

Growth and Poverty Reduction in Armenia

Achievements and Challenges



Enrique Gelbard, Jimmy McHugh,
Garbis Iradian, Christian Beddies,
and Laure Redifer



**International
Monetary
Fund**

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ARMENIA

- SELECTED CITIES AND TOWNS
- ⊙ PROVINCE (MARZ) CAPITALS
- ⊕ NATIONAL CAPITAL
- RIVERS
- MAIN ROADS
- RAILROADS
- PROVINCE (MARZ) BOUNDARIES
- · - INTERNATIONAL BOUNDARIES

Preface

During the past three years, Armenia has emerged as a reform leader within the Commonwealth of Independent States, and its economic performance has surpassed that of other low-income countries. The key factors behind Armenia's economic performance are prudent monetary and fiscal policies, liberal trade and foreign exchange regimes, rapid and relatively well-sequenced structural reforms, and support from the Armenian diaspora.

Many reforms were initiated between 1994 and 1998, with critical fiscal and quasi-fiscal consolidation and structural reforms undertaken between 2001 and 2005. In addition, the implementation of a poverty reduction strategy since 2002 has complemented the effect of economic growth on reducing poverty. This paper assesses the country's economic transformation during the past 10 years, focusing on the recent period of economic stability, strong economic growth, and poverty reduction, and on the challenges to sustaining these successes.

This paper is a collaborative work coordinated by Enrique Gelbard. The other principal authors are Jimmy McHugh, Garbis Iradian, Christian Beddies, and Laure Redifer. The authors would like to thank Julian Berengaut for his guidance on this project. We are also indebted to Jean Le Dem, Vahram Stepanyan, Gohar Minasyan, Vitali Kramarenko, Eric Mottu, Jerome Vandenbussche, David Grigorian, Nerses Yeritsyan, Armine Khachatryan, Hajime Takizawa, David Hauner, and Shuang Ding for their helpful comments on an earlier draft of the paper. Cecilia Lon compiled the document and provided invaluable administrative assistance. Special thanks to Debbie Chungu for her effective research assistance and to Linda Griffin Kean and Alicia Etchebarne-Bourdin in the External Relations Department of the Fund for their contributions in editing and coordinating the publication of the paper.

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Overview

The first decade of transition was difficult for Armenia. A severe earthquake, the breakup of the Soviet Union, and disputes with neighbors led to a drastic decline in output in the early 1990s. Unemployment rose sharply, real wages fell, and a shrinking tax base constrained government expenditures. The government suffered from persistent cash shortages that generated large external and domestic expenditure arrears. Declining living standards and rising poverty levels forced many of Armenia's most productive workers to migrate.

Several early reforms, initiated between 1994 and 1998, attempted to revitalize the economy. The reforms focused on privatizing land holdings and small-scale enterprises, and liberalizing prices, trade, and the foreign exchange regime. These policies adjusted relative prices and incentives, setting the stage for a period of market-driven capital formation. The economy rebounded in the second half of the 1990s, and inflation declined to single-digit levels.

As the 1990s ended, however, it became clear that a number of imbalances continued to constrain economic performance. Over 50 percent of the population still lived in poverty and emigration to other countries continued. Armenia's fiscal position was weak and was hampered by a continuous accumulation of internal and external payments' arrears. Furthermore, the banking sector entered into a difficult period that saw the collapse of about one-third of the country's commercial banks. Lastly, corruption in state-owned energy and water companies generated large interenterprise arrears and a sizable quasi-fiscal deficit.

In the face of these concerns, the authorities launched in 2001 a renewed stabilization and reform effort supported by the IMF's Poverty Reduction and Growth Facility (PRGF). Comprehensive reforms were introduced in the fiscal, banking, and energy sectors and these reforms were later aligned with a Poverty Reduction Strategy Paper (PRSP). The key goals were to boost growth through tax reform and deregulation, restore confidence in fiscal management and improve expenditure control, restructure the energy sector, and clean up the banking system.

The results have been impressive. Real economic growth has averaged 11 percent per year, annual inflation has averaged 3 percent, and poverty and inequality have fallen. The country has outperformed other low-income countries including those in the Commonwealth of Independent States (CIS). This is particularly important given the geographic location of Armenia, the closure of two critical borders, and occasional political turmoil. Notwithstanding these achievements,

per capita income is about US\$1,000, poverty rates are still high, and the structural reform agenda remains to be completed. Furthermore, the country's institutions need to be strengthened, and corruption remains a problem.

This paper evaluates Armenia's economic transformation since the early 1990s and identifies the issues and policies that deserve further attention to sustain growth and further reduce poverty. The first chapter contains an analysis of the path toward macroeconomic stabilization, the sequencing of reforms, and the successes and disappointments after a decade of transition. This analysis reveals four areas that are covered in the remaining chapters, namely, the growth process, the role of fiscal reforms, the importance of the financial sector, and trade integration.

Chapter 2 estimates productivity growth, analyzes changes in poverty and inequality, and looks at whether increase income levels in Armenia are likely to increase in line with the Millennium Development Goals (MDGs). Chapter 3 discusses fiscal and quasi-fiscal adjustment, the remaining priorities in the areas of tax and expenditure policies, and key long-term challenges. Chapter 4 deals with the barriers to financial sector development and ways to increase financial intermediation, while Chapter 5 describes recent changes in the pattern of trade, including the boom in exports and the potential effects of opening Armenia's borders. A concluding chapter summarizes the remaining reform agenda.