Armenia

Country Economic Update
Summer 2018

An Opportunity to Unlock Armenia's Potential

WORLD BANK GROUP

Macroeconomics, Trade & Investment
Global Practice

ARMENIA:

An Opportunity to Unlock Armenia's Potential

Country Economic Update

Summer 2018

WORLD BANK GROUP
Macroeconomics, Trade & Investment

Government fiscal year:	January 1 – December 31
Currency unit:	Armenian dram (AMD)
Currency equivalents:	Exchange rate effective as of June 1, 2018 US$1 = 482.9 AMD
Weights and measures:	Metric system

Abbreviations and acronyms

AMD	Armenian dram
CBA	Central Bank of Armenia
RPA	Republican Party of Armenia
CEU	Country Economic Update
EAI	Economic Activity Index
EEU	Eurasian Economic Union
EU	European Union
IMF	International Monetary Fund
FDI	Foreign direct investment
GoA	Government of Armenia
LPI	Logistics Performance Index
GDP	Gross Domestic Product
MTEF	Medium term Expenditure Framework
NPL	Nonperforming loan
NSS	National Statistics Service
SCD	Systematic Country Diagnostics
VAT	Value-added tax
WBG	World Bank Group

Table of Contents

Figures

Tables

Box

Annex Tables

Foreword

This edition of Armenia's Country Economic Update (CEU) is part of a semi-annual series designed to monitor socio-economic developments in Armenia. It presents a concise analysis of political, economic, and social developments as well as of progress achieved in the implementation of structural reforms since the Winter 2018 edition of the CEU. This edition's author is Armineh Manookian (Country Economist for Armenia), with a significant contribution by Evgenij Najdov (Senior Economist for South Caucasus) and support from Artsvi Khachatryan (Consultant). It also includes a special focus section highlighting the findings of the Foreign Direct Investment Sector Scan of the agribusiness sector in Armenia conducted by the World Bank Group. The authors are grateful for the support of, and inputs from, Mercy Miyang Tembon (Regional Director, ECCSC), Sylvie Bossoutrot (Country Manager for Armenia), Genevieve Boyreau (EFI Program Leader for South Caucasus), Jeff Chelsky (Lead Economist) and Moritz Meyer (Economist). Sarah Nankya Babirye (Program Assistant in Washington, D.C.) and Gayane Davtyan (Program Assistant in Yerevan) provided administrative support. Vigen Sargsyan (Senior Communications Officer, ECAEC) helped with the report dissemination.

María González-Miranda
Practice Manager
Macroeconomics, Trade & Investment Global Practice

Key Messages

The political landscape underwent a massive change in early 2018.

Following 10 years as President and after recently being elected Prime Minister, Serzh Sargsyan resigned on April 23, 2018, following nationwide protests. Nikol Pashinyan, the MP and opposition leader, was elected Prime Minister on May 8. The new administration has identified anti-corruption efforts, free and fair early parliamentary elections, and greater equity as its priorities.

In 2017, the economy grew at the fastest rate since the global financial crisis.

Supported by a recovery in the external environment and a strong rebound in domestic demand, the economy grew by 7.5 percent in 2017 (following flat growth in 2016). The positive trend continued in the first quarter of 2018, with high-frequency data suggesting that political developments in April and May did not significantly impact economic activity. Inflation was within the Central Bank of Armenia (CBA) inflation target range and low compared with the region. The fiscal position improved in 2017, although by less than planned, and government debt increased to 54 percent of GDP at end-2017, two percentage points of GDP above its 2016 level. Although the new government has signaled its commitment to lower the deficit while strengthening redistributive policies and fighting tax evasion, the details are yet to be articulated.

Low employment levels and poverty remain Armenia's two biggest obstacles to social progress.

The positive macroeconomic developments in 2017 had a relatively small impact on labor markets. The unemployment rate—which declined only marginally, from 18 percent in 2016 to 17.8 percent in 2017—remains among the highest in the region. Strong GDP growth in 2017 pushed GDP per capita up by 10 percent, reaching its 2014 level. However, the benefits of economic growth were not widely shared.

There is reason for optimism about Armenia's economic outlook, but significant risks remain.

Fresh political will to implement significant regulatory reforms governing competition and the business environment—together with efforts to strengthen human capital—can boost growth to above Armenia's medium-term baseline annual growth potential of 4 percent. However, in the short term, economic activity may slow as the economy adjusts to the new realities and as the drivers of growth from 2017 dissipate. Adverse shocks—affecting, for instance, the economic recovery of the Russian Federation, metal prices, or global demand—would undermine prospects for Armenia's external performance. Domestically, the capacity to design and push through reforms is yet to be tested. It will be important to preserve the gains achieved by recently-introduced reforms (in taxation and pensions, for example). Re-designing economic policies to address the population's grievances while safeguarding fiscal and macroeconomic stability may prove challenging.

A. Recent Developments

Political Developments

Nationwide protests resulted in a leadership change.

The political landscape underwent a massive change in recent months, culminating in a peaceful transition of power. On April 17, 2018, Serzh Sargsyan—who served two consecutive terms as President—was elected Prime Minister by parliament. With Armenia recently having completed a transition to a parliamentary system that shifted significant powers from the president to the prime minister, the move would have secured an additional term for Mr. Sargsyan. However, this was met with massive non-violent nationwide protests, building on growing dissatisfaction with the government's performance, particularly perceptions of systemic corruption and a lack of social and political reform. The protests resulted in the Prime Minister stepping down on April 23. Nikol Pashinyan, the leader of the protests, was subsequently elected Prime Minister on May 8 with the backing of 59 of 101 members of parliament, including some from Mr. Sargsyan's Republican Party. The new government was sworn in on May 21. Its members include several senior officials from the previous government, experienced technocrats, and young associates and political appointees representing the three factions in the Armenian Parliament.

The new government has identified anti-corruption and free and fair early elections as priorities -

The new administration has identified its immediate priorities as anti-corruption efforts and putting in place the conditions for free and fair early parliamentary elections. So far, several investigations have been launched against businesses for alleged tax evasion. At the same time, early parliamentary elections are slated to take place within one year, following amendments to the Electoral Code and electoral system.[1]

… while supporting continuity in international relations.

The new government has confirmed its commitment to Armenia's major international engagements. In particular, Mr. Pashinyan has expressed his administration's commitment to the implementation of the Comprehensive and Enhanced Partnership Agreement with the European Union (approved by the Armenian authorities on December 28, 2017), while maintaining close relationships with Russia and the Eurasian Economic Union. Importantly, the new administration has restated its openness to advancing negotiations on multiple issues with countries in the region.

Economic Growth and Inflation

In 2017 Armenia's economy expanded at the highest rate since

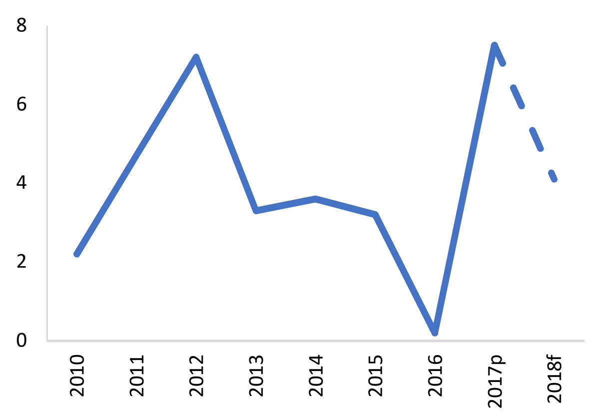
The favorable trends in economic activity in the first half of 2017 accelerated towards the end of the year, supported by a buoyant regional economy. Improving GDP growth rates was a global phenomenon in 2017. The region also experienced the fastest growth since the 2008 global financial crisis, mostly

[1] The holding of early elections is specified in the Government Program approved by the National Assembly on June 7, 2018.

the global financial crisis.

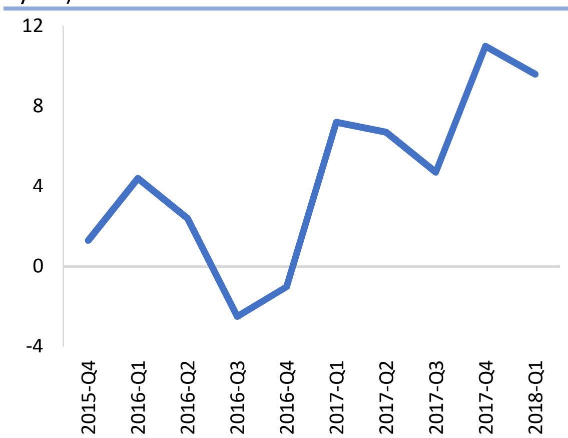
driven by rising private sector demand and a shift toward exports. Following a flat economic performance in 2016, Armenia's real GDP growth rate is estimated to have reached 7.5 percent in 2017, the highest rate in a decade (Figure 1) More than one-half of GDP growth came from a strong expansion in services, notably from trade, financial and insurance activities, and arts, entertainment, and recreation. This performance reflects positive developments in the labor market and higher remittance inflows as well as robust tourism earnings. Manufacturing expanded by 6 percent, while agriculture was the only sector that posted a contraction in 2017, with output falling by 5 percent year on year due to unfavorable weather conditions. Importantly, value added from the construction sector rose by 3 percent year on year, the sector's first positive contribution since 2008. On the expenditure side, economic growth was driven by a strong rebound in consumption and investment. At the same time, exports rose by about 20 percent in real terms; however, strong domestic demand resulted in a 26 percent increase in imports of goods and services. Consequently, net exports acted as a drag on growth, in contrast to recent years (Table 1).

Figure 1. Real GDP Growth
(In percent, year-over-year)



Source: NSS and World Bank staff calculations.

Figure 2. Quarterly Real GDP Growth
(In percent, quarter over same quarter previous year)

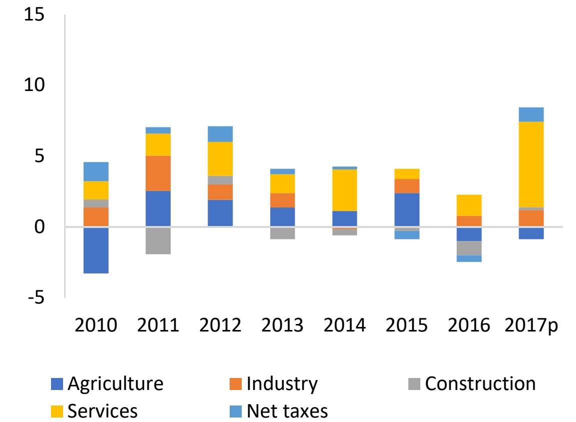


Source: NSS and World Bank staff calculations.

Favorable trends continued into early 2018, with the construction sector registering the fastest growth.

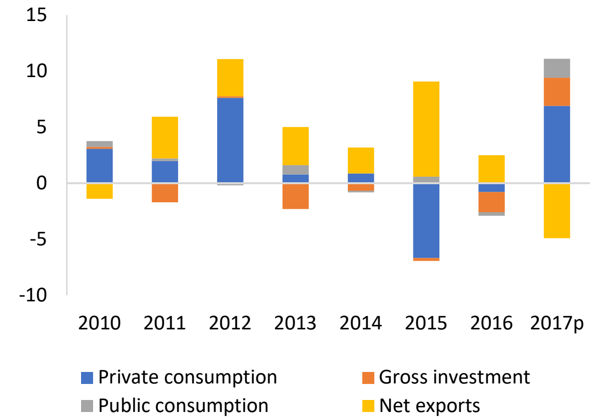
The expansion of the economy continued into the first quarter of 2018. Based on preliminary data, real GDP in the first quarter expanded by 9.6 percent compared with the first quarter 2017 (Figure 2). The recovery in the construction sector strengthened as value added rose by 13 percent year on year. However, years of contraction in the sector have significantly reduced its share in the total economy; as a result, the construction contributed only 0.5 percentage points to overall economic growth. Most of the expansion (6.2 percentage points out of 9.6 percent growth) came from growth in trade and other services, particularly from services related to human health and social work and real estate activities. Industry expanded by 6.4 percent in the first quarter of 2018, building on strong growth in 2017, while the agriculture sector continued to stagnate. High-frequency data for April showed a modest slowdown in the growth rate to 7.3 percent, possibly reflecting the impact of nationwide demonstrations and strikes during the month of April. So far, however, there is no conclusive evidence that recent political developments have had a significant negative impact on the overall economy.

Figure 3. GDP Growth by Sector
(In percent)



Source: NSS and World Bank staff calculations.

Figure 4. GDP Growth by Source of Demand
(In percent)



Source: NSS and World Bank staff calculations.

Table 1. Contribution to Real GDP Growth
(In percentage points)

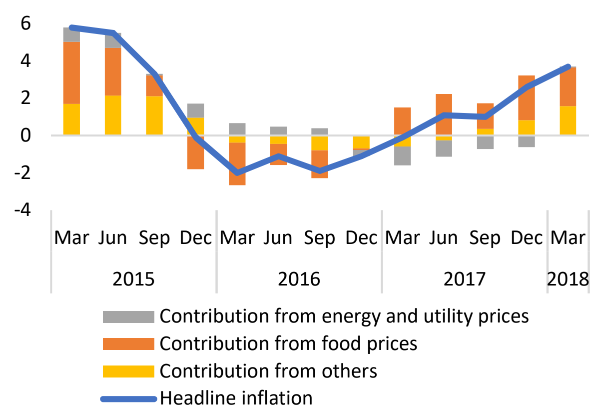
	2013	2014	2015	2016	2017p
Real GDP growth	**3.3**	**3.6**	**3.2**	**0.2**	**7.5**
Domestic demand	-0.7	0.0	-6.3	-2.9	11.1
Consumption	1.6	0.7	-6.1	-1.1	8.6
Gross capital formation	-2.3	-0.7	-0.3	-1.8	2.5
Net exports	3.4	2.3	8.5	2.5	-4.9
Exports of goods and services	2.4	1.8	1.4	5.7	6.5
Imports of goods and services	-1.0	-0.5	-7.1	3.2	11.5
Statistical discrepancy	0.6	1.3	1.0	0.6	1.3

Source: World Bank staff calculations based on data published by NSS.
Note: Sums may not add due to rounding.

Despite a slight uptick, inflation remains below the CBA target.

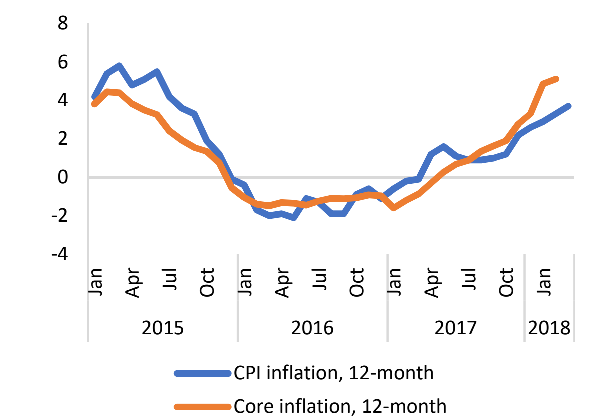
Recovering domestic demand, weak agriculture yields, and higher global food and fuel prices pushed inflation up, but it remained within the target range. Annual inflation at the end of 2017 reached 2.6 percent compared with deflation in 2016. The main contributor to the acceleration in 2017 was food prices (including beverages and cigarettes), which rose by 5.3 percent year on year. Transport prices increased by 4.6 percent in 2017. The other groups registered either lower inflation or deflation. The utilities price index declined by 4 percent on a year-on-year basis, due in part to reduction in administered prices for gas and electricity at the start of the year by 5 and 3 percent, respectively. Inflation accelerated to 3.7 percent in the first quarter of 2018, with the increase in food and beverage prices explaining half of the price increase. Meat prices (up by 14 percent year on year due mainly to higher international prices) made the largest contribution to the food price increase. Inflation was also pushed up by a significant (9 percent) increase in transport prices, particularly petrol and diesel (up 17 and 26 percent year on year, respectively), reflecting higher excise tax rates effective January 2018 and gradually recovering global oil prices. Core inflation edged up to 5.1 percent by the end of the first quarter of 2018, exceeding headline inflation, mainly owing to flat administered gas and electricity tariffs (Figure 5 and Figure 6). April data showed a deceleration in annual inflation, to 2.4 percent, suggesting that political developments did not have a major impact on product markets.

Figure 5. Inflation, by Component
(In percent, month over same month previous year)



Source: NSS and World Bank staff calculations.

Figure 6. Headline and Core Inflation
(In percent, month over same month previous year)



Source: NSS and World Bank staff calculations.

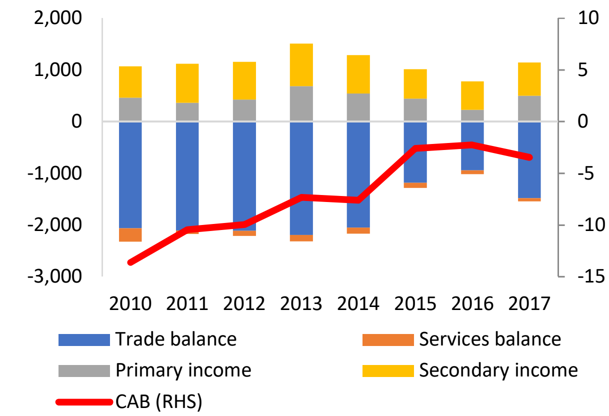
External Sector

Despite robust export earnings, the current account deficit widened.

The current account balance continued to improve in the first three quarters of 2017; however, a strong expansion in imports in the last quarter of the year resulted in the overall deficit widening to 3.5 percent of GDP, 1.2 percentage points higher than in 2016 (Figure 7) The significant increase in goods imports in the fourth quarter, particularly in December, was partly related to an in-kind military loan from Russia. Excluding this transaction, the 2017 current account deficit was about 2 percent of GDP. Importantly, goods exports continued to perform well, increasing by 26 percent year on year in nominal US dollar terms.[2] The services balance also registered an improvement, while remittance inflows increased by 12 percent, with 2017 being the first year since the 2014 Russian crisis when remittances increased (Figure 8).

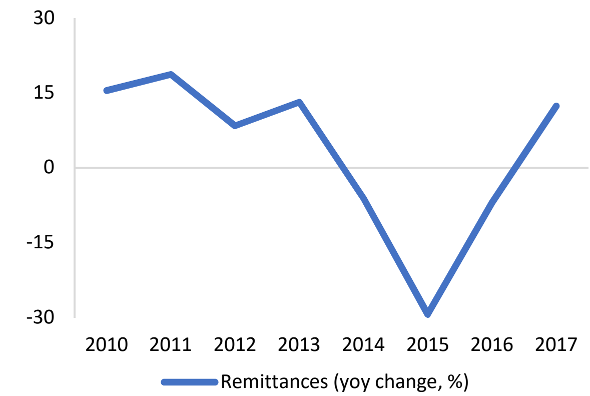
[2] Balance of payments data on free on board (FOB) basis.

Figure 7. Current Account Balance
(US$ million) (In percent of GDP)



Source: CBA, NSS and World Bank staff calculations.

Figure 8. Remittances
(Annual percent change)

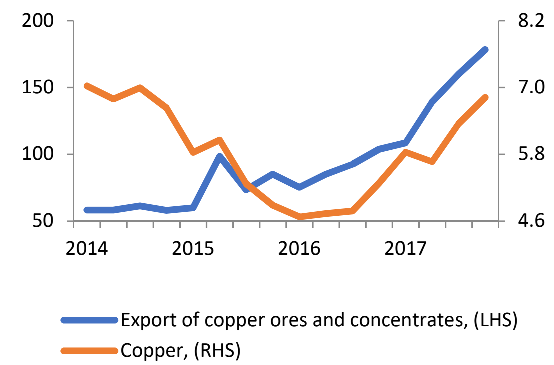


Source: CBA and World Bank staff calculations.

Exports of goods benefited from the continued recovery in commodity prices and growth in main trading partners.

The recovery in global metal prices, particularly for copper, and a resumption of growth in Russia pushed export earnings up by about 25 percent in 2017.[3] Copper exports rose by 64 percent in nominal terms (20 percent in volume terms), benefiting from higher demand as well as rising prices (Figure 9). Exports of Armenian wine increased by 76 percent year on year, with nearly 90 percent of wine exports sold at the Russian market. In sync with declining agricultural output, exports of agriculture products also contracted, especially of tomatoes and stone fruit (apricots, cherries, plums, and peaches, in particular). Exports of gold and jewelry also contracted by 14 percent year on year (Figure 10) The data on exports by destination market show that the share of total exports to Russia increased from 20 percent in 2016 to 24 percent in 2017. Exports to EU economies increased by 32 percent, bringing the block's total share of Armenian exports to 28 percent (Figure 11).

Figure 9. Exports of Copper Ore And World Price
(In US$ million) ('000 US$ per metric ton)



Source: CBA, NSS and World Bank staff calculations.

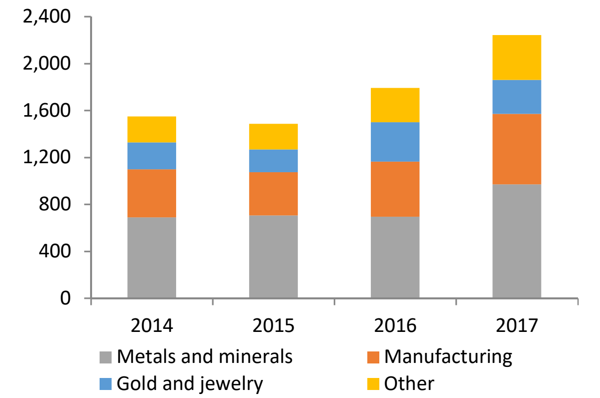
Foreign trade continued to expand briskly in the first quarter of 2018.

Exports grew by 34 percent year on year in the first quarter of 2018, following a similar trajectory to that recorded in 2017. Exports of textiles more than doubled year on year in the first quarter of 2018, boosting its share of total exports from 5 percent to 8.5 percent. At the same time, imports increased by 39 percent, driven mainly by rising capital goods imports (including imports of

[3] Foreign trade data on cost, insurance, and freight (CIF) basis.

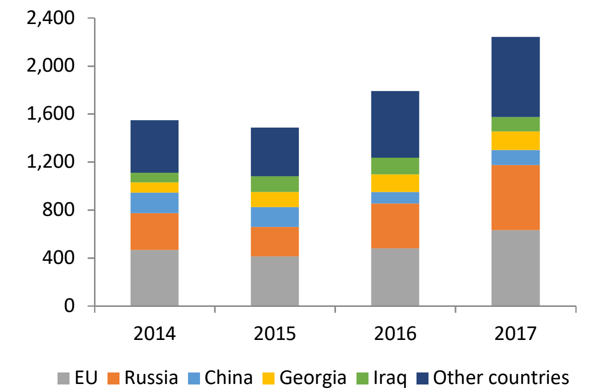
machines, equipment, and devices, and capital goods for land, air, and water transport).

Figure 10. Exports by Commodity Groups
(US$ million)



Source: NSS, World Bank staff calculations.

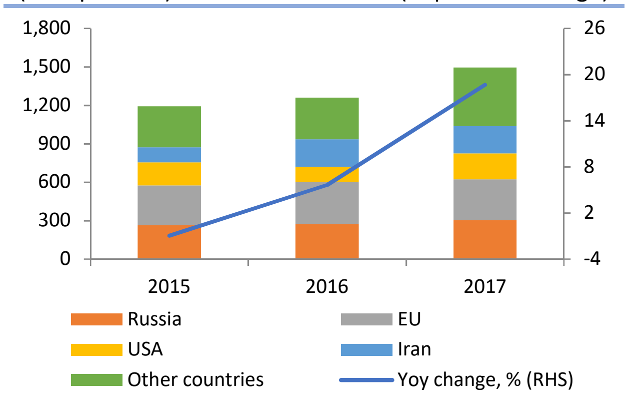
Figure 11. Exports by Destination Economy
(US$ million)



Source: NSS, World Bank staff calculations.

Despite improving in 2017, net service exports remained negative.

Figure 12. Tourist arrivals, by Economy
('000 persons) (In percent change)



Source: NSS, World Bank staff calculations.

Exports of services rose by 18 percent, 10 percentage points of which was due to an increase in tourism-related services as the number of tourists visiting Armenia reached 1.5 million (19 percent annual growth). One-fifth of tourists came from Russia, with a similar number coming from the European Union. More than 200,000 tourists from the Islamic Republic of Iran visited Armenia in 2017, accounting for 14 percent of all visitors (a similar proportion as in 2016). Tourist arrivals from the United State increased by 70 percent year on year, totaling around 200,000. Tourists from other economies also increased, by around 40 percent, suggesting some of diversification in Armenia's tourism base (Figure 12).[4] Exports of other services, such as information and communication technology (ICT) and construction abroad, also positively contributed to the improvement of the services balance in 2017.

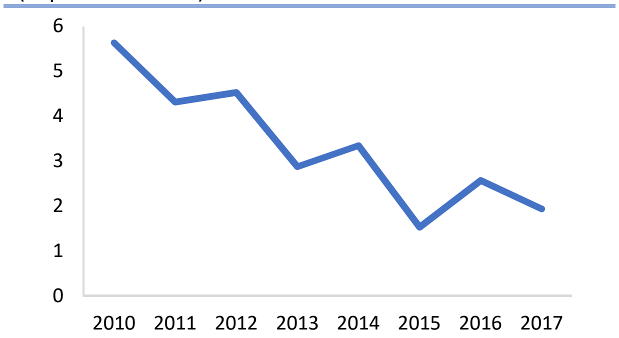
[4] In 2018, Armenia will host three major events that are expected to attract more members of the Armenian diaspora and international tourists. These are: (i) the 100th anniversary of the First Republic (May); (ii) The 2,800-year anniversary of Yerevan (September); and (iii) the Francophonie Summit (October).

Foreign direct investment flows remain subdued.

Capital and financial account inflows exceeded the current account deficit in 2017, allowing for some reserve accumulation although smaller than in 2016. Net FDI inflows fell to US$223 million in 2017, about 18 percent below the previous year. As a percentage of GDP, net FDI declined from 2.5 percent in 2016 to 1.9 percent in 2017 (Figure13), partly reflecting a high base of comparison (commercial banks increased capital levels in 2016 to meet higher capital requirements set by the CBA). Inflows of FDI in 2017 went mostly to the construction and mining sectors,[5] suggesting that efficiency-seeking investment—that is, investment that enters an economy to benefit from factors that enable it to compete in international markets—continues to bypass Armenia. The portfolio account registered a deficit of around US$87 million, as Armenian entities increased holdings abroad and reduced their foreign liabilities. Net inflows from loan transactions were positive, mainly reflecting government borrowing (including the military loan received from Russia in late 2017) as well as reduced short-term foreign claims of Armenian banks. As a result, international reserves continued to increase, reaching US$2.3 billion at end-2017, up by US$110 million compared to a year earlier, and providing 4.6 months of import cover (Figure 14) However, the political developments in April and May 2018 pushed up demand for foreign exchange, triggering limited interventions by the CBA. Nonetheless, reserves stood at more than US$2 billion by end-April, providing relatively comfortable cover.

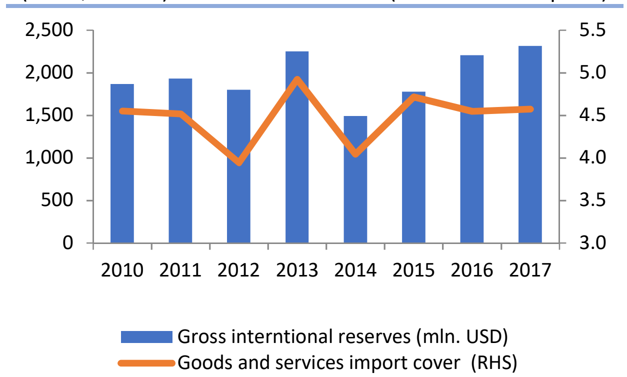
International reserves increased in 2017; but came under pressures during the recent political developments.

Figure 13. Net Foreign Direct Investment
(In percent of GDP)



Source: CBA, NSS, and World Bank staff calculations.

Figure 14. Gross International Reserves
(In US$ million) (In months of imports)



Source: CBA, NSS, and World Bank staff calculations.

Fiscal Policy and Public Debt

The fiscal deficit was larger than planned in 2017, resulting in rising government debt.

The fiscal position improved in 2017, although by significantly less than planned. After tightly controlling spending through November 2017, the government received an unbudgeted in-kind military loan from Russia in the last month of the year, resulting in the widening of the fiscal deficit to 4.8

[5] The majority of FDI in Armenia's mining sector in 2017 was related to the Amulsar Gold mine project, located in south-central Armenia. Owned 100 percent by Lydian International, the mine is expected to start operations in 2018.

percent of GDP, compared to a target of 2.8 percent. Excluding this transaction, the fiscal deficit would have been 3.3 percent of GDP. Still, the deficit was down from 5.5 percent in 2016 (Figure 15). In response, government debt increased to 54 percent of GDP by the end of 2017, up from 52 percent a year earlier. Public debt (including CBA debt) reached 59 percent of GDP, most of which (48 percent of GDP) was external debt (Figure 16).

The fiscal rule was adjusted in 2017 to provide greater flexibility for countercyclical fiscal policy. With government debt above 50 percent of GDP at the end of 2016, the fiscal rule[6] mandated a relatively rapid fiscal consolidation. However, in an environment of no growth, a rapid fiscal adjustment would have been procyclical. Furthermore, the fiscal rule was considered too restrictive as it did not provide an escape clause for unexpected events or developments. In response, the authorities, with technical assistance from the IMF, revised the fiscal rule at the end of 2017 by amending the Public Debt Law to remove the pro-cyclicality feature of the old rule, and the Budget System Law to define specific expenditure disciplinary rules which would become effective as public debt levels reach certain thresholds. To fully operationalize the new fiscal rule, the authorities still need to adopt a decision that will define certain technicalities, including the calculation of long-term GDP growth. (see Box 1 and Annex 2 for details of the new rule).

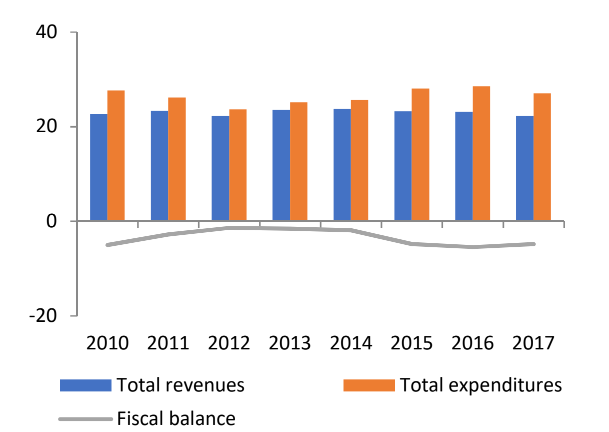
Box 1: Fiscal Rules

Fiscal rules have gained popularity in recent decades as countries have tried to improve fiscal discipline. A recent IMF blog “Fiscal Rules: Make them Easy to Love and Hard to Cheat”[7] analyzed fiscal rules which became effective over the last three decades in over 90 economies. The blog noted three attributes of effective fiscal rules—they need to be simple, flexible, and enforceable in the face of changing economic circumstances. However, the authors found that rules were often too complex, overly rigid, and difficult to enforce. The analysis also proposed principles for fiscal rule design.

Armenia’s recently revised its fiscal rule. In general terms, the revision brings Armenia’s fiscal rule closer to the good principles for fiscal rule design. For example, in line with proposed principles, the revised rule contains a debt rule (debt should not exceed 60 percent of GDP) but also introduces a number of operational rules that are supposed to guide annual budget decisions (for example, imposing limits on spending when certain thresholds are reached). Furthermore, the legislation envisages for a clear exemption from these rules in case of emergencies. On the other hand, the number of operational rules may be on the high end, while the incentives for better compliance may require strengthening. Experience over time will demonstrate if the revised rule strikes a better balance between effectiveness and simplicity.

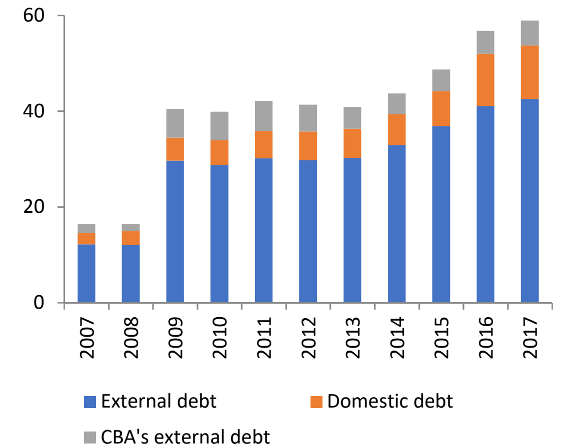
[6] The Fiscal Rule adopted in 2008 stated that if government debt exceeds 50 percent of previous year GDP, the fiscal deficit for the next year would be reduced to 3 percent of the average nominal GDP of the previous three years, and if it exceeds 60 percent of GDP, no further debt can be issued. Following to this rule, in 2016, when the debt level exceeded the 50 percent threshold, the government planned to reduce its deficit from 5.5 percent of GDP in 2016 to 2.8 percent of GDP in the 2017 State Budget Law.
[7] https://blogs.imf.org/2018/04/13/fiscal-rules-make-them-easy-to-love-and-hard-to-cheat/

Figure 15. Fiscal Developments
(In percent of GDP)



Source: MoF, NSS and World Bank staff calculations.

Figure 16. Public Debt Dynamics
(In percent of GDP)

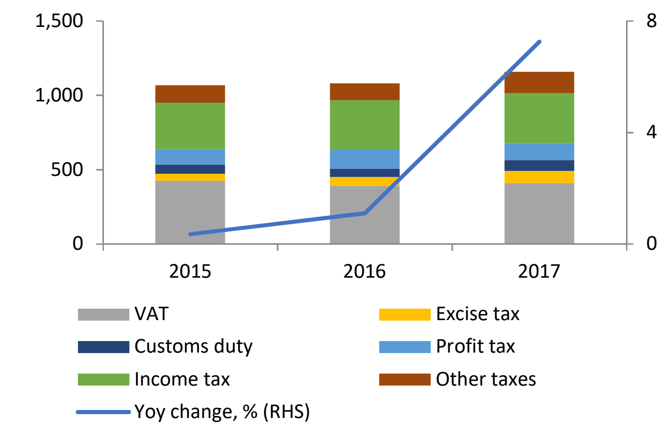


Source: MoF, NSS, and World Bank staff calculations.

Indirect taxes accounted for the bulk of the increase in tax collection.

Tax revenue rose by 7.3 percent year on year in 2017 in nominal terms, driven by higher collections of excise, customs, and environmental taxes. The share of indirect taxes and customs duties in total taxes increased from 47 to 49 percent (Figure 17). Environmental taxes[8] registered the highest year-on-year growth, rising by 47 percent. Profit tax collection was the only tax category which declined compared to the previous year. This decline was partly on account of the weak performance of the economy in 2016, which is the basis for profit tax payments in 2017. Social contributions collected from employees who are members of the fully-funded pension pillar[9] increased by 18 percent year on year, to AMD 16 billion. This amount was matched with a similar amount from the state budget and transferred to the pension system asset managers. Overall, the tax-to-GDP

Figure 17. Tax Revenues
(In dram billion) (In percent)



Source: MoF and World Bank staff calculations.

[8] Environmental taxes include natural protection and natural resource use fees, such as royalties, fees for emission of harmful substances into the environment, and fees for the use of water, biological resources, or for exhausted deposits of solid mineral resources.
[9] Since July 2014, the funded pillar has been mandatory for public sector employees and new labor market entrants born on or after January 1, 1974. For all other private sector employees, it will become mandatory in July 2018.

ratio in 2017 was 20.8 percent, half a percentage point of GDP lower than in 2016, led by the lower profit tax collections.

Current spending declined slightly, while capital spending was boosted by a military equipment purchase.

Current expenditures were tightly controlled, making room for an increase in capital spending, one-third of which was for military equipment purchased from Russia. The only category of current spending which registered a substantial increase was interest payments, rising from 1.9 percent of GDP in 2016 to 2.2 percent of GDP, mostly due to a higher domestic debt burden and a shift in the portfolio towards securities with longer maturities and higher interest rates[10]. The primary deficit declined to 2.6 percent of GDP in 2017, compared to 3.6 percent of GDP in 2016. Social benefits and the wage bill increased by 1.5 and 2 percent, respectively, compared with 2016. On the other hand, capital expenditures rose by 36 percent, mostly in the form of machinery and equipment (one-third of this was the military equipment purchased at the end of the year).

The 2018 budget envisages a significant fiscal consolidation.

The budget projects a reduction in the fiscal deficit to 2.6 percent of GDP in 2018 (from 4.8 percent of GDP in 2017), with the financing of the deficit evenly split between domestic and external sources (Table 2). As a percentage of GDP, current spending is projected to decline slightly, while a more significant reduction is envisaged for capital spending, given the elevated base associated with the 2017 Russian military equipment purchase. Excluding this, capital expenditures as a percentage of GDP are budgeted to remain on par with 2016 levels.

Underspending in the first quarter of 2018 resulted in a smaller deficit than expected.

So far in 2018, both revenues and expenditure appear to be below target, with a higher underperformance on expenditures. Based on preliminary execution data for the first quarter of 2018, state budget revenues totaled AMD 256 billion, 97 percent of the revenue target for the quarter.[11] At the same time, expenditures reached AMD 282 billion, 15 percent below the budget allocation for the period. As a result, the fiscal deficit in the first three months of 2018 was less than one-third of the planned amount.

[10] Medium and long-term domestic debt accounted for 95 percent of total domestic debt at the end of 2017, compared to 84 percent of domestic debt a year earlier. Yields on government securities with maturity of up to 1 year are around 6.5 percent, they increase to 8.5 percent on 5-year bonds and to above 10 percent on 10-year bonds.

[11] A direct comparison of tax collections between 2018 and 2017 is not possible due to changes in the coverage of tax revenue in the 2018 budget that are consistent with international good practices. These changes include the exclusion of the VAT refund and registering only the net tax revenue.

Table 2. State Budget
(In percent of GDP)

	2016 Actual	2017 Actual	2018 Plan
Total revenues and grants	23.1	22.2	22.1
Tax revenues and state duties /1	21.3	20.8	21.1
Official transfers / grants	0.6	0.3	0.6
Other revenues	1.2	1.2	0.4
Total expense	28.5	27.0	24.7
Current expenditures	25.2	22.7	22.1
Transactions with non-financial assets	3.3	4.2	2.7
Overall balance	-5.5	-4.8	-2.6
Domestic financing	2.1	1.4	1.3
Foreign financing	3.4	3.4	1.3

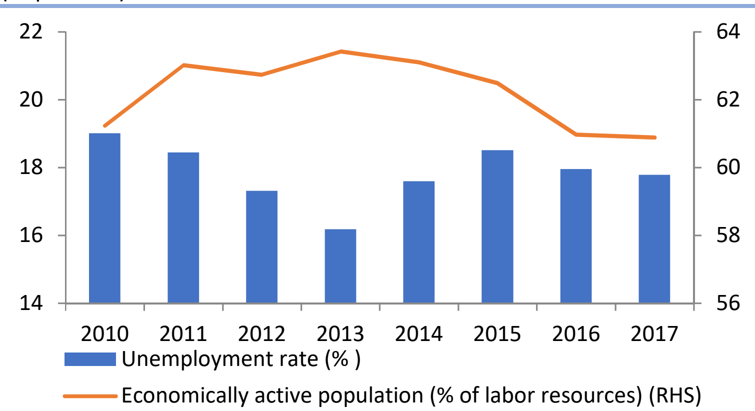
Source: MoF.
1/ The coverage of tax revenue changed in the 2018 budget plan making the data incomparable with previous years.

Social Sector and Labor Markets

The economically active population, on a downward trend since 2013, stabilized in 2017.

Around 61 percent of the labor force was economically active in 2017, similar to 2016 but still below the peak 2013 level of 63.4 percent. Despite strong economic growth in 2017, the unemployment rate fell only marginally (from 18 percent in 2016 to 17.8 percent in 2017). Armenia's unemployment rate remains among the highest in the region. The modest decline in the unemployment rate in 2017 was observed only among females and in urban areas; the unemployment rate in rural areas rose by 2 percentage points in 2017, reaching 7.7 percent. The lower unemployment rate in rural areas masks significant migration from villages to Yerevan, the capital city, or abroad—mainly due to a lack of job opportunities and profitable activities—but also reflects the vital role of subsistence farming in rural areas.

Figure 18. Unemployment and Labor Force Participation
(In percent)

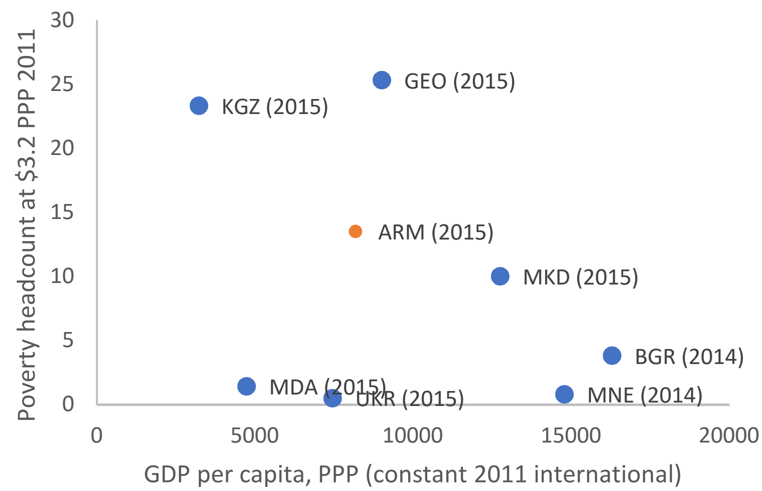


Source: NSS and World Bank staff calculations.

Armenia continues to have relatively high poverty rates.

Poverty continues to affect a significant proportion of Armenia's population. In 2016 (the last year for which poverty data are available), 14.1 percent of the population lived below the lower-middle-income economy poverty line of $3.2/day at 2011 purchasing power parity (PPP), calculated based on the World Bank methodology for international comparisons. Even though Ukraine and Moldova have a lower GDP per capita, their poverty rates were substantially lower than Armenia's (Figure 19). At the same time, Georgia has a higher poverty rate even though GDP per capita exceeds that of Armenia.

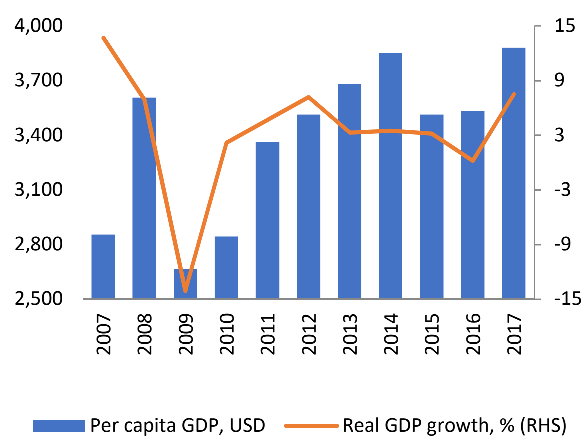
Figure 19. Poverty Rates in Europe and Central Asia



Source: World Development Indicators. Last Updated January 25, 2018.
Note: The poverty headcount is estimated using lower-middle-income economy poverty line of $3.2/day PPP 2011.

The impact of higher GDP per capita on poverty reduction may be limited.

Figure 20. Real GDP Growth and Per Capita Income
(In US$) (In percent)



Source: NSS.

As a result of strong economic growth, GDP per capita increased in 2017, reaching US$3,800, returning to its 2014 peak and approaching GDP per capita levels recorded in Georgia in 2016. However, available data suggest that the benefits of economic growth were not evenly distributed. Between 2011 and 2016, annual consumption growth for the poorest 40 percent of the population averaged 2.3 percent, well below the 4.6 percent consumption growth rate for the population overall. If the same pattern continued in 2017, then high economic growth in 2017 is unlikely to have translated into a significant reduction in Armenia's poverty rate.

Persistently high unemployment and poverty remain Armenia's two biggest challenges for social progress

High unemployment and poverty, which remain pressing concerns, fueled recent political protests. Over one-third (36 percent) of respondents to the 2017 Caucasus Barometer indicated that unemployment was the most important challenge facing Armenia. Just under two-fifths (17 percent) of respondents indicated that poverty was the most important issue, reflecting slow progress towards better living standards. Both issues have topped public concerns since the global financial crisis and, along with widespread corruption and an unequal economic environment, were among the main drivers of the massive nationwide protests in early 2018.

Monetary and Exchange Rate Policies

The monetary stance remains unchanged.

With inflation increasing to the CBA's target level and output growth approaching potential, monetary policy remains unchanged. The CBA last made adjustments to its main policy rate in February 2017, reducing it by 25 basis points to 6 percent in response to low (and even negative) inflation and anemic economic growth. Since then, the authorities have continued to assess the monetary policy stance as adequate and not requiring a change in the policy rate. However, at its May 2018 meeting, the CBA hinted that maintaining the inflation rate around the target of 4 percent over the forecast period may require a gradual offsetting of expansionary monetary policy[12] and an upward adjustment in the policy rate. With inflationary pressures intensifying, real interest rates continued to fall over the course of 2017 and into the first months of 2018 (Figure 21). Despite the unchanged policy rate, commercial banks' deposit and lending interest rates continued to fall as they adjusted to the 2015–16 cycle of monetary loosening and to increased competition in the banking sector (Figure 22).

The stock of credit and deposits grew by about 10 percent each in 2017 and the first quarter of 2018.

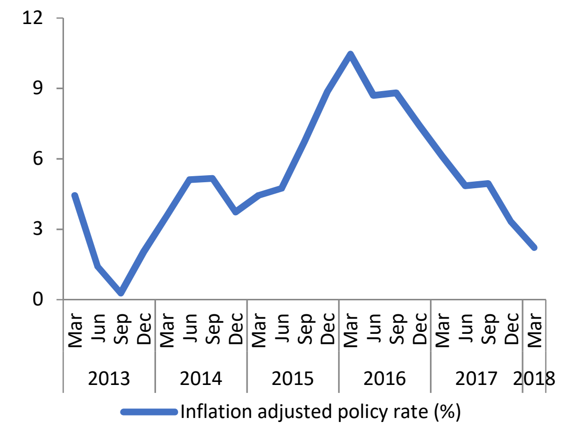
Credit from commercial banks expanded by 10 percent in 2017, moderating from the 15 percent growth rate in the previous year. Data on credit by economic area show that the construction sector registered the highest growth in 2017 (40 percent year on year), while credit to the agriculture sector contracted. Credit continued to expand in the first quarter of 2018 at a similar pace (rising by 12 percent year on year) with almost equal growth in credit denominated in domestic and foreign currency (14 and 12 percent, respectively). The dollarization of the loan portfolio stood at 62 percent at end-March 2018, down by 1 percentage point compared with end-2016.

Declining deposit interest rates also led to a moderation in deposits growth, to 9 percent in 2017. Dram deposits expanded faster due to relatively higher interest rates on dram deposits than on foreign currency deposits. A similar pattern continued into 2018, with deposits posting growth of 10 percent year on year at the end of first quarter. About one-half of the increase in total

[12] See https://www.cba.am/EN/News/Pages/news_20-06-12.aspx

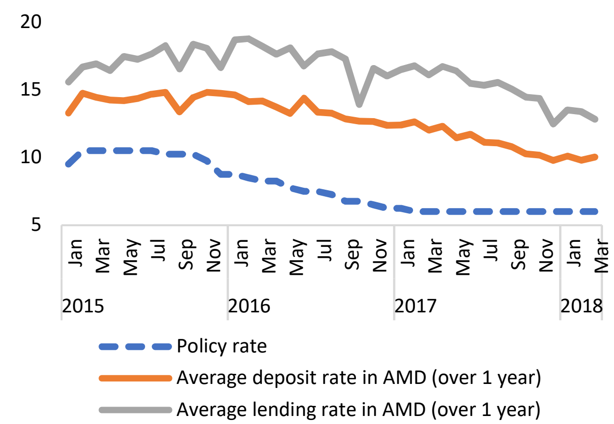
deposits relative to March 2017 was due to household dram time deposit growth. End-April 2018 data signaled a reduction in the outstanding net stock of deposits by 4 percent, mostly related to foreign currency deposits held by non-residents. However, this is expected to be only a temporary response to political developments; there is no indication that the pressure on deposits will continue. The deposit dollarization rate fell by 5 percentage points from 65 percent at end-2016 to 60 percent at end-March 2018 due to greater exchange rate stability and the large spread between dollar and dram interest rates for deposits.

Figure 21. Real Policy Rate
(In percent)



Source: CBA and World Bank staff calculations.

Figure 22. Policy, Deposit, and Lending Rates
(In percent)



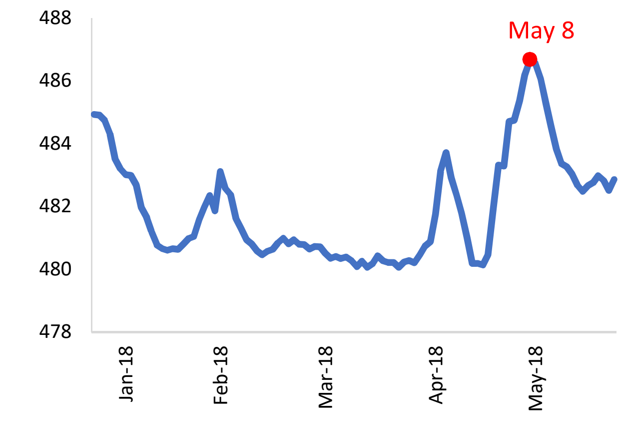
Source: CBA and World Bank staff calculations.

The exchange rate remained relatively stable in 2017, reflecting sound current and financial inflows, but came under pressure during the events of April 2018.

The CBA has continued to implement a flexible exchange rate policy, with interventions limited to smoothing out large fluctuations, including in response to the events of April and May 2018. The CBA took advantage of strong inflows of remittances and tourism proceeds in 2017 to increase purchases of foreign exchange and prevent the excessive appreciation of the dram. Domestic political instability in April 2018 put some downward pressure on the exchange rate; however, the quick resolution of the situation—together with prompt action by the CBA through open market operations—helped to stabilize the exchange rate. Although the dram depreciated by 1.4 percent during the protests (to AMD 487/US$1 on May 8), it has since recovered half of the lost value (Figure 23)

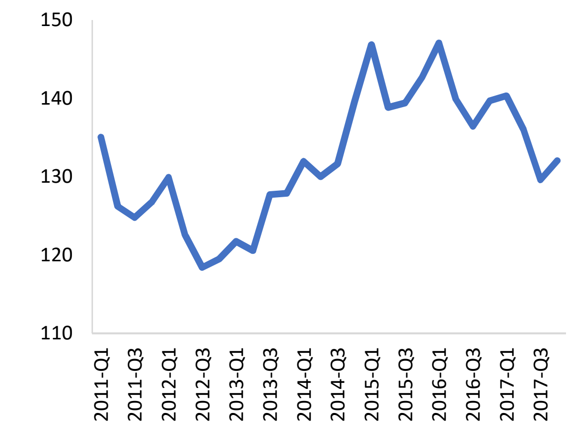
Based CBA calculations, the real effective exchange rate depreciated by 4.5 percent in 2017, reflecting a 2 percent nominal effective exchange rate depreciation and relatively low inflation (1 percent on average during this period) compared with inflation in its trading partners (Figure 24).

Figure 23. Exchange Rate
(Dram/US$)



Source: CBA.

Figure 24. Real Effective Exchange Rate
(Index, 1997=100)

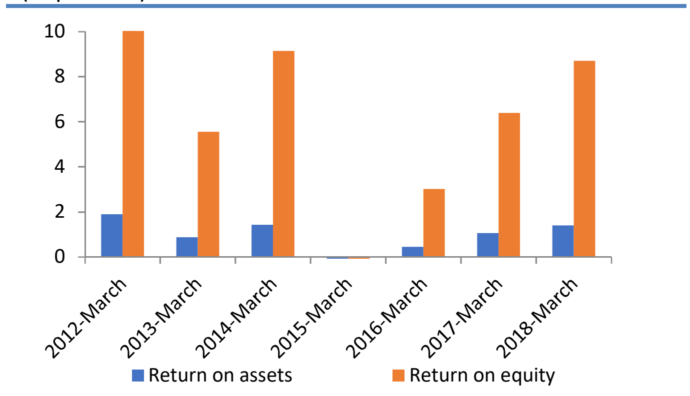


Source: CBA.

Financial Sector

The banking sector performed well in 2017, raising profitability.

Figure 25. Commercial Banks' Profitability
(In percent)



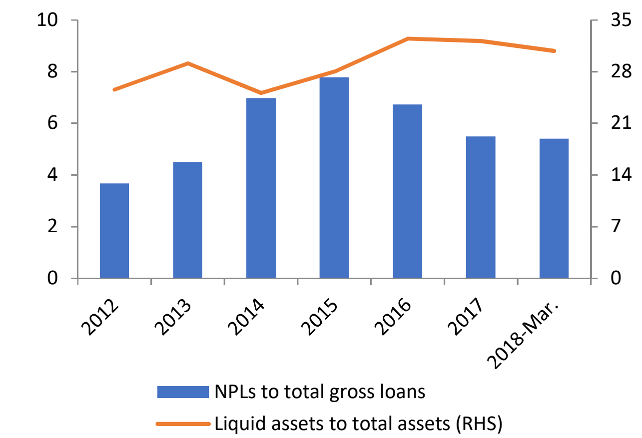
Source: CBA.

The banking sector has continued its recovery from the effects of the Russian Ruble crisis of 2014, which had a severe impact on Armenia's banking sector. Aggressive tightening by the CBA managed to control the situation, but commercial banks continued to run losses throughout 2015. The banking system's return on assets started to recover only in 2016, with the pace of recovery gradually strengthening. By March 2018, the return on assets reached 1.4 percent, close to pre-crisis levels. Attracting creditworthy clients and identifying bankable projects remain significant challenges for Armenian banks.

The sector remains adequately capitalized.

The capital-to-risk-weighted-assets ratio for the overall banking sector stood at 18.6 percent at end-2017, slightly lower than at the beginning of the year, but still well above the 12 percent minimum threshold. The nonperforming loan (NPL) ratio declined during 2017, returning to its pre-crisis level of 5.5 percent, and remained stable in early 2018. The sector remains very liquid, with liquid assets accounting for around 30 percent in early 2018, slightly below levels registered in 2017 but above levels in 2014 (Figure 26) Encouragingly, developments in April-May 2018 did not have a significant impact in the banking sector, reflecting growing confidence in Armenia's banks.

Figure 26. NPLs and Liquidity Ratio
(In percent)



Source: CBA.

B. Structural Reform Agenda

The new administration's program—approved on June 7— envisages political reforms, stronger equity, and tackling vested interests.

The new administration published its program, which aims to lay the groundwork for free and fair early elections and to strengthen social inclusion. According to the announced schedule, parliamentary elections should take place within one year, following the amendment of the Electoral code and adoption of changes to the electoral system. In the socio-economic sphere, the program prioritizes support for socially vulnerable groups by improving the targeting, fairness, and effectiveness of social benefits. The authorities agreed to proceed with the ongoing reforms to the pension system on July 1, 2018, although with some modifications (see below). Importantly, the government's program emphasizes strengthening competition and providing equal economic opportunities for all while targeting the elimination of political and economic favoritism. In the area of taxation, the government has initiated a review of the tax liabilities of some large businesses and has expressed its commitment to creating a stable and predictable tax environment, exploring opportunities to shift from income and capital taxation towards consumption taxation, and introducing a more equitable property tax system. These reforms, if properly implemented, have the potential to impact Armenia's economic and investment outlook positively.

Below is an update on progress achieved in the implementation of some important structural reforms which were undertaken by the previous administration and should be continued and strengthened by the current one.

The new tax code includes measures that are expected to strengthen the business environment.

The new tax code extends Armenia's system for the return or offset of overpaid VAT to any business operating in Armenia; previously this was only offered to exporters. This change will result in the release of a significant amount of overpaid VAT, providing businesses with additional working capital. The new tax code also exempts the import of industrial machinery, equipment, and raw materials from VAT payment at the border. Similarly, to increase the attractiveness of Armenia as a transit economy, the new code removes the requirement for VAT payment at the border at the time of import when goods are imported for re-exporting purposes.

The new administration is committed to continuing the pension reform process.

Following the introduction of pension reforms in 2014 for public sector employees,[13] the extension of the mandatory fully-funded pension pillar to private sector employees was planned for July 1, 2018. The new government agreed to move ahead as scheduled, but by shifting half of the burden of the employees' contribution to the budget[14]. This is expected to cost the Budget around 0.13 percent of GDP in 2018 and going up to almost 0.3 of GDP in later years. The measure is expected to be in place until the planned reduction in the personal income tax rates. However, the public remains lukewarm to the proposal, suggesting a need for the authorities to increase public awareness efforts highlighting the need for the reforms and also that further revisions may take place (also due to renewed motions to examine the constitutionality of parts of the reform). While a healthy public debate on pension reform has the potential to strengthen its prospects for sustainability, this debate should consider two critical factors: (i) the existing social security system does not provide for old-age financial security and with current demographic trends the situation is likely to deteriorate; (ii) a funded pensions system has the potential to increase savings in the economy and provide better old-age returns, but it also requires a larger insurance pool, which can be achieved by making the system mandatory to offset the relatively high fixed costs of running the system.

---

[13] Armenia introduced a funded pension pillar in 2014 to gradually replace its poorly performing pay-as-you-go system. The funded system, in which participants contribute 5 percent of their salaries which is matched 1:1 with contributions from the government (up to a ceiling of ARM 25,000), became mandatory for public sector staff and new private sector employees in July 2014. The extension to private sector employees born after January 1, 1974, was initially slated for 2017. However, it has proven unpopular with the general public and the implementation has been postponed twice; the new start date is July 1, 2018.

[14] The amendments to the Pension Law were approved at the National Assembly's extraordinary session on June 20, 2018.

The streamlining and reform of the inspection service was recently completed, helping to improve the business and investment climate.

Following these crucial reforms, the average number of inspections fell from 18 to 6. The legal framework for the change was approved in March 2018, allowing for the restructuring of the inspection bodies, the removal of overlaps, and ensuring better governance through institutional analysis and legal review. A perception survey of sole proprietors and companies on the inspection issue[15] showed that respondents feel that most aspects of inspections have improved during the past several years. The majority of respondents agreed that the duration of inspections has been reduced, inspections became easier, inspection decisions became fairer, and overlaps have been reduced.

A new medical insurance financing mechanism was introduced for public servants in 2017.

The new health insurance system for public sector employees is expected to improve the quality of service and increase efficiency in service delivery for around 100,000 beneficiaries (out of a total of 250,000 public sector employees). The new system covers civil servants, public school teachers, and some other categories of employees of public institutions. Under the new mechanism, the provision of medical services is organized through six private insurance companies licensed by the CBA to provide health insurance services in Armenia. Competition between private insurers will improve financial protection and access to care, and create incentives for efficiency and equity in service delivery.

A new law on public procurement took effect in 2017.

Armenia's new public procurement law is harmonized with the directives of the European Union and Eurasian Economic Union (EEU) regulations. With the introduction of the new legislative framework, the State Procurement Agency (SPA) was disbanded and its functions[16] were shifted to the Ministry of Finance. A three-member Complaints Resolution Body—comprised presidential appointees—was also created. The new government's program emphasizes the use of e-procurement to improve the transparency and efficiency of public procurement.

C. Economic Outlook and Risks

The external environment remains favorable but with growing downside risks.

Growth in the region is expected to strengthen in 2018, but moderate slightly over the medium-term. According to the World Bank's Global Economic Prospects, regional economic growth is projected at 3.2 percent in 2018 before moderating to 3 percent by 2020 as activity slows in commodity importers amid increasing capacity constraints and less accommodative fiscal and monetary policies. However, the risks are weighted to the downside, including the possibility of a disorderly tightening of financing conditions, lower-than-

[15] WBIFC "Armenia Investment Climate Reform Project. The survey was done with support from the WB "Armenia Investment Climate Reform Project" during July-September 2017 on a sample of 600 active private businesses. The compliance cost savings were reported in the amount of US$19 million, compared to a target of about US$5 million.

[16] These functions include procurement training and certification, upgrade and maintenance of the e-procurement system through outsourced companies, support to business and procurement entities in using the e-procurement system (ARMEP) and maintaining a hotline for consultations.

The priorities expressed by the new government could help tackle some of the factors constraining Armenia's potential …

projected oil prices, and heightened policy uncertainty.[17] Armenia's economic performance will benefit if the current favorable external conditions continue.

Recent developments in Armenia provide a new impetus to boost the country's efforts to reduce poverty and share prosperity. The new government has signaled a willingness to tackle some of the key constraints to Armenia's growth more forcefully, including by strengthening competition and the rule of law and dealing with vested interests.[18] Combined with a shift towards more effective social programs supported by prudent macroeconomic policies, this could signal change in the country's economic and poverty prospects.

… but, in the short run, GDP growth is likely to moderate.

In the short run, economic growth may slow to around 4 percent (the baseline scenario) as the impact of some of the factors that drove growth in 2017 dissipate. Given that the structural issues constraining Armenia's growth will take time to be addressed, growth will remain demand driven for a while and fragile. The policies of the incoming administration are gradually emerging, and some could face headwinds from a parliament where the new prime minister does not command a majority. At the same time, further gains in copper prices are not expected, and remittance inflows are expected to stabilize. Implementing some of the announced fiscal policies (higher wages and transfers, for example), could result in a higher fiscal deficit than currently envisaged and consequently increase the debt further. Under this scenario, fiscal adjustment is likely to be smaller.

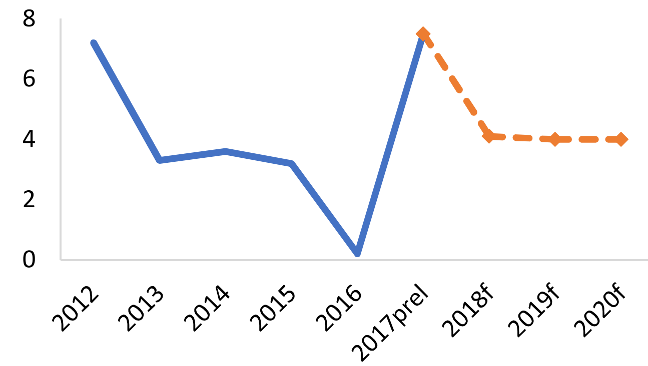
Armenia's potential growth rate is around 4 percent …

With current fundamentals (human, physical and institutional assets), and a moderate reform effort, Armenia's potential growth rate is estimated at about 4 percent. The agribusiness, information and communication technology (ICT), and tourism sectors could deliver solid growth as efforts to boost competitiveness and connectivity start to deliver results. Inflationary pressures are likely to remain moderate, due in part to the continued commitment of the monetary authority to price stability and an increasingly more sophisticated monetary policy toolbox. Under the baseline scenario, the fiscal balance is expected to narrow to below 3 percent of GDP as the authorities comply with the revised fiscal rule, helping put public and government debt on a downward trajectory. The current account deficit will remain close to the average in recent years. As the economy continues to grow and incomes rise—and remittance inflows continue to support livelihoods—the absolute poverty rate is forecast to decline to single-digit levels by 2020.

[17] World Bank. Global Economic Prospects, June 2018.

[18] For a fuller account of the development challenges facing Armenia, please see the recently completed Armenia Systematic Country Diagnostic at http://documents.worldbank.org/curated/en/716961524493794871/pdf/Armenia-SCD-in-Eng-final-04192018.pdf.

Figure 27. Medium-Term Growth Projection, Baseline
(In percent)



Source: NSS and World Bank staff projections.

… however, bolder reforms could raise potential growth.

Bold reforms to enhance competition and improve the business environment, together with efforts to develop human capital, can raise potential growth above the baseline scenario. Such reforms would open opportunities to attract more investment both from the Armenian diaspora and others and could slow down and eventually reverse out-migration. Stronger domestic demand could put upward pressure on prices compared to the baseline scenario; however, stronger competition in product and services markets could help offset some of this impact through gains in efficiency. Effective implementation of the tax code, plus additional measures to close loopholes and deal with tax evasion, combined with efforts to increase efficiency in spending (including effective enforcement of the new framework for public procurement and stronger public investment management) can help create fiscal space for new priorities while ensuring compliance with the fiscal rule. The external balance could also widen as higher domestic demand translates into higher imports; however, this could be financed by a stronger recovery in FDI.

The banking sector is expected to remain stable.

Building on the relatively favorable outlook, greater competition among banks, and a generally sound banking system, the baseline scenario envisages a positive trend for banking system stability. However, this will also depend on the evolving policies of the new government. For example, the authorities have announced plans to introduce measures to lower the debt service burden of indebted farmers and other groups. Such proposals should be carefully analyzed to ensure that the banks' financial health is not negatively affected and that financial discipline is not undermined.

Significant risks remain.

Risks to the outlook are tilted towards the downside. Externally, growth recovery may have already peaked in 2017 and that growth will decelerate in 2018 and beyond. While the deceleration of growth is expected to be moderate, a more severe slowdown cannot be ruled out if combined with greater trade and political tensions. Adverse shocks linked to the Russian recovery or metal export prices would undermine prospects for Armenia's exports of goods and services and FDI and remittances inflows. Domestically, so far, the implications of recent events have been limited to small pressure on the exchange rate and a contained run on deposits. However, prolonged tensions in parliament and uncertainty in upcoming parliamentary elections could affect economic activity. Re-designing economic policies to address the population's grievances and promises by the incoming administration while also safeguarding fiscal and macroeconomic stability will be challenging. Under the previous administration, Armenia recently made a number of important reforms, including in the area of taxation and pension reforms and a reversal could undermine gains.

Table 3. Baseline Scenario: Selected Macro-Fiscal Indicators
(In percent, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	2020
Real GDP growth	3.6	3.2	0.2	7.5	4.1	4.0	4.0
Agriculture	6.1	13.2	-5.0	-5.3	2.5	2.7	2.4
Industry	-2.3	2.8	-0.3	5.4	5.4	5.2	5.1
Services	6.7	1.6	3.2	12.4	3.9	3.8	3.9
Consumer price inflation, period average	3.0	3.7	-1.4	1.0	3.5	3.8	4.0
Current account balance (percent of GDP)	-7.6	-2.6	-2.3	-3.5	-2.9	-3.5	-3.8
Overall/primary fiscal deficit (percent of GDP)	-1.9	-4.8	-5.5	-4.7	-2.6	-2.5	-2.3
Public debt (percent of GDP)*	43.7	48.7	56.6	58.8	58.6	58.3	57.5
Government debt (percent of GDP)	39.4	44.1	51.9	53.7	53.3	52.9	52.0

Source: World Bank staff calculations based on data published by NSS, CBA and GEP.
Note: Sums may not add exactly due to rounding.
*/ Includes government and CBA debt

D. Special Topic: FDI Sector Scan, Agribusiness in Armenia

The recent World Bank Group Systematic Country Diagnostic identified agriculture, along with IT and tourism, as potential sources for stronger and more inclusive growth in Armenia. Both the previous and the new administrations considered agriculture as a priority sector. To better explore the opportunities and obstacles to realizing the potential of the agricultural sector, this edition of the Armenia Economic Update is devoted to the agribusiness sector. The section summarizes the results of a review of agribusiness sub-sector competitiveness for FDI (known also as a "FDI sector scan") undertaken by the World Bank Group in 2017.[19] The review attempted to identify agricultural subsectors that are sufficiently competitive to attract FDI and that are likely to have development impact.

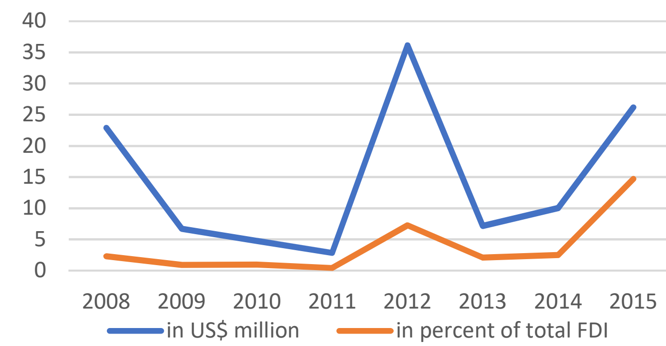
FDI in agriculture in Armenia is negligible and constitutes a small share of an already low level of FDI.

Armenia's track record in attracting FDI is modest, especially in the agriculture sector. Being a landlocked developing country with a small domestic market, an unfinished structural reforms agenda, and notable weaknesses in governance and competition, Armenia has been largely bypassed by FDI. Between independence in 1991 and 2005, Armenia received very modest amounts of FDI. FDI inflows increased in the second half of the 2000's, peaking at 8 percent of GDP in 2008. However, the global financial crisis of 2008–09 interrupted this trend and FDI

[19] The authors of the report are Robert Hejzak (Investment Promotion Consultant), Jana Krajcovicova (Private Sector Specialist), and Arsen Nazaryan (Senior Private Sector Specialist).

inflows have not recovered, falling to 2 percent of GDP in 2017 (with the exception of a positive FDI rebound in 2016). FDI in agriculture has been negligible ((Figure 28), with most financing going to viticulture and winemaking. Agriculture accounted for 2 percent of total FDI on average in 2008–15.[20] A small share of FDI in agriculture is, however, not unusual. In most economies, investment in agriculture tends to be dominated by local investors as these are usually better positioned to access land, interface with local farmers, understand the local climate, consumer tastes, and so on.

Figure 28. FDI in Agriculture in Armenia, 2008–15



Source: NSS, 2016.

Unresolved structural issues and policy and regulatory barriers constrain the sector.

Armenia benefits from intense solar radiation, but access to land and the availability and quality of supplies are obstacles. Access to consolidated arable land is limited given the existing land ownership structure and supply-side constraints for food processing industries. Other challenges—including poor transport links, low farming intensity, fluctuating seasonal supply of agricultural raw commodities, and inconsistent volume and quality of supplies—mean that contract farming is currently an unattractive value proposition for foreign investors. Although some non-equity investment[21] has taken place, the scope of the investment is small and difficult to scale up (non-alcoholic beverages are produced for the domestic market only; processed vegetable production is constrained by limited volume of locally produced raw materials).

Agriculture sector development and attraction of FDI to this sector remains a priority.

Addressing these issues can open the door to greater FDI. Increasing FDI in agribusiness will help to diversify the economy, increase value-added and support job creation, particularly among women. Armenia needs substantial investment in primary agriculture and necessary downstream activities, as well as in public goods like roads, electrification, and irrigation, but it also needs appropriate investor targeting for promoting FDI. The priority sectors should be selected based on a careful analysis of the benefits they offer to Armenia and to the investors. The analysis looked at the following agricultural sub-sectors: (i) aquaculture,[22] (ii) dairy sector (in particular cheese production), (iii) floriculture (flower production), and (iv) fruit and vegetable production.

[20] The exceptionally high share of FDI in agriculture as a percentage of total FDI in 2015 is due to low total FDI inflows rather than an increase in FDI in agriculture.

[21] French Bonduelle, for example, has been sourcing part of its canned vegetables production for the Russian market in Armenia; Coca Cola Hellenic Bottling Company Armenia is a franchised bottler of The Coca Cola Company.

[22] Includes caught and/or captive bred fish, crustaceans, and products derived from them.

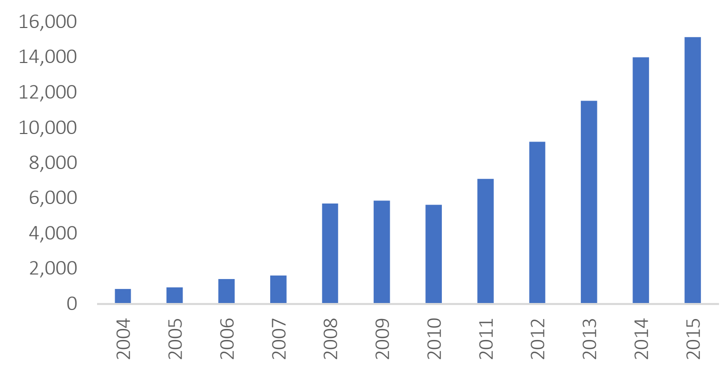
Sector Scan Results

Aquaculture

Aquaculture has grown rapidly, but prospects for future growth are uncertain.

The aquaculture sub-sector has expanded strongly over the past decade (Figure 29), with production rising by an annual average of 40 percent. The vast majority (92.6 percent) of the sector's exports go to Russia, yet Armenian exports of fish products make up only 0.2 percent of total Russian consumption. Most Armenian fish product is exported by air (passenger airplane) and by refrigerated truck. Currently, Armenia’s fish products supply chain lacks cold storage facilities and warehouses; the country mainly markets and exports fresh and chilled fish products on ice. Access to water is the most critical factor for future sector development and investment. Also, ongoing discussions about changes in aquaculture farming land reclassification could lead to further significant increases in land prices, land lease payments, and land tax.

Figure 29. Fish Production in Armenia
(In tons)



Source: NSS and Ministry of Agriculture.

FDI opportunities in aquaculture are currently scarce.

With limited access to water resources, potential investors would need to acquire existing aquaculture operations to obtain a water use permit. Given the small size of existing operations, the initial investment in modern intensive fish breeding technologies would not generate a high return on investment as the economies of scale would not be sufficient. According to information collected, a growing number of existing aquaculture producers are willing to sell their operations as growing costs—associated with tighter environmental regulations which require use of new water and environment saving technologies—bring down profit margins.

Dairy Products (Cheese)

A traditional economic sector, cheese is Armenia's main dairy product.

Cheese production capacities more than doubled over the past five years. Russia and the United States (mainly Armenians in the diaspora) are the leading export markets for Armenian cheese. At present, Armenian exporters benefit from the opportunities provided by Eurasian Economic Union (EEU) membership; however, competition in the Russian market is very intense. More than 70 percent of total domestic cheese production is in the informal sector. Formal and informal sectors compete for milk. Milk production in Armenia is still mainly a low-input, subsistence-based system, although a few intensive stall-fed operations exist in the country. There are around 180,000 dairy farms in Armenia and 95 percent of fresh cow milk is produced by farms that have fewer than seven cows. Armenia is still not self-sufficient in milk production; most milk or milk powder imports occur in the winter months when local production volumes decline.

Several binding constraints limit further expansion of the sub-sector.

The most critical impediment to expanding cheese production is the insufficient quantity and quality of milk as well as large seasonal fluctuations in milk supply. These issues are compounded by poor infrastructure (difficulties in setting up electricity, water, and gas supply lines for cheese production facilities) and lack of knowledge and skills in the dairy sector. Under current conditions, FDI in the Armenian dairy sector is unlikely. A lack of large domestic processing operations open to acquisition precludes FDI. Although investment opportunities could be promoted in some of the upstream value chain sub-sectors, such as fodder and intensive dairy cattle farming, interest is most likely to come from firms already operating in Armenia that are looking into the vertical integration of their operations rather than from large international companies. The Armenian diaspora may be interested in some small-scale dairy processing operations or in equity funding of some of the existing dairy operations. To stimulate future FDI in the dairy sector the government should resolve some of the export-related regulatory barriers and weak quality infrastructure.

Floriculture

Greenhouse flower production is a relatively new and dynamic sector in Armenia.

Most greenhouses in Armenia are small and do not use advanced technologies resulting in high costs and low productivity. However, there are notable exceptions. Ecotomato Company,[23] for example, is one of the top companies in the rose-growing market worldwide by production volume. Greenhouses can be an important source of new employment, particularly for women. Existing domestic companies operating in the floriculture sector have experienced considerable growth. The bulk of flowers grown are exported to emerging markets including Belarus, Georgia, Kazakhstan, and Russia.

[23] Ecotomato was founded in 2011 and is engaged in growing Dutch roses. It has built greenhouses jointly with Dutch Dalsem, a world leader in this business.

The flower growing industry could offer value-added to investors.

With rising global exports—in particular to emerging markets (including Russia)—a shift from traditional growers (in the Netherlands, for example) to new producers, and strong regional trade links, Armenia's floriculture sub-sector can present a robust value proposition to potential foreign investors. The current strong export performance of the domestic sector, availability of land, and supportive government policies could promote this sub-sector for potential FDI.

Fruit and vegetable production

Fruits and vegetables are traditional Armenian products.

Although both vegetable-sown areas and fruit orchards have been expanding over the last decade, infrastructure bottlenecks and climate uncertainties lower the attractiveness of open-field cultivation for FDI. For low-value fruits and vegetables produced during the main production season (for example tomato, cucumber, apricot, and peach crops), the high initial costs to establish the plantation (land purchase given limited availability of larger plots and irrigation systems) together with limited cold storage facilities, climatic risks, international competition, and high transportation costs, make FDI in primary production unlikely. FDI in primary or secondary processing is also unlikely given the limited output of existing Armenian agricultural production. Most of the domestic processing companies are unable to fully utilize their existing production facilities or expand their operations due to the limited supply of raw agricultural material.

Niche investment opportunities may exist in higher-value fruits and vegetables and in greenhouse crop production.

Higher-value fruits and vegetables—berries and nuts, in particular—have seen growth in investment interest from the Armenian diaspora. Investment opportunities may also exist in greenhouse crop production, both for low- and high-value crops. Greenhouse crop production has been expanding rapidly, particularly during the last four years, when the total area of greenhouse farms increased by nearly 2.5 times, from 510 ha in 2011 to 1,220 ha in 2016. At the same time, the technological sophistication of greenhouse farms has also improved. Employment generation opportunities are, however, likely to be modest due to the growing use of advanced intensive farming technologies, which minimize human work but are necessary to increase efficiency.

Conclusion

Greenhouse-grown flowers and fruits and vegetables have the most investment potential.

The sector scan identified flower production and greenhouse farming as potentially viable investment propositions for foreign investors (figure 30). However, none of the reviewed sub-sectors currently demonstrates robust enough features that could motivate FDI into a large-scale greenfield production in the short run. Greenfield investment is likely to be on the small-scale side. Diaspora seed capital is expected to continue to be attracted to projects in some niche sub-sectors (for example, berry or nuts cultivation), yet the economic benefits to the Armenian economy will not be substantial and will be mostly limited to capital inflow.

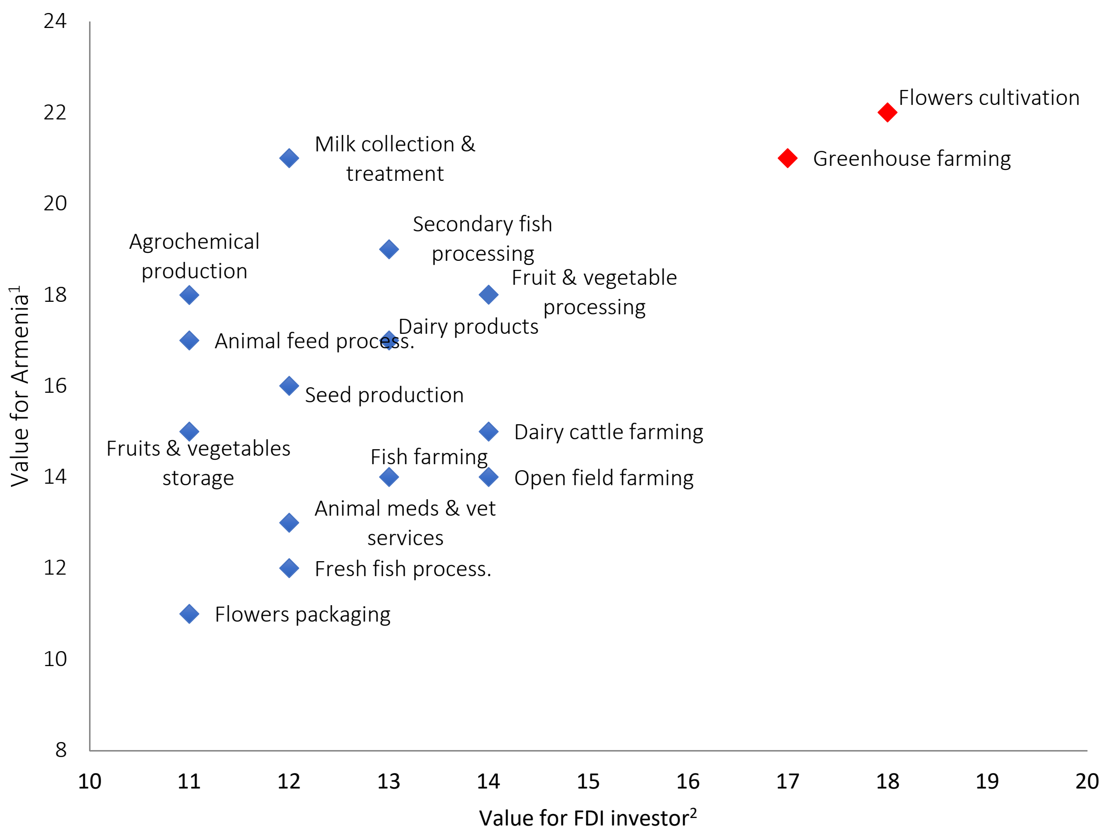
Supply-side obstacles reduce

There are significant general investment climate and sector-linked impediments which hamper investment and require action. On top of general investment

the attractiveness of the sector and need to be addressed.

climate obstacles—such as policy and regulatory uncertainty, access to export markets, and a shortage of skills and knowledge—investments in agriculture also face sector-specific impediments which make the sector less attractive for foreign investors. These impediments include access to land and irrigation, complex import procedures for agriculture sector inputs, cadastral classification of greenhouse structures, and energy efficiency issues. As an important sector, which has been identified as a priority sector for Armenian economic growth, the government should work to effectively regulate and invest in this sector to make it attractive for foreign investment.

Figure 30. Prioritization of Target Sub-Sectors For Proactive FDI Promotion



Source: World Bank staff calculations, based on interviews with policy-makers, investors and other stakeholders as well as existing studies of the value-chain needs and opportunities.

1/ The score is based on the sum of rankings (on a scale of 1 (lowest) to 5 (highest)) given for each of the following criteria: 1) Will new investors add value that is not already provided by local farmers / producers & existing investors? 2) Will new investors create additional jobs? Will investment contribute to job generation among women? 3) Will new investors increase opportunities for domestic firms to supply their goods/services to foreign investors? 4) Will new investors create increased export revenues or reduce imports? 5) Will new investors improve the performance of the value chain as a whole?

2/ The score is based on the sum of rankings (on a scale of 1 (lowest) to 5 (highest)) given for each of the following criteria: 1) Is the local and regional market attractive? 2) Is the global market attractive? 3) Does Armenia have competitive natural endowments (land, climate, location, etc.)? 4) Does Armenia have competitive infrastructure? 5) Does Armenia have competitive skills and supportive services? 6) Does Armenia offer a conducive business (regulatory/institutional) environment?

Annex 1: Tables

Table A 1. Selected Macroeconomic and Social Indicators, 2013-20

	2013	2014	2015	2016	2017	2018	2019	2020
						Projections		
	(Percent, unless otherwise indicated)							
National Income and Prices								
Nominal GDP (LCU bn)	4,556	4,829	5,044	5,067	5,569	5,925	6,272	6,635
Nominal GDP per capita (US$)	3,686	3,856	3,519	3,532	3,881	4,026	4,151	4,331
Real GDP growth	3.3	3.6	3.2	0.2	7.5	4.1	4.0	4.0
Private consumption growth	0.9	1.0	-7.8	-1.1	8.8	5.0	4.7	4.5
Gross investment growth	-9.1	-3.0	-1.2	-8.7	13.9	4.5	4.2	4.1
Exports of G&S growth	8.6	6.4	4.9	19.1	19.7	10.1	9.8	9.5
Imports of G&S growth	-2.1	-1.0	-15.1	7.6	26.8	10.3	9.5	8.9
Gross investment (percent of GDP)	22.3	20.9	20.7	18.4	19.4	18.6	18.8	19.1
Consumer price inflation, year-end	5.6	4.6	-0.1	-1.1	2.6	3.0	3.3	3.5
Consumer price inflation, pa	5.8	3.0	3.7	-1.4	1.0	3.5	3.8	4.0
GDP deflator	3.4	2.3	1.2	0.5	2.2	2.0	1.8	1.7
Real exchange rate change	1.5	7.1	6.5	-0.7	-4.6	...	...	...
	(Current US$ millions, unless otherwise indicated)							
External Accounts								
Merchandise exports, *of which:*	1,479	1,547	1,485	1,792	2,150	2,390	2,561	2,755
Key commodity exports	1,215	1,257	1,224	1,447	1,725	2,016	...	...
Metals and minerals	716	688	705	693	945	958	...	...
Products of prepared food	310	338	325	417	524	588	...	...
Precious stones and metals	188	230	194	337	257	469	...	...
Merchandise imports	4,386	4,424	3,239	3,274	3,993	4,380	4,601	4,849
Current-account balance	-813	-883	-272	-238	-400	-348	-434	-486
as percent of GDP	-7.3	-7.6	-2.6	-2.3	-3.5	-2.9	-3.5	-3.8
Foreign direct investment, net	320	388	162	272	224	525	556	606
Total official international reserves	2,252	1,489	1,775	2,204	2,314	2,464	2,604	2,754
Public external debt, total	3,899	3,785	4,316	4,806	5,495	5,793	5,927	6,184
as percent of GDP	35.1	32.6	40.9	45.5	47.5	48.4	48.0	48.0
	(Percent of GDP, unless otherwise indicated)							
Consolidated Fiscal Accounts								
Revenues	24.2	24.4	23.8	23.7	22.9	22.7	23.2	23.4
Expenditures	25.7	26.3	28.6	29.2	27.6	25.3	25.7	25.7
Overall fiscal balance	-1.5	-1.9	-4.8	-5.5	-4.7	-2.6	-2.5	-2.3
Primary fiscal balance	-0.5	-0.6	-3.3	-3.6	-2.6	-0.5	-0.3	0.0
Non-commodity fiscal deficit	-1.5	-1.9	-4.8	-5.5	-4.7	-2.6	-2.5	-2.3
Public debt and fiscal savings, net	40.9	43.7	48.7	56.6	58.8	58.6	58.3	57.5
	(Percent, unless otherwise indicated)							
Monetary Accounts								
Base money growth	6.9	-8.9	4.6	18.0	20.3	...	...	...

	2013	2014	2015	2016	2017	2018	2019	2020
							Projections	
Real growth of credit to the private sector	6.1	16.3	-3.0	16.2	7.4	…	…	…
Policy rate (eop)	7.75	8.50	8.75	6.25	6.00	…	…	…
Social Indicators								
Population, total (millions)	3.017	3.011	2.999	2.986	2.973	2.973	2.974	2.975
Population growth (percent)	-0.32	-0.22	-0.40	-0.42	-0.44	0.02	0.02	0.02
Unemployment rate (percent of labor force)	16.2	17.6	18.5	18.0	17.8	…	…	…
Poverty rate, national (percent of population)	32.0	30.0	29.8	29.4	…	…	…	…
International poverty rate (US$1.9/day 2011 PPP, percent of population)	2.2	2.3	1.9	1.8	1.4	1.3	1.0	0.8
Lower middle-income poverty rate (US$3.2 /day 2011 PPP, percent of population)	16.2	16.4	13.5	14.1	11.6	10.1	9.1	8.1
Inequality – Gini coefficient	0.372	0.373	0.374	0.375	…	…	…	…
Life expectancy (years)	74.8	75.0	75.0	75.0	…	…	…	…

Sources: World Bank staff calculations and estimates based on official data published and provided by the authorities.

Table A 2. Balance of Payments and Official Reserves, 2013–17
(US$ millions)

	2013	2014	2015	2016	2017
Current account balance	**-813.0**	**-882.9**	**-272.4**	**-238.1**	**-399.9**
Merchandise trade	-2,196.2	-2,055.4	-1,186.4	-944.4	-1,482.1
Exports f.o.b.	1,635.9	1,698.1	1,623.9	1,890.7	2,378.3
Metals and minerals	716.2	688.3	704.8	693.4	944.5
Products of prepared food	310.2	338.1	325.3	416.6	523.5
Precious stones and metals	188.1	230.3	194.0	336.9	256.7
Imports f.o.b.	3,832.0	3,753.6	2,810.3	2,835.1	3,860.4
Services	-125.0	-113.5	-95.4	-71.4	-62.5
Primary income	682.5	541.1	442.9	224.2	497.7
Secondary income	825.6	744.9	566.5	553.4	647.1
Capital and financial account balance	**1,582.8**	**259.7**	**754.7**	**921.1**	**607.7**
Foreign direct investment	319.5	387.9	161.5	271.9	223.5
Portfolio investment	689.4	- 38.4	235.0	33.9	86.8
Other investment	489.5	- 160.2	292.9	580.4	424.7
Capital transfers	84.4	70.4	65.3	34.9	46.3
Errors and omissions	**-299.2**	**-36.5**	**-149.3**	**-232.1**	**-112.0**
Overall external balance	**470.6**	**-659.6**	**332.9**	**450.8**	**95.8**
Change in FX reserves at Central Bank	-470.6	659.6	-332.9	-450.8	-95.8
Memorandum items:					
Official reserves, eop	2,251.6	1,489.3	1,775.3	2,204.1	2,313.9
SDR holdings	1.9	6.2	2.9	3.5	7.2
Foreign Exchange	2,249.7	1,483.2	1,772.4	2,200.6	2,306.6
GDP	11,121	11,610	10,553	10,546	11,537
Consumption	11,022	11,335	9,624	9,571	10,557
Gross capital formation	2,476	2,423	2,188	1,900	2,195
Exports of goods and services	3,154	3,316	3,137	3,496	4,390
Imports of goods and services	5,360	5,462	4,418	4,511	5,814

Source: World Bank staff calculations based on data published by CBA and NSS.
Note: Sums may not add exactly due to rounding.

Table A 3. Consolidated Fiscal Accounts, 2013–17
(Percent of GDP)

	2013	2014	2015	2016	2017
Revenue and grants	**24.2**	**24.4**	**23.9**	**23.7**	**22.9**
Tax revenue, of which	22.4	22.5	21.7	21.7	21.3
VAT	8.8	9.1	8.4	7.7	7.3
Profit tax	2.7	2.1	2.1	2.5	2.0
Income tax	5.6	6.0	6.2	6.5	6.1
Excise tax	1.1	1.0	1.0	1.2	1.5
Non-tax revenue	1.5	1.5	1.6	1.4	1.4
Capital revenue					
Grants	0.3	0.4	0.6	0.6	0.3
Expenditure and net lending	**25.7**	**26.3**	**28.7**	**29.2**	**27.6**
General government expenditures	**25.7**	**26.3**	**28.7**	**29.2**	**27.6**
Current expenses	22.7	23.4	25.4	26.1	23.3
Capital expenses and net lending	3.0	2.9	3.3	3.1	4.3
Overall fiscal deficit	**-1.5**	**-1.9**	**-4.8**	**-5.5**	**-4.7**
Primary fiscal deficit	-0.5	-0.6	-3.3	-3.6	-2.6
Deficit financing	1.5	1.9	4.8	5.5	4.7
Domestic borrowing, net	-0.3	1.5	0.2	2.1	1.3
Foreign borrowing, net	1.8	0.4	4.6	3.4	3.4
Privatization					

Source: World Bank staff calculations based on data published NSS and MoF.
Note: Sums may not add exactly due to rounding.

Annex 2: What Makes A Good Fiscal Rule?

A recent IMF blog "Fiscal Rules: Make them Easy to Love and Hard to Cheat"[24] analyzed fiscal rules which became effective over the last three decades in over 90 economies. The blog noted three attributes of effective fiscal rules—they need to be simple, flexible, and enforceable in the face of changing economic circumstances. However, the authors found that rules were often too complex, overly rigid, and difficult to enforce. The analysis proposed three principles for fiscal rule design:

- ✓ *Rules should be internally consistent, parsimonious, and guarantee debt sustainability*. Fiscal rules should include both a debt rule to set the course of medium-term fiscal policy, and a small number of operational rules that guide annual budget decisions, such as an expenditure rule or a budget balance rule.
- ✓ *They should contain incentives for compliance*. Financial sanctions and costs are often not credible. There appears to be more success with efforts that increase the political and reputational costs of non-compliance. In this case, Fiscal Councils could play an important role, by monitoring and publicizing mismanagement of public funds.
- ✓ They should allow for adequate flexibility in the face of shocks without sacrificing simplicity.

Below is a summary of the changes in the current fiscal rule as defined in Armenia's current Public Debt Law and the Budget System Law. Few details, such as method of calculations of the long-term GDP growth, are yet to be defined by a government decree to fully operationalize the rule. In general terms, the changes are consistent with the above principles. For example, the revised rule contains a debt rule as well as a number of operational rules and a clear exemption from these rules in case of emergencies. On the other hand, the number of operational rules may be on the high end while the incentives for better compliance may require strengthening. Experience over time will demonstrate if the revised rule strikes a better balance between effectiveness and simplicity.

OLD	NEW (Amended December 20, 2017)
Article 5, Section 6: State debt as at December 31 of the year in question shall not exceed 60 percent of previous year GDP.	**Article 5, Section 6:** As of December 31, of each year, the upper threshold for the ratio between the government debt and GDP of the Republic of Armenia is 60 percent.
Article 5, Section 7: Where state debt as at December 31 of the year in question exceeds 50 percent of GDP of the previous year, the state budget deficit of the next year shall not exceed 3 percent midpoint of the annual average	**Article 5, Section 7:** If the government debt as at December 31 of the previous year exceeded 40, 50, and 60 percent of GDP, the following rules shall apply. If >40 percent of GDP => • capital expenditure shall be not less than the deficit; If >50 percent of GDP =>

[24] https://blogs.imf.org/2018/04/13/fiscal-rules-make-them-easy-to-love-and-hard-to-cheat/

GDP for the previous three years.	1. same as above (1) 2. the maximum year-on-year growth rate for aggregate current expenditure (excluding government debt service costs) should be equal to long-term growth of GDP in previous years*. 3. within a range of 50-60 percent of previous year GDP, the government shall present an action plan in the state Medium-Term Expenditure Framework (MTEF) prepared in the following year for gradually bringing the projected path of the level of government debt below 50 percent of GDP. If > 60 percent of GDP => 1. Same as above (1) 2. Same as above (2) 3. Total current expenditure-to-tax revenue ratio shall be established by the government based on the long-term growth in the GDP of previous years*. 4. Together with presenting to the NA the MTEF in the following year, the government shall submit an action plan for consideration by the Standing Committees on Financial, Credit and Budget and Economic Issues bringing the projected path of the level of the government debt below 60 percent.
	The requirements set forth in section 8.2 of this Article shall not apply in exceptional cases defined by the government decree when negative economic developments arise due to large-scale natural and man-made disasters, military operations, economy's transition from peace to war and driven by economic shocks.
Article 5, section 8: Any instrument originating state debt, which is inconsistent with paragraphs 6 and 7 of this Law, shall be deemed void.	DELETED
* Pending to be defined by Government in a government decree.	

Armenia
Country Economic Update | Summer 2018

WORLD BANK GROUP