ECONOMIC MONITOR ARMENIA

Berlin Economics

Issue 1 | October 2019 [updated]

Overview

- Economic growth in Q1-19 (7.2%) and Q2-19 (6.5%) significantly higher than expected
- Budget surplus in 7M2019 due to high revenues & under-execution of capital expenditures
- Inflation forecast for 2019 at 2.1%; low inflation key ingredient of macroeconomic stability
- ➢ **Stable macroeconomic situation**

- Significant jump of current account deficit in 2018 to 9.4% of GDP; quite high
- FDI only at 2.1% in 2018, not sufficient for financing the current account deficit
- Imports (+21.4%) increased much stronger than exports (+7.8%) in 2018
- ➢ **Export promotion and FDI attraction key for external stability**

- Mid-term fiscal consolidation: budget deficit ≈ 2% and central gov debt < 50% of GDP
- At the same time: lower tax rates and higher expenditures on social & investment planned
- ➢ **Ambitious mid-term fiscal plans**

Special topics

- Recent political events
- Fight against corruption
- Energy: challenges and government plans
- FDI attraction: focus on most promising target groups and institutional framework

Basic indicators

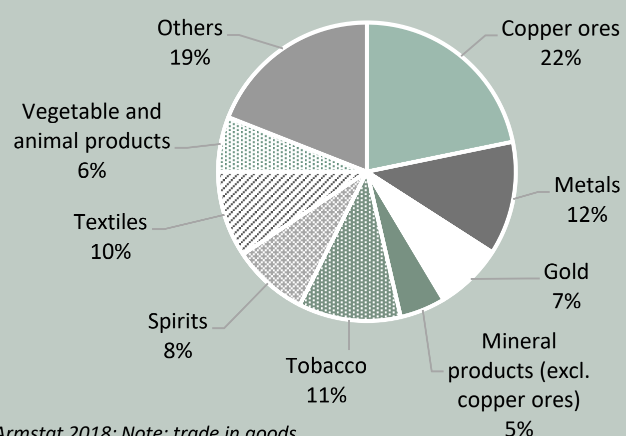
	Armenia	Azerbaijan	Georgia	Belarus	Ukraine	Russia
GDP, USD bn	13.1	45.2	17.2	61.0	134.9	1,610.4
GDP/capita, USD	4,381	4,498	4,661	6,477	3,221	11,191
Population, m	3.0	10.0	3.7	9.4	41.9	143.9

Source: IMF WEO from April 2019; Forecast 2019

Trade structure

Exports

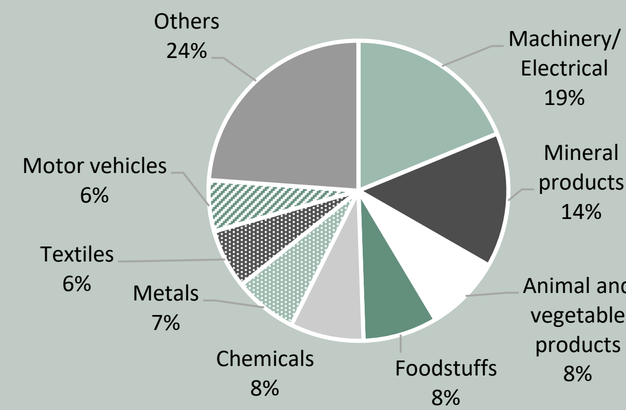
EU 28% | Russia 28% | Switzerland 14% | Others 30%



Source: Armstat 2018; Note: trade in goods

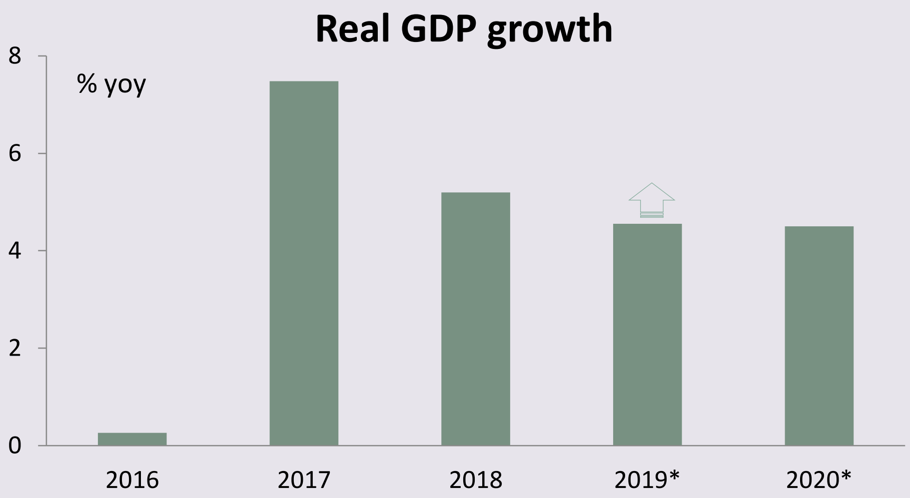
Imports

EU 23% | Russia 25% | China 13% | Others 39%



Source: Armstat 2018; Note: trade in goods

Economic growth



*Source: IMF; *Forecast. Note: forecast 2019 to be revised upwards*

Long-term GDP impact of successful reforms

Reform measure	Impact, % of GDP
Revenue-neutral tax policy reform	0.4
Governance	1.5
Labour market reforms	2.5

Source: IMF Country Report from June 2019

Economic growth

- 2018: growth down to 5.2%, mainly due to lower gov capital spending in H2-18
- Q1-19: 7.2%, Q2-19: 6.5%, significantly higher than forecast

Opportunities for mid-term higher growth

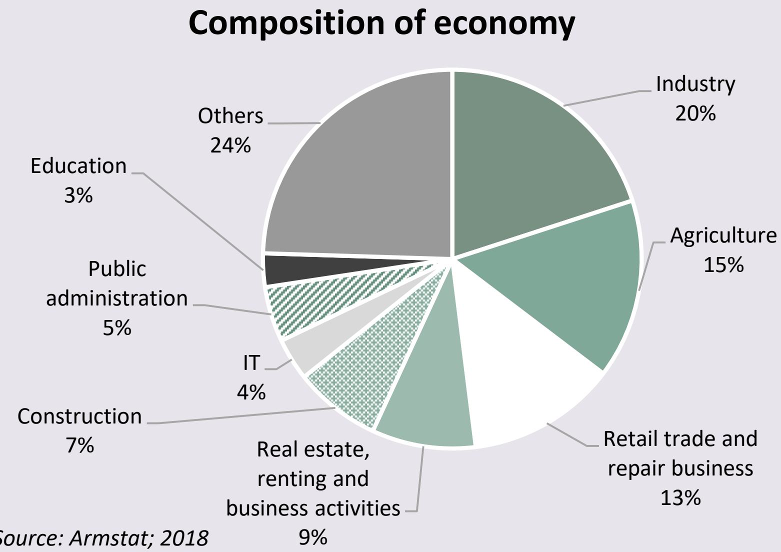
- Gov plans reforms on tax policy, governance and labour market
- If these reforms are well implemented, medium term growth should be higher

Downside risks

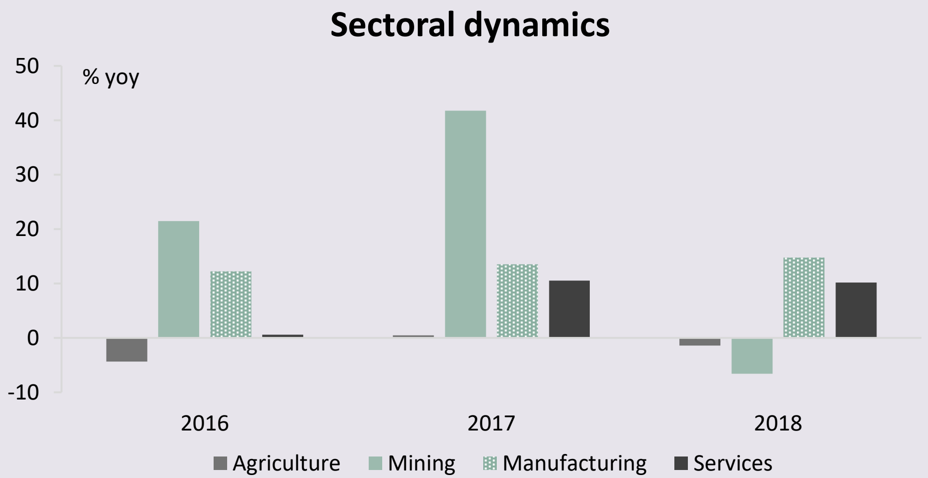
- Lower growth of trading partners
- Increase of regional geopolitical tensions (US-Iran, Nagorno-Karabakh)

Mid-term growth depends to a large extent on successful implementation of reforms, i.e. on internal factors

Sectoral perspective



Source: Armstat; 2018



Source: Armstat

Agriculture
- Weak performance in the last three years; contraction in 2018
- Structural problems in agriculture

Mining
- 2018: copper mine Teghut and foundry temporarily closed; negative impact on exports and growth
- Recently: Teghut re-started operations

Manufacturing
- Positive contribution to GDP

Services
- Dynamic sector, considerable contribution to growth in 2018
- IT: 4% of GDP; quite substantial

➢ **In general: important role of mining**

➢ **2018: manufacturing & services offset contraction in agro & mining**

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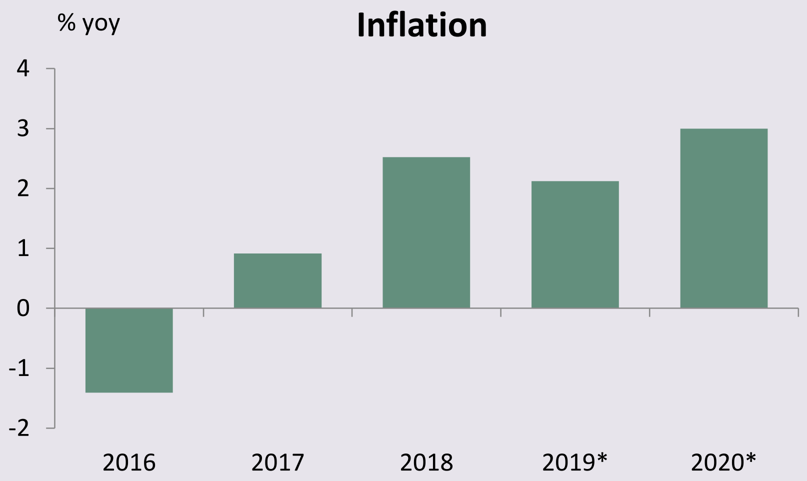
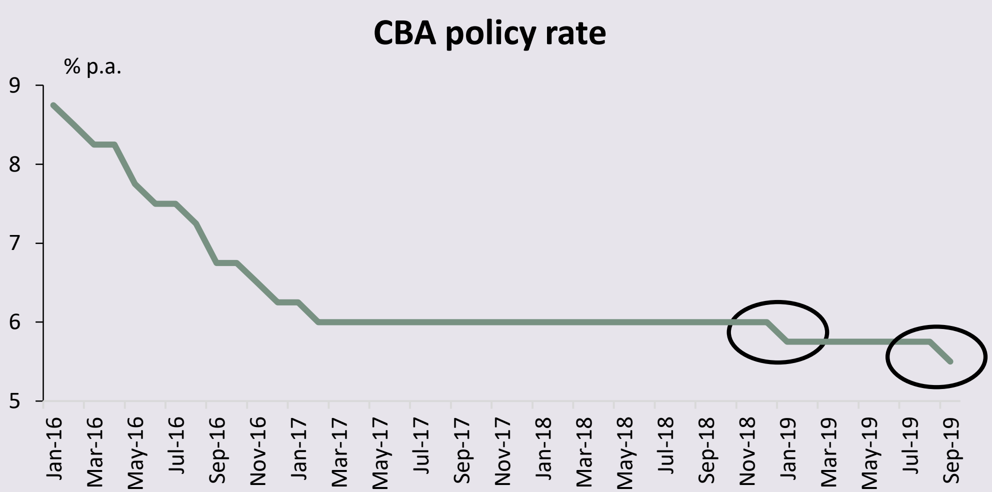
Inflation and monetary policy



*Source: IMF; *Forecast; Note: annual average (consumer prices)*



Source: Central Bank of Armenia

Monetary policy

- Central Bank of Armenia (CBA) implements "inflation targeting"
- Medium-term target is 4%, with a tolerance band of +/-1.5%
- Jul 2019: inflation rate at 1.7% yoy
- Overall: CBA successful in keeping inflation under control

Policy rate

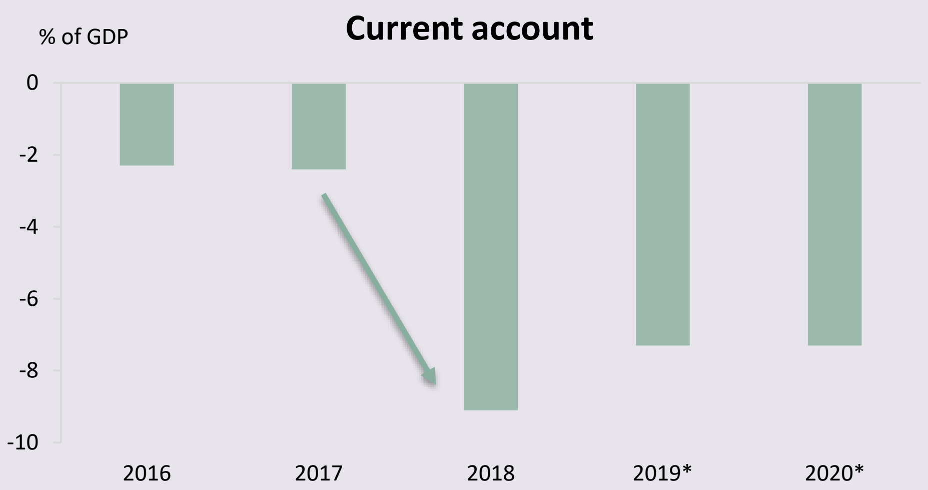
- 2019: policy rate was reduced twice by 25bp in the context of low inflation
- Current policy rate: 5.5%

Main challenges for monetary policy

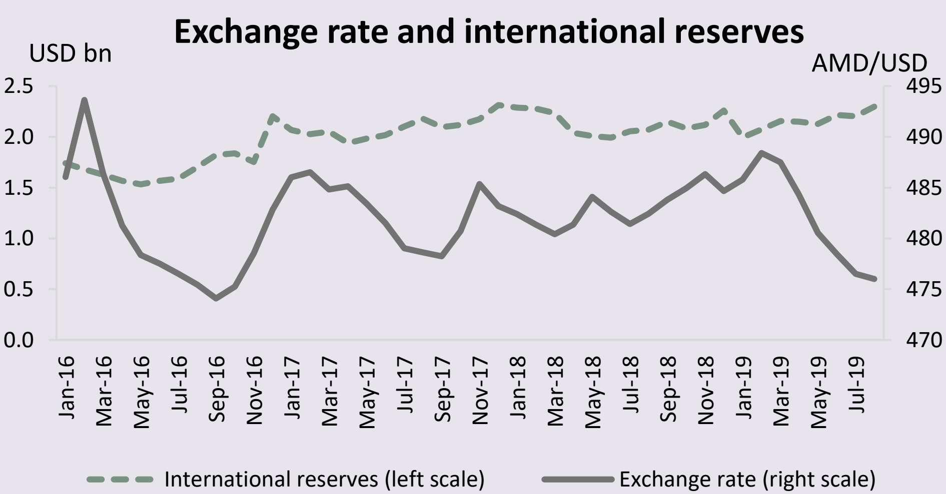
- Improve policy credibility and better anchor inflation expectations
- Reduction of dollarisation
- Development of capital markets

➢ **Stable and low inflation; key ingredient of macro stability**

Current account and exchange rate



*Source: IMF; *Forecast*



Source: Central Bank of Armenia

Current account

- 2018: jump in current account deficit (CAD) to 9.4% of GDP; quite high

Reasons

- Imports of goods grew much stronger (+21.4%) than exports (+7.8%) in 2018
- Temporary closure of copper mine and foundry contributed to weak exports
- High repatriation of profits

Capital account

- FDI only 2.1% of GDP (USD 266 m) in 2018 and strong decline in 6m2019
- FDI not sufficient for financing CAD

➢ **Need to increase exports and attract more FDI to ensure external stability**

International FX reserves

- Aug 2019: USD 2.3 bn or about 3.9 months of imports of goods and services

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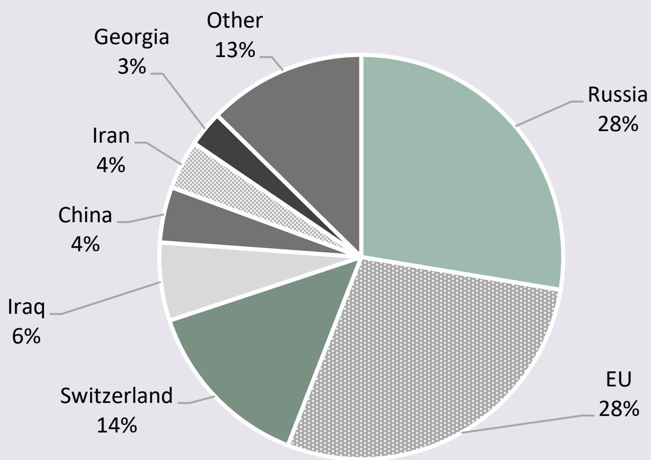
Trade in goods

Export by countries



Source: Armstat, 2018; Note: Trade in goods

Exports of mining products and metals in 2018

	USD m	% of total exports
Copper ores	525.5	21.8%
Other mineral products	119.2	4.9%
Metals	296.6	12.3%
Gold	176.9	7.3%
Sum	**1,118.2**	**46.3%**

Source: Armstat, Note: Trade in goods

Regional structure of trade

- EU and Russia are main export destinations, with a share of 28% each in total exports
- Large share of Switzerland (14%) due to exports of gold and copper

➢ **Regional trade rather limited, despite being a landlocked country**

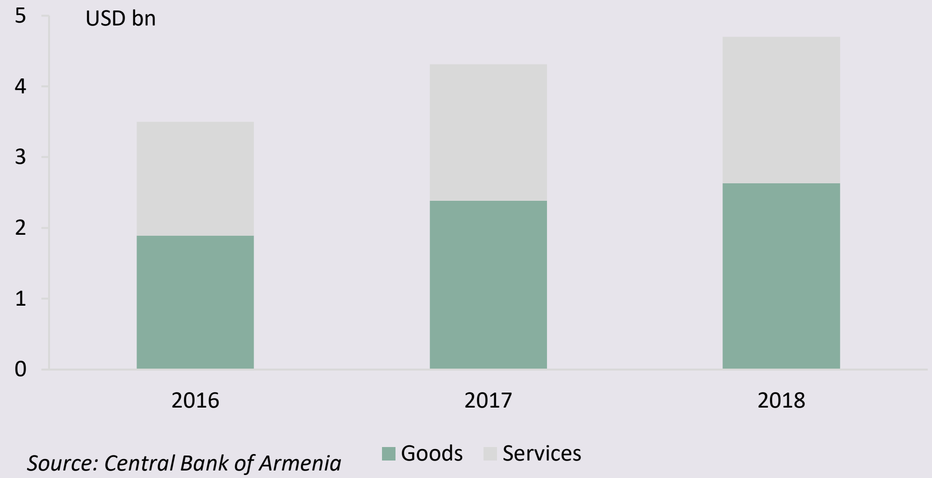
Reasons

- No trade with Azerbaijan and limited (indirect) trade with Turkey
- But also: concentrated commodity composition of exports; mining and metals 46% of total exports

➢ **Diversification of commodity composition of exports important to reduce external vulnerability**

Trade in services

Export of goods and services



Source: Central Bank of Armenia

Importance of exports of services – international comparison

	Share of services in total exports, 2018
Georgia	51%
Armenia	**44%**
USA	33%
Ukraine	27%
Azerbaijan	23%
Germany	18%
Russia	13%

Source: central banks of respective countries

Goods vs services

- Exports of goods, 2018: USD 2.6 bn
- Exports of services, 2018: USD 2.1 bn
- Services account for 44% of total exports, rather high

Main exports of services, 2018

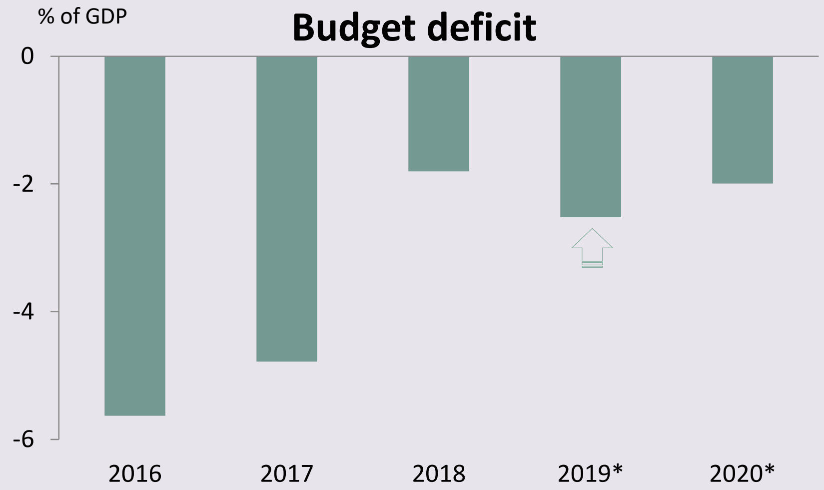
- Tourism: USD 1,208 m
- Transport: USD 256
- IT: USD 252 m
- Construction: USD 191 m

Reasons for strong exports of services

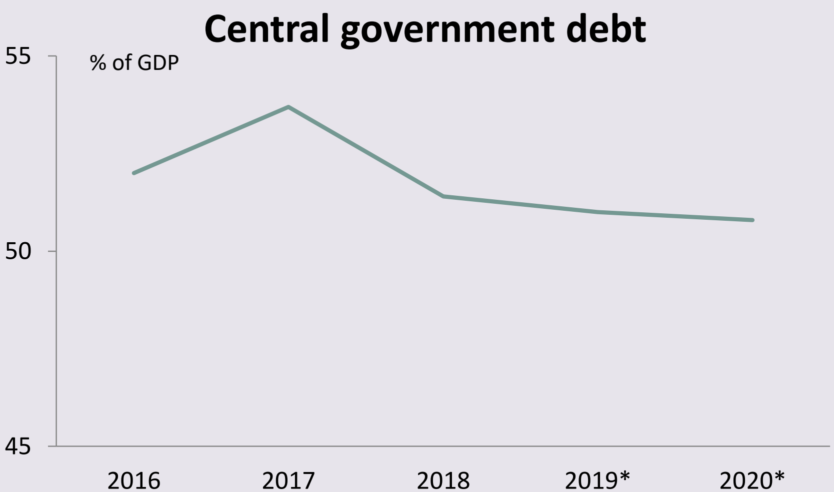
- Limited regional trade
- Landlocked country with relatively high transportation cost for goods
- Tourism: strong link to large diaspora
- IT: strong link to FDI in IT sector

Strong performance of services' exports makes economic sense

Public finances and government debt



*Source: IMF; *Forecast. Note: 2019 likely to be revised updwards (i.e. lower deficit)*



*Source: IMF; *Forecast*

2015-2017

- High budget deficits after shock in 2014

2018

- Revenues at 21.7% of GDP, as planned
- Expenditure only 23.5% of GDP, due to under-execution of capital expenditure
- Result: budget deficit only 1.8% of GDP; key contributor to lower GDP growth

7M2019

- Considerable under-execution of capital expenditure leads to a budget surplus

➢ **Low capital expenditure is an issue, as it reduces mid-term growth perspectives**

Mid-term outlook

- Medium term reduction of deficit to ≈ 2%
- Central gov debt < 50% (end 2017: 53.7%)
- Context: IMF programme

➢ **Fiscal consolidation planned**

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Revenue and expenditure plans

Budget 2020 ff: revenue side

Tax	Current	Planned
Personal income tax	progressive 23-36%	flat 2020: 23% 2021: 22% 2022: 21% 2023: 20%
Corporate income tax	20%	18%

Source: multiple sources

Budget 2019: expenditure side

Social spending	+9%
Capital spending	+27%

Source: IMF

Revenue side from 2020 onwards

- Lower personal income tax rate
- Lower corporate income tax
- Very high threshold for VAT participation
- Practically no taxation of microbusiness

Planned expenditures in 2019

- Higher social expenditure & public investment

Key question

- Compatible with fiscal consolidation?

Government approach

- Higher taxes for alcohol, tobacco, etc. as part of a general shift from direct to indirect taxes
- Strengthening tax administration
- Stronger property taxation
- FDI attraction and job creation
- Possibly: Laffer curve effect, i.e. lower tax rates lead to higher tax revenues

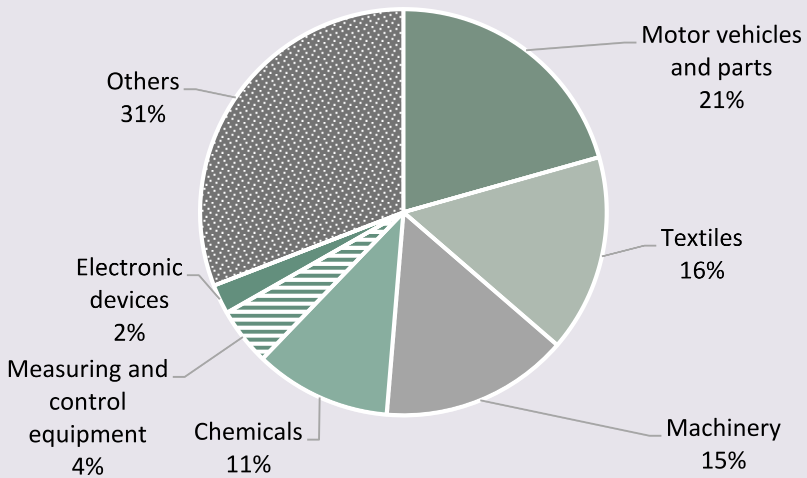
➢ **Ambitious plans in the fiscal sphere**

Bilateral trade between Germany and Armenia

German trade with Armenia

Source: German Federal Statistics Office; Note: Trade in goods

German exports to Armenia



Source: German Federal Statistics Office, 7M2019

Turnover

- 2018: EUR 344 m, increase by 30%
- Germany is Armenia‘s most important trading partner in the EU, followed by Bulgaria and Italy
- 7M2019: decrease by 26%

German exports

- 2018: significant increase by 31%
- Main reason: higher exports of cars
- 7M2019: decrease by 27%

German imports

- 2018: sizeable rise by 28%
- Main reason: increase in metals imports
- 7M2019: decrease by 23%

Strong performance of bilateral trade in 2018; weaker data for 7M2019

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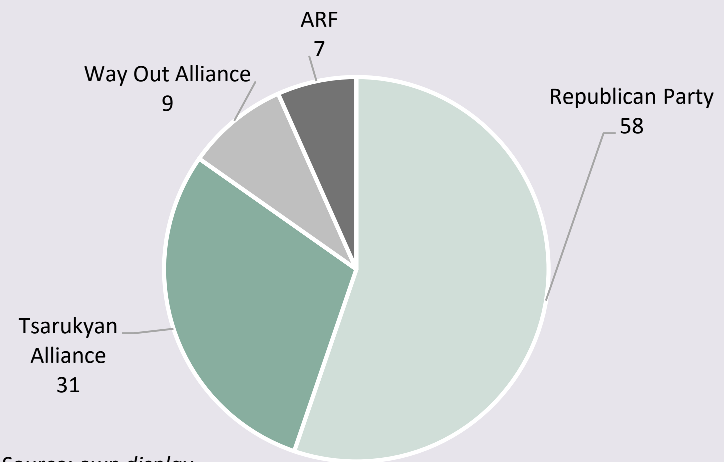
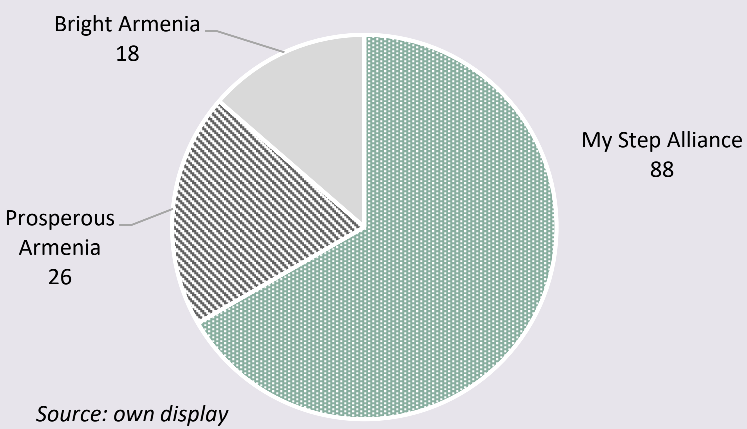
Recent political events

Seat distribution in former National Assembly



Source: own display

Seat distribution in new National Assembly



Source: own display

Key events

- **May 2018:** Pashinyan elected Prime Minister following massive protests
- **Oct 2018:** National Assembly dissolved
- **Dec 2018**: snap parliamentary elections
- **Jan 2019**: new government in office
- **Feb 2019**: 5-year programme announced

Seat allocation in new National Assembly

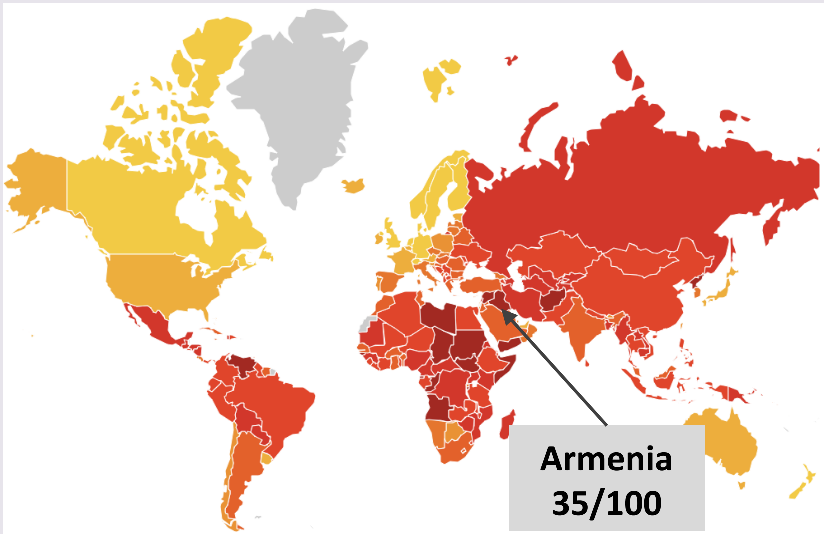
- My Step Alliance: 70.42% (88 seats)
- Prosperous Armenia: 8.26% (26 seats)
- Bright Armenia: 6.37% (18 seats)

➢ **Radical change in party political landscape; traditional parties no longer in Parliament**

➢ **Vast majority for PM Pashinyan crucial to enable swift implementation of reforms**

Fight against corruption

Corruption Perception Index, 2018



Source: Transparency International

Trading across borders, 2018

Country	Rank
Georgia	43
Ukraine	78
Azerbaijan	84
Russia	99
Armenia	**125**

Source: World Bank

Starting point

- Widespread corruption in Armenia
- Negative impact on economy and FDI

New gov: fight against corruption top priority

Progress so far

- Jan 2019: slight improvement in Corruption Perceptions Index; from 107th to 105th
- More importantly: companies report about much less problems at the border; customs appear to be working much better

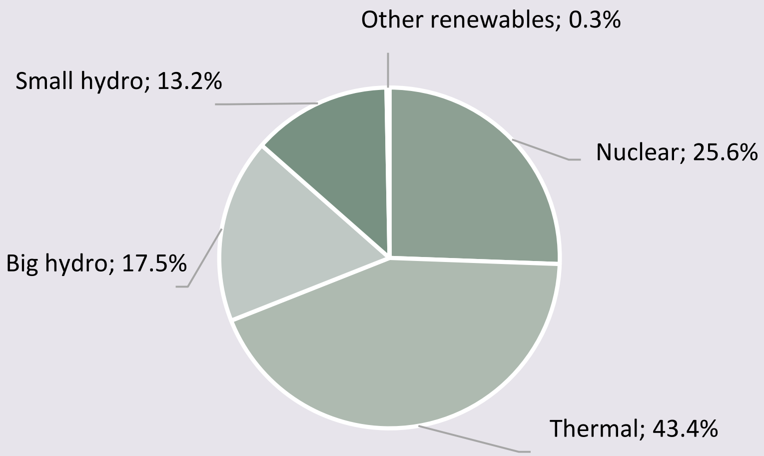
Key question: to what extent should old "deals" be examined?

- Legitimate to look at old deals, if there are strong indications of corruption
- At the same time: important not to drive out existing (foreign) investors

➢ **Success in fighting corruption key for political & economic performance of gov**

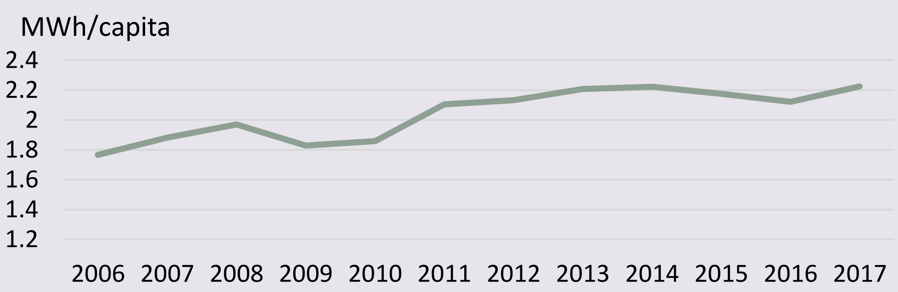
Challenges in the electricity sector

Electricity mix



Source: Armenian Energy Agency; 2018

Electricity consumption



Source: Armstat

Imports and exports

- Net exporter of electricity, yet no domestic hydrocarbon resources
- 84% of natural gas imports coming from Russia (via Georgia) and 16% from Iran; high concentration
- Armenia seeks to expand existing gas-for-electricity barter deal with Iran
- Barter deal currently exempt from U.S. sanctions

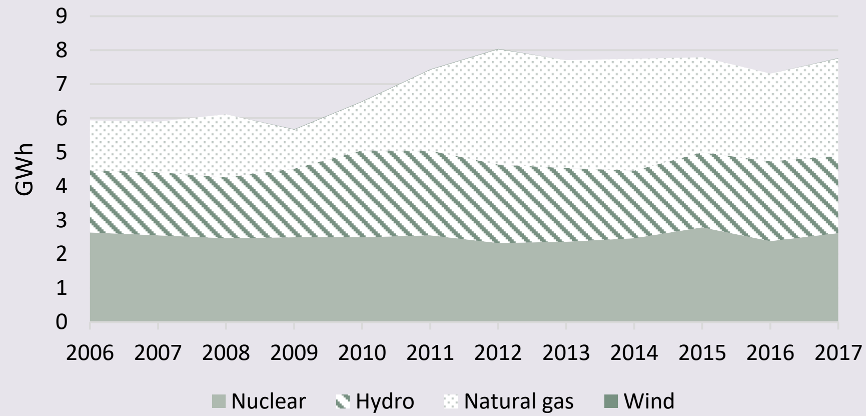
Electricity demand

- Generating capacities sufficient to meet current domestic demand
- But: electricity demand projected to grow 2-3% annually

➢ **Gov focus on strengthening domestic energy sources to improve energy security and growing demand**

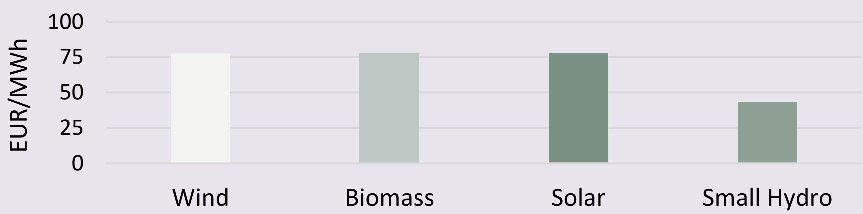
Gov plans on nuclear power and renewables

Electricity generation by fuel



Source: Armstat

Renewables feed-in tariffs



Source: Armenia Renewable Resources And Energy Efficiency Fund; 2018

Metsamor Nuclear Power Plant (NPP)

- Lifetime of only Armenian NPP to be extended until 2026
- International pressure to decommission reactor due to safety concerns
- But: gov plans to build new unit until 2026
- Start of construction postponed after Metsamor lifetime extension

➢ **Nuclear likely to remain backbone of power supply**

Renewable energy sources

- 2020 goal of 21% generation share from small hydro, wind, geothermal and solar looks unlikely
- Wind, geothermal and solar still marginal but with significant potential

➢ **Guaranteed feed-in tariffs aim at attracting investors**

FDI attraction: focus on most promising target groups

	Target groups	Investment potential	Competitive position	Development impact
Priority 1	IT	++	++	++
	Food	++	+	++
	Tourism	+	+	++
	BPO	++	+	+
Priority 2	Textile	++	0	+
	Pharma	++	0	+
	Jewelry	0	+	+

FDI attraction
- Key factor for achieving higher growth and creation of new jobs
- At the same time: limited gov resources
- Thus: need to focus on most promising target groups

Criteria for choice
- Investment potential
- Competitive position
- Development impact

Results of study by Berlin Economics
- IT, food, tourism and BPO are most promising target groups

Challenges ahead
- Ensuring an effective institutional framework for FDI attraction after unwinding of Business Armenia

Institutional framework for FDI attraction

Until recently: Business Armenia

- Established in 2015
- Responsible for investment attraction and export promotion
- Focal point for foreign investors
- June 2019: Business Armenia was closed down

Challenges for future set up

- Securing specific know-how, especially with regard to most promising FDI target groups
- Establishment contacts to investors and multipliers (network)
- Creation of a focal point for foreign investors
- Investors should easily find out whom to contact; as of today, this is not necessary the case, e.g. website of Business Armenia is still online

Latest gov decisions: ANIF and Investor Support Office at the Ministry of Economy

- Armenia National Interests Fund (ANIF)
  - For large investors; co-financing schemes
- Investor Support Office at Ministry of Economy
  - Implementation of FDI attraction; investor aftercare

➢ **Building up a suitable institutional framework is key for successful FDI attraction**

Institutional framework for FDI attraction

Increasing cooperation between IPAs and private sector at international level

- Stronger emphasis on existing investors and business community
- Innovative forms of cooperation utilising synergies
  - joint promotion activities (e.g. with real estate companies)
  - joint facilitation services (e.g. “welcome packages”)
  - new organisational / financing models (e.g. PPP)

After-care programmes providing the groundwork

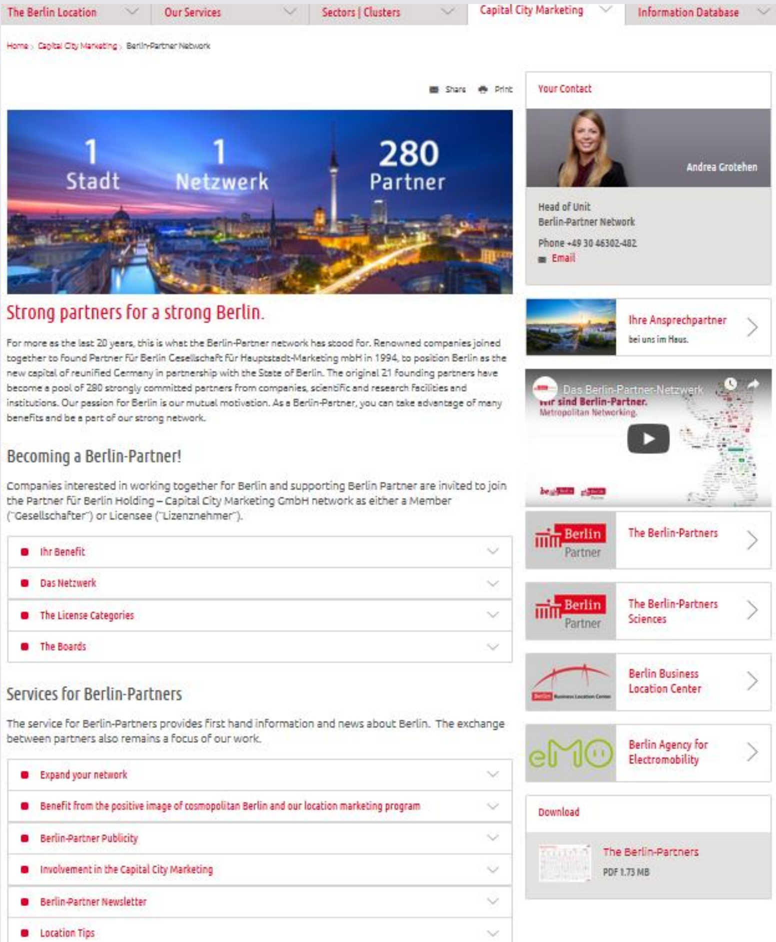
- Increasing number of IPAs implementing after-care programmes
- Cost-effective investment attraction tool
  - up to 70% of FDI can come from / be connected to existing investors
  - much easier to secure / fast-track re-investments than to attract first-time investors
- Important source of information for further investment policy and advocacy tools

Potential for Armenia

- Interviews indicate promising potential to be tapped with systematic after-care
- Existing investors recommended in study as a (cross-industrial) target group

Good-Practice example: Berlin Partner (Germany)

Berlin Partner Network



PPP model

- 280 partners hold 28% of shares and contribute a third of IPA's budget
- Different licence categories available
- Special unit organising various networking opportunities and events for partners

After-care programme

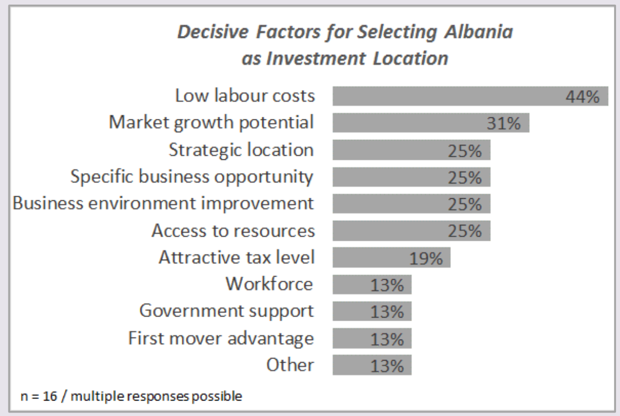
- Systematic after-care programme initiated with dedicated key account managers
- Re-investments of EUR 1.5 bn in 5 years

Further cooperation projects

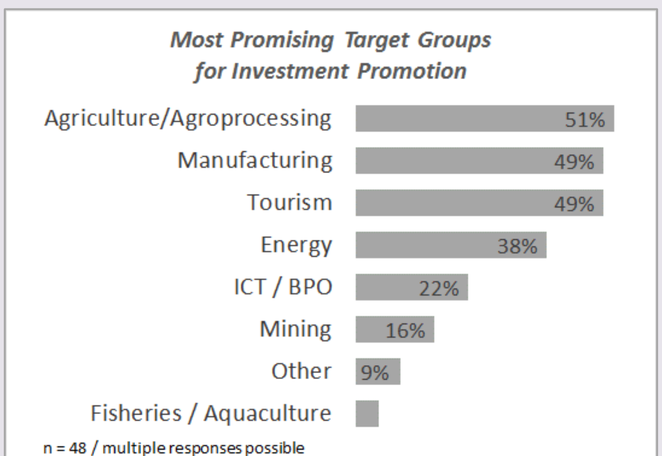
- Business Location Center with a broad range of investment facilitation services
  – 3-D virtual model of the city
  – Real estate portal and infrastructure atlas
  – Legal, HR and financial services
- Services available online and in a showroom

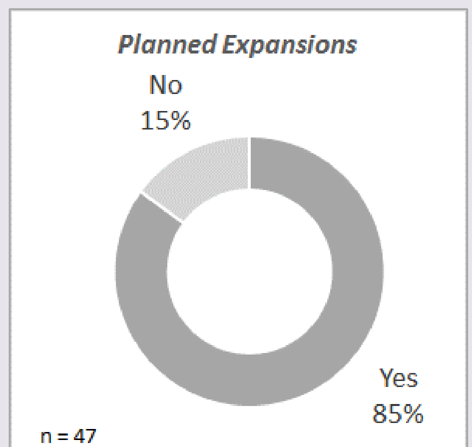
Good-Practice example: pilot initiative in Albania

As part of a technical cooperation project in Albania, 50 investors were visited to prepare an after-care programme and further investment policy tools. Amongst others, their investment decisions and plans, potential target groups, perception of support services and incentives, investment challenges and reform needs were discussed



Most Important Reforms	
1.	Improve legal / regulatory environment (for investments)
2.	Reform of tax system / administration
2.	Streamline and fast track investment-relevant processes
4.	Fight informal economy (practices)
5.	Extend investment support (services)
6.	Improve access to land
7.	Improve infrastructure, including (costs of) utilities
8.	Strengthen capacities
9.	Increase policy continuity and reliability
10.	Invest in skills / reform of educational system





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