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**Statement by Ms. Lundsager and Mr. Baukol on Republic of Armenia
(Preliminary)
Executive Board Meeting 04/43
May 3, 2004**

The authorities continue to meet program targets, notably structural measures, that contribute to strong macroeconomic performance. It is a welcome event to approve a review with no waivers on performance criteria. Nonetheless, the authorities will need to build on the improved track record this year, as private Lincy grants are completed. As we have noted in previous reviews, lower grants going forward will put a premium on fiscal policy to prepare to finance more of the burden of capital expenditures and support growth.

Fiscal policy: We continue to be baffled by the failure to increase revenues as a share of GDP. Once again revenues under-performed in 2003, and again the future projections have been reduced accordingly. We understand that GDP growth has been driven in part by non-taxable activities, but it is also clear that the authorities could do much more as indicated by the drop in VAT and profit tax collections. The sizable increase in VAT refund arrears for exports is also disconcerting. As a small, open economy, economic performance depends on exports, and the failure to refund VAT payments in a timely fashion could undermine export and revenue performance. We welcome the prior action to address this issue.

As we emphasized at the last review, the inability to increase revenues will impact future plans to increase social spending going forward. While strong GDP growth helps provide additional resources (as noted by Mr. Mozhin and Ms. Vtyurina), the authorities continue to plan for higher social spending than attainable without stronger revenue performance. Again, we would note that such spending plans (reflected in the PRSP) may need to be scaled back.

The authorities are taking welcome steps to improve tax and customs administration, as described in Messrs. Kremers and Stucka's clear and helpful statement. We encourage the authorities to follow through on the commitments regarding customs valuation and the regulation of retail markets. The introduction of an alternative enterprise profit tax, however, raises issues of transparency, governance and the extent of tax deductions. We welcome the discussion of more basic tax reform since administrative measures alone are insufficient to increase revenues. Simple, broad-based, low tax rate regimes with minimum exemptions are likely to perform the best. We understand that the Fund is providing TA on this topic.

On expenditures, the decentralization of noncommercial state organizations (mainly hospitals and schools) has the potential to reduce longer-term fiscal costs if it results in greater efficiency and better targeting of services. However, the staff are correct that stronger oversight is needed to ensure accountability and prevent an increase in contingent liabilities.

Monetary and banking issues: The emergence of higher inflation late last year is a cause for concern, even if largely driven by higher import prices on wheat. We concur with the staff that allowing the exchange rate to adjust freely is needed, particularly given the over-performance on reserves. The development of additional monetary policy tools should be a higher priority, and we would welcome more discussion of this topic in future reports.

The banking sector remains a key issue, effecting Armenia's longer-term growth prospects. Low lending and deposit levels indicate that the sector is not performing its role of intermediating savings to profitable investment projects. Given large remittances, this is a serious missed opportunity. We welcome efforts to complete bank resolution efforts, but further consolidation of the sector is needed to improve efficiency and sustain profitability. We concur with the staff that the Central Bank needs to build capacity to avoid future extended periods of CBA administration. We urge the authorities to follow up on IMF TA recommendations on mortgage lending.

The 2003 EBRD Transition Report includes a regional survey of secured transactions laws. Notably, the survey concluded that Armenia has "major problems and limitations" with respect to creditors rights and corruption within the court system and enforcement institutions. As a result it scored in the bottom half of the transition countries and behind Kazakhstan, Moldova, and Ukraine. We are encouraged to see legislation on bank bankruptcy to strengthen shareholder rights.

Structural issues: We commend the authorities for reducing the primary deficit in the energy sector. The improvement in electricity collection rates is also a substantial achievement. We hope the authorities will turn similar attention to the water and irrigation sectors, working with the World Bank. While additional reforms are needed in these areas, it appears that the Fund can phase out its conditionality, given the progress made in reducing their quasi-fiscal impact.

Implementation of the long awaited anti-corruption strategy is essential, particularly in tackling problems in court system. We welcome the steps that Armenia has taken in recent years in a variety of areas (see Box 2), but a more harmonized approach will be important to make additional progress going forward.

Program Extension: The authorities are requesting an extension of the current program until the end of the year. While we can support this proposal, we would urge the staff and the authorities to focus on making meaningful improvements in key macroeconomic policy areas, such as revenue performance, inflation, and banking sector development. Three years into this program, the authorities have made significant progress in structural areas, but progress has been disappointing in areas that should be in the 'core' of the Fund's work.