

Republic of Armenia: Fourth Review Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion—Staff Report; Staff Statement; and Press Release on the Executive Board Discussion

In the context of the fourth review under the Poverty Reduction and Growth Facility and request for waiver of performance criterion, the following documents have been released and are included in this package:

- the staff report for the fourth review under the Poverty Reduction and Growth Facility and request for waiver of performance criterion, prepared by a staff team of the IMF, following discussions that ended on **October 5, 2003**, with the officials of the Republic of Armenia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on November 6, 2003.** 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 **November 24, 2003** updating information on recent developments.
- a Press Release summarizing the **views of the Executive Board as expressed during its November 24, 2003 discussion** of the staff report that completed the request and review.

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

Joint Staff Assessment of the Poverty Reduction Strategy Paper
Letter of Intent sent to the IMF by the authorities of the Republic of Armenia*
Memorandum of Economic and Financial Policies by the authorities of the
Republic of Armenia*
Poverty Reduction Strategy Paper
Technical Memorandum of Understanding*

*May also be included in Staff Report

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF ARMENIA

**Fourth Review under the Poverty Reduction and Growth Facility and Request for
Waiver of Performance Criterion**

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

Approved by Julian Berengaut and Martin Fetherston

November 6, 2003

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ACRONYMS

ASYCUDA	Automated System for Customs Data
CBA	Central Bank of Armenia
DSA	Debt Sustainability Analysis
EBRD	European Bank for Reconstruction and Development
ESAF	Enhanced Structural Adjustment Financing
EU	European Union
EU2	European II Department
EUR	Euro
FAD	Fiscal Affairs Department
GFS	Government Finance Statistics
IAS	International Accounting Standards
IFS	International Financial Statistics
MEFP	Memorandum of Economic and Financial Policies
MFE	Ministry of Finance and Economy
MTEF	Medium-Term Expenditure Framework
NCE	Noncommercial Enterprise
NDA	Net Domestic Assets
NGO	Nongovernmental Organization
NIR	Net International Reserves
NPV	Net Present Value
NSS	National Statistics Service
PDR	Policy Development and Review Department
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
SAC	Structural Adjustment Credit
SDDS	Special Data Dissemination Standard
SDR	Special Drawing Right
SFSI	State Fund for Social Insurance
SPA	Special Privatization Account
STS	State Tax Service
VAT	Value-Added Tax

EXECUTIVE SUMMARY

Armenia's impressive economic performance continues in 2003 with double-digit economic growth, low inflation, and declining public debt ratios. All but one of the end-June 2003 quantitative performance criteria under the PRGF-supported program were met and all structural measures were implemented on time or with a small delay. The ceiling on the stock of domestic expenditure arrears was exceeded by a small margin because of verification problems and technical delays in expenditure execution. Structural reforms included measures to enhance tax administration, strengthen expenditure control, resolve one intervened bank, and tackle financial problems in energy companies.

The priorities in the period ahead comprise revamping the tax system and strengthening tax and customs administration, improving fiscal transparency, strengthening the banking system, finalizing an effective anti-corruption strategy, and tackling remaining inefficiencies in the energy, water, and irrigation sectors.

The program includes measures to shore up tax collections, enhance the efficiency of the VAT system, improve customs operations, ensure proper reporting and accountability in noncommercial enterprises (NCE), proceed with the resolution of the two remaining intervened large banks, and bolster corporate governance in state-owned energy companies. The authorities are also expected to finalize and adopt an effective anti-corruption strategy by year-end.

The 2004 draft budget envisages a further rationalization of nonpriority expenditures and increases in social and domestically-financed infrastructure expenditures while containing the fiscal deficit at no more than 2.5 percent of GDP. The authorities should continue seeking additional donor financing to fund fully the public investment objectives of the PRSP.

The monetary program for 2003–04 envisages a cautious monetary policy aimed at keeping inflation low and maintaining the current floating exchange rate system. The central bank is expected to keep foreign exchange market intervention at a minimum and increase the use of domestic instruments to enhance the effectiveness of monetary policy.

If the authorities continue with the reform effort, Armenia's medium term economic outlook remains favorable and the risks to the program appear manageable. Lower external financing in years to come will need to be compensated by fiscal consolidation through higher tax revenues and a sound expenditure policy that prioritizes social and infrastructure needs. The authorities will also need to press ahead with the aforementioned priorities to improve the business climate and foster private investment.

In view of the strength of the authorities' program and the fact that the deviation from the programmed level of arrears was minor, the staff supports the authorities' request for a waiver of the end-June performance criterion on the stock of domestic expenditure arrears and for the completion of the fourth review under the PRGF arrangement.

I. INTRODUCTION

1. The Executive Board concluded the third review under the Poverty Reduction and Growth Facility (PRGF) arrangement on April 2, 2003 (IMF Country Report No. 03/93).¹ At that time, Directors commended the authorities for the successful implementation of macroeconomic and structural policies that had kept inflation low, reduced the fiscal and external current account deficits, and created an environment conducive to strong economic growth. Directors encouraged the authorities to improve tax and customs administration and budget reporting, strengthen banking supervision, proceed with further reforms in the energy sector, and prepare an effective anti-corruption strategy.
2. Discussions on the fourth review of the PRGF arrangement were held in Yerevan during missions in July and September 2003.² In the attached Letter of Intent (Attachment I), the authorities request the completion of the fourth review and seek a waiver for the nonobservance of the end-June 2003 performance criterion on the stock of domestic expenditure arrears. The accompanying Memorandum of Economic and Financial Policies (Attachment II) describes the progress made this year in implementing the program and sets out the policy framework through June 2004. The program is broadly in line with the recently approved PRSP. Armenia's structural reform agenda is also supported by the World Bank Group, the European Bank for Reconstruction and Development (EBRD), and international donors. Appendix I summarizes Armenia's relations with the Fund including technical assistance provided and assessments of Standards and Codes. Appendices II and III describe relations with the World Bank and the EBRD, respectively. Appendix IV discusses the quality and timeliness of key economic data.

II. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

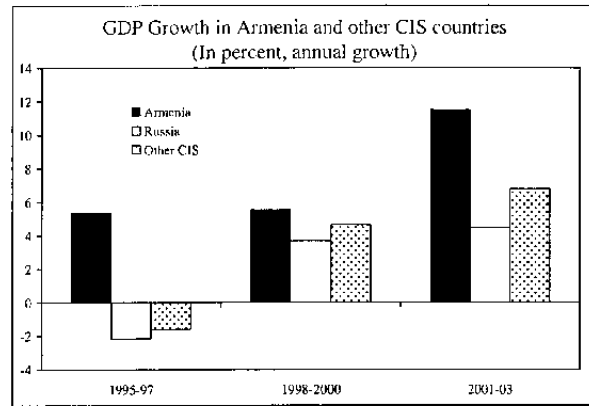
3. The **political situation** has stabilized after contentious general elections earlier this year. Following the May 25 parliamentary elections, the National Assembly endorsed a pro-presidential three-party coalition, the Prime Minister and the Minister of Finance were reconfirmed in their positions, and the sporadic demonstrations by the opposition subsided. The new government's program, endorsed by parliament in July, maintains a pro-reform

¹ Armenia's three-year PRGF arrangement for SDR 69 million (75 percent of quota) was approved on May 21, 2001 (IMF Country Report No. 02/73). SDR 40 million have already been disbursed and SDR 10 million will be available upon completion of the fourth review (Table 1).

² The missions met with the President, Mr. Kocharian; the Catholicos of the Armenian Apostolic Church; the Prime Minister, Mr. Margarian; the Minister of Finance and Economy, Mr. Khachatryan; the Chairman of the Central Bank, Mr. Sargsyan; the Minister of Energy, Mr. Movsesian; other senior officials; and representatives of the donor community, nongovernmental organizations (NGOs), and the private sector. The Fund staff team comprised Mr. Gelbard (head), Ms. Westin, Mr. York, Mr. Beddies, Ms. George (all EU2); Mr. Poddar and Mr. Simone (FAD); and Ms. Redifer (PDR). Mr. McHugh, the Fund's resident representative, assisted the missions.

policy stance and is in line with the PRSP. Negotiations with Azerbaijan on the Nagorno-Karabakh conflict have not yet resumed. There have been discussions with Turkish officials on possible steps to improve relations, but the lifting of the trade blockade remains uncertain.

4. Armenia's **economic performance** has continued to exceed expectations. Real GDP growth accelerated to 15.2 percent during the first 9 months of 2003. About one-half of such growth originates in the unusually high level of donor-financed investment, while the rest reflects a booming export sector and deepening import substitution.³ The twelve-month rate of inflation rose from 2 percent at the end of 2002 to 7.5 percent in September 2003, reflecting a 17 percent increase in the price of bread between June and September.⁴ All the other CPI components displayed little change during the twelve months through September. For the year as a whole, the projections for real GDP growth and inflation have been revised upwards to 12 percent and 4 percent, respectively (Table 2).



	2000	2001	2002	2003 Proj.	2004 Proj.
	(In percent of GDP, unless otherwise indicated)				
Real GDP growth (in percent)	6.0	9.6	12.9	12.0	7.0
Investment	18.6	19.8	21.0	22.2	20.1
Inflation (end of period, in percent)	0.4	2.9	2.0	4.0	3.0
Fiscal balance (commitment basis)	-6.4	-3.8	-0.6	-2.0	-2.5
Broad money growth (end of period, in percent)	38.6	4.3	34.0	12.4	12.1
External current account	-15.0	-10.0	-6.6	-7.7	-6.9
Gross international reserves (in months of imports)	3.8	3.6	4.7	3.9	3.6

Sources: Armenian authorities; and Fund staff estimates.

5. The **PRGF-supported program** remained on track during the first half of 2003. All but one of the quantitative performance criteria for end-June 2003 were met and all structural measures envisaged for implementation during April 2003–June 2003 were carried out on time or implemented with a small delay (Tables 3 and 4). The end-June 2003 performance criterion on the stock of domestic expenditure arrears (targeted at zero) was exceeded by a small margin because of verification and technical problems in handling some expenditures. As envisaged under the program, the authorities adopted measures in the second quarter of

³ A U.S.-based private foundation has committed funds for investment in housing, roads, and cultural sites equivalent to 2 percent and 3 percent of GDP in 2002 and 2003, respectively.

⁴ This item has a weight of 18 percent in the consumer price index.

2003 to strengthen expenditure control and the stock of arrears at end-August 2003 fell to AMD 0.2 billion.⁵

6. **Fiscal policy** remained prudent in the first half of 2003 and the targets on the cash deficit and nominal tax revenues were met. The fiscal deficit on a commitment basis during the first half of 2003 was equivalent to 1.7 percent of GDP compared to 3.1 percent under the program. This reflected lower-than-budgeted expenditures because of capacity constraints in project implementation units and a harsh winter (Table 5). The fiscal deficit for the year as a whole is projected at 2 percent of GDP. Although tax revenues increased by 12.7 percent in the first three quarters of 2003 compared with the same period last year, they are not keeping up with the unanticipated expansion in economic activity because of high growth in nontaxed sectors as well as weaknesses in tax and customs administration (Box 1).

Box 1. Armenia's Tax Revenue Performance

While nominal tax revenue has been improving since 2000, performance relative to GDP has been disappointing. This reflects weaknesses in tax administration as well as recent high growth in nontaxed activities such as re-exports of processed diamonds and grant-financed construction.

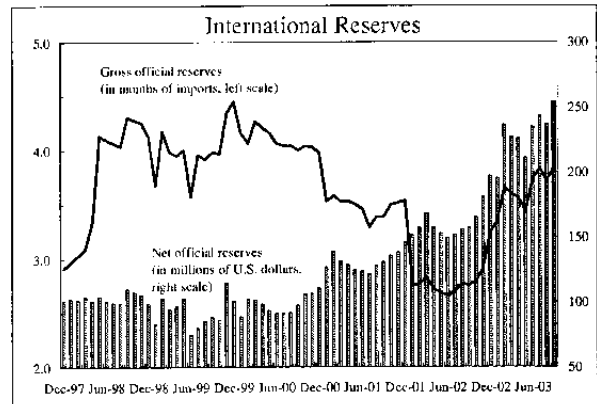
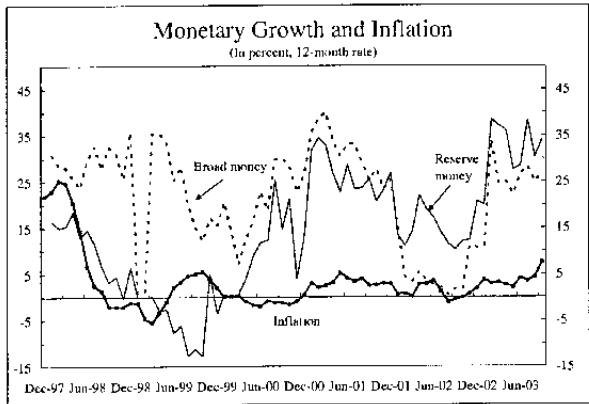
Profit tax collection in recent years has been particularly poor, showing a nominal decline of 11 percent year-on-year through September 2003. Moreover, the effective collection rate has been declining and is estimated at 6 percent in 2002, well below the statutory rate of 20 percent. Such weak performance is especially difficult to fathom given the booming economy and it reflects limited capacity of tax auditors, creative accounting practices by companies, and generous tax deductions.

Other taxes including the VAT have performed relatively better. VAT collections grew by 13 percent year-on-year through September 2003. Still, the tax base for the VAT (calculated by staff excluding value added in nontaxed sectors) shows that there is room for improvement in tax administration. Further, VAT exemptions on imports of selected intermediate inputs and capital goods (equivalent to about 15 percent of total imports) undermine the integrity of the tax system, distort price signals, and create an uneven playing field among importers.

Armenia: Tax Revenues			
	2000	2001	2002
	(In percent of GDP unless otherwise indicated)		
Tax Revenue	14.7	14.4	14.6
VAT and other taxes	12.8	13.0	13.4
Profit tax	2.0	1.4	1.3
Memorandum items:			
Profit tax collection in percent of profits 1/	9	7	6
Statutory profit tax rate	20	20	20
VAT in percent of VAT tax base 2/	11	11	12
Statutory VAT tax rate	20	20	20
1/ Profits are derived from national accounts data.			
2/ The VAT tax base is calculated as nominal GDP minus the estimated share of nontaxed value added in agriculture, construction, and commerce.			

⁵ However, a residual amount of arrears will persist because of occasional under-budgeting by line ministries, disputed bills with suppliers, and administrative errors by budgetary units. This has been addressed in the program by modifying the definition of the performance criterion on domestic arrears (Attachment III).

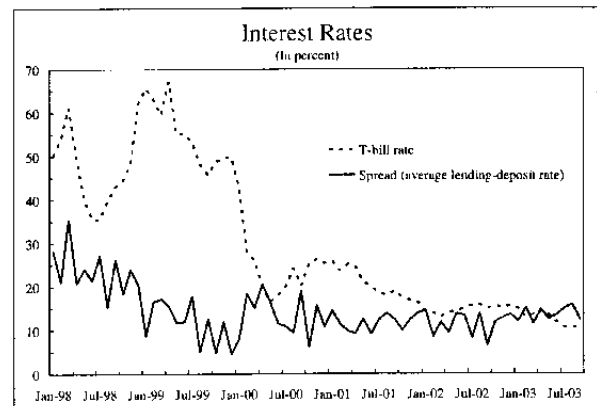
7. **Monetary policy** has been on track and all monetary targets were met. The target on the net domestic assets (NDA) of the central bank was met comfortably because of lower-than-anticipated government spending. During the twelve months through September 2003, broad money grew by 19.2 percent (Table 6). Official net international reserves (NIR) exceeded the programmed level by a wide margin in June and gross reserves remained at around 3.7 months of imports throughout the year.



8. The performance of the **banking sector** has been mixed. While the overall level of capitalization and liquidity are ample and profitability is adequate, asset quality remains weak as evidenced by a rise in nonperforming loans during the first three quarters of 2003. An average lending-deposit rate spread of nearly 1240 basis points continues to reflect inefficiencies in the system and difficulties in recovering collateral. As part of a medium-term strategy to restructure the banking system, minimum capital requirements were raised from US\$1.65 million to US\$2 million in July 2003 and the central bank started collecting premia for a deposit insurance scheme that will become operational in mid-2005.

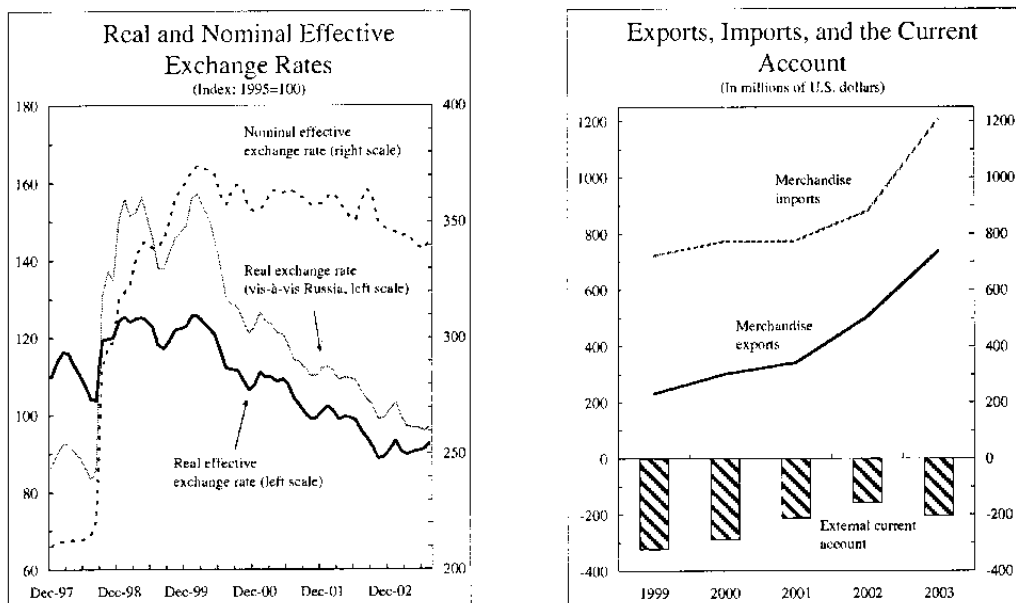
Armenia: Selected Banking System Indicators, 2000-03								
	2000		2001		2002		2003	
	Dec.	Dec.	Dec.	Mar.	June	Sept.		
	(In percent)							
Capital adequacy 1/	25.0	13.6	30.5	39.2	34.3	34.3		
Nonperforming loans/gross loans	6.2	6.0	4.9	6.3	8.2	6.7		
Liquidity 2/	30.5	33.1	44.5	47.3	49.2	48.8		
Profits 3/	-1.9	-9.1	3.9	1.5	1.4	2.1		

Source: Central Bank of Armenia.
 1/ Regulatory capital to risk-weighted assets.
 2/ Liquid assets to total assets.
 3/ Profits to period average assets.



9. The **external current account deficit** has weakened this year, but the **exchange rate** has remained stable. During the first half of the year, merchandise exports grew by 40 percent driven by increased sales of processed diamonds, food products, and non-precious metals. At the same time, import growth accelerated to 50 percent because of higher imports of raw diamonds and equipment. As a result of these developments, the current account deficit is projected to rise from 6.6 percent of GDP in 2002 to 7.7 percent in 2003 (Table 7). After a

small depreciation in 2002, the dram has remained broadly stable in both nominal and real effective terms this year.



10. Armenia's **external debt** indicators are improving further this year. The outstanding debt to Turkmenistan (US\$11 million) was repaid in kind and the entire debt to Russia (US\$94 million) was exchanged for equity in Armenian companies. As a result, Armenia's net present value (NPV) of debt-to-exports ratio is projected to fall from 131 percent at end-2002 to 94 percent at end-2003.⁶

11. The authorities have made good progress with the main **structural reforms** envisaged under the program. These were:

- **Public sector reforms** aimed at enhancing expenditure control, tax and customs administration, and fiscal transparency. The authorities amended the budget law to improve expenditure control, devised a plan to facilitate the monitoring and reporting of noncommercial enterprises (NCEs), established internal audit units and reporting requirements at the State Tax Service (STS) and the Customs Committee, and begun setting up a post-clearance verification program at customs.
- **Financial sector reforms** geared toward resolving the situation of three banks that have been under central bank administration for more than a year. One of these banks (Ardshinbank) was resolved through a purchase and assumption transaction earlier this

⁶ The NPV figures for 2002 and beyond are slightly higher than the ones presented in the April staff report because methodological changes in determining the net present value.

year⁷ and another bank (Credit Yerevan) is expected to be put forward for liquidation by end-November. A resolution strategy for the third bank (Armcommunications) and its main debtor, the state-owned chemical plant Nairit, has been formulated but discussions with a potential foreign investor for both the bank and Nairit are still in progress.⁸ Financial sector legislative reforms to date aimed at enhancing the ability of the central bank to execute bank resolution strategies, to more effectively create and enforce pledges, and to specify the modalities of the deposit insurance scheme.

- **Energy sector reforms** aimed at addressing a fragile financial situation, mismanagement, and corruption in state-owned companies. Two electricity-generating plants were privatized in 2003 and the financial management of the nuclear power plant was handed over to a foreign company. In the midstream sector, the transmission, dispatch, and settlement functions were separated and new companies formed. Reflecting improved performance of the privatized distribution company, collection rates have been at almost 100 percent throughout this year. Reforms on the water and irrigation sectors have been very limited, however, and the financial situation of the state-owned companies in these sectors will not improve until tariff rates are raised in 2004.⁹

Armenia: Performance of the Energy, Water, and Irrigation Sectors, 2000-03				
	2000	2001	2002	2003 Proj.
Primary balance (in percent of GDP)	-2.6	-3.6	-0.9	-0.5
Energy	-1.3	-2.5	-0.4	0.1
Water	-0.7	-0.6	-0.3	-0.3
Irrigation	-0.6	-0.5	-0.2	-0.3
Electricity transmission and distribution				
Technical and other losses (in percent of entry)	26	26	26	5
Collection rate (in percent of domestic billings)	89	81	90	98
Sources: Armenian authorities; and Fund staff estimates.				

III. POLICY DISCUSSIONS

The discussions focused on the medium-term macroeconomic framework, the 2004 budget, and fiscal, banking, and energy sector reforms. In the fiscal area, understandings were reached on measures to modernize the tax system and increase revenue collection and to improve budget management and reporting.

⁷ The acquirer has purchased some of the assets and assumed some of the liabilities of the insolvent bank. The remaining assets and liabilities have been placed in liquidation.

⁸ The assets of Credit Yerevan (once liquidated) appear to be sufficient to repay individual deposits (AMD 2.8 billion at end-June 2003), thus no fiscal costs are expected. Individual deposits in Armcommunications amounted to only AMD 0.5 billion at end-June 2003.

⁹ The increase in tariffs is envisaged in the draft of the forthcoming financial rehabilitation plan for the energy, water, irrigation, and urban transport sectors. If implemented early in the year, the increase is expected to yield savings of about 0.2 percent of GDP.

A. Medium-Term Framework and the PRSP

12. The **medium-term macroeconomic framework** is broadly in line with the PRSP.¹⁰ Driven by productivity growth and investment in the tradable goods sector, real GDP growth is projected at 7 percent in 2004 and 6 percent a year over the medium term (Table 8). Annual inflation is projected at 3 percent. The current account is forecast to narrow gradually over time in response to strong export growth and gross official reserves are expected to remain at 3.5 months of imports or more. These developments would be underpinned by fiscal consolidation based on increasing tax revenues and rationalizing expenditures, which would lead to a reduction of the fiscal deficit from 2.5 percent of GDP in 2004 to 2 percent in 2005–08 and to a further gradual decline thereafter.

13. Tangible **financing commitments** from donors and external development partners will be needed to finance the PRSP. As noted below, financing from a private donor for some investments identified in the PRSP have not yet been secured for 2004 and external financing of about 2 percent of GDP per year will be needed over the medium term.

B. Fiscal Policy and Public Sector Reform

14. The proposed **2004 budget** envisions a deficit of 2.5 percent of GDP, slightly above the projected outcome for 2002 (Table 5). On the **revenue** side, tax revenues are expected to increase by about 0.5 percent of GDP based on new policy measures and improvements in tax administration (see below). However, the authorities indicated that they were still unsure about commitments on external grants from private sources for 2004 of up to 1.9 percent of GDP and that, in light of this uncertainty, they would prepare a draft budget with a prudent assumption that such grants will amount to 0.4 percent of GDP (which corresponds to relatively more secure commitments).¹¹

Armenia: Selected Fiscal Indicators, 2000-04					
	2000	2001	2002	2003 Proj.	2004 Prop. Budget
	(In percent of GDP)				
Total revenue and grants	16.5	17.1	18.9	18.6	15.5
<i>of which: tax revenue</i>	14.7	14.4	14.6	14.3	14.8
Total expenditure	22.8	20.9	19.5	20.6	18.0
Current expenditure	17.5	15.8	14.0	14.1	13.8
Capital expenditure and net lending	5.4	5.1	5.4	6.5	4.2
Overall balance (commitment basis)	-6.4	-3.8	-0.6	-2.0	-2.5
Overall balance (cash basis)	-4.6	4.0	-2.6	-2.2	-2.5
Sources: Ministry of Finance; and Fund staff estimates.					

¹⁰ The PRSP macroeconomic framework is based on lower nominal GDP projections compared to the current framework. GDP projections were updated in September in light of unexpectedly high growth this year. The PRSP and the corresponding Joint Staff Assessment have been distributed to the Executive Board (IMF Country Report Nos. 03/362 and 03/378).

¹¹ If external capital grants are secured by the time the budget is finalized, they will be added to the budget.

15. On the **expenditure** side, in light of the possible reduction in external capital grants of up to 3 percent of GDP, the staff urged the authorities to increase domestically-financed capital expenditures and rationalize current expenditures. This is required to keep an appropriate balance between current and capital outlays while aligning the budget with the PRSP priorities on social and infrastructure spending. Lower subsidies to public utilities (especially water and irrigation companies) are expected to yield savings of 0.2 percent of GDP in 2004. In addition, the authorities succeeded in identifying nonpriority current expenditures equivalent to 0.2 percent of GDP and shifted those resources toward investment in road construction and housing. Understandings were also reached to moderate the nominal increase in public sector wages, certain subsidies, and outlays for other goods and services in 2004. These savings are large enough to allow for an increase in social expenditures equivalent to 0.4 percent of GDP as well as an increase in domestically-financed capital expenditures of 0.3 percent of GDP. The increases in social expenditures are in line with those envisaged in the PRSP. Overall, current expenditures are expected to decline by 0.3 percent of GDP in 2004.

Armenia: Functional Classification of Government Expenditures, 2002-08 (In percent of GDP)				
	2002	2003	2004	2005-08
		Proj.	Prop. Budget	Proj.
General public services	1.8	1.8	1.7	2.0
Defense and public order	3.9	4.2	4.2	4.2
Health, education, and social security	4.9	5.4	5.8	6.8
Housing and public utilities	1.6	2.8	1.8	1.8
Transportation, construction, and agriculture	1.7	3.4	2.2	2.5
Interest on public debt	0.9	0.8	0.8	0.7
Other	2.3	2.1	1.5	1.6
Unclassified	2.4	0.3	0.1	0.0
Total expenditure and net lending	19.5	20.6	18.0	19.6

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

16. The program includes a number of measures to protect its fiscal objectives. The main areas covered are:

Tax policy and administration. The authorities acknowledge the presence of serious weaknesses in revenue collection (especially on profit taxes) and a lack of equality of treatment among taxpayers. They envisage changes in tax policy and administration in both the near and the medium term to address these problems. Tax policy changes for 2004 include the introduction of a minimum profit tax based on one percent of companies' turnover, a revision of the profit tax law to limit deductions and loss carry-over provisions, a 10 percent increase in revenues from presumptive taxes, and a stamp system to levy taxes on beer. These and other tax policy measures are expected to yield about 0.4 percent of GDP of additional revenues in 2004. Additional gains of 0.1 percent of GDP are expected from improvements in tax administration. Tax administration changes include reviewing accounting procedures by companies, enhancing the withholding of income taxes, and strengthening the administration of the simplified tax. The authorities also intend to finalize by year-end a medium-term program of tax reforms in consultation with Fund staff.¹² The

¹² An FAD mission in September 2003 provided technical assistance on tax and customs administration.

staff encouraged the authorities to explore ways to eliminate simplified and presumptive taxes and expand the base for the VAT, to review the property tax system with a view to making it more progressive, and to deepen reforms in tax and customs administration.

VAT exemptions. A number of exemptions have been eliminated in 2002 and 2003 and the staff proposed that at least a similar step be taken in 2004. The authorities see these exemptions as a tool of industrial policy and have been hesitant to remove them. The staff noted that the exemptions, however, have many negative effects and that they undermine the integrity of the tax system, discriminate among importers, and discourage other import-competing activities. In the event, understandings were reached to remove exemptions on about one-fourth of the potentially taxable imports that are currently exempt (by value) in January 2004. To alleviate the financial burden on exporters and on importers of large capital goods, the authorities intend to expand the use of the temporary admission system for inward processing of raw materials in export sectors and introduce a VAT deferral system for imports of large capital goods in mid-2004.

Customs administration. There is an urgent need to improve transparency and efficiency in customs operations in order to combat corruption and increase revenues. Understandings were reached to establish a system of post-clearance field audit visits by year-end and to eliminate loopholes in the legislation related to customs declaration procedures and the development of the valuation database with invoice values. The latter is required to comply with WTO rules and reduce discretion by customs officials in the valuation of imports. In addition, the authorities plan to reduce documentation requirements and eliminate the certification fee for exports.

Budget management and reporting. The authorities acknowledge the need to strengthen transparency and accountability of the budget. They plan to set up a forward-looking cash management and financial planning system and enhance the internal audit function of the Treasury. To facilitate the production of consolidated government accounts in an efficient manner, the government envisages developing the legal basis for monitoring and budget reporting of noncommercial enterprises, including criteria under which these entities would be considered part of the general government. By April 2004, the system is expected to be operational and consolidated general government accounts including noncommercial enterprises, local governments, and the State Fund for Social Insurance (SFSI), would be reported.

C. Monetary and Financial Sector Issues

17. The central bank intends to maintain its **anti-inflation stance** to avoid accommodating recent and prospective increases in certain prices. While the recent hike in inflation was due to a supply-induced increase in the price of bread, the central bank has begun to adjust monetary policy in early October to avoid monetizing the recent increase in the price level and ensure that inflation does not exceed 3 percent in 2004. This is particularly important in light of the forthcoming increase in water tariffs. The program for 2004 foresees

an increase in broad money of 12 percent. In case of stronger-than-programmed capital inflows, the staff stressed the need to refrain from intervening in the foreign exchange market and allow the exchange rate to appreciate in response to market forces.¹³

18. The staff urged the authorities to resolve the situation of the two remaining **intervened banks** without further delays. It noted that in light of the difficulties encountered in recovering their assets there is little justification for continuing to keep these banks under central bank administration. The authorities intend to initiate the liquidation of Credit Yerevan by end-November 2003. The situation of Armcommunications hinges on the successful completion of negotiations with a foreign investor to take over both the chemical plant Nairit and the bank. If the negotiations fail, the central bank will initiate the liquidation of Armcommunications by end-November 2003. Lastly, to continue strengthening banking supervision and enhancing the legal framework governing the financial sector, the authorities have recently upgraded supervisory procedures (new onsite and offsite inspection manuals), and envisage adoption of various legal amendments by year-end as well as more vigorous enforcement of prudential norms.

D. External Sector

19. After increasing in 2003, the **current account deficit** is projected to fall next year. While unusually large grant-financed investments led to a surge in imports of construction material, machinery, and equipment in 2003, lower donor-financed investments in 2004 along with continued export growth should lead to a reduction in the current account deficit. At the same time, the services balance is expected to improve gradually on account of tourism and the growing export-oriented software industry. Gross **international reserves** are projected to remain at or above 3.5 months of imports.

E. Other Structural Policies

20. The continued implementation of the structural reform agenda remains a key element for sustaining economic growth over the medium term. In addition to the aforementioned reforms in tax and customs administration, the agenda includes efforts to combat **corruption** and enhance governance and transparency. In this regard, the authorities intend to finalize an anti-corruption strategy by year-end. The strategy is expected to analyze the nature of corruption in Armenia and contain a time-bound action plan of measures to deal with the problem.

21. As regards the **energy sector**, further efforts will be required to deal with past debts of state-owned energy companies and ensure sound management. In early November, the government is expected to approve the Integrated Financial Rehabilitation Plan and pass a

¹³ While foreign exchange intervention is still used as the main liquidity management tool, the central bank intends to gradually increase the use of domestic instruments such as repo operations and/or the deposit facility.

resolution to enforce its implementation (prior action for the fourth review). Measures set forth in the plan include: (i) institutional reforms, including phasing out management functions currently vested in the Ministry of Energy; (ii) restructuring of the energy sector debt; and (iii) moving toward direct contracting between power generators and the privatized distribution company. In addition, the plan envisages the complete restructuring of the midstream sector (comprising settlement, dispatch, and transmission companies) in 2004 by putting in place a sound corporate governance framework and adopting private management contracts.

IV. PROGRAM MONITORING AND CAPACITY TO REPAY THE FUND

22. The quality and timeliness of data generally permit effective program monitoring. There has been substantial progress in improving the quality and timeliness of economic data in recent years and the subscription to the Fund's Special Data Dissemination Standard (SDDS) is imminent.¹⁴ However, further efforts are needed with respect to the quality and transparency of fiscal data.¹⁵ Program implementation will be monitored according to quantitative performance criteria for end-December 2003 and indicative targets for the first half of 2004 (Attachment I, Table 1) as well as structural performance criteria and benchmarks for up to June 2004 (Attachment I, Table 2).¹⁶ Box 2 highlights the approach to structural conditionality. The performance criteria on the stock of domestic arrears of the central government and the State Fund for Social Insurance have been collapsed into a single performance criterion, with the definition of domestic arrears modified to take into account the persistence of a small amount of technical arrears (Technical Memorandum of Understanding Attachment III). The TMU outlines definitions and reporting requirements.

23. Armenia has a strong record of servicing its obligations to the Fund and should face no problems in servicing future obligations (Table 9). The conclusions of the debt sustainability analysis (DSA) conducted in April of this year (IMF Country Report No. 03/93) are still valid. The results indicated that Armenia's external debt is sustainable if prudent fiscal policies continue to be pursued.

¹⁴ A mission from STA provided technical assistance on the SDDS in September 2003.

¹⁵ Beyond the difficulties encountered with the creation of noncommercial enterprises, fiscal data are subject to frequent reclassifications and a significant aggregation is reported under the category of "other goods and services" (see Appendix IV).

¹⁶ The performance criteria for the sixth review will be set at the time of the fifth review.

Box 2. Structural Conditionality

Current PRGF-Supported Program. Structural conditionality in the program focuses on improving revenue collection through tax and customs reforms; expenditure control and budget management; public sector governance; the restructuring of the financial sector; and energy sector reform. The structural conditions under the first two years of the PRGF arrangement were discussed in IMF Country Report Nos. 02/73 (4/30/01), 02/228 (9/12/02), and 03/93 (3/14/03). All conditions were observed, some with minor delays. The status of implementation of the structural performance criteria and benchmarks under the fourth review is presented in Table 4.

World Bank Conditionality. The floating tranche of (Structural Adjustment Credit (SAC) IV (disbursed in December 2002) focused on reforms in the energy sector through improved financial performance and privatization of 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 a Medium-Term Expenditure Framework (MTEF). SAC V (approved by the Executive Board of the Bank in March 2003) covers private sector development and public enterprise reform, public sector reform, and social sector reform. The second disbursement under SAC V is conditional on several measures including the implementation of a medium-term plan for reforming tax and customs administration and improving budget management, resolving the situation of the intervened banks, implementing the pension law, submitting a new labor code to parliament, reforming the power and utility sectors, implementing a plan for improving the business environment, and adopting school and hospital rationalization programs.

Reforms Not Included in the Current Program. Measures in the areas of privatization, civil service reform, and the social safety net were included in the 1999 Enhanced Structural Adjustment Financing (ESAF)-supported program but are not in the current program. These areas are covered under various World Bank lending programs (Appendix II).

V. STAFF APPRAISAL

24. **The authorities should be commended for Armenia's strong economic performance that is the result of continued reforms and prudent economic policies.** Real GDP growth has been impressive, inflation has remained under control, and investment and export growth have been strong. Program implementation in the first half of 2003 has also been satisfactory: all but one of the quantitative performance criteria for end-June were met and all structural measures have been implemented on time or with a small delay.
25. **The authorities have adopted a poverty reduction strategy consistent with the PRGF-supported program.** As described in the Joint Staff Assessment of the PRSP, the effective implementation of the strategy will require prioritizing poverty-reduction measures, developing monitoring indicators, and building capacity within the government.
26. **The proposed budgetary framework for 2004 envisages an increase in tax revenue, an appropriate balance between current and capital expenditures, and a small increase in the overall deficit.** The authorities intend to reduce current outlays in favor of increased social and domestically-financed capital expenditures. This shift is appropriate but its execution needs to be monitored closely to gauge its effectiveness. In light of the likely decline in grant-financed investment in the medium term, firmer commitments from donors

are required to achieve the level of expenditures envisaged in the PRSP. In this regard, the authorities should also ensure that an increasing amount of domestic budgetary resources are allocated over time to finance public investment projects while appropriate restraint is placed on nonpriority current expenditures.

27. **In the period ahead, the authorities need to step up their efforts to reduce weaknesses in the tax system and in tax and customs administration.** The staff welcomes the authorities' commitment to impose a minimum profit tax on turnover, remove loopholes in tax legislation, remove VAT exemptions on an additional amount of imports, and set up a post-clearance verification unit at customs. These and other measures contemplated in the 2003–04 program will ensure the revenue gains needed to finance growth-enhancing and poverty-reducing fiscal expenditures. The staff also encourages the authorities to finalize and begin implementing a medium-term program of tax policy reforms aimed at eliminating simplified and presumptive taxes, expanding the base for the VAT, reforming the property tax system, and overhauling tax and customs administration. These reforms will set the basis for a sustained increase in tax revenues in the medium term as envisaged in the PRSP. Lastly, measures to improve corporate accounting practices will also need to be considered.

28. **Important steps are required to improve the coverage and transparency of government operations.** While the treasury system is considered to be among the best in the region, budget execution reports do not cover the operations of local governments and expenditure categories are subject to frequent ad-hoc reclassifications. In this regard, the staff welcomes the authorities' commitment to restore reporting and instill accountability in noncommercial enterprises and urges them to improve fiscal reporting in early 2004 by including the activities of these entities, local governments, and the social insurance fund in quarterly reports on general government operations.

29. **The central bank needs to continue with its cautious monetary policy, while minimizing foreign exchange market intervention.** The recent gradual tightening of monetary policy is appropriate and will contribute to bringing annual inflation down towards the central bank's 3 percent target. This stance should continue in order to counteract the envisaged administrative price increases in 2004. At the same time, the authorities should keep foreign exchange market intervention at a minimum, allow the dram to respond to market forces, and increase the use of domestic instruments to enhance the effectiveness of monetary policy and deepen the domestic financial market.

30. **The central bank needs to redouble its efforts to strengthen the banking system.** While progress has been made to provide incentives for rationalization and improve supervision, prudential norms need to be enforced more vigorously. At the same time, the authorities should resolve the situation of the two remaining intervened banks without further delay and ensure that any further intervention of problem banks is conducted swiftly and efficiently.

31. **The staff welcomes the envisaged reforms the energy, water, and irrigation sectors.** The draft financial rehabilitation plan sets the stage for the last round of reforms in these sectors, including establishing sound governance structures, clearing and restructuring their large debts, and preventing the Ministry of Energy from continuing to manage a large part of the energy sector. The staff also encourages the authorities to transfer the management function of the midstream energy companies through private management contracts. Lastly, the staff urges the authorities to proceed with the envisaged reforms in the water and irrigation sectors, including bringing tariffs closer to cost-recovery levels.

32. **The authorities acknowledge that corruption remains a serious issue in Armenia,** preventing an effective allocation of resources and compromising efforts to reduce income inequality. To this end, the authorities' commitment to finalize and adopt the anti-corruption strategy by the end of the year is welcome. The authorities need to ensure that the strategy is governed by a sound legal and institutional framework and that it includes a time-bound action plan for its implementation.

33. **Armenia's medium term economic outlook remains favorable provided that the reform effort remains strong.** Lower external financing in years to come will need to be compensated by fiscal consolidation through higher tax revenues and a sound expenditure policy that prioritizes social and infrastructure needs. The authorities will also need to press ahead with the reforms mentioned in paragraphs 27-32 above to improve the business climate and foster investment.

34. **There are a number of risks to the program that on balance appear manageable.** The external environment is conditioned by the difficulties in resolving the territorial conflict with Azerbaijan and the lack of trade relations with Turkey. The staff encourages the authorities to continue seeking a diplomatic solution to these problems. Adverse developments in the market for diamonds, Armenia's main source of export revenue, could also hamper growth prospects. Another risk arises from the unpredictability of external financing; this could be partly offset by seeking more actively commitments from donors. Lastly, failure to increase fiscal revenues, strengthen the legal and banking systems, and root out corruption will frustrate poverty reduction efforts and perpetuate an unequal distribution of income. Effective political leadership and strengthened capacity will be required to minimize these risks.

35. In view of the satisfactory performance to date and the strength of the authorities' program for the remainder of 2003 and 2004 and given the minor nature of the deviation in meeting the end-June performance criterion on the stock of domestic expenditure arrears, the staff supports the authorities' request for a waiver of this performance criterion and for the completion of the fourth review under the PRGF.

Table 1. Armenia: Fund Disbursements and Timing of Reviews, 2001–04

Date of Availability	Conditions	Amount (in SDR millions)
May 23, 2001	Board approval of the PRGF arrangement	10.00
September 25, 2002	Completion of first review (end-June 2001 test date) and second review (end-December 2001 test date)	20.00
April 8, 2003	Completion of third review (end-December 2002 test date)	10.00
November 24, 2003	Completion of fourth review (end-June 2003 test date)	10.00
April 15, 2004	Completion of fifth review (end-December 2003 test date)	10.00
October 15, 2004	Completion of sixth review (end-June 2004 test date)	9.00

Sources: Finance Department (IMF); and Fund staff.

Table 2. Armenia: Selected Economic and Financial Indicators, 1999–2004

	1999	2000	2001	2002	2003		2004 Proj.
					Prog.	Rev. Prog.	
(Annual percentage change, unless otherwise indicated)							
National income and prices							
Real GDP growth	3.3	6.0	9.6	12.9	7.0	12.0	7.0
Gross domestic product (in billions of drams)	988	1,033	1,176	1,357	1,474	1,565	1,725
Gross domestic product (in millions of U.S. dollars)	1,847	1,914	2,312	2,364	2,514	2,670	2,926
CPI (end of period)	2.0	0.4	2.9	2.0	2.0	4.0	3.0
GDP deflator	-0.2	-1.5	4.0	2.3	1.5	3.0	3.0
Investment and saving (in percent of GDP)							
Investment	19.5	18.6	19.8	21.0	22.4	22.2	20.1
National savings	2.0	4.6	9.2	14.3	15.9	14.5	13.2
Money and credit (end of period)							
Reserve money	0.0	34.4	11.1	38.4	7.1	8.2	8.1
Broad money	13.9	38.6	4.3	34.0	11.0	12.4	12.1
Commercial banks' 3-month lending rate (in percent) 1/ 2/	34.5	28.7	27.7	23.4	...	25.5	...
Government operations (in percent of GDP)							
Revenue and grants	19.3	16.5	17.1	18.9	19.5	18.6	15.5
Expenditure and net lending	26.5	22.8	20.9	19.5	22.0	20.6	18.0
Overall balance on a commitment basis	-7.2	-6.4	-3.8	-0.6	-2.5	-2.0	-2.5
Overall balance on a cash basis	-5.5	-4.6	4.0	-2.6	-3.4	-2.2	-2.5
Stock of domestic expenditure arrears	...	4.3	3.6	1.3	0.0	0.0	0.0
Primary balance of the energy sector (in percent of GDP) 3/	-0.8	-1.3	-2.5	-0.4	0.2	0.1	0.1
External sector							
Exports of goods and nonfactor services 4/	4.6	19.0	20.8	30.4	10.6	37.4	14.8
Imports of goods and nonfactor services 4/	-8.1	5.1	1.2	13.2	7.6	30.4	8.5
Current account (in percent of GDP)	-17.5	-15.0	-10.0	-6.6	-6.5	-7.7	-6.9
External debt-to-exports ratio 5/	157	139	132	131	91	94	81
Debt service ratio 6/	14.7	10.8	10.0	9.9	11.6	8.0	5.4
Import cover 7/	3.8	3.8	3.6	4.7	4.3	3.9	3.6
Nominal effective exchange rate 1/ 8/	18.5	0.3	3.4	-6.2	...	-2.3	...
Real effective exchange rate 1/ 8/	6.5	-7.8	-1.9	-11.3	...	2.0	...

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

1/ End of period.

2/ Data for 2003 is based on actual data for September.

3/ Data for 1999–02 include the electricity distribution company, Armelnet, which was privatized in late-2002. Data for 2003–04 exclude Armelnet and two generation companies that were also privatized.

4/ In U.S. dollars terms.

5/ Net present value of debt in percent of a three-year moving average of exports of goods and services, the latter centered on the previous year.

6/ In percent of exports of goods and services.

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

8/ A positive sign denotes appreciation. Base year 1995=100. Data for 2003 displays the change between December 2002 and August 2003.

The calculations are based on 1999–2001 average trade weights.

Table 3. Armenia: Quantitative Targets, December 2002 - June 2003 1/
(End of period ceilings on stocks, unless otherwise specified)

	2002	2003			
	Dec.	Mar.	June		
	Act.	Prog. 2/	Act.	Prog. 3/	Act.
(In billions of drams)					
Net domestic assets of the CBA 4/	-19.3	-13.9	-23.2	-18.5	-34.1
Net banking system credit to the government	1.0	5.4	-2.3	2.6	-14.6
Domestic arrears of the central government	7.1	8.0	7.2	0.0	0.9
Stock of arrears of the State Fund for Social Insurance	0.0	0.0	0.0	0.0	0.0
Tax revenues of the central government (floor) 5/	198.6	45.0	45.5	98.9	99.3
Balance of the central government on a cash basis (floor) 5/ Adjusted target 6/	-35.4	-9.0 -5.5	... 1.1	-27.5 -14.5	... -5.5
Reserve money (band) 2/	111.3	(93-96)	93.3	(93-97)	95.4
Primary balance of the energy sector (floor) 2/ 5/ 7/	1.7	-2.3	-0.8	-1.2	-1.6
(In millions of U.S. dollars)					
Contracting and guaranteeing of new nonconcessional external debt with maturity of more than one year 5/	7.1	0	0	0	0
Net disbursements of short-term external debt 5/ 8/	0	0	0	0	0
External arrears (continuous criterion)	0	0	0	0	0
Net official international reserves (floor) 4/	236	198	212	207	234

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 (TMU) (IMF Country Report No. 03/93, Attachment III).

2/ Indicative target.

3/ Performance criterion.

4/ At program exchange rates as specified in the TMU.

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

6/ As specified in the TMU, the March and the June targets have been increased by AMD 3.5 billion and AMD 8.5 billion, respectively, on account of a shortfall in externally financed disbursements.

7/ Excluding the balance of the privatized electricity distribution company.

8/ Obligations with maturity of less than one year, excluding normal import-related credit and sales of treasury bills to nonresidents.

Table 4. Armenia: Structural Measures Under the Fourth Review

Measures	Target Date ^{1/}	Status
Structural Performance Criteria		
1. Submit to parliament amendments to the Budget System law with a view to improving expenditure control.	April 2003	Met
2. Introduce version 1.16f of the Automated System for Customs Data (ASYCUDA) at all customs houses and customs points.	May 2003	Met
Structural Benchmarks		
1. Begin work on a new budget reporting system for noncommercial enterprises that will become operational in early 2004.	May 2003	Met
2. Complete least-cost diagnostic analyses and formulate resolution strategies for Armcommunications bank and Ardshinbank unless they are already liquidated or purchase and assume resolution strategies have been put in effect.	May 2003	Met
3. Improve administration of VAT refunds by simplifying procedures and preparing quarterly reports on outstanding VAT amounts.	June 2003	Met
4. Establish fully operational internal audit units at the State Tax Service and at the Customs Committee and prepare quarterly audit reports, the results of which will be shared with the President's office, the Prime Minister, the Ministry of Finance and Economy, and IMF and World Bank staff.	June 2003	Effectuated September 2003
5. Introduce a post-clearance verification program at customs' headquarters.	June 2003	Effectuated August 2003
6. Adopt financial rehabilitation plan for energy, water, and irrigation sectors. The plan will set the process for establishing independent boards of directors by September 2003 and performing independent financial audits beginning with the 2002 financial year for all state-owned companies in the energy sector, and will set a timetable for transferring their management functions through management contracts.	June 2003	Prior Action 2/
7. Submit to cabinet draft amendments to (i) the Civil Code (provisions on pledges) to more effectively create, register, and enforce pledges; (ii) the law on Bank Bankruptcy (shareholder rights) with a view to more effectively execute bank resolution strategies; and (iii) the law on the Central Bank of Armenia (CBA) to include provisions on deposit insurance.	July 2003	Met

1/ End of period.

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

Table 5. Armenia: Central Government Operations, 2001-04

	2001	2002 1/	2003				2004 Prop. Budget
			Jan-Jun		Jul-Dec	Year	
			Prog.	Prel.	Rev. Prog.	Rev. Prog.	
(In billions of drams)							
Total revenue and grants	200.8	256.3	122.8	115.9	175.7	291.6	268.1
Total revenue	182.3	209.3	102.2	103.3	128.4	231.7	260.3
Tax revenue	168.8	198.6	98.9	99.3	124.7	224.0	255.0
Nontax revenue	11.9	8.9	2.9	2.4	2.8	5.2	5.0
Capital revenue	1.6	1.8	0.4	1.6	0.9	2.6	0.3
Grants	18.5	47.0	20.6	12.6	47.2	59.8	7.7
Total expenditure	245.4	264.0	137.8	124.8	197.7	322.5	311.1
Current expenditure	185.2	190.4	99.4	93.6	127.7	221.3	238.2
Wages	32.2	23.6	12.6	12.4	16.7	29.1	32.1
Subsidies	6.5	8.1	6.7	6.7	7.6	14.3	12.2
Interest	14.5	12.7	7.3	6.2	6.1	12.3	13.0
Transfers and reserve fund	51.7	49.3	20.1	19.5	29.4	48.9	53.5
Goods and services	80.3	96.7	52.6	48.8	67.9	116.7	127.4
Capital expenditure and net lending	60.3	73.6	38.4	31.3	69.9	101.2	72.8
Capital expenditure	46.0	64.3	38.5	27.2	65.0	92.2	61.5
Foreign financed	32.0	55.4	32.2	23.0	52.3	75.3	38.1
Domestic financed	14.0	8.9	6.3	4.2	12.7	16.9	23.5
Net lending 2/	14.3	9.3	-0.1	4.1	4.9	9.0	11.3
Overall balance (commitment basis) 3/	-44.7	-7.7	-15.0	-8.9	-22.0	-31.0	-43.0
Net Accumulation of Arrears	-1.5	-28.8	-12.5	-6.3	-0.4	-6.6	0.0
Statistical discrepancy/float	-1.1	1.1	0.0	9.7	-6.0	3.7	0.0
Overall cash balance	-47.3	-35.4	-27.5	-5.5	-28.4	-33.9	-43.0
Financing	47.3	35.4	27.5	5.5	28.4	33.9	43.0
Domestic financing	15.2	-5.9	13.2	-13.8	25.6	11.8	3.7
Banking system	-1.2	-9.5	2.6	-15.6	15.2	-0.4	3.4
Central Bank of Armenia	0.0	-18.0	1.3	-18.9	9.5	-9.3	0.0
Commercial Banks	-1.2	8.5	1.3	3.3	5.6	8.9	3.4
Nonbank 4/	16.4	3.5	10.5	1.8	10.4	12.3	0.3
External Financing	32.1	41.4	14.4	19.3	2.8	22.0	39.3
Gross disbursements	44.3	51.4	31.5	24.0	30.6	54.6	47.2
Amortization due	-11.6	-13.8	-6.4	-4.3	-17.8	-22.2	-7.9
Change in Arrears (- = reduction)	-0.6	3.7	-10.7	-0.4	-10.0	-10.4	0.0

Table 5. Armenia: Central Government Operations, 2000-04 (concluded)

	2001	2002 1/	2003				2004 Prop. Budget
			Jan-Jun		July-Dec	Year	
			Prog.	Prel.	Rev. Prog.	Rev. Prog.	
(In percent of GDP)							
Total revenue and grants	17.1	18.9	25.6	22.4	16.8	18.6	15.5
Total revenue	15.5	15.4	21.3	19.9	12.3	14.8	15.1
Tax revenue	14.4	14.6	20.6	19.2	11.9	14.3	14.8
Nontax revenue	1.0	0.7	0.6	0.5	0.3	0.3	0.3
Capital revenue	0.1	0.1	0.1	0.3	0.1	0.2	0.0
Grants	1.6	3.5	4.3	2.4	4.5	3.8	0.4
Total expenditure	20.9	19.5	28.8	24.1	18.9	20.6	18.0
Current expenditure	15.8	14.0	20.8	18.1	12.2	14.1	13.8
Wages	2.7	1.7	2.6	2.4	1.6	1.9	1.9
Subsidies	0.6	0.6	1.4	1.3	0.7	0.9	0.7
Interest	1.2	0.9	1.5	1.2	0.6	0.8	0.8
Transfers and reserve fund	4.4	3.6	4.2	3.8	2.8	3.1	3.1
Goods and services	6.8	7.1	11.0	9.4	6.5	7.5	7.4
Capital expenditure and net lending	5.1	5.4	8.0	6.0	6.7	6.5	4.2
Capital expenditure	3.9	4.7	8.0	5.2	6.2	5.9	3.6
Foreign financed	2.7	4.1	6.7	4.4	5.0	4.8	2.2
Domestic financed	1.2	0.7	1.3	0.8	1.2	1.1	1.4
Net lending 2/	1.2	0.7	0.0	0.8	0.5	0.6	0.7
Overall balance (commitment basis)	-3.8	-0.6	-3.1	-1.7	-2.1	-2.0	-2.5
Net accumulation of arrears 3/	-0.1	-2.1	-2.6	-1.2	0.0	-0.4	0.0
Statistical discrepancy/float	-0.1	0.1	0.0	1.9	-0.6	0.2	0.0
Overall cash balance	-4.0	-2.6	-5.7	-1.1	-2.7	-2.2	-2.5
Financing	4.0	2.6	5.7	1.1	2.7	2.2	2.5
Domestic financing	1.3	-0.4	2.7	-2.7	2.4	0.8	0.2
Banking system	-0.1	-0.7	0.5	-3.0	1.4	0.0	0.2
Nonbank 4/	1.4	0.3	2.2	0.4	1.0	0.8	0.0
External financing	2.7	3.0	3.0	3.7	0.3	1.4	2.3
Gross disbursements	3.8	3.8	6.6	4.6	2.9	3.5	2.7
Amortization due	-1.0	-1.0	-1.3	-0.8	-1.7	-1.4	-0.5
Change in arrears (- reduction)	-0.1	0.3	-2.2	-0.1	-1.0	-0.7	0.0
Memorandum items							
Nominal GDP (in billions of drams)	1,176	1,358	479	518	1,047	1,565	1,725
Change in domestic expenditure arrears (in billions of drams)	-8.8	-25.5	-7.1	-6.3	-0.4	-6.6	0.0
Domestic expenditure arrears (in billions of drams) 5/	32.7	7.1	0.0	0.9	0.5	0.5	0.5
Overall balance excluding grants (in percent of GDP)	-5.4	-4.0	-7.4	-4.2	-6.6	-5.8	-2.9

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

1/ To facilitate the comparison of figures, the composition of expenditures for 2002 and the program columns for the first half of 2003 have been adjusted to reflect changes in expenditure categories brought about by the reclassification of budgetary institutions as non-commercial enterprises in 2003.

2/ Net lending figures in 2003 have been adjusted to reflect the share of loans from the Lincy Foundation intermediated through the banking system.

3/ Excluding external arrears on principal which are included in external financing.

4/ In the second half of 2003 the amount of non-bank financing reflects the cancellation of arrears as a result of the debt-equity swap with Russia.

5/ The stock of domestic arrears after June 2003 differs from the program's performance criterion of zero arrears (Attachment II, Table 1) as defined in the Technical Memorandum of Understanding (Attachment III). This is due to the recurrence of a negligible amount of arrears of a technical nature.

Table 6. Armenia: Monetary Accounts, 2002-04

	2002		2003				2004		
	March	June		Sept.	Dec.	March	June	Dec.	
		Act.	Prog.						Act.	Est.	Rev. Prog.	Prog.	Proj.
(in billions of drams, unless otherwise indicated)									
Central Bank of Armenia									
Net foreign assets 1/	136.7	122.4	113.7	134.7	144.2	149.4	142.4	140.7	155.3
Net international reserves	138.1	124.5	121.1	138.6	147.9	153.2	146.2	144.5	159.1
Special privatization account	6.1	5.7	...	4.4	4.3	4.4	4.4	4.4	4.4
Medium and long-term assets	-7.4	-7.8	-7.4	-8.3	-8.0	-8.2	-8.2	-8.2	-8.2
Net domestic assets	-25.4	-29.0	-18.5	-39.4	-40.8	-29.0	-35.3	-30.6	-25.2
Claims on government (net)	-9.7	-13.6	-8.4	-28.6	-31.6	-19.0	-24.0	-19.8	-19.1
Claims on banks	10.4	7.5	8.2	8.1	7.3	7.4	7.9	8.0	8.0
Other items (net)	-26.1	-23.0	-18.3	-18.9	-16.4	-17.4	-19.2	-18.8	-14.1
Reserve money	111.3	93.3	95.2	95.4	103.4	120.4	107.1	110.1	130.1
Currency issue	92.1	78.0	80.5	80.0	86.9	102.7	91.3	93.5	111.8
Deposits	19.2	15.4	14.7	15.4	16.5	17.7	15.8	16.6	18.3
Banking system									
Net foreign assets	155.9	149.0	135.3	168.3	183.8	184.5	178.1	177.2	193.9
Net domestic assets	56.0	34.4	56.1	26.5	28.2	53.6	40.3	49.6	73.1
Claims on government (net)	1.0	-2.3	2.6	-14.6	-13.1	0.5	-4.4	2.6	3.9
Claims on rest of the economy	98.3	87.7	93.1	92.6	92.5	104.2	93.4	99.1	114.6
Other items (net)	-43.3	-51.1	-39.5	-51.4	-51.2	-51.1	-48.8	-52.1	-45.4
Broad money	211.9	183.3	191.4	194.8	212.1	238.2	218.4	226.8	267.0
Currency in circulation	88.6	74.8	74.2	76.5	81.2	98.2	88.0	89.1	108.1
Deposits	123.3	108.5	117.2	118.4	130.9	139.9	130.4	137.7	158.9
Domestic currency	36.3	31.8	34.9	37.6	40.9	43.4	40.8	45.1	52.5
Foreign currency	87.0	76.8	82.3	80.8	90.0	96.6	89.5	92.5	106.4
Memorandum items									
Exchange rate (in drams per U.S. dollar, end of period)	584.9	589.5	...	584.8	570.1	...	...	...	...
NIR (in millions of U.S. dollars) 2/	236.1	211.1	...	237.0	259.4	...	...	...	...
NIR (in millions of U.S. dollars) 3/	231.0	212.0	207.0	234.0	258.1	262.0	250.0	247.0	272.0
Medium and long-term liabilities (in millions of U.S. dollars) 3/	10.9	12.7	12.7	12.7	12.7	14.0	14.0	14.0	14.0
NDA of the CBA (in billions of drams) 3/	-12.4	-23.2	-18.5	-34.1	-40.1	-24.6	-30.9	-26.2	-20.8
12-month change in reserve money (in percent)	38.4	27.7	27.9	28.2	28.6	8.2	14.8	15.4	8.1
12-month change in broad money (in percent)	34.0	22.2	22.7	24.9	19.2	12.4	19.1	16.4	12.1
12-month change in private sector credit (in percent)	0.7	0.6	4.4	3.9	-3.8	6.0	6.5	7.0	10.0
Velocity of broad money (end of period)	6.4	...	...	...	...	6.6	...	...	6.5
Money multiplier	1.9	2.0	2.0	2.0	2.1	2.0	2.0	2.1	2.1
Dollarization in bank deposits 4/	70.6	70.7	70.2	68.3	68.8	69.0	68.7	67.2	67.0
Liquidity preference ratio 5/	71.8	68.9	63.3	64.6	62.0	70.2	67.5	64.7	68.1

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

1/ The NFA series has been adjusted to include the special privatization account (SPA).

2/ At actual exchange rates, excluding the SPA.

3/ At program exchange rates. The 2003-04 program is based on end-December 2002 exchange rates (Attachment III, Table 1). Excluding the SPA.

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

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

Table 7. Armenia: Balance of Payments, 2001–06

	2001	2002	2003		2004	2005	2006
			Prog.	Rev. Prog.			
(In millions of U.S. dollars, unless otherwise indicated)							
Current account	-212	-157	-163	-205	-202	-196	-192
Trade balance	-431	-377	-362	-464	-447	-440	-433
Exports	342	505	583	738	872	973	1,078
Imports	-773	-883	-945	-1,202	-1,319	-1,413	-1,510
Services (net)	-18	-41	-40	-33	-32	-26	-24
Credits	187	184	185	209	215	230	243
Debits	-204	-225	-225	-242	-247	-257	-267
Income (net)	63	88	74	103	103	102	101
Private transfers (net)	102	119	110	140	125	113	109
Official transfers (net)	72	55	55	49	50	55	55
Capital and financial account	212	214	151	220	211	199	207
Capital transfers (net)	30	68	80	81	0	41	40
Foreign direct investments (net)	70	111	135	130	90	104	115
Portfolio investments (net)	-6	2	0	0	0	0	0
Public sector (net)	45	11	-50	-68	68	42	41
Disbursements	66	49	78	54	82	55	58
Amortization	-21	-38	-128	-121	-13	-13	-17
Other capital (net) 1/	73	23	-14	77	53	12	12
Overall balance	0	58	-12	15	9	3	15
Change in gross reserves (- increase)	-16	-101	-12	-40	-3	-13	-31
IMF repurchases	-10	-19	-24	-24	-32	-34	-29
Arrears/ debt relief with Russia, net (+ increase) 2/	-3	1	-17	-17	0	0	0
Arrears/ debt relief with Turkmenistan, net (+ increase)	1	0	-1	-1	0	0	0
Residual financing/gap	27	61	67	67	26	44	45
IMF	13	26	27	27	26	...	...
World Bank	14	35	40	41	0	...	...
Other	0	0	0	0	0	...	...
Memorandum items:							
Current account (in percent of GDP)	-10.0	-6.6	-6.5	-7.7	-6.9	-6.2	-5.6
Excluding official transfers	-13.4	-8.9	-8.7	-9.5	-8.6	-7.9	-7.2
Gross reserves (end of period)							
In months of imports	3.6	4.7	4.3	3.9	3.6	3.5	3.5
In months of next year's debt service 3/	53	65	100	104	102	106	132
Net international reserves (stock)	157	236	245	265	275	323	385
Nominal external debt 4/	906	1,026	999	1,019	1,082	1,114	1,157
Net present value (NPV) of external debt 5/	587	722	610	681	733	770	803
NPV of debt-to-exports ratio 5/ 6/	132	131	91	94	81	71	67
Stock of external arrears	17	17	0	0	0	0	0

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

1/ Includes errors and omissions.

2/ These claims are assumed settled by the end of the third quarter of 2003.

3/ Excludes amortization of short-term debt, deposits held by nonresidents, and debt acquired domestically by nonresidents.

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

5/ The increase in the estimated NPV of external debt in 2003 compared to the original program figure is due to an improved methodology used to calculate the net present value of future loan disbursements.

6/ Using a three year average of goods and services exports, centered on the previous year.

Table 8. Armenia: Medium-Term Macroeconomic Framework, 2003–08

	2003	2004	2005	2006	2007	2008
	Projections					
	(In percent of GDP, unless otherwise indicated)					
National income and prices						
Real GDP growth (percent change)	12.0	7.0	6.0	6.0	6.0	6.0
Gross domestic product (in millions of U.S. dollars)	2,670	2,926	3,177	3,449	3,748	4,072
Gross national income per capita (in U.S. dollars)	900	973	1,043	1,118	1,200	1,289
Inflation (annual percent change)	4.0	3.0	3.0	3.0	3.0	3.0
Investment and saving						
Investment	22.2	20.1	21.2	20.8	20.9	21.0
Government	5.9	3.6	4.8	4.2	4.1	4.0
Other	16.3	16.5	16.4	16.6	16.8	17.0
National savings	14.5	13.2	15.0	15.2	15.5	16.0
Government	4.5	1.7	3.4	2.9	2.8	2.7
Other	10.0	11.5	11.7	12.3	12.7	13.3
Government operations						
Revenue and grants	18.6	15.5	17.4	17.6	17.8	18.0
<i>of which: tax revenue</i>	14.3	14.8	15.2	15.6	16.0	16.4
Expenditure	20.6	18.0	19.6	19.6	19.8	19.9
<i>of which: social expenditure 1/</i>	5.4	5.8	6.3	6.8	7.3	7.7
Overall balance (commitment basis)	-2.0	-2.5	-2.1	-2.0	-2.0	-2.0
External sector						
Exports	35.5	37.1	37.9	38.3	37.4	36.7
Imports	54.1	53.5	52.5	51.5	49.7	48.0
Current account	-7.7	-6.9	-6.2	-5.6	-5.4	-5.0
Current account (in millions of U.S. dollars)	-205	-202	-196	-192	-201	-202
Capital and financial account (in millions of U.S. dollars)	220	211	199	207	210	216
<i>of which: direct foreign investment</i>	130	90	104	115	121	124
public sector disbursements	54	82	55	58	59	63
Gross international reserves (in millions of U.S. dollars) 2/	-40	-3	-13	-31	-25	-26
Arrears and debt relief (in millions of U.S. dollars)	-18	0	0	0	0	0
Financing/gap (in millions of U.S. dollars)	67	26	44	45	38	36
External debt (NPV, in percent of exports of goods and services)	94	81	71	67	65	63
Debt Service (in percent of exports of goods and services)	8.0	5.4	4.9	4.4	3.5	3.2
Gross international reserves (in months of imports)	3.9	3.6	3.5	3.5	3.5	3.5

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

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

2/ A negative figure indicates an increase.

Table 9. Armenia: Indicators of Fund Credit, 2002-08

	2002	2003	2004	2005	2006	2007	2008
	Act.	Projections					
(In units indicated)							
Existing and prospective Fund credit 1/							
In millions of SDRs	143.3	145.8	141.5	116.9	95.7	80.2	63.2
In percent of exports 2/	28.3	20.9	17.7	13.2	9.9	7.8	5.7
In percent of external debt	19.0	19.5	17.8	14.3	11.2	9.7	7.9
In percent of gross reserves	45.3	42.1	40.6	32.6	25.1	20.1	15.1
In percent of quota	155.7	158.5	153.8	127.0	104.0	87.2	68.6
Existing Fund credit 1/							
In millions of SDRs	143.3	135.8	112.5	87.9	66.7	51.2	34.2
In percent of exports 2/	28.3	19.5	14.1	9.9	6.9	5.0	3.1
In percent of external debt	19.0	18.1	14.1	10.7	7.8	6.2	4.3
In percent of gross reserves	45.3	39.2	32.3	24.5	17.5	12.8	8.1
In percent of quota	155.7	147.7	122.3	95.5	72.5	55.7	37.1
Prospective Fund credit 1/							
In millions of SDRs	...	10.0	29.0	29.0	29.0	29.0	29.0
In percent of exports 2/	...	1.4	3.6	3.3	3.0	2.8	2.6
In percent of external debt	...	1.3	3.6	3.5	3.4	3.5	3.6
In percent of gross reserves	...	2.9	8.3	8.1	7.6	7.3	6.9
In percent of quota	...	10.9	31.5	31.5	31.5	31.5	31.5
Repurchases, repayments, and charges due from existing and prospective drawings							
In millions of SDRs	...	18.4	24.2	25.4	21.5	16.0	17.5
In percent of exports 2/	...	2.6	3.0	2.9	2.2	1.5	1.6
In percent of external debt	...	2.5	3.0	3.1	2.5	1.9	2.2
In percent of gross reserves	...	5.3	6.9	7.1	5.6	4.0	4.2
In percent of quota	...	20.0	26.3	27.6	23.4	17.3	19.0
Repurchases and charges due from existing drawings							
In millions of SDRs	...	18.4	24.1	25.2	21.4	15.8	17.3
In percent of exports 2/	...	2.6	3.0	2.9	2.2	1.5	1.6
In percent of external debt	...	2.5	3.0	3.1	2.5	1.9	2.2
In percent of gross reserves	...	5.3	6.9	7.0	5.6	4.0	4.1
In percent of quota	...	20.0	26.1	27.4	23.3	17.2	18.8
Repurchases and charges due from prospective drawings							
In millions of SDRs	...	0.0	0.1	0.1	0.1	0.1	0.1
In percent of exports 2/	...	0.0	0.0	0.0	0.0	0.0	0.0
In percent of external debt	...	0.0	0.0	0.0	0.0	0.0	0.0
In percent of gross reserves	...	0.0	0.0	0.0	0.0	0.0	0.0
In percent of quota	...	0.0	0.1	0.2	0.2	0.2	0.2

Sources: Armenian authorities and Fund staff estimates.

1/ End of period.

2/ Exports of goods and services.

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

October 30, 2003

Dear Mr. Köhler:

The purpose of this letter and the attached Memorandum of Economic and Financial Policies (MEFP) is to inform you of progress in implementing the program supported by the Poverty Reduction and Growth Facility (PRGF), request a waiver for the nonobservance of the June performance criterion on domestic arrears, and set out the policies for the third annual program under the arrangement.

Based on discussions held with Fund staff during July-September 2003 on the fourth review of the PRGF arrangement, the MEFP reviews economic developments and policy implementation through September 2003, updates the macroeconomic framework, and discusses the financial policies and structural reform program for the period July 2003-June 2004. The government intends to make these understandings public and authorizes the IMF to publish this letter, the attached memorandum, the Joint Staff Assessment of the Poverty Reduction Strategy Paper (PRSP), and the staff report.

The structural performance criteria and all except one of the quantitative performance criteria for the first half of 2003 were observed. The end-June 2003 performance criterion on the stock of domestic expenditure arrears was exceeded by a small margin because of difficulties in expenditure control. To address this problem, we adopted earlier this year amendments to the budget law to enhance commitment control.

The government's economic program aims at providing the conditions for continued high real economic, maintaining inflation at no more than 3 percent, and enhancing tax revenue collection. The program focuses on five key areas: (i) monetary policy focused on price stability; (ii) fundamental improvements in tax and customs administration; (iii) enhanced control, reporting, and prioritization of government expenditures; (iv) reforms of the key state-owned companies in the energy, water, and irrigation sectors; and (v) reduction in administrative barriers and opportunities for corruption. The government is also committed to pursue the objectives set out in the PRSP. The paper is the centerpiece of the development strategy of Armenia and will be regularly updated to reflect ongoing developments and evolving priorities.

The government believes that the policies and measures described in the MEFP are adequate to achieve the objectives of the program, but it stands ready to take any additional measures that may be required. The government will consult with the Fund in advance of the adoption of any such measures or on any revision of the policies covered in the MEFP in accordance with the Fund's procedures for such consultations. It will also provide the Fund with the information required to assess progress in implementing the program.

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
October 30, 2003

This memorandum sets forth the government's economic objectives and policies for the period July 2003 to June 2004, the third year of the program supported under the Poverty Reduction and Growth Facility (PRGF). These policies constitute an integral part of the government's medium-term strategy for poverty reduction as envisaged in the recently approved Poverty Reduction Strategy Paper (PRSP).

I. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

1. The Armenian economy continues its strong performance in 2003. Real GDP grew by 15.2 percent in the first nine months of the year compared with the same period last year, bolstered by higher construction activity and a robust increase in the output of metals and precious and semi-precious stones. The 12-month rate of inflation rose from 2 percent at end-2002 to 7.5 percent in September 2003 mainly reflecting a large increase in the price of bread in June and September of this year.¹
2. During the twelve months through September 2003, reserve and broad money grew by 29 percent and 19 percent, respectively. Official net international reserves continued to be at a comfortable level and the dram remained broadly stable in both nominal and real terms this year.
3. Fiscal policy remained broadly on track in the first half of 2003, with tax revenues rising to AMD 100 billion. Both current and capital expenditures were somewhat lower than projected, the latter reflecting capacity constraints in project implementation units and a harsh winter. As a result, the deficit of the central government on a commitment basis amounted to just AMD 7 billion in the first half of the year compared with a programmed level of AMD 15 billion.
4. With regard to the main monetary and fiscal quantitative targets under the program, all but one of the end-June 2003 performance criteria were observed. The performance criterion on the stock of domestic expenditure arrears was missed by a small margin because of technical problems in the execution of expenditures.
5. On the structural side, the two performance criteria and most of the benchmarks scheduled for implementation under the fourth review of the program have been met. Three structural measures scheduled for June 2003 suffered a delay but two of them (issuing an order establishing a post-clearance verification program at customs and preparing a report on

¹ This item alone accounts for close to one-fifth of the consumer price index.

the audit operations of customs) have been implemented since then. The financial rehabilitation plan for the energy sector will be adopted by November 6, 2003 (prior action).

6. Developments in the banking system were mixed. A few banks continued to incur losses, reflecting weak asset quality. At the same time, commercial banks' exposure to the energy sector declined substantially. As planned, minimum capital requirements were raised from US\$1.65 million to US\$2 million in July 2003. Furthermore, the central bank submitted to the government amendments to the Law on Bankruptcy of Banks to execute more effectively bank resolution strategies; the Law on the Central Bank of Armenia to include specific clauses on the deposit insurance scheme; and the Civil Code to more effectively create, register, and enforce pledges. The amendments to the Civil Code have already been approved by parliament.

7. Further progress was made toward resolving the situation of the remaining three large intervened banks. Ardshinbank has been resolved through a purchase and assumption transaction and two least-cost analyses have been formulated for Armcommunications bank. The second least-cost test is based on a different set of assumptions regarding the chemical plant Nairit, the primary debtor of the bank. One key assumption is that a large infusion of private capital will be made to Nairit and enable the company to repay its loan to Armcommunications. The process of resolving the situation of the bank, however, has been rather slow, as the new foreign investor has tentatively agreed to operate Nairit pending further evaluation of the feasibility of the deal and the results of an audit of the company. Lastly, progress continues toward reducing the liabilities of Credit Yerevan, the third large intervened bank.

8. The envisaged reforms in the fiscal area were also implemented. In April 2003, the government amended the budget law with a view to enhancing expenditure control and began working on a plan to facilitate the proper monitoring and reporting of noncommercial enterprises (NCEs).² The administration of the value-added tax (VAT) is gradually improving: the processing time for exporters with a good compliance history has been shortened and the first quarterly report on outstanding VAT refunds has been published. The internal audit unit of the State Tax Service has published its first quarterly report and a similar report has recently been prepared by customs. Lastly, the latest version of the automated system of customs data (ASYCUDA) has been introduced at all customs' houses and customs' points.

9. The energy sector is undergoing significant reforms. As part of the debt-equity swap with Russia and in exchange for outstanding debt for nuclear fuel to a Russian supplier, the

² In early 2003, about 5,000 budgetary institutions were converted into non-commercial enterprises as part of a fiscal decentralization plan. These units, however, are not subject to standard reporting and auditing requirements, making it difficult for the government to assess their performance, the use of public funds, and the associated fiscal risks.

financial management of the nuclear power plant, the Hrazdan thermal power plant, and the Sevan-Hrazdan Cascade hydropower plant have been privatized. In the midstream sector, the transmission, dispatch and settlement functions have been separated. Reflecting improved performance of the privatized distribution company, collection rates have been at almost 100 percent throughout this year. The consolidated primary balance of the state-owned energy companies worsened in the second quarter of 2003, reflecting a delay in the delivery of nuclear fuel and higher use of more expensive thermal generation. As a result, the indicative target on the primary balance of the energy sector was missed by a small margin.

II. THE PROGRAM FOR THE PERIOD JULY 2003–JUNE 2004

10. **Economic objectives and policies.** The government's economic program aims at achieving the following core objectives:

- Providing the conditions for real economic growth of at least 12 percent in 2003 and 7 percent in 2004 so as to improve real per capita income and reduce the incidence of poverty;
- Maintaining the 12-month rate of inflation at no more than 3 percent and gross international reserves at more than 3.5 months of imports; and
- Further enhancing tax revenue collection in order to realize higher levels of social spending and public sector investment while controlling the fiscal deficit and public debt ratios.

The program for the coming year focuses on five key areas: (i) maintaining an independent monetary policy focused on price stability; (ii) reforming tax and customs administration; (iii) enhancing control, reporting, and prioritization of government expenditures; (iv) restructuring key state-owned companies in the energy, water, and irrigation sectors; and (v) reducing administrative barriers and opportunities for corruption.

11. **Monetary policy.** The overriding macroeconomic objective of the central bank will remain price stability. To this end, the Central Bank of Armenia (CBA) will use all instruments at its disposal to maintain inflation at no more than 3 percent while allowing the exchange rate to be market-determined. This will require a more cautious monetary policy in the remainder of 2003 and close monitoring of inflation, particularly because of a likely increase in administered prices (electricity, gas, and water). The monetary program for the remainder of 2003 and 2004 reflects this objective but anticipates further increases in the demand for money based on the remonetization of the economy and a gradual return of confidence towards the banking system. Broad money is projected to grow by about 12 percent in each year (2003 and 2004).

12. **Fiscal stance and expenditure policy.** Fiscal policy will remain prudent and no further domestic or external expenditure arrears will be incurred. The fiscal deficit on a commitment basis is projected at 2-2.5 percent of GDP in 2003 and 2004. In 2003, while nominal tax revenue targets will be met, tax revenues are likely to decrease as a share of

GDP. This is due to strong GDP growth in nontaxed sectors such as construction as well as protracted weaknesses in tax and customs administration. The latter problems will be tackled forcefully from now on to ensure a satisfactory revenue performance and achieve an increase in tax collections in 2004 of about 0.5 percentage points of GDP. The nominal tax target for 2004 could be subject to revision in light of new developments during the year and a supplementary budget could be prepared as needed. The budgeted level of social expenditures (health, education, and social security) will be fully executed in 2003 and those expenditures will increase by 0.4 percent of GDP.

13. **The 2004 budget.** The budget for 2004 will be based on total domestic (tax, nontax, capital) revenues of AMD 261 billion, current expenditures of AMD 238.2 billion, and a fiscal deficit on a commitment basis (after grants) capped at AMD 43 billion. With regard to capital expenditures, we will improve the execution of programmed capital spending by raising efficiency in project implementation units. After the exceptionally high levels attained in 2002–03, externally financed public investment could decline by as much as 2.6 percent of GDP in 2004 because of lower private capital grants. This will be partially compensated by an increase in domestically financed capital expenditures from 1.1 percent of GDP in 2003 to 1.4 percent (AMD 23.5 billion) in 2004. If external capital grants are secured by the time the budget is finalized, such grants will be added to the budget figures but the amount of domestically financed capital expenditures will be maintained. This will ensure a level of capital expenditures closer to the public investment needs envisaged in the PRSP and the provision of adequate financing for maintenance costs of public investment projects.

14. **Tax policy.** During the program period, we will undertake a number of measures to achieve our tax revenue target and improve the tax system. This will include reforming the VAT to improve its efficiency and reduce distortions. The main tax policy measures are:

- Introducing a minimum profit tax of 1 percent of companies' gross sales (expected yield: AMD 3 billion). Legislation on this tax will be passed by parliament by year-end and the tax will be enforced effective April 1, 2004;
- Amending the profit tax law in line with best international practice by March 2004. The amendments will include limiting the amount of interest deductibility to prevent thin capitalization or to limit interest payments if they exceed interest rates set by the CBA, enforcing withholding rules on employees, tightening loss carryover provisions, eliminating deductions for indirect taxes (especially the VAT), and ensuring that depreciation rules distinguish between expenses related to repairs and improvements that should be amortized (expected yield: AMD 1 billion)
- Increasing presumptive taxes on certain activities by January 1, 2004 so that overall presumptive tax revenue increases by 10 percent next year (expected yield: AMD 0.3 billion). These tax payments currently apply to various goods (such as cigarettes and diesel fuel) and services (such as haircuts), and have not been raised since their introduction in 1998;

- Make the presumptive tax on natural gas used by vehicles a function of sales, while increasing the minimum tax on each pump from 1 million drams per month to 1.5 million drams per month (expected yield: 0.4 billion drams);
- To ensure that the incentives to use natural gas are not eroded, we will introduce a presumptive tax on petrol stations based on the number of gasoline pumps, as it is currently done for natural gas (expected yield: AMD 0.3 billion).
- Introducing a stamp system to collect the excise tax on beer and bring such collection in line with that of other alcoholic beverages facing similar taxes (expected yield: AMD 0.3 billion).

15. **VAT exemptions on imports.** We will take a phased approach to reforming the VAT, in line with our institutional capacity and availability of technical assistance. First, we will approve legislation to reduce the coverage of imports currently exempt from VAT at the border effective January 1, 2004 (expected yield: AMD 1 billion). This reduction will amount to at least 282 customs lines representing 23 percent of the value of the potentially taxable imports in 2002 (AMD 19.5 billion). Second, we intend to expand the use of the current regime of temporary imports for processing of imported raw materials and intermediate goods destined primarily for exportation. At the same time, we will eliminate the penalty imposed on manufacturers who do not export 100 percent of their production. This penalty will only be applied to manufacturers who export less than 70 percent of their production. The last two measures will help alleviate some of the financial burden now faced by some importers and create incentives to expand production for both the export and the domestic market thus reducing the distortion imposed by these exemptions. Third, we intend to further reform the VAT regime by developing a deferral payment system for large imported capital goods (valued at more than US\$100,000). These capital goods are currently exempt from VAT liability at the border as a way to reduce the transaction costs of these imports. A commission (comprising representatives from the Ministry of Finance, Ministry of Trade and Development, State Tax Service, and State Customs Committee) will establish the information and technical criteria for granting a deferral in early 2004. By mid-2004, we intend to implement this deferral system on a pilot basis. The criteria for determining the items that will be covered under the pilot project will be developed in consultation with Fund staff.

16. **Tax administration.** During the program period, the government will step up its efforts to improve tax administration and remove remaining loopholes in the tax system to enhance equity, efficiency, and boost collections. To improve the withholding of income tax, we will amend legislation to oblige employers to provide detailed information on their employees. We will also improve the registration and accounting of business inventories and sales and revise the Enterprise Profit Tax form to include information on companies' balance sheets. By end-December 2003, we will clarify Article 4 of the Law on Simplified Tax so that it applies to taxpayers and not activities in order to limit the fragmentation and erosion of the profit tax base. In this context, we will also limit the ability to move between the profit tax and the simplified tax system. To enhance transparency, we will publish a list of delinquent

taxpayers in the official gazette and the media. Lastly, we will regulate the use of cash registers and register traders as businesses in large retail markets to increase tax revenues from these markets.

17. Budget management and reporting. Based on Fund technical assistance, we will implement a forward looking financial planning and cash management procedure. A draft manual that governs internal audit in line ministries and subordinate organizations will be completed this year. To ensure transparency and efficiency in the operations of NCEs, we will develop procedures for supervising and monitoring these enterprises. By end-November 2003, we will adopt the legal basis for a reporting system for NCEs and designate a monitoring unit for these entities within the Ministry of Finance. Minimum criteria will be developed for deciding when an NCE should be considered as part of the general government or as part of the public corporations sector (the activities of the latter will not be consolidated into the general government accounts). Steps will also be taken to prohibit NCEs from borrowing and ensure that their activities are subject to random audits. Furthermore, all NCEs will submit budgets and begin regular reporting of revenues and expenditures. This will enable the preparation of consolidated government reports by the treasury, combining both budgetary institutions and NCEs. By April 2004, the budget execution reporting by NCEs and the consolidation of their activities at the general government level will be operational.

18. Customs administration. There is an urgent need to improve transparency and efficiency of the customs service and eliminate loopholes and inconsistencies in legislation. As mentioned above, all customs houses and customs points have been updated with the latest version of ASYCUDA. Later this year all customs houses and passport-reading machines will be networked by a single system.³ Despite lack of progress in populating the valuation database with invoice values, we will ensure that the share of commercial imports whose approved customs value is determined by the transaction price will increase to at least 25 percent by December 2003 and 50 percent by mid-2004. As more imports are valued at transaction prices, a system of post-clearance audits is required. This program will become operational by the end of this year. As part of the ASYCUDA upgrade, beginning January 2004, we will implement a system whereby commercial importers and brokers will be able to prepare their own customs declarations at the time of importation using the customs computer system.⁴ By year-end, we will review legislation with a view to reducing document requirements and eliminating the certification fee for exports. We will also eliminate a provision in the customs code (Article 105.5) that allows importers to circumvent paying customs duties by removing the manufacturers' labels of goods carried when entering

³ Once this network is put in place, the customs code will be amended to set a 48-hour minimum stay in a foreign country in order to become eligible for duty free exemptions.

⁴ Once the information is inserted into the customs computer system at customs houses, it will be printed and signed by the importer.

Armenia. Finally, we will pass legislation to ensure that customs clearance of all petrol imports is undertaken at the point of entry in order to reduce smuggling.

19. **Banking supervision and problem banks.** The CBA will continue to strengthen banking supervision, act decisively against banks that violate prudential norms, and ensure that all market participants operate on equal terms. In this regard, the CBA is preparing an offsite inspection manual that will enhance day-to-day supervision. In addition, a manual on interim administration will be drafted with a view to enhancing the efficiency of resolutions of problem banks. Following the purchase and assumption of the major share of the assets and liabilities of Ardshinbank by a new bank, the remains of Ardshinbank are in the process of being liquidated. By end-November 2003, the CBA will revoke the license and nominate a liquidator for Credit Yerevan. By that time, we will also make a final decision on the future of Armcommunications. Assuming an agreement is reached with the investor for Nairit, the CBA will prepare a detailed and time-bound action plan—including resources paid and committed by the potential investor—that will demonstrate the viability of the potential transaction, i.e. a decline in Nairit's outstanding liabilities and a replenishment of the capital of the bank. If the agreement fails, the CBA will nominate liquidators for Armcommunications by end-November 2003.

20. **Financial sector legislation.** Enhancing the legal framework of the financial system and the functioning of the judiciary remains a key priority for financial sector development. Following the submission to the cabinet of draft amendments to the Law on Bank Bankruptcy and the Central Bank Law, we expect these amendments to be adopted by parliament by end-2003. In addition, before the end of the year we plan to submit to parliament new legislation on the mandatory registration of the title of movable property. The CBA will also draft amendments to various legal acts on corporate governance in line with best practice to enhance the management, transparency, and accountability of commercial banks.

21. **Balance of payments.** The current account deficit as a share of GDP is expected to deteriorate in 2003, reflecting strong import growth. Such import growth is partly associated with unusually large grant-financed investments that led to a surge in imports of construction material, machinery, and equipment during the first half of the year. Grant-financed investment is expected to fall rapidly after 2003 and contribute to a reduction in the current account deficit as a share of GDP in 2004. At the same time, the services balance is projected to improve because of higher tourism receipts and the growing export-oriented software industry. Gross international reserves are targeted to remain at over 3.5 months of imports of goods and services in 2003 and beyond.

22. **External debt.** The government will not accumulate external nonconcessional debt or external payments arrears of any sort during the program period. The debt-equity swap with Russia has just been finalized thereby exchanging about US\$94 million in debt for assets in Armenian companies. Similarly, the outstanding debt to Turkmenistan of US\$11 million has been paid through the provision of goods.

23. **Trade and foreign exchange regime.** Armenia became a member of the World Trade Organization in February 2003. We will ensure that recently passed legislation adhering to WTO rules is fully enforced. Furthermore, no distinctions will be made between WTO members and other countries when applying customs valuation methods. Armenia will maintain a floating exchange rate regime and a liberal trade regime with no restrictions in the making of payments and transfers for current international transactions. The latter are in conformity with Article VIII of the IMF's Articles of Agreement.

24. **Energy Sector.** By early November, the government will approve the Integrated Financial Rehabilitation Plan for the energy, water, and transport sectors and pass a resolution to enforce the implementation of institutional reforms and debt restructuring measures recommended in the plan. The plan is the centerpiece of future reforms of the sector in light of the recent privatization of the distribution company and a major power plant and the need to address protracted problems of mismanagement. In this regard, the energy sector is moving away from a single-buyer approach towards a model with direct or pooled-direct contracting of energy purchases between the distribution company and the power generators. By February 2004, the structure of the existing settlement, dispatch, and transmission companies in the midstream energy sector will be based on the recommendations of the plan, and a corporate governance structure will be established with independent board of directors and internal and external audit mechanisms. At the same time, Armenergo will be removed from the contracting process and by end-June 2004 Armenergo will be liquidated and all of Armenergo's outstanding liabilities to the government will be written off and the remaining debt will be restructured to arrive at a manageable debt burden. By mid-2004, the management of midstream operations will be governed by private performance-based management contracts. The government also intends to privatize the Vorotan Cascade hydropower plant and, eventually, the Yerevan Thermal Power Plant, based on transparent and competitive international tenders. As part of our reform of the energy sector, by January 2004, the Ministry of Energy will be transformed into a policy-making body and all business management functions will be vacated.⁵ Lastly, the newly reorganized regulatory commission for natural monopolies will regulate, oversee, and set the tariffs for the power and water sectors. It will ensure that proper and adequate regulation is in place to enhance transparency in these sectors.

25. **Water and irrigation sectors.** By the end of this year, the government will issue a tender to privatize the management of the Armenia Water and Waste Company. Water tariffs will gradually rise over the next few years to reach operations and maintenance cost recovery levels by 2007. In the irrigation sector, the management of infrastructure will be transferred to user associations over the medium term. Such a decentralized approach is expected to increase the efficiency of operations. Over the next few years, tariffs for bulk and end-users

⁵ Up until now, the Ministry of Energy has been engaged in financial and strategic decisions affecting state-owned companies including external debt transactions.

are expected to increase gradually, approaching cost recovery levels by 2007. The government will actively monitor the impact on the poor of these increases, and will stand ready to increase family support benefits if needed to compensate for such increases.

26. **Anti-corruption.** As part of our renewed efforts to root out corruption, we will finalize an anti-corruption strategy covering a wide range of measures in November 2003 and make the document available for comments from parliament and international donors. The strategy will lay out the main sources of corruption in Armenia and include a time-bound action plan with measures derived from the strategy. Particular emphasis will be placed on ensuring a sound legal framework (covering legislation that treats corruption as a criminal offense, freedom of information acts, and “whistle blower” protection legislation) and including measures to improve transparency in the judicial system, the police, and in customs and tax administration. The government will also ensure public scrutiny of the strategy and update it periodically in response to feedback from civil society.

27. **Program monitoring.** Program monitoring will be carried out according to semi-annual quantitative performance criteria (end-December 2003) and quarterly indicative targets for the first half of 2004 (Table 1) and structural performance criteria and benchmarks (Table 2). The quantitative performance criteria include ceilings on the net domestic assets (NDA) of the CBA, net banking system credit to the government, domestic expenditure arrears of the central government and the SFSI, net disbursements of short-term external debt, contracting and guaranteeing of new non-concessional medium- and long-term external debt, and external arrears. They also include floors on net official international reserves of the central bank, tax revenues of the central government, and the cash balance of the central government. There is an indicative band on reserve money, and an indicative floor on the primary balance of the energy sector. Details on the definitions, monitoring, and adjustors of quantitative performance criteria are contained in the attached Technical Memorandum of Understanding (TMU). A request for the sixth 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 fifth review under the program expected on April 15, 2004.

28. **Compilation and provision of information.** To insure the effective monitoring of the program, the relevant ministries, the CBA, and the National Statistics Service (NSS) will compile and share with Fund staff all core economic data on a timely basis as specified in the TMU.

Table 1. Armenia: Quantitative Targets, June 2003-June 2004 1/
(End of period ceilings on stocks, unless otherwise specified)

	2003			2004	
	Jun. Act.	Sept. Est.	Dec Prog. 3/	Mar. Prog. 2/	Jun. Prog. 2/
(in billions of drams)					
Net domestic assets of the CBA 4/	-34.1	-40.1	-24.6	-30.9	-26.2
Net banking system credit to the government	-14.6	-13.1	0.5	-4.4	2.6
Domestic arrears of the central government and the State Fund for Social Insurance	0.9	0.0	0.0	0.0	0.0
Tax revenues of the central government (floor) 5/	...	58.8	124.7	175.2	237.5
Balance of the central government on a cash basis (floor) 5/	...	-7.7	-28.4	-29.8	-44.2
Reserve money (band) 2/	95.4	103.4	(118-123)	(105-109)	(108-112)
Primary balance of the energy sector (floor) 2/ 5/ 6/	...	1.2	2.8	4.5	6.3
(in millions of dollars)					
Contracting and guaranteeing of new nonconcessional external debt with maturity of more than one year 5/	0	0	0	0	0
Net disbursements of short-term external debt 5/ 7/	0	0	0	0	0
External arrears (continuous criterion)	0	0	0	0	0
Net official international reserves (floor) 4/	234	258	262	250	247

1/ The definitions of the line items and the adjusters on the fiscal balance and the stock of domestic arrears are specified in the attached Technical Memorandum of Understanding (TMU).

2/ Indicative target.

3/ Performance criterion.

4/ At program exchange rates as specified in the TMU.

5/ Cumulative flow from June 2003 until the end of the month indicated.

6/ Excluding the balance of the distribution company and of two generation companies recently privatized.

7/ Obligations with maturity of less than one year, excluding normal import-related credit and sales of treasury bills to nonresidents.

Table 2. Armenia: Structural Measures under the PRGF-supported Program^{1/}

	Target Date ^{2/}
Prior Action for Completing the Fourth Review	
Approve the Integrated Financial Rehabilitation Plan for the energy, water, and irrigation and transport sectors and pass a government resolution to implement the reforms and debt restructuring measures recommended in the plan.	November 6, 2003
Performance Criteria	
Parliament to approve a law reducing the number of import categories exempt from VAT effective January 1, 2004. The reduction will apply to 282 customs lines representing 23 percent of the value of taxable imports (at 2002 prices).	December 2003
Parliament to approve legislation imposing a minimum profit tax of 1 percent of companies' gross sales effective April 2004. This tax will be non-refundable but will be credited against profit taxes due.	December 2003
Benchmarks	
Finalize resolution strategy for intervened banks by: (i) revoking the license and nominating a liquidator for Credit Yerevan and (ii) nominating liquidators for Arm communication bank if an agreement with a potential investor to purchase both the bank and Nairit does not materialize. If the agreement materializes, approve a detailed and time-bound action plan including projected financial flows for the resolution of Armcommunications.	November 2003
To limit the erosion of the profit tax base, clarify Article 4 of the Law on Simplified Tax so that it applies to taxpayers and not activities. Make taxpayers transferring to the simplified tax regime from the profit tax regime subject to the profit tax for a minimum of 3 years.	December 2003
Ensure compliance with customs procedures by:	
<ul style="list-style-type: none"> • making the post-clearance verification program at customs headquarters operational and increasing the share of the value of commercial imports for which the approved customs value is determined on the basis of the declared transaction price to at least 25 percent of the value of commercial imports; and 	December 2003
<ul style="list-style-type: none"> • increasing the above-mentioned share to 50 percent of the value of commercial imports. 	June 2004
Restructure the midstream energy sector (the settlement, dispatch, and transmission functions) as recommended in the integrated financial rehabilitation plan. Establish a corporate governance structure with independent board of directors, and internal and external audit mechanisms.	February 2004
Regulate the use of cash registers and register traders (as businesses) at large retail markets.	March 2004
Begin regular reporting for government-owned noncommercial enterprises.	April 2004
Develop a deferral payment system for VAT for large imported capital goods (valued more than US\$ 100,000) not currently taxed at the border:	
<ul style="list-style-type: none"> • A multi-agency commission (Ministry of Finance and Economy, State Tax Service, Customs Committee, Ministry of Trade) will establish the technical criteria for granting deferrals. 	April 2004
<ul style="list-style-type: none"> • The Customs Committee and the State Tax Service sign a Memorandum of Understanding on exchange of information and initiate the deferral system on a pilot basis. The criteria for determining the items that will be covered under the pilot project will be developed in consultation with Fund staff. 	June 2004

1/ The TMU defines these measures as needed. The performance criteria for the sixth review will be set at the time of the fifth review.

2/ End of period.

**GOVERNMENT OF ARMENIA
TECHNICAL MEMORANDUM OF UNDERSTANDING**

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

I. QUANTITATIVE TARGETS

1. The program targets a minimum level of **net official international reserves (NIR)** of the Central Bank of Armenia (CBA). The stock of such reserves will be calculated as the difference between total official gross international reserves 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 Special Drawing Rights (SDRs), any reserve position in the IMF, and holdings of convertible currencies in cash or in nonresident financial institutions (deposits, securities, or other financial instruments). Gross reserves held in the form of securities are marked to market. Gross reserves are reported separate from the balance on the government's Special Privatization Account (SPA) and excluding capital subscriptions in foreign financial institutions and illiquid foreign assets. There is no reporting on financial derivatives and other off balance sheet positions, as the CBA does not currently trade in such instruments. If the CBA decides to commence such trading it will promptly notify the IMF staff in order to establish 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, 2002 (Attachment III, Table 1).
2. The program targets a maximum level of **net domestic assets (NDA)** of the CBA. For program purposes, NDA is defined as reserve money minus Net International Reserves (NIR) plus medium- and long-term liabilities of the CBA. To evaluate program targets, the dram-equivalent values of NIR and medium- and long-term liabilities are calculated at the end-2002 official exchange rate of dram 584.9 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.
3. **Reserve money** targets are indicative and include a floor and a ceiling. They are subject to a daily bound of plus or minus 2 percent computed from the quarterly average standard deviation of excess reserves held by banks in percent of quarterly reserve money during the previous four years. Reserve money is defined as the sum of currency issue and

required and excess reserves and current and time deposit accounts of certain resident agents.¹

4. **The stock of credit from the CBA to the government** includes the CBA's holdings of treasury bills and treasury bonds less all types of 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.

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

6. **External debt limits** apply to all forms of new nonconcessional medium- and long-term external debt² with original maturities of more than one year, which are contracted or guaranteed by the government or the CBA. Excluded from the limits are changes in indebtedness resulting from refinancing credits or rescheduling operations, sales of treasury bills or treasury bonds to nonresidents (provided the sales go through the regular auction mechanism and involve no exchange rate guarantees), concessional loans, and credits extended by the IMF.³ Except for normal import-related credits, there is a zero limit on short-term external debt (obligations with original maturities of up to one year) contracted or guaranteed by the government or the CBA. Transactions subject to debt ceilings shall be

¹ Compared to the IFS definition, transactions under repurchase agreements and the CBA's deposit facility are not included in reserve money.

² The term "debt" shall have the meaning set forth in Section 9(a) of the Guidelines on performance criteria on external debt, as modified by the Executive Board Decision No. 12274-(00/85) of August 24, 2000, 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.

³ For program purposes, a loan is considered concessional if the grant element is at least 35 percent calculated using a discount factor based on the Commercial Interest Reference Rates (CIRRs) published by the OECD plus margins depending on the loan maturity. The margins are: 0.75 percent for repayment periods of less than 15 years, 1 percent for 15–19 years, 1.15 percent for 20–29 years, and 1.25 percent for 30 years or more. The average of the CIRRs over the last ten years will be used for loans with a maturity of at least 15 years and the average of the CIRRs for the preceding six months will be used for shorter maturities.

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

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

8. The **balance of the central government on a cash basis** is defined as the sum of domestic banking system net financing, domestic nonbank net financing, and external net financing to the government. **Net banking system credit to the government** equals the change during the period of net credit to the government. **Nonbank net financing** equals the sum of: (1) the change during the period of outstanding treasury bills and bonds to nonbanks (including accrued interest for treasury bills and excluding accrued interest for treasury bonds);⁴ and (2) any other disbursement or transaction that increases nonbanks' claims on the central government plus withdrawals from the SPA, less amortizations made by the central government to private resident nonbank agents. **External net financing** equals total debt-increasing disbursements from non-residents to the central government less total amortizations from the central government to non-residents. All foreign-currency denominated transactions are recorded in drams using the prevailing exchange rate at the time of the transaction.

9. The US-based Lincy Foundation extends grants to finance various investment projects. The project implementation units, which carry out Lincy-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. In addition, the US-based Lincy foundation extends loans to finance investments. To the extent that these loans are intermediated through the banking system, they are recorded in the financial accounts as a financing item below the line and are thus excluded from net lending.

10. Proceeds from selling enterprises 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. These proceeds are included in the definition of the monetary accounts of the CBA as part of net foreign assets with a counter entry in other items net. Any budgeted withdrawal from the SPA will be accounted for as privatization proceeds used to finance the budget and will be recorded below the line. Any unanticipated withdrawal from the SPA will be recorded below the line as privatization receipts; these withdrawals, however, will be replenished during the same fiscal year.

11. **Tax revenues** are defined in accordance with Government Financial Statistics (GFS), 1986, section IV.A.1. Total revenues collected by the State Tax Service (STS) and the

⁴ Domestic nonbank holdings of treasury bills and treasury bonds are defined as total outstanding treasury bills and bonds less holdings by the banking system and the SFSI.

Customs Committee (CC) are classified as follows: VAT (of which: presumptive tax on cigarettes, petroleum, and diesel), excises (of which: presumptive tax on cigarettes, petroleum, and diesel), enterprise profit tax, personal income tax, land tax, customs duties (of which: presumptive tax on cigarettes), other presumptive taxes, simplified tax, property tax, and other taxes (of which stamp duties and environmental taxes).

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

13. The program targets the **primary balance of the energy sector**, which is defined as current total revenues less total expenditures excluding interest payments and foreign-financed capital expenditures. The government will provide a detailed quarterly cash flow for the energy sector. The energy sector is defined by the following state-owned companies: (1) Yerevan thermal power plant; (2) Metsamor nuclear power plant; (3) Vorotan hydro-power plants system; (4) High Voltage Electricity Network; (5) Armenergo; (6) the Settlement Center; (7) the Dispatch Company; and (8) Armgasard.

II. ADJUSTERS

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

- **Foreign-financed project disbursements:** the target on the cash balance of the central government will be adjusted downward (upward) by the full amount of cumulative higher (lower) than programmed foreign-financed project disbursements. The programmed amounts are shown in Table 2 below.
- **Structural adjustment lending from the World Bank:** the following targets for December 2003 will be adjusted by the full amount of a lower than programmed SAC disbursement: NIR (downward), NDA of the CBA (upward), net credit to the government (upward), and the cash balance of the government (upward). The programmed amount is shown in Table 3 below.
- **KfW loans:** the target on the stock of net domestic assets of the CBA will be adjusted upward (downward) by the amount of any disbursement (repayment) from (to) KfW. The adjustment will be made at program exchange rates.

- **Lincy loans:** the following targets will be adjusted by the full amount of any conversion to grants or debt forgiveness of the outstanding stock of debt to the Lincy Foundation: net credit to government (downward) cash balance of the government (downward), NIR (upward), and NDA of the CBA (downward). The adjustment will be made at program exchange rates.

III. STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS

15. **VAT deferral system.** The information and technical criteria for granting deferrals need to be determined by the new commission. Among other things, this commission will determine the goods or activities that would be covered by the deferral system; whether all or specific enterprises are to be eligible; documentation requirements; the length of deferral (no more than 12 months); and the scope of the pilot project (selected activities or selected taxpayers). In addition, the exchange of information, specified in the memorandum of understanding between the Customs Committee and the State Tax Service, would include identification of taxpayer, content of information, format of data, form of transmittal, and frequency. Under the deferral system, Customs would allow imports without payment of VAT based on established criteria and provide documentation to the State Tax Service. The Tax Service would develop procedures to establish a liability record, revise tax forms to account for deferred VAT, and monitor compliance of taxpayers.

16. **Post clearance verification.** To make the post-clearance verification program operational will require the preparation of an audit procedures manual; staffing the audit unit with qualified staff based on specific criteria; and developing risk assessment selection profiles.

17. **Budget reporting of noncommercial enterprises.** Minimum criteria will be developed for deciding when an NCE should be considered as part of the general government or as part of the public corporations sector. The government will institute a system under which the enterprises will report data on an aggregated GFS basis on revenues, expenditures and arrears. The definition of arrears will be the same as that applying to budget institutions and the nature of the aggregation will be discussed with Fund staff. All noncommercial enterprises will disclose their budgets to the Ministry of Finance and Economy on the same basis as they will be reporting. This information will be reflected in the annual budget. Beginning with the first quarter of 2004, all NCEs will be required to submit quarterly reports no later than 30 days after the end of each quarter. A Government Decree will be issued under which the scope of the internal audit function of line Ministries will be expanded to incorporate the audit of NCEs. The Ministry of Finance and Economy will specify reporting and audit requirements in an appropriate regulation or by amending the Budget System law as needed.

18. **Resolution strategy for intervened banks.** The CBA will provide monthly data within 30 days of the end of each month on (i) the balance sheet of Armcommunications (ii) detailed information on cash flows/transactions between the Armcommunications, Nairit, and third parties, (iii), any supplementary agreements between the investor and the authorities.

IV. DATA REPORTING

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

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
CBA ⁵	CBA balance sheet	Summary	Weekly	Within 1 day of the end of each week
	CBA balance sheet	Summary at program exchange rates; and by chart of accounts at actual official exchange rates	Monthly	Within seven days of the end of each month
	Monetary survey	Summary banking system balance sheet for the central bank and the consolidated balance sheet of commercial banks at program exchange rates; and by chart of accounts at actual official exchange rates	Monthly	Within 21 days of the end of each month
	International reserves	By chart of accounts; at (i) program exchange rates; and (ii) at actual official exchange rates	Weekly	Within 1 day of the end of each week
		By chart of accounts; at (i) program exchange rates; and (ii) at actual official exchange rates	Monthly	Within 21 days of the end of each month
	Foreign exchange market	Official exchange rates (buying and selling); interbank turnover; and volume of CBA interventions	Weekly	Within 1 day of the end of each week
	Interest rates	Repo rate; interbank rate; by volume and maturity, T-bill rate, bond yield; and by maturity, deposit and lending rates	Monthly	Within 7 days of the end of each month
	CBA operations	Repo (reverse repo) operations; Lombard credits; and deposit facility	Monthly	Within 7 days of the end of each month
	Bank liquidity	Reserves and excess reserves	Biweekly	Within 7 days of the end of each month
	Special privatization account (SPA)	Monthly flows	Monthly	Within 7 days of the end of each month
	Banking indicators	Capital adequacy; asset composition and quality; profitability; liquidity; open FX positions; and compliance with prudential norms (Tables 4 and 5)	Quarterly	Within 30 days of the end of each quarter

⁵ As defined in CBA resolution No. 201 (December 6, 1999).

	CPI	Index of core inflation	Monthly	Within 21 days of the end of each month
	Other monetary data	IFS format	Monthly	Within 45 days of the end of each month
Customs Committee	Internal audit report	The audit report will include: the number of written appeals, complaints, and requests submitted to the IAUCC; the sources of the written submissions referred to in point 1 in broad categories (e.g. President's Office, the Prime Minister's Office, other Government officials, National Assembly, line Ministries, Law Enforcement bodies, individuals, non-government organizations); the IAUCC's actions in response to the written submissions referred to in point 1; the number and type of audits/investigations undertaken by the IAUCC; the overall results of the audits/investigations undertaken; and the actions taken by the IAUCC in response to the results of the audits/investigations undertaken.	Quarterly	Within 30 days of the end of each quarter
Ministry of Finance and Economy (MFE)	T-bill and coupon bond financing	By holders, i.e., CBA, resident banks, resident nonbanks, and nonresidents	Monthly	Within 7 days of each month
	External debt	Disbursements and stock of outstanding short-term and contracting or guaranteeing and outstanding stock of medium-and long-term external debt of the government, the CBA, and state-owned companies (by company); any stock of arrears on external debt service and outstanding stock of government guarantees and external arrears	Monthly	Within 21 days of the end of each month (preliminary data) and within 45 days of the end of each month (final data)
	Revenue collection	Total revenue collected separately by the SFSI, the STS, and the CC	Monthly	Within 7 days of the end of each month
	Expenditure arrears	Government and SFSI separately (Table 6)	Monthly	Within 20 days of the end of each month for SFSI arrears and within 45 days of the end of each month for government arrears
	Privatization receipts	Balance on the SPA; gross inflows into and outflows from the SPA during the month, specifying the nature of each transaction	Monthly	Within 7 days of the end of each month

	Treasury single account (TSA)	Detailed breakdown of central treasury account, including deposits at the central treasury, pension fund, community budgets, off budget account, monetization account, state budget account and the Republic correspondent account—flows during the month and end of month stocks.	Monthly	Within 7 days of the end of each month
MFE/SFSI	Budget execution	All cash receipts, cash expenditures, including debt-service payments, and external and domestic borrowing operations; expenditure data will be provided according to both economic and functional classifications, consistent with the GFS methodology	Monthly	Within one month following the end of each quarter.
MOE	Energy sector	Stock of accounts payables and receivables; composition of financing of the consolidated energy sector	Monthly	Within 28 days of the end of each month
		Cash flow statement of the consolidated energy sector (Table 7) ⁶	Monthly	Within 45 days of the end of each month
NSS	Balance of payments	Detailed export and import data	Monthly	Within 28 days of the end of each month
		Detailed export and import data	Quarterly	Within 45 days of the end of each quarter
	GDP	Estimates	Monthly	Within 30 days of the end of each month
	CPI	By category	Monthly	Within 5 days of the end of each month
STS	Tax arrears	By type of tax	Monthly	Within 30 days of the end of each month
		For or the 10 largest debtors and for all major companies in the energy, water, and irrigation sectors	Quarterly	Within 30 days of the end of each quarter

⁶ The table is in summary form. A more comprehensive table has been agreed in the form of an Excel workbook.

Table 1. Armenia: Program Exchange Rates of the CBA
(As of December 31, 2002)

Country	Drams Per Currency	Dollars Per Currency
Australian dollar	329.94	0.5641
Canadian dollar	372.92	0.6376
Swiss franc	416.61	0.7123
Danish krone	73.78	0.1261
Euro	606.88	1.0376
Pound sterling	935.94	1.6002
Japanese yen	4.87	0.0083
Norwegian krone	83.07	0.1420
Swedish krona	66.29	0.1133
U.S. dollar	584.89	1.0000
SDR	792.28	1.3546
Gold 1/	6568.46	11.2302

1/ Per gram.

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

2003		2004	
<u>September</u>	<u>December</u>	<u>March</u>	<u>June</u>
6.1	18.8	26.9	35.8

1/ Cumulative from June 2003.

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

2003	
<u>September</u>	<u>December</u>
0	11.7

1/ Cumulative, from June 2003; at program exchange rates.

Table 4. Armenia: Financial Soundness Indicators for the Banking Sector, 2000-04
(in percent, unless otherwise indicated)

	2000	2001	2002 1/	2003				2004	
				Mar. 2/	June 3/	Sept.	Dec.	Mar.	June
Capital adequacy									
Total regulatory capital to risk-weighted assets	25.0	13.6	30.5	39.2	34.3	34.3			
Tier I regulatory capital to risk-weighted assets	23.3	12.3	28.8	37.4	32.6	32.7			
Capital (net worth) to assets 4/	14.3	8.8	18.4	20.3	18.3	18.2			
Asset composition									
Sectoral distribution of loans (billions of drams) 5/									
Industry (excluding energy sector)	20.8	24.2	16.3	14.2	16.1	18.5			
Energy Sector	16.3	8.5	12.2	10.7	10.2	9.7			
Agriculture	10.4	9.9	7.1	7.8	8.7	7.7			
Construction	2.0	2.4	2.5	2.8	3.6	4.9			
Transport and communication	2.1	1.9	0.8	0.7	0.7	1.0			
Trade/commerce	12.7	13.4	13.9	14.7	16.6	16.9			
Sectoral distribution of loans to total loans (percent of total)									
Industry (excluding energy sector)	21.9	29.8	22.3	19.9	20.0	22.0			
Energy Sector	17.1	10.5	16.8	15.2	12.7	11.5			
Agriculture	10.9	12.1	9.8	11.1	10.9	9.1			
Construction	2.1	3.0	3.5	4.0	4.4	5.8			
Transport and communication	2.2	2.4	1.2	1.0	0.8	1.2			
Trade/commerce	13.4	16.5	19.0	20.8	20.7	20.2			
Foreign exchange loans to total loans 6/	85.9	84.7	82.5	80.9	73.7	72.9			
Asset quality									
Nonperforming loans (billions of drams)									
Watch (up to 90 days past due)	7.5	6.3	4.9	6.1	7.2	7.6			
Substandard (91-180 days past due)	...	...	2.3	3.8	4.6	4.3			
Doubtful (181-270 days past due)	4.7	4.4	1.7	1.1	1.8	2.3			
Loss (>270 days past due) 7/	2.8	1.9	0.9	1.1	0.8	1.1			
Non-performing loans to gross loans	16.8	25.7	11.5	11.1	12.3	12.0			
Provisions to non-performing loans 8/	6.2	6.0	4.9	6.3	8.2	6.7			
Spread between highest and lowest rates of interbank borrowing in AMD 9/	46.4	45.2	40.2	34.0	28.1	26.4			
Spread between highest and lowest rates of interbank borrowing in foreign currency 10/	46.7	29.0	7.8	5.5	2.4	1.9			
	35.0	22.0	3.6	1.8	4.5	2.0			
Earnings and profitability									
ROA (profits to period average assets) 10/ 11/	-1.9	-9.1	3.9	1.5	1.4	2.1			
ROE (profits to period average equity) 10 11/	-12.3	-78.6	21.6	7.8	7.5	11.1			
Interest margin to gross income 12/	30.7	27.8	37.6	44.2	42.7	42.4			
Interest income to gross income 13/	84.3	77.8	63.1	69.3	65.7	64.5			
Noninterest expenses to gross income 14/	36.4	42.7	48.3	49.5	47.9	47.8			
Liquidity									
Liquid assets to total assets	30.5	33.1	44.5	47.3	49.2	48.8			
Liquid assets to total short-term liabilities	86.1	80.4	108.8	114.7	114.0	109.9			
Customer deposits to total (non-interbank) loans 15/	146.4	198.4	195.3	180.8	188.0	185.0			
Foreign exchange liabilities to total liabilities 16/	80.6	79.7	72.2	72.9	71.3	71.8			
Sensitivity to market risk									
Gross open positions in foreign exchange to capital	22.5	88.3	15.3	19.0	15.9	14.5			

Source: Central Bank of Armenia.

1/ Includes the data of 20 banks and excludes the data of 8 banks under interim administration.

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

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

4/ The ratio shows the relationship between balance sheet capital and balance sheet assets (balance sheet assets exclude securities held under repo agreements).

5/ The ratio shows the sectoral distribution of total bank lending to residents (total bank lending includes loans, factoring, and financial leasing and excludes interbank borrowing).

6/ The ratio shows the share of foreign exchange lending in total lending (interbank lending is included in total lending).

7/ Stock of written off loans in the off-balance sheet.

8/ Includes the provisions of total loans (standard and nonperforming).

9/ From 1998 to 2001 the data show the interbank borrowing of residents and nonresidents. Starting in 2002 the data show only the interbank borrowing of residents.

Since June 2003 repo transactions are also included in interbank borrowing. These differences are due to the change of reporting forms during the above mentioned periods.

10/ Average assets (capital) are calculated based on the algebraic average of quarterly data. The average figures for 2002 are calculated based on 20 banks.

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

12/ Interest income minus interest expense divided by gross income (gross income is defined as the sum of interest and non interest income).

13/ Interest income divided by gross income.

14/ Noninterest expenses divided by gross income.

15/ Customer deposits include bank accounts, demand and term deposits of individuals, legal entities, and nonbank financial institutions.

16/ Foreign exchange liabilities show the balance sheet liabilities in foreign exchange.

Table 5. Armenia: Bank Compliance with Prudential Norms, 2001–2004 1/

	2001	2002	2003				2004	
			Mar.	June	Sept.	Dec.	Mar.	June
Number of banks 2/	30	20	20	20				
Capital adequacy (CAR)								
Capital/risk-weighted assets								
CAR < 12 %	9	0	1	1	1			
12% < CAR < 15%	0	2	0	0	0			
15% < CAR < 20%	2	3	1	2	1			
20% < CAR < 30%	6	3	7	7	9			
CAR > 30%	13	12	11	10	9			
Core capital/risk-weighted assets								
CAR < 8 %	9	0	1	1	1			
8% < CAR < 13%	0	3	0	0	0			
13% < CAR < 20%	3	2	3	3	3			
20% < CAR < 30%	5	3	6	6	7			
CAR > 30%	13	12	11	10	9			
Liquidity (LR)								
Liquid assets/demand liabilities								
LR < 80%	11	1	0	0	0			
80% < LR < 100%	3	5	3	6	4			
100% < LR < 150%	5	7	9	7	9			
150% < LR < 200%	3	3	2	2	4			
LR > 200%	8	4	6	5	3			
Liquid assets/total assets 3/								
LR < 20%			0	1	0			
LR < 25%	12	5	1	4	4			
25% < LR < 30%	3	2	4	2	5			
30% < LR < 40%	7	7	6	5	6			
40% < LR < 50%	1	2	2	2	2			
LR > 50%	7	4	7	7	7			
Exposure limits 4/								
Single external borrower/capital								
Exposure > 20%	4	4	2	3	1			
Single internal borrower/capital								
Exposure > 5%	1	0	0	0	0			
Total internal borrower/capital								
Exposure > 60%	1	0	0	0	0			
Total internal borrower/capital								
Exposure > 50%			0	0	0			
Net open foreign exchange position								
Total currencies position/capital								
Exposure > 25%	1	1	1	1	1			
Nonconvertible currencies position/capital								
Exposure > 5%	2	1	1	1	1			
Asset quality								
Nonperforming loans/gross loans (NPL)								
NPL < 2%	12	6	6	5	5			
2% < NPL < 4%	5	2	3	4	3			
4% < NPL < 6%	2	5	2	3	2			
6% < NPL < 10%	2	2	3	1	3			
NPL > 10%	9	7	6	7	7			

Source: Central Bank of Armenia.

1/ Lower bounds (capital adequacy and liquidity) and upper bounds (exposure limits and open foreign exchange positions) reflect Armenian standards.

2/ Prudential ratios are calculated based on 30 banks at end-2001 and 20 banks in 2002-2003.

The ratio on exposure limits is calculated based on 25 banks at end-2001 and 20 banks in 2002. Asset quality is calculated based on 30 banks at end-2001.

3/ Due to methodological differences, not all cases of a liquidity ratio below 25 percent constitute a violation of the prudential norm. Since February 2003 the margin for the liquidity to capital prudential ratio is set at 20 percent.

4/ Some violations occurred after the CBA required a capital write-off.

5/ Since February 2003 the margin for the total internal borrower/capital ratio is set at 50 percent.

Table 6. Armenia: Arrears of State Budget and SFSI, 2000-04
(In billions of drams; end of period)

	2000	2001	2002 2/	2003 3/				2004	
				Mar.	June	Sept.	Dec.	Mar.	June
Total arrears	44.3	42.2	17.8	17.9	11.2				
Total expenditure arrears	37.3	35.8	7.1	7.2	0.9				
Current expenditures	34.6	31.4	5.5	5.4	0.3				
Wages	0.5	0.4	0.1	0.1	0.0				
Subsidies 1/	0.9	0.8	0.1	0.1	0.0				
Interest	3.4	3.1	0.0	0.0	0.0				
Domestic interest	0.0	0.0	0.0	0.0	0.0				
External Interest	3.4	3.1	0.0	0.0	0.0				
Transfers	9.0	7.9	0.4	0.4	0.0				
Family Allowances	4.1	3.1	0.0	0.0	0.0				
Pension Contributions	1.1	1.1	0.2	0.2	0.0				
Contribution to pension fund	0.6	0.4	0.1	0.1	0.0				
Other 1/	3.3	3.3	0.2	0.1	0.0				
Goods and Services 1/	20.8	19.2	4.8	4.8	0.3				
Health	12.7	11.4	0.1	...	0.0				
Education	1.7	2.2	1.2	...	0.0				
Other	6.4	5.5	3.4	...	0.3				
Capital Expenditures 1/	2.7	4.4	1.7	1.8	0.5				
Net lending 1/	0.0	0.0	0.0	0.0	0.0				
External Amortization arrears	7.0	6.4	10.7	10.7	10.3				
Memorandum items:									
Domestic expenditure arrears	33.9	32.7	7.1	7.2	0.9				
<i>of which:</i> social expenditures arrears	21.7	20.0	1.5	0.1	0.0				
External payment arrears	10.4	9.5	10.7	10.7	10.3				
SFSI stock of arrears	4.4	1.4	0.0	0.0	0.0				

Source: Ministry of Finance and Economy and staff estimates.

1/ Arrears outstanding for more than 30 days.

2/ The end-December stock has been recalculated by the authorities as a result of revision of all claims.

3/ As specified in the TMU, the authorities will compile the data for the quarter ending in September 2003, December 2003, March 2004, and June 2004 within 45 days after the end of each quarter.

4/ These arrears have been cleared in September 2003, following understandings reached with Russia and Turkmenistan in 2002.

Table 7. Armenia: Cash Flow of the Consolidated Energy Sector, 2000-04 1/
(In billions of drams)

	2000	2001	2002		2003 2/					2004	
			Year	Year w/o Armelnet	Actual		Proj.		Year	Proj.	
					Q1	Q2	Q3	Q4		Q1	Q2
Revenues	79.9	65.1	70.7	63.8	19.1	13.4	10.6	15.0	58.1	16.7	12.3
Electricity revenues collected	75.3	62.8	68.9	62.0	19.0	12.6	10.1	14.4	56.1	15.9	11.7
Revenues collected for thermal energy supply	3.6	1.0	1.0	1.0	0.1	0.3	0.3	0.4	1.1	0.6	0.3
Non-core activities	1.0	1.3	0.9	0.9	0.0	0.5	0.3	0.3	1.0	0.2	0.3
Expenditures	101.3	105.7	93.9	77.2	21.4	18.3	13.3	17.3	70.2	14.4	13.8
Inputs	40.1	47.3	30.0	30.0	13.2	6.1	4.7	7.8	31.8	8.5	5.8
Imported gas	38.4	39.0	23.7	23.7	11.2	6.0	1.6	1.7	20.5	1.8	0.7
Nuclear fuel	1.7	8.3	6.3	6.3	1.4	0.1	2.1	2.1	5.7	2.0	2.0
Purchased electricity	...	...	...	...	...	...	1.0	4.0	5.0	4.7	3.1
O&M costs	34.2	31.1	24.0	13.0	2.5	3.1	2.4	2.4	10.3	2.4	2.4
Net payment of taxes accrued	17.2	14.8	21.6	18.9	4.1	4.8	2.2	2.6	13.8	2.0	2.0
Other current expenditures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest payments	5.0	4.7	9.2	8.2	1.0	1.5	0.9	1.3	4.7	0.9	1.0
Capital expenditures	4.8	7.8	9.0	7.1	0.6	2.8	3.1	3.1	9.6	0.6	2.7
Primary balance 3/	-13.5	-29.7	-5.1	1.7	-0.8	-0.9	1.2	2.1	1.7	3.7	2.0
Current balance	-11.6	-28.0	-4.9	1.9	-0.7	-0.6	1.4	2.2	2.3	3.8	2.2
Balance	-21.4	-40.6	-23.2	-13.4	-2.3	-4.9	-2.7	-2.2	-12.1	2.3	-1.5

Sources: Armenian authorities; and Fund staff estimates.

1/ Starting 2003, the cash flows do not include the activities of the electricity distribution company ArmElnet, which has been privatized at end-2002.

2/ As specified in the T/MU, the authorities will compile the data for the quarter ending in September 2003, December 2003, March 2004, and June 2003 within 45 days after the end of each quarter.

3/ The primary balance is defined as current revenues minus total expenditures excluding interest payments and foreign-financed capital expenditures.

ARMENIA: RELATIONS WITH THE FUND
(As of September 30, 2003)

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	101.85	110.70

III. SDR Department	SDR Million	Percent of Allocation
Holdings	9.21	n.a.

IV. Outstanding Purchases and Loans	SDR Million	Percent of Quota
Systemic transformation	9.84	10.70
PRGF arrangements	130.79	142.16

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	40.00
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	2003	2004	2005	2006	2007
Principal		6.19	23.31	23.28	21.18	15.43
Charges/interest		0.38	0.73	0.53	0.40	0.30
Total		6.57	24.04	23.81	21.58	15.73

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). Key outstanding issues that have been addressed since then include (i) the clarification of the nature of reserves placed with external asset managers and, in this context, a CBA resolution

requiring that these funds be marked to market; (ii) draft amendments to the central bank's organic law regarding the appointment of external auditors and the recognition and distribution of unrealized income; and (iii) the selection of external auditors and the CBA's internal audit function. The CBA has also clarified the nature of certain provisions and guarantees in its 2002 financial statements.

VIII. Exchange Rate Arrangement

- (a) On November 22, 1993, the Republic of Armenia introduced its national currency, the dram, at a rate of 200 Armenian rubles per dram. The exchange rate has been allowed to float since then 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 2002 Article IV consultation with Armenia was concluded on September 25, 2002. Armenia is subject to the 24-month consultation cycle.

X. FSAP Participation

A joint World Bank-International Monetary Fund mission conducted an assessment of Armenian financial sector as part of the Financial Sector Assessment Program (FSAP) between September 6-22, 2000. The Financial Sector Stability Assessment (FSSA) report was discussed at the Board on May 14, 2001, together with the 2001 Article IV staff report. The authorities have made progress in implementing the FSAP recommendations including raising minimum capital requirements and enacting a new bankruptcy law.

XI. Resident Representatives

Mr. James McHugh, since September 2002.

XII. Technical Assistance

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

Armenia: Technical Assistance from the Fund, 1998–2003

Subject	Type of Mission	Timing	Counterpart
Fiscal Affairs Department (FAD)			
Development of treasury	Resident Advisor	Since September 1998	Ministry of Finance and Economy (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 (MSR)
Tax policy and administration	Short-term	August 7–11, 2000	MFE and MSR
Tax policy and administration	Short-term	October 15–29, 2001	MFE, MSR, and Customs Committee
Tax policy and administration	Short-term	September 17–October 3, 2003	MFE, MSR, and Customs Committee
Monetary and Exchange Affairs Department			
Monetary and foreign exchange operations	Resident Advisor	Nov. 1997–Nov. 1998	Central Bank of Armenia (CBA)
Banking supervision	Short-term	Periodic visits 1998–99	CBA
Monetary and foreign exchange operations	Short-term	Jan. 20–Feb. 3, 1998	CBA
Monetary policy; OPS/BKG sector issues	Short-term	Nov. 9–Nov. 13, 1998	CBA
Monetary operations and banking supervision	Short-term	February 21–March 5, 1999	CBA
Monetary operations	Short-term	Periodic visits 1999–2000	CBA
Banking supervision	Resident Advisor	April 2000–December 2002	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 banking supervision	Short-term	September 3–14, 2001	CBA
Banking system issues	Short-term	April 15–19, 2002	CBA
Banking system, deposit insurance, foreign exchange market development, and CBA monetary operations.	Short-term	June 24–July 4, 2002	CBA
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
Data dissemination standards	Short-term	Sept. 18–25, 2003	National Statistics Service

ARMENIA: RELATIONS WITH THE WORLD BANK
(As of October 13, 2003)

Country Director: Donna Dowsett-Coirolo

Telephone: (202) 473-0121

I. IMPLEMENTATION OF STRUCTURAL REFORM MEASURES

A. Legal Framework

The Armenian Government has developed the core legal framework necessary for private sector operations, including the Civil Procedure Code, the Procurement law, and the Business Registration law. The government has also fully restructured the Bankruptcy law in order to harmonize it with the Civil Code and the Civil Procedure Code, as well as to strengthen the enforcement mechanisms for bankruptcy procedures. The Concession law has been enacted and the government has developed the new draft of the Labor Code, which would remove the existing over-regulation of the labor market and allow the labor market the necessary flexibility for job creation.

B. Business Environment

The government has made progress in the removal of administrative barriers for business and investment and the strengthening of consultative mechanisms with the business community. The steps undertaken included, inter alia, consolidating, downsizing, and clarifying mandates of various government inspections; enacting the new law on Business Registration; streamlining licensing procedures; issuing new accounting recommendations for small and medium-sized enterprises; establishing a regulatory framework that allows privatization of urban land by business entities; and adopting simplified procedures for obtaining site development and construction permits. The capacity of the Armenian Development Agency has been strengthened as a focal point for government's efforts to promote investment and exports as well as for identifying any remaining bottlenecks in the business environment. The enterprise surveys confirmed a reduction in the cost of doing business as well as a higher degree of satisfaction with government policies. Despite these improvements, there is still considerable scope for further reforms in the area of deregulation.

C. Energy and Infrastructure

The government has adopted a new privatization strategy for 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 government has also made satisfactory progress since 2001 in strengthening the legal and regulatory framework for urban heating systems in order to reduce heating subsidies.

The privatization of the electricity distribution company was completed in the second half of 2002 after a long preparatory process supported by the World Bank Group and other donors. The government has made considerable efforts to improve the legal and regulatory framework in the sector in order to establish a supportive environment for the new private operator. Budget allocations have also been increased to ensure full payments to the energy sector by the budgetary organizations and the public utilities. Since its privatization, the Electricity Distribution Company has remained in compliance with its License Agreements.

There has been limited progress in improving fiscal discipline and reducing losses in the irrigation and water sector. The World Bank has been working with the government to: (i) upgrade the management capacity of public companies in these sectors; (ii) ensure a gradual increase in tariffs to cost recovery levels; (iii) provide additional investments to improve technical efficiency; and (iv) ensure that the budget provides adequate financing for water consumed by public sector entities. The government has completed the medium-term Infrastructure Rehabilitation Plan to provide further guidelines for restructuring in water, irrigation, and public transportation. To provide full cost recovery, the government has developed and published a schedule for irrigation tariff increases in 2002–07.

D. Education and Health

The government adopted school rationalization plans for three administrative regions and has started their implementation. The plans envisage mostly in-school rationalization and limited consolidation of schools in urban areas. Based on preliminary data, implementation of the plans in 2002 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. The Government plans to carry out the 2003 school year rationalization program. At the same time, the government accelerated reforms that would improve the operational efficiency of general education. It has also developed and improved a new set of targets to reduce further excess capacity in the general education system in 2002–03. The 2003 budget provided for a 16 percent increase in education financing and a 20 percent increase in average teachers' salary.

Regarding the health sector, the government has adopted and started implementing the hospital rationalization plans aimed at a general decline in hospital capacity that, hitherto, significantly exceeded the needs and financing capabilities of Armenia. The first stage of implementation of the plan in 2001–02 was quite successful as the number of hospital beds in facilities outside Yerevan declined by about one half while the staff level was reduced by 15 percent. Based on this experience, the government plans to implement the hospital optimization strategy for Yerevan and to upgrade financial management, accounting, and reporting systems in public hospitals. The 2003 budget provides for a 27 percent increase in health financing.

E. Social Protection and Insurance

Since 1999, the government has been replacing a range of fragmented cash and traditional non-cash benefits and privileges with better-targeted transfers to families. The government has completed several important steps to enhance its capacity for administration of transfers to families, including: (i) re-registration of poverty benefit recipients; (ii) beneficiary assessment of the existing benefits; and (iii) establishment of a central database for poverty benefit recipients. Data from the recent household survey suggest that the system of benefits and transfers to the poor has become an efficient instrument for reducing extreme poverty.

The government has continued to implement the Pension Law. The Pension Law focuses on strengthening and streamlining the pension system. It provides for significant improvements in the existing system, including: (i) an equal retirement age for men and women at 63; (ii) separation of social insurance benefits from social pensions; (iii) elimination of most early retirement provisions; (iv) indexation of pensions to inflation; and (v) more direct links between benefits and contributions, with adequate provision for a minimum benefit.

The government has 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 part of the overall budget process. A pilot program has also been launched to implement a new system of Personal Identification Numbers (PINs), which would enhance monitoring and evaluation of social programs, and create the environment for better compliance with pension legislation.

II. LENDING

World Bank lending to Armenia as of October 13, 2003 totals US \$737.2 million, of which US \$597.3 million has been disbursed. Of the 29 IDA credits and one IBRD loan approved, 15 remain under implementation, and 15 have been completed. A third Country Assistance Strategy was presented to the World Bank's Board of Directors in May 2001, which envisaged base case lending of up to US \$150 million of IDA resources over the FY02-04 periods.

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

Active Projects	Credit Amount as of 10/13/03	Disbursement as of 10/13/03	Approval Date	Closing Date
<i>Active Projects</i>	261.9	130.6		
1. Health	10.0	9.1	07/29/97	12/30/03
2. Agric. reform support	14.5	13.7	01/27/98	06/30/04
3. Municipal development	30.0	19.3	06/11/98	04/30/05
4. Title registration	8.0	6.9	10/13/98	12/31/03
5. Electric. trans. & dist.	21.0	3.8	03/04/99	12/31/04
6. Irrigation dam safety	26.6	14.9	06/24/99	03/31/05
7. Transport	40.0	22.9	06/08/00	12/31/04
8. Social Investment Fund II	20.0	9.7	05/11/00	12/31/05
9. Judicial reform	11.4	2.3	09/14/00	12/31/04
10. Irrigation development	24.9	5.4	08/30/01	03/31/07
11. Enterprise incubator	5.0	0.7	11/30/01	06/30/05
12. Investment and export facilitation	1.0	0.2	04/16/02	12/31/05
13. Natural resource management	8.3	0.4	06/04/02	07/31/08
14. Municipal water	1.2	0.7	08/02/01	29/02/04
15. SACV	40.0	20.6	03/13/03	06/30/04
<i>Completed Projects</i>	475.3	466.7		
16. Irrigation rehabilitation	43.0	40.9	12/08/94	05/31/01
17. Highway	31.0	29.5	09/14/95	12/31/00
18. Social Investment Fund	12.0	11.1	11/09/95	12/31/00
19. Institution building	12.0	10.7	03/30/93	11/30/97
20. Earthquake rehabilitation	28.0	29.7	02/01/94	06/30/97
21. Power maintenance	13.7	13.2	12/08/94	06/30/99
22. Economic rehabilitation	60.0	64.3	02/28/95	06/30/96
23. SAC	60.0	58.5	02/29/96	12/31/97
24. SAC II	60.0	58.6	08/26/97	06/30/99
25. SATAC I	3.8	2.8	02/29/96	06/30/00
26. SAC III	65.0	63.4	12/22/98	06/30/01
27. Enterprise development	16.8	15.3	12/24/96	07/01/02
28. SATAC II	5.0	4.7	08/26/97	12/31/02
29. Education	15.0	14.6	11/20/97	10/31/02
30. SAC IV	50.0	49.4	05/22/01	03/31/03
Total	737.2	597.3		

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

(As of October 1, 2003)

As of 1 June, 2003, EBRD had signed nine projects in the power, transport, agribusiness, mining and financial sectors. Total cumulative commitments amounted to EUR 121.2 million.

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

There have also been a number of private sector projects in Armenia. The EBRD has provided a loan to the Yerevan Brandy Company owned by Pernod Ricard of France (EUR 19.1 million). In the banking sector, an equity participation in the Commercial Bank of Greece-Armenia (EUR 1.1 million) was approved in late 1999. Moreover, a multi-bank onlending facility of EUR 10 million was activated in early 2000. Initial experience with one Armenian bank on the program proved highly positive and another bank was added to the program in late 2002 (a total of EUR 1.9 million). The EBRD is committed to further expanding lending under this facility to other banks. A Trade Facilitation Program with the purpose to facilitate access of Armenian banks to trade financing was also made available to two Armenian banks in 2001 and 2002. In 2002 a loan to finance EUR 2.9 million in working capital expansion was signed with the Armenian Copper Programme (the only copper smelter in the region). Moreover, the EBRD has launched Turn Around Management (TAM) and Business Advisory Service Programmes in Armenia in 2003, funded by the EU-Tacis program, to support micro, small and medium-sized enterprises.

The key priorities of the EBRD for the coming years are (i) private sector development, (ii) infrastructure and (iii) financial sector. The EBRD will formulate a new country strategy for the next two years in November 2003.

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 on 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 that 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 data may not be reliable. Daily revenue and cash expenditure data for the central government are available with a lag of one to two days. The Ministry of Finance is undertaking a comprehensive reform of the treasury system, including the introduction of an internal auditing system in line ministries and their budgetary institutions. A single treasury account (TSA) was introduced in 1996, and all bank accounts held by budgetary institutions have been closed, except for the Project Implementation Units that 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 operations of local governments. Classification of government transactions by function and economic category are generally in line with Government Finance Statistics (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, the data has been subject to frequent reclassifications and wages for military personnel are reported in the broader category of "other" goods and services rather than as a wage item. The reconciliation of central government with general government operations is also difficult 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 an 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 October 31, 2003)

	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	10/31/03	10/31/03	10/31/03	10/24/03	10/24/03	October 2003	July 2003	Q2 2003	September 2003	September 2003	July 2003
Date received	11/03/03	11/03/03	11/03/03	11/03/03	11/03/03	11/03/03	7/26/03	9/16/03	10/13/03	10/24/03	7/26/03
Frequency of data	Daily	Daily	Daily	Weekly	Weekly	Monthly	Monthly	Quarterly	Monthly	Monthly	Quarterly
Frequency of reporting	Weekly	Weekly	Weekly	Weekly	Weekly	Monthly	Monthly	Quarterly	Monthly	Monthly	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	E-mail
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).



Press Release No. 03/203
FOR IMMEDIATE RELEASE
November 24, 2003

International Monetary Fund
Washington, D.C. 20431 USA

**IMF Completes Fourth Review Under PRGF for the Republic of Armenia, Grants Waiver,
and Approves Disbursement of US\$14 Million the Republic of Armenia**

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of the Republic of Armenia's economic performance under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement, and approved the disbursement of an amount equivalent to SDR 10 million (about US\$14 million). In completing the review, the Executive Board granted Armenia's request for a waiver of an end-June performance criterion for a minor deviation from the programmed level of domestic expenditure arrears.

Armenia's PRGF arrangement for the equivalent of SDR 69 million (about US\$100 million) was approved on May 21, 2001 (see [Press Release No. 01/25](#)). So far, the equivalent of SDR 40 million (about US\$58 million) have been disbursed.

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a Poverty Reduction Strategy Paper, or PRSP. This is intended to ensure that each PRGF-supported program is consistent with a comprehensive framework for macroeconomic, structural, and social policies, to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent, and are repayable over 10 years with a 5 ½-year grace period on principal payments.

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

"The Armenian authorities are to be commended for the satisfactory implementation of their PRGF-supported program. Prudent macroeconomic policies and structural reforms have contributed to a continued very strong economic performance, with growth exceeding expectations, low inflation, and declining public debt ratios. Armenia's comprehensive and participatory PRSP provides a sound basis for Fund concessional assistance. To sustain Armenia's strong growth while achieving broad-based job creation and improved living standards, the authorities will need to strengthen the tax system and increase social and infrastructure expenditures, and press ahead with their structural reform agenda, including through prompt implementation of an effective anti-corruption strategy.

“The fiscal program for 2004 contains important steps to increase tax revenue and social expenditures. To meet the government’s objectives, it will be important that the envisaged tax policy measures as well as the reforms in tax and customs administration are fully implemented, and that the effectiveness of social spending is closely monitored. The authorities are also expected to improve the transparency of public expenditures by enhancing audit and reporting requirements and producing budget execution reports at the level of the general government. Going forward, a sustained tax revenue effort will be needed to help achieve the PRSP objectives.

“Monetary policy is appropriately geared toward achieving the central banks’ inflation objective of 3 percent. Continued vigilance and, if necessary, preemptive action in the period ahead will remain important, as will close monitoring of inflation in the event of an increase in utility prices. To foster confidence in the banking system and increase lending to the private sector, further efforts will be needed to enhance the legal framework of the financial sector and strengthen banking supervision.

“The recently approved financial rehabilitation plan for the energy, water, irrigation, and transport sectors is welcome. It will now be important to move ahead with reforms to restructure these sectors, improve their governance, and bolster efficiency, all of which will further help reduce fiscal and quasi-fiscal costs that are ultimately born by the Armenian people.

“The authorities are about to finalize a comprehensive anti-corruption strategy in consultation with civil society and donors. Prompt and vigorous implementation of an effective strategy will be essential to improve the business climate and income distribution, and foster broad-based and sustained economic development,” Mr. Carstens stated.

Statement by the IMF Staff Representative
November 24, 2003

1. The following information has become available since the issuance of the staff report on November 7. It does not change the thrust of the staff appraisal.
2. **Prior Action.** The staff has received documentation confirming that the authorities carried out on November 6 the prior action on the approval of the financial rehabilitation plan for the energy, water, irrigation, and transport sectors (Table 2, memorandum of economic and financial policies).
3. **2004 Budget.** The government will submit the 2004 budget bill to Parliament in early December. Since the issuance of the documents to the Executive Board, the authorities have provided the staff with more detailed budget figures that reflect a different classification in their projections for capital expenditures compared to the figures discussed with the mission. The change involves the breakdown between current and capital expenditures on defense. Based on the latest information, total domestically-financed capital expenditures in 2004 are now projected at 1.1 percent of GDP (compared with 1.4 percent earlier) while current expenditures are projected at 14.1 percent of GDP (instead of 13.8 percent). There are also minor revisions to other revenue and expenditure items, but the key parameters of the budget including the overall deficit remain in line with the figures agreed with the staff.
4. **Banking system.** The authorities indicated that they intend to proceed as scheduled to nominate bank liquidators for Credit Yerevan by end-November. Regarding the situation of Armcommunications bank, the authorities reported that an agreement has been signed with a foreign investor that will take over both the bank and the chemical plant Nairit and that a detailed action plan for the resolution of the bank is being finalized (structural benchmark for end-November 2003). In another development, a medium-sized commercial bank (Ardshinvest) will take over the operations of another bank (Armagro); the new bank will be among the top five largest banks in Armenia. The central bank supports this acquisition because it is consistent with its goal of consolidating the banking system and because of complementarities between the two banks' branch networks.
5. **Anti-corruption strategy.** The government has just approved a draft anti-corruption strategy. The authorities restated their intention to circulate the document for comments from civil society and donors before beginning the implementation of the strategy in January 2004.
6. **Special Data Dissemination Standard.** Armenia subscribed to the Fund's Special Data Dissemination Standard on November 7, 2003.