TOWARDS AN EMPLOYMENT-FRIENDLY MACROECONOMIC POLICY FRAMEWORK: THE C ASE OF ARMENIA

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Towards an employment-friendly macroeconomic policy framework: The case of Armenia

The policy paper prepared for the ILO Decent Work Team and Country Office for Eastern Europe and Central Asia by Iyanatul Islam, Adjunct Professor, Griffith Asia Institute, Griffith University, Australia and former Branch Chief, ILO, Geneva

Acknowledgement

This study was prepared with the guidance and support of ILO, Moscow. The preliminary results were presented at a workshop in Yerevan, Armenia (26 May, 2017). The workshop was hosted by the National Institute of Labour and Social Research. Notable ILO constituents actively participated at the workshop and offered their feedback. The participants strongly endorsed the findings. There was a widely shared view at the workshop that macroeconomic policy issues need to be fully comprehended in order to make labour market policies more effective in meeting their goals.

Apart from the workshop, a number of meetings with ILO constituents were held to discuss the findings (24 to 26 May, 2017). Extensive and very fruitful discussions were held with:

- Head of Labour and Employment Department, Ministry of Labour and Social Affairs
- Head, State Employment Agency
- Head, Division on Strategic Programming, Department on Strategic Programming and Monitoring, Ministry of Economic Development and Investments
- Head, Division of Monitoring and Evaluation, Department on Strategic Programming and Monitoring
- Director, Labour and Social Research Institute
- Deputy Chairman of Confederation of Trade Unions of Armenia
- Chairman, Republican Union of Employers of Armenia.

The usual disclaimer applies. Any remaining errors or omissions are the sole responsibility of the author. They should not be attributed to the ILO and/or any of the ILO constituents listed here.

Executive Summary

Armenia's current macroeconomic framework has been profoundly influenced by the 2009 recession whose severity shook the complacency of the policy makers because it ended a historically unprecedented boom. The government responded with an ambitious fiscal stimulus package which managed to shield the poor and vulnerable from even worse outcomes and set the basis for a quick recovery. It also strengthened the hands of those who argued for large-scale fiscal consolidation to offset a sharp increase in the fiscal deficit and public indebtedness in 2009. This set the basis for an ambitious fiscal consolidation programme that is expected to intensify in 2017.

The fiscal consolidation agenda is guided by a debt rule that has received the imprimatur of the IMF through its lending arrangement that is still active. At the same time, the Armenian central bank has guided monetary policy with a view to upholding the medium-term inflation target of 4 per cent combined with a flexible exchange rate regime. These twin pillars of macroeconomic policy – debt rule and inflation targeting – are, in principle at least, to be complemented by a structural reform agenda that would unleash private sector-led growth and employment by reducing the regulatory burden on the business community.

The Armenian Development Strategy (ADS) that is expected to prevail between 2014 and 2025 has emerged under the shadow of fiscal consolidation. The ADS reflects the country's developmental aspirations to become an upper middle income country by 2025 with low levels of poverty and plentiful supply of well-paid and productive jobs.[1]

[1] It was pointed out to the author during one of the meetings held in Yerevan (24 May to 26 May, 2017) that the ADS and its revisions will henceforth be the responsibility of an autonomous body. It will consist of technical experts drawn from a wide range of institutions.

ADS has resolved the tension between macroeconomic imperatives and developmental aspirations by projecting that the key parameters of low debt and price stability will be achieved while meeting core development goals. The reality has, so far at least, turned out to be quite different. The growth target of 6.5 per cent is unlikely to be achieved if the IMF projections of 4.0 per cent medium term growth are to be believed. Public debt will be sustainable, but will be significantly higher than what is allowed for in the ADS projections and dominated by risky external debt.

The ADS has emerged against a background of sombre structural realities. Poverty in Armenia today is in excess of what it was in 2006, while the country is saddled with double digit unemployment rates, especially for young people, low labour force participation rates and employment rates. Poverty affects at least 25 per cent of the employed work-force.

Armenia also faces the challenge of disengaging from a pre-crisis growth model that was unsustainable and led by the construction sector. The government expects an economic revival led by manufacturing, high-end services and tourism. It seeks to support SMEs and revitalize the agricultural sector. These are laudable goals made even more impressive by the fact that the ADS has promulgated numerical targets across a wide range of policy areas.

The ADS is particularly noteworthy for its articulation of labour market and social protection policies. It seeks to spend more on health and education, social protection schemes, raise minimum wages well above the poverty line and is committed to reducing informality. The government embarked on new initiatives under active labour market policies by phasing out a modest programme of unemployment benefits in 2014.

The main challenge to Armenia's developmental aspirations emanates from its macroeconomic policy framework. The IMF acknowledges – and other international agencies agree – that the nature and scale of fiscal consolidation is rather ambitious and has damaged growth and employment prospects at a time when the external environment is not hospitable. This is because fiscal consolidation has been led by expenditure cuts especially in the area of capital expenditure which has large fiscal multipliers. Monetary policy has provided insufficient impetus to aggregate demand and has thus not been able to offset the contractionary consequences of fiscal consolidation.

One could argue that fiscal consolidation is unavoidable and that the way forward lies in improving the business climate through structural reforms that will enable private sector led growth to offset public sector demand. This is an overly optimistic, if not simplistic, perspective.

The paper offers pragmatic alternatives that can empower the government to pursue its 2025 vision with renewed vigour. The debt rule that has been the trigger for fiscal consolidation, especially for 2017, needs to be reviewed preferably under an independent fiscal commission.[2] There is ample international experience that such a commission might draw on. It could encourage the government to think in terms of flexible, investment-friendly fiscal rules rather than being fixated by specific debt targets. It could endorse the professional consensus that government's growth and employment objectives would be best served by revenue-based fiscal consolidation rather than expenditure cuts as is currently the case. Fiscal policy should really be a tool of development finance geared towards sustainably financing core development goals as laid out in the ADS.

[2] The IMF now acknowledges that the government has agreed to review its current approach to fiscal policy. As it notes: 'The (IMF) supports the authorities' plans to amend the existing pro-cyclical fiscal rule…' See http://www.imf.org/en/News/Articles/2017/04/12/pr17128-armenia-imf-staff-concludes-the-fifth-and-final-review-under-eff-and-2017-article-iv-visit

In the realm of monetary policy, which is saddled with the challenge of 'undershooting' of the inflation target in a deflationary environment and rather high policy rates in real terms, the central bank could consider the adoption of a 'dual mandate' in which equal weight is given to both price stability and employment objectives. At the same time, it could play a more active role in supporting the agenda of financial inclusion that has been shown to be an effective vehicle for both direct and indirect job creation and in reducing poverty.[3]

In the sphere of labour market policies that can complement an employment-friendly macroeconomic framework, one needs to move beyond a preoccupation with a regulatory reform agenda inspired by the need to do well in the much-noted Doing Business Indicators. Diluting Armenia's labour code, which provides a reasonable degree of protection to workers is unlikely to lead to plentiful supply of well-paid and productive jobs or a major reduction in informality.[4] Enterprise surveys show that labour regulations are not considered by the private sector to be the most important constraint.

The paper suggests that an employment-friendly macroeconomic framework can be complemented by labour market policies that are aligned with the goals of the ADS. This includes a commitment to reducing informality, raising minimum wages and supporting active labour market policies.

A reduction of informality is best achieved through policies that facilitate structural transformation, improve educational attainment and enhance tax coverage and compliance. The government envisages minimum wages to play a major role in eradicating working

[3] It was pointed during the workshop (26 May, 2017) by one of the participants that the Armenian central bank also includes the maintenance of financial stability as one of its core goals. This observation is compatible with advocacy of a 'dual mandate' for the central bank.
[4] During the meeting with Ministry of Labour and Social Affairs officials (24 May, 2017), it was pointed out to the author that the current labour code is scheduled for revision by 2018.

poverty even though they might lead to a modest negative impact on aggregate unemployment. This has to be weighed against the gains in living standards of the employed work-force.[5]

The government has made a promising start with active labour market policies. More needs to be done, especially in terms of comprehending what works best in terms of specific policy interventions. Indiscriminate funding of ALMPs may not yield good employment dividends, although ALMPs could benefit from more budgetary allocations that are in line with international norms. The paper argues that the agenda of enhanced employability for all is best achieved by increasing the coverage and quality of the overall education and training system.

[5] Union officials at the workshop presentation of this study (26 May, 2017) emphasized the critical role that minimum wages play in reducing working poverty.

Background and context

Armenia is small (population a little over 3 million), land-locked, but highly open, lower middle income country in the South Caucasus. Following the dissolution of the former Soviet Union, Armenia began its life as an independent state in 1991 in rather traumatic circumstances. Its per capita income dropped by more than 40 per cent. Fiscal imbalances reached crisis proportions. There was an exodus of mainly young people on such a scale that the population shrank and the size of the potentially productive work-force shrank even more. It was wracked by border disputes which, to this day, remains unresolved.

Despite such inhospitable initial conditions, Armenia managed to stage an economic recovery. This was partly due to policy reforms and partly due to benign external conditions – most notably the recovery of the Russian Federation, which happens to be a major trading and strategic partner.[6]

Armenia grew at a rapid rate throughout the late 90s to 2000s. There was a boom characterized by double digit growth that prevailed between 2003 and 2007. The boom ended when Armenia was deeply affected by a recession in 2009 in the wake of the global recession of 2008-2009. It has recovered since then, but growth remains tepid and expected to remain so over the medium-term. Net migration is still significant affecting the dependency ratio and the size of the work-force. External conditions have become adverse, especially because Russia is still in recession and unlikely to return to a path of robust growth in the medium-term.

[6] One estimate suggests that the contemporaneous correlation between Russian growth and Armenian growth is around 0.9 – which is indeed very high (Ayvazyan, K , 2015, 'Spillovers from Global and Regional Shocks to Armenia', IMF Working Paper No. 15/241

Despite rapid growth in the past, Armenia remains saddled with unsatisfactory labour market and social indicators. The overall unemployment rate is 18.5 per cent, while the female unemployment rate is close to 20 per cent. The youth unemployment rate is more than 30 per cent. Much of the unemployment (60 per cent of the total) is of a long-term nature. The employment rate is low (50 per cent). Income poverty is high even by national standards, with a working poverty rate of 26 per cent. More than the 40 per cent of the work-force is still dependent on low productivity agriculture. [7]Clearly, these indicators are far below the government's aspirations as reflected in its long-term development strategy of 2014-2025.[8] By then, the objective is to attain an upper middle income country status, with a per capita income which is roughly three times the level that prevails now. The government aims for a growth rate of 5.5 to 6.5 per cent, with greatly reduced poverty and good employment outcomes.

The four priorities of the government under the 2025 vision are:

1. Growth of employment
2. Development of human capital and skills development
3. Improvement of social protection system
4. Institutional modernization of public administration and governance.

In March 2014, the government secured financial assistance from the IMF under its Extended Funding Facility (EFF) which is a sequel to the Standby Arrangement (SBA) that Armenia had in the wake of the recession of 2008-2009. The SBA, which was approved in

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[7] These statistics are available under 'country profiles' maintained by ILOSTAT

[8] *Armenia Development Strategy for 2014-2025*, Annex, RA Government Decree, No.442, March 27, available at http://faolex.fao.org/docs/pdf/arm151333.pdf

March 2009, had a duration of 28 months, while the EFF has a duration of 38 months. Thus, Armenia's macroeconomic framework has been shaped by its interaction with the IMF and will remain so for the medium term. A review of progress under the EFF was completed in June 2016 and another took place in December 2016. The key elements of the EFF are:

1. Fiscal adjustment in 2016-2017 with the aim to attain sustainability of public debt
2. Implementing tax reforms
3. Creating fiscal space through higher tax revenues to support capital expenditure and address social needs
4. Ensuring greater exchange rate flexibility to reduce the current account deficit
5. Strengthening the monetary framework
6. Further strengthening of financial sector supervision
7. Improving the business environment to enhance competitiveness and reduce poverty.[9]

While one recognizes that the current macroeconomic framework – and the objectives specified above – has evolved as a result of the government's partnership with the IMF, it remains to be seen whether this framework will enable the government to respond to the aspirations laid out in the 2025 vision. For example, in the EFF there are no clearly specified targets on productive employment creation, nor on the financing and institutional needs of a comprehensive social protection system. There is a focus on financial sector supervision, but none on financial inclusion which can, as global evidence has shown, be an important source of poverty reduction and employment creation. There is too much emphasis on

[9] All documentation on IMF's interactions with Armenia can be found in http://www.imf.org/external/country/ARM/

improving the business environment and none at all on either passive or active labour market policies, including skills development. There is hardly any discussion of wages policy, nor of the challenges of reducing informality.

The EFF also pays insufficient attention to youth employment. Because of the lack of job opportunities for youth both skilled and unskilled, there is considerable migration of young people which is depriving Armenia of a key asset for sustainable growth in the mid-term.

In light of such lacuna, there is a case for revisiting the macroeconomic framework as it has evolved under EFF and, based on this review, suggest how one can strengthen the employment and social dimensions of the macroeconomic framework.

Structure of the study:

The background and context of the study set out above leads one to suggest the following structure for this paper. Section 1 briefly highlights the labour market and employment challenges facing Armenia within the milieu of recent growth performance and structural change. Poverty trends will be highlighted and their links to labour market status will be noted. A critical review will be offered of the 'old' growth model that prevailed in the pre-crisis period and why that is no longer deemed to be effective. Section 2 will revisit the 2025 vision of the government and note the key employment related targets and policy actions proposed by the government. This will in turn entail a brief assessment of the extent to which progress has been made in relation to the proposed targets. These sections will suggest that recent growth performance has been rather unsatisfactory. As a result, Armenia has fallen well below the growth target specified in the 2025 vision. This in turn means that the employment targets have also not been met, while progress in terms of poverty reduction and greater formalization of the economy have stalled. The lack of an enabling external environment has admittedly played a role in shaping such poor outcomes, but the internal policy environment has to be held primarily responsible for such outcomes.

The first two sections paves the way for a depiction of the current macroeconomic framework in Armenia as it has evolved under the influence of the IMF-supported IMF. Section three will suggest that the Armenian government cannot expect a great deal out of the current EFF. In particular, the government might wish to review a macroeconomic framework that is beholden to fiscal rules with their primacy on attaining fiscal consolidation rather than growth, employment and poverty reduction. At the same time, monetary policy has been insufficiently supportive of aggregate demand.

Having identified the key elements of the current macroeconomic framework, the paper will evolve into section four that will deal with a series of policy recommendations. It will commence with fiscal policy which is overly influenced by the government's fiscal rule on public debt. The biggest challenge is to move away from a framework that has sought to meet prudential targets pertaining to public debt by cutting down on public investment and by neglecting much needed expenditure on health and education.

The paper will also note that, according to the government's self-assessment (as reflected in research undertaken by the National Statistical Agency), an additional two per cent of GDP will need to be devoted to enhance the expenditure envelope that will eradicate poverty. This additional two per cent could be used to fortify social protection schemes, support active labour market policies and enhance public investment. The key issue, of course, is the sustainable financing of the two per cent target. This is where revenue mobilization using tax reforms becomes critical along with re-prioritization of public expenditure. A more pro-growth, employment-friendly approach to the current public debt driven fiscal rule is needed. The problem is not public debt per se but its composition which is heavily skewed towards external debt.

On the monetary policy front, the paper suggests that the government needs to re-think its preoccupation with an inflation targeting (IT) regime. Comparative analysis and evidence have now shown that an IT framework is insufficiently effective in boosting aggregate demand in a low inflation environment which is the current global norm. The Armenian central bank can certainly maintain an inflation target within a range that is appropriate to local circumstances. The monetary authorities clearly have an obligation to sustain financial stability, but more attention needs to be given to financial inclusion as a means of supporting growth and employment objectives.

The paper will also argue, through section five, that one needs to think of policy instruments beyond conventional fiscal and monetary policies that has the potential to boost growth and employment. The paper commences with a critique of the influential view that reducing the regulatory burden on the business community is a principal way of unleashing private sector-led growth and employment. Instead, the paper discusses a suite of labour market policies that can complement an employment-friendly macroeconomic framework. This leads the section to a discussion of ways of reducing informality, the role of minimum wages in reducing working poverty and active labour market policies to enhance employability. These issues are fully aligned with the goals and targets of the ADS.

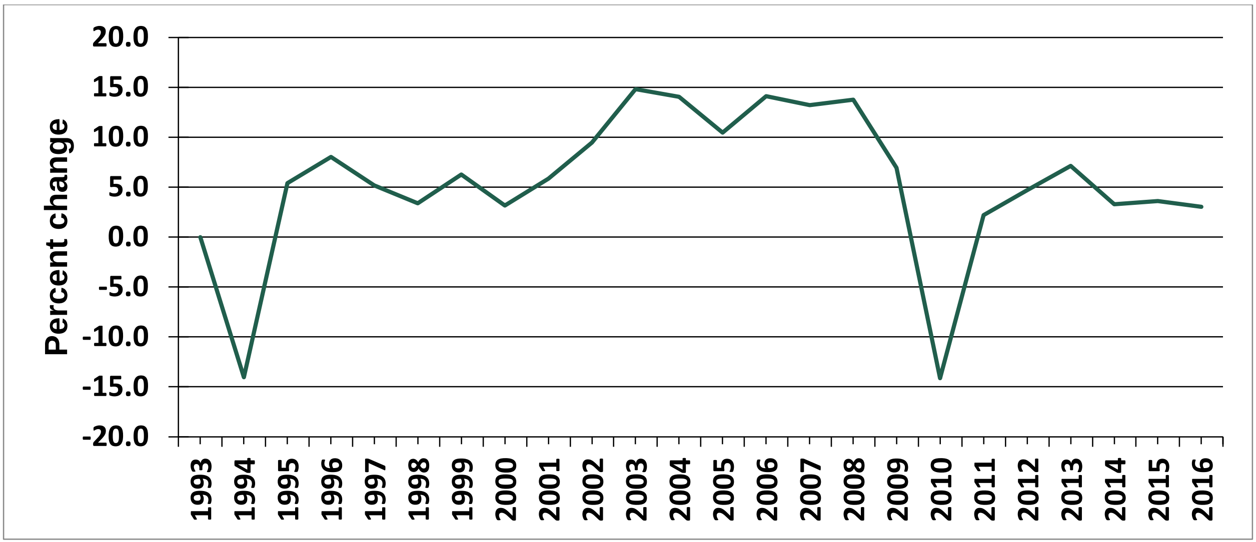
1. Labour Market and Employment Challenges in a Context of Slow Growth

Economic growth and structural change

The trajectory of Armenian growth has followed distinct phases: (a) an initial post-transition period of disruption and recession (1991-1993); (b) recovery and solid growth between 1994 and 2001; (c) the boom of the mid to late 2000s characterized by double digit growth and (d) recession followed by tepid recovery since 2010.

Figure 1 highlights the various growth milestones. The two steep recessions of the order of 14 per cent in the early 1990s and 2009 are evident. Double digit growth in excess of 10 per cent is clearly discernible between 2002 and 2007 as is the slow recovery after 2010. Indeed, the national statistical service of Armenia (ARMSTAT) notes that the fourth quarter of 2016 was characterised by negative growth of 1 per cent.

Figure 1: Armenia: GDP growth, 1993 to 2016



Sources: IMF, World Bank, national statistical agency as compiled by knoema.com

Given the boom of the 2000s, it is tempting to ask whether one should seek to replicate the pre-crisis growth model. Unfortunately, the conditions enabling the conspicuous boom prior to the 2009 recession was unsustainable. As one study notes, growth during the boom years were

'…(N)arrowly based on expansion of residential construction, domestic services and foreign exchange inflows. Fueled by remittances, the construction sector expanded by 5.2 times between 2001 and 2008 and dominated the economy with 25 per cent share in GDP. During the same period, the manufacturing sector declined from 17 per cent to 9 per cent of GDP; large remittance inflows and appreciation of the national currency rendered domestic tradables uncompetitive and left the economy highly vulnerable to economic shocks'.[10]

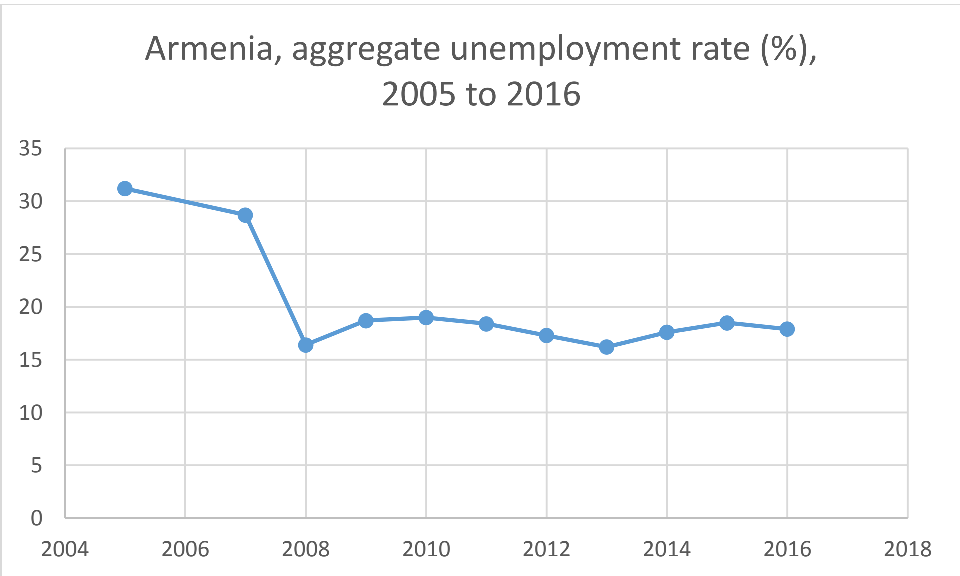
[10] World Bank (2013) 'Country Partnership Strategy for the Republic of Armenia, FY 2014-FY2017', October, Washington DC, October, p.iii

Such ‘external shocks’ materialized in 2009 as the global recession took hold and external financing of the domestic construction boom dried up. The construction sector contracted by a massive 48 per cent and accounted for 78 per cent of the decline in overall GDP.[11]

It would be churlish to deny that the short-lived pre-crisis boom did not bring about any tangible benefits. Armenia made the transition to a lower middle income economy in less than 10 years. Poverty – on which more later – fell sharply. By 2015, Armenia had either met many of the MDG indicators or was poised to do so.

When one examines socio-economic progress in Armenia through the prism of labour market indicators, a rather different – and disappointing – picture emerges. As can be seen in figure 2, the overall unemployment rate was actually significantly higher during the pre-crisis period than in the period following the recession of 2009. This is also manifested in trends in the youth unemployment rate both for males and females (figure 3).

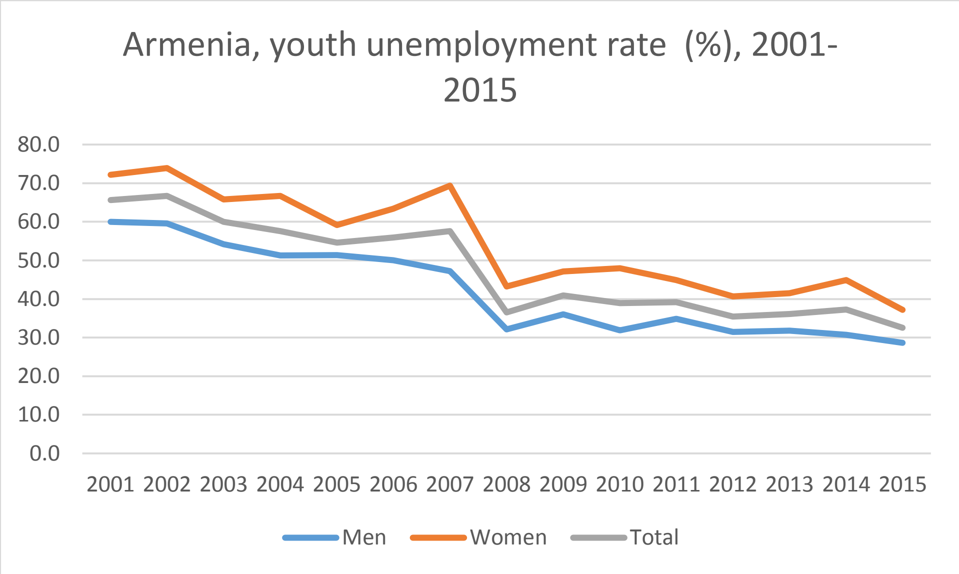
Figure 2



[11] World Bank (op.cit)

Source: ARMSTAT, Statistical Yearbook 2016 and knoema.com for observations prior to 2011

Figure 3

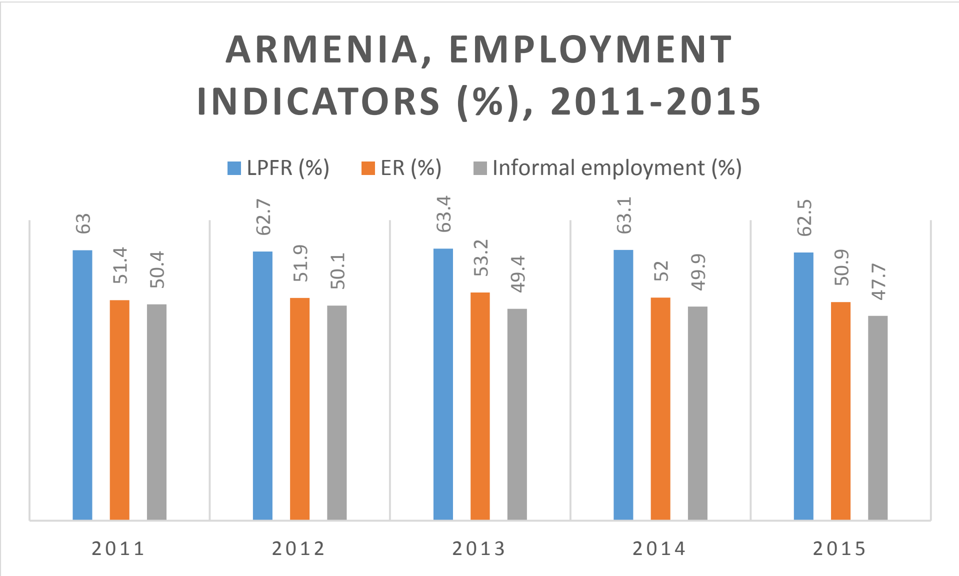


Source: National statistical agency (ARMSTAT), MDG database

The issue of unemployment in the pre- and post-2009 period deserves further study. One can only make some plausible conjectures here. First, the mid-2000s boom was led by the construction sector, but its expansion was offset by a sharp contraction of the manufacturing sector with adverse implications for net job creation. Second, it is possible that a significant part of the unemployment rate was voluntary in nature, with high remittance inflows engendered by the boom enabling households and individuals to finance periods of unemployment and to look for better employment opportunities rather than seek casual and low-paid work in construction. This proclivity might have been fortified by enhanced social protection measures.

In low and middle income countries, employment-related indicators, rather than unemployment, might be a better gauge of labour market performance. Pertinent information is provided in Figure 4 encompassing labour force participation rates (LFPR, %), the employment rate (ER, %) and the informal employment rate (%). As can be seen, the LFPR has hovered around 62-63 per cent. The employment rate between 50 and 53 per cent is rather low by both regional and international standards. There is a welcome reduction in the informal employment rate between 2011 and 2015, although at nearly 48 per cent, it is still quite high.

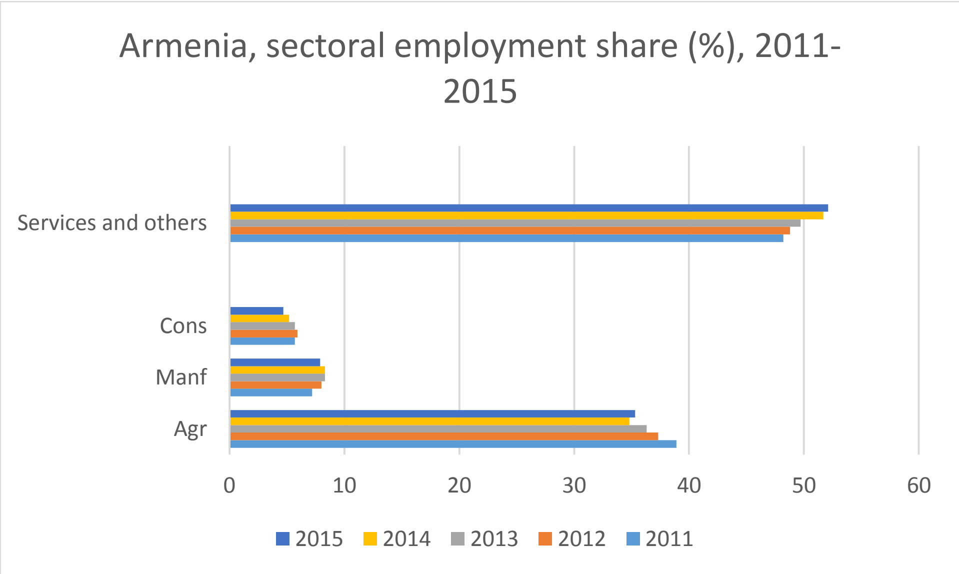
Figure 4



Source: ARMSTAT, Statistical Yearbook, 2016

As noted above, a major challenge facing Armenia is the lack of sustainable and productive structural transformation. The construction sector-led boom in the pre-2009 period was unsustainable and occurred in a context of rapid de-industrialization. In light of these concerns, Figure 5 tracks employment trends between 2011 and 2015 at the sectoral level, with a focus on agriculture, manufacturing and construction. The agricultural sector continues to shrink, although well over a third of the work-force still depend on it for livelihoods. There has been some revival in the employment share of manufacturing, but at around 8 per cent of the work-force, it still languishes well below the level that prevailed decades ago. Construction is no longer a major sector accounting for less than 5 per cent of total employment. It is clear that the services sector is the predominant source of employment in Armenia today and is likely to remain so in the medium term.[12]

Figure 5



Source: ARMSTAT, Statistical Yearbook 2016

[12] In figure 5, services is collated with 'others' that includes utilities, sanitation, transport and storage and self-employment and activities lf 'extraterritorial organizations'. In 2015, the 'others' amounted to less than 7 per cent of total employment. Within services, public administration and education accounted for 18.7 per cent of total employment in 2015. See, Statistical Yearbook, 2016, pp.61-63

Poverty trends in Armenia[13]

It would be useful at this juncture to delve into poverty trends in greater detail, given that it appears that poverty fell significantly at a time when the unemployment rate was high, the employment rate was low and the informal employment rate was high as well. In undertaking this discussion, one can draw on the work of the national statistical agency that has undertaken a comprehensive analysis of the nature of poverty and its links to the labour market in Armenia.

The approach to poverty monitoring in Armenia is multi-faceted. The approach uses multiple national poverty lines to identify 'extremely poor', 'very poor' and 'poor' categories.[14] Significant progress has been made across categories as Table 1 shows. Extreme poverty is very low (at less than 3 per cent). The significant reversal in poverty reduction as a result of the 2009 recession is also clear. Thus, overall poverty fell sharply from 53.5 per cent to 26.4 per cent between 2004 and 2007, but by 2009 it was above the level that prevailed in 2006 (30.2 per cent). While there has been some improvement since then, poverty in 2013 (at 32.0 per cent) was still higher than the 2006 benchmark.

[13] The discussion draws on ARMSTAT, Part 1 – Armenia: Poverty Profile and Labor Market Developments in 2008-2013

[14] Overall poverty is based on a national poverty line of 39,193 AMD/month (or 81 USD/month at the current exchange rate). Those who are very poor is based on a national poverty line of 32,318 AMD/month (or 67 USD/month at the current exchange rate). Extreme poverty is based on the food poverty line (22,993 AMD/month or 47 USD/month at the current exchange rate.

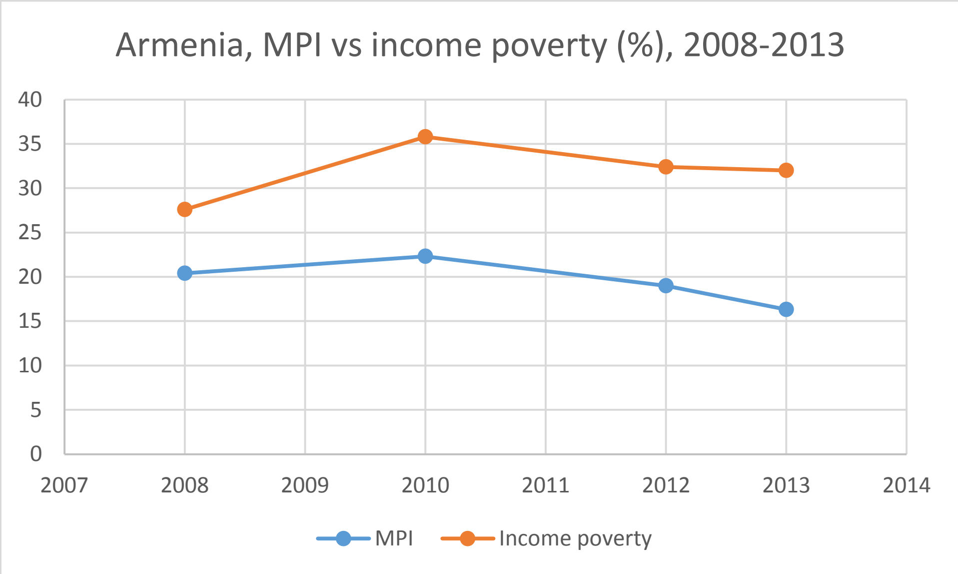
Table 1: Armenia, poverty trends, 2004-2013

Year	Poor	Very Poor	Extremely Poor
2004	53.5	32.6	4.4
2005	40.1	19.6	3.3
2006	30.2	14.2	2.3
2007	26.4	14.5	2.0
2008	27.6	12.6	1.6
2009	34.1	20.1	3.6
2010	35.8	21.3	3.0
2011	35.0	19.9	3.7
2012	32.4	13.5	2.8
2013	32.0	13.3	2.7

Source: ARMSAT, Part 1 – Armenia: Poverty Profile and Labor Market Developments in 2008-2013.

The national statistical agency also provides estimates of 'multidimensional poverty'. This broader notion of poverty encompasses deprivation in various spheres. In the Armenian case, an overall multidimensional poverty index (MPI) consists of aggregating multiple deprivations in education, health, labour, housing and food. As Figure 6 shows, after a temporary reversal in 2010 as a result of the 2009 recession, MPI has declined significantly over the relevant period. Furthermore, the incidence of MPI is not only lower than overall income poverty (the incidence is much closer to those who are classified as 'very poor'), but the reversal during the 2009 recession was also less severe.

Figure 6



Source: Derived

Source: ARMSAT, Part 1 – Armenia: Poverty Profile and Labor Market Developments in 2008-2013, page 57.

The lower line is MPI, while the upper line is income poverty.

The poverty-employment linkage is shown in Table 2. It is clear that, as recorded in 2013, the rate of working poverty is still high and ranges between 28.5 per cent and 25.6 per cent. It is also clear from Table 2 that poverty incidence among unemployed people is well above the national average.

In light of above finding, it would be useful to revisit the poverty-unemployment linkage by tracking co-movements between the two. This is shown in Figure 7. As the high unemployment rate down comes between 2005 and 2007, so does income poverty, although at a much faster rate. On the other hand, the impact of the 2009 recession on the unemployment rate is much lower than on income poverty.

In sum, the analysis undertaken here suggests a significant link between poverty and employment status, although the correlation is by no means perfect. In any case, the prevailing labour market, poverty and social indicators are far below the aspirations of the

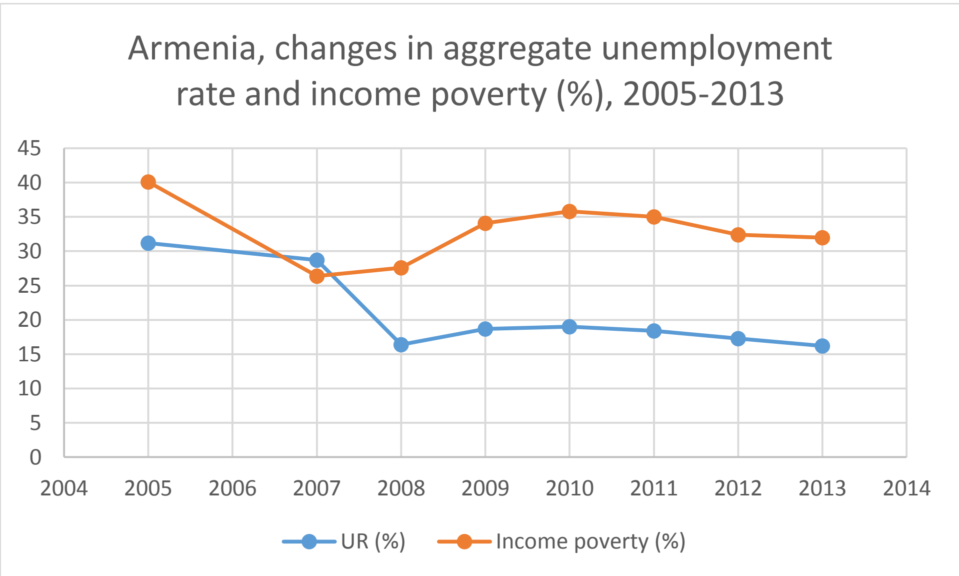
Armenia Development Strategy (ADS) with its 2025 vision to make the country a prosperous upper middle income nation. It is to the ADS that the discussion now turns.

Table 2: Poverty-employment linkage

Employment status (2013)	Poverty incidence (%) (2013)
Employed	25.6 (below national average poverty rate of 32.0 per cent)
Wage employment	24.4 (below national average poverty rate of 32.0 per cent)
Self-employment	26.7 (below national average poverty rate of 32.0 per cent)
Other employed	28.5 (below national average poverty rate of 32.0 per cent)
Unemployed	39.8 (significantly above national average poverty rate of 32.0 per cent)

Source: ARMSTAT, Part 1 – Armenia: Poverty Profile and Labor Market Developments in 2008-2013.

Figure 7



Source: Derived from ARMSAT, Part 1 – Armenia: Poverty Profile and Labor Market Developments in 2008-2013 and Statistical yearbook, 2016.

2. Vision 2025: the tension between macroeconomic policy imperatives and developmental aspirations

The current version of the ADS was launched in March 2014 and is expected to be implemented between 2014 and 2025. Its predecessor was the Sustainable Development Program that was adopted in 2008. The 2009 recession and its aftermath necessitated a review and a revised document. The ADS is both ambitious and comprehensive cutting across growth, jobs, macroeconomic framework, regional development, poverty and inequality, social protection, human development, labour market policies, environmental management and governance. This brief review will focus on some – but salient elements - of the ADS, most notably, growth, jobs, macroeconomic framework and the government's poverty reduction goal. Other sections will discuss social protection and labour market policies. In particular, the discussion will seek to assess (a) the extent to which the various numerical targets are attainable and (b) the extent to which the current macroeconomic framework is compatible with the proposed numerical targets.

The ADS recognizes – in line with evaluations by external agencies – that the pre-crisis growth model is neither replicable nor desirable. As it notes:

'The economic growth model in Armenia formed prior to the crisis (2003-2008) was based on foreign financing…As a result in conditions of double-digit growth, imports grew rapidly, the competitiveness of local industrial products in domestic markets declined, non-agricultural employment rates did not grow and exports…(shrank).[15]

[15] ADS (2014), p.12

The ADS clearly notes how the boom was led by an unsustainable and rapid expansion of the construction sector juxtaposed with rapid de-industrialization. It seeks to reduce reliance on foreign financing, stimulate export-led growth and foresees a gradual reduction of the construction sector.

The 'new' economic model that it espouses is, as noted in the introduction to the paper, built around four pillars: creating productive and well-paid jobs, developing human capital, strengthening social protection systems, and improving the quality of public administration and governance.

The ADS is noteworthy for its emphasis on forward-looking numerical targets ranging across growth, per capita income, job creation, poverty, social protection, labour market policies, with specific reference to minimum wages, as well as macro-policy indicators

Table 3: Salient numerical targets in ADS – growth, job creation, poverty, structural transformation

Indicators	Baseline (latest available actual data as reported in ADS)	2025
Real GDP Growth (%)	3.6 (2012)	6.5
Per Capita GDP (USD)	3290 (2012)	9441
Job creation (non-agriculture)	100,000 (2011)	220,000
GDP share of agriculture	19.1	14.6
GDP share of industry	17.2	21.2
GDP share of construction	12.2	10.3
GDP share of services	38.6	42.3
Poverty (%)	32.0 (2013)	14.0

Source: ADS, p.29.

How realistic are these targets and projections? So far, based on most recent developments, the attainment of the various targets represents a significant challenge. For example, for 2021 the IMF projects a growth rate of only 4.0 per cent as against 6.4 per cent for 2021 in in the ADS. Given that the growth target is driving a lot of other indicators, poverty may not decline at such a rapid rate or the economic structure change on a scale that is envisaged. Furthermore, given that, based on the latest data (final quarter, 2016) released by the national statistical agency, job creation rates have not improved beyond the base line estimates, the challenge of enhanced job creation in the non-agricultural sector remains paramount.

It is to the macroeconomic policy framework that one needs to turn in order to form an appreciation of the potential tension between this framework and the developmental aspirations of the ADS. The plan documents accepts as given the goals set by the fiscal and monetary authorities. In the case of fiscal policy, there is a resolute commitment to continue with the fiscal consolidation that started in 2010 and is expected to intensify in 2017 in order to meet public debt targets under the government's current fiscal rule. In the case of monetary policy, the central has staked its credibility to maintain a long run inflation rate of 4 per cent.

The ADS resolves the potential tensions between a constrained macroeconomic policy framework and its socio-economic aspirations by projecting a smooth transition to the fiscal and inflation targets by 2025 while attaining the socio-economic goals pertaining to growth, job creation, poverty reduction and structural transformation. Table 4 shows the differences between the ADS projections and the IMF projections which are available until 2021.

Table 4: Macro-policy indicators – ADS vs IMF

Indicator	ADS: 2021	IMF:2021
Public debt (% of GDP)	35.3	54.6
Fiscal deficit (% of GDP)	-1.8	-1.7
Inflation	4.0	4.0
Current account deficit (% of GDP)	-3.8	-4.4
GDP growth (%)	6.4	4.0

Source: ADS (2014) and IMF (2016)

It is clear that both the ADS and IMF projections concur on most of the macroeconomic policy indicators, but there is a conspicuous discrepancy in the projected values of public debt. The ADS projections appear to be overly optimistic about the future path of public debt relative to the IMF projections. The source of this discrepancy presumably lies in the differences in growth projections between the ADS and IMF. The former is notably bullish, the latter much less so. Given that a higher projected growth rate for any given scale of fiscal consolidation is likely to lead to lower public debt ratios, the discrepancy between the ADS and IMF estimates becomes understandable.

Beyond the macroeconomic indicators, there are areas of social policy – most notably social protection and minimum wages – in which the ADS also has prescribed numerical targets. These are worthy of discussion in a subsequent section of this paper.

For now, it is suffice to say that optimistic growth targets do not necessarily invalidate the premise of the ADS. Its attempt to disengage from an unsustainable pre-crisis model is laudable. Its embrace of the need for a new framework is impressive. It clearly believes in sector-specific policies, such as promoting tourism development, supporting high-end services, such as IT and communications, and the need for a renewed commitment to agricultural and rural development. The challenge lies in reconciling these aspirations with a particular macroeconomic framework that is preoccupied with fiscal consolidation and influenced by monetary policy that provides insufficient – or least inconsistent - support to aggregate demand. The paper now turns to an elucidation of these issues.

3. Armenia's macroeconomic policy framework and the IMF-supported programme: implications for growth and employment

As noted, Armenia's post-crisis macroeconomic policy framework has two pillars: (1) fiscal policy driven by a fiscal rule on public debt management (2) monetary policy based on an inflation targeting regime combined with a flexible exchange rate arrangement. They are legacies of the pre-crisis period, but swung into action following evidence of recovery from the 2009 recession.

Fiscal policy: from stimulus to consolidation

Armenia's current approach to fiscal policy is contingent on a fiscal rule that was enacted in 2008. It is a 'debt rule' which might be stated as follows:

'The public debt may not exceed 60 per cent of GDP in any given year. If the ratio of public debt over the previous year's GDP exceeds 50 per cent, the deficit in the following year should be lower than the 3 per cent of the average GDP of the previous three years'.[16]

The statutory basis of the debt rule is a political commitment by the central government which has since then become a state law. There are no independent bodies that engage in oversight functions pertaining to implementation and impact. There are no well specified

[16] Budina, N et al (2012) 'Fiscal rules at a glance: country details from a new dataset, IMF Working Paper No.273, p.7

escape clauses. There is no attempt to protect particular categories of expenditure, most notably public investment, when fiscal consolidation is undertaken.

When the 2009 recession hit the Armenian economy, the government engaged in a major fiscal stimulus package and did not, at the time, seem concerned about the likely implications of such an intervention on the 2008 fiscal rule. At the time, public debt as a proportion of GDP was well below 20 per cent. The fiscal stimulus package led to an increase in nominal public spending by about 13 per cent and the fiscal deficit rose to 7.6 percent of GDP.[17] In the absence of such interventions poverty would have been higher by about 18 percentage points.[18] Hence, from that perspective the fiscal stimulus package was vindicated.

Yet, the scale of the growth collapse was so large that it could not prevent the debt to GDP ratio to rise to well above 30 cent by 2012 as shown in figure 8. This, together with the large fiscal deficit, and growing signs of recovery from 2010 onwards strengthened the hands of those who supported fiscal consolidation. The fact that the Armenian government has had frequent and, in many cases, sustained interactions with the IMF since mid-1995,[19] reinforced the need for the government to take a cautious approach to fiscal policy with its emphasis on sustainable public debt management.

Currently, the government has a lending arrangement with the IMF (known as 'Extended Funding Facility' or EFF) which will expire in May 2017.[20] As noted in the introduction to this

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[17] Coulibaly, S (2012) 'Fiscal consolidation and Recovery in Armenia, World Bank Knowledge Brief, February, vo.45

[18] World Bank (2014:11)

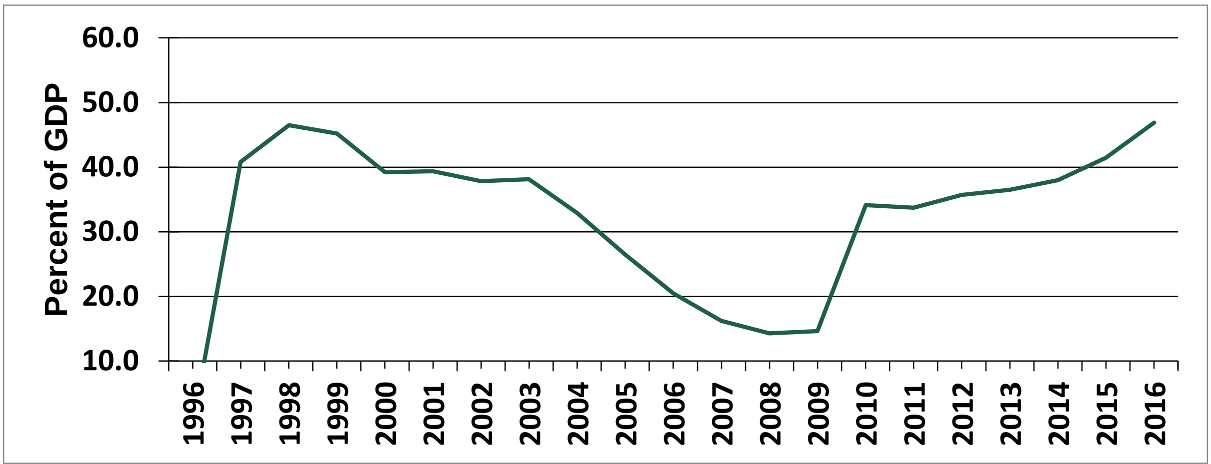
[19] http://www.imf.org/external/np/fin/tad/extarr2.aspx?memberkey1=35&date1Key=2017-02-28

[20] IMF (2016) *Republic of Armenia, fourth review under the extended arrangement and request for modification of performance criteria*, Country Report No,16/380, Washington DC

paper, the EFF supports fiscal consolidation and a flexible implementation of inflation targeting combined with exchange rate flexibility. The EFF emphasises 'structural reforms' to boost private sector-led growth and employment.

The latest review of the EFF was completed in December 2016. How has the Fund – and other agencies – assessed the scope and scale of the fiscal consolidation in Armenia? Has it been growth- and employment-friendly? This evaluation is important given that the government is poised to engage in a further round of fiscal consolidation as reflected in its 2017 budget because the 2008 debt rule would need to be activated given that public debt to GDP is poised to break the 50 per cent barrier in 2016 (see figure 8).

Figure 8: Armenia pubic debt to GDP ratio (%), 1996 to 2016



Source: IMF World Economic Outlook as compiled by knoema.com

Table 5 shows the scale of the fiscal adjustment that is contemplated

Table 5: Armenia: composition of fiscal adjustment in 2017

Fiscal indicators	Change from 2016
Total revenue and grants	0.6
Total expenditure	-2.5
Current expenditure	-0.6
Capital expenditure	-1.9
Overall balance	3.1 (target is to reduce the overall fiscal balance from 5.8 per cent in 2016 to 2.8 per cent in 2017)

Source: IMF (2016: 12)

While the IMF has uncritically accepted the importance of upholding the fiscal rule, it is also uncomfortable with both the magnitude of 2017 fiscal consolidation and the adverse growth and employment implications that are expected to follow from it. As it notes: 'Adjustment of such magnitude is challenging, both politically and economically'[21]. It proceeds to warn that

'The fiscal consolidation triggered by the fiscal rule *is bound to have an adverse impact on economic activity in 2017.* While this is not optimal from a growth perspective, it remains important to ensure fiscal discipline and to maintain public debt below the 60 per cent of GDP absolute ceiling stated in the fiscal rule'.[22] (italics added)

The IMF-supported programme for Armenia thus accepts that fiscal consolidation is more important than the growth objective. Yet, the dividends from accepting such a painful trade-off appear to be meagre. As discussed earlier, the IMF's own projections show that, despite the scale of the fiscal consolidation that is underway, the public debt to GDP ratio will

[21] IMF (2016:36)
[22] IMF (2016:17)

exceed the 50 per cent barrier even in 2021 - contrary to what the ADS predicts - and growth will be well below the 6.5 per cent target of the government.

Concerns about the nature and scale of fiscal consolidation in Armenia have been aired by various analysts for some time. In 2012, for example, one study noted that, while fiscal consolidation was deemed to be necessary to restrain a very high fiscal deficit incurred in fighting a severe recession, one needed to proceed with considerable caution. The government was advised to engage in gradual fiscal consolidation and to do so primarily on the basis of revenue mobilization that could then be utilized to support public investment and spending on health, education and social protection. Otherwise, one could expect a negative impact on growth.[23]

Two major public expenditure reviews (2014, 2016) by the World Bank reinforce the importance of such a message. [24]The 2016 public expenditure review notes that 'Armenia's fiscal consolidation …was among the most ambitious in the region'. It proceeds to observe that '…a broad-based expenditure downsizing was the main driver of the consolidation effort…with public investment programs withstanding the worst of the adjustment'. There was a precipitous drop in the share of public investment in GDP. It fell from 7 per cent of GDP in 2009 to 2.3 per cent in 2014, although it was partly due to under-execution of existing capital expenditure projects.

During the fiscal consolidation phase, expenditure on health and education declined significantly as well. These adverse developments happened in a context where Armenia

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[23] Coulibaly, (2012)

[24] World Bank (2014) *Republic of Armenia: Public Expenditure Review*, Report No.88586, May, Washington DC; World Bank (2016) Republic of Argentina: Supporting Effective Fiscal Management, Report No. ACS18362, June 20, Washington DC

significantly underspends on health and education relative to its regional peers. In general, public expenditure as a proportion of GDP is notably lower in Armenia than regional norms. Hence, fiscal consolidation that has been undertaken so far – and is expected to intensify in 2017 – is likely to worsen Armenia's relative position with respect to public expenditure and make it even more difficult for the government to reach the targets set in the ADS.

The growth and employment impact from an expenditure-based fiscal consolidation can be expected to be rather adverse, given that estimated fiscal multipliers, especially for capital expenditure are quite large for Armenia.[25] On the other hand, tax multipliers are rather low. Hence, based on these estimates, one can say that the Armenian economy responds a lot to spending shocks than tax shocks. This in turn reinforces the case for revenue-based fiscal consolidation.

The continuing concerns over fiscal consolidation in Armenia are in line with international experience. The available evidence shows that fiscal rules have to be carefully designed.[26] In order to minimize the tensions between growth, employment and public debt management, a rigid adherence to debt thresholds should be avoided as there is no robust or reliable estimates of safe debt levels.[27] Indeed, in the case of Armenia, the IMF's debt sustainability analysis covering projections to 2021 suggest that public debt to GDP ratio is sustainable even at thresholds that are well above the 50 per cent barrier that became the cause of

[25] The medium-term government expenditure multiplier is 0.9 while, at its peak, the estimated multiplier is 1.42. These values are derived from an econometric model calibrated to Armenian data. Se IMF (2015) 'Republic of Armenia: Selected Issues', *IMF Country Report* No.15/66, March. A comprehensive survey of the evidence on fiscal multipliers in both developed and developing countries can be found in Batini, N *et al* (2014) 'Fiscal multipliers: size, determinants and use in macroeconomic projections', Fiscal Affairs Department, IMF

[26] Ray, N, Velasquez, A and Islam, I (2015) **'Fiscal rules, growth and employment: a developing country perspective' ILO Working Paper No.184, Geneva,**

[27] Islam and Kucera (2014), chapter 4

triggering the 2017 fiscal consolidation in Armenia. The problem is not the level of public debt per se, but its composition which is dominated by external debt.

Fiscal rules need to be 'investment-friendly', that is, public investment programmes should be protected during periods of fiscal adjustment. Otherwise growth and employment prospects are impaired. Unfortunately, the debt rule in Armenia is not investment-friendly, nor is there any well designed escape clause that could have enabled the government to avoid stepping on the debt brake. The most recent research also shows that debt rules – unlike other well designed fiscal rules – do not reduce the pro-cyclical nature of fiscal policy, nor do they enhance fiscal space.[28]

Monetary policy: the limits of an inflation targeting regime

It is well known that the negative growth and employment consequences of fiscal consolidation can be offset by monetary policy accommodation, that is, monetary policy should provide sufficient support to aggregate demand through reduction in policy rates and through other mechanisms that enhances or maintains access to finance for the private sector, especially during downturns and periods of slow growth.

It appears that the Armenian central bank's monetary policy, driven by its mandate that upholds the primacy of price stability as reflected in the need to maintain a medium term inflation rate of 4 per cent, has provided insufficient – or least inconsistent - support to aggregate demand.[29] It is well known that inflation targeting regimes are not so effective in

[28] Nerlich, C and Teuter, W.H. (2015) 'Fiscal rules, fiscal space and procyclical fiscal policy', *European Central Bank,* Working Paper No.1872, December
[29] '*The basic objective of the Central Bank is ensuring the stability of prices in the republic…. In case other objectives of the Central Bank contradict its basic objective, the Central Bank grants priority to the basic objective'*. (italics added). See http://www.parliament.am/law_docs/300696HO69eng.pdf?lang=eng. Note that the core inflation target is allowed to deviate within a narrow band (+/-1.5%)

taming inflation that emanate from supply-side shocks. Yet, as the ADS itself has acknowledged, a significant part of inflationary pressures stems from supply-side factors, such as the drop in agricultural production due to natural climatic conditions, tariff increases for energy resources and so forth.[30] Given that the largely supply-side driven inflation rate during 2008-2003 was above the medium-term inflation target (5.8 per cent vs 4 per cent), the Central Bank was under pressure to bring down the incidence of 'overshooting'. Accordingly, it went through a tightening phase – most notably in August 2013 - when policy rates were increased and other restrictive monetary conditions were implemented, despite evidence of a growth slowdown after the sharp recovery in 2011 and 2012.[31]

Perhaps one of the most important findings of recent research is that inflation targeting regimes are good at dealing with 'overshooting' rather than 'undershooting' of targets. The latter happens when ultra-low inflation and even downright deflation take hold as is now the case globally.[32] Indeed, since 2016, Armenia has been in the grip of deflation which is only slowly expected to ease. The monetary authorities recognized this and have engaged in an unwinding of the tightening phase, but this might be a case of too little, too late. Indeed, the IMF has expressed concern that the policy rate in real terms is too high and has encouraged the monetary authorities to engage in further easing of monetary policy.[33]

One should also recognize that the preoccupation with a particular inflation target that falls within a narrow band should be interpreted with care. International evidence has shown

[30] ADS (2014:21)

[31] The policy rate was lowered to 8 per cent from 8.5 per cent in September 2011, but was increased to 8.5 per cent in August 2013 because the Central Bank was apparently concerned about 'second round effects' of the increase in gas and electricity prices. See World Bank (2014:4)

[32] IMF (2016) 'Global disinflation in an era of constrained monetary policy' in *World Economic Outlook*, October

[33] IMF (2016:14, 17). The policy rate, as recorded in 2015, stood at 6.75 per cent while the consumer price inflation went into negative terrain

that such targets are often arbitrarily set and are disconnected from historical experience or insufficiently grounded in empirical evidence pertaining to the growth-inflation trade-off.[34]

It is by no means clear that the inflation target for Armenia is grounded in robust empirical evidence pertaining to the growth-inflation trade-off. It is possible that the Armenian central bank's inflation aversion is driven by bitter memories of hyperinflation in the early 1990s making the monetary authorities determined not to replicate such an inglorious past. It is also possible that the central bank is responding to the inflation aversion of the private sector, even though such aversion might be disconnected from reality.[35]

There are other institutional constraints that impinge on an inflation targeting regime in the case of Armenia. The country has a high degree of dollarization. Historically, 65 per cent bank deposits have been held in dollars. In recent years, it has come down to 60 per cent.[36] The government has a comprehensive de-dollarization strategy in place, but international experience suggests that the impact of de-dollarization policy takes place gradually.

The high incidence of dollarization – which is likely to recede only slowly over time - limits the potency of monetary policy to influence aggregate economic activity. Given such institutional limits, and given the difficulty of overcoming the 'undershooting' of inflation targets during periods of ultra-low inflation and deflation, it makes sense for the monetary authorities to explore mechanisms for supporting growth and employment that go beyond

[34] Islam, I and Kucera, D (ed) *Beyond macroeconomic stability: structural transformation and inclusive development,* ILO and Palgrave McMillan: Geneva and London, chapter 3. The growth-inflation trade-off pertains to the empirically grounded proposition that there is a non-linear relationship between growth and inflation. Beyond a certain threshold, inflation has a negative impact on growth, but this is not discernible below the threshold. Hence, any given inflation target should be set in relation to the threshold

[35] Private sector attitudes to inflation are documented in ILO (2016) *Enabling Environment for Sustainable Enterprises in Armenia,* Geneva and Yereven

[36] IMF (2015)

its traditional policy instruments. This is where a greater emphasis on the agenda of financial inclusion would be appropriate as the discussion in the subsequent section shows.

In sum, this section has argued that the current macroeconomic policy framework in Armenia is not sufficiently growth and employment-friendly. Fiscal policy is preoccupied with fiscal consolidation and overly influenced by a debt rule that is not well designed to cope with downturns. Monetary policy has provided inadequate support to aggregate demand to offset the negative growth and employment consequences of fiscal consolidation.

One could argue that the IMF bears some responsibility for these outcomes. It has had long periods of engagement with Armenia going back to the mid-1990s and has an ongoing lending arrangement. By uncritically accepting that the debt rule needs to be upheld, despite the consequences for growth and employment, the IMF has probably reinforced the conviction of the government that fiscal consolidation has to be undertaken with urgency and on a large scale.

The IMF's endorsement of the Armenian government's is ironic because the Fund has played a leading role in proclaiming the case for 'growth-friendly' fiscal consolidation.[37] It has played a pivotal role in encouraging the government to undertake tax reforms – reflected most notably in a new tax code - that has a great deal of potential in supporting the case for revenue-based fiscal consolidation. Of course, revenue mobilization takes time to materialize while the government is impatient to implement the debt rule as soon as possible.

[37] Gaspar, V et al (2016) 'Macroeconomic management when policy space is constrained: a comprehensive, consistent and coordinated approach to economic policy', *IMF Staff Discussion Note*, September, SDN 16/09

Given the negative growth and employment consequences of fiscal consolidation, and the limited role that monetary policy can play in this respect, the Fund is presumably placing a lot of faith in improving the business climate through structural reforms as a way of re-igniting growth in Armenia. The efficacy of this approach needs to be critically examined – which is the task of the subsequent sections.

4. Policy recommendations: re-thinking fiscal and monetary policy to support growth and employment

The discussion in the previous section paves the way for a brief exploration of policy recommendations. The discussion in this section covers fiscal and monetary policy and how can one go beyond conventional approaches – fiscal rules and inflation targeting – to respond more directly to Armenia's growth and employment objectives.

Re-thinking fiscal policy as development finance

As far as fiscal policy is concerned, there is a case for reviewing the debt rule. As noted, it currently lacks well-designed escape clauses which can empower the government with the discretion to tailor fiscal policy to changing economic circumstances and to meet long-term development needs. Of course, the current debt rule is a state law, but no law is sacrosanct, especially when there is a good deal of evidence that such a law is not really fit for purpose. Debt sustainability is certainly an important goal, but the challenge is to manage the trade-off between debt sustainability and broader developmental aspirations. Armenia's own history suggests that public debt becomes much easier to manage when growth is buoyant. For example, the sharp drop in the debt to GDP ratio between 2001 and 2008 (when the ratio fell from nearly 40 per cent to 14 per cent – see figure 8) is the result of the boom in the 2000s rather than large-scale expenditure-based fiscal retrenchment.

Fiscal policy is better seen as a tool of development finance whereby the government enacts a sustainable resource mobilization strategy to meet public expenditure targets that are geared towards sustainable improvements in the well-being of a nation's citizens and long-term residents. One way of doing so is to make fiscal rules investment- friendly and to ensure that expenditure on health, education, social protection schemes and labour market policies that serve the needy and the vulnerable are protected.

To its credit, the Armenian government has managed to maintain its support for social protection – the bulk of which is made up of pensions and family benefits. It has set clear expenditure targets for social protection between now and 2025. The aim is to allocate 8.7 per cent of GDP to social protection by 2025.[38]

The Armenian government has been less successful in arresting the decline in expenditure on health and education, despite the fact that it underspends on these sectors relative to regional norms. The ADS seeks to allocate 6.4 per cent of GDP on health and education by 2025 relative to the 4.8 per cent of GDP that it currently spends.[39]

What is not clear is how these expenditure targets have been arrived at. Are they adequate relative to what is needed? For example, one could argue that an expenditure envelope should be determined by the resources required to eradicate poverty. One such exercise has been done by the national statistical agency. It notes that an additional 2 percent of GDP should be devoted to public expenditure to eradicate poverty. The ADS targets appear to be in line with that estimate – although this could be merely coincidental.

[38] ADS (2014), p.164
[39] ADS (2014), p.164

As noted, the government has really failed to shield public investment programmes from expenditure cuts. A primary aim should be to find ways of increasing support to public investment programmes and move towards levels that prevailed in the pre-crisis period.

The key question is how the various expenditure targets can be achieved given the government's commitment to uphold the debt rule. This is where revising the debt rule along the lines suggested above becomes important. A determined switch to revenue-based fiscal consolidation would be most desirable and would receive considerable support from international financial institutions. Improving budgetary executions of existing programmes, overhauling some that do not work effectively and re-allocating them to programmes that do work, would be another step in the right direction. An example is child benefits which is demonstrated by a government evaluation to be ineffective in improving children's well-being. It could be re-allocated to boosting family benefits which has been shown to be an effective anti-poverty scheme.[40]

In terms of institutional innovations to make fiscal policy more responsive to growth and employment objectives, the government might consider setting up an independent fiscal commission which would be entrusted with the mandate of reviewing the current debt rule and suggesting appropriate modifications. In addition, it could monitor the sustainable financing of expenditure targets and for improving the efficiency of public expenditure programmes.[41]

[40] ARMSTAT Part 1 – Armenia: Poverty Profile and Labor Market Developments in 2008-2013.
[41] As noted in the Executive Summary, the IMF, in its latest review (April 12, 2017) has reported that the Armenia government is poised to amend its 'pro-cyclical' fiscal rule.

Going beyond inflation targeting: rethinking the role of the central bank and enhancing the agenda of financial inclusion

The current preoccupation with inflation targeting has led the central bank to provide insufficient support to aggregate demand. One way in which the central bank's role could be strengthened is to consider its role beyond concerns about price and financial stability. This might include revisiting the inflation target and deriving it from robust of the growth-inflation trade-off. The threshold inflation target should then be subject to periodic review. Currently, no such review of the existing inflation target has taken place to account for changing economic circumstances.

As part of this review, the government might also wish to modify the mandate of the central bank by explicitly incorporating growth and employment objectives. A 'dual mandate' of this nature - of which the US Fed is a prime example - might create an incentive for the central bank to give equal weight to both price stability and broader socio-economic objectives.

As part of its obligations in supporting growth and employment objectives, the central bank might wish to play a more active role in promoting the agenda of financial inclusion. International experience has shown that financial inclusion, that is, the process of including those who are left outside the formal financial system, can be source of both direct and indirect job creation and in reducing poverty and vulnerability. Current indicators suggest that the degree of financial inclusion in Armenia is well below regional and international norms – see appendix.[42]

[42] One of the participants at the workshop presentation of this study (26 May, 2017) contested the claim that Armenia is a laggard in terms of financial inclusion relative to its neighbours. The author then shared the statistics compiled by the World Bank and as presented here. On receiving this information, the participant did not persist with his objection.

The central government has shown that it can play an important role in supporting projects geared towards promoting financial literacy. [43]This is an important initiative, but financial inclusion needs to be broader in scope and needs to be mainstreamed as part of one of the core functions of the central bank.

5. Complementing an employment-friendly macroeconomic policy framework: The role of labour market regulations, minimum wages and active labour market policies

The macroeconomic policy framework that has evolved under EFF includes complementary structural reforms to improve the business climate and foster private sector-led growth. This section will argue that this is not enough and suggests a way forward that is aligned with the aspirations of the ADS.

Going beyond 'Doing Business'

The ADS has the stated objective of promoting productive and well-paid employment. At the same time, the ADS suggests that Armenia should strive to emulate the flexible labour market regulations of its peers which might create a lot of low quality jobs. How does one resolve this seeming paradox?

Armenia has a rank of 35 in the World Bank's much-cited and much-noted Doing Business Indicators, while Georgia is far ahead at 16. [44]This places Georgia above several advanced economies, such as Australia. Should Armenia aspire to be another Georgia?

[43] http://www.afi-global.org/publications/2324/Grant-Snapshot-Financial-Inclusion-in-Armenia-The-Financial-Capability-Assessment-Project

[44] http://www.doingbusiness.org/data/exploreeconomies/armenia; http://www.doingbusiness.org/data/exploreeconomies/georgia

Salient labour market and poverty indicators for the two countries are shown in Table 7. Georgia does better than Armenia in terms of having lower working poverty, lower unemployment rate, higher labour force participation rate and employment rate and a slightly lower youth unemployment rate. Yet, these indicators are well below the aspirations of the ADS. Furthermore, Georgia has significantly higher extreme poverty than Armenia, while its dependence on the agricultural sector is far more than Armenia's reflecting lack of structural transformation. Hence, there is more to labour market policies than doing well in Doing Business. This is because such an approach emphasizes a reduction in the regulatory burden on the private sector as a major way of promoting growth and job creation. Yet, business enterprises themselves take a much more nuanced view of binding constraints that impede their growth.

Table 7: Doing Business, labour market and poverty indicators, Armenia vs Georgia

Indicator	Armenia	Georgia
Doing Business Rank (2016)	38	16
Working poverty rate (%) Extreme poverty based on international poverty line (%)	26.4 1.6	22.6 9.8
LFPR (%)	62.3	67.8
Share of agriculture in total employment (%)	35.3	50.9
Employment rate (%)	50.9	59.7
Unemployment rate (%)	18.3	12.0
Youth unemployment rate (%)	32.0	30.8

Source: ILOSTAT for labour market and employment indicators; World Bank for extreme poverty data (1.90 USD a day)

One way of gauging business perceptions about constraints that affect the private sector most is to focus on enterprise surveys. One pertains to the World Bank's World Enterprise Survey, the other to the ILO's Enabling Environment for Sustainable Enterprises (EESE) survey.[45] The World Bank survey dates back to 2013, while the EESE report was completed in 2016.

The World Enterprise survey for Armenia suggests that labour regulations are considered the least important constraint by the private sector. Tax rates and tax administration are considered the most important followed by concerns about political instability, customs and

[45] ILO (2016) 'Enabling environment for sustainable enterprises in Armenia', Yerevan and Geneva; World Bank survey available at http://www.enterprisesurveys.org/data/exploreeconomies/2013/armenia

trade regulations. Access to finance, practices of the informal sector and concerns about corruption are equally ranked. Somewhat surprisingly, an inadequately trained workforce does not rate as much importance as other constraints.

The EESE report - based on 300 firms - is more comprehensive and covers more areas and issues than the World Bank. There are some similarities with the World Enterprise Survey, but also some significant differences. Thus, the tax regime is a cause for concern, as are corruption, political instability and the quality of governance. Unlike the World Enterprise Survey, the respondents in the EESE report express a good deal of concern about lack of access to finance and, in particular, lack of access to financial products suitable for small and medium sized enterprises (SMEs). The respondents also express concern about inflation and its impact on the competitiveness of firms, a perception which is somewhat surprising given that Armenia has recently been in the grip of deflation. Power outages and, in general, the poor quality of the energy infrastructure are also seen as major constraints by respondents in the EESE report. Other areas of concern include labour costs, skill shortages and the negative attitude of employees. The informal sector is seen as a source of unfair competition as are monopolistic practices in the private sector.

These findings have important policy implications. Appropriate tax reforms are likely to respond to the concerns of the private sector while at the same time responding to the critical goal of revenue mobilization. Enhancing access to finance for SMES, alleviating skill shortages, improving the energy infrastructure are also important areas that deserve attention from policy makers. How to reduce informality is clearly a policy relevant issue as discussed below.

Labour regulations and informality

Dealing with the informal sector is clearly an agenda that resonates with the formal private sector. The ADS has enacted numerical targets for reducing informality in its 2025 vision that envisages a substantial increase in the share of formal employment in the non-agricultural sector.[46]

A well-known view is that onerous labour regulations, including the tax regime, are the major reasons for the persistence of informality as private sector operators seek to avoid and evade taxes and the regulatory reach of governments. Hence, reducing onerous labour regulations and cutting corporate taxes would encourage more firms to become formal.

How valid is this view for the case of Armenia? To start with, the World Enterprise Survey documents the fact that labour regulations in Armenia are considered the least important constraint (out of the ten most important) by the private sector. Hence, seeking to deregulate the labour market by diluting Armenia's labour code is unlikely to engender tangible benefits to the private sector while depriving workers of acceptable working conditions. Admittedly, there is evidence that Armenia's labour code reduces labour turnover but the impact on aggregate unemployment is modest.[47] This is a small price to pay for a corpus of regulations that, on paper at least, offers a fair degree of protection to workers.[48]

The persistence of informality reflect lack of adequate employment opportunities in the formal sector compelling individuals and households to eke out an existence in the informal

[46] ADS (2014), p.16. The target share is 83 per cent by 2025

[47] Hartwell, C (2010) Employment protection legislation and labor markets in transition: assessing the effects of the labor code in Armenia, *The European Journal of Comparative Economics*, 7(20)

[48] ADS (2014) pp.63-64

economy. Furthermore, as the EESE report points out, monopolistic practices in the formal sector might prevent the entry of firms.

A careful documentation of the informal economy in Armenia also provides clues to the structural factors that lie behind the persistence of informality. It notes that informality is highest in agriculture (98 per cent) and construction (nearly 60 per cent). Manufacturing, high-end services and the public sector have relatively low incidence of informality. The study also suggests, not surprisingly, that educational attainment significantly reduces the probability of being employed in the informal economy.[49]

These findings have important policy implications. It suggests that policies that facilitate structural transformation by increasing the employment share of manufacturing and high-end services will in turn have a positive spillover effect by reducing informality. Policies that lead to better educational attainments of the work-force will have similar salutary effects.

Other policy options include the EESE report's view that monopolistic practices impede the capacity of firms to become formal. This clearly suggests the need for pro-competition policies that will reduce entry barriers to the formal sector. Furthermore, the current agenda of tax reforms will encourage formality by bringing more firms into the tax system. Given that the Armenian government is committed to increasing the tax-to-GDP ratio significantly by 2025, this initiative in turn becomes an effective way of reducing informality.[50]

[49] ADB (2010) *The informal sector and informal economy in Armenia*, Manila. The report was done in partnership with ARMSTAT

[50] One participant at the workshop presentation of the study (26 May, 2017) proposed that the government should encourage electronic transactions rather than cash transactions. This will in turn act as an incentive to increase the incidence of formality.

Minimum wages, working poverty and employment

Minimum wages represent a time-honoured instrument for reducing the incidence of low pay and working poverty. Given that wages form a major part of the income of individuals and households, raising minimum wages to the standard of a 'living wage' and ensuring greater compliance can boost aggregate consumption and hence aggregate demand.

The Armenian government, unlike many low and middle income countries, have set numerical targets for minimum wages that are aligned with the notion of a 'living wage'. This is done by proposals for stepwise changes in the minimum wage over time that raises it well above the poverty line and ensures that they are linked to movements in average wages. The ADS envisages that, over time, minimum wages should apply to all families that have at least one family member.

Currently, minimum wages are set at 55,000 AMD per month which represents a substantial increase over the level that prevailed in 2012 (35,000 AMD per month). In that year, minimum wages were 80 per cent of the (upper) poverty line. In 2016, it was 120 per cent of the poverty line and the government has set a target that, by 2025, minimum wages should be set above 200 per cent of the national poverty line and correspond to 40 per cent of average wages.[51]

A well-known concern about minimum wages is that they harm employment prospects, especially if they are set at too high a level. There is a large literature on this topic, especially

[51] ADS (2014), pp.62-63

in the USA. The verdict is that the negative employment consequences of minimum wages is modest at the aggregate level and should be weighed against the improvement in living standards of still-employed workers.[52] The Armenian government seems to have opted for this view.

Active labour market policies (ALPMs) and employment

(ALMPs) ranging across support to public employment services, funding to support self-employment, training programmes, public works and/or employment guarantee schemes, wage subsidies and so forth. They are designed to respond to specific employment challenges, such as skills mismatches, insufficient labour demand and so forth – see table A1.

ALMPs are of comparatively recent origin in Armenia having started in 2014 after the government decided to phase out unemployment benefits (UB). As a programme, the UB in Armenia was rather modest. In 2013, for example, UBs only covered 11.3 per cent of the total unemployed.[53]

Armenia, in common with other Central Asian countries, generally allocate a modest amount ALPMs (less than 0.2 per cent in 2014). The activities under ALPMs include

> '…professional orientation, information and counselling. A jobless person is …entitled to training, assistance for setting up companies, assistance for setting up companies, assistance with job placement in remote areas, reimbursement of costs associated with visits to employers, and participation in reimbursed public works'.[54]

[52] Neumark, D (2015) 'The effect of minimum wages on employment', *FRBSF Economic Letter*, December 21
[53] ARMSAT, Statistical Year Book 2016, p.77
[54] World Bank (2014: 47)

ALMPs in Armenia might benefit from increased budgetary allocations to match international norms.[55] However, care should be taken not to indiscriminately fund ALMPs, as multiple evaluations show that the effectiveness of ALPMs depend on the type of intervention and the particular economic circumstances that a country faces. For example, one study that covers 152 impact evaluations across developed, developing and transition economies, arrives at the following conclusion for the latter.[56]

- Employment services and skills training had the most positive impacts, both on employment probability and earnings
- Results from public employment programs are mixed
- Wage and employment subsidies are generally negative, but can be effective in some cases
- There is insufficient evidence to arrive at credible conclusions pertaining to self-employment/small business assistance programs.

Table A2 lays out some key findings from a range of countries in Eastern Europe and Central Asia that policy-makers in Armenia can learn from. It appears that some ALMPs seem to work better than others. In the case of Armenia, some evaluations suggest that training programmes increases the likelihood of re-employment of unemployed workers.[57] Such a finding is in line with international evidence as noted above.

The role of ALMPs in enhancing employability should be set in a broader context. However, ALMPs - even if well-funded and well-designed - cannot act as a substitute for deficiencies of

[55] OECD data suggest that member states spent around 0.6 per cent of GDP on ALMPs
[56] Betcherman, G (2008) 'Active Labor Market Programs: Overview and International Evidence on What Works', World Bank, April
[57] World Bank (2014:47)

the overall education and training system that is the key determinant of skills development and employability. The aforementioned EESE report for Armenia suggests that employers express a good deal of concern about the lack of analytical and problem-solving competencies of new entrants to the work-force. The challenge for the education and training system, therefore, is to enhance such competencies which should be considered as part of universal basic skills. One way of measuring the ability of the education and training system to supply universal basic skills is PISA which is the best known metric for measuring the learning outcomes of 15 year olds. A comparative study suggests that if Armenia can reach a PISA threshold of 450, and combines this with universal secondary education, then long run growth rate is expected to increase annually by almost 1 per cent.[58]

[58] Hanushek, E and Woessman, 2015, *Universal basic skills: what countries gain to stand*, OECD, Paris

Appendix

Armenia, financial inclusion indictors, available at
http://datatopics.worldbank.org/financialinclusion/country/armenia

Armenia

Europe & Central Asia			Lower middle income
Population, age 15+ (millions)	2.4	GNI per capita ($)	3,800

	Country data	Europe & Central Asia	Lower middle income
Account (% age 15+)			
All adults	17.7	51.4	42.7
Women	14.7	47.4	36.3
Adults belonging to the poorest 40%	10.9	44.2	33.2
Young adults (% ages 15–24)	10.4	35.6	34.7
Adults living in rural areas	15.5	45.7	40.0
Financial Institution Account (% age 15+)			
All adults	17.2	51.4	41.8
All adults, 2011	17.5	43.3	28.7
Mobile Account (% age 15+)			
All adults	0.7	0.3	2.5
Access to Financial Institution Account (% age 15+)			
Has debit card	8.4	36.9	21.2
Has debit card, 2011	5.2	36.4	10.1
ATM is the main mode of withdrawal (% with an account)	51.6	66.7	42.4
ATM is the main mode of withdrawal (% with an account), 2011	55.4	72.5	28.1
Use of Account in the Past Year (% age 15+)			
Used an account to receive wages	7.2	22.5	5.6
Used an account to receive government transfers	0.7	7.3	3.3
Used a financial institution account to pay utility bills	1.5	12.5	3.1
Other Digital Payments in the Past Year (% age 15+)			
Used a debit card to make payments	3.9	22.9	9.6
Used a credit card to make payments	4.2	14.9	2.8
Used the Internet to pay bills or make purchases	5.0	11.9	2.6
Domestic Remittances in the Past Year (% age 15+)			
Sent remittances	3.2	12.9	14.2
Sent remittances via a financial institution (% senders)	..	31.5	30.9
Sent remittances via a mobile phone (% senders)	..	2.5	7.7
Sent remittances via a money transfer operator (% senders)	..	11.8	18.3
Received remittances	9.1	15.5	17.8
Received remittances via a financial institution (% recipients)	..	22.1	26.0
Received remittances via a mobile phone (% recipients)	..	1.0	5.7
Received remittances via a money transfer operator (% recipients)	..	15.6	16.6
Savings in the Past Year (% age 15+)			
Saved at a financial institution	1.6	8.4	14.8
Saved at a financial institution, 2011	0.8	4.9	11.1
Saved using a savings club or person outside the family	4.8	6.6	12.4
Saved any money	21.0	38.5	45.6
Saved for old age	2.1	11.8	12.6
Saved for a farm or business	3.2	5.1	11.8
Saved for education or school fees	4.7	12.1	20.0
Credit in the Past Year (% age 15+)			
Borrowed from a financial institution	19.9	12.4	7.5
Borrowed from a financial institution, 2011	18.9	7.8	7.3
Borrowed from family or friends	26.9	23.6	33.1
Borrowed from a private informal lender	2.8	2.1	8.5
Borrowed any money	47.3	39.5	47.4
Borrowed for a farm or business	8.6	2.8	9.2
Borrowed for education or school fees	5.2	6.2	10.1
Outstanding mortgage at a financial institution	15.2	10.2	4.7

Table A1: ALMPs - typology

Barrier to Employment	Type of ALMP	Program objective
Skills mismatches	Training (on the job, in class)	Enhance employability
Information asymmetries	Intermediation services, job search assistance, counselling	Enhance employability, promote job creation
Insufficient labour demand	Wage subsidies, public works programs/employment guarantee schemes, self-employment, work-sharing	Promote job creation

Source: adapted from Angel-Urdinola, D.F and Leon Solano, R.E (2013) A reform agenda for improving the delivery of ALMPs in the MENA region, *IZA Journal of Labor Policy*, 2:13

Table A2: ALMPs in Central and Eastern Europe and Commonwealth of Independent States (CIS) (summary of findings from multiple studies)

Country	Small business/self-employment assistance (statistically significant?)	Employment services (statistically significant?)	Skills training (statistically significant?)	Wage subsidies (statistically significant?)	Public works (statistically significant?)
Bosnia-Herzogovina	Indeterminate	Yes	Yes	Indeterminate	Indeterminate
Bulgaria	Yes	Not for men	Yes	Yes	Yes, but lowest positive impact
Estonia	Yes	Indeterminate	Yes	Indeterminate	Indeterminate
Hungary	Yes	Yes	Yes	No, except some target groups	No to indeterminate depending on target group
Kosovo	Indeterminate	Indeterminate	Yes	Indeterminate	indeterminate
Poland	Indeterminate	Indeterminate	Yes	Not for women	No
Romania	Yes	Indeterminate	Indeterminate	Indeterminate	Yes
Russia	Indeterminate	Yes	Indeterminate	Indeterminate	Indeterminate
Slovakia	Yes	Yes	Yes	No	Yes
Slovenia	Indeterminate	Indeterminate	Indeterminate	Indeterminate	Yes, but only in short run
Ukraine	Indeterminate	Indeterminate	Yes, but short run	Indeterminate	No

Source: compiled from Spevacek, A (2009) Effectiveness of Active Labor Market Programs: A Review of Programs in Central and Eastern Europe and the Commonwealth of Independent States, USAID, December 23.