

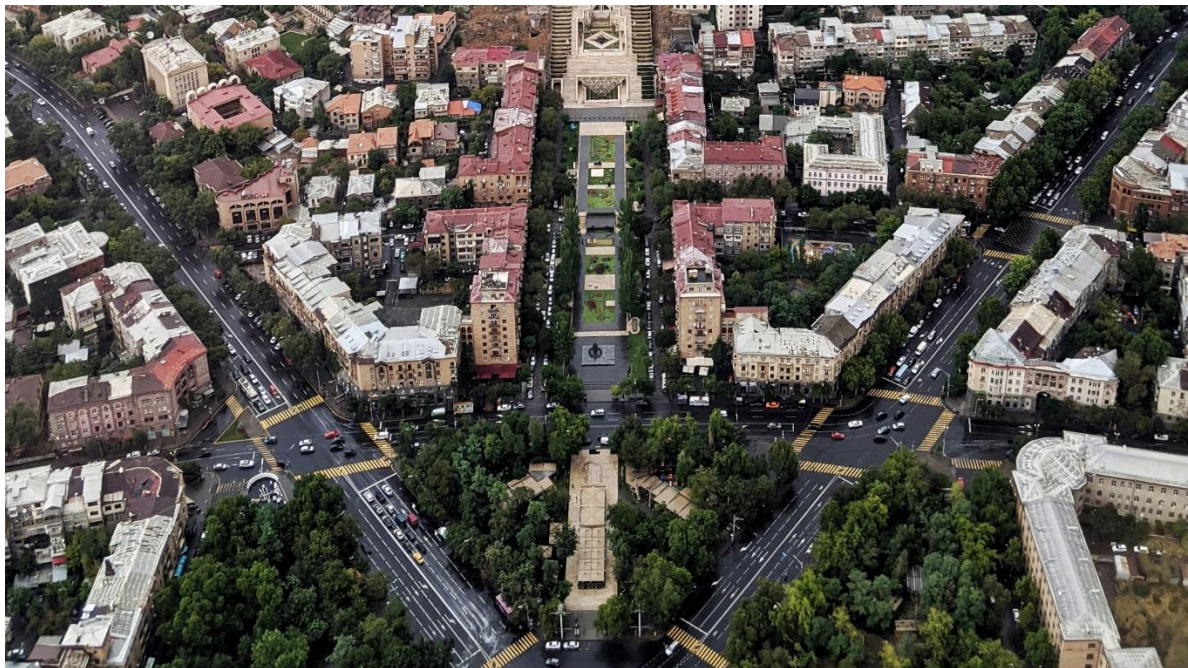


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Increasing the Economic Resilience of Armenia



Haykaz Fanyan, Armine Petrosyan & Meline Abrahamyan

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Abbreviations

ADB	Asian Development Bank
ANPP	Armenian Nuclear Power Plant
Armstat	National Statistical Committee of Armenia
BoP	Balance of Payments
CBA	Central Bank of Armenia
CEPA	Comprehensive and Enhanced Partnership Agreement
CSTO	Collective Security Treaty Organization
DAC	Development Assistance Committee
EAEU	Eurasian Economic Union
EBRD	European Bank for Reconstruction and Development
EDB	Eurasian Development Bank
ENA	Electric Networks of Armenia CJSC
ESI	Export Similarity Index
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GDP	Gross Domestic Product
GSP	Generalized Scheme of Preferences
HHI	Herfindahl-Hirschman Index
HS	Harmonized System
HPP	Hydropower Plant
HVEN	High Voltage Electric Networks of Armenia CJSC
ICT	Information and Communication Technologies
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
IT	Information technologies
MFN	Most Favoured Nation
MoF	Ministry of Finance of the Republic of Armenia
NPAs	Non-Performing Assets
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PSRC	Public Services Regulatory Commission
PV	Photovoltaic
RA	Republic of Armenia
R2E2	Renewable Resources and Energy Efficiency Fund
SBA	Stand-by Arrangement
SDG	Sustainable Development Goal
TCI	Trade Compatibility Index

TPP	Thermal Power Plant
UN	United Nations
VAT	Value-added Tax
WTO	World Trade Organization

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1. Introduction

Armenia is a small, landlocked country located in the Caucasus region. It shares borders with four countries, two of which—Azerbaijan and Türkiye—have been closed for years. A decade ago, Armenia was conducting large-scale reforms with the goal of European integration; however, in 2015, it suddenly shifted its geopolitical focus by becoming a member of the Eurasian Economic Union (EAEU), an economic union that unites Armenia, Russia, Belarus, Kazakhstan, and the Kyrgyz Republic. Armenia is also a member of the Russia-led Collective Security Treaty Organization (CSTO), which as time has shown is another strategic tool Russia uses to extend its influence over its neighbouring countries. Since gaining independence in the 1990s, Armenia’s dependency on Russia has steadily increased. At the time of writing, Russia is Armenia’s primary energy supplier, leading trading partner, and the largest foreign investor in its economy.

Over the last decade, Armenia has faced several shocks, including the political transition in 2018; the COVID-19 crisis and the escalation of conflict with Azerbaijan in 2020; the ongoing Russian invasion of Ukraine and the sanctions associated with it; and the resumption of hostilities in Nagorno-Karabakh in 2023, which led to the inflow of more than 100,000 forcibly displaced people from Nagorno-Karabakh. These developments have significantly impacted the country’s political and economic situation. In several cases, they deepened Armenia’s dependency on Russia. For example, following Russia’s full-scale invasion of Ukraine in 2022, Armenia saw increased inflows of people and capital from Russia. This increased immigration led to greater consumption of goods and services, a surge in deposit inflows, higher transactional income for banks, and growth in tax revenues, among other positive economic effects. Additionally, Western economic sanctions on Russia and changes to Russia’s parallel import regulations opened new opportunities for Armenian exporters, resulting in increased exports to Russia and overall growth in Armenia’s foreign and domestic merchandise exports. However, these developments also deepened Armenia’s economic dependency on Russia.

After the political transition in 2018, the new government vowed to balance Armenia’s relations with Russia and the West. The country maintained a strategic alliance with Russia, particularly within the frameworks of the EAEU and the CSTO, and at the same time, sought to strengthen ties with Western countries and institutions, emphasising Armenia’s commitment to democratic values and seeking economic cooperation and development assistance. In 2023, the Armenian government announced a new plan to become the “crossroads of peace” and a key transit country for trade between Central Asia and Europe—a plan that seeks to enhance Armenia’s geopolitical significance and economic prospects by positioning it as a critical hub for regional trade.

This study aims to identify Armenia’s key macroeconomic, structural, and institutional vulnerabilities, including dependencies on Russia, with the aim of offering economic policy recommendations designed to enhance the country’s resilience to various types of economic shocks.

The report consists of seven chapters, an introduction, and a recommendation section. It covers the domestic and external political developments in Armenia in recent years and their economic impact; macroeconomic and financial sector stability of the country; external economic relations, including fragility in the trade of goods and services; foreign investments; the outlook of the energy sector; Armenia’s sources of vulnerability; and risk factors. The recommendations section provides economic policy recommendations to increase Armenia’s resilience to various shocks.

The study covers the period from 2007 (the last year before the global financial crisis) to 2023 (the last year of available data). The data was collected in February 2024 (updated prior the report's publication), with the report being prepared between March and August of the same year. The study primarily used international data sources—the International Monetary Fund (IMF), the United Nations (UN), and its specialised agencies, etc. National statistical sources were also used when necessary.

The study was conducted by Modex LLC as part of the Increasing Economic Resilience of Armenia, Georgia, and Moldova project, which is led by CASE (Center for Social and Economic Research). Modex is an advisory company from Armenia, founded in 2017. It provides consulting services to international organisations and private and public sector clients.

2. Domestic and External Political Developments and Their Economic Impact

Over the last decade, Armenia has experienced several developments that have significantly impacted its political and economic situation. The country, which was conducting large-scale reforms with European integration in mind, **suddenly shifted its geopolitical direction towards Russia** and the EAEU in September 2013, following a meeting between former President Serzh Sargsyan and the President of Russia, Vladimir Putin (Radio Azatutyun, 2013a). In a harsh geopolitical trade-off, Armenia opted not to sign a Deep and Comprehensive Free Trade Agreement with the EU, choosing instead to deepen integration with Russia in the hope of balancing military forces in the region and mitigating the risk of conflict escalation with Azerbaijan. However, subsequent events have demonstrated that President Sargsyan's calculations were flawed.

In 2015, **Armenia became a member of the EAEU**. The EAEU, which consists of Armenia, Belarus, Kazakhstan, the Kyrgyz Republic, and the Russian Federation, is formally a customs union, meaning that it is bound by a common external tariff and allows the free movement of goods, services, capital, and labour. However, some experts believe that it is an initiative developed by Vladimir Putin to revitalise the influence and structure of the former Soviet Union (BBC, 2014). Indeed, time has shown that the EAEU, in line with the CSTO, serves not only as an economic entity but also as a strategic political tool to extend Russian influence over its neighbouring countries. Accession to the EAEU has impacted the structure of Armenia's external trade turnover, particularly leading to a decrease in Armenia's imports from countries outside the Union, such as EU countries, and increasing exports to EAEU countries. This has deepened Armenia's dependency on the Russian economy and increased its risk exposure.

In the spring of 2018, Armenia experienced a significant political transition triggered by widespread protests against then-President/Prime Minister Serzh Sargsyan. Sargsyan, who had already served two terms as President, attempted to extend his rule by becoming Prime Minister, a move perceived by many as an attempt to cling to power despite constitutional changes meant to limit such extended tenures. The protests, known as the **"Velvet Revolution"**, began in April 2018 and were led by opposition leader Nikol Pashinyan. On 23 April 2018, Sargsyan announced his resignation, and on 8 May 2018, Pashinyan was elected as the new Prime Minister by the National Assembly.

This shift was a turning point in Armenian politics, with Pashinyan's rise to power seen as a victory for democratic movements within Armenia and a shift away from the previously entrenched political elites. Several months later, in December 2018, Pashinyan organised snap elections. The political alliance led by him secured the majority of seats in the National Assembly, stabilising Pashinyan's power in the country. During his first term (2018–2021), Pashinyan established "a new rule of the game" based on the rule of law and significantly reduced the shadow economy in the country. His administration implemented various anti-corruption measures, leading to increased transparency and accountability within the government. These efforts were reflected in Armenia's improved rankings in international corruption perception indices and economic freedom reports.

Despite these domestic reforms, Pashinyan did not make any major geopolitical shifts. Instead, he aimed to balance Armenia's relations between Russia and the West. Pashinyan maintained Armenia's strategic alliance

with Russia, particularly within the frameworks of the EAEU and the CSTO. At the same time, he sought to strengthen ties with Western countries and institutions, emphasising Armenia's commitment to democratic values and seeking economic cooperation and development assistance.

In 2020, the Armenian economy faced serious challenges due to **the COVID-19 crisis and the escalation of conflict with Azerbaijan**. The 44-day war in Nagorno-Karabakh resulted in over 4,000 soldiers and civilians being killed, thousands injured, and tens of thousands forcibly displaced from Nagorno-Karabakh to Armenia. These events led to significant social and political tensions within the country, culminating in snap parliamentary elections in June 2021. In these elections, the Civil Contract party, led by Pashinyan, reaffirmed its majority in the parliament. The aftermath of the 44-day war, along with subsequent smaller border clashes and the CSTO's inaction, significantly reshaped Armenia's geopolitical stance. This shift became more pronounced after Russia's full-scale invasion of Ukraine, which influenced Armenia to pivot more towards the West. This realignment has been evident in Armenia's increased engagement with Western countries and organisations, reflecting a strategic move to balance its foreign relations.

Following Russia's full-scale invasion of Ukraine in 2022, Armenia saw increased inflows of people and capital from Russia. These migration flows led to increased consumption of goods and services, a surge in deposit inflows, higher transactional income for banks, and growth in tax revenues, among other positive economic effects. Additionally, Western economic sanctions on Russia and changes to Russia's parallel import regulations opened up new opportunities for Armenian exporters, resulting in increased exports to Russia and overall growth in Armenia's foreign and domestic merchandise exports.

However, these developments also deepened Armenia's economic dependency on Russia. This dependency was also influenced by Armenia's exclusion from the EU Generalised Scheme of Preferences Plus (GSP+) in 2022, which had previously granted duty reductions on exports to the EU on 6,200 tariff lines. Armenia ceased to benefit from the EU's GSP+ after being classified as an upper-middle-income country for three consecutive years. Overall, these economic dynamics contributed to strong economic growth in 2022, with GDP growth reaching 12.6%. Yet, despite this growth, the economy remains vulnerable to external shocks. By 2023, as the immediate impacts of the Russo-Ukrainian War began to subside, the rate of economic growth slowed, and this more moderate rate of growth is expected to continue in the medium term.

The military action in 2023 led to the inflow of approximately 100,000 forcibly displaced people from Nagorno-Karabakh. Many have relocated to various cities and villages throughout Armenia, and the Armenian government has been implementing different programmes to support their socioeconomic integration. For example, apart from the social assistance programmes, the government of Armenia will assume 70% of the loans that the government of Nagorno-Karabakh and other borrowers had with the financial and banking system of Armenia. The influx of displaced people from Nagorno-Karabakh will have both short-term and medium-term implications, affecting demand and supply conditions in the economy, as well as fiscal policy and public debt.

In 2023, the Armenian government announced a new plan to become the **"crossroads of peace"** and a key transit country for trade between Central Asia and Europe. This multifaceted plan aims to enhance Armenia's geopolitical significance and economic prospects by positioning it as a critical hub for regional trade. The initiative includes a strong political commitment to establishing lasting peace in the region, specifically by opening the border with Türkiye and achieving a peace agreement with Azerbaijan. The first steps have already been taken, with the delimitation of the borderline in the northeastern part of Armenia. Furthermore, the

Armenian government has announced plans to sign a peace agreement with Azerbaijan by the COP 29 summit in November 2024, which was held in Baku. However, the agreement was not signed and there is currently not enough evidence from the Azerbaijani side that they share the same vision about regional developments.

3. Macroeconomic Stability

3.1 Macroeconomic Policy Setup

The Central Bank of Armenia (CBA) is responsible for the price stability and financial stability of the country. Since 1 January 2006, the CBA has carried out an inflation-targeting policy to maintain a low and stable inflation level. The CBA targets the 12-month inflation indicator as of the end period. The inflation target is set at 4% with tolerance bands of 1.5 percentage points. To maintain price stability, the CBA formulates, approves, and executes a monetary policy. It has a clear legal mandate and operational independence to implement the monetary policy framework. According to several international indices that measure the Central Bank's independence—for example, those proposed by Cukierman (1998) and Grilli, Masciandaro, and Tabellini (GMT) (1991)—the CBA has maintained a high level of independence. For example, in 2013, the Cukierman weighted index for CBA was estimated to be 0.96 (out of 1.0), the Cukierman simple index was 0.92 (out of 1.0), and the GMT index was 13 (out of 16).¹ The CBA declares a floating exchange rate regime. However, to attain an inflation target, the CBA implements quantitative easing mechanisms, as well as the purchase and sale of foreign currency, which may change the demand and supply of foreign currency, thus affecting the exchange rate in the market.

Regarding fiscal policy, the Ministry of Finance of Armenia is responsible for the development of fiscal policy and for establishing clear guidance for public finance management. To ensure fiscal sustainability, the Parliament and Government have enacted general fiscal rules. Specifically, Armenia imposes a legal ceiling on the debt-to-GDP ratio, with regulations including:²

1. If the debt of the central government exceeds 40% of the GDP, the overall state budget deficit should not be greater than capital expenditures.
2. If the government debt is above 50% of GDP, then in addition to the previous rule, the growth of current expenditures is capped by the average GDP growth of the previous years. Furthermore, the government must introduce a debt reduction programme as part of its Medium-Term Expenditures Framework. Additionally, the government must submit a debt reduction programme to the Parliament when the government debt as a percentage of GDP is between 50% and 60%.
3. If the government debt exceeds 60% of GDP, in addition to the previous two rules, current expenditures are capped by the anticipated volume of tax revenues.

The monetary and fiscal policies are coordinated in the framework of the “Agreement on the Principles of Cooperation between the CBA and Ministry of Finance”. The two policies are coordinated in the process of preparation, adjustment, and implementation of medium-term, annual, quarterly, and monthly programmes. Coordination refers to the selection of the main macroeconomic indicators and the short-term regulation of

¹ Central Bank of Armenia (CBA), Central Bank website, accessed April 4, 2024, <https://bit.ly/3TGZKXH>

² Armenian legal information system (ARLIS), the Law of the Republic of Armenia on the “Budgetary system” of 21 August 1997, accessed April 4, 2024, <https://bit.ly/3xvhlKt>

liquidity by the CBA, the external financial flows by the government, and the issuance and placement of government bonds alike³.

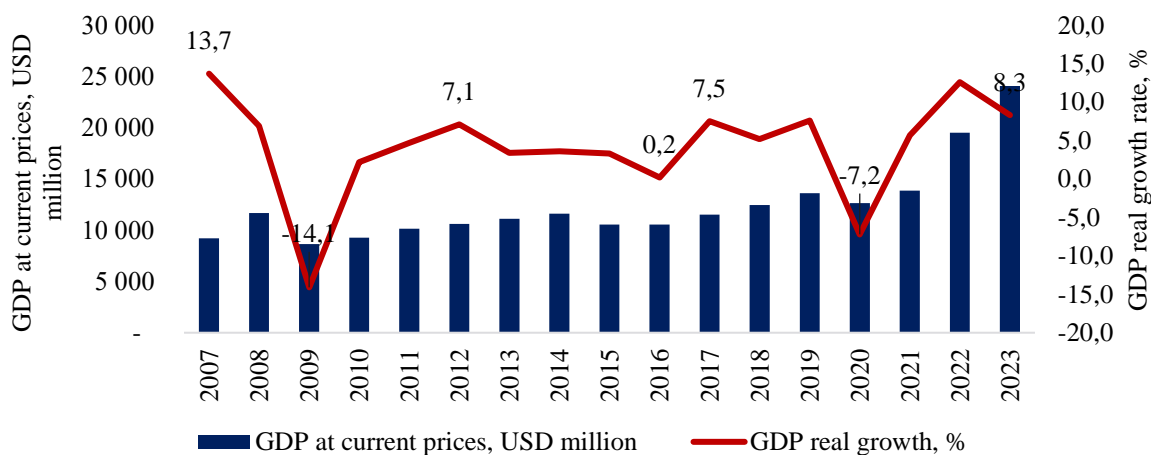
Armenia's macroeconomic stability undergoes regular reviews by the IMF under the Stand-by Arrangement (SBA). The 36-month SBA, which amounts to SDR 128.8 million (about USD 171.1 million), was approved by the IMF's Board on 12 December 2022 (IMF, 2022). This arrangement provides the country with short-term financial assistance and entails commitments to reforms in several key policy areas. These include maintaining macroeconomic stability; building fiscal buffers to support critical infrastructure and social spending; managing fiscal risks; enhancing monetary, macroprudential, and supervisory frameworks; and strengthening economic resilience through structural reforms in labour and product markets, access to finance, and governance. According to the third review under the SBA published in June 2024, Armenia met all end-December 2023 quantitative performance criteria and indicative targets (IMF, 2024). However, low inflation breached the lower outer band of the Monetary Policy Consultation Clause, causing macroeconomic risks, and there are also some delays in the implementation of structural benchmarks.

3.2 Macroeconomic Stability: Historical Perspective and Current Situation

Between 2007 and 2023, Armenia's real GDP grew at an annual average rate of 4.2%, from USD 9,206 million (AMD 3,149 billion) to USD 24,086 million (AMD 9,453 billion). In 2009, Armenia's GDP declined by 14.1% as a result of the 2007–2009 financial crisis. The slowdown of the global economy led to a reduction of remittances and investment to Armenia from abroad (especially from Russia). One of the most affected sectors was construction, which dragged down overall economic activity. This was not the only instance when external factors, especially developments in Russia, proved to be of essential significance for the Armenian economy. In 2016, the economic growth rate of Armenia slowed to 0.2% due to the economic downfall in Russia caused by the collapse of oil prices and Western sanctions, as well as the decline in global metal prices. After recovering over the next couple of years, in 2020, the GDP fell by 7.2% because of the COVID-19 pandemic and the war in Nagorno-Karabakh. However, since 2020, Armenia's economy has been growing at an impressive pace, significantly above its potential, reaching 12.6% in 2022 and registering 8.3% economic growth in 2023. A key reason for the strong economic growth of the last three years was the positive impact of external demand shock, migration, and capital inflows from Russia. The influx of Russians, including traditional tourists and highly skilled IT specialists, led to an increase in service exports from Armenia, as well as personal transfers to Armenia, which in turn led to the appreciation of dram (AMD) in 2022 (by 13.5%) and 2023 (by 9.9%). This is also reflected in the sharp growth of the USD-denominated GDP in 2022–2023, which is relatively higher compared to the growth in AMD-denominated GDP.

³ Central Bank of Armenia, "Monetary policy" [in Armenian], CBA official website, accessed April 4, 2024, <https://bit.ly/3PQMTRv>

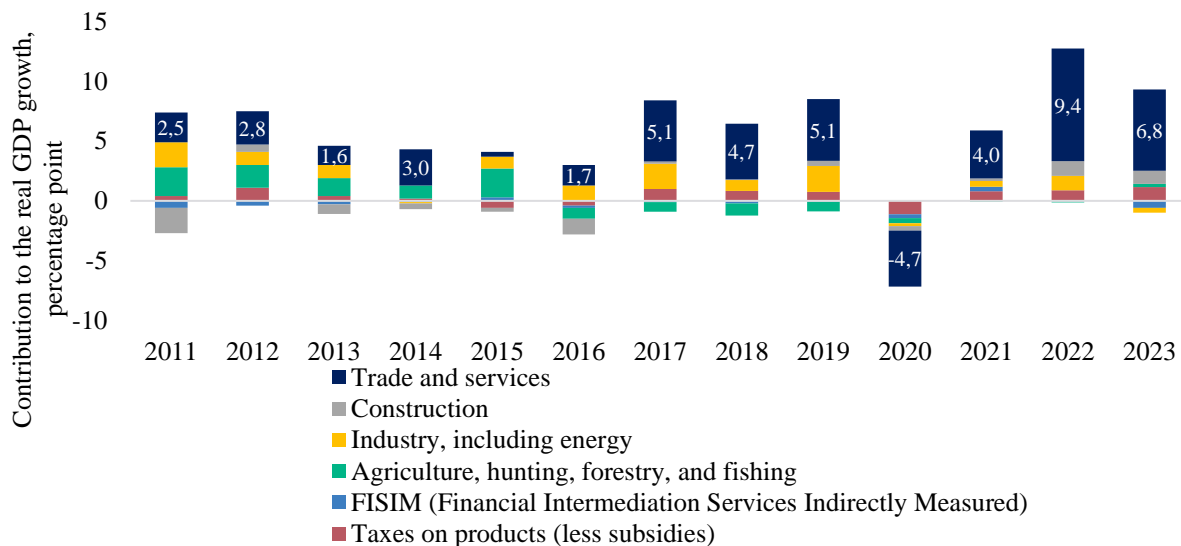
Figure 1. GDP at Current US Dollars and Growth Rate of Real GDP, 2007 to 2023



Source: IMF (for 2007–2022), Armstat (for 2023)

In terms of contribution to GDP, trade and services have been the main drivers of economic growth, while the shares of industry and agriculture have declined over the last decade (Figure 2). The share of the wholesale and retail trade in the production of GDP continued to stay strong over the review period, while the shares of financial and insurance activities and the information and communication technologies (ICT) sector increased, contributing to the greater economic importance of the service sector. Overall, the share of trade and services in the GDP grew from 41% in 2011 to 59% in 2023 (Armstat, 2023; ArmStatBank Database).⁴ In 2023, the key drivers of 8.3% economic growth in Armenia were trade, ICT, and construction with contributions of 2.7, 1.5, and 1.1 percentage points, respectively.

Figure 2. Decomposition of Economic Growth by Sector, 2011 to 2023

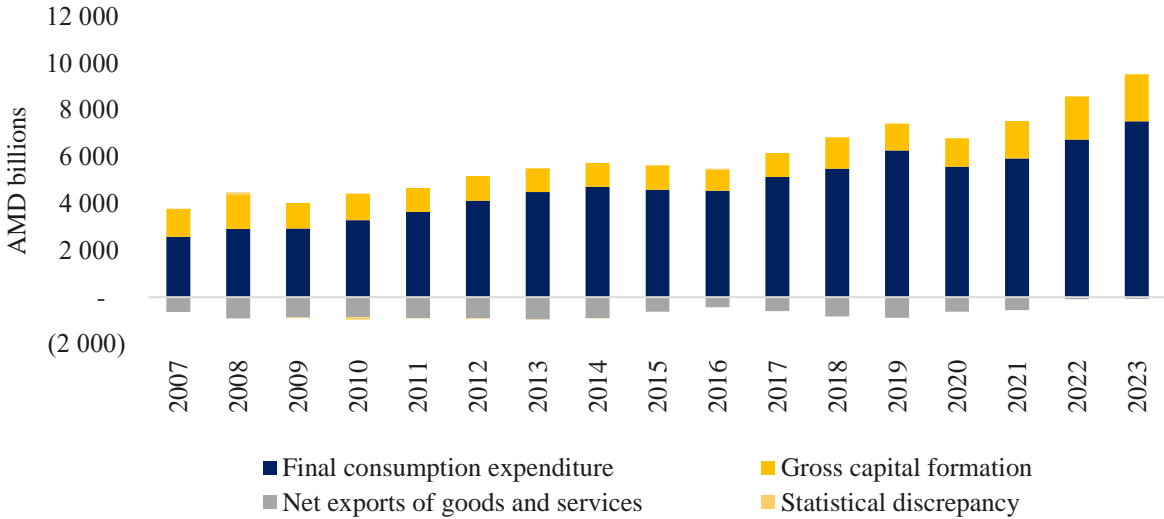


Source: Armstat

⁴ Armstat, ArmStatBank Database, accessed April 8, 2024, <https://bit.ly/4bV6bgX>

From the expenditure standpoint, growth has been driven by consumption and, to a lesser degree, by investment. Both household and government consumption have grown notably between 2007 and 2023. In 2022 and 2023, the positive impact of exports on economic growth increased significantly compared to the previous years. For example, the net exports in 2007 amounted to around AMD -629 billion, while in 2022, the gap narrowed to AMD -83 billion and reached around AMD -77 billion in 2023. The Russian economy was, to a large extent, responsible for this impressive growth in external demand. The Western sanctions that constrained the exports of other countries to Russia resulted in the growth of Armenian exports. In 2022, Armenian merchandise exports to Russia tripled. It is worth mentioning that while the domestic exports increased as well, the re-exports were the key driver for the surge of exports to Russia. Regarding gross capital formation, the majority of investments over the last decades, particularly in the last 2 years, represented investments in residential construction.

Figure 3. Use of GDP, 2007 to 2023



Source: Armstat

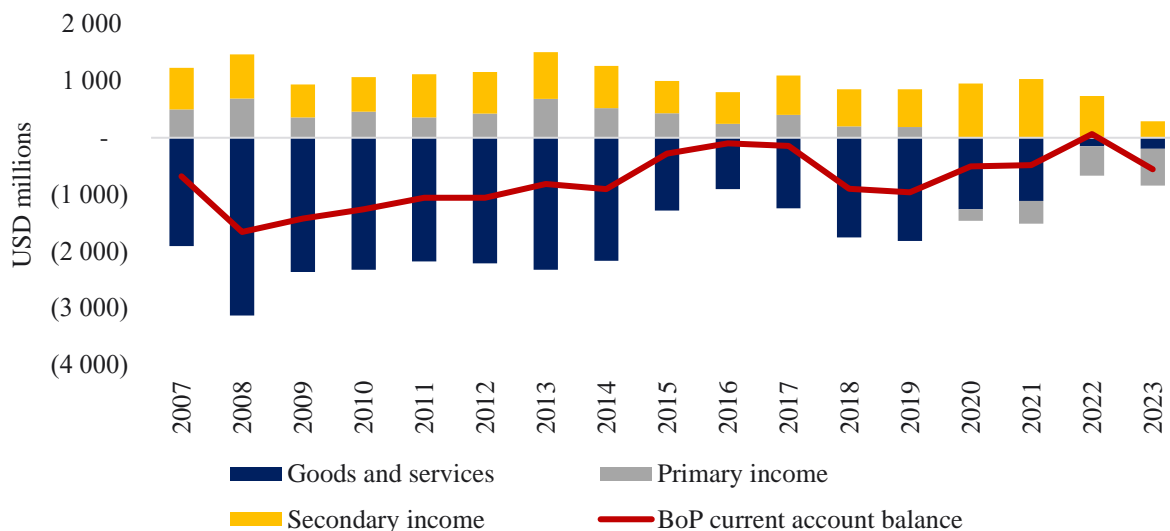
In 2008, Armenia’s current account deficit widened to USD 1,659 million (14.2% of GDP), up from USD 677 million (7.4% of GDP) in the previous year. In 2008 there was a decline in Armenian merchandise exports, mainly caused by the exports of copper, iron alloys, diamonds, gold, and jewellery, because of developments in the global markets (e.g. copper market crash caused by the global financial crisis). Additionally, the 2008 Russo-Georgian War complicated the transportation and exports from Armenia in the third quarter of 2008. In the following years, Armenia’s current account balance narrowed mainly due to the improvements in the global economy, particularly in the main partner countries. In the following years, the negative current account balance of Armenia narrowed mainly due to the improvements in the global economy, particularly in the main partner countries.

In 2021, Armenia’s current account deficit narrowed to USD 483 million, while in 2022, its current account balance moved into surplus. The surplus reflected the sharp rise of re-exports to Russia and the strong remittance inflow to Armenia linked to migratory flows from Russia driven by the war in Ukraine. In 2022, Western economic sanctions on Russia following the outbreak of the war in Ukraine and changed provisions on parallel imports by Russia opened a window of opportunity for Armenian exporters; this led to a growth both in re-exports and domestic merchandise exports from Armenia to Russia. The export of services also increased, mainly

reflecting the inflow of tourists and migrants from Russia (in 2021, the services balance was USD 390 million, while in 2022, it reached USD 1,719 million).

In 2023, these stimuli started to wane, which was also observed in the current account balance. The current account balance moved back into a deficit, with the balance of secondary income narrowing from USD 734 million in 2022 to USD 289 million in 2023.

Figure 4. BoP Current Account Balance, 2007 to 2023



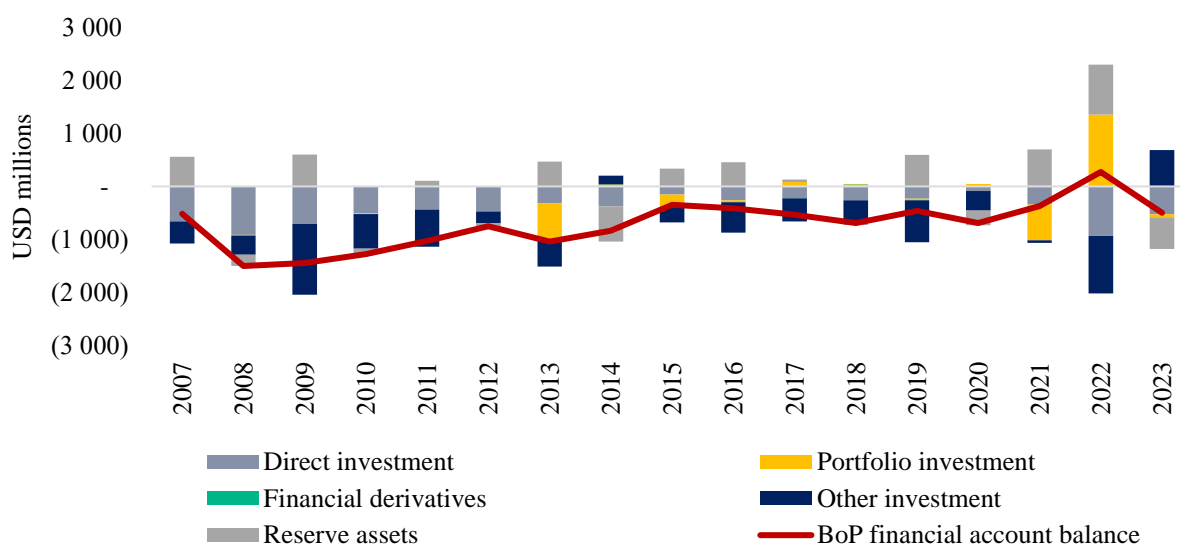
Source: IMF

A current account deficit, which Armenia has experienced over the decades, placed the country as a net borrower with the rest of the world. However, in 2022, the financial account balance moved to surplus. In 2022, the financial account recorded a net outflow of USD 272 million, having recorded a net inflow of USD 369 million in 2021. In 2023, as the impact of the Russo-Ukrainian War began to subside, the financial account balance returned to deficit, reaching USD -495 million.

In 2022, the net inflow of FDI in Armenia (net incurrence of liabilities) increased 2.7 times from a year before and reached nearly USD 1 billion, which is a historical high for the country. However, this impressive growth was partly due to the AMD appreciation. The contribution of AMD appreciation to the growth was 13.5% (Modex, 2023). It must also be mentioned that a significantly high share of the FDI inflow comes from the reinvestment of earnings (direct investors in direct investment enterprises). In 2023, reinvestment of earnings accounted for 66.1% of the net FDI inflow.

Regarding portfolio investments, in 2022, we observe a net outflow of USD 1,356 million compared to a net inflow of USD 672 million in 2021. In 2022, the net outflow of portfolio investment (net acquisition of financial assets) amounted to USD 1,032 million, compared to only USD 54 million in 2021. This impressive growth was due to growth in investments by deposit-taking corporations (except the Central Bank) in debt securities (USD 899 million). Since the onset of the war in Ukraine, Armenian banks have significantly benefitted from the large Russian inflows. The migration flows led to deposit inflow and increased transactional incomes, such as fees and other gains on currency conversion, growth in profitability, and capitalisation. To effectively manage their assets, banks increased their investments in debt securities, which is reflected in the growth of portfolio investments. In 2023, the portfolio investment balance returned to negative (USD -64.5 million).

Figure 5. BoP Financial Account balance, 2007–2023

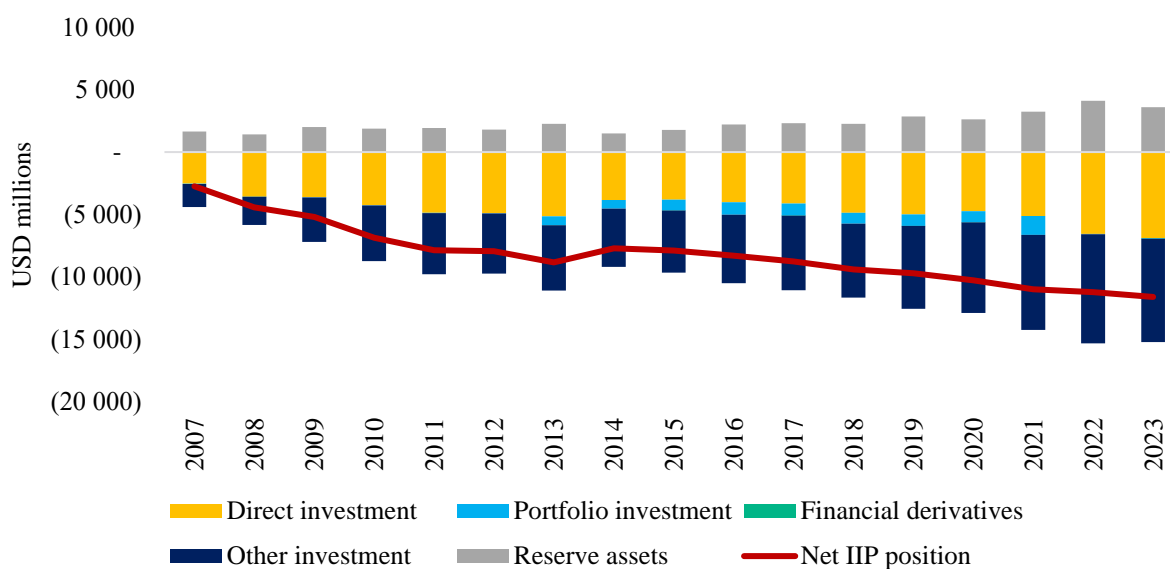


Source: IMF

Between 2007 and 2023, Armenia’s international asset position increased by USD 6,922 million and was valued at USD 9,214 million at the end of 2023, while the value of its liability position with the rest of the world increased by USD 15,884 million and reached USD 20,916 million. The increase in liabilities was mostly driven by a rise in deposits from non-residents in Armenian commercial banks, an increase in general government external debt, as well as reinvestments of foreign direct investors in their businesses. Regarding assets, the growth was largely driven by an increase in the asset positions of deposit-taking corporations (excluding the Central Bank) and a rise in reserve assets.

At the end of 2022, the international reserves of the CBA had increased by 27% compared to the end of the previous year, reaching USD 4,112 million; at the end of 2023, they fell by 12% and amounted to USD 3,608 million. From 2007 to 2023, the value of CBA international reserve assets more than doubled.

Figure 6. Net International Investment Position, 2007–2022



Source: IMF

Armenia’s general government has a very high level of centralisation. However, it must be noted that, regarding government finance, the statistics are limited to the central and local budgetary units, while there are a significant number of state-owned enterprises, which fall under the classification of commercial enterprises that belong to the government for which no comprehensive data is available. The centralisation becomes evident when examining the expenditures and revenues of central and local governments. For example, in 2023, the expenditures of the central government amounted to AMD 2,548 billion, 10.5 times the amount of the local government’s expenditure (about AMD 243 billion).

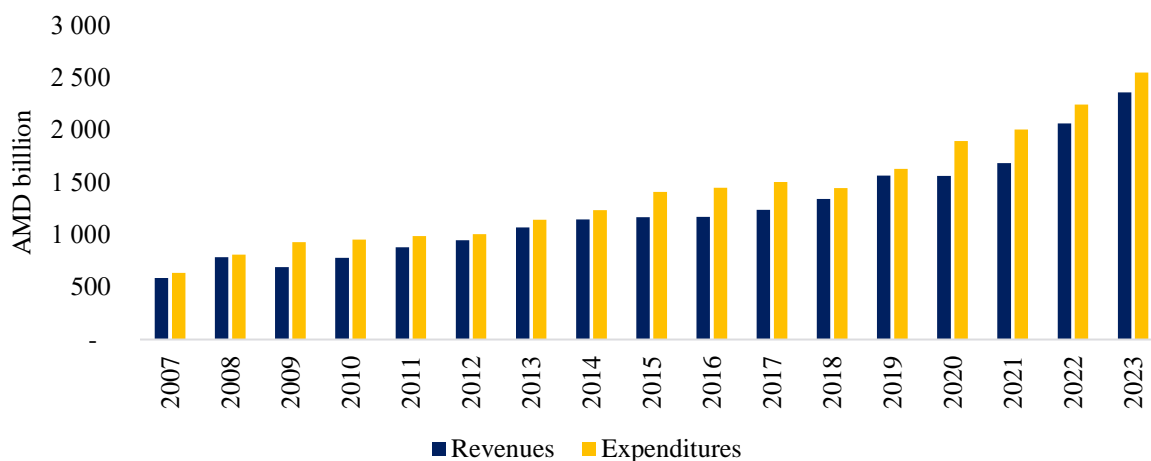
In Armenia, tax revenues are the main source of central government revenues (on average, 92% of total revenues in 2007–2023). In 2023, Armenia’s central government revenues amounted to AMD 2,359 billion (USD 6,010 million),⁵ a 14.3% growth from the previous year, mainly reflecting the growth in VAT, profit tax, and income tax. The 2023 growth in revenues is partly a reflection of the growth in re-exports to Russia and the migration inflow after Russia invaded Ukraine. Particularly, the increase in VAT is largely due to the increase in VAT paid for the import of goods from non-EAEU countries—part of which was re-exported to Russia. The increase in income tax was largely due to the influx of Russians and Russia-based companies specifically into the IT sector, which is a relatively highly paid industry.

Between 2007 and 2023, the expenditures of the central government increased 4.0 times from AMD 635 million to AMD 2,548 billion. In 2023, the expenditures grew by 13.6% compared to the previous year, amounting to AMD 2,548 billion (USD 6,491 million).

Over the years, the Armenian government started relying more on internal sources for financing the budget deficit rather than on external sources of financing. For example, since 2020, the deficit has been entirely financed by internal sources.

⁵ According to the 2022 annual average exchange rate, derived from CBA, <https://is.gd/2Y07MM>

Figure 7. Revenues and Expenditures of the Central Government, 2007–2023

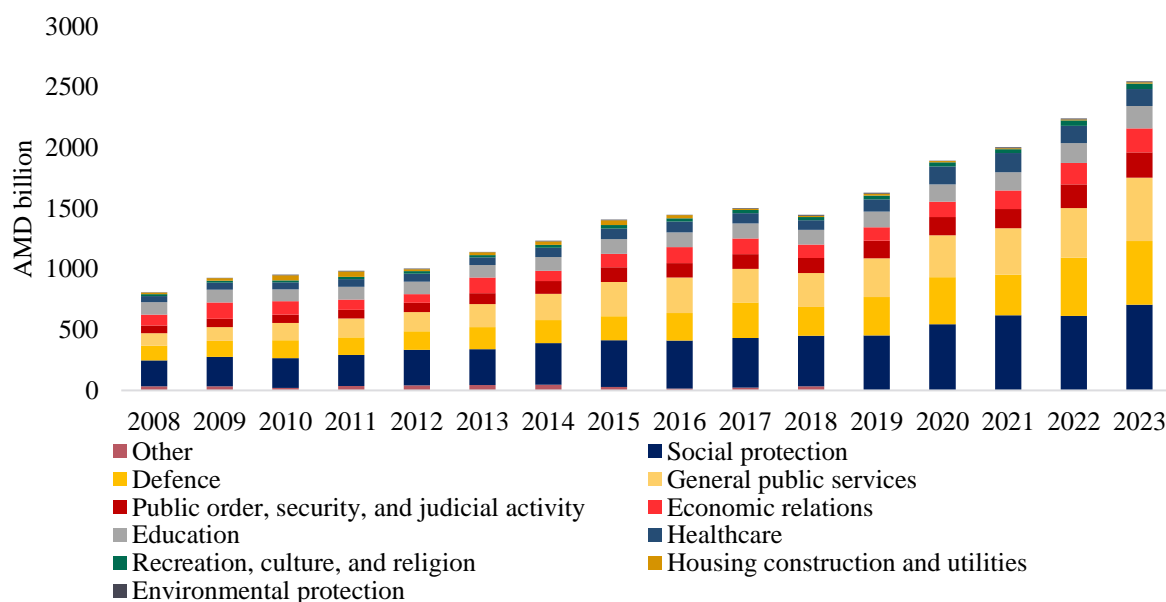


Source: IMF, RA MoF

Traditionally, in Armenia, the biggest share of state budget expenditures is allocated to social protection (on average, 28% of total expenditures in 2008–2023), including payment of pensions and social contributions. The next two major directions of public expenditures have been defence and general public services (each on average 17% of the total in 2008–2023). Over the years, the shares of defence and general public services (which includes debt service) increased by 6 and 8 percentage points, respectively. Overall, between 2008 and 2023, the expenditures on social protection tripled, while the expenditures on defence and general public services increased 4 and 5 times, respectively. In 2023, the expenditures on social protection amounted to AMD 706 billion (USD 1,798 million), defence to AMD 526 billion (USD 1,340 million), and general public services to AMD 523 billion (USD 1,331 million).

Between 2007 and 2023, on average, 85% of annual public spending accounts for current expenditures, while 15% has been directed to capital expenditures. Over these years, the current expenditures increased by nearly 5 times, and the capital expenditures 2.5 times.

Figure 8. Central Government Expenditures, 2008–2023



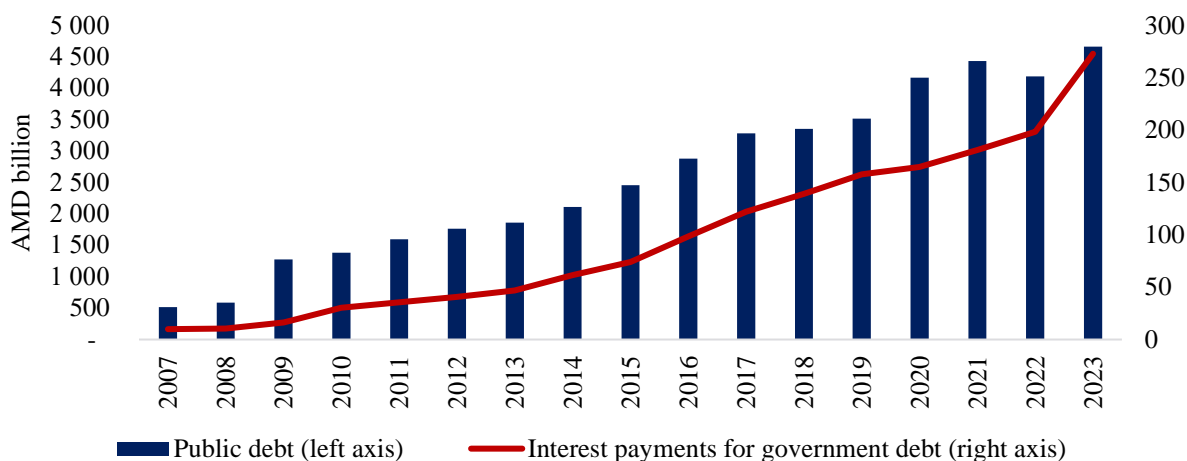
Source: IMF, RA MoF

The public debt of Armenia increased significantly over the years, and by the end of 2023, it had reached AMD 4,659 billion (USD 11.5 billion). In 2020 and 2021, amid the COVID-19 pandemic, the public debt-to-GDP ratio exceeded the debt ceiling of 60%. Due to favourable economic conditions, it was possible to bring the ratio back below 60% in 2022 (49.2%), even though the government initially planned to reach this target by 2026. The government debt constitutes around 95% of the public debt; the rest is the debt of the CBA.

Over the years, the debt service has also increased significantly. In 2007, 1.6% of public budget expenditures were directed to the interest payments for the government debt, while it reached 8.8% in 2022 and 10.3% in 2023. However, the government’s debt remains manageable. The increasing AMD component in the debt, as well as the fact that internal debt has been growing at a higher rate than external debt, has been favourable in terms of debt management. At the end of 2018, the debt acquired in AMD amounted to 18.7% of total government debt, while at the end of 2023, it reached 42.6%.⁶

⁶ MoF, “State budget” (web page), MoF website, accessed April 8, 2024, <https://is.gd/3esrgB>

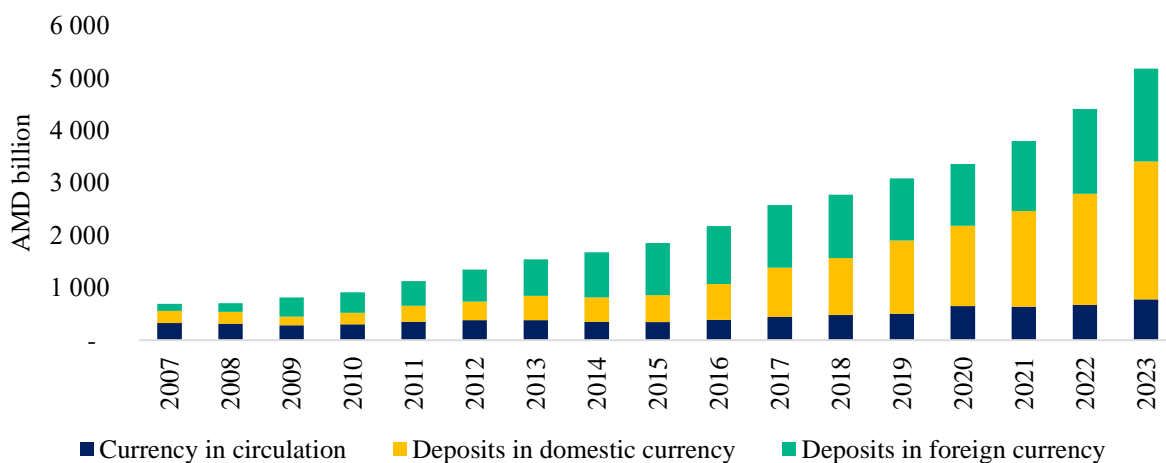
Figure 9. Public Debt and Government Debt Service, 2007–2023



Source: RA MoF

At the end of 2023, the stock of broad money totalled AMD 5,182 billion—an all-time high and 7.5 times the size of the 2007 year-end stock. Broad money growth accelerated from 13.1% in 2021 to 17.4% in 2023, fuelled by higher economic activity and by strong money transfers and capital inflows reflecting an influx of people and capital from Russia. Moreover, since 2008, the broad money stock increased more rapidly than income, leading to a steady decline in the income velocity of the broad money, which measures the ratio of nominal GDP to the stock of broad money and also creates inflationary pressures on the economy. In 2008, the size of nominal GDP was 5 times the stock of the broad money; in 2023, it fell to 1.8.

Figure 10. Broad Money, 2007–2023

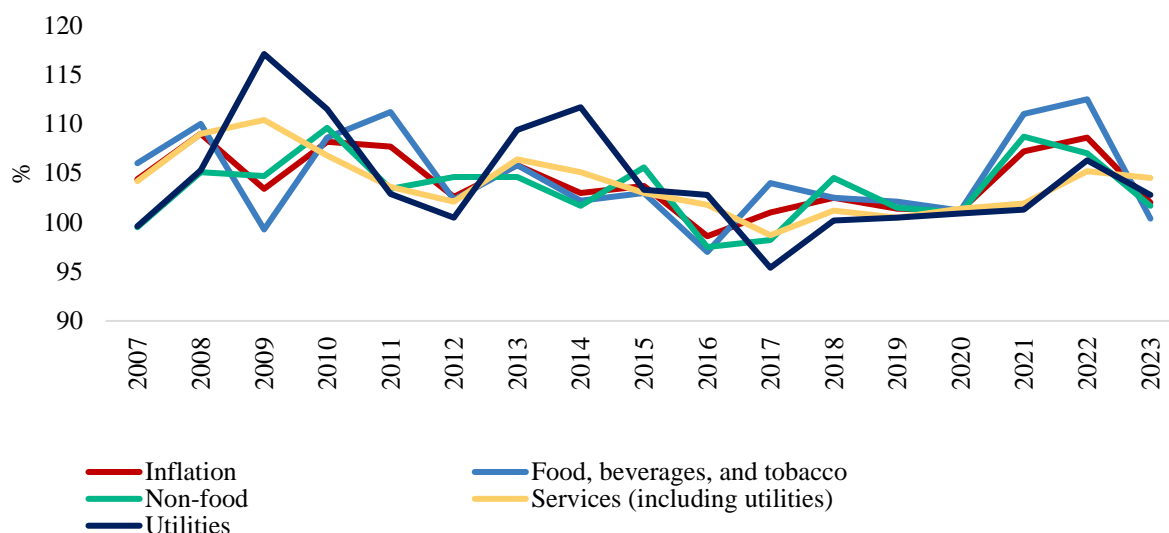


Source: IMF, CBA

From 2013 until the COVID-19 crisis, Armenia had low inflation. Before that, inflation picked up in 2008 due to the global financial crisis and again in 2010 fuelled by a sharp increase in food prices in international markets. In the last few years, Armenia’s inflation accelerated mostly due to external factors. Average annual inflation accelerated from 1.2% in 2020 to 7.2% in 2021 and further to 8.6% in 2022, well above the 5.5% upper limit of the

CBA’s target range. This acceleration in inflation was fuelled by strong domestic demand as a result of the influx of Russians after the outbreak of the Russo-Ukrainian War, as well as high food prices in the global markets.

Figure 11. Inflation, 2007–2023



Source: Armstat

To curb inflation, the CBA tightened monetary policy by raising the refinancing rate. Notably, in 2022, the policy rate was raised in several steps to reach 10.75% by year-end. In 2023, as the overall inflation environment in the world continued to soften, and due to the implemented monetary policy, inflation in Armenia gradually decreased and fell below the 2.5% lower limit target of the CBA. Consequently, the policy rate was lowered gradually to reach 9.25% by the end of 2023. In 2024, CBA continued to lower interest rates, and as of 6 November 2024, the refinancing rate stood at 7.25%.⁷ Generally, over the last few decades, CBA has reacted rapidly to inflationary pressures.

Although the CBA has predominantly used interest rates to curb inflation, over the years, it has also implemented changes in reserve requirements and used other open market operations to ensure greater financial stability. For example, between 2014 and 2016, a deflationary environment was maintained in Armenia, and the CBA implemented several tools along with changes in policy rates as a part of its monetary policy. Notably, in 2014, the inflation rate was reduced at a faster-than-expected pace and approached its lower limit target, driven primarily by sluggish economic growth and a considerable fall in the prices of some food products in light of low investment and slower private consumption growth rates. As a measure of monetary policy easing, the CBA lowered the reserve requirement ratio for local currency deposits from 4% to 2%, and the reserve requirements for funds attracted in foreign currency were increased from 12% to 24%, which was later lowered to 20%.⁸

⁷ Central Bank of Armenia, “MP Instruments Interest rates” (web page), accessed November 6, 2024, <https://is.gd/k6V6RX>

⁸ ARLIS, the CBA board resolution No. 39 on the “Approval of regulation 2 on “Regulation of banking, prudential standards for banking” of February 9, 2007, accessed April 8, 2024, <https://is.gd/RHKv88>

Additionally, as a monetary policy tool, the CBA uses the Lombard Repo Facility Rate. For example, in 2014, to manage risks to price and financial stability disruption, among other actions, the CBA raised the Lombard Repo Facility Rate from 8.25% to 21%.

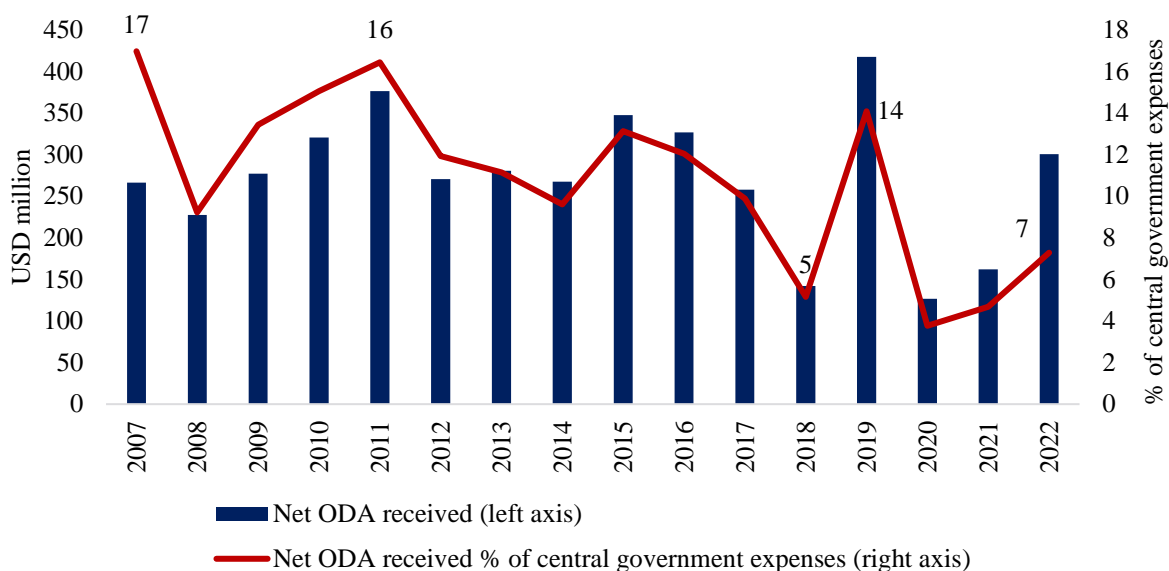
In 2015, the financial system of Armenia faced many external shocks, including a decline in base metal prices in international markets and the economic downturn in Russia. Along with changes in interest rates, the CBA implemented several other measures, such as a zero-level or easy mechanism of reserve requirements for long-term funds attracted by banks, easing of requirements for resident non-financial corporations that have foreign ratings, and the mitigation of risk weights for foreign currency borrowers engaged in exports (CBA, 2016).

In 2016, the deflationary environment in Armenia continued, and the CBA had to significantly loosen monetary conditions, which had a positive impact on private consumption. In particular, the CBA reduced the policy rate and, along with it, the reserve requirement rate on foreign currency funds from 20% to 18%. These actions led to a drop in the interbank, as well as credit and deposit markets' interest rates, and lending grew slightly. The obligatory reserve requirement ratio for funds in foreign currency has not changed since, while the reserve requirement ratio for the attracted AMD funds was last changed in 2021 and currently is 4%.

Overall, the inflationary environment in Armenia over the last decades has been shaped by a combination of monetary and non-monetary factors, reflecting the interconnectedness of the domestic economy with global markets and the effective monetary policy in maintaining price stability. Among the most important non-monetary factors that affect prices in Armenia are price volatility in international commodity markets and disruptions in global supply chains. This is due to the fact that the country heavily relies on imported food items to meet domestic demand, inflation rates, and macroeconomic developments in its major partner countries since Armenia's exports are highly concentrated. Regarding monetary factors, the CBA has been actively managing the money supply through its monetary tools such as interest rates and reserve requirements.

Since the beginning of the 1990s, Armenia has been receiving assistance from developed countries and international organisations aimed mainly at promoting the development and welfare of the country. In 2022, the net Official Development Assistance (ODA) received by Armenia amounted to USD 300 million, which is 85.5% more than in 2021 and 12.9% more than in 2007. ODA consists of grants and loans made on concessional terms (loans must have a grant element of at least 25%, calculated at a discount rate of 10%) by members of the Development Assistance Committee (DAC), multilateral institutions, and non-DAC countries to developing countries that are undertaken by the official sector to promote economic development and welfare. It must be mentioned that although net ODA received by Armenia in current USD terms has increased in the last 15 years, net ODA as a share of central government expenses has declined from about 17.0% in 2007 to 7.3% in 2022. In general, international donor funding in Armenia (all loans and grants provided to the central government by international donors) is directed mainly to the improvement of infrastructure. For example, in 2022, 36% of the funding from international donors was directed to the improvement of the road network and urban development; 17% to the improvement of irrigation, water supply, and drainage systems; and 16% to provide education and improve infrastructure (ACSES, 2023).

Figure 12. Net Official Development Assistance Received by Armenia, 2007 to 2022



Source: World Bank

3.3 Primary Sources of Macroeconomic Fragility and Key Macroeconomic Risks

In 2022 and 2023, the Armenian economy grew strongly thanks to the rapid expansion of consumption and services fuelled by the influx of people from Russia, as well as double-digit growth in exports, reflecting re-exports to Russia. As a result, the current account and fiscal account balances moved into surplus. However, these stimuli are expected to wane in the coming years, leading to moderate economic growth. According to the projections of international organisations—IMF, World Bank, Asian Development Bank (ADB), European Bank for Reconstruction and Development (EBRD), and Eurasian Development Bank (EDB)—the economic growth of Armenia is projected to range from 4.5% (EBRD, 2023) to 5.7% (ADB, 2024; EDB, 2023) in 2024 and from 4.5% (IMF, 2023; World Bank, 2024) to 6.0% (ADB, 2024) in 2025. Overall, it is expected that in the medium term, the economic growth in Armenia will reach its potential of around 5%. In addition, inflation is projected to revert gradually to the CBA’s target of 4%. For example, according to ADB, inflation is projected to reach 3% in 2024 and 3.5% in 2025.

Possible continuing geopolitical tensions between Armenia and Azerbaijan remain an important source of downside risks. According to the World Bank, long-term growth will also remain hampered by commodity dependence and weaknesses in connectivity and logistics, while the IMF observes rising financial sector risks, particularly in the housing sector (World Bank, 2024; IMF, 2023). Among other risks, the isolation of Russia, a major trading partner for Armenia, from Western markets could also have negative long-term consequences for the Armenian economy (EBRD, 2023). On the upside, according to the assessments of the aforementioned international organisations, the progress in re-opening the land border with Türkiye could yield economic benefits in the medium term.

If the government does not have policies in place to support sustainable and inclusive growth, the growth rate will considerably slow down. For example, a major driver of the 2023 economic growth was the vehicle re-exports

from Armenia through the territory of Georgia to Russia. According to some estimations, the contribution of the car business to Armenia's GDP in 2023 was 3.5%, while the tax contribution amounted to 7% of total tax revenue (Chervyakov et al., 2023). In January 2023, the EU and US extended the export sanctions on the export of cars against Russia to include all new and second-hand cars above a certain engine size ($> 1.900 \text{ cm}^3$), as well as electric and hybrid vehicles. Consequently, Georgia restricted exports, re-exports, and the transit of US cars (from August 2023) and EU cars (from September 2023) to Russia through its territory, which is the main trade route for car exports from Armenia to Russia. In August 2023, the re-exports of cars from Armenia declined considerably; since the sector does not have a sustainable economic model, its disappearance in 2024 had a considerable negative effect on the economy. Similar effects may be observed in other export-oriented sectors too.

The slowdown in exports of VAT-eligible goods may lead to a decline in tax revenues for the Armenian government. Another factor that may affect the tax revenues is the departure of IT companies and specialists who relocated to Armenia after the war broke out in Ukraine. The IT sector is highly paid and generates a significant share of income tax revenues for the state budget (nearly 16% of the total collected income tax in 2023), and the influx of people and companies from Russia strongly affected the growth of this revenue source in the last few years.

Regarding the debt burden, the public debt of Armenia is expected to grow in 2024. Namely, the Ministry of Finance expects that as of 31 December 2024, the public debt will amount to AMD 5,269 billion, or 52.1% of the GDP, and will increase by 1.5 percentage points compared to the end of 2023. The government's debt is expected to amount to AMD 5,037 billion, or 49.8% of GDP, which is 1.7 percentage points higher than at the end of 2023.⁹ A year earlier, the Minister of Finance had announced that the government would do everything to keep the government debt level below 50% in 2024 (Papoyan, 2023).

It must be noted that the government of Nagorno Karabakh and other borrowers from Nagorno Karabakh had AMD 315 billion worth of liabilities to the financial and banking system of Armenia as of the end of 2023, which the government of Armenia plans to restructure. Specifically, the RA government will assume 70% of Nagorno Karabakh's loans, while the remaining 30% will become liabilities of financial institutions. This will also add to the public debt burden. Furthermore, the government plans to implement programmes in the coming years to provide housing for those forcibly displaced from Nagorno Karabakh. These initiatives could add additional pressure to the budget's expenditure.

⁹ MoF, the Draft Law of the Republic of Armenia on the "2025 State budget" (in Armenian), accessed November 7, 2024, <https://bit.ly/4fhRYgl>

4. Stability of the Financial Sector in Armenia

Like many countries in Europe, especially in the post-Soviet sphere, Armenia has a small financial sector dominated by banks. This sector has been through several crises, both global and local, including the global financial crisis, COVID-19, the ongoing Russian invasion of Ukraine from 2014 onwards (and the sanctions associated with it), and the resumption of hostilities in Nagorno-Karabakh. Of these, the global financial crisis of 2008 to 2009 hit the economy particularly hard, resulting in a contraction of GDP of 14.1%; in the run-up to the crisis, as in other countries, household lending had accelerated substantially (doubling from 4.5% of GDP to 9.44% of GDP from 2006 to 2008, albeit from a very low base, as the mortgage market was underdeveloped in the early 2000s).

The crisis reversed this trend, with loans plateauing until 2011, but the Armenian financial sector weathered the storm fairly well. In particular, due to its low external exposure and lack of integration with developed country markets, the financial sector began to grow again fairly quickly after the crisis. Prudential supervision within the CBA also improved with an emphasis on ensuring capital buffers for the banking sector. Indeed, Armenia's financial sector, and especially its banking sector, has seen impressive growth over the past decade. Before the full-scale Russian invasion of Ukraine in 2022, Armenia's financial sector was growing quickly, with assets in the banking sector, in particular, rising from a paltry 15% of GDP in 2001 to 83.5% in 2021.

However, storm clouds connected to the invasion are on the horizon. After the full-scale Russian invasion, the growth in deposits has accelerated substantially, as assets from fellow Eurasian Economic Union member Russia have flowed into the banking sector, seeking safety from Western sanctions. Similarly, while capital markets remain small and undercapitalised compared to OECD benchmarks, they also have seen growth following the Russian invasion of Ukraine, with a 50.5% increase in capitalisation from 2022 to 2023, coming on the back of an amazing 599% growth from 2021 to 2022.¹⁰

This chapter examines the risks facing the Armenian banking sector in the wake of Russia's invasion of Ukraine. Undoubtedly, the increase in deposits connected with Russians fleeing to quality can destabilise the banking sector should they suddenly be withdrawn; moreover, the continued tensions between Armenia and Azerbaijan also increase the risk of capital flight. The IMF has also noted that bank lending in the mortgage and construction sectors can also be problematic for banks if growth should cool for the economy (perhaps as part of these aforementioned geopolitical tensions) (IMF, 2023). Weighed against these risks is the reality that the financial sector in Armenia has strengthened considerably since the global financial crisis, along with the ability of the CBA to oversee potential financial risks. While the financial sector in Armenia has increased its resilience, geopolitical trends will continue to define the risks for the country—as well as to show the benefits of structural reforms and diversification.

¹⁰ World Federation of Exchanges, <https://bit.ly/3LYWumR>

4.1 Banking Sector

Without a doubt, the banking sector in Armenia is the largest portion of the financial sector and the most important source of financial intermediation in the country. The sector itself has only been growing in importance since the global financial crisis: assets in the banking sector were 58% of Armenia's GDP in 2012, rising to 78% of GDP in 2017 and reaching 96.6% of GDP in 2023, or 9.181 trillion AMD (approximately USD 22.7 billion).¹¹ This growth has occurred entirely due to private banking services, as Armenia has no state-owned banks following a concerted effort to privatise and restructure from 1993 to 1996.

The sector is currently dominated by 18 banks, but the actual amount of concentration within the banking sector is low: according to the CBA, as of the end of 2023, the Herfindahl-Hirschmann concentration index for total assets was 0.092, for total liabilities was 0.096, and for total capital was merely 0.076.¹² Among these banks, Ardshinbank is the largest bank by the amount of assets in the Armenian market (USD 4.04 billion by the end of 2023) and the second largest in terms of capital (USD 472.7 million). Competing with Ardshinbank, and holding first place in terms of capital, was Ameriabank. In February 2024, it was announced that the Bank of Georgia Group had made a deal to purchase Ameriabank, transforming it into a foreign-owned (albeit regional) entity.

At almost the same time, the oldest foreign-owned bank in the country, present for nearly three decades, was going in the other direction. International financial powerhouse HSBC Bank and its local subsidiary, HSBC Bank Armenia, began their life in Armenia in 1996 as Midland Armenia Bank. Midland Armenia Bank was renamed HSBC Bank Armenia in 1999 and spent 25 years trading under that name. Its presence in the Armenian market had been slipping compared to other competitors, however, and by the end of 2023, it was only the 12th largest bank in the country. In February 2024, Ardshinbank made an agreement to purchase HSBC Bank Armenia and integrate its customers under the Ardshinbank name, meaning an increase in Ardshinbank's position as a wholly Armenian-owned entity.

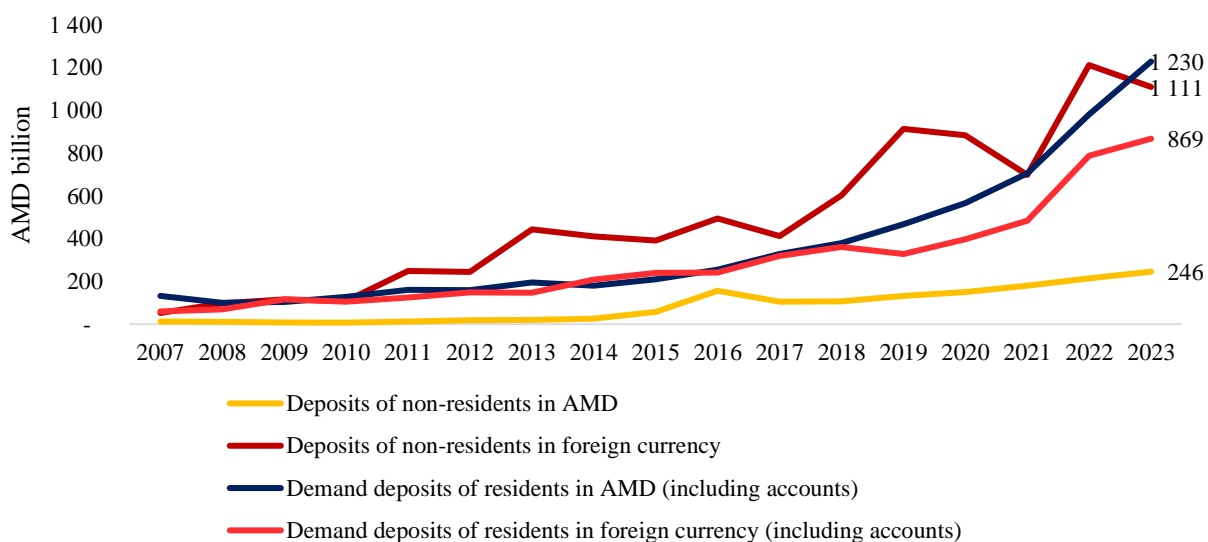
With the integration of HSBC into Ardshinbank, the largest banks in Armenia continue to have a domestic flavour. However, there has been quite a bit of reorganisation in the 2020s and a slight trend towards increased foreign ownership.¹³ Ameriabank has already been noted as purchased by investors in neighbouring Georgia. The next largest bank (in terms of profits) and the largest agricultural lender in the country is ACBA Bank, part-owned by France-based Credit Agricole. In 2022, Armbusinessbank, one of the original banks founded in the 1991 reforms, also changed hands, being sold from shareholders Vitaly Grigoryants (who held 95% of shares) and Arsen Mikayelyan (the remaining 5%) to Swiss-based firm MFM Global Invest, who now has a 75% interest. MFM immediately increased the capital in the bank and changed the name to AMIO Bank, but the bank has faced difficulties since then (including posting a loss in 2023) (Civilnet, 2022). VTB Armenia has also kept its foreign ownership, albeit as a wholly owned subsidiary of Russia's VTB Group; as such, it has been subjected to Western sanctions following Russia's invasion of Ukraine. The 14th largest bank in Armenia in terms of profit, VTB Armenia posted a loss of over AMD 1.4 billion in 2022 (approximately USD 3.5 million) but rebounded to show a profit of AMD 4.03 billion in 2023. Finally, as is consistent with the Armenian economy, there is substantial investment in the banking sector from the Armenian diaspora, with at least four of the top 18 banks having diasporic Armenians holding a controlling stake.

¹¹ CBA database, <https://bit.ly/4fOwB7c>

¹² Interim financial statements of banks, accessed March 25, 2024

¹³ Indeed, the head of the Union of Banks of Armenia, Daniel Azatyan, said in February 2024: "the arrival of international banks in Armenia is desirable and important" (Armbanks, 2024).

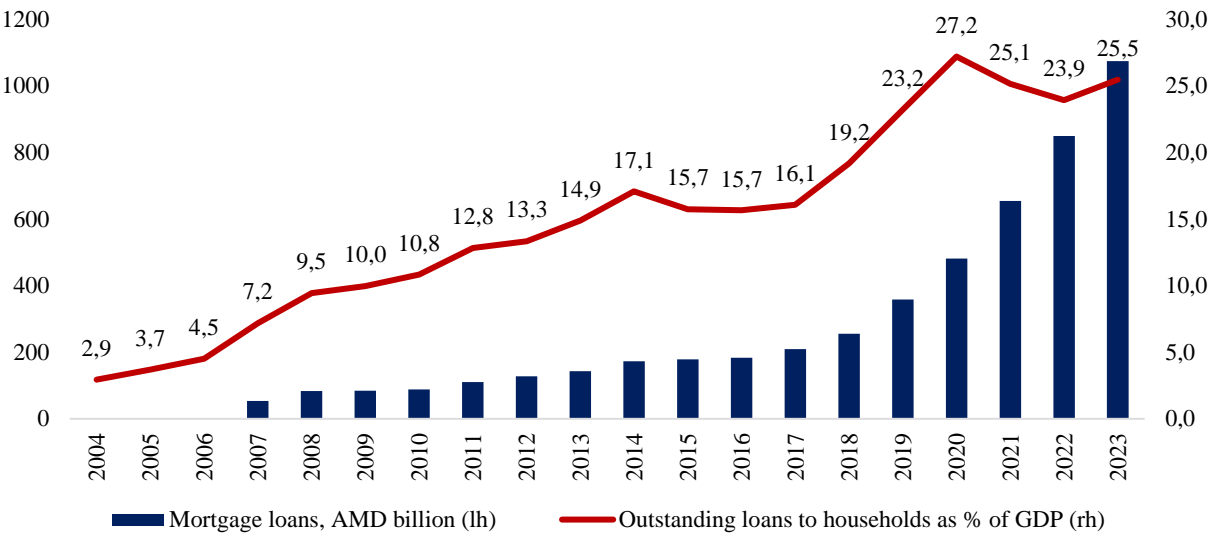
Figure 13. Demand Deposits Held by Residents in Armenia



Source: CBA

Beyond the ownership and status of these banks lie more important clues for the resilience of the financial sector in Armenia, namely the development of deposits and credit. Regarding deposits, as mentioned in the introduction, the Armenian banking sector experienced steady growth until the Russian invasion. Following this event, there was a significant surge in foreign currency deposits from non-residents, accompanied by similarly high growth in overall demand deposits from residents. Particularly, in 2022, deposits of non-residents held in foreign currency nearly doubled compared with 2021, while the total demand deposits of residents (including accounts) increased by 49%. Overall, non-residents' holdings (both AMD and foreign exchange) make up approximately 24% of all deposits in Armenia. Moreover, there are substantial flows monthly in terms of remittances and other money flowing into the financial sector, with money from Russia having the highest inflows by far: for January to September 2024, for example, money transfers from the Russian Federation comprised 65% of the total inflows of transfers through commercial banks. A reversal of such flows (due to, for example, the lessening of sanctions on Russia) could have a dramatic effect on the banking sector.

Figure 14. Outstanding Loans to Households from Commercial Banks



Source: IMF, CBA

In tandem with this increase in deposits, Armenia has seen a substantial increase in household lending over the past decade and a half, with a definite shift towards mortgage lending over the past 6 years (Figure 14). In fact, as Figure 14 shows, in the 2017–2023 period, mortgage lending has grown by 413%, with an increase of 26% from 2022 to 2023 alone. In 2023, the mortgage loans amounted to AMD 1,073.8 billion. Comparatively speaking, loans to industry peaked at AMD 655.7 billion in 2020 and have since fallen to AMD 508.9 billion in 2023, a drop-off of approximately 22%. Consumer loans were almost double this amount in 2023, standing at AMD 1,085.7 billion and comprising nearly 23% of all lending by Armenian banks. Trade and construction were other main beneficiaries of bank lending. Moreover, lending to the construction sector increased by 158% from 2019 to 2023.

Furthermore, the rise in lending has occurred as the profitability of Armenian banks has increased, although much of this had been a result of the large inflows of Russian capital into Armenian banks and an increase in non-interest income. For example, Evocabank saw its revenues increase an astounding 401% in 2022, with AMIO bank right behind with an increase of 211% and Ardshinbank seeing an additional 201% in revenues (Fitch, 2023). Return on equity in the entire sector rose from an average of 8% from 2011 to 2021 to 28% in 2022 and a still impressive 17% in 2023 (and Fitch Ratings, the rating agency, has forecast it at 15% in 2024). For Ardshinbank, 2023 was a banner year, with an average return on equity of 37.2% (down from a stellar 50% in 2022 but very impressive nonetheless) (Banks.am, 2024).

The increased profitability of Armenian banks has also coincided with a decrease in a standard measure of vulnerability for the financial sector: the prevalence of non-performing assets (NPAs). With the end of the COVID-19 pandemic and pandemic-related policies in late 2021, the incidence of NPAs decreased in Armenia from 5.31% of total assets to 2.66% (from August to September 2021) and has been consistently between 2 and 2.5% since this point. Perhaps more importantly, throughout 2023, NPAs have been hovering around 1.4% or lower for residents and around 1% in the case of non-residents, meaning that bank exposure to NPAs is quite low indeed (also due to increases in bank assets). The sector with the largest amount of NPAs is construction, at

0.27% of all assets, a number that has gone up throughout 2023 but is still lower than historic highs seen in early 2015 (1.12%) in the wake of sanctions on Russia following the illegal annexation of Crimea.¹⁴

In sum, while the banking sector has seen an increase in both deposits and household lending, for the moment, the sector appears able to handle the mostly salutary developments it faces.

4.2 Non-Banking Financial Institutions

By comparison with the banking sector, the non-bank financial sector (encompassing insurance companies, investment and pension funds, micro-finance organisations, as well as capital markets) is incredibly small. Correspondingly, their potential risks to financial stability are also dwarfed by the banking sector, which plays a far more important role in Armenia's growth prospects. For example, total assets in the insurance industry in 2023 totalled approximately AMD 89 billion, a mere 1.6% of total deposits in the banking sector. Investment companies fare somewhat better, with total assets of AMD 157 billion (approximately 2.8% of all deposits), but with much higher liabilities than in insurance, meaning a total capital of only approximately AMD 36 billion. The only financial vehicle that can even hope to rival the outsized influence of banks is the funding from Armenia's mandatory pension scheme, which had assets of approximately AMD 800 billion in 2023 against liabilities of only AMD 388 billion (and comprised 5.7% of financial system assets, according to the CBA). However, even this instrument has contributed to the dominance of banking in Armenia, as approximately 22% of these assets are invested in cash and deposit accounts, with a further 43% in low-yielding government bonds (Avetian, 2024).

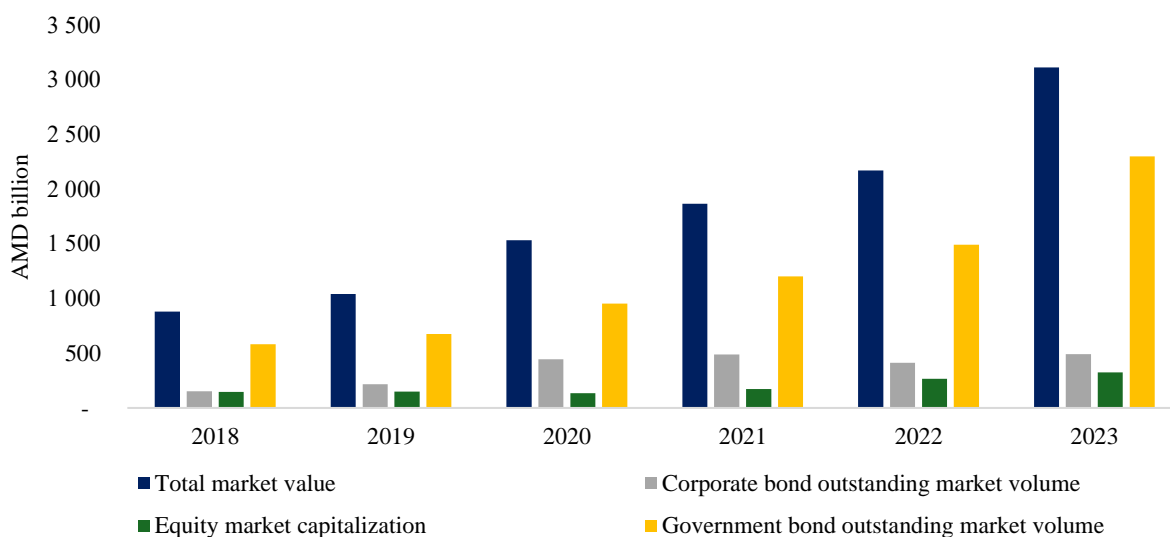
As noted in the introduction, capital markets in Armenia also remain small and underutilised as a source of investment for firms. Ownership of the Armenia Stock Exchange (AMX) has shifted since it began its operations in 2001; it was acquired by the NASDAQ OMX group in 2007, and 65% of its shares were sold to the Warsaw Stock Exchange in 2020. Despite this international interest, as of October 2024, the Armenian Stock Exchange had only 11 issuers trading shares and 23 issuers trading bonds (a total of 149 corporate securities). This number had been fairly constant over the years. For example, in 2020, 30 issuers were trading at AMX. In terms of value (Figure 15), AMX itself has shown consistent growth, but this has been mainly due to increases in the government bond market rather than private investment. Between 2018 and 2023, corporate and government bonds grew at a comparable average annual rate of 32%. However, by 2023, the size of the government bond market (as just noted, a destination for pension funds) was five times larger than that of the corporate bond market.

In general, investor protection laws and regulations—including bilateral investment treaties—are well-regarded in Armenia, but corruption remains an issue (albeit one in decline).¹⁵ The overall favourable climate, however, may not translate into the use of capital markets because of a more Armenia-specific issue: corporate governance has repeatedly been noted as a problem in Armenia's private sector, and this issue has translated into problems in capital markets, as non-transparent firms are unable to clear hurdles to list on the Armenia Stock Exchange (AMX). Increasing the pace of corporate governance reform in Armenia will help other firms to tap into capital markets, but this is a longer-term project. Indeed, it appears that the only issue for financial resilience in Armenia concerning capital markets is the over-weighting of government bonds on the AMX, which can create problems for the AMX if the government's finances waver. Yet the lack of use of the AMX, in general, means that the ripple effects for business will be tiny.

¹⁴ CBA, Monthly Statistical Overviews, <https://bit.ly/3AGKswv>

¹⁵ Heritage Index of Economic Freedom, October 2023, <https://is.gd/zzA8ir>

Figure 15. Key Indicators of the Armenia Stock Exchange, 2018–2023



Source: Armenia Stock Exchange

4.3 Financial Regulation

The entire financial sector and its operations across all of these vehicles are overseen by the CBA. Among governmental agencies, the CBA has long been seen as a competent and forward-looking institution. It has gradually reformed its approach towards financial sector regulation, instituting a risk-based framework in 2005 and setting banking standards during the global financial crisis in 2007–2008 (under the “Regulation of banking, prudential standards for banking”) (Hovanessian and Nurbekyan, 2018). In tandem with other central banks globally, the CBA now also monitors macroprudential risks and publishes an annual report on financial stability, noting developments in the country and actions that the CBA has taken to deal with specific risks.

Overall, since the global financial crisis and the shocks emanating from Russia after its first invasion of Ukraine in 2014, the CBA has taken a much more hands-on approach toward financial stability, including adjusting reserve requirements and increasing the countercyclical capital buffer for banks. The IMF has noted repeatedly that the CBA is in compliance with the Basel methodology for risk supervision and that its risk-based framework meets with international best practices (IMF, 2019); coupled with the publication of financial stability reports and regular updates on the CBA website, the financial regulator adheres to international standards of transparency. Perhaps most importantly, the regulatory approach towards the financial sector can be characterised as “conservative”, with an awareness of the risks both internally and externally to Armenia.

4.4 Main Sources of Financial Fragility and Risks

Armenia’s financial sector, dominated by banks, has seen an impressive period of consolidation and growth, with greater penetration from foreign investors. On the whole, the financial sector is much stronger than it was on the eve of the global financial crisis, showing signs of resilience from the spillover effects of the full-scale Russian invasion of Ukraine. However, as with other countries in the region, the war itself remains the largest threat to the banking sector; in particular, the flood of deposits linked to a “flight to quality” has the potential to

destabilise the banking sector, especially if there is a large-scale withdrawal. Banks need to take into account that this money is in some sense “hot,” in that it is highly dependent on geopolitical events and flows could reverse themselves quickly. In some ways, Armenian banks have already prepared themselves for this eventuality, investing these deposits in foreign liquid assets, enabling them to convert these assets into cash upon demand (see Chapter 5).

At the same time, the increase in lending for mortgages and the construction sector also requires monitoring in order to ensure that a bubble does not develop. With monetary policy easing since June 2023 and deflation starting to work its way through the economy,¹⁶ the dangers of a construction bubble arising are increasing, with households moving even more urgently into mortgages.

In general, Armenia’s financial sector has an enviable position, one of abundant deposits and a favourable macroeconomic environment. The main threat remains geopolitical jockeying related to the Russian invasion of Ukraine as well as existing tensions in the region. Both of these can severely impact growth and, by extension, the financial sector.

¹⁶ Armenia has experienced deflation in 2024, both on a year-over-year basis for each month from January to June, and in cumulative terms, with the percentage change from the start of the year to August (and before that) compared to the same period in the previous year.

5. External Economic Relations

5.1 Role of External Trade Relations in Armenia's Economy: Key Indicators

Armenia has open trade policies and actively engages in international trade. Since 2003, the country has been a member of the World Trade Organization (WTO); as a member, it maintains a most favoured nation (MFN) regime with all WTO members, which ensures that all member states receive the same favourable trade terms. However, Armenia is also a member of the EAEU, which implies that it applies the MFN principle in situations and under conditions outlined by international treaties between the union and third countries, as well as by international agreements between EAEU member states and third countries.¹⁷

The EAEU is an economic union between Armenia, Belarus, Kazakhstan, the Kyrgyz Republic, and the Russian Federation. Trade between EAEU member countries is exempted from customs duties. Regarding third countries, member states apply a common trade policy. After becoming the fifth member of the EAEU in 2015, Armenia gained the ability to establish free trade with a third country exclusively based on a Free Trade Agreement (FTA) between the EAEU and that party. However, the bilateral FTAs signed before 2015 may continue to be in force as long as they do not contradict the EAEU regulations. Currently, Armenia has several bilateral FTAs, including those with Georgia, Tajikistan, Moldova, Turkmenistan, and Ukraine.¹⁸ The EU–Armenia bilateral trade relations are regulated by a Comprehensive and Enhanced Partnership Agreement (CEPA), which was signed in November 2017 and fully entered into force on 1 March 2021 (European Commission, 2021). Until 2022, Armenia was also a beneficiary of the EU Generalized Scheme of Preferences (GSP), which offered duty-free treatment or reduced tariffs on a wide range of goods exported from Armenia to EU countries. However, according to the regulations of the EU GSP programme, the country was excluded from the preferential treatment after being classified by the World Bank as an upper-middle-income country for three consecutive years. However, Armenia continues to be a beneficiary of the GSP regimes of the USA, Canada, Switzerland, Japan, and Norway, as well as having duty-free access or reduced tariffs for selected goods.

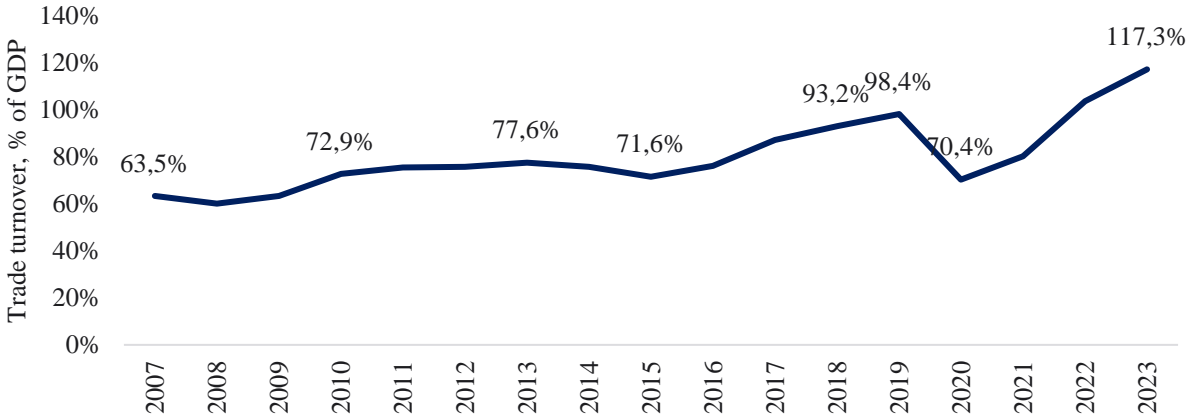
Armenia has closed borders with two of its four neighbours and the geographic position of the country constrains to a certain degree its involvement in global trade relations. Nevertheless, a persistent high trade-to-GDP ratio indicates the substantial trade openness of the country. Between 2007 and 2017, Armenia's trade-to-GDP ratio increased from 63.5% to 87.3%. Between 2018 and 2023, the general trend continued to grow (117.3% in 2023, up from 93.2% in 2018), except for 2020, when COVID-19 severely disrupted international trade. However, it is important to note that the growth in foreign trade and the high trade-to-GDP ratio have been driven not only by an increase in domestic exports but also significantly by the role of re-exports in the country's trade. The significant role of re-exports was particularly evident in 2018–2019 and 2022–2023. After joining the EAEU in 2015, Armenia gained free access to the EAEU market and was required to align its import duties with collective EAEU duties in 2020. For example, regarding vehicles, tariffs on imports from non-EAEU countries were to be increased

¹⁷ EAEU, "Treaty on the Eurasian Economic Union" adopted on May 29, 2014, <https://bit.ly/4c9xCnn>

¹⁸ World Trade Organization (WTO), Regional Trade Agreement Database, accessed July 2, 2024, <https://bit.ly/480PVtc>

from 10% to 20% in 2020. Since Armenia was granted preferential transition terms and new tariffs were to come into force in 2020, many saw a window of opportunity with low import tariffs and free access to the EAEU market, especially regarding imports and further re-exports of cars to EAEU countries. Exporters started importing cars from non-EAEU countries with low import duties and re-exporting them to EAEU countries before the end of the preferential term when import duties would increase. In 2018 and 2019, the imports of vehicles amounted to USD 235 million (64,000 cars) and USD 559 million (189,000 cars), which were mainly re-exported to Russia and Kazakhstan (Chervyakov et al., 2023). In 2022 and 2023, the Western economic sanctions on Russia following the outbreak of the war in Ukraine opened a new window of opportunity for Armenian exporters, leading to growth both in foreign and domestic exports from Armenia to Russia.

Figure 16. Trade Turnover in Goods and Services as % of GDP, 2007–2023

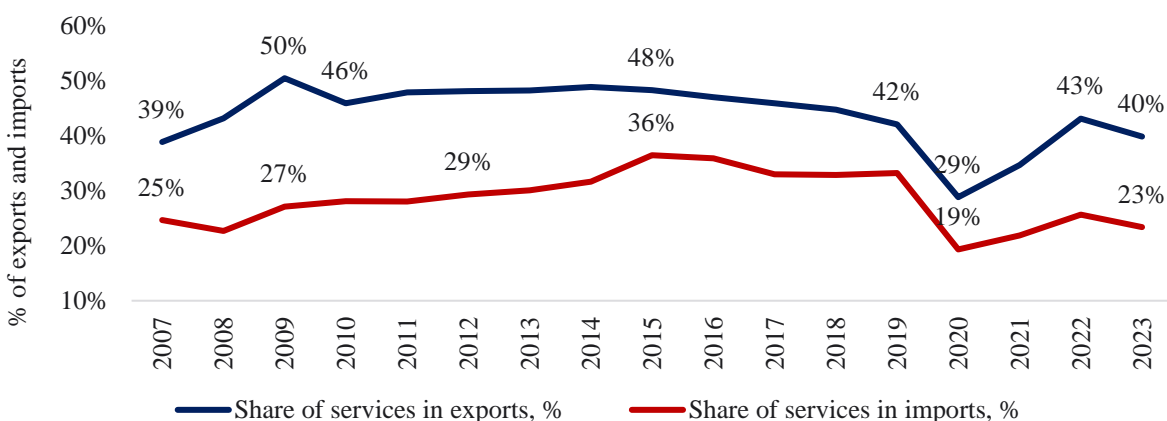


Source: CBA, Armstat

Armenia predominantly exports and imports goods. From 2007 to 2023, the share of merchandise exports in the total exports averaged 56.2%, and the share of merchandise imports averaged 71.6%. Despite the dominance of the merchandise trade, it must be mentioned that the share of services exported in Armenia is comparatively higher than in many countries. For example, in EU countries, the share of merchandise exports is more than twice that of services.

In the 2000s, the share of services in exports increased gradually; in 2009, it was 50%, up from 39% in 2007. In the following five years, it remained relatively stable (averaging 48% annually); however, since 2016, it has declined significantly. In 2022, due to the influx of Russians and Russia-based companies specifically into the IT sector, the export of services increased, driven by the export in travel and tourism as well as the ICT sectors. In 2023, the share of services in exports was 39.8%, while the share in imports stood at 23.3%.

Figure 17. Share of Services in Exports and Imports, 2007–2023

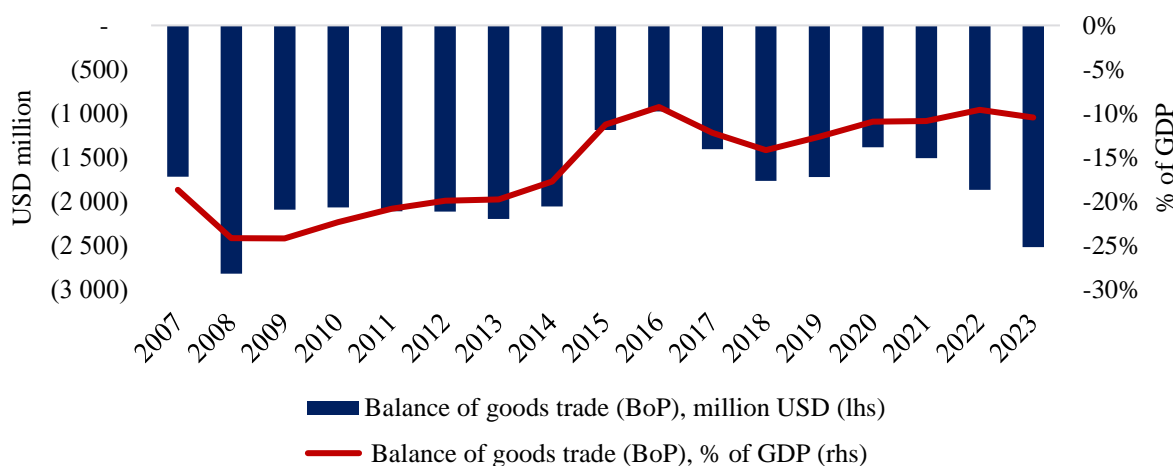


Source: World Bank, CBA

In 2008, Armenia’s current account deficit surged to 14.2% of GDP due to external shocks affecting exports but gradually narrowed to -1.3% by 2017. From 2018 to 2019, the current account balance widened again, while the deficit reached around -7% of GDP, driven by rising imports and slow export growth. By 2022, the current account moved into surplus (0.8% of GDP) due to re-exports to Russia and remittance inflows; however, by 2023, these factors diminished and the current account returned to a deficit of -2.3% of GDP (see Section 3.2).

Armenia is a net importer of goods, consistently maintaining a negative trade balance in goods over the years. Over the past decade and a half, the trade deficit has fluctuated, influenced by various external shocks. The trade balance in goods after widening in 2008 (due to the effects of the financial crisis) stabilised at around USD -2 billion in the subsequent five years and narrowed to USD -977 million in 2016, driven by the accelerated growth of exports over imports. A major driver of the 2016 growth in exports was the exports of precious and semi-precious stones, precious metals, and articles thereof. In the last years, the general trend was toward widening the deficit in goods trade. In 2022, the deficit in the trade in goods amounted to USD 1,866 million (-9.6% of GDP), and in 2023, it reached USD 2,515 million (-10.4%).

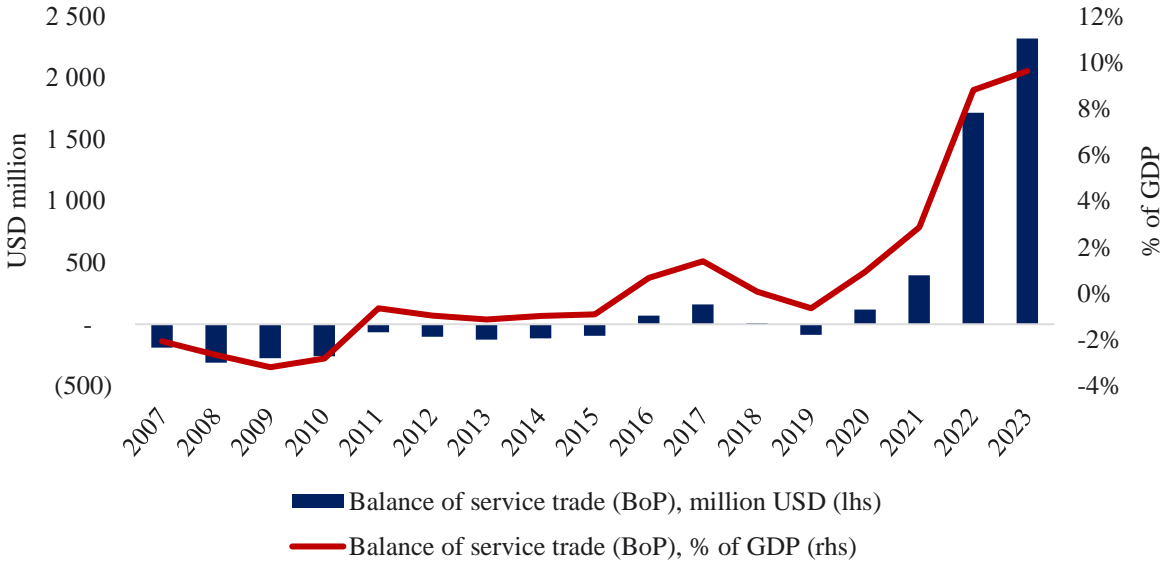
Figure 18. Balance of Goods Trade, 2007–2023



Source: World Bank, IMF, Armstat

In the last decade and a half, the export of services from Armenia gradually increased, which improved the balance of trade in services. In 2007, the trade in services deficit was USD 190 million (-2% of GDP), while in 2021, there was a surplus in the balance (USD 397 million or 3% of GDP). The growth in the export of services was driven by the ICT and tourism sectors. In 2022, the export in travel and tourism and ICT sectors accelerated, driven by the influx of people from Russia and Russia-based IT companies. This led to a USD 1,719 million surplus in 2022 (8.8%) and a USD 2,321 million surplus in 2023 (9.6%).

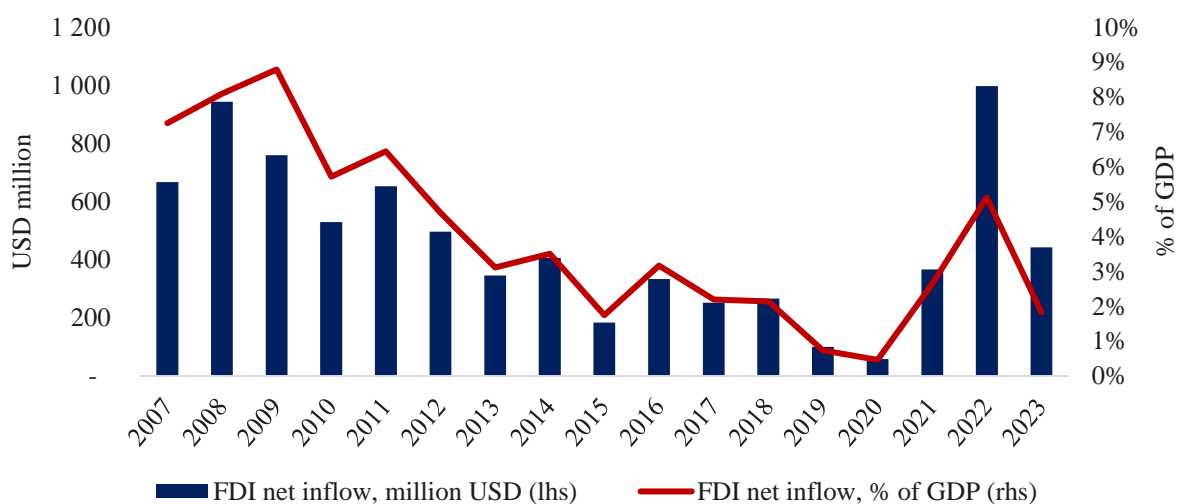
Figure 19. Balance of Service Trade over GDP, 2007–2023



Source: IMF, World Bank

Between 2008 and 2020, net inflows of FDI in Armenia were on a downward trend, though with fluctuations. In pre-COVID 2019, net FDI inflow was around USD 100 million (0.5% of GDP), down from USD 944 million in 2008 (8% of GDP). In 2022, in part due to the appreciation of AMD (in 2022, appreciation against USD was 13.5% compared with 2021), the net inflow of FDI to Armenia increased 2.7 times compared to the previous year and amounted to almost USD 1 billion (5% of GDP). The strong and rapid appreciation of AMD was caused by the substantial influx of Russian IT specialists and tourists, which greatly increased services exports, as well as personal transfers to Armenia.

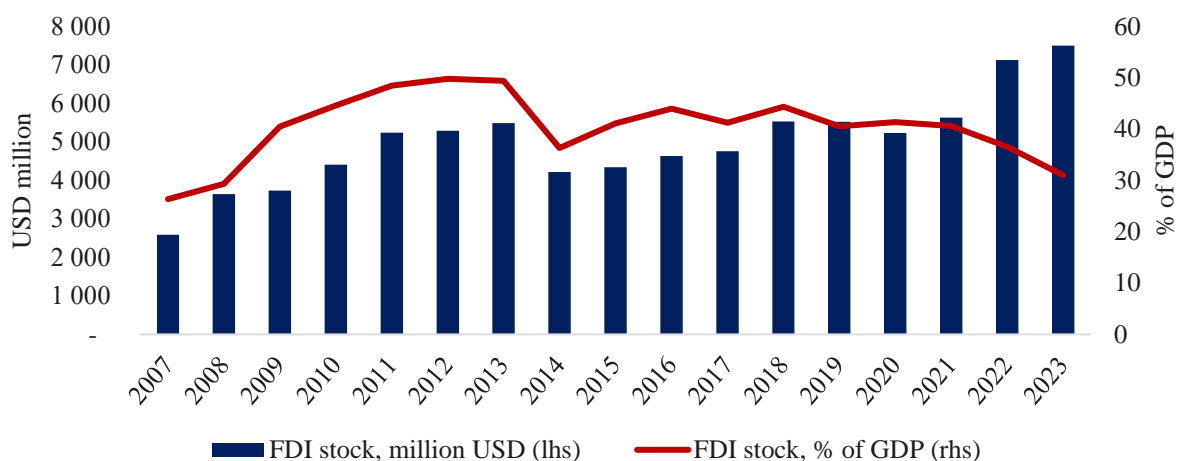
Figure 20. FDI Net Inflows, 2007–2023



Source: World Bank, CBA, Armstat

Armenia’s economy has a substantial presence of foreign capital. In 2012 and 2013, the FDI stock as a percentage of GDP peaked at around 50; since then, it has averaged 40.6 annually. The stock of inward FDI at the end of 2023 stood at USD 7.5 billion (31.0% of the country’s GDP), up from USD 7.1 billion (36.5% of GDP) at the end of 2022 and USD 2.6 billion (26% of GDP) in 2007. At the end of 2023, the FDI stock per capita stood at USD 2,507, up from USD 861 in 2007.

Figure 21. FDI Stock, 2007–2023



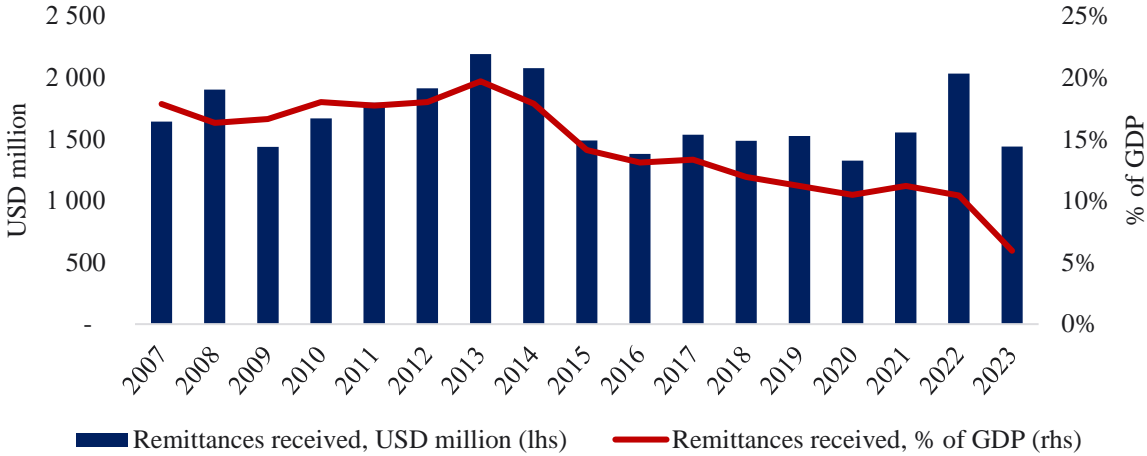
Source: World Bank, CBA

Armenia’s economy has been dependent on external sources of income, such as remittances, for years. In 2021, remittances received by households in Armenia stood at around USD 1,557 million—around 11.2% of the GDP. However, since 2007, the reliance on remittances has decreased. In 2007, the remittances received as a percentage of the GDP stood at around 18%. In 2022, due to the influx of Russians after the outbreak of the

Russo-Ukrainian war, the remittances to Armenia increased by 30.7% and amounted to USD 2,035 million. In 2023, remittances declined by 29.1% compared with 2022 and stood at USD 1,442 million or 6.0% of GDP.

Remittances often serve as an important source of income for Armenian households. For example, between 2007 and 2023, remittances received per capita averaged around USD 578, which is around 13.4% of the average annual GDP per capita for the same period.

Figure 22. Remittances to Armenia, 2007–2023



Source: World Bank, CBA

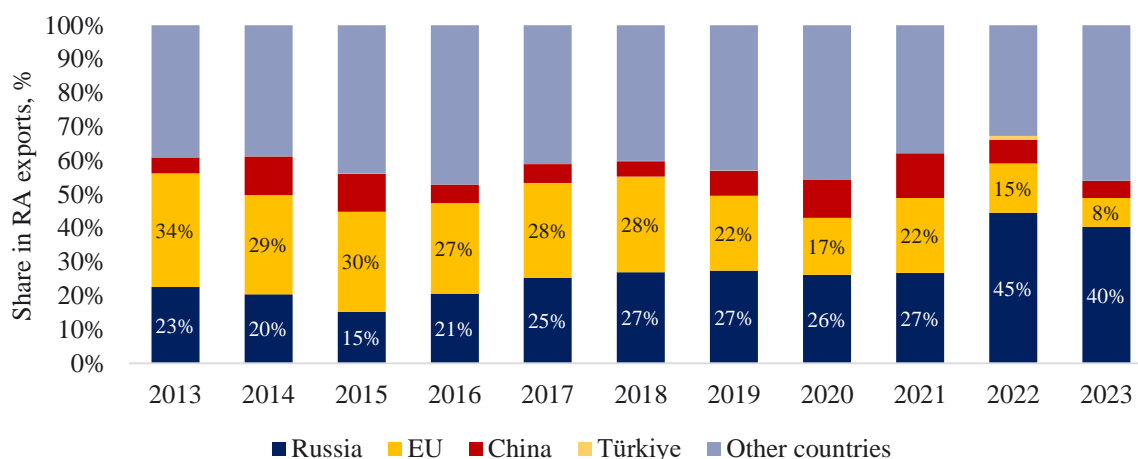
5.2 Fragility in Trade in Goods

Although Armenia has high trade openness, its structure in terms of both countries and products/services has been highly concentrated. In 2023, the main export market of Armenia was Russia with a 40.4% share, followed by the UAE (26.6%). The exports to the UAE in 2023 amounted to USD 2,223 million—4.2 times more than in the previous year. This export growth was fuelled mainly by the increased export of unwrought gold and jewellery.

Over the last decade, the structure of the export markets of Armenia has undergone some changes. In 2013, the main export market was the EU with a 33.6% share, followed by Russia with a 22.6% share. However, over the following years, the share of the EU decreased to 22.1% in 2019, the year before COVID-19, and 14.6% in 2022. In 2023, Armenia’s exports to the EU countries were around USD 709 million, 8.5% of total exports. In contrast, the value and share of Russia have increased. Between 2013 and 2023, Armenia’s exports to Russia increased tenfold, while its share in total exports nearly doubled from 22.6% to 40.4%. It must be mentioned, however, that the exceptional growth in exports to Russia during 2022 and 2023 (nearly triple in 2022, 1.4 times in 2023 compared to the previous year) is unsustainable since it is a result of an external shock. Namely, the Western economic sanctions on Russia following the outbreak of the war in Ukraine opened a window of opportunity for Armenian exporters, which led to growth in exports and, more importantly, re-exports to Russia.

Regarding other partners, exports to China have shown an upward trend, albeit with fluctuations. In 2023, Armenia’s merchandise exports to China were USD 425 million, 6 times more than in 2013. China accounted for 5.1% of Armenia’s export markets in 2023.

Figure 23. RA Exports by Market, 2013–2022

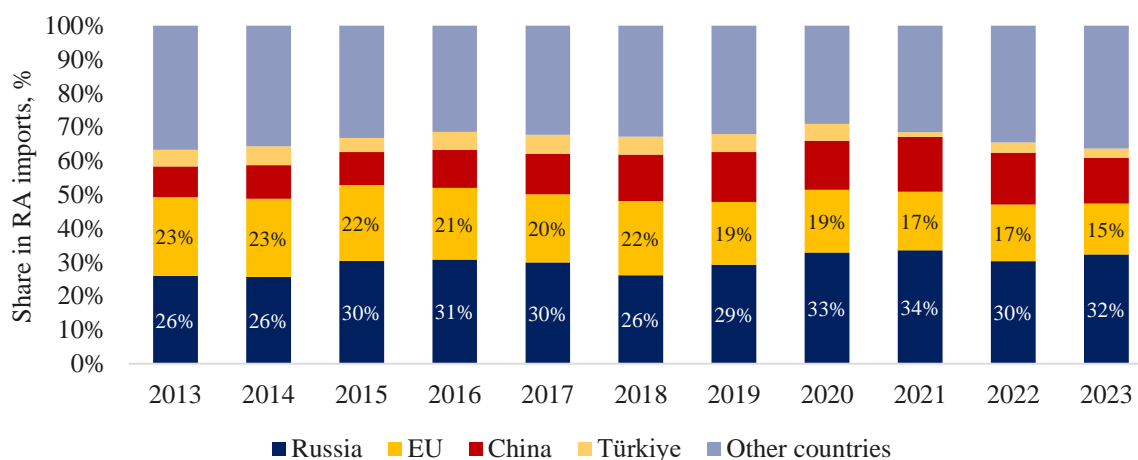


Source: UN Comtrade

Not only is Russia the main export market for Armenia, but it is also the country’s main supplier. Overall, around half of the imports of Armenia come from Russia and EU countries. In the last decade, Russia’s average share of Armenia’s imports was around 30%, while the EU’s share was 20%. Yet, between 2013 and 2023, Russia’s share increased from 26.0% to 32.3%, while the share of the EU countries decreased from 23.4% to 15.1%.

Another major supplier of Armenia is China. Between 2013 and 2023, imports from China quadrupled, while the share of China in Armenia’s imports increased from 9.0% to 13.5%.

Figure 24. RA Imports by Market, 2013–2022

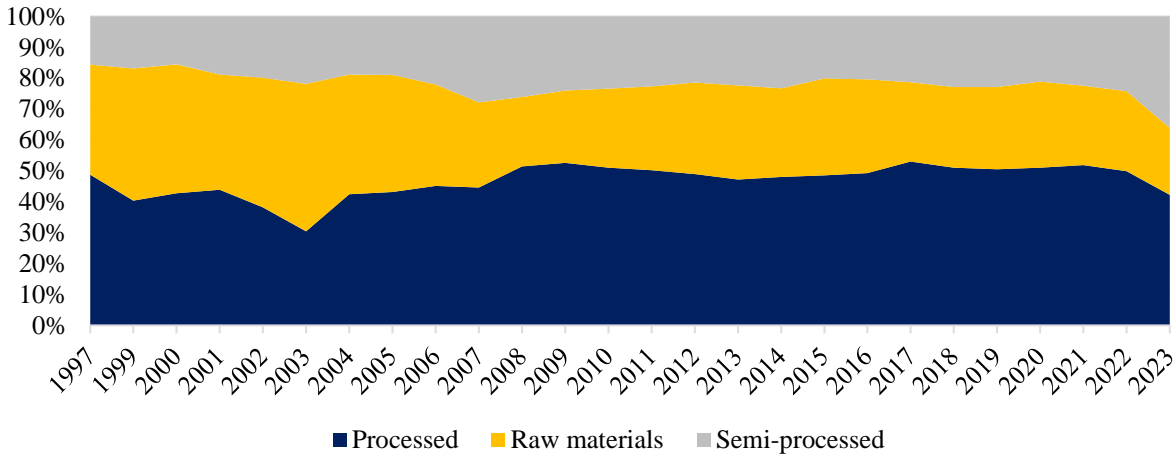


Source: UN Comtrade

Armenia’s imports and exports are dominated by processed and semi-processed goods. In 2023, processed goods accounted for 42% of Armenia’s imports, while semi-processed goods made up 36%. Since 1997, the share of raw materials in the overall imports has fallen from 36% to 22% in 2023, while the share of semi-processed goods has increased from 16% to 36%. The share of processed goods fluctuated over this period but generally remained between 40% and 50%. Although the share of raw materials in imports has declined, their volume has increased (7 times between 1997 and 2023), albeit not as rapidly as that of processed (10 times) and

semi-processed goods (27 times). Armenia is an importer of oil and gas, which constitute the majority of its raw material imports.

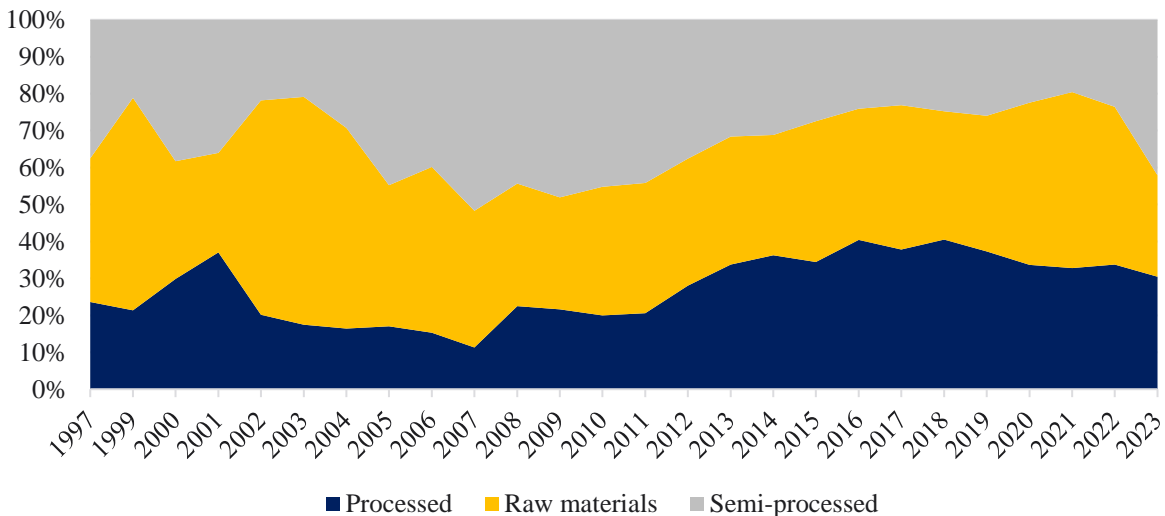
Figure 25. RA Imports by Processing Level, 1997–2023



Source: UN

In 2023, semi-processed goods accounted for 42% of Armenia’s exports, while processed goods made up 30% and raw materials 28%. The share of raw materials in overall exports fell from 39% in 1997 to 28% in 2023, while the share of processed goods has increased from 24% to 30% and the share of semi-processed goods from 38% to 42%. It must be mentioned that the share of semi-processed goods in the export of Armenia has been declining since 2007 (dropping from 52% to 24% between 2007 and 2022); however, it significantly increased in 2023, reflecting increased re-exports from Armenia.

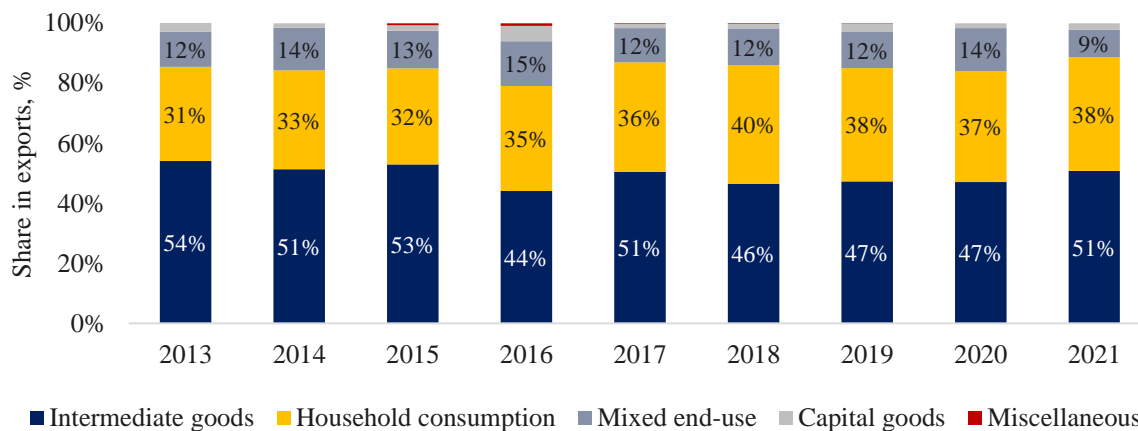
Figure 26. RA Exports by Processing Level, 1997–2023



Source: UN

Armenia mostly exports intermediate and household consumption goods. Between 2013 and 2021, the share of intermediate goods in the total exports averaged 49.4%, while the share of household consumption goods averaged 35.5%. The high share of intermediate goods reflects the high share of mineral products in Armenia's exports, while in the case of household consumption goods, it is mainly due to the exports of food products and beverages.

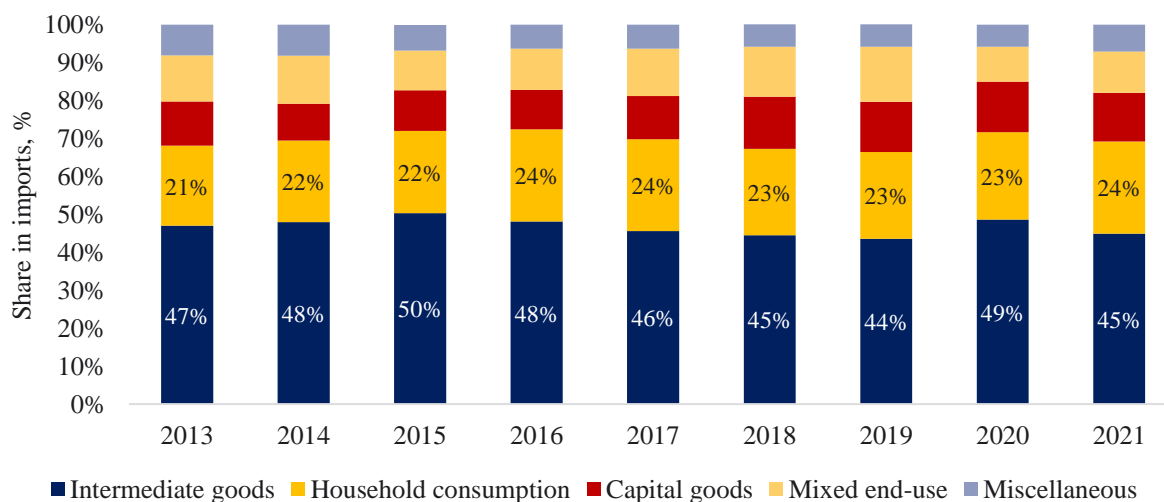
Figure 27. Exports by End Use, 2013–2021



Source: OECD

A similar structure is also observed in the case of imports. The imports are dominated by intermediate and household consumption goods. In 2013–2021, the share of intermediate goods in the total exports averaged 46.7%, while the share of household consumption goods averaged 22.9%. The predominance of intermediate goods may be explained by a significant share of imports of natural gas to Armenia. Between 2013 and 2021, the share of household goods in total imports increased from 21.1% to 24.3%, while the share of intermediate goods decreased from 47.0% to 44.9%.

Figure 28. Imports by End Use, 2013–2021

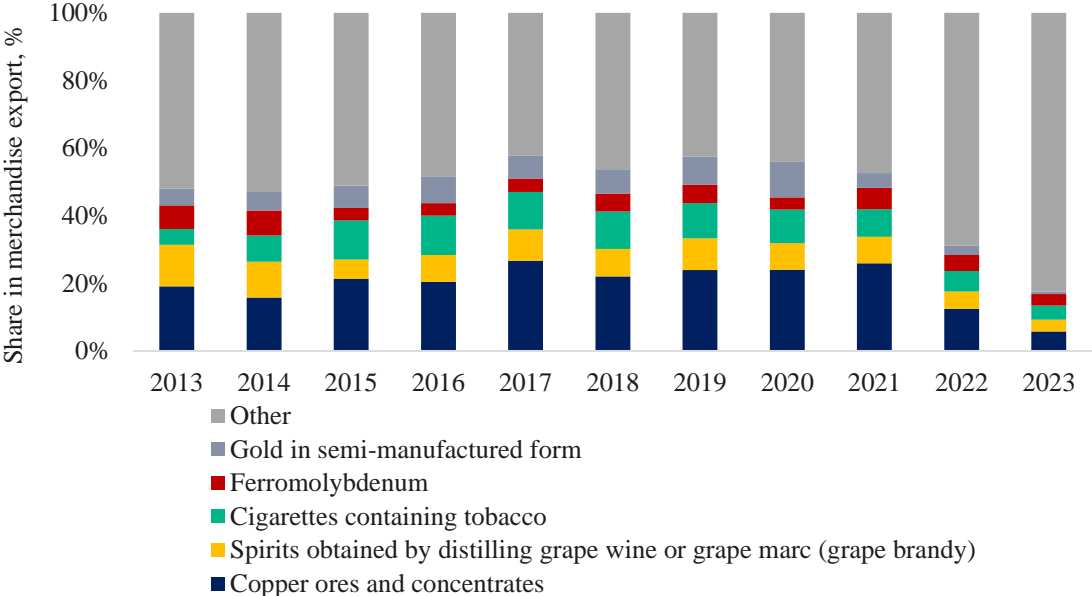


Source: OECD

Armenia’s exports have very limited diversification. Between 2013 and 2021, three commodities—copper ores and concentrates, spirits, and cigarettes—annually accounted for approximately 41% of total merchandise exports, on average. The significant increase in other goods in 2022 and 2023 is due to a sharp increase in re-exports of such goods as vehicles, machinery, and equipment to Russia.

Moreover, Armenia’s export market is vulnerable since each major product is predominantly exported to a single partner country. For example, in 2023, 71.2% of copper ores and concentrates were exported to China; 82.0% of brandy was exported to Russia; cigarettes containing tobacco were mainly exported to Iraq (46.2%) and the UAE (30.2%); ferromolybdenum was predominantly exported to the Netherlands (73.7%); and gold in semi-manufactured form was exported mainly to the UAE (60.2%) and India (37.8%). Regarding other goods, in 2023, Armenia exported a significant number of vehicles (HS 87) as well as machinery and mechanical appliances (HS 84), with more than 80% of each group being supplied to Russia.

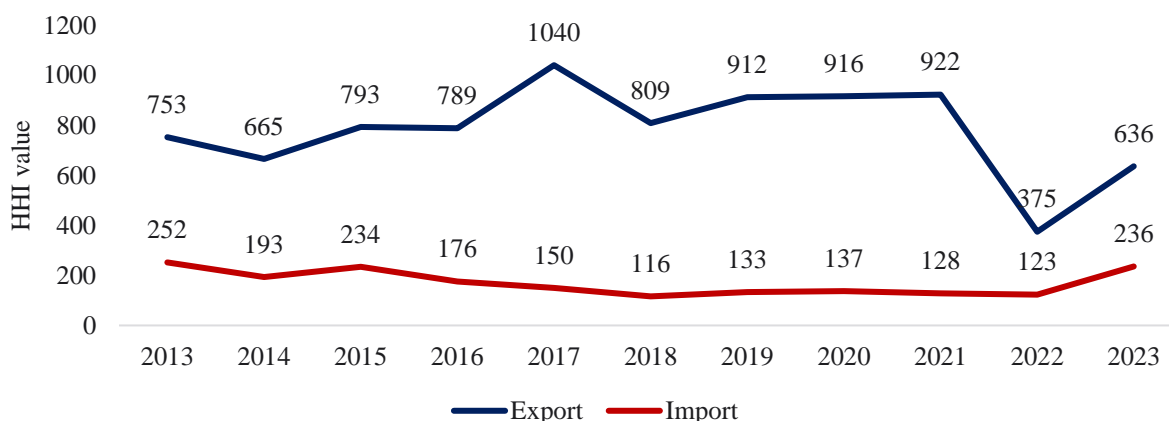
Figure 29. Merchandise Export Structure by Product, 2013–2023



Source: UN Comtrade

Due to the changes in the structure of exports in the last two years, Armenia’s HHI (which measures market concentration) has improved from 922 in 2021 to 375 in 2022; further, in 2023, it stood at 636, indicating low concentration. However, it must be mentioned that the HHI dynamics over the years do not offer an accurate, comprehensive picture of domestic export concentration, given that HHI also includes re-exports. Regarding import concentration, Armenia imports a wide variety of goods, which is reflected in its low concentration over the years. Mineral fuels (like natural gas and petroleum oils) account for the biggest share of Armenia’s merchandise imports, followed by machinery and equipment. Between 2013 and 2021, on average, mineral fuels annually accounted for around 18% of total merchandise imports. Given that the imports of vehicles and different machinery for re-exporting increased in 2022 and 2023, the share of fuels in imports has thus declined to 13% in 2022 and 9% in 2023.

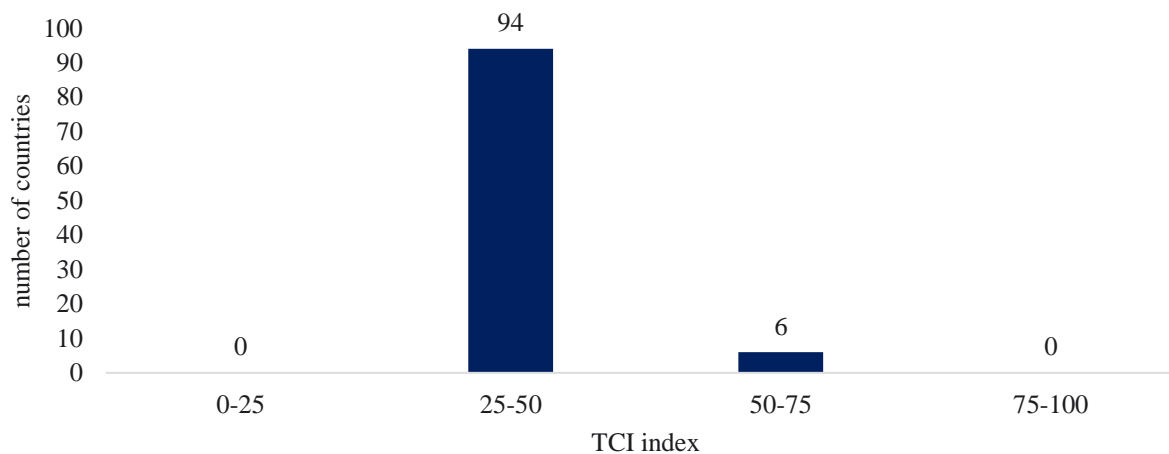
Figure 30. Export and Import Concentration (HHI) by Commodity, 2013–2023



Source: UN Comtrade

The analysis of the trade compatibility of Armenia and other countries shows that Armenia’s exports generally are moderately similar to the imports of other countries. In particular, among the observed 100 countries, Armenia’s trade compatibility index (TCI) is moderate (25–50) in the case of 94 countries and high (50–75) in only 6 countries. This suggests that there is some level of similarity in the exports of Armenia and imports of other countries but with notable differences in the types of goods traded. Armenia’s exports have high compatibility with the imports of the UAE (TCI of 55.3), Bahrain (54.2), Romania (52.2), Switzerland (50.7), and Botswana (50.3). Armenia’s exports have moderate compatibility with EU imports (41.2). Among EU countries, Armenia’s exports have comparatively high compatibility with the imports of Romania (52.2), Bulgaria (46.8), and Austria (46.8).

Figure 31. Compatibility of Armenia’s Exports with the Imports of Other Countries, 2022

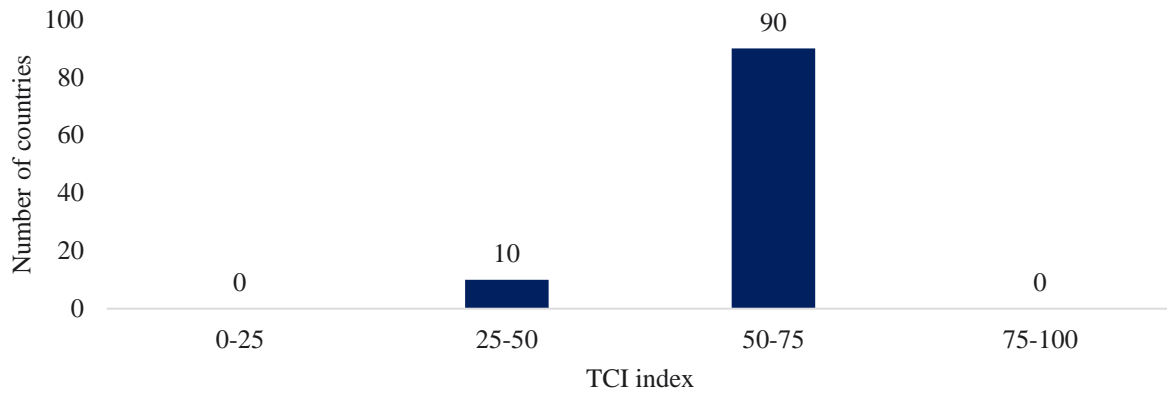


Source: Authors’ calculations based on data from WITS/World Bank Data

A slightly different picture is observed regarding Armenia’s imports. The patterns of Armenia’s imports are highly compatible (50–75) with the exports of 90 out of 100 observed countries and moderately compatible with the rest of the 10 countries (25–50). In particular, Armenia’s imports have a significant overlap in the types of goods

exported from countries such as Poland (74.0), Romania (72.6), the USA (72.2), France (70.9), Croatia (70.6), Bulgaria (70.3), and Türkiye (70.2).

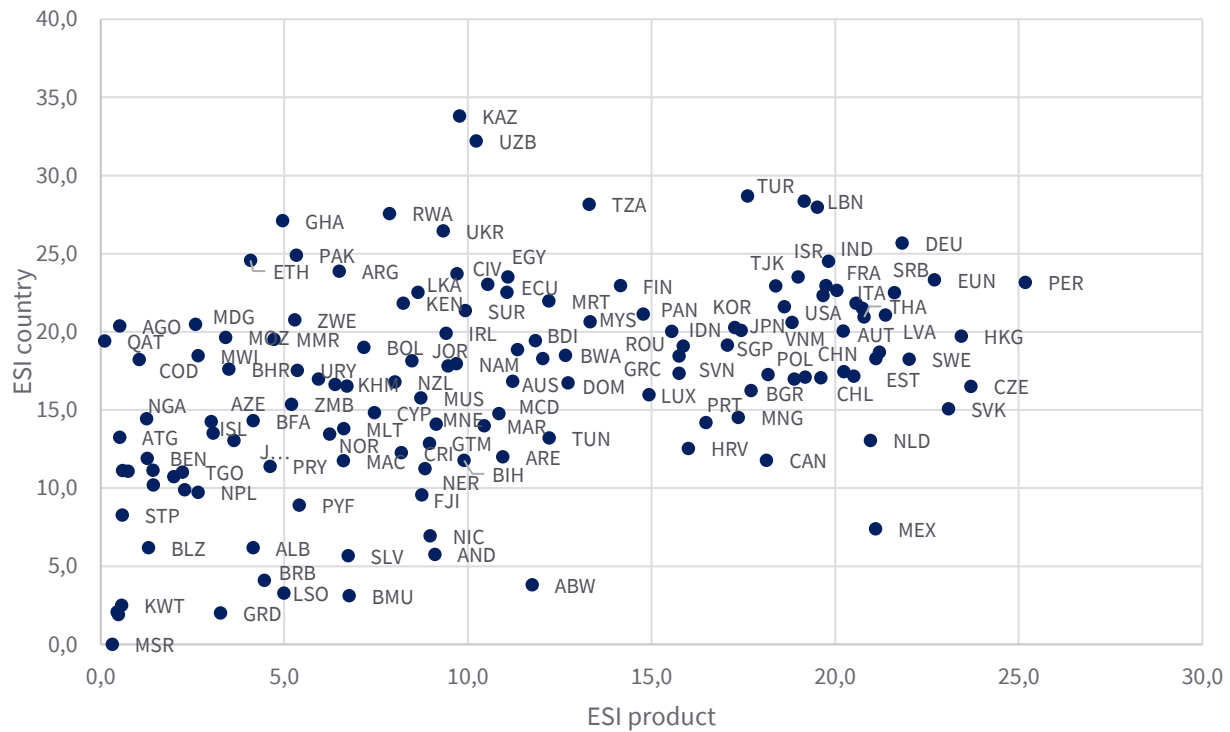
Figure 32. Compatibility of Armenia’s Imports with the Exports of Other Countries, 2022



Source: Authors’ calculations based on data from WITS/World Bank Data

Overall, Armenia’s exports—both in terms of geographical and commodity structure—have very low similarity with the trade of observed countries. Armenia has comparatively higher similarity regarding the structure of partners with the Kyrgyz Republic (ESI 61.9), Kazakhstan (33.8), Uzbekistan (32.2), Türkiye (28.7), and Lebanon (28.4); however, it has low similarity with these countries regarding the structure of exported goods (16.8, 9.8, 10.2, 17.6, and 19.2, respectively). Armenia, Kazakhstan, and the Kyrgyz Republic are members of the EAEU, which may explain the similarities in the structure of trading partners. Armenia has a comparatively high similarity in terms of exported goods with the Czech Republic (ESI 23.7), but the structures of the two countries’ trading partners are different (ESI 16.5). Among the observed countries, the country that has comparatively high similarity with Armenia, both in terms of the geographical structure of exports (ESI 23.1) and traded goods (25.2), is Peru; the similarity in the patterns of export may be because both countries are exporters of copper.

Figure 33. Export Similarity Between Armenia and Other Countries, 2022

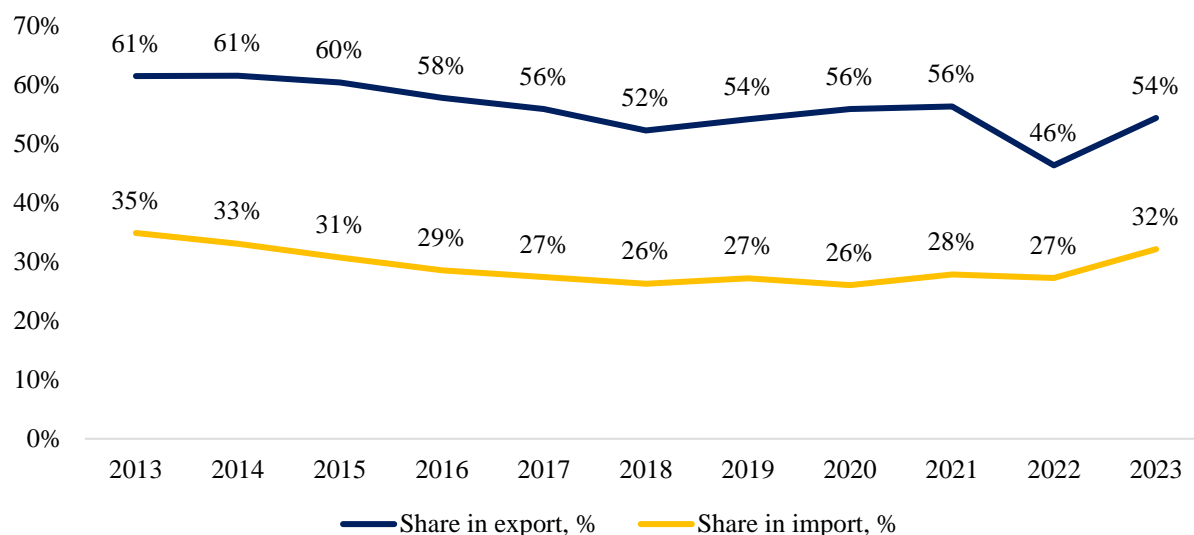


Source: Author's calculations based on data from WITS/World Bank Data

Raw materials¹⁹ have traditionally dominated Armenia's exports. Between 2013 and 2023, raw materials annually accounted for approximately 56% of total merchandise exports, on average. In 2022, the share of exports of raw materials fell to 46.3% from 56.3% the previous year due to a sharp increase in re-exports of vehicles, machinery, and other final products. In 2023, the exports of raw materials bounced back, mostly driven by exports of jewellery and precious and semi-precious stones (a threefold increase from a year before). Presumably, a significant part of the exports of jewellery and precious and semi-precious stones constitutes re-exports. This phenomenon can also be observed from the imports of these raw materials, which also drove the overall share of imports of raw materials in 2023 to 32.1%, up from 27.2% in 2022. Overall, Armenia mostly imports final goods. Over the 2013–2023 period, the annual imports of final goods accounted for around 71% of imports, on average.

¹⁹ Raw materials by 2-digit HS code: 25–29, 71, 72, 74–76, 78–81

Figure 34. Share of Raw Materials in Armenia’s Exports and Imports, 2013–2023



Source: UN Comtrade

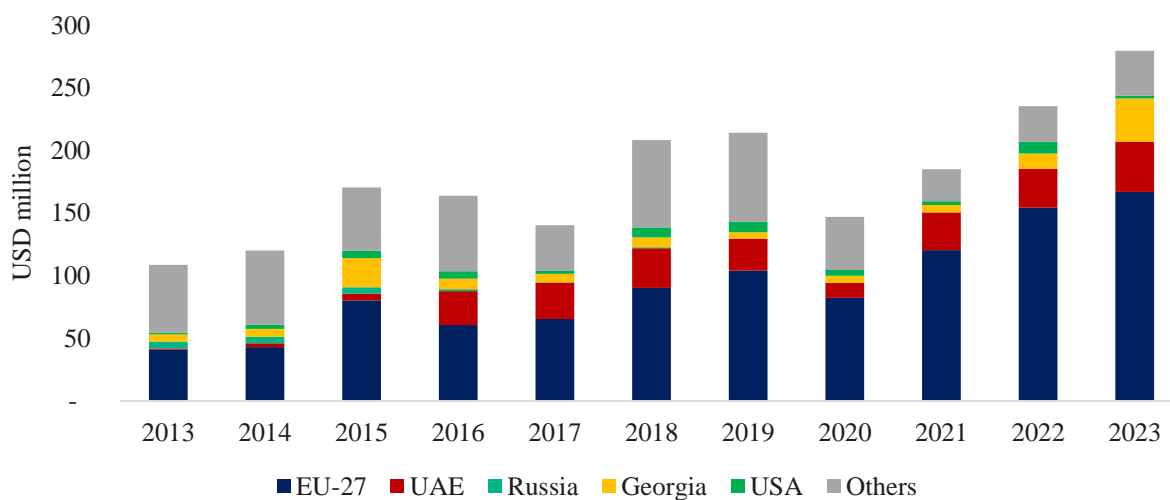
Armenia’s re-exports have increased nearly 2.6 times in the last decade. The UN reported that re-exports from Armenia in 2023 amounted to USD 280 million compared to USD 109 million in 2013. According to the UN statistics, in 2023, 59.7% of the re-exported goods from Armenia were directed to EU countries. However, these statistics do not offer an accurate picture of Armenian re-exports for several reasons. Firstly, Russia (the main trading partner of Armenia) is excluded from them, as are re-exports carried out by individuals. Regarding re-exports to Russia, the EAEU member countries trading with one another do not distinguish between domestic and foreign exports and report both flows as domestic exports. Hence, since 2018, according to the UN database, Armenia had no re-exports to the EAEU member countries. This distorts the real picture of Armenian re-exports since part of the Armenian exports to Russia are re-exports. For example, in 2023, Armenia exported nearly USD 378 million worth of cars (HS 8703) or 17,684 cars to Russia,²⁰ which are re-exports given that Armenia does not produce cars.

The US- and EU-imposed sanctions against Russia following Russia’s full-scale invasion of Ukraine have led to greater scrutiny of several economic activities in Armenia potentially related to the re-export of controlled goods into Russia. Armenian authorities have committed to adhering to the sanctions and export controls imposed by both the US and the EU and have implemented various measures to ensure compliance. For example, in May 2023, the RA government issued a decree that strictly controls the export and transit of 93 sensitive goods, including those identified by the US and EU among the list of High Priority Battlefield Items (ITA, 2023).²¹ In 2024, the list was updated to include 98 items.

²⁰ UN Comtrade Database, accessed May 15, 2024, <https://is.gd/oq1ZCj>

²¹ ARLIS, the Decision of the RA Government N 808-N of May 25, 2023, accessed May 15, 2024, <https://is.gd/8gjJjO>

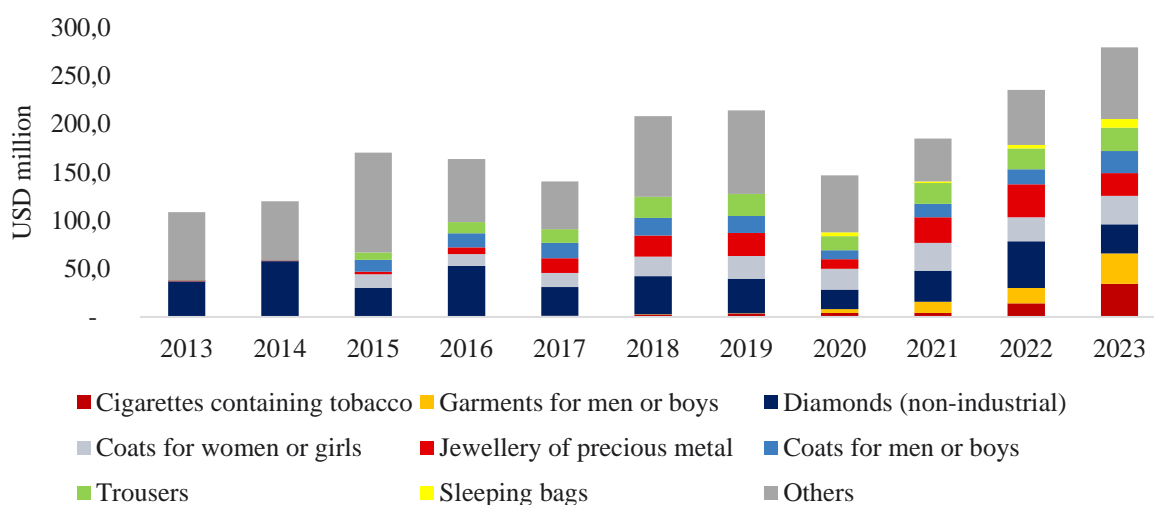
Figure 35. Re-exports from Armenia by Country, 2013–2023



Source: UN Comtrade

In 2023, cigarettes containing tobacco were the leading re-exported product from Armenia (without considering the re-export of goods to EAEU countries) with a 12.2% share (USD 34.2 million), followed by garments for men and boys (11.3%) and diamonds (10.8%). Between 2013 and 2023, the structure of re-exports has changed significantly. Notably, Armenia started re-exporting more diverse products. During this period, diamonds consistently were among the top three products re-exported from Armenia, although their share has declined due to the emergence of re-exports of other commodities. Over the past decade, there has been a notable increase in the re-exportation of various clothing items like coats, trousers, and jewellery.

Figure 36. Re-exports from Armenia by Commodity, 2013–2023



Note: (1) Goods are grouped by HS 6-digit; (2) due to methodological changes, re-exports to EAEU countries are not included in data from 2018 to 2023

Source: UN Comtrade

Armenia's landlocked location, closed borders with two of its four neighbours, coupled with poor physical infrastructure and logistics, hurt the country's competitiveness in external markets. For example, in the World Bank's International Logistics Performance Index (LPI), Armenia ranks 97 among 139 countries with a score of 2.5, which suggests significant challenges in the country's logistics infrastructure; this could impact its ability to move goods efficiently and participate effectively in global trade.²²

Armenia's borders with Azerbaijan and Türkiye are closed, leaving only the northern border with Georgia and the southern border with Iran accessible for trade and transportation. However, the connection to Iran is restricted due to international sanctions on the country. Trade is limited to truck transportation only, and it operates mainly one way: trucks from Iran move goods to or through Armenia only. In other words, Armenia's international trade predominately relies on freight corridors through its northern neighbour, Georgia. The bulk of inbound and outbound cargo transits Georgia's territory by road or is transhipped through the port of Poti on the Black Sea. It must be noted that recently, there have been talks about opening the land border between Armenia and Türkiye for the citizens of third countries and persons holding diplomatic passports, which several international organisations see as potentially positive for the connectiveness of Armenia (Ilurer, 2024). Air cargo is another option for transporting goods; however, it is generally limited by cost. To be more specific, prices of air freight are 4–5 times higher than that of road transport and 12–16 times that of sea transport (EBRD et al., 2023). Goods shipped by air generally have high values per unit or are very time-sensitive, such as pharmaceuticals, production samples, electronic consumer goods, and perishable agricultural and seafood products.

5.3 Fragility in Trade in Services

Armenia's export of services has been significantly concentrated for decades. From 2007 to 2023, travel accounted for an average of 57.3% of total service exports every year. The other two main categories in the exports are transport and IT sectors. This concentration indicates that Armenia's service exports are highly vulnerable to external shocks. For example, in 2020, due to the COVID-19 restrictions, the travel-led services export of Armenia declined considerably (54.8%) year over year, while in 2022, following the influx of Russian IT specialists after the outbreak of the Russo-Ukrainian War, it more than doubled.

In 2020, IT services surpassed transportation services to become the second-largest sector in Armenia's service exports. Since then, IT services have consistently maintained this position, reinforcing their role as the second-biggest contributor to the country's service exports.

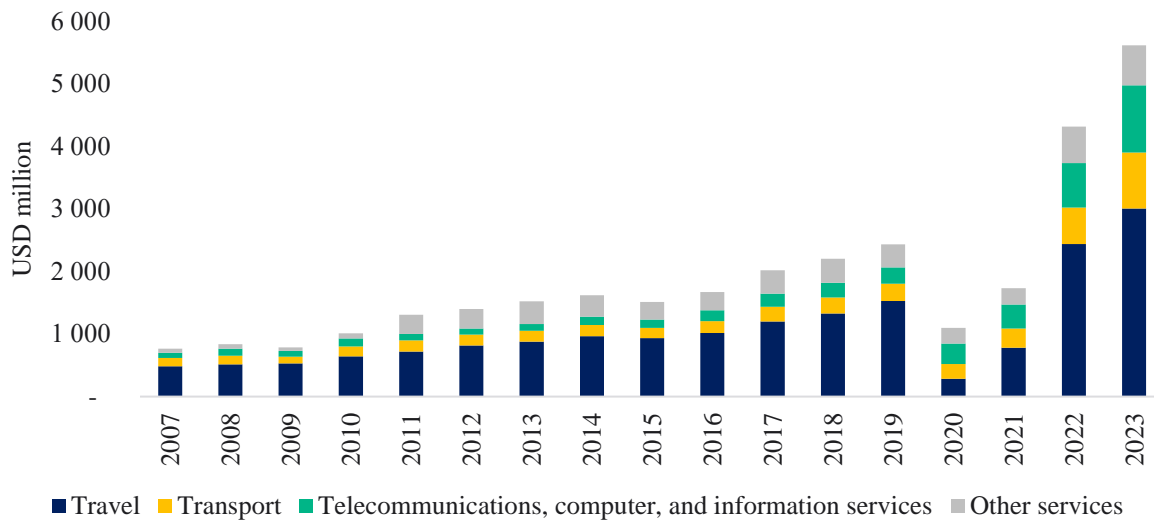
In 2023, Armenia's service exports continued to grow, increasing by 30% compared to 2022, reaching a total of USD 5,619 million, driven by the growth in the travel (23.4%), transport (53.1%), and IT (51.0%) sectors. Overall, in 2023, Armenia's service exports included USD 3,009 million from the travel sector, representing 53.6% of the total service exports. The IT sector contributed USD 1,074 million, or 19.1%, while transportation services accounted for USD 896 million, or 15.9%.

In 2022 and 2023, the influx of Russians and their significant use of financial services in Armenia led to a considerable increase in the export of financial services, contributing to a notable rise in their share of the

²² The World Bank, 2023 Logistics Performance Index (LPI), <https://is.gd/RPZG28>

country's overall service exports. For example, in 2022, the export of financial services increased 14 times from the previous year, with its share of total exported services standing at 4.6% versus 0.8% in 2021.

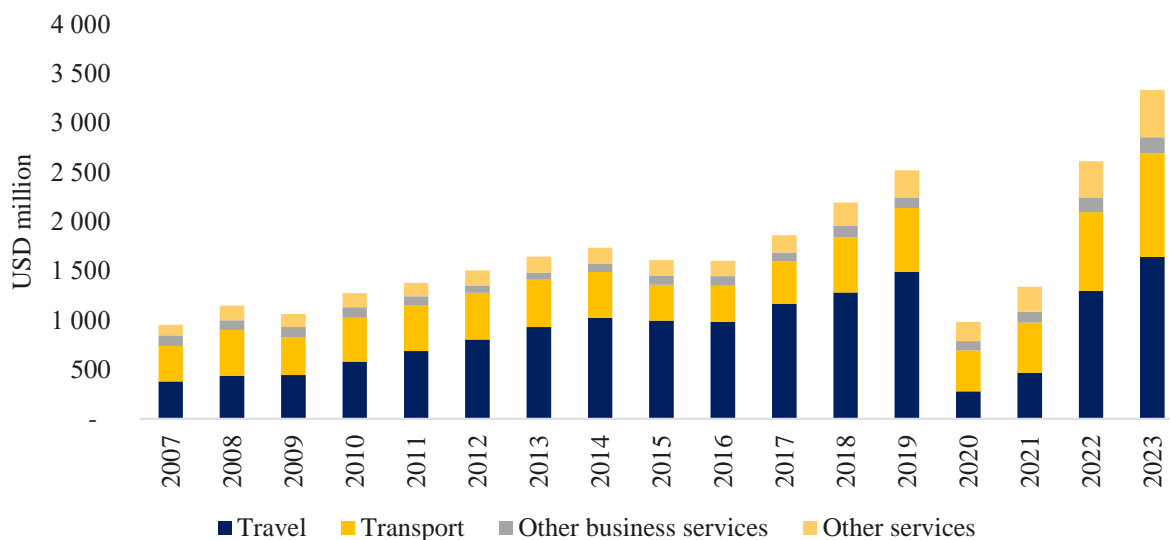
Figure 37. Services Exported from Armenia, 2007–2023



Source: World Bank, CBA

Armenia's imported services primarily consist of services linked to travel and transport. From 2007 to 2023, travel and transport together accounted for an average of 81.3% of total service imports every year. In 2023, Armenia imported travel services worth USD 1,642 million, up 26.6% compared to 2022. The import of transport services amounted to USD 1,050 million, up 31.5% from the previous year.

Figure 38. Services Imported to Armenia, 2007–2023



Source: World Bank, CBA

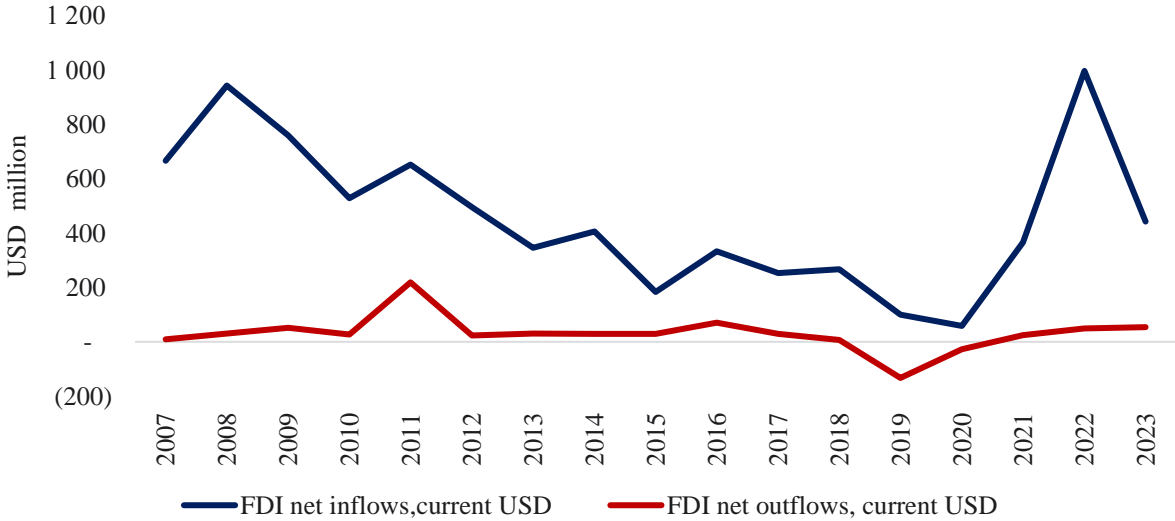
The third-largest sector in Armenia’s service imports is “Other business services”, which comprises professional and management consulting services, including legal, accounting, management consulting, public relations, advertising, and market research; technical and trade-related business services, including architectural, engineering, and scientific services; and research and development services. In 2023, Armenia imported USD 162 million worth of these types of services, which accounted for 4.9% of the country’s total service imports.

5.4 Fragility in Foreign Investment

Although Armenia has been implementing several measures to improve its investment climate, the country has been struggling with attracting foreign investment. The inward FDI in Armenia has been gradually declining since 2007. Between 2008 and 2020, Armenia’s net inward FDI declined from USD 944 million to USD 59 million. As a result of the COVID-19 pandemic and the war in Nagorno-Karabakh in 2020, the net inflows fell by 41.6% from a year before. Foreign investments in Armenia are generally highly sensitive to external shocks, whether positive or negative. For example, the sharp increase in 2022 was partly due to the AMD appreciation and the inflow of Russian capital after the outbreak of the Russo-Ukrainian War and the imposition of Western sanctions against Russia. In 2023, the net inward FDI slowed down; it was almost 56% lower compared with 2022; this partly reflects the much higher inward FDI reported in 2022.

Traditionally, the outward investments have been low, with a few fluctuations over the last decades.

Figure 39. Trends in Inward and Outward FDI, 2007–2023

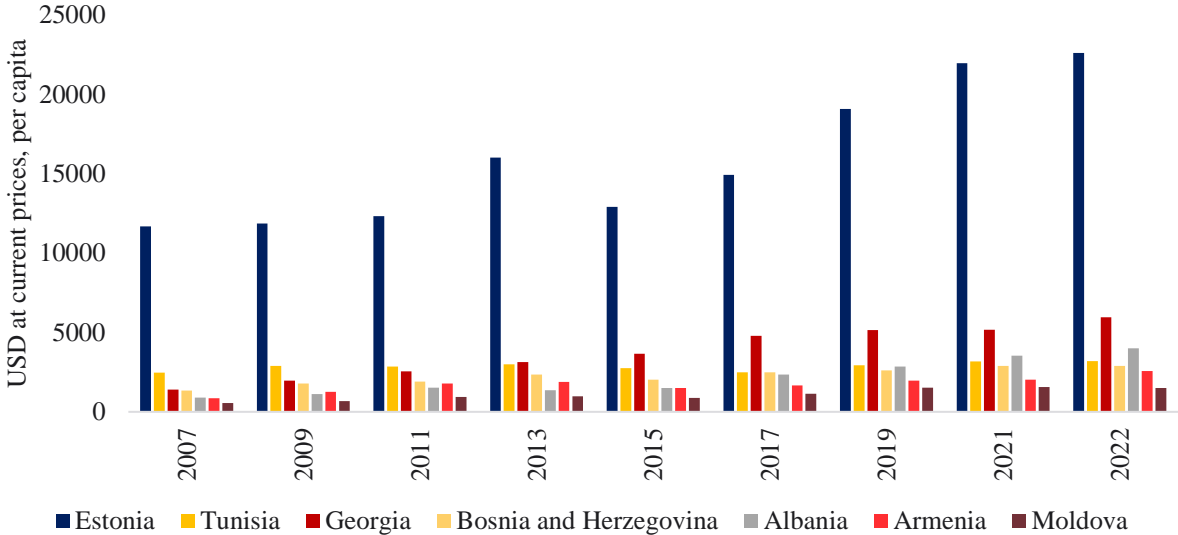


Source: World Bank

Armenia is behind its many peer countries in the level of inward FDI. Although, between 2007 and 2022, the inward FDI stock per capita increased nearly threefold and reached USD 2,562, in more recent years, it has been lower than that of most peer countries, driven by falling private investment. For example, in 2022, the value of inward FDI stock per capita of neighbouring Georgia was 2.3 times higher than that of Armenia. Additionally, since 2007, FDI stock per capita in Georgia has increased at a higher pace than in Armenia. The inward FDI stock per capita in Armenia’s aspirational peer Estonia in 2022 was even higher—nearly 9 times more than in Armenia. Among the reviewed peer countries, Armenia is only ahead of Moldova, where the stock per capita was USD

1,497. In Armenia, FDI stock per capita is lower compared to its peer countries due to several factors. These include the geopolitical situation, which creates uncertainty and risk for investors. Additionally, Armenia’s geographical location limits access to other markets, further hindering investment. The country also struggles with inadequate infrastructure and insufficient investment in its development.

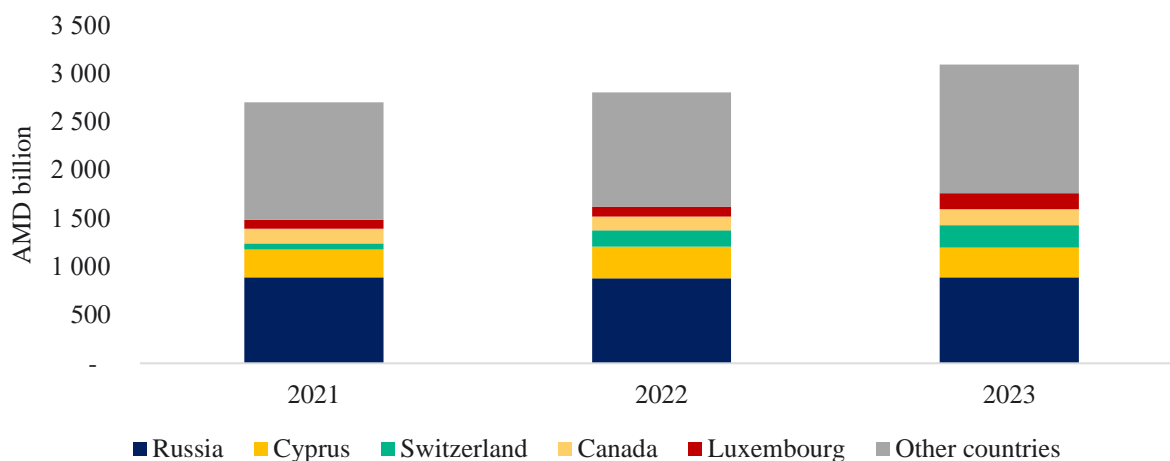
Figure 40. FDI Stock Per Capita Compared to Peer Countries, 2007–2022



Source: UNCTAD

As of 2023, three countries—Russia, Cyprus, and Switzerland—accounted for 46% of the stock of FDI in Armenia. Russia only accounted for 29% of the FDI stock, down from 33% in 2021. However, Russia remains the main foreign investor in Armenia’s economy. In 2023, Russia accounted for about 63% of the FDI inflow in the real sector of Armenia’s economy (USD 871 million). Russian investments are traditionally directed to electricity, gas supply, and telecommunications. The share of Cyprus in the stock of FDI in Armenia decreased by 2 percentage points from the previous year and, at the end of 2023, was 10%. Additionally, the stock of FDI invested by Switzerland in Armenia increased 3.7 times compared with 2021 and 26% compared with the previous year. Its share reached 7.5%, 5.2 percentage points higher than at the end of 2021; Switzerland’s FDI in 2023 was directed to wholesale trade and construction sectors.

Figure 41. Net FDI Stock by Country, 2021–2023

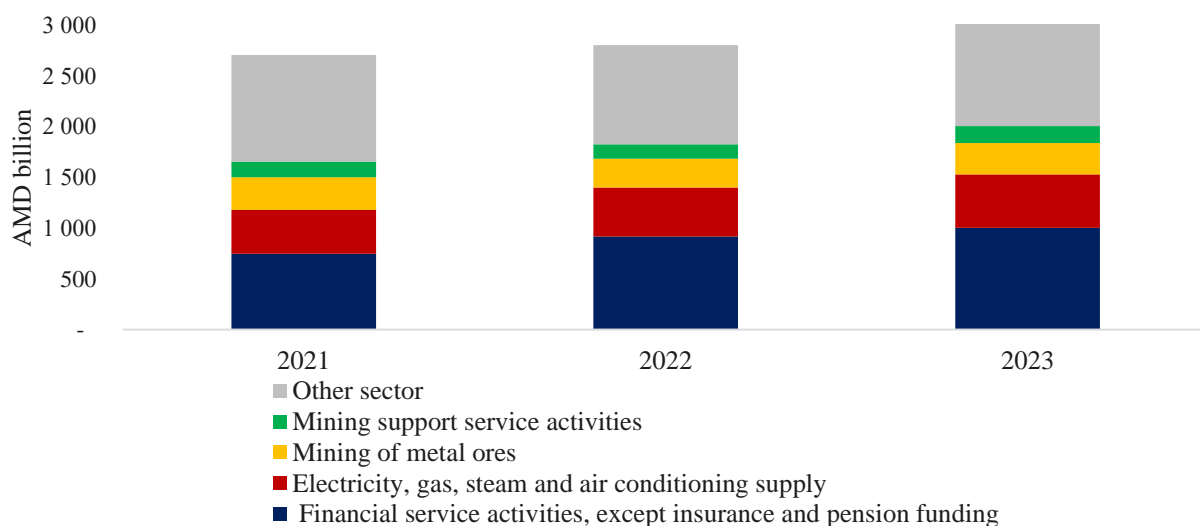


Source: Armstat

As of the end of 2023, financial service activities, electricity and gas supply, metal ore mining, and mining support activities accounted for 65% of the stock of inward FDI, with financial services activities, except insurance and pension funding, leading the sectoral distribution (32.4%, AMD 1,001 billion, or around USD 2.5 billion). Investments in the banking sector dominate the total investment in financial service activities. Most of the 18 banks operating in the Armenian financial sector have some level of foreign ownership.

Regarding the directions of inward investments in recent years, in 2023, the net FDI inflow in the financial service activities led the sectoral distribution of inward FDI flow with a 33% share. Electricity and gas supply was another major direction for the FDI inflows, with a 12% share in the total net FDI inflow of the country.

Figure 42. Net FDI Stock by Sector, 2021–2023

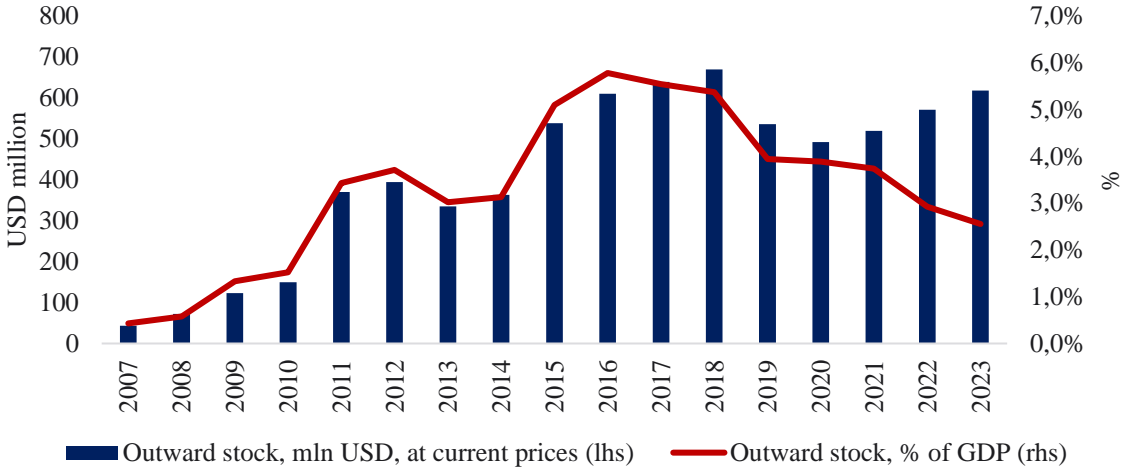


Source: Armstat

As seen from the composition of the FDI, most foreign investments in the Armenian economy are targeted at the domestic market, specifically in sectors like banking and infrastructure. These sectors primarily serve the local

population. However, in the mining sector, they play a crucial role in Armenia’s exports, as copper ore and gold are the country’s primary export products. Within mining, a large share of investment is concentrated in the gold mine projects (Lydian Armenia); however, over the last few years, these were the object of protests and sites were blocked by residents and environmental activists, causing operations to be suspended and thus investment to decline. However, the issues were resolved in 2023 as the government of Armenia announced a trilateral memorandum with Lydian Armenia and the Eurasian Development Bank (an interstate financial institution with primarily Russian and Kazakhstani capital) aimed at relaunching the Amulsar Gold Mine project (Hetq, 2023).

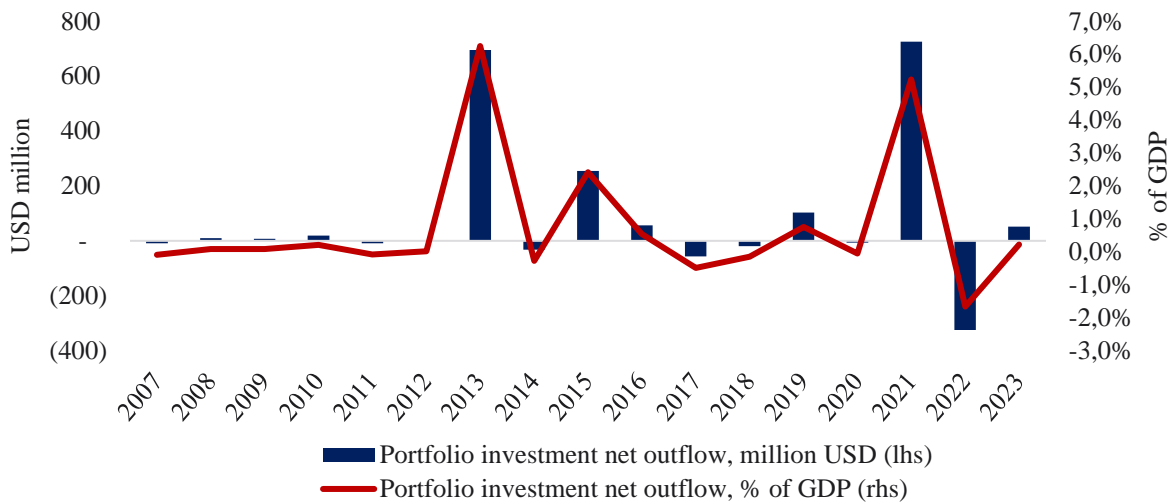
Figure 43. Outward FDI Stock, 2007–2023



Source: UNCTAD

Foreign direct investment has been a more commonly utilised investment tool in Armenia compared to portfolio investment, both in terms of outgoing and incoming investments. Overall, since 2007, both net inflow and net outflow of portfolio investment as a % of GDP on average were around 0.1. Between 2007 and 2023, the net inflow of portfolio investment peaked in three years—2013 (USD 695 million or 6.2% of GDP), 2015 (USD 255 million or 2.4% of GDP), and 2021 (USD 726 million or 5.2% of GDP). Investments in government debt securities constitute nearly all inflows from portfolio investment. The 356-fold increase in net inflows in 2013 was due to Armenia’s debut issue of USD 700 million in foreign currency government bonds (Eurobonds) in the international capital market in September 2013 (Radio Azatutyun, 2013b). Similarly, the sharp increases in 2015 and 2021 were due to new Eurobond issuances.

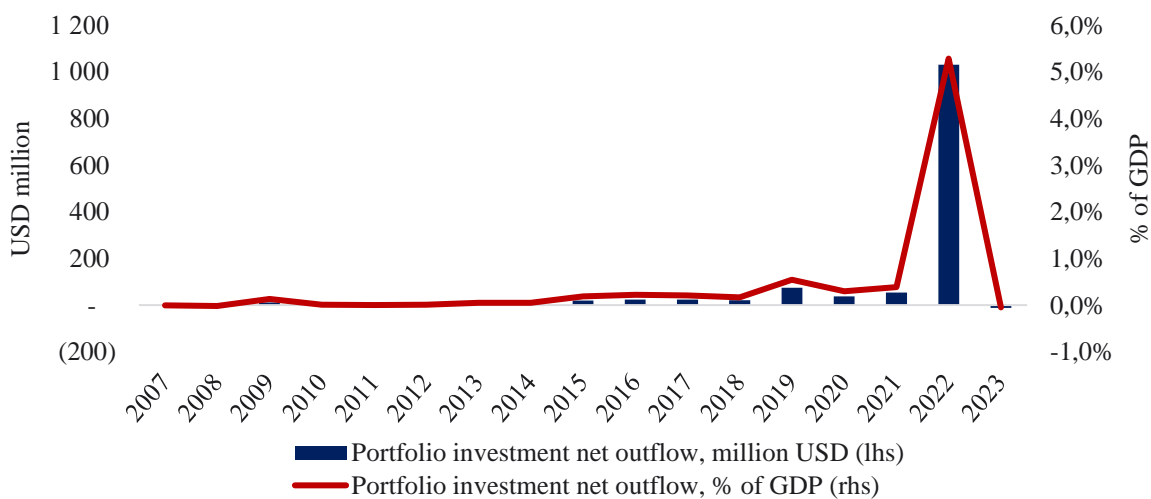
Figure 44. Net Inflow of Portfolio Investment, 2007–2023



Source: IMF

Regarding the net outflow of portfolio investments, since 2015, it has increased gradually. In 2015, the net outflow of portfolio investment was USD 19 million—a three-time increase from the previous year; in 2021, it amounted to USD 54 million. In this period, the residents of Armenia have been mostly investing through portfolio investment in foreign equity instruments. In 2022, the net outflow amounted to USD 1,356 million, a 19-time increase from the year before. This sharp increase was driven by the growth in investments by deposit-taking corporations (except the Central Bank) in debt securities (USD 903 million) as a consequence of the considerable inflow of Russian citizens and Russian capital into Armenia. Namely, since the onset of the war in Ukraine, the migration flows from Russia led to deposit inflow and increased transactional incomes, such as fees and other gains on currency conversion for Armenian banks. Thus, to effectively manage their assets, banks increased their investments in debt securities, which is reflected in the growth of portfolio investments.

Figure 45. Net Outflow of Portfolio Investment, 2007–2023

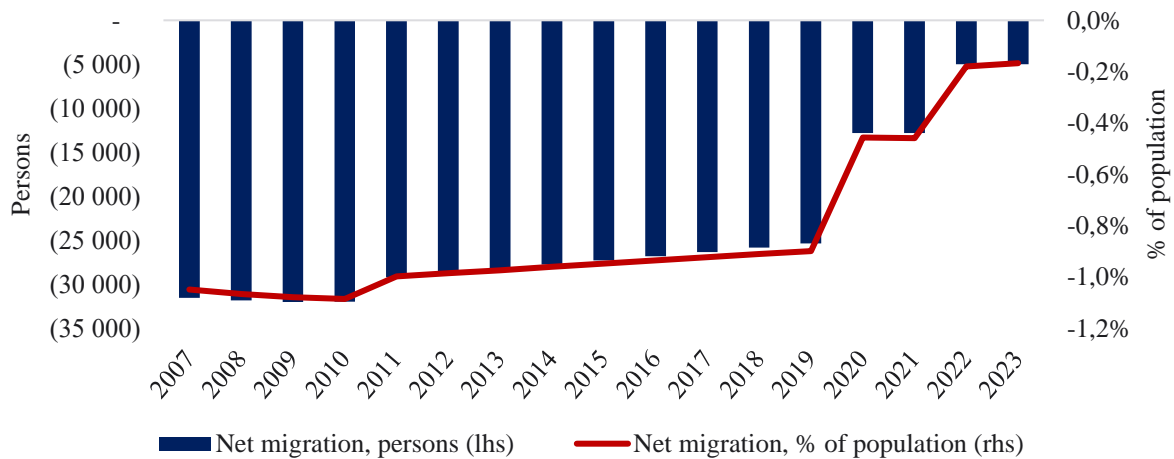


Source: IMF, CBA

5.5 Fragility Related to Personal Mobility

The 2007–2023 migration trends show that more emigration from Armenia was recorded than immigration into the country; although in the last several years, the gap has been narrowing due to an increase in immigration to Armenia. In 2022 and 2023, net migration stood at -5,000 (0.2% of the total population) compared with -31,530 in 2007 (1.0% of the total population).

Figure 46. Net Migration, 2007–2023

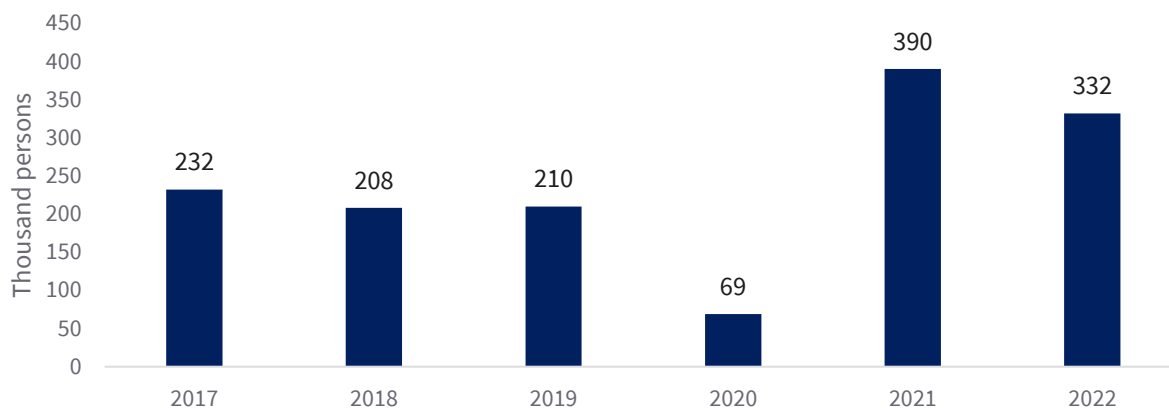


Source: World Bank, Armstat

In 2021, according to the ILO, there were 37,913 outgoing labour migrants in Armenia, which was 1.4% of the total population. The number of persons who left the country for employment reasons in 2021 declined compared with 2017 (86,837, or 3.0% of the population) and 2018 (68,141, or 2.4% of the population). In 2021, there were 2,545 incoming labour migrants (or 0.1% of the population) an increase compared with 2018 (615 persons, or 0.02% of the population). However, it must be mentioned that these figures do not present a complete and accurate picture of labour migration in Armenia, given the limitations of the statistics in this area.

For years, a significant number of Armenians have been leaving the country for employment, mostly seasonal work in Russia. For example, in 2017–2022, every year on average 240,000 citizens of Armenia left for Russia for employment reasons, which is around 8% of the population. In 2020, due to the COVID-19 pandemic, the number of outgoing labour migrants to Russia declined to 69,000. In 2022, 332,000 people left for Russia for work, accounting for a significant 12.0% of the total population.

Figure 47. Net Number of Outgoing Labour Migrants from Armenia to Russia, 2017–2022



Source: Ministry of Internal Affairs of Russia

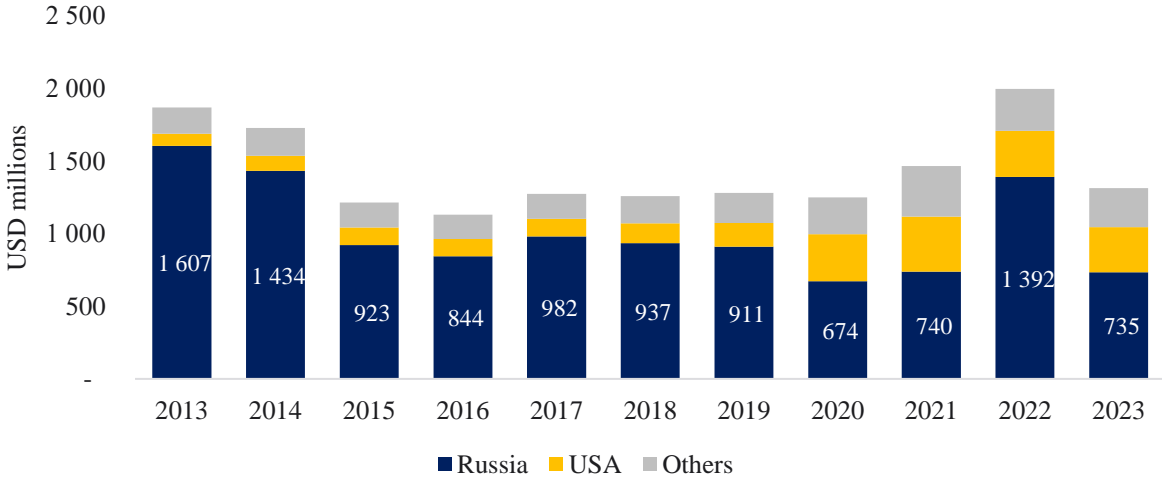
Overall, Russia is the primary destination for labour migrants from Armenia. According to the ILO, in 2021, approximately 96.0% of Armenian labour migrants chose Russia as their destination. Similarly, the majority of incoming labour migrants (67.2% in 2018) came from Russia.

In 2022, after the outbreak of the Russo-Ukrainian war, many Russian citizens moved to Armenia, including for employment reasons. According to Armenian officials, in 2022 around 108,000–110,000 Russian citizens moved to Armenia. They established 2,500 limited liability companies and 4,000 sole proprietorships. As of the end of 2022, the number of Russian citizens employed in the IT sector of Armenia was 7,215, which is 25 times more than at the beginning of the year (Modex, 2024). At the end of 2023, there were 8,262 Russian citizens in the IT sector. This segment of employment is highly paid, and the inflow of employers drove growth in consumption, as well as paid taxes, etc. It must be mentioned that given the low number of labour migrants to Armenia, their impact on the labour supply is not significant. Regarding the influx of Russians, for example, in the IT sector of Armenia, most Russian citizens work in relocated companies. Additionally, many of these companies, as a rule, do not hire Armenian citizens and operate in isolation from the Armenian IT community (Modex, 2024).

Remittances sent by labour migrants working in other countries have long been a significant source of income for the local population. In 2022, personal remittances received by Armenian residents were USD 2,035 million, which was equal to 10.4% of GDP. However, compared with 2007, the reliance on remittances has decreased. Namely, in 2007, as a percentage of GDP, it stood at 18.0. Given that most of the labour migrants of Armenia choose Russia as a destination, Russia also accounts for the majority of the share in the remittances received by Armenia.

Every year, the CBA publishes information about non-commercial money transfers of individuals sent to and received from abroad through commercial banks of RA. While the entire amount is not attributable to remittances, it still presents an illustration of the dynamics and structure of remittances. Russia accounts for most of the non-commercial money transfers sent to Armenia, although its share has declined over the years. In 2023, the non-commercial money transfers through banks from Russia to Armenia amounted to USD 735 million versus USD 1,607 million in 2013. The share of Russia over the same period has declined from 85.9% to 55.8%. In contrast, the share of the USA has increased.

Figure 48. Non-Commercial Transfers of Individuals Sent from Abroad to Armenia through Commercial Banks in 2013–2023



Source: CBA

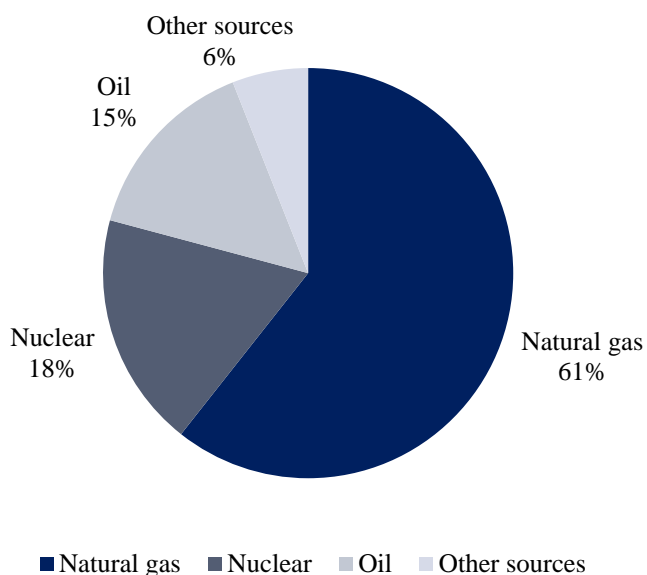
Overall, in the last decade, the number of non-commercial money transfers received by Armenia has declined. There was a sharp increase in 2022 due to the influx of Russians that year, and consequently, money transfers sent to them from Russia. It must be mentioned that money transfers to Armenia are very sensitive to external shocks, especially in Russia. While in 2022, the shock affected the Armenian economy positively in terms of remittances, in 2015, due to the significant challenges in the Russian economy (falling oil prices, Western sanctions, etc.), non-commercial money transfers to Armenia declined by 29.6%.

6. Energy Sector of Armenia: Overview, Dependency, and Outlook

6.1 Energy Background

The total primary energy supply of Armenia was 4,003.3 ktoe in 2022. Since Armenia has limited energy resources, it can meet only a fraction (27.0%) of the total demand from domestic sources and is highly dependent on imported energy resources such as oil and natural gas (Armstat, 2024). Most of Armenia's energy supply comes from natural gas. In 2022, natural gas accounted for 60.6% of the total energy supply of the country, followed by nuclear energy (18.5%) and oil (14.9%) (see Figure 49).

Figure 49. Total Energy Supply by Source, 2022

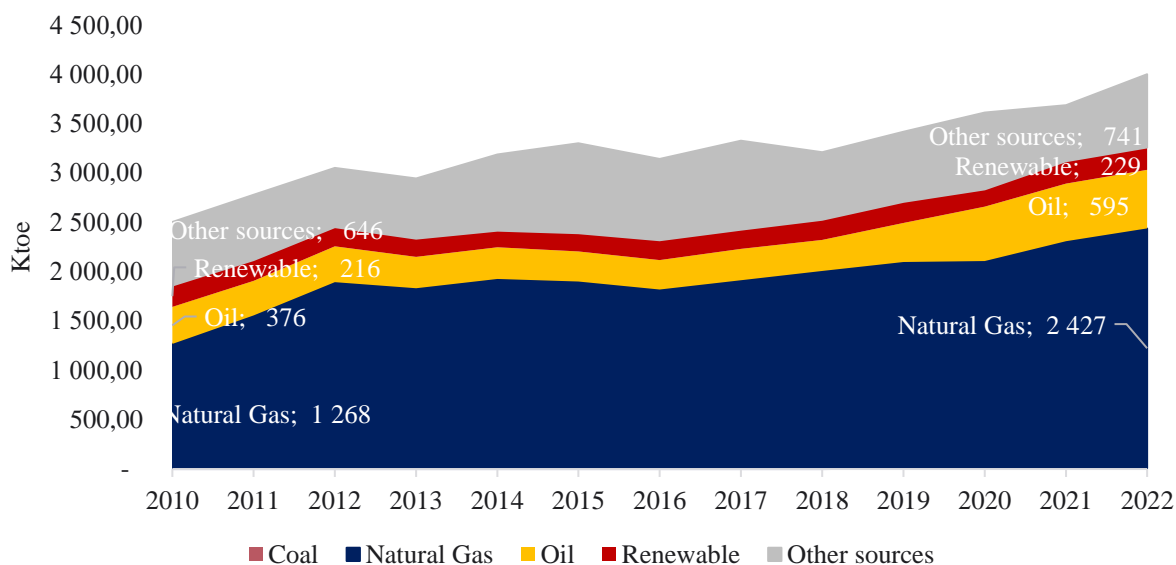


Source: International Energy Agency

Between 2010 and 2022, the share of natural gas in the total energy supply increased by 8.6 percentage points to reach 60.6%, while the share of supply from nuclear energy decreased by 7.6 percentage points and reached 18.5% in 2022 (see Figure 50).

Armenia's energy policy over the last few years has been focused on developing domestic energy sources, mainly renewables such as solar and wind. In 2022, solar, wind, and other renewable energy (excluding hydro) provided 1.5% (62 ktoe) of the total energy supply. Although this is not a significant amount, it has increased since 2007, when the share of these sources in the total energy supply stood at 0.01% (0.23 ktoe).

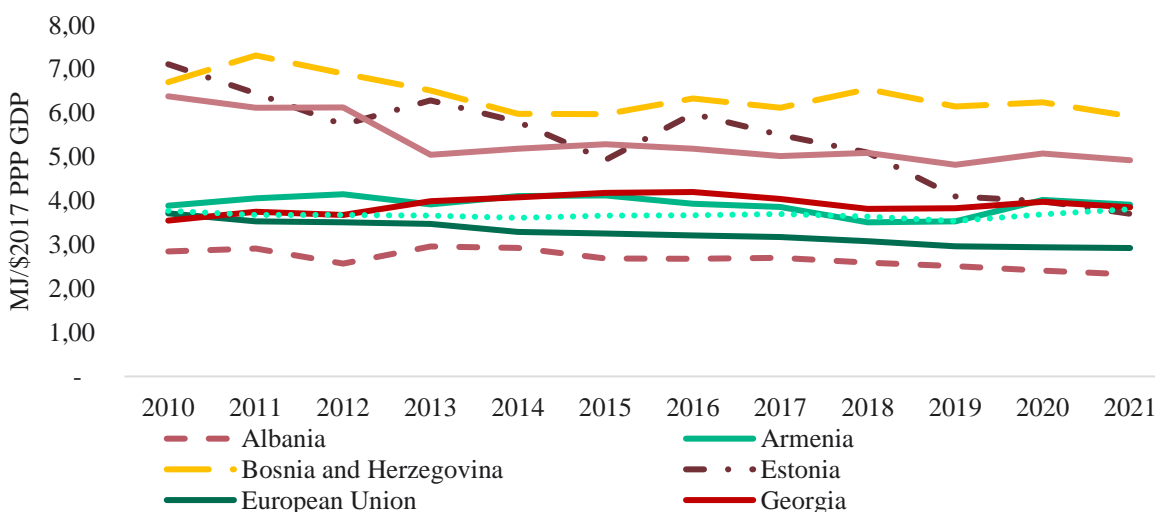
Figure 50. Dynamics of Energy Supply by Source, 2010–2022



Source: International Energy Agency

The energy intensity level, which indicates how much energy is used to produce one unit of economic output, has slightly improved in Armenia from 2010 to 2021. In 2021, the ratio of primary energy supply to GDP at purchasing power parity stood at 3.9, down from 4.2 in 2010 (see Figure 51). However, some of Armenia’s peer countries, such as Albania and Moldova, have improved their energy efficiency at a faster rate (by 25.5% and 21.3%, respectively, compared to 6.9% in the case of Armenia). Estonia, which is considered an aspirational peer, has also significantly improved its level of energy intensity over the years. For example, in 2007, Estonia had a higher energy intensity level (6.3) than Armenia (4.2), but by 2021, Estonia had surpassed Armenia in terms of energy efficiency.

Figure 51. Energy Intensity Level of Armenia and Selected Countries, 2010–2021



Source: World Bank

Gas transportation and distribution in Armenia is realised by Gazprom Armenia CJSC, which is owned by Russia's Gazprom. Gazprom Armenia is the owner of all gas infrastructure in Armenia and has exclusive rights to import, transport, and distribute gas to consumers. The company has 15 gas supply branches, as well as 5 subsidiary companies, including Transgaz LLC, which operates the gas transmission system and the Abovyan Underground Gas Storage Station.²³ The total length of gas pipelines and the pipeline branches serviced by the company in the gas transmission pipeline system is 1,841.2 km.²⁴ Armenia's natural gas transportation system is connected to the gas transportation systems of Georgia and Iran. Since Armenia does not share a border with Russia, the gas flows via Georgia's North-South Main Pipeline.

A gas pipeline from Iran was commissioned in stages between 2007 and 2009, crossing into Armenia at the border town of Meghri with a capacity of 2.3 billion cubic metres a year; this means that, in theory, Iran could meet most if not all of Armenia's current gas import requirements (IEA, 2022). Initially, the pipeline's diameter was projected at 1,500 mm; however, the Armenian government reportedly agreed to cut it to just 710 mm under pressure from Russia, which feared losing its status as the region's main gas supplier. Eventually, the capacity of the pipeline was reduced and the actual imports were enough to cover the gas-for-electricity swap agreement between Armenia and Iran. Since 2009, Armenia has been importing natural gas from Iran, using it to generate electricity at a domestic thermal power plant and then supplying it back to Iran.

Additionally, in 2016, the official representative of Iran announced that Iran was going to triple the volume of gas supplied to Armenia, as well as export gas through the territory of Armenia to other countries (Armenpress, 2016). On 4 August 2016, a decision was adopted to create a 100% state-owned company, ENERGAIMPEX CJSC, which would have the right to buy gas and electricity from Iran and transport it to other countries (Former RA MEINR, 2016). However, this project was not realised, reportedly due to interventions from Russia.

The fact that Gazprom owns the Armenian part of the pipeline that supplies Iranian gas to Armenia, as well as the rest of the pipeline infrastructure in Armenia, may potentially complicate Armenia's efforts to diversify its gas supply (Kramer, 2006).

Electricity in Armenia is transmitted and distributed by High Voltage Electric Networks of Armenia CJSC (HVEN) and Electric Networks of Armenia CJSC (ENA). Much of Armenia's electricity distribution infrastructure, including power lines and substations, is aging and in need of modernisation. Technical losses in the transmission and distribution are relatively high. In 2022, these losses totalled 605.6 million kWh, representing a 10% increase compared with 2021 (RA SRIE, 2024).

Armenia's transmission system is maintained by HVEN, which is a state-owned company. HVEN has 15 220kV and 110kV substations (with a total capacity of 2,561 MW), as well as 1,914.7 km of overhead transmission lines.²⁵ The main issues related to the transmission system are that it is aging and thus in need of modernisation.

The distribution and sales of electric energy in Armenia are conducted by the ENA. The overall spread of its grid is 36,000 km, and it serves over 1 million customers.²⁶ ENA was created by a merger of four state-owned regional electricity distribution companies (Yerevan Electric Networks, North Electric Networks, South Electric Networks, and Central Electric Networks). It was fully privatised in 2002 and subsequently sold to Russian company Inter

²³ Gazprom Armenia, "About us", Gazprom Armenia official website, accessed April 29, 2024, <https://is.gd/iSgLPx>

²⁴ Former Ministry of Energy Infrastructures and Natural Resources of the RA, "Power system: Companies of the system" (web page), Official website, accessed April 29, 2024, <https://is.gd/ZNbKbc>

²⁵ High Voltage Electric Networks of Armenia (HVEN), "About us", HVEN official website, accessed May 2, 2024, <https://is.gd/6YfXgM>

²⁶ Electric Networks of Armenia (ENA), "About us", ENA official website, accessed May 2, 2024, <https://is.gd/6VTUGL>

RAO in 2006. In September 2015, Liormand Holdings Limited acquired the company. From 14 April 2017, the shareholders of the ENA are Tashir Capital (70%) and Liormand Holdings Limited (30%). ENA is implementing a 2016–2027 investment programme aimed at modernising and rehabilitating its electricity distribution network. It plans to spend AMD 416.2 billion (more than USD 1 billion²⁷) for the programme, which is funded with loans from the ADB, EBRD, the International Finance Corporation (IFC), and its own funds (ENA, 2022). As of 30 June 2023, actual investments stood at AMD 223.5 billion (USD 559 million), representing 48.9% of the total budget. As part of the programme, ENA has implemented an automated electricity metering system that collects information on various parameters every half hour, including from small hydropower stations and solar photovoltaic (PV) stations above 5 MW that are connected to the grid. However, increased automation has also raised government concerns regarding cybersecurity (IEA, 2022).

It must be noted that, in 2022, the company was forced to significantly increase its exposure to loans, mostly short-term, from local banks to secure access to funding amid the heightened geopolitical risks in the region, which forced international banks to put on hold any new transactions with the company. This shift was approved by ENA’s core international lenders, including the IFC, ADB, and the EBRD as a temporary solution, and the company plans to refinance all its existing domestic loans with new long-term international financing. However, according to Moody’s, the ENA’s ability to restore its relationship with the international financing organisations remains uncertain (Moody’s, 2023). Additionally, in 2023, ENA issued bonds on the local stock exchange with a total volume of AMD 32 billion (over USD 80 million).

Additionally, Tashir Group, the owner of ENA, is a large Russian conglomerate, ultimately controlled by Samvel Karapetyan. Thus, although it has not yet been directly affected by the Western sanctions, the evolving nature of the Russo-Ukrainian War and the related vast economic sanctions on Russia continue to pose potential risks for the company through its shareholder.

The Electro Power System Operator CJSC is responsible for the strategic functioning of Armenia’s power system. The company has the exclusive rights to have operational and economic control of the power system’s technological process; to plan and coordinate the generation, import, export and transit of power; and to maintain the links between Armenia’s power system and regional power systems, among other things.

The primary domestic sources of energy production in Armenia are nuclear energy and hydroenergy. Nuclear energy plays a crucial role in Armenia’s energy independence. In 2022, its share in total primary energy production in Armenia was 68.6% (RA SRIE, 2024). Armenia has one nuclear plant (Armenian Nuclear Power Plant (ANPP)) and is the only country in the Caucasus region producing nuclear energy. The ANPP site is located 28 km west of the capital city of Yerevan and 16 km from the Turkish border, and it consists of two units with an installed capacity of 407.5 MW.²⁸ One of the units is in a long-term shutdown condition. In 2021, the service life of Unit 2 was extended to 2026 with plans to expand it after that for another 10 years. According to estimations, the 2026–2036 expansion will cost USD 160 mln.²⁹ Additionally, the government of Armenia plans to construct a new nuclear unit to replace the current one after 2036.³⁰ It should be noted that the ANPP receives its nuclear fuel from Russia.

²⁷ The AMD value is converted to USD using AMD/USD exchange rates of 400 as in the case of all forecasts in the ENA 2022–2031 program prospectus.

²⁸ ANPP, “History”, ANPP CJSC official website, accessed April 29, 2024, <https://is.gd/j7Aymx>

²⁹ The decision N ԱԾՈ-005-N of the National Assembly of the RA of June 13, 2024, on the approving the execution of the state budget for 2024 [in Armenian], accessed May 1, 2024, <https://bit.ly/4felSCz>

³⁰ The Decision of the RA Government N- 48-L of January 14, 2021, accessed April 29, 2024, <https://is.gd/aOZnL5>

Hydroenergy is the most developed renewable energy resource in Armenia. There are two major hydropower plants (HPPs) owned by International Energy Corporation CJSC and Contour Global Hydro Cascade CJSC, as well as several small HPPs. The total installed capacity of HPPs owned by the International Energy Corporation CJSC amounts to 561.4 MW, and the total installed capacity of HPPs owned by the Contour Global Hydro Cascade CJSC amounts to 404.2 MW. Additionally, in 2022, 189 small HPPs operated in Armenia with a total installed capacity of 409 MW (RA SRIE, 2024).

In addition to its nuclear and hydroelectric power plants, Armenia generates electricity through four major thermal power plants (ArmPower CJSC, Yerevan TPP, Hrazdan TPP, and Hrazdan-5), though thermal generation relies on imported gas. In 2023, ArmPower CJSC accounted for 22.8% of the total electricity production (for internal consumption), followed by Yerevan TPP (7%) and Hrazdan TPP (0.04%), while Hrazdan-5, which is owned by the Russian Gazprom, did not operate in 2023 (PSRC, 2024).

Armenia is taking steps to diversify its power generation mix, with a focus on significantly expanding its solar PV capacity. The government of the Republic of Armenia aims to increase the share of solar power generation by at least 15% or 1.8 billion kWh by 2030. For that purpose, solar power plants with a total installed capacity of 1,000 MW, including autonomous plants, are planned to be constructed.³¹ Expanding the installed capacity of solar energy will bring significant benefits, but it also presents challenges for Armenia, particularly in dispatching costs and balancing supply with demand. Armenia will need to incorporate storage solutions to manage the variability in energy production. Additionally, the grid infrastructure must be capable of handling the rapid changes in energy generation; this may require investment in smart grid technologies to efficiently dispatch energy and maintain stability. These adaptations can lead to increased costs and complexity for the country in grid management, requiring careful planning and investment to ensure reliable energy delivery.

In 2022, the total installed capacity of licensed solar PV plants reached 204.8 MW (RA SRIE, 2024). Additionally, there are currently two large solar farms either under construction (Masrik-1 and Ayg-1). Together, they will have a capacity of 255 MW. Moreover, 19,397 autonomous electricity producers with 290.7 MW of total installed capacity are connected to the distribution grid, while an additional 224 with a 9.9 MW total capacity are in the connection process (AEA, 2024).

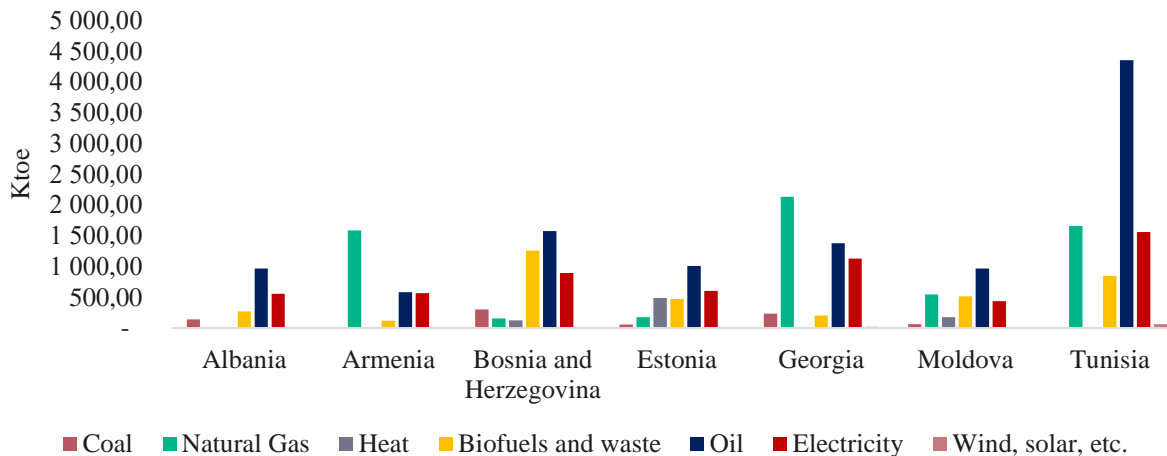
6.2 Energy Consumption

Armenia's energy demand in 2022 amounted to 2,938.4 ktoe—63.9% higher than in 2010. Consumers in Armenia use mainly natural gas and oil products, which together account for 75.1% of total final energy consumption. The use of wind and solar energy is less than 1% (0.6% in 2022). Over more than a decade, the energy consumption structure in Armenia has not changed significantly, although the consumption of biofuel and waste energy increased from 8 to 121 ktoe, and its share in 2022 reached 4.2%, up from 0.5% in 2010. There may be several reasons for the growth. For example, given that gas prices have increased, consumers in rural areas may have found it more affordable to switch to this energy source. In recent years, there has also been a slight increase in the use of solar and wind energy as well. Armenia's energy consumption is less diversified compared to its peer countries (see Figure 52). For example, in 2022, in neighbouring Georgia, where natural gas, oil, and electricity are also the main sources of energy consumption, the share of natural gas was 41.8% of the total energy consumption, while in Armenia, the leading energy source constituted 54.9% of the total. This difference

³¹ The Decision of the RA Government N- 48-L of January 14, 2021, accessed April 29, 2024, <https://is.gd/aOZnL5>

illustrates Armenia’s higher dependence on a single energy source. Similar patterns are also observed in Bosnia and Herzegovina, Moldova, and Estonia.

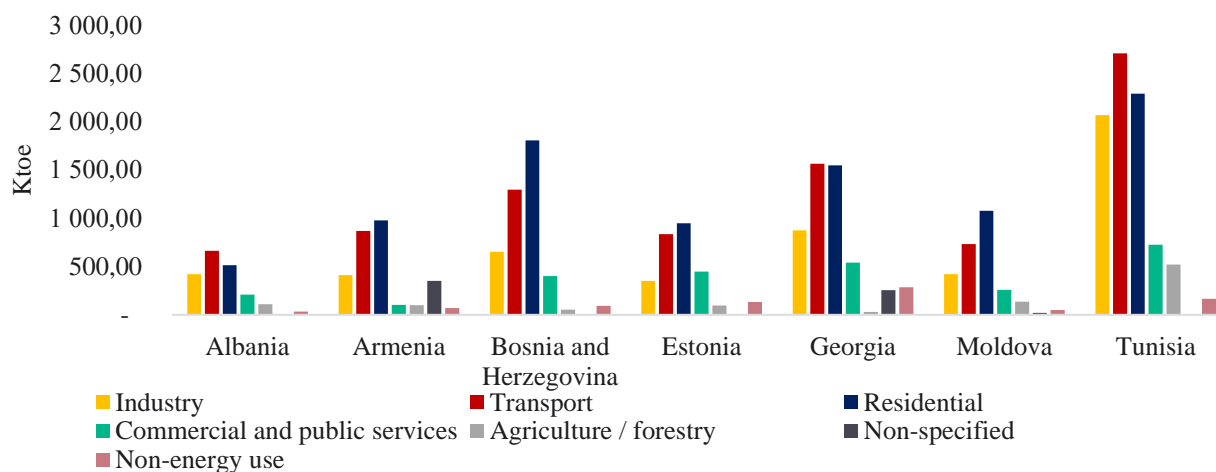
Figure 52. Total Final Energy Consumption by Source in Armenia and Selected Countries, 2022



Source: International Energy Agency

In 2022, the sectors with the highest energy consumption were residential buildings and transportation, with both sectors together accounting for 64.1% of total final energy consumption in Armenia (see Figure 53). Moreover, the energy consumption in transportation and residential buildings nearly doubled between 2010 and 2022, and these were the main drivers of growth in total energy consumption. This can be explained by an increase in residential building construction and a growing number of vehicles. In Armenia, households use mainly natural gas and electricity, while transport consumption consists of natural gas and oil products.

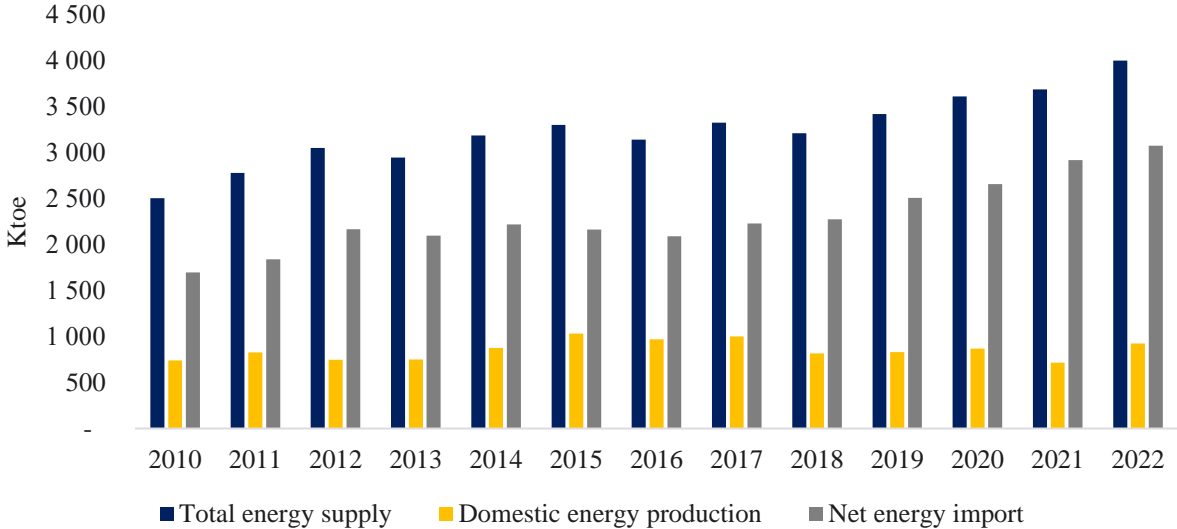
Figure 53. Total Final Energy Consumption by Customers in Armenia and Selected Countries, 2022



Source: International Energy Agency

The net import dependency of Armenia has increased since 2010 (see Figure 54). In 2022, the net energy import was 3,078 ktoe, which is 81.2% more than in 2010. In the same period, domestic energy production fluctuated and stood at 925 ktoe in 2022, 24.9% more than in 2010. The increase in import dependency was mainly conditioned by the increase in natural gas imports.

Figure 54. Total Energy Supply, Domestic Production, and Net Import, 2010–2022



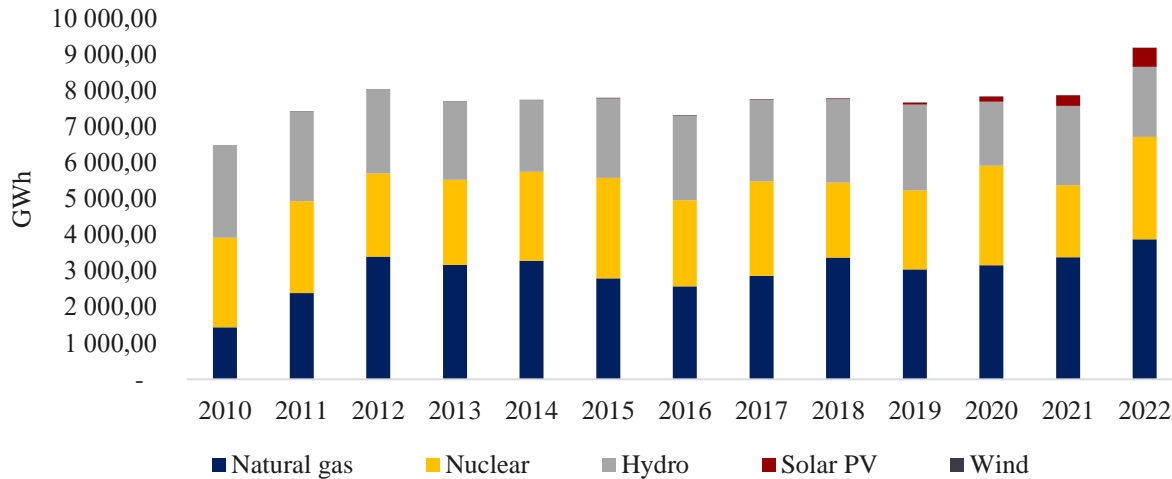
Source: International Energy Agency

Armenia is a net exporter of electricity, but much of this electricity is traded in exchange for natural gas from Iran. In 2022, Armenia produced 9,187 GWh of electricity, out of which natural gas covered 42.2% (3,878 GWh), 26.8% was generated from hydro and other renewable sources (2,463 ktoe), while nuclear covered 31% (2,846 GWh) (see

Figure 55). The contribution of natural gas has significantly increased since 2010, while the shares of hydro and nuclear energy sources have decreased. In the last decade, Armenia started generating electricity from solar

energy. In 2022, electricity generation from solar energy reached 523 GWh, marking a 1.8-fold increase compared to the previous year. Notably, this energy source was not utilised a decade ago.

Figure 55. Domestic Electricity Generation by Energy Source, 2010–2022

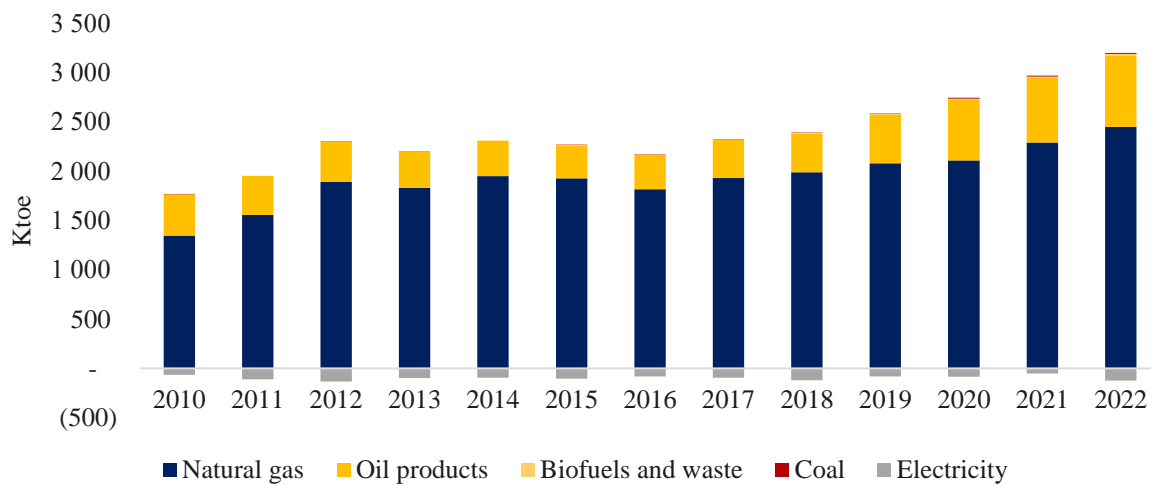


Source: International Energy Agency

All fossil fuels consumed in Armenia are imported, with natural gas representing 76.3% of Armenia’s energy imports (2,450.6 ktoe out of 3,213.8 ktoe in 2022), followed by oil products (22.6% or 727.0 ktoe in 2022) (see Figure 56).

In 2022, Armenia’s net energy imports were 3,078.0 ktoe, up by 1.8 times from 2010. The majority of the increase was driven by a rise in natural gas imports. Overall, in 2010–2022, imports of natural gas nearly doubled.

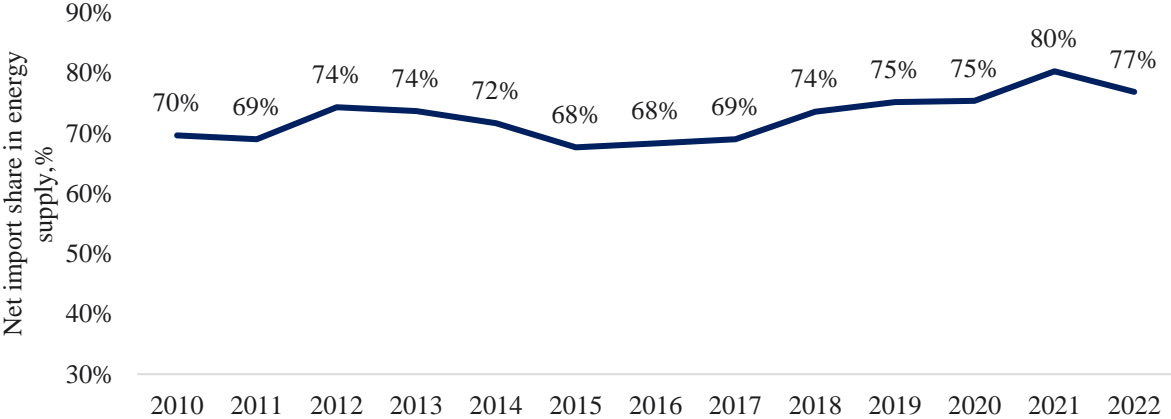
Figure 56. Net Energy Imports by Energy Source, 2010–2022



Source: International Energy Agency

Armenia is highly reliant on foreign sources for its energy needs, and this dependence has only grown in recent years. In 2022, imported energy (net) made up 76.9% of Armenia’s total energy supply (3,077.9 ktoe out of 4,003.3 ktoe)—a 7.2 percentage point increase from 2010 (see Figure 57).

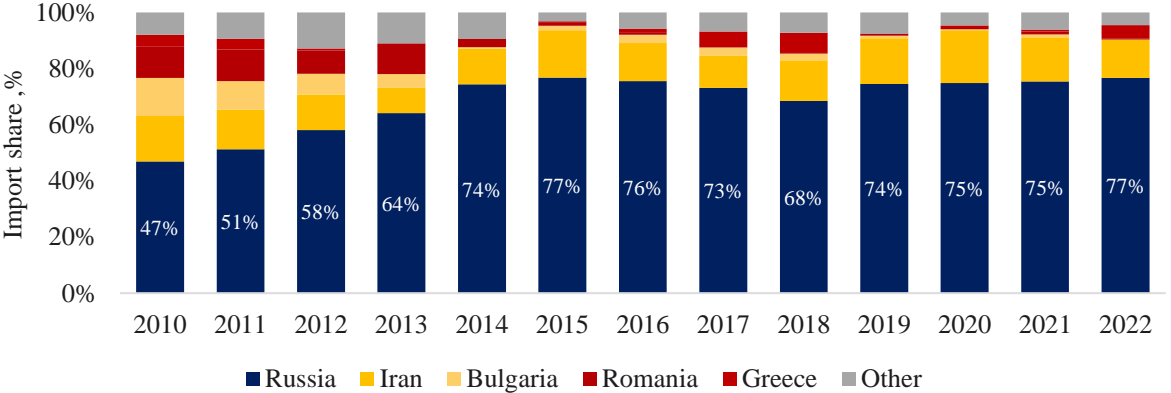
Figure 57. Share of Net Import in the Total Energy Supply, 2010–2022



Source: International Energy Agency

Russia is Armenia’s predominant energy supplier (see Figure 58). In 2022, over 76% of Armenia’s energy imports came from Russia, and 13.8% from Iran. Between 2010 and 2022, Russia’s share in Armenia’s energy imports increased substantially from 46.9% to 76.6%, potentially making Armenia more vulnerable to supply disruptions due to political issues, natural disasters, or other unforeseen events. While Russia’s share in Armenia’s energy imports has increased, the shares of other partners, such as Bulgaria and Romania, have declined. In 2022, Bulgaria and Romania’s shares in Armenia’s energy imports were around 0% each, down from 13.6% and 11.2%, respectively in 2010. Following Armenia’s accession to the EAEU, Russia reduced energy prices for Armenia, and customs duties were abolished in 2015, adding to the other benefits Russia provided to Armenia in previous years. These favourable terms contributed to an increased share of Russian energy imports in Armenia’s energy mix.

Figure 58. Energy Import by Partner Country, 2010–2022

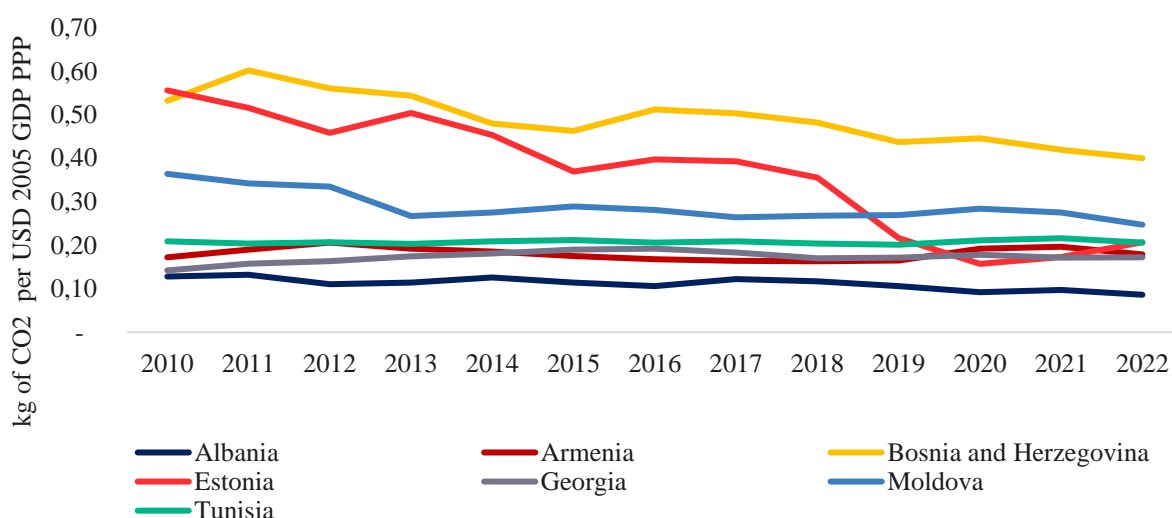


Source: WITS/ World Bank

6.3 Renewable Energy: Development and Potential

Armenia has moderate carbon intensity, which has remained relatively stable over the past decade. Between 2010 and 2022, on average 0.17 kg of CO₂ was emitted per unit of GDP; in 2022, it stood at 0.180 kg (see Figure 59). Armenia’s carbon intensity is more favourable compared to many of its peer countries, such as Bosnia and Herzegovina (0.4 in 2022), Moldova (0.25), and Estonia (0.21), and it is on a similar level to Georgia (0.17). However, in Georgia, the volume of emitted CO₂ per unit of GDP has worsened since 2010 (0.14), while Estonia has registered considerable progress with CO₂ per unit of GDP dropping from 0.56 to 0.21 between 2010 and 2022.

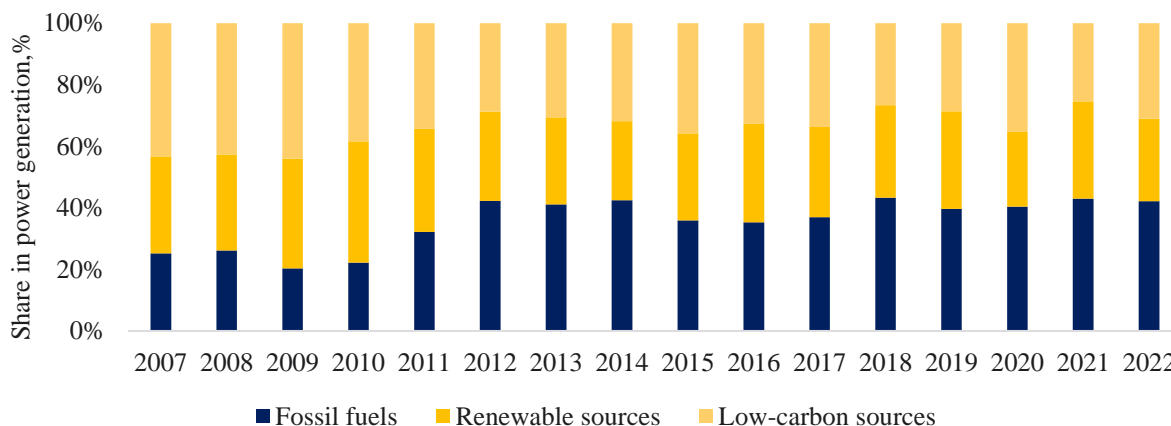
Figure 59. CO₂ Emissions Per Unit of GDP in Armenia and Selected Countries, 2010–2022



Source: International Energy Agency

In 2022, Armenia generated 9,187 GWh in electricity, with 42.2% of this total coming from a fossil fuel source—namely, natural gas, 31.0% was covered by low-carbon nuclear energy, and 26.8% of the electricity was generated from renewable sources, with hydroelectric power accounting for nearly all of it. From 2007 to 2022, the share of natural gas increased 1.7 times, while the shares of nuclear energy and renewable energy sources in power generation have declined by 12.3 and 4.7 percentage points, respectively (see Figure 60).

Figure 60. Share of Renewables, Low-carbon Sources, and Fossil Fuels in Electricity Generation, 2007–2022

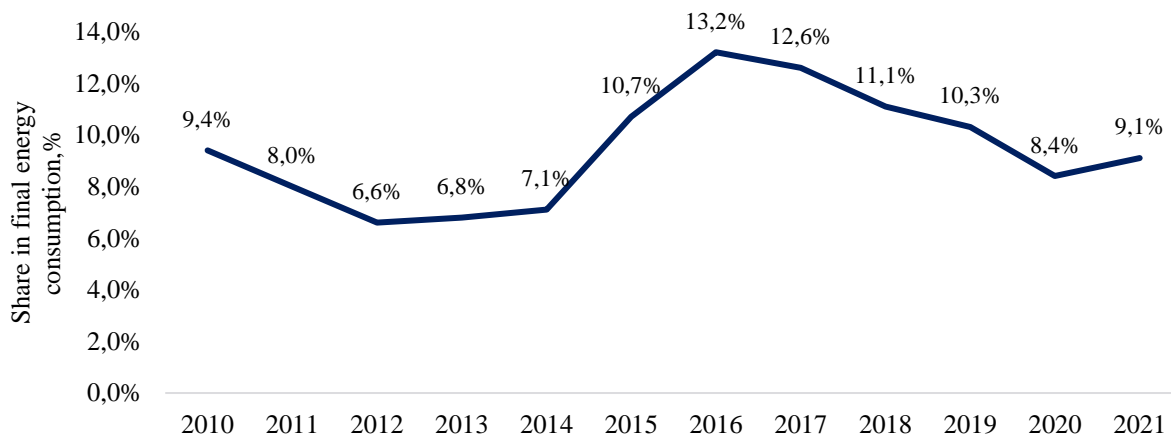


Source: International Energy Agency

Note: Here fossil fuels include natural gas; renewable sources include hydroelectric power, solar, and wind energy; and low-carbon sources include nuclear power.

In 2021, the share of renewable energy in Armenia’s total final energy consumption was 9.1%, which is significantly lower than in several of its peer countries such as Georgia (25.2%), Moldova (21.4%), Bosnia and Herzegovina (36.6%), Albania (41.9%), and Estonia (38.0%). In 2016, the share of renewable energy in Armenia’s energy consumption peaked at 13.2%; however, in the following years, it declined, reaching around the same level as in 2010 (see Figure 61).

Figure 61. Share of Renewable Energy (Excluding Biomass) in Total Final Energy Consumption, 2010–2021



Source: UNECE

Hydroelectric power is the most developed renewable energy source in Armenia. As of 2022, there are two major and 189 small HPPs in the country with a total installed capacity of 1,374.6 MW (SRIE, 2024). Armenia has

significant potential for the development of solar energy. The average annual solar energy output per square metre of horizontal surface is 1,720 kWh/m², with about a quarter of the country receiving up to 1,850 kWh/m² annually.³² However, the solar photovoltaic capacity is currently low. In 2022, the total installed capacity of licensed solar PV plants stood at 204.8 MW. It should be noted, however, that Armenia’s 2021 Energy Strategy calls for up to 1,000 MW of solar PV capacity by 2030. Armenia also has considerable wind energy potential. The total capacity stands at 450 MW with an annual output of 1.26 bln kWh of electricity.³³ In 2022, the total installed capacity of wind farms in operation was 4.2 MW (SRIE, 2024). As per 2021 data, the capacity utilisation rates in Armenia were 19% for solar energy, 19% for hydroenergy, and 6% for wind energy (IRENA, 2023).

6.4 Energy Policies and Outlook

In 2021, the government of Armenia adopted the “Republic of Armenia Energy Sector Development Strategic Programme to 2040” (Energy Strategy) and the “Action Plan to Ensure Implementation of the Republic of Armenia Energy Sector Development Strategic Programme”, which are considered Armenia’s main energy policy documents.³⁴ These documents replaced previous energy sector development strategies, including the 2013 national energy security concept and 2014–2020 activities for its implementation.

Armenia’s Energy Strategy outlines the sector’s transition plan through 2040, focusing on key initiatives such as maximising the use of renewable energy sources, boosting energy efficiency, and gradually liberalising the domestic electricity market. The strategy also calls for the construction of a new nuclear power plant and the expansion of power transmission links between Armenia and its neighbours, particularly Georgia and Iran, setting specific targets to be achieved by 2040. For example, the government aims to increase energy independence through an increased share of solar generation to 15% by 2030. It also aims to have electricity production of 12 billion kWh by 2030, of which about 5.0 billion kWh will be exported. Other goals are also outlined in the document.

It is worth noting that Armenia’s commitment to developing renewable energy sources is not new; it began in the 2000s. In 2004, the government adopted the Law on Energy Efficiency and Renewable Energy of Armenia, which sets the framework for promoting energy efficiency and renewable energy development in the country.³⁵ It was followed by the establishment of the Armenia Renewable Resources and Energy Efficiency Fund (R2E2 Fund) in 2005 to promote the development of renewable energy resources and to enhance energy efficiency throughout the country. Then came the Renewable Energy Roadmap (2011), Scaling-Up Renewable Energy

³² Armenian Energy Agency, “Solar Energy of Armenia”, AEA official website, accessed April 29, 2024, <https://is.gd/IGVKiW>

³³ Armenian Energy Agency, “Wind energy of Armenia”, AEA official website, accessed April 29, 2024, <https://is.gd/07Ob3C>

³⁴ The Decision of the RA Government N- 48-L of January 14, 2021, accessed April 29, 2024, <https://is.gd/aOZnL5>

³⁵ RA Law on Energy Efficiency and Renewable Energy of November 9, 2004, accessed April 29, 2024, <https://is.gd/hokQwa>

Programme Investment Plan (2014), and other documents, which provided analyses of renewable energy potential and set targets and objectives for renewable energy.

The Public Services Regulatory Commission (PSRC) of Armenia is responsible for setting electricity tariffs. Tariffs vary based on the voltage level at which a customer is connected to the power grid. There are currently two main tariffs for each voltage level, a day rate, and a night rate, designed to reflect peak and off-peak hours, incentivising consumers to shift their usage to times when demand is lower. There is also a special tariff for residential customers with low income. The tariff system includes incentives for renewable energy generation, like feed-in tariffs, net metering, and VAT incentives to encourage investment in renewable sources. Tariffs are typically reviewed and adjusted annually to reflect changes in energy costs, inflation, and other economic factors.

It is worth mentioning that the average Armenian end-user electricity tariffs are higher than the world average; they are also higher than average tariffs in Russia, though they are similar to those in neighbouring Georgia (IEA, 2022).

The natural gas prices in the country are determined not by the market mechanisms but by the agreement between the Government of the Republic of Armenia and the Government of the Russian Federation signed in 2013. Since 1 January 2019, the price of Russian gas at the border of Armenia and Georgia has not changed: it remains USD 165 per 1000 cubic metres, though it was USD 150 previously. According to Armenian officials, the gas price on the border will not change for Armenia until at least 2031 (IAE, 2022). In Armenia, for years there have been preferential gas tariffs for different groups of consumers, such as low-income customers, greenhouse farms operating in the field of agriculture, and those engaged in processing agricultural production. In 2022, Gazprom Armenia proposed to set a single tariff for all consumers; however, eventually, PSRC decided to leave the tariffs for low-income customers unchanged and increase the tariffs for the rest of the groups (Radio Azatutyun, 2022).

At the same time, the EAEU member countries plan to establish a common gas market. The member states have already adopted the concept of forming a common gas market and developed an implementation plan. It was initially planned to establish the market in 2025. However, due to the lack of consensus regarding gas prices, the formation of the common gas market has been delayed (Armenpress, 2024).

Strengthening regional integration is also a key component of Armenia's Energy Strategy. Along with political disputes with two neighbouring countries, Armenia's electricity interconnection with Georgia is not fully operational due to its asynchronous systems, while its link with Iran functions under restricted conditions. The government plans the construction of transmission lines and substations, which will enable electricity capacity to be increased between Iran and Armenia from 350 MW to 1200 MW and the transmission capacity of a parallel operation with Georgia from the existing 200 MW to 350 MW. Actions will be taken to establish prerequisites for regular electricity trade between Georgia and Armenia based on the EU directives. The government also plans to implement additional measures focused on the expansion of Armenia-Iran energy cooperation (USAID, 2021).

In recent years, Armenia's focus on enhancing energy independence and adopting renewable and green energy sources has sparked an interest in hydrogen energy. Currently, the Armenian government is cooperating with

Germany to estimate green hydrogen production costs in Armenia and assess both the domestic utilisation potential across several sectors and export feasibility (GET, 2023).

7. Sources of Vulnerability and Risk Factors

Macroeconomic Situation

In 2022 and 2023, the Armenian economy grew strongly (12.6% and 8.3%) with the rapid expansion of the consumption of goods and services fuelled by the influx of people from Russia, as well as double-digit growth in exports reflecting re-exports to Russia. As a result of this external shock, in 2022, the consistently negative current and financial account balances of Armenia shifted to a surplus. In addition, the tax revenues in 2022 and 2023 increased at a higher pace, mainly reflecting the growth in VAT, profit tax, and income tax, which is again partly the reflection of the growth in re-exports to Russia and the migration inflows from Russia.

These developments following the Russo-Ukrainian War stimulated significant economic growth in Armenia and had a positive overall impact on the country's economy. However, they also revealed that the economy is very vulnerable to external shocks. As these stimuli started to wane in 2023, the economic growth already began to slow down, and the current and financial accounts of the balance of payments moved back to deficit.

In the coming years, the growth is expected to moderate and return to its potential of around 5–6%. An excellent illustrative example of the potential impact of diminishing stimuli is the re-export of vehicles from Armenia to Russia ceasing. In 2023, a main driver of economic growth and the state budget revenues was the vehicle re-exports from Armenia through the territory of Georgia to Russia. Indeed, according to some estimations, the contribution of the car business to Armenia's GDP in 2023 might be 3.5% (Chervyakov et al., 2023). In January 2023, the EU and US extended the export sanctions against Russia on the export of cars to include all new and second-hand cars above a certain engine size (> 1.900 cm³), as well as electric and hybrid vehicles. Consequently, Georgia restricted exports, re-exports, and the transit of US cars (from August 2023) and EU cars (from September 2023) to Russia through its territory. As a result, in August 2023, the re-exports of cars from Armenia declined considerably, and since the sector does not have a sustainable economic model, its disappearance in 2024 may have a considerable negative effect on the economy. This vulnerability emphasises the need for robust economic policies and strategies in Armenia aimed at enhancing resilience and mitigating risks.

The macroeconomic situation in Armenia was also compromised by the military conflict with Azerbaijan, which led to the inflow of approximately 100,000 forcibly displaced people from Nagorno-Karabakh to various cities and villages throughout Armenia in the autumn of 2023. To support their socioeconomic integration, the Armenian government has been implementing different programmes, including one-time transfers, monetary assistance for rental housing and utilities, assistance for tuition fees, and pensions. According to the 2024 state budget, around AMD 49 bln (USD 122 million,³⁶ or 0.5% of the projected 2024 GDP) is allocated for various support programmes for displaced people in 2024. Additionally, the government of Nagorno-Karabakh and other borrowers had AMD 315 billion (USD 783 million) worth of liabilities to the financial and banking system of Armenia, which will be restructured. Notably, the government of Armenia will assume 70% (USD 548 million, or 2.1% of the projected 2024 GDP) of Nagorno-Karabakh's loans, while the remaining 30% will become liabilities of financial institutions.

³⁶ The value was converted from AMD to USD using the annual average exchange rate for 2024 as specified in the state budget.

The influx of displaced people from Nagorno-Karabakh will have both short-term and medium-term implications, affecting demand and supply conditions in the economy as well as fiscal policy and public debt. In terms of the fiscal policy, it is important to mention that the costs designated for supporting the forcibly displaced population will be covered by reallocating resources from the interstate loan originally intended for Nagorno-Karabakh. Therefore, the increase in the budget deficit expected in 2024 does not technically represent an increase in spending, but rather a redistribution of budgetary funds from loans to current expenses.

The CBA expects that over the medium term, the influx of displaced people from Nagorno-Karabakh will have a positive effect on the potential GDP growth (around 1%) through increased labour supply (CBA, 2024). However, in the short term, a rise in the unemployment rate is possible. Assuming that all individuals from Nagorno-Karabakh remain in Armenia and based on the CBA's estimates regarding the share of the labour force (around 43%) among the displaced population, the initial impact on the unemployment rate is projected to be a maximum of 2.7%.

Financial Sector

Armenia has a small financial sector dominated mainly by banks, which over the last few years have experienced several shocks, including COVID-19, the ongoing Russian invasion of Ukraine and the sanctions associated with it, and the resumption of hostilities in Nagorno-Karabakh. After the Russian invasion of Ukraine in 2022, the growth in deposits in Armenian banks has accelerated substantially, as assets from Russia have flowed into the banking sector, seeking safety from Western sanctions. Similarly, while capital markets remain small and undercapitalised compared to OECD benchmarks, they also have seen growth in the wake of Russia's full-scale invasion of Ukraine, with a 50.5% increase in capitalisation from 2022 to 2023, coming off the back of impressive 599% growth from 2021 to 2022.³⁷

However, banks need to consider that this money is in some sense “hot”, in that it is highly dependent on geopolitical events and flows could reverse themselves quickly, potentially destabilising the banking sector, especially if there is a large-scale withdrawal.

In tandem with this increase in deposits, Armenia has seen a substantial increase in household lending over the past decade and a half in Armenia, with a definite shift towards mortgage lending over the past 6 years. Regarding lending to economic activities, construction was one of the main beneficiaries (behind trade); the volume of bank loans to this sector increased by 158% compared to 2019. The increase in bank lending into mortgages and the construction sector can also be problematic for Armenia and requires monitoring in order to ensure that a bubble does not develop.

It must be mentioned, however, that the increased profitability of Armenian banks has also coincided with a decrease in a standard measure of vulnerability for the financial sector, the prevalence of NPAs. Throughout 2023, NPAs have been hovering around the 1.4% mark or lower for assets of residents and around 1% for non-residents, meaning that bank exposure to NPAs is quite low indeed (also due to increases in bank assets). The sector with the largest amount of NPAs is construction, at 0.27% of all assets, a number that has gone up throughout 2023 but is still lower than historic highs seen in early 2015 (1.12%).

Among other important developments in the financial sector of Armenia in recent years is the withdrawal of the oldest foreign-owned bank in the country. In February 2024, the Armenian Ardshinbank agreed to purchase HSBC Bank Armenia and integrate its customers under the Ardshinbank name, meaning an increase in Ardshinbank's position as a wholly Armenian-owned entity. On the other hand, another foreign-owned bank—

³⁷ According to data from the World Federation of Exchanges, available at: <https://statistics.world-exchanges.org/>.

the Bank of Georgia—acquired Ameriabank CJSC, which is one of the largest banks in Armenia. These developments may potentially have wide-ranging implications for Armenia’s financial sector. However, it must be mentioned that the Fitch ratings expect that Armenian banks’ credit metrics will remain better than historical averages for at least 2024–2025. In particular, the profitability, capitalisation, funding, and liquidity ratios will stabilise at above-average levels after the strong boost in 2022 due to immigration and capital inflows from Russia (Fitch, 2024).

Additionally, the entire financial sector in Armenia is overseen by the CBA, which has long been seen as a competent and forward-looking institution. CBA has gradually reformed its approach towards financial sector regulation, instituting a risk-based framework in 2005 and setting banking standards amid the global financial crisis in 2007–2008. Since the global financial crisis and the shocks emanating from Russia after its first invasion of Ukraine in 2014, the CBA has taken a much more hands-on approach toward financial stability, including adjusting reserve requirements and, in 2022, increasing the countercyclical capital buffer for banks twice during the year. The IMF has noted repeatedly that the CBA is in compliance with the Basel methodology for risk supervision and that its risk-based framework meets with international best practices. In sum, while the banking sector has seen an increase in both deposits and household lending, for the moment, the sector appears able to handle the developments it faces.

External Economic Relations

Armenia has traditionally been a net importer—except for in 2022, when in light of the sharp rise of re-exports to Russia, Armenian exports registered impressive growth and moved the country’s current account balance into surplus. One of the main characteristics associated with Armenia’s external trade is its concentration, both geographically and in terms of products. Russia is not only the main export market for Armenia but also the main supplier of the country.

Overall, around half of the imports of Armenia come from Russia and EU countries. Moreover, between 2013 and 2023, Russia’s share in Armenia’s imports increased from 26.0% to 32.3%, while the share of the EU countries decreased from 23.4% to 15.1%. Regarding exports, the value and share of Russia have also increased. In the same period, Armenia’s exports to Russia increased tenfold, while its share in total exports nearly doubled from 22.6% to 40.4%.

It must be mentioned, however, that the exceptional growth seen in 2022 and 2023 in exports to Russia (nearly 3 times in 2022 and 1.4 times in 2023 compared to the previous year) is unsustainable since it is a result of an external shock.

Armenia’s exports also exhibit a high concentration of exported products. Between 2013 and 2021, three commodities—copper ores and concentrates, spirits, and cigarettes—annually accounted for approximately 41% of total merchandise exports, on average. These concentrations pose challenges as they can make Armenia’s economy vulnerable to external shocks, market fluctuations, and disruptions in specific sectors or regions.

Armenia’s landlocked location, closed borders with two of its four neighbours, coupled with poor physical infrastructure and logistics, harms the country’s competitiveness in external markets. Armenia’s international trade predominately relies on freight corridors through its northern neighbour Georgia. However, recently, there have been talks about opening the land border between Armenia and Türkiye for the citizens of third countries and persons holding diplomatic passports, which several international organisations see as potentially positive for the connectedness of Armenia.

Foreign capital has a substantial presence in Armenia's economy. However, as of 2022, three countries—Russia, Cyprus, and Switzerland—accounted for about half of the stock of FDI in the country, with Russia remaining the main foreign investor in Armenia's economy. Similarly, three sectors—financial service activities, electricity and gas supply, and metal ore mining—accounted for 60% of the stock of inward FDI, with financial services activities, except insurance and pension funding, leading the sectoral distribution (32.7%). Investments in the banking sector dominate the total investment in financial service activities since 18 banks operating in the Armenian financial sector have some level of foreign ownership.

Energy Sector

Since Armenia has limited energy resources, it can meet only a fraction (27.0%) of the total demand from domestic sources and is highly dependent on imported energy resources, such as oil and gas, with the main supplier being Russia. Moreover, the Russian Gazprom is the owner of all gas infrastructure in Armenia and has exclusive rights to import, transport, and distribute gas to consumers. The state of the infrastructure is another challenge in Armenia's energy sector. For example, much of the country's electricity distribution infrastructure, including power lines and substations, is in need of modernisation given its age.

The primary domestic sources of energy production in Armenia are nuclear energy and hydroenergy. However, it must be mentioned that the fuel for nuclear energy in Armenia is again imported from Russia. Armenia's energy policy over the last few years has been focused on developing domestic energy sources, mainly renewables like solar and wind, to lower its energy dependency. However, the expansion of the installed capacity of solar energy will not only bring significant benefits but also present challenges for Armenia, particularly in dispatching costs and balancing supply with demand. Armenia will need to incorporate storage solutions to manage the variability in energy production. Additionally, the grid infrastructure must be capable of handling the rapid changes in energy generation, which may require investments in smart grid technologies to efficiently dispatch energy and maintain stability.

8. Recommendations

Macroeconomic Policy

- At the beginning of 2024, the income of the RA state budget has already been affected by the diminishing economic stimuli that have driven rapid growth over the past two years. Given this situation, it is advisable to strategically reduce the growth rate of state budget expenditures on current expenses. This approach is recommended to ensure fiscal sustainability and to reallocate resources towards more critical areas that can foster long-term growth and stability.
- With support from international donors, the state should undertake capital expenditures that target inclusive and robust economic growth—for example, in areas such as infrastructure, education, healthcare, and renewable energy. Investments in these areas have the potential to generate widespread benefits across various socio-economic groups, while collaborating with international donors will enable the implementation of initiatives that are beyond the capacity of domestic funding alone.
- As the proportion of public debt in Armenia’s national currency increases, primarily sourced from the local market, it is crucial to address the potential risks associated with increased domestic borrowing. To mitigate these risks, it is recommended that the government explore opportunities to secure funding in the national currency from international borrowers.
- Given that inflation rates continue to fall below the lower threshold of the target range, it is recommended to pursue a strategy of monetary easing by gradually lowering the refinancing rate. This reduction in the cost of borrowing will encourage increased consumer spending and business investment, thereby boosting overall economic activity. At the same time, the downward policy rate path will help to align price levels with the desired inflation target, ensuring that the economy avoids the risks associated with prolonged deflation.

Microeconomic and Sectoral Policy

- The increase in lending for mortgages and the construction sector requires monitoring to ensure that a bubble does not develop. With monetary policy easing and deflation starting to work its way through the economy, the dangers of a construction bubble arising are increasing, with households moving even more actively into mortgages.
- The developments following the Russo-Ukrainian war, including the influx of labour and capital, increased re-exports to Russia; this not only stimulated significant economic growth in Armenia but also led to some changes in the structure of the economy. In this light, it is recommended to develop and implement policies targeting sustainable growth in priority sectors, including the high-tech industry, and export-oriented sectors, with a special focus on services. To achieve this, it is recommended to develop a comprehensive export strategy that takes into account the

evolving economic landscape and the new opportunities arising from these developments. There has already been some progress in this direction.

- Advance and accelerate the development of solar power to reduce Armenia's reliance on imported gas and foster a more resilient and self-sufficient energy infrastructure. Develop a comprehensive approach that will address both the technical challenges of managing the integration of renewable energy sources into the existing power system and the economic aspects of ensuring that the transition to renewable energy is both secure and cost-effective. It is crucial to strengthen the grid infrastructure in Armenia. Notably, electrical grid systems need to be upgraded to accommodate increased solar power generation and ensure reliable distribution; investment is also required in energy storage solutions to manage supply and demand effectively.
- Strengthening regional integration is a key component of Armenia's energy security. It is essential not only for diversifying energy sources but also for enhancing the resilience and stability of Armenia's energy supply. Armenia should prioritise investments in upgrading the electricity infrastructure that connects the country to Georgia to facilitate better technical synchronisation, as well as upgrade and develop the links with Iran.

Institutional and Legal Changes

- Implement comprehensive public administration reforms that will include changes in organisational structures, decentralisation, public finance, and results-based management, among other elements. Although there has been progress toward public administration reforms over the last decades, there is a need for thorough reviews of existing ministries, government agencies, and departments to identify overlapping functions, inefficiencies, and areas for consolidation. It is also essential to strengthen citizen engagement and transparency.

External Economic and Political Relations

- Assess the progress of activities under the Comprehensive and Enhanced Partnership Agreement (CEPA) signed in 2017 between Armenia and the EU and explore opportunities for new initiatives that align with Armenia's strategic interests and the evolving EU-Armenia partnership.
- Armenia, as a member of the EAEU, benefits from a range of economic and trade opportunities within the union. However, to further enhance its economic growth and diversify its trade relations, Armenia should seek special status within the EAEU, which would enable it to independently negotiate and establish trade agreements with third countries. This move aims to enhance Armenia's global trade presence while maintaining its commitments to the EAEU.
- Facilitate trade by leveraging the WTO's flexibility and bilateral negotiations. Armenia's ambition to enhance and diversify its trade relations, particularly with the EU, necessitates the exploration of various trade facilitation mechanisms. While the WTO provides a framework and rules for international trade, flexibilities and provisions exist that, if adeptly navigated, can aid Armenia in achieving its trade objectives. This includes understanding permissible subsidies, leveraging special provisions for developing countries, and engaging in bilateral negotiations to create favourable trade conditions. In particular, Armenia could utilise WTO-compliant subsidies. This

requires a nuanced understanding of WTO rules, identification of subsidies permissible under WTO rules, and active engagement in bilateral negotiations. Armenia needs to work towards agreements that recognise certain Armenian subsidies as acceptable, for example, provided they meet agreed-upon criteria, such as transparency and non-distortion of EU markets. It is advisable to utilise the services of WTO advisory bodies or other international organisations to navigate complex negotiations and compliance issues.

- Armenia's geographic location presents both opportunities and challenges for international trade. Utilising Türkiye's territory for the transit and export of goods can significantly enhance Armenia's trade efficiency and market access. To capitalise on this opportunity, Armenia needs to engage in negotiations with Türkiye to establish favourable terms for using Turkish territory for export purposes, for example, to the EU.
- The Middle East represents a region of significant economic potential for Armenia, offering opportunities for trade and economic cooperation. Establishing and enhancing economic relations with Middle Eastern countries such as Iraq, Syria, and Lebanon can diversify Armenia's trade partnerships, access new markets, and foster economic growth. Armenia should prioritise active engagement with this region to capitalise on these opportunities.
- Proactively engage with international development partners to increase development assistance, with a particular focus on financing critical strategic projects. For example, the construction of a new nuclear power unit is a critical strategic project; however, the financial and technical requirements of such a project are substantial, necessitating robust international support and development assistance. In this regard, it is also essential to ensure regulatory and institutional readiness to manage the development and operation of the new nuclear power unit. It is imperative to invest in capacity-building programmes to ensure that Armenian institutions and professionals are equipped to oversee the project and meet international standards, as well as to develop capacities for waste management and decommissioning, ensuring that all aspects of the nuclear power unit's lifecycle are responsibly managed.

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