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Republic of Armenia: 2002 Article IV Consultation, First and Second Reviews Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria—Staff Report; Staff Statement; and Public Information Notice and News Brief on the Executive Board Discussion

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 2002 Article IV consultation with the Republic of Armenia and first and second reviews under the Poverty Reduction and Growth Facility and request for waiver of performance criteria, the following documents have been released and are included in this package:

- the staff report for the combined 2002 Article IV consultation and first and second reviews under the Poverty Reduction and Growth Facility, and request for waiver of performance criteria, prepared by a staff team of the IMF, following discussions that ended on **July 18, 2002**, 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 September 12, 2002**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **September 25, 2002** updating the information on recent developments.
- a Public Information Notice (PIN) and News Brief **summarizing the views of the Executive Board as expressed during its September 25, 2002 discussion** of the staff report that completed the review.

The document(s) listed below have been or will be separately released.

Statistical Annex/Appendix
PRSP Preparation Status Report
Joint Staff Assessment of the PRSP Preparation Status Report

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 2002 Article IV Consultation, First and Second Reviews Under the Poverty Reduction and Growth Facility, and Request for Waiver of Performance Criteria

Prepared by European II and Policy Development and Review Departments
(In consultation with other departments)

Approved by Paulo Neuhaus and Martin Fetherston

September 12, 2002

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Acronyms

AMD	Armenian dram
ASYCUDA	Automated System for Customs Data
CBA	Central Bank of Armenia
EBRD	European Bank for Reconstruction and Development
EDCs	Electricity Distribution Companies
ESAF	Enhanced Structural Adjustment Financing
EU2	European II Department
FAD	Fiscal Affairs Department
FSAP	Financial Sector Assessment Program
FTZ	Free-Trade Zone
GDDS	General Data Dissemination System
IMF	International Monetary Fund
I-PRSP	Interim PRSP
LTU	Large Taxpayers Unit
MAE	Monetary and Exchange Affairs Department
MEFP	Memorandum of Economic and Financial Policies
MFE	Ministry of Finance and Economy
MSR	Ministry of State Revenue
MTEF	Medium-Term Expenditure Framework
PDR	Policy and Development Review Department
PER	Public Expenditure Review
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
PSIA	Poverty and Social Impact Analysis
SAC	Structural Adjustment Credit
SDDS	Special Data Dissemination Standard
SDR	Special Drawing Right
TMU	Technical Memorandum of Understanding
VAT	Value-Added Tax

Executive Summary

In recent years, Armenia has experienced rapid growth with low inflation. Since 1999, real GDP has grown at an average annual rate of 8 percent, inflation has remained below 4 percent, the current account deficit has narrowed, and external-debt ratios have improved. The authorities have also maintained liberal trade and foreign exchange policies, and there has been a reduction in poverty.

The PRGF supported program approved in 2001 focuses on revenue mobilization, the clearance of government arrears, and a decline in the deficit of the energy sector. It aims at setting the conditions for fiscal and external-debt sustainability and higher poverty-reducing expenditures in the years ahead.

Performance during the first year of the program was mixed. Tax collection was sluggish and delays with structural reforms in the energy, water, and irrigation sectors led to the nonobservance of several quantitative performance criteria under the program. The implementation of fiscal and banking system measures was satisfactory, although some measures were implemented with delays. During the first half of 2002, the authorities carried out a number of reforms, leading to higher tax revenue collection, a reduction in domestic arrears, and improvements in the performance and prospects for the energy sector.

In the attached letter of intent and memorandum of economic and financial policies, the authorities describe their program for the period July 2002–June 2003, and request the completion of the first and second reviews under the PRGF arrangement. The objectives of the program are to maintain a growth rate of real GDP of at least 6 percent and to keep inflation at 3 percent or less. Tax revenues are projected to increase as a share of GDP, the fiscal deficit on a commitment basis is expected to decline to 2–2.5 percent of GDP, and budgetary arrears should be cleared. The program contemplates increases in social expenditures and public investment in line with the forthcoming medium-term expenditure framework and the PRSP. Monetary policy will continue to be guided by a reserve money corridor and a flexible exchange-rate policy will be maintained.

The structural component of the program focuses on improving tax and customs administration, promoting transparency and good governance, resolving the situation of eight intervened banks, and promoting confidence in the banking system. The authorities are expected to finalize a financial rehabilitation plan for the energy, water, and irrigation sectors, and to focus on privatization, selecting competent operators and bringing tariff rates in line with cost-recovery levels.

Despite a number of risks, the objectives of the program are attainable. The authorities need to fight tax evasion and corruption, proceed quickly and transparently with the resolution of the problem banks and with reforms in the energy sector, and improve the functioning of the legal system. The authorities are also encouraged to foster full ownership of the PRSP process and finalize a high-quality poverty alleviation strategy by end-2002.

I. Introduction

1. Discussions for the 2002 Article IV consultation and the first and second reviews under the Poverty Reduction and Growth Facility (PRGF) were completed in Yerevan during July 3–18, 2002, following three rounds of discussions on the reviews in July 2001, October 2001, and February 2002.[1] The missions met with President Kocharian; the Minister of Finance and Economy, Mr. Khachatryan; the Chairman of the Central Bank, Mr. Sargsyan; the Minister of State Revenue, Mr. Zakharyan; the Minister of Energy, Mr. Movsesian; the Chairman of the Customs Committee, Mr. Avetisyan; other senior officials; representatives of the donor community; and private sector representatives.

2. At the conclusion of the 2001 Article IV consultation on May 21, 2001, Directors commended the authorities for their success in maintaining macroeconomic stability but stressed the need to adopt stronger revenue-enhancing measures, eliminate budgetary arrears, and protect social expenditures. Noting remaining weaknesses in the banking system, they encouraged the authorities to further strengthen prudential regulations. Lastly, Directors urged the authorities to move ahead with the privatization of the energy distribution companies (EDCs), and emphasized the importance of financial rehabilitation of state-owned companies in the energy, water, and irrigation sectors.

3. A three-year PRGF arrangement in the amount of SDR 69 million (75 percent of quota) was approved on May 23, 2001.[2] SDR 10 million was disbursed at the time of approval, with another SDR 20 million to be disbursed upon completion of the combined first and second reviews (Table 1). Given Armenia's low tax-revenue ratios, its history of high fiscal deficits, inadequate social spending, and high level of domestic arrears, the PRGF-supported program focuses on revenue mobilization and the clearance of arrears, with a view to laying the foundation for sustainable economic growth. It also seeks to curtail chronically high deficits in the energy, water, and irrigation sectors, which have been a drain on the government budget. A disappointing revenue collection and a weak performance of the energy sector in 2001 led to substantial deviations from the program targets, prompting frequent exchanges with the authorities on measures required to bring the program back on track and delays in completing discussions on the reviews under the program. In the end, understandings were reached on corrective measures undertaken during the first half of 2002 and on an economic program for the period July 2002-June 2003.

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[1] The missions in 2001 and early 2002 were led by Mr. Wolf, and the July 2002 mission was led by Mr. Gelbard (both EU2). Staff participating in these missions were Mr. Shiells, Ms. Westin, Mr. Kumah, Mr. Zytek, and Ms. Abajyan (all EU2); Mr. Nielsen and Ms. Khandelwal (PDR); and Mr. Baldini (FAD). Mr. Iradian, the Fund's Resident Representative, assisted the missions. The July 2002 mission overlapped with an MAE mission on banking sector issues and monetary and foreign-exchange market operations led by Mr. Olafsson. The principal authors of this report are Mr. Gelbard, Ms. Westin, and Mr. Kumah, with inputs from Mr. Iradian, Mr. Baldini, Ms. Khandelwal, and Ms. Abajyan.

[2] EBS/01/61, 4/30/01; and Cor. 1, 5/18/01.

4. In a letter to the Managing Director dated September 11, 2002 (Attachment I), and in the accompanying Memorandum of Economic and Financial Policies (MEFP) (Attachments II and III), the government of Armenia describes the implementation of its economic program through end-December 2001 and requests waivers for the nonobservance of performance criteria at end-June and end-December 2001. The MEFP also presents the second annual program extending until June 2003. Armenia's adjustment efforts continue to be supported by the World Bank Group and international donors. Armenia's relations with the Fund, the World Bank Group, and the European Bank for Reconstruction and Development (EBRD) are summarized in Appendices I and II.

II. Background and Key Challenges

5. The Armenian economy has experienced a rapid transformation since the mid-1990s. Following a massive output contraction in the early 1990s and high inflation up until 1997, successful stabilization and structural reforms have led to a sustained recovery in output, price stability, and, more recently, improvements in poverty indicators. During the last five years, the authorities have carried out a number of financial system reforms, modernized the tax and customs regimes, undertaken a large privatization program, rationalized public sector employment, and reformed the legal system. Despite these achievements, poverty remains pervasive, the fiscal deficit remained above 4 percent of GDP until 2001, tax and expenditure arrears have accumulated, and a number of commercial banks began to experience problems in 2000. The investment climate has also been hampered by governance problems and red tape and by the lack of trade relations with Turkey and Azerbaijan.

6. Against this background, the main challenges facing Armenia are to increase fiscal revenue, eliminate domestic expenditure arrears, reorient public spending toward the social sectors, restructure the banking system, reduce corruption, improve the efficiency of the judicial system, and reform the energy, water, and irrigation sectors. Progress in these areas will be a precondition for sustainable growth and poverty reduction.

III. Recent Developments and Performance Under the Program

7. The **political situation** has stabilized since the assassination of the prime minister, the speaker of parliament, and six members of parliament in October 1999. President Kocharian enjoys a stable parliamentary majority and is the leading candidate in the upcoming presidential election scheduled for February 2003. Parliamentary elections will be held by June 2003. Political and economic relations with Russia are strengthening, but the lack of a permanent solution for the Nagorno-Karabakh region continues to weigh on Armenia's relations with Azerbaijan and Turkey.

8. The **growth and inflation** objectives of the program for 2001 were achieved, and economic performance in 2002 has been reassuring so far (Table 2). Real GDP grew by 9.6 percent in 2001 and by 9.7 percent year-on-year in the first seven months of 2002. Recent growth has been driven by advances in agricultural production, diamond cutting, food processing, construction, and increased tourism related to the 1,700-year anniversary of the adoption of Christianity as the state religion (Box 1). The 12-month rate of inflation was 3 percent in December 2001 and 1.2 percent in July 2002.

Armenia: Main Economic Indicators, 1999–2002

	1999	2000	2001 Prog.	2001 Act.	2002 Jan–Jun
	(Annual percent change, unless otherwise indicated)				
Real GDP growth 1/	3.3	6.0	6.5	9.6	10.1
Inflation (end of period)	2.1	0.4	3.5	3.0	3.7
Broad money growth (end of period)	13.6	25.8	12.0	15.0	0.7
Government balance (commitment, in percent of GDP)	-7.2	-6.4	-4.0	-3.9	-2.0
Current account balance (in percent of GDP)	-16.6	-14.6	-14.1	-9.5	-7.1
External debt service-to-exports ratio (in percent)	14.3	10.6	15.0	9.7	7.1
Gross international reserves in months of imports	3.8	3.8	3.7	3.7	3.5

Sources: Armenian authorities, and staff estimates.
1/ For the first half of 2002, the year-on-year growth rate is displayed.

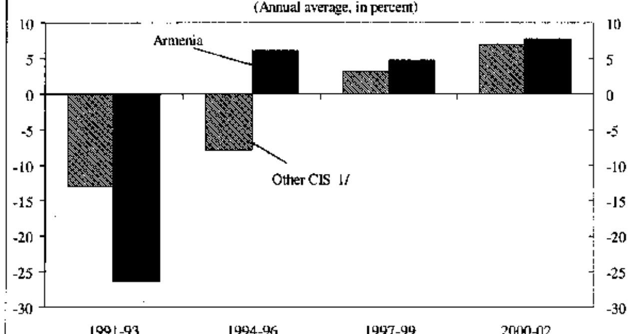
Box 1. Perspectives on the Growth Process

After a decline in real GDP of about 60 percent in 1991–93, a steady recovery began in 1994. Real GDP grew at an average of 6 percent per year during 1994–2001, a rate consistently higher than in most other CIS countries. Growth has been resilient despite several shocks, namely the 1998 Russian financial crisis, the 1999 political assassinations, the mass exodus of skilled youth, and the continued economic blockade by Turkey and Azerbaijan, two of Armenia's four neighboring countries. Notwithstanding this high growth, output in 2001 was about 25 percent below its 1991 level.

After the break-up of the Soviet Union, the composition of output shifted from heavy industry to agricultural production in the mid-1990s, and to light manufacturing in the second half of the 1990s. During the last five years, the most dynamic sectors have been food processing, non-metallic minerals, jewelry, and construction. Exports and donor-financed investment have been driving growth in recent years, with exports increasing from 12 percent of GDP in 1998 to 17 percent in 2001.

Real GDP Growth in Armenia and Other CIS Countries

(Annual average, in percent)



1/ Azerbaijan, Belarus, Georgia, Moldova, Kazakhstan, Kyrgyz Republic, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

This positive growth performance can be attributed to the natural catching up process after the collapse in output in the early 1990s and to radical economic reforms carried out since 1995. These reforms, implemented with the support of the Fund and the World Bank, led to significant capital inflows, improvements in competitiveness, and a continued process of market-driven import substitution.

While medium-term growth prospects for the country remain favorable, the forecasts need to be tempered by a number of risks and potential barriers, such as a high concentration of exports of processed diamonds, a low level of financial intermediation, limited managerial skills, and the inconsistent application of laws and bankruptcy procedures.

9. **Program implementation in 2001 was mixed.** Current non-interest expenditures were rationalized in 2001, allowing for savings of 1.2 percent of GDP. The fiscal deficit on a commitment basis narrowed to 3.9 percent from 6.4 percent of GDP in 2000. However, tax revenues fell short of expectations, reflecting insufficient improvements in tax administration.[3] The stock of domestic budgetary arrears also exceeded the program ceilings, mainly because of delays in World Bank financing which were, in turn, partly related to the failure to privatize the electricity distribution companies (EDCs). Pension fund arrears were significantly reduced in 2001, although not completely eliminated as envisaged under the program. Overall, nine quantitative and one structural performance criteria were not observed in 2001, mainly reflecting a disappointing tax revenue collection and poor performance of the energy sector.[4]

Armenia: Selected Fiscal and Quasi-Fiscal Indicators, 1999–2002

	1999	2000	2001 Prog.	2001 Actual	2002 Prog.
	(In percent of GDP, unless otherwise indicated)				
Central government					
Total revenue and grants	19.3	16.5	17.2	17.1	19.5
of which: tax revenue	16.1	14.7	15.1	14.4	15.0
Total expenditure and net lending	26.5	22.8	21.2	21.0	21.5
of which: current expenditure	19.2	17.5	16.3	15.8	15.0
Overall balance (commitment basis)	-7.2	-6.4	-4.0	-3.9	-2.1
Net accumulation of arrears (minus = net repayment)	2.0	1.2	-1.5	-0.1	-1.6
Overall balance (cash basis)	-5.5	-4.6	-5.5	-4.0	-3.3
Financing	5.5	4.6	5.5	4.0	3.3
Domestic	0.8	2.5	1.2	1.3	0.1
External	4.7	2.2	4.3	2.7	3.2
Energy, water, and irrigation sectors					
Technical and other losses (in percent of electricity transmitted)	15.0	15.0	9.6	15.0	14.3
Collection rate (in percent of domestic billings)	88.0	89.0	91.2	81.0	91.0
Energy sector primary balance	-0.8	-1.3	0.0	-2.5	-0.5
Water and irrigation primary balance	0.0	-1.3	-1.2	-1.1	-0.8

Sources: Armenian authorities; staff estimates and projections.

10. Delays with **structural reforms in the energy and other quasi-fiscal sectors**[5] continued to be a major constraint on their financial performance. A second attempt to privatize the EDCs—a condition under the World Bank's fourth structural adjustment credit (SAC IV) floating tranche—failed in that year because of the poor financial situation of these companies and the deterioration in the global investment climate following the terrorist attacks in the United States. The four EDCs were subsequently merged into one company in early 2002 and tender offers for a management contract or privatization of the merged company were launched. The primary deficit of the energy sector widened to

[3] This lack of improvement in tax and customs administration is partly related to the "administrative uncertainty" caused by a break-up of the Ministry of State Revenue (MSR) and customs into two separate organizations in July 2001. This break-up was implemented against FAD's advice.

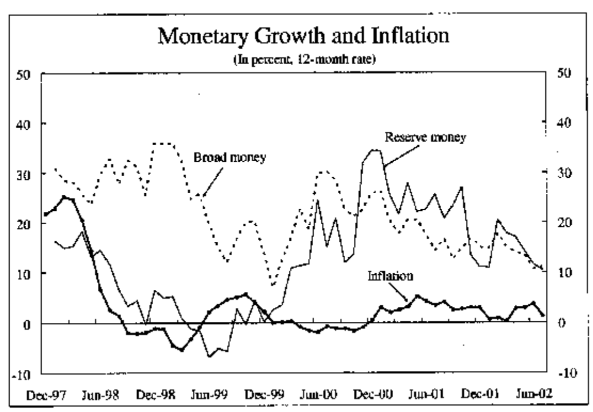
[4] The following performance criteria were not observed in 2001: (a) the end-June 2001 quantitative performance criteria on the stock of government arrears and on the primary deficit of the energy sector; (b) the end-June 2001 structural performance criterion on the adoption of the law on financial disclosure by senior public officials; (c) the end-December 2001 quantitative performance criteria on the net domestic assets of the central bank, tax revenues, the stock of government arrears, the stock of arrears of the State Fund for Social Insurance, the primary deficit of the energy sector, and the stock of external arrears; and (d) the end-December 2001 continuous performance criterion on non-accumulation of new external arrears.

[5] Comprising the water and irrigation sectors and the state-owned chemical company Nairit.

2.5 percent of GDP in 2001 (compared to equilibrium under the program) amid lower collection rates and low tariffs, while the combined primary deficit of the energy and other quasi-fiscal sectors increased from 2.6 percent of GDP in 2000 to 3.6 percent in 2001. Preliminary data indicate a rapid improvement in the primary balance of the energy sector in the first half of 2002, the result of new efficiency measures, a frontloading of subsidies to irrigation and water companies, and heavy rains which allowed for increased hydroelectric generation. In February 2002, an agreement was signed with a private manager for the state-owned chemical company Nairit, a notorious nonpayer of taxes and electricity supply.

11. Missions in July and October 2001 were unable to complete discussions on the first review because of insufficient reductions in budgetary arrears and lack of understanding on measures to improve revenue performance in 2002. Corrective measures began to be implemented in 2002. The authorities included a number of important tax and customs policy and administration measures in the 2002 budget, and a mission in February 2002 reached understandings on a program for 2002 including a set of prior actions and quantitative targets. However, the emergence of non-programmed expenditures and revenue concerns in March 2002 raised doubts about the ability to meet the tax revenue and budgetary arrears targets, leading to a further delay in the completion of the discussions on the reviews.[6] While a cause of concern, these overruns do not appear to have compromised the annual budgetary targets, as the authorities utilized budgeted amounts from the reserve fund. Past experience also points to a good track record of adhering to annual budgeted appropriations despite sporadic overruns during the first three quarters of the year. By mid-2002, tax revenues were in line with projections,[7] energy sector performance showed signs of improvement, and the authorities had implemented key measures in the areas of tax and customs administration and governance (Table 3 and Attachment II, Table 2) on the basis of which they are requesting waivers for the nonobservance of the performance criteria in 2001 (Tables 4 and 5).

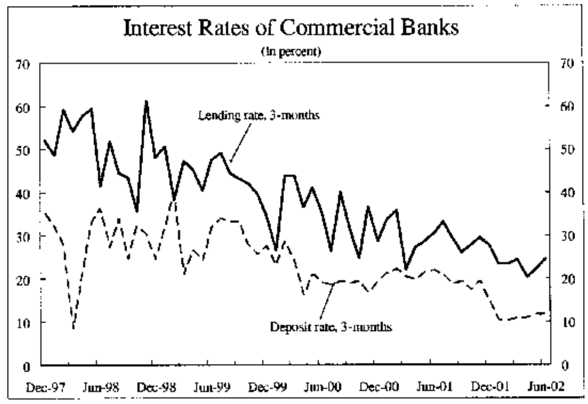
12. **Monetary policy** over the past 18 months has continued to focus on maintaining price stability. The central bank of Armenia (CBA) sought to keep reserve money within a target corridor and, more recently, it began monitoring inflation developments closely in order to fine-tune monetary policy and counteract unanticipated shifts in the demand for money. Concerns about deflationary pressures stemming in part from an unexpected decline in the price level between June and September 2001 prompted



[6] The expenditure overruns were related to an acceleration of subsidies to the water and irrigation sectors, increased net lending to the energy sector, and unexpected defense outlays. The overrun is also explained by lack of accuracy in the quarterly projections from the state budget.

[7] Tax revenues rose by 17 percent and 19.5 percent year-on-year during the first six and eight months of this year, respectively.

the central bank to ease monetary policy in the last quarter of that year. This, together with a larger-than-programmed profit transfer to the government to settle an unanticipated foreign debt payment, led to the nonobservance of the end-December net domestic assets target. Monetary policy was somewhat tightened in the second quarter of 2002 to dampen incipient price pressures as the 12-month rate of inflation rose to 3.7 percent in June. Net international reserves of the CBA exceeded the program floor at end-December 2001, and gross international reserves continued to exceed 3.5 months of imports of goods and services. Bank lending and deposit rates have declined in recent years, but they remain high in real terms mainly because of significant credit default risks.



13. The 2000 **Financial Sector Assessment Program (FSAP)** concluded that the financial sector could be vulnerable to potential internal and external shocks, but that a systemic crisis was unlikely and would have only a limited effect on the economy given the small size of the banking system. The report identified the need for further consolidation of the system and changes in provisioning and supervision procedures. Most of these recommendations have been implemented to date. There was a decline in nonperforming loans during the last three years mainly as a result of loan write offs and more cautious lending policies by commercial banks. Nevertheless, a number of commercial banks continued to struggle with low-quality loan portfolios, weak profitability, and worsening indicators of capital adequacy, liquidity, and solvency (Appendix IV). Between November 2000 and December 2001, the central bank liquidated two banks and placed seven others under interim administration. Most of these problems occurred as a result of insider abuse. In early 2002, the CBA merged two commercial banks, placed the merged bank under interim administration (bringing the number of intervened banks to eight), and extended a US$5.5 million credit line in its

Armenia: Indicators of Banking System Soundness, 1998–2002
(End-of-period ratios, in percent)

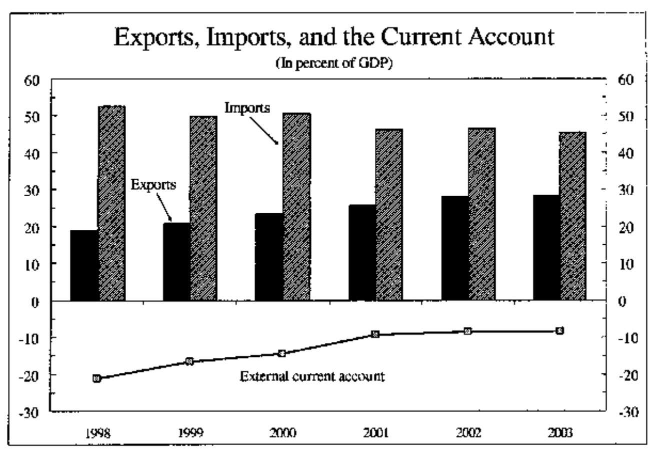
	1998	1999	2000	2001	June 2002 1/
Ratio of capital to risk-weighted assets	29.8	27.8	25.0	13.6	27.3
Non-performing loans to total loans	23.3	19.9	20.5	16.7	11.8
Return on assets (profits/average assets)	2.0	2.8	-0.9	-10.3	-1.2
Liquid assets to total short-term liabilities	83.3	100.1	86.1	80.4	105.5

Source: Central Bank of Armenia.
1/ These figures reflect the exclusion of seven banks currently in interim administration.

support. The eight banks under temporary administration account for 18 percent of the banking system's assets.[8] The central bank is taking steps to reinforce its supervision, and has created a bank resolution department to deal with problem banks. The staffs of the Fund and the Bank have been monitoring developments in this area and have concluded that while the current situation does not pose an imminent systemic threat (all but one of the intervened banks are currently non-operational), more frequent on-site inspections will be required to monitor performance and to adopt appropriate measures against banks that fail to comply with prudential requirements.

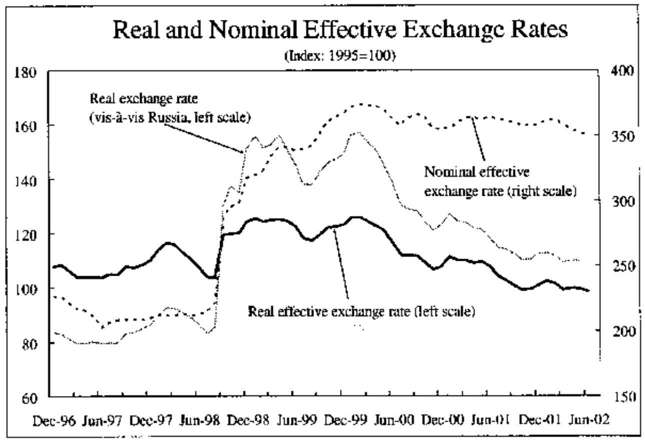
14. **The authorities have made progress in implementing fiscal and financial sector reforms during the last year.** All measures scheduled for implementation in 2001 were carried out, although in a few cases with delays (Table 5). The key measures implemented include passing a financial disclosure law for senior public officials and a treasury law, setting up an automated audit system for the value-added tax (VAT), and introducing legislation aimed at strengthening the CBA's ability to deal with problem banks. In addition, the authorities approved a new civil service law, established an internal audit unit at customs, and set up a government committee to work on an anti-corruption strategy in cooperation with donors. Further reforms in the areas of tax and customs administration and governance have been implemented since January 2002 (Table 3). These include a reduction in the number of goods exempted from VAT at the border effective January 1, 2003, the introduction of penalty rates for over-reporting of losses for profit tax purposes, the establishment of a large taxpayers unit (LTU), and amendments to the law on inspections to ease restrictions on audits of individual taxpayers and accelerate enforcement of penalties against fraudulent taxpayers.

15. The **external current account deficit** remains wide but, since 1998, it has narrowed significantly based on strong export growth, an upswing in tourism receipts, and subdued import demand. Both the trade balance and the current account have improved further in the first half of 2002, with merchandise exports growing by 40 percent. While emigration has deprived the country of a well-educated portion of the population, remittances have become a major source of income amounting to about 4 percent of GDP a year. Supported by the continued low-inflation environment, the dram has been stable in nominal effective terms in recent years. However, a real appreciation of the Russian ruble between December 1999 and June 2002 was matched by a 19 percent real depreciation of the dram during the same period. This real depreciation



[8] Their continued status under temporary intervention is motivated by the desire of the CBA to maximize the recovery of nonperforming assets.

combined with high productivity growth in the tradable sector and relatively low real wages have been the driving forces behind recent improvements in competitiveness and the observed narrowing of the current account deficit.[9]



16. **External debt** indicators have been gradually improving since 1999 (Table 2). At end-2001, Armenia's stock of external public debt amounted to US$587 million in net present value (NPV) terms (129 percent of exports of goods and services), of which US$17 million was in arrears to Russia and Turkmenistan. The authorities have been renegotiating Armenia's public debt to Russia and Turkmenistan, which amounts to 18 percent of the country's external debt in net present value terms. Pending final agreement, debt service was interrupted between September 2001 and August 2002. A 10-year program on economic cooperation with Russia was signed in 2001, and an agreement was subsequently reached on a debt-equity swap whereby all of Armenia's public debt to Russia (about US$100 million) will be exchanged for Russian stakes in Armenian state-owned enterprises by early 2003. The debt service savings in 2003 as a result of this agreement will amount to 0.5 percent of GDP. The authorities have also been negotiating a rescheduling agreement with Turkmenistan under which they will commit to pay the outstanding stock of debt by end-2003. Prior to the Executive Board meeting, it is expected that the authorities will have effectively regularized their external arrears to these creditors through cash payments and/or deferrals.

IV. Policy Discussions

17. Discussions for the 2002 Article IV consultation and the first and second reviews under the PRGF arrangement focused on policies required to bring the program back on track and address the key challenges facing the country. The authorities agreed that sound fiscal policies and an acceleration of reforms were essential for these purposes. The discussions covered (i) macroeconomic prospects and policies for the second annual program (July 2002–June 2003) and the medium term; (ii) fiscal and monetary policies and banking system reforms; (iii) the balance of payments and external debt outlook; (iv) reforms in the energy, water, and irrigation sectors; and (v) measures to increase transparency and strengthen governance.

[9] Armenian wages remain relatively low compared with other CIS-7 countries, though they have been increasing rapidly in recent years because of productivity growth.

A. Macroeconomic Objectives and Policies for 2002–03 and the Medium Term

18. The medium-term strategy envisaged in the interim poverty reduction strategy paper (I-PRSP) and aimed at maintaining high economic growth and reducing poverty remains unchanged. The PRSP is expected to be finalized by end-2002. The program for 2002–03 is centered on continued prudent macroeconomic policies and selected reforms in the areas of tax and customs administration, banking system, transparency, and governance. Within the context of the PRGF arrangement, the authorities are committed to increasing fiscal revenue, prioritizing expenditures, and improving governance. Reforms in the energy, water, and irrigation sectors are included under World Bank conditionality.

19. While the recent quick pace of economic activity bodes well for the future, the authorities recognize several uncertainties and have carefully formulated their growth assumptions. Real GDP growth is projected at 7.5 percent in 2002 and 6 percent in 2003–07, and inflation is targeted at no more than 3 percent a year. Growth will be driven by the development of technology-intensive and mineral and food-processing activities, aided by external grants channeled to investment and reconstruction. Fiscal policy will continue to be directed at increasing tax revenue in order to keep the budget deficit under control while increasing poverty-reducing expenditures and eliminating domestic payment arrears. The current account deficit is expected to narrow further toward 6 percent of GDP over the next five years, and gross international reserves are projected to remain at about 3.7 months of imports.

Armenia: Main Economic Indicators, 2001–07
(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004–07 (Average)
Real GDP growth (percent change)	9.6	7.5	6.0	6.0
Gross national income per capita (in U.S. dollars)	723	763	814	970
Inflation (annual percent change)	3.0	3.0	3.0	3.0
Investment	19.2	21.4	23.2	20.6
Public investment	5.3	6.5	6.8	5.2
Private investment	14.0	14.9	16.4	15.4
National savings	9.8	12.7	14.5	13.8
Government revenue and grants	17.1	19.5	19.8	18.5
of which: tax revenue	14.4	15.0	15.5	16.5
Government expenditure	21.0	21.5	22.2	21.0
of which: current expenditures 1/	15.8	15.0	15.5	15.8
Overall government balance (commitment basis)	-3.9	-2.1	-2.5	-2.5
External current account balance	-9.5	-8.7	-8.7	-6.8
NPV of debt-to-exports ratio	128.6	123.4	96.2	94.1
Debt service-to-exports ratio	9.7	10.5	13.3	6.7
Gross international reserves (in months of imports)	3.7	3.8	3.8	3.7

Sources: Armenian authorities; and Fund staff estimates and projections.
1/ Defined as current expenditure on health, education, and transfers to local authorities.

B. Fiscal Policy

20. **The fiscal deficit on a commitment basis is projected to decline further to 2.1 percent of GDP in 2002 and to increase slightly to 2.5 percent of GDP in 2003**, on the basis of continued efforts to mobilize revenue and prioritize expenditures (Table 6). The deficit on a cash basis is somewhat higher than the one on a commitment basis because of payments to settle domestic expenditure arrears. Tax revenues are projected to increase by about 0.5 percent of GDP a year. Current spending as a share of GDP will continue to fall in 2002 because of lower interest costs, further rationalization of employment, and better targeting of social allowances.[10] Contingent on clearing budgetary arrears related to existing commitments first, the room created by increased revenues in 2003 will allow for an increase in current expenditures and public sector wages in real terms. The authorities are also committed to increase social expenditures by about 0.3 percent of GDP in 2003, in line with the priorities identified in the Public Expenditure Review (PER) and the interim PRSP. Public investment is expected to increase by 1.6 percent of GDP in 2002 and by an additional 1.5 percent of GDP in 2003; much of the increase is being financed by grants from the American-based Lincy foundation.[11]

Armenia: Functional Classification of Government Expenditures, 1997–2007
(In percent of GDP, unless otherwise indicated)

	1997–2001	2002 Prog.	2003 Proj.	2004–07 Avg.
General public services	2.0	1.7	2.1	2.3
Defence and public order	5.0	4.2	4.6	4.5
Health, education, and social security	5.5	5.4	5.7	6.4
Housing and public utilities (incl. energy)	1.6	2.8	2.9	2.2
Transportation, mining, construction	1.1	2.2	2.6	1.4
Interest on public debt	1.9	1.1	0.9	0.7
Other services	3.9	4.1	2.9	3.4
Unclassified and arrears	1.7	0.1	0.6	0.0
Total expenditure and net lending	22.5	21.5	22.2	21.0

Sources: Armenian authorities; and staff estimates.

21. **The authorities agreed that increasing revenues is essential to meet expenditure needs and facilitate the clearing of expenditure arrears.** The tax and customs measures implemented during the first half of 2002 have set the stage for increased collections in the years ahead. The staff noted, however, that additional training of tax inspectors would help strengthen tax enforcement. It also underscored that tax liabilities should be strictly based on objective and transparent criteria rather than negotiated in an ad-hoc fashion, thereby preventing discriminatory treatment across taxpayers. Understandings were reached on a package of additional measures to be implemented during the program period aimed at enhancing transparency in tax and customs collection, reducing the room for discretion, and increasing revenue. These measures range from setting up fully operational audit units at the

[10] Social expenditures (health, education, and social security) are projected to fall from 5.9 percent of GDP in 2001 to 5.4 percent in 2002 as a result of improved targeting of those expenditures designed in consultation with the World Bank.

[11] Capital expenditures financed by Lincy foundation grants were not included in the 2002 budget. The staff proposed, and the authorities agreed, to reflect these grants in the fiscal accounts for 2001–02. They will also be included in the 2003 budget.

Ministry of State Revenue (MSR) and customs, to establishing a computerized customs valuation database (Box 2).

Box 2. Tax and Customs Administration Measures, September 2002–June 2003

- Review the law on the simplified tax with a view to eliminate remaining loopholes.
- Establish fully operational audit unit at the MSR and prepare quarterly audit reports at the MSR and at customs.
- Improve administration of VAT refunds by simplifying procedures, reducing processing time, and preparing reports on amounts of VAT due.
- Adopt codes of conduct for MSR and customs officials.
- Establish a computerized database on import valuation.
- Establish websites at the MFE, the MSR, and customs, displaying fiscal execution figures, tax and customs laws and regulations, and guidelines for staff.
- Reduce the bi-annual individual duty-free exemption from US$500 to US$300 and introduce mobile passport reading machines to enforce the limits on duty-free exemptions.
- Initiate a review of customs code regulations with a view to making their interpretation and implementation transparent.
- Introduce a system for random checking of goods at customs and improved management reporting.
- Introduce a post-clearance verification program at customs' headquarters.
- Expand the customs' consultative committee to include business representatives and external advisors.

22. **A free-trade zone (FTZ)** will be established at the Yerevan airport, exempting exporters operating in the zone from profit taxes. Since existing business may seek to move to the zone, the staff cautioned against a potential erosion of the tax base and suggested less distortionary tax incentives, such as investment allowances. The authorities were, however, confident that the FTZ would mainly attract new businesses that would have otherwise not come to Armenia, and that the zone would be sealed to prevent leakages. Understandings were reached to review the revenue implications (and, if necessary, the incentive scheme) of this initiative one year after the FTZ has begun its operations.

23. **Further reforms are also expected in the areas of expenditure control and budget management.** Building on the recent approval of the new treasury law and of procedures to improve public procurement, further measures envisaged in the program include implementing commitment control procedures, improving the budget reporting system, establishing an internal audit unit at the Ministry of Finance and Economy (MFE), and setting up a system to account for external grants to the government. The PER and the forthcoming medium-term expenditure framework (MTEF)[12], both developed in collaboration with the World Bank, will lay the ground for an improved composition and prioritization of public spending, particularly toward social programs.

[12] The MTEF is expected to be finalized in the fall of 2002.

C. Monetary Policy and Financial Sector Issues

24. **The monetary program for 2002–03 seeks to preserve price stability.** It assumes an increase in the demand for broad money of about 14 percent and 13 percent in 2002 and 2003 respectively (Table 7). Reserve money is programmed to grow by 10 percent a year, with the money multiplier increasing slightly alongside increasing confidence in the banking system. Because of the usual uncertainties surrounding the demand for money and the transmission mechanism, the central bank will, in addition to tracking intermediate monetary targets, continue monitoring inflation developments closely.

25. The staff noted that **weakness in the legal system** hampers the collection of collateral by banks and the enforcement of bankruptcy procedures. This, in turn, keeps credit risks and real lending rates high. The authorities acknowledged this problem, and stated their commitment to review the legislation on collection of collateral and on bankruptcy and seek to ensure the efficient functioning of the legal system.

26. **The staff urged the authorities to take decisive steps to resolve the situation of the eight problem banks under interim administration**, possibly through liquidation, and to ensure a rapid and orderly reduction in the number of banks in the system. While seven of the intervened banks are non-operating and do not pose a systemic risk, the staff noted that the situation of the largest one needed to be resolved promptly as this bank was reportedly insolvent but still operational. The staff also noted that a prolonged resolution process by the CBA for these banks may increase uncertainty and reduce confidence in the banking system. The authorities argued, however, that in light of the inefficiencies of the legal system, the central bank needed more time to maximize asset recovery and compensate depositors. Understandings were subsequently reached to revoke the licenses and hand over to the courts the five smallest banks under interim administration by February 2003, to prepare guidelines on temporary intervention and resolution of problem banks by February 2003, to conduct least-cost diagnostic analyses and formulate resolution strategies for the remaining three banks by April 2003, and to resolve the situation of the largest bank under interim administration by end-June 2003.

27. **The authorities agreed on the need to strengthen banking supervision and fully enforce prudential regulations.** To facilitate the restructuring of banks, the authorities will increase minimum capital requirements for existing banks from US$1.65 million to US$2 million in mid-2003, and to US$5 million (the same level as for new banks) in mid-2005. The authorities also plan to introduce a deposit insurance scheme by mid-2005, and premiums will start to be collected next year. MAE has endorsed the scheme, which will exclude the banks under interim administration. The central bank is developing a credit registry to facilitate the screening of borrowers, and there is a need for commercial banks to adopt this system as soon as possible.

28. The authorities have recently completed the Fund's Anti-Money Laundering/Combating the Financing of Terrorism questionnaire, which identified the need for changes in the legal and institutional frameworks. The authorities have recently adopted a resolution on anti-money laundering and established a committee to continue working on the issue. They are also evaluating the need for technical assistance. Lastly, legislation has been passed on non-bank

financial institutions, and the CBA is preparing the regulatory framework for their operations and supervision. In this context, the staff recommended that the functions of non-bank financial institutions be clearly defined to ensure that they do not become de-facto banks subject to less strict supervision.

D. External Sector and Capacity to Repay the Fund

29. **The balance of payments, although still vulnerable, should continue to improve during the program period.** The current account deficit is projected to narrow further in 2002 and remain unchanged in 2003 mainly as a result of continued growth in exports of minerals, processed diamonds, agricultural products, textiles and information technology. Capital transfers will be bolstered by grants from the Lincy foundation, and gross international reserves are expected to increase slightly to 3.8 months of imports in 2002–03 (Table 8). The remaining financing gap would be financed by IMF disbursements under the PRGF arrangement and structural adjustment loans from the World Bank.

30. **The authorities intend to maintain a flexible exchange-rate policy** and limit foreign-exchange market intervention to smoothing out short-term exchange rate fluctuations. Armenia accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement in 1997, and its exchange system is free of restrictions on payments and transfers for current international transactions.

31. **Armenia maintains a liberal trade regime** with about one third of imports subject to a single tariff rate of 10 percent and the remaining goods imported duty free. The country has a rating of one (most liberal) on the IMF trade restrictiveness index. There are no taxes on exports or quantitative restrictions. Substantial progress has been made on Armenia's accession to the World Trade Organization, and the authorities have indicated their intention to join the organization by end-2002. To that end, they have recently drafted legislation on procedures for valuation of imports at customs, tax exemptions in agriculture, and excise taxes. Tax exemptions to agriculture will be replaced by subsidies over a six-year period. The legislation is expected to be approved within the next few weeks. There have been no changes in Armenia's trade or exchange regimes since the last Article IV consultation.

32. **The outlook for external debt remains favorable.** By end-2002, the NPV of debt-to-exports ratio is expected to improve to 123 percent. The successful conclusion of the debt-to-equity swap with Russia would allow this ratio to decline further to 96 percent in 2003. Over the medium term, debt service payments are expected to decline from their current level of about 11 percent of exports of goods and services to about 6 percent (Table 9). Armenia has an excellent record of meeting its scheduled payments to the Fund, and the targeted buildup of foreign reserves provides ample room for future payments (Table 10).

E. Other Structural Reforms

33. In addition to the fiscal and banking sector reforms mentioned above, other reforms that impact macroeconomic performance and economic growth include reforms of sectors

controlled by parastatals, civil service reform; and measures to strengthen governance and the rule of law.

34. **Expanding the role of the private sector remains crucial to increase economic efficiency and alleviate fiscal pressures.** While most of the privatization agenda was completed during the first years of transition, a number of enterprises remain under state control. A rather ambitious privatization program for 2001–03 slated 954 mostly small and medium-sized enterprises for privatization, of which 140 have so far been privatized. The authorities are revising legislation that will expedite the liquidation of companies that cannot be privatized. They are committed to resolve the situation of the remaining companies through privatization or liquidation, though the timetable will need to be adjusted in consultation with World Bank staff.

35. Measures are being taken to improve efficiency in the energy sector, including technical improvements and better financial management. Since early 2002, staffing has been reduced by almost one quarter, the remuneration of remaining employees has been linked to performance, and the interruption of service to nonpaying customers has been better enforced. Losses stemming from technical factors and delinquency are expected to decline from a total of 26 percent in 2001 to 24 percent in 2003 and the overall collection rate is expected to increase from 81 percent to 94 percent during the same period. These improvements will eliminate the primary deficit of the energy sector by 2003. The authorities are currently in the process of privatizing the electricity distribution company. As the new owner is not directly involved in the energy sector, the authorities are discussing with the World Bank, in the context of SAC IV and SAC V, a transfer of management to a qualified operator.

Armenia: Selected Indicators for the Energy, Water and Irrigation Sectors, 2001–03

	2001	2002 Prog.	2003 Proj.
	(In percent of GDP, unless otherwise indicated)		
Primary balances	-3.6	-1.2	-0.4
Energy	-2.5	-0.5	0.0
Irrigation	-0.5	-0.4	-0.2
Water and Sewage Companies	-0.6	-0.4	-0.1
Electricity transmission and distribution			
Technical losses (in percent of electricity transmitted) 1/	15.0	14.3	14.2
Excess losses (in percent of electricity transmitted) 2/	11.0	10.4	9.7
Collection rate (in percent of domestic billings)	81.0	91.0	94

Sources: Armenian authorities; and Fund staff estimates.
1/ Total losses are the difference between electricity generated and end-use consumption. Technical losses are the result of leakages related to equipment defficiencies.
2/ Total losses minus technical losses. These losses are presumably related to theft.

36. The authorities are working on a financial rehabilitation plan for the energy, water, and irrigation sectors, a plan that will ensure a further reduction of losses and the elimination of payment and tax arrears. Tariff increases, technological improvements, and enhanced metering are expected to lead to a decline in water and irrigation subsidies. Beginning in 2003, subsidies to these parastatals will be included in detail in the central government budget. The new private manager of the Nairit chemical company has committed to a repayment schedule of the outstanding debts and arrears and Nairit is now expected to stay current on its energy bills or face a cutoff of service.

37. **Civil service reform is well under way.** Public sector employment was halved between 1995 and 2000. A council of experts from outside the government has been drafting supporting legislation for the civil service law passed in 2001, aimed at establishing a

merit-based system. Next year, work on a public employment strategy will be undertaken in collaboration with the World Bank.

38. **The authorities are addressing governance and transparency concerns.** Following the adoption of the financial disclosure law last year, they began publishing the incomes of government officials. In addition, an internal audit unit was established at the customs committee, and it will soon be established at the MSR and the MFE. By mid-2003, the internal audit units at customs and MSR will begin preparing reports to be shared with key government units and the staffs of the Fund and the World Bank. Later this year, the MSR and customs will adopt codes of conduct for their staff. To enhance transparency of the budgetary process, a quarterly budget bulletin is being published. Lastly, the government's anti-corruption strategy group has prepared an interim report including a time-bound action plan which will be discussed with key stakeholders. Suggested measures include streamlining legislation, enhancing the business climate, downsizing government entities and, in some cases, replacing them with regulatory bodies.

F. Poverty Alleviation and Social Impact of Reforms

39. **The full PRSP is expected to be finalized by end-2002.** Following the completion of the I-PRSP in early 2001, a consultative group meeting was held in July 2001, during which delegations commended the authorities for their progress in defining a poverty reduction strategy. They suggested that given the need for an improved database, work on the full PRSP could extend beyond the originally envisaged deadline of December 2001. With the support of the staffs of the World Bank and the Fund, the authorities decided to wait for the outcome of the 2001 nationwide census. The government has elaborated a PRSP preparation status report that outlines the steps to be taken to finalize the PRSP. As highlighted in the accompanying Joint Staff Assessment, important issues remain to be addressed for a good quality PRSP. During the discussions, the staff emphasized the need for the government to assume full ownership of the strategy and embrace it as the fundamental economic and social development plan for the country. The staff also urged the authorities to ensure a viable and well-targeted increase in social and infrastructure spending as a share of GDP in the context of the MTEF.

40. **The staff considers that the social impact of policies under the PRGF-supported program is positive.** Low inflation and rapid economic growth have provided a solid and powerful mechanism for reducing poverty. The minimum threshold for the personal income tax is quite high, just below the average wage, and the VAT base excludes most small businesses and markets frequented by the poor. Also, most excise taxes are levied on goods consumed by the middle and

Armenia: Social and Demographic Indicators
(Data for 2001, unless otherwise indicated)

Indicators	Armenia	CIS-7 (Avg.)
Population (millions, preliminary 2001census results for Armenia)	3.0	8.1
Infant mortality (per 1,000 live births)	15	18
Child malnutrition (in percent of children under 5 years, 2000)	13	16
Access to safe water (percent of total population, 2000)	87	87
Life expectancy at birth (years)	73	70
Illiteracy (percent of population age above 15 years)	1	1
Gini index of inequality (consumption) 1/	38	39
Share of income/consumption of richest 10 percent of population	32	29

Sources: Armenian authorities; and UNDP, Human Development Report 2001.
1/ A value of 0 (100) represents perfect equality (inequality).

upper classes. Preliminary data from the most recent household survey indicate that the share of the population living in poverty declined to 51 percent in 2001 from 55 percent in 1998/99 while the share of those living in extreme poverty declined to 16 percent from 23 percent during the same period.[13] The authorities are also expected to draw lessons from the recent poverty and social impact analysis (PSIA).[14] Lastly, they are currently modifying the real estate and motor vehicles taxes to make the tax rates an increasing function of property values. These taxes are to be kept by local governments and aim at redistributing income and reducing transfers from the central government.

V. Statistical Issues, Technical Assistance, and Program Monitoring

41. **The reporting of basic data is adequate for program monitoring.** Armenia is participating in the General Data Dissemination System (GDDS), and the authorities are making efforts to improve the quality of national accounts, balance of payments, and socio-economic data.[15] During the discussions, the staff welcomed the authorities' intention to implement the 2002 Government Financial Statistics guidelines, but noted the need to address weaknesses in the quality, content, and timeliness of fiscal expenditure data, especially lags in compiling fiscal execution data on an accrual basis and deficiencies in the classification and presentation of expenditures (Appendix III).

42. **In recent years, Armenia has received considerable technical assistance from the Fund** in the areas of tax policy and administration and monetary policy and foreign-exchange market operations (Appendix I). Resident advisors on treasury operations and banking supervision are currently in the field. During the discussions, authorities identified further technical assistance on tax administration as a key priority. The staff agreed with such assessment, and highlighted the need for further assistance on VAT administration and on the operations of the LTU. The staff also encouraged the authorities to ensure the full implementation of recent FAD recommendations on tax and customs administration.

43. **An on-site safeguards' assessment of the CBA** conducted in October 2001 noted that safeguards at the central bank are generally adequate to ensure the integrity of Fund resources (Appendix I). The report noted several vulnerabilities and made a number of recommendations, including the need for the securities that are part of net international reserves to be recorded at market prices. The CBA has implemented all the high priority

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[13] Poverty and extreme poverty are defined in relation to minimum consumption baskets, implying living on AMD 11,735 (US$21) and AMD 7,194 (US$13) per month, respectively, in 2001.

[14] The United Kingdom's Department for International Development is preparing a pilot PSIA of the Armenian water sector.

[15] The quality and timeliness of reserves and data on foreign currency liquidity meet the Special Data Dissemination Standard (SDDS) benchmarks, although more needs to be done to improve data coverage of predetermined and short-term drains on foreign-currency assets. With minor shortcomings, provision of external arrears data fulfils the SDDS benchmarks.

recommendations, and has recently begun providing quarterly data with securities marked to market.

44. The prior actions, quantitative and structural performance criteria and indicative targets under the program are specified in the attached MEFP. The program for 2002–03 includes quantitative performance criteria for end-December 2002 and indicative targets for end-June 2003. The primary balance of the energy sector, a performance criterion during the 2001 program, will be converted into an indicative target in the second annual program because the sector's financial performance depends on important factors (e.g., weather conditions) that are outside the control of the authorities. The approach to structural conditionality under the program is described in Box 3 below. A revised technical memorandum of understanding (Attachment III) updates definitions and reporting requirements. The program prospects are conditioned by the recent mixed performance and the fragile governance environment. The renewed commitment of the authorities to the reform process, the recent improvement in revenue performance, and the prior actions taken mitigate these risks.

Box 3. Structural Conditionality Streamlining Assessment

i. Coverage of Structural Conditionality in the Current Program

Structural conditionality in the program focuses on improving tax collection, tax and customs administration, expenditure control, budget management, public sector governance, and on ensuring an adequate restructuring of the financial sector. Energy sector reform is covered through World Bank conditionality. The structural conditions under the first year of the PRGF arrangement (tax administration, treasury management, banking sector legislation, and governance) were discussed in EBS/01/61 (4/30/01). All conditions were observed, albeit some with minor delays. The status of structural performance criteria and benchmarks for the relevant periods in 2001 is presented in Table 5.

ii. Structural Areas Covered by World Bank Lending and Conditionality

The floating tranche of SAC IV is conditional on reforms in the energy sector primarily through an improved financial performance and the selection of a private manager for the electricity distribution company. Previous SAC IV tranches focused on reforming social protection and pensions, streamlining the legal framework, improving public administration and the business environment, rationalizing the health and education sectors, and developing the land market. The Bank has also assisted the authorities in preparing a Public Sector Expenditure Review and is assisting them with a Medium-Term Expenditure Framework. A new loan (SAC V) is being discussed and will cover private sector development, public enterprise restructuring, public administration and budget management, and the social sectors.

iii. Other Relevant Structural Conditions Not Included in Current Program

The second annual program under the PRGF arrangement does not include energy sector measures, even though such measures were part of the 1999 program supported under the third annual Enhanced Structural Adjustment Financing (ESAF) arrangement EBS/98/213, Supplement 1 (12/8/98). The 2001 program included performance criteria on the primary balance of the energy sector while the proposed program includes only indicative targets. Measures in the areas of privatization, civil service reform, and the social safety net were included in the 1999 ESAF-supported program but are not included in the current program. These areas are important but not critical to the program's objectives and are outside of the Fund's areas of competence. They have been covered under the World Bank SAC IV and its other lending programs and will continue to benefit from such programs.

VI. Staff Appraisal

45. During the last three years, Armenia has experienced rapid growth with low inflation and a narrowing current account deficit. This has contributed to a rapid increase in real incomes and a reduction in poverty.

46. Despite these accomplishments, performance under the PRGF-supported program has been mixed. While all but one of the targets under the monetary program were met, disappointing tax collections and insufficient progress in reforming the energy sector led to the nonobservance of several quantitative performance criteria in June and December 2001. All the structural measures under the program were implemented, although in some cases with delays.

47. Since December 2001, the authorities have taken tax measures to bring the program back on track and the performance of the energy sector has begun to improve. Together with the additional measures contained in the proposed second annual program, these steps can yield a substantial increase in revenues as long as the authorities adopt a tough stance against tax evasion and ensure that all taxpayers are treated equally and in strict accordance with the law.

48. The fiscal consolidation built into the program for the near and medium term is appropriate and compatible with debt sustainability. The staff urges the authorities to maintain a tight control over spending and restrain non-priority current outlays. As envisaged under the program, every effort should be made to clear domestic expenditure arrears by mid-2003. In the medium term, higher levels of social and infrastructure spending would be warranted, and additional grants and concessional resources will likely be needed to finance these outlays.

49. The authorities have begun tackling pervasive structural problems in the energy, water, and irrigation sectors, but the remaining work is substantial. The staff urges the authorities to finalize the financial rehabilitation plan for these sectors and to carry out, in collaboration with the World Bank, immediate reforms focused on privatization or private sector development and on bringing tariff rates in line with cost-recovery levels. In addition, privatization or liquidation of large state-owned enterprises in other sectors should also be completed during the next two to three years.

50. The success of the central bank in maintaining low inflation during the last three years is highly commendable. Additional efforts are now needed to boost financial intermediation and ensure the successful restructuring of the banking system. There is an urgent need to proceed quickly and transparently with the resolution of the banks under interim administration as well as to approve regulations allowing the central bank to deal more expeditiously with problem banks and to ensure the full enforcement of prudential norms. The authorities also need to review the relevant legislation on collection of collateral and strengthen bankruptcy procedures. Over the medium term, commercial banks should adopt the system for screening borrowers that is being developed by the central bank, the number of banks should be reduced substantially, and the capacity of banking supervision should be reinforced.

51. Armenia's flexible exchange-rate system has served the country well and allowed it to maintain its external competitiveness as evidenced by the recent rapid expansion of the tradable sector. However, Armenia's export potential remains constrained by high transport costs and the lack of trade relations with Azerbaijan and Turkey. Debt and debt-service ratios are expected to decline over the medium term.

52. Corruption and weaknesses in the judicial system remain key barriers to improving fiscal management and the investment climate and foster financial intermediation. While investment and commercial laws and regulations are up to international standards, there are concerns regarding their inconsistent application, insufficient transparency, and red tape. The recently drafted anti-corruption strategy is an important step to improve governance and the staff urges the authorities to follow up on its recommendations and to take appropriate legal actions to curb corruption. Furthermore, wages in the public sector are low compared with the private sector and need to be raised to increase the availability of qualified staff and to foster good governance.

53. Despite the improvements in poverty indicators in recent years, poverty remains pervasive. Beyond the positive effect of macroeconomic stability and continued strong growth, further progress in this area will depend on improving public finances and public administration, targeting social expenditures better and in line with the PER, and adopting further measures to enhance the business environment and governance.

54. The PRSP preparation status report highlights the tasks required to develop an effective poverty reduction strategy. The Joint Staff Assessment emphasizes the need to link the MTEF with the PRSP to properly assess the costs of the strategy and identify financing needs within an appropriate medium-term macroeconomic framework. The assessment also notes the urgency of reforming the energy sector, improve regional trade linkages, and foster private sector development. The authorities are encouraged to sustain the ongoing work on preparing the PRSP, assume full ownership of the PRSP process, and finalize a high-quality strategy by end-2002.

55. The quality and timeliness of basic data for surveillance and program monitoring are adequate. Nevertheless, lags in compiling fiscal execution data on an accrual basis need to be reduced and budget presentation should be improved to enhance policy analysis and formulation. The staff is encouraged by the authorities' decision to begin regular publication of budget execution reports and welcomes plans for improving the quality and coverage of data in the context of the GDDS.

56. The authorities have indicated that they value highly the financial and technical support received from the Fund and the World Bank since the mid-1990s. Their responsiveness to past policy advice is satisfactory, although recent delays in a number of areas call for renewed impetus and ownership of the reform effort. In particular, the authorities need to press ahead with the implementation of recent FAD recommendations on tax and customs administration. They will also benefit from further technical assistance in these areas.

57. The implementation of the proposed program is subject to a number of risks, though on balance they appear manageable. The authorities would be well advised to strengthen program ownership and stay the course on macroeconomic adjustment and reform during the upcoming elections. Other important risks are a weakening of tax compliance and a further deterioration in the performance of commercial banks. The former can be dealt with by overcoming the resistance of vested interests to the even-handed application of tax and customs regulations, while the latter can be addressed by reinforcing supervision and dealing promptly with problem banks. Lastly, the authorities should continue to seek a peaceful and timely solution to the territorial conflict with Azerbaijan.

58. Overall, in view of the measures already undertaken to bring the program back on track and the authorities' renewed commitment to the program objectives in the macroeconomic, structural, and poverty alleviation areas, the staff recommends that the Executive Board conclude the first and second reviews under the PRGF arrangement and grant waivers for the nonobservance of ten performance criteria as explained in Section III above.

59. The staff recommends that the next Article IV consultation with Armenia be held on the 24-month cycle, subject to the provisions of the Board decision on consultation cycles approved on July 15, 2002 (SM/02/184, Supplement 1 (6/18/02).

Table 1. Armenia: Expected Fund Disbursements and Timing of Reviews

Date of Disbursement	Conditions	Amount (in SDR millions)
May 23, 2001	Board approval of the PRGF arrangement	10.00
September 2002	Completion of first review (end-June 2001 test date) and second review (end-December 2001 test date)	20.00
March 2003	Completion of third review (end-December 2002 test date)	10.00
September 2003	Completion of fourth review (end-June 2003 test date)	10.00
March 2004	Completion of fifth review (end-December 2003 test date)	10.00
September 2004	Completion of sixth review (end-June 2004 test date)	9.00

Table 2. Armenia: Selected Economic and Financial Indicators, 1998–2003

	1998	1999	2000	2001 Prog.	2001 Act.	2002 Prog.	2003 Prog.
	(Annual percentage change, unless otherwise indicated)						
National income and prices							
Real GDP growth	7.3	3.3	6.0	6.5	9.6	7.5	6.0
Gross domestic product (in billions of drams)	959	988	1,031	1,149	1,175	1,301	1,421
Gross domestic product (in millions of U.S. dollars)	1,899	1,847	1,912	2,089	2,119	2,300	2,515
Gross national income per capita (in U.S. dollars)	689	655	664	696	723	763	814
Consumer price index (CPI) (annual average)	8.7	0.7	-0.8	4.5	3.2	1.0	3.6
CPI (end of period)	-1.2	2.1	0.4	3.5	3.0	3.0	3.0
GDP deflator	11.1	-0.2	-1.5	4.5	4.0	3.0	3.0
Investment and saving (in percent of GDP)							
Investment	19.9	17.9	19.7	21.8	19.2	21.4	23.2
National savings	-1.3	1.3	5.1	7.7	9.8	12.7	14.5
Money and credit (end of period)							
Reserve money	6.5	0.0	34.4	2.0	11.0	10.0	10.0
Broad money	36.0	13.6	25.8	12.0	15.0	14.3	12.5
Commercial banks' 3-month lending rate (in percent) 1/	48.1	34.5	28.6	...	27.7	24.6	...
Central government operations (in percent of GDP)							
Revenue and grants	17.1	19.3	16.5	17.2	17.1	19.5	19.8
of which: tax revenue	13.6	16.1	14.7	15.1	14.4	15.0	15.5
Expenditure and net lending	21.9	26.5	22.8	21.2	21.0	21.5	22.2
of which : current expenditure	16.3	19.2	17.5	16.3	15.8	15.0	15.5
Overall balance (commitment basis)	-4.8	-7.2	-6.4	-4.0	-3.9	-2.1	-2.5
Overall balance (cash basis)	-4.7	-5.5	-4.6	-5.5	-4.0	-3.3	-3.5
Primary balance of the energy sector	-2.6	-0.8	-1.3	0.0	-2.5	-0.5	0.0
External sector							
Exports (based on U.S. dollar values)	8.9	6.5	16.6	17.7	20.8	18.7	11.1
Imports (based on U.S. dollar values)	5.0	-8.1	5.1	9.7	1.2	8.6	8.2
Current account (in percent of GDP)	-21.2	-16.6	-14.6	-14.1	-9.5	-8.7	-8.7
NPV of external debt to exports ratio 2/	144	154	135	128	129	123	96
Debt service ratio 3/	19.0	14.3	10.6	15.0	9.7	10.5	13.3
Import coverage 4/	3.9	3.8	3.8	3.7	3.7	3.8	3.8
Nominal exchange rate (drams per U.S. dollar) 1/ 5/	-5.2	-0.3	-5.1	...	-1.7	-4.6	...
Real effective exchange rate 5/	6.5	3.5	-5.9	...	-9.1	...	...

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

1/ End of period. For 2002, the column displays the actual for June.

2/ In percent of the three-year moving average of exports of goods and services centered on the previous year.

3/ In percent of exports of goods and services.

4/ Gross international reserves in months of import of goods and services.

5/ A positive sign denotes appreciation.

Table 3. Armenia: Fiscal Measures for 2002–03

Measures implemented during December 2001–August 2002

Revenue measures

1. Eliminate VAT exemption at the border for imports allegedly connected with humanitarian assistance in order to reduce fraud.
2. Extend the base for income and presumptive taxes.
3. Amend the Law on the Simplified Tax to make it more streamlined and equitable.
4. Draft legislation on real estate and motor vehicles taxes collected by local governments, with tax rates proportional to the value of the property.
5. Increase VAT penalty rates.
6. Introduce penalties for over-reporting of losses for profit tax purposes.
7. Amend the Law on Inspections to ease restrictions on audits of individual taxpayers and accelerate enforcement of legal judgments against fraudulent taxpayers.
8. Establish a Large Taxpayers Unit at the MSR, along the lines proposed by FAD.
9. Establish an internal audit unit at customs.
10. Enact a law providing that effective January 1, 2003, VAT is paid at the time of importation, before their release from customs, on an additional list of products mostly involving goods for final consumption and comprising at least 5 percent in value terms of all imported goods (by 2001 import weights).
11. Approve government decrees requiring the MSR and the Customs Committee (CC) to exchange information on VAT taxpayers, including the content and periodicity of information from entry and export declarations to be provided by the CC to the MSR, and TIN numbers issued and cancelled to be provided by the MSR to the CC.

Expenditure measures

12. Approve regulations and procedures for budget execution under the Treasury Systems Law.
13. Approve new procedures to improve the effectiveness of public procurement.
14. Publish key data under the Financial Disclosure Law for Senior Public Officials and introduce the necessary procedures and regulations to ensure its full enforcement.

Measures to be implemented during September 2002–June 2003

Revenue measures

15. Review the Law on Simplified Tax and, if deemed necessary, submit draft amendments to parliament with a view to eliminate any remaining loopholes.
16. Establish fully operational internal audit unit at the MSR and prepare quarterly internal audit reports at the MSR and customs to be shared with the MFE, the Prime Minister, the President's office, and the staffs of the Fund and the World Bank. 1/
17. Improve administration of VAT refunds: simplify procedures and reduce the processing time to three working days for exporters with a good compliance history; and prepare quarterly reports on outstanding amounts of VAT due. 1/
18. Adopt codes of conduct for MSR and customs officials. 1/
19. Establish a computerized database on import valuation. 1/

20. Improve the administration of VAT credits and refunds with a view to establish a basis for a deferral system for imports of capital goods above a certain dram threshold and for products to be reprocessed for re-exports.
21. Establish and maintain a website at the MSR with information in Armenian, Russian and English displaying tax forms to be downloaded and printed; tax laws and regulations; procedural guidelines for staff, except for sensitive information such as audit selection criteria; organizational charts; appeals procedures; revenue and return data; and the code of conduct for MSR staff.
22. Establish and maintain a website at customs with information in Armenian, Russian and English displaying customs code and regulations; import/export procedures; procedural guidelines, except for sensitive information such as criteria for selection of cargo for physical examination; organizational charts; appeals procedures; customs revenue data; the code of conduct for customs officials; and currency exchange rates used on entries.
23. Reduce the six-monthly individual duty-free exemption to US$300 from US$500. 1/
24. Initiate a review, in consultation with external experts, of the secondary legislation pertaining to the customs code, with a view to make its interpretation and implementation transparent.
25. Introduce version 1.16d of the Automated System for Customs Data (ASYCUDA), which will allow for random checking of imported goods and improved management reporting. 1/
26. Introduce a post-clearance verification program at the customs' headquarters. 1/
27. Expand the customs Consultative and Legislation Review Committee to include additional business representatives and external advisors. 1/
28. Introduce mobile passport reading machines to enforce the bi-annual limits on individual duty-free exemptions.

Expenditure measures

29. Implement new commitment control procedures and an improved budget reporting system. 1/
30. Approve all procedures for establishing an internal audit capacity at the MFE effective January 1, 2003. 1/
31. Complete a public expenditure review in cooperation with the World Bank, the results of which are to be reflected in the 2003 budget.
32. Establish and maintain a website at the MFE with information in Armenian and English displaying budget laws, public procurement, and treasury systems; secondary legislation and regulations; organizational charts; audit plan; data on extra budgetary funds of ministries; tax and expenditure arrears; procedures for use of the reserve fund; and quarterly budget execution reports according to both the economic and the functional classifications.
33. Eliminate all external arrears through cash payments, provision of goods, or deferrals by creditors.
34. Repay to the central government budget the AMD 4.9 billion loan extended to the energy sector in the first quarter of 2002.
35. Collect comprehensive information on external grants allocated to the government of Armenia and to government units, including all grants where the government decides on their allocation (e.g., Lincy grants) and irrespective of whether the government manages or controls the funds, and prepare and publish quarterly reports.

1/ Structural performance criterion or structural benchmark under the July 2002–June 2003 program.

Table 4. Armenia: Quantitative Performance Criteria and Indicative Targets, 2001

	2000	2001							
	Dec.	March		June		September		December	
	Act.	Proj. 1/	Act.	Prog. 2/	Act.	Prog. 1/	Act.	Prog. 2/	Act.
Quantitative performance criteria									
	(In billions of drams)								
Net domestic assets of the CBA	-4.0	-1.7	-6.9	-2.8	-3.3	-3.4	-3.5	-6.0	-5.0
Net banking system credit to the central government	9.4	10.4	5.7	10.8	5.0	11.2	6.3	12.1	9.5
Stock of central government arrears 3/ 4/	44.3	44.0		34.4		27.1		27.1	
Adjusted		42.8	46.3	35.5	38.5	28.2	39.1	29.3	42.2
Stock of arrears of the State Fund for Social Insurance	4.4	4.2	3.2	3.2	3.0	1.3	3.6	0.0	1.4
Tax revenues of the central government (floor) 5/	152.4	35.5	35.6	78.0	78.1	124.6	117.1	173.3	168.8
Overall cash balance of the central government 5/ 6/	-47.9	1.3		-26.0		-49.7		-63.5	
Adjusted		2.6	2.0	-26.0	-16.9	-50.1	-27.8	-65.9	-47.3
Primary balance of the energy sector (floor) 4/ 5/	-13.5	---	-5.2	0.9	-0.5	---	-13.3	-0.2	-29.7
	(In millions of U.S. dollars)								
Net disbursements of short-term external debt	0	0	0	0	0	0	0	0	0
Contracting and guaranteeing of new nonconcessional medium- and long-term external debt longer than one year 5/	0	12	0	12	0	12	0	12	11
of which: debt of 1-5 year maturities	0	12	0	12	0	12	0	12	11
External arrears 7/	19	24	23	0	0	0	0	0	17
Net official international reserves	138	117	124	126	127	134	136	145	155
Indicative targets									
	(In billions of drams)								
Reserve money									
Actual/corridor	72.4	(61.7 - 64.2)	61.4	(65.6 - 68.3)	66.7	(69.2 - 72.0)	71.6	(72.3 - 75.3)	80.4

1/ Benchmarks.

2/ Performance criteria.

3/ The ceiling for March 2001 has been adjusted downwards by higher-than-programmed grants of US$ 2.2 million. For June 2001, the ceiling has been adjusted upwards by lower-than-programmed grants of US$0.01million and non-receipt of amortization due from Georgia of US$1.9 million. For September and December, the ceilings have been adjusted upwards by non-receipt of amortization due from Georgia of US$ 1.9 million and US$ 3.8 million, respectively. The program exchange rate of dram 550 per US dollar was used for the conversions.

4/ The actual figure for the end-December 2000 stock of arears has been included, replacing the original program figure of dram 44.4 bilion. The December 2000 primary balance of the energy sector was also revised from the earlier preliminary figure of dram 0.2 billion.

5/ Cumulative during the year.

6/ The ceiling for March 2001 has been adjusted upwards by higher-than-programmed grants of US$2.2 million. For June 2001, the ceiling has been adjusted downwards by lower-than-programmed grants of US$ 0.01million. For September and December, the ceilings have been adjusted downwards by lower-than-programmed grants of US$0.8 million and US$4.3 million, respectively. The program exchange rate of dram 550 per US dollar was used for the conversions.

7/ As per the original agreement, there are two distinct performance criteria on external arrears, one on the stock of arrears and a continuous criterion on the non-accumulation of new arrears. The authorities had a deferral from external creditors between May and November 2001. At the expiration of the deferral, the authorities began to accumulate new arrears. As a result, the performance criteria on both the new and the existing stock of external arrears were not observed at end-December 2001.

Table 5. Armenia: Structural Performance Criteria and Benchmarks 2001

Measures	Timing of Implementation	Status
Structural Performance Criteria		
Adoption by the parliament and signing by the president of a law on financial disclosure of public officials.	June 2001	Signed in August 2001.
Structural Benchmarks		
Parliamentary approval of a treasury law.	June 2001	Approved in August 2001.
The comprehensive automated audit system will be operational in all Yerevan offices.	June 2001	Observed
The government will submit a new draft law on bankruptcy of banks to the parliament. The government will also submit draft amendments to the parliament of the CBA law and/or the law on banks and banking activity.	June 2001	Observed
Parliamentary approval of the new law on the bankruptcy of banks.	October 2001	Approved in November 2001.
The comprehensive automated audit system will be operational in all tax offices.	December 2001	Observed
Parliamentary approval of amendments to the CBA law and/or the law on banks and banking activity.	December 2001	Observed

Table 6. Armenia: Central Government Operations, 2000–03

	2000	2001		2002					2003
				Jan-Jun		Jul-Sept	Oct-Dec	Jan-Dec	
	Act.	Prog.	Act.	Prog. 1/	Prel.	Prog.	Prog.	Prog.	Prog.
	(In billions of drams)								
Total revenue and grants	170.0	197.6	200.8	107.3	110.3	65.6	77.4	253.3	281.2
Total revenue	163.4	183.2	182.3	93.5	96.3	52.1	56.0	204.4	225.2
Tax revenue	152.4	173.3	168.8	88.7	89.1	50.7	55.2	195.0	220.5
Nontax revenue	11.1	8.6	11.9	4.4	6.5	1.1	0.5	8.1	4.7
Capital revenue	0.0	1.4	1.6	0.4	0.6	0.3	0.3	1.2	0.0
Grants 2/	6.6	14.4	18.5	13.8	14.0	13.5	21.4	48.9	56.0
Total expenditure	235.8	243.9	247.2	114.5	119.1	73.7	87.5	280.3	316.1
Current expenditure	180.4	187.6	185.2	82.6	89.4	51.3	54.6	195.2	220.1
Wages	32.9	32.8	32.2	15.0	16.4	9.1	11.2	36.6	42.2
Subsidies	8.2	6.6	6.5	2.1	4.5	2.0	0.8	7.2	7.0
Interest	17.3	17.6	14.5	7.9	6.3	4.1	3.8	14.2	12.9
Transfers, reserve fund and contingent liabilities	45.8	49.8	51.7	24.4	27.9	10.4	13.4	51.6	62.5
Goods and services	76.3	80.9	80.3	33.2	34.4	25.7	25.5	85.5	95.6
Capital expenditure and net lending	55.3	56.2	62.0	32.0	29.7	22.5	32.9	85.1	96.0
Capital expenditure	39.7	44.6	46.0	25.8	19.2	23.7	29.0	72.0	99.5
Net lending	15.6	11.6	16.0	6.1	10.5	-1.3	3.9	13.1	-3.5
Overall balance (commitment basis)	-65.8	-46.3	-46.4	-7.2	-8.8	-8.1	-10.1	-27.0	-34.8
Net accumulation of arrears (minus = repayment) 3/	12.8	-17.2	-1.5	-11.1	-1.8	-6.8	-12.4	-21.0	-14.9
Statistical discrepancy	5.1	0.0	0.6	0.0	5.1	0.0	0.0	5.1	0.0
Overall balance (cash basis)	-47.9	-63.5	-47.3	-18.3	-5.5	-14.9	-22.5	-42.9	-49.7
Financing	47.9	63.5	47.3	18.3	5.5	14.9	22.5	42.9	49.7
Domestic financing	25.4	13.5	15.2	-3.1	-7.2	3.9	3.9	0.7	4.7
Banking system	-6.1	2.7	-1.2	-4.1	-9.6	3.6	3.1	-2.8	2.4
Central bank	0.0	0.0	0.0	-5.2	-12.8	3.6	2.8	-6.5	0.0
Commercial banks	-6.1	0.0	-1.2	1.1	3.3	0.1	0.3	3.7	2.4
Nonbank	31.4	10.8	16.4	1.0	2.4	0.3	0.8	3.5	2.4
External financing	22.5	50.0	32.1	21.4	12.7	11.0	18.6	42.2	45.0
Gross inflow	26.6	65.1	44.3	26.5	17.8	13.5	24.6	56.0	65.4
Amortization due	-11.1	-15.1	-11.6	-9.8	-9.8	-2.8	-7.8	-20.3	-21.9
Change in principal arrears (- = reduction)	7.0	0.0	-0.6	4.6	4.6	-1.5	0.0	3.1	-9.6
Debt referrals/relief	0.0	0.0	0.0	0.0	0.0	1.8	1.8	3.6	11.1
Memorandum items									
End-period stock of arrears	44.3	27.1	42.2	29.6	28.1	36.9	24.5	24.5	0.0
Stock of domestic arrears (end of period)	33.9	27.1	32.7	19.0	29.7	26.2	14.9	14.9	0.0
Stock of external arrears (end of period)	10.4	0.0	9.5	17.0	15.5	10.8	9.6	9.6	0.0
Overall balance (commitment basis, excluding grants)	-72.3	-60.7	-64.9	-21.0	-22.8	-21.6	-31.5	-75.9	-90.9

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

Table 6 (concluded). Armenia: Central Government Operations, 2000–03

	2000	2001		2002					2003
				Jan-Jun		Jul-Sept	Oct-Dec	Jan-Dec	
	Act.	Prog.	Act.	Prog. 1/	Prel.	Prog.	Prog.	Prog.	Prog.
	(In percent of GDP)								
Total revenue and grants	16.5	17.2	17.1	25.4	25.6	15.4	17.4	19.5	19.8
Total revenue	15.8	15.9	15.5	22.1	22.3	12.3	12.6	15.7	15.8
Tax revenue	14.7	15.1	14.4	21.0	20.7	11.9	12.4	15.0	15.5
Nontax revenue	1.1	0.7	1.0	1.0	1.5	0.3	0.1	0.6	0.3
Capital revenue	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Grants 2/	0.6	1.3	1.6	3.3	3.3	3.2	4.8	3.8	3.9
Total expenditure	22.8	21.2	21.0	27.1	27.6	17.4	19.6	21.5	22.2
Current expenditure	17.5	16.3	15.8	19.6	20.7	12.1	12.3	15.0	15.5
Wages	3.2	2.9	2.7	3.5	3.8	2.1	2.5	2.8	3.0
Subsidies	0.8	0.6	0.6	0.5	1.0	0.5	0.2	0.6	0.5
Interest	1.7	1.5	1.2	1.9	1.5	1.0	0.8	1.1	0.9
Transfers, reserve fund and contingent liabilities	4.4	4.3	4.4	5.8	6.5	2.4	3.0	4.0	4.4
Goods and services	7.4	7.0	6.8	7.9	8.0	6.1	5.7	6.6	6.7
Capital expenditure and net lending	5.4	4.9	5.3	7.6	6.9	5.3	7.4	6.5	6.8
Capital expenditure	3.8	3.9	3.9	6.1	4.5	5.6	6.5	5.5	7.0
Net lending	1.5	1.0	1.4	1.5	2.4	-0.3	0.9	1.0	-0.2
Overall balance (commitment basis)	-6.4	-4.0	-3.9	-1.7	-2.0	-1.9	-2.3	-2.1	-2.5
Net accumulation of arrears (minus = repayment) 3/	1.2	-1.5	-0.1	-2.6	-0.4	-1.6	-2.8	-1.6	-1.0
Statistical discrepancy	0.5	0.0	0.1	0.0	1.2	0.0	0.0	0.4	0.0
Overall balance (cash basis)	-4.6	-5.5	-4.0	-4.3	-1.3	-3.5	-5.1	-3.3	-3.5
Financing	4.6	5.5	4.0	4.3	1.3	3.5	5.1	3.3	3.5
Domestic financing	2.5	1.2	1.3	-0.7	-1.7	0.9	0.9	0.1	0.3
Banking system	-0.6	0.2	-0.1	-1.0	-2.2	0.9	0.7	-0.2	0.2
Central bank	0.0	0.0	0.0	-1.2	-3.0	0.8	0.6	-0.5	0.0
Commercial banks	-0.6	0.0	-0.1	0.3	0.8	0.0	0.1	0.3	0.2
Nonbank	3.0	0.9	1.4	0.2	0.6	0.1	0.2	0.3	0.2
External financing	2.2	4.3	2.7	5.1	2.9	2.6	4.2	3.2	3.2
Disbursements	2.6	5.7	3.8	6.3	4.1	3.2	5.5	4.3	4.6
Amortization due	-1.1	-1.3	-1.0	-2.3	-2.3	-0.7	-1.8	-1.6	-1.5
Change in principal arrears (- reduction)	0.7	0.0	-0.1	1.1	1.1	-0.4	0.0	0.2	-0.7
Debt referrals/relief	0.0	0.0	0.0	0.0	0.0	0.4	0.4	0.3	0.8
Memorandum items									
Nominal GDP (in billions of drams)	1,031.3	1,149.0	1,175.5	422.3	430.9	424.7	445.5	1,301.0	1,421.0
End-period stock of arrears	4.3	2.4	3.6	3.2	3.5	2.8	1.9	1.9	0.0
Stock of domestic arrears (end of period)	3.3	2.4	2.8	2.2	2.3	2.0	1.1	1.1	0.0
Stock of external arrears (end of period)	1.0	0.0	0.8	1.0	1.2	0.8	0.7	0.7	0.0
Overall balance (commitment basis, excluding grants)	-7.0	-5.3	-5.5	-5.0	-5.3	-5.1	-7.1	-5.8	-6.4

Sources: Armenian authorities; and staff estimates and projections.

1/ Agreed with the authorities during the February 2002 mission.
2/ Budget estimates adjusted to include the proceeds from monetization of commodity grants.
3/ Exluding external arrears on principal.

Table 7. Armenia: Monetary Accounts, 2000–03

	2000	2001		2002				2003		
	Dec.	Dec.		Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Dec.
	Act.	Prog.	Act.	Act.	Act.	Prog.	Prog.	Prog.	Prog.	Prog.
	(End-of-period figures in billions of drams, unless otherwise indicated)									
Central Bank of Armenia										
Net foreign assets	77.9	76.2	84.5	86.2	90.2	82.9	86.6	82.6	86.6	97.8
Net international reserves	76.4	79.8	88.1	89.8	94.3	88.8	92.7	88.8	92.7	103.9
Medium and long-term foreign assets	-1.6	-3.5	-3.5	-3.6	-4.1	-5.8	-6.1	-6.1	-6.1	-6.1
Net domestic assets	-9.0	-2.4	-4.2	-13.8	-15.8	-0.2	1.8	-0.2	0.1	-0.5
Claims on general government (net)	8.3	8.3	8.3	-0.9	-4.4	-0.9	1.9	-1.1	1.4	1.9
of which : claims on central government (net)	8.3	8.3	8.3	-0.8	-4.4	-0.9	1.9	-1.1	1.4	1.9
Claims on banks	3.3	6.3	3.9	6.6	7.6	11.0	10.1	10.9	8.9	7.8
Other items (net)	-20.6	-17.0	-16.3	-19.5	-18.9	-10.3	-10.1	-10.0	-10.2	-10.2
Reserve money	72.4	73.8	80.4	72.4	74.4	82.7	88.4	82.4	86.7	97.2
Currency issue	61.9	60.9	66.7	60.8	61.8	69.0	75.1	70.5	74.4	84.0
Deposits	10.5	12.9	13.7	11.6	12.6	13.8	13.3	11.9	12.3	13.2
Banking system 1/										
Net foreign assets	62.1	62.3	83.0	84.5	94.7	88.6	94.9	94.9	97.6	103.9
Net domestic assets	74.5	106.4	74.0	64.8	60.7	78.4	84.6	80.0	85.7	98.0
Claims on general government (net)	9.3	12.0	9.4	2.4	-0.1	3.5	6.6	4.6	7.7	9.0
of which : claims on central government (net)	9.4	12.0	9.5	2.5	0.0	3.5	6.6	4.6	7.7	9.0
Claims on rest of the economy	97.8	113.9	93.5	83.5	85.4	93.6	96.7	94.1	96.7	107.7
Other items (net)	-32.6	-19.5	-28.9	-21.1	-24.6	-18.7	-18.7	-18.7	-18.7	-18.7
Broad money	136.6	168.7	157.0	149.2	155.4	167.1	179.5	174.9	183.4	201.9
Currency in circulation	59.5	55.4	65.1	58.9	59.7	66.4	72.3	66.8	71.3	81.9
Deposits	77.1	113.2	92.0	90.4	95.7	100.7	107.2	108.1	112.1	120.1
Domestic currency	15.6	20.8	18.4	20.0	22.4	24.3	24.9	25.6	27.8	29.5
Foreign currency	61.4	92.4	73.6	70.3	73.3	76.4	82.3	82.6	84.3	90.5
Memorandum items										
Exchange rate (drams per U.S. dollars)	552.2	552.2	561.8	576.0	577.1	...	...	...	...	...
Net international reserves (in millions of U.S. dollars) 2/	140.3	...	156.8	156.0	163.3	...	...	...	...	...
Net international reserves (in millions of U.S. dollars) 3/	138.3	144.5	154.6	152.6	155.9	158.0	165.0	158.0	165.0	185.0
Net domestic assets of the CBA (in billions of drams) 3/	...	-6.0	-5.0	-11.7	-13.4	-0.2	1.8	-0.2	0.1	-0.5
Commercial banks' claims on central government (net)	1.1	3.7	1.2	3.3	4.4	4.4	4.7	5.7	6.3	7.1
Twelve-month change in reserve money (in percent)	34.4	2.0	11.0	17.8	11.6	15.6	10.0	13.9	16.5	10.0
Twelve-month change in broad money (in percent) 1/	25.8	12.0	15.0	3.8	0.7	5.3	14.3	17.2	18.0	12.5
Velocity of broad money (average)	8.1	7.5	...	...	...	...	8.0	...	...	7.6
Money multiplier	2.1	2.28	1.95	2.06	2.09	2.02	2.03	2.12	2.11	2.08
Dollarization in bank deposits 4/	79.7	81.6	80.0	77.8	76.6	75.9	76.8	76.4	75.2	75.4
Liquidity preference ratio 5/	77.2	49.0	70.7	65.1	62.3	66.0	67.5	61.8	63.6	68.2

Sources: Armenian authorities; and staff estimates and projections.

1/ Beginning November 2001, the broad money figures have been revised downward to exclude deposit liabilities of banks placed under interim administration.

2/ At actual exchange rates.

3/ At program exchange rates, as specified in the technical memorandum of understanding.

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

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

Table 8. Armenia: Balance of Payments, 2000–07

	2000	2001		2002	2003	2004	2005	2006	2007
	Act.	Prog.	Act.	Prog.	Prog.	Proj.	Proj.	Proj.	Proj.
	(In millions of U.S. dollars; unless otherwise indicated)								
Current account	-278	-294	-201	-199	-219	-220	-219	-212	-203
Trade balance	-464	-492	-420	-389	-397	-411	-420	-426	-431
Exports	310	356	353	458	516	557	602	647	696
Imports	-773	-848	-773	-847	-913	-969	-1,022	-1,073	-1,127
Services (net)	-56	-44	-18	-32	-40	-40	-39	-38	-36
Credits	137	166	187	182	195	212	231	250	272
Debits	-193	-210	-204	-214	-235	-252	-270	-288	-308
Income (net)	53	53	63	52	45	50	51	52	54
Private transfers (net)	86	89	102	105	108	116	124	134	145
Official transfers (net)	103	100	72	65	65	65	65	65	65
Capital and financial account	289	250	201	185	223	201	217	227	237
Capital transfers (net)	28	70	30	76	90	50	50	50	50
Foreign direct investments (net)	104	140	70	75	174	105	118	125	130
Portfolio investments (net)	-19	0	-6	0	0	0	0	0	0
Public sector (net)	46	41	45	42	-41	46	49	52	57
Disbursements	70	68	65	81	90	70	73	80	87
Amortization	-24	-27	-21	-39	-130	-13	-11	-15	-17
Other capital (net) 1/	130	0	62	-7	0	0	0	0	0
Overall balance	11	-45	0	-14	4	-19	-2	14	34
Change in gross reserves (- increase)	-18	-23	-16	-34	-24	-7	-24	-23	-29
IMF (net) 2/	-16	-10	-10	-19	-23	-31	-33	-28	-23
Russia, net (+ increase) 3/	18	-19	-3	7	-23	0	0	0	0
Turkmenistan, net (+ increase) 4/	5	0	1	-1	0	0	0	0	0
Financing gap	0	96	27	61	67	57	59	37	19
IMF	0	26	13	27	27	25	0	0	0
World Bank	0	50	14	34	40	0	0	0	0
Other	0	20	0	0	0	32	59	37	19
Memorandum items:									
Current account (in percent of GDP)	-14.6	-14.1	-9.5	-8.7	-8.7	-8.0	-7.3	-6.5	-5.7
Gross reserves (end of period)	314	336	329	364	388	395	420	442	471
In months of next year's imports 5/	3.8	3.7	3.7	3.8	3.8	3.7	3.7	3.7	3.7
In months of next year's debt service 6/	76.8	85.5	53.8	26.0	84.6	69.1	71.1	76.4	90.6
Net international reserves (stock)	140	145	157	173	194	207	264	318	369
Nominal external debt 6/	862	968	905	1,040	1,020	1,100	1,185	1,257	1,322
Net present value (NPV) of external debt	535	...	587	669	607	675	738	784	821
NPV of debt-to-exports ratio 7/	135	128	129	123	96	95	96	94	91
Stock of external arrears 8/	19	0	17	23	0	0	0	0	0

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

1/ Includes errors and omissions.

2/ Excluding prospective PRGF disbursements which are included in the financing gap.

3/ Accumulation and clearance of arrears and, in third and fourth quarters of 2002, also including debt relief based on the July 17, 2002 agreement with Russia that is expected to be finalized in 2003.

4/ In 2000, debt relief. In 2001-02, accumulation and clearance of arrears.

5/ Imports of goods and services.

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

7/ A three-year moving average of exports of goods and services (centered on the previous year).

8/ For 2002, the table shows a technical accumulation of arrears as a result of the debt agreement with Russia that is expected to be finalized in early 2003. This figure differs from the one in Attachment II, Table 1, because of the deferral obtained from the Russian authorities in July 2002.

Table 9. Armenia: Medium-Term Macroeconomic Framework, 2001–07

	2001 Act.	2002 Prog.	2003 Prog.	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.
	(In percent of GDP, unless otherwise indicated)						
National income and prices							
Real GDP growth (percent)	9.6	7.5	6.0	6.0	6.0	6.0	6.0
Gross domestic product (in millions of U.S. dollars)	2,119	2,300	2,515	2,756	3,009	3,286	3,588
Gross national income per capita (in U.S. dollars)	723	763	814	875	935	1,000	1,070
Inflation (annual percent change)	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Investment and saving							
Investment	19.2	21.4	23.2	21.1	20.7	20.5	20.1
Government	5.3	6.5	6.8	5.2	5.1	5.3	5.4
Private	14.0	14.9	16.4	15.9	15.6	15.2	14.7
National savings	9.8	12.7	14.5	13.1	13.4	14.0	14.4
Government	1.3	4.5	4.3	2.7	2.6	2.8	2.9
Private	8.4	8.2	10.2	10.4	10.8	11.2	11.6
Central government operations							
Revenue and grants	17.1	19.5	19.8	18.2	18.4	18.7	18.8
of which: tax revenue	14.4	15.0	15.5	16.0	16.4	16.7	17.0
grants	1.6	3.8	3.9	1.6	1.4	1.3	1.2
Expenditure	21.0	21.5	22.2	20.7	20.9	21.1	21.3
of which: social expenditures 1/	5.9	5.4	5.7	6.2	6.3	6.5	6.7
Overall balance (commitment basis)	-3.9	-2.1	-2.5	-2.5	-2.5	-2.5	-2.5
Overall balance (cash basis)	-4.0	-3.3	-3.5	-2.5	-2.5	-2.5	-2.5
External sector							
Exports of goods and services	25.5	27.9	28.2	27.9	27.7	27.3	27.0
Imports of goods and services	46.2	46.3	45.5	44.3	42.9	41.4	40.0
Current account	-9.5	-8.7	-8.7	-8.0	-7.3	-6.5	-5.7
Current account (in millions of U.S. dollars)	-201	-199	-219	-220	-219	-212	-203
Capital and financial account (in millions of U.S. dollars)	201	185	223	201	217	227	237
of which: direct foreign investment	70	75	174	105	118	125	130
public sector disbursements	45	42	41	46	49	52	57
Change in net international reserves (in millions of U.S. dollars)	25	53	48	38	57	51	52
Arrears and debt relief (in millions of U.S. dollars)	-2	6	-23	0	0	0	0
Financing gap (in millions of U.S. dollars)	27	61	67	57	59	37	19
of which: IMF gross disbursements	13	27	27	25	...	...	...
IDA loans	14	34	40	...	...	...	...
Net present value (NPV) of debt-to-exports ratio 2/	129	123	96	95	96	94	91
Debt-service ratio 2/	9.7	10.5	13.3	7.5	6.9	6.6	5.8
Import coverage 3/	3.7	3.8	3.8	3.7	3.7	3.7	3.7

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

1/ Defined as expenditures on health, education, and social security.

2/ In percent of the three-year average of exports of goods and services (centered on the previous year).

3/ In months of imports of goods and services.

Table 10. Armenia: Indicators of Fund Credit and Debt Servicing, 2001–07
(In units indicated)

	2001	2002	2003	2004	2005	2006	2007
Existing and prospective Fund credit 1/							
In millions of SDRs	137.3	143.3	145.8	141.5	116.9	95.7	78.2
In percent of exports 2/	32.0	28.1	25.8	23.1	17.6	13.4	10.2
In percent of external debt	19.1	17.3	18.0	16.2	12.4	9.6	7.4
In percent of gross reserves	52.4	49.5	47.3	45.0	35.0	27.2	20.9
In percent of quota	149.3	155.7	158.5	153.8	127.0	104.0	85.0
Existing Fund credit 1/							
In millions of SDRs	137.3	123.3	105.8	82.5	57.9	36.7	19.2
In percent of exports 2/	32.0	24.2	18.7	13.5	8.7	5.1	2.5
In percent of external debt	19.1	14.9	13.0	9.4	6.1	3.7	1.8
In percent of gross reserves	52.4	42.6	34.3	26.2	17.3	10.4	5.1
In percent of quota	149.3	134.0	115.1	89.7	62.9	39.9	20.9
Prospective Fund credit 1/							
In millions of SDRs	...	20.0	40.0	59.0	59.0	59.0	59.0
In percent of exports 2/	...	3.9	7.1	9.6	8.9	8.3	7.7
In percent of external debt	...	2.4	4.9	6.7	6.3	5.9	5.6
In percent of gross reserves	...	6.9	13.0	18.8	17.7	16.8	15.7
In percent of quota	...	21.7	43.5	64.1	64.1	64.1	64.1
Repurchases, repayments, and charges due from existing and prospective drawings							
In millions of SDRs	...	15.1	18.5	24.3	25.4	21.8	18.0
In percent of exports 2/	...	3.0	3.3	4.0	3.8	3.1	2.3
In percent of external debt	...	1.8	2.3	2.8	2.7	2.2	1.7
In percent of gross reserves	...	5.2	6.0	7.7	7.6	6.2	4.8
In percent of quota	...	16.4	20.1	26.4	27.7	23.7	19.5
Repurchases and charges due from existing drawings							
In millions of SDRs	...	15.1	18.3	24.0	25.1	21.5	15.7
In percent of exports 2/	...	3.0	3.2	3.9	3.8	3.0	2.0
In percent of external debt	...	1.8	2.3	2.7	2.7	2.2	1.5
In percent of gross reserves	...	5.2	5.9	7.6	7.5	6.1	4.2
In percent of quota	...	16.4	19.9	26.1	27.3	23.4	17.0
Repurchases and charges due from prospective drawings							
In millions of SDRs	...	0.1	0.2	0.3	0.3	0.3	2.3
In percent of exports 2/	...	0.0	0.0	0.0	0.0	0.0	0.3
In percent of external debt	...	0.0	0.0	0.0	0.0	0.0	0.2
In percent of gross reserves	...	0.0	0.1	0.1	0.1	0.1	0.6
In percent of quota	...	0.1	0.2	0.3	0.3	0.3	2.5

Sources: Armenian authorities; and staff estimates.

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

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

September 11, 2002

Dear Mr. Köhler:

On May 14, 2001, the Executive Board of the Fund approved a three-year arrangement for Armenia under the Poverty Reduction and Growth Facility. The purpose of this letter and the attached Memorandum of Economic and Financial Policies is to inform you of progress in implementing the program and request waivers for nonobservance of nine quantitative and one structural performance criteria pertaining to the first and second reviews under the arrangement. Though the number of required waivers is high, we would like to point out that the nonobservance can be attributed mainly to two developments: unsatisfactory tax revenue performance and insufficient reforms in the energy sector.

Economic performance during the last two years has been positive: real GDP has been growing at an average rate of 8 percent per year, annual inflation has remained below 4 percent, and the central government and external current account deficits have been narrowing. Progress has also been made in reducing poverty and income inequality.

Nevertheless, and despite this good performance, there have been difficulties with tax and customs revenue collection in 2001, as well as delays in implementing structural reforms in the energy, water, and irrigation sectors. In the fiscal area, tax revenues for the year as a whole were below the program target. This shortfall, combined with delays in external disbursements, caused the nonobservance of the June and December ceilings on expenditure arrears, and the December ceilings on the stock and flows of external arrears. The expenditure arrears of the State Fund for Social Insurance were significantly reduced in 2001, but they ended the year slightly above the programmed ceiling.

All targets under the monetary program for 2001 were met, except the December ceiling on the net domestic assets of the central bank, reflecting a larger-than-programmed profit transfer to the government. The cumulative primary deficit of the energy sector, a performance criterion, was also not observed in both June and December 2001 as a result of the failure to privatize the electricity distribution companies and changes in weather and consumption patterns. Lastly, the law on financial disclosure by public officials (the structural performance criterion) was passed two months after its target date of June 2001. All other structural benchmarks and measures under the program were implemented, although in some cases with a small delay.

Since December 2001, the government has successfully undertaken a number of measures to improve tax revenue collection and begun addressing the much-needed reforms in the aforementioned areas. As described in the attached memorandum, we will be moving decisively with our reform agenda during 2002–04. Our strategy is based on fiscal consolidation supported by structural reforms in sectors affected by inefficient state-owned companies, improvements in governance, and actions to strengthen the banking system. We are also committed to eliminate all domestic budgetary arrears by mid-2003. An ambitious rehabilitation program for the energy, water, and irrigation sector will be implemented in consultation with the World Bank. Lastly, we have issued a Poverty Reduction Strategy Paper (PRSP) Preparation Status Report, and the PRSP will be finalized by end-2002.

On this basis, we request completion of the first and second reviews under the arrangement and waivers of nonobservance of: (a) the end-June 2001 quantitative performance criteria on the stock of government arrears and on the primary deficit of the energy sector; (b) the end-June 2001 structural performance criterion on the adoption of the law on financial disclosure by senior public officials; (c) the end-December 2001 quantitative performance criteria on the net domestic assets of the central bank, the tax revenues of the central government, the stock of government arrears, the stock of arrears of the State Fund for Social Insurance, the primary deficit of the energy sector, and the stock of external arrears; and (d) the end-December 2001 continuous performance criterion on non-accumulation of new external arrears.

We are confident that the policies and measures described in the attached memorandum are adequate to achieve the objectives of the program, but will take further measures if deemed necessary. During the remaining period of the arrangement, the government will consult with the Managing Director on additional measures that may become appropriate and provide the Fund with the information required to assess progress in implementing the policies and reaching the objectives of the program. Armenia will conduct with the IMF the third semi-annual review of its program before March 31, 2003, as described in the attached memorandum.

Sincerely yours,

/s/
Andranik Margaryan
Prime Minister
Republic of Armenia

/s/
Vartan Khachatryan
Minister of Finance and Economy

/s/
Tigran S. Sargsyan
Chairman of the Central Bank

GOVERNMENT OF ARMENIA
MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

September 11, 2002

This memorandum sets forth the government of Armenia's economic objectives and policies for the period July 2002 to June 2003, the second year of the program supported under the Poverty Reduction and Growth Facility (PRGF). These objectives and policies are an integral part of the government's medium term strategy for poverty reduction envisaged in the interim Poverty Reduction Strategy Paper (PRSP).

I. Recent Developments and Performance Under the Program

1. The overall performance of the Armenian economy in 2001 and the first half of 2002 has been strong. Real economic growth, after slowing in 1999, accelerated to 9.6 percent in 2001, and it has averaged 6 percent annually since 1994. The robust growth has continued in 2002, with real GDP growing by 10.1 percent in the first half of the year compared with the same period of 2001. The rate of inflation has averaged less than 4 percent during the past four years; the 12-month rate of inflation stood at 3.7 percent in June 2002. The external current account deficit has declined significantly from 21.2 percent of GDP in 1998 to 9.5 percent in 2001. Preliminary data for the first quarter of this year suggest a further narrowing of the current account deficit compared with the same period of 2001, aided by a process of market driven import substitution and strong growth in exports.

2. Despite this overall positive performance, the implementation of the program in 2001 was not entirely successful. During the first half of 2001, the performance criteria on the cash deficit of the government budget, net domestic banking system credit to the government, and tax revenues were observed, but those on the stock of government arrears and the primary balance of the energy sector were not. For the year as a whole, tax revenues were 0.4 percent of GDP below the programmed amount, mainly the result of delays in improving tax and customs administration and poor energy sector performance.

3. In part due to the underperformance in tax revenues, but largely because of a shortfall in external disbursements, the end-December performance criterion on government expenditure arrears was also exceeded (although expenditure arrears were reduced from a peak of some 5 percent of GDP in September 2000 to around 3.6 percent of GDP at end-2001). Similarly, the end-year performance criteria on the stock of external arrears and the non-accumulation of new external arrears were also not observed. The shortfall in external financing was, in turn, partly related to noncompliance with World Bank conditionality on privatizing the electricity distribution companies (EDCs). Reductions in government expenditures during the second half of the year led to a decline in the fiscal deficit on a commitment basis from 6.4 percent of GDP in 2000 to 3.9 percent in 2001. Expenditure arrears of the State Fund for Social Insurance (SFSI) were significantly reduced in 2001 to 0.1 percent of GDP, only marginally above the target of zero arrears; the remaining arrears were cleared during the first half of 2002.

4. All targets under the monetary program for 2001 were met, except the end-December ceiling on the net domestic assets of the Central Bank of Armenia (CBA) (a performance criterion). The ceiling was exceeded by a small margin due to a larger-than-programmed profit transfer to the government to settle an unanticipated foreign debt payment. Net international reserves (NIR) of the CBA (a performance criterion) exceeded the end-year program floor by almost US$10 million.

5. The energy, water and irrigation sectors, along with the large state-owned chemical company, Nairit, continued to be a major source of non-payments in 2001. The management of Nairit was assigned to a private operator, but the planned privatization of the EDCs could not be realized because of the continued financial problems of the sector and the deterioration in the international investment climate after the September 11 terrorist attacks. The four EDCs were subsequently merged into a single company. In 2001, the annual technical loss rate (leakages in generation and transmission) for electricity generation stood at 15 percent, and the excess loss rate (presumably related to theft) was 11 percent, while the overall collection in terms of the amount billed was 81 percent compared to 89 percent in the previous year. The cumulative primary deficit of the energy sector, a performance criterion, exceeded the end-2001 target by 2.5 percent of GDP, while the combined primary deficit of the energy and other quasi-fiscal sectors increased from 2.6 percent of GDP in 2000 to 3.6 percent of GDP in 2001. Reflecting improvements undertaken since then, overall energy collections increased to 90 percent during the first half of 2002, and the sector's cumulative primary deficit declined sharply to 0.2 percent of GDP.

6. The financial disclosure law for senior public officials, a structural performance criterion, was enacted in 2001, although with a slight delay. All measures subject to structural benchmarks were implemented in 2001. These measures comprised the establishment of a comprehensive automated audit system for the VAT, the enactment of a treasury law and a law on the bankruptcy of banks, and the parliamentary approval of amendments to the central bank law and the law on banks and banking activity. Other structural measures implemented in 2001 include the establishment of an internal audit unit at the headquarters of the Customs Committee (CC) and the approval of a civil service law. The government also established a committee for the development of an anti-corruption program in cooperation with international donors. As part of its role as guardian of the stability of the banking system, the CBA placed seven problem banks under interim administration between November 2000 and December 2001, while two other banks were liquidated.

7. All quantitative targets for end-June 2002 discussed with the February IMF mission were met, except for the ceilings on domestic and external arrears (Table 1). Even though expenditures, in particular on subsidies and net lending, exceeded the projections in the first half of 2002, annual expenditure targets will not be affected because spending in the second half of the year (including subsidies) will be contained to ensure that the annual limits are not exceeded. Further structural measures have been taken in 2002, prior to the IMF Executive Board meeting on the combined first and second reviews under the PRGF. These include the publication of key individual data under the financial disclosure law and the introduction of

the necessary procedures and regulations for its full enforcement; the ratification of legislation for VAT to be paid at the time of importation on an additional list of products (comprising at least 5 percent of the total value of imports); and the approval of government decrees requiring the Ministry of State Revenue (MSR) and the CC to exchange key information on VAT taxpayers (Table 2). In addition, the AMD 4.9 billion loan extended to the energy sector in the first quarter of 2002 will be repaid to the state budget at least one week in advance of the Executive Board meeting. Finally, legislation was approved on non-bank financial institutions, including micro-finance institutions.

II. Medium-Term Strategy

8. Building on the progress achieved in 2001 and early 2002, we are committed to impart additional impetus to our macroeconomic and structural reform program during the next two years, including improving services and infrastructure, reforming the energy, water, and irrigation sectors, improving the enforcement of laws and regulations, reducing administrative barriers and red tape, and increasing the efficiency and transparency of public sector operations. This program, which has been developed in consultation with the staffs of the IMF and the World Bank, aims at maintaining the conditions for real economic growth of at least 6 percent per year and inflation at no more than 3 percent. Growth will be driven by continued development of export sectors such as technology-intensive and mineral and agricultural processing activities and by increased aid flows channeled to investment on infrastructure and reconstruction. Fiscal policy under the program will continue to be directed at substantially increasing government revenues in order to provide additional resources for poverty reducing expenditures, eliminating domestic payment arrears, and lowering the fiscal deficit to a sustainable medium-term path consistent with stable external-debt ratios.

9. Preliminary data from the 2001 household survey indicate that the share of the population living in poverty has declined to 51 percent from 55 percent in 1998/99 while the share of the population living in extreme poverty has declined to 16 percent from 23 percent. Further progress in these areas will depend not only on continued macroeconomic stability and sustained growth, but also on improvements in the targeting of social expenditures, the quality of public administration, and the integrity and efficiency of the judicial system. There is also the need to improve the business environment, particularly for small and medium-sized businesses and new business entities. Working closely with civil society and external donor organizations, the government has intensified its efforts to prepare a full PRSP by the end of this year. In the meantime, we have prepared a PRSP Preparation Status Report.

10. Fiscal and governance-related reforms will continue to be buttressed by a monetary policy aimed at ensuring price stability. As in the past, this objective will be accomplished through adherence to an indicative reserve money corridor. The CBA will continue to maintain a flexible exchange rate policy and will intervene in the foreign exchange market only to smooth short-term exchange rate fluctuations. Movements of reserve money toward the edges of the corridor provide the CBA with a signal of the need to reassess its short-term

credit and foreign exchange market policies. In the event that reserve money moves outside the corridor, the CBA will discuss with IMF staff any need for a change in monetary policy.

11. In the period 2002–03, the government is determined to significantly reduce the non-payments problem of the energy and other quasi-fiscal sectors. To that end, an overall financial rehabilitation plan will be implemented in collaboration with the World Bank and the merged EDC will be privatized by the end of this year. Over the medium-term, tariffs for water and irrigation will be raised towards full cost-recovery levels, and the installation of water meters will be extended to multi-family apartment buildings and single-family units.

III. The Program for the Period July 2002–June 2003

12. **Key economic objectives and policies.** In line with the medium-term strategy, the government's economic program for July 2002–June 2003 aims at achieving the following core objectives:

- Provide the conditions for real economic growth of at least 6 percent so as to improve the standard of living of the population and slow down emigration;

- Maintain the 12-month rate of inflation at no more than 3 percent and gross international reserves at 3.8 months of imports; and

- Further reduce the fiscal deficit and public debt ratios.

13. The main policies to achieve these objectives are: i) pursuance of an independent monetary policy focused on price stability; ii) improve tax and customs administration to yield higher tax revenues; iii) control and prioritize government expenditures; iv) strengthen the performance of key state-owned utilities in the energy, water, and irrigation sectors; v) protect the health of the banking system and promote financial intermediation; and vi) reduce administrative barriers and opportunities for corruption.

14. **Fiscal balance.** On the basis of ongoing revenue measures and a more efficient targeting of expenditures, the fiscal deficit on a commitment basis will decline from 3.9 percent of GDP in 2001 to 2–2.5 percent in 2002–03. On a cash basis, the deficit will also decline despite an accelerated repayment of domestic expenditure arrears.

15. **Revenue mobilization.** The government considers revenue mobilization to be the foundation of a sustainable fiscal platform for Armenia. We are therefore committed to a comprehensive program aimed at removing various loopholes in the tax system, and improving tax and customs administration. Several measures have been taken, and more will be taken in order to increase revenues by at least half a percentage point of GDP per year in 2002–04. The government does not propose to carry out major adjustments in tax rates next year but it will improve tax and customs administration and ensure the equal enforcement of the law on all taxpayers. The government stands ready to take immediate offsetting revenue measures in the event of a revenue shortfall.

16. **Tax policy.** A comprehensive package of measures designed to improve tax collections has been implemented since December 2001. The legislation that was enacted reduces the potential for fraud in claiming VAT tax exemptions for imports allegedly connected with humanitarian assistance, extends the base for the income and presumptive taxes, and penalizes over-reporting of losses in connection with the profit tax. The law on the simplified tax was streamlined and made more equitable. The law will be reviewed in late 2002 and may be amended again in 2003 with a view to eliminating remaining exemptions and loopholes. The government is also in the process of introducing legislation on real estate and motor vehicles taxes collected by local governments, with tax rates proportional to the market value of the property. The parliament recently passed legislation allowing for the establishment of a free-trade export-processing zone in the vicinity of the Yerevan airport. The government does not intend to establish other free-trade zones in Armenia, and is aware of the potential revenue loss resulting from this initiative. To address the latter concern, it will ensure that the zone remains sealed within a well-defined area and will calculate the loss in profit taxes resulting from the free-trade zone and record it as tax expenditures in the budget. After one year of operation, the government will evaluate the revenue impact and the nature of the tax exemptions.

17. **Value-added tax (VAT).** In line with international best practice, the government remains committed to the goal of eliminating VAT exemptions at the border for all imported goods (other than goods exempted under specific treaties and agreements entered into with internationally recognized donor organizations or other governments; and goods which constitute humanitarian assistance). Over the next two years, as the administrative capacity for VAT credits and refunds improve and if real lending rates decline significantly, we will make every effort to achieve this objective. These exemptions, excluding those for imports under specific customs procedures for re-export, currently apply to 25 percent of the total value of imports, down from 35 percent in 2000. Effective January 2003, these exemptions will be reduced further and will apply to just 20 percent of imports.

18. **Tax administration.** Major measures have been or will be taken in the area of tax administration. In January 2002, a large taxpayers unit was established within the MSR, which will significantly reduce tax evasion among the country's largest enterprises. Furthermore, the law on tax inspections has been amended in line with international best practice to remove restrictions on the number and duration of audits of individual taxpayers. In particular, the possibilities for on-site inspections and investigations and the audit powers of the local tax inspectorates have been enhanced. The MSR will adopt a code of conduct for its officials by November 2002, with a view to improving the transparency of tax operations. By the end of the year, the MSR will establish an internal audit unit and post on its website and in other media information including basic tax legislation and regulations covering the major taxes and the corresponding procedures.

19. **Customs administration.** The government is aware of the need to improve the integrity and efficiency of customs operations, and it has created a fully staffed internal audit unit at the CC headquarters. This unit will soon start preparing quarterly reports. The CC will also adopt a code of conduct for its officials later this year and, by January 2003, establish a

website with key information including customs tariffs and import/export procedures. To enhance customs valuation, the customs code will be amended, with a view to cease the current practice of basing customs values on domestic market prices, and a computerized database linked to the Automated System for Customs Data (ASYCUDA) will be established this year to verify values of imported products based on import prices. Furthermore, the authorities will initiate a review, in consultation with external experts, of the secondary legislation pertaining to the customs code, with a view to make its interpretation and implementation more transparent. At the same time, the existing Consultative Committee will be expanded to better reflect the composition of key stakeholders. In addition, mobile passport reading machines will be introduced by December 2002 to enforce the bi-annual limits on individual duty free exemptions; these exemptions will be subsequently reduced from US$500 to US$300. The key measures to be taken during the program period in this area are outlined in Tables 2 and 3.

20. **Expenditure policy.** The government is committed to clearing all domestic arrears by mid-2003. Given the assumptions on foreign financing, the program envisages the clearing of arrears and an increase in current government expenditure in 2003. The share of social expenditures in the budget (defined as total expenditure on health, education and science, and social security) will be increased by at least 0.3 percent of GDP in 2003. In the event of a financing shortfall, the government will undertake the necessary expenditure cuts within the 2003 budget and will halt the envisaged increase in current expenditures as a share of GDP in order to meet the arrears targets. The 2003 budget may also include about AMD6 billion in the reserve fund as a contingency for payments in late 2003 for supplies to the nuclear power plant. In this regard, the budget will include a provision under which, unless they are utilized for that specific purpose, these funds will be saved in the single treasury account at the CBA and their disposition will be subsequently discussed with the staffs of the Fund and the World Bank. Capital expenditure will increase rapidly in 2002 and 2003, mainly as a result of higher grant-financed public investment. A public expenditure review has been prepared and a medium-term expenditure framework is being prepared in consultation with the World Bank. The design and implementation of the latter, which will be linked to the 2003 budget so as to match sectoral expenditure priorities with resource availability, is an essential element of the PRSP process.

21. **Expenditure management and budget reform.** In the area of expenditure control, the government has approved regulations and procedures on budget execution under the treasury law that went into effect in January 2002. The government has also approved new procedures to improve the effectiveness of the public procurement process, and will be implementing new commitment control procedures and an improved budget reporting system in October 2002. At the same time, the Ministry of Finance and Economy (MFE) will establish a fully functioning internal audit capacity, effective January 2003, and increase the amount of information displayed on its website to include budget laws, internal audit reports, and quarterly budget execution reports according to both the economic and the functional distribution of expenditures. The government will also begin to identify, and later remove, any impediments to the inclusion in the budget of all external grants where a government decision is involved and irrespective of whether the funds are managed by government units.

Lastly, the government will take steps to further enhance the transparency of extrabudgetary funds, data on stocks and flows of tax and expenditure arrears, and, in collaboration with the World Bank, the procedures for utilization of the reserve fund.

22. **Social security system.** The finances of the SFSI have been placed on a sound footing: all remaining SFSI expenditure arrears were cleared by mid-2002, and the SFSI will remain current on its obligations during the program period. In light of the improved revenue performance, old-age pensions will be increased over the medium term. To enhance the efficiency of the pension system, pensions are now exclusively targeted to recipients residing in the country. Furthermore, the SFSI is undertaking significant technological improvements and reductions in staff. Finally, starting in 2002, citizens will begin to receive personal identification numbers (PIN) and, conditional on the availability of external financing, all citizens should receive a PIN by 2005.

23. **Monetary policy.** The paramount macroeconomic objective of the CBA is to maintain the rate of inflation at no more than 3 percent per year. The new monetary program covering the period July 2002–June 2003 has been tailored to this objective. The demand for broad money is projected to increase by about 14 percent in 2002 and 13 percent in 2003, above the growth of nominal GDP amid continuing monetization of the economy. Reserve money is targeted to increase by about 10 percent. In particular, in light of the incipient inflation pressures observed in the first half of 2002, the CBA has adjusted its monetary policy with a view to ensuring that the inflation target for this year is attained.

24. **Trade and foreign exchange regime.** Armenia maintains no restrictions in the making of payments and transfers for current international transactions and a very liberal trade regime. During the program period, the government will not introduce multiple currency practices, impose restrictions on payments and transfers for current transactions, introduce restrictions on imports for balance of payments purposes, or conclude any agreements inconsistent with Article VIII of the Fund's Articles of Agreement. Armenia maintains a freely floating exchange rate regime, contributing to flexibility of relative prices of traded versus nontraded goods and internal and external balance. Reflecting higher projected external disbursements in 2002 and 2003, net international reserves are projected to increase during the program period, keeping the import coverage of gross reserves at about 3.8 months of imports.

25. **Banking regulation and supervision.** The CBA will continue to improve its banking supervision and prudential regulation capabilities, so as to ensure the stability of the banking system. In that context, the CBA will review the adequacy of the banking system's exposure to balance sheet foreign exchange positions and, if necessary, require additional capital to cover this risk. The minimum capital requirements for existing banks were raised to US$1.65 million effective July 2002, and will be raised further to US$2 million by mid-2003 and US$5 million by mid-2005. The CBA will continue with its plan to introduce a deposit insurance scheme, which will start to collect premiums in 2003. The deposit insurance scheme will exclude the banks under interim administration. In this connection, the CBA will mount a public relations campaign on the scheme. By March 2003, the authorities will agree

with commercial banks on a strategy for the sharing of the start-up costs of the scheme, but the CBA will not make regular contributions to the scheme. The CBA will also complete preparations for the establishment of a fully operational credit registry as envisaged under the new CBA law. Furthermore, the CBA board has adopted a resolution on anti-money laundering, and the authorities have formed a committee under the leadership of the CBA chairman. This committee meets regularly to discuss these issues.

26. **Banks under interim administration.** The CBA will be moving expeditiously towards rehabilitation or liquidation of banks under interim administration. To that end, the CBA has resolved the conflict of interests between its roles in banking supervision and temporary administration of banks. Administrators of banks under interim administration now report to a newly established bank resolution department. The CBA has also prepared a detailed report regarding the situation of the three largest banks held under interim administration, and will discuss the results with the staffs of the Fund and the World Bank. The CBA will also issue clear guidelines for temporary administration of banks and its policy on open bank assistance and resolution of problem banks. In February 2002, two banks were merged and the new bank was placed under interim administration, bringing the total of such banks to eight. By February 2003, the five smallest banks (by size of assets) under interim administration will be liquidated, and least-cost diagnostic analyses of the three largest banks under interim administration and a resolution strategy will be completed by April 2003. These and other measures to be taken in this area are listed in Tables 2 and 3.

27. **Non-bank financial institutions.** As the financial sector of Armenia evolves, a number of non-bank financial institutions have been or are in the process of being established. Legislation to regulate these institutions, including micro-finance institutions, was approved in May 2002. In implementing the regulatory framework for the operations and supervision of non-bank financial institutions, the CBA will ensure the clear definition of functions and delineation of activities of these institutions to ensure that they do not become de-facto banks subject to less strict supervision.

28. **Balance of payments.** The current account deficit is projected to narrow further in 2002 and remain unchanged in 2003. Capital transfers will also be high owing to grants from the Lincy foundation. A remaining financing gap would be financed by IMF disbursements under the PRGF arrangement and structural adjustment loans from the World Bank.

29. **External debt.** The government will not accumulate external payments arrears during the program period, apart from those arising from debt service payments that become due pending the conclusion of the debt-to-equity swap agreement with Russia. This arrangement, which will be completed in a transparent manner in the next few months, will allow for the exchange of the outstanding external debt to Russia for equity positions in Armenian state-owned enterprises and lead to a substantial reduction in the present value of Armenia's external debt. The resulting savings to the government, together with adjustment lending from the World Bank, will help to clear remaining domestic arrears by mid-2003. The government has not been servicing its debt to Turkmenistan since October 2001 pending the conclusion of an agreement on the modalities for settling these obligations. Prior to the

Executive Board meeting, all external arrears to Turkmenistan will have been cleared through cash payments, the export of goods, or deferrals by the creditor.

30. **Energy sector.** Following the merger of the four EDCs into one company earlier this year, the government has recently taken steps to privatize the company. As the new owner is not directly involved in the energy sector the government is discussing with the World Bank the feasibility of contracting a qualified private manager for the company. The transfer of the management of the company to a private operator and the privatization of the company are expected to be finalized by the end of the year. In the meantime, the government is taking strong measures to improve efficiency and reduce waste and theft in the energy sector through better financial management and technical improvements. A large number of energy sector staff has been released from employment in 2002 and the remuneration of employees in key areas such as sales and collection is now tied to achieving performance targets. With these and other measures, including taking a stricter position with respect to cutting off service to nonpaying customers, we anticipate that the annual technical loss rate can be reduced to 14.3 percent in 2002 and the excess loss rate to 10.4 percent, while the overall collection rate can be raised to at least 91 percent. Assuming normal weather conditions and composition of usage across customer groups, the primary deficit of the energy sector is expected to decline to AMD 6.3 billion (0.5 percent of GDP) in 2002.

31. **Other key parastatals.** In the fourth quarter of this year, the government will approve a financial rehabilitation plan for the energy, water, and irrigation sectors that will ensure further reduction of excess losses and elimination of payment arrears by water and irrigation companies. There will also be a full and detailed inclusion in the 2003 state budget of subsidies to the quasi-fiscal sector and other parastatals. Through tariff increases, technological improvements, and increased metering, the combined primary deficit of the energy and other quasi-fiscal sectors is projected to decline from 3.6 percent of GDP in 2001 to 1.2 percent in 2002. The new private operator for Nairit has committed to a repayment schedule of the company's outstanding debts and arrears, allowing for deferment of repayments for up to five years after an initial operation period of 18 months. Nairit will henceforth stay current on its energy bills or face an immediate interruption of power.

32. **Privatization process.** While the privatization of small and medium-sized companies was completed in the first years of transition, a number of large enterprises still remain under government control. Some of these companies could be restructured and turned operable by a strategic investor. The government is aware of the burden posed by the remaining state-owned enterprises on the state budget and is committed to resolve this situation within the next two to three years, in cooperation with the World Bank.

33. **Civil service reform.** Following the adoption of a law to establish a merit-based system for civil service, a council of experts from outside the government has been established and is in the process of drafting the secondary legislation and formulating an action plan consistent with the primary legislation.

34. **Governance.** The government anti-corruption strategy group, with the support of the World Bank, has prepared an interim report including a time-bound action plan, which is now to be discussed with key stakeholders. Suggested measures include streamlining legislation, public administration reform, enhancing the business climate, downsizing government institutions and, in some cases, replacing them with regulatory bodies. In order to improve budget presentation and enhance transparency of the budgetary process, a quarterly budget bulletin and a citizen's guide are now being published in Armenian and English in collaboration with external donors.

35. **Program monitoring.** Program monitoring will be carried out on the basis of semi-annual quantitative performance criteria and quarterly quantitative benchmarks (Table 1), structural performance criteria (Table 2), and structural benchmarks (Table 3), with semi-annual reviews based on end-December 2002 and end-June 2003 test dates. The quantitative performance criteria include: ceilings on the net domestic assets of the CBA, net domestic banking system credit to the central government, the overall cash deficit of the central government, domestic arrears of the central government, SFSI arrears, net disbursements of short-term external debt, contracting and guaranteeing of new non-concessional medium- and long-term external debt of more than one year (with a sub-ceiling on debt of 1–5 year maturities), and a continuous performance criterion on the non-accumulation of external arrears of the government. They also include floors on the net official international reserves of the central bank and tax revenues of the central government. There is an indicative floor and ceiling on reserve money, and an indicative floor on the primary balance of the energy sector. The latter was a performance criterion during the first annual program, but it will be treated as an indicative target because the financial performance of the energy sector is subject to a number of factors (e.g. weather patterns) that are outside the control of the authorities. Details on the definition and monitoring (and adjustors) of quantitative performance criteria are contained in the attached TMU.

36. **Compilation and provision of information.** To insure the effective monitoring of the program, the relevant ministries, the CBA, and the National Statistics Service will compile and share with the staffs of the Fund and the World Bank all core data on a timely basis, as specified in the attached TMU.

37. The government believes that the policies described above are adequate to achieve the objectives of the program, but will stand ready to take any additional measures that may be necessary for this purpose. A request for the fourth disbursement under the PRGF arrangement is contingent upon the observance of the performance criteria set out in Tables 1–2, and the completion of the third review under the program.

Table 1. Armenia: Quantitative Targets, March 2002–June 2003 1/
(End of period stocks, unless otherwise specified)

	2002						2003	
	March		June		September	December	March	June
	Prog. 2/	Act.	Prog. 2/	Act.	Prog. 3/	Prog. 4/	Prog. 5/	Prog. 5/
	(In billions of drams)							
Net domestic assets of the CBA (ceiling) 6/	-1.7	-11.7	-4.7	-13.4	-0.2	1.8	-0.2	0.1
Net banking system credit to the central government	9.6	2.5	10.2	0.0	3.5	6.6	4.6	7.7
Domestic arrears of the central government 7/	24.5	28.8	19.0	29.7	26.2	14.9	3.6	0.0
Stock of arrears of the State Fund for Social Insurance	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Tax revenues of the central government (floor) 8/	40.2	39.9	88.7	89.1	139.4	194.6	42.5	95.7
Balance of the central government on a cash basis 7/ 8/	-8.9	-5.6	-15.0	-5.5	-20.4	-42.9	-21.5	-35.0
Reserve money								
Corridor/actual 5/	(73.6 - 76.6)	72.4	(76.8 - 79.9)	74.4	(79.9 - 83.1)	(86.6 - 90.2)	(80.8 - 84.0)	(85.0 - 88.4)
Primary balance of the energy sector (floor) 5/ 8/	-1.5	-1.1	-2.0	-0.9	-3.5	-6.3	-0.2	-0.9
	(In millions of U.S. dollars)							
Contracting and guaranteeing of new nonconcessional external debt of the public sector								
maturity of less than one year 9/	0	0	0	0	0	0	0	0
maturity of more than one year	0	0	0	0	0	0	0	0
External arrears (continuous criterion)	0	23	0	28	0	0	0	0
Net official international reserves (floor) 6/	137	153	143	156	158	165	158	165

1/ The definitions of the line items and the adjusters on the fiscal balance and the stock of domestic arrears are specified in the technical memorandum of understanding
2/ As elaborated with Fund staff in February 2002.
3/ Benchmark.
4/ Performance criterion.
5/ Indicative target.
6/ Based on program exchange rates as specified in the technical memorandum of understanding.
7/ Subject to adjusters on the amount of non-programmed foreign-financed project disbursements and World Bank SAC financing.
8/ Cumulative from beginning of calendar year until the end of the month indicated.
9/ Continuous criterion. Excluding normal import-related credit and sales of treasury bills to non-residents.

Table 2. Armenia: Prior Actions and Structural Performance Criteria, 2002–03

Measure	Timing of Implementation
Prior Actions	
1. Enact legislation providing that, effective January 1, 2003; VAT is paid at the time of importation on an additional list of products comprising at least 5 percent of all imported goods by value (by 2001 import weights) before their release from customs.	Effected May 2002
2. Publish key data under the Financial Disclosure Law for Senior Public Officials and introduce the necessary procedures and regulations to ensure its full enforcement.	Effected June 2002
3. Meet the cumulative target for tax revenues of the central government for the first half of 2002 (Table 1).	Effected June 2002
4. Approve government decrees requiring the MSR and the Customs Committee (CC) to exchange information on VAT taxpayers, including the content and periodicity of information from entry and export declarations to be provided by the CC to the MSR, and TIN numbers issued and cancelled to be provided by the MSR to the CC.	Effected August 2002
5. Prepare a report on the situation of the three largest banks under interim administration containing, for each bank, a brief description of its history, ownership structure, problems that led to its insolvency, steps taken by the CBA, main findings of the administrators, assets recovered, an evaluation of remaining assets and expected recovery, the amounts already paid to depositors and outstanding amounts, and any contingent or other liabilities. The report will map out a timetable for the steps that will be taken toward a final resolution for these banks.	Effected September 5, 2002
6. Eliminate all external arrears through cash payments, provision of goods, or deferrals by creditors.	Pending 1/
7. Repay to the central government budget the AMD 4.9 billion loan extended to the energy sector in the first quarter of 2002.	Pending 1/
Structural Performance Criteria Under the Third Review	
1. Establish a computerized valuation database at customs based on import prices and linked to the ASYCUDA system for the verification of customs values of imported goods.	End-December 2002
2. Revoke the licenses and appoint liquidators for at least three of the five smallest banks (by value of assets) currently under interim CBA administration.	End-December 2002
3. Revoke the licenses and appoint liquidators for the remaining banks among the five smallest banks under current CBA administration.	End-February 2003

1/ Information on the date of implementation will be provided before the Board meeting.

Table 3. Armenia: Structural Benchmarks, October 2002–June 2003

Measure	Timing of Implementation 1/
1. Implement commitment control procedures and improved budget reporting system, as defined by the regulations and procedures on budget execution under the new treasury law.	October 2002
2. Adopt codes of conduct for MSR and customs officials aimed at improving transparency and integrity of tax and customs operations.	November 2002
3. Issue written guidelines for the conduct of temporary intervention of banks.	December 2002
4. Establish internal audit capacity as determined by article 9.1.b of the treasury system law.	January 2003
5. Reduce the individual duty-free exemption to US$300 for every six months.	January 2003
6. Approve guidelines for the resolution of problem banks, including a "least-cost" test.	February 2003
7. Expand the customs Consultative and Legislation Review Committee to include additional business community representatives, external advisors, and other public officials.	April 2003
8. Introduce version 1.16d of the ASYCUDA system, which will allow for random checking of imported goods and improved management reporting.	April 2003
9. Complete least-cost diagnostic analyses, with the help of external experts, of the three largest banks under interim administration and formulate a resolution strategy.	April 2003
10. Improve administration of VAT refunds: simplify procedures and reduce the processing time to three working days for exporters with a good compliance history; and prepare quarterly reports on outstanding amounts of VAT due.	June 2003
11. Establish fully operational internal audit units at the MSR and at customs and prepare and share quarterly internal audit reports with the MFE, the Prime Minister, the President's office, and the staffs of the Fund and the World Bank.	June 2003
12. Introduce a post-clearance verification program at the customs' headquarters.	June 2003
13. The CBA will cease to be an administrator of the largest bank in temporary administration unless a final contract on capitalization has been signed with a legitimate investor. If no such contract has been signed the bank will be liquidated immediately.	June 2003

1/ End of period.

GOVERNMENT OF ARMENIA
TECHNICAL MEMORANDUM OF UNDERSTANDING

This technical memorandum defines the quantitative benchmarks, performance criteria, adjustors, and reporting modalities established in the Memorandum of Economic and Financial Policies (MEFP) for 2002–03.

I. QUANTITATIVE TARGETS

1. Quantitative targets for 2002–03 are presented in Table 1 of the MEFP and defined below. Benchmarks are set for end-September 2002, performance criteria are set for end-December 2002, and indicative targets are set for end-March and end-June 2003.

2. **Reserve money** targets are indicative and include a floor and a ceiling. They are subject to a daily band of plus or minus 2 percent computed from the quarterly average standard deviation of excess reserves held by banks in percent of quarterly reserve money during 1998–2001. If reserve money breaches the corridor, the CBA will consult promptly with IMF staff on the appropriate policy response. Reserve money of the Central Bank of Armenia (CBA) is defined as the sum of currency issue, required and excess reserves, and current and time deposit accounts of certain resident agents.

3. The program targets a minimum level of **net official international reserves (NIR)** of the CBA. The stock of such reserves will be calculated as the difference between total gross international reserves and official reserve liabilities. Total gross official international reserves are defined as the CBA's holdings of monetary gold (excluding amounts pledged as collateral or in swaps), holdings of SDRs, any reserve position in the IMF, and holdings of convertible currencies in cash or in nonresident financial institutions (deposits, securities, or other financial instruments). Gross reserves held in the form of securities are marked to market. Gross reserves are reported net of the balance on the government's Special Privatization Account (SPA). Capital subscriptions in foreign financial institutions and illiquid foreign assets are also excluded. There is no reporting on financial derivatives and other off balance sheet positions, as the CBA does not currently trade in such financial instruments. However, if the CBA decides to commence such trading it will promptly notify the IMF staff in order to establish proper reporting requirements in this regard. Official reserve liabilities shall be defined as outstanding liabilities to the IMF and convertible currency liabilities of the CBA to nonresidents with an original maturity of up to and including one year. NIR is monitored in U.S. dollars, and, for program monitoring purposes, assets and liabilities in currencies other than the U.S. dollar shall be converted into dollar-equivalent values using the exchange rates as of December 31, 2001 (Attachment III, Table 1).

4. The program targets a maximum level of **net domestic assets (NDA)** of the CBA. NDA is defined as reserve money less NIR plus medium- and long-term liabilities of the CBA, where the dram-equivalent values of NIR and medium- and long-term liabilities are calculated using the end-2001 official exchange rate of dram 561.81 per U.S. dollar. NDA is composed of net credit to the general government; outstanding credit to domestic banks by

the CBA (including overdrafts) minus liabilities not included in reserve money (exclusive of accrued interest), and other items net.

5. The government balance refers to the central government (state budget) only. The **State Fund for Social Insurance (SFSI)**, whose overall cash balance must be zero on an annual basis, will be monitored by a separate performance criterion covering the stock of SFSI arrears. Local governments—which are not allowed to borrow either domestically or externally—are excluded from the fiscal accounts, as there are reporting lags on their activities.

6. The US-based **Lincy Foundation** is helping Armenia's development through the extension of grants to finance various investment projects. The project implementation units, which carry out grant-financed projects, maintain accounts at the CBA. These grants are recorded in the fiscal accounts as external grants on the revenue side and as foreign-financed capital expenditure on the expenditure side.

7. **Net credit from the CBA to the central government** includes the CBA's holdings of treasury bills and treasury bonds less central government deposits (including deposits of donor-financed project implementation units, the Lincy foundation, and balances of proceeds from the sale of humanitarian assistance). Treasury bonds are valued at the purchase price and treasury bills are valued at the purchase price plus the implicit accrued interest. Except for treasury bills, accrued interest is excluded from net credit. The CBA does not extend direct credit to the central government. The source of the data to be used for program monitoring is specified in Section III below.

8. **Net credit from commercial banks to the government** includes: (1) gross credit from banks to the central government less central government deposits with banks (excluding accrued interest but including the counterpart funds of certain government onlending to the economy financed by the Lincy Foundation and the World Bank); and (2) banks' holdings of treasury bonds (valued at the purchase price and excluding accrued interest) and treasury bills (valued at the purchase price plus the implicit accrued interest). Accordingly, net credit of the banking system to the central government is the sum of net credit from the CBA and net credit from commercial banks; it was equivalent to dram 9.5 billion on December 31, 2001.

9. **External debt limits** apply to new medium- and long-term external debt[16] with original maturities of more than one year, which are contracted or guaranteed by the

[16] The term "debt" shall have the meaning set forth in Section 9(a) of the Guidelines on performance criteria on external debt, as modified by the Executive Board Decision No. 12274-(00/85) of August 24, 2000, and shall include all current (noncontingent) liabilities, which are created under a contractual arrangement through the provision of economic value in the form of financial or nonfinancial assets (including currency) or services, and/or income, and which require the debtor to make one or more payments in the form of such assets (including currency) or services at some future point(s) in time to discharge the principal and/or interest liabilities incurred under the contract. In particular, all instruments that share the characteristics of debt enumerated above (including loans, suppliers' credits, and leases) will be included in the performance criterion on external debt.

government (as defined above) or by the CBA, with a sub-limit on such debt with maturities of more than one year up to and including five years. In addition, there are limits on disbursements of short-term external debt contracted or guaranteed by the government or the CBA; all obligations with original maturities of up to one year fall under this limit, except normal import-related credits.

10. The program ceilings on the contracting and guaranteeing of **new nonconcessional medium- and long-term debt**, by the government or the CBA, will apply to all forms of external debt with maturity greater than one year. The only liabilities excluded from the limits are sales of treasury bills or treasury bonds to nonresidents, provided the sales go through the regular auction mechanism and involve no exchange rate guarantees; and concessional loans. For program purposes, a loan is considered concessional if the grant element is at least 35 percent calculated using a discount factor based on the Commercial Interest Reference Rates (CIRRs) published by the OECD plus margins depending on the loan maturity.[17] The average of the CIRRs over the last ten years will be used for loans with a maturity of at least 15 years and the average of the CIRRs for the preceding six months will be used for shorter maturities. For the purpose of monitoring compliance with the targets, all agreements concluded in respect of rescheduling or refinancing of existing debt shall be excluded from the limits. Transactions subject to these ceilings shall be valued in the contracted currencies and converted into U.S. dollars at the average monthly market exchange rate in the month when the borrowing commitment was contracted.

11. **External arrears** of the central government or the CBA will consist of all overdue debt-service obligations (i.e., payments of principal and interest) arising in respect of loans contracted or guaranteed by the government or the CBA since Armenia's independence, unpaid penalties or interest charges associated with these arrears, and overdue payments owed by the government or the CBA on imports received subsequent to independence.

12. The **central government budget balance** is defined from the financing side on a cash basis as the sum of domestic banking system net financing, domestic non-bank net financing, and external net financing to the central government. **Domestic banking system net financing** is measured as the change during the period of net domestic banking system credit to the government. **Domestic non-bank net financing** is measured as the sum of: (1) the change during the period of outstanding treasury bills and bonds to non-banks (including accrued interest for treasury bills and excluding accrued interest for treasury bonds);[18] and (2) any other disbursement or transaction (other than proceeds from privatizations which are deposited into the SPA) that increases non-banks' claims on the central government, less amortizations made by the central government to private resident non-bank agents. The Ministry of Finance and Economy (MFE) will provide these data in

[17] The margins are: 0.75 percent for repayment periods of less than 15 years, 1 percent for 15–19 years, 1.15 percent for 20–29 years, and 1.25 percent for 30 years or more.

[18] Domestic non-bank holdings of treasury bills and treasury bonds are defined as total outstanding treasury bills and bonds less holdings by the banking system and the SFSI.

consultation with the CBA. **External net financing** is measured as total debt-increasing disbursements from non-residents to the central government less total amortizations from the central government to non-residents. All foreign-currency denominated transactions are recorded in drams using the prevailing exchange rate at the time of the transaction.

13. Proceeds stemming from the selling of enterprises in the context of the **annual privatization program** are deposited into the SPA. The account is held at the CBA and the proceeds are invested abroad together with the CBA's international reserves. However, these proceeds are not included in the definition of the monetary accounts of the banking system. Any withdrawal from the SPA (including accrued interest) will be accounted for as privatization proceeds used to finance the budget. Proceeds from other privatizations are included in the regular budgetary accounts as capital revenue. These proceeds are deposited in a privatization account, held at the CBA and included in the definition of net credit to the central government, or spent for general budgetary purposes.

14. **Tax revenue** is defined in accordance with Government Financial Statistics (GFS) 1986, section IV.A.1. Total revenues collected by the Ministry of State Revenues and the Customs Committee are classified as follows: VAT (of which: presumptive tax on cigarettes and petroleum), excises (of which: presumptive tax on cigarettes and petroleum), enterprise profit tax, personal income tax, land tax, customs duties (of which: presumptive tax on cigarettes and petroleum), other presumptive taxes, simplified tax, property tax, and other taxes (of which stamp duties and environmental taxes).

15. The program targets maximum levels for the stock of **domestic government arrears** and the stock of **SFSI arrears.**[19] For program purposes, domestic arrears are defined as follows. With respect to wages, contributions to the pension fund, family allowances, and amortization and interest payments (domestic), the stock of arrears is defined as all unpaid claims outstanding as of the end of the month. For all other expenditure categories, arrears are defined as the stock of unpaid claims, as verified by the recipient of the goods and services, which has been outstanding for more than 30 days as of the end of the month.

16. The government will provide a detailed quarterly cash flow for the **energy sector**. The energy sector is defined by the following companies: (1) Hrazdan thermal power plant; (2) Yerevan thermal power plant; (3) Metsamor nuclear power plant; (4) Sevan-Hrazdan Cascade hydro-power plant; (5) Vorotan hydro-power plants system; (6) High Voltage Electricity Network; (7) Armenergo; (8) Armenia Electricity Network Company; (9) Armgazprom; and (10) Armtourtrade. The cash flow of the energy sector consists of the consolidation of the cash flows of these enterprises excluding Armgazprom. The program will target the primary balance of the energy sector, where the primary balance is defined as current revenues less total expenditures excluding all interest payments and capital expenditures related to foreign-financed projects.

[19] In the first annual program, the performance criterion on the stock of government arrears referred to the sum of domestic and external arrears. To facilitate monitoring, and since there is a separate performance criterion on external arrears, the current program targets only the stock of domestic arrears.

II. ADJUSTERS

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

i. **Non-programmed foreign-finance project disbursements.** The cash balance of the central government will be adjusted downward (upward) by the full amount of cumulative higher (lower) than programmed foreign-financed project disbursements (excluding structural adjustment lending by the World Bank) as shown in Table 2 below.

ii. **Non-programmed World Bank SAC disbursements.** During the program period, the ceiling on the stock of arrears and the floor on the cash balance of the government will be adjusted downward (upward) for any financing higher (lower) than the one reported in Table 3 arising from World Bank SAC disbursements. If the funds received exceed the amount required to bring the stock of domestic arrears to zero, the remaining balance will instead translate into an automatic downward adjustment of the net credit to government target, and the authorities will subsequently reach understandings with the staffs of the Fund and the World Bank on the use of this amount in the budget. In case of a shortfall in SAC financing, the ceilings on the stock of arrears will be capped at AMD 26.2 billion at end-December 2002, AMD 23.2 at end-March 2003, and AMD 11.3 at end-June 2003, the cash balance of the government will not be further adjusted, and the government will restrain budgeted expenditure increases as needed to meet the arrears targets.

III. DATA REPORTING

18. The government, the CBA, and the National Statistics Service (NSS) will provide the IMF with all necessary data to monitor economic developments and program performance. Unless otherwise indicated, the information will provided be in accordance with the definitions elaborated in the previous section.

19. **Balance sheet of the CBA.** The CBA has provided the IMF staff the chart of accounts and it will notify the staff of any revisions thereto. Weekly (summary[20]) and monthly end-of-period (by chart of account) data on the balance sheet of the CBA will be reported within seven days of the end of the reporting period.

20. **Balance sheet of the banking system.** Monthly banking system data, in the form of a monetary survey, as well as the consolidated balance sheet of the commercial banking system (by chart of accounts), will be reported to the IMF within 21 days of the end of each month.

[20] As defined in CBA Resolution No. 201 (December 6, 1999).

21. **Treasury bill and coupon bond financing** The CBA will provide monthly data to the IMF within seven days of the end of each month by the following categories of holders: the CBA, resident banks, resident non-banks, and nonresidents.

22. **International reserves.** The CBA will provide monthly data (by chart of accounts) within 14 days of the end of each month on both gross and net official international reserves. These data will be provided in two variants: (1) at program exchange rates; and (2) at actual official exchange rates.

23. **Non-tax and capital revenue.** The MFE will report on a monthly basis non-tax revenue, capital revenue, cash grants and proceeds from the sales of humanitarian assistance. This information will be reported within seven days of the end of each month.

24. **External debt.** The MFE, in collaboration with the CBA, will provide information on the disbursements and outstanding stock of short-term external debt; on contracting and guaranteeing and the outstanding stocks of medium- and long-term external debt of the government and of the CBA; any stock of outstanding arrears on external debt service payments, and the total amount of outstanding government guarantees and external arrears within 21 days of the end of each month.

25. **Tax and expenditure arrears.** The Ministry of State Revenues will report on an end-of-month basis the amount of outstanding tax arrears, by the end of the following month. The reports on expenditure arrears in the format of the attached Table 4 will be compiled monthly by the MFE for the central government and the SFSI separately, and reported by the MFE to the IMF within 45 days of the end of each month for government arrears and within 10 days for SFSI arrears.

26. **Budgetary sector employment.** The MFE will provide quarterly updates on employment by ministries and on average wages within one month following the end of each quarter.

27. **Budgetary and extra budgetary data.** The MFE will report to the IMF, on a monthly basis and within seven days of the end of each month, total revenue collected separately by the SFSI, the Ministry of State Revenue and the Customs Committee. Quarterly data on budgetary execution will be reported to the IMF by the MFE and the SFSI within one month following the end of each quarter. All cash receipts, all cash expenditures (including debt-service payments), and external and domestic borrowing operations will be part of this report. Expenditure data will be provided according to both economic and functional classifications, consistent with GFS methodology. In addition, budgetary financing by the MFE will be reported by economic and functional classification on a monthly basis by the end of the following month.

28. **Non-budgetary domestic arrears.** The MFE will coordinate—in collaboration with the Ministry of Energy, the CBA, and the NSS—a report to the IMF on a monthly basis on the stock of arrears of the 50 largest enterprise debtors, which are in arrears to the banking system, and energy arrears of households and enterprises. This information is to be provided within 28 days of the end of each month.

29. **Balance of payments data.** The NSS will provide: (1) on a monthly basis detailed export and import data within 28 days of the end of each month; and (2) on a quarterly basis a balance of payments within two months of the end of each quarter.

30. **Energy sector payable and receivable debts.** The MFE will provide monthly reports on the end-of-month stock of accounts payables and accounts receivables of the consolidated energy sector (defined in paragraph 19) with a lag of no more than 28 days. It will also provide the cash flow information with a lag of 45 days as displayed in Table 5 below.[21]

31. **Privatization proceeds.** In consultation with the CBA, the MFE will provide to the IMF information on: (1) the balance on the SPA at the end of each month; and (2) all gross additions and gross withdrawals specifying the purpose of each transaction during that month. The information will be provided on a monthly basis no later than seven days after the end of each month.

32. **Other financial sector information**. The CBA will provide information on the foreign exchange market (including the official, buying, and selling exchange rates, inter-bank turnover, and the volume of CBA sales and purchases) and interest rates by maturities (including the refinance rate, the inter-bank rate and volumes, the treasury bill and coupon bond yields and volumes by maturity, and bank deposit and lending rates by maturity). The CBA will also provide data on commercial banks' prudential ratios (including liquid asset ratios, capital adequacy ratios, open foreign exchange limits, and percentage of classified loans by category). These data will be provided on a monthly basis within 21 days of the end of each month. In addition, the CBA will provide other data as specified in CBA Resolution No. 201 (December 6, 1999).

33. **Real sector.** The NSS will notify the IMF of the monthly CPI by category by the fifth day of the following month, and convey quarterly GDP estimates within two months of the end of each quarter. The CBA will also submit the monthly index of core inflation within 21 days of the end of each month.

[21] The table is in summary form. A more comprehensive table will be provided in the form of an Excel workbook (the format of which has been agreed with IMF staff).

Table 1. Armenia: Program Exchange Rates of the CBA
(As of December 31,2001)

Currency	Drams Per Currency Unit	Dollars Per Currency Unit
Austrian dollar	285.17	0.5076
Canadian dollar	352.10	0.6267
Swiss franc	338.56	0.6026
Danish krone	65.56	0.1167
Euro	500.24	0.8904
Pound sterling	816.93	1.4541
Japanese yen	4.27	0.0076
Norwegian krone	62.27	0.1108
Swedish krona	53.23	0.0947
U.S. dollar	561.81	1.0000
SDR	706.04	1.2567
Gold 1/	4994.31	8.8897

1/ Per gram.

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

2002		2003	
September	December	March	June
23.2	36.6	12.2	23.8

1/ On a calendar year basis.

Table 3. Armenia: Cumulative World Bank
SAC Disbursements 1/
(In billions of drams)

2002		2003	
September	December	March	June
8.1	19.4	11.3	11.3

1/ On a calendar year basis.

Table 4. Armenia: Arrears of State Budget and SFSI
(In billions of drams; end of period)

	2000	2001				2002 2/				2003 2/	
		March	June	September	December	March	June	September	December	March	June
Total arrears	44.3	46.3	38.5	39.1	42.2	41.4	45.2				
Total expenditure arrears	37.3	37.5	36.1	34.9	35.8	32.5	34.0				
Current expenditures	34.6	35.2	33.3	32.5	31.4	29.0	30.6				
Wages	0.5	0.4	0.4	0.4	0.4	0.3	0.3				
Subsidies 1/	0.9	0.9	0.8	0.8	0.8	0.8	0.8				
Interest	3.4	4.2	1.9	2.4	3.1	3.7	4.3				
Domestic interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0				
External interest	3.4	4.2	1.9	2.4	3.1	3.7	4.3				
Transfers	9.0	9.0	8.8	8.8	7.9	6.8	6.7				
Family allowances	4.1	4.1	4.1	4.1	3.1	2.9	2.8				
Pension contributions	1.1	1.1	1.1	1.1	1.1	1.0	1.0				
Contribution to pension fund	0.6	0.6	0.4	0.4	0.4	0.0	0.0				
Other 1/	3.3	3.2	3.2	3.2	3.3	2.8	2.8				
Goods and services 1/	20.8	20.8	21.5	20.1	19.2	17.3	18.5				
Health	12.7	12.7	12.4	11.7	11.4	11.5	11.5				
Education	1.7	1.6	1.8	1.8	2.2	2.2	2.3				
Other	6.4	6.5	7.3	6.5	5.5	3.6	4.6				
Capital expenditures 1/	2.7	2.3	2.7	2.4	4.4	3.5	3.4				
Net lending 1/	0.0	0.0	0.0	0.0	0.0	0.0	0.0				
External amortization arrears	7.0	8.8	2.4	4.2	6.4	8.9	11.2				
Memorandum items:											
Domestic expenditure arrears	33.9	33.4	34.2	32.5	32.7	28.8	29.7				
of which: social expenditures arrears	21.7	21.6	21.5	20.9	20.0	19.4	19.5				
External payment arrears	10.4	12.9	4.3	6.6	9.5	12.7	15.5				
SFSI stock of arrears	4.4	3.2	3.0	3.6	1.4	-0.2	0.0				

Sources: MOFE and staff estimates.

1/ Arrears outstanding for more than 30 days.

2/ As specified in paragraph 25 of the TMU, the authorities will compile the data for the quarter ending in September 2002, December 2002, March 2003, and June 2003 within 45 days after the end of the quarter.

Table 5. Armenia: Cash Flow of the Consolidated Energy Sector
(In billions of drams)

	2000	2001	2002 2/					2003 2/		
			Q1	Q2	Q3	Q4	Year	Q1	Q2	Year
Revenues	79.9	65.1	20.7	14.5						
Electricity revenues collected	75.3	62.8	20.0	14.5						
Revenues collected for thermal energy supply	3.6	1.0	0.4	0.0						
Non-core activities	1.0	1.3	0.3	0.1						
Expenditures	101.3	105.7	23.9	15.9						
Inputs	40.1	47.3	10.3	3.7						
Imported gas	38.4	39.0	7.9	2.0						
Nuclear fuel	1.7	8.3	2.4	1.7						
O&M costs	34.2	31.1	7.2	5.8						
Net payment of taxes accrued	17.2	14.8	4.2	4.7						
Other current expenditures	0.0	0.0	0.0	0.0						
Interest payments	5.0	4.7	0.8	1.0						
Capital expenditures	4.8	7.8	1.5	0.7						
Primary balance 1/	-13.5	-30	-1.1	0.2						
Current balance	-11.6	-28.0	-1.0	0.3						
Balance	-21.4	-40.6	-3.3	-1.4						
Financing available	21.4	40.6	3.3	1.4						
Domestic sources	2.6	19.6	1.8	0.5						
Banks	-2.2	-4.7	0.1	-2.1						
Budgetary loans	-0.6	3.2	5.0	0.1						
Nonbank loans	-9.2	15.5	-6.7	-0.9						
Tax arrears	7.1	-0.1	0.6	3.0						
Pay for shares in ArmRusgas acquired earlier	0.0	0.0	0.0	0.0						
Production reserves	4.2	5.1	2.3	2.2						
Pre-payment for electricity	-0.5	-0.3	0.4	-1.8						
Collection of old arrears	3.8	0.9	0.1	0.0						
External sources	-0.3	1.2	1.4	-1.0						
Government subsidies on external loans	4.9	7.2	0.0	2.0						
ArmRosGasProm gas, gas for equity swap	14.3	12.6	0.0	0.0						
Errors and omissions	0.0	0.0	0.0	0.0						

Sources: Armenian authorities; and Fund staff estimates.

1/ The primary balance is defined as current revenues minus total expenditures excluding interest payments and foreign-financed capital expenditures.
2/ As specified in paragraph 30 of the TMU, the authorities will compile the data for the quarter ending in September 2002, December 2002, March 2003, and June 2003 within 45 days after the end of the quarter.

ARMENIA: RELATIONS WITH THE FUND
As of July 31, 2002

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

II.	**General Resources Account**	**SDR Million**	**Percent of Quota**
	Quota	92.00	100.00
	Fund holdings of currency	107.47	116.82
III.	**SDR Department**	**SDR Million**	**Percent of Allocation**
	Holdings	9.07	n.a.
IV.	**Outstanding Purchases and Loans**	**SDR Million**	**Percent of Quota**
	Systemic transformation	15.47	16.81
	ESAF arrangements	114.29	124.23

V. Latest Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	05/23/2001	05/22/2004	69.00	10.00
ESAF/PRGF	02/14/1996	12/20/1999	109.35	109.35
SBA	06/28/1995	02/14/1996	43.88	13.50

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

	Overdue	Forthcoming				
	12/31/2001	2002	2003	2004	2005	2006
Principal		6.50	17.40	23.30	24.70	21.20
Charges/interest		0.50	0.90	0.60	0.40	0.20
Total		7.00	18.30	23.90	25.10	21.40

VII. Safeguards Assessment

Under the Fund's safeguards assessment policy, the Central Bank of Armenia was subject to a full safeguards assessment with respect to the PRGF arrangement approved on May 23, 2001. The on-sight safeguards assessment of the CBA conducted in October 2001 found the safeguards at the CBA to be generally adequate to ensure the integrity of bank resources including Fund disbursements. However, the assessment noted a number of vulnerabilities and made recommendations in the external audit mechanism, legal structure and independence, financial reporting, internal audit mechanism, and system of internal controls (ELRIC). The CBA has since implemented the recommendations on the agreed schedule. Some lower priority measures are still being implemented as planned.

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. Subsequently, the exchange rate has been allowed to float with minimal intervention by the central bank. 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.

IX. Article IV Consultations

The 2001 Article IV consultation with Armenia was concluded on May 21, 2001. Armenia will now be subject to the 24-month consultation cycle, subject to the provisions specified in SM/02/184, Supplement I (6/18/02).

X. Resident Representative

Mr. Garbis Iradian, July 2000–August 2002. Mr. James McHugh, since September 2002.

XI. Technical Assistance

The following table summarizes the Fund's technical assistance to Armenia since 1998.

Armenia: Technical Assistance from the Fund, 1998–2002 1/

Subject	Type of Mission	Timing	Counterpart
Fiscal Affairs Department			
Development of treasury	Resident Advisor	Since September 1998	MFE
Tax policy	Short-term	March 1–12, 1999	MFE and Ministry of Nature Protection
Tax administration mission	Short-term	Feb. 28–March 13, 2000	MFE and Ministry of State Revenue
Tax policy and administration	Short-term	August 7–11, 2000	MFE and Ministry of State Revenue
Tax policy and administration	Short-term	October 15–29, 2001	MFE, Ministry of State Revenue, and Customs Committee
Monetary and Exchange Affairs Department			
Monetary and foreign exchange operations	Long-term	Nov. 1997–Nov. 1998	CBA
Bank supervision	Short-term	Periodic visits 1998–1999	CBA
Monetary and foreign exchange operations	Short-term	Jan. 20–Feb. 3, 1998	CBA
Monetary policy and OPS/BKG sector issues	Short-term	Nov. 9–Nov. 13, 1998	CBA
Monetary operations and bank supervision	Short-term	February 21–March 5, 1999	CBA
Monetary operations	Short-term	Periodic visits 1999–2000	CBA
Bank supervision	Long-term	Since April 2000	CBA
Monetary policy research	Short-term	April 28–May 4, 2000	CBA
Financial sector assessment program	Short-term	September 5–22, 2000	CBA
Monetary operations, monetary policy research and bank supervision	Short-term	September 3–14, 2001	CBA
Banking system issues	Short-term	April 15–19, 2002	CBA
Banking system issues, deposit insurance, foreign exchange market development and CBA monetary operations.	Short-term	June 24-July 4, 2002	CBA
Statistics Department			
Multisector	Short-term	Oct. 26–Nov. 11, 1998	MFE, CBA, Ministry of Statistics
National accounts statistics	Short-term	August 3–16, 1999	Ministry of Statistics
Balance of payments statistics	Short-term	Sept. 7–Oct. 4, 1999	Ministry of Statistics
Data dissemination standards	Short-term	Aug. 29–Sept. 11, 2000	National Statistics Service

1/ For technical assistance prior to 1998, see EBS/98/213 (12/8/98).

ARMENIA: RELATIONS WITH OTHER MULTILATERAL ORGANIZATIONS
(As of July 31, 2002)

WORLD BANK

I. IMPLEMENTATION OF STRUCTURAL REFORM MEASURES

A. Legal Framework

The Armenian Parliament has enacted both the amended Law on Joint Stock Companies and a new Law on Limited Liability Companies. Both Laws have been prepared with the assistance of the IFC and EU, and are in compliance with international best practice. The authorities also provided for considerable strengthening of the legal and regulatory framework for bankruptcy procedures, including the amendments to the Civil Code. The government is committed to submitting a new Bankruptcy Law to Parliament before the end of 2002. The new amendments to the Law on Privatization were adopted to provide for the possibility for asset privatization jointly with the relevant land parcel. The government also finalized the new draft Concession Law and submitted it to parliament.

B. Business Environment

The government made serious progress in implementing the Action Plan for removal of administrative barriers for business and investment, and strengthening consultative mechanisms with the business community. The steps undertaken included, inter alia, consolidation, downsizing and clarification of mandates of various government inspections; enacting the new Law on Business Registration; issuing new accounting recommendations for small and medium-sized enterprises; establishment of a regulatory framework that allows privatization of urban land by business entities; and adoption of simplified procedures for obtaining site development and construction permits. The recent enterprise survey confirmed a substantial improvement in costs of doing business, incurred by the private sector, as well as a higher degree of satisfaction with government policies. Despite these significant improvements, there is still considerable scope for further reforms in the area of deregulation.

C. Energy and Infrastructure

The government adopted a new strategy for privatization of the power sector. The strategy provides for privatization of all power sector enterprises with the exception of Armenergo, the High Voltage Electricity Network Company, the nuclear power plant, Armatom, Geoenergy, and the Energy Institute. The authorities also made considerable progress in reforming the district heating system and reducing heating subsidies in the course of the 2001–02 winter.

The government has been working with the World Bank on the privatization of Electricity Distribution Companies (EDCs) since 1998, and it was originally expected that the tender would be completed by end-2001. However, changes in the international investment climate in the energy sector has resulted in all the pre-qualified firms either formally withdrawing or suspending their participation in the privatization tender, despite strong and high-level government commitment to seek common ground on the key conditions of the sale. Under these circumstances, the government revised its strategy with the objective of transferring at least the operation and management of the (now consolidated) EDC to a qualified private operator, and with the ultimate goal of preparing the EDC for full privatization within the next three to five years while also improving their financial and technical performance. This strategy had been under implementation since April, 2002. However in August 2002 the government announced the sale of the EDC to an investor which does not appear to meet the originally agreed pre-qualification criteria. The government indicated that it would ensure that the new owner contracted a qualified manager to operate the EDC.

In the irrigation and water sector there has been limited progress in improving fiscal discipline and reducing losses. The World Bank has been working with the authorities to (i) upgrade management capacity of public companies in both sectors, (ii) ensure a gradual increases in tariffs to reach cost recovery levels, (iii) provide additional investments to improve technical efficiency, and (iv) ensure that the government budget provides adequate financing of water consumed by public sector entities, as well as of all remaining subsidies in the system.

D. Education and Health

The government adopted school rationalization plans for three administrative regions and started their implementation in September 2001. The plans envisage mostly in-school rationalization, and limited consolidation of schools in urban areas. Based on preliminary data, implementation of the pilots provided for a 6.5 percent reduction in the number of classes, and for 13 percent and 10 percent reductions in the number of teachers and administrative staff, respectively. At the same time, the number of general schools converted to an improved system of budgeting and management has increased.

Regarding the health sector, the government adopted a hospital rationalization plan, which provides for a gradual reduction in hospital bed capacity by an average of 35 percent in the medium term. The number of independently operated public medical facilities will be reduced through liquidation and consolidation. In 2001 and 2002 the government also ensured a major improvement in budget financing of public health as well as of primary education.

E. Social Protection and Insurance

The government has completed several important steps to enhance its capacity for administration of family poverty benefits, including: (i) re-registration of poverty benefit recipients; (ii) beneficiary assessment of the existing benefit; and (iii) establishment of a central database for poverty benefit recipients. Despite some reduction in budget spending on poverty benefits, data from the recent household survey suggest that the government system of benefits and transfers to the poor have become an efficient instrument for reducing extreme poverty.

The government has completed the preparation of a pension reform package and presented its principles for a broad public discussion. The Draft Law on State Pensions focuses on strengthening and streamlining the pension system. It provides for significant improvements in the existing system, and inter alia: (i) equalizes the retirement age for men and women, and increases both to the age of 63; (ii) separates social insurance benefits from social pensions; (iii) eliminates most of the early retirement provisions; (iv) introduces indexation of pensions to inflation; (v) introduces a formula to link more directly benefits and contributions, with adequate provision for a minimum benefit; and (vi) provides for unified regulations of public pensions. The government is committed to have the new Pension Law adopted in 2002.

The government also adopted the new Charter of the State Social Insurance Fund, which provides for more transparency in the Fund's operations, including a transfer of its accounts to the treasury, and parliamentary approval of the Fund's budget as a part of the overall budget process.

II. LENDING

World Bank lending to Armenia to date totals $696.0 million, of which $514.2 million has been disbursed. Of the 27 IDA credits and one IBRD loan approved, 16 remain under implementation, and 12 have been closed. A third Country Assistance Strategy was presented to the World Bank's Board of Directors in May 2001, which envisaged lending of up to $150 million of IDA resources over the FY 02–04 period.

List of World Bank Lending to Armenia

	Active Projects	Credit Amount as of 12/31/01	Disbursement as of 12/31/01	Approval Date	Closing Date
Active Projects		*298.2*	*103.8*		
1.	Health	10.0	7.5	7/29/97	6/30/03
2.	SATAC II	5.0	4.7	8/26/97	12/31/02
3.	Education	15.0	14.5	11/20/97	10/31/02
4.	Agric. reform support	14.5	12.2	1/27/98	12/31/02
5.	Municipal development	30.0	12.9	6/11/98	12/31/03
6.	Title registration	8.0	4.9	10/13/98	12/31/02
7.	Electric. trans. & dist.	21.0	1.5	3/4/99	12/31/02
8.	Irrigation dam safety	26.6	10.7	6/24/99	3/31/05
9.	Transport	40.0	10.5	6/08/00	31/12/04
10.	Social Investment Fund II	20.0	4.0	5/11/00	12/31/05
11.	Judicial reform	11.4	1.0	9/14/00	12/30/04
12.	SAC IV	50.0	14.4	22/05/01	31/3/02
13.	Irrigation development	24.9	2.6	30/08/01	31/3/07
14.	Enterprise incubator	5.0	0.3	30/11/01	30/6/05
15.	Investment and export facilitation	1.0	0.0	4/16/02	12/31/05
16.	Natural resource management	8.3	0.0	6/4/02	7/31/08
Completed Projects		*388.5*	*382.8*		
17.	Irrigation rehabilitation	43.0	40.9	12/8/94	5/31/01
18.	Highway	31.0	29.6	9/14/95	12/31/00
19.	Social Investment Fund	12.0	11.1	11/9/95	12/31/00
20.	Institution building	12.0	10.7	3/30/93	11/30/97
21.	Earthquake rehabilitation	28.0	29.7	2/1/94	6/30/97
22.	Power maintenance	13.7	13.2	12/8/94	6/30/99
23.	Economic rehabilitation	60.0	64.3	2/28/95	6/30/96
24.	SAC	60.0	58.5	2/29/96	12/31/97
25.	SAC II	60.0	58.6	8/26/97	6/30/99
26.	SATAC I	3.8	2.8	2/29/96	6/30/00
27.	SAC III	65.0	63.4	12/22/98	6/30/01
28.	Enterprise development	16.8	15.4	12/24/96	7/1/02
	Total	686.7	486.6		

EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT

As of end-July 2002, the European Bank for Reconstruction and Development (EBRD) had signed six projects in the power, transport, agricultural business and financial sectors. Total cumulative commitments amounted to EUR 136.8 million.

There are two sovereign projects. First, in March 1993 the EBRD approved a EUR 64.3 million direct loan to the Armenian government for construction of the Hrazdan Unit 5 thermal power plant, partly aimed at the eventual closure of Armenia's nuclear plant in Medzamor. The government is contemplating the privatization of Hrazdan once the construction is completed. The estimated cost has been recently increased by a further US$120 million. Second, in November 1994, a EUR 25.5 million loan to build an air cargo terminal in Zvartnots airport was signed under a guarantee by the Armenian government. The airport will now to be transferred to private management.

Currently, the EBRD is actively supporting the pending introduction of private sector expertise into companies comprising the electricity distribution system. The EBRD is also in preliminary discussions with the EU about the possibility of setting up a fund with other donors to finance the closure and the replacement of the generating capacity of Medzamor. The EBRD has provided a loan to the Yerevan Brandy Company which was sold to Pernod Ricard of France. A multi-bank onlending facility of EUR11.4 million was activated in early 2000; the initial experience with one Armenian bank on the program proved highly positive, EBRD is committed to further expand lending under this facility to other banks. The EBRD is currently considering three other private sector investments in Armenia in mining, textiles and agricultural sectors. The EBRD will enhance its technical assistance to Armenian small and medium-sized enterprise projects by further involvement of the TAM program in close cooperation with the EU.

ARMENIA: STATISTICAL ISSUES

The overall quality, timeliness, and coverage of macroeconomic statistics in Armenia have improved significantly over the past few years, a process in which the Fund has been heavily involved through technical assistance from the Fiscal Affairs Department, the Monetary and Exchange Affairs Department, and the Statistics Department. An Armenia country page was added to the *International Financial Statistics* in September 2000. Further improvements are needed in real, fiscal, and external sector statistics in order to enhance the design and monitoring of economic policies. The table below (Core Statistical Indicators) shows the availability of key macroeconomic data and the authorities' publication policy.

National accounts and price statistics. The National Statistics Service has made significant changes to the national accounts methodology to bring it in line with international best practices. Significant progress has been made in developing estimates of quarterly real GDP which are now published. Basic data collection procedures have also improved, with national accounts adopting the concept of gross value based on accrued sales valued at transaction prices. However, progress has been slow in improving the compilation of national accounts at constant prices; these data are still derived by re-valuing current output and inputs at previous year prices instead of deflating these by the relevant components of the producer price index. Data on the consumer price index and wages are reported on a timely basis, but wage data are still limited to the public sector.

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. However, the system to track arrears is cumbersome, there is a 45-day lag in the compilation of the data, and the reliability of the data is questionable. Daily revenue and cash expenditure data for the central government are available with a lag of one to two days. The treasury is undertaking a comprehensive reform of treasury systems including the introduction of an internal auditing system in the line ministries and their budgetary institutions. A single treasury account (TSA) was introduced in 1996, and all bank accounts held by budgetary institutions have been closed, except for the Project Implementation Units which are required by donors to operate with commercial banks' accounts. With this exception, all government receipts and payments are processed through the TSA, although there are still shortcomings on the timeliness and quality of data on the transactions of local governments. Classification of government transactions by function and economic category are in line with the GFS, and monthly data on central government operations are disseminated within 40 days of the end of the month. However, the budget presentation and the classification of items under the economic and functional classification of expenditures need to be made more transparent; for instance 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 owing to the need to identify manually transactions among central government, local government, and the Social Insurance State

Fund. Armenia has not yet provided GFS data to STA for publication in the GFS Yearbook or in the IFS.

Money and banking statistics. Money and banking statistics are provided on a timely basis. Daily data on the accounts of the CBA are provided with a one-day lag, while weekly data on the monetary survey are provided with a one-week lag. Interest rate data are provided with a one-month lag. A new chart of accounts, relying on 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.

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 available with a few weeks' lag. Quarterly balance-of-payment data are available with a two-month lag. However, data on private non-guaranteed external debt and on direct investment abroad are not compiled, and capital outflows are likely to be underestimated. The absence of a fully established (comprehensive and updated) business register in Armenia hampers a wider coverage of transactions and institutional units.

Core Statistical Indicators
(As of August 13, 2002)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Monetary Survey	Interest Rates	Consumer Price Index	Exports/ Imports	Balance of Payments	Central Government Balance	GDP	External Debt
Date of latest observation	8/9/02	8/9/02	8/8/02	8/2/02	July 2002	July 2002	April 2002	Q4 2001	July 2002	June 2002	December 2002
Date received	8/12/02	8/12/02	8/12/02	8/12/02	8/13/02	7/29/02	6/5/02	3/1/02	8/5/02	8/7/02	5/6/02
Frequency of data	Daily	Daily	Daily	Weekly	Weekly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Frequency of reporting	Weekly	Weekly	Weekly	Weekly	Weekly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Source of update	CBA	CBA	CBA	CBA	CBA	NSS	NSS	NSS	MFE	NSS	MFE
Mode of reporting	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	Fax
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of publication	Daily	Quarterly	Quarterly	Monthly	Monthly	Monthly	Monthly	Annually	Monthly	Quarterly	Annually

Abbreviations: CBA (Central Bank of Armenia), MFE (Ministry of Finance and Economy), NSS (National Statistics Service).

ARMENIA: BANKING SYSTEM—RECENT DEVELOPMENTS AND FUTURE AGENDA

Armenia's banking system comprises of 28 banks, three of which are foreign owned. There are no state-owned banks; the last state-owned bank was privatized in 2001.The foreign banks operate subsidiaries incorporated in Armenia; there are no branches of foreign banks. The largest five commercial banks (by asset size) account for 50 percent of total assets of the system, 43 percent of loans, and 57 percent of deposits.

Notwithstanding the continued high real GDP growth in recent years, there is still a **low level of financial intermediation and monetization.** At end-2001, the ratio of private sector credit-to-GDP was 8.0 percent, and the ratio of broad money to GDP was just 13.4 percent, well below the CIS average of 15.9 percent (Table 1). This reflects a number of factors, including inadequate bank capitalization; increasing credit risk in the midst of enterprise failures; consumer credit defaults; inadequate credit evaluation methods; and lack of progress on legal reforms, particularly on administrative procedures for enforcement of collateral.

Table 1. Armenia: Selected Indicators of Financial Development
(In percent; 1998–2001 average)

	Total Deposits/GDP 1/	Broad Money/GDP	Credit to the Private Sector/GDP	Foreign Currency/Broad Money
Armenia	7.3	12.3	9.1	47.5
CIS	9.7	14.8	17.5 2/	31.9

Sources: Central Bank of Armenia; and Fund staff estimates.
1/ The CIS average excludes Tajikistan, Turkmenistan, and Uzbekistan.
2/ Excluding Turkmenistan (credit-to-GDP of 68 percent) the CIS average would be 12.9 percent.

The economy remains highly dollarized, with U.S. dollar deposits accounting for 80 percent of total deposits. Currency substitution has been increasing in Armenia ever since the break-up of the Soviet Union. Currency substitution is mostly explained by a general dearth of savings instruments and political and economic uncertainty. Since end-2001, currency substitution has declined slightly and is expected to decline further during the next 2 years amid further administrative, structural, and legal changes initiated by the central bank. Continued low inflation and stable exchange rates should also support the decline in currency substitution.

Financial indicators suggest a reasonably strong banking system, even though they show deterioration in recent years (Table 2). Capital adequacy remains at a comfortable level, although it has declined sharply in the last few years. Banks' liquidity coverage seems adequate, as evidenced by investments in government securities lacking more profitable lending opportunities elsewhere in the economy. Loan portfolios seem reasonably healthy; reported non-performing loans have declined considerably since 1998, although the decline in part reflects recent loan write-offs as banks were placed under interim administration and loan provisioning increased. Earnings of the banking system have, however, continued to decline in recent years, with only twelve banks reporting profits in the first quarter of the year and with net losses for the first half of 2002 amounting to AMD 7.5 billion. These trends may reflect increasing asset problems attributed to compression of interest rate margins, increasing levels of non-earning assets, high collection costs, and high exposure to the energy sector. In particular, the recent problems of the second largest bank raised concerns about possible systemic risks.[22]

Table 2. Armenia: Selected Indicators of Banking System Soundness 1998–2002
(In percent, unless otherwise indicated)

	Dec. 1998	Dec. 1999	Dec. 2000	Dec. 2001 1/	June 2002 1/	
Capital adequacy						
Total regulatory capital to risk-weighted assets	29.8	27.8	25.0	13.6	6.9	27.3
Asset composition and quality						
Exposure to the energy sector	30.6	12.1	13.3	8.1	10.4	10.1
Non-performing loans to gross loans	23.3	19.9	20.5	16.7	12.6	11.8
Earnings and profitability						
ROA (profits to period average assets)	2.0	2.8	-0.9	-10.3	-17.5	-1.2
Liquidity						
Liquid assets to total assets	37.8	39.7	30.5	33.1	37.9	40.2
Liquid assets to total short-term liabilities	83.3	100.1	86.1	80.4	78.6	105.5

Sources: Central Bank of Armenia; and Fund staff estimates.
1/ Indicators in the second column under June 2002 exclude seven banks in interim administration.

A restructuring process began in the late 1990s aimed at banking-system consolidation, enhanced banking supervision, restructuring and privatization of state-owned banks, increased bank capitalization, and improved legal environment through amendments to the Law on the Central Bank, the Law on Banks and Banking Activity, and the Law on Bankruptcy of Banks. The banking supervision department of the central bank has received substantial technical assistance in these areas, including through foreign resident advisers. As a result of the amendments to the central bank law, the central bank can act more quickly in dealing with problem banks, without first having to resort to the courts. As of mid-2002, eight of the 28 banks in the system were placed under interim administration. In most cases, the demise of these banks has been the result of insider abuse. The eight banks under interim administration account for 18 percent of total assets of the banking system, 26 percent of total loans, and 32 percent of total deposits. A new loan-classification system was implemented in 2001, collateral and loan-valuation methods were further developed, subjective assessment methods were introduced in banking supervision, and new provisioning rules were adopted. Minimum capital requirements for existing banks were increased from US$1.3 million to US$1.65 million in July 2002. These requirements are scheduled to increase to US$2 million by mid-2003 and to US$5 million (the same level as is currently required for new banks) by mid-2005. The authorities are also planning to introduce a deposit insurance scheme that will begin collecting premiums from banks in mid-2003.

The 2000 FSAP report on Armenia concluded that the financial system could be vulnerable to several potential internal and external macroeconomic shocks, but that a systemic crisis was unlikely and would have only a limited effect on the economy given the small size of the banking system. The report noted that even though indicators suggest a relatively healthy financial system, the underlying situation contained severe weaknesses and vulnerabilities related in particular to credit and foreign-exchange risk. The report also noted that unless the financial infrastructure was strengthened, it would fail to deliver the growth-generating intermediation that was urgently needed. Furthermore, weaknesses in the banking system

[22] In February 2002, the manager of a major branch of the second largest commercial bank embezzled about US$2.5 million, leading to a run on the bank. The bank was merged with a smaller bank, the merged bank was placed under interim CBA administration, and the CBA subsequently extended a systemic type loan of US$5.5 million to the merged bank to help stabilize the situation.

could be sharply worsened by, and could in turn exacerbate, any macroeconomic crisis caused by external or internal shocks.

The FSAP report pointed to the need for further consolidation of the banking system, enhancement of resource mobilization, and increased efficiency of banks by exploiting economies of scale. Progress in these areas requires a prompt exit strategy for failed banks as well as macroeconomic and structural polices conducive to the consolidation of the banking system and the development of the private sector. The report also stressed the need to strengthen the legal framework and administrative procedures for enforcement of collateral. Most of the recommendations of the report have been or are in the process of being implemented through legislative and administrative initiatives and changes in banking supervision procedures and provisioning, including a scheduled increase in banks' minimum capital requirements.

Notwithstanding the efforts undertaken by the authorities, banking system performance has deteriorated since 2000, the degree of dollarization remains high, and the central bank remains saddled with long liquidation processes for problem banks.[23] The small size of most banks preclude them from attaining economies of scale as well as incurring large fixed costs in, for example, information technology. Looking ahead, the authorities will need to:

- Improve the quality and efficacy of banking supervision, particularly by placing less emphasis on quantitative assessments of banks, closely monitoring and enforcing prudential norms, and applying penalties to noncompliant banks as stipulated by the law;
- Introduce legislation giving additional liquidation powers to the central bank while shortening the duration of interim administrations;
- Resolve the situation of the banks currently under interim administration before the deposit insurance scheme begins collecting premiums in mid-2003;
- Promote a speedy consolidation of banks;
- Improve loan classification and provisioning rules; and
- Further develop the payments system and spot market operations.

The legal environment could be usefully strengthened by enhancing the transferability of property rights and their use as collateral, enforcing bankruptcy laws, and moving ahead with the privatization of the remaining state-owned companies. These steps should be supported by corporate restructuring, improvements in transparency and governance, and prudent macroeconomic policies. Over time, as perceived risks (measured by country and currency risk premia) decline, lending interest rates should follow suit, allowing for further expansion of credit to the private sector and financial deepening.

[23] The Armenian Bank Bankruptcy Law allows banks to be placed in interim administration for three years initially, with the possibility of an extension of another three years.

Statement by the IMF Staff Representative
September 25, 2002

1. The following information has become available since the issuance of the staff report (SM/02/170) on September 12. It does not change the thrust of the staff appraisal.

Prior Actions

2. The authorities have confirmed that the two outstanding prior actions listed in Table 2 of the Memorandum of Economic and Financial Policies (repayment of the loan to the budget and elimination of external arrears to Russia and Turkmenistan) have been implemented. More specifically, the loan for AMD 4.9 billion extended to the energy sector in the first quarter of 2001 was repaid to the Treasury on September 16, 2002. As part of a contract signed between the Armenian and the Russian authorities in July 2002, understandings were reached on the clearance of interest arrears and deferral of principal arrears until the end of this year. Regarding Armenia's external debt arrears to Turkmenistan, the authorities of both countries have been negotiating since August 2002 the settlement of all of Armenia's debt to Turkmenistan through the provision of goods. They are currently discussing the list of goods that would be supplied and their respective values.

Recent Developments

3. Earlier this month, the World Bank informed the Armenian authorities that the release of the US$20 million "floating" tranche of the Fourth Structural Adjustment Credit, expected in the fourth quarter of this year, was put on hold because of uncertainty about the effects of the sale of the electricity distribution company to a non-strategic investor. As specified in the technical memorandum of understanding, the program has adjusters in the event of a shortfall in external financing. In the meantime, the World Bank is proceeding with the Fifth Structural Adjustment Credit. Given the importance of the energy sector to the budget and the economy, the staffs of the Fund and the Bank have urged the authorities to ensure that the management selected for the company is fully qualified and able to assure a reliable and cost-efficient supply of electricity. The authorities are aware that this delay in foreign financing will require the formulation of a tighter budget for 2003 which should give priority to social expenditures and the clearance of domestic arrears. Discussions on the 2003 budget will be held during a staff visit in late October.

4. During the first seven months of the year, the average level of wages rose by 11 percent and the unemployment rate fell from 11 percent to 8.3 percent. At end-August 2002, the value of the dram vis-à-vis the U.S. dollar was almost unchanged compared to its value at end-December 2001.

5. The authorities have confirmed that they consent to the publication of the staff report, including the letter of intent, the memorandum of economic and financial policies, and the technical memorandum of understanding, as well as the PRSP preparation status report and the associated joint staff assessment.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/118
FOR IMMEDIATE RELEASE
October 9, 2002

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

IMF Concludes 2002 Article IV Consultation with the Republic of Armenia

On September 25, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Armenia.[1]

Background

Armenia has experienced rapid growth with low inflation in recent years. Since 1999, real GDP has grown at an average rate of 8 percent per year and inflation has remained below 4 percent. Economic growth has been primarily export-led, fueled by continued expansion in agriculture, manufacturing, construction, and tourism industries. The official unemployment rate declined from 11.7 percent at end-2000 to 9.5 percent by mid-2002. According to the 2001 household survey, the incidence of poverty, while still high, declined significantly between 1998 and 2001.

The external current account deficit has more than halved since 1998, reflecting strong export growth and continued subdued import demand. This adjustment has been supported by a 19 percent real effective depreciation of the dram. Gross international reserves have remained at a comfortable level, surpassing 3.5 months of imports of goods and services during the last three years. There has also been an improvement in external-debt indicators. At end-2001, the

[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 September 25, 2002 Executive Board discussion based on the staff report.

net present value of debt was equivalent to 129 percent of exports of goods and services, down from 154 percent in 1999.

Fiscal performance, however, has been mixed. The central government deficit on a commitment basis narrowed from 7.2 percent of GDP in 1999 to 3.9 percent of GDP in 2001, but it remains high. Tax revenues at 14.4 percent of GDP in 2001 have remained low, reflecting insufficient improvements in tax and customs administration. Tax revenue collections, however, began to increase in the first half of 2002 as a result of important tax and customs administration reforms implemented earlier in the year.

There has been progress in implementing structural reforms. Key measures implemented in 2001 include the passing of a financial disclosure law for senior public officials and a treasury law, setting up an automated VAT audit system, and introducing legislation aimed at strengthening the central bank's ability to deal with problem banks. In addition, the authorities approved a new civil service law, established an internal audit unit at customs, and developed an anti-corruption strategy in collaboration with donors.

The objectives of the authorities' program for the period July 2002–June 2003 are to maintain a growth rate of real GDP of at least 6 percent and to keep inflation at 3 percent or less. Tax revenues are projected to increase by 0.5 percent of GDP per year in 2002–03, the fiscal deficit on a commitment basis is expected to decline to 2–2.5 percent of GDP in 2002–03, and expenditure arrears will be eliminated. The program incorporates increases in government wages, social sector spending, and public investment. The central bank will continue to guide its monetary policy by adherence to a reserve money corridor and will maintain a flexible exchange-rate policy.

Structural reforms under the program focus on (i) improving tax and customs administration, (ii) resolving the situation of the banks under interim administration and promoting confidence in the banking system, and (iii) enhancing transparency and governance. The authorities are expected to finalize a financial rehabilitation plan for the energy, water, and irrigation sectors, and focus on privatization, selecting competent operators, and bringing tariff rates to cost-recovery levels. Over the medium term, the expenditure framework and the Poverty Reduction Strategy Paper (PRSP) contemplate higher social and infrastructure spending.

Prospects for the Armenian economy remain favorable, but several challenges remain. To sustain the high rates of growth experienced in recent years and to further reduce poverty, inequality, and unemployment, Armenia needs to increase revenue collection and spending on basic infrastructure and on the social sectors, strengthen the banking system, and reduce corruption and red tape. Property rights need to be strengthened, as well as the enforcement of bankruptcies and contracts. Private sector growth will hinge on enhanced financial intermediation, further bank consolidation, and increased ability of banks to collect collateral. Corruption needs to be reduced to ensure that the fruits of rapid growth are distributed more evenly among the population; the recently drafted anti-corruption strategy is an important step in that direction.

Executive Board Assessment

Executive Directors welcomed the authorities' success in keeping inflation low and the exchange rate stable, improving the external current account balance, and creating an environment conducive to an increase in real incomes and rapid output growth. However, while macroeconomic performance has been strong, policy performance in 2001 was mixed. Directors expressed particular concern that there had been slippages in the implementation of key structural policies; that tax revenue collection had fallen short of expectations—in part a result of inadequate auditing of enterprises and persistent tax evasion; that budgetary arrears had not been cleared; and that the banking system remained fragile.

Directors welcomed recent fiscal and energy sector measures as important steps that have begun to yield positive results. They emphasized, however, that the authorities would need to forcefully pursue structural reforms. Directors attached particular priority to progress in tax administration; reform in the energy, water, and irrigation sectors; and the clearance of budgetary arrears. They called for efforts to establish a stronger, more equitable and transparent regulatory and judicial infrastructure, and stressed the importance of continuing steps to fight corruption, which would strengthen the credibility of state institutions and contribute to private sector growth. Directors urged the authorities to strengthen program ownership and fully adhere to targets under the second annual program under the Poverty Reduction and Growth Facility (PRGF) arrangement.

Directors welcomed the targeted reduction in the budget deficit in 2002. They called for ambitious—and in the view of some Directors, more ambitious—revenue efforts and a strong focus on non-grant receipts. In this connection, Directors encouraged the authorities to strengthen tax and customs administration, fight tax evasion, and ensure that all taxpayers are treated in accordance with the law. They considered that the revenue impact of the airport free-trade zone should be monitored vigilantly. Directors emphasized that prioritization of expenditures and clearance of arrears are essential to enhance the government's ability to finance poverty reduction programs. They agreed that the further reforms anticipated in the area of expenditure control and budget management would lay the groundwork for an improved composition of public spending, including an increase in social spending as a share of GDP.

Directors welcomed the steps taken in 2002 to improve the performance of the energy, water, and irrigation sectors. They stressed the need to finalize the financial rehabilitation plan for these sectors, bring tariff rates in line with cost recovery levels, and to eliminate their quasi-fiscal deficits. Directors noted the importance of ensuring that the recent sale of the electricity distribution company results in improved efficiency and a more reliable supply of electricity. Energy sector developments should continue to be subject to close monitoring and review under the program, to ensure that these do not negatively impact macroeconomic performance. Some Directors would have preferred to retain a performance criterion on the energy sector balance and encouraged reconsideration of this in the future.

Directors considered the current floating exchange rate system appropriate. They agreed that monetary policy should remain focused on maintaining price stability through, inter alia, keeping reserve money within a target corridor. At the same time, in light of the uncertainties of gauging money demand in Armenia at the current juncture, the central bank should also continue to monitor inflation developments directly. They noted the importance of a supportive fiscal policy to achieve the authorities' monetary goals.

Directors welcomed the measures being taken to strengthen banking supervision and resolve the situation of banks under interim central bank administration, which were steps in the direction of enhancing the health and efficiency of the banking system. However, financial intermediation remains shallow, and weaknesses in the legal system hamper the collection of collateral and the enforcement of bankruptcy procedures. Directors emphasized the need for a prompt restructuring of the financial sector, a reinforcement of banking supervision, and an appropriate legal framework to deal with problem banks and the collection of collateral. They commended the authorities' adoption of a resolution on anti-money laundering and establishment of a committee to work on this issue, and looked forward to the prompt implementation of measures in this area.

Directors were encouraged by the recent increase in real incomes of households, the reduction in unemployment, and the improvement in poverty indicators. However, poverty remains high, and further progress in this area will depend on improving public finances, targeting social expenditures better, and adopting measures to enhance governance and the business environment. Regarding the PRSP Preparation Status Report and the associated Joint Staff Assessment, Directors highlighted the importance of linking the medium-term expenditure framework effectively with the PRSP; they encouraged the authorities to assume full ownership of the PRSP and finalize a high quality poverty reduction strategy by the end of this year. Directors encouraged the authorities to follow up on the recommendations of the recent anti-corruption report and intensify efforts to apply laws and regulations in a consistent manner.

Lastly, directors commended Armenia for maintaining a liberal trade regime and applying for accession to the World Trade Organization. They welcomed the recent decline in external debt ratios and the authorities' efforts to reduce the stock of nonconcessional debt, all of which will provide debt service savings that can be used to finance higher social expenditures. They also welcomed the regularization of external arrears.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Republic of Armenia: Selected Economic Indicators, 1999–2003

	1999	2000	2001	2002 Prog.	2003 Proj.
National income and prices					
Real GDP growth	3.3	6.0	9.6	7.5	6.0
Gross domestic product (in billions of drams)	988	1,031	1,175	1,301	1,421
Gross domestic product (in millions of U.S. dollars)	1,847	1,912	2,119	2,300	2,515
Gross National Income per capita (in U.S. dollars)	655	664	763	814	875
Inflation (end of period)	2.1	0.4	3.0	3.0	3.0
Investment and saving (in percent of GDP)					
Investment	17.9	19.7	19.2	21.4	23.2
National savings	1.3	5.1	9.8	12.7	14.5
Money and credit (end of period)					
Broad money	13.6	25.8	15.0	14.3	12.5
Commercial banks' 3-month lending rate (in percent) 1/	34.5	28.6	27.7	24.6	...
Central government operations (in percent of GDP)					
Revenue and grants	19.3	16.5	17.1	19.5	19.8
of which: tax revenue	16.1	14.7	14.4	15.0	15.5
Expenditure and net lending	26.5	22.8	21.0	21.5	22.2
Overall balance (commitment basis)	-7.2	-6.4	-3.9	-2.1	-2.5
Overall balance (cash basis)	-5.5	-4.6	-4.0	-3.3	-3.5
Primary balance of the energy sector	-0.8	-1.3	-2.5	-0.5	0.0
External sector					
Current account (in percent of GDP)	-16.6	-14.6	-9.5	-8.7	-8.7
NPV of external debt to exports ratio 2/	154	135	129	123	96
Debt service ratio 3/	14.3	10.6	9.7	10.5	13.3

Sources: Armenian authorities; and IMF staff estimates and projections.
1/ End of period. For 2002, the column displays the actual for June.
2/ In percent of the three-year moving average of exports of goods and services centered on the previous year.
3/ In percent of exports of goods and services.

INTERNATIONAL MONETARY FUND

NEWS BRIEF

FOR IMMEDIATE RELEASE

News Brief No. 02/101
FOR IMMEDIATE RELEASE
September 30, 2002

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

IMF Completes First and Second Review of Armenia's PRGF Arrangement and Approves Request for Waiver of Performance Criteria

The Executive Board of the International Monetary Fund (IMF) completed the first and second review of Armenia's economic performance under a three-year arrangement under the Poverty Reduction and Growth Facility and approved the request for waiver of performance criteria.

The Executive Board decision enables Armenia to draw an amount equivalent to SDR 20 million (about US$26 million) under the arrangement.

The PRGF arrangement was approved on May 23, 2001 (see Press Release No. 01/25) in a total amount of SDR 69 million (about US$91 million). So far, Armenia has drawn SDR 10 million (about US$13 million).

After the Executive Board's discussion on Armenia, Mr. Eduardo Aninat, Deputy Managing Director and Acting Chairman, stated:

"In recent years, Armenia has experienced rapid growth, low inflation, an increase in real incomes, reduced poverty, and narrowing current account deficits. In 2001, however, tax revenue collection was weak, and important reforms to enhance the efficiency and commercial viability of the energy sector were delayed. Corrective measures taken in those areas in 2002 have already yielded some positive results.

"Armenia's fiscal program for 2002–03 targets further improvements in the tax system to increase revenue, and these are crucial to reinforce fiscal sustainability and increase the scope for poverty reducing spending. The program also provides for a better prioritization of expenditures, a reduction in the overall fiscal deficit, and the clearance of domestic expenditure arrears. Forceful movement forward with these reforms now is critical to ensure sustained growth, and poverty reduction.

"Monetary and exchange rate policies remain sound, and measures are being taken to improve banking supervision and resolve the situation of eight intervened banks. With its new supervisory capacity, the central bank is equipped to deal expeditiously with the very important issue of the problem banks and to improve supervision. It should also move ahead with measures to enhance governance and promote the consolidation of the banking system.

"In the energy, water and irrigation sectors, continued close cooperation with the World Bank and other agencies should lead to improved efficiency, expanded private sector participation, and enhanced and more cost-effective service delivery. In the meantime, further progress is required to eliminate the chronic deficits in those sectors, and prevent the emergence of tax and payments arrears.

"The progress made by Armenia in developing its poverty reduction strategy provides a sound basis for continued concessional assistance by the Fund. Careful prioritization and costing of poverty reduction measures will be called for, to ensure that such measures are linked in a truly effective manner to the medium-term expenditure framework. Measures to improve governance in a wide range of areas will also strengthen the business environment, encourage further private sector development, and support poverty reduction efforts.

"The recent measures taken to improve the fiscal position and the performance of the energy sector, and the formulation of an ambitious official economic program for 2002–03 are especially welcome. Strong performance under the program will be essential to address the key economic challenges facing Armenia and mobilize support for a successful poverty reduction strategy," Mr. Aninat said.