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**Internal Evaluation of
Macro-financial Assistance Operations
Carried Out in Armenia
in the Period 1998-2003**

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LIST OF ACRONYMS

CBA	Central Bank of Armenia
CIS-5	Commonwealth of Independent States (Armenia, Georgia, Kyrgyz Republic, Moldova and Tajikistan)
ESAF	Enhanced Structural Adjustment Facility
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EU	European Union
FSP	Food Security Program
GDP	Gross Domestic Product
HIPC	Highly Indebted Poor Countries
IMF	International Monetary Fund
JTF	Joint Task Force
MFA	Macro-Financial Assistance
MoU	Memorandum of Understanding
NSS	National Statistical Service of Armenia
OSCE	Organization for Security and Cooperation in Europe
PCA	Partnership and Cooperation Agreements
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
SMoU	Supplementary Memorandum of Understanding
TACIS	Technical Assistance to Commonwealth of Independent States

INTRODUCTION

This evaluation covers the period from the start of the operation in 1998 to the end of 2003. It was conducted internally by the evaluation function of Unit-R3 (Strategic management and control, inter-institutional relations) of the Directorate-General for Economic and Financial Affairs. It draws on the analyses made in the context of a study (referred to as the “supporting study” in the rest of this document) made by external consultants in 2004.¹

The supporting study collected data from a number of sources: statistical data, documentation and studies (Armenian government, IMF, World Bank, EBRD, EU institutions and other credible international organisations), and from interviews with nearly 50 key informants representing a wide range of stakeholder viewpoints (national government and ministries, international donors, NGOs).

The report firstly provides a factual description of the MFA operation and its implementation. Second, as a starting point for subsequent analyses, it presents an analysis of how the Armenian economy would have evolved in the absence of the MFA (i.e. the counterfactual analysis) providing a basis for making a qualitative assessment of the “net” effects of the assistance (i.e. those effects to be attributed to the assistance). Thirdly, the effectiveness of the assistance in terms of its short-term intended effects on macro-economic stabilisation and social hardship are assessed. This is followed by analyses of how effectively the MFA supported structural reform over the short to medium-term and its contribution to returning the external financial situation of the Armenian economy to a sustainable path over the medium to longer term. Finally, conclusions and recommendations are presented.

As the empirical work of the underlying study was finalised in 2004, it does not capture more recent developments. Therefore, the report is complemented by an overview of recent economic developments and progress in reforms in annex 1.

Due to the nature of MFA, its evaluation necessarily requires an analysis of the economic performance of the recipient country. However, in accordance with the Commission’s evaluation framework², the judgements made in the course of this exercise focus on the *contribution of MFA to the structural reform process and to the performance of the Armenian economy*. The exercise therefore does not pass judgement on the policies of the national government or on the performance of the Armenian economy.

¹ At the time of the supporting study the operation was still underway.

² The Commission’s Communication on evaluation (SEC(2000) 1051) defines evaluation as the “judgement of *interventions* according to the results, impacts and the needs the aim to satisfy”.

1. THE MFA OPERATION AND ITS IMPLEMENTATION

1.1. Background

After Armenia gained independence in 1991, it experienced balance of payments and domestic fiscal deficits. In 1992, Armenia benefited from a €8 million EU short-term trade credit facility in the form of loans. Despite the fact that Armenia properly serviced the interest on this debt, it was not able to meet the principal repayment due to difficult economic, political and social circumstances. Starting from 1995, both the Armenian government and the EU pursued an active dialogue to reduce Armenia's debts to the Community taking into account improved economic relations between the two and the fact that the EU loan was one of Armenia's most expensive debts.³

In order to promote economic reform and help Armenia clear its outstanding liabilities towards the Community, the EU Council of Ministers granted Armenia an exceptional MFA assistance package on 17 November 1997, comprised of €8 million in loans and €30 million in grants, which became operational in December 1998, when Armenia fully settled its €1 million outstanding arrears towards the Community.⁴

1.2. Objectives

According to the 1997 Decision of the Council, the MFA was targeted to meet the residual financing needs of the country in the context of international donor assistance. The MFA was considered to be highly exceptional in character. According to the Memorandum of Understanding (MoU) of 1998 between the EU and the Armenian government, the MFA's objectives were to support reform efforts of the Armenian government and to alleviate social hardship. The latter objective, however, did not figure in any of the subsequent Supplementary Memoranda of Understanding (SMoU).

1.3. Financial aspects of the MFA operation

The MFA operation consisted of six tranches phased over a period of 8 years. The first tranche provided Armenia with €8 million in loans and €8 million in grants after it repaid its outstanding debt of €1 million towards the Community in 1998.⁵ Table 1 summarises the financial aspects of the MFA operation.

³ The interest rate was equal to the market rate on which the Community had borrowed the funds. Other loans usually carried concessional interest rates.

⁴ Council decision (97/787/EC) of 17 November 1997 providing exceptional financial assistance to Armenia.

⁵ Subsequent tranches were subject to the prior implementation of agreed measures (See 1.4).

Table 1. Financial stocks and flows resulting from the MFA

Financial flows: The disbursement by the Commission (in millions of euros)									
	1997	1998	1999	2000	2001	2002	2003	2004	2005
Loans	N/A	28	0	0	0	0	0	0	0
Grants	N/A	8	4	0	0	11	0	5.5	1.5
Stocks: Armenia's net debtor position towards the Community (in millions of euros)									
Principal Payments	0	51	5	0	0	14	0	7	2
Net Debtor position (end of year)	51	28	23	23	23	9	9	2	0

Source: MoU and SMOU's between the EU and the Armenian Government.

The first MoU between the European Community and the Armenian government was signed on 15 December 1998. A single tranche of €28 million in loans was made available with 15 years of maturity (with a 10-year grace period) and a LIBOR six-month interest rate. Grants of €8 million were also made available.

It was initially agreed that the rest of the grants would be made available in four subsequent tranches of a maximum of €5.5 million each, subject to macroeconomic and structural conditionality as well as payments to the EU by the Armenian government of amounts exceeding the annual grant by €2.5 million each year over four years (this figure was later lowered to €1.5 million).

Following the first interest payment of €450,000 in June 1999, in December 1999 a grant of €4 million was disbursed instead of the €5.5 million initially considered, following the reduction of Armenia's net debtor position towards the Community by €5 million instead of €8 million. This situation was due to budgetary constraints on both sides.

In July 1999, an agreement was reached between the European Community and the Armenian government on the structural conditionality of the third grant tranche for 2000. The Armenian authorities, however, failed to ratify this agreement. The prospects of cooperation between the Armenian government and the IMF were also dim in 2000. Given the failure to ratify the 1st SMOU, the Commission suspended the third grant tranche envisaged for 2000. The Commission staff mission also set the structural conditionality before the next grant tranche could be released to the Armenian government.

Following the evaluation of the Commission staff mission to Armenia in 2001 and the reduction of Armenia's net debtor position towards the Community by €7 million in the same year, the Commission approved a €5.5 million grant tranche for 2001.

On the basis of a Council decision taken in early 2000, the period of the MFA was extended until the end of 2004.⁶ Annual grant disbursements were fixed at €5.5 million for 2002-03 and €1.5 million for 2004. It was agreed that Armenia would make annual payments of €7 million in the 2002-03 period.

However, a disbursement was not made in 2003 and it was envisaged that the remaining €7 million in grants would be disbursed in 2004-2005. The final disbursement was to take place after Armenia reduced its net debtor position towards the Community to zero, by paying the outstanding €2 million.

1.4. Structural conditionalities of the MFA operation

The structure of MFA conditionality is made of two separate layers, i.e. IMF conditionality (macroeconomic performance indicators) and Community-specific conditionality (targeted reforms). The MoUs explicitly state that “the release of successive grant tranches by the Commission is subject to a satisfactory implementation by Armenia of any arrangements reached with the IMF and a positive evaluation by the Commission of progress made with respect to structural reforms.” With respect to macroeconomic conditionality, positive status was given as long as the IMF programme was on track.

Since the release of the yearly grant tranches (the loan was disbursed all at once in 1998) was explicitly subject to conditionality, and given that (except for 2000) subsequent tranches were released, the assessment of the EU was that conditionality criteria had been fulfilled. The European Commission officials in charge of the yearly evaluations provide a description of the level of compliance with conditionality, as documented in the EC reports of the missions to Yerevan from 1998 to 2002.

Structural conditionalities were agreed in the 1st MoU and the 2nd, 3rd and 4th SMOUs . They were progressively refined throughout the operation, focusing on the following areas:

- *Public and civil sector reform*, including improvements to tax administration and tax collection, reduction in public employment and an effective anti-corruption policy
- *Business climate reform*, including the completion of Armenia’s accession to the WTO and the promotion of a positive climate for foreign investments
- *Privatisation*, including liquidation of non-profitable state-owned enterprises
- *Financial sector reform*, including privatisation of major state-owned banks and improved banking regulation
- *Energy sector reform*, including privatisation, private management and energy strategies linked to the closure of the nuclear power plant

⁶ Council decision of 20 March 2000 amending decision 97/787/EC providing exceptional financial assistance for Armenia and Georgia in order to extend it to Tajikistan (2000/244/EC).

2. HOW WOULD THE ARMENIAN ECONOMY HAVE EVOLVED IN THE ABSENCE OF THE MFA?

In order to answer the question of how the Armenian economy would have evolved in the absence of the MFA, three counterfactual scenarios were elaborated. The likelihood and effects of the three scenarios were examined qualitatively through interviews with key informants and subsequently analysed. This analysis is referred to as the counterfactual analysis for the rest of the report. The scenarios examined⁷ were as follows:

- **Scenario 1a: No debt settlement, no EU non-humanitarian funds.** The working hypothesis is that without the MFA, Armenia would not have been capable of settling its debt towards the Community. Armenia would have then been deprived of any EU development funds to implement the Partnership and Co-operation Agreement (PCA) in terms of institutional, legal and administrative support.
- **Scenario 1b: No debt settlement, suspended IMF funds.** The working hypothesis is that the existence of unsettled arrears towards the Community would have jeopardised the levels of the IMF/WB funding, by triggering either a partial or a full suspension.
- **Scenario 2: Debt settlement without the MFA.** The working hypothesis is that without the MFA, Armenia would have taken the road of paying back its outstanding debt towards the Community with its own funds somehow, since the suspension of any IMF programme (in case of uncleared arrears) would have had disastrous consequences.

2.1. Analysis and findings

Data collected in the course of the interviews on the implementation scenarios converged to suggest that:

- Any request from the Armenian authorities to the Paris club to restructure its debt would *not* have been successful since, as a rule, the EU does not restructure its claims, and both the IMF and the World Bank would not have supported such a request since it would have distorted funds away from growth-enhancing programmes and structural reforms.
- Repayment of debt from Armenia's own national funds (Scenario 2) would have put a heavy burden on the budget and the government would have made most of the cuts in its social expenditure programmes, given the fact that the military budget could not have been touched at that time.
- The non-settlement of debt to the EU would have probably put at risk assistance from the TACIS and Food Security Programmes.

⁷ Scenarios 1a and 1b are not mutually exclusive.

- Some ad hoc credit line from the IMF targeted to repay Community debt was an unlikely, if not impossible, option.

Opinions of interviewees were, on the other hand, more mixed regarding the possibility of a partial or complete suspension of IMF operations in the country in the case of Armenia not meeting its debt obligations towards the EU:

- Both the IMF and the World Bank (implementing an Enhanced Structural Adjustment Facility Programme and a Structural Adjustment Credit Programme respectively at this time) were deeply interested in seeing reforms carried out in Armenia. *Government officials* therefore considered that suspension was an unlikely option and the IMF/WB would have probably had to come up with an alternative plan.
- Due to the IMF's specific conditionality of no external arrears, *representatives of the donor community* held a different viewpoint believing that the IMF would not have "bailed out" Armenia.

However, since the Armenian government agreed to an MFA package which expressly allowed Armenia to respect the IMF's specific conditionality of no external arrears to third parties and which ensured that EU non-humanitarian programmes continued to be implemented, this suggests that the risk of suspension of IMF support was considered as high and that the possibility that EU non-humanitarian aid would be halted was viewed as being real.

In terms of *effects* arising from the possible implementation scenarios, it can be deduced from the interviews that:

- If the Armenian government had decided to repay its debt to the EU from national funds, this would probably have led to cuts in social expenditure and hence an exacerbation of social hardship in the short term. Furthermore, this solution would also have had possible negative macroeconomic consequences since diverting funds from reform-oriented programmes would also have put pressure on the exchange rate, interest rates and the country's external debt rating. Alternatively, funding through the Central Bank's official reserves would have put them far off the official Central Bank target of 3 months of imports, again causing pressure on economic stability.
- The suspension of IMF assistance (Scenario 1b) would have meant that the three-year ESAF (Enhanced Structural Adjustment Facility) implemented in 1996, amounting to USD 149 million, would probably have been curtailed with possible negative consequences for any follow-on assistance.⁸ Furthermore, there was a strong possibility that the 1995-1997 reform momentum could have been lost.

⁸ The 1996 ESAF was followed in 2001 by an IMF Poverty Reduction and Growth Facility (PRGF) package of USD 87 million. The WB had implemented four structural adjustment credit facilities in the country by the end of 2002. The fifth structural adjustment credit facility amounting to USD 40

- The halting of EU ‘non-humanitarian’ assistance (Scenario 1a) would have led to the loss of some of the €131 million dispensed since 1998 (about 1% of GDP in Armenia on average annually). The likely negative effect of this, especially in the case of the FSP (Food Security Programme), would in all likelihood have been significant since 55% of the Armenian population was living below the poverty line, of which 23% in extreme poverty conditions. Furthermore, the FSP was targeting areas left untouched by other international donors to the country. The contribution of the FSP was also important for domestic growth since it supported internal consumption, which accounts for about 80% of total GDP in Armenia.

2.2. Conclusions

On the basis of the preceding analysis it can be concluded that the options for Armenia in the absence of MFA were extremely constrained, since it was highly unlikely that either the EU or the IMF would have agreed to alternative financing arrangements.

Both payment from national funds of its debt to the EU or not fulfilling its debt obligations, which may have resulted in the suspension of other EU support instruments (FSP in particular), would have undermined efforts to alleviate the social hardship experienced by the Armenian population. Either of these options would also have led to negative macroeconomic impacts, possibly undermining improvements in Armenia’s macroeconomic situation that had already been underway since 1995.

There is no consensus on the possible reaction of the IMF to Armenia not meeting its debt obligations to the EU. However, the actions of the Armenian government in agreeing to an MFA as a means of dealing with its debts to the EU suggest that in reality the risk of a partial or total suspension of IMF operations was credible, even if this meant that reform momentum risked being lost.

million was approved in 2003. The new Country Assistance Strategy (CAS) to be approved in June 2004 amounts to USD 65 million and envisages six new projects in the sectors of urban heating, water management, health administration, education and legal reform. Furthermore, the WB has been active in the areas of infrastructure rehabilitation, social sector, agriculture, energy and private sector, aimed at developing structural capacities in the country. The total portfolio of concessional loans that the WB holds in Armenia amounted to USD 704 million as of January 2003.

On this basis it can be concluded that without the MFA, it is likely that:

- IMF support would not have continued
- Armenia's reform programme would have slowed down significantly
- Improvements to the macroeconomic situation would have at least slowed down or even stopped
- The Armenian population would have suffered further social hardship

3. TO WHAT EXTENT WAS THE MFA EFFECTIVE IN TERMS OF THE SHORT-TERM MACROECONOMIC STABILISATION OF THE ARMENIAN ECONOMY?

The primary channel through which MFA acts is by contributing to short-term macroeconomic stabilisation through the provision of grants and/or loans as part of an overall financial package of assistance provided by the IMF. In this context, the individual financial contributions of donors cannot be meaningfully separated for analytical purposes.

The approach taken below is to examine the performance of the Armenian economy before and during the period of the MFA operation. Interview data and the counterfactual analysis are then used as a basis for making a qualitative assessment of the contribution of the overall reform programme to the evolution of the macroeconomic situation in Armenia up to and including 2003.

3.1. Analysis and findings

An analysis of macroeconomic data from the IMF and the National Statistical Service of Armenia (NSS) led to the following findings:

- Following a pronounced economic downturn between 1991 (the year in which Armenia gained its independence) and 1994,⁹ 1995 saw the start of an economic recovery and an improvement in Armenia's macroeconomic situation which continued after the IMF's Enhanced Structural Adjustment Facility (ESAF) programme for 1996-98 was launched. Real GDP growth gradually accelerated from below 5% in 1999, to reach 14% in 2003,¹⁰ mainly driven by consumption and construction investment and largely financed by external sources, in particular donor assistance, private remittances from the Armenian Diaspora and charity funding (notably from the Lincy Foundation).¹¹ Construction activities largely financed by the aforementioned foundation and private remittances from overseas account for some 20% of GDP.

⁹ From 1991 to 1994, Armenia incurred the largest output contraction among the countries of the Commonwealth of Independent States (CIS) over this period totalling about 47%. The military conflict over Nagorno Karabakh between Armenia and Azerbaijan, the lack of reliable transport corridors, and the energy crisis were the most pronounced factors contributing to economic downturn. Moreover, a trade blockade imposed by Turkey further exacerbated the state of the economy.

¹⁰ In the supporting study it is argued that real GDP was overestimated from 1998. Recalculating the data results in an estimate of an average growth rate of 5.5% between 1999 and 2003 compared to the official figure of 9%. The study points to the low (and falling) wage share in GDP, possible under-recording in the past of exports of precious stones, and falling energy production and consumption in recent years as evidence for this.

¹¹ Private remittances from the Armenian Diaspora averaged annually 15% of GDP over the 1995-2003 period. According to the Central Bank of Armenia, the level of private transfers exceeded USD 500 million, i.e. about 20% of GDP in 2003. Systematic donor assistance extended mainly through grants and concessional loans averaged annually about 7% of GDP. US-based Lincy Foundation funding to support construction activities averaged annually 2 to 3% of GDP. Construction activities accounted for 50% of reported real GDP growth in 2003.

- Armenia was hit hard by the Russian crisis of 1998, its foreign trade position being adversely affected due to a notable decline in Russian demand. Since this date, the macroeconomic performance of the country has improved and growth in recent years has been strongly supported by positive developments in Russia.
- Inflation fell from around 30% in 1995 to stabilise below 5% from 1998 to 2002, though 2003 saw an upswing to 9%. Key factors in stabilising inflation were tight monetary and sound fiscal policy.
- After a period of sustained depreciation, nominal exchange rates stabilised from the end of 2001, also contributing to the stabilisation of inflation.
- Prior to 1998, the current account deficit as a proportion of GDP was consistently above 25%. Between 1998 and 2003, Armenian exports were strongly reoriented away from the CIS and a gradual decline in the trade deficit led to a reduction in the current account deficit which levelled off at around 7%.
- In parallel to the improving balance of payments situation, between 1999 and 2003 Armenia's gross international reserves almost doubled to around 4 months of imports.
- The central government budget deficit as a proportion of GDP steadily declined from 5.2% in 1999 to 1.1% in 2003. However, tax revenues as a proportion of GDP grew slowly from 1995 and at 14% in 2003 remained significantly below the CIS average of 24.8%. The budget deficit was mainly financed by external sources (such as Lincy Foundation funding) and income from privatisations.

Coinciding with the Russian crisis, MFA was first granted to Armenia in 1998 and continued to be disbursed in five of the six following years. The assistance was relatively modest in financial terms and given the agreed debt repayment arrangements net financial flows were negative in all years that disbursements were made. The financial dimension of the MFA cannot therefore be said to have had a direct effect on the Armenian economy in the short term.

However, the view of the government authorities and IFI representatives interviewed was that the MFA had been fundamental for the Armenian economy and that in its absence Armenia would not have been able to produce the encouraging economic performance of the last few years:

- The main effect of the MFA on the short term macroeconomic situation was indirect due to the MFA allowing the continuation of IMF activities and the maintenance of Armenia's reform effort.
- MFA allowed a more prudent debt-management policy that helped to improve domestic and external debt sustainability through early debt repayment and by stabilising inflation.

3.2. Conclusions

Between 1998 and 2003, Armenia made a significant improvement to its economic performance. Its economic situation benefited from positive developments in regionally important economies, a reorientation of exports away from the CIS and financial inflows of donor assistance, charity funding and private remittances. This performance was also reflected in the positive evolution of key macroeconomic variables. It can therefore be concluded that macroeconomic stabilisation was successful.

While this positive dynamic was emerging prior to the launching of the MFA in 1998, agreement on the MFA ensured that IMF support for the Armenian economy would continue which, according to the counterfactual analysis in §2, was necessary to avoid the likely situation where improvements to the macroeconomic situation would have slowed down or stopped.

While it is not possible to unambiguously link or quantify the contribution of MFA/IMF support to the increased growth rate and stabilisation of the Armenian economy, it can be concluded that:

- The MFA had an indirect effect on the stabilisation of the country's macroeconomic situation, occurring through the ensured continuation of IMF support. In this context, the MFA/IMF support had a net positive effect on Armenia's external accounts and on its broader macroeconomic environment.
- The improved performance of the Armenian economy was in line with the IMF specific macroeconomic conditionalities, implying that the objectives of the IMF (and by proxy, those of the EU) had been met.

4. TO WHAT EXTENT WAS THE MFA EFFECTIVE IN ACHIEVING ITS SHORT-TERM OBJECTIVE OF ALLEVIATING SOCIAL HARDSHIP?

In addition to the usual short-term aim of macroeconomic stabilisation, a short-term objective of the Armenian MFA was to alleviate social hardship. However, what was meant in concrete terms by this statement was not elaborated upon. In this context, the following analysis makes a qualitative assessment of the achievement of this objective on the basis of NSS and IMF data and the results of the counterfactual analysis.

4.1. Analysis and findings

The 1998 Memorandum of Understanding (MoU) between the EU and the Armenian government stated that an objective of the assistance was to alleviate social hardship. This did not however remain an explicit objective of the operation in its later years.

Prior to 1998, Armenia was a country characterised by widespread poverty and inequality. Income was unevenly distributed geographically with the urban population being poorer than the rural one. Government spending in the health and education sectors was traditionally very low (it has historically stood at about less than 5% of GDP being one of the lowest in the CIS countries), with consequent problems of accessibility and affordability.

While social indicators evolved positively from 1996, poverty and inequality in Armenia still remained widespread in 2003. According to NSS data¹² for this period, the proportion of the population below the official poverty line¹³ fell from 55% to 43% and the Gini coefficient from 0.6 to 0.44. At the same time mortality rates increased and outward migration¹⁴ contributed towards declining birth rates and an aging population.

4.2. Conclusions

The channel by which the objective of alleviating hardship was to be reached was not made explicit in the MoU, neither was there a precise definition of what was meant by alleviation, which may be understood as both mitigation and improvement. While it is not possible to conclude that the MFA made any direct contribution to the modest improvement in social indicators, the results of the counterfactual analysis in §2 suggest that without the MFA the Armenian government would have reduced social expenditure to clear its

¹² Published after the supporting study was completed (PRSP Progress Report of May 2005).

¹³ In the supporting study it is argued that the threshold levels of poverty are significantly underestimated, being defined in terms of the minimum food consumption of 2100 kilocalories a day rather than in reference to a minimum consumption basket.

¹⁴ According to different sources, about one million people have left Armenia since 1991. The official population size in 2004 was 3.2 million.

debts or international assistance would have been suspended. In this context, it is likely that negative social impacts were mitigated by the operation and the Armenian population spared further social hardship in the short term.

5. TO WHAT EXTENT WAS THE MFA EFFECTIVE IN TERMS OF SUPPORTING STRUCTURAL REFORM IN ARMENIA IN THE SHORT TO MEDIUM-TERM?

Structural conditionality is the secondary channel through which MFA is intended to have an effect on a recipient country. Conditionality criteria are agreed with national governments as a means to support a country's institutional and economic reform effort in the short to medium-term. Criteria are progressively refocused through the period of the operation. The effects of the conditionality-supported reforms on economic and institutional structures are intended to contribute to ensuring that the internal and external financial situation of the recipient country moves onto a sustainable path in the medium and longer-term.

Structural conditionalities are heterogeneous in nature; some are precise actions to be undertaken while others describe what is to be achieved. In some cases they are very precise (and quantified) and in others they are general statements of intent. Their implementation is staggered over time with the result that some criteria may not have had sufficient time to produce their intended effects before the implementation of an MFA operation is complete. Furthermore, they are rarely, if at all, explicitly linked to clear, medium-term, socio-economic objectives, i.e. what they aim to achieve over and beyond their short-term effects is not usually made explicit. For these reasons, it is not possible to assess fully all the structural conditionalities in the framework of this evaluation and the analysis of the extent to which reforms gave rise to their intended effects is largely qualitative in nature, as is an assessment of effectiveness of the MFA in supporting the reform effort.

The analyses below focus on the five broad categories of structural conditionality agreed in the framework of the operation, examining the implementation and effects of conditionality-supported reforms between 1998 and 2003. *The analysis does not examine compliance with criteria as this is assessed as part of the management of MFA operations.* Analyses are based on statistical and documentary sources (NSS, IMF, WB and other stakeholders) covering the period before and during the assistance, and interview data from key informants.

5.1. Analysis and findings

5.1.1. Public sector and civil service reform

Structural conditionalities were agreed from the first year of the operation in the area of government and public sector reform, with a broad focus in 1998 on reforming the civil service and more specifically on reducing public sector employment. In 2000, the focus of civil service reform started to shift towards addressing corruption, while at the same time tax and budgetary issues also became a prominent element of conditionality.

Public sector employment

Structural conditionalities relative to reforms in the area of public sector employment were agreed early in the operation in the 1998 MoU and the 2000 and 2001 SMOUs. The objective of the reforms was to reduce public sector employment.

According to the NSS, from 1998 to 2002, total employment in the public sector as a percentage of total employment in the economy fell from slightly above 30% to about 26%. Also according to NSS data, this has been accompanied by more competitive real compensation in the sector. Over the same period, the real average wage for public employees relative to the economy's average real wage increased from about 45% to about 71%.¹⁵

Conditionality was timely and supportive of the reform effort in this area.

Corruption

The issue of corruption was firstly addressed in the 2000 SMOU alongside other civil service reforms. In the 2001 SMOU attention moved towards the elaboration of a strategy to fight corruption, which in the SMOU of 2002 became the central plank of structural conditionality in this area. Reform was to centre on the preparation and adoption by the Armenian government of a comprehensive anti-corruption strategy in the first instance, and the adoption and the making operational of an action plan for the strategy's implementation in the second.

There was a consensus among observers that corruption prior to the MFA was a very important problem for Armenia and remained so in 2003.¹⁶ However, while observers questioned whether the government was effectively addressing the problem of corruption, some recent surveys have suggested that progress was being made.¹⁷

¹⁵ It is argued in the supporting study that the data is not fully reliable since the significant gap between reported wages and GDP per capita implies that public sector wages are equivalent to only about 6% of GDP per capita.

¹⁶ This consensus corresponds with the perception of citizens of public corruption in Armenia. According to a survey conducted by the IMF in 2001, private entities and the public indicated that there was a high level of public corruption and state institutions were highly dishonest. The survey identified the impunity of high-ranking officials, low wages and the absence of law enforcement as the major causes of public corruption in Armenia. Police, tax and customs systems, and the judiciary were ranked as the most dishonest institutions. In the same vein, a survey for the World Bank (Business Environment and Enterprise Performance Survey) categorises Armenia as a high "bribe tax" country (the latter reflecting the percentage of sales that firms pay to public officials).

¹⁷ Armenia is viewed as making significant progress in reducing the level of corruption between 1999 and 2002 (Anti-corruption in Transition 2 – Corruption in Enterprise-State Interactions in Central Asia, 1999-2002). Another report by the World Bank on governance (Kaufmann et al, 2003) finds that

In accordance with the conditionality criteria mentioned above, an anti-corruption strategy programme was drawn up with the support of the international donor community. The proposal was submitted to the Armenian government early in March 2003 and at the end of 2003 the government adopted its anti-corruption strategy.

Given the abovementioned sequence of events and the timing of the supporting study, it is not possible to examine if the MFA has contributed to any changes in the level of corruption. However, stakeholders and observers have serious doubts about the focus of the adopted strategy vis-à-vis the problems of corruption in Armenia.

While the original proposal was wide-ranging in nature, covering issues such as economic transition and the shadow economy, energy, infrastructure and natural resources, oversight and regulation, the legislative and regulatory environment, the political system and elections, and civil society participation in anti-corruption initiatives, the adopted strategy had a strong focus on dealing with corruption in the health care and education sectors.¹⁸ However, it can be argued that these sectors are less prone to administrative corruption and are characterised by an almost non-existent level of vested public interests.

According to local interlocutors, the “inaction” of the Armenian government to follow the proposals elicited heavy criticism from the international Joint Task Force (JTF).¹⁹ The USAID evaluation was similarly critical noting that, “*the Government of Armenia draft was a considerably scaled-down version of the original strategy presented by the expert group. Much of the substance and analysis in the original strategy was removed, leaving an unclear, disjointed and fragmented list of mainly legislative interventions.*”

The IMF, WB and the EU, nevertheless, took a more positive stance in welcoming the strategy document as a step forward, providing a sufficient, if imperfect, basis on which to commence implementation and which lends itself to improvement over time.

the “control of corruption” as measured by one of six governance indicators improved from 1998 onwards.

¹⁸ By way of an example, while the strategy elaborates on one and two pages respectively on the healthcare and education sectors, it limits itself to a quarter of a page each to a general discussion on tax and customs administration.

¹⁹ The OSCE took the lead in coordinating donor assistance in combating corruption through the international Joint Task Force (JTF). The task force was comprised of representatives of all major international organisations and diplomatic missions in Armenia.

Tax and budgetary issues

Tax and budgetary issues have figured in the SMoUs of 2000, 2001 and 2002. Structural conditionalities focused on improving tax administration (with a particular emphasis on VAT in 2001) and the development of a medium-term expenditure framework. The 2000 SMoU specifically laid down that there should be an improvement in tax collection rates. The 2002 SMoU stated that the government should ensure that advanced tax collection was not imposed.

Armenia's tax base is characterised by its increasing dependence on indirect taxes. NSS statistics show that from 1995 there was a gradual shift from direct taxation, mostly to VAT, with the share of indirect taxes almost doubling and reaching about 76% of all collections, while the share of direct taxes declined from about 55% to 15%.

The VAT efficiency ratio, measuring the share of GDP collected for each percentage point of the standard VAT rate of 20%, improved over the 1995-1999 period from 0.16 to 0.34 and has since remained around this level. This suggests that since the conditionality criteria (SMoU 2001) had not up to 2003 led to the implementation of significant reforms having an effect on VAT collection rates.²⁰

As presented earlier (§3.1), tax revenues as a proportion of GDP increased slowly from 1995. However, they peaked in 1999 and have since been on a downward trend declining from 16% to 14%, even against the background of reportedly high economic growth.²¹ Calculations of the tax buoyancy ratio based on IMF and NSS data suggest that, while the dynamics of the tax buoyancy ratio were quite volatile over the 1995-2003 period, the efficiency of tax collection deteriorated from 1998.²²

According to the World Bank (2003), tax and customs policy and tax administration are the first factor constraining economic activity and investments in Armenia. In this context, tax administration in Armenia has been consistently highlighted as being both corrupt and highly discretionary according to various surveys implemented since

²⁰ In 2003, total VAT collection amounted to about 7% of GDP, a low figure given that consumption amounts to 90% of GDP. Since non-diamond imports amount to about 36% of GDP, with a standard VAT rate of 20%, this should yield VAT revenues equal to about 7% of GDP. This implies that there would be no actual VAT revenue from domestic sources.

²¹ A possible explanation for this trend is the existence of tax exemptions for certain activities (e.g. externally financed construction activities and agriculture).

²² Tax Buoyancy Ratio= $\% \Delta$ Tax Revenues / $\% \Delta$ GDP, i.e. the elasticity of tax revenues to GDP. Changes are measured in real terms after adjusting for inflation.

1998 (UNDP, 1998, IMF, 2001, American and EU Chambers of Commerce, 2003 and WB, 2003).

Respondents to a recent survey by the American and EU Chambers of Commerce indicated that procedural complexities and fear of retribution preclude many businesses from seeking judicial settlements of tax-related disputes.

While conditionality criteria on reforming tax administration figured initially in the 2000 SMoU and on ensuring that advance tax collection is not imposed in the 2002 SMoU, the Freedom House Report of 2004 on Armenia states that: “*Corruption among tax authorities has proved a particular impediment to the development of small businesses, which frequently come under pressure to pay taxes on their profits and revenue in advance, despite the fact that this is prohibited by law.*”

The above findings suggest that any progress made during the MFA operation in the area of tax administration had limited effects.

5.1.2. *Business climate reform*

Both the 1998 MoU and the 2000 and 2001 SMoUs included structural conditionalities in the area of business climate reform.

According to the transition indicators of the European Bank for Reconstruction and Development (EBRD), Armenia scores the highest 4+, which indicates a similarity to the world’s advanced economies. According to the same indicators of the EBRD, Armenia also scores the highest 4+ in terms of its trade and foreign exchange system.

In contrast, local observers interviewed in the course of the supporting study largely concurred that any appearance of a liberal market and trade regime was misleading at best, casting doubts on the extent to which price and market liberalisation had actually improved. In a similar vein, representatives of the donor community in Armenia also reported problems of control and/or monopolisation of markets and trade by government officials and connected oligarchs. In addition, representatives of the donor community in Armenia reported that WTO legislation was not being enforced.

A likely explanation of this divergence of views is that EBRD indicators are mainly based on the texts of laws and regulations while local interlocutors and representatives of the international donor community views are fashioned by direct contact with Armenian institutions.

Representatives of the donor community in Armenia also reported that there were significant impediments to improving the business climate:

- State and legislative capture by businesses and individuals, through high levels of corruption.
- Business capture by different branches of the government, judiciary and legislature, manifested through the use of state resources to exert pressure to ‘crowd-out’ and ‘bust-up’ profitable businesses that were not connected to public officeholders.
- The inability of the Armenian antitrust authority to deal with state and business capture.

The World Bank, on the other hand, classifies Armenia as a country with low state capture.²³

At the time of the supporting study it was too early to judge the effects of WTO accession on the business climate. However, improvements to the business climate are also to some extent contingent on the success of reforms in the areas of tax administration and corruption which, as previously indicated, had not given rise to any significant effects by 2003.

5.1.3. *Privatisation*

The privatisation of state-owned enterprises figured in the structural conditionalities of the MoU of 1998 and the SMoUs of 2000 and 2001. The 2002 SMoU, on the other hand, focused its attention on their reorganisation or liquidation.

The privatisation processes in Armenia started in 1994 with the support and encouragement of donor organisations. By the end of 1997, about 60% (around 6,000) of all small enterprises and about 60% (around 1,250) of all medium-sized and large enterprises had been privatised. In 1998, the pace of privatisation slowed, reflecting both the end of mass privatisation and the impact of the Russian crisis. In the first quarter of 1999, the pace of privatisation slowed further, but the government managed to overcome this negative trend by the end of the year.

The government adopted a list of 14 industrial giants that were to be sold or liquidated by 2001. According to the annual report on privatisation for 2001, 231 enterprises had been privatised out of the planned 900.

In 2003, a number of big privatisation and concession deals were completed. However, only one-third of the total number of enterprises envisaged for privatisation between 2001 and 2003 were actually privatised. Moreover, according to observers, the most

²³ The World Bank, *Anti-corruption in Transition 2 – Corruption in Enterprise-State Interactions in Central Asia, 1999-2002*.

recent privatisation deals were conducted in a non-transparent manner and privatised through pre-negotiated agreements.

In 2003, more than 70% of the Armenia's GDP was being produced by the private sector and approximately the same share of the workforce was employed by private companies. However, the majority of privatised, former state-owned firms were reportedly not actively functioning.

It can be concluded that the conditionality criteria were timely and supportive of the privatisation process. However, this has been slower and less complete than planned, falling significantly short of its objectives. Consequently, while the Armenian economy was going through a period of relatively strong performance, this had not been supported by a fundamental restructuring of productive capacity.

5.1.4. *Financial sector reform*

Financial sector reform was a constant element of the (S)MoUs between 1998 and 2002.

The banking and financial policies of the Armenian government had been consistently liberal and by the mid-1990s the Armenian government had removed most restrictions on interest rates, capital flows, and foreign ownership in banking. With the support of international donors, the reform process in the banking sector started in 1996 in response to the steadily growing volume of non-performing loans. The measures implemented led to most banks increasing earnings and accumulating capital, which in turn allowed them to write-off all pre-1996 non-performing loans at the end of 1997. The level of non-performing loans fell to 5% of total loans in 2002-2003.

In June 1997, an *ad hoc* law introduced stronger protection for owners of banking accounts, and revoked rights of any government agency to freeze money in bank accounts without a court decision.

In the 2002-03 period, six out of eight banks under CBA administration were either liquidated or converted to a credit union. In 2003, a deposit insurance scheme (to be operational from 2005 onward) and a Money Laundering Commission were established. A new minimum capital requirement is set at USD 5 million from 2005 onward.

According to local interlocutors, these measures created a limited boost in confidence in banks. While growth in total bank deposits was recently high, it was mostly due to hard currency deposits, though this may reflect a lack of trust in the Armenian currency rather than in the local banks.

With respect to the Armenian capital market, according to the Securities Commission of Armenia (SCA), 171 joint stocks were registered with the SCA and listed with the Armenia Stock Exchange. Market capitalization was USD 25 million or 1% of GDP. This estimate, however, can be considered as arbitrary given that there is almost no public trading, and thereby, no reliable market valuation of companies. Trade in government bonds dominates the market where traders deal at auctions organised by the CBA.

According to observers, despite reform efforts, the financial sector in Armenia was not playing a significant role in financing the real economy. The level of financial intermediation in the banking system remained low due to a number of factors, notably insufficient confidence in banks, a large informal sector, high real lending rates and a narrow range of saving instruments. Despite its physical presence, the securities market remained a largely non-operational institution.

As a result of these reforms, many of which predated the MFA operation, Armenia has a relatively well-regulated banking sector. However, it is rather segmented and remains small in size, with 20 banks in operation, the total assets of which stand at 15% of GDP, while domestic credit to GDP is only 10%.

It can be concluded that the conditionality criteria were timely and supportive of the reform process in the financial sector. Significant reforms took place before and during the MFA operation. However, despite these reforms, effects on the development of capital markets and the level of financial intermediation in the economy appeared to be limited.

5.1.5. Energy sector reform

Energy sector reform was a constant element of structural conditionality in the (S)MoUs between 1998 and 2002.

During the Soviet period, Armenia's energy sector had well-developed transmission and distribution networks. From 1991, however, the country experienced severe shortages of electricity supply. The situation improved significantly with the reopening of the Armenia Nuclear Power Plant in 1995 and structural reforms launched at the request of the international donor institutions in the same year.

Originally owned and operated as a vertically integrated state-owned entity, the energy sector was disaggregated into separate functional companies. An independent Energy Regulatory Commission was established in 1997 to issue licenses and approve tariffs.

Given the fact that the energy sector was one of the most important contributors to the fiscal deficit, the Armenian government launched

a financial rehabilitation programme for 1997-99 with the assistance of the World Bank.

In 2000, the Armenian parliament passed a law on energy sector privatisation allowing the privatisation of power transmission lines while retaining state control of most of the generation. In addition, four distribution companies were created and two functional networks were established. However, no bids were received for a 75% offering in any of the four distribution companies. The distribution companies were merged in 2001 and the Ministry of Energy launched the privatisation of the sector in 2002 to attract foreign investment.

In 2003, Sevan Hrazdan hydro power cascade and six hydroelectric power plants passed to Russian RAO UES as part of a broad equity-for-debt deal. The Medzamor nuclear power plant is managed by RAO UES for a period of five years to clear off debt for nuclear fuel. Consequently, virtually the entire energy sector passed under Russian control to settle Armenia's state debt towards Russia.

According to NSS and WB data, the reforms had significant effects:

- Technical, commercial and collection losses declined by about 1%, 15% and 40% respectively between 1995 and 2002.
- The sectoral deficit decreased markedly from 1995, while the collection rate reached almost 100% by the end of 2003.
- From 1995, the production of nuclear and hydro power increased, while thermal power production declined. From 1998, imports of gas, petrol and diesel consistently declined.

The Armenian Government has expressed its readiness to close the Medzamor nuclear power plant before the projected deadline of exploitation if substituting facilities would be established. However, no agreement was reached on a closure date for the Medzamor nuclear power plant, despite the EU's efforts to support the development of the energy sector so that sufficient replacement capacity would allow an early decommissioning of the plant.

In conclusion, significant progress was made in reforming the energy sector with consequent positive short to medium-term effects on the Armenian economy. Conditionality criteria were timely and supportive of the reform process.

5.2. Conclusions

Structural conditionality agreed during the implementation of the MFA focused on supporting reforms in five broad areas. Conclusions specific to each area are:

- Progress on *public sector and civil service* reform can only be partially assessed in terms of effectiveness due to some conditionalities being agreed in the later period of the MFA operation. Supported by an early element of conditionality, public sector employment was reduced. On the other hand, conditionalities relative to tax administration gave rise to limited effects. Action against corruption in the form of the implementation of a formal strategy was agreed late in the operation and when the supporting study was conducted had not had time to give rise to tangible effects. However, opinions diverge on the focus of the anti-corruption strategy in terms of the weight it gives to addressing what are considered to be the most important problems of corruption, and hence cast doubts on its future effectiveness. It can also be concluded that support for reform efforts in the area of corruption in particular lacked timeliness given the extent of the problem and its intractable nature.
- In the area of *business climate* reform, at the time of the supporting study, it was too early to draw conclusions on the broader issue of the repercussions of WTO accession on market liberalisation. However, impediments to making the business climate attractive to investors were identified and their resolution is to some extent contingent on the success of reforms in the areas of tax administration and corruption, where measures were only recently implemented or where significant effects were absent.
- While it can be concluded that conditionality criteria were timely and supportive of the *privatisation* of state enterprises, this process was slower and less complete than planned, falling significantly short of its objectives. As a result an effective restructuring of productive capacity had not occurred to the extent that was originally envisaged.
- The *financial sector* had undergone a lengthy and significant reform process and it can be concluded that the conditionality criteria were timely and supportive of this. However, while the reforms resulted in a relatively well-regulated banking sector, the extent to which they led to the financial sector playing a significant role in financing the Armenian economy was limited.
- Significant progress was made in reforming the *energy sector*, despite numerous problems encountered with its privatisation. As a result of the reforms there were positive short to medium-term effects on the sector as well as on the Armenian economy. Conditionality criteria were timely and supportive of the reform process in the energy sector.

MFA structural conditionalities aim to support the recipient country's reform programme which is intended to lead to economic and institutional changes. These changes should ensure that following short-term macroeconomic stabilisation the economy moves towards a sustainable external financial situation over the medium to longer term. In this context, the above conclusions suggest that the reforms supported by the MFA had mixed results with only the reform of the energy sector leading to any significant effects by the end of 2003. Conversely, despite progress in reforms in the areas of

privatisation, financial sector and tax administration, effects fell short of objectives. As for reform actions in the closely linked areas of corruption and the business climate, their late implementation means that tangible effects were not evident at the time of the supporting study.

The direct contribution of MFA structural conditionality to reinforcing the Armenian government's ability to legislate for and to implement reforms was not examined in the supporting study, so *it is not possible to assess the extent to which individual conditionality criteria were supportive*. Nevertheless, the analysis of how the economy would have evolved in the absence of the MFA (§2) suggests that Armenia's reform programme would have slowed down significantly in this situation. It can therefore be concluded that the modest results evidenced above would probably have been more limited without the assistance.

6. TO WHAT EXTENT HAS THE MFA CONTRIBUTED TO RETURNING THE EXTERNAL FINANCIAL SITUATION OF THE ARMENIAN ECONOMY TO A SUSTAINABLE PATH OVER THE MEDIUM TO LONGER-TERM?

MFA operations are intended to contribute to returning the external financial situation of a recipient country to a sustainable path over the medium to longer-term by ensuring that short-term macroeconomic stabilisation is underpinned by appropriate reforms. These reforms are supported by the structural conditionalities of the MFA.

The medium-term analysis draws on data over the 1998 to 2003 period from the NSS and the IMF, the Armenian European Policy and Legal Advice Centre (AEPLAC) Armenian Trends (2003) and P. Mathieu (2004). The data is adjusted to take into account the likely overestimation of exports of precious stones.²⁴ “Debt burden as a share of exported goods and services net of re-exports of precious stones” is therefore used to assess the capacity of the Armenian economy to service its external debt. “Central government revenues net of official transfers” is used to assess the debt service potential of the government.

In order to provide a benchmark for assessing the sustainability of the debt burden, the widely accepted enhanced HIPC thresholds are used:

- Present value of debt service equal to 150% of export revenues.
- Present value of debt service equal to 250% of central government revenues.

The longer-term analysis *projects* the medium-term effects over the 2004 to 2010 period in the form of a baseline scenario and a cautionary scenario. The former is based on positive assumptions (building on recent trends) about the performance of the Armenian economy and a benign external environment. The latter assumes more unfavourable internal conditions and external environment.

The basic equation used for projecting new external borrowing is the balance of payment identity:

$$\Delta D_t = (MGS_t - XGS_t - INC_t - CT_t) - (FDI_t + KT_t)$$

With ΔD_t the change in total external debt, MGS_t and XGS_t imports and exports of goods and services, INC_t net income, CT_t net current transfers from abroad, KT_t net capital transfers from abroad and FDI_t net inflow of foreign direct investments.

²⁴ The rapid increase in exports in recent years took place mainly in one sector: diamond-cutting and polishing and reflected surging re-exports of diamonds. According to the supporting study, this inflates the current size of the share of exports: the share of exported goods and services in the GDP increased from 25.5% in 2001 to 32.2% in 2003, while the value added from diamond polishing remained small. Growth dynamics in exports of precious stones are also likely to be overestimated as there is good reason to believe that size of exports of precious stones was underreported in earlier years.

In this analysis, the determinants of debt changes are modeled explicitly while keeping the dynamics of most of the macro variables exogenous and consistent with previously observed trends and publicly available forecasts (IMF and World Bank, 2004). While these assumptions were made with due care, results should be viewed as illustrative simulations rather than forecasts of actual developments.

The contribution of the MFA to the medium-term and longer term evolution of Armenia's external financial situation is assessed qualitatively.

6.1. Analysis and findings

Armenia's external debt is primarily long-term public or publicly guaranteed debt while private debt remains marginal. Almost 80% of public external debt in 2002 was multilateral (NSS and IMF data). This implies that debt sustainability in the medium term will be mainly driven by a pattern of official disbursements and repayments, keeping the risk of speculative attacks low. Comparison of the present value of debt service (USD 756 million) with the nominal stock of debt (USD 1096 million) in 2003 shows that the debt is highly concessionary, with the average grant element above one-quarter. As approximately 80% of debt carries fixed interest rates, changes in market rates would not have any major impact on the size of debt servicing.

Consequently, Armenia's external debt position is quite sheltered from any increase in international interest rates in the next few years. Furthermore, with the denomination of two-thirds of the debt in SDR, the basket of the main world currencies, the exposure to international exchange-rate movements is additionally reduced.

6.1.1. Evolution of key external debt sustainability indicators over the medium term

The repayment of the €51 million of debt to the EU in 1998 was a condition of the MFA operation. Through this arrangement the assistance made a direct, but modest, contribution to external sustainability by offsetting future debt service costs and hence the external debt burden in the medium term.²⁵ Consequently, debt service fell following the first year of MFA. However, they then underwent a significant increase between 2000 and 2003. At the same time ratios of present value of debt to central government revenue (net of official transfers) and to exports of goods and services (net of re-exports of stones and metals) both fell for most of the period 1998-2003. The ratio of present value of debt service to government revenue was consistently situated below the CIS-5 average and the HIPC threshold. Furthermore, Armenia is the only CIS-5 country where this ratio is below the HIPC threshold without additional debt relief. On the other hand, the ratio of present value of

²⁵ The external debt burden was reduced by around €30 million by the operation, approximately 4% of Armenia's external debt in 1998.

debt to exports of goods and services remained above the CIS-5 average and only fell below the HIPC threshold in 2003 (Table 2).

Table 2. Key external public debt sustainability indicators, 1998-2003

	1998	1999	2000	2001	2002	2003	2003 Av. CIS-5 ²⁶	HIPC Thres- hold ²⁷
In USD millions								
Debt Service	98	61	48	53	68	140		
Nominal Value of Debt	775	870	859	905	1026	1096		
Present Value of Debt	650	704	686	753	741	756		
Ratio to Central Government Revenue (Net of Official Transfers) (in %)								
Present Value of Debt	204	204	215	217	193	182	317	250
Ratio to Exports of Goods and Services (Net of Re-exports of Stones and Metals) (in %)								
Present Value of Debt	239	267	240	197	180	141	125	150

Source: NSS and IMF data, AEPLAC Armenian Trends and Mathieu (2004).

It can be concluded that the evolution of key external debt sustainability indicators over the medium-term was positive (i.e. downwards), even while debt service and the nominal value of debt were rising. This can be explained to some extent by:

- The increased concessionality of new borrowing and successful bilateral restructuring of non-concessional debt.
- A strong reorientation of exports, with exports to non-CIS countries (excluding stones and metals) increasing almost fourfold.
- The cautiousness of the Armenian authorities about contracting new debt.

6.1.2. *Evolution of key debt sustainability indicators over the longer term*

Baseline scenario

The baseline scenario is conditioned by the following factors:

- Sound macroeconomic policy is implemented and progress is made in structural reforms.

²⁶ Standard evaluation of enhanced HIPC export criterion is based on the ratio of present value of debt service to the total exports of goods and services as reported here for CIS-5 countries.

²⁷ The enhanced HIPC fiscal criterion requires that central government revenues are above 15% of GDP and exports of goods and services are above 30% of GDP. For Armenia these ratios are 15.5% and 33.5% in 2003, respectively, but exports of goods and services net of re-exports is only 20.1% of GDP.

- Strong external conditions and continuing support from the Diaspora and the international community.
- Rapid growth in exports, GDP and government revenue.

The baseline scenario is developed on the basis of the following assumptions: (i) real GDP growth rate will remain substantial, although lower compared to period of exceptionally high growth rates from 2001 to 2003; (ii) the share of government revenues in GDP will remain flat as the result of a combination of an unfavorable trend in tax collection and continuing strong official transfers; (iii) real exchange rate movements are projected to partly offset underlying shocks to the items of the external balance of payments; (iv) the baseline real exchange rate trend reflects widely held expectations. These assumptions are presented as quantified variables (Table 3).

Table 3. Factors underlying the baseline scenario, 2004-10

	Av. 98/03	2004	2005	2006	2007	2008	2009	2010
GDP, real growth rate (in %)	8.8	7.0	6.7	6.3	6.0	5.7	5.4	5.1
Exports of Goods and Services (Net of Re-exports of Stones and Metals) growth rate in USD millions (in %)	15.2	11.7	10.9	9.8	8.8	7.9	7.1	6.4
Real exchange rate appreciation against the US dollar (in %)	0.3	2.5	2.4	3.2	2.4	1.8	2.1	1.5
Central Government Revenue (Net of official transfers) share of the GDP (in %)	16.4	15.5	15.5	15.5	15.5	15.5	15.5	15.5

Table 4 shows the improvement in key external debt sustainability indicators that would occur under the preceding assumptions. After rising in the medium term, by 2010 debt service falls back to its 1998 level. Conversely, both the nominal and present value of debt rise over the projected period. The ratios of present value of debt to central government revenue (net of official transfers) and to exports of goods and services (net of re-exports of stones and metals) continue their downward trend into the longer term.

Table 4. Projected key external public debt sustainability indicators, baseline scenario, 2004-10

	2003	2004	2005	2006	2007	2008	2009	2010
In USD millions								
Debt Service	80	68	69	68	64	57	60	61
Nominal Value of Debt	1096	1143	1179	1196	1243	1265	1262	1231
Present Value of Debt	756	851	903	944	1010	1059	1089	1094
Ratio to Central Government Revenue (Net of Official Transfers) (in %)								
Present Value of Debt	182	187	182	173	171	167	159	150
Ratio to Exports of Goods and Services (Net of Stones and Metals) (in %)								
Present Value of Debt	141	142	136	129	127	123	118	112

To conclude, if all conditions for the baseline scenario materialise, key debt sustainability indicators are expected to further improve in the longer term, and are likely to fall to levels consistent with robust debt sustainability.

Cautionary scenario

There are a number of risks that could undermine the previously presented debt sustainability scenario:

- Slowdown of growth in Russia, Kazakhstan and Ukraine (e.g. due to a weakening of oil and gas prices).
- Stagnation or fall of private remittances by the Diaspora and official foreign external assistance (e.g. in the case of serious political turbulence).
- Relaxation of fiscal policy or successful opposition by vested-interest groups to further liberalisation of the economy.
- Substantial slowdown in the rate of growth of exports and GDP.

With respect to the growth of exports and GDP, despite strong export dynamics, the rapid GDP growth in Armenia took place primarily in non-tradable sectors (construction and services) and was associated with the spending boom fuelled by foreign transfers and remittances. Such growth is generally far less sustainable than broad-based, export-led growth because it does not benefit from fast productivity improvements in manufacturing. Moreover, most of the investments, including foreign direct investments, have in recent years been concentrated in the non-tradable sectors and therefore will not contribute to the future diversification of exports. The inability of the economy to generate a broader export base suggests that export revenues might possibly stagnate in the next few years. In addition, while the direct effect of structural reforms on GDP growth was not measured in these simulations, the slow progress in the

implementation of some major structural reforms, as shown in section 5 above, does not bode well for long-term high GDP growth, which may negatively affect debt sustainability.

A further assumption is that the adjustment in government spending, consumption and imports to a lower path of growth would not be instantaneous, so that Armenia would temporarily run higher current account deficits and accumulate additional debt. Therefore, the cautionary scenario implicitly assumes that the authorities will soften their current strict policy of not borrowing on non-concessionary terms.

Factors underlying changes in debt sustainability in the longer term in the context of a more cautionary scenario are presented in Table 5.

Table 5. Factors underlying the cautionary scenario, 2004-10

	Av. 98/03	2004	2005	2006	2007	2008	2009	2010
GDP, real growth rate	8.8	3.5	3.0	3.0	3.0	3.0	3.0	3.0
Exports of Goods and Services (Net of Re-exports Stones and Metals) growth rate in USD millions	15.2	5.1	5.1	4.5	3.9	3.3	3.2	3.1
Real exchange rate appreciation against US dollar	0.3	1.2	1.2	1.6	1.2	0.9	1.0	0.7
Central Government Revenue (Net of official transfers) share of the GDP	16.4	15.5	15.5	15.5	15.5	15.5	15.5	15.5

In comparison to the baseline scenario, the combination of economic slowdown, stagnating exports and inertia in public expenditure and imports underlying the cautionary scenario leads to a significant rebound in debt indicators with debt service increasing significantly over the period of the projection, while both the nominal and present values of debt would more than double and triple respectively. Consequently, the ratios of present value of debt to central government revenue and to exports of goods and services both rapidly increase to exceed the HIPC sustainability thresholds and continue to rise throughout the projected period.

Table 6. Projected key external public debt sustainability indicators, cautionary scenario, 2004-10

	2003	2004	2005	2006	2007	2008	2009	2010
USD million								
Debt Service	80	69	73	78	81	80	97	115
Nominal Value of Debt	1096	1169	1277	1431	1634	1885	2184	2528
Present Value of Debt	756	878	997	1162	1381	1656	1996	2403
Ratios to Central Government Revenue (Net of Official Transfers)								
Present Value of Debt	182	202	220	245	280	323	374	434
Ratios to Exports of Goods and Services (Net of Stones and Metals)								
Present Value of Debt	141	161	174	194	222	258	301	351

6.2. Conclusions

Key external debt indicators suggest that debt sustainability improved substantially in the *medium term*. As a result, HIPC debt relief was no longer considered appropriate or necessary for Armenia. Further improvements in debt sustainability are to be expected in the *longer term* if the baseline scenario prevails. Under the assumptions of continued strong export and output growth and the implementation of appropriate policies and reforms, indicators suggest that Armenia would be well on the path towards debt sustainability. In particular, the country would continue to move further away from the thresholds of enhanced HIPC, for which the country was still considered in 2001.

However, the continuation of this positive outlook is not unconditional. In the cautionary scenario, the country fails to achieve the export diversification needed to hedge exogenous foreign shocks; furthermore the output growth driven by the boom in the non-tradable sector, fuelled by foreign transfers and remittances, would be short-lived. In this scenario, sustainability indicators do not converge to low levels and increase above enhanced HIPC thresholds.

To conclude, the MFA made a direct, if modest, contribution to medium-term sustainability via its debt-relief element. It also made an indirect contribution by ensuring the continuation of IMF support. However, the slow progress in the implementation of some major structural reforms supported by the operation does not bode well for long-term high economic growth. Only if conditionalities agreed later in the operation (focusing on problems of corruption and the business climate) were to have significant effects would it be possible to conclude the contrary. At this stage an assumption that this positive outcome would occur would be premature given the intractable nature of problems in these areas.

7. CONCLUSIONS AND RECOMMENDATIONS

The MFA operation in Armenia was agreed in the specific circumstances of helping Armenia to clear its outstanding liabilities to the European Community. It was

implemented from 1998 to 2004 (though the last year fell outside the scope of this evaluation).

On the basis of the previously presented data and analyses, it can be concluded that the assistance was effective in terms of:

- Contributing to the short-term macroeconomic stabilisation
- Alleviating social hardship in the short-term
- Contributing to returning the external financial situation to a sustainable path over the medium term.

On the other hand, the MFA was not generally effective in supporting economic and institutional reform over the short to medium term, since the majority of conditionality-supported reforms fell short of their initial intentions. As a consequence, the operation's contribution to returning the Armenian external financial situation to a sustainable path over the longer term is limited.

A more detailed presentation of the conclusions is presented below along with associated recommendations.

7.1. To what extent was the MFA effective in terms of the short-term macroeconomic stabilisation of the Armenian economy?

While there is evidence to suggest that official statistics appear to overstate the performance of the Armenian economy, significant progress occurred between 1998 and 2003 in terms of GDP growth, inflation stabilization, improvement of the external position and the reduction of poverty.

MFA was first granted to Armenia in 1998. It was relatively modest in financial terms and given the agreed debt repayment arrangements net financial flows were negative in all years that disbursements were made. The financial dimension of the MFA cannot therefore be said to have had a direct effect on the Armenian economy in the short term.

However, the MFA ensured continued IMF support to Armenia, thus having an indirect effect on the stabilisation of the country's macroeconomic situation. In this context, the MFA/IMF support had a net positive effect on Armenia's external accounts and on its broader macroeconomic environment.

The improved performance of the Armenian economy was in line with the IMF's macroeconomic conditionality, implying that the objectives of the IMF (and by proxy, those of the EU) had been met.

Recommendations:

Given the success of the operation in terms of contributing to the short-term macroeconomic stabilisation of the Armenian economy, it is recommended that future MFA operations are more focused on achieving this objective. Further arguments in favour of this recommendation, on the basis of other conclusions, can be found below.

7.2. To what extent was the MFA effective in achieving its short-term objective of alleviating social hardship?

The alleviation of social hardship was a short-term objective of the MFA. It is not possible to conclude that the MFA made any direct contribution to the improvement in social indicators over the period of its implementation. However, it is likely that without the assistance the Armenian government would have reduced social expenditure to clear its debts, or EU assistance (and possibly aid from other international donors) would have been suspended. Consequently, it is likely that negative social impacts were at least indirectly mitigated by the operation and the Armenian population spared further social hardship in the short term.

Recommendations:

The objective of alleviating social hardship was defined without any apparent formalised assessment of how the objective would be achieved through the provision of the assistance, nor were possible synergies with other EU policy instruments, more specifically dedicated to achieving this type of objective, identified at the design phase of the operation.

Despite the relatively positive assessment of the assistance in respect to the achievement of this objective, it is recommended that explicitly addressing poverty concerns should be considered as outside the scope MFA, with efforts focused on ensuring complementarity and coherence of MFA operations with instruments implemented as part of the European Neighbourhood Policy.

7.3. To what extent was the MFA effective in terms of supporting structural reform in Armenia in the short to medium-term?

Structural conditionalities were agreed with the Armenian government in five broad areas of economic and institutional reform. Up to 2003, effects of the reforms in this area had been modest, though some actions were only the object of conditionalities in the latter period of the operation. Consequently, it was too early to judge the effectiveness of these particular reforms.

Only conditionality-supported reforms of the *energy sector* appeared to have had a significant positive effect on the economy in the short to medium-term.

Privatisation and the effects of *financial sector* reforms supported by the MFA fell short of objectives, resulting in limited effects on the restructuring of productive capacity and the role for the financial sector in Armenian economy.

In the area of *public sector and civil service* reform, public sector employment was reduced in accordance with an early structural conditionality. On the other hand, conditionalities focusing on the issues of corruption were only agreed in the later period of the operation and thus had not had the time to produce tangible effects by 2003. The effects of tax administration reforms had largely fallen short of expectations.

In the area of *business climate* reform, many impediments to improvement remained, since progress depended to a certain extent on reforms in the areas of corruption and tax administration. Furthermore, it was too early to draw conclusions on the broader issue of the repercussions of WTO accession on market liberalisation.

Issues of corruption, tax administration and the business climate are closely linked and making the business climate attractive to investors is to some extent contingent on the success of reforms in the preceding areas. However, important conditionality-supported reforms in the areas of corruption and tax administration were only implemented in the later period of the MFA and evidence from the supporting study suggests that problems in these areas are particularly resistant to reform efforts. This casts doubt on the effectiveness of the implemented actions to reduce corruption and to improve tax administration in the future. It can also be concluded that support for reform efforts in the area of corruption in particular lacked timeliness given the extent of the problem and its intractable nature.

Recommendations:

The conclusions of this evaluation highlight the somewhat varied effectiveness of the operation's structural conditionalities, which covered a broad range of reform areas rather than being focused where they were likely to have an optimal effect in terms of supporting macroeconomic stability.

The evaluation also concludes that the scheduling of certain conditionalities vis-à-vis each other over the period of the assistance was not optimal in cases where significant interactions between different elements of the reform actions could be foreseen.

Finally, it was not always clear what the objectives of conditionalities were and over what time period they were likely to be achieved. It is therefore recommended that:

- (1) Structural conditionalities should in the main be focused on reform areas that have a direct and unambiguous link to underpinning macroeconomic stability in the shorter term. In cases where support is provided for reforms that by their nature have to be implemented on a step-by-step over a number of years, or will only give rise to effects over the medium to the longer-term, timescales should be made explicit when conditionalities are established.
- (2) In the context of the above recommendation, efforts should be focused on ensuring complementarity and coherence of MFA operations with instruments implemented as part of the European Neighbourhood Policy, as well as with possible future budget support operations under the European Neighbourhood Partnership Instrument.
- (3) When broader ranging conditionalities are considered necessary to support essential reforms in areas that are more intractable/cross-cutting in nature, they should be implemented as early as possible in the operation so that they support subsequent conditionalities aimed at underpinning other reforms that are to some extent contingent upon early reform efforts (i.e. as illustrated by the interlinked nature of corruption, business environment and tax administration reforms in this evaluation)
- (4) Looking forward, structural conditionalities should be formulated in a homogeneous and unambiguous fashion in order to avoid potential misinterpretations or divergences of views regarding their fulfilment.

7.4. To what extent has the MFA contributed to returning the external financial situation of the Armenian economy to a sustainable path over the medium to longer-term?

The external financial situation of the Armenia improved significantly from 1998, putting the economy on to a sustainable path in the *medium term*. The MFA made a direct, if modest, contribution to this dynamic via its debt-relief element. It also made an indirect contribution by ensuring the continuation of IMF support. As a result, HIPC debt relief was no longer considered appropriate or necessary for Armenia.

On the other hand, the slow progress in the implementation of some major structural reforms supported by the operation does not bode well for output and export growth in the *longer term*. Only if conditionalities agreed later in the operation (focusing on problems of corruption and the business climate) were to bring about significant effects would it be possible to conclude the contrary. However, at this stage an assumption that this positive outcome would occur would be premature given the intractable nature of problems in these areas.

Projections under the baseline scenario developed in this evaluation show that Armenia's debt ratios would improve over the period 2003-10 to levels consistent with long-term debt sustainability. However, should the risks identified under the cautionary scenario materialise, including the failure of structural reforms to effectively take root, debt ratios would significantly deteriorate and exceed HIPC sustainability thresholds.

Recommendations:

While Armenia's external financial situation over the medium to longer term improved significantly, the limited contribution of the operation to this suggests that MFA is not particularly adapted to bringing about the significant changes to institutions, and more particularly to economic structures, that are required to underpin a shift of an economy to a long-term development path.

It is therefore recommended that MFA operation focus primarily on supporting a return to macroeconomic stability in the shorter term. EU support to promote medium to longer-term institutional and economic change should be left to other instruments implemented in the framework of the European Neighbourhood Policy.

Close and regular policy dialogue with the authorities in charge of implementing the reform measures is key to ensuring ownership and to monitoring results. The evaluation shows that a greater presence in the field or the direct involvement of qualified staff in the EC Delegations would be necessary to increase the impact of future MFA operations.

ANNEX 1: RECENT ECONOMIC DEVELOPMENTS AND PROGRESS IN REFORMS

1. Macroeconomic developments

Real sector developments

The record growth seen in recent years continued with 13.9% real GDP growth in 2005. Real GDP is now higher than its pre-transition level. Growth is driven in particular by investment and increased consumer spending, supported by remittances and increased private sector incomes. Construction was the fastest growing sector in 2005, with about 34% growth, not least because of a housing boom in Yerevan. Services and agriculture also performed well, with growth rates of about 16.7% and 10.9% respectively, while industrial production grew by 6.6%. The industrial sector accounts for more than 30% of GDP, while more people are employed in agriculture (almost half the labour force), which accounts for only 21% of GDP. The shadow economy is thriving and estimates put its size at more than 30% of GDP.²⁸

Registered unemployment has shown a downward trend since 2003, and fell to 8.9% in 2005 from 9.4% in 2004. Actual unemployment appears to be significantly higher at about 32%.²⁹ The labour force has been shrinking almost continuously since the early nineties, due mainly to net migration, but a slow reversal appears to have taken place in recent years. Average nominal wages increased by about 20% in 2005, while the consumer price index only increased 1.0%, due to a fall in food prices following a good harvest. The growth momentum is expected to continue at a slightly slower pace in 2006, with inflation projected to increase towards the Central Bank's 3% objective.

Fiscal developments

The central government budget deficit fell to about 1.0% of GDP in 2005 (1.7% in 2004), according to preliminary official estimates. Revenues (including grants) increased from 15.9% of GDP to 16.7% of GDP while total expenditures increased from 17.2% of GDP in 2004 to about 17.7% in 2005. The value-added tax is the most important source of revenue, accounting for more than one third of total tax revenues, while personal income tax accounts for only some 7%.³⁰ The public sector in Armenia is relatively small compared with other CIS countries. About 2.4% of GDP is spent on general government wages and about 5.5% of GDP on transfers. The public external debt is sustainable and fell as a ratio of GDP to about 29% in 2005 from 33% in 2004.

²⁸ See Tunyan, B. (2005), *The Shadow Economy of Armenia: Size, Causes and Consequences*, Armenian International policy Research Group Working Paper Series No. 05/01.

²⁹ Surveys conducted in line with ILO methodology indicate that unemployment fell to about 32% in 2004.

³⁰ See Gelbard, E. et al. (2005), *Growth and Poverty Reduction in Armenia*, IMF.

Monetary and exchange rate developments

Monetary policy has been focused on price stability (an objective of 3% annual inflation) and used monetary aggregates as an intermediate target. In recent years the Central Bank of Armenia (CBA) has often deviated from the programmed monetary indicators in order to ensure price stability. A move from monetary targeting towards inflation targeting was therefore deemed appropriate and took place in early 2006.

The consumer price index (CPI) only increased by 1.0% in 2005, but actual inflation is perceived to have been significantly higher. The main problem is that the consumption basket used for the CPI calculation is outdated (from 1997) with a resulting over-representation of basic commodities, which have shown limited price growth. An updated consumption basket that better reflects today's spending pattern is likely to be put in place during 2006.

The Armenian Dram appreciated 7.3% against the US dollar and 19.5% against the Euro during 2005 as a result of high remittances and other capital inflows. The repo rate was reduced slightly from 3.75% to 3.5% during 2005, and the CBA carried out partially sterilised foreign exchange interventions because of appreciation pressures caused by the strong capital inflows. There was a strong increase in money demand and broad money (M2) increased by 30% in 2005. Dollarisation of the economy is still significant. However, if inflation targeting is successful, a law implemented in 2005 requiring that certain transactions are quoted in drams only, should help to support an emerging decline in dollarisation.

External sector developments

The trade deficit narrowed slightly to 12.1% of GDP in 2005 from 12.9% of GDP in 2004, while the current account deficit narrowed to 3.9% of GDP in 2005 compared to 4.6% of GDP in 2004. Exports of goods and services (26% of GDP in 2005) increased by 13.5% while imports (40% of GDP in 2005) increased by 14.0%. Exports of metals and processed foodstuff have performed especially well, whereas the share of manufactured goods in Armenia's exports continues to be small. The real exchange rate appreciation appears to have had little impact on competitiveness so far. Remittances from abroad contributed significantly to the Armenian economy. Transfers officially amounted to 8% of GDP, but unofficial estimates range up to about 26% of GDP.³¹ Remittances appear to have been mostly invested in housing, land, education and small businesses.

The trade deficit is likely to increase significantly if Russia realises its plans to raise the price of gas supplied to Armenia from USD 56 to USD 110 per thousand cubic meters from April 2006 onwards. The price hike would increase the cost of gas by USD 66 – 80 million in 2006 (1.3-1.5% of GDP), depending on assumptions. Russia

³¹ See Roberts, B. W. and K. Banaian (2005), *Remittances in Armenia: Size, Impacts, And Measures to Enhance Their Contribution to Development*, Armenian International policy Research Group Working Paper Series No. 05/01.

is currently the sole supplier of gas to Armenia, but a gas pipeline from Iran to Armenia is under construction and scheduled for completion by the end of 2006.

FDI net inflows increased slightly to about USD 255 million or 5.6% of GDP, while portfolio investment and other investment flows (loans and deposits) bordered on insignificant. Foreign debt increased slightly from USD 1,183 million to USD 1,229 million, but fell as a percentage of GDP from 33% to 27%. Gross international reserves increased by USD 130 million to USD 677 million in 2005, equivalent to about 4 months of imports.

2. Trade Liberalisation and Economic Opening

Armenia has a liberal trade regime with low tariff barriers (average tariffs about 3%). However, the two closed borders are a constraint to further trade. Inefficiencies and corruption in customs also hold back trade. Revenue targeting for customs is one problem as it gives them incentives to "play with prices". A risk-based customs clearance programme was introduced in November 2005. This follows an increased use of transaction prices instead of reference prices for assessment of import declarations. These steps should help to push forward a more efficient and transparent customs clearance. Armenia joined the WTO in 2003.

Negotiations on an Armenia-EU action plan in the framework of the European Neighbourhood Policy were initiated in 2005. The ENP is expected to lead to an increasingly closer relationship between Armenia and the EU and may help, not least by means of legal approximation, to substantially increase both trade and foreign investment.

3. Business Climate

Privatisation, enterprise restructuring and business environment

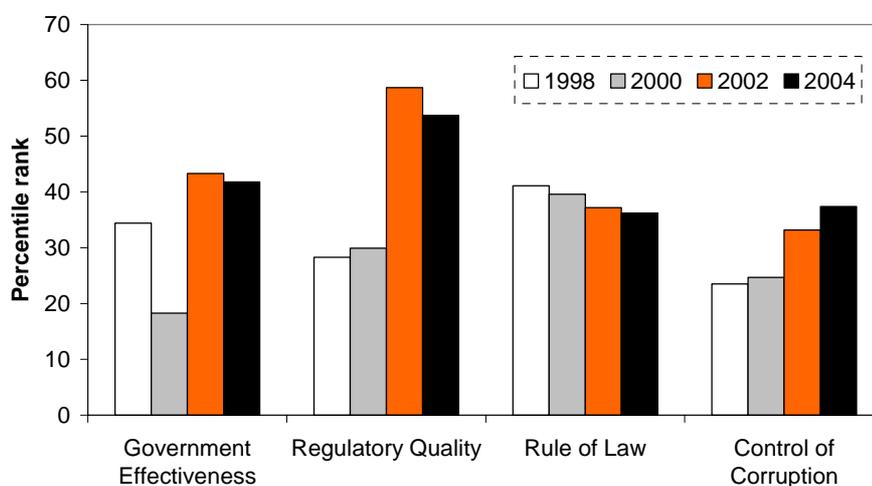
The pace of privatisations has slowed down during 2005. A number of strategic enterprises, including a few state-owned enterprises in the energy sector, still need to be privatised. The government aim to complete the privatisation process by end 2007.

Armenia has continued to advance with structural reforms, as indicated by EBRD 2005 transition indicators, and regulatory quality has improved.³² Armenia is indeed in the lead among CIS countries on most dimensions of structural reforms measured by the transition indicators. However, bureaucracy, corruption and limited access to finance are still perceived to damage the business climate, and a common complaint is that the government is doing little to facilitate business development. This is confirmed by the World Bank's governance indicators that show continued problems with the rule of law and government effectiveness. On the other hand, control of corruption has steadily (although slowly) improved (chart 1). The state commission on protection of economic competition is slowly becoming more

³² See EBRD (2005), *Transition Report 2005 – Business in Transition*, EBRD.

effective, but competition is still modest in several sectors. The Heritage Foundation in its 2006 Index of Economic Freedom ranked Armenia as "mostly free".

Chart 1: Armenia - Governance



Source: World Bank Governance indicators.
 Note: A higher ranking implies a better relative score.

There is a need for more political will to combat corruption. The Council of Europe's Group of States against Corruption (GRECO) published an evaluation report on Armenia in early 2006, which concluded that corruption is a major problem in Armenia, particularly so in the judiciary, the police, tax and customs operations and the education and health sectors. The report also states that there is an almost total absence of significant results in prosecuting and indicting individuals involved in serious cases of corruption. Immunity enjoyed by judges, prosecutors, parliamentary candidates, members of electoral commissions, candidate mayors and candidates for membership of the council of elders (local council) is also a matter of concern.

Progress is needed towards a more transparent and trustworthy judicial system. After the referendum on constitutional amendments, the Ministry of Justice announced a large-scale reform in the judicial sector. The reform is targeted at reorganizing the court system; strengthening the judiciary, advocacy and public defence structures; and improving the public's trust in the judicial system.

Financial sector reforms

The minimum capital requirement for banks was raised to USD 5 million from USD 2 million in July 2005, and this seems to have advanced some consolidation. A deposit insurance scheme was also launched in July. Financial depth is increasing, but access to finance is still limited. The efficiency of financial intermediation needs to be improved, as indicated by the interest rate spread, which remains very high, despite falling from 13.7% in 2004 to 12.2% in 2005.

Foreign participation in the banking sector increased during 2005, but is still dominated by HSBC. The large market share of a single foreign bank is an uncomfortable situation in terms of competitiveness and financial stability. The Armenian financial sector has a substantial growth potential, and more foreign

banks and insurance companies could bring expertise and increased competition to the sector. Supervision of banks will be upgraded significantly in 2006 in line with the IMF's Financial Sector Assessment Program (FSAP) recommendations. Development of the legal framework for mortgage institutions, the insurance sector and the securities market is also foreseen.

Labour market reforms

Armenia ratified two ILO core conventions (on forced labour) in 2005, but has still only ratified five of the eight core conventions.³³ Strengthening the institutional capacity in the state labour inspection is a priority. The fraction of companies that see labour skills as a constraint is much lower than the regional average. There is, however, some shortage of qualified workers and a continued need to improve the targeting of the educational system to the needs of the economy and improve the quality of and access to vocational training.

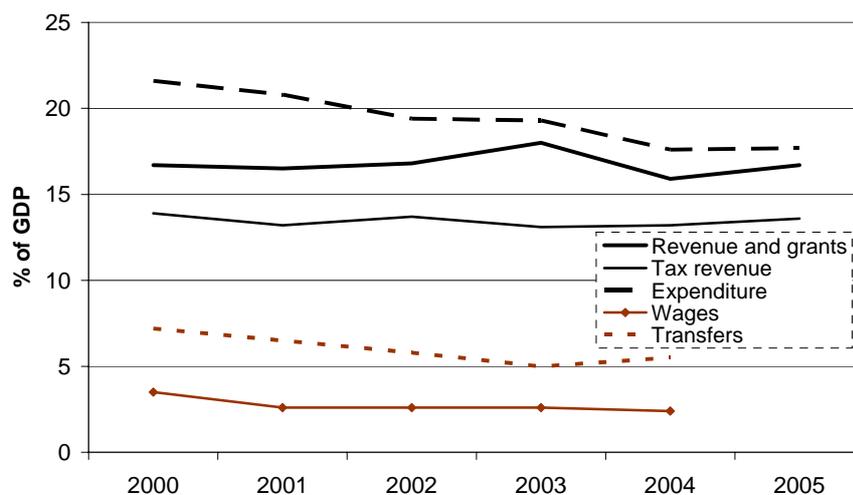
4. Public Institutions and Public Finance Management

Armenian government revenues are low due to a weak tax base and significant tax evasion, but noteworthy improvements were achieved during 2005 (chart 2). A corporate tax rate of 1% of company turnover introduced in January 2005 and a list naming the 300 top tax payers published in April 2005 (the move was aimed at embarrassing the country's wealthiest tax evaders) has helped to boost taxes to an estimated 13.6% of GDP in 2005 from 13.2% in 2004.

An action plan for tax and customs reforms (2005-2006) was adopted in May 2005 aimed at simplifying the tax system, broadening the tax base and reducing tax evasion. A major step forward is mandatory income statements, which are expected to be introduced in 2006. Public procurement and tender procedures are expected to be improved during 2006. Corruption and conflicts of interests have also been mentioned as barriers to raising tax revenues and need to be tackled.

³³ Azerbaijan, Georgia, Moldova and Ukraine have ratified all eight core conventions.

Chart 2: Armenia - Government revenues and expenditures



Source: Economist Intelligence Unit and E. Gelbard (2005)

An operational assessment on the soundness of Armenia's public finance management was carried out in April 2004. The European Commission, assisted by external experts, carried out a follow-up assessment in April 2005, which concluded that significant progress had been made in several areas. An internal audit development unit has been established in the Ministry of Finance and Economy to oversee the implementation of the Government Strategy for Development of Internal Audit System in 2005-2008. The positions of chief auditors, created in 2004, have been filled in most ministries and a training and certification programme is in place supported by donor-assistance.

The adoption of amendments to the Constitution in a national referendum in November 2005 paves the way for the modernisation of the legal framework for independent external audits by Armenia's supreme audit institution, the Chamber of Control. Other areas of progress include putting in place a regular reporting mechanism for government-owned non-commercial organisations (former budget organisations) on their revenues and expenditure.

Decommissioning of the Medzamor nuclear power plant will have significant fiscal implications and is expected to take place not later than 2012. Decommissioning will take several years and is estimated to cost about USD 0.7 – 1.2 billion and increase the government deficit by about 10% of GDP in 2020.³⁴ Though some of the costs could potentially be covered via an international donor conference, the fiscal implications underscore the need for a strengthening of the tax base. Further assessments of costs versus risks are also needed.

³⁴ See E. Gelbard et al. (2005), *Growth and Poverty Reduction in Armenia*, IMF.

5. Social Development and Poverty

Gross national income per capita increased to about USD 1450 in 2005 from USD 1120 in 2004. Poverty continues to fall, and extreme poverty - which affected 5.5% of the population in 2003 - may soon be eradicated.³⁵ However, current pension levels are still below the extreme poverty line. Pension reform is high on the agenda in Armenia, and a shift from the current pay-as-you-go (PAYG) system towards a three-pillar system with mandatory savings is being considered.

Remittances from abroad account for as much as about 16% of household income, and have made a significant contribution to reducing poverty and inequality, as poor households tend to be the main beneficiaries. Private households face a 52% increase in the retail price for gas from 10 April 2006 (following the price hike for gas imports from Russia), and this is likely to have a negative effect on poverty. Official female unemployment rates are more than twice as high (13.6%) as male unemployment rates (5.2%). About 5% of the population still lives in temporary shelters (war refugees and victims of the 1998 earthquake).

The EC is supporting Armenia with a TACIS action programme worth EUR 17 million in 2006 and focused on improved access to justice, and support for implementation of the national programme for Partnership and Co-operation Agreement.

The US pledged in March 2006 USD 235.65 million over the next five years under the Millennium Challenge Account (MCA) programme. The aid will be channelled into rural regions (upgrading of irrigation networks, repair of rural roads) that have seen little development. Armenia has also received continuous assistance from the World Bank, the IMF, UNDP, EBRD and national donors. Donor coordination is considered to be good in Armenia.

³⁵ Extreme poverty in Armenia is defined by the National Statistical Service based on World Bank methodology as household expenditures of less than USD 16 per month.

ARMENIA

Main economic indicators

	2001	2002	2003	2004	prel. 2005
Real sector					
Real GDP growth (% change)	9.6	13.2	13.9	10.1	13.9
Inflation (period average)	3.1	1.1	4.8	7.0	0.6
GDP nominal, in USD millions	2,120	2,373	2,805	3,558	4,580
GNI per capita, in USD	680	767	902	1,119	1453
Social Indicators					
Unemployment (officially registered)	10.4	10.8	10.1	9.4	8.9
Poverty rate (% of population)	51.0	49.0	43.0	---	---
Inequality (Gini index consumption/ income)		0.27/0.45	---	---	---
Fiscal Sector					
Total revenues, % of GDP	17.0	18.8	17.8	15.6	16.7
Total expenditure, % of GDP	20.9	19.3	18.9	17.2	17.7
Central govt. balance, % of GDP	-3.8	-0.4	-1.1	-1.7	-1.0
Gross Public Debt, % of GDP	45.3	46.6	40.9	30.7	28.6
Monetary sector					
Domestic credit to private sector (% of GDP)	8.3	7.2	6.4	7.5	---
Broad money (M3) (% change)	4.3	34.0	10.4	22.3	27.8
Degree of monetisation (M3/GDP, %)	14.5	14.9	14.4	15.1	---
Dollarisation in bank deposits (%)	80	71	71	71	---
External sector					
Current account balance, % of GDP	-9.5	-6.2	-6.8	-4.6	-3.9
Trade balance, % of GDP	-19.8	-15.5	-15.4	-12.9	-12.1
Foreign direct investment (net, % of GDP)	3.3	5.0	5.0	6.1	5.6
Import cover of reserves (months)	3.6	3.7	4.0	3.6	4.0
External Vulnerability					
External Public Debt, % of GDP	42.8	43.2	38.0	31.3	---
Debt Service Ratio ¹	9.7	9.8	15.6	9.7	5.7
Gross reserves (excl. gold, USD millions)	321	425	510	576	755
Reserves/M3	107	122	125	102	---
Financial sector					
Money market rate	19.4	12.3	7.5	4.2	3.2
Lending rate	26.7	21.1	20.8	18.7	18.0
Exchange rate (drams per USD, average)	555.1	573.4	578.8	533.3	457.7
Exchange rate (drams per EUR, average)	497.2	629.6	653.8	662.3	569.8
Real effective exchange rate (2000=100)	90.6	82.7	77.2	82.2	---

Sources: IMF, EBRD, Armenian authorities

¹ Public external debt service in % of exports of goods and services