December 2006
IMF Country Report No. 06/433

Republic of Armenia: 2006 Article IV Consultation and Third Review Under the Poverty Reduction and Growth Facility—Staff Report; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Authorities of 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 2006 Article IV consultation with the Republic of Armenia and third review under the Poverty Reduction and Growth Facility, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV Consultation and Third Review Under the Poverty Reduction and Growth Facility, prepared by a staff team of the IMF, following discussions that ended on September 13, 2006, with the officials of the Republic of Armenia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 3, 2006. 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 Public Information Notice (PIN) and Press Release, summarizing the views of the Executive Board as expressed during its November 22, 2006, discussion of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively; and

- a statement by the Executive Director for the Republic of Armenia.

The document listed below has been or will be separately released.

Selected Issues Paper

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ARMENIA

Staff Report for the 2006 Article IV Consultation and Third Review Under the Poverty Reduction and Growth Facility

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

Approved by Lorenzo Pérez and Adnan Mazarei

November 3, 2006

- A staff team visited Yerevan during August 31–September 13 to conduct the 2006 Article IV Consultation and Third Review Under the Poverty Reduction and Growth Facility. The mission met with Mr. Khachatryan (Minister of Finance and Economy), Mr. Chshmarityan (Minister of Trade and Economic Development), Mr. Movsisyan (Minister of Energy), Mr. Sargsyan (Chairman of the Central Bank), and other senior officials. It also met with members of parliament and representatives of the business and donor communities.

- The mission team consisted of Mr. Al-Atrash (head), Ms. Dabla-Norris, Mr. Floerkemeier (all MCD), Mr. Hauner (FAD), Mr. Atoyan (PDR), and Mr. Crowley (MCM). It was assisted by Ms. Oomes, resident representative, and Mr. Stepanyan and Ms. Minasyan, economists in the local office.

- The attached Letter of Intent (Attachment I) and the Memorandum of Economic and Financial Policies (MEFP, Attachment II) set out the authorities' economic program for the remainder of 2006 through June 2007.

- Appendices on relations with the Fund, the World Bank, the European Bank for Reconstruction and Development, statistical issues, and debt sustainability analysis are attached.

- 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).

- Armenia's data are adequate for surveillance and program monitoring. Armenia subscribes to the Special Data Dissemination Standard (SDDS).

- A press statement was issued and a press conference was held at the end of the mission.

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EXECUTIVE SUMMARY

Background

- **Armenia's economy** continues to perform strongly. Prudent fiscal and monetary policies and ongoing structural reforms have contributed to double-digit growth in a low inflation environment; a continued reduction in poverty; and a notable improvement in tax performance. The PRGF-supported program is on track.

Focus of discussions

- **Policy discussions** centered around the appropriate monetary, exchange rate, and fiscal policy mix to maintain macroeconomic stability in the context of sizable foreign exchange inflows and on measures needed over the medium term to sustain and broaden economic growth.

Main policy recommendations

- The cautious **monetary policy stance** in 2006 is appropriate. Inflationary pressures have increased owing to large foreign exchange inflows and supply shocks. The credibility of the monetary stance is particularly important in light of the authorities' move toward a full-fledged inflation targeting regime over the medium term. In this context, a floating exchange rate regime is essential.

- The **2006 and 2007 budgets** are compatible with PRSP objectives. Fiscal policy rightly emphasizes improving revenue performance and increasing expenditures for infrastructure and social services. It is important to increase tax buoyancy without resorting to ad hoc discretionary measures to increase collection.

- The focus of **fiscal reforms** in 2006–07 should continue to be on reducing tax privileges and loopholes as well as strengthening tax and customs administrations.

- **Financial sector reforms** should concentrate on improving corporate governance, strengthening regulation and supervision, and deepening financial intermediation, including the development of the nonbank financial sector. The implementation of these reforms, together with the envisaged entry of foreign banks, should increase competition and contribute to the narrowing of interest rate spreads.

Risks

- The **program's prospects** remain very good, but there are risks. The appreciation of the dram has raised serious concerns in the country, and inflationary pressures have increased. Effective policy coordination between the monetary and fiscal authorities is needed to maintain macroeconomic stability. A prudent fiscal policy is required in the run-up to next year's parliamentary elections.

I. INTRODUCTION

1. The **performance of the Armenian economy** continues to be very strong. Prudent fiscal and monetary policies, large external inflows, and ongoing structural reforms have contributed to double-digit growth in a low-inflation environment, a sustainable external current account and debt position, and a notable reduction in poverty[1] and unemployment (Table 1). Real per capita income in U.S. dollars has tripled since 2000. Nevertheless, the significant dram appreciation resulting from foreign exchange inflows is weakening external competitiveness and harming segments of the population that rely on dollar-denominated remittances and hold savings in dollars.

2. The **PRGF-supported program** remains on track. All end-June 2006 quantitative and structural performance criteria were met and all end-June structural benchmarks were observed (MEFP, ¶5–6; Tables 2 and 3).[2]

3. The **political scene** is dominated by the parliamentary and presidential elections that will take place in May 2007 and early 2008, respectively. A new round of talks between Armenia and Azerbaijan was recently initiated in an attempt to kick-start the deadlocked peace process over Nagorno-Karabakh.

4. The **discussions on the near-term challenges** focused on the appropriate monetary, exchange rate, and fiscal policy mix to maintain macroeconomic stability in the context of sizable foreign exchange inflows that are likely to continue (see the accompanying Selected Issues (SI) Chapter 1). Policy **discussions on medium-term issues** centered around measures needed to sustain economic growth and further reduce poverty, in particular:

- The importance of accelerating **fiscal reforms** to increase budget revenues in a transparent and nondiscretionary manner to finance infrastructure projects and expand essential poverty-reducing services;

- The need for continued **financial sector reforms** to improve the quality and depth of financial intermediation, strengthen monetary policy implementation, and increase market efficiency.

5. The authorities have concurred with the thrust of the Fund's economic assessment and broadly followed its **policy advice** (Country Report No. 04/410) to maintain macroeconomic stability and accelerate structural reforms. On fiscal reforms, important

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[1] The most recent household survey from 2004 showed a further decline in poverty, with the headline poverty rate falling from 56 percent in 1999 to an estimated 34.6 percent in 2004, and extreme poverty declining slightly in 2004, following the sharp drop in 2003 (Country Report No. 06/196). An update of the authorities' Poverty Reduction Strategy Paper (PRSP) is expected in early 2007.

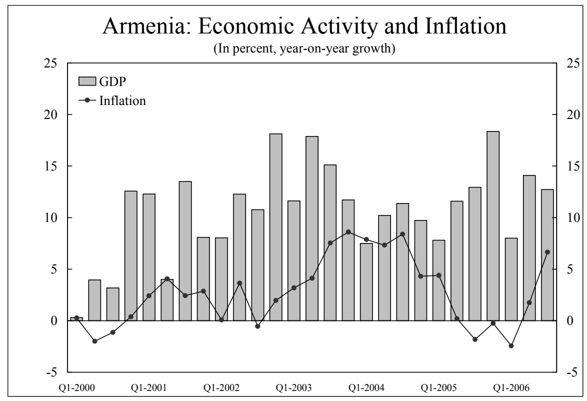
[2] The indicative target on the contributions to the State Fund for Social Insurance was missed by a small margin.

progress has been made in strengthening tax and customs administrations, but revenue mobilization could be further enhanced. On financial sector reforms, prudential regulations and oversight have been strengthened and reforms undertaken to improve corporate governance of banks, but financial intermediation is still low.

II. Macroeconomic Policies

A. Recent Growth and Outlook

6. **Real GDP** grew by over 12.5 percent in the first nine months of 2006, driven by strong growth in the nontradables sector, particularly the construction sector, which grew by almost 40 percent in real terms and accounted for about half of total GDP growth. Nevertheless, agricultural and industrial output declined in real terms. **Gross fixed capital formation** increased by 31 percent year-on-year in the first half of 2006, aided by improved execution of public investment projects.



7. Sustaining **high economic growth** is a key policy challenge. The strengthening of market institutions and an open trade regime have generated large increases in total factor productivity (TFP) in recent years (Box 1). The challenge will be to foster significant increases in high quality, productivity-enhancing investments and to improve the business climate to promote further growth.[3]

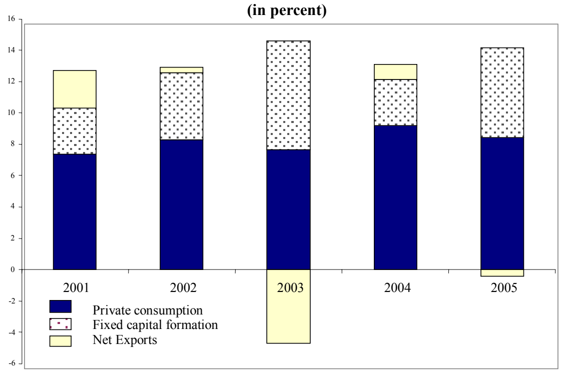
8. At the same time, **growth has been uneven**, driven primarily by buoyant domestic demand, and underpinned by strong foreign exchange inflows (remittances, foreign aid, and FDI) and an expansion of the nontradables sector, in particular construction. In contrast, the contribution of industry has been modest. While exports expanded rapidly until 2005, their structure is not sufficiently diversified, relying to a large extent on two industries (precious stones and base metals), which makes export earnings vulnerable to world commodity price developments and industry-specific shocks.

[3] Several recent surveys have shown improvements in the business environment, although important challenges remain, particularly in the areas of tax administration and access to credit. Armenia ranked 34 out of 175 economies—the highest ranking among CIS countries—in the "ease of doing business" index according to the World Bank's *Doing Business in 2007*. It scored 3.11 out of a highest possible score of 4.33 in the EBRD's 2005 transition index, also the highest score among CIS countries.

Box 1. Sources of Growth

Armenia's growth performance over the past five years has been impressive. Following the sharp contraction of the early 90's, economic growth averaged around 5 percent for the period 1996–2000, before accelerating to 12 percent during 2001–05. Growth has been driven primarily by buoyant domestic demand, fueled by strong foreign exchange inflows, and the expansion of nontradable sectors, notably construction and services. In contrast, the contribution of industry has been modest and, notwithstanding their recent expansion, exports remain undiversified.

Contributions to Real GDP Growth by Expenditures, 2001-05
(in percent)

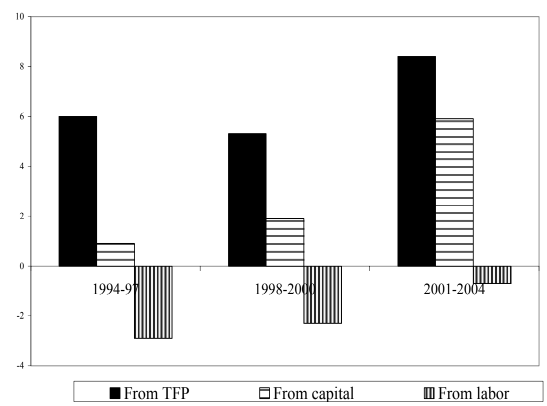


Armenia: Sources of Growth

	Average Annual Real Growth (In percent)		Contributions to Growth (Annual averages, in percent)	
	1996-2000	2001-2005	1996-2000	2001-2005
Industry	2.4	8.5	1.1	1.9
Agriculture	1.9	9.1	1.7	2.7
Construction	15.2	29.8	0.4	3.2
Services	8.9	10.9	1.5	3.6
Total	5.2	12.1		

Sources: Armenian authorities; and Fund staff estimates.

Armenia: Contribution to Growth, 1994-2004



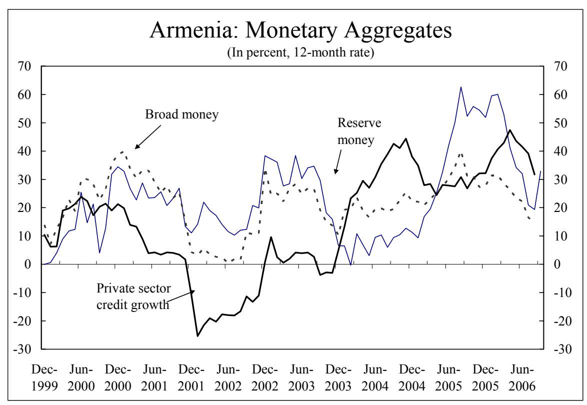
Economic liberalization, privatization, and a liberal trade regime have generated large total factor productivity (TFP) gains through a reallocation of resources since the start of transition. Growth accounting based on factor shares suggests that a large share of the recent high growth originates from TFP gains. However, TFP growth may reflect an increase in factor utilization following the collapse of output, and will likely decline in the coming years. The contribution of capital accumulation to growth, while increasing, has been lower. Further productivity growth will, therefore, depend on advancing market reforms and improving the business climate. The potential of labor in ensuring rapid growth is limited as labor supply is reduced by emigration and the negative incentives on labor supply of large-scale remittances. As a result, the potential for capital accumulation in boosting growth will become more important over the medium term.

9. Demand pressures, stemming from the rapid growth of incomes, appear to have been limited so far, but there are risks. While strong domestic demand has contributed to an increase in imports in recent years, the current account deficit narrowed from 6 to 4 percent of GDP between 2002 and 2005 reflecting trade gains, and the external position remains sustainable. Moreover, most of the increase in imports has been in intermediate and capital goods, in part related to foreign-financed public investment programs. Going forward, there may be **risks of overheating** (as evidenced by the pick-up in inflation in the second quarter of 2006 and increasing real estate prices) which will require cautious management of domestic demand.

10. The authorities believe that **medium-term economic prospects** continue to be strong, although they are concerned about the potential negative effects of rapid real appreciation on growth and external competitiveness. They aim to temper these negative effects by means of an appropriate economic policy mix focused on macroeconomic stability, together with structural reforms and investments in infrastructure supportive of private sector development. These will serve to foster productivity gains and create an environment conducive to continued robust growth. The authorities place particular emphasis on promoting the development of rural areas, including rural infrastructure under the aegis of the Millennium Challenge Account (MCA).

11. Reflecting the solid growth performance in the year to date, the **program** projects real GDP to grow by 11 percent in 2006 and 9 percent in 2007 on the back of continued buoyant activity in the construction and services sectors and an expected recovery in industry (MEFP, ¶13). Notwithstanding somewhat lower public investment rates, productivity gains resulting from increased share of private investment and improvements in infrastructure are expected to generate sustainable growth rates of 6 percent over the medium term.

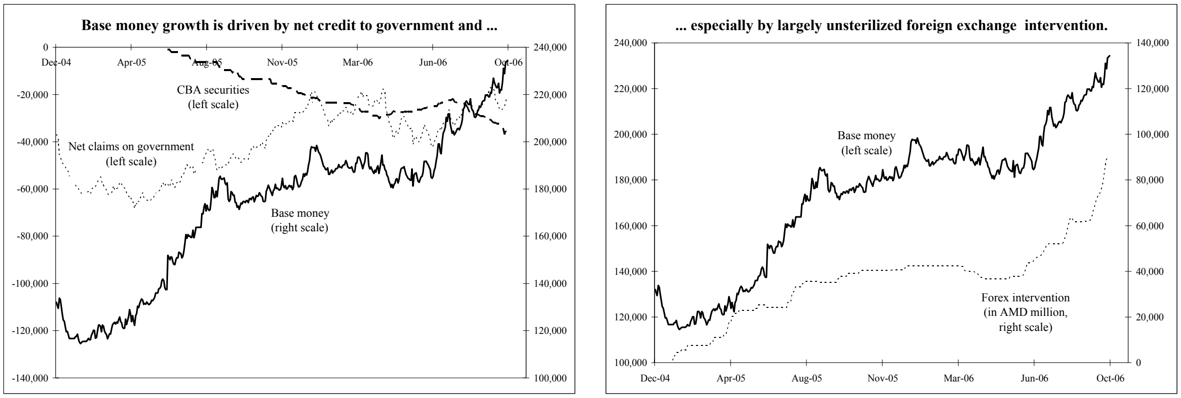
B. Inflation, Monetary, and Exchange Rate Policies



12. Year-on-year **inflation** increased to almost 6 percent in September on account of higher energy and food prices, while average inflation was comparatively low at 1.5 percent. **Broad money** growth (M2X) slowed to about 15 percent in August, largely due to the base effect of last year's strong growth and a recent drop in the value of foreign currency deposits (Table 4). After decelerating during the second quarter of 2006, **reserve money** growth picked up again in September to nearly 30 percent, owing to extensive unsterilized Central Bank of Armenia (CBA) foreign exchange intervention and a decline in government deposits with the CBA.[4] The repurchase rate has been raised three times, cumulatively by 75 basis points since July, reaching 4.75 percent in October.

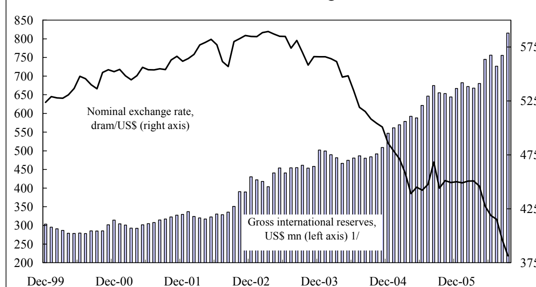
[4] Large-scale sterilized intervention is currently not possible due to the limited capacity of financial markets to absorb government securities.

Armenia: Base Money Growth, 2005–06



13. The **dram** has faced appreciation pressures since mid-May 2006, reflecting strong growth of remittances, foreign investment in real estate, cash dedollarization, and the weakening of the U.S. dollar vis-à-vis other major currencies (Box 2). It appreciated by 15 percent against the U.S. dollar in the year through end-September, despite sizable CBA foreign exchange intervention since June (during the first nine months of the year net purchases amounted to US$115 million, equivalent to over 14 percent of gross international reserves).

Armenia: Gross International Reserves and Nominal Exchange Rate



1/ Gross International Reserves including Special Privatization Account (SPA)

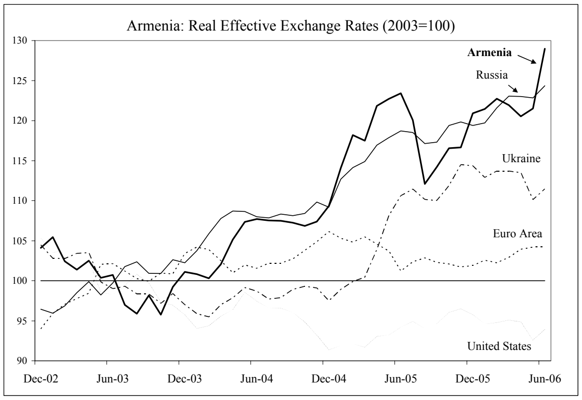
14. Progress has been made in strengthening the institutional prerequisites in support of an **inflation targeting (IT)** monetary framework. The CBA has significantly improved its new operational framework (introduced in March 2006), with the support of Fund technical assistance.[5] It has begun issuing quarterly inflation reports and publishing the minutes of its monthly board meetings on monetary policy. The CBA is also currently in the process of developing a quarterly inflation projection model, to be used in the first half of 2007.

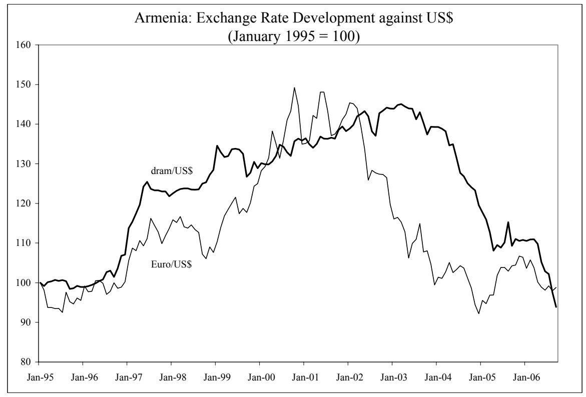
15. There is a **trade-off between resisting nominal appreciation pressures and maintaining low inflation.** With a large share of the population relying on U.S. dollar-denominated remittances and savings, and rising concerns about external competitiveness,

[5] The framework relies on the repurchase (repo) rate as the operating target and an interest rate corridor using standing facilities. During the transition to full-fledged IT, the central bank will maintain elements of its previous money targeting strategy (NFA floor and NDA ceiling) with a view to a smooth transition to the new regime.

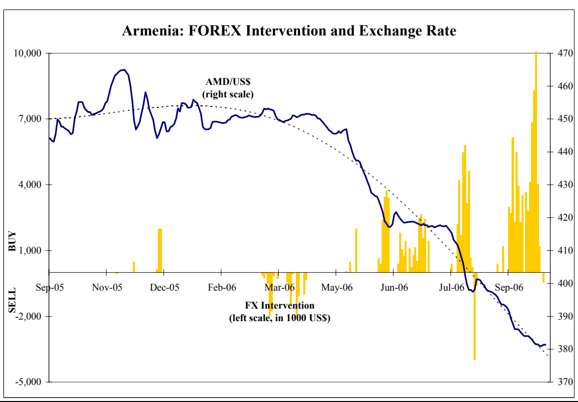
Box 2. Recent Exchange Rate Developments

Since end-2003, the dram has been under appreciation pressure owing to sizable foreign exchange inflows (in the form of rising remittances, foreign aid, and FDI) and a global weakening of the U.S. dollar. By end-September 2006, the dram had appreciated by 33 percent in nominal terms against the U.S. dollar (about 22 percent in real effective terms through July 2006). Periodically, the CBA has engaged in foreign exchange interventions, but until recently interventions were moderate and two-sided, with no evidence that the CBA has targeted a specific level or path for the exchange rate.





According to its monetary policy statement, the CBA is committed to conducting "*an independently floating exchange rate regime which is consistent with the principles of liberalized capital account and implementation of an independent monetary policy*." It recognizes the importance of allowing the exchange rate to be market-determined and to limit intervention in the foreign exchange market to "*moderating the rate of change and preventing undue fluctuations in the exchange rate, rather than establishing a level for it*."

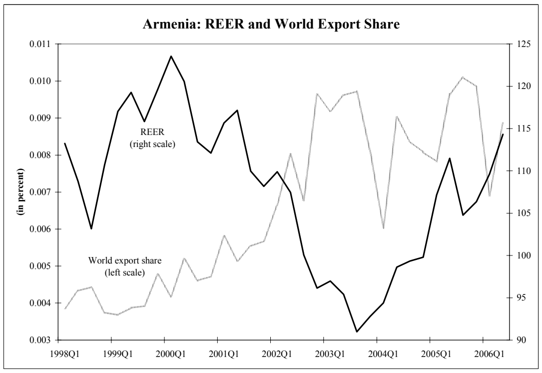


The dram/US$ exchange rate has fluctuated considerably over the past years, not radically different from the movement of the euro/US$ rate. Monthly volatility (measured as coefficient of variation) of the former has not been much lower than the latter during the time periods 1995–2006 or 2005–06.

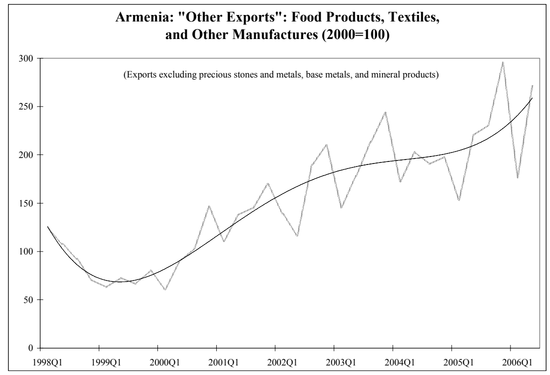
pressures to limit the nominal appreciation of the dram are increasing (Box 3). Until recently, the CBA had largely resisted these demands; however, since June 2006 it has heavily intervened in the foreign exchange market to limit the appreciation of the dram. Given the limited potential to sterilize interventions and absorb liquidity through open market operations, combined with inflationary pressures from both the demand side (strong income growth) and the supply side (energy and agricultural prices), the original end-year inflation target of 3 percent is almost certain to be exceeded.

Box 3. External Competitiveness—Is Appreciation the Major Concern?

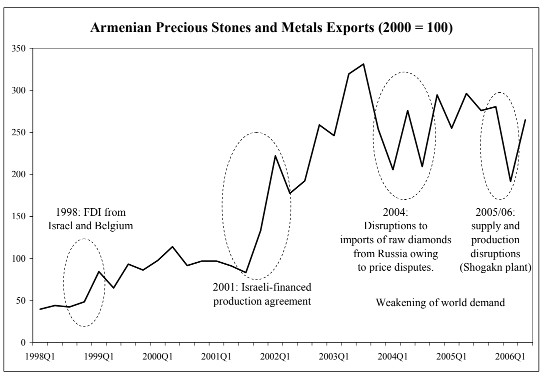
The real appreciation of the dram in recent years appears to have had a limited impact on external competitiveness so far. Armenia's share in world exports, which had doubled between 2001 and 2003, is broadly unchanged after two years of appreciation. Temporary setbacks in diamond exports were due to industry-specific factors (e.g., supply disruptions) and were quickly offset by rising exports of base metals. The base metal sector benefited from sizable foreign direct investment and rising world metal prices. The upward trend of other exports remained intact in 2005 and the first half of 2006.



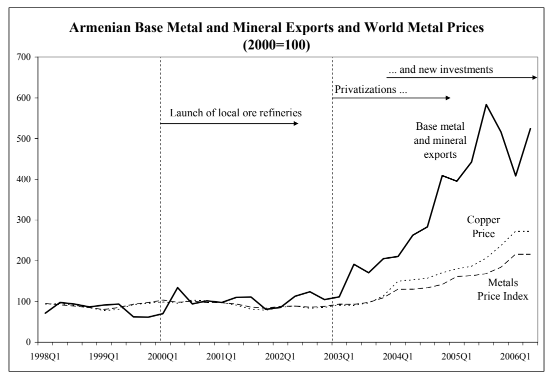
Armenia: REER and World Export Share



Armenia: "Other Exports": Food Products, Textiles, and Other Manufactures (2000=100)

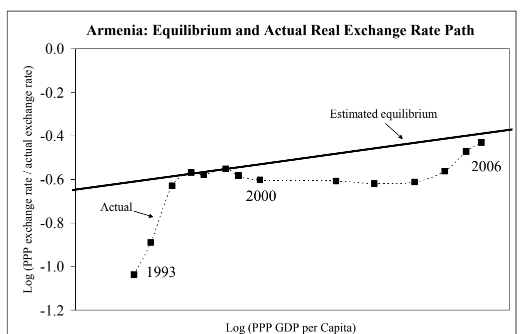


Armenian Precious Stones and Metals Exports (2000 = 100)



Armenian Base Metal and Mineral Exports and World Metal Prices (2000=100)

There is no clear evidence yet that the dram is overvalued. One approach to determine the equilibrium real exchange rate in Armenia is to estimate the "equilibrium distance" to Purchasing Power Parity (PPP). Based on a simple loglinear regression for a sample of 180 countries, an equilibrium relationship was estimated between the real exchange rate and GDP per capita, which is a proxy for productivity. The solid line indicates the implied equilibrium real exchange rate path for Armenia, while the dashed line plots the actual evolution of Armenia's real exchange rate against its GDP per capita. The difference between the dashed and dotted lines can be interpreted as a measure of real exchange rate misalignment while the vertical axis indicates the distance to PPP. The results indicate that the real exchange rate is close to equilibrium.



Armenia: Equilibrium and Actual Real Exchange Rate Path

Sources: WEO; IFS; and IMF staff estimates.

The estimates, which should be treated with caution given the large standard errors, suggest that the dram was approximately in equilibrium during 1995–98. Between 1998 and 2003, however, the dram became undervalued because the equilibrium exchange rate appreciated, while the actual real exchange rate remained constant. Since 2003, the dram has been converging back toward its equilibrium rate.

Factors other than the exchange rate also pose serious threats to Armenia's overall export performance and limit the potential for export-led growth. Because of the undiversified structure of exports, the trade balance is vulnerable to exogenous shocks affecting individual industries, such as supply disruptions in diamond processing or price volatility in commodity markets. At the same time, the potential for diversification remains limited due to structural factors (such as high transport costs) and weaknesses relating to technology, management, finance, and marketing.

16. There is evidence that the **CBA's new operating procedures** have led to an increase in interbank repo volumes, but further development of the money market will be crucial to strengthen monetary policy transmission. The CBA has been increasingly successful in maintaining short-term rates at or near the announced policy rate. Nevertheless, there still appears to be a significant level of excess liquidity in the banking system.

17. The CBA remains committed to maintaining **price stability**. However, given increased inflationary pressures, the authorities were concerned that an overly tight policy stance would be needed to reach the original end-2006 inflation target of 3 percent. In particular, the CBA would have to increase aggressively interest rates and conduct large-scale foreign exchange sales, which could trigger additional appreciation pressures, jeopardize financial stability by raising the interest rates on government bonds, deposits and loans, and eventually harm economic growth. Consequently, the CBA, while mindful of the implications for monetary policy credibility, proposed to raise the end-year inflation target to 5 percent in 2006 and 4 percent in 2007 (with a band of ±1.5 percentage points). The CBA is aware of the need to explain the reasons behind changes of the inflation target to the public.

18. The authorities also underlined their commitment to a **flexible exchange rate regime**. Noting the recent strong appreciation pressures, they pointed to the need for periodical interventions in the foreign exchange market aimed at moderating the rate of change and preventing undue volatility in the exchange rate, rather than targeting a particular level or rate. They agreed that their de facto exchange rate regime could be characterized as a managed float without a predetermined path.

19. The authorities acknowledged that the substantial **excess liquidity** in the banking system impedes monetary policy effectiveness and discourages the development of inter-bank money markets and secondary markets in government securities. However, they argued that it would be difficult to reduce this excess liquidity over the short term, as the room for the issuance of additional CBA securities or for foreign exchange sales for this purpose is very limited under the current circumstances.

20. The revised **monetary program** for the remainder of 2006 envisages reserve and broad money growth of 25 percent and 27 percent respectively, and end-year inflation of 5 percent (with a band of ±1.5 percentage points) (MEFP, ¶17). The monetary program for 2007 will target end-year inflation of 4 percent with a band of ±1.5 percentage points on account of inflationary pressures, notably large end-year fiscal expenditures and foreign exchange inflows, and a rise in telecommunication tariffs in early 2007 (MEFP, ¶18). Reserve money growth is programmed to slow to 20 percent in 2007, while broad money is expected to grow by 22.5 percent. During the transition to full-fledged IT, the program will retain the existing conditionality on monetary targets, in line with the authorities' approach (MEFP, ¶19).

C. Fiscal Policy

21. **Fiscal performance** remained sound in the first half of 2006, with the overall fiscal deficit on a commitment basis significantly smaller than programmed (AMD 12 billion compared to AMD 32 billion under the program), largely on account of strong revenue performance (Table 5). Tax revenue grew on account of improved collections of corporate and personal income taxes. While current expenditures were lower than programmed owing to capacity constraints in procurement, execution of capital spending improved relative to previous years.[6]

Armenia: Fiscal Indicators, June 2006

	Jun. 06 Prog.	Jun. 06 Act.
	(In billions of drams)	
Tax revenue 1/	162.0	166.6
Total expenditures 1/	211.3	200.2
Overal balance 1/, 2/	-31.9	-12.0

1/ Cumulative flow from the beginning of the year until the end of June.
2/ Overall balance on a commitment basis.

22. In April, the authorities entered a **new gas delivery contract** with Gazprom covering the period 2006–08, which involves a significant gas price increase. However, the deal was combined with an implicit and temporary price discount financed by the sale of a power plant to Gazprom. This discount is being passed on to consumers (see Country Report No. 06/196).

23. The **main challenge for fiscal policy** is the need to align additional public spending with PRSP priorities, and with a fiscal stance that continues to be consistent with low and stable inflation in an environment of persistent foreign exchange inflows. This highlights the importance of further raising revenues to finance priority expenditures while at the same time alleviating the burden on monetary policy, particularly as donor assistance will likely decline over time. At the same time, raising productivity, including by improving the efficiency of public spending, will be important for mitigating real appreciation pressures.

24. The authorities share the objectives of **raising revenues and improving expenditure efficiency**. They envisage a reduction in tax exemptions, the development of a unified tax code, and measures to further strengthen tax administration over the medium term. At the same time, the authorities noted that extensive social and infrastructure investment needs preclude a tightening of fiscal policy in the short term. Reflecting this, the Medium-Term Expenditure Framework (MTEF) for 2007–09 targets moderately larger fiscal deficits than in recent years.

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[6] The fiscal deficit on a commitment basis was equivalent to 0.4 percent of annual GDP, compared to 1.3 percent of annual GDP under the program (Table 5).The higher revenues and lower expenditures contributed to a lowering of the deficit-to-GDP ratio by 0.8 percentage points, while the remainder is attributable to an increased GDP growth projection for 2006.

Armenia: Functional Classification of Government Expenditures, 2003–08
(In percent of total expenditure)

	2003 Act.	2004 Act.	2005 Act.	2006-08 Proj.
General public services	9.1	11.2	9.1	9.7
Defense and public order	20.9	23.5	19.2	22.1
Health, education, social security, culture	28.9	35.4	35.5	38.1
Housing, public utilities, energy	7.5	6.6	6.7	5.8
Economic affairs	6.7	12.5	8.4	14.1
Other expenditure	27.0	10.8	21.3	10.1

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

25. Accordingly, the authorities intend to **spend part of the higher-than-budgeted revenues** in 2006. Some of the additional expenditures will be for defense, which the authorities explained by the regional security situation. Another priority area is PRSP-related social spending. The authorities agreed that it would be important to improve the capacity to efficiently absorb significant increases in social and infrastructure spending. With respect to the natural gas subsidy introduced in April 2006, the authorities noted that it will end once the current contract with Gazprom expires at end-2008, resulting in a tariff hike for consumers. The authorities do not intend to introduce new subsidies, but expect the impact on the most vulnerable to be mitigated by rising pensions and public sector wages.

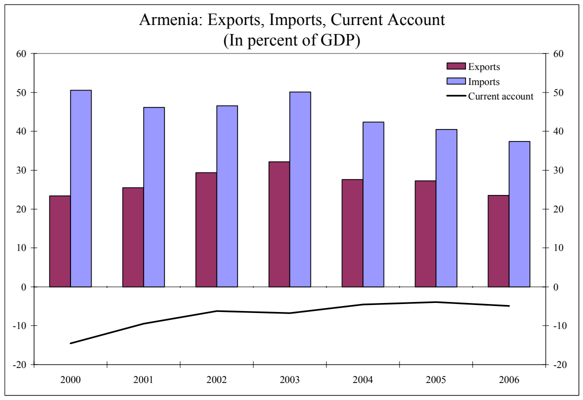
26. Given the rising inflationary pressures, the authorities intend to reduce the **2006 overall deficit** from 2.8 percent of GDP to 2.3 percent of GDP, mainly through improving revenue performance (MEFP, ¶14). The **program for 2007** envisages a roughly unchanged fiscal stance relative to the revised 2006 program (MEFP, ¶15). The draft budget for 2007 projects the tax-to-GDP ratio to rise by 1.0 percentage point.[7] The authorities view this target as ambitious but realistic, and understanding was reached to adjust overall expenditures downward should tax revenues be lower than budgeted in the first half of 2007.

D. External Sector Issues

27. The **external current account** worsened in 2006, largely on account of declining exports (Table 6). Preliminary data for the first nine months of 2006 show that exports were about 1 percent lower than in the corresponding period of the previous year, in large part due to weak international demand for diamonds and one-off factors affecting brandy exports to Russia. Imports, largely of intermediate and capital goods related to foreign financed public investment projects, grew by 19½ percent over the same period, leading to a widening in the trade deficit. Excluding diamonds, exports increased by 3½ percent, while imports surged by

[7] It is projected that the gas import price hike will yield additional VAT revenues of 0.25 percent of GDP; the elimination of VAT exemptions at the border will yield additional 0.15 percent of GDP (MEFP, ¶7); and several tax policy measures and a tightening of the VAT regime for construction will yield at least an additional 0.2 percent of GDP (MEFP, ¶21–22).

27 percent. Nevertheless, gross international reserves increased by $104 million through end-September, against the background of buoyant capital inflows.



28. The deterioration of the **trade balance** is projected to be reversed in the second half of 2006, as exports of diamonds show signs of recovery. The external current account deficit for the year, however, is projected to worsen from 4 percent of GDP in 2005 to 5 percent of GDP in 2006. But the risks to the external balance are on the downside: (i) real exchange rate appreciation owing to rising foreign exchange inflows favors expenditure-switching toward imports and may erode competitiveness of Armenia's less traditional exports (food processing and textiles); and (ii) world market prices for base metals have recently weakened.

29. Armenia's **external debt** position is sustainable. The joint Fund-World Bank debt sustainability analysis (DSA) indicates that Armenia is at a low risk of debt distress (Appendix 1). Notwithstanding its conservative assumptions, the DSA reveals that all external debt indicators are well below the relevant country-specific debt-burden thresholds. The authorities agreed with the assessment. Moreover, they indicated that at this time they would prefer to maintain the zero limit on the contracting (or guaranteeing) of new nonconcessional debt.

III. Fiscal Reforms

30. Despite recent **progress in increasing revenues and improving tax administration**, a number of obstacles hamper tax collection and undermine the investment climate (See SI, Chapter 2 and Box 4). Raising the tax-to-GDP ratio and improving tax buoyancy without resorting to ad hoc discretionary measures to increase collection remains a priority. Strengthening tax administration will be key to increasing revenues and reducing compliance costs, while improving incentives for businesses to enter the formal sector. **Expenditure efficiency** is also a concern given the increase in spending and insufficient monitoring of the noncommercial organizations (NCOs) that execute large parts of public spending.

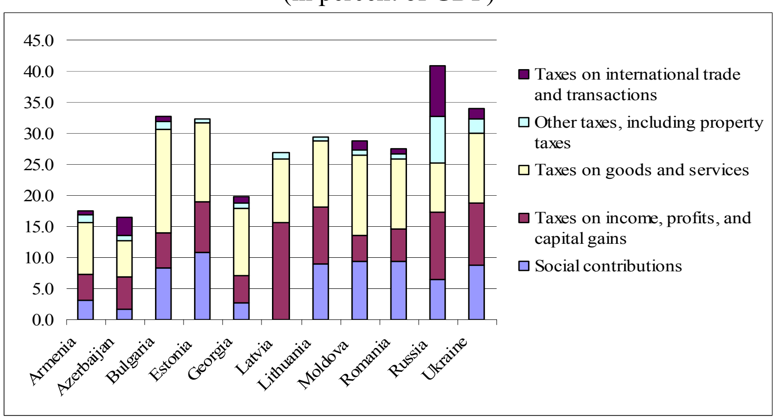
Box 4. What Explains the Low Tax-to-GDP Ratio?

Although there has been a notable improvement in tax revenue performance in 2005–06, the tax-to-GDP ratio at 14.4 percent of GDP (excluding social contributions) in 2005, is lower than in most other CIS countries and falls short of the levels in higher-income transition economies. It is also lower than the PRSP target of 15.8 percent of GDP for 2005.

Low tax-to-GDP ratios can be partly attributed to important **tax exemptions**, such as (i) tax holidays for foreign investors, which are due to expire in 2008; (ii) exemptions for large-scale agriculture, to be phased out by 2009 as stipulated in Armenia's WTO accession agreement; and (iii) wide-ranging exemptions of the construction sector from taxation.

However, shortcomings in **tax administration** account for the main part of the lackluster revenue performance. Tax evasion through under-declaration of VAT, reporting of losses for tax purposes by corporations, and the underreporting of wages are important factors in explaining weak tax performance. These factors are mainly rooted in weaknesses in tax audits and more generally a lack of capacity to accurately estimate tax liabilities. Moreover, revenue losses due to governance problems in the revenue agencies are a concern. Staff estimates suggest that the contribution of tax administration to the growth in tax revenue was minimal in recent years; its estimated contribution was actually negative in 2003 and about zero in 2004 (see SI, Chapter 2). However, in 2005, the contribution of tax policy and administration initiatives to revenue growth became substantial, accounting for 25–35 percent of the increase. This suggests that the tax and customs administration measures undertaken in recent years, combined with the reduction in access to the simplified tax regime in 2004–05, are yielding results.

Armenia: Revenue by Tax in Selected Transition Countries, 2005
(in percent of GDP)



31. The authorities believe it is important to raise revenues over the medium term and highlighted the large number of **tax policy and administration measures** they have implemented (MEFP ¶7): most exemptions from VAT payment at the border have been recently abolished or incorporated in the new capital deferral system; tax regulations for the evasion in the construction sector were tightened; access to the simplified tax and to deductions under the profit tax has been reduced; and the focus on VAT cross-checks and the reduction of dubious tax losses and tax arrears has been increased. On the **expenditure side**, most measures under the financial management and reporting action plan for NCOs have been implemented, and program budgeting is expected to be implemented fully within the next five years.

32. The **reform program** for the period ahead focuses on measures to broaden the tax base by reducing privileges and loopholes, in particular indexing of presumptive taxes (MEFP, ¶21). The establishment of the information technology needed for risk-based selection for VAT cross-checks, audits, and refunds, and of a network linking all inspectorates of the State Tax Service in 2007 will constitute a major improvement in tax administration (MEFP, ¶23). The law on NCOs will be amended to clarify their definition and activities, and to separate the functions of the management bodies (MEFP, ¶25), with a view to limiting the possibilities for converting public enterprises into NCOs. The Fund will continue to cooperate closely with the World Bank on the implementation of reforms in the customs area (MEFP, ¶24).

IV. Financial Sector Development

33. **Notwithstanding** important reforms over the past few years, **financial sector development** in Armenia has lagged behind other transition countries (see SI Chapter 3). Deepening of financial intermediation has been hindered by high cash ratios, credit risk, lack of competition, and institutional weaknesses. Armenia has a large shadow economy, which further limits the scope for financial intermediation (Box 5).

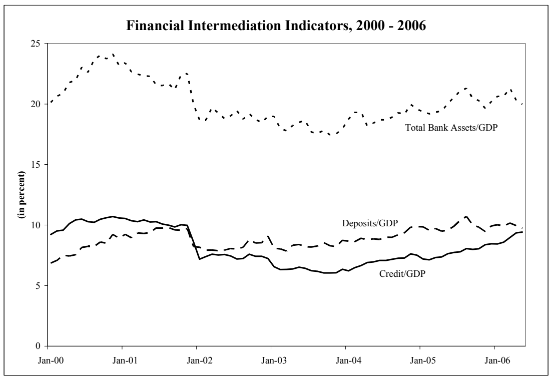
34. **Credit to the private sector** is still low even by regional standards (8.2 percent of GDP in 2005), but has grown rapidly in the recent past, reflecting strong economic growth, increasing personal incomes, and rising confidence. While the level of nonperforming loans is low and the banking sector generally sound, rapid credit growth, in particular in the consumer credit segment, may stress local banks' capacity to monitor and control the attendant risks.

35. Reforms to foster **financial intermediation** and strengthen prudential oversight are progressing. The authorities noted that they are actively encouraging the entry of additional reputable international banks with the aim to improve banking sector efficiency. With technical and financial assistance from various donors, they have initiated a project to develop the mortgage lending market. In addition, the authorities emphasized their efforts to encourage dedollarization and the use of bank transactions in the economy so as to facilitate the legalization of the informal economy and improve monetary policy transmission.

36. Another focus is the development of the **nonbank financial sector**, with impending reforms in insurance, capital markets, and the pension system. At the heart of this reform is an increase in the pension contribution rate that would generate large funds for investment. The CBA would like these funds to be managed by reputable international firms. With the help of Fund technical assistance, the authorities are drafting amendments to the AML/CFT law to bring it in line with international best practice.

Box 5. Financial Sector Development

The financial system remains small and bank dominated. Total assets of the banking sector were 20 percent of GDP in 2005, substantially below the CIS average of about 30 percent. Armenia has a large shadow economy, estimated to be about one-third of GDP, that does not rely on the formal financial sector. Firms and individuals rely to a large extent on cash for transactions, partly to evade taxes. This significantly diminishes the potential deposit base of the banking system and the market for products offered by banks and other financial institutions. Foreign currency cash holdings are large and have been roughly estimated up to one-third of GDP (80 percent of total cash holdings). Remittances from abroad also provide a source of funds that reduces the need to obtain financing from the financial sector.



Armenian banks are generally well capitalized, profitable, and liquid with a satisfactory level of asset quality, although the stock of nonperforming loans has increased recently (See Country Report No. 05/178 for FSAP update recommendations). Financial sector indicators improved, and financial intermediation expanded in 2005 with credit to the private sector growing by 32 percent, albeit from a low base. At end-2005, around 50 percent of banking system assets consisted of cash, interbank balances, and investments in securities, and only 40 percent of total assets were loans. The banking system remains heavily dollarized, with loan and deposit dollarization ratios of 64 percent and 67 percent at end-2005, respectively.

Banking spreads remain high at over 10 percentage points. Credit risk arising from poor creditor rights protection, weak auditing and accounting standards, and weaknesses in the institutional framework is a key factor in explaining high banking spreads in Armenia. A low degree of banking competition due to market segmentation, as well as bank-specific factors, such as opaque ownership structures with connected lending, lack of risk-assessment capacity, and comparatively high administrative and funding costs, are additional factors.

CIS and Baltic Countries: Selected Financial Sector Indicators 2005 (In percent)

	M2/GDP	Bank Assets/GDP	Bank Deposits/GDP	Bank Credit to Private Sector/GDP 3/	Domestic Currency Lending-Deposit Spread	Average Inflation	Average Real Deposit Rate
Armenia	16.4	20.2	10.7	8.2	12.2	0.6	5.8
Azerbaijan 1/	18.0	26.8	12.7	9.1	8.5	...	8.5
Belarus	19.9	31.3	20.0	10.2	2.1	10.3	9.2
Estonia	29.5	112.6	44.8	60.0	2.8	4.1	2.1
Georgia	16.6	26.3	12.8	14.8	14.1	8.2	7.6
Kazakhstan	26.6	63.3	25.6	26.7	...	7.6	...
Kyrgyz Republic	21.3	51.3	9.2	6.2	20.8	4.4	5.8
Latvia	23.1	123.2	36.7	60.1	3.3	6.8	2.8
Lithuania 2/	23.4	61.7	31.9	34.7	4.5	2.7	...
Moldova 1/	38.3	54.1	30.8	18.6	6.0	12.0	13.2
Russia	33.3	44.6	24.9	23.8	6.7	12.7	4.0
Tajikistan 1/	7.0	20.7	8.9	12.9	13.5	...	...
Ukraine	46.1	53.1	32.3	33.8	7.6	13.5	8.6

Sources: WEO, IFS, and MBTS (Money and Banking) databases.

1/ M2/GDP, Assets/GDP, Deposits/GDP, and Credit/GDP for 2004.
2/ Domestic currency deposit-lending spread for 2004.
3/ Credit to private sector, where available. Claims on private sector otherwise.

37. Implementation of the amended Law on Banks and Banking during the first half of 2006 has been smooth (MEFP, ¶8). Going forward, the authorities intend to further improve bank transparency and accountability by amending the Law on Bank Secrecy (MEFP, ¶26). Several measures encouraging non-cash transactions are under consideration, which will contribute to reducing the size of the shadow economy. In addition, measures encouraging dedollarization will strengthen monetary policy effectiveness (MEFP, ¶27). Regarding nonbank financial sector reform, a new Insurance Law that is compliant with the standards of the International Association of Insurance Supervisors and a pension framework law are currently under preparation. The CBA also plans to submit to parliament a new Securities Market Regulation that corresponds to the standards of the International Organization of Securities Commissions, and has invited a foreign stock market operator to advise on a plan to develop the Armenian capital markets with the objective to attract a strategic investor (MEFP, ¶28).

V. Staff Appraisal

38. **The Armenian economy continues to perform very well.** Prudent monetary and fiscal policies, strong external inflows, and ongoing structural reforms have contributed to double-digit growth since 2002, low inflation, and a reduction in unemployment and poverty. The outlook is for further strong growth in 2007, underpinned by high investment and remittance inflows.

39. **The major policy challenge is to maintain macroeconomic stability and sustain growth in the context of sizable foreign exchange inflows.** Sustaining broad-based growth will hinge not only on continued sound macroeconomic policies but also on fiscal and financial sector reforms. As foreign savings are expected to decline gradually over the coming years, higher investment will need to be financed by domestic saving. In this context, fostering financial services that could help channel more remittances into productive uses will be important to help promote private-sector growth in the future.

40. **The CBA's commitment to price stability is to be commended.** Staff agrees, however, that it would be difficult and perhaps costly to reach the CBA's original end-year inflation target of 3 percent. Accordingly, it supports the upward revision of the end-year target to 5 percent in 2006 and 4 percent in 2007. However, frequent revisions to the inflation target or exceeding the revised inflation targets should be avoided, as this could hurt not only economic growth, but also the credibility of monetary policy, particularly in light of the authorities' intention to move to a full-fledged inflation targeting regime over the medium term. Given the interrelationship between the fiscal stance, monetary policy, and appreciation and inflationary pressures, the authorities should continue to strengthen monetary operations, liquidity management, and coordination between fiscal and monetary policies. To this end, staff welcomes recent efforts to strengthen monetary operations and liquidity management, which will help support the move to formal inflation targeting.

41. **The flexible exchange rate regime has contributed to price stability.** Resisting nominal appreciation pressures will come at the expense of higher inflation which, in turn, could hurt the poor and possibly harm growth. Staff supports the central bank's policy of focusing on price stability, with foreign exchange intervention used primarily as an instrument to address excess liquidity in the banking system and to smooth exchange rate volatility. The exchange rate system, which can be classified as a managed float without a predetermined path, is consistent with macroeconomic stability. Moreover, there is no clear evidence that the dram is currently overvalued. Given concerns about exchange rate appreciation, the CBA needs to intensify its public information campaign to explain its causes.

42. **The real appreciation of the dram, if sustained, could jeopardize external competitiveness and cause Dutch disease**, unless structural reforms are implemented to improve productivity. The authorities need to move forcefully with policies to raise productivity, including by improving the business climate and spurring competition, particularly among importers. While recent surveys suggest some improvement in the business climate, more could be done, particularly in the area of tax reforms.

43. **Staff welcomes the tightening of the fiscal stance in 2006 and views the 2007 budget as compatible with macroeconomic stability.** The large tax revenue increase envisaged for 2007 appears feasible given reforms to date, the significant scope for additional revenue collection through improved administration, and the political commitment to enhance revenue collection. On the expenditure side, improving the capacity to efficiently absorb significant increases in social spending should be a priority. Social expenditures should be progressively raised toward the PRSP target. With respect to the gas subsidy, staff urges the authorities to (i) ensure full transparency in accounting for the subsidy by incorporating potential proceeds of any asset transfer to the budget; (ii) avoid general subsidies to offset higher gas price increases, as they are inefficient and will be difficult to eliminate; and (iii) develop a credible exit strategy to phase out the subsidy by end-2008 to ensure full cost-recovery and reduce medium-term fiscal risks.

44. **In the coming years, the authorities will be facing two competing fiscal objectives**, namely (i) maintaining a prudent fiscal stance in support of macroeconomic stability and (ii) raising expenditures on infrastructure and social services in line with their poverty reduction strategy. These dual objectives highlight the importance of further raising revenues to finance priority expenditures while at the same time alleviating the burden on monetary policy, particularly as donor assistance will likely decline over time.

45. **Fiscal reforms remain key to sustaining growth and reducing poverty.** Staff commends the authorities for the reforms implemented in recent years, which have contributed to the notable improvement in the tax-to-GDP ratio in 2005–06. Nevertheless, the tax-to-GDP ratio remains low by regional standards. The estimated shortfall of actual relative to potential revenue is about 4 percent of GDP. In tax policy, it is important to allow the tax holiday for foreign investors to expire and expand taxation of the construction sector.

Moreover, reliance on presumptive taxes should be reduced and taxation of more economic activities should be moved to the regular tax regime. In tax administration, the focus should be on improving the tax authorities' ability to check transactions and audit taxpayers. On expenditure efficiency, strengthening internal audit and the monitoring of service delivery should receive priority treatment.

46. **Further strengthening and streamlining of financial sector regulation as well as continued strong supervision are warranted** to improve bank corporate governance, foster competition, and reduce the large lending-deposit spreads. At the same time, the authorities have to strike a balance between safeguarding the integrity of the financial system and avoiding over-regulation, which could hold back financial development. The root causes of financial sector underdevelopment are the shadow economy as well as market segmentation and low bank competition. Progress in tax administration reform will be crucial to reduce the size of the informal economy. The expected participation of reputable international investors in the financial sector should spur competition, increase trust of depositors, improve governance, and bring expertise in credit risk management.

47. **The nonbank financial sector reform agenda is ambitious, but could also pose some risks.** Major legislation is expected later this year and in 2007 to overhaul the pension system, develop the insurance sector, and promote the securities market. However, the fiscal impact and effect on overall savings of the pension plan, which has many details that remain to be decided, are still uncertain.

48. **The program's prospects remain very bright, but there are risks.** Effective policy coordination between the monetary and fiscal authorities is needed to ensure that low inflation and fiscal stability are maintained. In this context, it will be important to sustain a prudent fiscal policy as the campaign for next year's parliamentary elections picks up.

49. **Armenia's performance under the PRGF arrangement has been very good.** Based on this track record, and the strong policy program for 2007, staff supports the authorities' request for the completion of the third review under the PRGF arrangement.

50. It is proposed that the next Article IV consultations will be held on the standard 24-month cycle.

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

	2001	2002	2003	2004	2005	2006	
					Act.	Prog.	Proj.
	(Annual percentage change, unless otherwise indicated)						
National income and prices							
Real GDP growth	9.6	13.2	14.0	10.5	14.0	7.5	11.0
Gross domestic product (in billions of drams)	1,176	1,362	1,625	1,908	2,244	2,467	2,578
Gross domestic product (in millions of U.S. dollars)	2,120	2,373	2,807	3,580	4,911	5,528	6,114
Gross domestic product per capita (in U.S. dollars)	660	739	874	1,114	1,528	1,711	1,892
CPI (period average)	3.1	1.1	4.7	7.0	0.6	3.0	2.8
CPI (end of period)	2.9	2.0	8.6	2.0	-0.2	3.0	5.0
GDP deflator	4.0	2.4	4.6	6.3	3.2	3.0	3.5
Unemployment rate (in percent)	10.4	9.4	10.1	9.6	8.1		…
Poverty rate (in percent)	50.9	…	42.9	34.6	…		…
Investment and saving (in percent of GDP)							
Investment	19.8	21.7	24.3	24.9	29.7	24.7	30.5
National savings	10.3	15.4	17.5	20.4	25.7	21.4	25.5
Money and credit (end of period)							
Reserve money	11.1	38.4	6.6	11.4	51.9	19.2	25.1
Broad money	4.3	34.0	10.4	22.3	27.8	21.0	27.0
Commercial banks' 3-month lending rate (in percent)	27.7	23.4	22.3	15.4	16.9	...	...
Central government operations (in percent of GDP)							
Revenue and grants	17.0	18.8	17.8	15.4	15.7	16.8	17.4
Of which : tax revenue	14.3	14.6	14.0	14.0	14.3	14.8	14.7
Expenditure and net lending	20.9	19.3	18.9	17.1	18.3	19.6	19.7
Overall balance on a commitment basis	-3.8	-0.4	-1.1	-1.7	-2.6	-2.8	-2.3
Overall balance on a cash basis	-4.0	-2.6	-1.5	-1.6	-2.6	-2.8	-2.3
Stock of domestic expenditure arrears	2.8	0.5	0.0	0.0	0.0	0	0.0
Government and government-guaranteed debt (in percent of GDP)	45.3	46.6	40.9	32.4	24.2	24.3	22.2
Share of foreign currency debt (in percent)	95.5	94.4	93.5	93.0	91.3	91.0	91.1
Primary balance of the energy sector (in percent of GDP) 1/	-2.5	-0.4	0.0	0.1	0.1	…	…
External sector							
Exports of goods and services (in millions of U.S. dollars)	540	698	903	985	1,337	1,494	1,437
Imports of goods and services (in millions of U.S. dollars)	-978	-1,107	-1,406	-1,514	-1,984	-2,214	-2,309
Exports of goods and services	20.8	29.3	29.5	9.0	35.7	12.4	7.5
Imports of goods and services	1.2	13.2	27.0	7.7	31.1	12.8	16.4
Current account (in percent of GDP)	-9.5	-6.2	-6.8	-4.5	-3.9	-3.9	-4.9
FDI (net, in millions of U.S. dollars)	70	111	121	217	252	204	267
External debt-to-exports ratio (NPV, in percent)	132	131	60	59	60	55	47
Debt service ratio 2/	9.7	9.8	15.6	9.7	5.7	4.6	4.2
Gross international reserves (in millions of U.S. dollars) 3/	329	430	502	547	667	757	790
Import cover 4/	3.6	3.7	4.0	3.3	3.5	3.8	3.6
Nominal effective exchange rate 5/	3.5	-5.8	-4.6	11.5	13.6	…	…
Real effective exchange rate 5/	-1.9	-10.8	-2.6	6.5	7.4	…	…
Average exchange rate (dram per dollar)	555	573	579	533	457.7	…	…
Memorandum item:							
Population (in millions)	3.213	3.210	3.212	3.214	3.215	…	…

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

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

2/ In percent of exports of goods and services.

3/ Gross international reserves excluding the special privatization account (SPA).

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

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

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

	2005	2006		
	Dec.	Mar.	Jun.	
	Act. 2/	Act. 3/	Prog.	Est. 2/
Net domestic assets of the CBA 4/	-42.5	-15.1	-29.8	-54.2
Net banking system credit to the government	5.16	-1.3	-1.2	-20.7
Domestic arrears of the central government	0	0	0	0
Tax revenues of the central government (floor) 5/	321.5	74.5	162.1	166.6
Balance of the central government on a cash basis (floor) 5/	-58.0	-0.6	-31.9	-6.5
Reserve money (band/level) 3/	200.6	189.1	(199-207)	199.1
Contributions to the State Fund for Social Insurance 3/ 5/	60.1	16.1	34.0	33.6
Contracting or guaranteeing of new nonconcessional external debt 5/ 6/	0	0	0	0
External arrears (continuous criterion)	0	0	0	0
Net official international reserves (floor)	458.4	332.3	492.0	510.4

1/ All items as defined in the Technical Memorandum of Understanding.
2/ Performance criterion.
3/ Indicative target.
4/ At program exchange rate of 500 dram per U.S. dollar for 2005 and program exchange rate of 450 dram per U.S. dollar for 2006.
5/ Cumulative flow from the beginning of the calendar year until the end of the month indicated.
6/ Includes debt with maturity of more than a year as well as obligations with maturity of one year or less, excluding normal import-related credit and sales of treasury bills to nonresidents.

Table 3. Armenia: Status of Structural Measures for the Third Review under the PRGF

Measure	Type of Conditionality	Target Date (End of Period)	Status
Tax policy			
Submit to parliament an amendment to the Law on Simplified tax that narrows access to the simplified tax regime by excluding activities that require state licenses with annual stamp duties of AMD 1 million or more.	Structural Performance Criterion	September 2006	Observed
Tax administration			
Complete a 2006-08 IT acquisition action plan for the STS based on the strategy paper and secure budget resources	Structural Benchmark	June 2006	Observed
Submit a law to parliament that raises the sanctions to at least AMD 1 million for providing false documentation to revenue agencies.	Structural Performance Criterion	March 2006 1/	Observed
Start applying universal VAT cross-checks	Structural Benchmark	June 2006	Observed
Customs administration			
Establish a dedicated Risk Management Unit in the SCC. One of the objectives of the unit will be the regular review and updating of examination selectivity criteria	Structural Benchmark	June 2006	Observed
Expand the use of the examination selectivity module in ASYCUDA to all customs houses and customs points.	Structural Benchmark	September 2006	Observed
Financial Sector			
Submit to Parliament an amendment to the Law on Insurance that eliminates the limitation on the range of services that insurance companies with substantial foreign ownership (above 49 percent of capital) can provide in Armenia.	Structural Performance Criterion	June 2006	Observed
Specify and implement a consolidated supervision framework for monitoring beneficiary owners beyond the licensing stage, in order to determine the appropriate structure of corporate governance and to identify how affiliate companies and related parties impact on bank's operations.	Structural Benchmark	June 2006	Observed

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

Table 4. Armenia: Monetary Accounts, 2005–07

	2005	2006						2007			
		Mar.		June		Sep.	Dec.	Mar.	June	Sep.	Dec.
	Act.	Prog. 1/	Act.	Prog. 1/	Act.	Proj. 1/	Proj. 1/	Proj. 1/	Proj. 1/	Proj. 1/	Proj. 1/
Central Bank of Armenia											
Net foreign assets	249.9	254.4	243.2	253.0	253.6	279.3	289.9	298.8	305.7	320.3	329.9
Net international reserves	220.3	242.8	213.7	242.5	244.6	269.0	282.8	295.0	321.1	335.7	345.3
Special privatization account	38.5	20.5	38.6	20.5	17.8	19.2	19.2	19.2	0.0	0.0	0.0
Medium and long-term	-8.9	-8.9	-9.1	-10.0	-8.8	-8.8	-12.0	-15.4	-15.4	-15.4	-15.4
Net domestic assets	-49.4	-61.4	-54.1	-50.3	-54.5	-51.1	-39.0	-57.3	-51.9	-43.3	-29.0
Claims on general government (net) 2/	-17.4	-39.1	-22.5	-27.1	-35.0	-22.9	-9.1	-24.6	-37.1	-34.1	-20.3
Of which : central government (net) 2/	6.6	-15.1	5.5	-3.1	-3.0	2.8	10.9	14.8	2.3	5.2	19.0
Claims on banks	4.0	4.0	10.6	5.1	12.5	10.5	13.7	17.0	17.5	17.5	17.5
KfW	11.7	11.7	11.9	12.8	12.5	12.5	15.7	19.0	19.0	19.0	19.0
Monetary instruments (net) excluding CBA bills	-7.7	-7.7	-1.3	-7.7	0.0	-2.0	-2.0	-2.0	-1.5	-1.5	-1.5
CBA bills	-21.2	-28.4	-29.1	-29.6	-23.9	-36.9	-43.9	-46.4	-42.3	-37.4	-38.4
Other items (net)	-14.8	2.1	-13.2	1.3	-8.0	-1.7	0.4	-3.3	10.0	10.7	12.1
SPA	-38.5	-20.5	-38.6	-20.5	-17.8	-19.2	-19.2	-19.2	0.0	0.0	0.0
Autonomous OIN	23.7	22.6	25.4	21.8	9.8	17.4	19.5	15.8	10.0	10.7	12.1
Reserve money	200.6	193.0	189.1	202.7	199.1	228.2	250.9	241.5	253.8	277.0	300.9
Currency issue	155.3	149.4	141.3	157.2	154.4	180.0	204.0	194.8	202.2	223.6	243.3
Deposits	45.3	43.5	47.8	45.4	44.7	48.2	47.0	46.7	51.6	53.4	57.6
Banking system											
Net foreign assets	275.0	271.9	270.4	269.7	261.4	283.8	293.3	299.3	303.4	315.4	322.6
Net domestic assets	90.5	94.7	88.0	115.4	109.4	138.4	170.9	159.6	171.2	208.1	246.1
Claims on government (net)	5.2	2.6	-1.3	-1.2	-20.7	-14.2	-3.9	-17.8	-28.1	-24.0	-7.5
of which: claims on central government (net)	29.1	26.6	26.7	22.8	18.6	25.2	35.4	21.5	11.3	15.4	31.8
Claims on rest of the economy	188.3	190.7	201.6	203.2	219.1	241.4	265.5	278.6	299.7	326.9	357.8
Other items (net)	-102.9	-98.6	-112.3	-86.7	-88.9	-88.8	-90.6	-101.2	-100.5	-94.8	-104.2
Broad money	365.6	366.6	358.5	385.1	370.8	422.2	464.3	458.8	474.6	523.5	568.7
Currency in circulation	144.3	140.4	130.3	148.2	144.3	171.0	195.0	185.8	193.2	214.6	234.3
Deposits	221.2	226.2	228.2	236.8	226.5	251.2	269.3	273.0	281.4	308.9	334.4
Domestic currency	80.5	83.2	80.6	90.5	85.2	96.7	111.4	114.7	120.1	136.1	152.4
Foreign currency	140.8	143.0	147.6	146.3	141.3	154.5	157.8	158.3	161.4	172.8	182.0
Memorandum items											
Exchange rate (in drams per U.S. dollar, end of period)	450.2	...	450.9	...	418.8	...	...	...	...	...	...
Program e-rate	...	450.0	...	450.0	...	450.0	450.0	450.0	450.0	450.0	450.0
Special privatization account (in millions of US$)	85.6	45.6	85.8	45.6	39.7	42.6	42.6	42.6	0.0	0.0	0.0
NIR (in millions of U.S. dollars) 3/	439.9	...	334.5	...	520.4	...	...	...	...	...	...
NIR (in millions of U.S. dollars) 4/	458.4	494.6	332.3	492.0	510.4	543.9	577.2	606.0	666.3	697.5	719.4
NDA of the CBA (in billions of drams) 5/	-42.5	-40.9	-15.1	-29.8	-54.2	-32.0	-19.8	-38.2	-51.9	-43.3	-29.0
12-month change in reserve money (in percent)	51.9	56.1	53.0	34.4	32.0	31.3	25.1	27.7	27.5	21.4	19.9
12-month change in broad money (in percent)	27.8	31.5	28.6	27.0	22.2	27.0	27.0	28.0	28.0	24.0	22.5
12-month change in private sector credit (in percent)	32.2	35.2	42.9	31.3	41.5	44.3	41.0	38.2	36.8	35.4	34.8
Velocity of broad money (end of period)	6.1	6.2	6.3	6.0	6.3	5.9	5.6	5.7	5.7	5.4	5.1
Money multiplier	1.8	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Dollarization in bank deposits 6/	63.6	63.2	64.7	61.8	62.4	61.5	58.6	58.0	57.3	55.9	54.4
Dollarization in broad money 7/	38.5	39.0	41.2	38.0	38.1	36.6	34.0	34.5	34.0	33.0	32.0
Currency in circulation in percent of deposits	65.2	62.1	57.1	62.6	63.7	68.1	72.4	68.1	68.6	69.5	70.1
Stock of FCD (in millions of USD)	312.7	317.7	327.9	325.2	314.0	343.4	350.8	351.8	358.6	383.9	404.4
Banking system financing of the central government (cumulative)	25.2	-2.5	-2.4	-6.4	-10.5	-4.0	6.2	-13.9	-24.1	-20.0	-3.6

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

1/ At program exchange rate of 450 dram/US$.

2/ See footnote 5 of Table 2.

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

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

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

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

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

Table 5. Armenia: Central Government Operations, 2006–07

	2006										2007						
	Q1		Q2		Q3		Q4		Jan.-Dec.		Q1	Q2	Q3	Q4	Jan.-Dec.		
	Prog. 1/	Act.	Prog. 1/	Act.	Prog. 1/	Proj.	Prog. 1/	Proj.	Prog. 1/	Proj.	IMF 1/				IMF 1/ $=450	IMF 1/ $=357	Auth. 2/ $=357
	(In billions of drams)																
Total revenue and grants	82.1	79.9	97.3	108.3	109.6	115.8	125.4	145.0	414.4	449.0	98.8	117.3	132.5	143.7	492.4	489.5	489.5
Total revenue	76.8	79.5	90.5	105.4	100.0	108.8	107.9	114.8	375.2	408.5	94.1	114.7	127.0	138.6	474.3	474.3	474.3
Tax revenue	74.1	74.5	87.9	92.1	97.0	101.0	105.2	110.5	364.3	378.1	90.2	110.8	123.1	134.7	458.9	458.9	458.9
Value-added tax	…	31.8	…	37.7	…	…	…	…	…	…	…	…	…	…	…	…	…
Excises	…	9.0	…	8.4	…	…	…	…	…	…	…	…	…	…	…	…	…
Profits, simplified, and presumptive taxes	…	16.6	…	26.5	…	…	…	…	…	…	…	…	…	…	…	…	…
Personal income tax	…	7.6	…	7.8	…	…	…	…	…	…	…	…	…	…	…	…	…
Customs duties	…	3.6	…	4.5	…	…	…	…	…	…	…	…	…	…	…	…	…
Other taxes	…	5.9	…	7.1	…	…	…	…	…	…	…	…	…	…	…	…	…
Nontax revenue	1.9	2.4	1.2	10.5	1.8	2.1	2.3	2.8	7.3	17.8	2.8	2.8	2.8	2.8	11.4	11.4	11.4
Capital revenue	0.8	2.5	1.3	2.8	1.2	5.7	0.4	1.5	3.6	12.6	1.0	1.0	1.0	1.0	4.1	4.1	4.1
Grants	5.3	0.4	6.8	2.9	9.6	7.0	17.5	30.2	39.3	40.5	4.7	2.6	5.5	5.2	18.0	15.2	15.2
Of which : MCA (for 2007) and Lincy	0.0	0.0	0.0	0.0	5.4	5.3	13.4	21.6	18.8	26.9	1.1	1.4	1.8	1.4	5.7	4.5	4.5
Total expenditure	93.5	83.5	117.8	114.1	126.2	141.9	146.8	169.6	484.3	509.1	104.0	134.7	147.3	174.6	560.7	557.9	557.9
Current expenditure	78.5	69.2	86.7	82.5	82.5	98.7	85.6	101.6	333.3	352.0	…	…	…	…	404.8	401.9	401.9
Wages	12.2	10.3	13.7	11.9	13.3	13.3	12.9	20.4	52.1	55.9	…	…	…	…	65.5	65.5	40.3
Subsidies	6.8	2.9	3.5	4.1	2.6	2.6	2.9	9.9	15.7	19.5	…	…	…	…	19.7	19.7	19.7
Interest	2.5	2.4	2.6	2.0	2.7	2.6	2.8	2.8	10.6	9.8	…	…	…	…	12.4	11.5	11.5
Transfers	21.0	19.6	21.2	22.8	21.7	21.7	22.3	23.1	86.2	87.2	…	…	…	…	94.1	94.1	94.1
Goods and services	36.1	34.0	45.6	41.8	42.2	58.4	44.7	45.4	168.7	179.6	…	…	…	…	213.1	211.2	236.3
Capital expenditure and net lending	15.0	14.3	31.2	31.5	43.7	43.2	61.2	68.0	151.0	157.1	…	…	…	…	156.0	156.0	156.0
Capital expenditure	10.8	11.0	26.8	27.3	38.6	38.6	57.8	63.2	134.0	140.1	…	…	…	…	134.7	134.7	134.7
Net lending	4.2	3.4	4.4	4.2	5.1	4.6	3.4	4.8	17.0	17.0	…	…	…	…	21.3	21.3	21.3
Overall balance (commitment)	-11.4	-3.7	-20.5	-5.7	-16.7	-26.1	-21.4	-24.6	-69.9	-60.2	-5.2	-17.4	-14.8	-30.9	-68.3	-68.3	-68.3
Statistical discrepancy/financing gap	0.0	3.0	0.0	-0.1	0.0	0.0	0.0	-2.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance (cash)	-11.4	-0.6	-20.5	-5.9	-16.7	-26.1	-21.4	-27.5	-69.9	-60.2	-5.2	-20.4	-14.8	-27.9	-68.3	-68.3	-68.3
Deficit/financing	11.4	0.6	20.5	5.9	16.7	26.1	21.4	27.5	69.9	60.2	5.2	20.4	14.8	27.9	68.3	68.3	68.3
Domestic financing	-2.5	-2.2	14.5	-6.9	10.7	20.2	14.3	16.3	37.1	27.4	-13.7	9.1	4.2	16.8	16.4	27.0	27.0
Bank financing	-2.6	-2.4	-3.8	-8.1	8.3	6.6	14.1	10.2	16.0	6.2	-13.9	-14.2	4.1	16.5	-7.5	7.0	…
Central Bank of Armenia (net) 3/	-3.7	-1.1	-6.0	-8.5	7.6	5.9	11.9	8.0	9.7	4.3	-15.5	-16.4	2.9	13.8	-15.1	-0.6	…
Commercial Banks (net)	1.2	-1.4	2.2	0.4	0.7	0.7	2.2	2.2	6.3	2.0	1.6	2.2	1.2	2.7	7.7	7.7	…
Nonbank financing (net)	0.1	0.2	0.2	1.2	0.1	0.1	0.2	0.2	0.7	1.8	0.2	0.2	0.1	0.3	0.9	0.9	…
Special Privatization Account (net) 3/	0.0	0.0	18.0	0.0	2.3	13.5	0.0	5.8	20.3	19.4	0.0	23.1	0.0	0.0	23.1	19.1	19.1
External financing 4/	13.8	2.8	6.0	12.8	5.9	5.9	7.1	11.2	32.8	32.8	18.9	11.3	10.6	11.2	51.9	41.4	41.4
Gross inflow	16.4	5.4	7.4	14.1	8.3	8.5	8.4	12.8	40.6	40.8	21.6	12.6	12.6	12.6	59.6	47.6	47.6
Of which: PRSC	…	0.0	…	9.2	…	0.0	…	0.0	…	9.2	9.0	0.0	0.0	0.0	9.0	7.1	…
Amortization due	-2.6	-2.5	-1.4	-1.4	-2.4	-2.6	-1.4	-1.5	-7.7	-8.0	-2.8	-1.4	-2.0	-1.5	-7.7	-6.3	-6.3

Table 5. Armenia: Central Government Operations, 2006–07 (concluded)

	2006										2007
	Q1		Q2		Q3		Q4		Jan.-Dec.		Jan.-Dec.
	Prog. 1/	Act.	Prog. 1/	Act.	Prog. 1/	Proj.	Prog. 1/	Proj.	Prog. 1/	Proj.	IMF 1/
	(In percent of GDP unless specified otherwise)										
Total revenue and grants	3.3	3.1	3.9	4.2	4.4	4.5	5.1	5.6	16.8	17.4	16.8
Total revenue	3.1	3.1	3.7	4.1	4.1	4.2	4.4	4.5	15.2	15.8	16.2
Tax revenue	3.0	2.9	3.6	3.6	3.9	3.9	4.3	4.3	14.8	14.7	15.7
Value-added tax	…	1.2	…	1.5	…	…	…	…	…	…	…
Excises	…	0.4	…	0.3	…	…	…	…	…	…	…
Profits, simplified, and presumptive taxes	…	0.6	…	1.0	…	…	…	…	…	…	…
Personal income tax	…	0.3	…	0.3	…	…	…	…	…	…	…
Customs duties	…	0.1	…	0.2	…	…	…	…	…	…	…
Other taxes	…	0.2	…	0.3	…	…	…	…	…	…	…
Nontax revenue	0.1	0.1	0.0	0.4	0.1	0.1	0.1	0.1	0.3	0.7	0.4
Capital revenue	0.0	0.1	0.1	0.1	0.0	0.2	0.0	0.1	0.1	0.5	0.1
Grants	0.2	0.0	0.3	0.1	0.4	0.3	0.7	1.2	1.6	1.6	0.6
Total expenditure	3.8	3.2	4.8	4.5	5.1	5.5	6.0	6.5	19.6	19.7	19.2
Current expenditure	3.2	2.7	3.5	3.3	3.3	3.8	3.5	3.8	13.5	13.7	13.9
Wages	0.5	0.4	0.6	0.5	0.5	0.5	0.5	0.8	2.1	2.2	…
Subsidies	0.3	0.1	0.1	0.2	0.1	0.1	0.1	0.4	0.6	0.8	…
Interest	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.4	0.4
Transfers	0.9	0.8	0.9	0.9	0.9	0.8	0.9	0.9	3.5	3.4	…
Goods and services	1.5	1.3	1.8	1.7	1.7	2.3	1.8	1.7	6.8	7.0	…
Capital expenditure and net lending	0.6	0.6	1.3	1.2	1.8	1.7	2.5	2.6	6.1	6.1	5.3
Capital expenditure	0.4	0.4	1.1	1.1	1.6	1.5	2.3	2.5	5.4	5.4	4.6
Net lending	0.2	0.1	0.2	0.2	0.2	0.2	0.1	0.2	0.7	0.7	0.7
Overall balance (commitment)	-0.5	-0.1	-0.8	-0.3	-0.7	-1.0	-0.9	-0.9	-2.8	-2.3	-2.3
Statistical discrepancy/financing gap	0.0	0.1	0.0	0.1	0.0	0.0	0.0	-0.2	0.0	0.0	0.0
Overall balance (cash)	-0.5	0.0	-0.8	-0.2	-0.7	-1.0	-0.9	-1.1	-2.8	-2.3	-2.3
Deficit/financing	0.5	0.0	0.8	0.2	0.7	1.0	0.9	1.1	2.8	2.3	2.3
Domestic financing	-0.1	-0.1	0.6	-0.3	0.4	0.8	0.6	0.6	1.5	1.1	0.6
Bank financing	-0.1	-0.1	-0.2	-0.3	0.3	0.3	0.6	0.4	0.6	0.2	-0.3
Central Bank of Armenia (net) 3/	-0.1	0.0	-0.2	-0.3	0.3	0.2	0.5	0.3	0.4	0.2	…
Commercial Banks (net)	0.0	-0.1	0.1	0.0	0.0	0.0	0.1	0.1	0.3	0.1	…
Nonbank financing (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Special Privatization Account (net) 3/	0.0	0.0	0.7	0.0	0.1	0.5	0.0	0.2	0.8	0.8	0.8
External financing 4/	0.6	0.1	0.2	0.5	0.2	0.2	0.3	0.4	1.3	1.3	1.8
Gross inflow	0.7	0.2	0.3	0.5	0.3	0.3	0.3	0.5	1.6	1.6	2.0
Amortization due	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.3	-0.3	-0.3
Memorandum items											
Underlying balance (excl. grants and interest, commitment)	-0.6	-0.1	-1.0	-0.4	-1.0	-1.2	-1.5	-1.9	-4.0	-3.5	-2.5
Primary balance (excl. interest, commitment)	-0.4	0.0	-0.7	-0.2	-0.6	-0.9	-0.8	-0.7	-2.4	-2.0	-1.9
Domestic expenditure arrears (stock in billions of drams)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Government and government-guaranteed debt	...	...	...	...	...	...	...	...	24.3	22.2	21.0
Of which: domestic debt	...	...	...	...	...	...	...	...	2.2	2.0	2.0
Nominal GDP (annual, in billions of drams)	2,467	2,578	2,467	2,578	2,467	2,578	2,467	2,578	2,467	2,578	2,922

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

1/ "Prog." refers to the program agreed to in March 2006. Relative to the budget, the staff presentation makes the following adjustments: (i) estimated military wages are reclassified from Other goods and services to Wages; (ii) external grants, external interest, and external financing are converted at the program exchange rate of AMD 450 per US dollar and AMD 504 per euro.

2/ According to the draft budget as of 10/17/06..

3/ As the SPA is not included in net claims on central government (NCCG), timing differences between the conversion of SPA funds into domestic currency deposits (which are included in NCCG) and their spending can affect the consistency between the CBA financing in the fiscal accounts and the change in NCCG in the monetary accounts.

Table 6. Armenia: Balance of Payments, 2005–10
(In millions of U.S. dollars, unless otherwise indicated)

	2005	2006	2007	2008	2009	2010
		Proj.	Projections			
Current account	-193	-301	-328	-370	-398	-417
Trade balance	-588	-822	-925	-997	-1,058	-1,122
Exports, fob	1,005	1,067	1,238	1,361	1,490	1,631
Imports, fob	-1,593	-1,889	-2,163	-2,358	-2,548	-2,753
Services (net)	-59	-50	-25	-19	-21	-19
Credits	332	370	414	459	496	540
Debits	-391	-420	-439	-479	-517	-559
Income (net)	45	103	138	145	156	176
Transfers (net)	409	469	484	502	525	548
Private	342	418	456	484	506	536
Official	67	50	27	18	20	13
Capital and financial account	330	425	446	499	452	407
Capital transfers (net)	51	60	13	66	69	71
Foreign direct investment (net)	252	267	292	319	323	329
Of which : Privatization/debt swap	57	0	0	0	0	0
Retained earnings/new investment	194	267	292	319	323	329
Portfolio investment (net)	-2	-1	0	0	0	0
Public sector (net)	36	56	101	181	128	78
Disbursements	50	73	118	195	147	100
Of which : World Bank program support	...	...	...	...	...	...
Amortization	-14	-17	-17	-14	-19	-22
Other capital (net)	-7	43	40	-66	-68	-72
Of which : Special Privatization Account	-57	43	0	0	0	0
Errors and omissions	5	0	0	0	0	0
Overall balance	141	124	118	129	54	-10
Financing	-141	-153	-148	-134	-54	10
Gross international reserves (increase: -)	-120	-123	-126	-110	-33	29
Use of Fund credit, net	-24	-32	-23	-25	-23	-21
Disbursements	10	...	...	...	...	...
Repurchases/repayments	-33	-31	-23	-25	-23	-21
Exceptional financing	1	1	1	1	2	2
Debt relief 1/	1	1	1	1	2	2
Financing gap	...	30	30	5	0	0
IMF	...	10	10	5	0	0
World Bank	...	20	20	0	0	0
Memorandum items:						
Current account (in percent of GDP)	-3.9	-4.9	-4.5	-4.5	-4.4	-4.2
Gross international reserves (end of period)	667	790	915	1025	1058	1029
In months of imports	3.5	3.6	3.9	4.0	3.8	3.5
Merchandise export growth, percent change	36.1	6.1	16.0	10.0	9.5	9.5
Merchandise import growth, percent change	33.1	18.6	14.5	9.0	8.0	8.0
Nominal external debt 2/	1,099	1,159	1,229	1,293	1,368	1,430
Nominal external debt stock (in percent of GDP) 2/	22	19	17	16	15	15
NPV of external debt in percent of exports 3/	60	47	44	42	41	40
External debt service in percent of exports 2/	5.7	4.2	2.9	2.6	2.5	2.3

Sources: Armenian authorities; and Fund staff estimates.

1/ From the United Kingdom through 2015 (in respect of IDA credits).
2/ Based on government and government-guaranteed medium- and long-term debt as at end-2005.
3/ Based on the low-income country debt sustainability analysis presented in Country Report No. 05/422.

Table 7. Armenia: Medium-Term Macroeconomic Framework, 2005–10

(In percent of GDP unless otherwise specified)

	2005	2006	2007	2008	2009	2010
	Act.	Projections				
	(In percent of GDP unless otherwise indicated)					
National income and prices						
Real GDP growth (percent change)	14.0	11.0	9.0	6.0	6.0	6.0
Gross domestic product (in millions of U.S. dollars)	4,911	6,114	7,312	8,183	8,979	9,853
Gross national income per capita (in U.S. dollars)	1,541	1,924	2,294	2,552	2,785	3,043
CPI inflation, end-of-peiod (annual percent change)	-0.2	5.0	4.0	3.0	3.0	3.0
Investment and saving						
Investment	29.7	30.5	29.9	30.7	29.1	29.1
Government	4.1	5.4	4.6	5.9	4.0	4.0
Other	25.6	25.0	25.3	24.8	25.1	25.1
National savings	25.7	25.5	25.4	26.2	24.7	24.9
Government	1.5	3.1	2.3	3.0	1.1	1.1
Other	24.2	22.4	23.2	23.2	23.6	23.8
Government operations						
Revenue and grants	15.7	17.4	16.8	17.5	17.9	17.9
Of which: tax revenue	14.3	14.7	15.7	16.1	16.5	16.9
grants 1/	0.4	1.6	0.6	1.0	1.0	0.6
Expenditure	18.3	19.7	19.2	20.4	20.8	20.8
Of which: social expenditure 2/	6.1	6.7	6.8	7.0	7.0	7.0
Current expenditure	13.6	13.7	13.9	13.8	16.1	16.1
Capital expenditure	4.1	5.4	4.6	5.9	4.0	4.0
Net lending	0.6	0.7	0.7	0.7	0.7	0.7
Overall balance (including grants) 3/	-2.6	-2.3	-2.3	-2.9	-2.9	-2.9
Domestic financing	1.9	1.1	0.6	0.4	1.2	2.0
External financing	0.7	1.3	1.8	2.5	1.7	0.9
Government and government-guaranteed debt	24.2	22.2	21.0	20.1	19.4	18.5
External sector						
Exports of goods and services	27.3	23.5	22.6	22.2	22.1	22.0
Imports of goods and services	40.5	37.8	35.6	34.7	34.1	33.6
Current account	-3.9	-4.9	-4.5	-4.5	-4.4	-4.2
Current account (in millions of U.S. dollars)	-193	-301	-328	-370	-398	-417
Capital and financial account (in millions of U.S. dollars)	330	425	446	499	452	407
Of which: direct foreign investment	252	267	292	319	323	329
public sector disbursements	50	73	118	195	147	100
Change in gross international reserves (in millions of U.S. dollars) 4/	-120	-123	-126	-110	-33	29
Arrears and debt relief (in millions of U.S. dollars)	1	1	1	1	2	2
Financing/gap (in millions of U.S. dollars)	0	30	30	5	0	0
Of which: IMF	0	10	10	5	0	0
World Bank	0	20	20	0	0	0
External debt (NPV, in percent of exports of goods and services)	60	47	44	42	41	40
Debt service (in percent of exports of goods and services)	5.7	4.2	2.9	2.6	2.5	2.3
Gross international reserves in months of imports	3.5	3.6	3.9	4.0	3.8	3.5

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

1/ For 2007–09, the figures include preliminary projections for disbursements under the U.S. Millennium Challenge Account.

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

3/ Differences between the overall balance and the total financing are due to a statistical discrepancy between the balance on a cash and commitment basis.

4/ A negative figure indicates an increase.

Table 8. Armenia: Indicators of Fund Credit, 2005–10

	2005	2006	2007	2008	2009	2010
	Act.	Projections				
	(In units indicated)					
Existing and prospective outstanding Fund credit 1/						
In millions of SDRs	123.4	108.8	99.9	86.2	71.0	56.9
In percent of exports 2/	13.6	11.2	9.0	7.0	5.3	3.9
In percent of external debt	16.6	13.9	12.1	9.9	7.7	5.9
In percent of gross reserves	27.3	20.4	16.2	12.5	9.8	8.0
In percent of quota	134.2	118.3	108.6	93.7	77.2	61.8
Existing outstanding Fund credit 1/						
In millions of SDRs	123.4	105.5	90.1	73.0	57.8	43.7
In percent of exports 2/	13.6	10.9	8.1	5.9	4.3	3.0
In percent of external debt	16.6	13.5	10.9	8.4	6.3	4.5
In percent of gross reserves	27.3	19.8	14.6	10.6	8.0	6.1
In percent of quota	134.2	114.7	97.9	79.4	62.9	47.5
Prospective outstanding Fund credit 1/						
In millions of SDRs	…	3.3	9.9	13.2	13.2	13.2
In percent of exports 2/	…	0.3	0.9	1.1	1.0	0.9
In percent of external debt	…	0.4	1.2	1.5	1.4	1.4
In percent of gross reserves	…	0.6	1.6	1.9	1.8	1.8
In percent of quota	…	3.6	10.7	14.3	14.3	14.3
Repayments and charges due from existing and prospective drawings						
In millions of SDRs	…	21.8	16.0	17.5	15.6	14.5
In percent of exports 2/	…	2.2	1.4	1.4	1.2	1.0
In percent of external debt	…	2.8	1.9	2.0	1.7	1.5
In percent of gross reserves	…	4.1	2.6	2.5	2.2	2.0
In percent of quota	…	23.7	17.3	19.1	16.9	15.7
Repayments and charges due from existing drawings						
In millions of SDRs	…	21.8	15.9	17.5	15.5	14.4
In percent of exports 2/	…	2.2	1.4	1.4	1.2	1.0
In percent of external debt	…	2.8	1.9	2.0	1.7	1.5
In percent of gross reserves	…	4.1	2.6	2.5	2.1	2.0
In percent of quota	…	23.6	17.3	19.0	16.9	15.6
Repayments and charges due from prospective drawings						
In millions of SDRs	…	0.0	0.0	0.1	0.1	0.1
In percent of exports 2/	…	0.0	0.0	0.0	0.0	0.0
In percent of external debt	…	0.0	0.0	0.0	0.0	0.0
In percent of gross reserves	…	0.0	0.0	0.0	0.0	0.0
In percent of quota	…	0.0	0.0	0.1	0.1	0.1

Source: Fund staff estimates.

1/ End of period stocks.
2/ Exports of goods and services.

Table 9. Armenia: Poverty Indicators and Millennium Development Goals, 1990–2015

	1990	1998/99	2000	2003	2004	2015 Target
	(In percent of total population unless otherwise stated)					
1 Eradicate extreme poverty and hunger						
Population below US$2.15 (PPP) a day	...	35.8	...	...		...
Overall poverty rate	...	56.3	50.9	42.9	39.0	19.7
Rural poverty	...	47.7	45.7	47.5	40.7	...
Extreme Poverty	...	26.1	16.2	7.4	7.2	4.1
Prevalence of child malnutrition (in percent of children under 5)	...	3.3	2.6	...		1.4
2 Achieve universal primary education						
Net primary enrollment ratio (in percent of relevant age group)	...	...	84.5	94.4	97	100
Youth literacy rate (in percent of group ages 15-24)	99.5	99.7	99.8	...	100	100
3 Promote gender equality						
Ratio of girls to boys in primary and secondary education (in percent)	...	...	104.0	101.1	102.8	100
Ratio of young literate females to males (in percent of group ages 15-24)	99.7	99.8	100.1	...	100.1	...
Proportion of seats held by women in national parliament (in percent)	36.0	6.0	3.0	...	5	...
4 Reduce child mortality						
Under 5 mortality rate (per 1,000)	60.0	47.0	37.0	35.0	32.0	20.0
Infant mortality rate (per 1,000 live births)	26.0	...	33.0	30.0	29.0	8.7
Immunization, measles (in percent of children under 12 months)	94.8	91.0	92.0	94.0	92.0	...
5 Improve maternal health						
Maternal mortality ratio (modeled estimate, per 100,000 live births)	40.1	32.9	21.8	18.6	...	10.0
Births attended by skilled health staff (in percent of total)	99.7	98.8	96.8	...	...	...
6 Combat HIV/AIDS, malaria and other diseases						
Prevalence of HIV, female (in percent of group ages 15-24)	...	0.0	0.2	0.1	0.1	Stabilize and reduce
Incidence of tuberculosis (per 100,000 people)	26.3	39.2	63.5	70.1	78.3	Stabilize and reduce
Tuberculosis cases detected under DOTS (in percent)	...	8.0	51.4	43.3	43.6	Stabilize and reduce
7 Ensure environmental sustainability						
Nationally protected areas (in percent of total land area)	...	7.4	7.6	7.6	7.6	...
GDP per unit of energy use (PPP $ per kg oil equivalent)	…	3.5	3.3	4.8	5	...
CO2 emissions (metric tons per capita)	…	1.0	1.1	...	...	...
Access to an improved water source (% of population)	...	...	...	92	...	...
Access to improved sanitation (% of population)	...	...	...	84	...	...
8 Develop a Global Partnership for Development						
Fixed line and mobile telephones (per 1,000 people)	157.0	145.2	144.9	178.4	259.7	...
Personal computers (per 1,000 people)	...	5.3	9.2	15.8	66.1	...
General indicators						
Population (in millions)	3.5	3.1	3.1	3.1	3.0	...
Adult literacy rate (in percent of group ages 15 and over)	97.5	98.3	98.5	98.6	99.4	...
Total fertility rate (births per woman)	2.6	1.2	1.2	1.1	1.3	...
Life expectancy at birth (years)	71.7	73.0	73.6	74.8	75	...
Gini index of inequality (consumption)	...	…	34.4	27.1	31	...
Gini index of inequality (total income)	...	57.0	52.8	44.0	41.0	...

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.

Table 10. Armenia: Financial Soundness Indicators for the Banking Sector, 2003–06
(In percent, unless otherwise indicated)

	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
	2003	2004				2005				2006	
Capital adequacy											
Total regulatory capital to risk-weighted assets	33.8	35.5	34.3	33.7	32.3	36.4	31.7	33.6	33.7	33.8	33.7
Tier I regulatory capital to risk-weighted assets	32.2	33.5	32.3	31.7	30.2	33.7	29.6	31.9	31.7	31.6	30.0
Capital (net worth) to assets	18.1	16.9	17.9	17.5	17.8	19.3	19.5	20.6	21.5	21.3	22.0
Asset composition											
Sectoral distribution of loans (billions of drams)											
Industry (excluding energy sector)	19.0	19.4	20.6	23.8	29.0	26.0	26.9	28.9	30.4	33.5	34.6
Energy Sector	10.7	9.5	11.6	11.6	6.6	5.6	6.5	7.4	8.7	6.3	8.3
Agriculture	8.2	8.4	9.0	7.6	8.6	10.0	12.5	10.7	11.3	12.1	13.3
Construction	4.8	5.4	5.1	5.9	5.3	5.9	6.0	7.4	7.9	8.5	8.2
Transport and communication	0.7	0.8	1.0	1.2	1.2	2.2	3.3	3.0	3.7	4.1	4.9
Trade/commerce	21.5	23.1	24.9	28.8	31.1	30.6	32.8	34.8	42.2	44.0	47.1
Sectoral distribution of loans to total loans (percent of total)											
Industry (excluding energy sector)	20.1	19.1	18.3	19.4	22.2	19.7	18.4	18.3	17.0	17.5	16.6
Energy Sector	11.4	9.4	10.3	9.4	5.0	4.2	4.5	4.7	4.8	3.3	4.0
Agriculture	8.6	8.2	8.0	6.2	6.6	7.6	8.5	6.8	6.3	6.3	6.4
Construction	5.1	5.3	4.5	4.8	4.0	4.5	4.1	4.7	4.4	4.5	3.9
Transport and communication	0.7	0.8	0.9	1.0	0.9	1.7	2.3	1.9	2.0	2.1	2.4
Trade/commerce	22.7	22.7	22.1	23.4	23.8	23.2	22.4	22.1	23.5	23.0	22.7
Foreign exchange loans to total loans	72.7	74.6	72.1	71.8	70.4	73.6	70.2	66.6	63.7	64.6	59.8
Asset quality											
Nonperforming loans (billions of drams)	6.7	5.8	4.3	5.0	3.1	4.0	4.0	4.1	3.8	6.5	6.6
Watch (up to 90 days past due)	4.9	3.0	2.5	2.9	1.5	2.8	2.7	2.8	2.9	4.9	4.6
Substandard (91-180 days past due)	0.9	1.8	1.5	0.9	0.4	0.8	0.9	0.6	0.5	1.2	1.4
Doubtful (181-270 days past due)	0.9	1.0	0.4	1.2	1.1	0.5	0.4	0.7	0.5	0.5	0.6
Loss (>270 days past due)	11.6	9.8	10.1	9.3		0.0	0.0	0.0	0.0	0.0	0.0
Nonperforming loans to gross loans	5.4	4.4	3.1	3.3	2.1	2.5	2.3	2.2	1.9	3.1	3.0
Provisions to nonperforming loans 1/	34.3	41.8	47.8	50.4	77.0	58.8	61.3	65.5	70.7	48.7	51.5
Spread between highest and lowest rates of interbank borrowing in AMD	2.6	2.3	2.5	2.5	2.0	1.8	3.5	0.5	3.7	1.5	2.0
Spread between highest and lowest rates of interbank borrowing in foreign currency	3.7	2.0	2.7	1.0	1.0	0.9	4.0	6.1	1.0	0.0	1.3
Earnings and profitability											
ROA (profits to period average assets) 2/ 3/	2.7	2.7	2.9	3.2	3.2	2.9	2.8	3.2	3.1	3.6	3.6
ROE (profits to period average equity) 2/ 3/	14.4	16.2	16.2	18.0	18.4	15.8	14.7	16.8	15.5	16.6	16.6
Interest margin to gross income	42.0	46.0	46.8	44.6	44.2	43.4	39.6	40.5	41.1	48.8	49.6
Interest income to gross income	62.7	67.9	67.8	64.6	63.7	63.9	58.2	59.4	59.8	70.0	70.2
Noninterest expenses to gross income	48.5	45.7	47.0	45.5	46.5	45.2	54.5	49.9	49.7	45.3	45.9
Liquidity											
Liquid assets to total assets	47.5	46.5	44.6	47.6	47.1	46.3	45.2	45.7	44.2	44.7	40.8
Liquid assets to total short-term liabilities	101.3	100.3	96.1	99.9	98.7	107.9	106.1	109.9	110.5	110.3	105.9
Customer deposits to total (non-interbank) loans	177.1	175.0	160.3	175.0	177.3	161.4	148.1	149.3	140.5	142.5	121.2
Foreign exchange liabilities to total liabilities	73.2	75.1	72.6	74.1	73.3	72.4	71.1	69.5	66.8	68.2	64.5
Sensitivity to market risk											
Duration (or average repricing period) of assets											
Duration (or average repricing period) of liabilities											
Gross open positions in foreign exchange to capital	13.8	10.8	12.5	9.9	7.4	10.5	5.6	5.3	4.9	4.3	3.9

Source: Central Bank of Armenia.

1/ Includes the data of 20 banks and excludes the data of 4 banks under interim administration.
2/ Includes the data of 20 banks and excludes the data of 2 banks under interim administration.
3/ Includes the data of 20 banks and excludes the data of 1 bank under interim administration. The data of 1 bank are included which operated until 24 of December.

APPENDIX I. RELATIONS WITH THE FUND

(As of September 30, 2006)

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

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	92	100
Fund holdings of currency	92	100

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Holdings	14.72	n.a.

IV. **Outstanding Purchases and Loans:**	**SDR Million**	**Percent of Quota**
PRGF arrangements	114.08	123.99

V. **Latest Financial Arrangements:**

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	05/25/2005	05/24/2008	23.00	9.84
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**

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

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	8.56	15.43	17.06	15.19	14.13
Charges/interest	0.28	0.49	0.41	0.33	0.26
Total	8.84	15.93	17.47	15.52	14.39

VII. **Safeguards Assessment**

Under the Fund's safeguards assessment policy, the Central Bank of Armenia (CBA) is subject to a safeguards assessment update in the context of the current arrangement. A safeguards update of the CBA was completed on November 7, 2005. The update found that the CBA's safeguards framework has been strengthened since the previous assessment completed in 2002. In particular, measures have been put in place to improve data reported to the Fund, to strengthen controls and reporting on externally managed foreign exchange investments, and to address weaknesses in the legal framework. Furthermore, the appointment term of the external audit firm has been lengthened and new regulations and procedures have been put in place to better define the actions and scope of the internal audit function. A number of areas were identified where further steps could be taken. This includes strengthening controls over reporting of monetary program data to the Fund, improving oversight of the audit processes and the internal control systems by establishing an audit committee, and enhancing the CBA's internal audit function. The CBA agreed with the specific recommendations and their implementation schedule.

VIII. **Exchange Rate Arrangement**

(a) On November 22, 1993, the Republic of Armenia introduced its national currency, the dram, at a rate of 200 Armenian rubles per dram. The exchange rate has been allowed to float since then, but in 2005-06, the CBA intervened in the foreign exchange market to smooth out volatility in the exchange rate. The exchange rate system can be classified as a managed float without a predetermined path. The official exchange rate is quoted daily as a weighted average of the previous day's interbank exchange rates.

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

IX. **Article IV Consultations**

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

X. **FSAP Participation and ROSCs**

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

ROSC Modules

Standard	Timing	Publication Status	Document Number
Basel Core Principles for Effective Banking Supervision (BCP)	April 2001	Unpublished	…
Core Principles for Systemically Important Payments Systems (CPSS)	April 2001	Unpublished	…
Insurance Principles set by the International	2001	Unpublished	…

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

XI. Resident Representatives

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, 2002–06

Subject	Type of Mission	Timing	Counterpart
Fiscal Affairs Department (FAD)			
Tax policy and administration	Short-term	September 17–October 3, 2003	MFE, State Tax Service (STS), and Customs Committee
Tax policy	Short-term	April 22–May 6, 2004	MFE, STS, and Customs Committee
Tax administration	Short-term	July 13–July 27, 2004	MFE, STS, and Customs Committee
Public expenditure management advisor		November 7, 2003–November 6, 2004	
Tax administration reform	Short-term	October 5–18, 2006	
Legal Department			
Tax legislation		September 1, 2004–December 31, 2005	
Legislation Development & FIU		July 31–August 7, 2006	

Monetary and Capital Markets Department			
Banking system issues	Short-term	April 15–19, 2002	CBA
Banking system, deposit insurance, foreign exchange market development, and CBA monetary operations.	Short-term	June 24–July 4, 2002	CBA
Unified financial supervision, mortgage financing markets and inflation targeting	Short-term	January 26–February 6, 2004	CBA
Financial sector assessment program update	Short-term	February 16–March 4, 2005	CBA
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
AML/CFT preventive measures		April 1, 2006–April 30, 2007	
Statistics Department			
Data dissemination standards	Short-term	September 18–25, 2003	National Statistical Service
Balance of payments: remittances		August 22–September 5, 2006	
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	

APPENDIX II. RELATIONS WITH THE WORLD BANK
(September 30, 2006)

Country Director: Donna Dowsett-Coirolo Telephone: (202) 473-0121

I. IMPLEMENTATION OF STRUCTURAL REFORM MEASURES

A. Legal Framework

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

B. Business Environment

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

3. The recent business surveys of Armenian entrepreneurs suggest that these efforts have already resulted in a more positive private sector perception of the business and investment environment. For example, the average time necessary to get construction and building renovation permits was reduced from 310 days in 2001 to 112 days in 2006. The FDI increased by almost 20 percent in 2005 compared with 2003. The State Customs Committee's websites became operational and during 2003, on average 467 references per

month were made to it. As part of the PRSC I, II and III the Customs introduced a self declaration system, reduced the role of reference prices and strengthened.

4. On tax administration, the government strengthened the operation of Large Tax Payers Unit (LTPU), placed a high priority on reducing the stock of VAT refunds owed to exporters and ensured that no additional VAT arrears were incurred to exporters. The government adopted decision announcing its intention to widen participation in the provision of international civil aviation services, raise efficiency and cut costs and initiated policy work. Despite these improvements, there is still considerable scope for further reforms in the areas of competition, deregulation and strengthening of business and investment climate, especially in commercial debt recovery procedures, improvements in the transparency and efficiency of the judicial system, tax and customs administrations, improvements in governance and implementing the anti-corruption strategy. In addition to the above-stated, further strengthening of both tax and customs administration are at the core of the PRSC III, in particular implementation of self-assessment systems; adherence to reforms for the Large Taxpayer Unit and good practices on VAT refund and tax arrears; completion, implementation and expansion of DTI facilities in major customs and implementation of intelligence-based system based on risk assessment.

C. Energy and Infrastructure

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

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

recovery in the irrigation system by 2007. 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

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

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

9. Implementation progress has been satisfactory and about 200 hospital accountants have been trained in new accounting procedures. The government developed an action plan for clearing the accumulated arrears in the health sector and prevented further arrears in this sector. The government also adopted a decision to introduce further reforms in the Basic Benefit Package in the health sector. The government undertook measures for financing and management of the Primary Health Care departments of polyclinic that are included in the hospital networks. Further reforms are needed in increasing the population overall health

status, reducing child and maternal mortality, increasing use of healthcare system by rural and low-income groups, monitoring public health and promoting better health behavior, and strengthening monitoring and financial reporting of the noncommercial organizations (NCOs) in the health sector. The government developed the national strategy on combating non-communicable diseases and plans to take necessary steps to address the public health threats from non-communicable diseases through development and implementation of specific priority programs on non-communicable diseases and through allocation of adequate public resources in the health care budget.

E. Social Protection and Insurance

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

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

II. LENDING

12. World Bank lending to Armenia as of September 30, 2006 totals US$932.3 million, of which US$797.3 million has been disbursed. The current Bank portfolio consists of 18 IDA credits with a total commitment of $251.7 million, of which $119.9 million is disbursed.

13. Building on the major Poverty Reduction Strategy Paper's (PRSP) themes, the fourth Country Assistance Strategy (CAS) for Armenia was discussed in the World Bank Board of Executive Directors on June 10, 2004 to focus on three main objectives of: (i) promoting private sector led economic growth; (ii) making growth more pro-poor; and (iii) reducing non-income poverty. Pursuant to agreements reached in the context of IDA-14, country resource envelopes are determined annually based on the Country Policy and Institutional Assessments and performance of the ongoing portfolio. Armenia has a very strong IDA performance rating and as a consequence was eligible for about $58 million in FY06 and $61 million in FY07. Based on a 2006 review of Armenia's creditworthiness, Armenia will now be eligible to receive a small amount of IBRD lending beginning in FY08, although it is not yet decided whether to do so.

14. The CAS includes four Poverty Reduction Support Credits (PRSCs) for FY05, 06, 07, and 08. These will support the PRSP objectives and focus 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. Macroeconomic stability is a precondition for the PRSC and is vital for facilitating an enabling environment necessary for successful structural reforms implementation. The PRSC's preparation is being closely coordinated with the IMF Poverty Reduction and Growth Facility (PRGF). The first PRSC was approved by the World Bank Board on November 18, 2004, became effective and disbursed in December 2004. The second PRSC in the amount of $20 million equivalent was approved by the World Bank's Board on January 19, 2006 and fully disbursed in April 2006. The third PRSC in the amount of USD$20 million is scheduled for Board's Approval in the first half of 2007.

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

	Active Projects	Credit Amount as of 09/30/06	Disbursement as of 09/30/06	Approval Date	Closing Date
Active Projects		***251.7***	***119.9***		
1.	Electric. Trans. & dist.	21.0	21.4	03/04/99	10/31/06
2.	Enterprise incubator	5.0	4.3	11/30/01	12/31/06
3.	Judicial reform	11.4	12.0	09/14/00	06/30/06
4.	Irrigation dam safety	26.6	20.8	06/24/99	09/30/07
5.	Irrigation development	24.9	22.2	08/30/01	03/31/07
6.	Social protection admin.	5.2	0.5	06/10/04	12/31/07
7.	Natural resource management	8.3	4.2	06/04/02	07/31/08
	Natural resource management (GEF)	5.1	2.0		
8.	Educ. qual. & relevance (APL #1)	19.0	6.4	01/20/04	11/30/08
9.	Municipal water and WW	23.0	10.2	05/04/04	02/28/09
10.	Health system mod.	19.0	6.9	06/10/04	06/30/09
11.	Irrigation dam safety 2	6.8	1.2	06/10/04	03/31/09
12.	Public sector mod.	10.1	1.3	05/04/04	03/31/09
13.	Rural Enterprise & small scale	20.0	1.4	07/07/05	05/31/10
14.	Urban Heating Project	15.0	2.3	07/12/05	06/30/10
15.	Yerevan water/waste water services	20.0	2.8	02/24/05	02/28/11
16.	Renewable Energy Project	5.0	0.0	03/29/06	31/12/10
17.	Avian Influenza Prep. Project	6.3	0.0	06/02/06	31/07/09
Completed Projects		***680.6***	***677.4***		
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	10.7	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	58.6	08/26/97	06/30/99
24.	SATAC I	3.8	2.8	02/29/96	06/30/00
25.	Highway	31.0	29.5	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	4.7	08/26/97	12/31/02
31.	Education	15.0	14.6	11/20/97	10/31/02
32.	SAC IV	50.0	49.4	05/22/01	03/31/03
33.	Health	10.0	9.3	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	40.4	06/08/00	12/31/04
37.	PRSC I	20.0	20.3	18/11/04	12/31/05
38.	Agric. Reform support	16.3	16.0	01/27/98	06/30/05
39.	Social Investment Fund II	20.0	20.0	05/11/00	12/31/05
40.	Investment and export facilitation	1.0	1.0	04/16/02	12/31/05
41.	Municipal development	30.0	33.0	06/11/98	01/31/06
42.	PRSC II	20.0	20.1	01/19/06	06/30/07
	Total	**932.3**	**797.3**		

APPENDIX III. RELATIONS WITH THE EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT (EBRD)

(As of September 30, 2006)

1. As of December 31, 2005, the EBRD approved 35 projects in the power, transport, agribusiness, textile, mining, construction and financial sectors. Total commitments amounted to EUR 136.3 million.

2. There are two sovereign projects. First, the EBRD approved a sovereign guaranteed loan of EUR 54.8 million for construction of the Hrazdan Unit 5 thermal power plant in March 1993, partly aimed at the eventual closure of Armenia's nuclear plant in Medzamor. The government is contemplating the privatization of Hrazdan Unit 5 as the completion of this plant is constrained by limited budgetary resources. The EBRD had funded technical assistance for the Hrazdan privatization prospectus and continues to follow the privatization process. The Hrazdan Thermal Power Complex excluding the unfinished Unit 5 has been transferred to the Russian Federation in the context of the debt-for-equity deal. Second, in November 1994, the agreement on a EUR 21.8 million loan to build an air cargo terminal in Zvartnots airport was signed under a guarantee by the Armenian government. The airport was transferred to private management in 2002. The new management has prepared a master plan for the development of the airport, which is expected to generate further cargo traffic for the cargo terminal.

3. 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 Programme (the only copper smelter in the region), and a new loan (EUR 4.3 million), including the refinancing of the existing loan, was signed in August 2004. Moreover, the EBRD has launched the Turn Around Management (TAM) and Business Advisory Service programmes in Armenia in 2003, originally funded by the EU-Tacis program but now funded from the ETC Fund, to support micro, small, and medium-sized enterprises. There were seven new projects completed during 2004 for a total amount of EUR 6.7 million. Two of them are in the banking sector (including equity investment), one in general industry sector (direct investment in equity of a local enterprise), one pre-export finance facility with a local company in the extractive industry and three trade facilitation programmes with local commercial banks. During 2005 the EBRD signed 11 projects with the total commitments of Euro 18 million. New commitments 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.

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.

Appendix IV. Statistical Issues

1. While data provision for surveillance is adequate overall, further improvements are needed in real, fiscal, and external sector statistics in order to enhance the design and monitoring of economic policies. The overall quality, timeliness, and coverage of macroeconomic statistics in Armenia 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) and has since then provided timely data for all SDDS prescribed data categories.

2. **National accounts and price statistics.** The National Statistics Service (NSS) has made significant changes to the national accounts methodology to bring it in line with best international practices. Progress has been made in developing estimates of monthly and (constant price) quarterly GDP that are now published. Basic data collection procedures have also improved. The national accounts have adopted the concept of gross value added using transaction prices mostly recorded on an accrual basis. However, progress has been slow in improving the compilation of national accounts at constant (1998) prices; annual data are still mainly derived by re-valuing current output and inputs at previous year prices instead of deflating them by the relevant components of the producer price index. Quarterly GDP estimates are published at constant and current prices. The CPI covers eleven large population centers in the Republic of Armenia and the capital city, Yerevan. The base year and expenditure weights are for 2005. Data on the consumer price index (CPI) and wages are reported on a timely basis. A ten-day CPI is compiled by the NSS and the Central Bank of Armenia, though its scope, geographical coverage, and dissemination are limited.

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

Manual on Government Finance Statistics 1986, and monthly data on central government operations are disseminated within 40 days of the end of the month.

4. 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 also difficult because of the need to manually identify transactions among central government, local government, and the Social Insurance State Fund.

5. The authorities submitted cash data, converted to the framework of the *Government Finance Statistics Manual 2001*, for publication in the *2006 Government Finance Statistics Yearbook*. Although the authorities expected to begin providing data for publication in the *IFS* in early 2005, such data have yet to be received. The *GFSM 2001* implementation plan is currently limited to bringing the classification of budgetary central government revenue, expense, and transactions in nonfinancial assets in line with international practices.

6. **Money and banking statistics.** Money and banking 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. Monthly interest rate data are provided with an one-week lag. A new chart of accounts meeting International Accounting Standards (IAS) was introduced in January 1998. Since then, the balance sheets of the CBA and of the deposit money banks follow IAS methodology.

7. Responding to a STA request, the CBA has compiled and submitted a complete set of monetary data beginning from December 2001 using STA's Standardized Report Forms (SRF). STA review validated the resulting monetary aggregates and the data have been cleared for publication in the December issue of *IFS Supplement*.

8. **External sector statistics.** The coverage of external sector data has improved in recent years. Trade statistics are provided on a timely basis, and trade data by origin or destination and by commodity are generally available within a month. Price data for exports and imports are less readily available. Quarterly balance of payment data are generally available with a three-month lag. However, the scope of data on private non-guaranteed external debt needs to be improved, while data on direct investment abroad (available from 2003) and on other capital outflows are likely underestimated. The compilation program that would enable proper measuring of the remittances data is not in place and that leads to considerable discrepancies among available source data, where the surveys data are considerably lower than the data obtained through the banking system. The absence of a comprehensive, continuously updated business register hampers the coverage of transactions

and institutional units. The latest quarterly data on international investment position are available for 2005.

Armenia: Table of Common Indicators Required for Surveillance
(As of October 17, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	8/31/06	not available	D	W	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	9/29/05	9/30/05	D	W	M
Reserve/Base Money	8/31/2006	10/13/2006	D	W	M
Broad Money	8/31/2006	10/13/2006	M	M	M
Central Bank Balance Sheet	8/31/2006	10/13/2006	D	W	M
Consolidated Balance Sheet of the Banking System	8/31/2006	10/13/2006	M	W	M
Interest Rates[2]	9/30/2006	10/13/2006	W	W	M
Consumer Price Index	August 2006	10/4/2006	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	Jun 05	7/30/05	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q2 05	8/31/05	Q	Q	Q
External Current Account Balance	Q2 06	not available	Q	Q	Q
Exports and Imports of Goods and Services	Q2 06	10/4/06	Q	Q	Q
GDP/GNP	Q2 06	10/4/06	M	M	M
Gross External Debt	Q1 05	6/30/05	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] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); and Not Available (NA).

APPENDIX V. DEBT SUSTAINABILITY ANALYSIS

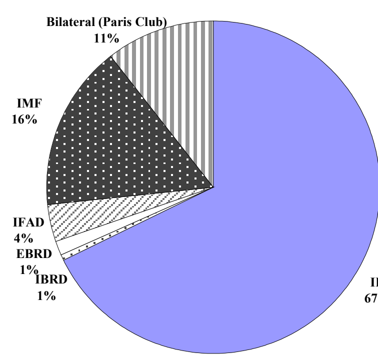
The IMF-World Bank staffs' debt sustainability analysis (DSA) suggests that Armenia is at a low risk of debt distress with all debt indicators well bellow the relevant country-specific debt-burden thresholds. The analysis underlines that continuing the structural reforms and preserving macroeconomic stability are critical for safeguarding the favorable debt outlook.

1. **The DSA was prepared jointly by Fund and World Bank staffs in consultation with the authorities, using the joint Bank-Fund Low-Income Country Debt Sustainability Framework.**[8] Macroeconomic assumptions underlying the baseline scenario are consistent with the framework presented in the staff report for the 2006 Article IV consultation and the third review under the PRGF (Box 1). The external debt data used for this exercise were updated by staffs based on information provided by the authorities and multilateral institutions.

Structure of debt and developments in 2005

2. **Armenia's external debt stock of public and publicly guaranteed debt as of end-2005 is estimated at $1,099 million (22 percent of GDP)**, 89 percent of which is owed to multilateral international organizations (Figure 1).[9] The outstanding debts to the World Bank and the Fund account for 68 percent and 16 percent of total debt stock, respectively. In addition, about 2 percent of GDP of public and publicly guaranteed debt is owed to domestic creditors.

Figure 1. Armenia's External Debt Stock, end-2005



3. **The external debt outlook improved considerably in 2005.** Prudent debt management combined with robust economic growth and favorable exchange rate dynamics contributed to a decline of external debt ratio from 33 percent of GDP in 2004 to 22 percent of GDP in 2005.[10]

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[8] Fund and Bank staffs have collaborated previously on debt sustainability issues, including in the context of the report on "Poverty Reduction, Growth and Debt Sustainability in Low-Income CIS Countries," February 5, 2002, (refer to www.imf.org) and "Republic of Armenia—First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility" (Country Report No. 05/422).

[9] The DSA covers the central government as other public sector debt is negligible.

[10] Relevant exchange rate dynamics include (i) dram appreciation against U.S. dollar and its impact on U.S. dollar denominated GDP level and (ii) debt portfolio implications of U.S. dollar appreciation (about 94 percent of debt outstanding is contracted in currencies other than U.S. dollar).

Box 1. Macroeconomic Assumptions, 2006–26

The baseline DSA has been developed on the following set of assumptions.

- **Annual real GDP growth is projected to average around 7 percent over the medium term. It is projected to decline subsequently to an average of 4 percent.** The near-term growth is supported by (i) robust investment performance on account of significant foreign exchange inflows to the public sector (Millennium Challenge Account and Lincy Foundation grants) and to the private sector (private transfers and remittances) and (ii) significant growth in services, led by development of financial sector.

- **Consistent with the CBA's target, the inflation rate is assumed to be around 3 percent per annum.** The near term inflation is projected to be somewhat higher, largely on account of higher food and international oil prices.

- **The external current account deficit is projected to average around 4½ percent of GDP in 2006–11,** against the background of strong import growth. Exports are projected to grow robustly over the medium term, as new investments in food processing, mining, and base metal sectors become operational. Buoyed by strong income growth in Russia, private transfers will remain large in the medium term, financing a significant share of the trade deficit. The long-run current account deficit is envisaged to improve gradually to an average of 2¾ percent of GDP.

- **In 2006–11, net FDI is expected to average about 3¾ percent of GDP**, gradually declining from the high 2005 level of 5 percent of GDP. In the near term, FDI is expected to be concentrated mostly in traditional sectors, like base metals, food processing, and telecommunication. 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 3 percent of GDP.

- **Central government revenues (excluding grants) are projected at around of 16¾ percent of GDP in 2006–11, and will gradually increase to about 19 percent by 2026.**

- **The overall fiscal deficit is projected at 2.9 percent of GDP through most of the PRSP horizon of 2015 and 2.3 percent of GDP thereafter.**

- **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 70 percent of country's total external debt stock as of end-2005—assume that starting from 2009 Armenia will begin receiving IBRD loans in addition to IDA credits, gradually shifting to exclusively IBRD borrowing by 2011. Starting 2007, IDA repayment terms are envisaged to harden, as maturity period shortens to 20 years. This reflects that Armenia's per capita income is expected to exceed the IDA eligibility threshold for two consequent years. Unidentified residual lending for 2017 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.** Residual borrowing from domestic sources reduces risks associated with currency mismatch of debt portfolio and contributes to deepening of domestic financial markets.

The baseline scenario

4. **The baseline scenario shows that the fiscal position remains sustainable (Table 1, Table 2a, Figure 2), but debt service costs will be rising.** Notwithstanding a progressively higher share of deficit financed by domestic and external borrowing, the net present value of public sector debt remains well below the corresponding thresholds, increasing from 16 percent of GDP in 2006 to 29 percent of GDP in 2026.[11] The debt service in percent of revenues is projected to increase from 15 percent in 2006 to 20 percent in 2026.

Table 1. Armenia's Debt Burden Indicators

	Threshold 1/	Armenia's ratios	
		2006	2026
NPV of debt in percent of			
GDP 2/	50	16	29
Exports 3/	200	47	32
Revenues 2/	300	92	148
Debt service in percent of			
Exports 3/	25	4	2
Revenues 2/	35	15	20

1/ Threshold values are based on the guidelines for low-income country in which Armenia is considered to be a strong performer.
2/ Refers to public debt.
3/ Refers to external debt.

5. **The external debt outlook is benign (Table 1, Table 3a, Figure 3).[12]** The net present value of external debt falls from 11 percent of GDP in 2006 to 8 percent of GDP in 2026, as share of deficit financing by domestic borrowing gradually increases. Similarly, the net present value of public external debt in percent of exports declines from 47 percent in 2006 to 32 percent in 2026. The external debt service in percent of Armenia's exports declines from 4 percent to 2 percent, over the same period.

Stress testing

6. **The alternative scenarios and bound tests indicate that Armenia's debt outlook is particularly sensitive to a lasting shock to economic growth and dynamics of primary balance (Table 2b, Table 3b).[13]** Nevertheless, even in these scenarios, Armenia's debt outlook is likely to remain manageable, with debt ratios exceeding relevant thresholds only in an unlikely scenario of permanently lower GDP growth. However, the historical scenario (which can be considered as a "no-reform" scenario) and the stress testing indicate that all debt ratios continue on an upward trend through the projected period, underlining the importance of continuing the process of structural reform and preserving macroeconomic stability in order to safeguard the debt outlook.

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[11] The assumption of increasingly expensive financing implies that the primary balance improves steadily as interest expenditure rises.

[12] To ensure data consistency, the external DSA covers only public and publicly guaranteed debt. To improve monitoring of private debt, the authorities are preparing the Law on State Debt that provisions obligatory reporting of foreign debt in excess of AMD 100 million contracted by the private sector. According to current data, private external debt totaled US$ 240 million at end-2005, about 22 percent of external public and publicly guaranteed debt.

[13] 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.

7. **Armenia's debt outlook is relatively insensitive to an increase in debt-creating flows.** The staffs also considered the possible impact on debt sustainability of a "significant" fiscal event, such as assumption by the government of pension liabilities. Assuming such an event were to occur in 2010 and cost around 10 percent of GDP, the net present value of public debt to GDP ratio in 2026 would remain manageable at about 32 percent, compared with 28 percent under the baseline.

8. **The authorities welcomed the finding that Armenia is at a low risk of debt distress.** Sound debt management continues to be a priority for the government. Since 2001, the Ministry of Finance and Economy has produced an Annual Report on Public Debt of Armenia, covering both domestic and external debt. This publication reports on the evolution of debt aggregates and the government's debt management strategy.

Table 2a.Armenia: Public Sector Debt Sustainability Framework, Baseline Scenario, 2003–2026
(In percent of GDP, unless otherwise indicated)

	Actual				Historical Average 5/	Standard Deviation 5/	Projections									
	2002	2003	2004	2005			2006	2007	2008	2009	2010	2011	2006-11 Average	2015	2026	2012-26 Average
Public sector debt 1/	47.1	40.9	32.6	24.2			23.9	22.3	22.7	23.5	24.7	26.0		28.6	32.2	
Of which : foreign-currency denominated	44.0	38.3	30.4	22.1			19.0	16.8	15.8	15.2	14.5	14.1		12.8	10.1	
Change in public sector debt	-1.0	-6.1	-8.3	-8.4	-3.0	5.0	-0.3	-1.6	0.4	0.8	1.2	1.3	0.3	0.6	0.2	0.4
Identified debt-creating flows	-4.8	-8.4	-8.8	-4.9	-6.0	2.4	-0.3	-1.6	0.4	0.8	1.2	1.3	0.3	0.6	0.2	0.4
Primary deficit	-0.4	0.4	1.2	2.1	2.7	2.0	2.0	1.8	2.3	2.2	2.4	2.2	2.1	1.0	0.2	0.6
Revenue and grants	18.8	17.8	15.5	15.7	16.9	1.4	17.4	16.8	17.5	17.9	17.9	17.9	17.6	19.3	19.3	19.2
Of which: grants	3.5	3.2	0.5	0.4	1.5	1.1	1.6	0.6	1.0	1.0	0.6	0.6	0.9	0.6	0.0	0.2
Primary (noninterest) expenditure	18.4	18.2	16.7	17.8	19.6	2.2	19.4	18.6	19.8	20.1	20.3	20.1	19.7	20.3	19.5	19.9
Automatic debt dynamics	-4.3	-8.0	-10.0	-6.5	-6.6	2.5	-3.3	-3.4	-1.9	-1.4	-1.2	-0.9	-2.0	-0.4	0.0	-0.2
Contribution from interest rate/growth differential	-5.7	-6.1	-3.8	-4.1	-3.9	2.3	-2.7	-2.0	-1.2	-1.1	-1.1	-0.8	-1.5	-0.4	0.0	-0.2
Of which: contribution from average real interest rate	-0.1	-0.3	0.0	0.0	0.0	0.3	-0.3	-0.1	0.1	0.2	0.3	0.4	0.1	0.7	1.3	0.9
Of which : contribution from real GDP growthO	-5.6	-5.7	-3.8	-4.1	-4.0	1.5	-2.4	-2.0	-1.3	-1.3	-1.3	-1.2	-1.6	-1.1	-1.2	-1.2
Contribution from real exchange rate depreciation	1.4	-2.0	-6.2	-2.4	-1.9	2.9	-0.6	-1.3	-0.7	-0.3	-0.1	-0.1	-0.5	0.0	0.0	0.0
Other identified debt-creating flows	-0.1	-0.7	0.0	-0.6	-0.4	0.5	1.0	0.0	0.0	0.0	0.0	0.0	0.2	0.0	0.0	0.0
Privatization receipts (negative)	-0.1	-0.7	0.0	-0.6	-0.3	0.5	0.0	0.0	0.0	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	0.0	0.0	0.0	0.0	0.0
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (central bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	1.0	0.0	0.0	0.0	0.0	0.0	0.2	0.0	0.0	0.0
Residual, including asset changes	3.7	2.2	0.4	-3.5	0.5	2.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
NPV of public sector debt	...	...	...	15.4			16.1	15.4	16.3	17.4	19.0	20.6		24.4	28.6	
Of which : foreign-currency denominated	...	...	...	13.3			11.1	9.9	9.4	9.1	8.8	8.7		8.6	6.4	
Of which : external	...	...	...	13.3			11.1	9.9	9.4	9.1	8.8	8.7		8.6	6.4	
NPV of contingent liabilities (not included in public sector debt)	...	...	...	...			...	...	...	...	...	...		...	...	
Gross financing need 2/	6.5	9.5	7.4	5.8			4.9	4.3	4.8	4.8	5.2	5.2		4.4	4.6	
NPV of public sector debt-to-revenue ratio (in percent) 3/	...	...	...	98.3			92.2	91.4	92.9	97.3	106.1	114.9		126.2	148.0	
Of which : external	...	...	...	84.8			63.9	58.7	53.4	51.1	49.3	48.7		44.4	33.3	
Debt service-to-revenue ratio (in percent) 3/ 4/	28.3	42.9	32.1	21.0			14.8	12.7	12.2	12.5	13.2	14.5		14.5	20.2	
Primary deficit that stabilizes the debt-to-GDP ratio	0.6	6.5	9.5	10.6			2.3	3.4	1.9	1.4	1.2	0.9		0.4	0.0	
Key macroeconomic and fiscal assumptions																
Real GDP growth (in percent)	13.2	13.9	10.1	14.5	8.7	4.2	11.0	9.0	6.0	6.0	6.0	5.0	7.2	4.0	4.0	4.1
Average nominal interest rate on forex debt (in percent)	1.0	0.9	0.7	0.9	1.0	0.4	0.8	0.8	0.8	0.8	0.8	0.9	0.8	1.0	2.4	1.5
Average real interest rate on domestic currency debt (in percent)	8.0	8.3	6.2	7.8	7.5	0.8	8.1	5.2	6.2	6.2	6.2	6.2	6.4	6.2	6.2	6.2
Real exchange rate depreciation (in percent, + indicates depreciation)	3.7	-5.2	-18.0	-9.0	-2.7	8.8	-2.9	-7.8	-4.3	-2.0	-1.0	...	-3.6	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	2.5	4.5	5.9	3.3	6.7	7.1	3.7	4.0	3.0	3.0	3.0	3.0	3.3	3.0	3.0	3.0
Growth of real primary spending (deflated by GDP deflator, in percent)	6.2	12.6	1.3	22.0	6.3	12.4	20.5	4.9	12.9	7.4	7.0	3.8	9.4	5.6	3.7	3.9

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

1/ Central government gross debt.
2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.
3/ Revenues including grants.
4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 2b. Armenia: Sensitivity Analysis for Key Indicators of Public Debt 2006–2026

	Estimate	Projections						
	2006	2007	2008	2009	2010	2011	2015	2026
NPV of Debt-to-GDP Ratio								
Baseline	16	15	16	17	19	21	24	28
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	17	17	18	19	20	22	27	37
A2. Primary balance is unchanged from 2005	16	16	17	18	19	20	28	47
A3. Permanently lower GDP growth 1/	16	16	17	19	21	24	33	68
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	16	17	19	21	23	26	33	47
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	16	18	21	22	23	25	28	32
B3. Combination of B1-B2 using one half standard deviation shocks	18	20	20	21	22	24	27	31
B4. One-time 30 percent real depreciation in 2007	16	19	19	20	21	23	26	30
B5. 10 percent of GDP increase in other debt-creating flows in 2010	16	15	16	17	29	30	31	32
NPV of Debt-to-Revenue Ratio 2/								
Baseline	92	91	93	97	106	115	126	147
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	98	102	103	107	115	123	143	190
A2. Primary balance is unchanged from 2005	93	94	94	98	106	114	144	244
A3. Permanently lower GDP growth 1/	92	93	97	104	118	132	171	352
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	92	99	107	116	130	144	172	242
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	92	108	121	123	131	139	146	164
B3. Combination of B1-B2 using one half standard deviation shocks	105	116	114	117	125	133	141	161
B4. One-time 30 percent real depreciation in 2007	92	112	110	112	119	127	136	154
B5. 10 percent of GDP increase in other debt-creating flows in 2010	92	91	93	97	162	167	163	166
Debt Service-to-Revenue Ratio 2/								
Baseline	15	13	12	13	13	15	14	20
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	15	14	15	14	15	16	18	25
A2. Primary balance is unchanged from 2005	15	13	13	13	13	14	18	32
A3. Permanently lower GDP growth 1/	15	13	13	14	15	17	21	47
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	15	13	14	16	17	19	20	33
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	15	13	18	20	18	17	16	23
B3. Combination of B1-B2 using one half standard deviation shocks	15	17	18	16	15	16	16	22
B4. One-time 30 percent real depreciation in 2007	15	13	12	13	14	15	15	21
B5. 10 percent of GDP increase in other debt-creating flows in 2010	15	15	13	13	14	15	15	21
Debt Service-to-GDP Ratio								
Baseline	3	2	2	2	2	3	3	4
A. Alternative scenarios								
A1. Real GDP growth and primary balance are at historical averages	3	2	3	3	3	3	3	5
A2. Primary balance is unchanged from 2005	3	2	2	2	2	3	3	6
A3. Permanently lower GDP growth 1/	3	2	2	2	3	3	4	9
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2007-2008	3	2	2	3	3	3	4	6
B2. Primary balance is at historical average minus one standard deviations in 2007-2008	3	2	3	4	3	3	3	4
B3. Combination of B1-B2 using one half standard deviation shocks	3	3	3	3	3	3	3	4
B4. One-time 30 percent real depreciation in 2007	3	2	2	2	2	3	3	4
B5. 10 percent of GDP increase in other debt-creating flows in 2010	3	2	2	2	2	3	3	4

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

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

Table 3a. Country: External Debt Sustainability Framework, Baseline Scenario, 2006–2026 1/

(In percent of GDP, unless otherwise indicated)

	Actual										Historical Average 6/	Standard Deviation 6/	Projections									
	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005			2006	2007	2008	2009	2010	2011	2006-11 Average	2016	2026	2012-26 Average
External debt (nominal) 1/	**35.6**	**42.7**	**41.6**	**46.3**	**45.1**	**42.7**	**43.2**	**39.1**	**33.3**	**22.4**			**19.0**	**16.8**	**15.8**	**15.2**	**14.5**	**14.1**		**12.5**	**10.1**	**11.9**
Of which : public and publicly guaranteed (PPG)	35.6	42.7	41.6	46.3	45.1	42.7	43.2	39.1	33.3	22.4			19.0	16.8	15.8	15.2	14.5	14.1		12.5	10.1	11.9
Change in external debt	5.9	7.1	-1.1	4.7	-1.2	-2.3	0.4	-4.0	-5.8	-10.9			-3.5	-2.2	-1.0	-0.6	-0.7	-0.4		-0.3	-0.4	-0.3
Identified net debt-creating flows	11.6	12.5	3.4	11.0	7.5	1.8	-3.1	-4.1	-9.8	-10.4			-1.4	-0.9	-0.3	0.0	0.1	-0.1		-0.9	-0.6	-0.7
Non-interest current account deficit	**17.2**	**15.2**	**19.5**	**15.8**	**13.9**	**8.6**	**5.4**	**6.4**	**4.3**	**3.7**	**10.3**	**5.9**	**4.8**	**4.3**	**4.4**	**4.3**	**4.1**	**3.7**		**2.5**	**2.4**	**2.6**
Deficit in balance of goods and services	33.1	38.0	34.3	29.9	27.7	20.7	17.2	17.9	14.9	13.2			14.3	13.0	12.4	12.0	11.6	10.9		7.8	5.0	7.1
Exports	23.1	20.1	18.6	19.9	22.8	25.5	29.4	32.2	27.7	27.3			23.5	22.6	22.2	22.1	22.0	22.4		25.0	26.0	25.0
Imports	56.1	58.1	52.8	49.8	50.5	46.1	46.6	50.1	42.6	40.5			37.8	35.6	34.7	34.1	33.6	33.3		32.8	31.0	32.2
Net current transfers (negative = inflow)	-11.6	-13.3	-9.4	-9.4	-9.8	-8.2	-7.3	-7.8	-9.3	-8.3	-9.4	1.8	-7.7	-6.6	-6.1	-5.8	-5.6	-5.3		-4.1	-2.3	-3.5
Other current account flows (negative = net inflow)	-4.3	-9.6	-5.4	-4.7	-4.0	-3.9	-4.5	-3.7	-1.3	-1.2			-1.8	-2.0	-1.9	-1.9	-1.9	-1.8		-1.2	-0.4	-1.0
Net FDI (negative = inflow)	**-1.1**	**-3.2**	**-11.7**	**-6.6**	**-5.4**	**-3.3**	**-4.7**	**-4.3**	**-6.1**	**-5.1**	**-5.1**	**2.8**	**-4.4**	**-4.0**	**-3.9**	**-3.6**	**-3.3**	**-3.3**		**-3.1**	**-2.8**	**-3.0**
Endogenous debt dynamics 2/	**-4.5**	**0.5**	**-4.4**	**1.8**	**-1.0**	**-3.5**	**-3.9**	**-6.2**	**-8.0**	**-8.9**			**-1.8**	**-1.3**	**-0.8**	**-0.7**	**-0.7**	**-0.6**		**-0.4**	**-0.2**	**-0.3**
Contribution from nominal interest rate	1.3	1.4	1.3	0.8	0.7	0.9	0.8	0.4	0.3	0.2			0.2	0.1	0.1	0.1	0.1	0.1		0.1	0.2	0.2
Contribution from real GDP growth	-1.4	-1.2	-2.7	-1.4	-2.7	-3.9	-5.0	-5.1	-3.1	-3.5			-2.0	-1.4	-0.9	-0.9	-0.8	-0.7		-0.5	-0.4	-0.5
Contribution from price and exchange rate changes	-4.4	0.2	-3.0	2.4	1.1	-0.4	0.4	-1.5	-5.1	-5.7			…	…	…	…	…	…		…	…	…
Residual (3-4) 3/	**-5.7**	**-5.4**	**-4.5**	**-6.3**	**-8.8**	**-4.1**	**3.5**	**0.1**	**3.9**	**-0.5**			**-2.0**	**-1.2**	**-0.7**	**-0.6**	**-0.8**	**-0.3**		**0.7**	**0.2**	**0.4**
Of which : exceptional financing	0.0	0.0	0.0	0.0	0.0	-0.2	-0.2	0.5	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0	0.0
NPV of external debt 4/	...	...	...	...	...	...	...	...	...	13.3			11.1	9.9	9.4	9.1	8.8	8.7		8.6	6.4	8.1
In percent of exports	...	...	...	...	...	...	...	...	...	48.9			47.3	43.8	42.1	41.4	40.1	38.9		34.3	24.8	32.4
NPV of PPG external debt	**...**	**...**	**...**	**...**	**...**	**...**	**...**	**...**	**...**	**13.3**			**11.1**	**9.9**	**9.4**	**9.1**	**8.8**	**8.7**		**8.6**	**6.4**	**8.1**
In percent of exports	...	...	...	...	...	...	...	...	...	48.9			47.3	43.8	42.1	41.4	40.1	38.9		34.3	24.8	32.4
Debt service-to-exports ratio (in percent)	20.3	14.3	19.5	14.9	10.8	9.7	9.5	7.2	9.7	4.6			4.2	2.9	2.6	2.5	2.3	2.3		1.4	2.0	1.8
PPG debt service-to-exports ratio (in percent)	20.3	14.3	19.5	14.9	10.8	9.7	9.5	7.2	9.7	4.6			4.2	2.9	2.6	2.5	2.3	2.3		1.4	2.0	1.8
Total gross financing need (billions of U.S. dollars)	...	...	...	0.2	0.2	0.2	0.1	0.1	0.0	0.0			0.1	0.1	0.1	0.1	0.1	0.1		0.0	0.0	0.0
Non-interest current account deficit that stabilizes debt ratio	11.3	8.0	20.6	11.1	15.2	10.9	5.0	10.4	10.1	14.6			8.2	6.5	5.4	4.9	4.8	4.2		2.8	2.8	2.9
Key macroeconomic assumptions																						
Real GDP growth (in percent)	5.9	3.3	7.3	3.3	6.0	9.6	13.2	13.9	10.1	14.5	8.7	4.2	11.0	9.0	6.0	6.0	6.0	5.0	7.2	4.0	4.0	4.1
GDP deflator in U.S. dollar terms (change in percent)	17.2	-0.7	7.6	-5.5	-2.2	1.0	-0.9	3.6	15.0	20.5	5.6	9.1	12.3	9.7	5.6	3.5	3.5	2.5	6.2	2.5	2.5	2.5
Effective interest rate (percent) 5/	5.4	4.0	3.4	1.8	1.5	2.2	2.0	1.1	0.9	1.0	2.3	1.5	0.9	0.9	0.8	0.8	0.8	0.8	0.9	1.1	2.3	1.5
Growth of exports of G&S (U.S. dollar terms, in percent)	22.9	-10.6	6.8	4.5	18.9	23.7	29.3	29.5	9.0	35.7	17.0	14.3	7.5	14.9	10.2	9.1	9.3	9.3	10.1	7.5	7.0	7.7
Growth of imports of G&S (U.S. dollar terms, in percent)	31.8	6.2	5.0	-8.0	5.2	1.1	13.2	27.0	7.7	31.1	12.0	13.5	16.4	12.7	9.0	8.0	8.0	6.5	10.1	6.5	6.0	6.2
Grant element of new public sector borrowing (in percent)						...	...	...	...	...	...	...	46.8	47.8	44.9	41.5	42.0	36.4	43.2	16.5	14.6	18.0
Memorandym item:																						
Nominal GDP (billions of U.S. dollars)	1.6	1.6	1.9	1.8	1.9	2.1	2.4	2.8	3.6	4.9			6.1	7.3	8.2	9.0	9.9	10.6		14.7	27.9	

Source: Staff simulations.

1/ Includes only public sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that NPV of private sector debt (if included) is equivalent to its face value.

5/ Current-year interest payments devided by previous period debt stock.

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

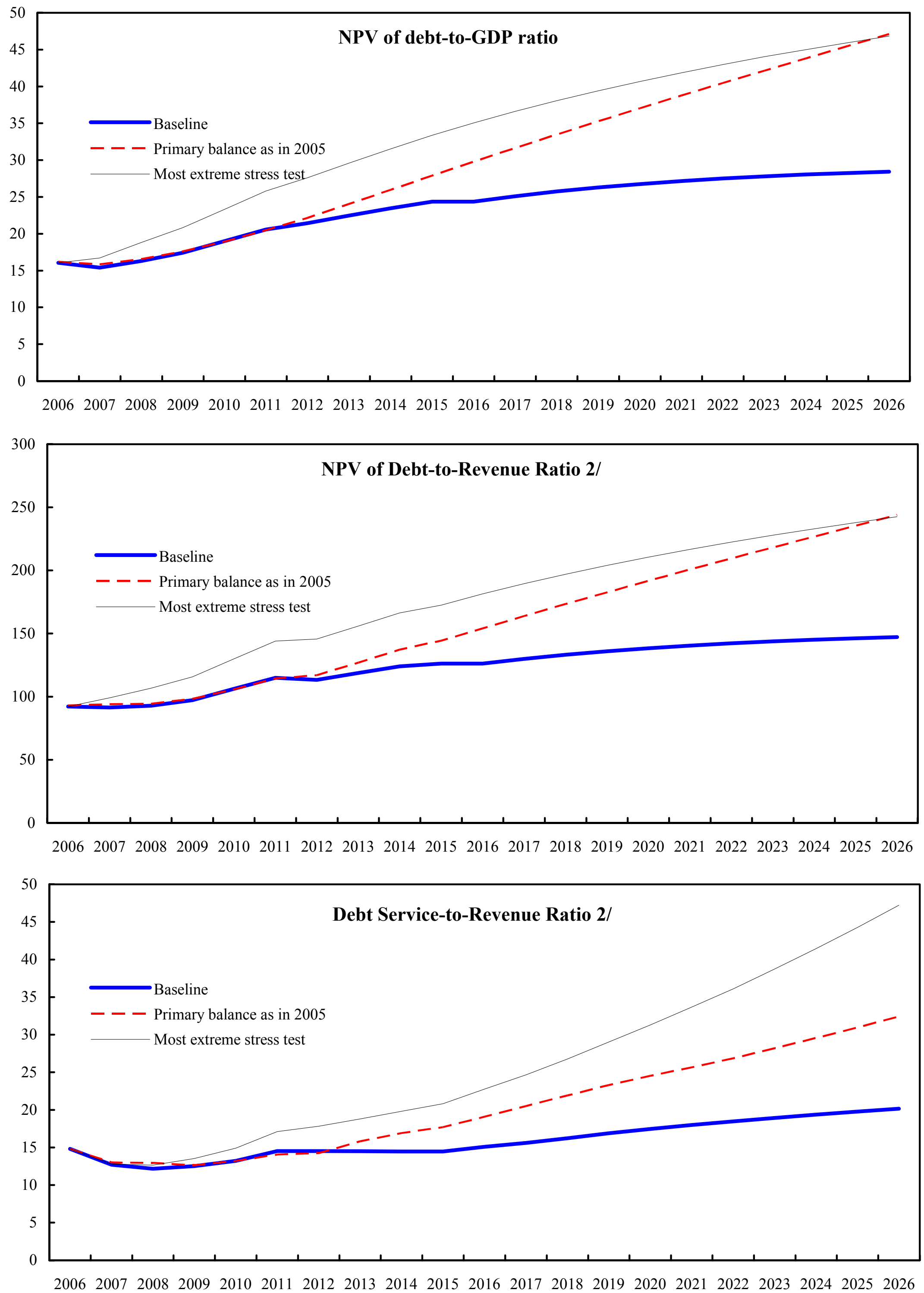
Table 3b. Country: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2006-26
(In percent)

	Projections							
	2006	2007	2008	2009	2010	2011	**2016**	2026
NPV of debt-to-GDP ratio								
Baseline	11	10	9	9	9	9	**9**	6
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007-26 1/	11	14	17	20	22	24	**35**	39
A2. New public sector loans on less favorable terms in 2007-26 2/	11	10	10	10	10	10	**11**	9
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	11	10	10	10	9	9	**9**	7
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	11	12	14	13	13	13	**11**	7
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	11	11	12	11	11	11	**11**	8
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	11	10	10	10	9	9	**9**	6
B5. Combination of B1-B4 using one-half standard deviation shocks	11	11	11	10	10	10	**10**	7
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	11	14	13	13	12	12	**12**	9
NPV of debt-to-exports ratio								
Baseline	47	44	42	41	40	39	**34**	25
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007-26 1/	47	64	78	90	101	109	**139**	149
A2. New public sector loans on less favorable terms in 2007-26 2/	47	45	45	46	45	45	**42**	35
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	47	44	42	41	40	39	**34**	25
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	47	58	75	73	71	68	**54**	32
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	47	44	42	41	40	39	**34**	25
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	47	46	44	43	42	41	**35**	25
B5. Combination of B1-B4 using one-half standard deviation shocks	47	46	43	43	41	40	**35**	26
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	47	44	42	41	40	39	**34**	25
Debt service ratio								
Baseline	4	3	3	2	2	2	**1**	2
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2007-26 1/	4	3	3	3	4	4	**6**	10
A2. New public sector loans on less favorable terms in 2007-26 2/	4	3	3	3	3	3	**2**	4
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2007-08	4	3	3	3	2	2	**2**	3
B2. Export value growth at historical average minus one standard deviation in 2007-08 3/	4	3	3	4	4	4	**4**	5
B3. US dollar GDP deflator at historical average minus one standard deviation in 2007-08	4	3	3	3	2	2	**2**	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2007-08 4/	4	3	3	3	2	3	**2**	3
B5. Combination of B1-B4 using one-half standard deviation shocks	4	3	3	3	2	3	**2**	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	4	3	3	3	2	2	**2**	3
Memorandum item:								
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	24	24	24	24	24	24	**24**	24

Source: Staff projections and simulations.

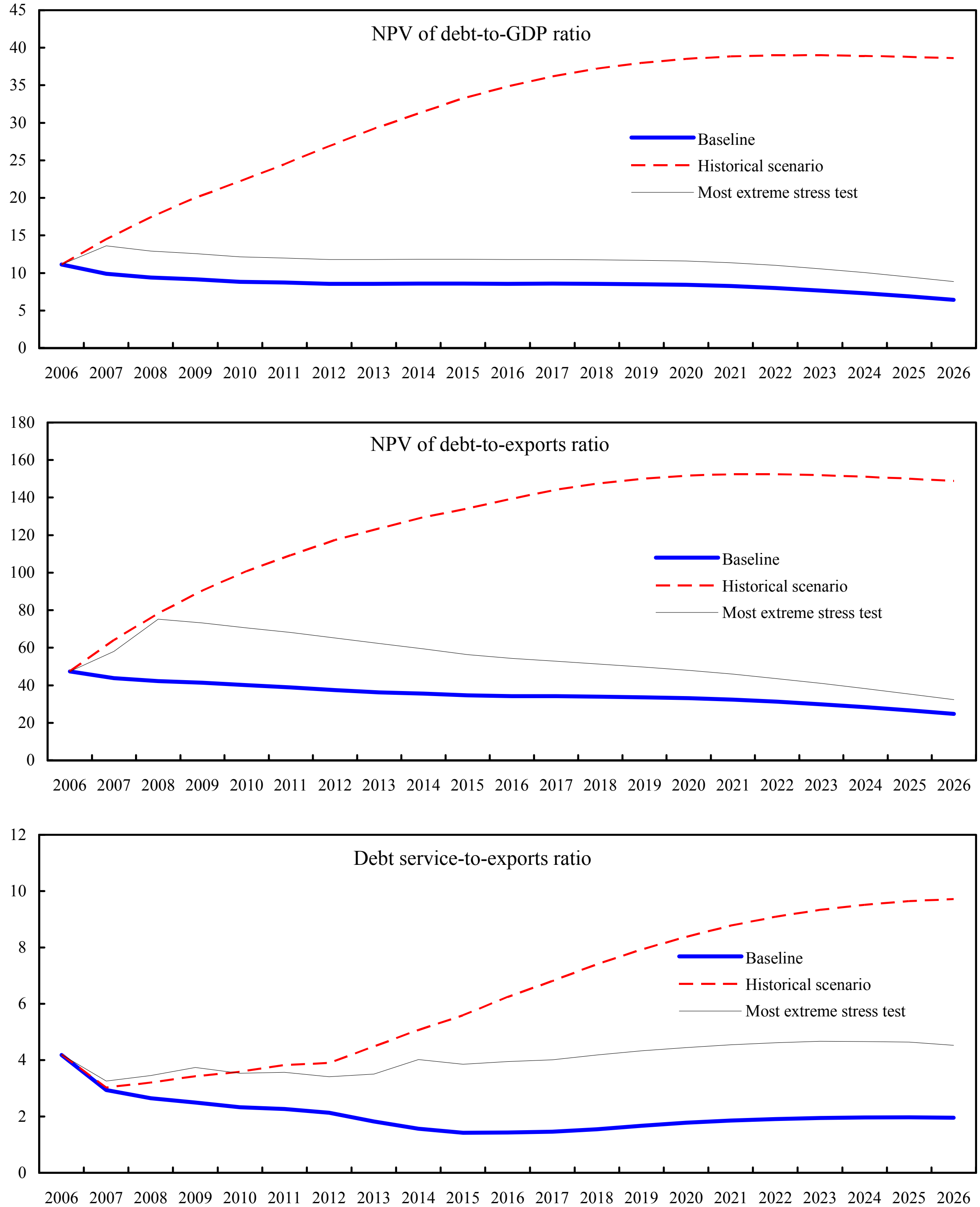
1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods 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 Debt Under Alternative Scenarios, 2006-2026 1/



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

Figure 3. Armenia: Indicators of Public and Publicly Guaranteed External Debt
Under Alternative Scenarios, 2006-2026
(In percent)



Source: Staff projections and simulations.

ATTACHMENT I. LETTER OF INTENT

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

November 1, 2006

Dear Mr. de Rato:

In the attached supplementary Memorandum of Economic and Financial Policies, we summarize progress to date in implementing our PRGF-supported program and set out our economic and financial policies for the period through June 2007. We request hereby the completion of the third review and the fourth disbursement under the PRGF arrangement as well as modification of the end-December quantitative performance criteria.

The PRGF-supported program is on track. The Armenian economy continues to perform very well and all quantitative and structural performance criteria under the PRGF arrangement for end-June 2006 were observed. Despite the impressive progress achieved in recent years, we recognize that a number of significant challenges remain to sustain high economic growth and reduce poverty. To this end, our economic program for the period ahead contains specific measures to address weaknesses in tax administration, enhance fiscal transparency and expenditure efficiency, and strengthen the financial system.

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

Sincerely yours,

/s/
Andranik Margaryan
Prime Minister
Republic of Armenia

/s/

Vartan Khachatryan
Minister of Finance and Economy
Republic of Armenia

/s/

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

ATTACHMENT II. MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

November 1, 2006

1. This memorandum reviews recent developments and sets forth the government's policies through June 2007. These policies constitute an integral part of the government's medium-term poverty reduction strategy, which is expected to be updated by early 2007.

I. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

2. The Armenian economy has continued to perform very well thus far in 2006. Real GDP increased by 11.3 percent in the first eight months of 2006, driven by strong growth in construction and services, as well as by robust inflows of remittances and other foreign exchange inflows, which helped to boost domestic demand. The average inflation rate over the first nine months remained low at 1.5 percent, although the 12-month rate of headline inflation rose to 5.9 percent in September, largely on account of higher food and international oil prices. Exports grew by only 2 percent in the first half of 2006, mostly due to weak international demand for diamonds. During the same period, imports continued to grow robustly, at 20 percent, leading to a widening in the trade deficit. Nevertheless, gross foreign exchange reserves increased by $90 million in the first half of 2006 on the back of strong foreign exchange inflows.

3. The overall **fiscal deficit** for the first half of 2006 was smaller than programmed, largely because of stronger revenue performance. Tax revenue grew by 19 percent during the first 8 months of the year, relative to the same period in 2005. Value-added and profit taxes accounted for the majority of the overperformance. Expenditure execution was lower than expected (by AMD 11 billion), although execution of capital spending improved relative to previous years.

4. Year-on-year **broad money** growth decelerated significantly during the first eight months of 2006, from 28 percent at end-2005 to 15 percent in August. Despite significant CBA foreign exchange intervention between June and mid-August (by a cumulative amount of $62.5 million), year-on-year **reserve money** growth slowed from 52 percent at end-2005 to 19.4 percent in August, on account of slower cash dedollarization, higher government deposits with the Central Bank of Armenia (CBA), and lower bank excess reserves. The CBA raised the repurchase rate five times since November 2005, implying an increase from 3 to 4.75 percent. While credit growth continued to be very strong at around 40 percent, this comes from a very low base, and we do not yet see any risks of a deterioration in credit quality. In accordance with the law, the CBA was recapitalized in April.

5. All **quantitative performance criteria** for end-June 2006 were met. However, the indicative target on the contributions to the State Fund for Social Insurance was missed by a

small margin, despite strong growth in revenues since the transfer of the collection function to the State Tax Service (STS).

6. We have continued to make good progress in the area of **structural reforms**. We submitted to parliament an amendment to the Law on Insurance that eliminates the limitation on the range of services that insurance companies with substantial foreign ownership can provide, which was a structural performance criterion for end-June, and parliament approved the amendment. In addition, we observed all end-June structural benchmarks.

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

- In the area of **tax policy**, parliament approved an amendment to the VAT law that reduces the list of goods exempt from VAT payment at the border, which became effective on July 22, 2006. We have also submitted to parliament an amendment to the law on simplified tax, which narrows access to the simplified tax regime by excluding activities that require state licenses with annual stamp duties of AMD 1 million or more. To increase revenue from the construction sector, we have submitted to parliament a number of amendments to existing legislation, including a provision that any new property development, regardless of type of ownership, will be taxed.[14] Moreover, we have submitted amendments to the profit tax law which specify the taxation of foreign currency assets, reduce deductions, and introduce pooled amortization. Finally, parliament has approved a new law on income and property declaration by natural persons.

- In the area of **tax administration**, we developed a 2006-08 action plan for the STS on information technology (IT) and acquisition. With the help of this action plan, we intend to (i) improve our IT management capacity; (ii) implement risk-based selection criteria in the areas of audits, arrears collection, and VAT refunds; (iii) improve information sharing between the tax inspectorates and headquarters; and (iv) improve cross-checking, by establishing a unified database for social contributions, tax collection, and tax arrears. We have also started to apply universal VAT cross-checks for all transactions above AMD 100,000. The sanctions for tax evasion in the criminal code were strengthened. Finally, we continue to implement our annual audit plan for large enterprises and our action plans for the reduction of tax arrears and reported tax losses.

- Regarding **customs administration**, we have established a dedicated Risk Management Unit in the State Customs Committee (SCC) that regularly reviews and

[14] While we had originally committed to introduce a new presumptive tax on property development (structural benchmark for end-March 2006), we instead amended existing legislation.

updates the examination selectivity criteria. We have also expanded the use of the selectivity module in ASYCUDA (Automated System for Customs Data) to all customs houses and customs points.

- On the **expenditure side**, we have implemented most measures under the financial management and reporting action plan for state noncommercial organizations (NCOs). The main remaining task is to introduce monitoring and supervision of performance indicators. In addition, we have started to apply program budgeting in four pilot ministries, and the future format of the budget is currently being discussed. However, technical and other constraints imply that we will not be able to implement full program budgeting for at least another five years.

8. We are continuing to strengthen the **banking sector** and its regulatory and supervisory framework. The implementation of the amended Law on Banks and Banking, which aims to improve bank corporate governance, has been smooth. Two feedback rounds through July confirmed that banks have been adjusting their charters to comply with the new legislation. We have also implemented guidelines for a consolidated supervision framework for monitoring beneficiary owners beyond the licensing stage, which will help us to determine the appropriate structure of corporate governance and to identify how affiliate companies and related parties affect bank operations. We expect that these guidelines will be formalized into a manual by January 2007.

9. The envisaged **entry of foreign banks** will contribute to the development of the financial sector. In September, Credit-Agricole entered the Armenian market. In addition, it is possible that another foreign bank may buy one of our local banks before the end of the year. Finally, the Nordic Group of Iceland has recently established a credit organization in Armenia and is considering plans to increase its capital and to apply for a full banking license.

10. In order to improve the supervision of **foreign exchange transactions**, we created a new department within the CBA that is responsible for licensing and overseeing foreign exchange offices. The division has been conducting comprehensive audits, as a result of which the licenses of a number of foreign exchange offices were revoked, due to noncompliance with foreign exchange regulations. Further, in close consultation with the IMF, we are in the process of drafting amendments to the AML/CFT Law to reflect the gaps identified in the self-study for MONEYVAL.

11. We are also strengthening the **nonbank financial sector** and its regulatory and supervisory framework. Thus far, the CBA has inspected and closed six out of 23 insurance companies. At our invitation, and as a prerequisite for rating Armenian corporations, Moody’s and Fitch gave Armenia sovereign ratings of Ba2 and BB-, respectively. We have invited companies to be rated and to issue securities, and we have announced that the highly-rated paper they issue may be used in monetary operations.

12. We continue to make progress in other areas of structural reforms. In the **energy sector**, the audit of Armenergo's balance sheet and its subsequent liquidation have now been completed. We leased the Yerevan Water and Sewage Company to a joint stock company created by a foreign operator, with the aim of eliminating budget support. Overall collection rates in the **water and irrigation** sectors have increased. However, transitional problems associated with the expansion of the water metering program, particularly in areas outside of Yerevan, resulted in somewhat higher losses in the first half of 2006.

II. The Program for the Period July 2006–June 2007

13. We remain committed to our growth and poverty-reduction strategy. For the remainder of 2006 and 2007, our macroeconomic policies will focus on price stability and continued tax, customs, and financial sector reforms. Reflecting our strong growth performance thus far this year, we now project real GDP to grow by 11 percent in 2006. Average inflation in 2006 is expected to remain within 3 percent, although end-period inflation for 2006 is now projected to be 5 percent. The economic program for 2007 envisages real GDP growth of 9 percent and end-year inflation of 4 percent. We intend to revise our medium-term macroeconomic framework in the context of the update of our Poverty Reduction Strategy Paper (PRSP).

A. Fiscal Policy

14. The **2006 fiscal deficit** is likely to be smaller than budgeted, largely reflecting higher-than-expected revenues. While we had originally targeted a deficit of AMD 69.9 billion (2.8 percent of GDP), we now target a deficit of AMD 60.2 billion (2.3 percent of GDP). On the revenue side, we will increase the tax revenue target by AMD 13.8 billion to AMD 378.1 billion to reflect performance to date and the higher-than-expected GDP growth. This implies an increase in the ratio of tax revenue to GDP from 14.3 percent in 2005 to 14.7 percent in 2006. Moreover, nontax and capital revenues are expected to be substantially higher than budgeted. On the expenditure side, we intend to also revise upwards the overall expenditure target by AMD 18.9 billion.

15. The **2007 budget**, which has been approved by government, is based on the following key parameters that are consistent with our Medium Term Expenditure Framework (MTEF) for 2007-09. The overall deficit of the central government (including grants) will not exceed AMD 68.3 billion (2.3 percent of GDP). Reflecting the fiscal reforms implemented to date and those specified in paragraphs 21-24, tax revenues are budgeted to increase by 1.0 percent of GDP to AMD 458.9 billion. Current expenditures will total AMD 401.9 billion, allocating the largest increases to defense, energy, and health, with overall social expenditures budgeted to increase from 6.7 percent of GDP in 2006 to 6.8 percent in 2007. At the same time, we will limit expenditure increases where the efficiency of expenditure is a concern. To ensure a balanced mix between current and capital spending, capital expenditures are budgeted at AMD 134.7 billion. To ensure that the deficit target is met, in the event of a shortfall in

revenues, expenditures for the year will be reduced if revenue developments during the first half suggest that the end-year target cannot be met.

B. Monetary and Exchange Rate Policies

16. Monetary policy will continue to focus on maintaining **price stability** and a **flexible exchange rate**, with the aim of moving to a full-fledged **inflation targeting** regime over the medium term. Foreign exchange interventions will be used as an instrument to manage liquidity and smooth out exchange rate volatility, without targeting a specific level or path for the exchange rate.

17. **Inflationary pressures** increased in 2006 due to high international energy and raw material prices, higher prices of agricultural products, strong wage growth, and significant foreign exchange inflows. Under these circumstances, it will be very difficult to reach our end-year inflation target of 3 percent. Accordingly, the CBA proposed to increase the inflation target for 2006 to 5 percent (with a band of ±1.5 percentage points) by amending the State Budget Law for 2006. Consistent with this target, we aim for a reserve money growth target of 25.1 percent. We intend to withdraw liquidity by increasing issuance of CBA securities.

18. We stand ready to further tighten the monetary policy stance if inflationary pressures persist. We expect inflationary pressures to remain in 2007, reflecting continued strong economic growth and foreign exchange inflows, as well as an envisaged increase in telecommunication tariffs. The **monetary program for 2007** targets end-year inflation of 4 percent (with a band of ±1.5 percentage points). To that end, the CBA seeks to limit reserve money growth to 19.9 percent and a possible buildup in foreign reserves. The government intends to increase the stock of treasury bills by AMD 8.5 billion, which will contribute to the development of the domestic government debt market.

19. Progress has been made in meeting the prerequisites for a full-fledged **inflation targeting** regime. With the help of IMF technical assistance, operational changes in liquidity management were implemented in March 2006. This has contributed to the effectiveness of monetary policy, and repo operations are now considered as the principal monetary policy instrument. Commercial banks have improved the management of their correspondent accounts with the CBA, resulting in lower excess liquidity in the banking system. The CBA has started publishing quarterly inflation reports, and is currently in the process of developing a quarterly inflation projection model, to be implemented in the first half of 2007. The CBA looks forward to receiving further IMF technical assistance to help deepen financial intermediation.

C. Structural Reforms

20. We will continue to press ahead with reforms that will improve the collection of tax and customs revenues and strengthen the financial sector.

Fiscal reforms

21. In the area of **tax policy**, we aim to take additional measures to broaden the tax base by reducing privileges and loopholes. In particular, we will:

- submit to parliament a number of tax policy measures by end-2006 under our harmonization agreement with the European Union;[15]

- submit to parliament legislation to change the calculation of the income tax bases from cash to accrual in order to unify the calculation period of income tax and social contributions (structural performance criterion, end-March 2007);

- submit to parliament amendments to all presumptive tax laws with the goal of indexing the presumptive tax rates to the CPI (structural benchmark, end-June 2007);

- complete the general part of the unified tax code in consultation with stakeholders (structural benchmark, end-June 2007), and subsequently submit it to parliament (structural benchmark, end-December 2007).

22. Our medium-term objective is to not introduce any new tax privileges and to reduce the number of exemptions. In particular, we will allow the profit tax exemptions for foreign investors to expire in 2008, and we will remove the exemption for agriculture in 2009 under our agreement with the WTO. We also want to limit the use of the presumptive tax regime, including by moving large-scale operations from the presumptive tax to the regular tax regime. Finally, when the capital market develops further, we will consider taxing dividends paid to resident and non-resident natural persons and legal entities under the income and profits tax laws.

23. In **tax administration**, we will focus on improving tax audits, tax arrears collection, and the VAT refund system. In particular, we will

- strengthen the IT capacity of the State Tax Service (STS) by (i) establishing an electronic risk-based selection system for VAT cross-checks, audits, and refunds, and issuing an STS decree specifying the procedures and a timeline that envisages full technical implementation by end-2007 (structural benchmark, end-December 2006); (ii) introducing a unified computer network linking all inspectorates of the STS (structural benchmark, end-June 2007);

[15] Specifically, we expect parliament to pass amendments to the customs code, the VAT law, the law on excises, and the law on the presumptive tax on tobacco production.

- submit legislation to parliament that will require the recording of taxpayers at the location of their main economic activity (structural performance criterion, end-March 2007);

- issue an STS decree specifying the documentation required from foreign entities in Armenia for all their transactions and for the entitlement to tax holidays;

- further accelerate the processing of VAT refunds.

24. In the area of **customs administration**, we continue to work with the World Bank and other development partners on implementing direct trader input (DTI), upgrading our ASYCUDA software, and introducing an intelligence-based system for risk assessment. To that end, we have extended the use of DTI facilities at the customs house of Araratsian to a group of brokers and privileged importers that have demonstrated high standards of competence and professionalism. Depending on this experience, the extension of DTI to all other import declarations in Araratsian will take place at a future date. We have also completed a thorough testing of the customs staff and have discharged more than [90] employees who failed to satisfy the testing standards. Recruitment and training of new staff are currently under way. In addition, we plan to open a specialized customs house for excisable goods by end-2006 so as to further improve the effectiveness of customs administration.

25. We intend to make further progress on **budget monitoring** and control. We will submit to parliament amendments to the law on state NCOs to clarify their definition and their activities, and to separate the functions of the management bodies (structural benchmark, end-December 2006). We will continue implementation of the NCO financial management and reporting action plan.

Financial sector reforms

26. We will continue to move forward with financial sector reforms. In the **banking sector**, we will submit to parliament an amendment to the law on banking secrecy to allow the CBA to publish violations of and sanctions against commercial banks that do not comply with the Law on Banks and Banking (structural benchmark, end-December 2006). In addition, we are considering several measures to reduce the size of the shadow economy by encouraging non-cash financial transactions in the economy. These measures include the introduction of mandatory point of sale outlets at larger retail establishments and the acceptance of credit card transaction receipts for tax verification purposes.

27. In order to strengthen monetary policy effectiveness, it is important to **encourage dedollarization**. We will, therefore, further strengthen the legislation regarding the regulation and supervision of foreign exchange bureaus, and we will limit their operations to the provision of retail services to households. We will also strengthen the enforcement of prohibitions against foreign cash transactions in the retail sector.

28. We also have several proposals for **nonbank financial sector** reforms:

- We view the development of the insurance sector as vital to financial sector deepening. In this context, we plan to submit to parliament a **new Insurance Law** that will address shortcomings in the existing law, including by being fully compliant with the standards of the International Association of Insurance Supervisors (structural performance criterion, December 2006).

- We plan to submit to parliament a **new Securities Market Regulation** that corresponds to the standards of the International Organization of Securities Commissions (structural benchmark, end-March 2007). The Armenian stock exchange (ARMEX), which is currently a self-regulatory body, will become a joint stock company. We have invited OMX to do a feasibility study and to advise on a development plan with the aim of preparing a business case for a potential strategic investor.. We are in the process of identifying companies that could be potential issuers of securities and candidates for IPOs as catalysts for securities market development.

- With the assistance of the World Bank, we are preparing a **pension framework law** that outlines a comprehensive overhaul of the pension system. The new system would raise the minimum pension, and would require those earning above a certain limit to invest in private funds to maintain their standard of living after retirement. The envisaged increase in contribution rates would necessitate significant capacity increases in asset management and insurance. Record keeping could be outsourced to the Central Depository.

III. Other Issues

29. We have prepared a **draft of the Law on State Debt** intended to regulate the public debt management process and to improve monitoring of external debt contracted by private physical and legal entities. We plan to submit the draft to parliament by [July 2007].

30. In the **energy and water sectors**, we will continue with our efforts to improve efficiency and reduce losses. We also intend to further strengthen the capacity of the water user associations and to move toward cost recovery in the irrigation sector.

IV. Program Monitoring

31. Program monitoring will be based on semi-annual quantitative performance criteria and indicative targets as well as structural performance criteria and benchmarks. The Technical Memorandum of Understanding (TMU) of October 2005 and the attached amendment to the TMU define the quantitative targets of Table 1, the program adjustors, and specific reporting requirements. Completion of the fourth review under the PRGF arrangement, scheduled for May 16, 2007, will require observance of the revised quantitative

performance criteria for end-December 2006, shown in Table 1, as well as the structural performance criteria listed in Table 2. The completion of the fifth review under the PRGF arrangement, scheduled for November 16, 2007, will require observance of the quantitative performance criteria for end-June 2007, shown in Table 1, as well as the March structural performance criteria listed in Table 2.

Table 1. Armenia: Quantitative Targets, June 2006–June 2007 1/
(End of period ceilings on stocks, unless otherwise specified)

	2006						2007	
	Jun.		Sep.		Dec.		Mar.	Jun.
	Prog.	Est. 2/	Prog.	Proj. 3/	Prog.	Proj. 2/	Prog. 3/	Prog. 2/
Net domestic assets of the CBA 4/	-29.8	-54.2	-27.3	-32.0	-15.4	-19.8	-38.2	-51.9
Net banking system credit to the government	-1.2	-20.7	7.1	-14.2	21.2	-3.9	-17.8	-28.1
Domestic arrears of the central government	0	0	0	0	0	0	0	0
Tax revenues of the central government (floor) 5/	162.1	166.6	259.1	267.6	364.3	378.1	90.2	201.1
Balance of the central government on a cash basis (floor) 5/	-31.9	-6.5	-48.5	-32.6	-69.9	-60.2	-5.2	-25.6
Reserve money (band/level) 3/	(199-207)	199.1	(216-225)	(224-233)	(234-244)	(246-256)	(237-246)	(248-258)
Contributions to the State Fund for Social Insurance 3/ 5/	34.0	33.6	52.4	52.4	74.0	74.0	17.1	37.7
Contracting or guaranteeing of new nonconcessional external debt 5/ 6/	0	0	0	0	0	0	0	0
External arrears (continuous criterion)	0	0	0	0	0	0	0	0
Net official international reserves (floor)	492.0	510.4	527.2	543.9	542.1	577.2	606.0	666.3

1/ All items as defined in the Technical Memorandum of Understanding.
2/ Performance criterion.
3/ Indicative target.
4/ At program exchange rate of 450 dram per U.S. dollar for 2006 and 2007.
5/ Cumulative flow from the beginning of the calendar year.
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. Armenia: Structural Measures for the Fourth and Fifth Reviews under the PRGF

Measure	Proposed Time-frame (End of Period)	Type of Conditionality
Tax policy		
Finalize the general part of the unified tax code:		
(i) Complete the general part of the unified tax code in consultation with stakeholders.	June 2007	Structural Benchmark
(ii) Submit to parliament.	December 2007	Structural Benchmark
Submit to parliament legislation to change the calculation of the income tax bases from cash to accrual so as to unify the calculation period of income tax and social contributions.	March 2007	Structural Performance Criterion
Submit to parliament amendments to all presumptive tax laws to index the rates to the CPI.	June 2007	Structural Benchmark
Tax administration		
Strengthen the IT capacity of the State Tax Service (STS):		
(i) Establish an electronic risk-based selection system for VAT cross-checks, audits, and refunds. Issue an STS decree specifying the procedures and a timeline that envisages full technical implementation by the end of 2007.	December 2006	Structural Benchmark
(ii) Introduce a unified computer network linking all inspectorates of the STS.	June 2007	Structural Benchmark
Submit legislation to parliament to require the recording of taxpayers at the location of their main economic activity.	March 2007	Structural Performance Criterion
Public financial management		
Submit to parliament amendments to the law on state non commercial enterprises to streamline their definition and their activities and define the functions of the management bodies.	December 2006	Structural Benchmark
Financial Sector		
Submit to parliament an amendment to the Law on Banking Secrecy which would allow the CBA to publish violations of and sanctions against commercial banks that do not comply with the Law on Banks and Banking	December 2006	Structural Benchmark
Submit to parliament a new Insurance Law that corresponds to the standards of the International Association of Insurance Supervisors.	December 2006	Structural Performance Criterion
Submit to parliament a new Securities Market Regulation Law that corresponds to the standards of the International Organization of Securities Commissions	March 2007	Structural Benchmark

ATTACHMENT III. AMENDMENTS TO THE TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

The TMU dated October 26, 2005 and its amendments dated April 27, 2006 will remain valid for the remainder of 2006 and 2007, with the revised baseline assumptions for (program) exchange rates of the CBA, foreign-financed project loan disbursements, World Bank lending, and KfW loan disbursements as indicated in Tables 1 to 4 below, and the following amendment to apply from October 1, 2006.

1. In Section II an adjuster is added on the total volume of **grants**: the following targets will be adjusted by the full amount of lower-than-programmed grant disbursements: NIR (downward), NDA of the CBA (upward), and net credit to government (upward). The targets will be adjusted by the full amount in the reverse direction should grant disbursements be higher than programmed. The programmed amounts are shown in Table 5 below.

Table 1. Armenia: (Program) Exchange Rates of the CBA
(As of December 30, 2005 for dollars per currency rates. Drams per currency rates are calculated using the 450 drams per U.S. dollar rate)

Country	Drams Per Currency	Dollars Per Currency
Australian dollar	328.05	0.729003
Canadian dollar	386.63	0.859171
Swiss franc	341.53	0.758946
Danish krone	71.87	0.159710
Euro	532.13	1.182501
Pound sterling	773.10	1.718008
Japanese yen	3.82	0.008483
Norwegian krone	66.78	0.148404
Russian ruble	15.63	0.034741
Swedish krone	56.39	0.125303
U.S. dollar	450.00	1.000000
SDR	643.17	1.429266
Gold 1/	7483.03	16.628956

1/ Per gram.

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

2007			
March	June	September	December
12.6	25.3	37.9	50.6

1/ Cumulative from December 2006, at program exchange rates.
2/ Excludes World Bank PRSC lending and KfW loan disbursements.

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

2007			
March	June	September	December
9.0	9.0	9.0	9.0

1/ Cumulative from December 2006, at program exchange rates.

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

2007			
March	June	September	December
3.4	3.4	3.4	3.4

1/ Cumulative from December 2006, at program exchange rates.

Table 5. Armenia: Total Grant Disbursements
(In billions of drams)

2006 1/			
		September	December
		12.1	31.2
2007 2/			
March	June	September	December
1.1	2.5	4.3	5.7

1/ Cumulative from September 2006, at program exchange rates.
2/ Cumulative from December 2006, at program exchange rates.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/138
FOR IMMEDIATE RELEASE
December 7, 2006

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

IMF Concludes 2006 Article IV Consultation with the Republic of Armenia

On November 22, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Armenia.[1]

Background

Armenia's economy has performed very strongly during the last five years. Average real GDP growth exceeded 12 percent during 2001–2005, while inflation averaged 3 percent. Real per capita income in U.S. dollars has tripled since 2000, and notable progress has been made in poverty reduction and structural reforms.

The strong performance of the economy continued in 2006. In the first nine months of 2006 real GDP growth was 11 percent. The 12-month rate of inflation rose to 6.1 percent, largely on account of higher food and energy prices. Average inflation in 2006 is expected to remain within 3 percent, although end-period inflation is now projected to be 5 percent. The dram has appreciated by 15 percent against the dollar in the first nine months of 2006 on account of robust foreign exchange inflows.

Fiscal policy has remained sound. Tax revenues through September 2006 increased by 19 percent over the same period last year. The fiscal deficit in 2006 is projected at 2.3 percent of GDP,

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[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. This PIN summarizes the views of the Executive Board as expressed during the November 22, 2006 Executive Board discussion based on the staff report.

significantly lower than the budgeted amount of 2.8 percent of GDP, mainly due to higher-than-expected tax revenues and lower expenditure execution, although execution of capital spending improved relative to previous years.

Regarding monetary policy, broad money and private sector credit grew by 27 percent and 44 percent in the twelve months through September, respectively. Dollarization of bank deposits decreased from about 70 to 55 percent during the same period. The central bank raised the repurchase rate five times since November 2005, by a cumulative 175 basis points to 4.75 percent.

After improving in the previous two years, the external current account is projected to worsen to 4.9 percent in 2006, owing to declining diamond exports and booming imports. Nevertheless, the overall balance of payments is expected to improve, supported by buoyant capital inflows, and gross international reserves increased by $104 million through end-September. Armenia's external debt position is sustainable, and external debt ratios are projected to decline further in 2006.

Progress continues to be made in the areas of fiscal and financial sector reforms. In particular, parliament recently approved an amendment to the value-added tax (VAT) law that significantly reduces the list of goods exempt from VAT payment at the border, and an amendment to the insurance law that provides a level playing field for domestic and foreign companies. Reforms to foster financial intermediation and strengthen prudential oversight are progressing, and the authorities are encouraging the entry of reputable international banks in the Armenian market.

Executive Board Assessment

Directors commended the authorities for their prudent monetary and fiscal policies which, together with ongoing structural reforms, have contributed to Armenia's double-digit growth since 2002, low inflation, and reduced unemployment and poverty. They welcomed the Armenian authorities' strong ownership of reforms and their successful implementation of the Poverty Reduction and Growth Facility-supported program. In the context of continuing strong growth prospects, the main challenges going forward will be to manage the macroeconomic impact of continued large capital inflows, and to boost tax revenue to finance expenditure increases in infrastructure and social services.

Directors welcomed the Central Bank of Armenia's commitment to price stability and its cautious monetary policy stance. They noted the authorities' intention to revise upward the end-year inflation targets for 2006 and 2007, but cautioned that frequent revisions should be avoided. Directors underscored the importance of proper communication of inflation objectives to the public so as to maintain the credibility of monetary policy in the transition to a full-fledged inflation targeting regime over the medium term. They also underlined the importance of more effective policy coordination between the monetary and fiscal authorities, particularly in the area of domestic debt issuance, in order to ensure low inflation and a competitive exchange rate in the context of continued fiscal prudence.

Directors supported the authorities' maintenance of a flexible exchange rate regime, which has contributed to price stability. They welcomed the central bank's policy of limiting foreign exchange market intervention to preventing undue volatility in the exchange rate, rather than targeting a particular level or rate. In this context, Directors cautioned that resisting nominal appreciation pressures could come at the expense of higher inflation, thereby possibly hurting the poor and harming growth. They agreed that there is no clear evidence that the dram is currently overvalued, and emphasized that competitiveness concerns are best addressed through forceful policies to raise productivity, including by improving the business climate and spurring competition, which could also support export diversification.

Directors welcomed the fiscal tightening in 2006, and viewed the 2007 budget as compatible with macroeconomic stability. They underscored the importance of meeting the 2007 tax revenue target to maintain a prudent fiscal stance, while raising expenditures on infrastructure and social services in line with the authorities' poverty reduction strategy. Directors underscored that progress in the area of tax administration would also help to reduce the large size of the informal sector. On the expenditure side, Directors believed that improving the capacity to efficiently absorb higher social spending should be a priority. They encouraged the authorities to put in place a credible strategy to phase out the gas subsidy by end-2008 to ensure full cost-recovery and reduce medium-term fiscal risks. Noncommercial organizations should be closely monitored, as they account for a significant part of public spending.

Directors considered that fiscal reforms remain key to sustaining growth and reducing poverty. They commended the authorities for the reforms implemented in recent years, which have contributed to the notable improvement in the tax-to-GDP ratio. Nevertheless, the ratio remains low by regional standards. In this context, Directors recommended allowing tax holidays for foreign investors to expire, expanding taxation in the construction sector, and improving the tax authorities' ability to check transactions and audit taxpayers. They also saw scope to increase expenditure efficiency by strengthening internal audit and monitoring of service delivery.

Directors welcomed efforts to promote financial sector development. They observed that reforms to foster financial intermediation and further strengthen financial sector regulation will improve bank corporate governance, encourage competition between banks, and reduce the high lending-deposit spreads, while also contributing to financial deepening and reducing dollarization. They also considered that increased participation of reputable international first-tier banks would help in this regard.

Republic of Armenia: Selected Economic Indicators, 2001–2006

	2002	2003	2004	2005	2006 (proj.)
Real Sector					
Real GDP growth (percentage change)	13.2	14.0	10.5	14.0	11.0
GDP (in millions of U.S. dollars)	2,373	2,807	3,580	4,911	6,114
GDP per capita (in U.S. dollars)	739	874	1,114	1,528	1,892
Inflation (in percent)					
Period average	1.1	4.7	7.0	0.6	2.8
End-of-period	2.0	8.6	2.0	-0.2	5.0
Central government operations (in percent of GDP)					
Revenue and grants	18.8	17.8	15.4	15.7	17.4
Expenditure	19.3	18.9	17.1	18.3	19.7
Overall balance (commitment basis)	-0.4	-1.1	-1.7	-2.6	-2.3
Monetary indicators					
Reserve money (end-of-period growth rate, in percent)	38.4	6.6	11.4	51.9	25.1
Broad money (end-of-period growth rate, in percent)	34.0	10.4	22.3	27.8	27.0
Broad money velocity	6.4	6.9	6.7	6.1	5.6
External Sector					
Current account balance (including transfers)					
In millions of U.S. dollars	-148	-191	-162	-193	-301
In percent of GDP	-6.2	-6.8	-4.5	-3.9	-4.9
External debt					
In millions of U.S. dollars	1,026	1,098	1,183	1,099	1,159
In percent of exports of goods and services	131	60	59	60	47
Gross official international reserves					
In millions of U.S. dollars	430	502	547	667	790
In months of imports of goods and services	3.7	4.0	3.3	3.5	3.6

Sources: Armenian authorities and IMF staff estimates.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Third Review Under PRGF Arrangement for Armenia and Approves US$4.9 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the third review of the Republic of Armenia's economic performance under the Poverty Reduction and Growth Facility (PRGF) arrangement.

The completion of the review enables Armenia to draw an amount equivalent to SDR 3.28 million (about US$4.9 million), which will bring total disbursements under the arrangement to the equivalent of SDR 13.12 million (about US$19.5 million).

The Executive Board approved the three-year arrangement on May 25, 2005 (see Press Release No. 05/123) for a total amount equivalent to SDR 23 million (about US$34.3 million) to support the government's economic program through 2008.

Following the Executive Board discussion, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, said:

"Armenia's economy continues to perform well under its PRGF-supported program. Prudent fiscal and monetary policies, large external inflows, and ongoing structural reforms have contributed to double-digit growth in a low inflation environment and to a sustained reduction in poverty and unemployment. There has been impressive progress in the areas of fiscal and financial sector reforms, including through improved tax administration, strengthened prudential regulations and oversight of the financial sector, and improved corporate governance of banks. Looking ahead, the focus of the authorities' policy will be to manage the macroeconomic impact of continued large capital inflows, and to boost tax revenue to finance expenditure increases in infrastructure and social services.

"The authorities' economic program for the remainder of 2006 and 2007 focuses on limiting inflationary pressures, maintaining a flexible exchange rate arrangement, and improving tax revenue performance. The draft 2007 budget is compatible with macroeconomic stability and envisages a significant increase in tax revenues, which will be needed to finance priority expenditures in infrastructure and social services.

"Continued fiscal and financial sector reforms remain key to sustaining growth and reducing poverty. In the fiscal area, the authorities' reform efforts will focus on broadening the tax base by reducing exemptions and loopholes and on improving the predictability and efficiency of tax administration. In the financial sector, reforms in the period ahead will focus on improving corporate governance, strengthening regulation and supervision, and deepening financial intermediation, including through the development of the nonbank financial sector," Mr. Kato said.

Statement by Jeroen Kremers, Executive Director for Republic of Armenia
and Lucian Croitoru, Senior Advisor to Executive Director
November 22, 2006

General

The Armenian authorities agree with the assessment of the staff report, which accurately describes economic developments and the program implementation so far. The authorities acknowledge that the report provides a realistic view of the policy challenges, and broadly agree with staff recommendations. They also think that the program conditionality is appropriate and are pleased that the program is on track, with all performance criteria for end-June 2006 met.

Macroeconomic developments are sound. Prudent macroeconomic policies, strong external inflows, and ongoing structural reforms supported GDP growth to 12.5 percent in the first nine months of 2006. Growth was driven by the nontradables sector, particularly the construction sector, which grew by 37 percent in real terms, compensating the decline in industrial real output and a zero increase in the real agricultural output. Expecting continued buoyant activity in the construction and services sectors, and recovery in industry, staff now foresees real GDP growth at 11 percent in 2006 and 9 percent next year. Growth above 10 percent since 2001 allowed the headline poverty rate to decline by 21.5 percentage points between 1999 and 2004, reaching 34.6 percent in 2004, and to substantially reduce extreme poverty. The effect of strong domestic demand, including from the rapid growth of incomes, on the current account deficit is expected to be limited, so that the current account is projected just below 5 percent of GDP in 2006. Twelve-month CPI inflation increased to almost 6 percent in September on account of higher energy and food prices but is expected to be 5 percent in December. Given increased inflationary pressures from both demand and supply, and to partly compensate for its extensive unsterilized foreign exchange intervention in the face of significant dram appreciation[1], the Central Bank of Armenia (CBA) has raised the repurchase rate three times, from 4 percent in July to 4.75 percent in October. In March it also implemented operational changes in liquidity management by adopting the repo rate as operational target and an interest rate corridor using standard facilities. Credit to the private sector is still low by regional standards, but has grown rapidly in the recent past. Fiscal performance remained sound in the first half of the year, with the deficit significantly smaller than programmed, largely on account of strong revenue performance and lower current expenditure.

Progress has been made in various areas of structural reform. Actions to strengthen the tax and custom administration have been taken, including by developing a 2006-08 action plan for the State Tax Service (STS) on information technology and acquisition, and by establishing a dedicated Risk Management Unit in the State Custom Committee. In the energy sector, Armenergo’s balance sheet audit and its subsequent

[1] Since end-2003 the dram has appreciated by 31.4 percent in nominal terms through September 2006 and 22 percent in real effective terms through July 2006.

liquidation have been completed. Overall collection rates in the water and irrigation sectors have increased, and the Yerevan Water and Sewage Company has been leased to a joint stock company created by a foreign operator. In the banking sector, preliminary steps have been made to strengthen corporate governance by implementing guidelines for a consolidated supervision framework for monitoring beneficiary owners beyond the licensing stage. A new department within the Central Bank of Armenia has been created to improve supervision of foreign exchange transactions.

Looking forward, the authorities remain committed to implementation of the Fund-supported program. To sustain growth and further reduce poverty, and also to help temper the negative effects of rapid real appreciation, the authorities will focus their economic policy mix on macroeconomic stability, structural reforms, and investment in infrastructure. With respect to structural reforms, the authorities acknowledge that although progress has been made in strengthening tax and custom administration, further improvements in this area and broadening the tax base remain the centerpiece of the fiscal reform program. They also see the need for increased competition in the banking sector and will concentrate on improving corporate governance, strengthening regulatory and supervisory framework, and deepening financial intermediation, including by fostering the development of the non-bank financial sector.

Fiscal policy

The authorities acknowledge that the main challenge for fiscal policy is to meet additional infrastructure needs and other PRSP priorities, while maintaining a fiscal stance consistent with low inflation and persistent capital inflows. Given the present relatively low tax-to-GDP ratio, and in view of a foreseeable decline in donor support over time, the authorities' strategy to deal with the challenge is to increase revenue performance, improve expenditure efficiency, and spend more in priority areas. This strategy is reflected in the budgetary framework for 2007-09 by slightly higher deficits as compared with the last years. However, the overall deficit (including grants) is expected to remain well below 3 percent.

The prospects to increase revenue are promising. Reflecting the results of past fiscal reforms and also the higher-than-expected GDP growth, the tax-to GDP ratio is estimated to increase by 0.4 percentage points this year. Additional measures to broaden the tax base by reducing privileges and loopholes, and also further improvements in tax and custom administration will allow tax revenue to increase by 1.0 percentage points of GDP in 2007.

To help tame inflationary pressures and alleviate real exchange rate pressures, the authorities intend to use part of revenue overperformance to reduce the overall fiscal deficit this year by 0.5 percent of GDP to 2.3 percent of GDP. At the same time, they will revise upwards the overall expenditure target. A similar policy, with a balanced mix between current and capital spending increases, will be implemented in 2007, when the deficit will be contained roughly to the same level as a percent of GDP. However, in case of revenue shortfalls, expenditure for the year will be reduced if revenue developments during the first semester suggest that the 2007 deficit target otherwise cannot be met.

Monetary policy

The CBA remains committed to maintaining price stability. The authorities acknowledge that the CBA's limited potential to sterilize interventions in the foreign exchange market added to inflationary pressures from both the demand and supply side, and makes almost certain that the original end-year inflation target will be missed this year. To avoid overly tightening the policy stance, which could trigger additional appreciation pressures and jeopardize financial stability, the CBA has chosen to revise up the year-end inflation target from 3 percent to 5 percent. However, the CBA stays ready to further increase the policy interest rate should the new inflation target come under pressure or if needed to secure reaching next year's inflation target of 4 percent. In addition, the MOF and the CBA will intensify their efforts to further develop the money market, which is crucial to further strengthen monetary policy transmission. In 2007 the government intends to increase the stock of treasury bills by AMD 8.5 billon to further develop the domestic government debt market. The central bank also remains committed to a flexible exchange rate regime, limiting its interventions in the foreign exchange market to reducing short-term volatility in the exchange rate, without targeting a specific level or path.

Preparations to adopt an inflation targeting monetary policy framework over the medium term continue. In addition to improving its new operational framework, the CBA has started publishing quarterly inflation reports and the minutes of board meetings. The central bank is developing a quarterly inflation projection model to be implemented in the first half of 2007. In pursuing their effort to deepen financial intermediation, the authorities look forward to receiving further technical assistance from the Fund.

Structural reforms

On the fiscal front reforms will be aimed at improving both the tax policy and strengthening the tax administration, the latter accounting for the main part of the lackluster revenue performance. With respect to tax policy, the focus will be to broaden the tax base by reducing privileges and loopholes. In the short term this will be done mainly by indexing the presumptive tax rates to the CPI and by changing the calculation of the income tax basis from cash to accrual. In the medium term, a unified tax code will be submitted to parliament by the end of 2007, the profit tax exemption for foreign investors will be allowed to expire (in 2008), and exemptions for agriculture will be removed (in 2009). The use of presumptive tax will be limited, including by bringing large-tax payers in agriculture into the regular tax regime, and taxing dividends will be considered in correlation with further development of the capital market. Regarding the tax administration, the authorities acknowledge the need for a comprehensive modernization program. They will focus on improving tax audit, tax arrears collection, and the VAT refund system. To this end, a major improvement in tax administration will come from the establishment of an electronic risk-based selection system for VAT cross checks, audits, and refunds, and of a unified computer network linking all inspectorates of STS in 2007. Further progress will be made in the area of budget monitoring and control by amending the law on noncommercial organizations (NCOs) to clarify their definition and activities, and to separate the functions of the management bodies, with a view to limiting the possibilities for converting public enterprises into NCOs.

In the financial sector, the authorities' reform efforts will continue to focus on further strengthening the market infrastructure and the regulatory and legal framework. After smoothly implementing the Law on Banks and Banking in 2006, the authorities will submit amendments to the Law on Bank Secrecy to further improve bank transparency and accountability. To reduce the size of the hidden economy, some measures are under consideration to encourage non-cash transactions, including the acceptance of credit card transaction receipts for tax verification purposes. Moreover, to increase monetary policy effectiveness, the authorities will encourage dedollarization of the economy. To this end, they will strengthen regulation and supervision of foreign exchange bureaus, limit their operations to the provision of retail services to households, and strengthen the enforcement of prohibition against foreign cash transactions in the retail sector.

Reform efforts will also focus on development of the non-bank financial sector and the pension system. Concerning the latter, a pension framework law that outlines a comprehensive overhaulof the pension system is currently under preparation. The new system would increase the minimum pension, and would require those earning above a certain limit to invest in private funds to secure their living standards after retirement. A new Insurance Law, fully compliant with the standards of the International Association of Insurance Supervisors, thus addressing shortcomings in the existing law, will be submitted to parliament by the end of 2006. Before end-March 2007 the CBA also plans to submit to parliament a new Security Market Regulations that corresponds to the standards of the International Organization of Securities Commissions. The authorities have invited OMX to advise on a plan to develop the Armenian capital market, including by transforming the Armenian stock exchange into a joint stock company.