

EDB MACRO REVIEW



04'2019

Republic of Armenia

CONTENTS

Information Disclosure	2
List of Abbreviations	3
SUMMARY	4
STATUS OF THE ECONOMY	5
Economic Activity	5
The Labor Market	7
Inflation	8
The External Sector	9
The Fiscal Sector	11
Monetary Conditions	12
ECONOMIC OUTLOOK	15
Background	15
Economic Activity	15
Inflation	17
Monetary Conditions	17

INFORMATION DISCLOSURE

This Review includes a detailed description of the current internal and external macroeconomic setting and an agreed set of forecasts that takes into account the interrelationships between the economies of the EDB operating region and the external sector.

The forecasts of the main macroeconomic indicators were prepared by the EDB jointly with the EEC using an integrated system of models based on a multi-country structural dynamic macroeconomic general equilibrium model. More detailed information about the structure of the integrated system of models, its main components, and its use for analysis of the macroeconomic situation and forecasting is contained in a joint EDB and EEC report entitled "Forecasting System for the Eurasian Economic Union".

This report is for information purposes only and cannot be regarded as a recommendation to buy or sell securities or any other financial instruments. Neither information contained in this research review nor any other information relating to its subject matter that may be disseminated in the future may be used as a basis for the recognition of any contract. The information contained in this review and the conclusions drawn therefrom were obtained from open sources that the EDB considers to be reliable, with the date of this publication as the cutoff date. For all the thorough preparation of this review, no EDB analyst, director, manager, employee, or counterparty gives any warranty or representation, express or implied, as to the reliability, accuracy or completeness of the information contained in this research review, and assumes no responsibility in this respect. The EDB expressly declines all responsibility and liability in connection with any information contained in this review. Any information contained in this review may change at any time without prior notice. No EDB employee undertakes to update, alter, or supplement this analytical review or notify its readers in any form, should any of the facts, opinions, calculations, forecasts or assessments mentioned in the review change or otherwise become irrelevant.

LIST OF ABBREVIATIONS

AMD – Armenian dram

CBRA – Central Bank of the Republic of Armenia

EAEU – Eurasian Economic Union

EDB – Eurasian Development Bank

EEC – Eurasian Economic Commission

FDI – Foreign Direct Investment

GDP – Gross Domestic Product

pp – percentage point

RA – Republic of Armenia

U.S. or USA – United States of America

USD – United States Dollar

% – percent

% YoY – Year-on-Year growth rate

SUMMARY

For the second consecutive year, Armenia remains the fastest-growing EAEU economy. In 2018, it grew by 5.2% after 7.5% the year before. The main factors behind the slowdown in its economic activity were the more moderate growth of household consumption than in 2017 and a decline of consumption in the public sector.

The EDB projects Armenian GDP growth to accelerate somewhat in 2019, assisted by increasing investment activity as the extraction industry gradually adapts to the new requirements, a recovery in agricultural output, and Government policy that supports investment, exports, and improving social conditions. In the medium term, GDP will trend towards its potential rate, that we estimate at some 5% per annum.

During 2018, inflation remained below the 4% CBRA target; in December 2018 it was 1.8% YoY. The main factor behind inflation trends in 2018 was food price volatility after a lower harvest.

According to our estimates, inflation will accelerate to 2.8% in 2019, driven by increasing domestic demand as wages and lending grow. By the end of 2021 inflation will approach the CBRA target (4%).

Given the economic background, the CBRA did not change its refinancing rate (6%) in 2018 and thus maintained a stimulative monetary policy. Interest rates on loans and deposits decreased during the year. According to our base scenario projection, as inflation gradually accelerates and approaches the CBRA target level, the CBRA will begin a series of rate rises that we expect to have a neutral impact on economic growth and inflation.

In 2018, amid economic activity growth, the government pursued a tight fiscal policy to maintain debt and fiscal sustainability. In the medium term, the focus of fiscal policy will remain the same.

STATUS OF THE ECONOMY



Economic Activity

GDP growth decelerates

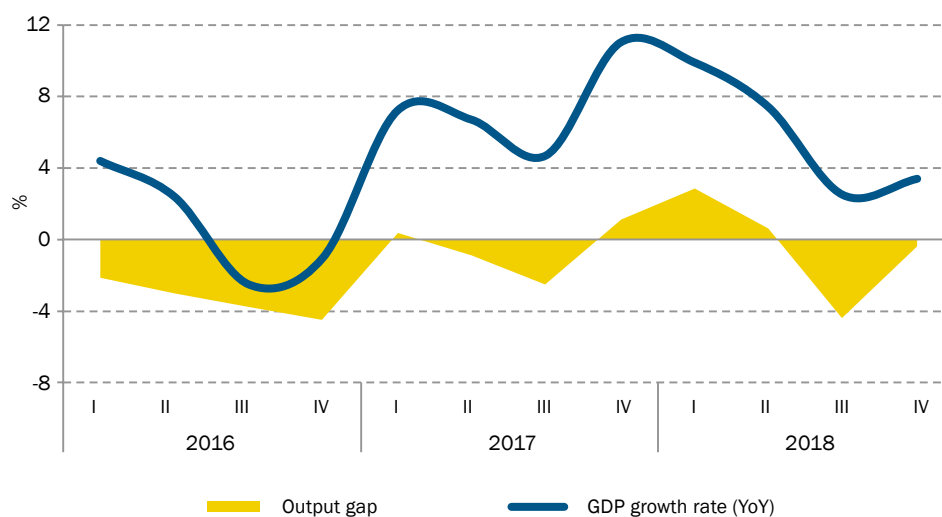
The 2018 economic growth rate was 5.2%, down from 7.5% in 2017. The main factors behind the economic activity slowdown were more moderate growth of household consumption than in 2017 and a decline of consumption in the public sector. Increased gross savings supported economic growth in 2018.

Trade and services, industrial output, and construction remained positive contributors to GDP growth, while agriculture had a negative effect.

Unstable intra-annual GDP trends

GDP growth gradually slowed down during 2018. In the 2nd half of 2018, the average quarterly year-on-year GDP growth rate was some 3.0%, compared to 8.7% in January to June 2018.

Figure 1.
Economic Activity



Source: Statistical Committee of the RA, authors' calculations

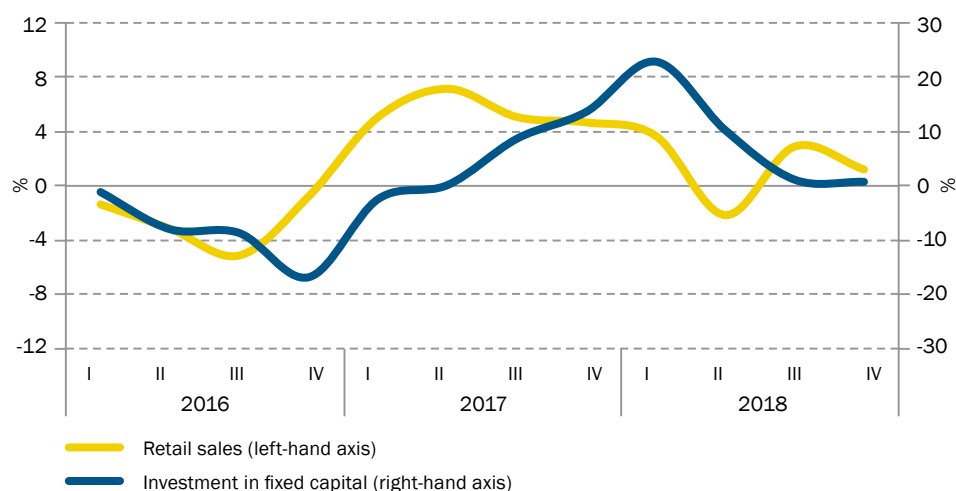
Consumer demand slows down

Consumer demand increased in 2018, but ultimate consumption growth decelerated considerably (to 3.4%, from 10.0% in 2017). Weaker consumer demand resulted from a household consumption slowdown (5.2% compared to 9.3% in 2017) amid moderate growth of real disposable incomes, as well as from reduced public consumption due to the tight fiscal policy applied.

Investment activity increases

Figure 2.
Retail Sales and Investment
(growth YoY)

Gross savings grew by 28.5% in 2018 (after 13.9% in 2017), and gross fixed capital formation rose by 5.0%. Most gross savings growth was from growing inventory stocks. The factors behind investment activity expansion in 2018 included lending growth.



Source: Statistical Committee of the RA

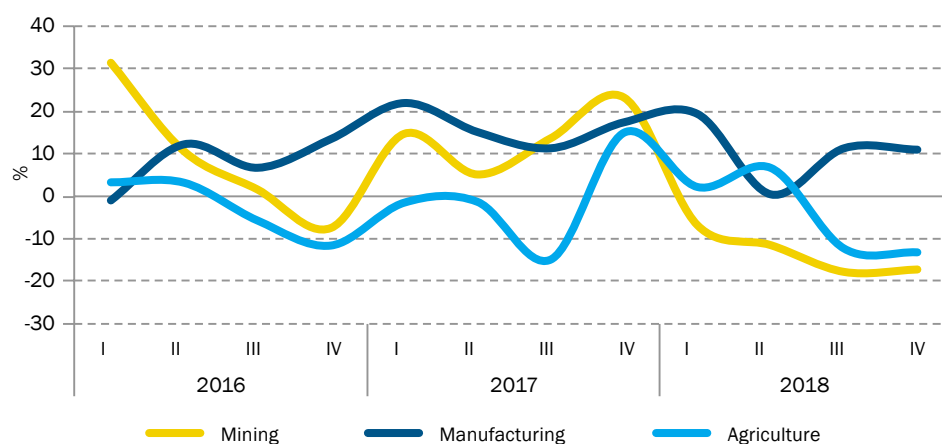
Industry growth driven by manufacturing output

Industry's contribution to economic growth decreased from the preceding year's level. According to the Statistical Committee of the RA, industry provided 0.7 pp of GDP growth in 2018, after 1.2 pp in 2017. Its smaller contribution resulted from a production decline in mining (-14% in 2018) as some major mining companies suspended work. On the other hand, the manufacturing industry continued to grow at a high rate, supported by expanded lending to the industrial sector. As a result, in 2018 the industrial output growth rate remained positive at 4.3% (in 2017 it was 12.6%).

Low harvest deepens agricultural decline

Agricultural production declined by 7.6% (after a 3% decline in 2017). This was caused by a low harvest of staple crops due to bad weather and by a 2.7% decrease of livestock produce output in 2018.

Figure 3.
Production
(growth YoY)



Source: Statistical Committee of the RA

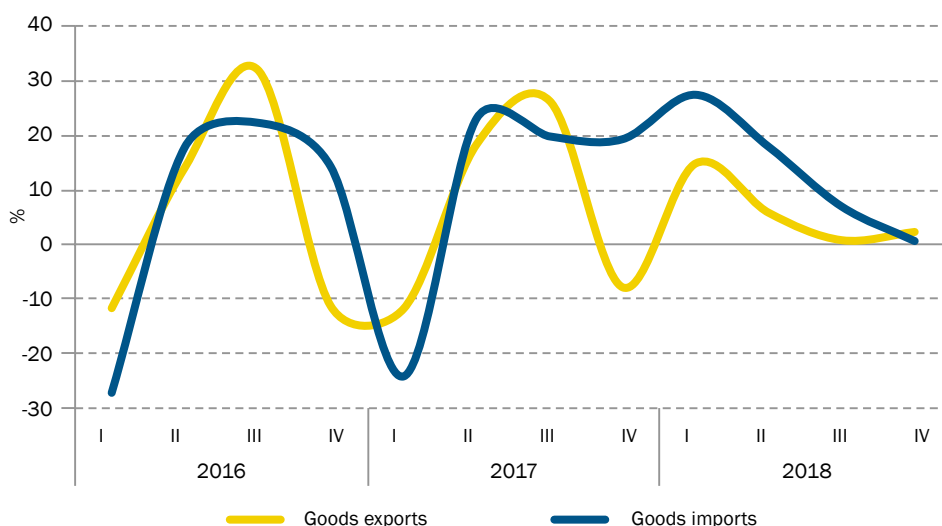
Services contribute much of GDP growth

Services (including trade) grew by 9.6% in 2018 to become the greatest contributor to economic growth (4.7 pp), mainly on account of increased 'arts, entertainment and recreation' activities, wholesale and retail trade, and financial and insurance activities. The growth of the service sector was accompanied by growth in lending, investment and construction, as well as by wage growth.

Net exports decline

The negative contribution of foreign trade to economic growth widened in 2018. Export volumes of goods and services grew by 5.2%, while import volumes grew by 10.9%, which was much slower growth than in the previous year (18.7% and 24.6%, respectively). The slowdown in exports resulted from declines in the mining industry and agriculture, and from the strengthening of the Armenian dram's real effective exchange rate in the second semester. Imports decelerated due to consumer demand weakening.

Figure 4.
Foreign Trade Volumes
(growth YoY)



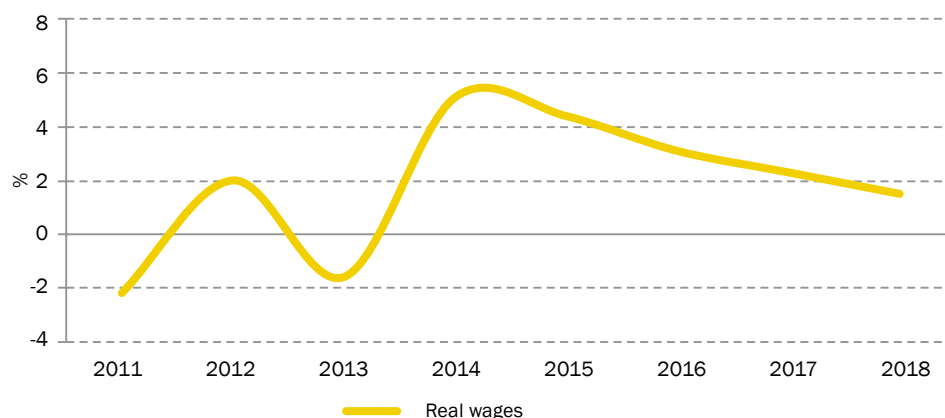
Source: Statistical Committee of the RA

The Labor Market

Wages and household incomes grow

In 2018, economic growth was accompanied by a rise in unemployment by 2.6 pp, to 20.4%, as well as growth in nominal wages. The growth in households' incomes was constrained by a decrease in remittances from abroad. A moderate increase in real wages (1.5%) promoted growth of incomes and consumer demand.

Figure 5.
Labor Market
Indicators
(growth YoY)



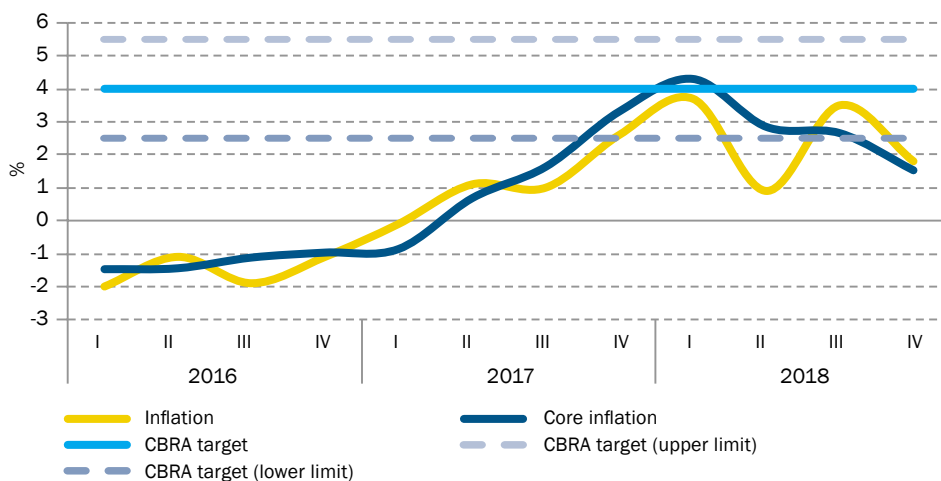
Source: Statistical Committee of the RA

Inflation

Inflation below the CBRA target

Inflation in Armenia slowed down in 2018, to fall below the CBRA target. The consumer price growth rate was 1.8% YoY in December 2018, down from 2.6% YoY in December 2017. The deceleration in price growth resulted from a decrease of prices in the food segment amid moderate domestic demand and low prices of some goods on foreign markets.

Figure 6.
Inflation
(last month in the quarter vs. the last month of the same quarter the year before)



Source: Statistical Committee of the RA, CBRA

Food price growth slows down

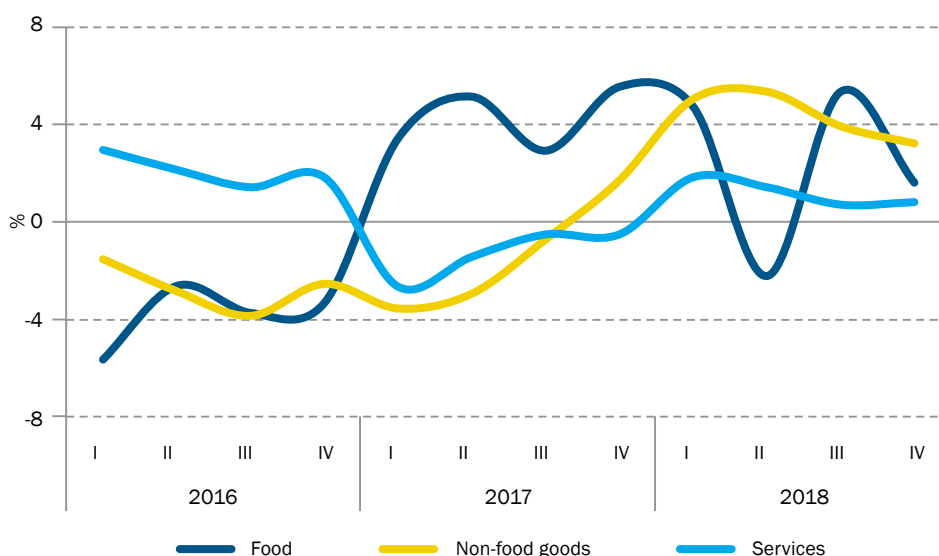
Food prices grew by 1.8% in 2018 after 5.3% the year before. Food inflation decelerated as the prices of some foodstuffs (vegetables, liquid dairy products, cheese, and eggs) decreased largely in line with consumer demand.

Non-food inflation accelerates

Non-food prices increased by 3.2% in 2018 (1.7% in 2017), largely on account of gasoline and diesel fuel price growth in early 2018. Price growth in 2018 was constrained by the consumer activity slowdown, the dram's stability versus the U.S. dollar and its strengthening against the currencies of Armenia's trade partner countries.

Service prices grew by 0.8% in 2018 (after a 0.5% decrease in 2017). Low inflation in the market for services to individuals was accompanied by weak growth in utility service prices and a decrease in telecommunication service prices.

**Figure 7.
Inflation Components**
(last month in the quarter vs.
the last month of the same
quarter the year before)



Source: Statistical Committee of the RA, CBRA

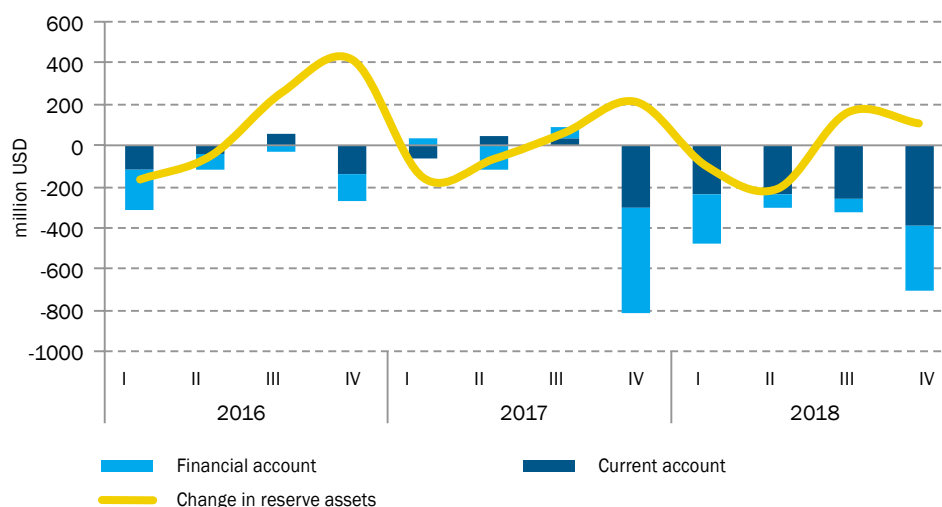
The External Sector

Balance of payments current account deficit expands

The deficit on the current account of the balance of payments was USD 1,130.6 million (9.1% of GDP) in 2018, up from USD 279.7 million (2.4% of GDP) the year before. The expansion in the current account deficit resulted from the increased negative balance of trade in goods and services (15.4% of GDP compared to 12.2% of GDP in 2017) and a decrease in both primary and secondary incomes. Remittances to Armenia in dollar equivalent decreased by 2.8% according to the CBRA, particularly due to the weakening of the Russian ruble against the U.S. dollar¹.

¹ Most of the remittances come to Armenia from the Russian Federation.

Figure 8.
Balance of Payments
of the RA



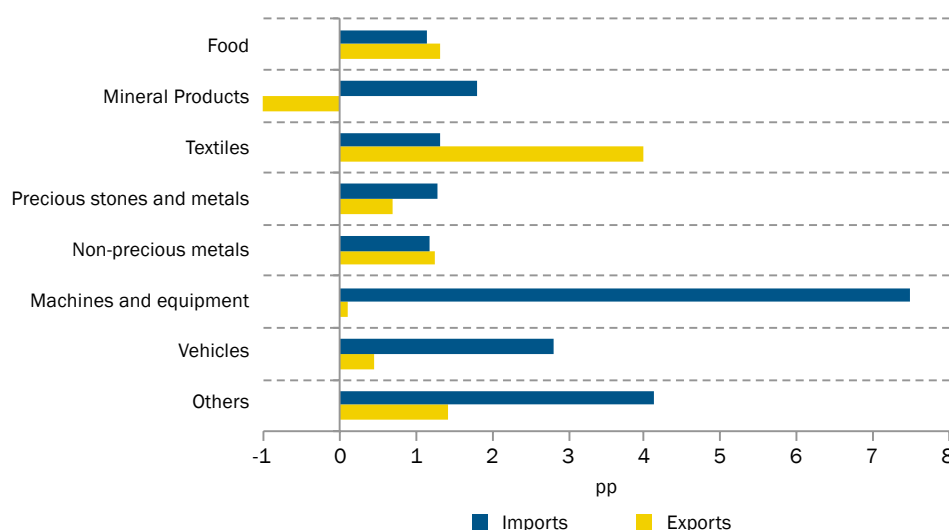
Source: CBRA

Negative balance of trade in goods expands

The expansion of the negative balance of foreign trade in goods in 2018 resulted from goods exports outpacing imports in nominal terms. According to the CBRA, the trade balance deficit was USD 1.8 billion, 28.4% more than in 2017. Import growth resulted from growing investment and rising energy prices, mainly those of oil and natural gas. Goods exports were supported by growing external demand due to higher consumer activity in most of the main trade partner countries. On the other hand, the mining decline constrained goods exports.

FDI inflow into the Armenian economy increased. The volume of FDI in the real sector was USD 266 million on a net basis in 2018, 16.9% more than in the previous year.

Figure 9.
Product Groups'
Contribution to
Growth of Exported
and Imported Goods
in 2018

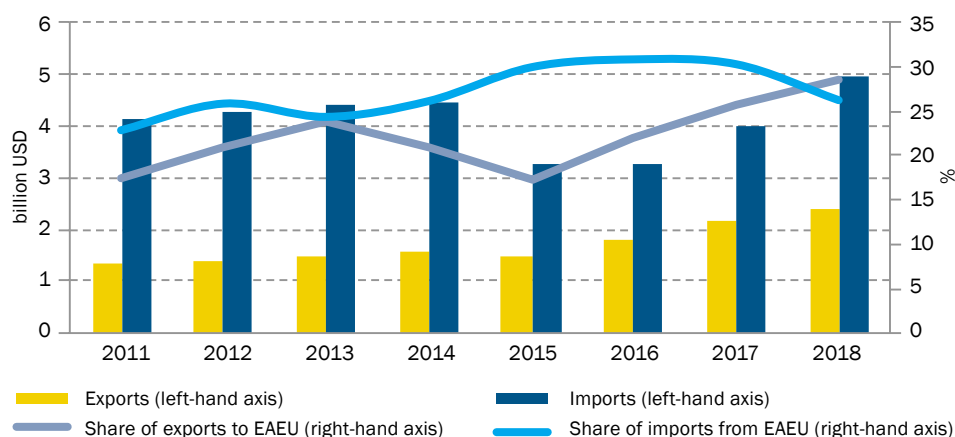


Source: Statistical Committee of the RA, authors' calculations

Goods exports to EAEU countries grow

Mutual trade within the EAEU continued to grow in significance for Armenia. Exports of RA goods to EAEU countries reached USD 689 million in 2018, 20.7% more than the year before. Armenian goods exported to third countries grew by a mere 3.4% in the period. As a result, the share of EAEU countries in Armenia's exports increased to 28.5% in 2018, from 25.5% the year before. Consumer goods, mainly textile products and foods, made a considerable contribution to the increase in sales to EAEU countries. The outperformance of these product groups' exports to the EAEU compared to third countries may have resulted from increased consumer activity in most of the integration association's member States.

Figure 10.
Goods Exports and Imports



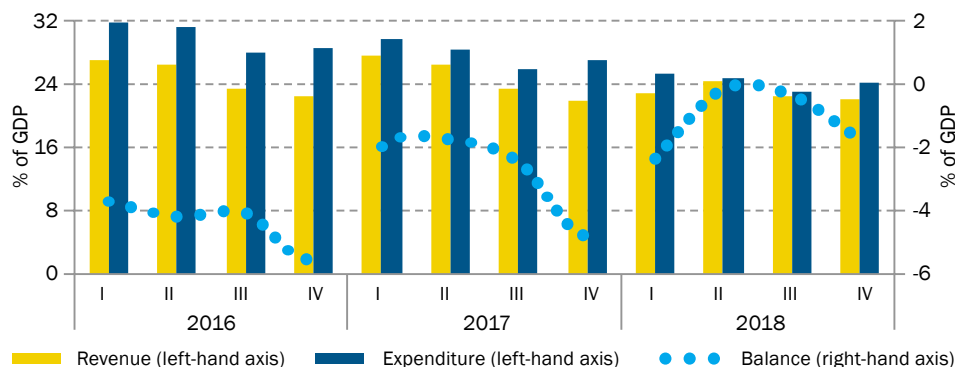
Source: EEC, authors' calculations

The Fiscal Sector

State budget deficit decreases

The State budget's deficit was 1.8% of GDP in 2018, down from 4.8% of GDP the year before. The decrease in the State budget deficit resulted from the public expenditure to GDP ratio falling by 2.9 pp (to 24.1%, from 27% in 2017) and the higher share of taxes and duties as a percentage of GDP, which increased by 0.5 pp to 21%.

Figure 11.
The State Budget
(cumulative for the period)

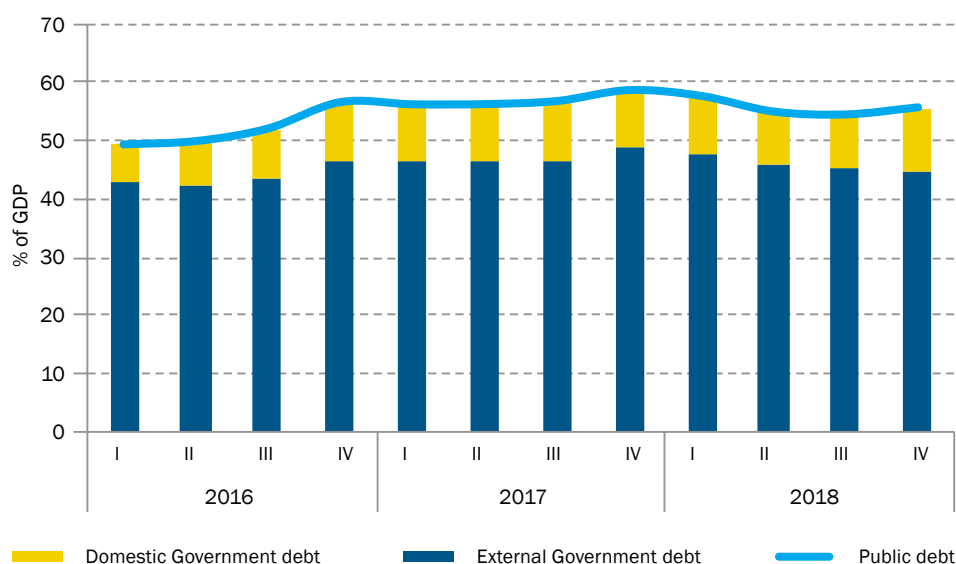


Source: Statistical Committee of the RA, authors' calculations

Public debt decreases

The share of external public debt in GDP decreased by 2.4 pp to 40.2%. The share of external liabilities in total public debt increased to 20% as of the end of 2018 to mark a new high. The continued trend towards the greater role of domestic debt as a source of funding the budget deficit will make the Armenian economy more resilient to external shocks. Total public debt decreased by 3.1 pp to 55.8% of GDP.

Figure 12.
Public Debt
(at end of period)



Source: Statistical Committee of the RA, authors' calculations

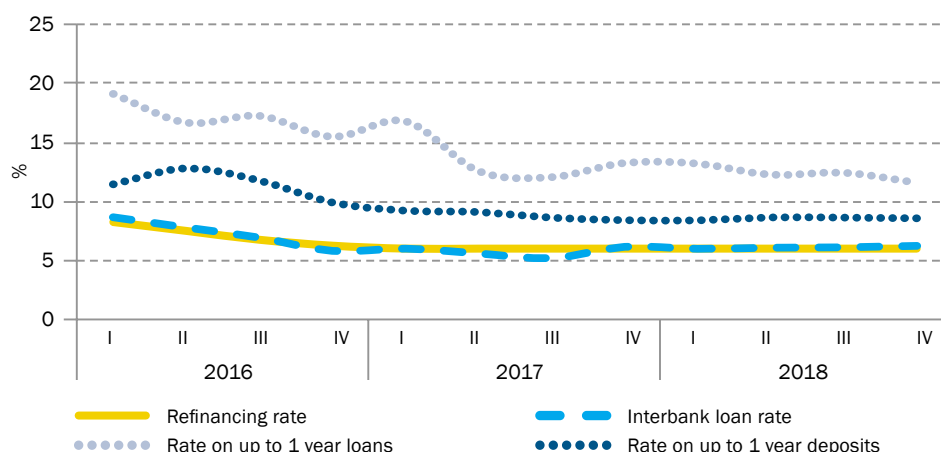
Monetary Conditions**Refinancing rate unchanged in 2018**

The refinancing rate did not change during 2018. The CBRA kept its rate at 6% last year, considering this level sufficient for a gradual inflation recovery while taking into account the disinflation risks. The short-term market rates and return on short-term public bonds were close to the refinancing rate.

Interest rates stable in 2018

Interbank market rates and interest rates on deposits remained virtually unchanged during 2018, given that the refinancing rate was stable. Interest rates on loans to the economy were consistent with inflationary expectations: the average rate on loans for up to one year decreased from 13.3% at the end of 2017 to 11.6% at the end of 2018.

Figure 13.
Interest Rates
(period average)



Source: CBRA, authors' calculations

Lending increases

Bank lending growth increased amid a stimulative monetary policy. The growth of loans to the economy was 17.2% in 2018 (16.1% in 2017). The increase in lending was supported by banks' lending facilitation steps (easing of loan issuing terms and procedures, and reduced interest rates). Mortgages and consumer loans were the greatest contributors to the growth in lending.

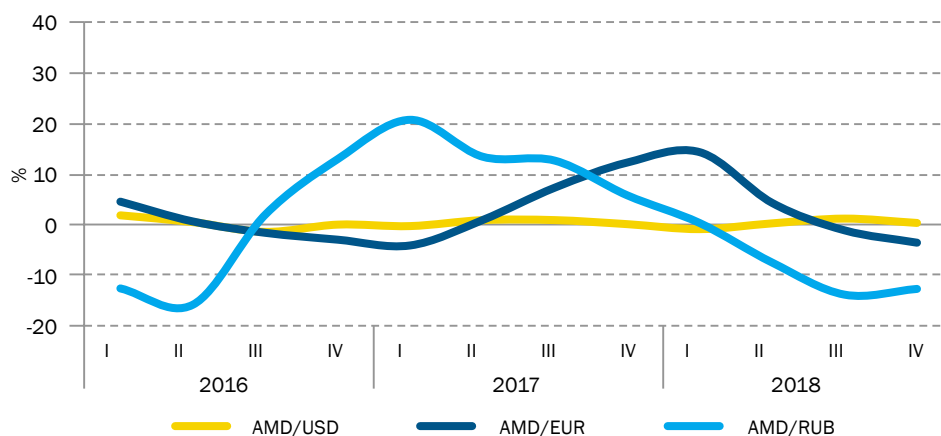
Dollarization of loans and deposits continues to decrease

The dollarization of bank loans and deposits continued to decrease. The share of loans issued to residents in foreign currency decreased to 53.9% as of the end of 2018, from 61.2% at the end of 2017. The share of residents' foreign currency deposits decreased to 52.7% as of the end of 2018, from 55.7% as of the end of 2017.

Armenian dram stable against U.S. Dollar

The main currency pairs showed mixed trends in 2018. The dram remained relatively stable vs. the U.S. dollar, weakening by 0.3% (December 2018 vs. December 2017). Its exchange rate vs. the euro strengthened by 3.5%, and its strengthening against the Russian ruble was 12.7%.

Figure 14.
Dram Nominal Exchange Rate
(change in period YoY, + = dram weakening)



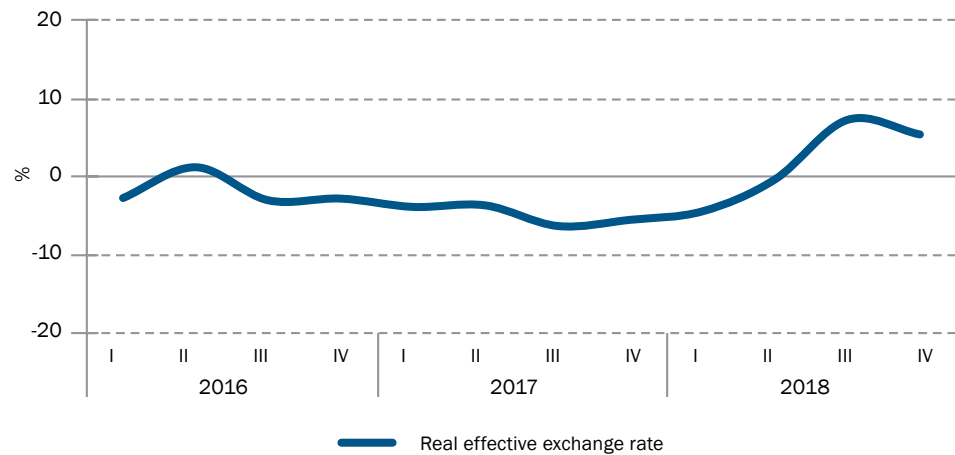
Source: CBRA, authors' calculations

Real effective dram exchange rate strengthens

Figure 15.
Real Effective Dram Exchange Rate

(change in period YoY,
+ = dram strengthening)

The Armenian dram's real effective exchange rate grew by 4.9% in 2018, mainly due to the strengthening of its nominal exchange rate against trade partner countries' currencies and a slowdown of inflation in 2018.



Source: CBRA, authors' calculations

ECONOMIC OUTLOOK

Background

External demand to slow down, commodity prices to grow in 2019

In the external sector, a slowdown of economic growth is expected in 2019 in Armenia's main partner countries. Growth in external demand is expected to decelerate mainly due to a decrease in the economic growth rate projected in the Russian Federation and Eurozone. Weak inflation will continue in the markets for raw materials and foodstuffs — caused, on the one hand, by low demand affecting food prices and, on the other hand, by increased oil production volumes in the USA. Copper prices are expected to recover gradually².

Economic policy to retain its main thrust

The projection scenario assumes a continued tight fiscal policy aiming to maintain both fiscal and public debt sustainability. Monetary policy will still be a stimulative one and will pursue the inflation target (4%±1.5 pp).

Table 1. Forecast Key Foreign Economic Indicators

	Average annual copper price (USD per tonne)	Average annual Urals oil price (USD per barrel)	Food prices, 2010 index=100	Russia's real GDP growth rate, %	Eurozone's real GDP growth rate, %
2019	6441	65.0	91.6	1.5	1.3
2020	6489	64.7	92.9	2.0	1.7
2021	6561	63.4	94.3	2.2	1.7

Source: authors' calculations, EEC

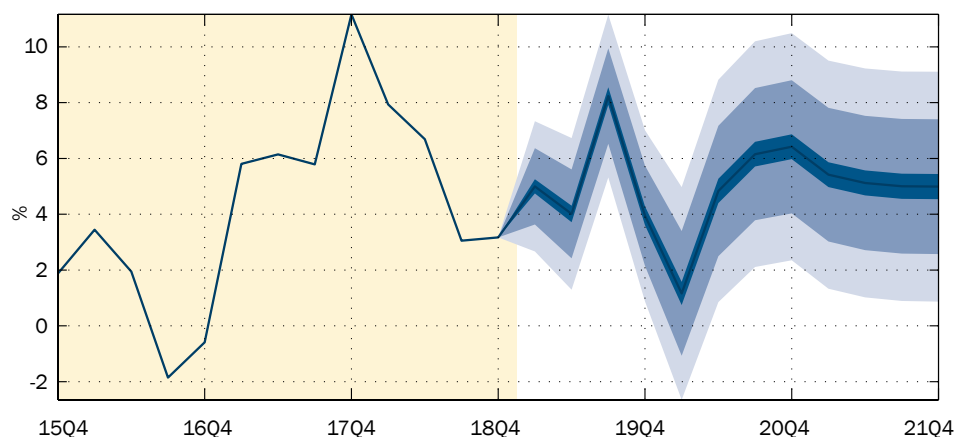
Economic Activity

GDP growth to accelerate in 2019

5.3% GDP growth is projected for 2019, mainly driven by a private consumption recovery amid active growth of lending to households. Economic growth will additionally be supported by the recovery of investment activity as the mining industry gradually adapts to the State's new requirements and as the Government implements its initiatives to improve the investment climate.

² Copper (ore concentrate and metal) is one of Armenia's staple export commodities. It accounted for 24.9% of all goods exported in 2018.

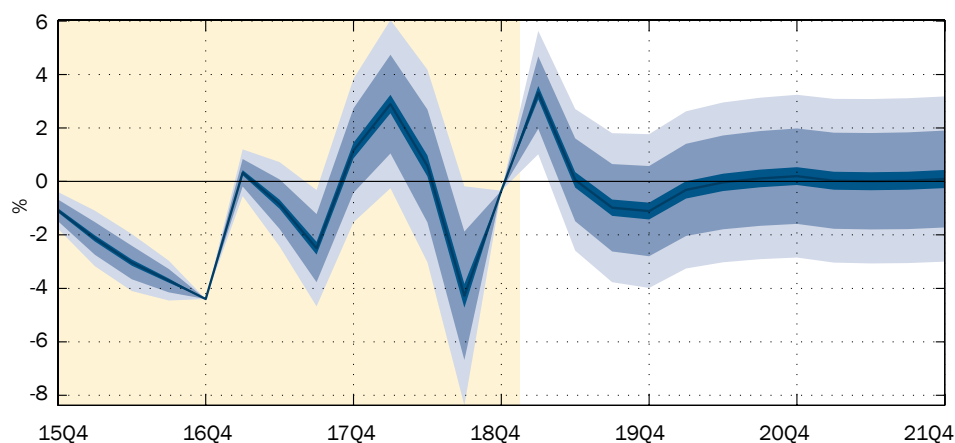
Figure 16.³
Real GDP⁴
(growth YoY)



Source: authors' calculations, EEC

The uncertainty around the continued operation of the Amulsara mine and the Alaverdi copper smeltery is a factor that may constrain economic growth in 2019.

Figure 17.
Output Gap



Source: authors' calculations, EEC

5% growth potential

In the medium term, Armenia's economic growth will trend towards its potential level that we estimate at 5%. Economic growth will be driven by positive trends in all of its components and, above all, by investment activity growth. The implementation of the Government's structural reforms and production capacity expansion will be conducive to greater potential growth of the economy.

³ Here and elsewhere the fan chart ranges correspond to the 10%, 50% and 75% confidence intervals.

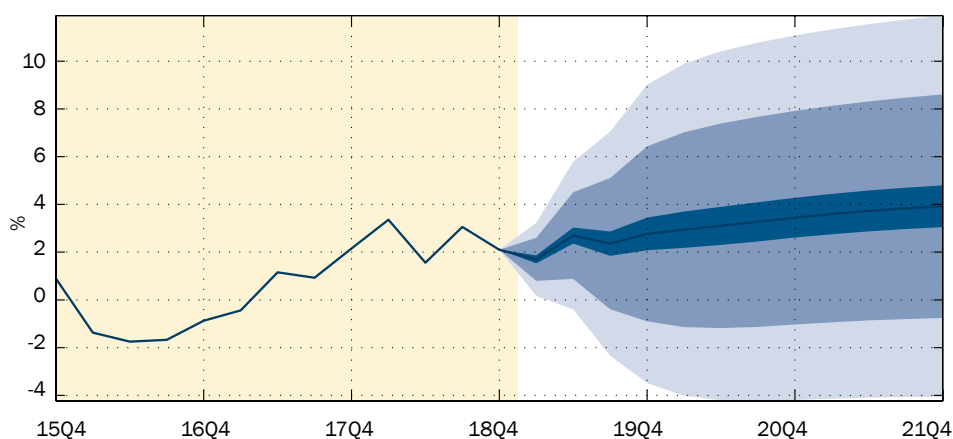
⁴ Seasonally adjusted data.

Inflation

Inflation to accelerate in 2019

Inflation will accelerate to 2.8% in 2019, driven by domestic demand growing as wages and lending increase. By the end of 2021, inflation will approach the CBRA target of 4%.

Figure 18.
Inflation⁵
(for each period, YoY)



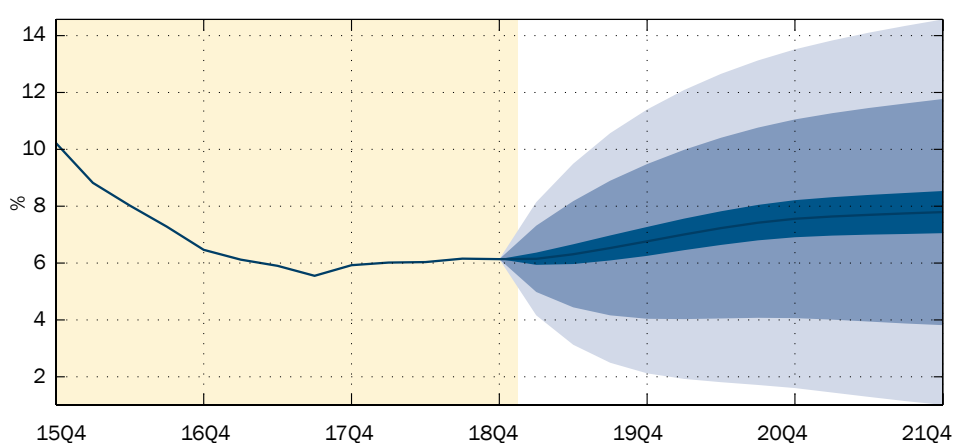
Source: authors' calculations, EEC

Monetary Conditions

Rates to increase as inflation accelerates

In our projection, we expect a round of rate rises to begin in 2019 and to continue as inflation gradually accelerates in 2020–2021, which will in turn be neutral for economic growth and inflation.

Figure 19.
1-day Interbank Loan Rate
(period average)



Source: authors' calculations, EEC

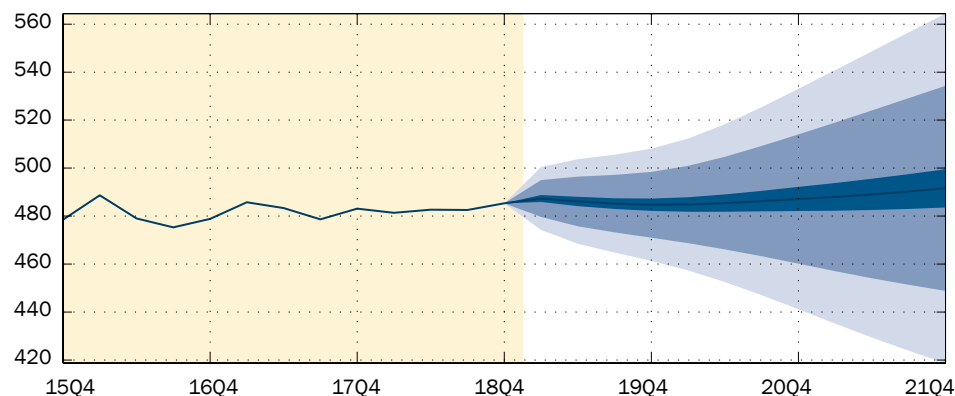
⁵ Seasonally adjusted data.

Dram exchange rate to be stable

The Armenian dram to U.S. dollar exchange rate will remain fairly stable in the projection period. Balanced foreign trade, supported by a growing inflow of foreign investment, will keep the Armenian dram stable.

Figure 20.
Armenian Dram to U.S. Dollar Exchange Rate

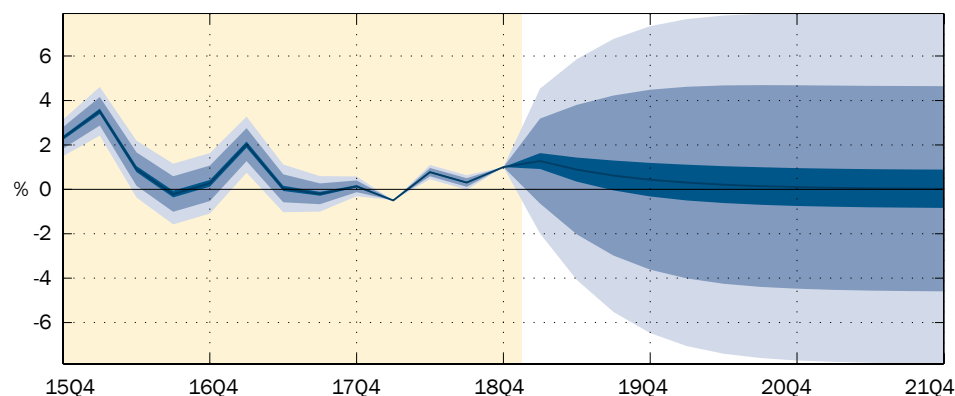
(AMD per USD)



Source: authors' calculations, EEC

Figure 21.
Real Dram to U.S. Dollar Exchange Rate Gap

(+ = the dram is undervalued)



Source: authors' calculations, EEC

Key Macroeconomic Indicators of the Republic of Armenia

Indicator	2016	2017	2018	2019F	2020F	2021F
GDP in constant prices (% growth YoY)	0.2	7.5	5.2	5.3	4.6	5.1
Consumer price index (% growth in December to previous year's December)	-1.1	2.6	2.1	2.8	3.4	3.9
1 Day Interbank Loans in National Currency (the year's average % per annum)	7.6	5.9	6.1	6.4	7.3	7.7
Nominal Armenian Dram to U.S. Dollar Exchange Rate, AMD per USD	480	483	483	486	486	490

Source: authors' calculations, EEC. F– forecast



Eurasian Development Bank

RESEARCH DEPARTMENT, EURASIAN DEVELOPMENT BANK

Your comments and suggestions
concerning this review are welcome at:
pressa@eabr.org

