development Strategy 2014-2025” the industrial sector will continue growing at 7.9% average annual rate, while agricultural sector will continue growing with not less than 3.8% average annual rate. The major connecting point of those two essential economic sectors will be food industry, the detailed analysis of which is presented in the next chapters.

Figure 13 Forecasted Growth Rates of Economic Sectors from Value-Added Point of View¹⁸, %



¹⁸ Source: “Armenia Development Strategy for 2014-2025”