Press Statement — IMF Staff Visit to Armenia

July 2, 2007

A mission from the International Monetary Fund (IMF), led by Ms. Marta Castello-Branco, visited Yerevan from June 26 to July 2, 2007 to discuss Armenia's macroeconomic performance and outlook with the new Government, the Central Bank of Armenia (CBA), business representatives, and the international donor community. The IMF mission held productive discussions with the authorities on various topics, including pension reform, the gas subsidy, and the measures needed to maintain external competitiveness against the backdrop of continued real appreciation pressures.

Macroeconomic Performance and Outlook

Armenia's economic performance so far this year remains impressive, with GDP growth stronger than expected, inflation in line with the CBA's target, and an overperformance in tax collection. On the downside, inflationary pressures are on the rise because of a sharp increase in grain import prices, higher government spending envisaged in the second half of the year, and expected continued foreign exchange purchases by the CBA.

Despite notable progress, several challenges remain. First and foremost, there is a need to sustain economic growth and further reduce poverty. Another key challenge is to keep inflation low—not an easy task in view of external shocks (such as the grain price hike), fiscal pressures, and persistent large foreign exchange inflows.

The Government Program for 2008-2012 rightfully addresses many of these issues. We welcome the program's focus on boosting growth, reducing poverty, and combating corruption, while maintaining sound macroeconomic policies. We are particularly encouraged by the emphasis given to strengthening tax administration, avoiding new tax exemptions, improving the quality and depth of financial intermediation, and, more generally, improving the business climate to downsize the shadow economy, raise productivity, and maintain competitiveness.

Pension reform

We welcome the authorities' plans to reform Armenia's pension system. However, a successful pension reform that improves living standards and strengthens the link between contributions and benefits will necessarily entail fiscal costs, which have to be realistically estimated and weighed against other competing government priorities. We therefore recommend a comprehensive assessment of all potential costs and their effect on inflation.

Gas subsidy

The government is committed to allowing the current gas subsidy to expire at end-2008. However, the expiration of the subsidy, combined with the likely increase in import prices when the current contract expires in 2009, creates the potential for sharp increases in consumer tariffs. One way to avoid this sharp increase would be to gradually reduce the subsidy, starting as soon as possible. The steady appreciation of the dram should help smooth this process, by making gas imports cheaper in dram terms. Budgetary savings from the gradual reduction in the subsidy could be used to protect low-income households, ideally by a well-designed safety net targeted to the poor.

Maintaining External Competitiveness

Foreign exchange inflows, mainly related to remittances and investments in real estate, have already resulted in a notable appreciation of the dram, complicating the conduct of monetary policy. Since these inflows are likely to continue in the foreseeable future, further real appreciation is inevitable. And this will come in the form of either nominal appreciation or inflation.

While specific export sectors and remittance-dependent households have suffered from the appreciation, the available evidence suggests that the Armenian economy as a whole remains broadly competitive. For example, total exports in the first quarter of 2007 still grew by 25 percent compared with the first quarter of 2006. Maintaining competitiveness, however, will require additional efforts by the government to improve the business environment and boost productivity.

Against the backdrop of large and sustained foreign exchange inflows, monetary policy cannot prevent real appreciation beyond the short term. While the CBA can limit nominal appreciation by purchasing foreign currency and selling dram, this will eventually lead to higher inflation, which is equally harmful for businesses and households, but especially for the poor. Therefore, the CBA's focus on price stability and on maintaining a broadly flexible exchange rate remains appropriate. At the same time, fiscal policy and structural reforms should play an important role in limiting pressures for real appreciation and helping businesses to adjust more easily to this appreciation. This will require a strong effort to implement "second generation" reforms, as envisaged in the Government's program.