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Armenia: Interim PRSP, Country Assistance Strategy and Fourth Structural Adjustment Credit

1. We welcome the discussion on Armenia’s Interim Poverty Reduction Strategy paper, the Country Assistance Strategy and the proposed Fourth Structural Adjustment Credit for Armenia. The Government of Armenia is to be complimented for preparing a fairly comprehensive I-PRSP. The Bank Staff have succeeded in establishing robust links between the CAS and the I-PRSP.

2. Poverty: Armenia remains a very poor country. Some 32.14% of the population are in poverty and 22.91% are destitute; the corresponding figures for households are 30.53% and 19.14% respectively. Moreover, some households are regarded as potentially poor, as their incomes are in the range 12,000-12,500 drams, only narrowly exceeding the poverty line. As a result, up to 68% of the population could need some form of poverty-related social protection. Armenia has failed to develop a middle class, instead exhibiting a high degree of income inequality. The income level among the wealthiest 20% of the population is 32.2 times that of the poorest 20%. At least 620,000 Armenians (and possibly up to 1 million), out of an official population of 3.8 million, are estimated to be currently abroad seeking alternative sources of income. Most of those abroad are of working age, and two-thirds are men. Emigration peaked in 1993 but has continued in subsequent years (with the possible exception of 1996), despite the end of hostilities with Azerbaijan and a return to GDP growth (both in 1994).

Both the I-PRSP and CAS fail to adequately address the issue of income inequality. Economic growth in such a situation is by no means a guarantee for poverty reduction. The proposed 5 percentage point reduction in poverty would need to be detailed with an emphasis on the lowest income deciles and an aggressive focus on employment generation. The high level of human capital (especially literacy levels) in Armenia seem to indicate that micro-credit programs could make a substantial impact on poverty. We would like to see more effort to promote micro-credit in Armenia both through the Bank and also IFC’s activities.
3. **Financial sector**: Armenia’s track-record in the regulation of the banking sector has been impressive and, perhaps, the best amongst all the Soviet successor states. The macro-economic management too has been extremely good with the hyper-inflation of the early 90s being successfully reigned in and the **dram** being one of the most stable currencies in the region. However, despite the favorable regulatory and macroeconomic environment, Armenia’s banking system shows few signs of deepening. This is a consequence of three factors:

- **Weak intermediation.** High lending rates on commercial loans (50% or more for short-term credits) restrict the intermediary role of banks in the enterprise sector. The Central Bank of Armenia has persisted with high interest rates despite the fall of inflation to single-digit levels. At present, Armenia has the highest real interest rates in the Former Soviet Union (FSU). This hinders the revival of industry after a decade of war and economic devastation, and the expansion of the intermediary capacity of local banks.

- **Low deposit base.** Armenia (along with Georgia) has experienced the most dramatic declines in personal incomes of all the former communist countries in the 1990s. This has prevented Armenian households from generating the surpluses needed to build the deposit bases of local banks. Despite impressive growth rates in recent years, income levels hover near subsistence levels. The problem is compounded by persistent Soviet habits, such as hoarding cash in homes, and the popular unfamiliarity with personal banking.

- **Limited foreign input.** Foreign investors have withheld investments in the modernisation of Armenia’s banking sector. While the diaspora played a visible role in bank privatisation, the sector attracted only one strategic foreign investor -- UK-based Hong Kong & Shanghai Banking Corporation (HSBC). This deprived Armenia of the spillover effects -- particularly the modernization of information technology (IT) and promotion of intermediary services -- seen in Hungary, Poland and other transition economies where strategic foreign investors played a central role in financial sector development.

Moreover, regulatory reforms in the securities market have lagged behind developments in the banking sector. The capital market is even thinner than the banking system. The overwhelming majority of transactions consist of trade in government securities, whose relative safety (not a single default) and attractive yields (50% or more) crowd out stocks, bonds, corporate paper and other forms of non-bank finance essential to private enterprise development. Turnover on the country’s three stock exchanges consists of sporadic trading of equity shares among a handful of listed companies. Secondary trading is virtually non-existent, restricting yield.
diversification and price discovery.

We would like to see more precise detailing, both in the full PRSP and perhaps in the CAS update, of what the Bank intends to do in these crucial areas of reform of the financial sector. The Bank should work in close collaboration with the EBRD, which has approved a Euro 10 million line of credit for the financial sector in Armenia.

4. **Governance**: Weak governance and administrative capacity will be a significant impediment to private sector development in Armenia. The CAS has rightly identified this area as a significant risk. The Bank would need to underpin its work in Armenia with increasingly sophisticated Economic and Sector Work in the area of governance, to make its lending program more effective.

5. **Agriculture and Disaster Management**: The country is yet to fully recover from the aftermath of the devastating earthquake in 1999. Last year, agricultural production contracted 3.7%, as a consequence of a severe drought. These incidents illustrate the need for a proper disaster management framework to be put in place. Neither the CAS nor the I-PRSP makes any mention of this aspect. It may be mentioned that Armenia has rightly switched to small-scale agriculture away from the large agro-industrial complex of the Soviet era. But the agricultural sector has long-term needs of more investment and updated technology to take care of farmers need of credit, high-yielding variety of seeds, irrigation and market.

   The full PRSP and CAS update should outline a comprehensive strategy for the agricultural sector as well as for disaster management.

6. **Environment**: Sustainable development and reversing the environmental degradation of the Soviet years is one of the greatest challenges facing Armenia. One of the worst problems is contamination of the water supply. Springs are the main source of potable water, but damaged and unmaintained pipes have led to pollution and transport losses of over 30% in the major water mains. Some towns and agricultural settlements are under threat because irrigation waters often contain high levels of oil derivatives, chloride, nitrates and heavy metals, along with other pollutants. The Medzamor nuclear plant remains a safety risk. Closed in 1988 after the Chernobyl disaster and the earthquake, the plant was reopened in 1995 to alleviate the severe shortages of electricity in the country that occurred in the early 1990s.

   We find it surprising that the CAS makes no mention of mainstreaming these environmental concerns in to Armenia’s development strategy.
7. **Foreign Trade and development of SMEs:** The outlook, at least in the near term, for promoting Armenian exports is decidedly mixed. The global slowdown and softening of commodity prices will have a dampening effect on foreign trade especially to the CIS countries, which are Armenia’s largest export markets. The current account deficit, at around 17%, is clearly unsustainable. The PRSP will need to give more thought to this issue.

8. **Fourth SAC:** The close donor coordination intended for the Fourth SAC is a positive feature of the Credit, given the relatively large amount of foreign aid that Armenia receives per capita. For example, the EBRD has a substantial program in Armenia which includes institutional strengthening of the telecommunications sector, restructuring the energy sector project portfolio, developing the financial sector, strengthening and financing local small and medium-sized enterprises (SMEs) and identifying investments that will facilitate the privatization of large enterprises.

   *We think the conditions for the release of the first, second and floating tranches are relevant and properly focussed. We support the proposed Credit.*

9. We commend all three documents. We think the Base case triggers and indicators outlined in the CAS are adequate. The settlement of the Nagorno-Karabakh dispute should not come in the way of the Bank’s activities in Armenia and we support the increased regional focus of analytical and technical assistance.

   *Subject to the comments above, we feel the proposed combination of lending and non-lending activities for Armenia is appropriate.*