

Policy Challenges for Armenia in the Context of Regional and Global Economic Shocks

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Outline

Global Outlook

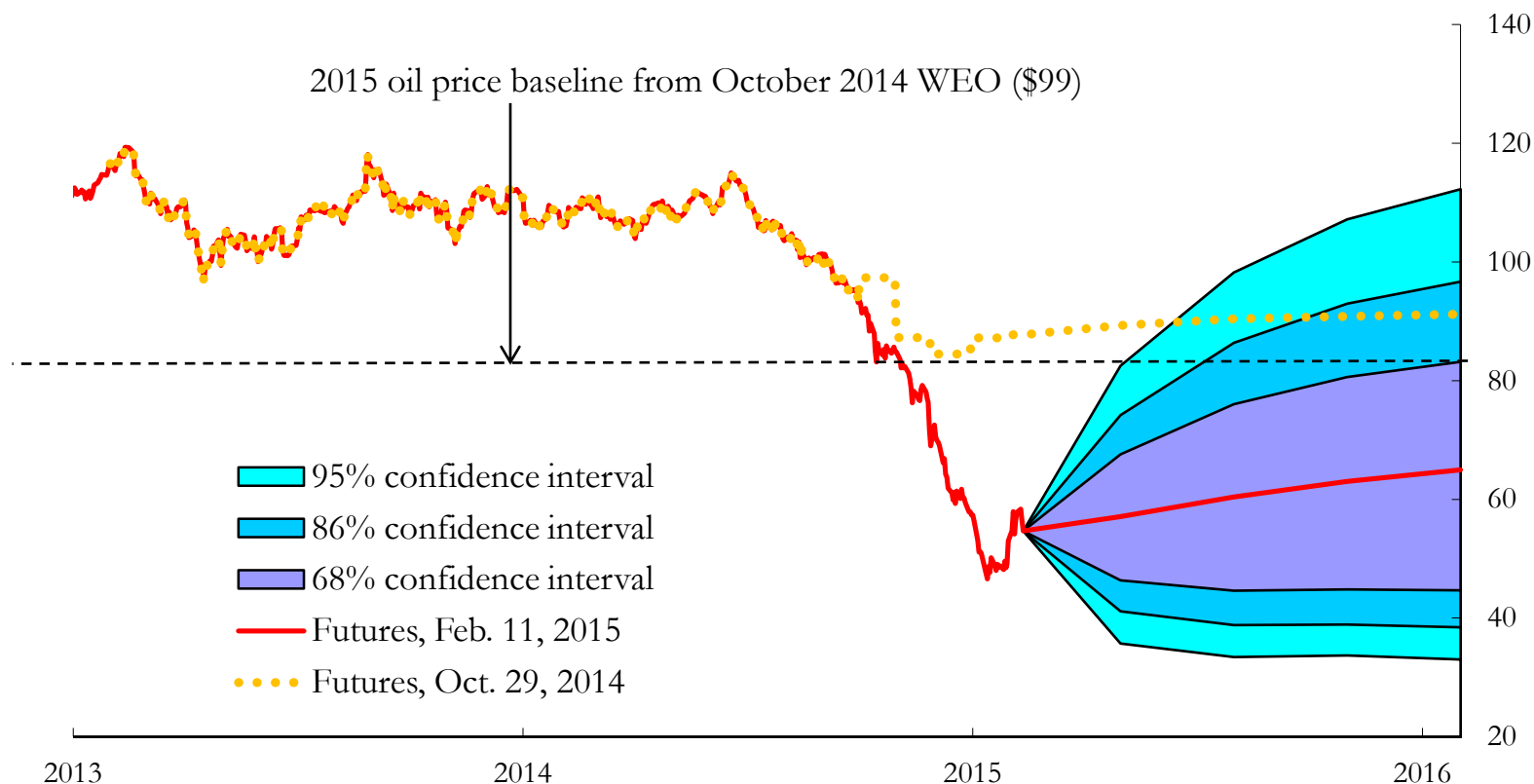
Armenia's Outlook from a Regional Perspective

Armenia's Challenges and Opportunities

One of the major recent global developments has been the almost 50 percent drop in oil prices

Oil Price Prospects

(Brent crude oil; U.S. dollars a barrel)



Sources: Bloomberg; and IMF Research Dept. Commodities team calculations.

¹Derived from prices of Brent futures and options on Feb. 11, 2015.



Difficult to predict how oil prices would evolve, given considerable historical volatility

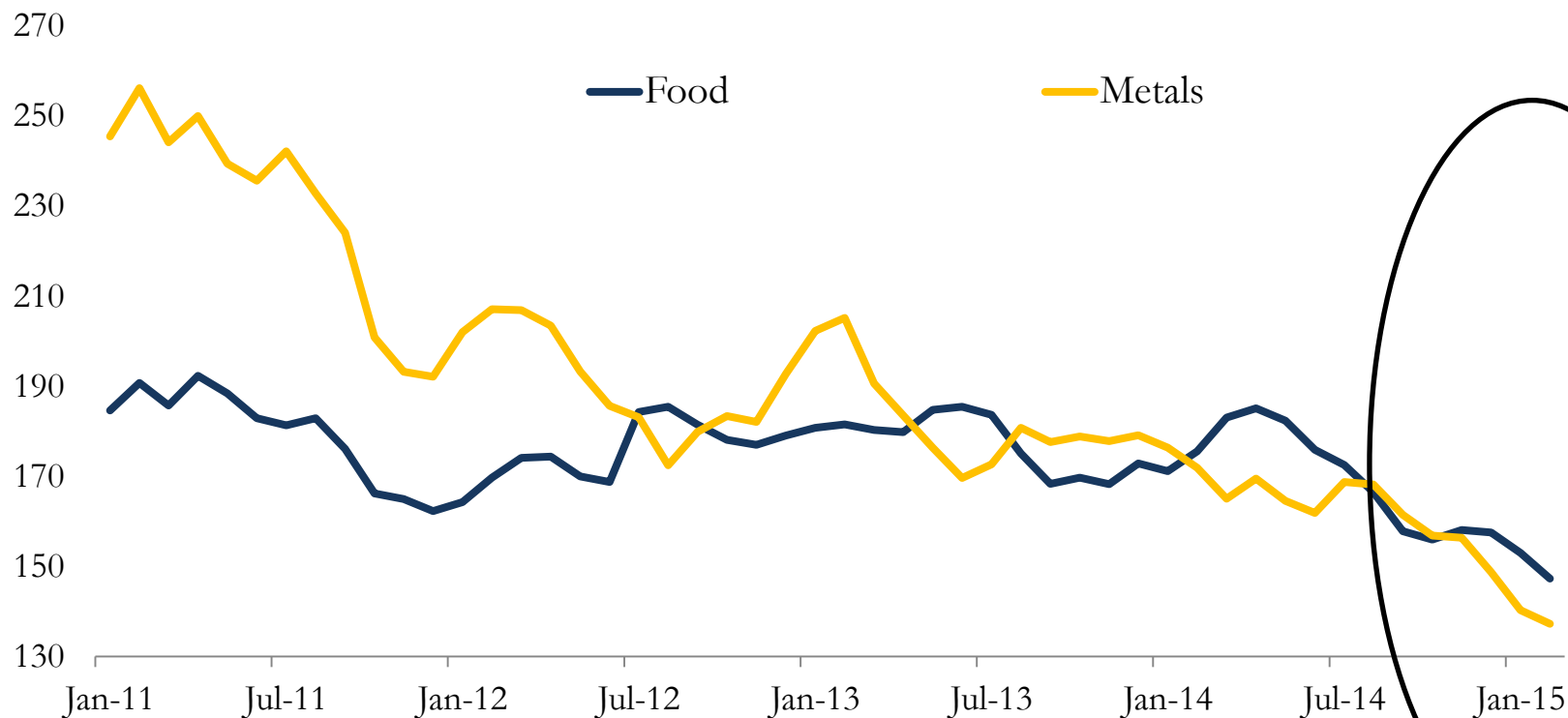
Brent Crude Oil Price

(U.S. dollars per barrel)



Other commodity prices have also declined

Commodity Prices
(2005=100)



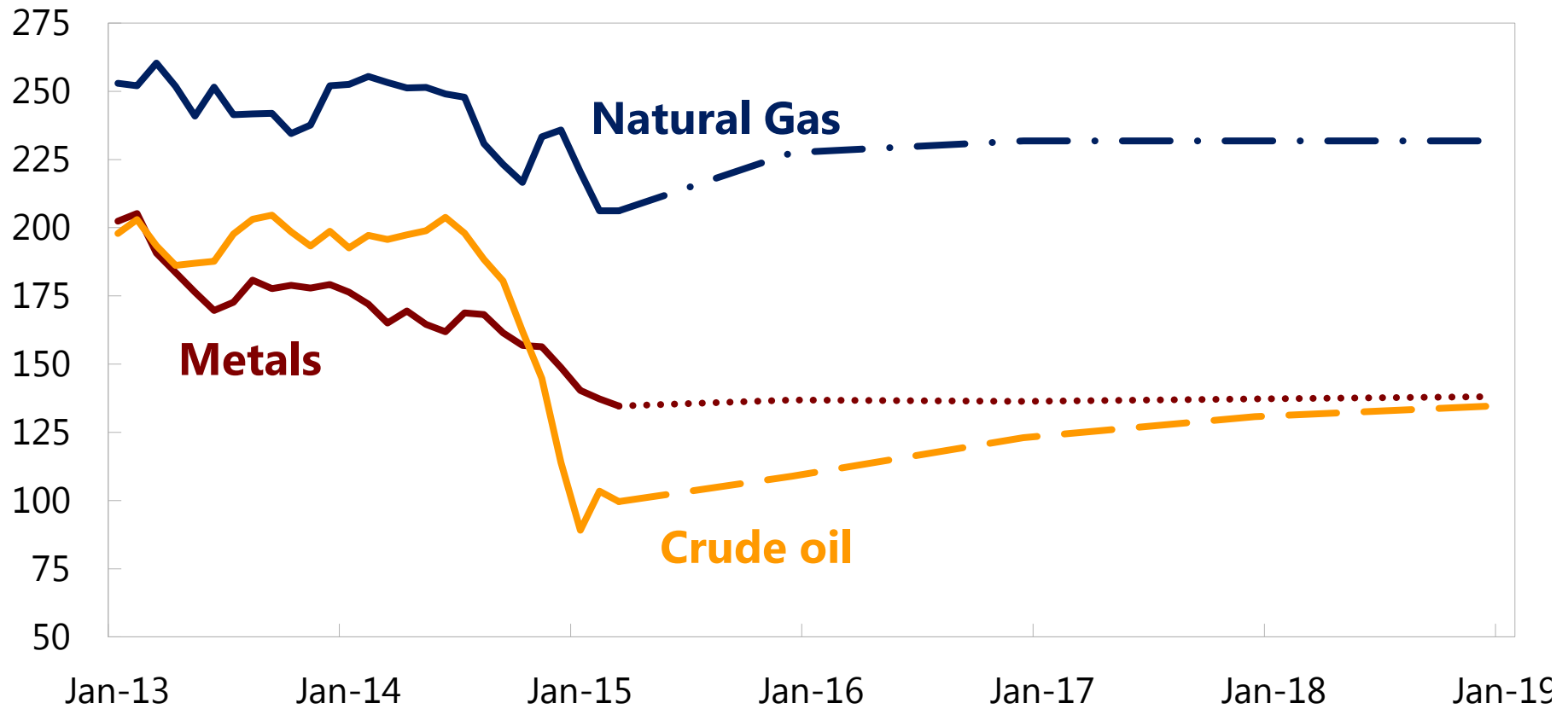
Source: IMF Primary Commodity Prices database.

Sources: IMF, WEO Global Assumptions; and Bloomberg, L.P.



Although some regional commodity prices, such as natural gas, have declined less ...

Price Indices



Sources: IMF, WEO Global Assumptions; and Bloomberg, L.P.



Global growth remains moderate and uneven, with significant downside risks



	World	U.S.	Euro Area	Emerging markets	China	Russia	Armenia
2014	3.4	2.4	0.9	4.6	7.4	0.6	3.4
2015	3.5	3.3	1.5	4.3	6.8	-3.8	0.0
Revision from Fall 2014	-0.3	0.2	0.1	-0.7	-0.3	-4.3	-4.5
2016	3.7	3.1	1.6	4.7	6.3	-1.0	1.0
Revision from Fall 2014	-0.3	0.3	-0.1	-0.5	-0.5	-2.5	-3.7

Sources: National authorities; and IMF staff calculations.



How is this affecting Armenia and the Caucasus and Central Asian Region?



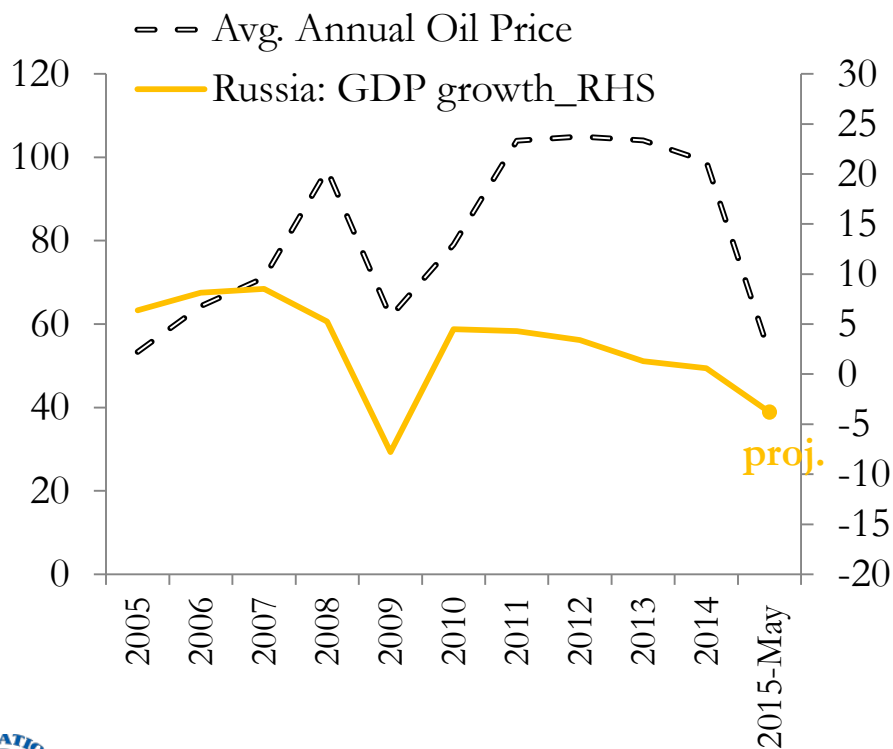
Directly because some CCA countries are heavily dependent on oil production and exports



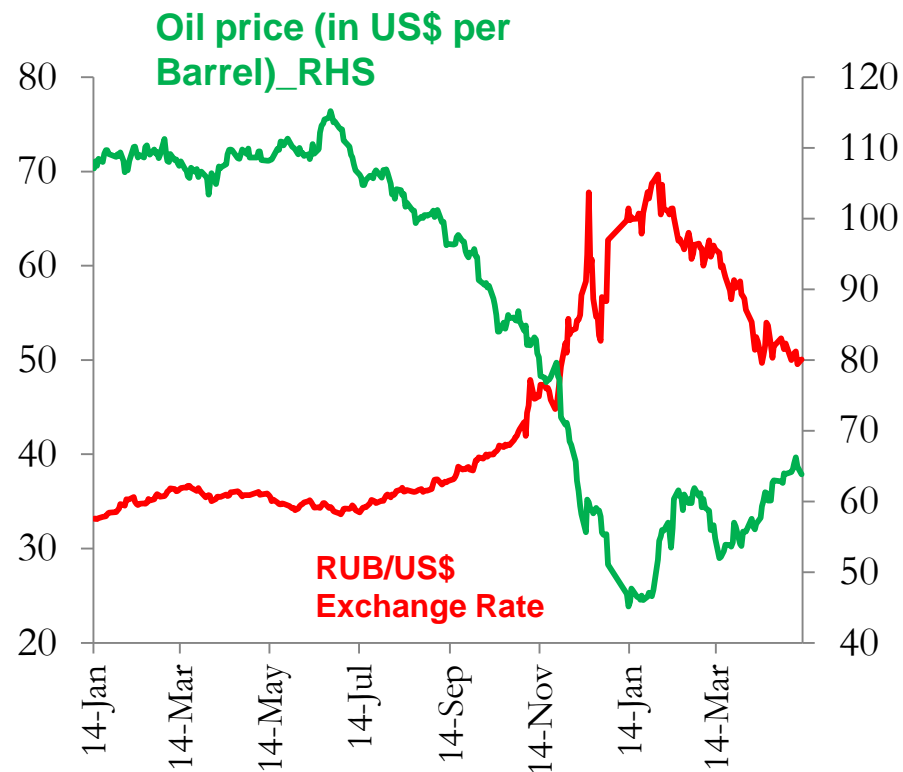
Sources: National authorities; and IMF staff estimates.

Indirectly, because Russia is also very dependent on oil production and oil prices

Growth in Russia is highly correlated with oil prices

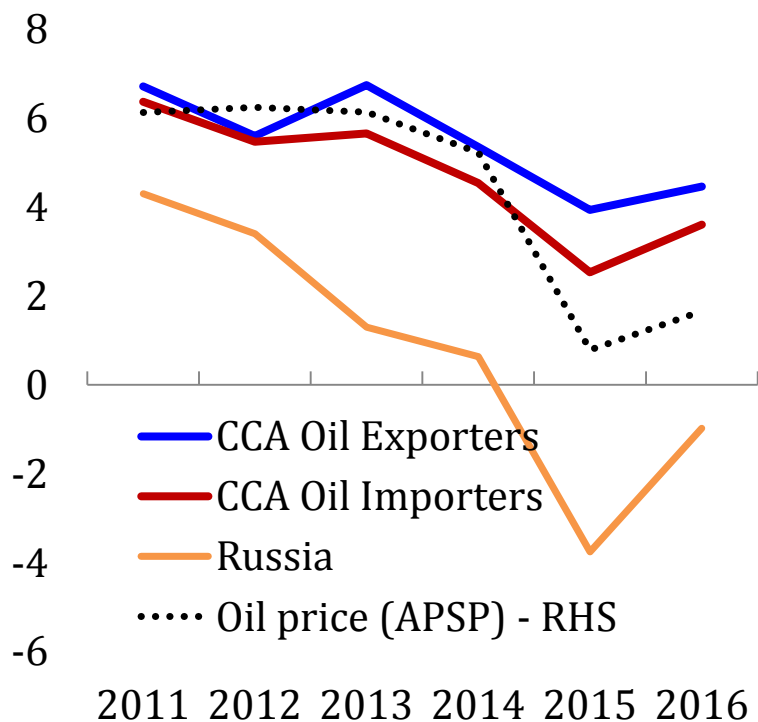


The Ruble/US\$ exchange rate is also highly correlated with oil prices

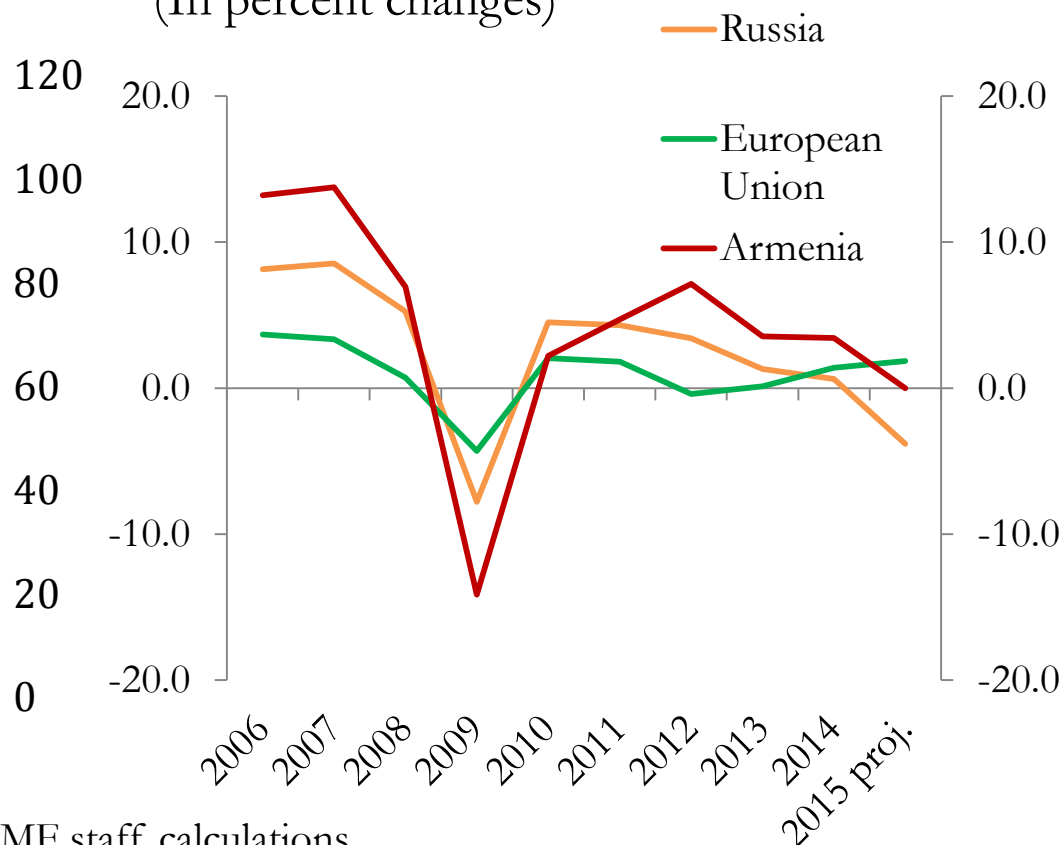


As a result, CCA countries have experienced “twin” shocks, because lower oil prices and Russia’s economic contraction

Real GDP Growth
(Annual percent change)



Real GDP growth
(In percent changes)



Sources: National authorities; and IMF staff calculations.



What are the transmission channels from Russia to Armenia and the CCA Region?



Sources: National authorities; and IMF staff estimates.

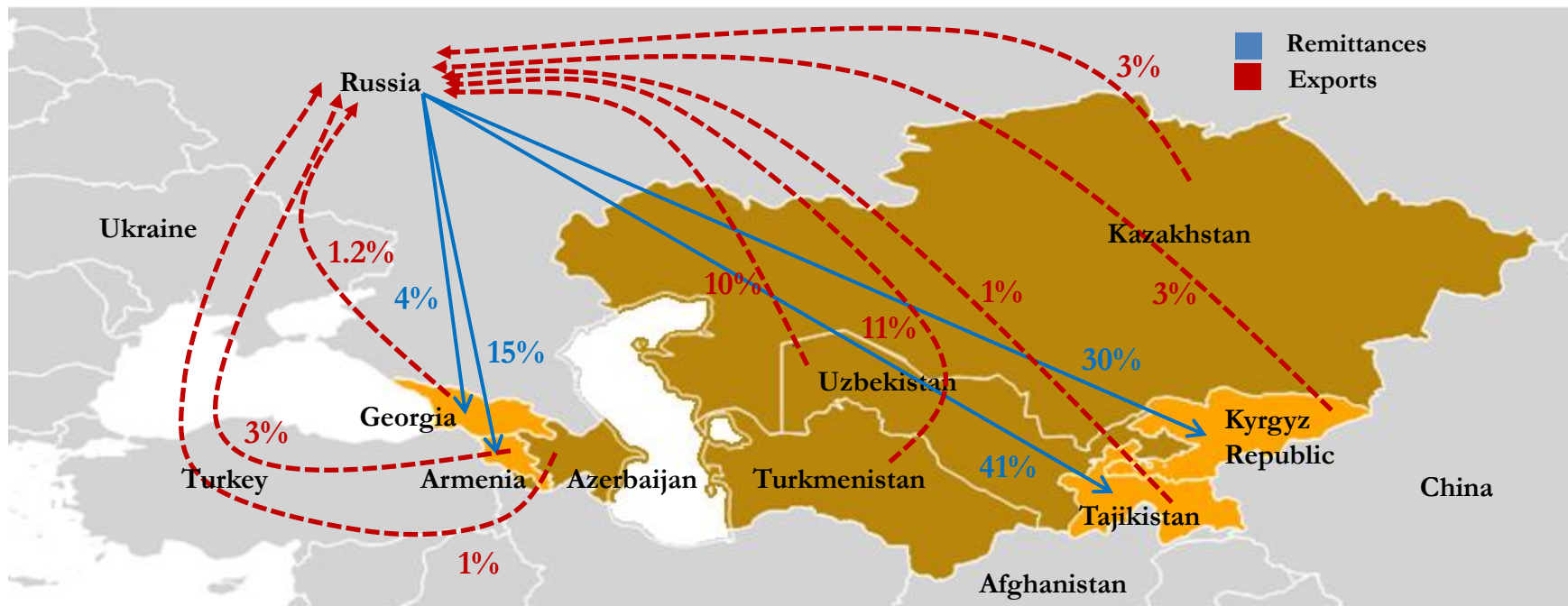
One of the transmission channels is through banking system linkages...and especially Armenia



Sources: National authorities; and IMF staff estimates.

...and the others are remittances from Russia and exports to Russia...

Exports to and Remittances from Russia (Share of GDP)



Sources: National authorities; and IMF staff estimates.



Ties to Russia go well beyond exports, remittances, and banking system; they include also FDI and confidence

Linkages with Russia

	Exports	Imports	Remittances	FDI	Banks 1/
ARM	Green	Red	Red	Red	Red
GEO	Green	Yellow	Yellow	Green	Grey
KGZ	Yellow	Red	Red	Yellow	Yellow
TJK	Green	Red	Red	Yellow	Grey
AZE	Green	Green	Green	Green	Yellow
KAZ	Yellow	Yellow	Green	Green	Red
TKM	Red	Yellow	Green	Green	Grey
UZB	Red	Yellow	Green	Green	Grey

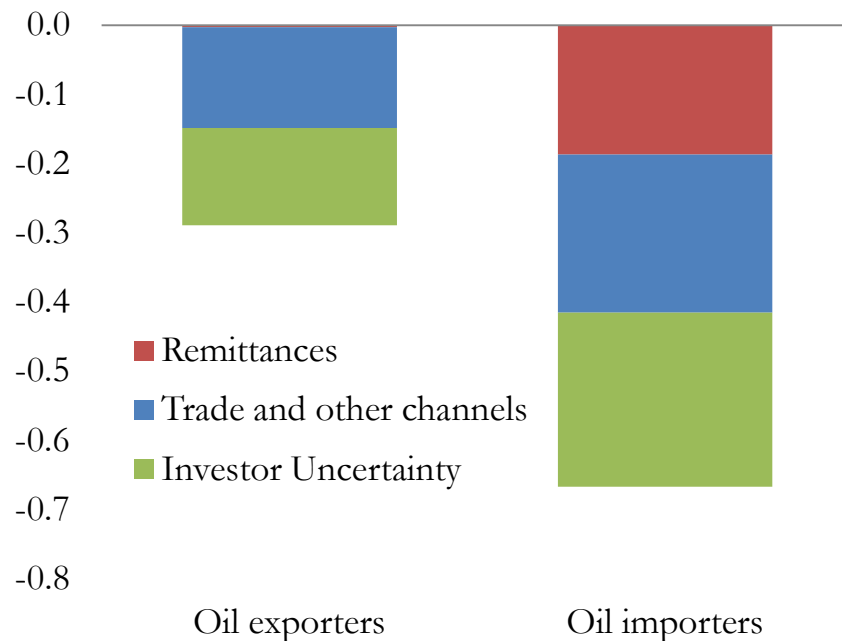
Sources: National authorities and IMF staff estimates.

1/ Outward and inward exposures to Russia's banking system as a share of the country's total banking system assets"

■ <3% of GDP
 ■ 3-10% of GDP
 ■ >10% of GDP

Impact of 1 percentage point fall in Russia's GDP growth and investor uncertainty on CCA GDP growth

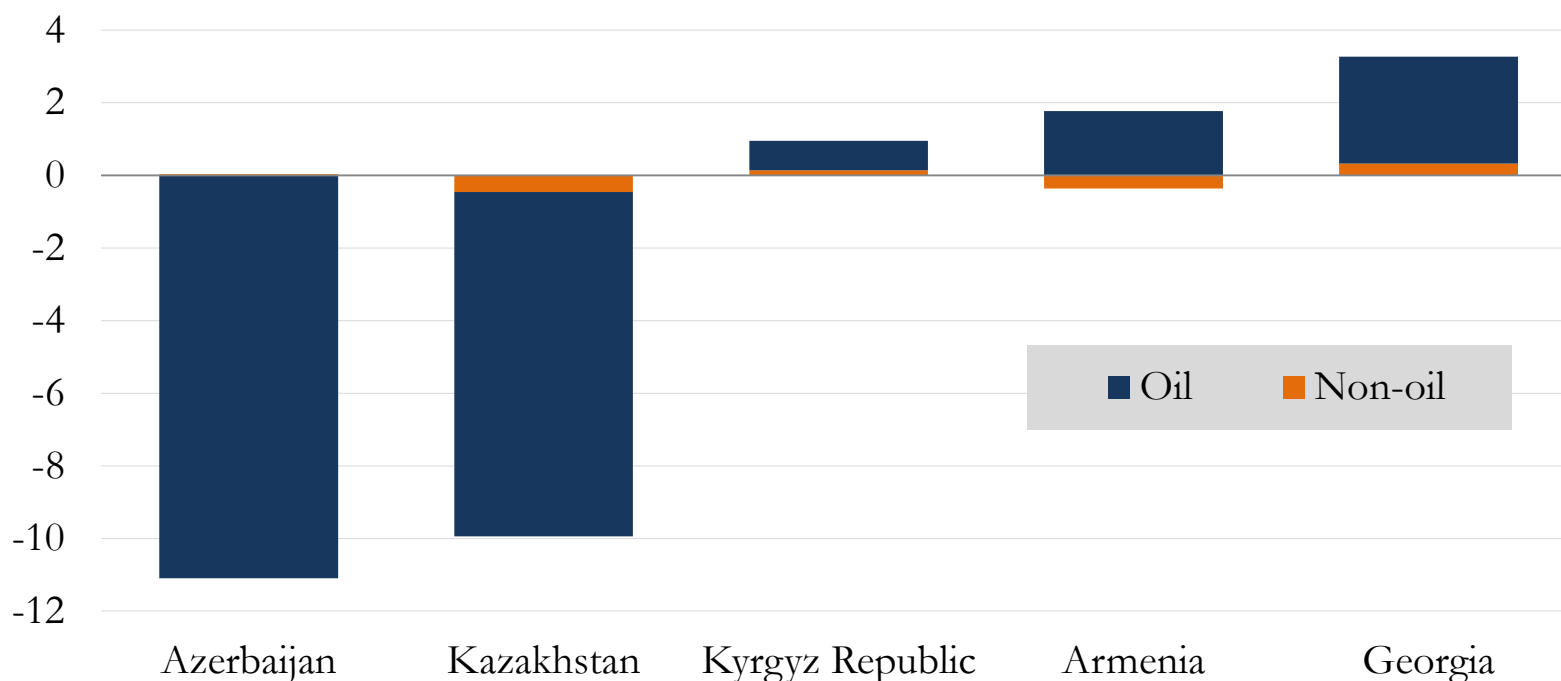
(Percent)



Unfortunately, lower oil prices have resulted in limited gains for oil importers

External windfall from lower commodities prices, 2015

(Percent of GDP)

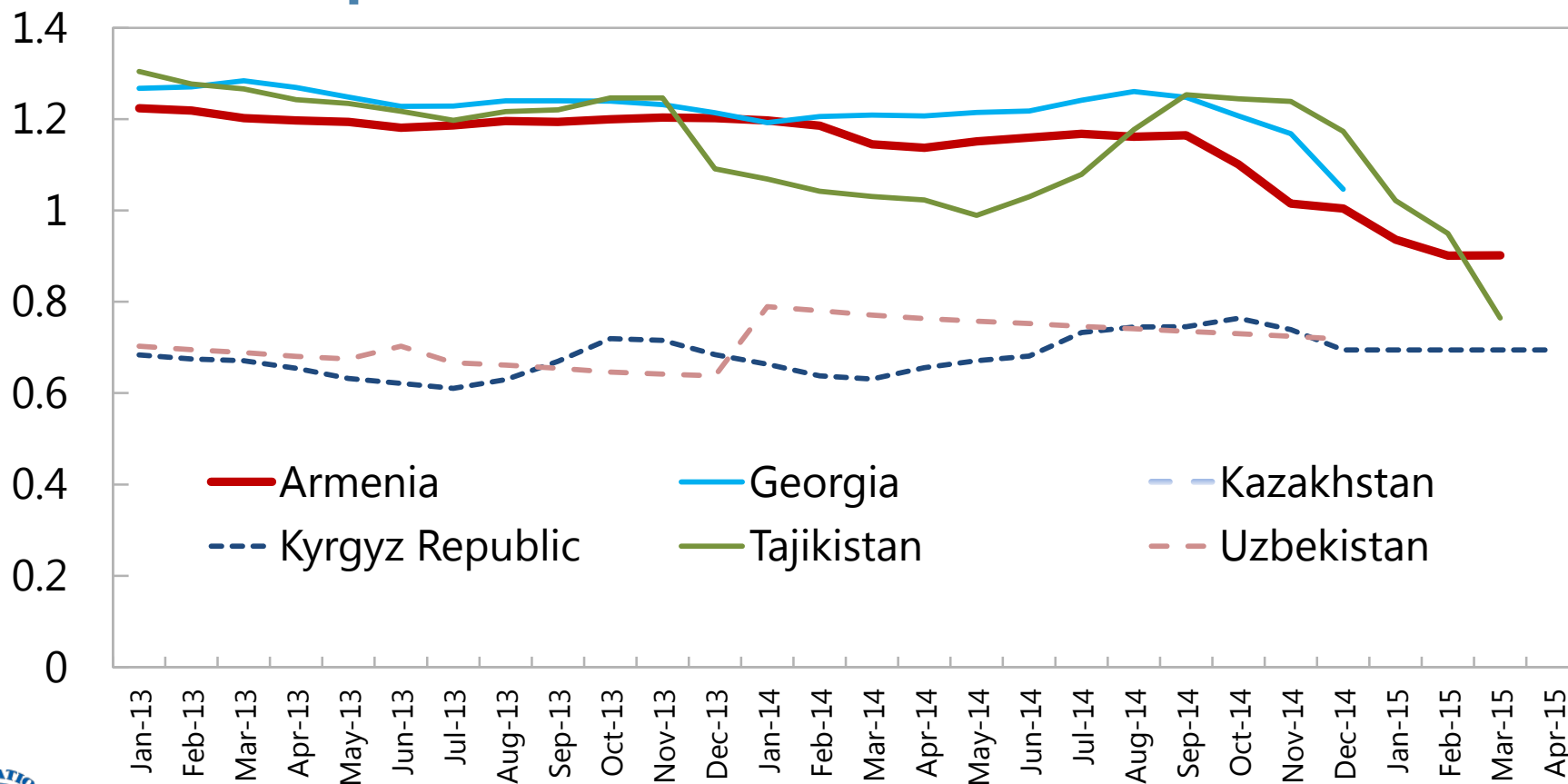


Sources: World Bank WITS database; Haver; IMF WEO; national authorities; and IMF staff calculations.



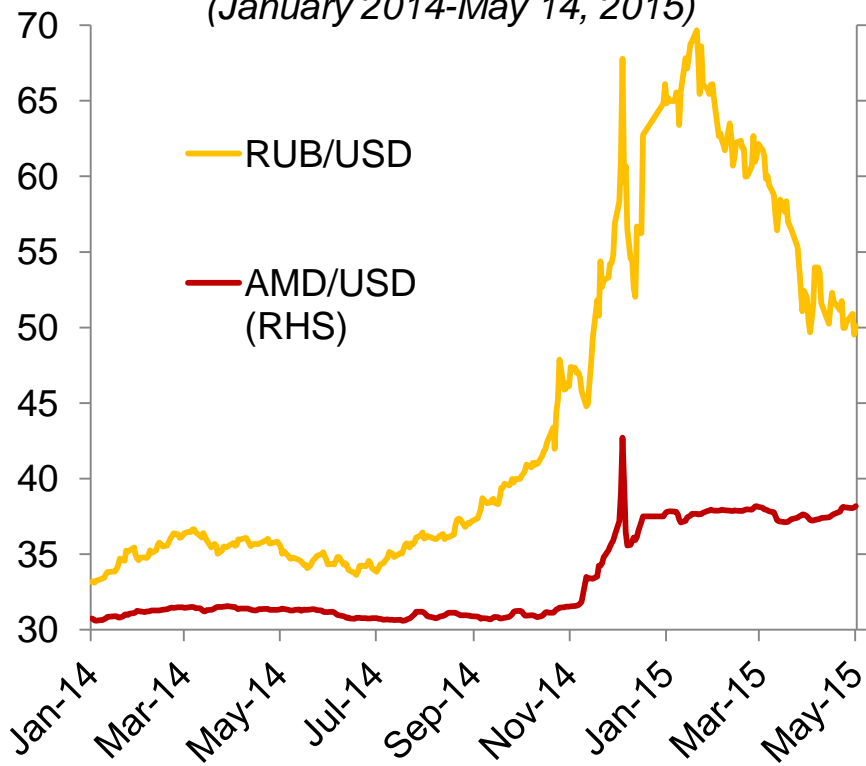
Why? Because several reasons limit the pass-through to petroleum retail prices in CCA countries

Gasoline R price

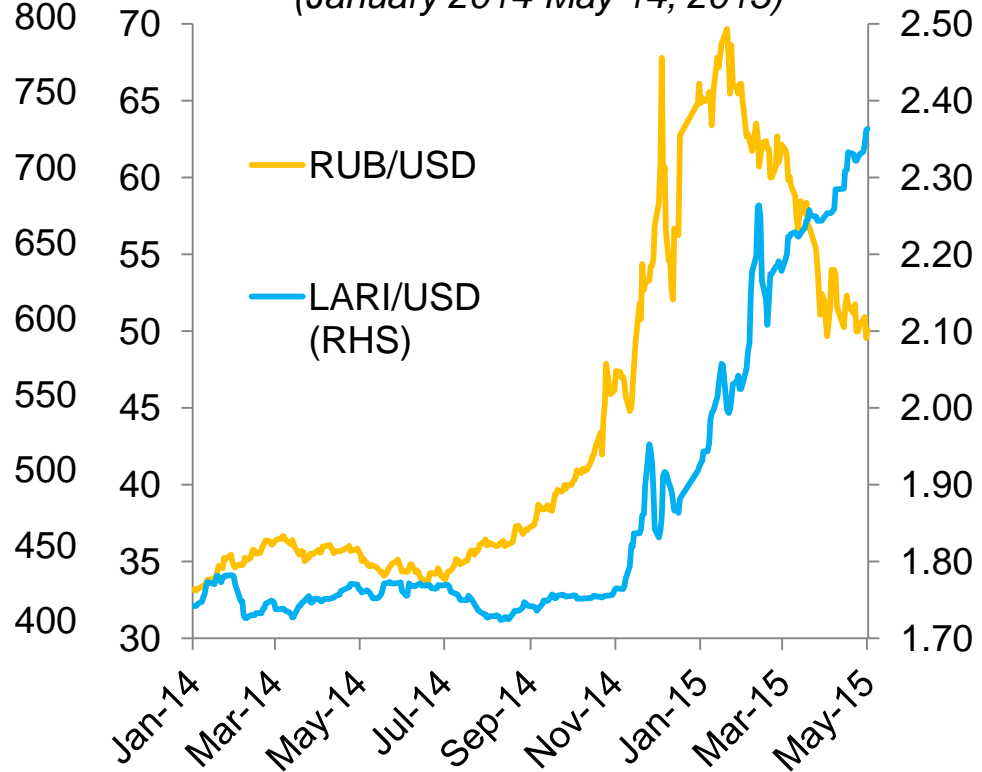


As a result of the “twin” shock, currencies of CCA countries have depreciated since November 2014

RUB/USD and AMD/USD (January 2014-May 14, 2015)



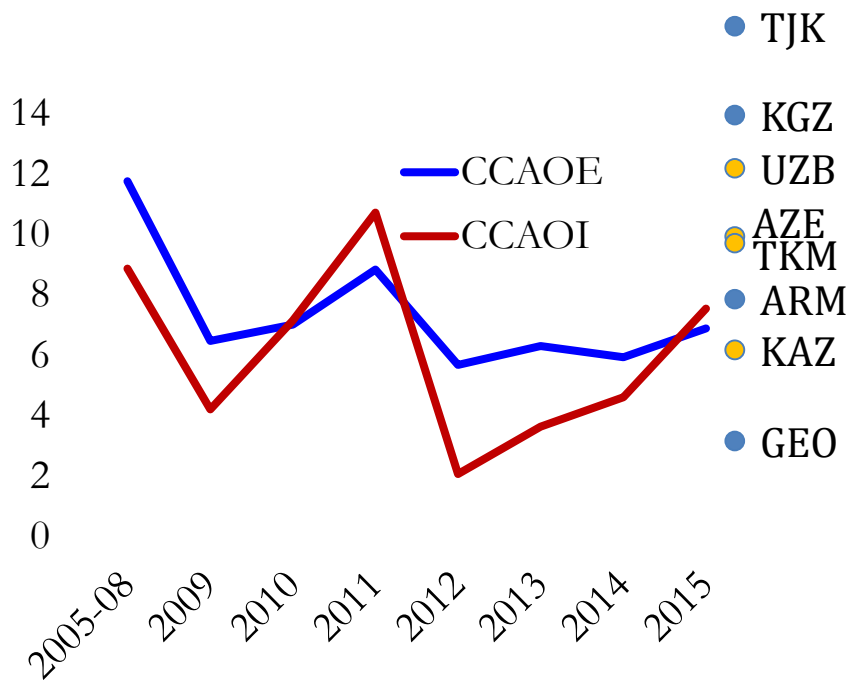
RUB/USD and LARI/USD (January 2014-May 14, 2015)



Depreciations are augmenting inflationary pressures, with an exception in Armenia

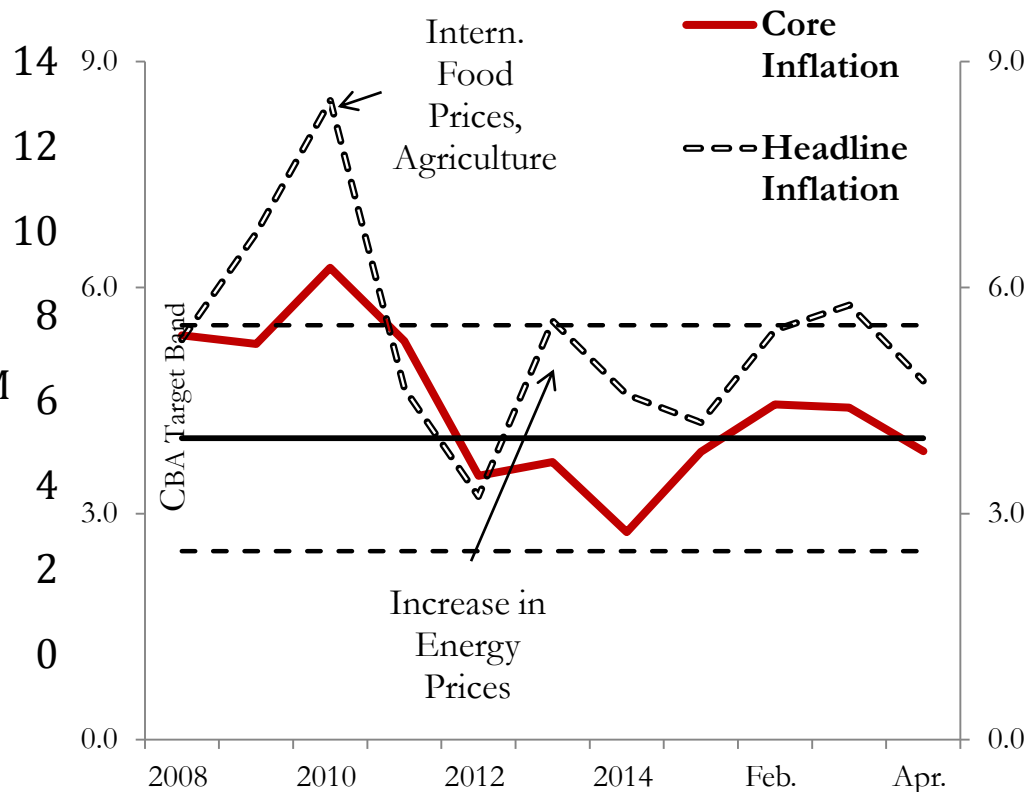
Inflation in CCA

(CPI, percent change; dots represent 2015 inflation)



Consumer Price Inflation

(In 12 month percent changes)



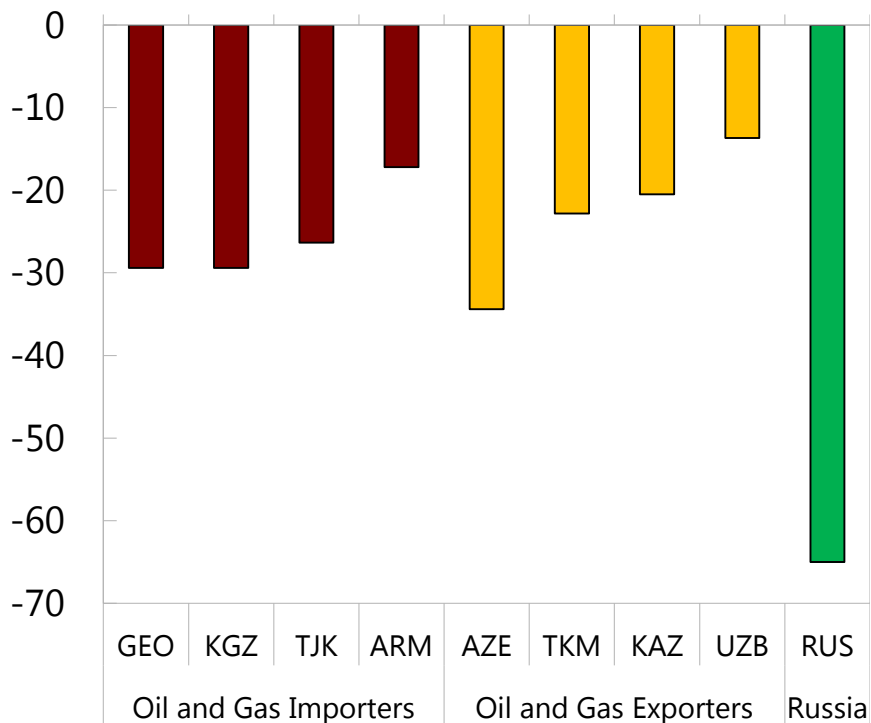
Sources: National authorities; and IMF staff calculations.



Currencies are weakening against US\$ yet losing competitiveness in real terms

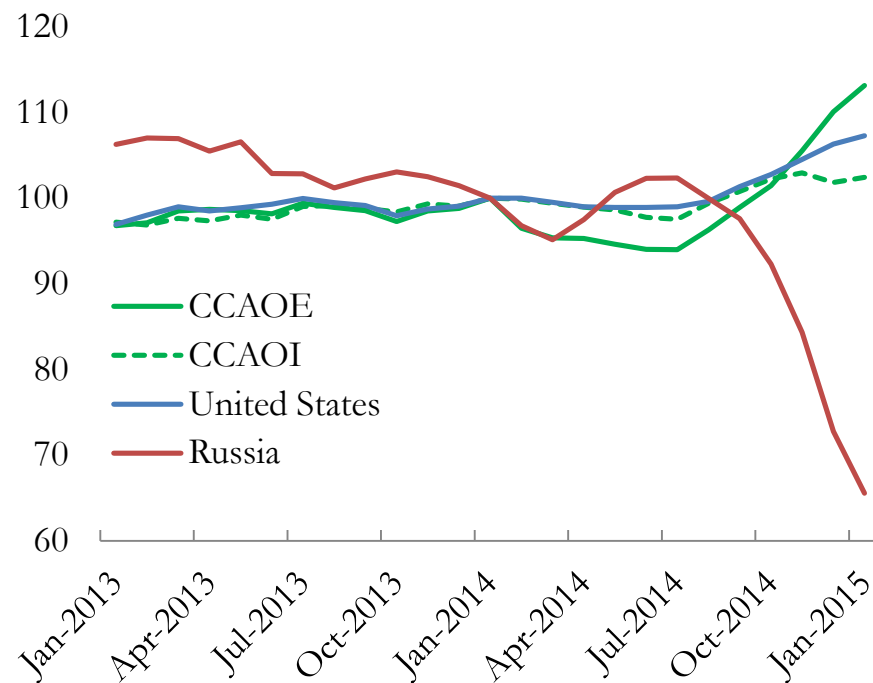
Exchange Rate Change in Percent

(Jan 2014-April 2015; national currency per US\$)



Real Effective Exchange Rates

(Index, Jan 2014=100)



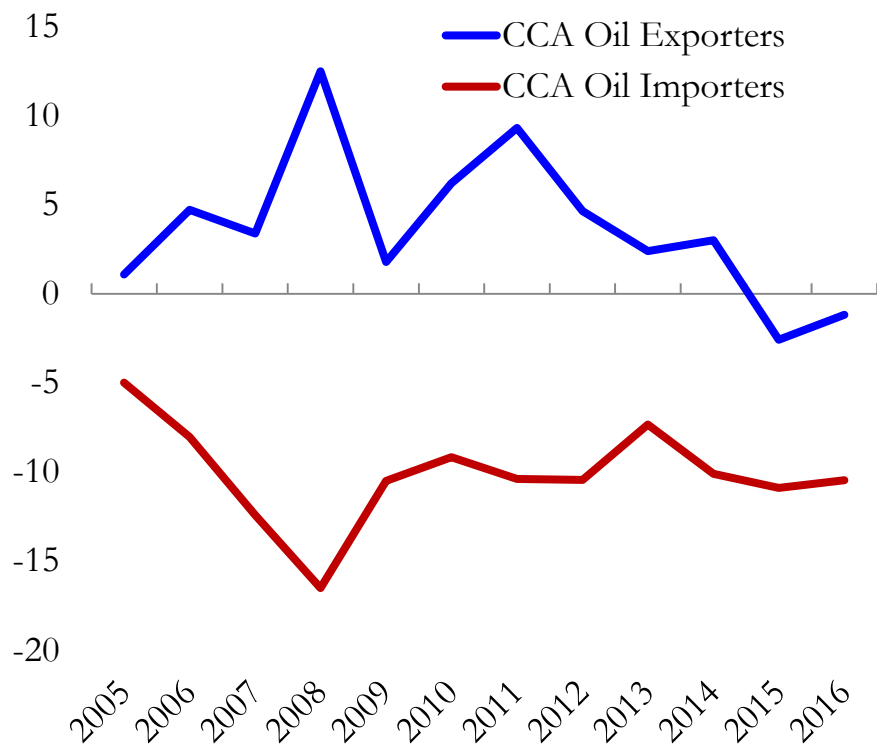
Sources: IMF INS database; and IMF staff calculations.



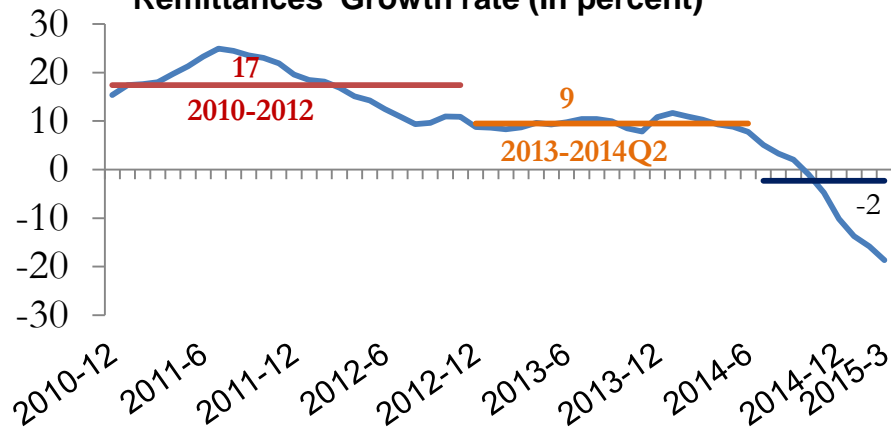
External positions are weakening because of sub-par growth of remittances and exports

Current Account Balances

(Percent of GDP)



Remittances Growth rate (In percent)



Export of goods growth rate (In percent)

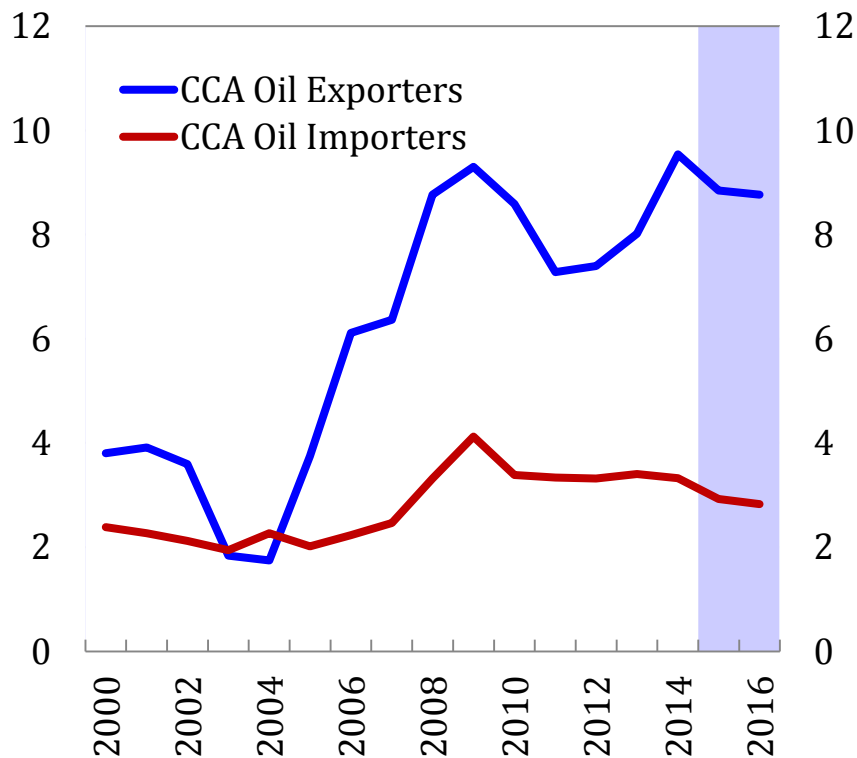


Sources: National authorities; and IMF staff calculations.

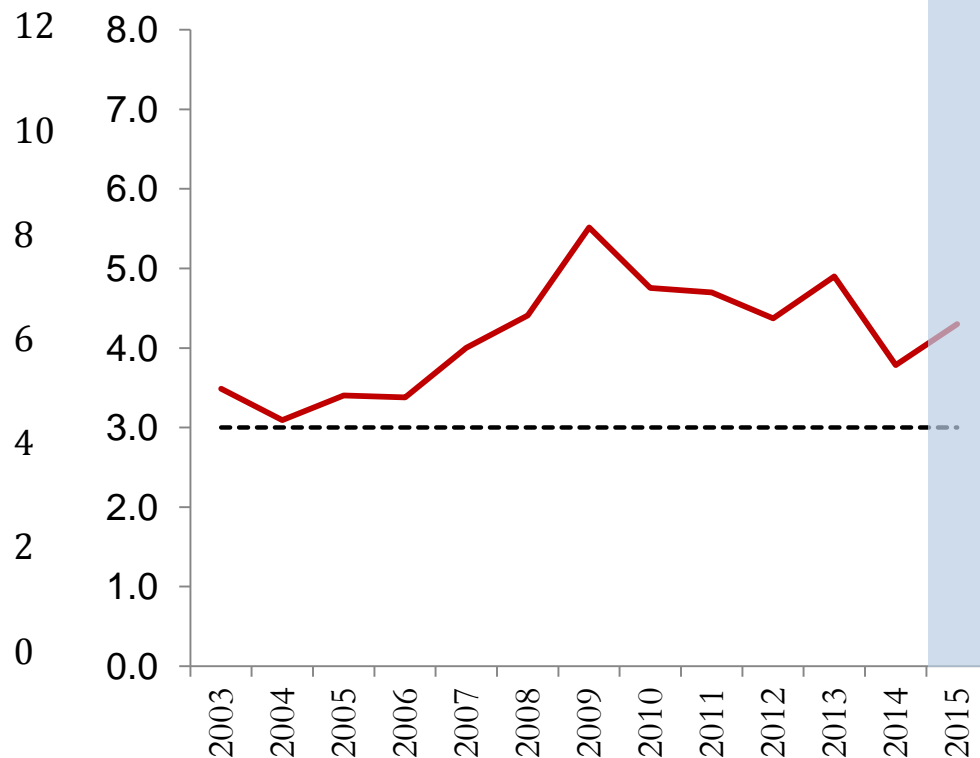


Buffers provided by international reserves are shrinking...although in Armenia remain relatively comfortable

Reserve Coverage
(Months of Imports)



Armenia: Reserve Coverage
(Months of Imports)



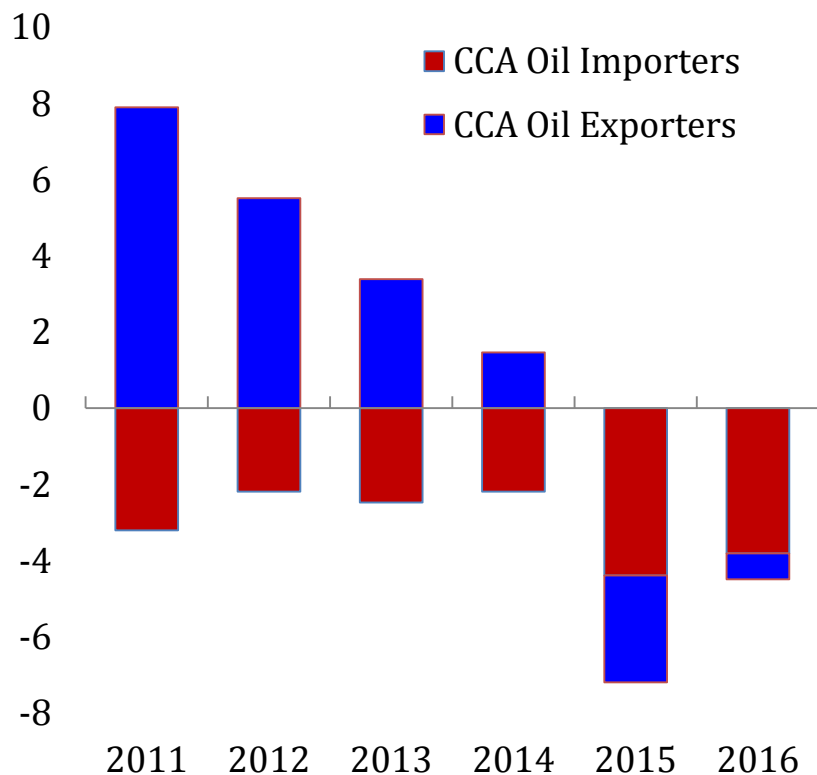
Sources: National authorities; and IMF staff calculations.



The “twin” shocks are deteriorating fiscal positions in CCA countries...

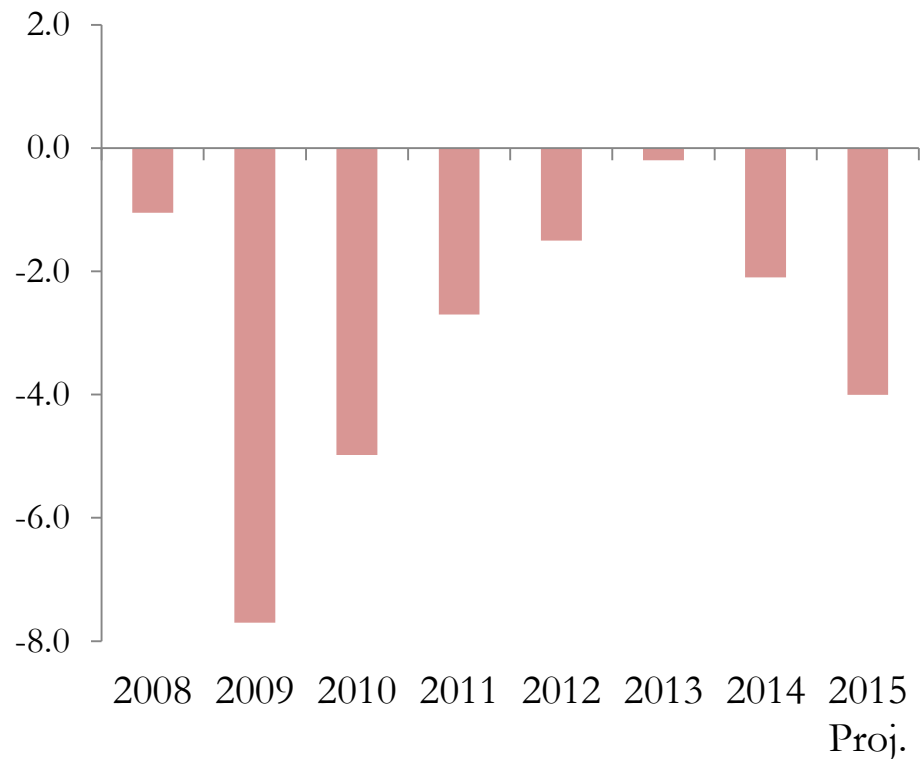
Fiscal Balances

(Percent of GDP)



Armenia: Budget Deficit

(In percent of GDP)

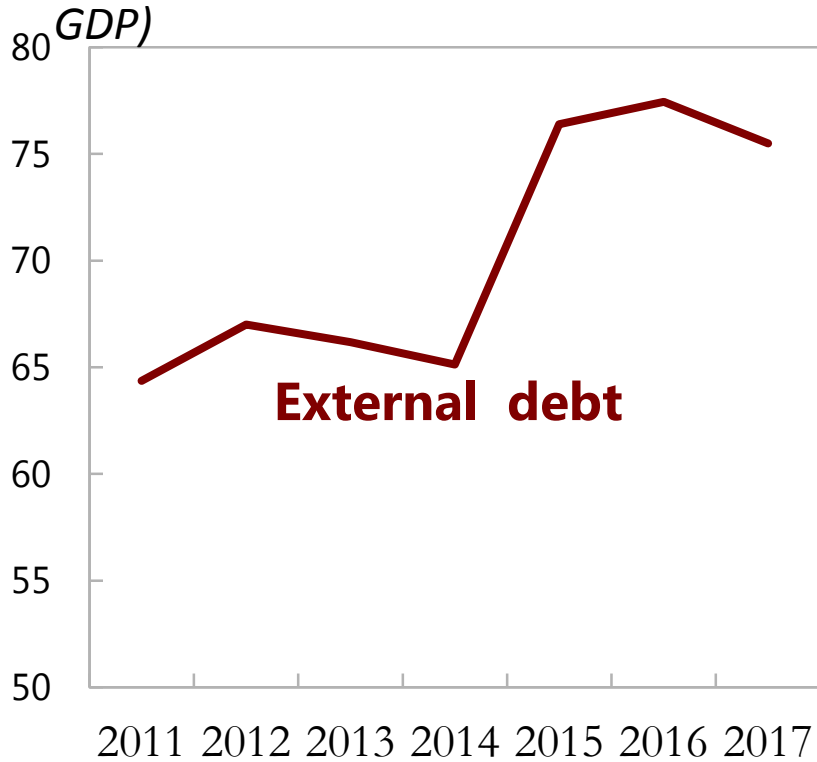


Sources: National authorities; and IMF staff calculations.

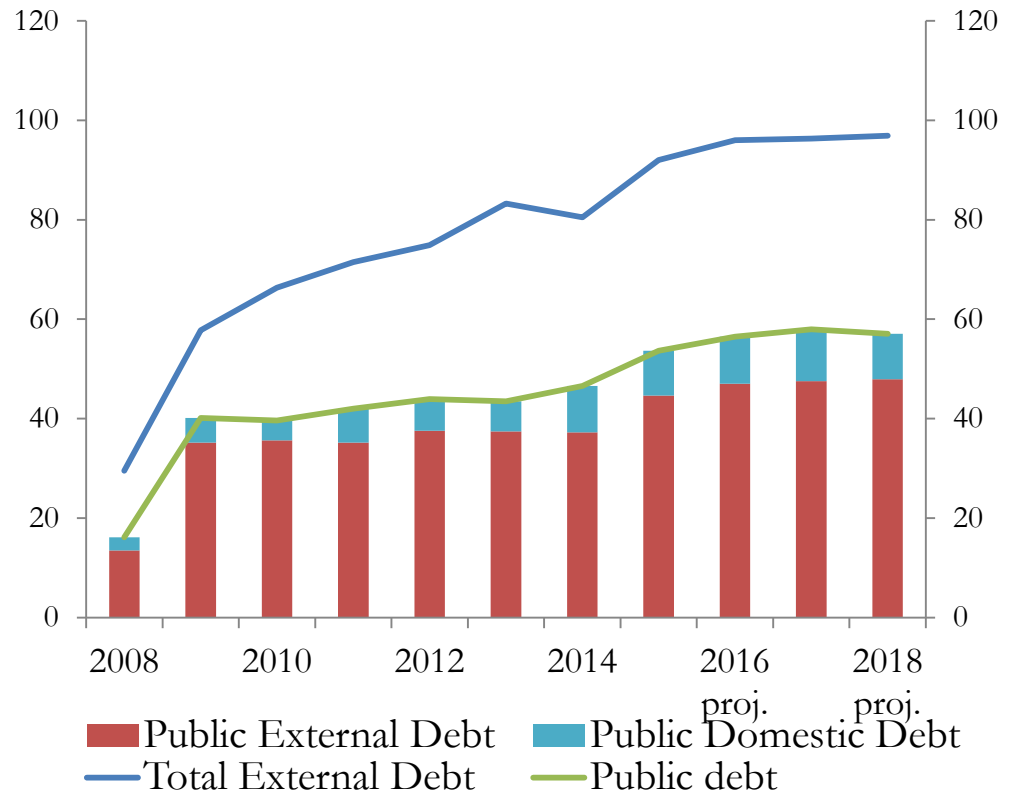


...and increasing external debt, especially in oil-producing countries

External Debt in Oil –producing Countries (private and public; percent of GDP)

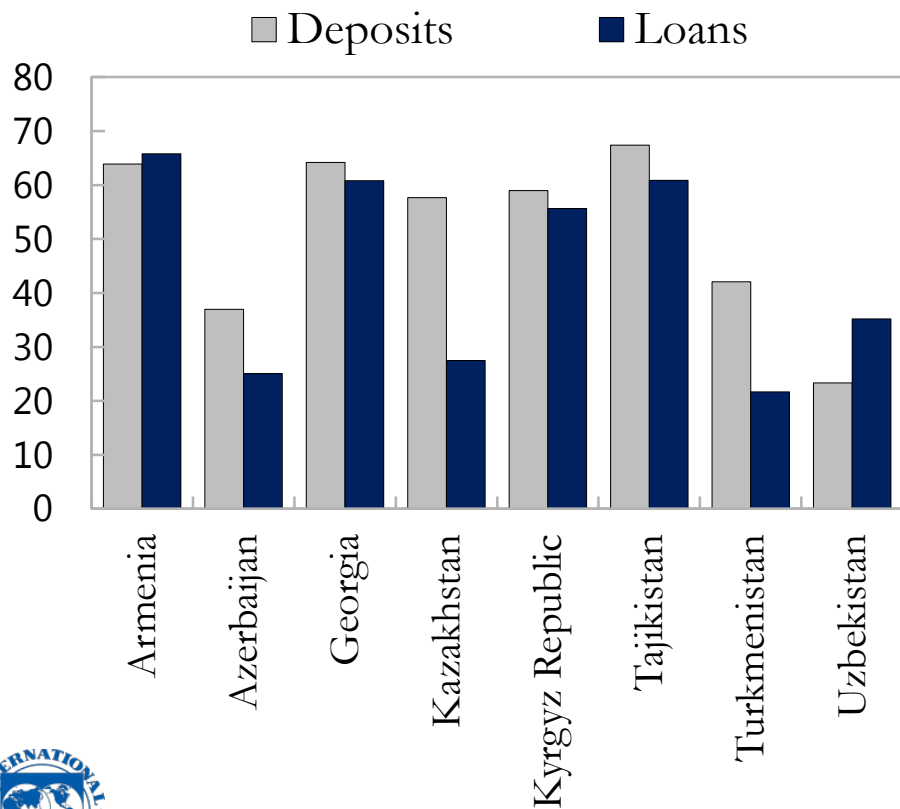


Armenia: Debt Dynamic (In percent of GDP)

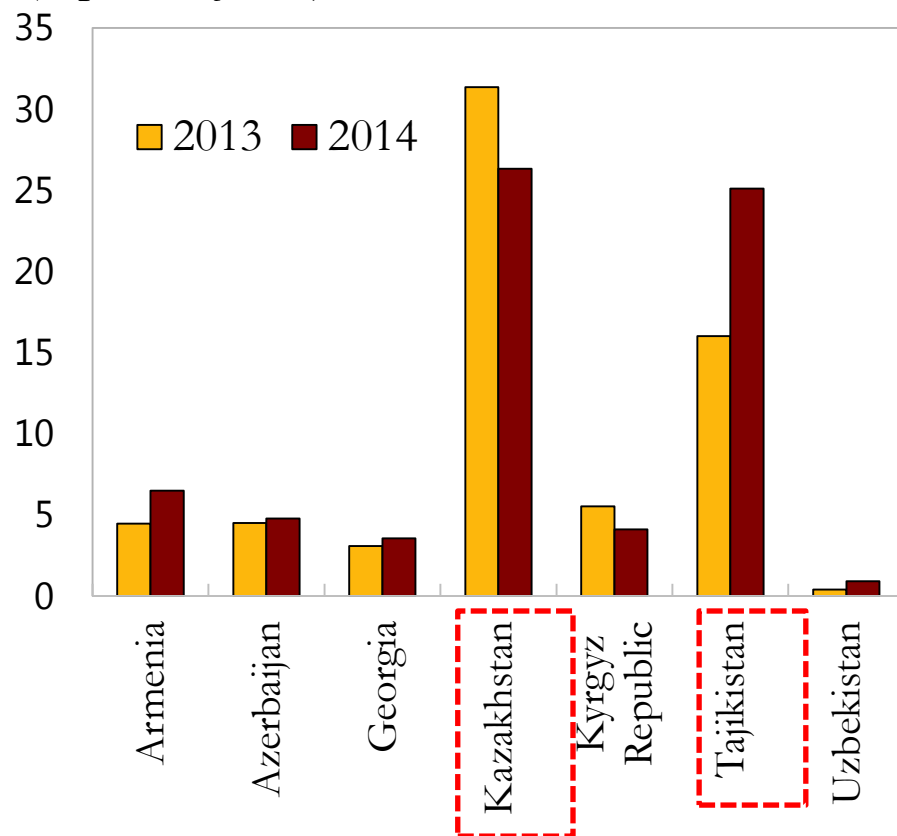


Financial sector vulnerabilities are rising, reflected in high dollarization and increasing NPL ratios...

Dollarization, 2014
(in percent of total)



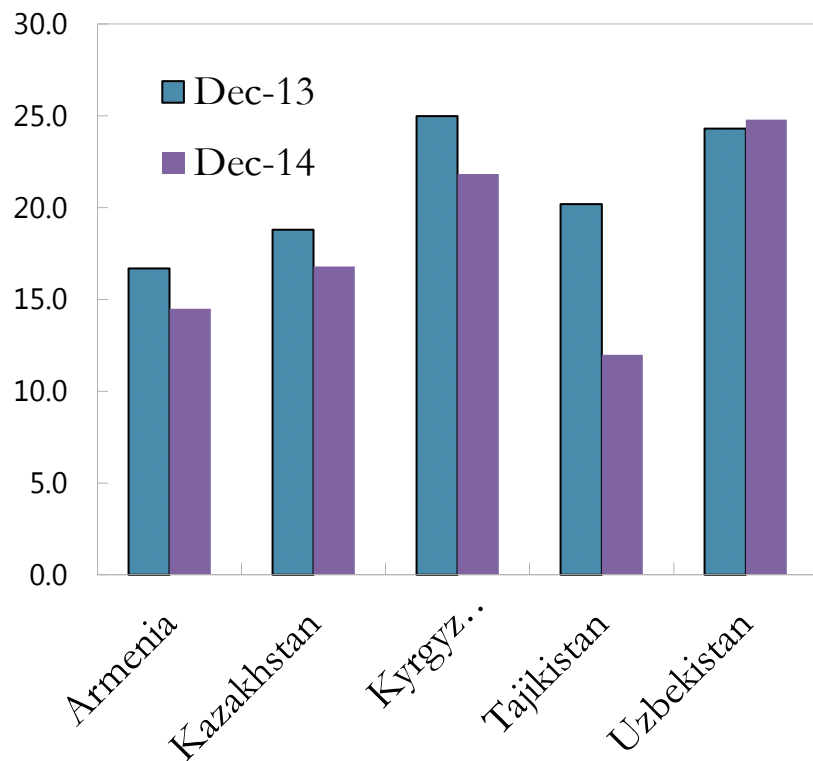
Nonperforming Loans
(in percent of total)



...mitigated by still comfortable buffers, especially in Armenia

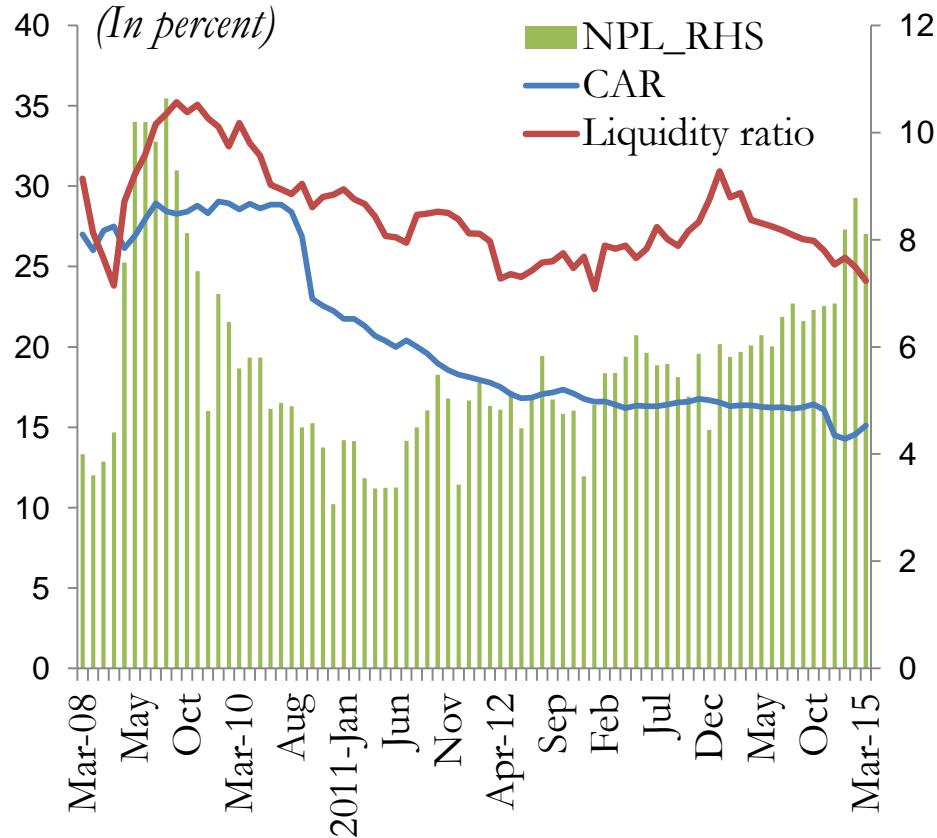
Capital Adequacy Ratios

(RWA as percent of capital)



Financial Soundness Indicators

(In percent)



Policy priority is providing support to the economy, while maintaining macroeconomic stability...

Fiscal Policy

Small counter-cyclical fiscal if possible to support the economy...

...but anchored clearly in a medium-term plan for consolidation

Improve the targeting and quality of spending and support the vulnerable

Monetary & Exchange Rate

Greater exchange flexibility, as a shock absorber, given continuing external imbalances and pressures, and gradual reversal of the monetary policy tightening of recent months...

while keeping an eye on growth and banks, given high dollarization.

Financial Sector

Step up risk monitoring

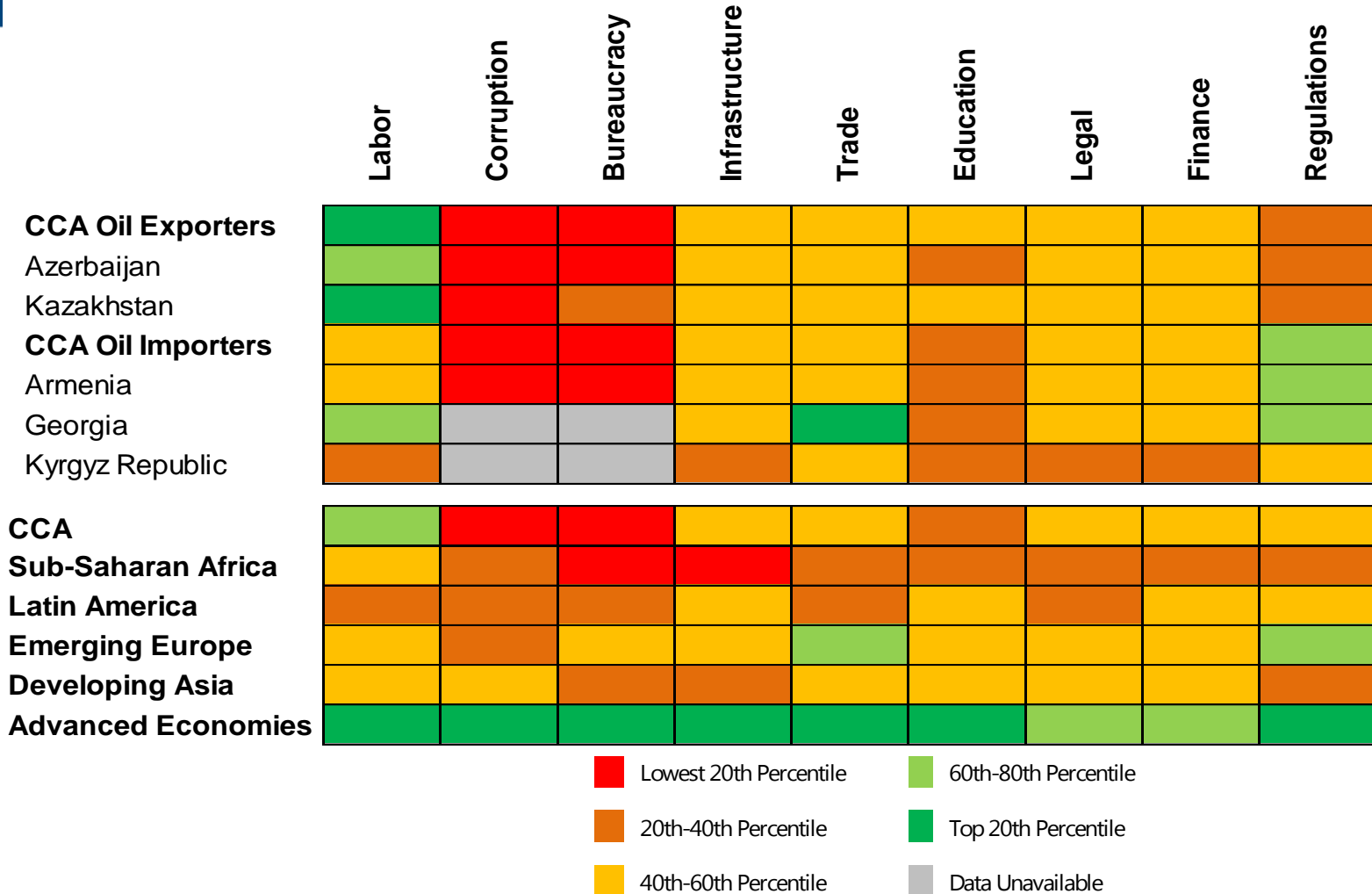
Strengthen supervision, especially of systemic banks

Strengthen crisis management frameworks

Pursue de-dollarization policies

...while implementing bold structural reforms to raise potential growth and make it more inclusive

Structural Reform Priorities



What should be Armenia's medium-term priorities?

Structural Reforms

Tax administration, business climate (e.g. inspection), energy, financial sector, connectivity, regulations, bankruptcy process, pension reform, and fiscal risks

Economic Integration

Balanced regional and multilateral trade integration initiatives, to diversify economies and improve medium-term growth prospects.

Policy Frameworks

- **Fiscal:** More fiscal transparency, stronger medium-term budget frameworks, program budgeting
- **Monetary:** Better communications, greater transparency on policy actions to provide an anchor to the economy.

Conclusions

- Global recovery remains fragile and commodity prices are declining. This is affecting Russia negatively, together with geopolitical tensions and investor concerns about medium-term growth prospects.
- As a result, Armenia's growth is slowing down. Short-term policy priorities are maintaining economic and financial stability and, providing short-term support to economic growth.
- Over the medium-term Armenia should focus on fiscal consolidation to rebuild buffers, exchange rate flexibility to restore competitiveness, step up structural reforms and monitor closely potential emerging risks in financial sector.