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REPUBLIC OF ARMENIA—ASSESSMENT LETTER TO THE ASIAN DEVELOPMENT BANK

February 21, 2014

This letter updates the assessment of the IMF staff included in the most recent report on Armenia that was discussed by the IMF Executive Board. This was the staff report on the Sixth Reviews Under the Extended Arrangement and the Extended Credit Facility (ECF) Arrangement (see IMF Country Report 13/238) of June 7, 2013. Since that time, the IMF staff has reached understandings with the Armenian authorities on their request for a new extended arrangement in support of the authorities' economic and financial program for 2014–17. The authorities' request for the extended arrangement will be considered by the IMF's Executive Board in early March 2014. The new arrangement follows the successful completion of the three-year Fund-supported program for 2010–13.

Recent Developments, Outlook, and Risks

Macroeconomic conditions remain favorable, despite a recent deceleration of growth. After output expanded by 7.1 percent in 2012, growth decelerated to 3.2 percent in 2013, reflecting weaker regional conditions, energy price hikes, a slowing of credit growth, and underexecution of budgetary spending, particularly for major foreign-financed infrastructure projects. Imports remained flat last year, while exports and remittances held up well—despite Russia's slowdown, so that the current account deficit improved significantly (from -11.2 to -8.4 percent of GDP), international reserve holdings of the Central Bank of Armenia (CBA) strengthened, and the dram appreciated. Timely monetary policy actions mitigated the impact of sizable utility tariff increases in July, keeping year-end inflation at 5.6 percent (y-o-y), almost within the CBA's 4 ± 1.5 percent inflation target range. Financial indicators remain sound, despite the slowing of credit growth and a mild weakening of commercial bank profitability.

The authorities took major financial and trade decisions in 2013. A debut 7-year, $700 million Eurobond was issued in September 2013 (6.25 percent yield, bullet repayment). With the proceeds, the authorities repaid the outstanding balance of a 2009 crisis loan from Russia ($450 million) and are using the rest for budget financing, net lending, and reserves. Also in September, President Sargsyan announced that Armenia would join the Eurasian Customs Union; in December, a road map to ECU membership was agreed. The ECU agreement helped pave the way for a new five-year gas arrangement with Russia and Gazprom, reached in December. Efforts to ensure that the final ECU arrangements are consistent with Armenia's WTO obligations will be important, as ECU external tariffs are generally significantly higher than Armenia's present tariff levels. The authorities are negotiating exemptions from higher ECU external tariffs, which will be important to avoid higher costs for domestic consumption, production, and exports through sharp increases in the prices of imported inputs, food, and machinery or through costs associated with a substantial reorientation of trade.

Growth is expected to strengthen in 2014 and beyond, while inflation should return to the CBA's target range. Following the slowdown in 2013, a pick-up is expected in 2014 with more supportive fiscal and monetary policies and improvements in external conditions. With growth-enhancing reforms, the IMF staff expects growth to stabilize at around 5 percent in the medium term. The authorities consider that growth could be somewhat higher. The authorities view their strategy of regional integration and their planned increase in public investment as key elements supporting growth, both in 2014 and in the medium term. Inflation is expected to reach 4 percent by end-2014, notwithstanding the gradual pick-up in activity. While the new gas agreement is likely to provide price stability, inflation is likely to remain volatile, given the large food component in the CPI basket and strong links between food and international commodity prices.

Over the medium term, growth and inflation outcomes are expected to improve, although risks are tilted to the downside. With supportive macroeconomic policies, improved external conditions, and growth-enhancing reforms, growth is projected to reach potential and inflation to remain within the target range. The external current account is expected to improve by a further 2 percent of GDP during 2014–17. This reflects the impact of lower gas prices and structural reforms under the new program that will lower costs and support export growth. Exports are also expected to be supported by infrastructure improvements and continued gains in Russian and ECU markets. Downside risks include adverse geopolitical events and external shocks, including a protracted slowdown in Russia. Mitigating factors are Armenia's sound policy framework, and continuing official support. The resolution of geopolitical tensions could provide a substantial boost. The issuance of the Eurobond and the new gas supply agreement have helped mitigate important near-term uncertainties.

Program Discussions

A three-year Fund-supported program under the ECF arrangement and an extended arrangement (with combined access equivalent to SDR 266.80 million, approximately $410 million) expired in July 2013, with sound performance. Program objectives were to restore fiscal and external sustainability, preserve financial stability, restore growth, and reduce poverty. These were largely met, and six reviews were completed with few delays or missed targets. Key achievements were reestablishing growth after a 14 percent contraction in 2009 and attaining major reductions in the fiscal and external current account deficits

Important challenges remain, nonetheless, in terms of stabilization, reducing vulnerabilities, and enhancing medium-term growth. Inflation and growth remain volatile, and the external current account deficit and dollarization are high. Despite recent progress, poverty and unemployment also remain high. Further reforms are needed to support and strengthen growth, improve the economy's resilience to shocks, and continue Armenia's transformation into an emerging market economy.

In light of these challenges, the Armenian authorities have requested a new 38-month extended arrangement under the Extended Fund Facility, with access to the equivalent of SDR 82.21 million (about $125 million). The new program's objectives are to: (i) safeguard sound public finances and provide more space for growth-enhancing and poverty reducing spending; (ii) continue monetary and financial sector policies that strengthen resilience and buffers; and (ii) promote greater competition, competitiveness, and regional integration, and thereby higher investment, exports, and growth.

Program Policies

Fiscal policy will aim to preserve stabilization gains, while addressing social and investment needs. Key objectives will be to place public debt on a declining path, to increase revenues in an equity- and growth-friendly way, to strengthen the implementation of investment projects, and to enhance the management of fiscal risks. The headline deficit is expected to increase from less than 1.0 percent of GDP in 2013 (preliminary, excluding a one-off gas-related transfer) to 2.3 percent in 2014, before falling below the debt-reducing deficit level of 2 percent in 2015 and 1.8 percent in 2016–17. The higher headline deficit in 2014 is premised on improved implementation of foreign-financed infrastructure investment projects and higher outlays for road maintenance, school rehabilitation, pension and wages, which were compressed following the crisis. Revenue increases will contribute to a reduction of outstanding tax credits in 2015, and in 2016–17, to fiscal consolidation and higher capital and social spending.

Monetary and exchange rate policies should continue to keep inflation within the 4±1.5 percent target range, while facilitating external adjustment. In addition, the CBA will aim at strengthening the inflation-targeting framework through improved communications and modeling. Program targets will move gradually away from monetary aggregates to inflation outcomes. The CBA is expected to continue allowing the dram to float, while avoiding abrupt changes in the exchange rate. The program will target continuing strong foreign exchange reserve coverage.

Financial sector policies aim at promoting further resilience to shocks and financial sector deepening. Actions will aim at strengthening risk assessment and mitigation, and supervision, particularly in light of the high level of dollarization. The launching of the new pension system in early 2014 is expected to provide an impulse to financial sector development; program measures in other areas will support financial sector deepening.

The program will support structural reforms needed to complete Armenia's transition towards a dynamic emerging market. These reforms, as laid out in the government's Armenia Development Strategy 2014–25, would help diversify the economy and make growth less volatile and more inclusive. To support implementation, the new program would target measures to improve the business climate, enhance connectivity and competition, and tackle key risks, such as in the energy sector. These efforts are expected to lead to higher investment and exports and contribute to a further adjustment of the external current account deficit, thereby reducing vulnerability.

Concluding Remarks

Despite sound performance under the 2010–13 Fund-supported program, challenges to the Armenian economy remain, in terms of macroeconomic stabilization, reduction of vulnerabilities, and medium-term growth dynamics. Inflation and growth remain highly volatile, as the growth slowdown and inflation increase in 2013 have illustrated. The external current account deficit and dollarization remain high, keeping economy vulnerable to shocks. Poverty and unemployment also remain high, and the transition towards an alternative to the pre-crisis construction-led growth model has been slow.

The authorities' new Fund-supported program rightly addresses these challenges and paves the way for exit from Fund support, with Armenia sustaining market access at the end of the program period and barring any major shocks. The program aims to support a rebound of growth, further program in poverty reduction, inflation stabilization, and a reduction in outstanding fiscal and external vulnerabilities. The program also puts in place structural reforms to promote robust and sustainable medium-term growth and address key risks. In the absence of major shocks, Armenia's balance of payments gaps should close by the end of the program period and the country should be able to sustain access to international financial markets, paving the way for exit from Fund program support, provided that balance of payments difficulties are resolved as expected.

Table 1. Armenia: Selected Economic and Financial Indicators, 2009–16

	2009	2010	2011	2012	2013		2014	2015	2016
	Act.	Act.	Act.	Prel.	EBS/13/75	Proj.	Proj.	Proj.	Proj.
National income and prices									
Real GDP (percent change)	-14.1	2.2	4.7	7.1	5.1	3.2	4.3	4.5	4.7
Gross domestic product (in billions of drams)	3,142	3,460	3,778	3,998	4,351	4,290	4,714	5,123	5,578
Gross domestic product (in millions of U.S. dollars)	8,648	9,260	10,142	9,950	10,365	10,547	11,216	11,609	12,039
Gross domestic product per capita (in U.S. dollars)	2,661	2,838	3,097	3,033	3,153	3,208	3,405	3,517	3,640
CPI (period average; percent change)	3.5	7.3	7.7	2.5	4.0	5.8	5.0	4.0	4.0
CPI (end of period; percent change)	6.7	8.5	4.7	3.2	4.0	5.6	4.0	4.0	4.0
GDP deflator (percent change)	2.6	7.8	4.3	-1.2	4.0	4.0	5.4	4.0	4.0
Poverty rate (in percent)	34.1	35.8	35.0	…	…	…	…	…	…
Investment and saving (in percent of GDP)									
Investment	33.8	29.4	27.0	22.8	24.5	23.9	24.4	24.9	25.5
National savings	18.0	14.6	16.1	11.6	14.4	15.5	17.3	18.1	18.9
Money and credit (end of period)									
Reserve money (percent change)	13.8	-0.8	32.3	1.9	10.3	29.9	9.0	…	…
Broad money (percent change)	16.4	10.6	23.6	19.6	15.9	15.2	11.3	…	…
Velocity of broad money (end of period)	3.8	3.8	3.4	3.0	2.8	2.8	…	…	…
Commercial banks' 3-month lending rate (in percent)	19.1	17.7	20.7	18.5	…	18.3	…	…	…
Central government operations (in percent of GDP)									
Revenue and grants	20.9	21.2	22.1	22.3	23.2	23.3	23.5	23.3	23.6
Of which: tax revenue 1/	16.1	16.4	16.7	18.1	21.7	22.5	22.7	22.7	23.0
Expenditure 2/	28.6	26.2	25.0	23.9	25.5	25.8	25.9	25.4	25.4
Overall balance on a cash basis	-7.9	-4.6	-2.8	-1.5	-2.3	-2.5	-2.3	-2.0	-1.8
Public and publicly-guaranteed debt (in percent of GDP)	40.2	39.7	42.0	44.0	43.5	45.4	45.2	46.0	46.2
Share of foreign currency debt (in percent)	88.9	87.4	86.8	86.9	86.4	84.8	84.4	84.4	84.9
External sector									
Exports of goods and services (in millions of U.S. dollars)	1,336	1,937	2,407	2,440	2,699	2,583	2,757	2,932	3,123
Imports of goods and services (in millions of U.S. dollars)	-3,683	-4,212	-4,797	-4,907	-5,135	-5,022	-5,155	-5,365	-5,596
Exports of goods and services (percent change)	-24.0	45.0	24.3	1.4	8.3	5.8	6.8	6.3	6.5
Imports of goods and services (percent change)	-22.4	14.4	13.9	2.3	4.9	2.3	2.6	4.1	4.3
Current account balance (in percent of GDP)	-15.8	-14.8	-10.9	-11.2	-10.0	-8.4	-7.2	-6.8	-6.6
FDI (net, in millions of U.S. dollars) 3/	725	562	447	474	440	549	413	432	472
External debt (in percent of GDP)	56.4	66.4	71.5	76.2	76.0	79.3	77.0	77.7	78.1
o.w. public debt (in percent of GDP) 4/	35.7	34.7	36.4	38.2	37.6	38.5	38.1	38.8	39.2
Debt service ratio (in percent of exports of goods and services) 4/	5.4	4.7	4.2	9.8	15.6	34.1	10.4	6.3	6.7
Gross international reserves (in millions of U.S. dollars)	2,004	1,866	1,869	1,799	1,467	2,253	2,193	2,278	2,376
Import cover 5/	5.7	4.7	4.6	4.3	3.3	5.2	4.9	4.9	4.9
Nominal effective exchange rate (percent change) 6/	-8.4	-2.6	-2.8	-7.3	…	…	…	…	…
Real effective exchange rate (percent change) 6/	-7.5	1.3	0.0	-6.1	…	…	…	…	…
End-of-period exchange rate (dram per U.S. dollar)	378	363	385.8	403.6	…	405.6	…	…	…
Average exchange rate (dram per U.S. dollar)	363	374	372.5	401.8	…	406.8	…	…	…
Memorandum item:									
Population (in millions)	3.2	3.3	3.3	3.3	…	…	…	…	…

Sources: Armenian authorities; and Fund staff estimates and projections.

1/ From 2013, tax revenue includes social contribution.

2/ In 2013 includes 1.5 percent of GDP related to the acquisition by Gazprom from the government of 20 percent of the shares of ArmRusGazprom, and the transfer (expenditure) of the same amount from the government to ArmRusGazprom to liquidate liabilities. Excluding this transaction, the deficit would amount to 1 percent of GDP.

3/ In 2013, a credit for $155 million is registered in FDI to reflect the acquisition by Gazprom of 20 percent of the shares of ArmRusGazprom, while an offseting debit is registered in other capital (net) to reflect the corresponding reduction in liabilities of the latter with the former.

4/ Based on public and publicly-guaranteed debt.

5/ Gross international reserves in months of next year's imports of goods and services, including the SDR holdings.

6/ A positive sign denotes appreciation.