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November 21, 2007

**Statement by Mr. Charleton on Republic of Armenia  
(Preliminary)  
Executive Board Meeting 07/103  
November 26, 2007**

We thank the staff for a well-focussed and concise report and Mr. Yakusha for his very informative Buff statement. This economy has made remarkable progress in recent years and we perceive few substantive differences between the staff and the authorities. To the extent there are threats to macro-stability, they arise largely from the rapid pace of economic growth and should be manageable. We agree with the broad staff view that a slight touch on the breaks of fiscal and monetary policy would be appropriate. We offer only a few comments for emphasis.

**Fiscal Policy**

While fiscal policy has, in general, been prudent and the deficit is small, one could argue that any country experiencing double digit growth over several years should really be running a fiscal surplus to guarantee medium-term sustainability. The authorities seem to accept that a lower deficit would help control inflationary pressures without really constraining needed social and capital spending. In this respect, the proposed increase in the deficit in 2008 is regrettable. Perhaps more importantly, there seems to be a trend deterioration in the primary fiscal balance. The authorities need to be cautious. A clear focus on tax reform to improve overall revenue and on better expenditure management are essential to prevent the emergence of future fiscal strains.

**Monetary Policy/Exchange Rate Issues**

While the staff characterizes inflation as moderate, it has accelerated quite sharply in 2007 and will breach the target for the year and persist into 2008. The projections are for inflation to fall back in 2009/2010 but this will require an active policy response. Inflation is becoming a problem in many countries, driven by energy and food prices and we may all be under-estimating the risks of its persistence. We note Mr. Yakusha's reassurance that the

authorities are taking this threat seriously and treating inflation as both an economic and political challenge. The Central Bank of Armenia's monetary policy approach seems appropriate. They have raised interest rates on several occasions and are open to further tightening, if necessary. It is unfortunate, but perhaps understandable, that the officially announced target for inflation has been revised upwards in two successive years. We agree with the staff that this runs a risk of undermining credibility in moving towards inflation targeting.

The authorities are to be commended, however, for accepting a considerable degree of exchange rate flexibility. Further real and nominal appreciation of the dram seems likely. This will be important in terms of controlling inflationary pressures. Given the importance of remittances to many families and the impact of currency appreciation on the domestic value of remittances, what is the strength of public pressure to avoid an otherwise appropriate appreciation? Could this undermine the consensus on policy? To cope with the potential erosion of competitiveness, the appropriate approach is to push forward with second-generation structural reforms, especially in terms of improving the business climate and enhancing domestic competition. The authorities and the staff share this analysis.

### **Other Issues**

We note the staff's strong reservations on the proposed tax measures/amnesties to promote capital market development and essentially share their view. Such amnesties are inherently undesirable and risky. Is there any indication at this stage of how extensive the amnesty might be?

In his Buff, Mr. Yakusha clearly articulates the forthcoming challenges facing Armenia and we wish them every success in meeting them.