International Monetary Fund

Republic of Armenia
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November 14, 2005

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Republic of Armenia: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

October 26, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431

October 26, 2005

Dear Mr. de Rato:

In the attached Memorandum of Economic and Financial Policies, we summarize progress to date in implementing our PRGF-supported program and set out our economic and financial policies for the period through June 2006. We request hereby the completion of the first review and the second disbursement under the PRGF arrangement as well as modification of the end-December quantitative performance criteria.

The PRGF-supported program is on track. The Armenian economy continues to perform well and all quantitative and structural performance criteria under the PRGF arrangement for end-June 2005 were observed. Despite the progress achieved in recent years, we recognize that a number of significant challenges remain to sustain high economic growth and reduce poverty. To this end, our economic program for the period ahead contains specific measures to address weaknesses in tax and customs administration, enhance fiscal transparency and expenditure efficiency, and strengthen the financial system.

The Government of the Republic of Armenia believes that the policies and measures set forth in the attached supplementary memorandum are adequate to achieve the objectives of the program, but it stands ready to take any additional measures that may be appropriate for this purpose. The Government will consult with the Fund in advance on the adoption of these measures in accordance with the Fund's policies on such consultation. The Government intends to make these understandings public and authorizes the IMF to publish this letter, the attached supplementary memorandum, and the staff report.

Sincerely yours,

/s/

Andranik Margaryan
Prime Minister
Republic of Armenia

/s/

Vartan Khachatryan
Minister of Finance and Economy
Republic of Armenia

/s/

Tigran S. Sargsyan
Chairman of the Central Bank
Republic of Armenia

REPUBLIC OF ARMENIA
MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES
October 26, 2005

1. This memorandum supplements the Memorandum of Economic and Financial Policies (MEFP) of May 10, 2005. It reviews recent developments and outlines the government's policies through June 2006.

I. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

2. The Armenian economy continues to register strong, noninflationary growth underpinned by sound macroeconomic policies and ongoing structural reforms. Real GDP increased by 11.7 percent in the first eight months of 2005, led by agriculture and private construction activity. The 12-month rate of inflation declined from 4.9 percent in January to –0.4 percent in September, reflecting mainly a good harvest and a strengthening dram. Strong exports of base metals and large remittance flows strengthened the external current account position, and gross official foreign reserves increased by $74.2 million as of end-June 2005.

3. The overall **fiscal deficit** for the first half of 2005 was smaller than programmed on account of strong revenue performance and under-execution of expenditures. Tax revenue grew by 21 percent through end-July relative to the same period in 2004, and was AMD 2.6 billion above the program target. Value-added and profit taxes accounted for the majority of the overperformance. Expenditure execution was lower than programmed by AMD 9.2 billion.

4. Against a backdrop of strong appreciation pressures on the exchange rate, stemming from remittances and capital inflows, the Central Bank of Armenia (CBA) conducted sizeable, partly sterilized, foreign exchange interventions, which contributed to 50 percent year-on-year increase in **reserve money** by July. Broad money also grew briskly (30 percent y-o-y in June), reflecting emerging financial re-intermediation and re-monetization.

5. All **quantitative performance criteria** for end-June 2005 were met. Two indicative targets for end-June, however, were missed. The floor on the contributions to the State Fund for Social Insurance (SFSI) was missed by a small margin. The ceiling on reserve money was exceeded by a wide-margin, reflecting higher-than-projected net international reserve (NIR) accumulation, associated with sizeable foreign exchange interventions through May, as well as an increase in reserve requirements.

6. We have made good progress in the area of **structural reforms**. Both end-June structural performance criteria and most benchmarks were observed. The only exception was the benchmark on amending the legal provisions on tax audits which was submitted to parliament in July and is expected to be approved by early December 2005.

7. We have continued our efforts to bolster tax and customs administration and strengthen budget execution and implementation:

- In **tax policy**, a law was submitted to Parliament that reduces the list of goods exempt from VAT payment at the border and a time limit was introduced after which VAT must be paid under the capital deferral system, both effective 2006. A law has been submitted to Parliament that abolishes the presumptive social security payment for simplified tax payers and incorporates them into the regular social security tax payments system. Additionally, the denomination of a number of excise taxes was changed from dollars to drams to raise revenue collections.

- In **tax administration**, we have finalized an implementation plan for the collection of tax arrears, reduced the end-2004 stock of VAT refund arrears; lowered the threshold for the universal application of VAT cross-checks to AMD 100,000; and are moving the VAT refund process and audit selection towards risk-based approaches. The large taxpayers unit (LTU) has been organized along sectoral lines and a rotation system for inspectors introduced. To facilitate tax collections, we passed a decree on an action plan for the establishment of a self-assessment system.

- Regarding **customs administration**, we have agreed upon terms of reference for an operational review of the State Customs Committee (SCC) to be undertaken by a specialized international company. Following the passage of the Law on Electronic Signatures, we conducted a wide campaign to inform traders and companies about the direct trader input system. Finally, we have created a new unit within the SCC to strengthen risk assessment and analysis, and continue to monitor the number of declarations selected for physical examination.

- On the **expenditure** side, a new procurement system was adopted earlier in the year, and the timetable for the 2006 budget was advanced considerably to improve expenditure execution. For the first time, we have included a public investment plan (PIP) in the medium-term expenditure framework (MTEF) for 2006-08 to improve the strategic planning of our capital expenditures. We continue to make progress in the implementation of the action plan on the financial management of nonfinancial organizations (NCOs).

8. We are continuing to strengthen the **financial sector** and its regulatory and supervisory framework. We submitted to Parliament an amendment to the Law on Banks and Banking (LBB) which will strengthen consolidated banking supervision, improve corporate governance of banks, and enhance the effectiveness of external audits in risk management. In order to encourage banking sector consolidation and new shareholder entry, we raised the minimum capital requirements for existing banks to US$5 million, effective July 1, 2005, with eligible capital to remain as is currently defined. With World Bank assistance, we have prepared a comprehensive legislation package aimed at strengthening creditor rights. Finally, a mandatory deposit insurance commenced coverage, effective July 1, 2005. We have also made progress in the area of non-banking sector reforms. With regards to the insurance sector, by-laws on prudential regulation and accounting and reporting requirements are being finalized. As to the mortgage market, a legislative package has been prepared to improve the

legal and regulatory framework that would contribute to the development of the primary mortgage market.

9. We continue to make progress in other areas of **structural reforms**. In the energy sector, overall collection rates have remained at 100 percent and technical and other losses have declined further. As a result, the energy sector is no longer receiving subsidies from the budget. To ensure the proper functioning of, and transparency in, the energy sector, the Public Service Regulatory Commission has passed resolutions on audit procedures for power sector entities, and market rules including power export model contracts, and dispatching relationships between the system operator and other entities of the system. The financial performance of the water and irrigation sectors has also shown improvement, owing to tariff increases and better collection. To improve governance, we have been steadfast in implementing the measures established in our anti-corruption action plan. In this regard, parliament was presented with a draft law on financial disclosure, extending coverage to all physical persons.

II. The Program for the Period July 2005–June 2006

10. We remain committed to our growth and poverty-reduction strategy. For the remainder of 2005 and 2006, our macroeconomic policies will focus on price stability and a forceful implementation of tax, customs, and financial sector reforms. We expect that ongoing reforms of our tax and customs administrations will generate the additional resources needed to fund infrastructure investment and expand essential poverty-reducing services. Our financial sector reforms will be geared towards improving the quality and depth of financial intermediation by strengthening further the market infrastructure and regulatory and legal framework underpinning our financial system.

11. Reflecting our strong performance in the year to date, we now project real GDP to grow by 11 percent and inflation to decline to below 2 percent in 2005. Based on the revised projections for this year, the economic program for 2006 envisages real GDP growth of 7.5 percent and inflation of 3 percent. The additional policies noted below, and summarized in Tables 1 – 3, supplement the May 2005 memorandum of economic and financial policies.

A. Fiscal Policy

12. We now envisage the **2005 fiscal deficit** to be smaller than programmed, at AMD 52.0 billion (2.4 percent of GDP) relative to AMD 61.8 billion (2.9 percent of GDP) originally programmed. On the revenue side, we will increase slightly the revenue target to AMD 314 billion (14.5 percent of GDP) to reflect higher-than-expected GDP growth, representing an increase of 0.4 percentage points of GDP from the 2004 outturn. On the expenditure side, we intend to revise slightly downwards the overall expenditures target by AMD 4.4 billion for 2005, recognizing that some of the delayed expenditure projects will not be implemented this year.

13. The **2006 budget**, which has already been submitted to parliament, is based on the following key parameters that are consistent with our MTEF for 2006–08. The overall deficit of the central government (including grants) will not exceed AMD 69.9 billion (2.9 percent of GDP). Domestic tax and nontax revenues (including revenues from capital transactions) will be targeted at AMD 372.8 billion, of which tax revenues will be at a minimum of AMD 362.8 billion, representing an increase of 0.6 percent of GDP from the revised 2005 revenue target. Current expenditures will be at most AMD 331.1 billion, allocating substantial increases to education, health, social transfers, and civil servants' wages. At the same time, we will reduce subsidies to the water and irrigation sectors and limit expenditure increases where the efficiency of expenditure is a concern. To ensure a balanced mix between current and capital spending, capital expenditures excluding those financed from potential grants from the Millennium Challenge Account (MCA) will be at least AMD 104.8 billion, representing a 17 percent increase relative to the revised 2005 estimate. We recognize that the 2006 deficit implies some loosening in the fiscal stance relative to the prospective 2005 outturn. But our large social and infrastructure investment needs justify a further expansion of public expenditures, particularly given the availability of low-cost financing.

B. Monetary and Exchange Rate Policies

14. Monetary policy will continue to focus on maintaining price stability and retaining the flexible exchange rate regime, with foreign exchange interventions limited to smoothing out volatility in the exchange rate. We will revise the monetary program for the second half of 2005. Subdued inflation, coupled with the increase in reserve requirements and the continued re-monetization (as well as the emerging de-dollarization), justifies higher-than-programmed reserve money growth without jeopardizing the annual inflation target. Specifically, we intend to revise the end-year reserve money growth target upward to 39 percent. Given the need for withdrawing liquidity to achieve this target, the CBA will increase issuance of its own securities as needed. We will stand ready to tighten the policy stance if signs of inflationary pressures emerge.

15. The monetary program for 2006, based on conservative assumptions on velocity and the money multiplier, targets inflation of 3 percent. To that end, it seeks to limit reserve money growth to 17 percent and envisages a further buildup in foreign reserves by US$19 million. The government intends to increase the stock of treasury bills by at least AMD 7 billion, which will contribute to the development of the domestic government debt market. Additionally, we are considering recapitalizing the CBA and are in the process of discussing the modalities of doing so.

16. The implementation of monetary policy through targeting monetary aggregates has been complicated by strong remittances and unstable money demand. Accordingly, we are considering adopting a full-fledged inflation targeting monetary policy framework over the medium term. We will begin to move towards this goal in 2006. We recognize that a better understanding of the monetary transmission mechanism is a pre-requisite for the successful implementation of such a framework and have been working on developing relevant indicators for forward looking inflation forecasting and general equilibrium models. We

intend to strengthen further the CBA's capacity to conduct domestic open market operations, including through augmenting its holding of government securities.

C. Structural Reforms

17. We will continue to press ahead with reforms to improve tax and customs collection, and to strengthen the financial sector.

Fiscal reforms

18. The centerpiece of the program will continue to be reforms in tax policy and tax and customs administration. Specific measures that we intend to undertake in the coming months, consistent with the approved two-year Tax Action Plan, are discussed below.

19. In **tax policy**, we aim to broaden the tax base by reducing privileges and loopholes:

- In the context of our reform package on social security, we will amend the Law on Simplified Tax to abolish the presumptive social security payment for simplified tax payers and incorporate them into the regular social security tax payments system (structural performance criterion). We also intend to raise the minimum contribution on social security payments from its current level of AMD 5,000.

- We will submit to parliament a law introducing a presumptive tax on property developers based on square meters of development to reduce tax evasion in the construction sector (structural benchmark).

- We intend to narrow the access to the simplified tax regime by excluding activities that require state licenses with annual stamp duties of AMD 1 million or more. In addition, companies offering hotel services will no longer be eligible for the simplified tax.

- We plan to eliminate profit tax exemptions for foreign exchange gains and allow for the deduction of losses by December 2005.

Additional tax policy measures that we are considering implementing over the medium term include moving the remaining exemptions from VAT payment at the border for capital goods to the capital deferral system when it becomes fully operational; finalizing a unified tax code; moving large-scale operations from the presumptive tax to the regular tax regime; and limiting the loss carry-forward for the profit tax. Additionally, we plan to allow the current profit tax exemptions for large foreign enterprises to expire in 2007 as stipulated in the law.

20. In **tax administration**, we will focus on improving tax audits, tax arrears collection, and the VAT refund system. In this context, the upgrading of our IT capacity is paramount.

- We will continue to implement an annual audit plan for large enterprises, based on a risk classification system and specifying priorities and targets, and limit the number of revisions in tax returns that may be submitted by taxpayers and prohibit such revisions during tax audits.

- In cooperation with a specialized agency, the State Tax Service (STS) is developing a comprehensive IT strategy for 2006-08, specifying requirements in: (i) risk-based selection criteria in the areas of audits, arrears collection, and VAT refunds; (ii) information sharing between the regional tax inspectorates and headquarters; and (iii) a unified database for social contributions, tax collection, and tax arrears to enable improved cross-checking.

- We will submit a law to parliament that raises the sanctions to at least AMD 1 million for providing false documentation to revenue agencies (structural performance criterion).

- We will implement our plan for the collection of tax arrears with a view to collecting arrears or writing off the unrecoverable part of the end-2004 stock of tax arrears by the end of 2006, and ensure that no new arrears are incurred on a monthly basis.

We also plan to enhance further the transparency and efficiency of tax administration through greater public disclosure of information on taxpayers, and are moving to a fully automatic system for VAT refunds.

21. To improve the functioning of **customs administration**, we intend to:

- increase the share of the number of declarations of imports (taxable at the border under ad valorem rates), for which the approved customs value is determined on the basis of declared transaction prices by 5 percentage points (structural benchmark). This will be confirmed by reports obtained directly from the ASYCUDA system.

- work in close cooperation with the international company completing the operational review of customs operations, with the aim of completing it by March 2006 (structural benchmark). The review will focus on: (i) the main strengths and weaknesses of the SCC; (ii) implementation of laws, regulations, policies and procedures, along with enforcement, prevention and investigation; (iii) information flows within the SCC, and between the SCC and STS; and (iv) transparency of regulations, procedures and operations.

- introduce an integrated computerized system to collect, analyze, and flag information on the time taken to process customs declarations. The development of this system will draw on the findings, and recommendations, of the operational review.

- expand the use of the examination selectivity module in ASYCUDA to all customs houses by April 2006.

22. We recognize the importance of better targeting of government **expenditures** to ensure adequate and high quality public investment and social spending. We will continue to

improve the procurement process to enhance expenditure execution and efficiency. We will press ahead with the Accounting and Second Generation Treasury Reform (A2GTR) project and the four-year action plan for the introduction of program budgeting.

23. We intend to make progress on **budget monitoring** and control. In order to reduce the fiscal risk stemming from a lack of disclosure and control of NCOs, we will implement our action plan for improving NCO financial management and reporting. Furthermore, we will adopt a sanction mechanism for failure to comply with reporting requirements.

Financial sector reforms

24. We will move forward with financial sector reforms. With regards to **banking regulation and supervision**, Parliament is expected to pass the amendment to the LBB, taking into account many of the FSAP recommendations, including enhancing the effectiveness of external audits and strengthening consolidated supervision (structural performance criterion). Following the passage of the amendment, we plan to specify and implement a consolidated supervision framework (structural benchmark). The amendment will also introduce key elements that are prerequisites for improved **corporate governance of banks**, including: (i) definition of separate duties and rights of shareholders, board of directors, and executive of banks; and (ii) a minimum number of bank nonaffiliated owners and a ceiling on individual equity capital participation of these members**.** We will continue to press ahead with strengthening the legal framework for creditor rights.

25. In order to ensure a level playing field for all market participants and to better monitor and control market risks, we have decided to adopt a **unified financial supervision system**, which will become effective January 2006. In this context, the CBA will finalize an action plan, in consultation with the Fund staff, to develop the internal structure and functions of departments by end-March 2006. The plan will specify mechanisms for internal coordination and reporting, and will put in place regulatory practices based on written guidelines for on-site and off-site supervision.

26. Furthermore, progress is being made in developing the **non-bank financial sector**. In the insurance sector, we plan to implement a regulatory and supervisory framework, including regulations on accounting, auditing, financial reporting, solvency, reserves, and reinsurance. In the area of mortgage finance, we are focusing on the development of the primary market and will implement legislations aimed at simplifying procedures for notarization and the registration of rights for immovables. As regards pension reform, we will continue our work on the evaluation of various fiscally sustainable reform options based on extensive actuarial projections.

III. Other Issues

27. On the implementation of **PRSP-related work**, we are preparing a comprehensive set of monitoring indicators that will be used to assess progress in implementing our poverty reduction strategy. To reflect the dynamic developments since the adoption of the PRSP in 2003, we plan to update our PRSP later this year or by early 2006 through a participatory process and by drawing on the results of the forthcoming 2004 household survey.

28. We are firmly committed to press ahead with our efforts to improve **governance**. We will continue to implement the anti-corruption strategy action plan, focusing on such areas as education, health care, and law enforcement agencies, while raising public awareness and participation.

29. In the **energy sector**, we plan to liquidate Armenergo in a transparent manner by the end of the year. We intend to introduce a leasing contract in the Yerevan Water and Sewage Company, with the aim of eliminating budgetary support. We also intend to improve collections by expanding the metering program, particularly in areas outside of Yerevan. We also intend to strengthen the capacity of the water user companies to reduce further losses in the irrigation sector. In cooperation with the World Bank, we will implement a 7-year program aimed at mitigating the impact of water tariff increases on the poorest population.

IV. Program Monitoring

30. Program monitoring will be based on semi-annual quantitative performance criteria and quarterly indicative targets as well as structural performance criteria and benchmarks (Tables 1 and 2). The Technical Memorandum of Understanding (TMU) attached to this Memorandum defines the quantitative targets of Table 2, the program adjustors, and specific reporting requirements. Completion of the second review under the PRGF arrangement, scheduled for May 16, 2006, will require observance of the revised performance criteria for end-December 2005 shown in Table 2 as well as the structural performance criteria listed in Table 1. The completion of the third review under the PRGF arrangements scheduled for November 16, 2006 will require observance of the quantitative performance criteria for end-June 2006 shown in Table 2 as well as the structural performance criteria listed in Table 1.

Table 1. Table of Structural Measures for the Second Review under the PRGF

Measure	Type of Conditionality	Target Date (End of Period)
Tax policy		
Parliament adopt an amendment to the Law on Simplified Tax to abolish the presumptive social security payment for simplified tax payers and incorporate them into the regular social security tax payments system.	Structural Performance Criterion	December 2005
Submit to parliament a law introducing a presumptive tax on property developers based on square meters of development to reduce tax evasion in the construction sector.	Structural Benchmark	March 2006
Tax administration		
Submit a law to parliament that raises the sanctions to at least AMD 1 million for providing false documentation to revenue agencies.	Structural Performance Criterion	March 2006 1/
Customs administration		
Increase by 5 percentage points the share of the number of declarations of imports for which the approved customs value is determined on the basis of declared transaction prices.	Structural Benchmark	December 2005
Complete operational review of customs operations through a specialized international company.	Structural Benchmark	March 2006
Financial Sector		
Parliament adopt the amendment to the Law on Banks and Banking to (i) to empower the CBA to identify ultimate beneficial owners, in the event of upward consolidation; (ii) define the separate duties and rights of shareholders, boards of directors, and executives of banks; (iii) require disclosure of potential conflicts of interest of board members; and (iv) require public disclosure of information on ownership and control of banks, including list of founders and copies of the company's statutes.	Structural Performance Criterion	December 2005
Specify and implement a consolidated supervision framework for monitoring beneficiary owners beyond the licensing stage, in order to determine the appropriate structure of corporate governance and to identify how affiliate companies and related parties impact on the bank's operations.	Structural Benchmark	June 2006

1/ This structural performance criterion is for the Third review under the PRGF arrangement.

Table 2. Armenia: Quantitative Targets, June 2005 – June 2006 1/
(End of period ceilings on stocks, unless otherwise specified)

	2005						2006	
	Jun.		Sept.		Dec.		Mar.	Jun.
	Prog.	Act. 2/	Prog.	Proj. 3/	Prog.	Rev. prog. 2/	Prog. 3/	Prog. 2/
Net domestic assets of the CBA 4/	-53.8	-56.0	-41.9	-56.7	-28.1	-51.4	-42.8	-36.9
Net banking system credit to the government	-17.2	-25.1	-8.0	-20.8	-6.3	-4.8	-17.4	4.0
Domestic arrears of the central government and the State Fund for Social Insurance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Tax revenues of the central government (floor) 5/	137.3	139.8	220.7	224.2	310.0	314.0	75.1	160.7
Balance of the central government on a cash basis (floor) 5/	-25.0	-3.3	-49.1	-23.3	-61.8	-52.0	0.0	-32.2
Reserve money (band/level) 3/	(122-127)	150.8	(129-134)	173.8	(148-154)	(181-188)	(174-181)	(180-187)
Contributions to the State Fund for Social Insurance 3/ 5/	29.8	28.7	46.4	46.4	64.8	64.8	16.1	34.5
Contracting or guaranteeing of new nonconcessional external debt 5/ 6/	0	0	0	0	0	0	0	0
External arrears (continuous criterion)	0	0	0	0	0	0	0	0
Net official international reserves (floor) 7/	379.0	436.4	373.3	437.8	389.2	449.9	415.5	414.4

1/ All items as defined in the Technical Memorandum of Understanding.
2/ Performance criterion.
3/ Indicative target.
4/ At program exchange rate (500 dram per U.S. dollar).
5/ Cumulative flow from the beginning of the calendar year until the end of the month indicated.
6/ Includes debt with maturity of more than a year as well as obligations with maturity of one year or less, excluding normal import-related credit and sales of treasury bills to nonresidents.
7/ Excludes reserve money liabilities denominated in foreign currencies for September 2005 Rev. Proj., December 2005 Rev. Prog., and 2006.

GOVERNMENT OF ARMENIA
TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum defines the benchmarks, performance criteria, indicative targets, adjustors, and reporting modalities referred to in the Memorandum of Economic and Financial Policies (MEFP).

I. QUANTITATIVE TARGETS

1. The program targets a minimum level of **net official international reserves (NIR)** of the Central Bank of Armenia (CBA). The stock of such reserves will be calculated as the difference between total official gross international reserves (excluding reserve money denominated in foreign currencies) and official gross reserve liabilities. Total gross official international reserves are defined as the CBA's holdings of monetary gold (excluding amounts pledged as collateral or in swaps), holdings of Special Drawing Rights (SDRs), any reserve position in the IMF, and holdings of convertible currencies in cash or in nonresident financial institutions (deposits, securities, or other financial instruments). Gross reserves held in the form of securities and other financial instruments are marked to market. Gross reserves are reported separate from the balance on the government's Special Privatization Account (SPA) and exclude capital subscriptions in foreign financial institutions and illiquid foreign assets. Official reserve liabilities shall be defined as outstanding liabilities to the IMF and convertible currency liabilities of the CBA to nonresidents with an original maturity of up to and including one year. NIR is monitored in U.S. dollars, and, for program monitoring purposes, assets and liabilities in currencies other than the U.S. dollar shall be converted into dollar-equivalent values using the exchange rates as specified in Table 1.

2. The program targets a maximum level of **net domestic assets (NDA)** of the CBA. For program purposes, NDA is defined as reserve money minus NIR, minus reserve money denominated in foreign currencies, and plus medium- and long-term liabilities (i.e. liabilities with a maturity of one year or more) of the CBA. To evaluate program targets, the dram-equivalent values of NIR, medium- and long-term liabilities, and reserve money in U.S. dollar are calculated at the program exchange rate of dram 500.00 per U.S. dollar. The dram-equivalent value of reserve money in Euro is calculated at the program exchange rate specified in Table 1. NDA is composed of net CBA credit to the general government; outstanding credit to domestic banks by the CBA (including overdrafts) minus liabilities not included in reserve money (exclusive of accrued interest), and other items net.

3. **Reserve money** targets are indicative and include a floor and a ceiling. They are subject to a daily bound of plus or minus 2 percent computed from the quarterly average standard deviation of excess reserves held by banks in percent of quarterly reserve money during the previous four years. Reserve money is defined as the sum of currency issued,

required and excess reserves, and current and time deposit accounts of certain resident agents.[1]

4. **The stock of net credit from the CBA to the government** includes the CBA's holdings of treasury bills and treasury bonds less all types of government deposits with the CBA (including the deposits in the Treasury Single Account, deposits of donor-financed project implementation units, the Lincy foundation, and balances of proceeds from the sale of humanitarian assistance). Treasury bonds are valued at the purchase price and excluding accrued interest and treasury bills are valued at the purchase price plus the implicit accrued interest.

5. **Net credit from commercial banks to the government** includes: (1) gross commercial bank credit to the central government less government deposits with commercial banks (including the counterpart funds of certain government on lending to the economy financed by the Lincy Foundation and the World Bank); and (2) banks' holdings of treasury bonds (valued at the purchase price and excluding accrued interest) and treasury bills (valued at the purchase price plus the implicit accrued interest). **Net credit of the banking system to the government** is the sum of net credit from the CBA and net credit from commercial banks to the central government.

6. **External debt ceilings** apply to all forms of new nonconcessional medium- and long-term external debt[2] with original maturities of more than one year, which are contracted or guaranteed by the government or the CBA or any other agency acting on behalf of the government. It does include debt with maturity of one year or less. Excluded from the limits are changes in indebtedness resulting from refinancing credits or rescheduling operations, sales of treasury bills or treasury bonds to nonresidents (provided the sales go through the regular auction mechanism and involve no exchange rate guarantees), concessional loans, and credits extended by the IMF.[3] Except for normal import-related credits, there is a zero limit on short-term external debt (obligations with original maturities of up to one year) contracted or guaranteed by the government or the CBA. Transactions subject to debt ceilings shall be valued in the contracted currencies and converted into U.S. dollars at the average monthly market exchange rate in the month when the commitment was contracted.

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[1] Liquidity absorbing transactions under reverse repurchase agreements, the CBA's deposit facility, and foreign currency swaps are netted out from claims on banks, i.e., they are excluded from the reserve money definition.

[2] The term "debt" shall have the meaning set forth in Section 9(a) of the Guidelines on performance criteria on external debt, as modified by the Executive Board Decision No. 12274-(00/85) of August 24, 2000.

[3] For program purposes, a loan is considered concessional if the grant element is at least 35 percent calculated using a discount factor based on the Commercial Interest Reference Rates (CIRRs) published by the OECD plus margins depending on the loan maturity. The margins are: 0.75 percent for repayment periods of less than 15 years, 1 percent for 15–19 years, 1.15 percent for 20–29 years, and 1.25 percent for 30 years or more. The average of the CIRRs over the last ten years will be used for loans with a maturity of at least 15 years and the average of the CIRRs for the preceding six months will be used for shorter maturities.

7. **External arrears** will consist of all overdue debt-service obligations (i.e., payments of principal and interest) arising in respect of public sector loans contracted or guaranteed including unpaid penalties or interest charges associated with these arrears.

8. **Balance of the central government on a cash basis** is defined as the sum of domestic banking system net financing, domestic nonbank net financing, and external net financing to the government. **Net banking system credit to the government** equals the change during the period of net credit to the government. **Nonbank net financing** equals the sum of: (1) the change during the period of outstanding treasury bills and bonds to nonbanks (including accrued interest for treasury bills and excluding accrued interest for treasury bonds);[4] and (2) any other disbursement or transaction that increases nonbanks' claims on the central government plus withdrawals from the special privatization account or the treasury subaccount containing privatization proceeds in dram, less amortizations made by the central government to private resident nonbank agents. **External net financing** equals total debt-increasing disbursements from non-residents to the central government less total amortizations from the central government to non-residents. All foreign-currency denominated transactions are recorded in drams using the prevailing exchange rate at the time of the transaction.

9. The project implementation units, which carry out projects financed by the US-based Lincy Foundation, maintain accounts at the CBA. These grants are recorded in the fiscal accounts as external grants on the revenue side and as foreign-financed capital expenditure on the expenditure side. In addition, any loans extended by the US-based Lincy foundation to finance investments and that are intermediated through the banking system are recorded in the financial accounts as a financing item below the line and are thus excluded from net lending.

10. Foreign currency proceeds from selling enterprises are deposited into the Special Privatization Account (SPA). The account is held at the CBA and the proceeds are invested abroad together with the CBA's international reserves. These proceeds are included in the definition of the monetary accounts of the CBA as part of net foreign assets with a counter entry in other items net. Any budgeted withdrawal from the SPA will be accounted for as privatization proceeds used to finance the budget and will be recorded below the line. Any unanticipated withdrawal from the SPA will be recorded below the line as privatization receipts; these withdrawals, however, will be replenished during the same fiscal year. Domestic currency proceeds from selling enterprises to residents are deposited in a subaccount of the treasury single account.

11. **Tax revenues** of the central government are defined in accordance with Government Financial Statistics (GFS), 1986, section IV.A.1. Total revenues collected by the State Tax Service (STS) and the Customs Committee (CC) are classified as follows: VAT (of which:

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[4] Domestic nonbank holdings of treasury bills and treasury bonds are defined as total outstanding treasury bills and bonds less holdings by the banking system and the SFSI.

presumptive tax on cigarettes, petroleum, and diesel), excises (of which: presumptive tax on cigarettes, petroleum, and diesel), enterprise profit tax, personal income tax, land tax, customs duties (of which: presumptive tax on cigarettes), other presumptive taxes, simplified tax, property tax, and other taxes (of which stamp duties and environmental taxes). **Payroll contributions to the State Fund for Social Insurance (SFSI)** are not included in tax revenue. For evaluating the performance criterion on tax collection, recorded tax revenues will exclude any tax payment related to non-programmed transfer, loan, or recapitalization operation carried out with state-owned companies or any VAT refunds in arrears.

12. The program targets ceilings for the stock of **domestic arrears of the central government and the State Fund for Social Insurance** (SFSI). Domestic arrears are defined as follows. With respect to wages, contributions to the pension fund, family allowances, and amortization and domestic interest payments, the stock of arrears is defined as all unpaid claims outstanding at the end of the month. This excludes technical arrears of up to AMD 0.5 billion that could arise because of minor delays in the execution of these expenditures. For all other expenditure categories, arrears are defined as the stock of unpaid claims, as verified by the recipient of the goods and services, which has been outstanding for more than 30 days as of the end of the month. However, at year-end all outstanding claims must be settled as required in the budget law.

II. ADJUSTERS

13. The quantitative performance criteria and benchmarks under the program are subject to the following adjusters:

- **Foreign-financed project loan disbursements:** the target on the cash balance of the central government will be adjusted downward (upward) by the full amount of cumulative higher (lower) than programmed foreign-financed project disbursements. The programmed amounts are shown in Table 2 below.

- **World Bank budget support:** the following targets will be adjusted by the full amount of lower than programmed World Bank direct budget support: NIR (downward), NDA of the CBA (upward), and net credit to the government (upward). The programmed amount is shown in Table 3 below.

- **KfW loan disbursements**: the target on the NDA of the CBA will be adjusted upward by the full amount of any non-programmed disbursement from KfW. The adjustment will be made at program exchange rates. The programmed amount is shown in Table 4 below.

- **Recapitalization of the CBA:** the target on the net credit of the banking system to the government will be adjusted upward by the full amount of the recapitalization of the CBA.

III. Structural Performance Criteria and Benchmarks

14. **Compulsory Social Contributions** (structural performance criterion). See paragraph 19 of the MEFP.

15. **Presumptive tax on property developers** (structural benchmark). See paragraph 19 of the MEFP.

16. **Sanctions for false documentation** (structural performance criterion). See paragraph 20 of the MEFP. This structural performance criterion is for the third review under the PRGF arrangement.

17. **Operational Review of the State Customs Committee (SCC)** (structural benchmark). Complete the operational review in line with the terms of reference by March 31, 2006. The broad objectives of the

review should be to: i) assess the operational efficiency of customs processes, including in comparison with other similar countries; ii) identify any capacity constraints and shortcomings in administration, which hamper revenue collection; iii) recommend specific reforms aimed at enhancing operational efficiency and revenue mobilization; and iv) in so doing, identify priority areas for further technical assistance.

18. **Valuation of imports at declared transaction prices** (structural benchmark). On the basis of reports obtained directly from the ASYCUDA system, demonstrate an increase of 5 percentage points, over 2004, in the number of declarations of imports (taxable at the border under ad valorem taxes), for which customs value is determined on the basis of the declared transaction price. Progress during the year will be reported quarterly, also on the basis of reports obtained directly from the ASYCUDA system. To support the use of transaction prices, the customs valuation database will be published, and kept up to date, on the SCC website.

19. **Law on the Banks and Banking.** An amendment to the Law on the Banks and Banking (LBB) will be passed by the Parliament by end-2005 (structural performance criterion).

Consolidated supervision

20. The amendment will clearly stipulate that, in the event of upward consolidation, the CBA is empowered to identify beneficial owners on a chain of ownership as far as the CBA sees appropriate for supervisory purpose.

Corporate governance

21. The amendment on the LBB will define the separate duties and rights of shareholders, boards of directors, and executives of banks.

22. The shareholders' rights should be performed through the decisions of the **General Meetings of Shareholders**, which at least covers the following issues: (i) electing or calling back the members of the Board of Directors, (ii) approving the external auditor of the bank, and (iii) approving the payments of dividends to the shareholders upon a request of the Board of Directors. This ultimate decision making power of the General Meeting of shareholders may not be transferred to the bank's Board of Directors, executives of the bank, or any other party.

23. The **Board of Directors** of the bank shall be responsible for the safe and sound operation of the institution, thus taking decisions on the following issues: (i) determining the strategy of the bank, (ii) appointing and firing the banks' executive officers, (iii) establishing the standards of risk management and internal controls, (iv) establishing the internal audit division and internal audit plan of the bank, (vi) approving the banks' internal administrative structure, (vii) initiating measures for the correction and elimination of failures identified during audits and imposing control over their implementation, and (viii) approving internal guidelines on financial operations conducted by the bank. This ultimate decision making power of the Board of Directors may not be transferred to the bank's General Meeting of shareholders, executives of the bank, or any other party.

24. The number of the members of the **Board of Directors** should be at least 5 but not exceed 15. Board members shall not be affiliated with each other. The executives of the bank and the members of the Board of Directors should also not be affiliated persons.

25. The **executives** of the bank should be appointed by the Board of Directors. The power of taking decisions by the executive may not be transferred to the General Meeting of shareholders, Board of Directors, or any other party.

26. The members of the Board of Directors and the executive officers should bear fiduciary responsibilities for acting in a non-sound and unfair manner.

27. The amendment on the LBB should stipulate public disclosure of information on ownership and control of the bank, including the list of significant shareholders and copies of bank's statutes. Major shareholders, members of the Board of Directors and executive officers of the bank should publicly disclose their remuneration and other benefits or loans, including those received by their affiliates.

IV. Data Reporting

28. The government will provide the IMF the information specified in the following table.

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
CBA[5]	CBA balance sheet	Summary	Weekly	Within 1 day of the end of each week
	CBA balance sheet	Summary at program exchange rates; and by chart of accounts at actual official exchange rates	Monthly	Within seven days of the end of each month
	Monetary survey	Summary banking system balance sheet for the central bank and the consolidated balance sheet of commercial banks at program exchange rates; and by chart of accounts at actual official exchange rates	Monthly	Within 21 days of the end of each month
	International reserves	By chart of accounts; at (i) program exchange rates; and (ii) at actual official exchange rates	Weekly	Within 1 day of the end of each week
		By chart of accounts; at (i) program exchange rates; and (ii) at actual official exchange rates	Monthly	Within 2 days of the end of each month
	Foreign exchange market	Official exchange rates (buying and selling); interbank turnover; and volume of CBA interventions, including foreign exchange swaps	Weekly	Within 1 day of the end of each week
	Interest rates	Repo rate; interbank rate; by volume and maturity, T-bill rate, bond yield; and by maturity, deposit and lending rates	Monthly	Within 7 days of the end of each month
	CBA operations	Repo (reverse repo) operations; Lombard credits; and deposit facility	Monthly	Within 7 days of the end of each month
	Bank liquidity	Reserves and excess reserves	Biweekly	Within 7 days of the end of each month
	Special privatization account (SPA)	Monthly flows	Monthly	Within 7 days of the end of each month
	Banking indicators	Capital adequacy; asset composition and quality; profitability; liquidity; open FX positions; and compliance with prudential norms	Quarterly	Within 30 days of the end of each quarter

[5] As defined in CBA resolution No. 201 (December 6, 1999).

	CPI	Index of core inflation	Monthly	Within 21 days of the end of each month
	Other monetary data	IFS format	Monthly	Within 45 days of the end of each month
Customs Committee	Report on the operations of the post verification unit	The report will include: information on the number of audits conducted, the number of infractions found, the amounts involved, and remedial measures taken	Quarterly	Within 30 days of the end of each quarter
	Report of the operations of the internal audit unit	The report will include: the number of written appeals, complaints, and requests submitted to the IAUCC; the sources of the written submissions (e.g. President's Office, the Prime Minister's Office, other Government officials, National Assembly, line Ministries, Law Enforcement bodies, individuals, non-government organizations); the IAUCC's actions in response to the written submissions; the number and type of audits/investigations undertaken by the IAUCC; the overall results of the audits/investigations undertaken; and the actions taken by the IAUCC in response to the results of the audits/investigations undertaken	Quarterly	Within 30 days of the end of each quarter
	Import data	1. Total value of recorded imports, breaking out raw diamond imports; 2. Total value of non-duty free recorded imports; 3. Number of total transactions involving recorded imports; 4. Number of total transactions involving non-duty free recorded imports 5. Value of recorded imports where customs value was assessed using transaction prices, breaking out raw diamond imports; 6. Value of non-duty free recorded imports where customs value was assessed using transaction prices; 7. Number of transactions involving recorded imports where customs value was assessed using transaction prices; and 8. Number of transactions involving non duty free recorded imports where customs value was assessed using transaction prices	Quarterly	Within 30 days of the end of each quarter

Ministry of Finance and Economy (MFE)	T-bill and coupon bond financing	By holders, i.e., CBA, resident banks, resident nonbanks, and nonresidents	Monthly	Within 7 days of each month
	External debt	Disbursements and stock of outstanding short-term and contracting or guaranteeing and outstanding stock of medium-and long-term external debt of the government, the CBA, and state-owned companies (by company); any stock of arrears on external debt service and outstanding stock of government guarantees and external arrears	Monthly	Within 21 days of the end of each month (preliminary data) and within 45 days of the end of each month (final data)
	Revenue collection	Total revenue collected separately by the SFSI, the STS, and the CC, including revenue by individual tax	Monthly	Within 7 days of the end of each month
	Expenditure arrears	Government and SFSI separately	Monthly	Within 20 days of the end of each month for SFSI arrears and within 45 days of the end of each month for government arrears
	Privatization receipts	Balance on the SPA; gross inflows into and outflows from the SPA during the month, specifying the nature of each transaction	Monthly	Within 7 days of the end of each month
	Treasury single account (TSA)	Detailed breakdown of central treasury account, including deposits at the central treasury, pension fund, community budgets, off budget account, monetization account, state budget account and the Republic correspondent account—flows during the month and end of month stocks.	Monthly	Within 7 days of the end of each month
	Consolidated central government	State budget and SFSI	Monthly	Within 30 days of the end of each month
	Consolidated general government	Central and local governments 1/	Quarterly	Within 60 days of the end of each quarter
	Consolidated general government	Central and local governments 1/	Annual	Within 180 days of the end of each year
MFE/SFSI	Budget execution	All cash receipts, cash expenditures, including debt-service payments, and external and domestic borrowing operations; expenditure data will be provided according to both economic and functional classifications, consistent with the GFS methodology	Monthly	Within one month following the end of each quarter.
NSS	Balance of payments	Detailed export and import data	Monthly	Within 28 days of

				the end of each month
		Detailed export and import data	Quarterly	Within 45 days of the end of each quarter
	GDP	Estimates	Monthly	Within 30 days of the end of each month
	CPI	By category	Monthly	Within 5 days of the end of each month
STS	Tax arrears	By type of tax	Monthly	Within 30 days of the end of each month
		For or the 30 largest debtors and for all major companies in the energy, water, and irrigation sectors	Quarterly	Within 30 days of the end of each quarter
	VAT refund claims in arrears	Detailed data on VAT refunds in arrears which include all outstanding VAT refunds that have not been accepted (and refunded), or offset (in full or in part), or rejected (in full or in part) after the 90 day processing period. Number of refund applications processed per month.	Monthly	Within 30 days of the end of each month

1/ Until NCE quarterly data reporting has been established, central government is defined as state budget (budgetary) + SFSI (social security fund). Once NCE quarterly data reporting has been established, central government is defined as state budget (budgetary) + NCEs that belong within the general government (extrabudgetary) + SFSI (social security fund). General government = central government + local governments.

Table 1. Armenia: (Program) Exchange Rates of the CBA
(As of December 30, 2004 for dollars per currency rates. Drams per currency rates are calculated using the 500 drams per U.S. dollar rate)

Country	Drams Per Currency	Dollars Per Currency
Australian dollar	389.85	0.779701
Canadian dollar	406.67	0.813334
Swiss franc	441.45	0.882904
Danish krone	91.47	0.182941
Euro	680.40	1.360798
Pound sterling	962.90	1.925799
Japanese yen	4.838	0.009676
Norwegian krone	82.40	0.164807
Swedish krone	75.85	0.151696
U.S. dollar	500.00	1
SDR	791.92	1.583834
Gold 1/	7,129.43	14.25885

1/ Per gram.

Table 2. Armenia: Cumulative Foreign-Financed Project Loan Disbursements 1/
(In billions of drams)

2005			
March	June	September	December
5.4	10.3	21.9	39.5

1/ Cumulative from December 2004, at program exchange rates.

Table 3. Armenia: World Bank Lending1/
(In billions of drams)

2005			
March	June	September	December
0	0	0	10.0

1/ Cumulative from December 2004, at program exchange rates.

Table 4. Armenia: KfW Loan Disbursements 1/
(In billions of drams)

2005			
March	June	September	December
0	0	0	0

1/ Cumulative from December 2004, at program exchange rates.