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Date: 31.01.2024

Subject: ARMENIA: Economic Report for December 2023

Summary

- The State Budget 2024 projects GDP growth at 7%, inflation at 4% +/-1.5%, and a budget deficit of 4.6%.
- Armenia's economic activity index grew 9.4% in eleven months of 2023. The foreign trade increased by 42.4%. The exports increased by 44.7%, and the imports grew by 41.0%. The consumer price index increased by 2.2%, and the industrial product index grew by 1.7%.
- The Central Bank of Armenia (CBA) lowered and set the refinancing rate at 9.25%.
- The CBA upgraded its GDP growth forecast for 2023 from 7.2% to 8.3%.
- Armenia's gross international reserves (GIR) have decreased by 8.5%, amounting to USD 3.813 billion in October 2023.
- The State Revenue Committee (SRC) collected 14.1% more taxes and state duties year-on-year in January-November 2023.
- Armenia's public debt has increased by 10 % year-on-year and stood at USD 11.1 billion by 01 November 2023.
- The Eurasian Economic Union (EAEU) signed free trade agreement (FTA) with the Islamic Republic of Iran on 25 December 2023. Armenian Government already approved the FTA on 14 December 2023 paving way for the ratification by the National Assembly.
- The Government extended a ban on exports of scrap and non-ferrous metal waste for six months. At the same time, the Government extended restrictions on the import of cement and clinker from third countries for six months.

Details:

Macroeconomic developments

1. **The National Assembly approved the Law on State Budget 2024 on 7 December 2023.** The document projects GDP growth at 7% in 2024. The revenues will amount to AMD 2.723 billion, making 25.9% of GDP. The expenses will stand at AMD 3.206 billion or 30.5% of GDP. The state budget deficit will be 4.6% of GDP. Annual inflation is projected at 4% +/-1.5%. The Law envisages tax revenues and state duties to have 24.9% share of GDP against 24.1% in 2023. More in the Annex 1.
2. **Armenia's economic activity index¹ increased by 9.4% in January - November 2023²** compared to the same period of 2022. It increased by 11% in November alone, compared to the same month of 2022, and by 0.6%, juxtaposed to October 2023. All the sectors of the economy have shown growth except for electricity production, which declined by 4.3%. **Foreign trade turnover increased by 42.4%.** The exports increased by 44.7%, and the imports grew by 41.0%. The trade balance remains negative at USD 3.98 billion. Exports make up 63.5% of imports. **The Consumer price index rose by 2.2%, and the industrial product index increased by 1.7%** in the mentioned period.
3. **The CBA cut the refinancing rate by 0.25 percentage points by setting it at 9.25%** and the Lombard repo rate at 10.75%. This became the fifth lowering in 2023. The last cut took place on 31 October 2023. The CBA expects a deflationary impact from the external sector

¹ **Economic Activity Index** is a monthly aggregate indicator of change in output real volume in economy

² **Armstat report EAI** - <https://armstat.am/file/doc/99542918.pdf>

on the Armenian economy. The agency also stated, "External demand is slowing, while domestic demand continues to remain high. The latter is mainly reflected in the high growth of private consumption."

4. **The CBA upgraded from 7.2% to 8.3% its GDP growth forecast for 2023.** The decision is supported by relatively high growth rates in the construction and services sectors. The CBA expects an increase in tax collections. The agency revised upwards its GDP expectations also for 2024 from the previous 5.6% to 6.1%.
5. **Armenia's GIR amounted to USD 3.813 billion in October 2023.** It will be sufficient to cover three months of imports. The GIR has decreased by 8.5% from its historical high of USD 4.2 billion in the previous month. The reduction was caused by a decline in external assets in hard currency by 9.7% in October 2023.
6. **The SRC collected AMD 1.954 billion in taxes and state duties in January-November 2023.** This is 14.1% more than in the same period in 2022.
7. **Armenia's public debt stood at USD 11.1 billion on 01 November 2023.** It has increased by 10% year-on-year. The domestic debt increased by 23.1% to USD 4.8 billion, whereas the external debt grew by 3.3% to USD 6.3 billion. The Government's share in external debt has increased from 91.2% a year earlier to 91.7% on 01 November 2023. The ratio of public debt to GDP decreased from 63.4% to 49.2% in 2022. The Government updated its projection for the share of public debt in GDP from 49% to 47% by the end of 2023.

Foreign trade developments

8. **The EAEU and its five member states signed the FTA with Iran** on the sidelines of the Supreme Eurasian Economic Council in St Petersburg, Russia on 25 December 2023. The FTA needs to be ratified by the parliaments of all six countries, parties of the FTA, to enter into full force. The parties agreed to completely eliminate tariffs for 87% of goods in their mutual trade. In preparation for the FTA, the EAEU and Iran had an interim preferential trade agreement, signed in 2018, which came into force in October 2019.
9. **The Armenian Government initiated the ratification procedures by approving the FTA** and sending it to the National Assembly of Armenia for ratification on 14 December 2023. Armenia managed to include in the FTA duty-free access to the Iranian market for several important products to the country. With regard to agricultural products, mineral and carbonated water, non-alcoholic beverages, chocolate, sweets, and mutton. As for industrial products, the Armenian list includes, among others, cigarettes, copper and zinc ore, molybdenum ore, pure copper, silver products, and thermostats. Reduced tariffs will apply to electricity and used batteries, jewellery, and medicines. Armenia's total export of pharmaceutical products worth USD 28.06 million and total import stood at USD 214.97 million in 2022.
10. **The Government of Armenia adopted a decree extending the current ban on scrap and non-ferrous metal waste exports for six months until 28 July 2024.** The aim is to enable local industries to develop their production using scrap and waste non-ferrous metals and alloys.
11. **By another Government's decision, Armenia will extend restrictions on the import of cement and clinker from third countries for six months until 17 July 2024.** The first such restriction was imposed on 13 January 2022. It aimed at securing local industry to be able to develop its own production. Since then, the Government has extended the restriction a few times for six months in accordance with the Eurasian Economic Union rules.

Sign-off: Vassilis Maragos, Head of Delegation

Annex 1 Note on the 2024 Budget of the Republic of Armenia

Key features of the Budget 2024

- Overall, the Budget for 2024 appears to be realistic and should contribute to macroeconomic and fiscal stability. It is based on projections of 7% economic growth and 3.2% inflation.
- Thanks to pursued tax policy and administration reforms, revenue is set to increase by 13% compared to 2023 and to reach 2,723 bln dram (about EUR 6.8 bln) or 25.9% of GDP compared to 25.4% estimated in 2023.
- Meanwhile, expenditure is planned to increase sharply (by 21%) and to reach 3,206 bln dram (about EUR 8 bln) or 30.5% of GDP (against 28.1% estimated in 2023).
- As a result, the deficit is projected to widen from 2.6% of GDP estimated in 2023 to 4.6% in 2024, or 483 bln dram (EUR 1.2 bln), and public debt would increase slightly to 48.3% of GDP from 47% in 2023.
- In the context of the lingering security crisis and more recent humanitarian crisis following the arrival of tens of thousands of refugees from Nagorno Karabagh in September 2023, the budget priorities appear to be well balanced, with defence (18% of total budget, with 557 bln dram – or EUR 1.25 bln) and social spending (41% of budget, with 1.3 bln dram – or EUR 2.9 bln), the latter including a 47 bln dram allocation to cover the urgent needs of the refugees (EUR 106 mln).
- The government is also making it a priority to increase investment in public infrastructure, with public investment reaching 6.6% of GDP in 2024 compared to 5.9% in 2023, thanks in particular to a 76.8 billion dram increase in education infrastructure (EUR 173 million) compared to 2023. The other two most important areas for public investment are defence and transport.
- However, a large part of the 21% budget increase from 2023 to 2024 is due to a considerable increase in the Government Reserve Fund, reflecting the integration of the former off-budget annual loans to the “Republic of Nagorno Karabagh” (156 bln drams for 2024, or EUR 353 mln), as well as a 18% increase in interest payments on public debt expected to reach a total of 323 bln dram in 2024 (EUR 729 mln). Another factor was the integration into the budget of a 72 bln dram (EUR 163 mln) mortgage subsidy program which was off-budget in previous years.
- Tax expenditures are quantified in the budget documentation; in 2024 they are expected to amount to 683 bln dram (EUR 1.5 bln) or 6.4% of GDP. Most of them relate to VAT exemptions to the financial/insurance sectors, as well as health, agriculture, and IT sectors.

General presentation of Budget 2024

The Budget for 2024³ is the third budget under the current Government Plan 2021-2026. It was prepared and adopted in a double context of buoyant economic growth on the one side and challenging security and humanitarian context, following the September 2023 Nagorno-Karabagh crisis and arrival of tens of thousands of refugees in Armenia, on the other side.

³ The Budget 2024 was adopted on 7 December 2023. The budget statement, budget law and citizens budget are available in Armenian on the MoF website: https://minfin.am/hy/page/petakan_byuje_2024t

The government priorities for 2024 are defence strengthening, economic infrastructure development and human capital development, with a particular focus on education infrastructure and social protection.

With Budget 2024, the authorities are turning to a slightly expansionary stance, with a significant deficit increase in spite of improving revenue collection. Indeed, expenditures are projected to soar from 28.1% of GDP in 2023 to 30.5% in 2024. However, a large part of this considerable increase is related to integration in the budget of two previously off-budget operations, namely:

- Former annual loans to the “Republic of Nagorno Karabagh”, the equivalent amount of which has been added to the Government Reserve Fund for 2024 (156 bln drams for 2024, or EUR 353 mln) to be available as contingency for support to Karabagh refugees, and
- A mortgage subsidy program (72 bln dram, or EUR 163 mln).

The other largest increases concern interest payments of public debt (+18% compared to 2023) and capital investment expenditure (+25%), in particular in education (+147%).

Meanwhile, the budget is starting to reap the fruits of tax policy and administration reforms introduced in recent years, with total revenue expected to increase by 0.4 percentage point of GDP in 2024, reaching 25.9% of GDP against 25.5% in 2023. That would represent a 13% increase in revenue from 2023.

With expenditures growing faster than revenue however, the fiscal deficit is expected to widen to 4.6% of GDP, from 2.6% in 2023⁴. Public debt meanwhile would rise to 48.3% of GDP, which the IMF considers as sustainable with moderate risk of sovereign stress⁵.

Table 1 – Macroeconomic indicators 2020-2024

<i>(bln dram)</i>	2020	2021	2022	2023 (est.)	2024
Total revenue	1,574.0	1,706.0	2,099.6	2,408.1	2,723.6
<i>to GDP</i>	25.5%	24.4%	24.7%	25.5%	25.9%
Total expenditure	1,908.0	2,027.0	2,279.1	2,653.4	3,206.5
<i>to GDP</i>	30.9%	29.0%	26.8%	28.1%	30.5%
Fiscal balance	334.0	320.5	179.5	245.3	482.9
<i>to GDP</i>	5.4%	4.6%	2.1%	2.6%	4.6%
Public debt	3,923.9	4,209.8	3,969.7	4,446.1	5,082.9
<i>to GDP</i>	63.5%	60.3%	46.7%	47.0%	48.3%

Source: Budget statement 2024. Note: 2023 data are preliminary estimates

The budget deficit of 482.9 bln dram (EUR 1.09 billion) is planned to be financed both from internal sources (72.7%) and external sources (27.3%).

Analysis of macroeconomic and fiscal assumptions underlying Budget 2024

At the time of Budget 2024 preparation, the government was estimating that GDP growth in 2023 would reach 7.4%. More recently, on January 8th 2024, the Minister of Economy announced that 2023 economic growth was in the 8.3-8.5% range⁶. This actually might lead to a re-evaluation of GDP growth projections for 2024.

⁴ Estimates for 2023 are preliminary MoF estimates as of October/November 2023

⁵ IMF Article IV consultation report, December 2023

⁶ <https://www.azatutyun.am/a/32767586.html>

The Budget for 2024 was developed based on a 7% growth scenario, with 3.2% inflation (period average). As the budget statement puts it, Armenia has seized the opportunity of international sanctions on Russia to turn itself into a trade, logistics and financial hub. Indeed, economic growth since 2022 has been largely driven by re-exports of various goods to Russia. In January-October 2023, Armenian exports to Russia rose by 63%, to USD 2.9 billion, representing half of Armenia’s overall export revenue. Meanwhile industrial output rose by only 2.1% in January-November 2023.

Table 2 – Macroeconomic indicators 2020-2024

<i>(bln dram)</i>	2020	2021	2022	2023	2024
Nominal GDP	6,181.9	6,991.8	8,501.4	9,450.1	10,516.1
GDP growth	-7.2%	5.8%	12.6%	7.4%	7.0%
Inflation (average)	1.2%	7.2%	8.6%	2.2%	3.2%
Current account to GDP	-4.0%	-3.5%	0.8%	-4.0%	-4.8%
Public debt to GDP	63.5%	60.3%	46.7%	47.0%	48.3%

Source: Budget Statement 2024

In this context, the Budget Statement 2024 identifies significant downward risks to its macroeconomic projections, among which:

- Lower growth of the Russian economy
- Lower global economy growth, in particular Armenia’s partner countries
- Reversal of significant inflow of people and capital from Russia to Armenia
- Net outflow of capital from Armenia and the increase in the cost of financing deficits with the external debt of the private sector and the government following higher-than-expected increase in interest rates in developed countries
- Deepening of the logistics problems of the export of RA goods
- Geopolitical situation, including regional military conflicts
- Internal risks such as AMD exchange rate, inflationary pressures, under-performance of capital investment projects, unfavourable climate conditions impacting agriculture growth.

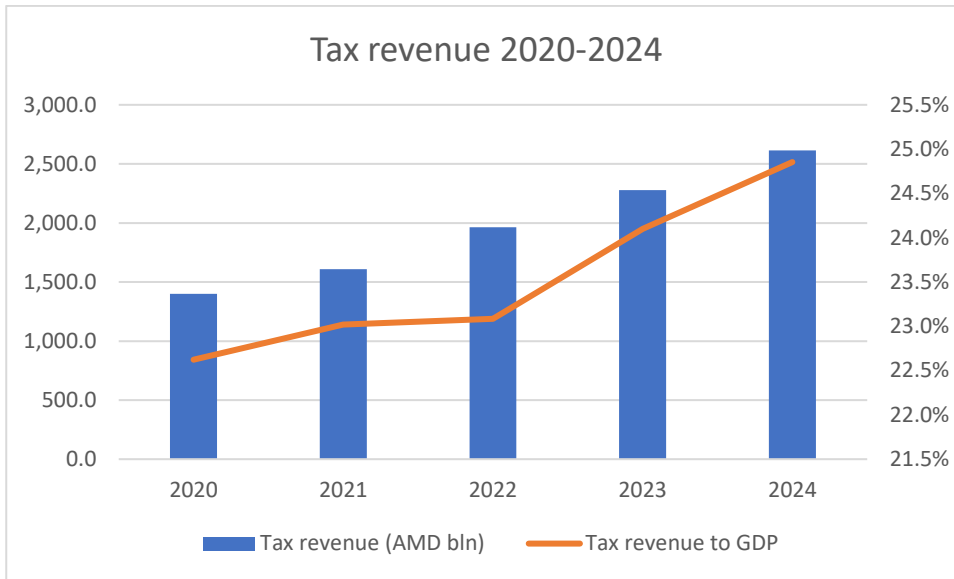
Analysis of the revenue side

Thanks to pursued tax policy and administration reforms, total revenue is set to increase by 13% compared to 2023 and to reach 2,723 bln dram (about EUR 6.8 bln) or 25.9% of GDP compared to 25.4% estimated in 2023. Total revenue is formed by domestic revenue (25.7% of GDP expected in 2024) and grants (0.2% of GDP), which include EU budget support. Grants have been stable at 0.2% since 2021 (they stood at 0.9% in 2020).

Domestic revenue includes tax and duties (24.9% of GDP in 2024) and non-tax revenue (0.8% of GDP).

Tax revenue (tax and duties) has increased consistently since 2020, from 22.6% of GDP in 2020 to 24.1% in 2023. The authorities’ ambition to bring tax revenue to 25% of GDP by 2026. However, with stronger-than-expected economic growth in 2022 and 2023, this target could be reached as early as 2024 (24.9%).

Figure 1 – Tax revenue 2020-2024



As can be seen in the table and graph below, the most important taxes are VAT (34% of total tax revenue), income tax (26%) and profit tax (15%). Customs duties are rather limited (3% of total tax revenue) due to Armenia’s membership in the Eurasian Economic Union with Russia, which includes a customs union. Customs duties on trade with Russia are therefore very limited.

Figure 2 – Tax revenue 2024 (by main taxes)

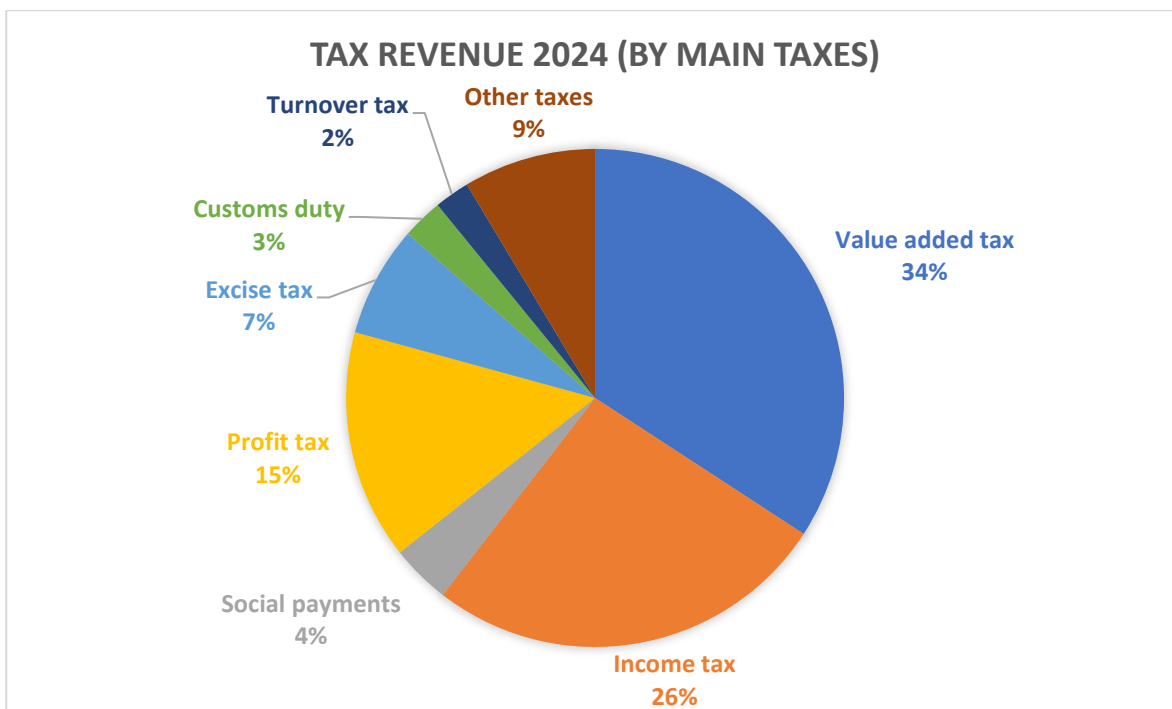


Table 3 – Revenue from main taxes and duties (2022-2024, in AMD billion and % of GDP)

	In AMD billion			In % of GDP		
	2022	2023	2024	2022	2023	2024
General taxes and duties	1,962.5	2,277.8	2,613.6	23.1	24.1	24.9
Value added tax	679.6	793.8	893.7	8.0	8.4	8.5
Income tax	511.3	591.8	687.0	6.0	6.3	6.5
Social payments	64.5	87.7	101	0.8	0.9	1
Profit tax	222.8	340.7	389.8	2.6	3.6	3.7
Excise tax	127.5	151.9	188.2	1.5	1.6	1.8
Customs duty	56.7	67.7	69.2	0.7	0.7	0.7
Turnover tax	40.7	53.8	59.6	0.5	0.6	0.6
Other taxes	259.5	190.4	225.2	3.1	2	2.1

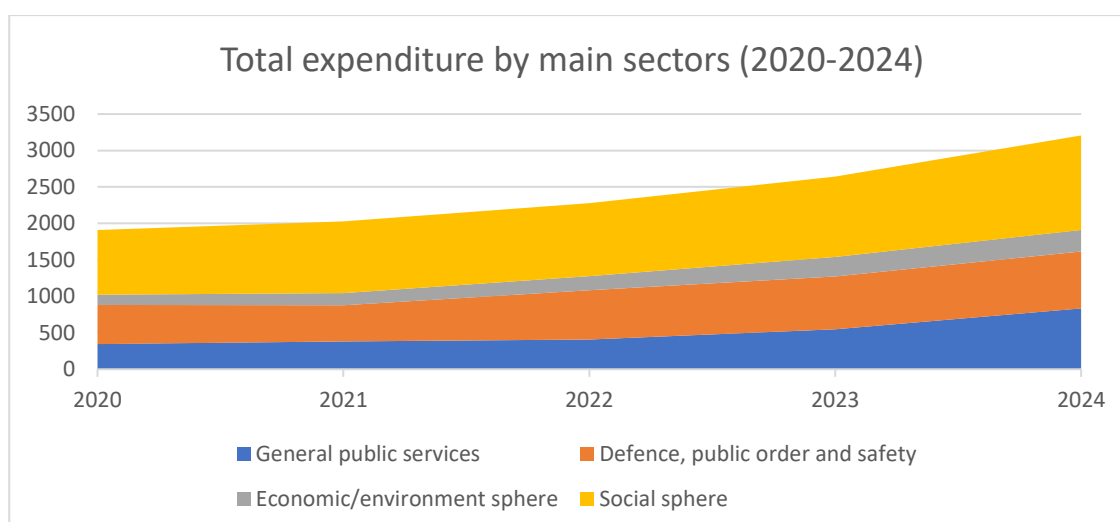
Analysis of the expenditure side

Expenditure is planned to increase sharply in 2024 (by 21%) and to reach 3,206 bln dram (about EUR 8 bln) or 30.5% of GDP (against 28.1% estimated in 2023).

Figure 3 below shows that the social and security sectors have dominated budgets since 2020. However, in 2024 the heading “General Public Services” took over security due to the integration in Budget 2024 of previously off-budget programs (annual loan to Nagorno Karabagh, now redirected to the Government Reserve Fund, and mortgage subsidy), as well as a surge in debt service, all of which are accounted for this category of expenditure.

Social spending are to increase in 2024, notably due to the influx of refugees from Nagorno Karabagh, which are to benefit from social protection programmes, but also due to a massive investment in education infrastructure (school renovation programme).

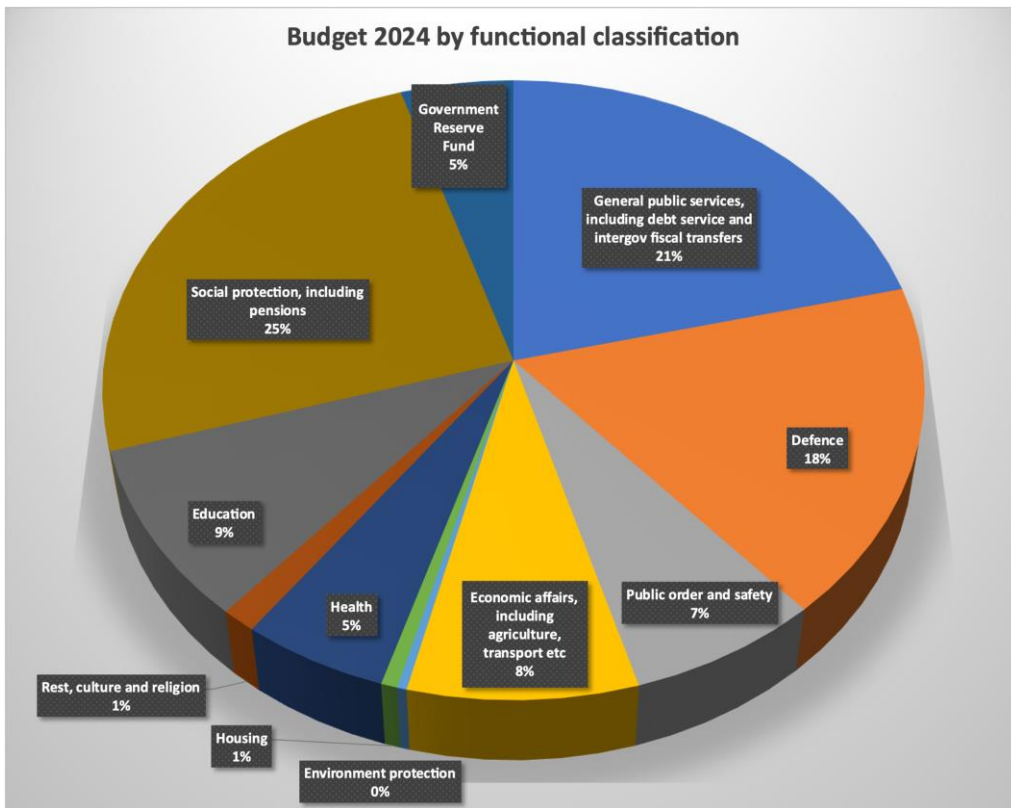
Figure 3 – Total expenditure by main headings of the functional classification (2020-2024)



More precisely, the structure of Budget 2024 by functional classification is shown in Figure 4 below. It shows that social protection (including pensions) represents 25% of public spending, followed by general public services (21%, which include debt service and intergovernmental fiscal transfers, i.e. grants from central government to subnational administrations and governments), defence (18%),

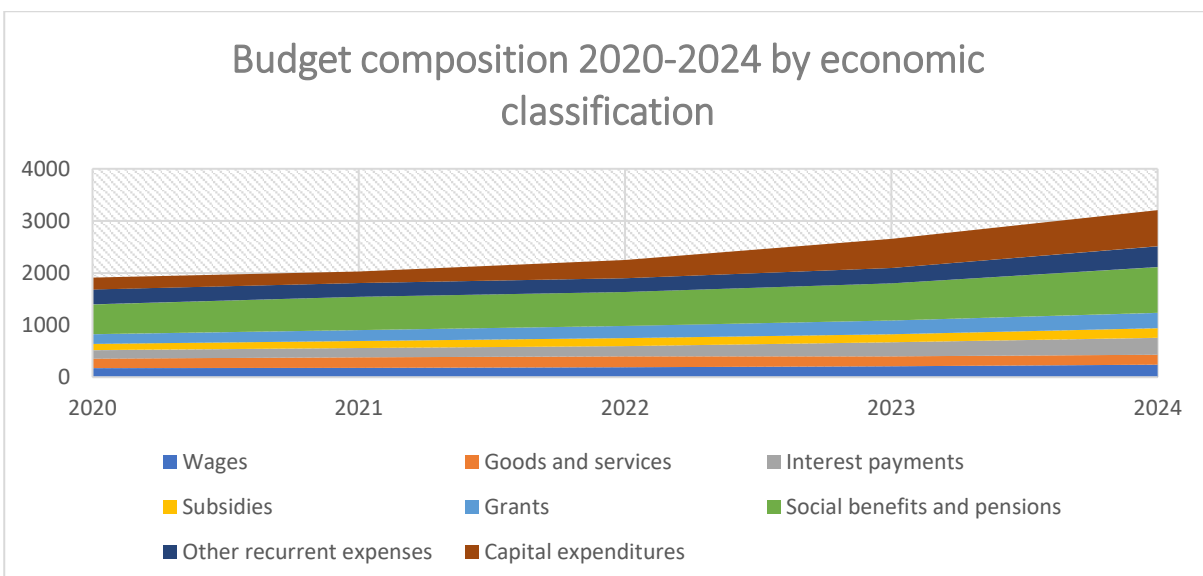
education (9%), economic sector (8%, which include agriculture, transport etc), public order and safety (7%, including judiciary), health (5%) etc.

Figure 4 – Budget 2024 by functional classification



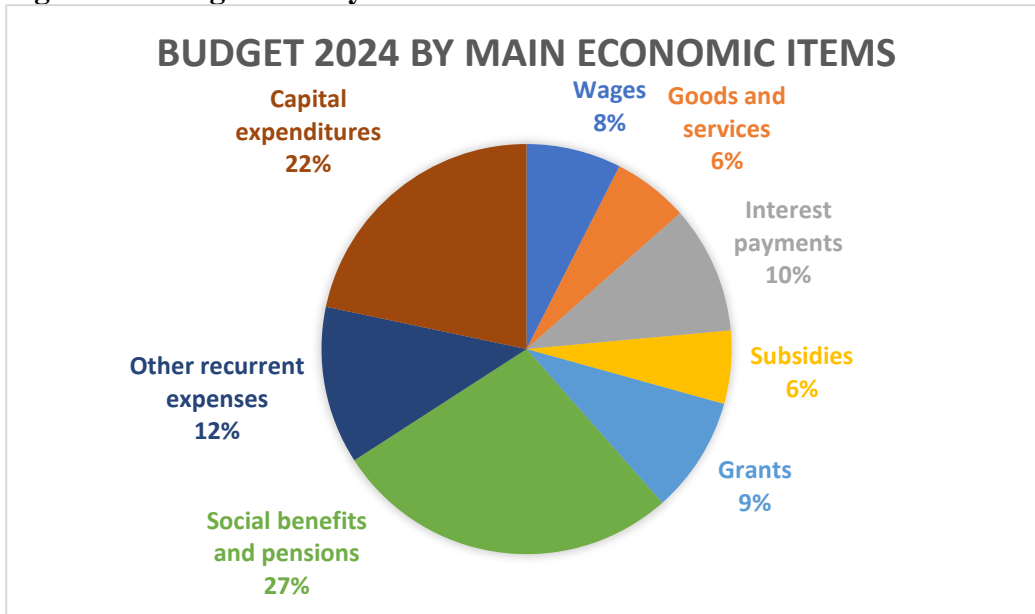
Budget composition by main economic items (economic classification) shows that social benefits and pensions have dominated the budget structure in the period 2020-2023 and will continue in 2024. It is noticeable that since 2023, the government has significantly increased capital expenditure, which is to reach 22% of the budget in 2024, as opposed to only 10% in 2020, as well as debt service (interest payment) which nearly doubled since 2020.

Figure 5 – Budget composition by economic classification (2020-2024)



In 2024, 78% of the budget is allocated to recurrent spending and 22% to capital expenditure. As can be seen in Figure 6 below, social benefits and pensions are the first expenditure items in 2024 (26%), followed by capital expenditures (22%), interest payments (10%), grants (9%), wages (8%), goods and services (6%), subsidies (6%), and other recurrent expenses (12%) etc.

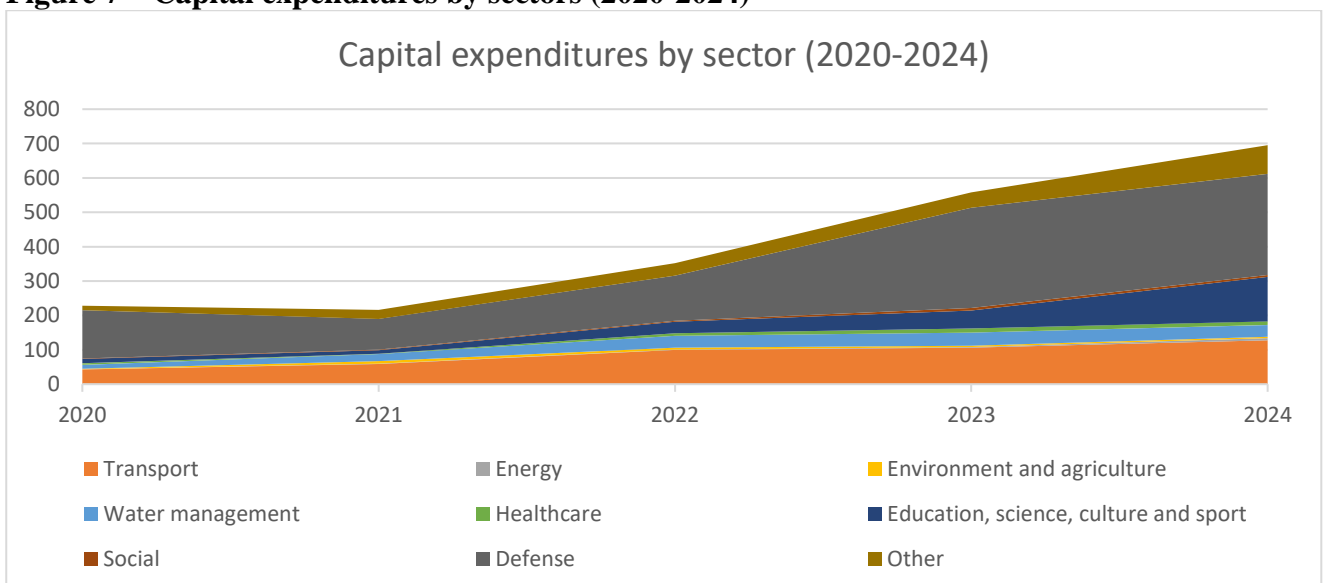
Figure 6 – Budget 2024 by main economic items



Capital expenditures are directed in such directions that will increase the potential of the economy in the medium and long term. The government has introduced major Public Investment Management reforms in 2023, under the leadership of the Ministry of Economy, with a new regulatory framework streamlining the public investment programme and strengthening investment project selection rules as well as monitoring and evaluation.

Figure 7 below shows that capital expenditures have been sluggish in the Covid years (2020-2021), which also were the years of the conflict with Azerbaijan over Nagorno Karabagh and its aftermaths, but started to increase substantially in 2022 and 2023, in particular in the defence sector. (42% of total public investment in 2024) Transport and education are increasing in 2024.

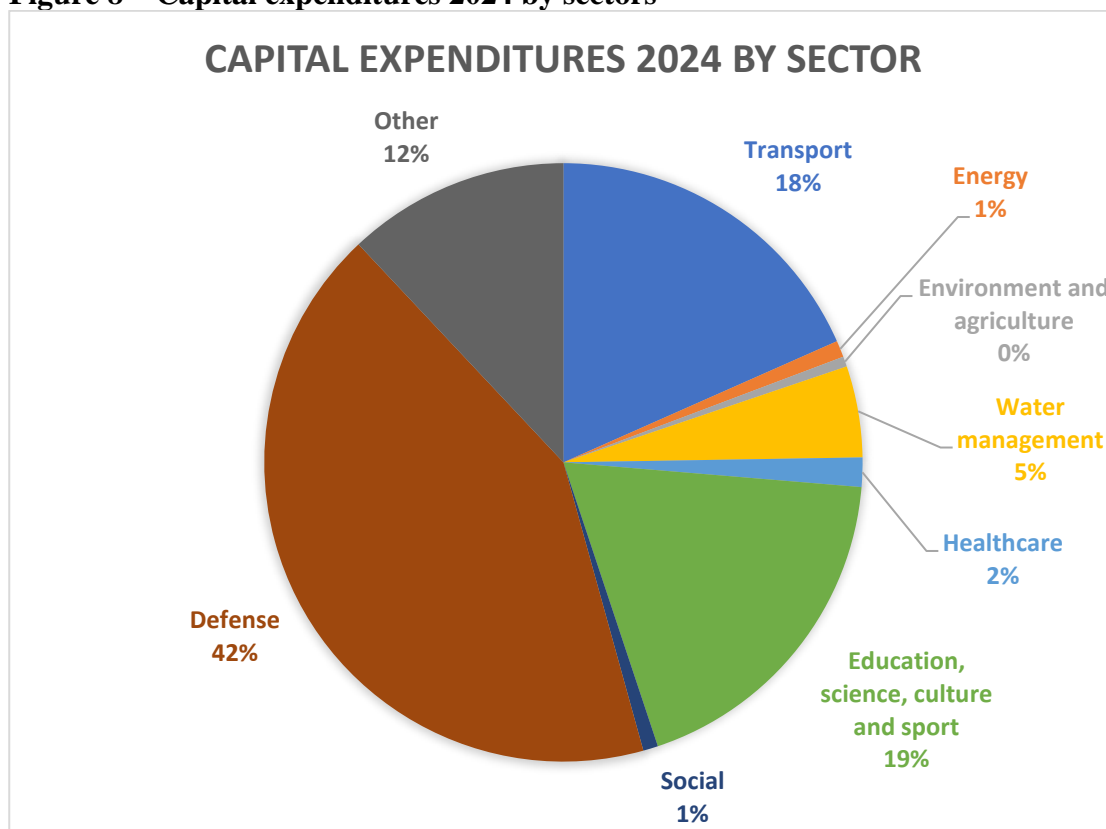
Figure 7 – Capital expenditures by sectors (2020-2024)



The government is making it a priority to increase investment in public infrastructure, with public investment reaching 6.6% of GDP in 2024 compared to 5.9% in 2023, thanks in particular to a 76.8 billion dram increase in education infrastructure (construction, repair or overhaul of 300 schools and 500 kindergartens) compared to 2023. As can be seen in Figure 8 below, the other three most important areas for public investment are defence, transport (road construction, with the North-South corridor and road repair programs) and water management (15 small and medium reservoir construction projects).

Total capital spending in Budget 2024 is set to reach AMD 695.3 bln (EUR 1.57 billion), 82.4% of which from domestic resources and 17.6% only financed externally.

Figure 8 – Capital expenditures 2024 by sectors



Subnational financing

Total transfers from central governments to local self-government bodies (communities) will amount to 157.2 bln drams in budget 2024, or 4.9% of total expenditure and 1.5% of GDP. Of these, 85.3 billion are for equalisation grants. Others transfer categories include special grants (subsidies) to communities and grants for delegated function.

Tax expenditures

Tax expenditures are quantified in the budget documentation; in 2024 they are expected to amount to 683 bln dram (EUR 1.5 bln) or 6.4% of GDP. Overall, tax expenditures represent 26.1% of total tax revenue in 2024. In 2023, tax expenditures were standing at 26.5% of tax revenue and 6.28% of GDP. Most of tax expenditure relate to VAT exemptions to the financial/insurance sectors, as well as health, agriculture, and IT sectors.

Conclusion

- Overall, the Budget for 2024 appears to be realistic and should contribute to macroeconomic and fiscal stability.
- Although the budget presents a higher deficit than in 2022 and 2023, it remains in line with the overall objective of fiscal stability agreed with the IMF, in particular keeping the debt to GDP ratio below 50% of GDP.
- Economic growth projections set at 7% seem reasonable, especially considering recent government statements that 2023 GDP growth was close to 8.5% (against 7.4% expected during budget presentation during Q4 2023); the IMF however is more prudent and sees growth moderating to 5% in 2024⁷.
- Yet, there are important downside risks, as growth is mainly based on trade with Russia. Security is also a significant risk in the context of heightened tensions with Azerbaijan.
- The projected increase in revenue (+13%) seems achievable considering that several key tax reforms will kick-in in 2024 with IMF support; there is a high level of commitment to tax reforms from government.
- Budget priorities are well-balanced with, beyond the strategic need to keep defence spending at a high level, increased investment in economic and social sectors to secure more effective and inclusive economic growth.

⁷ IMF projections are based on the Article IV mission that took place in September 2023; the report was issued in December 2023.