

## **SAY GOODBYE TO UNWARRANTED PREFERENCES**

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Interview with resident representative of International Monetary Fund in Armenia, Guillermo Tolosa

IMF representative explains key pillars of the new lending facility agreement with Armenia, EFF/ECF (Extended Fund Facility/Extended Credit Facility), which replaced the Stand-By arrangement signed in March 2009, and expounds on the economic projections of the Fund for Armenia made in May 2010, which remain active.

*EFF/ECF facilities have more concessional terms than the previous Stand-By arrangement. Do you think they may lay a foundation for a future independent growth, which won't need to be refueled by significant foreign aid?*

The ultimate objective of our programs is for the government to be able to stand on its own feet and not depend on foreign assistance any more. However, we don't think it's a sound idea in the short term to dramatically reduce the deficit in order not to need funds in the very short term because that would represent a significant negative impact on economy. So we think that the appropriate way forward is to gradually reduce the deficit, and in the meantime continue to use the resources from international organizations to have a smooth transition to a situation where deficit is going to be very low and there's going to be a very limited need for additional international resources.

The agreement envisages access of the country to 266,8 mln SDR (around \$392 mln), which will be equally disbursed under two credit facilities by June 2013. EFF facility will be tied to SDR interest rate, while ECF will have a zero interest. Both EFF and ECF facilities have a 10 years' maturity with a grace period of 4,5 and 5,5 years respectively. The former Stand-By agreement, signed in March 2009, provided allocation of \$540 mln, which in June 2009 was expanded to \$822,7 mln. As of end-2009, access of Armenia totaled around \$480 mln.

*Do you believe in the efficiency of the measures for dedollarization of national economy, applied by the Government?*

We think that dollarization of the economy is a negative factor, and we welcome all the efforts to reduce it. These measures are of certain help, as they make it more expensive for banks to intermediate in foreign currency. Therefore it reduces the incentives for banks to attract dollar deposits and to lend in dollars. But we think that the absolute key issue here in order to reduce dollarization is to continue recent policies in terms of strict adherence to completely flexible exchange rate. When there is a policy of systematic one-side interventions of the Central Bank in the market, agents expect a depreciation of the currency and that's why they dollarize their assets. But if the Central Bank continues its recent policy to moving to a more flexible exchange rate, then the public will start to incorporate the fact that it's a losing proposition to keep their savings in dollars because there is a lot of fluctuation in the purchasing power of dollar deposits. They are going to start gradually to convert them in drams and the dollarization of the economy is going to be reduced.

*What kind of interventions in the foreign exchange market does the new policy imply?*

We think that some small interventions are warranted, because FX market of Armenia is very shallow: one particular transaction can have a huge effect on the exchange rate, which is not ideal. In such cases, it makes sense for the government to intervene and to smooth unwarranted volatilities. We see no harm in interventions per se – the problem may arise in case of continuous one-sided interventions in the shape of selling foreign exchange. Central Bank has moved away from that policy, and I'm sure the new policy is going to be continuous, as it has been fixed in our recent agreement. We don't think that lately it's been the primary target of the CBA to depreciate foreign

currency. Again, the policy has changed, and it's a key issue for the IMF to be sure that the new policy has come to stay.

Today, there's a slight disagreement between the exchange rate of Armenian dram and the fundamentals, but that does not mean that once exchange rate policy has been changed, it will immediately converge to the fundamentals. Eventually in the medium term there should be some convergence. But it's extremely hard to predict how or when it's going to happen, especially that by that time the fundamentals may change completely.

*Do you support the policy of Armenian financial authorities to transfer to a risk-based system in VAT refunds and custom procedures?*

We have fully supported those efforts, it's one of the conditionalities of our program. We think that the risk-based approach minimizes the contact between the tax official and the taxpayer, and thereby the risk of corruption.

*Are those measures able to impact positively on tax collection?*

Insomuch as they help to increase the incentives for the taxpayers to comply with tax reporting procedures. The taxpayers will feel the reduced chances of being asked for a bribe, because in many cases there will be no actual contact between the official and the businessman. Another planned procedure is setting up an Appeals Committee for taxpayers under the Ministry of Finance and independent from the State Revenues Committee. It will have a team of specialists that is expected to react, quicker than the judicial system, on the taxpayers' claims for wrong decisions. I think that it will positively affect the behavior of some tax officials.

Besides, measures are designed to increase public access to tax legislation. Laws and governmental decrees are going to be interpreted by the Ministry of Finance and published on their website to make it completely clear that the rules are the same for everyone.

*What is your opinion on planned transfer of some economic activities from presumptive taxation to VAT?*

We think it is fully warranted. We think Armenia may have abused the presumptive tax regime, which has hurt the capacity of the country to collect taxes. We very much welcome the move away from excessive use of these regimes into a situation where most activities are covered by a normal VAT regime, and where there's no major unjustified difference in tax regimes for different sectors of the economy.

*Given that presumptive taxation is generally easier to administer, do you think that tax collection bodies will have enough capacities to enforce the new taxation?*

We think there's enough capacity to transfer to the VAT. In some cases the presumptive regime is warranted because of insufficient institutional capacity, but in this case the government has decided to move away from presumptive taxation, and I don't expect problems regarding capacity.

*Do you think that improvements in tax regime will enable the government to meet its target of increasing tax-to-GDP ratio by 1,7% by 2013?*

We think there's enough room to increase the efficiency of tax collection, but the precise effect of the reforms is always uncertain – it might as well be higher. The experience of other countries suggests that Armenia has enough opportunities to significantly increase tax collection. It depends on the strong will of the authorities to implement these reforms properly. There's always a risk that these

reforms would deliver less than expected, in which case the Government might need to take some tough decisions.

*Is that target more of a benchmark than an exact guide?*

In our program there are specific and very clear targets for what the government fiscal accounts will be. So if tax collection falls short, reforms should be launched, or other expenses cut, to offset the shortfall of mid-term targets.

*Another target is to decrease current account deficit to GDP ratio to 4,8% by 2013.*

Current account deficit is going to come down, but in 2010 it's expected to stay high, and this is in part a consequence of still significant stimulus the government is injecting into the economy. It is causing a lot of imports and a large deficit, and thereby current account deficit. But I think that as soon as this stimulus is withdrawn, the deficit is going to reduce, along with the imports. With these structural reforms, we expect that exports are going to pick up and increase much more than in the past, which must help to improve the position of the current account deficit.

*In the agreement, the government expresses its decision to save at least half of the over-performance in tax collection. Do you think it's warranted?*

Yes, we very much welcome the government's commitment. We think that the government should take any opportunity to reduce the deficit. In case the global economy behaves better than expected, and Armenian economy grows more than expected, the government should use that opportunity to reduce the deficit and achieve a sustainable level in foreseeable future.

*IMF mission, which visited Armenia in May and drew up the EFF/ECF agreement, projected GDP growth for 2010 of 4,8%, and annual inflation of 6,2%? Have these forecasts remained unchanged, considering GDP growth of 8,8% in the first five months of the year?*

Economic predictions for 2010, delivered by the last IMF mission, remain the same – 4,8% GDP growth, inflation at 6,2%. As you know, both of those projections are based upon the rebound of the economy that we've observed in the first 3 – 4 months of the year. Lowered growth rates had been fully predicted. They reflected the fact, that in the first quarter the growth had been unusually high and therefore did not promise to be sustainable. We're now achieving some numbers that are somewhat lower, but more sustainable.

*In January – June, GDP growth has slowed down to 6,7%. What are the main warranties of economic growth of the country throughout the rest of 2010?*

There's a conceptual difference between the growth to slow down and the economy to contract. We don't expect the economy to contract; we just expect a slowdown of the economic growth. Just because that's typically what we observe after the crisis – there can be a rapid rebound, but then growth tends to come down and to become more sustainable.

*Inflation had reached 5,3% in May, to decline to 4,5% in July. Is there a correlation between the lowered inflation and economic slowdown?*

We don't think so. One needs to consider in the first 3 – 4 months of 2009, which serve as a basis to calculate the inflation in 2010, prices for natural food, energy, metals and electronics were unusually low, amid the worst moment of the crisis. And in Armenia prices also were particularly low, because the exchange rate in the first months of 2009 was much lower than it is now. Now when the base period is the second half of 2009, when the prices started to wind up back and national currency had depreciated, the inflation will be lower.

Additional ups and downs during 2010 may arise because of the prices for agricultural foods, which have a large share in the consumption basket in Armenia, and which are exposed to price volatilities due to weather conditions. But there's nothing we call fundamentals, which could significantly impact on the inflation to increase.

*The Government stated that the crisis should serve as a touchstone for the Armenian economy, which would incorporate the need of diversification. Do you observe it today? And which sectors could be the main engines of that diversification?*

We'd say now that our projections involve growth on a broad basis. There is but no branch of the economy that is contracting. Some segments of agriculture, of course, suffer because of weather conditions. But on the whole the economy is doing better, though certainly many of the sectors perform better in percentage upon a very low base. So the main thing is that we observe much more spectacular growth, including exportable goods. To us the key of these other sectors of economy to develop is that the growth in the medium term would be sustainable, based on many sectors, not just a couple of them, and combined with improved business environment.

We don't think that the government should diversify the economy by simply taking money from one sector and pouring it into another, more attractive in terms of potential growth. If the government delivers on its commitments and its ambitious agenda to improve the business environment, this would be the main opportunity. Until recently we were in the phase of the crisis and we were focusing on it. But now we are entering a new phase, which is evidenced by the fact that we are launching a new program with Armenia. And the government, in its turn, starts to focus on mid-term issues, which would help to materialize the expectations of sustainable growth. If the government delivers on its commitments, we think there are going to be much more opportunities to invest in different sectors. As we had stated in one of our recent discussions, opportunities are all over the place but it will be more difficult to find them. In the context of a very challenging global environment for various years to come, this search of opportunities will be entwined with difficulties. This in particular refers to the main trade partners of Armenia, including the European Union.

*Is IMF happy with tax collection in the first half of 2010?*

Tax collection has been following the trend of nominal GDP growth. So we are happy that it' does not fall behind the economic growth. In the future we hope that tax-to-GDP ratio will significantly increase. So we expect that if the economy grows, tax collection will grow at outpacing rates. We think there's room for that to happen. If this doesn't, the government will have to face some difficulties. We have discussed the issue of tax administration reforms largely with the government. It's one of the core issues of our program, because tax collection growth depends on two big problems the country has. First is business environment, which in some cases and for some taxpayers can be quite difficult. It certainly discourages a lot of international business to invest in Armenia. The second big problem for the country, arising from tax administration issues, is actually the little capacity of government to spend in critical categories like health, education and infrastructure. This is related to informal economy (i.e. business in the shadow not paying any taxes at all) and also with large evasion of large taxpayers.

Armenian government assumes a complicated role to provide the necessary public good that the economy needs. We are very much focused on new reforms, trust the government fully and think that jointly designed measures will be effective.

