DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

MASTER FILES
ROOM C-525

0451

EBS/94/218
Supplement 1

CONFIDENTIAL

November 30, 1994

To: Members of the Executive Board

From: The Secretary

Subject: Republic of Armenia - Use of Fund Resources - Request for Purchase Under the Systemic Transformation Facility

Attached for consideration by the Executive Directors is the staff report on Armenia's request expected to be received for a first purchase under the systemic transformation facility in an amount equivalent to SDR 16.875 million. A supplement containing a draft decision will be issued shortly.

This subject, together with the statement of economic policies of the Armenian Government (EBS/94/218, 11/14/94), is now tentatively scheduled for discussion on Wednesday, December 14, 1994.

Mr. Shadman-Valavi (ext. 34532) or Mr. P. Ross (ext. 38973) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Preparation Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the European Commission (EC), the European Bank for Reconstruction and Development (EBRD), and the Organisation for Economic Cooperation and Development (OECD), following its consideration by the Executive Board.

Att: (1)

Other Distribution:
Department Heads

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

REPUBLIC OF ARMENIA

Staff Report for Request for Purchase Under the Systemic Transformation Facility

Prepared by European II and Policy Development and Review Departments
(In consultation with other Departments)

Approved by John Odling-Smee and Susan Schadler

November 29, 1994

Contents | Page

Appendices

Charts

I. Introduction

The Armenian authorities will shortly request a first purchase under the Systemic Transformation Facility (STF) for an amount equivalent to SDR 16.875 million (25 percent of quota), in support of a comprehensive program of macroeconomic stabilization and structural reform, covering the period December 1, 1994 through November 30, 1995. This request and the Statement of Economic Policies were circulated to the Executive Board on November 14, 1994. 1/ Annexes to that document provide details of the prior policy action commitments of the Government, intermediate policy targets, and structural benchmarks under the program. A Consultative Group meeting was held in Paris on November 22 to mobilize financial assistance in support of the authorities' program. The staff will report separately on the outcome of this meeting as well as on the implementation status of prior policy actions. The supplement to the present report will also include the proposed decision for the STF purchase.

In their letter of November 11, 1994, the authorities state their intention to reach understandings with the Fund on a comprehensive adjustment program that could be supported by an upper-credit tranche arrangement as soon as possible. Armenia is an ESAF-eligible country. With satisfactory performance under the STF, every effort will be made to expedite the transition to an ESAF, but the specification of a comprehensive three-year program will require considerable further technical work. In the interim, it may be necessary to start with an upper-credit tranche stand-by arrangement, during the first half of 1995, which could be replaced with an ESAF, in late 1995.

The most recent Article IV consultation with Armenia was completed on July 8, 1994 (SUR/94/76, July 13, 1994, SM/94/147, June 14, 1994, and SM/94/156, June 24, 1994). On that occasion, Executive Directors noted the progress made in transforming the economy and the increased determination of the authorities to embark upon a comprehensive program of stabilization and structural reform. They noted the need for an intensification of stabilization efforts and an acceleration of structural reforms. Directors also noted that without a peaceful settlement of the regional conflict, the scope for additional international financial assistance and the successful implementation of a comprehensive economic reform program would remain uncertain. They expressed the hope that efforts under way would lead to a durable and peaceful settlement of the conflict. Directors indicated that, with progress toward peace, the Fund should be prepared to provide financial assistance, under the STF, in support of an ambitious stabilization and structural adjustment program.

President Ter-Petrossian visited the Fund in August 1994 and assured the Acting Managing Director of progress toward peace and Armenia's commitment to systemic reform. Discussions on the STF program were held in

---

1/ See EBS/94/218, November 14, 1994.

Yerevan during September 14-27, 1994, and October 12-22, 1994, and in Madrid, during the Annual Meetings. 1/ The Armenian representatives included Prime Minister Bagratian; Finance Minister Barkhoudarian; Economy Minister Yeghiazarian; and Central Bank of Armenia (CBA) Chairman Asatrian, and other senior officials of the Government and the CBA. Discussions were also held with President Ter-Petrossian.

The World Bank has approved three loans for Armenia: an IDA/Earthquake Reconstruction Loan for SDR 20.1 million (January 1994), a Power Rehabilitation Loan of US$1.2 million (October 1993), and a US$12 million Institution Building Loan (April 1993). Disbursements under these loans totalled US$5.0 million through October 1994. Two additional loans (for irrigation and energy) are scheduled to be presented to the World Bank Executive Board in December 1994. Also, discussions on a rehabilitation credit for US$60 million have reached an advanced stage and Bank staff hope to proceed to formal negotiations in January 1995, and to present the loan to the Bank Executive Board in February 1995. Further, a World Bank loan for a Social Investment Fund is planned and will be discussed with the authorities in 1995.

Armenia's eligibility under the STF is discussed in Appendix I. Appendix II summarizes Fund Relations while Appendix III covers relations with the World Bank Group.

II. Recent Developments

1. Regional developments

Since the last Executive Board discussion on Armenia, significant progress has been made toward peace in the region. There have been no large-scale clashes between Azeri and Karabakh forces since agreement was reached on a cease fire on May 12. Further, on July 26, in response to the efforts of the Russian Federation and the CSCE, the Defence Ministers of Armenia and Azerbaijan and the Commander of the Karabakh forces signed a declaration that: (i) formalized a de facto cease fire; (ii) called for an acceleration of peace discussions with the aim of concluding an overall framework agreement; and (iii) provided for an automatic extension of the cease fire. Discussions on the peace process and the framework agreement have included contacts at the highest political levels. Although substantive progress has reportedly been made in these discussions, an agreement on a comprehensive political package has not yet been reached.

1/ These missions have included Messrs. Shadman-Valavi (Head), Ross (both EUR II), Messrs. de Schaetzen (PDR), Berg (RES), Gerson and Mongelli (FAD), Ms. Padmore and Ms. Nikdjou (Assistants, both EUR II). Mr. Odling-Smee joined the September mission for a few days for discussions with the political leaders, and held policy discussions with the authorities during the 1994 Annual Meetings.

2. Economic developments in 1994

a. Output, inflation and wages

After a close to 60 percent cumulative decline in real GDP in 1992-1993, economic activity has continued to be adversely affected by the external blockade, disruptions affecting remaining trade routes, and energy shortages in 1994. However, there are some signs of improvement because of the progress made toward resolving the regional conflict and the efforts to stabilize the economy. Tighter financial policies resulted in much lower inflation in May-September, although accumulation of payments arrears by the budget and enterprises indicate the need for additional measures to ensure further progress. Added impetus has been given to structural reform with further price liberalization, enterprise reform, and privatization.

There has been little change in output during the first three quarters of 1994 (Table 1 and Chart 1). The decline in industrial production and real net material product appears to have been halted in 1994 after cumulative declines of 50-60 percent in 1992-1993. 1/ Monthly inflation has dropped to around 3 to 6 percent in June-September 1994, after averaging over 50 percent in January-May, reflecting the implementation of tighter financial policies beginning in the second quarter of 1994.

Comprehensive data on wages is available only for the state sector. 2/ Despite some increases in recent months, real wages in the nonbudgetary sphere in August 1994 were less than 30 percent of their August 1993 levels. Real wages in the budgetary sphere have also declined sharply in 1994 due to resource constraints; real wages in August 1994 were less than 10 percent of their August 1993 levels.

b. The budget

The consolidated state government budget deficit on an accrual basis has decreased markedly so far in 1994 (Table 2 and Chart 2), due to a substantial increase in grants, a large decrease in net lending, and a lower level of current expenditure. Total revenues and grants are estimated to have increased from about 29 percent of GDP in 1993 to about 37 percent of

---

1/ Reliable GDP data are only produced at an annual frequency (see Appendix IV).

2/ The state sector includes the budgetary and nonbudgetary spheres. The budgetary sphere covers the Government and administrative operations, and people employed in the provision of health, education, and cultural services. The nonbudgetary sphere mainly comprises public enterprises.

GDP in 1994, 1/ although tax revenues are expected to decline from 16 percent to 15 percent due to lower payroll taxes. After a weak performance early in 1994, as collection efforts were hampered by high inflation, lower inflation and more vigorous collection efforts have led to an improved revenue performance in the second half of the year. Nontax revenues are expected to decline from about 7 percent of GDP in 1993 to about 4 percent in 1994 due, in part, to a decline in receipts of dividends from enterprises. Grants have increased substantially in 1994, essentially reflecting the European Union's decision to provide humanitarian commodity assistance in the form of grants instead of loans.

Total expenditure is estimated to have declined from 85 percent of GDP in 1993 to 61 percent in 1994. Current expenditure is expected to have declined from 60 percent of GDP in 1993 to 51 percent in 1994, despite an increase in subsidies from about 17 percent of GDP to about 20 percent. Expenditure on wages, pensions, and child allowances is estimated to have declined from over 14 percent of GDP in 1993 to about 8 percent in 1994 due to implementation of tight expenditure policies. Outlays on health and education (excluding wages) are also likely to decline from nearly 10 percent of GDP in 1993 to just over 4 percent in 1994, in part because the lack of fuel and other inputs led to the closure of many schools and health facilities early in the year. Capital expenditure and net lending are estimated to have declined from over 25 percent of GDP in 1993 to 10 percent in 1994, reflecting the virtual elimination of net lending to public enterprises.

While the financial position of the general government has improved significantly in 1994, the overall fiscal deficit remains large. As in 1993, most financing of the 1994 budget deficit (including domestic expenditure arrears) will be from domestic sources. In an effort to reduce inflation and to make implementation of a tight monetary program possible (see below), the authorities have tried to minimize bank financing of the budget deficit. With limited external financing available to the budget, however, this decision has led to a significant accumulation of domestic expenditure arrears.

c. Credit and money

Since April 1994, credit and monetary policies have been tightened significantly. Following agreement between the CBA and the Ministry of Finance on a monthly credit plan, borrowing by the budget was strictly limited, and the growth of CBA credit to banks was carefully controlled

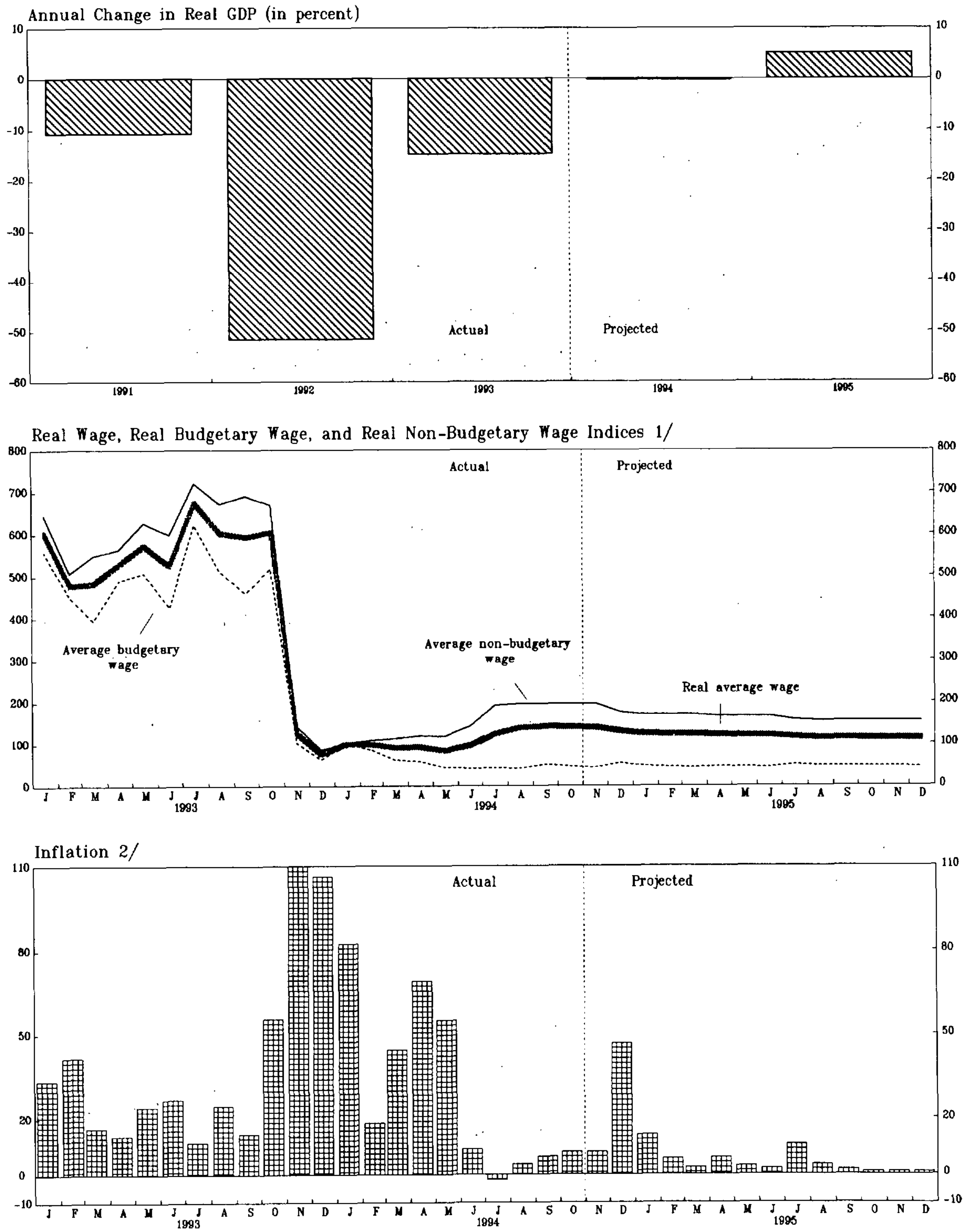
---

1/ There are significant problems with the measurement of GDP as discussed in Appendix IV. In light of these issues, all ratios to GDP should be treated as broad orders of magnitude and indicative of underlying trends rather than precise indicators. GDP in 1994 is estimated to be dram 111,216 million, or US$390 million converted at an average exchange rate of dram 285 per U.S. dollar.

Chart 1

ARMENIA

GDP, WAGES, AND INFLATION



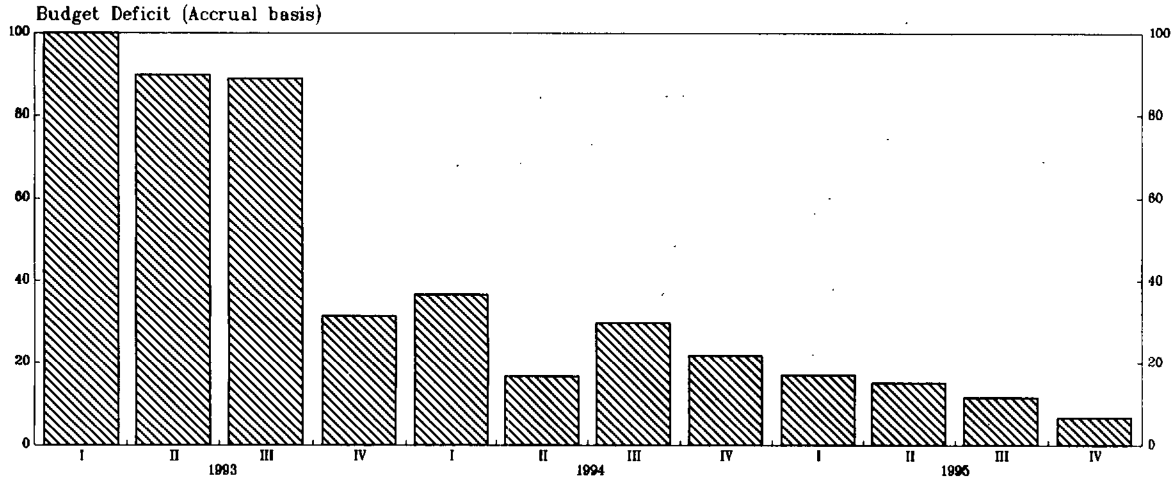
1/ Nominal wages deflated by CPI (Jan. 1994 = 100).
2/ Consumer prices increased by 438 percent in November 1993.

Chart 2

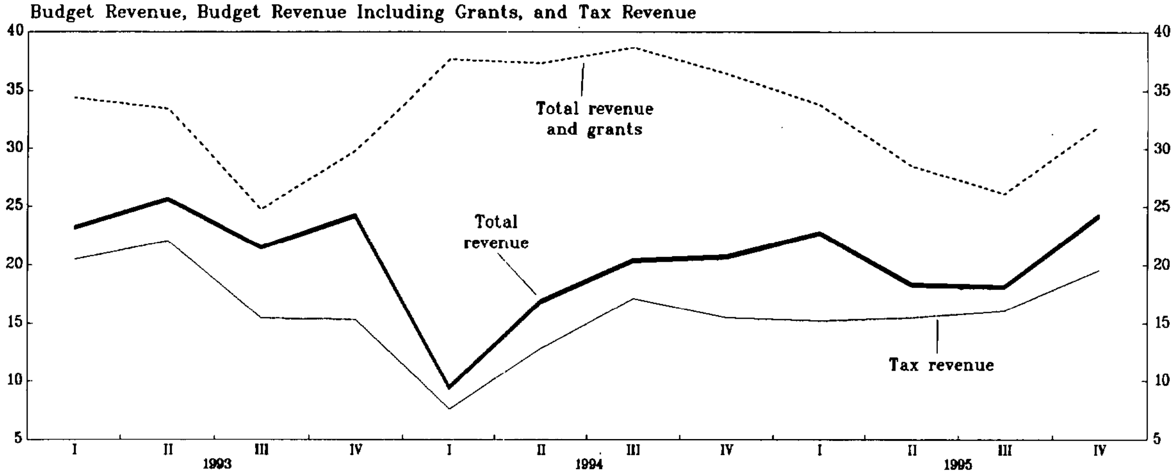
ARMENIA

FISCAL INDICATORS
(In percent of GDP)

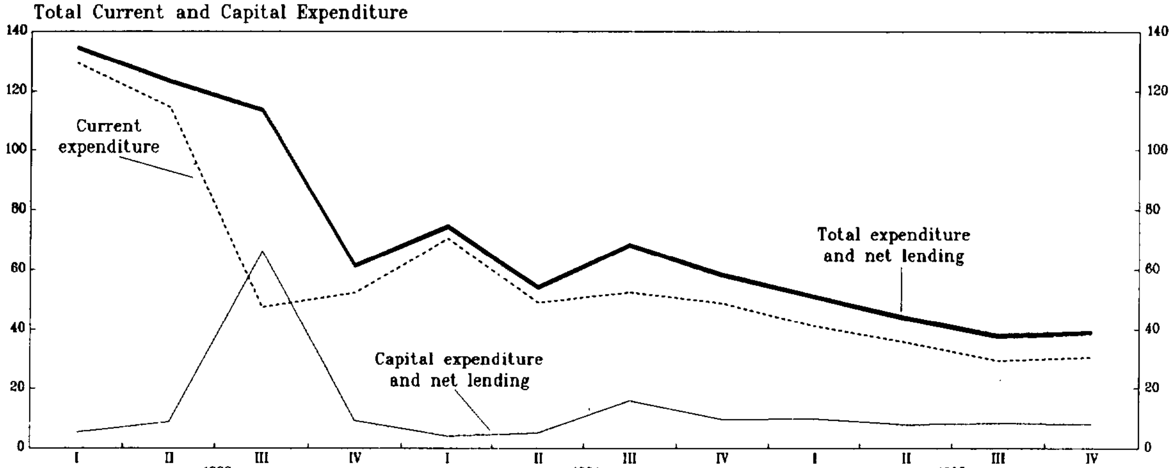
Budget Deficit (Accrual basis)



Budget Revenue, Budget Revenue Including Grants, and Tax Revenue



Total Current and Capital Expenditure



(Table 3). As a result, CBA reserve money grew by 8 percent per month in the third quarter, after 20 percent per month in the second quarter and 41 percent in the first quarter (Chart 3). Reflecting this tighter stance, the growth of banking system credit and broad money also declined (Table 4). 1/ At the same time, there was a substantial accumulation of domestic payments arrears that amounted to dram 35 billion as of October 1, 1994, mainly due to arrears of the budget and those within the energy sector. 2/

Interest rates were highly positive in real terms (relative to actual consumer inflation) from June 1994 onward, contributing to the decreasing rate of credit growth. The CBA refinance rate was increased to 360 percent per annum (30 percent per month, compounded monthly) in early spring and remained at this level until September 1, 1994 when it was reduced to 300 percent per annum (25 percent per month, compounded monthly). It was subsequently reduced to 210 percent per annum (17.5 percent per month, compounded monthly) in late September. The CBA restarted credit auctions on May 31, 1994. Since July, these auctions have been held weekly, although auction volumes have been modest--generally in the range of dram 40-80 million per auction--because of limited demand for auction credit due to the availability of directed credits.

The CBA has continued with measures to improve the operation of the banking system. In late-May it unified the reserve requirement on local currency deposits at 15 percent for all banks, except for the Savings Bank pending its restructuring. It also introduced prudential requirements for bank operations and has introduced a modification to the existing accounts of the banking system (used for reporting and monitoring banks' operations) that was expected to become operational on November 1, 1994. Moreover, in the summer of 1994, the CBA abolished the temporary minimum interest rate requirement on commercial bank loans.

After a sharp nominal depreciation during the first four months of 1994, the exchange rate showed greater stability during the summer, reflecting tighter financial policies implemented during the second quarter. After appreciating by 5 percent in nominal terms in July, the official exchange rate against the U.S. dollar depreciated by some 24 percent between end-July and end-October, reflecting concerns that monetary policy, although tighter than earlier in 1994, was still not tight enough to make holding

---

1/ Broad money grew at an average rate of 12 percent per month in July-August 1994, after increasing at 18 percent per month in the second quarter and 50 percent in the first quarter. Data for the banking system is only available through end-August.

2/ This figure amounts to 31 percent of 1994 GDP. It is an initial estimate prepared by the authorities and is highly tentative. A breakdown of these arrears between interenterprise and other arrears is not available for October 1, 1994; however, on September 1, 1994, total arrears amounted to dram 25.9 billion, of which dram 24.9 billion were interenterprise arrears.

dram denominated assets attractive. At the same time, after depreciating sharply in real terms between November 1993 and March 1994, the exchange rate of the dram against both the U.S. dollar and the Russian ruble appreciated in April-June and subsequently remained broadly stable in real terms (Charts 4 and 5). Also, the difference between cash and noncash exchange rates decreased as exemptions from official charges on cash withdrawals were granted to some enterprises. 1/ Since July foreign exchange auctions have been held twice a week and the volume traded has been US$3-5 million per month.

d. Balance of payments

The external situation remains weak (Table 5). Aside from aid inflows, most external transactions are heavily dependent on bilateral trade and clearing mechanisms with other FSU states, principally Russia and Turkmenistan. Lately, however, there have been signs of growing autonomous trade activities by public enterprises and the private sector helped by improved security and transportation conditions and earlier liberalization measures. These factors, together with the payment of arrears owed to Russia, have allowed a full resumption of trade with that country and resulted in a steady, albeit moderate, growth in trade during 1994. In addition, there have been signs of a diversification of trade away from traditional FSU markets.

Because of the balanced nature of trade under clearing agreements and imports financed by foreign aid, the current account is expected to be broadly in balance in 1994. As regards the capital account, most financing was provided by Russia. There was little change in the net foreign asset position of banks during the first half of 1994. All current external debt service obligations were met promptly and, as noted above, arrears due to Russia incurred in 1993 were paid in the second quarter of 1994. At the end of September 1994, the convertible currency official gross international reserves of the Central Bank amounted to US$7 million--or less than a week of 1994 imports.

e. Structural reform

Armenia made substantial strides in structural reform in the first ten months of 1994 building on earlier progress in 1992-93. Further price liberalization has taken place. Controls on prices and profit margins for milk, baby food, aviation services, inter-city transportation, and liquified natural gas were eliminated in October 1994. Urban bus transportation tariffs were also liberalized, but remain subject to profit margin control with a full pass-through of costs. Thus, currently only a limited number of goods and services remain subject to price regulation: bread, municipal transportation, electricity, gas, domestic telephone calls, rent, water,

---

1/ These charges vary according to the sector in which the enterprise operates, up to a maximum of 37 percent.

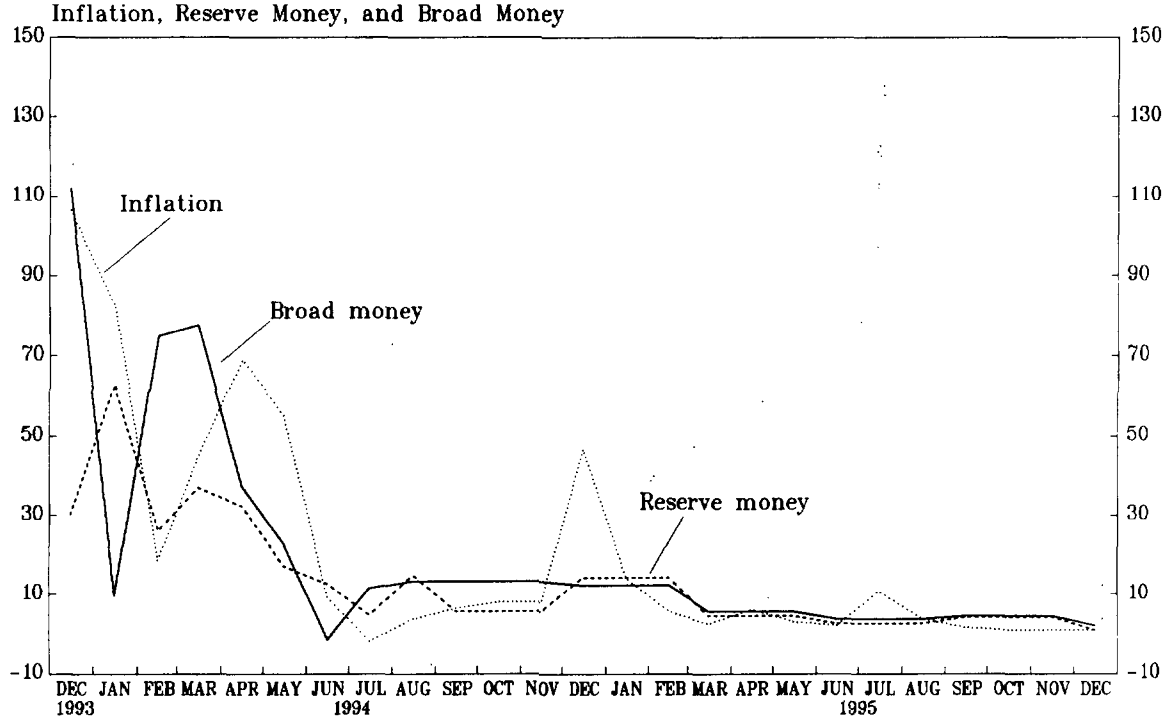
Chart 3

ARMENIA

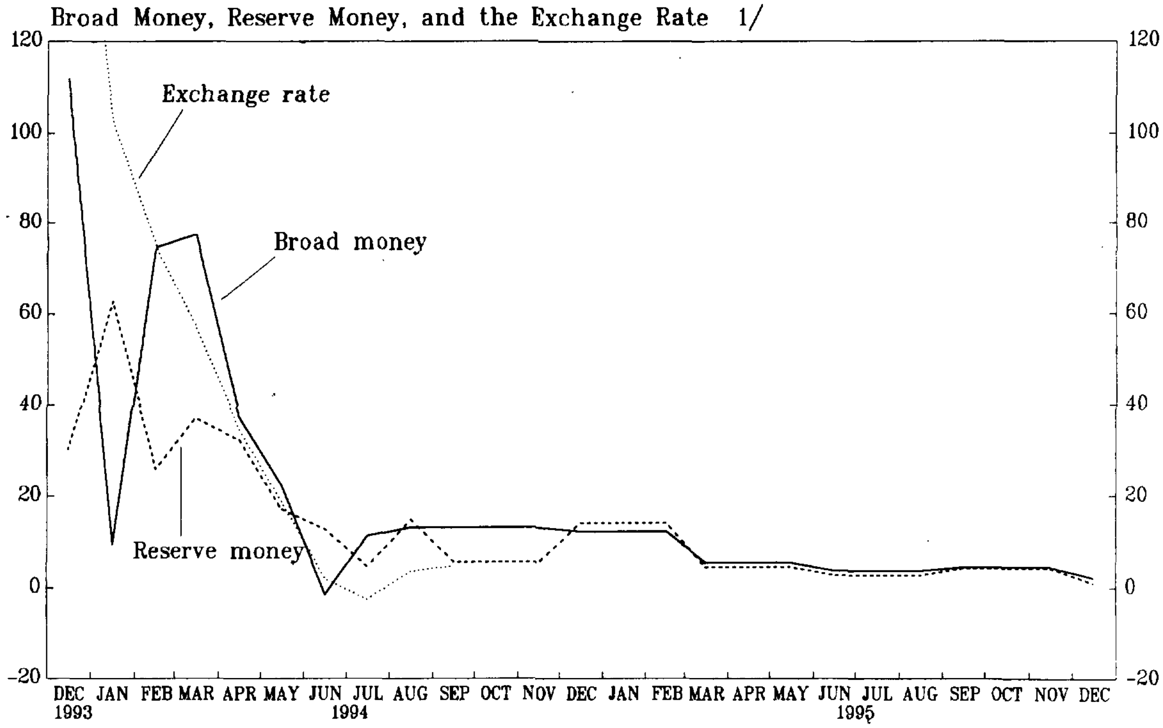
SELECTED MONETARY INDICATORS

(Monthly Percentage Changes)

Inflation, Reserve Money, and Broad Money



Broad Money, Reserve Money, and the Exchange Rate 1/



1/ A positive change in the exchange rate indicates a nominal depreciation.

Chart 4

ARMENIA

Real Exchange Rate Indices 1/

(log scale)

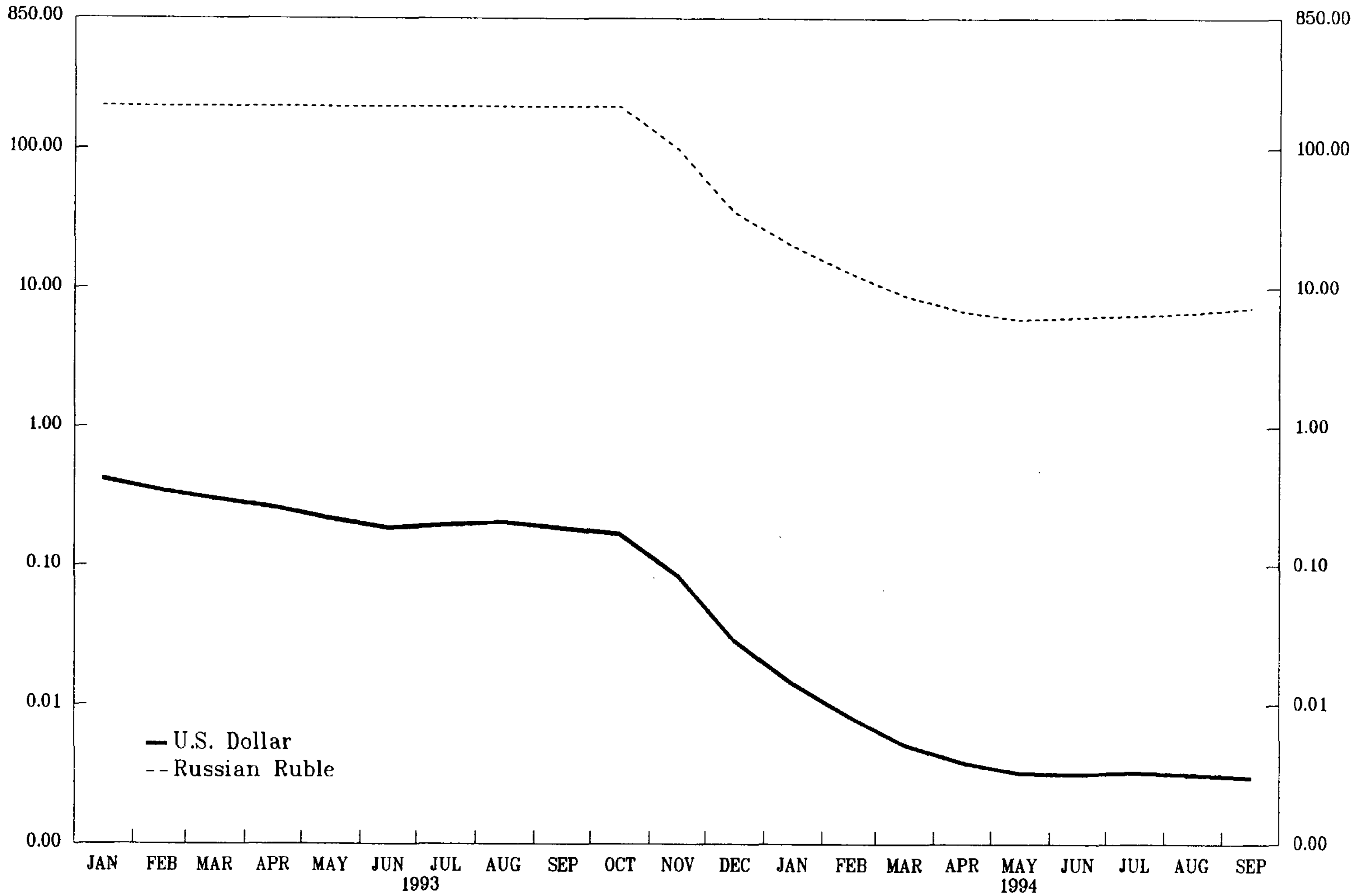
1/ Nominal exchange rates deflated by consumer price increases. For the period January - November 1993, nominal exchange rate for the pre-1993 ruble is converted to drams at a rate of Rub 200 per dram. An increase represents an appreciation. (Base January 1993 = 100)

Chart 5

ARMENIA

Nominal Exchange Rates 1/

(log scale)



1/ For the period January - November 1993, nominal exchange rate for the pre-1993 ruble is converted to drams at a rate of Rub 200 per dram. The exchange rate is expressed in units of foreign currency per dram.

garbage collection, and heating for households. Prices of many of these remaining items were also increased in October: rents and various charges on communal services such as sewerage and drinking water were increased by between two to eight times; price subsidies on gas to households were eliminated (the amount of gas provided to households has been very low in recent years); and the price of bread was increased from dram 4.5 to 6.0 per kilogram.

There has also been some progress in enterprise reform and privatization. Transfers and lending to enterprises from the budget have been virtually eliminated in 1994. Since July, the Government has begun to convert over 1,000 state enterprises to joint stock companies with distribution of 20 percent of shares free of charge to the workforce. The Government has also begun to privatize state enterprises. Over 200 small enterprises have been privatized in 1994, and another 600 are being privatized in the fourth quarter of 1994. Distribution of privatization vouchers began on October 10, 1994. Nearly 50 percent of the housing stock has been privatized, through free transfer of ownership to current tenants. A liberal foreign investment law was approved by Parliament in June 1994.

III. The Program for 1994-95

1. Program objectives

The program of policies is described in the Statement of Economic Policies (SEP) submitted by the authorities (EBS/94/218, November 14, 1994). 1/ The program aims to create conditions for sustained noninflationary growth, necessary to increase living standards. In line with this objective, a marked improvement in public finances will support a further tightening of monetary policy so as to reduce inflation sharply to 1 percent per month in the fourth quarter of 1995 and to increase gross official international reserves to the equivalent of 1.7 months of imports at end-1995. In addition, structural reforms will be accelerated with the aim of improving the economy's supply response. The main focus will be on:

1/ While the program covers a 12-month period, developments in the rest of the FSU, prospects for external financing, and insufficient focus on the medium term precluded specification of some of the program's targets and structural benchmarks beyond mid-1995. However, the authorities intend to reinforce the package of measures underlying the program and to request an upper-credit tranche arrangement in the coming months. In that context, the targets for the remainder of the program period will be specified. Accordingly, the program elaborates quantitative targets for credit to government, CBA reserve money, CBA net domestic assets, domestic budgetary expenditure arrears, external debt, external payments arrears, and net official international reserves for end-December 1994, end-March 1995 and end-June 1995, see Attachment I to EBS/94/218. Targets for the rest of 1995 will be established prior to a second STF purchase.

strengthening institutions of macroeconomic management; achieving significant progress toward full price liberalization, dismantling most exchange and trade restrictions; promoting private ownership; and creating a targeted, affordable, social safety net.

2. Fiscal policy

The program will make a strong start with the process of strengthening the public finances, which is likely to take some time. This will be accomplished through a combination of revenue-enhancing and expenditure-reducing measures, with strong emphasis on expenditure reduction. The overall fiscal deficit of the general government as a percentage of GDP (on an accrual basis) is targeted to fall sharply from 24 percent in 1994 to 12 percent in 1995. After repaying arrears incurred in 1994, the 1995 budget deficit on a cash basis is targeted to amount to somewhat less than 15 percent of GDP. The program assumes foreign financing equivalent to 15 percent of GDP is forthcoming, allowing a small repayment to the domestic banking system.

Revenue measures concentrate on reducing existing tax exemptions, modifying tax rate structures, introducing a few new taxes, and improving tax administration. These measures aim to mobilize additional tax revenue equivalent to 2 percent of GDP in 1995. The elimination of exemptions, in particular for VAT, the new structure of excise taxes and custom tariffs, and the revised tax on land are the principal sources of projected revenue growth. These changes should help to improve efficiency in the economy by removing ad hoc privileges. Further measures to improve tax administration, which will be implemented with Fund technical assistance, should lay the basis for improved revenue performance over the next few years. A comprehensive review of tax policy will be undertaken in 1995 and the results of the review will be implemented as part of the 1996 budget. With the increase in the price for bread (see below) and monetization of the commodity assistance, foreign grants are projected to provide substantial resources for the budget in 1995.

The program calls for a sharp reduction in overall expenditure from 61 percent of GDP in 1994 to 42 percent of GDP in 1995. This will be achieved mainly through a substantial cut in subsidies, while protecting certain priority expenditures, including provisions for health, education and social purposes. 1/ No new arrears will be incurred by the general

---

1/ This includes increased outlays by the Pension and Employment Fund for unemployment benefits expected to result from the projected growth in unemployment. Amounts provided for the social safety net are also available to provide compensation to the unemployed.

government and existing domestic expenditure arrears will be eliminated during the first three quarters of 1994. 1/

The reduction and removal of subsidies are central to reducing current expenditure and providing the right incentives for efficient resource allocation. Bread price liberalization will have the most significant implications for the budget. The price of bread will be increased from dram 6 per kilogram to dram 66 per kilogram on December 1, 1994, will be increased again on April 1, 1995, to adjust for inflation in the December 1994 through March 1995 period, 2/ and fully liberalized by no later than July 1, 1995. Other subsidies have been reduced, and adjustments to remaining administered prices will be made to ensure that nonbread budgetary subsidies are limited to dram 3.5 billion in 1995 (1 percent of GDP). As a result, total subsidies will decrease from 20 percent of GDP in 1994 to 3 percent in 1995. In order to help improve control over public finances, a treasury will be set up. The Ministry of Finance will also set quarterly limits on budgetary expenditure on commitment and cash bases.

The Government's investment program is being reoriented in an effort to reduce the share of domestically-funded capital expenditure and to take advantage of the availability of external finance for efficient economic rehabilitation and reconstruction projects. As a result, more than 100 domestically-financed projects will be canceled and expenditure on domestically-financed projects will be limited to a few priority areas and to a total of dram 5 billion (1.4 percent of GDP). The envisaged cuts are designed to cancel lower return projects from the investment program, but also involve, in some cases, postponement of projects that are likely to be undertaken when the public finances have further improved. Overall, the ratio of capital expenditure to GDP is expected to decline somewhat in 1995. The public investment program will be reviewed with World Bank staff.

In addition to the strengthening of the financial position of the Government, the program aims to reduce reliance on banking system financing of the budget deficit with the Government repaying credit to the banking system. As a first step, the Government started to issue treasury bills in September 1994. It plans to widen placement of these securities, and auctions for these instruments are scheduled to begin by May 1995. Treasury bills will also provide an important component in implementing a more market-oriented monetary policy, which will enhance the development of financial markets.

1/ The largest portion of arrears are owed for expenditure on state capital investment (40 percent) health and education (20 percent), and law enforcement (15 percent). There were no external arrears as of September 30, 1994.

2/ Excluding the impact of the bread price increase.

3. Monetary policy

The primary objective of monetary policy will be to reduce monthly inflation to about 1 percent by the end of the program period, by limiting strictly CBA credit growth and ensuring that the CBA refinance rate remains positive in real terms. The monetary program targets a continuous decline in the underlying monthly rate of inflation (excluding the impact of administered price increases) from 5 percent in December 1994 to 1 percent in the fourth quarter of 1995. The monetary program assumes that the demand for real balances will only begin to increase once the credibility of the program has been established, which can conservatively be expected in the fourth quarter of 1995. Also, the program will set uniform reserve requirements on all banks for all deposits, denominated in both local and foreign currency.

The granting of refinance credit on a directed basis will be discontinued, and market-based methods will be used instead. The proportion of all refinance credit to the nongovernment sector auctioned through the interbank market will be raised from an average of around 20 percent for the first nine months of 1994 to 70 percent in December, and directed credits will be eliminated by January 1, 1995. Distortions will also be reduced by removing Government and CBA-imposed charges on cash withdrawals by December 1, 1994 and eliminating interest rate minima on commercial bank deposits.

All official foreign exchange reserves of the Government will be transferred to the CBA by December 10. Reserve management procedures will be strengthened ahead of the projected increase in gross reserves.

4. External policies

The thrust of external sector policies will be to continue to liberalize the exchange and trade regime, promoting rapid export growth and better integration into the global economy. These policies, in conjunction with the other components of the macroeconomic adjustment program, should also encourage inflows of foreign investment. While the benefits of exchange rate stability are understood, the authorities believe that a floating exchange rate arrangement currently is most appropriate, in light of the large remaining fiscal imbalance, modest level of reserves, and uncertainties affecting the availability of external financing. A fixed exchange rate could be considered in the future when public finances have been strengthened, reserves have been built, and the availability of external financing has been clarified. Accordingly, the dram will, for the time being, continue to float with some intervention consistent with the monetary objectives of the program. Sustained implementation of the tight financial policies, however, should lead to relative exchange rate stability.

The program aims for an accumulation of official foreign exchange reserves. Gross reserves are targeted to increase to 1.7 months of projected 1995 imports by the end of December 1995. At the same time, the program limits strictly accumulation of official nonconcessional external debt.

A broadening and deepening of the foreign exchange market is also being encouraged by changes in the surrender requirement. Exporters are currently required to surrender foreign exchange earnings to local banks which, in turn, surrender them to the CBA. By December 1, the requirement for banks to surrender foreign exchange to the CBA will be replaced by an obligation for enterprises to sell surrendered amounts in the interbank market. Further, the surrender requirement will be reduced from 50 to 30 percent by January 1, 1995, and replaced by a simple repatriation requirement by the middle of the year. Moreover, the abolition of official charges on cash withdrawals should serve to reduce further the differential between the cash and noncash exchange rates (which is currently 10-12 percent), although charges by commercial banks for cash withdrawals may result in a continued differential between the cash and noncash exchange rates.

5. Social safety net

A targeted social safety net has been designed with the aim of protecting the most vulnerable during the period of stabilization and reform. Given the present financial constraints, resources amounting to only 4.3 percent of GDP have been earmarked in the 1995 year to compensate fully pensioners and the 500,000 most needy for the higher cost of bread and the December 1, 1994 increase in the electricity tariff to households. 1/ Consistent with these provisions, World Bank staff are working with the Government to prepare a compensation scheme to be implemented by December 1, 1994. In addition, a medium-term strategy for a social safety net will be developed by July 1, 1995 in close consultation with the staffs of the Fund and the World Bank. A poverty assessment study was initiated by the World Bank in the summer of 1994 and work on a social investment fund is presently under way.

6. Structural reforms

The main goals of the structural reforms are to complete price liberalization, impose hard-budget constraints on enterprises, make substantial progress toward privatization, undertake further financial sector reform, and improve the legal and institutional framework.

Price controls remain only on a limited number of essential goods, and adjustments will be made regularly to ensure prices do not decline in real terms. Bread prices will be liberalized by mid-1995, as noted above, and

---

1/ These resources would also provide any needed additional compensation for the unemployed, over and above the amount of unemployment benefits. An additional dram 1.3 billion (1.2 percent of 1994 GDP) has been allocated for the same purposes for the month of December 1994.

cross-subsidies on electricity will be removed. Remaining rent controls will be removed by end-1995 once the privatization of the housing stock has been completed. Private housing will be further promoted by eliminating cross-subsidies on household services.

A number of steps have been taken to impose market discipline and hard-budget constraints on enterprises. Transfers and lending to enterprises from the Government, as noted earlier, were virtually eliminated in 1994. 1/ Transfers from the Government and the CBA will only be made to enterprises as part of a comprehensive restructuring program for the enterprise. In this regard, neither the Government nor the CBA will provide financial resources to settle interenterprise arrears. Beginning April 1, 1995, rationing of energy will be sharply reduced, with 50-70 percent of oil products and electricity to be allocated by competitive means compared to less than 10 percent currently. This will eliminate implicit cross-subsidies as prices for rationed oil products and electricity are below those for electricity and oil products allocated competitively. In parallel, the program to privatize state enterprises will continue to be implemented. Procedures are also being developed to enable the privatization of large enterprises from the first quarter of 1995. Steps are being taken to improve the legal framework for a market-based economy by implementing laws on bankruptcy, collateral, and condominia. Steps will also be taken to improve the framework for agricultural land trading.

The Government intends to start to reform and overhaul the state order and task systems by introducing greater competition and reducing the scope for energy rationing as noted above. All state procurement, apart from a few construction projects, will be subject to competitive tender. Bilateral trade arrangements will be phased out as conditions permit. Reduced input allocation, ongoing privatization, and more market-oriented procurement policies should diminish the relative importance of the state order and task systems. Furthermore, all transactions that will remain under the state order and task systems will continue to be voluntary and will be conducted at market prices.

As part of financial sector reform, the CBA's banking supervision and regulatory functions will be improved. This will include the finalization of guidelines on bank licensing by the beginning of 1995 and the requirement for former specialized banks to prepare a plan for a prudent diversification of their credit portfolios, to be implemented with MAE technical assistance.

1/ The CBA has made no loans or transfers to enterprises in 1994.

IV. Balance of Payments Outlook, Medium-Term Prospects and Capacity to Repay

The external sector outlook continues to be highly uncertain for Armenia. For 1995, staff projections indicate a balance of payments gap of US$395 million, of which US$118 million could be provided by the Fund and other international organizations. A residual gap of US$277 million remains that should be filled through debt refinancing, and additional humanitarian assistance and balance of payments support. To mobilize additional financing for 1995, a Consultative Group meeting was held on November 22, 1994. If additional financing equal to the projected gap cannot be mobilized, this may result in a lower than currently projected level of import growth in 1995, which could adversely affect economic growth prospects.

The outlook for the balance of payments over the medium term would be an important element of the discussions for an upper-credit tranche arrangement. However, in view of the many uncertainties relating to the external sector outlook, it is not possible to present meaningful medium-term balance of payments projections at this time. First, political developments in the region, while encouraging, remain somewhat unpredictable. With progress toward peace, the economic blockade is expected to be lifted, but it is not clear at this time how quickly and to what extent this can be achieved. Improvements in the utilization of trade routes through Georgia will also have a positive impact on the Armenian economy, but this will also take time. Second, a major rehabilitation of the Armenian economy is needed that will affect external trade (including imports of inputs, investment goods, and energy), but the likely size of its impact cannot be assessed with any accuracy at this juncture. Finally, while improvements have been made in Armenia's balance of payments statistics, in part as a result of Fund technical assistance, the statistical base remains weak, limiting analysis of the external developments, particularly with the FSU countries, Armenia's main trading partners.

Nevertheless, given the mobilization of adequate financial assistance on concessional terms, Armenia's external position could improve relatively quickly if the authorities persevere with the stabilization effort and structural reforms initiated under the present program and indeed strengthen their adjustment policies in the context of an upper-credit tranche arrangement. In the interim, largely as a result of the need for increased imports of energy and other inputs, Armenia's external current account deficit is likely to widen in the next couple of years, before improving toward the end of this decade. Also, Armenia will need to strengthen its official reserve position, given the virtual absence of foreign reserves at the beginning of the program. Under those circumstances, Armenia's external debt is expected to increase somewhat, although most of it should be contracted on concessional terms. The proposed purchase is equivalent to 6 percent of 1994 GDP and some 13 percent of projected end-1994 external debt.

On the whole, Armenia is likely to need additional use of Fund resources and exceptional financing over the medium term, although the situation is expected to improve significantly. While repurchase obligations to the Fund are not expected to create serious difficulties for the authorities, Armenia's external reserves and indebtedness positions should be monitored closely so as to safeguard the country's capacity to repay the Fund. In this regard, the staff will report any important developments to the Executive Board, as necessary.

V. Staff Appraisal

Since its independence Armenia has faced extremely difficult economic conditions, but new and bolder reform efforts initiated in 1994 have begun to bear fruit. In particular, implementation of a tighter monetary policy has led to sharply lower inflation and a more stable exchange rate. However, despite significant strengthening, the financial position of the Government remains weak and has already led to a substantial accumulation of budgetary arrears. The authorities recognize that additional measures contained in the program are needed to stabilize the economy and to lay the foundation for sustainable economic growth. Substantive progress has also been made in the area of systemic reforms, but a further consolidation of structural reforms, at an accelerated pace, is also essential. The authorities are to be complimented for adopting the ambitious program of stabilization and structural reform, discussed above, which represents a clear break with the past.

A substantial strengthening of public finances is the centerpiece of the adjustment effort and the key to the success of the program. In the staff's view, fiscal measures envisaged under the program, together with the steps taken to reduce reliance on bank financing of the deficit are commensurate with the task. On the revenue side, the introduction of the tax measures envisaged by the authorities will broaden the tax base and should lead to an increased mobilization of resources, while improving resource allocation. The authorities intend to request Fund technical assistance in the areas of tax administration and policy. The aim is to begin promptly the work needed to strengthen tax administration during the program period and to incorporate tax policy recommendations in the 1996 budget.

As regards expenditure measures, the decision to reduce consumer subsidies, under extremely difficult circumstances, demonstrates the authorities' commitment to a strong policy of stabilization and reform. This decision, together with the pruning of other expenditure and a tight wage policy, will make room for increased spending for health, education, and social purposes, including the social safety net. Moreover, the careful review of public investment projects should improve the selection of high return investments needed for economic rehabilitation and reconstruction.

The fiscal package for 1995, while ambitious, carries some risks. The realization of the targeted level of receipts for the budget will depend crucially on the authorities' ability to mobilize the counterpart funds from sales of commodities provided as humanitarian assistance. The authorities should be prepared to reduce expenditure, on construction, operations and maintenance and, if necessary, on education and health, as outlined in the Statement of Economic Policies, should resources actually mobilized through this channel fall below program expectations. Further, realization of the fiscal objectives of the program will depend crucially on the timely disbursement of external assistance, especially the World Bank's rehabilitation loan and a resolution of the repayment obligation to the European Union. While implementation of the fiscal package for 1995 will contribute to the strengthening of the public finances, further measures will be needed to reduce the fiscal deficit to a sustainable level over the medium term.

The staff welcomes the efforts made by the CBA to pursue a tight monetary policy, to assure that the refinance rate remains positive in real terms, and to increase the CBA's administrative capacity. Continued implementation of a tight monetary program and positive real interest rates will be essential to ensure the achievement of the program's inflation objective. The size of the current stock of interenterprise arrears is of concern. While the position should improve following the settlement of domestic expenditure arrears by the budget, continued accumulation of interenterprise arrears carries risks for the program relating to implementation of a tight monetary policy and enterprise reform. The imposition of a unified reserve requirement, the elimination of interest rate minima and the tax on cash withdrawals, as well as the elimination of directed credit are also welcomed as these measures will allow market mechanisms to play a greater role in mobilizing and allocating financial savings. The staff notes the need to develop indirect instruments of monetary policy. Moreover, the envisaged further strengthening of the CBA, with Fund technical assistance, should allow it to conduct monetary policy more effectively and exercise an enhanced supervisory role.

The current exchange rate arrangement seems appropriate for a time, given the low level of reserves and the uncertainties affecting both the fiscal position and the timing and amounts of inflows of external financial assistance. However, serious consideration should be given to the introduction of a fixed exchange rate regime at the time of an upper credit tranche arrangement in order to lend added credibility to the authorities' adjustment efforts by providing a transparent nominal anchor. In the meantime, foreign exchange reserves should be accumulated at least in line with the program targets. It is hoped that the differential between cash and noncash rates will be substantially reduced as a result of the abolition of all official charges on cash withdrawals. The staff welcomes the intention to reduce and abolish the surrender requirement.

On trade arrangements, a continuation of the current liberal arrangements are welcome and remaining restrictions should be abolished as soon as possible. Also, a schedule for the phasing out of bilateral trading arrangements should be established at an early stage. In light of the growing stock of external debt which entails clear risks, the staff welcomes the arrangements to centralize the authority to contract and monitor external debt and urges that only very limited recourse be made to external debt on nonconcessional terms.

Regarding structural reform, considerable progress has been made in price and trade liberalization and in corporatization and privatization of public enterprises, but much remains to be done. Under the program, further price liberalization will be implemented; financial assistance to enterprises will not be provided other than as part of a comprehensive restructuring plan and no resources will be provided to help settle interenterprise arrears; an enhanced privatization program will be pursued; and the expeditious passage of the remaining laws needed for the legal framework appropriate for a market economy is planned. Together with continued progress in modernizing the CBA and major rationalization of the state order and task systems that are envisaged under the program these measures, no doubt, will increase the economy's sustainable growth rate.

The balance of payments position is likely to remain weak for the next few years. The measures under the program should improve the external position, but substantial external financial assistance will be needed to finance economic reconstruction and rehabilitation. The staff estimates that the financing gap for the balance of payments, including the envisaged accumulation of official reserves, will amount to some US$277 million in 1995. 1/ A pledging session was held on November 22, 1994 in Paris, the outcome of which will be reported separately. The staff believes that, in addition to determined implementation of the program's policy measures, timely and appropriate financial support will be essential for the success of the program.

Armenia is likely to need Fund financial assistance and exceptional financing for the next few years. While some progress toward external viability is foreseen, the medium-term prospects for the Armenian economy and Armenia's capacity to repay the Fund will depend critically on sustained implementation of adjustment policies and continuing improvements in trading relations and regional conditions.

The program outlined above contains some risks. First, continuation of progress toward a lasting peace and political stability in the region is critical for the successful implementation of the stabilization and reform measures. Second, while the authorities have demonstrated their commitment to take bold measures, their capacity to implement and monitor the program needs to be strengthened. Finally, the weak macroeconomic database and uncertainties surrounding developments in the rest of the FSU require

---

1/ The financing gap is after financing from the IMF (of a second STF purchase of 25 percent of quota), World Bank, and EBRD.

vigilance and the preparedness to act swiftly. This being said, the authorities' strong commitment to the program, backed up by their determination and demonstrated ability to pursue reform-oriented policies in the past, even under highly adverse circumstances, clearly deserves the support of the international community.

The Armenian authorities have cooperated closely with the staff both in policy discussions as well as in efficient use of technical assistance. Substantial additional Fund support will be needed to enhance the successful implementation of their ambitious program. In particular, continuation of the provision of technical assistance in the areas of modernization of the Central Bank and the Ministry of Finance as well as on statistical issues will be important.

Table 1. Armenia: Program Assumptions, Estimates, Projections, and Targets

	1993		1994				1995				1993	1994	1995
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Year Actual	Year Est.	Year Proj.
Real GDP change (percent) 1/													
Over previous quarter	27.7	10.2	-18.4	--	--	--	0.3	2.4	5.4	0.7			
Over same period in previous year	-16.3	24.2	26.1	14.8	-10.1	-18.4	0.3	2.6	8.2	9.0	-14.8	--	5.0
Inflation (in percent)													
Within period 2/	16.7	158.4	46.2	41.9	2.7	19.6	7.2	3.7	5.2	1.0	47.9	26.3	4.2
Period average over previous quarter	70.3	956.0	351.7	214.9	22.9	38.9	54.6	12.6	16.4	4.3			
Period average over same period in previous year	1,024.8	7,326.6	14,309.7	25,475.6	18,362.6	2,328.8	731.3	197.1	181.5	111.3	3,731.9	5,020.9	198.0
Real wages													
Over previous quarter	15.1	-56.9	-64.0	-5.4	47.2	1.2	-10.1	-2.3	-6.0	-1.0			
Over same period in previous year	-30.0	-68.5	-81.5	-83.1	-78.4	-49.3	26.6	30.8	-16.4	-18.3	-41.8	-76.5	1.5
Consolidated State Government Budget Deficit (percent of GDP)	...	...	-36.7	-16.6	-29.5	-21.7	-16.9	-15.1	-11.5	-6.7	-56.1	-23.9	-12.0
Growth in money stock (end-period over previous end-period)													
Reserve money 3/	...	...	180.6	74.2	26.9	48.8	14.0	8.0	13.1	3.0	...	822.9	43.4
Broad money (incl. foreign exchange deposits)	...	...	239.8	65.3	34.0	49.7	17.4	11.4	13.9	6.1	...	1,026.9	58.1
Velocity	...	5.6	4.2	7.3	5.9	6.8	7.1	7.3	7.8	7.7	5.6	6.8	7.7
(Percent change)	...	...	-24.9	72.9	-19.2	14.2	5.2	2.4	7.7	-2.2	...	19.7	13.4
Money multiplier	...	1.9	2.3	2.2	2.3	2.3	2.4	2.5	2.5	2.6	1.9	2.3	2.6
(Percent change)	...	...	21.1	-5.1	5.6	0.6	3.1	3.2	0.7	3.0	...	22.1	10.3
Exchange rate for program (dram/US dollar)													
Period average 4/	6	22	130	296	324	388	434	463	483	498	9	285	470
Actual (end-period) 4/	11	75	228	309	349	...	...	...	...	...	75	...	...
Current account balance (excluding official transfers) (millions of US dollars)	...	...	-30.2	-35.6	-44.7	-110.8	-86.7	-73.4	-78.2	-76.1	...	-221.4	-314.4
Net international reserves (millions of US dollars end-period)	...	2.1	3.1	4.3	6.3	7.0	1.1	10.5	18.8	17.4	2.1	7.0	17.4
Gross international reserves (millions of US dollars end-period)	...	2.1	3.4	4.3	7.0	30.6	24.8	34.2	66.0	64.6	2.1	30.6	64.6
months of current year imports of goods and services	...	...	0.1	0.1	0.2	1.0	0.6	0.9	1.7	1.7	...	1.0	1.7

1/ Quarterly changes are provisional staff estimates. These estimates are tentative and are derived from seasonally unadjusted cumulative comparable price data for 1993 that are difficult to interpret (see Appendix IV), but reflect special factors that buoyed recorded output in the fourth quarter of 1993. For 1994 and 1995 the estimates and projections contain a degree of smoothing for seasonality.

2/ Average monthly inflation in current period.

3/ Includes increase due to impact of reserve requirement on foreign currency deposits starting at the end of the fourth quarter of 1994.

4/ Official exchange rate.

Table 2. Armenia: Consolidated State Government Operations, 1993-95 1/

	1993 Off. Est.	1994 Q1	1994 Q2	1994 Q3	1994 Q4	1994 Jan-Dec.	1995 Q1	1995 Q2	1995 Q3	1995 Q4	1995 Jan-Dec.
						(In millions of drams)					
Total revenue and grants	1,125	3,125	9,738	12,392	16,242	41,498	23,361	22,728	25,510	32,941	104,540
Total revenue	918	779	4,395	6,544	9,246	20,964	15,733	14,585	17,681	24,870	72,870
Tax revenue	632	634	3,356	5,490	6,907	16,388	10,531	12,329	15,749	20,156	58,765
Value-added tax	196	181	907	1,403	1,500	3,991	2,855	3,597	4,755	4,638	15,845
Excises	46	33	151	187	329	700	406	585	725	922	2,637
Enterprise profits tax	174	249	1,674	2,582	1,795	6,300	3,590	4,596	6,205	5,926	20,316
Enterprise fixes asset tax	4	3	39	6	70	118	208	239	294	308	1,049
Personal income tax	63	75	296	483	1,795	2,650	1,508	1,066	1,156	4,992	8,723
of which: agriculture tax	42	5	5	8	733	750	618	95	95	3,944	4,752
Customs duties	7	64	51	232	126	474	469	561	727	1,043	2,799
Other taxes	142	29	239	596	1,291	2,156	1,496	1,685	1,888	2,327	7,395
Nontax revenue 2/	286	144	1,039	1,053	2,339	4,576	5,202	2,257	1,932	4,714	14,105
Grants 3/	207	2,347	5,343	5,848	6,996	20,534	7,628	8,143	7,830	8,070	31,670
Total expenditure	3,313	6,172	14,067	21,871	25,944	68,055	35,030	34,758	36,773	39,872	146,433
Current expenditure	2,319	5,837	12,719	16,780	21,618	56,955	28,234	28,351	28,570	31,398	116,553
Wages	293	432	786	1,072	1,592	3,882	2,466	2,744	3,148	3,148	11,507
Subsidies 4/	652	2,712	5,716	7,156	6,951	22,536	3,848	3,574	979	1,028	9,428
Domestic interest due	16	32	32	32	100	195	4,848	1,811	1,476	4,344	12,479
External interest due	13	--	592	940	776	2,308	347	1,204	725	896	3,172
Pensions and social safety net 5/	271	255	1,037	1,420	2,552	5,264	4,629	5,175	6,411	6,685	22,900
Health and Education	376	203	661	800	3,132	4,796	4,359	5,023	6,165	6,477	22,023
Other	698	2,204	3,895	5,361	6,515	17,975	7,738	8,821	9,666	8,819	35,043
Capital expenditure and net lending	994	335	1,348	5,091	4,326	11,100	6,796	6,406	8,204	8,474	29,880
Overall deficit (accrual (-)	-2,188	-3,047	-4,329	-9,479	-9,702	-26,557	-11,669	-12,030	-11,263	-6,932	-41,893
Net change in total exp. arrears	72	417	640	5,663	2,900	9,620	-2,675	-2,805	-4,220	--	-9,700
Domestic expenditure arrears	80	417	640	5,663	2,900	9,620	-2,675	-2,805	-4,220	--	-9,700
Settlement of old arrears	--	-80	--	--	-700	-780	-2,675	-2,805	-4,220	--	-9,700
Accumulation of new arrears	80	497	640	5,663	3,600	10,400	--	--	--	--	--
External interest arrears	-8	--	--	--	--	--	--	--	--	--	--
Overall deficit (cash) (-)	-2,116	-2,630	-3,689	-3,816	-6,802	-16,937	-14,344	-14,835	-15,483	-6,932	-51,593
Financing	2,116	2,630	3,689	3,816	6,802	16,937	14,344	14,835	15,483	6,932	51,593
Domestic sources	1,311	1,745	1,096	561	3,210	6,612	3,679	-2,941	-1,999	424	-837
External sources	806	885	2,593	3,256	3,592	10,326	10,665	17,776	-4,543	6,507	30,405
Gross inflow	806	885	2,600	3,256	3,592	10,333	10,665	17,776	17,481	6,507	52,430
Amortization due	...	--	7	--	--	7	--	--	22,025	--	22,025
Financing gap/unidentified financing	--	--	--	--	--	--	--	--	22,025	--	22,025
						(In percent of GDP)					
Memorandum items:											
Total revenue and grants	28.9	37.6	37.3	38.6	36.4	37.3	33.8	28.5	26.1	32.0	29.9
Tax revenue	16.2	7.6	12.8	17.1	15.5	14.7	15.2	15.5	16.1	19.6	16.8
Total expenditure and net lending	85.0	74.3	53.8	68.1	58.1	61.2	50.6	43.6	37.6	38.8	41.9
Deficit (accrual)	-56.1	-36.7	-16.6	-29.5	-21.7	-23.9	-16.9	-15.1	-11.5	-6.7	-12.0

Sources: Armenian authorities; and staff calculations.

1/ Consolidated accounts of State Government operations and the Pension and Employment Fund.

2/ Nontax revenue.

3/ Grants projected for 1995 assume that humanitarian assistance provided will support somewhat lower consumption levels. Identified commitments of humanitarian assistance are below these levels and additional humanitarian assistance will be needed in the second half of 1995.

4/ Subsidies on communal services, book printing, and bread.

5/ Total expenditure of the Pension and Employment Fund plus union contributions and child allowances in the state budget and the social safety net.

Table 3. Armenia: Accounts of the Central Bank, 1993-95
(End of period, millions of drams)

	1993 Q4	1994 Q1	1994 Q2	1994 Q3 Prel. Act.	1994 Q4 Proj.	1995 Q1 Proj.	1995 Q2 Proj.	1995 Q3 Proj.	1995 Q4 Proj.	1994 Year Proj.	1995 Year Proj.
Stocks											
NFA (convertible currencies) 1/	158	707	1,324	2,198	2,800	459	4,212	7,512	6,956	2,800	6,956
NFA (rubles) 2/	-248	117	197	197	197	197	197	197	197	197	197
NDA	1,680	3,637	6,253	7,466	11,675	16,064	13,645	12,706	13,881	11,675	13,881
General Government 3/	1,313	3,589	4,761	5,322	8,532	12,211	9,270	7,271	7,695	8,532	7,695
Banks 3/	421	1,030	2,325	2,010	3,009	3,719	4,241	5,301	6,051	3,009	6,051
Other items, net	-54	-982	-833	134	134	134	134	134	134	134	134
Reserve Money 4/	1,590	4,461	7,774	9,861	14,672	16,720	18,054	20,415	21,034	14,672	21,034
Currency outside CBA	1,237	2,766	4,369	6,799	...	...	...	...	...	...	...
Dram required reserves	59	282	402	337	...	...	...	...	...	...	...
FX required reserves	--	--	--	--	...	...	...	...	...	...	...
Correspondent Accounts	294	1,413	3,003	2,726	...	...	...	...	...	...	...
Flows (with respect to end of previous period)											
NFA (convertible currencies) 1/	131	549	618	874	602	-2,341	3,753	3,300	-556	2,643	4,156
NFA (Rubles) 2/	414	365	80	--	--	--	--	--	--	445	--
NDA	421	1,957	2,615	1,214	4,209	4,389	-2,419	-939	1,175	9,995	2,206
General Government 3/	131	2,276	1,172	561	3,210	3,679	-2,941	-1,999	424	7,219	-837
Banks 3/	393	609	1,295	-315	999	710	522	1,060	751	2,588	3,042
Other items, net	...	-928	148	968	--	--	--	--	--	188	--
Reserve Money 4/	...	2,872	3,313	2,087	4,811	2,048	1,334	2,361	619	13,082	6,362
Percentage change (with respect to end of previous period)											
NFA (convertible currencies) 1/	505	349	87	66	27	-84	817	78	-7	1,678	148
NFA (rubles) 2/	-63	-147	68	--	--	--	--	--	--	-179	--
NDA	33	116	72	19	56	38	-15	-7	9	595	19
General Government 3/	11	173	33	12	60	43	-24	-22	6	550	-10
Banks 3/	1,387	145	126	-14	50	24	14	25	14	615	101
Other items, net	...	1,729	-15	-116	--	--	--	--	--	-350	--
Reserve Money 4/	...	181	74	27	49	14	8	13	3	823	43
Memorandum items:											
CPI 5/	1,624	212	186	8	71	23	11	16	3	1,553	65
Nominal GDP 5/	226	155	186	8	71	24	14	23	4	1,249	79

1/ End-period exchange rate used through end Q3-1994 and thereafter program accounting exchange rate of dram 400 per US$.

2/ Includes only ruble assets and liabilities from 1992 and 1993, related to central bank correspondent accounts and cash deliveries of Gosbank notes and pre-1993 Bank of Russia notes.

3/ New definitions of credit aggregates have been used in this table, that differ from those used in earlier presentations of monetary data for Armenia.

4/ Reserve money includes cash issue, required reserves on dram deposits and FX deposits (from end-1994), and correspondent accounts of commercial banks.

5/ End of period month relative to last month in previous period.

Table 4. Armenia: Monetary Survey, 1993-95

(end of period, in millions of dram and percentage change)

	1993	1994				1995				1994	1995
	Q4	Q1	Q2 Prel. Act.	Q3 Est.	Q4 Proj.	Q1 Proj.	Q2 Proj.	Q3 Proj.	Q4 Proj.	Year Proj.	Year Proj.
Stocks											
Net foreign assets											
(convertible currencies) 1/	1,706	3,148	7,397	9,100	9,702	8,081	11,834	16,734	17,778	9,702	17,778
Net foreign assets (rubles) 2/	53	123	197	197	197	197	197	197	197	197	197
Net domestic assets	1,283	7,066	9,495	13,604	24,381	31,983	32,820	34,152	36,235	24,381	36,235
General Government 3/	1,252	2,997	4,094	4,655	7,865	11,544	8,603	6,604	7,028	7,865	7,028
Economy 3/	424	2,598	7,472	15,112	22,680	26,602	30,380	33,711	35,370	22,680	35,370
Other Items, Net	-393	1,471	-2,071	-6,163	-6,163	-6,163	-6,163	-6,163	-6,163	-6,163	-6,163
Broad Money	3,042	10,337	17,087	22,900	34,280	40,260	44,851	51,082	54,209	34,280	54,209
Dram	1,018	2,006	3,720	...	...	...	...	...	...	...	...
Deposits	2,024	8,331	13,367	...	...	...	...	...	...	...	...
Memorandum Items:											
Money multiplier	1.9	2.3	2.2	2.3	2.3	2.4	2.5	2.5	2.6	2.3	2.6
Velocity	5.6	4.2	7.3	5.9	6.8	7.1	7.3	7.8	7.7	6.8	7.7
Flows (with respect to end of previous period)											
Net foreign assets											
(convertible currencies) 1/	-3,138	1,442	4,249	1,703	602	-1,621	3,753	4,900	1,044	7,996	8,076
Net foreign assets (rubles) 2/	624	69	74	--	--	--	--	--	--	144	--
Net domestic assets	5,028	5,784	2,429	4,109	10,778	7,601	837	1,331	2,083	23,099	11,853
General Government 3/	207	1,745	1,097	561	3,210	3,679	-2,941	-1,999	424	6,613	-837
Economy 3/	206	2,174	4,874	7,640	7,568	3,923	3,778	3,330	1,659	22,256	12,690
Other Items, Net	...	1,864	-3,542	-4,092	--	--	--	--	--	-5,771	--
Broad Money	...	7,295	6,752	5,811	11,380	5,981	4,590	6,231	3,127	31,238	19,929
Percentage change (with respect to end of previous period)											
Net foreign assets											
(convertible currencies) 1/	-65	85	135	23	7	-17	46	41	6	469	83
Net foreign assets (rubles) 2/	-109	130	61	--	--	--	--	--	--	270	--
Net domestic assets	-134	451	34	43	79	31	3	4	6	1,801	49
General Government 3/	20	139	37	14	69	47	-25	-23	6	528	-11
Economy 3/	95	513	188	102	50	17	14	11	5	5,255	56
Other Items, Net	-92	-475	-241	197	--	--	--	--	--	1,469	--
Broad Money	...	240	65	34	50	17	11	14	6	1,027	58
Memorandum Items:											
CPI 4/	1,624	212	186	8	71	23	11	16	3	1,553	65
Nominal GDP 4/	226	155	186	8	71	24	14	23	4	1,249	79

1/ End-Period exchange rate used through end 3Q 1994 and thereafter program accounting exchange rate of dram 400 per US dollar.

2/ Includes only ruble assets and liabilities from 1992 and 1993, related to central bank correspondent accounts and cash deliveries of Gosbank notes and pre-1993 Bank of Russia notes.

3/ New definitions of credit aggregates have been used in this table, that differ from those used in earlier presentations of monetary data for Armenia.

4/ End of period month relative to last month in previous period.

Table 5. Armenia: Balance of Payments and External Financing, 1994-95 1/
(In millions of U.S. dollars)

	1994					1995				
	Q1	Q2	Q3	Q4	Annual	Q1	Q2	Q3	Q4	Annual
Current account (excluding official transfers)	-30.2	-35.6	-44.7	-110.8	-221.4	-86.7	-73.4	-78.2	-76.1	-314.4
Trade balance	-27.3	-27.0	-28.8	-89.0	-172.0	-69.5	-60.4	-64.1	-63.4	-257.4
Export	28.5	68.1	46.5	66.1	209.2	47.1	53.8	60.7	50.9	212.4
Import	-55.7	-95.2	-75.3	-155.1	-381.3	-116.6	-114.2	-124.8	-114.3	-469.8
of which gas	8.1	22.8	22.3	36.8	90.0	32.8	33.6	34.4	35.2	136.0
Services (net)	-12.0	-17.6	-24.9	-30.9	-85.3	-26.2	-22.0	-23.0	-21.7	-93.0
of which transp. (net)	-4.5	-3.1	-1.7	-17.2	-26.5	-14.9	-8.2	-8.8	-9.3	-41.1
Private transfers	9.0	9.0	9.0	9.0	36.0	9.0	9.0	9.0	9.0	36.0
Capital account	-18.3	11.3	1.6	-0.7	-6.1	1.8	--	-44.6	-4.0	-46.8
Amortization	--	-0.6	--	--	-0.6	--	--	-45.6	--	-45.6
Other	-18.3	11.9	1.6	-0.7	-5.5	1.8	--	1.0	-4.0	-1.2
Increase in Gross Reserves	-1.3	-0.9	-2.7	-23.6	-28.5	5.9	-9.4	-31.9	1.4	-34.0
Arrears reduction	--	-24.0	--	--	-24.0	--	--	--	--	--
Financing requirement	49.8	49.2	45.8	135.2	280.0	79.0	82.8	154.6	78.7	395.2
IFI's	0.5	3.3	7.6	27.6	39.0	16.4	32.6	55.5	13.4	117.9
IMF 2/	--	--	--	23.6	23.6	--	--	23.6	--	23.6
World Bank	0.5	3.3	1.6	3.0	8.4	13.7	29.7	27.7	8.7	79.8
EBRD	--	--	6.0	1.0	7.0	2.7	2.9	4.2	4.7	14.5
Financing identified	49.3	45.9	38.2	107.5	241.0	--	--	--	--	--
Residual Financing Gap	--	--	--	--	--	62.6	50.2	99.1	65.3	277.3
Debt Refinancing 3/	--	--	--	--	--	0.7	1.4	46.3	--	48.4
Commodity assistance, balance of payments support, and other financing	--	--	--	--	--	61.9	48.9	52.8	65.3	228.9

1/ Totals do not equal sum of components due to rounding.
2/ Includes STF purchases only equal to 50 percent of quota.
3/ Assumes debts are refinanced on concessional terms with no down payment and no amortization due in 1995.

Eligibility and Access under the Systemic Transformation Facility

Armenia's eligibility for financing under the Systemic Transformation Facility can be based on a substantial and permanent increase in net energy import costs, due to a shift from significant reliance on trading at nonmarket prices toward world market pricing. This increase was particularly severe in the case of Armenia due to its heavy dependence on energy imports following the 1988 earthquake and the consequent shutdown of the important nuclear power facility. (Armenia's energy exports are insignificant.)

For purposes of assessing the impact of the move to trading at market prices, energy import volumes in 1992 are used as a benchmark. Import volumes in 1992 were significantly lower than in 1991, reflecting the breakdown in trade and payments arrangements with other FSU countries, a lack of foreign exchange, the economic blockade, and other supply problems. Import volumes were further compressed in 1993 (when import prices rose sharply) but recovered somewhat in 1994.

The prices of energy resources imported from traditional FSU suppliers rose sharply in 1993, and coal and gasoline import prices rose further in 1994. The resultant increase in Armenia's energy import costs--evaluated on the basis of 1992 import volumes--is estimated at SDR 175 million in 1993 and SDR 206 million in 1994 (260 and 306 percent of quota, respectively), a level well in excess of the threshold required for a member to be eligible for STF support. In the judgment of the staff, the rise in net energy import costs continues to give rise to balance of payments difficulties in an amount equivalent to at least 50 percent of quota.

Table 1. Armenia: Energy Imports, 1991-94
(Values in millions of U.S. dollars, Unit costs in U.S. dollars)

	1991	1992			1993				1994			
	Vol.	Vol.	Unit Cost	Value	Vol.	Unit Cost	Value	Value of 1992 Vol. at 1993 Prices	Vol.	Unit Cost	Value	Value of 1992 Vol. at 1994 Prices
Natural gas 1/	4,154	1,879	7.7	14	801	80.0	64	150	1,125	80.0	90	150
Oil products 2/	3,481	1,520		45	351		41	154	460		74	199
Mazut	2,283	1,200	22.3	27	228	80.0	18	96.0	235	110.0	28	132
Diesel	513	191	57.6	11	72	183.0	13	35.0	90	167.0	15	32
Kerosene	158	2	43.1	--	13	171.0	2	...	49	180.0	9	--
Gasoline	419	104	66.5	7	26	204.0	5	21.2	77	298.7	23	31
Liquid gas	41	16	15.9	--	11	138.0	2	2.2	8	138.0	1	2
Other oil products	67	7	64.0	--	1	250	--	--	2	250	1	2
Other 2/		78		1	2		--	1	36		2	4
Coal	246	78	14.1	1	2	8.0	--	0.6	36	50.0	2	4
Total Cost of Energy Imports (millions of U.S. dollars)				61			105	305			166	354
Millions of SDR				43			75	219			117	250
Increase from 1992												
Millions of SDR				--				175				206
Percent of quota				--				260				306
Cumulative increase in cost since 1992												
Millions of SDR				--				175				382
Percent of quota				--				260				566

Sources: Ministries of Energy and Economy.

1/ Volumes in millions of cubic meters.
2/ Volumes in thousands of tonnes.

Armenia: Fund Relations
(As of October 31, 1994)

I. Membership Status: Joined May 28, 1992/Article XIV.

II. General Resources Account:	SDR Million	% Quota
Quota	67.5	100.0
Fund holdings of currency	67.5	100.0
Reserve position in the Fund	0.01	--

III. SDR Department:	SDR Million	% Quota
Net cumulative allocation	--	--
Holdings	--	--
Designation plan amount	--	--

IV. Outstanding Purchases and Loans:	SDR Million	% Quota
Stand-by arrangements	--	--
Extended arrangements	--	--
CCFF	--	--
SAF arrangements	--	--
ESAF arrangements	--	--

V. Financial Arrangements:

None.

VI. Projected Obligations to the Fund:

None.

VII. Exchange Rate Arrangement:

a. On November 22, 1993, the Republic of Armenia introduced its national currency, the dram at a rate of 200 Armenian rubles per dram. Subsequently, the exchange rate has been allowed to float. Currently, there is a weekly official exchange rate, which is the rate established at the auction for the sale of noncash dram against noncash U.S. dollars. The authorities have not yet officially informed the Fund about the exchange rate arrangement for the dram.

Until July 1993, the currency of the Republic of Armenia was the Russian ruble and in this period the Republic of Armenia has been classified by the staff with the group of countries whose currencies are pegged to another currency. A new classification would need to await formal notification of Armenia's current exchange arrangement.

b. Armenia maintains exchange restrictions in accordance with Article XIV, except for the restrictions arising from a bilateral payments agreement with a Fund member which is subject to approval under Article VIII.

VIII. Article IV Consultations:

(a) Armenia is on a 12-month consultation cycle.
(b) The second Article IV consultation with Armenia was concluded on July 8, 1994.

IX. Technical Assistance:

See Table 1 of this appendix.

X. Resident Representative:

None.

XI. Resident Advisor:

An MAE general advisor has been assigned to the Central Bank of Armenia from February 1994.

Table 1: Armenia: Fund Technical Assistance Missions: 1992-1994

Subject	Type of Mission	Timing	Counterpart
Fiscal Affairs Department (FAD)			
Fiscal	Multipurpose	Feb. 29 - Mar. 18, 1992	Ministry of Finance, Ministry of Labor, and the Central Bank of Armenia
Fiscal	Multipurpose	May 18 - Jun. 2, 1992	Ministry of Finance
Tax Policy and Administration	Follow-up Assistance	May 18 - Jun. 2, 1993	Ministry of Finance
Social Safety Net	Social safety net	August 28-Sept. 13, 1994	Ministry of Finance, Ministry of Economy, Ministry of Labor
Tax Administration	Program Implementation and Follow-up assistance	Nov. 20 - Dec. 3, 1994	Ministry of Finance and State Tax Service
IMF Institute (INS)			
Macroeconomic and Financial Policy	Seminar	Apr. 13 - 20, 1992	Ministry of Economy, Ministry of Finance
Financial Programming	Course	Apr. 18 - 29, 1994	Ministry of Finance
Monetary and Exchange Affairs Department (MAE)			
Central Bank - modernization	Advisory	May 27 - Jun. 10, 1992	Central Bank of Armenia
Central Bank - modernization	Multitopic	Oct. 18 - 30, 1992	Central Bank of Armenia
Central Bank - modernization	Follow-up assistance	Jun. 1 - 15, 1993	Central Bank of Armenia
Currency and Monetary Mgmt.	Technical Assistance	Oct. 29 - Nov. 9, 1993	Central Bank of Armenia
Foreign Exchange Operations	Expert Visit	Nov. 5 - 10, 1993	Central Bank of Armenia
Central Banking Operations	Operations Advisor Mr. Brentnall	Feb. - Dec. 1994	Central Bank of Armenia
Foreign Exchange Operations	Expert Visit	Mar. 5 - 10, 1994	Central Bank of Armenia
Central Bank - modernization	Multitopic	Jun. 14 - 25, 1994	Central Bank of Armenia

Table 1 (concluded). Armenia: Fund Technical Assistance Missions: 1992-1994

Foreign Exchange Operations	Expert Visit	Jul. 15 - 29, 1994	Central Bank of Armenia
Reserve Management	Expert Visit	Sept. 16 - 21, 1994	Central Bank of Armenia
Foreign Exchange Operations	Expert Visit	Sept. 22 - Oct. 6, 1994	Central Bank of Armenia
Central Bank - modernization	Multitopic	Nov. 20 - Dec. 3, 1994	Central Bank of Armenia
Statistics Department (STA)			
Consumer Prices	Technical Assistance	Sept. 3 - 22, 1992	Armenian Statistical Office, State Department of Statistics
Consumer Prices - Follow-up	Technical Assistance	Apr. 29 - May 11, 1993	State Department of Statistics
Balance of Payments	Technical Assistance	May 19 - Jun. 1, 1993	Ministry of Finance, Central Bank of Armenia, State Department of Statistics
Balance of Payments - Follow-up	Technical Assistance	Oct. 29 - Nov. 16, 1993	Ministry of Finance, Central Bank of Armenia, State Department of Statistics
Consumer Prices - Follow-up	Technical Assistance	Nov. 5-17, 1993	State Department of Statistics
Government Finance Statistics	Technical Assistance	June 15-26, 1994	Ministry of Finance
Money and Banking Statistics	Technical Assistance	Sept. 28 - Oct. 12	Central Bank of Armenia

Armenia--Relations with the World Bank
(as of November 11, 1994)

The Republic of Armenia joined the International Bank for Reconstruction and Development (IBRD) in September 1992. The World Bank has been actively involved with Armenia during the last two years. The first IBRD loan to Armenia was an Institution Building Loan for US$12 million, approved in March 1993, and US$1.5 million has been disbursed, to support the implementation of the Government's reform program in the areas of financial reform, privatization, tax administration, labor market services, and economic management.

An IDA/Earthquake Reconstruction Loan for SDR 20.1 million was approved by the Bank's Executive Board in January 1994. The loan will finance the reconstruction of housing and the restoration of employment sites in the earthquake zone and US$3.0 million has been disbursed.

A Power Rehabilitation Loan for US$1.2 million was approved by the Bank's Executive Board in November 1994 for rehabilitation of power generation facilities. An advance of US$0.5 million has been disbursed for project preparation.

A first Country Economic Memorandum was completed in March 1993, and an update is under way. A poverty assessment was initiated in the summer of 1994 and work on social investment is taking place. An Energy Sector Review was completed in June 1993, and an Agricultural Sector Review will be discussed with the authorities in September 1994.

In December 1994, irrigation rehabilitation and power maintenance credits are scheduled to be presented to World Bank Executive Board. Moreover, discussions on a US$60 million rehabilitation credit have reached an advanced stage and it is planned to present this loan for Bank Board approval in February 1995. Work is well advanced on a Social Investment Fund project that will be financed by the World Bank and bilateral sources.

Measurement of GDP

The national accounts data for Armenia should be treated with great caution. As elsewhere in the FSU, the data suffer from significant coverage and methodological problems. 1/

The coverage problems include: lack of comprehensive data on the output of the private sector and an absence of reliable information on activity financed from both private cash and commodity inflows from abroad. In Armenia, anecdotal evidence suggests that all these factors are large. Proper measurement of private sector activities is especially difficult in a transition economy, though efforts are under way to use surveys to gather information on some items. Enhanced coverage of private sector activity would, of course, increase measured GDP. Private assistance received by Armenia is substantial, both in commodities and cash. However, the measurement of this assistance is problematic, particularly for amounts provided in cash, most of which do not pass through the banking system. This adds a further bias toward under-reporting national income. The measurement of foreign trade by private agents and transfers from abroad should improve as trading conditions normalize for Armenia.

Beyond these coverage problems, important valuation and methodological problems affect Armenian GDP data. Appendix I of the 1994 paper on Recent Economic Developments analyzes some of these, particularly the absence of reliable GDP data at more frequent than annual intervals. An additional problem, affecting annual as well as quarterly data, is that much of the GDP data incorporates nonmarket prices. Specifically, for most sectors of activity, including industry, output is measured as total production at "normative" prices, where the normative price is the cost of production plus a fixed "normative" profit. This price may have little relation to market prices, particularly in an environment of rapidly changing market conditions and relative prices. There are currently no deflators for industrial production that use market prices, so the contribution of industry to GDP, both in nominal and real terms, is based on these normative prices. This practice, along with other anomalies in the calculation of the GDP deflator, may explain the enormous discrepancy between the CPI and the GDP deflator observed in 1993. 2/ The use of normative prices may bias GDP data in either direction, but lacking comprehensive data it is reasonable to assume that it will tend to reduce the size of officially measured GDP.

The authorities are working with bilateral and multilateral agencies to improve the coverage and methodology for preparing GDP data. Some of the factors mentioned above have ambiguous effects on the size of measured GDP.

1/ Many of these issues were described in greater detail in Appendix I of (SM/94/156, June 24, 1994).

2/ Between the fourth quarter of 1992 and the fourth quarter of 1993 the GDP deflator increased by 19 times compared to a CPI increase of 74 times. See Appendix I of SM/94/156, June 24, 1994) for more discussion of this discrepancy.

Overall, however, it is likely that official figures substantially understate actual GDP. This understatement is likely to increase as the size of the unrecorded private sector increases.