

**Republic of Armenia: First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility—Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Armenia**

In the context of the first review under the three-year arrangement under the Poverty Reduction and Growth Facility with the Republic of Armenia, the following documents have been released and are included in this package:

- the staff report for the First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, prepared by a staff team of the IMF, following discussions that ended on September 7, 2005, with the officials of the Republic of Armenia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 1, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Press Release summarizing the views of the Executive Board as expressed during its November 14, 2005 discussion of the staff report that completed the review.
- a statement by the Executive Director for the Republic of Armenia.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of the Republic of Armenia\*  
Memorandum of Economic and Financial Policies by the authorities of the  
Republic of Armenia\*  
Technical Memorandum of Understanding  
\*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ARMENIA

**First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility**

Prepared by Middle East and Central Asia Department  
(In consultation with other departments)

Approved by Julian Berengaut and Adnan Mazarei

November 1, 2005

- Program discussions were held in Yerevan during August 25–September 7, 2005. The mission met with President Kocharian, Mr. Khachatryan (Minister of Finance and Economy), Mr. Chshmarityan (Minister of Trade and Economic Development), Mr. Movsisyan (Minister of Energy), Mr. Sargsyan (Chairman of the Central Bank), other senior officials, and representatives of the donor community and civil society.
- The mission team consisted of Mr. Al-Atrash (head), Ms. Dabla-Norris, and Messrs. Ding and Takizawa (all MCD), Hauner (FAD), and Kelmanson (PDR). The mission was assisted by Mr. McHugh, resident representative, and Mr. Stepanyan and Ms. Minasyan, economists in the local office.
- The attached Letter of Intent (Attachment I), and the Memorandum of Economic and Financial Policies (Attachment II) set out the authorities' economic program for the remainder of 2005 through June 2006.
- The request for a three-year Poverty Reduction and Growth Facility (PRGF) arrangement of SDR 23 million (25 percent of quota) was approved by the Executive Board on May 25, 2005 (Country Report Number 05/178). The equivalent of SDR 3.28 million will be made available upon the completion of the first review under the PRGF arrangement.
- Relations with the Fund, World Bank, and the European Bank for Reconstruction and Development are summarized in Appendices I–III, respectively. The periodicity, availability, and quality of economic data are discussed in Appendix IV (Armenia subscribes to the Special Data Dissemination Standard). Finally, the joint Fund-World Bank debt sustainability analysis is discussed in Appendix V.

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## EXECUTIVE SUMMARY

Armenia's economy continues to perform strongly. Prudent fiscal and monetary policies, strong external inflows, and ongoing structural reforms have contributed to double-digit growth, low inflation, and declining poverty. The PRGF-supported program remains on track, with all quantitative and structural performance criteria for end-June 2005 being met.

The policy discussions focused on the 2006 budget and fiscal and financial reforms to sustain growth and foster poverty reduction. Structural reforms in the fiscal area focus on improving tax and customs administration to broaden the tax base and mobilize domestic revenues, while financial sector reforms aim at boosting the quality and depth of financial intermediation.

- The stance of fiscal and monetary policies in 2005 is in line with the authorities' 3 percent inflation objective. Armenia's flexible exchange rate regime has served the country well. The recent appreciation of the dram has contributed to subdued inflation and is partially offsetting the effect of higher energy prices. However, strong external inflows and uncertain money demand have complicated the authorities' efforts to attain their reserve money targets.
- The 2006 budget envisages an improvement in revenue performance and a better targeting of expenditures, in line with PRSP objectives. While it implies a slight loosening of the fiscal stance relative to the projected 2005 outturn, large social and infrastructure needs justify an expansion of public expenditures, particularly given the availability of low-cost financing and subdued inflation.
- The centerpiece of the reform program remains on broadening the tax base and strengthening tax and customs administration. In tax administration, the focus is on improving tax audits, tax arrears collection, and the VAT refund system. In customs administration, an operational review will be conducted with a view to identifying the main strengths and weaknesses of the State Customs Committee.
- The recent growth in private sector credit is a welcome development. Remaining financial sector reforms need to focus on strengthening further the market infrastructure and legal framework underpinning the financial sector.
- Good progress has been made in improving the financial performance of the energy and water sectors but further reforms are needed to avoid a return to quasi-fiscal operations. To tackle problems in governance, the legislative agenda for the anti-corruption action plan needs to be complemented with forceful enforcement and appropriate penalties for abuse.

Armenia's economic outlook is favorable, although not without risks. The main policy challenge is how to deal with large remittance inflows when government deposits are large and social and infrastructure needs remain pressing.

## I. INTRODUCTION

1. Discussions on the first review under the PRGF arrangement focused on recent developments and near-term policies aimed at consolidating macroeconomic stability and moving forward with structural reforms to sustain economic growth and further reduce poverty.

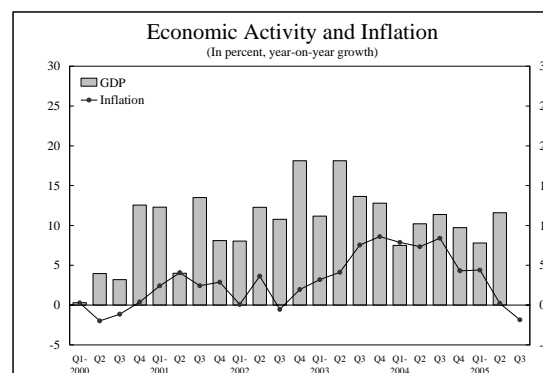
## II. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

2. In recent months, Armenia and Azerbaijan have renewed diplomatic contact over the future status of the disputed enclave of Nagorno-Karabakh. Both sides have indicated that they are moving closer to a settlement of the dispute. In late November, a referendum will be held on a series of constitutional amendments that will strengthen the independence of the judiciary and limit the powers of the presidency.

3. **The economy registered robust growth while inflation remains subdued** (Table 1). Real GDP expanded by 11.7 percent year-on-year in the first eight months of 2005, driven mainly by construction (31 percent) and agriculture (12 percent). Domestic demand continues to be buoyed by investment and remittances inflows. The 12-month CPI inflation declined from 4.9 percent in January to -0.4 percent in September, reflecting a significant drop in food prices associated with a good harvest and a strengthening dram. The pass-through effect of higher international energy prices has so far been limited, although the current CPI basket may understate such an effect owing to the very low weight of energy-related items (Box 1).<sup>1</sup> The official unemployment rate fell to 8.6 percent in June 2005 from 9.4 percent in 2004, but remains high notwithstanding the rapid output growth.<sup>2</sup>

	2001	2002	2003	2004	2005 Est.
Real GDP growth (in percent)	9.6	13.2	13.9	10.1	11.0
Investment	19.8	21.7	24.7	23.9	24.4
Inflation (average, in percent)	3.1	1.1	4.7	7.0	1.0
Inflation (end-of-period, in percent)	2.9	2.0	8.6	2.0	1.5
General government balance (commitment basis)	-3.8	-0.4	-1.1	-1.7	-2.4
External current account	-9.5	-6.2	-6.8	-4.6	-3.9
Debt-to-exports ratio	132	131	60	59	60
Poverty rate 1/	47	49	32	...	...

Sources: Armenian authorities; and Fund staff estimates.  
1/ Percent of population. Based on household surveys.



<sup>1</sup> Food items account for 59 percent of the CPI basket, while petrol, gas, diesel, gasoline, and kerosene have a combined weight of 2.3 percent.

<sup>2</sup> According to a survey based on ILO methodology, which employs a less restrictive definition of unemployment, unemployment declined from over 38 percent in 2001 to around 32 percent in 2004. Various factors have contributed to the high level of unemployment, including: (i) a high degree of temporary unemployment, (ii) the persistence of structural unemployment owing to skills mismatches (as evidenced by the substantial increase in average wages in recent years), and (iii) the existence of a large informal sector as many businesses prefer not to report their employees to avoid taxation.

**Box 1. Pass-through Effect of Higher International Energy Prices**

Despite sharp increases in international energy prices since 2002, Armenia has been relatively unaffected compared with other fuel-importing countries, owing to various country-specific factors.

Armenia: Domestic oil prices, 2002–05 (In AMD per liter)				
	2002	2003	2004	2005
	Dec.	Dec.	Dec.	Jun.
Regular gasoline	329	281	315	316
High octane gasoline 1/	369	321	355	356
Diesel	275	202	268	265
Kerosene	223	296	341	317
<u>Memorandum item:</u>				
AMD/USD official exchange rate	585	566	486	442

Sources: Armenia National Statistical Service; and Fund staff estimates.

**Exchange rate.** Since December 2002, the dram has appreciated by almost 25 percent against the dollar, thus muting the effect of the external oil price shock.

**Structure of energy production.** Armenia’s electricity supply is relatively diversified, with 40 percent of the electricity generated by the Armenia Nuclear Power Plant, 33 percent by hydro power plants, and the remainder by thermal power plants fueled by gas. The cost of nuclear fuel has been stable. Gas prices have also remained stable due to a long-term gas contract with Russia dating from 2000. However, gas prices could increase significantly in 2006 when the contract is renegotiated. In addition, Armenia has an electricity swap arrangement with Iran. Under the arrangement, Armenia receives electricity during the peak winter months, and exports hydro-generated electricity during the summer months. All these factors have contributed to the stable cost of energy.

**Taxation.** Unlike countries levying ad valorem taxes on oil, Armenia has adopted a specific tax, which has helped stabilize the final retail price of oil. From 2000 to 2004, oil was subject to a presumptive tax of \$220 per ton. To counter the adverse impact of the recent exchange rate appreciation on tax revenue, since early this year, the presumptive tax has been collected in terms of drams (the rate is currently AMD110,000 per ton).

4. **Performance under the PRGF-supported program has been good.** All quantitative and structural performance criteria for end-June were met, and all but one of structural benchmarks were observed (Tables 2 and 3). Two indicative targets for end-June were missed. The floor on the contributions to the State Fund for Social Insurance was missed by a small margin because of transitional problems associated with the transfer of the collection function to the State Tax Service (STS). The ceiling on reserve money was exceeded by a wide margin, reflecting sizeable foreign exchange interventions through May, as well as the change in reserve requirements. The structural benchmark on passing a law on tax audits to permit off-site audits has been delayed due to scheduling difficulties in parliament, but it is expected to be passed in December.

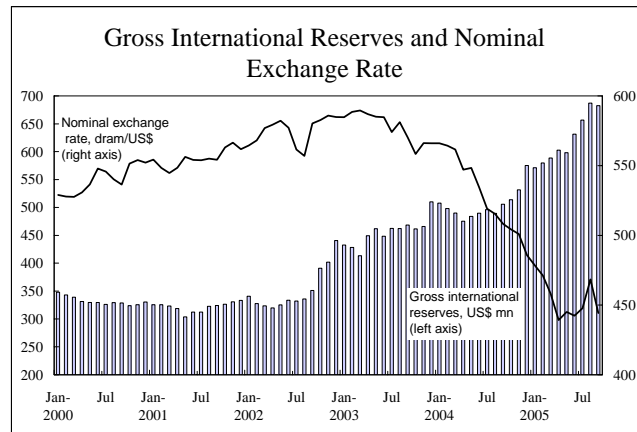
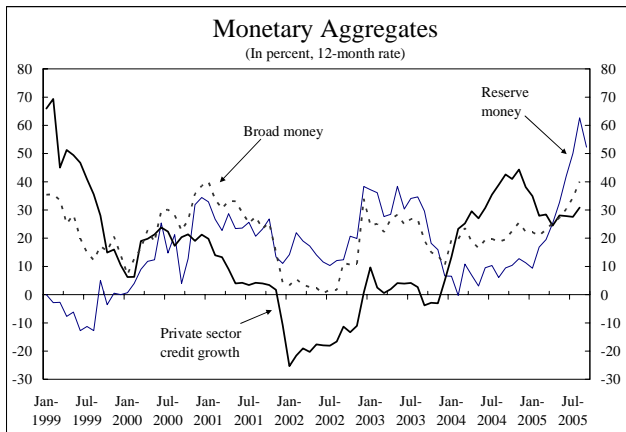


5. **Fiscal performance remained sound in the first half of 2005**, with the fiscal deficit on a commitment basis equivalent to 0.5 percent of GDP compared to 1.2 percent of GDP under the program (Table 4). This reflected both stronger revenue performance and lower-than-programmed expenditures, particularly in capital spending, due to disbursement delays under credit programs and capacity constraints in procurement. In line with the program target, nominal tax revenues through September 2005 increased by 19 percent over the same period last year.

	2002	2003	2004 Est.	2005 Proj.
Total revenue and grants	18.8	17.8	15.6	15.6
<i>of which</i> : tax revenue	14.6	14.0	14.1	14.5
grants	3.5	3.2	0.6	0.6
Total expenditure	19.3	18.9	17.2	18.0
Current expenditure	13.9	12.8	13.3	13.4
Capital expenditure and net lending	5.1	6.1	3.9	4.6
Overall balance (commitment basis)	-0.4	-1.1	-1.7	-2.4
Overall balance (cash basis)	-2.6	-1.5	-1.7	-2.4
Memorandum item:				
Social expenditure	4.9	5.0	5.4	6.3

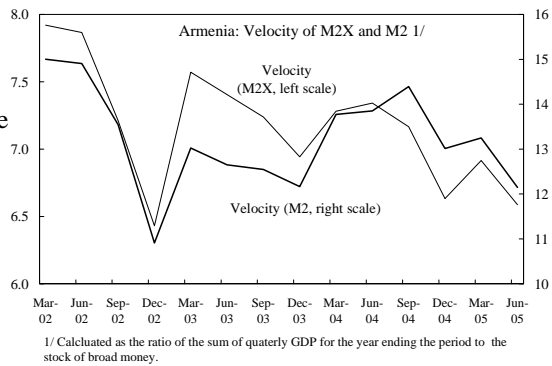
Sources: Ministry of Finance and Economy; and Fund staff estimates.

6. **Broad money grew briskly**, reflecting an accommodating policy stance taken by the Central Bank of Armenia (CBA) in an environment of muted inflationary pressures (Table 5). The CBA accommodated the increase in demand for domestic currency (Box 2) and undertook partially sterilized foreign exchange interventions in the face of dram appreciation pressures stemming from strong remittance inflows. The increase in demand for domestic currency has been accompanied by emerging de-dollarization, associated in part with a recently implemented law that encourages the use of the domestic currency by requiring certain commercial transactions to be quoted only in drams, and the recent dram appreciation. In June, the CBA started issuing its own bills, partly in order to facilitate end-year liquidity management.

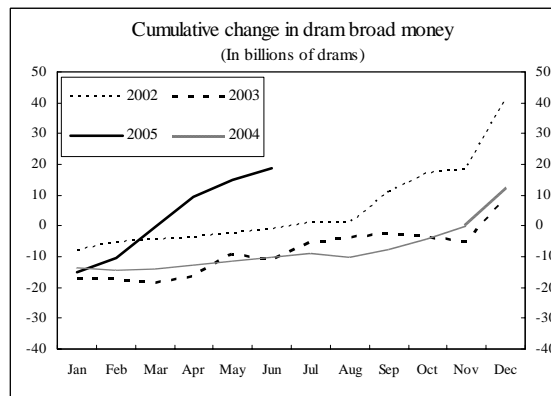


### Box 2. Recent Developments in Money Demand

The relationship between monetary aggregates and nominal economic variables in Armenia has recently shown notable changes. This, together with strong remittance inflows, has complicated the implementation of monetary policy.



Velocities for both M2X (domestic broad money plus foreign currency deposits) and M2 have declined since mid-2004. This decline reflects continued re-monetization in light of a rebound in confidence in the banking system and a stable inflation environment. Moreover, a law was implemented which requires certain commercial transactions to be quoted only in drams, with an aim to encourage the use of domestic currencies. In any case, significant cash dollarization in Armenia will continue to be a source of uncertainty in demand for domestic money.



7. **Banking sector performance continued to improve, but interest rate spreads remain high** (Table 6). Banks remain well-capitalized, liquid, and profitable. Growth of credit to the private sector, especially consumer loans, continued at a rapid pace, albeit from a low base, while the quality of loan portfolios remains sound. Nevertheless, average lending-deposit rate spread remains high (12.4 percentage points in July 2005), suggesting high credit risk and continuing inefficiencies in the banking system reflecting, inter alia, high noninterest expenses, inadequate competition,<sup>3</sup> and weak bank corporate governance. A slow decline in capital adequacy ratio suggests that banks have only been gradually responding to opportunities for profits from additional credit expansion.

<sup>3</sup> While there are currently twenty commercial banks in Armenia, individual economic sectors are often served by a few (sometimes only one) banks.

Armenia: Selected Banking System Indicators, 2001–05  
(End of period; in percent unless otherwise noted)

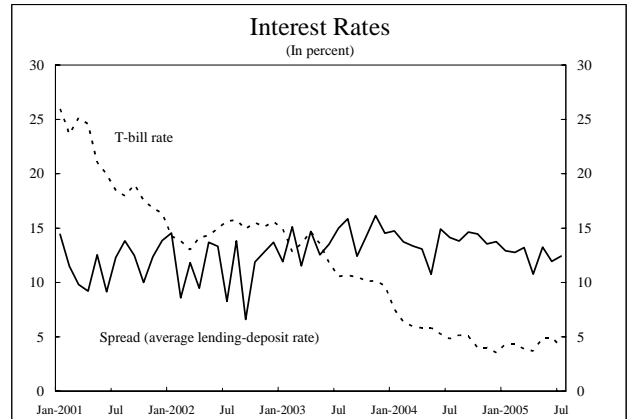
	2001	2002	2003	2004	2005	
	Dec.	Dec.	Dec.	Dec.	Mar.	Jun.
Capital adequacy 1/	13.6	30.5	33.8	32.3	36.4	31.7
Liquidity	33.1	44.5	47.5	47.1	46.3	45.2
Profits (profits to period average equity) 2/ 3/	-78.6	21.6	14.4	18.4	15.8	14.7
Profits (profits to period average assets) 2/ 3/	-9.1	3.9	2.7	3.2	2.9	2.8
Credit to the private sector (growth rate in percent)	-10.8	0.7	5.0	38.1	28.4	27.9
Of which: credit to households	-16.0	-12.0	36.0	58.1	46.3	43.7
Nonperforming loans/gross loans	6.0	4.9	5.4	2.1	2.5	2.3
Interest margin to gross income	27.8	37.6	42.0	44.2	43.4	39.6
Noninterest expenses to gross income	42.7	48.3	48.5	46.5	45.2	54.5

Source: Central Bank of Armenia.

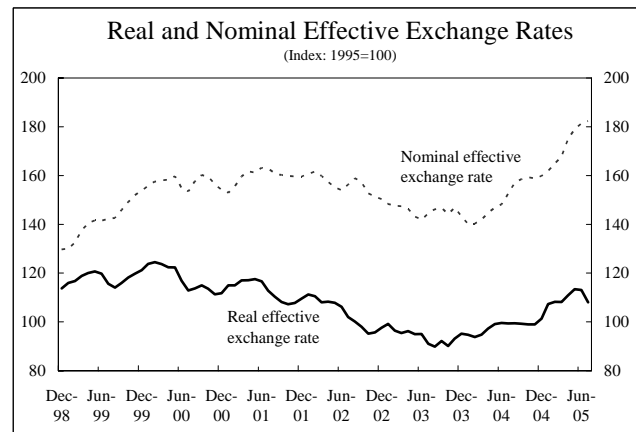
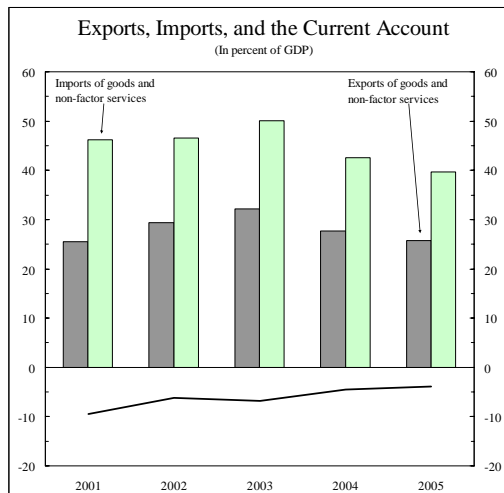
1/ Regulatory capital to risk-weighted assets.

2/ Average assets (capital) are calculated based on the algebraic average of quarterly data.

3/ Profit is the undistributed profit from the income statement. In the calculation of ROE and ROA, the annualized profit figure (quarterly profit multiplied by 4) is taken.



8. **The external position has strengthened.** Strong remittances and robust exports of base metals and processed foodstuffs have contributed to a narrowing of the external current account deficit to 3.9 percent of GDP in 2005 compared with 4.6 percent of GDP in 2004 (Table 7). Gross official international reserve coverage is projected to increase to 4 months of imports in 2005. The authorities have intervened intermittently in the foreign exchange market since October 2004 in order to smooth out volatility in the exchange rate. The dram has continued to appreciate, by 8.6 percent against the U.S. dollar through end-September and 6.6 percent in real effective terms through July. The pace of appreciation slowed somewhat from May, before picking up again more recently. The real exchange rate appreciation appears to have had little impact on external competitiveness, given Armenia’s continued favorable wage cost advantage and its focus on niche markets.<sup>4</sup> Armenia’s debt management strategy remains sound, relying on a mix of grants (public and private) and concessional borrowing (Appendix V).



<sup>4</sup> See Box 3 in Country Report Number 05/178.

9. **The authorities made good progress in structural reforms** (see Memorandum of Economic and Financial Policies (MEFP), paras 7–9). In the area of tax policy and tax and customs administration, the authorities adopted a comprehensive two-year Tax Action Plan in May 2005. Two major amendments to tax legislation, reducing exemptions and loopholes, were recently submitted to parliament. In customs administration, the authorities have agreed on the terms of reference for an operational review of the State Customs Committee (SCC) to be undertaken by a specialized international company. To improve expenditure execution, the budget process has been brought forward and a public investment plan (PIP) was included in the authorities' 2006–08 Medium-Term Expenditure Framework (MTEF).

10. **Financial sector reforms have advanced.** In line with the FSAP recommendations, the authorities submitted an amendment to the Law on Banks and Banking to strengthen banking supervision, improve corporate governance of banks, and enhance external audits in bank risk management. The minimum capital requirement for existing banks was raised to \$5 million effective July 1, 2005 with all banks meeting the requirement. A mandatory deposit insurance scheme commenced coverage from July 1, 2005. Legislative packages are being finalized to shore up creditor rights and to encourage the development of the mortgage market. Additionally, the authorities are finalizing a new prudential framework for the insurance sector.

11. **The financial performance of the energy, water, and irrigation sector has continued to improve, but the liquidation process of Armenergo made little progress.** In the energy sector, collection rates have remained at 100 percent and technical and other losses have declined. As a result, the energy sector is no longer receiving subsidies from the budget, and has met its tax obligations on a timely basis. The Public Service Regulatory Commission, fulfilling its commitment under the World Bank's Poverty Reduction Support Credit II, has adopted power market rules necessary for the adequate functioning of the sector. To bring the long-standing problems with Armenergo to a closure, a liquidation commission was established, but the audit of the company has been delayed. Losses in the water and irrigation sectors have also declined owing to substantial tariff increases and improved collection.<sup>5</sup>

### III. POLICY DISCUSSIONS

12. Discussions centered on near-term economic policies, in particular the 2006 budget, and fiscal and financial sector reforms. Structural reforms in the fiscal area focus on improving tax and customs administrations to mobilize domestic revenues while financial sector reforms aim at boosting financial intermediation.

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<sup>5</sup> Water tariffs were increased by about 40 percent in May 2005. The impact on the poorest segment of the population will be mitigated through the poverty family benefits and a World Bank supported program.

## A. Macroeconomic Framework and Medium-Term Outlook

13. **The macroeconomic outlook remains strong** (See MEFP, para 11). In light of the strong growth performance to date, GDP growth for 2005 was adjusted upward to 11 percent, representing a fourth consecutive year of double-digit growth (Table 8). End-year CPI inflation is now projected to be lower than 2

	2004	2005	2006	2007	2008
	Act.				
Real GDP growth (in percent)	10.1	11.0	7.5	6.0	6.0
Investment	23.9	24.4	24.8	25.2	25.5
Inflation (average, in percent)	7.0	1.0	3.0	3.0	3.0
Inflation (end-of-period, in percent)	2.0	1.5	3.0	3.0	3.0
General government balance (commitment basis)	-1.7	-2.4	-2.9	-2.9	-2.9
External current account	-4.6	-3.9	-4.1	-4.2	-4.0
Debt-to-exports ratio	59	60	55	54	56

Sources: Armenian authorities; and Fund staff estimates.

percent. The growth momentum is expected to continue in 2006, with GDP projected to grow by 7.5 percent and inflation to be 3 percent. Medium-term projections are broadly unchanged and in line with the government's MTEF. To reflect the developments since the adoption of the PRSP in 2003, the authorities plan to update the PRSP in early 2006.

14. **Foreign exchange inflows are likely to continue.** The government submitted its revised Millennium Challenge Corporation proposal in March, in the amount of US\$175 million. In addition, there are indications that the government is likely to receive a private grant amounting to US\$60 million. Armenia joined the Asian Development Bank in September, which is expected to start making disbursements next year.

## B. Near-Term Economic Policies

### Fiscal policy

15. **The 2005 fiscal deficit is likely to be smaller than programmed** (see MEFP, para 12). On the basis of revenue performance and budget under-execution to date, the 2005 fiscal deficit is expected to be 2.4 percent of GDP, lower than originally budgeted (2.9 percent). Notwithstanding the upward revision in the end-year nominal revenue target, the tax-to-GDP ratio is unlikely to increase as much as programmed, reflecting low tax buoyancy due to weak tax administration. Staff emphasized the importance of further strengthening fiscal institutions and moving away from ad hoc discretionary measures to attain tax revenue targets and towards a modern tax system that relies on a few broad taxes (i.e., VAT, profit, and income taxes).

16. **The 2006 budget envisages an improvement in revenue performance and a better targeting of expenditures, in line with PRSP objectives** (see MEFP, para 13). Tax revenues are targeted to increase by 0.6 percent of GDP relative to the 2005 outcome on account of tax and customs reforms (see Section C below). The revenue target is ambitious but realistic given the sizeable room for improved tax collections. The budget envisages a significant increase in allocations to social expenditure, with education, health, and social

security spending expected to increase by 0.5 percent of GDP; moreover, defense spending is also envisaged to increase by 0.5 percent of GDP. At the same time, some savings are envisaged, particularly in interest payments. Overall, total spending (excluding any potential grants from the Millennium Challenge Account (MCA)) is projected to increase by 0.8 percent of GDP relative to the 2005 outturn. The inclusion of a PIP in the 2006-08 MTEF and the new procurement process should contribute to improved expenditure execution. Staff welcomed this development and emphasized the need to remain vigilant regarding expenditure efficiency, particularly in the education and health sectors. The authorities expect confirmation on financing from the MCA in 2006 and will issue a supplementary budget to reflect any additional financing and spending.

17. **The projected 2006 fiscal stance is compatible with macroeconomic stability.** The projected deficit of 2.9 percent of GDP implies a slight loosening of the fiscal stance relative to the projected 2005 outturn. Staff agreed with the authorities that large social and infrastructure needs justify an expansion of public expenditures, particularly given the availability of low-cost external financing and subdued inflation. At the same time, staff cautioned that a more expansionary fiscal stance could intensify real exchange rate appreciation pressures and place additional burden on monetary policy to safeguard the inflation objective.

### **Monetary and exchange rate policies**

18. **Monetary policy will focus on maintaining price stability** (see MEFP, paras 14–16). The 40 percent reserve money growth envisaged under the revised 2005 monetary program, which implies a slowdown from September, is consistent with the annual inflation objective of 3 percent given the increase in money demand and the pass-through effect of nominal dram appreciation. As regards **2006 monetary policy**, the CBA intends to tighten its policy stance by limiting the increase in net foreign assets given the envisaged larger fiscal deficit in 2006, potential agricultural price pressures, and a slower increase in money demand.<sup>6</sup> Reserve money is programmed to increase by 17 percent. Regarding credit growth, staff and the authorities agreed that while the quality of loan portfolios appears to be sound, rapid credit growth requires continued monitoring of lending practices. Finally, the authorities are discussing the modalities for central bank recapitalization stemming from likely revaluation losses.

19. **The monetary policy framework will be underpinned by exchange rate flexibility.** The foreign exchange interventions undertaken this year were against the backdrop of large intermittent inflows, downward pressure on prices, and a strong increase in money demand, while the dram continued to appreciate. Going forward, staff emphasized the

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<sup>6</sup> The increase in demand for domestic money in 2005 is likely to be a one-off effect resulting from the implementation of the *Law on the Use of Domestic Currency*.

importance of limiting foreign exchange interventions to smoothing out excessive exchange rate volatility given that the muted inflationary environment is likely to be temporary.

20. **The CBA plans to move towards an inflation targeting monetary policy framework over the medium term** as the recent increase in demand for money, together with external shocks to the economy, have complicated the CBA's efforts to attain its reserve money target. For a successful implementation of the new framework, it was agreed that it will be important for the CBA to enhance further its understanding of monetary transmission mechanism, including the pace and the size of exchange rate pass-through, and develop forecasting models for relevant inflation indicators. The staff and the authorities agreed that the CBA would also need to strengthen its capacity to conduct domestic money market operations, including through augmenting its holdings of government securities over time. In this regard, the authorities plan to increase the stock of government securities by at least AMD 7 billion in 2006, which would contribute to the development of domestic government debt market needed for smoother monetary management.

### **External sector policies**

21. **Armenia's external current account and external debt remain sustainable.** After declining to 3.9 percent of GDP in 2005, the external current account deficit is projected to remain at around 4 percent over the medium-term. The joint IMF-World Bank debt sustainability analysis (DSA) indicates that Armenia is at a low risk of debt distress.<sup>7</sup> Notwithstanding its conservative assumptions, the DSA reveals that all external debt indicators are well below the relevant country-specific debt-burden thresholds. The findings of the DSA underline the importance of Armenia continuing the process of structural reform, and preserving macroeconomic stability in order to safeguard the debt outlook.

## **C. Structural Reforms**

### **Fiscal reforms**

22. **Fiscal reforms under the program will focus on improving the tax system and strengthening tax and customs administration** (see MEFP, paras.19–21). In the area of **tax policy**, efforts will be made to widen the tax base by reducing loopholes and tax evasion. The authorities will introduce a presumptive tax on property developers (structural benchmark) and integrate simplified tax payers into the regular social security tax payments system (structural performance criterion). Consistent with FAD recommendations, **tax administration** reforms focus on the development of a comprehensive 2006–08 information technology strategy for the STS, legislative changes to strengthen sanctions for providing false documentation to the revenue agencies (structural performance criterion), and further improvements in tax audits, arrears collection, and the VAT refund system. In **customs administration**, the operational review of the SCC with the assistance of a specialized

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<sup>7</sup> See Appendix V outlining the results of the joint Fund-World Bank debt sustainability analysis.

international company is scheduled to be completed by March 2006 (structural benchmark). In addition, the authorities will increase further the use of declared transaction values in assessing customs duties and VAT (structural benchmark) and extend the use of self-assessment and risk-based inspections. Staff agreed that these steps should improve the effectiveness of procedures and operations in customs and enhance the governance environment.

**23. Reforms in the expenditure area will center on improving budget implementation, expenditure management, and the monitoring of noncommercial organizations (NCOs)** (see MEFP paras. 22–23). The authorities plan to build capacity to manage expenditures and monitor investment projects, including by strengthening public procurement and tendering procedures. To improve NCOs' financial management and reporting, the authorities will adopt a sanction mechanism for failure to comply with existing reporting requirements and intend to move forward with implementing an action plan for improving the monitoring system. In addition, the authorities will implement a new law restricting the types of legal entities that can operate as NCOs, including by removing joint stock companies from NCO status.

#### **Financial sector reforms**

**24. Financial sector reforms will continue to focus on strengthening further the market infrastructure and regulatory and legal framework underpinning the financial system** (See Supplementary MEFP, paras. 24–26). Viewing weak corporate governance as a key factor limiting financial intermediation, the authorities' priority is to pass legislation amending the Law on Banks and Banking to improve corporate governance in the banking sector (structural performance criterion). The authorities believe that while this is an important first step in increasing competitiveness in the banking sector, a broader ownership structure of banks might ultimately be necessary in order to foster credit expansion to the wider economy. The authorities regard weak creditor rights as another impediment to the expansion of financial intermediation and remain committed to comprehensive legislative reforms in this area.

**25. Financial sector regulation and supervision will continue to be strengthened.** Many of the 2005 FSAP recommendations following the assessment of compliance with the Basel Core Principles for Effective Banking Supervision are due to be implemented, including amending the Law on Banks and Banking to empower the CBA to identify ultimate beneficial owners in the event of upward consolidation (structural performance criterion) and specifying and implementing a consolidated supervision framework (structural benchmark). More generally, noting the benefit of ensuring a level playing field for all market participants, and to address problems that have impeded the development of adequate insurance supervision (such as the lack of resources and technical skills), the authorities intend to move towards a unified financial supervision system by merging supervisors for insurance, banking, and the security market under the CBA.

**26. Progress continues to be made in developing the nonbank financial sector.** New prudential regulations as well as accounting and reporting requirements for the insurance



sector are due to be implemented in October. A legislative package aimed at developing the primary mortgage market, mainly through simplifying procedures for notarization and the registration of rights for immovable assets, is also expected to be approved by parliament.

### **Other structural reforms**

27. **Reforms in the public utility sector are designed to improve its services and financial viability** (see MEFP, para 29). The authorities intend to reduce subsidies to the water and irrigation sectors by 0.5 billion drams each year.<sup>8</sup> A leasing contract, expected to be introduced to the Yerevan Water and Sewage Company in mid-2006, will allow for the termination of budgetary support to the company. The authorities also anticipate a further reduction in losses in the irrigation sector by raising tariffs and strengthening the capacity of the water user associations. In the energy sector, while progress has been made in setting market rules, it will be important to ensure the independence and technical strength of the regulator given the concentration of ownership in electricity generation and distribution.

28. **As part of the efforts to improve the business climate, the government has pledged to reduce corruption** (see MEFP, para 28). The authorities will continue with the anti-corruption strategy action plan, focusing on such areas as education, health care, and traffic police. These efforts, while necessary, need to be supplemented by enhanced law enforcement and wider public participation. In this regard, it is important to pass the law on financial disclosure of physical persons and implement it forcefully.

### **D. Program Monitoring**

29. The performance criteria, structural benchmarks, and indicative targets under the program are specified in the attached memorandum of economic policies and the technical memorandum of understanding (Attachments II and III). Performance under the second review will be assessed based on end-December 2005 data and measures (Attachment II, Tables 1 and 2). The second review of the program is expected to take place in May 2006. A safeguards update report has been completed for the current PRGF arrangement (See Appendix I).

## **IV. STAFF APPRAISAL**

30. **The Armenian economy is performing strongly.** Prudent fiscal and monetary policies, strong external transfers, and ongoing structural reforms have contributed to double-digit growth, low inflation, and declining poverty. The program for 2005 remains on track. The outlook is for further strong growth in 2006, underpinned by high investment and remittance inflows.

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<sup>8</sup> Total subsidies to the water and irrigation sectors are projected to amount to 6.2 billion drams (roughly 0.3 percent of GDP) in 2005.

31. **The broad parameters of the 2006 budget are appropriate.** Staff supports the higher social and infrastructure spending envisaged in the budget, which is in line with PRSP priorities, particularly given that the deficit is being financed by drawing-down of government deposits and concessional aid flows. However, it will be important that the deficit target for 2006 not be exceeded given the continued pressures on dram appreciation stemming from significant foreign exchange inflows. In this context, the authorities are encouraged to meet the ambitious revenue target, building upon the progress made in increasing tax collections in 2005, and to adjust expenditures in accordance with any revenue shortfall during the year. Staff places particular importance on increasing the buoyancy of tax revenues without resorting to ad hoc discretionary measures to increase collections. Moreover, it encourages the authorities to improve further expenditure efficiency and targeting to ensure adequate and high quality public investment and social spending.

32. **A sound monetary policy framework has been instrumental in supporting macroeconomic stability.** This framework is based on a clear mandate on price stability. The current accommodative monetary stance is appropriate given an environment of subdued inflation and increasing money demand. Staff supports the authorities' intention to tighten the policy stance in 2006 in response to a slightly more expansionary fiscal stance, fuel price effects, and uncertainty in money demand. The recent appreciation of the dram has contributed to subdued inflation and is partially offsetting the effect of higher energy prices. Staff encourages the authorities to maintain the flexible exchange rate regime and to limit intervention in the foreign exchange market to smoothing out volatility in the exchange rate. Moreover, staff supports the authorities' intention to recapitalize the central bank.

33. **Staff notes the authorities' intention to move towards an inflation targeting monetary policy framework over the medium-term.** It encourages the authorities to work on strengthening the institutional pre-requisites for the implementation of such a regime, including by establishing a forward-looking framework for inflation forecasting, strengthening the banking system and its role in financial intermediation, and strengthening further the policy coordination between the ministry of finance and economy and the CBA.

34. **Notwithstanding the solid progress made so far, further tax and customs reforms are needed to broaden the tax base, mobilize budget revenues, and improve the business climate.** Efforts in tax administration should concentrate on boosting compliance, and improving managerial and organizational capacity, including risk-based analysis audit methods, information technology, and strengthening refund mechanisms and arrears clearance. Reducing discretion and improving transparency in customs administration would benefit the business climate. In this regard, staff places high priority on the completion of the operational review of customs with a view to identifying its main strengths and weaknesses, in order to lay the foundations for subsequent reforms.

35. **Financial sector reforms are focused appropriately on strengthening the market infrastructure and regulatory and legal framework underpinning the financial system.** Staff welcomes the recent increase in credit to the private sector, albeit from a low base, and

encourages the authorities to press ahead with their plans to foster greater financial intermediation by encouraging competition in the banking sector through strengthening the corporate governance of banks and by improving banking and nonbank regulation and supervision.

36. **Good progress has been made in improving the financial performance of the energy and water sectors but further reforms are needed to avoid a return to quasi-fiscal operations.** Staff supports the authorities' intention to complete the long-delayed liquidation of Armenergo by the end of 2005, and emphasizes the importance of having an independent and strong regulator to ensure adequate competition in the sector. Staff also encourages the authorities to follow through with reforms in the water and irrigation sectors to achieve operations and maintenance cost recovery by 2007. Regarding governance, the legislative agenda for the anti-corruption action plan needs to be complemented with forceful enforcement and appropriate penalties for abuse.

37. **The road ahead will require continued efforts to maintain macroeconomic stability and implement structural reforms.** The main risks to macroeconomic stability are the challenges posed by continued strong foreign exchange inflows while a potential slowdown of disbursements of grants and loans could increase fiscal vulnerability. This reinforces the importance of building the domestic revenue base, deepening financial markets, and implementing structural reforms aimed at raising productivity.

38. **Armenia's performance under the PRGF arrangement has been commendable.** Based on this track record, and the strong policy program set out in the MEFP, staff supports the authorities' request for completion of the first review under the PRGF arrangement and modification of the end-December quantitative performance criteria.

Table 1. Armenia: Selected Economic and Financial Indicators, 2001–06

	2001	2002	2003	2004	2005		2006
					Prog.	Proj.	Prog.
(Annual percentage change, unless otherwise indicated)							
National income and prices							
Real GDP growth	9.6	13.2	13.9	10.1	8.0	11.0	7.5
Gross domestic product (in billions of drams)	1,176	1,362	1,623	1,896	2,106	2,168	2,401
Gross domestic product (in millions of U.S. dollars)	2,120	2,373	2,805	3,558	4,217	4,580	5,192
Gross domestic product per capita (in U.S. dollars)	660	739	873	1,107	1,299	1,425	1,607
CPI (period average)	3.1	1.1	4.7	7.0	3.0	1.0	3.0
CPI (end of period)	2.9	2.0	8.6	2.0	3.0	1.5	3.0
GDP deflator	4.0	2.4	4.6	6.1	3.0	3.0	3.0
Unemployment rate (in percent)	10.4	9.4	10.1	9.4	8.9	8.9	...
Poverty rate (in percent)	47.0	...	32.0	...	...	...	...
Investment and saving (in percent of GDP)							
Investment	19.8	21.7	24.7	23.9	23.3	24.4	24.8
National savings	10.3	15.4	17.9	19.4	18.3	20.5	20.7
Money and credit (end of period)							
Reserve money	11.1	38.4	6.6	11.4	14.0	39.8	16.6
Broad money	4.3	34.0	10.4	22.3	18.5	27.2	19.5
Commercial banks' 3-month lending rate (in percent) 1/	27.7	23.4	22.3	15.4	...	...	...
Central government operations (in percent of GDP)							
Revenue and grants	17.0	18.8	17.8	15.6	15.8	15.6	16.8
<i>of which</i> : tax revenue	14.3	14.6	14.0	14.1	14.7	14.5	15.1
Expenditure and net lending	20.9	19.3	18.9	17.2	18.7	18.0	19.7
Overall balance on a commitment basis	-3.8	-0.4	-1.1	-1.7	-2.9	-2.4	-2.9
Overall balance on a cash basis	-4.0	-2.6	-1.5	-1.7	-2.9	-2.4	-2.9
Stock of domestic expenditure arrears	2.8	0.5	0.0	0.0	0.0	0.0	0.0
Government and government-guaranteed debt (in percent of GDP)	45.3	46.6	40.9	30.7	30.1	28.6	27.3
Share of foreign currency debt (in percent)	95.5	94.4	93.5	92.6	92.0	93.9	92.6
Primary balance of the energy sector (in percent of GDP) 2/	-2.5	-0.4	0.0	0.1	...	...	...
External sector							
Exports of goods and services (in millions of U.S. dollars)	540	698	903	985	1,037	1,180	1,340
Imports of goods and services (in millions of U.S. dollars)	-978	-1,107	-1,406	-1,514	-1,654	-1,819	-2,016
Exports of goods and services	20.8	29.3	29.5	9.0	6.9	19.8	13.5
Imports of goods and services	1.2	13.2	27.0	7.7	9.6	20.2	10.8
Current account (in percent of GDP)	-9.5	-6.2	-6.8	-4.6	-5.1	-3.9	-4.1
FDI (net, in millions of U.S. dollars)	70	111	121	217	198	255	152
External debt-to-exports ratio	132	131	60	59	67	60	55
Debt service ratio 3/	9.7	9.8	15.6	9.7	6.1	5.7	4.6
Gross international reserves (in millions of U.S. dollars)	329	430	502	547	582	677	693
Import cover 4/	3.6	3.7	4.0	3.6	3.9	4.0	3.8
Nominal effective exchange rate 5/	3.4	-5.8	-4.6	11.5	...	...	...
Real effective exchange rate 5/	-2.0	-10.8	-2.6	6.5	...	...	...
Average exchange rate (dram per dollar)	555	575	578	530	...	...	...
Memorandum item:							
Population (in millions)	3.213	3.210	3.212	3.214	3.215	3.215	...

Sources: Armenian authorities; and Fund staff estimates and projections.

1/ End of period.

2/ Comprises state-owned energy companies. Data for 2001–02 include the electricity distribution company, Armelnet, which was privatized in late-2002. Data for 2003–04 exclude Armelnet and two generation companies that were also privatized.

3/ In percent of exports of goods and services.

4/ Gross international reserves in months of next year's imports of goods and services.

5/ A positive sign denotes appreciation. Base year 1995=100. The calculations are based on 1999–2001 average trade weights.

Table 2. Armenia: Quantitative Targets, 2004–05 1/  
(End of period ceilings on stocks, unless otherwise specified)

	2004		2005	
	Dec.	Mar.	Jun.	
	Act.	Act.	Prog. 2/	Act.
	(In billions of drams)			
Net domestic assets of the CBA 3/	-21.2	-52.4	-53.8	-56.0
Net banking system credit to the government	-17.2	-35.7	-17.2	-25.1
Domestic arrears of the central government and the State Fund for Social Insurance	0.0	0.0	0.0	0.0
Tax revenues of the central government (floor) 4/	266.7	64.1	137.3	139.8
Balance of the central government on a cash basis (floor) 4/	-31.3	5.9	-25.0	-3.3
Reserve money (band/level) 5/	132.0	123.6	(122-127)	150.8
Contributions to the State Fund for Social Insurance 4/ 5/	48.8	13.9	29.8	28.7
	(In millions of dollars)			
Contracting or guaranteeing of new nonconcessional external debt 4/ 6/	0	0	0	0
External arrears (continuous criterion)	0	0	0	0
Net official international reserves (floor) 7/	329.4	374.9	379.0	436.4

Source: Armenian authorities.

1/ All items as defined in the Technical Memorandum of Understanding.

2/ Performance criterion.

3/ NDA valued at program exchange rate (500 dram per U.S. dollar).

4/ Cumulative flow from the beginning of the calendar year until the end of the month indicated.

5/ Indicative target.

6/ Includes debt with maturity of more than a year as well as obligations with maturity of one year or less, excluding normal import-related credit and sales of treasury bills to nonresidents.

7/ NIR data under the previous arrangement have been revised to reflect market prices of investment securities, as follows: from \$267.6 million to \$266.7 million for end-June 2004; from \$282.5 million to \$281.5 million for end-December 2003; and from \$231 million to \$232 million for end-December 2002.

Table 3. Status of Structural Measures for the First Review under the PRGF

Measure	Type of Conditionality	Target Date (End of Period)	Status
<p><u>Tax policy</u></p> <p>Submit to parliament an amendment to the VAT law to become effective January 1, 2006, that will reduce the list of goods exempt from VAT payment at the border as specified in paragraph 24 of the MEFP and introduce a time limit after which VAT must be paid under the capital deferral system, both effective 2006.</p>	Structural Benchmark	June 2005	Observed
<p><u>Tax administration</u></p> <p>Finalize, in consultation with Fund staff, an action plan for 2005-06 approved by the government, with a timeline for reforms of tax policy and tax and customs administration that are closely in line with Fund technical assistance reports.</p>	Prior Action		Observed
<p>Publish the names of the 300 largest taxpayers.</p>	Prior Action		Observed
<p>Improve the STS's ability to conduct audits by passing a law on tax audits, including provisions to: permit off-site audits and several types of audits at a time; extend the time limit for budget audits of large enterprises to at least 3 months; and, extend the time limit for drafting the audit report to at least 3 weeks.</p>	Structural Benchmark	June 2005	Not observed. The draft law was approved by the government but, due to scheduling difficulties in parliament, has not yet been approved by parliament.
<p><u>Customs administration</u></p> <p>Agree on the terms of reference for an operational review of the State Customs Committee by a specialized international company in preparation for tender.</p>	Structural Benchmark	June 2005	Observed
<p><u>Financial Sector</u></p> <p>(i) Submit to Parliament an amendment to the Law on Banks and Banking to empower the CBA to identify ultimate beneficial owners, in the event of upward consolidation.</p>	Structural Performance Criterion	June 2005	Observed
<p>(i) Submit to Parliament an amendment to the Law on Banks and Banking that defines the separate duties and rights of shareholders, boards of directors, and executives of banks; requires disclosure of potential conflicts of interest of board members; and requires public disclosure of information on ownership and control of banks, including list of founders and copies of the company's statutes.</p>	Structural Performance Criterion	June 2005	Observed

Source: Based on information from the Armenian authorities.

Table 4. Armenia: Central Government Operations, 2004-06

	2004				2005				2006											
	Jan-Dec		Q1		Q2		Q3		Q4		Q1		Q2		Q3		Q4		Jan-Dec	
	Act	Prog. 1/	Act	Prog. 1/	Act	Prog. 1/	Act	Prog. 1/	Act	Prog. 1/	Act	Prog. 1/	Act	Prog. 1/	Act	Prog. 1/	Act	Prog. 1/	Act	Prog. 1/
Total revenue and grants	294.9	67.1	69.8	79.4	81.5	90.9	93.0	95.4	93.9	332.9	338.2	85.0	95.5	107.5	114.5	402.5	382.0			
Total revenue	283.8	66.2	66.7	76.5	80.6	86.6	87.6	91.5	89.9	320.8	324.8	77.6	88.1	100.1	107.0	372.8	372.8			
Tax revenue	266.7	64.1	64.1	73.1	75.7	83.4	84.4	89.3	89.8	310.0	314.0	75.1	85.6	97.6	104.5	362.8	362.8			
Nontax revenue	8.0	1.3	2.1	1.3	1.4	1.3	1.4	0.5	0.5	5.3	5.3	1.6	1.6	1.6	1.6	6.5	6.5			
Capital revenue	9.1	0.8	0.5	2.0	3.5	1.9	1.9	0.8	-0.4	5.5	5.5	0.9	0.9	0.9	0.9	3.6	3.6			
Grants 3/	11.1	0.9	3.1	3.0	0.9	4.3	5.4	3.9	4.0	12.1	13.4	7.4	7.4	7.4	7.4	29.7	9.1			
of which: MCA and Lincy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	5.0	5.0	5.0	5.0	20.0	0.0			
Total expenditure	326.8	64.2	67.7	107.3	94.5	115.0	113.0	108.1	115.0	394.6	390.2	78.2	103.3	91.6	94.7	472.4	451.9			
Current expenditure	253.1	53.1	58.0	83.1	72.1	78.5	76.5	80.5	84.3	295.2	290.8	69.5	93.8	80.1	91.3	334.7	331.1			
Wages	40.2	9.5	14.3	11.3	8.3	11.2	11.2	14.1	12.3	46.1	46.1	12.1	14.3	14.2	17.9	58.5	34.3			
Subsidies	18.2	4.7	3.6	5.0	3.8	1.7	1.7	1.7	4.0	13.1	13.1	5.5	5.8	2.0	2.0	15.4	15.4			
Interest	9.8	2.5	2.2	2.6	2.3	3.8	3.7	3.2	3.5	12.1	11.7	2.3	2.6	3.2	3.1	11.1	10.8			
Transfers	64.9	16.1	16.0	17.2	18.5	18.2	18.2	17.3	16.1	68.7	68.7	20.3	21.7	22.9	21.8	86.7	86.7			
Goods and services	120.0	20.3	21.9	47.1	39.3	43.6	41.7	44.3	48.3	155.2	151.2	29.3	49.4	37.8	46.5	162.9	183.8			
of which: financed by MCA and Lincy 3/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.8	0.8	0.8	0.8	3.0	0.0			
Capital expenditure and net lending	73.7	11.0	9.8	24.3	22.4	36.5	36.5	27.6	30.7	99.4	99.4	8.7	9.5	11.4	3.3	137.8	120.8			
Capital expenditure 3/	62.2	8.5	7.0	20.4	18.9	32.4	32.4	28.0	31.1	89.3	89.3	4.7	3.4	4.9	4.0	121.8	104.8			
of which: financed by MCA and Lincy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	4.3	4.3	4.3	4.3	17.0	0.0			
Net lending	11.5	2.5	2.8	3.9	3.5	4.1	4.1	-0.4	-0.3	10.1	10.1	4.0	6.1	6.5	-0.7	16.0	16.0			
Overall balance (commitment)(-)	-31.9	2.9	2.1	-27.9	-13.0	-24.1	-20.0	-12.7	-21.1	-61.8	-52.0	6.9	-7.7	15.9	19.8	-69.9	-69.9			
Net clearance of arrears (plus = accumulation)	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			
Statistical discrepancy/financing gap	0.5	0.0	3.8	0.0	3.8	0.0	0.0	-7.6	-7.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0			
Overall balance (cash)	-31.3	2.9	5.9	-27.9	-9.2	-24.1	-20.0	-12.7	-28.7	-61.8	-52.0	0.0	-32.2	-23.3	-14.4	-69.9	-69.9			
Deficit/financing	31.3	-2.9	-5.9	27.9	9.2	24.1	20.0	12.7	28.7	61.8	52.0	0.0	32.2	23.3	14.4	69.9	69.9			
Domestic financing	-4.0	-9.2	-9.5	21.7	5.8	16.6	10.4	-1.9	15.4	27.2	22.1	-12.7	21.7	12.0	9.9	30.9	33.4			
Banking system	-1.2	-17.2	-16.7	19.2	10.3	9.2	4.3	1.6	16.0	12.9	13.9	-12.6	21.5	11.9	9.4	30.2	33.4			
Central Bank of Armenia	-3.9	-21.2	-21.2	13.5	5.0	6.6	5.4	9.9	21.7	8.7	10.8	-12.3	19.7	11.6	5.0	23.9	26.6			
Commercial Banks	2.7	4.1	4.6	5.8	5.3	2.6	-1.1	-8.3	-5.7	4.2	3.1	-0.3	1.8	0.4	4.4	6.3	6.9			
Nonbank	-2.7	8.0	7.2	2.5	-4.5	7.4	6.1	-3.6	-0.6	14.3	8.2	0.0	0.2	0.0	0.5	0.7	0.0			
of which: Privatization proceeds	0.0	6.3	6.3	0.0	0.0	6.3	6.3	0.0	0.0	12.5	12.5	0.0	0.0	0.0	0.0	0.0	0.0			
External financing	35.3	6.3	3.6	6.2	3.5	7.5	9.6	14.7	13.3	34.7	30.0	12.7	10.5	11.3	4.5	39.0	36.5			
Gross inflow	46.3	9.5	5.4	7.7	4.9	9.4	11.6	17.7	17.7	44.2	39.5	15.6	12.0	14.0	6.0	47.6	44.6			
Amortization due	-11.1	-3.1	-1.8	-1.5	-1.5	-1.9	-1.9	-3.0	-4.3	-9.5	-9.5	-2.9	-1.5	-2.7	-1.5	-8.7	-8.1			

(In billions of drams)

Table 4. Armenia: Central Government Operations, 2004-06 (concluded)

	2004		2005				2006					
	Jan-Dec	Act.	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Jan-Dec	
	Act.	Prog. 1/	Act.	Prog. 1/	Act.	Prog. 1/	Act.	Prog. 1/	Act.	Prog. 1/	Act.	
Total revenue and grants	15.6	3.2	3.2	3.8	4.3	4.3	4.5	4.0	4.5	4.8	16.8	15.9
Tax revenue	15.0	3.1	3.1	3.6	4.1	4.0	4.3	3.2	3.7	4.2	15.5	15.5
Nontax revenue	0.4	0.1	0.1	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.3	0.3
Capital revenue	0.5	0.0	0.0	0.1	0.2	0.1	0.0	0.0	0.0	0.0	0.2	0.2
Grants 3/	0.6	0.0	0.1	0.1	0.0	0.2	0.2	0.2	0.3	0.3	1.2	0.4
of which: MCA and Lincy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.2	0.8	0.0
Total expenditure	17.2	3.0	3.1	5.1	4.4	5.5	5.2	5.1	5.3	3.8	19.7	18.8
Current expenditure	13.3	2.5	2.7	3.9	3.3	3.7	3.5	3.8	3.9	3.3	13.9	13.8
Wages	2.1	0.5	0.7	0.5	0.4	0.5	0.5	0.7	0.6	0.6	0.7	2.4
Subsidies	1.0	0.2	0.2	0.2	0.2	0.1	0.1	0.2	0.2	0.1	0.1	0.6
Interest	0.5	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.1	0.1	0.5
Transfers	3.4	0.8	0.7	0.8	0.9	0.9	0.8	0.8	0.7	3.3	3.2	3.6
Goods and services	6.3	1.0	1.0	2.2	1.8	2.1	1.9	2.1	2.2	7.4	7.0	7.7
of which: financed by MCA and Lincy 3/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital expenditure and net lending	3.9	0.5	0.5	1.2	1.0	1.7	1.7	1.3	1.4	4.7	4.6	5.0
Capital expenditure 3/	3.3	0.4	0.3	1.0	0.9	1.5	1.5	1.3	1.4	4.2	4.1	4.4
of which: financed by MCA and Lincy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.2
Net lending	0.6	0.1	0.1	0.2	0.2	0.2	0.2	0.0	0.0	0.5	0.5	0.7
Overall balance (commitment)(-)	-1.7	0.1	0.1	-1.3	-0.6	-1.1	-0.9	-0.6	-1.0	-2.9	-2.4	-2.9
Net clearance of arrears (plus = accumulation)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Statistical discrepancy/financing gap	0.0	0.0	0.2	0.0	0.2	0.0	0.0	0.0	-0.4	0.0	0.0	0.0
Overall balance (cash)	-1.7	0.1	0.3	-1.3	-0.4	-1.1	-0.9	-0.6	-1.3	-2.9	-2.4	-2.9
Deficit/financing	1.7	-0.1	-0.3	1.3	0.4	1.1	0.9	0.6	1.3	2.9	2.4	2.9
Domestic financing	-0.2	-0.4	-0.4	1.0	0.3	0.8	0.5	-0.1	0.7	1.3	1.0	1.3
Banking system	-0.1	-0.8	-0.8	0.9	0.5	0.4	0.2	0.1	0.7	0.6	0.6	0.4
Central Bank of Armenia	-0.2	-1.0	-1.0	0.6	0.2	0.3	0.2	0.5	1.0	0.4	0.5	1.0
Commercial Banks	0.1	0.2	0.2	0.3	0.2	0.1	-0.1	-0.4	-0.3	0.2	0.1	0.0
Nonbank	-0.1	0.4	0.3	0.1	-0.2	0.4	0.3	-0.2	0.0	0.7	0.4	0.0
of which: Privatization proceeds	0.0	0.3	0.3	0.0	0.0	0.3	0.3	0.0	0.0	0.6	0.6	0.0
External financing	1.9	0.3	0.2	0.3	0.2	0.4	0.4	0.7	0.6	1.6	1.4	1.5
Gross inflow	2.4	0.4	0.2	0.4	0.2	0.4	0.5	0.8	0.8	2.1	1.8	2.0
Amortization due	-0.6	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.5	-0.4	-0.3
Memorandum items												
Underlying balance (excl. grants and interest, commitment)(-)	-1.7	0.2	0.1	-1.3	-0.5	-1.2	-1.0	-0.6	-1.0	-2.9	-2.5	-3.7
Primary balance (excl. interest, commitment)	-1.2	0.3	0.2	-1.2	-0.5	-1.0	-0.8	-0.5	-0.8	-2.4	-1.9	-2.4
Net borrowing/lending (commitment)(-)/4/	-1.7	0.4	0.4	-1.3	-0.6	-0.8	-0.6	-0.6	-1.0	-2.3	-1.8	-2.9
Domestic expenditure arrears (stock in billions of drams)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Government and government-guaranteed debt	30.7	...	...	...	...	...	...	...	...	30.1	28.6	27.3
of which: domestic debt	2.3	...	...	...	...	...	...	...	...	2.4	1.7	2.0
Nominal GDP (annual, in billions of drams)	1,896	2,106	2,168	2,106	2,168	2,106	2,168	2,106	2,168	2,401	2,401	2,401

Sources: Ministry of Finance and Economy, Central Bank of Armenia, and Fund staff estimates.

1/ Relative to the budget, the staff presentation makes the following adjustments: (i) estimated military wages are reclassified from Other goods and services to Wages, and (ii) in 2005 an AMD 12.5 billion fee for the participation in the tender for the Molybdenum copper plant is recorded as privatization proceeds instead of nontax revenue. (iii) External grants, external interest, and external financing are converted at the program exchange rate of 500 AMD per U.S. dollar and AMD 680.4 per euro.

2/ Draft budget as submitted to parliament in October 2005.

3/ For 2006, the "Proj." columns includes grants from the Lincy Foundation and the Millennium Challenge Corporation (MCC), except for AMD 3 billion, these grants are allocated to capital expenditure.

4/ Overall balance plus privatization proceeds.



Table 5. Armenia: Monetary Accounts, 2004–06

	2004		2005						2006				
	Dec.		Mar.	June		Sep.		Dec.	Mar.	June	Sep.	Dec.	
	Act.	Act. 1/	Act.	Prog.	Act.	Prog.	Est.	Prog.	Rev. prog.	Proj.	Proj.	Proj.	Proj.
(In billions of drams, unless otherwise indicated)													
<b>Central Bank of Armenia</b>													
Net foreign assets	162.6	167.3	165.0	183.2	184.8	193.8	211.8	221.2	278.6	262.7	262.7	271.2	288.0
Net international reserves	160.0	164.7	170.3	189.5	189.2	186.7	208.7	194.6	245.0	229.1	229.1	237.6	254.4
Special privatization account	13.7	14.1	4.7	5.1	4.5	20.8	12.0	42.6	42.6	42.6	42.6	42.6	42.6
Medium and long-term	-11.1	-11.4	-9.9	-11.4	-8.9	-13.7	-9.0	-15.9	-9.0	-9.0	-9.0	-9.0	-9.0
Net domestic assets 2/	-30.5	-35.3	-41.4	-58.9	-34.0	-62.7	-37.9	-70.6	-94.0	-85.4	-79.4	-71.3	-72.6
Claims on general government (net)	-36.8	-36.8	-59.8	-46.4	-54.5	-39.8	-48.2	-29.9	-27.5	-39.8	-20.1	-8.6	-3.6
of which : central government (net)	-15.7	-15.7	-36.9	-23.5	-31.9	-16.9	-26.6	-7.0	-4.9	-17.2	2.5	14.0	19.0
Claims on banks	10.9	10.9	5.1	-10.8	2.9	-5.7	9.7	-1.8	2.9	2.9	2.9	2.9	2.9
KfW	11.7	11.7	11.7	11.7	11.7	13.2	11.7	14.7	11.7	11.7	11.7	11.7	11.7
Monetary instruments (net) excluding CBA bills	-0.8	-0.8	-6.6	-22.5	-8.8	-18.9	-2.0	-16.5	-8.8	-8.8	-8.8	-8.8	-8.8
CBA bills	...	...	...	...	-3.5	...	-13.5	...	-29.6	-10.1	-24.4	-27.7	-33.3
Other items (net) 2/	-4.6	-9.3	13.4	-1.7	21.1	-17.1	14.1	-39.0	-39.7	-38.3	-37.8	-38.0	-38.6
SPA	-13.7	-14.1	-4.7	-5.1	-4.5	-20.8	-12.0	-42.6	-42.6	-42.6	-42.6	-42.6	-42.6
Autonomous OIN	9.1	4.8	18.1	3.4	25.6	3.7	26.1	3.6	2.8	4.2	4.7	4.6	3.9
Reserve money	132.0	132.0	123.6	124.3	150.8	131.1	173.8	150.6	184.6	177.3	183.2	199.9	215.4
Currency issue	105.5	105.5	98.8	99.2	113.4	105.6	132.2	117.8	146.4	137.6	142.3	156.5	170.6
Deposits	26.5	26.5	24.8	25.1	37.4	25.5	41.6	32.8	38.2	39.7	40.9	43.4	44.7
<b>Banking system</b>													
Net foreign assets	222.5	223.5	218.9	239.3	223.5	248.2	290.6	274.0	324.7	297.9	299.8	310.3	329.0
Net domestic assets	63.4	62.4	59.9	46.7	79.8	57.3	50.6	64.8	39.0	61.5	74.8	98.6	105.6
Claims on government (net)	-17.2	-17.2	-35.7	-17.2	-25.1	-8.0	-20.8	-6.3	-4.8	-17.4	4.0	16.0	25.4
of which: claims on central government (net)	3.9	3.9	-12.8	5.9	-2.5	15.2	1.8	16.8	17.8	5.2	26.7	38.6	48.0
Claims on rest of the economy	142.5	142.5	141.1	154.9	154.8	169.7	174.3	204.4	190.4	207.0	218.7	240.1	248.0
Other items (net) 2/	-61.8	-62.8	-45.5	-91.0	-49.9	-104.4	-102.8	-133.2	-146.6	-128.0	-148.0	-157.5	-167.8
Broad money	285.9	285.9	278.8	286.0	303.3	305.6	341.3	338.8	363.7	359.4	374.6	408.9	434.6
Currency in circulation	98.6	98.6	91.4	93.2	105.3	99.6	124.6	111.8	138.2	130.1	134.8	148.0	162.1
Deposits	187.4	187.4	187.4	192.8	198.0	205.9	216.7	227.0	225.5	229.3	239.7	260.8	272.5
Domestic currency	47.1	47.1	54.1	46.2	59.2	49.4	69.3	56.7	72.0	69.4	75.3	85.5	92.1
Foreign currency	140.2	140.2	133.3	146.6	138.8	156.6	147.4	170.4	153.5	159.9	164.4	175.4	180.4
<b>Memorandum items</b>													
Exchange rate (in drams per U.S. dollar, end of period)	485.8	485.8	458.1	...	442.3	...	444.2	...	...	...	...	...	...
Program e-rate	...	500.0	...	500.0	...	500.0	...	...	...	...	...	...	...
Privatization account (in millions of US\$)	28.1	28.1	10.2	10.2	10.2	41.6	27.0	85.1	85.1	85.1	85.1	85.1	85.1
NIR (in millions of U.S. dollars) 3/	329.4	329.4	371.6	...	427.8	...	469.9	...	...	...	...	...	...
NIR (in millions of U.S. dollars) 4/	...	329.4	374.9	379.0	436.4	373.3	484.0	389.2	490.0	458.1	458.1	475.2	508.7
NIR (in millions of U.S. dollars) 5/	...	...	...	...	385.4	...	424.3	...	...	...	...	...	...
NIR (in millions of U.S. dollars) 6/	...	...	...	...	393.5	...	437.8	...	449.9	415.5	414.4	426.3	458.3
NDA of the CBA (in billions of drams) 7/	...	-21.2	-52.4	-53.8	-56.0	-41.9	-56.7	-28.1	-51.4	-42.8	-36.9	-28.8	-30.0
12-month change in reserve money (in percent)	11.4	11.4	19.5	17.0	41.9	14.9	52.3	14.0	39.8	43.4	21.5	15.0	16.6
12-month change in broad money (in percent)	22.3	22.3	23.0	22.9	30.3	20.6	34.7	18.5	27.2	28.9	23.5	19.8	19.5
12-month change in private sector credit (in percent)	38.1	38.1	28.4	27.9	27.8	28.7	32.1	43.4	33.6	46.8	41.3	37.7	30.2
Velocity of broad money (end of period)	6.6	6.6	6.9	6.8	6.6	...	6.1	6.2	6.0	6.1	6.0	5.7	5.5
Money multiplier	2.2	2.2	2.3	2.3	2.0	2.3	2.0	2.3	2.0	2.0	2.0	2.0	2.0
Dollarization in bank deposits 8/	74.8	74.8	71.1	76.0	70.1	76.0	68.0	75.0	68.1	69.7	68.6	67.2	66.2
Dollarization in broad money 9/	49.0	49.0	47.8	51.2	45.8	51.2	43.2	50.3	42.2	44.5	43.9	42.9	41.5
Currency in circulation in percent of deposits	52.6	52.6	48.8	48.4	53.2	48.4	57.5	49.3	61.3	56.7	56.3	56.7	59.5
Stock of FCD (in millions of USD)	288.6	288.6	291.0	293.1	313.8	313.2	294.9	340.7	307.0	319.9	328.9	350.8	360.8
Banking system financing of the central government (cumulative)	...	...	-16.7	2.0	-6.4	11.3	-2.1	12.9	13.9	-12.6	8.8	20.8	30.2
Banking system financing of the general government (cumulative)	-2.6	-2.6	-18.4	0.0	-7.8	9.3	-3.6	10.9	12.4	-12.6	8.8	20.8	30.2

Sources: Central Bank of Armenia; and Fund staff estimates.

1/ At program exchange rate.

2/ The projected decline in other items (net) in 2005 is related to additional privatization proceeds primarily from the sale of a copper company. These proceeds will be deposited in the special privatization account (SPA) which is a separate account at the CBA and is subject to regular audit by Parliament. Those proceeds are not reflected in the fiscal accounts until funds are earmarked for spending within the budget.

3/ At actual exchange rates, excluding the SPA.

4/ At program exchange rates, excluding the SPA.

5/ At actual exchange rates, excluding the SPA and foreign currency reserve money.

6/ At program exchange rates, excluding the SPA and foreign currency reserve money.

7/ At program exchange rate of 500 dram/U.S. dollar; defined as reserve money minus NIR plus medium- and long-term liabilities. Reserve money denominated in foreign currencies is included in reserve money and NIR up to June 2005. They are excluded for September 2005 onward.

8/ Ratio of foreign currency deposits to total deposits (in percent).

9/ Ratio of foreign currency deposits to broad money (in percent).

Table 6. Armenia: Financial Soundness Indicators for the Banking Sector, 2003–05  
(in percent, unless otherwise indicated)

	2003				2004				2005	
	Mar	Jun	Sep	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
<b>Capital adequacy</b>										
Total regulatory capital to risk-weighted assets	39.2	34.3	34.3	33.8	35.5	34.3	33.7	32.3	36.4	31.7
Tier I regulatory capital to risk-weighted assets	37.4	32.6	32.7	32.2	33.5	32.3	31.7	30.2	33.7	29.6
Capital (net worth) to assets	20.3	18.3	18.2	18.1	16.9	17.9	17.5	17.8	19.3	19.5
<b>Asset composition</b>										
Sectoral distribution of loans (billions of drams)										
Industry (excluding energy sector)	14.2	16.1	18.5	19.0	19.4	20.6	23.8	29.0	26.0	26.9
Energy Sector	10.7	10.2	9.7	10.7	9.5	11.6	11.6	6.6	5.6	6.5
Agriculture	7.8	8.7	7.7	8.2	8.4	9.0	7.6	8.6	10.0	12.5
Construction	2.8	3.6	4.9	4.8	5.4	5.1	5.9	5.3	5.9	6.0
Transport and communication	0.7	0.7	1.0	0.7	0.8	1.0	1.2	1.2	2.2	3.3
Trade/commerce	14.7	16.6	16.9	21.5	23.1	24.9	28.8	31.1	30.6	32.8
Sectoral distribution of loans to total loans (percent of total)										
Industry (excluding energy sector)	19.9	20.0	22.0	20.1	19.1	18.3	19.4	22.2	19.7	18.4
Energy Sector	15.2	12.7	11.5	11.4	9.4	10.3	9.4	5.0	4.2	4.5
Agriculture	11.1	10.9	9.1	8.6	8.2	8.0	6.2	6.6	7.6	8.5
Construction	4.0	4.4	5.8	5.1	5.3	4.5	4.8	4.0	4.5	4.1
Transport and communication	1.0	0.8	1.2	0.7	0.8	0.9	1.0	0.9	1.7	2.3
Trade/commerce	20.8	20.7	20.2	22.7	22.7	22.1	23.4	23.8	23.2	22.4
Foreign exchange loans to total loans	80.9	73.7	72.9	72.7	74.6	72.1	71.8	70.4	73.6	70.2
<b>Asset quality</b>										
Nonperforming loans (billions of drams)										
Watch (up to 90 days past due)	6.1	7.2	7.6	6.7	5.8	4.3	5.0	3.1	4.0	4.0
Substandard (91-180 days past due)	3.8	4.6	4.3	4.9	3.0	2.5	2.9	1.5	2.8	2.7
Doubtful (181-270 days past due)	1.1	1.8	2.3	0.9	1.8	1.5	0.9	0.4	0.8	0.9
Loss (>270 days past due)	1.1	0.8	1.1	0.9	1.0	0.4	1.2	1.1	0.5	0.4
Nonperforming loans to gross loans	11.1	12.3	12.0	11.6	9.8	10.1	9.3	2.1	0.0	0.0
Provisions to nonperforming loans 1/	6.3	8.2	6.7	5.4	4.4	3.1	3.3	2.1	2.5	2.3
Spread between highest and lowest rates of interbank borrowing in AMD	34.0	28.1	32.5	34.3	41.8	47.8	50.4	77.0	58.8	61.3
Spread between highest and lowest rates of interbank borrowing in foreign curi	5.5	2.4	1.9	2.6	2.3	2.5	2.5	2.0	1.8	3.5
	1.8	4.5	2.0	3.7	2.0	2.7	1.0	1.0	0.9	4.0
<b>Earnings and profitability</b>										
ROA (profits to period average assets) 2/ 3/	1.5	1.4	2.1	2.7	2.7	2.9	3.2	3.2	2.9	2.8
ROE (profits to period average equity) 2/ 3/	7.8	7.5	11.1	14.4	16.2	16.2	18.0	18.4	15.8	14.7
Interest margin to gross income	44.2	42.7	42.4	42.0	46.0	46.8	44.6	44.2	43.4	39.6
Interest income to gross income	69.3	65.7	64.5	62.7	67.9	67.8	64.6	63.7	63.9	58.2
Noninterest expenses to gross income	49.5	47.9	47.8	48.5	45.7	47.0	45.5	46.5	45.2	54.5
<b>Liquidity</b>										
Liquid assets to total assets	47.3	49.2	48.8	47.5	46.5	44.6	47.6	47.1	46.3	45.2
Liquid assets to total short-term liabilities	114.7	114.0	109.9	101.3	100.3	96.1	99.9	98.7	107.9	106.1
Customer deposits to total (non-interbank) loans	180.8	188.0	185.0	177.1	175.0	160.3	175.0	177.3	161.4	148.1
Foreign exchange liabilities to total liabilities	72.9	71.3	71.8	73.2	75.1	72.6	74.1	73.3	72.4	71.1
<b>Sensitivity to market risk</b>										
Duration (or average repricing period) of assets				14.5						
Duration (or average repricing period) of liabilities										
Gross open positions in foreign exchange to capital	19.0	15.9	14.5	13.8	10.8	12.5	9.9	7.4	10.5	5.6

Source: Central Bank of Armenia.

1/ Includes the data of 20 banks and excludes the data of 4 banks under interim administration.

2/ Includes the data of 20 banks and excludes the data of 2 banks under interim administration.

3/ Includes the data of 20 banks and excludes the data of 1 bank under interim administration. The data of 1 bank are included which operated until 24 of December.

Table 7. Armenia: Balance of Payments, 2004–08  
(in millions of U.S. dollars, unless otherwise indicated)

September 23, 3.00pm	2004	2005		2006	2007	2008
		Prog.	Proj.	Projections		
Current account	-162	-213	-178	-213	-242	-263
Trade balance	-458	-524	-554	-607	-632	-641
Exports, fob	738	785	904	1,033	1,155	1,263
Imports, fob	-1,196	-1,309	-1,458	-1,640	-1,788	-1,904
Services (net)	-71	-93	-85	-69	-77	-101
Credits	247	252	276	307	317	333
Debits	-317	-345	-361	-376	-394	-434
Income (net)	37	85	90	93	92	99
Transfers (net)	330	318	371	370	376	380
Private	269	268	308	322	325	329
Official	61	50	63	47	51	51
Capital and financial account	206	260	313	232	281	306
Capital transfers (net)	34	10	20	40	60	60
Foreign direct investment (net)	217	198	255	152	154	159
of which: Privatization/debt swap	20	114	114	0	0	0
Portfolio investment (net)	-3	0	0	0	0	0
Public sector (net)	38	48	40	58	104	133
Disbursements	88	67	59	75	121	147
of which: World Bank program support	20	...	...	...	...	...
Amortization	-49	-19	-19	-17	-17	-14
Other capital (net)	-81	4	-2	-18	-37	-46
of which: Special Privatization Account	-20	-57	-57	0	0	0
Errors and omissions	2	0	0	0	0	0
Overall balance	46	47	136	18	39	43
Financing	-46	-77	-165	-48	-49	-49
Gross international reserves (increase: -)	-45	-41	-129	-16	-26	-24
Use of Fund credit, net	-6	-36	-36	-33	-24	-26
Disbursements	28	...	...	...	...	...
Repurchases/repayments	-35	-36	-36	-33	-24	-26
Exceptional financing	0	0	0	1	1	1
Arrears to Russia (+increase)	0	0	0	0	0	0
Debt relief 1/	0	0	0	1	1	1
Debt deferral 2/	0	0	0	0	0	0
Financing gap	...	30	30	30	10	6
IMF	...	10	10	10	10	5
World Bank	...	20	20	20	0	0
Memorandum items:						
Current account (in percent of GDP)	-4.6	-5.1	-3.9	-4.1	-4.2	-4.0
Gross international reserves (end of period)	547	582	677	693	719	743
In months of imports	3.6	3.9	4.0	3.8	3.7	3.5
Merchandise export growth, percent change	6.1	7.5	22.5	14.3	11.8	9.3
Merchandise import growth, percent change	5.8	10	21.9	12.5	9.0	6.5
Nominal external debt 3/	1,183	1,229	1,229	1,280	1,367	1,354
Nominal external debt stock (in percent of GDP)	33	29	27	25	24	21
NPV of external debt in percent of exports 4/	60	59	60	55	54	56
External debt service in percent of exports	9.7	6.1	5.7	4.6	3.6	3.3
Stock of external arrears	0	0	0	0	0	0

Sources: Armenian authorities; and Fund staff estimates.

1/ From Turkmenistan in 2003, and the United Kingdom from 2006 to 2008.

2/ The figure for 2003 reflects a Lincy foundation loan onlent to small- and medium-sized enterprises. As agreed by the Lincy Foundation, the government repaid US\$15 million of the US\$18 million loan.

3/ Government and government-guaranteed medium- and long-term debt.

4/ Based on the new low income country debt sustainability analysis framework.

Table 8. Armenia: Medium-Term Macroeconomic Framework, 2004–08

	2004	2005	2006	2007	2008
	Act.		Projections		
(In percent of GDP, unless otherwise indicated)					
National income and prices					
Real GDP growth (percent change)	10.1	11.0	7.5	6.0	6.0
Gross domestic product (in millions of U.S. dollars)	3,558	4,580	5,192	5,811	6,503
Gross national income per capita (in U.S. dollars)	1,119	1,453	1,636	1,818	2,023
CPI inflation, end-of-period (annual percent change)	2.0	1.5	3.0	3.0	3.0
Investment and saving					
Investment	23.9	24.4	24.8	25.2	25.5
Government	3.9	4.6	5.7	5.7	5.7
Other	20.0	19.8	19.1	19.5	19.8
National savings	19.4	20.5	20.7	21.1	21.5
Government	2.2	2.2	2.8	2.8	2.8
Other	17.2	18.3	17.9	18.3	18.6
Government operations					
Revenue and grants	15.6	15.6	16.8	16.8	17.1
<i>of which:</i> tax revenue	14.1	14.5	15.1	15.5	15.9
grants 1/	0.6	0.6	1.2	1.3	1.2
Expenditure	17.2	18.0	19.7	19.7	20.0
<i>of which:</i> social expenditure 2/	5.4	6.3	6.8	7.2	7.5
Current expenditure	13.3	13.4	13.9	14.0	14.3
Capital expenditure	3.9	4.6	5.7	5.7	5.7
Overall balance (including grants)	-1.7	-2.4	-2.9	-2.9	-2.9
Domestic financing	-0.2	1.0	1.3	0.8	0.5
External financing	1.9	1.4	1.6	2.1	2.4
Government and government-guaranteed debt	30.7	28.6	27.3	26.3	23.5
External sector					
Exports of goods and services	27.7	25.8	25.8	25.3	24.5
Imports of goods and services	42.6	39.7	38.8	37.5	35.9
Current account	-4.6	-3.9	-4.1	-4.2	-4.0
Current account (in millions of U.S. dollars)	-162	-178	-213	-242	-263
Capital and financial account (in millions of U.S. dollars)	206	313	232	281	306
<i>of which:</i> direct foreign investment	217	255	152	154	159
public sector disbursements	88	59	75	121	147
Change in gross international reserves (in millions of U.S. dollars) 3/	-45	-129	-16	-26	-24
Arrears and debt relief (in millions of U.S. dollars)	0	0	1	1	1
Financing/gap (in millions of U.S. dollars)	0	30	30	10	6
<i>of which:</i> IMF	0	10	10	10	5
World Bank	0	20	20	0	0
External debt (NPV, in percent of exports of goods and services)	59	60	55	54	56
Debt service (in percent of exports of goods and services)	9.7	5.7	4.6	3.6	3.3
Gross international reserves in months of imports	3.6	4.0	3.8	3.7	3.5

Sources: Armenian authorities; and Fund staff estimates and projections.

1/ For 2006-08, the figures include preliminary projections for disbursements under the U.S. Millennium Challenge Account (US\$100 million).

2/ Defined as total expenditure on health, education, and social security.

3/ A negative figure indicates an increase.

Table 9. Armenia: Indicators of Fund Credit, 2003–08

	2003	2004	2005	2006	2007	2008
			Projections			
(In units indicated)						
Existing and prospective Fund outstanding credit 1/						
In millions of SDRs	144.4	140.1	139.9	118.7	103.2	86.2
In percent of exports 2/	22.4	21.1	17.6	13.1	10.4	8.0
In percent of external debt	18.4	17.6	16.9	13.7	11.2	9.4
In percent of gross reserves	40.2	38.0	30.6	25.4	21.3	17.2
In percent of quota	157.0	152.3	152.0	129.0	112.2	93.7
Existing Fund outstanding credit 1/						
In millions of SDRs	144.44	140.1	120.1	99.0	83.5	66.5
In percent of exports 2/	22.4	21.1	15.1	10.9	8.4	6.2
In percent of external debt	18.4	17.6	14.5	11.5	9.1	7.3
In percent of gross reserves	40.2	38.0	26.3	21.2	17.2	13.3
In percent of quota	157.0	152.3	130.6	107.6	90.8	72.2
Prospective Fund outstanding credit 1/						
In millions of SDRs	...	...	19.7	19.7	19.7	19.7
In percent of exports 2/	...	...	2.5	2.2	2.0	1.8
In percent of external debt	...	...	2.4	2.3	2.1	2.2
In percent of gross reserves	...	...	4.3	4.2	4.1	3.9
In percent of quota	...	...	21.4	21.4	21.4	21.4
Repurchases, repayments, and charges due from existing and prospective drawings						
In millions of SDRs	...	...	24.0	21.8	16.0	17.5
In percent of exports 2/	...	...	3.0	2.4	1.6	1.6
In percent of external debt	...	...	2.9	2.5	1.7	1.9
In percent of gross reserves	...	...	5.3	4.7	3.3	3.5
In percent of quota	...	...	26.1	23.7	17.4	19.1
Repurchases and charges due from existing drawings						
In millions of SDRs	...	...	24.0	21.7	15.9	17.4
In percent of exports 2/	...	...	3.0	2.4	1.6	1.6
In percent of external debt	...	...	2.9	2.5	1.7	1.9
In percent of gross reserves	...	...	5.2	4.6	3.3	3.5
In percent of quota	...	...	26.0	23.6	17.3	19.0
Repurchases and charges due from prospective drawings						
In millions of SDRs	...	...	0.0	0.1	0.1	0.1
In percent of exports 2/	...	...	0.0	0.0	0.0	0.0
In percent of external debt	...	...	0.0	0.0	0.0	0.0
In percent of gross reserves	...	...	0.0	0.0	0.0	0.0
In percent of quota	...	...	0.0	0.1	0.1	0.1

Sources: Armenian authorities; and Fund staff estimates.

1/ End of period stocks.

2/ Exports of goods and services.

Table 10. Armenia: Poverty Indicators and Millennium Development Goals, 1990-2015

	1990	1998/99	2000/01	2002/03	2015 Target
(In percent of total population unless otherwise stated)					
<b>1 Eradicate extreme poverty and hunger</b>					
Population below US\$2.15 (PPP) a day	...	35.8	...	...	...
Overall poverty rate	...	56.3	47.0	32.0	19.7
Rural poverty	...	47.7	45.7	33.9	...
Extreme Poverty	...	26.1	16.2	5.5	4.1
Prevalence of child malnutrition (in percent of children under 5)	...	3.3	2.6	...	1.4
<b>2 Achieve universal primary education</b>					
Net primary enrollment ratio (in percent of relevant age group)	...	...	84.5	...	100
Youth literacy rate (in percent of group ages 15-24)	99.5	99.7	99.8	...	100
<b>3 Promote gender equality</b>					
Ratio of girls to boys in primary and secondary education (in percent)	...	...	104.0	...	100
Ratio of young literate females to males (in percent of group ages 15-24)	99.7	99.8	100.1	...	...
Proportion of seats held by women in national parliament (in percent)	36.0	6.0	3.0	...	...
<b>4 Reduce child mortality</b>					
Under 5 mortality rate (per 1,000)	60.0	47.0	37.0	35.0	20.0
Infant mortality rate (per 1,000 live births)	26.0	...	25.0	30.0	8.7
Immunization, measles (in percent of children under 12 months)	94.8	91.0	95.6	...	...
<b>5 Improve maternal health</b>					
Maternal mortality ratio (modeled estimate, per 100,000 live births)	40.1	32.9	21.8	18.6	10.0
Births attended by skilled health staff (in percent of total)	99.7	98.8	...	...	...
<b>6 Combat HIV/AIDS, malaria and other diseases</b>					
Prevalence of HIV, female (in percent of group ages 15-24)	...	0.0	0.2	...	Stabilize and reduce
Incidence of tuberculosis (per 100,000 people)	17.6	39.2	36.5	44.6	Stabilize and reduce
Tuberculosis cases detected under DOTS (in percent)	...	8.0	27.8	...	Stabilize and reduce
<b>7 Ensure environmental sustainability</b>					
Nationally protected areas (in percent of total land area)	...	7.4	7.6	7.6	...
GDP per unit of energy use (PPP \$ per kg oil equivalent)	...	3.5	3.3	...	...
CO2 emissions (metric tons per capita)	...	1.0	1.1	...	...
Access to an improved water source (% of population)	...	...	...	...	...
Access to improved sanitation (% of population)	...	...	...	...	...
<b>8 Develop a Global Partnership for Development</b>					
Fixed line and mobile telephones (per 1,000 people)	157.0	145.2	146.5	161.8	...
Personal computers (per 1,000 people)	...	5.3	9.2	15.8	...
<b>General indicators</b>					
Population (in millions)	3.5	3.1	3.1	3.1	...
Adult literacy rate (in percent of group ages 15 and over)	97.5	98.3	98.5	98.6	...
Total fertility rate (births per woman)	2.6	1.2	1.2	1.2	...
Life expectancy at birth (years)	71.7	73.0	73.6	74.8	...
Gini index of inequality (consumption)	...	...	34.4	27.1	...
Gini index of inequality (total income)	...	57.0	52.8	43.4	...

Sources: World Bank, and Armenian authorities.

Goal 1: Halve, between 1990 and 2015, the proportion of people whose income is less than \$2.15 a day. Halve, between 1990 and 2015, the proportion of people who suffer from hunger.

Goal 2: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.

Goal 3: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.

Goal 4: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.

Goal 5: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.

Goal 6: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.

Goal 7: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water.

Goal 8: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth.

**ARMENIA: RELATIONS WITH THE FUND**  
(As of September 30, 2005)

**I. Membership Status:** Joined 05/28/1992; Article VIII

<b>II. General Resources Account:</b>	<b>SDR Million</b>	<b>Percent of Quota</b>
Quota	92.00	100.00
Fund holdings of currency	92.00	100.01
<b>III. SDR Department:</b>	<b>SDR Million</b>	<b>Percent of Allocation</b>
Holdings	11.66	n.a.
<b>IV. Outstanding Purchases and Loans:</b>	<b>SDR Million</b>	<b>Percent of Quota</b>
PRGF arrangements	127.70	138.80

**V. Latest Financial Arrangements:**

<u>Type</u>	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR Million)</u>	<u>Amount Drawn (SDR Million)</u>
PRGF	05/25/2005	05/24/2008	23.00	3.28
PRGF	05/23/2001	12/31/2004	69.00	69.00
PRGF	02/14/1996	12/20/1999	109.35	109.35

**VI. Projected Obligations to Fund** (SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	7.56	21.18	15.43	17.06	15.19
Charges/interest	<u>0.32</u>	<u>0.56</u>	<u>0.46</u>	<u>0.38</u>	<u>0.30</u>
Total	7.88	21.74	15.89	17.44	15.49

**VII. Safeguards Assessment**

Under the Fund's safeguards assessment policy, the Central Bank of Armenia (CBA) is subject to a safeguards assessment update in the context of the current PRGF arrangement. A recently completed safeguards update report concluded that the CBA's safeguards framework has been strengthened since the 2002 assessment. However, some measures were proposed to address vulnerabilities identified in internal controls and audits, and staff will monitor progress in their implementation.

**VIII. Exchange Rate Arrangement**

(a) On November 22, 1993, the Republic of Armenia introduced its national currency, the dram, at a rate of 200 Armenian rubles per dram. The exchange rate has been allowed to float

since then but, more recently, the CBA has intervened in the foreign exchange markets to smooth out volatility in the exchange rate. The foreign exchange interventions undertaken this year were against the backdrop of large intermittent inflows, downward pressure on prices and a strong increase in money demand, while the dram continued to appreciate. The official exchange rate is quoted daily as a weighted average of the previous day's interbank exchange rates.

- (b) Armenia maintains no exchange restrictions on the making of payments and transfers for current international transactions except for exchange restrictions maintained for security reasons, and notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

**IX. Article IV Consultations**

The 2004 Article IV consultation with Armenia was concluded on December 1, 2004. Armenia is subject to the 24-month consultation cycle.

**X. FSAP Participation and ROSCs**

A joint World Bank-International Monetary Fund mission assessed Armenia's financial sector as part of the Financial Sector Assessment Program (FSAP) update during February 16–March 4, 2005. The Financial Sector Stability Assessment (FSSA) report was discussed by the Executive Board on May 25, 2005.

**ROSC Modules**

Standard	Timing	Publication Status	Document Number
Basel Core Principles for Effective Banking Supervision (BCP)	April 2001	Unpublished	...
Core Principles for Systemically Important Payments Systems (CPSS)	April 2001	Unpublished	...
Insurance Principles set by the International Association of Insurance Supervisors (IAIS)	2001	Unpublished	...
Principles set by the International Organization of Securities Commissions (IOSCO)	2001	Unpublished	...
Code of Good Practices in Monetary and Financial Policy Transparency (MFPT)	April 2001	Unpublished	...
Code of Good Practices on Fiscal Transparency	March 2001	Published	02/37
Data ROSC module	September 2000	Published	02/06
AML-CFT assessment by MONEYVAL	July 2004	Unpublished	...
Basel Core Principles for Effective Banking Supervision (BCP) update	May 2005	Unpublished	...
Corporate Governance	May 2005	Unpublished	...



**XI. Resident Representatives**

Mr. James McHugh, since September 2002.

**XII. Technical Assistance**

The following table summarizes the Fund’s technical assistance to Armenia since 2002.

**Armenia: Technical Assistance from the Fund, 2002–05**

Subject	Type of Mission	Timing	Counterpart
<b>Fiscal Affairs Department (FAD)</b>			
Tax policy and administration	Short-term	September 17– October 3, 2003	MFE, State Tax Service (STS), and Customs Committee
Tax policy	Short-term	April 22–May 6, 2004	MFE, STS, and Customs Committee
Tax administration	Short-term	July 13–July 27, 2004	MFE, STS, and Customs Committee
<b>Monetary and Exchange Affairs Department</b>			
Banking system issues	Short-term	April 15–19, 2002	CBA
Banking system, deposit insurance, foreign exchange market development, and CBA monetary operations.	Short-term	June 24–July 4, 2002	CBA
Unified financial supervision, mortgage financing markets and inflation targeting	Short-term	January 26– February 6, 2004	CBA
Financial sector assessment program update	Short-term	February 16– March 4, 2005	CBA
<b>Statistics Department</b>			
Data dissemination standards	Short-term	September 18–25, 2003	National Statistical Service
<b>International Capital Market Department</b>			
Sovereign credit quality	Short-term	September 6–10, 2005	CBA

**ARMENIA: RELATIONS WITH THE WORLD BANK**  
(October 4, 2005)

Country Director: Donna Dowsett-Coirolo

Telephone: (202) 473-0121

**I. IMPLEMENTATION OF STRUCTURAL REFORM MEASURES**

**A. Legal Framework**

1. The World Bank has supported the Armenian government to establish the core legal framework necessary for private sector operations, including the Civil Procedure Code, the Procurement law, the Business Registration law and the Public Auction law. The fully restructured and enacted Bankruptcy law is now harmonized with the Civil Code and the Civil Procedure Code, and strengthens the enforcement mechanisms for bankruptcy procedures. The Concession law has been enacted and the National Assembly has adopted a new Labor Code, which is compatible with the requirements of a market economy and is an important instrument of flexible job-creation. The government also has made significant progress in drafting the necessary legislation to improve the lending environment through strengthening the procedures for collateral registration and for foreclosure and enhancing the knowledge of the judiciary concerning commercial contracts. Specifically, the government has adopted amendments to civil code, criminal code, civil procedure law, law on compulsory enforcement, and public auction law.

**B. Business Environment**

2. The World Bank has supported the government to make satisfactory progress in removing administrative barriers for business and investment and has strengthened the consultative mechanisms with the business community. The steps taken include, inter alia, consolidating, downsizing, and clarifying mandates of various government inspections; enacting the new law on business registration; streamlining licensing procedures; issuing new accounting recommendations for small and medium-sized enterprises; establishing a regulatory framework that allows privatization of urban land by business entities; and adopting simplified procedures for obtaining site development and construction permits. The capacity of the Armenian Development Agency as a focal point for government's efforts to promote investment and exports as well as for identifying the remaining bottlenecks in the business environment has been strengthened. The functioning of the Business Council has been improved and the private sector's awareness of its activities has been enhanced.

3. The recent business surveys of Armenian entrepreneurs suggest that these efforts have already resulted in a more positive private sector perception of the business and investment environment. For example, the average time necessary to get construction and building renovation permits was reduced from 310 days in 2001 to 76 days in 2003. The number of goods subject to mandatory certification at the border was reduced from 80 in 2001 to 60 in 2003. The FDI increased by 46 percent in 2004 compared with 2003. The State

Customs Committee's websites became operational and during 2003, on average 467 references per month were made to it. The Customs introduced a self declaration system, reduced the role of reference prices and strengthened Post Clearance Unit. On tax administration, the government strengthened the operation of Large Tax Payers Unit (LTPU), placed a high priority on reducing the stock of VAT refunds owed to exporters and ensured that no additional VAT arrears were incurred to exporters. The government adopted decision announcing its intention to widen participation in the provision of international civil aviation services, raise efficiency and cut costs and initiated policy work. Despite these improvements, there is still considerable scope for further reforms in the areas of competition, deregulation and strengthening of business and investment climate, especially in commercial debt recovery procedures, improvements in the transparency and efficiency of the judicial system, tax and customs administrations, improvements in governance and implementing the anti-corruption strategy.

### **C. Energy and Infrastructure**

4. Since its privatization in the second half of 2002, the Electricity Distribution Company has remained in compliance with its licenses agreement as confirmed by making full payments to the generation and service providers, reporting to the regulator on a timely basis, and submitting investment plan to the regulator. Supported by the World Bank, the government has also made satisfactory efforts to improve the legal and regulatory framework in the energy sector in order to establish a supportive environment for the new private operator. Budget allocations have been increased to ensure full payments to the energy sector by the budgetary organizations and public utilities. The government implemented the Integrated Rehabilitation Plan for state-owned utilities (including energy, irrigation, drinking water companies and Yerevan metro) with strengthened corporate governance, creation of electricity market, and cessation of operations of the state electricity wholesale company. In addition, the Public Sector Regulatory Commission (PSRC) has made considerable progress in improving utilities regulatory framework and adopted several measures including, monitoring indicators for electricity service quality and standard. Despite this satisfactory performance, continued efforts are crucial for improvements in the energy sector through restructuring the midstream companies and strengthening the regulatory framework to ensure adequate functioning, transparency, and reliability of this sector.

5. There has been progress in improving fiscal discipline and reducing losses in the irrigation and water sectors. The World Bank has been working with the government to: (i) upgrade the management capacity of public companies in these sectors; (ii) ensure a gradual increase in tariffs to cost recovery; (iii) provide additional investments to improve technical efficiency; and (iv) ensure that the budget provides adequate financing for water consumed by public sector entities. To provide full cost recovery, the government has adopted a schedule for irrigation tariff increase in 2002–2007 in order to achieve full cost recovery in the irrigation system by 2007.

#### **D. Education and Health**

6. The World Bank has supported reforms in education and health. The government implemented a major rationalization program during the 2003 school year. As a result, 37 schools were merged or closed and about 9,000 teachers were made redundant. The medium-term action plan for improving the financial management, accounting, and financial reporting for higher education institutions was adopted by the government on January 26, 2003. Accountants at the higher institutions have been trained and special software has been prepared for use. Since the second quarter of 2003, the new accounting procedures are being used. The government increased the state budget allocation for primary and secondary education and improved teachers' salaries. The government also developed an action plan and cleared arrears in the education sector and prevented further arrears in this sector. The ratio of pupils to full-time equivalent teachers increased to over 14 and teacher salaries increased by 65 percent in 2005. In addition, the government developed a strategy on early childhood education and options for its piloting in two marzes. The government has also made initiatives to carry out the three year implementation plan for higher education reforms. Despite these improvements, there is scope for further reforms in education, including adoption of new curricula for secondary education, enhancement of standards for higher education to make it more responsive to employers' needs, improving preschool systems, and strengthening monitoring and financial reporting of the noncommercial organizations (NCOs) in the education sector.

7. The government adopted the hospital master plan for Yerevan in late 2002. As a result, the remaining public hospitals in Yerevan were to be merged into smaller number of hospital networks with necessary steps to be taken to restructure them. The government adopted a decree on November 21, 2003, identifying the configuration of ten hospital networks through consolidation of twenty-four public hospitals and thirteen outpatient health care institutions. Directors for nine of these hospital networks have been appointed. While the hospital merger process is being implemented, introduction of further appropriate adjustments may be required. The medium-term action plan for improving financial management accounting and reporting for the public hospitals was adopted by the government to prepare new reporting and accounting procedures and cost accounting manuals.

8. Implementation progress has been satisfactory and about 200 hospital accountants have been trained in new accounting procedures. The government developed an action plan for clearing the accumulated arrears in the health sector and prevented further arrears in this sector. The government also adopted a decision to introduce further reforms in the Basic Benefit Package in the health sector. The government undertook measures for financing and management of the Primary Health Care departments of polyclinic that are included in the hospital networks. Further reforms are needed in increasing the population overall health status, reducing child and maternal mortality, increasing use of healthcare system by rural and low-income groups, monitoring public health and promoting better health behavior, and strengthening monitoring and financial reporting of the noncommercial organizations

(NCOs) in the health sector. The government developed the national strategy on combating non-communicable diseases and plans to take necessary steps to address the public health threats from non-communicable diseases through development and implementation of specific priority programs on non-communicable diseases and through allocation of adequate public resources in the health care budget.

### **E. Social Protection and Insurance**

9. Since 1999, the government has been replacing a range of fragmented cash and non-cash benefits and privileges with better-targeted transfers to families. The government has been supported by the World Bank to complete several important steps to enhance its capacity for administration of transfers to families, including: (i) re-registration of poverty benefit recipients; (ii) beneficiary assessment of the existing benefits; and (iii) establishment of a central database for poverty benefit recipients. Data from the recent household survey suggest that the system of benefits and transfers to the poor has become an efficient instrument for reducing extreme poverty. The government introduced differentiation of benefits within the family poverty benefits. Continued efforts are needed to ensure the adequacy of the level and administrative capacity of the social protection systems to guarantee coverage of transfers to people with special needs. Based on the 2004 household survey results the government plans to evaluate effectiveness of the family poverty benefits.

10. The law on Public Pension focuses on strengthening and streamlining the pension system. It provides significant improvements in the pension systems, including: (i) introduction of an equal retirement age for men and women at age 63; (ii) separation of social insurance benefits from social pensions; (iii) elimination of most early retirement provisions; (iv) indexation of pension to inflation; and (v) establishment of more direct links between benefits and contributions, with adequate provision for a minimum benefit. Following adoption of the law, the government has made satisfactory progress in its implementation. The government Decree No. 309 of July 2003, established an inter agency working group to monitor introduction of the Personal Identification Numbers (PINs) into the pension system. Additionally, a range of necessary implementation regulations, based on the Public Pension Law, was developed, including: (i) the documents required for award of pensions; (ii) rules for awarding and making payments for partial pensions to those with less than the minimum required length of insurance history; (iii) procedures for making payments of the survivors' pensions to children under full state custody; and (iv) procedures for awarding, computing and making payments of the privileged pensions. While the fiscal performance of the State Pension Fund has improved and as a result, the average pension has increased, the level, coverage and sustainability of pensions are issues for further elaboration.

## II. LENDING

11. World Bank lending to Armenia as of October 3, totals US\$901.0 million, of which US\$731.9 million has been disbursed. The current Bank portfolio consists of 18 IDA credits with a total commitment of \$291 million, of which \$164 million is undisbursed.

12. Building on the major Poverty Reduction Strategy Paper's (PRSP) themes, the fourth Country Assistance Strategy (CAS) for Armenia was discussed in the World Bank Board of Executive Directors on June 10, 2004 to focus on three main objectives of: (i) promoting private sector led economic growth; (ii) making growth more pro-poor; and (iii) reducing non-income poverty. The CAS indicated that unless the high case is reached, IDA lending is expected to be up to \$45 million a year during the forthcoming CAS period and could reach up to \$55 million a year if Armenia moves into the high case during the FY05–08 CAS period. Pursuant to agreements reached in the context of IDA-14, country resource envelopes are determined annually based on the Country Policy and Institutional Assessments and performance of the ongoing portfolio. Armenia has a very strong IDA performance rating and as a consequence is at present eligible for about \$58 million per year under IDA-14. Towards the end of the CAS period, there could be a first IBRD loan if Armenia's creditworthiness improves sufficiently. The CAS includes three Poverty Reduction Support Credits (PRSCs) for FY05, 06 and 07. These will support the PRSP objectives and focus on four main components: (i) supporting private sector development; (ii) advancing public infrastructure reforms; (iii) improving core public sector functions; and (iv) enhancing human development and improving social safety nets. Macroeconomic stability is a precondition for the PRSC and is vital for facilitating an enabling environment necessary for successful structural reforms implementation. The PRSC's preparation is being closely coordinated with the IMF Poverty Reduction and Growth Facility (PRGF). The first PRSC was approved by the World Bank Board on November 18, 2004, became effective and disbursement of about \$21 million was made in December 2004. The second PRSC is currently being prepared.

**ARMENIA: RELATIONS WITH THE EUROPEAN BANK FOR  
RECONSTRUCTION AND DEVELOPMENT (EBRD)**

(As of September 30, 2005)

1. As of September 30, 2005, the EBRD had signed 25 projects in the power, transport, agribusiness, textile, mining, construction and financial sectors. Total commitments amounted to EUR 106.7 million.
  
2. There are two sovereign projects. First, the EBRD approved a sovereign guaranteed loan of EUR 54.8 million for construction of the Hrazdan Unit 5 thermal power plant in March 1993, partly aimed at the eventual closure of Armenia's nuclear plant in Medzamor. The government is contemplating the privatization of Hrazdan Unit 5 as the completion of this plant is constrained by limited budgetary resources. The EBRD had funded technical assistance for the Hrazdan privatization prospectus and continues to follow the privatization process. The Hrazdan Thermal Power Complex excluding the unfinished Unit 5 has been transferred to the Russian Federation in the context of the debt-for-equity deal. Second, in November 1994, the agreement on a EUR 21.8 million loan to build an air cargo terminal in Zvartnots airport was signed under a guarantee by the Armenian government. The airport was transferred to private management in 2002. The new management has prepared a master plan for the development of the airport, which is expected to generate further cargo traffic for the cargo terminal.
  
3. There have also been a number of private sector projects in Armenia. The EBRD has provided a loan to the Yerevan Brandy Company owned by Pernod Ricard of France (EUR 19.1 million). In the banking sector, an equity participation in the Commercial Bank of Greece-Armenia (EUR 1.1 million) was approved in late 1999. Moreover, a multi-bank on-lending facility of EUR 10 million was activated in early 2000. Within the framework of multi-bank facility the Bank currently has credit lines for micro and small enterprises with three local banks (a total of EUR 5.1 million). The EBRD is committed to further expanding lending under this facility to other banks. A Trade Facilitation Program with the purpose to facilitate access of Armenian banks to trade financing was also made available to four Armenian banks. In 2002, a loan to finance EUR 2.9 million in working capital expansion was signed with the Armenian Copper Programme (the only copper smelter in the region), and a new loan (EUR 4.3 million), including the refinancing of the existing loan, was signed in August 2004. Moreover, the EBRD has launched the Turn Around Management (TAM) and Business Advisory Service programmes in Armenia in 2003, originally funded by the EU-Tacis program but now funded from the ETC Fund, to support micro, small, and medium-sized enterprises. There were seven new projects completed during 2004 for a total amount of EUR 6.7 million. Two of them are in the banking sector (including equity investment), one in general industry sector (direct investment in equity of a local enterprise), one pre-export finance facility with a local company in the extractive industry and three trade facilitation programmes with local commercial banks. During the three quarters of 2005 EBRD signed 8 projects with the total commitments of Euro 8.8 million. New commitments include a trade facilitation project with a local bank, a direct lending facility with a small hydro power plant, three new SME loans, two equity investment projects with a pharmaceutical company (under

Direct Investment Facility) and an insurance and reinsurance company, and one medium-sized co-financing facility allowing local bank to share the risk of its selected clients with EBRD.

4. The key priorities of the EBRD for the coming years are: (i) financial sector; (ii) enterprise sector, (iii) development of alternative energy sources, (iv) portfolio monitoring and implementation support and (v) infrastructure. The EBRD's current country strategy was approved in November 2003 and a new country strategy will be developed by the end of 2005.



List of World Bank Lending to Armenia  
(In millions of U.S. dollars)

Active Projects	Credit Amount as of 10/03/05	Disbursement as of 10/03/05	Approval Date	Closing Date
<i>Active Projects</i>	286.4	125.3		
1. Municipal development	30.0	30.0	06/11/98	10/31/05
2. Electric. Trans. & dist.	21.0	20.0	03/04/99	12/31/05
3. Irrigation dam safety	26.6	19.4	06/24/99	09/30/07
4. Social Investment Fund II	20.0	20.0	05/11/00	12/31/05
5. Judicial reform	11.4	8.4	09/14/00	06/30/06
6. Irrigation development	24.9	15.0	08/30/01	03/31/07
7. Investment and export facilitation	1.0	0.9	04/16/02	12/31/05
8. Natural resource management	8.3	1.6	06/04/02	07/31/08
Natural resource management (GEF)	5.1	0.8		
9. Municipal water and WW	23.0	4.1	05/04/04	02/28/09
10. Educ. qual. & relevance (APL #1)	19.0	2.7	01/20/04	11/30/08
11. Yerevan water/ww services	20.0	0.0	02/24/05	02/28/11
12. Health system mod.	19.0	1.0	06/10/04	06/30/09
13. Social protection admin.	5.2	0.3	06/10/04	12/31/07
14. Irrigation dam safety 2	6.8	0.6	06/10/04	03/31/09
15. Public sector mod.	10.1	0.5	05/04/04	03/31/09
16. Rural Enterprise & small scale	20.0	0.0	07/07/05	03/31/10
17. Urban Heating Project	15.0	0.0	07/12/05	06/31/10
<i>Completed Projects</i>	614.6	606.6		
18. Irrigation rehabilitation	43.0	40.9	12/08/94	05/31/01
19. Highway	31.0	29.5	09/14/95	12/31/00
20. Social Investment Fund	12.0	11.1	11/09/95	12/31/00
21. Institution building	12.0	10.7	03/30/93	11/30/97
22. Earthquake rehabilitation	28.0	29.7	02/01/94	06/30/97
23. Power maintenance	13.7	13.2	12/08/94	06/30/99
24. Economic rehabilitation	60.0	64.3	02/28/95	06/30/96
25. SAC	60.0	58.5	02/29/96	12/31/97
26. SAC II	60.0	58.6	08/26/97	06/30/99
27. SATAC I	3.8	2.8	02/29/96	06/30/00
28. SAC III	65.0	63.4	12/22/98	06/30/01
29. Enterprise development	16.8	15.3	12/24/96	07/01/02
30. SATAC II	5.0	4.7	08/26/97	12/31/02
31. Education	15.0	14.6	11/20/97	10/31/02
32. SAC IV	50.0	49.4	05/22/01	03/31/03
33. SAC V	40.0	42.8	03/13/03	06/30/04
34. Health	10.0	9.3	07/29/97	12/30/03
35. PRSC	20.0	21.1	18/11/04	12/31/05
36. Title registration	8.0	7.8	10/13/98	09/30/04
37. Transport	40.0	40.4	06/08/00	12/31/04
38. Agric. Reform support	16.3	16.0	01/27/98	06/30/05
39. Enterprise incubator	5.0	2.5	11/30/01	06/30/05
<b>Total</b>	<b>901.0</b>	<b>731.9</b>		

### ARMENIA: STATISTICAL ISSUES

1. The overall quality, timeliness, and coverage of macroeconomic statistics in Armenia have improved significantly over the past few years. The Fund has substantially participated in this process, through technical assistance from the Statistics Department, the Fiscal Affairs Department, and the Monetary and Exchange Affairs Department. On November 7, 2003 Armenia subscribed to the Special Data Dissemination Standard (SDDS) and has since then provided timely data for all SDDS prescribed data categories. Further improvements are needed in real, fiscal, and external sector statistics in order to enhance the design and monitoring of economic policies. The accompanying Table of Common Indicators Required for Surveillance (TCIRS) shows the availability of key macroeconomic data and the authorities' publication policy.

2. **National accounts and price statistics.** The National Statistics Service has made significant changes to the national accounts methodology to bring it in line with international practices. Progress has been made in developing estimates of monthly and quarterly real GDP that are now published. Basic data collection procedures have also improved. National accounts have adopted the concept of gross value added using transactions prices mostly recorded on an accrual basis. However, progress has been slow in improving the compilation of national accounts at constant prices; these data are still mainly derived by re-valuing current output and inputs at previous year prices instead of deflating them by the relevant components of the producer price index. The CPI covers 9 large population centers in the Republic of Armenia (excluding the Ararat region) and the capital city – Yerevan. The base year weights are for 2002. Data on the consumer and producer price indices and wages are reported on a timely basis.

3. **Fiscal statistics.** The budget execution reporting system is compiled on a cash-basis and supplemented with monthly reports on arrears and quarterly reports on receivables and payables. Daily revenue and cash expenditure data for the central government are available with a lag of one to two days. The Ministry of Finance is undertaking a comprehensive reform of the treasury system, including the introduction of an internal auditing system in line ministries and their budgetary institutions. A single treasury account (TSA) was introduced in 1996, and all bank accounts held by budgetary institutions were closed, except for Project Implementation Units that are required by donors to operate with commercial banks' accounts. Starting in 2002, some budgetary institutions have been converted into "noncommercial organizations" (NCOs). These units have been taken out of the treasury system and have their own bank accounts. They have just started reporting data on their operations to the Ministry of Finance. These exceptions notwithstanding, all government receipts and payments are processed through the TSA, although there are still shortcomings on the timeliness and quality of data on the operations of local governments. Classification of government transactions by function and economic category are generally in line with the *Manual on Government Finance Statistics 1986*, and monthly data on central government operations are disseminated within 40 days of the end of the month. However, the budget presentation and the classification of items under the economic and functional classification

of expenditures need to be made more transparent; for instance, the data have been subject to frequent reclassifications and wages for military personnel are reported in the broader category of “other” goods and services rather than as a wage item. The reconciliation of central government with general government operations is also difficult because of the need to manually identify transactions among central government, local government, and the Social Insurance State Fund. The authorities submitted cash data, converted to the framework of the *Government Finance Statistics Manual 2001*, for publication in the *2005 Government Finance Statistics Yearbook*. Although the authorities expected to begin providing data for publication in the *IFS* in early 2005, no such data yet have been received. The *GFSM 2001* implementation plan is currently limited to bringing the classification of budgetary central government revenue, expense, and transactions in nonfinancial assets in line with international practices.

4. **Money and banking statistics.** Money and banking statistics are provided on a timely basis. Daily data on the accounts of the CBA are provided weekly with a one-day lag, while weekly data on the monetary survey are provided with a one-week lag. Monthly interest rate data are provided with an one-week lag. A new chart of accounts meeting International Accounting Standards (IAS) was introduced in January 1998. Since then, the balance sheets of the CBA and of the deposit money banks follow IAS methodology.

5. **External sector statistics.** The coverage of external sector data has improved in recent years. Trade statistics are provided on a timely basis, and trade data by origin or destination and by commodity are generally available within a month. Price data for exports and imports are available less readily. Quarterly balance of payment data is generally available with a three-month lag. However, data on private non-guaranteed external debt and on direct investment abroad are not compiled, and capital outflows are likely underestimated. The balance of payments data will need to be revised in light of recent studies showing that remittance inflows have been underestimated. The absence of a fully established (comprehensive and updated) business register in Armenia hampers a wider coverage of transactions and institutional units. The international investment position for 1997–2004 has been compiled and published.

**Armenia: Table of Common Indicators Required for Surveillance**  
(As of October 12, 2005)

	Date of latest observation	Date received	Frequency of Data <sup>6</sup>	Frequency of Reporting <sup>6</sup>	Frequency of publication <sup>6</sup>
Exchange Rates	9/30/05	9/30/05	D	W	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	9/29/05	9/30/05	D	W	M
Reserve/Base Money	9/29/05	9/30/05	D	W	M
Broad Money	8/31/05	10/7/05	M	M	M
Central Bank Balance Sheet	8/31/05	9/2/05	D	W	M
Consolidated Balance Sheet of the Banking System	8/31/05	10/7/05	M	W	M
Interest Rates <sup>2</sup>	9/30/05	10/7/05	W	W	M
Consumer Price Index	Sep 05	9/30/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> — General Government <sup>4</sup>	Q2 05	8/28/05	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> — Central Government	Jun 05	7/30/05	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt <sup>5</sup>	Q2 05	8/31/05	Q	Q	Q
External Current Account Balance	Q1 05	6/20/05	Q	Q	Q
Exports and Imports of Goods and Services	Q1 05	6/27/05	Q	Q	Q
GDP/GNP	Aug 05	10/3/05	M	M	M
Gross External Debt	Q1 05	6/30/05	Q	Q	Q

<sup>1</sup> Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup> Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup> Including currency and maturity composition.

<sup>6</sup> Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); and Not Available (NA).

### Armenia—Debt Sustainability Analysis (DSA)<sup>9</sup>

1. **Armenia is considered to be at a low risk of debt distress** with all debt indicators well below the relevant country-specific debt-burden thresholds, including when subjected to stress tests (see Table 1 below).
2. **The baseline DSA has been developed on a cautious set of assumptions**, including:
  - i) real GDP growth of 5 percent per year over the period 2008–12, and 4 percent thereafter;
  - ii) inflation of 3 percent throughout the projection period; iii) an overall fiscal deficit of 2.9 percent of GDP through the PRSP horizon of 2015, and 2.3 percent of GDP thereafter (implying a debt-stabilizing primary balance); iv) a steady increase in the share of both exports and imports as a proportion of GDP, leading to a gradual improvement in the current account balance over the projection period; and v) a shift away from highly concessional forms of external financing.

#### Under the baseline scenario:

- the fiscal position remains sustainable (see Table 1a and Figure 1).<sup>10</sup> In particular, the net present value of domestic and external public debt increases from 23 percent of GDP in 2005 to 31 percent in 2025. Note that this result is based on the conservative assumption that the deficit is financed with increasingly expensive domestic borrowing.<sup>11</sup> The net present value of debt to revenue, and the debt service to revenue ratio remain relatively stable throughout the projection period, and;
- the external debt outlook is benign (see Table 2a and Figure 2).<sup>12</sup> In particular, the net present value of external debt falls steadily from around 15 percent of GDP in 2005 to just over 8 percent by 2025, the net present value of debt-to-exports falls from just over 60 percent to around 25 percent over the same period, and the debt service-to-exports ratio decline from just under 6 percent in 2005 to around 2 percent by the end of the projection period.

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<sup>9</sup> This DSA was undertaken jointly by Fund and Bank staff, in consultation with the government of the Republic of Armenia, in August and September 2005. The DSA has been prepared in line with the interim guidance on the preparation of joint Fund-World Bank DSAs for low-income countries. Fund and Bank staff have collaborated previously on debt sustainability issues, including in the context of the report on “Poverty Reduction, Growth and Debt Sustainability in Low-Income CIS Countries,” February 5, 2002, (refer to [www.imf.org](http://www.imf.org)).

<sup>10</sup> The DSA covers the central government only as other public sector debt is negligible.

<sup>11</sup> This assumption also implies that as interest expenditure rises, the primary balance improves steadily.

<sup>12</sup> To ensure data consistency, the external DSA covers only public and publicly guaranteed debt. The authorities are currently considering ways to enhance the coverage and reporting of external private debt statistics. According to current data, private external debt totaled USD 704 million at end-2004.

<b>Table 1. Armenia's External Debt Burden Indicators</b>			
	<b>Threshold 1/</b>	<b>Armenia's Ratios</b>	
		<b>2005</b>	<b>2025</b>
<i>NPV of debt in percent of:</i>			
Exports	200	60	25
GDP	50	15	8
<i>Debt service in percent of:</i>			
Exports	25	6	2

1/ Threshold values are based on the guidelines for low-income country DSAs, in which Armenia is considered to be a strong performer.

3. **The framework for low-income country DSAs incorporates alternative scenarios and bound tests** aimed at identifying the sensitivities of the baseline projection to a range of potential shocks (see Tables 2b and 3b below). Based on these it can be seen that **Armenia's debt outlook is particularly sensitive to i) a lasting shock to the growth outlook, and ii) a slowdown in export growth.** Nevertheless, even in these scenarios, Armenia's debt outlook is likely to remain manageable. Staff also considered the possible impact on debt sustainability of a 'significant' fiscal event, such as assumption by the government of pension liabilities. Assuming such an event were to occur in 2010 and cost around 10 percent of GDP, the net present value of public debt to GDP ratio in 2025 would remain manageable at about 40 percent. While the historical scenario (which can be considered as a "no-reform" scenario) also projects debt ratios below the threshold indicators, the ratios generally continue on an upward trend through the projection period. **This finding underlines the importance of continuing the process of structural reform, and preserving macroeconomic stability in order to safeguard the debt outlook.** This is a key lesson from the DSA.

4. **The authorities welcomed the finding that Armenia is at a low risk of debt distress.** Sound debt management continues to be a priority for the government. Since 2001 the Ministry of Finance and Economy has produced an Annual Report on Public Debt of the Republic of Armenia, covering both domestic and external debt. This publication reports on the evolution of debt aggregates and the government's debt management strategy. Looking ahead, the authorities are considering the possibility of contracting commercial external debt cautiously, seeking, where possible to learn lessons from other countries in the region. As noted above, they are also considering ways to strengthen the coverage and reporting of external private debt.

Table 2a. Armenia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2002–25  
(In percent of GDP, unless otherwise indicated)

	Actual				Projections										
	2002	2003	2004	Historical Average 5/ Deviation 5/ Standard	2005	2006	2007	2008	2009	2010	2010	2015	2025	2011-25 Average	
<b>Public sector debt 1/</b>	46.3	41.8	35.6		33.9	32.8	32.5	32.1	32.4	32.8		35.7	35.7		
o/w foreign-currency denominated	43.2	39.1	33.3		26.7	24.2	23.0	22.1	21.4	20.4		17.3	13.3		
Change in public sector debt	-1.3	-4.5	-6.2	-1.4	-1.6	-1.1	-0.4	-0.4	0.2	0.4		0.7	0.0	0.2	
Identified debt-creating flows	-4.7	-8.2	-9.1	-6.3	-1.6	-1.1	-0.4	-0.4	0.2	0.4		0.7	0.0	0.2	
Primary deficit	18.8	17.8	15.6	17.1	15.6	16.8	16.8	17.1	17.4	17.7		16.9	18.7	18.5	
Revenue and grants	3.5	3.2	0.6	1.9	0.6	1.2	1.3	1.2	1.1	1.1		1.1	0.2	0.0	
Primary (noninterest) expenditure	18.4	18.2	16.7	20.2	17.6	18.8	18.8	19.0	19.3	19.6		18.8	19.9	18.7	
Automatic debt dynamics	-4.2	-7.9	-10.2	-6.6	-3.0	-4.2	-2.3	-2.2	-1.7	-1.4		-2.5	-0.6	-0.4	
Contribution from interest rate/growth differential	-5.6	-5.9	-3.8	-3.8	-3.6	-2.3	-1.7	-1.6	-1.3	-1.2		-2.0	-0.6	-0.4	
of which: contribution from average real interest rate	-0.1	-0.3	0.0	0.0	-0.1	0.1	0.2	0.2	0.3	0.3		0.2	0.8	1.0	
of which: contribution from real GDP growth	-5.5	-5.6	-3.8	-3.9	-3.5	-2.4	-1.9	-1.8	-1.5	-1.5		-2.1	-1.3	-1.4	
Contribution from real exchange rate depreciation	1.4	-1.9	-6.4	1.8	0.5	-1.9	-0.6	-0.4	-0.2	-0.2		-0.5	0.0	0.0	
Other identified debt-creating flows	-0.1	-0.7	0.0	-0.4	-0.6	1.0	0.0	0.0	0.0	0.0		0.1	0.0	0.0	
Privatization receipts (negative)	-0.1	-0.7	0.0	-0.3	-0.6	0.0	0.0	0.0	0.0	0.0		-0.1	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	0.0	
Other (central bank recapitalization)	0.0	0.0	0.0	0.0	0.0	1.0	0.0	0.0	0.0	0.0		0.2	0.0	0.0	
Residual, including asset changes	3.4	3.7	2.8	2.5	0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	0.0	
<b>NPV of public sector debt</b>	...	...	22.1		22.7	22.8	23.3	23.7	24.6	25.7		31.0	30.6		
o/w foreign-currency denominated	...	...	19.8		15.5	14.1	13.8	13.7	13.7	13.4		12.6	8.2		
o/w external	...	...	19.8		15.5	14.1	13.8	13.7	13.7	13.4		12.6	8.2		
NPV of contingent liabilities (not included in public sector debt)	...	...	...		...	...	...	...	...	...		...	...		
Gross financing need 2/	6.5	9.5	7.3		5.8	5.8	5.4	5.2	5.3	5.3		5.2	4.9		
NPV of public sector debt-to-revenue ratio (in percent) 3/	...	...	141.6		145.6	135.9	138.5	138.6	141.5	145.3		166.2	163.7		
o/w external	...	...	127.0		99.3	84.1	82.1	80.2	78.7	75.4		67.6	43.8		
Debt service-to-revenue ratio (in percent) 3/ 4/	28.3	42.9	31.9		21.6	20.1	17.8	17.1	16.8	16.8		17.8	22.8		
Primary deficit that stabilizes the debt-to-GDP ratio	0.9	4.9	7.4		3.6	3.2	2.3	2.2	1.7	1.4		0.6	0.0		
<b>Key macroeconomic and fiscal assumptions</b>															
Real GDP growth (in percent)	13.2	13.9	10.1	8.0	11.0	7.5	6.0	6.0	5.0	5.0		4.0	4.0	4.1	
Average nominal interest rate on forex debt (in percent)	1.0	0.9	0.7	1.1	0.9	0.9	0.9	0.9	0.9	0.9		1.0	3.0	1.8	
Average real interest rate on domestic currency debt (in percent)	8.0	8.3	6.2	7.5	6.2	6.2	6.2	6.2	6.2	6.2		6.2	6.2	6.2	
Real exchange rate depreciation (in percent, + indicates depreciation)	3.7	-5.2	-18.0	-1.6	1.8	-7.6	-2.9	-2.9	-2.0	-1.0		-2.4	0.0	0.0	
Inflation rate (GDP deflator, in percent)	2.5	4.5	5.9	22.5	3.2	3.0	3.0	3.0	3.0	3.0		3.0	3.0	3.0	
Growth of real primary spending (deflated by GDP deflator, in percent)	6.2	12.6	1.3	0.2	16.4	15.4	5.7	7.1	6.9	6.2		9.6	6.1	3.7	

Sources: Armenian authorities; and Fund staff estimates and projections.

1/ Central government gross debt.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues including grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2b. Armenia: Sensitivity Analysis for Key Indicators of Public Debt 2005–25

	Estimate		Projections					
	2005	2006	2007	2008	2009	2010	2015	2025
<b>NPV of Debt-to-GDP Ratio</b>								
<b>Baseline</b>	23	23	23	24	25	26	31	31
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	23	24	25	26	27	28	36	45
A2. Primary balance is unchanged from 2004	22	21	21	21	21	22	27	35
A3. Permanently lower GDP growth 1/	23	23	24	25	27	29	41	64
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2006-07	23	24	26	27	28	30	39	45
B2. Primary balance is at historical average minus one standard deviations in 2006-07	23	26	29	29	30	31	36	34
B3. Combination of B1-B2 using one half standard deviation shocks	23	25	27	28	28	29	34	33
B4. One-time 30 percent real depreciation in 2006	23	28	28	28	28	29	34	32
B5. 10 percent of GDP increase in other debt-creating flows in 2006	23	31	31	31	32	33	37	36
<b>NPV of Debt-to-Revenue Ratio 2/</b>								
<b>Baseline</b>	146	136	139	139	142	145	166	164
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	146	141	148	151	156	162	192	239
A2. Primary balance is unchanged from 2004	141	127	125	122	122	124	142	188
A3. Permanently lower GDP growth 1/	146	138	143	146	152	161	217	343
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2006-07	146	143	152	155	162	170	210	243
B2. Primary balance is at historical average minus one standard deviations in 2006-07	146	154	174	171	172	174	191	183
B3. Combination of B1-B2 using one half standard deviation shocks	146	149	163	161	163	165	183	178
B4. One-time 30 percent real depreciation in 2006	146	165	165	161	162	164	182	173
B5. 10 percent of GDP increase in other debt-creating flows in 2006	146	187	186	183	183	185	200	192
<b>Debt Service-to-Revenue Ratio 2/</b>								
<b>Baseline</b>	22	20	18	17	17	17	18	23
<b>A. Alternative scenarios</b>								
A1. Real GDP growth and primary balance are at historical averages	22	20	19	20	20	20	23	32
A2. Primary balance is unchanged from 2004	22	18	15	14	14	13	16	25
A3. Permanently lower GDP growth 1/	22	20	18	18	18	19	25	47
<b>B. Bound tests</b>								
B1. Real GDP growth is at historical average minus one standard deviations in 2006-07	22	21	20	20	20	21	23	33
B2. Primary balance is at historical average minus one standard deviations in 2006-07	22	20	24	27	23	20	19	26
B3. Combination of B1-B2 using one half standard deviation shocks	22	20	22	24	21	19	19	25
B4. One-time 30 percent real depreciation in 2006	22	20	18	18	17	17	18	25
B5. 10 percent of GDP increase in other debt-creating flows in 2006	22	20	37	28	24	21	20	28

Sources: Armenian authorities; and Fund staff estimates and projections.

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).

2/ Revenues are defined inclusive of grants.



Table 3a. Armenia: External Debt Sustainability Framework, Baseline Scenario, 2002–25 1/  
(In percent of GDP, unless otherwise indicated)

	Actual										Estimate										Projections				
	1998	1999	2000	2001	2002	2003	2004	Historical Average 6/	Standard Deviation 6/	2005	2006	2007	2008	2009	2010	2010 Average	2015	2025	2011-25 Average						
<b>External debt (nominal) 1/</b>	41.6	46.3	45.1	42.7	43.2	39.1	33.3			26.7	24.2	23.0	22.1	21.4	20.4	20.4	17.3	13.3	16.2						
o/w public and publicly guaranteed (PPG)	41.6	46.3	45.1	42.7	43.2	39.1	33.3			26.7	24.2	23.0	22.1	21.4	20.4	20.4	17.3	13.3	16.2						
Change in external debt	-1.1	4.7	-1.2	-2.3	0.4	-4.0	-5.8			-6.6	-2.5	-1.2	-0.8	-0.7	-1.0	-1.0	-0.3	-0.5	-0.5						
Identified net debt-creating flows	2.3	8.6	7.2	0.7	-4.4	-4.4	-7.1			-4.9	-0.6	0.2	0.3	0.8	1.0	1.0	0.3	-0.7	0.1						
<b>Noninterest current account deficit</b>	19.5	15.8	13.9	8.6	5.4	6.4	4.3	10.6	5.9	3.6	3.9	4.0	3.9	4.1	3.6	3.6	2.6	1.0	2.2						
Deficit in balance of goods and services	34.3	29.9	27.7	20.7	17.2	17.9	14.9			13.9	13.0	12.2	11.4	11.3	10.6	10.6	8.5	5.7	7.8						
Exports	18.6	19.9	22.8	25.5	29.4	32.2	27.7			25.8	25.8	25.3	24.5	25.0	25.5	25.5	27.9	32.1	29.1						
Imports	52.8	49.8	50.5	46.1	46.6	50.1	42.6			39.7	38.8	37.5	35.9	36.3	36.0	36.0	36.4	37.8	36.8						
Net current transfers (negative = inflow)	-9.4	-9.4	-9.8	-8.2	-7.3	-7.8	-9.3	-8.7	1.0	-8.1	-7.1	-6.5	-5.8	-5.6	-5.4	-5.4	-4.6	-3.5	-4.3						
Other current account flows (negative = net inflow)	-5.4	-4.7	-4.0	-3.9	-4.5	-3.7	-1.3			-2.2	-2.0	-1.8	-1.7	-1.6	-1.5	-1.5	-1.3	-1.2	-1.3						
<b>Net FDI (negative = inflow)</b>	-11.7	-6.6	-5.4	-3.3	-4.7	-4.3	-6.1	-6.0	2.7	-5.6	-2.9	-2.7	-2.4	-2.4	-1.8	-1.8	-1.8	-1.5	-1.7						
<b>Endogenous debt dynamics 2/</b>																									
Contribution from nominal interest rate	1.2	0.7	0.7	0.9	0.8	0.4	0.3			0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.4	0.3						
Contribution from real GDP growth	-2.6	-1.3	-2.7	-3.8	-4.9	-5.0	-3.4			-3.2	-1.8	-1.3	-1.3	-1.0	-1.0	-1.0	-0.7	-0.5	-0.6						
Contribution from price and exchange rate changes	-4.1	0.0	0.7	-1.7	-1.0	-1.8	-2.2			-1.0	-0.8	-0.7	-0.7	-0.6	-0.6	-0.6	-0.5	-0.4	-0.5						
<b>Residual (3-4) 3/</b>	-3.5	-3.9	-8.4	-3.0	4.8	0.4	1.3			-1.7	-1.9	-1.4	-1.2	-1.5	-2.1	-2.1	-0.6	0.1	-0.6						
o/w exceptional financing	0.0	0.0	0.0	-0.2	-0.2	0.5	0.0			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0						
NPV of external debt 4/	...	...	...	...	...	...	19.8			15.5	14.1	13.8	13.7	13.7	13.4	13.4	12.6	8.2	11.3						
In percent of exports	...	...	...	...	...	...	71.3			60.1	54.6	54.5	55.9	54.8	52.4	52.4	45.2	25.4	39.4						
<b>NPV of PPG external debt</b>	...	...	...	...	...	...	19.8			15.5	14.1	13.8	13.7	13.7	13.4	13.4	12.6	8.2	11.3						
In percent of exports	...	...	...	...	...	...	71.3			60.1	54.6	54.5	55.9	54.8	52.4	52.4	45.2	25.4	39.4						
Debt service-to-exports ratio (in percent)	19.5	14.9	10.8	9.7	9.5	7.2	9.7			5.7	4.6	3.6	3.3	3.1	2.8	2.8	1.7	2.4	2.2						
<b>PPG debt service-to-exports ratio (in percent)</b>	19.5	14.9	10.8	9.7	9.5	7.2	9.7			5.7	4.6	3.6	3.3	3.1	2.8	2.8	1.7	2.4	2.2						
Total gross financing need (billions of U.S. dollars)	0.2	0.2	0.2	0.2	0.1	0.1	0.0			0.0	0.1	0.1	0.1	0.2	0.2	0.2	0.1	0.1	0.1						
Noninterest current account deficit that stabilizes debt ratio	20.6	11.1	15.2	10.9	5.0	10.4	10.1			10.2	6.4	5.2	4.7	4.8	4.6	4.6	2.9	1.5	2.6						
<b>Key macroeconomic assumptions</b>																									
Real GDP growth (in percent)	7.3	3.3	6.0	9.6	13.2	13.9	10.1	9.1	3.8	11.0	7.5	6.0	6.0	5.0	5.0	5.0	6.8	4.0	4.0						
GDP deflator in U.S. dollar terms (change in percent)	10.7	0.1	-1.4	3.9	2.5	4.5	5.9	3.7	4.0	3.2	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0						
Effective interest rate (percent) 5/	3.4	1.8	1.5	2.2	2.0	1.1	0.9	1.8	0.9	1.0	0.9	0.9	0.9	0.9	0.9	0.9	1.0	1.0	1.7						
Growth of exports of G&S (U.S. dollar terms, in percent)	6.8	4.5	18.9	23.7	29.3	29.5	9.0	17.4	10.6	19.8	13.5	9.9	8.4	10.7	10.7	12.2	8.6	8.1	8.4						
Growth of imports of G&S (U.S. dollar terms, in percent)	5.0	-8.0	5.2	1.1	13.2	27.0	7.7	7.3	10.9	20.2	10.8	8.2	7.1	9.9	7.7	10.7	7.0	7.0	7.1						
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	...	...	...	...	51.3	48.5	35.6	32.4	27.6	29.8	37.5	14.6	14.6	14.6						
Memorandum item:																									
Nominal GDP (billions of U.S. dollars)	1.9	1.8	1.9	2.1	2.4	2.8	3.6			4.6	5.2	5.8	6.5	7.1	7.7	7.7	10.8	20.4	13.6						

Source: Staff simulations.

1/ Includes both public and private sector external debt.  
 2/ Derived as  $[r - g - \rho(1+g)] / (1+g+\rho+g\rho)$  times previous period debt ratio, with  $r$  = nominal interest rate,  $g$  = real GDP growth rate, and  $\rho$  = growth rate of GDP deflator in U.S. dollar terms.  
 3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.  
 4/ Assumes that NPV of private sector debt is equivalent to its face value.  
 5/ Current-year interest payments divided by previous period debt stock.  
 6/ Historical averages and standard deviations are derived over the period 1998-2004.

Table 3b. Armenia: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2005–25  
(In percent)

	Estimate			Projections				
	2005	2006	2007	2008	2009	2010	2015	2025
<b>NPV of debt-to-GDP ratio</b>								
<b>Baseline</b>	15	14	14	14	14	13	<b>13</b>	8
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2006-25 1/	15	17	18	20	21	22	<b>26</b>	31
A2. New public sector loans on less favorable terms in 2006-25 2/	15	15	15	16	16	16	<b>15</b>	11
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	15	14	14	14	14	13	<b>13</b>	9
B2. Export value growth at historical average minus one standard deviation in 2006-07 3/	15	15	15	15	15	14	<b>13</b>	9
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006-07	15	14	14	14	14	14	<b>14</b>	9
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 4/	15	13	12	12	12	12	<b>12</b>	9
B5. Combination of B1-B4 using one-half standard deviation shocks	15	14	12	12	12	12	<b>12</b>	9
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 5/	15	20	19	19	19	18	<b>18</b>	12
<b>NPV of debt-to-exports ratio</b>								
<b>Baseline</b>	60	55	54	56	55	52	<b>45</b>	25
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2006-25 1/	60	64	72	80	84	85	<b>94</b>	97
A2. New public sector loans on less favorable terms in 2006-25 2/	60	58	61	66	65	64	<b>55</b>	34
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	60	53	51	51	50	47	<b>43</b>	27
B2. Export value growth at historical average minus one standard deviation in 2006-07 3/	60	59	62	62	60	57	<b>50</b>	29
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006-07	60	53	51	51	50	47	<b>43</b>	27
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 4/	60	51	44	44	44	42	<b>40</b>	27
B5. Combination of B1-B4 using one-half standard deviation shocks	60	52	45	45	44	42	<b>40</b>	27
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 5/	60	53	51	51	50	47	<b>43</b>	27
<b>Debt service ratio</b>								
<b>Baseline</b>	6	5	4	3	3	3	<b>2</b>	2
<b>A. Alternative Scenarios</b>								
A1. Key variables at their historical averages in 2006-25 1/	6	5	4	4	4	4	<b>5</b>	8
A2. New public sector loans on less favorable terms in 2006-25 2/	6	4	4	4	4	3	<b>3</b>	4
<b>B. Bound Tests</b>								
B1. Real GDP growth at historical average minus one standard deviation in 2006-07	6	4	3	3	3	3	<b>3</b>	4
B2. Export value growth at historical average minus one standard deviation in 2006-07 3/	6	5	4	4	4	3	<b>3</b>	4
B3. US dollar GDP deflator at historical average minus one standard deviation in 2006-07	6	4	3	3	3	3	<b>3</b>	4
B4. Net non-debt creating flows at historical average minus one standard deviation in 2006-07 4/	6	4	3	3	3	3	<b>2</b>	3
B5. Combination of B1-B4 using one-half standard deviation shocks	6	5	3	3	3	3	<b>2</b>	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2006 5/	6	4	3	3	3	3	<b>3</b>	4
<i>Memorandum item:</i>								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	19	19	19	19	19	19	<b>19</b>	19

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), noninterest current account in percent of GDP, and nondebt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.

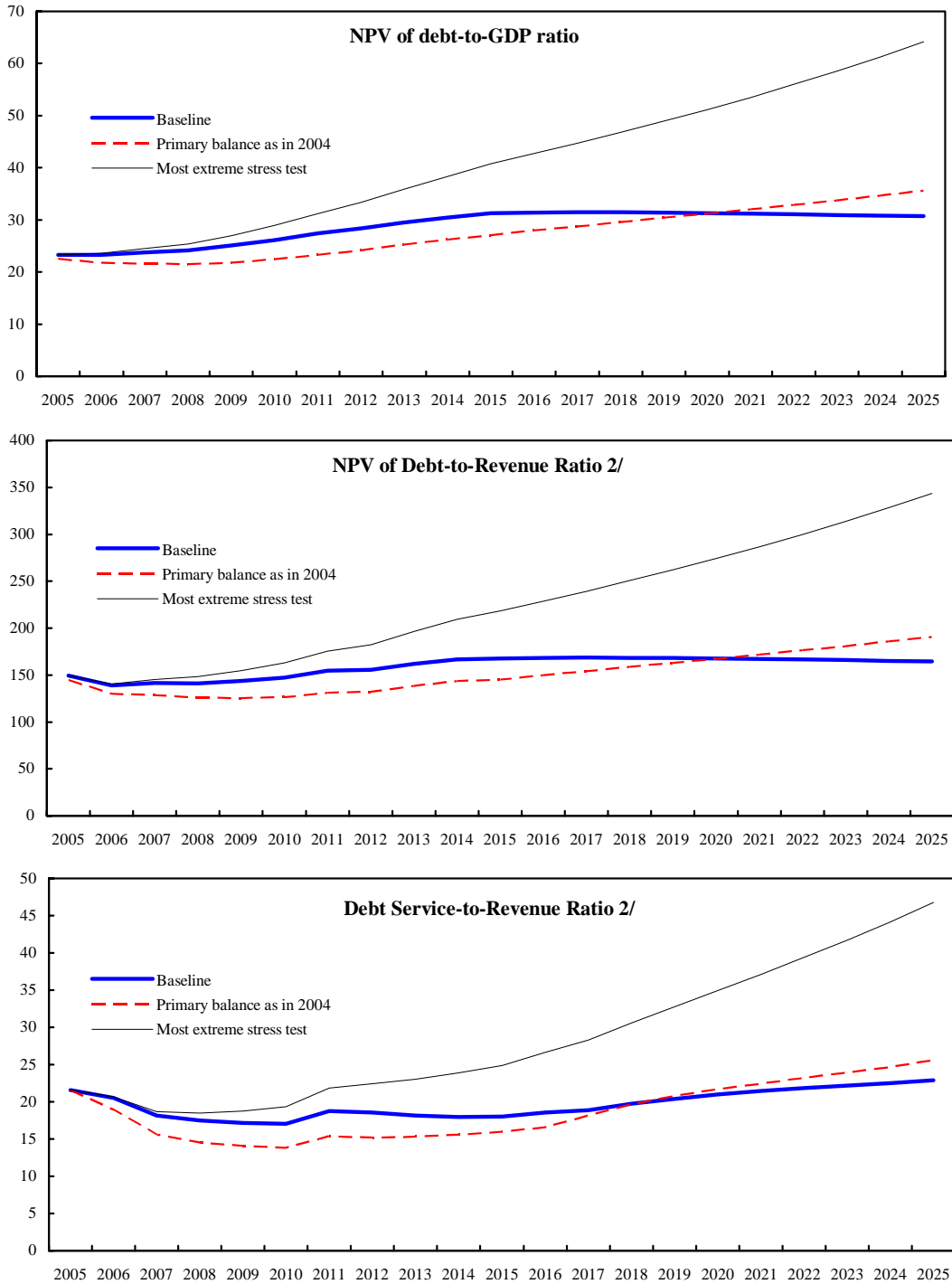
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

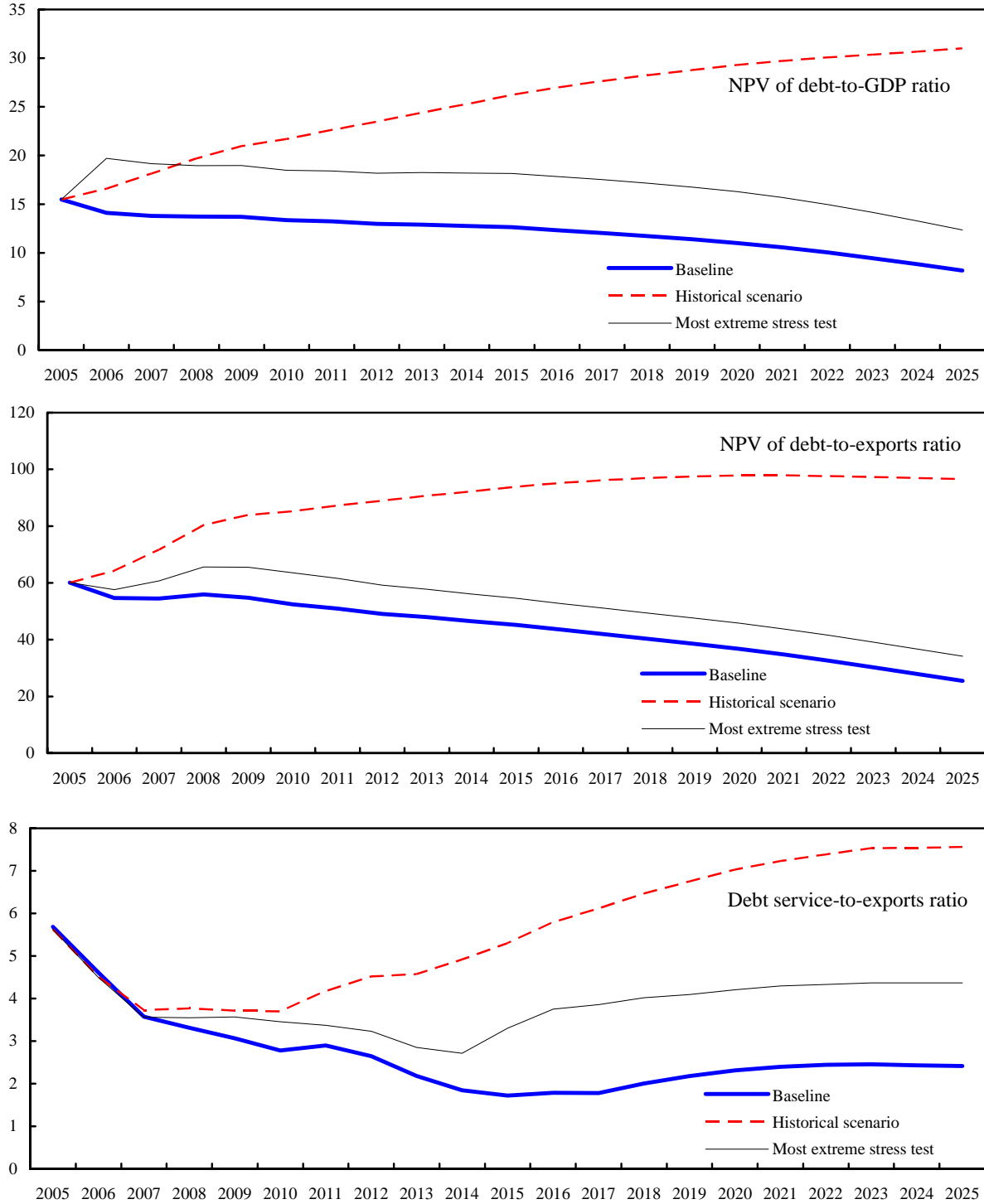
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Figure 1. Armenia: Indicators of Public Debt Under Alternative Scenarios, 2005–25 1/  
(In percent)



Source: Staff projections and simulations.  
 1/ Most extreme stress test is test that yields highest ratio in 2015.  
 2/ Revenue including grants.

Figure 2. Armenia: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2005–25 (In percent)



Source: Staff projections and simulations.

Mr. Rodrigo de Rato  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431

October 26, 2005

Dear Mr. de Rato:

In the attached Memorandum of Economic and Financial Policies, we summarize progress to date in implementing our PRGF-supported program and set out our economic and financial policies for the period through June 2006. We request hereby the completion of the first review and the second disbursement under the PRGF arrangement as well as modification of the end-December quantitative performance criteria.

The PRGF-supported program is on track. The Armenian economy continues to perform well and all quantitative and structural performance criteria under the PRGF arrangement for end-June 2005 were observed. Despite the progress achieved in recent years, we recognize that a number of significant challenges remain to sustain high economic growth and reduce poverty. To this end, our economic program for the period ahead contains specific measures to address weaknesses in tax and customs administration, enhance fiscal transparency and expenditure efficiency, and strengthen the financial system.

The Government of the Republic of Armenia believes that the policies and measures set forth in the attached supplementary memorandum are adequate to achieve the objectives of the program, but it stands ready to take any additional measures that may be appropriate for this purpose. The Government will consult with the Fund in advance on the adoption of these measures in accordance with the Fund's policies on such consultation. The Government intends to make these understandings public and authorizes the IMF to publish this letter, the attached supplementary memorandum, and the staff report.

Sincerely yours,

/s/

Andranik Margaryan  
Prime Minister  
Republic of Armenia

/s/

Vartan Khachatryan  
Minister of Finance and Economy  
Republic of Armenia

/s/

Tigran S. Sargsyan  
Chairman of the Central Bank  
Republic of Armenia

**REPUBLIC OF ARMENIA**  
**MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES**  
**October 26, 2005**

1. This memorandum supplements the Memorandum of Economic and Financial Policies (MEFP) of May 10, 2005. It reviews recent developments and outlines the government's policies through June 2006.

**I. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM**

2. The Armenian economy continues to register strong, noninflationary growth underpinned by sound macroeconomic policies and ongoing structural reforms. Real GDP increased by 11.7 percent in the first eight months of 2005, led by agriculture and private construction activity. The 12-month rate of inflation declined from 4.9 percent in January to -0.4 percent in September, reflecting mainly a good harvest and a strengthening dram. Strong exports of base metals and large remittance flows strengthened the external current account position, and gross official foreign reserves increased by \$74.2 million as of end-June 2005.

3. The overall **fiscal deficit** for the first half of 2005 was smaller than programmed on account of strong revenue performance and under-execution of expenditures. Tax revenue grew by 21 percent through end-July relative to the same period in 2004, and was AMD 2.6 billion above the program target. Value-added and profit taxes accounted for the majority of the overperformance. Expenditure execution was lower than programmed by AMD 9.2 billion.

4. Against a backdrop of strong appreciation pressures on the exchange rate, stemming from remittances and capital inflows, the Central Bank of Armenia (CBA) conducted sizeable, partly sterilized, foreign exchange interventions, which contributed to 50 percent year-on-year increase in **reserve money** by July. Broad money also grew briskly (30 percent y-o-y in June), reflecting emerging financial re-intermediation and re-monetization.

5. All **quantitative performance criteria** for end-June 2005 were met. Two indicative targets for end-June, however, were missed. The floor on the contributions to the State Fund for Social Insurance (SFSI) was missed by a small margin. The ceiling on reserve money was exceeded by a wide-margin, reflecting higher-than-projected net international reserve (NIR) accumulation, associated with sizeable foreign exchange interventions through May, as well as an increase in reserve requirements.

6. We have made good progress in the area of **structural reforms**. Both end-June structural performance criteria and most benchmarks were observed. The only exception was the benchmark on amending the legal provisions on tax audits which was submitted to parliament in July and is expected to be approved by early December 2005.

7. We have continued our efforts to bolster tax and customs administration and strengthen budget execution and implementation:

- In **tax policy**, a law was submitted to Parliament that reduces the list of goods exempt from VAT payment at the border and a time limit was introduced after which VAT must be paid under the capital deferral system, both effective 2006. A law has been submitted to Parliament that abolishes the presumptive social security payment for simplified tax payers and incorporates them into the regular social security tax payments system. Additionally, the denomination of a number of excise taxes was changed from dollars to drams to raise revenue collections.
- In **tax administration**, we have finalized an implementation plan for the collection of tax arrears, reduced the end-2004 stock of VAT refund arrears; lowered the threshold for the universal application of VAT cross-checks to AMD 100,000; and are moving the VAT refund process and audit selection towards risk-based approaches. The large taxpayers unit (LTU) has been organized along sectoral lines and a rotation system for inspectors introduced. To facilitate tax collections, we passed a decree on an action plan for the establishment of a self-assessment system.
- Regarding **customs administration**, we have agreed upon terms of reference for an operational review of the State Customs Committee (SCC) to be undertaken by a specialized international company. Following the passage of the Law on Electronic Signatures, we conducted a wide campaign to inform traders and companies about the direct trader input system. Finally, we have created a new unit within the SCC to strengthen risk assessment and analysis, and continue to monitor the number of declarations selected for physical examination.
- On the **expenditure** side, a new procurement system was adopted earlier in the year, and the timetable for the 2006 budget was advanced considerably to improve expenditure execution. For the first time, we have included a public investment plan (PIP) in the medium-term expenditure framework (MTEF) for 2006-08 to improve the strategic planning of our capital expenditures. We continue to make progress in the implementation of the action plan on the financial management of nonfinancial organizations (NCOs).

8. We are continuing to strengthen the **financial sector** and its regulatory and supervisory framework. We submitted to Parliament an amendment to the Law on Banks and Banking (LBB) which will strengthen consolidated banking supervision, improve corporate governance of banks, and enhance the effectiveness of external audits in risk management. In order to encourage banking sector consolidation and new shareholder entry, we raised the minimum capital requirements for existing banks to US\$5 million, effective July 1, 2005, with eligible capital to remain as is currently defined. With World Bank assistance, we have prepared a comprehensive legislation package aimed at strengthening creditor rights. Finally, a mandatory deposit insurance commenced coverage, effective July 1, 2005. We have also made progress in the area of non-banking sector reforms. With regards to the insurance

sector, by-laws on prudential regulation and accounting and reporting requirements are being finalized. As to the mortgage market, a legislative package has been prepared to improve the legal and regulatory framework that would contribute to the development of the primary mortgage market.

9. We continue to make progress in other areas of **structural reforms**. In the energy sector, overall collection rates have remained at 100 percent and technical and other losses have declined further. As a result, the energy sector is no longer receiving subsidies from the budget. To ensure the proper functioning of, and transparency in, the energy sector, the Public Service Regulatory Commission has passed resolutions on audit procedures for power sector entities, and market rules including power export model contracts, and dispatching relationships between the system operator and other entities of the system. The financial performance of the water and irrigation sectors has also shown improvement, owing to tariff increases and better collection. To improve governance, we have been steadfast in implementing the measures established in our anti-corruption action plan. In this regard, parliament was presented with a draft law on financial disclosure, extending coverage to all physical persons.

## **II. THE PROGRAM FOR THE PERIOD JULY 2005–JUNE 2006**

10. We remain committed to our growth and poverty-reduction strategy. For the remainder of 2005 and 2006, our macroeconomic policies will focus on price stability and a forceful implementation of tax, customs, and financial sector reforms. We expect that ongoing reforms of our tax and customs administrations will generate the additional resources needed to fund infrastructure investment and expand essential poverty-reducing services. Our financial sector reforms will be geared towards improving the quality and depth of financial intermediation by strengthening further the market infrastructure and regulatory and legal framework underpinning our financial system.

11. Reflecting our strong performance in the year to date, we now project real GDP to grow by 11 percent and inflation to decline to below 2 percent in 2005. Based on the revised projections for this year, the economic program for 2006 envisages real GDP growth of 7.5 percent and inflation of 3 percent. The additional policies noted below, and summarized in Tables 1 – 3, supplement the May 2005 memorandum of economic and financial policies.

### **A. Fiscal Policy**

12. We now envisage the **2005 fiscal deficit** to be smaller than programmed, at AMD 52.0 billion (2.4 percent of GDP) relative to AMD 61.8 billion (2.9 percent of GDP) originally programmed. On the revenue side, we will increase slightly the revenue target to AMD 314 billion (14.5 percent of GDP) to reflect higher-than-expected GDP growth, representing an increase of 0.4 percentage points of GDP from the 2004 outturn. On the expenditure side, we intend to revise slightly downwards the overall expenditures target by AMD 4.4 billion for 2005, recognizing that some of the delayed expenditure projects will not be implemented this year.



13. The **2006 budget**, which has already been submitted to parliament, is based on the following key parameters that are consistent with our MTEF for 2006–08. The overall deficit of the central government (including grants) will not exceed AMD 69.9 billion (2.9 percent of GDP). Domestic tax and nontax revenues (including revenues from capital transactions) will be targeted at AMD 372.8 billion, of which tax revenues will be at a minimum of AMD 362.8 billion, representing an increase of 0.6 percent of GDP from the revised 2005 revenue target. Current expenditures will be at most AMD 331.1 billion, allocating substantial increases to education, health, social transfers, and civil servants' wages. At the same time, we will reduce subsidies to the water and irrigation sectors and limit expenditure increases where the efficiency of expenditure is a concern. To ensure a balanced mix between current and capital spending, capital expenditures excluding those financed from potential grants from the Millennium Challenge Account (MCA) will be at least AMD 104.8 billion, representing a 17 percent increase relative to the revised 2005 estimate. We recognize that the 2006 deficit implies some loosening in the fiscal stance relative to the prospective 2005 outturn. But our large social and infrastructure investment needs justify a further expansion of public expenditures, particularly given the availability of low-cost financing.

#### **B. Monetary and Exchange Rate Policies**

14. Monetary policy will continue to focus on maintaining price stability and retaining the flexible exchange rate regime, with foreign exchange interventions limited to smoothing out volatility in the exchange rate. We will revise the monetary program for the second half of 2005. Subdued inflation, coupled with the increase in reserve requirements and the continued re-monetization (as well as the emerging de-dollarization), justifies higher-than-programmed reserve money growth without jeopardizing the annual inflation target. Specifically, we intend to revise the end-year reserve money growth target upward to 39 percent. Given the need for withdrawing liquidity to achieve this target, the CBA will increase issuance of its own securities as needed. We will stand ready to tighten the policy stance if signs of inflationary pressures emerge.

15. The monetary program for 2006, based on conservative assumptions on velocity and the money multiplier, targets inflation of 3 percent. To that end, it seeks to limit reserve money growth to 17 percent and envisages a further buildup in foreign reserves by US\$19 million. The government intends to increase the stock of treasury bills by at least AMD 7 billion, which will contribute to the development of the domestic government debt market. Additionally, we are considering recapitalizing the CBA and are in the process of discussing the modalities of doing so.

16. The implementation of monetary policy through targeting monetary aggregates has been complicated by strong remittances and unstable money demand. Accordingly, we are considering adopting a full-fledged inflation targeting monetary policy framework over the medium term. We will begin to move towards this goal in 2006. We recognize that a better understanding of the monetary transmission mechanism is a pre-requisite for the successful implementation of such a framework and have been working on developing relevant

indicators for forward looking inflation forecasting and general equilibrium models. We intend to strengthen further the CBA's capacity to conduct domestic open market operations, including through augmenting its holding of government securities.

### C. Structural Reforms

17. We will continue to press ahead with reforms to improve tax and customs collection, and to strengthen the financial sector.

#### Fiscal reforms

18. The centerpiece of the program will continue to be reforms in tax policy and tax and customs administration. Specific measures that we intend to undertake in the coming months, consistent with the approved two-year Tax Action Plan, are discussed below.

19. In **tax policy**, we aim to broaden the tax base by reducing privileges and loopholes:

- In the context of our reform package on social security, we will amend the Law on Simplified Tax to abolish the presumptive social security payment for simplified tax payers and incorporate them into the regular social security tax payments system (structural performance criterion). We also intend to raise the minimum contribution on social security payments from its current level of AMD 5,000.
- We will submit to parliament a law introducing a presumptive tax on property developers based on square meters of development to reduce tax evasion in the construction sector (structural benchmark).
- We intend to narrow the access to the simplified tax regime by excluding activities that require state licenses with annual stamp duties of AMD1 million or more. In addition, companies offering hotel services will no longer be eligible for the simplified tax.
- We plan to eliminate profit tax exemptions for foreign exchange gains and allow for the deduction of losses by December 2005.

Additional tax policy measures that we are considering implementing over the medium term include moving the remaining exemptions from VAT payment at the border for capital goods to the capital deferral system when it becomes fully operational; finalizing a unified tax code; moving large-scale operations from the presumptive tax to the regular tax regime; and limiting the loss carry-forward for the profit tax. Additionally, we plan to allow the current profit tax exemptions for large foreign enterprises to expire in 2007 as stipulated in the law.

20. In **tax administration**, we will focus on improving tax audits, tax arrears collection, and the VAT refund system. In this context, the upgrading of our IT capacity is paramount.

- We will continue to implement an annual audit plan for large enterprises, based on a risk classification system and specifying priorities and targets, and limit the number of revisions in tax returns that may be submitted by taxpayers and prohibit such revisions during tax audits.
- In cooperation with a specialized agency, the State Tax Service (STS) is developing a comprehensive IT strategy for 2006-08, specifying requirements in: (i) risk-based selection criteria in the areas of audits, arrears collection, and VAT refunds; (ii) information sharing between the regional tax inspectorates and headquarters; and (iii) a unified database for social contributions, tax collection, and tax arrears to enable improved cross-checking.
- We will submit a law to parliament that raises the sanctions to at least AMD 1 million for providing false documentation to revenue agencies (structural performance criterion).
- We will implement our plan for the collection of tax arrears with a view to collecting arrears or writing off the unrecoverable part of the end-2004 stock of tax arrears by the end of 2006, and ensure that no new arrears are incurred on a monthly basis.

We also plan to enhance further the transparency and efficiency of tax administration through greater public disclosure of information on taxpayers, and are moving to a fully automatic system for VAT refunds.

21. To improve the functioning of **customs administration**, we intend to:

- increase the share of the number of declarations of imports (taxable at the border under ad valorem rates), for which the approved customs value is determined on the basis of declared transaction prices by 5 percentage points (structural benchmark). This will be confirmed by reports obtained directly from the ASYCUDA system.
- work in close cooperation with the international company completing the operational review of customs operations, with the aim of completing it by March 2006 (structural benchmark). The review will focus on: (i) the main strengths and weaknesses of the SCC; (ii) implementation of laws, regulations, policies and procedures, along with enforcement, prevention and investigation; (iii) information flows within the SCC, and between the SCC and STS; and (iv) transparency of regulations, procedures and operations.
- introduce an integrated computerized system to collect, analyze, and flag information on the time taken to process customs declarations. The development of this system will draw on the findings, and recommendations, of the operational review.
- expand the use of the examination selectivity module in ASYCUDA to all customs houses by April 2006.

22. We recognize the importance of better targeting of government **expenditures** to ensure adequate and high quality public investment and social spending. We will continue to improve the procurement process to enhance expenditure execution and efficiency. We will press ahead with the Accounting and Second Generation Treasury Reform (A2GTR) project and the four-year action plan for the introduction of program budgeting.

23. We intend to make progress on **budget monitoring** and control. In order to reduce the fiscal risk stemming from a lack of disclosure and control of NCOs, we will implement our action plan for improving NCO financial management and reporting. Furthermore, we will adopt a sanction mechanism for failure to comply with reporting requirements.

### **Financial sector reforms**

24. We will move forward with financial sector reforms. With regards to **banking regulation and supervision**, Parliament is expected to pass the amendment to the LBB, taking into account many of the FSAP recommendations, including enhancing the effectiveness of external audits and strengthening consolidated supervision (structural performance criterion). Following the passage of the amendment, we plan to specify and implement a consolidated supervision framework (structural benchmark). The amendment will also introduce key elements that are prerequisites for improved **corporate governance of banks**, including: (i) definition of separate duties and rights of shareholders, board of directors, and executive of banks; and (ii) a minimum number of bank nonaffiliated owners and a ceiling on individual equity capital participation of these members. We will continue to press ahead with strengthening the legal framework for creditor rights.

25. In order to ensure a level playing field for all market participants and to better monitor and control market risks, we have decided to adopt a **unified financial supervision system**, which will become effective January 2006. In this context, the CBA will finalize an action plan, in consultation with the Fund staff, to develop the internal structure and functions of departments by end-March 2006. The plan will specify mechanisms for internal coordination and reporting, and will put in place regulatory practices based on written guidelines for on-site and off-site supervision.

26. Furthermore, progress is being made in developing the **nonbank financial sector**. In the insurance sector, we plan to implement a regulatory and supervisory framework, including regulations on accounting, auditing, financial reporting, solvency, reserves, and reinsurance. In the area of mortgage finance, we are focusing on the development of the primary market and will implement legislations aimed at simplifying procedures for notarization and the registration of rights for immovables. As regards pension reform, we will continue our work on the evaluation of various fiscally sustainable reform options based on extensive actuarial projections.

### III. OTHER ISSUES

27. On the implementation of **PRSP-related work**, we are preparing a comprehensive set of monitoring indicators that will be used to assess progress in implementing our poverty reduction strategy. To reflect the dynamic developments since the adoption of the PRSP in 2003, we plan to update our PRSP later this year or by early 2006 through a participatory process and by drawing on the results of the forthcoming 2004 household survey.

28. We are firmly committed to press ahead with our efforts to improve **governance**. We will continue to implement the anti-corruption strategy action plan, focusing on such areas as education, health care, and law enforcement agencies, while raising public awareness and participation.

29. In the **energy sector**, we plan to liquidate Armenergo in a transparent manner by the end of the year. We intend to introduce a leasing contract in the Yerevan Water and Sewage Company, with the aim of eliminating budgetary support. We also intend to improve collections by expanding the metering program, particularly in areas outside of Yerevan. We also intend to strengthen the capacity of the water user companies to reduce further losses in the irrigation sector. In cooperation with the World Bank, we will implement a 7-year program aimed at mitigating the impact of water tariff increases on the poorest population.

### IV. PROGRAM MONITORING

30. Program monitoring will be based on semi-annual quantitative performance criteria and quarterly indicative targets as well as structural performance criteria and benchmarks (Tables 1 and 2). The Technical Memorandum of Understanding (TMU) attached to this Memorandum defines the quantitative targets of Table 2, the program adjustors, and specific reporting requirements. Completion of the second review under the PRGF arrangement, scheduled for May 16, 2006, will require observance of the revised performance criteria for end-December 2005 shown in Table 2 as well as the structural performance criteria listed in Table 1. The completion of the third review under the PRGF arrangements scheduled for November 16, 2006 will require observance of the quantitative performance criteria for end-June 2006 shown in Table 2 as well as the structural performance criteria listed in Table 1.

Table 1. Table of Structural Measures for the Second Review under the PRGF

Measure	Type of Conditionality	Target Date (End of Period)
<u>Tax policy</u>		
Parliament adopt an amendment to the Law on Simplified Tax to abolish the presumptive social security payment for simplified tax payers and incorporate them into the regular social security tax payments system.	Structural Performance Criterion	December 2005
Submit to parliament a law introducing a presumptive tax on property developers based on square meters of development to reduce tax evasion in the construction sector.	Structural Benchmark	March 2006
<u>Tax administration</u>		
Submit a law to parliament that raises the sanctions to at least AMD 1 million for providing false documentation to revenue agencies.	Structural Performance Criterion	March 2006 1/
<u>Customs administration</u>		
Increase by 5 percentage points the share of the number of declarations of imports for which the approved customs value is determined on the basis of declared transaction prices.	Structural Benchmark	December 2005
Complete operational review of customs operations through a specialized international company.	Structural Benchmark	March 2006
<u>Financial Sector</u>		
Parliament adopt the amendment to the Law on Banks and Banking to (i) to empower the CBA to identify ultimate beneficial owners, in the event of upward consolidation; (ii) define the separate duties and rights of shareholders, boards of directors, and executives of banks; (iii) require disclosure of potential conflicts of interest of board members; and (iv) require public disclosure of information on ownership and control of banks, including list of founders and copies of the company's statutes.	Structural Performance Criterion	December 2005
Specify and implement a consolidated supervision framework for monitoring beneficiary owners beyond the licensing stage, in order to determine the appropriate structure of corporate governance and to identify how affiliate companies and related parties impact on the bank's operations.	Structural Benchmark	June 2006

1/ This structural performance criterion is for the Third review under the PRGF arrangement.

Table 2. Armenia: Quantitative Targets, June 2005 – June 2006 1/  
(End of period ceilings on stocks, unless otherwise specified)

	2005			2006				
	Jun.	Sept.	Dec.	Mar.	Jun.	Jun.		
	Prog.	Act. 2/ Prog.	Proj. 3/ Prog.	Rev. prog. 2/ Prog.	Prog. 3/ Prog.	Prog. 2/ Prog.		
Net domestic assets of the CBA 4/	-53.8	-56.0	-41.9	-56.7	-28.1	-51.4	-42.8	-36.9
Net banking system credit to the government	-17.2	-25.1	-8.0	-20.8	-6.3	-4.8	-17.4	4.0
Domestic arrears of the central government and the State Fund for Social Insurance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Tax revenues of the central government (floor) 5/	137.3	139.8	220.7	224.2	310.0	314.0	75.1	160.7
Balance of the central government on a cash basis (floor) 5/	-25.0	-3.3	-49.1	-23.3	-61.8	-52.0	0.0	-32.2
Reserve money (band/level) 3/	(122-127)	150.8	(129-134)	173.8	(148-154)	(181-188)	(174-181)	(180-187)
Contributions to the State Fund for Social Insurance 3/ 5/	29.8	28.7	46.4	46.4	64.8	64.8	16.1	34.5
Contracting or guaranteeing of new nonconcessional external debt 5/ 6/	0	0	0	0	0	0	0	0
External arrears (continuous criterion)	0	0	0	0	0	0	0	0
Net official international reserves (floor) 7/	379.0	436.4	373.3	437.8	389.2	449.9	415.5	414.4

1/ All items as defined in the Technical Memorandum of Understanding.

2/ Performance criterion.

3/ Indicative target.

4/ At program exchange rate (500 dram per U.S. dollar).

5/ Cumulative flow from the beginning of the calendar year until the end of the month indicated.

6/ Includes debt with maturity of more than a year as well as obligations with maturity of one year or less, excluding normal import-related credit and sales of treasury bills to nonresidents.

7/ Excludes reserve money liabilities denominated in foreign currencies for September 2005 Rev. Proj., December 2005 Rev. Prog., and 2006.

**GOVERNMENT OF ARMENIA**  
**TECHNICAL MEMORANDUM OF UNDERSTANDING**

This memorandum defines the benchmarks, performance criteria, indicative targets, adjustors, and reporting modalities referred to in the Memorandum of Economic and Financial Policies (MEFP).

**I. QUANTITATIVE TARGETS**

1. The program targets a minimum level of **net official international reserves (NIR)** of the Central Bank of Armenia (CBA). The stock of such reserves will be calculated as the difference between total official gross international reserves (excluding reserve money denominated in foreign currencies) and official gross reserve liabilities. Total gross official international reserves are defined as the CBA's holdings of monetary gold (excluding amounts pledged as collateral or in swaps), holdings of Special Drawing Rights (SDRs), any reserve position in the IMF, and holdings of convertible currencies in cash or in nonresident financial institutions (deposits, securities, or other financial instruments). Gross reserves held in the form of securities and other financial instruments are marked to market. Gross reserves are reported separate from the balance on the government's Special Privatization Account (SPA) and exclude capital subscriptions in foreign financial institutions and illiquid foreign assets. Official reserve liabilities shall be defined as outstanding liabilities to the IMF and convertible currency liabilities of the CBA to nonresidents with an original maturity of up to and including one year. NIR is monitored in U.S. dollars, and, for program monitoring purposes, assets and liabilities in currencies other than the U.S. dollar shall be converted into dollar-equivalent values using the exchange rates as specified in Table 1.

2. The program targets a maximum level of **net domestic assets (NDA)** of the CBA. For program purposes, NDA is defined as reserve money minus NIR, minus reserve money denominated in foreign currencies, and plus medium- and long-term liabilities (i.e. liabilities with a maturity of one year or more) of the CBA. To evaluate program targets, the dram-equivalent values of NIR, medium- and long-term liabilities, and reserve money in U.S. dollar are calculated at the program exchange rate of dram 500.00 per U.S. dollar. The dram-equivalent value of reserve money in Euro is calculated at the program exchange rate specified in Table 1. NDA is composed of net CBA credit to the general government; outstanding credit to domestic banks by the CBA (including overdrafts) minus liabilities not included in reserve money (exclusive of accrued interest), and other items net.

3. **Reserve money** targets are indicative and include a floor and a ceiling. They are subject to a daily bound of plus or minus 2 percent computed from the quarterly average standard deviation of excess reserves held by banks in percent of quarterly reserve money during the previous four years. Reserve money is defined as the sum of currency issued,



required and excess reserves, and current and time deposit accounts of certain resident agents.<sup>13</sup>

4. **The stock of net credit from the CBA to the government** includes the CBA's holdings of treasury bills and treasury bonds less all types of government deposits with the CBA (including the deposits in the Treasury Single Account, deposits of donor-financed project implementation units, the Lincy foundation, and balances of proceeds from the sale of humanitarian assistance). Treasury bonds are valued at the purchase price and excluding accrued interest and treasury bills are valued at the purchase price plus the implicit accrued interest.

5. **Net credit from commercial banks to the government** includes: (1) gross commercial bank credit to the central government less government deposits with commercial banks (including the counterpart funds of certain government on lending to the economy financed by the Lincy Foundation and the World Bank); and (2) banks' holdings of treasury bonds (valued at the purchase price and excluding accrued interest) and treasury bills (valued at the purchase price plus the implicit accrued interest). **Net credit of the banking system to the government** is the sum of net credit from the CBA and net credit from commercial banks to the central government.

6. **External debt ceilings** apply to all forms of new nonconcessional medium- and long-term external debt<sup>14</sup> with original maturities of more than one year, which are contracted or guaranteed by the government or the CBA or any other agency acting on behalf of the government. It does include debt with maturity of one year or less. Excluded from the limits are changes in indebtedness resulting from refinancing credits or rescheduling operations, sales of treasury bills or treasury bonds to nonresidents (provided the sales go through the regular auction mechanism and involve no exchange rate guarantees), concessional loans, and credits extended by the IMF.<sup>15</sup> Except for normal import-related credits, there is a zero limit on short-term external debt (obligations with original maturities of up to one year) contracted or guaranteed by the government or the CBA. Transactions subject to debt ceilings shall be valued in the contracted currencies and converted into U.S. dollars at the average monthly market exchange rate in the month when the commitment was contracted.

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<sup>13</sup> Liquidity absorbing transactions under reverse repurchase agreements, the CBA's deposit facility, and foreign currency swaps are netted out from claims on banks, i.e., they are excluded from the reserve money definition.

<sup>14</sup> The term "debt" shall have the meaning set forth in Section 9(a) of the Guidelines on performance criteria on external debt, as modified by the Executive Board Decision No. 12274-(00/85) of August 24, 2000.

<sup>15</sup> For program purposes, a loan is considered concessional if the grant element is at least 35 percent calculated using a discount factor based on the Commercial Interest Reference Rates (CIRRs) published by the OECD plus margins depending on the loan maturity. The margins are: 0.75 percent for repayment periods of less than 15 years, 1 percent for 15–19 years, 1.15 percent for 20–29 years, and 1.25 percent for 30 years or more. The average of the CIRRs over the last ten years will be used for loans with a maturity of at least 15 years and the average of the CIRRs for the preceding six months will be used for shorter maturities.

7. **External arrears** will consist of all overdue debt-service obligations (i.e., payments of principal and interest) arising in respect of public sector loans contracted or guaranteed including unpaid penalties or interest charges associated with these arrears.

8. **Balance of the central government on a cash basis** is defined as the sum of domestic banking system net financing, domestic nonbank net financing, and external net financing to the government. **Net banking system credit to the government** equals the change during the period of net credit to the government. **Nonbank net financing** equals the sum of: (1) the change during the period of outstanding treasury bills and bonds to nonbanks (including accrued interest for treasury bills and excluding accrued interest for treasury bonds);<sup>16</sup> and (2) any other disbursement or transaction that increases nonbanks' claims on the central government plus withdrawals from the special privatization account or the treasury subaccount containing privatization proceeds in dram, less amortizations made by the central government to private resident nonbank agents. **External net financing** equals total debt-increasing disbursements from non-residents to the central government less total amortizations from the central government to non-residents. All foreign-currency denominated transactions are recorded in drams using the prevailing exchange rate at the time of the transaction.

9. The project implementation units, which carry out projects financed by the US-based Lincy Foundation, maintain accounts at the CBA. These grants are recorded in the fiscal accounts as external grants on the revenue side and as foreign-financed capital expenditure on the expenditure side. In addition, any loans extended by the US-based Lincy foundation to finance investments and that are intermediated through the banking system are recorded in the financial accounts as a financing item below the line and are thus excluded from net lending.

10. Foreign currency proceeds from selling enterprises are deposited into the Special Privatization Account (SPA). The account is held at the CBA and the proceeds are invested abroad together with the CBA's international reserves. These proceeds are included in the definition of the monetary accounts of the CBA as part of net foreign assets with a counter entry in other items net. Any budgeted withdrawal from the SPA will be accounted for as privatization proceeds used to finance the budget and will be recorded below the line. Any unanticipated withdrawal from the SPA will be recorded below the line as privatization receipts; these withdrawals, however, will be replenished during the same fiscal year. Domestic currency proceeds from selling enterprises to residents are deposited in a subaccount of the treasury single account.

11. **Tax revenues** of the central government are defined in accordance with Government Financial Statistics (GFS), 1986, section IV.A.1. Total revenues collected by the State Tax Service (STS) and the Customs Committee (CC) are classified as follows: VAT (of which:

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<sup>16</sup> Domestic nonbank holdings of treasury bills and treasury bonds are defined as total outstanding treasury bills and bonds less holdings by the banking system and the SFSI.

presumptive tax on cigarettes, petroleum, and diesel), excises (of which: presumptive tax on cigarettes, petroleum, and diesel), enterprise profit tax, personal income tax, land tax, customs duties (of which: presumptive tax on cigarettes), other presumptive taxes, simplified tax, property tax, and other taxes (of which stamp duties and environmental taxes). **Payroll contributions to the State Fund for Social Insurance (SFSI)** are not included in tax revenue. For evaluating the performance criterion on tax collection, recorded tax revenues will exclude any tax payment related to non-programmed transfer, loan, or recapitalization operation carried out with state-owned companies or any VAT refunds in arrears.

12. The program targets ceilings for the stock of **domestic arrears of the central government and the State Fund for Social Insurance (SFSI)**. Domestic arrears are defined as follows. With respect to wages, contributions to the pension fund, family allowances, and amortization and domestic interest payments, the stock of arrears is defined as all unpaid claims outstanding at the end of the month. This excludes technical arrears of up to AMD 0.5 billion that could arise because of minor delays in the execution of these expenditures. For all other expenditure categories, arrears are defined as the stock of unpaid claims, as verified by the recipient of the goods and services, which has been outstanding for more than 30 days as of the end of the month. However, at year-end all outstanding claims must be settled as required in the budget law.

## II. ADJUSTERS

13. The quantitative performance criteria and benchmarks under the program are subject to the following adjusters:

- **Foreign-financed project loan disbursements:** the target on the cash balance of the central government will be adjusted downward (upward) by the full amount of cumulative higher (lower) than programmed foreign-financed project disbursements. The programmed amounts are shown in Table 2 below.
- **World Bank budget support:** the following targets will be adjusted by the full amount of lower than programmed World Bank direct budget support: NIR (downward), NDA of the CBA (upward), and net credit to the government (upward). The programmed amount is shown in Table 3 below.
- **KfW loan disbursements:** the target on the NDA of the CBA will be adjusted upward by the full amount of any non-programmed disbursement from KfW. The adjustment will be made at program exchange rates. The programmed amount is shown in Table 4 below.
- **Recapitalization of the CBA:** the target on the net credit of the banking system to the government will be adjusted upward by the full amount of the recapitalization of the CBA.

### III. STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS

14. **Compulsory Social Contributions** (structural performance criterion). See paragraph 19 of the MEFP.

15. **Presumptive tax on property developers** (structural benchmark). See paragraph 19 of the MEFP.

16. **Sanctions for false documentation** (structural performance criterion). See paragraph 20 of the MEFP. This structural performance criterion is for the third review under the PRGF arrangement.

17. **Operational Review of the State Customs Committee (SCC)** (structural benchmark). Complete the operational review in line with the terms of reference by March 31, 2006. The broad objectives of the

review should be to: i) assess the operational efficiency of customs processes, including in comparison with other similar countries; ii) identify any capacity constraints and shortcomings in administration, which hamper revenue collection; iii) recommend specific reforms aimed at enhancing operational efficiency and revenue mobilization; and iv) in so doing, identify priority areas for further technical assistance.

18. **Valuation of imports at declared transaction prices** (structural benchmark). On the basis of reports obtained directly from the ASYCUDA system, demonstrate an increase of 5 percentage points, over 2004, in the number of declarations of imports (taxable at the border under ad valorem taxes), for which customs value is determined on the basis of the declared transaction price. Progress during the year will be reported quarterly, also on the basis of reports obtained directly from the ASYCUDA system. To support the use of transaction prices, the customs valuation database will be published, and kept up to date, on the SCC website.

19. **Law on the Banks and Banking.** An amendment to the Law on the Banks and Banking (LBB) will be passed by the Parliament by end-2005 (structural performance criterion).

#### *Consolidated supervision*

20. The amendment will clearly stipulate that, in the event of upward consolidation, the CBA is empowered to identify beneficial owners on a chain of ownership as far as the CBA sees appropriate for supervisory purpose.

#### *Corporate governance*

21. The amendment on the LBB will define the separate duties and rights of shareholders, boards of directors, and executives of banks.

22. The shareholders' rights should be performed through the decisions of the **General Meetings of Shareholders**, which at least covers the following issues: (i) electing or calling back the members of the Board of Directors, (ii) approving the external auditor of the bank, and (iii) approving the payments of dividends to the shareholders upon a request of the Board of Directors. This ultimate decision making power of the General Meeting of shareholders may not be transferred to the bank's Board of Directors, executives of the bank, or any other party.

23. The **Board of Directors** of the bank shall be responsible for the safe and sound operation of the institution, thus taking decisions on the following issues: (i) determining the strategy of the bank, (ii) appointing and firing the banks' executive officers, (iii) establishing the standards of risk management and internal controls, (iv) establishing the internal audit division and internal audit plan of the bank, (v) approving the banks' internal administrative structure, (vi) initiating measures for the correction and elimination of failures identified during audits and imposing control over their implementation, and (viii) approving internal guidelines on financial operations conducted by the bank. This ultimate decision making power of the Board of Directors may not be transferred to the bank's General Meeting of shareholders, executives of the bank, or any other party.

24. The number of the members of the **Board of Directors** should be at least 5 but not exceed 15. Board members shall not be affiliated with each other. The executives of the bank and the members of the Board of Directors should also not be affiliated persons.

25. The **executives** of the bank should be appointed by the Board of Directors. The power of taking decisions by the executive may not be transferred to the General Meeting of shareholders, Board of Directors, or any other party.

26. The members of the Board of Directors and the executive officers should bear fiduciary responsibilities for acting in a non-sound and unfair manner.

27. The amendment on the LBB should stipulate public disclosure of information on ownership and control of the bank, including the list of significant shareholders and copies of bank's statutes. Major shareholders, members of the Board of Directors and executive officers of the bank should publicly disclose their remuneration and other benefits or loans, including those received by their affiliates.

#### IV. DATA REPORTING

28. The government will provide the IMF the information specified in the following table.

Reporting Agency	Type of Data	Description of Data	Frequency	Timing	
CBA <sup>17</sup>	CBA balance sheet	Summary	Weekly	Within 1 day of the end of each week	
	CBA balance sheet	Summary at program exchange rates; and by chart of accounts at actual official exchange rates	Monthly	Within seven days of the end of each month	
	Monetary survey	Summary banking system balance sheet for the central bank and the consolidated balance sheet of commercial banks at program exchange rates; and by chart of accounts at actual official exchange rates	Monthly	Within 21 days of the end of each month	
	International reserves		By chart of accounts; at (i) program exchange rates; and (ii) at actual official exchange rates	Weekly	Within 1 day of the end of each week
			By chart of accounts; at (i) program exchange rates; and (ii) at actual official exchange rates	Monthly	Within 2 days of the end of each month
	Foreign exchange market	Official exchange rates (buying and selling); interbank turnover; and volume of CBA interventions, including foreign exchange swaps	Weekly	Within 1 day of the end of each week	
	Interest rates	Repo rate; interbank rate; by volume and maturity, T-bill rate, bond yield; and by maturity, deposit and lending rates	Monthly	Within 7 days of the end of each month	
	CBA operations	Repo (reverse repo) operations; Lombard credits; and deposit facility	Monthly	Within 7 days of the end of each month	
	Bank liquidity	Reserves and excess reserves	Biweekly	Within 7 days of the end of each month	
	Special privatization account (SPA)	Monthly flows	Monthly	Within 7 days of the end of each month	
	Banking indicators	Capital adequacy; asset composition and quality; profitability; liquidity; open FX positions; and compliance with prudential norms	Quarterly	Within 30 days of the end of each quarter	
CPI	Index of core inflation	Monthly	Within 21 days of the end of each month		

<sup>17</sup> As defined in CBA resolution No. 201 (December 6, 1999).

	Other monetary data	IFS format	Monthly	Within 45 days of the end of each month
Customs Committee	Report on the operations of the post verification unit	The report will include: information on the number of audits conducted, the number of infractions found, the amounts involved, and remedial measures taken	Quarterly	Within 30 days of the end of each quarter
	Report of the operations of the internal audit unit	The report will include: the number of written appeals, complaints, and requests submitted to the IAUCC; the sources of the written submissions (e.g. President's Office, the Prime Minister's Office, other Government officials, National Assembly, line Ministries, Law Enforcement bodies, individuals, non-government organizations); the IAUCC's actions in response to the written submissions; the number and type of audits/investigations undertaken by the IAUCC; the overall results of the audits/investigations undertaken; and the actions taken by the IAUCC in response to the results of the audits/investigations undertaken	Quarterly	Within 30 days of the end of each quarter
	Import data	<ol style="list-style-type: none"> <li>1. Total value of recorded imports, breaking out raw diamond imports;</li> <li>2. Total value of non-duty free recorded imports;</li> <li>3. Number of total transactions involving recorded imports;</li> <li>4. Number of total transactions involving non-duty free recorded imports</li> <li>5. Value of recorded imports where customs value was assessed using transaction prices, breaking out raw diamond imports;</li> <li>6. Value of non-duty free recorded imports where customs value was assessed using transaction prices;</li> <li>7. Number of transactions involving recorded imports where customs value was assessed using transaction prices; and</li> <li>8. Number of transactions involving non duty free recorded imports where customs value was assessed using transaction prices</li> </ol>	Quarterly	Within 30 days of the end of each quarter
Ministry of Finance and	T-bill and coupon bond financing	By holders, i.e., CBA, resident banks, resident nonbanks, and nonresidents	Monthly	Within 7 days of each month

Economy (MFE)	External debt	Disbursements and stock of outstanding short-term and contracting or guaranteeing and outstanding stock of medium-and long-term external debt of the government, the CBA, and state-owned companies (by company); any stock of arrears on external debt service and outstanding stock of government guarantees and external arrears	Monthly	Within 21 days of the end of each month (preliminary data ) and within 45 days of the end of each month (final data)
	Revenue collection	Total revenue collected separately by the SFSI, the STS, and the CC, including revenue by individual tax	Monthly	Within 7 days of the end of each month
	Expenditure arrears	Government and SFSI separately	Monthly	Within 20 days of the end of each month for SFSI arrears and within 45 days of the end of each month for government arrears
	Privatization receipts	Balance on the SPA; gross inflows into and outflows from the SPA during the month, specifying the nature of each transaction	Monthly	Within 7 days of the end of each month
	Treasury single account (TSA)	Detailed breakdown of central treasury account, including deposits at the central treasury, pension fund, community budgets, off budget account, monetization account, state budget account and the Republic correspondent account—flows during the month and end of month stocks.	Monthly	Within 7 days of the end of each month
	Consolidated central government	State budget and SFSI	Monthly	Within 30 days of the end of each month
	Consolidated general government	Central and local governments 1/	Quarterly	Within 60 days of the end of each quarter
	Consolidated general government	Central and local governments 1/	Annual	Within 180 days of the end of each year
MFE/SFSI	Budget execution	All cash receipts, cash expenditures, including debt-service payments, and external and domestic borrowing operations; expenditure data will be provided according to both economic and functional classifications, consistent with the GFS methodology	Monthly	Within one month following the end of each quarter.
NSS	Balance of payments	Detailed export and import data	Monthly	Within 28 days of the end of each month



		Detailed export and import data	Quarterly	Within 45 days of the end of each quarter
	GDP	Estimates	Monthly	Within 30 days of the end of each month
	CPI	By category	Monthly	Within 5 days of the end of each month
STS	Tax arrears	By type of tax	Monthly	Within 30 days of the end of each month
		For or the 30 largest debtors and for all major companies in the energy, water, and irrigation sectors	Quarterly	Within 30 days of the end of each quarter
	VAT refund claims in arrears	Detailed data on VAT refunds in arrears which include all outstanding VAT refunds that have not been accepted (and refunded), or offset (in full or in part), or rejected (in full or in part) after the 90 day processing period. Number of refund applications processed per month.	Monthly	Within 30 days of the end of each month

1/ Until NCE quarterly data reporting has been established, central government is defined as state budget (budgetary) + SFSI (social security fund). Once NCE quarterly data reporting has been established, central government is defined as state budget (budgetary) + NCEs that belong within the general government (extrabudgetary) + SFSI (social security fund). General government = central government + local governments.

Table 1. Armenia: (Program) Exchange Rates of the CBA  
(As of December 30, 2004 for dollars per currency rates. Drams per  
currency rates are calculated using the 500 drams per U.S. dollar rate)

Country	Drams Per Currency	Dollars Per Currency
Australian dollar	389.85	0.779701
Canadian dollar	406.67	0.813334
Swiss franc	441.45	0.882904
Danish krone	91.47	0.182941
Euro	680.40	1.360798
Pound sterling	962.90	1.925799
Japanese yen	4.838	0.009676
Norwegian krone	82.40	0.164807
Swedish krone	75.85	0.151696
U.S. dollar	500.00	1
SDR	791.92	1.583834
Gold 1/	7,129.43	14.25885

1/ Per gram.

Table 2. Armenia: Cumulative Foreign-Financed Project Loan Disbursements 1/  
(In billions of drams)

2005			
<u>March</u>	<u>June</u>	<u>September</u>	<u>December</u>
5.4	10.3	21.9	39.5

1/ Cumulative from December 2004, at program exchange rates.

Table 3. Armenia: World Bank Lending 1/  
(In billions of drams)

2005			
<u>March</u>	<u>June</u>	<u>September</u>	<u>December</u>
0	0	0	10.0

1/ Cumulative from December 2004, at program exchange rates.

Table 4. Armenia: KfW Loan Disbursements 1/  
(In billions of drams)

2005			
<u>March</u>	<u>June</u>	<u>September</u>	<u>December</u>
0	0	0	0

1/ Cumulative from December 2004, at program exchange rates.



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FOR IMMEDIATE RELEASE  
November 14, 2005

International Monetary Fund  
Washington, D.C. 20431 USA

### **IMF Completes First Review Under PRGF for the Republic of Armenia and Approves US\$4.7 Million Disbursement**

The Executive Board of the International Monetary Fund (IMF) today completed the first review of the Republic of Armenia's economic performance under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement. The completion of the review enables Armenia to draw an amount equivalent to SDR 3.28 million (about US\$4.7 million), which will bring total disbursement under the arrangement to SDR 6.56 million (about US\$9.4 million).

The Executive Board approved the three-year arrangement on May 25, 2005, (see [Press Release No. 05/123](#)) for a total amount equivalent to SDR 23 million (about US\$32.8 million) to support the government's economic program through 2008.

Following the Executive Board discussion, Agustín Carstens, Deputy Managing Director and Acting Chair, said:

“Armenia’s economy continues to perform strongly. Prudent fiscal and monetary policies, strong external inflows, and ongoing structural reforms have contributed to double-digit growth, low inflation, and declining poverty in 2005. The outlook is for continued robust growth in 2006, underpinned by buoyant investment and remittance inflows.

“The authorities made good progress in structural reforms in 2005. They adopted a comprehensive two-year Tax Action Plan to improve tax and customs administrations. Two major amendments to tax legislation that reduce exemptions and loopholes have been submitted to parliament. Moreover, an operational review of customs is currently under way. Steps have also been taken to strengthen banking supervision and improve corporate governance of the financial sector. The financial performance of the energy, water, and irrigation sector has continued to improve.

“The thrust of the authorities’ economic program for 2006 is to maintain macroeconomic stability and keep inflation below 3 percent. The Central Bank of Armenia will continue to focus on maintaining price stability, and to limit intervention in the foreign exchange market to smoothing out volatility in the exchange rate.

“The government will also continue to pursue reforms aimed at enhancing growth prospects and alleviating poverty. In particular, structural reforms in the fiscal area focus on improving tax and

customs administration to mobilize domestic revenues to finance capital, and social expenditures. As part of the efforts to improve the business climate, the government will continue with the implementation of its anti-corruption action plan. Financial sector reforms should boost financial intermediation and reforms in the public utility sector will emphasize improving its services and financial viability,” Mr. Carstens said.

The PRGF is the IMF's concessional facility for low income countries. It is intended that PRGF-supported programs will in time be based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a PRSP. This is to ensure that each PRGF-supported program is consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent, and are repayable over 10 years with a 5½-year grace period on principal payments.

**Statement by Jeroen Kremers, Executive Director for Republic of Armenia  
and Lucian Croitoru, Senior Advisor to Executive Director  
November 14, 2005**

*General*

**The Armenian authorities appreciate the staff report, which accurately assesses economic developments in 2005 and the program implementation so far.** The authorities acknowledge that the report provides a realistic view of the policy challenges ahead, and broadly agree with staff recommendations. They also think that the program conditionality is appropriate and are pleased that the program is on track, with all performance criteria for end-June 2005 met.

**Macroeconomic developments are sound and progress has been made in implementing structural reforms.** Supported by prudent macroeconomic policies, strong external inflows, and ongoing structural reforms, GDP growth accelerated to 11.7 percent in the first three quarters of 2005. Staff now expect real GDP growth at 11 percent in 2005, which would be the fifth year in a row of 10 percent or higher real economic growth. This has allowed roughly a halving of the overall poverty rate, and virtually an end to extreme poverty as measured by the World Bank. The growth momentum is expected to continue next year at a rate of 7½ percent, resulting in a real GDP level no less than 85 percent higher than in 2000.

The 12-month CPI inflation declined from 4.9 percent in January to –0.4 percent in September, reflecting a significant drop in food prices and a strengthening of dram, and is expected to be 1.5 percent at the end of the year and not higher than 3 percent next year. While remaining consistent with its inflation target, the Central Bank of Armenia (CBA) accommodated, in an environment of temporary deflation, an increase in demand for domestic currency, including by partial sterilization of foreign exchange interventions in the face of dram appreciation. To facilitate end-year liquidity management, the CBA started issuing its own bills in June. The favorable wage-cost advantage prevented the dram appreciation (8.6 percent through September) from having a significant impact on external competitiveness, the current account narrowing from 4.6 percent of GDP in 2004 to 3.9 percent of GDP in 2005.

The fiscal performance was stronger than expected in the first nine months of 2005, with an annualized fiscal deficit equivalent of 1.5 percent of GDP, as compared to 2.9 percent of GDP under the program. This reflects both stronger revenue performance (nominal tax revenue through September 2005 increased by 19 percent as compared to the same period last year), and lower-than-programmed expenditure, due to disbursement delays and capacity constraints in procurement.

The structural reform agenda was further advanced. A two-year tax action plan was adopted in May 2005, and amendments to tax legislation aimed at reducing exemptions and loopholes were recently submitted to parliament. A public investment plan (PIP) is now part of the authorities' 2006-08 Medium Term Expenditure Framework (MTEF), and new steps

have been made on the road to reforming custom administration. In line with the FSAP recommendations, an amendment to the Law on Banks and Banking was submitted to parliament to strengthen supervision, governance and risk management in the banking sector, and the authorities are finalizing a new prudential framework for the insurance sector. The energy sector is no longer receiving subsidies from the budget, and losses in the water and irrigation sectors have also declined.

**Looking forward, the authorities remain committed to implementation of the Fund-supported program.** They agree with staff that the main policy challenge is to increase social and capital spending to meet the country's needs, while containing the effects of pressures on the real exchange rate associated with foreign exchange inflows. They also agree with staff that the centerpiece of the structural reform program remains broadening the tax base and strengthening the tax and custom administrations. The authorities also decided to move forward with other structural reforms needed to secure further strong economic growth and improve the business climate.

#### *Fiscal policy*

**In view of their objective to meet the large social and infrastructure needs, and given the availability of low-cost financing and subdued inflation, the authorities decided to slightly loosen the fiscal stance in 2006 relative to the projected 2005 outturn.** The new budget envisages an improvement in revenue performance and a better targeting of expenditure. The authorities acknowledge that the targeted increase in tax revenue of 0.6 percent of GDP is ambitious, but the space for improving tax collection is there. To avoid the problems encountered last year in executing expenditure, the authorities adopted new procurement procedures in addition to including PIP in the 2006-08 MTEF.

**The authorities also acknowledge that, given the foreign exchange inflows, a more expansionary fiscal policy would add to the existing real exchange rate pressures and place additional burden on monetary policy.** They are therefore committed to not exceed the deficit target for 2006. To this end, the authorities will work intensively to meet the revenue target, including by further strengthening fiscal institutions, and stand ready to adjust expenditure in compensation for any revenue shortfalls. The authorities also feel that their effort to enlarge the tax base and improve tax administration will also increase the buoyancy of the tax revenues.

#### *Monetary policy*

**The CBA will continue to focus on maintaining price stability.** The upward revision of the reserve money target in the second half of 2005 was justified by the combination of subdued inflation with increased reserve requirements and continued re-monetization. To achieve the new 39 percent base money growth target, the CBA will increase issuance of its own securities as needed and be prepared to tighten the policy stance if inflationary pressures emerge.

**Given the envisaged slightly looser fiscal stance, a slower increase in money demand, and also potential agricultural and oil price pressures, the CBA intends to tighten its policy stance in 2006 by limiting the increase in its net foreign assets.**

Consistent with an inflation target of 3 percent, the monetary program seeks to limit reserve money growth to 17 percent. The planned increase in the stock of treasury bills by the government will give the central bank the opportunity to further strengthen its capacity to conduct domestic money market operations by augmenting its holdings of government securities. The authorities are considering the capitalization of the central bank and are in the process of discussing the appropriate modalities. Given complications that result from unstable money demand and external shocks for the implementation of monetary policy through targeting monetary aggregates, the authorities intend to adopt an inflation targeting monetary policy over the medium term. For its successful implementation, the CBA is further enhancing its understanding of the monetary transmission mechanism and will start developing forecasting models for relevant inflation indicators.

### *Structural reforms*

**On the fiscal front, reforms will be aimed at improving the tax system and strengthening the tax and fiscal administration.** Simplified tax will be integrated into the regular social security tax payment system, and a presumptive tax will be introduced on property developers. An operational review of the State Customs Committee with foreign specialized assistance is planned to be completed in March 2006. A series of reforms are also aimed at improving budget implementation, expenditure management (by strengthening public procurement and tendering procedures), and monitoring of noncommercial organizations.

**In the financial sector, the authorities' reform efforts will continue to focus on further strengthening the market infrastructure and the regulatory and legal framework.** To this end, the authorities' priority is to pass legislation amending the Law on Banks and Banking. The amendment takes into considerations many of the FSAP recommendations, including enhancing the effectiveness of external audit and strengthening consolidated supervision. It also improves the weak corporate governance in the banking sector, which is viewed by the authorities as a key factor limiting financial intermediation. The authorities will also press ahead to strengthen the legal framework for creditor rights. To better monitor and control market risk and ensure a level playing field, a unified financial supervision system will become effective in January 2006 by merging supervisors for insurance, banking, and the security market under the CBA. By end-March, the CBA, in consultation with the Fund staff, will finalize an action plan to specify mechanisms for internal coordination and put in place regulatory practices for on-site and off-site supervision. In the non-bank financing sector, the authorities plan to implement a regulatory and supervisory framework in the insurance sector, to develop the primary market and simplified procedures in the area of mortgage finance, and evaluate various fiscally sustainable options for pension reform.

**Reforms are being made to improve services and financial viability in the public utilities sector.** In the energy sector, the liquidation of Armenergo will be completed in a transparent manner by the end of 2005, and the authorities are committed to ensuring the independence and the technical strength of the regulator. Reforms in the water and irrigation sectors continues by reducing subsidies by 0.5 billion drams each year, introduction of a leasing contract in the Yerevan Water and Sewage Company (with the aim of eliminating



budgetary support), raising tariffs in the irrigation sector, and strengthening the capacity of the water users associations. Regarding governance, the authorities will continue their agenda for the anti-corruption action plan, focusing on such areas as education, health care and traffic police, and also on enhancing law enforcement.