Armenia

Growth slowed across sectors in 2018, with agriculture contracting further. Inflation accelerated somewhat, and a larger trade deficit and lower remittances widened the current account deficit. Continued fiscal consolidation will mean slower growth in 2019 and 2020. Higher import duties and excise taxes will bring more inflation. A wider trade deficit is expected to keep the current account deficit sizable despite gains in income and service exports. Innovation is critical to ensure growth.

Economic performance

Growth slowed from an exceptionally strong 7.5% in 2017 to 5.2% in 2018. On the supply side, services and industry drove growth as agriculture contracted. Services, providing more than half of output, expanded by 9.6% on improvements in trade, finance, insurance, recreation, transportation, and health care, though growth was less than the 12.1% rise in 2017. Growth in industry excluding construction slackened from 6.6% in 2017 to 4.1% as mining and quarrying output plunged by 14.1% because of low international prices for copper, uncertainties surrounding a gold mining project, and the closure of Armenia's second largest copper and molybdenum mine. However, growth in manufacturing almost doubled from 5.9% to 10.1%, supported by strong gains in processed foods, beverages, tobacco, textiles, and nonferrous metal products. Growth in construction slowed from 2.5% in 2017 to 1.6% as private construction slumped. Adverse weather caused agriculture to contract by 8.5%, compounding a 5.3% drop in 2017 (Figure 3.1.1).

On the demand side, private consumption and investment were the main sources of growth. Private consumption slowed from 8.9% in 2017 but still expanded by 5.7%, benefiting from low inflation, increased consumer lending, and a government initiative in July 2018 to write off fines and penalties on overdue personal loans. Public consumption declined by 6.4%, reversing 13.1% growth in 2017. Despite lower public investment, total investment expanded by 28.5% on much higher inventories, which were likely motivated by disruptions and business uncertainty stemming from political events in 2018, and on a 5.0% rise in gross fixed capital formation. The deficit in net exports widened further as imports grew faster than exports.

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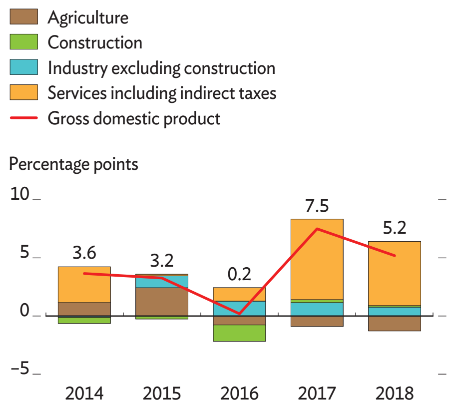
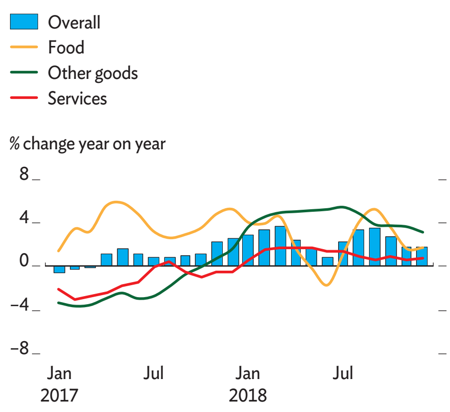
3.1.1 Supply-side contributions to growth



Source: Statistical Committee of Armenia. http://www.armstat.am (accessed 25 February 2019).

3.1.2 Inflation



Source: Statistical Committee of Armenia. http://www.armstat.am (accessed 25 February 2019).

Average annual inflation rose from 1.0% in 2017 to 2.5% in 2018, reflecting higher excise taxes on fuel, liquefied gas, beverages, and cigarettes, as well as increased customs duties since January 2018 for about 200 items under the Customs Code of the Eurasian Economic Union. Prices increased by 2.5% for food, 4.5% for other goods, and 1.2% for services. Inflation at 1.8% year on year in December 2018 was still well below the target band of 2.5%–5.5% set by the Central Bank of Armenia (Figure 3.1.2).

Monetary policy remained steady throughout the year, with the policy rate unchanged at 6.00% from February 2017 to the end of 2018. As inflation, while rising, stayed moderate, the central bank trimmed the policy rate to 5.75% in January 2019.

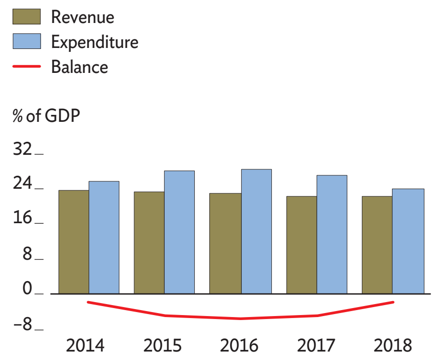
Monetary expansion slowed sharply from 18.5% in 2017 to 7.4% last year as net foreign assets tumbled by three-quarters, and despite a 12.0% rise in net domestic assets. Credit to the private sector rose significantly, pushing total credit higher by more than 17% in 2018, including an increase of 45.3% for consumers.

In a 2018 assessment, the International Monetary Fund found Armenia's financial system stable and noted significant progress in strengthening oversight of the sector, with improved regulation and supervision contributing to financial deepening along with additional capital from shareholders and several mergers. Despite improved financial soundness indicators, vulnerabilities remain. A high 47.1% of loans and 60.4% of bank deposits were in foreign currency at the end of 2018, and liquidity cushions were inadequate, with foreign currency loans four times higher than deposits.

Fiscal policy remained consistent with the government's medium-term consolidation objectives of reducing the deficit and the high ratio of public debt to GDP. The budget deficit narrowed sharply from 4.8% of GDP in 2017 to 1.8% in 2018, greatly outperforming the budget's 2.7% target (Figure 3.1.3). Domestic sources provided two-thirds of budget financing. Revenue rose by 8.3% to equal 22.3% of GDP, reflecting better tax collection, a new tax code with higher excise taxes and customs duties, and increased nontax revenue. Outlays declined by 3.9 percentage points to equal 24.1% of GDP as capital spending fell 12.2% short of the budget target. The ratio of public debt to GDP eased from 58.9% in 2017 to 55.8%, the first drop since 2013, as GDP grew faster than debt. External public debt grew by only 1.8% to $5.0 billion, equal to 44.6% of GDP, while domestic public debt rose by 8.6% to $1.4 billion (Figure 3.1.4).

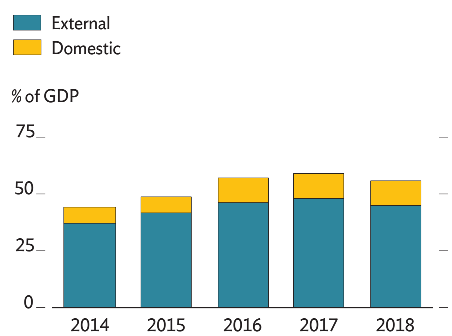
The estimated current account deficit more than doubled from 2.4% of GDP in 2017 to 6.6% as a much larger trade deficit and weaker remittances outweighed gains in service exports and income flows (Figure 3.1.5). Problems in mining slashed annual growth in exports from 26.2% in 2017 to 8.5% last year,

3.1.3 Fiscal indicators



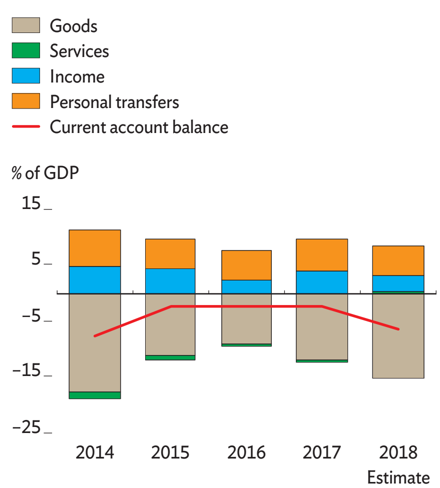
Sources: Ministry of Finance. http://www.minfin.am; Statistical Committee of Armenia. http://www.armstat.am (accessed 25 February 2019).

3.1.4 Public debt



Sources: Ministry of Finance. http://www.minfin.am; Statistical Committee of Armenia. http://www.armstat.am (accessed 25 February 2019).

3.1.5 Current account components



Sources: Central Bank of Armenia. http://www.cba.am (accessed 25 February 2019); ADB estimates.

while slackening domestic demand cut import growth from 32.6% to 18.5%. Remittances, measured as net inflow of private noncommercial transfers through banks, fell by 22.1% to $600 million in 2018. Ruble depreciation cut remittances from the Russian Federation by 16.1%, and remittances from other countries plunged even further (Figure 3.1.6).

Gross international reserves slumped by 2.8% to $2.2 billion at the end of 2018, estimated to cover 4.3 months of imports. The Armenian dram remained relatively stable in real effective terms but appreciated by 6.0% in nominal effective terms (Figure 3.1.7).

Economic prospects

Growth is projected to slow to 4.3% in 2019 then recover slightly to 4.5% in 2020 (Figure 3.1.8).

Risks to the outlook are broadly balanced. Growth could strengthen with improved political stability, following an eventful 2018, and as a new government pledges to promote competition, combat corruption, enhance public services, and encourage entrepreneurship and innovation. Major downside risks stem from any growth slowdown in 2019 in the Russian Federation, Armenia's main trade partner and destination for migrant workers; weaker mining output and diminished exports from lower prices for nonferrous metals; and preparations to repay a $500 million eurobond coming due in September 2020.

On the supply side, services should be the main driver of expansion, with lesser support from agriculture, industry, and construction. Services are projected to grow by 6.0% in 2019 and 5.5% in 2020, reflecting gains in wholesale and retail trade, finance, insurance, recreation, and transport and communications. Agriculture is projected to rebound by 2.5% in 2019 and 3.3% in 2020, assuming more normal weather but also continued government-subsidized loans to farmers for hail nets, drip irrigation, intensive gardening, and leasing, as well as the success of a pilot agricultural insurance program that promises to encourage planting. Expansion in industry excluding construction will likely slow to 2.9% in 2019 before recovering to 3.6% in 2020. While low international copper prices and problems in mining will again weigh on the output and export of minerals, growth could benefit from higher demand for processed foods, pharmaceuticals, textiles, and footwear from Eurasian Economic Union partners and the Middle East. Tepid capital spending will likely keep growth in construction modest.

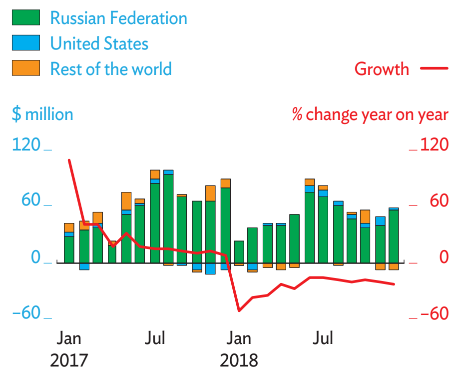
On the demand side, growth is expected to slow further for both investment and consumption. Fiscal consolidation including low capital outlays will likely limit gains in public consumption and investment, though private consumption and investment should find support in expected increases in remittances and tax changes to be implemented in 2019: the introduction of a

3.1.1 Selected economic indicators (%)

	2019	2020
GDP growth	4.3	4.5
Inflation	3.5	3.2
Current account balance (share of GDP)	−6.9	−6.1

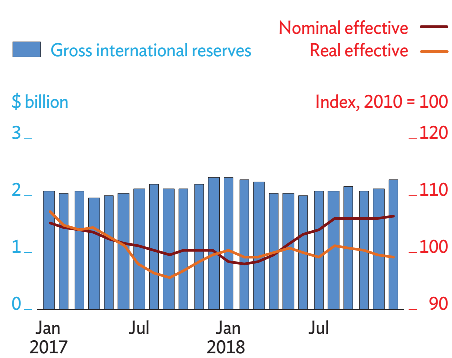
Source: ADB estimates.

3.1.6 Remittances by source



Source: Central Bank of Armenia. http://www.cba.am (accessed 25 February 2019).

3.1.7 Reserves and effective exchange rates



Sources: Central Bank of Armenia. http://www.cba.am; International Monetary Fund. International Financial Statistics online database (accessed 25 February 2019).

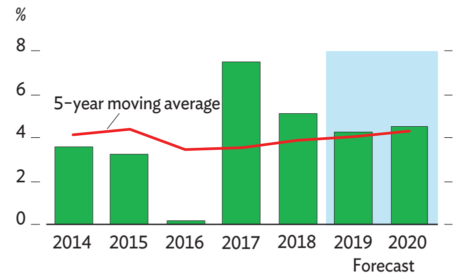
flat personal income tax at 23% and lower profit taxes on small firms. The deficit in net exports is expected to widen further as exports grow more slowly than imports.

Monetary policy will aim to support economic growth while curbing inflation. Despite slower growth, average annual inflation is projected to accelerate to 3.5% in 2019, boosted by higher customs duties for about 560 items imported from countries outside the Eurasian Economic Union, a 10% price rise for imported gas beginning in January 2019, and expected increases in excise taxes for fuel, beverages, and cigarettes in the second half of 2019. Inflation is seen moderating to 3.2% in 2020 as the effects of these factors abate.

Fiscal policy will remain tight under fiscal consolidation that includes planned government restructuring and the rationalization of some agencies that will likely trim employment in several ministries. The 2019 budget projects a fiscal deficit equal to 2.2% of GDP as revenue rises by 14.4% and expenditure by only 12.5%. Planned revisions to the tax code in the second half of the year should boost revenue collection by strengthening tax administration and enlarging the tax base, but preparations to repay the $500 million eurobond in September 2020 will pose a serious fiscal challenge. In addition, public debt engaged in 2018 but drawn down in 2019 will likely raise total public debt to about 58% of GDP.

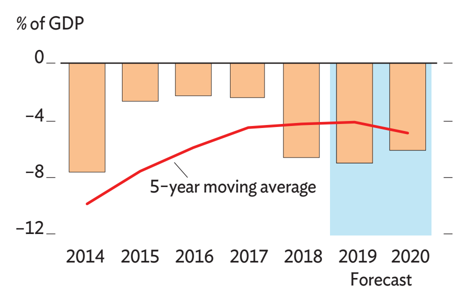
The current account deficit is projected to widen slightly to 6.9% of GDP in 2019 before narrowing to 6.1% in 2020 as higher income and service exports offset continued expansion of the trade deficit (Figure 3.1.9). Export growth is projected to slip further to 6.0% in 2019 and then recover to 8.5% in 2020 on higher exports of agricultural products, textiles, precious stones, and metal products, even as mineral earnings remain weak. Import growth will likely moderate to 8.2% in 2019 and 6.5% in 2020 but continue to outpace growth in exports as demand grows for consumer and capital goods. Gains in tourism and information technology (IT) will buoy net service inflows, while rising remittances are expected to boost net income and current transfers. International reserves are projected at $2.2 billion in 2019, rising in 2020 to $2.4 billion.

3.1.8 GDP growth



Sources: Statistical Committee of Armenia. http://www.armstat.am (accessed 25 February 2019); ADB estimates.

3.1.9 Current account balance



Sources: Central Bank of Armenia. http://www.cba.am; Statistical Committee of Armenia. http://www.armstat.am (both accessed 25 February 2019); ADB estimates.

Policy challenge—ensuring growth through innovation and a knowledge economy

Growth averaged a respectable 4.1% from 2010 to 2018 but faces an uncertain future. Remittances and exports of commodities may fuel growth, but they are vulnerable to external shocks. Armenia has responded by diversifying its export base, yet exports of goods with high value added remain small. To address these problems and ensure stable and more inclusive growth, Armenia's capacity for innovation must be strengthened.

In its *Global Competitiveness Report 2018*, the World Economic Forum ranked innovation capacity in Armenia at 60 out of 135 economies and 14 out of 34 peers in the upper-middle-income category. While Armenia scores well on international co-invention, patent applications, and buyer sophistication, it compares less favorably on workforce diversity, research and development (R&D) spending, the quality of its research institutions, and its use of cluster development. Addressing these issues and promoting a knowledge-based economy depends on the successful implementation of comprehensive education, science, technology, and innovation policies. Among key government objectives are upgrading Armenia's scientific infrastructure, ensuring a steady rise in the number of highly skilled workers, strengthening innovation, and internationalizing science and innovation. Specific targets for certain objectives appear in an innovation concept paper the government approved in 2011 and in other documents, notably *Strategy on Development of Science 2011–2020* and *Science and Technology Priorities 2015–2029*.

Successful policy implementation requires an enabling environment, support for human capital development, aid for R&D and innovation in private firms, and more integrated innovation systems. As human capital is especially important, innovation capacity depends crucially on the quality of education, particularly in science and technology, and the availability of workers with the necessary technical skills. Armenia has made considerable progress, and IT-related services now provide more than 11% of service exports, 16% of all services, and 5% of GDP. Continued rapid expansion in IT depends on enhanced education to meet the industry's growing demand for highly skilled workers. In particular, the quality of science, technology, engineering, and mathematics education must be improved by modernizing teaching and learning materials and by going beyond existing initiatives and projects to develop and promote techno-parks, innovation incubators, R&D centers opened and operated by global companies, IT classes, school engineering labs, and after-school learning platforms.

Though Armenia's skills base is evolving, R&D capacity and efforts still lag. R&D spending equaled only 0.3% of GDP in 2018, or barely one-six of the 1.8% average in upper-middle-income economies. Measures to support innovation must be comprehensively inventoried before they can be streamlined and reoriented. Flexible financing arrangements that include incentives and other cost-effective support could allow firms to improve their performance and become more willing to undertake the risks inherent in developing new products and services. The government is providing R&D and physical facilities for technology-based firms through a program called Engineering City and Engineering Cluster, designed to help firms and universities combine their efforts to commercialize research products and catalyze the growth of high-tech companies.