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

February 17, 2014

The following item is a Letter of Intent of the government of Armenia, which describes the policies that Armenia intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Armenia, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Letter of Intent

Christine Lagarde
Managing Director
International Monetary Fund
Washington, D.C. 20431

Yerevan, February 17, 2014

Dear Madam Lagarde:

1. **Armenia has made significant progress in recovering from the global financial crisis and reorienting its economy**. External and fiscal imbalances have been reduced, and the engine of growth has shifted from construction to agriculture, industry, and services. Under the 2010–13 IMF-supported program, growth was reestablished following a contraction of 14 percent in 2009, the overall fiscal deficit was reduced by six percentage points of GDP to below the debt stabilizing level of 2 percent of GDP in both 2012 and 2013, and the external current account deficit was lowered from nearly 16 percent of GDP in 2009 to 8½ percent of GDP in 2013, as exports and remittances have grown strongly in recent years. Important structural reforms have taken place in tax policy and revenue administration, the financial sector, pensions, and the business environment. Six program reviews under the Extended Fund Facility (EFF) and Extended Credit Facility (ECF) arrangements were completed with few delays or missed targets.

2. **Despite this success, important challenges remain**. Poverty increased with the crisis, and unemployment remains high. While activity has recovered, growth slowed significantly in 2013. Social and investment outlays should be increased to strengthen growth and ensure that it is sustainable, resilient, and inclusive. The external current account deficit and high dollarization in the financial system remain sources of vulnerability. Reserves of the Central Bank of Armenia (CBA) are healthy and were boosted by proceeds from the September 2013 Eurobond and foreign exchange (FX) market purchases in 2013; however, reserves are expected to decline in 2014, due in part to payments to the IMF. The reduction of the external current account deficit has been supported by the significant fiscal adjustment, which has reflected capital underspending in recent years. Further external adjustment will need to be driven by the private sector, although stepped-up private investment is also required. While structural reforms advanced under the Fund-supported program, private and foreign investment has not picked up strongly, and further business environment improvements targeting improved competition, competitiveness, connectivity, and regional integration would help shift private activity from consumption to investment.

3. **Recognizing that these important medium-term challenges remain, we request the approval of a new 38-month arrangement under the EFF in an amount equivalent to SDR 82.21 million (89.4 percent of quota).** We believe that such an arrangement would be the most appropriate way to support our program, as laid out in our new Armenian Development Strategy 2013–2025 and described in the attached Memorandum of Economic and Financial Policies (MEFP). We also request that an amount equivalent to SDR 11.74 million be made available upon

approval of the program. We believe that the policies outlined in the MEFP are adequate to help us achieve our program objectives.

4. We will maintain a close policy dialogue with the Fund and stand ready to take additional measures, as appropriate, to ensure the achievement of our social and economic objectives under the Fund–supported program. We will continue to consult with the Fund on the adoption of measures, and in advance of revisions of the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. We will also provide the Fund with information it requests for monitoring program implementation. The program's proposed performance criteria (PCs), indicative targets (ITs), and structural benchmarks (SBs) are set out in Tables 1 and 2 and described in the attached Technical Memorandum of Understanding (TMU).

5. We authorize the IMF to publish this Letter of Intent and its attachments, as well as the accompanying staff report.

Very truly yours,

/s/
Tigran Sargsyan
Prime Minister
Republic of Armenia

/s/
David Sargsyan
Minister of Finance
Republic of Armenia

/s/
Artur Javadyan
Chairman of the Central Bank
Republic of Armenia

Attachment I. Memorandum of Economic and Financial Policies

A. Recent Developments

1. **Economic activity slowed in 2013, while inflation picked up.** After accelerating to over 7 percent in 2012, led by agriculture, agro-processing, mining, and services, growth slowed to just over 3 percent in 2013, with the trade and services sectors slowing and construction again declining. A deceleration in the global and regional economy, energy price hikes, a tight fiscal position, and a slowing of credit growth were contributing factors. Higher food prices and energy tariff increases in July drove headline inflation (y-o-y) to 9.3 percent in August, well above the target band of the Central Bank of Armenia (CBA) of 4±1.5 percent. Inflation subsequently declined to 5.6 percent at end-year. The CBA increased its policy rate by ½ percentage point to 8.5 percent in August 2013, the first change in nearly two years, in order to mitigate possible second-round effects associated with the increase of food, gas, and electricity prices. As inflation was declining rapidly and activity was weaker than expected, the CBA reversed its move in November and cut the policy rate to 7.75 percent in December.

2. **We have continued our strict fiscal management**. The underlying fiscal deficit in 2013 is projected at 1 percent of GDP, compared with 2.6 percent of GDP in the budget, although preliminary data suggest that the deficit may have been lower. A one-off gas-related transfer amounting to 1.5 percent of GDP, financed by privatization proceeds, would bring the headline fiscal deficit to around 2½ percent of GDP. Revenues achieved the planned amount, but expenditures were lower, due mainly to delays in implementation of externally-financed capital spending.

3. **External adjustment accelerated in 2013. Exports and remittances each grew at a healthy pace, led by mining and agro-processing.** Together with a modest rise of imports, this contributed to a significant improvement of the external current account deficit. We issued Armenia's debut Eurobond in September, raising $700 million, with a 7-year repayment term, and a yield of 6.25 percent. The offering was four times oversubscribed. We used the proceeds to repay the remainder of a 2009 crisis loan from Russia ($457 million), as well as to reduce domestic financing and boost reserves.

4. **Monetary and financial conditions continue to be sound. Growth of broad money and private sector credit continued to decelerate in 2013, but remained relatively strong.** Overnight interest rates have remained close to the policy rate and the center of the CBA's interest rate corridor (300 basis points). The banking system remained highly liquid and well-capitalized, although heavily dollarized (two-third of deposits and loans), and with some banks close to the regulatory minimum capital requirement (12 percent). FSIs weakened somewhat in 2013, with NPLs at over 4 percent in December and profitability declining slightly. With the improvement of the external current account, the Armenian dram (AMD) remained stable, and the CBA bolstered its foreign exchange (FX) reserves with purchases in the market. After sales last March, the CBA bought over $100 million, while the dram appreciated by about 3 percent in nominal terms vis-à-vis the dollar.

5. In September, President Sargsyan announced that Armenia will join the Eurasian Customs Union (ECU). Accession to ECU membership will take place according to a road map agreed in December with the Eurasian Commission and the other ECU member countries, Belarus, Kazakhstan, and Russia. Signing of a customs union agreement is expected to take place in May 2014, after negotiation and agreement on a wide range of issues and scores of documents and legislative acts, and followed by ratification by the National Assembly and parliaments of the other ECU states. While the ECU membership decision has meant that a deep and comprehensive free trade agreement (DCFTA) with the European Union (EU) did not go forward, we also remain strongly committed to continuing to strengthen our ties with the EU.

6. Agreement on a new five-year gas supply arrangement with the Russian Federation and Gazprom was reached in December 2013. The agreement contains a new base price of $189 per 1000 m3, which represents a 30 percent discount from what would have been a new price of $270 per 1000 m3. The agreement will ensure a stable and predictable price and save Armenian consumers hundreds of millions of dollars through 2018.

7. Other reforms have advanced. The new mandatory funded pension system was launched on January 1st of this year, and the regulatory and supervisory framework has been progressively put in place. Contributions to individual accounts started in January, and two top-tier European asset management firms are managing funds under the new system. In the financial sector, the CBA recently issued a new regulation on minimum requirements for commercial bank internal controls that will help to make the banking sector more efficient and sound. We have approved a new policy framework for civil aviation to increase competition, improve connectivity, and lower costs, and we are advancing on "open skies" liberalization of the sector. We also continue to make progress reducing red-tape and costs for households and companies through our Regulatory Guillotine initiative.

B. Outlook for 2014 and the Medium Term

8. Growth is expected to pick up in 2014 and over the medium-term. In the absence of shocks, growth is expected to rebound to 4.3 percent this year and reach a trend of 5 percent during the program period, predicated on continued implementation of structural reforms, enhanced regional integration, and a pick-up of public, private, and foreign investment. The slowing of growth in 2013 likely meant that a small negative output gap reemerged.

9. Inflation is expected to return to the CBA's target range in 2014. The main impact of the July electricity and gas tariff increases on inflation was absorbed in 2013, and demand pressures remain moderate due to the gradual growth recovery. Food inflation pressures—which in Armenia are highly linked to movements in international commodity prices—are expected to moderate in 2014, but remain a source of risk given the large food component in Armenia's consumption basket.

10. Fiscal policy aims to provide an impulse this year, while continuing to rebuild buffers and place public debt on a downward trend. The overall fiscal deficit will increase in 2014 from the underlying 2013 outturn, with additional outlays to address important capital and social objectives. We expect to reduce the deficit in 2015 and 2016 back to and below the debt stabilizing deficit level of 2 percent of GDP. This further adjustment is important, as budgetary financing will be increasingly on non-concessional terms. We aim to meet spending needs with gradually increasing revenues.

11. The external current account is expected to strengthen further over the medium-term, reaching its estimated sustainable position during the program period. The external adjustment should be led by the private sector, as the headline fiscal deficit is not expected to be reduced significantly further. The current account deficit is projected to decline by a further 2 percentage points of GDP during 2014–17, reflecting continued strong growth of mining and food exports and lower gas imports. Exports are expected to be supported by infrastructure improvements, structural reforms, continued gains in Russian markets, and inroads in the rest of the ECU and the EU. The external improvement could be even larger if new mines and industrial projects now under development or consideration come on-line. FDI has been sluggish in recent years, but we are confident that our efforts to pursue further structural reforms, business environment improvements, and ECU membership will contribute to higher FDI over the medium-term. Following a peak of IMF repurchases in 2013–14, CBA gross reserves are expected to remain stable at above 4 months of imports over the medium-term, a level warranted by the high level of dollarization.

12. We remain mindful of downside risks present in the global economy and their potential impact on Armenia. Exports and remittances have remained strong, but could fade if the slowdown in Russia deepens. A tightening of global financing conditions could diminish capital inflows to Armenia, slowing investment and growth. On the other hand, agreement with the Russian Federation on a lower gas price limits risks of higher domestic energy prices for the next five years.

C. The New Program

13. The new program aims at consolidating stability and implementing further reforms to support Armenia's continuing transition towards a dynamic emerging market economy. The program targets consolidation of the fiscal adjustment through a gradual continuing increase of tax revenues. This would place debt on a downward path while providing additional resources for social and investment needs. Continued official budgetary support and financing in key social and physical infrastructure areas will be important. Monetary and exchange rate policies will target low inflation and support the external adjustment, while the CBA will maintain its buffers at healthy levels and strengthen its capacity to respond to shocks. The program also supports strong structural reforms to promote greater competition, competitiveness, and regional integration and thereby, higher investment, exports, and growth. These are complex reforms that call for a medium-term arrangement. At the same time, the program aims to be an "exit" from IMF support, with Armenia sustaining market access.

Fiscal Policy

14. Over the next three years, we intend to consolidate the post-crisis fiscal adjustment and to begin to reduce public debt, while addressing social and investment needs. We will seek a gradual reduction of the fiscal deficit in order to achieve a debt-reducing balance during the program. To this effect, we will increase revenues in a growth-friendly way that focuses on tax policy gaps and efficiency- and equity-enhancing tax policy and revenue administration gains, while limiting adverse business climate impacts. This will allow us to reduce the stock of tax credits that has built up in recent years and thereby stimulate private activity and augment spending on public infrastructure, while maintaining a well-targeted safety net and achieving the debt-reducing path for the deficit. We will strengthen execution of public investment spending to enhance predictability of the fiscal path and ensure that the fiscal policy properly addresses the intended targets. A further key objective is to strengthen institutional arrangements for assessing and managing fiscal risks.

15. The 2014 budget represents an important step to achieve these objectives. With growth slowing, it will provide a positive fiscal impulse through increased domestically-financed capital spending and higher pensions and civil service wages after several years of restraint and erosion, which have led to worsening social indicators among the elderly and difficulties attracting and retaining well-qualified staff. The budget will also cover new pension reform transition costs. We consider that tax policy measures could further depress activity and will focus our efforts on 2015 and beyond, continuing this year with efficiency-enhancing revenue administration reforms. The budget targets a headline deficit of 2.3 percent of GDP, over 1 percent of GDP higher than the 2013 outturn (excluding the gas-related transfer). This is above the debt reducing level of 1.8 percent of GDP targeted at the end of the program period, but in line with the projected path under the 2010–13 Fund-supported program. Financing is expected to come from a range of sources, including use of the Eurobond proceeds, official lending, and domestic treasury securities. Some of the Eurobond proceeds (AMD 32.3 billion, 0.7 percent of GDP) will be used for net lending on commercial terms to SMEs and exporters via three state institutions that have a strong track record in managing lending and support operations, including via commercial banks, with the banks taking full credit risk. Use of Eurobond resources to replace previously-planned domestic debt issuance is expected to generate savings on domestic interest costs. We will maintain a prudent fiscal reserve from the remaining proceeds at the CBA.

16. Pensions and public sector wages will increase this year. This is intended to address several critical civil service employment issues. Wages for many categories have not been increased since the crisis, leading to loss of qualified staff and poor governance incentives. Structural changes will introduce a more consistent wage policy, including introducing a grid structure based on clear job descriptions and standardized salaries across different government agencies and levels. We are working with the World Bank to strengthen performance assessments and flexibility in hiring and termination of staff, and will seek cost savings in the year ahead where possible. For example, we will rationalize the civil service and military grade structure, addressing grade inflation that occurred with previous reforms, with targeted grandfathering. The wage bills of state non-commercial organizations (hospitals, schools) will continue to be managed independently and autonomously and on the basis of payment by the state for specific services. This will help strictly control the broader public employment wage bill. Pension outlays will also increase in 2014, as we begin to address the severe, post-crisis erosion of pension levels. While we have set an ambitious political goal for further increases in the minimum wage, civil service wages, and pensions over the medium term, we recognize that achieving this goal must be consistent with fiscal sustainability and making adequate provisions for growth-enhancing capital outlays. Wage and pensions policy will also take into account the implications of increases for inflation, competitiveness, the private sector, and unemployment.

17. We will increase domestically-financed capital spending this year. As with wages and pensions, outlays in this area have eroded in recent years, and we will step up spending for road maintenance and school rehabilitation. Fiscal underspending in recent years has been largely related to externally-financed capital projects. Here, we believe that sustained progress on the North South Highway will now take place, although arrangements for Phases II and III of the project are complex, involving work with multiple agencies (ADB, EIB, the Eurasian Development Bank, and possibly others). If this project and other externally-financed infrastructure spending move forward at a faster-than-expected pace in 2014 and beyond, we will reach understandings with the Fund for modification of the program targets to allow for additional spending. We will also consider ways to strengthen and speed up the implementation of capital expenditures, particularly on donor-funded projects, without losing quality or introducing financial control concerns (e.g., by improving the tendering and contract execution stages). We will continue to make available to the public information on project assessments, tenders, implementation, and performance audits, particularly for large, complex projects.

18. We continue to place importance on poverty reduction and targeted social spending under the new program. Despite progress recently reflected in data for 2012, the poverty rate continues to be high in Armenia. Accordingly, we increased the minimum wage by 29 percent in July 2013 and will increase it by a further 11 percent in July 2014. The program should retain an indicative target (IT) on social spending, but cover a wider base than under the 2010–13 Fund-supported program., namely, the social assistance budget, including the flagship family benefits program, one-time childbirth benefits, childcare benefits for children less than two years of age, and benefits programs for families with disabled members or disabled children. We have made significant progress in our efforts to modernize the legal framework for social assistance and state benefits and to integrate and streamline the wide range of social services to improve efficiency and service quality. As such, 2014 will be the first year of operation of a transformed social benefits system. The new law on state benefits has been adopted by the National Assembly and a set of government decrees are being prepared to implement the new law. The new law on social assistance will be considered in parliament in early 2014 and will also be followed by a set of government legal acts for implementation. The two laws integrate the results of a pilot program involving 19 one-stop service centers where the functioning of the integrated system has been tested and refined, including social work and case management approaches. Over the next three years, we will put in place another 35 one-stop centers around Armenia. In the 2014 budget, we have redistributed funding for the unemployed from payment of modest unemployment benefits to measures that more actively help the unemployed integrate into the labor market, such as financial support for training, work skills, trips for job interviews, and job matching and placement.

19. We will strengthen monitoring and control of fiscal risks, including those related to public utilities, concessions, and PPPs. We will create a risk management unit at the Ministry of Finance by end-2014 (structural benchmark). The unit will help establish an effective monitoring and assessment framework by inventorying, maintaining, and assessing information on concessions, regulated utilities, state-owned enterprises (notwithstanding the extent of state shareholding or line-ministry affiliation), and PPPs. The unit will analyze potential fiscal risks from these and other sources (macro, financial, environmental, etc.) for the annual budget statement and decision-making. We will also prepare a policy paper on PPP strategy, including policy objectives, definitions, further legislative requirements, and proposal for a robust institutional set-up by end-2014. We would very much welcome TA from the IMF.

20. We aim to strengthen tax revenues during the program period through efficiency-enhancing revenue administration and tax policy measures. Our efforts will aim to consolidate the significant revenue gains that took place under the previous program, including an increase of the tax revenue-to-GDP ratio by over 2.5 percent of GDP in 2012–13, while focusing on compliance and policy gaps to help level the playing field and limit adverse business environment and poverty impacts. This approach will help us move away from a past practice of setting ambitious goals and targeting existing taxpayers to focusing efforts on areas where there is low compliance. In 2015, our efforts will allow us to reduce the stock of tax credits by 0.3 percent of GDP, while keeping the overall revenue-to-GDP ratio constant. The reduction of tax credits will support private activity by easing working capital constraints for taxpayers and supporting hiring, purchases, and investment. During 2016–17, we aim to generate revenue gains of 0.3 percent of GDP per year. These additional revenues will allow us to increase public investment spending and reduce the deficit. Higher customs revenues from higher ECU common external tariffs will also likely mean additional budgetary revenues.

21. In revenue administration, we will continue efforts to improve efficiency and transparency, while supporting revenue gains. In line with past IMF advice, we have enhanced our taxpayer registry and can now distinguish taxpayers by status of operations and tax liabilities of different types, with regular updates. Action areas in 2014 and beyond include the following:

- Implementation of a modern tax compliance program aimed at identifying and addressing major risks to revenues and promoting greater self-compliance through a continually more business-friendly service orientation and allocation of resources to areas that have the highest impact on increasing compliance and reducing tax gaps. We have recently strengthened our assessment of tax gaps at three regional inspectorates, and will extend this work to a comprehensive national strategy. Our National Plan for Fighting Tax Avoidance, Tax Fraud and Shadow Turnover will be an important part of the compliance program. To facilitate our activities, we will establish a Risk Management Unit (RMU) in the SRC by June 2014 (structural benchmark), with technical assistance support from the IMF. The RMU will prepare a compliance strategy for 2015 and beyond, with comprehensive annual action plans, monitoring, and ex post evaluation of tax payments.

- We will enhance coverage and capacity of the SRC's large taxpayer unit (LTU). We will increase the number of large taxpayers covered by the LTU by about 10 percent to 510 large taxpayers in 2014 and also increase LTU staff by 10 percent through reorganization. We will also augment the analytical capacity of the LTU by: (i) improved use of third-party information, (ii) strengthening sectoral analysis, and (iii) training and capacity building.

- Customs administration is a critical area for the business environment. We revised the customs code this year to require the SRC to respond more promptly to customs declarations. We have identified a number of additional urgent areas for modernization of the customs legislation, and we have drafted amendments to the customs code to: introduce an authorized economic operators (AEO) system; improve the appeals procedures; introduce an advance tariff information system; extend the scope of electronic declaration of goods; and introduce the possibility of postponing the payment of customs duties and taxes by introducing a systems for financial guarantees. These legislative changes aim to improve the business environment and facilitate trade. We will present the proposals to the National Assembly by March 2014 (structural benchmark). In the area of customs operations, we will enhance our post-clearance audit procedures, risk-management techniques, and IT tools to allow for incorporation of risk management feedback into the IT system and for electronic declarations. Furthermore, we will establish regulations for the AEO system by end-2014 to facilitate trade facilitation for trusted traders. We are assessing how our customs reforms will need to be oriented for ECU membership, for example, through development of a special transit regime via Georgia to Russia, the nearest ECU member state. We will seek TA from the IMF to identify additional ways to strengthen customs operations.

- Finally, to facilitate enhanced dialogue with taxpayers at a strategic level and thereby identify and address broad taxpayer concerns on tax policy and revenue administration issues, we will schedule two meetings per year on tax issues with both the business support council and the SME council, respectively. The agendas will be set well in advance to facilitate preparation and the exchange of views. This will complement other platforms and forums for taxpayer relations (e.g., appeals committee, call centers, taxpayer service centers, SRC business environment unit).

22. On tax policy, our efforts will focus on assessing and addressing remaining policy gaps. We have refined the draft law on transfer pricing to bring it in line with OECD guidelines and international practices, and we will resubmit it by March 2014 to parliament. Other legal changes to be submitted to parliament in 2014 for application from 2015 include: increasing of the natural resource user fee for non-metallic minerals, and unification of property and land taxes. Other outstanding areas for tax policy action may have adverse impacts on the poor or on the business environment, and therefore, require further consideration before deciding on a course of action. To this effect, during 2014, we will assess the incidence of tax policy changes and the scope for possible actions in 2015 and beyond for possible new tax instruments (e.g., new excises), increases of some tax rates (e.g., specific excise tax rates), and reducing or eliminating exemptions (e.g., for specific sectors, products, or forms of income). Additional areas for work will include strengthening of VAT refund procedures and more effective taxation of unfinished or undeveloped urban real estate sites. Addressing adverse impacts of many of these measures may be possible, but also complex and costly from an administration standpoint. To support our tax revenue efforts, the MOF and the State Revenue Committee (SRC) will strengthen analysis of tax gaps and potential gains, with support from IMF technical assistance. Finally, the MOF and SRC will also prepare by September 2014 (structural benchmark) a policy paper on strengthening collections from high-wealth individuals (HWI), covering necessary tax policy changes (e.g., dividend and capital gains taxation), revenue administration actions and legal or regulatory changes (risk and compliance profiles and audit), and the institutional set-up. Once again, IMF TA would be important.

D. Monetary and Exchange Rate Policy

23. Monetary policy will continue to be implemented within an inflation-targeting framework, complemented by exchange rate (ER) flexibility. Guided by its inflation target range, the CBA will continue to monitor current and expected inflation and output to determine whether changes to the policy rate and monetary operations are needed. The CBA will continue to limit its intervention in the foreign exchange (FX) market, so that the ER can move according to fundamentals and support external adjustment. During and after the crisis, the CBA drew down its reserves to provide FX market support and smooth volatility, but the CBA was able to rebuild buffers in 2013 with the Eurobond issuance and net purchases on the domestic FX market. Going forward, we consider it important to maintain buffers, particularly using periods when market conditions provide opportunities to acquire reserves without affecting overall market trends. We are confident that our policies will contribute to gradual dedollarization of savings, which would provide a further opportunity to build reserves. While we may pursue an additional modest reduction in reserve requirements on dram deposits, we see little scope for additional use of prudential measures to target dedollarization. We will conduct an assessment of the role these measures played in helping reduce dollarization from its 2009 peak.

24. The new program will move gradually to inflation targeting-based conditionality. As a first step, the program will be guided less by monetary aggregates than the 2010–13 Fund-supported program, as the targets on net domestic assets (NDA) will now include a cushion, implying that short-term liquidity operations—which may not be required given inflationary conditions—will no longer be needed to meet program targets. In addition, we propose that the reserve money indicative target (IT) will be replaced by conditionality on projected inflation (the midpoint of the forecast band of either 4±1.5 percent or an agreed path to return to this target band). A performance criterion (PC) on net international reserves would support our efforts to maintain adequate buffers. During the course of the program and following a durable reduction of inflation to within the CBA's target band, we will propose to drop the NDA PC and introduce an inflation-consultation clause conditionality, thereby aligning the conditionality framework with our current decision making process. In the meantime, we will continue efforts to analyze, model, and report on inflation and inflationary processes in Armenia and to strengthen CBA communications, in line with past and prospective IMF technical assistance.

25. We will continue to strengthen our operational framework for monetary policy. As noted, we will continue to enhance our communications with markets and the public to provide guidance on policy actions and ensure that inflation remains anchored at the target range. This will include use of an expanded range of communication channels, such as periodic press conferences and through strengthening the communications content of the inflation report, with further support from the IMF. This will be important for markets and the public to understand the nature of shocks and our policy responses, particularly now, as inflation is now above the target range. We will also continue to improve the interbank money market, in particular by supporting trade of one-day and seven-day instruments. We will also explore other policy actions to strengthen liquidity management within both the interbank and FX markets, including enhanced coordination between the CBA and the MOF. We will assess prospects to further reduce the width of the interest rate corridor around the policy rate, particularly in the context of the shift in program conditionality towards inflation targeting. We will continue to explore options to work with FX market participants to address occasional large purchases of FX that place undue, temporary pressures on the market. Finally, we will assess remaining obstacles to developing the FX derivatives market and FX risk hedging instruments for the economy and market participants.

E. Financial Sector Stability and Development

26. Financial sector policies will continue to promote both resilience to shocks and financial deepening. In 2013, the CBA approved a new regulation on commercial bank internal controls under the Basel II Pillar II framework—the regulation will become effective in mid-2014. The CBA has also prepared a timeline for Basel III implementation, and by June 2014, we will issue regulations on capital requirements and prepare the methodology on identifying domestic systemically-important banking institutions (SIBIs) (structural benchmark), with a phase-in period to apply between issuance of the regulations and full adoption. Given the high level of dollarization in our financial sector, we will continue to strengthen our monitoring capacity and work with local banks to enhance their management of FX exposure and risk. We will improve the quality of information received from banks on potential currency mismatches of large borrowers by standardizing reporting templates, and we will amend by December 2014 the regulation on the calculation of large exposures to align it to international best practices in the areas of (i) exposures to banks and sovereigns and (ii) consideration of collateral (structural benchmark). In this context, we will continue discussions with Fund staff regarding other areas of the large exposures regulation, including deductions from capital. We will also begin to implement a gradual increase in minimum FX liquidity ratios. As inflationary conditions ease, we will assess the impact of recent changes to the composition of reserve requirements, interactions with minimum FX liquidity ratios, and impacts on dollarization. In line with the 2012 FSAP Update recommendations, we will introduce measures to strengthen our crisis management infrastructure, including submitting legislative changes to the National Assembly by September 2014 on rules related to the Deposit Guarantee Fund (structural benchmark). To improve the operating environment for banks, we will prepare a policy paper with stakeholders by June 2014 on legal, regulatory, and institutional changes to simplify registration and execution of collateral (structural benchmark). This will be followed by submission of legislation to the National Assembly by June 2015. We will propose further improvements to the legislative framework for financial market development, including by submitting to the National Assembly by September 2014 an amendment to the securities law to facilitate access of foreign participants in Armenia's capital market, bringing our framework in line with international standards and best practices (structural benchmark). We have arranged with the local exchange NASDAQ/OMX-Armenia to start clearing/settling of Armenian treasury securities through Euroclear/ClearStream, so that they will be more readily available to potential foreign investors. Recent and forthcoming dram-denominated bond issuances by the IFIs would also provide an impulse to market development and issuances by Armenian corporates. Finally, we are working on creating the legal and operational environment for a modern mortgage finance system in order to assist housing affordability, financial market development, and banking sector soundness.

27. We have successfully launched our pension reform at the beginning of 2014. The last two key milestones of the reform—the licensing of two high-quality asset managers and the selection by the public of the company that will manage their respective pensions—have been completed, and contribution to individual accounts started in January. In connection with this reform, we will continue our efforts to further improve domestic debt management and the functioning of the primary and secondary government debt markets. This will be particularly important as pension reform is expected to expand the investor base in government debt markets.

F. External Debt

28. While we have established access to international financial markets, we will continue to work closely with official creditors under the new program. The debut sovereign bond issuance in September was a major step, as it allowed us to repay crisis support from Russia and provided budget financing, which has helped ease domestic interest costs. In addition, Armenia now has a long-term benchmark rating and interest rate, which will facilitate market access by other Armenian borrowers. Consistent with our efforts to rebuild buffers, the Eurobond has also allowed us to establish higher targets for international reserves. Official financing, especially on concessional terms, has been important for Armenia's development and addressing the impacts of the global crisis. We will continue close cooperation with official lenders, seeking concessional project and budget support where possible. As such financing is likely to become increasingly less available over time to Armenia and as poverty and infrastructure needs remain high, we propose that the program include an adjustor to permit use of project and budget support in excess of the programmed amounts, if such financing is available.

29. We are mindful that our first market issuance should be accompanied by clear and continuous signals about the soundness of our public finances and payment capacity and by increased debt management expertise. Accordingly, we will limit government guarantees of concessional or nonconcessional external financing under the program (indicative target). We will also build on sustained progress achieved in debt management in recent years by strengthening the compilation of comprehensive data and the analysis and monitoring of debt. We are also making institutional, professional, and legal and regulatory improvements needed for enhanced monitoring and managing of market-based external and domestic borrowing with the help of World Bank and IMF debt management TA.

G. Structural Reforms

30. We are continuing to pursue strong structural reforms essential for improving institutions, the business climate, competition, openness, and diversification and for addressing key risks. Our structural reforms will support export growth and a stronger capital account and thereby contribute to the external adjustment. A number of these reforms were part of the EU harmonization agenda and the DCFTA that we negotiated, and we intend to resolutely continue these efforts, where compatible with the ECU.

31. ECU membership is expected to create important opportunities for Armenia. An immediate benefit is access to imported natural gas at a price determined by the domestic price in Russia, transport costs, and a 30 percent discount through waiver of an export tariff levied in Russia. Membership will also lead to lower import prices for oil and petroleum products, diamonds, and possibly other goods (e.g., fertilizer, paper, aluminum, steel, leather). Membership should provide a strong boost to Armenia's exports to its traditional markets, by removing customs and non-trade barriers. It will also facilitate travel and work arrangements for Armenians in Russia and other ECU countries. At the same time, customs tariffs will increase. The average ECU common external effective tariff rate (ETR) is higher (9.6 percent) than Armenia's ETR (2.4 percent). We are seeking, where possible, agreement with the ECU on exclusions from the common external tariff, or transition periods, so that input costs do not rise significantly. This will be particularly important for socially-important goods, raw materials, and goods and services that would affect Armenia's WTO obligations. Key areas include agriculture and agro-processing, construction, mining, and transport. The conclusion of WTO transition periods for other ECU members (Russia), the gas price agreement, and cost-reducing and efficiency-enhancing structural reforms will also help mitigate a rise in Armenia's average ETR under the ECU. Higher tariffs, while imposing a burden on Armenian consumers, will mean additional budgetary revenues from the common customs pool.

32. ECU membership is also expected to lead to new external financing for important infrastructure and industrial projects in Armenia. These could include extension of the operating life of the Metsamor nuclear station, design and construction of a new reactor at Metsamor, further improvement of the national rail and road networks, and investment in the Yerevan-based synthetic-rubber producer, Nairit. We see prospects for greater foreign investment interest in the agro-processing, financial, information technology, light industry (furniture, textiles) and services sectors. Upgrading the national electric transmission network and completing a second high-voltage transmission line to southern Armenia are other important objectives. We will pursue options for financing for these (and other) projects in a way that targets concessional support, maximizes private sector involvement, and strictly limits government exposure and use of public funds. We will continue to consult with the IMF and the World Bank in advance of taking on any liabilities, including guarantees.

33. Armenia remains committed to deepening its relationship with the EU. We will carry out to the extent possible reforms to harmonize with EU standards and institutions agreed with the EU in the context of the DCFTA and compatible with ECU membership. These reforms will support our agenda of modernization and integration of the Armenian economy and contribute to export growth and diversification. We will continue cooperation with the EU under the Eastern Partnership initiative and look forward to continued EU macro-financial support, technical assistance, and twinning arrangements.

34. A new five-year gas agreement with the Russian Federation and Gazprom will facilitate stable and predictable prices, significant savings, and external adjustment. The agreement, which has been ratified by the National Assembly, will run through end-2018. We have published the agreement and associated documents, meeting a prior action for the new program. The agreement is based on a new border price of $189 per 1000 m3, representing a discount from existing and previously-expected future prices, with adjustment going forward based on changes in gas prices in Russia and U.S. CPI inflation. The new discounted base price was secured through waiver of a 30 percent export tariff by Russia. The agreement also involved sale of the government's remaining 20 percent stake in ArmRusGaz (ARG) to Gazprom for approximately $155 million, a positive valuation, given the ARG's recent financial difficulties and limited possibility for gas sales to other markets via Armenia. The privatization proceeds will be transferred to ARG to extinguish liabilities, and Gazprom will write-off claims on ARG of the same magnitude. This transaction will be fully reflected in the 2013 budget and the program fiscal accounts. The increase of domestic gas prices in July 2013 and the lower border prices have improved the finances of the gas operations of ARG, so that it is no longer incurring losses. Under the program, we will carefully monitor the operations and finances of ARG and other utilities on a frequent basis and act quickly to investigate and assess any worsening. We will not absorb any losses or liabilities or make payments on behalf of ARG or other utilities or companies (performance criterion). Finally, while we consider that the gas price agreement offers stable and competitive prices for the next five years, we also consider that the Armenian economy and consumers should to become more energy efficient to reduce vulnerabilities, cope with shocks, and be prepared for possible price adjustments after the agreement expires. We will work with the World Bank and other partners to prepare a study of policy options (energy efficiency investments, tariff adjustments, targeted protection for vulnerable groups) by end-2014 (structural benchmark).

35. In addition to the structural reforms discussed in other sections, focus areas under the new program will include:

- ***Business climate.*** Under our regulatory guillotine program, legislative packets for improving efficiency, reducing overlap, and streamlining regulations and red-tape for households and companies have been approved by the government in health, road transportation, and public utilities. Six additional packets are now being developed, from a total of 17 areas to be addressed by 2015. All six packets—covering entrepreneurship, tax, customs, social issues, foreign affairs and international relations, and culture—will be submitted for Cabinet approval by June 2014 (structural benchmark). In addition, we will introduce the practice of regulatory impact assessment for new regulations by June 2015 to help clearly identify cost and benefits of new regulations and to monitor effectiveness once they are in place. We expect to mainstream the regulatory guillotine by bringing it formally and permanently into the Ministry of Economy in 2015. Further, we have issued another Doing Business Action Plan for 2014, following similar efforts in recent years. The 2014 plan focuses on measures to improve contract enforcement, the insolvency process, arrangements for payment of taxes, and foreign trade. We will streamline insolvency processes, make them more predictable, improve incentives, and reduce time and costs, including in the courts. Accordingly, the Ministry of Economy and Ministry of Justice will map the entire bankruptcy process by June 2014 to identify the obstacles and gaps that need to be addressed by changes in the legislation (structural benchmark), and then prepare legislative proposals.

- ***Competition.*** A number of countries have vested their competition authorities with investigative, subpoena, and "dawn raid" powers; others vest these powers only with law enforcement agencies. We will continue to work to build consensus for providing these powers to the State Committee for Protection of Economic Competition (SCPEC). In the meantime, we have submitted to the National Assembly a packet of legal changes in the competition area, including clearer definitions of dominance and market abuse, stronger fines, and procedural changes (e.g., on timing of payment of fines). We hope for passage by March 2014. We will also put in place by June 2014 memoranda of cooperation between the SCPEC and the State Revenue Committee, the Economic Crimes Unit of the National Police, and the Office of the Public Prosecutor, covering investigative subpoena, and "dawn raid" operations, information required by the SCPEC, and participation by SCPEC staff in on-site examinations (structural benchmark). This year, we will also introduce a leniency program—an important element in detecting and addressing cartel activity, strengthen assessment and enforcement of proposed mergers, and prepare a concept paper on shifting the role of SCPEC from price monitoring to consumer protection. Finally, we will also submit to parliament by September 2014 legislation allowing for parallel import of products through alternative distribution channels (e.g., regional distributors of international pharmaceutical products in other countries). Parallel import should lead to greater competition and lower costs.

- ***Inspection reforms.*** We have been working on a major initiative to streamline inspection agencies and functions, eliminate overlaps and outdated approaches, introduce risk-based supervision and inspection, implement standard checklists, improve information systems, implement electronic management systems, and reduce corruption risks in inspection agencies, including through better training and remuneration. These efforts are intended to help reduce business costs and strengthen competitiveness, as well as improve the safety of services and products provided in the Armenian market. We have initiated a pilot merger of the inspection agencies of the Ministries of Health and Labor. Completion of this merger and initiation of a unified database for inspection agencies are expected by end-2014. We will submit a new draft law on inspection and inspection agencies to the National Assembly by March 2014 (structural benchmark). During the next few years, we will reduce the number of inspection agencies by half.

- ***Trade promotion.*** The quality infrastructure project is a critical initiative that we have been carrying out with EU assistance covering harmonization of standards, accreditation, technical control and certification, and market supervision practices. These systems help ensure the compliance and safety of our products and services, a key requirement for enhanced trade. We will continue to pursue this initiative. During the course of the program, we will clarify the strategy and rationalize the various enterprise development and promotion agencies—the PanArmenian Bank, the Armenian Development Agency, the Export Insurance Credit Agency, and SME-focused agencies.

- ***Civil aviation.*** Following the ceasing of operations of Armavia, the private national flag carrier in early 2013, we worked with the World Bank, other international agencies, and management consultants to develop a new policy framework for the civil aviation sector. The framework was approved in October and aims to increase competition, improve connectivity, enhance service quality, and lower costs. Key elements of the framework include: (i) promotion of competition and a move to open skies (limiting protection of particular airlines, for example, through frequency or capacity restrictions); (ii) transparency in publishing agreements in the sector; and (iii) splitting up the functions of the Directorate General for Civil Aviation (DGCA)—in particular policymaking, policy execution (negotiation of agreements), technical regulation, infrastructure operations, monitoring and enforcement, and accident investigation—to provide greater efficiency and transparency and address possible conflict of interests. With support from the World Bank and USAID, we are developing a road map for reforms, and will submit to the cabinet a plan to restructure the DGCA and establish the new set-up by April 2014 (structural benchmark). The new structure for the sector should be in place by May. The Ministry of Economy will become the lead policy agency and revisit 47 bilateral international aviation agreements—17 of which are now active in terms of flights—to reflect open skies principles. We have proposed or will propose bilateral open skies agreements with Russia, Ukraine, Israel, and Iraq. Connected with these reforms, the government has addressed the EU to begin negotiations on a Common Aviation Area Agreement, which would have a significant impact on aviation liberalization (open skies have been in place with the U.S. since 2008).

36. We are pleased that external financing may become available to support extension of the Metsamor Nuclear Power Station until 2022 ($300 million). Significant additional resources ($500 million) will be needed to subsequently decommission the plant, and we will explore the possibility of making a proposal by June 30, 2014 to the Public Service Regulatory Commission for an additional provision in the electricity tariff structure for more funding for continuing security and reliability outlays (now financed with support by donors) and decommissioning. We will also work with the World Bank on a study to support the introduction of seasonal variation of electricity tariffs to better reflect differences in underlying costs in the winter and summer and generate efficiency gains. If the study is positive, it would lead to a proposal for adoption of new methodology for seasonal tariff-setting. Other areas for analysis and action under the program include tariffs for alternative electricity sources (solar), adjustment of water and irrigation tariffs to ensure cost recovery and reduce subsidies from the state budget, continued expansion of metering in the water sector, and actions to reduce technical losses in municipal water systems. KfW and the AsDB are lead agencies in the water sector, assisting in our move to concession and lease arrangements for consolidated water operations in Yerevan and in the rest of Armenia, respectively, by 2016.

H. Conclusion

37. Program monitoring. The program will be monitored through semi-annual reviews. The first review is expected to be completed on or after September 30, 2014 and will assess performance as of end-June 2014. The second program review is expected to be completed on or after March 31, 2015.

Table 1. Armenia: Quantitative Targets, 2011–13 1/

	2011	2012	2013			2014			
	Dec.	Dec.			Dec.	Mar. 2/	Jun.	Sep. 2/	Dec.
	Act.	Act.	Proj.	Proj.	Proj.	Prog.	Prog.	Prog.	Prog.
Performance Criteria									
Net official international reserves (stock, floor, in millions of U.S. dollars)	794	830	712	1446	1068	952	950	968	1026
Net domestic assets of the CBA (stock, ceiling) 3/	201	231	255	13	231	259	274	296	318
Program fiscal balance (flow, floor) 4/	-187	-86	24	-4	-69	-44	-61	-77	-139
External public debt arrears (stock, ceiling, continuous criterion)	0	0	0	0	0	0	0	0	0
Absorption of losses or liabilities and making of payments on behalf of utilities and other companies (flow, ceiling, continuous criterion)						0	0	0	0
Indicative Targets									
Inflation (mid-point, percent) 5/					5.6	5.9	5.3	4.6	4.0
Average concessionality of newly contracted external debt (flow, floor, in percent) 6/	34	30	30	30	30	30	30	30	30
New government guaranteed external debt (stock, ceiling, in millions of U.S. dollars) 7/						100	100	100	100
Social spending of the government (flow, floor) 8/	29	33	16	25	34	11	23	35	48
Memorandum items:									
Budget support grants	28	36	38	45	48	48	48	48	55
o.w. EU MFA grant	19	19	19	19	19	19	19	19	19
Budget support loans	46	114	114	114	144	154	154	163	191
o.w. non-IMF loans	24	76	76	76	105	115	115	125	153
Project financing	44	47	19	40	83	6	21	36	83
KFW and IBRD loan disbursements	11	23	25	27	27	32	35	37	40
Reserve money	671	684	659	723	888	737	743	776	828

Sources: Armenian authorities; and Fund staff estimates.

1/ All items as defined in the TMU.
2/ Indicative target.
3/ NDA ceiling will be considered met if the outcome is within AMD 15 billion of the indicative target.
4/ Below-the-line overall balance excluding net lending and project financing until March 2011. Below-the-line overall balance excluding net lending from June 2011.
5/ End of period, year-on-year headline inflation. Mid-point within a +/- 1.5 range.
6/ Assessed on a calendar year basis.
7/ Includes both concessional and non-concessional debt.
8/ Defined as 100 percent of the budgeted amount of the family benefit program and lump-sum financial aid. Starting 2014, the mission will work with the authorities to define a wider base.

Table 2. Armenia: Structural Benchmarks Under the Fund-Supported Program

Item	Measure	Time Frame (End of Period)	Outcome	Comment /Status
Prior Action				
	- Publish the new five-year gas agreement with Russia and Gazprom and associated documents			Completed
Structural Benchmarks				
Tax administration				
	- Submit to the National Assembly legislative amendments to the customs code to introduce an Authorized Economic Operators (AEO) system, improve the appeals procedures, introduce an advance tariff information system, extend the scope of electronic declaration of goods, and introduce the possibility of postponing the payment by introducing a systems for financial guarantees	March 2014	Improve business environment and facilitate trade	
	- Establish a Risk Management Unit (RMU) in the State Revenue Committee (SRC) to develop and implement a modern tax compliance strategy	June 2014	Improve efficiency, transparency, and evenhandedness of revenue administration	
Tax policy				
	- Prepare a policy paper on strengthening collections from high-wealth individuals (HWI), covering necessary tax policy changes (e.g., dividend and capital gains taxation), revenue administration actions and legal or regulatory changes (risk and compliance profiles and audit), and the institutional set- up	September 2014	Strengthen tax revenue collections	
Public Financial Management				
	- Establish a fiscal risk management unit at the Ministry of Finance that analyzes and manages fiscal risks related to concessions, regulated utilities, state-owned enterprises (notwithstanding the extent of state shareholding or line-ministry affiliation), and PPPs in an integrated manner	December 2014	Strengthen monitoring and control of fiscal risks	
Financial sector				
	- Issue regulations to require banks to set minimum capital requirements for common equity and Tier 1 capital according to the Basel III recommendations, and prepare the methodology on identifying domestic systemically important banking institutions (SIBIs)	June 2014	Improve banking sector regulation and supervision	
	- Prepare a policy paper with stakeholders on legal, regulatory, and institutional changes to simplify registration and execution of collateral	June 2014	Improve the operating environment for banks	
	- Submit to National Assembly legislation to shorten the depositor pay-out period of the DGF.	September 2014	Improve bank resolution framework	
	- Submit to the National Assembly an amendment to the securities law to facilitate access of foreign participants in Armenia's capital market, bringing the framework in line with international standards	September 2014	Develop financial market	
	- Amend in a manner consistent with the 2012 FSAP Update recommendations the regulation on the calculation of large exposures to align it to international best practices in the areas of (i) weight of exposures to banks and sovereigns, and (ii) consideration of collateral.	December 2014	Improve banking sector regulation and supervision	
Regulatory and competition policy				
	- Submit to the National Assembly a new draft law on inspection and inspection agencies, for introduction of risk based inspection, maximization of the automation, and elimination of the overlaps by reducing agencies	March 2014	Improve business environment	
	- Submit to the Cabinet a plan to restructure the Directorate General for Civil Aviation and establish the new set-up for moving towards open skies	April 2014	Increase competition, improve connectivity, and lower costs	
	- Submit to the National Assembly six Regulatory Guillotine legislative packages, covering entrepreneurship, tax, customs, social issues, foreign affairs and international relations, and culture, in addition to completion of packets in 2012-13	June 2014	Improve business environment	
	- Map the entire bankruptcy process to identify the obstacles and gaps that need to be addressed by changes in the legislation	June 2014	Improve business environment	
	- Put in place memoranda of cooperation between the SCPEC and the SRC, the Economic Crimes Unit of the National Police, and the Office of the Public Prosecutor, covering investigative subpoena, and "dawn raid" operations, information required by the SCPEC, and participation by SCPEC staff in on-site examinations	June 2014	Improve business environment	
Energy				
	- Issue a study of policy options (energy efficiency investments, tariffs, and targeted protection for vulnerable groups)	December 2014	Improve efficiency of energy sector	

Attachment II. Technical Memorandum of Understanding

1. This memorandum sets out the understandings between the Armenian authorities and the IMF staff regarding the definition of performance criteria and indicative targets, their adjusters, and data reporting requirements for the EFF arrangement as per the Letter of Intent dated February 17, 2014.

2. For program monitoring purposes, all foreign currency-related assets, liabilities, and flows in the monetary accounts will be evaluated at program exchange rates. The program exchange rate of the Armenian dram to the U.S. dollar is set at 410 dram per one U.S. dollar. The cross-rates for other foreign currencies are provided in Table 1.

A. Quantitative Targets

3. The program sets performance criteria and indicative targets for defined test dates (see Table 1 in the LOI). The program sets the following performance criteria:

- Floor on the net official international reserves (NIR) of the Central Bank of Armenia (CBA);
- Ceiling on the net domestic assets (NDA) of the CBA;
- Ceiling on external public debt arrears (continuous);
- Floor on the program fiscal balance; and,
- Ceiling on absorption of losses or liabilities and making of payments on behalf of utilities and other companies (continuous).

The program sets the following indicative targets:

- Headline inflation;
- Floor on average concessionality of newly contracted external debt;
- Ceiling on new government guaranteed external debt; and,
- Floor on social spending of the government.

4. The net official international reserves (stock) of the Central Bank of Armenia (CBA) will be calculated as the difference between total gross official international reserves (excluding commercial bank required and excess reserves at CBA in FX) and gross official reserve liabilities.

- Gross official international reserves are defined as the CBA's holdings of monetary gold (excluding amounts pledged as collateral), holdings of Special Drawing Rights (SDRs), including the August 28, 2009 General Allocation and the September 9, 2009 Special Allocation, the country's reserve position at 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. Excluded from gross reserves are the balance on the government's Special Privatization Account (SPA), capital subscriptions in foreign financial institutions and illiquid foreign assets, any assets that are pledged, collateralized, or otherwise encumbered, claims on residents, claims in foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options), precious metals other than gold, assets in nonconvertible currencies, and illiquid assets.

- Official reserve liabilities shall be defined as the total outstanding liabilities of the government and the CBA to the IMF and convertible currency liabilities of the CBA to nonresidents with an original maturity of up to and including one year, as well as commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options).

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.

5. **Headline inflation** is defined as the year-on-year rate of change of the Consumer Price Index as measured by Armenia's National Statistics Service. The indicative target will be considered met if headline inflation falls within a range of +/- 1½ percentage point around the mid-point target.

6. **Net domestic assets** are defined as reserve money minus NIR, minus other assets not included in gross official international reserves, minus commercial bank required and excess reserves at CBA in FX, plus medium and long-term foreign liabilities (i.e., liabilities with a maturity of one year or more) of the CBA, plus other foreign liabilities not included in official reserve liabilities, minus the balance of outstanding Fund purchases credited to the government account at the CBA. NDA is composed of net CBA credit to the general government plus outstanding credit to domestic banks by the CBA (including overdrafts) minus liabilities not included in reserve money and other items net. The ceiling will be considered as met if the outcome is within AMD 15 billion of the indicative target sets in Table 1 attached to the LOI.

7. **External public debt arrears** are defined as all unpaid debt-service obligations (i.e., payments of principal and interest) arising in respect of public sector loans contracted or guaranteed to non-residents, including unpaid penalties or interest charges associated with these obligations that are overdue beyond 30 days after the due date.[1] The ceiling on external payment arrears is set at zero.

[1] The public sector is here defined following the *Government Financial Statistics Manual* (GFS 2001) and *System of National Accounts* (1993 SNA). It includes the general government and nonfinancial public enterprises (as defined in paragraph 13).

8. The program fiscal balance is cumulative from the beginning of the fiscal year and is measured from the financing side as the negative of the sum of net domestic banking system credit to the central government, net domestic nonbank financing, and net external financing to the central government. Should a general subsidy or any other fiscal transaction be introduced off-budget, the overall balance will be measured including the subsidy and other fiscal transactions as part of government spending.

- **Net banking system credit to the central government** equals the change during the period of net credit to the central government.

- **Net nonbank 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);[2] (2) any other disbursement or transaction that increases nonbanks' claims on the central government plus withdrawals from the Special Privatization Account (SPA) or the treasury sub-account containing privatization proceeds in drams, less amortization paid by the central government to private resident nonbank agents.

- **Net external financing** equals total debt-increasing disbursements from non-residents to the central government (including Fund net purchases credited directly to the government accounts at the CBA) less total amortization from the central government to non-residents. Net external financing also includes any privatization proceeds received from non-residents in foreign currency and not held in the SPA. All foreign currency-denominated transactions are recorded in drams using the prevailing exchange rate at the time of the transaction.

9. External and domestic net lending, which are recorded as financing items, are *excluded* from the calculation of the program fiscal balance. This effectively treats net lending as an expenditure item when loans are made and as a revenue item when the loans are repaid.

10. Some project implementation units maintain accounts at the CBA. Grants received by these units are recorded in the fiscal accounts as external grants on the revenue side and as foreign-financed expenditure on the expenditure side. In addition, any loans to finance investments 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. Under previous Technical Memoranda of Understanding, these activities were excluded from the calculation of the program fiscal balance. This treatment reflected lags in receiving information from project implementation units and on project loans intermediated through the banking system. With the shift to semi-annual program reviews with the arrangements under the previous Fund-supported program and consolidation of the accounts of these units in the Treasury, there is no longer a need for such exclusion, and these activities are now fully accounted for in the program fiscal balance.

[2] 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 State Fund for Social Insurance.

11. Foreign currency proceeds from selling enterprises are deposited SPA. The SPA 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 sub-account of the treasury single account and are also treated as a financing item and recorded below the line. Finally, as noted in ¶8, privatization proceeds received from non-residents in foreign currency and not held in the SPA are also treated as a financing item (sale of financial assets) and recorded below the line.

12. Absorption of losses or liabilities and making of payments on behalf of utilities and other companies. The program sets a continuous ceiling on absorption by the public sector (central and local governments and covering the state budget and state debt plus the CBA) of losses or liabilities from outside the budgetary sector. Absorption of losses or liabilities is defined as direct payment by the government of the losses or liabilities of other parties or coverage of losses or liabilities by other transactions, such as debt-for-equity swaps or a write-off of tax obligations or other state claims. The government is defined as the central government and covers obligations of the state budget and state debt. The ceiling is set at zero, and excludes AMD 10.718 billion, (approximately $26.1 million) of subsidies in the 2014 budget for Yerevan Metro, Yerevan Electric Transport, Irrigations Systems, Armenian Water and Sanitation, Nor Akunk, and irrigation water intake entities. During the program period, there may be occasions when absorption of a limited amount of losses or liabilities, or making limited payments on behalf of utilities or other companies would facilitate a positive outcome (e.g., a major foreign investment transaction, poverty alleviation or equity enhancement, or prevention of even greater losses that would endanger financial stability). In such instances, the Armenian authorities will discuss the circumstances and possible options with the Fund staff prior to any transaction. Any modification of the PC to make any such payments or absorb any losses will require approval by the IMF Executive Board.

13. Floor on average concessionality of newly contracted external debt. The program sets an annual indicative floor of 30 percent on the average concessionality of new debt on a contraction basis with nonresidents with original maturities of one year or more as contracted and guaranteed by the public sector.

- The grant element is the difference between the present value (PV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The PV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt. The discount rates used for this purpose are the currency specific commercial interest reference rates (CIRRs), published by OECD. For debt with a maturity of at least 15 years, the ten-year-average CIRR is used to calculate the PV of debt and, hence, its grant element. For debt with a maturity of less than 15 years, the six-month average CIRR is used. The margins for differing repayment periods (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to 19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more) are added to the ten-year and six-month CIRR averages.

- The public sector here comprises the general government (central, plus local governments and covering the state budget and state debt), the central bank, and nonfinancial public enterprises (enterprises and agencies in which the government holds a controlling stake—typically owns more than 50 percent of the shares, but which are not consolidated in the budget).

- For program purposes, the guarantee of a debt arises from any explicit legal obligation of the public sector to service a debt in the event of nonpayment by the debtor (involving payments in cash or in kind), or from any implicit legal or contractual obligation of the public sector to finance partially or in full any shortfall incurred by the debtor.

14. Ceiling on government guaranteed external debt. In addition to the indicative floor on average concessionality, a separate ceiling (IT) of $100 million for the program period applies to government guarantees of the total of concessional and non-concessional external financing. The issuance of debt guarantees will be measured at the exchange rates listed in Table 1. The above limit covers debt guarantees issued by the general government to entities outside the general government. Guarantee issuance will be monitored on a monthly basis and the Ministry of Finance will provide data within 21 days from the end of the month.

15. The program sets a floor on **social spending of the government**. For the purposes of the program, social spending of the government is defined as 100 percent of the budgeted amount of the family benefit program and lump-sum financial aid, one-time childbirth benefits, childcare benefits for children less than two years of age, and benefits programs for families with disabled members or disabled children.

16. The quantitative performance criteria and indicative targets under the program are subject to the following adjusters, calculated, where relevant, using program exchange rates:

- **Changes in reserve requirements**: The ceiling on the NDA of the CBA will be adjusted downward (upward) by the amount of banks' reserves freed (seized) by any reduction (increase) of the reserve requirement ratio on both domestic currency and foreign currency liabilities relative to the baseline assumption as per the following formula: $\Delta NDA = \Delta rB$, where B denotes the level of liabilities subject to reserve requirements in the initial definition and Δr is the change in the reserve requirement ratio.

- **KfW, Asian Development Bank, and World Bank loan disbursements**: the ceiling on the NDA of the CBA will be adjusted upward (downward) by the full amount of any excess (shortfall) of disbursements from the KfW, Asian Development Bank, and World Bank loans directed at SME financing compared to programmed amounts (Table 2). The floor on NIR will be adjusted upward (downward) by the cumulative amount of any excess (shortfall) of these disbursements compared to program amounts.

- **Budget support grants to the public sector** are defined as grants received by the general government for direct budget support from external donors and not related to project financing.

- **Budget support loans to the public sector** are defined as disbursements of loans from bilateral and multilateral donors for budget support and Fund purchases credited directly to the government accounts at the CBA.

- **Project financing to the public sector** is defined as disbursements of loans from bilateral and multilateral donors for public sector projects.

- **The floor on NIR** will be adjusted upward (downward) by the cumulative amount of any excess (shortfall) of budget support loans or budget support grants (excluding Fund purchases by the government) compared to program amounts (Table 3). The floor on NIR will be adjusted downward for any external public debt amortization amounts in excess of program amounts. The floor on NIR will be adjusted upwards by the amount of any funds received in respect of deposits held at regional financial institutions.

- **The ceiling on NDA** will be adjusted downward (upward) by the cumulative amount of any excess (shortfall) of budget support loans or budget support grants compared to program amounts (Table 3).

- **The floor on the program fiscal balance on a cash basis** will be adjusted upward (downward) by the cumulative total amount of the budget support grants received in excess (to account for a shortfall) of the program amounts (Table 3), subject to a cap of $50 million per year in either direction. The floor on the program fiscal balance on a cash basis will also be adjusted downward (upward) by the cumulative total amount of the project financing received in excess (to account for a shortfall) of the program amounts (Table 3), subject to a cap of $100 million in either direction.

B. Data Reporting

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

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
CBA	CBA balance sheet	Summary	Daily	The following working day
	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 at both program exchange rates and by chart of accounts at actual official exchange rates; the consolidated balance sheet of commercial banks by chart of accounts at actual	Monthly	Within 25 days of the end of each month

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
		official exchange rates		
	International reserves	By chart of accounts; at (i) program exchange rates; and (ii) at actual official exchange rates	Daily	The following working day
	Foreign exchange market	Official exchange rates (buying and selling); daily trade volume, and weighted average exchange rate of the interbank, intrabank and Nasdaq-OMX	Daily	Within 1 day
	Foreign exchange market	CBA foreign exchange operations, (exchange rate, volume, counterpart)	Daily	Within 1 day
	Foreign exchange market	Exchange rate (buying and selling)	Daily	Within 1 day
	Interest rates	Refinance rate	At least monthly	Within 1 days of the CBA Board decision
	Interbank money market	Daily interbank repo volume and interest rate and number of trades	Daily	Within 1 day
	CBA operations	Repo (reverse repo) operations, open market operations, Lombard credits, deposit facility, and foreign exchange swaps (volumes, maturity, yields, exchange rates)	Daily	Within 1 day
	Bank liquidity	Reserves and excess reserves, by currency	Monthly	Within 15 days of the end of each reference period
	Interest rates and flows of the funds attracted and allocated by commercial banks	By currency and maturity	Weekly	Last working day of the week
	T-bill and coupon bond financing, CBA securities	Auction data: date, original and remaining maturities, issuance volume, allocation, average yield and coupon yield (if available)	Weekly	Last working day of the week
	Banking data	Sectoral distribution of loans and deposits; dollarization of loans and deposits; loan maturities; interbank rate, by volume and maturity; T-bill rate, bond yield; deposit and lending rates, by maturity; monthly weighted average interest rate on government bonds	Monthly	Within 25 days of the end of each month

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
	Banking indicators	Capital adequacy; asset composition and quality; profitability; liquidity; open FX positions; and compliance with prudential norms	Monthly	Within 30 days of the end of each month
	Banking sector stress tests	Results of stress tests on exchange rate, liquidity, and credit risk	Monthly	Within 30 days of the end of each month
	On-lending via commercial banks	On lending via the CBA and government (from the Russian loan, KfW, WB, ADB, etc.) by type of on-lending projects (including loan disbursements and repayments)	Monthly	Within 10 days of the end of each month.
	CPI	Index of core inflation	Monthly	Within 21 days of the end of each month
	Transfers	Non-commercial transfers of individuals	Monthly	Within 30 of the end of each month
	Other monetary data	IFS format	Monthly	Within 45 days of the end of each month
Ministry of Finance (MOF)	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. For project implementation units, 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 tax administration and customs administration, including revenue by individual tax, and social contributions	Monthly	Within 7 days of the end of each month
	Domestic expenditure arrears	All unpaid claims outstanding at the end of the month which includes wages, social contributions (including for pensions), family allowances, and amortization and	Monthly	Within 45 days of the end of each month for government arrears

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
		domestic interest payments		
	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, 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	Monthly	Within 30 days of the end of each month
	Consolidated general government	Central and local governments, and Non-Commercial Enterprises that belong within the general government (NCEs)	Quarterly	Within 60 days of the end of each quarter
	Consolidated general government	Central and local governments, and NCEs that belong within the general government	Annual	Within 180 days of the end of each year
	Budget execution	All cash receipts, cash expenditures, including domestic and external debt-service payments, external and domestic borrowing and lending operations, and inflow of grants to the central government; expenditure data will be provided according to both economic and functional classifications, consistent with the GFSM2001 methodology	Monthly	Within one month following the end of each quarter.
	Financial information on utilities and other major companies with a state interest	Profit and loss indicators for regulated utilities, for companies with state shareholding of 50 percent or greater, and for companies with state shareholding of 0–50 percent and annual sales or outstanding liabilities of AMD 10 billion.	Quarterly	Within 60 days of 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

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
				quarter
		Detailed balance of payments data	Quarterly	Within 60 days of the end of each quarter
	CPI	By category	Monthly	Within 5 days of the end of each month
State Revenue Committee	Tax arrears	By type of tax	Monthly	Within 30 days of the end of each quarter (monthly data provided on a quarterly basis)
		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
	Tax credits	Detailed data, by type of tax, of outstanding tax credits for all types of tax revenues and by economic sectors (i.e. Agriculture, Industry, Mining, Construction, Trade and Services), in both net and gross terms	Monthly	Within 45 days of the end of each (monthly data provided on a quarterly basis)
	Tax Revenues	Tax Revenue by Economic Sectors (i.e. Agriculture, Industry, Mining, Construction, Trade and Services)	Monthly	Within 45 days of the end of each quarter (monthly data provided on a quarterly basis)
	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 statutory processing period. Number of refund applications processed per month.	Monthly	Within 45 days of the end of each month (monthly data provided on a quarterly basis)
	Large taxpayers	Data on the number of taxpayers and amount of taxes managed by the large tax inspectorate	Monthly	Within 45days after the end of each month
	Import data	1. Total value of recorded imports, breaking out raw diamond imports;	Quarterly	Within 30 days of the end of each

Reporting Agency	Type of Data	Description of Data	Frequency	Timing
		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; 8. Number of transactions involving non duty free recorded imports where customs value was assessed using transaction prices		quarter
	Automated VAT refunds	Number of refunds that were processed automatically (share of total refunds); total value of automated and automatic refunds and offsets; average waiting time (days) to receive refund	Monthly	Within 45 days of the end of each month (monthly data provided on a quarterly basis)
	Risk-based selection approach	Percentage of selected companies chosen on the basis of risk-based approach, identified revenue from risk-based audits	Monthly	Within 45 days of the end of each month (monthly data provided on a quarterly basis)

Table 1. Armenia: (Program) Exchange Rates of the CBA
(As of July 31, 2013 in U.S. dollars per currency rates)

Country	Drams Per Currency	Dollars Per Currency
Australian dollar	371.95	0.9072
Canadian dollar	398.33	0.9715
Swiss franc	440.91	1.0754
Danish krone	73.06	0.1782
Euro	544.28	1.3275
Pound sterling	627.83	1.5313
Japanese yen	4.18	0.0102
Norwegian krone	69.14	0.1686
Russian ruble	12.47	0.0304
Swedish krone	62.47	0.1524
SDR	621.04	1.5147

Table 2. Armenia: KFW, AsDB, and IBRD SME Loan Disbursements [1]

(In millions of U.S. dollars)

Dec-12	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Act.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
59.4	65.3	64.8	66.1	78.2	84.8	91.4	98.0

[1] Cumulative from end of the previous year.

Table 3. Armenia: External Disbursements to the Public Sector [1]

(In millions of U.S. dollars)

	Dec-12	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
	Act.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Project financing	122	49	97	202	14	51	88	203
Budget support loan	296	296	278	350	374	374	399	466
Budget support grant	94	97	111	116	116	116	116	133
of which: EU MFA 2/	50	50	47	47	47	47	47	47

1/ Budget support cumulative from the end of the previous year. Project financing cumulative during the same year.
2/ Change in September 2013 reflects valuation adjustment related to the new program exchange rates.