POLICY
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SPECIAL REPORT

ARMENIA: AVERTING AN ECONOMIC CATASTROPHE

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Visit: **www.pf-armenia.org**
Contact: **forum@pf-armenia.org**

EXECUTIVE SUMMARY

Armenia is beginning to show signs of a classic balance-of-payments crisis in the making. An unsustainable de *facto* exchange rate peg and structural policies are resulting in massive external imbalances, which will eventually lead to abandonment of the peg (i.e., devaluation) with very serious implications for the over-exposed banking sector and already high public debt levels. Huge external repayments scheduled for 2012-14 and adverse developments in Europe are making the situation much worse and are likely to accelerate the process. Unless drastic changes in the economic policy direction and political-economy landscape are carried out, we estimate the likelihood of a large devaluation of the dram and/or debt default within the next 3 years to be very high.

In 2009, Armenia underwent one of the worst economic declines in the world following the 2007-08 global crisis. But while the outcome in 2009 was mainly a result of the global turmoil made worse by domestic problems, what is transpiring now is largely due to domestic problems, which will be amplified by external shocks. These home-grown problems—much of which are in the realm of political will, rather than lack of resources or geography—are the main focus of the report. In it, we point out that the economy has not adjusted to the global shocks of 2007-08 and that there are clear signs of more pain to come exacerbated by new headwinds from Europe.

The country's political leadership needs to fully internalize these problems and related risks and address them expeditiously. So far it appears that the lessons of 2009 have largely been wasted and no significant change in policy direction was pursued, which may have better prepared Armenia for what is likely to come next. Instead, the elements of the same ***crony capitalist*** practices—where a select few have used their disproportionate access to power and influence over economic decision-making for their personal gain—have been reinforced, at the expense of growth, public health, education, and national security. This is not only immoral but in many ways also illegal and needs to change. Armenia's window of opportunity to build a viable economy and address its severe social and demographic problems is closing rapidly.

The effective handling of challenges facing the country should begin by forming a *legitimate authority* to oversee the new policy course on behalf of the people of Armenia. The upcoming parliamentary election provides that opportunity. Allowing people to exercise their free will and creating a sense of moral justice would enhance the public buy-in and—all other things being equal—would make policy measures more effective. On the contrary, yet another fraudulent election will undoubtedly lead to more political tension, social upheavals, and more challenges to be tackled down the road, many of which may prove unmanageable for the ruling regime this time around. The situation requires a true ***government of national unity*** that would lay out a workable agenda and reach out to all constructive forces in Armenia and the Diaspora to help accomplish that. These efforts would require adequate professional skills but also the air-cover of a truly national and clean political leadership to be successful.

INTRODUCTION

The Summit of European leaders that took place in Brussels on December 8-9, 2011 did not result in the quick fix everyone in Europe was longing for. Despite the fact that the agreement reached in Brussels carried with it the promise of averting the large-scale financial disaster hanging over Europe's head, the continent's economy is already projected to expect a recession in 2012 with a slow recovery in 2013. With little promise on the upside, a failure of politicians to act quickly enough hereafter poses a considerable risk: a sizable contraction of output accompanied by the departure of some peripheral countries from the Eurozone (with the possible abandonment of the Euro as the single currency of the region), bank failures and financial repression, more fiscal austerity, and social unrest. Depending on the magnitude and sequence of these events, a disintegration of the global financial system as we know it would not be unthinkable.

The Eurozone is Armenia's largest trading partner and has traditionally been the source of most of its budgetary grants and some bilateral loans. Conditions in Europe—those that have already been factored into the projections of analysts and international financial institutions, and those that could still surprise everyone by their scale and scope—will have serious implications for Armenia's economy, both directly as well as indirectly through their impact on Russia, Armenia's largest source of remittances. Remittances, of course, remain a critical lifeline for Armenia's fragile economy and its currency, at times reaching 20 percent of its Gross Domestic Product (GDP) annually.

In its 2008 report on "Implications of the World's Financial Crisis for Armenia's Economy", published in December 2008, Policy Forum Armenia warned of the imminent dangers for Armenia as a result of the financial crisis, which began showing signs of distress globally in late-2007. Armenia's leadership ignored most of the multifaceted policy recommendations contained in the report and instead opted out for a fix that consisted largely of foreign debt-funded fiscal stimulus. Despite a sizable injection of resources into the economy, the outcome was a devastating 14.2 percent decline in GDP—one of the worst performances in the world since 2007. Sadly, not much has changed in terms of policy direction since then.

The current report takes a step further. In addition to purely economic policy measures that are likely to mitigate the impact of the second wave of the crisis on Armenia's economy, in Section I we lay out a series of political-economy recommendations to address issues, which were behind the policy failures in 2008-09, and which are likely to haunt the economy for many years to come if left unaddressed.

The remainder of this report is structured in the following way. Section II outlines the main vulnerabilities of what is seen as a much weaker Armenian economy compared to that in 2008. It highlights major policy inconsistencies observed since the beginning of the global crisis and their counterproductive impact on key macroeconomic indicators. Section III offers a detailed set of recommendations that, if adopted, would help mitigate the impact of the European recession in the short term and address the economy's fundamental and potentially deadly weaknesses in the medium term.

The fiscal stimulus financed through massive external borrowing was ineffective and short-lived.

RECENT ECONOMIC DEVELOPMENTS AND UNDERLYING WEAKNESSES

Armenia needs to repay its external creditors over $1 billion in principal and interest in 2012-14.

Output, social conditions, and inflation

After a deep contraction in 2009, the Armenian economy grew at an average rate of 3.3 percent in 2010-11, which is significantly lower than pre-crisis growth levels, and which still leaves GDP below its 2007 level. The weak recovery is supported by a rebound in agriculture, industry, and services sectors, while the stagnant construction sector has put brakes on the recovery. The outcome in the agriculture benefited from a base effect (i.e., poor weather conditions in 2010). The growth in the industry was due to increased activity in the manufacturing (including processing) and mining sectors.[1] The services sector benefited from resumed growth in remittances. All in all, the tradable sector has not grown fast enough in recent years, and the economy still relies on domestic demand fueled by foreign savings. In general, economic activity remained constrained by corruption and administrative harassment, weak contract enforcement, and an uneven playing field.

These developments have taken place against the backdrop of dramatically worsening social conditions. Poverty has grown steadily since 2008: official statistics put 35.8 percent of population below the poverty line in 2010, compared to 27.6 in 2008 (NSS, 2011). Given the rather low official poverty threshold ($89.7 per adult per month), these statistics are likely understating the true number of people experiencing hardship. The overall social safety net remains inadequate, and there are reports of increased suicide rates (IWPR, 2011). Official data on unemployment is notoriously unreliable, but anecdotal evidence points to a massive increase in the number of people left without jobs since 2008. Along with the events of 2008 and their aftermath, the worsening social conditions have led to renewed outflow of population.[2]

Declining global demand and commodity prices were not adequately reflected in Armenia's inflation developments, while upward adjustments in the global commodity prices were quickly factored in. In early 2009, the annual inflation rate in Armenia declined to around one percent, only partially reflecting the decline in world commodity prices. Towards the end of the year, the inflation rate notably accelerated, despite relatively low world prices and a widening output gap. In contrast, increased world commodity prices, amplified by a weaker agricultural output domestically, quickly pushed the inflation rate above nine percent in 2010.[3] This pattern in Armenia's inflation—an easy upward adjustment but strong downward rigidities—signals a highly concentrated market structure with some agents having enough mar-

1 The latter had a double-digit growth driven by the surge in metal prices (particularly, copper).

2 Over a million people have left Armenia since independence, making it the number one population-exporting country in the world, if measured as a percentage of the original (i.e., pre-migration) population.

3 The annual inflation decelerated in 2011 owing to a base effect of the previous year's price shocks and better weather conditions compared with 2010.

ket power to set prices. This pattern is likely to seriously undermine the effectiveness of any existing anti-crisis macroeconomic policies: an attempt to stimulate the aggregate demand via monetary expansion will likely have more nominal rather than real effects.

Fiscal developments and public debt

Years of a highly pro-cyclical fiscal policy during the boom left Armenia without any precautionary fiscal buffers, which could have helped to mitigate the impact of the global recession. Armenia reacted to the crisis by a massive fiscal stimulus that was largely financed through external borrowing. However, not only did the stimulus not prevent the economy from nose-diving in 2009, but its effects were short-lived. More importantly, the foreign funding borrowed to finance this stimulus (and to replenish the central bank's foreign reserves, see below) more than doubled Armenia's public debt in 2009-10 and almost completely exhausted its borrowing capacity for years to come. This effectively imposed a ban on much-needed infrastructure projects (including the nuclear power plant) with the involvement of direct government borrowing or guarantees. Having reached 40 percent of GDP, Armenia's debt has come dangerously close to the default threshold for developing countries. It should also be noted that in contrast to the debt accumulated before the crisis, new debt is less concessional both in terms of interest rate and maturity.

Apart from the volume of sovereign debt, two additional issues are of major concern here. First, Armenia's repayment profile is concentrated: in the next 3 years (2012-14), the country needs to repay its external creditors over $1 billion in principal and interest (see Fitch Ratings, 2011), of which $600 million is owed to the International Monetary Fund.[8] Debt service of such magnitude will seriously undermine both Armenia's foreign exchange reserves and the available fiscal space. Given the presently observed external imbalances, debt restructuring in some way or another would appear inevitable.[9] This is likely to further aggravate the

By pegging the exchange rate the CBA has contributed to loss of ¾ of its pre-crisis gross external reserves.

[4] GDP growth in the 3rd and 4th quarters of 2010 turned negative in year-on-year terms.

[5] In addition, the use of borrowed funds (especially the on-lending to the private sector) was not transparent, with its rationale often unclear.

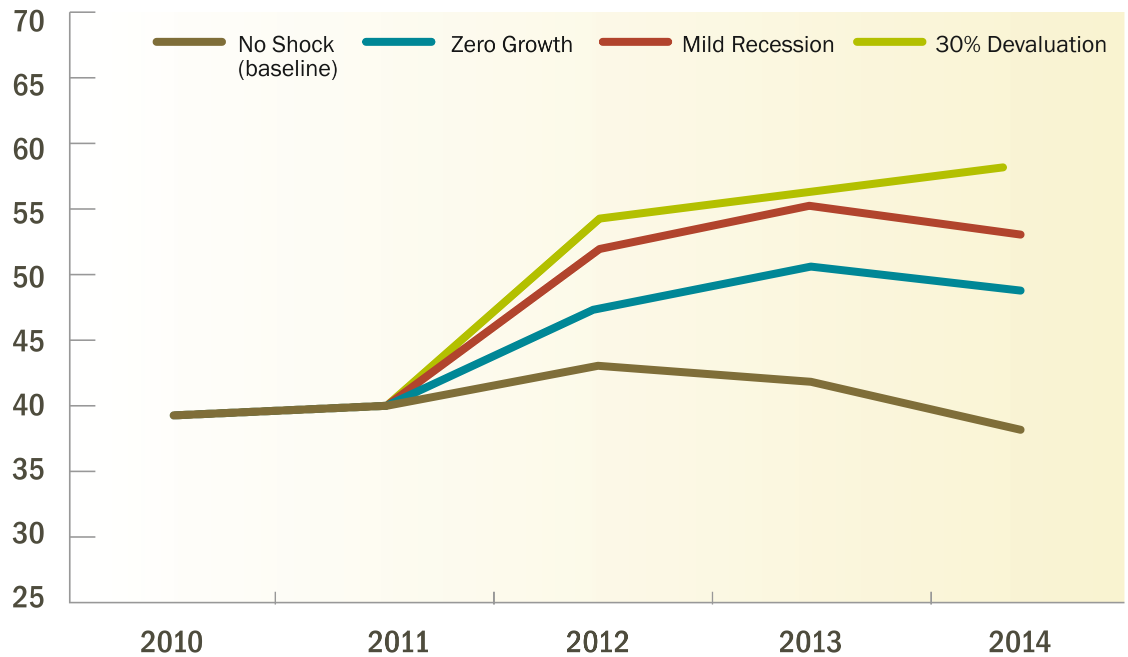
[6] Given the imminent closure of the nuclear power plant, the inability of the budget to borrow more to finance the construction of a new plant should put additional pressures to increase tax collection and improve the business environment to enable more private financing of energy projects down the road.

[7] Finger and Mecagni (2007) show that most recent sovereign debt crisis took place with debt levels above 39 percent.

[8] See here for Armenia's debt to IMF (in millions of Special Drawing Rights, or SDR). At the time this report was written, the exchange rate between SDR and $US was approximately $1.53/SDR.

[9] This may be true despite the fact that most of its debt is owed to official creditors.

Armenia: Public Debt Profile under Various Shock Scenarios
(PERCENT OF GDP)



Sources: IMF (2011); and PFA calculations
Note: See Appendix for assumptions behind each of the shock scenarios

internal social and economic conditions and to undermine Armenia's position regionally. Second, Armenia's debt profile is very sensitive to shocks, most importantly to possible output and exchange rate shocks. According to our simulations (see chart below and table in the appendix), a moderate decline in GDP in 2012 (which is not ruled out given expected deterioration of the external environment and large imbalances that Armenia must address) may drive debt-to-GDP ratio above 50 percent. Given the fact that almost 90 percent of Armenia's debt is in foreign currency, the outlook will be much worse if the dram is abruptly devalued. In the case of 30 percent devaluation, Armenia's debt-to-GDP ratio will reach 60 percent. A combined shock—with GDP decline and devaluation taken together (not shown on the chart)—will drive the debt-to-GDP ratio well over 70 percent.

Alarmed by the deteriorating debt outlook and in spite of sluggish recovery since 2009, the government embarked on fiscal consolidation in 2011. The key feature of this premature fiscal consolidation in Armenia is that its burden almost entirely falls on expenditures, both current and capital. Most expenditure categories have been stagnant in real terms since 2009, and capital expenditures are under substantial strain. Almost nothing has been done to improve revenue mobilization, and tax-to-GDP ratio in Armenia remains one of the lowest in CIS, reflecting large-scale tax evasion rather than low statutory tax rates. In fact, most tax rates in Armenia are at par with, or higher than, the rates in countries of the region and other comparators that have a higher tax-to-GDP ratio (see table below).[10]

There are widespread concerns about corruption in the tax and customs agency as well as about failures to collect taxes from government-connected oligarchs. Recent efforts to improve revenue generation have focused on increasing income tax rates for high-income earners and increasing collection from the small and medium sized enterprises, most of which have already been subjected to advance tax withholding and other unorthodox collection practices. Contrary to this, top government officials and parliamentarians, who are known to be very wealthy but declare only

The overvalued exchange rate harms Armenia's export potential, delays necessary external adjustment, and conceals the true indebtedness.

Tax Revenue and Select Statutory Tax Rates, 2011 [11]

	Tax revenue (percent of GDP)	Corporate Profit Tax (percent)	VAT (percent)
ARMENIA	16.3	20	20
CHILE	18.1	20	19
CYPRUS	25.9	10	15
GEORGIA	24.9	15	18
IRELAND	44.3	12.5	21
LATVIA	27.7	15	22
MOLDOVA	31.4	15	20
PARAGUAY	14.1	10	10
ROMANIA	28.2	16	24
RUSSIA (NON-OIL)	22.1	20	18
SERBIA	33.7	10	18

[10] See Davoodi and Grigorian (2007) and IMF (2010) for more on this issue.

[11] Source: Tax revenue-to-GDP figures from various IMF reports available here; Profit Tax figures (except Georgia and Moldova) are from "Corporate & Indirect Tax Survey 2011", KPMG (2011). For Georgia: here; for Moldova: here. VAT figures are from here.

Conditions in the banking sector are worrisome and risks are building up.

small fractions of their income and wealth, will continue to stay off of the radar screen of Armenia's tax collectors. On the expenditure side, according to the World Bank (2009), single-source procurement of public expenditures remains very high (around 80 percent), opening sizable room for corruption. In all, several hundred million dollars are embezzled annually in the form of non-payment of taxes and outright budgetary theft (PFA, 2010; Box 6).

Monetary and exchange rate policies and the financial sector

Monetary policy priorities have shifted frequently since the beginning of the crisis, and the central bank's response to inflation has lagged behind. It appears that in its initial response to the crisis, the Central Bank of Armenia (CBA) actually abandoned its inflation stabilization policy and focused heavily on stabilizing output. It also acted contrary to its undeclared objective of pegging the exchange rate (which would have required the monetary policy to be passive and driven by declining money demand) and by doing so, the CBA contributed to the loss of foreign exchange reserves (see below).[12] This was probably a reflection of the lack of operational independence of the CBA from political considerations. However, perhaps after realizing that its policy fueled inflation expectations, prevented downward price adjustments, and led to loss of its reserves—all instead of supporting the recovery—the CBA returned to inflation targeting again, hiking the monetary policy interest rate by 2.25 percent during Jan–May 2010. By this time, however, inflationary pressures had either already died or reversed their course.

CBA's *de facto* peg—put in place despite pressures on the exchange rate—resulted in substantial reserve losses. The one-off devaluation of approximately 20 percent in March 2009—effectively a pre-condition for IMF's emergency support—eased the pressures but only for a limited period. In late 2009, exchange rate pressures reemerged.[13] In total, the CBA has lost $1.2 billion—or ¾ of its pre-crisis gross external reserves—in foreign exchange interventions since the onset of the crisis, of which around $0.5 billion was lost after the March 2009 devaluation. It should be noted that the CBA's operations in foreign exchange markets are very asymmetric: it responds aggressively to devaluation pressures while allowing appreciation pressures of a largely seasonal nature to be reflected in the exchange rate.

[12] In a fixed/pegged exchange rate arrangement, any expansion of the reserve money beyond the increase in demand for money typically leads to a loss of foreign exchange reserves.

[13] IMF (2011)'s estimate of the dram's overvaluation (10-15 percent; see page 5)—while in our view somewhat optimistic—would still require a sizable nominal depreciation/devaluation to be eliminated (depending on the pass-through effect on domestic prices).

RECENT ECONOMIC DEVELOPMENTS AND UNDERLYING WEAKNESSES

At present, the overvalued exchange rate harms Armenia's export potential, delays necessary external adjustment, and conceals the true (external) indebtedness. Any adjustment observed in 2010-11 resulted largely from fiscal consolidation and an increase in prices for exported minerals and not through private sector consumption/investment patterns. The CBA argues that the main rationale for pegging the exchange rate is to control inflationary pressures arising, among other factors, from external price shocks (see IMF, 2011). Apart from the fact that pegged exchange rate regimes are not an effective mechanism for controlling inflationary pressures, there is empirical evidence that "fear of floating" (and the resulting pegging of exchange rates) may in fact strengthen the pass-through of external price shocks to domestic prices, whereas flexible exchange rate regimes may help to absorb the shocks (through profit margins and factor prices). In addition, the fact that the CBA continued to intervene asymmetrically in the foreign exchange market, even after inflationary pressures subsided, may suggest that there may be other factors at play behind exchange rate policy choices (such as keeping the dram artificially overvalued to support government-connected importers).

Despite the official claims about the health of the financial sector, the conditions are worrisome and risks are building up. *First,* the legacy of the 2009 recession is beginning to show in non-performing loans (NPLs). While the officially reported NPLs have been rising, the true quality of banks' loan portfolios is likely to be masked by the lax loan classification standards.[14] *Second,* while credit has been shrinking almost everywhere else in the world, Armenia's banking sector has seen a massive credit growth since early 2008,[15] much of which has been via borrowing from abroad, with banks having built sizable debt to creditors abroad.[16] Due to its rapid expansion, the quality of lending remains questionable.[17] *Third,* much of this acceleration in lending to the private sector is attributed to foreign exchange loans (constituting 60 percent of its total loan portfolio, according to IMF, 2011; Table 4), which have raised the vulnerability of the system to potential dram devaluation. Deposit dollarization, too, remains high, limiting the effectiveness of monetary policy. *Fourth,* the ownership in the banking sector remains very murky, a key factor

The inability to deliver a meaningful external adjustment is the main policy shortcoming of recent years.

[14] Armenian banks are required to classify a loan as a loss only when the payments on it have been overdue by 270 days. In most countries of Eastern Europe, loans are classified as losses after 180 days of overdue payments.

[15] Private sector credit grew by 37 percent through September 2011 compared to the same period in 2010 (IMF, 2011).

[16] While some of this could be borrowing by the non-financial private sector, IMF (2011) estimates that Armenia's private sector external debt is at $2.9 billion as of the end of 2011.

[17] The massive credit growth could have conceivably been part of the authorities' plan to boost the economy in 2009-2010, for which they directed the connected banks to borrow abroad.

behind the lack of competition in the sector and the high prevailing interest rate mark-ups charged by the banks. The highly politicized nature of the banks' ownership also limits the CBA's independence and its ability to conduct its supervisory functions, a situation which the CBA does not seem to mind.

External imbalances

The economy is much more vulnerable to both current and capital account shocks (that could be triggered by events in Europe) than it was in 2008. Armenia is the only country in Eastern Europe and Central Asia that runs a larger current account deficit than it did before the crisis: its current account deficit is estimated to have crossed the 12 percent mark of GDP in 2011, a far cry from the average of 3.3 percent for the five years preceding 2008. The deficit is expected to decline only moderately in the years to come. Armenia's trade account is expected to record a deficit of a staggering 21 percent of GDP, with imports exceeding exports by a factor of almost 4 to 1, despite sizable growth in exports of metals and minerals since 2009.[18] This growth, however, was not a result of improved competitiveness (or external adjustment), but was driven by higher external demand and prices. The inability to deliver a meaningful external adjustment—which has left the economy much more vulnerable to external shocks than it was prior to the start of the global crisis—is the main policy shortcoming of recent years.

To finance these sizable current account deficits, Armenia has three options: it needs to attract foreign private investment, secure official loans, or draw down on its foreign currency reserves. The distorted business environment, weak contract enforcement, and declining purchasing power of its population[19] will have an impact on the economy's ability to attract foreign private investment. In any case, Armenia remains cut off from the private capital markets, and given the current global environment, it is unlikely to be able to issue an international sovereign bond at fiscally prudent interest rates any time soon. In turn, when it comes to official financing, Armenia has reached most of its borrowing limits with the international financial institutions (e.g., World Bank and IMF), while its traditional bilateral

[18] A European recession will undoubtedly put a downward pressure on prices of metals worldwide, with implications for Armenia, where mining was the single most important factor behind the post-2009 recovery accounting for about 60 percent of exports. In addition, crisis in Europe that spills over to Russia may have implications for Armenia's remittances, which during 2009 have declined by an estimated 30 percent and was a key factor behind the collapse of GDP in 2009.

[19] This is also driven by sizable emigration that is rumored to have intensified in the past 2-3 years.

RECENT ECONOMIC DEVELOPMENTS AND UNDERLYING WEAKNESSES

lenders/grantors in Europe are under a pile of problems of their own, making any sizable lending to Armenia unlikely any time soon.[20] This leaves drawing down on Central Bank's foreign reserves as the only feasible option for Armenia during the times of economic stress. The problem with this option, however, is that the external debt repayments scheduled over the next three years leave less room for maneuvering.[21] Weaker foreign reserve coverage will make a sizable depreciation or devaluation of the dram (similar to the devaluation that took place in March 2009) a very likely outcome in the near future.

[20] To date, Armenia remains heavily dependent on disbursements from the International Financial Institutions, both for its balance-of-payments as well as fiscal financing needs.

[21] The Central Bank's reserves are estimated to have declined to $1.8 billion by the end of December 2011 from its highest end-year level of $2.0 billion as of the end of December 2009.

RECOMMENDATIONS

Political economy considerations

The effective handling of challenges facing the country should begin by **forming a *legitimate authority*** to oversee the new policy course on behalf of the people of Armenia. The 2012 parliamentary election provides that window. Allowing people to exercise their free will and creating a sense of moral justice would enhance the public buy-in and—all other things equal—would make policy measures more effective. Yet another fraudulent election will undoubtedly lead to more political tension, social upheavals, and more challenges to be tackled down the road, many of which may prove unmanageable for the ruling regime this time around.

The government must urgently roll out a **national program** of ending the social hardship and putting the economy on a path to meaningful growth. The most important pre-conditions for this should include: (i) a credible roadmap to eliminating all monopolies in production and import of goods and services, (ii) creating a level playing field for all entrepreneurs, and (iii) minimizing the interference of oligarchs in economic policymaking. The program should also address the following prerequisites: (i) tax collection and subsequently the ability of the budget to spend on the social safety net, public investment, education, and health, (ii) financial sector imperfections to reduce the (lending) interest rates, and (iii) corruption and administrative harassment.

For the above measures to be effective, a complete **revamping of the cabinet** would be required. The current cabinet as a whole lacks vision, capacity, and stamina to address the above concerns. In addition to reshaping the cabinet, as we proposed in our December 2008 Report, a Crisis Prevention Team (CPT) should be established as a high-level policy advisory body to the government. The CPT could report directly to the prime minister and should consist of economists and financial sector professionals with strong reputations and experience in dealing with crisis countries. To be considered credible, the CPT should include Diaspora (and possibly non-Armenian) professionals and should be non-partisan.

Building public buy-in would also require **credible reform in the judicial system,** which in turn would require far-reaching measures to clean up the top levels of the Prosecutor General's office and the Ministry of Justice as well as the courts. The business community and other civil society stakeholders should be brought in to play a role in this reform agenda.

Corruption in Armenia has names and addresses, and most of these belong to people high up in the corridors of formal power. A process of prosecuting senior government officials, who have used public office for personal wealth accumulation and clearly live beyond their official income, should be initiated as soon as possible. This will send a strong signal about the credibility of the reform effort and translate into a better business and administrative environment fairly quickly, since most money received by corrupt government officials results from either indirect ownership of businesses or provision of cover to other businesses for a fee. Apart from being unlawful and immoral, these activities distort the playing field and prevent efficient resource allocation.

Combating money laundering is of critical importance. Many top-level officials own lucrative business ventures, and most of them have accomplished that through repatriating funds from Armenia, registering offshore entities, and reinvesting the funds in Armenia through the back door. Among other things, this allows them to reap the benefits granted by the law to foreign investors and use public office to lobby for their businesses. Despite ample anecdotal evidence of wrongdoings by administration officials in this respect, no cases of financial fraud or money laundering have been brought to public's attention in recent years. The agency that deals with money laundering should be made independent and the compensation of its staff should be made performance-based.

The latest episodes of administrative harassment of Diaspora investors may have resulted in a critical blow to the relations between the Diaspora and Armenia. To avoid a further confrontation with, and be able to better utilize the potential of, the Diaspora, we propose the formation of an independent Diaspora-led commission to be tasked—on a regular/rolling basis—with the evaluation of Armenia's business environment and the compilation of a list of Diaspora-based candidates for high-level civil service positions in Armenia.

Fiscal/budgetary measures

Leaks from, and corruption within, the budget should be curtailed. A much larger share of budget procurement should be handled through competitive bidding, and safeguards should be instituted to reduce the participation of firms connected to government officials. The Prosecutor's Office should initiate legal proceedings against violations identified in the latest report by the Audit Chamber. Parliament should be updated on the progress on these proceedings at least quarterly.

Under-collection of tax and customs revenues should be addressed head-on and without delay. This should begin with sweeping management and staffing changes in the state tax and customs agency, which, in addition to being seen as corrupt, is also used as a tool of political score-settling by the ruling regime. Strengthened with additional powers of enforcement, the restructured agency should be given revenue collection targets benchmarked against international best practice and calibrated for Armenia's tax regime. Its senior staff should be fired if targets for the first year are substantially missed and mid- to lower-level employees should be hired on shorter-term and performance-based pay contracts.

In addition to enforcement, **tax and customs rules and regulations should be made clearer, less subjective, and less prone to rent-seeking.** It should be noted that increasing statutory tax rates and tightening tax administration for individuals and businesses that are already under a substantial burden will further depress economic activity and reinforce the widely held notion that taxation in Armenia is unjust.

These new tax administration and expenditure management measures will open up a significant fiscal space—hundreds of millions of dollars annually—for investment in public infrastructure, education, research and development, social security, and defense. All of these expenditure categories remain grossly underfunded, and addressing this issue expeditiously and meaningfully is Armenia's only ticket to future growth and prosperity.

Monetary and exchange rate policies and the financial sector

Despite the March 2009 devaluation of the dram, **Armenia's economy has not adjusted adequately since the start of the crisis.** Unless and until a sizable adjustment takes place, Armenia will continue to lose its foreign reserves and accumulate debt, and will be unable to grow. This adjustment should be driven by gradual exchange rate depreciation (as opposed to sudden devaluation, to avoid an impact on the banks' balance sheets and un-hedged foreign currency borrowers) with the target of completely eliminating the dram's overvaluation within 1 to 1.5 years. Given the output gap and the eventual depreciation-induced reduction in the volume of imported goods, the *effective* pass-through from exchange rate to prices will be minimal. Abandoning the *de facto* exchange rate peg will also strengthen the monetary policy channel and make monetary easing effective as opposed to only contributing to the loss of reserves and inflation.

The current trends in the banking sector cannot be sustained for much longer. Going forward, the expansion of credit should be weighed against the risks of financial instability and subsequent social unrest. Conditions could worsen if the banks are forced by creditors to repay the foreign credit lines (or if banks have difficulties rolling them over), a pattern presently observed across Eastern Europe. Apart from developments in Europe, this could also be triggered by continued deterioration of the bank lending portfolio in Armenia or by changes in depositor sentiment triggered by events both domestically and abroad.[22]

Structural reforms

To be competitive globally, more of Armenia's economic growth should come from **increased productivity and innovations.** Yet, the country's

[22] Further downgrades of Armenia (and almost automatically of commercial banks) by rating agencies could also result in additional margin calls from these creditors and/or higher fees and interest charged to maintain them.

once-prominent edge in science and technology has seriously—if not irreversibly—eroded due to large-scale migration and the government's outright neglect of higher education. To partially overcome this, in addition to swift and across-the-board reduction in red tape and improvement in the business environment, Armenia needs to improve conditions for innovation via focused measures, such as developing technology centers, ameliorating innovation funding, and enhancing entrepreneurial expertise. The latter could include pairing Diaspora professionals with local businesses in targeted sectors, a program which PFA could help develop.

Increased competition through the demise of monopolies will allow capital to seek new/unexplored sectors for higher profits. Meanwhile, it will both increase flexibility of nominal indicators and make them act as shock absorbers instead of as shock amplifiers.

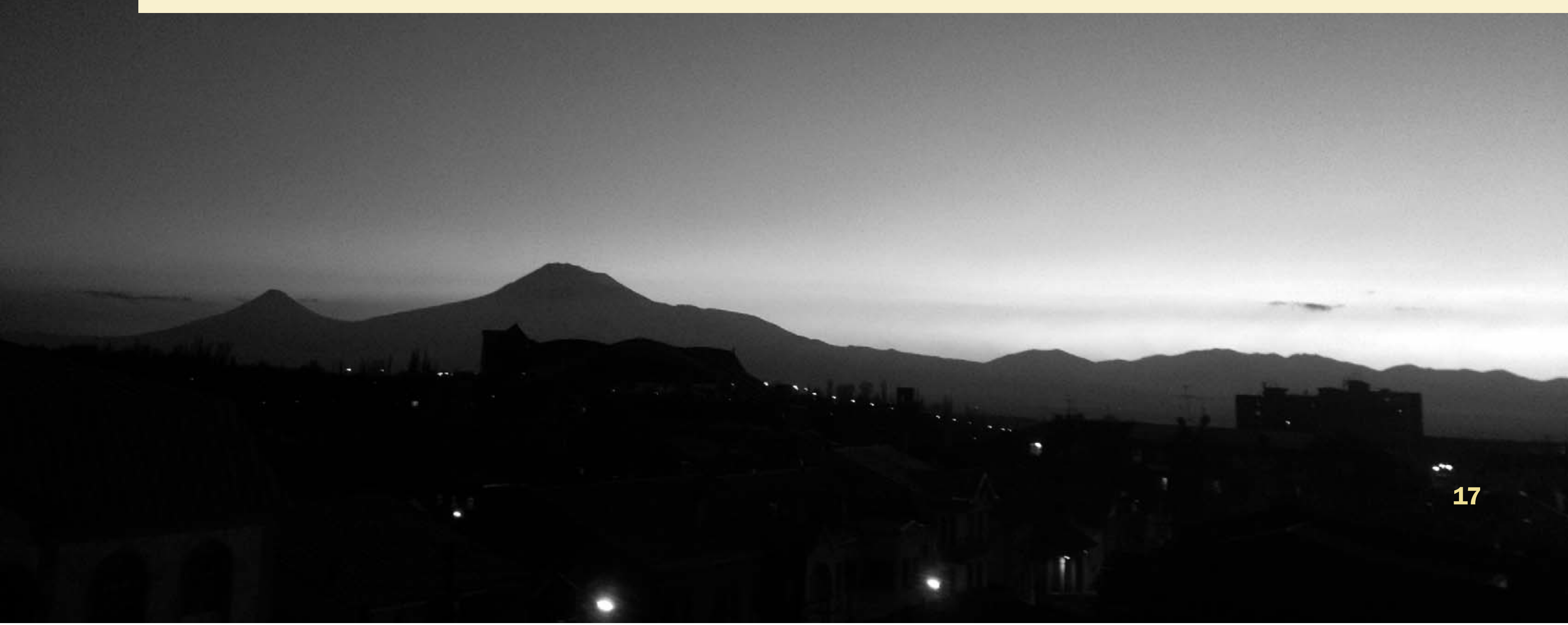
The rapid expansion in the mining sector—the government's pick for the frontrunner to replace the once-favorite construction sector—should be stopped immediately until: (i) all leakages for the budget are identified, (ii) transparency in the ownership structure of key enterprises is established (with the objective of bringing to justice those who have acquired mining interests while in public office), and (iii) sufficient and credible environmental safeguards have been established. The government should understand that leaving natural wealth in the ground for future generations (or perhaps until such time when more modern technologies for mining and processing be-

come available) can also be a viable economic solution under a wide range of economic and financial conditions and assumptions.

While Armenia requires significant changes to make its economy viable and to regain the trust of its people, this will not happen without significant civil society pressure from within and/or external pressure, including the Diaspora and Armenia's main creditors, the IMF and the World Bank. The latter need to move from their toothless program design and enforcement—factors that, in our view, have significantly worsened the moral hazard and weakened the incentives for the administration in Armenia to undertake reform—to a tougher, more effective stance towards policy slippages and lack of political will to reform.[23] Rolling over the government's external debt maturing in the next three years, without seeing significant changes in policy conduct, would be tantamount to pursuing the same old approach, and therefore should be avoided.

Recently, the ARF-Dashnaktsutyun—a former coalition partner and presently a parliamentary opposition party—has called for the resignation of the cabinet. We believe this move, even if undertaken, will not accomplish much unless it is accompanied by political changes at the top. What is required to move forward is a true government of national unity to lay out a workable agenda and to reach out to all constructive forces in Armenia and the Diaspora to help accomplish that. These efforts would require professional credibility and the support of a truly national and clean political leadership, which Armenia unfortunately lacks at the moment.

[23] The fact that the latest IMF report (IMF, 2011; paragraph 23) has taken up the issue of Nairit is indicative of the frustration that is increasing among the International Financial Institutions with the current administration's handling of Armenia's economic affairs. This is perhaps the single most important change that has taken place since 2008.



APPENDIX: MACROECONOMIC CONDITIONS UNDER VARIOUS SHOCK SCENARIOS, 2010-14

(In billions of drams, unless otherwise indicated)

	2010	2011	2012	2013	2014
Baseline Scenario					
REVENUES	734.3	840.4	888.4	972.8	1,057.5
EXPENDITURES	906.6	980.9	1,019.9	1,076.3	1,226.1
DEFICIT	-172.3	-140.5	-131.5	-103.5	-168.6
FINANCING GAP	0.0	0.0	0.0	64.2	80.0
DEBT-TO-GDP (%)	39.2	40.0	43.1	41.8	38.5
NOMINAL GDP	3,502.0	3,871.0	4,219.0	4,583.0	4,978.4
GDP DEFLATOR (%)	9.2	5.7	4.8	4.4	4.4
REAL GDP GROWTH (%)	2.1	4.6	4.0	4.0	4.0
Shock Scenario I (Zero GDP growth)					
REVENUES	734.3	840.4	825.2	841.7	893.0
EXPENDITURES	906.6	980.9	1,019.9	1,076.3	1,226.1
DEFICIT	-172.3	-140.5	-194.7	-234.6	-333.1
FINANCING GAP	0.0	0.0	63.2	195.3	244.5
DEBT-TO-GDP (%)	39.2	40.0	47.7	50.8	48.7
NOMINAL GDP	3,502.0	3,871.0	3,948.4	4,027.4	4,272.7
GDP DEFLATOR (%)	9.2	5.7	2.0	2.0	3.0
REAL GDP GROWTH (%)	2.1	4.6	0.0	0.0	3.0
Shock Scenario II (Mild recession in 2012)					
REVENUES	734.3	840.4	776.3	791.8	840.0
EXPENDITURES	906.6	980.9	1,019.9	1,076.3	1,226.1
DEFICIT	-172.3	-140.5	-243.6	-284.5	-386.1
FINANCING GAP	0.0	0.0	112.1	245.2	297.5
DEBT-TO-GDP (%)	39.2	40.0	52.0	55.3	53.1
NOMINAL GDP	3,502.0	3,871.0	3,714.2	3,788.5	4,019.2
GDP DEFLATOR (%)	9.2	5.7	1.0	2.0	3.0
REAL GDP GROWTH (%)	2.1	4.6	-5.0	0.0	3.0
Shock Scenario III (Dram is devalued by 30 percent)					
DEBT-TO-GDP (%)	39.2	40.0	54.4	56.5	58.6
DRAM/USD (E.O.P.)	363.4	375	487.5	509.2	531.8
SHARE OF EXTERNAL DEBT	87.4	87.5	87.4	85.2	85.2

Note: Green cells are exogenous assumptions; yellow cells contain calculations. For simplicity, expenditures are assumed unchanged relative to the baseline scenario, which is adopted from IMF (2011). It assumes some repayment of debt falling due. In contrast, 100 percent roll-over of existing obligations is assumed under all three shock scenarios.

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Policy Forum Armenia

1250 I (Eye) Street N.W., Suite 710
Washington, D.C. 20005, USA
forum@pf-armenia.org

www.pr-armenia.org