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REPUBLIC OF ARMENIA

March 2015

2014 ARTICLE IV CONSULTATION AND FIRST REVIEW UNDER THE EXTENDED ARRANGEMENT—STAFF REPORT; STAFF SUPPLEMENT; AND PRESS RELEASE

In the context of the Staff Report for the 2014 Article IV Consultation and First Review Under the Extended Arrangement, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on September 30, 2014, with the officials of Armenia on economic developments and policies underpinning the IMF arrangement under the Extended Fund Facility. Based on information available at the time of these discussions, the staff report was completed on December 5, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Staff Supplement** of December 16, 2014 updating information on recent developments.
- A **Press Release** including a statement by the Chair of the Executive Board.

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

Letter of Intent sent to the IMF by the authorities of Armenia*
Technical Memorandum of Understanding*
Selected Issues Paper

*Also 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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Washington, D.C.

REPUBLIC OF ARMENIA

December 5, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND FIRST REVIEW UNDER THE EXTENDED ARRANGEMENT

KEY ISSUES

Context, outlook, and risks. Armenia's economic environment has become more complex, particularly due to adverse external developments. Growth is expected to slow to 2.6 percent of GDP in 2014 and accelerate gradually over the medium term. Key risks include geopolitical developments in the region (Russia, Ukraine, Nagorno-Karabakh).

Fiscal policy. Fiscal policy is sustainable. However, continued capital budget underexecution is a concern. The draft 2015 budget envisages increased capital spending to help support growth. Fiscal reforms are advancing, but further revenue gains are needed to address pressing social and investment needs.

Monetary and financial sector. Monetary policy has turned accommodative in response to weakening demand and lower inflation, but will need to remain vigilant in light of rising global rates and excess liquidity in the banking system. The banking sector remains robust and well capitalized, but a recent increase in NPLs warrants monitoring. The authorities are strengthening financial sector regulation and resilience.

External stability. While consolidation has continued, the current account deficit is expected to remain high over the medium term. International reserves are adequate. Staff estimates suggest that an adjustment of the real exchange rate over the medium term, together with structural reforms, would facilitate further external adjustment.

Structural reforms. More forceful reforms would improve Armenia's capacity to grow, create jobs, and reduce poverty. The authorities should move faster to bolster the flagship pension reform to ensure its long-run success. They should leverage Eurasian Economic Union (EEU) membership to increase exports, improve standards, enhance domestic competition, and invest in infrastructure, while pursuing greater trade integration beyond the EEU.

Program. The program is broadly on track. All PCs and most ITs were met. There were some delays in meeting structural benchmarks, mainly due to the government change in mid-2014 rather than a change in policy direction. The authorities are requesting that the equivalent of SDR 11.74 million become available with completion of the review.

Article IV. Discussions focused on reducing vulnerabilities and boosting potential growth via: (i) overcoming fiscal underspending; (ii) more exchange rate flexibility to facilitate external adjustment; (iii) additional dedollarization measures; and (iv) more ambitious structural reforms to improve competitiveness and inclusiveness.

Approved By

Juha Kähkönen and Ranil Salgado

Discussions were held September 17–30 in Yerevan with Prime Minister Abrahamyan, Central Bank of Armenia (CBA) Chairman Javadyan, Finance Minister Khachatryan, Economy Minister Chshmaritian, Agriculture Minister Karapetyan, Labor and Social Affairs Minister Asatryan, Energy and Natural Resources Minister Zakharyan, other senior officials, and representatives of the private sector, civil society, and the diplomatic community. The mission team comprised M. Horton (head), F. Parodi and P. Rodriguez (all MCD), Y. Zhang (SPR), and R. Rozenov (FAD). T. Daban (IMF Resident Representative) and M. Aleksanyan, A. Manookian, and V. Janvelyan (IMF Office) assisted. M. Snel (ED) and A. Hubic (OED) joined the discussions. Z. Arvai (SPR), M. Fischer (MCD) and S. Salimi (MCD) contributed to the staff report.

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CONTEXT AND RECENT DEVELOPMENTS

Armenia's economic environment has become more complex, particularly due to adverse external developments—slow growth in Russia and the EU and uncertainty regarding the crisis in Ukraine, including sanctions and counter-measures. A challenging domestic policy environment is also playing a role, most notably setbacks in the implementation of the pension reform. In spite of these challenges, the Fund-supported program remains on track and its objectives highly relevant.

1. Recovery from the 2009 crisis is in place, but significant challenges persist. Growth has been reestablished after a 14 percent contraction in 2009, while major reductions in the fiscal and current account have been simultaneously achieved. Nonetheless, significant challenges remain, as the economy has not yet developed a robust alternative to the pre-crisis construction-led growth model, public, private and foreign investment remains suppressed, and the economy has struggled to generate sufficient jobs to stem emigration and reduce poverty. The still-high current account deficit and financial dollarization remain sources of vulnerability.

2. Cooperation between Armenia and the Fund has remained strong. A Fund-supported program was in place during 2010–13 and was completed with minor delays and few missed targets. More recently, a new 38-month arrangement was approved in March 2014 aimed at helping consolidate stability and buffers against possible external shocks and supporting growth through further reforms in the transition towards a dynamic emerging market economy. Beyond the program relationship, Armenia and the Fund have maintained a continuous dialog regarding policy challenges, and recent policy implementation has been consistent with past Fund advice (Box 1). There has also been close cooperation through Fund technical assistance.

3. Armenia's economic environment has become more complex in 2014. Externally, growth in Armenia's largest trading partners, Russia and the EU, has been weaker than expected, affecting exports and remittances. The slowdown in Russia—driven by both structural and geopolitical developments, including sanctions, represents a particular challenge, along with depreciation of the ruble. Domestically, the government has yet to overcome significant budget underexecution—particularly on capital expenditures—and the roll-out of the long-planned pension reform has experienced difficulties.

4. A new government, in place since May, has stressed continuity. The new government was formed following the resignation of Prime Minister Tigran Sargsyan in April, after six years in office. Major actions to date have included: merging the Ministry of Finance (MOF) and the State Revenue Committee (SRC); narrowing the scope of the pension reform after demonstrations and a ruling that some of its provisions were unconstitutional; implementation of an open skies policy in civil aviation; and concluding steps on accession to the Eurasian Economic Union (EEU).

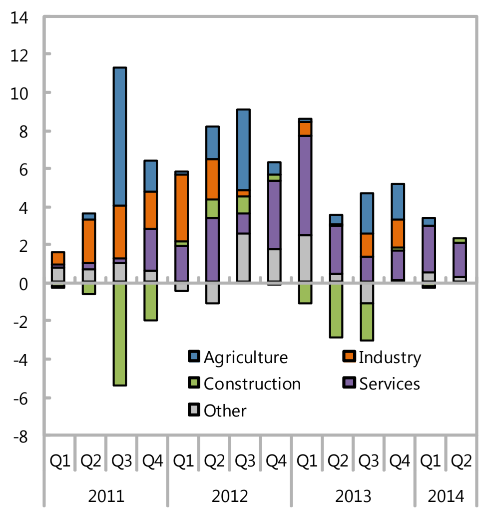
Box 1. Policies since the 2012 Article IV Consultation

Macroeconomic policies have been in line with past staff advice. The 2012 consultation called for: (i) greater tax revenue mobilization to strengthen the fiscal outlook; (ii) continuing monetary and financial sector reforms; and (iii) greater exchange rate flexibility to underpin external consolidation and sustainability. Since 2012, the authorities have increased revenue mobilization and reduced the underlying fiscal deficit, although the latter also reflected fiscal under-spending, mainly on capital projects. Monetary and exchange rate policies helped maintain price stability and supported external adjustment, as evidenced by the gradually declining external current account deficit. The authorities have implemented most of the recommendations from the 2012 FSAP Update, including: establishing minimum foreign currency liquidity ratios, introducing the use of Basel II Pillar II supervisory techniques, and preparing supporting regulations for the pension reform.

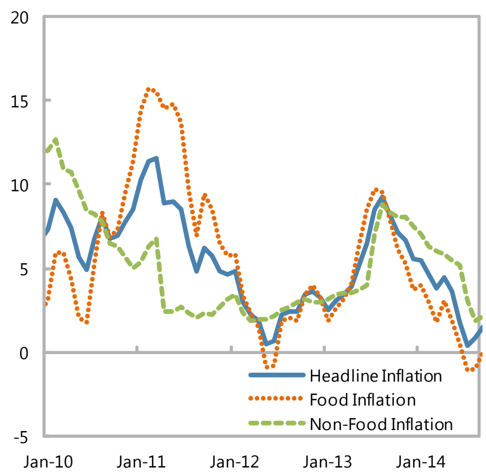
The authorities also made progress in implementing structural reforms, albeit with some delays. The 2012 consultations called for improvements to the business climate and competitiveness that were supported by the 2010 and 2014 Fund arrangements. Tax administration and financial reforms to improve business conditions have generally advanced. The authorities are continuing with the implementation of the flagship pension reforms, launched in January 2014, although these faced obstacles and were modified. The "open skies" framework for civil aviation is in place and delivering increased flights at lower costs. However, competition and regulatory reforms have advanced at a slower-than-expected pace. More broadly, while progress has been registered, a decisive breakthrough on structural reforms has not been achieved, with consequences for private and foreign investment.

5. Growth has softened, and inflation fell below the CBA's target range of 4±1.5 percent. Growth in the first half of 2014 was 2.7 percent (vis-à-vis 3.5 percent in 2013), as growth of exports and remittances slowed, and government spending was lower than budgeted. The slowdown was broad based, although construction, which has declined since the 2009 crisis, was relatively flat. Inflation through September was just 1.5 percent, primarily driven by low food inflation.

Sectoral Contributions to Growth
(In Percent, Production Approach)



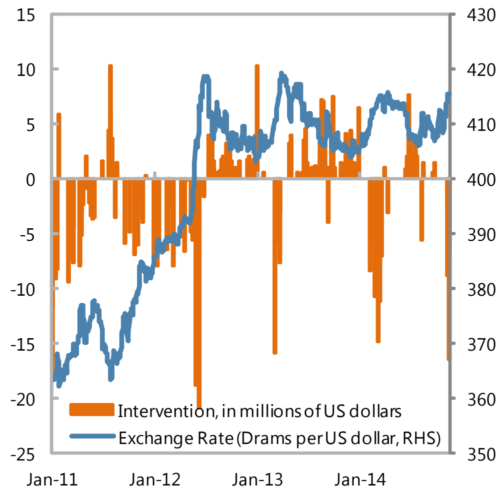
Consumer Price Inflation
(In Percentage Change)



Sources: National Authorities; and IMF staff calculations.

6. Pressures in the foreign exchange (FX) market have been associated with pressures on regional currencies. Depreciation pressures emerged in February and March in the context of higher payments for gas imports and pressures on regional currencies, leading to CBA intervention. Subsequently, the FX market remained stable, as weaker growth translated into low growth of imports. Moderate seasonal appreciation pressures emerged over the summer, associated with tourism receipts and low gas demand, allowing the CBA to recoup part of its earlier intervention. Pressures reemerged in November, in the context of depreciation of the Russian ruble, and lower remittances and exports to Russia, leading again to CBA intervention, as well as depreciation of the dram.

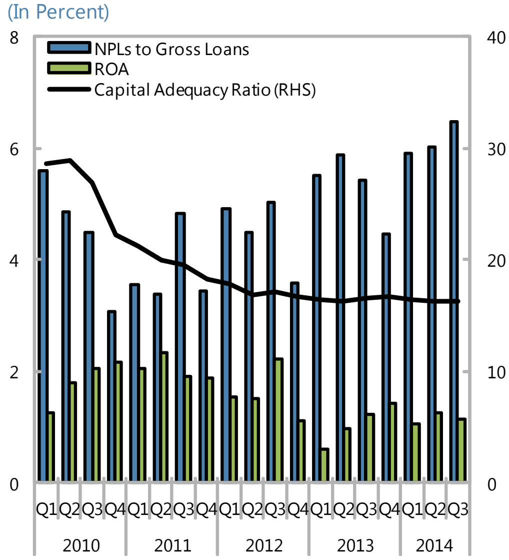
FX Intervention and Exchange Rate



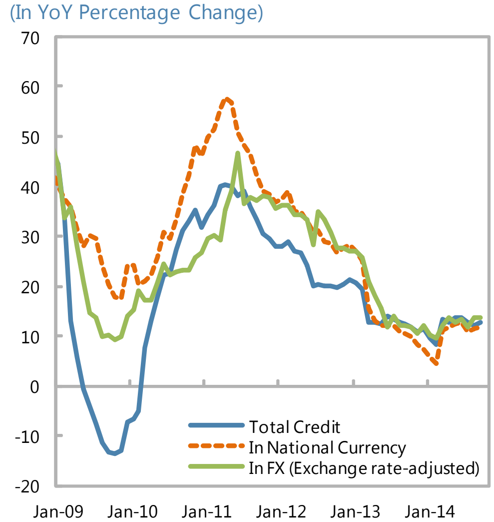
Source: National Authorities.

7. The banking sector remains profitable, but performance has weakened. Slower economic growth has been accompanied by an increase in NPLs, which reached 6.5 percent in September, a reduction of profitability, slower credit and deposits growth, and a small reduction in the capital adequacy ratio. In addition, competition among banks for clients in a weaker economic environment has reduced lending-deposit spreads, putting additional downward pressure on profitability.

Financial Soundness Indicators
(In Percent)



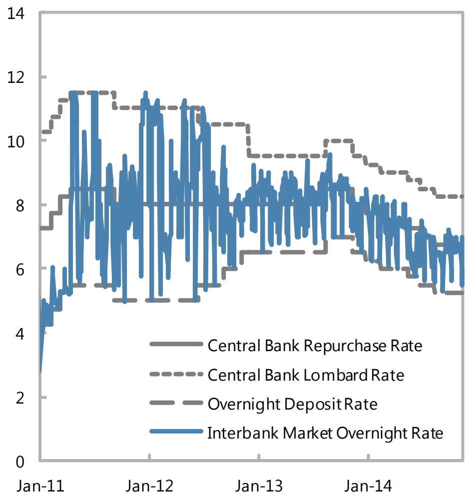
Credit Growth
(In YoY Percentage Change)



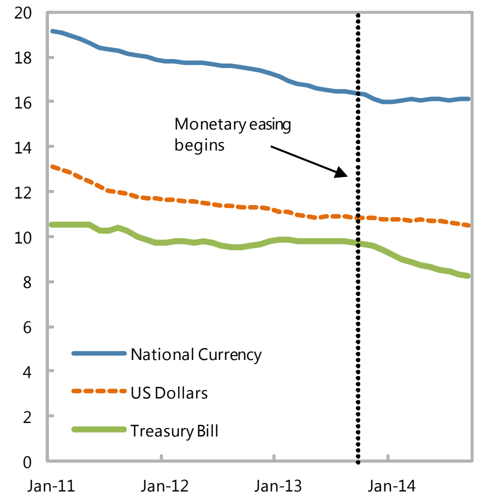
Sources: National Authorities; and IMF staff calculations.

8. **Monetary conditions have eased, in line with policy decisions.** An easing cycle initiated by the CBA in November of 2013 has continued, with the policy rate declining by 1.75 percentage points to reach 6.75 percent in August. This was accompanied by a reduction of reserve requirements for dram deposits from 4 to 2 percent in March. With budget underexecution and funding from last year's Eurobond, the MOF has stayed out of the T-bill market, and short-term T-bill and overnight rates have declined by a similar amount as the policy rate. The impact of the monetary policy easing has, however, not been significantly reflected in lending rates.

Short-Term Interest Rates
(In Percent)



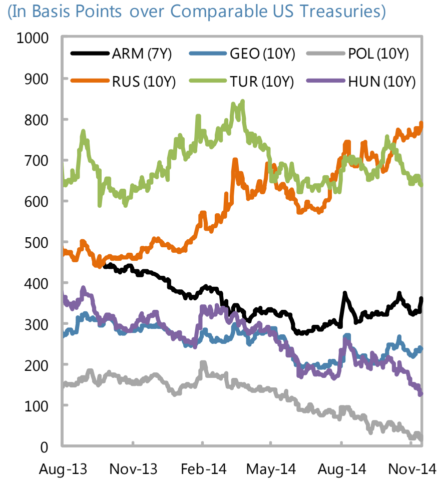
Short-Term Lending and T-Bill Rates 1/
(In Percent per Annum, 12 Month Average)



Source: National Authorities; and IMF staff calculations.
1/ Short-term lending rates are defined as interest rates on loans with a maturity of less than one year.

9. **With continued under-spending, the fiscal accounts posted small (underlying) deficits in 2013 and in the first eight months of 2014**. Under-execution affected major foreign-financed capital projects, especially the multi-donor North-South Highway and border crossing improvement projects.[1] The headline fiscal deficit was 1.7 percent of GDP in 2013, but included 1.5 percent of GDP of capital transfers related to a December debt-equity transaction with Gazprom. Despite lower growth, revenues have been close to budget targets, including in 2014. The small fiscal deficit of 0.1 percent of (annual) GDP recorded through August reflected further capital under-spending, lower-than-budgeted matching pension contributions (due to pension reform changes), and lower outlays on goods and services. In spite of regional uncertainties, Eurobond spreads have remained stable.

International Bond Spreads
(In Basis Points over Comparable US Treasuries)



Sources: Bloomberg; and IMF staff calculations.

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[1] Overcoming underexecution has proved to be a difficult task, as the causes vary depending on the project. For the North-South Highway, issues include complex land acquisition, resettlement, and archeological work. A new on-line procurement framework that aims at arm's-length transactions and improved transparency and governance may also be contributing to delays.

10. Uncertainty on EEU membership eased with signing of the accession treaty in October. On October 10, the presidents of Armenia, Belarus, Kazakhstan, and Russia, signed an agreement on Armenia's membership. Armenia is expected to formally join the Union in January, once the treaty is ratified by the four national parliaments (Annex I).

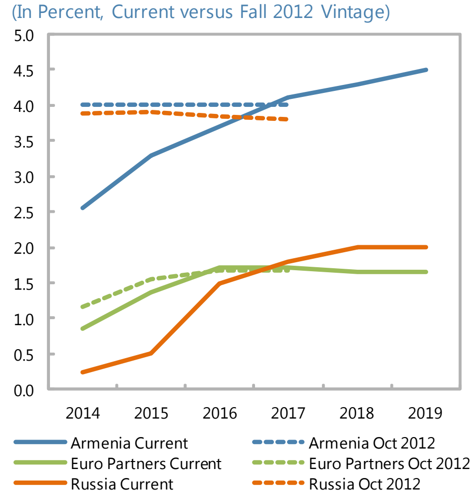
11. The Fund-supported program is on track and its objectives remain highly relevant. Despite adverse external developments and policy challenges, all end-June PCs, all continuous PCs, and most ITs and SBs were met. The objectives of the program—to consolidate stability and buffers against possible external shocks and to support growth—remain particularly relevant in the current environment.

OUTLOOK AND RISKS

With low growth in trading partners, activity in Armenia is expected to remain subdued in 2014–15 and to recover only gradually in the medium term. Significant downside risks exist, particularly connected with Russia, given substantial interlinkages via trade, remittances, bank flows, and FDI.

12. Growth is expected to remain restrained in 2014–15 and to recover only gradually in the medium term. Growth is now projected at 2.6 percent in 2014—down from 3.5 percent in 2013 and 4.3 percent in previous projections—and is expected to accelerate only gradually in 2015 and over the medium term, in light of expectations of a prolonged period of slow growth in Russia. The gradual recovery will also be driven by a moderate medium-term recovery of foreign and private investment in Armenia. Fiscal expenditures are again expected to be lower than planned this year. The deficit in 2014 is expected to reach 1.5 percent of GDP, well below the budget (2.3 percent of GDP). The deficit could be lower, by a further ½ to 1 percent of GDP, if capital spending remains restrained. The external current account consolidation is likely to be weaker than expected at the time of program approval in March, by 0.8 percent of GDP, due to slower export and remittance growth. Gross international reserves will also be lower than expected, given the weaker current account and other factors, such as the loss of EU financing. The authorities broadly shared staff views on the outlook, but argued that growth could be higher in 2015 and beyond, reflecting strong performance in agriculture, services, and light industry, as well as potential increases in FDI catalyzed by EEU accession.

Revisions to Growth Outlook: Armenia and Major Trading Partners
(In Percent, Current versus Fall 2012 Vintage)



Source: National Authorities; and IMF WEO.

13. Significant downside risks exist (see Risk Assessment Matrix). A worsening of global financial conditions and protracted slow growth in advanced and emerging markets could have an adverse impact on Armenia's outlook via lower exports and higher borrowing costs. Risks from the sharp slowdown in Russia and the depreciation of the ruble are significant, given the links between Russia and Armenia (Box 2). While EEU accession may bring benefits, the Armenian economy could become even more closely tied to Russia, and the end of negotiations on an Association Agreement with the EU could mean the loss of a long-term reform anchor and convergence to EU standards. Renewed conflict with Azerbaijan over Nagorno-Karabakh remains a significant country-specific risk. By contrast, upside developments could occur in the mining sector, where new copper and gold production could lead to an increase in exports. There is also upside potential in tourism and agriculture. Russia's counter-sanctions against European food products could potentially benefit Armenia's agricultural sector, although it will be difficult to scale up quickly. The authorities expressed concern regarding the impact of sanctions on Russia, including risk aversion by banks and investors to the region as a whole, and not just to Russia/Ukraine.

FIRST REVIEW UNDER THE EXTENDED ARRANGEMENT

The Fund-supported program remains on track, with all end-June performance criteria and most indicative targets met. The fiscal targets, however, were met in a context of significant budget underexecution, and progress on structural reforms was mixed, partly reflecting the government change. As conditions have been weaker than expected, the program's fiscal deficit projections for 2015 and 2016 are being eased to support additional capital expenditures and GDP growth, although the fiscal path will still achieve the debt-reducing fiscal deficit target of 1.8 percent of GDP by the end of the program period. Projections for gross international reserves and the import-coverage ratio are also being revised.

A. Fiscal Policy

14. The program deficit targets were met by wide margins, but the social spending IT was missed. A deficit of 0.5 percent of GDP (program definition) was recorded through June, significantly below the 1.3 percent of GDP target, primarily due to lower capital expenditure and lower matching pension contributions. Social spending was also below target, however, mainly reflecting further targeting and a lower number of families receiving social assistance than planned.[2] Tax revenues were just 0.2 percent of GDP below projections in the first half of the year, despite slower growth and even as the government stepped up efforts to reduce the stock of advanced tax payments and outstanding tax refunds. With a lower deficit, the government reduced the issuance of domestic debt and maintained a comfortable level of deposits at the CBA. The deficit is expected

[2] Other fiscal targets were met, including: (i) the continuous PCs on nonaccumulation of external arrears and on nonabsorption of losses, liabilities, or payments of utilities and other companies; and (ii) the indicative targets on government guarantees for external debt and the average concessionality of newly contracted external debt.

to widen in the second half, as the impact of higher wages and pensions kicks in and implementation of capital spending accelerates. The deficit is expected to close the year at around 0.8 percent of GDP below the budget target of 2.3 percent of GDP.

15. Fiscal reforms are advancing. The new government merged the MOF and SRC, which is expected to improve synergies and reduce collection gaps. The SRC established a Risk Management Unit (RMU), which is in the process of preparing a compliance strategy for 2015 (June and December 2014 structural benchmarks), and the MOF is making progress in establishing a second RMU with support from FAD TA to look into risks related to concessions, PPPs, utilities, and SOEs (December 2014 structural benchmark). The authorities are advancing in their assessment of possible new tax measures, including on high-wealth individuals (September 2014 and June 2015 structural benchmarks). New legislative amendments to the customs code were approved to improve customs operations and trade (March 2014 structural benchmark). In the social spending area, there has been progress in the establishment of integrated social service centers and an increase in allowances under the Family Benefits Program (FBP).

ARMENIA—RISK ASSESSMENT MATRIX

Potential Deviations from Baseline

Nature/source of risk	Relative likelihood	Possible impact if risk is realized	Policy response
Global Risks			
Side-effects from global financial conditions: - An abrupt surge in global financial market volatility, as investors reassess underlying risk - Financial imbalances from protracted period of low interest rates continue to build: excess leverage, especially for corporates; asset price bubbles; delays in fiscal and structural reforms.	**Staff assessment**: -High -Medium	**Staff assessment: Low/Medium** The current account deficit is a source of vulnerability, along with a reversal of bank flows. Armenia's sound policy framework, remaining resources from the 2013 Eurobond, and official support mitigate risks.	Increase exchange rate flexibility with occasional intervention to prevent disorderly conditions, and where possible, to build buffers. Prepare and implement contingency plans for potential financial spillovers. Enhance monitoring of FX risks
Protracted period of slower growth in advanced/emerging economies: - **Advanced**: lower-than-anticipated potential growth and persistently low inflation due to a failure to fully address the legacies of the financial crisis, leading to secular stagnation. - **Emerging markets:** Maturing of the cycle, misallocation of investment, and incomplete structural reforms leading to prolonged slower growth.	**Staff assessment**: -High -High	**Staff assessment: Medium** Effects would be via remittance, trade, finance, and investment channels, particularly if Russia is also affected.	Accelerate reforms to increase growth and diversify export destinations and products. Increase exchange rate flexibility.
Geopolitical fragmentation that erodes the globalization process and fosters inefficiency: - **Russia/Ukraine**: sustained tensions depress business confidence and heighten risk aversion, amid disturbances in global financial, trade and commodity markets. - **Heightened risk of fragmentation/state failure in**	**Staff assessment**: - Medium - Medium	**Staff assessment: High** Effects would be very strong, comprising both direct impacts from Russia and impacts from global disruptions. Tough sanctions against Russia	Prepare and implement contingency plans for potential financial spillovers related to regional geopolitical risks. Increase exchange rate flexibility.

Nature/source of risk	Relative likelihood	Possible impact if risk is realized	Policy response
the Middle East, leading to a sharp rise in oil prices, with negative spillovers to the global economy.		would lead to more severe impacts, including in the banking sector.	
Growth slowdown and financial risks in China: - Continued buildup and unwinding of excess capacity, eventually resulting in a sharp growth slowdown and large financial and fiscal losses (medium-term).	**Staff assessment**: - Medium	**Staff assessment: Medium** Effects would likely hit Armenia's mining exports, an important area of growth and source of FX earnings.	Diversify export destinations and products.
Country-Specific Risks			
Regional conflict: - Risks from sharp, renewed conflict with Azerbaijan over Nagorno-Karabakh - Deterioration of Russian-Georgian relations	**Staff assessment**: - Medium -Low	**Staff assessment: Very High** -Conflict with Azerbaijan would involve severe impacts and likely other countries (Russia, Turkey) -Deterioration of Russian-Georgian relations could lead to transport, trade, or energy supply disruptions.	Prepare and implement contingency plans. Increase exchange rate flexibility.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

16. A higher fiscal deficit is proposed for 2015 to support growth. With lower growth, meeting the envisaged 2.0 percent of GDP budget deficit would have led to a decline in capital spending, exacerbating the slowdown. Staff and the authorities agreed to ease the deficit target by 0.3 percent of GDP in 2015 to increase investment outlays (e.g., roads, infrastructure). The authorities will strengthen implementation of the foreign-financed capital budget by submitting monthly progress reports on externally-funded projects to the Office of the Prime Minister and preparing proposals on how to improve execution (April 2015 structural benchmark). They will also improve the procurement system for domestically-funded projects by shifting fully to e-procurement for both central and local governments in 2015. The program now foresees reaching the debt-reducing deficit target of 1.8 percent of GDP in 2017 rather than in 2016.

Box 2. Spillovers from Global and Regional Developments to Armenia

Global Risks. Normalization of monetary policies in key advanced economies would likely not have a strong direct impact, given the large share of concessional financing in Armenia's external debt and low international integration of the banking system. However, higher global interest rates would affect domestic financing conditions and demand due to high dollarization. In addition, they could affect Armenia via Russia, which is highly exposed to global financial conditions. A protracted slowdown in emerging markets could depress prices for Armenia's mineral and metal exports, nearly 50 percent of total exports. While hydrocarbon prices would be lower, the price of gas from Russia is already low and fixed for four more years.

Risks from Russia. The conflict in Ukraine and sanctions have affected Russia through a cut-off of external funding, lower investment, capital outflows, and higher policy and borrowing rates. These factors have contributed to significant depreciation of the ruble, along with the decline of oil prices and increasing concerns about medium-term growth. Armenia is closely integrated with Russia through a variety of channels:

- **Trade**. Russia accounts for around ¼ of Armenia's exports of goods, concentrated in job-creating sectors like agriculture, light industry, and transportation. Since 2008, the correlation of Russian GDP growth and Armenian exports has strengthened.
- **Remittances**. Armenia receives 18–20 percent of GDP in remittances, 90 percent from Russia, increasing the potential adverse effects of ruble depreciation. Since 2009, remittance growth has outpaced GDP growth, with deposits building up in the domestic banking system. A deep and protracted downturn in Russia could cause migrant workers to return, putting pressure on the local job market.
- **Bank flows**. Spillovers may be direct through Russian banks active in Armenia and indirect via confidence effects. Two major Russian banks are active, although the Armenia operations of these banks are very small compared to parent bank size. The exposure of Armenian banks to Russian assets or Armenian firms operating in Russia is a source of credit risk, although this impact appears relatively small and manageable at present. Indirect confidence effects may arise if banks in North America and Europe limit their new operations in Armenia due to geopolitical developments.
- **Investment**. Russia is an important source of FDI, especially government-related firms like Gazprom, UES, Russian Railways, and mobile phone operators. FDI plans of these firms and other Russian investors (e.g., Rosneft, RusHydro, mining companies, private firms) may be affected by a major slowdown. FDI from other sources could also decline, if investors reassess economies perceived as closely linked to Russia, although there could be more interest from investors from China, the Gulf, or if geopolitical conditions change, Iran and Turkey.

Policy response. Adverse spillovers would strengthen depreciation pressure, with possible balance sheet effects given high dollarization. The room for response is limited in the short term, but there may be space for a moderate fiscal stimulus and monetary easing. Increased exchange rate flexibility is needed to reflect changes in fundamentals, including the depreciation of the ruble. Accelerating reforms to increase growth and diversify export destinations and products would also increase resilience in the longer term.

17. Some targeted revenue measures will also contribute to supporting growth in 2015. The government will begin gradually replacing the current mixed (accrual/cash) method for determining VAT liability and providing credits/refunds within a unified regime where both debits and credits are calculated on an accrual basis. This change will ease cash-flow constraints for taxpayers and will be phased over three years, with estimated costs to the budget of AMD 5 billion (0.1 percent of GDP) in the first year. Costs in the second and third years will be higher and necessitate offsetting measures. In response to continuing weaknesses in construction, the government will allow for income tax deductibility of mortgage payments under loans for purchase of new apartments built after November 1, 2014. Tax incentives will also be provided to remote border regions adjacent to Azerbaijan. To contain the impact on revenues from these changes, the natural resource user fee for non-metallic minerals will be increased in 2015, and the government will consider raising excise rates on alcohol and tobacco, if needed.

18. Revenue measures, including strengthening of tax compliance, will be important in the coming years to address gaps in the tax system and increase fiscal space and buffers. Revenue measures in 2016 and beyond will be necessary to reduce the stock of advance tax payments (by 0.3 percent of GDP per year in 2016–17), increase capital and social expenditures, and bring the deficit to 1.8 percent of GDP by the end of the program period and set debt on a declining path. The government is initiating the preparation of a new tax code aimed at reforming the tax system and reducing high compliance costs through a well-defined set of taxation principles and rights and obligations of taxpayers and the tax administration, in line with best practices. Preparation and enactment of the code will present an opportunity to eliminate tax expenditures, subject the approval of new tax benefits to more stringent rules, and broaden the tax base (e.g., agriculture, fuels). To support this work, the government included for the first time an annex to the 2015 budget quantifying the main tax expenditures.

19. EEU membership could have major fiscal implications. After joining the EEU, Armenia is expected to receive 1.13 percent of the common customs pool, implying additional customs revenues of about 1½ percent of GDP annually (net of the current level). As ratification of Armenia's membership in the EEU is still pending, these revenues are not yet incorporated in the 2015 budget or in program targets. In light of Russia's commitments to the WTO, the revenue increases will be transitory, as EEU tariffs are expected to decline over the medium-term. Staff proposed that the revenues mainly be saved to build fiscal reserves and until high-quality capital projects and social spending can be identified (and capital underspending issues addressed). The authorities agreed, also citing concerns with the initiation and sustainability of the revenues. Staff identified potential downsides, including (i) the impact of sanctions and lower oil prices on Russia's imports; (ii) the medium-term forecasts of Russian custom revenues in light of Russia's commitments for WTO membership; (iii) possible delays due technical obstacles in implementing the customs pool revenue-sharing mechanism; (iv) the impact of seasonal import patterns on cash management; (v) possible legal provisions that could provide special exemptions and loopholes for member countries; and (vi) negotiations that may be needed with other WTO countries, as Armenia needs to raise tariffs above its WTO commitments. If ratification is achieved and membership commences from January, the Second Review (March 2015) will provide an early opportunity for assessment.

20. The authorities are continuing with implementation of the flagship pension reform, although its scope has been narrowed for now. The reform targets key economic and social objectives, including addressing Armenia's unfavorable population dynamics and old-age poverty and the lack of long-term funding in local currency. However, the reform was received with mistrust from some segments of the population, especially young high-wage workers, who led protests.

Following a decision in April by the Constitutional Court to strike down some provisions of the pension law, the government made changes to the reform (Annex II). These have necessitated adjustments to procedures, software, websites, and financial and information flows, which in turn have delayed full roll-out. As these adjustments are being made, the government's efforts are now targeted at increasing public awareness of the reform. The temporary narrowing of coverage of the reform will likely result in fiscal savings of up to 0.3 percent of GDP per year through 2017 because of lower government payments for matching contributions.

B. Monetary and Exchange Rate Policy

21. Program NIR and NDA targets were met, but the inflation indicative target was missed as inflation fell below the CBA's target range. The June NIR target was met, as the CBA was able to partially recoup the intervention undertaken early in the year and as imports weakened in the context of lower budget execution. The NDA target was met by a comfortable margin, even though the CBA further eased monetary policy. The CBA oversaw a decline in overnight rates without a large increase in credit to banks, due to weaker economic conditions, relatively strong growth in dram deposits, and lower budget execution. Preliminary data indicate that the September NIR and NDA indicative targets were also met. On the other hand, and in spite of the monetary easing since late 2013, the inflation indicative target was missed as a decline in both food and nonfood inflation led to end-June inflation falling below the 4 ± 1.5 target range. With inflation expected to return to the target range within the next few months, staff and the authorities agreed that a continuation of the current stance appears warranted, although an adjustment may be necessitated by changes in the transmission of monetary policy to market rates, developments in key trading partners, and monetary policy changes in advanced economies.

22. Monetary policy remains anchored on the CBA's inflation-forecast targeting (IFT) framework. In the near term, the IFT regime will continue to be complemented by a ceiling on NDA of the CBA, as the program transitions to inflation-consultation clauses. The CBA is further strengthening modeling and communications, both with Fund TA, and the monetary operations toolkit, particularly the use of one- and seven-day instruments for interbank lending. The CBA is assessing obstacles to developing the FX derivatives market and hedging instruments and will formulate a policy agenda.

23. Exchange rate policy will complement the IFT regime and support external adjustment. Staff and the authorities agreed that exchange rate policy should continue to be guided by letting the exchange rate to be determined by market developments, with occasional intervention to mitigate disorderly conditions, and where possible, to build buffers. As a result, policies may deviate from a pure float, but interventions are expected to be targeted and infrequent. In this respect, the recent depreciation of the Russian ruble poses a challenge with a need to balance limited intervention to mitigate disorderly conditions with exchange rate movements that reflect changes in fundamentals. Clear communications will be important to support these efforts. The staff noted that exchange rate policy may become more challenging as integration with the EEU advances, particularly if more transactions are settled in rubles, and suggested to step up monitoring of these changes in the context of future program reviews.

24. The Fund-supported program envisages new measures to strengthen the independence and operations of the CBA, in line with the most recent IMF Safeguards Assessment completed in August. During 2014–15, the CBA will work with its external auditors to present a consolidated financial position inclusive of enterprises owned by the CBA and will publish an annex in its annual report describing these investments, their rationale, objectives, development strategy, risks, risk-mitigation efforts, and where appropriate, the CBA's divestment strategy (June 2015 structural benchmark). The CBA will improve the charter for its board to better outline the roles and responsibilities of board members. Finally, the CBA and the government will work to advance long-pending legislation to require the government to issue marketable, interest-bearing securities to cover CBA losses.

C. Financial Sector Policy

25. The banking sector remains sound, but close monitoring is warranted given the weaker economic environment. Capital and liquidity ratios remain well above minimum regulatory requirements, and banks have increased provisions in response to higher NPLs, keeping the provisions-to-NPLs ratio at over 40 percent. Furthermore, while the system's net foreign assets are negative, liabilities mainly represent financing from parent banks and IFIs, relatively stable sources of financing. Nonetheless, close monitoring is warranted given that a further weakening of economic conditions could drive NPLs higher while sanctions against Russia could affect the sector. The authorities agreed, noting that sanctions had indeed adversely impacted local affiliates of Russian banks, although the effects were so far manageable. The authorities also noted that the high level of FX liquidity in the system should help mitigate the impact of additional adverse external pressures.

26. All financial sector structural benchmarks—covering supervision, regulation, and development—were met. The CBA has continued to make progress in adjusting its supervisory and regulatory framework to new Basel III guidance, which targets banking sector improvements in absorbing shocks, risk management and governance, and transparency and disclosures. Recent progress has focused on capital requirements, where a new regulation was passed, and on assessment of systemically important domestic institutions, where a new identification methodology was elaborated (June 2014 structural benchmark). The CBA has made progress in other financial sector reforms. Following FSAP recommendations, draft amendments to the legislation of the Deposit Guarantee Fund (DGF) were submitted to parliament to shorten the pay-out period (September 2014 structural benchmark). The authorities also submitted to parliament legislation to facilitate foreign investor participation in securities markets (September 2014 structural benchmark).

27. Further reforms to strengthen and develop the financial sector are envisaged under the program. First, building on the findings of a policy paper on registration and execution of collateral (June 2014 structural benchmark), the program envisages preparation of legislation aimed at removing obstacles (September 2015 structural benchmark). Second, the CBA will continue to align its regulatory and supervisory framework with Basel III guidance, particularly regarding liquidity requirements and large exposures (see program issues section below). Finally, the program will aim at strengthening the CBA's dedollarization framework, although the exact measures are still to be specified (see Article IV discussion below).

D. Structural Issues

28. Progress on structural issues has been mixed. The "open skies" framework—allowing for easier entry into the civil aviation market—is in place and delivering increased flights at lower costs (April 2014 structural benchmark), and preparatory work for overhauling bankruptcy processes is in motion. However, three structural benchmarks—on competition, inspection, and regulatory reforms—did not advance as expected. This reflects the government change and changes in senior officials at key ministries and agencies rather than differences of views or changes in commitments. The draft inspection law was submitted to parliament in October (March 2014 structural benchmark). The authorities expect to submit a packet for streamlining regulations by March 2015 (June 2014 structural benchmark).

29. Further reforms agreed during discussions will aim at improving the business environment. The program envisages: (i) completion of the last phase of the Regulatory Guillotine program in order to lighten the regulatory burden on the private sector, and introduction of impact assessments for new regulations; (ii) strengthening reporting by companies to level the playing field and reduce the shadow economy; (iii) simplifying bankruptcy procedures in order to improve financial intermediation (June 2015 structural benchmark); (iv) further reforms in the energy sector to increase the efficiency and sustainability of the sector; and (v) strengthening institutional administration within the government, particularly regarding accounting and reporting (December 2014 structural benchmark). These reforms will help address critical weaknesses in Armenia's business environment and, as a result, support growth.

E. Program Issues

30. EU financing is now unlikely and has been removed from the program's macroeconomic framework. The Fund-supported program incorporated EU macro-financial assistance (MFA) of $100 million in 2014–15, based on consultations with the European Commission (EC). However, in June, the EC informed the authorities that it would not pursue preparation of the MFA, as it considered Armenia's financing needs to be moderate, rather than substantial, and conditions to be stable, rather than acute. The EC indicated that it would continue to monitor developments and stand ready to reconsider, if conditions deteriorate sharply. Accordingly, the EU financing has been removed from the program's macroeconomic framework. The projected path of CBA reserves is now lower than at the time of program approval, but reserves remain well above standard import and debt metrics. The program is fully financed going forward, with firm financing commitments.

31. Staff and the authorities propose to drop two existing structural benchmarks. The December 2014 benchmark on amendments to the large exposures regulation was based on guidance that has been superseded. CBA regulations are already broadly in line with new Basel III guidance in most areas, and the central bank is assessing whether modifications are needed. The authorities also propose to drop a June 2014 benchmark that calls for memoranda of understanding between the State Revenue Committee and the Competition Commission (among other agencies) on information exchange, as they consider that an existing decree provides sufficient basis for enhanced collaboration.

ARTICLE IV DISCUSSIONS: REDUCING VULNERABILITIES AND INCREASING POTENTIAL GROWTH

With recovery from the 2009 crisis established, Armenia faces a period of moderate medium-term growth, as sluggish investment in recent years, the absence of strong growth drivers, and a still-weak business climate constrain the capacity of the economy to generate sufficient jobs to stem emigration and reduce poverty. EEU membership could boost Armenia's traditional exports, but also increase links to Russia, which faces high geopolitical risks and weak medium-term growth prospects. Discussions focused on more decisive implementation of reforms, as anchored in the Fund-supported program, to reduce vulnerabilities and boost potential growth.

A. Reducing vulnerabilities

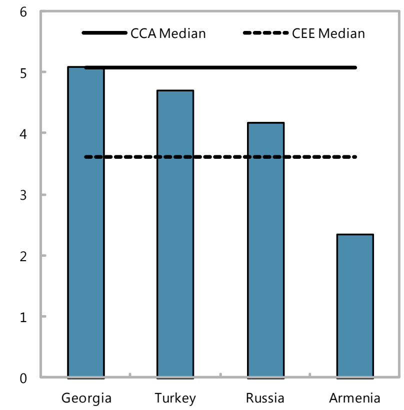
32. Reducing vulnerabilities remains a priority. The external current account deficit is expected to gradually decline from 8.0 percent of GDP in 2013 to 6½ percent of GDP over the medium term. Armenia's international reserve levels are adequate and meet international benchmark levels (Annex III). However, the trade deficit remains large, underscoring the need for enhanced competitiveness and additional exchange rate flexibility. While the public debt DSA suggests that public debt sustainability is not a major source of concern, external debt remains high at 82 percent of GDP at end-2013 and is sensitive to shocks (Annexes III and IV). In addition, the financial sector is highly dollarized.

33. The authorities are implementing a prudent macro-policy mix that aims to reduce vulnerabilities. Efforts aim at: achieving fiscal consolidation, while creating space for social and investment needs; allowing for more exchange rate flexibility and improving competitiveness through structural reforms; accumulating adequate levels of external reserves, reducing public debt, and increasing fiscal buffers; and fostering dedollarization.

Fiscal Policy

34. Further revenue measures and improvements in spending composition are needed to strengthen medium-term fiscal sustainability and boost potential growth. The public debt DSA suggests that posting fiscal deficits below 1.8 percent of GDP over the medium term will contribute to lower debt and enhanced fiscal sustainability. Meeting this target will require measures to increase revenues and improve spending composition. While the authorities have made progress in increasing revenues by almost 3 percentage points of GDP since 2009, the reduction in the underlying fiscal balance in 2013 and 2014 was achieved by underexecuting the capital budget, which is already low by regional standards. Staff stressed that persistent underexecution of the capital budget may lower potential growth. In this respect, high capital spending multipliers provide support for fully executing a well-designed and targeted public investment program (Selected Issues Paper). In addition, there is scope to improve the tax system and increase revenues by broadening the tax base.

Public Investment, 2013
(In Percent of GDP)



Source: National Authorities; and IMF staff calculations.
Note: CCA denotes Caucasus and Central Asia and CEE denotes Central and Eastern Europe.

Authorities' views

35. While the authorities agreed on the need to increase capital spending in a sustainable manner, they were concerned about the impact of higher tax revenues on growth and the business environment. The authorities agreed with staff on the importance of reducing capital under-execution and will prepare an analysis of under-execution and specific proposals to accelerate capital spending. They remain committed in principle to increasing revenues starting in 2016 to create fiscal space for priority social and investment spending, but they would like to limit the impact on the business environment and growth. In this respect, they stated that government support for the agricultural sector is significantly lower than in EU countries and that recent tax expenditure measures are limited in scope. Staff noted that additional EEU custom revenues of about 1½ percent of GDP per year could make a major difference supporting the build-up of a strong fiscal buffer, particularly in advance of debt repayment in 2020. The authorities noted that these revenues should be first secured and their sustainability assessed, along with the impact of higher EEU customs tariffs. Both sides agreed that the potentially higher revenues should not reduce the urgency for fiscal reforms.

Exchange Rate and International Reserves

36. A greater commitment to exchange rate flexibility will help facilitate external adjustment and enhance resilience to shocks. The CBA has become more active in the foreign exchange market, selling dollars when the dram has faced depreciation pressures, and purchasing

FX to stem the appreciation pressures.[3] Partly as a result of these interventions, the dram has experienced less volatility since mid-2013. However, the dram appreciated in real effective terms by close to 6 percent in 2013 and by a further 2 percent from end-2013 through August 2014. With thedepreciation of the Russian ruble against the dram between end-August to end-November, the real effective exchange rate appreciated further in that period. Staff estimates suggest the need for an adjustment of the dram in real terms over the medium term to bring the external current account balance to equilibrium levels (Annex V).[4] International reserves remain adequate based on standard import and debt metrics, as well as the IMF's composite metric. Reserves adequacy is also favorable in comparison with peer group countries (Annex III).

Authorities' views

37. The authorities reiterated their commitment to exchange rate flexibility, but questioned the robustness of staff's estimate of the valuation of the exchange rate. They pointed to the significant narrowing of the external current account deficit since 2012 as evidence that the dram may not be overvalued. Staff underscored that the recent improvement of the current account reflects to some extent developments in partner countries (higher earnings of Armenians living abroad), while the trade balance improved only marginally. The authorities placed less emphasis on the role of exchange rate adjustment and more on structural measures to improve competitiveness. Staff agreed that structural reforms to improve competitiveness would complement additional flexibility of the dram.

Financial Dollarization

38. Armenia's dedollarization strategy is broad and comprehensive, but progress has been slow, and there may be room for introducing additional measures. After spiking to over 70 percent in 2009 during the crisis, financial dollarization has remained at around 60 percent of total deposits and private sector credit in spite of a broad set of dedollarization measures. These have included macroeconomic stabilization (primarily fiscal consolidation) and micro-prudential and supervisory measures. The persistence of high dollarization is consistent with international experience, which suggests that dollarization is difficult to overcome. Staff noted that some dedollarization policies may have had the unintended consequence of increasing credit dollarization, at least temporarily, and argued that there is scope for deepening the dedollarization agenda, particularly through policies that help reduce external imbalances and increase FX liquidity requirements for bank borrowing and lending (Selected Issues Paper).

[3] Following a sequence of interventions in the foreign exchange market by the CBA in 2013, the de-facto exchange rate arrangement was reclassified from "floating" to "crawl-like" in March 2014.

[4] Staff estimates were calculated based on end-September data for the real effective exchange rates.

Authorities' views

39. The authorities were less enthusiastic regarding the scope for additional dedollarization measures, and were concerned with impact on financial intermediation. They argued that while further reforms could reduce dollarization, the impact of measures introduced in the past few years had been modest. The current strategy relies on high reserve requirements on FX deposits, held in dram, which staff observed may hinder intermediation and growth. Staff noted that dedollarization policies involve a trade-off with disintermediation, with some tradeoff justified by reduced vulnerabilities. The authorities and staff agreed to work on modifications to the dedollarization strategy. The CBA will prepare a policy paper assessing liquidity and reserve requirement regulations, including their levels and currency of denomination, impacts on interest rates, bank liquidity and buffers, and dollarization, compliance with new Basel III recommendations, and the scope for change (new March 2015 structural benchmark).

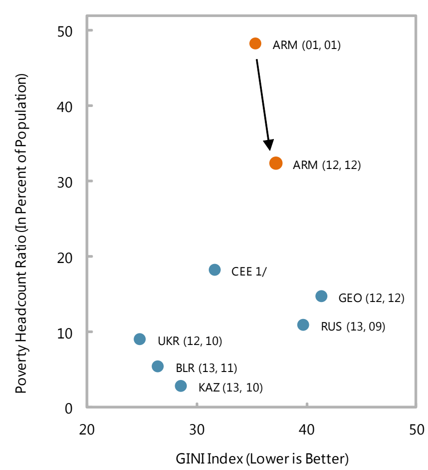
B. Increasing Potential Growth and Inclusiveness

40. Increasing potential growth is crucial for Armenia becoming a dynamic emerging market economy. Trend growth has averaged about 4.5 percent since 2010, but growth has been volatile, largely reflecting external developments, commodity price movements, and weather conditions. Staff and the authorities agreed that higher growth rates are necessary to further reduce poverty and inequality and discussed key constraints to growth (Box 3).

41. More efforts are needed to support job creation. Declines in unemployment and poverty since the 2009 crisis seem to mask long-term, underlying weaknesses in the labor market. The economy does not generate enough jobs to stem emigration, and without decisive policies to improve labor market conditions, the quality of education, and the business environment, Armenia will continue to export labor and rely on remittances to sustain consumption (Figure 1).

- Under the current baseline growth scenario, staff estimates that only 10 thousand jobs will be created per year. This is inadequate considering that 40 thousand Armenians have emigrated per year since 2009.

Poverty and Inequality



Source: National Authorities; and World Bank.
Note: Numbers in parentheses indicate observation dates, with the first number corresponding to poverty data and the second the GINI Index.
1/ Central and Eastern Europe, includes: BIH (11, 07), BGR (11, 11), HRV (11, 08), CZE (12, 11), EST (11, 11), MKD (10, 08), HUN (12, 11), LVA (12, 11), LTU (11, 11), POL (11, 11), ROM (11, 12), SRB (11, 10), SVK (11, 11), and SVN (11, 11).

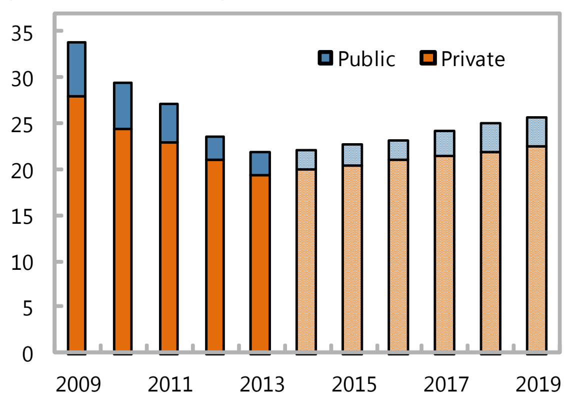
- Lack of managerial skills and inadequate education and training are often cited as structural problems that contribute to skills mismatches. Since 2006, Armenia has dropped from the first to third quartile in the WEF Global Competitiveness Index (GCI) for labor market efficiency. Similarly, Armenia ranks 120 out of 144 countries for availability of research and training services. There is a large degree of informality in labor markets, with roughly half of Armenians reportedly having jobs without formal contracts.

Box 3. Constraints to Potential Growth

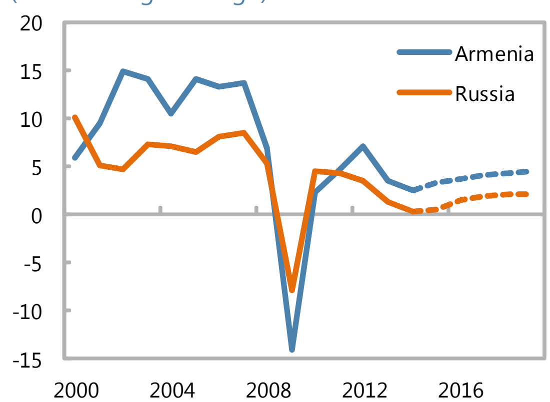
Since 2009, growth has returned to Armenia, but growth rates have been generally moderate and volatile. The authorities consider that growth could be higher—in the range of 6–7 percent underpinned by higher industrial and agriculture exports, IT services, and tourism. However, staff estimates suggest that potential growth over the medium term is about 4½ percent. There are several underlying constraints to potential growth:

- **Armenia has not developed an alternative to the pre-2009 construction-led growth model.** While growth prior to 2009 was driven by construction, post-crisis trend growth has been driven by agriculture, services, and mining. These sectors are held back by a relatively weak business environment. In 2013, Armenia fell 6 places in the WEF's GCI ratings.
- **Low private and public investment is having a negative impact on potential growth.** Investment declined from close to 30 percent of GDP in 2010 to about 22 percent in 2013, partly reflecting much lower construction. FDI has also been low since the 2009 crisis, due in part to conclusion of major privatization transactions, and is lower than in neighboring countries. Public investment has halved since 2010, and is below the regional median level. The World Bank estimates that investment of close to 30 percent of GDP is needed to support growth of 6–7 percent per year.
- **Outmigration and skills shortages constrain the contribution of human capital to medium-term growth**. Businesses have cited obstacles in expanding and improving competitiveness, due to skilled emigration and skills shortages.
- **Diminishing growth prospects in Russia will have an impact.** Armenia is closely linked to Russia via trade, remittances, financial, and investment channels, and growth in Russia is expected to remain restrained over the medium term. Still, Armenia's exports to Russia are small relative to size of the Russian economy (0.02 percent), so there is scope for growth through increased market penetration.

Investment
(In Percent of GDP)

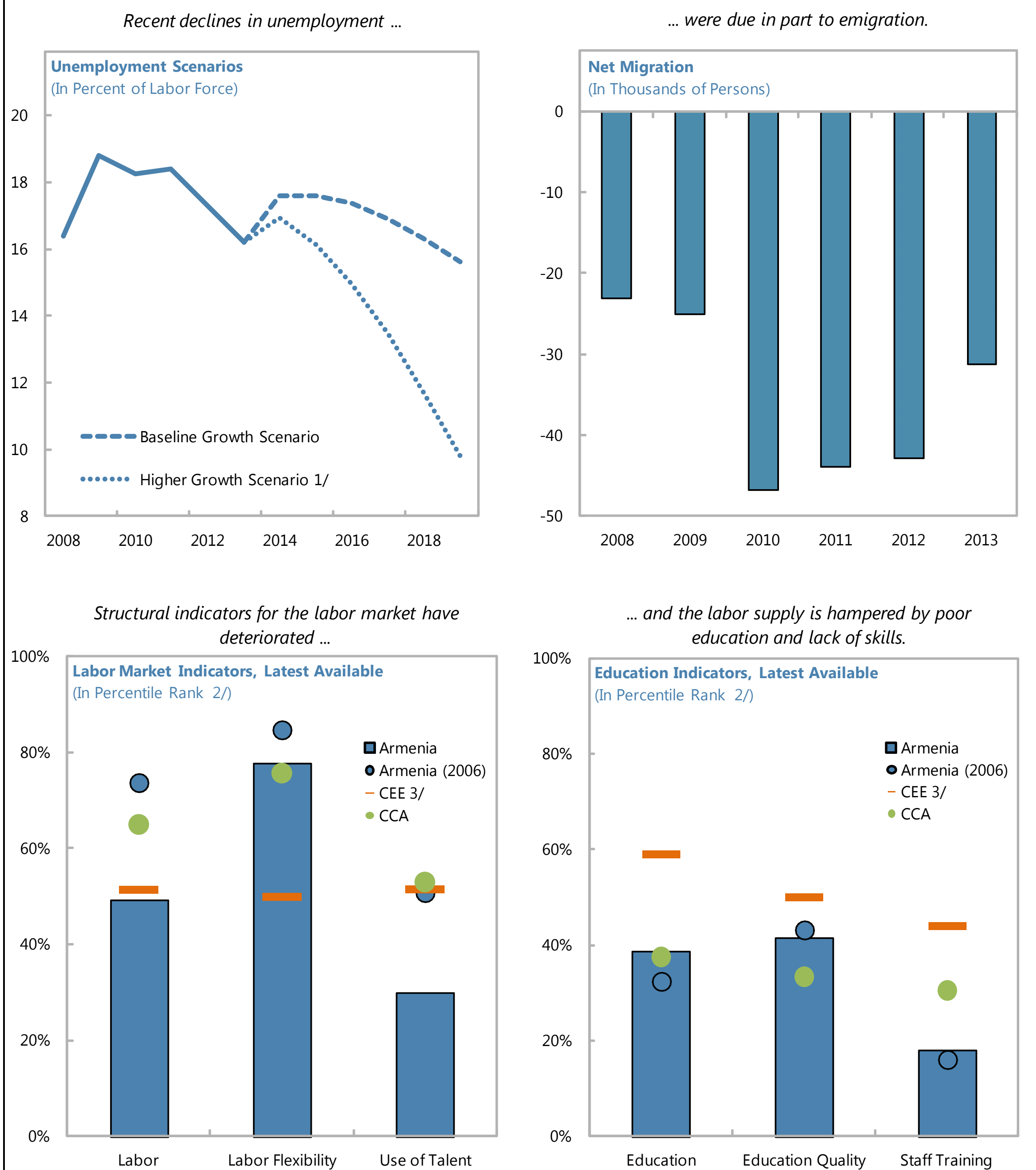


Growth Correlation with Russia
(In Percentage Change)



Source: National Authorities; and IMF staff estimates.

Figure 1. Armenia: Labor Market

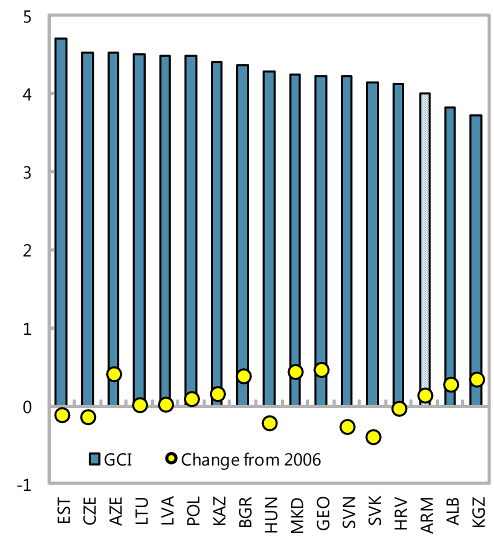


Sources: National Authorities, World Economic Forum; and IMF staff estimates and calculations.

1/ Growth scenario as outlined in the Armenian Development Strategy. Both scenarios assume an employment-growth elasticity of 0.2.
2/ Constructed from index score values. Higher values represent better outcomes.
3/ Central and Eastern Europe: includes Albania, Bulgaria, Croatia, Czech Republic, Hungary, Latvia, Lithuania, Macedonia, Poland, Serbia, Slovak Republic, and Slovenia.

42. To increase competitiveness, the authorities need to strengthen the business environment, foster domestic competition, and increase trade and financial integration. The 2013–25 Armenian Development Strategy (ADS) proposes a coherent growth strategy based on agriculture, IT, tourism, and industrial exports. But implementation of structural reforms has been uneven in recent years. This is reflected, for example, in Armenia's ranking in the WEF GCI, which lags relative to regional comparators and has not seen much improvement since its inception in 2006. In 2014, the "open skies" policy in civil aviation produced gains that extended to the tourism sector, which experienced a surge in activity. Staff noted that more needs to be done to improve other aspects of the business climate. While the authorities are now focusing on improving the collateral and bankruptcy regimes, measures to streamline inspections and cut unnecessary regulation have experienced delays. According to the World Bank, the current domestic market structure is characterized by excessive concentration, vertical integration, and ownership links. The authorities should step up efforts to limit anti-competitive behavior and foster a level playing field. Higher customs tariffs associated with EEU accession could pose risks in this area.

Global Competitiveness Index, 2014
(Score)



Source: World Economic Forum, Global Competitiveness Report.

43. Staff urged the authorities to make a concerted effort to ensure the pension reform's success. Staff and the authorities agreed that the pension reform was well designed and in line with international best practice. The reform will help address demographic trends, reduce old-age poverty, and provide a boost to capital market development by providing a pool of long-term savings to catalyze investment and growth. Staff expressed concerns that the phased, gradual implementation approach could lead to pressures to further delay or modify the reforms in three years—coinciding with the parliamentary and presidential elections cycle—and urged the authorities to overcome recent obstacles and ensure smooth implementation.

Authorities' views

44. The authorities emphasized that higher growth rates are achievable. They argued that steady implementation of the ADS and potential investments in mining, industry, transportation, agriculture, and services will help achieve strong growth rates. They pointed out that Armenia has experienced lower growth rates since the 2009 because of a combination of structural changes in the economy (less reliance on construction as the main growth driver) and cyclical factors in trading partners. While recognizing that FDI levels have been low in recent years, the authorities were confident that the EEU will catalyze new greenfield investments, including from foreign investors who see Armenia as a favorable platform for activities in Russia. In the authorities' view, lack of domestic competition is not a substantial impediment to growth, but rather reflects Armenia's small market size, closed borders, and high transportation costs, especially rail costs across Georgia. On pension reform, the authorities expressed their commitment to the reform's success and confidence that the gradual implementation approach will help overcome short-term obstacles and public mistrust.

Trade Integration

45. **EEU accession could provide a boost to Armenia's economy, although efforts are needed to ensure a smooth transition.** Accession is expected to provide enhanced access to the Russian market, as well as to Belarus and Kazakhstan, and the potential to increase exports substantially. The large number of exemptions to the EEU common external tariff during the eight-year transition period will reduce trade diversion. The enhanced status of Armenian workers in Russia is expected to ease risks of legal changes that could undermine remittances. The 2013 gas agreement has helped secure stable import prices through 2018. However, the authorities will need to put in place implementing regulations and modify legislation to complete entry to the EEU. As Armenia does not share a common border with any EEU member, the authorities will need to ensure a favorable transit regime with Georgia to benefit from the customs union, and Armenia's geographic location and high transport costs will continue to constrain exports.

46. **Further trade integration beyond the EEU, most notably with the EU, could bolster growth and reduce vulnerabilities**. The authorities are continuing efforts to improve ties with the broader regional and global economy, and they are discussing a framework for enhanced cooperation with the EU.

Authorities' views

47. **The authorities are optimistic about the impact of the EEU on the Armenian economy.** They underscored that the agricultural sector stands to gain from more secure access to the Russian market, and highlighted that Armenia offers an attractive platform for foreign investors seeking a foothold in the EEU. The authorities emphasized that the EEU membership will not end Armenia's push for more trade integration with the rest of the world. In particular, they highlighted their objective of continued strong cooperation with the EU.

Armenia and the EEU

(2013 figures, unless otherwise noted)

	Armenia	Belarus	Kazakhstan	Russia
Real GDP Growth	3.5	0.9	6.0	1.3
GDP in billions of U.S. dollars	10.4	71.7	231.9	2,096.8
GDP per capita (in current U.S. dollars)	3,173	7,577	13,509	14,591
Total Goods Trade in Percent of GDP 1/	51.4	111.9	57.4	41.3
Armenian Goods Exports to:				
In millions of U.S. dollars		9.0	8.0	352.4
In Percent of GDP		0.1	0.1	3.4
Armenian Goods Imports from:				
In millions of U.S. dollars		40.9	0.7	1,025.2
In Percent of GDP		0.4	0.0	9.8
2014 Global Competitiveness Rank 2/	85	…	50	53
2014 Doing Business Rank 3/	45	57	77	62
Population (in millions)	3.3	9.5	17.2	143.7

Sources: National Authorities; IMF WEO; IMF DOTS; World Bank; World Economic Forum; and IMF staff calculations.

1/ Total trade is defined as the sum of exports and imports of goods.

2/ Overall ranking out of 144 countries.

3/ Overall ranking out of 189 countries.These indicators should be interpreted with caution due to a limited number of respondents, a limited geographical coverage, and standardized assumptions on business constraints and information availability.

Energy Sector

48. **An integrated energy strategy is needed that is compatible with long-term fiscal sustainability, maximizes the role of the private sector, ensures transparency, and protects the poor.** Enjoying few natural resources, Armenia has developed an energy sector that balances consumption of gas from Russia, aging nuclear and hydro facilities, and a gas-for-electricity barter deal with Iran. Going forward, there are several critical long-term issues that need to be addressed:

- **Securing gas supply at affordable prices.** Last year's agreement on a five-year gas supply arrangement with Russia avoided a major price increase, but continued a series of debt-equity swaps. The gas network and other energy assets have now been fully transferred. The authorities need to be prepared for the end of the agreement in 2018 and possible price adjustments.

- **Extending the life of the Metsamor nuclear reactor, and securing power generation capacity once Metsamor's life expires.** Metsamor provides about 25 percent of Armenia's electric power. The reactor needs work to extend its life for another 10 years at a cost of up to 3 percent of GDP, for which the authorities have secured concessional financing from Russia. Construction of a new reactor would cost 50 percent of GDP, and staff urged the authorities to work with the World Bank to consider new generation capacity in a least cost planning framework, compatible with debt sustainability, and involving the private sector to reduce risks.

- **Ensuring fiscal sustainability and transparency of the power sector, while protecting the poor.** Low tariffs have contributed to short-term debts and limited maintenance and investment. To strengthen financial viability, the authorities raised tariffs by 10 percent in July, which affected the poor. A World Bank study shows that the poor are particularly vulnerable to tariff hikes and suggests mitigating impacts through the Family Benefits Program.

Authorities' views

49. A key priority of the authorities is to achieve greater energy security. While underscoring their commitment to private sector-led investment and least cost planning, they expressed concern on greater reliance on imported natural gas and interest in building a new nuclear power plant, if financing can be arranged. With the help of the World Bank, the authorities are preparing a strategy to lay out the long-term structure of energy sector, including the generation mix, tariff alignment, and protection of the poor (December 2014 structural benchmark). The authorities agreed on the need for transparency of operations in the energy sector, including asset sales.

STAFF APPRAISAL

50. Armenia faces a period of slower growth unless decisive actions are taken. Sound macroeconomic policies since the crisis have helped sustain domestic and external stability in a highly uncertain context. However, going forward, projected growth rates will not be sufficient to generate sufficient jobs and stem emigration. Sluggish investment in recent years, a still-weak business climate, and the absence of strong growth drivers constrain the capacity of the economy to generate sufficient jobs to stem emigration and reduce poverty. EEU membership could help increase exports to the large EEU market, but medium-term growth prospects for Russia are modest as well. Therefore, more decisive implementation of reforms, as anchored in the Fund-supported program, is needed to reduce vulnerabilities and boost potential growth.

51. Performance has moderated due to both domestic and regional factors. Growth is expected to slow to 2.6 percent of GDP in 2014 from 3.5 percent in 2013, while inflation has fallen below the CBA's target range. Growth of exports and remittances has weakened, but slower growth of imports meant that the FX market remained relatively stable through much of 2014, although pressures emerged in November-December. The banking sector remains well capitalized and liquid, but weakening conditions have been associated with an increase in NPLs. On a brighter note, while the slowdown has been broadly based, agriculture and tourism are benefitting from investment and structural reforms and are growing at a healthy pace.

52. Vulnerabilities remain high. While international reserves are adequate, the consolidation of the external current account deficit has slowed in 2014 due to lower-than-expected exports and remittances. Staff estimates that an adjustment of the real exchange rate over the medium term would help facilitate further external adjustment and improve competitiveness. However, the banking system is still highly dollarized, which could imply pressures on bank balance sheets if a disorderly external adjustment occurs.

53. **Armenia faces a high degree of risk.** Growth is projected to pick up to 3.3 percent of GDP in 2015, in the context of supportive macroeconomic policies—notably, monetary policy easing in 2013–14 and stronger capital budget execution. However, the short-term outlook is subject to a high degree of uncertainty, especially given regional geopolitical developments and tensions. An intensification of these would lead to further negative spillovers to Armenia's economy.

54. **The authorities should create fiscal space to boost social and investment spending over the medium term.** Efforts should focus on revenues, as underexecution of capital spending has had a negative impact on growth, although staff commends the authorities for not diverting spending into low pay-off areas and welcomes efforts to assess and address reasons for underspending. With lower growth, available financing, and few risks to inflation or sustainability, staff sees merit in a higher deficit in the 2015 budget, with increased spending going to capital outlays. Staff has long pressed for higher tax revenues to support higher social spending and growth-enhancing infrastructure projects. Tax measures should also aim to improve the tax system by eliminating gaps and ensuring greater equity. The upcoming formulation of a comprehensive tax code is an opportunity to broaden the tax base and rationalize exemptions and tax expenditures. EEU common customs pool revenues could provide a further opportunity to build fiscal buffers through savings. However, the revenues must be secured and in any event are transitory, as EEU tariffs are expected to decline over the medium-term. Staff commends the authorities' cautious approach in evaluating the sustainability of these additional revenues, prior to incorporating them in the budget framework.

55. **Further strengthening of monetary and financial sector policies should remain a priority, building on recent progress.** The CBA's IFT framework has served Armenia well and remains an appropriate anchor for monetary policy. Nonetheless, the effectiveness of the IFT framework should be further strengthened by reducing dollarization, improving monetary policy instruments, and enhancing the CBA's communication and modeling capabilities. Similarly, the CBA has made noteworthy progress in implementing FSAP recommendations and Basel III guidance, while strengthening financial sector regulation and resilience. However, further work is needed to incorporate new guidance on large exposures and liquidity requirements, as well as to revisit the dedollarization strategy, and to foster better financial intermediation via improved legislation on registration and execution of collateral.

56. **Exchange rate policy should support external adjustment.** The current situation poses challenges to exchange rate policy, notably the recent depreciation of the Russian ruble, uncertainty surrounding regional geopolitical events, and pressures to calm what are perceived as disorderly conditions in a thin market. While limited interventions to mitigate disorderly conditions are warranted, pressures that reflect economic fundamentals should be accommodated. Enhanced central bank communications will be important to provide clarity and guidance. Maintaining robust buffers, together with flexibility of the dram, should support further reduction of the external current account deficit to its sustainable level.

57. The authorities should implement ambitious reforms to bolster potential growth and promote inclusion. The successful implementation of "open skies" in civil aviation is a good example of how bold policy decisions can have positive results in a relatively short period of time. Recent delays in implementation of reforms in the competition and regulatory areas, while relatively minor, should be reversed. The reform agenda should be implemented decisively to improve Armenia's capacity to grow, create jobs, and reduce poverty. Business environment reforms should overcome long-standing concerns about uneven competition, unnecessary regulation, high costs, and skills shortages and mismatches. The authorities should move quickly to bolster the pension reform and ensure its long-run success. Reforms in the energy sector should be compatible with long-term fiscal sustainability, involve the private sector, and be transparent and cost-effective, while mitigating the impact on the poor. Finally, the authorities should leverage EEU membership to increase exports, improve standards, enhance domestic competition, and invest in infrastructure. They should also pursue deeper integration beyond the EEU to enhance growth prospects and reduce vulnerabilities.

58. Policies under the program remain on track. All PCs and most ITs were met. Competition and regulatory reforms have advanced at a slower-than-expected pace, causing delays in meeting structural benchmarks, mainly due to the government change in mid-2014 rather than a change in policy direction. Going forward, the program will accommodate a modest fiscal stimulus in 2015, while maintaining macroeconomic stability and fiscal sustainability. The NIR targets will help maintain strong buffers. Structural benchmarks for the remainder of 2014 and first half of 2015 are focused on core areas, including tax administration, PFM, financial sector development, and central bank operations.

59. Risks to the program are significant, but manageable, and Armenia's repayment capacity remains robust. While the short-term outlook is subject to a high degree of uncertainty, and Armenia is vulnerable to geopolitical developments, the authorities have a strong track record of sound macroeconomic policies and program implementation. A low fiscal deficit, moderate public debt, broadly adequate reserves, and growth-supporting reforms embedded in the program reinforce this assessment. Staff supports the authorities' request for the equivalent of SDR 11.74 million to become available with the completion of the First Review.

60. Staff recommends that the next Article IV Consultations be concluded in accordance with the September 28, 2010 Decision on Article IV Consultation Cycles

Table 1. Armenia: Selected Economic and Financial Indicators, 2009–16

	2009	2010	2011	2012	2013		2014		2015	2016
	Act.	Act.	Act.	Act.	EBS/14/18	Act.	EBS/14/18	Prel.	Proj.	Proj.
National income and prices:										
Real GDP (percent change)	-14.1	2.2	4.7	7.1	3.2	3.5	4.3	2.6	3.3	3.7
Gross domestic product (in billions of drams)	3,142	3,460	3,778	4,001	4,290	4,273	4,714	4,528	4,867	5,248
Gross domestic product (in millions of U.S. dollars)	8,648	9,260	10,142	9,958	10,547	10,431	11,216	10,969	11,278	11,559
Gross domestic product per capita (in U.S. dollars)	2,912	3,128	3,426	3,353	3,208	3,500	3,405	3,674	3,771	3,865
CPI (period average; percent change)	3.5	7.3	7.7	2.5	5.8	5.8	5.0	2.2	3.8	4.0
CPI (end of period; percent change)	6.7	8.5	4.7	3.2	5.6	5.6	4.0	2.9	3.6	4.0
GDP deflator (percent change)	2.6	7.8	4.3	-1.2	4.0	3.2	5.4	3.3	4.0	4.0
Poverty rate (in percent)	34.1	35.8	35.0	32.4	...	...	...	...	...	...
Investment and saving (in percent of GDP)										
Investment	33.8	29.4	27.0	23.4	23.9	21.8	24.4	22.0	22.6	23.1
National savings	16.2	15.2	15.9	12.4	15.5	13.7	17.3	14.0	15.3	16.0
Money and credit (end of period)										
Reserve money (percent change)	13.8	-0.8	32.3	1.9	29.9	29.9	9.0	3.1	9.3	...
Broad money (percent change)	16.4	10.6	23.6	19.6	15.2	15.2	11.3	11.5	11.0	...
Velocity of broad money (end of period)	3.8	3.8	3.4	3.0	2.8	2.8	...	...	...	...
Commercial banks' 3-month lending rate (in percent)	19.1	17.7	20.7	18.5	18.3	18.8	...	...	...	...
Central government operations (in percent of GDP)										
Revenue and grants	20.9	21.2	22.1	22.3	23.3	23.7	23.5	23.6	23.8	23.9
Of which: tax revenue 1/	16.1	16.4	16.7	18.1	22.5	22.8	22.7	22.7	22.5	22.8
Expenditure 2/	28.6	26.2	25.0	23.9	25.8	25.4	25.9	25.1	26.1	25.9
Overall balance on a cash basis	-7.9	-4.6	-2.8	-1.5	-2.5	-1.0	-2.3	-1.5	-2.3	-2.0
Public and publicly-guaranteed debt (in percent of GDP)	40.2	39.7	42.0	44.0	45.4	43.4	45.2	43.9	44.8	45.5
Share of foreign currency debt (in percent)	88.9	87.4	86.8	85.9	84.8	85.2	84.4	85.3	84.9	85.3
External sector										
Exports of goods and services (in millions of U.S. dollars)	1,366	1,976	2,468	2,554	2,583	2,734	2,757	2,914	3,089	3,243
Imports of goods and services (in millions of U.S. dollars)	-3,827	-4,359	-4,708	-4,814	-5,022	-4,938	-5,155	-5,050	-5,199	-5,388
Exports of goods and services (percent change)	-22.4	44.6	24.9	3.5	5.8	7.0	6.8	6.6	6.0	5.0
Imports of goods and services (percent change)	-23.1	13.9	8.0	2.2	2.3	2.6	2.6	2.3	3.0	3.6
Current account balance (in percent of GDP)	-17.6	-14.2	-11.1	-11.1	-8.4	-8.0	-7.2	-8.1	-7.3	-7.1
FDI (net, in millions of U.S. dollars) 3/	710	521	437	473	549	507	413	361	372	406
Debt service ratio (in percent of exports of goods and services) 4/	5.3	4.6	4.1	9.4	34.1	32.3	10.4	9.8	5.9	6.4
Gross international reserves (in millions of U.S. dollars)	2,004	1,866	1,869	1,799	2,253	2,253	2,193	2,025	1,989	2,075
Import cover 5/	5.5	4.8	4.7	4.4	5.2	5.4	4.9	4.7	4.4	4.5
Nominal effective exchange rate (percent change) 6/	-8.4	-2.6	-2.8	-2.4	...	-0.9	...	...	...	...
Real effective exchange rate (percent change) 6/	-7.5	1.3	0.1	-3.3	...	1.2	...	...	...	...
End-of-period exchange rate (dram per U.S. dollar)	378	363	386	403.6	405.6	405.6	...	...	...	...
Average exchange rate (dram per U.S. dollar)	363	374	373	401.8	406.8	409.6	...	...	...	...
Memorandum item:										
Population (in millions)	3.0	3.0	3.0	3.0	...	3.0	...	...	...	...

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

1/ From 2013, tax revenue includes social contribution.

2/ In 2013 includes 1.5 percent of GDP related to the acquisition by Gazprom from the government of 20 percent of the shares of ArmRusGazprom, and the transfer (expenditure) of the same amount from the government to ArmRusGazprom to liquidate liabilities. A surplus of 0.6 percent of GDP is obtained when this transaction is excluded.

3/ In 2013, a credit for $155 million is registered in FDI to reflect the acquisition by Gazprom of 20 percent of the shares of ArmRusGazprom, while an offseting debit is registered in other capital (net) to reflect the corresponding reduction in liabilities of the latter with the former.

4/ Based on public and publicly-guaranteed debt.

5/ Gross international reserves in months of next year's imports of goods and services, including the SDR holdings.

6/ A positive sign denotes appreciation.

Table 2. Armenia: Balance of Payments, 2009–19

	2009 Act.	2010 Act.	2011 Act.	2012 Act.	2013 Prel.	2014 EBS/14/18	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.
Current account	-1,520	-1,318	-1,124	-1,104	-839	-802	-884	-821	-819	-829	-836	-882
Trade balance	-2,090	-2,066	-2,110	-2,112	-2,092	-2060	-2,163	-2,164	-2,227	-2,290	-2,356	-2,437
Exports, fob	774	1,197	1,432	1,516	1,636	1830	1,640	1,752	1,839	1,923	2,021	2,126
Imports, fob 1/	-2,864	-3,263	-3,541	-3,628	-3,728	-3890	-3,804	-3,915	-4,066	-4,213	-4,378	-4,563
Services (net)	-371	-317	-130	-148	-112	-337	27	54	82	99	104	109
Credits	593	778	1,036	1,039	1,098	927	1,273	1,337	1,404	1,474	1,548	1,625
Debits	-964	-1,096	-1,167	-1,186	-1,210	-1265	-1,246	-1,283	-1,322	-1,375	-1,444	-1,516
Income (net) 2/	359	458	360	423	541	790	472	487	500	508	515	505
Transfers (net)	582	607	757	733	825	805	780	802	826	855	901	941
Private	498	513	584	625	704	743	718	754	795	839	885	925
Official	84	94	172	108	121	62	62	48	31	16	16	16
Capital and financial account	1,683	1,117	1,008	840	1,622	799	764	774	909	945	1,005	996
Capital transfers (net)	88	99	95	108	76	73	68	80	76	71	70	71
Foreign direct investment (net) 2/	710	521	437	473	507	413	361	372	406	423	441	472
Portfolio investment (net)	-4	18	-8	1	-10	-52	-1	-10	-40	-60	-60	-60
Public sector borrowing (net)	886	168	152	225	382	212	201	143	236	281	325	264
Disbursements	907	193	180	255	914	251	237	199	305	365	421	453
Amortization	-21	-25	-28	-30	-532	-39	-36	-56	-69	-84	-97	-189
Other capital (net)	3	310	332	34	667	153	135	188	230	230	230	249
Errors and omissions	-7	-99	28	246	0	0	0	0	0	0	0	0
Overall balance	155	-298	-88	-17	643	-3	-120	-48	90	116	169	114
Financing	-155	298	88	17	-643	-90	102	11	-126	-134	-169	-114
Gross international reserves (increase: -)	-597	138	-4	70	-454	60	228	36	-87	-78	-99	-30
Use of Fund credit, net	442	160	92	-53	-190	-150	-126	-25	-39	-57	-71	-84
Purchases/disbursements	466	181	114	103	83	…	18	…	…	… …	…	
Repurchases/repayments	-23	-22	-23	-155	-273	-150	-144	-25	-39	-57	-71	-84
Financing gap	0	0	0	0	0	93	18	36	36	18	0	0
IMF EFF	0	0	0	0	0	36	18	36	36	18	…	…
Other 3/	0	0	0	0	0	57	0	0	0	0	…	…
Memorandum items:												
Current account (in percent of GDP)	-17.6	-14.2	-11.1	-11.1	-8.0	-7.2	-8.1	-7.3	-7.1	-6.9	-6.6	-6.5
Trade balance (in percent of GDP)	-24.2	-22.3	-20.8	-21.2	-20.1	-18.4	-19.7	-19.2	-19.3	-19.0	-19	-18
Gross international reserves (end of period)	2,004	1,866	1,869	1,799	2,253	2,193	2,025	1,989	2,075	2,153	2,251	2,281
In months of next year's imports	5.5	4.8	4.7	4.4	5.4	4.9	4.7	4.4	4.5	4.4	4.4	4.5
Merchandise export growth, percent change	-30.1	54.8	19.5	5.9	7.9	6.9	0.3	6.8	5.0	4.5	5.1	5.2
Merchandise import growth, percent change	-27.0	14.0	8.5	2.4	2.8	1.9	2.0	2.9	3.8	3.6	3.9	4.2
Non-gas merchandise imports growth, percent change	-25.7	11.2	7.3	0.5	5.7	7.6	4.2	2.5	3.8	3.7	4.0	
Nominal external debt	4,878	6,145	7,252	7,456	8,551	8,640	8,840	9,229	9,645	10,038	10,496	10,927
o.w. public external debt	2,967	3,299	3,568	3,738	3,899	4,166	4,054	4,255	4,440	4,603	4,832	5,014
Nominal external debt stock (in percent of GDP)	56.4	66.4	71.5	74.9	82.0	77.0	80.6	81.8	83.4	83.5	83.0	81.1
External public debt-to-exports ratio (in percent)	217.1	167.0	144.6	146.4	142.7	151.1	139.1	137.7	136.9	135.5	135.4	133.6
External public debt service (in percent of exports)	5.3	4.6	4.1	9.4	32.3	10.3	9.8	5.9	6.4	7.0	8.0	10.8

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

1/ From 2014 on, imports of gas are calculated at the (lower) price of $189 per thousand cubic meter. In addition to reducing projected gas imports in 2014, this change also implies lower FDI (lower intercompany lending between parent and subsidiary)

2/ In 2013, a credit for $155 million is registered in FDI to reflect the acquisition by Gazprom of 20 percent of the shares of ArmRusGazprom, while an offseting debit is registered in other capital (net) to reflect the corresponding reduction in liabilities of the latter with the former.

3/ Prospective EU financing. The authorities had requested about $100 million in Macro Financial Assistance from the EU.

Table 3. Armenia: Monetary Accounts, 2009–15

	2009	2010	2011	2012	2013	2014				2015			
	Act.	Act.	Act.	Act.	Act.	Act.	Act.	Act.	Proj. 1/	Proj. 1/			
					Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.
Central Bank of Armenia													
Net foreign assets	515.4	423.8	465.0	467.2	655.8	553.8	472.3	440.3	585.9	501.3	414.0	394.1	536.8
Net international reserves	595.8	500.6	521.2	538.7	768.7	672.9	590.9	556.1	702.8	626.8	546.0	528.9	675.8
Other	-80.5	-76.9	-56.3	-71.5	-112.9	-119.1	-118.6	-115.7	-116.9	-125.5	-132.0	-134.9	-138.9
Net domestic assets	-3.7	83.8	206.3	216.6	232.2	225.6	241.0	278.5	329.8	323.9	367.7	401.6	463.7
Claims on general government (net)	-152.5	-95.6	-66.7	-93.3	-175.9	-156.4	-154.3	-133.6	-121.1	-123.8	-129.6	-143.5	-82.6
Of which: central government (net)	-138.8	-76.7	-54.2	-80.5	-160.1	-131.4	-126.3	-105.5	-93.1	-95.7	-101.5	-115.5	-54.6
Claims on banks	66.2	57.4	137.0	152.9	174.0	141.0	142.5	144.7	165.8	187.0	208.2	229.4	250.6
CBA bills 2/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other items (net)	82.6	122.0	136.0	157.0	234.1	241.0	252.8	267.4	285.1	260.7	289.0	315.8	295.8
Reserve money	511.7	507.6	671.3	683.8	888.1	779.4	713.3	718.8	915.7	825.2	781.6	795.7	1,000.5
Currency issue	320.7	348.2	398.8	440.1	446.8	382.5	403.3	416.6	459.7	397.3	422.2	439.7	488.5
Deposits	191.0	159.4	272.5	243.7	441.2	396.9	310.0	302.2	456.0	427.9	359.4	356.0	512.0
Deposits in drams	42.3	61.4	169.9	157.7	202.4	187.5	176.2	181.2	193.7	196.7	201.8	205.0	217.6
Deposits in foreign currency	148.7	98.0	102.6	86.0	238.8	209.4	133.8	121.0	262.3	231.2	157.6	150.9	294.4
Banking system													
Net foreign assets	379.1	193.8	31.9	-124.2	-58.8	-137.1	-156.6	-227.6	-227.9	-294.2	-323.6	-350.3	-353.4
Net domestic assets	444.9	717.4	1,094.7	1,471.2	1,610.9	1,681.1	1,756.1	1,838.6	1,958.4	1,991.5	2,079.5	2,145.2	2,274.4
Claims on government (net)	-125.3	-50.9	-1.8	17.0	-9.6	5.3	7.7	30.6	57.7	63.1	65.3	59.3	128.2
Of which: claims on central government (net)	-111.6	-32.0	10.7	29.8	6.1	30.3	35.7	58.7	85.7	91.1	93.3	87.3	156.2
Claims on rest of the economy	728.3	922.9	1,251.2	1,587.9	1,781.7	1,817.6	1,876.3	1,919.5	2,007.3	2,025.0	2,105.8	2,172.5	2,227.8
Other items (net)	-158.0	-154.5	-154.7	-133.7	-161.2	-141.8	-127.9	-111.6	-106.6	-96.6	-91.6	-86.6	-81.6
Broad money	824.0	911.2	1,126.6	1,347.0	1,552.1	1,544.0	1,599.4	1,611.0	1,730.5	1,697.3	1,755.9	1,794.9	1,921.0
Currency in circulation	282.7	304.5	349.6	384.3	384.9	329.2	348.3	361.2	394.5	340.7	364.1	381.1	420.2
Deposits	541.3	606.7	777.0	962.7	1,167.2	1,214.8	1,251.1	1,249.8	1,335.9	1,356.6	1,391.8	1,413.8	1,500.8
Domestic currency	170.7	216.7	306.5	355.9	470.2	471.7	501.6	521.0	582.1	577.8	603.1	615.0	677.0
Foreign currency	370.6	389.9	470.5	606.8	697.0	743.2	749.5	728.8	753.8	778.8	788.8	798.8	823.8
Memorandum items:													
Exchange rate (in drams per U.S. dollar, end of period)	377.9	363.4	385.8	403.6	405.6	413.3	407.3	407.6	...	...	...	...	...
NIR, program definition, at program exchange rates (USD millions)	1,019	892	794	830	1,068	912	936	933	979	896	884	872	918
12-month change in reserve money (in percent)	13.8	-0.8	32.3	1.9	29.9	20.8	8.2	-0.5	3.1	5.9	9.6	10.7	9.3
12-month change in broad money (in percent)	16.4	10.6	23.6	19.6	15.2	13.3	15.3	10.2	11.5	9.9	9.8	11.4	11.0
12-month change in private sector credit (in percent)	14.0	26.7	35.6	26.9	12.2	12.2	13.4	13.6	12.7	11.4	12.2	13.2	11.0
Velocity of broad money (end of period)	3.8	3.8	3.4	3.0	2.8	2.8	2.7	2.8	2.6	2.7	2.7	2.7	2.5
Money multiplier	1.6	1.8	1.7	2.0	1.7	2.0	2.2	2.2	1.9	2.1	2.2	2.3	1.9
Dollarization in bank deposits 3/	68.5	64.3	60.6	63.0	59.7	61.2	59.9	58.3	56.4	57.4	56.7	56.5	54.9
Dollarization in broad money 4/	45.0	42.8	41.8	45.0	44.9	48.1	46.9	45.2	43.6	45.9	44.9	44.5	42.9
Currency in circulation in percent of deposits	52.2	50.2	45.0	39.9	33.0	27.1	27.8	28.9	29.5	25.1	26.2	27.0	28.0
Stock of foreign currency deposits (in millions of U.S. dollars) 1/	980.8	1,012.9	1,222.2	1,576.1	1,700.1	1,812.6	1,828.0	1,777.5	1,838.5	1,899.5	1,923.9	1,948.3	2,009.3
Banking system financing of the central government (cumulative) 5/	-86.3	79.6	42.7	19.1	-23.7	24.2	29.6	52.5	79.6	5.4	7.6	1.6	70.5
Banks' deposits at CBA to deposits in banking system (in percent)	35.3	26.3	35.1	25.3	37.8	32.7	24.8	24.2	34.1	31.5	25.8	25.2	34.1

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

1/ At the program exchange rate.

2/ Following the agreement between the CBA and the Ministry of Finance, the issue of new CBA bills was terminated in 2008.

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

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

5/ Discrepancy between the fiscal and monetary accounts in 2009Q3-Q4, 2010, and 2011 is explained by government lending to the economy through commercial banks.

Table 4. Armenia: Financial Soundness Indicators for the Banking Sector, 2009–14

	2009	2010	2011	2012	2013	2014		
	Dec.	Dec.	Dec.	Dec.	Dec.	Mar.	Jun.	Sep
Capital adequacy								
Total regulatory capital to risk-weighted assets	28.3	22.2	18.3	16.8	16.7	16.4	16.2	16.3
Capital (net worth) to assets	21.0	20.4	17.2	15.9	15.3	15.7	16.0	16.1
Asset composition								
Sectoral distribution of loans (in billions of drams)								
Industry (excluding energy sector)	115.3	156.7	178.6	250.3	222.7	218.0	239.5	236.3
Energy sector	31.7	47.2	77.5	74.9	95.4	95.1	92.1	92.9
Agriculture	44.2	52.4	80.7	101.4	118.2	129.6	137.3	135.8
Construction	54.1	74.8	96.0	100.1	109.4	113.3	109.9	114.8
Transport and communication	15.4	25.7	50.9	48.3	54.0	50.0	49.0	46.4
Trade/commerce	145.5	184.8	275.7	321.0	352.3	344.6	343.6	357.9
Consumer credits					365.6	390.7	403.0	415.2
Mortgage loans					143.2	145.1	150.8	154.6
Sectoral distribution of loans to total loans (percent of total)								
Industry (excluding energy sector)	16.5	17.7	14.0	15.5	12.2	11.6	12.5	11.9
Energy sector	4.5	5.3	6.1	4.6	5.2	5.1	4.8	4.7
Agriculture	6.3	5.9	6.3	6.3	6.5	6.9	7.1	6.8
Construction	7.7	8.4	7.5	6.2	6.0	6.0	5.7	5.8
Transport and communication	2.2	2.9	4.0	3.0	3.0	2.7	2.6	2.3
Trade/commerce	20.8	20.9	21.6	19.9	19.3	18.4	17.9	18.0
Consumer credits					20.1	20.8	21.0	20.9
Mortgage loans					7.9	7.7	7.8	7.8
Foreign exchange loans to total loans	54.0	58.0	61.2	64.7	63.8	64.2	64.1	63.8
Asset quality								
Nonperforming loans (in billions of drams)	36.3	28.6	43.7	58.4	79.7	108.5	113.2	125.9
Watch (up to 90 days past due)	14.9	11.3	18.8	26.5	41.4	66.4	58.4	63.0
Substandard (91-180 days past due)	10.1	11.3	15.6	19.0	19.5	27.6	36.6	36.0
Doubtful (181-270 days past due)	11.3	6.1	9.3	12.8	18.8	14.4	18.3	26.9
Loss (>270 days past due)	26.2	34.6	45.2	77.4	108.0	119.9	124.4	136.8
Nonperforming loans to gross loans	4.8	3.1	3.4	3.6	4.5	5.9	6.0	6.5
Provisions to nonperforming loans	46.7	56.7	55.4	55.1	49.5	39.4	41.0	41.5
Spread between highest and lowest rates of interbank borrowing in AMD	2.5	4.0	1.5	1.0	2.2	0.5	1.2	0.3
Spread between highest and lowest rates of interbank borrowing in foreign currency	3.0	5.0	5.3	9.5	6.3	0.5	1.0	1.8
Earnings and profitability								
ROA (profits to period average assets)	0.7	2.2	1.9	1.1	1.4	1.1	1.3	1.1
ROE (profits to period average equity)	3.4	10.2	9.8	11.5	9.2	6.8	8.0	7.2
Interest margin to gross income	42.2	43.8	42.0	40.6	37.1	36.2	36.5	36.9
Interest income to gross income	78.3	77.0	78.3	80.0	79.1	78.4	78.5	78.5
Noninterest expenses to gross income	40.7	39.2	36.4	34.2	33.0	32.1	32.4	32.1
Liquidity								
Liquid assets to total assets	34.2	29.5	27.9	25.6	29.1	29.6	27.5	26.7
Liquid assets to total short-term liabilities	142.1	131.5	120.8	126.1	142.3	145.6	134.1	133.2
Customer deposits to total (non-interbank) loans	96.4	87.2	91.5	92.6	105.6	105.5	101.8	99.3
Foreign exchange liabilities to total liabilities	67.6	64.9	63.3	64.9	64.1	65.9	64.6	63.6
Sensitivity to market risk								
Gross open positions in foreign exchange to capital	3.4	2.9	3.0	3.8	3.7	2.6	2.9	2.8
Net open position in FX to capital	1.9	-0.2	-0.9	1.6	0.1	0.3	0.7	-0.8

Source: Central Bank of Armenia.

Table 5. Armenia: Central Government Operations, 2009–16

(In percent of GDP)

	2009	2010	2011	2012	2013	2014		2015		2016
	Act.	Act.	Act.	Act.	Act. 2/	EBS/14/18	Proj.	Budg.	Proj.	Proj.
Total revenue and grants	655.6	734.3	834.5	892.6	1011.5	1108.1	1068.5	1155.7	1157.0	1252.2
Total revenue	634.4	706.1	776.6	875.7	1000.7	1088.2	1057.7	1129.6	1129.6	1236.8
Tax revenues	505.9	568.9	629.6	723.4	974.5	1069.9	1025.9		1095.9	1197.6
VAT	239.2	278.1	301.5	340.4	371.7	413.1	398.4		425.7	464.4
Profits, simplified and presumptive	104.9	99.7	143.8	164.5	167.6	197.2	168.5		150.2	162.1
Personal income tax	60.2	73.9	81.2	91.7	274.8	287.1	284.5		303.2	332.3
Customs duties	25.1	29.4	34.7	41.3	44.3	51.8	46.9		52.9	57.0
Other	76.5	87.8	68.4	85.6	116.1	120.7	127.6		163.9	181.8
Social contributions 1/	102.9	105.3	123.4	129.1	17.9	0.0	4.0		6.6	10.0
Other revenue	25.6	31.8	23.6	23.2	26.2	18.3	27.8		27.1	29.2
Grants	21.2	28.2	57.9	16.9	10.8	19.9	10.8	26.2	27.5	15.3
Budget support	10.3	5.4	28.4	10.5	6.3	7.0	0.0			
Project grants	9.0	22.8	29.5	6.4	4.5	12.9	10.8			
Total expenditure	897.1	906.6	943.1	956.3	1084.1	1218.5	1135.9	1269.9	1269.9	1357.6
Expenses 2/	712.0	727.9	788.7	852.4	980.6	1065.8	1037.1	1161.0	1161.0	1237.5
Wages	184.3	187.3	190.5	194.3	215.6	256.0	249.7		291.3	307.4
Social Contributions	4.6	4.5	4.7	4.8	0.0	0.0	0.0		0.0	0.0
Payments to individual pension accounts	0.0	0.0	0.0	0.0	0.0	20.7	8.0		13.3	20.0
Subsidies	5.4	3.4	4.3	4.6	4.9	8.0	10.6		12.2	10.7
Interest	16.2	30.2	35.2	40.2	46.7	63.4	63.4		73.9	77.5
Social allowances and pensions	239.9	241.7	255.1	287.4	294.0	343.7	344.3		379.3	409.1
Pensions/social security benefits	176.0	176.8	186.6	197.5	198.4	236.3	223.6		249.9	268.2
Social assistance benefits	64.0	64.9	68.5	89.9	95.6	87.9	120.7		129.5	140.9
Employer social benefits	0.0	0.0	0.0	12.1	0.0	19.5	0.0		0.0	0.0
Goods and services	79.0	84.2	95.4	132.6	140.9	144.4	149.3		154.9	162.0
Grants	62.0	66.6	69.2	71.4	78.2	86.9	86.9		100.8	106.5
Other expenditure 3/	120.5	110.1	134.3	117.1	200.3	142.6	124.8		135.3	144.4
Transactions in nonfinancial assets	185.1	178.7	154.4	103.9	103.5	152.7	98.9	108.9	108.9	120.0
Acquisition of nonfinancial assets	195.7	179.2	157.7	106.6	105.0	152.7	100.3		109.7	120.0
Disposals of nonfinancial assets	10.6	0.5	3.3	2.7	1.6	0.0	1.4		0.7	0.0
Overall balance (above-the-line)	-241.5	-172.3	-108.7	-63.8	-72.6	-110.4	-67.5	-114.1	-112.8	-105.4
Statistical discrepancy	-6.2	13.2	2.9	2.1	28.6	0.0	0.0		0.0	0.0
Overall balance (below-the-line)	-247.7	-159.1	-105.8	-61.6	-43.9	-110.4	-67.5		-112.8	-105.4
Financing	247.7	159.1	105.8	61.6	43.9	110.4	67.5		112.8	105.4
Domestic financing	-108.5	96.5	62.7	6.8	-43.9	69.5	44.5		98.8	45.3
Banking system 4/	-40.0	95.6	55.1	20.1	-23.7	56.9	79.6		70.5	19.6
CBA	-54.4	62.1	22.4	-26.3	-79.6	42.5	67.0		38.5	7.6
Commercial Banks	14.4	33.5	32.7	46.4	55.9	14.4	12.6		32.0	12.0
Nonbanks	-68.5	0.9	7.6	-13.2	-20.2	12.6	5.8		29.1	25.7
Privatization proceeds	0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
T-Bills	8.7	5.5	4.3	-24.6	-62.7	3.6	-3.2		8.0	3.0
Promissory note/other	-3.2	-2.0	0.0	0.0	63.3	0.0	0.0		0.0	0.0
Net lending	-74.0	-2.6	3.4	11.4	-20.9	9.0	9.1		21.1	22.7
External financing	356.2	62.5	43.0	54.8	87.8	26.9	23.0		14.0	60.1
Gross inflow 3/ 5/	395.6	105.3	88.9	118.4	373.1	105.5	97.8		85.7	138.5
Amortization due	-6.3	-9.7	-10.8	-27.9	-246.4	-40.9	-38.6		-26.6	-29.8
Net lending	-33.1	-33.1	-35.1	-35.6	-38.9	-37.7	-36.2		-45.1	-48.6
Other financing 6/	...	...	...	...	0.0	14.0	0.0		0.0	0.0
Memorandum items:										
Nominal GDP (in billion of drams)	3,142	3,460	3,778	4,001	4,273	4,714	4,528	4,868	4,867	5,248
Program balance 7/	-354.8	-124.4	-137.4	-85.9	-40.4	-139.1	-94.6		...	...
Debt-creating fiscal balance 8/	-274.6	-205.4	-143.7	-99.4	-48.2	-148.1	-103.7		-157.9	-154.0
T-bill issuance	45.4	30.2	30.3	30.8	20.4	...	...		...	...

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

1/ From 2014, social contributions include contributions to the second pillar of the pension system.
2/ Composition of expense reclassified in November 2013 to account for wage bill more accurately.
3/ In 2013 includes AMD 63 billion related to the acquisition by Gazprom from the government of 20 percent of the shares of ArmRusGazprom (gross inflow), and the transfer (other expenditure) of the same amount from the government to ArmRusGazprom to liquidate liabilities. Excluding this transaction, the deficit would amount to AMD 43.6 billion, or 1 percent of GDP.
4/ Discrepancy between the fiscal and monetary accounts in 2009Q3-Q4, 2010, and 2011 is explained by government lending to the economy through commercial banks.
5/ Includes IMF budget support.
6/ Prospective EU financing. The authorities have requested about $100 million in Macro Financial Assistance from the EU.
7/ The program balance is measured as below-the-line overall balance minus net lending, except from 2010 to 2011Q1, where project financing is also subtracted.
8/ Sum of overall balance (above-the-line) and external net lending. In 2013, it excludes the transfer associated to the acquisition of ArmRusGazprom by Gazprom, since it was financed with the sale of the government's shares in the company.

Table 6. Armenia: Central Government Operations, 2009–16
(In billions of dram)

	2009	2010	2011	2012	2013	2014		2015		2016
	Act.	Act.	Act.	Act.	Act.	EBS/14/18	Proj.	Budg.	Proj.	Proj.
Total revenue and grants	20.9	21.2	22.1	22.3	23.7	23.5	23.6	23.7	23.8	23.9
Total revenue	20.2	20.4	20.6	21.9	23.4	23.1	23.4	23.2	23.2	23.6
Tax revenues	16.1	16.4	16.7	18.1	22.8	22.7	22.7		22.5	22.8
VAT	7.6	8.0	8.0	8.5	8.7	8.8	8.8		8.7	8.8
Profits, simplified and presumptive	3.3	2.9	3.8	4.1	3.9	4.2	3.7		3.1	3.1
Personal income tax	1.9	2.1	2.1	2.3	6.4	6.1	6.3		6.2	6.3
Customs duties	0.8	0.8	0.9	1.0	1.0	1.1	1.0		1.1	1.1
Other	2.4	2.5	1.8	2.1	2.7	2.6	2.8		3.4	3.5
Social contributions 1/	3.3	3.0	3.3	3.2	0.4	0.0	0.1		0.1	0.2
Other revenue	0.8	0.9	0.6	0.6	0.6	0.4	0.6		0.6	0.6
Grants	0.7	0.8	1.5	0.4	0.3	0.4	0.2	0.5	0.6	0.3
Budget support	0.3	0.2	0.8	0.3	0.1	0.1	0.0			
Project grants	0.3	0.7	0.8	0.2	0.1	0.3	0.2			
Total expenditure	28.6	26.2	25.0	23.9	25.4	25.9	25.1	26.1	26.1	25.9
Expense 2/	22.7	21.0	20.9	21.3	23.0	22.6	22.9	23.9	23.9	23.6
Wages	5.9	5.4	5.0	4.9	5.0	5.4	5.5		6.0	5.9
Social Contributions	0.1	0.1	0.1	0.1	0.0	0.0	0.0		0.0	0.0
Payments to individual pension accounts	0.0	0.0	0.0	0.0	0.0	0.4	0.2		0.3	0.4
Subsidies	0.2	0.1	0.1	0.1	0.1	0.2	0.2		0.3	0.2
Interest	0.5	0.9	0.9	1.0	1.1	1.3	1.4		1.5	1.5
Social allowances and pensions	7.6	7.0	6.8	7.2	6.9	7.3	7.6		7.8	7.8
Pensions/social security benefits	5.6	5.1	4.9	4.9	4.6	5.0	4.9		5.1	5.1
Social assistance benefits	2.0	1.9	1.8	2.2	2.2	1.9	2.7		2.7	2.7
Employer social benefits	0.0	0.0	0.0	0.3	0.0	0.4	0.0		0.0	0.0
Goods and services	2.5	2.4	2.5	3.3	3.3	3.1	3.3		3.2	3.1
Grants	2.0	1.9	1.8	1.8	1.8	1.8	1.9		2.1	2.0
Other expenditure 3/	3.8	3.2	3.6	2.9	4.7	3.0	2.8		2.8	2.8
Transactions in nonfinancial assets	5.9	5.2	4.1	2.6	2.4	3.2	2.2	2.2	2.2	2.3
Acquisition of nonfinancial assets	6.2	5.2	4.2	2.7	2.5	3.2	2.2		2.3	2.3
Disposals of nonfinancial assets	0.3	0.0	0.1	0.1	0.0	0.0	0.0		0.0	0.0
Overall balance (above-the-line)	-7.7	-5.0	-2.9	-1.6	-1.7	-2.3	-1.5	-2.3	-2.3	-2.0
Statistical discrepancy	-0.2	0.4	0.1	0.1	0.7	0.0	0.0		0.0	0.0
Overall balance (below-the-line)	-7.9	-4.6	-2.8	-1.5	-1.0	-2.3	-1.5		-2.3	-2.0
Financing	7.9	4.6	2.8	1.5	1.0	2.3	1.5		2.3	2.0
Domestic financing	-3.5	2.8	1.7	0.2	-1.0	1.5	1.0		2.0	0.9
Banking system 4/	-1.3	2.8	1.5	0.5	-0.6	1.2	1.8		1.4	0.4
CBA	-1.7	1.8	0.6	-0.7	-1.9	0.9	1.5		0.8	0.1
Commercial Banks	0.5	1.0	0.9	1.2	1.3	0.3	0.3		0.7	0.2
Nonbanks	-2.2	0.0	0.2	-0.3	-0.5	0.3	0.1		0.6	0.5
Privatization proceeds	0.0	0.0	0.0	0.0	0.0	0.0	0.0		0.0	0.0
T-Bills	0.3	0.2	0.1	-0.6	-1.5	0.1	-0.1		0.2	0.1
Promissory note/other	-0.1	-0.1	0.0	0.0	1.5	0.0	0.0		0.0	0.0
Net lending	-2.4	-0.1	0.1	0.3	-0.5	0.2	0.2		0.4	0.4
Of which: financed with the Russian loan	-2.5	0.1	0.1	0.3	-0.5	0.0	0.0		0.0	0.0
External financing	11.3	1.8	1.1	1.4	2.1	0.6	0.5		0.3	1.1
Gross inflow 3/ 5/	12.6	3.0	2.4	3.0	8.7	2.2	2.2		1.8	2.6
Amortization due	-0.2	-0.3	-0.3	-0.7	-5.8	-0.9	-0.9		-0.5	-0.6
Net lending	-1.1	-1.0	-0.9	-0.9	-0.9	-0.8	-0.8		-0.9	-0.9
Other financing 6/	…	…	…	…	0.0	0.3	0.0		0.0	0.0
Memorandum items:										
Nominal GDP (in billion of drams)	3,142	3,460	3,778	4,001	4,273	4,714	4,528	4,868	4,867	5,248
Program balance 7/	-11.3	-3.6	-3.6	-2.1	-0.9	-3.0	-2.1		…	…
Debt-creating fiscal balance 8/	-8.7	-5.9	-3.8	-2.5	-1.1	-3.1	-2.3		-3.2	-2.9
T-bill issuance	1.4	0.9	0.8	0.8	0.5	…	…		…	…

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

1/ From 2014, social contributions include contributions to the second pillar of the pension system.
2/ Composition of expense reclassified in November 2013 to account for wage bill more accurately.
3/ In 2013 includes AMD 63 billion related to the acquisition by Gazprom from the government of 20 percent of the shares of ArmRusGazprom (gross inflow), and the transfer (other expenditure) of the same amount from the government to ArmRusGazprom to liquidate liabilities. Excluding this transaction, the deficit would amount to AMD 43.6 billion, or 1 percent of GDP.
4/ Discrepancy between the fiscal and monetary accounts in 2009Q3-Q4, 2010, and 2011 is explained by government lending to the economy through commercial banks.
5/ Includes IMF budget support.
6/ Prospective EU financing. The authorities have requested about $100 million in Macro Financial Assistance from the EU.
7/ The program balance is measured as below-the-line overall balance minus net lending, except from 2010 to 2011Q1, where project financing is also subtracted.
8/ Sum of overall balance (above-the-line) and external net lending. In 2013, it excludes the transfer associated to the acquisition of ArmRusGazprom by Gazprom, since it was financed with the sale of the government's shares in the company.

Table 7. Armenia: Medium-Term Macroeconomic Framework, 2009–19

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
	Act.	Act.	Act.	Act.	Act.	Projections					
National income and prices											
Real GDP (percent change)	-14.1	2.2	4.7	7.1	3.5	2.6	3.3	3.7	4.1	4.3	4.5
Gross domestic product (in millions of U.S. dollars)	8,648	9,260	10,142	9,958	10,431	10,969	11,278	11,559	12,024	12,643	13,478
Gross national income per capita (in U.S. dollars)	3,033	3,283	3,548	3,495	3,682	3,833	3,934	4,032	4,190	4,399	4,674
CPI inflation, period average (percent change)	3.5	7.3	7.7	2.5	5.8	2.2	3.8	4.0	4.0	4.0	4.0
Investment and saving											
Investment	33.8	29.4	27.0	23.4	21.8	22.0	22.6	23.1	24.1	24.9	25.7
Private	27.9	24.3	22.9	20.8	19.3	19.8	20.3	20.8	21.3	21.8	22.3
Public	5.9	5.2	4.1	2.6	2.4	2.2	2.2	2.3	2.7	3.0	3.3
National savings	16.2	15.2	15.9	12.4	13.7	14.0	15.3	16.0	17.2	18.2	19.1
Private	18.0	15.0	14.7	11.3	13.0	13.3	15.4	15.8	16.3	17.0	17.6
Public	-1.8	0.2	1.2	1.0	0.7	0.7	-0.1	0.3	0.9	1.3	1.5
Central government operations											
Revenue and grants	20.9	21.2	22.1	22.3	23.7	23.6	23.8	23.9	24.1	24.3	24.4
Of which: tax revenue	16.1	16.4	16.7	18.1	22.4	22.7	22.5	22.8	23.1	23.3	23.4
grants	0.7	0.8	1.5	0.4	0.3	0.2	0.6	0.3	0.2	0.2	0.1
Expenditure	28.6	26.2	25.0	23.9	25.4	25.1	26.1	25.9	25.9	26.0	26.1
Current expenditure	22.7	21.0	20.9	21.3	23.0	22.9	23.9	23.6	23.2	23.0	22.8
Capital expenditure	5.9	5.2	4.1	2.6	2.4	2.2	2.2	2.3	2.7	3.0	3.3
Overall balance on a cash basis	-7.9	-4.6	-2.8	-1.5	-1.0	-1.5	-2.3	-2.0	-1.8	-1.8	-1.8
Domestic financing	-3.5	2.8	1.7	0.2	-1.0	1.0	2.0	0.9	0.5	0.3	0.3
External financing	11.3	1.8	1.1	1.4	2.1	0.5	0.3	1.1	1.3	1.5	1.4
Unidentified financing	…	…	…	…	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public and publicly-guaranteed debt	40.2	39.7	42.0	44.0	43.4	43.9	44.8	45.5	45.4	45.0	43.6
External sector											
Exports of goods and services	15.8	21.3	24.3	25.7	26.2	26.6	27.4	28.1	28.2	28.2	27.8
Imports of goods and services	44.3	47.1	46.4	48.3	47.3	46.0	46.1	46.6	46.5	46.0	45.1
Current account (in percent of GDP)	-17.6	-14.2	-11.1	-11.1	-8.0	-8.1	-7.3	-7.1	-6.9	-6.6	-6.5
Current account (in millions of U.S. dollars)	-1,520	-1,318	-1,124	-1,104	-839	-884	-821	-819	-829	-836	-882
Capital and financial account (in millions of U.S. dollars)	1,683	1,117	1,008	840	1,622	764	774	909	945	1,005	996
Of which: direct foreign investment	710	521	437	473	507	361	372	406	423	441	472
public sector disbursements	907	193	180	255	914	237	199	305	365	421	453
Change in gross international reserves (in millions of U.S. dollars) 1/	-597	138	-4	70	-454	228	36	-87	-78	-99	-30
Arrears and debt relief (in millions of U.S. dollars)	0	0	0	0	0	0	0	0	0	0	0
Financing gap (in millions of U.S. dollars)	0	0	0	0	0	18	36	36	18	0	0
Of which: IMF	0	0	0	0	0	18	36	36	18	…	…
Other	0	0	0	0	0	0	0	0	0	…	…
Gross international reserves in months of imports	5.5	4.8	4.7	4.4	5.4	4.7	4.4	4.5	4.4	4.4	4.5
Memorandum items:											
Debt-creating fiscal balance 2/	-8.7	-5.9	-2.2	-2.5	-1.1	-2.3	-3.2	-2.9	-2.6	-2.6	-2.6

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

1/ A negative figure indicates an increase.

2/ Sum of overall balance (above-the-line) and external net lending.

Table 8. Armenia: Indicators of Capacity to Repay the Fund, 2011–19

				Projections					
	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Fund obligations based on existing credit									
(in millions of SDRs)									
Principal	14.4	101.0	180.2	93.4	16.4	25.3	36.9	45.2	50.9
Charges and interest	7.9	7.4	5.4	1.9	1.9	1.8	1.6	1.4	1.0
Total obligations based on existing and prospective credit									
In millions of SDRs	22.5	108.7	185.6	95.3	18.7	27.7	39.2	47.3	55.6
In millions of U.S. dollars	35.5	167.2	281.2	146.7	28.7	42.6	60.4	73.8	86.8
In percent of gross international reserves	1.9	9.3	12.5	7.2	1.4	2.1	2.8	3.3	3.8
In percent of exports of goods and services	1.4	6.5	10.3	5.0	0.9	1.3	1.8	2.1	2.3
In percent of debt service 2/	34.9	69.5	31.9	51.5	15.8	20.6	25.2	25.9	21.5
In percent of GDP	0.3	1.7	2.7	1.3	0.3	0.4	0.5	0.6	0.6
In percent of quota	24.4	118.1	201.7	103.6	20.3	30.1	42.7	51.4	60.4
Outstanding Fund credit based on existing credit 2/									
In millions of SDRs	539.0	505.0	379.7	293.4	277.0	251.7	214.8	169.7	118.8
In millions of U.S. dollars	850.9	776.9	575.4	451.4	426.1	387.2	330.5	265.1	185.6
In percent of gross international reserves	45.5	43.2	25.5	22.3	21.4	18.7	15.3	11.8	8.1
In percent of exports of goods and services	34.5	30.4	21.0	15.5	13.8	11.9	9.7	7.4	4.9
In percent of debt service 2/	837.6	322.7	65.3	158.5	234.4	187.1	138.0	93.1	45.9
In percent of GDP	8.4	7.8	5.5	4.1	3.8	3.4	2.7	2.1	1.4
In percent of quota	585.8	548.9	412.8	318.9	301.1	273.6	233.5	184.4	129.1
Net use of Fund credit based on existing and prospective credit	58.1	-34.2	-125.2	-69.9	7.1	-1.8	-25.2	-45.2	-53.8
Disbursements	72.5	66.8	55.0	23.5	23.5	23.5	11.7	0.0	0.0
Repayments and repurchases	14.4	101.0	180.2	93.4	16.4	25.3	36.9	45.2	53.8
Memorandum items:									
Nominal GDP (in millions of U.S. dollars)	10,142.1	9,957.9	10,431.2	10,968.8	11,278.2	11,558.6	12,024.0	12,643.3	13,478.1
Exports of goods and services (in millions of U.S. dollars)	2,467.9	2,554.4	2,733.5	2,913.6	3,088.8	3,243.1	3,396.6	3,569.2	3,751.5
Gross international reserves (in millions of U.S. dollars)	1,869.5	1,799.4	2,253.0	2,025.1	1,988.6	2,075.4	2,153.0	2,251.5	2,281.2
Debt service (in millions of U.S. dollars) 2/	101.6	240.7	881.7	284.8	181.8	207.0	239.5	284.7	404.6
Quota (in millions of SDRs)	92.0	92.0	92.0	92.0	92.0	92.0	92.0	92.0	92.0

Source: Fund staff estimates and projections.

1/ Indicators cover both GRA and ECF credit.

2/ Total debt service includes IMF obligations.

Table 9. Armenia. External Financing Requirements and Sources, 2013–17
(In millions of U.S. dollars, unless otherwise indicated)

	2013	2014	2015	2016	2017
			Projections		
Gross Financing Requirements	2,922	1,615	1,668	1,840	1,901
External current account deficit (excl. transfers)	1,664	1,664	1,623	1,645	1,683
Debt amortization and Fund repurchases	805	179	56	69	84
Gross international reserve accumulation	454	-228	-36	87	78
Available financing	2,839	1,579	1,631	1,804	1,883
Capital Account and Current Transfers	2,839	1,579	1,631	1,804	1,883
of which: Capital transfers (net)	76	68	80	76	71
Foreign Direct Investment	507	361	372	406	423
Public Borrowing	914	237	143	236	281
Private transfers	704	718	754	795	839
Commercial banks net flows	507	235	245	260	260
Financing gap	83	36	36	36	18
Exceptional Financing	83	36	36	36	18
Of which: IMF EFF program	0	36	36	36	18
Memorandum item:					
Current Account deficit, percent of GDP	-8.0	-8.1	-7.3	-7.1	-6.9
Fiscal balance, percent of GDP	-1.0	-1.5	-2.3	-2.0	-1.8
Net International Reserves	1,895	1,722	1,656	1,798	1,819
Gross Reserves	2,253	2,025	1,989	2,075	2,153
In months of prospective imports	5.4	4.7	4.4	4.5	4.4

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

Table 10. Armenia: Fund Disbursements and Timing of Review Under the 38-Month Arrangement Under the Extended Fund Facility

Date of Availability	Conditions	Amount (millions of SDRs)	Percent of Quota
		EFF	EFF
March 7, 2014	Board approval of the arrangement	11.74	12.76
September 30, 2014	Observance of end-June 2014 performance criteria and continuous performance criteria, and completion of first review	11.74	12.76
March 30, 2015	Observance of end-December 2014 performance criteria and continuous performance criteria, and completion of second review	11.74	12.76
September 30, 2015	Observance of end-June 2015 performance criteria and continuous performance criteria, and completion of third review	11.74	12.76
March 30, 2016	Observance of end-December 2015 performance criteria and continuous performance criteria, and completion of fourth review	11.74	12.76
September 30, 2016	Observance of end-June 2016 performance criteria and continuous performance criteria, and completion of fifth review	11.74	12.76
March 30, 2017	Observance of end-December 2016 performance criteria and continous performance criteria, and completion of sixth review	11.77	12.79
	Total	82.21	89.36

Source: Fund staff estimates and projections.

Appendix I. Letter of Intent

Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431

Yerevan, December 3, 2014

Dear Madam Lagarde:

1. **Armenia's economic performance has weakened in 2014 in the context of adverse regional and global developments**. Growth has decelerated by approximately 1 percentage point, as the slowdown in Russia and still sluggish growth in the European Union (EU) have translated into subpar growth of exports and of remittances. Inflation has also decelerated and is expected to close the year well near the bottom of Central Bank of Armenia's (CBA) target range (4 ± 1.5 percent). Pressures on regional currencies early in 2014 also affected the dram and CBA reserves. Banking sector profitability has declined, as credit growth has slowed, while nonperforming loans have increased. The sector remains well capitalized; however, and deposit growth has remained strong. The fiscal deficit will again be lower than budgeted, as capital underspending has continued, particularly on complex, externally financed projects. The consolidation of the external current account deficit will slow this year with lower growth of exports and remittances.

2. **Growth is expected to recover somewhat in 2015, but a deepening of the slowdown in Armenia's largest trading partners—Russia and the EU—are downside risks**. Domestic policies should support a moderate pick-up of growth and inflation. The outlook is subject to a high degree of uncertainty, however, as an intensification of regional and global geopolitical tensions could cause negative spillovers on Armenia's economy, particularly if Russia and Europe are strongly affected.

3. **Our program, supported by the Extended Fund Facility (EFF) arrangement with the IMF is broadly on track**. All continuous and quantitative performance criteria (PCs) and most indicative targets (ITs) for end-June and end-September 2014 were met. There has been also significant progress implementing the program's structural benchmarks (SBs), although overall progress has been uneven. On the positive side, financial sector reforms are advancing, the "open skies" framework for civil aviation is in place and delivering increased flights at lower costs, and preparatory work for overhauling bankruptcy processes is in motion. However, competition and regulatory reforms have advanced at a slower pace, in part reflecting personnel changes with the new government, which came into office in May. This letter of intent (LOI) describes policies for the remainder of 2014 and the first half of 2015.

A. The Program for 2014–15

4. Our economic policy objectives remain focused on sustaining macroeconomic stability and establishing the basis for strong, inclusive growth. For the short term, our focus remains on consolidating stability and maintaining strong buffers against possible external shocks. We are also supporting growth through far-reaching reforms that aim to further Armenia's transition towards a dynamic emerging market economy: greater openness and domestic competition, an improved business environment, and enhanced competitiveness and regional integration. We are conscious that poverty alleviation remains a critical objective, and we are confident that our reform efforts will foster sustainable and inclusive growth in the medium-term. In this context, we are continuing to strengthen our well-targeted social programs to support the most vulnerable segments of the population, while at the same time creating room in the state budget to address key social and investment needs.

B. Fiscal Policy

5. We continue to implement prudent fiscal policy. We expect the budget deficit in 2014 to be around 1½ percent of GDP, 0.8 percent less than budgeted. Against the background of deteriorating external environment and slowing down of economic activity, revenue will likely be somewhat lower than planned. However, the revenue shortfall will be more than offset by underexecution of capital spending, due largely to delays in implementation of large foreign-financed projects. Changes in the design of the pension reforms, following a March Constitutional Court ruling have also contributed to the lower expenditure outturn via lower coverage of the new pension system than initially envisaged in the budget and lower government matching contributions.

6. The 2015 budget reflects our commitment to the objectives of the program. Fiscal policy aims at supporting economic activity next year by providing a positive impulse. The overall budget deficit will increase relative to the projected outcome for 2014 by 0.8 percent of GDP to 2.3 percent. This expansionary stance is warranted given that expected GDP growth is well below potential, inflationary pressures are low, and public debt levels are moderate. We will continue efforts to reduce the stock of tax credits or prepayments so as to achieve a reduction in the amount of 0.3 percentage points of GDP in 2015. In addition, uncertainty continues to weigh on the outlook, posing downside risks for revenue, whereas legally-mandated spending limits the scope for reducing current outlays. Nonetheless, consistent with the goals of the program, we will make provisions for capital expenditures with the aim of at least maintaining the level of investment spending expected in 2014, 2.2 percent of GDP. A program adjustor will allow for additional foreign-financed capital spending during the year, if project implementation proceeds faster than expected. In the medium term, as growth picks up and the output gap closes, we will undertake gradual fiscal consolidation, and we remain determined to reduce the fiscal deficit below the debt stabilizing level of 2 percent of GDP. We recognize that legally-mandated current expenditures and interest outlays may crowd out capital spending and additional spending in areas such as health and education, unless revenues are increased.

7. Armenia membership in the Eurasian Economic Union (EEU) is expected to lead to additional customs revenues. After joining the EEU, Armenia will receive 1.13 percent of the common customs pool, currently estimated at about $23–25 billion annually. This will imply additional customs revenue of about 1½ percent of GDP (net of the current level of collections). As ratification of Armenia's membership in the EEU is still pending, this revenue is not yet planned in the 2015 budget, although with membership, it could start from January 2015. If membership proceeds as expected, we will save the additional customs revenues until consultations with the IMF staff at the time of the second review under the EFF. We expect to incorporate the additional revenues into a supplementary budget along with additional priority social and investment spending.

8. Underexecution of the capital budget in recent years has been a source of concern. Multiple factors have contributed to delays in the execution of capital projects, including ineffective planning and project management capacity of project implementation units (PIUs), procurement delays due to the technological complexity of some of the contracts, and specific problems with land acquisition and resettlement on major road projects. We understand the importance of strengthening investment in physical infrastructure for growth and job creation and have taken measures to address constraints in project implementation. To address underspending on externally-funded projects, we recently adopted a decree that requires PIUs to submit to the Office of the Prime Minister monthly progress reports, with expected outcomes and risks for implementation. This information is compiled and discussed in the cabinet and corrective actions are being taken as needed. We will review the results from these measures and prepare an analysis and actions to step up budget execution (new April 2015 structural benchmark). In parallel, we will improve the procurement system for domestically-funded projects by fully shifting to e-procurement for both central and local governments effective in 2015. With this change, we expect to achieve a more efficient and transparent procurement process.

9. We continue to attach high importance to social spending and improved conditions for the civil service. The budget allocation to social benefits programs in 2015 is about 7 percent higher than in 2014. Spending on pensions will increase as well, mostly reflecting the carryover of a pension increase for one target group from January 1, 2014 and for another target group from July 1, 2014. We raised the monthly family allowance by AMD 1,000 to AMD 17,000 from August 1, 2014 and expanded coverage of the program to reach nearly 105 thousand beneficiaries, up from 84 thousand in 2011. The new Law on Social Assistance provides an integrated framework for provision of social services. A key element in this framework is the establishment of integrated social service centers (ISSC). We intend to create such centers in the remaining 36 areas across the country, at least 10 of which will be launched in 2015. We will continue our efforts to improve the quality of the civil service. An important step in that direction was the introduction of a new grade structure for civil servants based on clear job descriptions and standardized salaries across different government agencies and levels. The public sector wage increase, effective from July this year, will help to attract and retain qualified staff.

10. We will aim to ensure that fiscal risks are identified, analyzed, disclosed, and managed effectively. We will create a risk management unit (RMU) at the Ministry of Finance to monitor fiscal risks arising from macroeconomic sources, as well as from regulated utilities, enterprises with state participation, concessions, and PPPs (December 2014 structural benchmark). The RMU will be set up following good international practices and in line with IMF TA recommendations. We will assess the RMU's capacity development requirements and may request additional TA from the IMF. The unit will expand by May 2015 the statement of fiscal risks that is included in the Medium-Term Expenditure Framework and budget documents, for example, to cover risks from utilities, enterprises with state ownership, concessions, and PPPs.

11. The guiding principles for tax policy continue to be strengthening the revenue gains achieved in recent years, improving the fairness of the system, and supporting growth. In 2014, we made several changes in tax legislation aimed at improving business conditions in a difficult economic environment, while removing exemptions and aligning our tax regime with international practices. We eliminated the minimum profits tax, reduced the turnover tax for small companies in the trade sector conditional on providing supporting documentation, moved tobacco products from the presumptive regime to regular excise taxation, and proposed elimination of VAT exemptions for financial services not related to interest income. For 2015, we envisage additional measures to provide stimulus to the economy. We will gradually replace the current mixed (accrual/cash) method for determining VAT liability and providing credits/refunds with a unified regime where both debits and credits are calculated on an accrual basis. The change will ease cash-flow constraints for taxpayers and will be phased over three years, with estimated cost to the budget of AMD 5 billion in the first year. Costs in the second and third years will be substantially higher and will necessitate significant offsetting measures. In response to the continuing weaknesses in construction, we will allow for income tax deductibility of mortgage payments under loans for purchase of new apartments built after November 1, 2014. Tax incentives will also be provided to some remote border regions adjacent to Azerbaijan. To contain the impact on revenues from these changes, we will increase the natural resource user fee for non-metallic minerals in 2015 by introducing royalties, and if necessary, and consider raising excise rates on alcohol and tobacco.

12. We are continuing work on other tax policy changes that will contribute to enhanced revenues over the program period. We will also continue to work on strengthening the framework for taxation of high wealth individuals (HWIs). We have prepared a policy paper on strengthening collections from HWI, covering necessary tax policy changes (e.g., dividend and capital gains taxation), revenue administration actions and legal or regulatory changes (risk and compliance profiles and audit), and the institutional set-up (September 2014 structural benchmark). We will build on this to prepare specific proposals for cabinet (capital gains, dividends, property taxation, audit), along with estimated revenue effects, if revenue gains are positive compared with potential negative economic and financial impacts of the measures (new June 2015 structural benchmark). We are initiating preparation of a new tax code, a major undertaking aimed at reforming the tax system by reducing Armenia's high tax compliance costs through introduction of well-defined set of taxation principles and spelling out the rights and obligations of taxpayers and tax administration, in line with best international practices. The code will replace numerous tax laws and regulations with a single document. Preparation and enactment of the code will present an opportunity to eliminate tax expenditures, subject the approval of new tax benefits to more stringent rules, and broaden the tax base (e.g., agriculture, diesel fuel, LNG). To support this work, we included for the first time an annex to the 2015 budget that lists and quantifies the main tax expenditures. Work on the tax code has started and a working group at the Ministry of Finance will closely collaborate with international agencies involved in the project. We expect to complete the first draft by the end of 2015. Finally, the recently-established tax council has provided an encouraging platform for dialogue between the government and the private sector on tax issues.

13. We will intensify our tax and customs administration efforts to enhance compliance. We established a Risk Management Unit in the SRC (June 2014 structural benchmark); the unit will prepare a compliance strategy for 2015 and beyond, with comprehensive annual action plans and monitoring (December 2014 structural benchmark). We have increased the number of large taxpayers covered by the large taxpayer unit (LTU) from 471 to 515 with a commensurate increase in the number of staff and will increase the number by a further 50 large taxpayers by March 2015. In the past few years, we have introduced tax labeling of consumer products to strengthen collection enforcement. We will expand further the list of goods subject to labeling in 2015 to include pharmaceutical and food products, and we will require the introduction of new cash registers to improve record keeping and tax compliance. Starting from next year, we will only accept electronic invoices and from 2016, all documentation will be in electronic form. In the area of customs, we have drafted the secondary legislation for the new customs code and have submitted it for review to the government agencies. We will continue to improve the business environment by streamlining customs documentation requirements and introducing a one-stop shop in customs clearance, while at the same time enhancing risk management and post-clearance control systems. Improvements in customs administration will also facilitate transshipment of goods to other Eurasian Economic Union member countries across the territory of Georgia.

14. We are determined to continue with the implementation of the flagship pension reform. The reform aims to address a number of critical issues, including Armenia's unfavorable population dynamics, old-age poverty, and the lack of long-term funding in local currency. Following a decision in March by the Constitutional Court to declare some provisions of the pension law unconstitutional, we made amendments to the legislation to comply with the ruling and to adjust other elements of the reform. We phased the introduction of the second pillar over a three-year period through July 1, 2017, included the state budget in the process of collecting and transferring the mandatory social payments to the individual retirement accounts (IRAs), and provided some incentives to encourage participation, particularly by younger, high-wage workers. These changes have necessitated a range of adjustments to procedures, software, websites and financial and information flows, which are underway. Our efforts now are targeted at increasing public awareness of the pension reform through various channels, including a new Internet pension portal, a telephone hotline, TV and radio announcements, targeted briefings to large employers and in regional cities and towns, and training courses. The success of the campaign hinges crucially on building trust in the reform. In this regard, we have overcome the technical difficulties of transferring the contributions to the IRAs, and we will minimize any possible financial costs associated with the implementation of the reform and address them in a transparent manner, by channeling them through the state budget.

C. External Debt

15. **Maintaining debt sustainability remains a key priority for fiscal policy**. We will pursue options for budget support and financing of projects that involve concessional support, maximizing private sector involvement, and strictly limiting government exposure and use of public funds. We have concluded discussions on $300 million financing package with the Russian Federation to extend the operating life of the Metsamor nuclear station. The package incorporates a sizeable grant and a long-term, low-interest rate loan. To minimize risks for the budget, we will conclude a loan arrangement with "Armenian Nuclear Power Plant" CJSC to ensure that debt obligations are met in a timely manner. The modernization will be incorporated into the electricity tariff base, with adequate and timely rate adjustments, so that "Armenian Nuclear Power Plant" CJSC can generate the necessary cash flow to repay the obligation. Expected financing from the EU (MFA) in the amount of $100 million over the period 2014–15 now appears unlikely to materialize. We will continue discussions with the EU; in the meantime, we have addressed the financing shortfall, through recourse to remaining financing from the 2013 Eurobond. We will continue to consult with the IMF and the World Bank in advance of taking on any liabilities, including guarantees.

D. Monetary and Exchange Policy

16. **Monetary policy will continue to aim at maintaining price stability.** The CBA initiated an easing cycle in November 2013 in anticipation of weakening demand conditions and low inflationary pressures. The policy rate has been reduced gradually by nearly 2 percentage points. At this stage, we foresee that inflation will return to the target range within a year, but the CBA may pursue further easing if conditions warrant.

17. **We continue to prepare for a transition of the monetary policy framework under the Fund-supported program towards inflation targeting-based conditionality.** Supported by Fund TA, we have improved our forecasting and communication capacity. In addition, we have gained experience in the operation of the transmission mechanism of interest rates during the recent period of monetary easing and are drawing lessons that we will incorporate into our monetary policy framework. While transitioning towards inflation targeting-based conditionality, we will continue to ensure compliance with the program's PC on net domestic assets, which remains an effective complement to our monetary policy framework.

18. **Our monetary operations framework has performed well, but we envision further strengthening.** The interbank market remains well anchored around the central bank's policy rate and during the recent period of monetary easing, the CBA was able to steer overnight rates towards the policy rate and to communicate effectively with the markets via press releases and the inflation report. Nonetheless, the interbank market still exhibits significant volatility and continues to be dominated by overnight transactions, while our communications strategy is focused on traditional

channels. In this context, we will continue to support the development of the interbank money market—the platform for one-day and seven-day instruments is already operational—including through adjustments to the central bank's operational targets and by expanding our communication efforts to reach a wider audience. In addition, we will assess obstacles to developing the FX derivatives market and FX risk hedging instruments for the economy and market participants and develop possible policy responses.

19. A flexible exchange rate regime will continue to complement our inflation targeting framework and support the external adjustment. CBA interventions in the foreign exchange market will be limited and focused on mitigating disorderly conditions. Outside of those situations, our policy will be to let the dram move according to its fundamentals—thereby avoiding economic distortions and supporting external adjustment—while maintaining strong reserve buffers. We remain conscious that our external current account deficit is still high and constitutes a source of vulnerability and that our external competitiveness needs to be improved. We envisage that the external current account deficit will continue to adjust over time without major disruptions—as in recent years—supported by continued increases in tourism and mining, agricultural, and light industrial exports and a moderation of credit growth.

20. We will continue to take other actions to strengthen the independence and operations of the CBA. The central bank has investments in some enterprises that are engaged in important financial sector development and infrastructure activities. These include a credit card processing company, a mortgage finance company, and a cash collection agency. Some of these enterprises are profitable, others continue to require support. During 2014–15, the CBA will work with its external auditors to present a consolidated position inclusive of these enterprises and will publish an annex describing these investments in its annual report covering the rationale for the investments, along with objectives, development strategy, enterprise risks, risk mitigation efforts, and where appropriate, the CBA's divestment strategy (new June 2015 structural benchmark). In addition, to improve internal operations, the CBA will improve the charter for its board that outlines the roles and responsibilities of board members and clarifies the nature of supervisory activities. Finally, the CBA and the Government will work to advance long-pending legislation that would require the government to issue marketable, interest-bearing securities to cover CBA losses. We will also seek National Assembly approval of amendments to the Law on the CBA to provide the CBA with access to company-level data for non-financial firms; this is needed to compile and analyze the balance of payments statistics, for which the CBA is responsible.

E. Financial Sector Stability and Development

21. We continue to implement reforms to promote resilience of the financial sector to shocks and financial development and deepening. The CBA has issued regulations to gradually require banks to set minimum capital requirements according to Basel III recommendations (June 2014 structural benchmark). We will continue to set internal capital requirements above those suggested by the Basel Committee to maintain strong buffers. We have developed a methodology for identifying domestic systemically important banking institutions and are allocating additional supervisory resources to those institutions. In line with past FSAP recommendations, we have submitted to the National Assembly legislation to shorten the pay-out period of our Deposit Guarantee Fund (September 2014 structural benchmark). To promote financial sector development, we have prepared a policy paper on legal, regulatory, and institutional changes to simplify the registration and execution of collateral—a key factor increasing borrowing costs and hindering financial sector development (June 2014 structural benchmark). In addition, we submitted to the National Assembly legislation to facilitate access of foreign participants in Armenia's capital market, which should facilitate the integration of the domestic and international markets (September 2014 structural benchmark).

22. Further reforms will strengthen banking sector buffers and remove constraints on intermediation. As we continue to align our prudential framework with Basel III recommendations we will explore the implications of the new liquidity recommendations and revisit our current liquidity and prudential frameworks. In particular, we will prepare a policy paper assessing our liquidity and reserve requirement regulations, including their levels and currency of denomination, impacts on interest rates, bank liquidity and buffers, and dollarization, compliance with new Basel III recommendations, and exploring the scope for change (new March 2015 structural benchmark). In addition, we will amend our regulation on the calculation of large exposures in order to align it with international standards. In this context, we propose to drop the planned December 2014 structural benchmark to avoid making changes that will contravene Basel III guidance. Finally, we will build on the findings of the policy paper on registration and execution of collateral by consulting widely with stakeholders to prepare and submit legislative changes to the National Assembly to address the main obstacles hindering this important element of financial sector development (new September 2015 structural benchmark).

F. Structural Reforms

23. Objectives. We are committed to pursuing a comprehensive structural reform agenda, as set out in the 2014–25 Armenia Development Strategy (ADS) and in cooperation with international partners and other stakeholders. The Fund-support program provides a strong framework to support reforms that are essential for addressing key risks and improving institutions, the business climate, competition, openness, connectivity, and diversification.

24. We look forward to an economic boost from joining the Eurasian Economic Union. We expect that EEU membership will provide an impulse to Armenia's exports to its traditional markets by reducing tariff and non-tariff barriers and promoting new investment and trade links. It will also facilitate travel and work arrangements for Armenians in Russia and the other EEU countries. Since the weighted average EEU common external tariff rate is significantly higher (9.5 percent) than Armenia's current weighted average tariff rate (3.0 percent), we have secured transition periods to the EEU common external tariff rates of one to eight years for 752 goods, for which Armenia's current tariffs are lower, and 18 goods for which Armenia's current tariff rates are higher. Our aim to accelerate structural reforms recognizes, in part, that higher tariffs could impose a burden on Armenian consumers, and we will closely monitor impacts on the most vulnerable and on local market competition. As part of the accession agreement, we have requested $50 million in grants from the founding EEU members to help finance the direct costs of customs union implementation, such as new software and hardware for customs, and new agricultural and food testing labs.

25. Armenia remains committed to deepening its relationship with the EU. We will continue strong cooperation with the EU under the Eastern Partnership initiative and European Neighborhood Policy Program and look forward to possible EU macro-financial support, continued technical assistance, and institution-building arrangements (including twinning programs). We also look forward to a new framework-type agreement to guide relations in all possible areas. EU-Armenia cooperation will be developing in new sectors, such as civil aviation.

26. Sound management of the energy sector is critical to mitigating risks and sustaining strong growth. Ensuring the financial sustainability of energy companies and utilities is essential. To this end, in July 2014 we raised end-user electricity tariffs by 10 percent to a level consistent with cost-recovery and enhanced maintenance. In light of past losses and debt-equity transactions, we are closely monitoring the operations and finances of the utility sector and met the end-June PC on the non-absorption losses or liabilities or making of payments on behalf of utilities or other companies. Also, while the gas price agreement signed in December 2013 with the Russian Federation offers stable and competitive prices for the next five years, we consider that the Armenian economy and consumers should become more energy efficient to reduce vulnerabilities, cope with shocks, and be prepared for possible price adjustments after the agreement expires. Accordingly, we have issued a decree approving a comprehensive 2014–2020 action plan on Armenia's energy security strategy. This action plan sets a timetable to put in place energy efficiency investments, measures to improve the reliability of gas and electricity supplies, and continued cooperation with Georgia and Iran on electricity transfers. Our next step will be to build on this work by issuing, with support from the World Bank, a more comprehensive strategy that also includes (i) a process to estimate costs of investment options and bring them into a least cost planning framework; (ii) a strategy to involve the private sector and investors in energy sector projects and mitigate costs and risks to the state budget; (iii) an explicit decision-making process for the possible new nuclear power station; (iv) a review of tariff policies with a view to ensuring timely cost recovery and addressing impacts on the poor; (v) a review of taxation of energy supplies and fuels; and (vi) a plan to manage demand and encourage energy conservation (December 2014 structural benchmark). Macro-critical components of this strategy will subsequently be incorporated in the Fund-supported program.

27. Other structural reforms areas:

- ***Business climate.*** Under our regulatory guillotine program, we have developed a further six packets for streamlining of regulations in entrepreneurship, tax, customs, social issues, foreign affairs and international relations, and culture. We intended to submit all six packets to the National Assembly for approval by June 2014 (structural benchmark), but the process was delayed by the government transition. We now expect to submit these six packets and an additional 10 packets to cabinet by March 2015. We will approve a decree establishing the practice of regulatory impact assessment for new regulations by September 2015. This will help better identify costs and benefits of new regulations and to monitor effectiveness once they are in place. As part of the Doing Business Action Plan for 2014, we have introduced measures to improve contract enforcement, the insolvency process, arrangements for payment of taxes, and foreign trade, and the National Assembly enacted a new customs code in May 2014 that provides for streamlining of procedures. We aim to establish a single customs window by March 2015 to reduce costs and increase transparency. Cabinet will approve a new Doing Business Action Plan by end-year.

- ***Institutional administration:*** Achieving and sustaining higher economic growth calls for the coordinated effort of all government agencies. The Ministry of Economy will take the lead role in promoting GDP growth, while other line ministries and agencies will promote growth through their own activities. We will undertake measures to improve public administration and promote growth and tax compliance by addressing weaknesses in reporting and accounting. Management and administrative shortcomings—and tax gaps—are evident in several sectors with significant state activity, such as healthcare, natural resource use, energy, education, transport, agriculture, and urban development and construction. We believe that more adequate accounting, inventory, and reporting practices of the entities operating in these sectors would promote growth and enhance enforcement of tax compliance. Our efforts will initially focus on strengthening the reporting framework through overhauling existing accounting, reporting, and information technology systems and introducing electronic invoicing and payments. By December 2014, the government will approve a decree with an action plan detailing our specific measures by sector (new December 2014 structural benchmark). The successful implementation of these reforms will require broad support and active involvement of different government agencies. However, the envisaged measures would bring significant benefits to the budget in the form of better administrative control and management and revenue gains that would allow stepping up spending in priority areas.

- ***Competition:*** We have made progress to strengthen the powers of the State Committee for Protection of Economic Competition (SCPEC). A package of legal changes related to projection of economic competition, including clearer regulations of dominance and dominance abuse, clearer fines and compliance with international standards, as well as procedural changes was submitted to the National Assembly at the end of 2013. However, we did not meet the structural benchmark on establishing memoranda of cooperation between the SCPEC and the Ministry of Finance and the Prosecutor General's Office (June 2014 structural benchmark), as we encountered legal obstacles. The respective memorandum was concluded between SCPEC and the National Police. An existing government decree on information exchange among government agencies, including between SCPEC and the Ministry of Finance, should be sufficient to facilitate cooperation, and we will work to ensure that information exchange and follow-up actions in the area of competition are improved. In addition, based on the recommendation of the SCPEC, provisions were included in the legal package to be submitted to the National Assembly to allow for parallel import of pharmaceutical products through alternative channels to promote greater competition and lower costs.

- ***Bankruptcy reform.*** With a view to simplifying the complicated and inefficient insolvency processes in Armenia, the entire process of bankruptcy has been outlined, and the obstacles and gaps to be addressed through legislative amendments have been identified (June 2014 structural benchmark). As a result, it has been revealed that there exist shortcomings in the process of bankruptcy and particularly in court processes that may result in significant delays in bankruptcy proceedings. The provided recommendations include: (i) further improving specialization in the examination of bankruptcy cases at the courts; (ii) bringing procedures in line with international best practices; and (iii) increasing the number and qualifications of bankruptcy administrators. The Ministry of Justice is reviewing—together with other state authorities and interested parties—lessons learned in the bankruptcy outlining. Following these consultations, draft legislation on the aforementioned amendments will be submitted to the Government for consideration by June 2015 (new June 2015 structural benchmark).

- ***Inspection reforms.*** We have been working on a major initiative to streamline inspection agencies and functions, eliminate overlaps and outdated approaches, introduce risk-based supervision and inspection, implement standard checklists, improve information systems, implement electronic management systems, and reduce corruption risks, including through better training and remuneration. These efforts should reduce business costs and strengthen competitiveness, as well as improve the safety of services and products. We submitted a draft law on inspection and inspection agencies to the National Assembly in October (March 2014 structural benchmark). Delays in submission of the draft law reflected resolution of issues to ensure the operational and financial independence of inspection agencies. Our next step will be to prepare an action plan for implementation of the new law.

- ***Civil aviation***. Recent measures to reform civil aviation have resulted in enhanced connectivity, lower costs, and a boost to the tourism sector. With support from the World Bank and USAID, we have developed a roadmap for reforms, and passed four decrees to restructure the Directorate General for Civil Aviation (DGCA) and establish the new set-up for open skies (April 2014 structural benchmark). Under the umbrella of a new Civil Aviation Council, the Ministry of Economy is the lead policy agency while the DGCA serves as an independent regulator. A single-window approach has been adopted to facilitate certification and authorization procedures for airlines, which will be provided by the Ministry of Economy. A newly-established board will set objective criteria and ensure unbiased certification and authorization procedures. We have already removed restrictions with six countries and are currently negotiating 14 further agreements in the framework of open skies policy and a Common Aviation Area Agreement with the EU. We will continue to work to strengthen the capacity of the two agencies to carry out their new functions.

G. Conclusion

28. We request that the IMF Executive Board complete the First Review of the EFF-supported program. We also request that an amount equivalent to SDR 11.74 million be made available upon completion of the review.

29. We will maintain a close policy dialogue with the Fund and stand ready to take additional measures, as appropriate, to ensure the achievement of our social and economic objectives under the Fund–supported program. We will continue to consult with the Fund on the adoption of measures, and in advance of revisions of the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. We will also provide the Fund with information it requests for monitoring program implementation. The program's proposed performance criteria (PCs), indicative targets (ITs), and structural benchmarks (SBs) are set out in Tables 1 and 2 and described in the attached Technical Memorandum of Understanding (TMU). The program's Second Review is expected to be completed on or after March 30, 2015.

30. We authorize the IMF to publish this Letter of Intent and its attachments, as well as the accompanying staff report.

Very truly yours,

/s/
Hovik Abrahamyan
Prime Minister
Republic of Armenia

/s/
Gagik Khachatryan
Minister of Finance
Republic of Armenia

/s/
Artur Javadyan
Chairman of the Central Bank
Republic of Armenia

Table 1. Armenia: Quantitative Targets, 2013–15

	2013	2014												2015			
	Dec.	Mar. 2/			Jun.			Sep. 2/			Dec.			Mar. 2/	Jun.	Sep. 2/	Dec. 2/
	Act.	EBS/14/18	Adj. Prog.	Act.	EBS/14/18	Adj. Prog.	Act.	EBS/14/18	Adj. Prog.	Proj.	EBS/14/18	Adj. Prog.	Proj.	Prog.	Prog.	Prog.	Prog.
Performance Criteria																	
Net official international reserves (stock, floor, in millions of U.S. dollars)	1068	952	924	912	950	923	936	968	917	933	1026	958	979	857	845	833	879
Net domestic assets of the CBA (stock, ceiling) 3/	231	259	254	235	274	269	241	296	301	261	318	330	311	301	337	366	419
Program fiscal balance (flow, floor) 4/	-40	-44	-39	-21	-61	-58	-22	-77	-59	-35	-139	-145	-95	-36	-71	-107	-143
External public debt arrears (stock, ceiling, continuous criterion)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Absorption of losses or liabilities and making of payments on behalf of utilities and other companies (flow, ceiling, continuous criterion)		0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Indicative Targets																	
Inflation (mid-point, percent) 5/	5.6	5.9	5.9	3.8	5.3	5.3	1.8	4.6	4.6	1.5	4.0	4.0	2.9	3.1	3.3	3.4	3.6
Average concessionality of newly contracted external debt (flow, floor, in percent) 6/	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30	30
New government guaranteed external debt (stock, ceiling, in millions of U.S. dollars) 7/		100	100	0	100	100	0	100	100	0	100	100	0	100	100	100	100
Social spending of the government (flow, floor) 8/	34	11	11	10	23	23	21	35	35	35	48	48	48	12	26	40	54
Memorandum items:																	
Budget support grants	48	48		48	48		48	48		48	55		55	55	55	55	62
o.w. EU MFA grant	19	19		19	19		19	19		19	19		19	19	19	19	19
Budget support loans	144	154		148	154		148	163		148	191		168	168	168	168	201
o.w. non-IMF loans	105	115		110	115		110	125		110	153		130	130	130	130	162
Project financing	83	6		6	21		24	36		53	83		77	11	23	34	46
KFW and IBRD loan disbursements	27	32		32	35		35	37		38	40		40	47	51	56	60
Reserve money	888	737		779	743		713	776		719	828		916	825	782	796	1001

Sources: Armenian authorities; and Fund staff estimates.

1/ All items as defined in the TMU.
2/ Indicative target.
3/ NDA ceiling will be considered met if the outcome is within AMD 15 billion of the indicative target.
4/ Below-the-line overall balance excluding net lending and project financing until March 2011. Below-the-line overall balance excluding net lending from June 2011.
5/ End of period, year-on-year headline inflation. Mid-point within a +/- 1.5 range.
6/ Assessed on a calendar year basis.
7/ Includes both concessional and non-concessional debt.
8/ Defined as 100 percent of the budgeted amount of the family benefit program and lump-sum financial aid. Starting 2014, the mission will work with the authorities to define a wider base.

Table 2. Armenia: Existing Structural Benchmarks under the Fund-Supported Program

Item	Measure	Time Frame (End of Period)	Outcome	Lead Agency	Status	Comment
Tax administration						
	- Submit to the National Assembly legislative amendments to the customs code to introduce an Authorized Economic Operators (AEO) system, improve the appeals procedures, introduce an advance tariff information system, extend the scope of electronic declaration of goods, and introduce the possibility of postponing the payment by introducing a systems for financial guarantees	March 2014	Improve business environment and facilitate trade	SRC	**Met**	Amendments submitted to the National Assembly in March 2014 and approved in May 2014.
	- Establish a Risk Management Unit (RMU) in the State Revenue Committee (SRC) to develop and implement a modern tax compliance strategy	June 2014	Improve efficiency, transparency, and evenhandedness of revenue administration	SRC	**Met**	Unit was established in February, with functions approved in March. Risk management functions clarified in the newly reorganized MOF-SRC structure in August.
Tax policy						
	- Prepare a policy paper on strengthening collections from high-wealth individuals (HWI), covering necessary tax policy changes (e.g., dividend and capital gains taxation), revenue administration actions and legal or regulatory changes (risk and compliance profiles and audit), and the institutional set- up	September 2014	Strengthen tax revenue collections	MOF/SRC	**Met**	Authorities have provided a draft paper to the Fund staff, including a review of policies and practices in European countries and the region.
Public Financial Management						
	- Establish a fiscal risk management unit at the Ministry of Finance that analyzes and manages fiscal risks related to concessions, regulated utilities, state-owned enterprises (notwithstanding the extent of state shareholding or line-ministry affiliation), and PPPs in an integrated manner	December 2014	Strengthen monitoring and control of fiscal risks	MOF	**In Progress**	
Financial sector						
	- Issue regulations to require banks to set minimum capital requirements for common equity and Tier 1 capital according to the Basel III recommendations, and prepare the methodology on identifying domestic systemically important banking institutions (SIBIs)	June 2014	Improve banking sector regulation and supervision	CBA	**Met**	Regulations and methodology approved in June.
	- Prepare a policy paper with stakeholders on legal, regulatory, and institutional changes to simplify registration and execution of collateral	June 2014	Improve the operating environment for banks	CBA	**Met**	Authorities have provided a draft paper to the Fund staff.
	- Submit to National Assembly legislation to shorten the depositor pay-out period of the DGF	September 2014	Improve bank resolution framework	CBA	**Met**	Draft legislation has been submitted to the National Assembly.
	- Submit to the National Assembly an amendment to the securities law to facilitate access of foreign participants in Armenia's capital market, bringing the framework in line with international standards	September 2014	Develop financial market	CBA	**Met**	Draft legislation has been submitted to the National Assembly.
	- Amend in a manner consistent with the 2012 FSAP Update recommendations the regulation on the calculation of large exposures to align it to international best practices in the areas of (i) weight of exposures to banks and sovereigns, and (ii) consideration of collateral	December 2014	Improve banking sector regulation and supervision	CBA	**Dropped**	Benchmark was superseded by more recent Basel III recommendations, which are in line with CBA current practices.
Regulatory and competition policy						
	- Submit to the National Assembly a new draft law on inspection and inspection agencies, for introduction of risk based inspection, maximization of the automation, and elimination of the overlaps by reducing agencies	March 2014	Improve business environment	MOE	**Met with Delays**	The draft was submitted to the National Assembly in October 2014.
	- Submit to the Cabinet a plan to restructure the Directorate General for Civil Aviation and establish the new set-up for moving towards open skies	April 2014	Increase competition, improve connectivity, and lower costs	MOE/GDCA	**Met**	
	- Submit to the National Assembly six Regulatory Guillotine legislative packages, covering entrepreneurship, tax, customs, social issues, foreign affairs and international relations, and culture, in addition to completion of packets in 2012-13	June 2014	Improve business environment	MOE/NCLR	**Not Met**	Legal packages have been prepared, but not yet sent to the National Assembly. The process of preparation and submission was negatively impacted by the government change.
	- Map the entire bankruptcy process to identify the obstacles and gaps that need to be addressed by changes in the legislation	June 2014	Improve business environment	MOJ	**Met**	MOJ completed the mapping, which was submitted to the MOE for comments and assessment of further actions.
	- Put in place memoranda of cooperation between the SCPEC and the SRC, the Economic Crimes Unit of the National Police, and the Office of the Public Prosecutor, covering investigative subpoena, and "dawn raid" operations, information required by the SCPEC, and participation by SCPEC staff in on-site examinations	June 2014	Improve business environment	SCPEC	**Dropped**	A previously-existing decree for information exchange by government agencies can provide legal framework for collaboration envisaged in the envisaged memorandum of cooperation.
Energy						
	- Issue a study of policy options (energy efficiency investments, tariffs, and targeted protection for vulnerable groups)	December 2014	Improve efficiency of energy sector	MOEnergy	**In Progress**	

Table 3. Armenia: New Structural Benchmarks under the Fund-Supported Program

Area	Measure	Time Frame (End of Period)	Lead Agency	Macro-criticality /program-criticality
Tax Administration	SRC Risk Management Unit to prepare a compliance strategy for 2015 and beyond, with comprehensive annual action plans, monitoring, and ex post evaluation of tax payments	December 2014	MOF/SRC	Strengthen tax revenues
	Cabinet to approve a decree with an action plan detailing specific measures to enhance accounting, inventory, and reporting practices of state entities operating in healthcare, natural resource use, energy, education, transport, agriculture, and urban development and construction sectors	December 2014	MOF/SRC	Strengthen tax compliance and tax revenues
Tax Policy/Revenue Administration	Submit to cabinet specific proposals to strengthen collections from high-wealth individuals (capital gains, dividends, property taxation, audit), along with estimated revenue effects, to be included in the new tax code	June 2015	MOF	Strengthen tax revenues and equity
Public Financial Management	Submit to the Office of the Prime Minister an analysis of the reasons for underexecution of the capital budget, with proposals of how to increase capital budget execution	April 2015	MOF	Improve budget implementation
Financial Sector	Prepare a policy paper assessing CBA's liquidity and reserve requirement regulations, including their levels and currency of denomination, impacts on interest rates, bank liquidity and buffers, and dollarization, compliance with new Basel III recommendations, and exploring the scope for change	March 2015	CBA	Ensure financial stability
	Submit to National Assembly legislative changes to address the main obstacles hindering registration and execution of collateral	September 2015	CBA/MOJ	Promote financial intermediation
Bankruptcy Framework	Submit to Cabinet draft legislation to (i) further improve the specialization in the examination of bankruptcy cases at courts; (ii) bring procedures in line with the international best practices; and (iii) increase the number and qualifications of bankruptcy administrators	June 2015	MOJ	Improve business climate and strengthen competitiveness
Central Bank Operations	CBA to publish an annex describing investments in enterprises that are engaged in financial sector development and infrastructure activities in its annual report covering the rationale for these investments , along with objectives, development strategy, enterprise risks, and risk mitigation efforts, and where appropriate, the CBA’s divestment strategy	June 2015	CBA	Improve CBA operations

Note: MOJ is the Ministry of Justice.

Attachment I. Technical Memorandum of Understanding

1. This memorandum sets out the understandings between the Armenian authorities and the IMF staff regarding the definition of performance criteria and indicative targets, their adjusters, and data reporting requirements for the extended arrangement as per the Letter of Intent and Memorandum of Economic and Financial Policies dated February 17, 2014 and the Letter of Intent for the First Review dated December 3, 2014.

2. For program monitoring purposes, all foreign currency-related assets, liabilities, and flows in the monetary accounts will be evaluated at program exchange rates. The program exchange rate of the Armenian dram to the U.S. dollar is set at 410 dram per one U.S. dollar. The cross-rates for other foreign currencies are provided in Table 1.

Quantitative Targets

3. The program sets performance criteria and indicative targets for defined test dates (see Table 1 in the LOI). The program sets the following performance criteria:

- Floor on the net official international reserves (NIR) of the Central Bank of Armenia (CBA);
- Ceiling on the net domestic assets (NDA) of the CBA;
- Ceiling on external public debt arrears (continuous);
- Floor on the program fiscal balance; and,
- Ceiling on absorption of losses or liabilities and making of payments on behalf of utilities and other companies (continuous).

The program sets the following indicative targets:

- Headline inflation;
- Floor on average concessionality of newly contracted external debt;
- Ceiling on new government guaranteed external debt; and,
- Floor on social spending of the government.

4. The net official international reserves (stock) of the Central Bank of Armenia (CBA) will be calculated as the difference between total gross official international reserves (excluding commercial bank required and excess reserves at CBA in FX) and gross official reserve liabilities.

- Gross official international reserves are defined as the CBA's holdings of monetary gold (excluding amounts pledged as collateral), holdings of Special Drawing Rights (SDRs), including the August 28, 2009 General Allocation and the September 9, 2009 Special Allocation, the country's reserve position at 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 and other financial instruments are marked to market. Excluded from gross reserves are the balance on the government's Special Privatization Account (SPA), capital subscriptions in foreign financial institutions and illiquid foreign assets, any assets that are pledged, collateralized, or otherwise encumbered, claims on residents, claims in foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options), precious metals other than gold, assets in nonconvertible currencies, and illiquid assets).

- Official reserve liabilities shall be defined as the total outstanding liabilities of the government and the CBA to the IMF and convertible currency liabilities of the CBA to nonresidents with an original maturity of up to and including one year, as well as commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options).

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 specified in Table 1.

5. **Headline inflation** is defined as the year-on-year rate of change of the Consumer Price Index as measured by Armenia's National Statistics Service. The indicative target will be considered met if headline inflation falls within a range of +/- 1½ percentage point around the mid-point target.

6. **Net domestic assets** are defined as reserve money minus NIR, minus other assets not included in gross official international reserves, minus commercial bank required and excess reserves at CBA in FX, plus medium and long-term foreign liabilities (i.e., liabilities with a maturity of one year or more) of the CBA, plus other foreign liabilities not included in official reserve liabilities, minus the balance of outstanding Fund purchases credited to the government account at the CBA. NDA is composed of net CBA credit to the general government plus outstanding credit to domestic banks by the CBA (including overdrafts) minus liabilities not included in reserve money and other items net. The ceiling will be considered as met if the outcome is within AMD 15 billion of the indicative target sets in Table 1 attached to the LOI.

7. **External public debt arrears** are defined as all unpaid debt-service obligations (i.e., payments of principal and interest) arising in respect of public sector loans contracted or guaranteed to non-residents, including unpaid penalties or interest charges associated with these obligations that are overdue beyond 30 days after the due date.[1] The ceiling on external payment arrears is set at zero.

8. The program fiscal balance is cumulative from the beginning of the fiscal year and is measured from the financing side as the negative of the sum of net domestic banking system credit to the central government, net domestic nonbank financing, and net external financing to the central government. Should a general subsidy or any other fiscal transaction be introduced off-budget, the overall balance will be measured including the subsidy and other fiscal transactions as part of government spending.

- **Net banking system credit to the central government** equals the change during the period of net credit to the central government.

- **Net nonbank 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);[2] (2) any other disbursement or transaction that increases nonbanks' claims on the central government plus withdrawals from the Special Privatization Account (SPA) or the treasury sub-account containing privatization proceeds in drams, less amortization paid by the central government to private resident nonbank agents.

- **Net external financing** equals total debt-increasing disbursements from non-residents to the central government (including Fund net purchases credited directly to the government accounts at the CBA) less total amortization from the central government to non-residents. Net external financing also includes any privatization proceeds received from non-residents in foreign currency and not held in the SPA. All foreign currency-denominated transactions are recorded in drams using the prevailing exchange rate at the time of the transaction.

9. External and domestic net lending, which are recorded as financing items, are *excluded* from the calculation of the program fiscal balance. This effectively treats net lending as an expenditure item when loans are made and as a revenue item when the loans are repaid.

10. Transactions related to the extension of the operating life of the Metsamor nuclear power station—which are expected to take place via lending from the Ministry of Finance of the Russian Federation—will be excluded from the measure of the program fiscal deficit.

11. Some project implementation units maintain accounts at the CBA. Grants received by these units are recorded in the fiscal accounts as external grants on the revenue side and as foreign-

[1] The public sector is here defined following the *Government Financial Statistics Manual* (GFS 2001) and *System of National Accounts* (1993 SNA). It includes the general government and nonfinancial public enterprises (as defined in paragraph 13).

[2] 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 State Fund for Social Insurance.

financed expenditure on the expenditure side. In addition, any loans to finance investments 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. Under previous Technical Memoranda of Understanding, these activities were excluded from the calculation of the program fiscal balance. This treatment reflected lags in receiving information from project implementation units and on project loans intermediated through the banking system. With the shift to semi-annual program reviews with the arrangements under the previous Fund-supported program and consolidation of the accounts of these units in the Treasury, there is no longer a need for such exclusion, and these activities are now fully accounted for in the program fiscal balance.

12. Foreign currency proceeds from selling enterprises are reflected in the state budget and deposited in the SPA. In addition, the Government will ensure full transparency of revenues and spending from the sales of major assets (beyond regular day-to-day operations) of enterprises with state ownership. The SPA 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 withdrawal from the SPA will be accounted for as privatization proceeds used to finance the budget and will be recorded below the line. Domestic currency proceeds from selling enterprises to residents are deposited in a sub-account of the treasury single account and are also treated as a financing item and recorded below the line. Finally, as noted in ¶8, privatization proceeds received from non-residents in foreign currency and not held in the SPA are also treated as a financing item (sale of financial assets) and recorded below the line.

13. Absorption of losses or liabilities and making of payments on behalf of utilities and other companies. The program sets a continuous ceiling on absorption by the public sector (central and local governments and covering the state budget and state debt plus the CBA) of losses or liabilities from outside the budgetary sector. Absorption of losses or liabilities is defined as direct payment by the government of the losses or liabilities of other parties or coverage of losses or liabilities by other transactions, such as debt-for-equity swaps or a write-off of tax obligations or other state claims. The government is defined as the central government and covers obligations of the state budget and state debt. The ceiling is set at zero, and excludes AMD 10.718 billion, (approximately $26.1 million) of subsidies in the 2014 budget for Yerevan Metro, Yerevan Electric Transport, Irrigations Systems, Armenian Water and Sanitation, Nor Akunk, and irrigation water intake entities. For 2015, the ceiling will exclude support for these same firms in an amount not exceeding AMD 13.561 billion. During the program period, there may be occasions when absorption of a limited amount of losses or liabilities, or making limited payments on behalf of utilities or other companies would facilitate a positive outcome (e.g., a major foreign investment transaction, poverty alleviation or equity enhancement, or prevention of even greater losses that would endanger financial stability). In such instances, the Armenian authorities will discuss the circumstances and possible options with the Fund staff prior to any transaction. Any modification of the PC to make any such payments or absorb any losses will require approval by the IMF Executive Board.

14. Floor on average concessionality of newly contracted external debt. The program sets an annual indicative floor of 30 percent on the average concessionality of new debt on a contraction basis with nonresidents with original maturities of one year or more as contracted and guaranteed by the public sector.

- The grant element is the difference between the present value (PV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The PV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt. The discount rate used for this purpose is a unified discount rate set at 5 percent.

- The public sector here comprises the general government (central, plus local governments and covering the state budget and state debt), the central bank, and nonfinancial public enterprises (enterprises and agencies in which the government holds a controlling stake—typically owns more than 50 percent of the shares, but which are not consolidated in the budget).

- For program purposes, the guarantee of a debt arises from any explicit legal obligation of the public sector to service a debt in the event of nonpayment by the debtor (involving payments in cash or in kind), or from any implicit legal or contractual obligation of the public sector to finance partially or in full any shortfall incurred by the debtor.

15. Ceiling on government guaranteed external debt. In addition to the indicative floor on average concessionality, a separate ceiling (IT) of $100 million for the program period applies to government guarantees of the total of concessional and non-concessional external financing. The issuance of debt guarantees will be measured at the exchange rates listed in Table 1. The above limit covers debt guarantees issued by the general government to entities outside the general government. Guarantee issuance will be monitored on a monthly basis and the Ministry of Finance will provide data within 21 days from the end of the month.

16. The program sets a floor on **social spending of the government**. For the purposes of the program, social spending of the government is defined as 100 percent of the budgeted amount of the family benefit program and lump-sum financial aid, one-time childbirth benefits, and childcare benefits for children less than two years of age.

17. The quantitative performance criteria and indicative targets under the program are subject to the following adjusters, calculated, where relevant, using program exchange rates:

- **Changes in reserve requirements**: The ceiling on the NDA of the CBA will be adjusted downward (upward) by the amount of banks' reserves freed (seized) by any reduction (increase) of the reserve requirement ratio on both domestic currency and foreign currency liabilities relative to the baseline assumption as per the following formula: $\Delta NDA = \Delta rB$, where B denotes the level of liabilities subject to reserve requirements in the initial definition and Δr is the change in the reserve requirement ratio.

- **KfW, Asian Development Bank, and World Bank loan disbursements**: the ceiling on the NDA of the CBA will be adjusted upward (downward) by the full amount of any excess (shortfall) of disbursements from the KfW, Asian Development Bank, and World Bank loans directed at SME financing compared to programmed amounts (Table 2). The floor on NIR will be adjusted upward (downward) by the cumulative amount of any excess (shortfall) of these disbursements compared to program amounts.

- **Budget support grants to the public sector** are defined as grants received by the general government for direct budget support from external donors and not related to project financing.

- **Budget support loans to the public sector** are defined as disbursements of loans from bilateral and multilateral donors for budget support and Fund purchases credited directly to the government accounts at the CBA.

- **Project financing to the public sector** is defined as disbursements of loans from bilateral and multilateral donors for public sector projects.

- **The floor on NIR** will be adjusted upward (downward) by the cumulative amount of any excess (shortfall) of budget support loans or budget support grants (excluding Fund purchases by the government) compared to program amounts (Table 3). The floor on NIR will be adjusted downward for any external public debt amortization amounts in excess of program amounts. The floor on NIR will be adjusted upwards by the amount of any funds received in respect of deposits held at the Inter State Bank.

- **The ceiling on NDA** will be adjusted downward (upward) by the cumulative amount of any excess (shortfall) of budget support loans or budget support grants compared to program amounts (Table 3).

- **The floor on the program fiscal balance on a cash basis** will be adjusted upward (downward) by the cumulative total amount of the budget support grants received in excess (to account for a shortfall) of the program amounts (Table 3), subject to a cap of $50 million per year in either direction. The floor on the program fiscal balance on a cash basis will also be adjusted downward (upward) by the cumulative total amount of the project financing received in excess (to account for a shortfall) of the program amounts (Table 3), subject to a cap of $70 million in either direction.

Data Reporting

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

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
CBA	CBA balance sheet	Summary	Daily	The following working day

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
	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 at both program exchange rates and by chart of accounts at actual official exchange rates; the consolidated balance sheet of commercial banks by chart of accounts at actual official exchange rates	Monthly	Within 25 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	Daily	The following working day
	Foreign exchange market	Official exchange rates (buying and selling); daily trade volume, and weighted average exchange rate of the interbank, intrabank and Nasdaq-OMX	Daily	Within 1 day
	Foreign exchange market	CBA foreign exchange operations, (exchange rate, volume)	Daily	Within 1 day
	Foreign exchange market	Exchange rate (buying and selling)	Daily	Within 1 day
	Interest rates	Refinance rate	At least monthly	Within 1 days of the CBA Board decision
	Interbank money market	Daily interbank repo volume and interest rate and number of trades	Daily	Within 1 day
	CBA operations	Repo (reverse repo) operations, open market operations, Lombard credits, deposit facility, and foreign exchange swaps (volumes, maturity, yields, exchange rates)	Daily	Within 1 day
	Bank liquidity	Reserves and excess reserves, by currency	Monthly	Within 15 days of the end of each reference period
	Interest rates and	By currency and maturity	Weekly	Last working day

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
	flows of the funds attracted and allocated by commercial banks			of the week
	T-bill and coupon bond financing, CBA securities	Auction data: date, original and remaining maturities, issuance volume, allocation, average yield and coupon yield (if available)	Weekly	Last working day of the week
	Banking data	Sectoral distribution of loans and deposits; dollarization of loans and deposits; loan maturities; interbank rate, by volume and maturity; T-bill rate, bond yield; deposit and lending rates, by maturity; monthly weighted average interest rate on government bonds	Monthly	Within 25 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	Monthly	Within 30 days of the end of each month
	Banking sector stress tests	Results of stress tests on exchange rate, liquidity, and credit risk	Monthly	Within 30 days of the end of each month
	On-lending via commercial banks	On lending via the CBA and government (from the Russian loan, KfW, WB, ADB, etc.) by type of on-lending projects (including loan disbursements and repayments)	Monthly	Within 10 days of the end of each month.
	CPI	Index of core inflation	Monthly	Within 21 days of the end of each month
	Transfers	Non-commercial transfers of individuals	Monthly	Within 30 of the end of each month
	Other monetary data	IFS format	Monthly	Within 45 days of the end of each month
Ministry of Finance (MOF)	T-bill and coupon bond financing	By holders, i.e., CBA, resident banks, resident nonbanks, and nonresidents	Monthly	Within 7 days of each month

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
	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. For project implementation units, 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 tax administration and customs administration, including revenue by individual tax, and social contributions	Monthly	Within 7 days of the end of each month
	Domestic expenditure arrears	All unpaid claims outstanding at the end of the month which includes wages, social contributions (including for pensions), family allowances, and amortization and domestic interest payments	Monthly	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, 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	Monthly	Within 30 days of the end of each month

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
	Consolidated general government	Central and local governments, and Non-Commercial Enterprises that belong within the general government (NCEs)	Quarterly	Within 60 days of the end of each quarter
	Consolidated general government	Central and local governments, and NCEs that belong within the general government	Annual	Within 180 days of the end of each year
	Budget execution	All cash receipts, cash expenditures, including domestic and external debt-service payments, external and domestic borrowing and lending operations, and inflow of grants to the central government; expenditure data will be provided according to both economic and functional classifications, consistent with the GFSM2001 methodology	Monthly	Within one month following the end of each quarter.
	Financial information on utilities and other major companies with a state interest	Profit and loss indicators for regulated utilities, for companies with state shareholding of 50 percent or greater, and for companies with state shareholding of 0-50 percent and annual sales or outstanding liabilities of AMD 10 billion.	Quarterly	Within 60 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
		Detailed balance of payments data	Quarterly	Within 60 days of the end of each quarter
	CPI	By category	Monthly	Within 5 days of the end of each month

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
State Revenue Committee	Tax arrears	By type of tax	Monthly	Within 30 days of the end of each quarter (monthly data provided on a quarterly basis)
		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
	Tax credits	Detailed data, by type of tax, of outstanding tax credits for all types of tax revenues and by economic sectors (i.e. Agriculture, Industry, Mining, Construction, Trade and Services), in both net and gross terms	Monthly	Within 45 days of the end of each (monthly data provided on a quarterly basis)
	Tax Revenues	Tax Revenue by Economic Sectors (i.e. Agriculture, Industry, Mining, Construction, Trade and Services)	Monthly	Within 45 days of the end of each quarter (monthly data provided on a quarterly basis)
	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), or offset (in full or in part), or rejected (in full or in part) after the 90 day statutory processing period. Number of refund applications processed per month.	Monthly	Within 45 days of the end of each month (monthly data provided on a quarterly basis)
	Large taxpayers	Data on the number of taxpayers and amount of taxes managed by the large tax inspectorate	Monthly	Within 45days after the end of each month
	Import data	1. Total value of recorded imports, breaking out raw diamond imports; 2. Total value of non-duty free	Quarterly	Within 30 days of the end of each quarter

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
		recorded imports; 3. Number of total transactions involving recorded imports; 4. Number of total transactions involving non-duty free recorded imports 5. Value of recorded imports where customs value was assessed using transaction prices, breaking out raw diamond imports; 6. Value of non-duty free recorded imports where customs value was assessed using transaction prices; 7. Number of transactions involving recorded imports where customs value was assessed using transaction prices; 8. Number of transactions involving non duty free recorded imports where customs value was assessed using transaction prices		
	Automated VAT refunds	Number of refunds that were processed automatically (share of total refunds); total value of automated and automatic refunds and offsets; average waiting time (days) to receive refund	Monthly	Within 45 days of the end of each month (monthly data provided on a quarterly basis)
	Risk-based selection approach	Percentage of selected companies chosen on the basis of risk-based approach, identified revenue from risk-based audits	Monthly	Within 45 days of the end of each month (monthly data provided on a quarterly basis)

Table 1. Armenia: (Program) Exchange Rates of the CBA
(As of July 31, 2013 in U.S. dollars per currency rates)

Country	Drams Per Currency	Dollars Per Currency
Australian dollar	371.95	0.9072
Canadian dollar	398.33	0.9715
Swiss franc	440.91	1.0754
Danish krone	73.06	0.1782
Euro	544.28	1.3275
Pound sterling	627.83	1.5313
Japanese yen	4.18	0.0102
Norwegian krone	69.14	0.1686
Russian ruble	12.47	0.0304
Swedish krone	62.47	0.1524
SDR	621.04	1.5147

Table 2. Armenia: KFW, AsDB, and IBRD SME Loan Disbursements [1 2]
(In millions of U.S. dollars)

Dec-13		Mar-14		Jun-14		Sep-14		Dec-14		Mar-15	Jun-15	Sep-15	Dec-15
EBS/14/18	Act.	EBS/14/18	Act.	EBS/14/18	Act.	EBS/14/18	Proj.	EBS/14/18	Proj.	Prog.	Prog.	Prog.	Prog.
66.1	69.0	78.2	77.0	84.8	85.0	91.4	91.6	98.0	98.2	114.8	125.4	136.0	146.5

1/ Cumulative from end of the previous year
2/ Adjustors from EBS/14/18 remain the reference for 2014 targets.

Table 3. Armenia: External Disbursements to the Public Sector [1 2]
(In millions of U.S. dollars)

	Dec-13		Mar-14		Jun-14		Sep-14		Dec-14		Mar-15	Jun-15	Sep-15	Dec-15
	EBS/14/18	Act.	EBS/14/18	Act.	EBS/14/18	Act.	EBS/14/18	Proj.	EBS/14/18	Proj.	Prog.	Prog.	Prog.	Prog.
Project financing	202	141	14	24	51	57	88	130	203	187	28	56	84	112
Budget support loan	350	360	374	360	374	360	399	360	466	410	410	410	410	489
Budget support grant	116	118	116	118	116	118	116	118	133	135	135	135	135	150
of which: EU MFA	47	47	47	47	47	47	47	47	47	47	47	47	47	47

1/ Budget support cumulative from the end of the previous year. Project financing cumulative during the same year.
2/ Adjustors from EBS/14/18 remain the reference for 2014 targets.

Annex I. Armenia's Accession to the Eurasian Economic Union

1. The presidents of Armenia, Belarus, Kazakhstan and Russia signed Armenia's EEU accession treaty in October. The EEU is a customs union and "single economic space" that calls for free movement of goods, services, capital, and people within its borders. With a total GDP of nearly $2.5 trillion in 2013, and more than 170 million people, EEU membership provides an opportunity for Armenia to expand its exports and deepen integration with Russia, source of 90 percent of Armenia's remittances.

2. Armenian exports could benefit from enhanced access to EEU markets. Armenia is already a member of the CIS Free Trade Agreement, but EEU membership is expected to eliminate the need for customs declarations and inspections, thus reducing non-tariff barriers and delays. However, as Armenia does not share common borders with EEU members, gains will depend on expedited transit procedures with Georgia.

3. The authorities have sought to mitigate trade diversion and adverse impacts of higher external tariffs. Since the weighted average EEU CET rate is higher (9.5 percent) than Armenia's current weighted average tariff rate (3.0 percent), Armenia has secured transition periods to the EEU CET rates of one to eight years for 752 goods (including selected food products, chemicals, medicines and medical equipment, cars, and machinery), for which Armenia's current tariffs are lower, and 18 agricultural products for which Armenia's current tariff rates are higher. The EEU CET rate schedule will decline over the medium term, reducing risks of trade diversion when transition periods end. Armenia is not expected to have permanent exclusions from the CET schedule past the transition period.

4. Armenia could potentially benefit from higher customs revenues. Armenia has secured 1.13 percent of the EEU common customs pool from 2015, and Armenia could receive up to $250–275 million annually, approximately 2½ percent of GDP, compared with 1 percent of GDP in customs revenues at present. Excises, VAT, and customs fees are not covered and will remain national.

5. Armenians are expected to have more secure access to the Russian labor market. Armenians will not be required to obtain a work permit prior to seeking a job in any EEU member state. They will have the same labor rights as Russian citizens, and will be considered legal residents of Russia during the course of their employment. EEU citizens will also face fewer restrictions in travelling between member states.

6. EEU membership could possibly lead to deeper integration across a broad range of areas. In addition to establishing a customs union, the EEU treaty provides a framework for further collaboration, including macroeconomic, exchange rate, competition, energy, labor migration, financial market, investment, and intellectual policies. In addition, the Eurasian Commission was established as the permanent governing body of the union. Depending on the degree of political will, the treaty could be just a customs union or lay the basis for much deeper integration.

7. In connection with EEU membership, Armenia has obtained additional benefits. The authorities secured favorable terms for gas imports from Russia (with savings of 1.5 percent of GDP per year), renewed security assurances, and concessional financing of $300 million to refurbish the Metsamor nuclear plant. The authorities have also requested $50 million in grants from founding EEU members to finance the direct costs of customs union implementation, such as new software and hardware for customs, and new agricultural and food testing labs.

8. There are costs and risks associated with EEU membership. Under EEU membership, the Armenian economy may become more closely linked to the Russia economy, which is volatile, linked to oil, and expected to grow slowly over the medium term, unless significant structural reforms are implemented. Moreover, the end of negotiations on an Association Agreement with the EU could mean the loss of a long-term reform anchor and convergence to EU standards.

Annex II. Pension Reform: Recent Developments and Changes

1. Earlier this year, the Constitutional Court ruled some provisions of the pension reform unconstitutional, in particular provisions related to mandatory contributions and allocation of contributions to asset managers through non-budgetary channels. The court gave the government and parliament until September to change the provisions. In July, the National Assembly approved a new pension law that addressed the ruling and introduced other changes to address concerns raised in public demonstrations, including a gradual implementation approach and additional incentives for contributors.

2. *Incorporation of the state budget into the pension system architecture.* Under the new law, collections will be transferred to the depository through the budget and reported in the fiscal accounts, with ownership transferred accordingly.

- ***Gradual implementation.*** Mandatory contributions remain, but deadlines for joining vary for different groups. Public sector employees were required to join from July 1st 2014. For private sector workers, new labor market entrants must join immediately, while workers employed on July 1, 2014 are allowed to postpone participation until July 2017, provided they submit an application before December 25, 2014. This change will provide Pillar 2 with an estimated 65,000 participants by end-2014, compared with 275,000 originally envisaged.
- **Greater incentives to encourage participation include**:

  1. *Caps for mandatory payments of high-wage individuals*. Under the original law, mandatory contributions—10 percent of salaries—were not capped. The new law establishes at a fixed cap of AMD 25,000 until 2020, with indexation to increases in the minimum wage thereafter.

  2. *Matching contributions for individuals born after January 1964*. Under the original law, individuals born before 1974 were allowed to participate on Pillar 2 on a voluntary basis, although without government matching contributions. Under the new law, matching will be provided.

  3. *Early retirement*. Under the new law, participants are entitled to draw a funded pension at age 55, if cumulated assets are sufficient to buy an annuity. Previously, early retirement was allowed only for disability or changes in citizenship or moving to a foreign country.

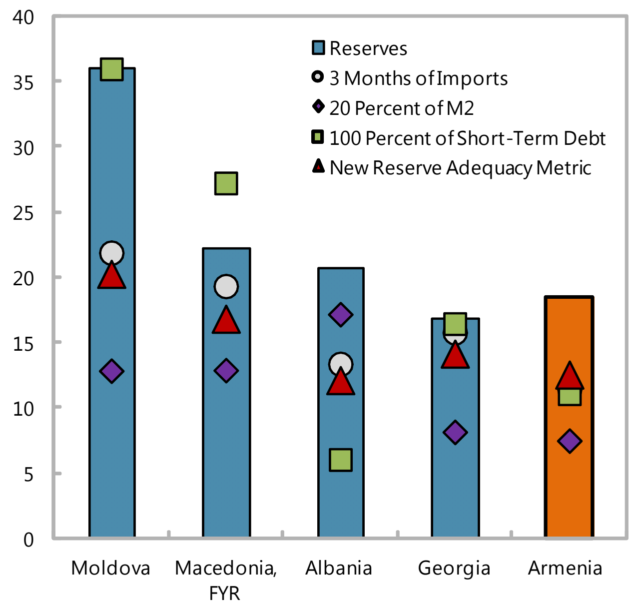
3. Assessment. Successful implementation of the new pension law hinges on several key elements: (i) swift functioning of software changes and transfer of mandatory payments to personal accounts; (ii) a successful strategy to bring on board private sector workers during 2015–17 and reduce risks to the reform from parliamentary and presidential elections in 2017–18; and (iii) an evaluation of the impact of the changes on the business plans of the two blue-chip foreign asset managers and their capacity to contribute to local capital market development.

Annex III. Reserve Metrics and External Stability Assessment

Armenia has made progress in rebuilding reserve buffers that declined in the crisis years, and the current level is broadly adequate by most reserve metrics. The rebuilding of reserves is a welcome development, given that the economy remains vulnerable to shocks, while high dollarization calls for added reserve cushions. Moreover, despite the considerable external adjustment in 2013, the current account deficit is still sizeable at around 8 percent of GDP, and staff's estimates suggest that a further adjustment of the dram in real terms is needed over the medium term. External debt sustainability has deteriorated somewhat, and high external gross financing needs raise rollover risks.

1. **Armenia's current level of reserves appears broadly adequate.** Gross reserves are projected to cover 4.7 months of imports at end-2014 and then to gradually decline to 4.5 months of imports by 2019. These reserves figures are adequate based on standard import and debt metrics, as well as the IMF's composite metric. Reserves adequacy also looks favorable in comparison with peer group countries. Still, current reserve levels are not excessive given the risks Armenia faces, and staff has called on the authorities in the past to seek a cushion greater than suggested by the benchmarks. This is motivated by Armenia's vulnerability to shocks and by the high degree of dollarization: 62 percent and 58 percent for credit and deposit dollarization, respectively, as of September 2014.

Projected Reserve Adequacy Indicators, 2014
(In Percent of GDP)



Source: National Authorities; and IMF staff calculations and estimates.

2. **Armenia's external debt-to-GDP ratio remains high, and is expected to decline only moderately in the medium term.** The ratio was 82 percent of GDP at end-2013, and it is projected to decline to around 81 percent by 2019. The ratio improved rapidly in the mid-2000s reaching a low of 29½ percent of GDP in 2008. The improvement was largely due to exchange rate appreciation and growth, as well as increasing non-debt creating FDI inflows, partly offset by modest current account deficits. Subsequently, the debt-to-GDP ratio increased with the global crisis (both as a result of higher nominal debt and lower GDP). Large external current account deficits—partly offset by FDI flows—were the most important factor in the deterioration in the external debt-to-GDP ratio in this period with some contribution from the nominal interest rate.

3. Staff's assessment of external debt sustainability has deteriorated with the revised projections. This is primarily due to lower revised medium-term projections for growth and FDI. The debt stabilizing non-interest current account deficit is estimated at 5.7 percent of GDP as opposed to 6.9 percent of GDP previously. In the baseline, the change in external debt is dominated by current account deficits (excluding interest payments) averaging about 4.2 percent of GDP during 2014−19, which is offset by projected non-debt creating FDI, whereas automatic debt dynamics have a smaller impact.

4. External sustainability is sensitive to standard shocks other than the nominal interest rate. The external debt ratio increases to 94–97 percent of GDP under standardized shocks to growth and the non-interest current account, as well as under the combined scenario (Figure 1 below). A one-time 30 percent real ER depreciation would raise the debt ratio by around 36 percentage points above the baseline path to 117 percent of GDP in 2019. Given the large share of concessional financing in external public debt, external sustainability is robust to a standardized shock to the interest rate.

Table 1. Country: External Debt Sustainability Framework, 2009-2019
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2009	2010	2011	2012	2013			2014	2015	2016	2017	2018	2019	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	56.4	66.4	71.5	74.9	82.0			**80.6**	**81.8**	**83.4**	**83.5**	**83.0**	**81.1**	**-5.7**
2 Change in external debt	26.9	10.0	5.1	3.4	7.0			-1.4	1.2	1.6	0.0	-0.5	-1.9	
3 Identified external debt-creating flows (4+8+9)	20.1	6.7	2.3	6.7	-0.3			2.8	1.4	0.6	0.1	-0.3	-0.5	
4 Current account deficit, excluding interest payments	16.4	13.0	9.1	8.8	5.4			5.2	4.4	4.2	4.0	3.7	3.6	
5 Deficit in balance of goods and services	28.5	25.7	22.1	22.7	21.1			19.5	18.7	18.6	18.2	17.8	17.3	
6 Exports	15.8	21.3	24.3	25.7	26.2			26.6	27.4	28.1	28.2	28.2	27.8	
7 Imports	44.3	47.1	46.4	48.4	47.3			46.0	46.1	46.6	46.5	46.0	45.1	
8 Net non-debt creating capital inflows (negative)	-7.7	-3.8	-3.0	-5.8	-4.9			-3.3	-3.3	-3.5	-3.5	-3.5	-3.5	
9 Automatic debt dynamics 1/	11.5	-2.5	-3.8	3.7	-0.8			0.8	0.2	-0.1	-0.4	-0.5	-0.6	
10 Contribution from nominal interest rate	1.2	1.2	2.0	2.3	2.6			2.8	2.8	2.9	2.9	2.9	2.9	
11 Contribution from real GDP growth	5.6	-1.2	-2.8	-5.2	-2.5			-2.0	-2.6	-3.0	-3.3	-3.4	-3.5	
12 Contribution from price and exchange rate changes 2/	4.7	-2.6	-2.9	6.6	-1.0			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	6.8	3.3	2.9	-3.3	7.3			-4.2	-0.2	1.0	0.0	-0.2	-1.5	
External debt-to-exports ratio (in percent)	357.0	311.1	293.9	291.9	312.8			303.4	298.8	297.4	295.5	294.1	291.3	
Gross external financing need (in billions of US dollars) 4	2.1	1.9	2.0	2.5	2.7			2.6	2.4	2.5	2.6	2.7	3.0	
in percent of GDP	24.8	20.8	19.6	24.6	26.3	10-Year	10-Year	23.4	21.6	21.8	21.8	21.7	22.1	
Scenario with key variables at their historical averages 5/								**80.6**	**73.8**	**68.2**	**63.2**	**59.1**	**55.2**	**-11.7**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	-14.1	2.2	4.7	7.1	3.5	6.2	8.4	2.6	3.3	3.7	4.1	4.3	4.5	
GDP deflator in US dollars (change in percent)	-13.6	4.8	4.6	-8.4	1.3	8.4	13.0	2.5	-0.5	-1.2	-0.1	0.8	2.0	
Nominal external interest rate (in percent)	3.0	2.3	3.2	3.2	3.7	2.5	0.9	3.6	3.6	3.6	3.6	3.7	3.7	
Growth of exports (US dollar terms, in percent)	-22.4	44.6	24.9	3.5	7.0	12.2	18.6	6.6	6.0	5.0	4.7	5.1	5.1	
Growth of imports (US dollar terms, in percent)	-23.1	13.9	8.0	2.2	2.6	13.8	18.1	2.3	3.0	3.6	3.7	4.2	4.4	
Current account balance, excluding interest payments	-16.4	-13.0	-9.1	-8.8	-5.4	-8.2	5.2	-5.2	-4.4	-4.2	-4.0	-3.7	-3.6	
Net non-debt creating capital inflows	7.7	3.8	3.0	5.8	4.9	5.7	1.7	3.3	3.3	3.5	3.5	3.5	3.5	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

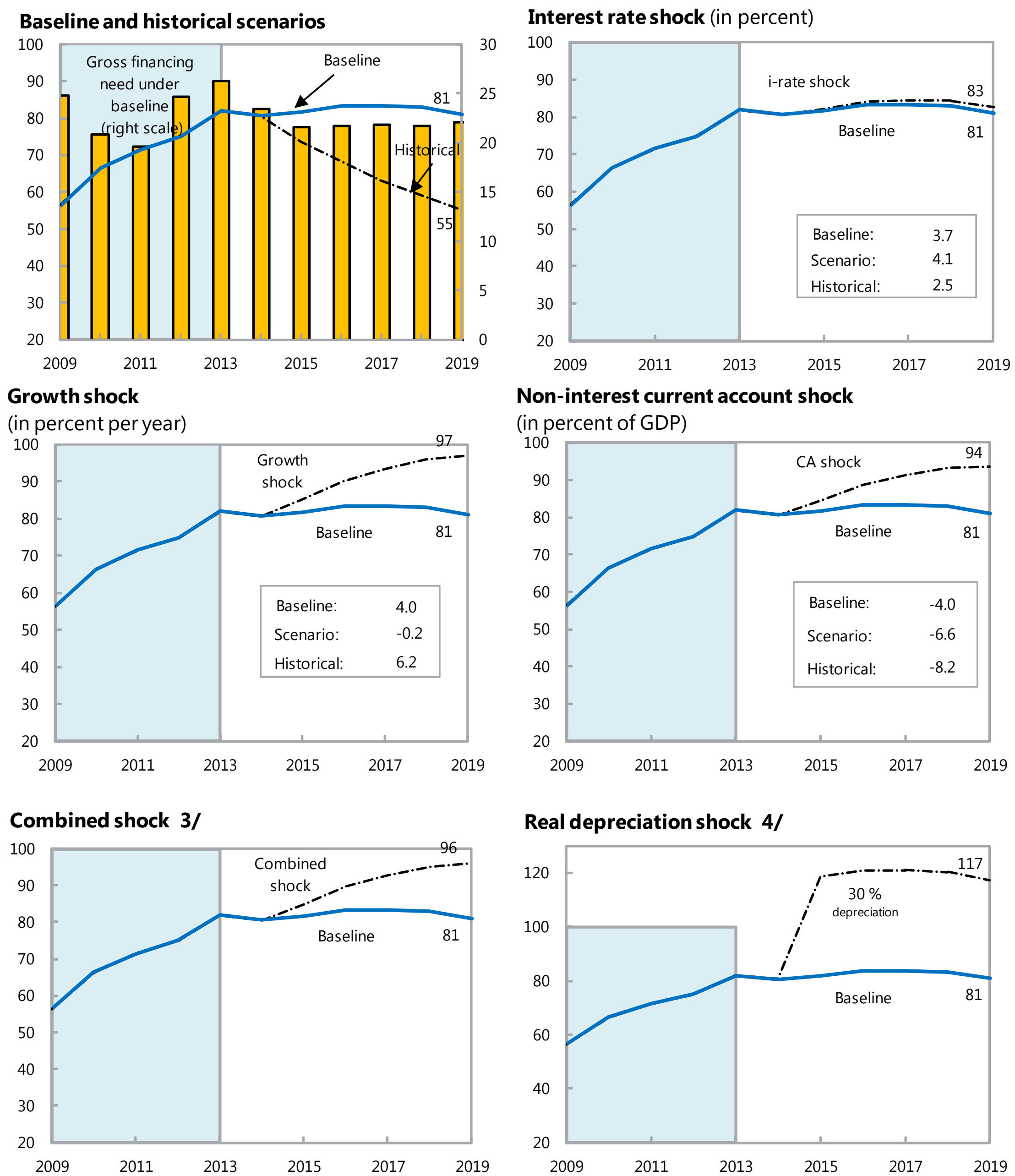
3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 1. Country: External Debt Sustainability: Bound Tests 1/ 2/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2015

Annex IV. Public Debt Sustainability Analysis

The debt sustainability analysis (DSA) using staff's baseline medium-term macroeconomic projections suggests that Armenia's public debt remains sustainable. Alternative scenarios based on constant primary balance and key variables at their historical averages do not result in significant increases in public gross financing needs or debt levels.

1. Gross public debt stood at 43.4 percent of GDP at the end of 2013, slightly lower than a year earlier. In the period before the crisis, debt was on a declining trend, falling from 40 percent of GDP in 2003 to 16 percent of GDP in 2008. Against the background of sharply deteriorating economic conditions, debt started to accumulate quickly and in 2009 alone the debt ratio increased by 24 percent of GDP, due to contraction of output, depreciation of the dram and new borrowing, including a $500 million loan from Russia. This loan was fully repaid with the proceeds from a $700 million Eurobond that the government successfully placed in 2013.

2. Macroeconomic assumptions underlying the current DSA have changed since the time of the program request. The changes were triggered primarily by the worsening of the external environment, notably the growth outlook for Russia. GDP growth projections for Armenia have been marked down reflecting weaker exports and remittances. The fiscal deficit in 2014 will most likely be below the budget target due to lower matching pension contributions and continuing underexecution of the capital budget. The primary deficit is projected to remain in the 0.2–0.8 percent of GDP range in the medium term, well below the estimated debt-stabilizing level of 1.6 percent of GDP.

3. Going forward, under the baseline scenario public debt is expected to remain the range of 44–46 percent of GDP till 2016 and gradually decline thereafter. The small initial increase is mainly driven by the assumed gradual adjustment of the dram exchange rate over the medium-term to correct for the misalignment established in the real exchange rate assessment (Annex V). As growth picks up and the exchange rate approaches its equilibrium value, public debt is expected to decline to 43.6 percent in 2019. Government's gross financing needs remain moderate during the period under consideration as the Eurobond repayment does not occur until 2020.

4. Alternative scenarios based on assumptions of a constant primary balance and key variables at their historical averages do not deviate much from the baseline. The dynamics of public debt and gross financing needs under the constant primary balance scenario closely mirror the baseline. Under the historical scenario, financing needs increase over the medium term but do not exceed 8 percent of GDP, and the debt ratio stays below 50 percent. Overall, the foregoing analysis confirms the conclusion in the previous DSA that Armenia's public debt remains sustainable. Maintaining prudent fiscal policy in the future would allow reducing the level of debt over time and freeing up space for much needed investments in infrastructure and human capital.

Armenia Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

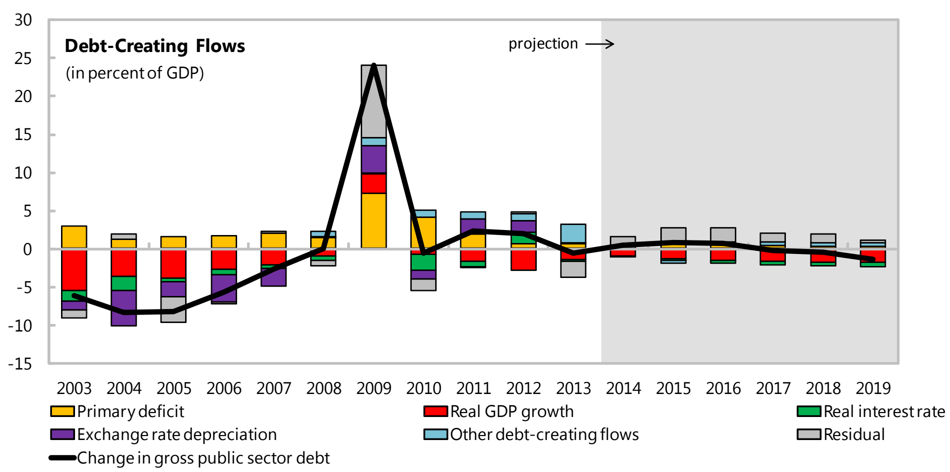
Debt, Economic and Market Indicators [1/]

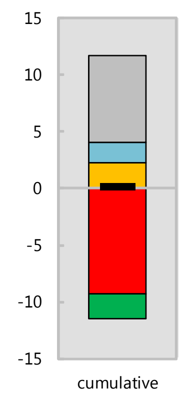
	Actual			Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	30.1	44.0	43.4	43.9	44.8	45.5	45.4	45.0	43.6
Public gross financing needs	5.1	4.0	8.7	3.4	4.6	4.7	4.9	5.1	4.8
Net public debt		34.5	34.6	35.8	37.6	39.3	40.1	40.5	39.9
Real GDP growth (in percent)	7.3	7.1	3.5	2.6	3.3	3.7	4.1	4.3	4.5
Inflation (GDP deflator, in percent)	4.8	-1.2	3.2	3.3	4.0	4.0	4.0	4.0	4.0
Nominal GDP growth (in percent)	12.4	5.9	6.9	6.0	7.5	7.8	8.3	8.5	8.7
Effective interest rate (in percent) [4/]	2.0	2.5	2.7	3.3	3.5	3.3	3.1	3.0	2.8

As of October 22, 2014		
Sovereign Spreads		
Spread (bp) 3/		349
CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	Ba2	n.a.
S&Ps	BB-	n.a.
Fitch	BB-	n.a.

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-0.6	1.98	-0.56	0.5	0.8	0.8	-0.2	-0.4	-1.4	0.2	
Identified debt-creating flows	-1.0	1.75	1.50	0.5	0.8	0.8	-0.2	-0.4	-1.4	0.2	
Primary deficit	2.7	0.6	0.6	0.1	0.8	0.5	0.4	0.3	0.2	2.3	-1.6
Primary (noninterest) revenue and grants	19.0	22.3	23.7	23.6	23.8	23.9	24.1	24.3	24.4	144.0	
Primary (noninterest) expenditure	21.7	22.9	24.3	23.7	24.6	24.4	24.5	24.5	24.6	146.3	
Automatic debt dynamics [5/]	-4.0	0.3	-1.5	0.2	0.3	-0.1	-1.0	-1.2	-2.2	-3.9	
Interest rate/growth differential [6/]	-3.0	-1.3	-1.7	-1.1	-1.6	-1.9	-2.2	-2.3	-2.4	-11.5	
Of which: real interest rate	-0.9	1.5	-0.3	0.0	-0.3	-0.4	-0.5	-0.5	-0.6	-2.2	
Of which: real GDP growth	-2.1	-2.8	-1.4	-1.0	-1.3	-1.5	-1.7	-1.8	-1.9	-9.3	
Exchange rate depreciation [7/]	-1.0	1.6	0.2	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.4	0.9	2.4	0.2	-0.3	0.3	0.5	0.5	0.5	1.8	
Domestic net lend./drawdown of gov. dep.	0.0	0.0	1.5	-0.6	-1.2	-0.6	-0.4	-0.4	-0.4	-3.7	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
External net lending to Nagorno-Karabakh	0.4	0.9	0.9	0.8	0.9	0.9	0.9	0.9	0.9	5.5	
Residual, including asset changes [8/]	0.4	0.2	-2.1	1.3	1.9	1.8	1.2	1.2	0.3	7.6	





Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Bond Spread over U.S. Bonds.

4/ Defined as interest payments divided by debt stock at the end of previous year.

5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

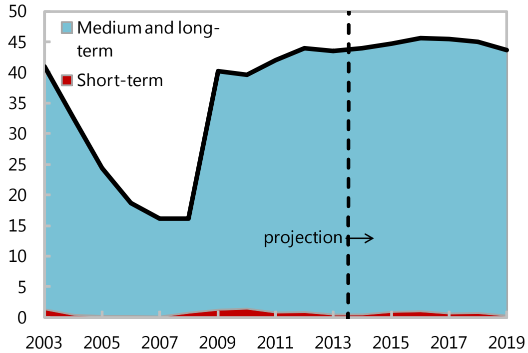
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

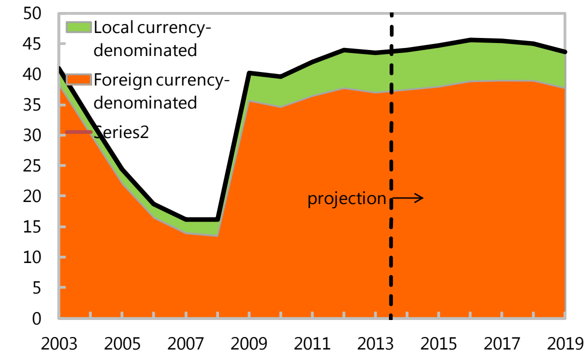
Armenia Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



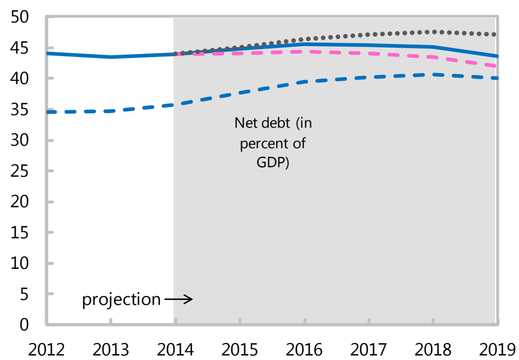
By Currency
(in percent of GDP)



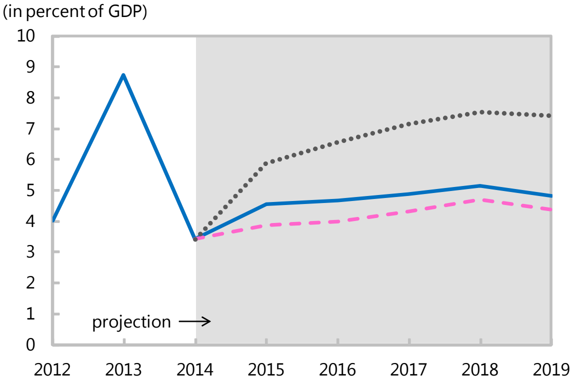
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.6	3.3	3.7	4.1	4.3	4.5
Inflation	3.3	4.0	4.0	4.0	4.0	4.0
Primary Balance	-0.1	-0.8	-0.5	-0.4	-0.3	-0.2
Effective interest rate	3.3	3.5	3.3	3.1	3.0	2.8
Constant Primary Balance Scenario						
Real GDP growth	2.6	3.3	3.7	4.1	4.3	4.5
Inflation	3.3	4.0	4.0	4.0	4.0	4.0
Primary Balance	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Effective interest rate	3.3	3.5	3.3	3.1	2.9	2.8

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.6	6.2	6.2	6.2	6.2	6.2
Inflation	3.3	4.0	4.0	4.0	4.0	4.0
Primary Balance	-0.1	-2.2	-2.2	-2.2	-2.2	-2.2
Effective interest rate	3.3	3.5	3.2	2.9	2.7	2.4

Source: IMF staff.

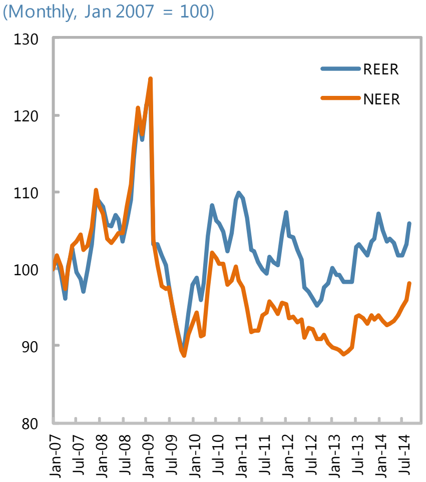
Annex V. Real Exchange Rate Assessment

1. **Despite a sizeable improvement since 2012, Armenia's external current account deficit remained large at 8 percent of GDP in 2013, and is expected to improve only gradually over the medium term.**[1] [2] The sharp improvement in 2013 was primarily due to earnings of Armenians abroad; the net increase in compensation of employees and private transfers was around $270 million, equivalent to around 2.6 percent of GDP. The improvement in services was also significant, mostly related to construction abroad, whereas the trade balance only improved marginally. With cautious projections for both remittances and exports going forward, the current account deficit will improve slowly to 6.5 percent of GDP by 2019.

2. **Staff's estimates suggest that an adjustment of the dram in real terms would be needed in the medium-term to bring the external current account into equilibrium.** The extent of REER misalignment is assessed using a combination of the Fund's new External Balance Approach-lite (EBA-lite) and CGER-type methodologies.[3] Potential real ER misalignment is assessed using the *macrobalance approach* developed under EBA-lite, which replaces the previous CGER-type macrobalance approach, and the *external sustainability approach,* as well as the *equilibrium real exchange rate approach* using CGER-type models. In the EBA-lite methodology, the norm is based on 2013 actual figures; for the other approaches the norm is based on projections.

3. **The exchange rate is estimated to be overvalued in real terms (see text table).** The *macrobalance approach* suggests a current account norm of -6.6 percent of GDP for 2013, about 1.4 percentage points less than the current account that year. The current account norm assumes a desired P* medium-term fiscal deficit that is 0.5 of GDP lower than the 2013 cyclically adjusted headline fiscal balance (2.3 percent, including the ArmRusGaz transaction), no change in desired international reserves, and a benchmark level of private credit to GDP that is 10 percentage points higher than the 2013 level (42.8 percent). This EBA-lite methodology-

Effective Exchange Rates
(Monthly, Jan 2007 = 100)



Source: IMF Information Notice System.

[1] The CBA started to publish BOP data according to the BPM6 methodology from June 2014, with revised data back to 1991.

[2] Staff estimates were calculated based on end-September data for the real effective exchange rates.

[3] EBA-lite is an extended EBA methodology developed by Fund staff. See IMF WP/13/272 for details of the methodology. One essential difference is that EBA makes a sharper distinction between positive (descriptive) understanding of current accounts and real exchange rates and making normative evaluations. Another is that EBA takes into account a much broader set of factors—including policies, cyclical conditions, and global capital market conditions—that may influence the current account and real exchange rate.

based calculation would imply an ER misalignment of about 10 percent. The CGER-type *external sustainability approach* estimates a current account norm for Armenia that stabilizes the ratio of Net Foreign Assets (NFA) to GDP of the country around its norm (5.3 percent of GDP). Comparing this current account norm with its underlying value implies a REER overvaluation of 8.3 percent. Finally, the reduced form *equilibrium real exchange rate approach*, suggests an undervaluation of around 0.2 percent, taking into account information up to Q3 2014. Taking account of the depreciation of the Russian ruble against the dram since then would suggest an overvalued exchange rate in real terms.

4. **These methodologies are subject to limitations and are sensitive to assumptions; the results should therefore be viewed with some caution.** And while the exact magnitude of overvaluation is difficult to determine with certainty, the results do tend to confirm the view suggested by the evolution of the balance of payments that the real ER remains moderately overvalued, despite improvement in the external current account in the last few years.

Estimates for Real Exchange Rate Misalignment

(In percent of GDP, unless indicated otherwise)

	Macrobalance approach (EBA-lite)	Equilibrium Real Exchange Rate (CGER-type)	External sustainability (CGER-type)
Current account norm	-6.6		-5.3
Underlying current account 1/	-8.0		-6.5
CA gap	-1.4		-1.2
Elasticity	-0.14		-0.15
Real exchange rate gap 2/	9.5	-0.2	8.3

1/ 2013 actual value for the macrobalance approach and 2014 and 2019 projections for the ERER and external sustainability approaches, respectively.

2/ Movement in real exchange rate needed to close the gap between norm and projection.

INTERNATIONAL MONETARY FUND

REPUBLIC OF ARMENIA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND FIRST REVIEW UNDER THE EXTENDED ARRANGEMENT—INFORMATIONAL ANNEX

December 5, 2014

Prepared By

The Middle East and Central Asia Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of October 31, 2014)

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

General Resources Account:

	SDR Million	Percent of Quota
Quota	92.00	100.00
Fund holdings of currency	253.98	276.07
Reserve Tranche Position	0.00	0.00

SDR Department:

	SDR Million	Percent of Allocation
Net cumulative allocation	87.99	100.00
Holdings	6.72	7.64

Outstanding Purchases and Loans:

	SDR Million	Percent of Quota
Stand-By Arrangements	16.84	18.30
ECF Arrangements	146.99	159.77
Extended Arrangements	145.14	157.76

Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
EFF	03/07/2014	05/06/2017	82.21	11.74
ECF	06/28/2010	07/02/2013	133.40	133.40
EFF	06/28/2010	06/24/2013	133.40	133.40

Projected Payments to Fund
(SDR million; based on existing use of resources and present holdings of SDRs)

			Forthcoming		
	2014	2015	2016	2017	2018
Principal	15.56	16.43	25.29	36.88	45.17
Charges/interest	0.45	1.93	1.79	1.61	1.35
Total	**16.02**	**18.34**	**27.06**	**38.47**	**46.50**

Safeguards Assessment

Under the Fund's safeguards policy, an update safeguards assessment of the Central Bank of Armenia (CBA) was concluded in August 2014 with respect to the extended arrangement approved in March 2014. The CBA has established good practices in financial reporting, the external audit mechanism, and the internal audit function. The assessment made recommendations to strengthen the independence and operations of the CBA.

Exchange Rate Arrangement

The de jure arrangement is "free floating." The de facto arrangement was reclassified to "floating" from a "stabilized arrangement," effective March 3, 2009. More recently, and following interventions to rebuild reserves in the last three quarters of 2013, the de facto arrangement was reclassified from floating to crawl-like arrangement, effective March 12, 2013. This designation reflects the appreciation of the Armenian dram within a 2 percent band against the U.S. dollar during the last three quarters of 2013.The official exchange rate is quoted daily as a weighted average of the buying and selling rates in the foreign exchange market.

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

Article IV Consultations

The 2014 Article IV consultation with Armenia was concluded on December 19, 2014. Armenia is subject to a 24-month consultation cycle.

FSAP Participation and ROSCs

A joint World Bank-IMF mission assessed Armenia's financial sector as part of a Financial Sector Assessment Program (FSAP) update during February 1–14, 2012. The Financial Sector Stability Assessment (FSSA) report was approved by the Executive Board in June 2012. The most recent previous FSAP update took place in 2005.

Resident Representative

Ms. Teresa Daban Sanchez, since August 2013.

Technical Assistance

The following table summarizes the Fund's technical assistance (TA) to Armenia since 2010.

Armenia: Technical Assistance from the Fund, 2010–14

Subject	Type of Mission	Timing	Counterpart
Fiscal Affairs Department (FAD)			
Tax administration	Short-term	March –May 2010	MoF, SRC
Tax administration	Short-term	August - November 2010	MoF, SRC
Tax administration	Short-term	September 2010	MoF, SRC
Tax administration	Short-term	November 2010	MoF, SRC
Tax policy	Short-term	February 2011	MoF
Tax administration	Short-term	February–March 2011	MoF, SRC
Tax administration	Short-term	May–June 2011	MoF, SRC
Tax policy (mining)	Short-term	June 2011	MoF
Budget process	Short-term	October 2011	MoF
Public Financial Management	Short-term	November 2012	MoF
Tax Administration	Short-term	April 2013	MoF, SRC
Tax Administration	Short-term	September 2013	MoF, SRC
Fiscal Risk	Short-term	October 2013	MoF, SRC
Tax Administration	Short-term	December 2013	MoF, SRC
Public Finance Management	Short-term	March 2014	MoF
Fiscal Risk	Short-term	November 2014	MoF
Legal Department			
Banking Law	Short-term	June 2011	CBA
AML/CFT	Short-term	Various	MoF
AML/CFT	Short-term	April 2014	MoF
Monetary and Capital Markets Department			
Contingency planning, crisis preparedness	Short-term	March–April 2010	CBA
Workshop on Inflation Targeting (with IMF Research Dept.)	Workshop	April–May 2011	CBA
Bank resolution framework	Short-term	June 2011	CBA
Medium-term debt management strategy	Short-term	December 2011	CBA
FSAP update	Short-term	February 2012	CBA
Inflation targeting (with IMF Research Dept.)	Short-term	February-March 2012	CBA
Inflation targeting	Short-term	November 2012	CBA
Inflation targeting	Short-term	January 2013	CBA
Bank prudential framework	Short-term	April 2013	CBA
Monetary and Foreign Exchange Policy	Short-term	June 2013	CBA

Safeguard Assessment	Short-term	March 2014	CBA
Central Bank Communication	Short-term	April 2014	CBA
Inflation Targeting	Short-term	April 2014	CBA
Statistics Department			
National accounts	Short-term	September 2010	NSS
BOP and external debt statistics	Short-term	October 2011	CBA
National accounts	Short-term	April 2012	NSS
Monetary statistics	Short-term	April 2012	CBA
National accounts	Short-term	May 2012	NSS
Monetary statistics	Short-term	October 2012	CBA
Construction Price Index	Short-term	September 2013	NSS

WORLD BANK AND IMF COLLABORATIONS—JMAP IMPLEMENTATION

(As of November 7, 2014)

Title	Products	Provisional timing of missions	Expected delivery date (tentative)
1. Bank program in the next 12 months	***Selected Ongoing and New Operations***		
	Public Sector Modernization Project II (US$9m)	Semi Annual	Project Implementation started in Sept. 2010 and closing is Dec. 2014
	Tax Administration Modernization Project (US$12 m)	Semi Annual	WB Board approval July 2012, effective since Dec. 2012, closing date is Dec, 2015
	New DPO series to support competitiveness and ensure sustainability (US$ 197m)	Quarterly	Board date for DPO-2: November 12, 2014 DPO-3: September 2015
	New Health Project for Disease Prevention and Control (US$30m)	Semi Annual	WB Board approved – March 2013
	Public Sector Modernization (III) and PFM project	Semi Annual	Targeted Board Date – March 2015
	Analytic Work		
	Programmatic Poverty work	Continuous	Annual Series, 2014 report
	Programmatic Fiscal work (fiscal incidence assessment, public sector wage assessment, review of social assistance programs)		Delivered in June 2014 Dissemination in November 2014.
	New Country Economic Memorandum		Dissemination in May 2015
	Assessment of EEU membership on Armenia's economy		Dissemination in Dec 2014
	Promoting Productive employment in Armenia – a note on labor market activation		Policy workshop in December 2014

	Selected Technical Assistance	Ongoing	
	IDF grant for guillotine exercise		2014-15
	Macro-monitoring		
	One-stop shop for providing construction permits		
2. IMF work program in the next 12 months	Second EFF Review	March 2015	May 2015
	Third EFF Review	September 2015	December 2015
	Selected Technical Assistance/Training		
	FAD (follow-up on Risk Management Unit)	TBD	TBD
	FAD (Tax Administration)	June 2015	December 2015
	FAD (Public Financial Management)	TBD	TBD
	MCM/RES (Inflation targeting)	January 2015	June 2015T

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

(As of October 21, 2014)

1. **As of October 21, 2014, the EBRD had approved 131 projects in the power, transport, agribusiness, municipal and infrastructure, manufacturing and services, property, telecommunications, and financial sectors. Total commitments amounted to around EUR 757.8 million**. During the year 2014, the EBRD signed 10 projects with a total volume of EUR 50.1 million.

2. **EBRD has signed six sovereign projects in Armenia to-date. 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**. The government was contemplating the privatization of Hrazdan Unit 5 as the completion of this plant was constrained by limited budgetary resources. The EBRD had funded TA for the Hrazdan privatization prospectus and followed the privatization process. 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 (according to a concession agreement). The new management prepared a master plan for the development of the airport, which is expected to generate further cargo traffic for the cargo terminal. In April 2007, the EBRD approved a EUR 7 million loan to the State Committee for Water Systems, owner of the water and wastewater assets located in the small municipalities outside of Yerevan. The proceeds of this loan have been used to improve wastewater treatment in five municipalities located near Lake Sevan. In March 2010, EBRD signed a first EUR 5.0 million sovereign loan with Yerevan Metro Company. This project is providing emergency investments in the Yerevan Metro, covering immediate rehabilitation needs including safety upgrades and energy efficiency. The investment is part of a plan to improve and reform public transport services in the capital of Armenia. In August 2012, EBRD signed its second EUR 5.0 million sovereign loan with Yerevan Metro to primarily address issues related to water ingress into the tunnels. In November 2012, the EBRD signed a EUR 10 million loan to the Armenian government for the construction of a new bridge at Bagratashen, the main border crossing point between Armenia and Georgia, as part of the EU's Integrated Border Management regional initiative. Other financiers, including EIB, the EU, EU NIF, UNDP and the Armenian government, have joined forces to rehabilitate transport infrastructure at the Armenian-Georgian border.

3. **Most of the Bank's projects (87%) in Armenia are in the private sector**. In addition to the loan to Electric Networks of Armenia (see below), the Bank approved an additional loan to Zvartnots

International Airport in the amount of EUR 29.6 million (supplemented by investments from ADB and DEG). This project followed on from the successful completion, in May 2007, of the first phase of the Passenger Terminal, for which the Bank provided a EUR 14.8 million loan together with DEG (USD 10 million). This project involved the construction and purchase of equipment for the second phase of the Passenger Terminal complex at Zvartnots International Airport and facilitated the completion of Airport Terminal development reallocating all operations (arrivals and departures) from the old Airport building. The loan was a commercial facility with no sovereign support. In 2009 and 2011, the Bank invested a total of USD 7.4 million in Lydian Int., is a Jersey-based company listed on the Toronto Stock Exchange. In 2014 an additional USD 3 million was invested by EBRD bringing our equity share to 7.9%, on par with IFC. Lydian's largest shareholders include two US funds (c.10% and 9%) followed by IFC and EBRD (c.8%, 8%) and management and directors (c.8%), who own a number of exploration assets in Armenia (through its 100% owned subsidiary Geoteam) and Georgia. Other private sector finance includes relatively smaller loans to private companies and equity participation in a number of companies in various sectors of the industry.

4. **By the mid of October 2014 the Bank committed EUR 50.1 million to Armenia through 10 transactions, including 8 projects in the financial institutions sector (it is worth mentioning that two transaction relate to an energy efficiency credit line which will also cater for residential users, the first of its kind for EBRD in Armenia), one in Natural Resources and one in Agribusiness sector**.

5. **In the banking sector, a first equity participation in the Commercial Bank of Greece-Armenia (EUR 1.1 million) was approved in late 1999. Now there are four local banks where EBRD participates in equity: Armeconombank, Byblos Bank Armenia, Ararat Bank and ProCredit Bank**.

6. **The Armenia Multi-Bank Framework Facility II (AMBFF II), established to provide loans and equity to commercial banks and leasing companies in Armenia, was approved by the EBRD Board in March 2006 for an amount of $40 million, and then extended for another $80 million in November 2007.** In late 2009, the EBRD has approved a further $100 million extension to AMBFF II in order to support increased financial intermediation and the development of the financial sector in Armenia and to contribute to economic development by providing medium to long-term funding to selected Armenian financial intermediaries. Another extension to this Facility of $100 million was approved in mid-2011. The Facility seeks to develop new products for financial institutions, including provision of local currency loans, agricultural credit lines and mortgage financing. Through the program additional TA is provided to partner banks.

7. The EBRD expanded its relationship with partner banks in Armenia from four to twelve (taking into account that two EBRD clients – Ameria Bank and Cascade Bank merged in 2010). Nine banks were provided with new credit facilities under the AMBFF. One institution (Armeconombank) was provided with a mortgage facility, and the first leasing facility in Armenia was signed with ACBA Leasing in 2008 for EUR 5.9 million. A co-financing facility with six local banks was also extended resulting in 14 sub-loans to Armenian corporates. By means of co-financing lines, the Bank has entered such new sectors as healthcare and telecoms, in addition to significantly expanding its portfolio of agribusiness loans. A Trade Facilitation Program with the purpose of facilitating access of Armenian banks to trade financing was also made available to nine Armenian banks.

8. By the mid of October 2014, the EBRD has disbursed about EUR 85 million in local currency to Armenian commercial banks and micro financing institutions. Another EUR 20 million equivalent in Armenian drams are in the pipeline. The Currency Exchange (TCX) provides the Armenian dram hedge to the EBRD. In parallel, the EBRD and IMF are assisting the government and the CBA to implement reforms aiming to facilitate financing in dram, reduce the level of dollarization, and foster the development of local capital markets.

9. The one-year bonds for a total of AMD 2 billion (approximately USD $5 million) were placed via an auction on the NASDAQ OMX Armenia exchange in Yerevan on 31 January. This was the first publicly-auctioned issue by either a foreign borrower or an international financial institution on NASDAQ OMX and it was also the first floating rate note to be issued on the local market. Ameriabank CJSC and HSBC Bank Armenia CJSC acted as advisers and agents to the issuer.

10. In early 2012, EBRD together with other international financial institutions supported the creation of the Caucasus Growth Fund. This fund is managed by the Small Enterprise Assistance Funds (SEAF), a global fund manager, and is be the first institutional quality fund to provide debt and equity to SMEs in the Caucasus region.

11. Supporting development of renewable energy is another core activity of the Bank. To that end, the EBRD joined forces with the WB, USAID, and Cascade Credit (a financing arm of Cafesjian Foundation) to launch the Armenian Renewable Energy Program (AREP). The Bank's participation took the form of a loan to Cascade Credit. The Bank also continued to finance renewable energy projects on its own through a Direct Lending Facility, with two such projects signed. In addition to renewable energy, the Bank returned to the mainstream segment of the sector, seeking to support post-privatization development with a loan to the Armenian privately-owned power distribution company. In April 2009, the EBRD signed a EUR 42 million loan with Electric Networks of Armenia to upgrade and modernize obsolete low-voltage infrastructure and improve energy efficiency. In December 2012, the EBRD provided a EUR 19 million loan to International Energy Corporation (IEC) to finance the rehabilitation of seven hydropower plants of the Sevan-Hrazdan Cascade. The project is bringing the Company's technical standards in line with best international practice.

12. The EBRD launched the Enterprise Growth Programme (EGP) and Business Advisory Service programs in Armenia in 2003 to support micro, small, and medium-sized enterprises. Since 2003, BAS has completed 936 projects in the amount of EUR 5.9 million, as well as 63 Market Development Activity (MDA) projects. EGP has delivered more than 25 projects. Among the donors is Canada, Taiwan Province of China, the United Kingdom, the EU, EU - Eastern Partnership Multi-Beneficiary Technical Assistance, the United States, the Early Transition Countries Fund (ETCF), the EBRD, and EBRD Shareholder Special Fund (ESSF).

13. The Bank has launched a USD 25 million program to finance projects for industrial energy efficiency and renewable energy through local banks. In October 2010, the first USD 3.0 million, energy efficiency credit line was signed with Anelik Bank. TA has been put in place financed by the Government of Austria. The Bank has also launched a TA program to review and amend the legal, regulatory, institutional, operational and technical frameworks for energy efficiency in the residential sector. Since 2013 three of the largest banks and one credit organisation joined the program signing loans of EUR 15m in total to be on-lent to industrial and residential EE sub-projects. EBRD will continue offering financing and capacity building to Armenian commercial banks to support investments in this sector. The residential sector in Armenia is a large energy consumer with significant potential for energy savings and carbon emission reductions.

14. As part of inspection reform and doing business programs, the EBRD is assisting the government toward improvement of the business environment. The EBRD supported the roll-out of a corporate governance code in cooperation with the Ministry of Economy, the Central Bank, the Stock Exchange and the IFC. The Bank is also providing assistance to the Public Services Regulatory Commission for telecommunications sector regulation. This assistance is being financed by the Government of Finland.

15. The EBRD's current country strategy was approved in May 2012. The key priorities of the EBRD for the coming three years are: (i) developing the financial sector and improving access to finance; (ii) improving municipal and urban transport infrastructure; (iii) developing agribusiness and high value-added, export-oriented industrial companies; and (iv) improving the regulatory and institutional framework for sustainable energy and increasing value added in the mining sector. The new Country Strategy will be adopted in July 2015.

RELATIONS WITH THE ASIAN DEVELOPMENT BANK (ASDB)

(As of October 15, 2014)

1. **Armenia joined AsDB in September 2005, and is currently eligible for financing from AsDB's concessional Asian Development Fund (ADF), as well as its non-concessional Ordinary Capital Resources (OCR)**. AsDB's country operations business plan (COBP) for 2014–16, approved in December 2013, identifies infrastructure development as priority area for AsDB's operations. AsDB is preparing a new 2014–18 country partnership strategy for AsDB's Board consideration in 2015.

2. **As of October 15, 2014, the AsDB cumulative sovereign lending amounted to $839.67 million**. In September 2014 AsDB signed a loan agreement with the Ministry of Energy and Natural Resources on «Power Transmission Rehabilitation Project» ($37 million) to increase the efficiency of power system operation and reduce transmission losses. "Infrastructure Sustainability Support Program" ($49 million) approved in October 2014, will improve road and water service provision through results-based public management and financing reforms. The program will introduce a cross-sector approach, where sector and finance ministries collaborate at all four levels of results-based management—planning, budgeting, implementation, and monitoring.

3. **In 2012 AsDB approved two public sector loans**. The Women's Entrepreneurship Support Sector Development Program, approved in October 2012, will promote gender-inclusive growth by improving the enabling environment and capacity of women entrepreneurs and micro and small enterprises (MSMEs). The program includes two components: (i) a program loan ($20 million) supporting reforms related to improving the business environment for women; and (ii) a financial intermediation loan ($20 million) through the German-Armenian Fund in which medium-term local currency loans will be made by participating financial institutions to MSMEs, with at least 50% of the loans going to women's MSMEs. In 2012, AsDB provided $40 million as additional financing for the Water Sector and Sanitation Sector Project, approved in 2007, for improving access to safe, reliable, and sustainable services in about 29 towns and up to 160 project villages, managed on commercial principles and with environmentally sound practices.

4. **In 2011, ADB approved a $400 million multi-tranche financing facility (MFF) for the Sustainable Urban Development Investment Program, which aims to help Armenia upgrade its urban transport services, to improve living conditions, and bolster economic opportunities in 12 of the country's major and secondary cities**. In 2011, AsDB approved Tranche 1 for $48.64 million to improve and extend the urban infrastructure and to strengthen the institutional capacity in Yerevan.

5. **In 2009, ADB approved a $500 million MFF to fund the North–South Road Corridor Investment Program**. In 2009 AsDB approved Tranche 1 ($60 million) for improving the Yerevan-Ashtarak section of the road. Tranche 2 ($170 million) approved in 2010 finances the upgrade of the road between Ashtarak and Talin. In 2013 AsDB approved Tranche 3 for $100 million to finance

continuing construction of the road to Gyumri (additional co-financing will be provided by the European Investment Bank). Tranche 3 will also finance engineering and economic studies of the southern sections of the North-South Road Corridor.

6. The Crisis Recovery Support Program Loans ($80 million), approved in July 2009, helped Armenia through the global financial crisis by allowing it to protect budgetary social spending and implement anti-crisis measures in a time of economic contraction and declining fiscal revenues.

7. In 2007, AsDB approved a $30.6 million loan for the Rural Road Sector Project to help the government upgrade 220 kilometers of rural roads. A supplemental financing of $17.32 million was approved in 2008 to address financial shortcomings of the project. A $36 million loan for the Water Supply and Sanitation Sector Project, approved in 2007, helped the government repair and replace water supply infrastructure in small towns and villages.

8. With the exception of the North-South Road Corridor Tranche 2 and Tranche 3 investment program loans, all approved sovereign loans are from the AsDB's concessional ADF. The Tranche 2 and Tranche 3 loans for the North-South road are from the AsDB's non-concessional OCR.

9. AsDB has approved four private sector projects a total of $133 million in non-sovereign financing in Armenia and one trade finance program. In May 2013, ADB signed a $25 million loan with International Energy Corporation to rehabilitate and to improve the reliability and safety of Sevan-Hrazdan Cascade Hydropower, in a program cofinanced with the European Bank for Reconstruction and Development (EBRD). In November 2011, AsDB approved a non-sovereign lending program totaling $65 million for four commercial banks to expand lending to small and medium-size enterprises (SMEs). One non-sovereign loan for $40 million was provided to Armenia International Airports for the Zvartnots Airport Expansion Project (Phase 2). The loan financed the construction of a new terminal building and purchase of equipment to supplement the existing concourse building, in a program cofinanced with EBRD and DEG (German Investment and Development Corporation). In 2007 AsDB extended a $3 million loan to a local bank for on-lending to small businesses. AsDB's Trade Finance Program works with three banks in Armenia and has supported over $19 million in trade.

10. In addition to financing projects and programs, the AsDB is also involved in advisory services and capacity development. These include technical assistance programs for urban development in secondary cities, improved access to finance for women entrepreneurs, infrastructure sustainability, preparation of an investment forum, and solid waste management. In 2013 ADB approved a TA program to carry out seismic risk mitigation study of public buildings in four secondary towns. Armenia is also included in a number of AsDB's multi-country TA projects, providing assessments and development plans in topics of common interest across countries.

STATISTICAL ISSUES

(As of November 14, 2014)

Background

1. Data provision by Armenia has shortcomings, but is broadly adequate for surveillance. In November 2003, Armenia subscribed to the Special Data Dissemination Standard (SDDS), and the overall quality, timeliness, and coverage of macroeconomic statistics have improved significantly over the past few years. The IMF has supported this process through TA from the Statistics Department (STA), the Fiscal Affairs Department (FAD), and the Monetary and Capital Markets Department (MCM). An April 2008 data ROSC mission prepared a detailed evaluation of the quality of macroeconomic statistics. A multi-topic statistics mission visited Yerevan in February 2010 to review progress with implementation of past recommendations and follow up on outstanding issues in national accounts, balance of payments, and monetary and financial statistics. A follow up STA mission in September 2010 provided further guidance, focusing on improving the accuracy of annual and quarterly GDP estimates. Further improvements in real, fiscal, and external sector statistics would be desirable to facilitate enhanced design and monitoring of economic policies.

Real sector statistics

2. The National Statistics Service (NSS) compiles and disseminates annual and quarterly national accounts. The NSS also compiles and disseminates annually a full set of accounts (up to financial accounts) for the total economy and by institutional sectors. The NSS is developing a plan for implementing the *System of National Accounts 2008 (2008 SNA)*.

3. The accuracy of the annual estimates of the national accounts is undermined by the lack of exhaustive source data for informal activities and of appropriate price and volume indicators, particularly for construction activities. Construction output volume measures are derived by deflating current values with a price index for output, which uses weights and base year prices from a survey in 1984. To improve volume measures of construction, the NSS has started compiling a new construction output price index based on more sound methodology. Until the new construction price index becomes available, the NSS should use other indicators for deriving construction aggregates at constant prices. The NSS should also implement new surveys to derive a proper benchmark for informal activities.

4. The production-side estimates at current prices are derived partially from cumulative source data (from business statistics surveys) and partially from discrete data sources. The NSS validates and reconciles data from different sources, but underlying problems associated with de-cumulating the cumulative output data distort the quarterly pattern. The NSS is currently working to produce GDP data at current and at constant prices to be fully in accordance with the SNA. The NSS received IMF TA on estimating quarterly GDP from discrete data sources only and is using statistical techniques that conform to international standards. Recent publications of the NSS have reflected this effort. The NSS has discontinued compiling GDP volume measures at the prices of the corresponding quarter of the previous year and instead adopted the recommendation of the IMF STA mission to compile only one set of quarterly GDP estimates—quarterly GDP at previous-year average prices—and derive time series through chain-linking. These estimates would be conceptually consistent with the annual data. They would also allow comparisons between different periods, which are essential for analysis of the business cycle. Since 2012, NSS has discontinued compiling GDP on average prices of 2005 and instead they just published GDP for 2009-2012 on average prices of year 2008. As of January 2011, the NSS also started compiling a monthly indicator of economic activity (IEA), following international best practices. The monthly GDP compilation was discontinued. The monthly IEA is an implicit volume index compiled by aggregation of monthly volume indices of output using gross output weights. The CPI covers 11 large population centers and Yerevan. Since January 2011, the CPI has been computed using 2010 weights. Concepts and definitions used in the compilation of the CPI are broadly in line with international standards; source data and compilation techniques are generally adequate. The NSS compiles a ten-day and a monthly CPI. The ten-day index and the monthly index are disseminated jointly. A February data 2009 ROSC mission recommended development of an approach to include household expenditure on owner-occupied dwellings in the CPI calculations.

Government finance statistics

5. The budget execution reporting system compiles government finance data on a cash basis, supplemented with monthly reports on arrears and quarterly reports on receivables and payables. Daily revenue and cash expenditure data for the central government are available with a lag of one to two days and monthly data on central government operations are disseminated one month after the reporting period. The ministry of finance (MoF) is undertaking a comprehensive reform of the treasury system, including the introduction of an internal auditing system in line ministries and their respective budgetary institutions. A treasury single account (TSA) was introduced in 1996, and all bank accounts held by budgetary institutions were closed, except for project implementation units (PIU) that are required by donors to operate with commercial bank accounts. Since 2010 these PIU accounts also are being moved gradually to the TSA. 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 since 2003 report data on cash flows and balances to the MoF. The February 2009 ROSC report recommended including NCOs in the government finance statistics data published on national websites. These exceptions notwithstanding, all government receipts and payments are processed through the TSA, although there are still shortcomings on the timeliness and quality of data on the operations of local governments.

6. 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 have been subject to frequent reclassification, and wages for military personnel, teachers, and doctors are reported in the category of goods and services and other expense, rather than as a wage item. The February 2009 ROSC report recommended using market value rather than face value for financial assets other than loans, and for nonfinancial assets. The reconciliation of central government with general government operations is done by the NSS in cooperation with the MoF.

7. Since 2008, government finance statistics meet the classification requirements of the *Government Finance Statistics Manual 2001* (*GFSM 2001*) for the central government.

Monetary and financial statistics

8. Monetary and financial statistics are provided on a timely basis. Data on the accounts of the CBA are provided daily with a one-day lag, while monthly data on the monetary survey are provided with a three-week lag (and preliminary weekly data with a one-week lag). The balance sheets of the CBA and of the deposit money banks follow IAS methodology. Monthly interest rate data are provided with a one-week lag.

9. Responding to an IMF STA request, the CBA has compiled and submitted a complete set of monetary data beginning from December 2001 using standardized report forms (SRF). STA validated the resulting monetary aggregates, and the data have been published since the December 2006 issue of *IFS Supplement* and are used to update IFS. An integrated monetary database has also been established by STA to share the SRF data with the IMF's Middle East and Central Asia Department. The CBA also produces the financial soundness indicator table every month, published on both the IMF and CBA websites.

External sector statistics

10. In 2009, the Armenian authorities decided to transfer the responsibility for compiling the balance of payments, international investment position (IIP), and external debt statistics from the NSS to the CBA. The February 2010 STA mission provided advice on an action plan aimed at ensuring a smooth institutional transfer of responsibility, as well as consistency and continuity in the production of the external sector statistics. The responsibilities of compiling external sector statistics were *de facto* transferred to the CBA in January 2011, and since then, the CBA has compiled balance of payments, external debt, and IIP data for 2011. The transfer of responsibilities was smooth and during the short period after the transfer, the CBA undertook a number of important actions aimed at improving the compilation system. A follow up IMF STA mission in October 2011 undertook a comprehensive assessment of the institutional arrangements, data sources, methodology, and compilation practices for external sector statistics employed by the CBA, and advised on areas for improvement including further developing data sources and compilation practices.

11. The coverage of external sector data has improved in recent years. Trade statistics are provided on a timely basis, and trade data by origin, destination, and commodity are generally available within a month. Price data for exports and imports are less readily available. Quarterly balance of payments statistics are generally available with a three-month lag. However, for remittances, there are considerable discrepancies among available source data. Remittance data obtained from surveys are considerably lower than data obtained through the money transfer system. The absence of a comprehensive, continuously updated business register hampers the coverage of transactions and institutional units; in particular, the coverage of the financial account items for the private nonbank sector. There are also concerns with regard to the collection of data on international trade in services, specifically on import of services. The CBA is currently considering the implementation of an international transactions reporting system that would allow for collecting data on all cross-border payments and receipts going through the banking system.

12. Quarterly data on the international investment position are published by the CBA within one quarter after the reference period, and the annual data within two quarters; and are also provided for publication in IFS.

Armenia: Common Indicators Required for Surveillance

(As of November 7, 2014)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]
Exchange Rates	Nov. 2014	11/7/2014	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Nov. 2014	11/7/2014	D	D	M
Reserve/Base Money	Sept. 2014	10/25/2014	D	D	D
Broad Money	Sept. 2014	10/25/2014	M	M	M
Central Bank Balance Sheet	Sept. 2014	10/25/2014	D	M	M
Consolidated Balance Sheet of the Banking System	Sept. 2014	10/25/2014	M	M	M
Interest Rates[2]	Oct. 2014	10/31/2014	W	W	M
Consumer Price Index	Oct. 2014	11/05/2014	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]— General Government[4]	Q2 2014	11/31/2014	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government	Aug. 2014	10/13/2014	M	M	Q
Stocks of Central Government and Central Government-Guaranteed Debt[5]	June. 2014	08/28/2014	M	M	Q
External Current Account Balance	Q2 2014	10/08/2014	Q	Q	Q
Exports and Imports of Goods and Services	Q2 2014	10/08/2014	M	M	Q
GDP/GNP	Q2 2014	10/08/2014	Q	Q	Q
Gross External Debt	Q2 2014	10/08/2014	Q	Q	Q
International Investment Position[6]	Q2 2014	10/08/2014	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extrabudgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); and Not Available (NA).

INTERNATIONAL MONETARY FUND

REPUBLIC OF ARMENIA

December 16, 2014

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND FIRST REVIEW UNDER THE EXTENDED ARRANGEMENT—SUPPLEMENTARY INFORMATION, SUPPLEMENTARY LETTER OF INTENT

Approved By: **Juha Kähkönen (MCD) and Ranil Salgado (SPR)**

This supplement updates the staff report and the staff appraisal.

Developments

1. **Pressures in the foreign exchange (FX) market have continued, and monetary conditions have tightened**. The dram continued to come under pressure in late November and early December, largely reflecting developments in Russia, including further depreciation of the ruble, and affecting remittances and exports. The Central Bank of Armenia (CBA) moved to stem these pressures through large, intermittent FX market interventions, including sales of $33 million during the week of November 24–28 and $63 million during the week of December 1–5. The US$-dram exchange rate (ER) moved from AMD 415 per dollar in mid-November to AMD 447.86 per dollar on December 5, and net international reserves (NIR) of the CBA reached $760 million, well below the end-December target. In addition, the CBA tightened dram liquidity conditions by increasing the Lombard rate for repo transactions from 8.25 percent to 10.25 percent in late November, and further to 21 percent in early December. As a result, interest rates on the overnight market jumped from 7.0 percent to 10.3 percent during the week of November 24–28, and subsequently to over 20 percent during the week of December 1–5.

2. **The authorities have taken specific actions to adjust FX and monetary policies, in order to limit further *ad hoc* intervention and allow the dram to move to a new equilibrium ER**. These actions aim to address what now appear to be more than temporary pressures. On December 8, the authorities began conducting pre-

announced daily FX auctions of up to a specific maximum amount that aims not to meet market demand, but rather to provide limited liquidity to help with price discovery.[1] The daily maximum is moderate and sustainable, initially $6 million per day for the first week, and declining significantly each week to less than $1 million daily in the fourth week. On the first 5 days of auctions, $6 million were sold each day, with bids amounting to approximately $20 million per day and a tightening of spreads among bids. The weighted average auction ER has moved each day, reaching AMD 470.22 per dollar on December 12. The difference between dollar sales and dollar purchase volumes of banks outside of the auction has narrowed. The authorities expect to maintain their efforts to limit dram liquidity for the time being, until conditions strengthen and there are clear signs that inflation remains anchored. Even with the programmed maximum intervention, reserve levels would still be adequate based on standard import and debt metrics, as well as the IMF's composite metric (see figure).

3. **The auctions were pre-announced to market participants and the public and will cap further FX sales through end-December, although CBA purchases are also possible**. The auction schedule will cap further sales at approximately $65 million through year-end. However, if demand is less than the daily maximum, the CBA will sell fewer dollars. Also, the CBA is expecting inflows in December of over $90 million, including disbursements from official financing. The CBA may also be in a position to reverse its FX interventions and purchase dollars from the market, as the end of the calendar year is a time of seasonal FX sales, as firms and individuals convert dollars to pay taxes and make other end-year transactions, including related to the holidays. The CBA and the government have stepped up communications, with an interview by the Deputy Prime Minister on the actions on December 7 and a press conference by the CBA Chairman on December 9.

4. **The authorities intend to limit FX sales in 2015.** The proposed end-March 2015 indicative target and end-June 2015 performance criterion on CBA NIR have not been adjusted. These targets built in modest CBA market sales The authorities consider that the targets are ambitious in light of the recent FX sales. However, the movement of the dram to a new equilibrium level and enhanced ER flexibility should support the return to more normal market conditions and the rebuilding of buffers. In a supplementary letter of intent, the authorities have reiterated their readiness to adjust monetary and exchange policies—as well as other policies—as needed.

Staff Appraisal

[1] Staff assessed the CBA's multiple-price FX auction to be a multiple currency practice (MCP) as there was no mechanism in place to prevent spreads between the rates of winning bids from exceeding 2 percent. The authorities have since adopted a provision to prevent spreads of more than 2 percent between the rates of winning bids in the auction, based on which staff has found the MCP to be eliminated. As the overall auction framework was in place prior to approval of the Extended Arrangement, the finding of the MCP (since eliminated) has no impact on the continuous performance criterion on introduction or modification of MCPs.

5. **Staff welcomes the authorities' move to put in place a clear, transparent, and sustainable FX framework in the face of market pressures**. These pressures emanate in large part from external developments that are expected to be more than temporary. The changes were well communicated, and the authorities have demonstrated their commitment to limiting FX auctions to the daily maximum, in order to establish credibility of the new approach. This has provided a clear cap on CBA intervention, helping the market find a new equilibrium ER, and fostering sales of FX by banks, exporters, and others. The new ER should facilitate external adjustment and improve competitiveness.

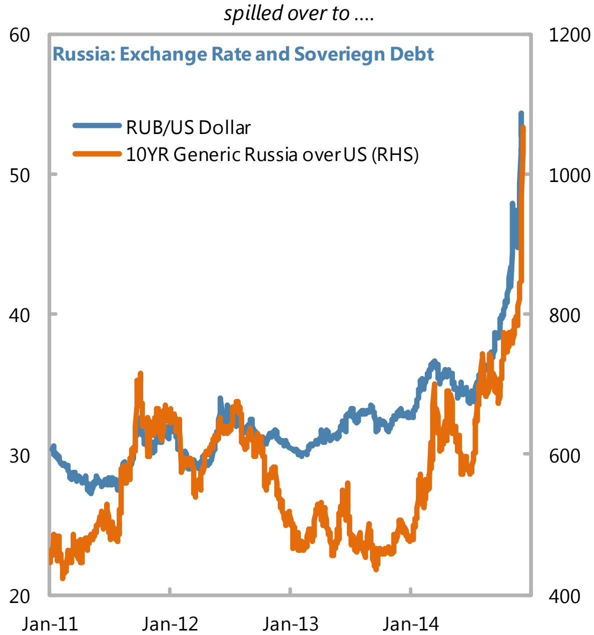
6. **Staff welcomes the authorities' commitments to limit FX sales in 2015, rebuild buffers, and further adjust policies as needed**. The authorities are to be commended for limiting intervention and strengthening communications and guidance to market participants. These should continue when there are seasonal FX demands. The steps to tighten liquidity should be reversed when pressures have abated. The recently activated auction system provides a framework for managing exchange rate pressures and preventing *ad hoc* interventions. The auction could also be used to rebuild buffers in 2015, for example, by providing a mechanism for daily FX purchases. As the dram adjustment and the increase of interest rates—combined with slowing growth—could have implications for the banking sector, the authorities should continue to monitor the situation closely, with frequent stress testing and contingency plans in place. If pressures continue, a tightening of monetary and fiscal policies may be needed.

7. **Challenges are likely to continue**. The authorities have rightly noted that the period ahead is expected to be characterized by continued uncertainty and volatility, including in the oil markets and the regional geopolitical context. The policy framework of a low fiscal deficit, reinforced exchange rate flexibility, sound buffers, and growth enhancing reforms is appropriate, although as indicated in the staff appraisal, more ER flexibility and decisive structural reform implementation would be desirable.

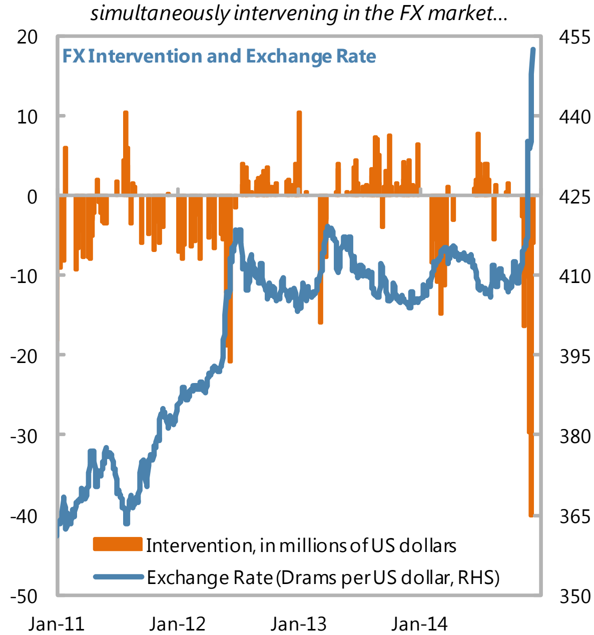
8. **Staff continues to support the conclusion of the First Review**.

Armenia: Exchange Rate and Reserve Developments

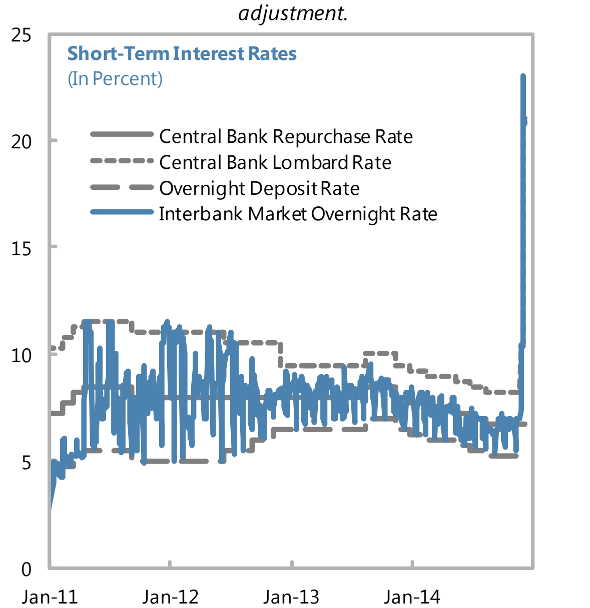
Further worsening of economic conditions in Russia has spilled over to ….



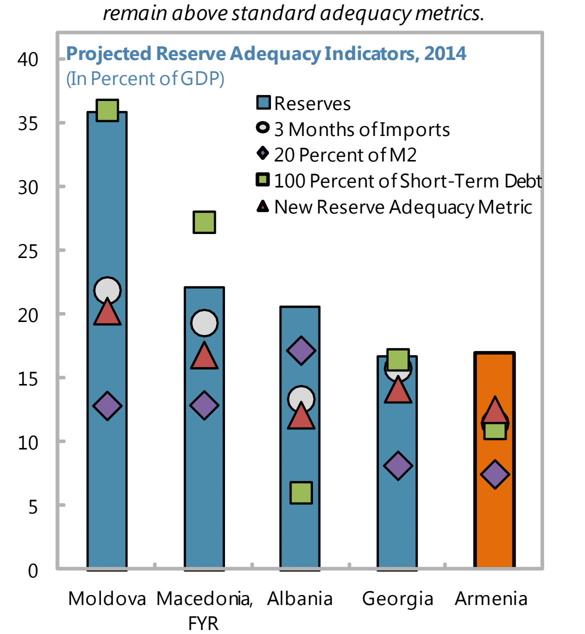
…Armenia. The CBA has allowed the dram to adjust while simultaneously intervening in the FX market…



…and tightening dram liquidity to prevent a disorderly adjustment.



In spite of the FX intervention, international reserves remain above standard adequacy metrics.



Source: National authorities; Bloomberg; and IMF staff estimates and calculations.

Republic of Armenia—Supplementary Letter of Intent
First Review Under the Extended Arrangement

Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431

Yerevan, December 15, 2014

Dear Madam Lagarde:

This letter supplements the letter of intent (LOI) for the First Review Under the Extended Arrangement of December 3, 2014.

1. Pressures in the foreign exchange (FX) market have continued, and monetary conditions have tightened. The dram has continued to come under pressure in late November and early December, mainly reflecting developments in Russia and depreciation of the ruble. The Central Bank of Armenia (CBA) has moved to stem these pressures by selling FX and simultaneously allowing the exchange rate of the dram to adjust. Monetary conditions have also tightened, including the rate for access to the Lombard facility and overnight interest rates. Still, pressures remain, and sizeable FX sales have continued. Timely actions are needed to address what appear to be more than temporary pressures, to limit further CBA intervention, and to allow the exchange rate of the dram to move to a new equilibrium.

2. Accordingly, we have adjusted our FX and monetary policies. From December 8, we began conducting pre-announced daily auctions of dollars up to a specific maximum amount that does not aim to meet recent market demand in full, but rather to help with price discovery. The maximum daily amount is limited, moderate, and sustainable—initially $6 million per day for the first week. We have indicated in public announcements that the amount will be significantly reduced each week. New specific daily maximum sales amounts will be preannounced for each week, declining to $1 million or less in the fourth week. We will strictly limit sales to the maximum daily amount to establish credibility of the new approach; foster sales of FX by banks, exporters, and others; cap the potential maximum amount of CBA intervention; and support the market in finding a new equilibrium rate. We recognize that the market may well temporarily overshoot, and we are prepared for this. If demand is less than the daily maximum amount, the CBA will sell less. Moreover, the CBA may be in a position to recoup its FX intervention, including by using the auction mechanism for purchases; the end of the calendar year is a time of seasonal FX sales as firms and individuals convert dollars to pay taxes or make other end-year transactions and reflecting holiday-related FX flows.

3. Recent efforts to limit dram liquidity will be maintained, but these could be eased as conditions strengthen and as there are clear signs that inflation remains anchored. This statement updates ¶16 of the December 3 LOI, which described the monetary policy easing cycle that began in November 2013 and suggested that the CBA may pursue further easing if conditions warrant.

4. We intend to continue to limit FX sales in 2015. We have not requested modification of the proposed end-March 2015 indicative target or the end-June 2015 performance criterion on CBA NIR that we agreed with the Fund staff in the context of the First Review discussions (Table 1 of the December 3, 2014 LOI). The targets built in modest first quarter CBA sales to the market ($30 million) reflecting seasonal demand patterns, including for example, for payment of energy imports during the winter. While the targets are ambitious in light of the recent developments and FX sales, we consider that the movement of the dram to a new equilibrium exchange rate should support the return to more normal FX market conditions and provide opportunities to rebuild buffers and meet the agreed targets, and stand ready to adjust other policies as well as needed. At the same time, we are mindful that the period ahead is likely to be characterized by continued uncertainty and volatility, including in the oil markets and in the regional geopolitical context.

5. We authorize the IMF to publish this Supplementary Letter of Intent and the accompanying staff report supplement.

Very truly yours,

/s/	/s/	/s/
Hovik Abrahamyan	Artur Javadyan	Gagik Khachatryan
Prime Minister	Chairman of the Central Bank	Minister of Finance
Republic of Armenia	Republic of Armenia	Republic of Armenia

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International Monetary Fund
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Washington, D. C. 20431 USA

IMF Executive Board Completes First Review under the Extended Arrangement, Approves US$17 Million Disbursement, and Concludes 2014 Article IV Consultation with Armenia

On December 22, 2014, the Executive Board of the International Monetary Fund (IMF) completed the first review of Armenia's economic performance under a three-year program supported by the extended arrangement under the Extended Fund Facility (EFF). The completion of the first review enables the release of SDR 11.74 million (about US$17 million), bringing total disbursements under the arrangement to SDR 23.48 million (about US$34 million). The extended arrangement for SDR 82.21 million (about US$119.1 million was approved on March 7, 2014 (see Press Release No. 14/88) In addition, the Executive Board concluded the 2014 Article IV consultation[1] with Armenia and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

After a steady recovery during 2010–12 from the deep 2009 recession, Armenia's growth softened in 2013 and has remained subdued in 2014. The softening of economic activity has been broad based, as growth of exports and remittances slowed, and government spending was lower than budgeted. Construction, which had declined since the 2009 crisis, was relatively flat. Growth is projected at 2.6 percent in 2014 and is expected to increase only gradually in 2015 and over the medium term in light of expectations of slow growth in key trading partners. In line with the subdued economic activity, inflation fell during the year below the Central Bank of Armenia's (CBA) target range (4±1.5 percent) but is expected to return to that range, as the recent depreciation of the dram pushes the price of imported goods up.

In the context of regional developments, pressures in the foreign exchange (FX) market emerged in early 2014 and reemerged in late November due to further depreciation of the Russian ruble. The CBA moved to stem these pressures by allowing some depreciation of the dram in line with changes in economic fundamentals, but also increasing its FX supply to the market. On

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.
[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

December 8th the CBA activated pre-announced daily FX auctions to help ensure smooth functioning of the FX market. The CBA also tightened dram liquidity conditions by increasing the Lombard rate for repo transactions to 21 percent in early December. As a result, interest rates on the overnight market jumped to over 20 percent from December 1–5. International reserve levels are adequate based on standard import and debt metrics. Reserves also continue to compare well with peer countries.

The banking sector remains sound, but performance has been weakening amid challenging economic conditions. In particular, bank profitability has declined as weaker economic growth has been accompanied by an increase in non-performing loans (NPLs), which reached 6.5 percent in September, and as credit and deposits growth have slowed. The recent tightening of domestic liquidity conditions and FX developments may also put pressure on bank profits going forward. The CBA has continued to monitor financial sector developments closely, and the robust capitalization of the banking sector constitutes an important cushion.

The fiscal deficit is expected to reach 1.5 percent of GDP in 2014, well below the budget (2.3 percent of GDP). This reflects capital under-spending (especially in the multi-donor North-South Highway), lower-than-budgeted matching pension contributions (due to pension reform changes), and less spending on goods and services. Despite lower growth, revenues have been close to budget targets so far this year, and even amid regional uncertainties, Eurobond spreads have remained stable.

The authorities' policies remain geared toward maintaining macroeconomic stability and fostering sustainable and inclusive growth. The CBA continues to conduct monetary policy under an inflation targeting framework, accompanied by exchange rate flexibility, and to implement policies aimed at maintaining and strengthening financial sector stability. Fiscal policy remains focused on keeping the deficit and debt at manageable levels, while augmenting growth-enhancing expenditures and strengthening social protection. In addition, the authorities are pursuing a structural reform agenda to foster growth. On October 10, the presidents of Armenia, Belarus, Kazakhstan, and Russia signed an agreement on Armenia's membership in the Eurasian Economic Union (EEU). Armenia is expected to formally join the Union in January, once the treaty is ratified by the four national parliaments.

Executive Board Assessment

In concluding the 2014 Article IV consultation with Armenia, Executive Directors endorsed the staff appraisal in the staff report as follows:

Armenia faces a period of slower growth unless decisive actions are taken. Sound macroeconomic policies since the crisis have helped sustain domestic and external stability in a highly uncertain context. However, going forward, projected growth rates will not be sufficient to generate sufficient jobs and stem emigration. Sluggish investment in recent years, a still-weak business climate, and the absence of strong growth drivers constrain the capacity of the economy to generate sufficient jobs to stem emigration and reduce poverty. EEU membership could help increase exports to the large EEU market, but medium-term growth prospects for Russia are modest as well. Therefore, more decisive implementation of reforms, as anchored in the Fund-supported program, is needed to reduce vulnerabilities and boost potential growth.

Performance has moderated due to both domestic and regional factors. Growth is expected to slow to 2.6 percent of GDP in 2014 from 3.5 percent in 2013, while inflation has fallen below the CBA's target range. Growth of exports and remittances has weakened, but slower growth of imports meant that the FX market remained relatively stable through much of 2014, although pressures emerged in November-December. The banking sector remains well capitalized and liquid, but weakening conditions have been associated with an increase in non-performing loans (NPLs). On a brighter note, while the slowdown has been broadly based, agriculture and tourism are benefitting from investment and structural reforms and are growing at a healthy pace.

Vulnerabilities remain high. While international reserves are adequate, the consolidation of the external current account deficit has slowed in 2014 due to lower-than-expected exports and remittances. Staff estimates that an adjustment of the real exchange rate over the medium term would help facilitate further external adjustment and improve competitiveness. However, the banking system is still highly dollarized, which could imply pressures on bank balance sheets if a disorderly external adjustment occurs.

Armenia faces a high degree of risk. Growth is projected to pick up to 3.3 percent of GDP in 2015, in the context of supportive macroeconomic policies—notably, monetary policy easing in 2013–14 and stronger capital budget execution. However, the short-term outlook is subject to a high degree of uncertainty, especially given regional geopolitical developments and tensions. An intensification of these would lead to further negative spillovers to Armenia's economy.

The authorities should create fiscal space to boost social and investment spending over the medium term. Efforts should focus on revenues, as underexecution of capital spending has had a negative impact on growth, although staff commends the authorities for not diverting spending into low pay-off areas and welcomes efforts to assess and address reasons for underspending. With lower growth, available financing, and few risks to inflation or sustainability, staff sees merit in a higher deficit in the 2015 budget, with increased spending going to capital outlays. Staff has long pressed for higher tax revenues to support higher social spending and growth-enhancing infrastructure projects. Tax measures should also aim to improve the tax system by eliminating gaps and ensuring greater equity. The upcoming formulation of a comprehensive tax code is an opportunity to broaden the tax base and rationalize exemptions and tax expenditures. EEU common customs pool revenues could provide a further opportunity to build fiscal buffers through savings. However, the revenues must be secured and in any event are transitory, as EEU tariffs are expected to decline over the medium-term. Staff commends the authorities' cautious approach in evaluating the sustainability of these additional revenues, prior to incorporating them in the budget framework.

Further strengthening of monetary and financial sector policies should remain a priority, building on recent progress. The CBA's Inflation-Forecast Targeting (IFT) framework has served Armenia well and remains an appropriate anchor for monetary policy. Nonetheless, the effectiveness of the IFT framework should be further strengthened by reducing dollarization, improving monetary policy instruments, and enhancing the CBA's communication and modeling capabilities. Similarly, the CBA has made noteworthy progress in implementing recommendations of the Financial Sector Assessment Program (FSAP) and Basel III guidance, while strengthening financial sector regulation and resilience. However, further work is needed to incorporate new guidance on large exposures and liquidity requirements, as well as to revisit the dedollarization strategy, and to foster better financial intermediation via improved legislation on registration and execution of collateral.

Exchange rate policy should support external adjustment. The current situation poses challenges to exchange rate policy, notably the recent depreciation of the Russian ruble, uncertainty surrounding regional geopolitical events, and pressures to calm what are perceived as disorderly conditions in a thin market. While limited interventions to mitigate disorderly conditions are warranted, pressures that reflect economic fundamentals should be accommodated. Enhanced central bank communications will be important to provide clarity and guidance. Maintaining robust buffers, together with flexibility of the dram, should support further reduction of the external current account deficit to its sustainable level.

The authorities should implement ambitious reforms to bolster potential growth and promote inclusion. The successful implementation of "open skies" in civil aviation is a good example of how bold policy decisions can have positive results in a relatively short period of time. Recent delays in implementation of reforms in the competition and regulatory areas, while relatively minor, should be reversed. The reform agenda should be implemented decisively to improve Armenia's capacity to grow, create jobs, and reduce poverty. Business environment reforms should overcome long-standing concerns about uneven competition, unnecessary regulation, high costs, and skills shortages and mismatches. The authorities should move quickly to bolster the pension reform and ensure its long-run success. Reforms in the energy sector should be compatible with long-term fiscal sustainability, involve the private sector, and be transparent and cost-effective, while mitigating the impact on the poor. Finally, the authorities should leverage EEU membership to increase exports, improve standards, enhance domestic competition, and invest in infrastructure. They should also pursue deeper integration beyond the EEU to enhance growth prospects and reduce vulnerabilities.

Policies under the program remain on track. All performance criteria and most indicative targets were met. Competition and regulatory reforms have advanced at a slower-than-expected pace, causing delays in meeting structural benchmarks, mainly due to the government change in mid-2014 rather than a change in policy direction. Going forward, the program will accommodate a modest fiscal stimulus in 2015, while maintaining macroeconomic stability and fiscal sustainability. The Net International Reserves (NIR) targets will help maintain strong buffers. Structural benchmarks for the remainder of 2014 and first half of 2015 are focused on core areas, including tax administration, Public Financial Management (PFM), financial sector development, and central bank operations.

Risks to the program are significant, but manageable, and Armenia's repayment capacity remains robust. While the short-term outlook is subject to a high degree of uncertainty, and Armenia is vulnerable to geopolitical developments, the authorities have a strong track record of sound macroeconomic policies and program implementation. A low fiscal deficit, moderate public debt, broadly adequate reserves, and growth-supporting reforms embedded in the program reinforce this assessment. Staff supports the authorities' request for the equivalent of SDR 11.74 million to become available with the completion of the first review.

In addition, the Executive Board endorsed the staff appraisal of the staff supplement as follows:

Staff welcomes the authorities' move to put in place a clear, transparent, and sustainable FX framework in the face of market pressures. These pressures emanate in large part from external developments that are expected to be more than temporary, calling for ER adjustment. The changes were well communicated, and the authorities have demonstrated their commitment to limiting FX auctions to the daily maximum, in order to establish credibility of the new approach. This has provided a clear cap on CBA intervention, helping the market find a new equilibrium ER, and fostering sales of FX by banks, exporters, and others. The new ER should facilitate external adjustment and improve competitiveness.

Staff welcomes the authorities' commitments to limit FX sales in 2015, rebuild buffers, and further adjust policies as needed. The authorities are to be commended for limiting intervention and strengthening communications and guidance to market participants. The steps to tighten liquidity should be reversed when pressures have abated. The recently activated auction system provides a framework for managing exchange rate pressures and preventing ad hoc interventions. The auction could also be used to rebuild buffers in 2015, for example, by providing a mechanism for daily FX purchases. As the dram adjustment and the increase of interest rates—combined with slowing growth—could have implications for the banking sector, the authorities should continue to monitor the situation closely, with frequent stress testing and contingency plans in place. If pressures continue, a tightening of monetary and fiscal policies may be needed.

Challenges are likely to continue. The authorities have rightly noted that the period ahead is expected to be characterized by continued uncertainty and volatility, including in the oil markets and the regional geopolitical context. The policy framework of a low fiscal deficit, reinforced exchange rate flexibility, sound buffers, and growth enhancing reforms is appropriate, although as indicated in the staff appraisal, more ER flexibility and decisive structural reform implementation would be desirable.

Staff continues to support the conclusion of the First Review.

Armenia: Selected Economic and Financial Indicators, 2009–16

	2009	2010	2011	2012	2013		2014		2015	2016
	Act.	Act.	Act.	Act.	EBS/14/18	Act.	EBS/14/18	Prel.	Proj.	Proj.
National income and prices:										
Real GDP (percent change)	-14.1	2.2	4.7	7.1	3.2	3.5	4.3	2.6	3.3	3.7
Gross domestic product (in billions of drams)	3,142	3,460	3,778	4,001	4,290	4,273	4,714	4,528	4,867	5,248
Gross domestic product (in millions of U.S. dollars)	8,648	9,260	10,142	9,958	10,547	10,431	11,216	10,969	11,278	11,559
Gross domestic product per capita (in U.S. dollars)	2,912	3,128	3,426	3,353	3,208	3,500	3,405	3,674	3,771	3,865
CPI (period average; percent change)	3.5	7.3	7.7	2.5	5.8	5.8	5.0	2.2	3.8	4.0
CPI (end of period; percent change)	6.7	8.5	4.7	3.2	5.6	5.6	4.0	2.9	3.6	4.0
GDP deflator (percent change)	2.6	7.8	4.3	-1.2	4.0	3.2	5.4	3.3	4.0	4.0
Poverty rate (in percent)	34.1	35.8	35.0	32.4	...	...	...	...	...	...
Investment and saving (in percent of GDP)										
Investment	33.8	29.4	27.0	23.4	23.9	21.8	24.4	22.0	22.6	23.1
National savings	16.2	15.2	15.9	12.4	15.5	13.7	17.3	14.0	15.3	16.0
Money and credit (end of period)										
Reserve money (percent change)	13.8	-0.8	32.3	1.9	29.9	29.9	9.0	3.1	9.3	...
Broad money (percent change)	16.4	10.6	23.6	19.6	15.2	15.2	11.3	11.5	11.0	...
Velocity of broad money (end of period)	3.8	3.8	3.4	3.0	2.8	2.8	...	...	...	...
Commercial banks' 3-month lending rate (in percent)	19.1	17.7	20.7	18.5	18.3	18.8	...	...	...	...
Central government operations (in percent of GDP)										
Revenue and grants	20.9	21.2	22.1	22.3	23.3	23.7	23.5	23.6	23.8	23.9
Of which: tax revenue 1/	16.1	16.4	16.7	18.1	22.5	22.8	22.7	22.7	22.5	22.8
Expenditure 2/	28.6	26.2	25.0	23.9	25.8	25.4	25.9	25.1	26.1	25.9
Overall balance on a cash basis	-7.9	-4.6	-2.8	-1.5	-2.5	-1.0	-2.3	-1.5	-2.3	-2.0
Public and publicly-guaranteed debt (in percent of GDP)	40.2	39.7	42.0	44.0	45.4	43.4	45.2	43.9	44.8	45.5
Share of foreign currency debt (in percent)	88.9	87.4	86.8	85.9	84.8	85.2	84.4	85.3	84.9	85.3

External sector										
Exports of goods and services (in millions of U.S. dollars)	1,366	1,976	2,468	2,554	2,583	2,734	2,757	2,914	3,089	3,243
Imports of goods and services (in millions of U.S. dollars)	-3,827	-4,359	-4,708	-4,814	-5,022	-4,938	-5,155	-5,050	-5,199	-5,388
Exports of goods and services (percent change)	-22.4	44.6	24.9	3.5	5.8	7.0	6.8	6.6	6.0	5.0
Imports of goods and services (percent change)	-23.1	13.9	8.0	2.2	2.3	2.6	2.6	2.3	3.0	3.6
Current account balance (in percent of GDP)	-17.6	-14.2	-11.1	-11.1	-8.4	-8.0	-7.2	-8.1	-7.3	-7.1
FDI (net, in millions of U.S. dollars) 3/	710	521	437	473	549	507	413	361	372	406
Debt service ratio (in percent of exports of goods and services) 4/	5.3	4.6	4.1	9.4	34.1	32.3	10.4	9.8	5.9	6.4
Gross international reserves (in millions of U.S. dollars)	2,004	1,866	1,869	1,799	2,253	2,253	2,193	2,025	1,989	2,075
Import cover 5/	5.5	4.8	4.7	4.4	5.2	5.4	4.9	4.7	4.4	4.5
Nominal effective exchange rate (percent change) 6/	-8.4	-2.6	-2.8	-2.4	…	-0.9	…	…	…	…
Real effective exchange rate (percent change) 6/	-7.5	1.3	0.1	-3.3	…	1.2	…	…	…	…
End-of-period exchange rate (dram per U.S. dollar)	378	363	386	403.6	405.6	405.6	…	…	…	…
Average exchange rate (dram per U.S. dollar)	363	374	373	401.8	406.8	409.6	…	…	…	…
Memorandum item: Population (in millions)	3.0	3.0	3.0	3.0	…	3.0	…	…	…	…

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

1/ From 2013, tax revenue includes social contribution.
2/ In 2013 includes 1.5 percent of GDP related to the acquisition by Gazprom from the government of 20 percent of the shares of ArmRusGazprom, and the transfer (expenditure) of the same amount from the government to ArmRusGazprom to liquidate liabilities. A surplus of 0.6 percent of GDP is obtained when this transaction is excluded.
3/ In 2013, a credit for $155 million is registered in FDI to reflect the acquisition by Gazprom of 20 percent of the shares of ArmRusGazprom, while an offseting debit is registered in other capital (net) to reflect the corresponding reduction in liabilities of the latter with the former.
4/ Based on public and publicly-guaranteed debt.
5/ Gross international reserves in months of next year's imports of goods and services, including the SDR holdings.
6/ A positive sign denotes appreciation.