

Republic of Armenia: 2008 Article IV Consultation and Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility—Staff Report; Staff Supplement; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Armenia.

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2008 Article IV consultation with the Republic of Armenia and request for a three-year arrangement under the poverty reduction and growth facility, the following documents have been released and are included in this package:

- The staff report for the combined 2008 Article IV Consultation and Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility, prepared by a staff team of the IMF, following discussions that ended on September 16, 2008, 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 October 31, 2008. 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 staff supplement on the joint IMF/World Bank debt sustainability analysis.
- A staff statement of November 17, 2008, updating information on recent developments.
- A public information notice (PIN) and Press Release, summarizing the views of the Executive Board as expressed during its November 17, 2008 discussion of the staff report that concluded the Article IV consultation and the request, respectively.
- 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*
Selected Issues
Poverty Reduction Strategy Paper
Joint Staff Advisory Note
*Also 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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Washington, D.C.**

INTERNATIONAL MONETARY FUND

REPUBLIC OF ARMENIA

**Staff Report for the 2008 Article IV Consultation
and Request for a Three-Year Arrangement under the
Poverty Reduction and Growth Facility**

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

Approved by Lorenzo L. Pérez and Adnan Mazarei

October 31, 2008

EXECUTIVE SUMMARY

Background: Under the 2005–08 PRGF-supported program, Armenia achieved a marked reduction in poverty within a high-growth and low-inflation macroeconomic environment. The new (low-access) PRGF-supported program builds on these achievements and addresses unfinished reform issues. Article IV discussions focused on the policy adjustments needed to maintain macroeconomic stability in the face of a more challenging economic environment. So far the policy mix has appropriately combined sound fiscal and monetary policies with exchange rate flexibility, but macroeconomic imbalances are growing.

Staff views: Rising inflation, high credit growth, and a widening current account deficit have raised concerns about overheating. But the downward risks from the global economic downturn could help unwind existing macroeconomic imbalances. Policy adjustments may be called for if economic conditions deteriorate more than anticipated. With no evidence of a significant exchange rate misalignment, productivity-enhancing structural reforms are needed to safeguard external sustainability and support medium-term growth prospects.

The authorities' views: The authorities shared staff's concerns about the risks associated with rising inflation, but were not convinced that these reflected overheating. They saw merit, however, in withdrawing fiscal stimulus during 2008–09, and recognized the importance of boosting productivity, improving the business environment, strengthening policy frameworks, and enhancing policy coordination. Given Armenia's size and marginal links with the global financial system, they saw limited downside risks for growth in the short term, but stressed that medium-term risks have increased with the potential for a global economic downturn.

New low-access PRGF arrangement: The program focuses on strengthening the fiscal and monetary policy frameworks and their coordination, while deepening productivity-enhancing structural reforms, and improving governance. Reforms in the areas of tax administration and tax policy, where progress has been insufficient, are key to the success of the program.

Contents

Page

I.	Introduction.....	4
II.	Background.....	5
III.	Policy Discussions	11
	A. Macroeconomic Outlook and Risks.....	11
	B. The Policy Mix.....	13
	C. Structural Reforms	18
	D. The New Program.....	19
IV.	Staff Appraisal	24

Boxes

1.	Armenia's Third PRGF-Supported Program: Objectives and Achievements	4
2.	Response to Fund Advice	5
3.	Evolving Fiscal Stance.....	9
4.	Effectiveness of Foreign Exchange Market Interventions.....	16
5.	Exchange Rate Assessment.....	17
6.	Structural Conditionality, 2008–09.....	22

Figures

1.	Recent Economic Developments	6
2.	Recent Fiscal Developments.....	8
3.	Recent Monetary Developments.....	10
4.	Business Environment	20

Tables

1.	Poverty Indicators and Millennium Development Goals, 1990–2015.....	26
2.	Selected Economic and Financial Indicators, 2003–09	27
3.	Central Government Operations, 2006–09	28
4.	Monetary Accounts, 2006–09.....	30
5.	Balance of Payments, 2006–12.....	31
6.	Medium-Term Macroeconomic Framework, 2007–12.....	32
7.	Financial Soundness Indicators for the Banking Sector, 2004–08	33
8.	Fund Disbursements and Timing of Reviews Under the Prospective Three-Year Low-Access PRGF Arrangement, 2008–11	34
9.	Indicators of Capacity to Repay the Fund, 2007–15.....	35
10.	Quantitative Targets, 2008–09.....	36

Attachments

I.	Letter of Intent	37
II.	Memorandum of Economic and Financial Policies	39
III.	Technical Memorandum of Understanding	51

I. INTRODUCTION

1. Under the 2005-08 PRGF-supported program, Armenia achieved a marked reduction in poverty within a high-growth and low-inflation macroeconomic environment. This strong performance was underpinned by sustained macroeconomic discipline, but also reflected a favorable global environment, and large-scale foreign exchange inflows. Meanwhile, progress with structural reforms was uneven: reforms in the financial area, where ownership was strong, were more successful than in tax policy and tax/customs administration, where vested interests resisted the comprehensive approach necessary to create an efficient and fair tax system (Box 1).

Box 1: Armenia's Third PRGF-supported Program—Objectives and Achievements

Objectives: (i) maintain macroeconomic stability through prudent monetary and fiscal policies; (ii) generate additional domestic resources to finance poverty-reducing and growth-enhancing expenditures, in particular by strengthening tax and customs administration; and (iii) boost private sector activities by fostering financial sector development, and improving public and corporate governance.

Achievements: These objectives have been achieved to a large extent. Program conditionality and staff policy advice helped the authorities to implement prudent monetary and fiscal policies and make progress on structural reforms in an environment of strong growth, low inflation, rising real incomes, and declining poverty rates. Nominal revenue targets were consistently exceeded, and the tax-to-GDP ratio increased by two percentage points amid double-digit GDP growth. Financial sector infrastructure, regulation, and supervision improved markedly during the program period. Financial intermediation almost doubled in relation to GDP, and progress was made in money and capital market development.

It can be argued, however, that structural conditionality—constrained by political limitations and ownership considerations—could have been more ambitious and comprehensive, in particular regarding tax policy, and tax/customs administration. While the piecemeal approach adopted in these areas addressed specific shortcomings, it failed to create an efficient and fair tax system.

2. On the surveillance side, response to Fund advice has been generally positive (Box 2). In particular, the new government (in office since April) has demonstrated strong impetus for reform. In line with previous staff recommendations, the authorities are moving ahead with several initiatives aimed at strengthening tax and customs administration, addressing tax policy weaknesses, and improving the business environment.

3. The recent war in neighboring Georgia and the global financial turmoil are unlikely to affect the short-term growth outlook significantly, but downside risks are rising. While the conflict demonstrated Armenia's vulnerability to disruptions in transport (70 percent of Armenian imports are shipped through Georgia), fuel shortages and trade interruptions were temporary and had limited impact on production, consumer confidence, and domestic prices. At the same time, the conflict served as a catalyst for preliminary talks with Turkey, which could eventually lead to the opening of the border between the two countries—a highly desirable scenario for land-locked Armenia. Given its limited integration with the

Box 2. Armenia: Response to Fund Advice

Fiscal Policy: The authorities followed Fund recommendations to achieve lower-than-budgeted deficits during the past two years by prudent expenditure execution and saving of revenue overperformance. Response to Fund advice in tax policy and administration—notably regarding presumptive tax regimes, tax incentives for companies listing in the stock market, and modernizing tax administration—has been mixed, but recent moves are encouraging.

Monetary Policy: In line with Fund advice, the Central Bank of Armenia (CBA) committed to a preannounced three-year inflation target and tightened monetary policy in response to heightened inflationary pressures. The fiscal and monetary authorities improved policy coordination in monetary operations and debt management following Fund recommendations.

Financial Sector: Bank corporate governance was strengthened in line with the 2005 FSAP update, and the financial sector infrastructure was bolstered through improved market transparency, creditor rights, and consumer protection. The authorities also introduced risk-based supervision.

international financial system, Armenia is not directly affected by the recent turmoil, but is likely to suffer from any serious deterioration in Russia's economic prospects.

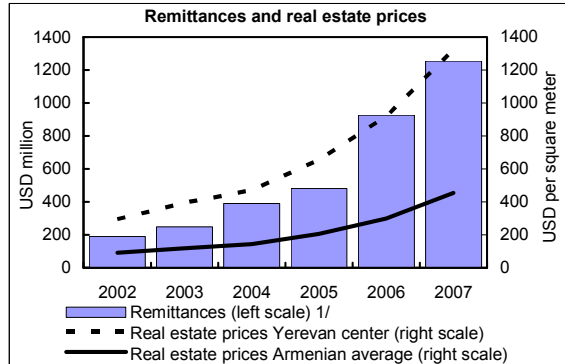
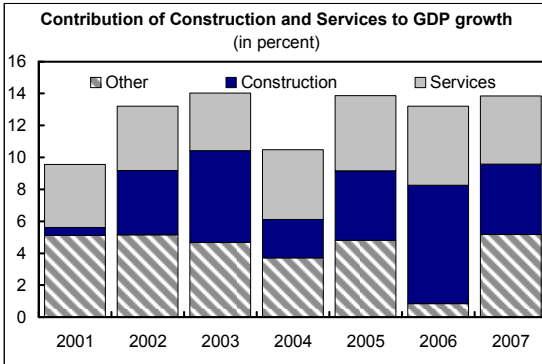
4. The authorities have requested a low-access PRGF arrangement to support their ambitious reform agenda. A new Fund program is seen as crucial to safeguard macroeconomic stability, and signal to donors, creditors, and foreign investors that policy implementation is on track—especially in light of increasing risks. Importantly, the new program will support the completion of politically difficult tax reforms, essential to improve the business environment and promote broad-based growth. Moreover, Armenia's narrow export base and heavy reliance on remittances suggest that additional Fund resources could be needed even in the absence of a significant exogenous shock. While the authorities have been successful in reducing poverty, the overall poverty level is still high, and more progress is needed to reach the Millennium Development Goals (Table 1).

II. BACKGROUND

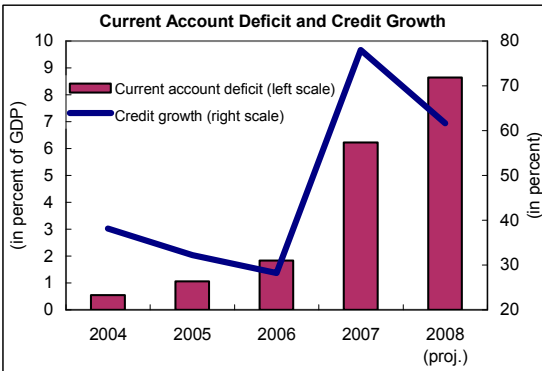
5. Armenia is poised for another year of double-digit growth, but inflation and external imbalances are growing (Figure 1). Notwithstanding the temporary trade disruptions during the Georgia conflict, annual real GDP grew by 10.4 percent in the nine months to September, and is projected to remain around 10 percent this year, assuming continued strong activity in construction and services. Annual inflation has remained high but, at 11.3 percent in September, is still lower than in neighboring countries, thanks to a gradual tightening of monetary policy, exchange rate flexibility, and a moderate fiscal stance. While inflation was driven mainly by the global spike in food and energy prices (including the elimination of the off-budget subsidy to end-users of natural gas last May), demand pressures have played an increasing role. Indeed, rising wages, persistently large foreign exchange inflows, rapid credit growth, and a sharply widening current account deficit have raised concerns about overheating (Table 2).

Figure 1. Armenia: Recent Economic Developments

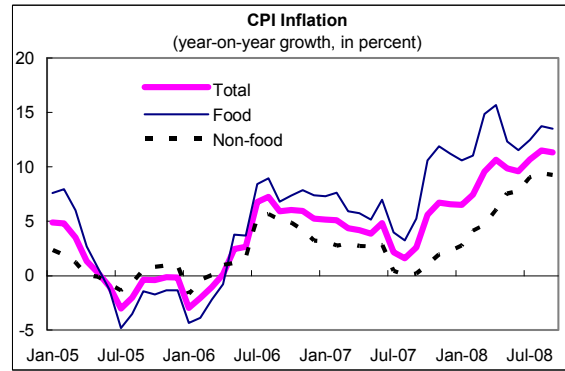
Economic growth remains strong, but excessively dependent on construction and remittances.



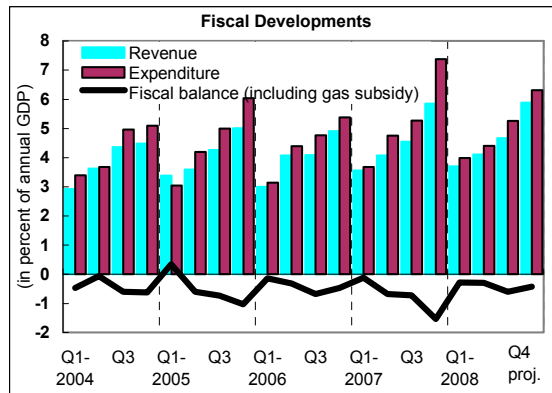
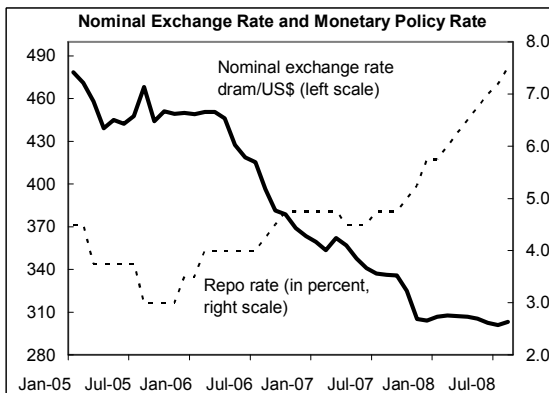
Meanwhile imbalances are growing...



with inflation as the key policy challenge.



Strong macroeconomic performance has been underpinned by exchange rate flexibility and relatively disciplined monetary and fiscal policies.



Sources: Armenian authorities; and Fund staff estimates.

1/ Remittances are defined as the sum of compensation of employees, workers' remittances, and other non-government current transfers.

Armenia: Main Economic Indicators, 2005–08

	2005	2006	2007	2008 H1	2008 Proj.
Real GDP growth	14.0	13.3	13.8	10.3	10.0
Inflation (end of period)	-0.2	5.2	6.6	9.6	7.5
Fiscal balance (commitment basis, in percent of GDP)	-2.1	-2.0	-2.3	-0.3	-1.4
Underlying fiscal balance 1/	-2.3	-2.3	-3.0	-1.9	-1.9
Broad money growth (end of period)	27.8	32.9	42.3	36.2	26.0
External current account balance (in percent of GDP)	-1.0	-1.8	-6.4	-12.6	-9.7
Gross international reserves (in months of imports)	3.2	3.6	4.3	3.4	3.9

Source: Armenian authorities; and Fund staff estimates.

1/ Excluding grants and external interest payments.

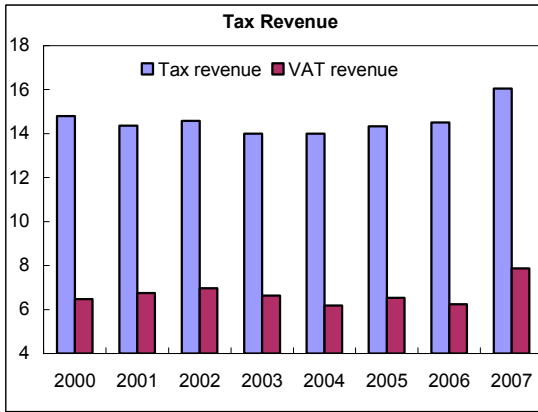
6. Budget execution in 2008 has been prudent (Table 3). Tax collection has been well above expectations, driven by a surge in VAT revenue partly associated with high import growth (Figure 2). Limited implementation capacity for capital projects and the postponement of a \$50 million disbursement from the Millennium Challenge Corporation (MCC) resulted in significant spending underexecution, notwithstanding a 60-percent increase in average pensions included in the 2008 budget. The shortfall in MCC-financed rural road construction was partly offset with domestic resources within the same budgetary envelope. As a result, the overall budget remained close to balance through July. This may reverse the previous deterioration in the *underlying fiscal balance* (including the gas subsidy, but excluding grants and external interest payments), which provides a better measure of the impact of fiscal policy on domestic demand (Box 3).

7. Monetary policy has been tightened to address rising inflationary pressures. To limit the second-round effects of higher food and energy prices, the CBA raised the repurchase rate gradually from 4.5 percent in June 2007 to 7.75 percent in September 2008, but left the rate unchanged in October, in response to the uncertain external economic environment. Broad money growth has remained robust, reflecting continued remonetization and surging private sector credit (Table 4). Reserve money growth moderated slightly during the first eight months of 2008 on account of larger government deposits with the CBA and higher-than-usual foreign exchange sales during the first half of the year (Figure 3).

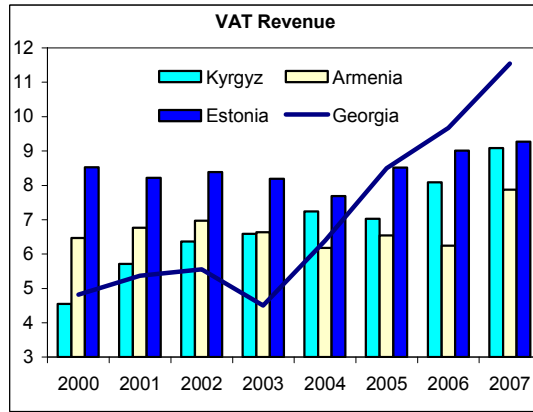
8. Despite large private transfers, the current account has continued to deteriorate. Imports have surged on the back of high international food and energy prices and buoyant demand, while export performance has been disappointing (Table 5). Weak exports reflect declining competitiveness in diamond-processing, and temporary shortfalls in base metals output, but also the high cost of doing business in Armenia. With appreciation pressures dampened by rising import demand, the dram/dollar exchange rate has been broadly stable since December 2007. International reserve coverage dropped somewhat, but remains adequate, at 3½ months of imports.

Figure 2. Armenia: Recent Fiscal Developments 1/

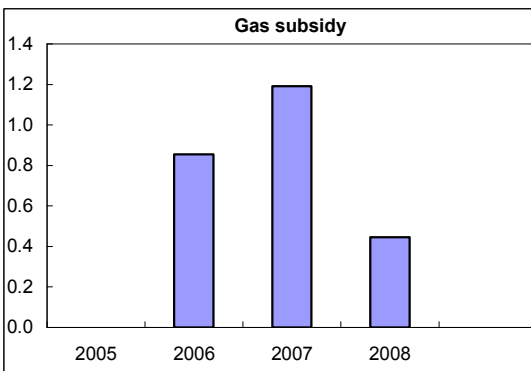
Tax revenues have shown some buoyancy lately...



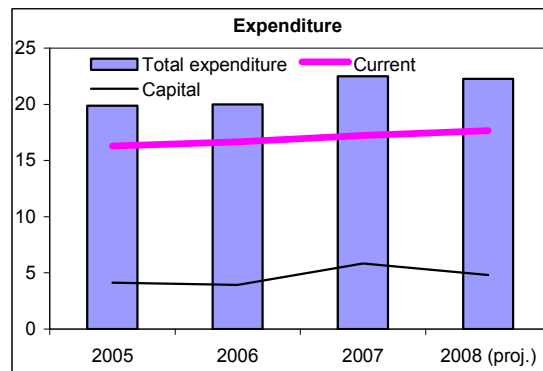
but they are still low relative to neighboring countries.



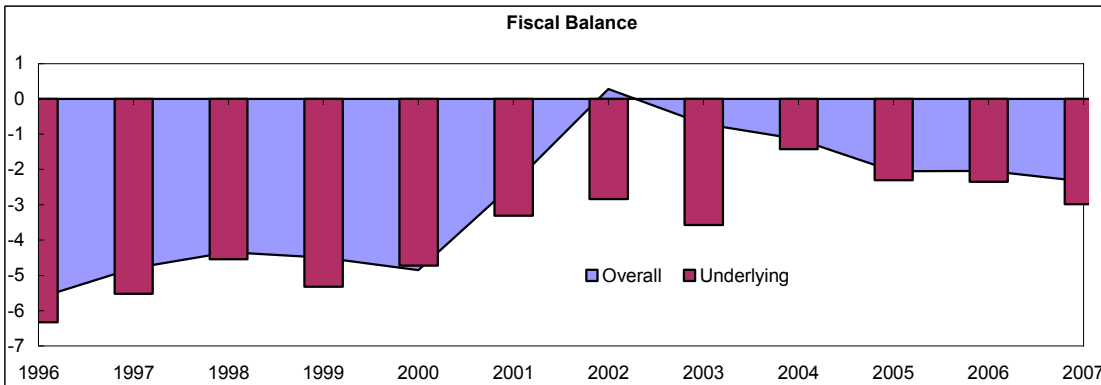
Although the gas subsidy has added pressure on the expenditure side...



overall expenditure increases have been moderate, resulting in a prudent fiscal stance.



However, the underlying fiscal balance has been deteriorating steadily since 2004.



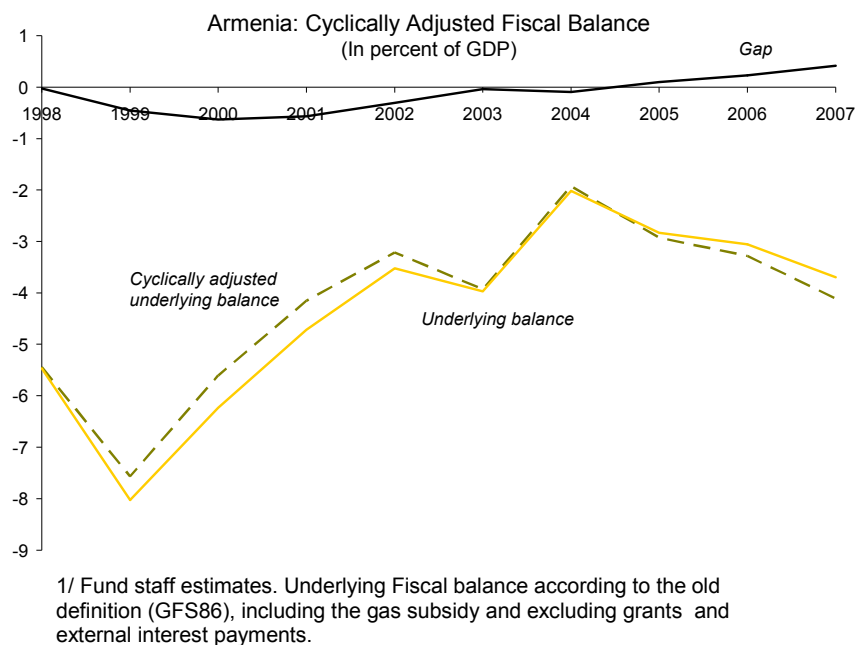
1/ All figures are in percent of GDP.

Source: Armenian authorities; and Fund staff estimates.

Box 3. Armenia: Evolving Fiscal Stance ^{1/}

Fiscal policy can be used as an effective demand management tool in Armenia, as demonstrated by the impressive fiscal adjustment of 1999–2004. During this period, the underlying fiscal deficit was slashed from 8 to about 2 percent of GDP, significantly contributing to macroeconomic stability, and paving the way for double-digit growth.

This trend has been reversed. Since 2004, the underlying balance has steadily deteriorated and fiscal policy has become moderately pro-cyclical—the cyclically-adjusted underlying balance has deteriorated even further, at a time when output was above potential. Given Armenia’s weak automatic stabilizers and looming macroeconomic risks (including the planned pension reform), fiscal policy should be used more effectively as a countercyclical tool going forward.



1/ For details, see Selected Issues, Chapter 1: “Enhancing Fiscal Policy in Armenia.”

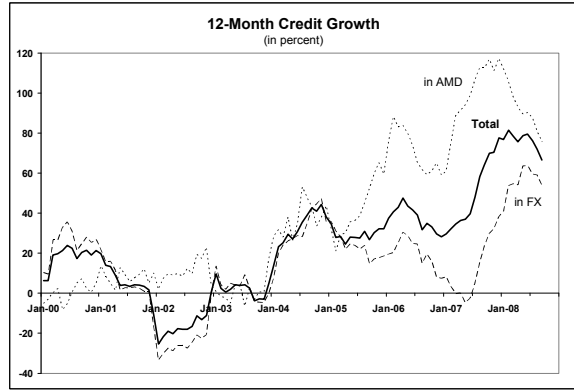
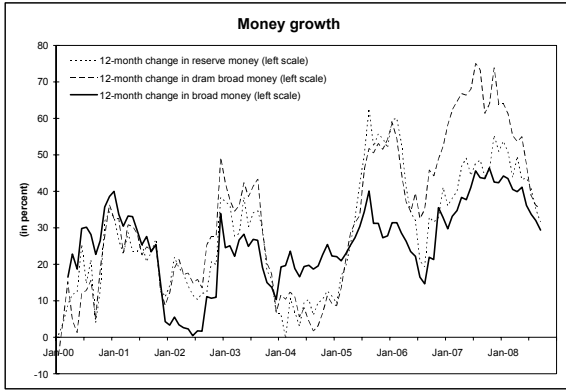
9. The new government has given clear priority to reforms in tax policy and administration:

- To address tax policy deficiencies, a VAT threshold and a simplified tax regime below the threshold have been approved, becoming effective from January 2009.
- A comprehensive and well-targeted plan for modernizing the tax administration (in line with Fund advice) has been adopted.
- The recent merger of tax and customs administrations in a single State Revenue Committee (SRC) is expected to yield efficiency gains in administrative and

Figure 3. Armenia: Recent Monetary Developments

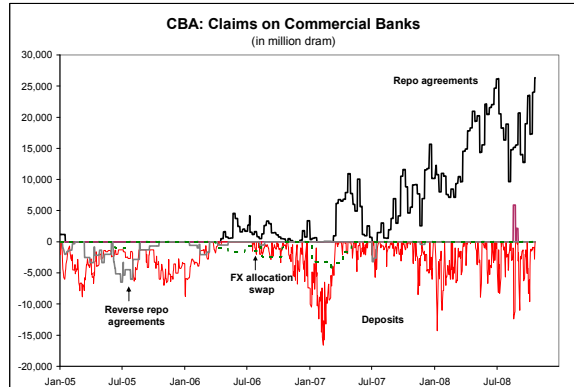
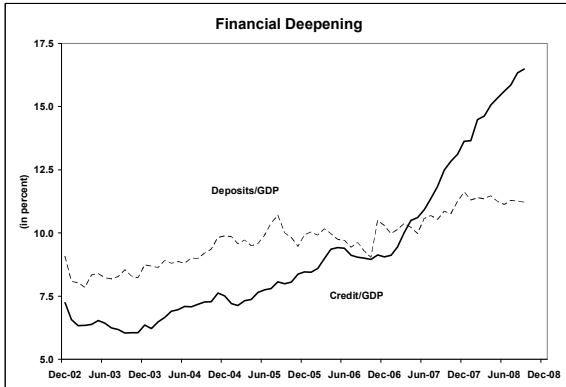
Growth of monetary aggregates is easing slightly,...

...but the credit boom continues,...



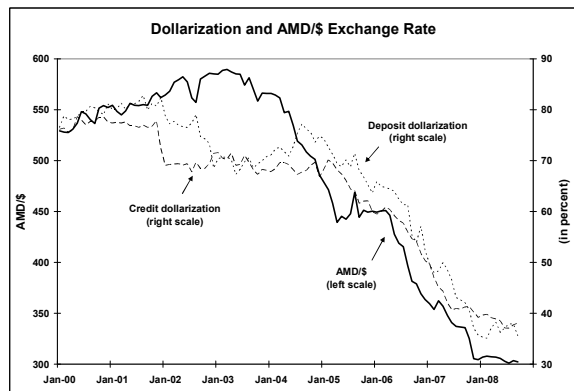
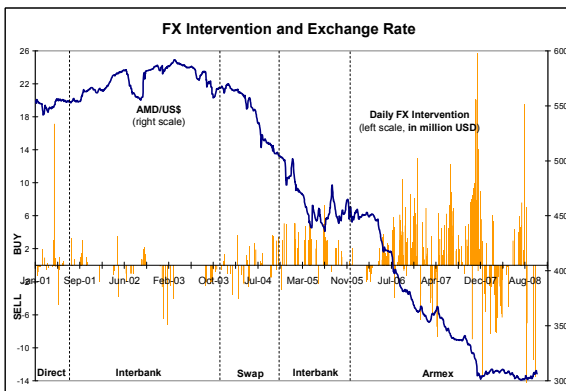
...resulting in significant financial deepening,...

...and increasing banks' demand for liquidity.



Strong dram appreciation...

...was followed by substantial dedollarization.



Source: Central Bank of Armenia.

- information-related support functions, provided that reforms are implemented vigorously, and that the core functions of the two organizations are not integrated.
 - The government has prepared a comprehensive plan for pension reform, including cost estimates. The SRC has established a working group to prepare for the collection of pension contributions.
10. The authorities have pressed ahead with reforms to strengthen the financial sector infrastructure:
- To improve financial sector transparency and consumer protection, legislation has been adopted on financial arbitration, the disclosure of financial terms of consumer loans and bank deposits, and the establishment of financial ombudsperson services.
 - A comprehensive program of securities market development has been launched by the CBA and the new stock market operator Nasdaq-OMX.
 - An insurance registry has been established at the CBA.

III. POLICY DISCUSSIONS

A. Macroeconomic Outlook and Risks

High-paced growth and commodity price hikes require a tighter policy stance to stem inflationary pressures, contain real exchange rate appreciation, and safeguard external sustainability. But the downward risks from the global economic downturn could dampen the risks of overheating.

Armenia: Medium-Term Macroeconomic Outlook, 2008-12
(In percent of GDP, unless otherwise indicated)

	Projections				
	2008	2009	2010	2011	2012
Real GDP growth (percent change)	10.0	8.0	7.0	6.0	6.0
Inflation (percent change, end of period)	7.5	5.0	4.0	4.0	4.0
Investment	36.8	36.3	36.1	35.9	35.6
Fiscal balance (commitment basis)	-1.4	-1.0	-1.1	-1.0	-1.4
Underlying fiscal balance ^{1/}	-1.9	-1.7	-1.6	-1.5	-1.8
Current account balance	-9.7	-10.8	-10.7	-9.5	-8.3

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

^{1/} Excluding grants and external interest payments.

11. On balance, the short-run outlook remains favorable, although staff projections are subject to a higher-than-usual degree of uncertainty. Growth is projected to moderate to around 8 percent in 2009, reflecting a slowdown in Russia and in residential construction in Armenia. Monetary and fiscal policy tightening and the expected easing of commodity prices

in international markets should bring inflation back to the CBA's target range (4 ± 1.5 percent) by end-2009. Under a new contract with Gazprom, gas prices will be raised from \$110 to \$154 per 1,000 m³ from April 2009, a price that remains significantly lower than those paid by neighboring countries. Credit growth is projected to slow down on account of rising interest rates and banks' limited capacity to secure long-term funding for lending, particularly in the current uncertain global environment. On the downside, the current account deficit is set to widen further, reflecting continued buoyant imports, and poor export performance, although import demand could be dampened if inflows lose pace faster than currently anticipated.

12. The medium-term outlook is also benign (Table 6). With several investment projects underway and relatively stable remittance inflows, growth rates of around 6–8 percent seem within reach. Inflation is expected to stabilize around the CBA's target rate of 4 percent, assuming supportive macroeconomic policies. Monetary policy is expected to become more effective with financial deepening and the move to full-fledged inflation targeting, while the planned improvements in the fiscal framework should lead to a more active stabilization role for fiscal policy. This would require a sustained revenue effort and better spending prioritization to make room for infrastructure and social needs, especially in view of prospects for lower grants and GDP growth rates in the medium term. The widening external current account deficit calls for accelerated structural reforms to diversify production, raise productivity, and boost the export potential.

13. Nevertheless, an escalation of external risks cannot be ruled out. With a potential global recession in sight amid a financial turmoil, the international economic environment has become increasingly challenging. Importantly, a collapse in world oil prices could lead to a protracted downturn in Russia and negatively affect private transfers and FDI inflows to Armenia, depressing economic activity, and damaging growth prospects. Moreover, the outlook for international commodity prices is uncertain, and the geopolitical landscape remains fragile.

14. Current debt levels and borrowing plans do not raise major sustainability concerns. The Debt Sustainability Analysis (DSA) suggests that Armenia is at low risk of debt distress, with all debt indicators well below the relevant country-specific debt burden thresholds in the baseline scenario. An alternative scenario including financing for a planned new nuclear power plant would result in a sharp but temporary worsening of debt indicators. The authorities agreed with the analysis and the underlying assumptions, but noted that government debt financing for the potential nuclear power plant is currently not under consideration. To finance several large infrastructure projects in the medium term, they are considering increasing external borrowing (partly on nonconcessional terms) from the World Bank and other international financial institutions, but these plans still need to be firmed up.

B. The Policy Mix

The current policy mix has appropriately combined sound fiscal and monetary policies with exchange rate flexibility. As long as the risks of overheating outweigh the risks of a sharp drop in foreign exchange inflows, monetary and fiscal policies will need to remain tight.

Fiscal policy

15. Fiscal policy should balance the need for a more countercyclical stance with the spending requirements for further poverty reduction. To that end, continued strong revenue performance would be crucial to finance infrastructure investment and social programs, highlighting the importance of tax reforms. On balance, staff viewed some fiscal tightening as appropriate, given the existing signs of overheating. Against the background of persistent inflationary pressures and the uncertain outlook for commodity prices, the authorities saw merit in withdrawing fiscal stimulus during 2008-09 (MEFP ¶19 and ¶20), but noted that the policy stance in 2009 might need to be revised in light of the rapidly-changing external environment.

- For 2008, the ‘underlying’ deficit will be limited to 1.9 percent of GDP, compared with 3.5 percent of GDP with full budget execution.¹ The lower deficit will be achieved by saving revenue over-performance and curtailing non-priority spending. This should be feasible, given revenue performance to date.
- For 2009, the underlying deficit will be further reduced to 1.7 percent of GDP (corresponding to an overall deficit of 1.0 percent of GDP). The budget accommodates higher spending on wages, pensions, infrastructure, and targeted benefits to mitigate the impact of higher food and fuel costs. The revenue target is ambitious, considering that the improvement in tax collection in 2007 was accompanied by a significant build-up of tax credits that have not yet been cleared.² Increasing domestic financing would contribute to the development of the securities market.

¹ These figures include the off-budget gas subsidy in place until May 2008.

² These credits appear to result from irregular requests for advanced tax payments or negotiated payments between businesses and tax inspectors struggling to meet collection targets.

Armenia: Fiscal Stance
(In percent of GDP, unless otherwise specified)

	2006	2007	2008		2009
			IMF	Budg.	IMF
Underlying balance 1/	-2.3	-3.0	-1.9	-3.5	-1.7
Overall balance 2/					
with gas subsidy	-2.0	-2.3	-1.4	-2.6	-1.0
without gas subsidy	-1.2	-1.1	-1.0	-2.2	-1.0
<i>Memorandum items</i>					
Tax revenue	14.5	16.0	16.4	16.3	16.8
Current expenditure	16.7	17.2	17.3	18.4	17.6
Capital expenditure	3.9	5.8	4.5	5.0	4.7
Nominal GDP (in billion drams)	2,656	3,149	3,672	3,520	4,169

1/ Overall balance (new definition), including the State Fund for Social Insurance (SFSI) and the gas subsidy, and excluding grants and external interest payments.

2/ Data for 2006 and 2007 reflect staff estimates on the consolidation of the SFSI into the central government accounts, and on a GFSM2001 consistent presentation.

16. Rising medium-term risks call for continued fiscal prudence. Plans to increase pension outlays, introduce a funded pension pillar, and build a new nuclear power plant, together with the lack of effective monitoring and controls of noncommercial organizations (NCOs) that are mainly financed through the budget, are expected to put pressure on the budget in the coming years.

- The introduction of a funded pillar by January 2010, together with the envisaged increases in state-funded pensions, need to be carefully assessed. Preliminary estimates suggest that the cost of the funded pillar could be relatively small (around 0.4 percent of GDP per year). But plans to raise average pensions to the level of the minimum consumption basket (MCB) by 2012 could add up to 1.4 percent of GDP to total annual spending. Staff reiterated earlier concerns about keeping the costs of the reform within manageable levels, implementing the pension reform gradually, and containing the risks associated with the planned unification of the personal income tax with social insurance contributions to a funded pillar. The planned temporary transfer of legal ownership from employees to the state budget of half of the amount to be accumulated in individual accounts (the 5 percent state participation) is particularly worrisome, since future governments may decide to change the law and not return to employees this part of their contributions. The authorities noted that pension reform in Armenia will have an important poverty-reduction aspect.
- The new monitoring and control systems for NCOs, elaborated with World Bank assistance, will be piloted in four sectors. While the pilot project will be implemented with World Bank funding, staff stressed—and the authorities agreed—that full program implementation will require significant additional resources at the NCO unit of the Ministry of Finance (MoF), in line ministries, and in individual NCOs.

- The construction of a new nuclear power plant, planned to begin in 2011, would cost about \$4–6 billion, according to current estimates. Depending on final financing decisions taken by the authorities, the project has the potential to significantly raise public or publicly-guaranteed debt. Staff cautioned that any financing decision needs to be consistent with long-term debt sustainability.

17. A more comprehensive approach to analyzing fiscal risks is needed to strengthen the budget process and enhance fiscal policy credibility. The current three-year Medium-Term Expenditure Framework (MTEF) establishes priorities and expenditure envelopes, but is short on risk analysis and related policy responses. Moreover, some policy decisions affecting medium- and long-term fiscal sustainability (such as the recent increase in basic pensions) have been taken outside the MTEF. The authorities recognize the importance of strengthening the fiscal framework and are committed to stepping up fiscal analysis during the program period (MEFP ¶26 and ¶29).

Monetary and exchange rate policies

18. The CBA is committed to further tightening monetary policy to bring down inflation if signs of overheating persist. While commodity price increases were the initial drivers of inflation, demand factors have increasingly added to inflationary pressures. Against this background, the CBA considered bolder interest rate hikes, but eventually settled for a more cautious approach due to the heightened uncertainties created by the conflict in Georgia. If inflationary pressures linger, the CBA plans to continue raising the repo rate gradually, but is ready to move faster if needed (MEFP ¶21). While the pass-through of policy rate changes has been limited so far, commercial banks have slowly begun to adjust loan and deposit interest rates in response to tighter funding conditions resulting from rapid credit growth and limited availability of external resources.

19. The key elements for successful inflation targeting (IT) are already in place, but the IT framework is new and untested, and the monetary transmission mechanism remains weak. To enhance monetary operations and debt management, the CBA will discontinue issuing its own securities and will instead focus on conducting repo operations, while the treasury will recommence issuing short-term T-bills (MEFP ¶24). Close coordination of debt issuance will be crucial, taking into account both budget financing and liquidity management needs. The CBA also plans to increase its holdings of treasury securities over the medium term in order to strengthen its capacity to conduct reverse repo operations. To improve banks' liquidity management, the CBA is considering lengthening the reference period for reserve requirements, introducing an overnight credit facility, and establishing an electronic interbank trading platform (MEFP ¶25).

20. The authorities intend to maintain a flexible exchange rate regime, consistent with the IT framework (MEFP ¶23). Since 2003, the CBA has increasingly engaged in foreign exchange interventions to smooth exchange rate volatility and accommodate capital inflows,

remonetization, and dedollarization. Empirical analysis suggests that the impact of this policy on both the level and the volatility of the exchange rate has been limited (Box 4).

Box 4. Armenia: Effectiveness of Foreign Exchange Market Interventions ^{1/}

Armenia maintains a managed floating exchange rate regime, and the CBA regularly intervenes in the foreign exchange market. Interventions aim at ensuring orderly conditions in a thin market—with a small number of participants, lumpy foreign exchange inflows, and vulnerability to external shocks. Managing banking system liquidity and accumulating foreign exchange reserves have at times been secondary objectives of CBA interventions.

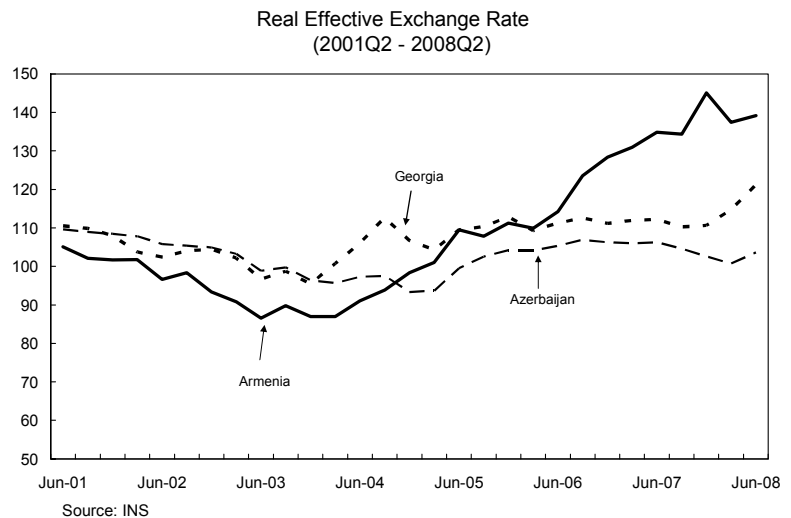
The effectiveness of interventions—measured in terms of their impact on the level and volatility of the exchange rate—was analyzed for the period January 2001-May 2008 using a GARCH framework. A two-step procedure was employed to address the identification problem resulting from the two-way causality between intervention activity and exchange rate movements.

Preliminary results from various GARCH specifications over different sub-periods suggest that interventions have had little impact on slowing dram appreciation and on lowering exchange rate volatility. There is only some limited evidence that foreign exchange sales have been associated with lower exchange rate volatility. However, only daily data are available, and it may well be that foreign exchange interventions have had stabilizing intra-day effects—in particular in the context of lumpy foreign exchange inflows.

The authorities stress that a significant part of interventions was conducted to accommodate cash dedollarization. But since the extent of dedollarization is difficult to quantify, large-scale unsterilized foreign exchange purchases may have added to inflationary pressures. Foreign exchange sales in the first half of 2008 have been more in line with the tightening of monetary policy needed to curb inflation. More broadly, allowing two-way exchange rate flexibility would be important to avoid one-way bets.

1/ For details, see Selected Issues, Chapter 2: “Smoothing Exchange Rate or Fuelling Inflation: What Are the Effects of Foreign Exchange Market Intervention in Armenia.”

In 2008, out of concern for the potential destabilizing effects of political uncertainty and the Russian-Georgian conflict, the authorities reduced their tolerance for exchange rate volatility, and the dram fluctuated within a narrower band. Intervention, however, has not been targeted at the level of the exchange rate.

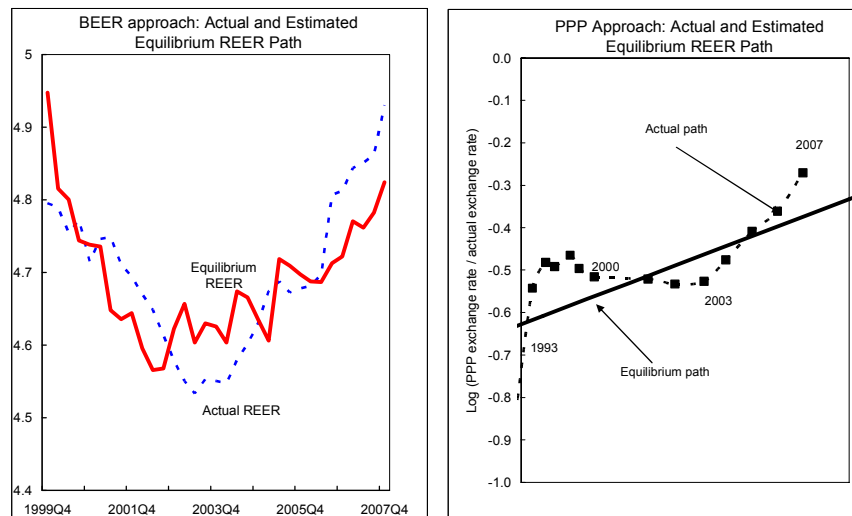


21. The current exchange rate level does not raise serious concerns about external stability. The marked nominal appreciation of the dram in recent years has helped keep inflation well below the regional average, while real appreciation has been far above that of similar countries. Based on a range of different estimates, the authorities and staff agreed that there may have been a slight overvaluation in 2007 (Box 5), which the authorities believe is likely to have been reduced by developments during 2008. The authorities also agreed with staff that competitiveness issues should be addressed by structural policies, in particular by promoting a business-friendly environment.

Box 5. Exchange Rate Assessment^{1/}

The steady dram appreciation in recent years has raised concerns about external competitiveness and the appropriate level of the exchange rate. Staff's current assessment, based on various approaches, indicates moderate deviations from equilibrium, which are not sufficiently large to generate future external instability. The authorities' own findings are broadly consistent with staff's assessment.

Staff estimates suggest that the recent appreciation has reversed the previous undervaluation of the dram. Both the **behavioral equilibrium exchange rate approach** and the **purchasing power parity approach** (pictured below) indicate that the exchange rate is currently slightly above its equilibrium value. The **External Sustainability Approach (ES)** suggests that the previous undervaluation from the benchmark growth (6 percent) was reversed in 2007, when a slight overvaluation was observed. Armenia's sustainable external current account deficit norm is estimated to range between 2 and 14 percent of GDP, assuming that the NFA position will stabilize at about 25 percent of GDP.



Sources: WEO (April 2008); IFS; and Fund staff estimates.

Recent developments in external price and cost competitiveness indicators are mixed. Armenia's export market shares have remained relatively stable for all major export destinations. Nominal unit labor costs (ULC) have continued to edge upward, indicating a decline in wage competitiveness, particularly in agriculture and industry. Despite this trend, foreign-investor interest in Armenia remains relatively strong.

1/ For details, see: Selected Issues, Chapter 3: "Exchange Rate Appreciation and External Competitiveness in Armenia."

Financial sector issues

22. Armenia's financial sector infrastructure, regulation, and supervision have improved significantly, but a number of unresolved issues remain. The banking sector still suffers from a lack of sufficient long-term funding, unsatisfactory level of risk management, market segmentation, and high interest rate spreads. Although deposits are increasing at a healthy pace, deposit growth has lagged credit growth during the past three years. In line with earlier Fund recommendations, the authorities have bolstered their efforts to foster commercial bank risk management capacity and improve market transparency and consumer protection. Several legislative measures have been implemented, and currently the CBA is preparing an extensive financial service consumer education campaign. The supervisory system is effective, and the share of foreign bank ownership is on the rise. A number of banks have benefited from technical assistance provided by international banks or through the USAID financial sector deepening project.

23. Financial soundness indicators do not yet indicate significant vulnerabilities (Table 7). Banks continue to be profitable, and nonperforming loans, have remained low and concentrated in a couple of banks. Yet, the sharp pickup in credit growth since mid-2007—while a welcome boost to financial intermediation—could potentially impact negatively on financial sector stability. Although large-scale equity capital inflows into the banking system are continuing, limited access to external borrowing is becoming an increasing constraint to credit expansion. This will eventually trigger a welcome moderation in credit growth. At the same time, due to the limited external exposure of local banks, the international financial turmoil is not expected to have a direct impact on the stability of the Armenian financial system. Looking ahead, a potential downward correction in real estate prices could add to credit risk, although the mortgage share in total credit is still comparatively low.

C. Structural Reforms

While Armenia has made significant strides in financial sector reform, additional efforts are needed to boost competitiveness, notably by improving the business environment.

24. Sustained growth requires a more diversified and competitive economy. While some progress has been made, the cost of doing business in Armenia remains high, and a large part of economic activity remains underground. The World Bank's "Doing Business 2009" report shows a slight deterioration in Armenia's position (from 41st to 44th rank), notably in categories such as 'starting a business' and 'trading across borders.' Yet, 'paying taxes' remains the worst category by far, with Armenia slipping from 147th to 150th place (Figure 4).

25. The authorities acknowledged the need and urgency to buttress competitiveness by enhancing the business climate. The planned overhaul in tax and customs administration is a major step in this direction, since it should contribute to scaling down the shadow economy

and discouraging tax evasion (thus promoting financial deepening), while creating room for productivity-enhancing infrastructure and capital investments. External competitiveness would also be boosted by fostering domestic competition, notably by tackling import monopolies. World Bank support in various areas (including regulatory changes, infrastructure development, competition policy, and customs reform) should contribute to enhance competitiveness.

D. The New Program

Program objectives and design

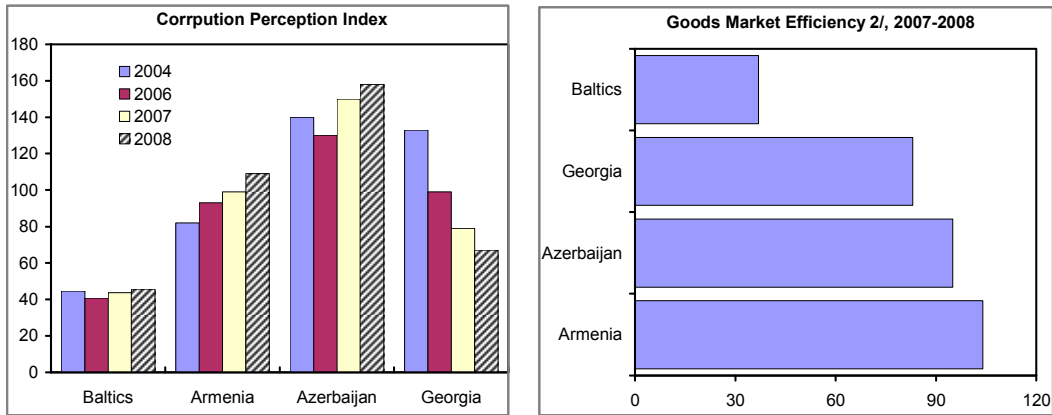
26. The PRGF-supported program builds on recent policy discussions and on the updated PRSP, renamed Sustainable Development Program (SDP).³ The new arrangement will cover the three-year period starting from Board approval. Access is limited to 10 percent of quota (SDR 9.2 million), with seven disbursements (Table 8). Since Armenia has large repurchases falling due in 2008–11, outstanding Fund credit is projected to decline during this period (Table 9).

27. The main goals of the new program are to sustain and broaden economic growth, and further reduce poverty, consistent with SDP priorities. Appropriate fiscal and monetary policies will underpin the macroeconomic objectives of the program. Its main focus will be on strengthening the fiscal and monetary policy frameworks and their coordination, while deepening productivity-enhancing structural reforms, and improving governance. To this end, the program will aim at having in place a fully-developed fiscal framework and a full-

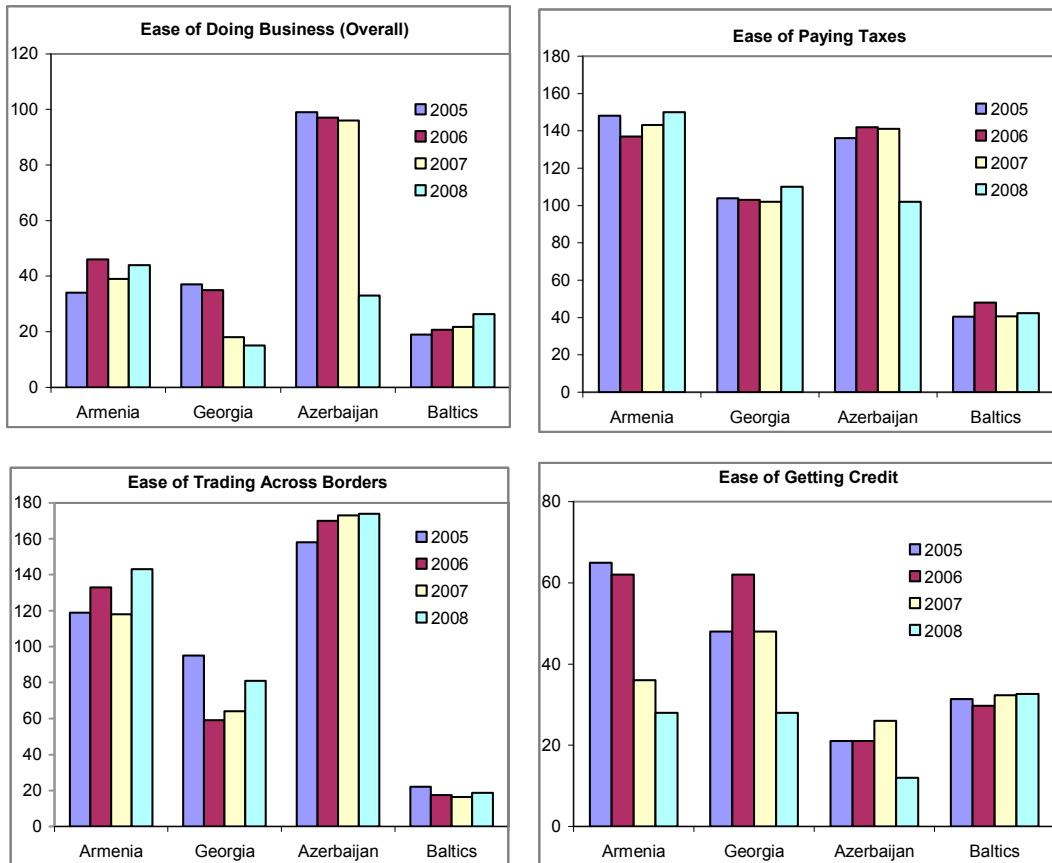
³ The views of World Bank and IMF staffs on the SDP are presented in the Joint Staff Assessment Note.

Figure 4. Armenia: Business Environment 1/

Increasing corruption and low goods market efficiency continue to impact negatively on the business environment.



While Armenia ranks reasonably in terms of the ease of doing business, it scores unfavorably when it comes to paying taxes, trading across borders, and obtaining credit.



1/ In all figures, the higher the number, the lower the rank.

2/ Goods market efficiency is related to ease of starting a business, intensity of local competition, market power, efficiency of antitrust policy, customs procedures, and nontariff barriers.

Sources: Transparency International, 2008, World Economic Forum, Global Competitiveness Report 2007-08, World Bank Doing Business Report, 2009.

fledged IT framework by the end of the three-year period. This will require, among other things, strengthening the institutional and analytical capacity at the MOF,⁴ and adopting a Forecasting and Policy Analysis System for inflation targeting at the CBA. The current global crisis highlights the need to minimize Armenia's vulnerabilities by stepping up efforts to diversify production and reduce dependence on remittances.

Program monitoring

28. Program implementation will be monitored on a semi-annual basis. The first review is expected to be completed by June 2009, based on December 2008 quantitative performance criteria (MEFP Table 1). To reflect changed circumstances, conditionality was modified compared to previous programs:

- The overall balance of the central government was replaced by the underlying fiscal balance (excluding grants and external interest payments). Given Armenia's low debt levels, it is difficult to anchor short-term fiscal policy to long-term fiscal sustainability. Against that background, the underlying balance provides a better measure of the impact of fiscal policy on domestic demand.
- The zero limit on contracting/guaranteeing new nonconcessional external debt was replaced by a small positive amount (\$50 million), making room for the authorities' debt issuance plans and projects financed by the World Bank and Asian Development Bank, consistent with the fiscal program and domestic capacity.
- While monetary aggregates will still be used as indicative targets in the transition period to full-fledged IT, during the program period conditionality will switch to a periodic assessment of a defined set of monetary indicators, together with a requirement for consultation with Fund staff if the inflation target is missed.

Structural conditionality

29. Structural conditionality focuses mainly on tax administration/policy reforms, given their positive impact on the business environment, financial intermediation, and economic growth. The reasons why the specific structural measures to be adopted during the first year of the program are macro-critical are presented in Box 6.

30. The tax-to-GDP ratio in Armenia is lower than in most transition countries, and well below potential. Weaknesses in tax policy and administration (including customs) are at the heart of Armenia's poor revenue performance. Customs reforms, largely supported by the World Bank, will focus on establishing risk-based processes to minimize the interaction

⁴ For details, see Chapter 1 of the Selected Issues Paper.

Box 6. Armenia: Structural Conditionality, 2008–09

Structural Measure	Rationale for Macro-Criticality
<p>1. Restructure the tax administration by:</p> <p>(i) implementing a modern function-based structure;</p> <p>(ii) merging the four specialist inspectorates into a single large taxpayer inspectorate (LTI);</p> <p>(iii) significantly reducing the number of tax inspectorates.</p>	<p><i>Tax administration is perceived as the biggest constraint on businesses in Armenia. Without significant reform, further improvements in tax collection will be difficult, and recent ones may not be sustainable.</i></p> <p>Remove inefficiencies (such as duplicated activity) and ensure better use of tax administration resources.</p> <p>Focus on large taxpayer segment, where contributions to total tax revenues have been declining in recent years.</p> <p>Redirect tax administration resources to higher revenue-yielding activities.</p>
<p>2. Introduce best practices in VAT refund processing to exporters by:</p> <p>(i) clearing backlog of refund claims; meeting statutory 90-day processing deadline for all claims filed in 2009;</p> <p>(ii) implementing risk-management approaches;</p> <p>(iii) implementing forecasting system for refund levels;</p> <p>(iv) strengthening penalties for false refund claims and paying interest on legitimate refunds not paid on time.</p>	<p><i>Denied refunds in Armenia cause considerable tension between tax administration and businesses, effectively taxing exports.</i></p> <p>Reduce the stock of refund claims, which has been increasing since late 2006 because of pressure to meet collection targets and concerns about VAT fraud.</p> <p>Introduce best practice in modern tax administration in Armenia, which should be feasible given small number of claims.</p> <p>Ensure that funds are available to pay legitimate refund claims as they occur.</p> <p>Enhance the integrity of VAT system by strengthening incentives for both tax payers and tax administration.</p>
<p>3. Strengthen domestic debt market by signing an agreement between MoF and CBA on coordination of government securities auctions, including:</p> <p>(i) discontinuation of CBA security issuance;</p> <p>(ii) commitment to avoid using cut-off yields at treasury auctions, except to reject clearly speculative bids that lie outside normal range of bidding.</p>	<p><i>The domestic debt market remains underdeveloped, and there have been coordination failures between monetary policy and debt management.</i></p> <p>Remove market segmentation.</p> <p>Strengthen monetary transmission mechanism, boost credibility of the government’s macroeconomic framework, and encourage development of treasury securities market.</p>
<p>4. Improve CBA recapitalization mechanism following best practice, using marketable government securities.</p>	<p><i>Current modalities (non-marketable, non-interest bearing promissory notes) lack transparency, hinder monetary policy implementation, and discourage debt market development.</i></p>
<p>5. Strengthen fiscal framework with analytical reports, identifying fiscal challenges, risks, policy responses.</p>	<p><i>Fiscal policy should become a more effective and credible demand management tool.</i></p>

between customs officials and importers (MEFP ¶17). Program conditionality targets several well-pointed measures aimed at significantly improving Armenia’s tax environment, in line with FAD recommendations (MEFP Table 2):

- Significant reform in the system for VAT refund processing (structural performance criterion, MEFP ¶27).
- Modernization of the tax administration, including adoption of a function-based organizational structure, merger of the large taxpayer inspectorates, and a significant cut in the number of regional offices (structural benchmark, MEFP ¶28).
- Abolishment of current presumptive tax regimes (notably those related to fuel and tobacco) during the program period (MEFP ¶27).

31. The program includes measures to strengthen the fiscal framework. To enhance fiscal policy credibility and strengthen the budget process, the authorities will publish an annual report on medium-term fiscal risks and contingency plans (structural benchmark, MEFP ¶29).

32. The program also includes measures to improve the coordination of monetary and fiscal policies:

- Agreement on the coordination of government securities auctions, including (i) the discontinuation of CBA security issuance, and (ii) a commitment to avoid using cut-off yields in treasury auctions (structural performance criterion, MEFP ¶24).
- Revamped recapitalization mechanism for the central bank, using marketable government securities (structural benchmark, MEFP ¶31).

Risks to the program

33. In the midst of unprecedented uncertainty, risks to the program have intensified. The main short-term risk is that a protracted economic downturn in Russia will significantly cut back inflows of remittances and FDI. This could offset the main concern to date—the risk of overheating. On the home front, lack of political support could jeopardize the authorities’ ambitious reform program. In the medium term, the economic vulnerabilities described in paragraphs 13 (global economic environment), 14 (debt sustainability), and 23 (financial sector), and Box 4 (dedollarization) are compounded by lingering geopolitical risks (unresolved conflict with Azerbaijan and closed borders with Turkey), which hamper market access and economic diversification. Moreover, the recent hostilities in neighboring Georgia have exposed Armenia’s vulnerability to disruptions in trade. Given its good debt servicing record and strong commitment to macroeconomic discipline, Armenia is not expected to experience difficulties in repaying the Fund.

IV. STAFF APPRAISAL

34. Armenia made significant strides during the last PRGF-supported program. Prudent monetary and fiscal policies, together with a flexible exchange rate regime, delivered double-digit growth and low inflation, and a notable reduction in poverty. This impressive performance was supported by large-scale foreign exchange inflows and a favorable external environment. The short-term outlook remains favorable although tempered by regional instability and rising uncertainties about the global economy.

35. But macroeconomic imbalances have widened recently. During the past year, rising inflation, a widening current account deficit, and rapid credit growth have raised concerns about overheating. While supply shocks ignited inflation, buoyant demand kept inflationary pressures high and fueled import growth. At the same time, Armenia's export potential remains weak, the production base is undiversified, and the economy continues to be heavily dependant on remittances to finance its large trade deficit and a construction boom.

36. Sluggish structural reforms are at the heart of these rising imbalances. The resulting weak business environment discourages economic diversification, hinders export growth, and accentuates Armenia's dependence on foreign exchange inflows and vulnerability to external shocks. The government's intention to press ahead with overdue reforms is a welcome step to make the economy more resilient to future terms of trade shocks and disruptions in foreign exchange inflows.

37. The current global financial turmoil and the threat of a severe economic downturn compound the significant challenges ahead. While the current tightening financial conditions are unlikely to impact directly on Armenia, a regional slowdown would affect FDI and remittance inflows, undermining growth prospects. At the same time, a moderation in these inflows would help unwind the accumulated macroeconomic imbalances and mitigate the risk of overheating. It would be crucial to take this opportunity to complete the unfinished reform agenda and pave the way for broad-based growth.

38. Sustained policy adjustments will be needed to maintain macroeconomic stability in the face of a more challenging economic environment. Unless the risks of overheating dissipate on the heels of weakening world demand, monetary and fiscal policies will need to remain tight. While the monetary framework is well-designed, fiscal management needs to be strengthened to support the inflation targeting regime and enhance policy effectiveness.

- With monetary policy effectiveness constrained by large foreign exchange inflows and a weak transmission mechanism, supportive fiscal policy will be essential to ensure that inflation targets are met. To that end, the authorities' decision to withdraw fiscal stimulus in 2008-09 is commendable. Over the medium term, fiscal policy should balance the need for a more countercyclical fiscal stance with the spending requirements for further poverty reduction.

- Monetary policy will have to be tightened further in case inflationary pressures do not recede. To support inflation control, the authorities should refrain from extensive unsterilized foreign exchange purchases in response to large foreign exchange inflows. A conservative prudential approach would help mitigate risks from the sharp pick-up in credit growth.
- Exchange rate flexibility will continue to be the best option for Armenia. While real appreciation pressures will be inevitable if large foreign exchange inflows persist, a tight fiscal policy and structural reforms would guard against loss of competitiveness.

39. Statistical data are adequate for surveillance purposes. The authorities are encouraged to implement the recommendations of the recent data ROSC to address remaining weaknesses.

40. Armenia's request for a new PRGF arrangement comes at a time of unprecedented uncertainty in the world economy. Policy adjustments may be required if economic conditions in Armenia deteriorate more than anticipated. The program's focus on strengthening the fiscal and monetary frameworks and on completing tax reforms adequately addresses the significant challenges ahead. Achieving the program's objectives will require a concerted effort to fully implement structural policies, while maintaining financial stability. Monetary and fiscal policies will need to remain prudent, responding flexibly to new developments. In particular, the authorities will need to balance the need to boost social spending to meet SDP objectives with the need to limit the fiscal impulse in order to control inflation, which mostly affects the poor.

41. Structural conditionality under the new program will focus on tax administration and tax policy reform, given their positive impact on the business environment and economic growth. Tax administration needs to be more transparent and fair to encourage compliance and ensure a level playing field for business. Major tax administration reforms are needed to ensure that the recent improvement in tax collection is sustainable. The implementation of these measures is likely to be resisted by vested interests, and will thus be a test of the government's resolve to move ahead with reforms.

42. Based on the authorities' good track record and the strong policy and structural program envisaged for 2009, staff supports the authorities' request for a new PRGF arrangement. However, in view of increasing global risks, Armenia's external financial requirements may increase as well, possibly calling for higher access than under the current PRGF arrangement. In these circumstances, staff would support a prompt review of access and modalities of Fund support. It is proposed that the next Article IV consultations be held on the standard 24-month cycle.

Table 1. Armenia: Poverty Indicators and Millennium Development Goals, 1990–2015

(In percent of total population, unless otherwise indicated)

	1990	2000	2005	2006	2007	2015 Target
1 Eradicate extreme poverty and hunger						
Population below \$2.15 (PPP) a day 1/	...	36.1	0.8	...	...	...
Overall poverty rate	...	50.9	29.8	26.5	25.0	10.1
Rural poverty	...	45.7	28.3	23.4	25.5	...
Extreme poverty	...	16.2	4.6	4.1	3.8	1.6
Prevalence of child malnutrition (in percent of children under 5)	...	2.6	4.2	...	...	1.4
2 Achieve universal primary education						
Net primary enrollment ratio (in percent of relevant age group)	...	83.7	86.3	...	...	100.0
Youth literacy rate (in percent of group ages 15-24)	99.5	99.8	100.0	...	...	100.0
3 Promote gender equality						
Ratio of girls to boys in primary and secondary education (in percent)	...	104.2	103.2	103.7	...	100.0
Ratio of young literate females to males (in percent of group ages 15-24)	...	100.1	...	...	...	...
Proportion of seats held by women in national parliament (in percent)	13.0	11.0	5.0	5.3	8.4	...
4 Reduce child mortality						
Under 5 mortality rate (per 1,000)	55.9	36.3	25.5	23.8	24.0	20.0
Infant mortality rate (per 1,000 live births)	47.3	31.8	22.8	21.4	21.0	8.7
Immunization, measles (in percent of children under 12 months)	94.8	92.0	94.0	92.0	92.0	...
5 Improve maternal health						
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	76.0	...	...	10.0
Births attended by skilled health staff (in percent of total)	96.8	97.0	...	...	97.8	...
6 Combat HIV/AIDS, malaria and other diseases						Stabilize and reduce
Incidence of tuberculosis (per 100,000 people)	33.1	70.7	71.8	72.3	...	...
Tuberculosis cases detected under DOTS (in percent)	...	46.6	59.7	59.4	...	...
7 Ensure environmental sustainability						
Nationally protected areas (in percent of total land area)	...	7.6	7.4	7.4	7.4	...
GDP per unit of energy use (PPP \$ per kg oil equivalent)	0.9	3.0	4.9	...	...	...
CO2 emissions (metric tons per capita)	1.1	1.1	...	...	...	...
Access to an improved water source (% of population)	...	93.0	...	98.0	...	...
Access to improved sanitation (% of population)	...	89.0	...	91.0	...	...
8 Develop a Global Partnership for Development						
Fixed line and mobile telephones (per 1,000 people)	158	179	302	...	...	...
Personal computers (per 1,000 people)	...	8	98	...	...	...
General indicators						
Population (in millions)	3.5	3.1	3.0	3.0	3.0	...
Total fertility rate (births per woman)	2.5	1.5	1.4	1.3	...	...
Life expectancy at birth (years)	68.5	70.8	71.5	71.6	72.0	...
Gini index of inequality (consumption)	...	36.2	...	...	...	...
Gini index of inequality (total income)	...	52.8	35.9	36.9	...	...

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.

1/ 2000 and 2003 poverty surveys based on different methodology than in other years.

Table 2. Armenia: Selected Economic and Financial Indicators, 2003–09

	2003	2004	2005	2006	2007	2008 Proj.	2009 Proj.
(In percent of GDP, unless otherwise specified)							
National income and prices							
Real GDP growth	14.0	10.5	14.0	13.3	13.8	10.0	8.0
Gross domestic product (in billions of drams)	1,625	1,908	2,243	2,656	3,149	3,672	4,169
Gross domestic product (in millions of U.S. dollars)	2,807	3,578	4,909	6,386	9,228	12,069	14,019
Gross domestic product per capita (in U.S. dollars)	874	1,113	1,523	1,976	2,842	3,698	4,274
CPI (period average)	4.7	7.0	0.6	2.9	4.4	9.2	5.2
CPI (end of period)	8.6	2.0	-0.2	5.2	6.6	7.5	5.0
Unemployment rate (in percent)	10.1	9.6	8.1	7.2	7.1	...	...
Poverty rate (in percent)	42.9	34.6	29.8	26.5	...	...	...
Investment and saving (in percent of GDP) 1/							
Investment	24.3	24.9	30.5	35.9	37.2	36.8	36.3
National savings	17.5	24.3	29.4	34.1	30.8	27.1	25.5
Money and credit (end of period)							
Reserve money	6.6	11.3	51.9	41.1	50.9	18.6	17.6
Broad money	10.4	22.3	27.8	32.9	42.3	26.0	21.1
Commercial banks' 3-month lending rate (in percent)	22.5	17.5	18.3	17.1	18.6	...	...
Central government operations (in percent of GDP)							
Revenue and grants	17.8	15.4	17.8	18.0	20.1	20.2	21.1
<i>Of which: tax revenue 2/</i>	14.0	14.0	14.3	14.5	16.0	16.4	16.8
Expenditure and net lending 3/	18.9	17.1	19.9	20.0	22.4	21.6	22.1
Overall balance on a cash basis	-1.5	-1.6	-2.0	-2.1	-2.2	-1.4	-1.0
Underlying balance 4/	-3.6	-1.4	-2.3	-2.3	-3.0	-1.9	-1.7
Government and government-guaranteed debt (in percent of GDP)	40.9	32.4	24.3	18.7	17.4	15.8	14.6
Share of foreign currency debt (in percent)	93.5	93.0	90.8	88.2	88.0	85.5	81.3
External sector 5/							
Exports of goods and services (in millions of U.S. dollars)	903	1,071	1,416	1,510	1,777	1,896	2,168
Imports of goods and services (in millions of U.S. dollars)	-1,406	-1,628	-2,124	-2,536	-3,589	-4,671	-5,641
Exports of goods and services (percentage change)	29.5	18.5	32.2	6.7	17.6	6.7	14.4
Imports of goods and services (percentage change)	27.0	15.8	30.5	19.4	41.5	30.1	20.8
Current account (in percent of GDP) 1/	-6.8	-0.5	-1.0	-1.8	-6.4	-9.7	-10.8
FDI (net, in millions of U.S. dollars)	121	246	233	450	701	815	962
External debt-to-exports ratio (NPV, in percent)	60	59	60	72	67	46	43
Debt service ratio (in percent of exports of goods and services) 6/	15.6	8.9	4.4	3.9	2.9	2.9	2.6
Gross international reserves (in millions of U.S. dollars) 7/	502	547	667	1,072	1,657	1,836	1,968
Import cover 8/	3.7	3.1	3.2	3.6	4.3	3.9	3.7
Nominal effective exchange rate 9/	-4.6	13.4	11.7	15.6	14.1	...	...
Real effective exchange rate 9/	-2.6	8.6	5.1	14.7	12.6	...	...
End-of-period exchange rate (dram per dollar)	566	486	450	364	304	...	...
Average exchange rate (dram per dollar)	579	533	458	416	342	...	...
Memorandum item:							
Population (in millions)	3.212	3.214	3.223	3.231	3.280	...	...

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

1/ The 2004-2006 external current account figures were revised following changes in methodology.

2/ Tax revenues in 2007 include 0.2 percent of GDP in tax arrears paid by Armentel, which were not part of the official target.

3/ Including the gas subsidy during 2006-08.

4/ Overall balance excluding grants and external interest payments.

5/ With the exception of gross international reserves, figures for 2007 are estimates.

6/ Private external debt included since 2006.

7/ Excluding the special privatization account (SPA).

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

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

Table 3. Armenia: Central Government Operations, 2006–09
(In billions of drams)

	2006	2007	2008		2009				2009	
	Jan.-Dec.	Jan.-Dec.	Jan.-Dec.		Q1	Q2	Q3	Q4	Jan.-Dec.	
	Act.	Act.	IMF Proj.	Budg.	Proj.	Proj.	Proj.	Proj.	IMF Proj.	MTEF
Total revenue and grants	477.2	632.5	740.5	724.0	172.1	200.6	225.1	281.6	879.4	878.7
Total revenue	465.1	609.1	720.0	689.1	166.2	194.0	217.1	265.8	843.2	843.1
Tax revenues	383.8	504.3	602.8	575.1	130.7	160.7	183.6	225.0	700.0	703.3
VAT	165.9	248.0	...	...	...	...	...	...	...	...
Profits, simplified and presumptive	88.1	103.4	...	...	...	...	...	...	...	...
Personal income tax	35.5	46.8	...	...	...	...	...	...	...	...
Customs duties	18.3	24.0	...	...	...	...	...	...	...	...
Other	76.1	82.1	...	...	...	...	...	...	...	...
Social contributions	73.3	85.1	104.9	104.9	28.3	31.6	32.2	36.3	128.4	128.4
Other revenue	7.9	19.6	12.2	9.0	7.2	1.7	1.3	4.5	14.8	11.3
Grants	12.1	23.5	20.6	34.9	5.8	6.6	8.0	15.8	36.2	35.6
Total expenditure	531.2	706.1	792.2	816.1	172.5	226.2	236.1	284.6	919.4	924.9
Expense	442.9	541.6	633.7	649.1	148.6	185.7	175.5	225.1	734.8	728.8
Wages 1/	49.8	61.3	80.6	80.6	...	...	...	...	...	...
Pensions	20.1	21.1	4.6	4.6	...	...	...	...	7.0	...
Subsidies	39.1	58.9	37.0	37.0	...	...	...	...	...	...
Of which : gas subsidy	22.7	37.4	16.1	16.1	...	...	...	...	0.0	...
Interest	9.0	10.0	11.0	11.0	...	...	...	...	16.0	...
Social allowances and pensions	152.5	183.7	210.4	210.4	...	...	...	...	239.0	...
Of which : social insurance	71.0	85.8	156.6	156.6	...	...	...	...	180.1	...
Goods and services	172.4	206.7	133.2	133.2	...	...	...	...	...	...
Grants	...	...	47.6	47.6	...	...	...	...	...	...
Other expenditure	...	...	109.3	124.7	...	...	...	...	...	...
Transactions in non-financial assets	88.4	164.5	158.5	167.0	23.9	40.6	60.6	59.5	184.5	196.1
Acquisition of non-financial assets	104.2	183.3	166.5	175.0	26.9	44.5	63.1	63.4	197.9	198.1
Disposals of non-financial assets	15.9	18.9	8.0	8.0	3.0	3.9	2.5	3.8	13.3	2.0
Overall balance (above-the-line)	-54.0	-73.5	-51.6	-92.1	-0.4	-25.6	-11.0	-3.0	-39.9	-46.2
Statistical discrepancy	-2.6	4.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance (below-the-line)	-56.7	-69.4	-51.6	-92.1	-0.4	-25.6	-11.0	-3.0	-39.9	-46.2
Deficit/Financing	56.7	69.4	51.6	92.1	0.4	25.6	11.0	3.0	39.9	46.2
Domestic financing	44.8	30.6	32.2	62.6	3.7	18.4	13.6	-21.0	14.6	27.7
Banking system	-9.3	-6.4	1.7	10.0	2.2	18.6	13.9	-20.8	13.9	5.1
CBA	-12.7	-16.2	-10.8	...	-15.9	15.5	11.0	-23.7	...	...
Commercial Banks	3.4	9.9	12.5	...	18.1	3.1	2.9	2.9	...	...
Nonbanks	54.1	37.0	30.5	52.6	1.4	-0.2	-0.3	-0.3	0.6	22.6
Privatization proceeds	50.0	44.2	16.1	29.4	0.0	0.0	0.0	0.0	0.0	0.0
T-Bills	4.8	-2.8	5.9	25.0	2.0	0.3	0.3	0.3	3.0	25.0
Promissory note/other	-0.1	-1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending	-0.5	-3.4	-1.8	-1.8	-0.6	-0.6	-0.6	-0.6	-2.4	-2.4
External financing	11.8	38.8	19.4	29.5	-3.3	7.2	-2.6	24.0	25.3	18.5
Gross inflow	34.9	64.5	48.8	58.8	7.2	16.5	7.2	33.4	64.4	...
Amortization due	-7.1	-6.0	-4.8	-4.8	-2.3	-1.2	-1.8	-1.3	-6.5	...
Net lending	-16.0	-19.7	-24.5	-24.5	-8.1	-8.1	-8.1	-8.1	-32.5	-32.5
Memorandum items										
Underlying balance 2/	-62.4	-93.6	-68.6	-123.5	-5.2	-31.2	-18.0	-17.7	-72.0	-77.7

Table 3. Armenia: Central Government Operations, 2006–09 (continued)
(In percent of GDP, unless otherwise specified)

	2006	2007	2008		2009				2009	
	Jan.-Dec.	Jan.-Dec.	Jan.-Dec.		Q1	Q2	Q3	Q4	Jan.-Dec.	
	Act.	Act.	IMF Proj.	Budg.	Proj.	Proj.	Proj.	Proj.	IMF Proj.	MTEF
Total revenue and grants	18.0	20.1	20.2	20.6	4.1	4.8	5.4	6.8	21.1	21.1
Total revenue	17.5	19.3	19.6	19.6	4.0	4.7	5.2	6.4	20.2	20.2
Tax revenues	14.5	16.0	16.4	16.3	3.1	3.9	4.4	5.4	16.8	16.9
VAT	6.2	7.9	...	...	...	...	...	...	...	...
Profits, simplified and presumptive	3.3	3.3	...	...	...	...	...	...	...	...
Personal income tax	1.3	1.5	...	...	...	...	...	...	...	...
Customs duties	0.7	0.8	...	...	...	...	...	...	...	...
Other	2.9	2.6	...	...	...	...	...	...	...	...
Social contributions	2.8	2.7	2.9	3.0	0.7	0.8	0.8	0.9	3.1	3.1
Other revenue	0.3	0.6	0.3	0.3	0.2	0.0	0.0	0.1	0.4	0.3
Grants	0.5	0.7	0.6	1.0	0.1	0.2	0.2	0.4	0.9	0.9
Total expenditure	20.0	22.4	21.6	23.2	4.1	5.4	5.7	6.8	22.1	22.2
Expense	16.7	17.2	17.3	18.4	3.6	4.5	4.2	5.4	17.6	17.5
Wages 1/	1.9	1.9	2.2	2.3	...	...	...	...	...	...
Pensions	0.8	0.7	0.1	0.1	...	...	...	...	0.2	...
Subsidies	1.5	1.9	1.0	1.1	...	...	...	...	...	...
Of which : gas subsidy	0.9	1.2	0.4	0.5	...	...	...	...	0.0	...
Interest	0.3	0.3	0.3	0.3	...	...	...	...	0.4	...
Social allowances and pensions	5.7	5.8	5.7	6.0	...	...	...	...	5.7	...
Of which : social insurance	2.7	2.7	4.3	4.5	...	...	...	...	...	...
Goods and services	6.5	6.6	3.6	3.8	...	...	...	...	...	...
Grants	...	...	1.3	1.4	...	...	...	...	...	...
Other expenditure	...	...	3.0	3.5	...	...	...	...	...	...
Transactions in non-financial assets	3.3	5.2	4.3	4.7	0.6	1.0	1.5	1.4	4.4	4.7
Acquisition of non-financial assets	3.9	5.8	4.5	5.0	0.6	1.1	1.5	1.5	4.7	4.8
Disposals of non-financial assets	0.6	0.6	0.2	0.2	0.1	0.1	0.1	0.1	0.3	0.0
Overall balance (above-the-line)	-2.0	-2.3	-1.4	-2.6	0.0	-0.6	-0.3	-0.1	-1.0	-1.1
Statistical discrepancy	-0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance (below-the-line)	-2.1	-2.2	-1.4	-2.6	0.0	-0.6	-0.3	-0.1	-1.0	-1.1
Deficit/Financing	2.1	2.2	1.4	2.6	0.0	0.6	0.3	0.1	1.0	1.1
Domestic financing	1.7	1.0	0.9	1.8	0.1	0.4	0.3	-0.5	0.4	0.7
Banking system	-0.4	-0.2	0.0	0.3	0.1	0.4	0.3	-0.5	0.3	0.1
CBA	-0.5	-0.5	-0.3	...	-0.4	0.4	0.3	-0.6	...	...
Commercial Banks	0.1	0.3	0.3	...	0.4	0.1	0.1	0.1	...	...
Nonbanks	2.0	1.2	0.8	1.5	0.0	0.0	0.0	0.0	0.0	0.5
Privatization proceeds	1.9	1.4	0.4	0.8	0.0	0.0	0.0	0.0	0.0	0.0
T-Bills	0.2	-0.1	0.2	0.7	0.0	0.0	0.0	0.0	0.1	0.6
Promissory note/other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending	0.0	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	-0.1	-0.1
External financing	0.4	1.2	0.5	0.8	-0.1	0.2	-0.1	0.6	0.6	0.4
Gross inflow	1.3	2.0	1.3	1.7	0.2	0.4	0.2	0.8	1.5	...
Amortization due	-0.3	-0.2	-0.1	-0.1	-0.1	0.0	0.0	0.0	-0.2	...
Net lending	-0.6	-0.6	-0.7	-0.7	-0.2	-0.2	-0.2	-0.2	-0.8	-0.8
Memorandum items										
Nominal GDP	2,656	3,149	3,672	3,520	4,169	4,169	4,169	4,169	4,169	4,169
Underlying balance 2/	-2.3	-3.0	-1.9	-3.5	-0.1	-0.7	-0.4	-0.4	-1.7	-1.9
Overall balance excl. gas subsidy 3/	-1.9	-1.9	-1.4	-2.6	...	...	...	...	-1.8	-1.9

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

1/ Relative to the budget, the staff presentation reclassifies estimated military wages from Other goods and services and Other expenditure to Wages.

2/ Underlying balance is defined as overall balance before grants, and excluding external interest payments.

3/ Old definition.

Table 4. Armenia: Monetary Accounts, 2006–09
(In billions of AMD, unless otherwise indicated)

	2006		2007				2008				2009			
	Dec.	Mar.	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	Mar.	June	Sep.	Dec.	
	Act.	Act.	Act.	Act.	Act.	Act.	Act.	Est. 1/	Proj. 1/	Proj. 1/	Proj. 1/	Proj. 1/	Proj. 1/	
Central Bank of Armenia														
Net foreign assets	321.8	317.8	349.1	383.3	515.4	423.0	417.0	449.5	486.5	460.9	470.8	487.2	522.7	
Net international reserves	329.9	326.1	357.3	393.3	525.6	434.6	429.0	462.1	499.7	474.1	484.0	500.3	535.9	
Medium-and long-term	-8.0	-8.3	-8.2	-10.0	-10.3	-11.6	-12.0	-12.6	-13.2	-13.2	-13.1	-13.1	-13.1	
Net domestic assets	-38.8	-53.0	-61.8	-50.3	-88.2	-42.2	-4.3	-3.0	19.9	10.4	31.7	52.8	73.0	
Claims on general government (net)	-57.7	-66.6	-93.8	-87.9	-89.8	-124.7	-121.6	-113.1	-99.0	-114.9	-99.4	-88.4	-112.1	
Of which: central government (net)	-16.2	-30.2	-39.9	-32.6	-51.5	-90.7	-84.8	-76.4	-62.3	-78.1	-62.6	-51.7	-75.3	
Claims on banks	7.9	15.4	13.3	23.8	24.6	30.4	41.9	41.9	42.5	44.2	44.8	45.9	46.8	
KfW	11.9	12.0	12.6	13.2	14.4	16.0	17.3	17.9	18.5	18.5	18.5	18.5	18.4	
Monetary instruments (net) excluding CBA bills	-4.0	3.4	0.7	10.5	10.2	14.4	24.7	24.0	24.0	25.7	26.4	27.5	28.4	
CBA bills	-39.0	-52.1	-45.3	-49.9	-49.0	-36.0	-17.7	-9.3	-1.3	0.0	0.0	0.0	0.0	
Other items (net)	50.0	50.4	64.0	63.7	25.9	88.0	93.1	77.5	77.8	81.1	86.2	95.2	138.2	
Reserve money	283.0	264.8	287.3	333.0	427.1	380.8	412.7	446.6	506.4	471.3	502.6	540.0	595.8	
Currency issue	226.8	216.1	241.9	278.6	350.3	325.8	343.3	368.2	413.4	399.9	411.0	430.3	477.4	
Deposits	56.2	48.7	45.5	54.4	76.8	55.1	69.4	78.4	93.0	71.4	91.6	109.6	118.3	
Banking system														
Net foreign assets	332.5	322.9	353.4	353.3	369.6	347.7	344.0	354.4	363.9	338.3	332.1	332.3	357.9	
Net domestic assets	153.2	160.0	169.7	228.6	321.8	331.0	368.1	413.7	507.2	510.1	547.4	612.6	696.6	
Claims on government (net)	-31.8	-42.3	-70.1	-64.0	-54.0	-80.4	-78.2	-67.3	-50.8	-48.5	-29.9	-16.0	-36.8	
Of which: claims on central government (net)	9.7	-5.8	-16.3	-8.8	-15.7	-46.4	-41.4	-30.6	-14.1	-11.8	6.8	20.7	-0.1	
Claims on rest of the economy	241.5	271.6	306.3	371.2	429.8	485.7	550.6	611.8	699.6	742.3	845.4	934.7	1,050.2	
Other items (net)	-56.4	-69.3	-66.5	-78.6	-54.0	-74.3	-104.3	-130.8	-141.6	-183.7	-268.1	-306.0	-316.8	
Broad money	485.7	482.9	523.0	581.9	691.3	678.7	712.1	768.1	871.1	848.3	879.5	945.0	1,054.5	
Currency in circulation	211.5	201.7	227.0	260.3	326.0	302.5	320.5	344.2	389.4	375.9	387.0	406.3	453.4	
Deposits	274.3	281.3	296.0	321.6	365.3	376.1	391.6	423.9	481.7	472.5	492.5	538.6	601.1	
Domestic currency	130.9	145.4	158.4	186.3	235.0	236.4	246.4	278.0	329.2	328.2	347.4	387.4	442.9	
Foreign currency	143.4	135.8	137.6	135.3	130.3	139.8	145.2	145.9	152.4	144.2	145.1	151.2	158.2	
Memorandum items														
Exchange rate (in drams per U.S. dollar, end of period)	363.5	362.1	341.0	335.8	304.2	...	...	...	...	...	...	...	...
Program e-rate	...	...	...	...	...	304.2	304.2	304.2	304.2	304.2	304.2	304.2	304.2
NIR (in millions of U.S. dollars) 2/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	...	...
NIR (in millions of U.S. dollars) 3/	842.5	833.3	987.9	1,083.4	1,380.7	1,324.3	1,279.4	1,407.6	1,517.9	1,440.3	1,469.5	1,516.8	1,610.0	
NDA of the CBA (in billions of drams) 4/	0.0	0.0	0.0	0.0	0.0	-42.2	-4.3	-3.0	19.9	10.4	31.7	52.8	73.0	
12-month change in reserve money (in percent)	41.1	40.0	44.3	44.1	50.9	43.8	43.6	34.1	18.6	23.8	21.8	20.9	17.6	
12-month change in broad money (in percent)	32.9	34.7	41.1	43.5	42.3	40.5	36.2	32.0	26.0	25.0	23.5	23.0	21.1	
12-month change in private sector credit (in percent)	28.2	34.7	39.8	64.6	78.0	78.8	79.8	64.8	62.8	52.8	53.5	52.8	50.1	
Velocity of broad money (end of period)	5.5	5.6	5.4	5.1	4.6	4.7	4.7	4.5	4.2	4.4	4.4	4.2	4.0	
Money multiplier	1.7	1.8	1.8	1.7	1.6	1.8	1.7	1.7	1.7	1.8	1.8	1.8	1.8	
Dollarization in bank deposits 5/	52.3	48.3	46.5	42.1	35.7	37.2	37.1	34.4	31.6	30.5	29.5	28.1	26.3	
Dollarization in broad money 6/	29.5	28.1	26.3	23.3	18.9	20.6	20.4	19.0	17.5	17.0	16.5	16.0	15.0	
Currency in circulation in percent of deposits	77.1	71.7	76.7	80.9	89.2	80.4	81.8	81.2	80.9	79.6	78.6	75.4	75.4	
Stock of FCD (in millions of U.S. dollars)	394.5	375.1	403.6	403.0	428.4	459.4	477.4	479.7	501.1	474.0	477.0	497.0	519.9	
Banking system financing of the central government (cumulative)	-19.4	-15.6	-26.0	-18.5	-25.5	-30.7	-25.7	-14.8	1.7	2.2	20.9	34.7	13.9	

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

1/ At program exchange rate of 304.22 dram per U.S. dollar for 2008 and 2009.

2/ At actual exchange rates, excluding the Special Privatization Account and foreign currency reserve money.

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

4/ Defined as reserve money minus NIR plus medium- and long-term liabilities.

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

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

Table 5. Armenia: Balance of Payments, 2006–12
(In millions of U.S. dollars, unless otherwise indicated)

	2006	2007	2008	2009	2010	2011	2012
		Est.			Projections		
Current account	-117	-589	-1,172	-1,517	-1,706	-1,718	-1,675
Trade balance	-896	-1,600	-2,466	-3,110	-3,436	-3,624	-3,804
Exports, fob	1,025	1,197	1,269	1,403	1,613	1,839	2,097
Imports, fob	-1,921	-2,797	-3,735	-4,513	-5,050	-5,464	-5,901
Services (net)	-130	-213	-310	-363	-385	-343	-327
Credits	485	580	626	765	918	1,092	1,224
Debits	-615	-793	-936	-1,128	-1,303	-1,436	-1,550
Income (net)	215	279	398	497	531	563	597
Transfers (net)	694	945	1,205	1,460	1,583	1,687	1,858
Private	614	850	1,140	1,410	1,551	1,660	1,759
Official	80	94	65	50	32	27	99
Capital and financial account	558	1,228	1,371	1,666	1,803	1,896	1,795
Capital transfers (net)	86	143	173	197	203	164	0
Foreign direct investment (net)	450	701	815	962	1,106	1,272	1,374
Portfolio investment (net)	9	9	8	8	8	8	0
Public sector (net)	68	133	148	167	230	255	218
Disbursements	83	149	163	189	254	283	245
Amortization	-16	-17	-14	-22	-24	-27	-27
Other capital (net)	-55	242	227	333	256	196	203
Errors and omissions	-16	-41	0	0	0	0	0
Overall balance	426	597	199	150	96	178	120
Financing	-426	-597	-201	-154	-100	-182	-120
Gross international reserves (increase: -)	-405	-585	-179	-132	-80	-162	-99
Use of Fund credit, net	-21	-14	-23	-23	-22	-22	-23
Disbursements	10	10	3	...	...	...	...
Repurchases/repayments	-31	-24	-26	-23	-22	-22	-23
Exceptional financing 1/	1	1	1	2	2	2	2
Financing gap	...	0	2	4	4	4	0
Memorandum items:							
Current account (in percent of GDP)	-1.8	-6.4	-9.7	-10.8	-10.7	-9.5	-8.3
Trade balance (in percent of GDP)	-14.0	-17.3	-20.4	-22.2	-21.5	-20.1	-18.9
Gross international reserves (end of period)	1,072	1,657	1,836	1,968	2,049	2,210	2,309
In months of next year's imports	3.6	4.3	3.9	3.7	3.6	3.6	3.4
Merchandise export growth, percent change	2.0	16.7	6.1	10.5	15.0	14.0	14.0
Merchandise import growth, percent change	20.6	45.6	33.5	20.8	11.9	8.2	8.0
Nominal external debt 2/	1,206	1,582	1,652	1,707	1,866	2,081	2,251
Nominal external debt stock (in percent of GDP) 2/	19	17	14	12	12	12	11
NPV of external debt in percent of exports 3/	72	67	46	43	40	38	36
External debt service in percent of exports 2/	3.9	2.9	2.9	2.6	2.3	2.2	2.1

Sources: Armenian authorities; and Fund staff estimates.

1/ Debt relief from the United Kingdom through 2015 (in respect of IDA credits).

2/ Starting from 2006, based on government, government-guaranteed, and private sector medium- and long-term debt.

3/ Based on low-income country debt sustainability analysis.

Table 6. Armenia: Medium-Term Macroeconomic Framework, 2007–12

	2007	2008	2009	2010	2011	2012
		Projections				
(In percent of GDP, unless otherwise specified)						
National income and prices						
Real GDP growth (percent change)	13.8	10.0	8.0	7.0	6.0	6.0
Gross domestic product (in millions of U.S. dollars)	9,228	12,069	14,019	15,965	18,008	20,117
Gross national income per capita (in U.S. dollars)	2,928	3,820	4,426	5,005	5,606	6,222
CPI inflation, end-of-period (annual percent change)	6.6	7.5	5.0	4.0	4.0	4.0
Investment and saving						
Investment	37.2	36.8	36.3	36.1	35.9	35.6
Government	5.8	4.5	4.7	4.8	4.8	4.8
Other	31.4	32.2	31.5	31.3	31.1	30.8
National savings	30.8	27.1	25.5	25.4	26.3	27.3
Government	3.5	3.1	3.8	3.7	3.8	3.4
Other	27.4	23.9	21.7	21.7	22.5	23.9
Government operations						
Revenue and grants	20.1	20.2	21.1	21.4	21.8	22.2
<i>Of which:</i> tax revenue	16.0	16.4	16.8	17.2	17.6	18.0
grants 1/	0.7	0.6	0.9	0.7	0.5	0.5
Expenditure and net lending	22.4	21.6	22.1	22.5	22.8	23.6
<i>Of which:</i> social expenditure 2/	6.3	6.3	6.4	6.5	6.6	6.6
Current expenditure	17.2	17.3	17.6	17.9	18.3	18.9
Capital expenditure	5.8	4.5	4.7	4.8	4.8	4.8
Net lending	-0.6	-0.2	-0.3	-0.3	-0.3	-0.1
Overall balance (including grants)	-2.3	-1.4	-1.0	-1.1	-1.0	-1.4
Underlying balance 3/	-3.0	-1.9	-1.7	-1.6	-1.5	-1.8
Domestic financing	1.0	0.9	0.4	0.4	0.4	1.0
External financing	1.2	0.5	0.6	0.7	0.6	0.4
Government and government-guaranteed debt	17.4	15.8	14.6	14.3	14.8	15.5
External sector 4/						
Exports of goods and services	-19.3	-15.7	-15.5	-15.9	-16.3	-16.5
Imports of goods and services	38.9	38.7	40.2	39.8	38.3	37.0
Current account (in percent of GDP)	-6.4	-9.7	-10.8	-10.7	-9.5	-8.3
Current account (in millions of U.S. dollars)	-589	-1,172	-1,517	-1,706	-1,718	-1,675
Capital and financial account (in millions of U.S. dollars)	1,228	1,371	1,666	1,803	1,896	1,795
<i>Of which:</i> direct foreign investment	701	815	962	1,106	1,272	1,374
public sector disbursements	149	163	189	254	283	245
Change in gross international reserves (in millions of U.S. dollars) 5/	-585	-179	-132	-80	-162	-99
Arrears and debt relief (in millions of U.S. dollars)	1	1	2	2	2	2
Financing/gap (in millions of U.S. dollars)	0	2	4	4	4	0
<i>Of which:</i> IMF	0	2	4	4	4	0
World Bank	0	0	0	0	0	0
Gross international reserves in months of imports	4.3	3.9	3.7	3.6	3.6	3.4

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

1/ For 2008-09, the figures include projections for disbursements under the U.S. Millennium Challenge Account.

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

3/ Underlying balance is defined as overall balance before grants and excluding external interest payments.

4/ With the exception of gross international reserves, figures for 2007 are estimates.

5/ A negative figure indicates an increase.

Table 7. Armenia: Financial Soundness Indicators for the Banking Sector, 2004–08
(In percent, unless otherwise indicated)

	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
	2004	2005	2006	2007			2008		
Capital adequacy									
Total regulatory capital to risk-weighted assets	32.3	33.7	34.9	35.3	32.7	31.4	30.1	27.0	26.0
Tier I regulatory capital to risk-weighted assets	30.2	31.7	32.7	33.4	31.4	30.2	29.0	26.1	...
Capital (net worth) to assets	17.8	21.5	22.9	23.2	23.9	22.3	22.5	22.7	22.1
Asset composition									
Sectoral distribution of loans (billions of drams)									
Industry (excluding energy sector)	29.0	30.4	34.3	39.4	43.0	47.8	49.1	57.4	59.9
Energy sector	6.6	8.7	5.0	5.4	6.4	10.1	7.2	7.4	8.3
Agriculture	8.6	11.3	14.2	16.4	18.1	19.0	22.4	24.1	30.3
Construction	5.3	7.9	11.5	13.1	14.8	17.4	22.0	25.6	31.7
Transport and communication	1.2	3.7	3.9	4.2	4.5	4.4	5.8	7.1	10.6
Trade/commerce	31.1	42.2	49.6	55.4	60.3	75.5	86.8	97.6	109.6
Sectoral distribution of loans to total loans (percent of total)									
Industry (excluding energy sector)	22.2	17.0	16.2	15.4	14.8	13.5	11.9	12.4	11.3
Energy sector	5.0	4.8	2.3	2.1	2.2	2.9	1.7	1.6	1.6
Agriculture	6.6	6.3	6.7	6.4	6.2	5.4	5.4	5.2	5.7
Construction	4.0	4.4	5.5	5.1	5.1	4.9	5.3	5.5	6.0
Transport and communication	0.9	2.0	1.9	1.6	1.5	1.2	1.4	1.5	2.0
Trade/commerce	23.8	23.5	23.4	21.7	20.7	21.4	21.1	21.1	20.8
Foreign exchange loans to total loans	70.4	63.7	52.8	46.3	42.5	42.3	40.7	39.0	37.5
Asset quality									
Nonperforming loans (billions of drams)									
Watch (up to 90 days past due)	3.1	3.8	6.0	7.3	8.6	10.6	10.3	18.7	19.2
Substandard (91-180 days past due)	1.5	2.9	3.6	5.4	5.5	7.0	5.8	13.3	11.9
Doubtful (181-270 days past due)	0.4	0.5	1.0	1.1	2.1	2.2	1.3	2.0	4.8
Loss (>270 days past due)	1.1	0.5	1.4	0.9	0.9	1.4	3.1	3.3	2.6
Nonperforming loans to gross loans	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Provisions to nonperforming loans	2.1	1.9	2.5	2.8	2.8	2.9	2.4	4.0	3.6
Spread between highest and lowest rates of interbank borrowing in AMD	77.0	70.7	64.3	54.7	54.4	53.8	66.6	43.9	46.4
Spread between highest and lowest rates of interbank borrowing in foreign currency	2.0	3.7	3.0	1.4	1.3	1.3	0.5	5.0	7.0
	1.0	1.0	2.3	0.0	N/A	0.0	0.0	0.0	0.0
Earnings and profitability									
ROA (profits to period average assets)	3.2	3.1	3.6	3.5	3.6	3.8	3.4	3.0	2.8
ROE (profits to period average equity)	18.4	15.5	15.9	15.2	15.6	16.7	15.0	13.0	12.4
Interest margin to gross income	44.2	41.1	47.1	48.6	49.1	48.6	47.9	48.8	48.2
Interest income to gross income	63.7	59.8	66.3	69.9	69.6	69.0	68.6	74.4	74.0
Noninterest expenses to gross income	46.5	49.7	45.1	45.5	44.3	43.2	44.5	42.1	43.5
Liquidity									
Liquid assets to total assets	47.1	44.2	41.2	41.0	36.7	34.7	33.7	30.5	27.1
Liquid assets to total short-term liabilities	98.7	110.5	106.1	109.9	98.6	93.7	98.2	101.0	95.6
Customer deposits to total (non-interbank) loans	177.3	140.5	130.8	119.3	118.3	105.9	106.2	96.4	91.4
Foreign exchange liabilities to total liabilities	73.3	66.8	56.0	52.4	51.0	48.7	48.3	48.7	50.0
Sensitivity to market risk									
Gross open positions in foreign exchange to capital	7.4	4.9	4.4	4.3	4.8	5.5	8.8	6.9	4.8

Source: Central Bank of Armenia.

Table 8. Armenia: Fund Disbursements and Timing of Reviews under the Prospective Three-Year Low-Access PRGF Arrangement, 2008-11

Date of Availability	Conditions	Amount (In millions of SDR)
17 November, 2008	Board approval of the low-access PRGF arrangement	1.31
15 May, 2009	Completion of first review (end-December 2008 quantitative performance criteria and relevant structural performance criteria)	1.31
15 November, 2009	Completion of second review (end-June 2009 quantitative performance criteria and relevant structural performance criteria)	1.31
15 May, 2010	Completion of third review (end-December 2009 quantitative performance criteria and relevant structural performance criteria)	1.31
15 November, 2010	Completion of fourth review (end-June 2010 quantitative performance criteria and relevant structural performance criteria)	1.31
15 May, 2011	Completion of fifth review (end-December 2010 quantitative performance criteria and relevant structural performance criteria)	1.31
1 November, 2011	Completion of sixth review (end-June 2011 quantitative performance criteria and relevant structural performance criteria)	1.34

Source: Fund staff estimates.

Table 9. Armenia: Indicators of Capacity to Repay the Fund, 2007–15

	2007	2008	2009	2010	2011	2012	2013	2014	2015
	Actual				Projections				
Fund obligations based on existing credit									
(in millions of SDRs)									
Principal	15.4	17.1	15.2	14.1	14.4	14.8	11.1	7.4	4.3
Charges and interest	0.5	0.5	0.4	0.3	0.3	0.2	0.1	0.1	0.0
Fund obligations based on existing and prospective credit									
(in millions of SDRs)									
Principal	15.4	17.1	15.2	14.1	14.4	14.8	11.1	7.8	5.2
Charges and interest	0.5	0.5	0.4	0.4	0.3	0.2	0.2	0.1	0.1
Total obligations based on existing and prospective credit									
In millions of SDRs	16.0	17.6	15.6	14.5	14.7	15.0	11.2	7.9	5.3
In millions of US\$	24.4	26.4	23.5	22.0	22.3	22.7	17.0	12.0	8.0
In percent of Gross International Reserves	1.5	1.4	1.2	1.1	1.0	1.0	0.7	0.5	0.3
In percent of exports of goods and services	1.2	1.2	1.0	0.8	0.7	0.7	0.5	0.3	0.2
In percent of debt service 1/	46.9	48.3	41.5	37.2	34.8	32.3	23.8	16.7	10.1
In percent of GDP	0.3	0.2	0.2	0.1	0.1	0.1	0.1	0.0	0.0
In percent of quota	17.3	19.1	17.0	15.7	16.0	16.3	12.2	8.6	5.7
Outstanding Fund credit 1/									
In millions of SDRs	99.9	87.5	74.9	63.4	51.6	36.9	25.8	18.0	12.8
In billions of US\$	0.15	0.13	0.11	0.10	0.08	0.06	0.04	0.03	0.02
In percent of Gross International Reserves	9.2	7.2	5.7	4.7	3.5	2.4	1.7	1.2	0.8
In percent of exports of goods and services	8.6	6.9	5.2	3.8	2.7	1.7	1.0	0.6	0.4
In percent of debt service 1/	293.5	240.6	199.4	163.1	122.0	79.4	54.7	38.2	24.7
In percent of GDP	1.7	1.1	0.8	0.6	0.4	0.3	0.2	0.1	0.1
In percent of quota	108.6	95.1	81.4	68.9	56.1	40.1	28.1	19.6	13.9
Net use of Fund credit (millions of SDRs)									
Disbursements	-8.9	-12.5	-12.6	-11.5	-11.8	-14.8	-11.1	-7.8	-5.2
Repayments and Repurchases	6.6	4.6	2.6	2.6	2.7	0.0	0.0	0.0	0.0
Repayments and Repurchases	15.4	17.1	15.2	14.1	14.4	14.8	11.1	7.8	5.2
Memorandum items:									
Nominal GDP (in millions of US\$)	9,228.2	12,069.2	14,019.0	15,965.0	18,008.0	20,117.2	22,473.3	24,627.2	26,987.5
Exports of goods and services (in millions of US\$)	1,776.7	1,895.6	2,168.0	2,531.5	2,931.8	3,320.4	3,736.3	4,205.5	4,720.3
Gross International Reserves (in millions of US\$)	1,656.9	1,836.0	1,968.0	2,048.5	2,210.3	2,309.5	2,292.4	2,285.7	2,308.5
Debt service (in millions of US\$) 1/	52.1	54.7	56.7	59.0	64.2	70.4	71.6	71.6	78.7
Quota (millions of SDRs)	92.0	92.0	92.0	92.0	92.0	92.0	92.0	92.0	92.0

Sources: IMF staff estimates and projections.

1/ Total debt service includes IMF repurchases and repayments.

Table 10. Armenia: Quantitative Targets, 2008–09 1/
(End of period ceilings on stocks, unless otherwise specified)

	2007	2008		2009			
	Dec.	Jun.	Dec.	Mar.	Jun.	Sep.	Dec.
	Act.	Act.	Prog. 2/	Prog. 5/	Prog. 2/	Prog. 5/	Prog. 2/
	(In billions of drams)						
Net domestic assets of the CBA 3/	-95.5	-8.0	19.9	10.4	31.7	52.8	73.0
Net banking system credit to the general government	-54.0	-78.2	-50.8	-48.5	-29.9	-16.0	-36.8
Underlying fiscal balance on a cash basis (floor) 4/	-93.6	-11.0	-68.6	-5.2	-36.4	-54.4	-72.0
Reserve money 5/	427.1	412.7	506.4	471.3	502.6	540.0	595.8
	(In millions of dollars)						
Contracting or guaranteeing of new nonconcessional external debt 4/ 6/	0	0	0	50	50	50	50
External arrears (continuous criterion)	0	0	0	0	0	0	0
Net official international reserves (floor)	1403.7	1330.8	1517.9	1440.3	1469.5	1516.8	1610.0

1/ All items as defined in Country Report No. 05/422 and its subsequent amendments, with the exception of the underlying balance, which is defined as the overall balance excluding grants and external interest payments.

2/ Performance criterion.

3/ At program exchange rates (357 dram per dollar in 2007 and 304.2 dram per dollar in 2008 and 2009).

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.

ATTACHMENT I. ARMENIA: LETTER OF INTENT

September 16, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn:

In support of its economic reform program, the Government of the Republic of Armenia requests a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) in an amount equivalent to SDR 9.2 million (10 percent of quota). The low access for this arrangement intends to signal Armenia's status as a mature stabilizer.

Under the three-year PRGF program that expired on May 24, 2008, we have achieved important results. The implementation of prudent monetary and fiscal policies and far-reaching structural reforms have supported strong economic growth, low inflation, rising real incomes, and declining poverty rates. The challenge before us is how to consolidate these gains. While stability is necessary for growth, it is only by boosting the productive potential of the economy that we can make growth sustainable. The new program addresses the unfinished structural reform agenda to fully equip policy frameworks and institutions for the next challenges facing the Armenian economy.

The attached Memorandum of Economic and Financial Policies (MEFP) outlines our broad macroeconomic objectives for 2008-11 and provides specific measures for 2008-09. The focus will be on strengthening the fiscal and monetary policy frameworks, deepening productivity-enhancing structural reforms, reducing barriers to competition, and improving governance. Fiscal reforms aimed at strengthening tax and customs administration are particularly important for the success of these efforts.

The Government believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of the program, but it will take other measures that may become necessary for this purpose. The Government will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. Moreover, after the period of the

PRGF arrangement, and while Armenia has outstanding financial obligations to the Fund from loans on earlier arrangements, the Government will consult with the Fund on Armenia's economic and financial policies from time to time, at the initiative of the Government or at the request of the Managing Director. We expect to complete the first semi-annual review under the proposed arrangement by June 2009.

Very truly yours,

/s/
Tigran Sargsyan
Prime Minister
Republic of Armenia

/s/
Tigran Davtyan
Minister of Finance
Republic of Armenia

/s/
Artur Javadyan
Chairman of the Central Bank
Republic of Armenia

**ATTACHMENT II. ARMENIA: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES
(SEPTEMBER 16, 2008)**

1. This Memorandum sets out the economic and financial policies of the Armenian government for 2009–11, which are aimed at sustaining economic growth and reducing poverty. These policies form the basis for a new three-year Fund-supported program under a low-access PRGF arrangement, signaling Armenia’s status as a mature stabilizer.
2. The new program will build on the substantial progress already achieved under the PRGF-supported arrangement that expired on May 24, 2008. The focus will be on strengthening the fiscal and monetary policy frameworks, deepening productivity-enhancing structural reforms, reducing barriers to competition, and improving governance. Fiscal reforms aimed at strengthening tax and customs administration are critical for the success of these efforts.
3. This Memorandum presents a summary of the performance under the government’s 2005–08 program, outlines the medium-term objectives and policy framework for 2009–11, and sets out specific economic and financial policies for 2008-09. We have reached understandings with Fund staff on a set of macroeconomic targets and structural benchmarks for 2008-09, which are presented in Tables 1 and 2. Policies described in the Memorandum are consistent with our updated Poverty Reduction Strategy Paper (PRSP), renamed Sustainable Development Program (SDP), and the government’s Medium-Term Expenditure Framework for 2009–11. We expect to complete the first semi-annual review under the proposed arrangement by end-June 2009; the second review by end-November 2009, and the third review by end-June 2010.

I. PERFORMANCE UNDER THE 2005–08 PROGRAM

4. The 2005–08 program focused primarily on three objectives: a) maintaining macroeconomic stability through prudent monetary and fiscal policies; b) generating additional domestic resources to finance poverty-reducing and growth-enhancing expenditures; and c) boosting private sector activities by fostering financial sector development, and improving public and corporate governance. To a large measure, these objectives have been achieved.
5. Prudent monetary and fiscal policies and far-reaching structural reforms supported strong economic growth, low inflation, rising real incomes, and declining poverty rates. Over the period 2005–07, GDP growth averaged 13.7 percent per year, and inflation remained below 3 percent on average. At the same time, the overall poverty rate declined from 34.6 percent in 2004 to 26.5 percent in 2006. Despite a rising external current account deficit, which reflected double-digit growth and strong investment activity, gross international reserves increased from 3.1 to 4.3 months of import coverage between 2004 and 2007. Large capital inflows, mostly in the form of FDI, provided the necessary financing, reflecting

improved investment opportunities in the Armenian economy. The increase in external borrowing led to a slight deterioration in external debt indicators, which, however, remain comfortably low.

6. Fiscal prudence was crucial for the success of our program. The overall fiscal deficit was kept at about 2 percent of GDP. The progress achieved with revenue mobilization was used to finance poverty-reducing and growth-enhancing expenditures. The tax revenue ratio was raised from 14 percent of GDP in 2004 to 16 percent of GDP in 2007, and grants and non-tax revenues increased as well. This allowed us to increase expenditure from 17.1 percent of GDP to 22.4 percent of GDP (including the gas subsidy)¹ over the same period, while government debt was reduced from 32.4 percent of GDP to 17.4 percent of GDP.

7. The monetary framework was strengthened with the adoption of an implicit inflation targeting regime in 2006. Moreover, by committing to a preannounced three-year target in 2008, the Central Bank of Armenia (CBA) took an important step toward full-fledged inflation-targeting. Together with a flexible exchange rate, the new framework contributed to our success in maintaining moderate inflation, providing an anchor to inflation expectations in the face of significant external shocks. Monetary policy implementation was greatly enhanced by a more extensive use of indirect instruments, particularly open market operations, which helped improve liquidity management and fostered the development of the money market.

8. Our tax policy during the program period was focused on reducing the scope of tax exemptions. We limited access to the simplified tax regime, with the final objective of eliminating it, and reduced the number of goods exempt from VAT at the border. Presumptive taxes were indexed to the CPI. Additionally, we completed and submitted to Parliament the general part of the tax code. Tax administration reform concentrated on strengthening IT capacity, limiting the interaction between taxpayers and tax officials by eliminating recording commissions, and introducing risk-based audit selection systems. Moreover, we have recently adopted a comprehensive and ambitious medium-term tax reform plan.

9. Structural reforms have improved the financial sector infrastructure and the regulatory and supervisory framework, promoting private sector activity and financial deepening. As a result, financial intermediation almost doubled in relation to GDP since end-2006.

- Key weaknesses in banks' corporate governance were addressed early on in the program, improving accountability and confidence in the banking system. Market transparency, creditor rights, and consumer protection were enhanced through new

¹ The budget figures do not include the gas subsidy.

legislation and the establishment of a credit registry at the CBA as well as a private credit bureau. Financial institutions were strengthened through increased minimum capital requirements, the implementation of the first pillar of Basel II Accord provisions, investments in banks' risk management capacity, and the entry of reputable international commercial banks. Most recently, we adopted legislation on asset securitization and mortgage-backed securities to promote the development of the mortgage market, on Anti-Money Laundering and Combating the Financing of Terrorism, on the disclosure of financial terms of consumer loans and bank deposits, and on the establishment of financial ombudsperson services.

- Financial sector regulation and supervision was strengthened markedly through consolidation and introduction of risk-based supervision, and the recent move to a functional or process-oriented structure, separating the main functions of (i) prudential requirements, (ii) market conduct, and (iii) consumer protection.
- With a view to containing activities in the informal economy and strengthening monetary policy effectiveness, we introduced several measures limiting cash operations and the use of foreign currency. These include improved regulation and supervision of foreign exchange offices, introduction of mandatory point of sales outlets at larger retail establishments, acceptance of credit cards transaction receipts for tax verification purposes, and legislation on cash transaction limits and the electronic payment of salaries.
- In the insurance sector, we adopted legislation fully compliant with the standards of the International Association of Insurance Supervisors. We also implemented by-laws and regulations to improve accounting, auditing, and financial reporting; solvency and reserves; reinsurance; oversight of insurance companies; and procedures for the liquidation of insurance companies. An insurance registry at the CBA was established and is now operational.
- Progress has been achieved in money and capital market development with the adoption of a new securities market law corresponding to the standards of the International Organization of Securities Commissions, the conversion of the Armenian stock exchange (Armex) from a self-regulatory body into a joint stock company, and the takeover of Armex and the central depository by Nasdaq-OMX.

10. The second phase of public sector reform was completed in August 2007. To improve the efficiency and the accountability of the public sector, we introduced new management structures; improved procedures of human resource management and development in civil service; regulated and decentralized service delivery; encouraged public participation in decision-making; and improved communication with the public. Moreover, we have finalized a strategy for the third phase of reforms, which will focus on streamlining the civil service. We have made progress on the development of a new anti-corruption strategy that identifies

specific objectives and performance indicators, with an action plan expected to be finalized in November 2008.

11. Following the reforms initiated in 2000, our efforts to restructure the energy sector have continued. Efficiency gains, lower distribution losses, and improved collection have led to further financial consolidation of privatized companies, contributing to contain tariff adjustments and reducing the need for government support. At the same time, the reliability of electricity, gas, water, and irrigation flows has improved. Plans for the replacement of the nuclear power plant, to be decommissioned in 2016, are under way.

II. PROGRAM OBJECTIVES AND STRATEGY FOR 2009–11

12. The new program builds on our past achievements and our strategy to implement the SDP. Armenia has achieved remarkable results in terms of growth and poverty reduction by opening up its economy, removing barriers to competition, and following sound macroeconomic policies. The challenge before us is how to consolidate these gains. While stability is necessary for growth, it is only by boosting the productive potential of the economy that we can make growth sustainable. The new program addresses the unfinished structural reform agenda to fully equip policy frameworks and institutions for the next challenges facing the Armenian economy.

13. With the past program, we have achieved important results in many areas, but we are aware that additional efforts are needed in several other areas. As we prepare for the transition to full-fledged inflation targeting, the fiscal framework needs to be refined to be more attuned to the needs of stabilization policy and to facilitate the formulation of appropriate policy responses to key fiscal risks. Reforms aimed at enhancing productivity and improving the business climate are necessary to boost the competitiveness of Armenian companies and encourage the emersion of the underground economic activities. In this context, reforms in tax policy and administration are particularly important. Despite our past efforts, the tax revenue-to-GDP ratio in Armenia still remains low, limiting the use of resources for productivity-enhancing and poverty-reducing expenditures. We will continue our efforts to deepen financial intermediation, which remains low by international standards.

14. Continuation of sound macroeconomic policies and effective implementation of structural reforms would support real growth rates of at least 8 percent on average over the next three years. The underlying fiscal balance, which better measures the fiscal impact on domestic demand by excluding grants and external interest payments, is projected to be below 2 percent of GDP during 2010-11, after an initial improvement in 2009. Hence, fiscal policy will contribute to achieve sustainable growth while maintaining macroeconomic stability. Tax collection improvements will be underpinned by tax reforms, and will allow additional spending for infrastructure, pension reform, and poverty reduction. These policies are expected to achieve a further reduction in the poverty rate, a key objective of the SDP. The external current account deficit will decline only gradually to about 8 percent of GDP in

2011, reflecting strong demand for imported capital and intermediate goods needed to support growth. External debt ratios are projected to decline to about 9 percent of GDP.

15. Macroeconomic stability will remain the main objective of fiscal policy, as it is key to sustain and broaden economic growth, and further reduce poverty. In light of rising inflation, the fiscal stance will be tightened to mitigate demand pressures. Furthermore, the Ministry of Finance (MoF) will strengthen the fiscal framework to enhance fiscal policy credibility by analyzing and disclosing fiscal risks and associated policy responses, and by improving economic modeling and projection capacity. We will also enhance our capacity to assess and implement investment projects; this will allow us to carry out high-return projects with partly non-concessional financing.

16. Price stability will remain the main focus of monetary policy. During the program period, the CBA will complete the transition to full-fledged inflation targeting (IT) in the context of a flexible exchange rate regime by strengthening the policy transmission mechanism. Monetary policy implementation will benefit from the expansion of open market operations in the context of closer coordination with MoF on debt and liquidity management. Structural measures aimed at developing the interbank and foreign exchange markets will help improve the effectiveness of monetary policy instruments.

17. Strengthening tax policy and administration is a top priority over the next three years. Removing remaining weaknesses in this area is crucial to improve the business environment and boost competitiveness. The tax policy framework will be streamlined and simplified to make it easy to comply with and administer. The establishment of a VAT threshold with a simple regime for small businesses below the threshold is a step in this direction. Tax administration reform aims at increasing voluntary compliance and establishing a self-assessment system in which the direct interaction between taxpayers and tax officials is eliminated to reduce corruption risks. Similarly, customs reforms will focus on establishing risk-based processes to minimize the interaction between customs officials and importers.

18. Financial sector reforms in the period ahead will focus on further deepening financial intermediation and broadening the range of financial services available in Armenia, while at the same time safeguarding financial sector stability. We will also adopt an extensive package of capital market development measures in collaboration with Nasdaq-OMX.

III. THE NEW PROGRAM FOR 2008-09

A. Fiscal Policy

19. The fiscal deficit for 2008, defined according to GFSM 2001, is expected to be limited to 1.4 percent of GDP, significantly lower than the 2.6 percent of GDP targeted in the

budget (including the gas subsidy),² thanks to tax revenue overperformance and slow expenditure execution. Tax revenues have performed well on account of rapid import growth, better enforcement at customs, and strong VAT performance. However, the attempt to achieve ambitious targets led to a significant increase in tax credits. Tax revenues are expected to reach AMD 603 billion of GDP in 2008. Grants, on the other hand, were lower than expected, in part due to the delay in the disbursement of \$50 million from the Millennium Challenge Account.

20. For 2009, a budget deficit of 1 percent of GDP strikes the right balance between the need to contain demand pressures and that to provide resources for high-priority and poverty-reducing projects. Tax revenues would reach AMD 700 billion, reflecting the positive impact of tax reforms, and the tax revenue ratio would rise from 16.4 percent of GDP projected for 2008 to 16.8 percent of GDP in 2009. Grants and non-tax revenues are projected to increase by 0.4 percent of GDP. Expenditure is expected to reach AMD 919 billion, or 22.1 percent of GDP, up from 21.6 percent of GDP in 2008, as a result of increased spending on pensions and infrastructure. The underlying balance would improve to -1.7 percent of GDP in 2009 from -1.9 percent of GDP in 2008. A potential risk to achieving the deficit target is represented by the large amount of outstanding tax credits (AMD 121 billion as of August 1, 2008) associated with weak tax-audit capacity. We are committed to analyzing and fixing the systemic problems underlying these tax credits to ensure that any risks to the target are mitigated.

B. Monetary and Exchange Rate Policies

21. Monetary conditions will continue to be tightened to achieve the CBA inflation target. Inflationary pressures from high food and energy import prices in a context of strong domestic demand have caused inflation to exceed the inflation target range of 4 ± 1.5 percent. We will continue with our strategy of gradually increasing the repo rate, and we stand ready to increase it at a faster pace if inflationary pressures persist. Money supply growth will be contained for the remainder of the year, supported by lower foreign exchange market intervention, a lower-than-projected budget deficit, and increased net issuance of treasury bills. The government intends to increase the stock of treasury bills by AMD 25 billion, in close coordination with the CBA. The monetary program seeks to limit reserve money growth to around 18.5 percent and envisages a broadly stable level of foreign reserves relative to 2007. Barring further external shocks, we are confident that these measures will help bring inflation back to the target range in 2009.

22. The transition to full-fledged IT will be completed during the program period. The institutional prerequisites are largely in place. A 2007 review of our strategy and organizational framework, conducted with the support of IMF technical assistance,

² See footnote 1.

concluded that most of the key elements for successful IT are present in Armenia, including the independence of the CBA, appropriate internal organization and sufficient capacity of the CBA, a quarterly inflation projection model as one of the inputs in the monetary policy decision-making process, and a well-developed communication strategy. Since 2006, the CBA has issued quarterly inflation reports and published the minutes of its monthly board meetings on monetary policy. We have also moved from an end-year to a continuous inflation target.

23. We are committed to maintaining a flexible exchange rate regime. While increased intervention has been necessary in the face of large-scale and volatile capital inflows and heightened uncertainty in the course of 2008, foreign exchange interventions will be used only as an instrument to smooth out exchange rate volatility without targeting the level of the exchange rate.

24. The CBA will sign a memorandum of understanding with the MoF regulating the issuance of government securities (performance criterion). As soon as an agreement is reached, the CBA will discontinue issuing its own securities and will instead focus on conducting repo operations. The treasury will recommence issuing short-term T- bills. Debt issuance will be closely coordinated between the MoF and CBA to take account of both budget financing and liquidity management needs, and the MoF will commit to avoid using cut-off yields at its auctions, except to reject clearly speculative bids that lie outside the normal range of bidding. Over the medium term, the CBA intends to increase its holdings of treasury securities in order to strengthen its capacity to conduct reverse repo operations.

25. At the same time, we recognize that the monetary transmission mechanism is still weak. We will therefore continue following an IT “lite” regime in the period ahead, while paying close attention to monetary aggregates. We aim at strengthening the monetary transmission mechanism by further improving our operational framework and fostering financial deepening and interbank money market development. To improve the functioning of the interbank market, the CBA is considering the introduction of an electronic trading platform. To improve bank liquidity management, we also consider introducing an overnight credit facility, and lengthening the reference period for reserve requirements from two weeks to four weeks against the background of high monthly volatility of government spending.

C. Structural Reforms

Fiscal reforms

26. We are improving our fiscal framework. The State Law on Debt Management, which introduces a ceiling on the amount of total debt (equal to 60 percent of GDP) and limits on the size of deficits if debt is above 50 percent of GDP, has been approved. Starting in 2009, we intend to improve the Medium Term Economic Framework by including a section on debt management that will help align policy decisions over the medium term (next three years)

with their long-term fiscal implications. We plan to complete the specific part of the tax code by June 2009.

27. We plan to introduce several changes in tax policy. On VAT, a new streamlined system for small traders and a registration threshold of AMD 58.35 million will become effective on January 2009. We are also considering the introduction of an annual business license for microbusinesses. We have amended the general presumptive tax regime by moving trade fairs to the general VAT and income tax regimes. We plan to abolish all presumptive tax regimes, and bring all sectors currently subject to presumptive taxation within the regular tax regimes (excise tax, customs duties, profit tax, and VAT) during the program period. In order for us to prepare the necessary changes, we will strengthen our administrative capacity, especially in the areas of auditing, professional recruitment and training, and risk analysis. A timetable for the implementation of these changes will be set during the first program review. We intend to reform the system of VAT refunds following best international practices. We will clear the backlog of refund claims, introduce risk-management approaches and a refund forecasting system, and amend the law to strengthen penalties for false claims and pay interest on late refunds arising from claims filed after December 31, 2009 (performance criterion). Importantly, we will process all VAT refund claims filed after December 31, 2008 within the 90-day statutory period.

28. We are reorganizing the tax administration:

- We are adopting a function-based organizational structure and will merge the four specialist inspectorates by January 1, 2009. Moreover, we plan to close a number of regional inspectorates that are not cost effective by end-2008 and further consolidate regional inspectorates by June 2009 (structural benchmark).
- We are merging the State Customs Service with the State Tax Service to achieve efficiency gains. These gains will mainly concern administrative support functions and information systems, while the core functions of customs and tax administration will not be integrated owing to their different nature. The merger, which has created a new organization named State Revenue Committee (SRC), is expected to be completed by January 2009.

29. We plan to introduce a funded pension pillar on January 1, 2010. We have completed a White paper including estimates of the costs of this reform and started developing an action plan for implementation. Drafting of the legislation introducing a unified tax has started already, and submission to parliament is expected by mid-2009. The SRC, which will assume the task of collecting contributions, has already started preparations. In the context of the Medium Term Economic Framework, we intend to produce an analytical report on medium-term fiscal risks, including those associated with the introduction of the funded pillar, which would also include the cost of the increase in basic pensions over the next few years (structural benchmark).

Financial sector

30. We will continue moving forward with banking sector reforms:
- To complement the recently-adopted legislation on consumer protection, we are preparing an extensive campaign to educate consumers about financial terms, products, and services.
 - To increase the availability of credit and foster financial intermediation, we plan to introduce a consistent credit scoring system; enhance credit analysis; and further improve consumer rights protection, as stipulated in the recently approved law “On Circulation of Loan Information and On Activities of Credit Bureaus.”
 - To foster the development of commercial banks’ risk management capacity, the CBA will develop guidelines and a new system of risk assessment for banks, taking best international practices as a basis. Moreover, the CBA is considering the introduction of an assessment of banks’ risk management systems as part of its regular supervisory activity.
31. To further develop the securities market:
- We plan to implement a comprehensive program of securities market development, as laid out in our capital market development action plan. We have designed a new public debt management strategy that foresees an increase of domestic debt issuance over the medium term, bringing the stock of domestic debt to 7 percent of GDP by 2020. Benchmark bonds in 4 maturities will be issued for that purpose. To increase the stock of government securities available for open market operations, we will amend Article 11 of the “Law on the Central Bank of the Republic of Armenia” by mid-2009 (structural benchmark, June 2009) to allow a gradual recapitalization of the CBA with marketable securities.
 - Having established a rating system for enterprises, the CBA will continue to produce ratings for companies that are potential candidates for initial public offerings at Nasdaq-OMX. The rating system developed at the CBA will be handed over eventually to the private sector.
32. Regarding insurance sector reforms:
- We plan to finalize the classification of insurance companies’ assets.
 - We will introduce a new minimum capital requirement of AMD 500 million for newly established insurance companies in January 2009. Over time, we plan to increase this requirement to AMD 1 billion for non-life insurance companies and AMD 1.5 billion for life insurance companies.

- We will introduce legislation on the introduction of mandatory third-party liability auto insurance by January 2010. This will provide a major push for insurance market development in Armenia and is expected to attract new reputable market entrants.

Other structural reforms

33. We intend to continue our efforts to improve governance and reduce corruption. We plan to finalize the new anti-corruption strategy action plan by November 2008, and we are strongly committed to continue its implementation over the program period. We intend to implement the third phase of public sector reform, which is expected to improve performance and ethical standards in the civil service.

34. We have approved a five year strategy to develop Armenia into a center for excellence of doing business and investments. The 2008 action plan approved by the Government and the decision of the Prime Minister to address impediments to the SME sector are major first steps in this direction. The reforms will accelerate in 2009, targeting improvements of the Doing Business indicators significantly.

IV. PROGRAM MONITORING

35. Progress in implementing the program will be monitored through quantitative performance criteria and indicative targets set forth in Table 1 as well as structural performance criteria and benchmarks as listed in Table 2. The Technical Memorandum of Understanding (TMU) attached to this Memorandum defines the quantitative targets of Table 1, and specifies reporting requirements. Semiannual performance criteria will be monitored under two reviews. The quantitative targets include targets for the underlying fiscal balance (excluding grants and external interest payments, and including any new subsidies) and limits on contracting/guaranteeing external debt (see Table 1). Monetary aggregates will continue to be used as indicative targets during the transition to full-fledged IT. Once the transition has taken place, a defined set of monetary indicators will be used to assess compliance with the inflation target.

Table 1. Armenia: Quantitative Targets, 2008–09 1/
(End of period ceilings on stocks, unless otherwise specified)

	2007	2008		2009			
	Dec.	Jun.	Dec.	Mar.	Jun.	Sep.	Dec.
	Act.	Act.	Prog. 2/	Prog. 5/	Prog. 2/	Prog. 5/	Prog. 2/
	(In billions of drams)						
Net domestic assets of the CBA 3/	-95.5	-8.0	19.9	10.4	31.7	52.8	73.0
Net banking system credit to the general government	-54.0	-78.2	-50.8	-48.5	-29.9	-16.0	-36.8
Underlying fiscal balance on a cash basis (floor) 4/	-93.6	-11.0	-68.6	-5.2	-36.4	-54.4	-72.0
Reserve money 5/	427.1	412.7	506.4	471.3	502.6	540.0	595.8
	(In millions of dollars)						
Contracting or guaranteeing of new nonconcessional external debt 4/ 6/	0	0	0	50	50	50	50
External arrears (continuous criterion)	0	0	0	0	0	0	0
Net official international reserves (floor)	1403.7	1330.8	1517.9	1440.3	1469.5	1516.8	1610.0

1/ All items as defined in Country Report No. 05/422 and its subsequent amendments, with the exception of the underlying balance, which is defined as the overall balance excluding grants and external interest payments.

2/ Performance criterion.

3/ At program exchange rates (357 dram per dollar in 2007 and 304.2 dram per dollar in 2008 and 2009).

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.

Table 2. Proposed Structural Conditionality for 2009

Item	Measure	Proposed Time Frame (End of Period)	Type of Conditionality
1	Strengthen domestic debt market by signing an agreement between the Ministry of Finance (MoF) and Central Bank (CBA) on the coordination of government securities auctions, including (i) the discontinuation of CBA security issuance; (ii) a commitment to avoid using cut-off yields at its auctions, except to reject clearly speculative bids that lie outside the normal range of bidding.	December 2008	Performance Criterion
2	Restructure the tax administration organization by (i) implementing a modern function-based structure; (ii) merging the four specialist inspectorates into a single large taxpayer inspectorate (LTI); and (iii) closing at least 10 tax inspectorates that are not cost-effective.	December 2008	Structural Benchmark
3	Further reduce the number of tax inspectorates by at least 20.	June 2009	Structural Benchmark
4	Improve the recapitalization mechanism for the central bank by amending Article 11 of the "Law on the Central Bank of the Republic of Armenia" to allow a gradual recapitalization of the CBA with marketable securities.	June 2009	Structural Benchmark
5	Introduce best practices in VAT refund processing to exporters by (i) clearing the stock of late refund claims, while meeting the statutory 90-day processing deadline for all claims filed in 2009; (ii) implementing risk-management approaches (i.e. taxpayers with good compliance histories to get fast-track refunds, while risky cases face pre-refund audits); (iii) implementing a forecasting system to anticipate refund levels so that funds are available to pay legitimate refund claims as they occur; and (iv) submitting legislation to parliament to strengthen penalties for false refund claims and pay interest on legitimate refunds not paid on time (interest will apply only to new claims filed after December 31, 2009). Interest will be paid out of VAT revenues.	December 2009	Performance Criterion
6	Strengthen the fiscal framework by producing a yearly analytical report identifying fiscal challenges and risks over the short- and medium-term, and potential fiscal policy responses to them.	December 2009	Structural Benchmark

ATTACHMENT III. 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 the Millennium Challenge Account (MCA) 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 304.22 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. The program's ceiling on **reserve money** is an indicative target. Reserve money is defined as the sum of currency issued, required and excess reserves, and current and time deposit accounts of certain resident agents.¹

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) bank 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 debt² 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.³ 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 or any other agency acting on behalf of the government. Transactions subject to debt ceilings shall be valued in the contracted

¹ Liquidity absorbing transactions under reverse repurchase agreements, the CBA's deposit facility, foreign currency swaps, and securities issued by the CBA are netted out from claims on banks, i.e., they are excluded from the reserve money definition.

² 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.

³ 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.

currencies and converted into U.S. dollars at the average monthly market exchange rate in the month when the commitment was contracted.

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.⁴

8. **The underlying balance of the central government on a cash basis** is defined as the negative of the sum of domestic banking system net financing, domestic nonbank net financing, external net financing to the government; plus external interest payments, less grants to the central government. Should a general subsidy be introduced off-budget, the underlying balance will be measured including the subsidy as part of government spending. **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);⁵ (2) any other disbursement or transaction that increases nonbanks' claims on the central government plus withdrawals from the special privatization account or the treasury sub-account containing privatization proceeds in dram, less amortizations made by the central government to private resident nonbank agents; and less domestic net lending following the GFSM2001. **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, and less external net lending following the GFSM2001. Grants equal total non-debt increasing disbursements from non-residents to the central government. External interest payments equal interest paid 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

⁴ The public sector is defined following the *Government Financial Statistics Manual* (GFS 2001) and *System of National Accounts* (1993 SNA). It includes the general government and nonfinancial public enterprises.

⁵ 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.

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 sub-account of the treasury single account.

11. The program targets ceilings for the stock of **domestic arrears of the central government**. Domestic arrears are defined as follows. With respect to wages, social contributions (including for pensions), 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

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

- **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 2 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 3 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

13. Strengthen domestic debt market by signing an agreement between the Ministry of Finance (MoF) and Central Bank (CBA) on the coordination of government securities auctions, including (i) the discontinuation of CBA security issuance; (ii) a commitment to avoid using cut-off yields at its auctions, except to reject clearly speculative bids that lie outside the normal range of bidding (performance criterion, December 2008). The agreement will specify the criterion to identify outlier bids (based on a deviation from the average yield either in terms of a multiple of standard deviations or in absolute basis points). See paragraph 24 of the MEFP.

14. Restructure the tax administration organization by (i) implementing a modern function-based structure; (ii) merging the four specialist inspectorates into a single large taxpayer inspectorate (LTI); and (iii) closing at least 10 tax inspectorates that are not cost-effective by end-2008 (structural benchmark, December 2008). Further reduce the number of tax inspectorates by at least 20 by June 2009 (structural benchmark, June 2009). See paragraph 28 of the MEFP.

15. Improve the recapitalization mechanism for the central bank by amending Article 11 of the “Law on the Central Bank of the Republic of Armenia” by mid-2009 (structural benchmark, June 2009) to allow a gradual recapitalization of the CBA with marketable securities. See paragraph 31 of the MEFP.

16. Introduce best practices in VAT refund processing to exporters by (i) clearing the stock of late refund claims, while meeting the statutory 90-day processing deadline for all claims filed in 2009; (ii) implementing risk-management approaches;⁶ (iii) implementing a forecasting system to anticipate refund levels so that funds are available to pay legitimate refund claims as they occur; and (iv) submitting legislation to parliament to strengthen penalties for false refund claims and pay interest on legitimate refunds not paid on time (interest will apply only to new claims filed after December 31, 2009) (performance criterion, December 2009). See paragraph 27 of the MEFP.

17. Strengthen the fiscal framework by producing a yearly analytical report identifying fiscal challenges and risks over the short- and medium-term, and potential fiscal policy responses to them (structural benchmark, December 2009). See paragraph 29 of the MEFP.

⁶ The implementation by the tax administration of a risk-management approach to administering VAT refunds will be evidenced by: (i) a documented risk-based audit strategy, plan, and methodology; (ii) regular risk assessments and maintenance of risk profiles for all exporters making VAT refund claims, using information in tax and customs databases and from third parties; (iii) payment of refunds within 14 days to exporters assessed as low-risk (i.e. those with sound compliance histories in relation to VAT and other taxes), supported by selective post-refund audits; and (iv) pre-refund audits within the statutory 90-day processing period to verify claims of exporters categorized as high-risk (i.e. those with a poor compliance history).

IV. DATA REPORTING

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

Reporting Agency	Type of Data	Description of Data	Frequency	Timing	
CBA ⁷	CBA balance sheet	Summary	Weekly	Each Friday	
	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 25 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	Each Friday
			By chart of accounts; at (i) program exchange rates; and (ii) at actual official exchange rates	Monthly	Within 21 days of the end of each month
	Foreign exchange market	Official exchange rates (buying and selling) and volume of CBA interventions, including foreign exchange swaps; daily trade volume, number of trades, and weighted average exchange rate of Armex	Weekly	Each Friday	
	Interest rates	Repo rate; interbank rate; by volume and maturity, T-bill rate, bond yield; and by maturity, deposit and lending rates; monthly weighted average interest rate on government bonds	Monthly	Within 7 days of the end of each month	
	Interbank money market	Daily interbank repo volume and interest rate	Weekly	Each Friday	
	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 10 days of the end of each biweekly period	
	Banking data	Sectoral distribution of loans and deposits, dollarization of loans and deposits, loan maturities	Monthly	Within 25 days of the end of each month	

⁷ As defined in CBA resolution No. 201 (December 6, 1999).

	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
	Other monetary data	IFS format	Monthly	Within 45 days of the end of each month
Ministry of Finance (MOF)	T-bill and coupon bond financing	By holders, i.e., CBA, resident banks, resident nonbanks, and nonresidents	Monthly	Within 7 days of each month
	T-bill and coupon bond financing	Auction data: date, original and remaining maturities, issuance volume, demand, allocation, minimum yield, cut-off yield, average yield	Weekly	Each Friday
	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 tax administration and customs administration, including revenue by individual tax, and social contributions	Monthly	Within 7 days of the end of each month
	Expenditure arrears	Government	Monthly	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, 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	Monthly	Within 30 days of the end of each month

	Consolidated general government	Central and local governments, and Non-Commercial Enterprises that belong within the general government (NCEs)	Quarterly	Within 60 days of the end of each quarter
	Consolidated general government	Central and local governments, and NCEs that belong within the general government	Annual	Within 180 days of the end of each year
	Budget execution	All cash receipts, cash expenditures, including domestic and external debt-service payments, external and domestic borrowing operations, and inflow of grants to the central government; expenditure data will be provided according to both economic and functional classifications, consistent with the GFSM2001 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
State Revenue Committee	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
	Tax credits	Detailed data, by type of tax, of outstanding tax credits for all types of tax revenues	Monthly	Within 45 days of the end of each month
	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 statutory processing period. Number of refund applications processed per month.	Monthly	Within 30 days of the end of each month

	Import data	<ol style="list-style-type: none"> 1. Total value of recorded imports, breaking out raw diamond imports; 2. Total value of non-duty free recorded imports; 3. Number of total transactions involving recorded imports; 4. Number of total transactions involving non-duty free recorded imports 5. Value of recorded imports where customs value was assessed using transaction prices, breaking out raw diamond imports; 6. Value of non-duty free recorded imports where customs value was assessed using transaction prices; 7. Number of transactions involving recorded imports where customs value was assessed using transaction prices; 8. Number of transactions involving non duty free recorded imports where customs value was assessed using transaction prices 	Quarterly	Within 30 days of the end of each quarter
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Table 1. Armenia: (Program) Exchange Rates of the CBA
 (As of December 30, 2007 for dollars per currency rates.
 Drams per currency rates are calculated using
 the 304.22 drams per U.S. Dollar rate)

Country	Drams Per Currency	Dollars Per Currency
Australian dollar	266.62	0.8764
Canadian dollar	310.90	1.0220
Swiss franc	268.22	0.8817
Danish krone	59.94	0.1970
Euro	446.96	1.4692
Pound sterling	608.27	1.9994
Japanese yen	2.71	0.0089
Norwegian krone	56.22	0.1848
Russian ruble	12.40	0.0408
Swedish krone	46.99	0.1545
U.S. dollar	304.22	1.0000
SDR	480.21	1.5785
Gold 1/		

1/ Per gram.

Table 2. Armenia: World Bank PRSC Lending 1/
 (In billions of dram)

2009			
<u>March</u>	<u>June</u>	<u>September</u>	<u>December</u>
0.0	0.0	0.0	0.0

1/ Cumulative from December 2008, at program exchange rates.

Table 3. Armenia: KfW Loan Disbursements 1/
 (In billions of dram)

2009			
<u>March</u>	<u>June</u>	<u>September</u>	<u>December</u>
0.03	0.06	0.09	0.13

1/ Cumulative from December 2008, at program exchange rates.

INTERNATIONAL MONETARY FUND

REPUBLIC OF ARMENIA

Joint IMF/World Bank Debt Sustainability Analysis

Prepared by the Staffs of the International Monetary Fund and
the International Development Association

October 31, 2008

The IMF-World Bank staffs' debt sustainability analysis (DSA) suggests that Armenia is at a low risk of debt distress, with all external debt indicators well below the relevant country-specific debt-burden thresholds. An alternative scenario explores the impact of a new nuclear power plant. The analysis highlights the importance of continued sound macroeconomic policies and structural reforms for safeguarding the favorable debt outlook.

1. The DSA was prepared by Fund and World Bank staffs, using the joint Bank-Fund Low-Income Country Debt Sustainability Framework.¹ The macroeconomic assumptions underlying the baseline scenario are consistent with the framework presented in the staff report for the 2008 Article IV consultation and request for a low-access PRGF. The external debt data used for this exercise are broadly consistent with the authorities' medium term borrowing plans.

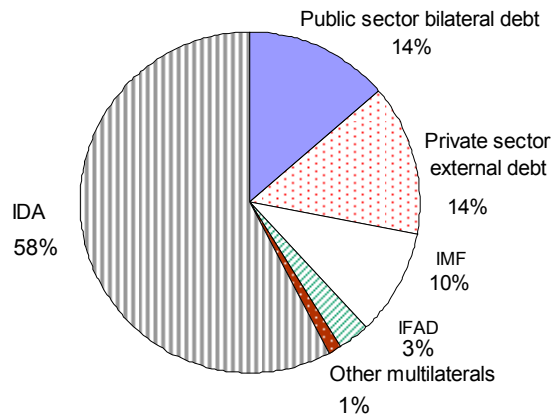
I. STRUCTURE OF DEBT

2. Armenia's external debt stock as of end-2007 is estimated at \$1,846 million (20 percent of GDP), mostly representing public and publicly-guaranteed (PPG) debt owed to multilateral international organizations (Figure 1).² The outstanding debts of the government to the World Bank and to the Fund account for 58 percent and 10 percent of total external debt stock, respectively. Armenia's private sector external debt outstanding accounts for about 14 percent of total external debt.

¹ The most recent assessment of Armenia's debt sustainability was conducted in November 2007 in the context of the Fifth Review of the PRGF (Country Report No. 07/377).

² The DSA covers the central government only, since other public sector debt is believed to be negligible.

Figure 1. Armenia: External Debt Stock, end-2007



3. The total debt outlook continued to improve in 2007. Prudent debt management, combined with favorable exchange rate dynamics and robust economic growth, contributed to a decline in the external debt ratio from 25 percent of GDP in 2005 to 20 percent of GDP in 2007.

4. The share of domestic debt in the stock of public and publicly guaranteed debt is rather small, reflecting the limited development of the domestic debt markets. In 2007, the PPG debt owed to domestic creditors accounted for only 2.1 percent of GDP, virtually unchanged from the previous year.

II. THE BASELINE SCENARIO

5. The baseline scenario shows a sustainable fiscal position (Tables 1 and 2). The net present value of public sector debt would gradually increase over the projection period from about 10 percent of GDP in 2008 up to 20 percent of GDP in 2028, reflecting the increasing issuance of domestic debt securities on the one hand, but a declining share of public external debt on the other hand. The net present value of debt-to-revenue ratio would increase from 47 percent in 2008 to 67 percent in 2028, while the debt service-to-revenue ratio would edge up somewhat but not exceed 6 percent in any given year over the projection period. Throughout the projection period, these indicators for public debt would remain at comfortable levels and below the indicative thresholds for external debt.³

6. The external debt outlook remains benign, notwithstanding a notable moderation in external concessional financing (Table 3a, Figure 2). The net present value of external debt is expected to fall from 7 percent of GDP in 2007 to 5 percent of GDP in 2028, reflecting a

³ External debt indicator thresholds for Armenia are as follows: present value of debt to export ratio (200 percent), present value of debt to GDP ratio (50 percent), present value of debt to revenue ratio (300 percent), debt service to export ratio (25 percent) and debt service to revenue ratio (35 percent).

Box 1. Macroeconomic Assumptions for the DSA Baseline Scenario, 2008–28

Annual real GDP growth is projected to average around 7 percent over the medium term, gradually declining to its long-run rate of 4 percent. The near-term growth is supported by the robust activity in construction and services, on the back of continued private transfers and FDI inflows.

Consistent with the CBA's target, the average inflation rate is assumed to be around 4 percent in the long-run. The near-term inflation is projected to be somewhat higher, largely on account of higher food and energy prices.

The external current account deficit is projected to average around 7 percent of GDP over the DSA projection period. Somewhat higher deficits are envisaged in the near-term, against the background of strong import growth. Exports are projected to grow robustly over the medium term, as new investments in base metal, minerals, and food processing sectors become operational. Private transfers will grow strongly in the near-term, financing a significant share of the trade deficit, but will gradually moderate thereafter.

In 2008–12, net FDI is expected to average about 7.0 percent of GDP, gradually moderating from the high levels explained by the privatization in base metal and mineral sectors. In the near term, FDI is expected to be concentrated mostly in these two traditional sectors, but also in food processing, telecommunication, banking and energy sectors. Improvements in business climate, however, should yield a more diversified FDI structure, with new investment going into new industries (e.g., tourism and IT sector). The long-run net FDI is projected to average around 5 percent of GDP.

Central government revenues (excluding grants) are projected to gradually increase from 19.6 percent of GDP in 2008 to 22.3 percent of GDP in 2013, and will continue to improve over the long-run, in line with government revenue targets.

The overall fiscal deficit is projected to decrease from 1.4 percent of GDP in 2008 to 1.0 percent of GDP in 2009, in line with understandings reached under the new PRGF program, and in the long term, remain at around 1 percent of GDP. Consistent with the staff recommendations, the gas subsidy expired on May 1st 2008 and the baseline assumes that no new subsidy will be introduced. It is also assumed that the import prices for gas will increase in 2009 from their current level of \$110 to \$154 per 1,000m³.

The level of concessionality of new external borrowing is envisaged to decline in the future, as Armenia's income increases. The projected disbursements from the World Bank—Armenia's largest creditor, accounting for about 60 percent of country's total external debt stock as of end-2007—assume that starting from 2009 Armenia will begin receiving IBRD loans in addition to IDA credits, gradually shifting to exclusively IBRD borrowing by 2017. Starting 2009, IDA repayment terms are hardened, with the maturity period of 20 years. This reflects the fact that Armenia's per capita income exceeded the IDA eligibility threshold for two consequent years. Unidentified residual lending for 2009 and beyond is assumed to be on IBRD terms.

Consistent with the authorities' intention, deficit financing is assumed to be increasingly financed by domestic, rather than external, borrowing such that the stock of domestic debt would increase from 2.1 percent of GDP in 2007 to 10.1 percent of GDP in 2021, and to 14.9 percent by 2028. Residual borrowing from domestic sources reduces risks associated with currency mismatch of debt portfolio and contributes to deepening of domestic financial markets.

The private sector external debt stock in 2007 is estimated as the difference between Armenia's long-term total external debt and government's external debt. The new external borrowing by the private sector is assumed to match the balance of payments' conservative assumption on commercial banks' inflows of about 1 percent of GDP per annum. As the terms of Armenia's private sector borrowing are unknown, they are assumed to be similar to those in other comparable countries. Specifically, the maturity period is assumed to be 6 years (with a 1 year grace period) and the interest rate is set at 8 percent—a compromise between the interest rate on U.S. dollar-denominated sovereign bonds of similar maturity in Russia and Ukraine (about 6.5 percent), and the ongoing lending rate in U.S. dollars charged by Armenian banks on long-term loans (about 15–17 percent). To the extent that most of this lending is likely to be from foreign banks to their Armenian subsidiaries, this relatively low interest rate assumption is justified.

gradual increase in the share of the fiscal deficit financed by domestic sources and increasingly greater importance of external borrowing by the private sector. While Armenia's reliance on external financing gradually diminishes, the borrowing terms are projected to harden, leaving the external debt service in percent of exports broadly stable at about 3 percent over the long-term. The net present value of public external debt in percent of exports should fall from 46 percent in 2008 to 22 percent in 2028.

III. STRESS TESTING AND ALTERNATIVE SCENARIO

7. The standard menu of alternative scenarios and bound tests indicate that Armenia's public debt outlook would be most adversely affected by a lasting shock to economic growth (Figure 2).⁴ Under the extreme adverse growth scenario the stress tests indicate that public debt ratios would follow a persistent upward trend through the projection horizon. Under permanently lower real GDP growth, the net present value of public debt-to-GDP would exceed 50 percent from 2025 onward, even though other debt indicators would remain at comfortable levels. Debt indicators are less prone to unfavorable debt dynamics under other stress tests. This result reinforces the importance of maintaining prudent financial policies and preserving macroeconomic stability in order to safeguard the debt outlook.

8. Armenia's external debt outlook is robust to a variety of shocks (Table 3b). Under all standard alternative scenarios and bound tests, the external debt ratios remain well below the relevant thresholds.

9. In addition to the standard stress test, an alternative baseline scenario, which included higher external debt financing for the planned construction of a power plant was also considered. The power plant is estimated to cost about \$6 billion to be constructed during the period 2011–2017. This excludes the decommissioning of the existing nuclear power plant at an estimated cost of \$1 billion. While the financing arrangements of this project are yet to be finalized, it is assumed as a worse case scenario that about \$6 billion of the total cost will be financed by the government through the acquisition of non-concessional loans on commercial terms.⁵ The funds are assumed to be evenly disbursed over six years.

10. The assumed increases in external borrowing associated with the power plant would result in a sharp but temporary worsening of debt indicators. The main debt indicators would more than double from 2011–2018, but revert to pre-power plant borrowing trend by the end of the projection period.

⁴ The framework for low-income country DSA incorporates alternative scenarios and bound tests aimed at identifying the sensitivities of the baseline projection to a range of potential shocks.

⁵ Assumed terms for power plant financing are as follows: interest rate of 8 percent, one year grace period, and six years to maturity.

11. The external debt service to export ratio would breach the policy dependent threshold (25 percent) by 2013, but would quickly return to more sustainable levels and decline to less than 5 percent by 2028. The present value of debt to export ratio would jump from 39 percent in 2010 to 127 percent by 2014 but decline to 20 percent by the end of the projection period. The present value of the public sector debt to GDP ratio would increase from 9 percent of GDP and peak at 45 percent in 2016, while the debt to revenue ratio would move from 42 percent to a peak of 188 percent in 2016.

12. The results from this DSA suggest that Armenia's debt outlook is relatively stable. However, the debt outlook would deteriorate if a significant proportion of nonconcessional resources are required to finance projects such as the power plant. Given increasing external vulnerabilities and the sensitivity of the debt outlook to long-term growth assumptions, it is important that the authorities continue to follow a prudent borrowing strategy over the medium term.

Table 1. Armenia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2005-2028
(In percent of GDP, unless otherwise indicated)

	Actual			Average	Standard Deviation	Estimate					Projections				
	2005	2006	2007			2008	2009	2010	2011	2012	2013	2008-13 Average	2018	2028	2014-28 Average
Public sector debt 1/	24.7	21.1	19.3			16.0	14.9	14.8	15.4	15.6	15.7		18.0	21.7	
<i>Of which: foreign-currency denominated</i>	22.4	18.9	17.2			13.7	12.2	11.7	11.6	11.2	10.6		9.8	6.9	
Change in public sector debt	-10.9	-3.6	-1.8			-3.3	-1.1	-0.1	0.6	0.2	0.2		0.8	0.3	
Identified debt-creating flows	-4.9	-3.6	-3.1			-1.5	-0.1	0.4	0.8	0.9	0.5		0.1	-0.4	
Primary deficit	1.5	1.7	2.0	2.1	1.8	1.1	0.6	0.9	1.1	0.7	0.6	0.8	0.4	0.4	0.4
Revenue and grants	17.8	18.0	20.1			20.2	21.1	21.4	21.9	22.3	22.8		25.2	30.2	
<i>Of which: grants</i>	0.4	0.5	0.7			0.6	0.9	0.7	0.6	0.5	0.4		0.4	0.3	
Primary (noninterest) expenditure	19.4	19.6	22.2			21.3	21.7	22.3	23.0	23.0	23.4		25.6	30.6	
Automatic debt dynamics	-5.9	-3.9	-4.6			-3.3	-0.6	-0.5	-0.3	0.3	-0.1		-0.3	-0.8	
Contribution from interest rate/growth differential	-1.2	-1.7	-1.3			-0.9	0.1	0.0	0.2	0.7	0.3		-0.3	-0.8	
<i>Of which: contribution from average real interest rate</i>	3.3	1.2	1.3			0.8	1.3	1.0	1.1	1.5	1.1		0.4	0.0	
<i>Of which: contribution from real GDP growth</i>	-4.5	-2.9	-2.6			-1.8	-1.2	-1.0	-0.8	-0.9	-0.9		-0.7	-0.8	
Contribution from real exchange rate depreciation	-4.6	-2.2	-3.4			-2.4	-0.7	-0.5	-0.5	-0.4	-0.4		...	...
Other identified debt-creating flows	-0.6	-1.4	-0.5			0.8	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Privatization receipts (negative)	-0.6	-1.9	-1.4			-0.4	0.0	0.0	0.0	0.0	0.0		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	
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	
Other (specify, e.g. bank recapitalization)	0.0	0.5	0.9			1.2	0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Residual, including asset changes	-6.0	0.0	1.3			-1.8	-1.0	-0.5	-0.3	-0.8	-0.3		0.7	0.7	
Other Sustainability Indicators															
PV of public sector debt	2.2	2.2	11.2			9.6	9.3	9.4	9.9	10.3	11.1		15.0	20.3	
<i>Of which: foreign-currency denominated</i>	0.0	0.0	9.1			7.3	6.6	6.3	6.1	6.0	6.0		6.8	5.5	
<i>Of which: external</i>	...	...	9.1			7.3	6.6	6.3	6.1	6.0	6.0		6.8	5.5
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...	...		...	...
Gross financing need 2/	4.6	4.3	3.8			3.9	1.9	1.4	1.7	2.0	1.8		1.6	2.2	
PV of public sector debt-to-revenue and grants ratio (in percent)	12.6	12.2	55.5			47.4	44.2	43.8	45.3	46.4	49.0		59.7	67.4	
PV of public sector debt-to-revenue ratio (in percent)	12.9	12.6	57.7			48.7	46.1	45.2	46.5	47.4	50.0		60.6	68.2	
<i>Of which: external 3/</i>	...	...	46.9			37.1	32.5	30.2	28.6	27.4	26.8		27.4	18.3
Debt service-to-revenue and grants ratio (in percent) 4/	15.7	12.0	9.6			3.8	3.9	3.8	4.0	4.9	4.6		4.8	6.1	
Debt service-to-revenue ratio (in percent) 4/	3.0	2.0	1.7			1.6	1.9	1.9	2.0	2.8	2.6		2.4	2.0	
Primary deficit that stabilizes the debt-to-GDP ratio	12.4	5.3	3.8			4.4	1.6	1.0	0.5	0.5	0.4		-0.4	0.1	
Key macroeconomic and fiscal assumptions															
Real GDP growth (in percent)	14.5	13.3	13.8	10.5	3.9	10.0	8.0	7.0	6.0	6.0	6.0	7.2	4.0	4.0	4.2
Average nominal interest rate on forex debt (in percent) 5/	1.0	0.9	0.9	1.6	0.8	0.8	0.8	0.9	0.9	1.0	1.1	0.9	1.7	2.9	2.1
Average real interest rate on domestic debt (in percent)	-5.3	-4.0	-12.2	13.9	23.8	-6.6	6.1	5.3	5.2	9.1	6.3	4.3	3.9	1.5	2.8
Real exchange rate depreciation (in percent, + indicates depreciation)	-26.6	-18.4	-33.6	-10.1	15.8	-24.0
Inflation rate (GDP deflator, in percent)	20.5	15.0	26.7	8.1	10.7	19.2	7.6	6.4	6.4	5.4	5.4	8.4	2.3	1.5	2.5
Growth of real primary spending (deflated by GDP deflator, in percent)	0.3	0.1	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grant element of new external borrowing (in percent)	53.9	44.7	56.1	58.8	48.7	15.8	46.3	15.8	15.8	...

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

1/ 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 excluding 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 2. Armenia: Sensitivity Analysis for Key Indicators of Public Debt, 2008-2028

	Projections							
	2008	2009	2010	2011	2012	2013	2018	2028
PV of Debt-to-GDP Ratio								
Baseline	10	9	9	10	10	11	15	20
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	10	9	10	10	10	12	19	26
A2. Primary balance is unchanged from 2008	10	9	8	8	8	8	16	29
A3. Permanently lower GDP growth 1/	10	8	8	8	9	10	23	67
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2009-2010	10	9	8	8	8	9	15	27
B2. Primary balance is at historical average minus one standard deviations in 2009-2010	10	11	13	13	12	12	17	23
B3. Combination of B1-B2 using one half standard deviation shocks	10	10	12	11	10	10	13	16
B4. One-time 30 percent real depreciation in 2009	10	11	10	9	8	8	14	22
B5. 10 percent of GDP increase in other debt-creating flows in 2009	10	18	17	16	15	15	19	25
PV of Debt-to-Revenue Ratio 2/								
Baseline	47	44	44	45	46	49	60	67
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	47	45	45	46	47	51	76	85
A2. Primary balance is unchanged from 2008	47	41	38	36	35	37	66	98
A3. Permanently lower GDP growth 1/	47	40	37	38	38	42	91	222
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2009-2010	47	40	38	38	36	38	61	88
B2. Primary balance is at historical average minus one standard deviations in 2009-2010	47	54	63	59	54	53	66	77
B3. Combination of B1-B2 using one half standard deviation shocks	47	50	54	50	44	42	50	54
B4. One-time 30 percent real depreciation in 2009	47	51	45	41	36	37	54	72
B5. 10 percent of GDP increase in other debt-creating flows in 2009	47	84	77	72	67	65	75	83
Debt Service-to-Revenue Ratio 2/								
Baseline	4	4	4	4	5	5	5	6
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	4	4	4	8	8	9	12	14
A2. Primary balance is unchanged from 2008	4	4	4	5	6	6	8	12
A3. Permanently lower GDP growth 1/	4	4	4	5	6	7	13	35
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2009-2010	4	4	4	5	6	6	7	10
B2. Primary balance is at historical average minus one standard deviations in 2009-2010	4	4	5	13	14	10	7	9
B3. Combination of B1-B2 using one half standard deviation shocks	4	4	4	11	11	8	5	5
B4. One-time 30 percent real depreciation in 2009	4	4	5	5	6	6	6	9
B5. 10 percent of GDP increase in other debt-creating flows in 2009	4	4	7	29	9	19	8	10

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 length of the projection period.

2/ Revenues are defined inclusive of grants.

Table 3a. Armenia: External Debt Sustainability Framework, Baseline Scenario, 2005-2028 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average	Standard Deviation	Projections							2008-2013			2014-2028	
	2005	2006	2007			2008	2009	2010	2011	2012	2013	Average	2018	2028	Average		
External debt (nominal) 1/	27.3	22.7	20.1			17.5	16.5	15.7	14.8	13.8	12.7				11.3	8.3	
Of which : public and publicly guaranteed (PPG)	22.4	18.9	17.2			13.7	12.2	11.7	11.6	11.2	10.6				9.8	6.9	
Change in external debt	-6.0	-4.6	-2.6			-2.6	-1.0	-0.8	-0.9	-1.0	-1.1				0.1	-0.4	
Identified net debt-creating flows	-12.9	-11.6	-7.8			1.4	2.8	2.7	1.6	0.7	1.4				1.7	-1.9	
Non-interest current account deficit	0.3	1.3	6.0	6.6	5.2	9.3	10.3	10.2	9.2	8.0	8.3				7.4	2.6	5.9
Deficit in balance of goods and services	14.4	16.1	19.7			23.0	24.8	23.9	22.0	20.5	19.8				17.8	11.0	
Exports	28.9	23.7	19.3			15.7	15.5	15.9	16.3	16.5	16.6				19.5	25.2	
Imports	43.3	39.7	39.0			38.7	40.2	39.8	38.3	37.0	36.5				37.4	36.3	
Net current transfers (negative = inflow)	-10.7	-10.9	-10.3	-9.3	1.2	-10.0	-10.4	-9.9	-9.4	-9.2	-8.4				-7.8	-6.2	-7.2
Of which : official	-1.3	-1.3	-1.0			-0.5	-0.4	-0.2	-0.1	-0.5	0.0				-0.3	-0.2	
Other current account flows (negative = net inflow)	-3.5	-4.0	-3.5			-3.8	-4.0	-3.8	-3.5	-3.3	-3.1				-2.7	-2.3	
Net FDI (negative = inflow)	-4.7	-7.0	-7.2	-6.1	2.3	-6.8	-6.9	-6.9	-7.1	-6.8	-6.5				-5.6	-4.5	-5.2
Endogenous debt dynamics 2/	-8.4	-5.8	-6.5			-1.1	-0.7	-0.6	-0.4	-0.5	-0.4				-0.1	0.0	
Contribution from nominal interest rate	0.8	0.6	0.4			0.5	0.5	0.4	0.4	0.3	0.3				0.3	0.3	
Contribution from real GDP growth	-3.5	-2.8	-2.2			-1.5	-1.2	-1.0	-0.8	-0.8	-0.7				-0.4	-0.3	
Contribution from price and exchange rate changes	-5.7	-3.6	-4.8			...	...	...	...	...	...				...	...
Residual (3-4) 3/	6.9	6.9	5.1			-4.0	-3.8	-3.6	-2.5	-1.7	-2.6				-1.6	1.5	
Of which: exceptional financing	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0				0.0	0.0	
PV of external debt 4/	...	...	12.0			11.1	10.9	10.3	9.4	8.6	8.1				8.3	6.9	
In percent of exports	...	...	62.0			70.5	70.5	64.8	57.5	52.1	48.6				42.5	27.2	
PV of PPG external debt	...	...	9.1			7.3	6.6	6.3	6.1	6.0	6.0				6.8	5.5	
In percent of exports	...	...	47.1			46.3	42.6	39.6	37.6	36.2	36.0				34.8	21.6	
In percent of government revenues	...	...	46.9			37.1	32.5	30.2	28.6	27.4	26.8				27.4	18.3	
Debt service-to-exports ratio (in percent)	2.7	2.5	2.2			8.3	8.1	8.7	8.6	8.0	7.2				4.1	4.5	
PPG debt service-to-exports ratio (in percent)	-2.1	-2.9	-2.6			2.9	2.6	2.3	2.2	2.1	1.9				1.8	2.7	
PPG debt service-to-revenue ratio (in percent)	-3.5	-3.9	-2.6			2.3	2.0	1.8	1.7	1.6	1.4				1.4	2.3	
Total gross financing need (Billions of U.S. dollars)	-0.2	-0.3	-0.1			0.5	0.7	0.7	0.6	0.5	0.7				0.9	-0.5	
Non-interest current account deficit that stabilizes debt ratio	6.3	5.9	8.6			11.8	11.3	11.1	10.0	9.0	9.5				7.3	3.0	
Key macroeconomic assumptions																	
Real GDP growth (in percent)	14.5	13.3	13.8	10.5	3.9	10.0	8.0	7.0	6.0	6.0	6.0			7.2	4.0	4.0	4.2
GDP deflator in U.S. dollar terms (change in percent)	20.5	15.0	26.7	8.1	10.7	19.2	7.6	6.4	6.4	5.4	5.4			8.4	2.3	1.5	2.5
Effective interest rate (percent) 5/	3.2	2.8	2.7	2.9	0.6	3.0	3.2	3.1	2.8	2.6	2.5			2.8	2.8	3.9	3.1
Growth of exports of G&S (U.S. dollar terms, in percent) 6/	43.8	6.7	17.6	19.0	12.8	6.7	14.4	16.8	15.8	13.3	12.5			13.2	10.7	8.0	9.8
Growth of imports of G&S (U.S. dollar terms, in percent) 7/	40.3	19.4	41.5	15.2	16.6	30.1	20.8	12.6	8.6	8.0	10.0			15.0	7.5	5.3	6.8
Grant element of new public sector borrowing (in percent)	...	...	...	...	...	53.9	44.7	56.1	58.8	48.7	15.8			46.3	15.8	15.8	15.8
Government revenues (excluding grants, in percent of GDP)	17.4	17.5	19.4			19.6	20.2	20.8	21.4	21.8	22.3				24.8	29.8	26.3
Aid flows (in Billions of U.S. dollars) 7/	0.3	0.2	0.3			0.2	0.3	0.5	0.8	1.0	1.2				2.2	3.7	
Of which : Grants	0.0	0.0	0.1			0.1	0.1	0.1	0.1	0.1	0.1				0.1	0.2	
Of which : Concessional loans	0.3	0.2	0.2			0.1	0.2	0.4	0.7	0.9	1.1				2.1	3.5	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...			1.1	1.2	1.4	1.4	1.0	0.6				0.5	0.4	0.5
Grant-equivalent financing (in percent of external financing) 8/	...	...	...			71.3	74.8	70.9	70.1	64.6	46.6				39.9	51.0	45.5
Memorandum items:																	
Nominal GDP (Billions of U.S. dollars)	4.9	6.4	9.2			12.1	14.0	16.0	18.0	20.1	22.5				32.8	60.3	
Nominal dollar in GDP growth	38.0	30.3	44.2			31.1	16.2	13.9	12.8	11.7	11.7			16.2	6.4	5.6	6.8
PV of PPG external debt (in Billions of U.S. dollars)	...	...	0.8			0.9	0.9	1.0	1.1	1.2	1.3				2.2	3.3	
(PVt-PVt-1)/GDPT-1 (in percent)	...	...	...			0.4	0.4	0.6	0.6	0.6	0.7			0.5	0.8	0.0	0.4

Source: Staff simulations.

1/ Includes both public and private sector external debt.

2/ Derived as $[r - g - r(1+g)] / (1+g+r)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and r = 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 PV 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 generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 3b. Armenia: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2008-2028
(In percent)

	Projections										
	2008	2009	2010	2011	2012	2013	2018	2019	2020	2027	2028
PV of debt-to GDP ratio											
Baseline	7	7	6	6	6	6	7	7	7	6	5
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2008-2028 1/	7	5	4	3	4	3	3	3	3	9	10
A2. New public sector loans on less favorable terms in 2008-2028 2/	7	7	7	7	6	6	7	7	8	7	6
B. Bound Tests											
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	7	7	6	6	6	6	7	7	7	6	6
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	7	7	9	9	8	8	8	8	8	6	6
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2009-2010	7	7	8	7	7	7	8	8	9	7	7
B4. Net nondebt creating flows at historical average minus one standard deviation in 2009-2010 4/	7	11	14	13	13	12	11	11	11	7	6
B5. Combination of B1-B4 using one-half standard deviation shocks	7	10	14	13	13	12	11	11	11	7	6
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	7	9	9	8	8	8	9	10	10	8	8
PV of debt-to-exports ratio											
Baseline	46	43	40	38	36	36	35	35	34	23	22
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2008-2028 1/	46	33	22	20	21	20	16	15	15	34	40
A2. New public sector loans on less favorable terms in 2008-2028 2/	46	43	41	40	38	37	37	37	37	27	25
B. Bound Tests											
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	46	43	40	38	36	36	35	35	34	23	22
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	46	52	67	63	60	58	50	49	48	29	27
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2009-2010	46	43	40	38	36	36	35	35	34	23	22
B4. Net nondebt creating flows at historical average minus one standard deviation in 2009-2010 4/	46	70	88	81	76	73	57	54	51	27	24
B5. Combination of B1-B4 using one-half standard deviation shocks	46	66	87	81	76	73	57	55	52	28	25
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	46	43	40	38	36	36	35	35	34	23	22
PV of debt-to-revenue ratio											
Baseline	37	33	30	29	27	27	27	28	28	20	18
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2008-2028 1/	37	25	17	15	16	15	13	12	12	29	34
A2. New public sector loans on less favorable terms in 2008-2028 2/	37	33	31	31	29	27	29	29	29	22	21
B. Bound Tests											
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	37	33	31	29	28	27	28	28	28	20	19
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	37	37	43	40	38	37	34	33	32	21	19
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2009-2010	37	36	37	35	33	32	33	33	33	24	22
B4. Net nondebt creating flows at historical average minus one standard deviation in 2009-2010 4/	37	53	67	62	58	54	45	43	41	23	21
B5. Combination of B1-B4 using one-half standard deviation shocks	37	52	67	62	58	55	46	44	42	24	22
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	37	45	42	40	38	37	38	38	38	27	25

Table 3b. Armenia: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2008-2028 (continued)
(In percent)

Debt service-to-exports ratio											
Baseline	3	3	2	2	2	2	2	2	2	3	3
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2008-2028 1/	3	2	2	1	1	1	0	1	1	1	1
A2. New public sector loans on less favorable terms in 2008-2028 2/	3	3	2	2	2	2	2	2	2	2	2
B. Bound Tests											
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	3	3	2	2	2	2	2	2	2	3	3
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	3	3	3	3	3	3	3	3	4	4	4
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2009-2010	3	3	2	2	2	2	2	2	2	3	3
B4. Net nondebt creating flows at historical average minus one standard deviation in 2009-2010 4/	3	3	3	3	3	3	4	4	4	4	4
B5. Combination of B1-B4 using one-half standard deviation shocks	3	3	3	4	3	3	4	4	4	4	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	3	3	2	2	2	2	2	2	2	3	3
Debt service-to-revenue ratio											
Baseline	2	2	2	2	2	1	1	2	2	2	2
A. Alternative Scenarios											
A1. Key variables at their historical averages in 2008-2028 1/	2	2	1	1	1	1	0	1	1	1	1
A2. New public sector loans on less favorable terms in 2008-2028 2/	2	2	2	2	2	2	2	2	2	1	1
B. Bound Tests											
B1. Real GDP growth at historical average minus one standard deviation in 2009-2010	2	2	2	2	2	1	1	2	2	2	2
B2. Export value growth at historical average minus one standard deviation in 2009-2010 3/	2	2	2	2	2	2	2	2	2	3	3
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2009-2010	2	2	2	2	2	2	2	2	2	3	3
B4. Net nondebt creating flows at historical average minus one standard deviation in 2009-2010 4/	2	2	2	3	2	2	3	4	4	3	3
B5. Combination of B1-B4 using one-half standard deviation shocks	2	2	2	3	3	2	3	4	4	3	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	2	3	2	2	2	2	2	2	2	3	3
<i>Memorandum item:</i>											
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	23	23	23	23	23	23	23	23	23	23	23

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest 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.

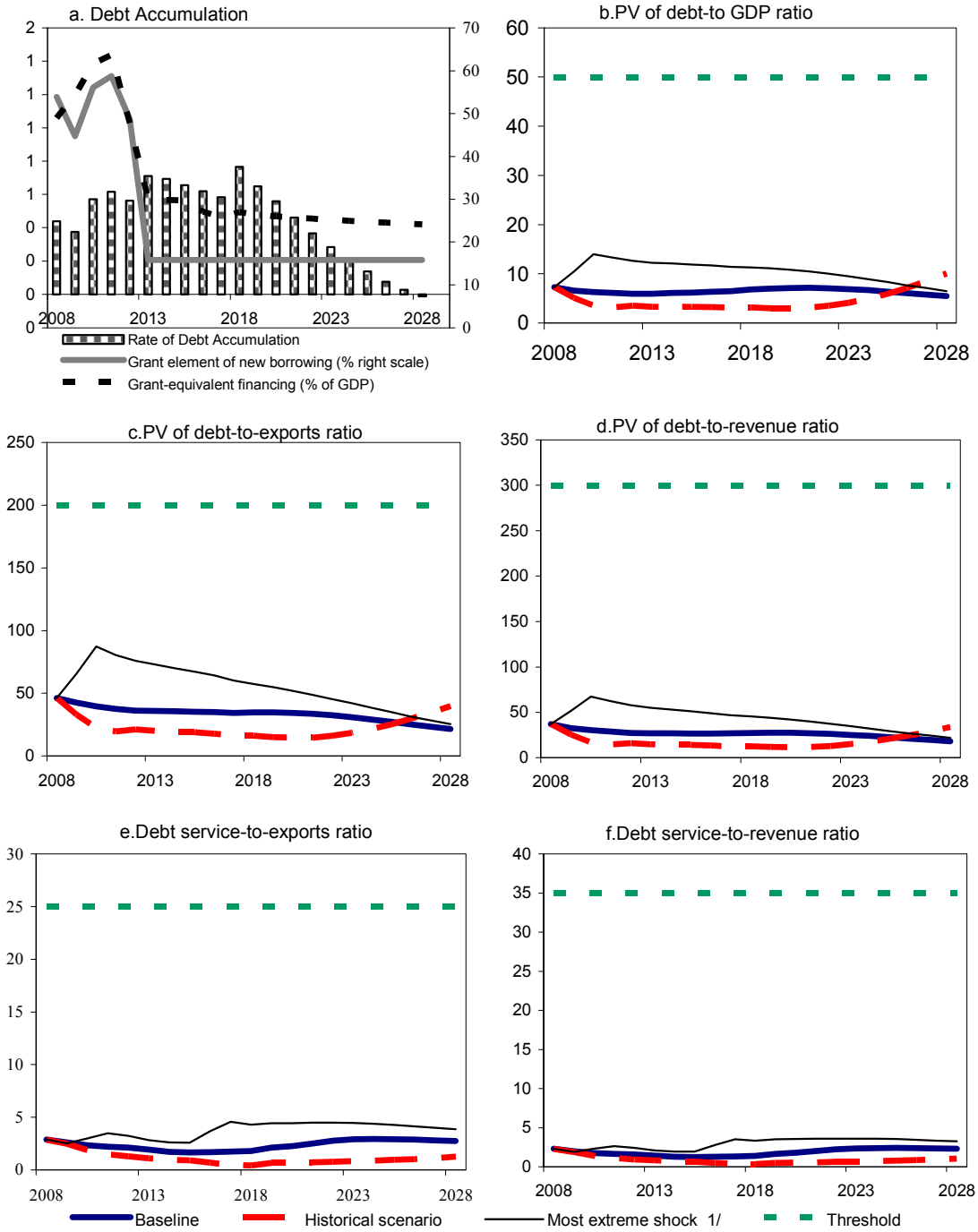
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

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.

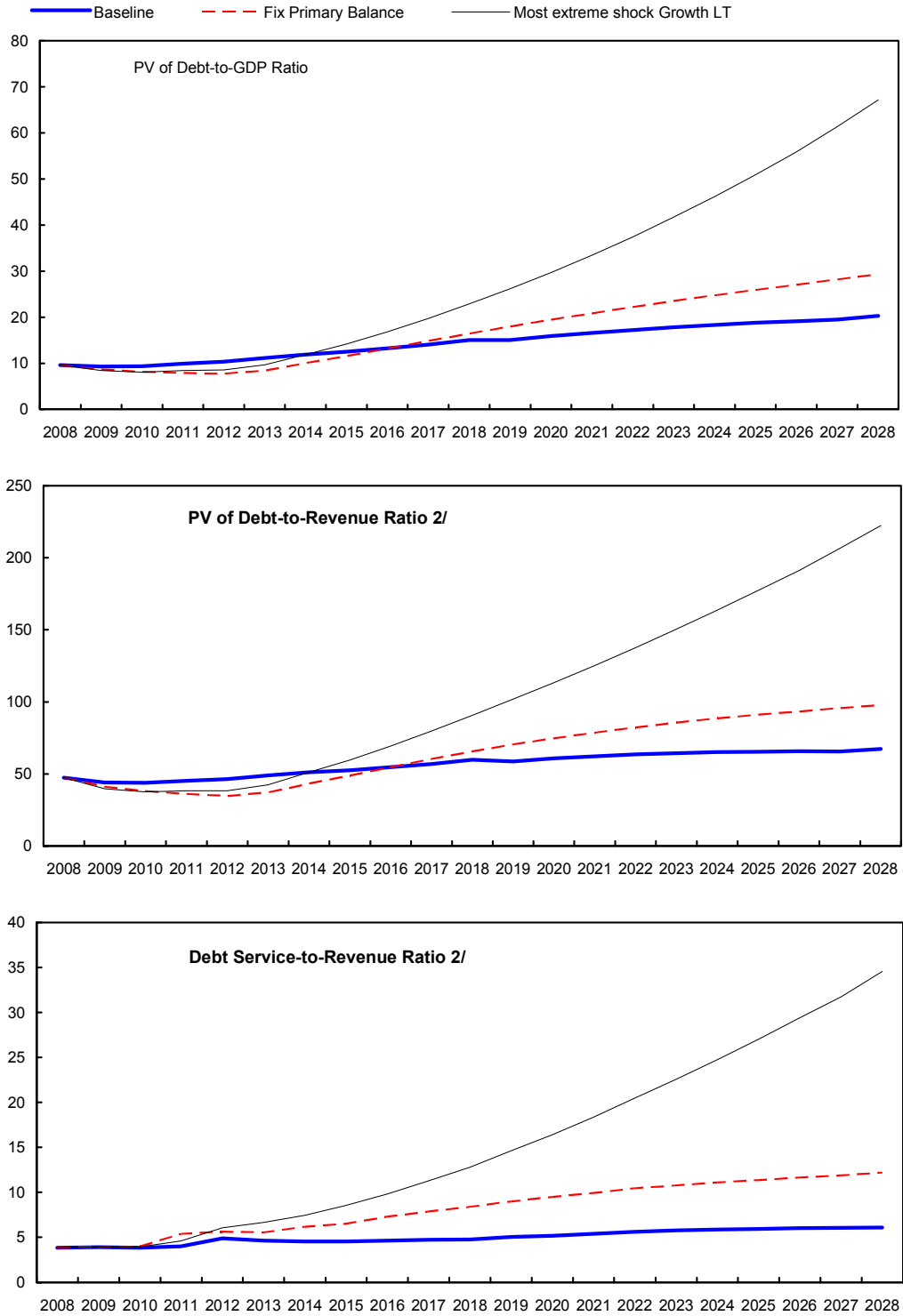
Figure 2. Armenia: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2008-2028



Source: Staff projections and simulations.

1/ The most extreme stress test is the test that yields the highest ratio in 2018. In figure b. it corresponds to a Combination shock; in c. to a Combination shock; in d. to a Combination shock; in e. to a Non-debt flows shock and in picture f. to a Non-debt flows shock

Figure 3. Armenia: Indicators of Public Debt Under Alternative Scenarios, 2008-2028



Sources: Armenian authorities; and Fund staff estimates and projections.
 1/ The most extreme stress test is the test that yields the highest ratio in 2018.
 2/ Revenues are defined inclusive of grants.

INTERNATIONAL MONETARY FUND

REPUBLIC OF ARMENIA

**2008 Article IV Consultation and Request for Three-Year Arrangement
Under the Poverty Reduction and Growth Facility**

Informational Annex

Prepared by Middle East and Central Asia Department

October 31, 2008

	Contents	Page
I.	Relations with the Fund	2
II.	Relations with the World Bank	7
III.	Relations with the EBRD	16
IV.	Statistical Issues	18

ANNEX I. ARMENIA: RELATIONS WITH THE FUND
(As of September 30, 2008)

- **Mission:** Discussions were held in Yerevan on September 3–16, 2008.
- **Country interlocutors:** The mission met with Mr. T. Sargsyan (Prime Minister), Mr. T. Davtyan (Minister of Finance), Mr. N. Yeritsyan (Minister of Economy), Mr. A. Javadyan (Chairman of the Central Bank), other senior officials, and representatives of the donor community, private sector, and civil society.
- **Team:** Ms. Castello-Branco (head), Messrs. Bonato and Floerkemeier (all MCD), Mr. Gracia and Ms. Everaert and Mr. Harrison (FAD), and Mr. Darius (SPR). Mr. Pérez (MCD) and Mr. Yakusha (OED) participated in the policy discussions. Ms. Oomes (resident representative), Ms. Manookyan, and Mr. Stepanyan (economists in the local office) assisted the mission.
- **Exchange rate regime:** managed float with no pre-determined path for the exchange rate.
- **Fund relations:** Armenia has accepted the obligations under Article VIII Sections 2, 3, and 4, and maintains an exchange system free of restrictions on payments and transfers for current international transactions, except for exchange restrictions maintained for security reasons that have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).
- **Data:** Armenia's data are adequate for surveillance and program monitoring. Armenia subscribes to the Special Data Dissemination Standard (SDDS).
- **Outreach:** Meetings with parliamentarians, NGOs, donors, and private sector; press conference and press statement.
- **Consultation cycle:** 24 months.

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

II.	General Resources Account:	SDR Million	Percent of Quota
	Quota	92.00	100.00
	Fund holdings of currency	92.00	100.01
III.	SDR Department:	SDR Million	Percent of Allocation
	Holdings	8.94	n.a.

IV. Outstanding Purchases and Loans:	SDR Million	Percent of Quota
PRGF arrangements	94.37	102.58

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	23.00
PRGF	05/23/2001	12/31/2004	69.00	69.00
PRGF	02/14/1996	12/20/1999	109.35	109.35

VI. Projected Payments to Fund ^{1/}

(SDR Million; based on existing use of resources and present holdings of SDRs)

	<u>Forthcoming</u>				
	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Principal	8.19	15.19	14.13	14.44	14.75
Charges/interest	<u>0.23</u>	<u>0.40</u>	<u>0.33</u>	<u>0.26</u>	<u>0.18</u>
Total	8.42	15.58	14.46	14.70	14.94

^{1/} When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

VII. Safeguards Assessment

Under the Fund's Safeguards Assessments policy, an update safeguards assessment of the Central Bank of Armenia (CBA) is currently underway with respect to the prospective arrangement. An earlier update assessment completed on November 7, 2005 found that the CBA's safeguards framework has been strengthened since the initial assessment completed in 2002.

VIII. Exchange Rate Arrangement

- (a) The exchange rate system can be classified as a managed float without a predetermined path. During 2005–07, the CBA intervened heavily in the foreign exchange market to smooth out volatility in the exchange rate. 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 2006 Article IV consultation with Armenia was concluded on November 22, 2006. Armenia is subject to a 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	...
Data ROSC module	April 2008	...	...

XI. Resident Representatives

Ms. Nienke Oomes, since August 2006.

XII. Technical Assistance

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

Armenia: Technical Assistance from the Fund, 2002–08

Subject	Type of Mission	Timing	Counterpart
Fiscal Affairs Department (FAD)			
Tax policy and administration	Short-term	September 17– October 2, 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 13–27, 2004	MFE, STS, and Customs Committee
Public expenditure management advisor		November 7, 2003– November 6, 2004	
Tax administration	Short-term	October 5–18, 2006	MFE, STS
Public financial management reform	Short-term	November 27 – December 8, 2006	MFE
Tax administration	Short-term	October 31 – November 13, 2007	MFE, STS
Tax administration	Short-term	January 5 – 22, 2008	MFE, STS
Tax administration	Short-term	April 1-12, 2008	MFE, STS
Tax administration	Short-term	June 11-17, 2008	MFE, STS
Legal Department			
Tax legislation		September 1, 2004– December 31, 2005	
Legislation Development & FIU	Short-term	July 31–August 7, 2006	
Unified Tax Code	Short-term	June 16–23, 2007	MFE
Monetary and Capital Markets Department			
Banking system issues	Short-term	April 15–19, 2002	CBA
Banking system, deposit insurance, foreign exchange market development,	Short-term	June 24–July 4, 2002	CBA

and CBA monetary operations.

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
Recapitalization of the Central Bank of Armenia	Short-term	December 8–14, 2005	CBA
Monetary policy and markets		December 4, 2005– December 31, 2006	
Strengthening the implementation of monetary policy	Short-term	March 8–21, 2006	CBA
Monetary policy implementation and money market development	Short-term	October 5–17, 2006	CBA
AML/CFT preventive measures		April 1, 2006–April 30, 2007	
Inflation Targeting, Foreign Exchange Market Development and Responding to Dedollarization	Short-term	August 29— September 10, 2007	CBA

Statistics Department

Data dissemination standards	Short-term	September 18–25, 2003	National Statistical Service
Balance of payments: remittances	Short-term	August 22– September 5, 2006	CBA

International Capital Market Department

Sovereign credit quality	Short-term	September 6–10, 2005	CBA
Sovereign credit risk	Short-term	August 20, 2005– August 20, 2006	CBA

ANNEX II. ARMENIA: RELATIONS WITH THE WORLD BANK
(August 1, 2008)

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. With support and advice through the Judicial Reform Project (JRP) supported by the World Bank, the Judicial Leadership and the Government were able to formulate the long term development course for the judicial system reflected in particular in Judicial Code and consequent establishment of the Judicial Department responsible for judicial administration and career public service in judicial system (excluding judges). JRP made all the normative legal acts available electronically through ARLIS legal database with free on-line access and CD/DVD versions are also available. The number of visitors to the website of ARLIS has grown dramatically after launching the database in end 2005. Special automated case management information systems were developed and piloted for courts (CAST) and Enforcement Service for Judicial Acts (AESMS). CAST has been already rolled-out across the entire judicial system. The World Bank has also supported the rehabilitation of 13 courthouses housing 15 courts and the installation of digital case recording audio systems.

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 112 days in 2006. FDI increased by almost 3-fold in 2007 compared with 2005. As part of the PRSC supported programs, Customs introduced a self declaration system and reduced the role of reference prices. It has also provided public access to customs values through the official customs website (www.customs.am).

4. On tax administration, the government strengthened the operation of Large Tax Payers Unit (LTPU), which should help to reduce the stock of VAT refunds owed to exporters and ensure that no additional VAT arrears will be incurred to exporters.

5. 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.

6. In addition to the above-stated, further strengthening of both tax and customs administration were at the core of the PRSC IV, A series of measures have been adopted by STS aimed at promoting the development of the self-assessment system. A separate division for taxpayer service has been established within the STS headquarters designated for (i) defining the policies and procedures of taxpayer education and assistance for tax inspectorates, (ii) overseeing the performance of taxpayer service divisions of tax inspectorates, and (iii) managing the taxpayer education and assistance operations throughout the STS. The capability of this unit was built up. Under **PRSC-IV**, the near term agenda for reforms was fleshed out. A work plan for improving the enforcement of the Law on Declaring Individuals' Property and Income was developed. Recording commissions were abolished as of July 1st 2008.

7. The administrative and audit capacity of the LTPU was strengthened under the PRSC-supported program. Reforms focused on legislative initiatives to facilitate effective tax audits and on development of personnel, institutional and administrative infrastructures in support of LTU. An annual audit plan based on risk classification, priorities and targets was introduced. Other measures, such as periodic publication of the list of 300 large taxpayers and changes in the management practices greatly helped to increase the productivity of this unit. PRSC supported reform agenda the Government of Armenia introduced changes to the structure of the STS by which, the large taxpayers, banking and financial, excise, and mining inspectorates were merged into one inspectorate - the Large Taxpayers Inspectorate.

8. Over the PRSC program, significant structural improvements were achieved in customs administration, such as the introduction of modern software and improved personnel practices. The central reform was the institution of *direct trader input* (DTI) that currently covers about 70 percent of imports. DTI has initiated a systemic change away from the intimate involvement of customs officials at the declaration validation stage, where opportunities for discretionary behavior are rife. The system has the capability to provide for immediate validation and assessment of acceptable declarations. Under PRSC-IV, the working of DTI was made increasingly effective through the implementation of a comprehensive post-release review program for imports. The post-release reviews are being increasingly effective in ensuring proper customs administration whilst minimizing the opportunities for poor governance.

9. PRSC-IV also supported the detailed preparatory technical work for the introduction of a bank guarantee mechanism for approved importers to facilitate the smooth flow of imports, strengthen the rules-based regime, reduce risks, and minimize the interface between importers and customs officials as is the case in all advanced countries. Legislative amendments for the implementation of guarantees were approved by the government at end-September 2007. Progress has also been made in *selectivity of customs control*. A risk-based system was introduced under the PRSC program. Reforms in this area under the PRSC program have led to greater automaticity and predictability in clearance of goods, reduced discretion and lowered business costs. The reform program has introduced transparent and swift procedures destined to facilitate trade while safeguarding revenue collection in line with established international good practice.

C. Energy and Infrastructure

10. 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 and the regulator have 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. The market rules in the energy sector have improved. The Electricity Distribution Company is allowed to enter into direct contracts with the electricity generators and service providers, which has enhanced sector transparency. The regulator has adopted and enforced service quality standards for electricity supply. 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.

11. 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. The World Bank has supported an innovative public-private partnership in water supply, which has substantially increased reliable water supply throughout the country (70% of Yerevan now has 24 hour service). The government has adopted a schedule for irrigation tariff increases in order to move closer to full cost recovery in the irrigation system. As part of the PRSC III reforms, the Government has also developed and now considering a step-by-step civil aviation liberalization action plan. Railway restructuring plan and development of telecommunication regulations are also underway.

D. Education and Health

12. 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. Later in 2006, during the second phase of the reforms, in the scope of the staff optimization and social assistance program approximately 3,200 new redundant teachers have been registered and were provided with different type of social assistance. 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, by 16.1 percent in 2006, and by 27.0 percent in 2007. In addition, the government approved a strategy on preschool education and a pilot project for its implementation 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 upper

secondary education in the framework of the transition to 12-year general secondary education, strengthening the strategy for teacher education and ongoing professional development, enhancing capacities of IST use and its integration in teaching and learning, introduction of new mechanisms of higher education financing and establishment of a national quality assurance framework, enhancement of standards for higher education to make it more responsive to employers' needs, setting a student loan system, promoting school readiness and equal opportunities through improved preschool education system and increasing enrollment rate, and strengthening monitoring and financial reporting of the noncommercial organizations (NCOs) in the education sector.

13. 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. Significant investment has been done through the WB financed project to upgrade physical condition, equipment and improve internal management and governance of three hospital mergers in Yerevan, which demonstrated the biggest efficiency gains. While the hospital merger process in capital city has been implemented with notable progress in productivity and efficiency indicators in selected hospital networks, introduction of further appropriate adjustments is required. In addition, in 2006 the Government adopted a regional hospital optimization/modernization plan, aimed at improving efficiency and productivity of outpatient services in regions. The consolidation of regional hospitals in smaller networks is in the process. 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. The Government plans to conduct independent financial audit of all public hospitals for the next three years.

14. Implementation progress has been satisfactory and about 200 hospital accountants have been trained in new accounting procedures. All public hospitals use updated financial management and accounting procedures. The government cleared all accumulated arrears in the health sector. Furthermore, the level of public financing in health sector has been continuously increasing as projected under the MTEF. The government also adopted a decision to introduce further reforms in the Basic Benefit Package in the health sector. The Government strategy for increasing revenues in the short term is to not expand the benefits package but to raise the reimbursement rates to reduce the gap with the cost of services. The government undertook measures for increasing financing of the Primary Health Care in order to secure access to quality basic health services, in particular for the poor and in rural areas. 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

15. 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.

16. The Government of Armenia is in the process of designing a new pension system. In August 2007 the Government prepared a new Draft Framework Law on Pension Reform in Armenia which defines benefits and beneficiaries of pillars zero and pillar one and the accumulation phase of the mandatory accumulation system. The draft pension reform concept would also involve the mandatory introduction of a second pillar for those above 30 years of age financed by an add-on contribution rate, a flat-benefit budget-financed first pillar and a universal zero-pillar for those that did not contribute to the system. Prior to the Law enactment, the fiscal and social impact of the selected design of the pension system is being assessed and compared to alternative solutions. A Pension Task Force has been established in the Government to analyze these issues.

II. LENDING

17. World Bank lending to Armenia as of August 1, 2008 totals US\$ 1,056.1 million, (including 2 GEF operations) of which US\$953.3 million has been disbursed. The current Bank portfolio consists of 17 IDA credits and 2 GEF projects, for a total commitment of \$291.7 million, of which \$187.5 million is disbursed. Armenia portfolio continues to be low risk with the projects rated as satisfactory or moderately satisfactory. In FY08, one investment operation—Irrigation Development: Additional—was approved in July 2007 for \$5 million and one development policy operation—PRSC-IV for \$18.5 million – was approved in November 2007.

18. 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 and focuses on three main objectives of: (i) promoting private sector led economic growth; (ii) making growth more pro-poor; and (iii) reducing non-income poverty. CAS PR (Progress Report) was considered by the Board on March 8, 2007 and reconfirmed this focus. IDA 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 eligible for about \$56 million in FY09. In addition, based on a 2006 review of Armenia's creditworthiness, Armenia is now eligible to receive IBRD lending, although it has not done so yet.

19. The CAS included four Poverty Reduction Support Credits (PRSCs) for FY05, 06, 07, and 08 which focused on four main components: (i) supporting private sector development and governance; (ii) advancing public infrastructure reforms; (iii) improving core public sector functions; and (iv) enhancing human development and improving social safety nets. All four have been extended and disbursed. The PRSCs' preparation was closely coordinated with the IMF Poverty Reduction and Growth Facility (PRGF). A new economic reform dialogue has been initiated starting in FY09.

20. A new World Bank CPS will be prepared during FY09, which will lay out expected lending and analytic work for the next four years. This will be based on Armenia's development priorities to be contained in the recent update of their Poverty Reduction Strategy Paper (PRSP), renamed Sustainable Development Program (SDP).

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

Active Projects	Credit Amount as of 07/31/08	Disbursement as of 07/31/08	Approval Date	Closing Date
<i>Active Projects</i>	291.7	187.5		
1. Irrigation Dam Safety	26.6	23.9	06/24/99	12/31/08
2. Irrigation Development	29.9	30.6	08/30/01	03/31/09
3. Social Protection Admin.	5.2	3.9	06/10/04	06/30/09
4. Natural Resource Management	8.3	8.8	06/04/02	01/31/09
Natural Resource Management (GEF)	5.1	4.0	06/04/02	01/31/09
5. Educ. Qual. & Relevance (APL #1)	19.0	14.6	01/20/04	11/30/08
6. Municipal Water and WW	23.0	21.8	05/04/04	02/28/09
7. Health System Modernization	19.0	15.2	06/10/04	06/30/09
8. Irrigation Dam Safety 2	6.8	4.2	06/10/04	03/31/09
9. Public Sector Modernization	10.2	3.7	05/04/04	03/31/09
10. Rural Enterprise & Small Scale Agric.	20.0	11.3	07/07/05	05/31/10
11. Urban Heating	15.0	11.1	07/12/05	06/30/10
12. Yerevan Water/Wastewater	20.0	6.7	02/24/05	02/28/11
13. Renewable Energy	5.0	2.6	03/29/06	12/31/10
Renewable Energy (GEF)	3.0	0.8	03/29/06	12/31/10
14. Avian Influenza Preparedness	6.3	3.3	06/02/06	07/31/09
15. Armenia SIF III	25.0	14.7	10/26/06	30/06/11
16. Health Systems Moderniztn (APL-II)	22.0	1.8	03/08/07	12/31/12
17. Judicial Reform II	22.5	4.4	03/08/07	12/31/12
<i>Closed Projects</i>	764.5	765.8		
18. Economic Rehabilitation	60.0	64.3	02/28/95	06/30/96
19. SAC	60.0	58.5	02/29/96	12/31/97
20. Institution Building	12.0	10.6	03/30/93	11/30/97
21. Earthquake Rehabilitation	28.0	29.7	02/01/94	06/30/97
22. Power Maintenance	13.7	13.2	12/08/94	06/30/99
23. SAC II	60.0	58.5	08/26/97	06/30/99
24. SATAC I	3.8	2.9	02/29/96	06/30/00
25. Highway	31.0	29.6	09/14/95	12/31/00
26. Social Investment Fund	12.0	11.1	11/09/95	12/31/00
27. Irrigation Rehabilitation	43.0	40.9	12/08/94	05/31/01
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	4.4	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. Health	10.0	9.4	07/29/97	12/30/03
34. SAC V	40.0	42.8	03/13/03	06/30/04
35. Title Registration	8.0	7.8	10/13/98	09/30/04
36. Transport	40.0	41.2	06/08/00	12/31/04
37. PRSC I	20.0	21.2	18/11/04	12/31/05
38. Agric. Reform Support	16.3	15.9	01/27/98	06/30/05
39. Social Investment Fund II	20.0	20.9	05/11/00	12/31/05
40. Investment and Export Facilitation	1.0	1.2	04/16/02	12/31/05

41.	Municipal Development	30.0	30.9	06/11/98	01/31/06
42.	PRSC II	20.0	20.3	01/19/06	06/30/07
43.	Enterprise Incubator	5.0	5.5	11/30/01	12/31/06
44.	Judicial Reform	11.4	12.4	09/14/00	12/31/06
45.	Electricity Transmission & Distribution	21.0	21.7	03/04/99	06/30/07
46.	PRSC III	28.0	28.6	03/08/07	06/30/08
47.	PRSC IV	18.5	19.6	11/27/07	06/30/08
	Total	1056.1	953.3		

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

(As of May 7, 2008)

1. As of December 31, 2007, the EBRD approved 50 projects in the power, transport, agribusiness, textile, mining, construction and financial sectors. Total commitments amounted to EUR 207 million.

2. There are three 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 was 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. Third, the EBRD approved a 7 million EUR loan to the State Committee for Water Systems, owner of the water and wastewater assets located in the small municipalities outside of Yerevan, in April 2007. The proceeds of this loan will be used to improve wastewater treatment in five municipalities located near Lake Sevan.

3. Most of the Bank's projects in Armenia are in the private sector. The EBRD has provided a loan to the Yerevan Brandy Company owned by Pernod Ricard of France (EUR 16.5 million). In the banking sector, a first equity participation in the Commercial Bank of Greece-Armenia (EUR 1.1 million) was approved in late 1999 and a second equity participation in Armeconombank was approved in 2004. The Bank also acquired an equity stake in an Armenian non-bank financial intermediary, CIRCO, an insurance subsidiary of Cascade Capital. 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 8.0 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 Program (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 programs 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 programs with local commercial banks. Commitments during 2005 include a trade facilitation project with a local bank, two direct lending facility with a small hydro power plant and gold mining company, three new SME loans, three equity investment projects with a pharmaceutical company, plastic preform manufacturer (under Direct Investment Facility), an insurance and reinsurance company, and two medium-sized co-financing facility allowing local banks to share the risk of their selected clients with EBRD. During 2006 the EBRD signed 2 projects with the total commitments of Euro 20 million—one of them an on-lending long-term loan to support renewable energy projects, and the other one to Armenian International Airports CJSC to complete the construction of a new international passenger terminal. In the financial sector EBRD undertook two equity investments in 2007 with foreign strategic co-investors (ProCredit and ITB-Byblos) and two further A/B syndications with international commercial banks for ACBA-Credit Agricole and Armeconbank. Additionally, two new Trade facilitation program (TFP) facilities were launched.

4. The key priorities of the EBRD for the coming years are: (i) financial sector; (ii) enterprise sector, particularly SME and micro-enterprise financing through credit lines to Armenian banks or direct loans and equity investments, (iii) infrastructure investments in the development of alternative energy sources and municipal infrastructure projects and (iv) portfolio monitoring and implementation support. The EBRD's current country strategy was approved in February 2006.

ANNEX IV. ARMENIA: STATISTICAL ISSUES

1. Data provision has some shortcomings, but is broadly adequate for surveillance. Further improvements in real, fiscal, and external sector statistics would be desirable in order to facilitate enhanced design and monitoring of economic policies. The overall quality, timeliness, and coverage of macroeconomic statistics have improved significantly over the past few years. The Fund has substantially facilitated this process through technical assistance from the Statistics Department, the Fiscal Affairs Department, and the Monetary and Capital Markets Department. On November 7, 2003 Armenia subscribed to the Special Data Dissemination Standard (SDDS). The April 2008 data ROSC mission prepared a detailed evaluation of the quality of the macroeconomic statistics.

Real sector statistics

2. The National Statistics Service (NSS) has made significant changes to the national accounts methodology to bring it in line with best international practices although some shortcomings on data sources and methods remain. Progress has been made in developing estimates of monthly and (constant price) quarterly GDP that are now published. Basic data collection procedures have also partially improved. The national accounts statistics are compiled following the conceptual frameworks of the *1993 SNA* and *ESA 95*. The classification of value added by economic activity follows the *ESA 95* directions and data are published grouped accordingly to the A3, A6, A17 and A60 codes of the EU nomenclature of economic activities.

3. Annual and quarterly GDP estimates are compiled at current prices, at comparable previous year's prices, and at average annual prices of the base year (1998) for the series up to the year 2006. Since 2007, GDP at constant prices is computed at average annual 2005 prices. The April 2008 ROSC mission found that compilation techniques for the estimates of GDP by production at constant prices are sound, however there is still need for improvements in the corresponding estimates of GDP by expenditure, particularly regarding the deflators of imports and exports. The mission also found that government expenditures and some transactions with the rest of the world are recorded on a cash basis rather than the required accrual method. Moreover, quarterly data are still collected on a cumulative basis, which are likely to undermine their accuracy. Additionally, statistical techniques need improvements regarding the estimates of the imputed rental services for owner-occupied dwellings, consumption of fixed assets, and work in progress in agriculture.

4. The CPI covers 11 large population centers and the capital city. Since January 2006 the CPI has been computed using 2005 weights. Concepts and definitions used in the compilation of the CPI are broadly in line with international standards; source data and compilation techniques are generally adequate. The NSS compiles a ten-day and a monthly CPI. The ten-day index and the monthly index are disseminated jointly.

Government finance statistics

5. The budget execution reporting system compiles data on a cash basis 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 (MoF) 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 but report data on cash flows and balances to the MoF since 2003. 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 one month after the reporting period.

6. By law, expenditures are classified and presented in the budget in accordance with the *1986 GFSM*, but the MoF is working to implement the *Government Finance Statistics Manual 2001 (GFSM 2001)*. The budget presentation and the classification of items under the economic and functional classification of expenditures needs 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 done by the NSS in cooperation with the MoF.

7. The authorities submitted cash data, converted to the framework of the *GFSM 2001* for publication in the *2007 Government Finance Statistics Yearbook*. The authorities began providing data for publication in the *IFS* in July 2007. 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.

Monetary and financial statistics

8. Monetary and financial statistics are provided on a timely basis. Daily data on the accounts of the Central Bank of Armenia (CBA) are provided weekly with a one-day lag, while weekly data on the monetary survey are provided with a one-week lag. The balance sheets of the CBA and of the deposit money banks follow IAS methodology. Monthly interest rate data are provided with an one-week lag.

9. Responding to a STA request, the CBA has compiled and submitted a complete set of monetary data beginning from December 2001 using Standardized Report Forms (SRF). STA validated the resulting monetary aggregates and the data have been published since the December 2006 issue of *IFS Supplement* and are used to update IFS. An Integrated Monetary Database (IMD) has also been established by STA to share the SRF data with MCD.

External sector statistics

10. The coverage of external sector data has improved in recent years. Trade statistics are provided on a timely basis, and trade data by origin, destination, and commodity are generally available within a month. Price data for exports and imports are less readily available. Quarterly balance of payments statistics are generally available with a three-month lag. However, on remittances, which account for a significant part of the inflows, there are considerable discrepancies among available source data. Survey data are considerably lower than data obtained through the money transfer system. The NSS and CBA are working on establishing a compilation program that would enable proper measurement of remittances. The absence of a comprehensive, continuously updated business register hampers the coverage of transactions and institutional units; in particular, the coverage of the financial account items for the private nonbank sector.

11. Quarterly data on international investment position are published by the NSS within one quarter after the reference period, and the annual data within two quarters; and are also provided for publication in IFS.

Armenia: Table of Common Indicators Required for Surveillance

(As of October 10, 2008)

	Date of latest observation	Date received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of publication ⁷
Exchange Rates	Sep. 2008	10/7/2008	D	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Aug. 2008	9/30/2008	D	M	M
Reserve/Base Money	Aug. 2008	9/14/2008	D	M	M
Broad Money	Jul. 2008	9/14/2008	M	M	M
Central Bank Balance Sheet	Aug. 2008	9/14/2008	D	M	M
Consolidated Balance Sheet of the Banking System	Jul. 2008	9/14/2008	M	M	M
Interest Rates ²	Aug. 2008	9/14/2008	W	M	M
Consumer Price Index	Aug. 2008	10/2/2008	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ — General Government ⁴	Q2 05	8/28/05	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing ³ — Central Government	Q1 08	6/18/08	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	Q2 08	8/29/2008	Q	Q	Q
External Current Account Balance	Q2 08	9/26/2008	Q	Q	Q
Exports and Imports of Goods and Services	Q2 08	9/26/2008	Q	Q	Q
GDP/GNP	Q2 08	10/2/2008	M	Q	Q
Gross External Debt	Q2 08	9/30/08	Q	Q	Q
International Investment Position ⁶	Q2 08	9/26/2008	Q	Q	Q

¹ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

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

³ Foreign, domestic bank, and domestic nonbank financing.

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

⁵ Including currency and maturity composition.

⁶ Includes external gross financial asset and liability positions vis-à-vis nonresidents.

⁷ Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); and Not Available (NA).

Statement by the IMF Staff Representative on the Republic of Armenia
November 17, 2008

1. This statement reports on economic and policy developments in Armenia since the staff report was issued. These developments do not change the thrust of the staff appraisal.
2. Recent economic data are consistent with staff projections for 2008.
 - Year-on-year headline inflation decreased as expected, from 11.3 percent in September to 8.6 percent in October, mainly due to a decline in food inflation.
 - Net international reserves were lower than projected in September 2008, owing to foreign exchange intervention by the CBA in support of the dram. The end-year target is still within reach, as large-scale FDI inflows are expected in the next several weeks.
 - Preliminary third-quarter data on budget execution show a lower-than-projected deficit through September 2008. Tax revenues were slightly higher than projected, whereas expenditures were on target.
3. The short-term impact of the global financial crisis is expected to be contained, given Armenia's limited integration with the international financial system. But longer-term risks to growth have increased with the prospects of a global recession. In the best-case scenario, the global slowdown could help unwind the accumulated macroeconomic imbalances and dampen the pre-crisis risk of overheating. But a hard landing cannot be ruled out in case of a drastic decline in remittances and FDI, given Armenia's strong dependence on these inflows.
4. In reaction to the worsened international outlook, the CBA has kept its policy rate unchanged since September, putting on hold its policy of gradual monetary tightening. In addition, the authorities are temporarily supporting the exchange rate to reduce the risk of redollarization and currency destabilization. Staff has advised the authorities to allow two-way exchange rate flexibility to avoid one-way bets and a reduction of international reserves. Given current policies and the stable financial sector, a moderate depreciation is unlikely to cause a loss of confidence in the dram. But it would help improve external competitiveness and reduce the large current account deficit.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 08/143
FOR IMMEDIATE RELEASE
November 20, 2008

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2008 Article IV Consultation with the Republic of Armenia

On November 17, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Armenia.¹

Background

Armenia's recent economic performance has remained strong, and the economy is poised for another year of double-digit growth. But macroeconomic imbalances have widened. Rising inflation, a widening current account deficit, and rapid credit growth have raised concerns about overheating. While the impact of the current international financial turmoil is expected to remain limited, the threat of a severe global economic downturn could undermine growth prospects.

The Armenian economy continues to register strong growth underpinned by sound macroeconomic policies and ongoing structural reforms. Real GDP increased by 13.8 percent in 2007, the sixth consecutive year of double-digit growth, and remained strong through September 2008 (10.4 percent), on the back of continued buoyant activity in construction and services. Inflationary pressures have increased on account of surging food and energy import prices. The end-year inflation rate, at 6.6 percent, exceeded the target band for 2007 (4 ± 1.5 percent), and inflation reached 8.6 percent in October 2008. However, inflation is still lower than in neighboring countries, thanks to a gradual tightening of monetary policy, exchange rate

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

flexibility, and a moderate fiscal stance. Inflationary pressures will remain strong in the period ahead, given significant demand pressures and an announced hike in gas import prices.

Despite strong growth in private transfers, the external current account has continued to deteriorate. Imports have surged on the back of high international food and energy prices and buoyant demand. Export performance has been disappointing, reflecting declining competitiveness in diamond-processing and temporary shortfalls in base metals output, but also the high cost of doing business in Armenia. With appreciation pressures dampened by rising import demand, the dram/dollar exchange rate has been broadly stable since December 2007.

Fiscal policy has remained prudent. Tax collection has been well above expectations, driven by a surge in value added tax (VAT) revenue partly associated with high import growth. Together with expenditure underexecution, this resulted in a lower-than budgeted overall deficit in 2007 and an overall budget close to balance through July 2008. However, the underlying fiscal balance (including the gas subsidy, but excluding grants and external interest payments) has been deteriorating.

Monetary policy has been tightened to address inflationary pressures and limit second-round effects of higher food and energy prices. In 2007-08, the Central Bank of Armenia (CBA) gradually increased the repo rate to currently 7.75 percent.

Armenia's financial sector infrastructure, regulation, and supervision have improved significantly, and financial soundness indicators do not yet indicate significant vulnerabilities. Banks continue to be profitable, well-capitalized, and nonperforming loans are still low. Exposure to the international financial turmoil is limited due to low external commercial borrowing. Yet, the sharp pickup in credit growth since mid-2007—while a welcome boost to financial intermediation—could potentially impact negatively on financial sector stability.

The government's program emphasizes the authorities' commitment to policy continuity and accelerated implementation of reforms along the lines of Fund advice, with a particular focus on improving tax policy and administration, and the business environment. The authorities have requested a low-access Poverty Reduction and Growth Facility (PRGF) arrangement to support their ambitious reform agenda. A new Fund program is seen as crucial to safeguard macroeconomic stability and as a signal of the authorities' continued reform drive.

The authorities intend to continue publishing all documents related to the Article IV consultation.

Executive Board Assessment

Executive Directors commended the authorities for the successful implementation of macroeconomic policies under the PRGF-supported program that expired in May 2008. These policies, supported by large-scale foreign exchange flows, have contributed to a period of strong economic growth, low inflation, rising real incomes, and declining poverty rates.

Directors were encouraged by the authorities' commitment to continued prudent monetary and fiscal policies and far-reaching structural reforms. These actions are necessary to consolidate past gains and to strengthen the economy's resilience against external shocks. Vigorous implementation of structural reforms will be key to address Armenia's weak business environment, limited export potential, and undiversified production base.

While Armenia's short-term outlook remains favorable, inflationary pressures, a widening external current account deficit, and rapid credit growth have raised concerns about overheating. However, the current global financial turmoil and the unfolding economic downturn—as well as regional instability—could affect foreign direct investment (FDI) and remittance inflows and undermine growth prospects, while at the same time also dampening risks of overheating.

Directors welcomed the authorities' intention to withdraw fiscal stimulus during 2008-09 in order to address current imbalances. Going forward, fiscal policy should balance the need for a countercyclical stance with the spending requirements for poverty-reducing and infrastructure spending. Directors therefore welcomed the authorities' strong efforts to strengthen revenues by addressing weaknesses in tax policy and administration. The envisaged tax reform will also bring important benefits in terms of containing the shadow economy and discouraging tax evasion; reducing significantly the cost of doing business, particularly in the export sector; contributing to leveling the playing field; and, ultimately, promoting private sector development. Directors commended the plans to strengthen the medium-term expenditure framework and debt management policy.

Directors welcomed the commitment of the Central Bank of Armenia (CBA) to tighten monetary policy further if signs of overheating persist. The CBA also intends to continue the preparation for a full-fledged inflation targeting regime. Some Directors thought that a more gradual transition might be preferable as the monetary policy transmission mechanism remains weak.

Directors considered that exchange rate flexibility will continue to be the best option for Armenia, and that it should facilitate adjustment of the external balance. The authorities should refrain from extensive unsterilized foreign exchange intervention to lend credibility to the inflation targeting regime. Several Directors underscored the importance of allowing two-way exchange rate flexibility to avoid one-way bets. Directors noted the staff assessment that, despite the notable appreciation of the exchange rate in previous years, there is no evidence of a significant exchange rate misalignment. This highlights the importance of accelerating key structural reforms aimed at improving external competitiveness through a more favorable business environment.

Directors noted that Armenia's financial sector infrastructure, regulation, and supervision have improved significantly. Relevant indicators do not point to significant vulnerabilities nor are there signs that the global financial crisis has affected financial institutions in Armenia. Nevertheless, in view of the continuing areas of weakness as well as the rapid credit growth, the authorities should further strengthen the financial system—in particular, the supervisory framework and risk management—and prepare contingency plans in case of financial system stress.

Directors endorsed the authorities' request for a low-access PRGF arrangement, given Armenia's good track record and strong policy and structural program for 2009. They acknowledged that the program's focus on further strengthening the fiscal and monetary policy frameworks and their coordination, while deepening productivity-enhancing structural reforms, is appropriate to address the significant challenges ahead. Some Directors recognized, however, that Armenia's financing needs might increase with rising global risks, and supported an early review of the situation if needed. Directors also welcomed the authorities' readiness to take additional policy measures as needed.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Republic of Armenia: Selected Economic Indicators, 2004–08					
	2004	2005	2006	2007	2008 (proj.)
Real Sector					
Real GDP growth (percentage change)	10.5	14.0	13.3	13.8	10.0
GDP (in millions of U.S. dollars)	3,578	4,909	6,386	9,228	12,069
GDP per capita (in U.S. dollars)	1,113	1,523	1,976	2,842	3,698
Inflation (in percent)					
Period average	7.0	0.6	2.9	4.4	9.2
End-of-period	2.0	-0.2	5.2	6.6	7.5
Central government operations (in percent of GDP)					
Revenue and grants	14.0	14.3	14.5	16.0	16.4
Expenditure and net lending	17.1	19.9	20.0	22.4	21.6
Overall balance (cash basis)	-1.6	-2.0	-2.1	-2.2	-1.4
Monetary indicators					
Reserve money (end-of-period growth rate, in percent)	11.3	51.9	41.1	50.9	18.6
Broad money (end-of-period growth rate, in percent)	22.3	27.8	32.9	42.3	26.0
Broad money velocity	6.7	6.1	5.5	4.6	4.2
External Sector					
Current account balance (including transfers)					
In millions of U.S. dollars	-20	-51	-117	-589 1/	-1,172
In percent of GDP	-0.5	-1.0	-1.8	-6.4 1/	-9.7
External debt					
In millions of U.S. dollars	1,183	1,099	1,206	1,582 1/	1,652
In percent of exports of goods and services	59	60	72	67 1/	46
Gross official international reserves					
In millions of U.S. dollars	547	667	4,072	1,657	1,836
In months of imports of goods and services	3.1	3.2	3.6	4.3	3.9

Sources: Armenian authorities; and IMF staff estimates.

1/ Estimates.



Press Release No. 08/292
FOR IMMEDIATE RELEASE
November 18, 2008

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves Three Year, US\$13.6 Million Poverty Reduction and Growth Facility Arrangement for the Republic of Armenia

The Executive Board of the International Monetary Fund (IMF) has approved a three year, SDR 9.2 million (about US\$13.6 million) arrangement under the Poverty Reduction and Growth Facility (PRGF) for the Republic of Armenia to support the government's economic program through 2011. The decision will enable the Republic of Armenia to draw an amount equivalent to SDR 1.31 million (about US\$1.9 million) from the IMF immediately.

Following the Executive Board's discussion, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, stated:

“After the successful conclusion of its third PRGF-supported program in May 2008, Armenia's economic performance has remained very strong. High growth has been maintained and has contributed significantly to the marked reduction in poverty. Inflation has increased in the wake of rising international food and fuel prices and growing domestic demand pressures, although it remains lower than in other CIS countries. Adherence to prudent macroeconomic policies and the progress made in structural reforms has helped to achieve these results.

“The worsened global macroeconomic outlook has increased uncertainty, but Armenia is in a strong position to withstand the impact of the global economic downturn. A gradual deceleration of growth in Armenia may help dampen inflationary pressures. It may also contribute to reducing the external current account deficit, which has increased on the back of rising imports and sluggish exports, despite strong remittance inflows. Medium-term prospects, although highly uncertain, remain benign in view of favorable investment opportunities.

“Continued sound fiscal and monetary policies remain key to maintaining macroeconomic stability. Prudent policies are necessary to reduce the current macroeconomic imbalances. Current challenges highlight the need to strengthen policy frameworks. The floating exchange rate regime continues to be the best option for Armenia, and the authorities are encouraged to complete the transition to full-fledged inflation targeting. At the same time, building capacity for fiscal policy analysis will help strengthen the budgetary process and

enhance fiscal policy credibility, increasing its effectiveness as a demand management tool. In addition, the authorities must be prepared to adjust swiftly to a rapidly changing economic environment. A weakening external environment might also increase Armenia's financing needs and possibly call for an early review of the situation.

“Improving external competitiveness requires a renewed push for structural reforms. Focus should be on enhancing productivity, improving the business environment, and boosting domestic competition. In this regard, the completion of the unfinished tax policy and administration reform agenda is particularly important. These reforms would significantly reduce the cost of doing business, particularly in the export sector, and contribute to leveling the playing field, ultimately promoting private sector development,” Mr. Portugal said.

Recent Economic Developments

Armenia is poised for another year of double-digit growth, but inflation and external imbalances have been growing. Notwithstanding the temporary trade disruptions during the Georgia conflict, annual real GDP grew by 10.4 percent in the nine months to September 2008, and is projected to remain around 10 percent this year, assuming continued strong activity in construction and services. Annual inflation remained high through September at 11.3 percent, but dropped to 8.6 percent in October on the heels of falling food prices, remaining lower than in some neighboring countries.

While inflation was driven mainly by the global spike in food and energy prices (including the elimination of a natural gas subsidy last May), demand pressures have played an increasing role. Indeed, rising wages, persistently large foreign exchange inflows, rapid credit growth, and a sharply widening current account deficit have raised concerns about overheating. But the downward risks from the global economic downturn could help unwind accumulated macroeconomic imbalances.

Budget execution in 2008 has been prudent. Tax collection has been well above expectations, driven by a surge in VAT revenue partly associated with high import growth. The overall deficit remained lower than projected through September 2008, at 0.5 percent of projected annual GDP.

Monetary policy has been tightened to address rising inflationary pressures. To limit the second-round effects of higher food and energy prices, the Central Bank of Armenia (CBA) raised the repurchase rate gradually from 4.5 percent in June 2007 to 7.75 percent in September 2008, but left the rate unchanged since, in response to the uncertain external economic environment.

Despite large private transfers, the current account has continued to deteriorate. Imports have surged on the back of high international food and energy prices and buoyant demand, while export performance has been disappointing. With appreciation pressures dampened by rising import demand, the dram/dollar exchange rate has been broadly stable since December 2007. International reserve coverage dropped somewhat, but remains adequate, at about 3 ½ months of imports.

Program Summary

Armenia's PRGF-supported economic program builds on the authorities' Sustainable Development Program (SDP). The main goals of the new program are to sustain and broaden economic growth, and further reduce poverty, consistent with SDP priorities.

Appropriate fiscal and monetary policies will underpin the macroeconomic objectives of the program. Its main focus will be on strengthening the fiscal and monetary policy frameworks and their coordination, while deepening productivity-enhancing structural reforms, and improving governance. In particular, reforms in tax policy and tax administration will be essential for the success of the program.

Strengthening the policy frameworks will require, among other things, strengthening the institutional and analytical capacity at the Ministry of Finance, and adopting a Forecasting and Policy Analysis System for inflation targeting at the Central Bank of Armenia. The current global crisis highlights the need to minimize Armenia's vulnerabilities by stepping up efforts to diversify production and reduce dependence on remittances. In view of increasing global risks, Armenia's external financial requirements may increase as well, possibly calling for higher access than under the current PRGF arrangement.

Armenia: Selected Economic and Financial Indicators, 2003–09							
	2003	2004	2005	2006	2007	2008 Proj.	2009 Proj.
(In percent of GDP, unless otherwise specified)							
National income and prices							
Real GDP growth	14.0	10.5	14.0	13.3	13.8	10.0	8.0
Gross domestic product (in billions of drams)	1,625	1,908	2,243	2,656	3,149	3,672	4,169
Gross domestic product (in millions of U.S. dollars)	2,807	3,578	4,909	6,386	9,228	12,069	14,019
Gross domestic product per capita (in U.S. dollars)	874	1,113	1,523	1,976	2,842	3,698	4,274
CPI (period average)	4.7	7.0	0.6	2.9	4.4	9.2	5.2
CPI (end of period)	8.6	2.0	-0.2	5.2	6.6	7.5	5.0
Unemployment rate (in percent)	10.1	9.6	8.1	7.2	7.1	...	...
Poverty rate (in percent)	42.9	34.6	29.8	26.5	...	...	...
Investment and saving (in percent of GDP) 1/							
Investment	24.3	24.9	30.5	35.9	37.2	36.8	36.3
National savings	17.5	24.3	29.4	34.1	30.8	27.1	25.5
Money and credit (end of period)							
Reserve money	6.6	11.3	51.9	41.1	50.9	18.6	17.6
Broad money	10.4	22.3	27.8	32.9	42.3	26.0	21.1
Commercial banks' 3-month lending rate (in percent)	22.5	17.5	18.3	17.1	18.6	...	...
Central government operations (in percent of GDP)							
Revenue and grants	17.8	15.4	17.8	18.0	20.1	20.2	21.1
<i>Of which: tax revenue 2/</i>	14.0	14.0	14.3	14.5	16.0	16.4	16.8
Expenditure and net lending 3/	18.9	17.1	19.9	20.0	22.4	21.6	22.1
Overall balance on a cash basis	-1.5	-1.6	-2.0	-2.1	-2.2	-1.4	-1.0
Underlying balance 4/	-3.6	-1.4	-2.3	-2.3	-3.0	-1.9	-1.7
Government and government-guaranteed debt (in percent of GDP)	40.9	32.4	24.3	18.7	17.4	15.8	14.6
Share of foreign currency debt (in percent)	93.5	93.0	90.8	88.2	88.0	85.5	81.3
External sector 5/							
Exports of goods and services (in millions of U.S. dollars)	903	1,071	1,416	1,510	1,777	1,896	2,168
Imports of goods and services (in millions of U.S. dollars)	-1,406	-1,628	-2,124	-2,536	-3,589	-4,671	-5,641
Exports of goods and services (percentage change)	29.5	18.5	32.2	6.7	17.6	6.7	14.4
Imports of goods and services (percentage change)	27.0	15.8	30.5	19.4	41.5	30.1	20.8
Current account (in percent of GDP) 1/	-6.8	-0.5	-1.0	-1.8	-6.4	-9.7	-10.8
FDI (net, in millions of U.S. dollars)	121	246	233	450	701	815	962
External debt-to-exports ratio (NPV, in percent)	60	59	60	72	67	46	43
Debt service ratio (in percent of exports of goods and services)	15.6	8.9	4.4	3.9	2.9	2.9	2.6
Gross international reserves (in millions of U.S. dollars) 7/	502	547	667	1,072	1,657	1,836	1,968
Import cover 8/	3.7	3.1	3.2	3.6	4.3	3.9	3.7
Nominal effective exchange rate 9/	-4.6	13.4	11.7	15.6	14.1	...	...
Real effective exchange rate 9/	-2.6	8.6	5.1	14.7	12.6	...	...
End-of-period exchange rate (dram per dollar)	566	486	450	364	304	...	...
Average exchange rate (dram per dollar)	579	533	458	416	342	...	...
Memorandum item:							
Population (in millions)	3.212	3.214	3.223	3.231	3.280	...	...

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

1/ The 2004–2006 external current account figures were revised following changes in methodology

2/ Tax revenues in 2007 include 0.2 percent of GDP in tax arrears paid by Armentel, which were not part of the official target.

3/ Including the gas subsidy during 2006–08.

4/ Overall balance excluding grants and external interest payments.

5/ With the exception of gross international reserves, figures for 2007 are estimates.

6/ Private external debt included since 2006.

7/ Excluding the special privatization account (SPA).

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

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

**Statement by Yuriy G. Yakusha, Alternate Executive Director
for the Republic of Armenia
November 17, 2008**

My Armenian authorities sincerely appreciate staff's advice and would like to emphasize that Armenia followed the course of macroeconomic policy advocated by the Fund.

Revenue overperformance was largely saved, tax administration reform has been launched, monetary policy was gradually, but persistently tightened in response to inflationary pressures. The authorities also implemented recommendations of the FSAP update. Downside risks from the global economic slowdown will dampen risks of overheating even further. Since monetary policy in Armenia has been assessed as rather a success story of previous programs' implementation, I would like to concentrate on some of the underlying fiscal challenges that have become persistent in Armenia despite the prudent fiscal stance overall.

So far, the extremely high growth rates demonstrated by Armenia were accompanied and supported by the extremely low role of government redistribution of GDP. The revenue collection has improved only marginally in recent years, and not always in a way that could be confidently sustained (owing to dependence on growing import prices, tax credits, etc.). Additionally, an inefficient tax administration is perceived as an important constraint on business. Being ahead of many its peers in the Doing Business Report's overall rankings, Armenia definitely lags behind on tax administration issues.

Armenia is hoping to become a middle income country by the time the current program is implemented and will also likely feel a more pronounced business cycle. The authorities are cognizant of the need for a more countercyclical role of fiscal policy. In order for fiscal policy to become a more effective and credible demand management tool, the authorities have recently developed and adopted a comprehensive medium-term tax reform plan. To this effect, the authorities have implemented important policy measures for the new program, targeting existing inadequacies in the tax administration. Some of these measures were contemplated by staff as a part of future program conditionality, but were adopted by the authorities before the program negotiations started in earnest. Tax policy is going to be firmly anchored around the need to reduce the scope of tax exemptions and to address governance problems. In the case of Armenia, one needs not only to overcome deeply entrenched vested interests, but also to gain trust from businesses and households, whose perception of tax inspectors is rather negative. Massive retraining efforts and personnel changes are, therefore, expected. Modern auditing capabilities are also still lacking in the country, limiting the scope for risk-based tax compliance enforcement.

The new tax code is now with the Parliament. Program performance criteria are directly related to the progress of tax reform. On the expenditure side, the authorities intend to concentrate on the productivity-enhancing and poverty-reducing expenditures. Urgently needed sizeable increases in spending on infrastructure and on pension reform will only be possible when tax reform succeeds. Before more pronounced effects from the tax reform materialize, the authorities are limiting their deficit to 1.4 percent of GDP instead of the originally planned 2.6 percent. Next year, the intention is to keep the deficit under 1 percent of GDP in order to improve the underlying fiscal balance. These measures are not easy to implement politically, given the pressing need to continue to address poverty in Armenia, especially the rural poverty: geographically, Armenia is mostly a mountainous arid area, where agriculture is challenging and risky. Despite notable progress in bringing overall poverty levels down, rural poverty is still high.

Another timely pillar of the reform program to be supported by the PRGF is based on the past achievements in improving banks' corporate governance. It is targeting further enhancement of the financial sector infrastructure, its regulatory and supervisory framework, promoting financial sector deepening, and addressing related risks. Credit growth has been very high in the past two years (though from a very low base); it moderated somewhat only recently. Financial sector risks are, nevertheless, probably lower than in many other countries, given that the banking sector assets to GDP ratio is currently still at only around 15 percent, even after the recent surge in domestic credit. The share of deposits and assets denominated in foreign currencies is also among the lowest among the CIS countries.

On the monetary side, exchange rate flexibility will be maintained. The authorities will aim at bringing inflation back to the target range in 2009 and will continue their preparation for a fully-fledged inflation targeting regime. The most important challenge, to this end, will be the development of the domestic debt market, which will require close coordination between the CBA and the Government as well as external technical assistance. The monetary program envisages broadly stable level of the foreign reserves, relative to 2007.

So far, the authorities see the new program with the Fund as predominantly a signaling device and a tool to enhance internal policy coordination and boost confidence in the reform agenda of the new government. Until now, the balance of payments challenges have been manageable. The authorities acknowledge that external imbalances have grown somewhat, because of energy and food price pressures, persistent foreign exchange inflows, incomes and credit growth. In the case of Armenia, the common price pressures have been, unfortunately, magnified by effects of the conflict in the neighboring Georgia: 70 percent of Armenian trade passes through Georgia. Trade interruption, temporary shortages of fuel, notable increase in the cost of transportation and insurance, other lost opportunities (including FDI, tourism, others) have all contributed to additional pressures on the economy. In addition, on the export side the country experienced some confidence-related temporary shortfalls in important industries. It is probably too early to judge whether the effect on Armenia will be

prolonged, since it is only three months that the hostilities ended in Georgia, though immediate losses and lost opportunities are estimated by the Armenian business community in hundreds of millions of dollars.

Weakening global demand may eventually pose additional challenges, and the authorities committed themselves to additional measures, if needed. They cannot exclude that additional adjustment in response to materializing global risks may also require additional financing, including from the Fund. They also expect Fund's staff to keep external risks to the program under constant review and hope that the Fund will stand ready to augment Armenia's access to financing under the program, if warranted.