

Global and Regional Economic Outlook: Policy Challenges and Opportunities for Armenia

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Outline

Global Outlook

CCA Outlook, Risks, and Policies

**Armenia's Policy Challenges
and Opportunities**

An uneven global recovery continues

Real GDP Growth Projections

(Percent change from a year earlier)



World

U.S.

Euro Area

**Emerging
markets**

China

Russia

Armenia

2013

3.3

2.2

-0.4

4.7

7.7

1.3

3.5

2014

3.3

2.2

0.8

4.5

7.4

0.2

2.6

2015

3.8

3.1

1.4

5.0

7.1

0.5

3.5

Global recovery remains fragile

Geopolitical risks (Russia-Ukraine, Middle East)

Further risks to growth in emerging market economies

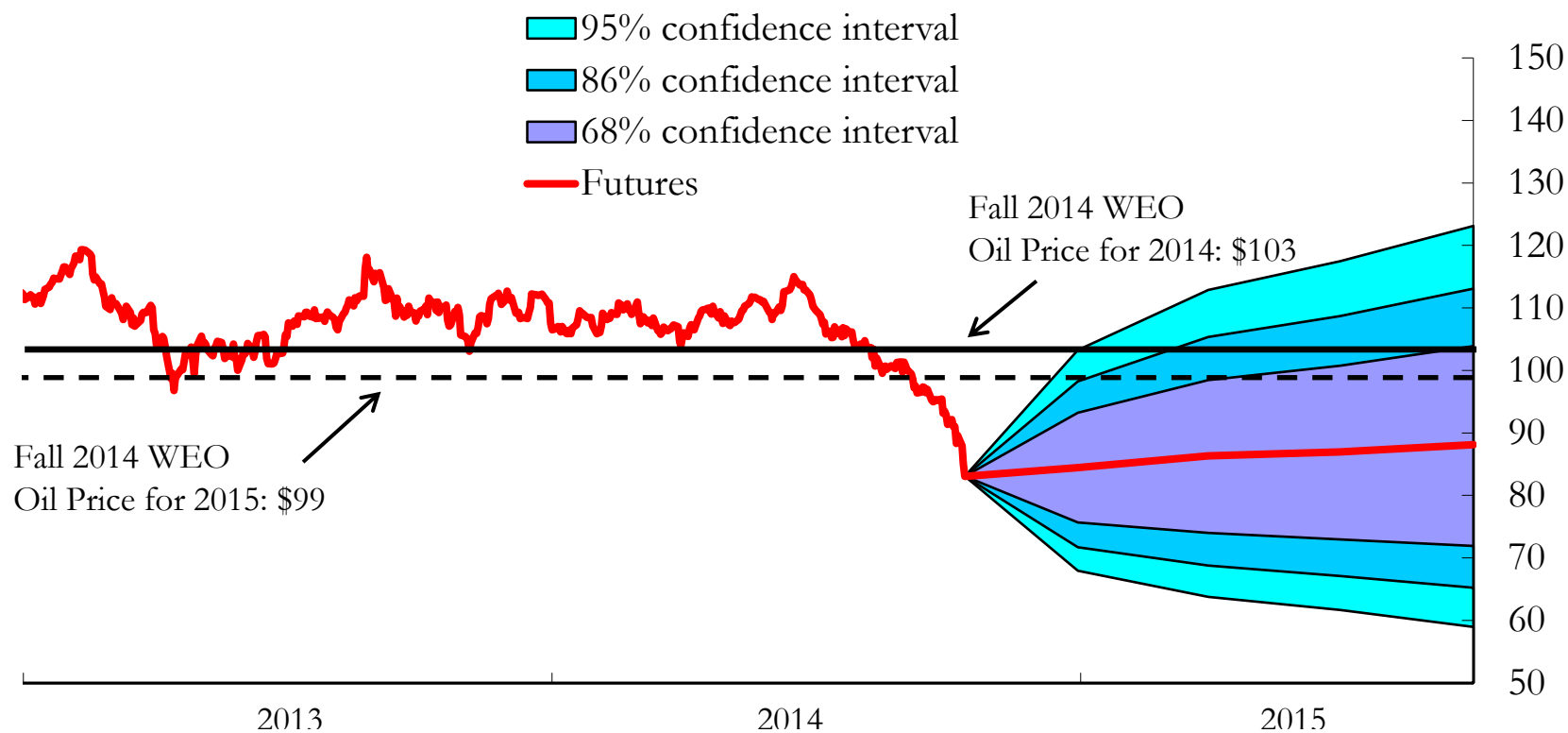
Risks related to normalization of monetary policy in advanced economies

Protracted period of slow growth in advanced economies

Oil prices have declined considerably since projections were made; risks are high in both directions

Brent Crude Oil Price¹

(U.S. dollars per barrel)



Sources: Bloomberg; and IMF staff calculations.

¹Derived from prices of futures and options on October 15, 2014.

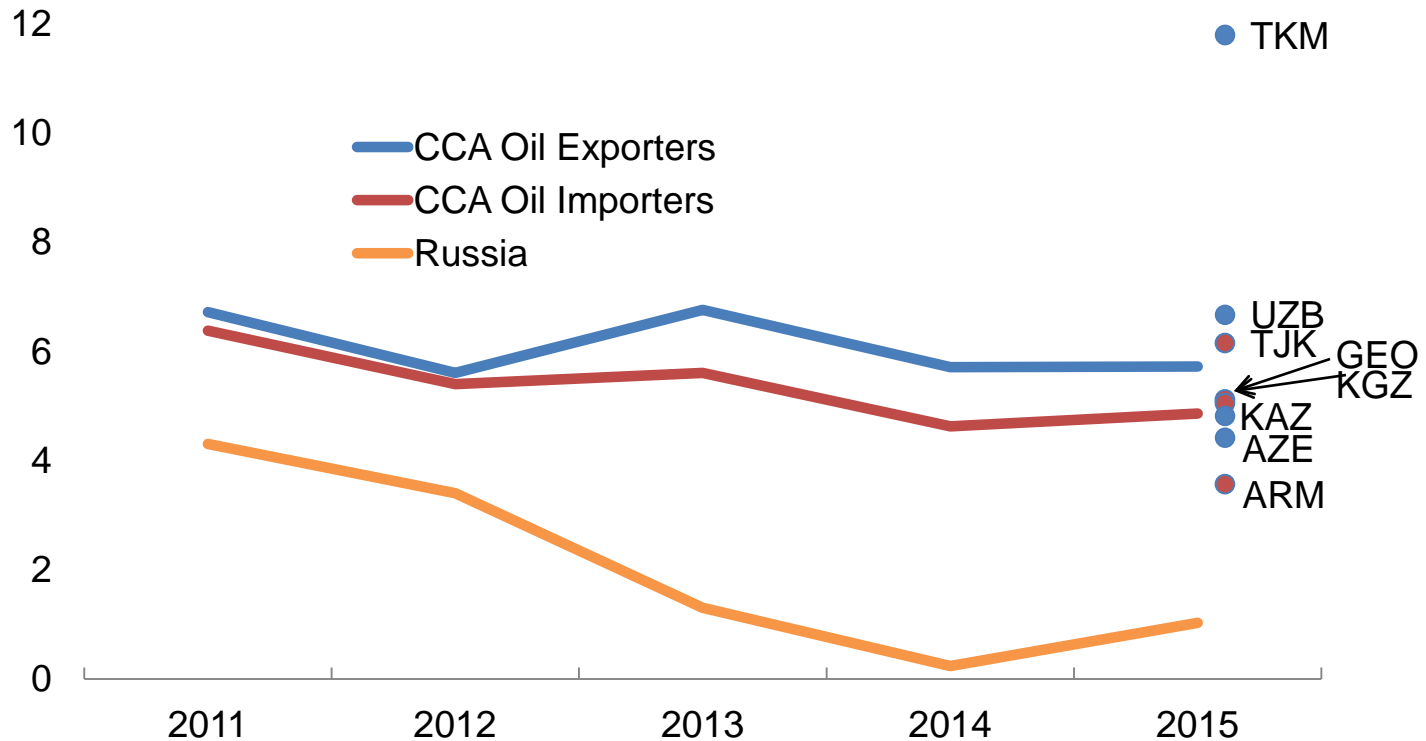


Caucasus and Central Asia



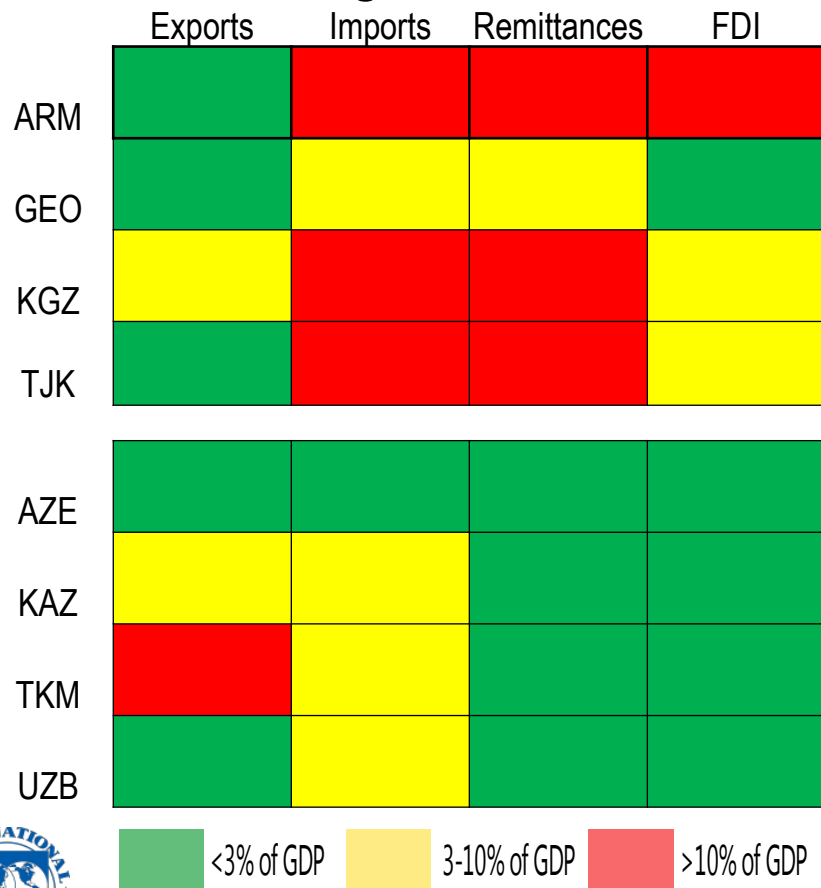
Growth is slowing, due to spillovers from Russia and weaker domestic demand, yet remains robust

Real GDP Growth (Annual percent change)

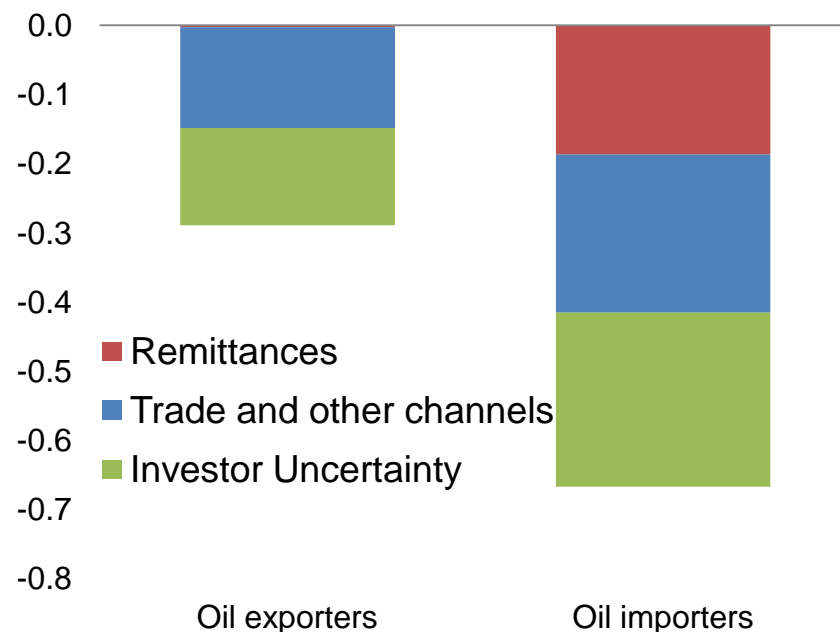


Close linkages with Russia create downside risks to the outlook

Linkages with Russia



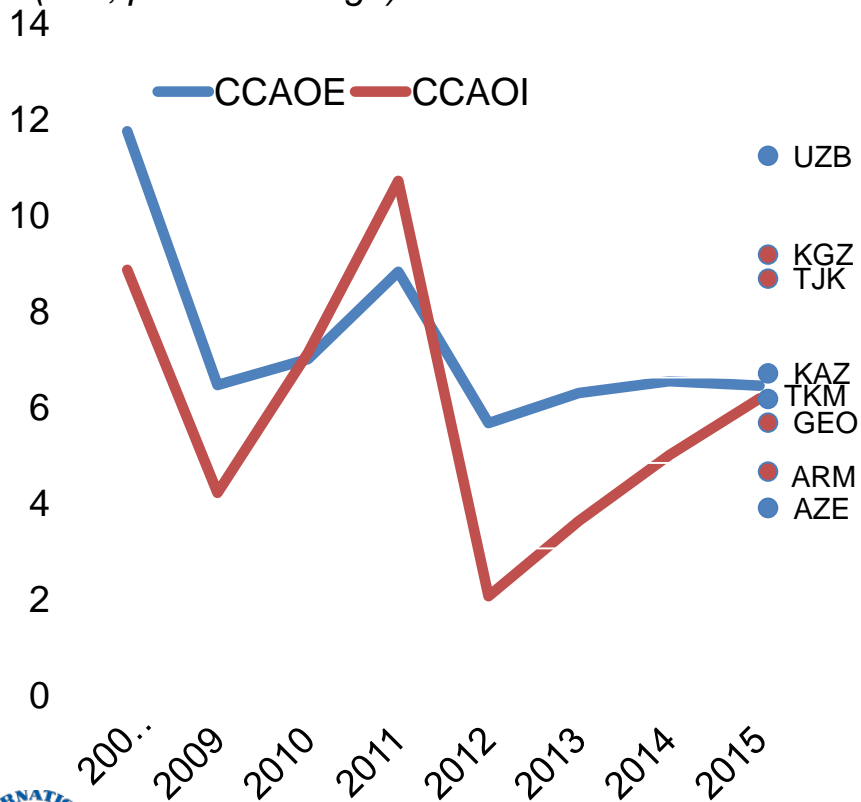
Impact of 1 percentage point fall in Russia's GDP growth and investor uncertainty on CCA GDP growth (percent)



Despite slowing growth, inflationary pressures are rising because of recent depreciations

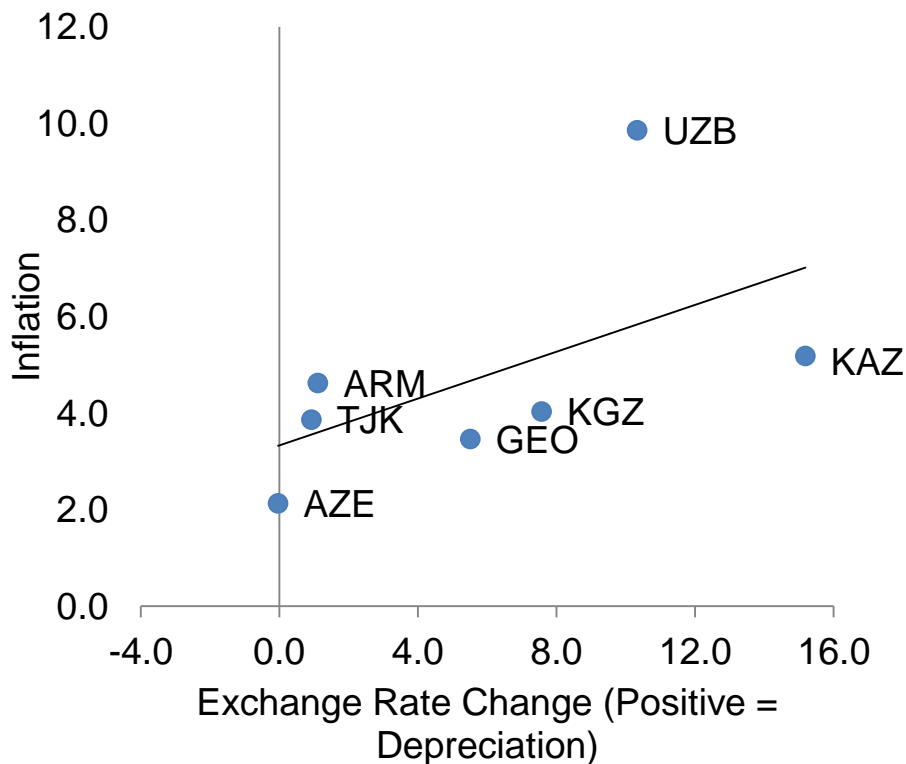
Inflation in CCA

(CPI, percent change)



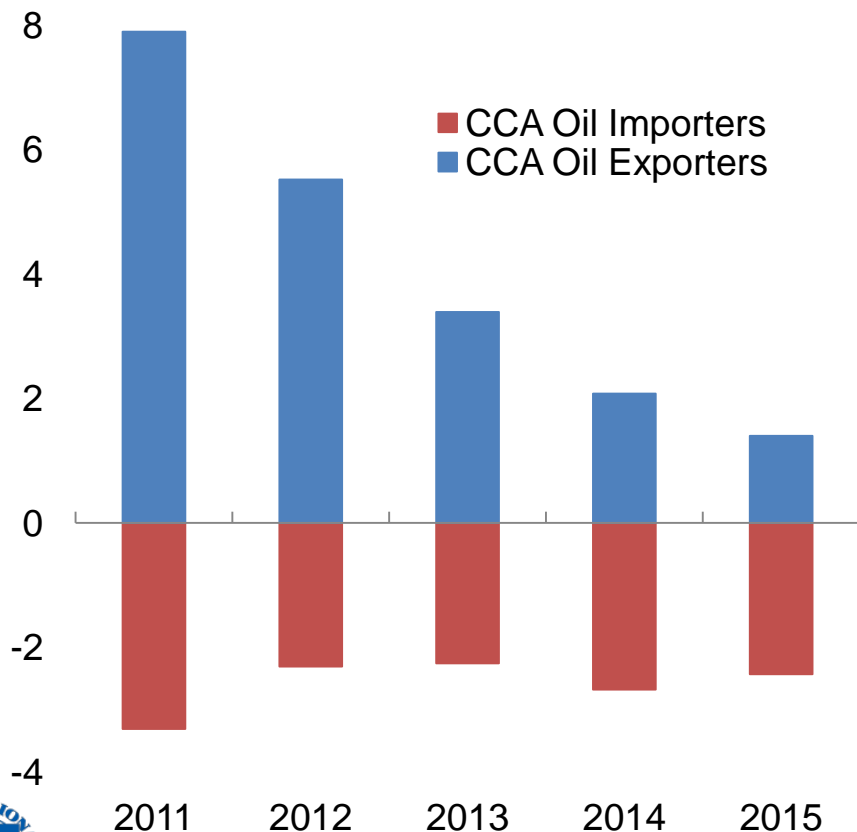
Inflation vs. Nominal Exchange Rate Depreciation

(y-o-y percent change through end-Feb 2014)

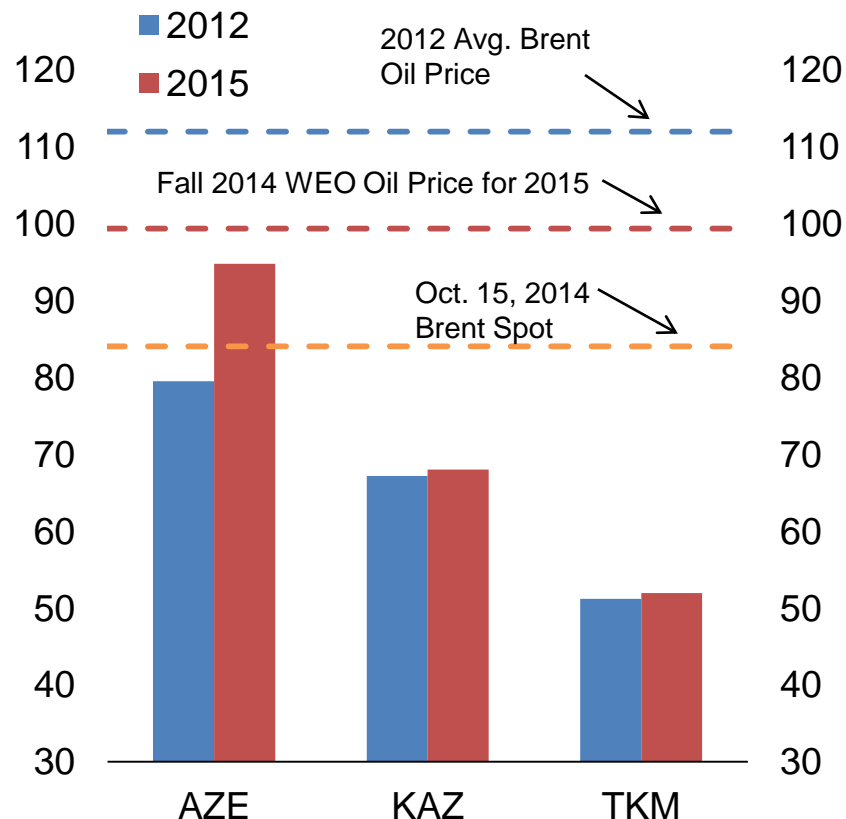


Fiscal positions are vulnerable

Fiscal Balances
(In percent of GDP)

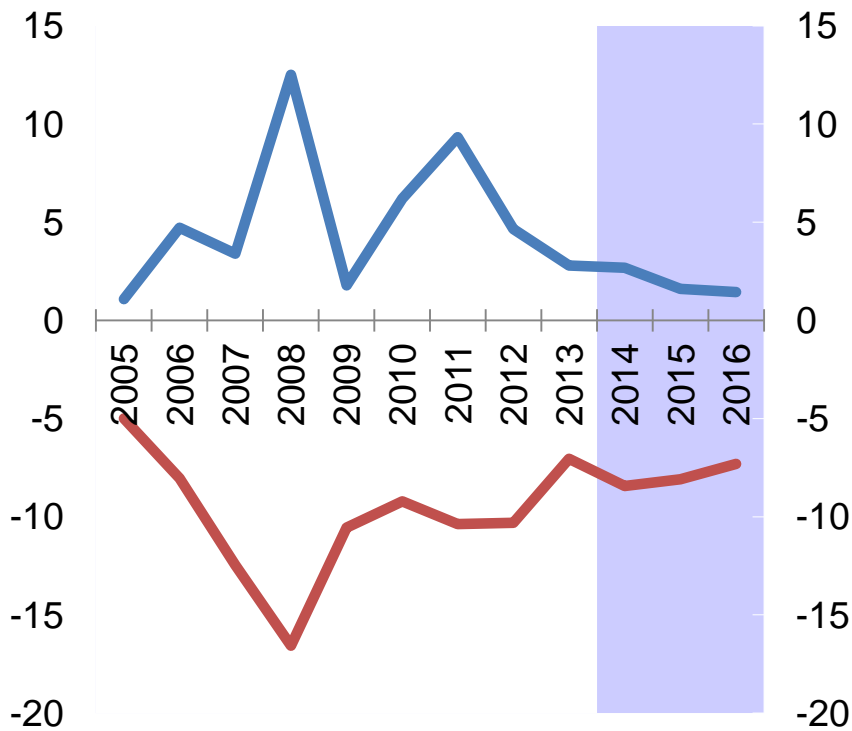


Fiscal breakeven oil prices
(U.S. dollars per barrel)

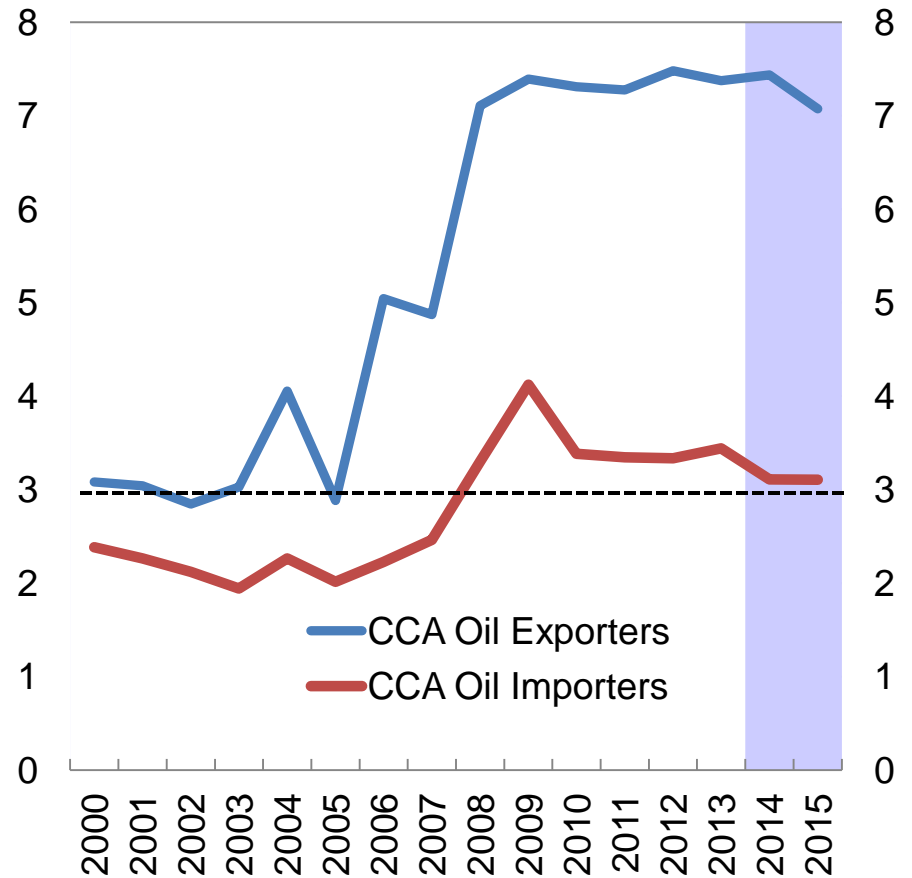


External positions are weakening

Current Account Balances
(Percent of GDP)



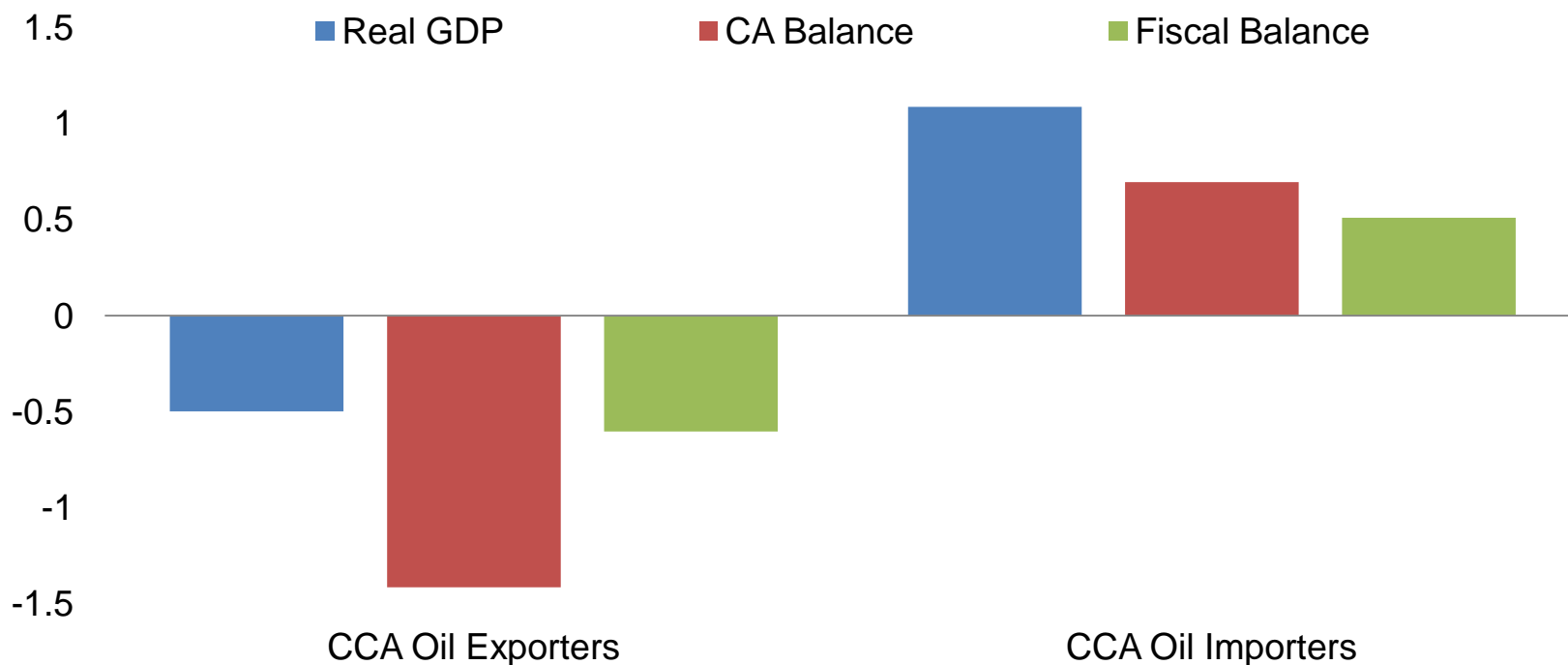
Reserve Coverage
(Months of Imports)



— CCA Oil Exporters — CCA Oil Importers

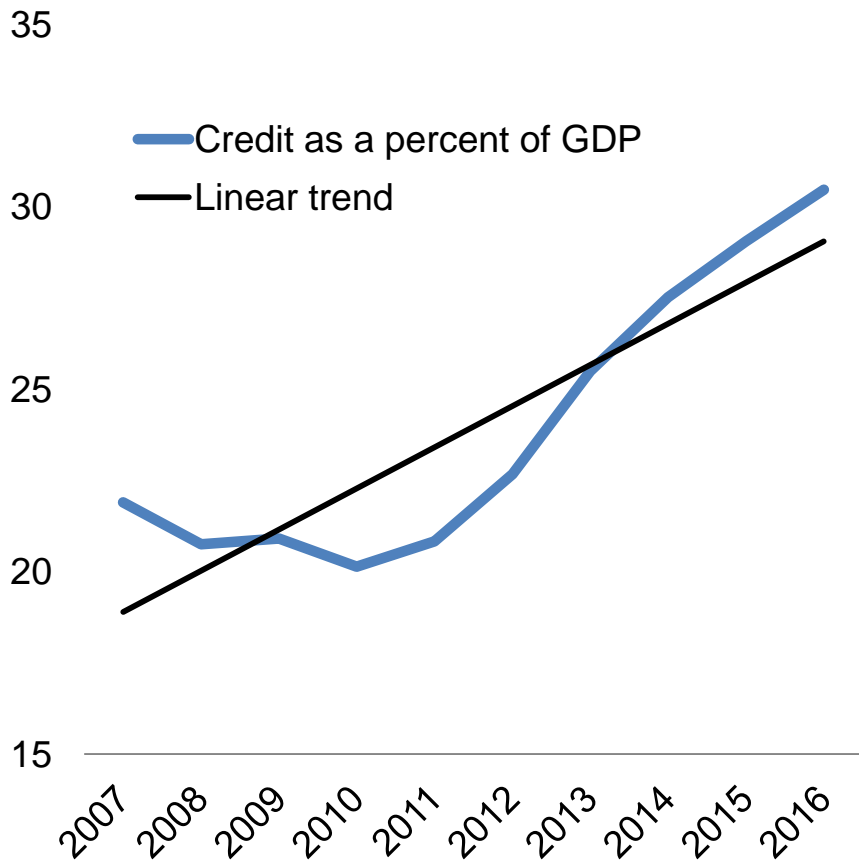
Continued low oil prices would have mixed effects on the CCA oil exporters and importers

Effects of a 20 Percent Decline in Oil prices from the Fall 2014
WEO Baseline, 2015
(Percent of GDP)



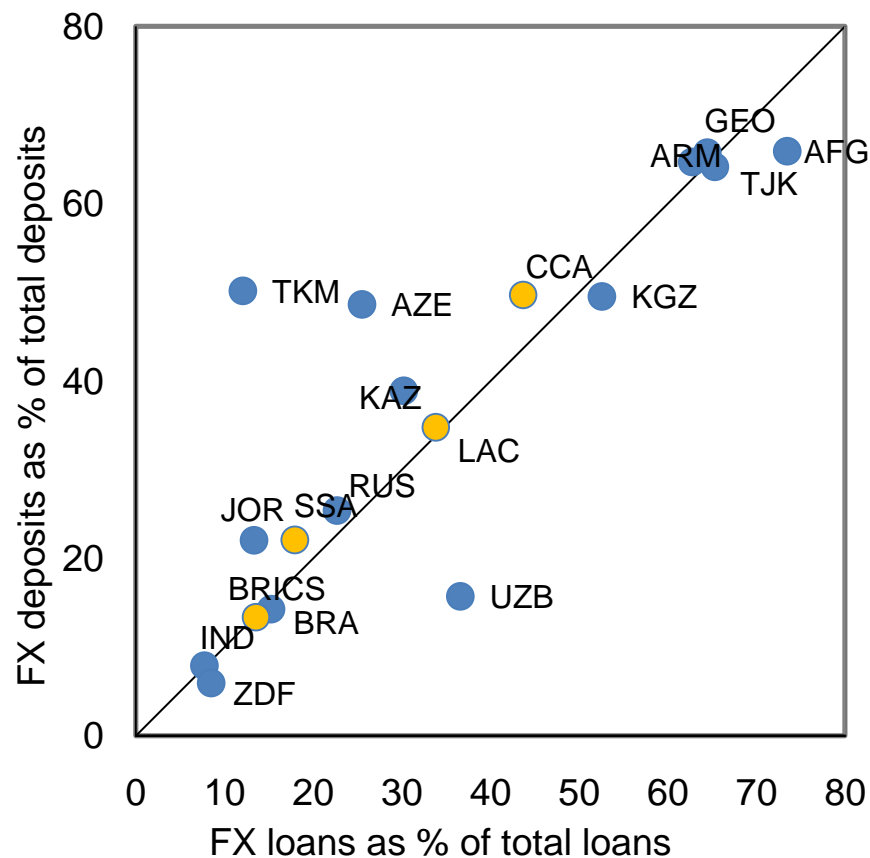
Financial risks (old and new) are significant

Private Sector Credit to GDP vs. Trend



High Dollarization

(latest year available)



Near-term Policy Priorities

Fiscal

- Weakening growth prospects justify a temporary pause in fiscal consolidation, where financing allows, in the context of credible medium-term plans.
- Countries with low buffers and financing shortages need to continue growth-friendly fiscal consolidation.

Monetary & External

- Tighten monetary policy, if inflationary pressures persist.
- Otherwise, monetary policy can remain neutral, and greater exchange rate flexibility can help buffer against shocks and protect export competitiveness.

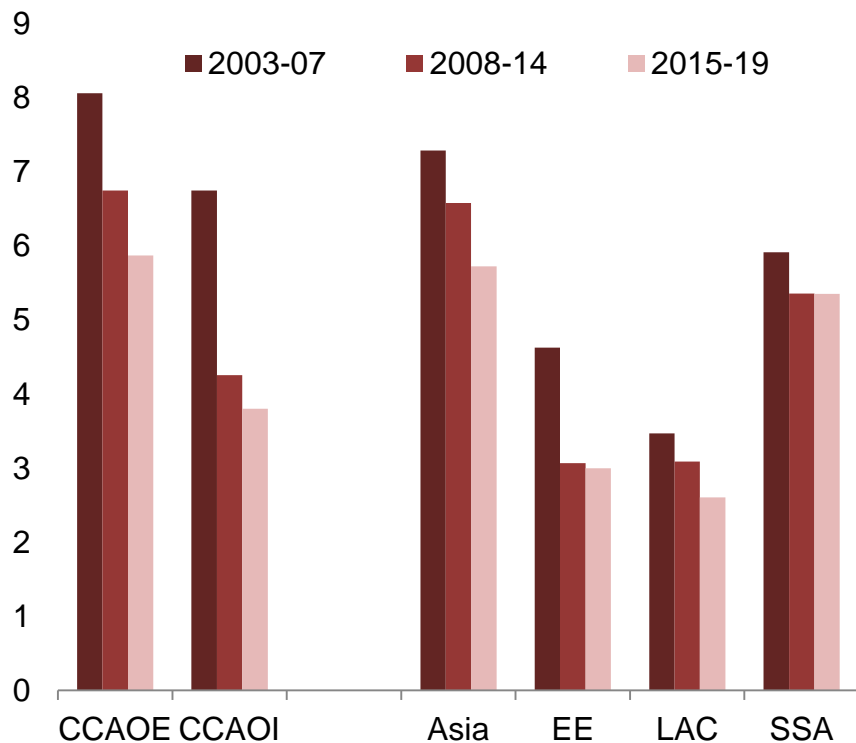
Financial

- Stronger macro-prudential regulations to reduce NPLs and discourage unsustainable increases in consumer loans.
- Reduce dollarization through financial deepening.
- Discourage directed lending.

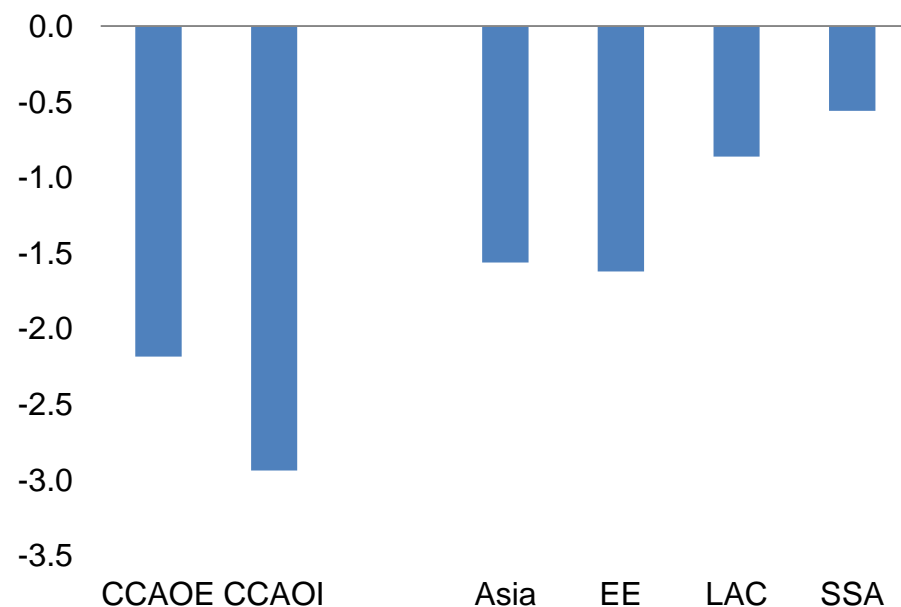


CCA medium-term growth prospects are weakening

Potential GDP Growth
(Percent)



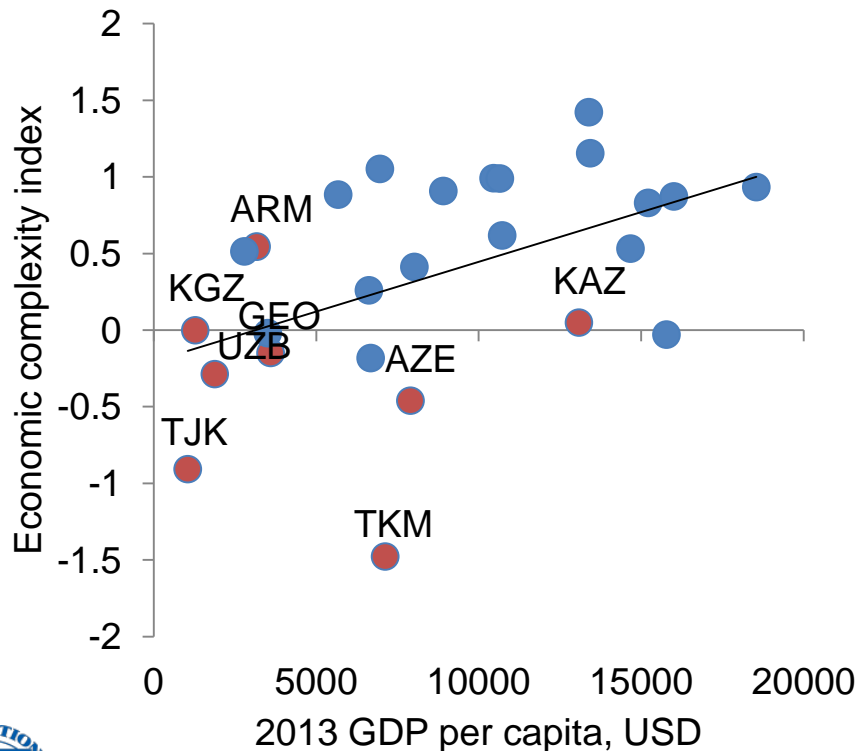
Potential GDP Growth Changes, 2015-19 vs. 2003-07
(Percent)



Growth has been driven by commodities, with little intra-regional trade

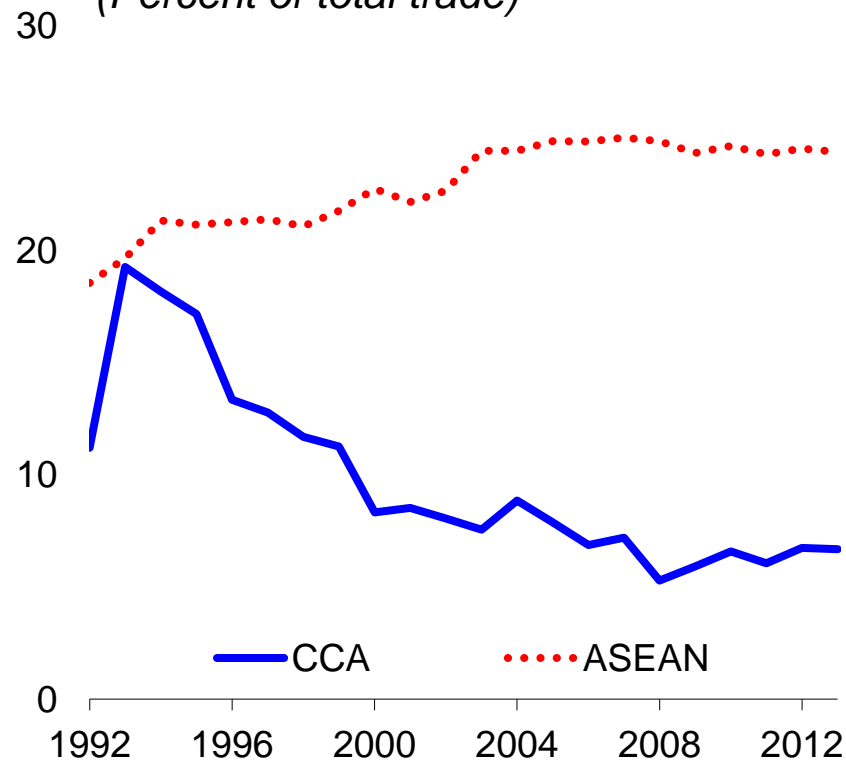
CCA vs. EMs: Economic Complexity

(-3 to +3 scoring scale; higher is better)



Intra-regional Trade

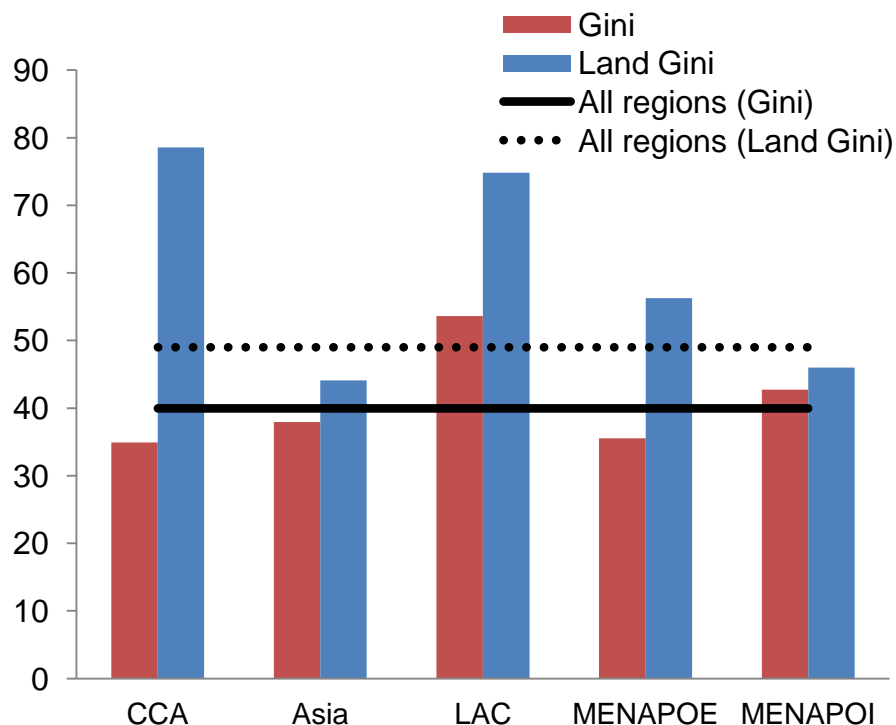
(Percent of total trade)



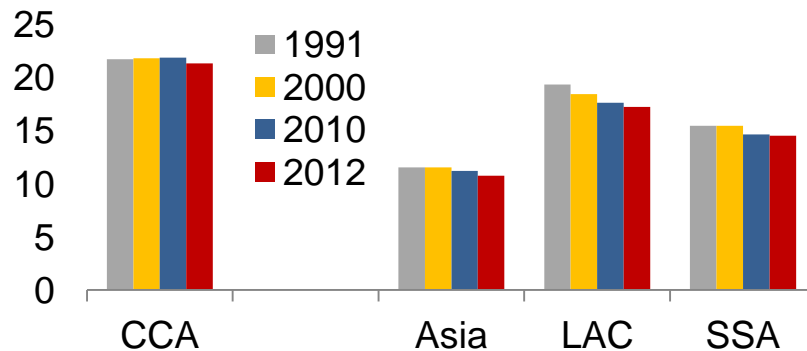
High unemployment and inequality suggest that growth has not been sufficiently inclusive

Gini and Land Gini Indexes

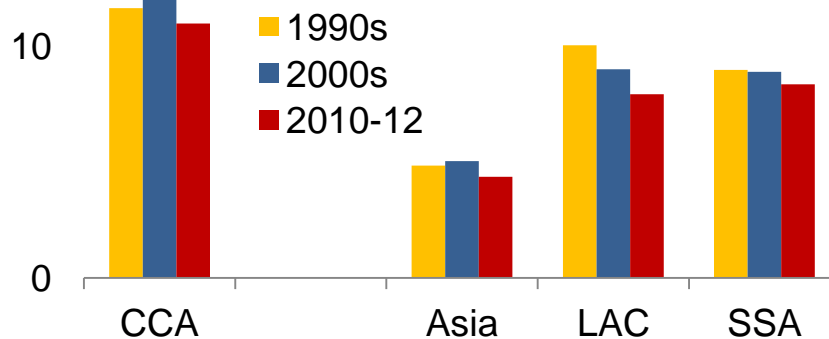
(Index, higher values are more unequal)



Youth unemployment rate (percent)



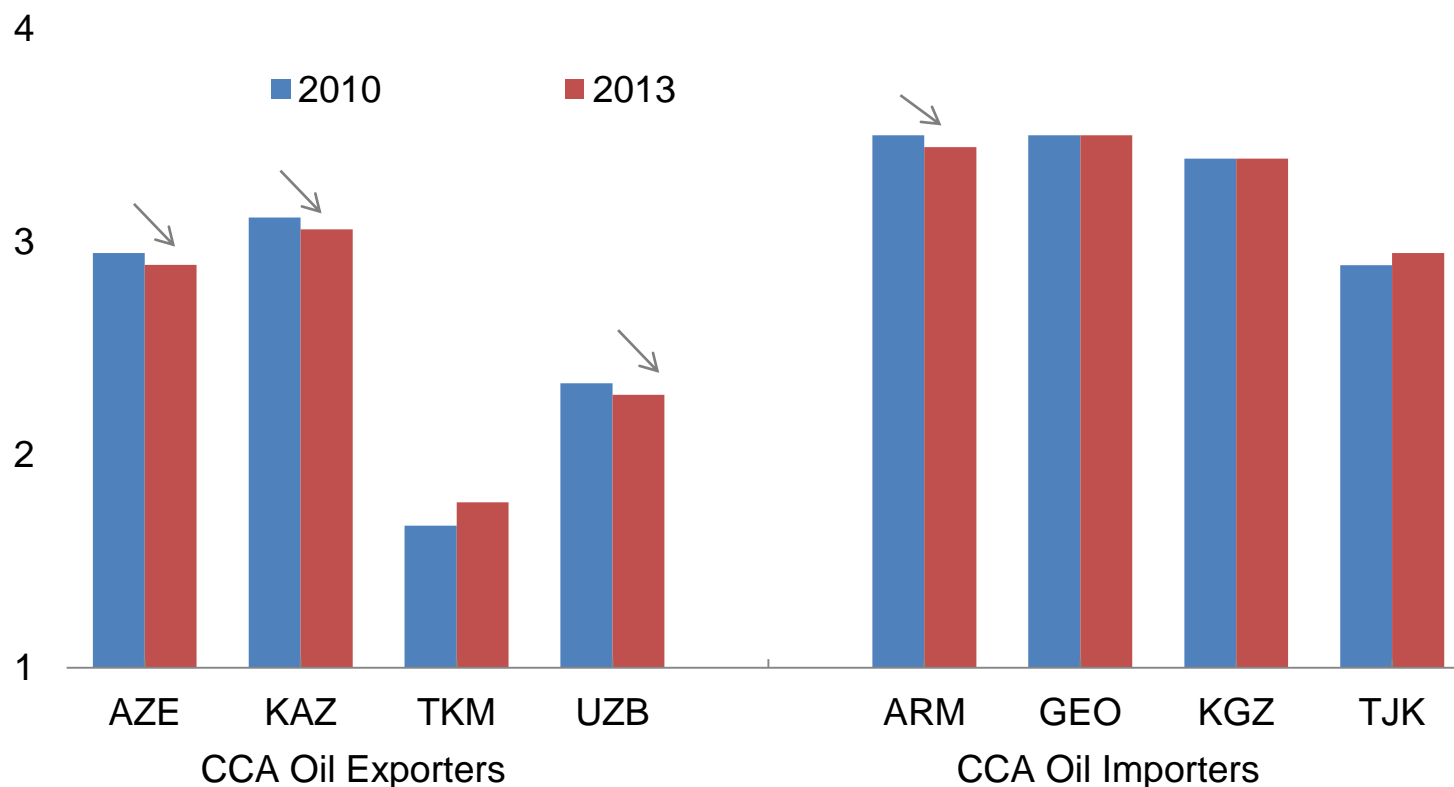
Unemployment rate (Decade averages, percent)



Slowdown in structural reforms does not bode well for raising growth and inclusiveness

Reversals or delays in structural reforms

(1 to 4+ scale; higher is better)



A new economic model is needed



Medium-term Policy Priorities

Bolder Structural Reforms

- Structural reforms, especially in areas of governance and regulation, to address weak growth potential and low inclusiveness.

Wider Economic Integration

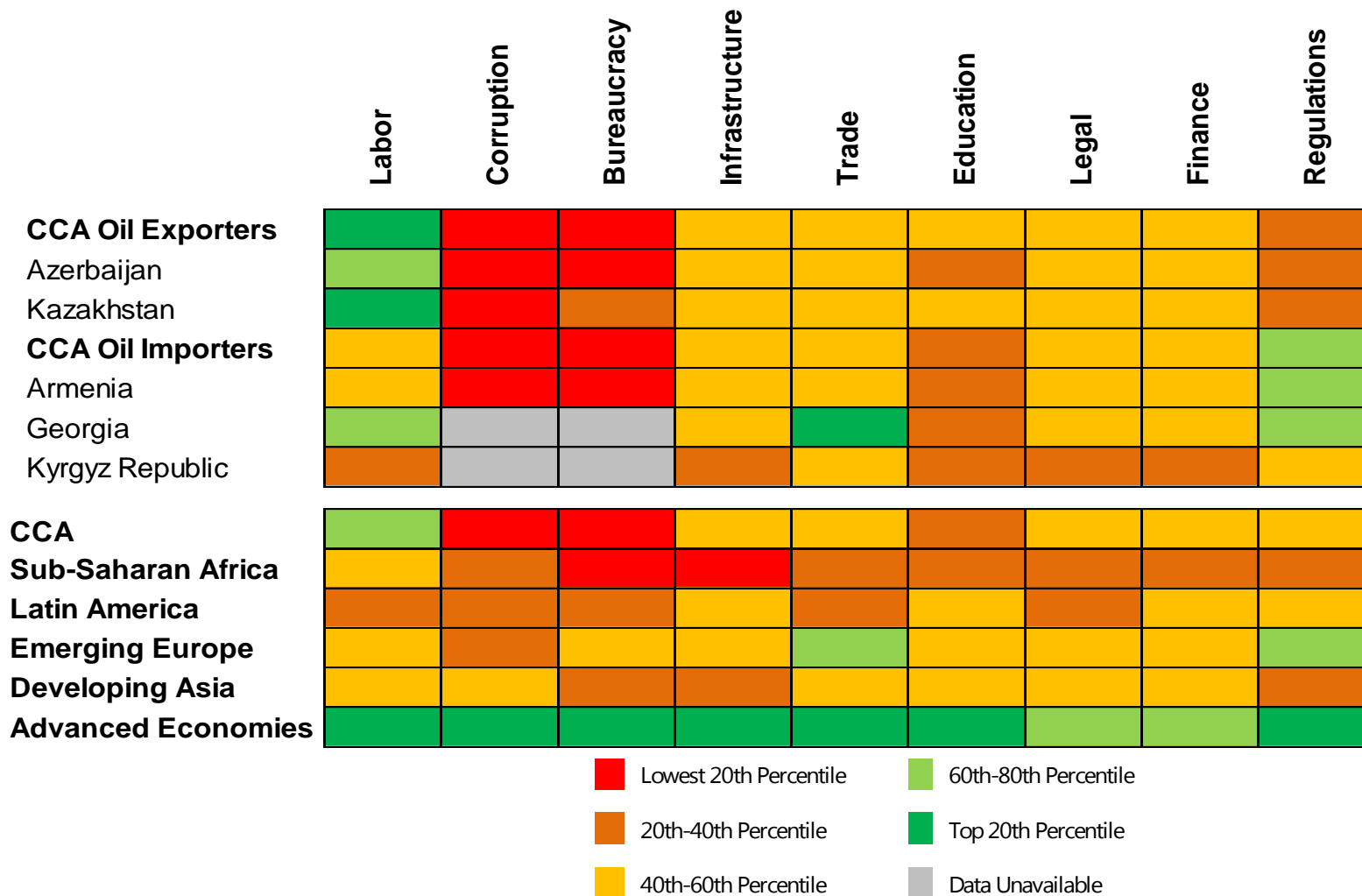
- Balanced regional and multilateral trade integration initiatives, to diversify economies and improve medium-term growth prospects.

Stronger Policy Frameworks

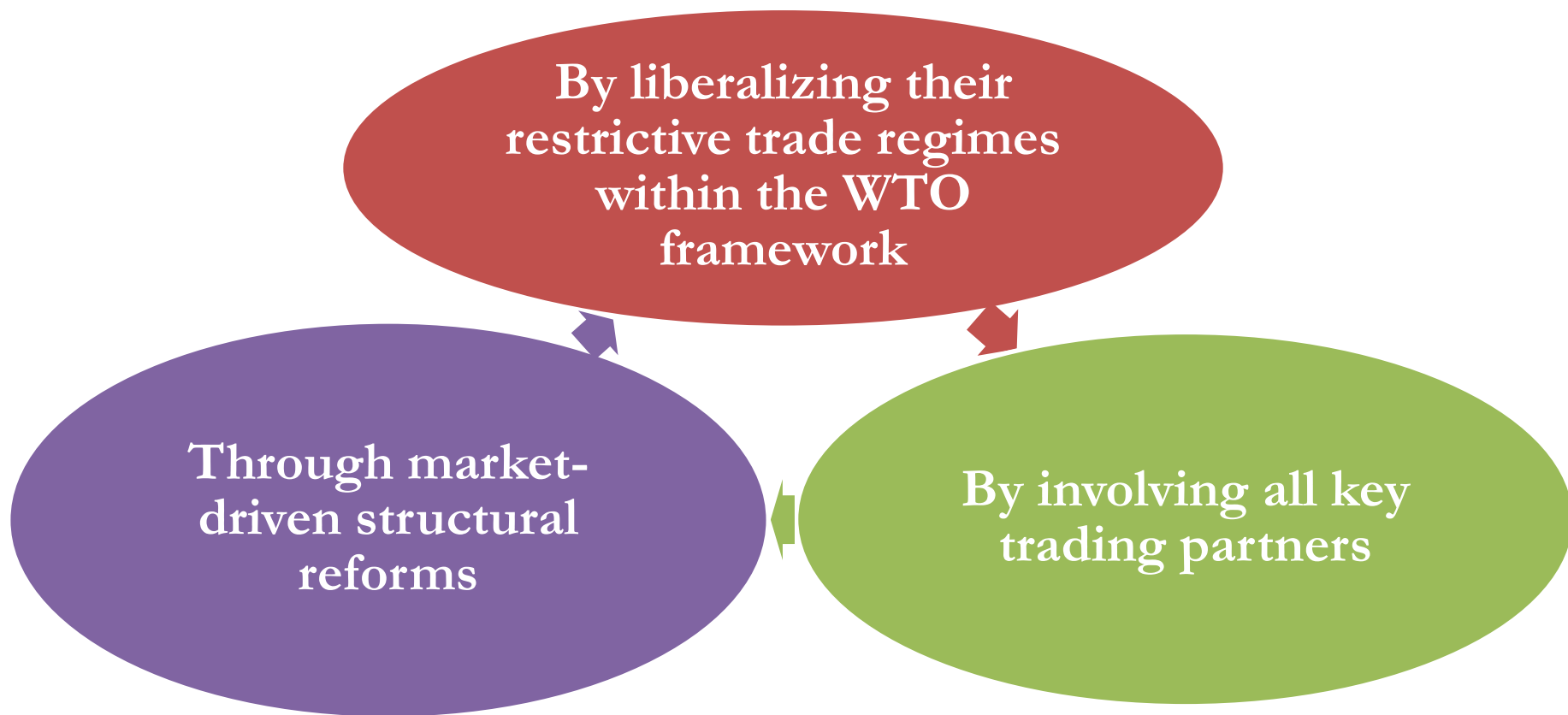
- Fiscal: More fiscal transparency, and stronger medium-term budget frameworks.
- Monetary: Modern monetary policy regimes with clear interest rate guidance, and widening exchange rate bands, to provide an anchor to the economy.

Bold reforms, particularly in governance and regulation, can improve growth and inclusiveness

Structural Reform Priorities



Successful economic integration in the CCA needs to be multilateral and market-driven



Greater exchange rate flexibility would help economies adjust to unanticipated shocks

Monetary Policy Framework

Exchange Rate Arrangement

U.S. dollar or Euro anchor, Monetary Target, Other

Inflation targeting

Conventional peg, Stabilized arrangement, Crawl-like arrangement, Other managed arrangement

Angola, **AZE**, Bangladesh, Belarus, China, Congo, Croatia, **KAZ**, **KGZ**, **TKM**, Macedonia, Nigeria, Rwanda, Russia, **TJK**, **UZB**, Venezuela, Vietnam

ARM, Czech Rep., Dominican Rep.

Floating, Free floating

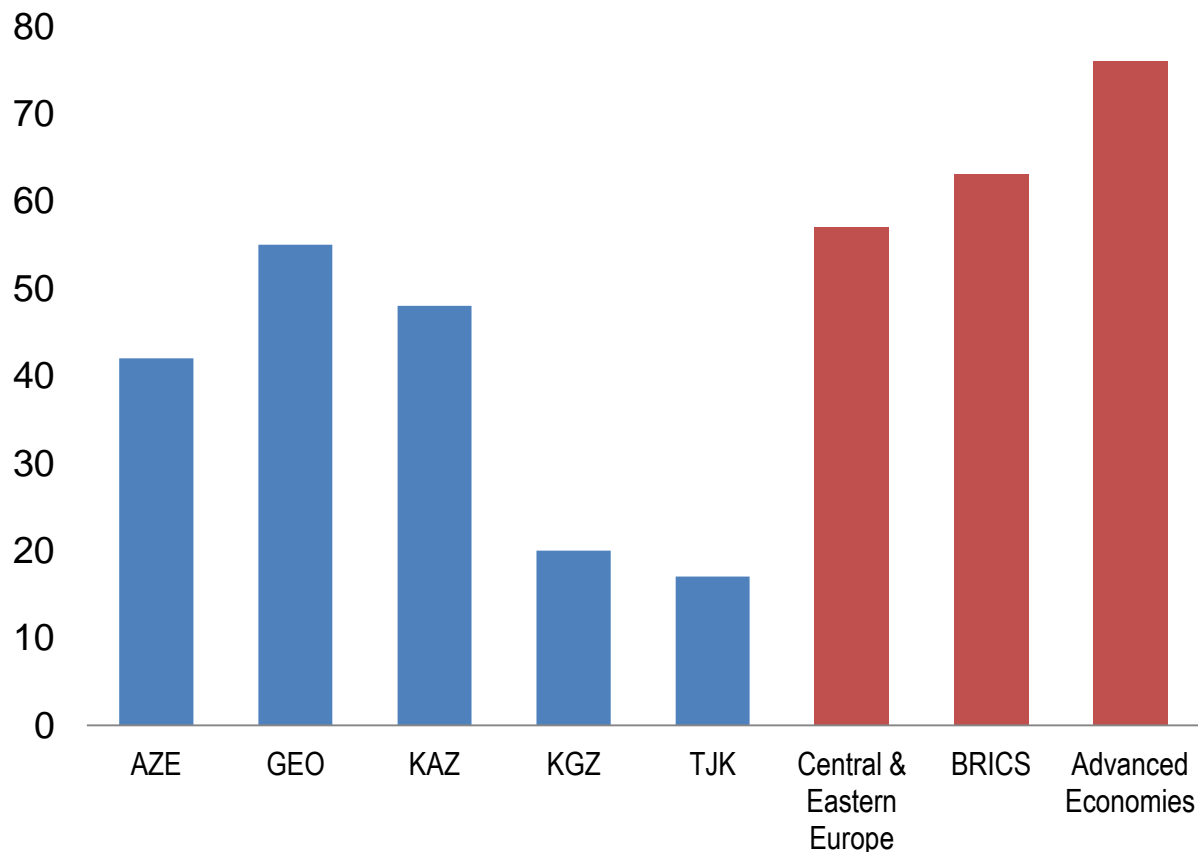
Brazil, Chile, **GEO**, Mexico, Poland, Romania, South Africa, Turkey



Increasing fiscal transparency would strengthen fiscal frameworks and enhance economic resilience

Fiscal Transparency Index

(Index, latest available data; higher values are better)



Overview of Armenia Economy

Outlook

Growth has weakened in 2014 in the context of Russia's slowdown and the EU's still sluggish growth.

Risks

- Recession in Russia, sanctions, slower world growth, high dollarization, energy security, natural disasters, etc
- Old domestic and new regional geopolitical risks

Policies

- Supportive macroeconomic policies in 2015
- Over the medium-term fiscal consolidation, further external adjustment, and greater exchange rate flexibility
- Stepping up structural reforms on taxation, energy, business environment, and financial supervision.

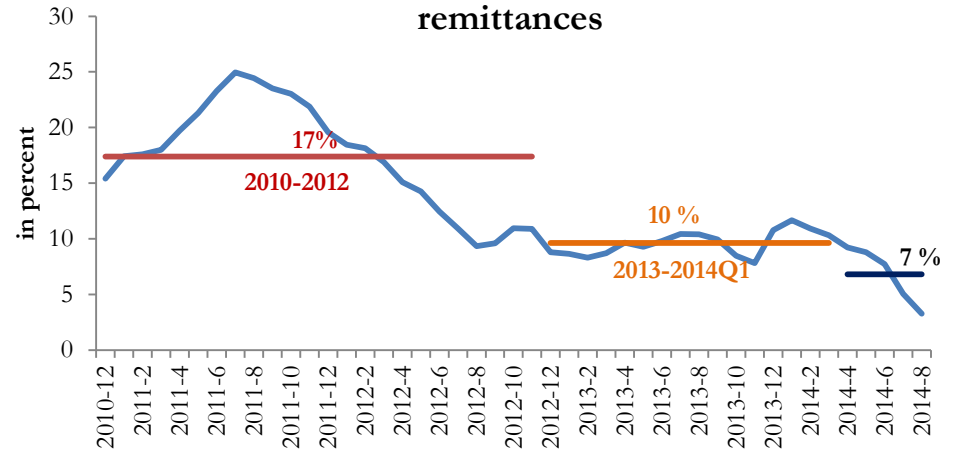


Growth is slowing down ...

..in the context of Russia's slowdown and the EU's still sluggish growth.



Source: World Economic Outlook Database, October 2014



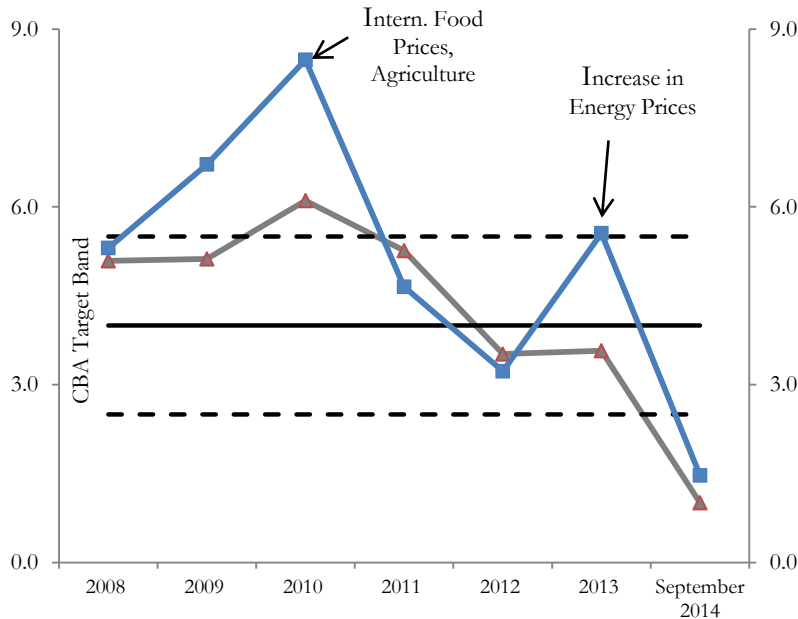
Domestic demand remains weak...

...and inflation low...

...mainly reflecting sizeable budget under-execution.

Consumer Price Inflation
(In 12 month percent changes)

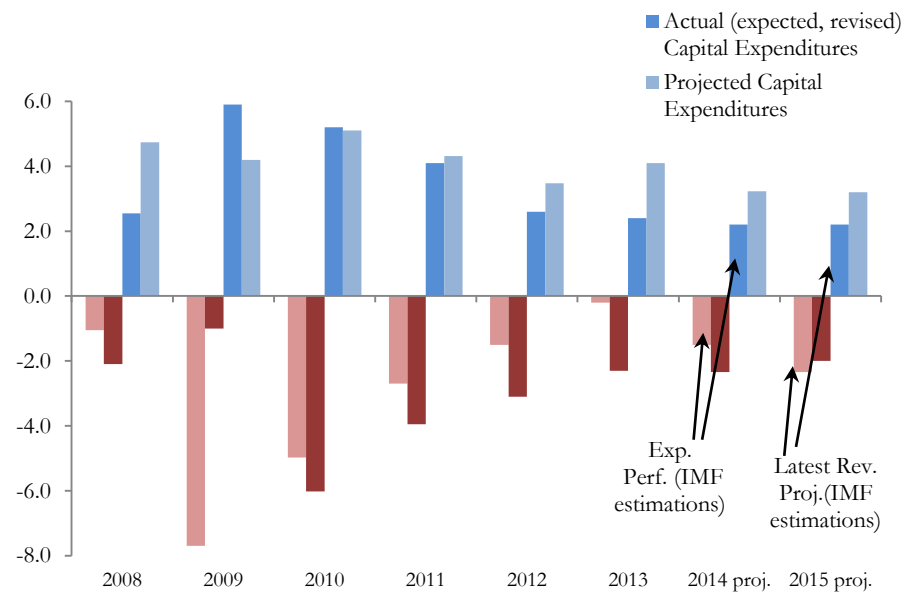
▲ Core Inflation
■ Headline Inflation



Source: National Statistical Service

Performance of Budget Deficit and Capital Expenditure Projections
(In percent of GDP)

■ Actual (expected, revised) Deficit
■ Projected Deficit
■ Actual (expected, revised) Capital Expenditures
■ Projected Capital Expenditures



Source: Ministry of Finance and IMF

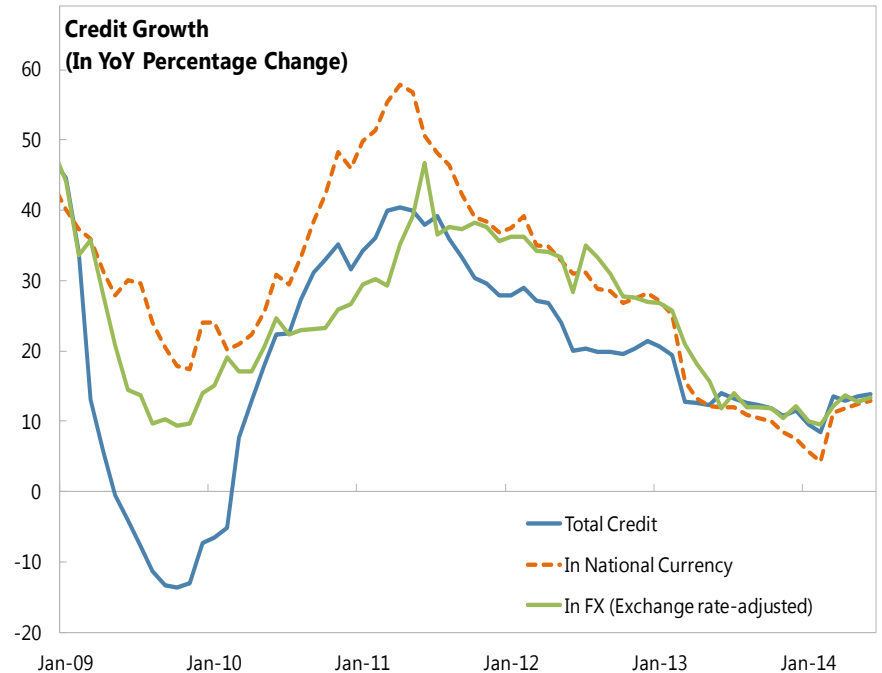
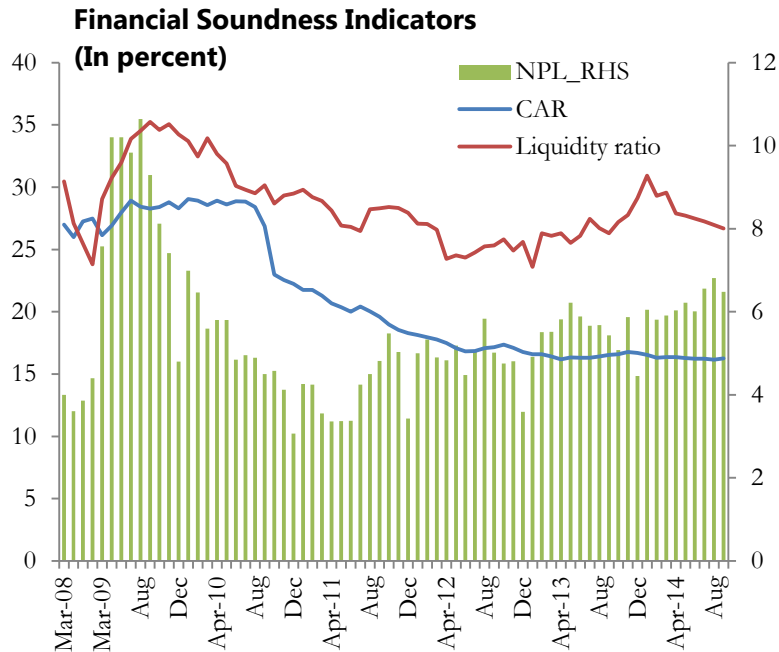
Above the line deficit is presented, gas transaction is excluded from the deficit in 2013



Banking system remains sound

Well-capitalized and liquid...

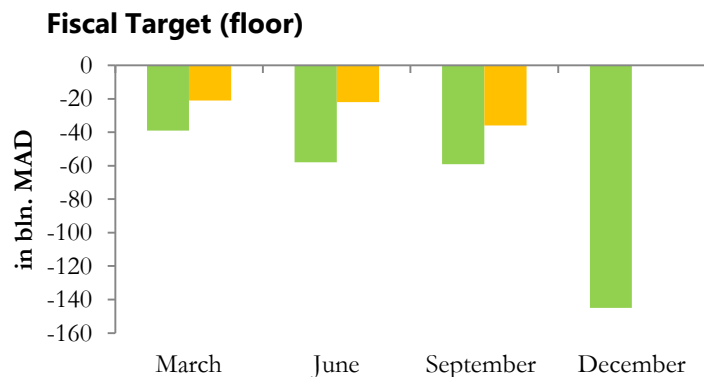
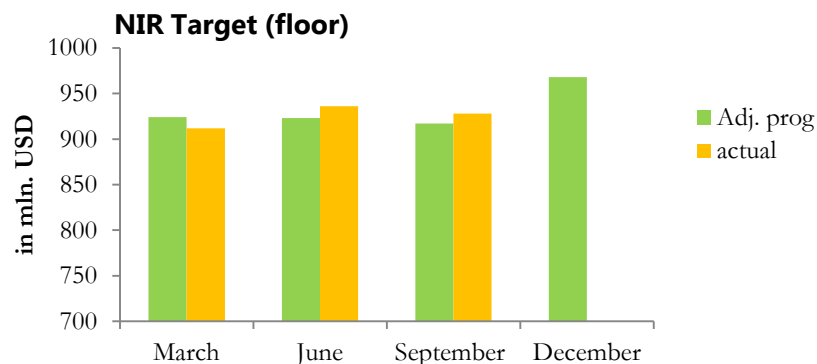
...despite slowdown in credit and picking up in NPL.



Program through June remains on track

Fiscal and reserves target were met, despite pressures on regional currencies in early in 2014

...while structural reforms are advancing, although overall progress has been uneven.



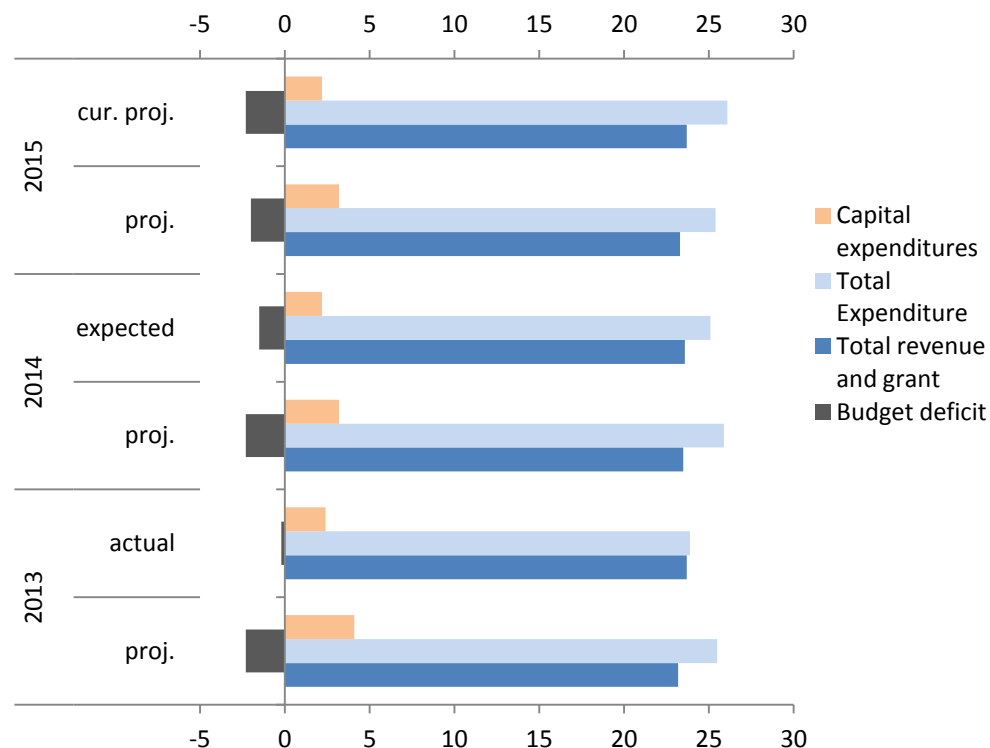
- Financial sector reforms
- Open Skies
- Overhauling of bankruptcy process
- Competition
- Inspections



Program's policies remain essential

- Preliminary agreement on a policy framework for 2014-2015 .
- Moderate fiscal expansion in 2015 to support demand plus efforts to strengthen capital spending execution, improve tax administration, and mitigate fiscal risks.
- The CBA will continue its commitment to a flexible exchange rate and inflation-targeting regime.
- Other reforms aim to enhance the financial sector, the business climate and competition, implement the new pension law, and ensure sustainability and greater efficiency in the energy sector.

Central Government Operations
(In percent of GDP)



Source: Actual data: Ministry of Finance and IMF

Projections: IMF Country Report No. 14/89

Above the line deficit is presented, gas transaction is excluded from the expenditures and deficit in 2013



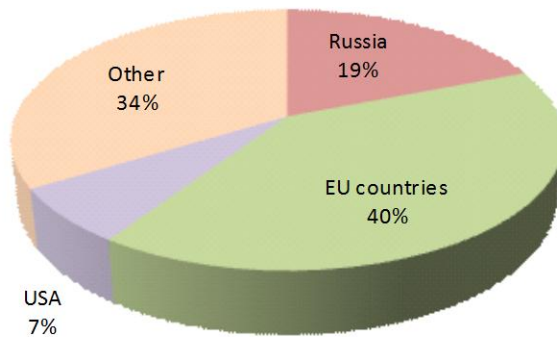
Eurasian Economic Union

- **Accession Treaty signed on October 10 by Presidents; ratification is pending, plus extensive legal changes and implementation**
- **Favorable elements include:**
 - **No custom clearance**
 - **Extensive list of tariff exclusions for 1-8 years**
 - **Participation in the EEU's pool of custom duties**
- **Opportunity for Armenia to increase penetration in Russian market, but also making Armenia more vulnerable to Russian shocks or to the propagation of global shocks through Russia.**
- **Nonetheless, need to continue working on further integration with other trade areas such as European Union.**

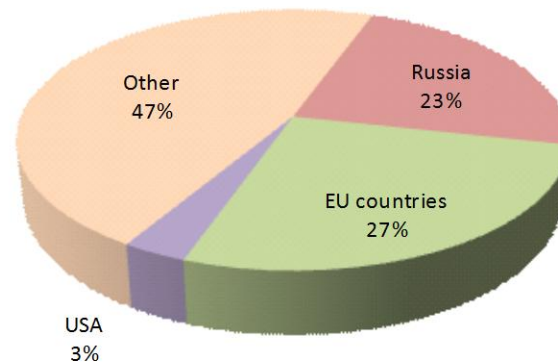


Eurasian Economic Union

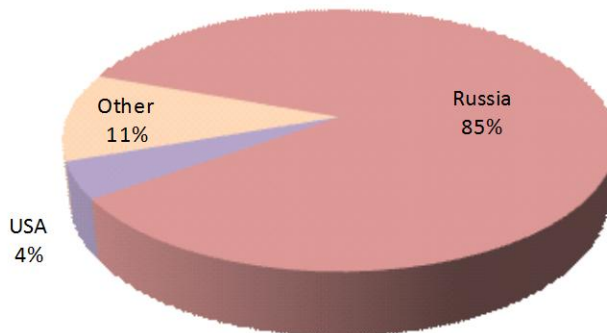
export



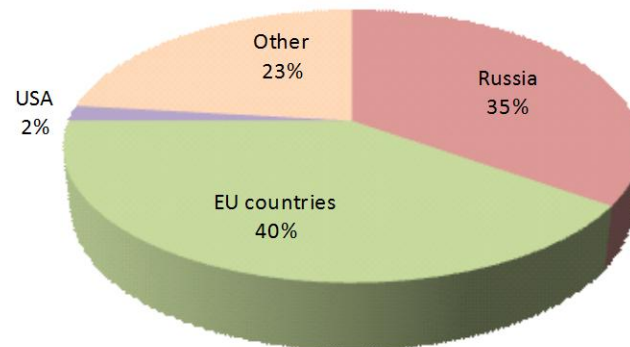
import



remittances



fdi



Takeaways

- Growth is slowing in Armenia, as well in the CCA region because of negative spillovers from Russia and weaker domestic demand, and risks are tilted to the downside.
- Countries with fiscal space and financing, like Armenia, could slow the pace of fiscal consolidation and keep monetary policy neutral, while maintaining credible medium-term plans, while macro-prudentials need to be strengthened.
- Potential growth risks to weaken, including in Armenia. Inclusiveness remains an issue. In some countries, policy frameworks are not sufficiently robust to react to shocks.
- A new economic model is needed: structural reforms to make growth sustainable, more inclusive and diverse and supported by modern policy frameworks.

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