

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

In the context of the third 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 third 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 **February 6, 2003**, 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 March 14, 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 Press Release summarizing the **views of the Executive Board as expressed during its April 2, 2003** discussion of the staff report that completed the review.

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REPUBLIC OF ARMENIA

**Third Review Under the Poverty Reduction and Growth Facility and
Request for Waiver of Performance Criterion**

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

Approved by Julian Berengaut and Martin Fetherston

March 14, 2003

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ACRONYMS

ASYCUDA	Automated System for Customs Data
CBA	Central Bank of Armenia
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
NDA	Net Domestic Assets
NIR	Net International Reserves
NPV	Net Present Value
NSS	National Statistics Service
PDR	Policy and Development Review Department
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
SAC	Structural Adjustment Credit
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 robust macroeconomic performance continued in the second half of 2002 and early 2003 with double-digit growth, low inflation, a stable exchange rate, and narrowing fiscal and external current account deficits. Energy sector performance also improved.

The PRGF-support program remained on track. All but one of the December 2002 quantitative performance criteria were met and all structural measures envisaged for implementation up until February 2003 have been carried out or implemented as a prior action for the third review. The targets on tax revenue, stock of domestic arrears, fiscal deficit, and net international reserves were met with comfortable margins. The authorities also implemented the envisaged structural reforms, including the adoption of codes of conduct for tax and customs officials, the establishment of a computerized valuation database at customs, and the initiation of liquidation procedures for five commercial banks.

The macroeconomic outlook for 2003 is favorable. Monetary policy aims at maintaining annual inflation at or below 3 percent, the overall fiscal deficit is targeted at 2.5 percent of GDP, and the remaining expenditure arrears are to be cleared by end-June. The 2003 budget includes an ambitious yet achievable tax revenue target, allows for a recovery in current and capital expenditures and a suitable increase in social spending, and makes a proportion of non-priority expenditures contingent on the availability of external financing.

The authorities intend to finalize the PRSP by May 2003. Issues that are being addressed include the prioritization and costing of different policies, the refinement of the macroeconomic framework, and the need for further emphasis on actions to curb corruption.

The near-term agenda for structural reform has been slightly modified to update banking system measures and include additional budgetary and energy sector reforms. Of the remaining three banks under central bank administration, one will be liquidated and the situation of the other two is expected to be resolved by May 2003. Steps will also be taken to prevent the accumulation of expenditure arrears and improve reporting of expenditures. Regarding the energy sector, the financial rehabilitation plan for the state-owned companies will include a timetable for improving corporate governance, moving toward management contracts, and conducting independent audits. The authorities are also expected to ensure sound debt management practices and prepare a plan to deal with the existing energy sector debts.

The authorities face a number of challenges in the period ahead, including improving of tax and customs administration; monitoring banking system developments closely; pressing ahead with reforms in the energy, water, and irrigation sectors; and implementing an effective anti-corruption strategy. The authorities are aware that these reforms are critical to improve the business climate, maintain high rates of economic growth, reduce poverty, and ensure fiscal and debt sustainability.

I. INTRODUCTION

1. The Executive Board concluded the 2002 Article IV consultation and the first and second reviews under the Poverty Reduction and Growth Facility (PRGF) arrangement on September 25, 2002 (EBS/02/170, 9/12/02).¹ At that time, Directors commended the authorities for maintaining macroeconomic stability, as evidenced by a good inflation performance, a stable exchange rate, an improving external position, and a favorable growth rate. Directors urged the authorities to follow up closely on program implementation, especially with regard to tax collection. They stressed the need to press ahead with reforms on tax and customs administration; the judiciary; and the energy, water, and irrigation sectors.

2. Discussions on the third PRGF review took place in Yerevan during January 22-February 6, 2003.² In the attached Letter of Intent and Supplementary Memorandum of Economic and Financial Policies (MEFP) (Attachments I and II), the authorities request completion of the third review and a waiver for the nonobservance of the end-December 2002 quantitative performance criterion on nonconcessional external debt. In support of these requests, the MEFP reviews the progress made during the second year of the PRGF-supported program and sets out the policy and budgetary framework for 2003 and the specific measures to be implemented through mid-2003. Armenia's adjustment efforts continue to be supported by the World Bank Group and international donors. Appendices I-III summarize Armenia's relations with the Fund, the World Bank Group, and the European Bank for Reconstruction and Development, respectively.

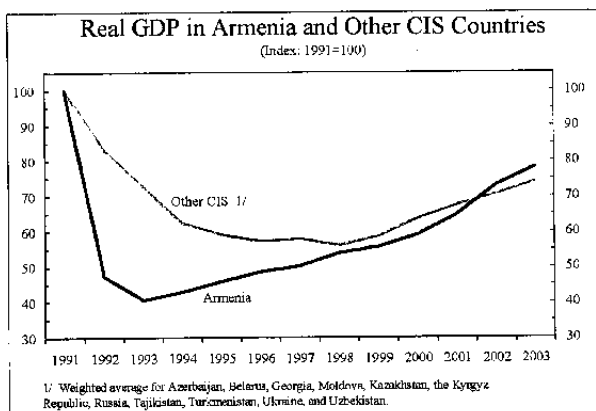
II. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

3. President Kocharian was re-elected by a large margin in the runoff presidential election on March 5. A number of international observers stated that the elections fell short of international standards and criticized irregularities in the counting of votes. Parliamentary elections are scheduled for May 2003. Discussions with Azerbaijan on the Nagorno-Karabakh conflict could continue after this year's elections in both countries. Political and economic relations with Russia are strengthening, as evidenced by the recent agreement to exchange the stock of Armenia's government debt to Russia for stakes in Armenian state-owned enterprises.

¹ A three-year PRGF arrangement for SDR 69 million (75 percent of quota) was approved on May 23, 2001. SDR 30 million have already been disbursed and SDR 10 million will be available upon completion of the third review (Table 1).

² The staff team comprised Mr. Gelbard (head), Ms. Westin, Mr. McHugh (Resident Representative), Mr. Kumah, Mr. Beddies, (all EU2); Ms. Khandelwal (PDR); and Mr. Poddar (FAD). The mission met with the Minister of Finance and Economy, Mr. Khachatryan; the Chairman of the Central Bank, Mr. Sargsyan; the Minister of Energy, Mr. Movsesian; the Chairman of the State Tax Service, Mr. Zakharyan; the Chairman of the Customs Committee, Mr. Avetisyan; and other senior officials and representatives of the donor community, the private sector, and civil society. The principal authors of this report are Mr. Gelbard and Ms. Westin, with input from the other members of the team.

4. **Armenia's strong macroeconomic performance continued in the second half of 2002 and early 2003.** Real GDP growth accelerated to 12.9 percent in 2002 and 13 percent in January 2003 (Table 2). Such growth was driven primarily by higher grant-financed construction and manufacturing activity. Meanwhile, inflation remained subdued with the 12-month rate at 2 percent in December 2002 and 3 percent in February 2003.



	2000	2001	2002	2003
				Prog
	(In percent, unless otherwise indicated)			
Real GDP growth	6.0	9.6	12.9	7.0
Investment (in percent of GDP)	19.7	19.2	20.4	22.4
Inflation (end of period)	0.4	2.9	2.0	2.0
Fiscal balance (commitment basis, in percent of GDP)	-6.4	-3.8	-0.6	-2.5
Broad money growth (end of period)	25.8	4.3	34.0	11.0
External current account balance (in percent of GDP)	-14.6	-9.5	-6.2	-6.5
External debt service (in percent of exports)	10.6	9.7	10.2	11.6
Gross international reserves (in months of imports)	3.8	3.6	4.5	4.3

Sources: Armenian authorities and Fund staff estimates.

5. **The PRGF-supported program remained on track in recent months.** All but one of the quantitative performance criteria for end-December 2002 were met and all structural measures envisaged for implementation during October 2002–February 2003 were carried out or have been implemented as prior action for the third review (Tables 3 and 4). The ceiling on external nonconcessional debt was exceeded as the authorities issued a guarantee for a US\$7.1 million medium-term loan to finance construction of power lines. This breach, however, does not jeopardize debt sustainability.³ Understandings were also reached on measures to increase transparency and further restructure the energy sector, work with Fund and World Bank staff on a strategy for dealing with energy companies' debts, and avoid granting further guarantees during the program period.

6. **The overall fiscal outturn for 2002 exceeded expectations** and the targets on the cash deficit, expenditure arrears, and tax revenues were met comfortably. The fiscal deficit on a commitment basis declined from 3.8 percent of GDP in 2001 to 0.6 percent in 2002 reflecting both lower-than-budgeted current and capital expenditures (the latter mainly attributed to over-budgeting by project implementation units) and stronger-than-projected revenues. Social expenditures in 2002 were 4 percent lower than budgeted because of lower social security payments and over-budgeting of investment in the health sector. Domestic expenditure arrears were reduced from 2.8 percent of GDP at end-2001 to 0.7 percent at end-2002.

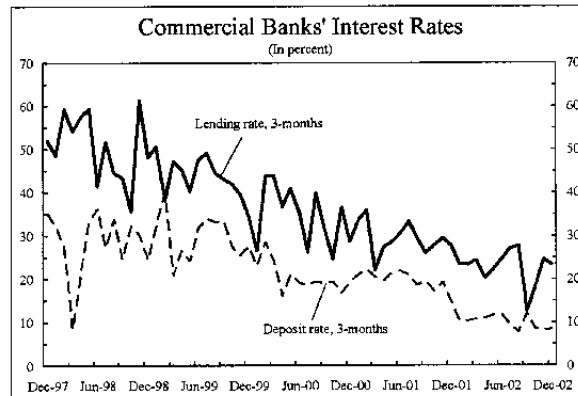
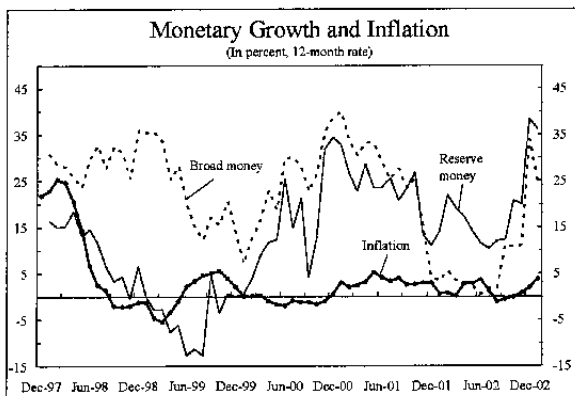
³ The loan is equivalent to 1 percent of the net present value of Armenia's debt and could be disbursed during the next three years. The repayment period would extend for another three years at an interest rate equal to libor plus 3 percentage points.

On a cash basis, the deficit declined from 4 percent of GDP to 2.4 percent. While tax revenues as a share of GDP increased by 0.2 percentage points, tax revenues as a share of domestic demand (a better proxy for the economy's tax base) rose by 0.6 percentage points (Table 5). During the last four years, GDP grew faster than domestic demand reflecting export-led growth and a rapid improvement in the external current account balance.

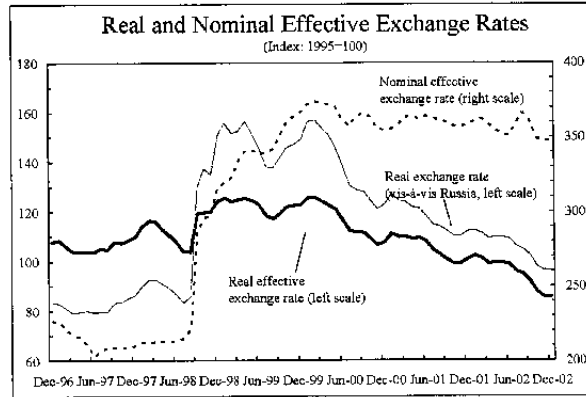
Armenia: Selected Fiscal Indicators, 2000-03					
	2000	2001	2002		2003 Prog.
			Prog.	Act.	
(In percent of GDP, unless otherwise indicated)					
Total revenue and grants	16.5	17.1	19.5	18.9	19.5
<i>of which: tax revenue</i>	14.7	14.4	15.0	14.6	15.0
Total expenditure	22.8	20.9	21.5	19.5	22.0
Current expenditure	17.5	15.8	15.0	14.0	15.3
Capital expenditure and net lending	5.4	5.1	6.5	5.5	6.7
Overall balance (commitment basis)	-6.4	-3.8	-2.1	-0.6	-2.5
Net accumulation of arrears (minus = net repayment)	1.2	-0.1	-1.6	-2.0	-0.8
Overall balance (cash basis)	-4.6	-4.0	-3.3	-2.4	-3.4
Deficit/financing	4.6	4.0	3.3	2.4	3.4
Domestic	2.5	1.3	0.1	-0.4	1.1
External	2.2	2.7	3.2	2.8	2.3

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

7. **All monetary performance criteria were met** including the targets on net domestic assets of the central bank, net credit to government, and net international reserves (Table 3). The process of re-monetization gained momentum in 2002 and velocity fell sharply. Growth in monetary aggregates rose sharply in the last quarter of 2002 mainly because of the clearance of the bulk of expenditure arrears following the receipt of a World Bank structural adjustment credit (SAC) toward the end of the year (Table 6). Since the beginning of 2003, the central bank has intervened in the foreign-exchange market to mop up the excess liquidity. Official net international reserves exceeded their programmed levels by a wide margin amid strong foreign exchange inflows attributed to higher private grants, World Bank loans, and net purchases by the central bank. During the year, average commercial bank lending rates declined from 27 percent 19 percent. However, interest rates remain high in real terms reflecting credit default risks and inefficiencies in the legal system.



8. **The balance of payments improved further in 2002** and the current account deficit narrowed to an estimated 6.2 percent of GDP (Table 7). Merchandise exports grew by 47 percent mainly reflecting increases in sales of processed diamonds, textiles, and food products. Meanwhile, imports rose by 13 percent. There was also a marked increase in foreign direct investment and in net foreign assets of the banking system. At end-2002, gross international reserves amounted to 4.5 months of 2003 imports, up from 3.6 months a year earlier. During 2002, the dram remained stable in nominal effective terms but it depreciated by 17 percent in real effective terms reflecting its real depreciation against the Russian ruble (about one third of Armenia's trade is with Russia).



9. **The structural reform agenda is being implemented**, including measures on the adoption of codes of conduct for tax and customs officials, the establishment of a computerized valuation database at customs linked to the Automated System for Customs Data (ASYCUDA), and the initiation of liquidation procedures for five intervened banks (Table 4). The structural benchmark to approve guidelines for the resolution of problem banks originally scheduled for February 2003 was subject to a small technical delay and was implemented in early March.

10. **Energy sector performance improved in 2002** reflecting the implementation of efficiency-enhancing measures, the incidence of favorable weather allowing for increased use of hydropower, and the privatization of the electricity distribution company. The primary deficit of the energy sector fell to 0.4 percent of GDP in 2002 compared with 2.5 percent in 2001 while overall collection as a share of electricity billed increased from 81 percent to 90 percent. Technical and other losses, however, remained unchanged at about 26 percent of total electricity generated.

	2000	2001	2002		2003
			Prog.	Est. 1/	Proj.
Primary balance (in percent of GDP)					
Energy 2/	-1.3	-2.5	-0.5	-0.4	0.2
Water	-0.7	-0.6	-0.4	-0.4	-0.3
Irrigation	-0.6	-0.5	-0.4	-0.4	-0.3
Electricity transmission and distribution					
Technical and other losses (in percent of entry)	26	26	25	26	4
Collection rate (in percent of domestic billings)	89	81	91	90	100

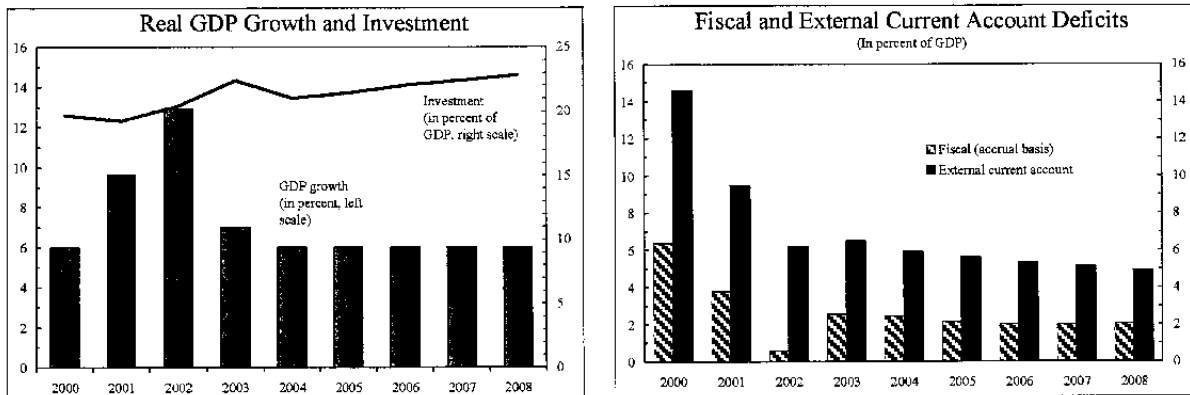
Sources: Armenian authorities and Fund staff estimates.
 1/ Water and irrigation figures for 2002 are estimates based on actuals for the first half of the year.
 2/ The projection for 2003 excludes the energy distribution company.

III. POLICY DISCUSSIONS

11. Discussions with the authorities focused on the medium-term economic framework, the 2003 budget, and reforms in the banking and energy sectors.

A. The Medium-Term Framework and the PRSP

12. In line with the forthcoming Poverty Reduction Strategy Paper (PRSP) and medium-term expenditure framework (MTEF), the authorities project real GDP growth of 7 percent in 2003 and 6 percent per year over the medium term. Inflation is projected at 2 percent in 2003 and 3 percent thereafter (Table 8). Economic growth is expected to be driven by continued investment in the tradable sector and high productivity growth. The current account deficit is expected to narrow gradually over time and gross official reserves are projected to remain above 4 months of imports. These developments would be supported by fiscal consolidation based on increasing tax revenues, expenditure rationalization, and declining debt ratios. The fiscal deficit is projected to decline from 2.5 percent of GDP in 2003 toward 2 percent in 2006–08.



13. **The authorities intend to finalize the PRSP by May 2003**, taking into account comments received from various stakeholders within civil society and the international donor community. The authorities are now focusing on the prioritization and costing of the measures proposed; ensuring a consistent macroeconomic framework between the PRSP, the MTEF, and the program supported under the PRGF arrangement; and emphasizing measures to curb corruption. The document will also draw on the pilot poverty and social impact analysis of water sector policies recently prepared by the United Kingdom's Department for International Development.

B. Fiscal Policy

14. **The 2003 budget foresees a deficit on a commitment basis of 2.5 percent of GDP**, a cash deficit of 3.4 percent, and the elimination of remaining expenditure arrears by end-June. Tax revenues of the central government are projected to increase by 0.4 percent of GDP in 2003 based on recent tax policy changes and improvements in tax and customs administration (see below). Nontax revenues are expected to fall as a share of GDP primarily because of lower central bank profits attributed to reduced interest earnings on foreign assets

(Table 5). In the event of a revenue shortfall, the authorities indicated that they would be prepared to undertake additional tax measures including further reductions in value-added tax (VAT) exemptions at the border.

15. The staff welcomed recent and planned **tax and customs administration reforms**. Taxes for gasoline retailers have been raised while customs duty exemptions have been reduced. The large taxpayers unit established last year has already begun to yield good results and is expected to generate further increases in tax collections this year. Effective January 2003, the value of imported goods exempted from VAT at the border was reduced from 25 percent to 20 percent. The simplified tax was further streamlined and a minimum income tax for businesses operating under the normal tax regime was introduced as part of the 2003 budget. A website at the State Tax Service⁴ will be completed this year. This fall, the authorities will submit to parliament an amendment to the law on tax inspections aimed at increasing transparency and clarifying the relationship between tax auditors and taxpayers.

16. Regarding **customs administration**, the computerized valuation database will be updated with actual invoice values, and the share of imported goods whose import values equal their invoice values is expected to increase rapidly. The latest version (1.16f) of ASYCUDA will be introduced at all customs checkpoints by end-May 2003. This will enhance customs' capability of random checking of imported goods and improve reporting. By July, all customs houses and custom points are expected to be networked in a single system. The recently expanded customs consultative committee will hold regular meetings and publish its activities. Lastly, a post-clearance program will be introduced at customs headquarters by mid-year.

17. **Total expenditure is budgeted to increase from 19.5 percent of GDP in 2002 to 22 percent in 2003** as both current and capital spending recover from unusually low levels in 2001–02 when priority was given to clearing expenditure arrears. Public sector wages are budgeted to increase by 0.4 percent of GDP from their currently depressed levels as part of ongoing civil service and governance reforms. Expenditures on goods and services are budgeted to increase by 1.3 percent of GDP mainly reflecting higher expenditures on health and education as well as the proper classification of certain expenditures previously aggregated into the reserve fund. Capital expenditures will increase sharply because of exceptional grants from a private US-based foundation.

	Average 1997-2001 Act.	2002 Act.	2003 Prog.	Average 2004-08 Proj.
General public services	2.0	1.6	1.8	1.9
Defence and public order	5.0	3.9	4.4	4.3
Health, education, and social security	5.3	4.8	5.7	7.1
Housing and public utilities	1.6	1.0	3.2	1.6
Transportation, construction, and agriculture	2.6	2.9	3.5	2.4
Interest on public debt	1.9	0.9	0.9	0.8
Other	2.3	2.9	2.1	1.9
Unclassified	1.7	1.2	0.3	0.0
Total expenditure and net lending	22.5	19.5	22.0	20.1

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

⁴ Formerly the Ministry of State Revenue. The new unit no longer has ministerial status but continues to report to the Prime Minister.

The authorities have adopted a cautious expenditure policy by making the execution of expenditures equivalent to 0.7 percent of GDP contingent upon the availability of external financing.⁵ Further progress is also expected in the areas of budget management and expenditure control. By May 2003, the authorities plan to submit to parliament amendments to the Budget System law to make it possible to reduce nonpriority expenditures by up to 10 percent without parliamentary approval in the event of a shortfall in receipts. By mid-year, the treasury will develop a detailed audit manual consistent with international standards. Later this year, the government intends to put in place a financial and cash management procedure involving daily forecasts for central government budget receipts and payments for the next twelve months.

C. Monetary Policy and Financial Sector Issues

18. **The monetary program for 2003 aims at keeping inflation at no more than 3 percent.** The program assumes an 11 percent increase in the demand for broad money alongside a 15 percent increase in private sector credit and a small increase in net international reserves. The money multiplier will increase slightly because of a projected decline in the currency-to-deposit ratio (reflecting rising confidence in banks) and a reduction in reserve requirements from 8 percent of deposits to 6 percent effective July 1, 2003. Given the uncertainty surrounding the monetary transmission mechanism and the limited array of monetary policy instruments available, the Central Bank of Armenia (CBA) will need to continue monitoring inflation developments closely. If needed, a limited degree of foreign exchange market intervention could be utilized to accommodate unexpected shifts in the demand for money with the objective of keeping inflation below 3 percent.

19. **The central bank has taken steps to resolve the situation of eight intervened banks** (there are 20 other active banks in the system). The CBA has issued guidelines for the conduct of intervention of banks and for performing “least cost” tests for troubled banks and initiated liquidation procedures for five of the eight intervened banks. By end-May, a least-cost analysis and resolution strategy will be completed for one other bank (Armcommunications) while the remaining banks (Credit Yerevan and Ardshin) will be liquidated this year.⁶

20. **The CBA plans to move ahead with the introduction of the deposit insurance scheme** that will begin collecting premia in mid-2003. The scheme will become operational in mid-2005. The staff cautioned the authorities to ensure that the modalities of the scheme are clearly specified, that weak banks are excluded from the scheme, and that the premium be set at a level comparable to that of similar countries. The premium originally proposed by the authorities was above international comparable levels and is being reconsidered. The authorities agreed on the need to draft amendments to the Central Bank law specifying the

⁵ Contingent expenditures mainly comprise housing and utilities, the reserve fund, fuel and energy, and general public services.

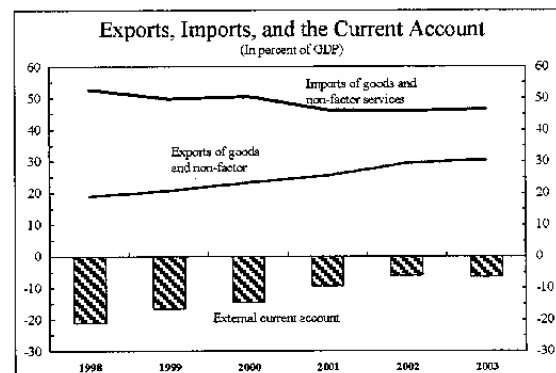
⁶ The CBA has made a decision to liquidate Credit Yerevan as negotiations with a potential foreign strategic investor were stalled. The situation of Ardshin is being resolved through a purchase and assumption transaction.

modalities of the scheme including the insurance event, management of the fund, accounts to be covered, and structure of payments. The details of the scheme will be made public by end-April 2003 and will encompass a premium and a level of coverage comparable (in terms of GDP per capita) to other transition economies. Any banks that might have been intervened by mid-2005 will be excluded from the scheme.

21. **The authorities agreed on the need to strengthen the effectiveness of banking supervision.** On a number of occasions, banks have breached prudential norms and the fines imposed on them seem insufficient to deter them from repeating such actions. The authorities will undertake—in consultation with external experts—a review of the system of penalties imposed on banks and will finalize an onsite inspection manual to enhance risk-based supervision. The authorities agreed on the need to act forcefully against banks that consistently breach the norms and ensure that all market participants operate on a level playing field. The CBA will also draft amendments to the law on Bank Bankruptcy and to the Civil Code to enhance its ability to execute bank resolution strategies and to more effectively create and enforce pledges.

D. External Sector and Capacity to Repay the Fund

22. The current account deficit is projected to increase marginally in 2003 because of increased grant-financed imports before improving further in the medium term. Gross international reserves should remain at over 4 months of imports. The authorities are committed to maintain a flexible exchange rate and liberal trade and investment regimes. The mission welcomed Armenia's accession to the World Trade Organization in February of this year.



23. **The outlook for external financing remains favorable.** The authorities expect to finalize the agreement to exchange Armenia's debt to Russia (US\$94 million at end-2002) for stakes in Armenian state-owned companies by April 2003. All outstanding interest arrears—amounting to US\$7.4 million—have been paid and the agreement is now awaiting ratification by the Russian parliament. The authorities are also in the process of clearing their external arrears and outstanding debt to Turkmenistan through the provision of goods; US\$1.8 million were cleared last year and the remaining debt of US\$9.4 million is expected to be settled in 2003. Because of these developments, the net present value of Armenia's external debt is projected to fall from 120 percent of exports at end-2002 to 91 percent at end-2003.

24. **Armenia's external public debt is expected to decline over the medium term.** The baseline scenario of the updated debt sustainability analysis extends the medium-term framework to 2015 and assumes continued macroeconomic stability, fiscal consolidation, and successful structural policies (Box 1). The analysis shows that the net present value of debt as a share of exports will fall further to 72 percent in 2010 and 66 percent in 2015 (Table 9).

Box 1. Fiscal and Debt Sustainability

Baseline scenario. The baseline scenario for the period 2003–15 assumes continued macroeconomic stability with average inflation and real GDP growth of 3 percent and 5.5 percent, respectively. It also assumes a deepening of the structural reform process that successfully transforms the banking system, improves efficiency in state-owned enterprises, and enhances the effectiveness of the judicial system. Exports of goods and services are projected to grow by 9 percent a year and the current account deficit is expected to fall toward 2 percent of GDP by 2015.

Fiscal consolidation would lead to a narrowing of the government deficit on a commitment basis from 2.5 percent of GDP in 2003 to 1.5 percent in 2015. The fiscal projections assume further reforms in tax and customs administration and expenditure rationalization including a reduction in defense spending and a continued increase in social spending. Tax revenues of the central government are expected to rise steadily to around 19 of GDP by 2015. Total expenditure as a share of GDP would remain slightly below 21 percent.

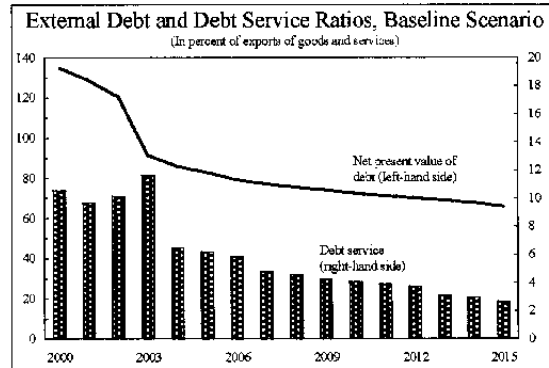
The results show that the net present value of debt would decline from 120 percent of exports of goods and services in 2002 to 66 percent in 2015. Over the same period, the net present value of debt in terms of fiscal revenue would fall from 185 percent to 107 percent and the debt-service ratio would fall from 10 percent to around 3 percent.

Sensitivity analysis. Two alternative scenarios were considered in assessing the sustainability of Armenia’s debt. The first scenario assumes a 10 percent decline in the value of exports in 2004, a decrease in GDP growth to 2 percent during 2004–05, and a slow resumption to baseline growth rates thereafter. This shock could arise from a 25 percent decline in the world price of diamonds or a disruption in imports of unpolished diamonds that cuts supply by 20 percent. There would be an additional financing gap leading to further concessional borrowing. In this scenario, the debt-to-exports ratio would peak at 113 percent in 2010 but the ratios would remain well below the thresholds considered for assistance to heavily indebted poor countries.

The second scenario posits a weakening of the commitment to reform, poor revenue collection (a constant revenue-to-GDP ratio) and further increases in current spending leading to a fiscal deficit of 5 percent of GDP during 2004–08. It is assumed that the concomitant deterioration in the macroeconomic environment leads to growth rates of GDP and exports that are half of those in the baseline scenario. The financing gap would then be filled with nonconcessional borrowing (which might or might not be forthcoming). A fiscal crisis ensues under this scenario: the present value of debt-to-exports ratio would increase rapidly to above 150 percent after 2007 and the debt service ratio to above 20 percent, implying that the debt would no longer be sustainable (Table 9).

Armenia: Economic Projections, 2002–15					
	2002	2003	2008	2010	2015
(In percent of GDP, unless otherwise indicated)					
Real GDP growth (percent change)	12.9	7.0	6.0	5.0	5.0
Central government revenue and grants	18.9	19.5	18.6	18.9	19.2
<i>of which:</i> tax revenue	14.6	15.0	16.8	17.4	18.9
Government Expenditure	19.5	22.0	20.6	20.6	20.7
<i>of which:</i> social expenditure 1/	4.8	5.7	7.8	7.9	9.1
Overall fiscal balance (commitment basis)	-0.6	-2.5	-2.0	-1.8	-1.5
Current account	-6.2	-6.5	-4.9	-4.2	-2.1
External debt (NPV, in percent of exports)	120	91	75	72	66
Debt Service (in percent of exports)	10.2	11.6	4.6	4.0	2.6

Sources: Armenian authorities; and Fund staff estimates and projections.
1/ Expenditure on health, education, and social security.



The debt will also decline in a scenario that assumes a one-time decline in exports. It is not likely to remain sustainable, however, in a scenario that assumes a stagnation of the reform process and fiscal policy slippages. Armenia has an excellent record of meeting its scheduled payments to the Fund, and the results of the debt sustainability analysis together with the targeted buildup of foreign reserves point to ample capacity for future repayments (Table 10).

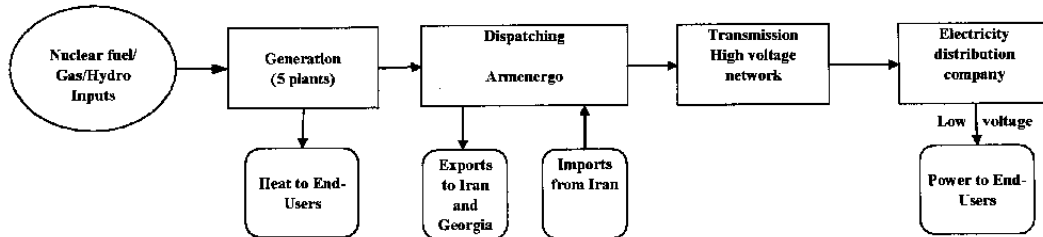
E. Energy Sector and Governance

25. **Energy sector performance is likely to improve further in 2003** reflecting the privatization of a thermal power plant and the expected improvement in the performance of water and irrigation companies. Nevertheless, state-owned companies in the energy sector have liabilities of nearly US\$31 million to domestic and foreign banks (most without explicit government guarantees). The difficult situation of these companies raises concerns about their future. Moreover, the ongoing privatizations are creating pressures for direct contracting between the distribution company and the generating plants and for corporate governance changes in the remaining state-owned companies of the sector (Box 2). In this context, the authorities are proposing: (i) to include in the integrated financial rehabilitation plan for the quasi-fiscal utility sectors that will be finalized by mid-2003 a timetable for strengthening corporate governance in the energy sector and moving toward management contracts for the state-owned enterprises; (ii) to establish independent boards of directors by September 2003; (iii) to carry out and publish annual independent audits in all the state-owned enterprises in the sector; (iv) to consult with the staffs of the World Bank and the Fund on a strategy for dealing with outstanding liabilities; and (v) to avoid any further guarantees of the sector's domestic or foreign loans. Furthermore, the authorities will begin regular disclosure of energy sector financial and technical information (Attachments II and III).

26. **The authorities are expected to press ahead with plans to enhance governance and transparency.** Following the introduction of a financial disclosure law for public officials last year, a draft law on the declaration of income for all citizens was submitted to parliament in early 2003. A comprehensive draft anti-corruption strategy was prepared last year in collaboration with external experts covering a wide range of measures. The authorities have subsequently prepared a draft of a more focused strategy that is being discussed with key stakeholders. The strategy contains a matrix of actions and a timetable, though it does not seem to have appropriate oversight procedures. Starting this year, the State Tax Service and customs will prepare quarterly internal audit reports that will be shared with key officials and the staffs of the Fund and the World Bank.

Box 2. Energy Sector Reforms

Energy sector reforms begun in the mid-1990s when the single company in charge of generation, transmission, and distribution was broken up into separate joint-stock government-owned companies. The financial flows of the sector remained largely controlled by the contract and dispatch company (Armenergo) and the sector continued to be troubled by insufficient investment, mismanagement, and theft leading to a fragile supply of energy, the accumulation of debts, and external, tax, and inter-enterprise payment arrears. Following the privatization of the electricity distribution company in late 2002 and of a major generating station this year, the government will retain control of about two thirds of the total generating capacity (including the nuclear power plant) and the midstream dispatch and transmission companies. The privatized retail company has had a promising start boosting bill collection rates and cutting off non-payers. At the same time, subsidies to water, irrigation, and urban transport companies were increased this year to prevent them from accumulating tax and energy payments' arrears (these companies are also undergoing restructuring). The current structure of the energy sector is shown in the following diagram:



The recent privatizations and the large debts accumulated are prompting a move towards direct contracting between the power generators and the distribution company and as a result are forcing Armenergo out of the system. The privatized companies are likely to prefer to engage in direct contracting to lower costs and ensure a reliable chain of payments.

The government is now finalizing a financial rehabilitation plan for the state-owned companies. The plan is expected to strengthen corporate governance by introducing independent boards of directors for the generating stations and for the midstream sector (comprising the settlements, contracting, and dispatch functions, and the high voltage transmission system), establish annual independent and transparent audits of the companies, move toward management contracts, and develop management plans without political interference. There is also a need to develop a strategy for dealing with the indebtedness of the sector.

IV. PROGRAM MONITORING

27. **The reporting of basic data is generally adequate for program monitoring.** The authorities have improved the classification of the reserve fund and reclassified several expenditure items under new relevant categories (Appendix IV). Ongoing treasury system and accounting reforms are addressing the current long lags in compiling fiscal execution data on an accrual basis and the authorities have agreed to work with Fund staff to move towards the reporting of budget execution data on a general government basis within the next six months. Owing to a new civil service law and ongoing decentralization reforms, a number of budgetary institutions such as universities, libraries, and hospitals were converted this year into "noncommercial enterprises". These entities are no longer required to submit spending reports to the treasury. Consequently, a substantial part of government expenditure including wages, subsidies, and other transfers will be classified in budget execution under "other

goods and services". The authorities acknowledge the importance of an appropriate classification of expenditures and intend to re-establish reporting requirements early next year and begin processing the corresponding information into budget execution reports. Following the on-sight safeguards assessment of the CBA in October 2001, a number of recommendations were provided to address the identified vulnerabilities. The CBA has since then addressed most of these recommendations (Appendix I).

28. The prior actions, quantitative and structural performance criteria, and indicative targets under the program are specified in the attached MEFP. The program for 2003 includes quantitative benchmarks for end-March, performance criteria for end-June, and indicative targets for the remainder of the year. The indicative target on the primary balance of the energy sector has been redefined to exclude the electricity distribution company. Box 3 describes the approach to structural conditionality under the program. A revised technical memorandum of understanding (Attachment III) updates definitions and reporting requirements.

Box 3. Structural Conditionality

Current PRGF-Supported Program. Structural conditionality in the program focuses on improving tax collection through tax and customs administration measures; expenditure control and budget management; public sector governance; an adequate restructuring of the financial sector; and energy sector reform. The structural conditions under the first two years of the PRGF arrangement were discussed in EBS/01/61 (4/30/01) and EBS/02/170 (9/12/02). All conditions were observed, some with minor delays. The status of implementation of the structural performance criteria and benchmarks under the third review is presented in Table 4.

World Bank Conditionality. The floating tranche of SAC IV (disbursed in December 2002) focused on reforms in the energy sector through an improved financial performance and the 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. SAC V (approved by the Executive Board of the Bank on March 13, 2003) covers private sector development and public enterprise reform, public sector reform, and advancing social sector reform. The second disbursement under SAC V is conditional on the completion of several key measures including submitting a new labor code to parliament, implementing a plan for improving the business and investment environment, establishing a satisfactory environment for privatized firms in the energy and utility sectors, and implementing school and hospital rationalization programs. During 2003, the Bank plans to prepare a Utilities Restructuring Credit to deal with reforms in the energy, water, and irrigation sectors.

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 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

29. **Armenia's economic performance during the second year of the PRGF-supported program has continued to be strong.** Real GDP growth has been the fastest in the region, inflation has been subdued, investment and export growth have surpassed expectations, and poverty rates have fallen during the last two years.
30. **The authorities should be commended for the strong economic performance that is the result of continued reforms and prudent fiscal and monetary policies.** During the second half of 2002, the authorities met all but one of the quantitative program targets, including the targets on tax revenue, domestic arrears clearance, fiscal deficit, and net international reserves. The authorities also implemented the envisaged structural reforms, most notably the adoption of codes of conduct for tax and customs officials, the establishment of a computerized valuation database at customs, and the initiation of liquidation procedures for five of the eight intervened banks.
31. **The fiscal stance for 2003 is appropriate.** The budget includes ambitious yet realistic tax revenue and arrears clearance targets, allows for a recovery in current and capital expenditures from the unexpected drop in 2002, and targets a suitable increase in social spending. The authorities need to ensure that all budgeted social expenditures are actually executed and that they are safeguarded in the event of a shortfall in receipts. The authorities are expected to move ahead with the envisaged amendments to the budget systems law aimed at preventing the accumulation of expenditure arrears. The staff also urges the authorities to move ahead with the envisaged steps to improve reporting requirements for noncommercial enterprises and reflect their expenditures in line with Government Finance Statistics methodology.
32. **The monetary program is consistent with the aim of maintaining low inflation.** The recent strengthening of the balance of payments reflects gains in competitiveness and suggests that the authorities would do well to keep foreign exchange market intervention at a minimum and allow the dram to appreciate in response to market forces.
33. **The authorities are making good progress in preparing a comprehensive poverty reduction strategy.** The consultative process has worked well and the authorities are in the process of considering the comments provided by various stakeholders. Important elements to be developed include the prioritization and costing of different policies, alternative macroeconomic scenarios, and further emphasis on actions to curb corruption. It will also be crucial to ensure sufficient ownership of the strategy within the government in order for it to become a blueprint for Armenia's social and economic development.
34. **Notwithstanding the successes obtained so far, a number of challenges to improve the business climate and create the conditions for high private investment in the years ahead remain.** These challenges include the need to monitor banking system developments closely; press ahead with reforms in the energy, water, and irrigation sectors; implement an effective anti-corruption strategy; and further improve budget execution and tax and customs administration. The authorities are aware of the importance of these reforms, and several actions in these areas are included in the program for 2003.

35. **The central bank needs to monitor banking developments closely.** There are too many small banks and little financial intermediation largely reflecting still limited confidence in the system. The planned gradual increase in minimum capital requirements provides incentives for banks to rationalize and/or merge. In the meantime, however, the capacity of banking supervision is overstretched. The central bank needs to strengthen its supervisory authority and capacity to conduct on-site examinations, step up supervision efforts, and act on banks that fail to comply with prudential requirements. Experience also shows that the liquidation of failing banks in Armenia could usefully be expedited.

36. **The strategic nature of the energy sector calls for courageous reforms.** A number of promising measures have recently been undertaken: they include privatization, employment rationalization, and efficiency improvements. However, governance concerns in the remaining state-owned energy sector companies and the large debts accumulated have brought to the forefront the need to deal with this troubled sector at once. The authorities' plans for appointing independent boards of directors and establishing management contracts for the remaining state-owned companies are appropriate. The staff urges the authorities to hire suitable private operators as managers and to step up the controls and financial monitoring of the operations of Armenergo and of the high-voltage company. The authorities recognize that these measures are critical to deal with mismanagement and inefficiencies in the sector and ensure a reliable and low-cost supply of energy. Yet they need to act vigorously against remaining vested interests to forestall derailment of the process.

37. **The authorities consider that corruption remains a major problem in Armenia,** leading to a waste of resources and compromising efforts to reduce income inequality. An anti-corruption plan with a wide range of recommendations was prepared last year, and a more focused draft of the plan has recently been prepared. It would be important that the authorities move expeditiously to finalize a high-quality strategy that includes appropriate oversight institutions and that they begin with its implementation.

38. **Armenia's economic outlook remains favorable.** Further grant-financed investment and import substitution should help maintain an above average rate of economic growth in 2003. Over the medium term, fiscal and debt sustainability will hinge on further tax and customs administration reforms and a strengthening of revenue collection. This will generate a string of primary fiscal surpluses that will help finance higher social and infrastructure expenditures, reduce aid dependence, and maintain debt sustainability. Yet for some time the country will remain dependent on foreign assistance and the authorities will need to speed up remaining reforms to improve the business climate and reassure investors and the international community.

39. Given the very good performance in 2002 and the strength of the authorities' program for 2003, the staff recommends completion of the third review under the PRGF arrangement. The staff supports the authorities' request for a waiver of performance criterion related to the nonobservance of the ceiling on nonconcessional external debt on the basis that the breach does not compromise debt sustainability and that steps have been taken to avoid similar problems in the future.

Table 1. Armenia: Expected 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
March 15, 2003	Completion of third review (end-December 2002 test date)	10.00
September 15, 2003	Completion of fourth review (end-June 2003 test date)	10.00
March 15, 2004	Completion of fifth review (end-December 2003 test date)	10.00
September 15, 2004	Completion of sixth review (end-June 2004 test date)	9.00

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

	1998	1999	2000	2001	2002		2003 Prog.
					Prog.	Prel.	
(Annual percentage change, unless otherwise indicated)							
National income and prices							
Real GDP growth ^{1/}	7.3	3.3	6.0	9.6	7.5	12.9	7.0
Gross domestic product (in billions of drams)	959	988	1,031	1,176	1,301	1,358	1,474
Gross domestic product (in millions of U.S. dollars)	1,899	1,847	1,912	2,122	2,300	2,365	2,514
Consumer price index (CPI) (annual average)	8.7	0.7	-0.8	3.1	1.0	1.1	2.2
CPI (end of period)	-1.2	2.1	0.4	2.9	3.0	2.0	2.0
GDP deflator	11.1	-0.2	-1.5	4.0	3.0	2.3	1.5
Investment and saving (in percent of GDP)							
Investment	19.9	17.9	19.7	19.2	21.4	20.4	22.4
National savings	-1.3	1.3	5.1	9.8	12.7	14.2	15.9
Money and credit (end of period)							
Reserve money	6.5	0.0	34.4	11.1	10.0	38.4	7.1
Broad money	36.0	13.6	25.8	4.3	14.3	34.0	11.0
Commercial banks' 3-month lending rate (in percent) ^{2/}	48.1	34.5	28.6	27.7	...	23.4	...
Central government operations (in percent of GDP)							
Revenue and grants	17.1	19.3	16.5	17.1	19.5	18.9	19.5
Expenditure and net lending	21.9	26.5	22.8	20.9	21.5	19.5	22.0
Overall balance on a commitment basis	-4.8	-7.2	-6.4	-3.8	-2.1	-0.6	-2.5
Overall balance on a cash basis	-4.7	-5.5	-4.6	-4.0	-3.3	-2.4	-3.4
Stock of domestic expenditure arrears	...	...	3.3	2.8	1.1	0.7	0.0
Primary balance of the energy sector (in percent of GDP)	-2.6	-0.8	-1.3	-2.5	-0.5	-0.4	0.2
External sector							
Exports of goods and nonfactor services (in U.S. dollars)	8.9	6.5	16.6	20.8	18.7	28.6	10.6
Imports of goods and nonfactor services (in U.S. dollars)	5.0	-8.1	5.1	1.2	8.6	11.2	7.6
Current account (in percent of GDP)	-21.2	-16.6	-14.6	-9.5	-8.7	-6.2	-6.5
External debt-to-exports ratio ^{3/}	144	154	135	129	123	120	91
Debt service ratio ^{4/}	19.0	14.3	10.6	9.7	10.5	10.2	11.6
Import cover ^{5/}	3.9	3.8	3.8	3.7	3.8	4.5	4.3
Nominal effective exchange rate ^{2/ 6/}	50.9	15.8	-3.3	1.0	...	-3.3	...
Real effective exchange rate ^{2/ 6/}	13.1	-1.0	-12.5	-6.2	...	-16.9	...

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

^{1/} Real GDP in 2002 was 64 percent of its 1990 level. The recent economic recovery has been driven by the expansion of new sectors such as construction, food processing, and diamond polishing.

^{2/} End of period.

^{3/} Net present value of debt in percent of the three-year moving average of exports of goods and services centered on the previous year.

^{4/} In percent of exports of goods and services.

^{5/} Gross international reserves in months of next year's imports of goods and services.

^{6/} A positive sign denotes appreciation.

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

	2002				
	June	September		December	
	Act.	Prog. 2/	Act.	Prog. 3/	Act.
	(In billions of drams)				
Net domestic assets of the CBA (ceiling) 4/	-13.4	-0.2	-14.5	1.8	-12.4
Net banking system credit to the central government	0.0	3.5	-5.0	6.6	0.0
Domestic arrears of the central government	29.7	26.2	22.8	14.9	...
Adjusted target 5/				14.2	9.1
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) 6/	89.1	139.4	141.7	194.6	198.6
Balance of the central government on a cash basis 6/	-5.5	-20.4	...	-42.9	...
Adjusted target 7/		-13.9	-9.4	-35.3	-31.9
Reserve money (band) 8/	74.4	(79.9-83.1)	80.4	(86.6-90.2)	111.3
Primary balance of the energy sector (floor) 6/ 8/	-0.9	-3.5	-0.3	-6.3	-5.1
	(In millions of U.S. dollars)				
Contracting and guaranteeing of new nonconcessional external debt with maturity of more than one year 6/	0	0	0	0	7.1
Net disbursements of short-term external debt 6/ 9/	0	0	0	0	0
External arrears (continuous criterion)	28	0	0	0	0
Net official international reserves (floor) 4/	156	158	180	165	231

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) (EBS/02/170, Attachment III).

2/ Benchmark.

3/ Performance criterion.

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

5/ As specified in the TMU, the target for December 2002 has been reduced by AMD 0.8 billion on account of excess in SAC disbursements.

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

7/ As specified in the TMU, the September 2002 target has been increased by AMD 6.5 billion on account of a shortfall in external project disbursements. For December 2002, the target has been increased by AMD 4.7 billion on account of a AMD 8.3 billion shortfall in external project disbursements, and a AMD 0.8 billion excess in SAC disbursements.

8/ Indicative target.

9/ Continuous criterion. 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 Third Review, October 2002–February 2003

Measures	Target Date 1/	Status
Structural Performance Criteria		
Establish a computerized valuation database at customs based on import prices and linked to the ASYCUDA system for the verification of customs values of imported goods.	December 2002	Met
Revoke the licenses and appoint liquidators for at least three of the five smallest banks (by value of assets) currently under interim CBA administration.	December 2002	Met
Revoke the licenses and appoint liquidators for the remaining banks among the five smallest banks under current CBA administration.	February 2003	Met
Structural Benchmarks		
Implement commitment control procedures and improved budget-reporting system, as defined by the regulations and procedures on budget execution under the new treasury law.	October 2002	Met
Adopt codes of conduct for State Tax Service and customs officials aimed at improving transparency and integrity of tax and customs operations.	November 2002	Met
Issue written guidelines for the conduct of temporary intervention of banks by the central bank.	December 2002	Met
Establish internal audit capacity as determined by article 9.1.b of the treasury system law.	January 2003	Met
Reduce the individual duty-free exemption to US\$300 for every six months.	January 2003	Met
Expand the customs consultative and legislation review committee to include additional business community representatives, external advisors, and other public officials.	April 2003 2/	Met
Prior Action		
Approve guidelines for the resolution of problem banks, including a "least-cost" test. 3/	February 2003	Approved on March 14, 2003

1/ End of period.

2/ This measure was a benchmark for the fourth review.

3/ This measure was a benchmark for the third review.

Table 5. Armenia: Central Government Operations, 2001-03 (continued)

	2001		2002		2003		
	Act.	Prog.	Prel.	Jan-Mar	Apr-Jun	July-Dec	Year
	(In billions of drams)						
Total revenue and grants	200.8	253.3	256.1	53.4	69.4	164.3	287.1
Total revenue	182.3	204.4	209.3	46.2	56.0	123.9	226.1
Tax revenue	168.8	195.0	198.6	45.0	53.9	121.6	220.5
Nontax revenue	11.9	8.1	8.9	0.9	2.0	2.3	5.2
Capital revenue	1.6	1.2	1.8	0.3	0.1	0.0	0.4
Grants	18.5	48.9	46.8	7.2	13.4	40.4	61.0
Total expenditure	245.4	280.3	264.3	57.9	79.9	186.7	324.6
Current expenditure	185.2	195.2	190.2	43.5	53.9	126.8	226.2
Wages	32.2	36.6	36.0	8.9	10.6	25.4	44.9
Subsidies	6.5	7.2	8.1	2.2	2.1	4.5	8.8
Interest	14.5	14.2	12.5	3.4	3.9	6.6	13.9
Transfers and reserve fund	51.7	51.6	53.7	9.5	12.2	30.7	52.4
Goods and services	80.3	85.5	80.0	19.5	27.1	59.5	106.2
Capital expenditure and net lending	60.3	85.1	74.0	14.4	24.0	60.0	98.4
Capital expenditure	46.0	72.0	64.1	13.6	24.9	59.2	97.7
Net lending	14.3	13.1	9.9	0.8	-0.9	0.7	0.6
Overall balance (accrual)(-)	-44.7	-27.0	-8.2	-4.5	-10.6	-22.5	-37.5
Net accumulation of arrears (plus = accumulation) 1/	-1.5	-21.0	-26.8	-4.5	-8.0	0.0	-12.5
Statistical discrepancy	-1.1	5.1	3.1	0.0	0.0	0.0	0.0
Overall balance (cash) = Financing (-) 1/	-47.3	-42.9	-31.9	-9.0	-18.5	-22.5	-50.0
Deficit/financing 1/	47.3	42.9	31.9	9.0	18.5	22.5	50.0
Domestic financing	15.2	0.7	-5.9	5.7	7.5	2.7	15.9
Banking system	-1.2	-2.8	-9.5	5.5	-2.9	2.4	5.0
Nonbank 2/	16.4	3.5	3.5	0.2	10.3	0.4	10.9
External financing	32.1	42.2	37.9	3.3	11.1	19.7	34.1
Gross inflow	44.3	56.0	51.3	8.7	22.8	37.6	69.1
Amortization due	-11.6	-20.3	-17.1	-4.7	-1.7	-17.8	-24.3
Change in arrears (- = reduction)	-0.6	3.0	3.7	-0.7	-10.0	0.0	-10.7

Table 5. Armenia: Central Government Operations, 2001–03 (concluded)

	2001		2002		2003		
	Act.	Prog.	Prel.	Jan-Mar	Apr-Jun	July-Dec	Year
	(In percent of GDP)						
Total revenue and grants	17.1	19.5	18.9	29.4	23.3	16.5	19.5
Total revenue	15.5	15.7	15.4	25.4	18.8	12.5	15.3
Tax revenue	14.4	15.0	14.6	24.8	18.1	12.2	15.0
Nontax revenue	1.0	0.6	0.7	0.5	0.7	0.2	0.4
Capital revenue	0.1	0.1	0.1	0.2	0.0	0.0	0.0
Grants	1.6	3.8	3.4	4.0	4.5	4.1	4.1
Total expenditure	20.9	21.5	19.5	31.8	26.9	18.8	22.0
Current expenditure	15.8	15.0	14.0	23.9	18.8	12.7	15.3
Wages	2.7	2.8	2.6	4.9	3.6	2.5	3.0
Subsidies	0.6	0.6	0.6	1.2	0.7	0.5	0.6
Interest	1.2	1.1	0.9	1.9	1.3	0.7	0.9
Transfers and reserve fund	4.4	4.0	4.0	5.2	4.1	3.1	3.6
Goods and services	6.8	6.6	5.9	10.7	9.1	6.0	7.2
Capital expenditure and net lending	5.1	6.5	5.5	7.9	8.1	6.0	6.7
Capital expenditure	3.9	5.5	4.7	7.5	8.4	6.0	6.6
Net lending	1.2	1.0	0.7	0.4	-0.3	0.1	0.0
Overall balance (accrual)(-)	-3.8	-2.1	-0.6	-2.5	-3.6	-2.3	-2.5
Net accumulation of arrears (plus = accumulation) 1/	-0.1	-1.6	-2.0	-2.5	-2.7	0.0	-0.8
Statistical discrepancy	-0.1	0.4	0.2	0.0	0.0	0.0	0.0
Overall balance (cash) = financing (-)	-4.0	-3.3	-2.4	-4.9	-6.2	-2.3	-3.4
Deficit/financing	4.0	3.3	2.4	4.9	6.2	2.3	3.4
Domestic financing	1.3	0.1	-0.4	3.1	2.5	0.3	1.1
Banking system	-0.1	-0.2	-0.7	3.0	-1.0	0.2	0.3
Nonbank 2/	1.4	0.3	0.3	0.1	3.5	0.0	0.7
External financing	2.7	3.2	2.8	1.8	3.7	2.0	2.3
Gross disbursements	3.8	4.3	3.8	4.8	7.7	3.8	4.7
Amortization due	-1.0	-1.6	-1.3	-2.6	-0.6	-1.8	-1.6
Change in arrears (- reduction)	-0.1	0.2	0.3	-0.4	-3.4	0.0	-0.7
Memorandum items							
Nominal GDP (in billions of drams)	1,176	1,301	1,358	181.9	297.1	995.2	1,474
Domestic demand (in billions of drams)	1,419	...	1,583	...	...	...	1,710
Tax revenues (in percent of domestic demand)	11.9	...	12.5	...	...	...	12.9
Domestic expenditure arrears 3/	2.8	1.1	0.7	0.5	0.0	0.0	0.0
Domestic expenditure arrears (in billions of drams)	32.7	14.9	9.1	8.0	0.0	0.0	0.0
Domestic primary balance 4/	-0.8	...	1.2	...	...	...	-0.4

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

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

2/ In the second quarter of 2003 the amount of non-bank financing reflects the conclusion of the debt-equity swap with Russia.

3/ The amount of arrears to be cleared in 2003 exceeds the end-2002 stock of arrears by AMD 3.5 billion. The reason for the difference is that some unpaid expenditures (in this case AMD 3.5 billion) are only counted as arrears 30 days after the end of the month.

4/ Defined as total revenue minus total expenditure excluding interest payments, foreign-financed capital expenditures, and foreign-financed net lending.

Table 6. Armenia: Monetary Accounts, 2001–03

	2001		2002				2003		
	Dec.	March	June	Sept.	Dec.		March	June	Dec.
	Act.	Act.	Act.	Act.	Prog.	Act.	Prog.	Prog.	Proj.
(In billions of drams, unless otherwise indicated)									
Central Bank of Armenia									
Net Foreign Assets (NFA)	84.6	84.4	85.9	98.2	86.6	130.6	108.4	113.7	135.9
Net International Reserves (NIR)	88.2	88.0	89.9	105.2	92.7	138.1	115.8	121.1	143.3
Medium and Long term (net)	-3.7	-3.6	-4.1	-7.0	-6.1	-7.4	-7.4	-7.4	-7.4
Net Domestic Assets	-4.1	-11.3	-11.5	-17.8	1.8	-19.3	-13.9	-18.5	-16.7
Claims on government (net)	8.3	-0.9	-4.4	-11.4	1.9	-9.7	-4.5	-8.4	-6.4
Claims on banks	3.9	7.4	7.6	9.7	10.1	10.4	9.0	8.2	7.2
Other items (net)	-16.3	-17.8	-14.6	-16.2	-10.1	-20.0	-18.4	-18.3	-17.4
Reserve Money	80.4	73.1	74.4	80.4	88.4	111.3	94.5	95.2	119.2
Currency issue	66.7	60.8	61.8	68.7	75.1	92.1	79.8	80.5	102.5
Deposits	13.7	12.3	12.6	11.7	13.3	19.2	14.7	14.7	16.7
Banking System									
Net Foreign Assets	84.2	90.2	99.9	117.2	94.9	155.9	129.5	135.3	162.2
Net Domestic Assets	74.0	59.8	56.1	60.7	84.6	56.0	63.0	56.1	73.0
Claims on government (net)	9.4	2.4	-0.1	-5.1	6.6	-0.1	5.4	2.6	4.9
Claims on rest of the economy	97.5	87.2	89.1	96.1	96.7	98.3	92.7	93.1	113.0
Other items (net)	-33.0	-29.8	-32.9	-30.3	-18.7	-42.2	-35.1	-39.5	-45.0
Broad Money	158.2	150.0	156.0	177.9	179.5	211.9	192.5	191.4	235.2
Currency in circulation	65.0	58.9	59.7	66.4	72.3	88.6	74.9	74.2	97.0
Deposits	93.1	91.2	96.3	111.5	107.2	123.3	117.6	117.2	138.2
Domestic currency	18.6	20.3	22.7	28.3	24.9	36.3	34.8	34.9	42.8
Foreign currency	74.5	70.8	73.7	83.2	82.3	87.0	82.8	82.3	95.4
Memorandum Items									
Exchange rate (drams/US\$, end of period)	561.8	576.0	577.1	580.2	561.8	584.9	...	...	...
NIR (in millions of US\$) 1/	156.8	156.0	163.3	188.2	...	236.0	...	...	...
NIR (in millions of US\$) 2/	154.6	151.9	155.9	179.8	165.0	231.0	198.0	207.0	245.0
Medium and Long term liabilities (in millions of US\$) 2/	6.7	6.4	6.4	10.9	12.5	10.9	12.7	12.7	12.7
NDA of the CBA (in billions of drams) 2/	-5.0	-8.7	-9.6	-14.5	1.8	-12.4	-13.9	-18.5	-16.7
12-month change in reserve money (in percent)	11.1	19.0	11.5	12.4	10.0	38.4	29.3	27.9	7.1
12-month change in broad money (in percent)	4.3	4.3	1.1	11.2	14.3	34.0	28.3	22.7	11.0
Velocity of broad money (end of period)	7.4	...	...	...	7.2	6.4	...	...	6.3
Money multiplier	2.0	2.1	2.1	2.2	2.0	1.9	2.0	2.0	2.0
Dollarization in deposits 3/	80	78	76	75	77	71	70	70	69
Liquidity preference ratio 4/	70	65	62	60	67	72	64	63	70

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

1/ At actual exchange rates.

2/ At program exchange rates. For 2002, the program is based on end-December 2001 exchange rates (EBS/02/170, Attachment III). For 2003, the figures are based on end-December 2002 exchange rates (Attachment III, table 1).

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

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

Table 7. Armenia: Balance of Payments, 2001–08

	2001	2002		2003	2004	2005	2006	2007	2008
	Act.	Prog.	Est.	Prog.	Projections				
(In millions of U.S. dollars, unless otherwise indicated)									
Current account	-201	-199	-146	-163	-161	-166	-171	-178	-185
Trade balance	-420	-389	-353	-362	-375	-392	-408	-426	-444
Exports	353	458	519	583	639	701	768	843	925
Imports	-773	-847	-872	-945	-1,014	-1,093	-1,176	-1,269	-1,368
Services (net)	-18	-32	-40	-40	-44	-44	-46	-48	-50
Credits	187	182	175	185	201	219	238	259	281
Debits	-204	-214	-215	-225	-244	-262	-283	-306	-332
Income (net)	63	52	76	74	86	92	96	101	106
Private transfers (net)	102	105	110	110	116	124	131	139	148
Official transfers (net)	72	65	60	55	55	55	55	55	55
Capital and financial account	201	185	212	151	198	193	196	199	205
Capital transfers (net)	30	76	60	80	55	57	56	53	50
Foreign direct investments (net)	70	75	110	135	80	94	105	111	118
Portfolio investments (net)	-6	0	1	0	0	0	0	0	0
Public sector (net)	45	42	16	-50	63	41	36	35	37
Disbursements	66	81	54	78	76	55	54	54	54
Amortization	-21	-39	-38	-128	-13	-13	-19	-19	-17
Other capital (net) 1/	62	-7	25	-14	0	0	0	0	0
Overall balance	0	-14	66	-12	37	27	25	21	20
Change in gross reserves (- increase)	-16	-34	-109	-12	-35	-37	-41	-45	-45
IMF (net) 2/	-10	-19	-19	-24	-32	-34	-29	-21	-23
Arrears/ debt relief with Russia, net (+ increase) 3/	-3	7	1	-17	0	0	0	0	0
Arrears/ debt relief with Turkmenistan, net (+ increase)	1	-1	0	-1	0	0	0	0	0
Financing Gap	27	61	61	67	30	44	45	44	48
IMF	13	27	26	27	26	0	0	0	0
World Bank	14	34	35	40	0	20	20	0	0
Residual	0	0	0	0	4	24	25	44	48
Memorandum items:									
Current account (in percent of GDP)	-9.5	-8.7	-6.2	-6.5	-5.9	-5.6	-5.3	-5.1	-4.9
Excluding official transfers	-12.9	-11.5	-8.7	-8.7	-7.9	-7.5	-7.0	-6.7	-6.3
Gross reserves (end of period)	329	364	439	451	486	523	564	609	654
In months of imports	3.6	3.8	4.5	4.3	4.3	4.3	4.3	4.3	4.3
In months of next year's debt service 4/	55	...	60	100	102	106	129	133	142
Net international reserves (stock)	157	165	236	245	286	356	427	492	560
Nominal external debt 5/	905	1,040	1,025	999	1,060	1,112	1,164	1,223	1,284
Net present value (NPV) of external debt 5/	587	669	675	610	658	698	730	777	833
NPV of debt-to-exports ratio 5/	129	123	120	91	86	83	79	77	75
Stock of external arrears	17	23	17	0	0	0	0	0	0

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

1/ Includes errors and omissions.

2/ Excluding prospective PRGF disbursements which are displayed under multilateral financing.

3/ Accumulation of arrears until the second quarter of 2002. During 2003, the clearance of arrears based on the July 17, 2002 debt-to-equity swap agreement with Russia. This operation is also reflected in foreign direct investment in 2003.

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

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

Table 8. Armenia: Medium-Term Macroeconomic Framework, 2002–08

	2002	2003	2004	2005	2006	2007	2008
	Act.	Prog.	Projections				
(In percent of GDP, unless otherwise indicated)							
National income and prices							
Real GDP growth (percent change)	12.9	7.0	6.0	6.0	6.0	6.0	6.0
Gross domestic product (millions of U.S. dollars)	2,365	2,514	2,729	2,963	3,217	3,495	3,797
Gross national income per capita (in U.S. dollars)	800	840	905	972	1,044	1,122	1,205
Inflation (annual percent change, end of period)	2.0	2.0	3.0	3.0	3.0	3.0	3.0
Investment and saving							
Investment	20.4	22.4	21.0	21.4	22.0	22.4	22.8
Government	4.7	6.6	4.2	4.4	4.7	5.0	5.4
Other	15.7	15.8	16.8	17.0	17.3	17.4	17.4
National savings	14.2	15.9	15.1	15.8	16.7	17.3	17.9
Government	4.9	4.1	2.2	2.8	3.2	3.5	3.9
Other	9.4	11.8	12.8	13.1	13.5	13.8	14.1
Central Government operations							
Revenue and grants	18.9	19.5	17.4	17.8	18.1	18.3	18.6
<i>of which:</i> tax revenue	14.6	15.0	15.4	15.8	16.2	16.5	16.8
grants	3.4	4.1	1.4	1.4	1.3	1.2	1.2
Expenditure	19.5	22.0	19.8	19.9	20.1	20.3	20.6
<i>of which:</i> social expenditure 1/	4.8	5.7	6.5	6.8	7.0	7.4	7.8
Overall balance (commitment basis)	-0.6	-2.5	-2.5	-2.1	-2.0	-2.0	-2.0
External sector							
Exports	29.4	30.5	30.8	31.0	31.3	31.5	31.8
Imports	46.0	46.5	46.1	45.7	45.4	45.1	44.8
Current account	-6.2	-6.5	-5.9	-5.6	-5.3	-5.1	-4.9
Current account (millions of U.S. dollars)	-146	-163	-161	-166	-171	-178	-185
Capital and financial account (millions of U.S. dollars)	212	151	198	193	196	199	205
<i>of which:</i> direct foreign investment	110	135	80	94	105	111	118
public sector disbursements	54	78	76	55	54	54	54
Gross international reserves (millions of U.S. dollars; -= increase)	-109	-12	-35	-37	-41	-45	-45
Arrears and debt relief (millions of U.S. dollars)	1	-18	0	0	0	0	0
Financing gap (millions of U.S. dollars)	61	67	30	44	45	44	48
External debt (NPV, in percent of exports of goods and services)	120	91	86	83	79	77	75
Debt Service (in percent of exports of goods and services)	10.2	11.6	6.5	6.2	5.9	4.8	4.6
Gross international reserves (in months of imports)	4.5	4.3	4.3	4.3	4.3	4.3	4.3

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

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

Table 9: Armenia: Debt Sustainability Analysis, 2002-15 1/
(In million of dollars unless otherwise indicated)

	2002	2003	2004	2005	2006	2007	2010	2015
Present value of debt	675	610	658	698	730	777	951	1,308
Existing Debt								
Multilaterals	498	480	455	426	398	378	337	308
World Bank	281	289	298	304	308	312	311	296
IMF	165	148	122	94	69	51	12	0
EBRD	37	29	21	13	6	0	0	0
Other	15	14	14	14	15	15	14	13
Bilaterals	167	50	50	49	49	48	46	37
Russia	92	0	0	0	0	0	0	0
USA 2/	47	31	30	29	28	27	24	18
Other	27	19	20	20	21	22	22	20
Commercial credits 3/	10	0	0	0	0	0	0	0
New Debt	...	80	154	223	283	351	568	963
Nominal debt	1,025	999	1,060	1,112	1,164	1,223	1,407	1,750
Existing Debt								
Multilaterals	810	770	727	682	638	604	523	435
World Bank	542	541	540	536	530	522	488	416
IMF	195	171	139	106	77	56	12	0
EBRD	38	30	22	14	6	0	0	0
Other	35	28	26	26	26	25	23	19
Bilaterals	205	82	80	78	77	75	68	52
Russia	94	0	0	0	0	0	0	0
USA 3/	61	41	40	38	36	35	29	21
Other	50	40	40	40	40	40	38	32
New Debt	...	147	253	352	449	544	816	1,262
Memorandum items:								
Net present value of debt in percent of exports 4/	120.4	91.4	85.8	82.8	79.2	77.1	72.2	65.7
Net present value of debt in percent of fiscal revenue 5/	185.1	158.1	151.2	143.9	135.4	130.4	119.8	107.0
Debt service in percent of exports	10.0	11.6	6.5	6.2	5.9	4.8	4.0	2.6
Grant element 6/	34.2	39.0	37.9	37.3	37.3	36.4	32.4	25.2
Sensitivity analysis of impact:								
Disruption in diamond exports								
Net present value of debt in percent of exports 4/	120.1	91.1	94.4	102.4	109.0	110.8	113.2	108.0
Net present value of debt in percent of fiscal revenue 5/	185.1	158.1	160.7	165.1	165.7	167.7	170.1	163.8
Debt service in percent of exports	10.0	11.6	7.6	7.6	7.5	6.4	5.9	4.3
Stagnation of reform process and fiscal policy slippage								
Net present value of debt in percent of exports 4/	120.1	91.1	97.8	111.1	126.6	142.6	181.0	164.0
Net present value of debt in percent of fiscal revenue 5/	185.1	158.1	174.8	195.5	216.7	239.7	289.8	275.1
Debt service in percent of exports	10.0	11.6	6.8	9.4	12.5	15.6	25.1	23.5

Sources: Ministry of Finance; and Fund staff estimates.

1/ All debt indicators refer to public and publicly guaranteed debt.

2/ Including loans from the private Lincy foundation.

3/ Government-guaranteed credits and suppliers' credits.

4/ Exports of goods and services; 3-year moving average centered on the preceding year.

5/ Based on central government revenues, excluding grants.

6/ Difference between nominal and present value of debt in percent of nominal debt.

Table 10. Armenia: Indicators of Fund Credit, 2002-08
(In units indicated)

	2002	2003	2004	2005	2006	2007	2008
	Act.			Projections			
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/	28.1	25.8	22.9	17.3	12.9	9.9	7.1
In percent of external debt	19.0	19.8	18.2	14.3	11.2	8.9	6.7
In percent of gross reserves	44.4	44.0	39.6	30.4	23.0	17.9	13.1
In percent of quota	155.7	158.5	153.8	127.0	104.0	87.2	68.7
Existing Fund credit 1/							
In millions of SDRs	143.3	125.8	102.5	77.9	56.7	41.2	24.2
In percent of exports 2/	28.1	22.3	16.6	11.5	7.7	5.1	2.7
In percent of external debt	19.0	17.1	13.2	9.5	6.6	4.6	2.6
In percent of gross reserves	44.4	37.9	28.7	20.2	13.7	9.2	5.0
In percent of quota	155.7	136.8	111.5	84.6	61.6	44.8	26.3
Prospective Fund credit 1/							
In millions of SDRs	...	20.0	39.0	39.0	39.0	39.0	39.0
In percent of exports 2/	...	3.5	6.3	5.8	5.3	4.8	4.4
In percent of external debt	...	2.7	5.0	4.8	4.6	4.3	4.1
In percent of gross reserves	...	6.0	10.9	10.1	9.4	8.7	8.1
In percent of quota	...	21.7	42.4	42.4	42.4	42.4	42.4
Repurchases, repayments, and charges due from existing and prospective drawings							
In millions of SDRs	...	18.4	24.2	25.4	21.8	15.9	17.5
In percent of exports 2/	...	3.3	3.9	3.8	2.9	2.0	2.0
In percent of external debt	...	2.5	3.1	3.1	2.5	1.8	1.9
In percent of gross reserves	...	5.6	6.8	6.6	5.2	3.6	3.6
In percent of quota	...	20.0	26.3	27.6	23.7	17.3	19.0
Repurchases and charges due from existing drawings							
In millions of SDRs	...	18.4	24.0	25.2	21.5	15.7	15.9
In percent of exports 2/	...	3.3	3.9	3.7	2.9	1.9	1.8
In percent of external debt	...	2.5	3.1	3.1	2.5	1.7	1.7
In percent of gross reserves	...	5.5	6.7	6.5	5.2	3.5	3.3
In percent of quota	...	20.0	26.1	27.3	23.4	17.0	17.2
Repurchases and charges due from prospective drawings							
In millions of SDRs	...	0.1	0.2	0.3	0.3	0.3	1.6
In percent of exports 2/	...	0.0	0.0	0.0	0.0	0.0	0.2
In percent of external debt	...	0.0	0.0	0.0	0.0	0.0	0.2
In percent of gross reserves	...	0.0	0.0	0.1	0.1	0.1	0.3
In percent of quota	...	0.1	0.2	0.3	0.3	0.3	1.8

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

March 7, 2003

Dear Mr. Köhler:

The authorities of the Republic of Armenia held discussions with Fund staff during January 22–February 6, 2003 on the program supported under the Poverty Reduction and Growth Facility. The purpose of this letter is to inform you of the progress in implementing the program and request the fourth disbursement following the completion of the third review under the arrangement.

The program is on track. All but one of the quantitative performance criteria for end-December 2002 were observed and all structural measures scheduled for implementation up to February 2003 have been carried out. In particular, we have settled most domestic expenditure arrears, linked the computerized valuation database at customs with the Automated System for Customs Data, and initiated liquidation procedures for five of the eight banks under interim administration. The performance criterion on medium- and long-term nonconcessional external debt was exceeded by a small margin as the government issued a guarantee on a medium-term loan to finance construction of power lines. This operation does not compromise debt sustainability and no further guarantees will be issued. Based on this strong performance, we request a waiver for the nonobservance of the end-December performance criterion on external debt.

The attached Memorandum of Economic and Financial Policies (MEFP) supplements the memorandum of September 11, 2002, and sets out the government's policies for the period ahead. It describes the understandings reached with the staff on performance criteria and benchmarks until mid-2003. Consistent with our commitment to transparency, the government intends to make these understandings public and authorizes the Fund to publish this letter, the attached memorandum, and the staff report on the third review under the arrangement.

The government believes that the policies and measures described in the MEFP are adequate to achieve the objectives of the program but it will also take additional measures that may become appropriate for the purpose. The government will consult with the Fund in advance of the adoption of any such measures or on any revision to 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
SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

March 7, 2003

This memorandum complements the Memorandum of Economic and Financial Policies of September 11, 2002. It reviews the implementation of the second annual program supported by the Poverty Reduction and Growth Facility (PRGF) and presents an update of the government's economic objectives and policies for 2003. These objectives and policies are integral parts of the government's strategy for poverty reduction as envisaged in the interim Poverty Reduction Strategy Paper (PRSP).

I. Recent Developments and Performance Under the Program

1. The overall strong performance of the Armenian economy continued in the second half of 2002. Real economic growth accelerated to 12.9 percent in 2002 mainly because of higher grant-financed construction activity and manufacturing production. At the same time, inflation remained subdued with the 12-month rate at 2.0 percent. However, during the fourth quarter of 2002, reserve money and broad money grew by 38 percent and 19 percent, respectively. These increases were associated with an accelerated clearance of domestic arrears in December, which could not be easily sterilized given the limited instruments available to the central bank to control liquidity. The external current account deficit narrowed further in 2002 to a preliminary 6.2 percent of GDP, primarily reflecting strong growth in exports.
2. The fiscal deficit on a commitment basis declined from 3.8 percent of GDP in 2001 to 0.6 percent in 2002 owing to lower-than-expected current and capital expenditures (mainly attributed to over budgeting by project implementation units) and revenue mobilization measures. On a cash basis, the deficit declined from 4 percent of GDP to 2.4 percent. At the same time, the stock of domestic expenditure arrears fell from 2.8 percent of GDP at end-2001 to 0.7 percent at end-2002.
3. The performance of the energy sector improved in 2002 reflecting increased use of hydropower, measures undertaken to enhance efficiency, and the privatization of the electricity distribution company. In addition, the largest thermal power plant and the management of the financial flows of the nuclear power plant are also being privatized. The primary deficit of the energy sector was 0.4 percent of GDP in 2002 compared with 2.5 percent in 2001. Total collection as a share of the amount of electricity billed increased to 90 percent in 2002 from 81 percent in 2001 while technical and excess losses declined marginally to 25.9 percent from 26.5 percent in 2001. Such developments follow years of mismanagement that have raised the indebtedness of the sector to unsustainable levels and crippled its ability to deliver reliable and cost-effective power. At end-2002, domestic and foreign banks had claims of nearly US\$31 million on state-owned energy sector companies.

4. In line with this positive performance, the program for the second half of 2002 remained on track. All but one end-December quantitative performance criteria were observed, including the targets on domestic expenditure arrears, tax revenues, and net international reserves (NIR) of the Central Bank of Armenia (CBA). NIR at program exchange rates rose to US\$231 million at end-December 2002 compared with a targeted floor of US\$165 million. The sharp increase in NIR in the last quarter of the year can be attributed to a number of factors, including CBA purchases of foreign exchange to stem deflationary pressures, lower-than-projected government imports, and the disbursement of the floating tranche of the fourth World Bank Structural Adjustment Credit. However, the ceiling on external non-concessional debt was not observed as a government guarantee was issued for a US\$7.1 million medium-term external loan to the energy sector. This loan will not jeopardize debt sustainability. We have also instructed the Ministry of Energy and all the state-owned companies in the sector that no such guarantees will be available in the future.

5. All structural performance criteria and all but one of the benchmarks scheduled for implementation during the period October 2002–February 2003 have been observed. There was a slight technical delay in the approval of guidelines for the resolution of problem banks (benchmark) scheduled for end-February 2003. This measure will be implemented by mid-March and will be a prior action for completing the third review. Key measures implemented include the adoption of codes of conduct for tax and customs officials, the establishment of a computerized valuation database at customs linked to the Automated System for Customs Data (ASYCUDA), and the revocation of licenses and appointment of liquidators for the five smallest banks under interim central bank administration.

II. Macroeconomic Policies for 2003

6. In line with the medium-term economic strategy, the government's program for 2003 aims at achieving the following core objectives:

- Provide the conditions for real economic growth of at least 7 percent in order to reduce poverty and unemployment and further slow down emigration;
- Maintain the 12-month rate of inflation at no more than 3 percent and gross international reserves above 4 months of imports; and
- Maintain fiscal discipline and further reduce public-debt ratios.

Fiscal policy

7. **Budget for 2003.** The fiscal deficit on a commitment basis is projected at 2.5 percent of GDP. Tax revenues of the central government are expected to increase to 15 percent of GDP based on improvements in tax and customs administration. The government stands ready to undertake additional tax measures in the event of a revenue shortfall, such as further reducing value-added tax (VAT) exemptions at the border. Total expenditure is budgeted to increase from 19.5 percent of GDP in 2002 to 22 percent in 2003. The government is committed to clear remaining arrears by mid-2003 and to reduce expenditures below

budgeted amounts by up to 0.7 percent of GDP in the event of a shortfall in external financing.

8. **VAT.** In January 2003, the value of imported goods exempted from VAT at the border was reduced from 25 percent to 20 percent of total imports. Over the next two years, as the administrative capacity for VAT credits and refunds further improve, the government is committed to eliminate all VAT exemptions at the border other than for goods exempted under agreements with international organizations or governments. Other measures taken to improve the system for VAT refunds include the introduction of limits on cash transactions. By mid-2003, the refund system will be further improved by preparing quarterly reports on outstanding VAT amounts.

9. **Tax administration.** In late 2002, a code of conduct for tax officials was adopted and an internal audit unit was established at the State Tax Service. Beginning in 2003, this unit will prepare quarterly audit reports to be shared with key officials and IMF and World Bank staff. A website including basic tax legislation and regulations covering the major taxes will be completed later in the year. The simplified tax has been further streamlined and a universal turnover ceiling of AMD 50 million was introduced in the 2003 budget. A minimum annual income tax of AMD 30,000 for businesses was also introduced to prompt small businesses to move away from the “normal” tax regime where due to administrative difficulties they used to pay little taxes to the simplified tax regime. In early 2003, a draft law was submitted to parliament on the declaration of income for all citizens. Lastly, the government intends to submit to parliament this fall an amendment to the law on tax inspections aimed at increasing transparency and simplifying the relationship between tax auditors and taxpayers.

10. **Customs administration.** The computerized customs valuation database will be updated with actual invoice values and we expect that the share of imported goods whose import values equal their invoice values will increase rapidly during the year. An updated version (1.16f) of ASYCUDA will be introduced at all customs houses and customs points by end-May 2003, which will enhance the possibility of random checking of imported goods and improve management reporting. In addition, all customs houses will be networked with the ASYCUDA system by April while all custom points will be networked via satellite by July 2003. A website has been established with key information including customs tariffs and import/export procedures. Mobile passport-reading machines were introduced last fall to enforce the bi-annual limits on individual duty free exemptions. These exemptions were reduced from US\$500 to US\$300 effective January 2003. The internal audit unit at customs will begin preparing quarterly audit reports based on criteria specified by IMF staff, which will be shared with key officials and IMF and World Bank staff. In 2002, the customs consultative committee was expanded to include further representatives among businesses and international consultants in Armenia. This committee will meet quarterly and publish their agenda and minutes for each meeting. Lastly, by end-June 2003, a post-clearance program will be introduced at customs headquarters.

11. **Expenditure policy.** The government remains committed to clearing all arrears by mid-2003. Social expenditures (defined as expenditure on health, education, and social security) are projected to increase to 5.7 percent of GDP in 2003 compared with 4.8 percent in 2002. In the event of a financing shortfall, the government will not execute the contingent expenditures detailed in the 2003 budget. However, priority expenditures, including family allowances, will be protected. Capital expenditure will increase rapidly mainly because of higher grant-financed public investment. Lastly, a medium-term expenditure framework for 2004–06 will be finalized in October 2003.

12. **Expenditure management and budget reform.** Further updating of the budgeting reporting software is still needed for a fully functioning system. At end-2002, the Ministry of Finance approved procedures for establishing internal audits in the budgetary sector (comprising all line ministries). By mid-2003, a manual consistent with international auditing standards will be prepared. To further improving expenditure arrears control, the government will submit amendments to the Budget System law that will make it possible to reduce budgeted expenditures by up to 10 percent in the case of a revenue shortfall without parliamentary approval. In such an event, social expenditures will be safeguarded. A website including budget laws, internal audit reports, and budget execution reports according to both the economic and the functional distribution of expenditures will be completed this spring. Later this year, the government intends to put in place a financial and cash management procedure involving daily forecasts for central government budget receipts and payments for the next twelve months. Work will also continue on identifying and tracking external grants with a view to include them in the budget.

Monetary and financial sector policies

13. **Monetary policy.** The overriding macroeconomic objective of the CBA is to maintain inflation at no more than 3 percent a year. Given the rapid increase in monetary aggregates toward the end of 2002 and the associated inflationary risks, the CBA has engineered a reduction in the money supply during the first quarter of 2003. The CBA will continue to use all instruments at its disposal to contain any inflationary pressure. Reserve money is projected to increase by 7 percent during the year while the demand for broad money is projected to increase by 11 percent. The multiplier is expected to increase reflecting both a projected decline in the currency-to-deposits ratio and the reduction in reserve requirements from 8 percent of deposits to 6 percent in mid-2003. The latter is planned in connection with the introduction of the deposit insurance scheme.

14. **Banking system.** The CBA has taken steps to resolve the situation of the eight banks under temporary administration. The liquidation of five of those banks has been initiated and by mid-March, the CBA will issue guidelines for the conduct of intervention of banks and for performing “least-cost” diagnostic tests. The CBA will also announce its decision to liquidate Credit Yerevan (a large intervened bank) during 2003. The CBA will share with the staffs of the IMF and the World Bank monthly cash flow statements and balance sheets of Credit Yerevan, whose liabilities are expected to decline rapidly until the bank is brought to liquidation. By end-May 2003, the situation of the remaining two banks will be resolved. In

addition, the CBA will continue to strengthen banking supervision, act decisively against banks that violate prudential norms, and ensure that all market participants operate on a level playing field. In this context, the CBA will—in consultation with external experts—review the system of penalties imposed on banks that violate prudential standards. Moreover, the CBA is preparing an onsite inspection manual to enhance risk-based supervision. The central bank has also communicated to the commercial banks that it will not tolerate any violations of exposure limits (particularly from the energy sector) and that all regulations will be fully enforced. The government will move cautiously with regard to the introduction of the deposit insurance scheme that will begin collecting premia in mid-2003. To ensure transparency, amendments will be made in the central bank law to clarify the insurance event, accounts covered, management of the insurance fund, and the structure of payments. The CBA will publish the modalities of the scheme by end-April 2003, setting a premium and a level of coverage comparable (in terms of GDP per capita) to other transition economies. Any bank that might be placed under interim administration before July 2005 would be excluded from the scheme.

15. **Financial sector legislation.** The financial legal framework and the functioning of the judiciary need to be improved to foster financial sector development. Despite continuing macroeconomic stability, interest rates remain high and the financial sector remains small and fragile. This is primarily attributed to the lack of proper mechanisms to ensure creditor rights, leading to liquidity and solvency problems for banks as they confront significant difficulties in recovering problem assets. To address this situation, we will draft amendments to the law on Bank Bankruptcy, the law on Banks and Banking, the law on Enforcement of Court Decisions, the Civil Code, and the Civil Procedure Code. These changes will enhance our ability to execute bank resolution strategies and more effectively create, register, and enforce pledges.

External policies

16. **Balance of payments.** The current account deficit is projected to deteriorate slightly in 2003. Capital transfers will continue to be high owing to grants from a US-based private foundation. Gross international reserves are projected to remain at around 4.3 months of imports of goods and services. A remaining financing gap would be financed by IMF disbursements and a structural adjustment loan from the World Bank.

17. **Trade and foreign exchange regime.** Armenia became a member of the World Trade Organization in February 2003. Armenia is committed to maintain a liberal trade regime with no restrictions in the making of payments and transfers for current international transactions and in conformity with Article VIII of the IMF's Articles of Agreement. The floating exchange rate regime will be maintained.

18. **External debt.** The government will not accumulate external nonconcessional debt or external payments arrears during the program period. The debt-equity swap agreement with Russia is expected to be completed in the next few months. The agreement, which entails the exchange of the outstanding debt to Russia for equity positions in Armenian state-owned

enterprises, will significantly reduce Armenia's external debt ratios. The government has cleared its outstanding arrears to Turkmenistan through the provision of goods and intends to repay the remaining debt to that country in the first half of 2003.

Structural policies

19. **Energy sector.** By mid-2003, the government will approve an integrated financial rehabilitation plan for the energy, water, and irrigation sectors for the period of 2003–07. The rehabilitation plan will include a timetable for strengthening corporate governance in the energy sector and for transferring the management function of the state-owned enterprises through management contracts. In addition, independent boards of directors will be established by September 2003 whose composition will be determined by a Prime Ministerial decision. The government and other state institutions shall not interfere in the activities of the energy companies. The boards will approve independent management plans for the respective enterprises and board members shall act independently from the government, parliament, and special-interest groups. The board of directors for the transmission, settlement, and dispatch centers will include representatives from the electricity distribution and power generation companies. There will be regular annual independent audits of all state-owned enterprises in the energy sector carried out by reputable auditors, beginning with financial year 2002. The auditor(s) will submit audited financial reports to the boards and appropriate government bodies and the reports will be published via mass media and the internet. In the meantime, the energy regulatory commission will start implementing a power sector performance monitoring and public dissemination system for intra-sectoral flows of electricity and payments as specified in paragraph 18 of the attached Technical Memorandum of Understanding (TMU). The financial rehabilitation plan will contain a strategy for dealing with the debts of the state-owned companies and will prevent them from increasing their net bank liabilities. The central bank will continue to require commercial banks to provision in full for any unsecured lending to the energy sector. Furthermore, the government will not extend any further guarantees on the sector's domestic or foreign loans. In April 2003, the government will restructure the existing external debt guarantee to the nuclear power plant (US\$7 million). In 2003, the energy sector primary surplus excluding the distribution company is expected to increase to 0.2 percent of GDP from 0.1 percent in 2002.

20. **Other key parastatals.** The financial rehabilitation plan will ensure further reduction of excess losses and elimination of payment arrears by water and irrigation companies. The 2003 budget contains sufficient subsidies to these and electric public transport companies to prevent the accumulation of tax and energy payments' arrears. Through ongoing technical improvements, including enhanced metering, the combined primary deficit of the water and irrigation sectors is also projected to decline to 0.6 percent of GDP in 2003 compared with a projected 0.8 percent in 2002.

21. **PRSP.** The government has prepared a draft PRSP that has been circulated for comments to civil society and the international donor community. The draft is currently being revised in light of comments received, focusing on the prioritization and costing of the

measures proposed. The final document is expected to be approved by the government by mid-2003.

22. **Governance.** The government is aware of the need to fight corruption and it has prepared an anti-corruption strategy in late 2002 based on an earlier consultant's report on the subject. The document will be further revised to emphasize key anti-corruption measures and establish an action plan for their implementation.

III. Program Monitoring

23. Program monitoring will be carried out based on semi-annual quantitative performance criteria and quarterly quantitative benchmarks (Table 1) as well as structural performance criteria and benchmarks (Table 2). The fourth review under the PRGF-supported program, scheduled for completion by end-September 2003, will be based on compliance with end-June 2003 quantitative targets and the implementation of the envisaged structural measures. The quantitative performance criteria include: ceilings on the net domestic assets of the CBA, net domestic banking system credit to the government, the overall cash deficit of the central government, domestic expenditure arrears of the central government, State Fund for Social Insurance arrears, contracting and guaranteeing of non-concessional medium- and long-term external debt, and continuous performance criteria on non-accumulation of external arrears of the government and on net disbursements of short-term external debt. There are also floors on net official international reserves of the central bank and tax revenues of the central government, an indicative bound on reserve money, and an indicative floor on the primary balance of the energy sector. The attached TMU details definitions and monitoring (including adjusters) of quantitative performance criteria.

24. **Compilation and provision of information.** The relevant ministries, the CBA, and the National Statistics Service will share with the staff all data as specified in the TMU. Following the adoption of a new civil service law last year and as part of reforms in collaboration with the World Bank toward further decentralization, in 2003 a large number of budgetary institutions such as schools and universities, libraries, and hospitals were converted into noncommercial enterprises that are controlled and largely financed by the government. As a result, a large part of government expenditure including wages, subsidies, and other transfers will be classified in budget execution under "other goods and services". Since these enterprises constitute instruments of government policy, their financial risks largely correspond to government fiscal risks. While the current reporting of budgetary units is in line with Government Finance Statistics methodology, the reporting by economic categories for these enterprises is required for the analysis of their spending behavior, fiscal control, and performance. Therefore, the government will request these entities to begin submitting budget execution reports in line with the economic classification of expenditures. The treasury will work (in consultation with the IMF) towards ensuring that these reports are aggregated into the regular budget execution reports in early 2004.

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

	2002		2003		
	December	March	June	September	December
	Act.	Prog. 2/	Prog. 3/	Prog. 4/	Prog. 4/
	(In billions of drams)				
Net domestic assets of the CBA (ceiling) 5/	-12.4	-13.9	-18.5	-18.1	-16.7
Net banking system credit to government	0.0	5.4	2.6	2.0	4.9
Domestic arrears of the central government	9.1	8.0	0.0	0.0	0.0
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) 6/	198.6	45.0	98.9	157.7	220.5
Balance of the central government on a cash basis 6/	-31.9	-9.0	-27.5	-39.8	-50.0
Reserve money (band) 4/	111.3	(92.6-96.4)	(93.3-97.1)	(103.5-107.7)	(116.8-121.6)
Primary balance of the energy sector (floor) 4/ 6/	-5.1	-2.3	-1.2	2.5	2.7
	(In millions of U.S. dollars)				
Contracting and guaranteeing of new nonconcessional external debt with maturity of more than one year 6/	7.1	0	0	0	0
Net disbursements of short-term external debt 6/ 7/	0	0	0	0	0
External arrears (continuous criterion)	0	0	0	0	0
Net official international reserves (floor) 5/	236	198	207	224	245

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/ Benchmark.

3/ Performance criterion, unless otherwise indicated.

4/ Indicative target.

5/ At program exchange rates (as specified in the TMU).

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

7/ Continuous criterion. 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 Fourth Review

Measures	Target Date 1/
Performance Criteria	
1. Submit to parliament amendments to the Budget System law with a view to improving expenditure control.	April 2003
2. Introduce version 1.16f of the ASYCUDA system at all customs houses and customs points.	May 2003
Benchmarks	
1. Begin work on a new budget reporting system for noncommercial enterprises that will become operational in early 2004.	May 2003
2. Complete least-cost diagnostic analyses and formulate resolution strategies for Armcommunications bank and Ardshin bank unless they are already liquidated or purchase and assume resolution strategies have been put in effect.	May 2003
3. Improve administration of VAT refunds by simplifying procedures and preparing quarterly reports on outstanding VAT amounts.	June 2003
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
5. Introduce a post-clearance verification program at customs' headquarters.	June 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
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 to include provisions on deposit insurance.	July 2003

1/ 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.

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 SDRs, any reserve position in the IMF, and holdings of convertible currencies in cash or in nonresident financial institutions (deposits, securities, or other financial instruments). Gross reserves held in the form of securities are marked to market. Gross reserves are reported net of the balance on the government's Special Privatization Account (SPA) 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. NDA is defined as reserve money less net foreign assets of the CBA. Net foreign assets are defined as NIR minus 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.

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

4. The stock of **net credit of the banking system to the government** is the sum of net credit from the CBA and net credit from commercial banks. **The stock of credit from the CBA** includes the CBA's holdings of treasury bills and treasury bonds less all types of government deposits. Treasury bonds are valued at the purchase price and treasury bills are valued at the purchase price plus the implicit accrued interest. **The stock of net credit from**

commercial banks includes: (1) gross credit to the government less government deposits (including the counterpart funds of certain government onlending to the economy financed by the Lincy Foundation and the World Bank); and (2) banks' holdings of treasury bonds (valued at the purchase price and excluding accrued interest) and treasury bills (valued at the purchase price plus the implicit accrued interest).

5. **External debt limits** apply to all forms of new nonconcessional medium- and long-term external debt⁷ 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), and concessional loans.⁸ Except for normal import-related credits, there is a zero limit on net disbursements of 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 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.

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

7. The **central government budget balance on a cash basis** is defined from the financing side as the sum of domestic banking system net financing, domestic nonbank net financing, and external net financing to the government. **Domestic banking system net financing** equals the change during the period of net credit to the government. **Domestic 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

⁷ 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.

⁸ 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.

excluding accrued interest for treasury bonds);⁹ and (2) any other disbursement or transaction that increases nonbanks' claims on the central government plus net 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 transaction. The central government comprises all entities mentioned under the state budget including ministries and noncommercial public enterprises.

8. The **State Fund for Social Insurance (SFSI)**, whose overall cash balance cannot be less than zero on an annual basis, is monitored by a separate performance criterion on the stock of SFSI arrears.

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.

10. Proceeds from privatizations are deposited into the SPA. The account is held at the CBA and the proceeds are invested abroad together with the CBA's international reserves. However, these proceeds are not included in the definition of the monetary accounts of the banking system. Any withdrawal from the SPA will be accounted for as privatization proceeds used to finance the budget and will be recorded below the line. These withdrawals need to be replenished during the fiscal year and the corresponding negative financing amount will be recorded below the line.

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

12. The program targets maximum levels for the stock of central government **domestic arrears**. For program purposes, 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. For all other expenditure categories, arrears are defined as the stock of unpaid

⁹ 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.

claims, as verified by the recipient of the goods and services, that has been outstanding for more than 30 days as of the end of the month.

13. 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) Hrazdan thermal power plant; (2) Yerevan thermal power plant; (3) Metsamor nuclear power plant; (4) Sevan-Hrazdan Cascade hydropower plant; (5) Vorotan hydropower plants system; (6) High Voltage Electricity Network; (7) Armenergo; and (8) Armtourtrade. 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.

II. Adjusters

14. The quantitative performance criteria and benchmarks under the program are subject to the following adjuster on **the cash balance of the government**: the cash balance of the central government will be adjusted downward (upward) by the full amount of cumulative higher (lower) than programmed foreign-financed project disbursements (excluding structural adjustment lending by the World Bank). The programmed amounts are shown in Table 2 below.

15. The following adjuster on **the net domestic assets of the CBA** will apply to changes in the stock of medium- and long-term liabilities of the CBA: 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.

III. Structural Targets

16. For the structural performance criterion on amending the Budget System law the following changes will be made: “The Government, within the scope of its authority provided in Article 23 shall organize commitment control and cash management of budgetary flows in order to ensure that shortfalls in receipts can be handled without increasing expenditure payment arrears. If at the time of budget execution there is a possibility of a shortfall of receipts for the year, and in order to avoid increases in expenditure payment arrears, the Government may and shall withhold up to 10 percent of the aggregate budget allocation for the year without having to obtain the approval of the National Assembly.”

17. For the benchmark on the budget reporting of noncommercial enterprises, the government will institute a system under which these enterprises will report data in line with the GFS economic classification on revenues, expenditure and commitments (revenue from the budget, other capital revenue, other current revenue; wages, subsidies, pension transfers, other transfers, other goods and services, foreign-financed capital expenditures, domestic-financed capital expenditures). After introduction of the reporting system, these units will be required to submit quarterly reports on the execution of their budget no later than 30 days after the end of each quarter. These units will be subject to random internal

audits. 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. The authorities will ensure that adequate regulation is in place to ensure transparency of physical flows of electricity; related payment flows in the sector; and payment flows including those from end users to the distribution company, to the various midstream power operations, and to the individual generators. The sector entities shall report on a (monthly) quarterly basis figures on:

- Power produced and sold by each power generation plant,
- Power exports and imports,
- Power received by the distribution company,
- Power supplied to end users (by major customer category),
- Technical losses, separately for the transmission and distribution systems,
- Amounts invoiced and amounts collected from customers (by customer category) and from exports,
- Amounts invoiced by generating plant and for imports,
- Amounts paid to each generating plant and for imports,
- Amounts of fuel purchased and paid for by each thermal power plant,
- Amounts paid to others in the supply chain: transmission company, settlement, dispatch, and contracting centers, and others.

The authorities will disseminate the performance data to the public on its website and to the World Bank and the IMF no later than 45 days after the end of each (month) quarter beginning with the data for the first quarter of 2003.

IV. Data Reporting

19. The government of the Republic of Armenia will provide the IMF the following information as defined in Section II above.

20. **Balance sheet of the CBA.** The CBA has provided the IMF staff the chart of accounts and it will notify the staff of any revisions thereto. Weekly (summary¹⁰) and monthly end-of-period (by chart of account) data on the balance sheet of the CBA will be reported within seven days of the end of the reporting period.

21. **Balance sheet of the banking system.** Monthly banking system data, in the form of a monetary survey for the central bank and the consolidated balance sheet of the commercial banking system (by chart of accounts) will be reported electronically to the IMF within

¹⁰ As defined in CBA Resolution No. 201 (December 6, 1999).

21 days of the end of each month. The format for publication in the International Financial Statistics will be reported within 45 days of the end of each month.

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

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

24. **Other financial data.** The CBA will provide foreign exchange market data (including the official, buying, and selling exchange rates, inter-bank turnover, and the volume of CBA sales and purchases) and data on interest rates of different maturities (including the refinance rate, the inter-bank rate and volumes, the treasury bill and coupon bond yields and volumes by maturity, and bank deposit and lending rates by maturity). The CBA will also provide data on commercial bank soundness indicators (including capital adequacy ratios, asset composition and quality, profitability, liquid asset ratios, open foreign exchange positions, and percentage of classified loans by category) (Table 3). In addition, the CBA will provide data on bank compliance with prudential regulations (Table 4). These data will be provided on a quarterly basis within 30 days of the end of each quarter. Lastly, the CBA will provide other data as specified in CBA Resolution No. 201 (December 6, 1999).

25. **Non-tax and capital revenue.** The Ministry of Finance and Economy (MFE) will report on monthly non-tax revenue, capital revenue, cash grants and proceeds from the sales of humanitarian assistance. This information will be reported within seven days of the end of each month.

26. **External debt.** The MFE, in collaboration with the CBA and the Ministry of Energy, will provide information on disbursements and outstanding stocks of short-term external debt; on contracting and guaranteeing and outstanding stocks of medium- and long-term external debt of the government, the CBA, and state-owned companies in the energy sector (by company); any stock of outstanding arrears on external debt service payments, and the total amount of outstanding government guarantees and external arrears within 21 days of the end of each month for preliminary data and within 45 days for final data.

27. **Tax and expenditure arrears.** The STS will report on an end-of-month basis the following data on outstanding stock of tax arrears by the end of the following month: (1) by type of tax (monthly), (2) for the 10 largest debtors (quarterly), and (3) for all major companies in the energy, water, and irrigation sectors (quarterly). The reports on expenditure arrears (Table 5) will be compiled monthly by the MFE for the central government and the SFSI separately, and reported within 45 days of the end of each month for government arrears and within 10 days for SFSI arrears.

28. **Central government employment.** The National Statistics Service (NSS) will provide quarterly updates on employment by ministries and average wages within one month following the end of each quarter.

29. **Budget Execution.** The MFE will report to the IMF total revenue collected separately by the SFSI, the STS, and the Customs Committee on a monthly basis within seven days of the end of each month. Monthly data on budget execution will be reported by the MFE and the SFSI within one month following the end of each quarter. All cash receipts, cash expenditures (including debt-service payments), and external and domestic borrowing operations will be part of this report. Expenditure data will be provided according to both economic and functional classifications, consistent with GFS methodology.

30. **Balance of payments.** The NSS will provide: (1) on a monthly basis detailed export and import data within 28 days of the end of each month; and (2) on a quarterly basis a balance of payments within 45 days of the end of each quarter.

31. **Energy sector.** The Ministry of Energy will provide monthly reports on the end-of-month stock of accounts payables and accounts receivables for the consolidated energy sector (defined in Section I above) with a lag of no more than 28 days. It will also provide the cash flow information with a lag of 45 days (Table 6).¹¹

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

33. **Prices and GDP.** The NSS will provide the monthly CPI by category by the fifth day of the following month, and the monthly GDP estimates within one month of the end of the period. The CBA will also submit the monthly index of core inflation within 21 days after the end of each month.

¹¹ 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
Austrian 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)

March 2003	June 2003
8.7	19.8

1/ On calendar year basis.

Table 3. Armenia: Financial Soundness Indicators for the Banking Sector, 2000–03
(In percent, unless otherwise indicated)

	Dec-00	Dec-01	Jun-02 1/	Sep-02 2/	Dec-02 2/	Mar-03	Jun-03
Capital adequacy							
Total regulatory capital to risk-weighted assets	25.0	13.6	27.3	31.1	30.5		
Tier I regulatory capital to risk-weighted assets	23.3	12.3	26.1	29.7	28.8		
Capital (net worth) to assets	14.2	8.8	17.3	17.8	17.6		
Asset composition							
Sectoral distribution of loans (billions of drams) 3/							
Industry (excluding energy sector)	20.8	24.2	25.1	14.2	16.3		
Energy Sector	16.3	8.5	8.2	15.5	12.2		
Agriculture	10.4	9.9	7.7	3.1	7.1		
Construction	2.0	2.4	3.0	1.9	2.5		
Transport and communication	2.1	1.9	1.8	0.8	0.8		
Trade/commerce	12.7	13.4	13.9	12.7	13.9		
Sectoral distribution of loans to total loans (percent of total)							
Industry (excluding energy sector)	17.1	23.0	31.2	20.4	23.7		
Energy Sector	13.3	8.1	10.1	22.3	13.9		
Agriculture	8.5	9.4	9.6	4.4	9.0		
Construction	1.6	2.3	3.7	2.7	3.7		
Transport and communication	1.7	1.8	2.2	1.1	1.0		
Trade/commerce	10.4	12.7	17.2	18.3	20.6		
Foreign exchange loans to total loans	85.9	84.7	84.1	81.9	82.5		
Asset quality 4/							
Non-performing loans to gross loans	20.5	16.7	11.8	6.4	4.9		
Provisions to non-performing loans	14.0	16.2	29.8	43.5	40.2		
Spread between highest and lowest interbank rates	27.7	21.0	N/A	13.4	14.0		
Earnings and profitability							
ROA (profits to period average assets)	-0.9	-10.3	-1.2	0.6	7.6		
ROE (profits to period average equity)	-6.0	-127.9	-7.4	3.2	5.5		
Interest margin to gross income	24.7	21.6	23.3	26.7	27.4		
Noninterest expenses to gross income	29.4	33.1	32.3	34.5	35.2		
Liquidity							
Liquid assets to total assets	30.5	33.1	40.2	47.5	44.5		
Liquid assets to total short-term liabilities	86.1	80.4	105.5	118.6	108.8		
Customer deposits to total (non-interbank) loans	156.0	216.1	198.4	196.4	218.6		
Foreign exchange liabilities to total liabilities	80.6	79.7	78.1	61.1	74.6		
Sensitivity to market risk							
Gross open positions in foreign exchange to capital	22.5	97.8	21.9	24.4	15.3		

Source: Central Bank of Armenia

1/ Includes the data of 21 banks and excludes the data of 7 banks under interim administration.

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

3/ Includes only loans to residents.

4/ Detailed data on classified loans are currently being prepared by the CBA.

Table 4. Armenia: Bank Compliance with Prudential Norms, 2001–03 1/
(Number of Banks) 2/

	Dec-01	Mar-02	Jun-02	Sep-02	Dec-02	Mar-03	Jun-03
Capital adequacy (CAR)							
Capital/risk-weighted assets							
CAR < 12 %	9	1	1	1	0		
12% < CAR < 15%	0	3	2	1	2		
15% < CAR < 20%	2	1	1	2	3		
20% < CAR < 30%	6	4	5	5	3		
CAR > 30%	13	11	11	11	12		
Core capital/risk-weighted assets							
CAR < 8 %	9	1	1	0	0		
8% < CAR < 13%	0	2	2	2	3		
13% < CAR < 20%	3	3	1	2	2		
20% < CAR < 30%	5	4	5	6	3		
CAR > 30%	13	10	11	10	12		
Liquidity (LR)							
Liquid assets/demand liabilities							
LR < 80%	11	2	1	1	1		
80% < LR < 100%	3	4	2	4	5		
100% < LR < 150%	5	5	7	4	7		
150% < LR < 200%	3	1	3	4	3		
LR > 200%	8	8	7	7	4		
Liquid assets/total assets 3/							
LR < 25%	12	4	4	2	5		
25% < LR < 30%	3	1	2	5	2		
30% < LR < 40%	7	7	7	3	7		
40% < LR < 50%	1	1	1	4	2		
LR > 50%	7	7	6	6	4		
Exposure limits 4/							
Single external borrower/capital							
Exposure > 20%	4	3	3	5	4		
Single internal borrower/capital							
Exposure > 5	1	0	1	1	0		
Total internal borrower/capital							
Exposure > 60	1	0	0	0	0		
Net open foreign exchange position							
Total currencies position/capital							
Exposure > 25%	1	0	0	0	1		
Nonconvertible currencies position/capital							
Exposure > 5%	2	1	1	1	1		
Asset quality							
Nonperforming loans/gross loans (NPL)							
NPL < 2%	12	6	5	5	6		
2% < NPL < 4%	5	1	2	3	2		
4% < NPL < 6%	2	2	3	2	5		
6% < NPL < 10%	2	3	2	4	2		
NPL > 10%	9	10	10	8	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 on the basis of 30 banks at the end of 2001 and 20 banks in 2002. 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.

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

Table 5. Armenia: Arrears of State Budget and SFSI
(In billions of drams; end of period)

	2000	2001				2002				2003 2/	
		March	June	September	December	March	June	September	December	March	June
Total arrears	44.3	46.3	38.5	39.1	42.2	41.4	45.2	35.2	19.8		
Total expenditure arrears	37.3	37.5	36.1	34.9	35.8	32.5	34.0	24.0	9.1		
Current expenditures	34.6	35.2	33.3	32.5	31.4	29.0	30.6	21.7	7.4		
Wages	0.5	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3		
Subsidies 1/	0.9	0.9	0.8	0.8	0.8	0.8	0.8	0.7	0.7		
Interest	3.4	4.2	1.9	2.4	3.1	3.7	4.3	1.2	0.0		
Domestic interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
External interest	3.4	4.2	1.9	2.4	3.1	3.7	4.3	1.2	0.0		
Transfers	9.0	9.0	8.8	8.8	7.9	6.8	6.7	5.4	0.4		
Family Allowances	4.1	4.1	4.1	4.1	3.1	2.9	2.8	2.8	0.3		
Pension Contributions	1.1	1.1	1.1	1.1	1.1	1.0	1.0	1.0	0.0		
Contribution to pension fund	0.6	0.6	0.4	0.4	0.4	0.0	0.0	0.0	0.0		
Other 1/	3.3	3.2	3.2	3.2	3.3	2.8	2.8	1.5	0.0		
Goods and Services 1/ 3/	20.8	20.8	21.5	20.1	19.2	17.3	18.5	14.0	5.9		
Health	12.7	12.7	12.4	11.7	11.4	11.5	11.5	11.3	4.8		
Education	1.7	1.6	1.8	1.8	2.2	2.2	2.3	2.1	0.9		
Other	6.4	6.5	7.3	6.5	5.5	3.6	4.6	0.7	0.3		
Capital Expenditures 1/	2.7	2.3	2.7	2.4	4.4	3.5	3.4	2.3	1.7		
Net lending 1/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
External Amortization arrears	7.0	8.8	2.4	4.2	6.4	8.9	11.2	11.2	10.7		
Memorandum items:											
Domestic expenditure arrears	33.9	33.4	34.2	32.5	32.7	28.8	29.7	22.8	9.1		
of which: social expenditures arrears 3/	21.7	21.6	21.5	20.9	20.0	19.4	19.5	17.7	6.0		
External payment arrears	10.4	12.9	4.3	6.6	9.5	12.7	15.5	12.4	10.7		
SFSI stock of arrears	4.4	3.2	3.0	3.6	1.4	-0.2	0.0	0.0	0.0		

Source: Ministry of Finance and Economy.

1/ Arrears outstanding for more than 30 days.

2/ As specified in the TMU, the Authorities will compile the data for the quarter ending in March 2003 and June 2003 within 45 days after the end of each quarter.

3/ The December 2002 composition of arrears under Goods and Services is preliminary.

Table 6. Armenia: Cash Flow of the Consolidated Energy Sector 1/
(In billions of drams)

	2000	2001	2002					2003 2/				
			Q1	Q2	Q3	Q4	Year	Year w/o Armelnet	Q1	Q2	Year	
Revenues	79.9	65.1	20.2	15.1	12.8	22.6	70.7	63.9	17.8	11.2	55.4	
Electricity revenues collected	75.3	62.8	19.6	15.0	12.1	22.2	68.9	62.1	17.1	10.8	53.0	
Revenues collected for Thermal Energy Supply	3.6	1.0	0.3	0.0	0.6	0.0	1.0	1.0	0.5	0.1	1.4	
Non-Core Activities	1.0	1.3	0.3	0.1	0.1	0.4	0.9	0.9	0.2	0.3	1.0	
Expenditures	101.3	105.7	24.1	16.0	17.6	36.3	93.9	77.2	24.4	14.6	69.3	
Inputs	40.1	47.3	10.3	3.8	3.3	12.6	30.0	30.1	14.2	4.6	30.1	
Imported Gas	38.4	39.0	8.0	2.1	1.3	12.4	23.7	23.8	12.4	3.5	23.9	
Nuclear Fuel	1.7	8.3	2.4	1.7	2.0	0.2	6.3	6.3	1.8	1.1	6.2	
O&M Costs	34.2	31.1	7.2	5.8	5.0	6.0	24.0	13.0	3.2	3.1	13.0	
Net Payment of Taxes Accrued	17.2	14.8	4.2	4.7	3.9	8.9	21.6	18.9	2.5	2.0	8.6	
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	0.8	1.0	4.3	3.2	9.2	8.2	1.0	1.4	3.8	
Capital Expenditures	4.8	7.8	1.6	0.7	1.1	5.7	9.0	7.1	3.5	3.5	13.8	
Primary Balance 3/	-13.5	-29.7	-1.7	0.8	0.6	-4.9	-5.1	1.7	-2.3	1.2	2.7	
Current Balance	-11.6	-28.0	-1.6	0.8	0.7	-4.9	-4.9	2.0	-2.0	1.4	3.7	
Balance	-21.4	-40.6	-3.9	-0.9	-4.7	-13.7	-23.2	-13.3	-6.6	-3.4	-13.9	
Financing available	21.4	40.6	3.3	1.4	4.8	...	...	...	...	...	...
Domestic Sources	2.6	19.6	1.8	0.5	0.9	...	...	...	...	...	...
Banks	-2.2	-4.7	0.1	-2.1	-0.8	...	...	...	...	...	...
Budgetary loans	-0.6	3.2	5.0	0.1	-7.0	...	...	...	...	...	...
Nonbank loans	-9.2	15.5	-6.7	-0.9	4.9	...	...	...	...	...	...
Tax Arrears	7.1	-0.1	0.6	3.0	0.1	...	...	...	...	...	...
Production Reserves	4.2	5.1	2.3	2.2	1.6	...	...	...	...	...	...
Pre-payment for electricity	-0.5	-0.3	0.4	-1.8	2.3	...	...	...	...	...	...
Collection of old arrears	3.8	0.9	0.1	0.0	0.0	...	...	...	...	...	...
External Sources	-0.3	1.2	1.4	-1.0	1.0	...	...	...	...	...	...
Gov. Subsidies on external loans	4.9	7.2	0.0	2.0	2.9	...	...	...	...	...	...
ArmRosGasProm Gas, debt for equity swap	14.3	12.6	0.0	0.0	0.0	...	...	...	...	...	...
Errors and Omissions	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...

Sources: Armenian authorities, and Fund staff estimates.

1/ Starting 2003, the cash flows do not include the activities of the electricity distribution company ArmFlnet, which was privatised at end-2002.

2/ As specified in the TMU, the authorities will compile quarterly data for 2003 within 45 days after the end of each quarter. The figures displayed in the table are projections.

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 February 28, 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	104.66	113.76
III. SDR Department	SDR Million	Percent of Allocation
Holdings	19.07	n.a.
IV. Outstanding Purchases and Loans	SDR Million	Percent of Quota
Systemic transformation	12.66	13.76
ESAF/PRGF arrangements	127.54	138.63

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	30.00
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)

	Forthcoming				
	2003	2004	2005	2006	2007
Principal	14.34	23.31	24.68	21.18	15.43
Charges/interest	0.83	0.71	0.48	0.34	0.25
Total	15.17	24.02	25.17	21.53	15.68

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. The on-sight safeguards assessment conducted in October 2001 found that the safeguards at the CBA were generally adequate to ensure the integrity of bank resources including Fund disbursements. 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, as reported in EBS/02/170 (9/12/02). Key outstanding issues have since been addressed including (i) 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. Implementation of a few remaining low-key measures by the CBA is being monitored by the staff.

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. Since then, the exchange rate has been floating 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 now subject to the 24-month consultation cycle, subject to the provisions specified in SM/02/184, Supplement I (6/18/02).

X. Resident Representatives

Mr. Iradian, July 2000–August 2002.

Mr. McHugh, since September 2002.

XI. Technical Assistance

The following table summarizes the Fund's technical assistance to Armenia since 1998. For technical assistance prior to 1998, see EBS/98/213 (12/8/98).

Armenia: Technical Assistance from the Fund, 1998–2002

Subject	Type of Mission	Timing	Counterpart
Fiscal Affairs Department			
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
Monetary and Exchange Affairs Department			
Monetary and foreign exchange operations	Long-term	Nov. 1997–Nov. 1998	Central Bank of Armenia (CBA)
Bank 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 bank supervision	Short-term	February 21–March 5, 1999	CBA
Monetary operations	Short-term	Periodic visits 1999–2000	CBA
Bank supervision	Long-term	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 bank supervision	Short-term	September 3–14, 2001	CBA
Payment systems	Short-term	Periodic visits since 2002	
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

ARMENIA: RELATIONS WITH THE WORLD BANK
(As of January 31, 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 is committed to developing the new 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 implementing the Action Plan for removal of administrative barriers for business and investment and strengthening consultative mechanisms with the business community. The steps undertaken included, inter alia, 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 recent enterprise survey 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, Geenergy, 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.

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. 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 provides 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 drafted a hospital optimization strategy for Yerevan and made the commitment 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. Despite some reductions in budget spending on poverty benefits, 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 completed preparations for a pension reform package and has presented its principles for public discussion. The new law on State Pensions 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 January 2003 totals US\$697.2 million, of which US\$554.3 million has been disbursed. Of the 28 IDA credits and one IBRD loan approved, 14 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 period.

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

Active Projects	Credit Amount as of 01/31/03	Disbursement as of 01/31/03	Approval Date	Closing Date
<i>Active Projects</i>	<i>221.9</i>	<i>87.6</i>		
1. Health	10.0	8.4	07/29/97	09/30/03
2. Agric. reform support	14.5	12.7	01/27/98	06/30/04
3. Municipal development	30.0	15.1	06/11/98	12/31/03
4. Title registration	8.0	6.1	10/13/98	12/31/03
5. Electric. trans. & dist.	21.0	1.6	03/04/99	12/31/04
6. Irrigation dam safety	26.6	13.0	06/24/99	03/31/05
7. Transport	40.0	17.9	06/08/00	12/31/04
8. Social Investment Fund II	20.0	6.7	05/11/00	12/31/05
9. Judicial reform	11.4	1.2	09/14/00	12/31/04
10. Irrigation development	24.9	4.1	08/30/01	03/31/07
11. Enterprise incubator	5.0	0.4	11/30/01	06/30/05
12. Investment and export facilitation	1.0	0.1	04/16/02	12/31/05
13. Natural resource management	8.3	0.0	06/04/02	07/31/08
14. Municipal water	1.2	0.3	08/02/01	01/31/03
<i>Completed Projects</i>	<i>475.3</i>	<i>466.7</i>		
15. Irrigation rehabilitation	43.0	40.9	12/08/94	05/31/01
16. Highway	31.0	29.5	09/14/95	12/31/00
17. Social Investment Fund	12.0	11.1	11/09/95	12/31/00
18. Institution building	12.0	10.7	03/30/93	11/30/97
19. Earthquake rehabilitation	28.0	29.7	02/01/94	06/30/97
20. Power maintenance	13.7	13.2	12/08/94	06/30/99
21. Economic rehabilitation	60.0	64.3	02/28/95	06/30/96
22. SAC	60.0	58.5	02/29/96	12/31/97
23. SAC II	60.0	58.6	08/26/97	06/30/99
24. SATAC I	3.8	2.8	02/29/96	06/30/00
25. SAC III	65.0	63.4	12/22/98	06/30/01
26. Enterprise development	16.8	15.3	12/24/96	07/01/02
27. SATAC II	5.0	4.7	08/26/97	12/31/02
28. Education	15.0	14.6	11/20/97	10/31/02
29. SAC IV	50.0	49.4	05/22/01	03/31/03
Total	697.2	554.3		

**ARMENIA: RELATIONS WITH THE EUROPEAN BANK FOR
RECONSTRUCTION AND DEVELOPMENT (EBRD)**
(As of January 31, 2003)

As of January 31, 2003, EBRD had signed nine projects in the power, transport, agribusiness, mining and financial sectors. Total cumulative commitments amounted to EUR 133.3 million.

There are two sovereign projects. First, in March 1993 the EBRD approved a loan of EUR 64.3 million guaranteed by the Armenian government for construction of the Hrazdan Unit 5 thermal power plant, partly aimed at the eventual closure of Armenia's nuclear plant in Medzamor. The government is contemplating the privatization of Hrazdan 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 25.5 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.

The EBRD continues to support the introduction of private sector expertise in the energy sector. The EBRD is in preliminary discussions with the European Union (EU) about the possibility of setting up a fund with other international donors to finance the closure of and the replacement generating capacity for Medzamor. A project to establish a US\$15 million fund to finance projects in renewable energy is also under consideration.

The EBRD has provided a loan to the Yerevan Brandy Company owned by Pernod Ricard of France. 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. The EBRD is committed to further expanding lending under this facility to other banks. A EUR 1.1 million participation in the Commercial Bank of Greece-Armenia was approved in late 1999. A Trade Facilitation Program with the purpose to facilitate access of Armenian banks to trade financing was also made available to two Armenian banks.

The EBRD is currently considering two other private sector investments in construction and textiles sectors in Armenia. The EBRD has launched a Business Advisory Service program in Armenia in early 2003, funded by the EU-Tacis program. This will further enhance technical assistance to Armenian small and medium-sized enterprises in close co-operation with the EU.

ARMENIA: STATISTICAL ISSUES

The overall quality, timeliness, and coverage of macroeconomic statistics in Armenia have improved significantly over the past few years—a process in which the Fund has been heavily involved through technical assistance from the Fiscal Affairs Department, the Monetary and Exchange Affairs Department, and the Statistics Department. An Armenia country page was added to the *International Financial Statistics* in September 2000. Armenia participates in the IMF General Data Dissemination System (GDDS), with metadata first posted to the Fund's Dissemination Standards Bulletin Board in March 2001. The metadata describe current practices in the production of the statistics and plans for improvement. Further improvements are needed in real, fiscal, and external sector statistics in order to enhance the design and monitoring of economic policies. The table below (Core Statistical Indicators) shows the availability of key macroeconomic data and the authorities' publication policy.

National accounts and price statistics. The National Statistics Service has made significant changes to the national accounts methodology to bring it in line with international best practices. Significant progress has been made in developing estimates of quarterly real GDP 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. The absence of a comprehensive and updated business register in Armenia also renders difficult the compilation of national accounts. 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. The authorities have recently improved the classification of the reserve fund and reclassified several expenditure items under new relevant categories. However, the system to track arrears is cumbersome, there is a 45-day lag in the compilation of the data, and its reliability is questionable. Daily revenue and cash expenditure data for the central government are available with a lag of one to two days. The treasury is undertaking a comprehensive reform of treasury systems including the introduction of an internal auditing system in the line ministries and their budgetary institutions. A single treasury account 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 single treasury account, although there are still shortcomings on the timeliness and quality of data on the transactions of local governments. Classification of government transactions by function and economic category are generally in line with the GFS, and monthly data on central government operations are disseminated within 40 days of the end of the month. However, the budget presentation and the classification of items under the economic classification of expenditures need to be made more transparent; for instance,

wages for military personnel are reported in the broader category of “other” goods and services rather than as a wage item. This has been further complicated by recent reclassification of budgetary units as noncommercial enterprises with different reporting requirements. 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. The authorities are working to address this problem, and plan to move towards the reporting of general government operations within the next six months. 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 1-day lag, while weekly data on the monetary survey are provided with a one-week lag. Interest rate data are provided with a 1-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 business register hampers a wider coverage of transactions and institutional units.

Core Statistical Indicators
(As of February 28, 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	2/21/03	2/27/03	2/21/03	2/16/03	2/16/03	January 2003	Dec. 2002	Q3 2002	January 2003	December 2002	December 2002
Date received	2/25/03	2/28/03	2/25/03	2/25/03	2/25/03	2/7/03	1/22/03	1/22/03	2/17/03	1/20/03	1/22/03
Frequency of data	Daily	Daily	Daily	Weekly	Weekly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Frequency of reporting	Weekly	Weekly	Weekly	Weekly	Weekly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Source of update	CBA	CBA	CBA	CBA	CBA	NSS	NSS	NSS	MFE	NSS	MFE
Mode of reporting	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	Fax
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of publication	Daily	Quarterly	Quarterly	Monthly	Monthly	Monthly	Monthly	Annually	Monthly	Quarterly	Annually

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



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April 2, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Third Review of Armenia's PRGF Arrangement and Request for Waiver of Performance Criterion

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

The Executive Board decision enables Armenia to draw an amount equivalent to SDR 10 million (about US\$14 million) under the arrangement.

The PRGF arrangement was approved on May 23, 2001 (see [Press Release No. 01/25](#)) in a total amount equivalent of SDR 69 million (about US\$95 million). So far, Armenia has drawn the equivalent of SDR 30 million (about US\$41 million).

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

“The Armenian authorities should be commended for the strong performance under the PRGF-supported program, in particular the reduction in the fiscal deficit, the repayment of domestic expenditure arrears, and continued low inflation. Continued implementation of sound macroeconomic policies and further structural reforms will be necessary to sustain high growth and facilitate further progress in poverty reduction.

“The fiscal program for 2003 includes measures aimed at improving budget execution and tax administration, while safeguarding social spending and preventing the accumulation of expenditure arrears. Monetary and exchange rate policies remain consistent with the central bank's inflation objective. Recent measures geared toward enhancing the effectiveness of banking supervision and bank resolution already yielded positive results, but further efforts will be needed. At the same time, the introduction of the deposit insurance scheme should be conducted in a prudent manner and the premium set at a level comparable to other transition economies.

“Building on the improvements in the performance of the energy sector during 2002, additional measures are required to deal with the sector's debts and governance problems. In this regard, the authorities' commitment to move toward management contracts for the state-owned

companies, establish independent boards of directors, and begin public disclosure of financial audits and energy sector data is welcomed.

“The authorities expect to finalize their poverty reduction strategy paper by May 2003. It will be important to ensure that the paper contains an adequate prioritization and costing of poverty reduction measures in line with the medium-term expenditure framework. At the same time, further work is required to finalize an effective anti-corruption strategy and begin with its implementation.

“In view of the favorable performance under the 2002 program and the strength of the program for 2003, the Executive Board completed the third review under the PRGF arrangement and granted a waiver for the nonobservance of one performance criterion. Continued good performance under the program will be essential to address the key economic challenges facing Armenia and mobilize support for a successful poverty reduction strategy,” Mr. Aninat said.