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# Armenia

## Country Economic Memorandum

(In Two Volumes) Volume I

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Europe and Central Asia Region  
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## CURRENCY EQUIVALENTS

Currency Unit = Ruble

US\$1.0 = Rb 620

(as of February, 1993)

## FISCAL YEAR

January 1 - December 31

## **ACRONYMS AND ABBREVIATIONS**

<b>AR:</b>	=	Armenian Railways
<b>CEEC:</b>	=	Central and Eastern European Countries
<b>ECA:</b>	=	Europe and Central Asia
<b>FSU:</b>	=	Former Soviet Union
<b>GDP:</b>	=	Gross Domestic Product
<b>GNFS:</b>	=	Goods and Non-Factor Services
<b>GNP:</b>	=	Gross National Product
<b>IAEA:</b>	=	International Atomic Energy Agency
<b>MOT:</b>	=	Ministry of Transport
<b>NBA:</b>	=	National Bank of Armenia
<b>NGOs:</b>	=	Non-Governmental Organizations
<b>NMP:</b>	=	Net Material Product
<b>NPP:</b>	=	Nuclear Power Plant
<b>OECD:</b>	=	Organization for Economic Cooperation and Development
<b>SNA:</b>	=	System of National Accounts
<b>SOE:</b>	=	State Owned Enterprise
<b>SPERBANK:</b>	=	State Savings Bank
<b>USAID:</b>	=	U.S. Agency for International Development
<b>VAT:</b>	=	Value added tax
<b>VEB:</b>	=	Vneshekonombank

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**ARMENIA**

**COUNTRY ECONOMIC MEMORANDUM**

**VOLUME I**

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## **EXECUTIVE SUMMARY**

i. Armenia is a small, mountainous, landlocked country with a rich cultural and literary tradition dating back to several centuries B.C. Turkey lies to the west, Georgia to the north, Iran to the south, and Azerbaijan to the east with one province also to the south-west of Armenia. Its land area is 29,800 square kilometers, and the ethnically homogeneous population numbers 3.5 million. With few resources and stony land, Armenians have learned to survive through skill, ingenuity, and trade with those around them. The level of education is high, and the Armenian diaspora has a strong tradition of successful entrepreneurship which should work to the country's advantage in the difficult times ahead.

ii. Within the former Soviet Union, Armenia is a pioneer in reform: no other republic has moved so far or so fast. The country has swept the old guard from power and elected a new liberal-minded Government which is putting in place a substantial and far-reaching program of reforms. Agricultural land has already been privatized and the Government is moving ahead with tax, pricing and legislative reform, creating a sound framework for private sector development. The country's position at the intersection of regional trading routes is a potential strength. Despite its good long-term prospects, however, Armenia now faces extreme adversity.

iii. Two problems dominate the immediate future. First, Armenia is an economy under siege. Trade routes have been blocked because of internal disruption in Georgia over South Ossetia and Abkhazia and conflict with Azerbaijan over the enclave of Nagorno-Karabakh, with the result that Armenia's trade, and, most importantly, its energy imports, have been cut to a trickle. During the 1991/92 winter, most of industry had to be shut down and heating for homes cut off in sub-freezing temperatures. It was not possible to replenish fuel supplies adequately in the summer and the 1992/93 winter was even worse. Problems were compounded by the harshest weather conditions in 46 years. Death-rates for old people and children rose sharply, and pre-famine conditions developed. Widespread starvation was only averted by humanitarian grain shipments. Second, in common with all the countries of the former Soviet Union (FSU), Armenia is experiencing falling output (see Table 1) due in part to the disruption of the Soviet monetary, payments, trade and transport systems. Although a small country at the edge of the empire, Armenia was one of the most highly integrated republics in the Soviet system of production and trade and is suffering correspondingly now.

### **Recent economic developments**

iv. Due to the progressive deterioration of Soviet production, trade and payment arrangements in the second half of the 1980s, real GDP started falling in 1987. Then in December 1988, Armenia experienced a severe earthquake, which caused at least 25,000 deaths and widespread destruction of fuel pipelines and industrial plant, and left 500,000 homeless. Many people are still living in metal containers and disused fuel tanks. The country's nuclear reactor was shut down after the earthquake as a safety precaution, reducing generating capacity by about one-third. Apart from a rebound in real GDP in 1989 caused by the short-lived post earthquake construction boom, each year after 1986 has shown an accelerating decline. Privatization of agricultural land, which began in 1991, produced a 15% surge in output in that sector in 1991. But the recovery in agriculture could not outweigh the decline in other sectors caused by the disruption of the former Soviet economy and now aggravated by lack of foreign exchange, fiscal shortfalls, a sharp reduction in real credit, a 60% fall in real wages, the absence of functioning financial and other systems appropriate to a private

enterprise economy, and, overall, by the shock of change. Compounding all these problems is the blockade, which has cut imports and exports sharply and has denied the country vital food, fuel and medical supplies.

#### The Government's reform program

v. Despite these extreme difficulties, the Government is attempting to set in place a comprehensive reform program with the objectives of attaining: (i) macroeconomic stability; (ii) a largely privately run and owned economy where individuals and companies are free to transact at market determined prices and contracts are enforceable; (iii) a society which takes care of vulnerable groups of the population; (iv) an economy with an effective and efficient public sector that provides public goods and services and implements policies that promote sustainable growth. However, the Government must also address the immediate reality, tailoring its measures in such a way that they also help move the economy and society in the desired medium-term direction.

#### Short-term imperatives and constraints

vi. The reality that Armenia faces is one of sharply rising prices, falling output, worsening unemployment, lack of fuel for industry, schools, hospitals and home heating, fiscal crisis, and severely restricted trade; all of which mean considerable suffering for the population and which provide a fertile recruiting ground for radical movements. Refugees are flowing into the country from Azerbaijan, adding to the hundreds of thousands made homeless by the 1988 earthquake. The immediate choices and judgements about managing the transition must be made by a Government overwhelmed by these immediate difficulties, not yet familiar with a market economy, and which cannot afford to lose the public support and popular constituency for reform that now exist.

vii. The starting point is an economy heavily constrained by the legacy of central planning, with distorted prices and wages, command institutions, and an uneconomic and deteriorating capital stock. The structure of the economy still mainly corresponds to the centrally determined pattern of production and trade with a large industrial sector and relatively small services sector. Reforms so far have produced positive results in agriculture but macroeconomic stability has been compromised by an unfortunate sequencing of fiscal and financial sector reforms. The previous system of taxation was removed before a replacement tax structure had been designed and implemented. The consequent drastic fall in tax revenue, particularly from the enterprise sector, produced a large fiscal deficit. At the same time, removal of controls from State banks enabled an expansion of credit associated with a high risk, low return loan portfolio that has compromised future financial stability and may result in heavy charges on the government budget in the future.

viii. The tension between the vision outlined in the Government's reform program and the constraints of the current situation demands of the Government that it adopt a strategy to achieve the medium term objectives while also managing the next six to twenty-four months in a way that moderates human social and economic costs – yet fits in with and promotes the medium term strategy. Careful design, sequencing and implementation of reforms will be crucial. To help achieve these goals, it will be important for the international community to provide Armenia with aid resources with some degree of concessionality. In the near term, Armenia will require considerable external financing while it is narrowing its current account deficit, particularly in view of the

enormous increase under way in energy import prices. In the medium-term, however, the prospects for competitiveness, growth and creditworthiness are good.

#### Macroeconomic overview

ix. The Government's highest priority is to avert a free fall in output while reasserting control over money and credit to the extent possible and running an effective fiscal policy so that Government arrears and claims on bank credit do not further destabilize the economy. In the longer run, it will need to restore aggregate demand in conditions of macroeconomic stability, which in turn will require institutions capable of exercising effective monetary and credit control and of performing expenditure and revenue functions in the framework of a Government budget linked to a view of the requirements of the macroeconomy. In due course, it will have to deal with issues of currency and exchange rate management.

#### Fiscal policy - the first priority

x. Government revenue has fallen from over 50% of GDP in 1989 to an estimated 18% in 1992. Falling revenue and a growing deficit seriously jeopardise the Government's capacity to carry out the reform program, maintain income support and medical services, and create conditions for macroeconomic stability. Consequences for public investment are also adverse, implying further losses of output in the future. Armenia moved too quickly to a new tax system, introducing VAT and excise taxes. Strengthening of the tax administration is now urgently needed, with particular focus on the VAT, where returns are only one-third of forecast levels. A Customs function must be set up, and VAT, excise taxes and import duties must be collected on non-FSU imports. It would also be advisable to raise the corporate income tax and highest personal income tax rates to at least 35%. Substantial, if not full, cost recovery should be introduced for maintenance of housing, communal services (heating, gas and water) and electricity.

#### Money, credit and prices

xi. Prices have increased rapidly over the last year, with the main surge occurring in the first four months of 1992 when retail prices increased by 642.5% compared to the first four months in 1991. By the end of 1992, the average annual increase in prices over the previous year was 828% while the December quarter increase was 1219% on the same quarter a year before. Soaring prices have created a decline in real money balances that is reinforced by lack of liquidity in the banking sector. Real credit has also declined sharply.

xii. Information on the components of the retail price index shows that the rate of increase is still high for inter-republican exports but appears to have come down for domestic goods, while wages and benefits have increased much less rapidly. For the second half of 1992, the minimum wage was 600 rubles per month as compared with 900 rubles per month in Russia, and average wages are below two-thirds of the Russian level. Recent figures indicate that the retail price index actually declined in August 1992 when decreases in farm product prices outweighed increases in other prices.

xiii. A number of factors could help account for these disparate price developments, including the improved supply response in agriculture since land privatization, the continued monopsony of State buying organizations, and real wage discipline. But it seems probable that the divergence also reflects the extent to which price increases can be validated by money and by credit growth, which in turn depends on whether the activity takes place in the cash or the credit economy. Differential capacity to extract high prices for output is generating a split in the real economy, with worrying consequences. It appears that the cash economy is subject to tighter monetary conditions than the credit economy and is responding better to the new relative price signals; credit is also tight but - at least when fuel supplies are available - tends to maintain the existing composition of SOE output, permitting inventory accumulation estimated at 6 billion rubles in May 1992. At the same time, both segments of the market are oriented to short-term returns in the absence of instruments and incentives that would promote intermediation and medium-term investment.

xiv. The risk is that the claim on resources of the enterprise credit economy, with its ability to earn higher prices and accumulate stocks, will undermine the emerging strength of the cash economy and its greater competitiveness and allocative efficiency. This dangerous development underlines the high priority of imposing financial discipline on enterprises and introducing market evaluation and control techniques to the banking sector.

#### Balance of payments, exchange rate and currency option

xv. In the short term, Armenia faces a problem of current account sustainability, with a structure of trade inherited from the Soviet regime that generates large external deficits. Inter-republican trade was normally in balance in the period before the earthquake. Now there is no immediate prospect that external deficits of the order needed to restore output to previous levels could be financed by corresponding capital inflows. The potential balance of payments deficit will widen once prices have moved to world market levels, when a severe deterioration in Armenia's terms of trade is expected, but in the short run the country is able to exploit its monopoly advantage in a number of products for FSU markets. It is also finding substantial demand for its products in markets outside the FSU, indicating that its balance of payments deficit can in time be overcome. Meanwhile, foreign financing is urgently needed to sustain a level of imports that could halt and help turn around the output decline but may take time to materialize given the lack of macroeconomic stability and high level of uncertainty about immediate prospects. In the short run, export promotion is required but is hampered by the difficulty of ensuring continued supply. Exchange rate policy is the only other instrument potentially available but its use would require radical decisions which Armenia is not yet willing nor well prepared to take. In the immediate future, Armenia will continue to be dependent on Russia for oil imports and for access to trade credit. It should use this time to build up the macroeconomic policy and implementation capacity to manage its own currency: in particular, capacity to control the money supply and the fiscal deficit, while pursuing the systemic reforms that will underpin macroeconomic stability.

#### Trade policy

xvi. Armenia wishes to seek full integration in the world economy as a trading nation, and in the medium-term, is likely to develop as a center for trade and services in the region. In the

immediate future, however, its trading activities are severely constrained by the blockade and by lack of foreign exchange. The country's heavy dependence on trade, and external imports in particular, makes it imperative to address this situation in the near term in a way that will promote exports, especially in hard currency. This objective implies early attention to privatization in agricultural support industries and agro-processing, and to the establishment of an enabling environment for private sector activity, including improvement in airport facilities and trade facilitation procedures.

xvii. In the near term, the country cannot afford to relinquish the inter-republican trade that remains, and in most cases will have to accept the trading conditions imposed on it by more powerful trading partners, particularly where food and fuel are concerned. However, retention of the old system at the country-to-country procurement level does not prevent liberalization of the domestic transactions related to state orders as a way of preparing the ground for full-scale competition in the future. The Government has already moved to a system whereby goods purchased under state orders are auctioned, and suppliers are invited to submit bids in open competition to fulfill orders. It should be possible to privatize transport and distribution of these goods on the domestic market in the near future. Enterprises have considerable freedom over pricing and will continue to expand their ties and be responsible for negotiating prices and deliveries.

xviii. A strategy for trade policy must be developed. At least in the near future, it will be advisable for Armenia to retain preferential access to the FSU market, which implies that it will impose tariffs only imports from outside the FSU. Rather than keep the old FSU tariff, however, it would make sense to adopt a uniform tariff of about 20% for the next few years while the need for revenue is particularly pressing, with a stated plan to reduce rates to 5-10% in the medium-term. Measures to implement zero-rating of exports should be introduced.

xix. Effective institutional underpinning will be required if Armenia is successfully to become a diversified and open trading nation. This calls for an agency, not necessarily within Government, to provide information on markets and help establish trading contacts, and also a Customs agency to facilitate trade, collect revenue, and supply data needs for economic policy-making.

#### Private sector development: the enabling environment

xx. Substantial progress has already been made with price liberalization - an essential prerequisite for the development of private markets. Armenia is also well launched on the project of developing the legal environment necessary for a fully functioning market economy, with the legal framework already established for land reform, privatization, free entry and competition, together with a property law, company code and commercial code, and financial sector law.

xxi. It is now important to press ahead with the draft legislation under discussion on foreign investment and licensing of exports and other economic activity, anti-monopoly, and bankruptcy and collateral. Attention will also be needed to the regulatory underpinning for legislation and capacity for implementation will need to be built up, including specialised courts. Social, health and safety, and environmental law affecting the private sector should be clarified, especially as uncertainty about their future responsibilities could inhibit foreign investors. To support the

development of land markets, land registration offices and cadastral surveys are needed, and the Government should reduce or eliminate the three year waiting period before land sales are permitted.

xxii. The Government has already reduced licensing requirements and would do well to go further and switch to a system of certification for most activities. Registration requirements could also be reduced and moved to a default basis, whereby registration would become automatic in the absence of official objections during a set time after deposition of documents. Access to space for commercial use should be facilitated in the period before full privatization of central and municipal enterprises creates a market for operating space. In order to smooth the way and lower transactions costs for private investors and, in particular, foreign investors, it would be useful to have a "one-stop shop" or agency supplying information on all requirements for carrying on a business in Armenia and where all application and registration procedures could take place.

#### Progress with privatization

xxiii. Armenia has already completed privatization of 90% of agricultural land and is now moving ahead with the privatization of retail trade and distribution, which will facilitate the expansion of activity in the agricultural and industrial sectors. A Privatization Commission and Board have been set up, and a variety of techniques for privatization are envisaged, including use of vouchers for up to 30% of the value of assets being released on the market. It will now be important to determine clear priorities for privatization, as it will not be logistically possible to tackle the bulk of public sector enterprises simultaneously. A high priority must be the privatization of agricultural inputs, services and distribution of goods, to build on the progress already achieved in this sector, help feed the population, and promote agricultural exports. The objective of export promotion will also be served by the early privatization of a small number of key industrial enterprises with export potential, particularly light and high-tech goods that can be exported by air, given the blockade of land transport.

#### Enterprise reform: tackling the industrial sector

xxiv. Further improvements in the capacity for supply response are now needed to allow price signals to be translated into effective and efficient allocative decisions. Two factors in particular impede the development of a well-functioning private sector: the continuing dominance of the state industrial enterprise sector, largely untackled as yet; and the highly precarious and shrinking financial sector, discussed below.

xxv. While the Government has already gone a long way to hardening the budget constraint on SOEs by withdrawing cash subsidies, the impact on these enterprises has been diluted in many cases by their ability to charge monopoly prices and avoid taxation. The rapid growth of inter-enterprise credit and to a lesser extent, bank credit, both frequently extended without regard to financial risk, has also insulated many enterprises from the budget constraint. The issues of enterprise and financial sector reform are thus closely linked and will for that reason have to be developed in tandem.

xxvi. In the short run, the Government must grapple with an enterprise sector free of central control and simultaneously free of any semblance of normal market disciplines. Many of the enterprises enjoy monopoly power within the FSU and have raised prices many times further than the average increase in the price level. A number of enterprises are principal shareholders in banks and therefore have access to a tame credit supply, enabling them to avoid adjustment while continuing to produce for inventory and pay above-market wages. At the same time, however, enterprises are highly vulnerable to the malfunctioning payments system within the FSU and to fuel and other input shortages due to the blockade. To the extent possible, the Government will need to ensure continued supplies of fuel and essential consumer products through the next year to eighteen months while also moving forward to change the ownership and structure of enterprises and the framework in which they operate.

xxvii. Action will be required at several levels. The authorities need to establish a legal and operating environment based on property rights and freedom of contract, while also ensuring an open trade and competition policy and promoting the development of sound financial markets and institutions providing a range of instruments and services. At the enterprise level, the objective is improved allocative, managerial and technical efficiency. In the majority of cases, this will mean privatization leading to the establishment of competitive firms. This will involve not only the transfer of ownership but also measures designed to improve corporate governance and action to deal with monopolistic structures. The Government will also want to ensure efficient management of firms awaiting privatization and firms which remain in the public sector.

xxviii. To start with, some triage is necessary. Neither the Government nor the recently set up Privatization Commission can possibly deal simultaneously with the large number of enterprises in this sector, whether this involves restructuring, privatization or liquidation. The first priority is an immediate review to classify enterprises into four main groups: those which are good candidates for early privatization because they have export prospects and can be sold with minimal preparation; uneconomic enterprises which should be closed immediately to prevent a further claim on bank credit and drain on scarce imported inputs; enterprises to be retained in the public sector; and a remaining large group in which an order of priorities must be struck for introducing improved corporate management while the enterprise is prepared for restructuring or privatization.

### Financial sector

xxix. Direct government control over the financial sector was reduced quickly after independence without, however, creating a basis for future financial sector development. It is now urgent to restore confidence in the banking sector and establish the infrastructure and banking practice for commercial operations in the future.

xxx. The financial sector is currently operating within an extremely distorted economic environment, with a low level of skills and weak operating procedures. Resources are not being allocated on a commercial basis, and the formal financial sector is playing only a small role in intermediation. Within that sector, both State banks and new banks are lending with little capacity to evaluate risk or return. Most financial institutions are effectively controlled by public enterprises which themselves are operating in an autonomous fashion, and credit is allocated primarily to shareholders of the banks, related enterprises and inherited public enterprise clients. A large amount

of credit allocation is also taking place through the informal expansion of inter-enterprise credits. Since the economy has become severely constrained by the blockade, credit has been centrally allocated to survival industries (hospitals, bakeries) and a small number of industries with export orders.

xxxii. Management of the financial system during the transition between a state controlled and a market economy is going to be extremely difficult since the policies to decentralize and liberalize the banking system can lead to perverse outcomes as long as the economy is not stabilized, part of the economy is under direct controls, most enterprises are still public, prices are distorted and inputs are rationed, making it difficult to assess the commercial viability of enterprises.

xxxiii. The speed with which the banking system can begin operating on a commercial basis depends on cutting the direct and indirect links between the banks and the unviable public enterprise clients. Many of the enterprises now being financed will and should become casualties of the economic restructuring process. But the Government will not want to risk sending the economy into free fall by accelerating enterprise collapses before activity begins to respond to new signals and new relative prices - including in particular oil price and exchange rate developments, which will continue to exert strong restructuring pressure. In the interim period while the restructuring process works itself through, the Government wants to maintain activity in the most economically and financially sound way possible. Decisions will be required to close irredeemably uneconomic enterprises rather than continuing to allocate subsidies and bank credit to them. These decisions will have to be taken by the Government or by a restructuring agency until the banks start to operate in a commercial way.

xxxiiii. Within the banking sector, the Government will need to re-assert some controls over the State banks as an immediate priority, where restraints on lending have been lifted without the recognition of corresponding prudential responsibilities and in an environment of perverse incentives including highly negative real interest rates. No further sale of shares in State banks should take place and their unsafe practices should be stopped: selling shares in insolvent banks, lending to shareholders, on-lending Savings Bank household deposits to high risk banks, and any lending to unviable clients. Over time diagnostic studies should be launched of the large state banks so these can be restructured, privatized, or liquidated. In the interim, the state banks should be under management contracts to enforce commercialization of operations. It may be advisable to approach reputable foreign banks for assistance with strengthening management.

xxxv. Also required immediately is a halt to the licensing of new banks on the current basis where licensing requirements are lax and capital standards inadequate. To curtail the risks posed by existing "cowboy" banks it will be important to insist that: licensing requirements are fulfilled (including character requirements); the minimum capital requirement of 40 million rubles should be indexed to inflation immediately; and minimum capital/deposit ratios should be upheld (recommended ratio 1:8, to be raised to 1:10 after one year). Before any new banks are licensed, technical and character requirements should be strengthened, requiring previous experience in financial management.

xxxvi. Since it will be imperative to monitor the banking system and the financial institutions closely while continuing to move away from direct controls on the system, an essential ingredient of the reform program will be to strengthen the information management, economic analysis, operational, and supervision capacity in the National Bank of Armenia. The NBA should prepare to respond to the evolving economic situation by adjusting available monetary and financial policy

instruments and regulations on the banks. The NBA should prepare the regulations to support the new Banking Law as soon as possible, and should require banks to adopt international accounting standards.

xxxvi. The Government needs to implement its plan to honor the liabilities of the Savings Bank as soon as possible to prevent the further erosion of credibility in the financial system. The Government should assume responsibility for blocked household deposits and the accrued interest from the Savings Bank, recognizing that the payments will need to be spread over many years. The repayment plan may combine cash, government bonds, long-term savings instruments, and privatization bonds. The plan should be put in place very soon to allow households to take part in the small-scale privatization program. Since the Savings Bank has an extensive branch network, it should be reorganized, restructured, and recapitalized or the facilities should be sold to other banks within the next few years.

### Labor market

xxxvii. The labor market is key to a successful transition in Armenia from the point of view of efficient adjustment as well as of welfare. Armenia must now move from the past system involving numerous rigidities to a freely functioning labor market with a well-trained and mobile labor force. A high priority for the Government will be an active labor market policy. This will mean measures to identify vacancies and employers' skill requirements, counsel displaced workers, speed placement, provide appropriate training in new private sector skills, and, where possible, promote labor force attachment and income support through employment on public works. Given the shortage of budget funds this could best be done with financial support from external agencies, including the many bilateral agencies involved in earthquake reconstruction and relief.

xxxviii. To support an active labor market policy, and also to keep fiscal control and prevent abuse of the unemployment benefit system once labor mobility is permitted, the Government must also ensure that it has an efficient record system and well-functioning employment offices.

xxxix. Policies to improve labor market flexibility will also be required. In 1993, at the same time that it starts to privatize the housing market, the Government plans to remove the "propiska law" which confines workers to a 60km radius of their residence in their search for jobs.

### Income Maintenance

xl. In the short run, the Government needs to demonstrate tangible support for the poor, including earthquake victims, refugees, and the many casualties of the economic disruption following the disintegration of the FSU. However, it is unable to find the financial resources to sustain its social programs as revenue continues to fall and more and more people fall below the poverty line. Some fine-tuning has already taken place but it appears that a more radical approach will prove necessary.

xli. Sharper targeting is essential if dwindling budget resources are to be directed to those in greatest need, especially given the evidence of severe malnutrition and, in some cases, slow

starvation. In the immediate future, the Government should define a minimum social benefit linked to a subsistence food basket to provide a safety net for those most in need, including low-income people not eligible for pensions or unemployment compensation. Meanwhile pensions and unemployment compensation should be reduced to the same flat-rate benefit level (this can be done fairly easily as benefit differentials are already being progressively eroded with each round of partial indexing) and paid only where no other income was available. To provide additional gross savings, the age of retirement would be raised in stages. At the same time, it will be important to improve information on who the poor are, drawing on statistical surveys and the knowledge of local agencies and non-governmental organizations.

xlii. In the longer run, Armenia will need to consider what role the Government should play in income support. A range of possibilities is available. It could gear up to provide a traditional social insurance program, partially or fully funded, with income payments related to work history, contributions made and previous levels of income earned. Or it could keep only the role of minimum provider of social assistance geared to need, leaving income replacement above that level to the private sector or to an optional second-tier government scheme (e.g., Canada). Experience in OECD countries indicates that social insurance programs tend to generate high non-wage labor costs without providing full coverage at an adequate level for the population as a whole, and tend to be disadvantageous to women. This can lead to pressure for subsidies from general revenue or for the creation of a subsidiary scheme, raising budget costs. It is inadvisable to link social insurance to the workplace as this can also undermine labor market flexibility if benefits are not portable; and, at a time of economic upheaval, it is preferable not to tie entitlements to the performance of specific firms or industries. For fiscal, efficiency and welfare reasons, Armenia will want to consider the options carefully before determining the structure of income support in the future.

### Health and housing

xliii. The blockade has added lack of adequate food and hypothermia - due to lack of winter heating - to the health problems associated with homelessness and inadequate temporary housing arising since the 1988 earthquake and the inflow of refugees. Atmospheric chemical pollution causes respiratory illness and smoking is a serious public health problem. Medical supplies and equipment are lacking, and the top health priority in the near term will be the search for humanitarian assistance for vaccines, drugs and medical supplies. Urgent efforts should also be made to provide permanent housing and sanitation in the earthquake zone.

xliv. The Government wishes to establish a national health scheme with universal access, but within that framework will have a number of issues to resolve regarding organization and financing. In due course it will also need to address the problems it faces owing to excessive centralization of health sector management, less adequate provision in rural areas and poor incentive structures including drastic under-payment of doctors and other professionals (the average wage in the health sector is two-thirds that in industry).

xliv. In the housing sector, the Government will need to move ahead with the privatization of housing in line with the removal of the "propiska" law that prevents labor mobility. The planned program envisages the transfer of dwelling units to their current occupants and a quick reduction of housing subsidies, with the intention of releasing funds for new construction.

**Active policies to promote supply response and sustainable growth**

xlvi. The reform program is already setting the legal and policy framework for efficient and effective supply response throughout the economy. In addition, positive policies for transport services and infrastructure will be required to facilitate private sector development. Economic pricing and other measures will be needed to deal with environmental costs, promote efficient allocation of resources, and prevent erosion of the natural resource base. Specific sector policies will also be needed in agriculture and energy to reform sectoral policies, practices and institutions and ensure that the economic growth that emerges is sustainable.

xlvii. Beside urgent rehabilitation in the energy and water sectors, Armenia has considerable need for infrastructure investment. A higher priority in the short term will be to ensure maintenance of the road network and other existing infrastructure, rather than to seek to launch new investments, especially before capacity to evaluate investment projects in a macroeconomic context is better advanced. Much can be achieved by better organization of existing facilities, especially in the transport sector, and reform is urgently needed of the the airport system. Critical spares and material will be needed in the energy, transport, industry and agricultural sectors to get the most out of existing infrastructure.

xlviii. Once the blockade is lifted, Armenia can realistically seek external financial support for large-scale investments. The energy sector is a high priority, although the initial need will be for investment in energy-efficient replacement capacity and and storage, rather than a rapid increase in overall capacity. Investment requirements in the energy sector over the next five years are roughly estimated at US\$ 200 million. Substantial investment will also be required in the water sector to replace worn-out and inefficient systems. Careful attention is required to the impact on debt service and recurrent costs of such a program.

xlix. **Transport.** Short-term priorities should focus on essential maintenance to keep open the road and rail networks needed for trade, together with investment in alternative trading routes to the south and west. Privatization of truck and taxi fleets should continue. Meanwhile the longer-term framework for an efficient transport sector should be developed. Such a framework will include corporatization of airport management and operations, inter-modal planning, competent regulatory authorities, adequate technical and safety standards, and capacity to evaluate and rank investment proposals. Infrastructure and rolling stock will largely be privatized or managed commercially. Any State subsidies for social purposes will be identifiable contributions from the budget. In the near future, however, the priorities will be essential maintenance of aircraft, trucks and rail rolling stock and the track that they use. The Government is already working on defining activities that could be privatized and a schedule for privatization. This should proceed as soon as possible.

1. **Environment.** Concern for the environment is strong in Armenia and environmental legislation has already been passed by Parliament. Environmental damage has inflicted severe costs on the economy (especially in agriculture) and is creating risks to health. If Armenia is to achieve sustainable growth it will have to ensure that environmental costs are internalized and that provision is made to safeguard and where possible restore its "natural capital". This will involve pricing policies based on long-term cost considerations, and a regulatory framework covering pollution limits and penalties, together with the technical and scientific capacity to define and monitor standards.

Desalinization of agricultural land and environmental clean-up is required, and a decision will also have to be taken on the nuclear plant.

li. The main environmental issue in Armenia is the decline in the water level of Lake Sevan and its consequences, which include a reduced flow of good quality water to service the agricultural, industrial, urban and power sectors. It is a high priority to develop and review the national water plan from an economic, technical and environmental point of view. Armenia will also need an overall environmental assessment leading to an environmental action plan covering land management, agriculture, industry, urban conditions and public health.

lii. **Agriculture.** More progress has been made to privatize and liberalize in agriculture than in any other sector, with excellent initial results in terms of output and a shift to more efficient composition of activity and allocation of resources. Great scope exists to raise agricultural performance, but much remains to be done to sustain the transformation and improve productivity. Given Armenia's need to expand exports and provide adequate food for the population, the highest priorities in this sector are privatization of distribution and transport systems. Pricing of agricultural inputs and parts and machinery must be brought into line with economic costs. Armenia also has an urgent need for pesticides and other chemicals to stem crop losses and maintain the expansion in agricultural output. The irrigation system is badly in need of redesign and repair. Water charges were introduced into the agricultural sector in early 1992, which should reduce wasteful use, but the irrigation canals lose up to 50% of water carried. In addition, to help switch production from the livestock industry towards more profitable horticulture and crops, and to expand agricultural production and markets, Armenia will need a combination of investment at the farm and plant level, policy advice, institutional development, technical assistance and training, marketing advice and information.

liii. **Energy.** It is clear that the situation arising from the blockade is not sustainable for either the energy sector or the rest of the economy. Energy supplies are inadequate even for the summer period of reduced demand let alone for the winter. Energy supply is critical not only for survival but also as an essential input to permit increased economic production. However, even if the blockade were lifted, Armenia would still face serious problems in the sector arising from the dilapidated infrastructure, lack of economic pricing, and poor institutional management and design of facilities.

liv. The urgent immediate priority is to increase and diversify energy supply; improve the efficiency of use of available energy supplies including hydro resources; ensure continued service from existing plant and equipment; and provide new energy-efficient investment to replace old equipment, thereby increasing total effective capacity. However, the capital stock in this sector is deteriorating rapidly. If it is left to do so, rehabilitation will soon become an even higher priority than the search for new fuel supplies.

**Immediate policy imperatives**

iv. Armenia has a wide-ranging and impressive program for reform. However, resources and expertise to implement the program are limited, especially in the short term, so that it will be important to focus on the immediate priorities needed to strengthen the economy and protect the population. These priorities should be as follows.

lvi. *First are key actions needed to promote exports, facilitate supply response and increase food supply.* This translates into some immediate priorities within the privatization program: privatization of agricultural inputs, marketing and distribution to build on the positive supply response that has already resulted from land privatization; privatization of retail trade and transport, in order to generate a consistent supply response, harness entrepreneurial talent and demonstrate real change to the population; and privatization of a small number of key industrial enterprises with export prospects -- in current circumstances, probably those with high value, low bulk products that can be exported by air -- and closure of hopeless cases to prevent a further drain on resources.

lvii. *Second, measures are urgently needed to raise tax revenue so as to finance the reform program and social safety net and lay the foundations for macroeconomic stability.* This will require early action to strengthen the tax administration, focusing particularly on collections from enterprises; it will also require changes to some taxes and tax rates.

lviii. *Third, measures must be put in place to lay the foundations for a modern financial sector, incorporating market disciplines under the oversight of an effective central bank.* The links between insolvent banks and non-viable enterprises will need to be phased out in the context of effective enterprise reform. Meanwhile the National Bank of Armenia will need to establish sound licensing and prudential policies and deal with widespread insolvency in the existing system. Close monitoring will also be needed of the restructuring programs for the State banks, whose weak portfolios are dominated by public enterprises scheduled for privatization.

lix. *Fourth, with unemployment rising and hardship increasing, the Government will need to work out how to restructure the social safety net so as to target available funds to need.* This will mean cutting back on income-related supplements, income-testing of benefits, and the introduction of a minimum benefit, so as to look after those who are most in need. It will also be important to gear up capacity in employment offices so as to cope with rising numbers of unemployed people. These measures should be in place before the next winter.

lx. In brief, the Government must maintain output and welfare in the short run without sacrificing the liberalized future; and it must at the same time create the foundations for that future. Successful management of this balance is a major theme of this report. What it requires in specific contexts is further explored in each chapter of the report. Sectoral and issue-specific areas are dealt with in Annexes to the report.

Table 1. ARMENIA: Main Economic and Social Indicators

<b>Social and demographic indicators (1992)</b>					
Area	29,800 sq.km.				
Population	3.645 million (January)				
Urban	2.5 million (68.9%)				
Rural	1.1 million (31.1%)				
Population Density	120.8 per sq.km.				
Life Expectancy at birth	70.7 years in 1990				
Infant mortality rate	17.3 per thousand in 1990				
Gross domestic product (GDP) (1992)	70,138 million rubles				
GDP per capita	19,242 rubles				
	1988	1989	1990	1991	1992
<b>Annual Changes of Real Output in %</b>					
Gross Domestic Product	-0.7	12.4	-7.4	-17.3	-52.6
Net material product (NMP)	-2.6	14.2	-8.5	-11.8	-49.9
Industry	-1.6	2.3	0.5	-8.5	-51.9
Agriculture	-43.1	17.2	-13.2	15.2	-29.1
<b>Composition of NNP in %</b>					
Industry	54.6	50.2	45.4	48.3	41.4
Agriculture	18.5	14.4	17.3	25.7	45.6
Construction	10.8	21.2	25.4	15.3	4.7
Transport and Communication	4.1	3.5	4.1	2.2	1.5
Other sectors	12.0	10.7	7.8	9.2	6.7
<b>Average Price Change (1992)</b>					
Wholesale price increase	3.2	12.7	4.8	219.7	—
Retail price increase	3.0	4.0	12.0	274.1	1345.5
Average monthly wage (real change)	3.2	12.7	4.8	-47.9	—
<b>Interrepublican and foreign trade (in billions of rubles at domestic prices)</b>					
Exports	3.8	3.7	3.5	5.5	7.18
Imports	4.9	4.9	4.9	8.0	10.34
Trade balance	-1.1	-1.2	-1.1	-2.5	-3.16
Trade balance in % of GDP	-13.7	-12.6	-11.4	-16.0	-4.5
<b>Central government budget</b>					
Revenue		4.9	4.1	4.6	12.53
Expenditures		4.7	3.5	4.5	22.58
Overall balance		0.2	0.7	0.1	-10.05
In percent of GDP		2.1	7.2	0.6	-14%
<b>Money and credit (end of period)</b>					
Total deposits	4.6	7.3	8.2	11.4	23.9*
Total domestic credit	3.8	3.5	4.7	9.8	32*
Net credit to the Government	-1.0	-1.0	-0.6	0.3	6.7*

Source: Data provided by authorities, and staff calculations.

\* Figures end of period, November 1992

## CHAPTER I

### **WHERE ARMENIA HAS COME FROM AND WHERE IT IS HEADED**

#### Background

1. Armenia is a striking example of the Soviet belief in economies of scale, central planning, and the achievement of political control through economic interdependence. This belief led to extreme specialization within the former Soviet Union and meant that industrial units were large. Heavy industry was seen as the vehicle of economic development. The artificially low price of energy favored uneconomic activities and waste, and promoted the use of transport over long distances at great economic cost. The nature of trade and production that was assigned to Armenia on this basis has little in common with its comparative advantage. This means that the country has been saddled with a structure of highly concentrated production that corresponds only weakly with the composition of activity that is likely to evolve in a free market future.

**TABLE 2. ARMENIA: Commodity Composition of Trade in 1990\***

	EXPORTS in Percent			IMPORTS in Percent		
	Interrep.	Extrarep.	Total	Interrep.	Extrarep.	Total
Power	0.45	0.00	0.44	0.85	0.00	0.74
Oil and Gas	0.00	0.00	0.00	19.76	0.00	17.05
Coal	0.00	0.00	0.00	0.39	0.00	0.34
Other Fuels	0.00	0.00	0.00	0.00	0.00	0.00
Ferrous	0.87	0.31	0.86	7.88	0.60	6.88
Non-Ferr.	6.86	8.54	6.92	4.55	3.70	4.43
Chemicals	8.81	9.94	8.84	7.56	10.64	7.98
Machinery	39.72	64.60	40.50	26.72	18.22	25.56
Wood & Paper	0.29	0.00	0.28	2.29	8.12	3.08
Constr. Mat.	2.36	0.00	2.29	1.54	1.56	1.55
Light Industry	24.36	10.40	23.92	8.71	14.70	9.53
Food Prod.	3.43	5.28	3.49	5.32	27.47	8.35
Other Ind.	11.56	0.47	11.22	4.25	0.88	3.79
Agriculture	0.20	0.31	0.20	2.35	14.04	3.95
Other Food	1.05	0.16	1.02	7.83	0.08	6.77

\* Percentages are based on trade flows in foreign-trade prices. Each column totals to 100%

2. Armenia's product composition also yields a high degree of dependence on trade with other republics, with both exports and imports representing over 50% of GDP during the 1980s. Armenia's role in the USSR economy was to process intermediate goods and materials procured from other republics and to supply a wide range of consumer and non-specialized producer goods. The country developed substantial capacity in light industry (textiles, knitwear and shoes), food processing, and also heavy industry, exporting vehicle tires, caustic soda, synthetic rubber, and a large quantity of electric motors and cables and metal-cutting machine tools. For this, the country was dependent on imports of energy, agricultural and chemical inputs, wood and paper and other intermediate goods (see Table 2). Armenia also had a disproportionate share of the Soviet military-industrial complex, supplying high technology lasers and electronics.

3. Under the assigned production structure, industry constituted about 60% of net material product (see Table 3 on sectoral NMP). Most activity took place under the system of State orders and inter-republican trade protocols, whereby the State determined production and export quotas and agreed on the volume and type of trade with other republics. State sector employment was predominant, though the proportion has eroded since its peak in 1987 due to the growth of employment in cooperatives and private farms. But by 1992 the state still employed 973 million workers, or something over 63% of the labor force. Industry absorbed 23% of workers, agriculture 26%, and services 51%. Privatization of most agricultural land has already occurred and is taking place in retail trade and distribution, but not in industrial enterprises thus far.

Table 3. ARMENIA: Net Material Product at Constant (1983) Prices

Sector / year	Sectoral NMP in constant (1983) prices						Growth in sectoral NMP at constant (1983) prices					
	1987	1988	1989	1990	1991	1992	87-88	88-89	89-90	90-91	91-92	87-92
Industry (incl. turnover tax)	3611.4	3553.7	3636.3	3654.5	3343.9	1607	-1.6	2.3	0.5	-8.5	-51.9	-11.4
Agriculture	849.5	783.6	566.7	491.9	566.7	401	-43.1	17.2	-13.2	15.2	-29.1	-12.9
Construction	704.9	618.5	1457.1	1081.2	722.2	119	-12.3	135.6	-25.8	-33.2	-83.5	-22.1
Transport and communication	199.1	239.4	243.1	205.2	187.3	54	20.2	1.5	-15.6	-8.7	-71.1	-19.1
Trade and catering	241.0	217.9	311.6	331.9	253.0	43	-9.6	43.0	6.5	-23.8	-63.2	-11.4
Other mat. sphere branches	451.3	488.8	522.1	399.5	366.0	210	8.3	6.8	-23.5	-8.4	-42.6	-13.2
<b>NET MATERIAL PRODUCT TOTAL</b>	<b>6057.2</b>	<b>5901.9</b>	<b>6736.9</b>	<b>6164.2</b>	<b>5439.1</b>	<b>2725.29</b>	<b>-2.6</b>	<b>14.2</b>	<b>-8.5</b>	<b>-11.8</b>	<b>-49.9</b>	<b>-11.63</b>

Source: Department of Statistics, Yerevan 1992

### The output decline and its causes

4. Armenia's outstanding immediate problem is the severe fall in output. Set in motion by the progressive deterioration of Soviet production, trade and payment arrangements in the second half of the 1980s, real GDP started falling in 1987. Apart from a rebound in 1989 caused by the short-lived post earthquake construction boom, each year after 1986 has shown an accelerating decline<sup>1</sup>. Privatization of agricultural land, which began in 1991, produced a 15% surge in output in that sector in 1991.<sup>2</sup> However, the recovery in agriculture could not outweigh the decline in other sectors caused by the disruption of the former Soviet economy and aggravated by the factors noted in paragraphs 5-10 below.

1/ Shown also by the track of Net Material Product in Table 3.

2/ The output increase also included a response to changing relative prices, as there was a 30% increase in crop production and a decline in less profitable beef and pig farming, a promising sign of the eventual potential once the rest of the economy is on a private market basis.

5. Armenia lacks the foreign exchange for imported inputs that are essential to maintain production. Although the country exported the bulk of its exports to the FSU (99% in the first half of 1992), it obtained no less than a quarter of its imports from external sources, for which the central government used to supply the required hard currency. The proportion of dollar imports rose to from 16% in 1988 to 25% in 1990 when supplies of ruble imports were disrupted. It has since fallen to less than 1% in the first half of 1992. Thus the country enters the period of transformation with a built-in external trade deficit. Hard currency exports cannot be quickly expanded so as to finance external imports at the previous level, and possibilities for substituting ruble for external imports are small. *Hence, even in the absence of the blockade, imports would be severely constrained.* As 80% of imports in 1991 were capital goods and intermediate goods needed to sustain production (see Table 4), there are consequent further losses of future as well as current output.

Table 4. ARMENIA: Structural Features of Exports and Imports 1991

	Mill Rbbs 1991		Per cent of Total	
	Imports	Exports	Imports	Exports
<b>TOTAL</b>	5852	3732	100.0	100.0
of which:				
Inter-republican	4471	3612	76.4	96.8
of which:				
Industrial Goods <sup>1)</sup>	3627	990	62.0	26.5
Consumer Goods	843	2622	14.4	70.3
External	1381	119	23.6	3.2
of which:				
Industrial Goods <sup>1)</sup>	1067	14	18.2	0.4
Consumer Goods	314	104	5.4	2.8

Source: Department of Statistics, Yerevan and mission estimates

1) Including intermediate and capital goods

6. The decline in economic activity is aggravated by fiscal shortfalls which mean that the Government cannot finance public investment or industrial production at the same level as in the past. The output fall itself, together with defiscalization of enterprise profits and weak administration of new and unfamiliar taxes, has sent Government revenue from over 50% of GDP in 1989 to an estimated 18% in 1992. In an effort to keep the fiscal deficit to 4% of GDP in 1992, the Government has already eliminated almost all subsidies to enterprises and has cut public investment to the bone, *reducing future as well as current output*<sup>3</sup>.

7. A further aggravating factor is the credit crunch. Real money and credit have declined sharply in the wake of the surge in prices which started in the first quarter of 1991. A second surge occurred in the first quarter of 1992 with the liberalization of almost all prices and removal of margin controls. Real credit declined sharply in 1991 and contracted further in the first half of 1992, when inflation was estimated at over 600% and GDP in real terms was about half of the

<sup>3/</sup> Even so, the deficit target is unlikely to be reached, with a resulting buildup of arrears and continued reliance on borrowing from the central bank.

level in the first six months of 1991. Over the same period, credit to enterprises rose only 40% in nominal terms. Even when adjusted by estimates of the expansion of inter-enterprise credits, the credit crunch is severe (see chapter II and Annex 2).

8. Meanwhile, wage policy has not been accommodating. Unlike Russia, Armenia has succeeded in holding the growth of public sector wages and benefits far below the increase in prices. (Wages increased by just over 200% and prices by over 500% between June 1991 and June 1992). While this decline in real wages shows public solidarity with the reform process and is promising for future competitiveness, it also further lowers aggregate demand and contributes to the build up of stocks in the present. The Department of Economic Reform estimates that 80% of the expenditure of most households is now on food.

9. To these factors must be added the impact of the shock of change. Although Armenians had more contact than many other inhabitants of the FSU with foreign cultures and markets through family members of the diaspora, they are still profoundly shaken by the crumbling of the Soviet Union, the transformation of the economic operating environment, and the surge in uncertainty which has followed. Old systems are failing them and new systems are not yet workable. Banks, including the central bank, are just starting to experiment with new operating procedures; trading banks are not functioning in a commercial way; state owned enterprises exist in a limbo in which they can operate with substantial autonomy, free of both central controls and the disciplines of the market; the legal framework for contracts and employment relations is unclear and insecure; new relative price signals are swamped by the huge increase in the price level; infrastructure is deteriorating. The struggle for survival under these conditions results in declining output and especially investment, and in many cases produces perverse results in economic terms.

**Table 5. ARMENIA: Economic Indicators**

INDICATOR	PERCENTAGE CHANGE
Consumer Price Index: 1992 over 1991.	828.7
Price Index for services: 1992 over 1991.	1140.5
Consumer Price Index: On monthly rate of inflation during Aug'92	-2.2%
Price Index for services: August 1992.	+0.6%
Rail transport (tonnes) Jan-Aug 1992 in per cent of Jan-Aug 1991	22.8
Road transport (tonnes) Jan-Aug 1992 in per cent of Jan-Aug 1991	21.1
Air transport (tonnes) Jan-Aug 1992 in per cent of Jan-Aug 1991	79.2

Source: Department of Statistics, Yerevan, September 1992

10. Overshadowing all these problems is the blockade. During the winter of 1991/92, economic activities were heavily constrained by the transport blockade imposed by Azerbaijan and civil strife in Georgia, blocking Armenia's second major transport route. Lack of fuel and other imported inputs closed two-thirds of enterprises but, with the improvement of the situation in

Georgia, supply conditions eased somewhat from the middle of March 1992. However, railway bridges and other key installations in Georgia were blown up at irregular intervals and road transport through Georgia was often subject to attacks and looting, resulting in sharp frequent reductions in Armenian imports of fuel, food, raw materials and other inputs, and leading in turn to closures in a large number of state enterprises. Overall, during the first four months of 1992, road and rail transport fell to 18% and industrial production fell to 48% of the levels of the same period in 1991. These proportions recovered slightly by August 1992, as shown in Table 5. But by September 1992, industry was still operating at only 20% of capacity.

11. By November 1992, fuel reserves had been exhausted. The country's isolation worsened as Georgia came under pressure to extend the blockade on Armenia, though some supplies continued to get through. The gas pipeline was blown up repeatedly by saboteurs on the Georgian side of the border, further reducing Armenia's energy resources. A bleak situation was compounded by the harshest winter for 46 years, with temperatures between 0 and 5 degrees Fahrenheit until late February. Most homes were without heat, as the price of kerosene heaters and kerosene put them beyond the reach of all but a few families, and electricity was restricted to few hours per day. Trees in city parks and streets have been cut for firewood. Survey findings by the Centre for Disease Control, a United States agency, showed pre-famine conditions in December 1992, and widespread starvation was only averted by humanitarian grain shipments delivered through Georgia and Turkey. Even so, death rates were reported to have increased 30% for old age pensioners and 20% for children in January 1993 relative to the same month a year previously.

12. Industry was almost at a standstill. The Government used hydroelectricity to keep essential industries going: hospitals, bakeries, and a small number of key industries with export orders. In February 1993, the Minister of Finance estimated that about 700,000 people were effectively unemployed in industry in addition to the 60,000 officially registered as unemployed. Falling tax revenue meant that pensions and unemployment benefits could only be paid intermittently. Concerned about the spiral downwards of economic activity and tax revenue, and the effect on people of intense cold and lack of work, the Government raised the volumes of water flowing from Lake Sevan, the country's main water source, through the hydroelectric power stations in an effort to get industry back to work. By March 1993, the number of industries operating had increased from 3 to 34. However, even at maximum use, hydroelectricity can only supply a fraction of Armenia's energy needs; and use at this rate is not sustainable as water resources are being depleted faster than they can be replenished. And Lake Sevan is not normally considered as an available resource for these purposes given the need to restore lake levels for ecological reasons.

13. In order to get around the blockade, both public and private sectors have been exploring alternative trade routes for fuel, other imports, and exports. Some petroleum products have been flown in from Russia and small amounts come from Iran by truck, as well as unpredictable amounts through Georgia which are subject to a 25-30% transit tax. The Government plans to expand exports by air and to send some surface exports to Russia out through Iran and across the Caspian Sea. Armenia continues to have a high level of export orders from both inside and outside the FSU, and it appears that, without the blockade, the economy would be operating at a high level of activity. Under siege conditions, however, trade by means of the few available routes is limited and high cost, and domestic activity is correspondingly meagre. By the end of 1992, GDP had fallen to almost a third of its level in 1989.

**Future developments: three scenarios**

14. The path the economy takes in the next year and into the future is heavily dependent on prospects for lifting the blockade and the degree to which effective new FSU monetary, trade and payment systems can be established, together with the timing of these two crucial developments. There is no central tendency here: the alternatives and their consequences are clear-cut.

15. Prospects of peace and stability will also condition Armenia's ability to attract external financing and in particular funds for investment. The economy will be shaped, too, by the country's capacity to deal with the challenges of the transition to a market economy: the creation of a new framework of laws and property rights; development of the institutions and skills required by core government and by the private sector; and the ability to deal with the closures and other social and economic problems associated with the imperative to re-orient economic activity to the new set of relative prices and integrate Armenia into the world economy.

16. The following three scenarios trace the country's GDP path according to specific assumptions about the speed with which the first two constraints - the blockade and disruption in FSU systems - can be removed or alleviated. As far as policy commitment is concerned, experience so far indicates that the determination, if not always the capacity, exists to deal positively with the challenges of the transition. This factor is therefore held constant in each scenario. It is further assumed that the flow of investment funds will be contingent on success in lifting the two principal constraints. Variants of these scenarios could be constructed - for instance, with different degrees of success in policy design and implementation - but the three presented below probably represent the upper and lower bounds available together with a medium case, which has been taken as the base case for external financing projections. (See Attachment 1 on macroeconomic scenarios).

17. **Pessimistic scenario.** If the transport constraint is not removed before the mid 90s, enterprise activity will continue to be severely constrained by lack of energy and other inputs.<sup>4</sup> A siege economy will become entrenched, with consequent deterioration and loss of capital equipment. The economy will shift towards a subsistence basis, depending on domestic labor-intensive activities that require little capital, intermediate goods, or energy input.

See Figure 1.

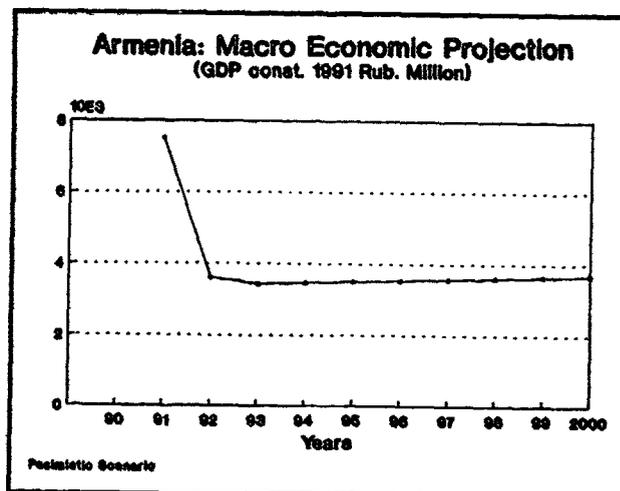


Figure 1

18. **Medium scenario.** The transport blockade is relieved in mid-1993, but trade and investment are hampered by further deterioration and disruption within the FSU, and continuing depreciation of the ruble. However Armenia starts to reorient its trade to the west, and foreign investment as the situation becomes more settled. A large proportion of existing capacity is restored to use, the situation stabilizes in the mid-90s, and the real growth rate is 5% the last few years of the decade. See Figure 2.

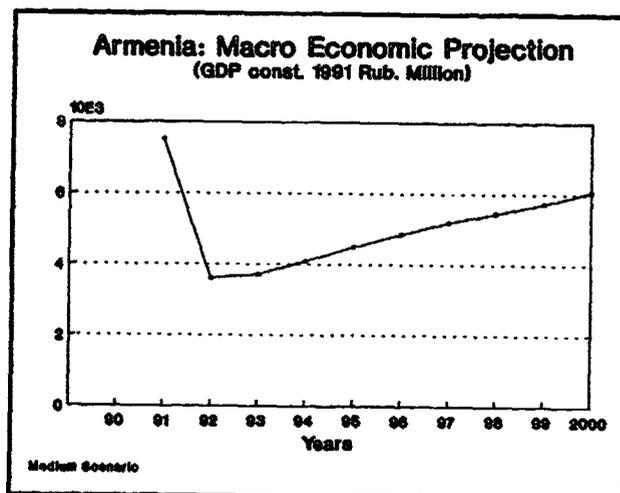


Figure 2

19. **Optimistic scenario.** The transport blockade is lifted in mid-1993, inter-republican trade and payments systems stabilize, and the ruble slide is halted<sup>5</sup>. This leads to a rapid upward shift in production in 1994 and 1995 as existing capacity is brought back into use. There is then some stowing in the rate of growth of aggregate activity from 1996 onwards while investment capital flows in, there are substantial changes in the composition of output and some degree of macroeconomic stabilization. From 1998 real growth occurs at between 7 and 8% per year, leading to a restoration of the 1989 level of output by the year 2000 (Figure 3).

4/ The construction of a gas pipeline through Iran would provide alternative energy supplies and, under the other scenarios, would also provide a much needed opportunity to close down hydro-electric power stations and restore the level of water resources. However, it has not been assumed for the purpose of this projection.

5/ Or Armenia successfully establishes its own currency.

20. The Government's performance so far indicates that it will do its utmost to relieve the constraints blocking the economy and release the economy on to a new growth path. However, some of the constraints are largely or wholly beyond its control; and even on optimistic assumptions, it will be a long haul before economic growth is restored and living standards begin to rise. These conditions will affect the way the reform program is designed and implemented.

21. In the near term, the reform program will vary depending on the speed with which the blockade can be lifted. For instance, it may be necessary to impose fuel rationing next winter to safeguard against hypothermia and ensure that a critical minimum of industry and agriculture can continue to operate. In the absence of a well-functioning central bank and financial sector, controls may need to be reimposed on State banks to ensure that credit is allocated to activities essential for survival (and to halt lending for unwanted inventory accumulation). Sectoral priorities are also likely to vary depending on the extent to which Armenia is battering down for survival or is able to expand trading and other opportunities in the near future. In all cases, however, the Government will need to design short-term stopgap measures in such a way as to minimize the cost to its longer term strategy and, where possible, to promote the changes required for its successful implementation.

22. It will also be important to communicate with the population, explain that the reform program is moving in the right direction, and look after people who are casualties during the transition. These issues are further addressed in chapter IV below.

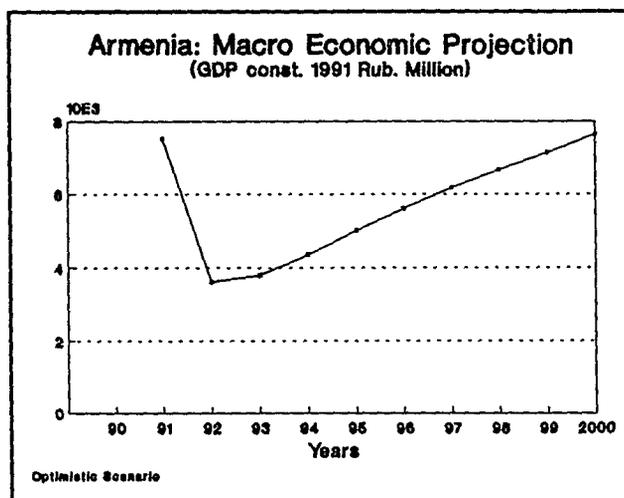


Figure 3

## CHAPTER II

### HALTING THE OUTPUT DECLINE WHILE PROMOTING MACROECONOMIC STABILITY

#### A Macroeconomic overview

23. The Government's highest priority is to avert a free fall in output while reasserting control over money and credit to the extent possible and running an effective fiscal policy so that Government arrears and claim on credit do not further destabilize the economy. In the longer run, it will need to restore aggregate demand in conditions of macroeconomic stability, which in turn will require institutions capable of exercising effective monetary and credit control and of performing expenditure and revenue functions in the framework of a Government budget linked to a view of the requirements of the macroeconomy. In due course, it will have to deal with issues of currency and exchange rate management.

24. The immediate challenge is to devise ways of slowing the output decline which will also contribute to the attainment of longer-term objectives. However, as explained in paragraphs 4-13 above, the output decline is provoked by a variety of causes, not all of which are under the Government's control. For instance, as a member of the ruble zone, Armenia does not have an independent monetary policy. In this context, what instruments does the Government have at its disposal? To what extent can it use fiscal, financial, trade and exchange rate policy? Issues and strategy for each instrument are reviewed below.

#### B Fiscal policy - the first priority

25. The fiscal collapse is disabling. It deserves the Government's immediate attention. Lack of revenue and a growing deficit undermine its capacity to maintain the reform program as a whole, provide income support during the transition, and create conditions for macroeconomic stability. Notwithstanding the deep cuts already made in expenditure and substantial efforts to raise revenue, the fiscal balance is not sustainable. The Government will need to redouble its efforts on the tax front and intensify the search for expenditure savings, while also watching closely over the composition of expenditure and its future budget implications. Even so, it will not be possible to achieve fiscal stability in the near future. The fiscal deficit will have to be

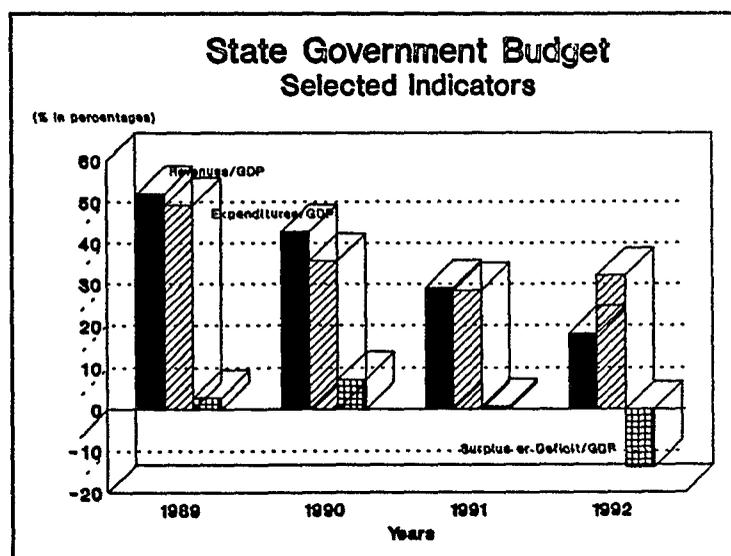


Figure 4

acknowledged as an initial by-product of reform and ways found of financing it in the least disruptive manner.

26. As in other FSU countries, the transition to a market economy is associated with a deteriorating fiscal position. Captive revenues from state economic activities have been eliminated in favor of a tax system which leaves a high proportion of previously fiscalized profits with enterprises, even though most remain in the state sector. Revenue declines are compounded by the fall in production and hence in profits and incomes, while claims on expenditure are growing, particularly for social reasons.

27. These common developments have been aggravated in Armenia by the loss of subventions from the Union budget and by extraordinary circumstances that further compress the tax base and generate the need for additional budget expenditures: (i) the 1988 earthquake which destroyed income-earning activities and created a massive need for reconstruction and social assistance; and (ii) expenditure on defence at the border with Azerbaijan and the supply of resources to the Armenians in Nagorno-Karabakh, which may amount to up to 5% of GDP; (iii) the need to assist about 260,000 refugees from Azerbaijan, combined with (iii) the severe constriction of economic activity resulting from the blockade of Armenia's normal trading routes.

28. In addition, Armenia moved too fast to a new tax system, losing the solid revenue earners of the turnover tax and the previous system of corporate taxation in favor of a VAT and a new corporate tax. The yield of the value added tax - introduced in January 1992 with little or no preparation - has been particularly poor, at 33% of expected collections at the end of FY92. Unfamiliarity with the new systems on the part of both tax inspectors and taxpayers, lack of training and computerized equipment, and general administrative weakness compound the loss of revenue due to the fall in output. Strengthening tax administration must be a high priority.

29. The Customs administration, too, deserves early attention. A Customs function hardly existed under the former regime. Now a new Customs administration must be built up

#### BOX 1 - TAX REFORMS

Armenia has introduced substantial tax reforms.

Under the new tax policy, personal income taxes on income from all sources have been equalized. A new four step personal income tax schedule has been introduced with a top rate of 30%. This harmonizes with the new rate of corporate income tax of 30%. The turnover tax has been abolished and replaced by a value added tax at 28% (the Russian rate) and an excise tax has also been introduced. Businesses pay a payroll tax of 30% into the Pension Fund to finance pensions and unemployment benefits. Future reforms envisaged include a move towards self-financing for local authorities from designated taxes together with set proportions for revenue-sharing between republican and local budgets. In the tax administration, there will be a shift in emphasis from taxpayer penalties to methods of encouraging compliance and better dissemination and management of information.

covering the new borders and replacing the defence and policing function on the old external borders with a service that facilitates the movement of people and goods, while collecting adequate levels of duty and tariff revenue (see also Volume II, Annex 1 on Trade Policy).

30. Reflecting all these factors, revenues fell from 50% of GDP in 1989 to 18% in 1992. Revenue in January 1993 was only 1.1 billion rubles. Expenditure, though sharply below its real 1990 and 1991 levels, was approximately 32% of GDP in FY92. The emergence of the large fiscal deficit in FY92 was financed through arrears and borrowing from the banking sector in the absence of monetary emission or bond financing. Arrears are currently estimated at 1.5 billion rubles. This points up the urgent need for greater revenue raising efforts, rationalization of income support, and further speedy but judicious cuts in expenditure, especially as the fiscal position is expected to deteriorate even further, for the reasons explained below. The Government is planning to introduce bonds to finance approximately half the deficit and will need to ensure that revenue is allocated to service bond interest due, to prevent any further erosion of confidence in financial instruments.

31. The gulf between taxable capacity and claims on expenditure will widen once large-scale layoffs occur. In February 1993, only 60,000 people were officially registered as unemployed, because firms are reluctant to retrench workers during what they consider temporary closures and because many highly qualified unemployed workers will not accept low-skill jobs, and cannot therefore register as unemployed. A more realistic estimate of the actual as opposed to the registered unemployment rate is in the region of 23% of the estimated 2 million labor force in FY92<sup>6</sup> due to labor shedding late in 1992 after seasonal peaks in employment and fuel shortages that have forced industrial closures. Another 30% approximately are being paid some proportion of their previous wage but are effectively without work.

32. The payroll tax is already inadequate to fund pensions and unemployment benefits (the Pension Fund is in large deficit and is being supplemented from general revenue) and the Government will need to decide soon *how to rationalize provision of benefits and allowances from dwindling revenue* (see chapter IV). In addition, it will need to allocate sufficient resources to gear up administrative capacity to deal with large numbers of job-seekers and promote training oriented to the demands of a private economy.

33. The consequences of present non-viable bank lending decisions are also likely to fall on the government budget in the future. The Government will face the need to recapitalize State banks and compensate at least some depositors. This consideration reinforces the need to introduce financial discipline in the public enterprise and banking sectors as soon as possible (see chapter III, section on Financial Sector and Annex 2).

### Revenue Raising

34. The Government now needs urgently to shore up the revenue position. In the short run, the public enterprise sector represents the best source of rapidly improved collections.

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<sup>6/</sup> This estimate does not include hidden unemployment, short time working and underemployment.

35. **Income taxes.** Wisely, the Government has brought down the top marginal rate on wages and salaries (previously 45%) into line with the marginal rate on enterprise profits (30%). This will reduce tax avoidance. Given the urgent need for revenue, the Government may now wish to consider raising this common rate to at least 35%. This would make the change approximately revenue neutral. The tax rate on banks (45%) should be brought into line with that on other enterprises. The authorities also need to restore collection rates from the enterprise sector to previous levels and, while the majority of enterprises remain unstructured and in the public sector, insist on dividend payments from those enterprises which are profitable. Withholding taxes should be introduced. The tax on wages and salaries should be extended to fringe benefits, income from self-employment (unincorporated businesses) and cash transfers (pensions, family allowances and unemployment benefits) unless these benefits are reduced and merged with comprehensive social assistance (see chapter IV).

36. **Taxes on imports.** Armenia should extend the VAT and excise taxes to imports from non-FSU countries.<sup>7</sup> It should also collect import duties on goods from non-FSU countries, either those imposed as part of a common external tariff or as part of its own tariff regime. Rather than seeking to undercut other FSU tariffs so as to promote transit trade at this stage, an external tariff of 15% (approximating the Russian tariff), or even higher, would be advisable given Armenia's urgent revenue needs. This could be reduced in stages to 5 or 10% in five years' time (see Trade Policy section for further discussion of this issue).

37. **Cost recovery.** Substantial if not full cost recovery should be introduced for maintenance of housing, communal services (heating, gas and water) and electricity. It will also be necessary to introduce metering (see chapter 5, Section D). This policy would promote conservation and facilitate privatization of housing (see chapter 4, Section C) as well as reduce net expenditures on these services. Full heating charges will have to be phased in, however. In present conditions, heating charges cannot credibly be raised to economic levels in one step if fuel for heating is not available, or alternatively, if the Government is not willing to cut off supply to delinquent payers when temperatures are below freezing point. It will be some time before real wages and salaries can cover economic charges for energy. It may be therefore advisable to adopt a household tariff with a low rate for an initial "survival" amount of energy, with charges rising substantially after that.

38. **Tax administration and compliance.** There is substantial scope for raising revenue through reinforcing tax administration and improving compliance. A first target should be the value added tax. Taxpayer education and advice on accounting requirements for VAT calculations are essential. Other high priorities to improve tax yields are the introduction of single taxpayer identification numbers, computerized accounts, random audits, training of inspectors and clear codification of taxpayer obligations.

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7/ At present, imports from the FSU are at tax-inclusive prices while external imports are not, creating a distortion according to source. The imposition of VAT on imports will also create an incentive to participate in the formal tax system in order to claim tax due. This should expand revenue collections overall even though taxes on inputs net out.

## Expenditure

39. **Consequences of budget tightness for expenditure.** Changes in the composition of budgetary expenditures are hard to determine as data are not yet available in economic or functional categories. Defence expenditures are shown as a line item in the 1992 budget for the first time, but this line understates the actual drain on resources - flowing through a number of ministries - occasioned by the conflict with Azerbaijan<sup>8</sup>. The Government estimates that the actual drain is not more than 5% of GDP and has offered to open its books on military expenditure to the Bank and the Fund.

40. It is clear that the drastic reduction in Government revenue has already been translated into a severe cut in expenditures on the national economy, reinforcing the fall in output. The Government estimates that 100 billion rubles would have been required in 1992 to keep public investment at 1991 levels; whereas 6 billion was allocated in the initial 1992 budget, cut further to 4 billion rubles at half-year. Investment priorities are water works for irrigation and to improve the supply of water for hydro-electricity, together with construction of alternative trade routes<sup>9</sup>. All budget-financed civil construction was halted in the second half of 1992 but a small amount of road construction continued with private grant finance. Subsidies to industry and social sector investment have been almost completely eliminated, but an effort is being made to maintain current expenditures on communal services for cities, health and education. The exhaustion of resources in the extra-budgetary funds for old age/unemployment and disability/sickness/ maternity will require changes in income support (see chapter IV).

41. To make further cuts, Government must now scrutinize the remaining claims on expenditure while maintaining the social safety net at least at subsistence level.

42. **Budget presentation.** Extra-budgetary funds will need to be integrated in the general budget so that government has a complete overview of all the allocative decisions to be taken. Exceptions to this principle are the Old Age/Invalidity Fund (for as long as it remains separately funded on social insurance principles), and revenues from privatization of public enterprises, which should be treated as capital account entries given their exceptional, non-recurrent nature.

43. The Government needs to reduce the opacity of public expenditure accounts, classifying them into analytically useful categories and computerizing them. This would permit policy makers to see where resources are going, and in particular, to track capital versus recurrent expenditures, various categories of wage and non-wage expenditures, ministerial budgets, and the sectoral allocation of public funds. It is also important to introduce a zero-based budgeting approach, questioning the purposes of all expenditures and reducing or eliminating lower priority activities. The efficiency of expenditure planning can be raised by introducing investment programming, coordination of external financing, and external debt management.

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<sup>8/</sup> Some part of the cost of the conflict is also borne by the diaspora and by Armenians in Nagorne - Karabakh.

<sup>9/</sup> Priorities are road and bridge construction on the road to Iran and improvement of facilities at the transit point at the Turkish border.

44. **New functions.** The Government is currently setting up coordination machinery within the Ministry of the Economy to deal with technical assistance. It will now be important to expand this capability so as to deal with project investment and policy-based borrowing as well as technical assistance, and to assure effective liaison with all multilateral and bilateral financing agencies. Project investment priorities will need to be based on a comprehensive medium-term public investment program that corresponds to sector development strategies and is placed within a macroeconomic framework. Implications for recurrent charges and maintenance expenditure on project investment and for the size and time profile of associated debt service will need to be analysed and incorporated into budget planning. Institution-building and technical assistance will need to be explicitly related to priorities developed within the Government's overall reform program, including the urgent need to generate additional revenue and rationalize social safety net expenditures.

45. **Inter-governmental relations.** There are three levels of government in Armenia: the central or republican government; a second level consisting of 21 cities and 37 regions; and a third level made up of city districts and villages and towns of the regions. The State budget covers all three, while the Republican budget covers the central government only. In the past these operated on a system of revenue-sharing, municipal rights to some tax revenue from enterprises in their areas, and contributions to the Republican and Union budgets. A substantial challenge will be posed to this system by the transfer of social service responsibilities from enterprises to central and/or local budgets. Rights and responsibilities of different levels of government need to be codified in the context of the new tax structure, with appropriate revenue assignments in the light of estimated expenditure requirements. The Government may wish to reserve the urban land and buildings tax for local authorities, rationalize the assignment of other taxes and develop principles for fiscal equalization.

### C Money, credit and prices

46. How are money and credit conditions affecting the economy? This is a complicated issue. Armenia relies for is in deficit on its correspondent account with Russia. Prices have increased rapidly over the last year, with the main surge occurring in the first four months of 1992 when retail prices increased by 642.5% compared to the first four months in 1991. The average rate of price increase in 1992 over 1991 was 828%, but the increase in the December quarter 1992 over the same quarter in 1991 was over 1218.5%. Information on the components of the retail price index shows that the rate of increase is still high for inter-republican exports but appears to have come down for domestic goods, while wages and benefits have increased much less rapidly<sup>10</sup>. Recent figures indicate that the retail price index actually declined in August when decreases in farm product prices outweighed increases in other prices.

47. A number of factors could help account for these disparate price developments, including the improved supply response in agriculture since land privatization, the continued monopsony of State buying organizations, and real wage discipline. But it seems probable that the divergence also reflects the extent to which price increases can be validated by money and by credit

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<sup>10/</sup> The minimum wage is 600 rubles per month as compared with 900 rubles per month in Russia, and average wages are below two-thirds of the Russian level.

growth, which in turn depends on whether the activity takes place in the cash or the credit economy (the two appear to be fairly rigidly segmented). This characteristic then influences the allocation of resources (also see chapter III, section D). Differential capacity to extract high prices for output is generating a split in the real economy, with worrying consequences. The cash ruble and the credit economy are considered in turn.

48. In the absence of control over its own currency issue, Armenia cannot control cash money stocks, depending on its correspondent account with Moscow for ruble issue. Fourteen billion rubles have been issued in 1992, over twice the initially agreed amount for 1992. However, soaring prices have created a decline in real money balances that is reinforced by lack of liquidity in the banking sector. Public distrust of banks has arisen since deposits in the Savings Bank (Sperbank) and the external trade bank were frozen in 1991, and real interest rates are negative (deposit rates are about 6%). There has been a consequent collapse in intermediation and an apparent increase in rubles held in the nonbank private sector.

#### BOX 2 - A REAL DEPRECIATION

Price developments in the second and third quarter of 1992 suggest that disinflationary pressures are at work in the domestic economy, restraining price increases for labor and domestic products, but that inflation is fuelled by rising import prices, driven ever higher as the ruble depreciates, by pricing in Russia and Ukraine, and also by Armenia's exercise of monopoly pricing for the commodities for which it is the sole supplier in the FSU (for instance, synthetic rubber, chemical fibre, electromotors, and some types of metal-cutting machines). In effect, Armenia is raising domestic competitiveness through a real depreciation, but remains vulnerable to ruble area monetary and price developments. Once the country is in a position to manage its own currency and run an independent macroeconomic policy, its ability to improve competitiveness under difficult conditions bodes well for its future as a successful trading nation.

49. To what extent is there an actual shortage of rubles? In the absence of positive real interest rates and any financial instrument which could inspire confidence, there is an incentive for individuals to hold rubles rather than bank them. (In parallel, enterprises are accumulating inventory to the extent permitted by the blockade rather than holding monetary and financial instruments). This suggests that the shortage of rubles may be confined to the formal economy and the banking sector. However, it is not clear to what extent the population is in a position to hold excess rubles, given that purchasing power has declined sharply for the great majority. Cash wages in the Government are heavily controlled and wages are subject to a tax-based incomes policy. And cash benefits have not only fallen sharply in real terms - over periods of several months at a time, they have not been paid at all. This indicates that real cash incomes in the formal economy are so low that there is little scope for accumulating rubles. However, there is an active black market and a growing private sector, albeit growing from a small base. The Government estimates that rubles held by the population may total 4bn. But until reliable monetary instruments are available, yielding positive real interest rates, it will not be possible to evaluate the extent of the population's cash holdings.

50. Although real credit has also declined sharply, the credit economy appears to be somewhat less constrained than the cash economy. At present, the financing needed to keep the bulk of economic activity going is supplied by a combination of bank credit and, more importantly, inter-enterprise credits. Inter-enterprise credits tripled in the first four months of 1992 and the stock of arrears represented 65% of outstanding bank loans<sup>11</sup>. Flows are likely to be much larger.

51. In a general clearance of enterprise arrears throughout the FSU between August and September 1992, around 11 billion net credit was extended in Armenia, of which about 6.5 billion rubles was domestic and 4.5 billion went to enterprises elsewhere in the FSU. Total domestic credit emission was estimated at 40 billion rubles in 1992. Additionally, Armenia received a technical credit from Russia of 20 billion rubles in 1992 to finance trade, and expects to receive a similar credit of 130 billion rubles in 1993.

52. Enterprises are also financing themselves by creating banks which then lend to their owners, a practice that is leading to a proliferation of new banks owned by ministries and enterprises. Capital requirements are low and prudential supervision almost non-existent. There is virtually no evaluation of risk, and banking sector liabilities now exceed assets. Because of the segmentation of the economy between credit and cash, and the cash shortage, lending is biased towards activities that generate cash in the short-term: trade in consumption goods sold in the domestic economy. However, the predominant influence on the composition of lending appears to be the maintenance of relationships formed under the previous enterprise trading system. These are dangerous developments.

53. It appears that the cash economy is subject to tighter monetary conditions than the credit economy but is responding better to the new relative price signals; credit is also short but tends to maintain the existing composition of SOE output, which permitted inventory accumulation estimated at 6 billion rubles in May 1992 (of which 4 billion had been accumulated during 1991). Since then, the tightening blockade has restricted activity largely to profitable enterprises with export orders, which may paradoxically have hastened adjustment. At the same time, both segments of the market are oriented to short-term returns in the absence of instruments and incentives that would promote intermediation and medium-term investment.

54. The risk is that the claim on resources of the enterprise credit economy, with its ability to earn higher prices and accumulate stocks, will undermine the emerging strength of the cash economy and its greater competitiveness and allocative efficiency. This dangerous development underlines the high priority of financial and enterprise reforms.

55. The Government's strategy in this context must be twofold. First, it must seek to re-establish public confidence in the banking system. There must be cautious and progressive release of frozen Sperbank deposits; the Government must accelerate the development of the National Bank of Armenia (NBA) into a central bank capable of performing normal functions, including prudential supervision, and introduce capital requirements high enough to discourage the proliferation of under-capitalized banks and force mergers that will create banks with a higher probability of survival. Movement towards positive real interest rates must continue (though this will lead in the short term to

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<sup>11/</sup> Armenia followed Russia in clearing enterprise arrears in August 1992.

higher claims on credit and ultimately on the government budget). The NBA must also arrange the launching of training programs in central bank functions, accounting, loan evaluation and portfolio assessment<sup>12</sup>.

56. Second, it must deal with the mushrooming inter-enterprise credit system which lies outside normal money and credit channels. This will form an important part of enterprise and financial reform<sup>13</sup>.

#### **D Balance of payments, exchange rate and currency option**

57. Armenia clearly faces a problem of current account sustainability, with a structure of trade inherited from the Soviet regime that generates large external deficits. Previously this feature was accepted as a by-product of the chosen strategy. Now there is no immediate prospect that deficits of this order could be financed by corresponding capital inflows. Foreign financing is urgently needed to sustain a level of imports that could halt and help turn around the output decline but may take time to materialize given the lack of macroeconomic stability and high level of uncertainty about immediate prospects. In the short run, export promotion is required but is hampered by the difficulty of ensuring continued supply. Trade policy can help (see next section). Exchange rate policy is the only other instrument potentially available but its use would require radical decisions which Armenia is not yet willing nor well prepared to take.

58. Before the earthquake of 1988, Armenia was normally in balance or ran a surplus on inter-republican trade. It was not able to sustain this performance after the destruction of capacity due to the earthquake but the resulting deficits were not large. The inter-republican trade deficit in the first half of 1992 was 3131 million current rubles which represented only 31% of its imports from the FSU area<sup>14</sup>.

#### Terms of trade effect

59. Inter-republican trade. For Armenia, the internal (FSU) terms of trade effect is dominated by the oil price rise, which is now close to world market levels. In the first quarter of 1993, Russia was charging the market price but converting it at an exchange rate of 420 rubles to the dollar, as opposed to the 620 rate then prevailing, which resulted in a one-third subsidy. (Avg. price of petroleum for 9 months in FY92 was paying 4670 rubles per ton for gasoline - See annex 7 for more details on energy prices). However, Armenia has a monopoly in some industrial and strategic products for FSU markets whose prices have risen disproportionately, such as synthetic rubber and chemical engineering products (see section on enterprise reform for price increases), which is moderating the adverse intra-FSU terms of trade movement.

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12/ See section below on Financial Sector.

13/ See Enterprise Reform section below.

14/ Department of Statistics, Armenia.

60. Analysis of the impact of converting inter-republican trade to world prices (Tarr, 1992) indicates that the terms of trade would have fallen 31.4% and the revalued deficit for 1990 would have been considerably larger than 80.3 million rubles, mainly because of Armenia's resource-dependence<sup>15</sup>. Tarr estimates that GDP would have fallen 11.6% in 1990 and 8.3% in 1989 had the terms of trade reflected world prices. In the event, other constraints on output proved more significant and FSU monopoly pricing has not yet been eroded. However, as relative prices converge on world prices, (and in particular, as oil prices continue to rise) the terms of trade will deteriorate further. Armenia can expect to face a worsening balance of payments deficit on FSU trade (if past patterns of trade continue) which will translate into debt obligations to the rest of the FSU. It is already in debt to Turkmenistan for gas imports.

61. External trade. External export prices have risen more than import prices: Tarr calculates a 52.3% improvement in Armenia's terms of trade on 1990 data and a 77.1% improvement using 1989 data. But the benefit of this positive terms of trade movement diminishes sharply when weighted by external trade volumes in those years, yielding potential increases in GDP of 3.4% and 4.7% respectively. In actuality, the absence of foreign exchange meant that little advantage could be taken of the relatively lower price of imports. External trade in total has shrunk considerably (see Trade Policy section).

62. The balance of payments as well as the budgetary balance has suffered a severe blow from the termination of Union subventions. For instance, in 1991, US\$ 166.7 million was transferred from the Union Budget (see table 6).

63. Debt. Armenia is a member of the Inter-republican Debt Management Agreement signed March 1992 and its share of the former Soviet Union's external debt was US\$ 561.6 million, or 0.86% of the total. However, it appears that Armenia has now signed the zero option whereby it has no further obligation to service old FSU debt, in return for renouncing all claims on FSU assets. As an independent republic, Armenia has incurred five loans so far. Two ruble loans of 400 and 500 million were received from Russia in 1991 and 1992, respectively, for earthquake reconstruction. Other loans include a 38 million ECU loan from the EEC for grain imports, a 30 million yuan loan from China for agricultural imports and a US\$ 0.59 million loan from the Netherlands. A \$60 million EBRD loan for the energy sector is expected to be approved in 1993. Food aid has also been arranged in 1992 but on a grant basis. This modest degree of external debt may increase, however, if the Armenian Government has to assume responsibility for substantial government-guaranteed inter-enterprise debts to other republics in the event of enterprise bankruptcies.

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15/ An analysis of Soviet interrepublic trade done by Brown and Belkindas shows that while domestic prices overvalued both Armenian exports and imports, exports were more overvalued so that the terms of trade shift from a move to world market prices is negative. PlanEcon reports that in 1988, Armenia's interrepublican trade deficit was 1120 million rubles in domestic prices and 1400 million rubles in world prices.

### External financing needs

64. Estimation of future balance of payments financing needs depends on the extent to which trade is restored to previous levels and composition. As noted above, Armenia inherits a structural current account deficit imposed by the Soviet-assigned structure of production and trade. In the last 12-18 months this deficit persisted even though trade was severely constrained by the blockade, and it will increase again once trade flows recover. In addition, according to the Armenian authorities, externally financed imports were at unusually high levels in 1991 because there was a surge of foreign financed imports for humanitarian and relief purposes. This produced a sudden divergence from trend in dollar imports. A return towards trend in these imports is assumed for 1993 and 1994, however, as humanitarian relief efforts subside.

65. The medium scenario has been assumed for the purpose of calculating future external financing needs. According to this scenario, the decline in GDP would be halted during 1994 and GDP growth would recover in the mid-90s as existing capacity was restored, stabilizing at 5% in the last two years of the decade. Under this scenario it is assumed that exports grow strongly and that the proportion of external exports will rise steadily, while imports are assumed to grow at 6% per year in 1995 after initial large increases in energy prices and volumes and as capacity is brought back into operation during 1993 and 1994. The trade deficit jumps sharply as oil prices move to market levels and as energy requirements increase (though the energy intensity of the economy declines). After this initial dramatic worsening, the trade deficit narrows gradually as export earnings begin to overtake import requirements. Armenia clearly needs some degree of concessional financing in these early years if it is not to accumulate an unsustainable debt burden that would compromise future growth prospects; - growth prospects that are otherwise promising once the massive oil price adjustments of the next two to three years are over and as structural adjustment progresses in the economy as a whole. In order to keep the debt service ratio at or below 20%, the average grant element of external resource inflows in the coming three to four years would need to be at least 70%, declining to 25% during the second half of the decade. In order to achieve this financing profile it is assumed that a stabilization program is put in place by mid-1993 and that Armenia obtains a blend of financing, with the mix weighted heavily towards highly concessional financing (i.e. on grant terms or on terms equivalent to IDA) during 1993-96. Armenia would need to seek this blend from a combination of bilateral and multilateral sources so as to provide adequate financial support in these crucial early years. On these assumptions, the debt service ratio could be kept within manageable limits.

**TABLE 6. ARMENIA: Balance of Payments Summary at Current Prices**  
(In millions of current US dollars)

	1991	1992	1993
Exports	3731.6	353.5	424.0
FSU	3645.4	321.0	340.0
External	86.2	32.5	84.0
Imports	4768.4	421.6	627.0
FSU	4331.6	344.5	302.0
of which Energy	428.1	84.5	205.0
External	436.8	77.1	120.0
Resource Balance	-1036.8	-68.1	-203.0
Net Services	-401.0	-31.6	-157.0
Total interest Due	0.0	0.0	4.0
Net current transfers	518.6	2.1	120.0
Curr. A/C Balance	-919.2	-97.6	-240
Errors and omissions	919.2	56.4	..
Overall Balance	..	75.8	-258.1
Financing	..	19.4	107.4
Changes in net reserves of NBA	..	-21.8	17.5
Financing Gap	..	0	-150.7

Source: Armenian authorities and staff estimates

### Currency option

66. The authorities recognize that, unless Russia stabilizes, macroeconomic stabilization will be difficult if not impossible while Armenia remains in the ruble area. Although domestic price inflation is decelerating rapidly, FSU import prices rise continually and the country is also plagued by the vagaries of a ruble issue over which it has little control. The decision to leave the area will be hard to take, however, for the following three reasons.

67. For oil imports, Armenia still relies largely on Russian petroleum products at below world market prices (see Table 6 above). It is also highly dependent on Moscow for access to trade credit, without which the fall in output would become even more catastrophic. And it does not want to lose Russian security guarantees.

68. The relative significance of these factors will change with time, and it is possible that the authorities may launch their own currency at some point in the next year or so. In the meantime, it will be important to prepare for this eventuality by developing the capacity to manage a currency: in particular, capacity to control the money supply and the fiscal deficit. Armenia has no previous experience with central banking and it will take time to develop the required expertise, together with the preparedness to enforce banking standards and, in due course, use positive real interest rates to

control monetary and credit growth in the system. Nor is the machinery yet in place to permit reliable revenue raising and expenditure programming and control in the context of a unified budget. Development of this macroeconomic policy capacity will be needed in any case, as well as being a prerequisite for launching a new currency.

69. It will also be helpful to build up reserves to permit stabilization of the new currency once it is issued. At present, Armenia's reserves are low (though some may be held offshore). Before introducing its own currency, the Government will also want to look for commitments of external stabilization support to reduce the risk that it would lose its reserves and then be overtaken by a cycle of depreciation and inflation.

## **E Trade policy**

70. Armenia is a trading nation and will remain so. However, it is starting its existence as an independent republic severely constrained by the trade blockade and confronted by the need to deal with the large external and FSU trade deficits it has inherited from the Soviet structure of production and trade. As noted in para 5 above, hard currency earnings are minimal while about 25% of imports were in hard currency which the central government used to supply. This proportion fell to 10% under the blockade. The country's heavy dependence on trade, and external imports in particular, makes it imperative to address this situation in the near term in a way that will promote exports, especially in hard currency.

71. The great bulk of trade is with the FSU. Over 96% of exports have been to FSU countries, rising to 99% in the first half of 1992, and FSU trade represents 47.2% of production. Of Armenia's trade within the FSU, Russia accounts for 60%, Ukraine for 20% and Kazakhstan, Turkmenistan and Belarus together for 15%. Turkmenistan is particularly important to Armenia as a supplier of natural gas - now imported through Georgia, previously through Azerbaijan - and Russia supplies oil.

72. In the future, however, it is probable that inter-republican trade will be lower than it was in the past. A number of republics will find that it is economic to source externally or to substitute domestic supplies for some ruble imports, especially once energy prices reach world levels. This will also reduce the transport content - and hence oil dependence - of their production and consumption. Relative prices have changed and will continue to do so as oil prices rise and the exchange rate evolves also. Armenia's exports will decline in physical volume but values are likely to increase, as the country exports more of the high tech, low bulk goods in which it has an advantage. At the same time, the share of trade with countries outside the FSU will rise. Thus the pattern of trade is bound to change. And Armenia sees its trading future in integration in the world economy. *The challenge is therefore how to wean itself from present uneconomic patterns of FSU trade without provoking a catastrophic fall in the trade now required for survival, while also providing the policy and incentive framework needed to generate an efficient pattern of future trade in external as well as FSU markets.* External markets are particularly important given the dependence of activity on hard currency imports; however, it would be hard to do without FSU trade in the short-term as it supplies Armenia's fuel imports and some essential foodstuffs.

73. Both external and FSU trade has shrunk sharply. The volume of trade by cross-border rail transport declined dramatically between 1990 and 1991 and in 1991 was only half the planned volume. Total road and rail transport in January-April 1992 declined further to a mere 18% of that in the same period of 1991. These figures reflect Armenia's dependence on its neighbors for access: Azerbaijan was the trade route for 85% and Georgia for 15% of ruble trade, which highlights the importance of normalizing relations with and in these republics.

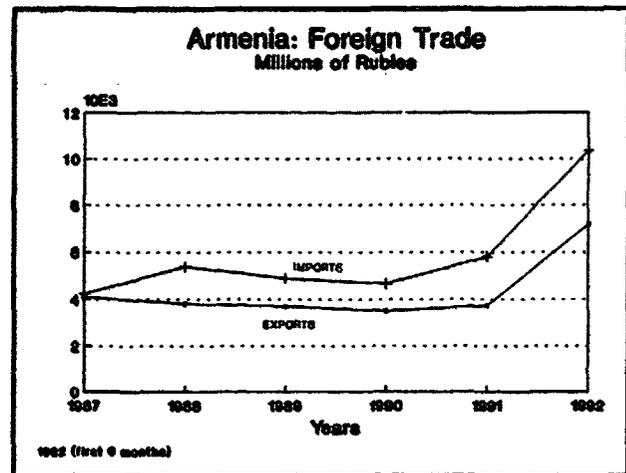


Figure 5

#### Trade: moving away from the Soviet system

74. In the next 18 months, Armenia cannot afford to relinquish the inter-republican trade that remains. However, the Government needs to develop clear policy on trade with FSU countries, given the high level of interdependence at present. It will need to decide how to handle the state order system and what tariff policy and indirect tax system to adopt for both external and FSU trade. At the same time it will need to encourage and facilitate re-orientation of trade to external markets. The objective of expanding hard currency exports will also need to guide Armenia's near-term actions in reforming its financial and enterprise sectors.

75. At present, FSU trade is largely dominated by the system of state orders and inter-republican trade protocols. State orders incorporate production and export quotas, accounting for just over 50% of Armenia's domestic production (sharply down from two years ago). In the past the state agreed to provide inputs for the production it undertook to purchase, but this system is breaking down, leaving the enterprises to fend for themselves. The consequent forging of enterprise-to-enterprise links is a positive development in the current situation.

76. Trade protocols in current use specify the volume and nature of goods to be bartered but do not specify prices, so enterprises are now able to negotiate prices and are also responsible for the delivery of barter goods to other FSU countries. This also promotes inter-enterprise links.

77. The Government should progressively move away from the state order system. During the next 18 months it should eliminate state orders and trade protocols except for fuel and other essential inputs and for food imports in cases where this suits its major suppliers (Russia, Ukraine, and Turkmenistan). These transactions would normally be settled in rubles but, depending on the requirements of the exporting country, Armenia may have to accept some barter trade in the near term. State orders would then be limited to products requested by these countries in exchange for fuel and foodstuffs.

78. However, retention of the old system at the country-to-country procurement level does not prevent liberalization of the domestic transactions related to state orders as a way of preparing the

**BOX 3 - COMPARATIVE ADVANTAGE**

Armenia's ability to remain a trading nation depends primarily on stability in the region. However, its geographic position will be an asset in time of peace, and it should develop new patterns of trade and commerce as rapidly as possible that correspond with its comparative advantage. At this stage, its advantages appear to be:

- a well-trained and well-educated labor force;
- agricultural resources for brandy, wine and specialty fruits;
- a range of non-ferrous metals such as copper, molybdenum, zinc and other ores that are likely to be valuable at world prices;
- high-technology equipment and trained personnel in lasers, optics, electronics, and semi-conductors, that could lead to the development of high-value, small bulk exports to niche markets;
- potential for development as a center for light industrial goods and the provision of trade and financial services in the region.

ground for full-scale competition in the future. The Government has already moved to a system whereby goods purchased under state orders are auctioned, and suppliers are invited to submit bids in open competition to fulfill orders. It should be possible to privatize transport and distribution of these goods on the domestic market in the near future. Enterprises will continue to expand their ties and be responsible for negotiating prices and deliveries.

79. The approach just outlined promotes private markets while cushioning the decline in output and trade; however, it will be limited in its effectiveness while high degrees of concentration remain in industry (see chapter III section E).

80. Armenia will need to choose its trade regime. It is probably not in the country's interest to adopt a completely independent trade policy with its own tariffs, as Armenia would then face positive tariff rates in FSU countries. Especially in the early stages of the transition, it is not clear that Armenia could compete with third countries in FSU markets without the benefit of preferential access. At a time of rapid change in the enterprises' environment, with traditional links disappearing before new ones are forged, it will be advisable to retain preferential access to FSU markets. At present, FSU imports enter free of tariffs, and Armenian goods transit through Russia and Georgia free of customs duties<sup>16</sup>. As far as external imports are concerned, the 1981 Customs tariff of the FSU remains in force, with some ad hoc amendments, while Armenia considers what tariff to impose on imports from external sources.

81. The alternatives for trade with other FSU countries are a customs union or a free trade area. The risk with a customs union is that Armenia would have little influence over the levels and variance of rates, both of which could turn out too high. On the other hand, if Armenia decides

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<sup>16/</sup> There is a multilateral agreement on transit trade signed in Alma Ata which includes Russia but not Georgia but a bilateral trade agreement with Georgia is planned in the near future.

to join a free trade area and pursues a tariff policy which is independent of the other republics, and lower than theirs, it will also confront problems. Trade between Armenia and Russia, its major trading partner, is likely to equalize prices and - given the relative size of the two economies - probably at Russia's level rather than Armenia's. This means Armenian consumers would face higher prices anyway, but the Government would have foregone potential tariff revenues, effectively transferring them to Russian and Armenian traders.

82. Armenia will have to explore these issues and the preferences of its FSU trading partners. In the meantime, given its interest in expanding external trade, it would make sense to aim for low and uniform tariffs in the medium-term, while accepting that there may be a need for moderate tariffs, (preferably at a 15-20% level) to protect domestic and FSU countries from competition in a transitional period. Without this initial degree of protection, the pressure to introduce quantitative restrictions could prove extremely high. A higher initial tariff would also help to supply much-needed revenue in the interim before effective collection systems are established for direct corporate and personal taxation. However, it would be important to state from the outset that the aim was to reduce rates to a 5-10% level in the medium-term and to announce, and stick to, a staged program to reach that target.

83. Armenia will also need to rationalize the application of VAT and excise taxes. At present, Armenia, like other FSU countries, applies VAT on the origin principle<sup>17</sup>. As a result, it subjects its own exports to VAT while allowing imports from outside the FSU to enter free of VAT. These imports, to the extent that they come from countries which impose tax on the destination principle, are already VAT-exempt. This arrangement distorts relative prices and has a perverse effect on industrial incentives, as domestic production and FSU imports are sold at VAT-inclusive prices. Hence domestic production faces negative protection, and intra-FSU trade is discouraged at the time when it is most needed. Exemptions from VAT reinforce this bias.

84. The treatment of exports for VAT purposes is complicated in this situation because zero-rating of exports (which is preferable to exemption so that all previous taxes can be reimbursed) would result in a net outflow for the Armenian treasury. At least in the near term, a reasonable compromise would be to zero-rate exports but reimburse only those taxes collected by the Armenian Government. The Government would also need to ensure that the rebate was being provided only for external exports and not exports to other FSU countries. At the same time, it should apply VAT and excise duties on imports from outside the FSU to provide neutral treatment of all goods. In the longer run, it will wish to consider moving to a destination system

85. The Government has lifted most export-import and foreign exchange regulations and taxes but a few remain to be tackled. The Government has removed export taxes and the "valuta" tax and now permits 100% retention of foreign exchange. (This last measure has attracted some exports in transit through Armenia from other republics, even under current adverse conditions). Banks with foreign exchange licenses are entitled to hold foreign exchange balances in foreign banks, and a number of enterprises are also doing this. In May 1992, a law was adopted extending the right to open foreign exchange accounts to all residents. Export licenses have largely been removed but still

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<sup>17/</sup> VAT is collected in producing countries; it is not levied on imports, and taxes paid on inputs are deductible even when paid in another CIS country.

remain on 56 products, and no import licenses are required except for health and safety reasons. Enterprises have legal access to foreign exchange for their foreign trade transactions without going through the central bank, but are still hampered by the freezing of accounts in Vneshekonombank-Moscow (VEB). One result of foreign exchange liberalization is that the central bank has difficulty in accumulating reserves in foreign currencies.

86. Effective institutional underpinning will be required if Armenia is successfully to become a diversified and open trading nation. This calls for an agency, not necessarily within Government, to provide information on markets and help establish trading contacts, and also a well-functioning Customs Department.

87. The dissolution of the former Soviet Union has rendered obsolete the previous Customs organization, which reported to Moscow and which functioned at only a few points along a fortified border with Iran and Turkey. The Russian Army still supplies some border guards for defense purposes under the FSU defense agreement. The Armenian Customs points in Yerevan, Gumri and Megri are vestigial and do not function effectively. As well as facilitating trade, the Customs organization will also need to serve a statistical function, monitoring and reporting on export and import volumes and values, and should provide space for the agricultural import inspectorate<sup>18</sup>. The Customs Department has little capacity as yet to perform these functions. Created only in January 1992, it is independent from the Tax Department and the Ministry of Finance, reporting directly to the Prime Minister. Until recently, no record was kept of FSU imports, but an import declaration form has now been introduced for both external and FSU trade. Considerable effort will have to be put into building up a Customs function that facilitates the movement of people and goods, while collecting information and adequate levels of duty and tariff revenue.

88. New trade routes will also have to be developed. Armenia has already signed an agreement with Iran to create an Armenian zone in two Iranian ports (one on the Caspian Sea and one on the Persian Gulf) and is planning to sign an agreement with Georgia to have an Armenian zone at the port of Poti on the Black Sea. To the extent possible in current conditions, Armenia is importing crude oil to the refinery at Batumi in Georgia and taking refined products across Georgia. It is seeking to diversify energy supply further by expanding access from Iran, and is exploring the possibility of constructing a natural gas pipeline from Iran which would lessen Armenia's dependence on FSU sources. Armenia also needs to expand the small volume of trade now going through Turkey, which provides access both to the Black Sea and the Mediterranean.

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<sup>18/</sup> Armenia is vulnerable to the importation of plant and animal diseases and recently exhausted stocks of its most useful pesticide eradicating a potato disease imported from Belarus.

## **CHAPTER III**

### **ARMENIA NEEDS TO PROVIDE AN ENABLING ENVIRONMENT FOR ITS GROWING PRIVATE SECTOR**

89. The Government is committed to creating favorable conditions for a financially and economically sound private sector. Despite considerable progress away from the Soviet framework of activity in the eighteen months since Independence, pressing problems remain which must be tackled if the reform effort is not to falter.

#### **A Price liberalization**

90. Substantial progress has already been made with price liberalization - an essential prerequisite for the development of private markets. Decontrol of administered prices started with several rounds of price reform from April 1991 onwards. The great majority of administered prices were then abolished in the great wave of price liberalization in January 1992. Further decontrol in June 1992 left only bread, transportation and utilities controlled and salt under profit margin control<sup>19</sup>. Controls on distribution margins have been removed.

91. The surge in prices that followed liberalization has muffled the new relative price signals but these signals should increasingly emerge as prices continue to decelerate. The prevalence of monopoly in industrial activity, however, will be a worrying influence on prices until more competitive conditions have been established. Trade and foreign exchange liberalization will help in this regard, but attention will also need to be paid to breaking up concentrations of economic power.

#### **B Legal framework**

92. Armenia is well launched on the project of developing the legal environment necessary for a fully functioning market economy. Privatization of agricultural land began under the Land Reform Law effective February 1991 and privatization of small businesses started under Presidential decree in June 1991. The property law enacted in October 1991 provides a legal basis for companies and a commercial code. Equal treatment of public and private enterprises is provided in retail trade, production, taxation, banking, importing and exporting. All legal restrictions on private entry and competition in wholesale trade have been removed.

93. The most significant development since the company law<sup>20</sup> was the passage of the enterprise privatization law in July, 1992<sup>21</sup>. This law covers Armenia's remaining small units not already sold under the presidential decree of June 1991, most of its 700 larger firms (defined as those with more than 25 employees in trade or 50 employees in manufacturing), and 4000 unfinished construction sites. The law provides for a program to be developed every year, spelling out which enterprises will be privatized or "de-statized" under leases, management contracts or joint ventures,

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19/ Salt remains under control because it is a domestic monopoly.

20/ Law on Enterprises and Entrepreneurial Activity adopted March 14, 1991.

21/ Law on Privatization and Denationalization of State Enterprises adopted July 29, 1992.

and how the proceeds will be used. It places no restrictions on foreign investors (although quick enactment of the draft law on foreign investment is needed to help Armenia attract foreign buyers).

94. Draft legislation on foreign investment and licensing of exports and other economic activity, anti-monopoly (including provision for an anti-monopoly agency) and bankruptcy, has been developed and is being debated by the Parliament. The legislation to set up the National Bank of Armenia as a central bank and to govern the financial sector has been drafted and is under discussion. It will also be important to prepare a law on collateral, and to clarify social, health and safety, and environmental law affecting the private sector, especially as uncertainty about their future responsibilities could inhibit foreign investors.

95. The legal framework for markets must also include land markets for agriculture, industrial enterprises, and distribution. In agricultural areas, land registration offices and cadastral surveys are required immediately to facilitate the establishment of a market where buyers and sellers can meet and trade title to land. Regional governments should establish the value of land for tax purposes, using available land information and market values for land as they develop. The Government plans to eliminate the three year waiting period before land sales are permitted and should do so without delay. Development of the land market will permit commercial banks to accept land as collateral for investment and working capital loans and hence provide an essential element in the development of market based agriculture. As long as reliable leasing arrangements are available, land markets are less urgently needed in industry and distribution. For this, however, facilities for registering leases and other contracts must be provided. See also Annex 5 on the legal framework.

96. Early attention needs to be paid to the development of effective regulatory and monitoring capacity and a well-functioning judicial system. There is a risk that Armenia may construct a full legal framework which will be a dead letter in the absence of the means for its implementation. Supporting regulations will be required, and staff trained to monitor and enforce requirements; while a court system including specialized commercial courts will be needed to defend individual and company rights and enforce contract obligations.

### **C Lifting constraints on private sector activity**

97. **Licensing.** The Government is lightening licensing requirements and would do well to go further and switch to a system of certification for most activities. This would lift restrictions on entry while still requiring that standard safety and hygiene requirements had to be met. In parallel, ministries should develop separate units with capacity to monitor and certify standards in both public and private enterprises in their sphere.

98. **Registration.** The time taken to register new businesses has already declined sharply but the process remains unnecessarily heavy, given that all business activities are now legal unless expressly forbidden. Businesses could simply be required to submit documentation to the municipality or to a company register for information purposes, and regard themselves as registered unless notified otherwise within thirty days.

99. **Access to municipal space.** Privatization of central government and municipal enterprises will eventually free space for commercial use. In the meantime, measures are needed to

ensure that municipalities make space available for lease or rent and that rents do not discriminate according to the type of business activity.

100. **One-stop shop.** In order to smooth the way and lower transactions costs for private investors and, in particular, foreign investors, it would be useful to have a "one-stop shop" or agency supplying information on all requirements for carrying on a business in Armenia and where all application and registration procedures could take place. The agency would be responsible for liaison with the relevant Ministries but would not necessarily need to be within Government: it could be run by a Chamber of Commerce.

#### **D Progress with privatization**

101. Ownership and production have already moved to a private sector basis in the agriculture sector and are moving increasingly in that direction in retail trade and distribution. Rapid privatization of distribution is both feasible and desirable to facilitate the expansion of activity in the agricultural and industrial sectors. A high priority must also be the privatization of agricultural inputs and services. However, as in other CEEC countries, privatization of the enterprise sector will be complex and time-consuming. This issue is explored in Section E below.

102. Armenia has already made progress in liberalizing distribution. Until recently, internal commerce in Armenia was dominated by the Ministry of Trade which directed a network of wholesale and retail trading organizations and shops for manufactured goods and for food. Public enterprises and municipalities also ran shops. Retailers now contract directly with producers or wholesalers for their inputs, and enterprises can sell any goods not under state order to shops directly or to the Ministry's wholesalers. Several thousand state shops and restaurants are now independent accounting and management entities.

103. However, sales have been proceeding slowly, partly because they were viewed as an experiment prior to the passage of the privatization law and partly because of public fear that assets will fall into the hands of criminals and/or the previous nomenklatura. The Privatization Law enacted on July 29, 1992, addresses some of the public's concerns about the privatization by placing it in the context of a system of vouchers<sup>22</sup> and limited employee benefits. If government capacity to handle privatization is strengthened, it should be feasible to sell the retail distribution network in two years: the institutions already exist and the early experience has provided valuable training. Wholesale distribution, freight handling and trucking could become bottlenecks unless they too are rapidly sold. Here it could be wise to seek foreign investors who may be interested in purchasing a wholesale company and helping to modernize this critical area of the economy.

104. Meanwhile the Ministry of Trade is being converted into a ordinary ministry supported by the budget, instead of by the funds captured from its shops. Falling availability of budget funds will supply its own spur to speed the process of privatization.

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<sup>22/</sup> See Annex 4, Section 3: The Voucher System.

### Next steps

105. Further improvements in the capacity for supply response are now needed to allow price signals to be translated into effective and efficient allocative decisions. Two factors in particular impede the development of a well-functioning private sector: the continuing dominance of the state industrial enterprise sector, largely untackled as yet; and the highly precarious and shrinking financial sector, discussed below.

106. While the Government has already gone a long way to hardening the budget constraint on SOEs by withdrawing subsidies, the impact on these enterprises has been diluted in many cases by their ability to charge monopoly prices and avoid taxation. The rapid growth of inter-enterprise credit and to a lesser extent, bank credit, both frequently extended without regard to financial risk, has also insulated many enterprises from the budget constraint. The issues of enterprise and financial sector reform are thus closely linked and will for that reason have to be developed in tandem. They are discussed in turn below. Private sector development is discussed in more detail in Annex 4.

### **E Enterprise reform: the industrial sector**

107. Reforming the industrial enterprise sector presents perhaps the biggest challenge that the Government faces. The Government wishes to develop a mixed economy in which most enterprises are in private hands. This requires action at several levels. The authorities need to establish a legal and operating environment based on property rights and freedom of contract, while also ensuring an open trade and competition policy and promoting the development of sound financial markets and institutions providing a range of instruments and services. At the enterprise level, the objective is improved allocative, managerial and technical efficiency. In the majority of cases, this will mean privatization leading to the establishment of competitive firms. This will involve not only the transfer of ownership but also measures designed to improve corporate governance and action to deal with monopolistic structures. The Government will also want to ensure efficient management of firms awaiting privatization and firms which remain in the public sector.

108. In the short run, the Government must grapple with an enterprise sector free of central control and simultaneously free of any semblance of normal market disciplines. Many of the enterprises enjoy monopoly power within the FSU and have raised prices many times further than the average increase in the price level (see para 104 below). A number of enterprises are principal shareholders in banks and therefore have access to a tame credit supply, enabling them to avoid adjustment while continuing to produce for inventory and pay above-market wages. At the same time, however, enterprises are highly vulnerable to the malfunctioning payments system within the FSU and to fuel and other input shortages due to the blockade. To the extent possible, the Government will have to ensure continued supplies of fuel and essential consumer products through the next year to eighteen months while also moving forward to change the ownership and structure of enterprises and the framework in which they operate.

109. To start with, some triage is necessary. Neither the Government nor the recently set up Privatization Commission can possibly deal simultaneously with the large number of enterprises in this sector, whether this involves restructuring, privatization or liquidation. *The first priority is an immediate review to classify enterprises into four main groups: those which are good candidates for*

*early privatization because they have export prospects and can be sold with minimal preparation; uneconomic enterprises which should be closed immediately to prevent a further claim on bank credit and drain on scarce imported inputs; enterprises to be retained in the public sector; and a remaining large group in which an order of priorities must be struck for introducing improved corporate management while the enterprise is prepared for restructuring or privatization. This approach is elaborated below in the section Enterprise reform: managing the short-term in the context of a long-term strategy. A brief description of the sector follows (paragraphs 110-116).*

110. At present, there is little competition within Armenian industry, reflecting the continued role of state orders, large size of enterprises and the inclusion of many factories within large vertical or horizontal conglomerates or associations, frequently headed by a supervisory ministry. As a result of the Soviet industrial strategy, production in Armenia is highly concentrated among a few large firms. This degree of concentration would limit the action of domestic competitive forces even if state orders were no longer a factor.

111. There are 400 former Union enterprises classified as heavy industry covering chemicals and drugs, metal products, machine building, jewelry and diamonds. The largest activity is machine building which falls into three branches: equipment and auto machine-building, electro-technical, and defense.<sup>23</sup> The first branch produces general-purpose machines for forming metal parts, as well as pumps and motors. The second is highly developed in the Soviet context, being the third or fourth largest Soviet complex in areas such as electric motors, generators, gauges, and electric cables. The third represents the former All-Union defence industry enterprises. It is believed to include the best quality equipment and most highly skilled employees in Armenia.

112. The current situation of these branches is quite differentiated. Some of the factories, particularly in the electrotechnical branch, have adequate orders, including those through the state system, and are operating at moderately high levels of capacity. Many of the firms have the advantage of producing relatively unspecialized products, that might find quite broad export interest, particularly in middle-income countries. The financial situation of the third branch is the most serious. Military production had decreased from 10% of industrial output in 1990 to 5% in 1991, and about 10% of the employees have left in the last year, some having been recruited by the private sector.<sup>24</sup> Although this represents an informal process of conversion, the government is concerned that critical mass will be lost in some areas of expertise, and that this will seriously reduce the value of the enterprises.

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<sup>23/</sup> Equipment and auto machine building (61 factories and 30,000 employees); electrotechnical industry (70 factories and 40,000 employees); and radio electronics (100 factories and 75,000 employees).

<sup>24/</sup> In the opinion of the Ministry, those who have left represent the best "second rank" of engineers and technicians.

113. The degree of monopoly and concentration in Armenia has important consequences for output prices<sup>25</sup> and also for the pattern of labor retention and wage adjustment. Within an overall situation of wage restraint, the highest average wages are found in heavy industry. Patterns of wage, price and output movements across branches in 1991 suggest that monopoly power (for those branches with continued demand) has been an important factor affecting price and wage increases and the ability to avoid layoffs - and adjustment. This pattern is consistent with that found for other FSU states, including Russia, where price liberalization has resulted in a substantial terms of trade movement in favor of industry.

114. In response to these wage developments, the Government has introduced a tax-based incomes policy as a transitory measure until competitive forces are better established and ownership rights are clarified and substantially privatized. It also plans to introduce an anti-monopoly law, but it seems clear that more proactive measures will be required to break up monopolistic structures and introduce financial and market discipline on prices.

115. Armenian enterprises have been all the more oriented to the FSU markets and their existing input and output relationships because Vneshekonombank (Moscow) effectively confiscated their foreign exchange deposits. Tightened credit resulted from the shrinking of deposits in real terms, because of highly negative interest rates and a loss of confidence in the financial system due to Pavlov's abortive confiscatory reforms in 1991. In Armenia, the freezing of Sperbank deposits has further undermined confidence in financial institutions and contributed to reduce the availability of credit. However, the real value of debt has shrunk while capital gains on inventories acquired before the price surge have also provided some relief. The use of inventories as a store of value is now emerging in the absence of institutions which could safeguard deposits and pay positive real interest rates. Enterprises and their supervisory ministries are also starting their own banks to provide credit to themselves, with the result that the lack of "arms length" relationships in the financial sector, and correspondingly weak balance sheets, is now a serious problem. The availability of inter-enterprise and own bank credit means that the effect of raising interest rates in the near term could be negated as enterprises will simply demand increased credit to finance the interest payments. *This indicates the importance of moving on ownership issues if monetary reforms are to be effective.*

116. Another FSU-wide development that has seriously affected Armenia's enterprises is the deterioration in the clearing system, particularly for interrepublican payments. With suppliers unwilling to ship intermediate inputs until payment has been credited to their accounts, Armenia's enterprises face lengthy periods of closedown even when willing and able to purchase supplies. Finally, the cash shortage impacts on Armenia's sales, as it does in other parts of the FSU, squeezing demand for consumer goods and contributing to the buildup of stocks of final products.<sup>26</sup>

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25/ From April 1991 to April 1992, the increase in prices was as follows: Oil-chemical prices - 27.2 times, electric energy - 26.1 times, chemicals - 17.2 times, non-ferrous metallurgy - 15.7 times, cellulose paper - 19.3 times, processed meat and dairy products - 14.3 times, and machine building and building materials - more than 10 times.

26/ For an analysis of the "cash shortage" in Russia, see Richard Layard, "Prices, Incomes and Hardship", paper presented at Stockholm Institute of Soviet and East European Studies, June 15-16, 1992. The cash shortage affects especially private businesses. At least one in Armenia has opened a

Enterprise reform: managing the short-term in the context of a long-term strategy

117. The Government has already successfully launched its privatization strategy in other sectors (see this chapter, section D above). The recently passed Privatization Law provides the legal basis for privatization of the enterprise sector and an institutional structure for privatization is now in place with the establishment of the Privatization Commission, which will oversee the process, and the Privatization Board, which will be responsible for implementation.

118. Notwithstanding the Government's commitment to privatization, it is clear that institutional capacity to carry out the reform is still weak. And, as indicated by experience in Eastern Europe, privatization is a complex process that could take a number of years to complete. But the government is already faced with difficult and pressing decisions. To promote an early improvement in allocative efficiency and reduce the claims of uneconomic enterprises for credit, the Government must make hard decisions now about which enterprises to sustain and prepare for privatization and which to cut off. It cannot finance enterprises from the budget, and it should not tolerate further expansion of credit on an uncontrolled basis. Yet it wants to minimize output and employment losses while accelerating the transition to a market economy. However, current market signals are highly distorted and are also constrained by the blockade. Current financial performance is therefore a poor guide to the future potential of enterprises, and this situation will not change until the economic environment is regularized. How to deal with this dilemma?

119. To help take immediate hard decisions, the Government will need to develop a framework for setting priorities for its social and industrial policies and to classify enterprises into several groups: enterprises suitable for immediate privatization, open for foreign participation, enterprises that should be temporarily mothballed but not liquidated and problem enterprises with little prospect of longer-run viability. For such an exercise to be useful, it will have to take into account the tight limits on investment that will prevail for some time, and also the impact of energy prices as they rise to world market levels. Environmental damage and pollution must also be taken into account, as internalization of these costs will render some enterprises uneconomic. This exercise should identify enterprises where intensified efforts to improve management are warranted. It would also enable the Government to identify promising cases for conversion of industry from military to civilian use, especially where export potential exists (Armenia possesses advanced optics, electronics, and laser technology). At the same time it would help single out uneconomic and/or environmentally damaging enterprises that should be radically restructured or liquidated now, rather than wasting further effort and funds on readying hopeless cases for privatization. In this context, questions must be raised about the environmentally damaging chemicals industries<sup>27</sup>.

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casino in order to secure a supply of cash rubles.

<sup>27/</sup> A copper smelting factory at Alaverdi in the north has already been closed down because it caused severe environmental damage, and there appear to be other candidates for closure or for strict emission control. Armenian economists have in the past criticized the chemicals industry on the grounds of ecological danger as well as for its intensive energy and water use.

120. The process of taking stock of industrial assets could be linked to the preparation of enterprise documents that would be used to help attract foreign partners. Foreign investment will have to play a key role in the regeneration of Armenia's industry and its refocusing towards non-FSU markets. Foreign investors bring far more than finance. Their main contribution will be the design, management and marketing skills needed to complement the existing production and research strengths of Armenia. There is no other way to acquire these vital skills rapidly. As the home market of a small country like Armenia offers little attraction to foreign investors, foreign investment must be seen as part of an export-oriented recovery strategy, targeting both FSU and other markets. Armenia is in a much stronger position than many of the other republics in this regard, given the financial strength and market skills of the large Armenian diaspora.<sup>28</sup>

121. In many cases, public enterprises are currently providing health and educational services that would need to be taken over by an appropriate Ministry or municipal agency, with the future costs of these services falling directly on the government or municipal budget. Any remaining social obligations would have to be clearly specified at the time of privatization.

122. The Government must also deal with public distrust of the privatization process and fear of protection rackets and other criminal activity. It has already gone some way to meeting concerns that the previous elite will dominate the process with the proposed introduction of a voucher system for asset purchase (see Annex 4, section 3). However, these public concerns underscore the need for good management of enterprise reform. The Government might find that public acceptance would be enhanced by holding a small number of initial, well-prepared sales of economic enterprises in which it was possible to maintain employment at or near previous levels. The prior diagnostic study would assist in identifying good candidates for early privatization. Privatization methods are discussed in paragraphs 128 - 138 below. In many cases, however, *enhancement of competition* and *improved management* before privatization will be a higher priority for the Government and will be more feasible and attainable than quick sales. The Government will need to operate on a number of fronts simultaneously to bring these problems under control and start to lay the foundations of a competitive and efficient private sector, while also ensuring that industries essential for near-term survival do not go to the wall.

#### Enhancement of competition: the trading environment

123. Sections A, B and C above deal with the legal framework and other aspects of the competitive environment needed for private sector development. In addition, the degree of monopoly and concentration within Armenia points to the need for Armenia to implement an open external trade policy. In this regard, the liberalization of foreign exchange retention from exporting has sent an important signal to the enterprise sector. State orders should be reduced to the extent that the country's economic security permits. The degree of concentration also signals the need to encourage the dissolution of industrial conglomerates, increasing the number of firms and the level of

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<sup>28/</sup> The advantage of a diaspora is suggested by the experience of China, where the "open door" policy has led to a rapid growth in exports partly due to a dramatic rise in export-oriented foreign investment, overwhelmingly made by foreign Chinese investors.

competition in the economy, where this can be done without unduly sacrificing gains from economies of scale and advantageous trading positions.

124. As well as breaking up conglomerates, the Government must withdraw Ministries from direct economic activity, shifting them towards setting the regulatory framework for industrial activities and monitoring industrial performance. Ministries should not directly own banks, shops, or shares in enterprises or head associations or concerns. They should shift their advisory and service functions on to a contractual basis and spin them off into independent commercial ventures.

#### Better corporate governance

125. Improved management of public assets is needed during the transition, which in some cases could prove as long as five or even ten years, in order to prevent deterioration and theft of the assets and ensure that they are put to the most productive uses possible, while simultaneously preparing the enterprises for privatization. This will require establishment of objectives, performance standards, and stringent contracts with public enterprise managers.

126. Enterprises should be transformed into joint stock companies with boards of directors including, where appropriate, representatives from outside government (and in some cases from outside the country). The composition of the board would change with privatization, to reflect the new balance of ownership. As far as possible, the process of corporatization should be managed so as to increase the number of separate enterprises, breaking up the large horizontally and vertically integrated conglomerates. In the interim period before privatizations can be completed, clear contracts will be needed between the oversight ministries and managers to monitor the managers of enterprises not yet privatized and spell out new obligations such as the introduction of accounting and financial reporting. The Privatization Commission or a similar agency would need to specify minimum requirements for such contracts and monitor their implementation.

127. Armenia's accounting systems are oriented to physical targets based on Net Material Product for the great bulk of the economy and are under-developed in the largely informal or private cooperative sector. Financial reporting is unknown and it is extremely difficult to assess the operating account position or net worth of enterprises that have any degree of complexity. It will be important to reform accounting practices to enable useful information to be provided on a timely basis by the enterprises, and operating enterprises should be obliged to introduce regular financial reporting and submit to audit. Development of accounting systems will also be needed to facilitate the transfer of large enterprises from public to private sectors; and to provide a reliable basis for the VAT and enterprise profits taxes. Capacity to analyze financial information should be strengthened within the oversight ministry.

#### Privatization

128. The Government presently envisages a three-stage privatization program under which privatization of industrial enterprises would be the last stage (see Annex IV, section 2). As indicated above, there are compelling reasons for cutting across this timetable and moving to privatize a small number of large enterprises immediately, particularly enterprises with good export prospects and those

which could attract foreign investors. Enterprises serving agriculture should also be rapidly privatized to encourage further productivity gains and reduce losses of output in storage and distribution. At the same time, valuable assets could be spun off from existing public enterprises.

129. After an initial spurt of privatization, the Government's efforts to transfer ownership to the private sector have been slowed by Parliamentary resistance to the process. It has therefore been evolving other approaches to public sector disengagement that do not require an explicit initial change of ownership. It is increasingly using leasing, which could help put a lot of assets under private management quickly, halting further mismanagement and erosion of asset values. However, leases do not provide the revenues that come from sales, and there is a risk that ministries could use leases to give preferences to themselves and friends, obstructing further privatization. It would therefore make sense to require that any lease with an option to buy, or for a more than two year period, should be approved by the Privatization Commission on recommendation from the Board. Approval would also have to cover the rent charged. The Commission will also need to see that assets are not sold for below market prices to associates and subsidiaries of the ministries and current management.

130. The Government is also encouraging small businesses to split from large industrial enterprises, with the idea that change can more easily be effected by small flexible firms, while the main enterprises can change their profile only slowly. There is now a substantial number of semi-independent firms in all branches of industry, which are obliged to fill contracts from the main plant but are otherwise free to produce and trade as they wish.

131. A further method of effective divestiture is by changing ownership shares in the capital stock through investment. The Government intends that any new investment from own funds should belong to the enterprise. While this proposal has the merit of providing positive incentives to managers and workers, it could risk promoting investment in obsolete industries, and the Government may prefer to postpone introduction of this approach until after the review of enterprise assets.

132. The Government plans to introduce a voucher scheme for public participation, issuing vouchers to the value of 30% of the assets to be privatized in any one year (see Annex IV, section 3). Vouchers would therefore be released in successive tranches and would be valid only for a specified period, which would keep up the pressure to release the required amount of assets on to the market during that time. Privatization bonds will also be introduced against blocked deposits in the Savings Bank; purchases other than by vouchers or by bonds would come from private sources.

133. Privatization by the methods just described was open to two criticisms which the Government has now moved to meet: first, lack of incentives for existing managers and workers to preserve and increase the value of the assets, and second, lack of concentration of share ownership so as to provide effective control. Further elements have now been added to meet these concerns. Existing managers and employees will now be awarded 10, 20, or 30% of the shares, depending on the enterprise; and consideration will also be given to auctioning a critical mass of shares in one package so as to provide a nucleus of ownership control.

134. Shares in enterprises should be tradable, and it would make sense to permit the development of Investment Funds to help concentrate owner interests, encourage the development of

capital markets<sup>29</sup>, and manage shares. However, an appropriate regulatory framework, disclosure requirements, and other safeguards would be needed to prevent the abuses which have cropped up in other countries.

135. The Privatization Board, which is responsible for implementing the yearly program, is likely to need considerable technical assistance in the early stages. In order to lessen the burden on the Agency, and also involve existing management in the process in a constructive way, enterprises should be given a time limit to prepare their own privatization plans. This method has had a good response in Russia. In order to give employees an incentive to maintain the value of the enterprise, it could be worth allocating them a portion of the shares free (e.g. 10%). This would be more straightforward than the existing plan whereby employees would have the right to buy shares at a 30% of the initial asking price.<sup>30</sup>

136. To deal with monopoly, the anti-monopoly agency could be charged with establishing a short list of enterprises which should not be privatized in their current form. Privatization plans for these enterprises would have to spell out the measures to be taken to achieve competitiveness. Apart from this short list, no further restraints would be put on the process.

137. Further issues that will require attention are the treatment of existing social service functions, and share ownership in banks. Transfer of social functions to local or central government will probably have to be negotiated on a case by case basis, as budget resources do not exist to enable a wholesale transfer of current services. And connected lending problems must be dealt with before enterprises can be privatized. Enterprises must divest themselves of shares in banks before privatization so that "arm's length" relationships with the financial sector can be established.

138. Enterprise reform and privatization issues are dealt with in more detail in Annexes 3 and 4 of volume II of this report.

## **F Financial sector**

139. Direct government control over the financial sector was reduced quickly after independence without, however, creating a basis for future financial sector development. It is now urgent to restore confidence in the banking sector and establish the infrastructure and banking practice for commercial operations in the future<sup>31</sup>.

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<sup>29/</sup> Effectively investment funds allow share trading without requiring a fully fledged stock market.

<sup>30/</sup> This could produce resentment when the market price far exceeds the initial valuation, as is likely in a large number of cases.

<sup>31/</sup> Annex 2 reviews the financial sector and priorities for restoring financial discipline and re-orienting the flow of credit towards economic enterprises.

140. The financial sector is currently operating within an extremely distorted economic environment, with a low level of skills and weak operating procedures. Resources are not being allocated on a commercial basis, and the formal financial sector is playing only a small role in intermediation. Within that sector, both State banks and new banks are lending to their owners. The strongly negative real interest rates have helped enterprises by eroding the burden of outstanding debts, but are now causing severe distortions in both the financial sector and the real economy. Especially in the presence of strongly negative real interest rates, and a leap in prices that has reduced the real value of debt, these banks have incentives to lend with little concern for risk or return. Hence most financial institutions are effectively controlled by public enterprises which themselves are operating in an autonomous fashion, and credit is allocated primarily to related enterprises and inherited public enterprise clients. A large amount of credit allocation is also taking place through the informal expansion of inter-enterprise credits.

141. The five State banks and about fifty new small banks have severe problems, including uncovered obligations for blocked household deposits in Sperbank and blocked enterprise deposits in VEB. The flow of new household deposits into the banks has slowed to a trickle: the public remains reluctant to deposit its funds in the banking system given the past record of frozen deposits and strongly negative real interest rates. Meanwhile it is likely that enterprises will continue to draw down their deposits in the banking system so as to pay staff in the short term, further reducing their working capital and the liquidity of the system. In addition, the weak portfolio of enterprise loans will deteriorate as the economy is restructured. Many of the new banks are fragile and will not survive once interest rates increase and prudential standards are introduced.

142. Questions of ownership and the criteria on which credit is allocated must be resolved if the system is to move towards commercial banking. The Government is already working on the development of a central bank and the provision of an appropriate legal and regulatory framework, and should move ahead quickly with these reforms. Without the rapid introduction of sound capital requirements, prudential regulation and supervision, and commercial banking practice, efficiency gains from privatization are likely to be compromised.

143. In dealing with this situation and seeking to restore confidence in the banking system, the Government will need to bear in mind that, in the future, much of the finance required to cover defaults, meet outstanding liabilities and recapitalize State banks will have to come from the government budget, which it can ill afford. Nor, at this stage, can it afford to finance investment or operations in essential but unprofitable enterprises (for instance in the energy sector) through the budget. This means that financing for this purpose will have to come from the banks at least in the near term, and ways should be devised of doing this at minimum cost to the banking system. *The key issue is how to manage damage limitation over time.* Extension of credit must gradually become more sensitive to risk and profit considerations while budget capacity and provisioning are built up to cover the losses that will inevitably come.

144. In sum, the Government wants to restore confidence and discipline to the banking system without precipitating further severe losses in output and employment, or at least while minimizing those losses. It also wants to minimize its own potential budget liability, whether through direct subvention now or through bailing out and recapitalizing failed banks in the future. Insofar as some risks of this kind are unavoidable, it wants to postpone as far as possible large calls on the

budget until revenue capacity has grown (which will in turn be related to the degree to which output levels can be maintained).

145. The manner in which it handles immediate problems and the speed with which reform can be pursued will be related to the evolution of the political and macroeconomic situation; as discussed below.

146. Under the pessimistic scenario, with the economy gearing down to minimum levels of activity, centralized control and rationing might have to be re-established over much of the economy. With further economic deterioration, most enterprises would close down and most new banks would fail, compounding the already difficult task of rebuilding confidence in the banking system. The Government would have to direct lending to activities essential to survival, and might also need to regain ownership control of the previous State banks. Banks that are funding enterprise losses or social objectives cannot meet prudential requirements or undertake extensive restructuring or operate on commercial principles. The development of a commercial banking system would have to be postponed.

147. If the economy continues on the present track with weak economic performance and disruption of FSU trade and payments (medium scenario), the Government will need to manage the transition to a healthy financial sector. Bank and enterprise restructuring and privatization programs must move ahead in parallel. Many enterprises will be unable to cover operating costs either temporarily or permanently, and until they are restructured and commercialized or closed, their response to price and financial signals is likely to be perverse: for instance the response to higher interest rates will be a higher demand for credit. If the financial condition of the banks is not to deteriorate further, ownership control and prudential standards, risk assessment and arms length relationships will have to be introduced in short order. This may need to include the re-assertion of Government control over State banks at the expense of the interests of Ministry and enterprise shareholders, together with the introduction of explicit lending guidelines based on commercial standards.

148. Under the optimistic scenario, the macroeconomic situation will stabilize and privatization can move forward quickly. Complementary measures can be taken to move towards a commercial banking system. In addition to the reforms associated with the medium scenario, it will be important to build financial skills and expand financial services, raising interest rates towards positive real levels to improve resource allocation, restructuring, privatizing or liquidating the State banks, and developing instruments of monetary and fiscal control. By closely supervising the banks and ensuring that prudential regulations are enforced, the central bank can help rebuild confidence in the depository institutions. Significant progress could be made in the next five years to privatize public enterprises, develop markets, reduce if not eliminate public ownership and build the skills and incentives needed for commercial banking.

### Sequencing of reforms

149. Management of the financial system during the transition between a state controlled and a market economy is going to be extremely difficult since the policies to decentralize and liberalize the banking system can lead to perverse outcomes as long as the economy is not stabilized,

part of the economy is under direct controls, most enterprises are still public, prices are distorted and inputs are rationed, making it difficult to assess the commercial viability of enterprises.

150. Public enterprise and banking reforms must therefore move forward together. *The speed with which the banking system can begin operating on a commercial basis depends on cutting the direct and indirect links between the banks and the unviable public enterprise clients.* Many of the enterprises now being financed will and should become casualties of the economic restructuring process. But the Government will not want to risk sending the economy into free fall by accelerating enterprise collapses before activity begins to respond to new signals and new relative prices - including in particular oil price and exchange rate developments, which will continue to exert strong restructuring pressure. In the interim period while the restructuring process works itself through, the Government wants to maintain activity in the most economically and financially sound way possible. *The specific issue of allocation of finance to public enterprises and their relative dependence on own financing, bank credit and inter-enterprise credit will need to be explicitly tackled in the context of enterprise reform.* Decisions will be required to close irredeemably uneconomic enterprises rather than continuing to allocate subsidies and bank credit to them. These decisions will have to be taken by the Government or by a restructuring agency until the banks start to operate in a commercial way.

151. In the banking sector, the Government will need to re-assert some controls over the five main (State) banks as an immediate priority. The present situation is reminiscent of the savings and loan debacle in the U.S., in that restraints on lending have been lifted without the recognition of corresponding prudential responsibilities and in an environment of perverse incentives (including, in Armenia's case, highly negative real interest rates). No further sale of shares in State banks should take place and their unsafe practices should be stopped: selling shares in insolvent banks, lending to shareholders, on-lending Sperbank household deposits to high risk banks, and any lending to unviable clients. Over time diagnostic studies should be launched of the large state banks so these can be restructured, or liquidated. In the interim, the state banks should be under management contracts to enforce commercialization of operations. It may be advisable to approach reputable foreign banks for assistance with strengthening management.

152. As from now, Ministries and state holding companies must no longer be permitted to buy shares in banks. Where Ministries already hold shares, they must be relinquished. Public enterprise shares must be disposed of when the enterprise is privatized. To avoid a repetition of problems of interdependence, it would be advisable for the Ministry of Finance to take over these shares and hold them in trust, for later privatization.

153. Also required immediately is a halt to the licensing of new banks on the current basis where licensing requirements are lax and capital standards inadequate. To curtail the risks posed by existing "cowboy" banks it will be important to insist that: licensing requirements are fulfilled (including character requirements); the minimum capital requirement of 40 million rubles should be indexed to inflation immediately; and minimum capital/deposit ratios should be upheld (recommended ratio 1:8, to be raised to 1:10 after one year). Before any new banks are licensed, technical and character requirements should be strengthened, requiring previous experience in financial management.

154. The Government also intends to set up a Development Finance Corporation, which would fill the gap in the provision of longer-term financing. Their aim is to interest a reputable

foreign bank in setting up an investment bank that would be a model for good banking practice, and that would provide advice and help evaluate business plans as well as provide funding.

### The role of the central bank

155. Since it will be imperative to monitor the banking system and the financial institutions closely while continuing to move away from direct controls on the system, an essential ingredient of the reform program will be to strengthen the information management, economic analysis, operational, and supervision capacity in the National Bank of Armenia. The NBA should prepare to respond to the evolving economic situation by adjusting available monetary and financial policy instruments and regulations on the banks.

156. To establish the infrastructure for the banking system, the NBA should prepare the regulations to support the new Banking Law as soon as possible. Another priority is to require banks to adopt international accounting standards. While a longer phase-in period may be desirable for some requirements (e.g. higher capital standards), the NBA should enforce the prudential regulations that cover the areas of highest risk (insider lending, loan concentration, and foreign exchange exposure). Until the problems with insolvent and illiquid banks in the system are resolved, the NBA should stop licensing new banks. In addition, the NBA should be much more restrictive about licensing commercial banks for foreign operations until the banks have appropriately trained personnel. It may be premature to allow the banks to take foreign currency denominated deposits. The NBA will also need technical assistance in other operations, such as payment systems, foreign operations, reserve management, bank inspection and supervision. Technical assistance with these operations and the introduction of new accounting standards throughout the financial sector is likely to be available.

157. The entrance of new banks in the system has broken the monopoly of the large state banks and provides some, albeit limited, competition in the system. However, to make sure that the introduction and growth of the new banks benefits the system, care should be taken to foster the stronger financial institutions through prudential supervision and advice while closing those that are already insolvent, illiquid or violating prudential standards so as to prevent the spread of banking problems and the erosion of confidence in the system. The NBA should help arrange mergers or sales or orderly exit, honoring household deposits first, for the weakest banks.

158. The Government needs to develop its plan to honor the liabilities of the Savings Bank as soon as possible to prevent the further erosion of credibility in the financial system. The Government should assume responsibility for blocked household deposits and the accrued interest from the Savings Bank, recognizing that the payments will need to be spread over many years. A schedule should be established according to which funds will be made available to Savings Bank depositors in a cautious and controlled way as budget funds permit. The repayment plan may combine cash, government bonds, long-term savings instruments, and privatization bonds. The plan should be put in place very soon to allow households to take part in the small-scale privatization program. Since the Savings Bank has an extensive branch network, which will be useful in mobilizing savings throughout the country once reintermediation begins, it should be reorganized, restructured, and recapitalized or the facilities should be sold to other banks within the next few years.

159. The Government is also planning to introduce bonds soon as a way of extending its financing possibilities, although in the short term it can only expect banks to buy them rather than the general public. It would be well advised to reject deposit insurance, which could create a moral hazard and which it could not afford to deliver on, preferring the development of prudential standards to protect depositors.

## **G Labor market**

160. The labor market is key to a successful transition in Armenia from the point of view of efficient adjustment as well as of welfare. In the past, the labor market was characterized by numerous rigidities - job security, administrative job assignment, conformity to standard full-time working hours, obligation to work, prohibition on geographic mobility, and a centrally imposed wage structure which paid manufacturing workers twice as much as doctors or other "non-material" workers under a job classification tariff based on education, physical strain and working conditions. Some regional variations were permitted in the tariff, and bonus schemes were superimposed on base wages to stimulate productivity. During the second half of the 1980s, however, productivity was falling while real wages were growing. In 1991, both productivity and real wages plummeted to around the levels seen in 1980. Real wages declined a further 60% in the first half of 1992.

161. State sector employment was predominant, though it has eroded since its peak in 1987 due to the growth of employment in cooperatives and private farms. But by the first half of 1992, the state still employed 973 million workers, or 63% of the labor force. The labor market also displayed strong female labor force participation at 60%, fairly high turnover and hidden unemployment, and high levels of formal education. Since February 1988 there has been an inflow of about 260,000 Armenians from Azerbaijan and an outflow of 170,000 Azeris from Armenia. Most of the latter came from the rural sector and the former from the urban sector, with the result that urban unemployment has been further boosted while the labor force in agriculture has been depleted.

162. Massive layoffs have yet to happen. Although state enterprises reduced employment by 10% during the first quarter of 1992, this was primarily accomplished by laying off pensioners. In March 92, over 336,000 workers were also on enforced leave on two-thirds pay. Only 11,775 job-seekers were registered in the two months after unemployment benefits were introduced in March 1992, (of whom only 2,000 had been laid off) but the number rose to 38,000 in September (of whom 29,331 had been laid off). By February 1993, the number of registered unemployed had risen to 60,000 while an estimated 700,000 were not working but retained on the payroll for a fraction of their previous pay. The Government expects, however, that long-postponed layoffs will become unavoidable, and is trying to gear up services at employment offices and training centers accordingly. Considerable changes from existing organization and practice will be required, as will additional funding. So far, employment services including benefits and training have been financed by the Employment Fund through a one percent payroll contribution. This will soon prove inadequate. The Government will need to raise the contribution rate as well as allocate direct budget funding if it is to respond constructively to future labor market adjustment needs.

163. Policies to improve labor market flexibility will also be required. In 1993, at the same time that it starts to privatize the housing market, the Government plans to remove the "propiska law" which confines workers to a 60km radius of their immediate locality in their search

for jobs. To keep fiscal control and prevent abuse of the unemployment benefit system once labor mobility is permitted, the Government must also ensure that it has an efficient way of tracking claimants. Good records, well-trained employment officers and a computerized system should be introduced as soon as possible.

164. An efficient record system and well-functioning employment offices will also be needed to implement an active labor market policy - a high priority for the Government. This will mean measures to identify vacancies and employers' skill requirements, counsel displaced workers, speed placement, provide appropriate training, and, where possible, promote labor force attachment and income support through employment on public works.

165. Good information on job-seekers and their qualifications will help promote higher quality and speedier job-matching, as will regular surveys of employer requirements. Information on employer needs should also be used to re-orient existing training provision for new entrants as well as displaced workers. However, it will be hard to expand training rapidly in the new skills required, some of which are crucial to adjustment. In the short-run, employer-based or donor-supplied training may be the only training available, and the Government's primary role may therefore be to ensure that appropriate contracts are struck, so that trainees and apprentices are not exploited, and that consistent standards and certification are applied.

166. Training is important to raising the speed and quality of economic adjustment but may do little to restrain the growth in aggregate numbers of those who are unemployed. To promote continued labor force attachment and prevent the erosion of human capital and confidence during long periods of unemployment the Government also wishes to create jobs through public employment programs in areas such as earthquake reconstruction, reforestation, environmental clean-up, and care for children and the elderly (which could also help limit institutional costs). Given the shortage of budget funds this could best be done with financial support from external agencies, including the many bilateral agencies involved in earthquake reconstruction and relief.

167. When large-scale layoffs are imminent, employment services should be provided at the site, supplying information on job opportunities, counselling, and identification of training needs.

168. During the transition, when short-term financial indicators may not accurately signal long-term viability, Government (or an enterprise restructuring agency) and enterprises will need to exercise judgement about labor shedding, distinguishing between those enterprises that are temporarily handicapped by lack of inputs but are potentially economic and those that have depended on unsustainably low input prices and artificially stimulated demand. These decisions about labor shedding will have to be taken in conjunction with decisions on the allocation of credit and budget subsidies to enterprises (see sections E and F above).

169. To provide a forum for discussion of these decisions and of future policies and legislation the Government may wish to establish a National Conciliation Council with a tripartite structure (of Government, employers, and unions). It will also want to promote acceptance of the need for adjustment and understanding of the course reform is taking by supplying information, for instance on the implications of exchange rate and oil price movements, and explaining its intention to share the burden of adjustment equitably.

## CHAPTER IV

### BUILDING A SOCIETY THAT CARES FOR THE POOR AND CASUALTIES OF THE TRANSITION

#### A Income Maintenance

170. The Government needs to demonstrate tangible support for the poor, including earthquake victims, refugees, and the many casualties of the economic disruption following the disintegration of the FSU. This need is all the more urgent as hypothermia and severe malnutrition are now claiming victims among the old and the very young. However, the Government is increasingly unable to find the financial resources to sustain its social programs as revenue falls and more and more people fall below the poverty line<sup>32</sup>. If the system continued on the former basis, benefits would be over 25% of Gross Domestic Product - and rising. Some fine-tuning has already taken place but it appears that a more radical approach will prove necessary. This section describes the existing framework of support. Paragraphs 176-185 recommend alternative ways of meeting objectives within budget constraints.

#### The existing system is too costly to maintain

171. Armenia has an extensive set of programs that pay cash benefits for old age, invalidity (permanent disability), unemployment, short term sickness, pregnancy, death, children's allowances and student stipends. The dependency ratio is high, as children and old age pensioners are more than 2 million of the 3.5 million population, and unemployment is growing. Combined benefits from these programs exceeded 2.0 billion rubles in 1991 or 12.6 percent of Gross Domestic Product. The old-age/invalidity program, the largest of the cash benefits programs, paid a total of 771 million rubles in 1991. Old age/disability and unemployment benefits are largely financed by the payroll tax on wages and salaries, with the remainder coming from the budget.

172. In addition, the Ministry of Labor and Social Welfare has a network of 69 Social Protection Agencies, which maintain a list of the most needy persons in their district and have limited funds to provide assistance. Also, unemployment benefits have some social assistance features in that they cover new entrants and re-entrants to the labor force, and the long-term unemployed can receive extended, reduced benefits by being reclassified as re-entrants. As the economy has deteriorated, a few local groups have taken initiatives to help the poor by establishing soup kitchens or visiting the elderly. The Armenian Apostolic Church is also involved in food distribution. Finally, many people are reportedly living off previous savings and receiving assistance through the informal social safety net of family and friends.

173. In the past, consumer subsidies helped to maintain the affordability of a wide variety of consumer items, including essential foods (especially bread and milk products), education, hospital services and pharmaceuticals, utilities, housing rents, and transportation. Gradually, however, these subsidies are being, and need to be, cut. The general subsidy on milk and yogurt has recently been

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<sup>32/</sup> Pensions were not paid from March to July 1992, unemployment benefits were not paid in September, and the Government is relying on enterprises to pay child allowances.

eliminated, and the bread subsidy has been substantially reduced. Until effective minimum assistance has been introduced, however, it will be difficult to let bread prices rise to market levels.

174. In the first quarter of 1991, the poverty line was defined at 414 rubles. By the first quarter of 1992, 90% of the population fell below this poverty line. A new poverty line is now being developed, and benefits have been held to 600 rubles per month till the end of 1992 despite the rapid rise in prices. The average wage in the public sector during the same period was 1200 rubles per month. It is estimated that food now accounts for 80% of expenditure by most households.

175. Starting in January 1992, government employees began to receive a flat-rate salary supplement of 150 rubles a month to compensate them for price increases. It is not clear whether other public sector wage employees receive this supplemental payment, but those in most need - pensioners, the disabled, the unemployed and large families - do not benefit from the supplement.

#### Future directions for social protection

176. Armenia now has a mix of two systems: the previous Communist system of broadly-based benefits together with recently introduced elements of a Western European type of social insurance provision<sup>33</sup>. Given the current very severe budgetary constraints, savings through better targeting need to be identified. Of course, sharper targeting may entail some loss of political support and will lead to increased administrative costs, but the resources are no longer there to maintain either of these systems. The search for savings will involve a move away from the previous social philosophy whereby support is given for recognized categories of beneficiary (e.g., child allowances are given in support of all children), rather than targeting need. Similarly, social insurance entitlements normally relate to the previous history of employment and earnings, rather than to current need. The exigencies of the moment and the year ahead indicate that the Government can no longer provide social protection on either basis.

177. In the longer run, Armenia will need to consider what role the Government should play in income support. A range of alternatives is available. At present, Government thinking is that it should keep only the role of minimum provider of social assistance geared to need, leaving income replacement above that level to a separate agency (which could be an optional second-tier government scheme or in the private sector). This agency would in due course gear up to provide a traditional social insurance program, partially or fully funded, with income payments related to work history, contributions made and previous levels of income earned. However, the structure of this scheme would have to be carefully defined. Experience in OECD countries indicates that social insurance programs tend to generate high non-wage labor costs without providing full coverage at an adequate level for the population as a whole, and tend to be disadvantageous for women. This can lead to pressure for subsidies from general revenue or for the creation of a subsidiary scheme, raising budget costs. It is not advisable to link social insurance to the workplace, as this can undermine labor market flexibility if benefits are not portable. And at a time of widespread economic restructuring, it is particularly undesirable to tie benefit entitlements to the performance of particular firms or

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<sup>33/</sup> Unemployment benefits were introduced in March 1992 and a law adjusting both pensions and unemployment benefits according to previous income became effective in July 1992.

industries. For fiscal, efficiency and welfare reasons, Armenia will want to consider the options carefully before determining the structure of income support in the future.

178. As indicated in Chapter 1, section on Future Developments, a wide range of possible economic outcomes must be contemplated in seeking to tailor social assistance to available resources. Even in the high case, the next eighteen months will be extremely difficult. In the medium case, there will be at least five very hard years with high unemployment, and under the pessimistic scenario, the country will have to cope with increasing numbers of refugees and gear down to subsistence living. With this perspective, two sets of recommendations have been developed. The first (high case, described in Annex 6) relies on further fine-tuning of the existing system in the expectation that after 18 months it should be possible to return to the existing comprehensive system. Emergency measures will still be required in the short-term, however. The second is appropriate to the medium and low case, and is based on the view that Armenia cannot at this stage afford a social insurance system along European lines with differentiated levels of benefit according to length of work history and size of contributions. Nor, unfortunately, can it afford expressions of social solidarity such as the provision of child allowances to all families irrespective of income. (As family allowances are better targeted towards poverty than other types of benefit, however, it could be wise to retain the benefit subject to a family income test).

179. At present, resources are inadequate to cover pensions and unemployment benefits, which have remained unpaid for months at a time during the last eighteen months. With the aim of meeting basic need, bread is now rationed at 250 grams per person per day, but the price increased sharply and was 45 rubles a kilo in February 1993. At the same date butter cost 1,200 per kilo, 30 eggs were 1,000, while 20 litres of petrol cost about 6,000 rubles, against a minimum wage of 2,000 rubles per month. Since pre-famine conditions developed in Armenia, it has become even more urgent to restructure the system so as to avert starvation among those without other means of support. The top priority is taken to be provision of social assistance to those who are most in need. Later on, and depending on which scenario best matches the evolution of Armenia's economy and fiscal capacity, social provision can be redrawn.

180. In the immediate future, the Government should develop a social assistance program that will channel available resources to the poorest. This first priority category will cover some existing beneficiaries and also some other low-income people not eligible for pensions or unemployment compensation. Meanwhile pensions and unemployment compensation should be reduced to the same flat-rate benefit level (this can be done fairly easily as benefit differentials are already being progressively eroded with each round of indexing). These benefits would be paid as a second priority, but not if the recipient was in employment or had other income (as is the case with large numbers of pensioners). First and second priority categories would then become unified under one comprehensive social assistance program, in which funds would only be allocated to the second priority if the first had been covered. Work history records should continue to be kept, so that when the second-tier scheme can be developed people will be in a position to claim their entitlements. To provide additional gross savings, the age of retirement would be raised in stages.

181. In this connection, the government will need to improve the information system on who the poor are. This can be done through improved statistical surveys and local information channels developed by the Social Protection Agencies with the help of district and village governments, NGOs and the Armenian Apostolic Church.

182. Armenia should move quickly from the current somewhat eclectic system of benefits and social assistance to this more formal unified social assistance program. Administrative capacity will have to be developed to deliver assistance under the new system. This will require a clear codification of the new system, staff training, and computerization. The last requirement will be particularly important if staff are not to be swamped by the large numbers of unemployed who will apply for benefit once industries are forced to cut their labor force and, in the low case, by further large numbers of refugees. (Computerization is also discussed in chapter III, Section F: Labor Market. Also see Attachment 2 to this report on institutional support).

183. The Ministry of Labor and Social Welfare could administer the new system, drawing on its network of Social Protection Agencies. Three measures would be required: (i) specification of improved targeting of the existing cash benefit programs and conversion of benefits to social assistance; (ii) identification of the poor by agreed criteria (for example, adjustments in the poverty line for geographic location, if relevant, and household composition); and (iii) structuring of benefits and organization of assistance to encourage self-help.

184. The level of assistance would be defined relative to a subsistence basket of food and non-food essentials<sup>34</sup>. The Government would have to track the cost of these items, and to raise minimum incomes to cover the cost of these essentials. This approach is advocated as an exception to the general policy of non-indexation of expenditures—including the minimum wage (as long as it remains above the poverty line). Non-indexation is important if the government is to retain control over its fiscal policy, but adequate expenditures on subsistence incomes are essential for maintaining the social safety net, especially in communities where the informal social safety net has weakened.

185. Until this social assistance program can be introduced, a reduced but continuing bread subsidy would provide an effective means of income targeting, since family budget studies show higher bread consumption by the poor and a shift to bread from other products as incomes decline. The proposed coupons for free or highly subsidized milk or bread, to be given to the most needy persons, would also provide them some protection for the inevitable price increases for these essential products in the future.

## **B Health**

186. The blockade has added hypothermia - due to lack of winter heating - to the health problems associated with lack of housing since the 1988 earthquake. Malnutrition has now reached serious dimensions especially among pensioners and children aged 0-5 years. In addition, atmospheric chemical pollution causes respiratory illness when factories are working, and smoking is a serious public health problem. In the immediate future, the country's urgent need is for vaccines, drugs and medical supplies. In due course it will also need to address the deeper rooted problems it faces owing to excessive centralization of health sector management, less adequate provision in rural

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**34/** Work is already under way within the administration to identify a food basket consisting largely of bread and potatoes, some milk and eggs, and excluding meat, cheese and fruit.

areas, and poor incentive structures including drastic under-payment of doctors and other professionals<sup>35</sup>.

187. Notwithstanding these defects, Armenia's health indicators before the blockade intensified in the 1991/92 winter were comparable to, or better than, those in other parts of the FSU. Life expectancy in 1991 was an estimated 70 years and the infant mortality rate was 17 per 1000. Until recently, preventive services and control of communicable diseases have been good, helping to explain the low infant mortality rate. Exceptions are insufficient attention to improved diets and reduced smoking—which are associated with rapidly rising rates of cardiovascular disease and cancers, especially lung cancer—and insufficient provision of a broad range of birth control methods.<sup>36</sup> Since the beginning of 1992, health services have deteriorated dramatically. Immunizations were disrupted at the beginning of the year due to lack of vaccines, and stocks of other drugs and medical supplies are depleted.<sup>37</sup> The lack of adequate housing for many households (see Section C below) contributes to the health risk under such adverse circumstances.

188. The system of health services consists of about 176 hospitals and more than 200 polyclinics. Urban areas are well served, and some public enterprises run their own polyclinics. Thirty-seven polyclinics serve the total rural population. Salaries of doctors are low, but the ratio of doctors and hospital beds to people is high by international standards (see Table 7). Curative care is widely reported to be of low quality; doctors are allegedly poorly trained and equipment outdated. The whole system is highly centralized in management and government financed; but most doctors, particularly in city hospitals, are given extra payments by patients. Less than 3 percent of GNP is spent in the sector, excluding these private payments.

**Table 7. ARMENIA: Comparative Social Indicators of Development 1990**

	ARMENIA	NEW ZEALAND	IRELAND	NICARAGUA	ALBANIA
Population (millions)	3.5	3.4	3.5	3.8	3.25
Popn. growth rate (%)	0.15	0.7	-0.2	3.3	1.9
Labor force (millions)	1.68	1.57	1.48	1.2	1.59
Age dependency ratio	0.57	0.51	0.61	0.94	0.62
Life expectancy (years)	72.0	75.4	74.4	64.7	72.3
Infant mortality per 10 <sup>3</sup> births	17.3	10.0	7.2	55.1	25.4
Persons per hospital bed	90.0	—	—	517.0	—
Persons per physician	223.8	575.0	681.0	1564.0	—

Source: Social indicators of Development 1991-92, the World Bank.

35/ The average wage in the health sector is two-thirds that in industry.

36/ The abortion rate is high—about one for every three live births—and many are performed outside hospitals.

37/ See "Armenia: Report of a UNICEF Mission", mimeo, March 1992.

189. The top priority in the near term will be the search for humanitarian assistance for vaccines, drugs and medical supplies. Reform of the health system will then pose a major challenge. The Government wishes to retain universal access to health care and does not want to institute a medical insurance system. Within these broad lines, however, a great deal will need to be resolved concerning health system reorganization and financing. Based on preliminary inquiries, the following elements of reform will be important:

-Decentralization of the management of the public system of health services, providing to municipalities and hospital directors more discretion (within specified clinical guidelines) in use of their budgets, which might be initially allocated on the basis of population size.

-Development of programs to attack the causes of rising adult mortality, including smoking, and to increase dramatically the availability of contraceptive methods and sterilization.

-Introduction of user fees in the public system, to provide incentives for improved efficiency as well as to contribute to the overall financing. Fees should be restricted to particular types of services (excluding immunizations and other preventive care) and to those able to pay. Patients should pay for private rooms, meals, and ancillary services.

-After the immediate needs listed above have been addressed, Armenia will need to consider how to define the role of the private sector in health care. It will be important to safeguard against cost inflation and the tendency to take spending decisions without regard to available funding capacity. It should also avoid the use of public resources and funds for services that are provided in the private sector.<sup>38</sup>

## C Housing

190. Privatization of housing and the development of a private housing market will support a broader and more flexible labor market, promote budget and private savings, and provide people with a potentially valuable asset and incentives for upkeep. Armenia will have to move from the current system under which nearly half the housing stock and its maintenance is in public hands to privatize housing and provide the framework for a functioning housing market in which owners freely transact, service mortgages, and undertake their own maintenance.

191. Adequate housing and sanitation are also an important part of the social safety net, and many Armenians do not now have either. The December 1988 earthquake near Gumri (formerly Leninakan) left more than 500,000 people homeless, many of whom are still living in temporary shelters and disused metal containers. In addition, an estimated 260,000 of the 350,000 Armenian refugees from Azerbaijan have come to Armenia, starting in 1988. Of these, over 100,000 are still homeless. Special programs have been undertaken by the government and some international assistance has been received from foreign governments and from NGOs, but additional help is needed.

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<sup>38/</sup> The latter is an invitation to uncontrolled spending and cost increases in the private sector--financed by the taxpayer.

192. Privatization of housing is one of the few areas of reform in which Armenia has not taken the lead in the FSU<sup>39</sup>. However, the Parliament is now considering options for rapid privatization of existing government housing as a way to increase the resources available to house the homeless. The Government is also planning to open the construction industry to the market. Currently, about 45 percent of the housing stock in Armenia is public and the rest is private, with the latter particularly prevalent in the rural areas. Of the public housing, the majority is owned by the government—in principle, the local authorities—and smaller shares are owned by state enterprises. A law on privatization of state housing was passed in 1989; however, relatively few apartments have been privatized to date. All city housing has basic services, but housing everywhere shows the effects of deferred maintenance.<sup>40</sup>

193. Privatization of housing has merit in itself, and is also closely linked to labor market liberalization. Currently, people must work in the locality where they live (propiska law, to be abolished in January 1993). To give real effect to the removal of this law, housing transfers including sales must be feasible so as to facilitate labor mobility.

194. The Parliament favors an emergency program that would quickly reduce housing subsidies, releasing funds for use in new construction. The privatization program now under consideration would transfer existing housing to the current occupants. In Yerevan alone<sup>41</sup>, the government would save budgetary resources in 1991 prices on the order of R 270 million (R 180 million in current expenditures and R 90 million in capital repairs) by transferring these costs to the new owners.<sup>42</sup> Sitting tenants currently pay approximately R 100 per sq. meter to buy their apartment, and there is a proposal to either tax or sell the "extra space"—that is, the space additional to the normal allotment of 10 square meters per person. Approximately 15 percent of the Yerevan apartments have extra space. A moderate transactions tax on housing sales should also be imposed.

195. The broad thrust of the emergency privatization program is attractive for a number of reasons. First, it would involve relatively little initial dislocation of households. Second, as most flats are approximately the same size, the program is relatively equitable. If special charges were made for extra space, one major source of inequity would be addressed.<sup>43</sup> The remaining inequities, in terms of future property values, would lie in the initial condition and location of the housing, with apartments in better condition and near the center of town claiming a premium. The advantages of a

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39/ Georgia, for example, is well advanced, with 95% of rural housing already privatized and completion of privatization of urban housing expected by the end of 1992.

40/ See note by Jerold S. Kayden (USAID/ICMA/PADCO), "Housing Sector in Armenia: Selected Information", May 1992.

41/ Approximately 50 percent of all housing in Yerevan, or 186,000 units, belongs to the public sector.

42/ Figures provided by the Parliamentary Committee on Social Questions.

43/ To minimize the disruption caused by such charges, they could be indexed and deducted from the sale price received by the owner when the property first changes hands.

relatively quick, convenient, and transparent privatization program would seem to outweigh the shortcomings associated with these remaining inequities, however.

196. Despite the many advantages of a privatization program, it will be nevertheless important to develop a comprehensive framework for the housing sector; and the government should do this, possibly with some external assistance, before proceeding further. Such a framework would need to include: an overall financial plan that looks at how to finance new housing as well as how to finance current housing; a legal framework; a privatization plan that takes into account individual behavior and the feasibility of implementation; and implications of the financial and privatization plans for government revenue and expenditure on housing for the homeless. These elements are further discussed in Attachment 3 to this report.

## CHAPTER V

### ACTIVE POLICIES TO PROMOTE SUPPLY RESPONSE AND SUSTAINABLE GROWTH

197. The reform program is already setting the legal and policy framework for efficient and effective supply response throughout the economy. In addition, positive policies for transport services and infrastructure will be required to facilitate private sector development. Economic pricing and other measures will be needed to deal with environmental costs, promote efficient allocation of resources, and prevent erosion of the resource base. Specific sector policies will also be needed in agriculture and energy to reform sectoral policies, practices and institutions and ensure that the economic growth that emerges is sustainable.

#### A Transport

198. The immediate challenge is to keep transport modes essential for trade viable and functioning while developing the longer-term framework for an efficient transport sector. Such a framework will include inter-modal planning, competent regulatory authorities, adequate technical and safety standards, and capacity to evaluate and rank investment proposals. Infrastructure and rolling stock will largely be privatized or managed commercially. Any State subsidies for social purposes will be identifiable contributions from the budget. In the near future, however, the priorities will be essential maintenance of aircraft, trucks and rail rolling stock and the track that they use. The Government is already working on defining activities that could be privatized and a schedule for privatization. This should proceed as soon as possible.

199. The Government has inherited one segment of the Union road system, a railway system that formed a minuscule part of the massive Union network, and one segment of the Union-wide air transport system, now Armenian Airlines. With these came responsibility for transport infrastructure and rolling stock in each mode that was in need of substantial maintenance and investment.

#### Roads

200. About half the public road system of 7,700 km is paved and the Ministry of Transport estimates that 40% of the system, including 30% of the major inter-republican roads, need either rehabilitation or upgrading. Rolling stock in the sector includes 20,000 vehicles operated by the Ministry of Transport (MOT) of which more than half are special purpose vehicles and trucks of load capacity varying from 1 to 40 tons<sup>44</sup>. The rest are buses, automobiles and taxis. Ministries and public enterprises own another 80,000 vehicles. The average age of the fleet is 6.5 years and the daily availability is only about 70% due to lack of maintenance and spare parts<sup>45</sup>. Average usage is

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<sup>44/</sup> Some vehicles can handle 40' containers, which may be significant when considering the future of the railway

<sup>45/</sup> This is a particularly serious problem for the bus fleet, which was purchased from Hungary. Hard currency is therefore required to purchase spare parts.

60,000 km per year. The fleet's main responsibilities are carrying construction materials, container traffic, and foodstuffs.

201. The MOT owns 102 garages and workshops for repairs. The workshops are already run on independent profit-making lines. Additionally, the MOT runs a civil engineering brigade and two hot-mix asphalt plants with equipment which maintains the bituminous pavement. For design and control of works the MOT has a central materials laboratory and two institutes of scientific research.

202. Taxis have been free to set their own tariffs since January 1992, but the Ministry of Economy sets tariffs for the rest of the MOT fleet and the other 80,000 vehicles. On the basis of current tariffs, MOT's trucks and taxis are profitable, whereas buses - both urban and interurban - and the Yerevan metro have to be subsidized.

203. The highest priority in the road system is maintenance. If not carried out quickly the task will become one of rehabilitation and reconstruction at far higher cost. It will be important to inventory the system so as to identify the most highly trafficked sections for immediate action. Vehicles are also in need of repair and maintenance. Spare parts are needed, together with re-tuning of engines.

204. The vehicle fleet should be quickly privatized, together with the repair and maintenance functions and the civil engineering brigade and its equipment. Tariffs for trucks should be freed and the Government should raise fares on buses and metro to eliminate losses. The MOT will need to be restructured to perform regulatory and monitoring functions.

## Rail

205. The railway track consists of an electrified main track of 825 km, two short branch lines to Gumri and Lake Sevan, and international links: two in the north (one with Georgia and one with Azerbaijan) and one in the south (with Azerbaijan). There is also an out-of-gauge connection with Turkish railways at Ahurian, near Gumri.

206. The rolling stock is 100 diesel electric locomotives, many 20-25 years old, and 80 diesel locomotives for shunting. There are also road/rail container terminals operated by Armenian Railways (AR) at Yerevan, Gumri, and Kirivakan, and rail/rail at Ahurian. Maintenance needs are high and as spare parts are increasingly hard to obtain (most require hard currency) the locomotive fleet is now being cannibalized.

207. The ruggedness of the terrain and sharp changes in altitude require double heading and reduced loads. These factors, together with the comparatively short length of the system, raise questions about its long-term viability. In the past, the Armenia Division of the USSR Railways was permitted tariffs up to three times higher than elsewhere in the USSR in recognition of these higher operating costs. Even if the branch lines were closed, it seems unlikely that AR could survive commercially.

208. The future viability of AR is the main issue in this sub-sector. Until the Government has conducted a study to define the future role of AR under various scenarios, it should postpone any

major investment, while concentrating on essential maintenance to keep the track open and trains needed for exports and imports in operation. In particular, it would be inadvisable to go ahead with the massive investment planned at Ahurian to transfer cargo between gauges. Initial review of this proposal indicates that the objective could be achieved much more cheaply than at present contemplated, and the project should in any case await the results of the sub-sector study.

### **Aviation**

209. With the dispersion of the FSU Aeroflot to the republics, Armenia acquired a collection of old and fuel-inefficient aircraft, two major airports and six minor airports and strips. It still shares arrangements with Aeroflot for fleet maintenance, reciprocal rights, and allocation of costs and revenues.

210. The air freight business has already been turned over to a joint venture with a private company, while Armenia Airlines runs normal FSU passenger flights and international charters in collaboration with foreign agencies.

211. Airport facilities at the old Yerevan airport, now used for international flights outside the FSU, are very poor. Adequate security and safety procedures are lacking, and capacity for handling both passengers and cargo is vestigial and disorganized. Facilities are better at the new Yerevan airport but this is only used for FSU links. Before undertaking major airport terminal or cargo warehouse investment, the Government should rationalize use of the existing facilities and organize Customs and immigration procedures in a way that will encourage foreign investment and trade.

212. The Government is working on a comprehensive aviation reform under which the aviation system would be corporatized. Four separate corporations would be created which would be required to adopt transparent commercial relations in their transactions with each other. An effective regulatory framework and agency, similar to the United States Federal authority, would also be established. This reform should proceed as soon as possible. The Government also intends to extend landing rights to other airlines and is currently negotiating with some major European carriers. A study of future options for civil aviation in Armenia could include relations with Aeroflot, and the role and possible privatization of the new domestic airline, and should be undertaken in the near future. It would be useful to include consideration of airport facilities in this study.

### **B Environment**

213. Concern for the environment is strong in Armenia and environmental legislation has already been passed by Parliament. Environmental damage has inflicted severe costs on the economy (especially in agriculture) and is creating risks to health. If Armenia is to achieve sustainable growth it will have to ensure that environmental costs are internalized and that provision is made to safeguard and where possible restore its "natural capital". This will involve pricing policies based on long-term cost considerations, and a regulatory framework covering pollution limits and penalties, together with the technical and scientific capacity to define and monitor standards. A decision will also have to be taken on the nuclear plant.

214. Armenia will need an overall environmental assessment leading to an environmental action plan covering land and water resource management, agriculture, industry, urban conditions and public health.

215. The main environmental issue in Armenia is the decline in the water level of Lake Sevan and its consequences, which include a reduced flow of good quality water to service the agricultural, industrial, urban and power sectors.

216. Under the Soviet regime, the decision was taken to reduce the size of Lake Sevan, the main body of water in Armenia. The draw-down was stopped when the lake's area had been halved and it was 18 m below its original level, because the ecology of the lake was noticeably changing with increasing water temperatures as the water became shallower, together with climate change and other environmental problems. The fish catch from the lake has plummeted and, in the area around the lake, plant and bird life has been disrupted; the land is no longer arable due to its salinity. It is converting to desert from which the wind blows salt into arable lands nearby, reducing fertility there also.

217. Recently, the government has been attempting to raise the level by 4 meters; however, fuel shortages have forced a further draw-down for hydroelectric power generation. Reduced hydro generation from the Sevan-Hrazdan cascade so as to allow the level of Lake Sevan to rise will mean higher fuel requirements (and costs) in the future.

218. In addition, wasteful use of water has caused salinization and severe environmental damage to the head waters in and around Lake Sevan as well as to the valleys through which the water flows. Flood irrigation together with poor drainage has caused salts in the soil to move to the surface. Unfortunately, about 30,000 ha of land in the Ararat valley is now saline and has little use in crop production. It will take three to five years to bring the land back into production if treatment can be started now. The Government has designed a program to desalinate the affected area by constructing drainage canals and chemical treatment of the soils. As chemicals could have unfortunate side effects, the Government should investigate the desalination measures now being applied in Kazakhstan and around the Aral Sea.

219. Water is clearly of great importance from both a narrowly economic and an environmental point of view. *Before further investments in water development in the country, it is a high priority to develop and review the national water plan from an economic, technical and environmental point of view.* It would then be adopted as the principal guideline for water use over the next two decades. The proposed national water plan takes into account multiple uses: (a) agriculture, (b) fish farming, (c) power, (d) urban and (e) industrial use within acceptable environmental constraints. The Plan projects water supply and demand balance toward 2010 and recommends a program of investment to increase the water level in Sevan lake by 6 meters. It seeks to increase water availability in the country from the current use of 4 billion m<sup>3</sup> to 6.4 billion m<sup>3</sup>. Seventy-five percent of the water would go for agriculture of which about one-half would be used for power generation and fish farming, and the remaining twenty-five percent of the water would go for urban and industrial use.

220. Fuel combustion is one of the main sources of environmental problems, especially now as normal supplies of clean-burning natural gas have been suspended by the blockade.

Temperature inversions in Yerevan combined with the high sulfur (3-5%) mazout used by power plants and industrial boilers (all in need of combustion and emissions controls), low quality diesel oil and gasoline used by badly tuned vehicles result in highly visible and severe atmospheric pollution which causes respiratory illness. The extent to which fuel handling and storage cause environmental problems has not been determined; however, the impact would be localized. The main risk is contamination of soils and groundwater.

221. Armenia has a number of heavy industries including chemical industries which are responsible for serious pollution, creating chemical smog and acid rain. One of the worst offenders, a copper smelting plant at Alaverdi, was shut down for environmental reasons, and the synthetic rubber plant in Yerevan was also shut down but restarted recently. With a FSU monopoly in synthetic rubber, Armenia has strong short-term incentives to keep production going. Existing regulations and pollution control equipment already offer considerable scope to reduce industrial pollution but are not always used. The Government should ensure that existing controls are applied, while also reviewing regulations and pollution charges to see whether more economic outcomes could be attained. In addition, the diagnostic assessment of public enterprises will help to determine whether severe polluters are actually economic or likely to remain so once energy prices are at market levels and external costs are internalized.

222. Another environmental threat arises from the nuclear plant, which was shut down after the 1988 earthquake (also see Annex 7, Energy Sector). The reactors were not damaged in the earthquake and technical studies by the IAEA indicate that there is no immediate risk. However, the reactors are of the VVER 440/230 type, which have been recommended for phase-out as soon as practical by the G-7 First Ministers. The cost of providing an outer containment shield, required if reasonably safe operation was to be restored, would be prohibitive, and it is clear that the Government could obtain a much higher return for financing of that magnitude elsewhere in the energy sector. Completion of Hrazdan 5 and 6 thermal plants, for instance, would be cheaper and would supply more electricity,

223. Pressure to restore energy supply from this source and achieve a greater degree of energy autonomy would be alleviated if the blockade were lifted, as nuclear capacity would not be needed to meet Armenia's requirements for electricity if a reliable supply of gas and mazout could be assured for the thermal plants. And calculations of energy requirements and energy intensity under the three macroeconomic scenarios (see chapter 1) indicate that the nuclear source would not be needed as long as energy conservation measures were taken.

224. A final consideration is the potential impact on Armenia's ability to attract external financing and donor support. It is likely that a decision to start up the nuclear plant would alienate a significant amount of otherwise available support.

## **C Agriculture**

225. More progress has been made to privatize and liberalize in agriculture than in any other sector, with excellent initial results in terms of output and a shift to more efficient composition of activity and allocation of resources. Privatization of agricultural land is almost complete and charges for water use were introduced in early 1992. The agriculture sector in Armenia is reviewed

in: Armenia: Introduction to the Agricultural Sector, published by Country Department III, ECA, June 1992.

226. Great scope exists to raise agricultural performance, but much remains to be done to sustain the transformation and improve productivity. Given Armenia's need to expand exports and provide adequate food for the population, the highest priorities in this sector are privatization of distribution and transport systems. Pricing of agricultural inputs and parts and machinery must be brought into line with economic costs. Existing irrigation systems and types of machinery are not suitable for the smaller land holdings which have emerged in the wake of land privatization (though some mergers are taking place and private cooperatives are being formed).

227. The irrigation system is badly in need of redesign and repair. Armenia cannot afford to continue to waste one of its scarce resources, water. A start was made towards the establishment of economic pricing, which will help to reduce wasteful use, with the modest water charges introduced into the agricultural sector in early 1992. However, repairs are urgently need to the irrigation canals which lose up to 50% of water carried. It is now urgent to review and implement the National Water Plan. (See also Section B on environment).

228. Of Armenia's three million hectares, about 36% is mountainous and unsuitable for cultivation and 46% is farmland. Stones must be picked out of cultivable land annually and lack of water or complementary chemicals means that only about 70% of cultivable land is actually planted. Soils are volcanic and many lack trace elements necessary for fertility. Erosion is a persistent problem.

229. The rural sector accounts for about 25% of employment and net material product and is a net importer of foods. Fruit and vegetables are produced in irrigated regions while grains and forages are grown in the northern highlands. Cattle and sheep are raised primarily in the mountainous north.

230. Large state farms dominated the agriculture sector, though, since 1986, the mixed farm was established as a type of long-term leasehold which has proven economically efficient in the use of resources and profitable for the owners. The production carried out on individual plots and the mixed farms accounted for over one-third of value added in the sector before reform started.

231. Under the Land Reform Law of February 1991, agricultural land was sold to those currently working it. About two-thirds of the land planted to crops had been transferred to farm workers and managers by early 1992, and by the end of that year 90% of all agricultural land had been fully privatized. Crop production increased by 30% in the 1991 season, though livestock production declined due to lack of animal feed, and substantial output was<sup>46</sup> also lost through lack of pesticides, inadequate storage and disruption of trade and distribution systems. Problems remain, including the need to adapt the supply of agricultural machinery and the irrigation system to the size of plots now being operated. Despite these obstacles, agricultural output increased by 15% in 1991.

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46/ Up to half according to estimates made by the Ministry of Economy in July 1992.

232. A high priority now is to privatize distribution systems in the sector and introduce economic pricing of machinery, parts, energy and other inputs. Armenia has an urgent need for pesticides and other chemicals to stem crop losses and maintain the expansion in agricultural output.

233. It is likely that farming of large animals will prove uneconomic and that farmers will switch to chickens and will also expand production of high valued fruits, vegetables and grapes (for wines and brandy), juices and pastes, oils and honey. In the short term, mineral water may provide a good opportunity for export expansion. To support these shifts in activity, agricultural extension is needed to introduce best practice, improve animal husbandry, land management and erosion control, and improve productivity.

234. In addition, to expand agricultural production and markets, Armenia will need a combination of investment at the farm and plant level, policy advice, institutional development, technical assistance and training, marketing advice and information. Reform will also be needed of efficiency and hygiene in the storage, distribution and agro-processing systems. This objective will be aided by the broader privatization effort.

## **D Energy**

235. It is clear that the situation arising from the blockade is not sustainable for either the energy sector or the rest of the economy. Energy supplies are inadequate even for the summer period of reduced demand let alone for the winter. Energy supply is critical not only for survival but also as an essential input to permit increased economic production. However, even if the blockade were lifted, Armenia would still face serious problems in the sector arising from the dilapidated infrastructure, lack of economic pricing, and poor institutional management and design of facilities. Artificially low prices have led to inefficiency, and excessive use of energy in industry, agriculture and households is a serious problem, although Armenia compares reasonably well with other FSU countries on this count where energy intensity (energy per unit GNP) was roughly double. In 1990 its primary energy intensity, however, was about double that of market economies with similar levels of income (Figure 6). Because of the drop in economic output by 1992, Armenia's energy intensity is roughly double its 1990 level.

236. The urgent immediate priority is to increase and diversify energy supply; improve the efficiency of use of available energy supplies including hydro resources; ensure continued service from existing plant and equipment; provide new capacity to replace old inefficient equipment that is uneconomic to rehabilitate. A number of options to increase and diversify energy supply are being considered, including the construction of a gas pipeline through Iran. However, the capital stock in this sector is deteriorating rapidly. If it is left to do so, rehabilitation will soon become an even higher priority than the addition of new supplies.

237. Concurrently there is a need to address policy issues in order to: improve sector financial viability, including the increased use of metering and economic pricing; provide a cheap minimum supply as a social safety net for low income groups, with charges rising sharply thereafter; and strengthen and/or restructure existing institutions. (See Annex 6)

238. The energy sector is currently caught in a vicious circle of economic decline. By the end of May 1992, and repeatedly during the fall and winter of 1992/93, gas supplies from both Azerbaijan and Georgia were cut off and all stocks depleted. Transportation fuels, although available (legally) through the private sector, were in short supply and prices reflected their scarcity. Due to a rail transport strike in Georgia, heavy fuel oil (mazout) supplies were insufficient to meet even a reduced daily requirement for electricity generation and stocks had been drawn down to the point where only about a day's supply remained. As a result, the Government was compelled to order further load shedding in the industrial sector as well as to order full utilization of all available hydro plants, resulting in a further draw-down of Lake Sevan.<sup>47</sup>

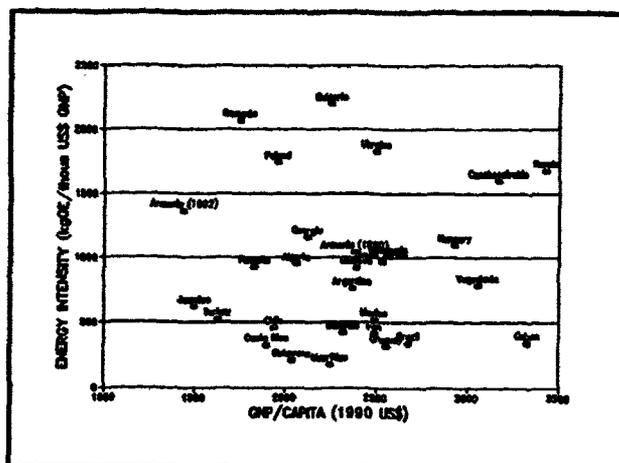


Figure 6 International Comparison of Energy Intensity 1990

239. The entire energy sector is physically deteriorating due to a lack of maintenance and repair. The power sector is being rapidly decapitalized not only because of a lack of maintenance but also due to damage to generators and distribution networks caused by over-loading. Most of the damage sustained during the 1991/92 winter has not yet been repaired because spare parts and materials inventories have been exhausted. The district heating systems, very inefficient even when built, suffer heat losses up to 60% due to low combustion efficiency, inadequate water treatment, lack of insulation, steam and water leaks among other factors.

240. The Government has increased prices for both electricity and district heating in the face of increased energy supply costs.<sup>48</sup> At the same time, Government has also attempted to maintain a high degree of cross-subsidization to household consumers from industries as real household incomes continue to fall with sharply higher prices and increasing unemployment. The overall level of cost recovery is inadequate and an additional squeeze has been put on maintenance budgets leading to yet further deterioration in the quality of service beyond the load shedding caused by fuel shortages.

241. Recent reviews of earlier Soviet exploration data indicate sufficient oil and gas reserves (possibly 8-10 years' demand) to warrant immediate further development. Other indigenous energy resources which may be economic to develop are limited to hydro, peat, and coal. The Government is also interested in developing renewable sources of energy including solar, windpower,

<sup>47/</sup> Government has been trying to restrict the use of hydro energy in order to raise the level of Lake Sevan to reverse the ecological damage that has occurred from the draw-down prior to 1976.

<sup>48/</sup> C.i.f petroleum and gas prices have gone up to an amount 20-30 times the average 1991 level due to price increases by Russia but are still below world prices. See Annex for more detailed information.

and geothermal; however, it is unlikely that in the near term these sources could contribute substantially to the country's energy needs.

242. The nuclear power plant (NPP) has been shut down since March 1989 following the 1988 earthquake (see the Environment section for a more detailed discussion). With the completion of the 300 MW Hrazdan 5 conventional thermal plant in 1994, nuclear capacity would not be required to meet Armenia's requirements for electricity if a reliable supply of gas and mazout could be assured. The use of funds elsewhere, notably in energy efficiency and rehabilitation of generating plant, would likely yield higher returns.

243. Energy demand projections have been prepared on the basis of the medium economic sceneario outlined in Chapter I and illustrated in Figure 7. With the drop in economic output and the high fixed component of energy use especially for heating energy intensity has doubled compared with the 1990 level but is projected to return to the 1990 level by about 2000. This reduction could arise with the return to economic growth, the beginning of restructuring and with vigorous efforts to improve energy efficiency as a key component of the Government's energy sector strategy.

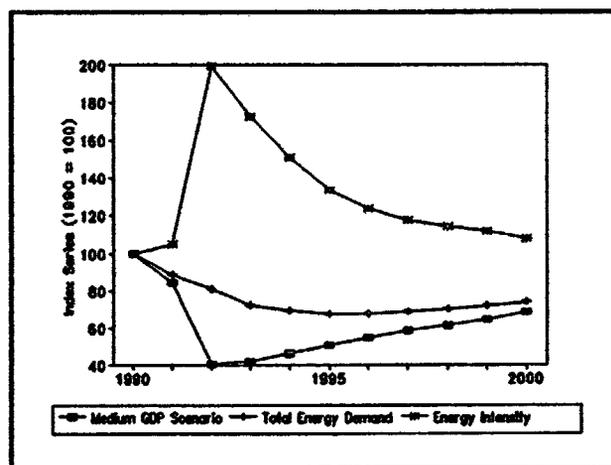


Figure 7 GDP and Energy Demand Projections

244. Assuming that there would be no supply constraint from mid 1993 onward, overall energy consumption is projected to decline to about 68% of its 1990 level of 8.9 million TOE by 1995/96 and then begin to rise reaching three-quarters of the 1990 level by 2000. The composition of demand by fuel type and total energy demand in TOE is indicated in Figure 8. With the lifting of the blockade, gas consumption could displace oil products particular in power generation, heating and industrial use. Large boilers in Armenia are equipped for dual firing with gas and mazut so that there is considerably flexibility for fuel substitution depending on availability and cost.

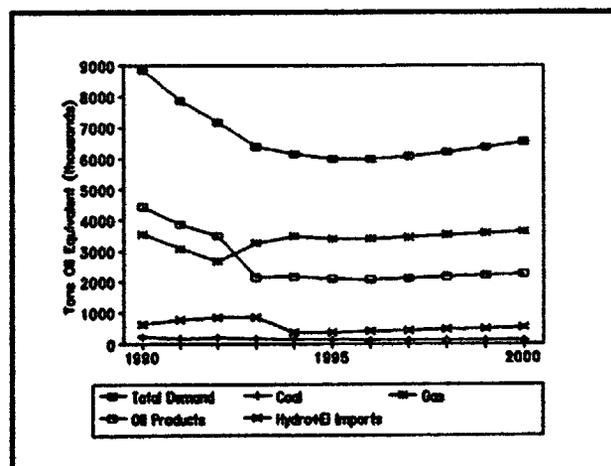


Figure 8 Composition of Energy Demand and Supply

## E Infrastructure

245. Beside urgent rehabilitation in the energy and water sectors, Armenia has considerable need for infrastructure investment. A higher priority in the short term will be to ensure maintenance of the road network and other existing infrastructure, rather than to seek to launch new investments, especially before capacity to evaluate investment projects in a macroeconomic context is better advanced. Much can be achieved by better organization of existing facilities, especially in the transport sector including the airports. Critical spares and material will be needed in the energy, transport, industry and agricultural sectors to get the most out of existing infrastructure.

246. Once the blockade is lifted, Armenia can realistically seek external financial support for large-scale investments. The energy sector will probably be the highest priority, where investment requirements over the next five years are roughly estimated at US\$ 200-300 million.<sup>49</sup> Substantial investment will also be required in the water sector to replace worn-out and inefficient systems. Given the magnitude of the investment requirements, careful attention is also required concerning the impact on debt service and recurrent costs of such a program.

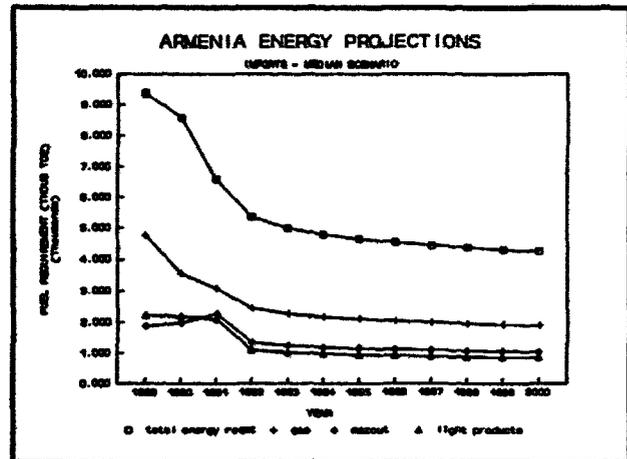


Figure 9

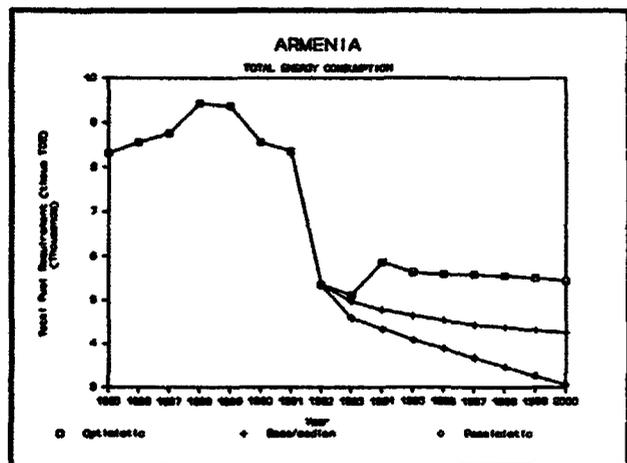


Figure 8

<sup>49/</sup> At present procurement within FSU would be likely to result in lower costs; however, given the uncertainty of prices and exchange rates, non-FSU procurement has been assumed in order to provide a stable basis for planning.

## ***ATTACHMENT I***

### **MACROECONOMIC SCENARIOS FOR ARMENIA**

247. Three macroeconomic scenarios have been constructed for Armenia according to assumptions about the major factors which will affect the economy in the future.

#### **Problems of regional relations**

248. Because of its landlocked situation, Armenia is dependent on transport links through other countries. Its traditional primary trade route for rail transport and gas pipelines through Azerbaijan has been blockaded because of the conflict over Nagorno-Karabakh; its secondary route through Georgia (road, rail and gas pipelines) is hazardous and intermittently completely blocked because of internal conditions there.

249. Regional economic relations have also been disrupted because of the breakdown in transport, trade and payments systems in the FSU.

#### **Problems of transition**

250. The economic adjustment will be substantial as Armenia re-orientes its economy to world prices and, in particular, oil prices. Much of industry will prove obsolete or uneconomic, necessitating large shifts in investment and type of production. Armenia is well equipped in terms of human resources but may lose skilled labor to the west; and may also have difficulty in attracting adequate foreign financing and investment, depending on the evolution of the other factors affecting the macroeconomy.

#### **Scenarios**

251. The factors listed above may be seen as constraints. Once the most binding constraint is removed, another may take its place as the most serious impediment to adjustment growth. The scenarios are developed as follows:

##### **Pessimistic:**

252. The present transport constraint is not relieved before the mid nineties. The long closures of enterprises in a siege economy lead to deterioration and loss of potentially useable capital equipment and the domestic economy degenerates to near a subsistence level economy, although some export industries are kept open.

##### **Medium:**

253. Transport constraints due to the blockade are relieved in 1993, but external trade and investment are hampered by further deterioration and disruption within FSU. Armenia slowly re-

orients its trade towards the west, and begins to attract foreign investment. Existing capacity is brought back into operation, the economy begins to stabilize, and real growth is 5% annually in the last few years of the decade.

### **Optimistic**

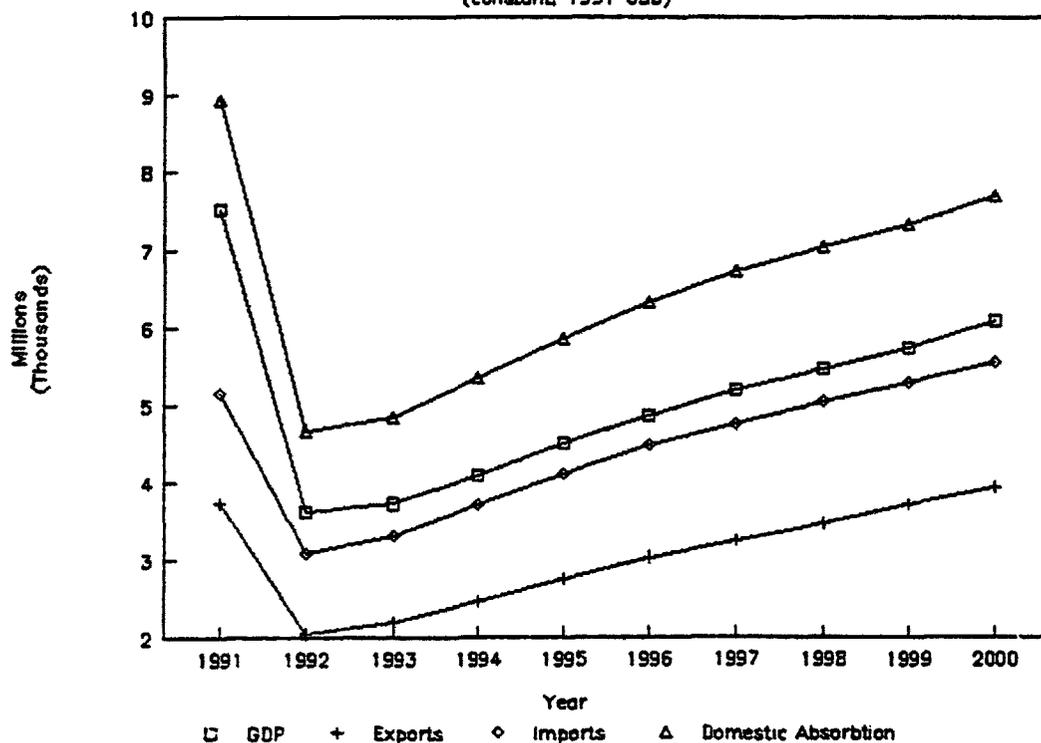
254. The transport constraint is relieved by mid 1993. This leads to a rapid upward shift in production from 1994 as capacity is restored. Considerable investment capital is available and, with macro-economic stabilization, high rates of real growth occur from 1997 on.

ARMENIA: MACROECONOMIC PROJECTIONS  
MEDIUM SCENARIO  
( Constant, 1991 USD )

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
GDP	7525	3612	3720.36	4092.4	4501.64	4861.77	5202.09	5462.19	5735.3	6079.42
GDP (growth rates)		-0.52	0.03	0.1	0.1	0.08	0.07	0.05	0.05	0.06
Exports	3731.6	2052.38	2196.05	2459.57	2754.72	3030.19	3242.31	3469.27	3712.12	3934.84
Exports (growth rates)		-0.45	0.07	0.12	0.12	0.1	0.07	0.07	0.07	0.06
Imports	5158.2	3094.92	3311.56	3708.95	4116.94	4487.46	4756.71	5042.11	5294.22	5558.93
Imports(growth rates)		-0.4	0.07	0.12	0.11	0.09	0.06	0.06	0.05	0.05
Domestic Absorbtion	8951.6	4654.54	4835.88	5341.78	5863.85	6319.03	6716.49	7035.04	7317.4	7703.51
Domestic Absorbtion (gr rates)		-0.48	0.04	0.14	0.1	0.09	0.07	0.05	0.05	0.05

AREMNNIA: MACROECONOMIC PROJECTIONS

(constant, 1991 USD)



## **ATTACHMENT 2**

### **MANAGEMENT OF THE TRANSITION: INSTITUTIONS AND SKILLS**

255. This section addresses the institutions and capacity Armenia will need to carry through the substantial and far-reaching program of reform on which it has embarked, and briefly outlines priority areas for capacity development.

256. To carry through the massive reform program it has launched, Armenia needs to develop the institutions and expertise, within both public and private sectors, appropriate to a liberalized economy. Although the commitment to such a transformation is clearly there, and the country is already making good progress with reform, the present structure of both Government and production still largely corresponds to the requirements of the former Soviet Union. Government ministries control most of the economy, while the apparatus of central government functions without benefit of the standard mechanisms of expenditure programming, accounting and financial control, and statistical and other support for policy-making. A majority of the functions which are commonplace in western governments do not exist in Armenia while others are performed in ways that are inimical to transparency and efficiency. Hence the government needs to rethink its role, structure and functions in the new environment and to establish transparent and accountable institutions and agencies. Capacity for giving advice on macroeconomic policy needs to be enhanced. Effective mechanisms for expenditure programming and control, revenue-raising, and debt management must be developed. The banking sector, including the central bank, must be modernized, and effective management and financial systems introduced into the nascent private sector, soon to be enlarged by the privatization of public enterprises. The Armenian government is seeking to develop an enabling environment for private sector development, including a legal framework for business.

#### **Role and Structure of the Government**

257. Armenia does not have the luxury of designing a master plan for a new system of government *ab origo* and then setting out to implement it. The pressures of the moment dictate early action. The highest priorities are to define the limits of government - explicitly withdrawing from productive activities and setting the legal and regulatory framework for economic activity - and to establish government responsibilities for the central functions of macroeconomic policy and for social provision.

258. It will also be important to ensure coherence and consistency across ministries and agencies in the systems they adopt and the norms established for accountability. Without fair and effective governance, the capacity of the government to implement the reform program will be compromised and public confidence will be undermined. Public confidence in the integrity of the statistical function and the confidentiality of information submitted to tax and other agencies is also needed to develop the compliance culture required for effective functioning. Provision for public recourse or appeal against administrative decisions will assist in establishing confidence and undermining the mentality of central planning and control.

### Macroeconomic Policy unit

259. A policy unit has already been established under the Minister of the Economy responsible for macroeconomic policy. This unit has redrafted banking legislation covering the newly created Central Bank and for banking operations which will go to Parliament shortly. The unit is responsible for developing legislation and advice on the financial sector, for monetary policy advice - which mainly consists of damage control in dealing with the problems of the ruble area which are determined outside Armenia - and for advice on fiscal policy and incomes policy. Financial and monetary advice functions should soon be transferred to the Central Bank. The unit should then focus on government expenditure and tax policy in the context of economic disruption and inflation, and advise on the links between these policies and macroeconomic performance and creditworthiness. To perform these tasks, the unit will need capacity to analyze the impact of macroeconomic policies and the overall reform program on the Armenian economy. It will need to develop economic monitoring and forecasting capacity.

### Management of external financing

260. The government needs to develop capacity to manage and coordinate funding from all external sources. This will involve the following tasks: to prepare the government's aid strategy, negotiate with donors, develop an information base on donors and their lending and procurement requirements, liaise with implementing agencies, monitor and evaluate aid projects and technical assistance, and manage and coordinate technical assistance. It will also be important to identify training needs in project management and procurement procedures and arrange for the appropriate training. Procurement and disbursement procedures will have to be established rapidly as external borrowing has already begun.

### Revenue

261. In the next 18 months, it will be one of the Government's highest priorities to improve revenue collections so that the Government can finance its reform program and provide essential social protection.

262. Customs. The government's decision to open the economy means that it is now a high priority for the reform program to design and implement a modern Customs function along Armenia's borders (see section on Trade Policy). The need for an effective Customs organization is particularly urgent where hard currency imports are concerned as much-needed revenue is being lost.

263. Direct and indirect taxation. Armenia is experiencing great difficulties on the tax front. Although taxation existed under the Soviet system, it was essentially managed within government entities and there was no taxation of entrepreneurial activity or property. Underpinnings for an effective system, such as a single taxpayer number, do not exist. A value added tax was introduced in January 1992 with little specification of the system, preparation of the public, or training of agents. Capacity is now needed to redesign the VAT, introduce zero-rating of exports, apply excise taxes to imports and domestic production, and establish effective systems of corporate and personal income tax (including the excess wage tax) and property tax. It will be advisable to

reduce the discretionary powers of tax inspectors and provide appropriate training. The following requirements have been identified: information systems; technical assistance for drafting tax policy for VAT design and reinforcement, and for property taxation planning and implementation; for study/review/redesign of tax-based incomes policy; computerization, including provision of hardware and off-the-shelf software. Capacity is also required for tax collection policies and procedures; strengthening the methodology of tax collection of a range of taxes; implementation of unique taxpayer identification numbers; and development of training programs. Taxpayer education and advice to companies on accounting procedures needed to assess corporate tax and VAT need to be reinforced.

### Expenditures

264. Design and implementation of programming, control and monitoring systems for public expenditure including investment will be essential. This will require introduction of a new planning and budgeting system on the basis of an integrated budget. Capacity for economic evaluation of public investment projects will need to be developed, together with the ability to program investment in the context of a medium-term macroeconomic forecast. Operational criteria for evaluating and arbitrating expenditure proposals from sector ministries will also be needed. Ability to use shadow pricing will be important given the substantial underpricing of some inputs especially energy. The Government will need to decide where these functions are to be located and, if the Ministries of Economy and Finance are not to be merged, how to establish separate and discrete functions for policy advice and for expenditure programming and control, as well as set up effective links and feedback between the two functions. In due course, technical ministries will also need the capacity to develop sectoral strategies and use cost-benefit analysis to screen projects.

### National Income Accounting / Statistics

265. The Statistical Office (Goskomstat) functions well but is oriented to the definitions and accounting systems of the FSU and is under-equipped. It now needs to establish SNA methodology for calculating GDP/GNP and all other national accounting indicators and to develop survey capacity to measure private sector activity. In due course it should also upgrade its population and social statistics. The Government intends to place the balance of payments statistical function in the National Bank of Armenia. The National Bank and the Statistics Office will both need to introduce the concepts of the SNA and balance of payments systems, and then design operational systems for the collection, tabulation and manipulation of statistical data.

### Financial sector restructuring

266. Financial sector issues loom large, with a proliferation of banks with inadequate capital - some of them owned by ministries and public enterprises -, slow and malfunctioning payments and clearance systems, and deposits of the public frozen in the savings bank. The government needs to establish confidence in the banking sector, support the introduction of effective financial systems and help the central bank develop prudential supervision and other central banking functions. (1) At the level of the central bank, it will be necessary to reorganize the National Bank of

Armenia to cover the following activities: reorganizing the domestic payments system; preparing regulations to support the new central and commercial banking laws (to be done by the Macroeconomic Policy unit); developing internal audit and control of the central bank; improving monetary and financial statistics and policies; improving supervision and inspection of commercial banks; upgrading foreign operations; and coordinating financial restructuring and discount policy. (2) Before privatization of the state banks, the following actions are needed: formulation of policies to control the state banks until these banks can be privatized; audits and diagnostic studies of the current position of the banks; design of a restructuring program to redefine the role and rationalize the strategy banks; depending on the restructuring strategy chosen, developing policies so that the government can play an effective role as "owner" of the banks.

### Privatization

267. The Government has embarked on a staged program of privatization of state-owned enterprises, which account for over 80% of the total economic activity of Armenia. The first stage was the privatization of agricultural land, followed by the fairly rapid privatization of small enterprises and shops that is now under way. The next stage will tackle large and medium-scale enterprises which number around one thousand. The Government has set up a privatization implementation agency and is enacting framework legislation for private sector activity. The Government recognizes that it faces serious constraints in the effective implementation of the privatization program and will need to develop capacity to cope with detailed design issues, institutional support for the agencies set up within the government to design and implement privatization, the legal and regulatory environment, assistance for pilot privatization transactions, assessment of asset value and export potential in the larger enterprises, better management of public assets awaiting privatization, and assistance with conversion of military industries to civilian production. It is intended that the public should be able to participate in the privatization process through the issue of vouchers for up to 30% of the value of the assets being released on the market. Design and implementation of the voucher scheme will also require specialized capacity.

268. The Government should give priority to a quick overview or diagnostic study of the large enterprise sector with a view to making an initial assessment asset values and potential for export, setting priorities for privatization recommending an immediate closures, and identifying where the need to introduce improved management systems is greatest in the interim before privatization occurs (which in some cases could be several years).

### Public Enterprise management

269. Experience in other countries indicates that the privatization process takes considerable time. Despite the government's commitment to privatization, it is clear that the process will be complex and time-consuming in Armenia. Meanwhile, there is a strong probability that existing systems of control will deteriorate further, with consequent loss of output, deterioration of assets, and, in some cases, criminal activity. Enterprises are in principle controlled by holding companies subject to Ministries, but in fact are largely autonomous. In order to protect public assets from further deterioration and to manage them as profitably as possible in the interim before privatization, the government wishes to reassert ownership control and introduce clear objectives and performance

standards, with stringent contracts for all public enterprise managers. Contracts will be introduced in descending order of priority, and managers will be expected to introduce accounting and audit systems. The present form of contract needs to be substantially changed and to include specific performance requirements.

### Accounting

270. Armenia's accounting systems are oriented to physical targets based on Net Material Product for the great bulk of the economy and are under-developed in the largely informal or private cooperative sector. Financial reporting is unknown. It is extremely difficult to assess the operating account position or net worth of enterprises that have any degree of complexity. It will be important to design means of improving and developing Armenia's accounting and auditing systems in both public and private sectors. Development of accounting systems will also be needed to facilitate the transfer of large enterprises from public to private sectors; and to provide a reliable basis for the VAT and enterprise profits taxes. Identification of enterprises warranting priority attention will be required (see diagnostic assessment above).

### Price reform

271. In striking a balance between maintaining and raising current output levels and re-orienting economic activity towards efficiency and profit, the Government will find the introduction of market prices a powerful instrument, particularly in the energy sector. Infrastructure pricing, water charges, and market prices for inputs, outputs and distribution will also need to be introduced where these do not already exist. Some of the pricing issues are complex and the Government will need to develop appropriate expertise, for instance in designing the electricity tariff and determining the extent to which differential pricing would be justified and efficient in the electricity industry.

### Judicial and regulatory

272. Part of a well-functioning private sector environment is clear and consistent law and regulations, so that the rules of the game are known; respect for contracts; reliable, fair and independent judicial and regulatory systems, and access to impartial dispute resolution when needed. In order to improve the business environment, the Government will need to identify weaknesses in the judicial and regulatory systems and develop corrective measures, and introduce capacity to adjudicate in commercial law.

### Insurance

273. As part of the enabling environment for private sector development, the government should establish the appropriate legal framework and regulations for development of the insurance industry. For this it needs to develop policy, legal drafting and lay down professional standards.

### Company registry

274. To facilitate the establishment of a single company register (which would also provide a list of companies for the benefit of the tax authorities), and notification of required information on companies, the Government wants to set up a company registry under the aegis of the Statistical Office.

### Adjustment and competition

275. The Government would also like to review policy, institutions, infrastructure and support systems in key sectors with the aim of promoting adjustment. Priority areas for this focus are: agricultural policy advice, introduction of agricultural extension services, and the establishment of land registries and cadastral surveys to facilitate the development of a market where land titles can be traded. Capacity is also needed as a matter of priority in order to introduce economic and environmental criteria into water planning and energy planning. In the transport sector, priority attention is required to establish an adequate safety and regulatory framework; set up effective regulatory and monitoring agencies; and introduce modern techniques of intermodal planning, design, and construction management before further public investment occurs in this sector.

276. In the labor market, provision of information to both employers and jobseekers, identification of skills required by employers, and appropriate training to supply those skills, will raise the speed of economic adjustment, especially if the information and training network offers services to the employed population as well as the unemployed so that they can acquire the skills (e.g., computing, accountancy) demanded by employers in the new market environment. Institutional and technical capacity will have to be developed to realize these objectives.

277. As economic restructuring proceeds, new imperatives will emerge. Overall, the Government will want to ensure that institutional capacity and skills keep pace with the reforms that it undertakes and that the reform program is implemented in a transparent manner. The Government must also seek to share the costs of adjustment as equitably as possible and communicate clearly with the electorate. Within the former Soviet Union, Armenia is a pioneer in reform: no other republic has moved so far or so fast. Interest in the success of the Armenian reform program extends far beyond its borders, and will influence the transformation to liberal economies and societies within the region as a whole.

## **ATTACHMENT 3**

### **HOUSING PRIVATIZATION AND DEVELOPMENT OF A HOUSING MARKET**

278. Once full cost recovery for the existing stock of housing has been achieved and a satisfactory legal framework (see below) has been established, the stage is set for the development of a housing market where people can rent or sell their apartments. The housing market will require supporting financial services (construction finance, mortgages, and insurance), but it should lead to a positive real rate of return on new housing, as excess demand for existing housing bids up its rental value and sales price. The government will still need to take continuing responsibility for implementing a program to address the need for new housing for the homeless, however, since these families will not have the effective demand to rent or purchase living space on their own. In addition to housing subsidies, the government may want to consider the possibilities of public works (see Chapter on the labor market) and "sweat equity" or other forms of participatory construction plus ownership.

279. Legal framework. The new Law on Ownership will provide clear ownership rights to different types of assets by level of government and thereby open the road to privatization. Local authorities are expected to receive title to housing and communal services, as well as to shops, some enterprises, and education and health facilities. In addition, however, the building and land ownership status for specific housing properties will need to be defined, distinguishing the areas subject to privatization and the rights of easement. For property subject to privatization, provision should be made for condominium and co-ownership laws, a rental statute with sample contracts, sample maintenance contracts, insurance laws, and mortgage security and foreclosure rules. For land remaining in the public sector, provision should be made for different types of leasehold contracts.

280. Privatization program. Local authorities should clearly explain the housing privatization program in the media so that the process becomes transparent and the advantages of ownership and a housing market are understood. Consensus at the national level on the model and preconditions for a privatization program will facilitate and speed up the process at the local level. Cost recovery through more realistic rents (discussed above) and the formation of a cooperative, with by-laws and a governing body, should both be pre-conditions for privatization. Majority rules governing choice of manager and decisions on maintenance and major repairs will be needed in buildings that are either partially or totally privatized, and provisions for contributions to maintenance by the poor will need to be considered (for example, through provision of cash benefits linked to a subsistence basket covering minimal housing costs, as discussed above). At the same time, sanctions for non-payment of cooperative fees will need to be specified. Government maintenance and construction teams have reportedly already formed themselves into cooperatives, which could provide maintenance services in a competitive environment.

281. Implications for government revenues and expenditures on new public housing. The establishment of private housing would provide a wider base for property taxes, which are normally assigned to local government. Local authorities may also want to raise additional revenues through the sale of city property to private investors and to levy a small transactions tax on real estate sales (not more than 4 percent, so as not to discourage the new housing market) to help finance their expenditures. Revenues from such sources could be expected to grow over time as the real estate market develops. In addition, budgetary saving on maintenance and communal services subsidies would provide substantial resources that could be earmarked over a period of say 5 years to provide

**housing for the homeless. Alternative private-public arrangements for construction could be explored, and some provision for the expression of consumer preferences could be introduced in apartment designs. As discussed above, public works to provide new housing in the earthquake zone should be explored as one way to provide residual employment in a socially useful way. Equity would require that the new apartments be made available to the homeless on terms similar to those made available to households already occupying public housing.**





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