Ex-post Evaluation of Macro Financial Assistance (MFA) operation to Armenia

European Commission, Directorate-General for Economic and Financial Affairs

Final Report
October 2013
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A great deal of additional information is available on the Internet. It can be accessed through the Europa server (ec.europa.eu)

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<th>Description</th>
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<tbody>
<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<tr>
<td>ACF</td>
<td>Anti-Crisis Fund</td>
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<td>AMD</td>
<td>Armenian Dram</td>
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<td>BoP</td>
<td>Balance of Payments</td>
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<td>CBA</td>
<td>Central Bank of Armenia</td>
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<tr>
<td>CHU</td>
<td>Central Harmonisation Unit</td>
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<td>CoC</td>
<td>Chamber of Control</td>
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<td>CPI</td>
<td>Consumer Price Index</td>
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<td>CPS</td>
<td>Country Partnership Strategy</td>
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<tr>
<td>DB</td>
<td>Defined Benefit</td>
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<tr>
<td>DC</td>
<td>Defined Contribution</td>
</tr>
<tr>
<td>DCFTA</td>
<td>Deep and Comprehensive Free Trade Area</td>
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<tr>
<td>DFID</td>
<td>Department for International Development</td>
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<tr>
<td>DG DEVCO</td>
<td>Directorate-General for Development and Cooperation</td>
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<tr>
<td>DG ECFIN</td>
<td>Directorate-General for Economic and Financial Affairs</td>
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<tr>
<td>DPO</td>
<td>The Development Policy Operation</td>
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<tr>
<td>EAPIC</td>
<td>Eastern Partnership Integrations and Cooperation Programme</td>
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<tr>
<td>EBRD</td>
<td>European Bank for Reconstruction And Development</td>
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<tr>
<td>ECF</td>
<td>Extended Credit Facility</td>
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<td>EDA</td>
<td>Eurasian Development Bank</td>
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<tr>
<td>EEAS</td>
<td>European External Action Service</td>
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<td>EFF</td>
<td>Extended Fund Facility</td>
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<tr>
<td>ENP</td>
<td>European Neighbourhood Policy</td>
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<td>ENPI</td>
<td>European Neighbourhood Partnership Instrument</td>
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<td>EU</td>
<td>European Union</td>
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<td>EUR</td>
<td>Euro</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
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<tr>
<td>FMIS</td>
<td>Financial Management Information System</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>GIZ</td>
<td>Gesellschaft für Internationale Zusammenarbeit</td>
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<tr>
<td>GoA</td>
<td>Government of Armenia</td>
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<tr>
<td>GPA</td>
<td>Government Procurement Agreement</td>
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<tr>
<td>GVA</td>
<td>Gross Value Added</td>
</tr>
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<td>IDA</td>
<td>International Development Aid</td>
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### Acronym List

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Definition</th>
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<tbody>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>INSOTAI</td>
<td>The International Organisation of Supreme Audit Institutions</td>
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<tr>
<td>MFA</td>
<td>Macro Financial Assistance</td>
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<td>MoF</td>
<td>Ministry of Finance</td>
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<td>NDA</td>
<td>Net Domestic Asset</td>
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<td>NGO</td>
<td>Non-Governmental Organization</td>
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<td>NIR</td>
<td>Net International Reserves</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<tr>
<td>PFM</td>
<td>Public Finance Management</td>
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<td>PIFC</td>
<td>Public Internal Financial Control</td>
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<tr>
<td>SBA</td>
<td>Stand-By Arrangement</td>
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<tr>
<td>SDR</td>
<td>Special Drawing Rights</td>
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<tr>
<td>SIGMA</td>
<td>Support for Improvement In Governance and Management</td>
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<td>SMEs</td>
<td>Small and Medium Size Enterprises</td>
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<td>SRC</td>
<td>State Revenue Committee</td>
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<td>TAIEX</td>
<td>Technical Assistance and Information Exchange Instrument</td>
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<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
</tr>
<tr>
<td>USAID</td>
<td>United States Agency for International Development</td>
</tr>
<tr>
<td>USD</td>
<td>United States Dollar</td>
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<tr>
<td>WB</td>
<td>World Bank</td>
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<tr>
<td>WTO</td>
<td>World Trade Organisation</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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Abstract

This report sets out the findings, conclusions and recommendations of the ex-post evaluation of the macro-financial assistance (MFA) provided to Armenia during 2011 and 2012 to support the country’s recovery from the 2009 economic crisis. The MFA operation consisted of a long term loan of EUR 65 million and a grant of EUR 35 million. The evaluation concludes that the MFA had a positive net impact on the Armenian economy by enabling a more gradual fiscal consolidation than would otherwise have been possible. This conclusion is supported by model-based simulation which shows that Armenia’s GDP would have been 0.3 to 0.6 per cent lower in 2011 and up to 0.3 per cent lower in 2012 in the counterfactual scenario. Moreover, by linking the disbursement of tranches to specific conditions, the MFA promoted reforms in the areas of public finance management, customs and taxation. These reforms are expected to contribute to improved economic governance and business environment in Armenia in the medium to long term.

Source: World Bank
Executive Summary

This Report presents the results of the ex-post evaluation of the Macro-Financial Assistance (MFA) to Armenia (2011 to 2012). The evaluation was commissioned by the Directorate-General for Economic and Financial Affairs (DG ECFIN). The work was undertaken by ICF GHK in association with Cambridge Econometrics and with inputs from a local economist based in Armenia.

The MFA operation in Armenia

Armenia’s economy was badly hit by the global economic crisis: real GDP contracted sharply in 2009 (by more than 14 per cent) and the poverty rate shot from 23.5 per cent in 2008 to 34.1 per cent in 2009 after more than a decade of continuous decline. The Government of Armenia responded rapidly with (i) a counter-cyclical fiscal ‘stimulus’ aimed at maintaining essential social expenditure; (ii) temporary loosening of monetary policy to counteract the output contraction; (iii) and return to a flexible exchange rate regime in March 2009 to restore external balance. To offset lower private capital inflows and budget revenues, the Government also requested for international assistance from various sources, including the International Monetary Fund (IMF) and macro financial assistance from the EU.

In response, the European Parliament and the Council approved an MFA operation consisting of a grant of EUR 35 million and a loan of EUR 65 million in November 2009 (Decision No 890/2009/EU). Further details including the number of tranches, approximate timing of disbursements and conditions related to implementation of structural reforms were agreed in the Memorandum of Understanding (MoU) signed by European Union and the Government of Armenia in February 2011. The total size of the MFA operation was substantial, accounting for circa 1.7 per cent of the Armenian GDP between the third quarter of 2011 and first quarter of 2012 (when the MFA was disbursed), and representing 9 per cent of the total international assistance received by Armenia in the form of budget support between 2009 and 2012. The MFA operation was linked to the IMF programme under its Extended Credit Facility/Extended Fund Facility (ECF/EFF) Facility approved in June 2010 and amounting to SDR 266.80 million (approximately EUR 513.2 million).

The MFA was disbursed in two instalments:

- The first instalment of EUR 40 million was disbursed in July 2011;
- The second and final instalment of EUR 60 million was disbursed in December 2011.

Evaluation objectives and methods

The overall objective of this evaluation is to provide an independent assessment of the MFA operation in Armenia, focusing in particular on the following three areas of analysis:

- The macroeconomic impact of the operation on the Armenian economy (with and without IMF involvement);
- Sustainability of the country’s external position as a result of the assistance;
- Value added of EU intervention.

The evaluation is both summative and formative, and attempts to draw lessons which could be applied to the design and implementation of future MFA operations.

The evaluation is based on a mixed-methods approach. A variety of quantitative and qualitative techniques have been used to build the evidence base for the evaluation and to provide the basis for triangulation of results: (i) a review of relevant literature and official documentation; (ii) semi-structured interviews with key informants during two missions in Armenia, missions to Brussels and Washington DC. During these missions,
consultations were conducted with European Commission officials, Government officials in the relevant ministries and departments in Armenia, international financial institutions / multilateral development banks (IMF, World Bank, Asian Development Bank and Eurasian Development Bank), key development partners (e.g. GIZ) and the EU Delegation in Armenia; (iii) a focus group discussion with non-governmental stakeholders in Yerevan; (iv) desk based analyses of macroeconomic outcomes and impacts of structural reforms; and (v) macroeconomic modelling.

Results of the evaluation: Macroeconomic and external sustainability impact

The evaluation concludes that the MFA contributed to macroeconomic stability in Armenia and supported the country’s post-crisis recovery. The MFA allowed for a smoother fiscal adjustment path from 2009 onwards and overall, had a net positive impact on the Armenian economy. This conclusion is supported by model-based simulation which shows that Armenia’s GDP growth would have been 0.3 to 0.6 per cent lower in 2011 and up to 0.3 per cent lower in 2012 in the counterfactual scenario.

The MFA was closely linked to the IMF programme and the combined macroeconomic impact of these two operations is found to have been substantially larger than the impact of the MFA alone. Specifically, the modelling exercise suggests that the joint EU-IMF support helped to avoid a much more severe recession in 2009: the decline in GDP could, potentially have been closer to 20 per cent in the counterfactual scenario (i.e. 6 per cent more than the observed level of 14.1 per cent). In the counterfactual scenario, without the IMF and MFA support, it is highly unlikely that Armenia would have had access to alternative external (or domestic) financing on a similar scale and on similar concessional terms. By implication, the combined impact of the MFA assistance and the IMF programme on Armenia’s external sustainability is also likely to have been positive.

Results of the evaluation: Impact on structural reforms

The disbursement of the second tranche of the MFA assistance was, inter alia, dependent on satisfactory fulfilment of nine reform conditions, agreed in the Memorandum of Understanding between the EU and the Government of Armenia. The MFA conditionality targeted the following areas:

- Public Finance Management (PFM) reforms focusing on public debt management, public internal financial control and external audit;
- Improving legislation in the areas of public procurement and pension system;
- Upgrading tax administration; and
- Compliance with the World Trade Organisation’s (WTO’s) rules on tax and customs policy.

The conditionality attached to the MFA was selected on the basis of (i) an operational assessment of Armenia’s PFM systems which was carried out in February 2010 by independent consultants on behalf of the European Commission; and (ii) discussions with Armenian authorities, the EU Delegation, the EU Advisory Group and other development partners, in particular the IMF.

The choice of conditionality was based on several factors, notably:

- Key reform priorities as identified by the Government of Armenia;
- Reforms concerning PFM as identified in the Operational Assessment; and
- Areas of interest to the EU.

1 The study takes into account both of the IMF programmes: the Stand-by Agreement (SBA) operational from March 2009 to March 2010 (SDR 350.43 million); and Extended Credit Facility/ Extended Fund Facility (ECF/EFF) operational from June 2010 to December 2012 (SDR 133.40 million).
Moreover, the conditionality was designed to be consistent with the policy lines anchored in the IMF programme and the priorities of the European Neighbourhood Policy Instrument (ENPI) and Eastern Partnership. This seems to have been the case with the MFA supporting reforms in the areas of good economic governance and efficiency of public spending (e.g. internal and external audit and public procurement), trade and investment (e.g. tax administration and tax and customs policy) which were complementary to those supported via ENPI. The conditionality did not focus on socio-economic reforms or sustainable development issues, also supported by ENPI, apart from pension reform that can be seen to support this goal.

Reforms were generally well targeted, focusing on key issues that could be effectively targeted within the short timeframe available for the implementation of an MFA instrument. For example, there is a strong consensus among stakeholders (international and non-governmental national stakeholders) that the most crucial challenge facing the country is to improve its business environment. The MFA conditionality relating to implementation of a customs valuation system that is in line with the WTO Valuation Agreement was an example of conditionality aimed at improving the business environment.

As regards progress, all conditions were fully met technically, as the Armenian authorities implemented the necessary actions. The evaluation found evidence of reinforcing effect of the MFA in the areas of tax and customs policy reforms. These are areas where international donors considered the EU to have had considerable leverage through the Deep and Comprehensive Free Trade Agreement (DCFTA) negotiations. The MFA was seen to have reinforced meeting the prerequisite requirements in a timely manner and prepare Armenia’s accession for the DCFTA negotiations. In the area of PFM reform, particularly reforms relating to internal and external audit, MFA potentially reinforced the internationally agreed reform agenda and possibly helped to support the implementation timeframe, although it is difficult to be conclusive given the number of international actors involved in this area supporting the Armenian government.

However, in other areas, the evaluation is inconclusive as regards the political or reinforcing effect of the MFA. These are typically reform areas where domestic ownership was high and consequently, it is highly likely that these reforms would have been undertaken by Armenian authorities even in the absence of the MFA. This was particularly the case with the pension reform, which was already a part of the Government Programme for 2008-2012. In addition, conditionality relating to the establishment of public procurement legislation compliant with the EU Directives and international standards was already adopted in December 2010, and effective from January 2011, prior to the signature of the MoU. The Armenian Government had also agreed to acquire a new debt recording system financed by the World Bank before the signature of the MoU, even if the system itself was installed at a later date. These conditionalities were probably relevant when the discussions on the MFA first started in 2009. However, given the long negotiation and approval process of the MoU these reforms had either been successfully implemented or were at an advanced stage by the time the MFA-MoU was signed. Overall, reforms in some areas progressed more quickly than the MFA negotiations, and in these areas, it is particularly difficult to identify the added value of MFA reforms. It is plausible that the MFA negotiations might have influenced the shape and or timetable of these reforms when they were at an early stage, but this cannot be concluded with certainty in absence of any substantive supporting evidence.

The assessment of impact varies between the conditions. The most tangible impacts can be seen in two areas:

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3 According to the official documentation, the dialogue on conditionality started in 2009.
Customs policy and tobacco taxation: the MFA removed bottlenecks and facilitated the subsequent commencement of the DCFTA negotiations in May 2012 and their completion in July 2013. The MFA played a key role in furthering tax and customs policy reforms, whose fulfilment acted as part of the preconditions for the negotiations.

Tax administration reforms: the actions included in the tax administration reform will provide benefits to the Armenian citizens through the implementation of tax service centres and e-filing of tax returns.

Most of the reforms are however long term in nature and tangible impacts are expected to accrue in the future, beyond the timeframe of this evaluation.

Results of the evaluation: Design and implementation issues

Timetable

The commitment for EU MFA was made at the end of November 2009 when the Council Decision on providing macro-financial assistance came into force. Although the first fact finding mission to Armenia took place three months later in February 2010, the EU MFA operation was considerably delayed. The MoU was signed 15-months after the coming into force of the Council Decision (in February 2011 and 12 months after the fact-finding mission). One explanation for the long gestation period could be that the crisis had abated and there was therefore little urgency on part of the Armenian authorities to sign the MoU, as evident from the timeline of the negotiation process.

Consequently, the support arrived after the crisis was over and Armenian economy had returned to a growth path – although it should be noted that output remained below pre-crisis levels during the period the MFA was disbursed.

Size and form of assistance

The assistance was provided on highly concessional terms which was considered favourable by the Armenian government and which made it an attractive form of funding, especially helpful in the context of the country’s rising debt burden and the need to consolidate public spending. In line with the IMF’s concessional funding (the combined ECF/EFF intervention), the EU MFA offered a 35 per cent grant element – 5 per cent above the minimum 30 per cent grant element required by the IMF. The MFA also fit in well with Armenia’s gradual fiscal adjustment favoured by the IMF so as not to endanger recovery.

The assistance corresponded to 33 per cent of the residual financing needs in 2010-11 and was appropriately sized given the General Criteria.

Visibility

The MFA instrument lacks visibility among Armenian stakeholders beyond the Government, and is typically confused with the EU budget support. With the exception of the IMF, international development partners were unable to distinguish MFA from other EU support. As such, the MFA instrument cannot be expected to play much of a role in improving the broader perceptions of the EU as a partner of Armenia.

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4 It should be noted that the political context changed dramatically during the final stages of the evaluation. On 3 September 2013, the Armenian president announced that Armenia will join the Russian-led “Customs Union,” thereby ending any possibility of forging the pending Deep and Comprehensive Free Trade Area (DCFTA) element of the Association Agreement between the EU and Armenia.

5 WTO membership, and adherence to its rules, is a precondition to entering negotiations on DCFTA with the EU.

6 The General Criteria provide a broad “political” framework for MFAs. They set out some basic principles that an MFA operation must conform to.
Results of the evaluation: EU Value Added

The provision of the support on concessional terms was an important element distinguishing MFA from other international support available to Armenia in the post-crisis environment. Specifically, the bullet re-payment made the MFA extremely attractive for the Government of Armenia.

MFA supported a more gradual fiscal adjustment path thus allowing the Government to maintain essential social expenditure. This avoided further deterioration of the social and economic situation in the country.

From the EU perspective, MFA accelerated the process of implementing customs valuation system that in operational terms adheres to the WTO Valuation Agreement. This was particularly important for preparing Armenia to commence negotiations on acceding to Deep and Comprehensive Free Trade Area (DCFTA) with the EU. In more general terms, the MFA contributed to economic and social stability in the region by supporting an orderly adjustment and economic recovery.

Considerations for future

The MFA instrument would be strengthened by better aligning its declared objectives with the design and implementation practice. Maintaining the focus on dealing with serious short-term balance-of-payments or budget difficulties would require shortening of the approval procedures. Moreover, the EU would have greater leverage in promoting sound macroeconomic policies, structural reforms and political relationships if the MFA could be deployed as a genuine anti-crisis instrument providing speedy support.

A stronger focus on supporting structural reform efforts in beneficiary countries might benefit from introducing more flexibility in the way the conditions are formulated. Specifically, it could be beneficial if conditionality could be adapted to evolving circumstances during the MFA implementation period (e.g. dropping already fulfilled conditions, adjusting conditions that become infeasible / controversial in view of changed macroeconomic and /or political realities). It is recognised that these recommendations would require high level political decisions.

The quick-disbursing nature of the MFA instrument implies that conditions will need to continue being specified in terms of expected short-term outputs. However, it is recommended that expected longer-term outcomes and impact of conditionality should also be explicitly explained to strengthen domestic ownership, minimise the risk of implementation deficit (the difference between de jure and de facto reforms), and to provide the basis for future ex-post evaluations and follow-up through EU budget support.

An independent reforms assessment (similar to the Operational Assessment of PFM systems) and conditionality framework could be used as tools to guide the selection of conditionality.

It is also recommended to better communicate to both targeted stakeholder groups and general public in Armenia about the MFA as an element of the broader package of EU assistance. The level of knowledge of the instrument is rather low, and in comparison to other international actors, the overall promotion of EU as a supporter of specific activities is lacking in visibility.

Although the nature of fiscal adjustment is controversial – some stakeholders criticise that the Government’s fiscal response mainly focused on maintaining social expenditure and not sufficiently on growth enhancing measures.
1. Introduction

This is the Final Report for the Ex-post Evaluation of Macro Financial Assistance (MFA) operation to Armenia (2011 to 2012). The evaluation was commissioned by the Directorate-General Economic and Financial Affairs (DG ECFIN) in January 2013. The work was undertaken by ICF GHK in association with Cambridge Econometrics and with inputs from a local economist based in Armenia.

1.1 The Scope and objectives of the evaluation

This evaluation covers the EU’s macro-financial assistance (MFA) to Armenia over the period 2011 to 2012 (Decision No 890/2009/EU). The MFA to Armenia, consisting of a loan of EUR 65 million and of a grant of EUR 35 million, was released in two instalments:

- The first instalment in July 2011: EUR 40 million (a grant of EUR 14 million and a loan of EUR 26 million)
- The second instalment in December 2011 (for grant part) and February (for a loan): EUR 60 million (a grant of EUR 21 million and a loan of EUR 39 million).8

The overall objective of this evaluation is to provide an independent assessment of the above operation, focusing in particular on the following three areas of analysis:

- The macroeconomic impact of the MFA assistance operation on the Armenian economy (e.g. economic growth, balance of payments, fiscal balances, exchange rate); with and without IMF involvement.
- Value added of EU intervention i.e. to what extent assistance added benefits to what would have resulted from other interventions.
- Sustainability of the country’s external position as a result of the assistance.

1.2 Evaluation approach and methodology

The evaluation was based on a structured and systematic approach to collecting, analysing and presenting evidence. Table 1 summarises the approach and methods used to address the evaluation questions set out in the Terms of Reference.

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<thead>
<tr>
<th>Core Issue</th>
<th>Evaluation Question</th>
<th>Methodological Approach</th>
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<tbody>
<tr>
<td>Macroeconomic impact of the MFA</td>
<td>How would the economy of Armenia have evolved in the absence of MFA (and IMF)</td>
<td>Identification of all potential counterfactual scenarios</td>
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<tr>
<td>operation</td>
<td>assistance?</td>
<td>Assessment of the likelihood of occurrence of each counterfactual scenario</td>
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<td></td>
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<td>Modelling of the most likely/ plausible counterfactual scenarios</td>
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<tr>
<th>Core Issue</th>
<th>Evaluation Question</th>
<th>Methodological Approach</th>
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</table>
| Core Issue Evaluation Question Methodological Approach | To what extent has the MFA assistance been effective in terms of the short-term macroeconomic stabilisation of Armenia? | ▪ Description of actual macroeconomic outcomes (as observed in macroeconomic data)  
▪ Estimation of net impact = the difference between actual outcomes and counterfactual outcomes |
| Impact on external sustainability | To what extent has the MFA contributed to returning the external financial situation of Armenia to a sustainable path over the medium to longer-term? | ▪ Analysis of trends in key external indicators: before and after MFA  
▪ Macroeconomic modelling of key external indicators: with and without MFA (and IMF programme) |
| Impact on structural reforms | To what extent has the MFA assistance been effective in terms of supporting structural reform in Armenia? | ▪ Assessment of relevance, fulfilment and durability, additionality and impact of MFA-supported reforms |
| Impact on structural reforms | What have been the indirect and/ or unexpected effects of the MFA assistance? | ▪ Elaboration of the ex-ante intervention logics of all structural reform measures  
▪ Ex-post verification of the intervention logics  
▪ Comparison between the ex-ante intervention logic and ex-post outcomes to identify actual indirect and/ or unintended effects |
| Design and implementation     | How has the way in which the MFA operation was designed and implemented conditioned its effectiveness and efficiency? | ▪ Examination of relevance and effectiveness of the package (financial support + reforms) and their relation with identified features of design and implementation |
| Added value                    | To what extent has EU added value been                                                                 | ▪ Assessment of financial and non-financial added |
A combination of quantitative and qualitative research methods was used to build a comprehensive evidence base for the evaluation and to provide the basis for triangulation of results. These methods are described below.

1.2.1 Desk research

This entailed an in-depth review and analysis of the following documentation, literature and data:

- **European Commission files relating to the MFA operation** which comprised documents such as the initial request for assistance submitted by the Government of Armenia (GoA) to the EU; the Commission’s proposal for a Council Decision providing MFA to Armenia; Council Decision approving the operation; ex-ante evaluation statement prepared the Commission; the Memorandum of Understanding between the EU and GoA; MFA Grant/Loan Agreement; mission reports prepared by the Commission; compliance statement and documentation submitted by the GoA etc.;

- **Operational Assessment prepared by PwC** prior to the implementation of the MFA;

- **EU Policy** documentation such as European Neighbourhood Policy (ENP) country reports, EU-Armenia Action Plan and progress reports;

- **European Commission documents relating to Sector Policy Support Programmes** supporting reforms in the area of Public Finance Management (PFM), pension system, public procurement and tax and custom policies;

- **Documentation published by the Armenian authorities** such as economic strategies, reform programmes, action plans and progress reports, annual reviews;

- **IMF documents** namely, the Letters of Intent submitted by the GoA to the IMF and IMF Country Reports;

- **World Bank documents** such as Country Partnership Strategies, program documents relating to the Bank’s Development Policy Operations in Armenia, documents relating to projects supporting relevant reforms;

- **Academic and grey literature** on political and economic developments in Armenia and its progress with the implementation of structural reforms (particularly PFM reforms and tax administration);

- **Macroeconomic data and statistics** on Gross Domestic Product (GDP) and its components, Balance of Payments (BoP), public finances, exchange rates, inflation, unemployment etc.;

- **Other literature and data** such as reports and data published by the European Bank for Reconstruction and Development (EBRD) and by other relevant stakeholders such us international (i.e. OECD) and national think-tanks/research institutes.
1.2.2 Semi-structure interviews

A series of semi-structured interviews was carried out with key informants notably, European Commission officials, representatives of relevant Armenian authorities and international development partners including the International Monetary Fund (IMF), World Bank and Asian Development Bank (ADB) officials. All interviews were carried out face to face. The purpose of these interviews was to collect additional background and contextual information relating to the operation.

Table 2 provides an overview of the interviews carried out in the context of this evaluation. The list of interviewees is available in Annex 3.

Table 2 Overview of semi-structured interviews carried out as a part of the evaluation

<table>
<thead>
<tr>
<th>Stakeholder Group</th>
<th>Key Informants</th>
<th>No. of Interviews</th>
</tr>
</thead>
<tbody>
<tr>
<td>European Commission</td>
<td>DG ECFIN</td>
<td>4</td>
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<tr>
<td></td>
<td>DEVCO</td>
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<td></td>
<td>DG Trade</td>
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<tr>
<td>European External Action Service (EEAS)</td>
<td>EU Delegation to Armenia</td>
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<tr>
<td>Armenian Authorities</td>
<td>Ministry of Finance</td>
<td>15</td>
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<td></td>
<td>Ministry of Economy</td>
<td></td>
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<tr>
<td></td>
<td>Central Bank of Armenia (CBA)</td>
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<tr>
<td></td>
<td>The Chamber of Control of the Republic of Armenia</td>
<td></td>
</tr>
<tr>
<td></td>
<td>State Revenue Commission</td>
<td></td>
</tr>
<tr>
<td>Bretton Woods Institutions (Bretton Woods)</td>
<td>IMF</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td>World Bank</td>
<td></td>
</tr>
<tr>
<td>Other donors</td>
<td>EBD (Anti-Crisis Fund)</td>
<td>5</td>
</tr>
<tr>
<td></td>
<td>ADB Office in Armenia</td>
<td></td>
</tr>
<tr>
<td></td>
<td>GIZ Office in Armenia</td>
<td></td>
</tr>
<tr>
<td>Total Number of Interviews</td>
<td></td>
<td>35</td>
</tr>
</tbody>
</table>

1.2.3 Focus group discussion

A group discussion was organised in Yerevan to gauge wider stakeholder perceptions of Armenia’s reform efforts and the specific role of the EU in promoting better economic governance in the country. The focus group comprised representatives of national business associations, research institutes, think-tanks and civil society institutions. Detailed list of focus group participants is available in Annex 3 and a report of the discussion held with non-governmental stakeholders in Annex 5.

1.2.4 Macroeconomic modelling

A model based approach was used to determine the net economic impact of the MFA, i.e. the difference between actual macroeconomic outcomes (what actually happened) and
potential ‘counterfactual’ scenarios (what could have happened in the absence of the MFA).

The macroeconomic model used for the evaluation shares many of the features of the models used in previous MFA evaluations for the European Commission, drawing upon the principles of ‘flow of funds’ and financial-programming approaches used, for example, by the IMF.

The model links the following key economic and financial variables:

- Gross Domestic Product (GDP) and its components;
- Government finances (revenue, expenses, deficit financing/debt);
- Armenia’s Balance of Payments (trade flows, transfers, changes in reserves etc).
- The model also includes indicators of money supply (remittances inflow) and a simple treatment of employment (linked to economic activity) as auxiliary components. The detailed description of the model is presented in Annex 4.

As a principle, the model is based on a ‘flow of funds’ approach. In such a model, a flow of funds from one sector (expenditure) must either show up as a flow of funds to one or more other sectors (receipts) or alter the stock of a particular asset. For example, when domestic firms receive revenue from household domestic expenditure, funds flow from households to firms. An example of a change in a stock is government deficit-financing. In years when the Government spends more than it receives, it must make up the gap by running a deficit; the Government’s stock of debt must increase. Thus, changes in trade patterns, transfers and finance alter an array of other economic variables, simply by accounting definition.

Accounting identities and ratios make up the majority of the model framework and, combined with assumptions about sources (and limits) of financing and a small number of behavioural equations, yield an internally-consistent picture of the counterfactual scenarios.

The model produces annual projections over recent history (up to 2012). The model uses Armenia’s national economic statistics and data published by the IMF (principally the International Finance Statistics publication).

1.2.5 **Strengths and limitations of the methodology**

Table 3 critically assesses the information sources used and the validity of the data collected as part of this evaluation. Although each method has its strengths and limitations, the various methods taken together helped build a robust evidence base for the evaluation and provided the basis for cross-checking of findings.
<table>
<thead>
<tr>
<th>Research Method</th>
<th>Strengths</th>
<th>Limitations and caveats</th>
</tr>
</thead>
<tbody>
<tr>
<td>Desk research</td>
<td>A rich source of facts; statistical data; and, recorded information on the MFA operation. Helped provide first answers to the evaluation questions.</td>
<td>Desk research only provided part of the evidence base for the evaluation; it was necessary to update, cross-check and complement the information collected from secondary sources through primary research. While desk research was useful in developing a preliminary outline of the potential counterfactual scenarios, these needed to be validated and elaborated through stakeholder interviews.</td>
</tr>
<tr>
<td>Stakeholder interviews</td>
<td>Provided additional context and insights. Helped fill the gaps in the evidence base. Stakeholder interviews were also useful for confirming the accuracy of the information collected from other sources and corroborating what had been established from other sources.</td>
<td>Interviews covered stakeholder groups which were closely involved in the implementation of the assistance. The evaluation team detected some bias in their responses to the evaluation questions - particularly those relating to the relevance and impact of the financial assistance and reforms promoted by the MFA.</td>
</tr>
<tr>
<td>Macroeconomic modelling</td>
<td>Was used to quantify the net macroeconomic impact of the MFA. A key advantage of a quantitative model is that it is explicit in its framework, economic logic and assumptions, allowing for scrutiny and testing of the results it produces. A quantitative, model-based approach has clear economic logic and assumptions.</td>
<td>A counterfactual cannot be directly observed, but is approximated with reference to a potential alternative scenario. The specification of counterfactual is thus, essentially based on subjective judgements and educated guesses as to what might have happened in the absence of the MFA. It cannot be specified with certainty and is based on a number of assumptions.</td>
</tr>
<tr>
<td>Research Method</td>
<td>Strengths</td>
<td>Limitations and caveats</td>
</tr>
<tr>
<td>-----------------</td>
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<tr>
<td>Research Method</td>
<td>Changes in exogenous assumptions generate concomitant changes in the endogenous variables in the model, yielding an internally-consistent simulation of states of the world with and without MFA. A model based approach thus, provided an explicit framework for scrutiny and testing of results. Given the small scale of the assistance, it is obvious that the macroeconomic impact of MFA would be rather marginal. However, modelling helps quantify the scale of the impact.</td>
<td>The time span of the available statistical data for Armenia is relatively short and in many instances official data published by the authorities does not cover the latest period. Therefore making estimates of certain parameters was characterised by higher uncertainty. Given the uncertainty in the economic climate when the MFA was provided, it is important to interpret the model results with care; the results rely on a number of assumptions and so the direction and orders of magnitude of the effects are to be interpreted with more certainty than the precise point estimates.</td>
</tr>
<tr>
<td>Focus Group</td>
<td>Focus group discussions provided a forum to collect the views and opinions of a wider group of stakeholders i.e. those 'outside' the Government and not directly involved in the operation. The group dynamic was particularly useful in triggering an objective discussion on the reform process and its outcomes. Focus group discussions provided an indication of the visibility of the MFA among wider stakeholder groups and their perceptions of the role of MFA in promoting reforms. Focus group discussions were also useful in determining if the MFA had any confidence boosting effects and / or impact on EU-Armenia relations, public opinion of the EU.</td>
<td>The scope of the focus group discussions was limited by definition. The focus group focussed on issues such as visibility of EU support, its role in promoting reforms and it covered also the overall assessment of the reforms' pace in Armenia since the MFA implementation.</td>
</tr>
</tbody>
</table>
1.3 This Report

The remainder of the document is structured as follows:

- Section 2: Context and content of the MFA operation in Armenia
- Section 3: Macro-economic impact of the operation
- Section 4: Scope and impact of structural reforms
- Section 5: Design and implementation issues
- Section 6: EU Added Value
- Section 7: Cross Country Analysis

Annexes:

- Annex 1: Methodological framework for the evaluation
- Annex 2: Assessment of the completion of structural reforms
- Annex 3: Overview of stakeholders consulted
- Annex 4: Description of the Approach to Macroeconomic Modelling
- Annex 5: Report of focus group discussion held with non-governmental stakeholders
- Annex 6: List of references
2 The MFA operation in Armenia: Background and context

This section describes the economic situation in Armenia in the period leading up to the crisis, the Government’s policy response and the key elements of the anti-crisis support provided by the IMF, the EU and other multilateral institutions/ bilateral donors to support the country’s stabilisation and recovery.

2.1 Armenia at a glance

Armenia is a landlocked mountainous country located between Western Asia and Eastern Europe. It borders with Turkey, Georgia Azerbaijan and Iran. It is a multiparty democracy with the President as head of Government elected for a five year mandate.

**Box 1 Key Facts and figures**

Armenia is a small and open economy with a GDP of approximately EUR 7.9 billion (2012) and population of 3.3 million\(^9\) (2011).

The majority of population live in the capital Yerevan which has approximately 1.1 million inhabitants.

Poverty rate is among the highest in Europe: 35.8 (2011).

Historically Armenian has had a very large diaspora estimated at around 7-8 million\(^10\). Key countries of residence are: Russia (in particular Moscow region), USA, France, Georgia and Ukraine.

Armenia is a member in over 40 international organisations including the Council of Europe and World Trade Organisation.


2.2 Pre-crisis context in Armenia

Armenia’s transition from a socialist to a market-oriented economy was characterised by trade friendly policies, privatisation and rapidly expanding private sector as a result of an improvement in its business climate. In the seven-year period preceding the crisis (between 2001 and 2008), the Armenian economy experienced strong growth with an average annual GDP growth of 12.6 per cent. Over the same period, GDP per capita tripled its value to US$2500\(^11\).

During this period, the fiscal policies of the Armenian government remained prudent: public deficit remained below 2.5 per cent of the GDP and the public debt was gradually reduced from 49 per cent to 16 per cent of GDP\(^12\). The rapid growth was accompanied by a reduction of poverty rate from 34.6 per cent in 2004 to 25 per cent in 2007.

Table 4 presents the evolution of key macroeconomic indicators prior, during and in the post crisis period.

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\(^9\) Including Nagorno-Karabakh Republic and region of Javakhk


\(^12\) The World Bank, 2011. Republic of Armenia - Fiscal Consolidation and Recovery. Available at: https://openknowledge.worldbank.org/handle/10986/2808
### Table 4 Overview of macroeconomic indicators

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012*</th>
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<tr>
<td><strong>Real Sector</strong></td>
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<tr>
<td>Real GDP Growth (%)</td>
<td>9.6</td>
<td>13.2</td>
<td>14</td>
<td>10.5</td>
<td>14</td>
<td>13.2</td>
<td>13.7</td>
<td>6.9</td>
<td>-14.1</td>
<td>2.2</td>
<td>4.7</td>
<td>6.2</td>
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<tr>
<td>Nominal GDP (in billion USD)</td>
<td>2.1</td>
<td>2.3</td>
<td>2.8</td>
<td>3.5</td>
<td>4.9</td>
<td>6.4</td>
<td>9.2</td>
<td>11.6</td>
<td>8.6</td>
<td>9.3</td>
<td>10.1</td>
<td>10.2</td>
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<tr>
<td>GDP per capita (USD)</td>
<td>660</td>
<td>739</td>
<td>874</td>
<td>1113</td>
<td>1523</td>
<td>1982</td>
<td>2853</td>
<td>3606</td>
<td>2647</td>
<td>2840</td>
<td>3076</td>
<td>3135</td>
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<td>CPI average (%)</td>
<td>3.1</td>
<td>1.1</td>
<td>4.7</td>
<td>7.0</td>
<td>0.6</td>
<td>3</td>
<td>4.6</td>
<td>9</td>
<td>3.5</td>
<td>7.3</td>
<td>7.6</td>
<td>2.4</td>
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<tr>
<td>Unemployment rate (%)</td>
<td>10.4</td>
<td>9.4</td>
<td>10.1</td>
<td>9.6</td>
<td>8.1</td>
<td>27.8</td>
<td>28.7</td>
<td>16.4</td>
<td>18.7</td>
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<td>19.0</td>
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<td><strong>Fiscal sector</strong></td>
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<tr>
<td>Government Revenues (in billion EUR)</td>
<td>0.40</td>
<td>0.46</td>
<td>0.44</td>
<td>0.43</td>
<td>0.62</td>
<td>0.92</td>
<td>1.32</td>
<td>1.60</td>
<td>1.50</td>
<td>1.32</td>
<td>1.75</td>
<td>1.77</td>
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<tr>
<td>Total Government Expenditure (in billion EUR)</td>
<td>0.49</td>
<td>0.47</td>
<td>0.47</td>
<td>0.48</td>
<td>0.72</td>
<td>1.02</td>
<td>1.48</td>
<td>1.74</td>
<td>2.06</td>
<td>1.63</td>
<td>1.98</td>
<td>1.94</td>
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<tr>
<td>Total Government Revenues (% of GDP)</td>
<td>17</td>
<td>18.8</td>
<td>17.8</td>
<td>15.4</td>
<td>15.7</td>
<td>18</td>
<td>20.1</td>
<td>20.5</td>
<td>20.9</td>
<td>21.0</td>
<td>21.9</td>
<td>21.4</td>
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<tr>
<td>Total Government Expenditure (% of GDP)</td>
<td>20.9</td>
<td>19.3</td>
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<td>Tax revenue (% of GDP)</td>
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<td>14.6</td>
<td>14</td>
<td>14.1</td>
<td>14.3</td>
<td>14.4</td>
<td>16</td>
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<td>20.2</td>
<td>20.4</td>
<td>20.6</td>
<td>20.9</td>
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<tr>
<td>Net Lending/Borrowing (% of GDP)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-2</td>
<td>-2</td>
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<td>-1.8</td>
<td>-7.7</td>
<td>-4.9</td>
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<td>-3.1</td>
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<tr>
<td>General Government Debt (% of GDP)</td>
<td>45.3</td>
<td>46.6</td>
<td>40.9</td>
<td>32.4</td>
<td>24.3</td>
<td>18.7</td>
<td>14.2</td>
<td>14.6</td>
<td>40.2</td>
<td>39.7</td>
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<td>General Government Deficit (% of GDP)</td>
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<td>-</td>
<td>-0.7</td>
<td>-0.8</td>
<td>-1</td>
<td>-0.3</td>
<td>-0.6</td>
<td>-0.5</td>
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<td><strong>Monetary Sector</strong></td>
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<td>Central Bank Base Rate (%)</td>
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<td>3.8</td>
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<td>Private Credit Growth (%)</td>
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<td>-</td>
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<td>82.2</td>
<td>61.8</td>
<td>12.9</td>
<td>26.0</td>
<td>35.8</td>
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<td><strong>External Sector</strong></td>
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<tr>
<td><strong>Current account balance (% of GDP)</strong></td>
<td>-9.5</td>
<td>-6.2</td>
<td>-6.8</td>
<td>-0.5</td>
<td>-1</td>
<td>-1.8</td>
<td>-6.4</td>
<td>-11.8</td>
<td>-15.8</td>
<td>-14.8</td>
<td>-10.9</td>
<td>-10.4</td>
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<td><strong>Current account (in million USD)</strong></td>
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<td>-148</td>
<td>-191</td>
<td>-20</td>
<td>-51</td>
<td>-117</td>
<td>-589</td>
<td>-1382</td>
<td>-1373</td>
<td>-1061</td>
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<td><strong>Export of goods and services (in million USD)</strong></td>
<td>540</td>
<td>698</td>
<td>903</td>
<td>985</td>
<td>1180</td>
<td>1510</td>
<td>1777</td>
<td>1757</td>
<td>1336</td>
<td>1937</td>
<td>2407</td>
<td>2588</td>
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<td><strong>Import of goods and services (in million USD)</strong></td>
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<td>-1107</td>
<td>-1406</td>
<td>-1514</td>
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<td>-2536</td>
<td>-3589</td>
<td>-4748</td>
<td>-4212</td>
<td>-4920</td>
<td></td>
<td></td>
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<tr>
<td><strong>Exports, fob (in million USD)</strong></td>
<td>540</td>
<td>698</td>
<td>903</td>
<td>985</td>
<td>1,337</td>
<td>1025</td>
<td>1197</td>
<td>1112</td>
<td>749</td>
<td>1175</td>
<td>1580</td>
<td>1724</td>
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<tr>
<td><strong>Imports, fob (in million USD)</strong></td>
<td>-978</td>
<td>-1,107</td>
<td>-1,406</td>
<td>-1,514</td>
<td>-1,984</td>
<td>-2,400</td>
<td>-3776</td>
<td>-3208</td>
<td>-3817</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Exports of good and services (% of GDP)</strong></td>
<td>20.8</td>
<td>29.3</td>
<td>29.5</td>
<td>9.0</td>
<td>19.8</td>
<td>23.4</td>
<td>19.2</td>
<td>15</td>
<td>15.5</td>
<td>20.6</td>
<td>23.5</td>
<td></td>
</tr>
<tr>
<td><strong>Import of good and services (% of GDP)</strong></td>
<td>1.2</td>
<td>13.2</td>
<td>27.0</td>
<td>7.7</td>
<td>20.2</td>
<td>39.3</td>
<td>39.2</td>
<td>40.70</td>
<td>43.0</td>
<td>44.8</td>
<td>48.1</td>
<td></td>
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<tr>
<td><strong>Trade balance (% of GDP)</strong></td>
<td>-19.6</td>
<td>-15.6</td>
<td>-15.4</td>
<td>-12.9</td>
<td>-11.9</td>
<td>-14</td>
<td>-17.4</td>
<td>-22.8</td>
<td>-24.1</td>
<td>-21.9</td>
<td>-20.5</td>
<td>-20.3</td>
</tr>
<tr>
<td><strong>FDI Net (in million USD)</strong></td>
<td>70</td>
<td>111</td>
<td>121</td>
<td>217</td>
<td>252</td>
<td>450</td>
<td>701</td>
<td>940</td>
<td>725</td>
<td>562</td>
<td>477</td>
<td>320</td>
</tr>
<tr>
<td><strong>FDI (Net Inward) (% of GDP)</strong></td>
<td>3.3</td>
<td>4.8</td>
<td>4.3</td>
<td>7.1</td>
<td>4.9</td>
<td>7.1</td>
<td>7.6</td>
<td>8</td>
<td>9.0</td>
<td>6.1</td>
<td>6.5</td>
<td></td>
</tr>
<tr>
<td><strong>FDI (Net Outward) (% of GDP)</strong></td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.1</td>
<td>0.1</td>
<td>0</td>
<td>0</td>
<td>0.1</td>
<td>0.6</td>
<td>0.1</td>
<td>0.8</td>
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</tr>
</tbody>
</table>

### External Vulnerability

<p>| | | | | | | | | | | | |</p>
<table>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment (% of GDP)</strong></td>
<td>19.8</td>
<td>21.7</td>
<td>24.7</td>
<td>23.9</td>
<td>24.7</td>
<td>33.6</td>
<td>38.2</td>
<td>43.8</td>
<td>33.8</td>
<td>29.4</td>
<td>28.8</td>
</tr>
<tr>
<td><strong>National Savings (% of GDP)</strong></td>
<td>10.3</td>
<td>15.4</td>
<td>17.9</td>
<td>19.4</td>
<td>21.4</td>
<td>31.7</td>
<td>31.8</td>
<td>32</td>
<td>18</td>
<td>14.6</td>
<td>17.9</td>
</tr>
<tr>
<td><strong>Nominal External Debt Stock (% of GDP)</strong></td>
<td>-</td>
<td>44</td>
<td>39</td>
<td>33</td>
<td>23</td>
<td>18.9</td>
<td>15.7</td>
<td>13.5</td>
<td>57.8</td>
<td>65.4</td>
<td>72.8</td>
</tr>
<tr>
<td><strong>External Public Debt Service Ratio (% of export)</strong></td>
<td>9.7</td>
<td>9.8</td>
<td>15.6</td>
<td>9.7</td>
<td>5.7</td>
<td>5.7</td>
<td>6.4</td>
<td>7.8</td>
<td>5.4</td>
<td>4.7</td>
<td>4.2</td>
</tr>
<tr>
<td><strong>Gross Reserves (Including Gold, in (million USD))</strong></td>
<td>329</td>
<td>430</td>
<td>502</td>
<td>547</td>
<td>667</td>
<td>1072</td>
<td>1659</td>
<td>1407</td>
<td>2004</td>
<td>1866</td>
<td>1869</td>
</tr>
<tr>
<td></td>
<td>2001</td>
<td>2002</td>
<td>2003</td>
<td>2004</td>
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</tr>
<tr>
<td>Import cover</td>
<td>3.6</td>
<td>3.7</td>
<td>4.0</td>
<td>3.3</td>
<td>3.3</td>
<td>3.6</td>
<td>4.2</td>
<td>4.6</td>
<td>5.7</td>
<td>4.7</td>
<td>4.5</td>
</tr>
</tbody>
</table>

* Projected
Sources: IMF, Central Bank of Armenia, World Bank
This pre-crisis growth was mainly driven by the construction sector and was heavily dependent on external factors. The growth in the construction sector was fuelled by remittances sent by the vast Armenian diaspora (according to some estimates, 60 per cent of the Armenian population resides in Russia alone and holds tight links to Armenia\textsuperscript{13}). The volume of remittances increased significantly during the pre-crisis period (on average by circa 100 per cent on annual basis between 2002 and 2007)\textsuperscript{14} and these were predominantly channelled towards the construction sector. Consequently, the construction sector went through a phase of rapid expansion - its share in real GDP rose from 10 per cent in 2001 to 25.3 per cent in 2008. In parallel, real estate prices increased significantly. Figure 1 illustrates this relationship.

\textbf{Figure 1 Sharp increase in inflow of remittances [in million US\$]}

\begin{figure}[h!]
\centering
\includegraphics[width=\textwidth]{remittances_inflow.png}
\caption{Real estate prices in Yerevan US\$/m\textsuperscript{2}}
\end{figure}

Source: Adopted from IMF

In addition to capital inflows in the form of remittances, Armenia also experienced a very high inflow of foreign direct investment (FDI), in particular from Russia: the net FDI grew from 121 million US$ in 2003 to 815 million US$ in 2008 (over 670 per cent) accumulating particularly in the telecommunication, mining, air transport, construction and food processing sectors\textsuperscript{15}.

\subsection*{2.2.2 Causes and consequences of the crisis}

Despite the impressive economic growth in the pre-crisis period and tangible improvements in socio-economic conditions, significant underlying structural weaknesses persisted: a large shadow economy, low level of tax administration accompanied by Armenia's low institutional strength, low external trade, high social polarisation and poverty rate, high unemployment and emigration. These are explained below.

\subsubsection*{2.2.2.1 Structural weaknesses}

- Low tax collections: tax collections represented 16.8 per cent of GDP (2008) in Armenia – as compared to Moldova and Georgia where the tax revenue for the

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\textsuperscript{13} Compared to the country’s population of 3.2 million (Statistical Service of Armenia, 2009), 2 million are estimated to be be residing in Russia (http://www.armeniadiaspora.com/population.html)

\textsuperscript{14} Council of the European Union, 2009. Proposal on providing macro-financial assistance to Armenia.

same period was 20.4 and 23.8 per cent of GDP respectively.\(^\text{16}\) Largest level of incompilance was observed in construction and agriculture sectors. International donors highlighted that higher integrity of the tax system was needed to lower the costs of the system to private sector and to improve the tax administration practices pursued by public authorities.

- **Narrow economic base:** In 2008 services sector accounted for 33.8 per cent of GDP\(^\text{17}\), whereas construction and agricultural sectors represented 25.3 and 16.3 per cent of GDP respectively. Armenia’s considerable reliance on construction, agriculture and to some extent commodities, exposed weaknesses in the narrow economic given the sectors’ sensitivity to external shocks.

- **The low diversification of exports** with 36.6 per cent of export structure composed of mining commodities in 2008, in particular ferroalloys, diamonds and copper\(^\text{18}\) made the sector vulnerable to price volatility. In addition, opaque network with informal commodity based cartels and semi-monopolies were hampering the efforts to reform the sector and increase its competitiveness\(^\text{19}\).

- **Weak business climate** characterised by bureaucratic red tape, high level of corruption, opaque taxation regime and distortion in competition due to existing oligopolies was not supportive of efforts to reform the economy. Improvements in business environment were repeatedly listed as a key reform area by international donors such as IMF, World Bank and USAID. According to 2008 Corruption Perceptions Index Armenia was listed as 109\(^\text{th}\) country given the extent of corruption (frequency and/or size of bribes)\(^\text{20}\). Furthermore, high costs and time needed for business registration, multiple licensing procedures and inability of public authorities to increase competition were seen as major impediments for the creation and growth of companies, especially SMEs\(^\text{21}\).

### 2.2.3 Pre-crisis vulnerabilities

- **Excessive reliance on remittances:** remittances accounted for 16 per cent of the Armenian GDP in 2008. According to the World Bank, Armenia was 15th largest recipient of remittances in the world (measured by their contribution to GDP) and third largest in Europe after Moldova and Bosnia\(^\text{22}\). In 2008, the net inflow of non-commercial banking transfer constituting the large share of all remittances corresponded to around USD 1.2 billion\(^\text{23}\). In addition, as already indicated, vast majority of remittances (89 per cent\(^\text{24}\)) was sent by Armenian diaspora residing in Russia.

- **A high degree of exposure to the Russian economy:** approximately 89 per cent of remittances in the pre-crisis period were received from Armenian diaspora residing in Russia. Overall, capital inflows from Russia corresponded to about 75 per cent of all FDI to Armenia\(^\text{25}\). Following the 8 per cent contraction in Russian

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\(^\text{17}\) Armenian Ministry of Economy, 2013. Macroeconomic Indicators. Available at: [http://www.mineconomy.am/eng/2/graphics.html](http://www.mineconomy.am/eng/2/graphics.html)


\(^\text{19}\) Transformation Index, BTI 2012. Available at: [http://www.bti-project.org/countryreports/pse/arm/](http://www.bti-project.org/countryreports/pse/arm/)


\(^\text{22}\) World Bank Development Indicators, 2008.


In 2009, Armenia experienced a sharp reduction of FDI inflows and a drop in Russian demand, a destination of 20 per cent of its exports.

- In the period leading up to the crisis, Armenia’s economy showed signs of overheating: The share of construction sector increased from 10 to 25 per cent of GDP between 2000 and 2008 with strong growth in the residential housing segment. Some construction laws were also relaxed, for example the average time necessary to get construction and building renovation permits was reduced from 310 days in 2001 to 112 days in 2006. That said, the boom in the sector was largely driven by external capital inflows (remittances and FDI). Although not representative for the whole country, in Yerevan real estate prices rose by almost 400 per cent between 2002 and 2007 suggesting formation of the bubble with negative implications to the economy.

2.2.3.1 Impact of the crisis to Armenian economy

Given the above structural weaknesses and underlying vulnerabilities, the crisis had a huge impact on country’s economic performance and key social indicators:

- Real GDP began to contract in Q4 2008 and plummeted in 2009 (14.1 per cent on a year on year basis). The output contraction was driven primarily by a fall in exports (from 23.4 per cent of GDP in 2006 to 15 per cent of GDP in 2008 and 2009) and investment expenditure.

- Due to a fall in global metal prices, the country’s mining industry faced danger of close-down. Some mining enterprises had to temporarily stop because of the fall of copper and molybdenum prices on the international markets.

- Increase in poverty and income inequality:
  - Poverty rate rose from 23.5 per cent in 2008 to 34.1 per cent in 2009 after more than a decade of continuous decline
  - Inequality as measured by the Gini coefficient increased on the basis of both consumption (from 0.24 to 0.26) and income aggregates (0.34 to 0.36) between 2008 and 2009

- Loss of confidence in the Dram leading to high dollarization of the economy. Share of AMD deposit in total deposits shrank from 60 per cent to 30 per cent during Q4 2008 and Q1 2009.

A specific characteristic of Armenia during the crises was that, unlike some of the other countries, the financial sector remained largely intact: its stability was not at risk nor did it face liquidity or solvency problems. Yet the availability of the credit in real economy worsened significantly (due to risk aversion and widespread shrinkage of dram resources in the banking system) affecting the level of consumption.

2.3 Government policy response

The Government reacted quickly to the unfolding crisis and launched an anti-crisis plan in November 2008, key elements of which are summarised in the box below.

**Main elements of the Government’s anti-crisis response**

The Government’s anti-crisis policy response was chiefly aimed at boosting economic activity rather than strengthening financial institutions and providing additional

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guarantees against eventual risks. The main principles of the anti-crisis action included:

- Achieving macroeconomic stability through financial sustainability;
- Efficient exchange rate policy pursuit;
- Ensuring effective feedback with society and businesses;
- Implementation of expansive monetary and fiscal policy;
- Realization of large-scale infrastructure-related programs;
- Business environment improvement and temporary support for entrepreneurship;
- Priority given to socially-targeted programs.

The anti-crisis action plan also listed certain priorities in key areas, a short summary of which is provided below:

**Monetary policy**

The interest rate of Repo transactions was raised by one percentage point to 7.75 per cent in an effort to avoid speculative phenomena and eventual price-hikes caused by exchange-rate liberalization. In parallel to subsequent exchange rate corrections and eased pricing pressures, the Repo rate was gradually brought down to the level of 5.00 per cent.

**Tax reform**

Tax reform stems from the 2008-2011 the tax administration strategy improvement programme. Several tax rule simplifications were envisaged. Tax rules (particularly regarding VAT) were simplified for the businesses, in particular for SMEs. The measures also included the launching of an accounting service centre to help implement unified policy for each category of taxpayers, as well as to provide them with standardised, high-quality and affordable services. The Government also implemented inspections and check-ups, in the period from June 1, 2009 to January 1, 2011 for a certain category of economic entities.

**Customs reform**

Customs administration procedures were envisaged to be simplified, including reducing the number of documents to be submitted by importers and exporters when crossing the border. Many procedures have been simplified and risk assessment criteria have been revised in the customs-clearance servicing computer software to enhance control efficiency.

**Improved business environment**

Action in this area is linked to the Business Environment Improvement Action Plan. A number of improvements were envisaged, including: establishing a business support centre, and preparing draft laws on a single tax payable for land and immovable assets and simplifying the process of creating a legal person.

**Infrastructure**

The Government initiated a series of infrastructure-related projects in the spheres of road building, communications, power engineering, industry and social security. The key projects included the North-South Transport Corridor, which includes motorway and railway components. Other infrastructure projects included rural road rehabilitation projects, technology centre and activities in power engineering. For example, EBRD

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funding (USD 1.5 million) was envisaged for two selected geothermal projects and High-Voltage Electricity Transmission Line is partly financed by the German KfW Bank.

**Construction**

The problems of disaster-hit and vulnerable households were given a special focus on the part of the Government, with a housing programme designed for the earthquake zone.

The Government also aimed at reviving the building sector considering its impact on the GDP. To this end, State guarantees were being provided to those developers who owned unfinished multi-storey apartment houses with 50 per cent and more completion status.

**Real sector support**

The key elements of real sector support were to be aimed at SMEs. These included setting-up a special investment/lending organisation, which used the Russian stabilisation credit of USD 500 million (about 15 billion drams) to provide lending both for implementation of development-oriented major business projects and purchase of stakes in corporate capital. Resources coming from international financial institutions were also to be used to fund SMEs: USD 50 million out of USD 85 million worth of World Bank loan proceeds have already been injected (in 2009) into local SMEs with the balance having to be spent on road building activities.

**Welfare programmes**

The focus was on a programme aimed at helping young families get housing by means of mortgage lending, which is provided in preferential terms.

**Foreign economic policy**

Armenia’s adherence to the GSP+ customs system was considered crucial in terms of strengthening economic ties with the European Union. It would allow access to preferential terms of export for domestic exporters while intervening into the European marketplace which in turn will bring down the cost of Armenian exports to ensure enhanced competitiveness for Armenian products. The signing of the Republic of Armenia-European Union free trade agreement was considered a key objective behind the cooperation envisaged under the Eastern Partnership Initiative as effective since 2008.

A key element of the Government’s anti-crisis response was to seek international financial assistance to meet the country’s financing needs. The following section provides details of the assistance provided by the IMF, the EU and other key development partners.

### 2.4 Overview of financial assistance provided to Armenia

#### 2.4.1 Overview of the IMF package

**2.4.1.1 Stand-by arrangement**

On 6 March 2009, the IMF approved an SDR 368 million (circa US$ 540 million) Stand-by Agreement (SBA) for Armenia for a period of 28 months. Its main objective was to support the country’s program; to help it to adjust to the deteriorated global outlook; restore confidence in the currency and financial system; and protect the poor. The

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approval implied an immediate availability of US$ 237 million. In addition, it envisaged nine subsequent instalments, each conditioned by a quarterly review.

In the context of a worsening economic situation and a stronger than expected impact on Armenia’s economy, in June 2009, the SBA was augmented to SDR 533.6 million (circa US$ 822.7 million)\textsuperscript{30}.

The key areas of action, quantitative performance criteria and structural benchmarks attached to the SBA are outlined in Table 5.

\textsuperscript{30} IMF, June 2009, Press Release No. 09/228
Table 5 Overview of the prior actions, quantitative performance criteria and structural benchmarks (SBA)

<table>
<thead>
<tr>
<th>Prior actions</th>
<th>Quantitative performance criteria</th>
<th>Structural benchmarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary, Exchange rate, and Financial policies</td>
<td>Performance criteria:</td>
<td>Tax administration reform:</td>
</tr>
<tr>
<td>1. Return to flexible exchange rate regime;</td>
<td>1. Net official international reserves (floor);</td>
<td>1. Meet the statutory 90-day processing deadline for all VAT refund claims filed in 2009 (Met, Continuous in 2009);</td>
</tr>
<tr>
<td>2. Gearing monetary policy towards supporting the return to a flexible exchange regime (CBA will increase policy rate at the time of return to a flexible regime and conduct communication campaign to explain depreciation to the public);</td>
<td>2. Net domestic assets of the CBA (ceiling);</td>
<td>2. As a necessary condition for implementing a fully functional risk-based approach to VAT refund processing, submit legislation to parliament that allows only high-risk VAT refunds to be subject to review (Met, March 2010).</td>
</tr>
<tr>
<td>3. Strengthening financial stability: CBA will prepare contingency plan for the financial sector, bank supervision will be enhanced;</td>
<td>3. Net banking system credit to the government (ceiling);</td>
<td></td>
</tr>
<tr>
<td>4. Returning to inflation-targeting framework.</td>
<td>4. Program fiscal balance (floor);</td>
<td></td>
</tr>
<tr>
<td>Fiscal policies</td>
<td>5. External public debt arrears (continuous criterion).</td>
<td></td>
</tr>
<tr>
<td>1. Limiting spending; restricting non-priority expenditure, boosting spending on social protection programs, restrict spending financed by domestic resources, rely on external financing to fund the increase in capital spending;</td>
<td>Indicative targets:</td>
<td></td>
</tr>
<tr>
<td>2. Changes in tax policy; raising temporarily customs tariffs for some goods, fixing the systematic problems underlying tax credits, introducing best practices in VAT refund processing to exporters.</td>
<td>1. Reserve money (ceiling);</td>
<td></td>
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<tr>
<td>Public finance policies</td>
<td>2. Stock of tax credits (ceiling);</td>
<td></td>
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<tr>
<td>1. Tax administration reform;</td>
<td>Contracting or guaranteeing of new non-concessional debt (ceiling, in millions of U.S. dollars).</td>
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<tr>
<td>2. Introduce funded pension pillar in January 2010;</td>
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</tr>
<tr>
<td>3. Establish a high-level committee to monitor developments in the economy and coordinate the policy response.</td>
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</tr>
<tr>
<td>Financial sector policies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Foster the development of commercial banks’ risk management capacity;</td>
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<td></td>
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<tr>
<td>2. Enhance credit availability and improve financial</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prior actions</td>
<td>Quantitative performance criteria</td>
<td>Structural benchmarks</td>
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<tr>
<td>------------------------------------------------------------------------------</td>
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</tr>
<tr>
<td>3. Launch a campaign to educate consumers about financial terms, products;</td>
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<tr>
<td>4. Further develop securities market as laid out in capital market development</td>
<td></td>
<td></td>
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<tr>
<td>action plan.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Development policies:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strengthening business environment.</td>
<td></td>
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</tr>
</tbody>
</table>
In practice, not all approved allocation was disbursed. Actual disbursement amounted to SDR 350.43 million (circa US$ 532.2 million) as authorities requested the cancellation of the SBA before the completion of the fourth review. The reason was a stabilisation of the macro-economic situation on one hand, and the need of stronger focus on medium term weaknesses which could be tackled by structural reforms supported by new, more tailored Extended Fund Facility (EFF) and Extended Credit Facility (ECF) arrangement\(^\text{31}\) (see next section).

Table 6 presents the size and specific timing of disbursements from the SBA.

**Table 6 SBA- size and timing of financing**

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount disbursed (in SDR)</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 March, 2009</td>
<td>161,552,000</td>
</tr>
<tr>
<td>24 June, 2009</td>
<td>102,668,000</td>
</tr>
<tr>
<td>3 November, 2009</td>
<td>37,720,000</td>
</tr>
<tr>
<td>31 March, 2010</td>
<td>48,485,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>350,425,000</strong></td>
</tr>
</tbody>
</table>

Source: IMF transactions with Armenia

2.4.1.2 ECF/EFF

In June 2010, the IMF approved a 36 months arrangement under the Extended Fund Facility (EFF) in an amount equivalent to SDR133.40 million (US$197.4 million) and a three-year arrangement under the Extended Credit Facility (ECF) in an amount equivalent to SDR 133.40 million (US$197.4 million) for the Republic of Armenia.\(^\text{32}\) After the completion of the fifth review under EFF/ECF Arrangement in December 2012, the total disbursement under this arrangement amounted to SDR211.8 million (about USD 324.4 million)\(^\text{33}\).

Table 7 presents size and specific timing of disbursements from ECF/EFF.

**Table 7 ECF/EFF – size and timing of financing**

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount disbursed (in SDR)</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 June, 2010</td>
<td>17,500,000</td>
</tr>
<tr>
<td>15 July, 2010</td>
<td>18,700,000</td>
</tr>
<tr>
<td>03 December, 2010</td>
<td>17,500,000</td>
</tr>
<tr>
<td>06 December, 2010</td>
<td>18,700,000</td>
</tr>
<tr>
<td>01 July, 2011</td>
<td>17,500,000</td>
</tr>
<tr>
<td>07 July, 2011</td>
<td>18,700,000</td>
</tr>
<tr>
<td>14 December, 2011</td>
<td>17,500,000</td>
</tr>
<tr>
<td>22 December, 2011</td>
<td>18,700,000</td>
</tr>
<tr>
<td>15 June, 2012</td>
<td>17,500,000</td>
</tr>
</tbody>
</table>

\(^{31}\) IMF, Country Report No. 10/223  
Date                  | Amount disbursed (in SDR)
----------------------|------------------------
25 June, 2012         | 16,000,000
07 December, 2012     | 17,500,000
17 December, 2012     | 16,000,000

Source: IMF transactions with Armenia

Structural conditionality concentrated around tax policy and administration, fiscal and debt sustainability and financial stability. Table 8 shows the main programme priority actions, quantitative performance criteria and structural benchmarks.
### Table 8 Overview of the prior actions quantitative performance criteria and structural benchmarks (ECF/ EFF)

<table>
<thead>
<tr>
<th>Prior actions</th>
<th>Quantitative performance criteria</th>
<th>Structural benchmarks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Public finance policies</strong></td>
<td><strong>Performance criteria:</strong></td>
<td><strong>Tax administration:</strong></td>
</tr>
<tr>
<td>1. <strong>Tax administration reform:</strong> modernising tax administration, strengthening taxpayers rights and curtailing the discretionary authority of the tax agency (the State Revenue Committee – SRC);</td>
<td>1. Floor on the net official international reserves (NIR) of the Central Bank of Armenia (CBA);</td>
<td>1. Issue a government decree stipulating that clarifications and interpretations of laws, regulations, and procedures on taxes, duties, and mandatory fees should be approved by the Ministry of Finance. These clarifications and interpretations will become normative acts to be published and applied consistently across all taxpayers effective September 1, 2010. (Met, July 2010);</td>
</tr>
<tr>
<td>2. <strong>Developing strong medium-term expenditure and debt framework;</strong></td>
<td>2. Ceiling on the net domestic assets (NDA) of the CBA;</td>
<td>2. Set up a Tax Appeals Committee under the Ministry of Finance to deal with legal and procedural disputes of taxpayers. (Met with delay, September 2010);</td>
</tr>
<tr>
<td>3. <strong>Protect social spending:</strong> setting a floor on expenditures on the Family Benefits program – Armenia’s social safety net, the government continues to support the poor through pensions and other programs (unemployment benefits and paid public works);</td>
<td>3. Ceiling on external public debt arrears (continuous);</td>
<td>3. A. Develop manuals for tax audits for usage starting January 2011. (December 2010 – modified see B);</td>
</tr>
<tr>
<td><strong>Monetary, exchange rate, and financial policies</strong></td>
<td>4. Floor on the program fiscal balance.</td>
<td>4. B. <em>(Modified in 2010 1st review)</em> Develop manuals in tourism, real estate, transport, and sectors using cash register machines for tax audits for usage starting January 2011. (Met, December 2010);</td>
</tr>
<tr>
<td>1. <strong>Allowing for greater exchange rate flexibility;</strong></td>
<td><strong>Indicative targets:</strong></td>
<td>5. Simplify the reporting system by reducing the frequency of reporting to tax authorities and considerably streamline tax forms for VAT, profits tax, and personal income tax. (December 2010);</td>
</tr>
<tr>
<td>2. <strong>Neutral monetary policy in the short run:</strong> The CBA remains committed to inflation targeting through the policy rate;</td>
<td>1. Ceiling on reserve money;</td>
<td>6. Adopt a government decree establishing a mechanism for implementing a fully functional risk management approach in VAT refund processing. (Met, December 2010);</td>
</tr>
<tr>
<td>3. <strong>Safeguarding financial stability:</strong> Strengthening the regulation on foreign currency exposures, improving comprehensive crisis preparedness and contingency planning with technical assistance from the Fund. In addition, enhancing financial deepening, encouraging banking sector competition and improving functioning of the financial markets.</td>
<td>2. Floor on average concessionality of new debt (quarterly on a disbursement basis);</td>
<td>7. <em>(Added in 2010 1st review)</em> Implement a fully functional risk-based management approach in VAT refund processing. (Met with delay, June 2011)</td>
</tr>
<tr>
<td><strong>Sustained growth and poverty reduction policies</strong></td>
<td>3. Floor on social spending of the government.</td>
<td>8. A. <em>(Added in 2011 2nd review)</em> Set up a taxpayer registry. (December 2011 – modified see B)</td>
</tr>
<tr>
<td>1. <strong>Tax administration:</strong></td>
<td><strong>(Modified in 2011 3rd review)</strong> Establish the capacity to identify whether the taxpayer has VAT liability by adding</td>
<td>9. B. <em>(Modified in 2011 3rd review)</em></td>
</tr>
<tr>
<td>Prior actions</td>
<td>Quantitative performance criteria</td>
<td>Structural benchmarks</td>
</tr>
<tr>
<td>--------------</td>
<td>----------------------------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td>1. Improving competitiveness and business environment: simplifying and streamlining the tax regime, regulations and reporting requirements, strengthening standardization and certifications, breaking-up of monopolistic behaviour, and stepping-up investments in transport infrastructure and information technology, addressing corruption;</td>
<td>a VAT payer identification number to the tax identification number. (Met, December 2011)</td>
<td>10. <em>(Added in 2011 3rd review)</em> Issue a White Paper detailing the measures and costs to address of addressing mixed cash and accrual accounting and refunding or setting off against future VAT liability excess VAT credits. (Met, March 2012)</td>
</tr>
<tr>
<td>2. Reducing poverty levels; improving coverage of social assistance programs, significantly improving the efficiency and targeting of education and health spending</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Tax policy**

11. *(Added in 2011 2nd review)* Increase the tax rate structure for up-market luxury vehicles and SUVs for 2012 and adjust the specific tax on cars annually for inflation. (Partly met, December 2011);

12. *(Added in 2011 2nd review)* Introduce legislative changes that provide for annual automatic indexation of excises for inflation. (Not met, August 2011);

13. *(Added in 2011 2nd review)* Approve a Tax Strategy Paper (Met, December 2011);

14. *(Added in 2011 3rd review)* Overhaul fiscal regime for the mining sector. (December 2011, Met):
   - a. Strictly limit the fiscal stability clause in the new mining code to tax rates and to a set period of 5 years.
   - b. Introduce and collect resource rents in terms of a variable royalty regime with the sliding rate depending on the EBIT to sales value.
   - c. Clarification of deductibility of contributions for mine rehabilitation and mine site clean-up;

15. *(Added in 2012 4th review)* Submit to Parliament legislative proposals to adopt OECD guidelines for transfer pricing for implementation in 2013.

**Fiscal and debt sustainability:**

<table>
<thead>
<tr>
<th>Prior actions</th>
<th>Quantitative performance criteria</th>
<th>Structural benchmarks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>strategy. (Met, August 2010). 17. <em>(Added in 2012 4th review)</em> Complete first set of estimates of the fiscal cost of the pension reform. (December 2012)</td>
</tr>
</tbody>
</table>
2.5 EU MFA

2.5.1 Objectives of the operation

Following Armenia’s request in February 2009 (letter of Minister of Finance, Mr Tigran Davtyan) and subsequent meetings between DG ECFIN and Armenian authorities (late 2009 and 2010) the European Parliament and the Council approved the Commission’s proposal for providing MFA of EUR 100 million in combination of loans and grants\textsuperscript{34} in November 2009 (Decision No 890/2009/EU).

The EU MFA programme, put in place in close coordination with the IMF, was part of the external financing provided to Armenia to cover the country’s balance of payments needs in 2010-2011. It was also aimed at supporting the economic adjustment and reform programme of the Armenian authorities designed to achieve sustainable medium-term growth.

The specific objectives of the operation were as follows:

- To complement support from the IMF foreseen under the stand-by arrangements revision agreed by the IMF board on 3 March 2009, as well as World Bank support due to take the form of budget support policy loans (Council Decision 2009/890/EC);

- To alleviate financial constraints on the implementation of the government’s stabilisation programme (Council Decision 2009/890/EC);

- To address social hardship caused by the step economic crisis (Memorandum of Understanding).

The MFA to Armenia amounting to EUR 100 million corresponded to 19 per cent of the ex-ante residual financing gap identified by the IMF in 2009. However, under the revised assessment of Armenia's financing needs, the MFA was expected to cover about one third of the residual financing gap in 2010-2011, the initial period covered by the MFA programme\textsuperscript{35}.

Specific conditions attached to the MFA operation, including the number of tranches and approximate timing of disbursements were agreed in the Memorandum of Understanding signed by European Union and the Government of Armenia in February 2011 – see section 2.5.3.

2.5.2 Implementation of the operation

The MFA to Armenia, consisting of a loan of EUR 65 million and of a grant of EUR 35 million, was released in two instalments:

- The first instalment in July 2011: EUR 40 million (a grant of EUR 14 million and a loan of EUR 26 million);

- The second instalment in December 2011 (for grant part) and February (for a loan): EUR 60 million (a grant of EUR 21 million and a loan of EUR 39 million)\textsuperscript{36}.

In contrast to the relatively long time span between a request for the MFA and signing of the Memorandum of Understanding, the implementation of the MFA operation proceeded in line with the initial planning that had foreseen disbursement of all the resources during a period of 6 months. No delays were encountered in distributing the funds in line with meeting the reform conditions.

\textsuperscript{34} 35 per cent of the financial assistance was provided in a form of a grant and the remaining 65 per cent were a loan.

\textsuperscript{35} European Commission, 2011. MFA to Armenia, review mission, 26-28 October 2011, and next steps.

Table 9 illustrates timing and relative size of MFA disbursements and IMF programme disbursements.

Table 9 MFA and IMF tranche disbursements, 2009-2012 (EUR million & per cent of quarterly GDP)

<table>
<thead>
<tr>
<th></th>
<th>MFA (million EUR)</th>
<th>IMF (million EUR)</th>
<th>MFA (per cent of quarterly GDP)</th>
<th>IMF (per cent of quarterly GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1Q09</td>
<td>105</td>
<td>9.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2Q09</td>
<td>73</td>
<td>4.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3Q09</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4Q09</td>
<td>25</td>
<td>1.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1Q10</td>
<td>35</td>
<td>2.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2Q10</td>
<td>29</td>
<td>1.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3Q10</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4Q10</td>
<td>25</td>
<td>1.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1Q11</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2Q11</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3Q11</td>
<td>40</td>
<td>1.8</td>
<td>1.1</td>
<td></td>
</tr>
<tr>
<td>4Q11</td>
<td>27</td>
<td>1.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1Q12</td>
<td>60</td>
<td>4.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2Q12</td>
<td>13</td>
<td>0.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3Q12</td>
<td>15</td>
<td>0.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4Q12</td>
<td>28</td>
<td>1.2</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


2.5.3 Conditionality attached to the operation

MFA disbursements were conditional upon the implementation of specific structural reforms agreed by the Republic of Armenia and the European Union in the Memorandum of Understanding, and in parallel by IMF Board decisions to approve program reviews under the Extended Fund Facility and Extended Credit facility. The adherence to the IMF program was a *sine qua non* for further MFA disbursement.

Besides the positive review of reforms linked to IMF package, the disbursement of the second tranche of MFA, however, was also aligned to structural reforms specified in the Memorandum of Understanding. These covered several areas focusing on PFM and customs and taxation policies in the context of international trade. Nine specific structural conditions attached to disbursements are indicated below:

Table 10 Conditionality of MFA – Structural Reforms

<table>
<thead>
<tr>
<th>No.</th>
<th>Area</th>
<th>Specific condition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Debt Management</td>
<td>Consistently with the Action Plan of the Ministry of Finance regarding Public Debt Management Strategy adopted by the Ministerial Order 150-A, the Ministry of Finance acquires the new debt recording system.</td>
</tr>
<tr>
<td>2</td>
<td>Debt</td>
<td>The Ministry of Finance specifies in its internal regulation the</td>
</tr>
<tr>
<td>No.</td>
<td>Area</td>
<td>Specific condition</td>
</tr>
<tr>
<td>-----</td>
<td>-------------------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td></td>
<td>Management</td>
<td>functions of the front-office, the middle office and the back office within the Public Debt Management Department and the relevant job descriptions.</td>
</tr>
<tr>
<td>3</td>
<td>Pension System</td>
<td>The Government submits to the Parliament draft legislation for pension system reform including a privately funded pillar.</td>
</tr>
<tr>
<td>4</td>
<td>Public Internal Financial Control</td>
<td>The government takes necessary steps to ensure that the Central Harmonisation Unit in the Ministry of Finance provides methodological guidance and monitoring of financial management and control matters and internal audit across the government.</td>
</tr>
<tr>
<td>5</td>
<td>External Audit</td>
<td>The Chamber of Control adopts an Action Plan with deliverables for improving its working practices in line with the INTOSAI standards</td>
</tr>
<tr>
<td>6</td>
<td>Procurement Policy</td>
<td>The Government submits to Parliament legislation, compliant with the EU Directives and international standards, enabling administrative bodies to conclude contracts with tenders and establishing an Appeal body for dealing with Public Procurement Complaints.</td>
</tr>
<tr>
<td>7</td>
<td>Tax Administration</td>
<td>The Government adopts a sequenced and time-bound Action Plan for upgrading tax administration in the areas of: risk based tax audits, cross-checks, development of economic databases and information sharing, e-filing, evaluation of tax audits' efficiency, establishment of tax-payers centres and training of the personnel on the above issues. Such Action Plan should be accompanied by respective budget allocations for each action in the Budget of 2011.</td>
</tr>
<tr>
<td>8</td>
<td>Tax Policy</td>
<td>The government takes the necessary actions to ensure non-discriminatory taxation of domestically produced and imported tobacco products, in full compliance with WTO rules and Armenia’s undertakings. The government will provide the evidence of effective compliance</td>
</tr>
<tr>
<td>9</td>
<td>Customs Policy</td>
<td>The Government implements customs valuation system, that in operational terms, adheres strictly to the conditions of the WTO Valuation Agreement (Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade of 1994) and is based – as a matter of principle – on transaction value and proper valuation of the methods set out in Article 1 to 7, in sequence. The implementation of the customs valuation system according to the above rules will entail progressive development of risk-based post clearance valuation controls.</td>
</tr>
</tbody>
</table>

Source: Annex 1 of signed Memorandum of Understanding between European Commission and the Government of Armenia

2.5.4 Other budget support provided to Armenia

Armenia received support from several other donors, in particular from the World Bank, Russia, Asian Development Bank and through the budget support under the European Neighborhood and Partnership Instrument (ENPI).
2.5.4.1 ENPI

Under the the European Neighborhood and Partnership Instrument, Armenia received EUR 32 million over the period 2009-2010. The funding for EU bilateral assistance to Armenia amounts to EUR 157 million for 2011-13. Priority areas of EU support are:

- **Democratic structures and good governance**: Including strengthening the rule of law and reform of the judiciary, public administration reform including local government and e-governance, public finance management, and the fight against corruption;

- **Trade and investment**: Including regulatory approximation to EU laws, strengthening institutional and administrative capacity, including the areas of business environment, customs and taxation in the prospect of establishing DCFTA;

- **Socio-economic reform and sustainable development**: One of the priorities of Eastern Partnership addressed the need for improved infrastructure, human capital development and SME development.

In total, ENPI disbursed EUR 40 million in grants for budget support between 2009 and 2012, including EUR 8 million in the last quarter of 2009, EUR 17 million in the last quarter of 2011 and EUR 15 million in the last quarter of 2012 under the Eastern Partnership Integrations and Cooperation Programme (EAPIC).

2.5.4.2 World Bank

The World Bank’s Country Partnership Strategy (CPS) for Armenia for FY09-12, developed in the context of the crisis, envisaged total IDA/IBRD allocation of US$545 million in FY09-12, of which US$150 million was from IDA and US$395 million was the indicative IBRD lending, with front-loading reflecting the crisis requirements. The strategy was built around two pillars: (i) addressing vulnerability and mitigating the adverse poverty effects of the crisis, and (ii) strengthening the foundations for medium-term competitiveness and growth.

The Bank provided development policy lending and project loans in the form of investment lending. The Development Policy Operation (DPO) for 2009-12 addressed the country’s vulnerabilities of social and structural nature and helped create grounds for more sustainable future growth.

To protect the poor the operation supported spending levels of pro-poor and social protection programs and strengthening the management of education and health. To strengthen competitiveness for recovery and post-crisis growth, the operation focused on improving the business climate for SMEs, modernizing the regulatory framework for mining and telecommunications, reducing compliance cost for tax and customs administration, and enhancing the enforcement powers of the State Commission for the Protection of Economic Competition.

Three Development Policies Operations took place between 2009 and 2012: DPO-1 amounted for EUR 44 million and was disbursed in the last quarter of 2009. DPO-2 amounted for EUR 18 million and was disbursed in the second quarter of 2011 and DPO-3...
amounted for EUR 62 million, disbursed in the second quarter of 2012. In total WB disbursed EUR 124 million for budget support (DPOs) during the period 2009-2012.

In addition WB provided EUR 246 million in investment lending during the same period. The projects were addressing the needs in various sectors including infrastructure, energy, agriculture, education, health, irrigation, rural development and public administration. Tax administration modernisation project and public financial management projects were particularly complementary to the MFA conditionality. Its main objectives are to increase voluntary tax compliance, reduce tax evasion, reduce compliance costs and increase administrative efficiency through institutional development (strengthening Ministry of Finance and State Revenue Commission), strengthening operations, system modernisation and improved project management.\(^{41}\)

### 2.5.4.3 Asian Development Bank

The Asian Development Bank (ADB) approved a Crisis Recovery Support Program\(^{42}\) in 2009 which took the form of ad hoc fiscal support aiming at the maintenance of public expenditure programme without further cuts (especially in social expenditures). This was delivered in the form of two loans disbursed in the last quarter of 2009 totalling EUR 55 million equivalent. Given the acute need of assistance in 2009, and the time constraints, the ADB loan was anchored to the IMF SBA. Structural benchmarks for the IMF program (see table 2.4.) became priority actions for ADB’s support. ADB did not impose any new condition on its own, however it was foreseen that additional financing would be used for maintaining core public expenditure (support to keep 6,500 public jobs and maintain social safety net for the poor) and enable public investment.

### 2.5.4.4 State Loan from Russia

In February 2009, Armenia secured a loan of USD 500 million from Russia\(^{43}\). The loan was disbursed in 2009 and its size was significant representing almost 6 per cent of country GDP. A significant portion of the sum was intended to be used to finance development programs envisaged by the Armenian state budget for 2009.\(^{44}\) In addition, the loan was re-lent to SMEs and allocated to mortgage lending to give much needed boost to the construction sector.

Table 2.8 outlines specific sums along with areas that were meant to be targeted using Russian loan.

**Table 11 Specific distribution of the loan from Russia [US$ 500]**

<table>
<thead>
<tr>
<th>Projects financed by the US$ 500 loan from Russia</th>
<th>US$ million</th>
<th>Per cent of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earthquake zone reconstruction project</td>
<td>130</td>
<td>1.5</td>
</tr>
<tr>
<td>On lending through the banking system</td>
<td></td>
<td></td>
</tr>
<tr>
<td>■ Mortgage market</td>
<td>32</td>
<td>0.4</td>
</tr>
<tr>
<td>■ Small and Medium Enterprises</td>
<td>67</td>
<td>0.8</td>
</tr>
<tr>
<td>■ Other sectors</td>
<td>81</td>
<td>0.9</td>
</tr>
<tr>
<td>On-lending through SMEs development centre</td>
<td>12</td>
<td>0.1</td>
</tr>
<tr>
<td>Direct loan to systematically important companies</td>
<td>62</td>
<td>0.7</td>
</tr>
</tbody>
</table>


Projects financed by the US$ 500 loan from Russia

<table>
<thead>
<tr>
<th>Projects financed by the US$ 500 loan from Russia</th>
<th>US$ million</th>
<th>Per cent of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other</td>
<td>115</td>
<td>1.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>500</strong></td>
<td><strong>5.8</strong></td>
</tr>
</tbody>
</table>

Source: IMF Country Report, November 2009

2.5.5 Overall summary of budget support disbursements across lenders

As outlined in the Table 12 below, over the period of 2009 to 2012, international development partners have provided Armenia in total with more than EUR 1 billion Euros of budget support. The highest proportion of funds was provided in 2009 when development partners disbursed EUR 661 million. In the last quarter of 2009, the IMF, World Bank, Russia, ADB and ENPI have contributed 225 million Euros or equivalent of 14 per cent of Armenian GDP.

Table 12 Time table of IFIs disbursements for budgetary support*, quarterly 2009 – 2012 (in millions EUR)

<table>
<thead>
<tr>
<th>IFI assistance</th>
<th>2009 Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>2010 Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>2011 Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>2012 Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>IMF – SBA*</td>
<td>105</td>
<td>73</td>
<td>-</td>
<td>25</td>
<td>35</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>238</td>
</tr>
<tr>
<td>IMF – ECF*</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>15</td>
<td>-</td>
<td>13</td>
<td>-</td>
<td>-</td>
<td>13</td>
<td>-</td>
<td>14</td>
<td>-</td>
<td>13</td>
<td>-</td>
<td>81</td>
</tr>
<tr>
<td>IMF – EFF*</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>14</td>
<td>-</td>
<td>12</td>
<td>-</td>
<td>-</td>
<td>12</td>
<td>-</td>
<td>13</td>
<td>-</td>
<td>15</td>
<td>-</td>
<td>80</td>
</tr>
<tr>
<td>WB</td>
<td>-</td>
<td>-</td>
<td>44</td>
<td>-</td>
<td>-</td>
<td>18</td>
<td>-</td>
<td>13</td>
<td>-</td>
<td>-</td>
<td>15</td>
<td>-</td>
<td>14</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>124</td>
</tr>
<tr>
<td>Loan from Russia</td>
<td>-</td>
<td>122</td>
<td>117</td>
<td>113</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>352</td>
<td></td>
</tr>
<tr>
<td>ADB- Crisis recovery support</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>55</td>
<td></td>
</tr>
<tr>
<td>EU MFA (loan + grants)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>40</td>
<td>-</td>
<td>60</td>
<td>-</td>
<td>-</td>
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<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>100</td>
</tr>
<tr>
<td>ENPI (grants)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>8</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>17</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>15</td>
<td>-</td>
<td>40</td>
</tr>
<tr>
<td><strong>Total IFIs support</strong></td>
<td><strong>105</strong></td>
<td><strong>195</strong></td>
<td><strong>117</strong></td>
<td><strong>245</strong></td>
<td><strong>35</strong></td>
<td><strong>28</strong></td>
<td><strong>-</strong></td>
<td><strong>25</strong></td>
<td><strong>-</strong></td>
<td><strong>18</strong></td>
<td><strong>65</strong></td>
<td><strong>43</strong></td>
<td><strong>60</strong></td>
<td><strong>75</strong></td>
<td><strong>15</strong></td>
<td><strong>43</strong></td>
<td><strong>1069</strong></td>
</tr>
</tbody>
</table>


*Total disbursements including support for CBA. The share of reserve vs. budget assistance under SBA, ECF and EFF is presented in the Figure below.

Table 13 IFIs total budget support* as a percentage of GDP, quarterly 2009 – 2012

<table>
<thead>
<tr>
<th></th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>2009</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>2010</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>2011</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>2012</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>IMF – SBA*</td>
<td>9%</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
<td>6%</td>
<td>3%</td>
<td>2%</td>
<td>0%</td>
<td>1%</td>
<td>0%</td>
<td>1%</td>
<td>3%</td>
<td>2%</td>
<td>5%</td>
<td>4%</td>
<td>1%</td>
<td>2%</td>
<td>0%</td>
<td>1%</td>
<td>2%</td>
<td>0%</td>
<td>1%</td>
<td>2%</td>
<td>3%</td>
<td>1069</td>
</tr>
</tbody>
</table>


*Including reserve support from IMF SBA and ECF.
2.5.6 **Headline overview of investment lending for specific projects**

In addition to budget support, Armenia continued to receive investment lending from various international development partners during the crisis. Development partners’ investment lending was particularly concentrated in funding infrastructure projects such as the North-South transport corridor, rehabilitation of rural roads, activities in sphere of power engineering etc.\(^{45}\) During the period 2009 – 2011, EUR 609 million of loan agreements for specific projects were signed. Similar to the budget support the investment lending was the highest in 2009 when it reached EUR 223 million or 4 per cent of Armenia’s GDP.

**Table 14 Time table of IFIs investment lending, annually 2009 – 2012 (in millions EUR)**

<table>
<thead>
<tr>
<th>IFIs Investment Lending</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBRD</td>
<td>-</td>
<td>5</td>
<td>7</td>
<td>n/a</td>
</tr>
<tr>
<td>OPEC Fund for International Development</td>
<td>-</td>
<td>-</td>
<td>14</td>
<td>n/a</td>
</tr>
<tr>
<td>ADB</td>
<td>43</td>
<td>-</td>
<td>159</td>
<td>n/a</td>
</tr>
<tr>
<td>WB</td>
<td>166</td>
<td>27</td>
<td>39</td>
<td>24</td>
</tr>
<tr>
<td>KfW</td>
<td>15</td>
<td>119</td>
<td>-</td>
<td>n/a</td>
</tr>
<tr>
<td>EIB</td>
<td>-</td>
<td>5</td>
<td>-</td>
<td>n/a</td>
</tr>
<tr>
<td>International Fund for Agricultural Development</td>
<td>-</td>
<td>10</td>
<td>-</td>
<td>n/a</td>
</tr>
<tr>
<td>KBC BANK NV</td>
<td>-</td>
<td>4</td>
<td>-</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Total IFIs Investment Lending</strong></td>
<td>223</td>
<td>166</td>
<td>220</td>
<td>n/a</td>
</tr>
</tbody>
</table>

*Data for 2012 not available

Note: Investment support is calculated as amount of new loan agreements. These loans are typically disbursed over several years.

**Figure 2 IFIs total investment support (new loan agreements signed during the year)* as a percentage of GDP, annually 2009 - 2012**

*Data for 2012 is not available

Note: Investment support is calculated as amount of new loan agreements. These loans are typically disbursed over several years

3 Macroeconomic Impact of the Operation

The macroeconomic impact of the MFA operation has been assessed at two levels:

- Gross impact as observed in actual macroeconomic outcome (Section 3.1);
- Net impact which is the difference between what actually happened and what might have happened in absence of the IMF/ MFA support; this involved the construction of counterfactual scenarios (Sections 3.2 and 3.3).

3.1 Observed macroeconomic outcomes

This section describes the evolution of the macroeconomic situation in Armenia from 2008 to date.

3.1.1 Economic output and growth

3.1.1.1 Economic trajectory

Armenia’s economy returned to growth quickly. After a sharp decline of GDP in 2009 (14.2 per cent) the economy recovered in the first quarter of 2010, posting 7 per cent growth. The economy has since been on a steady growth trajectory: in 2010, the real GDP grew by 2.2 per cent, accelerating to 4.7 per cent in 2011 and up to 7.2 per cent in 2012\(^{46}\). More recently, in the first quarter of 2013 the GDP level has eventually surpassed the pre-crisis level of AMD 509 billion (EUR 1,103 million) and generated AMD 720 billion (EUR 1,332). Rapid growth of credit and consumption, favourable weather, and high metals prices have been the main contributory factors\(^{47}\).

The economy is expected to grow during 2013-2014, albeit the IMF projects the economy to slow down to around 4.25 per cent during 2013–14 as a result of weaker credit expansion and continuation of fiscal consolidation.

Figure 3 outlines Armenia’s economic recovery path over the period 2008 to 2013.

Figure 3 Evolution of real GDP 2008 - 2013, quarterly (in billion AMD and % change yoy)


Note: The time of MFA disbursements is shaded in orange.

---


Agriculture and service industries (in particular, real estate, financial industry and tourism) have driven growth after the crisis. These two sectors represented the biggest share of the Armenian economy at the end of 2012 (17 per cent and 40 per cent of GDP respectively). Although manufacturing accounted for approximately 10 per cent of total economy output at the end of 2012, it grew less than 1 per cent since 2009).48

The construction sector has also shown signs of recovery representing 12 per cent of the economy by the end 2012. The sector however, continues to be rather volatile: since its bust in 2009 (contracting by 50 per cent in the third quarter of 2009), signs of recovery emerged from the second half of 2011, only for the industry to contract again 15 per cent at the beginning of 2013.49

Figure 4 shows the sectoral composition of the economic recovery path.

**Figure 4 Evolution of main GDP sectoral components 2008 - 2013, quarterly (% change yoy)**


Note: The time of MFA disbursements is shaded in orange.

On the expenditure side, one of the main drivers of post crisis growth has been the gradual growth of household expenditure. On average, household expenditure has grown 11 per cent per quarter since 2010 (see Figure 3 and Figure 4). On the other hand, Government consumption expenditure has remained unchanged.

Persistently low investment (gross capital formation has experienced an average drop of 8 per cent quarterly over the last two years) and consistent trade deficit of the economy (above 20 per cent of GDP between 2010 and 201250) show that in competitiveness terms the economy has remained weak.

Quarterly data on expenditure components of GDP are shown in Figure 3 and Figure 4.

---

3.1.2 Public finances

3.1.2.1 Public debt

The counter-cyclical fiscal policy pursued in 2009 as an immediate response to the crisis, resulted in a significant debt build up. The public debt-to-GDP ratio nearly tripled, from 14.6 per cent of annual GDP in 2008 to 41.8 per cent of the annual GDP in 2011.

Despite relatively high levels of public debt, the IMF has indicated that the debt levels are sustainable, with low risk of distress, largely due to anticipated economic growth.
3.1.2.2 Public revenue and expenditure

A larger than expected fiscal consolidation\(^{51}\) coupled with healthy economic growth, have helped to consistently reduce the public deficit from 2010 onwards. The fiscal deficit narrowed from 9 per cent in the second quarter of 2009, to only 1 per cent of GDP in the first three quarters of 2012. On an annualised basis the fiscal deficit stood at 2.1 per cent at the end of 2012, reduced from 7.6 per cent in 2009. Figure 8 shows an overview of public finances over the period 2009 to 2012, whereas Figure 9 presents the Government revenue, expenditure and deficit on a quarterly basis for the same period.

**Figure 8 Overview of public finances 2009 – 2012, (% of GDP)**

Note: The time of MFA disbursements is shaded in orange

---

**Government revenue**

Government revenues increased steadily in absolute and in relative terms over the period 2009 to 2011. As a proportion of GDP, Government revenues rose from 20.9 per cent in 2009 to 21.2 per cent in 2010 and 22.1 in 2011. This trend was reversed slightly in 2012 when revenues declined in relative terms to 21.3 per cent. IMF has furthermore predicted that revenue will continue to grow (to around 22.2 per cent in 2013).

Armenia has also made progress in improving tax collections. Since 2009, revenue from taxes has grown annually (11.9 per cent in 2010, 11.1 per cent in 2011 and 13 per cent in 2012), which has included the improvement in value added tax (driven by the increase in household consumption), rise in collection of income tax and custom duties. The Government has projected that tax revenues will increase by 13.1 per cent in 2013.

However, despite increases in tax revenue, tax collection as a proportion from GDP remains one of the most important macro-critical issues facing Armenia. At around 22 per cent of the GDP, Armenia’s tax collection rate is amongst the lowest in the post-Communist world and not adequate to support a minimum level of public services. Stakeholder interviews suggest that a tax collection rate in the range of 25 per cent to 30 per cent of GDP is needed for a country like Armenia to deliver minimum public goods.

**Government expenditure**

Armenia is a low-spending country compared to its peers: from 2001 to 2008, Armenia’s total expenditure to GDP fluctuated between 19 and 23 per cent, compared to a Europe and Central Asia average above 30 per cent of GDP. Moreover, during 2006–09, compared to some regional benchmarks, Armenia appears to have under-spent on general public services, real sector, social security and health, while over-spending on defence, education and housing. Armenia spent on average 1.5 per cent of GDP more on defence, 0.3 per cent more on education and 0.2 per cent more on housing and public utilities.

The 2012–14 MTEF indicates that the spending cuts mainly target capital expenditure (-2.2 per cent of GDP), construction works in disaster areas (-0.7 per cent of GDP), education expenditure (-0.4 per cent), health care (-0.3 per cent), defence spending (-0.2 per cent) and subsidies to cover the loss of enterprises (-0.1 per cent).

---

53 World Bank (2013) Fiscal consolidation and recovery in Armenia
The implementation of pension reform in 2014 is also expected to add cost anticipated at the level of 0.4 – 0.7 per cent GDP annually. Since Armenia has one of the lowest salaries of public officials, this expenditure is also likely to increase in the future.

**Figure 10 State budget expenditures by functional classification in 2008-2011 (% GDP)**

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total (in billion AMD)</strong></td>
<td>514.6</td>
<td>674.1</td>
<td>807.5</td>
<td>929.1</td>
<td>959.2</td>
<td>998.6</td>
</tr>
<tr>
<td>In per cent of GDP</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General public services</td>
<td>2.4</td>
<td>2.5</td>
<td>2.9</td>
<td>3.6</td>
<td>4.3</td>
<td>4.1</td>
</tr>
<tr>
<td>Defence</td>
<td>3.0</td>
<td>3.1</td>
<td>3.3</td>
<td>4.2</td>
<td>3.9</td>
<td>3.7</td>
</tr>
<tr>
<td>Public order, and judicial work</td>
<td>1.6</td>
<td>1.7</td>
<td>1.7</td>
<td>2.2</td>
<td>2.0</td>
<td>1.6</td>
</tr>
<tr>
<td>Real sector</td>
<td>1.8</td>
<td>3.3</td>
<td>2.4</td>
<td>4.3</td>
<td>3.3</td>
<td>2.6</td>
</tr>
<tr>
<td>Environmental protection</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.3</td>
</tr>
<tr>
<td>House-building and public utilities</td>
<td>0.5</td>
<td>0.6</td>
<td>0.4</td>
<td>0.7</td>
<td>1.3</td>
<td>1.2</td>
</tr>
<tr>
<td>Health</td>
<td>1.5</td>
<td>1.5</td>
<td>1.4</td>
<td>1.8</td>
<td>1.7</td>
<td>1.7</td>
</tr>
<tr>
<td>Recreation, culture, religion</td>
<td>0.5</td>
<td>0.5</td>
<td>0.4</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Education</td>
<td>2.5</td>
<td>2.8</td>
<td>2.8</td>
<td>3.5</td>
<td>2.9</td>
<td>2.9</td>
</tr>
<tr>
<td>Social security</td>
<td>4.8</td>
<td>4.7</td>
<td>5.8</td>
<td>7.9</td>
<td>7.0</td>
<td>7.2</td>
</tr>
<tr>
<td>Other</td>
<td>0.7</td>
<td>0.7</td>
<td>0.9</td>
<td>1.1</td>
<td>0.6</td>
<td>0.7</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance

### 3.1.3 Inflation

The Central Bank of Armenia (CBA) has followed an inflation targeting framework, a strategy adopted since July 2006 to ensure price stability. The framework could have contributed to the fact that inflation has, by and large, remained below the CBA’s 4 per cent target on a quarterly basis (Figure 11). However, low levels of world prices of basic food and commodities should be seen as at least equally instrumental. In annualised terms inflation (CPI average) has however been more volatile; around 7 per cent in 2010 and 2011 before falling below 3 per cent in 2012. Inflation is projected to stay around 4 per cent in 2013-2014.

---

The Central Bank of Armenia has played an active role through its monetary policy to stabilise the economy. The CBA had responded to the economic crisis by reducing the policy interest rate (refinancing rate) to 5 per cent between November 2009 and January 2010, and gradually adjusting it upwards from the first quarter of 2010 as the economy showed signs of recovery. The policy rate has been kept at 8 per cent since September 2011 (see Figure 12). In addition, as a response to volatility in interbank interest rates (between 5 per cent deposit rate and 11 per cent Lombard repo rate), the CBA strengthened its operations and gradually narrowed the difference between lombard repo rates and deposit rates from 600 to 300 bps in November 2012.

The CBA uses three policy instruments to implement its monetary policy through the interest rate channel: deposit rate, lombard repo rate and refinancing rate.

3.1.4 Exchange rate, money and credit

Armenia’s small but growing financial system dominated by banks was resistant to the serious economic contraction and exchange rate depreciation in 2009 and has remained sound\(^{58}\).

However, the rapid dollarisation following the crisis has increased the system’s vulnerabilities. Following the weakening of Dram in 2009, the share of foreign currency denominated deposits increased from 45 per cent in 2009 to 70 per cent in 2012 as depositors switched their currency denomination (see Figure 14). The proportion of foreign currency denominated loans is lower but still accounts for 50 per cent of all loans.

Since the third quarter of 2010 the currency has appreciated and the exchange rate has remained fairly stable (see Figure 13). However, the IMF considers the real exchange rate to be overvalued, although closer to its equilibrium level\(^{59}\). The CBA has permitted greater flexibility of Dram over the past year, even if greater exchange rate flexibility is still needed in order to narrow the current account deficit, restore buffers, and ensure an adequate level of reserves.

**Figure 13 Exchange rate AMD/EUR, quarterly average (2008 – 2012)**

Credit expansion has been strong since the crisis. In 2009 credit on average grew by 17 per cent each quarter, and although slightly weakened in recent years, credit grew on average 7 per cent per quarter in 2012. Despite the rapid credit expansion banks remain well capitalised with a capital ratio of almost 17 per cent, and no bank below 12 per cent\(^{60}\).

Despite the growth the system shows a relatively low level of credit to the private sector, which accounted only for 29 per cent of GDP at end 2012. Loans to private sector have increased in recent years and currently present 65 per cent of total loans, whereas household loans represent around 45 per cent of all loans.

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\(^{59}\) IMF, 2013. Republic of Armenia: 2012 Article IV Consultation and Fifth Reviews Under the Extended Fund Facility and Under the Extended Credit Facility, and Request for Waiver and Modification of Performance Criterion—Staff Report; Press Release; Public Information Notice; and Statement by the Executive Director for Republic of Armenia

\(^{60}\) IMF, 2013. Republic of Armenia: 2012 Article IV Consultation and Fifth Reviews Under the Extended Fund Facility and Under the Extended Credit Facility, and Request for Waiver and Modification of Performance Criterion—Staff Report; Press Release; Public Information Notice; and Statement by the Executive Director for Republic of Armenia
Overview of Source: Central bank of Armenia.
Note: The time of MFA disbursements is shaded in orange.

3.1.5 Balance of payments and external sustainability

3.1.5.1 Current account

Armenia has made progress on its way to restore sustainable current account since the end of 2009. It has reduced its trade deficit and its remittances inflow has gradually rebounded. The current account deficit has reduced since the end of 2009 from 15.8 per cent of GDP to 14.8 per cent in 2010, and from 10.9 per cent of GDP in 2011 to 10 per cent in 2012. One of the main reasons behind the deficit reduction has been the restored growth in remittances after the crisis. On average, remittances grew by 25 per cent per quarter since 2011, which is partly explained by the recovery of Russian economy (it is estimated that approximately 89 per cent of remittances are sent from Russia).

Yet current account deficit remains high and elements such as low level of FDI reflect some structural weaknesses of the economy. The FDI inflows are low and represented 3 per cent of GDP in the first quarter of 2013. On the one hand, the trend reflects the end of large privatisations and investments in telecommunications, energy, and transportation, along with small market size and relative isolation of the country. On the other, low competition, high entry barriers determined by oligopolies operating in certain subsectors as well as too slow improvement of business environment have not helped attract foreign investors.

Figure 15 presents the change in current account balance and its components.

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64 IMF, 2013. Republic of Armenia: 2012 Article IV Consultation and Fifth Reviews Under the Extended Fund Facility and Under the Extended Credit Facility, and Request for Waiver and Modification of Performance Criterion—Staff Report; Press Release; Public Information Notice; and Statement by the Executive Director for Republic of Armenia
Moreover, as a net importing country, trade balance has continuously been negative at around 30 per cent of GDP (see Figure 16). In the first quarter of 2013 trade deficit accounted 221 billion AMD (EUR 409 EUR) or 31 per cent of GDP. However, it has shown some signs of improvement in recent years (see Figure 16). After the decline in exports between the first and third quarters of 2009 (by 22, 25 and 23 per cent respectively), export growth has remained positive since the first quarter of 2010. Moreover, since the fourth quarter of 2010 export growth has remained higher than the import growth. In the first quarter of 2013 exports grew by 11 per cent, estimated at around 220 billion AMD (EUR 408 million) or 31 per cent of GDP while import’s value is twice as high in nominal term oscillating around 442 billion AMD (EUR 817 million) or 61 per cent of GDP. It has been argued that the recently concluded negotiations on Deep and Comprehensive Free Trade Area (DCFTA) should have positive impact on the improvement of trade balance in the mid-term run,\(^{65}\) although this remains to be seen as Armenia has since also joined the Russian led Customs Union\(^{66}\).

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\(^{66}\) http://www.euractiv.com/europes-east/eu-loses-armenia-russia-customs-news-530224
3.1.5.2 Gross external debt

As explained in previous sections of the report, the anti-crisis support provided by international community in the form of loans led to a significant build-up of external debt. External debt shot up from 14.6 per cent of the GDP in 2008 to 41.8 per cent in 2011. In 2012 gross external debt accounted for 78 per cent of GDP, 50 per cent of which was external public debt. In the first quarter of 2013 external debt accounted for AMD 3,163 billion (EUR 5,848 million).

In September 2013, Armenia issued its first Eurobond (USD 700 million), which according to some commentators will be used to refinance its debt. The Eurobond sale might also be connected with the recent completion of the IMF’s lending programme launched in 2010. According to the Economist Intelligence Unit the Eurobond sale could help Armenian private companies sell their corporate bonds abroad at more favourable rates. The shift from multilateral credit facilities to international markets may also increase investor confidence in the country.

3.1.5.3 Reserves

Despite the high existing debt levels, reserves have remained adequate (Figure 17). In the fourth quarter of 2012 reserves represented 126 per cent of total imports). It is however expected, that reserves will come under pressure when Armenia starts repaying the crisis support. However, this is less likely to be an issue now due to the Eurobond issuance.

67 The Eurobond has a yield of 6 per cent with a seven year maturation period. It has been rated Ba2/Stable by Moodys and BB-/Stable by Fitch.
Summary

- Armenian economy quickly returned to growth after the large contraction in 2009. Although it was only in 2013 that output returned to pre-crisis levels
- Agriculture and service industries have driven growth after the crisis. These two sectors represented the biggest share of the Armenian economy at the end of 2012
- Armenia’s small but growing financial system dominated by banks has remained sound, and was resistant to the serious economic contraction
- The Government’s policy response supported by the IMF and EU-MFA contributed to short-term macro-economic stabilisation.
- The fiscal situation has improved (through consolidation of current expenditures and external assistance)
- External position has improved
- Although the public debt-to-GDP ratio nearly tripled as a consequence of the crisis assistance, the debt levels are sustainable with low risk of distress
- The underlying structural weaknesses still need to be addressed and some vulnerabilities remain:
  - Improvements in business environment are needed to support the creation and growth of enterprises: business climate remains characterised by bureaucratic red tape, high level of corruption and distortion in competition due to existing oligopolies
  - Despite recent increases in tax revenue, tax collection as a proportion of GDP remains one of the most important macro-critical issues facing Armenia
  - Current account deficit remains high
  - Persistently low investment (gross capital formation has decreased over the last two years) and consistent trade deficit of the economy (above 20 per cent of GDP between 2010 and 2012) show that in competitiveness terms the economy

Source: Central bank of Armenia
Note: The time of MFA disbursements is shaded in orange.
The next section analyses the net impact of the MFA operation by examining whether Armenia's economic trajectory would have been any different in the absence of the MFA.

3.2 Net impact of the MFA

3.2.1 Identification and assessment of plausible counterfactual scenarios

A three-step approach was followed to the development of counterfactual scenarios:

- As a first step, a long list of all potential counterfactual scenarios was developed on the basis of literature review and macroeconomic data analysis.
- The potential counterfactual scenarios were then tested with key informants (most notably, the Armenian authorities and the key development partners) during the missions to Yerevan and Washington DC.
- On the basis of these discussions and further desk research, the most likely or plausible counterfactual scenarios were then shortlisted for inclusion in the model-based macroeconomic analysis.

Section 3.2.2 outlines the initial long list of potential counterfactuals considered and the rationale for rejection or approval of a particular scenario. The subsequent section specifies the modelling treatment of the retained counterfactual scenarios.

Section 3.3 presents the results from the modelling work.

3.2.2 Potential counterfactual scenarios – initial list

Table 15 sets out the range of candidate counterfactual scenarios that were initially considered and analysed for plausibility in the inception stage. It also provides an updated assessment of each following the consultation phase.

The selection was based primarily on the following sources of information:

- Views of the Armenian authorities;
- Views of the IMF and World Bank experts;
- Analysis of historical macroeconomic data and other economic data on Armenia (e.g. on the domestic debt market, etc.);
- Literature review;
- Views of the evaluation team, including an Armenian economist, and;
- Discussions with the Steering Group.
Table 15 Assessment of counterfactual scenarios

<table>
<thead>
<tr>
<th>Potential counterfactual</th>
<th>Description</th>
<th>Initial Assessment</th>
<th>Revised Assessment</th>
<th>Conclusion</th>
</tr>
</thead>
</table>
| **Scenario 1: No MFA**   | Government expenditure is maintained at levels observed in the macroeconomic data. | The MFA was relatively small in size representing 3 per cent and 2 per cent of public expenditure in 2011 and 2012 respectively. | The domestic debt market is characterised by:  
- Very short duration: the weighted average maturity of outstanding debt stood at 1697 days (or 4.6 years) at the end of 2011  
- Steep yield curves: the weighted average yield of outstanding Government Securities was 10.39% in 2009, 11.67% in 2010 and 12.95% in 2011  
- Narrow investor base (mostly Armenian commercial banks) – at the end of 2011, Government securities accounted for 13% of the total value of outstanding public debt and 97% of the stock is held by local institutions | **Discard scenario** |
| Scenario 1A: No change in GoA’s spending behaviour – MFA replaced by domestic borrowing | In the absence of the EUR100 million MFA (EUR 60 million in 2011 and EUR 40 million in 2012), Government’s domestic borrowing would have been higher (to replace the MFA). Other budget support remains unaffected:  
- IMF  
- WB  
- ADB  
- EU ENPI  
- USD 500 m State loan from Russia | As above | Overall, Armenia had other more attractive options such as access to concessional external lending. |
| Scenario 1B: No change in GoA’s spending behaviour – MFA | Government expenditure is maintained at levels observed in the macroeconomic data. | As above | If EU MFA were not available to GA, the authorities could have borrowed from the Anti-Crisis Fund in order to follow the fiscal adjustment path agreed with the IMF. | **Retain for modelling – although short term macroeconomic impact would** |
### Potential counterfactual

<table>
<thead>
<tr>
<th>Description</th>
<th>Initial Assessment</th>
<th>Revised Assessment</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>replaced by other external financing</td>
<td>the EDB’s Anti-Crisis Fund or from Russia to maintain public expenditure and deficit at observed levels. Other budget support remains unaffected:  - IMF  - WB  - ADB  - EU ENPI  - USD 500 m State loan from Russia</td>
<td>The only short-term effect is an increase in Armenia’s foreign debt by EUR 35 million corresponding to the grant element of the MFA (NB: the change in debt servicing costs of the support fall outside of the period being examined here). Since MFA amount is fully substituted by ACF credits, it can be assumed that the Government’s policy response would have been no different to that observed.</td>
<td>not be too different from that observed</td>
</tr>
</tbody>
</table>

**Scenario 1C: Reduction in public expenditure**

Other budget support remains unaffected:  - IMF  - WB  - ADB anti-crisis support  - EU ENPI  - USD 500 m State loan from Russia

However, under this scenario, GA reduces its expenditure by the amount supported by the MFA.

Under this scenario, the fiscal deficit would be equal to that observed in the historical data.

In view of the rising debt to GDP ratio, GA could have adopted a cautious fiscal stance to ensure a sustainable level of debt. It is possible that GA would have cut its expenditure by the amount of the MFA so as to reduce Government borrowing requirements, cut public debt, and provide the necessary fiscal space in case of another external shock.

This scenario although possible would have been highly undesirable. In both years, 2011 and 2012, fiscal consolidation was larger than planned:  - 2011: the deficit was 2.8% of GDP, compared with IMF target of 3.9%  - 2012: headline deficit of 2.1% of GDP, compared with a target of 3.1%

The lower deficits were largely due to delays in infrastructure projects.

Public spending is already low in priority areas such as road maintenance, health and education facilities - constrained

Retain for modelling
<table>
<thead>
<tr>
<th>Potential counterfactual</th>
<th>Description</th>
<th>Initial Assessment</th>
<th>Revised Assessment</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scenario 2: No MFA and no IMF</td>
<td>Scenario 2A: A more expansive monetary policy to finance government borrowing to maintain the size of the fiscal</td>
<td>International assistance from the following sources remains unaffected:  - WB  - EU ENPI  - USD 500 m State loan from Russia</td>
<td>Sterilised intervention by the Central Bank.</td>
<td>The AMD base had contracted rapidly in 2009. An expansionary policy would have had a large inflationary effect. To keep the macro-financial policy stable this is not an option. Moreover, direct purchases of government securities in the primary market are not allowed by the law. In a very unlikely event of respective discard option.</td>
</tr>
</tbody>
</table>

While faster fiscal adjustment would have been desirable to limit debt accumulation, given that public spending was already significantly compressed, there was little scope for further fiscal tightening as it would have threatened pro-poor and pro-growth outlay.

ADB and WB lending was also conditional upon maintaining social expenditures.

In this scenario, social spending would have been maintained, and expenditure cuts would have been made elsewhere.

by poor revenue mobilisation/tax collection. Consequently, the Government has resorted to external borrowing to maintain a minimum level of public spending.
<table>
<thead>
<tr>
<th>Potential counterfactual</th>
<th>Description</th>
<th>Initial Assessment</th>
<th>Revised Assessment</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td>stimulus accompanied by devaluation programme</td>
<td>ADB would not have provided anti-crisis support to Armenia. Increase in government debt funded by central bank purchases of bonds (with consequent increases in the money supply and inflation).</td>
<td>amendments such policy would result in additional inflation.</td>
<td>Overall, additional borrowing from domestic market (to fully replace MFA / IMF/ ADB support) does not seem plausible for reasons discussed above.</td>
<td></td>
</tr>
<tr>
<td>Scenario 2B: Reduction in public expenditure</td>
<td>International assistance from the following sources remains unaffected:  - WB  - EU ENPI  - USD 500 m State loan from Russia  There is no EU or IMF support. In the absence of the IMF programme, ADB would not have provided anti-crisis support to Armenia. Increase in government debt funded by central bank purchases of bonds (with consequent increases in the money supply and inflation).</td>
<td>In absence of both IMF and MFA financing (particularly, the IMF financing which was sizeable), it is doubtful that the GA could have responded with such as large fiscal stimulus. Consequently, the stimulus would have been smaller in 2009 and the Government would have to significantly cut spending in subsequent years (particularly, social expenditures).</td>
<td>Given the significant contraction in the economy and depreciation expectations leading to rapid dollarization, it would not have been feasible for GA to respond by simply cutting expenditures. Other adjustments would have been necessary – see scenario 2C</td>
<td>Discard option</td>
</tr>
<tr>
<td>Scenario 2C: Alternative external financing</td>
<td>International assistance from the following sources remains unaffected:  - WB  - EU ENPI  - USD 500 m State loan</td>
<td>In 2010 Russia granted Armenia a preferential loan of USD 500 million over 15 years to help it pull out of the financial crisis. It is plausible that Russia would have granted up to USD 1 billion</td>
<td>The most likely counterfactual scenario that emerges is as follows: A part of the Russian loan (USD 386.74 million) earmarked for specific initiatives</td>
<td>Retain for modelling</td>
</tr>
<tr>
<td>Potential counterfactual</td>
<td>Description</td>
<td>Initial Assessment</td>
<td>Revised Assessment</td>
<td>Conclusion</td>
</tr>
<tr>
<td>--------------------------</td>
<td>-------------</td>
<td>--------------------</td>
<td>--------------------</td>
<td>------------</td>
</tr>
</tbody>
</table>
| from Russia              | There is no EU or IMF support. In the absence of the IMF programme, ADB would not have provided anti-crisis support to Armenia. International assistance from other sources to fill the shortfall created by lack IMF and MFA support. | in anti-crisis loans to Armenia, although the conditions might not have been acceptable to the GA. | • domestic on-lending programmes  
• earthquake support would have been re-assigned to general public expenditure to allow GA to maintain priority expenditure in 2009 and 2010. | This implies reduced investment spending (corresponding to the expenditure incurred on-lending programmes and earthquake support).  
As the economy recovered in 2010, the Government started a process of fiscal consolidation. However, in the absence of IMF, ADB and EU support, the Government could have opted for  
• Tighter fiscal adjustment in 2011 and 2012 (by reducing public expenditures by the volume of IMF and MFA disbursements) – however, this could have jeopardised recovery/reduced growth; or  
• It could have borrowed from the ACF to maintain spending, allowing the government to run a |
<table>
<thead>
<tr>
<th>Potential counterfactual</th>
<th>Description</th>
<th>Initial Assessment</th>
<th>Revised Assessment</th>
<th>Conclusion</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>higher fiscal deficit</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### 3.2.3 Model-based macroeconomic assessment

The following two counterfactual scenarios were shortlisted for modelling based analysis, each with two variants:

1. ‘No MFA operation’:
   - a. ACF borrowing to fill the financing gap
   - b. No further financing, leading to government spending cuts

2. ‘No MFA operation and no IMF programme’:
   - a. ACF borrowing to fill financing gap from 2010 onwards; forced spending cuts in 2009
   - b. No further financing, leading to government spending cuts from 2009 onwards

In all cases, the model was calibrated to replicate the actual observed outcome (the ‘outturn’ or ‘baseline’). Changes to the input assumptions have been made to reflect the absence of the external support each year, relative to the initial baseline. Taking these together, with assumptions regarding the likely policy response to the lack of MFA (or MFA and IMF) funds, the model has generated consequent changes in other macroeconomic variables and thus provides an internally-consistent description of the counterfactuals, i.e. descriptions of possible alternative states of the world, had EU/IMF support not been provided to Armenia.

Each of the main counterfactuals (‘No MFA’ and ‘No MFA and no IMF’) has two variants. One variant assumes that Armenia would have borrowed from the Eurasian Development Bank’s Anti-Crisis Fund (ACF) to finance its deficit. The other variant considers situations in which the Armenian government would have opted to cut its spending in order to reduce its deficit (rather than try to finance the deficit by borrowing from elsewhere). The deficit-reduction measures are entirely on the expenditure, rather than revenue (taxation), side. The two variants provide a range of potential counterfactual outcomes, with the most likely counterfactual outcome lying probably somewhere in between.

Table 16 summarises the EU and IMF support to Armenia as well as the ADB’s anti-crisis which was effectively tied to the IMF support. Where relevant, the component of the support that was related specifically to government budget support is also identified. The three rightmost columns indicate the reduction in funds to Armenia each year (in some variants part or all of this money is replaced with loans from elsewhere), once converted to Armenian drams.

Note that while EUR 61 million of MFA was disbursed in 2011, some of those funds (a EUR 21 million grant) were provided at the end of the year, in December 2011. Consequently, in the modelling, it is assumed that this portion of the funds was not actually spent by the government until 2012.

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68 This also makes the assumption that the government only spent the funds it had, rather than spending in 2011, in anticipation of receiving the support at a later date.
Table 16 Summary of EU and IMF Support to Armenia

<table>
<thead>
<tr>
<th>Year</th>
<th>EU MFA (EURm)</th>
<th>IMF SBA (SDR m) [of which budget support]</th>
<th>IMF EFF/ECF (SDR m) [of which budget support]</th>
<th>ADB Anti-Crisis Support (SDR m) [all budget support]</th>
<th>AMD /EUR exchange rate</th>
<th>AMD /SDR exchange rate</th>
<th>EU MFA (AMD bn) [of which budget support]</th>
<th>Total IMF Programme (AMD bn)</th>
<th>ADB Anti-Crisis Support (AMD bn) [all budget support]</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>-</td>
<td>301.9 [102.7]</td>
<td>-</td>
<td>51.4</td>
<td>507.4</td>
<td>592.4</td>
<td>-</td>
<td>178.8 [60.8]</td>
<td>30.4</td>
</tr>
<tr>
<td>2010</td>
<td>-</td>
<td>48.5 [24.9]</td>
<td>72.4 [37.4]</td>
<td>-</td>
<td>496.0</td>
<td>559.7</td>
<td>-</td>
<td>67.7 [34.9]</td>
<td>-</td>
</tr>
<tr>
<td>2011</td>
<td>61.0</td>
<td>-</td>
<td>72.4 [37.4]</td>
<td>-</td>
<td>518.7</td>
<td>592.3</td>
<td>31.6</td>
<td>42.9 [22.2]</td>
<td>-</td>
</tr>
<tr>
<td>2012</td>
<td>39.0</td>
<td>-</td>
<td>67.0 [0.0]</td>
<td>-</td>
<td>516.4</td>
<td>620.3</td>
<td>20.1</td>
<td>41.6 [0.0]</td>
<td>-</td>
</tr>
</tbody>
</table>

Source(s): European Commission, IMF and Central Bank of Armenia.

The difference between the actual outcome and the ‘No MFA’ counterfactuals provides an indication of the net impact of EU MFA, while the difference between the actual outcome and the second set of counterfactuals (‘No MFA and no IMF’) provides an indication of the combined net impact of EU and IMF support. The latter is important because EU’s MFA assistance is conditioned on an IMF programme being in place (i.e. in practice a country cannot receive MFA without having a running IMF programme and the programme being on track). The MFA thus adds up to resources available under the IMF programme. A model-based analysis of two counterfactual scenarios (‘No MFA’ and ‘No MFA and no IMF’) provides a more robust basis for disentangling the impact of the MFA from the IMF support, than a single scenario (‘No MFA’) based analysis.

The model used has been developed specifically for this evaluation, making, as far as possible, the best use of the available data. This approach also means that country-specific factors, such as Armenia’s relatively large current dependence on remittances, can be accounted for. The model has been constructed with the key evaluation questions in mind.

The model has been built in the tradition of ‘flow-of-funds’-type economic models, in which outflows of funds from one institutional sector must be matched to inflows of funds to one or more others (including ‘Rest of the World’ as a sector). Such accounting consistency is a feature of a number of long-established modelling approaches, including the IMF’s ‘financial programming’ approach. Similar models have been built and applied for more recent analyses, including previous MFA evaluations.

The advantage of a model-based approach is that it generates internally-consistent macroeconomic outcomes, accounting for wider effects and feedbacks.

The model generates annual projections to 2012 with the database constructed principally from national-level sources (but checked for consistency against international publications). A small number of variables relating to GDP by the income approach were estimated to obtain values for 2012.

Further details on the specification of the model can be found in Annex 4.
This counterfactual scenario considers the case where Armenia did not receive the EUR 100 million MFA, comprising of a loan of EUR 65 million and a grant of EUR 35 million, which were released in two instalments:

- July 2011: EUR 40 million (a grant of EUR 14 million and a loan of EUR 26 million);
- December 2011 (grant of EUR 21 million) and February 2012 (loan of EUR 39 million)

The timing of the final grant payment (EUR 21 million in December 2011) was such that, in the modelling, these funds are assumed to have been spent in 2012.

Two possible options were identified (see Table 15 above) as plausible counterfactuals to replace the EU MFA, while the IMF, World Bank and EU support under ENPI remain at actually observed levels:

- Borrowing from the Eurasian Development Bank to fully replace the lost funds (corresponding to Scenario 1B in Table 15); or
- Rather than attempting to raise additional deficit financing, the Armenian government opts to reduce its spending instead to reduce the deficit (Scenario 1C from Table 15).

### 3.2.3.2.1 Scenario 1A: Replacement of MFA with borrowing from elsewhere

In the first counterfactual variant, the MFA is replaced by borrowing from the Anti-Crisis Fund (ACF) managed by the Eurasian Development Bank on the following terms:

- No grant element
- Annual interest rate: 1 per cent (fixed); maturity and grace period: 20 years, including grace period of 5 years

The change in debt servicing costs associated with the above loan fall outside the period being examined by this evaluation. In the modelling, under the assumption that the ACF financing simply replaces the lost MFA funds, the only economic impacts of the ACF money would be to raise Armenia’s foreign public debt by EUR 35 million. This is because the loan part of the MFA would have been replaced by a loan of the same size from the ACF, while the grant part of the MFA (a transfer, rather than a loan) would have been replaced by a loan. Put another way, under the assumption that the EU MFA simply allowed Armenia to avoid borrowing from the Eurasian Development Bank, the only effect of the EU support was to avoid the incurrence of a loan of EUR 35 million (because it was this part of the MFA that was provided in grant form).

The above presumes no other impacts of ACF borrowing. However, it is possible that either of the following could have taken effect:

- The differing terms of the ACF loan may have raised investors’ concerns about the sustainability of Armenia’s future debt situation compared to EU MFA; or
- The lack of EU support may have affected investor confidence in the EU’s own assessment of Armenia’s prospects.

In either of the above cases, while the Armenian government’s finances in the evaluation period were unaffected, lower investor confidence about the country’s future prospects may have deterred current investment. This is tested as a sensitivity in the quantitative analysis, to gauge the extent to which a reduction in investment might have affected Armenia’s macroeconomic performance. In the modelling, this is represented as a 1 percentage-point reduction in the share of real Gross Fixed Capital Formation in real GDP.

The ACF conditionality would most likely have been based on the IMF programme and it can thus be assumed that this would not have imposed, as a requirement, a tighter fiscal
policy over the evaluation period. Finally, no other government response and no change in interest rates or exchange rates are assumed.

3.2.3.2.2 Scenario 1B: Deficit reduction in the absence of MFA

In contrast to the previous counterfactual variant, in this second scenario, Armenia does not replace the lost MFA funding with financing from elsewhere. Without additional sources of deficit finance (or any scope for raising additional revenue), Armenia has no option but to reduce its deficit through spending cuts.

There is an overall loss of resources with which to fund the deficit although it seems likely that Armenia would have adjusted its spending as follows:

- The Government re-allocates part of the Russian loan earmarked for earthquake support (USD 120 million) to its general expenditure;
- The planned expenditure on earthquake support therefore, does not take place.

In modelling terms, however, the above is treated in the same way as if there were no re-allocation of funds. The model does not differentiate alternative types of expenditure on goods and services and only the total reduction in resources is of relevance.

Overall, Armenia’s holdings of foreign debt in this counterfactual would be EUR 65 million lower than in the baseline (from the absence of the MFA loan; the grant does not affect Armenia’s debt position).

As with the previous variant, no change in interest rates or exchange rates is assumed in the counterfactual.

3.2.3.3 Counterfactual scenario 2: No MFA operation and no IMF programme

This counterfactual scenario considers the case where Armenia did not receive MFA (matching the treatment in the previous scenario) but also did not receive IMF financial support. All other international assistance remains unaffected; in particular, World Bank and EU support under ENPI remain at observed levels.

Specifically the following amounts are not disbursed in this counterfactual:

- The SBA approved in 2009 comprising SDR 350.4 million disbursed as SDR 301.9 million in 2009 and SDR 48.5 million in 2010; of this SDR 350.4 million, SDR 127.6 million went to the government as budget support and the remaining SDR 222.8 million went to the central bank to strengthen its foreign exchange reserves
- SDR 211.8 million disbursed under the Extended Fund (EFF) and Extended Credit facilities (ECF) as SDR 72.4 million in 2010, SDR 72.4 million in 2011 and SDR 67.0 million in 2012; of this SDR 211.8 million, SDR 74.8 million went to the government as budget support and the remaining 137.0 million went to the central bank to strengthen foreign exchange reserves

and, as a consequence of the absence of IMF support, the absence of

- ADB anti-crisis programme funds of SDR 51.4 million in 2009, effectively tied to IMF support

In total, therefore, the loss of IMF support and the ADB loan disbursement amount to the following reduction in funding:

- For the government of Armenia: SDR 253.8 million
- For the central bank: SDR (222.8+137.0) = SDR 359.8 million

In these counterfactuals, it is assumed that Armenia would have diverted USD 333 million (or c. SDR 216.2 million) from its existing loan from the Russian government; this amount represents two thirds of the total USD 500 million Russian loan, on the grounds that on-lending and earthquake support represented about that proportion of the loan and these elements could be diverted to budget support). Furthermore, it is assumed
that the Russian loan is used in the same way as the SBA/ECF/ADB funding was actually used. Again, as far as the modelling is concerned, it is the overall reduction in funds that is important.

The two variants in this counterfactual differ in the extent to which Armenia could have borrowed from the ACF to replace the lost finances.

In the first variant, it is assumed that Armenia could have met its financing needs from 2010 onwards through ACF borrowing, limiting the impact of the lost funds to a one-off reduction in support in 2009 (the IMF SBA plus the ADB anti-crisis funds effectively tied to it). Sensitivity is also tested where the ‘shock’ in 2009 reduces investor confidence over the remainder of the evaluation period. As with the previous pair of ‘No MFA’ counterfactuals, a 1 percentage-point reduction in the investment share is applied.

In the second variant, it is assumed that Armenia would instead have engaged in deficit reduction over 2009-2012, to compensate for the lost MFA and IMF support.

In both cases, the size of the financing gap was considered large enough for there to be exchange rate effects arising from the foreign-exchange gap.

Both counterfactuals see a substantial reduction in support in 2009 (in excess of AMD 200 billion), leading to a sharper depreciation compared to that actually observed. The depreciation in the (real) exchange rate is set at 30 per cent, compared to the depreciation of 10 per cent that actually occurred. This is in line with IMF analysis that suggested that the real exchange rate prior to the 2009 depreciation was around 30 per cent above equilibrium.

In the counterfactual in which Armenia then meets its financing needs over 2010-2012 with additional ACF borrowing, it is assumed that the central bank begins to use the inflows of foreign exchange reserves to strengthen the currency once more. The exchange rate gradually returns to those actually observed in 2012.

In contrast, where Armenia suffers a much longer period of limited funds, there is no assumption of further central bank intervention, leading to a step change in the exchange-rate path.

In the first counterfactual variant, Armenia’s external debt would be SDR 209.2 million lower than in the baseline in 2009. This is equal to the size of the IMF and ADB funds not provided in 2009. In the subsequent years, Armenia incurs the same amount of debt in SDRs as before to replace the lost IMF support. Armenia also incurs a further EUR 35 million of debt to replace the grant component of the MFA (as with the IMF funds, the loan component is replaced like-for-like by the additional ACF borrowing).

In the second counterfactual, Armenia’s external debt is much lower than in the baseline by 2012, as it does not incur the EUR 65 million MFA loan, nor any of the IMF/ADB support, which amounted to SDR 613.6 million over the period.

### 3.3 Macroeconomic and external sustainability impact

The explicit construction of counterfactual scenarios in the previous section enables estimating an indicative size of net macroeconomic impact of the MFA (or a combination of the MFA and IMF assistance). It is calculated as the difference between an observed macroeconomic path of the Armenian economy (what has actually happened) and the counterfactual path (what would have happened without MFA assistance or without both MFA and IMF assistance). Figure 18 illustrates this graphically.

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The three sections that follow present:

- The Outturn: a summary of the key indicators from the observed outcome over 2009-2012;
- The case of no MFA operation: the results from the counterfactuals without MFA (with either additional borrowing or spending cuts); and
- The case of no MFA operation and no IMF programme: the results from the counterfactuals without MFA or IMF support (with either additional borrowing from 2010 onwards or spending cuts).

The counterfactuals were modelled as scenarios with the MFA and IMF support ‘taken away’ but, for presentational purposes, the impacts presented in the sections that follow are shown in such a way as to present the contribution of the various forms of support to the final observed outcome i.e. the positive impact of EU and IMF support.

Discussion around the sensitivity of the results to alternative parameter values can be found in Annex 4, along with the detailed model description.

### 3.3.2 Key baseline outcomes

This subsection presents the key baseline/outturn indicators against which the subsequent counterfactuals are measured.

Table 17 presents the baseline outcomes, highlighting the following:

- The strengthening post-crisis GDP growth in Armenia, with growth of 2.2 per cent in 2010, rising to 7.6 per cent in 2012;
- A relatively constant current account deficit; and
- Stable holdings of reserve assets, at just over EUR 1,400 million.

Inflation has been more volatile over 2009-2012, with a small fall in the price level in 2012 (by 1.6 per cent), whereas the unemployment rate has been close to 20 per cent over the same period.
### Table 17 Baseline Outcomes

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP (AMD billion)</td>
<td>2,651</td>
<td>2,710</td>
<td>2,838</td>
<td>3,053</td>
</tr>
<tr>
<td>Real GDP growth (per cent)</td>
<td>-14.1</td>
<td>2.2</td>
<td>4.7</td>
<td>7.6</td>
</tr>
<tr>
<td>Real GDP (EUR 2005 million)</td>
<td>5,226</td>
<td>5,464</td>
<td>5,472</td>
<td>5,913</td>
</tr>
<tr>
<td>Inflation (per cent)</td>
<td>2.6</td>
<td>7.8</td>
<td>4.2</td>
<td>-1.6</td>
</tr>
<tr>
<td>Current account (EUR m) [negative is a deficit]</td>
<td>-980</td>
<td>-1,035</td>
<td>-796</td>
<td>-868</td>
</tr>
<tr>
<td>Reserve assets (EUR m)</td>
<td>1,435</td>
<td>1,406</td>
<td>1,407</td>
<td>1,400</td>
</tr>
<tr>
<td>Employment (‘000s)</td>
<td>1,153</td>
<td>1,185</td>
<td>1,175</td>
<td>1,139</td>
</tr>
<tr>
<td>Unemployment rate (per cent)</td>
<td>19.0</td>
<td>17.5</td>
<td>19.1</td>
<td>20.1</td>
</tr>
</tbody>
</table>

### 3.3.3 The case of no MFA operation

To recap, the ‘no MFA’ counterfactual scenario comprises two variants:

- A variant in which Armenia borrows from the Eurasian Development Bank ACF, to replace the absent EU MFA; and
- A second variant in which Armenia is unable to raise any additional funds and instead cuts government spending in order to reduce its public deficit.

As mentioned previously, a straight substitution between EU MFA and ACF during the period of evaluation (2009-2012) would have no macroeconomic impacts beyond an increase in Armenia’s foreign debt by EUR 35 million (the value of the EUR 35 million MFA grant, which would have been replaced by the equivalent as a foreign loan). The debt-servicing requirements of the ACF loan fall outside the period of analysis. However, the terms of the loan (or simply the absence of EU backing) may potentially have altered investor confidence in Armenia’s longer-term fiscal sustainability and/or economic stability, with implications for current investment patterns (through greater pessimism regarding the potential future return on any investment). Table 18 presents the results from the counterfactual in which the investment share is reduced by 1 percentage point compared to the baseline case, to simulate such a loss in confidence.

### Table 18 MFA Replaced by ACF Borrowing

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP (AMD billion)</td>
<td>2,652</td>
<td>2,710</td>
<td>2,829</td>
<td>3,043</td>
</tr>
<tr>
<td>Real GDP growth (per cent)</td>
<td>-14.1</td>
<td>2.2</td>
<td>4.4</td>
<td>7.6</td>
</tr>
<tr>
<td>Real GDP (EUR 2005 million)</td>
<td>5,226</td>
<td>5,464</td>
<td>5,453</td>
<td>5,892</td>
</tr>
<tr>
<td>Inflation (per cent)</td>
<td>2.6</td>
<td>7.8</td>
<td>4.2</td>
<td>-1.6</td>
</tr>
<tr>
<td>Current account (EUR m) [negative is a deficit]</td>
<td>-980</td>
<td>-1,035</td>
<td>-820</td>
<td>-856</td>
</tr>
<tr>
<td>Reserve assets (EUR m)</td>
<td>1,435</td>
<td>1,406</td>
<td>1,419</td>
<td>1,424</td>
</tr>
</tbody>
</table>
This compares to the results in Table 19 which show the second counterfactual, in which Armenia cuts its spending, in order to cope with the lower deficit financing available.

**Table 19 No MFA with Government Deficit Reduction**

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment ('000s)</td>
<td>1,153</td>
<td>1,185</td>
<td>1,173</td>
<td>1,137</td>
</tr>
<tr>
<td>Unemployment rate (per cent)</td>
<td>19.0</td>
<td>17.5</td>
<td>19.2</td>
<td>20.2</td>
</tr>
<tr>
<td>Real GDP (AMD billion)</td>
<td>2,652</td>
<td>2,710</td>
<td>2,820</td>
<td>3,026</td>
</tr>
<tr>
<td>Real GDP growth (per cent)</td>
<td>-14.1</td>
<td>2.2</td>
<td>4.1</td>
<td>7.3</td>
</tr>
<tr>
<td>Real GDP (EUR 2005 million)</td>
<td>5,226</td>
<td>5,464</td>
<td>5,437</td>
<td>5,860</td>
</tr>
<tr>
<td>Inflation (per cent)</td>
<td>2.6</td>
<td>7.8</td>
<td>4.2</td>
<td>-1.6</td>
</tr>
<tr>
<td>Current account (EUR m) [negative is a deficit]</td>
<td>-980</td>
<td>-1,035</td>
<td>-810</td>
<td>-836</td>
</tr>
<tr>
<td>Reserve assets (EUR m)</td>
<td>1,435</td>
<td>1,406</td>
<td>1,367</td>
<td>1,349</td>
</tr>
<tr>
<td>Employment ('000s)</td>
<td>1,153</td>
<td>1,185</td>
<td>1,171</td>
<td>1,133</td>
</tr>
<tr>
<td>Unemployment rate (per cent)</td>
<td>19.0</td>
<td>17.5</td>
<td>19.3</td>
<td>20.4</td>
</tr>
</tbody>
</table>

The impacts of MFA under these two possible counterfactual scenarios are summarised in Table 20 below.

The counterfactual analysis shows that MFA contributed to slightly more positive GDP growth in 2011 (between 0.3 and 0.6 percentage points) and in 2012 (up to 0.3 percentage points). Compared to the outturn growth rates of 4.7 and 7.6 per cent, the contribution is not particularly large in growth-rate terms, but if it was indeed the case that Armenia would not have been able to secure financing from elsewhere, the difference is almost 1 per cent in terms of lost output.

The impact of the support was not sufficiently large to have any effect on inflation.

In both counterfactual variants, the MFA reduced the current account deficit slightly in 2011, by 3 per cent or less but this was offset in 2012 by a wider current account deficit as imports recovered. The overall effect on reserves varies by scenario. In the case where MFA meant that Armenia did not need to secure financing from the ACF, the effect on investor confidence may have been enough for the higher investment to lead to slightly higher imports. In the alternative, where MFA filled a financing gap that could not otherwise have been filled, the model results suggest that MFA helped to bolster Armenia’s foreign exchange reserves.

Figure 19 below shows the EU MFA’s contribution to real GDP in circumstances where the Government would not have been able to replace the MFA and would have pursued with a deficit reduction\(^{70}\). More growth might have been possible in 2011 and 2012 without the MFA, but the overall level of GDP would not have been as high.

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\(^{70}\) This corresponds to counterfactual scenario with Government deficit reduction, see table 3.6.
Table 20 Estimated Contribution of EU MFA

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution to GDP growth</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(percentage points)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>0.0</td>
<td>0.0</td>
<td>+0.3</td>
<td>0.0</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>0.0</td>
<td>0.0</td>
<td>+0.6</td>
<td>+0.3</td>
</tr>
<tr>
<td>Contribution to GDP, relative</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>to no MFA counterfactual (per</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>cent)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>0.0</td>
<td>0.0</td>
<td>+0.3</td>
<td>+0.3</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>0.0</td>
<td>0.0</td>
<td>+0.6</td>
<td>+0.3</td>
</tr>
<tr>
<td>Contribution to inflation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(percentage points)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Contribution to current account</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>balance (EUR m) (positive is</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a decrease in the deficit)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>0</td>
<td>0</td>
<td>+24</td>
<td>-10</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>0</td>
<td>0</td>
<td>+14</td>
<td>-32</td>
</tr>
<tr>
<td>Contribution to end-of-year</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>level of reserve assets (EUR m)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>0</td>
<td>0</td>
<td>-12</td>
<td>-24</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>0</td>
<td>0</td>
<td>+40</td>
<td>+51</td>
</tr>
</tbody>
</table>

Note: The results should be treated as indicative only. Annex 4 provides alternative estimates obtained in the sensitivity analysis.

3.3.3 The case of no MFA operation and no IMF programme

The second counterfactual considers a situation in which Armenia does not receive any MFA or IMF support.
In the first counterfactual, Armenia is unable to meet the financing gap in 2009 and must lower its spending accordingly, in order to reduce the deficit. This leads to a sharper depreciation in 2009 but the borrowing from the ACF over 2010-2012 allows Armenia to both finance its deficit spending at outturn levels and to begin to intervene in foreign-exchange markets once more, in order to return the value of its currency to baseline levels by 2012. As with the ‘no MFA’ counterfactual in which Armenia is able to secure funds from the ACF, a small reduction in investor confidence is modelled.\(^{71}\)

The results from this first counterfactual are presented in Table 21 below.

### Table 21 No MFA and No IMF Replaced by ACF Borrowing from 2010 Onwards

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP (AMD billion)</td>
<td>2,482</td>
<td>2,638</td>
<td>2,773</td>
<td>2,989</td>
</tr>
<tr>
<td>Real GDP growth (per cent)</td>
<td>-19.6</td>
<td>6.3</td>
<td>5.1</td>
<td>7.8</td>
</tr>
<tr>
<td>Real GDP (EUR 2005 million)</td>
<td>3,918</td>
<td>4,563</td>
<td>4,938</td>
<td>5,788</td>
</tr>
<tr>
<td>Inflation (per cent)</td>
<td>6.4</td>
<td>10.4</td>
<td>5.5</td>
<td>-1.6</td>
</tr>
<tr>
<td>Current account (EUR m) [negative is a deficit]</td>
<td>-716</td>
<td>-846</td>
<td>-693</td>
<td>-794</td>
</tr>
<tr>
<td>Reserve assets (EUR m)</td>
<td>1,206</td>
<td>1,341</td>
<td>1,490</td>
<td>1,596</td>
</tr>
<tr>
<td>Employment ('000s)</td>
<td>1,116</td>
<td>1,169</td>
<td>1,162</td>
<td>1,127</td>
</tr>
<tr>
<td>Unemployment rate (per cent)</td>
<td>21.6</td>
<td>18.6</td>
<td>20.0</td>
<td>20.9</td>
</tr>
</tbody>
</table>

Table 22 shows the results from the second counterfactual variant, in which Armenia is unable to secure any financing and must cut its spending accordingly. Without the external assistance, there is no scope for the central bank to intervene in foreign-exchange markets and the severe depreciation in 2009 persists over the remainder of the period.

### Table 22 No MFA and No IMF with Government Deficit Reduction

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP (AMD billion)</td>
<td>2,482</td>
<td>2,594</td>
<td>2,702</td>
<td>2,901</td>
</tr>
<tr>
<td>Real GDP growth (per cent)</td>
<td>-19.6</td>
<td>4.5</td>
<td>4.2</td>
<td>7.4</td>
</tr>
<tr>
<td>Real GDP (EUR 2005 million)</td>
<td>3,918</td>
<td>4,189</td>
<td>4,173</td>
<td>4,500</td>
</tr>
<tr>
<td>Inflation (per cent)</td>
<td>6.4</td>
<td>11.8</td>
<td>8.1</td>
<td>2.0</td>
</tr>
<tr>
<td>Current account (EUR m) [negative is a deficit]</td>
<td>-716</td>
<td>-756</td>
<td>-515</td>
<td>-498</td>
</tr>
<tr>
<td>Reserve assets (EUR m)</td>
<td>1,206</td>
<td>1,277</td>
<td>1,425</td>
<td>1,653</td>
</tr>
</tbody>
</table>

\(^{71}\) Without this adjustment for investor confidence, the model results suggest that the one-off shock in 2009 only has a temporary effect in macroeconomic terms: the key indicators are very close to baseline levels by 2012.
The estimated contribution of the combined EU and IMF support under the two counterfactual variants is summarised in Table 23. Because the response is identical in 2009 (Armenia is not able to secure financing from elsewhere), the impacts across the two counterfactuals are identical.

The model results suggest that the combined EU and IMF support avoided a more severe recession in 2009: there could have been a decline in GDP of almost 20 per cent compared to the actual 14 per cent fall. The growth effects in the later years would suggest that Armenia grew slower with the support than without but this ignores the size of the loss in output: EU and IMF support led to a higher level of GDP in Armenia in 2012 by between 2 and 5 per cent, depending on the counterfactual.

The counterfactual analysis also suggests that by avoiding a more severe (and potentially sustained) devaluation of the Armenian dram, the EU and IMF support helped to stave off higher inflation, by as much as 4 per cent in the scenario where the central bank is unable to intervene to defend the value of the currency.

The effects on reserves and the current account arise simply from the extent of the recession avoided in 2009 combined with the absence of the largest tranche of reserves to the central bank that same year. Armenia would have continued to accumulate reserves in the counterfactuals but simply from a lower base post-recession.

Table 23 Estimated contribution of EU MFA and IMF/ADB support

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution to GDP growth (percentage points)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>+5.5</td>
<td>-4.1</td>
<td>-0.4</td>
<td>-0.2</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>+5.5</td>
<td>-2.3</td>
<td>-0.5</td>
<td>+0.2</td>
</tr>
<tr>
<td>Contribution to GDP level (percentage points)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>+6.8</td>
<td>+2.7</td>
<td>+2.3</td>
<td>+2.1</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>+6.8</td>
<td>+4.4</td>
<td>+5.0</td>
<td>+5.2</td>
</tr>
<tr>
<td>Contribution to inflation (percentage points)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>-3.8</td>
<td>-2.6</td>
<td>-1.3</td>
<td>0.0</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>-3.8</td>
<td>-4.0</td>
<td>-3.9</td>
<td>-3.2</td>
</tr>
<tr>
<td>Contribution to current account balance (EUR m) (positive is a decrease in the deficit)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>-264</td>
<td>-189</td>
<td>-103</td>
<td>-74</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>-264</td>
<td>-279</td>
<td>-281</td>
<td>-370</td>
</tr>
<tr>
<td>Contribution to end-of-year level of reserve assets (EUR m)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>+229</td>
<td>+65</td>
<td>-83</td>
<td>-196</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>+229</td>
<td>+129</td>
<td>-18</td>
<td>-253</td>
</tr>
</tbody>
</table>

Note: The results should be treated as indicative only. Annex 4 provides alternative estimates obtained in the sensitivity analysis.

Overall, the combined EU and IMF support was important in avoiding a much more severe recession in 2009 and would have contributed substantially to overall output by 2012. The support, if it would have avoided a severe depreciation of the currency, would...
also have helped to stave off higher inflation. There were clear macroeconomic benefits from the support. Reserves would have been lower in the absence of support in 2009 but Armenia would have continued to accumulate foreign exchange in the subsequent years.

Figure 20 shows the combined EU MFA/IMF impact on real GDP during and after the crisis corresponding to circumstances where the Government would not have been able to secure financing from elsewhere and would have pursued with a deficit reduction.72

Figure 20 IMF / EU MFA contribution to real GDP (in billion AMD, current prices)

3.4 Conclusions

The evidence suggests that the EU MFA operation made a positive contribution to supporting macroeconomic recovery in Armenia, following the 2009 crisis. The support allowed for higher government spending (and therefore, a smoother fiscal adjustment) in the post-crisis years, leading to GDP being around 0.3 to 0.6 per cent higher in 2011 and 0.3 to 0.9 per cent higher in 2012 when compared to a counterfactual without the MFA support.

The MFA was closely linked to the IMF support programme and the combined macroeconomic impact of these two operations was substantially larger than the impact of the MFA alone. Specifically, the modelling exercise suggests that the combination of the IMF and EU MFA support might have raised Armenian GDP between 2.1 and 5.2 per cent by 2012. The support helped to avoid a much more severe recession in 2009 (the decline in GDP could, potentially have neared 20 per cent). The combined MFA/IMF assistance also promoted a somewhat more stable inflation.

The estimates of the MFA impact are robust and they remain in the similar order of magnitude under alternative assumptions on counterfactual paths and model parameters. Annex 4 provides further details.

While the MFA and IMF support clearly had an impact on current account developments during the assistance period, no clear evidence has been identified of any medium- to long-term impact on current account. The MFA has contributed to external sustainability of the country by limiting the public external debt issuance (that would likely be needed e.g. to later finance investment expenditure foregone in the counterfactual scenario of no

72 This corresponds to counterfactual scenario with Government deficit reduction, see Table 22.
MFA). The support also raised economic growth leading to marginally lower debt- and deficit-to-GDP ratios (but this effect is small).

A similar logic applies to the case of a combined MFA and IMF support. Lack of IMF lending would force cuts in fiscal expenditures, including investment expenditures during 2009-2012. However, in this counterfactual scenario public expenditures would likely need to eventually increase at some point in the future, e.g. to compensate for necessary but earlier foregone public investments. Then these additional expenditures would need to be financed by borrowing and it is highly unlikely that Armenia would be able to obtain alternative external (or domestic) financing on similarly concessional terms to what was provided by the IMF. Hence, the combined impact of the MFA assistance and the IMF programme on public external debt sustainability has also been positive.

Table 24 provides a summary of all the counterfactual scenarios:

**Table 24 Summary of estimated contributions of EU MFA and EU MFA/IMF support to Armenia**

<table>
<thead>
<tr>
<th>Contribution to GDP growth (percentage points)</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution of EU MFA</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>0.0</td>
<td>0.0</td>
<td>+0.3</td>
<td>0.0</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>0.0</td>
<td>0.0</td>
<td>+0.6</td>
<td>+0.3</td>
</tr>
<tr>
<td>Contribution of MFA/IMF</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>+5.5</td>
<td>-4.1</td>
<td>-0.4</td>
<td>-0.2</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>+5.5</td>
<td>-2.3</td>
<td>-0.5</td>
<td>+0.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Contribution to GDP level (per cent)</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution of EU MFA</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>0.0</td>
<td>0.0</td>
<td>+0.3</td>
<td>+0.3</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>0.0</td>
<td>0.0</td>
<td>+0.6</td>
<td>+0.9</td>
</tr>
<tr>
<td>Contribution of MFA/IMF</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>+6.8</td>
<td>+2.7</td>
<td>+2.3</td>
<td>+2.1</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>+6.8</td>
<td>+4.4</td>
<td>+5.0</td>
<td>+5.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Contribution to inflation (percentage points)</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution of EU MFA</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Contribution of MFA/IMF</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>-3.8</td>
<td>-2.6</td>
<td>-1.3</td>
<td>0.0</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>-3.8</td>
<td>-4.0</td>
<td>-3.9</td>
<td>-3.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Contribution to current account balance (EUR m) (positive is a decrease in the deficit)</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution of EU MFA</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>0</td>
<td>0</td>
<td>+24</td>
<td>-10</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>0</td>
<td>0</td>
<td>+14</td>
<td>-32</td>
</tr>
<tr>
<td>Contribution of MFA/IMF</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>with ACF borrowing</td>
<td>-264</td>
<td>-189</td>
<td>-103</td>
<td>-74</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>-264</td>
<td>-279</td>
<td>-281</td>
<td>-370</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Contribution to end-of-year level of reserve assets (EUR m)</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
</table>
## Contribution of EU MFA

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>with ACF borrowing</td>
<td>0</td>
<td>0</td>
<td>-12</td>
<td>-24</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>0</td>
<td>0</td>
<td>+40</td>
<td>+51</td>
</tr>
</tbody>
</table>

## Contribution of MFA/IMF

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>with ACF borrowing</td>
<td>+229</td>
<td>+65</td>
<td>-83</td>
<td>-196</td>
</tr>
<tr>
<td>without ACF borrowing</td>
<td>+229</td>
<td>+129</td>
<td>-18</td>
<td>-253</td>
</tr>
</tbody>
</table>
4 Impact of the Structural Reforms

This section provides an assessment of the MFA impact on structural reforms. The analysis is based on extensive desk research and interviews with stakeholders from the Armenian authorities, the European Commission and other development partners, and experts in relevant fields.

4.1 Results

4.1.1 Implementation of the Reforms

The analysis of MFA conditions related to structural reforms focused on the following elements:

- the nature and scope of the conditionality attached to the MFA operation;
- the rationale for each condition;
- the implementation of the conditionality by the Armenian authorities;
- evidence for reform impact, and
- evidence of MFA contribution to the reform progress.

The MFA conditionality focussed on reforms in the areas of public debt management, pension system, public internal financial control, external audit, public procurement, tax administration and tax and customs policy.

The selection of conditionality was done on the basis of operational assessments carried out in February 2010 by independent consultants on behalf of the European Commission and in consultations with other donors, especially the IMF, World Bank, EBRD and in dialogue with EU Delegation, the EU Advisory Group and the Armenian authorities. Coordination between the IMF, World Bank and the EU took place at the level of exchange of staff reports and other policy papers.

The selected reform areas effectively promoted fiscal sustainability (e.g. improved debt management, tax administration and pension system), good governance and efficiency of public spending (e.g. public procurement legislation adhering to international standards and improved working practices in public internal financial management and external audit). Other reforms (e.g. tax and customs policy) related to areas that were high on the EU’s policy agenda, and to an extent were meant to have an impact on the business environment.

However, one omission from the conditionality has potentially been the lack of direct support for the business environment. Many international stakeholders and local NGOs have pointed out, for example, that the focus could have more strongly been on improving the business environment, in particular as the economy is characterised with a chronic lack of competition in the market and the EU specifically is seen to have political leverage over this issue.

The ex-ante evaluation of the MFA operation to Armenia also suggested that conditionality was designed to be consistent with the policy lines anchored in the IMF programme and to remain in line with the priorities of the Neighbourhood Policy and Eastern Partnership. This seems to have been the case with the MFA supporting reforms in the areas of good governance and efficiency of public spending (e.g. internal and external audit and public procurement), trade and investment (e.g. tax administration and tax and customs policy) which were complementary to those supported via ENPI. The conditionality did not focus on socio-economic reforms or

---

sustainable development, also supported by ENPI, apart from pension reform that can be seen to support this goal.

Overall, it appears that the coordination between the different EU instruments (namely ENPI and MFA) could have been made more explicit from the outset. In particular from the perspective that MFA could have been more strongly used to provide further leverage to other EU reform areas. This is particularly relevant when many of the reforms are longer-term undertakings, and by nature their impact cannot be assessed in the short-term.

The figures and tables below provide an assessment of the following aspects of structural reforms conditionality:

- intervention logic underpinning the selection of conditions as reconstructed by the evaluation team;
- expected outputs, i.e. actions or products expected as the fulfilment of conditions;
- implementation, i.e. actions related to fulfilling conditions;
- implementation deficit, i.e. whether there is any evidence on implementation problems, e.g. discrepancy between de jure and de facto situation;
- immediate outcomes, i.e. what benefits were expected quickly after fulfilment of conditions and whether there is any evidence of their materialisation;
- longer-term outcomes and impacts, i.e. what changes / benefits were expected in the longer-term and whether there is any evidence of their materialisation;
- domestic ownership of reforms and donor support, i.e. to what extent reforms were part of the domestic policy agenda and which other actors promoted reforms in a given area; and
- MFA value added, i.e. to what extent any effects can be attributed to the MFA.

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74 Although the specific condition can be fulfilled in a short-time span, the implementation can only be asssed in the future.
Figure 21 Intervention Logic: Debt Management Reform (Conditions 1 and 2)

**Rationale for the Reform**
- Rapid increase in external and domestic debt stock
- Inefficient debt management system in place with two different IT systems recording domestic and external debt situation
- Structure of public debt management department needs to be aligned and changed at functional level with clear reporting lines

**Output(s)**
- Installation of Debt Management and Financial Analysis System (DMFAS 6.0 software) – thus, integrating debt recording (domestic and external) onto one system
- Reorganisation of the Public Debt Management Department specifying functions of the front-office, the middle-office and the back-office with relevant job descriptions

**Immediate Benefits**
- Improved efficiency - availability of more accurate and timely data on public debt from a single source
- Greater transparency – real-time data is accessible across the Ministries and the general public has access to data on MoF website which is updated monthly
- Improved internal organisation and management – the operational structure of the Public Debt Management Department is clear with specific tasks, functions and reporting lines

**Outcomes & Impacts**
- Improved debt management
- Savings through lower debt servicing
- Reduced risk within debt portfolio
- Maintaining debt at sustainable levels
- Improved governance
**Condition 1**: Consistently with the Action Plan of the Ministry of Finance regarding Public Debt Management Strategy, by adopting the Ministerial Order 150-A, the Ministry of Finance acquires a new debt recording system

**Implementation**

In March 2010 Ministry of Finance adopted the Public Debt Management Strategy. In April 2011 a contract was signed between the MoF and the UNCTAD DMFAS Programme. In May 2011 DMFAS 6.0 was installed in the MoF, and UNCTAD provided technical support for DMFAS. In June 2011 functional training was provided to the relevant staff by UNCTAD. From June – August 2012 UNCTAD translated relevant documents into Armenian.

Prior to this DMFAS was operational only for the external debt operations. The Public Debt Management Department (PDMD) migrated its domestic debt database to DMFAS.

A mission took place from December 10 to December 14, 2012 in UNCTAD headquarters and had the following objectives: 1) to test the debt buy-back module which had been developed by UNCTAD, 2) to solve any technical problems encountered in the use of the software, 3) to provide advice training to the head of the back office on the functional administration of the system and, 4) to discuss possible future activities of the DMFAS programme in Armenia.

**Evidence of Implementation deficit**

No evidence of implementation deficit encountered.

**Relevance**

Severe recession and sizable foreign assistance inflows led to rapid accumulation of external public debt (from 14 per cent of GDP in 2008 to 42 per cent in 2011).

The benefits of improvement in this area were also highlighted by the Operational Assessment conducted in March 2010. Armenia operated separate systems for recording and monitoring domestic and external debt, which meant that the external and domestic debt recording and analysis was done in isolation from each other.

The installation of DMFAS in the Treasury addressed a serious short-coming in the operations of the PDMD. Before the implementation of DMFAS, the PDMD was using its in-house developed Debt Tracking System (DTS) as the external debt database and Excel for the domestic debt one. The recording systems used by the PDMD were characterised by: 1) higher operational risks, 2) duplication of tasks, 3) separated databases for the domestic debt and external debt records. The purchase of DMFAS was aimed at overcoming these shortcomings.

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77 Technical Assistance Report (December 2012) on Customisation of DMFAS.
78 The difference between de jure and de facto reforms
80 ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.
81 Technical Assistance Report (December 2012) on Customisation of DMFAS.
### Importance of reform

After the introduction of the new debt recording system, a more comprehensive and coherent approach for debt management exists, which jointly assesses the domestic and external debt situation. As a result, the management of public debt has been improved. Having a coherent and robust system in place is also envisaged to help the government to approach capital markets in the future for the country’s financing needs.

### Domestic ownership & donor support

The condition was linked to the Public Debt Management Strategy that was high on government agenda. The RA government would have pursued the debt management system also in the absence of the MFA. The World Bank provided assistance to finance the software. The software was purchased, installed and training was carried out by the UNCTAD DMFAS Programme.

The main driver was the government and a timetable provided in the Ministry of Finance action plan. The World Bank was also supporting the reform through helping to finance the debt recording system. The IMF also provided technical assistance support to this reform area. The EU Delegation also provided technical assistance to the PDMD in 2012.

### Added Value of MFA

MFA added additional endorsement to fulfil the reform, although the reform would have taken place even in the absence of the MFA, and as timeline for the implementation indicates the system was installed soon after the signature of the MoU between EU and Armenia in February 2011.

### Evidence of benefits

Government officials pointed out that there is increased transparency of managing public debt (the information is provided to the public on the website). There is also increased accuracy and timeliness of the information provided (information is provided on a monthly basis, whereas before the information was only available quarterly/annually). There is also increased ability to access data real time across the Ministries (the server enables MoF, MoE and CBA to have real time access to the data). Operational risks have been reduced as the information system has a backup for loss of data.

### Evidence of long-term Impacts

None identified at this stage
The a priori impacts highlighted in the intervention logic can be expected to materialise in the medium to long term

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82 ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.
83 ICF GHK Mission to Yerevan, 5-8 May 2013, Interviews with international donors.
84 ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.
85 ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.
### Condition2: The Ministry of Finance specifies in its internal regulation the functions of the front-office, the middle-office and the back-office within the Public Debt Management Department (PDMD) as well as the relevant job descriptions.

### Implementation

With support of the World Bank, a new charter and staff list of the Public Debt Management Department were approved by the Minister of Finance on 17 September 2011 (Order 663-A). The support from the World Bank was provided under the "Public Management" Grant Project. The implementation of the restructuration of the PDMD accordingly to the front/ middle/ back office (FO/ MO/ BO) structure is a gradual process. All the information flows within the PDMD are not yet fully in line with the FO/ MO/ BO model as would be understood in the context of an advanced DMO. However, the functional lines are relatively well implemented.

### Evidence of Implementation deficit

No evidence of implementation deficit encountered so far.

### Relevance

In addition to the debt management recording system, an improvement in clear subordination and streamlining of reporting lines within the Public Debt Management Department was also indicated in the result of the Operational Assessment exercise. The adoption of the revised charter of the PDMD in September 2011 is a significant step towards introducing an internal organisation of the department based on functional lines. The restructuration of the PDMD accordingly to the front/ middle/ back office (FO/ MO/ BO) structure is an important milestone of the Action Plan. It is also a condition for reinforcing the debt strategy framework as a division of the PDMD – the middle office - is now in charge of the formulation of the debt strategy and of the monitoring of its implementation.

### Importance

The department has been restructured which means that the work can be better organised and managed. Back office is responsible for reporting division and servicing of payments; the middle office for drafting government debt management strategy and identifying and managing existing risks. The responsibility also includes programming cash flows of treasury single account. The front office is the transaction division (negotiation and issuing government securities, and dealing with government borrowing).

### Domestic ownership &

Prior to the EU MFA, the Public Debt Management Department was benefiting from support of the EU Advisory Group for the reform of the operations by developing relevant job description, Code of Conduct, and guidelines on information exchange.

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87 Technical Assistance Report (December 2012) on Customisation of DMFAS.

88 Ibidem.

89 Technical Assistance Report (December 2012) on Customisation of DMFAS.

90 ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.
<table>
<thead>
<tr>
<th><strong>donor support</strong></th>
<th>The EU Advisory Group proposed a new structure that would cover (i) cash flow management, (ii) front desk, (iii) middle office and (iv) back office.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Added Value of MFA</strong></td>
<td>The MFA is likely to have reinforced the reform and supported the earlier work of the EU Advisory Group. However, the restructuring itself was undertaken with support from the World Bank, and prior commitment from the government to this effect existed. EU Delegation also supported PDMD in 2012 in this area.</td>
</tr>
<tr>
<td><strong>Evidence of benefits</strong></td>
<td>The operational structure of the public debt management department is clear, with specific tasks, functions and reporting lines attached to the back, middle and front office (see above under section on importance) although some improvements could be made to its implementation.</td>
</tr>
<tr>
<td><strong>Evidence of long-term Impacts</strong></td>
<td>None identified at this stage.</td>
</tr>
</tbody>
</table>

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92 This includes areas such keeping specifically to the role assigned to the back middle and front offices. Source: Technical Assistance Report (December 2012) on Customisation of DMFAS.
Figure 22 Intervention Logic - Pension System Reform (Condition 3)

**Rationale for the Reform**
- To accelerate the proposed pension reform as outlined by the government
- To improve the following:
  a) Fairness of the pension system;
  b) Financial pension system stability
  c) Create incentives for workers to work in the formal (legal) sector

**Output(s)**
- Adoption of legal acts that provide for three pillar pension system, and the compulsory and voluntary funded pension systems as its components
- Adopting a law on pension system that includes the privately funded pillar

**Immediate Benefits**
- Improved efficiency:
  i) Direct linkage between contributions and future pensions
  ii) Increased contributions to pension system
  iii) Reduced incentives to work in the shadow economy

**Outcomes & Impacts**
- A more robust pension system: reduced disparity between wages, years of employment and pensions
- More sustainable public finances
- Improved fiscal sustainability: Reduced burden on public budget
- Development of domestic debt market
- Increased long term domestic investment
Condition3: The Government submits to the Parliament draft legislation for pension system reform including proposals concerning the privately funded pillar.

Implementation
Reforming pension system was part of Poverty Reduction Strategy Paper and RA Government Programme 2008-2012. In December 2010 the package of legal acts on the pension system reform was adopted by the Parliament. The legal acts provide for the introduction of a three-pillar pension system, and the compulsory and voluntary funded pension systems as its components.

As specified in the Law "On Cumulative Pensions", the voluntary cumulative pension was implemented from January 2011.

In July 2011 RA Government adopted decision No 1190-N on “Defining Quantitative and currency limitations of investing voluntary pension fund assets in financial instruments” in order to reduce risk of voluntary pension fund investments. Related tax reforms took effect in January 1, 2013. The compulsory cumulative pension system will come into effect in 2014. There is a Road Map of actions yet to be done and their implementation deadlines. The government decrees to be drafted and the AMPIS system are expected to be ready within their determined deadlines. Other relevant legislation in this field include: Legislation of this field includes Law on Funded pension, Law on Investment funds, Law on Income tax, Law on Income Tax and Mandatory Pension Payment Personified Accounting.

Evidence of Implementation deficit
None. The pension reform has been part of the government’s long-standing priority.

Relevance
Pension system reform was highlighted already in the Poverty Reduction Strategy Paper from 2003 and in the RA Government Programme 2008-2012 and is a step necessary to fight old age poverty, support social integration and consolidation of public finances on a long run. Pension system reform was not specifically addressed in the OA.

The rationale for complementing the existing system with the two new pillars, mandatory and voluntary funded pillars, is to entirely change the existing defined benefit (DB) scheme and create the defined contribution (DC) scheme, which will ensure the participation and ownership of current workers in their future welfare. The new system is intended to increase financial

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95 RA MoF, 2011. Report on results of activities carried out by the ministry of finance of the RA in 2011.
96 ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.
97 ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.
99 ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.
system stability, create incentives for workers to work in the formal (legal) sector. In the current system employees are not motivated to contribute to the pension system, because it will not pay them back adequate pensions (reimbursement rate is lower than the internationally accepted standards).\textsuperscript{100}

| Importance | The pension reform is expected to contribute to reduction of fiscal pressure on the central budget, willingness to increase the level of private savings and also boost the domestic bond market. |
| Domestic ownership & donor support | Pension reform is a long term undertaking driven by the RA government. Domestic ownership is strong. |
| Added Value of MFA | The main driver behind the pension reform is RA government. The MFA had no particular influence on the outcomes of the pension reform. The government would have pursued the pension reform even in the absence of the MFA and within the same timeframe\textsuperscript{101}. The evaluation found no evidence of a political or operational reinforcing effect. |
| Evidence of benefits | No evidence encountered so far given the long term nature of the reform. The expected results of the reform will be long-term money in the economy, developed financial market, new financial instruments. |
| Evidence of long-term Impacts | The financing of the system will be based on the employee’s contribution in the form of 5 per cent deduction from his/her salaries and the government contribution, also at the level of 5 per cent. For this purpose the income tax rate will be increased from 20 to 25 per cent. |

\textsuperscript{100} ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.\textsuperscript{101} ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.
Figure 23 Intervention Logic – Public Internal Financial Control & External Audit Reforms (Conditions 4 and 5)

**Rationale for the Reform**
- Internal audit: A need to strengthen internal audit functions across government institutions through improving the role of Central Harmonisation Unit in the Ministry of Finance
- External audit: A need for methodological and financial independence of Chamber of Control (independent supreme audit institution) in line with the INTOSAI standards

**Output(s)**
- Adoption of law on Internal Audit improving the existing system and harmonising with the EU standards. Establishment of Central Harmonisation Unit (CHU)
- Strengthening the role of CHU: establishment of a common set of principles and basic rules for the entire public service
- Improving working practices of Chamber of Control in line with the INTOSAI standards: preparation of Strategic Development Plan and Implementation Plan for 2011-2016

**Immediate Benefits**
- Improved strategic planning, management and operational control
- Improved understanding of public officials of the role and importance of audits in public institutions
- Improved transparency of public management

**Outcomes & Impacts**
- Improved efficiency of public expenditure and strategic allocation of resources
- Improved governance: greater transparency and accountability
- Reduced risks of fraud and corruption in public spending
**Condition4**: The government takes necessary steps to ensure that the Central Harmonisation Unit in the Ministry of Finance provides methodological guidance and monitoring of financial management, control matters and internal audit functions across the government.

**Implementation**

In August 2010 Central Harmonisation Unit (CHU) was established in the MoF (Government Protocol Decree 1146 of 19 August 2010)\(^{102}\). In December 2010 draft Law on Internal Audit is adopted and lays the foundation for the deployment of PIFC concept within the public sector as a whole. A strategy on Public Internal Financial Control (PIFC) was adopted by the government in 2010 with an action plan covering the 2010-2013 period.

Feb 2011 - Dec 2011: The documents CHU prepared with the support of the EU SIGMA experts (concept papers on new legislation on financial inspection and on financial management control) as well as public sector standards and the internal audit and behaviour rules of internal auditors were approved by the Government Decision 1233-N\(^{103}\). Within the framework of envisaged measures of Domestic Public Financial Management strategy MoF has developed concepts of RA Law drafts on “Financial Management and Control” and “Financial Inspection”\(^{104}\). In August 2011 “Standards of the activity of international auditors and internal audit professional conduct rules” that fully comply with internationally recognized standards have been developed and adopted (Resolution No. 1233)\(^{105}\).

In the course on 2012 methodological guidelines of applying the standards of the internal auditor’s professional activity have also been adopted. A legislative bill “On establishing the guidelines on regulating the manual internal audit in the public sector” has been developed and submitted to the Parliament\(^{106}\).

During 2012 (with formal process completed by July 1\(^{st}\) 2012) internal audit systems had been established in 52 government bodies out of 59. So far only financial audit was carried out, but the new law also foresees expanding to performance compliance audit, though not specifically anti-corruption audits. The biggest challenge has been finding, certifying and training competent internal auditors to fill the new positions both at the central and local level public administration bodies. The universities do not provide a specialized knowledge in the field. The gaps are filled in by ad hoc trainings. Starting from January 1\(^{st}\) of 2013, internal audit systems have been rolled-out to municipalities and are now covered by 44 out of 48 municipalities\(^{107}\).

At present (in 2013), the Government is in the process of drafting a law on “Financial management and control” and “Financial Inspectorate”. Overall, these reforms have also been integrated in the recent Government Programme adopted in May 2013\(^{108}\).

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\(^{104}\) RA MoF, 2011. Report on results of activities carried out by the ministry of finance of the RA in 2011.


\(^{107}\) ICF GHK Mission to Yerevan, 5-8 May 2013, Interviews with international donors.

\(^{108}\) ICF GHK Mission to Yerevan, 5-8 May 2013, Interviews with international donors.
| Evidence of Implementation deficit | No evidence of implementation deficit encountered so far. The continuous professional training for the public sector internal auditors has become a part of the 2013 priority actions of the Government of Armenia. |
| Relevance | The principal rationale was the strengthening of internal audit and financial management functions across the government institutions still perceived as not sufficiently effective, also in the reports of external assessors. |
| Importance | OA highly prioritised the establishment and functioning of CHU in accordance with PIFC concepts. The CHU having the clear status and authority as well as independence from the Ministry of Finance would provide the required guidance, streamline the audit process as well as improve its transparency and effectiveness. |
| Domestic ownership & donor support | PIFC reforms were not specifically targeted in government action plans or strategies, yet the government did commit itself to implement anti-crisis and strategic development programs with maximum accountability and transparency. PFM and PIFC reforms have been supported by the international community and numerous projects have been defined and funded by organisations including the World Bank, EU, DFID, the US Treasury and the GIZ. Armenia-EU ENP Action Plan has a focus on improving the RA PIFC system and PFM is also a priority in the ENPI in the 2007-2013 country strategy. EU SIGMA experts were also involved in preparing concept papers on new legislation on financial inspection and on financial management and control. An EU-funded twinning project will start at the end of 2013. |
| Added Value of MFA | MFA conditionality enforced de facto implementation of CHU role as outlined in the law (Government Protocol Decree 1146 of 19 August 2010). |
| Evidence of benefits | None identified yet as benefits accrue over a longer period of time as they by nature imply institutional change. |
| Evidence of long-term Impacts | No evidence as yet. Rapid reforms in PIFC are not possible to implement and a time perspective of 5 to 10 years is envisaged as a minimum. |

112 ICF GHK Mission to Yerevan, 5-8 May 2013, Interviews with international donors.  
**Condition 5:** The Chamber of Control (CoC) adopts an Action Plan with deliverables for improving its working practices in line with the INTOSAI standards.

**Implementation**

Based on technical work conducted with support from SIGMA experts (who visited Armenia in March 2011) the Chamber of Control prepared a Strategic Development Plan (SDP) and an Implementation Action Plan (IAP) for the years 2011-2016. The two documents were approved by a Chamber of Control in June 2011 by Decree 19/5 of the Chamber of Control. The SDP includes five strategic goals:

- To improve the legal framework regarding external public audit, and thereby improving its effectiveness within the Government of Armenia;
- To ensure the continuing impartiality and independence of the CoC and, in particular, of the Board of CoC, taking into account the organization and structure of the CoC;
- To develop the level of professionalism of CoC staff and their capacity to undertake audits that meet international auditing standards;
- To improve the logistical support of the CoC, with particular regard to Information Technology, premises and transport services; and
- To ensure effective collaboration with the legislative, executive and judicial bodies of the Government, with the other public stakeholders, with civil society, with sister Supreme Audit Institutions; and with donor and other international organizations.

**Evidence of Implementation deficit**

The condition has been met on paper but several stakeholders consider that the ability to perform in accordance to the standards is to be improved, and at present progress has been achieved at the level of principle. A key constraint is lack of change management capacity and the lack of full implementation of the International Standards of SAI (ISSAI) on the full independence of the CoC (functional, organisational, financial).

**Relevance**

Improvement and compliance with INTOSAI standards was recommended in the Operational Assessment conducted in March 2010. The key rationale was to increase the effectiveness and transparency of the external audit. At present Chamber of Control is independent in principle but for example annual audit plans are approved by the National Assembly rather than by CoC itself, and the organisation is dependent on its budget by the Government.

**Importance**

It was indicated that financial and methodological independence of Chamber of Control, whose work depends on the National Parliament, should be enforced. The need of improvement in external audit was also highlighted by the OA. The procurement and construction sectors for example have a large share of the government funds, and accurate audit is

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115 ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.

116 PwC, 2010. Armenia Operational Assessment
important to address any potential risks of corruption.

<table>
<thead>
<tr>
<th>Domestic ownership &amp; donor support</th>
<th>The support in this area is led by SIGMA, but other donors such the World Bank, GIZ and NL SAI also support related reforms. In comparison to PIFC, external audit is much less developed in Armenia(^\text{117}).</th>
</tr>
</thead>
<tbody>
<tr>
<td>Added Value of MFA</td>
<td>SIGMA has been important in developing the Action Plan, whereas the World Bank, GIZ and NL SAI have been important in supporting the implementation.(^\text{118}) The role of MFA is complementary to that of SIGMA, by enforcing the adoption of the Action Plan.</td>
</tr>
<tr>
<td>Evidence of benefits</td>
<td>No evidence can be detected at this stage – this is a longer term institutional reform. However, there have been some improvements in that the government has implemented the recommendations from the CoC, such as improvements concerning the social system. The CoC has also raised some serious concerns concerning the public procurement, in particular concerning the construction sector, which was debated in the Parliament.</td>
</tr>
<tr>
<td>Evidence of long-term Impacts</td>
<td>No evidence can be detected at this stage – this is a longer term institutional reform.</td>
</tr>
</tbody>
</table>

\(^\text{117}\) ICF GHK Mission to Yerevan, 5-8 May 2013, Interviews with international donors.  
\(^\text{118}\) ICF GHK Mission to Yerevan, 5-8 May 2013, Interviews with international donors.
Figure 24: Intervention Logic – Public Procurement Reform (Condition 6)

**Rationale for the Reform**

- Lack of efficiency and transparency of the public procurement system
- Excessive centralisation of the procurement process with one agency responsible for all government institutions
- Low quality of tender documents and lengthy processes due to the excessive possibility of complaints during the procurement process

**Output(s)**

- Adopting legislation which corresponds to EU standard and allows accession to the WTO Procurement Agreement
- Establishment of a Board of Appeal which includes representative from the government and the Third Sector

**Immediate Benefits**

- Improved functioning the public of procurement system

**Outcomes & Impacts**

- More efficient spending of public money
- Increased transparency of public procurement
- Improved access to public tenders for Armenian as well as foreign companies
Condition 6: The Government submits to the Parliament the legislation which complies with the EU Directives and international standards, enabling administrative bodies to conclude contracts with tenders and establishing an appeal body for dealing with public procurement complaints.

Implementation

The Law "On Procurement" was adopted by the National Assembly on 22 December 2010 and came into effect on 1 January 2011. The new Law corresponded to the EU Standards and its adoption allowed Armenia’s accession to the WTO Procurement Agreement. Under this Law, the procurement system was entirely decentralised: all the state authorities procure independently. Also, the Law established an independent Board of Appeal where not only the state authorities are represented, but also the communities, the Central Bank and non-governmental organizations representing the private sector.

In February 2011, the Government adopted a decree on the organisation of the procurement process (Government Decree 168-N of 10 February 2011). The procurement package was prepared with support of SIGMA experts. In addition to meeting the conditionality, in September 2011 RA acceded to the WTO Government Procurement Agreement (GPA) and was the first CIS country to adhere to it. The electronic purchases system (software and hardware insurance) of Armenia has been tested and developed. It is planned that state procurements will mostly be carried out by means of this electronic system.

The Law on Procurement introduces a fully decentralised system of public procurement with about 3000 contracting units. The Ministry of Finance remains in charge of procurement regulations, policy and coordination; the new Centre for Procurement Support provides services to contracting Units and to business; and the Procurement Complaint Review Board outside the Ministry solves the appeals related to the bidding processes. However, the law does not ensure full independence of the Board’s members and does not clarify the authority who nominates them.

The e-procurement system became operational for all types of open procurement procedures in 2012.

Evidence of Implementation deficit

At present, the performance concerning implementation of the law cannot be fully measured. However, following can be noted on the basis of EBRD assessment: The new Armenian public procurement laws are modern and reasonably responsive to market challenges, yet not all transparency safeguards recommended by international standards have been adopted in local legislation. In key policy areas, such as public procurement planning and public contract management significant gaps have been identified and should be addressed. Recent amendments to the law and a brand new institutional framework result in a distinctly lower quality of local public procurement practice than expected from a GPA member.

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120 RA MoF, 2011. Report on results of activities carried out by the ministry of finance of the RA in 2011.
121 RA MoF, 2011. Report on results of activities carried out by the ministry of finance of the RA in 2011.
122 ICF GHK Mission to Yerevan, 5-8 May 2013, Interviews with international donors.
The Chamber of Control (CoC) Report 2012 that was issued on 29 March 2013 highlights the lack of efficiency and effectiveness of the procurement systems and systemic problems in the systems application. Moreover, the report reveals that the reform to introduce an e-procurement system has been carried out since 2004 with little results to date. Currently, a new initiative for e-procurement system reform is being developed within a new timeframe 2013-2015 that aims at improving the system. EBRD, WB, USAID, ADB, EU/SIGMA, EU/TAIEX, GIZ are supporting this new plan.124

### Relevance

The procurement system in Armenia was very centralised with one agency responsible for the procurement process for all government institutions. Weaknesses included the quality of tender documents, and length of process due to formal possibility to complain at almost all stages of procurement process. The need to progress toward e-procurement was also highlighted as an area for development.125

### Importance

To increase the effectiveness and provide specific government entities with more flexibility, the reform was intended to bring more decentralisation. At the same time the reform was intended to improve the public procurement practices and make the process more effective and transparent.

According to information received, there are approximately 300 products for which price ceilings have been established, resulting in approximate savings for the period May - July 2013 at 160 million AMD (circa EUR 3 million)126.

### Domestic ownership & donor support

Several actors are involved in the area of public procurement reform, including OECD SIGMA, the EU, ADB, USAID and the EBRD. There is also a domestic ownership in the area given that Armenia completed GPA negotiations became a party to GPA in September 2011, which is a major achievement in the EBRD region.127

### Added Value of MFA

The main driver was WTO GPA. The new laws would have been adopted regardless of the MFA, which is also implied by the adoption of the legislation prior to the signature of the MoU between the EU and Armenian Government.

### Evidence of benefits

No statistics are available but key progress includes that the review body has 20 days to resolve disputes and is accessible with 70 euro fees.

### Evidence of long-term Impacts

No evidence can be detected as yet.

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124 ICF GHK Mission to Yerevan, 5-8 May 2013, Interviews with international donors.
125 PwC, 2010. Armenia Operational Assessment
126 ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.
Figure 25 Intervention logic – Tax Administration Reform (Condition 7)

Rationale for the Reform

- Chronically low tax revenue
- Need to enhance revenue collection, identify new sources of taxable income, decrease operational costs and improve overall integrity of the taxation system

Output(s)

A time-bound Action Plan accompanied with budget allocation for upgrading tax administration in the areas of: risk based tax audits, cross-checks, development of economic databases and information sharing, e-filing evaluation of tax audits’ efficiency, establishment of taxpayers centres and training of the personnel

Immediate Benefits

- Easier tax filling system
- Improved support for taxpayers
- Better and more accurate data, better overview of tax collection

Outcomes & Impacts

- Higher government revenue
- Better supervision of the tax system
- More efficient tax administration
**Condition 7:** The Government adopts a sequenced and time-bound Action Plan for upgrading tax administration in the areas of: risk-based tax audits, cross-checks, development of economic databases and information sharing, e-filing, evaluation of tax audits’ efficiency, establishment of tax-payers centres and training of the personnel on the above issues. Such Action Plan should be accompanied by respective budget allocations for each action in the Budget of 2011.

**Implementation**

In May 2011 Tax System Reform Programme for 2011-2013 was adopted by decree of the President of Armenia (Decree 92-N). The strategy includes the harmonization of tax laws and measures in the areas of voluntary compliance and simplification of procedures, strengthening of tax collection, development of risk-based tax audits, changes in the structure and organisation of the State Revenue Committee (SRC), development of information technologies, etc. In July 2011 SRC prepared an Action Plan for the period 2011-2013. MoF and SRC conducted consultations on funding sources for the Tax Reform Programme. An additional amount of AMD 2,780 million (approximately EUR 5.4 million) was allocated to the SRC budget of 2011.

Since January 2012 VAT taxpayers are required to file electronically. White paper was issued detailing measures and costs of addressing mixed cash and accrual accounting for VAT and refunding or offsetting excess VAT credits (structural benchmark)\(^{128}\).

In line with 2012–14 tax administration strategy, the Government will continue to decrease the number of field offices—by up to 5 offices in the regions and expand service centres and extend e-filing. It is envisaged that e-filing will be made available for all types of tax returns. The Government aims included that 40% of all tax returns would be filed electronically by end-2012, increase from less than 10%.

The anticipated goals include that by end of 2013, over 90 per cent of tax returns would be filed electronically, whereas from 2014 all tax payers are obliged to submit their return electronically. In line with this, tax-payers centres will be expanded with services being offered throughout the country using existing courier services offices (ca. 600 across Armenia)\(^{129}\).

**Evidence of Implementation deficit**

No direct implementation deficit encountered for the specific conditionality but generally tax revenue collection is extremely low in Armenia as compared to its peers. The IMF fifth review under the ECF/EFF programme indicates that although the Armenian authorities have taken steps to strengthen and modernise tax policy and revenue administration, including enactment of a new mining royalty, adoption of risk-based approaches in tax and customs administration, initiation of e-filing and taxpayer service centres, and formation of a high-level tax appeals committee, these actions have not translated into significantly higher revenues collected in a business-friendly manner. Collections remain 4–6 percentage points of GDP below regional and international comparators.

**Relevance**

Tax administration in Armenia is seen as performing far below the appropriate level, also when compared to its neighbours (i.e. Georgia). Tax collection accounts for just over 20% of GDP in Armenia when the rate in Georgia is about 26% of GDP. In addition, in the context of the crisis, tax revenues between 2008 and 2009 decreased by about 15%.

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\(^{128}\) Republic of Armenia, 2012. Letter of Intent and Technical Memorandum of Understanding May 2012 (in the context of its request for financial support from the IMF)

\(^{129}\) ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.
## Importance

The plan envisaged specifically: enhancement of revenue collection, identification of new sources of taxable income, decrease of operational costs and the overall improvement of the integrity of the taxation system. Moreover, the process for tax filing and tax-payers services are ultimately improved a great deal impacting every tax paying citizen and VAT compliant company. The new e-tax system also incorporates a direct link to calculating pension contributions under the new three-pillar pension system, and is furthermore operated on the basis of improved analytical capability with respect to risk-based audits.

## Domestic ownership & donor support

Tax revenue collection and administration is an area that all donors agree should be improved. The IMF has several structural benchmarks regarding tax administration reform attached to SBA as well as EFF/ECF facilities. World Bank has supported tax administration reform in particular concerning e-filing. The reform also has domestic ownership, in particular when it comes to e-filing.

## Added Value of MFA

MFA has reinforced reforms in the revenue mobilisation and simplification of procedures but its specific impact is difficult to disentangle the overall reforms in this area. The main added value comes from a joint leverage that IFIs have in this area.

## Evidence of benefits

There has been moderate success in increasing tax revenue to GDP ratio by approximately 2 percentage points between 2006 and 2010. Armenia has also made some progress in paying taxes as captured by the improved Doing Business rating for 2013 where Armenia scored 108 moving from 152 in the preceding year. One of the main benefits has been implementing the e-filing of tax returns which will benefit every tax paying citizen and VAT compliant company.

## Evidence of long-term Impacts

No evidence of longer terms impacts have been identified.

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130 ICF GHK Mission to Yerevan, 5-8 May 2013, Interviews with international donors.
Figure 26 Intervention logic - Tax Policy Reform (Condition 8)

Rationale for the Reform

- Discriminatory taxation of imported tobacco products and custom duties on imported tobacco (24 per cent) above Armenia’s WTO bound rate (15 per cent)
- Ukraine’s complaint under the WTO dispute settlement mechanism
- Preparations for DCFTA negotiations with the EU where the issue would need to be addressed

Output(s)

- Non-discriminatory taxation of domestically produced and imported tobacco products, in full compliance with WTO rules

Immediate Benefits

- Easier market access in Armenia for tobacco – removal of preferences for domestic producers
- Lower prices of imported tobacco
- Removing an obstacle to DCFTA negotiations

Outcomes & Impacts

- More competition in the Armenian tobacco market
- Lower domestic tobacco prices (ceteris paribus)
**Condition 8:** The government takes the necessary actions to ensure non-discriminatory taxation of domestically produced and imported tobacco products, in full compliance with WTO rules and Armenia’s undertakings. The government will provide the evidence of effective compliance.

| Implementation | In October 2010 amendments to the three laws relevant for the taxation of tobacco products: “On Excise Tax”, “On Presumptive Payments for Tobacco Products” and “On Value Added Tax” were made. The amended laws stipulate a phasing out of presumptive payment rates for domestic tobacco products over the years 2011 – 2013 and an introduction of new formula for calculating VAT on tobacco products. In December 2010 the government adopted a decree stipulating that, pending the entry in force of the amended taxation rules, the implementation of the current system of presumptive taxation should not result in ad valorem import duties of more than 15 per cent (Armenia’s WTO bound tariff). Since January 2011 new method of calculation has been used by the State Revenue Committee (SRC). During 2011-2013 a timetable existed for phasing out of presumptive payment rates, and from January 2014 the same rate will be used for excise tax; 500 AMD per 1000 cigarettes. |
| Evidence of Implementation deficit | None. In July 2011 mission conducted by EU trade experts (financed by TAIEX) concludes that the Government Decree of December 2010 and the new method of calculation used by the SRC ensure that Armenia meets its WTO commitment on the bound ad valorem tariff of 15 per cent. |
| Relevance | Armenian authorities maintained the uneven tax treatment between domestically produced and imported tobacco products putting foreign producers in clearly disadvantaged position and breaching the WTO rules. |
| Importance | The practice was in breach of WTO rules to which Armenia is a member. In July 2010 Ukraine filed a complaint under the WTO dispute settlement mechanism. |
| Domestic ownership & donor support | The EU was driving the reform through the framework of Armenia’s preparations to the negotiations of the Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU. The issue did not have a strong domestic ownership. |
| Added Value of MFA | MFA reinforced the reform. Faster progress on addressing the issue of tobacco products compared to an analogous problem with alcoholic beverages may suggest a role played by the MFA. MFA condition only related to tobacco products not to alcoholic beverages. |
| Evidence of benefits | Armenia is in compliance with the WTO rules. |
| Evidence of long-term Impacts | None identified as of yet. |

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131 ICF GHK Mission to Yerevan, 5-8 May 2013 and 18 July, Interviews with the RA government officials.
Figure 27 Intervention logic – Customs Policy Reform (Condition 9)

Rationale for the Reform

Excessive use of reference custom valuation instead of actual transaction values
Preparations for DCFTA negotiations with the EU where the issue would need to be addressed

Output(s)

Effective implementation of the customs valuation system, that in operational terms, adheres strictly to the conditions of the WTO Valuation Agreement is based on transaction value and proper valuation methods

Immediate Benefits

Easier market access in Armenia especially for products for which valuation was most problematic
Greater transparency in customs valuation procedures – lower trade barriers
Removing one obstacle to DCFTA negotiations

Outcomes & Impacts

More competition in the Armenian market
Lower domestic prices especially products for which customs valuation was most problematic
Improved business climate in Armenia
Condition 9: The Government implements customs valuation system, that in operational terms, adheres strictly to the conditions of the WTO Valuation Agreement (Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade of 1994) and is based – as a matter of principle – on transaction value and proper valuation methods set out in Article 1 to 7, in sequence. The implementation of the customs valuation system according to the above rules will entail progressive development of risk-based post clearance valuation controls.

Implementation

In 2011 a new rule was introduced obliging the Customs Service (part of the SRC) to accept or reject within two days a customs declaration based on transaction values. In case of no decision over 2 days, declared customs value should be considered as accepted.

Furthermore, although with some delay, National Authorities provided statistical data on number of transaction valuation methods applied which were instrumental for the EC. According to this data, 4 valuation methods were practised with the following frequency in 2010 and 2011:

- transaction price method: (67.8 per cent in 2010 and 68.4 per cent in 2011).
- transaction price of the same goods: (2.8 per cent in 2010 and 3.4 per cent in 2011).
- transaction price of similar goods: (1.9 per cent in 2010 and 2.1 per cent in 2011).
- calculated value: (27.5 in 2010 and 26.1 in 2011).

In addition, guidelines and manuals clarifying the customs procedures providing access to relevant information were published and the risk-based post-clearance valuation controls were developed, but not yet fully implemented.

On 5 December, 2012 the law on RA Customs Code amendments was adopted (signed by the President on 22 December, 2012). This legislation is mostly related with changes in customs valuation field. It came into force on 6 January 2013.

Evidence of Implementation deficit

There is some level of implementation deficit. According to Armenian official statistics, 90% of the EU goods are cleared using the Transaction value method. However anecdotal evidence provided by one stakeholder suggests that almost 50% of western businesses are still subjected to reference prices according to independent survey (although on a small sample covering only 12 firms and therefore, not statistically representative). Overall, it is difficult to discern to a full extent the implementation effectiveness as recent statistics are not readily available. Moreover, the existing statistics are difficult to verify as there is no reliable computerized system to verify the different operations. The development of a fully fledge computerized system to clear goods is one of the goals of the reforms.

Relevance

Action was needed in order to improve compliance with the WTO standards, increase of Armenia’s capacity to implement the Free Trade Agreement and more generally improve of effectiveness of Armenian custom authority operations, implementation of best practices for custom valuations, and transparency.

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133 ICF GHK Mission to Yerevan, 5-8 May 2013, Interviews with international donors.
At the time of negotiations these were key issues for Armenia in facilitating their preparedness for fulfilling requirements for the Deep and Comprehensive Free Trade Area (DCFTA) and starting official negotiations concerning the Association Agreement. The preparations for DCFTA had already started in early 2009 at time of the severe financial crisis.

<table>
<thead>
<tr>
<th>Importance</th>
<th>The problem of valuation of imported goods was highlighted as a high priority in the OA. The customs formalities and requirements are based on out of date customs legislation. The reforms in this area could also be seen as important in improving the business environment in the country, particularly when it comes to international trade.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic ownership &amp; donor support</td>
<td>The reform is seen as important by several donors and the EU is leading the reform in the framework of DCFTA. Domestic ownership exists in the context of DCFTA but compliance and implementation is not fully enforced by the relevant customs authorities. Reforms have been supported by the EU through Budget Support programmes, a twining project and the EUAG.</td>
</tr>
<tr>
<td>Added Value of MFA</td>
<td>The customs policy reforms are being led by the EU and MFA is likely to have played role in accelerating the start of the DCFTA negotiations as part of its enforcement of the reform.</td>
</tr>
<tr>
<td>Evidence of benefits</td>
<td>Armenia started the DCFTA negotiations with the EU in May 2012, and in July 2013 EU and Armenia agreed on key elements of the agreement, which will create a new framework for trade relations between EU and Armenia. It has been estimated that the agreement will have significant impacts on Armenia’s trade with 15% increase in exports and 8% increase in imports in the long run. It is also expected that the economy would gain extra €146 million a year, representing a 2.3% increase in GDP.</td>
</tr>
<tr>
<td>Evidence of long-term Impacts</td>
<td>None identified as of yet.</td>
</tr>
</tbody>
</table>

134 Although these benefits are unlikely to be attributable to MFA, it is understood it reinforced the DCFTA accession agenda by preparing Armenia’s readiness for the negotiations. Source for the statistics: Armenia press (24 July 2013) [http://armenpress.am/eng/news/727162/eu-and-armenia-conclude-dcfta-talks.html](http://armenpress.am/eng/news/727162/eu-and-armenia-conclude-dcfta-talks.html)
The above exposition is based on both analyses of documents and interviews with several national and international stakeholders. Differences in views among stakeholders, lack of explicit discussion of certain issues in documents, often very difficult attribution of certain decisions to MFA conditions relative to other forces at play, and inherent uncertainty as regards to observed and future impacts of certain policy measures all limit the precision of possible analysis and suggest certain caution in interpretation of the results.

### 4.1.2 Feasibility of modelling structural reforms

The feasibility of using a model based approach to determine the impact of the structural reforms was assessed during the inception phase. Most of the conditional reforms associated with the MFAs are long-term in nature. They are designed to strengthen various aspects of government (notably debt management, internal and external audit, pension reform, public procurement procedures, tax administration), and assure compliance with international standards with respect to audit, public procurement and tax and customs policies. Although in some cases these reforms could begin to have budgetary or economic implications within the period of interest (2011/2012), at this early stage these impacts would be negligible and not worth attempting to quantify in detail. More generally, the reforms would give the Government greater credibility with respect to their capacity to achieve targets for deficit and debt management, improve transparency, modernise procedures and services and increase confidence in the business environment in the country. This in turn would possibly strengthen investor confidence in the general operating environment for the private sector and support business growth in the country. But this effect should be assessed as part of a view on the general confidence-building impact of the MFAs, rather than related to any specific reforms. Much of the effect would, presumably, only come in the longer term (outside the period of evaluation) as investors wait to see evidence that the reforms are actually implemented.

For these reasons we do not attempt to apply formal economic modelling to the assessment of the MFA contribution to the Armenian structural reform agenda.

### 4.2 Conclusions

On the basis of the analysis presented above, several conclusions can be made of the MFA supported structural reforms in Armenia, the role played by MFA in achieving progress in the reform areas, and the overall appropriateness of the promoted reforms.

Table 25 provides a summary assessment concerning the conditionality, which is further explained in the remainder of this section.

#### Table 25 Conclusions

<table>
<thead>
<tr>
<th>Conditionality</th>
<th>Relevance</th>
<th>Implementation</th>
<th>Impact</th>
<th>EU Added Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt management</td>
<td>++</td>
<td>++</td>
<td>+</td>
<td>?</td>
</tr>
<tr>
<td>Pension system</td>
<td>+</td>
<td>++</td>
<td>++</td>
<td>?</td>
</tr>
<tr>
<td>PIFC</td>
<td>++</td>
<td>+</td>
<td>+</td>
<td>~</td>
</tr>
<tr>
<td>External Audit</td>
<td>++</td>
<td>+</td>
<td>+</td>
<td>~</td>
</tr>
</tbody>
</table>

135 This assessment is done jointly for the adoption of action plan to implement the new debt recording system and the reorganisation of the Public Debt management Department as the two reforms complement each other.
4.2.1 Relevance

All the reforms included as conditionality were relevant at the time of the MFA, both from the perspective of the Armenian authorities and the international development partners. The only reform which may have been of limited relevance as MFA conditionality concerned the pension reform as it is questionable whether MFA could ever have had a real impact in reforming a pension system which is a large long-term national undertaking, and already enjoyed a national level backing prior to the MFA. Reforms concerning debt management and public procurement were relevant at the time of the negotiations and in particular areas which MFA could influence. However, they might have also been undertaken in the absence of the MFA as they were supported by pre-existing government goals, and were completed by the time the MFA was being implemented, given the long negotiation and approval process in agreeing the MoU. It is plausible that the MFA negotiations\textsuperscript{136} might have influenced the shape and / or timetable of the above reforms when they were at an early stage, but this cannot be concluded with certainty in absence of any substantive supporting evidence. Overall, all of the reforms to an extent enjoyed Government backing, and were related to the Government’s own reform agenda.

The process of selecting conditionalities attached to the MFA followed well-established procedures, whereby the conditionality was selected on the basis of the operational assessment carried out by independent consultants on behalf of the European Commission, consultations between the EU and Armenian authorities, as well as through exchange of information between the IFIs, in particular with the IMF and World Bank. However, IFIs did not influence the choice of conditionality selected, which was determined on the basis of a dialogue between the EU and the Armenian authorities.

4.2.2.1 Implementation and impact

The MFA reforms in most instances also related to areas where other international actors were active. Therefore, to an extent, the implementation of the MFA reforms was supported by their actions. Often EU institutions were heavily involved, including the EU Advisory Group, EBRD, EU SIGMA and ENPI. As such, several of the MFA conditions stimulated processes (e.g. enactment of legislation, adoption of action plan), whose achievement was to be fully realised in the near future with the support from other donors.

Overall, in most reform areas, with the exception of customs policy reforms, one or more IFIs were involved in supporting Armenian authorities in their implementation. This was the case for example in:

\textsuperscript{136} According to the official documentation, the dialogue on conditionality started in 2009
Public debt management where the World Bank helped finance the new debt recording system and the training to use the system was carried out by the UNCTAD DMFAS Programme

Internal and external audit where EU SIGMA, World Bank, US Treasury, German GIZ and ENPI for example were providing sustained reform efforts, primarily in the area of implementation

Public procurement which was supported by the EBRD, OECD SIGMA, USAID, and ENPI, and;

Improvements in tax administration, which was also supported by the IMF and World Bank.

In these cases, it is difficult to disentangle the specific role of the MFA in implementation and impact, especially as the conditionality was not formulated with explicit MFA-related objectives in mind.

The above is an important point as at present the MFA’s role cannot be considered independently from the influence of many other factors, which makes it difficult to disentangle the net impact of the MFA in promoting reforms, particularly where their full realisation is longer-term in nature. This is consistent with the findings from the field work in that, although MFA seems to have provided Government leverage to push implementation of the reform, it never seems to have been the sole reason for implementing a reform or a primary force behind it. Overall, MFA appears to have promoted actions that were considered important by other IFIs and the Armenian authorities.

Reforms where the MFA has been identified as reinforcing the timeframe for the adoption of actions, and thereby accelerating the overall implementation timeline, includes the customs policy reforms. This also appears to be an area where international donors considered the EU having considerable leverage through the Deep and Comprehensive Free Trade Agreement (DCFTA) negotiations. The MFA was seen to have reinforced meeting the tax and customs conditionality in a timelier manner than would otherwise have been the case. In the case of tax policy reform, the ongoing MFA negotiations directly impacted on the adoption of a government degree to cease discriminatory practice between domestically produced and imported tobacco products in January 2011\(^{137}\). As to the customs policy reform, although there are concerns with the appropriateness of the implementation of the customs valuation system, and reliable data is hard to come by, the procedures and systems for import have improved in comparison to the situation before. This is also exemplified through the subsequent commencement of the DCFTA negotiations with the EU.

The MFA is also seen to have reinforced the timely adoption of an action plan concerning tax administration, with tangible impacts to the Armenian citizens through the implementation of tax services centres and e-filing of tax returns.

Overall, the focus of conditions on initiation of an action or process, without specifying what success would look like, and the absence of explicit specification of concrete (and where possible, measurable) objectives behind given conditions limit the possibility to verify MFA outcomes in the area of structural reforms. Specifying such objectives would make it easier to assess MFA impact but also potentially to communicate the

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\(^{137}\) This reform was completed a month prior to the signature of the MoU in February 2011, but retained as a condition to signify MFA’s role in its achievement. The study has taken the view that it would not be appropriate to assert that the tax policy reform should not have been retained as a condition, given that it was achieved on paper prior to the signature of the MoU. The MFA had played a direct role in its timely adoption, and analysis of the implementation has concluded that during 2011-2013 a timetable existed for phasing out of presumptive payment rates, and from January 2014 the same rate will be used for excise tax; 500 AMD per 1000 cigarettes.
impacts of MFA to the wider public. In comparison, the IMF for example, has structural benchmarks and prior actions assigned to its assistance which provide a concrete framework to consider the assistance. This issue is taken up in the final recommendation section of this report.

4.2.3 Added Value

From the perspective of the reinforcing effect of the MFA, all conditions required some level of domestic support, and where domestic ownership was high, it is highly likely that these reforms would have been undertaken by Armenian authorities even in absence of the MFA. This was particularly the case with the pension reform, which was already part of the Government Programme 2008-2012. That said, the MFA was negotiated at the time when the government was considering the specific design of the pension system and the MFA may have contributed to this process. In addition, the Government had already committed to debt management and public procurement reforms. Public procurement legislation compliant with the EU Directives and international standards was already adopted in December 2010, and effective from January 2011, prior to the signature of the MoU. The Armenian Government had also agreed to acquire a new debt recording system financed by the World Bank before the signature of the MoU, even if the system itself was installed at a later date. It should be clarified that these conditionalities were relevant when the discussions on MFA first started in 2009. However, they were completed by the time the MFA was being implemented. Overall, reforms in some areas progressed more quickly than the MFA negotiations, and in these areas, it is particularly difficult to identify the added value of MFA reforms. It is plausible that the MFA negotiations might have influenced the shape and or timetable of these reforms when they were at an early stage, but this cannot be concluded with certainty in absence of any substantive supporting evidence.

EU Added Value is difficult to disentangle from the PFM reforms on internal and external audit. In these areas the MFA reinforced the internationally agreed reform agenda in which a number of international actors are involved to support the Armenian Government. The MFA may have helped to support the implementation timeframe, although this is difficult to validate.

The Added Value is most visible in customs policy reforms, possibly also reinforced by the fact that it is an area where the EU is seen by the international community to drive these reforms. The MFA was seen to have reinforced meeting the tax and customs conditionality in a timely manner and prepare Armenia’s accession for the DCFTA negotiations. The fulfilment of tax and customs policy reforms was effectively part of the preconditions for the DCFTA negotiations. The most tangible impacts can be seen in the subsequent commencement of the DCFTA negotiations in May 2012 and their completion in July 2013.

To maximise EU added value in the future, MFA could provide further leverage to ENPI, particularly as in financial terms it is sizeable. This is particularly relevant where many of the reforms are longer-term undertakings, and by nature their impact cannot be assessed in the short-term. Within this context the EU stakeholders also pointed out that there is a greater coherence to be had across the EU instruments, whereby

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138 According to the official documentation, the dialogue on conditionality started in 2009
139 WTO membership, and adherence to its rules, is a precondition to entering negotiations on DCFTA with the EU.
140 It should be noted that the political context changed dramatically during the final stages of the evaluation. On 3 September 2013, the Armenian president announced Armenia’s intention to join the Russian-led “Customs Union,” thereby ending any possibility of forging the pending Deep and Comprehensive Free Trade Area (DCFTA) element of the Association Agreement between the EU and Armenia.
141 Although the specific condition can be fulfilled in a short-time span, the implementation can only be assessed in the future.
the MFA could be capitalised more for the purposes of EU political leverage. This might help condition the reforms in the future so that they would tie into the implementation timetable of a wider reform agenda more explicitly, such as the ENPI budget support.

Moreover, the EU could have more actively promoted reforms concerning the business environment where it is considered to have leverage. One omission from the conditionality has potentially been the lack of direct support for the business environment. Many international stakeholders and local NGOs have pointed out for example that the focus could have more strongly been on improving the business environment, in particular as the economy is characterised with a chronic lack of competition in the market and the EU specifically is seen to have political leverage over this issue.

The choice of reforms has not been identified to have led onto any unforeseen implications.
5 Design and Implementation Issues

5.1 Preparation of the operation

The MFA operation was prepared in full consideration of the large financing needs faced by Armenia and in close co-operation with the IMF, other EU institutions and the Armenian authorities.

An ex-ante evaluation of Armenia’s financing needs in 2009 concluded that the large financing needs faced by Armenia were a justification for urgent action. In determining the actual amount of the tranches under the MFA programme, the Commission services took into consideration the financing gap identified by the IMF, progress in the implementation of the IMF programme and of the World Bank development policy loans, as well as the timeframe of other main donors supporting Armenia with budget support in order to effectively coordinate the MFA operation.

The commitment for EU MFA operation was communicated end of November 2009 when the Council Decision on providing MFA came into force. The first fact finding mission to Armenia took place three months later in February 2010 to scope the issues to be included in the MoU as conditionality. The Operational Assessment performed by external contractor in February 2010 assessed the needs concerning public finance management reform and contributed to the definition of appropriate conditionality in this area. Shortly after, DG ECFIN team’s visit in Armenia followed, also in order to assess and discuss the possible areas of conditionality to be included in the MoU. The list of conditions was sketch out and further refined also during the discussion within the EU-Armenia Sub Committee on Trade, Economic, Legal and other related issues which took place in June 2010. Moreover, the EU worked in close collaboration with the IMF regarding the timing and form of the assistance. Coordination was undertaken with the World Bank concerning the conditionality of the MFA, which was less relevant in the case of the IMF as the MFA disbursements were conditional upon the IMF programme being on track. Negotiation between IMF and World Bank focussed on short-term financial stability. The final list of MFA conditions was agreed in the MoU signed in February 2011.

All in all, the EU MFA operation was considerably delayed. The MoU was signed in February 2011, 15-months after the coming into force of the Council Decision, which was also 12 months after the fact-finding mission. The EU MFA came a year after the IMF had changed their programme parameters, as part of moving from SBA to the combination of EFF and ECF from June 2010 onwards. The delay in EU MFA was primarily due to the longer time taken in the negotiation of the MoU which took over half a year, as did its ratification. However, the MFA was not subjected to the new rules under Lisbon Treaty of requiring the European Parliament’s approval, as the operation itself was approved prior to coming into force of the Lisbon Treaty. One explanation for the long gestation period could be that the crisis had abated and there was therefore, little urgency on part of the Armenian authorities to sign the MoU, as evident from the timeline of the negotiation process. The table below highlights the overall key actions surrounding the design and implementation of the MFA operation, whereas sections 5.1.2 and 5.1.3 describe the specific aspects of the design and implementation of the operation.

142 Commission Staff working document [COM(2009)531 Final]. Ex-ante evaluation statement: Macro-financial Assistance to Armenia
<table>
<thead>
<tr>
<th>Phase</th>
<th>Timing</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preparatory phase</td>
<td>24 February 2009</td>
<td>Armenian Minister of Finance, Tigran Davtyan requests the MFA assistance.</td>
</tr>
<tr>
<td></td>
<td>16 September 2009</td>
<td>Positive review of Armenian request by Economic and Financial Committee.</td>
</tr>
<tr>
<td></td>
<td>17 August 2009</td>
<td>EC submits note to EFC regarding its intention to submit to the Council a proposal for MFA</td>
</tr>
<tr>
<td>Political approval</td>
<td>30 November 2009</td>
<td>Positive Council Decision on providing EU MFA to Armenia in amount of EUR 100 million (EUR 35 million grant component and EUR 65 million loan component)</td>
</tr>
<tr>
<td>Design and negotiation</td>
<td>24-26 February 2010</td>
<td>DG ECFIN mission to prepare the implementation of the MFA operation.</td>
</tr>
<tr>
<td></td>
<td>15 March 2010</td>
<td>Conclusions from Armenia Operational Assessment prepared by PwC concerning the identification of potential conditions that could be aligned to EU MFA – key identified areas are public finance management and improvement in the tax administration system.</td>
</tr>
<tr>
<td></td>
<td>April 2010</td>
<td>Draft MoU between the EU and Government of Armenia is prepared</td>
</tr>
<tr>
<td></td>
<td>16-17 June 2010</td>
<td>Further DG ECFIN discussion with Armenia Ministry of Finance in Yerevan regarding the MFA conditionality</td>
</tr>
<tr>
<td></td>
<td>20 July 2010</td>
<td>Government of Armenia submits its comments on draft MoU</td>
</tr>
<tr>
<td></td>
<td>8 August 2010</td>
<td>EU response to Armenia</td>
</tr>
<tr>
<td></td>
<td>December 2010</td>
<td>Grant Agreement is signed</td>
</tr>
<tr>
<td></td>
<td>15 February 2011</td>
<td>Signature of memorandum of Understanding between Armenia and EU including definite list of conditions.</td>
</tr>
<tr>
<td>Implementation</td>
<td>July 2011</td>
<td>Disbursement of first tranche of EU MFA in amount of EUR 40 million (EUR 14 million grant and EUR 26 million loan)</td>
</tr>
<tr>
<td></td>
<td>26-28 October 2011</td>
<td>DG ECFIN fact-finding mission express satisfactory fulfilment of all condition but one where significant progress was made though. Hence, it recommends the disbursement of second tranche of the EU MFA.</td>
</tr>
</tbody>
</table>
5.1.2 Design of the operation

In consideration of the design of the MFA operation, three aspects have been important: timeliness of the operation, the size of the assistance and lending terms, as well as the conditionality attached onto the disbursements.

5.1.2.1 Timeliness of the operation

Although from a crisis point of view the EU MFA came late (when the acute phase of the crisis was over), it was still highly relevant in 2011 to meet the financing needs of Armenia and support the gradual economic recovery. But, in the context of the IMF’s assessment of the financing gap, the preferred situation would have been a more timely disbursement of the EU MFA in 2010. In the case of Armenia, the IMF managed to disburse large amounts of assistance in a short period of time (over a period of 12 months), which however amounted to a large share of the Armenian GDP (approximately 5 per cent) – a situation which is typically avoided by the IMF.

In the case of EU, the early commitment to the funding (announced in Council Decision end of November 2009) was important at signalling that EU assistance would be made available to Armenia, and which allowed the IMF to frontload its financial assistance.

Other IFIs were able to act promptly in the onset of crisis, in the context of which the EU MFA was disbursed late. Figure 28 shows the timeline of the disbursements made by the development partners.

Figure 28 Overview of the timeline of disbursements

<table>
<thead>
<tr>
<th>Timing of IFI assistance</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>IMF - SBA</td>
<td>Q1</td>
<td>Q2</td>
<td>Q3</td>
<td>Q4</td>
</tr>
<tr>
<td>IMF - ECF</td>
<td>Q2</td>
<td>Q3</td>
<td>Q4</td>
<td>Q1</td>
</tr>
<tr>
<td>IMF - EFF</td>
<td>Q4</td>
<td>Q1</td>
<td>Q2</td>
<td>Q3</td>
</tr>
<tr>
<td>WB</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan from Russia</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ADB- Crisis recovery support</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU MFA (loan + grants)</td>
<td>Q1</td>
<td>Q2</td>
<td>Q3</td>
<td>Q4</td>
</tr>
<tr>
<td>ENPI (grants)</td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>

There is consensus among several stakeholders concerning the need for faster procedures in the EU for the MFA to act as an effective crisis instrument. In fact some stakeholders question the positioning of MFA as a ‘crisis instrument’. At present, it is perceived to be most helpful in longer-term crisis situations.

5.1.2.2 The size and lending conditions of the EU MFA

The size of the EU MFA of EUR 100 million disbursed between Q3 2011 – Q1 2012 was significant, corresponding to about 1.7 per cent of the Armenian GDP in the same period. The first disbursement of EUR 40 million in Q3 2011 amounted for 2 per cent of GDP in that quarter, whereas disbursement of EUR 60 million in Q1 2012 amounted
for 5 per cent of GDP in the same quarter. It is also sizeable in the context of other budget support provided to Armenia at the time of the crisis, and considering the quick succession of disbursement of the MFA within a six-month period:

- ENPI budget support totalled to about a third of the EU MFA (EUR 40 million) over the period of Q4 2009-Q4 2012;
- World Bank’s Development Policy Lending equalled to EUR 124 million between Q4 2009 and Q2 2012, the disbursements were spread between 2009, 2011 and 2012; and
- The ADB’s anti-crisis support totalled ca. EUR 55 million in Q4 2009.

Only the total IMF package (ca. EUR 399 million over Q1 2009 to Q4 in 2012) and the Russian loan (ca. EUR 352 million over Q2-Q4 in 2009) were considerably more sizeable than the EU support. Overall, EU MFA made up of about 9 per cent of the entire budget assistance provided to Armenia between 2009 and 2012.

The lending terms of the EU MFA were also considered favourable by the Armenian Government, which made it an attractive form of funding. The grant component of the MFA was considered especially helpful in the context of increased debt burden and the need to consolidate public spending. In line with the IMF’s concessional resources as part of the combined ECF/EFF intervention, the EU MFA offered a 35 per cent grant element – 5 per cent above the minimum 30 per cent grant element required by the IMF. The MFA also fit in well with gradual fiscal adjustment favoured by the IMF so as not to endanger recovery.

5.1.2.3 Conditionality relating to the operation

The factors affecting the choice of conditionality, the focus of conditionality and the role played by MFA in achieving progress in the reform areas, have already been discussed in detail in section 4. The choice of conditionality in nine reform areas focusing on the areas of debt management, pension and tax administration reform, internal and external audit, public procurement and tax and customs policy have been judged as broadly appropriate.

However, there remains a fundamental question on the de-facto positioning of the MFA instrument and how it can reconcile the purpose of providing crisis support and promoting reforms/ institution building in beneficiary countries. One particular area where several stakeholders interviewed in the evaluation process expressed their views related to the fact that the way which the conditions were formulated did not allow for their clear measurement and in principle their real impacts were to be realised in the medium to longer-term. This means that although the condition areas were broadly appropriate, their meaningfulness on leading onto specific EU or MFA attributable impact was often unclear, perhaps with the exception of the customs and tax policy reforms. On the other hand, customs reforms form a significant undertaking as part of Armenia’s accession to the DCFTA, and are also covered via other EU assistance. The ethos of MFA focuses on short-term macro-economic stabilisation but its true value in contributing to structural reforms’ outcomes seem to come from its reinforcement effect, which somewhat masked as the intended objectives of the assistance are not made explicit.

The MFA operation was linked to the IMF programme, supportive of ENPI, and as was discussed in section 4, the coordination of selection of conditionality between the MFA and other donors ensured complementarity without direct overlap.
5.1.3 Monitoring and implementation

The EU MFA was effectively implemented over six months between July 2011 and February 2012, although the process of preparing and designing the operation started 15-months before from December 2009 after the coming into force of the Council Decision. Both the disbursements were made as initially planned, and no delays occurred in this respect. Overall progress in the reforms prescribed within the MFA package was seen by the European Commission as broadly satisfactory.

Monitoring of the progress in the fulfilment of the abovementioned conditions was based on the progress reports on reforms, compliance statements of Armenian authorities, and on-filed missions performed by European Commission experts. Annex 2 provides a detailed overview of the monitoring of the MFA conditionality upon which the financial assistance was conditional. In parallel, monitoring of following key macroeconomic and financial indicators was also conducted (see Table 27).

From the perspective of the Armenian authorities the MFA operation was well monitored and managed but the delay in agreeing and approving conditionality was not desirable and effective. Although the funding was needed in 2011 when it was disbursed to support the gradual economic recovery, the delay meant that the Government needed to rely on the IMF to frontload their assistance. The delay was also longer than expected from the IMF’s perspective, despite Fund’s experience with previous MFA operations.

Table 27 Key macroeconomic and financial indicators monitored through the assistance period

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Frequency of revision</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP or national income</td>
<td>Yearly data or quarterly data if available</td>
</tr>
<tr>
<td>Main component of GDP</td>
<td>Yearly data</td>
</tr>
<tr>
<td>Price indicators</td>
<td>Monthly when available</td>
</tr>
<tr>
<td>Employment and unemployment rates</td>
<td>When available</td>
</tr>
<tr>
<td>Interest rates</td>
<td>Monthly</td>
</tr>
<tr>
<td>Level and composition of government revenue and expenditures as well as government payment arrears</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Foreign trade</td>
<td>Monthly</td>
</tr>
<tr>
<td>Balance-of-payment</td>
<td>Quarterly</td>
</tr>
<tr>
<td>International reserve position</td>
<td>Monthly</td>
</tr>
<tr>
<td>External public debt including external arrears</td>
<td>Monthly</td>
</tr>
<tr>
<td>Domestic public debt and debt service</td>
<td>Monthly</td>
</tr>
</tbody>
</table>

Source: Annex 1 of signed Memorandum of Understanding between European Commission and the Government of Armenia
6 EU Added Value

This evaluation has identified added value of the EU assistance provided in the form of the MFA operation in several areas which are described in this section.

At the time of the ex-ante evaluation of the MFA assistance in 2009\(^{145}\), the Commission considered that by providing financing complementary to resources made available to Armenia by the IMF and the World Bank, the EU would support Armenia’s domestic efforts of responding to the impact of current global economic crisis and by doing so it would encourage and strengthen the implementation of the Armenia’s reform programme. Moreover, the effect of the EU’s involvement would be strengthened as a result of the synergy with other Union programmes aiming at supporting Armenia’s poor fiscal situation, in particular the ENPI budget support grants. The macro-financial assistance was to contribute to support the European Union’s strategy towards Armenia, in particular in the context of the European Neighbourhood Policy and the Eastern Partnership. In this context and in the short run, it was expected that the MFA would both increase substantially EU’s leverage on Armenia’s policy making and strengthen the country’s European orientations, and provide a highly valuable financial support to help the country wind off the effects of the current economic crisis\(^{146}\).

In the above context, and on the basis of the review of information and stakeholder consultations, added value of the MFA has been identified in the following areas:

- Financial value added and gradual fiscal adjustment to support recovery;
- Acceleration of reforms concerning tax and customs policy;
- Leverage effect to other IFIs agenda concerning debt management, public procurement and tax administration;
- Strengthening the country’s European orientations and improving political relations between the EU and Armenia;
- Improvement in international trade relations and business environment.

**Financial value added and gradual fiscal adjustment to support recovery**

The EU MFA supported gradual fiscal adjustment in Armenia so as not to endanger recovery, which was in line with the IMF policy. In Armenia’s case, this was particularly important as consolidation could not have been done at the expense of social expenditure, which is already at a low level (with approximately 1.5 per cent of GDP spent on health and 3 per cent on education). The MFA effectively supported Armenia to withstand economic downturn and avoid deterioration of the social and economic situation in the country. The further added value comes from the fact that 35 per cent of the assistance was provided in concessional terms, not adding to the country’s external debt stock, and thereby to an extent supporting external sustainability.

The MFA support was also sizeable with its share of 9 per cent in the overall budget support provided to Armenia between 2009 and 2012, and comprising of 33 per cent of the residual financing needs in 2010-11. The MFA also contributed to a slightly more positive GDP growth in 2011 (0.3 to 0.6 per cent) and 2012 (up to 0.3 per cent), as identified by the counterfactual analysis. In the event that Armenia would have

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\(^{145}\) Commission Staff working document [COM(2009)531 Final]. Ex-ante evaluation statement: Macro-financial Assistance to Armenia

\(^{146}\) Commission Staff working document [COM(2009)531 Final]. Ex-ante evaluation statement: Macro-financial Assistance to Armenia
been able to replace the MFA with funding from the ACF, this is likely to have slightly eroded investor confidence and added to the country’s debt burden, although the effects to the overall macroeconomic situation in this case are likely to have been minor.

**Accelerating key reforms and providing political reinforcement internally within the government**

As shown in section 4, MFA played a direct role in accelerating reforms over which the EU was seen to have the most leverage over the Armenian Government reforms. This was in particular the case with the tax and customs policy reforms. For example, although the tax policy issue was solved by the time of the signature of the MoU through the Government Decree of December 2010 and the new method of calculation used by the State Revenue Committee since January 2011, the condition’s inclusion can be seen as a signalling effect that MFA reinforced the timely adoption. Faster progress on addressing the issue of tobacco products compared to an analogous problem with alcoholic beverages may in particular suggest a role played by the MFA. MFA condition only related to tobacco products not to alcoholic beverages. Moreover, MFA can be seen to have accelerated the process of implementing customs valuation system that in operational terms adheres to the WTO Valuation Agreement. This was particularly important for preparing Armenia to commence negotiations on acceding to Deep and Comprehensive Free Trade Area (DCFTA) with the EU. The negotiations commenced in May 2012, concluding in July 2013.

Reforms concerning the pension system, public procurement law and debt management were such that the MFA did not have a strong role to play in its own right. These reforms were important, and relevant, but the MFA was not seen to have significantly enforced their adoption at domestic level, as a specific commitment already existed. These were also areas where the international commitment to their implementation was strong, and the MFA’s contribution can rather be seen as leverage to the already existing reform agenda. This is further elaborated in the following section.

The specific added value of MFA concerning internal and external audit has not been possible to disentangle from the support of other donors. Although MFA reinforced the internationally agreed reform agenda and possibly helped to support the implementation timeframe, this is difficult to validate given the number of international actors involved in this area supporting the Armenian Government.

**Leverage effect to key reform agenda shared across development partners**

Several areas of the MFA reforms were related to a wider reform agenda supported by a multitude of actors, and some IFIs noted that the MFA provided overall leverage to their own reform efforts. For example, in the case of conditionality regarding debt management, the MFA conditionality concerned the need to acquire a new debt recording system, whereas the system itself was jointly funded by the World Bank and the Armenian authorities and technical support was provided by UNCTAD. In the case of public procurement, the MFA conditionality concerned the adoption of legislation that complies with the EU Directives and international standards, which was also supportive of the EBRD initiative, which includes the review and improvement of Armenian public procurement secondary legislation and drafting of guidelines for implementing framework agreements and conducting procurements as well as building initiatives to improve procurement capacity147.

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The conditionality in tax administration on the other hand is one of the most important reform areas in Armenia according to the IMF, which is also an area where the MFA reform complemented the IMF and World Bank’s conditionality. Although it can be conceived that MFA has reinforced reforms in the revenue mobilisation, its specific impact is difficult to disentangle the overall reforms in this area and the main added value comes from a joint leverage that IFIs have in this area. That said, the EU conditionality specifically supported, among other things, the establishment of tax payers centres and e-filing for tax returns. This is one of the most tangible reforms from the perspective of citizens, in that every tax-paying citizen and VAT compliant company will benefit from the improvement of the service. This is also directly linked to the pension reform, which allows for the transfer of relevant tax contributions directly onto the pension. This represents a large tangible impact and service improvement across the country, and ultimately in the longer-term supports the sustainability of public finances.

**Strengthening the country’s European orientations and improving political relations between the EU and Armenia**

The request for financial assistance was provided in the context of Armenia’s commitment towards EU-Armenia ENP Action Plan[^148^], which was adopted in 2006, and the Eastern Partnership launched in 2009. It is in this context that the MFA was envisaged to have a further reinforcing effect in policy areas included in the action plan. Although the coordination between ENPI budget support priorities and the MFA could potentially be improved on the basis of stakeholder consultations, it is clear that the MFA addressed core ENP Action plan areas, with a particular focus on trade-related issues, good governance and regulatory reforms. The goals in these areas (such as those related to PFM reforms and the DCFTA negotiations) can be found in the spirit of the MFA conditionality[^149^]. In this regard Armenia has improved its orientations towards the EU standards on one hand but also shown commitment to EU as a partner. The Armenian authorities could have requested financial assistance from the Eurasian Development Bank’s Anti-Crisis Fund instead of the EU. One contributory factor to requesting EU assistance was the grant element but it is also reasonable to assume that it was also a commitment towards EU orientation. Continued support from the EU helps reinforce EU integration as a genuine political alternative to closer integration with Russia. It also supports the approximation of Armenian legislation towards EU and international standards. In particular the Association Agreement is a concrete process towards EU integration by bringing Armenia closer to EU model in the Customs area which also includes adopting EU procedures and approximation of legislation[^150^].

**Improvement in international trade relations and business environment**

The conditionality linked to customs valuation and tobacco taxation can be expected to have an impact on immediate trade relations and in the longer-term business environment in Armenia. The EU added value here is strong through the Deep and Comprehensive Free Trade Area (DCFTA) in the framework of the bilateral Association Agreement. The implementation of the customs valuation in letter and in spirit would also ultimately benefit EU companies exporting to Armenia.

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[^148^]: Request from the Republic of Armenia for MFA Assistance – letter from the Ministry of Finance to EU Commissioner for Economic and Monetary Affairs


[^150^]: However, the political context has changed following Armenia’s announcement 3 September 2013 regarding the country’s intention to join the Customs Union led by Russia. This decision would end possibility of forging the pending Deep and Comprehensive Free Trade Area (DCFTA) element of the Association Agreement between the EU and Armenia and would thereby diminish Armenia’s European orientations.
The structural reforms in the areas of customs valuation and excise tariffs were also directly relevant in the context of for starting negotiations on an EU-Armenia Deep and Comprehensive Free Trade Area (DCFTA). In 2011 Armenia was undertaking steps in preparedness for starting the negotiations. The perception is that the EU MFA operation accelerated and helped to start negotiations of DCFTA in May 2012 and not in several years to come. The negotiations were concluded in July 2013 which is intended to create a new framework for trade relations between the EU and Armenia. It has been estimated that the agreement would have significant impacts on Armenia’s trade with 15% increase in exports and 8% increase in imports in the long run. It is also expected that the economy would gain extra EUR 146 million a year, representing a 2.3% increase in GDP. On the other hand, it is estimated that the EU would gain some EUR 74 million.\(^\text{151}\)\(^\text{152}\)

The reforms in this area also add value from the perspective of EU trade relations with Armenia. In 2011 Armenia’s imports from the EU amounted to EUR 600 million whereas its export represented exactly half of this sum\(^\text{153}\). Given the context, design and implementation of the MFA operation is Armenia, there is a possibility that the EU Added Value can also be seen as a kind of ‘cushioning effect’ for the reforms implemented elsewhere in the EU policy (particularly in relation to trade and customs policies). The MFA might support the reinforcement of the implementation of reforms which in the short-term have implementation costs before the benefits are expected to accrue in the country concerned.

\(^{151}\) Although these benefits are unlikely to be attributable to MFA, it is understood it reinforced the DCFTA accession agenda by preparing Armenia’s readiness for the negotiations. Source for the statistics: Armeniapress (24 July 2013) http://armenpress.am/eng/news/727162/eu-and-armenia-conclude-dcfta-talks.html

\(^{152}\) However, given Armenia’s recent decision in September 2013 to join the Russian-led “Customs Union,” it is unlikely these benefits will accrue. The decision effectively ended possibility of forging the Deep and Comprehensive Free Trade Area (DCFTA) element of the Association Agreement between the EU and Armenia.

7 Conclusions and Recommendations

This section sets out the main conclusions and recommendations emerging from the evaluation.

7.1 Conclusions

*How would the economy of Armenia have evolved in the absence of MFA (and IMF) assistance?*

In the absence of the MFA it is highly likely that a faster fiscal consolidation would have been necessary leading to a more subdued recovery from the 2009 recession. The MFA allowed for a smoother fiscal adjustment path from 2009 onwards and overall, had a net positive impact on the Armenian economy. This conclusion is supported by model-based simulation which shows that Armenia’s GDP would have been 0.3 to 0.6 per cent lower in 2011 and up to 0.9 per cent lower in 2012 in the counterfactual scenario.

Lack of both MFA operation and support from the IMF programme would have yet stronger negative implications in view of the large size of the IMF programme. The support helped to avoid a much more severe recession in 2009 with the decline in GDP potentially having become close 20 per cent. The support also helped to boost holdings of foreign exchange reserves during, as well as in the immediate aftermath of, the crisis although in the years after then, Armenia’s reserve assets would have tended to rise, albeit to a lower level than without the support.

In absence of the combined IMF and EU-MFA support, it is highly likely that the Armenian Government would have pursued more aggressive fiscal consolidation (due to lack of alternative sources of deficit funding from early 2009) and this would have led to a slower, more fragile recovery. EU and IMF support led to a higher level of GDP in Armenia in 2012 by between 2 and 5 per cent, depending on the counterfactual.

*Figure 29 shows the combined EU MFA/IMF impact on real GDP during and after the crisis corresponding to circumstances where the Government would not have been able to secure financing from elsewhere and would have pursued with a deficit reduction.*

*Figure 29 IMF / EU MFA contribution to real GDP (in billion AMD, current prices)*

![Graph showing the contribution of real GDP during and after the crisis](image-url)

*Source: Counterfactual modelling undertaken as part of this assignment*
To what extent has the MFA assistance been effective in terms of the short-term macroeconomic stabilisation of Armenia?

The MFA disbursements took place after the 2009 crisis was over and economic growth had resumed. However, the MFA was provided in a context of a fragile recovery and uncertain economic environment: the output remained well below pre-crisis levels.

The MFA was crucial in meeting the financing gap in late 2011/early 2012 (especially in the context that the IMF had frontloaded its assistance), and there was not scope for the existing lenders to increase their funding, albeit Armenia could possibly have requested support from the EDB’s Anti-Crisis Fund. The MFA corresponded to meeting 33 per cent of the residual financing needs in 2010-11, which also represented 9 per cent of the over budget support provided by international donors from 2009 to 2012.

Quantitative estimates suggest MFA and IMF support was of most importance in the short-term, when the Government financing gap was largest. The MFA allowed for smoother fiscal adjustment, thus supporting recovery. It was not until the first quarter of 2013 when the economic output surpassed the pre-crisis level.

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

Impact on external debt

While Armenia has reduced its fiscal deficit from 2.8 per cent in 2011 to 2.1 per cent in 2012, the opposite trend has been observed as regards to increase in public debt which nearly tripled from 14 per cent of GDP in 2008 to 42 per cent of GDP in 2011. A significant portion (73 per cent in 2011) of this represented gross external debt, which built up during the crisis when the Government sought significant amounts of international financial assistance. In 2012, 78 per cent of public debt was external debt.

As Armenian domestic debt market is under-developed and opportunity to raise finance limited, Armenia has little choice but to meet the bulk of its financing needs from foreign sources. In the absence of MFA, Armenia would have had to borrow through foreign sources. Another form of funding would likely have increased the debt burden by EUR 35 million as per the concessional element of the MFA funding.

In absence of EU MFA and MFA, it is highly unlikely that Armenia would have been able to access external financing on a similar scale on similarly concessional terms (as provided by the IMF and the EU). It follows therefore, that the combined impact of the MFA assistance and the IMF programme on public external debt sustainability has been positive.

Impact on foreign exchange reserves

The counterfactual modelling suggests that the MFA also helped to bolster Armenia’s foreign exchange reserves, which are likely to come under pressure once Armenia starts to service its foreign external debt. The IMF has furthermore indicated that despite relatively high levels of public debt is sustainable, with low risk of distress, largely due to anticipated economic growth.

Impact on current account deficit

Although the current account deficit has reduced from 15.8 per cent in 2009 to 10.4 per cent in 2012, it remains rather high. As a net importing country, trade balance has continuously been negative at around 30 per cent of GDP. In the first quarter of 2013 trade deficit accounted AMD 221 billion (ca. EUR 409 million) or 31 per cent of GDP. On the basis of counterfactual modelling, MFA has had a positive but small role in affecting the medium- and long-term external financial situation. In addition to
positive impact on economic growth during 2011-2012, the MFA is also seen to have reduced the current account deficit slightly in 2011, by 3 per cent or less even if this was offset in 2012 by a wider current account deficit as imports recovered.

**To what extent has the MFA assistance been effective in terms of supporting structural reform in Armenia?**

The MFA assistance has been effective in terms of supporting structural reforms in Armenia in the following areas:

- Tax and customs policy reforms, and to an extent;
- Tax administration

Indeed, the most tangible effect of the reforms concern the tax and customs policy reforms which have contributed to the subsequent commencement of the DCFTA negotiations in May 2012 and their completion in July 2013, upon which the MFA is seen to have asserted additional pressure. These reforms were also part of preconditions for the commencement of the DCFTA negotiations\(^\text{154}\). At another level, actions included in the tax administration reform will provide benefits to the Armenian citizens through the implementation of tax services centres and e-filing of tax returns with a direct link to individual pension contributions.

Additionally, MFA included conditions relating to reforms in:

- Debt management;
- Pension; and
- Public procurement.

However, the above conditions were not particularly effective as they reflected reforms that would have been undertaken regardless of the MFA. Indeed the public procurement law was enacted before the MoU was signed, and commitment to the debt recording system was made prior to the MFA with funding from the World Bank. The pension reform was already part of the Government Programme 2008-2012, even if the structure of the new pension system was yet to be decided.

Although the above conditions were relevant at the time the operation was initially conceived, they were completed by the time the MFA was being implemented, given the long negotiation and approval process in agreeing the MoU. Reforms in some areas progressed more quickly than the MFA negotiations, and in these areas, it is particularly difficult to identify the added value of MFA reforms. It is plausible that the MFA negotiations\(^\text{155}\) might have influenced the shape and or timetable of these reforms when they were at an early stage, but this cannot be concluded with certainty in absence of any substantive supporting evidence.

Overall, however, the MFA conditions were well coordinated with the IMF and other international donors. The reforms were complementary to those supported by ENPI and pertinent to the international donor supported PFM reform agenda in Armenia. This overall good coordination is likely to have strengthened overall coherence of international developments partners’ support to Armenian reform efforts. At the same time it makes the task of disentangling the net impact of the MFA alone more difficult.

\(^{154}\) WTO membership, and adherence to its rules, is a precondition to entering negotiations on DCFTA with the EU.

\(^{155}\) According to the official documentation, the dialogue on conditionality started in 2009
What have been the indirect and/or unexpected effects of the MFA assistance?

The main identified indirect effect of the MFA was its impact on the implementation of the IMF programme to the extent that the IMF had to frontload its assistance to meet the large financing gap in 2009 and in 2010, initially allocated to be fulfilled by the MFA. The delay in disbursing most of the MFA funds in 2011, i.e. long after the 2009 crisis was overcome was not intended. However, the MFA disbursements proved timely in meeting the financing gap in 2011, comprising of 33 per cent of the residual financing needs, after other IFIs (notably the IMF, World Bank and the ADB) had exhausted their financial support and there was no room for increasing the level of funding, given the large amounts disbursed in 2009 and 2010.

How has the way in which the MFA operation was designed and implemented conditioned its effectiveness and efficiency?

The MFA operation was prepared in full consideration of the large financing needs faced by Armenia and in close co-operation with the IMF, other EU institutions and the Armenian authorities.

Although from crisis point of view the EU MFA came late (when the acute phase of the crisis was over), it was still highly relevant in 2011 to meet the financing needs of Armenia and support the gradual economic recovery. In the case of EU, the early commitment to the funding (announced in Council Decision end of November 2009) was important at signalling that EU assistance would be made available to Armenia, and which allowed the IMF to frontload its financial assistance. However, the delay in the negotiation of the MoU, and hence the subsequent disbursement of the MFA, have minimised any acute anti-crisis impact of the operation.

The part concessional terms of the MFA has been an important feature of the operation increasing MFA’s attractiveness to the Armenian authorities in comparison to other forms of assistance. In line with the IMF’s concessional resources as part of the combined ECF/EFF intervention, the EU MFA offered a 35 per cent grant element – 5 per cent above the minimum 30 per cent grant element required by the IMF. The MFA also fit in well with gradual fiscal adjustment favoured by the IMF so as not to endanger recovery.

As regards the selection of conditionality, as has already been highlighted, some of the conditions did not add specific value, as they would have ultimately been implemented regardless of the MFA.

One omission from the conditionality has potentially been the lack of direct support for business environment. Many international stakeholders and local NGOs have pointed out for example that the focus could have more strongly been on improving the business environment, in particular as the economy is characterised with a chronic lack of competition in the market and the EU specifically is seen to have political leverage over this issue.

To what extent has EU added value been maximised?

The EU has supported Armenia’s domestic efforts to withstand the impacts of the economic crisis and helped the implementation of Armenia’s reform programme. The MFA has also provided complementarity to reforms supported via ENPI. The MFA has in particular added value in regards to supporting gradual fiscal adjustment to support recovery, accelerating reforms concerning tax and customs policy, leveraging other IFIs reform agenda, strengthening Armenia’s European orientations and improving international trade relations with Armenia and business environment.

In Armenia’s case, gradual fiscal adjustment supported by the MFA was particularly important as consolidation could not have been done at the expense of social
expenditure, which is already at a low level (with approximately 1.5 per cent of GDP spent on health and 3 per cent on education). This avoided further deterioration of the social and economic situation in the country.

From the EU perspective, key benefits related to the MFA’s role in supporting Armenia’s economic stability and its EU orientations, with related, although impossible to quantify economic, social and political benefits.

7.2 Considerations for future

Design and focus of the MFA instrument

The long preparation process of the Armenian MFA operation (15 months from the adoption of the Council Decision to the onset of disbursements of the funds) has been identified as an issue in the ability for the MFA to effectively act as a crisis instrument. If the instrument is to retain any meaningful anti-crisis character and be able to address extraordinary balance of payment difficulties it would need to be designed in a much faster manner. This would require changes in the current post Lisbon legal framework of the MFA with more powers granted to the European Commission.

The MFA instrument would be strengthened by better aligning its declared objectives with the design and implementation practice. Maintaining the focus on dealing with serious short-term balance-of-payments or budget difficulties would require shortening of the approval procedures. A stronger focus on supporting structural reform efforts in beneficiary countries might benefit from introducing more flexibility in the way the conditions are formulated. Specifically, it could be beneficial if conditionality could be adapted to evolving circumstances during the MFA implementation period (e.g. dropping already fulfilled conditions, adjusting conditions that become infeasible / controversial in view of changed macroeconomic and/or political realities). It is recognised that these recommendations would require high level political decisions.

The quick-disbursing nature of the MFA instrument implies that conditions will need to continue being specified in terms of expected short-term outputs. However, it is recommended that expected longer-term outcomes and impact of conditionality should also be explicitly explained to strengthen domestic ownership, minimise the risk of implementation deficit (the difference between de jure and de facto reforms), and to provide the basis for future ex-post evaluations.

The above point might also encourage further coordination between the MFA and ENPI to more specifically leverage the reforms pursued within both these instruments. The longer-term monitoring of MFA structural reforms could also be undertaken as part of the activities carried out in the context of ENPI budget support. This closer coordination could also act as a way in promoting clearly spelled out and unified EU action. In particular, EU stakeholders at an operational level have suggested that further synergies in this respect could be capitalised on.

The conditionality should be updated to reflect economic developments during the design and negotiation period. The selection of conditionality should be guided by a set of broadly defined principles which for example could include demonstrable EU added value, macro-criticality and economic governance.

Visibility of MFA as a broader element of EU assistance

It is also recommended to better communicate to both targeted stakeholder groups and general public in Armenia about the MFA as an element of the broader EU assistance. The MFA instrument has lacked visibility among Armenian stakeholders beyond the Government, and has often been confused with the EU budget support. Some international development partners also found it challenging to distinguish MFA
from other EU support. As such, the level of knowledge of the instrument is rather low, and in comparison to other international actors, the overall promotion of EU as a supporter of specific activities is not visible. Other IFIs tend to advertise their involvement more actively. While the EU is occasionally featured in the country’s media, it has not been portrayed as supporting the economic development of the country, or advocating improved business environment, which are important aspects of the country’s development. This has also been highlighted in the portrayal of DCFTA negotiations in Armenia which was high on the agenda during this evaluation. The general knowledge of what the DCFTA means for the country and its perceived benefits have not been made clear. Overall, data from an opinion barometer suggests that 35% of the general public in Armenia are aware of the EU providing support to the country.

Suggestions to improve the EU’s image and role in Armenia include more actively organising events to communicate the benefits of the EU role, which seems not to have been effectively undertaken. A large section of the population seems to be unaware of the EU’s role and objectives in the country. In the case of promoting macroeconomic stability and economic development the challenge will be even greater given the economic literacy of the population. As a starting point, events could be organised (e.g. guest lectures in the universities) to promote and better explain the EU’s role in the country’s development.

In addition, the EU could more actively use press releases to inform population of its role in Armenia. These releases should on one hand be specific to the MFA, and on the other promote the EU’s overall role in the country. Information concerning the MFA could focus on the signature of the MoU and the impact and added value of the MFA operation. The EU’s overall role in Armenia should distinguish MFA as a broader element of the assistance, emphasising the large overall value that the EU brings to Armenia through financial assistance provided by several EU institutions. This would help the EU emphasise its overall commitment to and development focus in Armenia.

**Support to NGOs on the ground**

On the other side, the EU could help promote the development of non-governmental organisations which traditionally have had a weak role in the country. This would help add checks and balances to keeping the government policies in check and will be crucial for a longer-term development of the country. The extent to which an instrument like MFA could play a role in this in somewhat unclear given that its main partner in Armenia is the government. It could possibly contain structural reform actions, such as development of a charter between the government and the civil society on promoting economic development in the country. There is general dissatisfaction among the NGO community that reforms tend to have been promoted with a short-term view, and the overall the reform progress of Armenian authorities during the MFA implementation has therefore been considered as short-sighted.

**Direct to support to improve business environment**

There is also a strong sense from international and national stakeholders alike that the most crucial challenges facing the country is to improve its business environment in order to allow for economic development. These types of reforms are such that they can be promoted alongside PFM reforms as part of the structural reform conditionality attached to an instrument like the MFA. More actively supporting direct improvements in the business environment would also transfer concrete and tangible benefits to the country, also recognised by the general public in addition to improving investor confidence. Importantly, these types of structural reforms are growth enhancing and therefore would bring longer-term benefits to the country.
ANNEXES
Annex 1 Methodological framework for the evaluation
<table>
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<th>Evaluation Question</th>
<th>Quantitative Analysis</th>
<th>Qualitative Analysis</th>
<th>Sources of Information</th>
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<tbody>
<tr>
<td>- How would the economy of Armenia have evolved in the absence of the MFA assistance?</td>
<td>▪ Analysis of macroeconomic trends - examination of key macroeconomic indicators such as GDP, public finances, balance of payments, monetary indicators, employment, inflation etc. before the introduction of MFA (and IMF) to determine their likely trajectory in absence of MFA/IMF support</td>
<td>▪ Development of potential counterfactual scenarios and their likelihood of occurrence - stakeholders and local economist’s assessment of what would have happened in absence of the MFA (and IMF) support. The options at the disposal of Armenian authorities to fill the financing gap if MFA (and IMF) resources had not been provided?</td>
<td>Document and data review:</td>
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<td>▪ Analysis of data on Government spending, borrowing etc. to determine likely counterfactual scenarios e.g. the scope for Armenian Government to reduce its expenditure or increase revenue (and thus run a lower fiscal deficit) or borrow from the market to meet its financing needs</td>
<td></td>
<td>- Macroeconomic data sourced from IMF, World Bank and national sources</td>
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<td></td>
<td>▪ Specification and modelling of counterfactual scenarios – see section 5 and annex 1</td>
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<td>- MFA documentation</td>
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<td>- IMF/ WB documentation</td>
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<tr>
<td>- To what extent has the MFA assistance been effective in terms of the short-term macroeconomic</td>
<td>▪ Analysis of actual macroeconomic imbalances experienced by Armenia and their financing sources</td>
<td>▪ Stakeholders and local economist’s views on the specific contribution of MFA to short-term macroeconomic stabilisation</td>
<td>Semi-structured interviews:</td>
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<td>▪ A description of what actually</td>
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<td>- EC officials: DG ECFIN</td>
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<td>- IMF/ WB officials</td>
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<td>- Key bilateral/multilateral donors</td>
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<td>- Armenian authorities</td>
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<td>- EU Delegation</td>
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<td>Inputs from the local economist</td>
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</tbody>
</table>
### stabilisation of Armenia?

- Happened as a result of MFA and IMF support as observed in key macroeconomic data such as GDP, public debt, public spending, revenues, external balances, employment etc.
- **Modelling of the net impact of MFA** i.e. the difference between what actually happened and the counterfactual scenario(s)

### To what extent has the MFA assistance been effective in terms of supporting structural reform in Armenia?

The MFA focused on reforms in the areas of public debt management, pension system, public internal financial control, external audit, public procurement, tax policy and tax administration, and customs policy.

Assessment will be undertaken on the extent to which the reforms promoted by the MFA in these areas can also be modelled. A separate methods paper concerning econometric modelling will be provided following the discussions on counterfactuals during the inception meeting.

To answer this question, the study team will examine the following issues:

**Relevance of MFA conditionality**

- Whether the focus of MFA conditionality on PFM reforms was relevant and appropriate in Armenia’s context and also bearing in mind the characteristics of the MFA instrument (such as its quick disbursing nature, scale of assistance)?
- Whether there was a clear rationale for focussing MFA conditionality on PFM, quantitative debt management, procurement policy and custom policy?

### Documentary analysis:

- Memorandum of Understanding (MoU), signed on 5 July 2010, detailing a set of economic policy conditions for the disbursement of MFA
- Loan and Grant Agreement between the EU and Armenia
- Republic of Armenia PEFA Assessment and PFM Performance Report (WB)
- PIFC Gap Analysis, if available
- Operational Assessment of Armenia’s PFM system
- Report and supporting documentation
Fulfilment and durability of reforms

- To what extent were the MFA conditions fulfilled? i.e. what specific action was taken by the Armenian authorities in response to the MFA conditions?

- What has been done since the end of the MFA operation - have the Armenian authorities made further progress in any of these areas? Have any of the MFA promoted reforms been reversed?

Additionality (the specific role of MFA in promoting the reforms)

- Did the MFA operation reinforce the Armenian authorities' general commitment to PFM reform?

- Whether MFA was the main driver behind the reforms?

- Whether the MFA supported and accelerated domestic reform efforts and the efforts of other donors for example, by providing a useful second voice and a

submitted by the Armenian authorities to the European Commission on the fulfilment of the structural reform criteria related to the first tranche
- Commission’s assessment of compliance with conditionality requirements
- IMF Reviews
- EC and donor group other PFM reports and performance indicators/metrics

Semi-structured interviews:
- EC officials: DG ECFIN, DG DEVCO
- IMF/ WB officials
- Other bilateral/multilateral donors supporting PFM reforms in Armenia
- Armenian authorities
- EU Delegation

Focus groups
clear timetable for implementation

- Is there any evidence to suggest that the MFA accelerated the timing and/or influenced the sequencing of reforms?

- How far can the MFA conditions be said to have influenced their fulfilment? Would these reforms have taken place anyway? And at the same speed?

Complementarity with conditions attached to EU budget support

- The extent of cross-conditionality with budget support

- Whether the cross-conditionality between MFA and budget support gave the EU greater leverage in promoting PFM reforms

Impact

- What difference did the MFA conditionality make? For example, the extent to which MFA conditionality relating to numerical fiscal rules
What have been the indirect and/or unexpected effects of the MFA assistance?

- Trends analysis: analysis of key macroeconomic indicators to identify unusual patterns (indicating unexpected or indirect effects)
- Elaboration of ex ante intervention logic to identify potential indirect effects
- Ex post verification of intervention logic
- Identification of unusual patterns/unintended outcomes
- Anecdotal or concrete evidence provided by stakeholders on indirect/unexpected effects of MFA assistance

Document and data review:
- Macroeconomic data sourced from IMF, World Bank and national sources
- MFA documentation
- IMF reviews and country reports
- Academic and grey literature

Semi-structured interviews:
- EC officials: DG ECFIN, DG DEVCO
- IMF/ WB officials
- Key bilateral/multilateral donors
- Armenian authorities
- EU Delegation

Focus groups
Input from local economist

To what extent has the MFA contributed to returning the external indicators?

4 Analysis of trends in key external indicators: before and after MFA
5 Evolution of external indicators

Stakeholders and local economist’s assessment of the country’s current

Document and data review:
- Macroeconomic data sourced from IMF, World Bank and national sources
### How has the way in which the MFA operation was designed and implemented conditioned its effectiveness and efficiency?

- The extent to which the MFA addressed the financing gap facing Armenia

### Design considerations:

- Size and form of assistance - whether the scale and form (i.e. loans) of the MFA operation was appropriate in relation to Armenia’s financing needs and in the context of EU-Armenia relationship
- Degree of consensus among key stakeholders/informants regarding the relevance and importance of the MFA (in absolute and relative terms)
- Choice of conditionality – answered as part of Q.3

### Document and data review:

- Macroeconomic data sourced from IMF, World Bank and national sources
- MFA documentation

### Semi-structured interviews:

- EC officials: DG ECFIN, DG DEVCO, EEAS
- IMF/ WB officials
- Armenian authorities
- EU Delegation

### Inputs from local economist

- Stakeholders and local economist’ assessment of the contribution of MFA
- Bank and national sources
- MFA documentation
- IMF reviews and country reports
- Academic and grey literature
### Implementation issues:
- Whether MFA disbursements were timely
- Whether there was effective dialogue between the European Commission and Armenian authorities
- Whether there was effective monitoring of the MFA operation

Look for good practice / lesson learned from the design and implementation of MFA operation in Armenia

**To what extent has EU added value been maximised?**

- The role of MFA/IMF support in averting a crisis in Armenia
- Supplementary analysis will be carried out, to identify, in broad terms, the economic added value of MFA/IMF support -the extent to which Armenia’s economy would have been worse off in the absence of MFA/IMF leading to a reduced demand for the EU’s exports to Armenia
- Stakeholders' perceptions of confidence boosting effect of EU support e.g. stock market indicators, Government borrowing rates, changes in FDI and exchange rates
- Qualitative assessment of links between wider fluctuations in confidence indicators and EU assistance
- Political and economic relations between the EU and Armenia subsequent to the MFA
- Stakeholders’ perceptions of impact of EU support on bilateral political and economic relations

**Document and data review:**
- Macroeconomic data sourced from IMF, World Bank and national sources
- MFA documentation
- IMF reviews and country reports
- Academic and grey literature

**Semi-structured interviews:**
- EC officials: DG ECFIN, DG DEVCO
- EEAS
- IMF/ WB officials
- Key bilateral/multilateral donors
- Armenian authorities
economic relations between Armenia and the EU

- Whether MFA/IMF support by averting and economic crisis in Armenia, contributed to regional stability

- EU Delegation
  Focus groups
  Inputs from local economist
Annex 2 Assessment of the completion of structural reforms
<table>
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<tr>
<th>Type of reform</th>
<th>Main conditions of the reform</th>
<th>Rationale – weaknesses or issues that the reform was designed to address</th>
<th>Action taken by Armenian authorities</th>
<th>EU assessment</th>
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<tbody>
<tr>
<td>Debt management</td>
<td>Condition 1: Consistently with the Action Plan of the Ministry of Finance regarding Public Debt Management Strategy, by adopting the Ministerial Order 150-A, the Ministry of Finance acquires a new debt recording system</td>
<td>The sizable foreign assistance inflows led to rapid accumulation of external public debt (from 13.2 per cent in 2008 to 45 per cent in 2011). Likewise, the deficit grew from -1.5 per cent in 2007 to -7.7 per cent in 2009. Therefore, the Armenian authorities recognised the need for management strategy and tailored system based on best practices and enabling robust risk management. The benefits of improvement in this respect were also highlighted by Operational Assessment</td>
<td>After the adoption by the Ministry of Finance of the Public Debt Management Strategy in summer 2010, the Ministry held negotiations with the UN Trade and Development Organization (UN TDO) with the aim of purchasing the Debt Management and Financial Analysis System (DMFAS) software on debt recording and accounting. As a result, the corresponding contract was signed on 26 April 2011 and the system was installed in the Ministry of Finance. Subsequently, the specialists of the UN TDO carried out training for the use of DMFAS 6.0 software.</td>
<td>Condition fulfilled</td>
</tr>
<tr>
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<tr>
<td>Debt management</td>
<td>Condition 2: The Ministry of Finance specifies in its internal regulation the functions of the front-office, the middle-office and the back-office within the Public Debt Management Department as well as the relevant job descriptions.</td>
<td>Improvement in clear subordination and streamlining of reporting lines was also indicated in the result of the Operational Assessment exercise.</td>
<td>The Ministry of Finance undertook the restructuring of its Public Debt Management Department, with support of the World Bank (under the &quot;Public Management&quot; Grant Project). As a consequence, a report on the &quot;Revision of the Public Debt Responsible Units and their functions&quot; had been prepared. Based on this report, a new charter and staff list of the Public Debt Management Department were approved by the Minister of Finance on 17 September 2011 (Order 663-A).</td>
<td>Condition fulfilled</td>
</tr>
<tr>
<td>Pension system</td>
<td>Condition 3: The Government submits to the Parliament draft legislation for</td>
<td>Key reasons were the improvement of well-being of pensioners (pensions in Armenia were at the poverty line),</td>
<td>The package of legal acts on the pension system reform was adopted by the Parliament (National Assembly) on 22 December 2010. These legal acts provided the</td>
<td>Condition fulfilled</td>
</tr>
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<tbody>
<tr>
<td>Pension System Reform Including Proposals Concerning the Privately Funded Pillar</td>
<td>reduction of fiscal pressure on the central budget, willingness to increase the level of private savings and also boost the domestic bond market. Privately funded pension system would cover employees at the age of up to 45. The financing of the system would be based on the employee’s contribution in the form of 5 per cent deduction from his/her salaries and the government contribution, also at the level of 5 per cent. For this purpose the income tax would be increased from 20 to 25 per cent.</td>
<td>introduction of a three-pillar pension system, and the compulsory and voluntary funded pension systems as its components. As specified in the Law &quot;On Cumulative Pensions&quot;, the voluntary cumulative pension system shall be implemented starting from 2011. The compulsory cumulative pension system will come into effect from 2014. The World Bank experts were involved in this exercise.</td>
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<tr>
<td>Public Internal Financial Control</td>
<td>Condition 4: The government takes necessary steps to ensure that the Central Harmonisation Unit in the Ministry of</td>
<td>The principal rationale was the strengthening of audit functions across the government institutions still perceived as not sufficiently effective, also in the reports of external</td>
<td>A Central Harmonisation Unit (CHU) was established in the Ministry of Finance in August 2010 (Government Protocol Decree 1146 of 19 August 2010). The CHU acts under the direct subordination of the Minister of Finance and consists</td>
<td>Condition fulfilled</td>
</tr>
<tr>
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<tr>
<td>External Audit</td>
<td>Condition 5: The Chamber of Control</td>
<td>The key rationale was to increase the</td>
<td>Based on technical work conducted with support from SIGMA experts</td>
<td>Condition fulfilled</td>
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</table>
|                |                               | assessments\(^{158}\). The CHU having the clear status and authority as well as independence from the Ministry of Finance would provide the required guidance, streamline the audit process as well as improve its transparency and effectiveness. | of two separate divisions: a) Internal Audit Methodology Division, and b) Financial Management and Control Methodology Division. The charter, the structure and the staff list of the CHU were approved by the Minister of Finance. The CHU was made responsible for the development and monitoring of financial management, control and internal audit system in the whole public sector. 
The CHU prepared, with the support of the EU SIGMA experts, concept papers on new legislation on financial inspection and on financial management and control. Also, the CHU prepared the documentation on public sector standards of the internal audit and behaviour rules of internal auditors, which were defined in PIFC Strategy. These documents were approved by the Government by Decision 1233-N from 11 August 2011. |                         |

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<tbody>
<tr>
<td>Procurement Policy</td>
<td><strong>Condition 6:</strong> The Government submits to the Parliament the legislation which</td>
<td>The procurement system in Armenia was very centralised with one agency responsible for the procurement process</td>
<td>(who visited Armenia in March 2011 and had meetings with a number of Armenian public bodies, including the State Committee on Budgetary Issues, the Ministries of Finance, Education and Science, Economy, Transport and Communication, the State Revenue Committee and the Yerevan Municipality), the Chamber of Control prepared a Strategic Development Plan (SDP) and an Implementation Action Plan (IAP) for the years 2011-2016. The two documents were approved by a Chamber of Control in June 2011 by Decree 19/5 of the Chamber of Control. Armenian Authorities cooperated also with the Dutch Court of Auditors to improve certain aspects of its functioning.</td>
<td>Condition fulfilled</td>
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<td></td>
<td>adopts an Action Plan with deliverables for improving its working practices in line with the INTOSAI standards</td>
<td>effectiveness and transparency of the external audit. It was indicated that financial and methodological independence of Chamber of Control, whose work depends on the National Parliament, should be enforced. The need of improvement in external audit was also highlighted by Operational Assessment conducted in March 2010.</td>
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159 PwC, 2010. Armenia Operational Assessment
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<tr>
<td>Tax Administration</td>
<td>Condition 7: The Government adopts a sequenced and time-bound Action Plan for upgrading tax administration</td>
<td>Tax administration in Armenia was traditionally seen as performing far below the appropriate level, also when compared to its</td>
<td>The State Revenue Committee of the Government of the Republic of Armenia (SRC-Armenia) developed and the National Security Council of Armenia approved the Tax System Reform Programme for 2011-2013.</td>
<td>Condition fulfilled</td>
</tr>
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</table>

Standards and its adoption allowed Armenia's accession to the WTO Procurement Agreement.

Under this Law, the procurement system was entirely decentralised: all the state authorities procure independently. Also, the Law established a Board of Appeal where not only the state authorities are represented, but also the communities, the Central Bank and non-governmental organizations representing the private sector.

In February 2011, the Government adopted a decree on the organisation of the procurement process (Government Decree 168-N of 10 February 2011). The procurement package was prepared with support of SIGMA experts.

Weaknesses in the quality of tender documents, length of process also due to formal availability of complain route at almost all stages of procurement process. The need to progress toward e-procurement was also highlighted\(^\text{160}\).

complies with the EU Directives and international standards, enabling administrative bodies to conclude contracts with tenders and establishing an appeal body for dealing with public procurement complaints.

complies with the EU Directives and international standards, enabling administrative bodies to conclude contracts with tenders and establishing an appeal body for dealing with public procurement complaints.

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<td>in the areas of: risk based tax audits, cross-checks, development of economic databases and information sharing, e-filing, evaluation of tax audits' efficiency, establishment of tax-payers centres and training of the personnel on the above issues. Such Action Plan should be accompanied by respective budget allocations for each action in the Budget of 2011.</td>
<td>Neighbours (i.e. Georgia). Construction sector accounting for 25 per cent of the real economy in 2008 was striking example with low tax administration and significant shadow economy. Low tax administration was also more typical for SMEs than large companies. This became particularly pressing problem when the public finances deteriorated substantially and need of improvement of the revenue side of the budget became even clearer. Tax revenues between 2008 and 2009 decreased by about 15%. The plan envisaged specifically: enhancement of revenue collection, identification of new sources of taxable income, decrease of operational costs and the</td>
<td>The Programme was officially adopted by Decree of the President of Armenia (Decree 92-N of 18 May 2011. The Programme identifies measures (altogether 67) that should ensure Armenia's approximation with the EU countries in the field of taxation. The strategy includes the harmonization of tax laws and measures in the areas of voluntary compliance and simplification of procedures, strengthening of tax collection, development of risk-based tax audits, changes in the structure and organisation of the SRC, development of information technologies, etc.</td>
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<td>In the context of the implementation of the Programme, the SRC prepared an Action Plan containing specific actions for the period 2011-2013. The Action Plan was approved by the Chairman of the SRC in July 2011. The Ministry of Finance and the SRC-Armenia conducted also consultations on funding sources for</td>
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<tr>
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<tr>
<td>Tax Policy</td>
<td>Condition 8: The government takes the necessary actions to ensure non-discriminatory taxation of domestically produced and imported tobacco products, in full compliance with WTO rules and Armenia’s undertakings. The government will provide the evidence of effective compliance</td>
<td>overall improvement of the integrity of the taxation system.</td>
<td>the Tax Reform Programme and an amount of AMD 2,780 million (approximately EUR 5.4 million) was allocated to the SRC’s budget of 2011 on top of the initial allocation approved under the State’s budget.</td>
<td>Condition was fulfilled</td>
</tr>
</tbody>
</table>

In order to regulate the taxation of tobacco products in Armenia in accordance with Armenia’s WTO obligations, the Government prepared and the National Assembly adopted (in October 2010) amendments to the three laws relevant for the taxation of tobacco products: laws “On Excise Tax”, “On Presumptive Payments for Tobacco Products” and “On Value Added Tax”.

The amended laws stipulate a phasing out of presumptive payment rates for domestic tobacco products over the years 2011 to 2013 and the introduction of a new formula for calculating VAT on tobacco products.

Also, in December 2010 the government adopted a decree

*Despite clear objections in 2010 and first months of 2011, the mission conducted by EU trade experts (and financed under the programme TAIEX) in July 2011 concluded that the Government Decree of December 2010 and the new method of calculation used by the State Revenue Committee since January 2011 have provided a solution to ensure that Armenia meets always its WTO commitment on the bound ad-valorem tariff of 15%. 
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<tr>
<td>Customs Policy</td>
<td><strong>Condition 9:</strong> The Government implements customs valuation system, that in operational terms, adheres strictly to the conditions of the WTO Valuation Agreement (Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade of 1994) and is based – as a matter of principle – on transaction value and proper valuation methods set out in Article 1</td>
<td>The overriding reasons were as follows: compliance with the WTO standards, increase of Armenia’s capacity to implement the Free Trade Agreement and more generally improvement of effectiveness of Armenian custom authority operations, implementation of best practices for custom valuations, higher transparency. Despite significant progress, the benefits of improvement of custom valuation practices were also highlighted by</td>
<td>stipulating that the amended taxation rules, and the implementation of the current system of presumptive taxation should not result in ad valorem import duties of more than 15% (bound tariff consistent with Armenia's WTO obligations). In 2011 as a new rule was introduced making obligation to the Customs Service (part of the SRC) to accept or reject within two days a customs declaration based on transaction values. In case of no decision over 2 days, customs value should be considered as accepted. Furthermore, although with some delay, National Authorities provided statistical data on number of transaction value valuation methods applied which were instrumental for the EC. According to this data, Armenian authorities informed that 4 valuation methods were practised with the following frequency in 2010 and 2011:</td>
<td>Fulfilment of this condition was found problematic but eventually approved in light of efforts made by Armenian authorities (provision of statistics on frequency of valuation methods used by customs authorities was crucial). Armenia’s customs administration was often criticised for not using the standard customs valuation method based on transaction values but rather the one based on undisclosed reference values, not complying</td>
</tr>
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<td>Operational Assessment conducted in March 2010[^161]</td>
<td>(67.8 per cent in 2010 and 68.4 per cent in 2011).&lt;br&gt;• Customs value determination by transaction price of the same goods: (2.8 per cent in 2010 and 3.4 per cent in 2011).&lt;br&gt;• Customs value determination by transaction price of similar goods: (1.9 per cent in 2010 and 2.1 per cent in 2011).&lt;br&gt;• Customs value determination by calculated value: (27.5 in 2010 and 26.1 in 2011).&lt;br&gt;In addition, guidelines and manuals clarifying the customs procedures providing access to relevant information were published and the risk-based post-clearance valuation controls were developed.</td>
<td>with WTO standards. According to statistical information on the methods of customs value determination applied by Armenian authorities which was provided in December 2011, the use of the transaction value method was slowly albeit steadily increasing at the expense of other valuation methods[^162]. However, the reference value method was also found to be used extensively. The risk based post clearance valuation controls were found to be efficient: all or nearly all controls were resulting in discovery of</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Operation</td>
<td>7, in sequence. The implementation of the customs valuation system according to the above rules will entail progressive development of risk-based post clearance valuation controls.</td>
<td></td>
</tr>
</tbody>
</table>


[^162]: Note: According to the statistics provided by Armenian authorities, among all customs declarations the share of those where customs value was determined on the basis of the transaction price was 68 per cent. In parallel, Armenian authorities informed that among all applications requesting the use of the transaction price method, only approximately 2 per cent were refused.
<table>
<thead>
<tr>
<th>Type of reform</th>
<th>Main conditions of the reform</th>
<th>Rationale – weaknesses or issues that the reform was designed to address</th>
<th>Action taken by Armenian authorities</th>
<th>EU assessment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>violations by importers.</td>
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<tr>
<td></td>
<td></td>
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<td></td>
<td>All in all, EC concluded that the practice of customs valuation appeared to be based, as a matter of principle, on transaction values, and seemed to become gradually more transparent and therefore more WTO-consistent. Progress in this respect, demonstrated also by the provision of relevant statistics on custom valuation methods by Armenian authorities, was noted by the EU and despite some remaining concerns was found sufficient and resulted in agreement to release the second tranche of the MFA assistance.</td>
</tr>
</tbody>
</table>

**Main sources:**

European Commission, 2010, Preparation of the macro-financial assistance;
DG ECFIN D-3 Mission 24-26 February 2010;

Mission Report from 12th EU-Armenia Cooperation Committee on Trade issue, 20 September 2011;

DG ECFIN, October 2011, Note from MFA Review Mission; Compliance Statement; Ministry of Finance of the Republic of Armenia;

DG ECFIN, 2011. Background Note on Economic Development and Compliance with the Policy Conditions of MFA to Armenia for 2010-2011;

Annex 3  List of Interviewees
### Table 29 List of interviewees

<table>
<thead>
<tr>
<th>Stakeholder Group</th>
<th>Stakeholder Name</th>
<th>Role</th>
<th>Date of Interview</th>
</tr>
</thead>
<tbody>
<tr>
<td>European Commission, DG ECFIN, Unit D2</td>
<td>Mr Andreas Papadopoulos</td>
<td>Deputy Head of Unit/Armenia supervisor</td>
<td>15 March 2013</td>
</tr>
<tr>
<td>European Commission, DG ECFIN, Unit D2</td>
<td>Ms Krista Kalnberzina</td>
<td>Former Desk Economist for Armenia</td>
<td>15 March 2013</td>
</tr>
<tr>
<td>European Commission, DEVCO</td>
<td>Mr Jari Haapala</td>
<td>International Aid Cooperation Officer</td>
<td>15 March 2013</td>
</tr>
<tr>
<td>European Commission, DG TRADE, Unit 2</td>
<td>Ms Idzikowska Iwona</td>
<td>Russia, CIS, Ukraine, Western Balkan, EFTA, EEA and Turkey Bilateral trade relations with South Caucasus</td>
<td>15 March 2013</td>
</tr>
<tr>
<td>ADB Office in Armenia</td>
<td>Mr David Dole</td>
<td>Head of Resident Representative in Armenia</td>
<td>6 May 2013</td>
</tr>
<tr>
<td>ADB Office in Armenia</td>
<td>Mr Grigor Gyurjyan</td>
<td>Economics Analyst</td>
<td>6 May 2013</td>
</tr>
<tr>
<td>EDB (Anti-Crisis Fund), Armenia</td>
<td>Mr Armen Poghosyan</td>
<td>Deputy Director</td>
<td>7 May, 2013</td>
</tr>
<tr>
<td>EDB (Anti-Crisis Fund), Armenia</td>
<td>Mr Vaghan Voskanyan</td>
<td>Senior Project Finance Manager</td>
<td>7 May, 2013</td>
</tr>
<tr>
<td>EU Delegation in Armenia</td>
<td>Mr Alessandro Zanotta</td>
<td>Macroeconomics, PFM and Institutional Building Adviser</td>
<td>7 May, 2013</td>
</tr>
<tr>
<td>EU Delegation in Armenia</td>
<td>Mr Ludovic Ciechanowski</td>
<td>Trade and Private Sector Development (N/A - contribution in writing)</td>
<td>7 May, 2013</td>
</tr>
<tr>
<td>EU Delegation in Armenia</td>
<td>Mr Jean-Christophe Gayrand</td>
<td>Head of Operations Section</td>
<td>7 May, 2013</td>
</tr>
<tr>
<td>Central Bank of Armenia</td>
<td>Mr Artur Nakhshikyan</td>
<td>Head of Financial Department</td>
<td>7 May, 2013</td>
</tr>
<tr>
<td>Central Bank of Armenia</td>
<td>Mr Vahagn Grigoryan</td>
<td>Head of Division –External Economic relations and Analysis Division – Monetary Policy department</td>
<td>7 May, 2013</td>
</tr>
<tr>
<td>Central Bank of Armenia</td>
<td>Mr Andranik Grigoryan</td>
<td>Head of Financial System Stability and Development Department</td>
<td>7 May, 2013</td>
</tr>
<tr>
<td>Central Bank of Armenia</td>
<td>Mr Vakhtang Abrahamyan</td>
<td>Board Member</td>
<td>7 May, 2013</td>
</tr>
<tr>
<td>Stakeholder Group</td>
<td>Stakeholder Name</td>
<td>Role</td>
<td>Date of Interview</td>
</tr>
<tr>
<td>-------------------------------------------</td>
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<td>----------------------------------------------------------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>Central Bank of Armenia</td>
<td>Mr Mher Abrahamyan</td>
<td>Head of Financial Systems and Regulation Department</td>
<td>7 May, 2013</td>
</tr>
<tr>
<td>Control Chamber of Republic of Armenia</td>
<td>Mr Karen Arustamyan</td>
<td>Head of the Methodology and International Affairs Department</td>
<td>18 July, 2013</td>
</tr>
<tr>
<td>Ministry of Finance in Armenia</td>
<td>Mr Vardan Aramyan</td>
<td>Deputy Minister of Finance</td>
<td>7 May, 2013</td>
</tr>
<tr>
<td>Ministry of Finance in Armenia</td>
<td>Mr Karen Gasparyan</td>
<td>Head of International Cooperation Department</td>
<td>7 May, 2013</td>
</tr>
<tr>
<td>Ministry of Finance in Armenia</td>
<td>Mr Artak Marutyan</td>
<td>Head of Division – Deputy Head of Department – Public Debt Management Department</td>
<td>8 May, 2013</td>
</tr>
<tr>
<td>Ministry of Finance in Armenia</td>
<td>Mr Arman Poghosyan</td>
<td>Head of State Revenue Policy and Administration Methodology Department</td>
<td>18 July, 2013</td>
</tr>
<tr>
<td>Ministry of Finance in Armenia</td>
<td>Mr Arman Jhangiryan</td>
<td>Head of Financial Market Development and Methodology Division – Deputy Head</td>
<td>18 July, 2013</td>
</tr>
<tr>
<td>Ministry of Finance/Public Procurement Department in Armenia</td>
<td>Mr Vahe Mahtesyan</td>
<td>Deputy Director of Public Procurement Department</td>
<td>18 July, 2013</td>
</tr>
<tr>
<td>Ministry of Finance in Armenia</td>
<td>Mr Garegin Melkonyan</td>
<td>Deputy Minister of Economy</td>
<td>8 May, 2013</td>
</tr>
<tr>
<td>Ministry of Finance in Armenia</td>
<td>Mr Artak Baghdasaryan</td>
<td>Head of Economic Development Policy Department</td>
<td>8 May, 2013</td>
</tr>
<tr>
<td>State Revenue Committee</td>
<td>Mr Vakhtang Mirumyan</td>
<td>Deputy Chairman</td>
<td>18 July, 2013</td>
</tr>
<tr>
<td>GIZ Office in Armenia</td>
<td>Mrs Varsenik Mnatsakanyan</td>
<td>Senior Expert Public Finance Management project</td>
<td>8 May, 2013</td>
</tr>
<tr>
<td>IMF Office in Armenia</td>
<td>Mr Guillermo Tolosa</td>
<td>Head of Resident Representative Office for Armenia</td>
<td>6 May 2013</td>
</tr>
<tr>
<td>IMF Office in Armenia</td>
<td>Ms Armine Ghazaryan</td>
<td>Economist</td>
<td>6 May 2013</td>
</tr>
<tr>
<td>Stakeholder Group</td>
<td>Stakeholder Name</td>
<td>Role</td>
<td>Date of Interview</td>
</tr>
<tr>
<td>------------------------------</td>
<td>------------------------------</td>
<td>------------------------------------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>IMF, Washington DC</td>
<td>Mr Jose Gijon</td>
<td>Senior economist, Middle East and Central Asia</td>
<td>16 May, 2013</td>
</tr>
<tr>
<td>IMF, Washington DC</td>
<td>Mr Pedro Rodriguez</td>
<td>Economist</td>
<td>16 May, 2013</td>
</tr>
<tr>
<td>WB, Washington DC</td>
<td>Mr Pedro L. Rodriguez</td>
<td>Lead Economist Bulgaria and Romania</td>
<td>15 May, 2013</td>
</tr>
<tr>
<td>WB, Washington DC</td>
<td>Mr Ulrich Bartsch</td>
<td>Senior Country Economist for Armenia</td>
<td>15 May, 2013</td>
</tr>
<tr>
<td>WB Office in Armenia</td>
<td>Mr Jean-Michel Happi</td>
<td>Head of World Bank Armenia Office</td>
<td>6 May 2013</td>
</tr>
<tr>
<td>WB Office in Armenia</td>
<td>Mr Davit Melikyan</td>
<td>Public Sector expert</td>
<td>6 May 2013</td>
</tr>
<tr>
<td>Workshop participants in Yerevan (18 July, 2013)</td>
<td>Varuzan Hoktanyan</td>
<td>Executive Director</td>
<td></td>
</tr>
<tr>
<td>Civil Society Institute</td>
<td>Arman Danielyan</td>
<td>President</td>
<td></td>
</tr>
<tr>
<td>Economic Development Research Centre (EDRC)</td>
<td>Karine Harutyunyan</td>
<td>Executive Director</td>
<td></td>
</tr>
<tr>
<td>Economic Development Research Centre (EDRC)</td>
<td>Mushegh Tumasyan</td>
<td>Director</td>
<td></td>
</tr>
<tr>
<td>Regional Studies Centre</td>
<td>Richard Giragosian</td>
<td>Director</td>
<td>18 July, 2013</td>
</tr>
<tr>
<td>Republican union of Employers of Armenia</td>
<td>Vahan Simonyan</td>
<td>Executive Director</td>
<td></td>
</tr>
<tr>
<td>Production and Export Support Association</td>
<td>Mkrtich Aznauryan</td>
<td>Director</td>
<td></td>
</tr>
<tr>
<td>Armenian State University of Economics</td>
<td>Arman Tavadyan</td>
<td>Senior Researcher</td>
<td></td>
</tr>
</tbody>
</table>
Annex 4 Detailed Description of the Approach to Macroeconomic Modelling

A4.1 Introduction

This annex sets out the key features of the model applied to inform the evaluation. The purpose of the model is to provide a framework with which to quantify the effects of EU and IMF support to Armenia across a variety of different (but interlinked) indicators. The analysis complements the other aspects of the evaluation.

This annex is divided into the following sections:

- The motivation for a model-based approach;
- An overview of the model developed specifically for this evaluation, in terms of its key components and indicators;
- The approach taken in the counterfactual analysis (a ‘baseline-scenario’ approach);
- A description of the input data to the model and the nature of the model’s parameterisation;
- Further details on the specification of each component of the model; and
- Discussion of the sensitivity of the model results presented in the main body of the report.

A4.2 Motivation

An evaluation of the impact of EU and IMF support to Armenia, whether explicitly or implicitly, requires a comparison between two states of world:

- The one in which Armenia received Macro-Financial Assistance (MFA) and IMF support: the ‘outturn’. This actually occurred and this state is thus observable in the published statistics and by interviewed stakeholders.
- A ‘counterfactual’ in which Armenia did not receive the above support. This state cannot be observed directly because it never actually took place.

The difference between the above two states of the world gives an indication of the (net) impact of international support in the crisis.

However, as already mentioned, because the second state, the counterfactual, is never actually observed directly, it must be constructed, for the purposes of comparison.

Certain elements of the counterfactual are straightforward to specify. It is obvious that if one were to consider a counterfactual without EU MFA then, in that state of the world, Armenia would not have been in receipt of the EUR 100 million of assistance (consisting of a loan element of EUR 65 million and a grant element of EUR 35 million, in instalments over 2011-2012). The difficulty is then in establishing supporting information, which can be divided into two types:

- The likely policy response (and constraints) in the absence of that support.
- Indirect effects and feedbacks.

In the case of the former, a key consideration is whether the Armenian government would (or, indeed, could) have secured financing from elsewhere or if, instead, it would have needed to cut its spending. These elements of the counterfactual required
consultation with stakeholders and local experts in order to identify plausible responses in the absence of MFA.

However, even then, the counterfactual is potentially incomplete because of the possibility of indirect effects or feedback: wider effects that extend beyond the initial counterfactual specification.

As an example, consider a counterfactual where Armenia did not receive MFA and to which the most likely policy response was a cut in government spending (thereby reducing the requirement for deficit financing). Lower government spending would lead to lower production requirements in the economy and, in turn, lower incomes paid to workers. Lower household income tends to lead to lower household spending which leads to further reductions in domestic production. This is an example of a 'multiplier' effect where the initial reduction in government spending generates a fall in economic activity that exceeds the initial spending cut.

Another effect of the spending cut in this example may arise from lower production requirements leading to higher unemployment. Higher unemployment will require additional government transfers (social security), forcing higher government spending through this 'automatic stabiliser'. Consequently, government expenses in the counterfactual will not necessarily equal outturn expenditure minus the value of the spending cut.

On the government receipts side, lower economic activity leads to fewer taxable economic activities and transactions: tax revenues will not necessarily match those in the outturn case.

As a result of the above, it is possible that the deficit in this example counterfactual will not equal the initial cut in financial support. Should the counterfactual be specified such that the government could not have raised additional deficit financing from elsewhere, further spending cuts may be necessary to satisfy the constraints of the public budget.

This example serves to illustrate how complex a counterfactual may be, even given a constraint as (apparently) simple as a reduction in deficit financing possibly with a maximum government deficit.

In order to trace through the impacts in a counterfactual scenario, it is necessary to have in mind some kind of 'model' that embeds the relationships between different aspects of the economy. The purpose of the modelling exercise here is to establish an explicit, rather than implicit, representation of the key features of the Armenian economy and to provide a consistent framework to analyse counterfactuals.

In the model developed for the evaluation, changes in exogenous input assumptions, such as the disbursement or otherwise of MFA and IMF funds, and the likely government response, generate concomitant changes in the endogenous variables in the system. It is thus possible to simulate alternative states of the world through changes in these assumptions and to analyse the wider effects in an internally-consistent manner\textsuperscript{163}.

The advantages of a formal model lie in its explicitly-specified framework, logic and assumptions, allowing for scrutiny and interrogation of its results. A key limitation is that what is incorporated into the model must be possible to model or, at the very least, possible to model in a satisfactory manner with respect to the questions of interest. More abstract (or less quantifiable) concepts are not readily interpretable or represented in such a framework. To some extent, the same holds with regard to the

\textsuperscript{163} It is not always so straightforward to identify inconsistencies in a model that has not been formalised in this way.
inherent uncertainty in crisis conditions. In modelling terms, some of this can be addressed with sensitivity analysis, to gauge the robustness of the outcomes to alternative assumptions and/or parameters (e.g. the nature of the import-demand response). In other cases, more qualitative analysis is required.

### A4.3 Model Overview

As mentioned in the previous section, the aim of the model is capture, in a consistent manner, key elements and relationships in the Armenian economy.

The main indicators of interest, which correspond broadly to the main components of the model (as set out in Table 30) are:

- The performance of the 'real' economy, as defined by production and transactions in goods and services (GDP, prices etc)
  - For example, changes in government spending on goods and services should have an effect on GDP and, as a consequence, affect household incomes and spending.
- Government finances (revenues, expenditures and, as a consequence, deficit financing and debt)
  - Drawing on the example from the previous bullet, changes in government spending should, other things being equal, alter the deficit-financing requirements of the Armenian government.
- The Balance of Payments (current and capital accounts, as well as changes in holdings of foreign exchange reserves
  - The absence of the MFA grant component should be reflected in a corresponding deterioration in the current account (before accounting for wider effects); and
  - The absence of the MFA loan component should be reflected in a corresponding reduction in liabilities incurred in the capital/financial account.
- The labour market (employment/unemployment).

### Table 30 Components of the Model

<table>
<thead>
<tr>
<th>Component</th>
<th>Description</th>
<th>Dataset</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Economy</td>
<td>Indicators of macroeconomic performance</td>
<td>National Accounts</td>
</tr>
<tr>
<td>Government Finances</td>
<td>Indicators of the Armenian government’s fiscal position e.g. surplus/deficit and debt</td>
<td>Government Finance Statistics</td>
</tr>
<tr>
<td>Balance of Payments</td>
<td>Indicators of Armenia’s external sustainability e.g. foreign exchange reserves</td>
<td>Balance of Payments statistics</td>
</tr>
<tr>
<td>Labour Market</td>
<td>Indicator of socio-economic performance</td>
<td>Labour Market statistics</td>
</tr>
</tbody>
</table>

In previous evaluations that have applied models of this type, a further component, the monetary/financial system, was also included. The principal reason for its inclusion...
in past evaluations was to incorporate a (monetary) mechanism to explain inflation. In this evaluation, owing to the relatively open nature of the Armenian economy, particularly with respect to imports, inflation is instead related to the exchange rate. While monetary statistics are accounted for in the model, the outcomes from this component do no feed directly into any other component of the model. Consequently, this model description does not dwell on the specification of the monetary system.

Crucially, the other indicators and components of the model are not independent. For example:

- Government tax receipts are linked to transactions and other activities in the real economy;
- Some government expenses are autonomous with, for example, higher unemployment leading to higher expenditure on social security; and
- Changes in exports and imports (as they appear in the national accounts) are reflected in the current account of the Balance of Payments, also leading to corresponding changes in foreign exchange reserves, to balance the account.

While the first two are policy-rated and thus country specific (tax rates and social security, respectively), the last is a requirement in order to preserve accounting consistency. While not a new idea, accounting consistency is one of the key features of the model developed for this evaluation.

The model draws on the ‘flow of funds’ tradition in economics, in the sense that it aims to capture the idea of transactions (flows) that take place between pairs of actors: one sector’s outflow must show up as an inflow to another in current prices and the same currency. Such a principle underpins the IMF’s ‘financial programming’ approach as well as previous model-based analyses of MFA for the European Commission. It is by this framework that the model combines multiple datasets into a consistent whole (as in the above example of national-accounts trade affecting the balance of payments, including reserve assets).

Moreover, the model aims to incorporate, where the data permit, elements of the more recent ‘Stock-Flow Consistent’ modelling approach, whereby differences between a sector’s total inflows and total outflows imply changes in that sector’s balance sheet (a change in stocks). An example of this is provided by government finance statistics. If government expenses (e.g. on goods and services, or social security) exceed total receipts (e.g. from taxes), the gap (a deficit) between the two must be met by other sources of finance (such as bonds). This leads to an increase in government debt (the stock).

The system by which the components of the model are linked can be represented as a table or ‘transactions matrix’, loosely following the exposition in Godley and Lavoie.

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164 Given the limited availability of data for the countries in receipt of MFA, such a treatment is more pragmatic than the preferred, albeit more data-intensive, alternative, which is to build up a measure of production costs (materials, labour, taxes etc) and to then apply a mark-up to yield the final price i.e. cost-plus pricing.

165 A key element of the model, in order to capture the effect of exchange-rate effects, is to ensure that input variables specified in foreign currency are converted using the correct exchange-rate assumptions in the counterfactuals. Moreover, in the case of stocks actually denominated in foreign currency (but modelled in Armenian dram), it is important that changes in stocks represent both changes in the holdings of foreign currency and revaluation from changes in the exchange rate.

(2007)\textsuperscript{167}, which has parallels with the Social Accounting Matrices sometimes used to represent a country’s national accounts. The transactions matrix so depicted in Table 31 lists the institutional sectors of the economy (households, firms, government etc.) in the columns and the types of flow (investment, exports, imports etc.) in the rows.

Set out in this form, the transactions matrix becomes useful to identify the source of outflows and the destination of inflows. The accounting requirement is that the rows should sum to zero, indicating that each outflow is recorded somewhere else as an inflow. Outflows appear in the matrix as negative values, indicating a use of (a decrease in) funds while inflows are positive, representing a receipt (an increase) of funds. The first row of the matrix shows how Private Consumption involves an outflow of funds from Households (-C) and to Firms, in return for goods and services (+C). A slightly more complex example can be seen in the case of Income/Output, where Household income is the sum of:

- Domestic sources of income: wages and distributed profits from firms; and
- Foreign sources of income: remittances.

In this example, disposable household income is the sum of the above, and net of taxes and transfers (e.g. social security).

The bottom three rows of the table (the ‘Changes in …’ items) represent the allocation of sectoral surpluses and deficits. Of these, the changes in debt (fiscal sustainability) and foreign exchange reserves (external sustainability) are tracked in the model but private wealth (or debt) is not, owing to a lack of data.

Note that accounting consistency must hold regardless of the behavioural relationships embedded in the model. The implication is that of ‘quadruple entry accounting’ where a change in a particular element of the matrix should lead to changes in at least three other items: one in the same column (a shift in uses/receipts for that sector); and one in each of the two rows (the shift in uses/receipts of the transacting sectors).

A transactions matrix of this type provides a convenient framework in which to link disparate datasets together and identify accounting discrepancies.

The matrix also provides a way to set out the transmission channels between sectors of the model. Moreover, the matrix imposes constraints on the specification of the model because it implies that a choice must be made as to which variables are determined behaviourally and which must arise as a matter of accounting consistency.

In summary, the model has the following features, which make it well-equipped for this evaluation:

- It combines the real and financial economies together such that developments in one have implications for the other i.e. feedback; this is a growing area of interest in economics and relatively few models do this;
- It combines a range of disparate datasets in as consistent a manner as possible, to ensure, for example, consistency between external financial assistance and government receipts of these finances;
- It is relatively light in terms of its data requirements, reflecting the limited availability of data for Armenia; and
- It generates a set of consistent indicators to assess economic-financial stability.

Table 31 An Example Transactions Matrix

<table>
<thead>
<tr>
<th></th>
<th>Households</th>
<th>Firms</th>
<th>Financial system</th>
<th>Government</th>
<th>Foreign (Rest of World)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Consumption</td>
<td>-C</td>
<td>+C</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Government Spending</td>
<td>+G</td>
<td>-G</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Exports</td>
<td>+X</td>
<td>-X</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Imports</td>
<td>-M</td>
<td>+M</td>
<td></td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Income/Output</td>
<td>+Y</td>
<td>-Y_d</td>
<td></td>
<td>-Y_f</td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Net Taxes/Subsidies /Transfers</td>
<td>-T_h</td>
<td>-T_f</td>
<td>+T</td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Grants/Loans (including MFA)</td>
<td></td>
<td></td>
<td>+MFA</td>
<td>-MFA</td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Changes in Debt</td>
<td>+/- D_d</td>
<td>+/- D</td>
<td>+/- D_f</td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Changes in Foreign Exchange Reserves</td>
<td>+/- R</td>
<td></td>
<td>+/- R</td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Changes in Wealth/Deposits</td>
<td>+/- W</td>
<td></td>
<td>+/- W</td>
<td></td>
<td></td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
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<td>0</td>
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Note: h and f subscripts on Net Taxes/Subsidies/Transfers denote Households and Firms, respectively.
d and f subscripts on Income/Output and Changes in Debt denote Domestic and Foreign, respectively.

A4.4 Evaluation Approach

The model-based evaluation follows a baseline-scenario approach in which the counterfactuals (scenarios in which Armenia does not receive EU and/or IMF support) are compared against the baseline case (the outturn). The difference between the two yields the estimated impact of EU MFA and IMF financing in the crisis for the historical period covered by the model.

Where appropriate, sensitivity analysis is also conducted, to assess the robustness of the core findings.

The model also generates indicators that can be interpreted as gauges of fiscal and external sustainability such as deficit-to-GDP and debt-to-GDP ratios. While it is not possible for the model to simulate the transition into a crisis, it is able to track the evolution of such indicators under alternative input assumptions. One may not be able
to say at what point higher debt would lead to a crisis situation but it is reasonable to think that higher debt-to-GDP ratios would tend to indicate greater vulnerability to a crisis than lower ratios.

The model-based evaluation thus generates metrics that enable one to comment qualitatively on the contribution of international aid to:

- Support macroeconomic stability: economic growth and prices;
- Promote fiscal sustainability: deficit and debt-to-GDP ratios; and
- Provide external sustainability: slower depletion of foreign exchange reserves.

### A4.5 Input Data and Model Parameterisation

This section covers the input data to the model and also discusses the parameterisation of the model. Combined with alternative input assumptions, the model then generates results for each of the counterfactuals.

#### A4.5.1 Input Data

The data available for incorporation into the model are relatively limited in both detail and timespan. Consequently, the model is annual in frequency, to make best use of the available data:

- National Accounts: National Statistical Service of the Republic of Armenia;
- Balance of Payments: National Statistical Service of the Republic of Armenia;
- Monetary Statistics: Central Bank of Armenia; and

The above indicate a preference for national-level data, on the grounds that these data are consistent with international sources (such as the IMF and World Bank) and relatively more detailed (in general, international organisations only require or publish a subset of the available detail).

The model is ‘aggregate’ in the sense that it does not sub-divide the institutional sectors from Table 31 any further. There is, for example, no distinction between manufacturing and services within Firms. While there are indeed some data broken down in such a way, there are insufficient data across all the required datasets for it to be feasible to represent this level of detail in the model.

For ex post counterfactual analysis, the model must run to 2012. The data are largely complete to 2012, with some National Accounts data relating to the breakdown of income constructed using the 2011 shares.

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168 This is because the tipping point is not fixed at some particular threshold but depends instead on a range of varying and interdependent factors such as investor confidence and the wider political situation.
169 http://www.armstat.am/en/
170 http://www.armstat.am/en/
172 http://www.armstat.am/en/
174 http://www.armstat.am/en/
175 Some elements of the national accounts are available earlier than others. This is typically followed by a balancing exercise to reconcile the data to conform to official national accounting conventions. Given the baseline-scenario approach followed in this evaluation, the estimation method to complete the baseline to 2012 is unlikely to have much of a bearing on the final results, particularly as the key indicators are already known.
A4.5.2 Parameterisation: Closure Rules

In addition to the accounting framework outlined above, the model requires at least some elements of the system to be endogenously determined to generate behavioural effects, such as the response of private consumption to changes in income.

The strict accounting requirements of the transactions matrix each period (the requirement for all rows and columns to sum to zero once accounting for changes in stocks) means that a decision must be made as to which elements should/can be solved behaviourally and which ones must instead arise by accounting necessity\textsuperscript{176}. Such a decision relates to the ‘closure rules’ of the model.

In some cases, the choice is obvious: for example, final demand should be set by the sectors that consume (demand) the output and Firms’ production should follow to meet that demand. Household consumption should be set by an equation (as set out later on in this annex), and firms’ production should match it. The same holds for the other components of final expenditure although, in the case of government, that expenditure is in turn governed by a binding constraint on the deficit. The implication of such a decision is that the real-economy part of the model is demand-driven.

In other cases the choice requires some judgement, possibly based on the relative flexibility/availability of the economic/financial assets (which variables/sectors typically use as ‘buffers’ to accommodate unexpected changes) and the sectors that purchase/supply them. One example of this is the change in foreign exchange reserves in the Balance of Payments which automatically adjusts in order to balance the accounts.

A4.5.3 Parameterisation: Behavioural Relationships

The accounting in the model consists of identity relationships that are clearly defined and fixed; only the decision regarding the closure rules is potentially ambiguous. The accounting rules thus relate the elements of the transaction matrix to each other and the key decision is which variables are set by accounting identity.

In contrast, behavioural relationships in the model determine how the elements of the transactions matrix are set. Ideally, these relationships would be derived from econometric analysis of the data, lending an empirical foundation to the model’s behaviour. However, short time series\textsuperscript{177} and the likely presence of outliers and structural breaks prevent the rigorous use of these more formal methods\textsuperscript{178}. A range of alternatives to econometric estimation are discussed in Swann (2006)\textsuperscript{179}.

Where behavioural relationships are required, their parameters have been set by assumption, where possible drawing on existing empirical literature. There are few empirical studies that relate specifically to Armenia and the parameters used, in some sense, reflect ‘average’ or ‘representative’ values.

Elsewhere, where there is evidence of stability through time, simple ratios are taken between variables.

\textsuperscript{176} For \( n \) elements in a particular row of the transactions matrix, the \( n \)th element is implied by the other \( n-1 \) elements so as to ensure that the sum of inflows and outflows equals zero.

\textsuperscript{177} Just over ten years for national accounts data and even fewer for suitably-detailed government finance statistics; the balance of payments statistics are reasonably complete from the early-1990s onwards.

\textsuperscript{178} Calibration, which involves fitting parameters to the available data by hand, is also unlikely to be possible in many cases.

A4.5.4 Parameterisation: Calibration to Outturn

No behavioural equation can perfectly replicate the historical data; there is always some discrepancy e.g. the errors from an econometric equation or other discrepancies from imposing simple ratios through time. Collectively, these ‘residuals’ explain the deviation of the raw baseline model results from those observed in the outturn data. By the accounting requirements of the model, these residuals then propagate through the system. While accounting consistent, the model cannot be guaranteed to replicate the outturn, once behavioural relationships have been incorporated.

In order to generate a baseline run that matches the outturn, the approach taken is to ‘calibrate’ the model by calculating the residuals from the baseline run and adding them back in during solution. In this way, the baseline run used for the analysis (the model results plus the residuals) replicates the outturn data. The residuals are similarly applied to the counterfactual runs in order to be able to compare the counterfactual outcomes consistently against the actually-observed state of the world.

A4.6 Specification of Model Components

This section details the structure of each of the five key components of the model.

A4.6.1 The Real Economy

The real economy represents the production of goods and services in an economy. The national accounts is the principal statistical framework that tracks the evolution of the real economy. It is this framework that defines the concepts that lead to the calculation of a country’s GDP, expressed equivalently by:

- The production approach: the sum of Gross Value Added of all relevant producers plus taxes less subsidies on products;
- The expenditure approach: the sum of final uses of goods and services, less imports; and
- The income approach: the sum of primary incomes distributed by producers in the economy.

The specification of the real economy in the model is demand driven. The underlying assumption is that supply adjusts to meet demand and that the most important accounting identity in the real economy block of the model is the one that describes GDP in final-expenditure terms:

\[ GDP = C + I + G + X - M \]

where:

- \( C \) is private final consumption expenditure
- \( I \) is Gross Capital Formation (investment expenditure, including changes in inventories)
- \( G \) is government expenditure
- \( X \) is exports
- \( M \) is imports

The main behavioural relationships that drive the model (particularly in terms of the multiplier response) centre on the response of:

- Private Final Consumption;
- Gross Fixed Capital Formation (the largest component of Gross Capital Formation);
Government Expenditure; 
Exports; and 
Imports.

By identity, GDP can be equivalently broken down into sources of income, of which some accrues to households. This forms a loop from expenditure (demand) to production (supply) to income which then feeds back to drive expenditure. The nature of income generation in Armenia is such that it is important to account for income by source (particularly the domestic/foreign split). The final key element in the real economy is the price level. In both cases, more detail can be found further down.

Given the short ex post evaluation period, where elasticities are used, the preference is for short-run, rather than long-run, elasticities.

**A4.6.1.1 Private Final Consumption**

Household Final Consumption Expenditure is the largest component of final expenditure in Armenia, accounting for 80-90% of GDP. While the transactions matrix is specified in current prices, the equation that determines household expenditure is expressed in real terms (volumes/constant prices) as a function of household disposable income and the price level.

The timespan of the compiled model database was too short for econometric analysis to be feasible. Instead, the parameters were set as follows, in line with short-run behavioural responses identified in the literature:

- The income elasticity of demand was set to 0.30;
- The price elasticity of demand was set at 0.20.

For many countries, it is straightforward (and often reasonable) to use domestic economic activity (e.g. GDP) as a proxy for income. However, in Armenia, remittances from overseas are an important source of household income. The income variable is thus formed explicitly from a combination of domestic and foreign sources (see below). This is also important when considering counterfactuals with alternative exchange rates, as it alters the domestic value of remittances.

The price level is also determined endogenously (see below).

Real expenditure is converted back to current prices before insertion into the transactions matrix.

**A4.6.1.2 Gross Capital Formation**

The main components of Gross Capital Formation (investment) are:

- Gross Fixed Capital Formation (GFCF); and
- Changes in inventories (stock building).

Of the above, GFCF is by far the largest component of investment and is determined endogenously. Changes in inventories are held constant across the scenarios.

Economic theory highlights the importance of expectations in determining investment. Agents will tend to invest less in a more uncertain economic and political climate, such as that seen during the crisis, when MFA was provided. This is because greater

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180 The elasticities in Davidson, J. E. H., Hendry, D. F., Srba, F & Yeo, S. (1978), ‘Econometric Modelling of the Aggregate Time-Series Relationship Between Consumers’ Expenditure and Income in the United Kingdom’, for example, are indicative of the type of parameter values identified. More recent studies suggest similar elasticities.
uncertainty and/or pessimism reduces agents’ expectations of the future return on their investment.

Expectations are not straightforward to represent in an economic model, with the concept of ‘rational expectations’ being a common approach, albeit one that has endured greater scrutiny in the wake of the crisis.

Since 2005, GFCF averaged around 30% of GDP in Armenia each year. This ratio is applied in the scenarios, in real terms, with accounting residuals to explain the remaining difference each year.

**A4.6.1.3 Government Expenditure**

Government expenditure is a key element of the analysis. The nature of the government response is a critical detail in the counterfactuals without financial support.

In the counterfactuals, the Armenian government’s ability to raise alternative deficit financing varies. In some of the scenarios, the government is limited in its ability to raise additional funds and must cut its spending accordingly. All deficit-reduction strategies in the counterfactuals involve some form of expenditure reduction; none of the scenarios consider the possibility of tax increases in order to raise further revenue.

Changes in government spending affect incomes and other real-economy expenditure (through the multiplier effect). This may also lead to further effects through higher unemployment requiring greater provision of social security (an increase in mandatory transfers; an example of an automatic stabiliser). Where there is a deficit limit in the scenarios, there may be a requirement for further adjustments to discretionary spending, beyond those required to reduce the initial deficit.

**A4.6.1.4 Exports**

In a multi-country model, it would be reasonable to model demand for exports such that it depends on economic activity in the rest of the world, and the relative price of domestic and foreign production (allowing for exchange-rate effects), to capture competitiveness. This is not so straightforward in a single-country model, unless one is willing to specify alternative trajectories for world economic growth. It seems unlikely that Armenia is a large enough economy for that to be the case in the counterfactuals identified in this study.

In the scenarios, the real-terms value of exports is held constant, under the assumption that global demand for Armenian production does not change as a result of economic developments in Armenia. The implication on the supply side is that no economic developments in Armenia affect its ability to supply goods and services to meet foreign demand.

Thus, in the model, exports are assumed fixed across the scenarios in foreign-currency terms. The assumption is that Armenian exports are priced in foreign currency (e.g. dollars) and, with Armenian exporters as price takers, the nominal value of the exports, in dram, must increase (while the volume remains unchanged).

**A4.6.1.5 Imports**

Imports represent the second-largest component of final expenditure in Armenia (behind private final consumption expenditure).

Import demand is a function of real domestic economic activity. As with investment, imports as a ratio to GDP was relatively stable over the period of analysis in the range 40-50%. As such, real import demand is set at 45% of real GDP (again, with the observed differences between the model results and the actual outcomes added back, in order to calibrate to the outturn).
A4.6.1.6 Household Income

As mentioned above, for many countries, it is reasonable to use domestic economic activity (e.g. GDP) as a proxy for income. This is not so defensible for Armenia because of the importance of remittances from overseas and the fact that some counterfactuals incorporate alternative exchange-rate trajectories that alter the value of these remittances once converted into Armenia dram.

Consequently, the model builds up household disposable income from the following components:

- Wage income (compensation of employees in the national accounts);
- Profit income (proxied by Net Operating Surplus in the national accounts; under the strong assumption that no profit is retained by firms from year to year);
- Domestic transfers (social security);
- Foreign income and transfers (whose value in domestic currency changes under alternative exchange-rate assumptions); and
- Taxes (as a negative item).

This breakdown is important in order to capture the effect of exchange rates on remittances.

The final term, once converted to real terms, enters into the household consumption function.

A4.6.1.7 Price Level

The preferred approach to determining prices in the model would be to relate them, empirically, to changes in the underlying domestic and import costs. However, this is difficult given the available data and perhaps of somewhat limited value given that the model is not disaggregated in a way that identifies multiple industry sectors and cost structures.

Instead, the approach is to link the price level to the exchange rate, on the basis that Armenia has a relatively high dependency on imports. The exchange-rate elasticity of domestic prices (the GDP deflator) has been set at 0.20.

This treatment contrasts to that followed in previous evaluations, where changes in the money supply affected the price level. The approach in this evaluation resembles more a cost-plus pricing approach (linked to imported intermediates) than the monetary theory of inflation embodied in previous evaluations.

A4.6.2 Government Finances

The government sector is defined in terms of:

- Revenues (inflows);
- Expenses (outflows); and
- The surplus/deficit arising from differences between the above (leading to changes in the stock of debt).

The main sources of revenue are taxes and social-security contributions, which are linked to the relevant real-economy flows e.g. income tax is linked to earned income. The other key source of revenue to the government is foreign grants, of which MFA is one. In the counterfactuals, this component of the receipts is removed.

Expenses consist primarily of:
- Consumption expenditure on goods and services;
- Social security payments;
- Interest payments; and
- Subsidies.

As with revenues, some of these elements are linked to other variables in the model, in order to represent non-discretionary spending, such as social security. Spending on goods and services, on the other hand, is discretionary and set by assumption/rule. Where a counterfactual incorporates a deficit constraint, expenditure adjusts in order to preserve the deficit at the specified levels (modelling situations in which it was not possible for Armenia to incur further debt, accounting for the absence of deficit finance such as IMF support and MFA loans).

The difference between expenses and revenues gives the deficit/surplus, which drives the evolution of the stock of public debt through time.

**A4.6.3 The Balance of Payments**

The Balance of Payments accounts for transactions between residents and non-residents of a particular economy. It is composed of:

- The Current Account;
- The Capital Account; and
- The Financial Account.

The accounts balance through changes in Armenia’s stock of foreign exchange reserves (depending on the representation of the Balance of Payments, these may be incorporated into the Financial Account).

In the model, the treatment of the Balance of Payments is entirely accounting/identity-based, serving as a means to track the external implications of developments in the Armenian economy:

- Changes in exchange rates affect the value of flows once converted into Armenian dram e.g. a depreciation of the dram will increase the value of remittances, once converted to domestic currency;
- Changes in exports and imports lead to corresponding changes to the goods and services component of the Current Account;
- The absence of MFA (which was provided as a mix of loans and grants) in the counterfactuals is modelled as a deterioration of the transfers part of the current account and the incurrence of liabilities part of the financial account, with corresponding changes to revenues and deficit finances in the government budget;
- The absence of IMF support in the counterfactuals is modelled as a reduction in Armenian drawings of Fund credit/loans; and
- Flows of foreign exchange reserves are calculated as the residual to maintain balance in the accounts, leading to changes in Armenia’s stock of reserve assets.

The effect of alternative exchange-rate scenarios only directly alters the value of international transactions. The relative-price effects of alternative exchange rates affects trade demand in the real-economy block which are then reflected in the current account and reserve assets (by residual).
A4.6.4 Labour Market

The model generates employment as a socio-economic indicator. Output (real GDP) is the driver, with an elasticity of 0.50 on employment. A more detailed treatment cannot be easily incorporated into the model given the available data and risks introducing a potentially misleading level of complexity. Unemployment follows as the difference between employment and an exogenously-set workforce, which precludes the possibility of changes in labour participation across scenarios.

While quite simple, an additional reason to model the labour market is in order to represent the automatic-stabilising effect of social security. It is common for government deficits to increase in a recession, as higher unemployment drives higher non-discretionary public expenses. By including a labour-market treatment in the model, it is possible to capture this feature of public deficits in a downturn.

A4.7 of Model Results

This final section considers the sensitivity of the results from the quantitative analysis to changes in the model’s parameters and the extent to which the key results are robust to changes in these parameters.

In this context, the key results of the model-based analysis are as follows:

- EU MFA support contributed to slightly higher GDP growth over 2011-2012, leading to an overall higher level of GDP of almost 1 per cent compared to the case where MFA was not provided
- The contribution of MFA to improving Armenia’s reserve assets position is less clear and depends on whether Armenia could have secured deficit financing from elsewhere and the confidence-building effects of EU support
- Combined EU and IMF support would likely have averted a much more severe recession in 2009, leading to a lower level of GDP of between 2 and 5 per cent by 2012

The IMF (and ADB) support helped to sustain Armenia’s holdings of foreign exchange reserves during the crisis.

In the model, the parameters that would have the most bearing on the above relate to:

- Those that determine components of GDP by the expenditure approach:
  - The household income elasticity on consumption;
  - The investment share;
  - The import propensity.
- The import response, which, for a given amount of output, determines the extent to which income flows out of Armenia (with corresponding changes in reserves); and
- At least in principle, the output elasticity of employment.

The parameters that relate to final expenditure drive the GDP outcomes in the model such that parameter values that generate greater responsiveness of GDP to changes

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181 This is not directly quantifiable, although some analysis of the possible economy-wide implications of a fall in investment was made in the evaluation.
182 The effect in the model for Armenia is very weak.
in income etc.\textsuperscript{183} would tend to suggest a larger difference between the counterfactual and the outturn and thus a larger impact from the support.

For a given level of GDP, the imports parameter determines the extent to which changes in national income lead to changes in imports, directly affecting the balance of trade and the flow of reserves in the balance of payments.

Finally, the more responsive employment is to changes in economic activity, the faster government payments of social security benefit will fall when the economy picks up. In scenarios where the government faces a budget constraint, this frees resources that can be spent on goods and services, which has a multiplier effect on GDP (via production, income and back to expenditure).

In the no MFA scenarios, the GDP effect is little changed by alternative parameter values:

- The household income elasticity on demand was set at 0.3 in the main runs and tested at 0.1 and 0.5: the impact of MFA on GDP in 2012 remains around 1 per cent higher from the case where Armenia cut government spending (0.8 per cent with the lower elasticity and 1.1 per cent with the higher elasticity);
- The investment-share parameter was set to 0.3 in the main runs and tested at 0.25 and 0.35: GDP in 2012 in the no MFA and deficit-reduction scenario suggests a 1 per cent impact under the higher elasticity (compared to 0.9 per cent in the main results) and little change with the low elasticity;
- The import propensity was set at 0.45 in the main runs and tested at 0.30 and 0.60: the GDP impacts are similar to those for the household-income sensitivities, but with marginally higher impacts on reserve assets\textsuperscript{184}: in the no MFA with deficit reduction scenario, the low-imports sensitivity indicates that MFA increased reserves by EUR 62 million in 2012, compared to EUR 59 million using a higher income elasticity on consumption (the main analysis suggested an increase of EUR 51 million).

The direction and magnitude of the impacts of MFA are robust to alternative parameter values.

In the no MFA and no IMF scenarios, the relatively greater sensitivity of the model responses of consumption to income and imports to output become more apparent, with the imports response in particular leading to GDP impacts in 2009 of between 4.7 and 8.4 per cent in the no-borrowing scenario. This compares to the finding in the main analysis that GDP would have been 6.8 per cent higher that year with the support (but still having declined compared to 2008). By 2012 the contribution to GDP in levels is between 3.0 and 6.9 per cent (compared to 2.2 per cent in the main analysis). These results constitute the lower and upper bounds of the sensitivity. With the imports parameter set to its least responsive, Armenia’s holdings of reserve assets could potentially have been EUR 518 million lower as a result of the support package (owing to inelastic imports offsetting much of the inflow of reserves).

In the main model runs the output elasticity of employment was set at 0.5 (a 1 per cent increase in GDP raises employment by 0.5 per cent). Alternative values of 0.25 and 0.75 were tested. The sensitivity of the results to these changes was found to be small, barely changing the key outcomes in percentage terms in any of the scenarios.

\textsuperscript{183} Higher income and investment responses and a lower import response (because it acts in the opposite direction to the other components).

\textsuperscript{184} Because changes in imports lead to one-for-one changes in reserves, whereas consumption drives imports indirectly through higher overall activity.
Annex 5 Report from Stakeholder Workshop

Ex-post evaluation of the 2011-2012 EU’s Macro-financial Assistance (MFA) operation to Armenia
Second mission to Yerevan, 17-18 July 2013
Workshop Report

Workshop
Date of the workshop: 18 July 2013
ICF GHK participants: Charu Wilkinson, Silja Russell and Oskar Andruszkiewicz
Participants present at the meeting:

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<td>Varuzan Hoktanyan</td>
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<td>Executive Director</td>
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<td>Arman Danielyan</td>
<td>Civil Society Institute</td>
<td>President</td>
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<td>Karine Harutyunyan</td>
<td>Economic Development and Research Centre (EDRC)</td>
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<td>Mushegh Tumasyan</td>
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<td>Vahan Simonyan</td>
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<tr>
<td>Arman Tavadyan</td>
<td>Armenian State University of Economics</td>
<td>Senior Researcher</td>
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Overview of the workshop
ICF GHK gave a presentation regarding the aims and objectives of the evaluation, and provided an overview of the purpose and focus of the workshop. This was followed by an open discussion with the participants. Below is a summary of the key points discussed.

Public awareness about the EU assistance
The participants pointed out that there is a limited awareness of EU assistance in Armenia. In general, data from an opinion barometer suggests that around 35 per cent of the population is aware about EU providing assistance to the country.

The level of EU awareness among the general public was seen by participants as particularly low which contrasts with higher awareness of specific institutions/experts who are usually directly involved in issues concerning the EU in one way or another (i.e. academia, beneficiaries of the EU support).

EU is also often perceived to be more active in the area of fundamental rights and democracy rather than in providing direct financial assistance to Armenia.
Perceptions regarding Armenia’s closeness to the EU

In general, closeness to the EU is viewed in a positive light. However, there is a lack of understanding of the key conditions on moving closer to the EU, including potential obligations (i.e. harmonisation with the EU acquis and its implications). Also, Armenia’s specific relationship with the EU is not being discussed by politicians and ambitions towards the EU are not clearly expressed by the authorities. On the other hand, some of the participants pointed out that this was also a pragmatic approach considering Armenia’s close relationship with Russia. It was emphasised that the good relationship with Russia is vital for Armenia given the current geopolitical situation (i.e. challenges such as the closed border with Turkey since 1992 and conflict in Nagorno-Karabakh with Azerbaijan). However, the participants also considered that overcoming isolation would be one of the most important issues facing the country and that tighter relations with the EU could potentially be helpful in this respect.

One of the major issues debated in Armenia at the time of the workshop was the negotiations that were taking place regarding the Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU. The participants were of the view that general knowledge about the DCFTA was rather limited and its benefits seemed to be unclear, or at least had not been articulated clearly to the general public. The challenge regarding the DCFTA was seen not to be the approval of the Association Agreement but rather its implementation in practice.

On the other side, participants expressed the view that progress had been made in respect to customs policy reform, and although statistical data is sometimes contested (official statistics show that 90 per cent of import transactions for goods comply with the WTO standards), it is clear that the situation has improved from what it was previously. The participants also raised the issue that EU might over time face a challenge in EU-Armenia relationship given the poor relations between Turkey and Armenia, and the on-going dispute of recognising the Armenian genocide.

Progress regarding reforms in Armenia

In general terms, the participants considered that the pace of reforms of the current government has not been satisfactory. Participants viewed the reforms as not deep enough and not fast enough, pointing to the low inflow of FDI as one of the direct consequences. Key issues facing the country were considered to be the low tax collection undermining the fiscal stability in the long run as well as high corruption and still comparatively unfavourable business environment. EU was seen as a well-placed partner that could incentivise the authorities for more dynamic reforms. For instance, the EU can, and already to an extent, empowers the civil society institutions. The civil society organisations are involved in some of the reform areas supported via ENPI.

Overall, the Armenian authorities’ progress in advancing reforms during the MFA implementation was assessed by participants as unsatisfactory. They were of the view that the government’s anti-crisis programme was not coherent and the international assistance was often channelled to short-term social spending instead of longer-term sustainable reforms.

The participants considered that there should have been more growth enhancing measures implemented by the government, and these should also have been supported by the EU. Within this context, it was highlighted that insufficient financing was available for entrepreneurs. Interest rates attached to investment loans were too high for many businesses to take advantage of such loans. The entrepreneurial landscape in Armenia is characterised by businesses run by oligarchs and little is being done to encourage growth and improve the overall business environment. In addition, many banks focus on consumption credits and currency exchange operations, given that these are considered as less risky and more profitable source of revenue.
Some of the participants pointed out that a proposal which could potentially provide significant support to small entrepreneurs in Armenia (and alleviate poverty) was the abolition of the income tax for enterprises with a turnover below EUR 40,000. However, such proposals have been rejected, also due to the unwillingness of the government to include any tax concessions onto the tax system. There is a risk that the already existing monopolies would take advantage of this by breaking up their operations, and therefore the simplicity and integrity of tax system, (excluding any tax concessions) has so far been favoured.

At a national level, Armenia’s progress in reforms has often been judged against those of Azerbaijan and Turkmenistan which the participants thought was inadequate and unhelpful. These countries should not necessarily be considered as model benchmarks to aspire to.

Besides, insufficient scrutiny from media and civil society along with general apathy of the population facing the everyday hardship were also seen as significant causes lowering the pace of reforms.

**Remarks on effectiveness of structural reforms**

Improvement in the current political system was seen as a pre-condition for successful reforms, including reforms on improvement of business environment and competitiveness in the marketplace. In this context, the participants considered that EU should have stronger emphasis on increasing market competition and tackling monopolies, run by the oligarchs.

The participants stated that indicators defining the success in the fulfilment of the conditions should be made clearer. However, it was not straightforward to anticipate what the consequences of non-implementation should be. For example, cuts in provided assistance might be too radical approach as the effects would be primarily felt by the most vulnerable people in the society. On the other hand, some of the participants also pointed out that although harder stance and cuts in assistance would affect the most vulnerable groups of the society in the short-run, those would be eventually compensated by structural improvement and long-term benefits (i.e. improvement of political system/democratic standards/ transparency leading to faster economic growth), assuming that risk of cuts would be an effective instrument to bring the intended outcome.

In order to increase the impact of EU structural reforms in the future, the participants pointed out the following:

- EU should promote growth enhancing policies more actively, and funding for social spending (which mainly has short-term effects) should be considered pragmatically based on the needs in the crisis situation. Growth enhancing measures in certain situations may need to be given higher priority than currently is the case;
- Business environment is the key area that reforms should focus on. Major problems in this area include: lack of competition, lack of finance for SMEs and lack of incentives to start up a business;
- Strengthening the civil society to keep the government in check and increase civil society’s advocacy;
- Strengthening the capacity of national institutions to ensure the integrity of the government policies.
Annex 6 References

18. European Commission, (2012), Report from the Commission to the Council and the European Parliament on the implementation of macro-financial...


