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Ex ante evaluation statement

Macro-financial Assistance to Armenia

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1. PROBLEM ANALYSIS AND NEEDS ASSESSMENT

1.1. Background

During the last six years, prudent macroeconomic policies and economic reforms together with a flexible exchange rate regime (abandoned de facto in the outbreak of the financial turmoil) delivered in Armenia double digit non inflationary growth which was accompanied by large-scale foreign exchange inflows and remittances. The macroeconomic performance had been good with relatively low inflation (the lowest in the CIS region), low fiscal deficit (1.2% of GDP) and low debt stock (13% of GDP). Macroeconomic stability and strong growth rates contributed to rising incomes and improved social conditions which led to the reduction of poverty rates from 34.6% in 2004 to 25% in 2007. However, GDP increased by only 6.8% in 2008 down from 13.7% in 2007, being mainly the result of a sharp decrease of the economic activity in the fourth quarter amid the deepening global financial and economic crisis.

As the fall in economic activity and in foreign inflows continued sharper in 2009, the Armenian Central Bank decided to limit its interventions and to revert to a full floating exchange rate regime allowing a de-facto devaluation of the currency around 22%. At the same time, the IMF announced on the 6 March 2009, a USD 540 million (400% of the quota), 28-month Stand-By Arrangement which was expected to stabilize the external accounts, to provide enough liquidity in forex for the banking sector and finally to calm down market worries by ensuring the smooth transition to the floating exchange rate regime. Despite this adjustment, in the virulent worsening economic environment external and fiscal conditions deteriorated rapidly resulting to an increase of the resources of the Fund by about USD 250 million (180% of quota) after the completion of the first programme review, approved by the IMF Board on 22 June 2009. The revised programme also foresees additional bilateral financing, including by the EU. The Community Macro-financial assistance will consist of a combination of a grant (EUR 35 million) and a loan (EUR 65 million).

1.2. Recent economic developments and prospects

The Armenian economy grew by 6.8% in 2008, after six years of double digit growth based mainly on remittances inflows and FDI's from Russia. However, the global economic downturn and particularly the rapid deterioration of the Russian economy had a deep impact on the economic activity in Armenia which started to contract since the last quarter of 2008.

Growth in construction, the main contributor to the economic growth of the recent years, dropped from 19% in 2007 to 7% in 2008. Activity contracted in metallurgy (-9.6%) and in diamond processing (-15%); the chemicals subsector also stood idle because of declining global demand for synthetic rubber and other chemicals. This situation resulted to the deterioration of the current account deficit to 11.3% of GDP in 2008 from 6.4% in 2007.

The Armenian currency remained relatively stable during 2008 partly because of the interventions of the Central Bank (leading to a 20% reduction of the reserves until January 2009); however, given the continuous deterioration in the economy, the authorities reverted in early March to a fully floating exchange rate regime allowing a de-facto devaluation of the Armenian Dram of around 22 % against the euro and the USD. At the same time the IMF approved a USD 540 million 28-month Stand-By Arrangement to help Armenia to deal with the worsening economic environment and to ensure the smooth transition to the floating exchange rate regime.

The negative effects of the devaluation have been largely absorbed due to prudent economic management by the authorities (1% increase in the Central Bank of Armenia policy rate) and effective communication. Deposits did not fall, while dollarization remained stable following a sharp rise prior to the devaluation. The banking system has absorbed so far the balance sheet losses arising from the devaluation and the inflation rate increased slightly from 1% in March to 3% in April and to 3.5% in May in the face of a weak domestic demand.

Nevertheless, the economic situation in the first six months of 2009 has dramatically worsened with the GDP contracting by 16.3% on a year-on-year basis. Industrial output contracted by 11.5% whereas construction sector declined by 53.5% in the first six months year-on-year. On the completion of the first review of the IMF SBA (approved on the 22 of June), overall real GDP is forecasted to contract by 9.5% in 2009[1] representing a massive turnaround compared to growth rates of the previous years, and also a substantial deterioration of Armenia's economic outlook (see Tables below) compared by what was anticipated at the time of the approval of the SBA (in March 2009).

The economic contraction resulted in large additional government financing needs as revenues fell by 33% in the first five months of 2009 (year-on-year) and the authorities did not manage to meet the target for the fiscal deficit despite the postponement of non essential expenditures. Therefore, even with significant budget cuts the fiscal deficit is projected to be around 6.5% of GDP in 2009 and is unlikely to be covered by financing sources identified originally by the IMF.

Although the banking system remains solid, credit conditions in the economy have worsened. Liquidity in local currency remains a constraint. With high deposit dollarization (nearly 70%), banks are reluctant to lend in local currency. As a result credit to the private sector is largely frozen hurting further economic activity. Also, prospects for placing domestic debt in local currency appear limited in this context.

The economic downturn has also led to a sharp widening of the external financing needs compared to March 2009. This is the result of a much deeper deterioration in export earnings, remittances and FDI despite the devaluation of the exchange rate in March 2009. During the first six months of 2009, foreign trade turnover contracted by 31.5% year-on-year, with exports dropping by 45.9% and imports by 27.5%. Remittances fell by 30%[2] during January-May 2009 compared to the same period of 2008. Exports and remittances are now expected to contract between 10-20% in both 2009 and 2010 leading to a widening current account deficit of 13% of GDP for 2009, despite the devaluation of the exchange rate.

[1] More recent data suggest that GDP contraction is likely to be more than 10% in 2009.
[2] Preliminary more recent data suggest that the fall in remittances is likely to be more than 30% in 2009.

Table 1: Armenia - Main Economic Indicators

	2007	2008	2009	2010
	Actual	Projections		
Real sector				
Real GDP growth (% change)	13.7	6.8	-9.5	1.3
CPI Inflation (period average)	4.4	9.0	3	2.7
GDP per capita, in USD	2,853	3,685	2,857	2,722
Unemployment rate, %	7.0	6.3		
Fiscal Sector				
Revenue, incl. grants % of GDP	20.1	20.0	20.4	20.4
Expenditure, % of GDP	22.4	21.8	26.8	23.3
Overall balance, % of GDP	-2.3	-1.3	-6.5	-5.8
Capital spending and net lending, % of GDP	5.2	3.9	5.0	5.2
Net lending, % of GDP	2.3	1.3	6.5	5.8
Government and government-guaranteed debt, % of GDP	17.5	17.8	37.6	43.5
External sector				
Current account balance, % of GDP	-6.4	-11.3	-13.0	-13.5
Exports of goods and services, % of GDP	19.3	14.5	13.6	16.5
Imports of goods and services, % of GDP	39.0	39.3	37.7	41.7
Foreign direct investment, % of GDP	7.6	7.8	4.7	5.4
Monetary sector				
Broad money growth, %	42.3	2.4	10.3	
Private credit growth, %	77.9	48.7	10.6	
Foreign exchange deposit, % of total	-9.1	32.4	90.2	
External Vulnerability				
External public debt, % of GDP	17.3	15.3	31.5	38.8
Public debt service ratio[1]	2.9	3.2	5.7	6.3
Total external debt, % of GDP	21.0	18.0	34.2	40.0
Gross reserves (excl. gold, USD millions)	1,659	1,405	1,604	1,546
Import cover (months)	4.3	4.8	5.1	4.6

Sources: IMF, World Bank

[1] in % of exports of goods and services

1.3. The Government programme of economic reforms

The economic policies pursued by the Armenian authorities have been updated and revised to reflect the more challenging outlook. The objectives of the program remain unchanged: namely, to help Armenia adjust to the changed external outlook, maintain confidence, and protect the poor. The main economic policy measures of the Armenian government are summarised below in the Box 1:

Box 1 – Armenian Government Policy Measures

Monetary, exchange rate and financial sector policies

- Flexible exchange rate regime, transparent and smooth intervention policy, reserves building,
- Prudential measures regarding foreign currency exposures
- Unlock the frozen credit market and strengthen the transmission of monetary policy
- Gradual recapitalization of the CBA with marketable interest-bearing securities
- Development of government securities with extended maturities
- Credit easing operations – Improvements in Banks' monitoring and risk management
- Enhancement of deposit guarantee fund

Fiscal policies

- Focus on the sustainability of medium-term fiscal position
- Refocus of targeted public spending, increase of external sources to capital spending and SME's
- Increase domestic financing moderately to address financing needs in addition to supporting financial intermediation
- Reforms in tax policies and tax administration

Structural policies

- Improvements in business climate, establishment of industrial zones, protection of economic competition

1.4. Armenia's external financing needs

The estimate of Armenia's external financing needs in 2009-2010 contained in the first SBA review is summarised in Table 2 (on next page). Total needs for the two years, comprising essentially the financing of the current account deficits of about 13% of GDP, amount to USD 4.2 billion. Available financing, including the reduced private capital flows (FDI is expected to go down to about 5% of GDP from nearly 8% in 2007-2008) and the bulk of project-related public sector funding is projected to leave a financing gap of close to USD 1.7 billion.

Out of this amount, the IMF is expected to provide USD 746 million (including the original SBA funding and the recently approved augmentation of Armenia's access to IMF resources), while the World Bank (IDA) and the Asian Development Bank are putting in place an additional USD 200 million, mainly in the form of budget support. The residual financing gap of Armenia – about USD 720 million – is expected to be covered by bilateral donors: Russia has announced a total credit of USD 500 million (for project financing) and is currently finalising the operation; the UK is planning additional budget support grants; finally, the EU has put in place sectoral budget support grants under the European Neighbourhood and Partnership Instrument (ENPI). The macro-financial assistance under preparation amounting to EUR 100 million – or around 19% of the residual financing needs – would be an appropriate contribution of the EU to close the financing gap.

Table 2: Armenia - External Financing Requirements and Sources

in million US dollars

	2009	2010	2009-10
Total Requirements	**2.228**	**1.969**	**4.197**
External current account deficit (exc. transfers)	1.983	1.982	3.965
Debt amortization	22	24	46
IMF repurchases and repayments	24	21	45
Gross international reserve accumulation	200	-58	141
Available financing	**1.115**	**1.420**	**2.535**
Current transfers	739	732	1.471
Private	704	718	1.423
Official 1/	35	13	48
Capital Account	374	687	1.060
Capital transfers (net)	103	73	176
Foreign Direct Investment	440	490	930
Public Sector Disbursements	177	165	342
Other Capital 2/	-347	-41	-388
Debt Relief 3/	2	2	4
Financing gap	**1.113**	**549**	**1.662**
Exceptional IFI financing	**585**	**359**	**944**
IMF	455	291	746
SBA - Initial	349	139	488
SBA - Augmentation	106	152	258
Expected additional World Bank financing	60	43	103
Expected additional Asian Development Bank financing	70	25	95
Residual Financing Gap after IFI Financing	**528**	**190**	**718**
Expected exceptional bilateral financing	**532**	**46**	**578**
Additional ENPI Budget Support	17	27	44
Additional UK Budget Support	15	19	34
Loans from Russia	500		500
Residual		***140***	***140***

Sources: Armenian authorities, IMF staff estimates and Commission calculations.

1/ Excludes undisbursed amounts under EU (ENPI) and UK Budget support and the recently suspended US/MCC road project financing (USD 20 and 15 million in 2009-2010).

2/ Includes portfolio investment and net errors and omissions.

3/ Includes debt deferal from the Lincy Foundation in 2003 and debt relief from Turkmenistan in 2003 and from the United Kingdom from 2006 to 2008.

2. OBJECTIVES AND RELATED INDICATORS OF THE MACRO-FINANTIAL ASSISTANCE

2.1. Objectives

The objectives of the proposed macro-financial assistance operation are the following:

- Contribute to covering Armenia's external financing needs; alleviate budgetary financing needs;
- Support the fiscal consolidation effort in the context of an IMF programme;
- In this respect, help Armenia to reduce the financial constraints on the implementation of its comprehensive economic reform programme;
- Facilitate and encourage efforts of the authorities of Armenia to implement measures identified under the EU-Armenia Action Plan and the Eastern Partnership;
- Reinforce the EU role in the economic policy dialogue with the Armenian authorities on the programme of reforms.

Detailed macro-economic and structural reform objectives will be further defined in the context of a Memorandum of Understanding, to be agreed with the authorities.

2.2. Indicators

To monitor the fulfilment of the objectives of the programme throughout the implementation period of the assistance, the Commission will use two types of indicators:

- Adherence to the IMF-supported programme; it will be a conditio sine qua non for the implementation of the assistance;
- Progress in the implementation of specific actions that will be part of the conditions for disbursement. Those actions will be specified in the aforementioned Memorandum of Understanding. They will be consistent with the policy lines anchored in the IMF programme, as well as the European Neighbourhood Policy and Eastern Partnership priorities.

3. ALTERNATIVE DELIVERY MECHANISMS AND RISK ASSESSMENT

3.1. Delivery mechanisms

Given the sharp deterioration of Armenian economy, the country's low income profile and its entitlement in receiving concessional borrowing, it is deemed appropriate to provide part of the foreseen macro-financial assistance in the form of grants (EUR 35 million) and the rest in the form of loans (EUR 65 million).

Macro-financial assistance is an untied and undedicated macroeconomic support, which helps the beneficiary meet its external financing needs, and contributes alleviating budgetary financing needs. Moreover, as experienced with similar operations, including in Armenia, the economic policy conditionality attached to this support strengthens the stabilisation and reform process.

3.2. Risk assessment

There are both fiduciary and policy risks related to this macro-financial assistance operation.

There is a risk that this assistance, which is not dedicated to specific expenses (contrary to project financing, for example), would be used in a fraudulent way, like any other type of assistance. Generally speaking, this risk is related to factors such as the independence of the central bank, the quality of systems and procedures related to the management, control and oversight functions in the financial circuits and processing of such assistance, IT security and internal/external audit capacity of the beneficiary authorities.

To mitigate the risks of fraudulent use, several measures will be taken. The Memorandum of Understanding and the Grant/Loan agreements will comprise a set of provisions on inspection, fraud prevention, audits, and recovery of funds in case of fraud or corruption. Also, the assistance will be paid to clearly identified accounts at the Central Bank of Armenia. Moreover, before the agreement on the Memorandum of Understanding is reached, the Commission services will assess the reliability of financial circuits and administrative procedures that are relevant to this type of assistance and will determine whether the framework for sound financial management of macro-financial assistance is sufficiently effective in Armenia (for details, see Financial Statement, section 7). In the light of this assessment, specific mechanisms applying to the management of the funds by the beneficiaries may be introduced in agreement with the national authorities. The Commission may also use other assistance instruments at its disposal to help the beneficiary authorities improve their public finance management systems if this area is not sufficiently covered by other donors.

Finally, the assistance will be liable to verification, control and auditing procedures under the responsibility of the Commission, including the European Antifraud Office (OLAF), and the European Court of Auditors.

As regards policy risks, the main assumption is that the Government of Armenia will remain committed to fiscal adjustment and in compliance with its agreement with the IMF. This will be validated on the basis of IMF’s quarterly monitoring of performance indicators and structural benchmarks. There is a risk that the Government of Armenia will not comply with the IMF programme conditions, as the fiscal target may turn out more difficult to reach than assumed, in particular as the risks to the growth assumptions are clearly on the downside.

While seriously taking into account these risks, the Commission services consider that there are sufficiently strong grounds to proceed with MFA to Armenia. The large financing needs faced by Armenia in particular in 2009 and to a lesser extend in 2010 plead in favour of urgent action.

The Commission services will maintain close contacts with the authorities during the implementation of the macro-financial assistance in order to address quickly any concerns that may arise.

4. ADDED VALUE OF COMMUNITY INVOLVEMENT

By providing financing complementary to resources made available to Armenia by the International Monetary Fund and the World Bank, the Community would support Armenia's domestic efforts of responding to the impact of current global economic crisis. It would encourage and strengthen the implementation of the reform programme. This will be particularly important in the areas targeted by the programme’s conditionality, in particular the fiscal consolidation effort aimed at reducing public expenditures to a sustainable level. Moreover, the effect of the Community’s involvement will be strengthened as a result of the synergy with other Community programmes aiming at supporting Armenia's dire fiscal situation, in particular the European Neighbourhood and Partnership Instrument budget support grants (EUR 32 million to be provided in two instalments in 2009 and 2010).

The macro-financial assistance is a policy-based instrument and would therefore also contribute to support the European Union’s strategy towards Armenia, in particular in the context of the European Neighbourhood Policy and the Eastern Pertnership

5. GENVAL CRITERIA

The Commission services have given due consideration to the five Genval criteria.

Exceptional character:

Armenia's financing requirements in 2009-2010 result from the impact of the global economic crisis on Armenia, and its high exposure to this crisis in view of its external and fiscal imbalances and its high dependence on foreign inflows and remittances.

The exceptional character of the foreseen MFA is further stressed by the limited timeframe of the programme. In determining the actual amount of the tranches under the MFA programme, the Commission services intend to take into consideration the progress in the implementation of the IMF programme and of the World Bank development policy loans, as well as the timeframe of other main donors supporting Armenia with budget support, which still need to be identified.

Scope:

Armenia is an active partner to the European Neighbourhood Policy as well as to the recently established Eastern Partnership. It has demonstrated a good record of macroeconomic management and economic reforms in the recent past while it respects democracy and human rights and as such should be considered as eligible for EC MFA support.

Complementarity:

The Community MFA will be complementary to external financing coming from two main sources: (i) the International Monetary Fund and the World Bank; and (ii) bilateral donors in case some preliminary financing indications can be confirmed and enable for disbursements over the programme period. It should also be noted in this context that it is complementary to budgetary support expected to be provided under the Community ENPI programme (EUR 32 million over 2009-2010). In this context and in the short run, MFA will both increase substantially the European Union's leverage on Armenia's policy making and strengthen the country's European orientations, and provide a highly valuable bridge financing to help the country weather the effects of the current economic crisis.

Conditionality:

The macro-financial assistance to Armenia will be linked to an IMF stand-by arrangement. As usual with this type of assistance, disbursements under this macro-financial assistance will be subject to progress in the implementation of the IMF arrangement. It will also be conditional upon specific structural reform measures that will be further defined in the context of a Memorandum of Understanding to be jointly agreed between the Commission and the Armenian authorities.

Given the nature of the planned operation, in defining the conditionality in the area of structural policies, particular attention will be paid to public finance management with a view to strengthening efficiency, transparency and accountability, and because of its importance for fiscal consolidation. As Armenia is a partner country to the European Neighbourhood Policy and to the Eastern Partnership, the Commission may consider targeting specific sectoral policies of particular importance, identified as such in the EU-Armenia Action Plan or 2009 Progress Report like banking supervision.

Financial Discipline:

The Commission services propose to limit the macro-financial assistance to Armenia to up to EUR 100 million. This corresponds currently to the 19% amount (ex-ante) of the residual financing gap foreseen after IMF and World Bank support identified by the IMF for the year 2009-2010. Data on the balance-of-payments gap are by nature volatile. Additionally, additional bilateral financing may materialise in the course of the programme that cannot yet be included in the current programme assumptions.

Concerning sound financial management, the Commission services are taking action in order to fulfil the requirements of the Financial Regulation. The Commission will launch an Operational Assessment (OA) of the reliability of financial circuits and administrative controls at the Ministry of Finance and the Central Bank of Armenia. Based on the OA report's findings, the Commission services will determine whether the framework for sound financial management is sufficiently effective in Armenia. Also, the results of the OA will contribute to the definition of appropriate conditionality in the area of public finance management.

6. PLANNING FUTURE MONITORING AND EVALUATION

This assistance is of exceptional and macro-economic nature and its monitoring and evaluation will be undertaken in line with the standard Commission procedures:

6.1. Monitoring

The monitoring system will be ensured by the provision of reports and data by the authorities, as to be set out in the Memorandum of Understanding and the organisation of review missions in Armenia by Commission staff. Although this assistance is centrally managed, where appropriate, Commission Delegation will also be called to provide additional reporting.

In particular, the monitoring of the action by the Commission services will take place on the basis of a system of macro-economic and structural policy indicators to be agreed with the authorities of Armenia. In this process, the Commission services may also monitor key areas to be identified in the above-mentioned Operational Assessment on public finance management.

An annual report to the European Parliament and to the Council on the implementation of this assistance is foreseen in proposed text of the Council Decision on MFA to Armenia.

6.2. Evaluation

In the context of DG ECFIN Multi-annual Evaluation Programme, two to three ex-post evaluations of MFA operations are planned per year. It is in this framework that an independent evaluation of the assistance will be carried out by duly authorised representatives of the Commission in due course. A provision foreseeing an ex-post evaluation will be included in the Memorandum of Understanding. Financial resources for this evaluation would be drawn from the corresponding MFA budget line.

7. ACHIEVING COST-EFFECTIVENESS

In implementing the programme, the Commission will be guided by the following principles:

- The assistance will be made available by the Commission to Armenia in principle in two instalments. Each instalment will be released on the basis of a satisfactory track record in implementing the macro-economic programme under the IMF-supported programme and the specific economic policy conditions attached to the assistance. The latter will be negotiated with the authorities as soon as possible and laid down in a Memorandum of Understanding concluded to this effect.

- As soon as the Council has adopted the proposal, the Commission will negotiate with the Armenian authorities a Memorandum of Understanding laying out the conditions for the release of the EU assistance, as well as a grant and a loan agreement. All tranches of the proposed assistance will be made available by the Commission to Armenia on the basis of a satisfactory track record of the implementation of the IMF programme and the economic policy and financial conditions attached to the assistance.

- In negotiating specific policy conditions, the Commission will draw on all the expertise, including of the International Monetary Fund and the World Bank and of bilateral and multilateral aid agencies active in the same areas. In addition, the

Commission will aim at synergies with other Community policies and instruments (notably ENPI as indicated above) that could be used to support the implementation by the beneficiary of the relevant measures (notably in the area of public finance management and of the financial sector). Where appropriate, links to any related action under the European Neighbourhood Policy or Eastern Partnership or findings of the Progress Reports can also be established.

- This action is exceptional by nature and will not involve an increase in the number of Commission staff.