

2008 Article IV Consultation with

Armenia

RIA OREANDA, Russia
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Yerevan. OREANDA-NEWS On 26 November was announced, that the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Armenia.

Background

Armenia's recent economic performance has remained strong, and the economy is poised for another year of double-digit growth. But macroeconomic imbalances have widened. Rising inflation, a widening current account deficit, and rapid credit growth have raised concerns about overheating. While the impact of the current international financial turmoil is expected to remain limited, the threat of a severe global economic downturn could undermine growth prospects.

The Armenian economy continues to register strong growth underpinned by sound macroeconomic policies and ongoing structural reforms. Real GDP increased by 13.8 percent in 2007, the sixth consecutive year of double-digit growth, and remained strong through September 2008 (10.4 percent), on the back of continued buoyant activity in construction and services. Inflationary pressures have increased on account of surging food and energy import prices. The end-year inflation rate, at 6.6 percent, exceeded the target band for 2007 (4 1.5 percent), and inflation reached 8.6 percent in October 2008. However, inflation is still lower than in neighboring countries, thanks to a gradual tightening of monetary policy, exchange rate flexibility, and a moderate fiscal stance. Inflationary pressures will remain strong in the period ahead, given significant demand pressures and an announced hike in gas import prices.

Despite strong growth in private transfers, the external current account has continued to deteriorate. Imports have surged on the back of high international food and energy prices and buoyant demand. Export performance has been disappointing, reflecting declining competitiveness in diamond-processing and temporary shortfalls in base metals output, but also the high cost of doing business in Armenia. With appreciation pressures dampened by rising import demand, the dram/dollar exchange rate has been broadly stable since December 2007.

Fiscal policy has remained prudent. Tax collection has been well above expectations, driven by a surge in value added tax (VAT) revenue partly associated with high import growth. Together with expenditure underexecution, this resulted in a lower-than budgeted overall deficit in 2007 and an overall budget close to balance through July 2008. However, the underlying fiscal balance (including the gas subsidy, but excluding grants and external interest payments) has been deteriorating.

Monetary policy has been tightened to address inflationary pressures and limit second-round effects of higher food and energy prices. In 2007-08, the Central Bank of Armenia (CBA) gradually increased the repo rate to currently 7.75 percent.

Armenia's financial sector infrastructure, regulation, and supervision have

Financial soundness indicators do not yet reflect the current economic conditions. Banks continue to be profitable, and credit growth remains strong. However, credit growth is still low. Exposure to the international financial turmoil is limited due to low external commercial borrowing. Yet, the sharp pickup in credit growth since mid-2007 while a welcome boost to financial intermediation could potentially impact negatively on financial sector stability.

The government's program emphasizes the authorities' commitment to policy continuity and accelerated implementation of reforms along the lines of Fund advice, with a particular focus on improving tax policy and administration, and the business environment. The authorities have requested a low-access Poverty Reduction and Growth Facility (PRGF) arrangement to support their ambitious reform agenda. A new Fund program is seen as crucial to safeguard macroeconomic stability and as a signal of the authorities' continued reform drive.

The authorities intend to continue publishing all documents related to the Article IV consultation.

Executive Board Assessment

Executive Directors commended the authorities for the successful implementation of macroeconomic policies under the PRGF-supported program that expired in May 2008. These policies, supported by large-scale foreign exchange flows, have contributed to a period of strong economic growth, low inflation, rising real incomes, and declining poverty rates.

Directors were encouraged by the authorities' commitment to continued prudent monetary and fiscal policies and far-reaching structural reforms. These actions are necessary to consolidate past gains and to strengthen the economy's resilience against external shocks. Vigorous implementation of structural reforms will be key to address Armenia's weak business environment, limited export potential, and undiversified production base.

While Armenia's short-term outlook remains favorable, inflationary pressures, a widening external current account deficit, and rapid credit growth have raised concerns about overheating. However, the current global financial turmoil and the unfolding economic downturn as well as regional instability could affect foreign direct investment (FDI) and remittance inflows and undermine growth prospects, while at the same time also dampening risks of overheating.

Directors welcomed the authorities' intention to withdraw fiscal stimulus during 2008-09 in order to address current imbalances. Going forward, fiscal policy should balance the need for a countercyclical stance with the spending requirements for poverty-reducing and infrastructure spending. Directors therefore welcomed the authorities' strong efforts to strengthen revenues by addressing weaknesses in tax policy and administration. The envisaged tax reform will also bring important benefits in terms of containing the shadow economy and discouraging tax evasion; reducing significantly the cost of doing business, particularly in the export sector; contributing to leveling the playing field; and, ultimately, promoting private sector development. Directors commended the plans to strengthen the medium-term expenditure framework and debt management policy.

Directors welcomed the commitment of the Central Bank of Armenia (CBA) to tighten monetary policy further if signs of overheating persist. The CBA also intends to continue the preparation for a full-fledged inflation targeting regime. Some Directors thought that a more gradual transition



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ary policy transmission mechanism remains

Directors considered that exchange rate flexibility will continue to be the best option for Armenia, and that it should facilitate adjustment of the external balance. The authorities should refrain from extensive unsterilized foreign exchange intervention to lend credibility to the inflation targeting regime. Several Directors underscored the importance of allowing two-way exchange rate flexibility to avoid one-way bets. Directors noted the staff assessment that, despite the notable appreciation of the exchange rate in previous years, there is no evidence of a significant exchange rate misalignment. This highlights the importance of accelerating key structural reforms aimed at improving external competitiveness through a more favorable business environment. Directors noted that Armenia's financial sector infrastructure, regulation, and supervision have improved significantly. Relevant indicators do not point to significant vulnerabilities nor are there signs that the global financial crisis has affected financial institutions in Armenia. Nevertheless, in view of the continuing areas of weakness as well as the rapid credit growth, the authorities should further strengthen the financial system-in particular, the supervisory framework and risk management-and prepare contingency plans in case of financial system stress.

Directors endorsed the authorities' request for a low-access PRGF arrangement, given Armenia's good track record and strong policy and structural program for 2009. They acknowledged that the program's focus on further strengthening the fiscal and monetary policy frameworks and their coordination, while deepening productivity-enhancing structural reforms, is appropriate to address the significant challenges ahead. Some Directors recognized, however, that Armenia's financing needs might increase with rising global risks, and supported an early review of the situation if needed. Directors also welcomed the authorities' readiness to take additional policy measures as needed.
