

## REGIONAL ECONOMIES

**ARMENIA:  
THE CRISIS AND  
FUNDAMENTAL  
ECONOMIC PROBLEMS**

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The world crisis interrupted the stable economic growth Armenia had been enjoying for the past fifteen years. Progressive development began in 1994, whereby between 2001 and 2007 the growth indices reached double digits. In 2008, the increase in GDP came to a halt due to the Russian-Georgian war and amounted to only 6.8%.<sup>1</sup>

And as early as the first six months of 2009, the GDP began to decrease, dropping as low as 16.3% compared to the same period of the previous year, which is one of the worst indices for the entire

<sup>1</sup> For more detail, see: H. Khachatrian, "Armenia: Economics," in: *Central Eurasia 2008*, CA&CC Press®, Sweden, 2009.

CIS.<sup>2</sup> In July, the drop in GDP amounted to 18.7%, which encouraged people to think that the crisis had bottomed out.

The Armenian government took measures that reduced the negative impact of the crisis to a minimum. This was mainly assisted by financial aid from the outside. However, both independent observers and government representatives admit that the crisis only aggravated the problems that already existed in the country's economy. While there are others who believe that the crisis will be conducive to radical restructuring that will make the economy more efficient and competitive.

<sup>2</sup> Main macroeconomic indices of the CIS countries (January-June 2009 compared to January-June 2008), available at [www.cisstat.com], 20 August, 2009.

## Anticipation of the Crisis and the Government's Anticrisis Campaign

From the very beginning, it was clear that Armenia, with its small domestic market, would be dealt a severe blow by the crisis that began beyond its borders since it was bound to affect the countries to which the republic exports goods and services and which make investments in Armenia.

Nonferrous metals (copper, molybdenum, and aluminum) constitute about half of Armenia's export. In recent years, the pricing environment has been shaping up favorably, and the export earnings have noticeably grown. But it was obvious that the crisis threatened a cutback in the consumption of nonferrous metals and a drop in prices, particularly for copper, which is used in large amounts in construction. It is worth recalling that it was precisely a decline in construction that triggered the world crisis.

The export of manpower is another important article of Armenia's revenue. After the collapse of the U.S.S.R., between 600,000 and 800,000 Armenians (15-20% of the population), according to some sources, left the country in search of a way to earn a living. Approximately 60,000 periodically leave to work at seasonal jobs. It goes without saying that the remittances labor migrants and members of the Armenian diaspora send to their relatives in Armenia constitute the republic's revenue from this "export." In 2008, the noncommercial bank transfers amounted to 1 billion \$630 million, which is more than 10% of GDP and almost 48% of the domestic trade turnover.

In actual fact, the inflow of money is much greater, although it is impossible to determine the true amount of this revenue, since a large portion of the money bypasses the banking system. Revenue from the export of manpower depends on the demand for it in those countries where labor migrants live and work. Eighty percent of the money comes to Armenia from Russia, so there is close economic interaction between these countries. The state of the Russian economy is primarily determined by the world oil prices and this is another important factor that affects Armenia.

The decrease in inflow of foreign investments, primarily into the construction business, is the third important way the world crisis is having an impact on Armenia. It began to dwindle as early as the end of 2008 as a result of the Five-Day War between Russia and Georgia.

During 2009, all the above-mentioned factors had an immense effect on the republic's economy. In particular, as early as the end of 2008, world copper and molybdenum prices fell by half (compared to the beginning of the same year), and the volume of their export from Armenia significantly dropped. As for remittances (commercial and noncommercial), during the year their inflow shrank by 34% (as of July 2009).

As early as November 2008, Prime Minister Tigran Sargsian presented the National Assembly with the main provisions of the government's anticrisis program. It included a standard set of measures: increasing government expenditures to raise demand (numerous infrastructure projects), streamlining local production units, and stimulating export.

In particular, potentially productive local manufacturers were to be offered preferential loans and loan guarantees. There were plans to create particularly lucrative conditions for small and medium businesses, since they offer the largest number of jobs. There were no plans to lower tax rates since, in April-May 2008, the government announced its strategic goal to be the opposite task, that of reducing the shadow economy sector, i.e., increasing the amount of tax collected. The program did not plan on allotting special financial resources from the state budget. It was decided not to cut back the state budget initially offered for 2009 that envisaged GDP growth of 6-8%. The government planned on making up for the shortage of funds by increasing external borrowing. International financial organizations—the IMF, World Bank, and Asian Development Bank—were considered as potential lend-

ers. These calculations could have fully justified themselves: Armenia had a sufficiently low level of external debt—14% of GDP (at the end of 2008).

These expectations were justified, even though America's Millennium Challenge Corporation announced the partial curtailment of its programs due to the violation of democratic freedoms in Armenia (meaning the events relating to the presidential election on 19 February, 2008). This shortage of funds amounted to around \$75 million, but it was amply compensated for by loans from the IMF (more than \$800 million, \$400 million of which were received before May 2009),<sup>3</sup> as well as by Russia's interstate loan of \$500 million dollars, which was issued at a LIBOR+3 rate and for a term of 15 years.<sup>4</sup>

In addition, on 2 June, 2009, the government passed a law through the National Assembly according to which the upper threshold for the state budget deficit was raised from 5.0% to 7.5% of GDP. This permits the government to borrow a total of 230 billion drams (\$640 million) to cover the budget deficit in the event the annual GDP falls by 15%. And even in that case, budget assignments (940 billion drams) will be fully activated, including for wages, pensions, and benefits. It should be noted that the necessary borrowed funds are already available.

This does not exhaust the list of borrowings. In March, the World Bank made a decision to grant Armenia four loans (totaling \$85 million), including one for \$35 million, which will immediately be spent on creating new jobs. The Asian Development Bank also allotted \$47 million; in the future, the government hopes to receive quite a large loan from it (see below).

One of the goals of the anticrisis program is attracting the funds of the Armenian diaspora into the banking system. The matter concerns not only the deposits of large investors (several banks fully or partially belong to large private owners from the diaspora), but also an attempt to increase the relatively small revenues from Armenians living abroad by turning the republic into a serene harbor: the growing bank crisis has essentially not affected Armenia.

In order to execute the intended plans, a law was adopted at the beginning of 2009 on founding an All-Armenian Bank, but further steps in this direction have not been taken.

## Impact of the Crisis

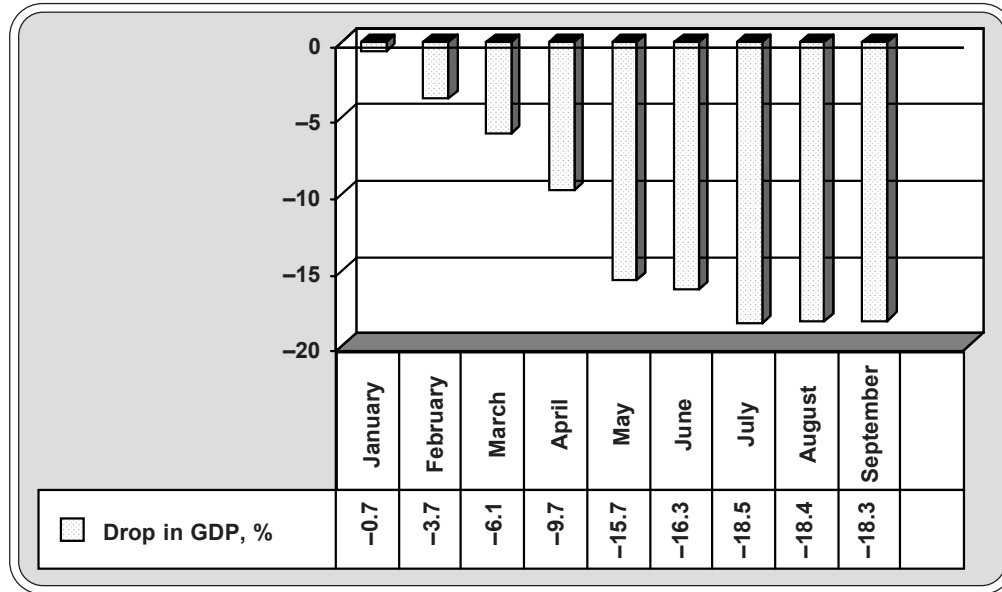
According to the Armenian National Statistics Board, in January-July 2009, the country's GDP amounted to 81.5% compared to the same index for the previous year.

As Figure 1 shows, two phases can be identified in the dynamics of change in GDP over the year—an abrupt drop and relative stabilization. The first phase continued until July: after a relatively small decrease in the first months of the year—6.1% in the first quarter, there was an abrupt acceleration in the drop to 16.3% in the first six months, which continued to a low of 18.5% in July (as noted above, this was the worst index for all the CIS countries). In the next two months, the drop came to a halt, and the economy even recovered its losses somewhat: in August and September, this index rose slightly to 18.4% and 18.3% compared to the same periods of the previous year, respectively. This created grounds for cautious optimism: the government announced that the economy had begun to stabilize, and by the end of the year the drop would constitute “a mere” 15% of the previous year's level.

<sup>3</sup> For more on the IMF Council's decision, see: [<http://www.imf.org/external/np/sec/pr/2009/pr09228.htm/>].

<sup>4</sup> At the end of June, the government of Armenia adopted a decision, according to which in 2009 only about \$245 million of this amount would be spent. The rest would be saved in the stabilization fund.

Figure 1

Dynamics of Change in Armenia's GDP  
in 2009

The data presented in the table on p. 46 confirm these estimates. The table shows that the most abrupt drop in production output was seen in construction; by July the volume had dropped by almost half. The output of industrial production fell by 12%, while the decrease in agricultural production was less. For the abovementioned reasons (decrease in nonferrous metal prices), there was a sharp drop in export in terms of value, by almost half. In so doing, in July, the import volume was 4.57-fold higher than the export volume. In the following two months, a slow improvement in almost all the mentioned parameters was seen, which is clear from the data presented in the table. The recovery in the construction industry and increase in export—in September it increased by 26.5% compared with August—are particularly encouraging factors from the government's viewpoint. Evidently, the government's anticrisis measures played a certain role in these processes, which will be discussed below.

The crisis also aggravated problems in lending. By May 2009, bank lending rates, which were high anyway at 16% per annum, had increased by more than two percentage points; it became more difficult for businessmen to obtain loans; and consumer lending had stopped entirely. In so doing, the banks had surplus liquidity, that is, they issued fewer loans than they could have. The corresponding parameter N2 (ratio of the volume of highly liquid assets to overall assets), which, according to Central Bank regulations, should have been equal to 15%, amounted to an average of 23.85% in December, later reaching 30.74%, while the volume of free monetary resources increased from December to May from 41.6 billion drams to 54.09 billion (\$146 million).

In order to lower lending rates, the Central Bank decreased the refinancing rate from 7.75% to 5.00% (March-September), whereby the low inflation rate (2-3%) made it possible to do this without any alarming repercussions. In addition, approximately \$60 million were pumped into the banking

Table

**Change in Armenia's Macroeconomic Parameters  
in January-September 2009  
(in percentages of the same period for 2008)**

	January-July	January-September
<b>Gross domestic product</b>	<b>81.5</b>	<b>81.7</b>
<b>Output of industrial production</b>	<b>88.0</b>	<b>88.6</b>
<b>Output of agricultural production</b>	<b>97.9</b>	<b>98.7</b>
<b>Volume of construction</b>	<b>55.0</b>	<b>56.2</b>
<b>Volume of retail trade</b>	<b>100.1</b>	<b>100.8</b>
<b>Volume of services</b>	<b>99.5</b>	<b>98.8</b>
<b>Average nominal wages</b>	<b>111.3</b>	<b>112</b>
<b>Export</b>	<b>55.5</b>	<b>58.5</b>
<b>Import</b>	<b>70.5</b>	<b>72.1</b>

system thanks to foreign aid and Russian loans. However, it has still not been possible to achieve a decrease in the lending rates.<sup>5</sup>

It should be noted that the first phase of the world economic crisis, which began in September 2008, had essentially no impact on Armenia—it did not have a developed financial system and its interaction with other countries in this sphere was minimum. In particular, the republic's banking system did not have any ties with financial institutions abroad, apart from its own parent banks or international organizations (for example, the HSBC-Armenia bank with its parent British HSBC bank). These circumstances, as well as the extremely strict control exercised by Central Bank, led to the fact that Armenia proved to be the only country in the CIS that did not need financial aid to support its banking system, which, on the whole, remained profitable.

All the same, problems with state finances arose. In the first six months of 2009, due to the economic slump, state budget revenues were 12.9% lower than the index for the previous year. Whereby, according to the budget plan, revenues should have increased on average over the year by 14%. In addition, as already noted, remittances from abroad during the same period decreased by 34%. The government managed to fulfill its main fiscal commitments only with the help of unprecedented borrowing, as mentioned above. Against the background of these troubling figures, it is surprising that the volumes of retail trade and services essentially remained the same. In other words, the country has not suffered from any abrupt drop in the standard of living. This is explained by the fact that, despite the crisis, wages continue to increase in the country (see the table), whereby in the state sector they are even higher (118.1%) than in the private. In previous years, the exact opposite trend was typical.

<sup>5</sup> By the end of August, the amount of loan deposits increased slightly compared to June by approximately 5% after a drop of the same amount in the previous three months. This is possibly the beginning of a revival in active lending.

## The Government's Anticrisis Measures

List of main anticrisis measures of the Armenian government:

- The activity of five mining companies producing copper and molybdenum has fully recovered. Around 6,000 jobs were retained, which were particularly important for Siunik marza (a province in the south of the country). Some enterprises were offered subsidies and loans totaling \$60 million; they again became relatively profitable thanks to the partial restoration of the former world price level. Two enterprises upgraded their equipment.
- The assistance was rendered to several local companies that a special government commission evaluated as potentially productive. The assistance took various forms: loans, loan guarantees, and the purchase of some shares. In so doing, the range of activity of those enterprises that received assistance is extremely wide: food processing, the production of environmentally pure products, textile production, software manufacture, machine-tool production, and so on. By the end of October, 44 companies had been allotted aid totaling more than 30 billion drams (\$80 million).
- Attempts are being made at the same time to give a new boost to the soft financing of small and medium businesses. In particular, the World Bank issued a loan of \$50 million in March and, on 1 April, a corresponding program was launched. But the lending rates in the country are still very high.
- A decision was made to grant loan guarantees to developer companies in order to stimulate the completion of facilities, the construction of which had halted due to the crisis (providing these facilities were already more than halfway built). Such guarantees, totaling more than \$10 million, were offered to five companies. In July-August, it was not possible to activate the construction industry. However, a slight increase in construction began in September (see the table).

## Monetary Policy

As already mentioned, the world financial crisis essentially caused Armenia no direct harm due to its insufficient integration into the world financial system. All the same, the inflow of funds from abroad has been dwindling (since the fall of 2008). In addition, the demand for American dollars has increased in the republic, just as it has in Russia. The dram exchange rate remained at 305 drams to the dollar for quite a long time. Armenian officials chose conservative tactics to combat the growing demand for U.S. currency, trying to maintain the previous exchange rate. Often more than \$60 million a day would be sold on the exchange market, which is ten times higher than the average level.

As a result, from October 2008 to March 2009, the Central Bank of Armenia spent approximately \$600 million (one third of its foreign exchange reserves) on exchange market interventions, and the percentage of dollar deposits rose from 40% to 70%. In other words, the de-dollarization of the economy accompanied by an increase in the dram exchange rate that occurred between 2004 and 2006<sup>6</sup> was reversed.

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<sup>6</sup> See: H. Khachatryan, "Armenian Currency: The Drama of the Dram," in: *Central Eurasia: National Currencies*, ed. by E.M. Ismailov, CA&CC Press®, Stockholm, 2008.

Finally, on 3 March, 2009, the Central Bank announced that it was curtailing its efforts to support the dram exchange rate, that is, it was returning to a floating exchange rate policy, although it had technically never renounced it. The exchange rate of the national currency instantly fell from 305 to 370 drams to the dollar.

The events of the following months confirmed the forecasts that the band the dram is allowed to trade within in the future would amount to 360-380 to the dollar. As of August 2009 (when this article was written), no upheavals had occurred in the exchange market.<sup>7</sup> It is believed that the financial structures were able to make adjustments to the exchange rate incurring the least losses for the population and banks (there was no outflow of deposits). Thanks to this, the IMF offered Armenia a Stand-by loan without delay. As already mentioned, on the whole, the banking system ended the first six months of the year in the black.

## Construction

From the very beginning, particular importance was placed on building infrastructure when elaborating the anticrisis measures. The country was in great need of an improved infrastructure network, and this would also ensure the creation of new jobs.

The government began unfolding an extensive plan for modernizing rural roads and also began developing a project for building a new international highway linking Iran with the Georgian port of Batumi by the shortest route (Meghri-Erevan-Gumri-Akhalkalaki-Batumi). Armenia and Georgia were counting on receiving a loan from the Asian Development Bank, but it would most likely not be issued before the end of 2009, which would be too late to assuage the crisis phenomena.

The same also applied to two other projects: the Iran-Armenia railroad and the Tabriz-Ararat pipeline for transporting petroleum products. In mid-August, the government announced that due to the situation in Iran the launching of another Armenian-Iranian project—building a hydropower plant on the border river Arax—would be postponed. Iran promised to grant a total of \$400 million to infrastructure projects in Armenia, but not one of them has been launched yet.

The government is also putting great store by growth of the construction industry, since in the past five years it has proven to be the driving force behind the economy, and its growth rates have been amounting on average to more than 20% a year. As a result, by 2008, construction ensured 27% of Armenia's GDP, whereas in 2002 it provided only 6.6%. So, as of today, this industry accounts for the lion's share of the economic slump.

In January-May 2009, the share of construction in GDP abruptly dropped compared to the same period for 2006 (see Fig. 2),<sup>8</sup> and the government is exerting great efforts to retain this important sector of the economy.

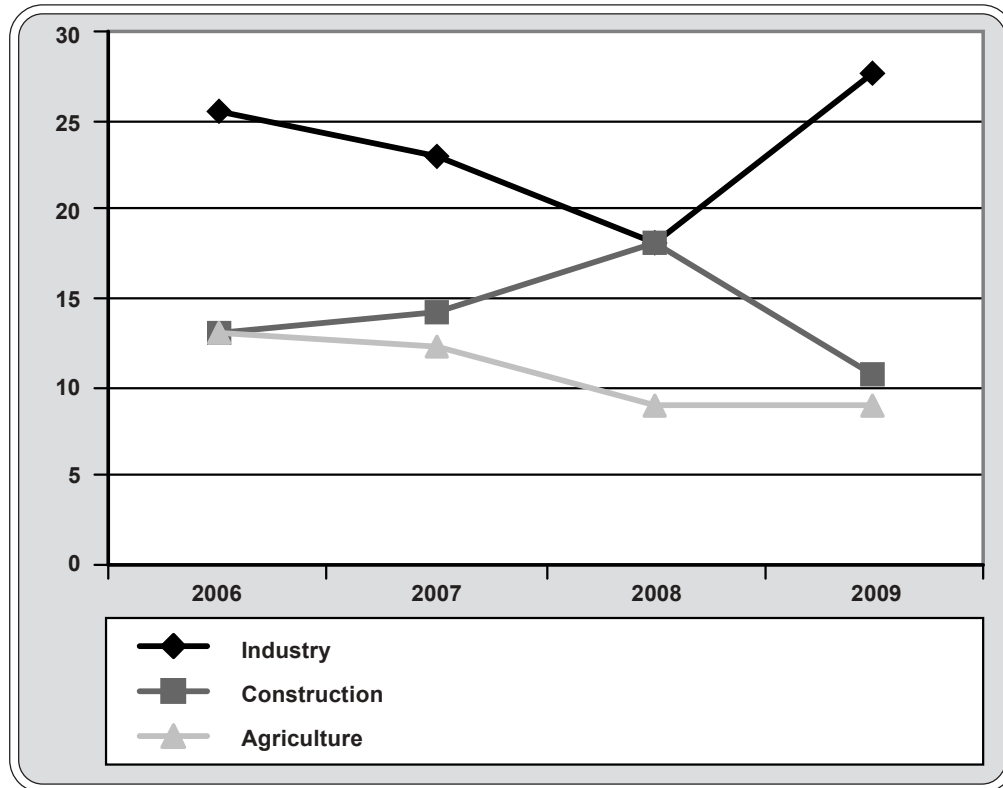
The government's plans placed special focus on construction in the Spitak earthquake zone, where approximately 7,000 residents still do not have a decent roof over their heads since the disaster occurred in 1988. There were plans to allot approximately 70 billion drams (\$190 million) from budget and borrowed funds for this purpose. Real revival of construction work in this zone did not begin until September.

The government is also planning to step up private demand for construction which, during the boom years in the construction industry, provided 90% of the revenue into this sphere. There are plans

<sup>7</sup> Fluctuations in the dollar exchange rate did not go beyond the above-mentioned band right up until January 2010, the time this article underwent its final revision.

<sup>8</sup> The figure shows the data for January-May of the past four years. The share of construction in GDP at this time was much lower than on average for the year due to the seasonal dependence of the parameters being studied.

Figure 2



to stimulate mortgage loans for this. Another step in this direction was taken in June 2009. A National Mortgage Company (NMC) was created to refinance mortgage loans of commercial banks.

By this time, mortgage loans totaling 87 billion drams (\$235 million) had been issued, but the country still needs another \$150 million in such loans. The initial capital of the NMC amounted to 17 billion drams and the Central Bank of Armenia is its only property owner, but in the future the authorities are also hoping to attract private investors to the NMC.

## Measures to Improve the Business Sphere

Government representatives have repeatedly emphasized that the anticrisis program is nothing more than a way to soften the blow dealt by the world crisis, whereas it will take radical economic reforms to achieve the formation of a competitive economy. This means not only so-called “second generation reforms,” which were mentioned at the beginning of the 2000s and which never came to fruition.

Tigran Sargsian’s government, which began working in April 2008, designated several primary measures: improving the tax administration, cutting back the shadow economy, fighting monopolism,



and creating a contemporary information society, that is, promoting the penetration of information technology into every sphere of life.

There are many obstacles in the way since the ruling Republican Party of Armenia largely depends on oligarchs who occupy a monopoly position in various branches of the economy and make use of unofficial privileges in the tax and customs spheres.

President Serge Sargsian, who is the government's only political bastion, has apparently found himself between a rock and a hard place, since he also happens to be the leader of the "oligarch" RPA that is resisting the reforms.

One way or another, however, the government has managed to achieve some success in the struggle to improve the business climate and create equal conditions for all:

1. A decision was made to grant a three-year deferment for paying value added tax when importing equipment.
2. The regulations in customs and tax payments and accounting for small and medium businesses have been simplified. This is just part of the program calculated for three years to carry out reform of the tax administration.
3. Some improvement has been achieved in tax revenue, that is, the shadow economy is being cut back. The authorities claim that this is what is creating the paradoxical phenomenon of a decrease in GDP without the same drop in retail trade. A campaign has begun in the country aimed at issuing checks to customers in stores, without which it is impossible to determine the true volume of trade turnover. Moreover, the tax department announced that between January and June 2009, it managed to raise the share of profits tax to 16% of the total tax collections instead of the 11.5% achieved in 2008. This is another phenomenon that in no way fits the picture of an economic slump. Consequently, there are positive changes in the taxation sphere.
4. In October, the National Assembly finally adopted a set of amendments to the tax legislation, according to which tax representatives should be on permanent duty at dozens of large enterprises to monitor the amount of goods dispatched and the prices for them. The government first presented this set of amendments in May of 2009 and it was met with great resistance in the parliament: it was not adopted until the third attempt, whereby in a version that was perceptibly "softer" than the original one. Nevertheless, its adoption could become the beginning of the government's noticeable victory in the fight against monopolism and tax privileges.

So it follows from the above that the government is continuing its efforts to create a contemporary and effective business environment, as well as a highly efficient economy on its basis. Focus points are being created in promising spheres for attracting the funds of private investors.

The first series of facilities is already functioning: an industrial park in the city of Gumri, a Center of International Tourism on the grounds of the Tatev medieval monastery complex, a free trade area near the airport of Zvartnots, a nuclear medicine center at the Erevan Institute of Physics, and so on.

## *Conclusion*

The world economic crisis revealed two main reasons for the weakness of the Armenian economy: its permanent need for remittances from abroad and its great dependence on the state of certain spheres of the economy (construction and metallurgy).

The government has so far managed to prevent any negative social consequences of the crisis, while it is also trying to create conditions for developing a more diversified and efficient economy.

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