



## ARMENIA

### Highlights

- **The economy grew at a swift pace in the beginning of 2016 but slowed in the second quarter.** In the first quarter of 2016, GDP grew by 4.5 per cent on the back of strong export performance, but growth decelerated to 1.5 per cent year-on-year in the second quarter of the year.
- **Progress was made in a number of reform areas.** The new Tax Code aims to enhance fiscal revenue generation and to foster the transition towards relatively less distortionary taxation. The authorities have initiated an energy sector financial recovery plan. Steps were taken to promote better capitalisation of the banking sector, although elevated non-performing loans (NPLs) and low profitability continue to pose challenges.
- **Armenia is complying with commitments under the IMF programme.** The third review was completed in June 2016, paving the way for the release of another tranche, as Armenia is broadly in compliance with the programme's performance criteria and structural benchmarks.

### Key priorities for 2017

- **Business environment reforms need to advance further.** Tax and customs administration require improvements to ease compliance requirements for taxpayers. Further improvements to the regulatory environment and stronger competition on the domestic market are important priorities in the context of diversifying sources of growth.
- **Fiscal and monetary policies should continue to be prudent.** Deflation and exchange rate stability in the first nine months of 2016 have created room for faster monetary policy easing, while a well-sequenced fiscal consolidation is needed to unwind the increased budget deficit.
- **Banking sector recapitalisation needs to be completed in an orderly fashion.** The Central Bank of Armenia (CBA) should continue to ensure that safeguards of financial stability are in place and that the banking sector emerges stronger and more resilient after the new minimum capital requirements become effective in 2017.

#### Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	7.2	3.3	3.6	3.0	2.0
Inflation (average)	2.6	5.8	3.0	3.7	-0.5
Government balance/GDP	-1.5	-1.6	-1.9	-4.8	-4.5
Current account balance/GDP	-10.0	-7.3	-7.6	-2.7	-2.5
Net FDI/GDP [neg. sign = inflows]	-4.5	-2.9	-3.3	-1.6	-2.5
External debt/GDP	72.3	78.5	73.5	84.8	n.a.
Gross reserves/GDP	16.6	20.2	12.8	16.8	n.a.
Credit to private sector/GDP	37.6	39.5	45.3	42.1	n.a.

## Macroeconomic performance

**Growth has remained positive despite a challenging external environment.** Growth in 2015 and in the first half of 2016 was maintained at close to the 2013-14 level despite negative spillovers from Russia, an adjustment of regional currencies, reduced remittances and lower copper prices. Growth of 3 per cent in 2015 was driven by government consumption and an improvement in net exports, although gross capital formation decreased slightly and household consumption was down by nearly 8 per cent in real terms. The agriculture and mining sectors contributed strongly on the supply side. In the first quarter of 2016, GDP increased by 4.5 per cent year-on-year, driven by 24.0 per cent year-on-year real growth in exports. Growth slowed to 1.5 per cent year-on-year in the second quarter of the year on account of weak domestic demand. The fiscal deficit is expected to widen in 2016 beyond the initially targeted 3.5 per cent of GDP due to revenue shortfall. Meanwhile, inflation remained negative in the first eight months of 2016, and the central bank's refinancing rate was gradually lowered from 10.50 per cent in August 2015 to 6.75 per cent in September 2016.

**A large import contraction has led to a lower current account deficit.** The current account deficit shrank from 7.6 per cent of GDP in 2014 to 2.7 per cent of GDP in 2015. Remittances to Armenia dropped by approximately 29 per cent year-on-year in 2015 and by 13 per cent year-on-year in the first half of 2016, affecting consumption and contributing to a sharp reduction of imports. Imports of goods and services declined by 19.5 per cent year-on-year in 2015 and by 3.9 per cent year-on-year in the first half of 2016. At the same time, export performance was supported by the opening of a new copper mine in December 2014 and by diversification of Armenia's exports to new markets, with exports up by 7.8 per cent year-on-year in the first half of 2016. Gross international reserves have rebounded, reaching US\$ 1.7 billion by August 2016 and covering more than four months of imports.

**The near-term growth outlook is affected by external factors and domestic policies.** The economy is expected to grow at 2 per cent in 2016 and in 2017. Armenia is not immune to the regional slow-down and remains exposed to Russia via trade, remittances and investment. Export revenues are influenced by copper prices. After the expected widening of the budget deficit in 2016, the fiscal rule may require significant fiscal adjustment in 2017 which would impact growth.

## Major structural reform developments

**Structural reforms have advanced within the framework of the IMF programme.** In June 2016, the Executive Board of the International Monetary Fund (IMF) completed the third review of Armenia's performance under a three-year arrangement under the Extended Fund Facility (EFF). Progress was made in relation to structural reform conditionality. In particular, the authorities have started to publish regular consolidated statements about the domestic budget lending programmes, adopted the financial recovery plan for the energy sector, and adopted the new Tax Code (see below).

**The authorities made progress with business environment reforms but further improvements are required.** The "regulatory guillotine" initiative and regulatory impact assessments continued with a view to streamlining business procedures. Some efforts were made to develop legislative changes aimed at promoting domestic competition and improving bankruptcy procedures. At the same time, Armenia's achievements and weaknesses in the business environment are reflected in the World Bank's *Doing Business 2017* report where Armenia ranks 38th out of 190 economies, with lower scores in dealing with construction permits, getting electricity, paying taxes and resolving insolvency. Businesses continue to face challenges related to the tax and customs administration and informality.

**The new Tax Code was approved by the parliament.** The Tax Code adopted in October 2016 will consolidate multiple existing legal acts that regulate taxation into a single document. The approved Tax Code is designed to shift focus towards indirect taxation, which is relatively less distortionary. The new tax system is considered to be an important element of the medium-term fiscal consolidation effort. It aims to improve compliance and to increase budget revenues by further closing tax loopholes. At the same time, some last-minute modifications have somewhat weakened the new Tax Code's focus on improving fairness and addressing loopholes.

**Reforms in the energy sector gained momentum.** In September 2015, international auditing company Deloitte concluded a review of the electricity tariff hike which became effective in August 2015. It supported the decision by the Public Services Regulatory Commission (PSRC) to increase the tariff. In the same month, the privately owned electricity distribution monopoly, Electricity Networks of Armenia (ENA), was purchased by a new investor following financial difficulties experienced by ENA in 2015. Steps were taken by the new investor to align ENA's management with international practices. The authorities have developed a financial recovery plan for the energy sector and begun its implementation with the technical and financial support of the World Bank. The plan includes refinancing of the short-term commercial debt owed by the publicly owned generators on more concessional terms and eliminating non-core expenditures by the state energy companies.

**The banking sector is being strengthened although the operational environment remains difficult.** Higher capitalisation requirements that aim to enhance the soundness of the banking sector are scheduled to enter into force from 1 January 2017. Armenian banks attracted up to US\$ 150 million in the form of new capital in 2015 and re-capitalisation continued in the first nine months of 2016. Further capital injections and consolidations are being discussed. The CBA has prepared a draft law that will allow it to introduce, if necessary, counter-cyclical capital buffer requirements and charges for systemically important banks, in line with Basel III standards. However, NPLs remain elevated at approximately 9 per cent of total loans as of the end of July 2016 and system-wide profitability is low.

**Pension reform implementation continued although full adoption of the new system was postponed by one year.** Based on the Constitution Court ruling and the subsequent amendments to the pension law in 2014, individual contributions to the second pillar of the pension system have been made mandatory for public employees and new entrants into the labour market. Private sector employees were allowed to postpone participation until July 2017. The authorities rolled out an outreach campaign to increase awareness of the new pension system. Since the revision of the pension law in 2014, approximately 140,000 workers enrolled in the new pension system. Despite progress, the authorities decided to postpone making participation in the new system mandatory for all eligible workers until July 2018, taking into account the technical challenges and budgetary pressures associated with the increased matching contributions.