

## Analysis

### Armenia: How a Small Country Counters the Global Crisis

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#### Abstract

Armenia, a small country lacking substantial natural resources and a competitive economy, is potentially very vulnerable to the global economic crisis. The first wave, namely the financial storm that began in September, had no effect in Armenia for the simple reason that the Armenian financial system is very small and had little contact with international financial markets. However, beginning in October 2008, the country felt a strong impact.

#### Crisis Challenges

At the beginning of the global economic crisis, most experts and officials agreed that the main challenges presented by the crisis for Armenia were external and derived from the crisis' impact on Armenia's major trading partners. Two shocks were seen as especially dangerous, namely, the drop in exports and the failure of the country to attract foreign investment.

Two major components of Armenia's exports are most vulnerable to the crisis. First, Armenia is a major exporter of basic metals, primarily copper and molybdenum. Shrinking demand and/or falling prices in the world market would hit the country hard. The second type of Armenian exports are not always considered to be "exports." This "export" is in fact private transfers of money from Armenians living abroad, mostly migrant workers, who send money to their relatives back to Armenia. The amount of this money is quite large: in 2008 it was more than \$2.1 billion, which is more than half of the domestic retail trade turnover. For specialists, such remittances represent an export of labor. And like other types of exports, revenues flowing back to Armenia depend on the demand for the exported commodity (the labor) and on its price, i.e., the amount of employment and the level of salaries in the countries where these people work. As more than 70 percent of Armenian migrant workers are in Russia, the fate of this type of Armenian "exports" depends, first of all, on the performance of the Russian economy, in particular, the construction industry, where a substantial part of the Armenian migrant workers are employed. In the worst-case scenario, the crisis might force some of the Armenians living abroad to return home, which might cause an even higher rate of unemployment and more burden on the government budget.

Both types of exports suffered as the economic crisis reached Armenia's partners. The price for metals dropped in October-December to half of the level they had been in early 2008, and Armenian mine production fell 7

percent in the first ten months of 2008. As for the second important component of Armenian "exports," private remittances fell 25 percent in January-March 2009. Both factors combined to cause a shortage of foreign currency in the country, forcing the authorities to depreciate the dram, the national currency of Armenia. The Central Bank preferred to avoid a gradual depreciation of the dram (contrary to what was seen in Russia), and sold dollars for a while to avoid mass panic. However, on March 3, 2009, they announced their decision to stop intervening in the market and the dram exchange rate immediately fell from 305 dram/dollar to 360. Since then, the situation in the currency market has been relatively stable, and the Central Bank has had no need to intervene.

The second negative trend, the decrease in foreign investments (especially in the construction sector, which had been growing quickly in recent years) started even before the global crisis reached Armenia. The August Georgia-Russia war created transportation problems for Armenia and raised fears among investors. As a result, investments shrank drastically, and the crisis, which arrived a month later, prevented investment activity from recovering.

#### The Impact of the Crisis

The crisis has had a strong impact on the Armenian economy. In 2008, the economy grew 6.8 percent. This seemingly high rate was in fact a sign of trouble, as during the previous seven years, Armenian GDP had grown at rates above 10 percent a year. Meanwhile, in 2009, the situation deteriorated much faster, since in January-March real GDP was 6.1 percent lower than a year earlier. This drop was the first decline in the Armenian economy since 1994, the end of the crisis caused by the USSR's collapse and the war over Nagorno Karabakh. In addition, budget revenues in the first quarter of 2009 fell almost 10 percent against the level of the previous year, whereas the state budget had envisaged 14 per-

cent growth. The government decided to re-schedule its spending plans, moving some of the previously planned expenditures to the fourth quarter, hoping that it would have more money then.

The decline affected almost every sphere of the economy, with industrial output dropping to 90.5 percent of the level of the first quarter of 2008, agricultural production to 94.9 percent, and construction to 78.1 percent. The service sector was the only one to show a slight increase. Foreign trade shrank drastically, with exports comprising just 52.7 percent of the level of a year ago, and imports, 77.8 percent.

In late March, the Central Bank presented its latest forecast for the real GDP, according to which, it will fall by approximately 3 percent year-to-year by the end of 2009, and the most likely value of inflation is 5.9 percent in December.

### The Anti-Crisis Program

The government announced the general outline of its anti-crisis program early on, in November 2008. Prime Minister Tigran Sargsyan presented the National Assembly a plan including measures similar to those adopted by many developed nations, seeking to stimulate consumption while supporting local producers and exports. In particular, the government promised to subsidize or provide loan guarantees to companies having difficulties and even take a stake in some of them. The authorities also pledged to improve conditions for small and medium-sized companies, which create most jobs. No tax cuts were planned (although some measures reducing the tax burden were undertaken later) and the government continues to push ahead with its strategy to improve tax collection and reduce the size of the shadow economy, a program started in May 2008. Finally, the government pledged to meet all its social obligations, including the construction of cheap housing and making mortgages available to a wider range of people.

A major part of the anti-crisis program was infrastructure construction. It included extensive plans to modernize rural roads and build a new international motorway, a project for which the presidents of Armenia and Georgian reached preliminary agreement in October. This road will run from the Georgian port of Batumi to the Armenian-populated Samtskhe-Javakhetia region of Georgia into Armenia and then through Gyumri-Yerevan-Meghri to the Armenian-Iranian border. The government expects to get loans from the Asian Development Bank for these works. A large-scale construction program in the zone of the 1988 earthquake, where several thousand people are still homeless, is part of the gov-

ernment program as well. 70 billion drams (190 million dollars) are planned for this purpose.

The government also announced its decision to create two "Free Economic Zones," one around Zvartnots international airport near Yerevan, and one in Gyumri, the second largest city of Armenia, which was strongly hit by the 1988 earthquake and has been economically depressed since then.

Finally, a distinguishing feature of the anti-crisis plan is its ambition to attract the funds of non-residents, particularly Diaspora Armenians, into the Armenian banking system. This system is relatively small, but the banks are well capitalized, and, as indicated above, did not suffer from the global financial turmoil. Thus, the government hopes to persuade the Diaspora Armenians to use the Armenian banks as a safe haven for their money during the crisis. In addition, the government is going to launch the so-called All-Armenian bank, a special commercial structure (with the government as a major shareholder) aimed at attracting the funds of Diaspora Armenians for investments in Armenia.

### External Assistance

Evidently, the government will need funds from external sources to implement these anti-crisis measures, especially as state budget revenues declined following the economic downturn. The sum needed to close the budget gap and realize the above-mentioned ambitious plans is estimated to be at least 1.5 billion dollars (the official state budget is equivalent to 2.5 billion dollars, however, it is unlikely to be fully collected). The government has already succeeded in getting part of this sum. In March, the IMF approved a \$540 million stand-by arrangement, of which \$239 million was made available immediately. The IMF acknowledged the quality of the anti-crisis program of the Armenian government by providing a loan unprecedented in size, as it equals four times Armenia's quota in the IMF. Second, Russia, Armenia's important economic and political partner, provided initial consent in February for a \$500 million stabilization loan. This loan was expected to arrive in a lump sum in March, however, it has been delayed (reportedly, due to technical reasons) and is now expected to be available in June. The World Bank, in turn, agreed on extending to Armenia four loans totaling \$85 million, including \$35 million in fast-track funds aimed at providing "immediate employment opportunities." This is part of a \$525 million World Bank assistance package for 2009-2012. Finally, the Asian Development Bank has agreed to extend two loans totaling \$47 million for different programs.

Negotiations are under way for additional sources of external funding. In addition, a large inflow of funds is expected from Iran to implement several joint programs in Armenia, including construction of a hydro-power station and a pipeline for pumping oil products from Tebriz to Armenia.

### Anti-Crisis Measures

The Armenian government has so far performed the following major anti-crisis measures to boost business activity and create jobs.

- Simplification of tax, accounting and reporting rules for small and medium-sized businesses. This process started with the adoption of a legislative package last year, but its implementation is controversial.
- Full restoration of operations at five mining companies producing copper and molybdenum. This measure saved 6,000 jobs, which were important especially for the Syunik province (marz) in the south. Due to some recovery in metal prices, their work is nearly profitable; in addition, the government provides assistance to these companies.
- Government subsidies to perspective businesses. So far, more than twenty companies have received some 25 billion drams (\$67 million) in different forms of assistance, such as loans, credit guarantees and share-buying by the government. These companies

are involved in a wide range of activities, including food processing, textiles, software, machine-tool production and others.

- Loan guarantees to developers for completing the construction of buildings that are already 50 percent or more complete. The total sum of guarantees declared on April 13 was 20 billion drams (\$54 million).
- Start of the small and medium-size business crediting program under the World Bank's \$50 million loan.

The results of these measures are not yet evident. In particular, local business is in a very difficult state due to extremely high interest rates, now around 20 percent for credits. Government critics claim it has much to do in improving the business climate in the country.

### Conclusion

Externally, no crisis signs are evident in Armenia. Life in the country has not undergone visible changes. Moreover, recently released statistical data show that retail trade in January-March 2009 increased against the same period of the previous year, despite the decrease in the GDP. The government has not encountered any problems in fulfilling its promises. However, the living standards of the population in Armenia may drop if the world economic crisis persists.

#### *About the author*

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