

Republic of Armenia: Fifth Review Under the Poverty Reduction and Growth Facility and Request for Extension of the Arrangement—Staff Report; Staff Statement; and Press Release on the Executive Board Discussion

In the context of the fourth review under the Stand-By Arrangement and request for waiver of performance criteria, the following documents have been released and are included in this package:

- the staff report for the fifth review under the Poverty Reduction and Growth Facility and request for extension of the arrangement, prepared by a staff team of the IMF, following discussions that ended on **February 20, 2004**, with the officials of the Republic of Armenia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 15, 2004.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **April 30, 2004** updating information on recent developments.
- a Press Release summarizing the **views of the Executive Board as expressed during its May 3, 2004 discussion** of the staff report that completed the review.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of the Republic of Armenia*
Memorandum of Economic and Financial Policies by the authorities of the Republic of Armenia*
Technical Memorandum of Understanding*

*May also be included in Staff Report

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

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REPUBLIC OF ARMENIA

**Fifth Review Under the Poverty Reduction and Growth Facility and
Request for Extension of the Arrangement**

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

Approved by Julian Berengaut and Martin Fetherston

April 15, 2004

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EXECUTIVE SUMMARY

During the last two years, Armenia has experienced an impressive expansion in exports, investment, and real incomes. This has been the result of prudent fiscal and monetary policies, continued economic reforms, and substantial support from the Armenian diaspora. However, poverty is still high, the sustainability of growth remains a concern, and the reform agenda is still unfinished.

Performance under the PRGF-supported program since mid-2003 has been satisfactory: the authorities met all quantitative targets and implemented most of the envisaged structural measures. Tax revenue collection was somewhat disappointing in 2003, though it has improved in early 2004.

The budget for 2004 is prudent and in line with the PRSP. It targets an increase in the tax-to-GDP ratio of 0.5 percent of GDP and accommodates higher social expenditures despite a substantial decline in private grants. Monetary policy will need to be tight and focused on the goal of bringing inflation down to 3 percent by end-2004.

The authorities need to press ahead with key reforms in the following areas: tax and customs administration, the banking system, fiscal transparency and accountability, and the energy and water sectors.

Tax and customs administration reforms should be accelerated to secure a strong revenue base and improve the business environment. Near-term priorities are to achieve greater transparency on the operations of the tax and customs services, ensure the equal treatment of taxpayers, improve the administration of the value-added tax, and implement risk-based audit systems. Medium-term priorities comprise preparing a unified tax code and strengthening the overall coherence of the tax system. In addition, the authorities could usefully revamp the management structure of tax and customs to ensure the success of these reforms.

Future growth in Armenia will increasingly depend on the ability of the banking system to mobilize and allocate domestic savings. To this end, the focus should be on improving banking supervision and strengthening the legal system and governance in the judiciary.

The decentralization reforms in the health, education, and water sectors require development of capacity, accountability for operations, and transparent budgetary management in government-owned noncommercial organizations. These reforms have the potential to improve the quality and efficiency of the services that these sectors provide and contribute to poverty reduction. Similarly, further reforms in the energy sector will improve governance and efficiency and contribute to a more reliable supply of energy.

Armenia's medium-term economic prospects remain favorable assuming a continuation of the reform effort. In addition, the authorities will have to implement the actions envisaged in the PRSP and ensure that future budgets give priority to social expenditures, public investments, and maintenance of the public infrastructure.

I. INTRODUCTION

1. The Executive Board concluded the fourth review under the Poverty Reduction and Growth Facility (PRGF) arrangement on IMF Country Report No. 03/379.¹ At that time, Directors commended the authorities for Armenia's strong macroeconomic performance and their satisfactory implementation of the Fund-supported program. Directors noted that to sustain growth and reduce poverty, further efforts will be required to improve tax and customs administration; carry out the remaining reforms in the banking, energy, and water sectors; and press ahead with the implementation of the poverty reduction strategy and an effective anti-corruption program.
2. Discussions on the fifth review took place in Yerevan during February 6–20, 2004.² In the attached Letter of Intent and Supplementary Memorandum of Economic and Financial Policies (Attachments I and II), the authorities request the completion of the fifth review and describe the policy framework for 2004 as well as the measures to be implemented during the next four months. The program is consistent with the recently approved Poverty Reduction Strategy Paper (PRSP). Armenia's structural reform agenda is also supported by the World Bank Group, the European Bank for Reconstruction and Development (EBRD), and international donors. Appendix I summarizes Armenia's relations with the Fund including technical assistance provided and assessments of Standards and Codes. Appendices II and III describe relations with the World Bank and the EBRD, respectively. Appendix IV discusses the quality and timeliness of key economic data.

II. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

3. The **political situation** has been stable and the three-party coalition has continued in power despite sporadic internal disagreements. Recently, however, the opposition has attempted to organize anti-government demonstrations and boycott sessions of Parliament. There has been no ostensible progress towards normalized trade relations with Turkey or a solution to the territorial dispute with Azerbaijan.

¹ Armenia's three-year PRGF arrangement for SDR 69 million (75 percent of quota) was approved on May 21, 2001 (IMF Country Report No. 02/73). SDR 50 million have already been disbursed and SDR 10 million will be available upon completion of this review (Table 1).

² The mission met with the President, Mr. Kocharian; the Prime Minister, Mr. Margarian; the Minister of Finance and Economy, Mr. Khachatryan; the Chairman of the Central Bank, Mr. Sargsyan; the Minister of Energy, Mr. Movsesian; the Minister of Foreign Affairs, Mr. Oskanian; other senior officials; and representatives of the donor community, nongovernmental organizations, and the private sector. The staff team comprised Mr. Gelbard (head), Mr. Beddies, Ms. George (all MCD); Mr. Simone (FAD); Ms. Redifer (PDR); and Mr. Wickens (STA). Mr. McHugh (the Fund's resident representative), and Mr. Stepanyan and Ms. Minasyan (local economists) assisted the mission.

4. Armenia robust **economic growth** continued in 2003 with real GDP expanding by 13.9 percent (Table 2). Grant-financed and private investment in construction as well as exports of metals and polished diamonds played a key role in the expansion. Real wages during the year grew by 21 percent. **Inflation** at end-year rose to 8.6 percent mainly because of an increase in the prices of imported wheat flour and cereals.³ An analysis of price behavior during the year indicates that this increase accounted for more than half of the annual inflation rate and that monetary policy played at most a minor role in explaining the pick up in inflation. By March 2004, the 12-month rate of inflation was 8.7 percent.

Armenia: Main Economic Indicators, 2000–04					
	2000	2001	2002	2003	2004 Prog.
(In percent of GDP, unless otherwise indicated)					
Real GDP growth (in percent)	6.0	9.6	12.9	13.9	7.0
Investment	18.6	19.8	21.0	23.0	20.9
Inflation (end-of-period, in percent)	0.4	2.9	2.0	8.6	3.0
Fiscal balance (commitment basis)	-6.4	-3.8	-0.5	-1.1	-1.9
Broad money growth (end of period, in percent)	38.6	4.3	34.0	10.4	10.5
External current account	-15.0	-10.0	-6.6	-7.1	-5.9
Gross international reserves (in months of imports)	3.8	3.6	3.7	4.1	3.7

Sources: Armenian authorities; and Fund staff estimates.

5. **Poverty and inequality** indicators have improved between 1998 and 2002, although the incidence of poverty remains high (Table 3).⁴ Assuming continued economic growth and successful implementation of poverty reduction policies, Armenia should be able to achieve most of the Millennium Development Goals by 2015, including bringing down the incidence of poverty below 20 percent.

6. In 2003, **performance under the PRGF-supported program** was satisfactory. The authorities met all the end-December 2003 quantitative and structural performance criteria, as well as two of the five structural benchmarks scheduled for this review (Tables 4 and 5). In particular, about one-third of the remaining value-added tax (VAT) exemptions on imports were eliminated. Two benchmarks scheduled for implementation by December 2003 were not entirely met. The authorities have not yet made fully operational the post-clearance verification unit at customs and one of the previously-envisaged changes to the simplified tax (imposing a three-year minimum for companies to prevent them from exiting the profit tax regime) was not carried out. Regarding the former, the authorities are now committed to carry out the remaining step of developing risk assessment selection profiles and begin conducting post-clearance audits on imports by mid-2004. Regarding the latter, the staff agreed with the authorities that the amendments passed were significant while the missed component was less significant and would have been difficult to enforce. Lastly, the benchmark on the registration of traders and the use of cash registers at large retail markets (expected in March 2004) has

³ Higher import prices led to a 32 percent increase in the domestic price of bread and cereals during the second half of 2003. These items have a weight of 18 percent in the consumer price index.

⁴ The 2002 household survey shows no discernible change in poverty compared to the 2001 household survey, although different methodologies and sampling procedures make it difficult to derive firm conclusions. Overall, most of the available social indicators display an improving trend over a 4–5 year period.

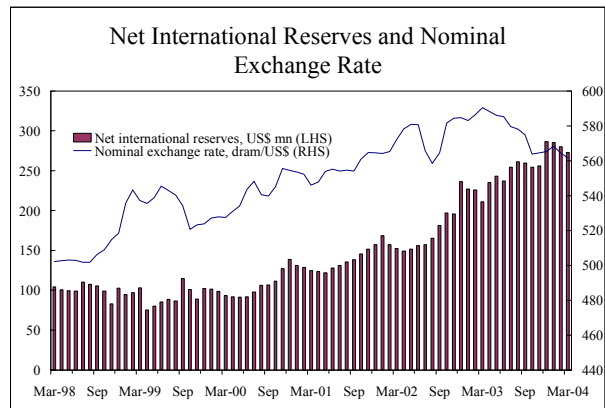
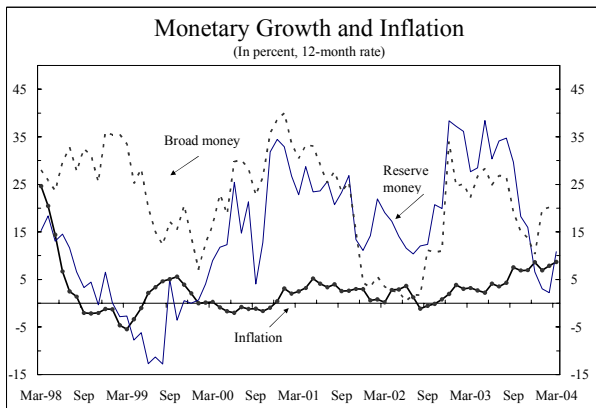
not yet been fully implemented; the law requiring the use of cash registers is expected to be approved by Parliament in May.⁵

7. **Fiscal policy** remained prudent in 2003. The fiscal deficit on a cash basis was 1.5 percent of GDP compared to 2.2 percent of GDP under the program (Table 6). This reflected lower-than-budgeted current expenditures attributed to capacity constraints in project implementation units. The budgeted amount of social expenditures, however, was almost fully executed. Although nominal tax revenues rose by 14.5 percent in 2003, the tax-to-GDP ratio fell to 14.1 percent owing to strong growth in nontaxed activities (grant-financed construction and diamond polishing), as well as weaknesses in tax and customs administration.⁶ Tax revenue collection during the first quarter of 2004 has improved with the annual year-to-date rate of growth at 18 percent.

	2000	2001	2002	2003		2004 Prog.
				Prog.	Act.	
Total revenue and grants	16.5	17.2	18.9	18.6	17.8	15.7
<i>of which</i> : tax revenue	14.8	14.5	14.6	14.3	14.1	14.6
grants	0.6	1.6	3.5	3.8	3.2	0.8
Total expenditure	22.8	20.9	19.4	20.6	18.9	17.7
Current expenditure	17.5	15.7	13.9	14.1	12.9	13.7
Capital expenditure and net lending	5.4	5.1	5.4	6.5	6.1	4.0
Overall balance (commitment basis)	-6.4	-3.8	-0.5	-2.0	-1.1	-1.9
Overall balance (cash basis)	-4.6	-4.1	-2.6	-2.2	-1.5	-1.9

Sources: Ministry of Finance; and Fund staff estimates.

8. All end-December **monetary targets** were met (Table 4). Monetary policy was tightened in the fourth quarter of 2003, with reserve money growth slowing down to

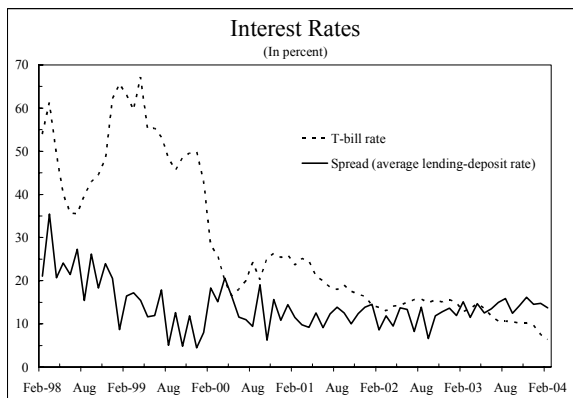


⁵ Shop owners have for long complained about the “tax free” status of stall owners in retail markets. However, vested interests in Parliament are resisting the passage of this law.

⁶ Construction activity grew by 44 percent in 2003. This growth has been largely untaxed because of international agreements with official and private donors. This, however, cannot entirely justify the poor VAT and profit tax collections in 2003, which fell by a total of 0.5 percent of GDP.

6.6 percent by year-end (Table 7). This followed an accommodative stance during the first three quarters of 2003. Net international reserve accumulation was higher than programmed, and gross international reserves ended the year covering 4.1 months of imports.

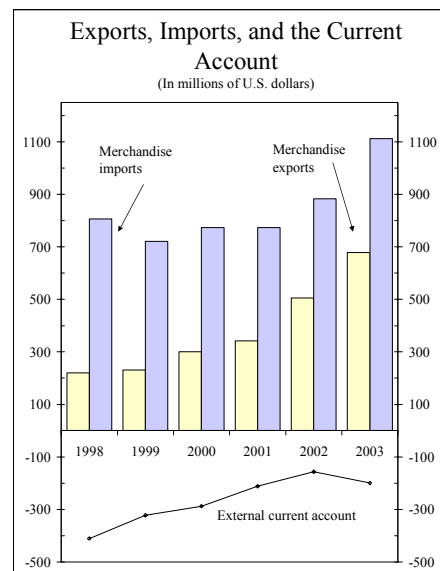
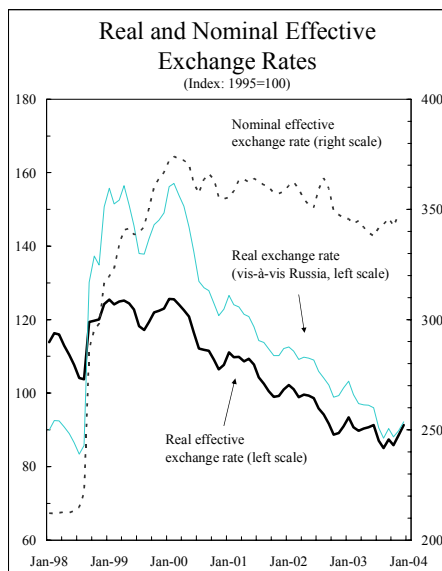
9. The **banking sector** experienced further consolidation in 2003, with Credit Yerevan placed in liquidation and two other banks merged. Higher minimum capital requirements led to improved capital adequacy ratios, while better classification requirements contributed to the reported increase in nonperforming loans. However, credit growth has been sluggish at 5 percent and interest rate spreads remain high, reflecting inefficiencies in the banking system. Despite recent legal changes to facilitate the registration and enforcement of collateral, debt recovery remains difficult owing to weaknesses in the judicial system and weak corporate governance in the banking sector.



	2000	2001	2002	2003
Capital adequacy 1/	25.0	13.6	30.5	33.8
Nonperforming loans/gross loans	6.2	6.0	4.9	5.4
Liquidity 2/	30.5	33.1	44.5	47.5
Profits 3/	-1.9	-9.1	3.9	2.7

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

10. The **external current account** deficit increased from 6.6 percent of GDP in 2002 to an estimated 7.1 percent in 2003, owing to substantially higher imports of intermediate and



capital goods (Table 8). In 2003, export growth remained high at 34 percent in U.S. dollar terms, driven by exports of precious stones that now represent over one-half of total exports. Foreign direct investment continued to increase, and external debt ratios fell sharply. The latter reflects the exchange of Armenia's debt to Russia (US\$94 million) for stakes in Armenian state-owned companies. Over the past year, the dram has remained broadly stable in nominal and real effective terms.

11. Notwithstanding a number of delays, the authorities made progress in implementing structural reforms in the following areas:

- **Tax policy.** VAT exemptions on a number of import categories were eliminated to improve the efficiency of the system and revenue collection. In addition, a minimum profit tax equivalent to one percent of companies' turnover was introduced as a temporary measure to deal with low profit tax collections. The staff expressed reservations about deductions allowed in this tax for amortization of investments and for some sectors with low profitability ratios. The authorities agreed, but indicated that parliament insisted on these deductions and that, on balance, they believed the measure would achieve its intended objective. The authorities will monitor the performance of this measure until mid-year and reconsider its usefulness at that time. To address loopholes in legislation, the profit tax law was amended to limit deductions, tighten loss-carryover provisions, and clarify depreciation rules. Lastly, presumptive taxes were raised on certain activities.
- **Tax administration.** The authority of the State Tax Service to deal with delinquent taxpayers has been strengthened by allowing it to seize bank assets and debtors' receivables. In addition, legislation was passed obliging companies to provide information to the tax authorities about their employees.
- **Budget management and expenditure control.** A legal framework was adopted to establish a reporting system for noncommercial organizations (NCOs) and to prevent these entities from borrowing.⁷ There have been delays, however, in setting up a monitoring unit for NCOs within the Ministry of Finance and Economy and in designing reporting requirements for these entities.
- **Banking system.** The resolution process for the two remaining intervened banks has entered its last stage. In November 2003, the authorities appointed a liquidator for

⁷ In early 2003, about 5000 budgetary organizations (nearly 15 percent of the budget) were given a different legal status as part of a wide decentralization reform. However, these entities (mainly schools and hospitals) were not subject to sufficient auditing and reporting procedures, rendering their activities less transparent. The staff had expressed concern about the lack of accountability in these entities and the loss of budgetary control. The authorities argued that the flexibility given to NCOs over their budgets is necessary to improve their services.

Credit Yerevan and adopted an action plan for the resolution of Armcommunications bank.⁸ Another positive development was the submission of laws to parliament strengthening shareholder rights and clarifying the functioning of the deposit insurance scheme.

- **Energy and water sectors.** Subsequent to the approval of the Financial Rehabilitation Plan in November 2003, the authorities established independent board of governors for the midstream companies and expanded the energy regulatory commission to oversee the telecommunications and water sectors. In 2003, electricity losses fell and collection rates increased to almost 100 percent, reflecting efficiency gains from the privatization of the distribution company. The end-December 2003 indicative target on the primary balance of the energy sector was missed by a small margin because of lower-than-projected revenues from thermal generation and exports. In the water sector, a tender was issued to privatize the management of the Armenia Water and Waste Company. In the irrigation sector, decentralization of the irrigation infrastructure has been underway supported by a World Bank project.

Overall, however, there has been limited progress in reducing quasi-fiscal losses in the water and irrigation sectors.

	2000	2001	2002	2003		2004
				Proj.	Est. 1/	
Primary balance (in percent of GDP)	-2.7	-3.6	-1.2	-0.5	-0.6	-0.3
Energy	-1.3	-2.5	-0.4	0.1	0.0	0.1
Water	-0.7	-0.5	-0.4	-0.3	-0.3	-0.2
Irrigation	-0.6	-0.5	-0.4	-0.3	-0.3	-0.2
Electricity transmission and distribution						
Technical and other losses (in percent of electricity distributed)	26	26	26	5	4	3
Collection rate (in percent of current billings)	89	81	90	98	101	100

Sources: Armenian authorities; and Fund staff estimates.
1/ Water and irrigation data for 2003 are estimates.

12. The coverage of structural conditionality under the Fund and World Bank programs has attempted to tackle the most significant economic and social issues facing Armenia (Box 1). The staffs have been closely coordinating their activities and discussing future work in line with the respective institutions' areas of expertise.

⁸ The authorities signed an agreement with a foreign investor who will recapitalize this bank. The authorities are committed to liquidate the bank by end-June 2004 if the investor does not honor the agreement.

Box 1. Structural Conditionality

PRGF-Supported Program. Structural conditionality in the program focuses on improving tax and customs administration; enhancing fiscal transparency; restructuring the banking system, and reforming the energy sector. The structural measures under the first two years of the PRGF arrangement were discussed in IMF Country Report Nos. 02/73 (4/30/01), 02/228 (9/12/02), 03/93 (3/14/03), and 03/150 (11/7/03). Most conditions were observed, some with minor delays. The status of implementation of the structural performance criteria and benchmarks under the fifth review is presented in Table 5.

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 program supported by the Enhanced Structural Adjustment Facility but are not in the current program.

World Bank Conditionality. The floating tranche of (Structural Adjustment Credit (SAC) IV (disbursed in December 2002) focused on energy sector reforms through improved performance and privatization of the electricity distribution company. Previous SAC IV tranches focused on reforming social protection and pensions, 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 (two tranches disbursed in March and December 2003) covered private sector development, public sector reform, and social sector reform. The second disbursement under SAC V was contingent on progress made in the following areas: tax and customs administration; financial and energy sector reforms; labor market, health and education, and pension reforms; budget management systems; and the business environment.

III. POLICY DISCUSSIONS

13. The discussions centered on the requirements for maintaining macroeconomic stability and on selected policy areas where progress is most needed, namely tax and customs administration, fiscal transparency and monitoring of noncommercial organizations, energy sector reforms, and the anti-corruption strategy. The medium-term macroeconomic framework remains broadly consistent with the baseline presented in the PRSP: real GDP is projected to grow at 6 percent, the inflation rate is projected at 3 percent, and the fiscal and external current account deficits are expected to narrow gradually over the medium term (Table 9).⁹

A. Fiscal Policy and Structural Reforms in the Public Sector

14. **The budget framework for 2004 remains prudent.** The fiscal deficit on a commitment basis is expected to increase from 1.1 percent of GDP in 2003 to 1.9 percent in 2004. This increase is mainly related to higher social spending (see below). On the revenue

⁹ The macroeconomic framework in the PRSP is based on lower nominal GDP projections compared to the current framework. The PRSP and the corresponding Joint Staff Assessment were considered by the Executive Board on November 24, 2003 (IMF Country Report Nos. 03/362 and 03/378).

side, the tax-to-GDP ratio is expected to increase by 0.5 percent of GDP in 2004.¹⁰ The 2004 budget assumes no further grants from a U.S.-based diaspora foundation that has provided support to Armenia amounting to 6 percent of GDP during the last three years. The authorities have requested further assistance from this foundation, but no decision has been made yet.

15. **The 2004 budget envisages lower total expenditures but higher social spending as a share of GDP.** Total expenditure will be 1.2 percent of GDP lower than in 2003 because of the expected reduction in grant-financed capital expenditures. This decline is minimally compensated by increases in external loan-financed and domestically-financed capital expenditures. Current expenditures are budgeted to increase by 0.8 percent of GDP in 2004 because of higher social expenditures (0.6 percent),¹¹ a higher wage bill (0.1 percent), and higher defense outlays (0.1 percent). The 2004 budget allocations for the health, education, and other social sectors are consistent with the amounts specified in the PRSP.

Armenia: Functional Classification of Government Expenditures, 1999-2007 (In percent of total expenditure)					
	1999-2001	2002	2003 Prel.	2004 Prog.	2005-07 Proj.
General public services	8.8	9.2	9.1	10.5	10.6
Defense and public order	20.9	20.2	20.9	23.7	21.6
Health, education, and social security	25.4	25.2	26.5	31.8	34.5
Housing and public utilities	6.4	6.4	14.0	8.7	9.2
Transportation, construction, and agriculture	11.9	8.7	14.1	11.1	12.8
Interest on public debt	6.9	4.4	3.6	4.1	3.0
Other	7.6	11.9	11.1	9.1	8.1
Unclassified	12.1	14.1	0.7	1.1	0.0
Total expenditure and net lending	100.0	100.0	100.0	100.0	100.0

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

16. **The authorities are following up with the recommendations outlined in the Joint Staff Assessment of the PRSP.** They have prepared an action plan with specific measures covering the period 2004–06, organized conferences with stakeholders to increase participation, and initiated work on a set of monitoring indicators. Looking ahead, the staff emphasized the importance of increasing social and public investment outlays and public investment and focusing on the actions envisaged in the PRSP to improve quality and access in the areas of health and education.

17. **Understandings were reached on further measures to improve the functioning of the tax system.** The staff emphasized the importance of implementing the measures recommended by recent technical assistance from the Fiscal Affairs Department of the Fund. The authorities are committed to proceed with plans to expand the regime of temporary importation for processing, develop a deferral payment system for VAT on large imported

¹⁰ This increase reflects the expected yield from the following measures: minimum profit tax and amendment to the profit tax law to limit deductions (0.2 percent of GDP), reduction of VAT exemptions on imports (0.1 percent of GDP), increases in presumptive taxes (0.1 percent of GDP), and improvements in tax administration (0.1 percent of GDP).

¹¹ Health and education spending is within the “goods and services” category in the economic classification of the budget.

capital goods not currently taxed at the border, and introduce a control system to enforce the collection of excise taxes on beer. In addition, there is a need to address delays in refunding VAT claims to exporters and deal with the remaining stock of tax arrears by companies.¹² The authorities agreed on the need to regularize these payments and write off invalid claims. The near term actions envisaged are: (i) preparing a report that will define immediate measures to strengthen the administration of VAT refunds and formulate a plan for the repayment of the stock of arrears (prior action for completing the fifth review, effected April 14, 2004); (ii) publicizing the penalties for abuses by tax officers; (iii) approving legislation to set up a risk-based tax audit system; and (iv) analyzing tax arrears by companies to assess the portion collectible and write off the remaining amounts subject to appropriate safeguards.

18. **The program includes measures to improve customs operations.** By mid-2004, the authorities will increase the use of invoice pricing to at least 50 percent of the value of imports. Understandings were also reached to begin developing risk assessment profiles that will enable risk-based control of imports by the post-clearance verification unit and prepare reports on the audits conducted by this unit. These measures will help reduce custom officers' discretion in how imports are valued while at the same time providing incentives for honest reporting by importers. The authorities also plan to introduce a disciplinary code of conduct for customs officials by mid-2004.

19. **Beyond the tax and customs measures mentioned above, additional work is required to harmonize the tax system and ensure a sustainable revenue base.** In particular, it will be useful to review certain aspects of the tax system such as remaining profit tax exemptions; the coverage of the VAT, simplified, and presumptive taxes; and the balance between direct and indirect taxation. The authorities have recently requested Fund technical assistance in these areas and have begun preparatory work to build a unified tax code.¹³ They also intend to finalize a medium-term program of tax reforms in the third quarter of this year. Lastly, the staff pointed to the need to review the organizational structure of the tax and customs agencies with a view to improving their transparency and accountability.

20. **The staff urged the authorities to monitor closely the effects of the recent decentralization of noncommercial organizations.** This decentralization affects critical sectors such as health and education, and the authorities need to ensure full transparency and accountability in these organizations. If major difficulties arise in these latter areas, however, the authorities may also need to re-examine some aspects of this reform. On reporting

¹² At end-2003, the value of outstanding VAT refund claims and tax arrears amounted to 1.3 and 5.3 percent of GDP, respectively. The authorities indicated that most of these arrears accumulated prior to 2003 and that a portion of them may correspond to companies that are no longer in operation.

¹³ A mission from the Fiscal Affairs Department is scheduled for late April 2004.

procedures of NCOs, there is a need to speed up the staffing of the recently established monitoring unit in the Ministry of Finance and Economy and put in place reporting requirements for NCOs consistent with Government Finance Statistics methodology. Understandings were reached on a series of steps that will lead to the preparation of consolidated general government data including NCOs by September 2004. In addition, all NCOs will be required to submit bank statements with their report forms and will be subject to comprehensive audits.

B. Monetary and Financial Sector Issues

21. **The central bank intends to bring inflation down to 3 percent by end-2004, but this may prove difficult.** The monetary program for 2004 projects reserve and broad money growth at about 4 and 10 percent, respectively, as well as a slight decrease in net international reserves.¹⁴ The authorities agreed on the importance of pursuing a prudent monetary policy and allowing the exchange rate to adjust freely.¹⁵ This is particularly important in light of the recent increase in consumer prices and the vulnerability of the price level to further shocks in the international wheat market.¹⁶ On the latter, the authorities are actively monitoring developments in this market and working on an assessment of regional and local distortions.

22. **The staff welcomed the authorities' interest in fostering the development of financial markets in Armenia, but encouraged proper sequencing.** As a first step, the staff stressed the importance of ensuring adequate creditor rights, sufficient disclosure standards, and good governance in financial institutions; all underpinned by a well-functioning judiciary.¹⁷ A promising development is a recent increase in mortgage lending and the lengthening of maturities in government securities of up to five years. Regarding banking supervision, the authorities agreed on the importance of improving capacity within the central bank to keep pace with further consolidation in the banking system and with the introduction of deposit insurance in 2005. In this regard, the timing of a possible unified supervisory authority for the entire financial system will need to be carefully chosen to prevent an erosion of capacity at the central bank.

¹⁴ Given the limited availability of domestic monetary instruments, this decline is compatible with the objective of keeping reserve money growth at 4 percent during the year.

¹⁵ During the last two years, the authorities have exceeded their net international reserve targets in light of strong foreign exchange inflows. This has prevented an appreciation of the exchange rate.

¹⁶ Gas prices have just been increased by 16 percent and water tariffs are expected to double later this year. However, these categories have very small weights in the consumer price index and the staff estimates that the pass-through effect of these increases will not exceed 1 percentage point of inflation.

¹⁷ In February 2004, a mission from the Fund's Monetary and Financial Systems Department discussed with the authorities a series of specific steps to facilitate mortgage lending. On corporate governance in the banking system, the authorities are drafting new legislation.

C. External Sector

23. **Armenia's balance of payments and external debt ratios remain sustainable.** The current account deficit is projected to fall in 2004 based on continued export growth and a slowdown in grant-financed import growth. Gross international reserve coverage is expected to fall to 3.7 months of imports. Considering Armenia's recent performance and future prospects, the country should be able to fill its medium-term financing gap of about 2–3 percent of GDP per year.¹⁸ At the same time, the updated debt sustainability analysis shows that Armenia's external debt will remain sustainable if prudent policies continue to be pursued (Table 11).

D. Other Structural Issues

24. **Further reforms are needed in the energy sector.** Despite a delay in finalizing the financial rehabilitation plan, the authorities plan to move away from a single electricity buyer in the midstream sector to direct contracting between the distribution company, power generators, and other service providers. This requires an appropriate regulatory framework clarifying market mechanisms, rules, and audit procedures. There is also a need to remove Armenergo—the state-owned single buyer company that has been subject to political interference and mismanagement—from the energy sector. Understandings were reached for these reforms to be carried out by July 2004, including the transformation of the Ministry of Energy into a policymaking body.

25. **While most of the previously envisaged reforms in the energy and water sectors have been implemented, those in the irrigation sector have been lagging.** In particular, the capacity of user associations in irrigation should be developed to enable an efficient management of the respective infrastructures.¹⁹ Over the next three years, the authorities expect to increase water and irrigation tariffs towards cost-recovery levels. They will also need to monitor the impact of these increases on the poor, and if needed, increase social benefits beyond the amounts envisaged in the PRSP.

26. **Governance and the business environment have improved in recent years, but more remains to be done.** In this regard, Armenia's anti-corruption strategy provides a promising concept to deal with remaining problems in this area (Box 2). The staff agreed with the authorities on the need to move to the implementation stage. In this regard, it would be useful to specify some of the actions envisaged and prioritize the ones that will be

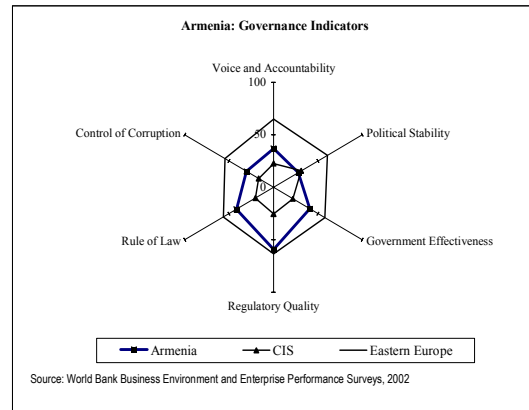
¹⁸ Armenia has a strong record of servicing its obligations to the Fund and is not expected to experience problems in servicing future obligations (Table 10).

¹⁹ The authorities have recently decentralized the management of the irrigation infrastructure to regional water user associations to give users more control and improve accountability. The transitional period was expected to be difficult given the limited capacity of these groups.

implemented this year. The authorities intend to carry out consultations with civil society within the next few weeks and discuss technical assistance issues with key donors.

Box 2. Armenia's Anti-Corruption Strategy

Armenia's standing in Transparency International rankings improved from the 80th percentile in 1999 to the 50th percentile in 2003. Similar progress can be noted in World Bank's governance indicators and the EBRD business environment surveys that rank Armenia ahead of other CIS countries in this area. This reflects a number of reforms introduced during the last three years, including the simplification of licensing procedures, civil service reform, the introduction of a new criminal code, privatization in the energy sector, and dissemination laws and regulations. Despite these improvements, corruption remains a problem in critical areas such as the judiciary and tax and customs operations; and petty corruption is widespread throughout society.



After a long preparation period, the authorities finalized an anti-corruption strategy in November 2003. The strategy discusses the causes of corruption, the government priorities, and contains a three-year action plan with a number of measures to be implemented. Important areas covered include:

- The harmonization of legislation to specify sanctions for corruption, protect witnesses, and improve access to information;
- Reforms on tax and customs administration and the judiciary, and;
- Public financial audit standards and a strengthened role of parliament in the audit process.

Further work is now required to involve civil society in the process of defining some of the actions envisaged, prioritizing them, and specifying a more concrete timetable and benchmarks for the different activities. It will be particularly important to identify enforcement mechanisms, work on whistle blower protection regulations, and increase the transparency and accountability of local governments.

IV. PROGRAM MONITORING

27. The quality and timeliness of economic data generally permit effective program monitoring, although further efforts are needed to improve real sector, fiscal, and balance of payments statistics (Appendix IV). The prior action, performance criteria, structural benchmarks, and indicative targets under the program are specified in the attached memorandum of economic policies and the technical memorandum of understanding (Attachments II and III). Performance under the sixth review will be assessed based on end-June 2004 data and measures covering up to July 2004 (Attachment II, Tables 1 and 2). The sixth review of the program is expected to take place in October 2004. According to the

guidelines for members with longer-term program engagement, a post-program assessment will also be discussed on that occasion.

V. STAFF APPRAISAL

28. The authorities should be commended for their prudent economic policies and continued reform efforts. This, together with substantial support from the Armenian diaspora, has led to an impressive expansion in exports, investment, and GDP during the last two years. Program implementation since mid-2003 has also been broadly satisfactory. The authorities met all quantitative targets and implemented most of the envisaged structural measures.

29. The program for 2004 is in line with the PRSP. The budgetary framework envisages a 0.5 percent increase in the tax-to-GDP ratio and accommodates higher social expenditures despite a substantial decline in private grants. The central bank will need to maintain a prudent monetary policy and allow full exchange rate flexibility in order to bring inflation down to 3 percent by end-2004. This is particularly important in light of possible further turbulence in the wheat market and increases in administered prices.

30. Notwithstanding the progress made in recent years, further impetus is needed to advance Armenia's structural reform agenda to improve the business environment and foster employment creation and poverty reduction. In this regard, substantial gains can be achieved by the steadfast implementation of remaining reforms in the areas of tax and customs administration; fiscal transparency and accountability; the financial system; corruption; and the energy and water sectors.

31. In the area of tax and customs administration, it will be critical to achieve greater transparency on the operations of the respective agencies, ensure the equal treatment of taxpayers, implement a system of risk-based tax audits, improve the handling of VAT refunds and tax arrears, and develop a deferral system for VAT payments on imports of capital goods. In the medium term, the authorities need to prepare a medium-term program of tax and customs reforms, compile a unified tax code, and revisit the management structure of tax and customs.

32. While recent fiscal decentralization involving the creation of noncommercial organizations could yield benefits in the medium term, the staff remains concerned that some of the basic preconditions for success, namely capacity, accountability, and transparency, may not yet be fully in place. In this regard, the new legislation to prevent NCOs from borrowing and the requirement for them to submit bank statements are welcomed. On the reporting side, the new reporting framework needs to become operational immediately, beginning with the collection of information by line ministries and the compilation of consolidated accounts. On the overall reform, the authorities should monitor the situation to ascertain the appropriate course of action and ensure that the requirements for successful decentralization are firmly in place.

33. Regarding the financial sector, the authorities are rightly concerned about the lack of intermediation and limited availability of long-term credit. While further work is needed to identify specific measures to deal with these problems, it is clear that the basic preconditions of confidence in banks and in the judiciary are still lacking in Armenia. In this regard, the authorities would do well to focus their efforts on strengthening the legal framework, rooting out corruption in the judiciary, facilitating capacity-building in the banking system, improving banking supervision, and dealing expeditiously with problem banks.

34. The authorities expressed their commitment to press ahead with remaining reforms in the energy, water, and irrigation sectors. Key reforms during the next few months involve establishing market rules in the energy sector and liquidating Armenergo. In addition, the single regulatory commission needs to maintain an appropriate regulatory framework, carefully monitor the sectors under its supervision, and make sure its decisions are timely and transparent. Lastly, water and irrigation tariffs should be progressively increased towards cost-recovery levels and the capacity of user associations in the irrigation sector should be developed.

35. The recently adopted PRSP and the anti-corruption strategy herald a promising phase of reforms to deal with two major challenges facing Armenia: poverty and corruption. The staff urges the authorities to proceed with the implementation of the actions outlined in these strategies with proper prioritization and within a broad participatory process. Poverty reduction will require robust employment creation within an environment that ensures equal opportunities and is supportive of new enterprise formation. It will also require improved access to high-quality health and education services. These goals, however, will not be accomplished without effective measures to improve transparency and fight corruption. In addition, well-targeted social benefits and other pro-poor expenditures will need to be increased during the next few years to ameliorate the costs of transition and lend political support to market-oriented reforms.

36. Armenia's medium-term economic prospects remain favorable assuming a continuation of the reform effort and effective political leadership that puts the common good above vested interests. This will likely lead to further external assistance in years to come. In this scenario, appropriate weight will have to be given to public investment, maintaining public infrastructures, and strengthening institutional capacity to make efficient use of such assistance. In this regard, the authorities should prepare a medium-term public investment program that balances ambitious objectives with Armenia's absorptive capacity. This program could in turn be used to complement the 2005–07 medium-term expenditure framework as well as guide future external assistance.

37. In view of the satisfactory performance to date and the strength of the proposed program for 2004, the staff supports the authorities' request for the completion of the fifth review under the PRGF and the extension of the arrangement until the end of this year.

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

Date of Availability	Conditions	Amount (in millions of SDRs)
May 23, 2001	Board approval of the PRGF arrangement	10.00
September 25, 2002	Completion of first and second reviews (end-June 2001 and end-December 2001 quantitative performance criteria and relevant structural performance criteria)	20.00
April 8, 2003	Completion of third review (end-December 2002 quantitative performance criteria and relevant structural performance criteria)	10.00
November 24, 2003	Completion of fourth review (end-June 2003 quantitative performance criteria and relevant structural performance criteria)	10.00
April 28, 2004	Completion of fifth review (end-December 2003 quantitative performance criteria and relevant structural performance criteria)	10.00
October 15, 2004	Completion of sixth review (end-June 2004 quantitative performance criteria and relevant structural performance criteria)	9.00

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

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

	1999	2000	2001	2002	2003		2004
					Prog.	Act.	Prog.
(Annual percentage change, unless otherwise indicated)							
National income and prices							
Real GDP growth	3.3	6.0	9.6	12.9	12.0	13.9	7.0
Gross domestic product (in billions of drams)	988	1033	1176	1357	1565	1618	1784
Gross domestic product (in millions of U.S. dollars)	1847	1914	2120	2364	2670	2796	3151
Gross national income per capita (in U.S. dollars)	576	615	680	756	809	894	996
CPI (end of period)	2.0	0.4	2.9	2.0	4.0	8.6	3.0
GDP deflator	-0.2	-1.5	3.9	2.2	3.0	4.7	3.0
Investment and saving (in percent of GDP)							
Investment	19.5	18.6	19.8	21.0	22.2	23.0	20.9
National savings	2.0	3.6	9.8	14.3	14.5	15.9	15.0
Money and credit (end of period)							
Reserve money	0.0	34.4	11.1	38.4	8.2	6.6	3.9
Broad money	13.9	38.6	4.3	34.0	12.4	10.4	10.5
Commercial banks' 3-month lending rate (in percent) 1/	34.5	28.7	27.7	23.4	...	22.3	...
Government operations (in percent of GDP)							
Revenue and grants	19.3	16.5	17.2	18.9	18.6	17.8	15.7
Expenditure and net lending	26.5	22.8	20.9	19.4	20.6	18.9	17.7
Overall balance on a commitment basis	-7.2	-6.4	-3.8	-0.5	-2.0	-1.1	-1.9
Overall balance on a cash basis	-5.3	-4.6	-4.1	-2.6	-2.2	-1.5	-1.9
Stock of domestic expenditure arrears	2.1	4.3	3.6	1.3	0.0	0.0	0.0
Primary balance of the energy sector (in percent of GDP) 2/	-0.8	-1.3	-2.5	-0.4	0.1	0.0	0.1
External sector							
Exports of goods and services 3/	4.6	19.0	20.8	30.4	37.4	28.3	12.1
Imports of goods and services 3/	-8.1	5.1	1.2	13.2	30.4	24.9	7.8
Current account (in percent of GDP)	-17.5	-15.0	-10.0	-6.6	-7.7	-7.1	-5.9
External debt-to-exports ratio 4/	157	139	132	131	94	89	74
Debt service ratio 5/	14.7	10.8	10.0	9.9	8.0	8.7	7.3
Import cover 6/	3.8	3.8	3.6	3.7	3.9	4.1	3.7
Nominal effective exchange rate 1/ 7/	18.5	0.3	3.4	-6.2	...	-4.2	...
Real effective exchange rate 1/ 7/	6.5	-7.8	-1.9	-11.3	...	-2.7	...

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

1/ End of period.

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

3/ In U.S. dollars terms.

4/ Net present value of debt in percent of the three-year moving average of exports of goods and services.

5/ In percent of exports of goods and services.

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

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

Table 3. Armenia: Poverty Indicators and Millennium Development Goals, 1990-2015

	1990	1998/99	2000	2001/2	2015 Target
(In percent of total population unless otherwise stated)					
1 Eradicate extreme poverty and hunger					
Population below US\$2.15 (PPP) a day	..	36.8	..	..	..
Overall poverty rate	..	56.3	..	49.3	19.7
Rural poverty	..	47.7	..	44.7	..
Extreme Poverty	..	26.1	..	17.0	4.1
Prevalence of child malnutrition (in percent of children under 5)	..	3.3	2.6	..	1.4
2 Achieve universal primary education					
Net primary enrollment ratio (in percent of relevant age group)	..	..	94.0	..	100
Youth literacy rate (in percent of group ages 15-24)	99.5	99.7	99.8	99.8	100
3 Promote gender equality					
Ratio of girls to boys in primary and secondary education (in percent)	..	..	105.8	..	100
Ratio of young literate females to males (in percent of group ages 15-24)	99.7	99.8	99.9	99.9	..
Proportion of seats held by women in national parliament (in percent)	36.0	6.0	3.0	3.0	..
4 Reduce child mortality					
Under 5 mortality rate (per 1,000)	58.0	47.0	38.0	35.0	19.3
Infant mortality rate (per 1,000 live births)	50.0	42.0	35.0	31.0	16.7
Immunization, measles (in percent of children under 12 months)	93.0	96.0	92.0	93.0	..
5 Improve maternal health					
Maternal mortality ratio (modeled estimate, per 100,000 live births)	40.1	29.0	55.0	..	13.2
Births attended by skilled health staff (in percent of total)	99.7	97.4	96.8	..	..
6 Combat HIV/AIDS, malaria and other diseases					
Prevalence of HIV, female (in percent of group ages 15-24)	..	..	0.1	..	Stabilize and reduce
Incidence of tuberculosis (per 100,000 people)	..	..	69.1	77.0	Stabilize and reduce
Tuberculosis cases detected under DOTS (in percent)	..	8.0	39.0	..	Stabilize and reduce
7 Ensure environmental sustainability					
Nationally protected areas (in percent of total land area)	..	7.4	7.6	7.6	..
GDP per unit of energy use (PPP \$ per kg oil equivalent)	1.4	3.3	3.5	..	..
CO2 emissions (metric tons per capita)	1.1	1.1	..	..	..
Access to an improved water source (% of population)	..	..	86.9	..	..
Access to improved sanitation (% of population)	..	..	62.9	..	..
8 Develop a Global Partnership for Development					
Fixed line and mobile telephones (per 1,000 people)	..	153.3	146.7	..	..
Personal computers (per 1,000 people)	..	2.4	7.9	..	..
General indicators					
Population (in millions)	3.5	..	3.3	3.2	..
Adult literacy rate (in percent of group ages 15 and over)	97.5	98.0	98.5	98.6	..
Total fertility rate (births per woman)	2.6	1.6	1.4	1.5	..
Life expectancy at birth (years)	71.7	72.3	74.2	74.8	..
Gini index of inequality (consumption)	..	29.8	..	27.2	..
Gini index of inequality (income)	..	63.5	..	44.7	..

Source: World Development Indicators database, April 2002

Goal 1: Halve, between 1990 and 2015, the proportion of people whose income is less than US\$2.15 a day. Halve, between 1990 and 2015, the proportion of people who suffer from hunger.

Goal 2: Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.

Goal 3: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.

Goal 4: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.

Goal 5: Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.

Goal 6: Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.

Goal 7: Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water.

Goal 8: Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth.

Table 4. Armenia: Quantitative Targets, June-December, 2003 1/
(End of period ceilings on stocks, unless otherwise specified)

	2003			
	Jun.	Sept.	Dec.	
	Act.	Act.	Prog. 2/	Act.
	(in billions of drams)			
Net domestic assets of the CBA 3/ Adjusted target 4/	-34.1	-40.1	-24.6	-39.2
			-26.3	...
Net banking system credit to the government Adjusted target 4/	-14.6	-13.1	0.5	-14.6
			-1.2	...
Domestic arrears of the central government and the State Fund for Social Insurance	0.9	0.3	0.0	0.0
Tax revenues of the central government (floor) 5/	...	184.2	124.7	127.4
Balance of the central government on a cash basis (floor) 5/ Adjusted target 6/	...	-27.9	-28.4	-19.0
	...	...	-24.2	...
Reserve money (band) 7/	95.4	103.4	(118-123)	118.6
Primary balance of the energy sector (floor) 5/ 7/ 8/	...	1.2	2.8	2.2
	(in millions of U.S. dollars)			
Contracting and guaranteeing of new nonconcessional external debt with maturity of more than one year 5/	0	0	0	0
Net disbursements of short-term external debt 5/ 9/	0	0	0	0
External arrears (continuous criterion)	0	0	0	0
Net official international reserves (floor) 3/ Adjusted target /10	234.0	258.1	262.0	282.5
			264.9	...

1/ The definitions of the line items and the adjusters on the fiscal balance, NIR, NDA, net credit to the government and the stock of domestic arrears are specified in IMF Country Report No. 03/379, Attachment III.

2/ Performance criterion, unless otherwise indicated.

3/ At program exchange rates as specified in IMF Country Report No. 03/379, Attachment III.

4/ The December target has been decreased by AMD 1.7 billion on account of a lower than anticipated Lincy loan repayment.

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

6/ The December target has been increased by AMD 2.5 billion and AMD 1.7 billion on account of lower than anticipated foreign financed project disbursements and a lower than anticipated Lincy loan repayment, respectively.

7/ Indicative target.

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

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

10/ The December target has been increased by US\$2.9 million on account of a lower than anticipated Lincy loan repayment.

Table 5. Armenia: Structural Measures Under the Fifth Review 1/

	Target Date 2/	Status
Performance Criteria		
Parliament to approve a law reducing the number of import categories exempt from VAT effective January 1, 2004. The reduction will apply to 282 customs lines representing 23 percent of the value of taxable imports (at 2002 prices).	December 2003	Met
Parliament to approve legislation imposing a minimum profit tax of 1 percent of companies' gross sales effective April 2004. This tax will be non-refundable but will be credited against profit taxes due.	December 2003	Met
Benchmarks		
Finalize resolution strategy for intervened banks by: (i) revoking the license and nominating a liquidator for Credit Yerevan and (ii) nominating liquidators for Arm communication bank if an agreement with a potential investor to purchase both the bank and Nairit does not materialize. If the agreement materializes, approve a detailed and time-bound action plan including projected financial flows for the resolution of Armcommunications.	November 2003	Met
To limit the erosion of the profit tax base, clarify Article 4 of the Law on Simplified Tax so that it applies to taxpayers and not activities. Make taxpayers transferring from the simplified tax regime to the profit tax regime subject to the profit tax for a minimum of 3 years.	December 2003	Not met
Ensure compliance with customs procedures by making the post-clearance verification program at customs headquarters operational and increasing the share of the value of commercial imports for which the approved customs value is determined on the basis of the declared transaction price to at least 25 percent of the value of commercial imports.	December 2003	Expected June 2004
Restructure the midstream energy sector (the settlement, dispatch, and transmission functions) as recommended in the integrated financial rehabilitation plan. Establish a corporate governance structure with independent board of directors, and internal and external audit mechanisms.	February 2004	Met
Regulate the use of cash registers and register traders (as businesses) at large retail markets.	March 2004	Expected May 2004

1/ Relevant measures are defined in IMF Country Report No. 03/379, Attachment III.

2/ End of period.

Table 6. Armenia: Central Government Operations, 2001–04

	2001 1/ Year	2002 1/ Year	2003 1/ Year		2004	
					Jan-Jun	Year
			Prog.	Act.	Prog.	Prog.
(In billions of drams)						
Total revenue and grants	202.8	256.8	291.6	288.8	124.3	280.8
Total revenue	184.3	209.3	231.7	236.6	118.7	266.1
Tax revenue	170.9	198.6	224.0	227.4	115.2	260.0
Nontax revenue	11.9	8.9	5.2	5.9	3.2	5.3
Capital revenue	1.6	1.8	2.6	3.2	0.4	0.7
Grants	18.5	47.5	59.8	52.2	5.6	14.7
Total expenditure	245.4	262.9	322.5	306.6	141.7	315.6
Current expenditure	185.2	189.2	221.3	208.2	111.2	243.8
Wages	25.7	28.5	36.1	35.2	18.8	41.7
Subsidies	6.5	8.1	14.3	14.7	7.5	14.1
Interest	14.5	11.5	12.3	11.2	6.0	13.1
Transfers	46.8	49.3	48.9	47.5	23.8	54.1
Goods and services	91.6	91.8	109.8	99.6	55.1	121.0
Capital expenditure and net lending	60.3	73.7	101.2	98.4	30.5	71.7
Capital expenditure	46.0	64.3	92.2	91.9	25.2	60.4
Foreign financed	32.0	55.5	75.3	68.5	15.8	40.0
Domestic financed	14.0	8.9	16.9	23.4	9.4	20.4
Net lending	14.3	9.3	9.0	6.5	5.3	11.3
Overall balance (commitment)(-)	-44.6	-6.1	-31.0	-17.7	-17.4	-34.8
Overall balance excluding grants (commitment)(-)	-63.1	-53.6	-90.8	-70.0	-23.0	-49.5
Net clearance of arrears (plus = accumulation) 2/	-1.5	-28.8	-6.6	-7.1	0.0	0.0
Statistical discrepancy/financing Gap	-2.5	-0.9	3.7	0.0	0.0	0.0
Overall balance (cash)	-48.6	-35.8	-33.9	-24.8	-17.4	-34.8
Deficit / Financing	48.6	35.8	33.9	24.8	17.4	34.8
Domestic financing	16.5	-5.9	11.8	-2.6	4.0	3.1
Banking system	0.1	-9.4	-0.4	-15.6	3.6	1.8
Nonbank 3/	16.4	3.5	12.3	12.9	0.4	1.3
External financing	32.1	41.7	22.0	27.4	13.4	31.6
Gross inflow	44.3	51.4	54.6	53.2	18.2	44.6
Amortization due	-11.6	-13.4	-22.2	-17.3	-4.8	-13.0
Change in Arrears (- reduction)	-0.6	3.7	-10.4	-10.4	0.0	0.0
Debt deferral	0.0	0.0	0.0	1.9	0.0	0.0

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

Table 6. Armenia: Central Government Operations, 2001–04 (concluded)

	2001/1	2002 1/	2003 1/		2004	
	Year	Year	Year		Jan-Jun	Year
			Prog.	Act.	Prog.	Prog.
	(In percent of GDP)					
Total revenue and grants	17.2	18.9	18.6	17.8	21.6	15.7
Total revenue	15.7	15.4	14.8	14.6	20.6	14.9
Tax revenue	14.5	14.6	14.3	14.1	20.0	14.6
Nontax revenue	1.0	0.7	0.3	0.4	0.5	0.3
Capital revenue	0.1	0.1	0.2	0.2	0.1	0.0
Grants	1.6	3.5	3.8	3.2	1.0	0.8
Total expenditure	20.9	19.4	20.6	18.9	24.6	17.7
Current expenditure	15.7	13.9	14.1	12.9	19.3	13.7
Wages	2.2	2.1	2.3	2.2	3.3	2.3
Subsidies	0.6	0.6	0.9	0.9	1.3	0.8
Interest	1.2	0.8	0.8	0.7	1.0	0.7
Transfers	4.0	3.6	3.1	2.9	4.1	3.0
Goods and services	7.8	6.8	7.0	6.2	9.6	6.8
Capital expenditure and net lending	5.1	5.4	6.5	6.1	5.3	4.0
Capital expenditure	3.9	4.7	5.9	5.7	4.4	3.4
Foreign financed	2.7	4.1	4.8	4.2	2.7	2.2
Domestic financed 2/	1.2	0.7	1.1	1.4	1.6	1.1
Net lending	1.2	0.7	0.6	0.4	0.9	0.6
Overall balance (commitment)(-)	-3.8	-0.5	-2.0	-1.1	-3.0	-1.9
Overall balance excluding grants (commitment)(-)	-5.4	-4.0	-5.8	-4.3	-4.0	-2.8
Net Clearance of Arrears (plus = accumulation) 3/	-0.1	-2.1	-0.4	-0.4	0.0	0.0
Statistical discrepancy	-0.2	-0.1	0.2	0.0	0.0	0.0
Overall balance (cash)	-4.1	-2.6	-2.2	-1.5	-3.0	-1.9
Deficit / Financing	4.1	2.6	2.2	1.5	3.0	1.9
Domestic financing	1.4	-0.4	0.8	-0.2	0.7	0.2
Banking system	0.0	-0.7	0.0	-1.0	0.6	0.1
Nonbank 4/	1.4	0.3	0.8	0.8	0.1	0.1
External financing	2.7	3.1	1.4	1.7	2.3	1.8
Gross inflow	3.8	3.8	3.5	3.3	3.2	2.5
Amortization due	-1.0	-1.0	-1.4	-1.1	-0.8	-0.7
Change in Arrears (- reduction)	-0.1	0.3	-0.7	-0.6	0.0	0.0
Debt deferral 5/	0.0	0.0	0.0	0.1	0.0	0.0
Memorandum items						
Tax Revenue/estimated tax base (in percent) 6/	16.1	16.5	...	16.4	...	16.9
Domestic Balance 7/	-1.2	0.8	-0.4	0.3	-0.7	-0.2
Change in domestic expenditure arrears (in billions of drams)	-8.8	-25.5	-7.1	-7.1	0.0	0.0
Domestic expenditure arrears (in billions of drams)	32.7	7.1	0.0	0.0	0.0	0.0
Government and government-guaranteed debt	44.8	45.9	...	40.8	...	37.8
of which: domestic debt 8/	2.1	2.6	...	2.7	...	2.6
Nominal GDP (in billions of drams)	1,176	1,357	1,565	1,618	577	1,784

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

1/ To facilitate the comparison of figures, the composition of expenditures for 2001–03 have been adjusted to reflect changes in expenditure categories brought about by the reclassification of budgetary institutions as non-commercial enterprises in 2003 and the reclassification of public order and safety wages previously classified in goods and services.

2/ The actual figure for domestically financed capital expenditures in 2003 includes a recapitalization of state-owned water companies of 0.3 percent of GDP.

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

4/ The nonbank financing figure in 2003 reflects the cancellation of AMD 10 billion in arrears as a result of the debt-equity swap with Russia.

5/ Reflects a deferral on part of a loan repayment to the the Lincy foundation. The funds were on-lent to the private sector and the creditor agreed to a deferral while the government attempts to collect the remaining amount.

6/ The tax base is estimated by excluding from GDP 90 percent of the value-added in construction. Construction is largely tax exempt because of international agreements with official and private donors.

7/ Defined as total domestic revenue minus total expenditures excluding external interest, foreign-financed capital expenditures and foreign-financed net lending.

8/ Excluding domestic expenditure arrears.

Table 7. Armenia: Monetary Accounts, 2001-04

	2001	2002	2003		2004			
			Dec.		March Prog.	June Prog.	Sept. Prog.	Dec. Prog.
			Prog.	Act.				
(in billions of drams, unless otherwise indicated)								
Central Bank of Armenia								
Net foreign assets	86.6	136.7	149.4	158.1	146.2	143.0	144.7	152.0
Net international reserves	88.2	138.1	153.2	162.0	151.3	150.2	151.9	159.2
Special privatization account	2.0	6.1	4.4	4.6	4.6	4.6	4.6	4.6
Medium and long-term assets	-3.7	-7.4	-8.2	-8.6	-9.7	-11.8	-11.8	-11.8
Net domestic assets	-6.2	-25.4	-29.0	-39.5	-41.6	-35.9	-32.5	-28.8
Claims on government (net)	8.3	-9.7	-19.0	-31.5	-30.9	-30.6	-31.1	-32.8
Claims on banks	3.9	10.4	7.4	8.7	3.2	8.5	10.0	13.5
Other items (net)	-18.3	-26.1	-17.4	-16.7	-14.0	-13.8	-11.4	-9.5
Reserve money	80.4	111.3	120.4	118.6	104.6	107.1	112.2	123.2
Currency issue	66.7	92.1	102.7	96.8	87.1	89.6	94.4	104.8
Deposits	13.7	19.2	17.7	21.7	17.4	17.5	17.8	18.4
Banking system								
Net foreign assets	84.2	155.9	184.5	202.6	187.0	185.4	192.8	200.2
Net domestic assets	74.0	56.0	53.6	31.2	30.7	38.6	47.2	58.2
Claims on government (net)	9.4	1.0	0.5	-14.6	-12.1	-11.0	-11.0	-12.8
Claims on rest of the economy	97.5	98.3	104.2	103.2	104.0	106.0	108.2	113.5
Other items (net)	-33.0	-43.3	-51.1	-57.4	-61.2	-56.4	-50.0	-42.5
Broad money	158.2	211.9	238.2	233.8	217.6	224.1	240.0	258.4
Currency in circulation	65.0	88.6	98.2	92.0	83.8	85.1	88.8	98.2
Deposits	93.1	123.3	139.9	141.8	133.8	138.9	151.2	160.2
Domestic currency	18.6	36.3	43.4	41.4	42.4	44.8	51.6	51.7
Foreign currency	74.5	87.0	96.6	100.4	91.4	94.1	99.6	108.5
Memorandum items								
Exchange rate (in drams per U.S. dollar, end of period)	561.8	584.9	...	566.0	...	...	...	...
NIR (in millions of U.S. dollars) 1/	157.0	236.1	...	286.3	...	...	...	...
NIR (in millions of U.S. dollars) 2/	159.8	231.0	262.0	282.5	267.3	265.3	268.3	281.3
NDA of the CBA (in billions of drams) 2/	-0.5	-12.4	-24.6	-39.2	-37.0	-31.3	-27.9	-24.2
12-month change in reserve money (in percent)	11.1	38.4	8.2	6.6	12.1	12.3	8.5	3.9
12-month change in broad money (in percent)	4.3	34.0	12.4	10.4	18.7	15.0	13.2	10.5
12-month change in private sector credit (in percent)	-10.8	0.7	6.0	5.0	18.5	14.5	17.0	10.0
Velocity of broad money (end of period)	7.4	6.4	6.7	6.9	...	...	...	6.9
Money multiplier	2.0	1.9	2.0	2.0	2.1	2.1	2.1	2.1
Dollarization in bank deposits 3/	80.0	70.6	69.0	70.8	68.3	67.7	65.9	67.7
Dollarization in broad money 4/	47.1	41.1	40.6	42.9	42.0	42.0	41.5	42.0
Currency in circulation in percent of deposits	69.8	71.8	70.2	64.9	62.6	61.3	58.7	61.3

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

1/ At actual exchange rates, excluding the SPA.

2/ At program exchange rates. The 2003 program is based on end-December 2002 exchange rates (IMF Country Report No. 03/379, Attachment III, Table 1).

The 2004 program is based on end-December 2003 exchange rates (Attachment III, Table 1). Excluding the SPA.

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

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

Table 8. Armenia: Balance of Payments, 2001-06

	2001	2002	2003		2004 Prog.	2005 Proj.	2006 Proj.
			Prog.	Est.			
(In millions of U.S. dollars; unless otherwise indicated)							
Current account	-212	-157	-205	-200	-184	-178	-179
Trade balance	-431	-377	-464	-434	-434	-436	-447
Exports	342	505	738	678	771	856	933
Imports	-773	-883	-1,202	-1,112	-1,205	-1,292	-1,380
Services (net)	-18	-41	-33	-64	-66	-63	-60
Credits	187	184	209	206	219	231	235
Debits	-204	-225	-242	-270	-286	-294	-295
Income (net)	63	88	103	103	110	103	102
Private transfers (net)	102	119	140	135	155	163	171
Official transfers (net)	72	55	49	62	50	55	55
Capital and financial account	212	214	220	244	179	175	167
Capital transfers (net)	30	68	81	95	0	0	0
Foreign direct investments (net) 1/	70	111	130	136	98	105	108
Portfolio investments (net)	-6	2	0	0	0	0	0
Public sector (net)	45	11	-68	-13	56	55	47
Disbursements	66	49	99	91	78	67	62
Amortization 1/	-21	-38	-121	-104	-22	-11	-15
Other capital (net) 2/	73	23	32	24	25	15	12
Overall balance	0	58	15	44	-6	-3	-12
Change in gross reserves (- increase)	-16	-101	-40	-74	12	-18	-27
IMF repurchases	-10	-19	-24	-24	-35	-37	-29
Russia, net (+ increase) 1/	-3	1	-17	-17	0	0	0
Turkmenistan, net (+ increase)	1	0	-1	-1	0	0	0
Debt deferral 3/	0	0	0	3	0	0	0
Financing/Gap	27	61	67	68	28	57	68
IMF	13	26	27	27	28	...	...
World Bank	14	35	41	41	0	...	...
Other	0	0	0	0	0	...	...
Memorandum items:							
Current account (in percent of GDP)	-10.0	-6.6	-7.7	-7.1	-5.9	-5.2	-4.8
Gross reserves (end of period)	329	430	470	504	492	509	537
In months of imports	3.6	3.7	3.9	4.1	3.7	3.7	3.7
Nominal external debt 4/ 5/	906	1,026	1,019	1,065	1,109	1,154	1,193
External present value of debt in percent of exports 5/	132	131	94	89	74	66	62
External debt service (cash, in percent of exports)	10.0	9.9	8.0	8.7	7.3	5.4	5.1
Stock of arrears 4/	17	17	0	0	0	0	0

Sources: Data provided by the Armenian authorities; and staff estimates.

1/ The figures for 2003 reflect the debt-equity swap with Russia.

2/ Includes errors and omissions.

3/ Reflects a Lincy foundation loan onlent to small and medium sized enterprises. The government repaid US\$15 million of the US\$18 million loan and is still collecting the remainder. The Lincy Foundation has agreed to wait for the repayment.

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

5/ Three-year moving average of exports centered on the previous year.

Table 9. Armenia: Medium-Term Macroeconomic Framework, 2003–08

	2003	2004	2005	2006	2007	2008
	Est.		Projections			
(In percent of GDP, unless otherwise indicated)						
National income and prices						
Real GDP growth (percent change)	13.9	7.0	6.0	6.0	6.0	6.0
Gross domestic product (in millions of U.S. dollars)	2,796	3,151	3,463	3,779	4,126	4,505
Gross national income per capita (in U.S. dollars)	894	996	1,078	1,162	1,253	1,352
Inflation (annual percent change)	8.6	3.0	3.0	3.0	3.0	3.0
Investment and saving						
Investment	23.0	20.9	22.1	22.0	22.0	22.0
Government	5.7	3.4	4.5	4.3	4.2	4.1
Other	17.3	17.5	17.6	17.7	17.8	17.9
National savings	15.9	15.0	16.9	17.2	17.5	17.7
Government	5.0	2.1	2.2	2.2	2.2	2.2
Other	10.9	13.0	14.7	15.0	15.3	15.5
Government operations						
Revenue and grants	17.8	15.7	16.0	16.4	16.7	17.1
<i>of which:</i> tax revenue	14.1	14.6	15.0	15.4	15.8	16.2
grants 1/	3.2	0.8	0.6	0.6	0.5	0.5
Expenditure	18.9	17.7	18.7	18.9	19.1	19.4
<i>of which:</i> social expenditure 2/	5.0	5.6	6.1	6.6	7.0	7.4
Overall balance (including grants)	-1.1	-1.9	-2.7	-2.5	-2.4	-2.3
Overall balance (excluding grants)	-4.3	-2.8	-3.3	-3.1	-2.9	-2.8
External sector						
Exports	31.6	31.4	31.6	31.1	30.5	29.9
Imports	49.4	47.3	46.1	44.6	43.0	41.6
Current account	-7.1	-5.9	-5.2	-4.8	-4.5	-4.3
Current account (in millions of U.S. dollars)	-200	-184	-178	-179	-186	-191
Capital and financial account (in millions of U.S. dollars)	244	179	175	167	184	194
<i>of which:</i> direct foreign investment	136	98	105	108	110	113
public sector disbursements	91	78	67	62	79	85
Change in gross international reserves (in millions of U.S. dollars) 3/	-74	12	-18	-27	-29	-29
Arrears and debt relief (in millions of U.S. dollars)	-18	0	0	0	0	0
Financing/gap (in millions of U.S. dollars)	68	28	57	68	50	50
<i>of which:</i> IMF	27	28	...	...	...	...
World Bank	41	0	...	...	...	...
External debt (NPV, in percent of exports of goods and services)	89	74	66	62	60	60
Debt Service (in percent of exports of goods and services)	8.7	7.3	5.4	5.1	4.0	3.7
Gross international reserves in months of imports	4.1	3.7	3.7	3.7	3.7	3.7

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

1/ The PRSP macroeconomic framework assumes additional grants equivalent to about 1 percent of GDP per year in the medium-term, but those amounts have not been secured yet. The authorities expressed confidence that even higher amounts could be secured later this year.

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

3/ A negative figure indicates an increase.

Table 10. Armenia: Indicators of Fund Credit, 2002-08

	2002	2003	2004	2005	2006	2007	2008
			Projections				
(In units indicated)							
Existing and prospective Fund credit 1/							
In millions of SDRs	143.3	145.8	141.5	116.9	95.7	81.9	64.9
In percent of exports 2/	28.3	22.4	19.4	14.6	11.1	8.9	6.6
In percent of external debt	19.0	18.6	17.3	13.8	10.9	8.9	6.8
In percent of gross reserves	45.3	39.4	39.1	31.2	24.2	19.7	14.8
In percent of quota	155.7	158.5	153.8	127.0	104.0	89.1	70.5
Existing Fund credit 1/							
In millions of SDRs	143.3	135.8	112.5	87.9	66.7	52.9	35.9
In percent of exports 2/	28.3	20.9	15.5	11.0	7.8	5.8	3.7
In percent of external debt	19.0	17.3	13.8	10.3	7.6	5.8	3.8
In percent of gross reserves	45.3	36.7	31.1	23.4	16.9	12.7	8.2
In percent of quota	155.7	147.7	122.3	95.5	72.5	57.5	39.0
Prospective Fund credit 1/							
In millions of SDRs	...	10.0	29.0	29.0	29.0	29.0	29.0
In percent of exports 2/	...	1.5	4.0	3.6	3.4	3.2	3.0
In percent of external debt	...	1.3	3.6	3.4	3.3	3.2	3.1
In percent of gross reserves	...	2.7	8.0	7.7	7.3	7.0	6.6
In percent of quota	...	10.9	31.5	31.5	31.5	31.5	31.5
Repurchases, repayments, and charges due from existing and prospective drawings							
In millions of SDRs	...	18.4	24.3	25.3	21.7	14.2	17.4
In percent of exports 2/	...	2.8	3.3	3.2	2.5	1.5	1.8
In percent of external debt	...	2.3	3.0	3.0	2.5	1.5	1.8
In percent of gross reserves	...	5.0	6.7	6.8	5.5	3.4	4.0
In percent of quota	...	20.0	26.4	27.5	23.6	15.4	18.9
Repurchases and charges due from existing drawings							
In millions of SDRs	...	18.4	24.3	25.3	21.6	14.1	17.3
In percent of exports 2/	...	2.8	3.3	3.2	2.5	1.5	1.8
In percent of external debt	...	2.3	3.0	3.0	2.5	1.5	1.8
In percent of gross reserves	...	5.0	6.7	6.7	5.5	3.4	4.0
In percent of quota	...	20.0	26.4	27.5	23.5	15.3	18.8
Repurchases and charges due from prospective drawings							
In millions of SDRs	...	0.0	0.0	0.1	0.1	0.1	0.1
In percent of exports 2/	...	0.0	0.0	0.0	0.0	0.0	0.0
In percent of external debt	...	0.0	0.0	0.0	0.0	0.0	0.0
In percent of gross reserves	...	0.0	0.0	0.0	0.0	0.0	0.0
In percent of quota	...	0.0	0.0	0.1	0.1	0.1	0.1

Sources: Armenian authorities and Fund staff estimates.

1/ End of period.

2/ Exports of goods and services.

Table 11. Armenia: Debt Sustainability Analysis, 2003-15 1/

	2003	2004	2005	2006	2007	2010	2015
	Act.			Projections			
	(in millions of U.S. dollars; unless otherwise indicated)						
Present value of debt	621	633	650	671	702	877	1,092
Existing Debt							
Multilaterals	571	538	514	489	471	421	380
World Bank	344	354	363	369	374	377	364
IMF	180	153	125	99	81	27	0
Other	47	31	26	21	16	17	16
Bilaterals	49	50	51	52	52	51	45
Russia	0	0	0	0	0	0	0
USA 2/	38	39	40	41	41	42	45
Other	11	11	11	11	11	9	0
New Debt	...	44	84	130	179	405	668
Nominal debt	1,065	1,109	1,154	1,193	1,256	1,406	1,468
Existing Debt							
Multilaterals	965	909	863	816	778	669	556
World Bank	674	672	669	662	654	615	530
IMF	215	180	145	114	91	22	0
Other	76	57	49	41	34	32	26
Bilaterals	101	95	94	92	90	82	65
Russia	0	0	0	0	0	0	0
USA 2/	45	40	38	36	35	29	21
Other	56	56	56	56	56	53	44
New Debt	...	104	197	285	387	655	847
Memorandum items:							
Net present value of debt in percent of exports 3/	89	74	66	62	60	62	57
Net present value of debt in percent of fiscal revenue 4/	152	135	123	113	106	96	75
Debt service in percent of exports	8.7	7.3	5.4	5.1	4.0	3.9	2.2
Grant element 5/	41.8	42.9	43.7	43.8	44.1	37.6	25.6
Sensitivity analysis:							
1. Strong disruption in export growth 6/							
Net present value of debt in percent of exports 3/	89	81	85	96	101	103	96
Debt service in percent of exports	8.7	9.0	9.0	8.5	6.8	6.6	3.7
2. Sharp increase in external borrowing 7/							
Net present value of debt in percent of exports 3/	89	112	94	83	75	63	57
Debt service in percent of exports	8.7	6.9	12.9	12.2	10.9	5.0	2.2

Sources: MOF External Debt Management Department; and Fund staff estimates.

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

2/ Including loans from the private Lincy foundation.

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

4/ Based on central government revenues, excluding grants.

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

6/ Assumes export growth at historical averages minus 2 standard deviations in 2004-05.

7/ Assumes 10 percent of GDP increase in other debt-creating flows in 2004.

Ms. Anne Krueger
Acting Managing Director
International Monetary Fund
Washington, D.C. 20431

April 7, 2004

Dear Ms. Krueger:

The authorities of the Republic of Armenia held discussions with Fund staff during February 6–20, 2004, on the program supported by the Poverty Reduction and Growth Facility (PRGF). The purpose of this letter and the attached Memorandum of Economic and Financial Policies is to inform you of the progress in implementing the program, set out the policies for the period ahead, and request the sixth disbursement following the completion of the fifth review under the arrangement as well as the extension of the arrangement until December 2004.

The program is on track. Our economy has performed well and all quantitative and structural performance criteria for end-December 2003 were observed. Despite the progress achieved in recent years, we recognize that a number of significant challenges remain to sustain high economic growth and reduce poverty. To this end, our economic program for 2004 contains specific measures to address weaknesses in tax and customs administration, enhance fiscal transparency, reduce corruption, and press ahead with reforms in the energy and water sectors. The government intends to make these understandings public and authorizes the IMF to publish this letter, the attached memorandum, and the staff report.

The government believes that the policies and measures described in the memorandum are adequate to achieve the objectives of the program, but it stands ready to take any additional measures that may be required. The government will consult with the Fund in advance of the adoption of any such measures or on any revision of the agreed policies 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

REPUBLIC OF ARMENIA
Supplementary Memorandum of Economic and Financial Policies
April 7, 2004

1. This memorandum supplements the Memorandum of Economic and Financial Policies (MEFP) of October 30, 2003. It updates the government's policies for 2004 including specific measures for the remainder of the third annual program supported by the Poverty Reduction and Growth Facility.

A. Recent Developments

2. Economic performance remains strong in Armenia. Real GDP in 2003 surpassed earlier expectations, expanding by 13.9 percent. Grant-financed and private investments in construction as well as exports have been the main sources of the recent growth. At 8.6 percent, year-end inflation was above the central bank's target of 3 percent, owing mainly to higher prices of imported wheat flour and cereals. Broad money growth slowed down, toward the end of 2003, growing by 10.4 percent through December. The dram remained broadly stable in nominal and real effective terms, and gross international reserves ended the year covering 4.1 months of imports.

3. In 2003, the outturn of the fiscal deficit on a cash basis was better than expected at 1.5 percent of GDP (compared to 2.2 percent of GDP under the program) mainly because of lower-than-expected current expenditures. Current spending was lower because of delays in carrying out projects in the energy and transport sectors. The delays, in turn, are related to capacity constraints in project implementation units. Notwithstanding these constraints, we estimate that about 97 percent of the budgeted amount of social expenditures was executed in 2003. Although the nominal tax revenue target was met, the tax-to-GDP ratio fell because of stronger-than-expected growth in nontaxed activities and persistent weaknesses in tax and customs administration. Regarding the latter, we are taking concerted efforts to ensure that performance improves this year and in the medium-term (see below).

4. We met all of the program's quantitative and structural performance criteria at end-December 2003, as well as two of the five structural benchmarks scheduled for implementation up to March 2004. The benchmark on the simplified tax law was only partially met. As previously envisaged, the law was clarified to ensure that it applies to taxpayers and not economic activities. However, we decided not to proceed with the requirement of a three-year minimum for businesses to transfer from the profit tax category to the simplified tax category because we concluded that this measure would be easy to circumvent in Armenia by closing a company and re-opening it as a new one. The structural benchmark on the functioning of the post-clearance verification program at customs was not fully met. We completed two of the three steps required for this measure, namely the staffing of the unit and the preparation of an audit procedures manual. The remaining step to develop risk assessment selection profiles will require more work than previously anticipated and will be completed by

June 2004. Lastly, the measure on registering traders at large retail markets was met, but the passage of the law on the use of cash registers is presently under Parliament review.¹ This law is expected to be passed in May 2004.

5. We are making progress with the reform agenda. In the area of tax policy, and as a temporary measure to deal with the problem of low profit tax collections, we have introduced a minimum profit tax equivalent to 1 percent of companies' turnover. However, to avoid a higher effective tax rate on profits than the statutory rate of 20 percent, we have allowed for deductions in the energy, diamond, health, and education sectors. These sectors typically have profitability ratios below 5 percent of turnover. Despite our opposition to amendments that will weaken this measure, Parliament also introduced deductions for amortization of capital investments and indirect taxes. We will monitor the performance of this measure until mid-year and reconsider its usefulness at that time. More importantly, we have amended the enterprise profit tax law to limit deductions, tighten loss carryover provisions, and clarify depreciation rules. To improve the efficiency of the value-added tax (VAT) system, we have reduced further the number of import categories exempt from VAT at the point of entry. The reduction applies to about one-third of the value of remaining taxable imports (at 2002 values). We also raised presumptive taxes on certain activities such as cigarettes and diesel fuel, made the presumptive tax on natural gas used by vehicles a function of sales, increased the tax on gas pumps, and introduced a presumptive tax on petrol stations based on the number of gasoline pumps.

6. Regarding tax administration, legislation was passed to oblige employers to provide detailed information to the tax authorities about its employees. In addition, to strengthen the authority of the State Tax Service to collect tax arrears, we amended the legal framework to allow for the seizure of bank assets and debtors' receivables.

7. In the area of budget management and expenditure control, a legal framework was adopted setting up the basis for a reporting system for noncommercial organizations and a monitoring unit was designated within the Ministry of Finance and Economy. These entities are also being prevented from borrowing. An internal audit manual consistent with international standards was also adopted. This manual will govern internal audits in line ministries and their subordinate organizations.

8. In the banking sector, we are finally reaching an end to the resolution process for the two remaining intervened banks. The license of Credit Yerevan was revoked and a liquidator was appointed. A detailed action plan was adopted for the resolution of Armcommunications. We have also submitted for parliamentary approval amendments to the Law on Bankruptcy of Banks strengthening shareholder rights, and to the Law on the Central Bank of Armenia pertaining to the deposit insurance scheme.

¹ The law designates the sectors where the cash registers should be used and establishes deadlines for their installation.

9. Notwithstanding some delays, we are also making progress on the next set of reforms in the energy sector. In November 2003, the government approved the Financial Rehabilitation Plan (FRP) for the energy, water, and transport sectors and passed a resolution to enforce the implementation of institutional reforms and debt restructuring measures recommended in the plan. In the midstream sector, we established independent board of governors for the transmission, dispatch, and settlement companies.² At the same time, we have established a single utility regulatory commission for the energy, telecommunication, and water sectors. Reflecting improved performance of the energy sector, total losses in distribution fell substantially in 2003 and collection rates have increased to almost 100 percent. The end-December 2003 indicative target on the primary balance of the energy sector was missed by a very small margin because of lower-than-projected revenues from thermal energy generation and exports. In the water sector, the government issued a tender to privatize the management of the Armenia Water and Waste Company. Lastly, the primary deficit of the water and irrigation sectors was 0.6 percent of GDP as programmed.

10. To achieve broader participation and to prioritize the policy objectives outlined in the Poverty Reduction and Strategy Plan (PRSP), we had two conferences with stakeholders and prepared an action plan with specific measures covering the period 2004–06. At the same time, a broad-based partnership agreement (which will become the participatory steering committee) and a working group were formed to implement PRSP-related policies. The 2004 budget allocations for the health, education, and other social sectors are broadly consistent with those outlined in the PRSP.

B. Economic Policies in the Period Ahead

11. During 2004, our macroeconomic policies will be focused on price stability, improving tax and customs administration, and enhancing fiscal transparency. Together with other structural policies, this will help us to maintain a high rate of economic growth while continuing our efforts to reduce poverty and corruption. Some of these policies were listed in the October 2003 memorandum of economic and financial policies but will be supplemented by additional policies as noted below. Tables 1 and 2 present the quantitative targets and key structural measures for the period ahead.

Monetary policy and the financial sector

12. The recent increase in wheat and cereal prices that led to higher consumer prices is an unfavorable development that punishes the most vulnerable in society. At the macroeconomic level, monetary policy is being tightened to prevent a spillover effect into other prices and to bring the 12-month rate of inflation to less than 3 percent by end-year. We are also taking a

² The government also intends to establish independent board of governors for the remaining state-owned energy and water companies by end-April 2004.

closer look at developments in the wheat market in the region and the commercialization structure in Armenia to ascertain the presence of monopolistic behavior and remove any market distortions that may exist.

13. The more conservative stance of monetary policy for 2004 is reflected in the revised financial framework for our program (Table 1). Base and broad money are projected to expand by about 4 and 10 percent, respectively. The Central Bank of Armenia (CBA) will widen its range of tools to support its monetary policy, including through a gradual buildup of the stock of government securities. To support the tighter monetary policy stance, we anticipate a slight decline in net international reserves in 2004. Aside from temporary (intra-week) smoothing of fluctuations in the value of the dram, the central bank will ensure exchange rate flexibility.

14. The central bank will strive to improve banking supervision to keep pace with the evolving banking system. During the next year, we will develop, in consultation with Fund staff, a program to establish an independent unified financial sector supervisory authority. We recognize, however, the importance of ensuring a successful transformation of the banking system before setting up a unified supervisory agency. We would also like to promote the development of mortgage lending with a view to facilitating broad-based access. As a first step, we will focus on the enhancement of the market infrastructure in the primary market by further enhancing the legal framework, ensuring adequate competition in mortgage lending, and establishing a sound framework for assessing, documenting, and publishing developments in the real estate market. Lastly, in line with the agreement recently signed with a foreign investor, we will ensure that Armcommunications bank is either recapitalized or liquidated by end-June 2004.

Fiscal policy

15. The program for 2004 is in line with the budget and broadly consistent with the PRSP. It targets an overall deficit of about 1.9 percent of GDP. Revenues and expenditures as a share of GDP will be lower in 2004 compared with 2003, owing to a sharp decline of grants from the Lincy foundation and the correspondingly lower capital expenditures that these grants finance. The tax revenue target for 2004 (AMD 260 billion) is based on the projection of nominal GDP growth of 10 percent. The targets for the second half of the year may be adjusted if GDP developments during the first half of the year lead to a change in the annual projection. The increase in current expenditure envisaged in 2004 is mainly due to higher social expenditures (0.6 percent of GDP) and an increase in the wage bill (0.1 percent of GDP). We will include in the budget any further external grants or concessional borrowing for infrastructure development and other capital expenditures that may be secured later this year.

16. We are confident that the tax measures recently approved by Parliament in the context of the 2004 budget are sufficient to achieve our tax revenue objectives. We envisage other policies to improve the efficiency of the tax system, such as expanding the regime of temporary importation for processing, developing a deferral payment system for VAT on large imported capital goods not currently taxed at the border, and introducing a control system to

enforce the collection of the excise tax on beer.³ Furthermore, and in light of recent problems with the enforcement of tax collection and the system for VAT refunds, we will:

- i. Carry out a sustained media campaign (including television) explaining complaint procedures and penalties for tax officers accepting bribes or demanding advanced payments beyond those stipulated by law (since April 2004).
 - ii. Prepare a report analyzing evolution of the stock of VAT refund claims in arrears with a view to defining immediate measures to strengthen the administration of refunds (audit and accounting procedures), prevent new arrears, and formulating in consultation with Fund staff a plan for the quarterly repayment of outstanding VAT refund claims (prior action).⁴
 - iii. Approve and publish an audit reform decree to implement a system of tax audits according to established risk criteria beginning in June 2004. The decree will be designed to shift audit resources toward partial audits and conduct comprehensive audits only when partial audits reveal significant violations. The State Tax Service (STS) will establish numerical targets for regional offices in terms of economic sectors and types of taxpayers to be audited and an audit manual will be prepared covering all aspects of the audit function.
 - iv. Conduct an analysis of tax arrears to estimate the proportion of arrears that are recoverable as well as the measures needed for ensuring such collection (including bankruptcy proceedings or direct seizures), and for writing off uncollectible debts from the accounts of the STS.
17. To improve the functioning of customs administration, we intend to focus on four areas where progress is most needed and achieve the following results by mid-2004. First, we are working to ensure that declared transaction prices are used to the greatest extent possible for assessing customs duties. To this end, we will increase the share of the value of commercial imports for which the approved customs value is determined on the basis of the declared transaction price from 30 percent in the last quarter of 2003 to at least 50 percent in the second quarter of 2004. Second, we will develop risk assessment selection profiles for the operations of the recently established post-clearance verification unit and will begin conducting audits and preparing audit reports to be shared with Fund and World Bank staff. Third, we will implement a direct trader input system at customs points whereby commercial importers and brokers will be allowed to input directly their customs declarations into the Customs computer system.

³ This will include the introduction of production-based monitoring based on metering of production and ongoing reporting by companies and random onsite inspections.

⁴ VAT refunds in arrears are defined as all outstanding VAT refund claims during each month that have not been accepted (and refunded), offset, or rejected after the 90 day processing period.

Lastly, we will prepare a disciplinary code of conduct for customs officials and require them to sign a commitment of compliance.

18. Notwithstanding the beneficial effects of the near-term tax and customs administration measures mentioned above, there are still remaining challenges that need to be addressed in the medium-term to enhance efficiency and compliance and ensure fiscal sustainability. At present, a complex and fragmented set of laws and regulations creates incentives for evasion and side payments to tax and customs inspectors and taxpayers alike. In this regard, we have begun preparatory work to build a unified tax code containing an internally consistent set of tax laws and regulations and a better balance between direct and indirect taxation (less reliance on taxes on goods and services compared to income and profit taxes). This work will necessitate a broader agenda for the key remaining reforms in the areas of tax and customs administration. Such an agenda will be embedded in a two-year action plan to be prepared in consultation with Fund staff by the third quarter of 2004. The action plan will contain immediate steps to revamp the management structure of the STS and customs service. We will also consider integrating these units into a single structure with direct reporting lines to the Ministry of Finance and Economy. Compliance will be enhanced through further measures to improve transparency and the identification and registration of taxpayers, developing a tax culture, and preventing the accumulation of tax arrears. A strengthened legal and judicial framework designed to address fraud and corruption (see below) will support these reforms. The plan will also contemplate legislation aimed at eliminating remaining VAT exemptions on imports, rationalizing simplified and presumptive taxes (the above tend to transform the VAT into a single-stage tax, thus nullifying its advantage), eliminating unjustified deductions and exemptions, and broadening the tax base. Lastly, the plan will also need to tackle remaining problems at customs administration and fully implement the system for customs valuation and control and ensure full transparency of customs operations.

19. Despite some delays, we intend to make progress on budget monitoring and control. In order to reduce the fiscal risk stemming from a lack of disclosure and control of noncommercial organizations (NCOs) budget allocations, the process of hiring and training for staff in the NCO monitoring unit will be completed by May 2004, line ministries and regional centers will receive full information and begin reporting by July 2004, and the consolidated accounts will be prepared by the Ministry of Finance and Economy by September 2004. In addition, all NCOs will be required to disclose their bank statements to line ministries. Lastly, as defined in the GFS Manual, we have determined that all NCOs as well as joint stock companies that provide nonmarket goods and services belong to the general government.

20. We are in the process of improving the coverage of government statistics and we will begin in May of this year to publish consolidated monthly central government data including the SFSI with a one-month lag. The next major step will be the compilation of quarterly

consolidated general government data covering the consolidated central government⁵ and the local governments with a 2-month lag beginning in July 2004.

21. On the implementation of PRSP-related work, we are preparing a comprehensive set of monitoring indicators that will be used to assess progress in implementing the poverty reduction strategy. During the next 6 months, we will also prepare the medium-term expenditure framework for 2005–07 in consultation with Fund and World Bank staff. We are also improving infrastructure in the education and health sectors and will ensure a sizable increase in family allowances and pensions that are targeted to those most in need in the 2005 budget.

Other structural policies

22. Over the next six months, we intend to continue implementing the Financial Rehabilitation Plan for the energy and water sectors. The energy sector is moving away from a single-buyer approach towards direct contracting between the distribution company, power generators, and other service providers. To this end, the utility regulatory commission will create by end-June 2004 an appropriate regulatory framework to ensure the proper functioning and transparency in these sectors. At the same time, regulations will be issued and implemented to include electricity market structure and market rules, rules of electric service, connection policy, and financial and operational audit procedures. The commission will also implement the license monitoring system, which includes closely monitoring the safety and reliability criteria for the operation of the system. By mid-year, the Ministry of Energy will be transformed into a policymaking body, all business management functions will be vacated, and the management of midstream operations will be subject to performance-based management contracts. Lastly, by July 2004, Armenergo will be extricated from all cash and non-cash transactions, and will be prevented from making any new contracts in the energy sector. Moreover, all of Armenergo's outstanding liabilities to the government will be written off, its remaining debt restructured, and the company's removal from the enterprise registry will be initiated through the court system by October 2004.

23. Water tariffs will gradually rise over the next few years to reach operations and maintenance cost recovery levels by 2007. In the irrigation sector, we are developing the capacity of the user associations to enable their efficient management of the infrastructure. Over the next three years, tariffs for bulk and end-users are also expected to increase gradually, approaching operations and maintenance cost recovery levels by 2007. The government will actively monitor the impact of these increases on the poor, and will increase family support benefits and social security outlays beyond those envisaged in the PRSP.

⁵ Including NCOs that belong within the general government sector after September 2004.

24. Despite some delays, we recently completed and made public an anti-corruption strategy that contains an action plan to deal with corruption in areas such as tax and customs services, the legal system, the judiciary, and law enforcement. The strategy focuses on five key elements: (i) legislative reform aimed at removing discrepancies in different pieces of legislation that create ambiguities conducive to corruption, including amendments to the procedures of the criminal code in order to clarify and specify criminal sanctions for corruption and protect witnesses; (ii) harmonizing legislation with international standards and ensure freedom of information on activities of the government and public agencies; (iii) strengthening the monitoring of fraudulent activity in the banking sector, including money laundering; (iv) reforms in tax and customs administration; and (v) public sector reform including developing public financial audit standards and strengthening the role of parliament in the audit process. During the next few weeks, we will conduct a series of consultations to seek feedback from parliament, civil society, and donors and discuss technical assistance and implementation details. We will also form a monitoring group that will coordinate and oversee the implementation of the strategy and adapt it over time. The group will comprise a wide range of representatives from civil society, members of Parliament (including opposition parties), and the government.

C. Program Monitoring

25. Program monitoring will be based on semi-annual quantitative performance criteria and quarterly indicative targets as well as structural performance criteria and benchmarks (Tables 1 and 2). There will be a semi-annual review based on end-June 2004 data and measures covering up to July 2004. The quantitative performance criteria include ceilings on the net domestic assets of the CBA, net domestic banking system credit to the central government, domestic expenditure arrears of the central government and the State Fund for Social Insurance, net disbursements of short-term external debt, contracting or guaranteeing of new non-concessional medium- and long-term external debt, and external arrears. They also include floors on net official international reserves of the central bank, tax revenues of the central government, and the overall cash balance of the central government. Regarding the tax revenue target, the definition of tax revenues has been clarified to exclude VAT refund claims in arrears or any non-programmed operation with state-owned companies used to settle tax arrears. There is an indicative band on reserve money and an indicative floor on the primary balance of the energy sector. Details on the definitions, monitoring, and adjustors of quantitative performance criteria are contained in the attached Technical Memorandum of Understanding (TMU). A request for the seventh disbursement under the PRGF arrangement is contingent upon the observance of the measures envisaged, the performance criteria set out in Tables 1–2, and the completion of the sixth review under the program expected on October 15, 2004. To insure the effective monitoring of the program, the relevant ministries, the CBA, the State Tax Service, the Customs Committee, and the National Statistics Service will compile and share with Fund staff all core economic data on a timely basis as specified in the TMU.

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

	2003	2004			
	Dec. Act.	Mar. Prog. 2/	Jun. Prog. 3/	Sep. Prog. 2/	Dec. Prog. 2/
	(in billions of drams)				
Net domestic assets of the CBA 4/	-34.8	-37.0	-31.3	-27.9	-24.2
Net banking system credit to the government	-14.6	-12.1	-11.0	-11.0	-12.8
Domestic arrears of the central government and the State Fund for Social Insurance	0.0	0.0	0.0	0.0	0.0
Tax revenues of the central government (floor) 5/	227.4	52.2	115.2	184.2	260.0
Balance of the central government on a cash basis (floor) 5/	-24.8	-6.3	-17.4	-27.9	-34.8
Reserve money (band) 2/	118.6	(103-107)	(105-109)	(110-114)	(121-126)
Primary balance of the energy sector (floor) 2/ 5/ 6/	0.7	2.5	3.0	0.0	1.2
	(in millions of dollars)				
Contracting or guaranteeing of new nonconcessional external debt with maturity of more than one year 5/	0	0	0	0	0
Net disbursements of short-term external debt 5/ 7/	0	0	0	0	0
External arrears (continuous criterion)	0	0	0	0	0
Net official international reserves (floor) 4/	286.3	267.3	265.3	268.3	281.3

1/ The definitions of the line items and the adjusters on the fiscal balance, NIR, NDA, net credit to the government and the stock of domestic arrears are specified in the TMU (Attachment III).

2/ Indicative target.

3/ Performance criterion.

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

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

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

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

Table 2. Armenia: Structural Measures Under the PRGF-Supported Program 1/

	Target Date
Prior Action(s) for Completing the Fifth Review	
Prepare a report analyzing evolution of the stock of VAT refund claims in arrears. The report will show the amounts and describe the factors that led to the accumulation of arrears in since 1998; define a timetable of immediate key measures to strengthen the administration of refund payments and prevent new refund arrears from arising; and formulate in consultation with Fund staff a plan for the elimination of outstanding VAT refund claims in arrears (the definition of refund claims in arrears is provided in Attachment III, paragraph 15)	Effected April 14, 2004
Performance Criteria for the Sixth Review	
The Customs Committee will improve customs operations by:	June 30, 2004
(i) Developing risk-based assessment profiles for post-clearance verification of imports; issuing rules for the external audits of import declarations; and preparing a report on these audits for the Chairman of the Customs Committee (as defined in Attachment III, paragraph 16).	
(ii) Increasing to at least 50 percent of imports the share of imports for which the approved customs value is determined on the basis of the declared transaction price.	
The Public Utilities Regulatory Commission will adopt regulations enabling direct contracting among different companies in the energy sector and specifying a risk-sharing mechanism. The government will adopt and publish a decision prohibiting Armenergo from signing any new contracts and mediating any cash or non-cash transactions in the energy sector (as defined in Attachment III, paragraph 17).	July 31, 2004
Benchmarks for the Sixth Review	
Develop a deferral payment system for VAT for large imported capital goods not currently taxed at the point of entry.	June 30, 2004
Prepare a report to identify types of tax arrears, evaluate the potential for recovery and appropriate actions to that end, and determine the measures needed to write-off uncollectible debts from the STS accounts.	July 31, 2004
Approve audit reform legislation to implement a system of tax audits according to established risk criteria and prepare an audit manual covering all aspects of the audit function.	July 31, 2004
Begin regular reporting for government-owned noncommercial organizations.	July 31, 2004

1/ The TMU defines these measures as needed.

**GOVERNMENT OF ARMENIA
TECHNICAL MEMORANDUM OF UNDERSTANDING**

This memorandum defines the benchmarks, performance criteria, adjustors, and reporting modalities referred to in the Supplementary 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 Special Drawing Rights (SDRs), any reserve position in the IMF, and holdings of convertible currencies in cash or in nonresident financial institutions (deposits, securities, or other financial instruments). Gross reserves held in the form of securities are marked to market. Gross reserves are reported separate from the balance on the government's Special Privatization Account (SPA) and excluding capital subscriptions in foreign financial institutions and illiquid foreign assets. 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, 2003 (Attachment III, Table 1).

2. The program targets a maximum level of **net domestic assets (NDA)** of the CBA. For program purposes, NDA is defined as reserve money minus Net International Reserves (NIR) plus medium- and long-term liabilities of the CBA. To evaluate program targets, the dram-equivalent values of NIR and medium- and long-term liabilities are calculated at the end-2003 official exchange rate of dram 566.0 per U.S. dollar. NDA is composed of net credit to the general government; outstanding credit to domestic banks by the CBA (including overdrafts) minus liabilities not included in reserve money (exclusive of accrued interest), and other items net.

3. **Reserve money** targets are indicative and include a floor and a ceiling. They are subject to a daily bound of plus or minus 2 percent computed from the quarterly average standard deviation of excess reserves held by banks in percent of quarterly reserve money during the previous four years. Reserve money is defined as the sum of currency issue, required and excess reserves, and current and time deposit accounts of certain resident agents.¹

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

4. **The stock of net credit from the CBA to the government** includes the CBA's holdings of treasury bills and treasury bonds less all types of government deposits (including deposits of donor-financed project implementation units, the Lincy foundation, and balances of proceeds from the sale of humanitarian assistance). Treasury bonds are valued at the purchase price and treasury bills are valued at the purchase price plus the implicit accrued interest.

5. **Net credit from commercial banks to the government** includes: (1) gross credit to the government less government deposits (including the counterpart funds of certain government 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). **Net credit of the banking system to the government** is the sum of net credit from the CBA and net credit from commercial banks.

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

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

² The term "debt" shall have the meaning set forth in Section 9(a) of the Guidelines on performance criteria on external debt, as modified by the Executive Board Decision No. 12274-(00/85) of August 24, 2000, and shall include all current (noncontingent) liabilities, which are created under a contractual arrangement through the provision of economic value in the form of financial or nonfinancial assets (including currency) or services, and/or income, and which require the debtor to make one or more payments in the form of such assets (including currency) or services at some future point(s) in time to discharge the principal and/or interest liabilities incurred under the contract. In particular, all instruments that share the characteristics of debt enumerated above (including loans, suppliers' credits, and leases) will be included in the performance criterion on external debt.

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

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

9. The U.S.-based Lincy Foundation extends grants to finance various investment projects. The project implementation units, which carry out Lincy-financed projects, maintain accounts at the CBA. These grants are recorded in the fiscal accounts as external grants on the revenue side and as foreign-financed capital expenditure on the expenditure side. In addition, any loans extended by the U.S.-based Lincy foundation to finance investments and that are intermediated through the banking system are recorded in the financial accounts as a financing item below the line and are thus excluded from net lending.

10. Foreign currency proceeds from selling enterprises are deposited into the special privatization account. The account is held at the CBA and the proceeds are invested abroad together with the CBA's international reserves. These proceeds are included in the definition of the monetary accounts of the CBA as part of net foreign assets with a counter entry in other items net. Any budgeted withdrawal from the SPA will be accounted for as privatization proceeds used to finance the budget and will be recorded below the line. Any unanticipated withdrawal from the SPA will be recorded below the line as privatization receipts; these withdrawals, however, will be replenished during the same fiscal year. Domestic currency proceeds from selling enterprises to residents are deposited in a subaccount of the treasury single account.

11. **Tax revenues** are defined in accordance with Government Financial Statistics (GFS), 1986, section IV.A.1. Total revenues collected by the State Tax Service (STS) and the Customs Committee (CC) are classified as follows: VAT (of which: presumptive tax on cigarettes, petroleum, and diesel), excises (of which: presumptive tax on cigarettes, petroleum, and diesel), enterprise profit tax, personal income tax, land tax, customs duties (of which: presumptive tax on cigarettes), other presumptive taxes, simplified tax, property tax, and other taxes (of which stamp duties and environmental taxes). For evaluating the performance criterion on tax collection, recorded tax revenues will exclude any tax payment related to

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

non-programmed transfer, loan, or recapitalization operation carried out with state-owned companies or any VAT refunds in arrears.

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

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

II. ADJUSTERS

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

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

III. PRIOR ACTIONS, STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS

15. **VAT refunds in arrears.** VAT refunds in arrears are defined as all outstanding VAT refund claims during each month that have not been accepted (and refunded), offset, or rejected after the 90 day processing period.

16. **Customs operations.** The customs committee will develop risk-based assessment selection profiles based on recommendations provided by the January 2004 technical assistance report from the Fiscal Affairs Department “Key Areas for Further Tax and Customs Reforms”; issue rules for conducting external audits on import declarations based on the risk assessment selection profiles, and prepare a report for the Chairman of the Customs Committee on the operations of the post-clearance verification unit. The latter will contain information on the number of audits and infractions, the amounts involved, and remedial measures imposed as well as information on whether those measures have been successfully implemented.

17. **Direct contracting in the energy sector and initiation of liquidation of Armenergo.** (i) The Public Utilities Regulatory Commission will adopt regulations establishing market rules in the energy sector in Armenia. These regulations will specify a risk-sharing mechanism that assigns financial responsibility in the case of unexpected changes to the cost structure (including arising from changes in the mix of generation) if those changes affect the basis upon which the pre-determined electricity tariffs for end-users were determined.⁵ (ii) The government will adopt and publish a government decision prohibiting Armenergo from signing any new contracts and mediating any cash or non-cash transactions in the energy sector.

18. **VAT deferral system.** The development of the deferral payment system for VAT for large imported capital goods (valued more than US\$ 100,000) not currently taxed at the border will comprise: (i) setting up a multi-agency commission (Ministry of Finance and Economy, State Tax Service, Customs Committee, Ministry of Trade) that will establish the technical criteria for granting deferrals; and (ii) the signing of a memorandum of understanding between the Customs Committee and the State Tax Service on exchange of information and the initiation of the deferral system on a pilot basis. The criteria for determining the items that will be covered under the pilot project will be developed in consultation with Fund staff. The information and technical criteria for granting deferrals will be determined by the new commission. Among other things, this commission will determine the goods or activities that would be covered by the deferral system; whether all or specific enterprises are to be eligible; documentation requirements; the length of deferral (no more than 12 months); and the scope of the pilot project (selected activities or selected taxpayers). In addition, the exchange of information, specified in the memorandum of understanding between the Customs Committee and the State Tax Service, would include identification of taxpayer, content of information, format of data, form of transmittal, and frequency. Under the deferral system, Customs would allow imports without payment of VAT based on established criteria and provide documentation to the State Tax Service. The Tax Service would develop procedures to establish a liability record, revise tax forms to account for deferred VAT, and monitor compliance of taxpayers.

19. **Collection of tax arrears.** The report will identify different types of arrears such as for: (i) very large cases; (ii) difficult cases; and (iii) normal cases that are potentially

⁵ The mechanism could be in the form of establishing an equalization fund or adding an energy adjustment clause to the tariff laws.

recoverable. It will also evaluate the potential for recovery and appropriate actions to that end. The government will also draft legislation to determine the measures needed for collecting old debts, seeking bankruptcy proceedings or direct seizures and write-off uncollectible debts from the STS accounts along with appropriate safeguards and independent review.

20. **System of tax audits.** The following actions will be carried out (i) establish a system of risk assessment profiling of taxpayers with a view to moving toward risk-based audit selection; (ii) put in place procedures to specify tax auditors' access to bank information within the overall tax audit framework and use these as a base to draft legislation that will progressively liberalize bank secrecy laws and allow tax administration easier access to such information; (iii) establish a national audit plan with headquarters setting numerical targets for regional offices in terms of the economic sectors and types of taxpayers that are to be audited, as well as for the types of audits (partial audits, advisory visits, and VAT refunds examinations). The plan will be prepared on an annual basis with quarterly reporting and midterm reviews and with emphasis on partial audits. Comprehensive audits should be used only for high-risk taxpayers or when partial audits reveal serious underpayment of tax liabilities; (iv) develop a detailed audit manual covering all aspects of the audit function beginning with indirect audit methods.

21. **Budget reporting of noncommercial organizations.** All NCOs will report to their authorizing bodies: (i) information on their 2004 budgets by July 2004; and (ii) quarterly data on their cash flow operations, as well as balance sheet information, by July 2004, covering the first two quarters of 2004. Authorizing bodies will begin reporting the consolidated NCO data to the MFE by August 2004.

IV. DATA REPORTING

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

Reporting Agency	Type of Data	Description of Data	Frequency	Timing	
CBA 1/	CBA balance sheet	Summary	Weekly	Within 1 day of the end of each week	
	CBA balance sheet	Summary at program exchange rates; and by chart of accounts at actual official exchange rates	Monthly	Within seven days of the end of each month	
	Monetary survey	Summary banking system balance sheet for the central bank and the consolidated balance sheet of commercial banks at program exchange rates; and by chart of accounts at actual official exchange rates	Monthly	Within 21 days of the end of each month	
	International reserves		By chart of accounts; at (i) program exchange rates; and (ii) at actual official exchange rates	Weekly	Within 1 day of the end of each week
			By chart of accounts; at (i) program exchange rates; and (ii) at actual official exchange rates	Monthly	Within 21 days of the end of each month

	Foreign exchange market	Official exchange rates (buying and selling); interbank turnover; and volume of CBA interventions, including foreign exchange swaps	Weekly	Within 1 day of the end of each week
	Interest rates	Repo rate; interbank rate; by volume and maturity, T-bill rate, bond yield; and by maturity, deposit and lending rates	Monthly	Within 7 days of the end of each month
	CBA operations	Repo (reverse repo) operations; Lombard credits; and deposit facility	Monthly	Within 7 days of the end of each month
	Bank liquidity	Reserves and excess reserves	Biweekly	Within 7 days of the end of each month
	Special privatization account (SPA)	Monthly flows	Monthly	Within 7 days of the end of each month
	Banking indicators	Capital adequacy; asset composition and quality; profitability; liquidity; open FX positions; and compliance with prudential norms (Tables 4 and 5)	Quarterly	Within 30 days of the end of each quarter
	CPI	Index of core inflation	Monthly	Within 21 days of the end of each month
	Other monetary data	IFS format	Monthly	Within 45 days of the end of each month
Customs Committee	Audit report on the operations of the post verification unit	The audit report will include: information on the number of audits conducted, the number of infractions found, the amounts involved, and remedial measures taken	Quarterly	Within 30 days of the end of each quarter
	Report of the operations of the internal audit unit	The report will include: the number of written appeals, complaints, and requests submitted to the IAUCC; the sources of the written submissions (e.g., President's Office, the Prime Minister's Office, other Government officials, National Assembly, line Ministries, Law Enforcement bodies, individuals, non-government organizations); the IAUCC's actions in response to the written submissions; the number and type of audits/investigations undertaken by the IAUCC; the overall results of the audits/investigations undertaken; and the actions taken by the IAUCC in response to the results of the audits/investigations undertaken	Quarterly	Within 30 days of the end of each quarter
	Import data	1. Total value of recorded imports, breaking out raw diamond imports; 2. Total value of non-duty free recorded imports; 3. Number of total transactions	Quarterly	Within 30 days of the end of each quarter

		<p>involving recorded imports;</p> <p>4. Number of total transactions involving non-duty free recorded imports</p> <p>5. Value of recorded imports where customs value was assessed using transaction prices, breaking out raw diamond imports;</p> <p>6. Value of non-duty free recorded imports where customs value was assessed using transaction prices;</p> <p>7. Number of transactions involving recorded imports where customs value was assessed using transaction prices; and</p> <p>8. Number of transactions involving non duty free recorded imports where customs value was assessed using transaction prices</p>		
Ministry of Finance and Economy (MFE)	T-bill and coupon bond financing	By holders, i.e., CBA, resident banks, resident nonbanks, and nonresidents	Monthly	Within 7 days of each month
	External debt	Disbursements and stock of outstanding short-term and contracting or guaranteeing and outstanding stock of medium-and long-term external debt of the government, the CBA, and state-owned companies (by company); any stock of arrears on external debt service and outstanding stock of government guarantees and external arrears	Monthly	Within 21 days of the end of each month (preliminary data) and within 45 days of the end of each month (final data)
	Revenue collection	Total revenue collected separately by the SFSI, the STS, and the CC	Monthly	Within 7 days of the end of each month
	Expenditure arrears	Government and SFSI separately (Table 6)	Monthly	Within 20 days of the end of each month for SFSI arrears and within 45 days of the end of each month for government arrears
	Privatization receipts	Balance on the SPA; gross inflows into and outflows from the SPA during the month, specifying the nature of each transaction	Monthly	Within 7 days of the end of each month
	Treasury single account (TSA)	Detailed breakdown of central treasury account, including deposits at the central treasury, pension fund, community budgets, off budget account, monetization account, state budget account and the Republic correspondent account—flows during the month and end of month stocks.	Monthly	Within 7 days of the end of each month
	Consolidated central government	State budget and SFSI	Monthly	Within 30 days of the end of each

				month
	Consolidated general government	Central and local governments 2/	Quarterly	Within 90 days of the end of each quarter
	Consolidated general government	Central and local governments 2/	Annual	Within 180 days of the end of each year
MFE/SFSI	Budget execution	All cash receipts, cash expenditures, including debt-service payments, and external and domestic borrowing operations; expenditure data will be provided according to both economic and functional classifications, consistent with the GFS methodology	Monthly	Within one month following the end of each quarter.
MOE	Energy sector	Stock of accounts payables and receivables; composition of financing of the consolidated energy sector	Monthly	Within 28 days of the end of each month
		Cash flow statement of the consolidated energy sector (Table 7) 3/	Quarterly	Within 45 days of the end of each quarter
NSS	Balance of payments	Detailed export and import data	Monthly	Within 28 days of the end of each month
		Detailed export and import data	Quarterly	Within 45 days of the end of each quarter
	GDP	Estimates	Monthly	Within 30 days of the end of each month
	CPI	By category	Monthly	Within 5 days of the end of each month
STS	Tax arrears	By type of tax	Monthly	Within 30 days of the end of each month
		For or the 30 largest debtors and for all major companies in the energy, water, and irrigation sectors	Quarterly	Within 30 days of the end of each quarter
	VAT refund claims in arrears	Detailed data on VAT refunds in arrears, which include all outstanding VAT refunds that have not been accepted (and refunded), offset , or rejected after the 90-day processing period.	Monthly	Within 30 days of the end of each month

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

2/ Until NCOs' quarterly data reporting has been established, central government is defined as state budget (budgetary) + SFSI (social security fund). Once NCOs' quarterly data reporting has been established, central government is defined as state budget (budgetary) + NCO's that belong within the general government (extrabudgetary) + SFSI (social security fund). General government = central government + local governments.

3/ 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, 2003)

Country	Drams Per Currency	Dollars Per Currency
Australian dollar	420.54	0.743004
Canadian dollar	431.83	0.762951
Swiss franc	451.54	0.797774
Danish krone	77.07	0.136166
Euro	702.24	1.240707
Pound sterling	1005.39	1.776307
Japanese yen	5.288	0.009343
Norwegian krone	83.66	0.1478
Swedish krone	77.25	0.1365
U.S. dollar	566.00	1
SDR	841.06	1.48597
Gold 1/	7524.59	13.2943

1/ Per gram.

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

2004			
<u>March</u>	<u>June</u>	<u>September</u>	<u>December</u>
5.8	17.8	28.8	43.6

1/ Cumulative from December 2003, at program exchange rates.

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

2004			
<u>March</u>	<u>June</u>	<u>September</u>	<u>December</u>
0	0	0	0

1/ Cumulative from December 2003, at program exchange rates.

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

	2000	2001	2002 1/	2003				2004			
				Mar. 2/	June 3/	Sept.	Dec.	Mar.	June	Sept.	Dec.
Capital adequacy											
Total regulatory capital to risk-weighted assets	25.0	13.6	30.5	39.2	34.3	34.3	33.8				
Tier I regulatory capital to risk-weighted assets	23.3	12.3	28.8	37.4	32.6	32.7	32.2				
Capital (net worth) to assets 4/	14.3	8.8	18.4	20.3	18.3	18.2	18.1				
Asset composition											
Sectoral distribution of loans (billions of drams) 5/											
Industry (excluding energy sector)	20.8	24.2	16.3	14.2	16.1	18.5	19.0				
Energy Sector	16.3	8.5	12.2	10.7	10.2	9.7	10.7				
Agriculture	10.4	9.9	7.1	7.8	8.7	7.7	8.2				
Construction	2.0	2.4	2.5	2.8	3.6	4.9	4.8				
Transport and communication	2.1	1.9	0.8	0.7	0.7	1.0	0.7				
Trade/commerce	12.7	13.4	13.9	14.7	16.6	16.9	21.5				
Sectoral distribution of loans to total loans (percent of total)											
Industry (excluding energy sector)	21.9	29.8	22.3	19.9	20.0	22.0	20.1				
Energy Sector	17.1	10.5	16.8	15.2	12.7	11.5	11.4				
Agriculture	10.9	12.1	9.8	11.1	10.9	9.1	8.6				
Construction	2.1	3.0	3.5	4.0	4.4	5.8	5.1				
Transport and communication	2.2	2.4	1.2	1.0	0.8	1.2	0.7				
Trade/commerce	13.4	16.5	19.0	20.8	20.7	20.2	22.7				
Foreign exchange loans to total loans 6/	85.9	84.7	82.5	80.9	73.7	72.9	72.7				
Asset quality											
Nonperforming loans (billions of drams)											
Watch (up to 90 days past due)	7.5	6.3	4.9	6.1	7.2	7.6	6.7				
Substandard (91-180 days past due)	...	...	2.3	3.8	4.6	4.3	4.9			
Doubtful (181-270 days past due)	4.7	4.4	1.7	1.1	1.8	2.3	0.9				
Loss (>270 days past due) 7/	2.8	1.9	0.9	1.1	0.8	1.1	0.9				
Non-performing loans to gross loans	16.8	25.7	11.5	11.1	12.3	12.0	11.6				
Provisions to non-performing loans 8/	6.2	6.0	4.9	6.3	8.2	6.7	5.4				
Spread between highest and lowest interbank rates (AMD) 9/	46.4	45.2	40.2	34.0	28.1	32.5	34.3				
Spread between highest and lowest interbank rates (in foreign currency)	46.7	29.0	7.8	5.5	2.4	1.9	2.6				
Earnings and profitability											
ROA (profits to period average assets) 10/ 11/	35.0	22.0	3.6	1.8	4.5	2.0	3.7				
ROE (profits to period average equity) 10 11/	-1.9	-9.1	3.9	1.5	1.4	2.1	2.7				
Interest margin to gross income 12/	-12.3	-78.6	21.6	7.8	7.5	11.1	14.4				
Interest income to gross income 13/	30.7	27.8	37.6	44.2	42.7	42.4	42.0				
Noninterest expenses to gross income 14/	84.3	77.8	63.1	69.3	65.7	64.5	62.7				
Liquidity											
Liquid assets to total assets	36.4	42.7	48.3	49.5	47.9	47.8	48.5				
Liquid assets to total short-term liabilities	30.5	33.1	44.5	47.3	49.2	48.8	47.5				
Customer deposits to total (non-interbank) loans 15/	86.1	80.4	108.8	114.7	114.0	109.9	101.3				
Foreign exchange liabilities to total liabilities 16/	146.4	198.4	195.3	180.8	188.0	185.0	177.1				
Sensitivity to market risk											
Gross open positions in foreign exchange to capital	80.6	79.7	72.2	72.9	71.3	71.8	73.2				

Source: Central Bank of Armenia.

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

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

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

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

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

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

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

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

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

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

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

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

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

13/ Interest income divided by gross income.

14/ Noninterest expenses divided by gross income.

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

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

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

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

Source: Central Bank of Armenia.

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

2/ Prudential ratios are calculated based on 30 banks at end-2001 and 20 banks in 2002-2003. December 2003 data include one bank that operated until December 24. The ratio on exposure limits is calculated based on 25 banks at end-2001 and 20 banks in 2002. Asset quality is calculated based on 30 banks at end-2001.

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

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

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

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

	2000	2001	2002 1/	2003 2/				2004 2/				
				Mar.	June	Sept.	Dec.	Mar.	June	Sept.	Dec.	
Total arrears	44.3	42.2	17.8	17.9	11.2	0.3	0.4					
Total expenditure arrears	37.3	35.8	7.1	7.2	0.9	0.3	0.4					
Current expenditures	34.6	31.4	5.5	5.4	0.3	0.2	0.4					
Wages	0.5	0.4	0.1	0.1	0.0	0.0	0.0					
Subsidies 3/	0.9	0.8	0.1	0.1	0.0	0.0	0.0					
Interest	3.4	3.1	0.0	0.0	0.0	0.0	0.0					
Domestic interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0					
External Interest	3.4	3.1	0.0	0.0	0.0	0.0	0.0					
Transfers	9.0	7.9	0.4	0.4	0.0	0.0	0.1					
Family Allowances	4.1	3.1	0.0	0.0	0.0	0.0	0.0					
Pension Contributions	1.1	1.1	0.2	0.2	0.0	0.0	0.0					
Contribution to pension fund	0.6	0.4	0.1	0.1	0.0	0.0	0.1					
Other 3/	3.3	3.3	0.2	0.1	0.0	0.0	0.0					
Goods and Services 3/	20.8	19.2	4.8	4.8	0.3	0.2	0.3					
Health	12.7	11.4	0.1	...	0.0	...	...			
Education	1.7	2.2	1.2	...	0.0	...	...			
Other	6.4	5.5	3.4	...	0.3	...	...			
Capital Expenditures 3/	2.7	4.4	1.7	1.8	0.5	0.1	0.0					
Net lending 3/	0.0	0.0	0.0	0.0	0.0	0.0	0.0					
External Amortization arrears 4/	7.0	6.4	10.7	10.7	10.3	0.0	0.0					
Memorandum items:												
Domestic expenditure arrears	33.9	32.7	7.1	7.2	0.9	0.3	0.4					
<i>of which:</i> social expenditures arrears	21.7	20.0	1.5	0.1	0.0	0.0	0.0					
External payment arrears	10.4	9.5	10.7	10.7	10.3	0.0	0.0					
SFSI stock of arrears	4.4	1.4	0.0	0.0	0.0	0.0	0.0					

Source: Ministry of Finance and Economy and staff estimates.

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

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

3/ Arrears outstanding for more than 30 days.

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

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

	2000	2001	2002		2003 2/					2004				
			Year	Year w/o ArmElnet	Actual					Proj.				
					Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year
Revenues	79.9	65.1	70.7	63.8	19.1	13.3	11.8	11.5	55.6	17.2	12.2	13.0	14.9	57.3
Electricity revenues collected	75.3	62.8	68.9	62.0	19.0	12.6	11.1	11.3	54.0	16.0	11.3	12.1	14.1	53.5
Revenues collected for thermal energy supply	3.6	1.0	1.0	1.0	0.1	0.3	0.4	0.1	0.9	1.0	0.6	0.6	0.7	2.9
Non-core activities	1.0	1.3	0.9	0.9	0.0	0.5	0.3	0.0	0.8	0.2	0.3	0.3	0.2	0.9
Expenditures	101.3	105.7	93.9	77.2	21.4	18.3	12.9	13.0	65.5	18.2	15.6	19.5	17.6	70.8
Inputs	40.1	47.3	30.0	30.0	13.2	6.1	3.9	7.0	30.1	9.3	6.3	11.5	9.2	36.3
Imported gas	38.4	39.0	23.7	23.7	11.2	6.0	1.8	4.2	23.2	6.6	1.6	1.7	1.8	11.7
Nuclear fuel	1.7	8.3	6.3	6.3	1.4	0.1	2.1	2.1	5.7	2.1	2.2	0.9	2.0	7.2
Purchased electricity	...	...	...	...	...	...	...	0.7	0.7	0.6	2.5	8.9	5.5	17.5
O&M costs	34.2	31.1	24.0	13.0	2.5	3.1	3.0	3.0	11.6	2.9	2.9	2.4	2.4	10.4
Net payment of taxes accrued	17.2	14.8	21.6	18.9	4.1	4.8	3.7	0.3	12.9	2.4	2.4	2.0	2.0	8.7
Interest payments	5.0	4.7	9.2	8.2	1.0	1.5	0.9	2.2	5.5	0.4	0.8	0.4	0.7	2.3
Capital expenditures	4.8	7.8	9.0	7.1	0.6	2.8	1.5	0.6	5.4	3.2	3.3	3.3	3.3	13.0
Primary balance 3/	-13.5	-29.7	-5.1	1.7	-0.8	-0.8	1.0	1.2	0.7	2.5	0.5	-3.0	1.2	1.2
Current balance	-11.6	-28.0	-4.9	1.9	-0.7	-0.6	1.2	1.2	1.1	2.6	0.7	-2.8	1.3	1.8
Balance	-21.4	-40.6	-23.2	-13.4	-2.3	-4.9	-1.1	-1.6	-9.8	-1.0	-3.4	-6.5	-2.6	-13.5

Sources: Armenian authorities; and Fund staff estimates.

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

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

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

ARMENIA: RELATIONS WITH THE FUND
(As of February 29, 2004)

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	99.04	107.65
III. SDR Department	SDR Million	Percent of Allocation
Holdings	9.29	n.a.
IV. Outstanding Purchases and Loans	SDR Million	Percent of Quota
PRGF arrangements	134.04	145.69
Systemic transformation	7.03	7.64

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	50.00
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				
	2004	2005	2006	2007	2008
Principal	19.93	23.28	21.18	15.43	17.06
Charges/interest	0.74	0.58	0.45	0.35	0.27
Total	20.68	23.86	21.63	15.78	17.33

VII. Safeguards Assessment

Under the Fund's safeguards assessment policy, the Central Bank of Armenia (CBA) is subject to a full safeguards assessment with respect to the PRGF arrangement approved on May 23, 2001. The safeguards assessment of the CBA, completed on February 19, 2002, found the safeguards at the CBA to be generally adequate to ensure the integrity of bank resources, including Fund disbursements. However, the assessment noted a number of vulnerabilities and proposed specific measures to address the weaknesses, as reported in IMF Country Report No. 02/228. The CBA has implemented all the measures recommended.

VIII. Exchange Rate Arrangement

- (a) On November 22, 1993, the Republic of Armenia introduced its national currency, the dram, at a rate of 200 Armenian rubles per dram. The exchange rate has been allowed to float since then with minimal intervention by the central bank. The official exchange rate is quoted daily as a weighted average of the previous day’s interbank exchange rates.
- (b) Armenia maintains no exchange restrictions on the making of payments and transfers for current international transactions.

IX. Article IV Consultations

The 2002 Article IV consultation with Armenia was concluded on September 25, 2002. Armenia is subject to the 24-month consultation cycle.

X. FSAP Participation and ROSCs

A joint World Bank-International Monetary Fund mission assessed Armenia’s financial sector as part of the Financial Sector Assessment Program (FSAP) during September 6–22, 2000. The Financial Sector Stability Assessment (FSSA) report was discussed at the Board on May 14, 2001, together with the 2001 Article IV staff report. The authorities have made progress in implementing the FSAP recommendations. Outstanding issues that need to be addressed include several legislative and regulatory shortfalls and the need for enactment of the legal protection for supervisory authorities.

ROSC Modules

Standard	Timing	Issue date	Document number
Basel Core Principles for Effective Banking Supervision (BCP)	April 2001	Unpublished	...
Core Principles for Systemically Important Payments Systems (CPSS)	April 2001	Unpublished	...
Insurance Principles set by the International Association of Insurance Supervisors (IAIS)	2001	Unpublished	...
Principles set by the International Organization of Securities Commissions (IOSCO)	2001	Unpublished	...
Code of Good Practices in Monetary and Financial Policy Transparency (MFPT)	April 2001	Unpublished	...
Code of Good Practices on Fiscal Transparency	March 2001	March 4, 2002	02/37
Data ROSC module	September 2000	January 16, 2002	02/06

XI. Resident Representatives

Mr. James McHugh, since September 2002.

XII. Technical Assistance

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

Armenia: Technical Assistance from the Fund, 1998–2003

Subject	Type of Mission	Timing	Counterpart
Fiscal Affairs Department (FAD)			
Development of treasury	Resident Advisor	Since September 1998	Ministry of Finance and Economy (MFE)
Tax policy	Short-term	March 1–12, 1999	MFE and Ministry of Nature Protection
Tax administration mission	Short-term	February 28–March 13, 2000	MFE and Ministry of State Revenue (MSR)
Tax policy and administration	Short-term	August 7–11, 2000	MFE and MSR
Tax policy and administration	Short-term	October 15–29, 2001	MFE, MSR, and Customs Committee
Tax policy and administration	Short-term	September 17–October 3, 2003	MFE, State Tax Service (STS), and Customs Committee
Monetary and Exchange Affairs Department			
Monetary and foreign exchange operations	Resident Advisor	November 1997–November 1998	Central Bank of Armenia (CBA)
Banking supervision	Short-term	Periodic visits 1998–99	CBA
Monetary and foreign exchange operations	Short-term	January 20–February 3, 1998	CBA
Monetary policy; OPS/BKG sector issues	Short-term	November 9–13, 1998	CBA
Monetary operations and banking supervision	Short-term	February 21–March 5, 1999	CBA
Monetary operations	Short-term	Periodic visits 1999–2000	CBA
Banking supervision	Resident Advisor	April 2000–December 2002	CBA
Monetary policy research	Short-term	April 28–May 4, 2000	CBA
Financial sector assessment program	Short-term	September 5–22, 2000	CBA
Monetary operations, monetary policy research and banking supervision	Short-term	September 3–14, 2001	CBA
Banking system issues	Short-term	April 15–19, 2002	CBA
Banking system, deposit insurance, foreign exchange market development, and CBA monetary operations.	Short-term	June 24–July 4, 2002	CBA
Unified financial supervision, mortgage financing markets and inflation targeting	Short-term	January 26–February 6, 2004	CBA
Statistics Department			
Multisector	Short-term	October 26–November 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	September 7–October 4, 1999	Ministry of Statistics
Data dissemination standards	Short-term	August 29–September 11, 2000	National Statistics Service
Data dissemination standards	Short-term	September 18–25, 2003	National Statistics Service

ARMENIA: RELATIONS WITH THE WORLD BANK
(As of March 03, 2004)

Country Director: Donna Dowsett-Coirolo

Telephone: (202) 473-0121

I. Implementation of Structural Reform Measures

A. Legal Framework

The Armenian Government has established the core legal framework necessary for private sector operations, including the Civil Procedure Code, the Procurement law, the Business Registration law and the Public Auction law. The fully restructured and enacted Bankruptcy law is now harmonized with the Civil Code and the Civil Procedure Code, and strengthens the enforcement mechanisms for bankruptcy procedures. The Concession law has been enacted and the Government has submitted to the National Assembly a new Labor Code, which is compatible with the requirements of a market economy and is a useful instrument of flexible job-creation.

B. Business Environment

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

The recent business surveys of the Armenian entrepreneurs during 2002 and 2003, suggest that these efforts have already resulted in a more positive private sector perception of the business and investment environment. For example, the average time necessary to get construction and building renovation permits was reduced from 310 days in 2001 to 76 days in 2003. The number of goods subject to mandatory certification at the border was reduced from 80 in 2001 to 60 in 2003. The number of registered joint ventures increased by 25 percent from January 1, 2002 to November 1, 2003, and the FDI (outside the energy sector) increased by 44 percent in the first nine months of 2003 compared with a similar period in 2002. The State Customs Committee's websites became operational and during

2003, on average 467 references per month were made to it. Despite these improvements, there is still considerable scope for further reforms in the areas of competition, deregulation and strengthening of business and investment climate, especially in commercial debt recovery procedures, improvements in the transparency and efficiency of the judicial system, tax and customs administrations, and improvements in governance and implementing the anti-corruption strategy.

C. Energy and Infrastructure

Since its privatization in the second half of 2002, the Electricity Distribution Company has remained in compliance with its licenses agreement as confirmed by making full payments to the generation and service providers, arranging a bank guarantee in the Escrow Account, reporting to the regulator on a timely basis, and submitting investment plan to the regulator. The Government has also made satisfactory efforts to improve the legal and regulatory framework in the energy sector in order to establish a supportive environment for the new private operator. Budget allocations have been increased to ensure full payments to the energy sector by the budgetary organizations and public utilities. Despite this satisfactory performance, continued efforts are crucial for improvements in the energy sector through restructuring the midstream companies and strengthening the regulatory framework to ensure the adequate functioning, transparency, and reliability of this sector.

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

E. Education and Health

The Government implemented a major rationalization program during the 2003 school year. As a result, 37 schools were merged or closed and about 3,500 teachers were made redundant. The medium-term action plan for improving the financial management, accounting, and financial reporting for higher education institutions was adopted by the Government on January 26, 2003. Accountants at the higher institutions have been trained and special software has been prepared for use. Since the second quarter of 2003, the new accounting procedures are being used. The Government increased the state budget allocation for primary and secondary education and improved teachers' salaries. The Government also developed an action plan and cleared arrears in the education sector and prevented further

arrears in this sector. Despite these improvements, there is scope for further reforms in education, including adopting new curricula for secondary education, enhancing standards for higher education to make it more responsive to employers' needs, improving preschool systems, and strengthening monitoring and financial reporting of the noncommercial organizations (NCOs) in the education sector.

The Government adopted the hospital master plan for Yerevan in late 2002. As a result, the remaining public hospitals in Yerevan were to be merged into smaller number of hospital networks with necessary steps to be taken to restructure them. The Government adopted a decree on November 21, 2003, identifying the configuration of ten hospital networks through consolidation of twenty-four public hospitals and thirteen outpatient health care institutions. Directors for nine of these hospital networks have been appointed. While the hospital merger process is being implemented, introduction of further appropriate adjustments may be required. The medium-term action plan for improving financial management accounting and reporting for the public hospitals was adopted by the Government on September 14, 2003, to prepare new reporting and accounting procedures and cost accounting manuals.

Implementation progress has been satisfactory and about 200 hospital accountants have been trained in new accounting procedures. The Government developed an action plan for clearing the accumulated arrears in the health sector and prevented further arrears in this sector. The Government also adopted a Decision to introduce further reforms in the Basic Benefit Package in the health sector. Further reforms are needed in increasing the population overall health status, reducing child and maternal mortality, increasing use of healthcare system by rural and low-income groups, monitoring public health and promoting better health behavior, and strengthening monitoring and financial reporting of the noncommercial organizations (NCOs) in the health sector.

F. Social Protection and Insurance

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

The law on Public Pension focuses on strengthening and streamlining the pension system. It provides significant improvements in the pension systems, including: (i) introduction of an equal retirement age for men and women at age 63; (ii) separation of social insurance benefits from social pensions; (iii) elimination of most early retirement provisions; (iv) indexation of

pension to inflation; and (v) establishment of more direct links between benefits and contributions, with adequate provision for a minimum benefit. Following adoption of the law, the Government has made satisfactory progress in its implementation. The Government Decree No. 309 of July 2003, established an inter agency working group to monitor introduction of the Personal Identification Numbers (PINs) into the pension system. Additionally, a range of necessary implementation regulations, based on the Public Pension Law, was developed, including: (i) the documents required for award of pensions; (ii) rules for awarding and making payments for partial pensions to those with less than the minimum required length of insurance history; (iii) procedures for making payments of the survivors' pensions to children under full state custody; and (iv) procedures for awarding, computing and making payments of the privileged pensions. While the fiscal performance of the State Pension Fund has improved and as a result, the average pension has increased, the level, coverage and sustainability of pensions are issues for further elaboration.

II. Lending

World Bank lending to Armenia as of March 03, 2004 totals US\$738.6 million, of which US\$638.2 million has been disbursed. Of the 31 IDA credits and 1 IBRD loan approved, 16 have closed. A third Country Assistance Strategy was presented to the World Bank's Board of Directors in May 2001, which envisaged base case lending of up to US\$150 million of IDA resources over the FY02-04 periods. A forthcoming CAS is expected to be presented to the World Bank's Board of Directors in June 2004.

Building on the major Poverty reduction Strategy Paper (PRSP)'s themes, the forthcoming CAS is likely to focus on three main objectives of: (i) promoting private sector led economic growth, (ii) making growth more pro-poor, and (iii) reducing non-income poverty. Unless the high case is reached, IDA lending is expected to be up to \$45 million a year during the forthcoming CAS period and could reach up to \$55 million a year if Armenia moves into the high case during the FY05-08 CAS period. Towards the end of the CAS period, there could be a first IBRD loan if Armenia's creditworthiness improves sufficiently. The forthcoming CAS is likely to include three Poverty Reduction Support Credits (PRSCs) for FY05, 06 and 07. These will support the PRSP objectives and could focus on four main components: (i) supporting private sector development, (ii) advancing public infrastructure reforms, (iii) improving core public sector functions, and (iv) enhancing human development and improving social safety nets. Macroeconomic stability is a precondition for the PRSC and is vital for facilitating an enabling environment necessary for successful structural reforms implementation. The PRSC's preparation is being closely coordinated with the IMF Poverty Reduction and Growth Facility (PRGF).

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

Active Projects	Credit Amount as of 03/03/04	Disbursement as of 03/03/04	Approval Date	Closing Date
<i>Active Projects</i>	223.3	128.7		
1. Health	10.0	9.3	07/29/97	12/30/03
2. Agric. reform support	14.5	13.7	01/27/98	06/30/04
3. Municipal development	30.0	24.1	06/11/98	04/30/05
4. Title registration	8.0	7.5	10/13/98	09/30/04
5. Electric. trans. & dist.	21.0	5.3	03/04/99	12/31/04
6. Irrigation dam safety	26.6	15.6	06/24/99	03/31/05
7. Transport	40.0	28.6	06/08/00	12/31/04
8. Social Investment Fund II	20.0	11.5	05/11/00	12/31/05
9. Judicial reform	11.4	3.2	09/14/00	12/31/04
10. Irrigation development	24.9	6.3	08/30/01	03/31/07
11. Enterprise incubator	5.0	1.0	11/30/01	06/30/05
12. Investment and export facilitation	1.0	0.4	04/16/02	12/31/05
13. Natural resource management	8.3	0.5	06/04/02	07/31/08
14. Municipal water	1.2	0.9	08/02/01	12/31/04
15. Educ. Qual. & Relevance (APL # 1)	1.3	0.6	09/20/02	06/30/04
16. Urban Heat	1.0	0.2	01/23/03	05/31/05
<i>Completed Projects</i>	515.3	509.5		
17. Irrigation rehabilitation	43.0	40.9	12/08/94	05/31/01
18. Highway	31.0	29.5	09/14/95	12/31/00
19. Social Investment Fund	12.0	11.1	11/09/95	12/31/00
20. Institution building	12.0	10.7	03/30/93	11/30/97
21. Earthquake rehabilitation	28.0	29.7	02/01/94	06/30/97
22. Power maintenance	13.7	13.2	12/08/94	06/30/99
23. Economic rehabilitation	60.0	64.3	02/28/95	06/30/96
24. SAC	60.0	58.5	02/29/96	12/31/97
25. SAC II	60.0	58.6	08/26/97	06/30/99
26. SATAC I	3.8	2.8	02/29/96	06/30/00
27. SAC III	65.0	63.4	12/22/98	06/30/01
28. Enterprise development	16.8	15.3	12/24/96	07/01/02
29. SATAC II	5.0	4.7	08/26/97	12/31/02
30. Education	15.0	14.6	11/20/97	10/31/02
31. SAC IV	50.0	49.4	05/22/01	03/31/03
32. SAC V	40.0	42.8	03/13/03	06/30/04
Total	738.6	638.2		

**ARMENIA: RELATIONS WITH THE EUROPEAN BANK FOR
RECONSTRUCTION AND DEVELOPMENT (EBRD)**
(As of March 1, 2004)

As of 1 March, 2004, EBRD had signed twelve projects in the power, transport, agribusiness, mining and financial sectors. Total cumulative commitments amounted to EUR 91.2 million.

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

There have also been a number of private sector projects in Armenia. The EBRD has provided a loan to the Yerevan Brandy Company owned by Pernod Ricard of France (EUR 19.1 million). In the banking sector, an equity participation in the Commercial Bank of Greece-Armenia (EUR 1.1 million) was approved in late 1999. Moreover, a multi-bank on-lending facility of EUR 10 million was activated in early 2000. Within the framework of multi-bank facility the Bank currently has credit lines for micro and small enterprises with three local banks (a total of EUR 4 million). The EBRD is committed to further expanding lending under this facility to other banks. A Trade Facilitation Program with the purpose to facilitate access of Armenian banks to trade financing was also made available to four Armenian banks. In 2002 a loan to finance EUR 2.9 million in working capital expansion was signed with the Armenian Copper Programme (the only copper smelter in the region). Moreover, the EBRD has launched the Turn Around Management (TAM) and Business Advisory Service Programmes in Armenia in 2003, funded by the EU-Tacis program, to support micro, small and medium-sized enterprises.

The key priorities of the EBRD for the coming years are (i) enterprise sector, (ii) financial sector, (iii) portfolio monitoring and implementation support and (iv) infrastructure and state-owned public utilities. The EBRD's new country strategy was approved in November 2003.

ARMENIA: STATISTICAL ISSUES

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

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

Fiscal statistics. The budget execution reporting system is compiled on a cash-basis and supplemented with monthly reports on arrears and quarterly reports on receivables and payables. However, the system to track arrears is cumbersome, there is a 45-day lag in the compilation of the data, and the data may not be reliable. Daily revenue and cash expenditure data for the central government are available with a lag of one to two days. The Ministry of Finance is undertaking a comprehensive reform of the treasury system, including the introduction of an internal auditing system in line ministries and their budgetary institutions. A single treasury account (TSA) was introduced in 1996, and all bank accounts held by budgetary institutions have been closed, except for the Project Implementation Units that are required by donors to operate with commercial banks' accounts. However, starting in [2002], some budgetary institutions have been converted into "noncommercial organizations" (NCOs). These units have been taken out of the treasury system and have their own bank accounts, but NCOs will start reporting data on their operations later in 2004. With these exceptions, all government receipts and payments are processed through the TSA, although there are still shortcomings on the timeliness and quality of data on the operations of local governments. Classification of government transactions by function and economic category are generally in line with Government Finance Statistics (GFS), and monthly data on central government operations are disseminated within 40 days of the end of the month. However, the budget presentation and the classification of items under the economic and functional classification of expenditures need to be made more transparent; for instance, the data has been subject to frequent reclassifications and wages for military personnel are reported in the

broader category of “other” goods and services rather than as a wage item. The reconciliation of central government with general government operations is also difficult owing to the need to identify manually transactions among central government, local government, and the Social Insurance State Fund. Armenia has not yet provided GFS data to STA for publication in the GFS Yearbook or in the IFS. However, the authorities envisage doing so later in 2004.

Money and banking statistics. Money and banking statistics are provided on a timely basis. Daily data on the accounts of the CBA are provided weekly with a one-day lag, while weekly data on the monetary survey are provided with a one-week lag. Monthly interest rate data are provided with an one-week lag. A new chart of accounts, 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 generally available within a month. Price data for exports and imports is less readily available. Quarterly balance-of-payment data are available with a three-month lag. However, data on private non-guaranteed external debt and on direct investment abroad are not compiled, and capital outflows are likely underestimated. The absence of a fully established (comprehensive and updated) business register in Armenia hampers a wider coverage of transactions and institutional units. The International Reserves Template data have been recently revised to exclude from predetermined short-term net drains the foreign exchange inflows from expected but yet undisbursed loans and financial grants.

Armenia: Core Statistical Indicators
(As of March 31, 2004)

	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	03/26/04	03/26/04	03/26/04	03/19/04	03/26/04	Feb 2004	Jan 2004	Q3 2003	Feb 2004	Feb 2004	Dec 2003
Date received	03/29/04	03/29/04	03/29/04	03/29/04	03/29/04	03/03/04	03/09/04	02/03/04	03/15/04	03/26/04	02/03/04
Frequency of data	Daily	Daily	Daily	Weekly	Weekly	Monthly	Monthly	Quarterly	Monthly	Monthly	Quarterly
Frequency of reporting	Weekly	Weekly	Weekly	Weekly	Weekly	Monthly	Monthly	Quarterly	Monthly	Monthly	Quarterly
Source of update	CBA	CBA	CBA	CBA	CBA	NSS	NSS	NSS	MFE	NSS	MFE
Mode of reporting	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of publication	Daily	Quarterly	Quarterly	Monthly	Monthly	Monthly	Monthly	Annually	Monthly	Quarterly	Annually

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

Statement by the IMF Staff Representative
April 30, 2004

1. The following information has become available since the issuance of the staff report on April 19. It does not change the thrust of the staff appraisal.
2. **Supplementary budget.** The authorities have initiated discussions with World Bank staff on a Poverty Reduction Support Credit that could be submitted to the Bank's Executive Board in the fourth quarter of this year. The associated budgetary support in 2004 is estimated at US\$20 million (0.6 percent of GDP). The authorities intend to prepare a supplementary budget to allocate some or all of the additional resources to priority expenditures on maintenance and reconstruction of the public infrastructure. Any remaining amount would be attached to expenditures in the 2005 budget. This would help compensate for the projected reduction in grant-financed investment this year. As a result, the fiscal deficit for 2004 would increase from 1.9 percent of GDP to no more than 2.5 percent of GDP. The latter figure is consistent with the PRSP macroeconomic framework (which envisaged a higher level of grants) and does not compromise fiscal sustainability. The authorities have indicated that they would seek understandings with the staff on the supplementary budget in coming weeks, and revised end-December indicative targets will be proposed in the context of the next review.
3. **Quantitative targets.** All indicative monetary targets for end-March 2004 have been met. The stock of reserve money declined to AMD 103.4 billion, just above the lower level of the indicative band. Net international reserves stood at US\$272 million compared to a target of US\$267 billion. Net credit to the government fell slightly to AMD -17.9 billion, suggesting that the fiscal deficit target was also met. During the first quarter of 2004, cumulative tax revenues exceeded the program target by AMD 1.5 billion (3 percent).
4. **Inflation and exchange rate.** The 12-month rate of inflation in April was 7.8 percent compared to 8.6 percent in December 2003. The dram appreciated by 3 percent with respect to the U.S. dollar between end-December 2003 and end-April 2004.



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International Monetary Fund
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IMF Completes Fifth Review Under PRGF for the Republic of Armenia, Approves Request for Extension of the Arrangement Through December 2004

The Executive Board of the International Monetary Fund (IMF) today completed the fifth review of the Republic of Armenia's economic performance under a three-year Poverty Reduction and Growth Facility (PRGF) arrangement, and approved a request for the extension of the arrangement by seven months to December 31, 2004. The completion of the review enables Armenia to draw an amount equivalent to SDR 10 million (about US\$15 million).

Armenia's PRGF arrangement for the equivalent of SDR 69 million (about US\$100 million) was approved on May 21, 2001 (see [Press Release No. 01/25](#)). So far, the equivalent of SDR 50 million (about US\$73 million) have been disbursed.

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

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

“The Armenian authorities should be commended for the satisfactory implementation of macroeconomic policies and structural measures under the PRGF-supported program. These policies have contributed to an improved business environment and a strong economic performance in 2003.

“Raising revenues and reforming tax and customs administration remain critical objectives in the period immediately ahead. The recent reduction in VAT exemptions and reform of the profit tax are welcomed steps in this regard, but further efforts are needed to improve the tax system and generate resources for poverty reduction. In particular, it will be important to improve the transparency of tax and customs operations, ensure the equal treatment of taxpayers, and implement risk-based audit systems. Additional steps are needed in the medium term to

strengthen the overall coherence of the tax system and the management of the tax and customs agencies.

“Recent increases in bread and utility prices pose the risk of rekindling inflationary expectations, and the central bank will need to maintain a tight monetary policy to bring inflation down to its goal of 3 percent by end-2004. To further develop Armenia’s financial system, it will be important to build capacity and promote sound corporate governance in the banking system, and strengthen the legal framework and the judiciary.

“The recent process of fiscal decentralization has the potential to improve the quality and efficiency of services delivered by state-owned noncommercial organizations in the health, water, and education sectors. Complementary capacity building initiatives and a properly functioning reporting framework remain essential to ensure transparency and accountability in the operations of these entities.

“Other structural reforms will be important to sustain growth and reduce poverty in the medium term. The anti-corruption strategy needs to be implemented forcefully and in consultation with civil society. The authorities are encouraged to move forward with their plans to reform the energy and water sectors, including establishing market rules for electricity trading, and liquidating the state-owned company Armenergo,” Mr. Carstens said.