

Republic of Armenia: Ex Post Assessment of Long-Term Program Engagement

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REPUBLIC OF ARMENIA

Ex Post Assessment of Long-Term Program Engagement

Prepared by a staff team from the Middle East and Central Asia, Fiscal Affairs,
and Policy Development and Review Departments¹

Authorized for distribution by the Middle East and Central Asia
and Policy Development and Review Departments

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EXECUTIVE SUMMARY

Beginning in 1994, the Fund has provided almost continuous financial assistance to Armenia in support of its economic reform efforts. Given Armenia's long-term program engagement with the Fund, preparation of an ex post assessment is required.

Armenia's overall macroeconomic performance—particularly its strong growth and low inflation—compares favorably with similar countries in the region. Especially in recent years, growth has been broad based. Foreign financing has been provided by grants, concessional lending, and private investment—both transfers from Armenians living abroad and foreign direct investment.

The quality of program implementation was uneven at the early stages of Fund engagement, but it has improved in recent years. Implementation of some key structural reforms—pertaining mainly to banking, tax and customs administration, and the energy sectors—suffered delays, reflecting in part capacity constraints and at times insufficient ownership, particularly during the period of political instability (1999–01).

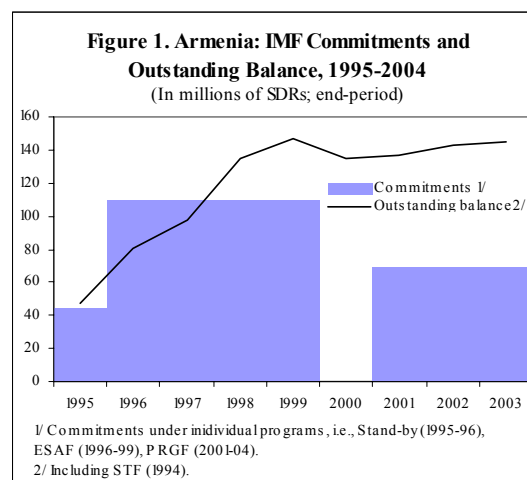
Capacity constraints were accompanied by insufficient political will to tackle the above-mentioned reforms more forcefully. In a few instances, this may have contributed to erratic implementation progress as evidenced by the need for waivers and prior actions. An assessment of the authorities' ownership, priorities, and capacity should be a key ingredient in the formulation of any future assistance program.

Continued Fund engagement would be beneficial, though a successor arrangement should involve reduced access. Despite achieving macroeconomic stability and making substantial progress in the reform agenda, key reforms in areas of Fund competence remain to be implemented. A Fund-supported program could play a valuable role in facilitating internal consensus on appropriate policies, capacity building, and providing confidence to donors and investors, while helping to preserve macroeconomic stability, and foster growth and poverty reduction. Such engagement should be accompanied by the authorities' intensified commitment to the remaining reforms in the areas of taxation, banking, and governance.

Collaboration between the Fund and the World Bank has been good. The Bank played a valuable role in facilitating the streamlining of conditionality under the PRGF arrangement. Efforts to intensify ownership and sharpen program design would be enhanced by continued collaboration between the two institutions.

I. INTRODUCTION

1. **Armenia's engagement with the Fund began with support under the Systemic Transformation Facility in late 1994.** It was followed by a Stand-By Arrangement (1995–96), an Enhanced Structural Adjustment Facility arrangement (1996–99), and a Poverty Reduction and Growth Facility arrangement (2001–04) (Figure 1). This report reviews Armenia's performance under the two most recent Fund-supported programs, covering 1996–04. It provides an assessment of the lessons emerging from this experience and a direction for future Fund engagement.



2. **Armenia faced the same daunting economic challenges in 1991 as other post-Soviet countries.** Its macroeconomic performance, however, has been stronger than most countries in the region.² Armenia's average real GDP growth has been among the highest for the CIS-7 and inflation among the lowest (Tables 1 and 2). This performance is especially impressive given the numerous political and economic shocks that have beset the economy.

- Despite its strong macroeconomic performance, Armenia's implementation of the Fund-supported programs has been uneven, especially with regard to delays in the implementation of some key structural reforms.
- This implementation record was due to a combination of capacity constraints and uneven ownership. The major lapse in ownership occurred during a period of political instability in 1999–2001. Since then, there has been a marked improvement in program performance.
- Nonetheless, some questions about the depth of ownership are raised in this report and the authorities will need to demonstrate an intensified commitment to tackle remaining economic reforms before further financial support can be made available from the Fund.

² For such comparisons, Armenia is often grouped with Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan, which are collectively known as the CIS-7.

II. OVERVIEW OF PROGRAM OBJECTIVES AND PERFORMANCE

A. Program Objectives and Streamlining

3. **The Enhanced Structural Adjustment Facility (ESAF) focused on reducing external and fiscal vulnerabilities.** Particular emphasis was given to decreasing external debt ratios and budget arrears. Structural measures focused on improving tax administration; reducing quasi-fiscal deficits in the energy sector; strengthening regulation of banks and improving governance. The primary macroeconomic objectives of the Poverty Reduction and Growth Facility (PRGF) arrangement have been to enhance revenue performance to eliminate expenditure arrears and reduce reliance on external financing. Structural reforms concentrated on improving tax administration; eliminating quasi-fiscal deficits (mainly in the energy and water sectors); strengthening regulation of banks and enhancing governance. Hence, the two programs were broadly consistent with respect to their objectives.

4. **Conditionality under the PRGF arrangement was more focused than in the ESAF.** Through streamlining and greater cooperation with the World Bank, measures addressing privatization, civil service reform, and the social safety net were dropped from the PRGF arrangement. The overall number of conditions, however, was not reduced (Tables 3, 4, and 5). For example, the number of quantitative performance criteria averaged 10 in each of the staff reports under both the ESAF and PRGF arrangements. The number of structural measures (performance criteria and benchmarks) was broadly the same under the two programs.

B. Macroeconomic Performance

5. **A strong macroeconomic performance characterized the ESAF period, but it was not without slippages.** End-period inflation declined from 32 percent in 1995 to 2 percent in 1999 and real GDP growth averaged nearly 5 percent during the program period. Nonetheless, serious financial imbalances persisted during most of the program period. The external current account deficit declined, but remained high (17 percent of GDP) as of 1999. The fiscal deficit on a commitment basis showed little improvement, but the deficit on a cash basis decreased because of the accumulation of wage and pension arrears. Despite a weakening of program implementation late in the ESAF period, the final review was completed (September 1999). Although three performance criteria were missed and some benchmarks were implemented “only partially or with considerable delay,” the staff appraisal noted that macroeconomic performance remained broadly positive. The political instability in 1999 hindered the government’s ability to implement its reform program. Consequently, macroeconomic performance deteriorated over the next several months with inflation accelerating in early 2000 and budget arrears accumulating. (Budget arrears were equivalent to 4.5 percent on GDP as of end-June 2000.) It would be 18 months after the completion of the last review under the ESAF before a new Fund-supported program was approved.

6. **Although initial performance under the PRGF arrangement was weak reflecting** lingering political difficulties, performance improved since 2002. Completion of the first review was delayed and eventually combined with completion of the second review in September 2002, 16 months after the program was approved.³ For 2001–03, real GDP increased at an average annual rate of 12 percent compared with program projections of 9 percent. Growth has been broad based and financed by grants, concessional lending, and private investment (both transfers from Armenians living abroad and foreign direct investment). Inflation averaged 4.5 percent in the same period reflecting a prudent monetary stance. On the structural side, there has been only one prior action for each of the third, fourth and fifth reviews. Compliance with quantitative and structural performance criteria was also better in this period (Table 3).

C. Fiscal Policy

7. **Overall, there has been significant fiscal consolidation under the Fund-supported programs.**⁴ The fiscal deficit, on a commitment basis, decreased from about 9 percent of GDP in 1996 to 1 percent in 2003. Such a decrease was compatible with program targets and, after 1999, helped to reduce external debt ratios. In the ESAF period, consolidation was limited because of higher expenditures resulting from the Russian crisis and the political instability that occurred late in the program period. Most of the consolidation that was achieved through expenditure compression as progress with revenue mobilization was limited. Total expenditures were reduced by 4.8 percent of GDP from 1996 to 2003, while tax revenues increased by 3.5 percent of GDP in the same period. Most of the improvement in revenues (3 percent) resulted from a change in the principle of taxation of the VAT from origin to destination for CIS countries in 1997-98. During the PRGF period, tax revenues have declined slightly as a share of GDP due to decreases in collections of taxes on profits and income.

8. **The limited success in increasing tax revenues mainly reflects weaknesses in tax and customs administration.** During the ESAF period, a combination of accumulating tax arrears, extensive netting out operations (tax arrears with expenditure arrears) and one-off schemes to reduce tax arrears exacerbated collection problems. Performance was better under the PRGF, but problems remained, especially in dealing with accumulated tax arrears. Taxes on profits and income as a share of GDP declined during 2001–03 because of a reduction in rates, the use of tax incentives, relatively high rate of growth in sectors with significant tax-exempt grant-financed activities and weaknesses in tax administration.

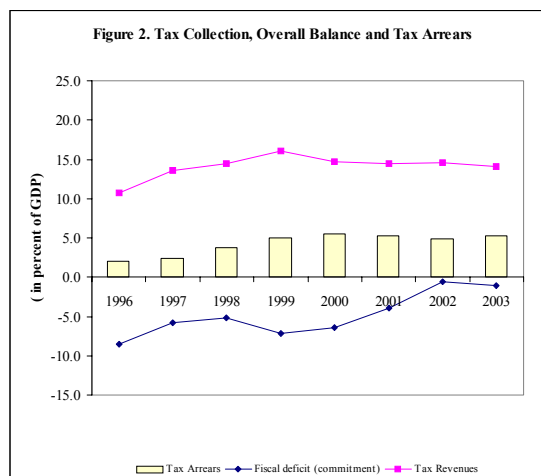
³ In order to complete the first two reviews, the authorities requested 10 waivers, nine for missed quantitative performance criteria, and one for an unmet structural performance criterion. The missed performance criteria were mainly the result of under-performance on revenue collection and delays with energy sector reform.

⁴ Despite fiscal adjustment social spending, which averaged 5 percent of GDP in both programs, was largely safeguarded. Nonetheless, more effective revenue mobilization could have allowed for higher levels of social spending and basic infrastructure outlays.

9. Modest progress with improving tax and customs administration reflects structural problems (Figure 2).⁵

The slow pace of institutional strengthening (mainly weak collection enforcement powers, inadequate audit processes, lack of self-assessment and governance problems) lies at the heart of Armenia's limited progress in tax collections.

Conditionality in this area was broadly in line with technical assistance and facilitated increased transparency, the development of codes of conduct, and a number of legislative changes. However, capacity improvements in both tax and customs agencies—which were separated from the Ministry of Finance against staff's advice—fell short of expectations. While these problems were identified in staff reports, it is now clear that their resolution depends primarily on political will.



10. Public expenditure management has improved in recent years. Numerous measures were included in the ESAF to strengthen the treasury, but expenditure management remained weak and gave rise to repeated budget sequestrations and expenditure arrears. Safeguarding social expenditures, including the safety net, was a concern in some reviews as expenditure arrears delayed payment of family benefits and social security benefits as well as wages. More recently, however, treasury operations have improved significantly with the introduction of a commitment control system and improved cash management procedures. The budget process was also enhanced in the context of a medium-term expenditure framework that was derived from the PRSP. Improved treasury operations contributed to the near elimination of domestic expenditure arrears in 2003.⁶ More recently, however, efforts to decentralize government operations without appropriate reporting requirements in place have raised the specter of governance problems because of reduced transparency and accountability.⁷

⁵ Tax revenue data for 1999 are distorted by large netting out operations making the apparent increase artificial.

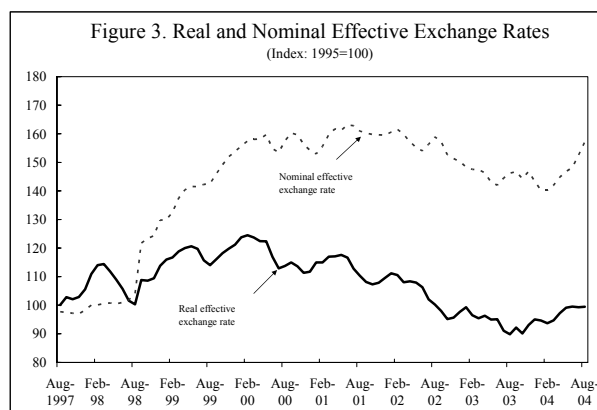
⁶ Some payments arrears remain pending verification of claims on the government.

⁷ About 5,000 out of 6,500 budgetary institutions have been converted into non-commercial organizations and removed from treasury coverage. While the decentralization reform has the potential of improving the efficiency of service provision, the reform needs to be monitored closely; at the same time, as envisaged under the current PRGF, reporting, commitment control, and compliance checking mechanisms should be fully implemented to prevent potential problems in terms of accountability and transparency.

D. Monetary and Exchange Rate Policy

11. **Declining inflation reflects a steady improvement in monetary policy and limits on bank financing of the fiscal deficit.** Implementation of the monetary program during the ESAF arrangement was mixed, but improved significantly under the PRGF arrangement. The uneven performance under the ESAF is attributable largely to the effects of the Russian crisis and a period of political uncertainty. Several performance criteria and benchmarks were missed and indicative targets for broad money growth were frequently exceeded in 1998–99. Under the PRGF, the Central Bank of Armenia (CBA) enhanced its implementation of monetary policy by limiting central bank financing of the government; the adoption of better (indirect) instruments; improvements in the treasury bill market and the use of open market operations to enhance liquidity management. Accordingly, the CBA structured its monetary operations with a view to meeting the indicative reserve and broad money targets, thereby allowing it to limit its intervention in the foreign exchange market and still adhering to the program’s monetary objectives.⁸ Aside from sporadically erratic monetary management during 1998-1999, the programmed levels of reserve money have been consistent with the respective outcomes and the goal of eradicating high inflation. Since the third review, all monetary performance criteria were met, including that on net domestic assets of the central bank, net credit to government, and net international reserves.

12. **Armenia has formally maintained a flexible exchange rate system, although the data suggest some exchange rate management.** Competitiveness has remained high as evidenced by strong export growth in recent years and a real depreciation of the dram. The foreign exchange regime was liberalized early on in the ESAF period and has contributed to promoting trade and investment. In addition to prudent monetary policy, the large import content of the consumer price index also



helped to hold down the rate of inflation when import prices fell in the late 1990s. Meanwhile, a real appreciation of the Russian ruble in 2002 vis à vis major currencies contributed to the observed 19 percent real effective depreciation of the dram. During the first half of 2004, however, the dram has appreciated slightly in both nominal and real effective terms.

⁸ Despite these improvements, domestic money markets remain thin and foreign exchange operations are still the most effective tool for liquidity management.

E. External Position

13. There has been substantial improvement in the balance of payments.

Notwithstanding the adverse effects of the Russian crisis, the current account deficit in percent of GDP has continued to decline, narrowing from 35½ percent of GDP in 1994 to about 7 percent of GDP in 2003. This improvement is due to an increase in domestic savings (resulting from fiscal consolidation) and a strong export performance, including agriculture, metals, and diamonds. Foreign direct investment played a significant role in supporting this strong export performance, as did transfers from Armenians living abroad. As a result, the official external reserve position strengthened substantially, with gross reserves at US\$502 million (4 months of imports) at end-2003.

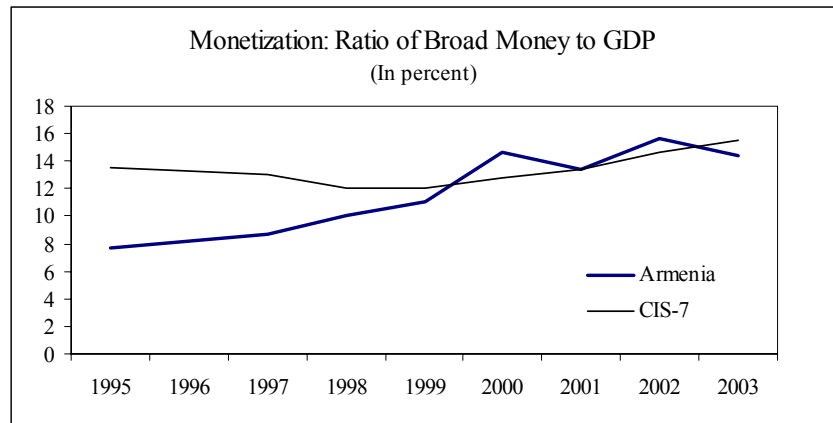
14. Debt management has been generally satisfactory Between 1995 and 1999, grants were not readily available and Armenia had to finance most of its reconstruction needs with concessional debt. During this period, both the World Bank and the Fund provided substantial resources to the country, thus contributing to rising debt ratios. The situation was quickly reversed after 1999 because of a successful growth performance and more reliance on grant financing. Some problems arose during the ESAF in the context of external borrowing to support the energy sector, but they were resolved within the framework of the program. The latest debt sustainability analysis indicates that Armenia's medium-term external debt dynamics are sustainable. Armenia has an excellent track record of servicing its financial obligations to the Fund though it should be noted that its share of Fund credit in total external debt is the highest among PRGF countries. Overall, debt management issues appear to have been well handled under Fund-supported programs.

F. Structural Reform

15. Despite extensive Fund involvement, there has been only modest improvement in financial intermediation. The extent of monetization (ratio of broad money to GDP) increased between 1995 and 2000, but has been unchanged subsequently and remains below the average for CIS-7 countries (Figure 4). Another measure of monetization (ratio of banks' private sector loans to

GDP) has been broadly constant since 1995 and is well below the average for comparable countries (Figure 5). A major factor behind this trend has been the failure of eight banks during 2000–02. Echoing this latter trend, banks in Armenia have actually decreased their exposure to the private sector as a share of total assets and

Figure 4



economic growth was primarily financed from other sources, mainly retained earnings, foreign direct investment, and transfers from abroad.

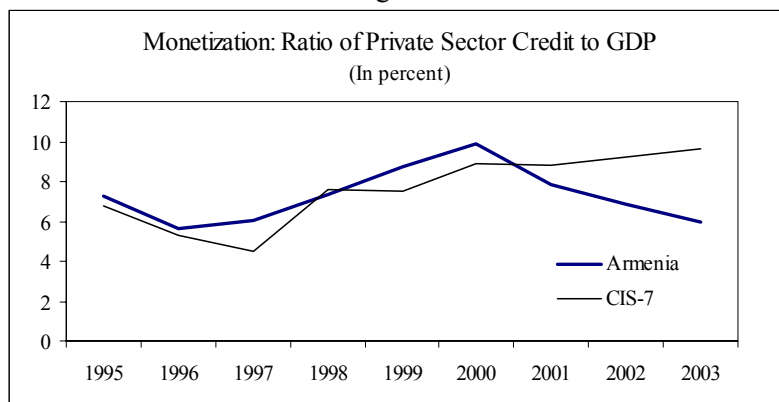
16. The problems confronting banks were well recognized in Fund-supported programs.

Conditionality in the SBA included revising prudential requirements, enforcing reserve requirements, and strengthening the accounting regulations for banks. The ESAF also sought to strengthen the banking sector with at least 10 structural benchmarks aimed at improving the supervision, legal framework, and operation of commercial banks. While the benchmarks appear to have been implemented, their effectiveness is unclear. The report of the Financial Sector Assessment Program (FSAP) mission in 2000 noted that because of its small size, a systemic crisis in the banking sector would not pose a threat to the economy. The weakness of the sector, however, would likely exacerbate the impact of shocks. The report also observed that the vulnerability and weakness of the system precluded it from delivering growth-generating financial services.

17. The PRGF arrangement introduced several structural measures pertaining to banks. The overlap between the FSAP recommendations and PRGF conditionality included, inter alia, enacting a new bankruptcy law and enhancing the central bank's supervisory authority. One consequence of the changes to the legal framework governing banks recommended by the Fund staff was to allow the CBA greater latitude to intervene in problem banks. Beginning in late 2000 and during most of 2001 the CBA placed the eight troubled banks (accounting for a third of total deposits) under interim administration because of problems caused by insider abuse. The problem of the "intervened banks" became a key concern for the PRGF program and most of the structural benchmarks covering money and banking for subsequent reviews were focused on the resolution of these banks to restore confidence in the system. Additional measures supported legislative changes regarding the registration of collateral and shareholder rights. Remaining problems relate to the functioning of the judicial system (to enforce creditor rights), poor accounting by firms, and weak corporate governance in banks. These factors, coupled with the banking failures and the relatively late introduction of reforms to strengthen creditor rights explain the sluggish remonetization and financial intermediation.

18. Progress with restructuring the energy sectors to reduce quasi-fiscal activities was initially slow. During the ESAF, measures setting the stage for privatization of the energy sector were implemented. In particular, the 1997 energy law separated the electricity company (Armenergo) into generation, transmission, and distribution companies, and established the Energy Regulatory Commission (ERC). The creation of the ERC was

Figure 5



intended to separate policy making from the influence of government ownership and strengthen the financial condition of the enterprises in the energy sector. Despite these improvements, the financial condition of the energy sector during the ESAF was largely unchanged. In large part, this reflects the difficulty of imposing a hard budget constraint on enterprises in energy sector. This contributed to a breach, in 1997, of a continuous performance criterion prohibiting non-concessional borrowing in order to provide financing for enterprises in the energy sector. Data for 1997 are not available, but staff estimated the quasi-fiscal deficit of the energy sector to be 4 percent in 1998.

19. **The financial situation of the energy sector has improved substantially under the PRGF arrangement.** The electricity distribution companies were privatized and the primary fiscal deficit of the energy sector was largely eliminated. There has been less progress, however, in the water and irrigation sectors. Overall and primary deficits in these sectors have decreased as a share of GDP because of higher tariffs, but water losses remain high.

20. **Governance has also improved in recent years, but much more remains to be done.** According to several measures (e.g., compiled by the World Bank and Transparency International) Armenia's standing has improved in recent years. Contributing factors include the simplification of licensing procedures, civil service reform, adoption of a new criminal code, privatization in the energy sector, and more widespread dissemination of laws and regulations. Fund-supported programs have addressed governance issues by promoting legislative changes in core areas of Fund competencies, including elimination of distortionary taxes, greater transparency in the budget and introducing Basel standards for bank supervision. Much more remains to be done, however, particularly in the areas of tax and customs administration and the judiciary. The government has approved an anti-corruption strategy at end-2003; the challenge now is to press ahead with its implementation in a fully participatory process.

III. COLLABORATION WITH THE WORLD BANK

21. **Collaboration between the Bank and the Fund has been close.** There was some overlap of conditionality under the ESAF arrangement as both the Fund and the Bank program contained measures regarding privatization, civil service reform and social protection (Box 1). Coordination and division of responsibilities has been better under the PRGF arrangement, with the Bank taking the lead in key structural reforms areas including strengthening expenditure policy, fostering private sector development, reforming the public sector, and protecting the environment. In those areas with direct implications for macroeconomic stabilization, the Fund reinforced Bank conditionality. When structural reforms have lagged in areas with significant macroeconomic impact (e.g., reform of the government wage bill), the Fund often introduced its own structural conditionality. Cooperation has been particularly effective—as with the PRGF—when started early in the program design cycle and responsibilities are clearly defined. Nonetheless, there is scope for improving collaboration. For example, close coordination with Bank staff will be necessary to reconcile efforts to decentralize public sector management with the need for transparency and financial accountability in the decentralized agencies.

Box 1. Bank-Fund Collaboration		
Area	Fund Involvement and Instruments	Bank Involvement and Instruments
Macroeconomic framework	Fiscal policy, monetary and exchange rate policies, trade policy; selected tax, customs, and banking sector reforms, and economic statistics. Instruments: quantitative and structural performance criteria and benchmarks.	Economic growth, PRSP-related expenditure allocations, financial sector reforms, and economic statistics. Instruments: Macroeconomic monitoring, CEM Growth studies, Trade and Transport Facilitation Project, financial sector TA, SAC5, PRSC.
Budget	Formulation and execution, tax policy and administration, customs, debt management, extra budgetary funds. Instruments: performance criteria on overall fiscal balance, limits on borrowing from the banking system, and bench marks on revenue collection and recurrent expenditure.	Public expenditure review, development budget formulation, especially in the social and infrastructure allocation areas, country procurement and financial accountability assessments. Instruments: public expenditure review updates, PRSP support updates, strengthening treasury capacity IDF, SAC5 and PRSC.
Public sector reform	Public sector management, quasi-fiscal deficits, selected civil service and energy sector reforms, and tax and customs components of anti-corruption strategy. Instruments: ESAF/PRGF structural performance criteria and benchmarks in fiscal and energy sector areas.	Civil service reform, anti-corruption agenda, decentralization, and energy sector reform. Instruments: Anti-corruption IDF, Building capacity for public procurement IDF, Public sector modernization project, Judicial reform project,
Poverty and social sectors	...	Poverty analysis; education, health, social protection reforms; and community-driven development support. Instruments: Poverty studies and assessments, labor market study, and IDA credits for education, health and social investment funds, social protection SAC5 and PRSC.
Private sector and infrastructure development	...	Cost of doing business surveys, legislation and regulatory framework for private sector, privatization and market liberalization. Instruments: Rural infrastructure study, Financial sector note, Business surveys, and support through existing and proposed IDA credits for water supply, municipal development, roads, transport, energy and private sector.

22. **The Bank’s recent involvement in Armenia is regarded as satisfactory.** Two recent World Bank reports—the Country Assistance Strategy (June 2004) and the Country Assistance Evaluation (CAE)—assess both Bank and country performance for 2001–03. These reports identified an improved business environment, reduced quasi-fiscal deficits in

the energy sector and improved governance (via civil service reform) as the areas where Bank involvement yielded the greatest results.⁹

IV. ASSESSMENT AND LESSONS

A. Fund Engagement and Program Effectiveness

23. **Quantitative projections under both the ESAF and the PRGF arrangements were generally accurate.** Projections for most key indicators (e.g., inflation, overall fiscal balance, and reserve money) were broadly correct. Projections for real GDP growth under the PRGF arrangement often proved conservative, but this may be understandable given the unprecedented growth experienced in recent years.¹⁰ As a result, expected improvements in revenue collection (as a share of GDP) were often too optimistic. Nonetheless, the persistent weaknesses in tax and customs administration have prevented higher revenue collection, which highlights the absence of sufficient political will to deal with this problem.

24. **Program design and choice of conditionality were appropriate and focused on program priorities.** In accordance with the programs' objectives, the majority of structural measures (both performance criteria and benchmarks) concentrated on fiscal and banking issues. Even though both the ESAF and the PRGF arrangements relied heavily on structural measures to aid program implementation, the Fund seems to have accommodated the authorities' capacity constraints and policy concerns. The ESAF program was quite flexible in accommodating the impact of the 1998 Russian financial crises. Reflecting efforts to streamline conditionality, the latter arrangement was more narrowly focused than the earlier one. The number of structural conditions, however, has not diminished. Since mid-2002, there was an average of eight structural measures for each review. Additionally, many of the structural conditions appear to be very detailed. Reliance on such detail may be a response to weak implementation performance and/or it may reflect an increased understanding of structural constraints.

25. **Both the ESAF and PRGF arrangements have made liberal use of prior actions,** although this has diminished under recent reviews. Frequent reliance on prior actions may have indicated uneven ownership of the program. Beginning in mid-2002, however, performance improved significantly suggesting improved ownership.

26. **The Fund's engagement in Armenia was part of a broader initiative to stabilize the CIS countries in the immediate post-Soviet era.** The combination of Armenia's impressive macroeconomic performance—mainly with respect to growth and inflation—

⁹ The CAE, which is prepared by the Bank's Operations Evaluation Department (March 2004) concluded that most of the Bank's projects (86 percent) had a satisfactory outcome. It noted, however, that an earlier and more intense focus on improving the business climate and public sector management would have been desirable.

¹⁰ It should be pointed out that the fiscal deficit outturns were consistently lower than programmed under the PRGF arrangement, thereby counteracting tendencies toward overheating.

extensive outstanding reform agenda and widespread poverty have fostered a presumption of continued Fund engagement and financial assistance. While there may be a case for ongoing engagement and assistance, the mixed pattern of implementation in selected areas during some periods of the program is a cause for concern. Most of the implementation problems occurred during a period of political uncertainty, but delays with some structural reforms in recent years suggest that there is scope for further strengthening of ownership. In some instances, weak program performance was compensated for by introducing more structural reform measures, when in reality the poor implementation was largely due to a lack of ownership.

27. **Most of the program's broad macroeconomic objectives were met.** The restoration of growth and reduction of inflation were achieved quickly and the results compare favorably with those for other CIS countries. Reduction of the current account deficit progressed more slowly, but it was correctly not viewed as a cause for concern because it was financed largely by concessional borrowing, FDI, and private transfers. Although some non-concessional borrowing occurred in connection with slow structural reform in the energy sector, this was quickly addressed and debt sustainability does not appear to be a problem. Overall, fiscal performance has been satisfactory, but efforts to improve tax administration have yielded only modest results. Fund-supplied technical assistance complemented program priorities (Box 2) though capacity remains weak as it is concentrated in a few agencies and individuals within those agencies.

Box 2. The Fund's Technical Assistance

The Fund's technical assistance (TA) concentrated on the fiscal, monetary, and banking areas. In the fiscal area, it focused on tax policy, revenue administration, and public expenditure management. Technical assistance from MFD centered on monetary and foreign exchange operations, and banking supervision. Additional TA sought to support structural reforms in the banking sector embodied in the two ESAF/PRGF arrangements. FAD's recommendations on the revenue side and public expenditure management were instrumental in keeping the revenue-to-GDP ratio stable, and in improving the operations of the Treasury. Similarly, the improvements observed in meeting the monetary and financial targets, the generally adequate supervisory and regulatory framework, and a better use of monetary policy instruments, suggests that the TA provided by MFD also had a positive impact.

28. **While there has been progress in expenditure management, improving revenue collection has proved difficult.** Efforts to strengthen the management of public expenditures progressed slowly in the early days of the PRGF, but have since accomplished much. Revenue performance, however, remains a problem area. Numerous structural measures pertaining to budget and tax issues were included in both the ESAF and the PRGF arrangements. As compliance with these measures was generally satisfactory, it suggests problems with program design and/or the authorities' commitment to effective implementation. The significant improvement in budget management in recent years may suggest that earlier weaknesses stemmed from insufficient commitment on the part of the authorities.

29. **Structural reform in the banking sector has been slow.** Compliance with structural measures pertaining to the banking sector was weak under the ESAF, but better under the PRGF arrangement. Nonetheless, given delayed implementation of some of the structural conditions pertaining to the banking sector; the banking failures during 2000–02; and the lack of well-established creditor and property rights; improvements in financial intermediation and confidence in banks are just beginning to materialize. The CBA’s intervention in the administration of eight weak banks was critical in that it was designed to remove from the system unsound institutions. However, the authorities unnecessarily prolonged the period of administration in some of these banks, thus preventing a faster recovery of the public’s confidence in the system.

30. **The pattern of reform in the energy (mainly electricity) sector suggests that although** ownership was a constraint early on, it has improved in recent years. During the ESAF arrangement, progress was slow, but then improved during the subsequent arrangement. Although compliance with energy sector conditionality was not good initially under the PRGF arrangement, more recently the quasi-fiscal activities (as measured by the primary deficit) have been reduced. This pattern may partly reflect the complexity of these reforms, but it also appears to reflect the authorities’ varying commitment over time to politically difficult measures.

31. **Armenia has consistently displayed strong growth and low levels of inflation.** As performance with respect to key quantitative measures has been generally satisfactory under the two arrangements, this suggests that Fund-supported programs contributed to macroeconomic stability. Although implementation of structural reforms has improved significantly in recent years, the sustainability of growth in the near term will depend critically on completing the structural reform agenda.

B. Lessons

32. **On balance, the Fund’s involvement in Armenia has been beneficial.** Nonetheless, the lessons that emerge from recent experience can contribute to refining and enhancing future Fund engagement in Armenia.

- The strong economic performance was driven by a combination of recovery from the break-up of the FSU, steadily improving macroeconomic policy and large capital inflows consisting mainly of concessional assistance, FDI, and private transfers. The role of the Fund was to support and guide the stabilization process. The implementation of most quantitative measures was broadly satisfactory.
- The structural reform process, however, proved to be more difficult than expected, partly because of capacity constraints but also because at times there was insufficient political support. This contributed to uneven implementation of reform policies and resulted in the need for waivers, prior actions, and various benchmarks. **Possible future Fund support should be targeted to areas that are macro-critical and accompanied by a demonstration of strong commitment to pending reforms.** At

the same time, a **realistic assessment of the authorities' ownership, priorities and capacity should be a key ingredient in the formulation of any future program.**

- The consequences of weak ownership are evident during the period of political uncertainty, 1999–2001. **The delays in preparing a successor arrangement and concluding the first two reviews indicate that the Fund disengaged appropriately when implementation and commitment were weak.**
- The modest progress in strengthening tax collections and improving confidence in the banking sector illustrate the need for enhancing ownership. Introducing a more stringent structural reform agenda will not substitute for commitment and capacity building on the part of the authorities. **The formulation of clear reform objectives in these areas and the articulation of an implementation path would enhance ownership and implementation performance.**

V. CONSIDERATIONS FOR FUTURE FUND INVOLVEMENT

33. **Continued Fund engagement and financial assistance would be beneficial in light of the importance of macroeconomic stability in fostering effective poverty reduction and the unfinished reform agenda.** This will require policies to maintain economic stability and address weaknesses in tax and customs administration as well as completing banking system reforms. Debt ratios should remain low and further official financing and grants should be the main vehicle for financing the balance of payments gap. Armenia's institutions and implementation capacity has improved, but it remains fragile and concentrated in a few small groups within the government. Overall, the Fund could play a pivotal role in helping the authorities to formulate a policy framework to address the remaining reforms and providing a catalytic role in securing financial and technical support from donors and other development partners. Over time, this will facilitate access to more diversified sources of financing, including on nonconcessional terms. In addition, with Fund involvement in its core areas, the authorities' ability to address a broader spectrum of critical problems will be strengthened. The authorities also see the signaling role of a Fund-supported program as critical to garnish support from donors as well as strengthen their stance against vested interests. Nonetheless, consideration should be given to reducing access—to 10 percent of quota—as financing gaps are likely to be lower in the medium term.

34. In addition to the emphasis on continued macroeconomic stability, there are three areas of concentration for a Fund-supported program.

- **Improving tax and customs administration is critical.** Emphasis should, however, be on enhancing the transparency, efficiency and equity of the tax system as a means of improving the business environment and ultimately, on raising higher revenues. Similarly, more remains to be done to improve customs administration to further remove discretion from customs officials, increase transparency, and effectively implement risk-based control systems. Given pressing social needs, broader medium-term tax reforms are essential to create an equitable and efficient tax system

and increase revenues. In the near term, however, it will be important to concentrate on improving the quality of tax and customs administration.

- **The impressive economic growth of the past decade occurred without the banking sector playing a significant role, as has been the case in most other transition countries.** External financing was essential, but is unlikely to be a substitute for domestic sources of financing in the medium and long-term. Hence, increasing public confidence in banks should continue to be a central objective of any future Fund engagement. While the Fund can take the lead in this area, the substantial and prolonged TA requirements will necessitate close collaboration with the World Bank and other donors.
- **Strong private sector growth has been the foundation for Armenia's post-Soviet recovery.** Recent improvements in governance combined with financing via foreign transfers have facilitated the rapid expansion of private sector activity. Nonetheless, as noted in recent World Bank reports, there is substantial scope for further improvement in governance. This should be an area of emphasis and close cooperation for the Fund and Bank.

35. **Intensified ownership in the remaining reform areas will be essential for future Fund support.** Different vehicles for demonstrating intensified ownership could be envisioned. One possibility is for the authorities to articulate an ambitious strategy for the remaining structural reforms in the tax and banking areas. Implementation of the key portions of this strategy early on could serve as an effective demonstration of ownership.

36. **The priorities for future Fund engagement in Armenia complement those of the World Bank.** The Bank's recent assessment of program performance and future priorities should allow continued strong collaboration with the Fund. Both institutions will need to be involved in the three priority areas envisioned. The Fund should, however, take the lead in tax and selected banking reforms and integrate strong TA support from the Bank.

37. **An exit from PRGF support is envisaged.** The country's income level will soon exceed IDA thresholds, and the financing gap is likely to shrink further. One step toward graduation would be a reduced level of access in a potential new PRGF. After that, and if Armenia is able to carry out the remaining macro-critical reforms during the next three years, a subsequent Fund arrangement may not be necessary.

38. **The major risk facing any future Fund-supported program is the loss of political commitment and ownership.** The consequences of such an event are evident from Armenia's performance during the latter period under the ESAF and early part of the PRGF arrangement. Thus, the Fund should remain ready to disengage if implementation of the reform agenda falters. A hiatus, but not disengagement, between the present arrangement and a future program of assistance may be needed to ensure that there is enough ownership to carry on with the remaining reforms.

Table 1. Economic Growth in CIS-7 Countries, 1995–2003

	Armenia	Azerbaijan	Georgia	Kyrgyz Republic	Moldova	Tajikistan	Uzbekistan
Average real GDP growth, 1995–99	5.3	2.5	5.9	3.5	-3.1	-1.2	1.7
Standard deviation	1.9	8.6	4.2	5.8	3.4	7.3	1.6
Average real GDP growth, 2001–03	12.1	10.6	6.3	4.0	6.7	9.8	2.9
Standard deviation	2.3	0.7	2.0	3.5	0.9	0.6	1.3

Table 2. Inflation in CIS-7 Countries, 1995–2003

	Armenia	Azerbaijan	Georgia	Kyrgyz Republic	Moldova	Tajikistan	Uzbekistan
Annual average, 1995–99	43.8	85.2	46.3	29.0	22.5	237.9	98.2
Standard deviation, 1995–99	74.6	182.9	66.5	12.7	13.0	263.4	117.1
Annual average, 2001–03	3.0	2.2	5.0	4.0	8.9	22.4	35.5
Standard deviation, 2001–03	1.9	0.6	0.5	2.6	3.3	14.2	18.0

Table 3. Armenia: Overview of Compliance Under IMF Arrangements

	Prior Actions			Quantitative Performance Criteria				Structural Performance Criteria				Structural Benchmarks			
	Met	Not Met	Total	Met	Not Met	Total	Met	Not Met	Total	Met	Not Met	Total	Met	Not Met	Total
SBA (1995–96)															
Mid-term review	...	...	0	8	0	8	...	...	...	...	...	...	8	1	9
ESAF (1996–99)															
First annual arrangement	15	0	15	...	...	...	...	...	...	...	...	...	...	...	...
Mid-term review	...	...	...	9	0	9	2	1	3	4	1	5	4	1	5
Second annual arrangement	5	0	5	10	0	10	...	...	...	7	0	7	7	0	7
Mid-term review	3	0	3	9	2	11	1	1	2	3	1	4	3	1	4
Third annual arrangement	7	0	7	9	1	10	...	...	...	1	...	1	1	...	1
Mid-term review	15	0	15	7	3	10	1	0	1	6	4	10	6	4	10
PRGF (2001–04)															
Approval	9	0	9	...	...	...	...	...	...	...	...	...	...	...	...
First review 3/	...	...	...	9	2	11	0	1	1	3	0	3	3	0	3
Second review 3/	7	0	7	5	6	11	1	0	1	3	0	3	3	0	3
Third review	1	0	1	9	1	10	3	0	3	7	0	7	7	0	7
Fourth review	1	0	1	9	1	10	2	0	2	6	1	7	6	1	7
Fifth review	1	0	1	9	0	9	2	0	2	3	2	5	3	2	5

1/ The status of the seven measures was not reported on in the reports. Thus it was assumed that they were met.

2/ Only one structural benchmark was reported on in the table, although the second annual arrangement staff report set up four structural benchmarks.

3/ The first and second reviews were completed at the same time.

Table 4. Armenia: Compliance with Performance Criteria and Structural Conditions Under ESAF, 1996–99

Measures	First Annual Arrangement		Second Annual Arrangement		Third Annual Arrangement	
	Approval	Mid-Term Review	Approval	Mid-Term Review	Approval	Mid-Term Review
Prior actions	15	...	5	3	7	15
Quantitative Performance Criteria						
Net banking system credit to the government	...	Met	Met	Met	Met	Met
NDA of the central bank	...	Met	Met	Met	Met	Met
Domestic core expenditure arrears (continuous)	...	Met	Met 1/	Waiver	Met	Waiver
Net disbursements of short-term debt	...	Met	Met	Met	Met	Met
Contracting and guaranteeing of new nonconcessional medium and long-term external debt longer than 1 year	...	Met	Met	Waiver	Met	Met
External arrears (continuous)	...	Met	Met	Met	Met	Met
NIR	...	Met	Met	Met	Met	Waiver
State budget tax revenue	Met	Met	Met	Waiver
State budget cash deficit 1/	Met	...	Met	Met
Dram broad money 1/	Met
Reserve money 1/	Met
Broad money (indicative)	...	Met	...	Not met	...	...

Table 4. Armenia: Compliance with Performance Criteria and Structural Conditions Under ESAF, 1996–99 (concluded)

Measures	First Annual Arrangement		Second Annual Arrangement		Third Annual Arrangement	
	Approval	Mid-Term Review	Approval	Mid-Term Review	Approval	Mid-Term Review
Structural Performance Criteria						
Budget	Waiver	...	...
Civil service reform	...	Met	...	...	...	...
Tax policy and administration	Met	...	Met
Banking	...	Two met/ one waiver	...	...	...	...
Structural Benchmarks						
Budget	...	One met with delay/one met	Three met	...	...	One not met/ two met
Tax policy and tax and customs administration	...	Met	...	Two met	...	Met
Civil service reform	Met
Banking	...	Not met	Three met	One met/ one not met	Met	Met with delay
Energy	...	Met with delay	Met	...	...	Two not met
Privatization and public enterprise reform	One met with delay/one not met

1/ Indicative target for the third annual arrangement.

Table 5. Armenia: Compliance with Performance Criteria and Structural Conditions Under PRGF, 2001–04

Measure	Approval	First Review 1/	Second Review 1/	Third Review	Fourth Review	Fifth Review
Prior Actions	9	...	7 1/	1	1	1
Quantitative Performance Criteria						
NDA of central bank	...	Met	Waiver	Met	Met	Met
Net banking system credit to the government	...	Met	Met	Met	Met	Met
Domestic arrears of the central government	...	Waiver	Waiver	Met	Waiver	...
Domestic arrears of the central government and the state fund for social insurance	Met
Stock of arrears of the state fund for social insurance	...	Met	Waiver	Met	Met	...
Central government tax revenues	...	Met	Waiver	Met	Met	Met
Central government cash balance	...	Met	Met	Met	Met	Met
Reserve money (band; indicative)	...	Met	Not met	Not met	Met	Met
Primary balance of the energy sector (indicative, beginning third review)	...	Waiver	Waiver	Met	Not met	Met
Contracting or guaranteeing of new nonconcessional external debt with maturity of more than one year	...	Met	Met	Waiver	Met	Met
Net disbursements of short-term external debt	...	Met	Met	Met	Met	Met
External arrears	...	Met	Waiver	Met	Met	Met
NIR	...	Met	Met	Met	Met	Met

Table 5. Armenia: Compliance with Performance Criteria and Structural Conditions Under PRGF, 2001–04 (concluded)

Measure	Approval	First Review 1/	Second Review 1/	Third Review	Fourth Review	Fifth Review
Structural Performance Criteria						
Budget system	Met	...
Customs	Met	Met	Met
Tax policy and administration	Met
Banking sector	Two met	...	...
Public official financial disclosure	...	Waiver	Met	...	...	...
Structural Benchmarks						
Budget system	Met	Met	...
Customs	Three met	Met with delay	Not met
Tax policy and administration	Met	One met with delay/ one met	Two not met
Audit	...	Met	Met	Met	...	...
Treasury	...	Met with delay	...	...	...	...
Energy sector	Not met 2/	Met
Banking sector	...	Met	One met with delay/one met	Met	Two met	Met

1/ The first and second reviews were completed at the same time.

2/ Converted into prior action.

Table 6. Armenia: Original Program Targets and Outcomes Under ESAF, 1996-99

	1996		1997		1998		1999	
	Program	Outcome	Program	Outcome	Program	Outcome	Program	Outcome
Real								
Real GDP growth	6.5	5.8	3.3	3.1	5.5	7.3	3.5	3.3
Inflation (end-period)	18.0	5.8	21.0	21.9	3.8	-1.3	8.0	2.0
Fiscal								
Fiscal balance (cash basis)	-9.3	-9.3	-6.7	-4.7	-5.6	-4.7	-6.1	-5.3
Tax revenues	11.4	10.5	12.4	13.4	15.3	13.6	16.6	16.1
Total expenditures	...	23.7	21.2	22.8	24.3	22.4	26.2	26.5
Tax arrears	...	2.0	...	2.4	...	3.8	...	5.1
				(Annual percent change)				
				(Percent of GDP)				
Monetary								
Net domestic assets	27.1	21.5	6.4	3.1	6.1	4.0	6.3	1.2
Net credit to government from banking system	22.9	23.3	15.5	16.0	20.6	20.0	22.0	15.4
Reserve money	33.5	41.3	46.6	50.6	52.9	53.8	51.9	53.9
Net international reserves (millions of US\$)	16.0	46.7	86	106	99.5	108.5	97.0	113.2
External								
Current account balance	-29.5	-18.2	-27.1	-18.7	-23.7	-21.3	-24.7	-16.7
Gross international reserves (millions of US\$)	133	168	219	243	291	298	309	305
<i>Memorandum items:</i>								
Nominal GDP (billions of drams)	...	660	...	804	...	959	...	988

(Billions of drams; unless otherwise indicated)

(Percent of GDP; unless otherwise indicated)

Table 7. Armenia: Original Program Targets and Outcomes Under PRGF, 2001–04

	2001		2002		2003		2004	
	Program	Outcome	Program	Outcome	Program	Outcome	Program	Outcome
Real								
Real GDP growth	6.5	9.6	7.5	13.2	12.0	13.9	7.0	...
Inflation (end-period)	3.5	3.0	3.0	2.0	4.0	8.6	3.0	...
		(Annual percent change)						
Fiscal		(Percent of GDP)						
Fiscal balance (cash basis)	-5.5	-4.0	-3.3	-2.6	-2.0	-1.5	-1.9	...
Tax revenues	15.1	14.3	15.0	14.6	14.3	14.0	14.6	...
Total expenditures	21.2	20.9	21.5	19.3	20.6	18.9	17.7	...
Tax arrears	...	5.2	...	4.9	...	5.3	...	...
		(Billions of drams; unless otherwise indicated)						
Monetary								
Net domestic assets 1/	-6.0	-4.5	1.8	-12.4	-26.3	-39.2	-24.2	...
Net credit to government from banking system	12.1	9.5	6.6	0.0	-1.2	-14.6	-12.8	...
Reserve money (indicative band)	72–75	80.4	87–90	111.3	118–123	118.6	121–126	...
Net international reserves (millions of US\$) 1/	145	155	165	231	264.9	282.5	281.3	...
External		(Percent of GDP; unless otherwise indicated)						
Current account balance	-14.1	-9.5	-8.7	-6.2	-7.7	-6.8	-5.9	...
Gross international reserves (millions of US\$)	336	329	364	430	470	502	492	...
<i>Memorandum items</i>								
Nominal GDP (billions of drams)	...	1,176	...	1,362	...	1,618	1,784	...

1/ At program exchange rates defined in the respective TMU.