

**EXECUTIVE
BOARD
MEETING**

EBS/20/90
Correction 1

May 14, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Armenia—Second Review Under the Stand-By Arrangement,
Requests for Augmentation of Access, Modification of Performance Criteria,
and Monetary Policy Consultation Clause**

Board Action: The attached corrections to EBS/20/90 (5/4/20) have been provided by the staff:

**Factual Errors Not
Affecting the
Presentation of Staff's
Analysis or Views**

Pages 4, 8, 13, 21, 25, 26, 41

Typographical Errors

Page 2

Questions:

Mr. Porter, MCD (ext. 37316)
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Approved By
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The team comprised N. Porter (head), M. El Said, H. Tabarraei, and K. Akepanidaworn (MCD), Y. Ustyugova (Resident Representative), K. Tokuoka (SPR), and M. Bellon (FAD). V. Janvelyan and L. Karapetyan (IMF Office) assisted the mission. LEG participated in the mission to follow up on governance-related conditionality. [SH](#). Harutyunyan (OED) participated in meetings with the authorities. R. Al Farah (MCD) provided assistance and B. Laumann (MCD) provided document management (MCD). The team met remotely during March 16–April 8, 2020 with Deputy Prime Minister Grigoryan, Governor of the Central Bank of Armenia Javadyan, Minister of Finance Janjughazyan, Minister of Economy Khachatryan, State Revenue Committee Deputy Chairman Mashadyan and other senior government officials.

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DEVELOPMENTS AND PROGRAM IMPLEMENTATION

A. Context

1. Macroeconomic conditions were favorable before the COVID-19 pandemic shock.

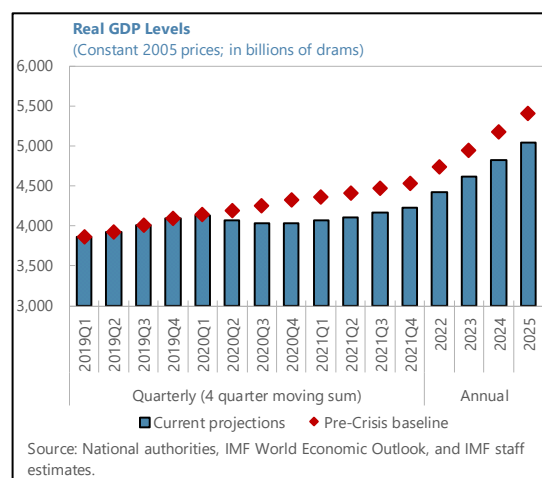
- Real GDP growth in 2019 was exceptionally strong at 7.6 percent, driven by strong private consumption on the back of rising household incomes and strong household credit. Manufacturing and service sector activity was also buoyant (Figure 2, Table 1). Growth is becoming more inclusive as labor market conditions improve. In 2019 the unemployment rate decreased by ~~1.6~~^{almost 3} percentage points, and remittance income increased slightly. The poverty rate fell from 25.7 percent in 2017 to 23.5 percent in 2018.
- Despite strong domestic demand conditions, annual CPI inflation fell to 0.7 percent (y/y) in December due to lower food prices and some exchange rate appreciation.¹
- The fiscal deficit was around 1 percent of GDP in 2019. Revenue significantly overperformed, due to growth in tax-paying sectors and strengthened compliance, while spending fell short of budget as capital execution remained below plans. The lower fiscal deficit helped reduce central government debt to around 50 percent of GDP, the authorities' medium-term objective.
- Financial conditions were stable in 2019. Dollarization continued its downward trend. While private sector credit grew rapidly (18.5 percent (y/y to December)), led by household credit growth (32 percent (y/y)), financial soundness indicators (FSIs) do not suggest signs of distress given stable non-performing loan (NPL) and relatively high capital and liquidity (Figure 1 and Table 6).
- The external position strengthened in 2019 and is assessed as broadly consistent with fundamentals and desired policies (Annex II). Higher FX receipts from non-resident deposits, coupled with stable market conditions and de-dollarization, allowed a build-up of international reserves. Despite strong domestic demand, the current account deficit narrowed to 8.2 percent of GDP in 2019 reflecting strong services exports (especially tourism), although the composition of trade changed considerably (Figure 1).² Net remittances in 2019 edged up by 1½ percent in US dollar terms but fell relative to GDP. Reserve buffers were broadly adequate at 123 percent of the ARA metric at end-2019.

¹ Ongoing IMF TA aims to improve the reliability of food price statistics, and the associated CPI sub-indexes. Besides increasing overall resources allocated to ArmStat, key recommendations include: (i) automating some price compilation and increased training; (ii) updating basket weights every three years; and (iii) improving the reporting methodology for key food items to reduce volatility.

² Errors and omissions have also been large, possibly reflecting under-reported car re-exports.

sectors: agriculture, manufacturing, and wholesale and retail trade. However, as economic activities are curtailed, the unemployment rate is expected to increase, and the marked progress in poverty reduction could stall.

- **Inflation** is expected to gradually pick up towards the Central Bank of Armenia's (CBA) inflation target on the back of fiscal expansion, recovering food prices, and depreciation of the dram.
- **Fiscal.** The deficit is projected to widen to 5 percent of GDP compared to 2¼ percent in the 2020 Budget. This reflects the cyclical impact on revenues and higher current spending for healthcare and economic support, with debt expected to rise above 60 percent of GDP (see 19).
- **External.** The external position is also expected to weaken severely. The pandemic has hit tourism receipts, remittances and FDI, and it is expected to cause a reversal of private capital inflows. The dram depreciated by 5 percent against the USD in March 2020 and the authorities intervened by about US\$ 127 million between mid-March and early April. However, the dram recovered by around 5 percent from its trough and the CBA intervened on the buy side since, lowering total net intervention this year to ~~\$51~~³⁶ million. In 2020, the current account deficit is projected to widen to 8.6 percent of GDP driven by lower remittances (mostly from Russia) and tourism receipts, while the financial account would decline sharply, reflecting the reversal of private flows in the form of non-resident deposits. Without additional financing, this would result in gross international reserves falling below 100 percent of the ARA metric, creating a BoP financing gap of about US\$316 million in 2020 (and a total financing gap of around US\$422 million over 2020–22) (Table 8).
- **Financial.** Rapid credit growth is expected to slow due to lower aggregate demand and restrictions on activity. Nonetheless, several government support packages (Box 1), which offer co- and re-financing, may support credit growth this year.



Armenia: Selected Economic and Financial Indicators, 2019–22

	2019	2020		2021		2022	
	Prel.	Pre-Covid	Proj.	Pre-Covid	Proj.	Pre-Covid	Proj.
Real GDP (percent change)	7.6	5.5	-1.5	5.0	4.8	4.5	4.5
Gross domestic product (in billions of drams)	6,552	7,127	6,519	7,730	6,990	8,382	7,543
Fiscal balance (in percent of GDP)	-1.0	-2.3	-5.0	-1.9	-2.9	-1.9	-2.0
Public and publicly-guaranteed (PPG) debt (in percent of GDP)	53.7	51.6	64.1	50.8	62.1	50.1	59.8
Central Government's PPG debt (in percent)	50.1	48.9	60.9	48.7	59.1	48.6	57.3
Current account balance (in percent of GDP)	-8.2	-8.4	-8.6	-8.0	-7.2	-7.2	-6.7
Sources: Armenian authorities; and Fund staff estimates and projections.							

budget documentation and the development of coordinated and centralized capacity within the Ministry of Finance with clarified functions and responsibilities (MEFP ¶13). In the near-term, staff encouraged the authorities to transparently report estimated contingent fiscal risks associated with the crisis response measures alongside annual budgets.

16. The authorities are contemplating actions to support the post-crisis recovery. Although the most direct action would be through the implementation of a pipeline of high-quality capital projects aimed at strengthening national infrastructure, the government is also considering spurring innovation through limited direct equity investment into innovative companies. Staff noted that alternative measures to encourage private innovation would be preferable, including targeted and limited direct subsidies or co-financing. If the authorities decide to go ahead with equity investment, transparency and careful management of any fiscal risks created will be essential. Additionally, direct equity investment would require independent management of the equity portfolio, transparency over the selection of projects and partners as well as the financial performance of the equity portfolio, protections to limit the impact on competition and governance, and safeguards to prevent the value of the state's investment being undercut.

B. Monetary and Financial Policies in the Era of COVID-19

17. The CBA has responded to the COVID-19 crisis, balancing its mandates for price and financial stability. Since the pandemic's outbreak, markets have generally functioned smoothly. Policy responses include:

- **Policy rate.** Balancing pressures from capital outflows with the space provided by low inflation, the CBA lowered its policy interest rate by $\frac{1}{4}$ percentage point in March, and by a further $\frac{1}{4}$ percentage point in late April, bringing it to 5 percent. Given the high uncertainty on external developments and the high levels of dollarization, there is no scope for further rate cuts at this point.
- **FX intervention.** The CBA undertook limited FX sales intervention in March to address excessive dram volatility. Since then the dram has appreciated relative to the USD and the CBA has undertaken some FX purchases. While CBA may need to respond to prevent disorderly movements, it should also ensure that the exchange rate remains flexible and should not lean against necessary exchange rate adjustments.
- **Liquidity.** The interbank market has been relatively active since the beginning of the crisis. In addition, the CBA has conducted repos and FX swap operations to ensure ample liquidity conditions across the market.

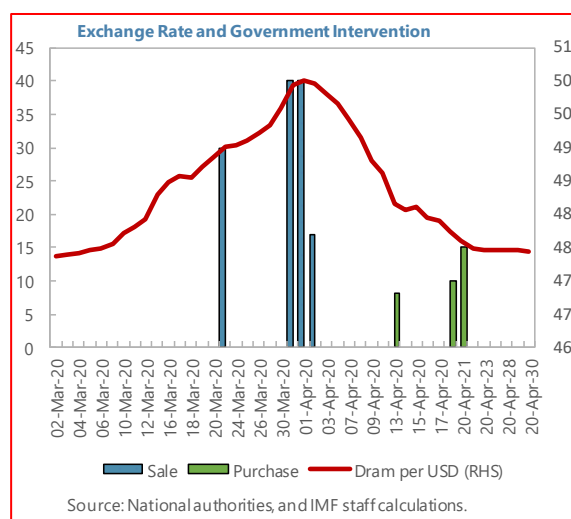
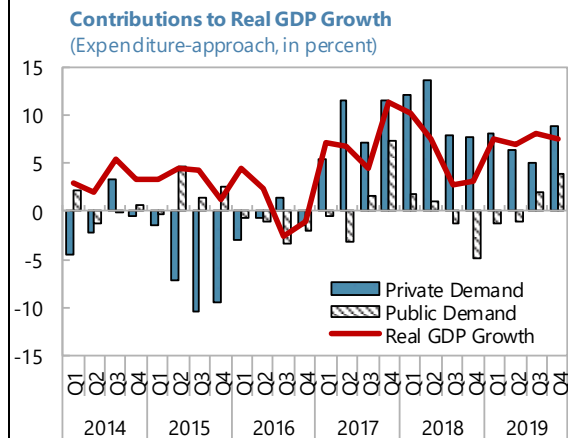
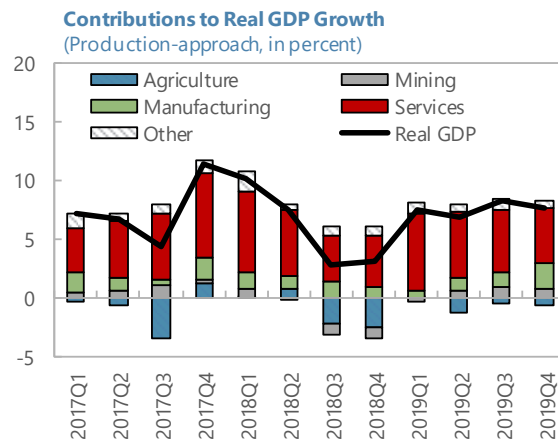


Figure 2. Armenia: Real Sector Developments

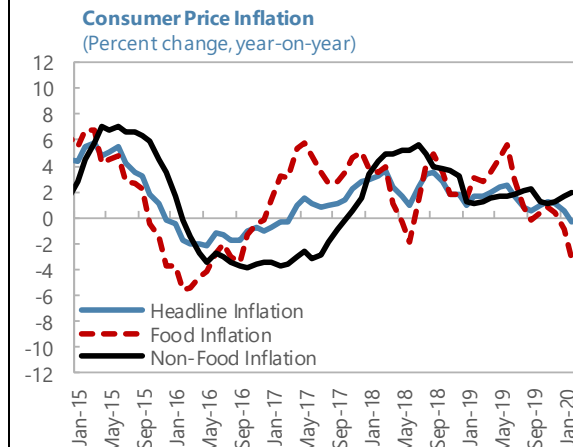
Growth in 2018–19 was mainly driven by private demand



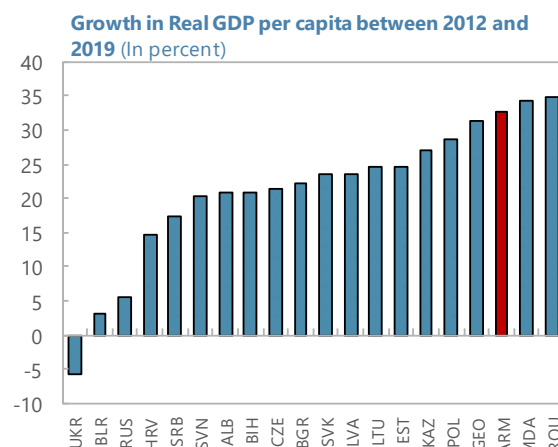
Preliminary data show strong growth performance in 2019Q4 on the back of stronger than anticipated activity in the service and manufacturing sectors



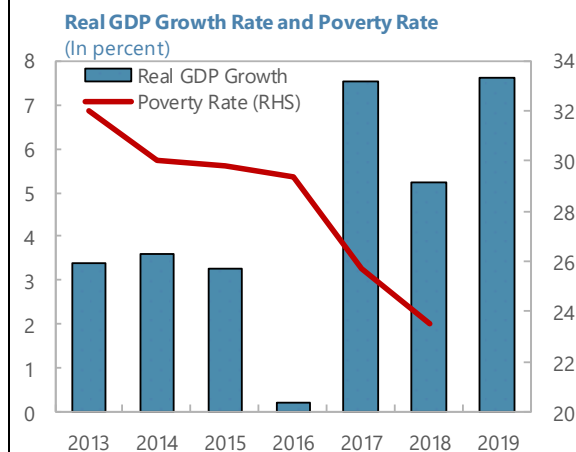
Both food and non-food inflation are below expectations



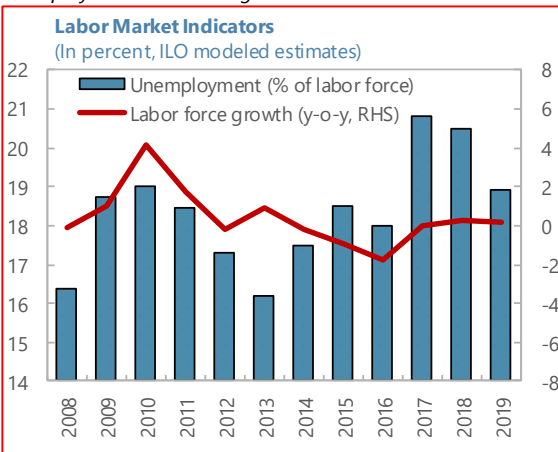
Armenia's per capita income growth is high, compared with peers



Robust GDP growth helped poverty rates fall significantly



Employment growth increased in recent years, although unemployment remains high

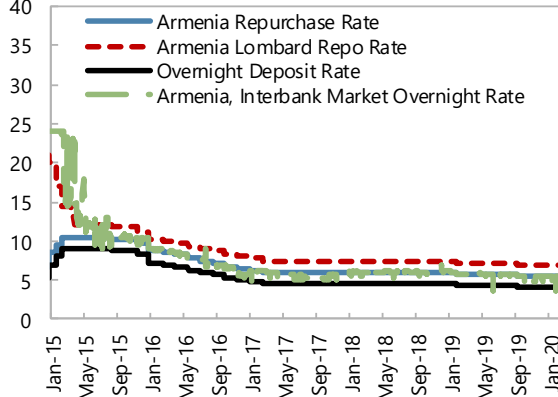


Sources: National authorities, Haver, IMF World Economic Outlook, and IMF staff calculations.

Figure 6. Armenia: Financial Developments

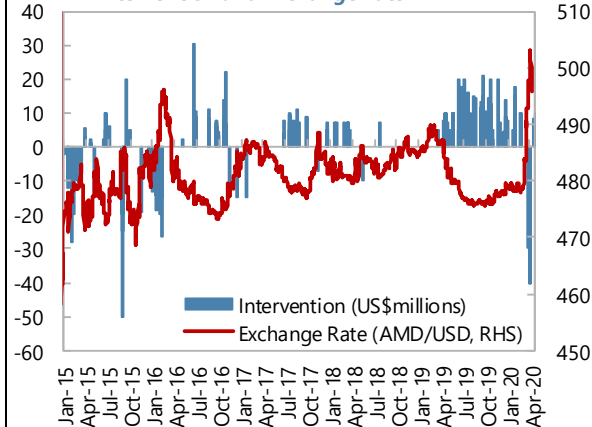
The CBA lowered the policy rate twice in 2019 and twice in March and April 2020 (each time by 25 bps each), and did it again on March 17, 2020.

Interest Rate Corridor (In percent)



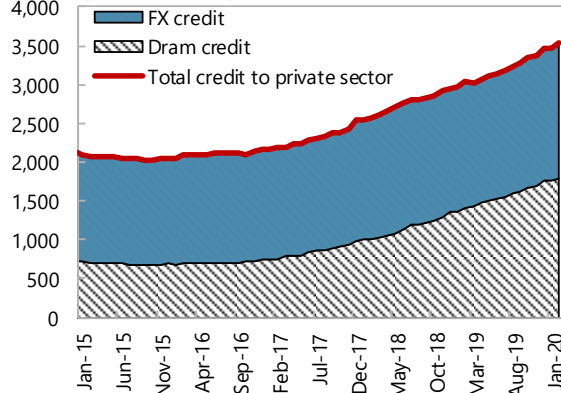
The exchange rate slightly depreciated in the beginning of 2020.

FX Intervention and Exchange Rate



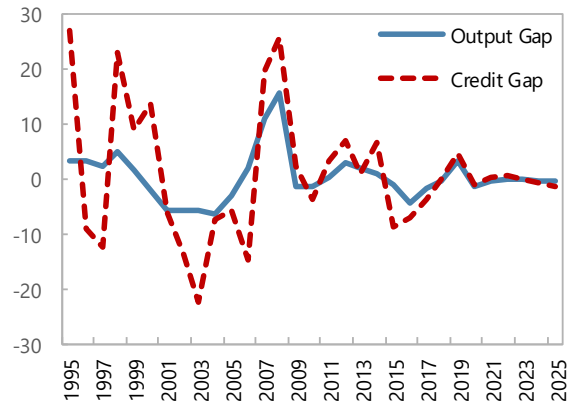
Given stable exchange rates, credit dollarization has fallen.

Private Sector Credit (In billion drams)



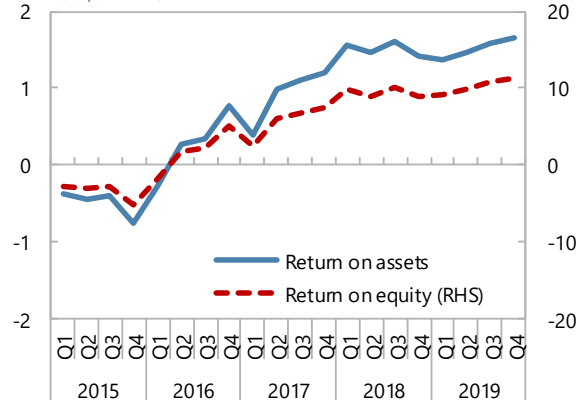
The credit-to-GDP gap is estimated to be marginally negative.

Output Gap vs Credit Gap



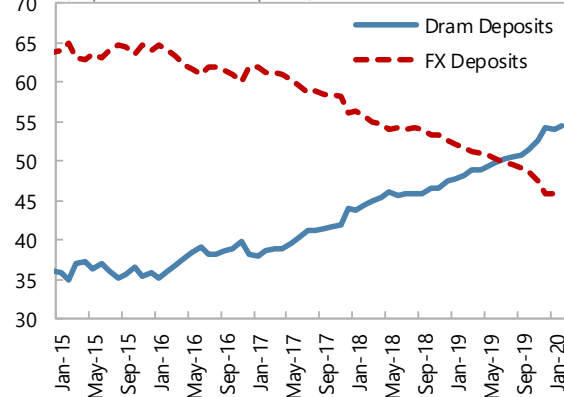
With stable monetary and financial conditions, profitability is increasing.

Financial Soundness Indicators (In percent)



Deposit dollarization has declined as well.

Deposit dollarization (In percent of total deposits)



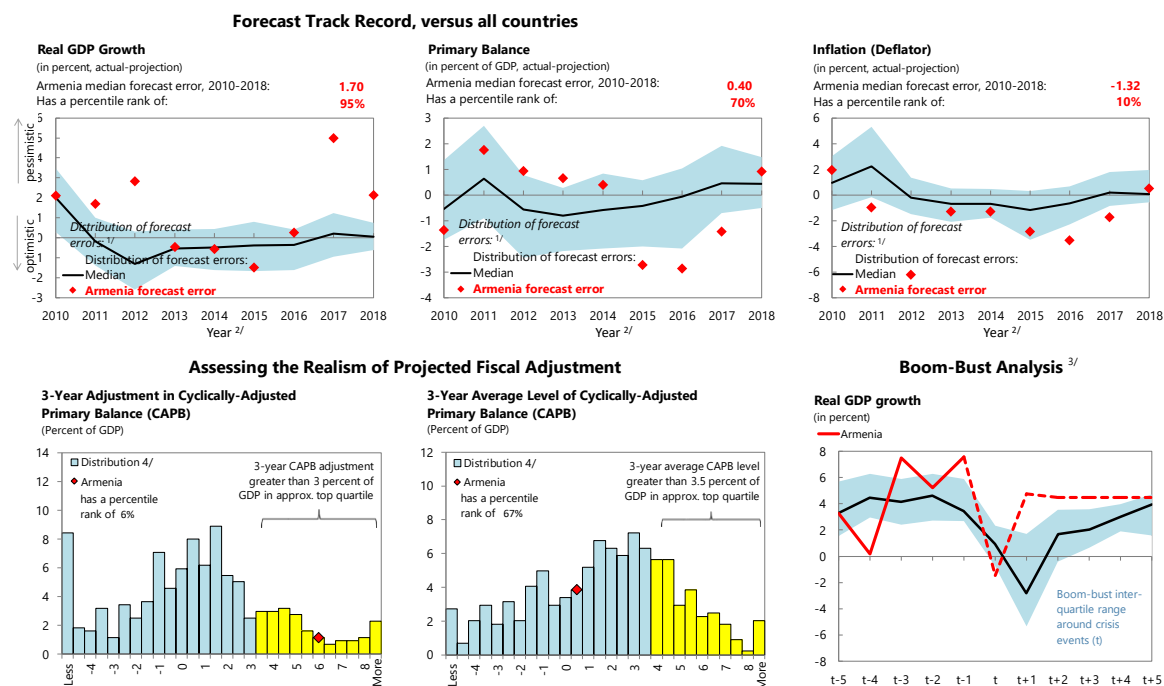
Sources: National authorities, Central Bank of Armenia, Bloomberg, and IMF staff calculations.

Table 1. Armenia: Selected Economic and Financial Indicators, 2017–25

	2017	2018	2019	2020	2021	2022	2023	2024	2025
	Act.	Act.	Prel.				Proj.		
National income and prices:									
Real GDP (percent change)	7.5	5.2	7.6	-1.5	4.8	4.5	4.5	4.5	4.5
Final consumption expenditure, Contrib. to Growth	7.4	4.1	8.8	1.2	1.5	1.8	1.8	1.5	1.9
Gross fixed capital formation, Contrib. to Growth	1.5	0.7	0.8	0.0	2.3	2.4	2.5	2.5	2.6
Changes in inventories, Contrib. to Growth	1.1	3.8	-1.7	-2.5	0.0	0.0	0.0	0.0	0.0
Net exports of goods and services, Contrib. to Growth	-1.2	-2.7	0.1	-0.2	1.0	0.3	0.1	0.1	0.0
Gross domestic product (in billions of drams)	5,564	6,005	6,552	6,519	6,990	7,543	8,181	8,909	9,721
Gross domestic product (in millions of U.S. dollars)	11,527	12,433	13,637	12,977	13,422	14,536	15,597	16,768	18,041
Gross domestic product per capita (in U.S. dollars)	3,869	4,188	4,593	4,370	4,520	4,894	5,251	5,645	6,073
CPI (period average; percent change)	1.0	2.4	1.4	0.9	2.0	3.0	3.5	3.8	3.9
CPI (end of period; percent change)	2.6	1.8	0.7	1.5	2.5	3.5	4.0	4.0	4.0
GDP deflator (percent change)	2.1	2.5	1.4	1.0	2.3	3.3	3.8	4.2	4.4
Unemployment rate (in percent)	20.8	20.5	18.9	19.0	17.9	17.6	17.5	17.4	17.3
Investment and saving (in percent of GDP)									
Investment	19.3	22.4	19.2	21.4	21.9	22.4	23.0	23.5	24.1
National savings	16.3	13.0	11.0	12.8	14.7	15.7	16.6	17.4	18.1
Money and credit (end of period)									
Reserve money (percent change)	-1.0	17.8	8.8	5.4	13.2	11.1	10.8	8.0	8.2
Broad money (percent change)	18.5	7.4	11.2	3.9	13.2	11.1	10.8	8.0	8.2
Private sector credit growth (percent change)	16.5	17.2	18.5	7.0	13.0	11.0	9.0	8.5	8.5
Central government operations (in percent of GDP)									
Revenue and grants	21.2	22.3	23.9	23.3	23.7	24.9	25.3	25.4	25.4
Of which : tax revenue	20.2	21.0	22.3	21.7	22.0	22.9	23.1	23.2	23.3
Expenditure	26.0	24.1	24.9	28.3	26.5	26.9	26.9	26.9	26.9
Overall balance on a cash basis	-4.8	-1.8	-1.0	-5.0	-2.9	-2.0	-1.7	-1.5	-1.5
Public and publicly-guaranteed (PPG) debt (in percent of GDP)	58.9	55.8	53.7	64.1	62.1	59.8	57.0	54.8	52.8
Central Government's PPG debt (in percent)	53.7	51.3	50.1	60.9	59.1	57.3	55.0	53.3	51.8
Share of foreign currency debt (in percent)	81.1	80.0	79.0	75.7	73.5	74.1	75.1	74.3	73.7
External sector									
Exports of goods and services (in millions of U.S. dollars)	4,312	4,700	5,274	4,091	4,817	5,344	5,765	6,150	6,557
Imports of goods and services (in millions of U.S. dollars)	-5,723	-6,647	-7,246	-5,946	-6,606	-7,289	-7,815	-8,307	-8,830
Exports of goods and services (percent change)	23.2	9.0	12.2	-22.4	17.7	10.9	7.9	6.7	6.6
Imports of goods and services (percent change)	26.7	16.1	9.0	-17.9	11.1	10.3	7.2	6.3	6.3
Current account balance (in percent of GDP)	-3.0	-9.4	-8.2	-8.6	-7.2	-6.7	-6.4	-6.1	-6.0
FDI (net, in millions of U.S. dollars)	222	247	397	161	292	385	404	439	461
Gross international reserves (in millions of U.S. dollars)	2,314	2,259	2,840	2,190	2,245	2,446	2,578	2,587	2,598
Import cover 1/	4.2	3.7	5.7	4.0	3.7	3.8	3.7	3.5	3.3
End-of-period exchange rate (dram per U.S. dollar)	484	484	480	...	...	...	...	...	...
Average exchange rate (dram per U.S. dollar)	483	483	480	...	...	...	...	...	...

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

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

Figure A3. Armenia: Public DSA - Realism of Baseline Assumptions

Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Armenia has had a positive output gap for 3 consecutive years, 2017-2019 and a cumulative increase in private sector credit of 12 percent of GDP, 2016-2019. For Armenia, t corresponds to 2020; for the distribution, t corresponds to the first year of the crisis.

4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.