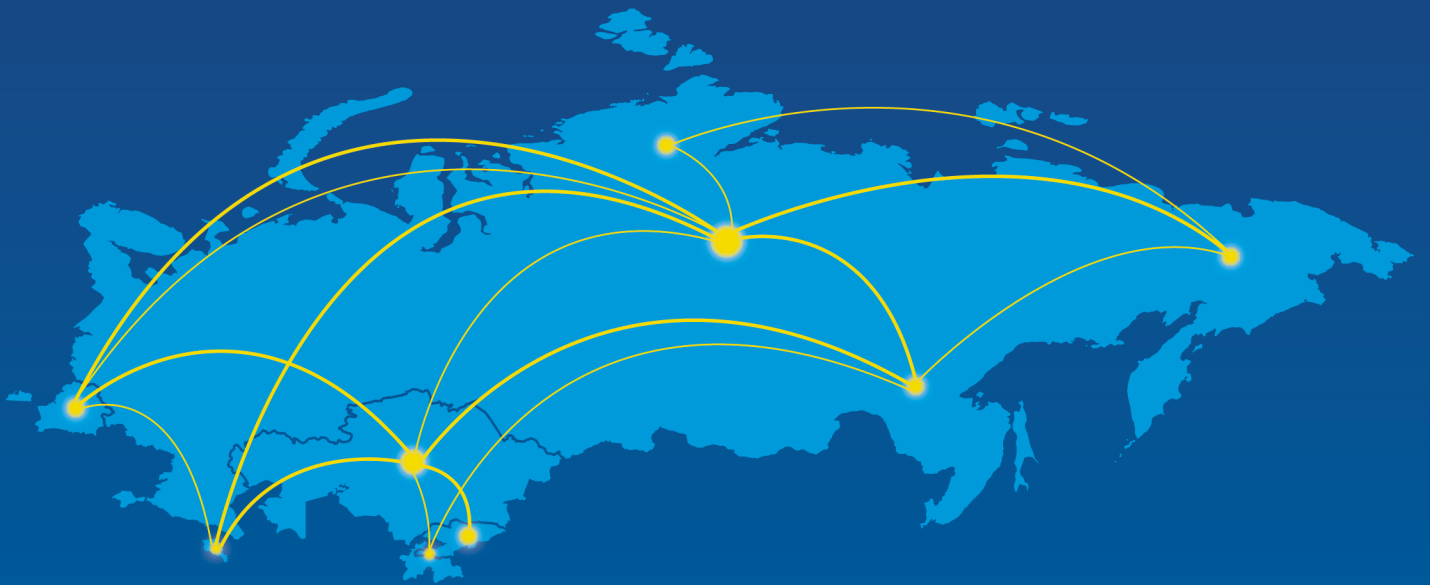


EDB MACRO REVIEW



09'2020

Republic of Armenia

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INFORMATION DISCLOSURE

This Review includes a detailed description of the current domestic and external macroeconomic setting and a consistent 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”.

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LIST OF ABBREVIATIONS

CA — Current Account

CBRA — Central Bank of the Republic of Armenia

EEU — Eurasian Economic Union

EDB — Eurasian Development Bank

EEC — Eurasian Economic Commission

FDI — Foreign Direct Investment

GDP — Gross Domestic Product

IBL — Interbank Loans Market

pp — percentage point

RA — Republic of Armenia

RF — Russian Federation

U.S., USA — United States of America

% — per cent

% YoY — Year-on-Year growth rate

SUMMARY

Armenia's economy experienced a 5.7% YoY contraction in the first half of 2020 (in 2019, a 7.6% increase). Both domestic and external demand affected by the COVID-19 pandemic drove the decline in real GDP. The EDB projects Armenian GDP to decrease by 3.5% in 2020 overall. Shrinking consumer demand resulting from lower income, including remittances received from abroad, wages and the employment rate, as well as a decline in investment activity amid the restrictions imposed due to the pandemic and growing uncertainty, will be behind the negative trend.

In 2021–2022, the economy is projected to recover at 7–9% per year, driven by increased remittances to the country and increased prices of exports (in particular, ore and metal) as the economic situation in the world normalizes, as well as by stimulative fiscal and monetary policies.

In June 2020, inflation kept below the CBRA target range ($4\pm 1.5\%$) at 1.7% YoY. Its acceleration from 0.7% YoY at the beginning of the year is largely attributed to the contribution from changes in seasonally volatile and regulated prices. The EDB projects the consumer basket rate of increase to return in 2022 to the range envisioned in CBRA policy, affected by the recovering aggregate demand in the economy.

Amid the economic recession and low inflation, the Central Bank of the Republic of Armenia decreased its refinancing rate by 1.0 p, to 4.5%¹ in the first half of 2020. According to the EDB's base case, the Central Bank will begin raising its interest rate at the end of 2021 as inflation gradually accelerates.

In the first half of 2020, the state budget posted a deficit of AMD 48.8 billion (1.0% of GDP), against a surplus of AMD 121.9 billion, or 4.5% of GDP, in the same period of 2019. The state of public finances deteriorated as spending increased due to the financing of measures aimed at combating the coronavirus outbreak and supporting the economy. The tax collection rate improved due to increased administrative efficiency, thus somewhat smoothing the adverse effect of the pandemic on the budget.

¹ The rate was further decreased to 4.25% in September 2020.

EXTERNAL CONDITIONS

Economic activity

Unprecedented decline in global economic activity

The first half of this year was marked by a huge challenge — the COVID-19 pandemic. As the disease spread, government bodies in the majority of countries responded by taking measures intended to contain it, which then led to a disruption in global supplies and increased volatility in the financial and commodity markets and exerted an overall negative impact on a great number of key economic sectors. Lockdown measures resulted in a reduction of consumer and investment activity, real and business incomes, and increased unemployment.

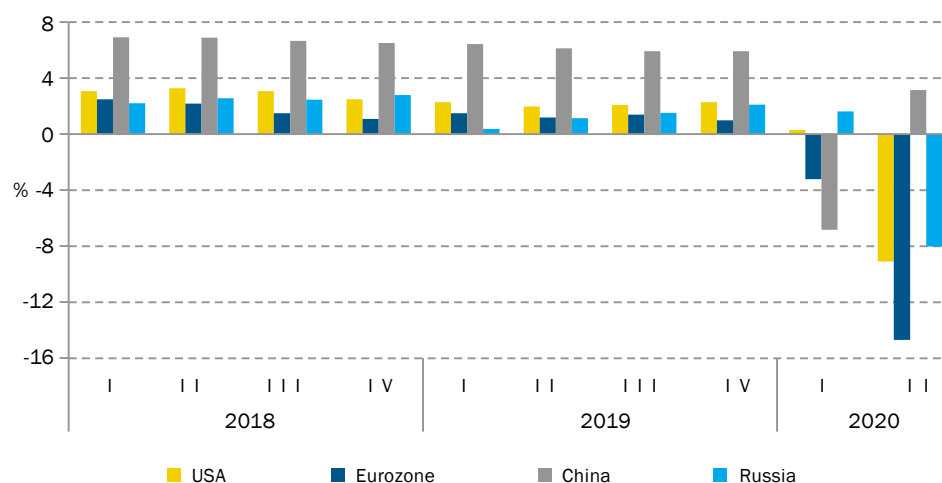
Among the world's largest economies, the biggest decline in business activity in 2Q2020 was observed in the Eurozone, where GDP declined by 14.7% YoY¹ (down 3.2% YoY in January–March 2020), which is the highest drop since the indicator was first calculated in 1995. GDP of the USA decreased by 9.1% YoY² (0.3% growth in Q12020) over the same period, which had not been at this level since 1947. China's GDP showed a positive trend in Q2: it increased by 3.2% YoY (down 6.8% YoY in January–March) upon the restrictions being eased in the spring.

The Russian economy contracted by 8% YoY in 2Q2020 (down 3.4% YoY in the first half of the year). The deteriorating epidemiological situation resulted in a fall in consumer and investment demand, with reduced extraction under the OPEC+ agreement holding back exports further. Coal production, in which heavy-duty Belarusian equipment is used, has experienced a significant decrease.

¹ Seasonally adjusted data. As per our estimates, the year-on-year decrease compared to the previous quarter (seasonally adjusted) amounted to some 40%.

² Seasonally adjusted data. The year-on-year decrease compared to the previous quarter (seasonally adjusted) amounted to 31.7%.

Figure 1.
GDP of the world's largest economies (YoY)



Source: CEIC Data, BEA, Eurostat, Rosstat

Big losses in the service sector

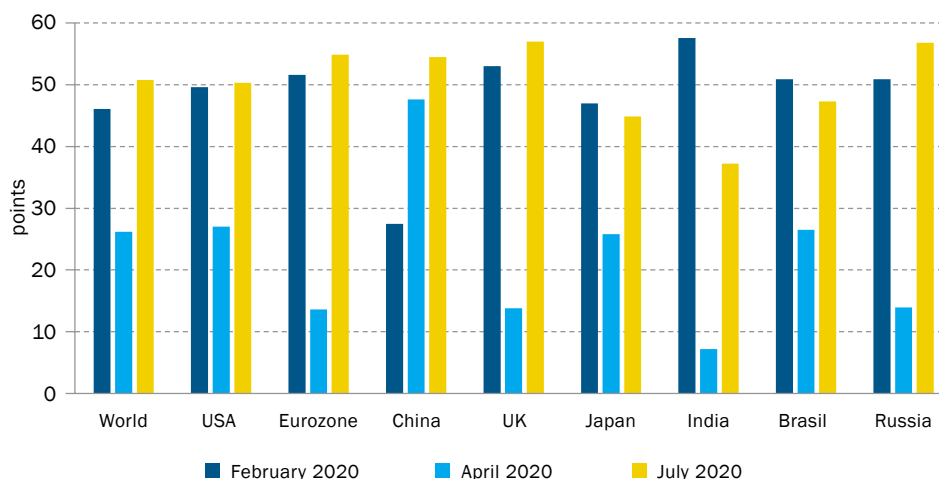
In terms of industry, the largest losses were incurred by businesses providing consumer services. This follows from PMI survey results³, evidencing a significant decrease in business activity in the tourism and hotel industries, as well as in the transport and real estate sectors. A significant deterioration in business sentiment affected technology and financial firms, along with the telecommunications services segment. An output decline was also caused in the manufacturing industry, primarily in mechanical engineering and automobile production. There was a lesser impact of the pandemic on the food and pharmaceutical industries.

Stabilization of the world economy at reduced levels in June–July

The maximum impact of the crisis (barring a second global wave of the disease or provided that its duration and consequences are not overly severe) is likely to have been passed in April–May, with the composite PMI at 26.2 (a record low) and 36.3 points, respectively. In June–July, the indicator increased to 47.7 and 50.8 points, respectively, which attests to a significant slowdown in the economic downturn after lockdown restrictions were eased. The composite PMI for Russia reached 56.8 points in July (13.9 in April 2020), 54.9 in the Eurozone (13.6 in April 2020), 50.3 in the USA (27 in April 2020), and 54.5 in China (27.5 in February 2020).

³ PMI is an indicator describing changes in business activity and the operating conditions of private companies in the manufacturing and service industries. This indicator is based on monthly surveys of purchasing managers. A PMI index reading of over 50 points indicates an increase in economic activity, while readings below 50 indicate a decrease. For more information, please see: <https://www.markiteconomics.com/Public/Release/PressReleases>

Figure 2.
Composite PMI



Source: IHS Markit

Economic sentiment improved in June–July both in the service sector (real estate operations, banking products, telecommunications) and in the manufacturing industry (production of construction materials, automobiles, chemical products, etc.). There was a significant slowing in the decline of new orders volumes, including exports. However, the recovery in global business activity is uneven due to differences in the epidemiological situation, and leading indicators overall signal the stabilization of global output at significantly lower levels than pre-crisis, which indicates the world economy is likely to be slow in returning to its “normal” state.

Inflation

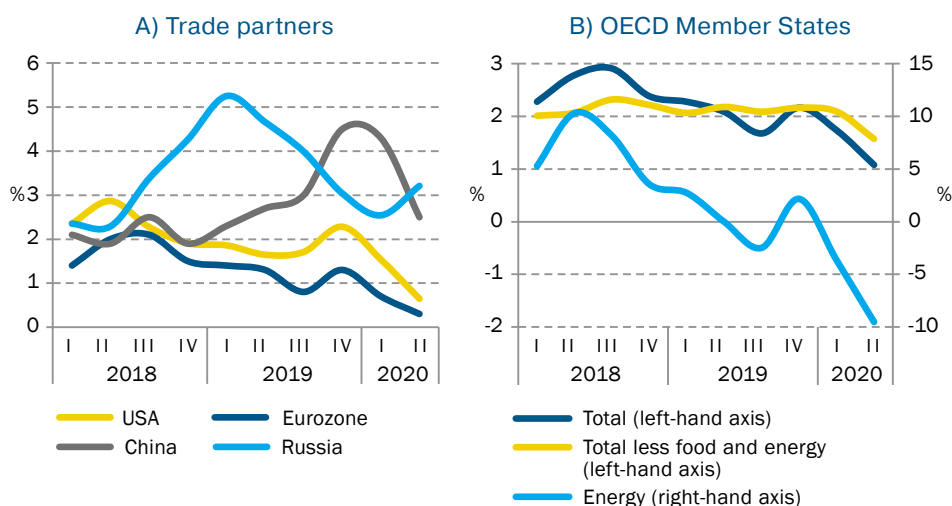
Weak inflation background

The decline in global economic activity resulted in a slowdown in the world’s inflationary processes. Inflation in the OECD countries fell to 1.1% YoY in June from 2.2% in December 2019; in the U.S., it fell to 0.6% from 2.3%; in the Eurozone, it fell to 0.3% from 1.3%; and in China, it fell to 2.5% from 4.5%. The fall in energy costs due to decreased demand acted as an additional disinflationary factor. Accelerated food price growth had an impact on consumer prices despite their decrease in the international market, which might be driven by temporary difficulties relating to transportation and feverish demand for certain products in late March–early April.

Russia retains a moderate price environment: inflation remained below the Bank of Russia’s target (4%) in August, amounting to 3.6% YoY, an increase from 3% YoY in December 2019. The increase in the indicator mainly stems

from the rise in the cost of food products due to the weakening of the national currency, the challenging transportation and logistics situation, as well as the low base effect in the fruit and vegetable segment. Core inflation amounted to 3.1% YoY in August, as in December 2019. Weakened domestic consumer demand curbed its movement.

Figure 3.
Foreign inflation
(the last month in a quarter vs. the last month of the same quarter a year before)



Source: OECD, RF CB

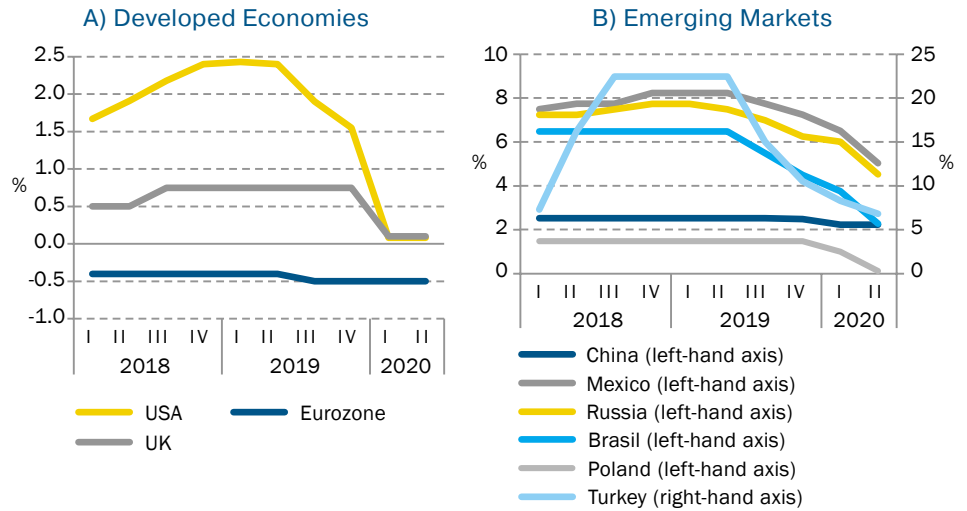
Monetary and fiscal policy

Easing of monetary policy

Active government measures taken to support the population, business and the financial sector were instrumental in limiting the scale of decline of the world's largest economies. Monetary regulators eased monetary policy significantly in the first half of 2020 by lowering key interest rates and expanding asset purchase programs. In addition, top central banks announced their intention to maintain a soft policy in the medium term.

Monetary regulators in developing countries also lowered key rates, most actively in March–April 2020. As of the end of August 2020, the Bank of Russia key rate amounted to 4.25%, 2 pp lower compared to its level at the beginning of the year. The regulator's actions are explained by a shift in the balance of risks in 2Q toward disinflation due to a deep drop in both domestic and external demand, which might cause inflation to drop below the 4% target in the medium term. Since the inflationary trend has proven to be rather moderate, we assess the Bank of Russia's monetary policy as moderately stimulative.

Figure 4.
Key interest rates of foreign countries
(as at the end of period)

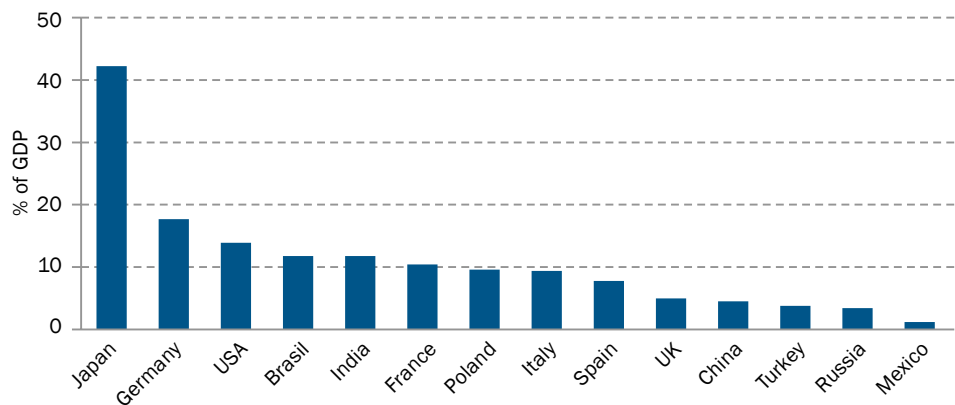


Source: CEIC Data

Stimulative fiscal policy

The volume of fiscal assistance was significantly expanded in the first half of 2020, since a need for anti-crisis measures arose, factoring in support for business and real incomes. According to the COVID-19 Economic Stimulus Index⁴ as of August 25, the volume of fiscal stimulus in Japan amounted to 42.2% of GDP; in the U.S., 13.9% of GDP; in Germany, 17.7% of GDP; in France, 10.4% of GDP; in Italy, 9.4% of GDP; in the UK, 5% of GDP; in China, 4.5% of GDP; and in Russia, 3.4% of GDP.

Figure 5.
Scope of fiscal support measures



Source: COVID-19 Economic Stimulus Index

⁴ For more information, see: Elgin C., Basbug G., Yalaman A. 2020. Economic Policy Responses to a Pandemic: Developing the Covid-19 Economic Stimulus Index. CEPR. Covid Economics, Vetted and Real-Time Papers. No 3. PP. 40–53.

Commodity markets

Low oil prices

The prices of most key exchange-traded goods were driven largely by global demand and expectations of its recovery. After falling in March and April, prices for oil, metals and food began to recover in the face of a revival in economic activity. The OPEC+ agreement also had a positive impact on oil prices, providing for a large-scale reduction in raw materials extraction from May 2020. As a result, the price of Brent rose to USD 42.8 per barrel in July (Urals rose to USD 43.9) from a multi-year low of USD 23.3 in April (Urals: USD 18.2), but remained much lower than before the crisis.

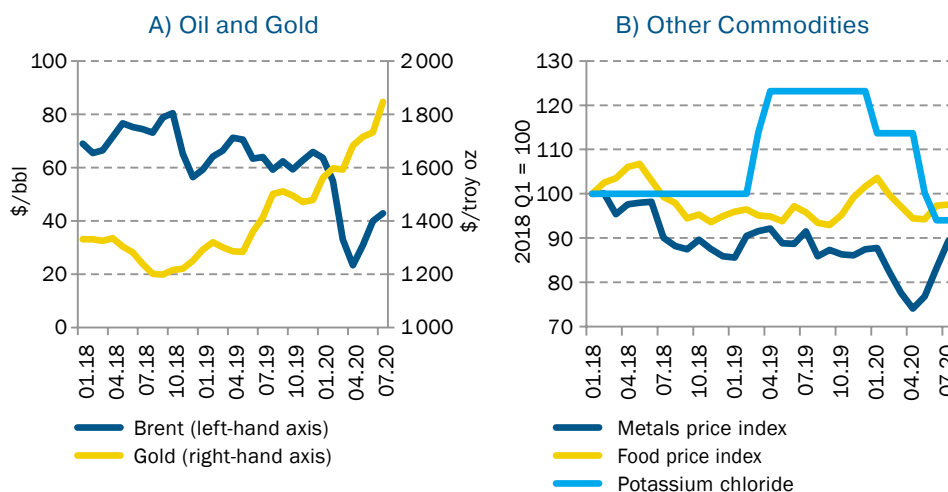
Falling global prices of potash fertilizers

The metal price index increased by 20.7% in July versus the April minimum, and exceeded the level of December 2019. This was largely influenced by the revival of economic activity in China. The weakening of the U.S. dollar against key world currencies, as well as the risk of reduced supply of industrial metals, including copper, caused by the spread of coronavirus in Latin America, also affected the rapid growth of the indicator in June–July. The food price index showed a similar trend: after falling in April–May, there was a recovery in June–July. The market for potash fertilizers and coal remains just as weak in terms of prices, with one ton costing USD 202.5 in June–July 2020, a 23.7% decrease since December 2019 (USD 265).

Increase in gold prices

Amid increasing global uncertainty in the first half of this year, there was a significant increase in demand for protective assets such as gold, with its prices reaching an all-time high in July 2020, being almost 25% higher than in last December. The soft policy maintained by major central banks furthered the increase, accompanied by large-scale injections of liquidity.

Figure 6.
Commodity prices



Source: World Bank

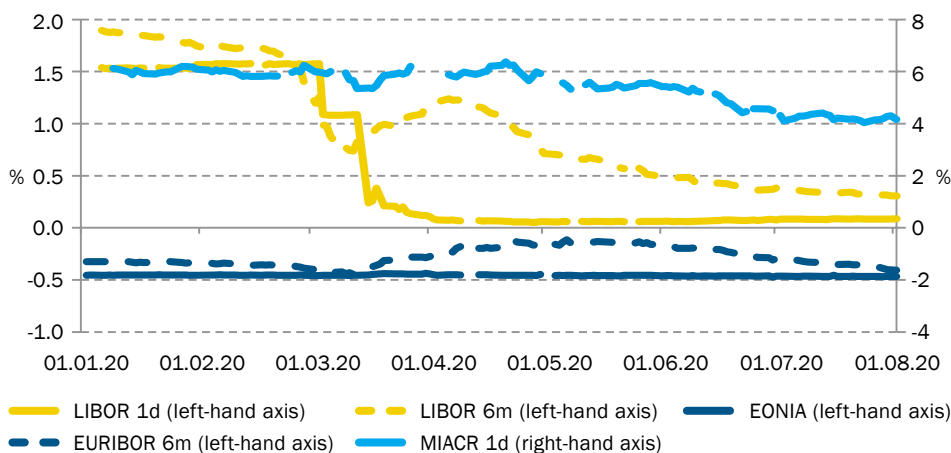
Financial markets

Lowering of interbank market rates

LIBOR rates in U.S. dollars, as well as indicators of the Eurozone money market, decreased in 2Q2020 after monetary regulators opted to ease monetary policy. Central banks' efforts to maintain financial markets liquidity and somewhat improved business sentiment amid stabilizing economic activity were instrumental in reducing spreads between rates on one-day and longer interbank loans, which had returned to pre-crisis levels after an upsurge in March.

The short-term interbank loan rates decreased in Russia over January–June 2020, staying near the policy rate, with a small negative spread resulting from a structural surplus of liquidity remaining in the banking sector. The yield on ruble FLBs also significantly decreased in April–July after an increase in March, propelled by the expectation of a key rate adjustment and the stabilization of the financial market after a period of increased turbulence around the middle of March.

Figure 7.
Money market rates

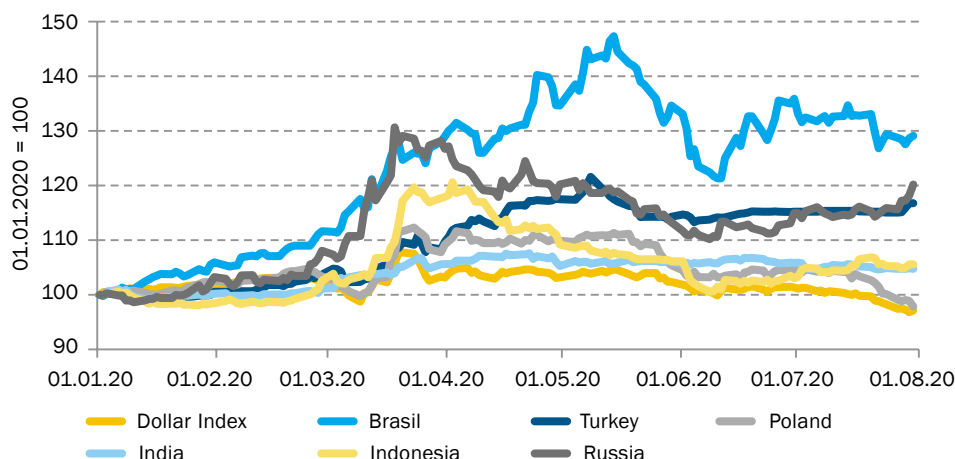


Source: CEIC Data

Weakening of the U.S. dollar against the currencies of developed countries

The U.S. dollar exchange rate against key world currencies weakened markedly in June–July after strengthening in March–April, when investors were exiting from risky assets. The decline in the value of the U.S. currency was caused by a number of factors, including the FRS's statements about its intention to support an extremely soft monetary policy in the medium term, a still high rate of coronavirus disease spread in the USA, and the EU countries' agreement to issue common bonds in July.

Figure 8.
Exchange rates
against the U.S. dollar



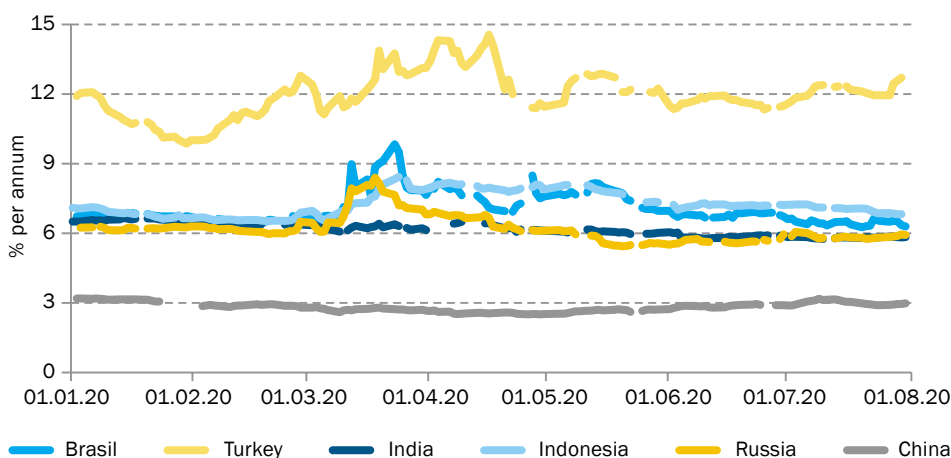
Source: CEIC Data, Investing.com

Volatility in emerging market currencies

The currencies of emerging market countries regained in 2Q2020 some of the ground lost against the U.S. dollar in March, largely driven by signs of recovery in economic activity. In addition, these movements were largely corrective, since the currencies were oversold amid the March panic. However, exchange rates remain volatile. In the wake of new COVID-19 outbreaks in late June and July and a deterioration in China–United States relations, emerging market currencies were again pressurized by increased concerns about a second wave of the pandemic and a decrease in investor interest in risky assets.

The yield on long-term government bonds of emerging market countries decreased in April–July after a significant increase in March; it basically returned to the levels observed prior to the start of the pandemic, if not lower. Both the reduction in key interest rates of central banks and the beginning of recovery processes across economies played a crucial role in this.

Figure 9.
Ten-year government
bond profitability in
emerging markets

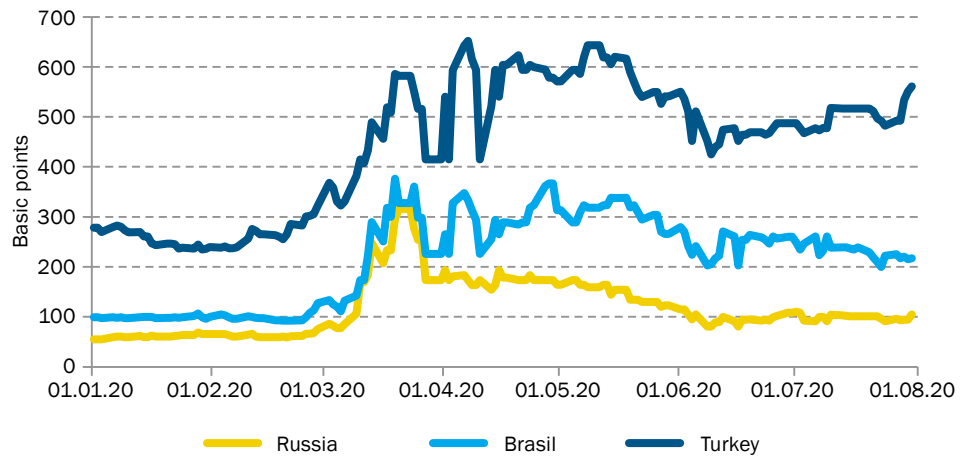


Source: Investing.com

Risk premium has stabilized at a heightened level

Risk premiums for developing economies in 2Q2020 decreased against the highs of March–April, as indicated by the CDS trends. Nevertheless, their indicators stabilized in June–July, at levels higher than those before the crisis, which might be driven by the remaining high uncertainty about the global economic outlook. Country risk premiums will likely remain high until the spread of coronavirus slows in a sustained fashion.

Figure 10.
Five-year CDS in emerging markets



Source: Investing.com

STATE OF THE ECONOMY

Economic activity

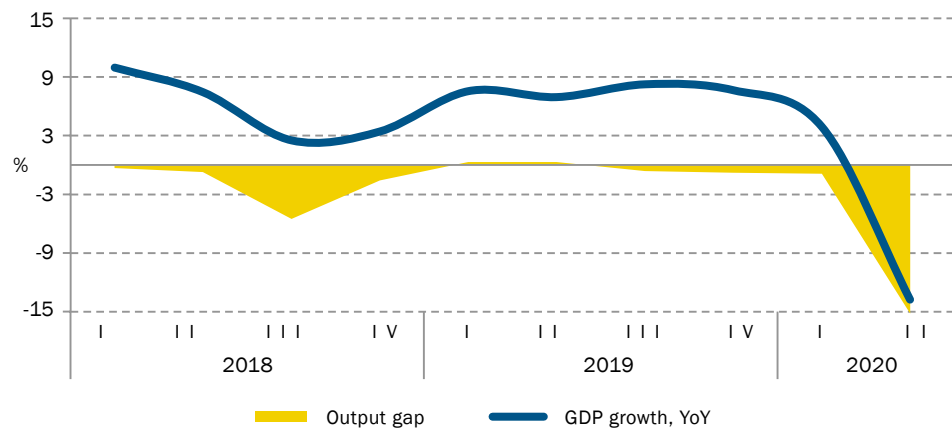
GDP decline

Armenia's economy experienced a 5.7% YoY contraction² in the first half of 2020 (in 2019, up 7.6%). Domestic and external demand affected by the COVID-19 pandemic (factoring in the disease outbreak within the country) served as a driver behind the real GDP decline.

Varied output trend by industry

Production trends were of a varied nature in the main economic sectors. Restrictions imposed to contain the coronavirus in the spring of 2020 resulted in a large drop in activity in such industries as foodservice, construction, real estate operations and trade (down 43.1%, 30.6%, 13.9%, and 9.9% YoY, respectively). The manufacturing sector (except for construction) ended up less affected: manufacturing decreased output by 6.3% YoY and energy by 1.2% YoY, with agriculture and mining showing growth of 1.6% and 21.7% YoY, respectively. The mining industry managed to adapt successfully to increased regulatory requirements after the political changes in 2018, thus showing strong results.

Figure 1.
Economic activity



Source: Statistical Committee of the RA, calculations by the EEC authors

² The figures shown in the *Economic activity* section (excluding gross output in industry and manufacturing discussed below) were calculated by the authors drawing on the quarterly data published by the Statistical Committee of the RA.

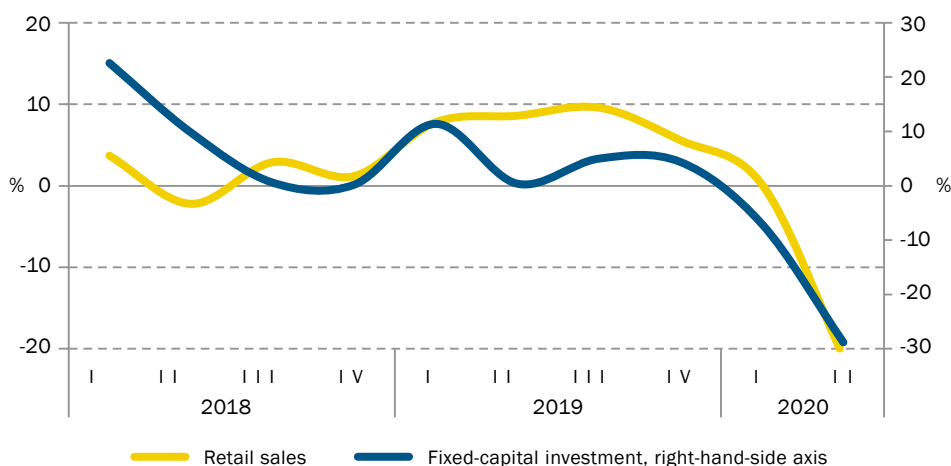
Consumer demand reduction

Consumption declined in the first half of 2020. In particular, household spending dropped by 9.0% YoY (after a 12.8% increase in 2019) due to the employment decline and reduced wages along with other types of income, factoring in remittances sent from abroad.

Drop in investment activity

Fixed investments decreased by 19.5% YoY after an increase of 4.7% YoY in the previous year. Decreased investment in fixed assets results from the direct impact of the coronavirus spread and measures taken to contain it (for example, the temporary suspension of construction work), the indirect effect of the reduction in financial resources, which otherwise would have been invested in the economy, as well as increasing uncertainty.

Figure 2.
Retail sales and investment
Year-on-Year growth rate



Source: Statistical Committee of the RA

Slowdown in manufacturing output

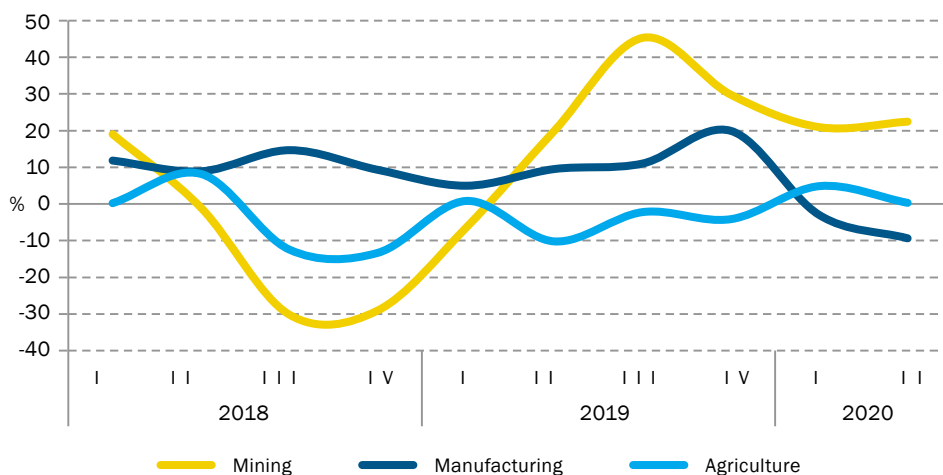
According to the Statistical Committee of Armenia, gross industrial output increased by 1.5% YoY in the first half of 2020 after 9.0% in 2019. The fall in output in a number of manufacturing industries, including relatively large ones, such as beverages (down 6.8% YoY), tobacco (down 22.6% YoY), clothing (down 5.1% YoY) and other non-metallic mineral products (factoring in a significant part of construction materials) (down 2.8% YoY) was the main factor behind the slowdown in this sector of the economy. In some cases, the pandemic did not come as the only factor causing the decline: a reduction in the production of raw materials used by agriculture-related industries in 2019 might have affected their trend (strong output growth last year occurred on the back of a relatively low harvest yield).

Agricultural output stabilizes

Agriculture showed moderate growth in January–June 2020 (up 1.6% YoY after a 4.0% decline in 2019). Both crop and livestock farming output stabilized. Given the preliminary information, the production of certain agricultural

products (in particular, grapes and wheat) is projected to increase in 2020. Due to bad weather affecting the yield of some fruit (for instance, apricots), we find it difficult to project the overall results of the agricultural sector in 2020.

Figure 3.
Production activity
Year-on-Year growth rate

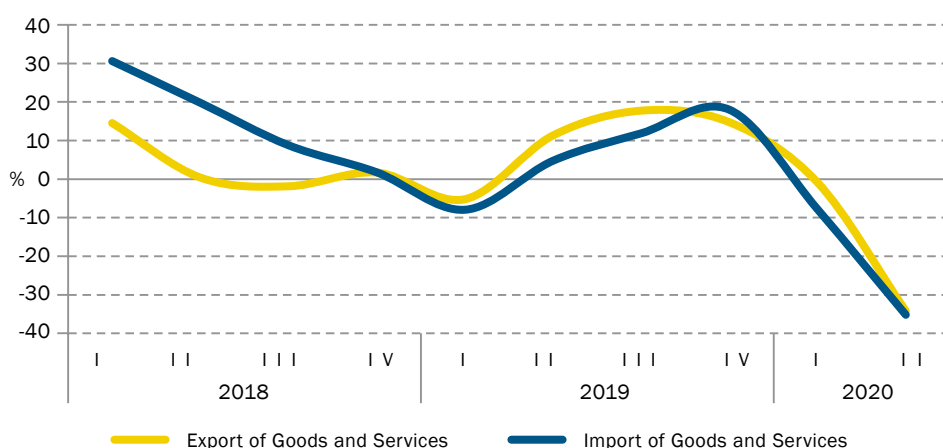


Source: Statistical Committee of the RA

A drop in real foreign trade volumes, reduction of the negative contribution of net exports to GDP

The fall of economic activity both in the country and abroad was accompanied by a significant foreign trade turnover decrease on the back of the coronavirus outbreak. The real export volume of goods and services decreased by 18.7% YoY in the first half of 2020, with imports contracting by 22.3% YoY. A decline in imports outrunning that of exports (and their significantly larger volume) suggests that foreign trade operations made a positive contribution to the GDP trend in the first half of the year.

Figure 4.
Physical volumes of foreign operations
Year-on-Year growth rate



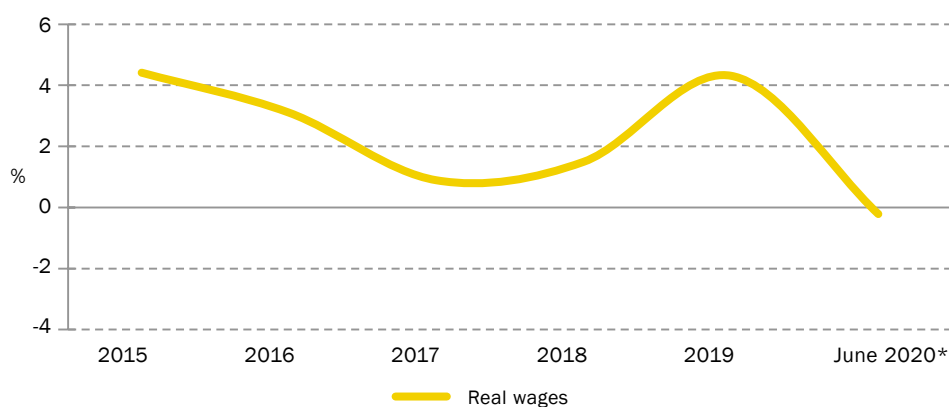
Source: Statistical Committee of the RA

The labor market

Wage growth slowdown

Wage growth slowed down in the first half of 2020 amid a downturn in the economy, although on average in January – June wages in the country increased by 5.4% YoY, due to their rapid increase at the beginning of the year (up 10.5% YoY in January). In June, growth amounted to 1.5% YoY, remaining below inflation (1.7% YoY). This can be attributed to the deteriorating labor market situation: the pressure on one vacancy (the number of job seekers divided by the number of vacancies)³ increased by 40% YoY and kept on accelerating up to 90% YoY in July.

Figure 5.
Labor market indicators
Year-on-Year growth rate



* EDB projection

Source: Statistical Committee of the RA

Inflation

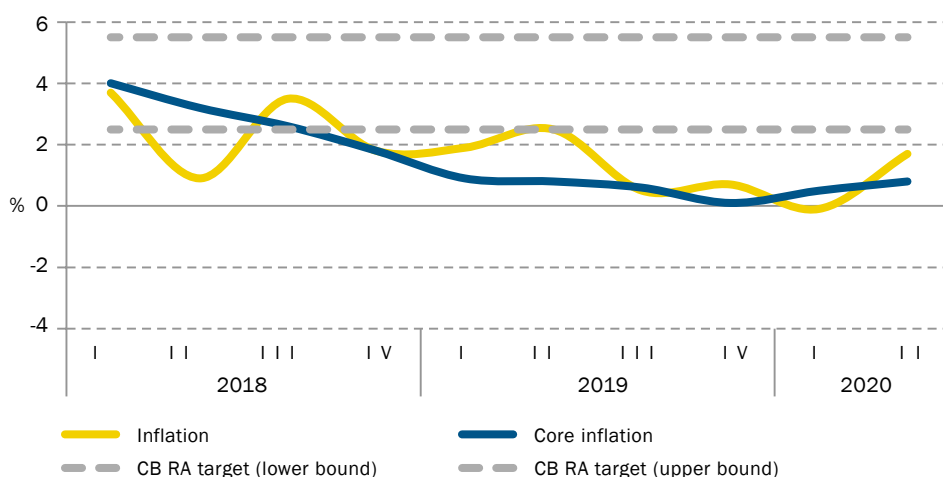
Inflation below CBRA target

Consumer price growth in the first half of 2020 kept below the target range of the Central Bank of Armenia ($4\pm 1.5\%$) and amounted to 1.7% YoY in June. Moderate inflation is largely attributed to weak demand in the economy in the wake of the pandemic, as well as to relative national currency stability against the U.S. dollar, which is instrumental in stabilizing the cost of imported goods and services in the domestic market. Core inflation⁴, smoothed from the influence of short-term fluctuations in seasonally volatile and regulated prices, also remained below the CBRA target (amounting to 0.8% YoY in June), thus proving that monetary factors predominated among the causes of low inflation in the first half of the year.

³ Calculated by the Statistical Committee of the RA.

⁴ Core inflation is smoothed to remove the influence of unstable food prices and thus describes the average annual price trend in the economy.

Figure 6. Inflation
(last month in quarter versus last month of same quarter a year before)



Source: Statistical Committee of the RA, CBRA

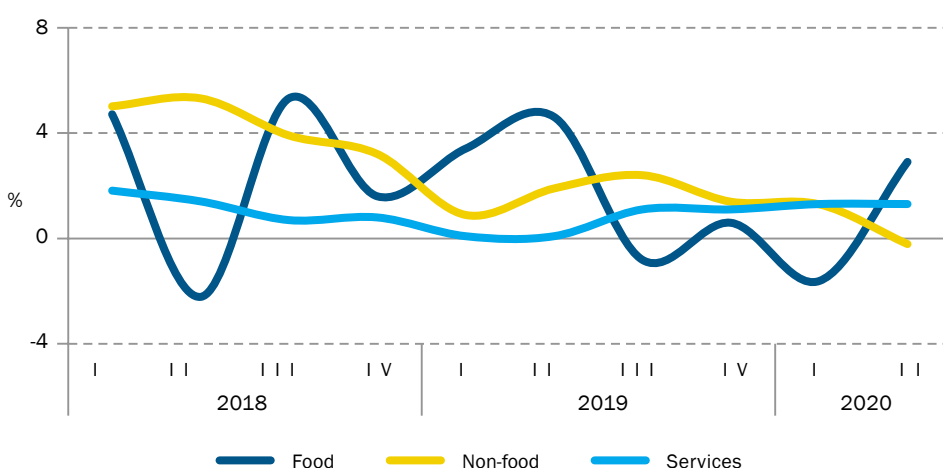
Food price growth accelerates in the middle of 2020

Food (including alcohol and tobacco) appreciated by 2.9% YoY in June 2020 after a 0.3% YoY increase in December 2019. Weak agricultural output partially accounts for the price acceleration in this segment in 2020.

Non-food inflation slows down

Non-food product prices fell by 0.2% YoY in June 2020 (up 1.4% YoY in December 2019). Their trend was affected by weak demand in the economy and a drop in prices for gasoline, diesel fuel and fuel and lubricants on the back of low oil prices in the world market. Service prices grew by 1.3% YoY (versus 1.1% YoY in December 2019). Due to the appreciation of medical and education service prices, against weak price growth or decreases for other types of services, inflation somewhat accelerated in this segment overall.

Figure 7. Inflation components
(last month in quarter versus last month of same quarter a year before)



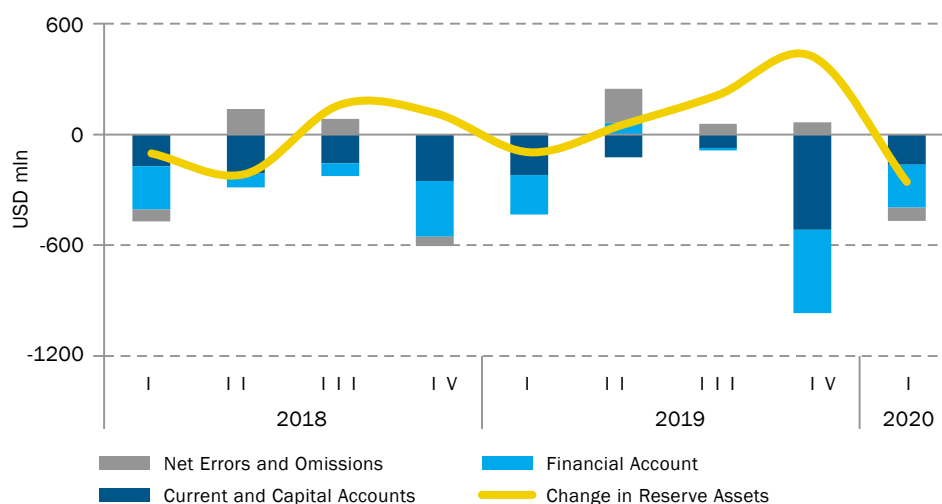
Source: Statistical Committee of the RA, CBRA

The external sector

Deficit on current account of balance of payments shrinking

The external balance of the Armenian economy improved in January–March 2020, thus increasing its resilience to the shock that soon followed the spread of coronavirus in the world. The current account posted a deficit of USD 196.7 million over this period (versus USD 228.2 million in the first three months of 2019). The improvement of the trade balance in goods was a driver behind the indicator shrinking: its deficit amounted to USD 328.1 million in 1Q2020 (versus USD 356.7 million in the previous year). The deficit of primary incomes decreased from USD 49.7 million to USD 31.3 million, being another driver behind the CA improving. Meanwhile, the weakening of currencies such as the Russian ruble and the euro against the U.S. dollar resulted in a decrease in net inflow of remittances in 1Q2020 to USD 97.5 million (versus USD 109.4 million in the same period of the previous year), which had an adverse effect on the balance of the secondary income account.

Figure 8.
Balance of payments of the RA



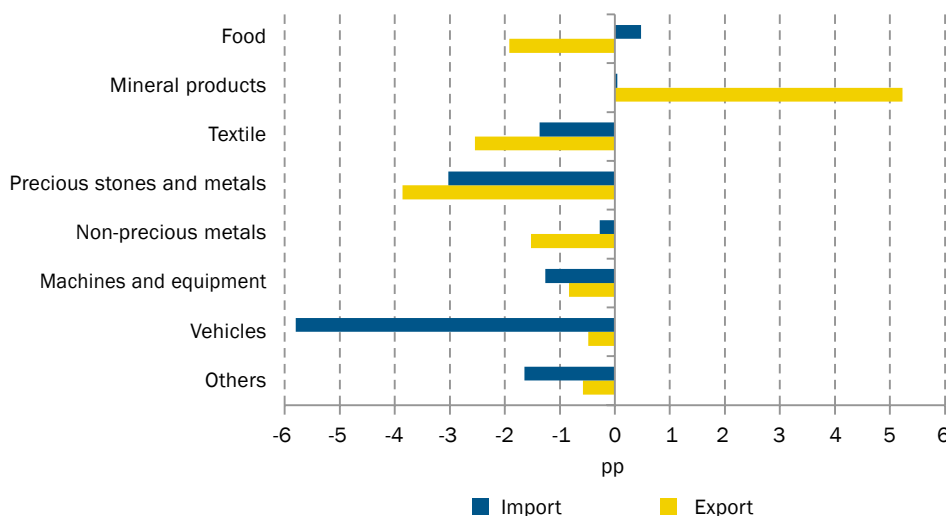
Source: CBRA

Improvement of the trade balance

The negative balance of foreign trade in goods decreased to USD 916.9 million in January–June 2020 (versus USD 1,138.1 million a year before). The greater stability of exports compared to imports was one of the drivers behind the balance improvement: the decline in most major items was smoothed by an increase in sales of mineral products in foreign markets (due to an increase in physical volumes of metal ore supplies). Imports experienced a larger downturn, primarily due to reduced purchases abroad of durable goods (vehicles) and precious stones and metals (to a large extent, raw materials for the jewelry industry, which reduced production and exports in the wake of the pandemic).

Figure 9.
Groups' contribution to goods export and import growth

(January–June 2020 against January–June 2019)

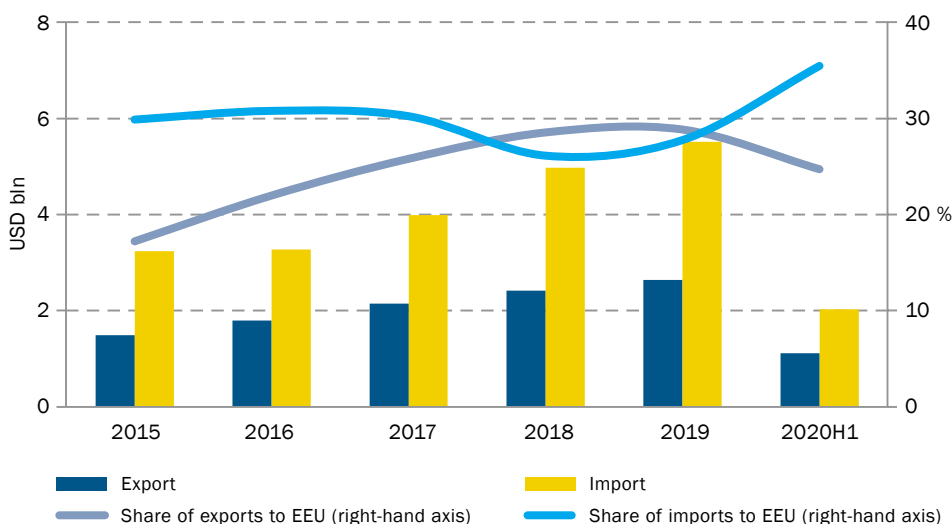


Source: Statistical Committee of the RA, calculations by the authors

Reduced role of the EEU countries as an export destination and increased role as a source of imports

Exports from Armenia to the EEU states decreased by 18.2% YoY to USD 273.6 million in the first half of 2020 (24.7% of all exports to foreign countries). Sales in the Union markets decreased in agriculture and the clothing industry in particular. By contrast, imports to Armenia from EEU countries increased by 8.7% YoY, to USD 717.6 million (35.4% of total RA imports), due to an increase in imports from Russia across a number of items, including oil products and natural gas, products of some engineering industries, food and pharmaceutical industries.

Figure 10.
Exports and imports

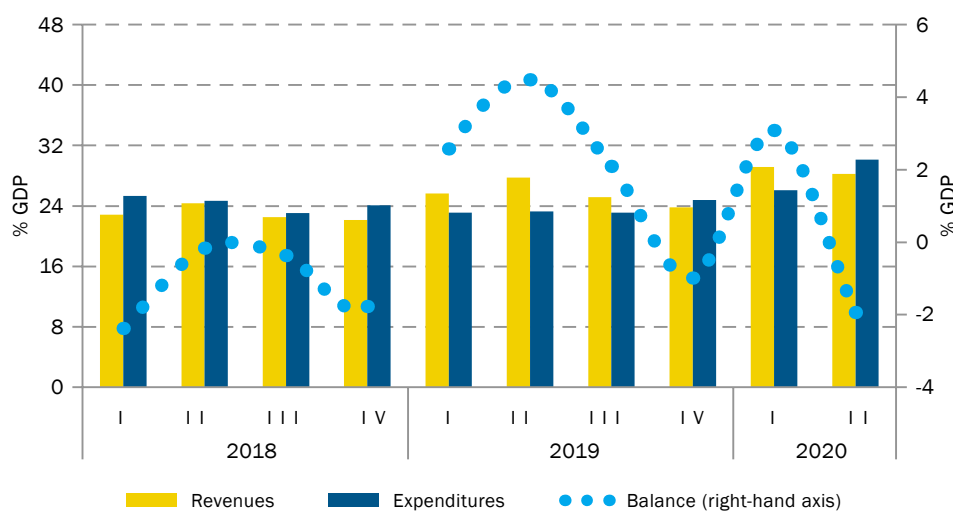


Source: EEC, calculations by the authors

The fiscal sector

State budget in deficit In the first half of 2020, the state budget posted a deficit of AMD 48.8 billion (1.0% of GDP). In the same period of the previous year, the budget recorded a positive surplus of AMD 121.9 (4.5% of GDP). The state of public finances deteriorated as spending increased: expenses experienced an upturn to AMD 765.5 billion (30.2% GDP) from AMD 636.6 billion (23.3% GDP) in the previous year, partially according to plan and partially due to the financing measures aimed at combating the coronavirus outbreak and supporting the economy. Budget revenues decreased to AMD 716.7 billion from AMD 758.5 billion in the first half of 2019: an increase in tax collection partially offset the adverse effect of the pandemic.

Figure 11.
The state budget
(the period's cumulative)



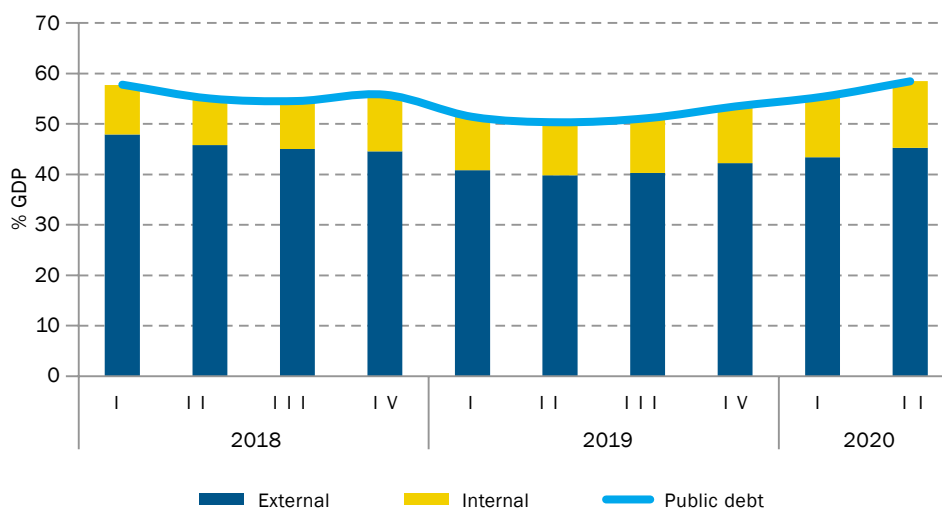
Source: Statistical Committee of the RA, calculations by the authors

Public debt increases On the back of the budget deficit, the national debt of Armenia began to grow again and reached 58.4% of GDP in the first half of 2020 (versus 53.5% of GDP at the end of 2019). As of June 30, external and domestic debt amounted to 45.3% and 13.2% of GDP, respectively, having experienced an increase of 3.0 and 1.9 p over the first half of the year. The share of domestic debt (denominated mainly in drams) increased to 22.5% of the total volume. In terms of the economy's resilience to external shocks, this is a positive trend; in the medium term, though, it entails an increase in the cost of debt servicing.

Sovereign rating unchanged, Fitch outlook downgraded The sovereign ratings assigned to Armenia by international agencies remained unchanged in the first half of 2020. However, Fitch revised its outlook from "stable" to "negative" while keeping the country's default risk indicator at the

BB- level. A decline in the cost of raw materials, a slowdown in economic growth in Russia (which leads to a reduction in trade, remittances and FDI), a decline in tourism, as well as the adverse effect of external shocks on public debt were listed among the drivers behind the decision.

Figure 12.
Public debt
(as at the end of period)



Source: Statistical Committee of the RA, calculations by the authors

Monetary conditions

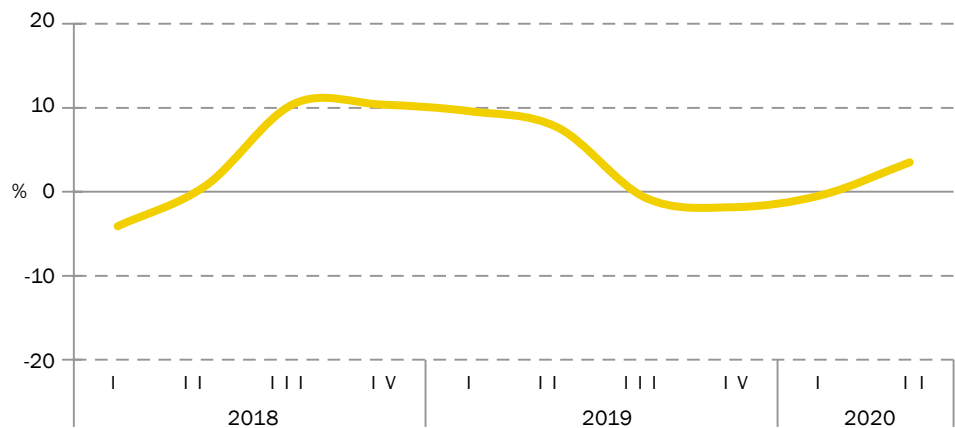
Central Bank lowered the refinancing rate to 4.25% The Central Bank strengthened its stimulative monetary policy amid a slowdown in economic activity and inflation sticking below the target range ($4\pm 1.5\%$) in the first half of 2020. With this in mind, the regulator lowered the refinancing rate from 5.5% at the beginning of the year to 4.5% by the end of June. In September 2020, it was reduced again to 4.25%.

Lower interest rates in the credit and deposit markets The change in the refinancing rate affected financial market indicators. In January–June 2020, short-term interbank lending rates, government bond yields and interest rates on deposits experienced a downturn. The cost of the country's bank lending also decreased due to the policy of the Central Bank of Armenia, although the process was held back by the high risks in the first half of this year on account of the pandemic.

Relative stability of the dram

In the first half of 2020, the Armenian dram maintained a high level of stability against the U.S. dollar: it appreciated against the U.S. currency by 1.0% YoY in the first quarter, while it fell by 0.7% YoY in the second quarter. The strengthening of the dram against the Russian ruble, which was more volatile, averaged 10.1% YoY in April–June 2020. These conditions compelled the real effective exchange rate of the Armenian currency to rise by 3.5% YoY on average in 2Q2020. Its strengthening against the currencies of the trade partner countries was partially smoothed by relatively low inflation in the country.

Figure 15.
Real effective dram exchange rate
(growth rate, Year-on-Year, + = dram strengthening)



Source: CBRA, calculations by the authors

ECONOMIC DEVELOPMENT OUTLOOK

Background

Trade partner economies to gradually recover in medium term

Under our base case, a further easing of lockdown restrictions is expected in the world's largest economies (the US, the Eurozone and China) in the second half of 2020, which, along with stimulative fiscal and monetary policies, will be instrumental in a gradual recovery in consumer and investment activity, as well as international trade. However, due to the increased uncertainty, deterioration of the labor market, disruption of value chains that existed before and anticipated changes in consumer habits (social distancing, higher savings rates, etc.), the return to pre-crisis production levels will be slow and is unlikely to be complete until 2022.

External demand constrained

The negative output gaps in those economies will gradually close, remaining in negative territory over the entire projection horizon (2020–2022) owing to restrained recovery in economic activity. As a result, external demand for Armenian exports is expected to stay depressed in the medium term.

Moderate oil price growth

Under the EDB base case, oil prices will grow at a moderate pace in 2020–2022, encouraged by a recovery in global economic activity. Nevertheless, we are quite conservative in our expectations of the increase in energy commodity prices, which will continue to be affected by the uncertain global outlook.

Low foreign inflation

External inflation will remain weak in the medium term. We expect the growth rate of the consumer price index in Russia, the Eurozone and the USA to be below the RF CB, ECB and FRS targets in the wake of moderate demand.

Table 1. Forecasts of Key Foreign Economic Indicators (base case)

	Average annual copper price (USD per ton)	Average annual Urals oil price (USD per barrel)	Food prices, 2010 index=100	Russia's real GDP growth rate, %	Eurozone real GDP growth rate, %
2020	5,942	42.4	91.9	-4.2	-8.4
2021	6,392	48.9	89.5	3.2	5.5
2022	6,408	52.7	89.1	2.7	3.7

Source: calculations by the authors, EEC

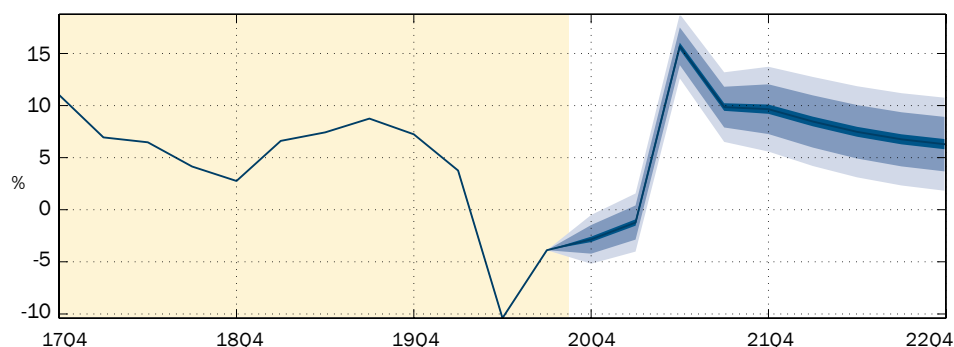
Economic activity

GDP to decrease by 3.5% in 2020

The decrease in GDP is projected at 3.5% in 2020. Restrained external and domestic demand for goods and services produced in the country has caused business activity to drop, with the restrictions on the activities of households and businesses induced by the pandemic remaining. Their weakening will enable a gradual recovery of the Armenian economy: we expect GDP to return to the levels of the end of last year during 2021. Growth in remittances sent to the country and in export prices (in particular, ores and metals) as the economic situation in the world normalizes will support this process. We believe that these conditions will compel GDP to increase by 8.3% in 2021 and by 7.2% in 2022.

In the short term, there are still risks of a repeated slowdown in economic growth due to the risk of new outbreaks of coronavirus both in the world and within the country. Geopolitical risks, including sanctions imposed by Western countries against Armenia's economic partners (Russia), may also affect its economy.

Figure 16⁵.
Real GDP
Year-on-Year growth rate

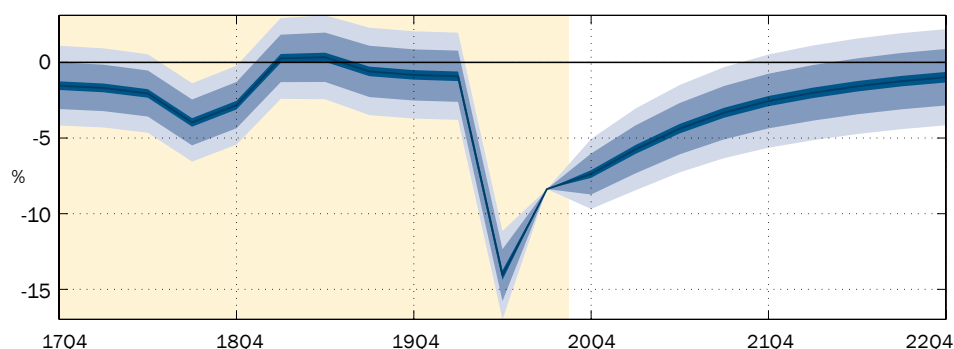


Note: seasonally adjusted data.
Source: calculations by the authors, EEC

Negative output gap over the entire forecast period

The negative output gap expanded significantly in 2Q2020 amid a downturn in economic activity; it will remain till 2022, accompanied by a gradual decrease. Thus, the economy will continue to experience excess production capacity restraining inflation.

Figure 17.
Output gap



Source: calculations by the authors, EEC

Inflation

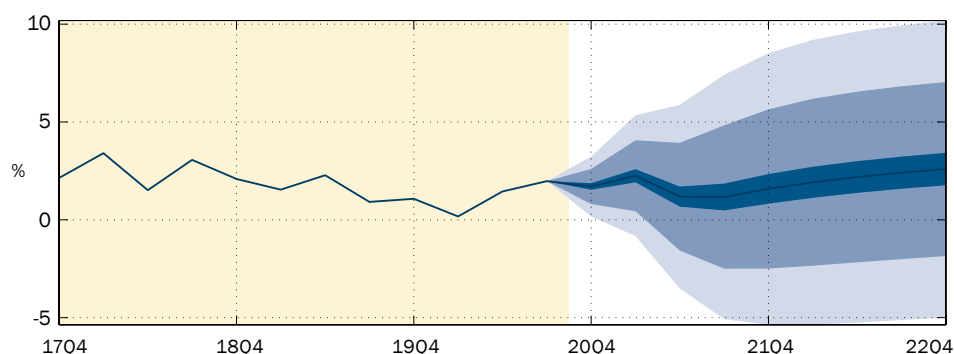
No sustained acceleration of inflation in 2020–first half of 2021.

The EDB projects the reduced demand in the economy to retain a significant disinflationary impact. Prices will be affected primarily by changes in the cost of food in the domestic market. Inflation is expected to return to the lower limit of the target range of the CBRA (4±1.5%) in 2022, driven by stimulative monetary and fiscal policy.

⁵ Here and elsewhere fan chart ranges correspond to 10%, 50% and 75% confidence intervals.

A deviation of inflation from the forecasts is possible in both directions. If the national currencies in the EDB operating region weaken against the U.S. dollar to a more significant nature than assumed in the base case, the strengthening of the dram (marked by a higher level of stability against the U.S. dollar) may have an additional disinflationary impact. And vice versa, should the regional currencies strengthen against the U.S. dollar, price growth will accelerate in Armenia. In the latter case, the rate of inflation may exceed that projected by the EDB.

Figure 18.
Inflation
(period Year-on-Year)



Note: seasonally adjusted data.

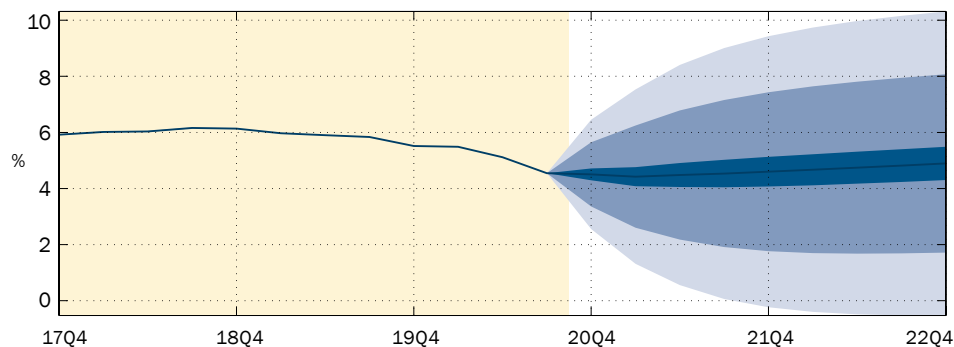
Source: calculations by the authors, EEC

Monetary conditions

Rates to increase as inflation accelerates

The EDB’s forecasts assume monetary policy to remain stimulative in the medium term, factoring in the weak inflationary background. In our base case, we expect a round of refinancing rate rises to commence at the end of 2021 as inflation gradually returns to the target range.

Figure 19.
Overnight interbank loan rate
(the period’s average)

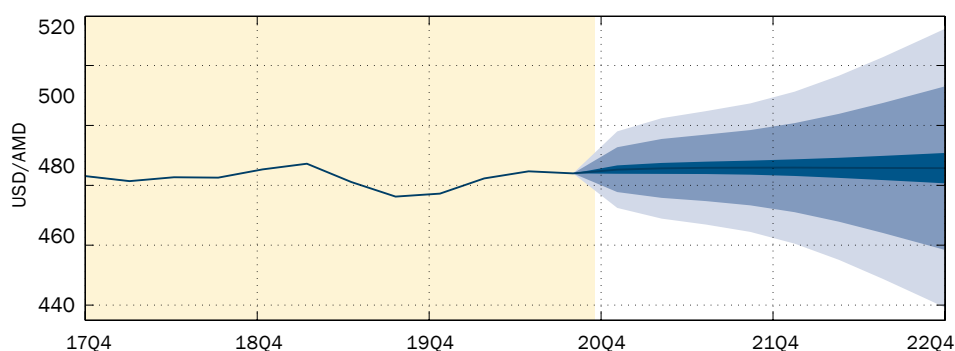


Source: calculations by the authors, EEC

Dram exchange rate to be stable

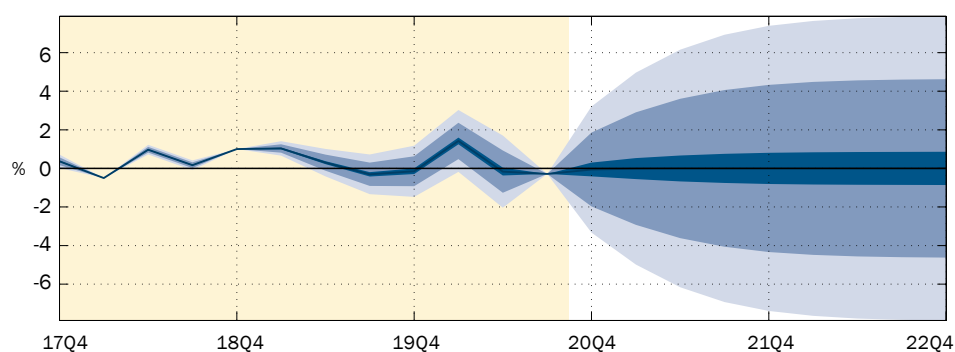
The dram is expected to maintain a stable exchange rate against the U.S. dollar in the medium term. An increase in export revenues, as well as an increase in foreign investment and remittances in 2021–2022, will be drivers behind the national currency's stability. The dram to U.S. dollar real exchange rate will favor a near-equilibrium level over the period.

Figure 20.
Armenian dram to U.S. dollar exchange rate
(AMD per USD)



Source: calculations by the authors, EEC

Figure 21.
Real dram to U.S. dollar exchange rate gap
(+ = the dram is undervalued)



Source: calculations by the authors, EEC

Table 2. Key Macroeconomic Indicators of the Republic of Armenia

Indicator	2017	2018	2019	2020F	2021F	2022F
GDP in constant prices (% growth YoY)	7.5	5.2	7.6	-3.5	8.3	7.2
Consumer price index (% growth in December versus previous year's December)	2.6	1.8	0.7	1.7	1.5	2.6
1 Day Interbank Loans in National Currency Rate (%, the year's average)	5.9	6.1	5.8	4.9	4.5	4.8
Exchange Rate of National Currency to U.S. dollar (the year's average)	483	483	480	484	486	486

Source: calculations by the authors, EEC



Eurasian Development Bank

**RESEARCH DEPARTMENT,
EURASIAN DEVELOPMENT BANK**

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

