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Report No. 24459

PROJECT PERFORMANCE ASSESSMENT REPORT

ARMENIA

REHABILITATION CREDIT
(Credit 2683-AM)

STRUCTURAL ADJUSTMENT CREDIT I
(Credit 2824-AM)

STRUCTURAL ADJUSTMENT TECHNICAL ASSISTANCE CREDIT I
(Credit 2825-AM)

STRUCTURAL ADJUSTMENT CREDIT II
(Credit 2980-AM)

STRUCTURAL ADJUSTMENT CREDIT III
(Credit 3153-AM)

July 3, 2002

Country Evaluation and Regional Relations Group
Operations Evaluation Department

Currency Equivalents

Currency Unit		Armenian Dram
1995 US$1	=	D402.00
1996 US$1	=	D435.07
1997 US$1	=	D494.98
1998 US$1	=	D522.03
1999 US$1	=	D523.77
2000 US$1	=	D552.18

Abbreviations and Acronyms

CAS	Country Assistance Strategy
CBA	Central Bank of Armenia
CEM	Country Economic Memorandum
CIS	Commonwealth Independent States
ECA	Europe and Central Asia
EM	Evaluation Memorandum
FSU	Former Soviet Union
GDP	Gross Domestic Product
GOA	Government of Armenia
IBL	Institution Building Loan
ICR	Implementation Completion Report
IDA	International Development Agency
IDI	Institutional Development Impact
IMF	International Monetary Fund
MOP	Memorandum of the President
MTEF	Medium Term Expenditure Framework
NK	Nagaro Karabakh
OED	Operations Evaluation Department of the World Bank
PPAR	Project Performance Assessment Report
PSD	Private Sector Development
RC	Rehabilitation Credit
SAC I	Structural Adjustment Credit I
SAC II	Structural Adjustment Credit II
SAC III	Structural Adjustment III
SAC IV	Structural Adjustment IV
SATAC I	Structural Adjustment Technical Assistance Credit I
SOEs	State-owned Enterprises
TA	Technical Assistance
TIN	Taxpayer Identification Number
WTO	World Trade Organization

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The World Bank
Washington, D.C. 20433
U.S.A.

Office of the Director-General
Operations Evaluation

July 3, 2002

MEMORANDUM TO THE EXECUTIVE DIRECTORS AND THE PRESIDENT

SUBJECT: **Project Performance Assessment Report on Armenia—Rehabilitation Credit (Credit 2683-AM); Structural Adjustment Credit (Credit 2824-AM); Structural Adjustment Technical Assistance Credit I (Credit 2825-AM); Structural Adjustment Credit II (Credit 2980-AM); Structural Adjustment Credit III (Credit 3153-AM)**

Attached is the Project Performance Assessment Report (PPAR) on the above credits to Armenia, made from 1995 to 2001. The main objectives of the four adjustment operations were to establish and maintain macroeconomic stability; improve financial discipline in the private and public sectors; accelerate the growth and development of the private sector; and ensure the social sustainability of reforms. They were intended to support the government's program to remove distortions and controls left over from the central planning system, remedy institutional deficiencies, and set up a framework that could support a market economy. The technical assistance credit provided capacity-building and advice to support implementation of reforms.

Reform progress was more rapid in 1995 and 1996 than it was later. This was because: the types of reforms addressed in the later period were more difficult to tackle; after 1996 the Armenian political process became more fragmented; and after 1996 there was a weakened government willingness and ability to tackle vested interests opposed to reform.

The adjustment credits were partially successful; there was considerable success in macroeconomic stabilization, with low inflation and a stable exchange rate. Real GDP has grown for 7 consecutive years, averaging growth of over 5% per year. However, the country receives a large amount of remittances (8-9% of GDP) that together with international assistance (10.5 % of GDP) permit it to finance a large current account deficit. While GDP has grown, there has been no impact on poverty—which remains at 55% of the population—and negligible growth in employment.

The adjustment credits substantially facilitated progress in the removal of nearly all price controls and trade barriers; privatization of nearly all state-owned enterprises; strengthening of the financial sector; improving payment discipline and the establishment of a strong regulatory regime in the energy sector; significant strengthening of irrigation and drinking water firms; establishment of a legal framework suitable for a market economy; important education reforms; and improved benefits targeting.

However, the adjustment program placed insufficient emphasis on many critical aspects of private sector development. Insufficient weight was accorded to establishment of a business environment conducive to private enterprise and the entry of new firms; enterprise restructuring; building adequate government capacity to support a market economy; a judicial system with credible enforcement of contracts and property rights; and effective procedures for bankruptcy and liquidation.

The PPAR rates the outcome of the Rehabilitation Credit as *highly satisfactory*, institutional development impact as *substantial*, and borrower performance as *highly satisfactory*, the same as the ICR and the OED ES. Sustainability is rated as *highly likely*, as compared to *likely* in the ICR and OED ES because, with the benefit of additional time, it is evident that the reforms achieved are part of the fabric of Armenian society, and have very broad support. Bank performance is rated as *highly satisfactory*, higher than the OED ES, because with access to more information the PPAR finds that while mobilization of donor funds through the Consultative Group was only modestly successful, this shortfall was in large measure due to the reluctance of many potential donors to support the government at a time when the conflict over Nagorno-Karabakh had just ended—an obstacle that could not be overcome by painstaking Bank efforts.

The PPAR rates the outcome of the First Structural Adjustment Credit as *satisfactory*, and Bank and borrower performance as *satisfactory*, the same as the ICR and the OED ES. Institutional development impact is rated as *substantial*, as compared to *modest* in the OED ES and substantial in the ICR. Sustainability is assessed as *highly likely*, as compared to *likely* in the ICR and OED ES, for the same reasons as in the Rehabilitation Credit.

The PPAR rates the outcome of the First Structural Adjustment and Technical Assistance Credit as *moderately satisfactory*, the same as the OED ES but lower than the ICR. With the benefit of access to more information, the PPAR finds that the legal assistance component placed inadequate emphasis on enforcement, while important work on civil service reform and bankruptcy training were dropped. The PPAR rates institutional development impact as *modest*, and Bank and borrower performance as *satisfactory*, the same as the OED ES and the ICR. Sustainability is assessed as *highly likely*, for the same reasons as in the two earlier credits.

The PPAR rates the outcome of the Second Structural Adjustment Credit as *moderately unsatisfactory*, compared to *satisfactory* in the ICR and *marginally satisfactory* in the OED ES. Institutional development impact is assessed as *modest*, and borrower performance as *satisfactory*, the same as the ICR and the OED ES. The PPAR rates sustainability as *likely*, compared to *uncertain* in the OED ES and *likely* in the ICR. Bank performance is assessed as *unsatisfactory*, as compared to *satisfactory* in the two earlier assessments. Borrower performance is assessed as *satisfactory*, the same as in the ICR and the OED ES. With the benefit of greater time and access to more information, the PPAR assesses the project as having modest relevance because it did not address some of the country's key development needs. The principal shortcoming was the lack of sufficient emphasis on critical aspects of private sector development, which resulted to some extent from the shortcomings of the project design as well as the government's reluctance to tackle some important reforms. The PPAR also finds that the release of the credit's second tranche was made on the basis of insufficient evidence of the achievement of the requisite conditions. The project's health financing reforms were poorly designed, and the privatization of the telecom company was implemented without the development of a satisfactory regulatory framework.

The PPAR rates the outcome of the Third Structural Adjustment Credit as *moderately satisfactory*, compared to *satisfactory* in the ICR and *moderately satisfactory* in the OED ES. Sustainability is rated as *likely*, the same as in the ICR and the OED ES. Institutional development impact is rated as *substantial*, compared to *substantial* in the ICR and *modest* in the OED ES. IDI is rated as substantial because the PPAR weighs IDI achievements in the energy, education, financial, and irrigation sectors more highly. Bank and borrower performance are rated as *satisfactory*, the same as the ICR and the ES. While the project had only modest relevance and did not achieve one important condition—sale of the electricity generating company—the PPAR finds that the government and the Bank made an impressive effort to do so, only to attract no bidders. Most other relevant objectives were achieved, including a number of very valuable ones in the energy, financial, irrigation, social protection, and education areas.

The main lessons derived were:

- Effectiveness can be enhanced when adjustment projects are synergistic with sector investment projects.
- For an adjustment program focused on private-sector led growth, key constraints to private sector development must be confronted
- As the reform program advances, progress may become more difficult.
- It is unrealistic to assume that if "the fundamentals" are in place, an automatic "supply response" will take place
- Legal reform should take adequate account of enforcement capacity
- Continuity and dedication of the country team contribute to program effectiveness
- Turnover among Government policy officials hindered reform progress

Robert Picciotto
by Gregory K. Ingram

OED Mission: Enhancing development effectiveness through excellence and independence in evaluation.

About this Report

The Operations Evaluation Department assesses the programs and activities of the World Bank for two purposes: first, to ensure the integrity of the Bank's self-evaluation process and to verify that the Bank's work is producing the expected results, and second, to help develop improved directions, policies, and procedures through the dissemination of lessons drawn from experience. As part of this work, OED annually assesses about 25 percent of the Bank's lending operations. In selecting operations for assessment, preference is given to those that are innovative, large, or complex; those that are relevant to upcoming studies or country evaluations; those for which Executive Directors or Bank management have requested assessments; and those that are likely to generate important lessons. The projects, topics, and analytical approaches selected for assessment support larger evaluation studies.

A Project Performance Assessment Report (PPAR) is based on a review of the Implementation Completion Report (a self-evaluation by the responsible Bank department) and fieldwork conducted by OED. To prepare PPARs, OED staff examine project files and other documents, interview operational staff, and in most cases visit the borrowing country for onsite discussions with project staff and beneficiaries. The PPAR thereby seeks to validate and augment the information provided in the ICR, as well as examine issues of special interest to broader OED studies.

Each PPAR is subject to a peer review process and OED management approval. Once cleared internally, the PPAR is reviewed by the responsible Bank department and amended as necessary. The completed PPAR is then sent to the borrower for review; the borrowers' comments are attached to the document that is sent to the Bank's Board of Executive Directors.

About the OED Rating System

The time-tested evaluation methods used by OED are suited to the broad range of the World Bank's work. The methods offer both rigor and a necessary level of flexibility to adapt to lending instrument, project design, or sectoral approach. OED evaluators all apply the same basic method to arrive at their project ratings. Following is the definition and rating scale used for each evaluation criterion (more information is available on the OED website: http://worldbank.org/oed/eta-mainpage.html).

Relevance of Objectives: The extent to which the project's objectives are consistent with the country's current development priorities and with current Bank country and sectoral assistance strategies and corporate goals (expressed in Poverty Reduction Strategy Papers, Country Assistance Strategies, Sector Strategy Papers, Operational Policies). *Possible ratings:* High, Substantial, Modest, Negligible.

Efficacy: The extent to which the project's objectives were achieved, or expected to be achieved, taking into account their relative importance. *Possible ratings:* High, Substantial, Modest, Negligible.

Efficiency: The extent to which the project achieved, or is expected to achieve, a return higher than the opportunity cost of capital and benefits at least cost compared to alternatives. *Possible ratings:* High, Substantial, Modest, Negligible. This rating is not generally applied to adjustment operations.

Sustainability: The resilience to risk of net benefits flows over time. *Possible ratings:* Highly Likely, Likely, Unlikely, Highly Unlikely, Not Evaluable.

Institutional Development Impact: The extent to which a project improves the ability of a country or region to make more efficient, equitable and sustainable use of its human, financial, and natural resources through: (a) better definition, stability, transparency, enforceability, and predictability of institutional arrangements and/or (b) better alignment of the mission and capacity of an organization with its mandate, which derives from these institutional arrangements. Institutional Development Impact includes both intended and unintended effects of a project. *Possible ratings:* High, Substantial, Modest, Negligible.

Outcome: The extent to which the project's major relevant objectives were achieved, or are expected to be achieved, efficiently. *Possible ratings:* Highly Satisfactory, Satisfactory, Moderately Satisfactory, Moderately Unsatisfactory, Unsatisfactory, Highly Unsatisfactory.

Bank Performance: The extent to which services provided by the Bank ensured quality at entry and supported implementation through appropriate supervision (including ensuring adequate transition arrangements for regular operation of the project). *Possible ratings:* Highly Satisfactory, Satisfactory, Unsatisfactory, Highly Unsatisfactory.

Borrower Performance: The extent to which the borrower assumed ownership and responsibility to ensure quality of preparation and implementation, and complied with covenants and agreements, towards the achievement of development objectives and sustainability. Possible ratings: Highly Satisfactory, Satisfactory, Unsatisfactory, Highly Unsatisfactory.

Contents

The report was prepared by Elliott Hurwitz (Consultant). Mr. Jorge Garcia-Garcia was the peer reviewer. Tirsit Dinka provided administrative support.

Contents (cont.)

Annexes

Attachment

Ratings and Responsibilities

Rehabilitation Credit (March 7, 1995-June 30, 1996)

Performance Ratings

	*ICR**	*ES**	*PPAR*
Outcome	Highly Satisfactory	Highly Satisfactory	Highly Satisfactory
Sustainability	Likely	Likely	Highly Likely
Institutional Development Impact	Partial	Partial	Substantial
Bank Performance	Highly Satisfactory	Satisfactory	Highly Satisfactory
Borrower Performance	Highly Satisfactory	Highly Satisfactory	Highly Satisfactory

*The Implementation Completion Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The Evaluation Summary (ES) is an intermediate OED product that seeks to independently verify the findings of the ICR.

Key Staff Responsbile

Staff	*Appraisal*	*Completion*
Task Manager	Jonathan Walters	Ana Revenga
Division Chief	Wafik Grais	Wafik Grais
Country Director	Basil Kavalsky	Basil Kavalsky

ICR prepared by Gary McMahon

Ratings and Responsibilities

SAC I (March 22, 1996-December 31, 1997)

Performance Ratings

	*ICR**	*ES**	*PPAR*
Outcome	Satisfactory	Satisfactory	Satisfactory
Sustainability	Likely	Likely	Highly Likely
Institutional Development Impact	Substantial	Modest	Substantial
Bank Performance	Satisfactory	Satisfactory	Satisfactory
Borrower Performance	Satisfactory	Satisfactory	Satisfactory

*The Implementation Completion Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The Evaluation Summary (ES) is an intermediate OED product that seeks to independently verify the findings of the ICR.

Key Project Responsibilities

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ICR prepared by Richard Carroll

Ratings and Responsibilities

SATAC I (March 22, 1996-June 30, 2000)

Performance Ratings

	*ICR**	*ES**	*PPAR*
Outcome	Satisfactory	Marginally Satisfactory	Moderately Satisfactory
Sustainability	Likely	Likely	Highly Likely
Institutional Development Impact	Partial	Modest	Modest
Bank Performance	Satisfactory	Satisfactory	Satisfactory
Borrower Performance	Satisfactory	Satisfactory	Satisfactory

*The Implementation Completion Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The Evaluation Summary (ES) is an intermediate OED product that seeks to independently verify the findings of the ICR.

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ICR prepared by Richard Carroll

Ratings and Responsibilities

SAC II (September 22, 1997-June 30, 1999)

Performance Ratings

	*ICR**	*ES**	*PPAR*
Outcome	Satisfactory	Marginally Satisfactory	Moderately Unsatisfactory
Sustainability	Likely	Uncertain	Likely
Institutional Development Impact	Partial	Modest	Modest
Bank Performance	Satisfactory	Satisfactory	Unsatisfactory
Borrower Performance	Satisfactory	Satisfactory	Satisfactory

*The Implementation Completion Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The Evaluation Summary (ES) is an intermediate OED product that seeks to independently verify the findings of the ICR.

Key Project Responsibilities

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Country Director	Basil Kavalsky/Judy O'Connor	Judy O'Connor

ICR prepared by Richard Carroll

Ratings and Responsibilities

SAC III (December 28, 1998-June 30, 2001)

Performance Ratings

	*ICR**	*ES**	*PPAR*
Outcome	Satisfactory	Moderately Satisfactory	Moderately Satisfactory
Sustainability	Likely	Likely	Likely
Institutional Development Impact	Substantial	Modest	Substantial
Bank Performance	Satisfactory	Satisfactory	Satisfactory
Borrower Performance	Satisfactory	Satisfactory	Satisfactory

*The Implementation Completion Report (ICR) is a self-evaluation by the responsible operational division of the Bank. The Evaluation Summary (ES) is an intermediate OED product that seeks to independently verify the findings of the ICR.

Key Project Responsibilities

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ICR prepared by Reza Ghasimi

Preface

This is the Project Performance Assessment Report for the Rehabilitation Credit (C2683); First Structural Adjustment Credit (C2824); First Structural Adjustment Technical Assistance Credit (C2825); Second Structural Adjustment Credit (C2980); and Third Structural Adjustment Credit (C3153). All four of the adjustment credits disbursed 100 percent of their funds, and the technical assistance credit (SATAC) disbursed 75 percent of its original amount.

The Rehabilitation Credit was approved on February 28, 1995, became effective on March 7, 1995, and totaled US$73.3 million. The project closed on June 30, 1996, the original closing date.

The First Structural Adjustment Credit was approved on February 29, 1996, became effective on March 22, 1996, and totaled US$60 million. The credit closed on December 31, 1997, the original closing date.

The First Structural Adjustment Technical Assistance Credit was approved on February 29, 1996, became effective on March 22, 1996, and totaled US$3.8 million. The credit was postponed four times, and closed on June 30, 2000, compared with an original closing date of December 31, 1997.

The Second Structural Adjustment Credit was approved on August 26, 1997, became effective on September 22, 1997, and totaled US$60 million. The credit closed on June 30, 1999, compared with the original closing date of March 31, 1999.

The Third Structural Adjustment Credit was approved on December 22, 1998, became effective on December 28, 1998, and totaled US$65 million. The credit closed on June 30, 2001, compared with the original closing date of June 30, 2000.

This PPAR is based on President's Reports, credit documents, project files, economic and sector reports from 1995 to 2001, documents from the International Monetary Fund, interviews with current and former Government officials (during a mission that visited Armenia in March 2001), discussions with former and current Bank staff involved directly in the credits or in the lending program to Armenia, and Implementation Completion Reports. Their cooperation and assistance in preparing this report are greatly appreciated.

The PPAR differs, in part, with the ICR findings and ratings on the projects. Differences in judgment are due partially to the additional information, and longer perspective, available to the mission and to the PPAR.

The PPAR was sent to the Government for comments but the comments received (attached as Attachment 1) did not require any revisions to the report.

1. Introduction

1.1 OED selected these five lending operations to evaluate key aspects of the Bank's stabilization, adjustment and technical assistance program to Armenia, and derive lessons for future operations. The five adjustment operations comprise a continuous program of reform over the period 1995-2001. Their timing and size are shown below.

Figure 1.1: Five Projects Included in the PPAR and Related Credits

	US$	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
➡ **Rehabilitation**	60								
➡ **SAC I**	60								
➡ **SATAC I**	3.8								
Ent Devlopmt	16.8								
SATAC 2	5								
➡ **SAC II**	60								
➡ **SAC III**	65								

➡ **Project included in this Assessment**

1.2 By early 1995, Armenia was attempting to overcome three main development challenges: (1) large macroeconomic imbalances, and a huge fall in GDP—around 50 percent since 1990; (2) transition from a centrally planned to a market economy; (3) the lingering effects of the conflict with Azerbaijan (for which a ceasefire had been reached in 1994): closed borders limited trade and access to energy supplies.

1.3 By 1995 the country had privatized agricultural land and implemented some "first generation" reforms:[1] decontrol of most prices; elimination of most trade restrictions; decontrol of the distribution system; initial development of a legal framework suitable for a market economy. The macroeconomic situation was starting to improve from the terrible circumstances that had prevailed earlier in the decade: GDP had started to grow, but from a very low base; inflation was 175 percent, down from 4,962 percent the previous year; and the budget deficit, -9 percent of GDP, had improved from the two previous years.

1.4 The Bank's reform strategy appropriately focused on macroeconomic stabilization and completion of first generation reforms. Other aspects of the program included revenue mobilization; stronger bank regulation; energy sector restructuring and payment discipline; reform of the irrigation and drinking water sectors; and reform of health, education, and social protection. By 2001, significant progress had been made in most of these areas.

1.5 However, while progress was being made in achievement of first generation reforms, by 1996-98 the Bank recognized that it would be necessary to go beyond them. "Second generation" reforms identified as key to enabling growth were: adequate government capacity to support a market economy, including civil service reform and effective regulation; an

[1] As discussed below in paragraph 2.3, "first generation reforms" included: privatization of most state-owned companies; elimination of price and wage controls; elimination of state control of trade; establishment of a liberal trade regime; ending government control of distribution; and establishment of a legal framework adequate to support a market economy.

environment conducive to private business, including protection from arbitrary administrative actions; effective procedures for bankruptcy and liquidation, and circumstances favorable to the entry of new firms; a transparent legal framework and a judicial system with credible enforcement of contracts and property rights; availability of adequate financing for working and fixed capital.

1.6 Overall, *little progress was made* from 1995 to 2001 in achieving second generation reforms. In some cases, work was undertaken as part of the extant reform program but has not yet borne fruit. In other cases, the Bank undertook analytical work and a dialog with the government, but little progress resulted. And in yet other areas, government reluctance or delay prevented progress. (Paragraph 2.4 provides more detail)

1.7 Following independence in 1991, Armenia suffered a steep fall in income, with real GDP declining by 11.7 percent in 1991 and 41.8 percent in 1992; at its nadir in 1993 GDP had fallen an aggregate of around 63 percent (since 1990).[2] The rapid decline was caused by: the country's conflict with Azerbaijan, which raged until 1994, and which caused the closure of the borders with Azerbaijan and Turkey as well as a huge inflow of refugees; the loss of markets in the FSU; termination of subsidies from Moscow through implicit price transfers; severe shortages of foreign exchange; a large reduction in energy supply due to the interdiction of pipelines from Azerbaijan and Georgia, along with an enormous increase in energy prices;[3] and a sharp reduction in credit.

Macroeconomic Stabilization, but No Reduction in Poverty

1.8 *Macroeconomic progress.* Armenia made great progress in stabilizing its economy during the period 1995-2001. As shown in Table 1.1, below, GDP bottomed out in 1993, climbing in 1994 and in every year since. Inflation was still extremely high in 1995, but it began to decline that year and has continued to decline each year since then. The exchange rate began to stabilize in 1995 and since then has slowly declined, losing around 33 percent of its value against the U.S. dollar in the last six years.

1.9 *Virtually no impact on poverty.* Armenia's growth since 1994 has been at the high end of the CIS countries. Armenia also compares quite favorably with other low-income CIS countries in terms of fiscal discipline and debt sustainability (additional detail is in Annex H). But growth was from a severely depressed level and narrowly based, with little new investment and negligible job creation (see Table 1.1). Growth disproportionately benefited workers in a few relatively well-paid sectors that employed a small proportion of total labor.[4] For industry and agriculture combined, with almost two thirds of total employment, real wage growth was insignificant. Poverty remained high at 55 percent. Exports remained low, declining about 10

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[2] Armenia's income decline of 63 percent was greater than that of any Former Soviet Union country except Georgia. The average decline for the Commonwealth Independent States (CIS, excluding the Baltics) was 51 percent. World Bank, ECA, "Transition After a Decade," 2000, p. 15 (November 2000 draft).

[3] For example, the Producer Price Index for electricity increased 25-fold in 1992 over 1991 in nominal terms, with even larger increases in subsequent years. CIS Statistical Committee CD-ROM.

[4] For example, the public administration, transport and communications, and construction sectors accounted for about 10 percent of 1998 employment, but 25 percent of the economy-wide increase in the real wage bill. See World Bank, ECA, "Armenia: Growth Challenges and Government Policies," p. 7-9.

percent between 1995 and 1999; the country receives a large amount of remittances (8-9 percent of GDP) that together with international assistance (10.5 percent of GDP) permit it to finance a large current account deficit (16 percent of GDP in 2000). Armenia's income inequality increased faster, and reached a higher level, than any other CIS country.[5] Emigration continues,[6] and domestic savings are negative (-15 percent of GDP). Annex H has a more detailed discussion of macroeconomic performance and the degree to which Armenia fulfilled the conditionalities of each of the adjustment credits reviewed in this PPAR.

Table 1.1: Selected Macroeconomic Indicators

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
Annual Real GDP growth		-11.7	-41.8	-8.8	5.4	6.9	5.8	3.1	7.2	3.3	4.5
GDP level (1990=100)	100	88.3	51.4	46.9	49.4	52.8	55.9	57.6	61.7	63.8	66.3
Annual inflation, CPI		174.1	728.7	1822.9	4962.3	175.4	18.8	13.8	8.6	0.6	-0.8
FDI (mil. USD)					2.6	19.1	17.6	51.9	220.8	122.0	104
Budget deficit, as % of GDP		-1.8%	-7.7%	-51.9%	-16.5%	-9.0%	-8.6%	-5.7%	-4.7%	-5.5%	-4.0%
Tax revenues, as % GDP		4.3%	3.8%	15.0%	13.1%	12.7%	12.9%	16.3%	13.6%	16.1%	14.8%
Current Account, as % of GDP							-26.6	-26.1	-26.7	-17.3	-16.1
Total employed (000)					1,488	1,476	1,436	1,372	1,337	1,298	1,283
Exchange rate, Dram/US$					240.5	406.2	414	490.6	504.5	535	539
Exchange rate, Ruble/US$		22	220	932	2204						

Source: Country Department; employment data from IMF, Recent Economic Developments, May 2001, Table 17.
Note: The Dram was introduced in late 1993.

Intermittent Reforms

1.10 Armenia was an early and active reformer. Prior to Bank involvement, the government began privatization of agricultural land in 1991. Privatization of small businesses began in June 1991. Price decontrol began in April 1991, and by June 1992 most prices were decontrolled. Coverage of the economy by the state order system was reduced in 1992 to 50 percent of its level the previous year. And initial steps were taken to privatize the distribution system. Armenia also made a good start on developing the basic legal framework necessary for a market economy (see Annex D for details).

1.11 *But Armenian reform was an intermittent, stop-go process*, an attribute which vexed Bank staff through the entire period covered by this PPAR. This process is depicted graphically in Figure 1.2. During 1991 and the first half of 1992, reforms proceeded rapidly. But during mid-1992 the ongoing conflict with Azerbaijan over Nagorno Karabakh (NK) dominated government attention. However, in May 1994, a ceasefire was reached, which provided reform-minded policy officials with latitude to resume reforms in earnest. These officials, a small group of reform-oriented technocrats, collaborated effectively with the Bank to consolidate the reforms. From 1994-96, the remainder of the state order system and nearly all price controls were eliminated, privatization accelerated, and trade barriers were removed. Significant

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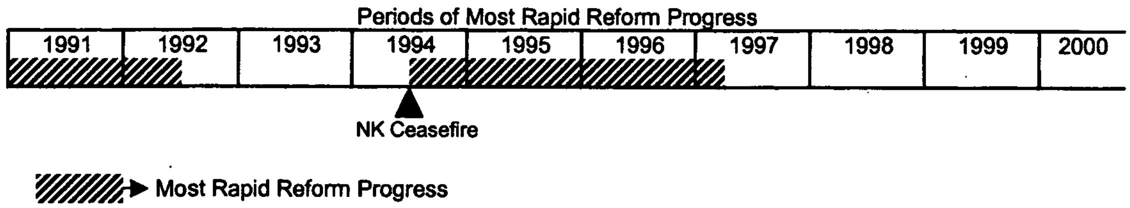
[5] The Gini coefficient rose from 0.27 in 1987-90 to 0.61 in 1996-98, op. cit. "Transition After a Decade," ECA, 2000, p. 21. While it would have been preferable to use the Gini ratio for consumption, (1) existing data do not support a broad cross-national and temporal comparison; and (2) consumption data show implausibly large differences between consumption and income.

[6] Official figures overstate the population, but many sources estimate that around 20-25 percent of the population has emigrated since 1991, concentrated in the best-educated working age segments. See Norwegian Refugee Council, www.idpproject.org.

improvements were also made in financial sector regulation, payment discipline[7] and the regulatory regime in the energy sector, and targeting of social benefits. A new law on intellectual property was passed, and reform of company, banking, and bankruptcy laws was undertaken.

Figure 1.2: Periods of Most Rapid Reform Progress



1.12 In the 1996 presidential election, substantial social discontent was manifested largely over the lack of economic progress. Subsequently, however, the shadow of the NK stalemate began to hinder the reform process (see Box 1.1), and the impetus for reform diminished. Government had less willingness and ability to tackle vested interests opposed to reform. The relative lack of reform progress also delayed and diminished the gains from reform for most people, and the perception that reforms had brought few benefits to the majority of the population contributed to weakening popular support for further reform. And a final factor hindering progress was that the country had begun to confront a more difficult "Second Generation" of reforms (described in greater detail below), which challenged entrenched vested interests to a greater extent than the reforms achieved thus far. These second generation reforms were also more complex, and required greater institutional capacity to implement.

Box 1.1: The Conflict over Nagorno Karabakh: Enduring Economic Implications

From 1991-1994, Armenia engaged in a conflict with Azerbaijan over NK, an ethnic Armenian enclave inside Azerbaijan. This resulted in many refugees from Azerbaijan entering Armenia and the closure of trade routes with Azerbaijan and Turkey. While a cease-fire was reached in 1994, and many rounds of negotiations have been held since, a peace agreement has not been concluded. Continuing economic implications include:

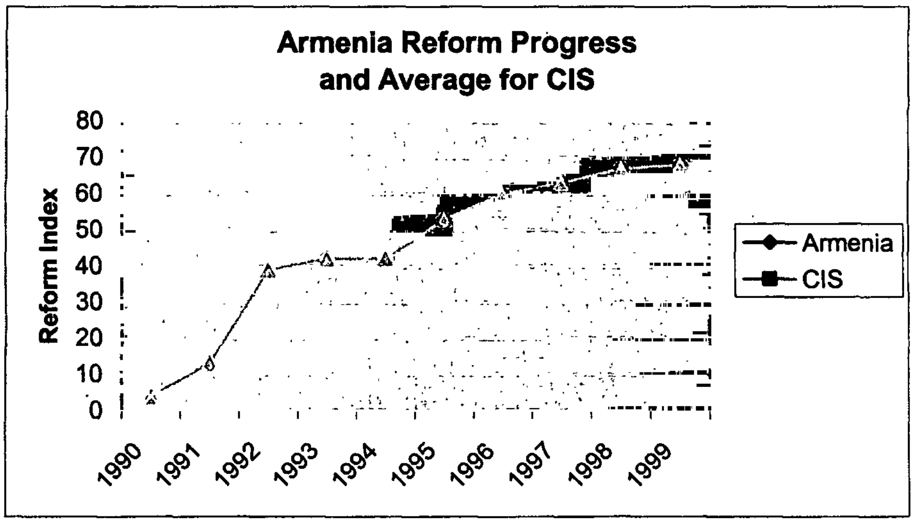
- Weakened Government willingness and ability to tackle vested interests opposed to reform
- The NK conflict delayed and diminished the gains from reform, and thus made the sustainability of reform more difficult
- Negative effects on the perceptions of potential foreign investors
- Transport costs around 50-100 percent higher than if borders were open
- Energy costs around 30 percent higher than if borders were open
- High defense costs around 26 percent of budgetary expenditures

1.13 An institutional transformation that also acted to slow the pace of reforms was the increasing fragmentation of the Armenian political process during the period covered by this PPAR. Whereas power had previously been more centralized, and opposition relatively muted, in the late 1990s alternative power centers arose which made it more difficult to implement reforms.

[7] "Payment discipline" and "energy collections" refer to the degree to which consumers and organizations are current in their payments to energy suppliers.

1.14 An index of reform in transition economies shows that Armenia rose from 4 in 1990 to 68 in 1999, impressive when compared with other CIS countries (0=centrally planned; 100=market economy). Figure 1.3, below, shows this reform index during the 1990s. The slope of the curve shows the very rapid progress the country made during 1991-92, and 1995-96, and the subsequent slowing of reform. Nonetheless, in absolute terms, Armenia's structural reforms have gone further than in the average CIS country (see next paragraph).

Figure 1.3: Armenia Reform Progress, 1990-1999



0=centrally planned; 100=market economy. Index is composite of two indices of (1) internal price liberalization; (2) privatization and regulation of new entries; (3) trade and exchange reform.

Source: "Armenia: Growth Challenges and Government Policies." World Bank, 2001. Latest data available.

1.15 Other sources characterize overall Armenian reform progress as extensive, although with progress in different areas varying significantly. EBRD,[8] for example, estimates that the private sector share of Armenia's GDP was 60 percent in mid-2000, which places it in a tie for second among CIS counties. However on a five-point scale, with higher numbers signifying better performance, reform progress is rated as 4 for the trade and foreign exchange system, 3+ for small scale privatization, 3 for large scale privatization and price liberalization, but just 2 for enterprise governance and restructuring. Banking and securities markets are rated at 2+ and 2-, respectively, while competition policy is rated at 1. Similarly, the Heritage Foundation Index of Economic Freedom[9] rates Armenian structural reform highly—the country has the highest overall ranking for 2001 of any CIS nation—but with "regulation" and "black market" rated at 4 (also on a five point scale), and no improvement in these areas 1996-2001. Property rights are rated at 3, also with no progress achieved in the last five years. (data prior to 1996 were not

[8] Op. cit., EBRD, "Transition Report 2000."

[9] www.heritage.org

available) Finally, the U. S. Department of Commerce has observed that bribery and influence-peddling in Armenia has undermined the emergence of the private sector.[10]

1.16 So, Armenia has made considerable reform progress since independence, but progress slowed in the late 1990s.[11] For example, the sale of most large companies—including one of the most viable, Yerevan Cognac Factory—was accomplished only after a long delay,[12] and the results have not been as beneficial as expected (see Annex C). *Bankruptcies and liquidations have been negligible,*[13] as the government's willingness to liquidate non-working enterprises and release their assets for productive use has been limited.[14]

1.17 However, during the same period progress was made on better targeting of social benefits, implementation of reforms in primary education, land and real estate registration, improved energy collections (see Annex E), and passage of new legislation (e.g., a new Civil Code and amended Real Property and Land Codes). Within the last three years, progress slackened after the Russian financial crisis (August, 1998), increased after the May, 1999, elections, but then slowed again after the tragic assassination of the country's Prime Minister and other leading officials in October, 1999.

2. Objectives and Design

2.1 As noted earlier, the five operations that are the subject of this PPAR supported a consistent and cohesive program of reform over the period 1995-2001. The program of four adjustment operations, accompanied by a Technical Assistance credit, proved to be a potent stimulus to the reform process. Table 2.1 shows the areas of reform addressed by each project. All of the credits had very broad agendas; SAC III alone had 28 "core" and 37 "non-core" conditions. The following were the most prevalent areas of program support:

- Economic Management: assisting the government to formulate economic policy and coordinate donor assistance
- Privatization Support: Legal and Regulatory Reform
- Social Sector: Improved Benefits Targeting
- Energy Sector: Improved Collections and Privatization Support
- Financial Sector Reform: Tighter bank supervision; IAS-compatible accounting; new banking laws, bank privatization; restructuring of problem banks; audits of all banks.

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[10] "...bribery is widespread and the most common form of corruption. Relationships between high Government officials and the emerging private sector is another fast-growing phenomenon, establishing influence-peddling between officials and private firms from which they benefit...These practices promote protectionism, creation of monopolies or oligopolies, hinder competition and undermine the image of the Government as a facilitator of private sector growth." http://www.bisnis.doc.gov/tdabrussels.htm

[11] Frequent changes of key officials also hindered reform progress. Brief tenures provide less incentive to implement reforms that offer a payoff only in the longer term.

[12] A few large companies remain state-owned and are supported in large measure by subsidies.

[13] While many bankruptcy proceedings were "initiated," prior to 2001 the process was only finalized for a few small firms due to weaknesses in implementation capacity. In 2001, spurred by SAC IV, a significant number of bankruptcy cases were completed.

[14] It should be noted that liquidation was also limited by a lack of demand for the liquidated assets.

Overall Assessment of Objectives

2.2 The reform program was aimed at removing the distortions and controls left over from the central planning system, remedying institutional deficiencies, and setting up a framework that could support a market economy. The explicit assumption underlying the program was that if these actions could be successfully completed, and the vast majority of assets privatized, then a "*supply response*" would be forthcoming. That is, if the envisioned reforms could be successfully accomplished, growth in income and employment based mainly on private investment (both domestic and foreign) would occur. This initial set of actions came to be characterized as "first generation reforms," and included:

- Privatization of most state-owned companies.
- Elimination of price and wage controls.
- Elimination of state control of trade, and establishment of a liberal trade regime.
- The end of government control of distribution.
- Implementation of a stable macroeconomic framework.
- Establishment of a legal framework adequate to support a market economy.

2.3 During 1996-98, Bank management and staff increasingly realized[15] that the basic assumption (described in the previous paragraph) upon which the program was based was unrealistic, and a new agenda "second generation of reforms" would be needed to establish the conditions for broad-based growth, with the significant creation of new jobs. In the context of this realization, Bank managers and staff identified, and in many cases discussed with government, the type of environment that would be needed to facilitate the growth of employment and reduction of poverty, and analytic work was done to support initiatives in these areas.[16] The following were identified as key to enabling growth:[17]

- adequate government capacity to support a market economy, including civil service reform and effective regulation;
- an environment conducive to private business, including protection from arbitrary administrative actions;[18]
- effective procedures for bankruptcy and liquidation, and circumstances favorable to the entry of new firms;
- a transparent legal framework and a judicial system with credible enforcement of contracts and property rights;
- availability of adequate financing for working and fixed capital.

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[15] See, for example, Memorandum prepared for Armenia Country Director, July 24, 1996.

[16] E.g., World Bank, "Armenia: Public Administration in Transition," 1996: Public Expenditures in Armenia, November, 1997; Judicial Assessment Report, April, 1998.

[17] Memorandum prepared for Armenia Country Director, July 24, 1996. See also, World Bank, Armenia Country Department, 2001 CAS, p. 8, where many of these obstacles are discussed.

[18] Many sources have stated that corruption is a severe hindrance to sustained growth. According to surveys, Armenia suffers from relatively low "state capture," but very high "administrative corruption," i.e., harassment by public officials: "Seize the State, Seize the Day: State Capture, Corruption, and Influence in Transition" (PRWP 2444). The same point is made in "Anticorruption in Transition, a Contribution to the Policy Debate," World Bank, 2000, p. 15.

Table 2.1: Reform Areas Addressed by the Five Projects Included in the Assessment

Area/component	Rehabilitation	SAC 1	SATAC 1	SAC 2	SAC 3
► **Economic management**					
→Economic policy formulation/ aid coordination	Create stable macro environment; fiscal deficit 12% or less	Create stable macro environment; inflation 19% or less; fiscal deficit 7.6 %		Create stable macro environment; inflation 10% or less; fiscal deficit 6.7%	Maintain satisfactory macro framework
→Civil service/governmental reform		Perform comprehensive review of government structure, functions	Planned public service review and functional review of key ministries		Introduce medium-term expenditure framework; announce civil service reform strategy
→Price liberalization	Liberalize nearly all prices				
→Trade liberalization	Remove most obstacles to exports	Limit tariffs to 10 %; remove remaining export restrictions			
► **Enterprise reform/ private sector development**					
→Privatization support	Privatize 3,000 small firms; begin medium/large privatization (900 firms)	Streamline privatization procedures; Satisfactory implementation of 1996 Government privatization program—around 1200 additional companies	Public information program on privatization; preparation of enterprises for privatization; support to Auction Center; TA on liquidation; planned training in bankruptcy procedures	Satisfactory completion of the 1996-97 privatization program by the end of 1997—around 500-600 firms to be sold in 6 months	Liquidate certain small enterprises; privatization of 200 medium and large firms per year in 1999 and 2000
→Public enterprise support (Including irrigation/drinking water reforms)			Consulting and TA services to perform financial rehabilitation plan; provide automation equipment	Approve financial rehabilitation plan for irrigation firms; increase irrigation and drinking water tariffs	Key public enterprises switch to IAS-consistent accounting; GoA ensures implementation of financial rehabilitation plan; tariffs differentiated, increased; collections increased

→Reform policies and conventions to support PSD	Reduce enterprise budget subsidies		Support for streamlined procedures for enterprise restructuring and liquidation		
→Tighten enterprise financial discipline	Monitor enterprise arrears				
→Legal and regulatory reform	Establish new laws; privatize housing; develop cadastral system	Adopt new Bankruptcy law; establish rules for enterprise reorganization	Provide technical and consulting services to support legal and judicial reform	Regulations for real property; submit civil code	
→Enterprise restructuring		Place 11 indebted firms in restructuring program		Initiate reorganization /liquidation for strategic enterprise not successfully privatized	
► Energy Sector					
→Improve collections	Improve energy collections	Improve energy collections to 75%	TA, consultant service, and equipment provided to support Energy Regulatory Commission and financial rehabilitation plan	Complete and implement financial rehabilitation plan; regulations to increase collections from budgetary agencies	Review financial rehabilitation plan results; improve collections to 87%; clear all energy arrears from budgetary agencies;
→Reform tariffs	Electricity tariffs to cover O&M costs	Increase energy tariffs			Increase energy tariffs
→Restructure sector/ establish energy regulatory agency		Restructure sector		Establish energy regulatory agency; adopt privatization strategy for sector	Strategy for district heat reforms issued
→Energy privatization support		New energy law		Initiate privatization of power companies	Electricity distribution companies licensed by ERC, audited by int'l auditors, offered for sale

▶ **Financial sector reform**					
→Improve bank financial discipline	Develop guidelines for exposure, shareholder lending, forex; increase minimum statutory capital	Raise minimum capital; restructure weak banks; new law on bank insolvency	TA in privatization of large bank; establish work-out unit in 2 banks; provide advisor to CBA (bank resolution)	Initiate bankruptcy for banks failing to meet CBA targets; privatize/ restructure 2 large banks	Large state-owned bank privatized; raise general capital adequacy ratio to 12%
→Improved audits/accounting		audit all banks; design IAS-compatible system	Supported introduction of new accounting, audit standards	Banks move to IAS accounting basis	1998 audits completed
▶ **Social Sector**					
→Improve benefits targeting	Provide cash benefits to compensate for removal of price controls; establish household survey	Restructure benefits, improve targeting		Introduce single vulnerability benefit	Submit law on benefits; enhance efficiency of social assistance
→Pension reform	New pension law, increase retirement age			Adopt strategy for pension reform	Enhance sustainability of pension system
→Social safety net				Establish cash transfers to replace categorical benefits	
→Health/education reform		Submit law, strategy for financing and delivery of health care; develop tools to rationalize education, provide textbooks		Increase share of budget for health and education; revise system for health care delivery, financing; adopt pilot strategy for education reform	Monitor budgetary expenditures; Approve and introduce pilot school rationalization plans.

► **Revenue Mobilization**					
→Tax administration			Support for automation of tax administration	Complete automation of tax offices; broaden scope of TINs; develop strategy for better public expenditure management	
→Customs administration/ trade facilitation			Support for customs automation (software, hardware) and streamlining of procedures; establish training center	Complete automation of customs; reduce duty-free exemption	

2.4 Progress in some of these areas had been part of the reform program, e.g., the legal framework, but had not yet borne fruit in terms of an improved legal climate for business. (See Annex D). Other areas, such as civil service reform (to include downsizing the bureaucracy), had been the subject of Bank analytic studies and dialogue with the government, but had not yet made progress.[19] And the privatization of large enterprises was an exceedingly slow and difficult process that had so far yielded few benefits (see Annex C). In some areas, government reluctance or delay prevented progress.[20]

2.5 So, while in 1995-96 (RC and SAC I), *the reform program was substantially relevant* to the "first generation" obstacles faced by Armenia, *by 1997-98* (SAC II and SAC III) *the program had become less relevant* as it became apparent that a second generation of reforms would be required which were to a significant degree not addressed by the reform program. *The design of SAC II and SAC III were less relevant to the country's development needs than the earlier projects.*[21] (The design of SAC IV, approved in May, 2001, was quite different, and focused to a much greater extent on improving the environment for private business) The designs of SAC II and SAC III were also deficient in that there was a partial mismatch between their objectives and their conditionalities. The objectives of both credits were identical: (a) improve financial discipline in the private and public sectors; (b) accelerate the growth and development of the private sector; (c) ensure the social sustainability of reforms, so as to

[19] The initial (1995-97) obstacle to reform in this area was the inability to identify interested GOA counterparts; in effect it was too early in the transition process. Later (1998-2000), when government was more willing to tackle these issues, the Bank was not able to develop an agreed strategy and recommendations.

[20] In late 1998, the Bank initiated a review of governmental institutions (National Institutional Review), aimed in part at strengthening the capacity to support a market economy. Due to political turmoil in the country and later the unavailability of Bank staff, the recommendations developed have not yet been implemented.

[21] The SAC III ICR states (section 6.2) : "Improving the investment and business climate, an area that should have been addressed earlier... under SAC III, is a central feature of SAC IV reforms, and is considered critical by the Government for sustainable growth, job creation, and export promotion." (emphasis added).

preserve Armenia's stock of highly-skilled human capital.[22] However, while these two credits did have important conditions that contributed to these objectives, in some areas the conditions did little to directly support the stated objectives (especially objective "b"), e.g., privatization (as it was carried out, with the number of privatizations being the most important measure of success)[23]; legal reform (where little attention was given to enforcement); restructuring and privatization of the financial sector (where the high proportion of informal economic activity limited the use of the banking system). And, as noted in "Lessons Learned," paragraph 8.2, SAC II and SAC III pursued privatization without sufficient emphasis on key factors such as enterprise governance and restructuring, as well as other complimentary aspects of private sector development.

2.6 As of this writing, the second generation of reforms has yet to be accomplished. As the SAC IV MOP (April, 2001) stated, "The evidence from various enterprise surveys seems to be quite clear: Armenian enterprises face substantial institutional barriers for investment, restructuring, and growth. These barriers cover the entire list of traditional problems for the FSU: discretion in tax and customs administration, corruption, administrative harassment and red tape, difficulties for new entry, weak contract enforcement, unavailability of market information and other supporting services, etc. In addition, there are major problems in the incentive structure at the enterprise level, where most of the recently-privatized state enterprises (SOEs), especially those in manufacturing, have been demonstrating quite a weak restructuring effort."

3. Rehabilitation Credit

3.1. *Objectives*. The objectives of the proposed credit were to: (i) support the Government's reform program to stabilize the economy and create the conditions for a resumption of growth and an improvement in living standards; (ii) provide foreign exchange for the purchase of critical imports, particularly for the private sector; (iii) provide budgetary support, especially for the strengthening of the social safety net for the most vulnerable groups; and (iv) provide a framework for urgently-needed financial assistance from other donors. The reform program included policies that (a) promote development of private markets and the private sector through privatization, liberalization, and regulatory reform; (b) enhance financial discipline for enterprises and banks; (c) improve the targeting of the social safety net to the most needy.

3.2. *Relevance*. The Rehabilitation Credit (RC) became effective in 1995, and thus was effective when the "first generation" reforms were being actively pursued. The project emphasized economic stabilization, trade liberalization, privatization, legal and regulatory reform, financial sector reform, improved energy collections, and better targeting of social benefits. These objectives were of *substantial relevance* to the development challenges facing the country. Clearly, assistance with macroeconomic policy formulation was important in helping the country continue on its stabilization track (Annex H). Legal and regulatory advice

[22] The social sustainability of reforms is generally considered to consist of actions taken to ensure that the (overall) reform program is socially accepted, despite possible worsening economic and social hardship in the short-term, or inter-group differences in gains.

[23] However, as discussed in footnote 27, below, the approach to privatization conformed to the "best practice" of this period.

and drafting was important to the government's developing program of new laws and regulations suitable for a market was important in light of the government's fiscal straits and its ability to provide basic economy. Facilitating revenue mobilization—strengthening customs administration—was important in light of the government's fiscal straits and its ability to provide basic services and cope with the crisis. And the goal of improving benefit targeting was highly relevant given Armenia's widespread poverty.

3.3. *Implementation Experience.* The RC was the Bank's fifth operation in Armenia. Implementation went very well: the project was brief--just 16 months from effectiveness to completion--and was undertaken during a period of fervent reform activity. Government had begun to pursue sound macroeconomic policies and implement structural reforms well before effectiveness. Privatization accelerated, with privatization of small enterprises more rapid than that of large (Annex C). Nearly all of the structural reforms envisioned were achieved, although some were completed after the RC had ended. The major exception was that electricity tariffs were not set to cover operations and maintenance costs.

3.4. *Outcome.* This PPAR rates the outcome of the RC as *highly satisfactory*, the same as in the ICR and OED ES. The RC achieved or exceeded nearly all of its objectives. As described earlier, enormous progress was made in <u>macroeconomic stabilization</u>, which was facilitated by IMF agreement to a Stand-by Agreement in June, 1995. The budget deficit declined to 9.0 percent of GDP, below the 12 percent threshold specified in the credit (Annex H). US$73.3 million in <u>foreign exchange</u> was provided for the purchase of critical imports, thereby making available funds for additional social expenditures, which increased in real terms. As described in Annex C, the RC set specific goals for the privatization of small (3,000), and medium and large enterprises (900), goals that were almost completely met in 1996 after the credit had closed. Other contributions to private sector development included the successful abolition of most remaining <u>trade and price controls</u>, the passage of key legislation (Annex D), and the strengthening of the regulatory framework for the <u>financial sector</u> (Annex F).

3.5 The project benefited from having a highly supportive reformist government, and initiated the reform process in the <u>energy sector</u>, with the proportion of households that paid for energy rising from 10 percent to 33 percent during the project. However, the RC condition that electricity tariffs cover operations and maintenance costs was *not* achieved (Annex E). The RC established a foundation for financial sector reform by strengthening the legal and regulatory framework and bolstering the bank supervisory capacity of the Central Bank. Most price and trade controls were eliminated. While <u>mobilization of donor funds</u> through the Consultative Group was only modestly successful, this shortfall was almost entirely due to a reluctance on the part of many potential donors to support the government at a time when the conflict over NK had just ended. The project team made very substantial efforts to stimulate additional funding, but had only limited success in overcoming this obstacle.[24]

3.6 *Sustainability.* Sustainability of the benefits achieved under the RC is *highly likely.* First generation reforms—including private ownership of shops and small enterprises, and the array of energy and financial sector reforms achieved under SAC I—have become part of the fabric of Armenian society, and their realization never been disputed by any political group.

[24] No quantitative estimate was available of the degree to which this objective was achieved.

And in nearly every case the measures implemented during this operation have been extended and built upon by later credits.[25]

3.7 *Bank Performance.* Bank performance is rated as *highly satisfactory*, the same as the ICR but higher than the OED ES's rating of Satisfactory. During the RC, Bank staff functioned successfully in a difficult environment: the country was just emerging from the conflict over NK, and the Bank was dealing with a small group of enthusiastic reformers sitting atop a largely unresponsive post-Soviet bureaucracy. Project design was satisfactory, in that it addressed the areas of most pressing need, and aimed to further the first generation of reforms. And supervision was excellent in that staff worked closely and flexibly with government to identify and overcome obstacles, and keep a focus on development impact. While the project team made strong efforts to mobilize donor funds, exogenous factors limited their success.

3.8. *Borrower Performance.* The PPAR rates Borrower Performance in the RC as *highly satisfactory*, the same rating as the OED ES and the ICR. Despite the shocks it had suffered during the previous few years, and severely limited capacity, the government vigorously undertook an impressive reform program. During the RC, the GOA took full ownership of this program, and succeeded. Macroeconomic performance improved dramatically and project progress was rapid.

3.9. *Institutional Development Impact.* The RC is assessed as having had *substantial* IDI. As described earlier, the project displayed substantial relevance to the economic development challenges faced by the country, and realized important achievements. Noteworthy contributions to IDI included: completion of most first generation reforms: trade and price reform; removal of most remaining procurement controls; strengthening customs and tax administration; legal reform (Annex D); the start of energy sector reforms (Annex E); and improved benefits targeting and pension reform.

4. First Structural Adjustment and Technical Assistance Credit (SATAC I)

4.1 *Objectives.* The primary objective of the project was to enhance the capacity of the Government to implement the structural reform program supported by the Bank's adjustment credits. This included support for institutional development, policy formulation, legal drafting, and training of public servants. Technical assistance was focused on four key areas: (1) privatization and post-privatization support; (2) financial sector restructuring; (3) civil service reform; and (4) resource (revenue) mobilization.

4.2 *Relevance.* SATAC I provided technical assistance (TA) complementary to the 3 SACs, and the project objectives were of *substantial* relevance. The project provided technical help to a

[25] It should also be noted that, for all five projects that are the subject of this PPAR, sustainability is enhanced by Armenia's ongoing relationship with the Bank and the IMF. For example, the Judicial Reform Project, approved in September 2000, and the SAC IV project, approved in May, 2001, help reinforce and extend many of the benefits achieved by these five projects. And the IMF Executive Board approved a new three year loan under the PRGF in May 2001.

government that had limited capacity in nearly all areas of project activity, particularly privatization, legal reform, and enhancement of customs performance.

4.3 *Implementation Experience.* SATAC I followed the Institution Building Loan (IBL) in providing advice to facilitate the Armenian reform program (see OED Performance Audit Review of IBL, June 5, 2001). The project became effective in February, 1996, and was originally intended to close in December, 1997. However, disbursement was slow, and closing was postponed four times, with the project eventually closed in June, 2000. The main reason for the slow disbursement, in many cases, was that Armenia obtained grant funding for most of the TA it needed. Work was dropped on bankruptcy training and establishment of a bank resolution unit, and funds reallocated to water sector reform, judicial assessment, and energy sector development. Detracting from the project's success was the fact that it was postponed four times, with the last postponement breaching an agreement with the Government to close the project if any further delays occurred.[26]

4.4 *Outcome is assessed as moderately satisfactory*, the same as the OED Evaluation Summary, and lower than the ICR, which rated it as Satisfactory. The project made an important contribution to the country's capacity, especially in the area of macroeconomic stabilization. The credit was successful in strengthening the country's capacity to privatize enterprises, especially in the <u>mass privatization</u> of medium and large enterprises, which accelerated during SATAC I (see Annex C). The activities in support of <u>revenue mobilization</u> and energy sector reform—especially payment discipline—were also successful. Customs and tax administration were strengthened, customs software (AYSCUDA) was provided, enforcement was enhanced and tax revenue as a percent of GDP, 12.7 percent in 1995, averaged 14.7 percent in the five succeeding years (Table 1.1). As noted in paragraph 6.5, energy collections increased from 10 percent (of bills issued) in 1995 to 33 percent in 1996, and eventually reached 85-90 percent in 2001 (Annex E). In the <u>financial sector</u>, the project provided training and advisory services that strengthened bank supervision (Annex F), which were successful in facilitating bank privatization and strengthening the financial system. However, while SATAC I contributed to the development of a legislative framework to support a market economy, insufficient emphasis was placed on *enforcement* of these laws (see Annex D). Work on <u>civil service reform</u> and bankruptcy training was unfortunately dropped. Government capacity in these and other areas remained weak throughout the decade, which hindered Armenian economic development, and bankruptcies were negligible until 2001 (see paragraph 1.17).

4.5 *Sustainability.* SATAC I helped to build a foundation of knowledge and proficiency that could support a market economy. Policy makers and citizens appreciate the stronger and more stable financial sector, even while they have seen turbulence in this area in other FSU countries. For those benefits that this credit achieved, sustainability is *highly likely.*

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[26] PSR, April 1999. The supervision mission had agreed with the Minister of Finance and Economy on a work program that would allow closing of the project by August 30, 1999, and the government agreed that if implementation of the work program was delayed, then unused credit proceeds would be cancelled. In the event, the project was extended for the fourth and final time.

4.6 *Bank Performance.* Bank performance is rated as *satisfactory*, the same as the OED ES and the ICR. The project was important: most TA provided was critical to enabling the Government to implement the reform program. While the Bank underestimated the amount of grant TA that ultimately became available thus causing slow disbursement and four postponements, some of those grant funds became available only after SATAC I effectiveness. When bilateral TA programs did become established, project staff worked effectively to assure that SATAC assistance was complementary to bilateral assistance. The Bank assistance was viewed as highly professional and was greatly appreciated by officials. Supervision could have been more effective in adhering to the agreement with the Government to close the project if any further delays occurred, which was not done thus eroding Bank credibility.

4.7 *Borrower Performance.* The PPAR rates Borrower Performance as *satisfactory*, the same rating as the OED ES and the ICR. The Borrower made good use of the TA, especially in the areas of macroeconomic stabilization; energy sector reform; and development of new legislation. Development of the energy sector is a bright spot in Armenia's economic development in the last decade. The legislative framework is quite adequate to support a market economy, although more thought should have been given to enforcement.

4.8 However, the Government missed an important opportunity to tackle important obstacles to development when it requested the reprogramming of funds originally intended for civil service reform and bankruptcy training. On balance, it is judged that the Borrower made satisfactory use of SATAC I resources, and contributed effectively to the achievement of the project's development objectives.

4.9 *Institutional Development Impact.* SATAC I is assessed as having *modest* IDI, the same as the OED ES and consistent with the ICR rating of "partial." While much of the work performed under the project built important and useful capabilities, the economic development benefits of privatization support was limited (Annex C). Also, project support for bankruptcy training and civil service reform was dropped, proficiencies that would have been quite useful as the reform program progressed. Finally, although the legal reforms supported by the project resulted in a good legal framework for a market economy, there was insufficient emphasis on enforcement.

5. First Structural Adjustment Credit (SAC I)

5.1 *Objectives.* SAC I was intended to support the Government's reform program to stabilize the economy and create conditions for a resumption of growth and improvement in living standards, through policies aimed at:

- reorienting the role of the state away from direct management of the economy toward support for private sector development;
- improving financial discipline for enterprises and banks;
- improving the targeting of social services and benefits to the most needy.

5.2 The reform program supported by SAC I addressed 3 major areas and 9 sub-areas:

- Macroeconomic stability

- Improving Enterprise Financial Discipline
    - o Trade—Elimination of foreign exchange surrender requirement; reduction in tariff duties
    - o Energy Policy—Tariff increases; sector restructuring; improved collections; new energy law
    - o Privatization and Private Sector Development
    - o Enterprise Restructuring—New Bankruptcy Law; eleven enterprises in "strategic privatization program will receive final offer for privatization or be liquidated
    - o Financial Sector Reform—New law on Bank Insolvency; audits of all banks; new loan classification system, and increased provisioning; bank resolution unit established in CBA
- Improving the Efficiency of the Public Sector
    - o Targeting Social Assistance
    - o Health Reform—Plans to be developed for: health financing; strengthening primary care; hospital consolidation
    - o Education Reform—Development of analytical tools to rationalize and consolidate schools; strategy to improve textbook availability
    - o Pay and Employment Reform

5.3 *Relevance.* SAC I became effective in early 1996, when "first generation" reforms were being actively pursued. In pursuit of the above objectives, the credit emphasized economic stabilization, trade liberalization, privatization, legal and regulatory reform, financial sector reform, improved energy collections, and better targeting of social benefits. The objectives were of *substantial relevance* to the development challenges facing the country. Clearly, assistance with macroeconomic policy formulation was important to helping the country continue on its stabilization track. The goals of supporting private sector development were intended to facilitate the path for private firms to be Armenia's "engine of growth." Legal and regulatory advice and drafting were important to the government's developing program of new laws and regulations suitable for a market economy. And the goals of improving benefit targeting and reforming tariffs were highly relevant given Armenia's widespread poverty.

5.4 The quality of SAC I design was diminished, as was that of the other adjustment operations considered by this PPAR, by an undue emphasis on counting the numbers of enterprises privatized, with inadequate attention to the quality of privatization.[27] The emphasis on numbers of firms privatized shifted the focus from other important goals such as facilitating bankruptcy and liquidation, and promoting the entry of new firms. Privatization had been expected to lead to significant gains in the short- to medium-term—and a decrease in the fiscal burden was achieved—but institutional weakness and lack of progress on enterprise

[27] This deficiency is acknowledged in the 2001 CAS, p. 8, and is also discussed in World Bank, OED, "IDA Review of Private Sector Development," March 2001." However, it should be noted that privatization, as pursued in the Armenian adjustment program, conformed to the "best practice" of that period. *Ex post* reviews have clarified that implementation of complementary measures—e.g., stronger enterprise governance and legal protection for minority shareholders and other investors—would probably have increased the gains from privatization.

restructuring and governance, among other factors, limited the gains.[28] Further, as noted in "Lessons Learned" (para. 8.2), privatization is only one part of what is needed to stimulate private sector-led growth, and must be complemented by other measures to stimulate private sector development. Annex C provides further detail.

5.5 *Implementation.* Implementation of SAC I was the most straightforward of the three SACs. SAC I benefited from being implemented mainly during a period of strong support for reform. Measures were put into effect that continued increases in energy tariffs, started under the RC, and which later continued under subsequent projects. As part of the enterprise restructuring program, 11 "strategic" enterprises were placed in a program in which they were intended to be privatized or liquidated (Annex C). Additional measures strengthened the financial sector, primary health care, and the school system (see next section).

5.6 *Outcome.* SAC I outcome is assessed as *satisfactory*, the same as the OED Evaluation Summary and the ICR. As described in paragraphs 4.3 and 4.4 and Annex H, macroeconomic performance was very good. Real GDP growth averaged around 4.5 percent, and inflation declined substantially. The project was substantially relevant, completed a number of remaining first generation reforms, and met its numerical targets for privatization of 2,000 small enterprises (Annex C). Privatization of medium and large enterprises was substantial, but less than the Government had originally planned. Five hundred of these enterprises, 25 percent of the country's total of 2,000, were sold in 1996. While this was less than the Government's overly-ambitious plan—1,200 medium and large firms privatized—the Bank considered the performance to have been satisfactory and released the 2nd tranche ahead of schedule in December, 1996. In retrospect, it seems doubtful that the Government could have moved much faster in this area, and the Bank's decision to release the 2nd tranche was probably sound (Annex C). However, progress in the sale, liquidation, or restructuring of "strategic" enterprises was negligible during the credit (Annex C).

5.7 The Government achieved significant financial sector reforms, and met all Credit conditions, e.g., strengthening bank supervision capabilities, adoption of a new law on bank insolvency, restructuring of a major state-owned bank, and design of an IAS-compatible accounting system (which was then implemented under SAC II; see Annex F). Energy collections were also significantly improved to 75 percent by end-1996, and tariffs were increased by 25 percent (Annex E). A revised Bankruptcy Law was adopted, and a new pension law was passed that provided for an increase in the retirement age. And in the education sector, a promising start was achieved on improving the efficiency of the education system through the development of planning tools—including a nationwide school map and database—that were later built upon by SAC II. And in conjunction with the Education Project, SAC I supported development of an innovative (for the CIS) policy that entailed a revolving fund which has proved very successful in financing school books (Annex G). Also, while project conditions providing for pay and employment reform (public service review, reassessment of appropriate role of government) were implemented, no meaningful change in this area resulted. This

[28] See "IDA Review of Private Sector Development," op. cit; "Transition After a Decade," ECA, November 2000, op. cit; and World Bank, "Between State and Market: Mass Privatization in Transition Economies," September 1997.

occurred despite Bank preparation of a Public Expenditure Review and an extensive study of civil service reform.[29]

5.8 *Sustainability.* Sustainability of the benefits achieved under SAC I is *highly likely.* Completion of the first generation reforms—including private ownership of shops and small enterprises, and the array of energy and financial sector reforms achieved under SAC I—has become part of the fabric of Armenian society, and has never been disputed by any political group.

5.9 *Bank Performance.* Bank performance is rated as *satisfactory*, the same as the OED ES and the ICR. Project design was substantially relevant, as the project essentially completed first generation reforms, and pushed forward in the privatization, financial sector, and energy areas. Government commitment was initially strong. And a number of Government officials praised the diligence and professionalism of Bank staff.

5.10 In the course of the project, Bank management and staff increasingly realized that for broad-based growth to occur, with significant creation of new jobs, a second generation of reforms would be needed. While the need for a new generation of reforms was raised with the government, the government did not respond favorably, and the Bank did not press the case further.

5.11 *Borrower Performance.* The PPAR rates Borrower Performance as *satisfactory*, the same rating as the OED ES and the ICR. Government complied with most of the credit commitments, less enthusiastically toward the end of the project than at the start. Considerable progress was made in financial sector reform, energy payments discipline, social benefits targeting, and privatization of small enterprises. Less progress was made in privatization of medium and large enterprises, strategic enterprises, and in enterprise restructuring. Although Government met the formal conditionality on civil service reform, it did not respond favorably to the Bank's findings under SAC I that a fundamental modernization of the civil service was needed.

5.12 *Institutional Development Impact.* SAC I is assessed as having *substantial* IDI. As described earlier, the project displayed substantial relevance to the economic development challenges faced by the country, and realized important achievements. In particular, noteworthy contributions to IDI included: the completion of first generation reforms: trade and price reform, and the removal of remaining procurement and other controls; strengthening customs and tax administration; legal reform; the start of energy sector reforms; and improved benefits targeting and pension reform.

6. Second Structural Adjustment Credit (SAC II)

6.1 *Objectives.* The objectives were to (a) improve financial discipline in the private and public sectors; (b) accelerate the growth and development of the private sector; (c) ensure the

[29] World Bank, Armenia Country Department, "Public Administration in Transition," 1996 (the Lister Report) recommended substantial changes in reducing the size of the government, increasing pay and professionalism, and institutionalizing a politically neutral civil service. However, these were never implemented.

social sustainability of reforms (defined in footnote 22), so as to preserve Armenia's stock of highly-skilled human capital. SAC II supported the Government's reform program in the following areas:

- Macroeconomic stability
- Improving Financial Discipline in the Private and Public Sectors
    - Strengthen fiscal framework—Increase resource mobilization capability; expand tax base, improve collections; resolve arrears
    - Deepen reforms in the energy sector—Complete and implement Energy Financial Rehabilitation Plan; improve collections; eliminate gas arrears among state-owned entities; Energy Regulatory Commission to issue regulations on unified accounting system
    - Irrigation and drinking water—Approve strategic financial plan for sector; increase collections to 55 percent of supply
- Accelerating Development of the Private Sector
    - Restructuring the banking sector—Initiate bankruptcy proceedings for banks failing to meet CBA targets; move banks to IAS accounting
    - Completing privatization (see Annex C for detailed objectives)
    - Clarifying property rights—Adopt Law on Registration of Real Property; amend legislation to allow enterprises to purchase land they occupy; submit to Parliament the first part of Civil Code
    - Developing capital markets—Adopt strategy for capital markets development; adopt law providing for establishment of independent regulatory authority
- Ensuring the Social Sustainability of Reform
    - Strengthening social assistance and insurance—Introduce single "vulnerability benefit"
    - Reforming the provision and financing of education—Increase share of public spending allocated to education in 1998 budget; adopt plan for school consolidation, complete pilot plans
    - Reforming health care—Increase share of public spending allocated to health in 1998 budget; revise and redesign "Basic Benefit Package" of services provided by state

6.2 *Relevance.* SAC II (effective September, 1997—June, 1999) was carried out after first generation reforms had been largely completed, and after the Bank had realized that their completion would not automatically lead to private sector-led growth in income and employment. The additional obstacles to private sector growth (described in para. 2.3) were recognized and in most cases were raised with the Government. However, despite these efforts, and the findings of analytical work, these obstacles were for the most part not addressed during loan implementation, in large measure because of government reluctance. Additionally, as a matter of project design, the credit conditions did not completely address the stated objectives, particularly objective (b). Finally, while the project aimed to enhance the social sustainability of reforms by restructuring the system of health care financing, the methodology used was not entirely relevant to the Armenian context (additional detail is provided below in "Bank Performance.") Consequently, the project is assessed as having *modest* relevance.

6.3 *Implementation Experience.* SAC II became effective in September, 1997, with a first tranche of US$40 million disbursed upon effectiveness. The second tranche (US$20 million) was disbursed in December, 1997, nearly a year ahead of schedule. (This tranche release turned out to be premature, as described below). A major event that occurred during SAC II was the privatization of the telecom company, a unsatisfactory effort[30] that unfortunately had the effect of increasing public cynicism over privatization and the reform process generally (see outcome, below, and Annex C).

6.4 The project was implemented during an unsettled period in Armenian politics following an intense period of reform progress and during a time when there was a weakened government willingness and ability to tackle vested interests opposed to reform. Additional constraints on reform progress were prompted by the election campaign in early 1998. SAC II implementation was marked by nominal compliance with project conditionality, grudging progress in some areas (e.g., better financial discipline among energy and water companies, social protection), and a general unwillingness on the part of government to undertake a "second phase" of reforms.

6.5 *Outcome.* Outcome is assessed as *moderately unsatisfactory*, compared to moderately satisfactory in the OED Evaluation Summary, and Satisfactory in the ICR. SAC II is assessed as having modest relevance because it did not address significant development obstacles. While SAC II achieved important benefits, it also had key shortcomings: the premature release of the second tranche, the deficient process used in the privatization of the telecom company, as well as the failure to develop a telecom regulatory framework in preparation for the sale.[31]

- *Main Achievements.* <u>Strengthen Fiscal Framework</u>—A number of tax measures were introduced, including the Enterprise Pilot Tax and the introduction of specific taxation on tobacco and alcohol imports. Duty-free exemptions for goods purchased abroad were lowered from US$1,000 to US$500. In addition, tax and customs computerization was completed, and further progress was made in developing the unified treasury account system. Tax revenues rose starting in mid-1997; as shown in Table 1.1, revenues rose to 16.3 percent of GDP in 1997, and 13.6 percent in 1998, compared to an average of 12.9 percent in the 3 years preceding the credit. <u>Energy sector reforms</u> were significant, with collections and service improving (Annex E). The Energy Regulatory Commission was established, which in time became an effective regulator. The Power Sector Financial Rehabilitation Plan was adopted, which established specific quantitative goals for energy

[30] A December, 2000, memorandum from the President describes the privatization process as "deeply flawed."
[31] ArmenTel was one of the 11 large companies whose privatization was the subject of SAC II conditionality.

firms regarding tariffs, collections, arrears, use of barter in payment, and for restructuring receivables and payables. This plan thus constituted a framework for analysis of the subsequent performance of the energy sector. For drinking water, collections of bills issued were increased as required to 55 percent (from 40 percent at project approval), and tariffs were increased 82 percent, which permitted a higher rate of cost recovery and smaller budgetary burden. In the financial sector, three large banks were restructured, and there was a decline in the share of non-performing loans (of total loans) from 24.7 percent in March,1997 to 12.1 percent in March, 1998 (see table in Annex F). The country's macroeconomic performance was good, and satisfied credit conditions except that the 1997 current account deficit of 26.1 percent of GDP exceeded the target set in the credit of 24 percent (Annex H).

- SAC II achievements included privatization of large numbers of small enterprises. In addition to the 5,000 small firms sold earlier, SAC II conditions stipulated the sale of an additional 4,700, which was achieved. By 1998, over 85 percent of small enterprise in the country were private (see Annex C). For medium and large firms, SAC II aimed to complete the 1996-97 privatization program, and initiate the 1997-98 program, which would have meant around 500-600 firms to be sold during July-December, 1997. The Government did achieve the sale of 250 enterprises during that time, however the Bank declared that the condition was "met in substance." While the Bank was on weak ground in approving this tranche release, the problem originated in an excessively ambitious condition, and the Government probably achieved as much as could practicably be done. In clarifying property rights, the agreed reforms were implemented: as required, the first part of the new Civil Code was submitted to Parliament, including relevant provisions regarding the treatment of collateral and secured transactions.[32] To help develop capital markets, as agreed, the Government adopted a decree that enterprises with more than 50 shareholders must register all shareholders with the National Share Registry.

- In the social sector, a single, targeted poverty benefit was initiated, replacing a complex system of child allowance and other benefits that was provided to poor and non-poor alike. Exemptions (for favored groups) for electricity tariffs, transport, and communal services were drastically reduced and replaced with cash transfers to a more narrowly defined group of highly vulnerable beneficiaries. Education reforms were begun—mainly in the finance and management of education—and the 1998 budgetary shares of the education (as well as health) sectors met the credit conditions.

- *Shortcomings*. Telecom Privatization—In 1997, the telecom company, ArmenTel, was sold to a Greek firm, OTE. Government was limited in the sale of the remaining 51 percent by its previous sale of 49 percent of the firm to a foreign investor, Transworld, which had a veto over the sale of the remaining shares. (The Bank was not involved in the earlier action) This arrangement prevented the Bank from supporting measures that would promote competition.

[32] The entire Civil Code, not required by SAC II, was passed in 1999 (see Annex D).

- After agreement from Transworld had been obtained, the 1997 sale of 90 percent of ArmenTel (Transworld's 49 percent plus 41 percent of the government stake) to OTE for US$142 million was the first major cash sale in the international cash tender program. In structuring this sale, the Government and its Bank-sponsored investment advisor attempted to maximize the selling price, and granted OTE a 15-year monopoly on all major services. OTE had made substantial promises regarding planned investment in the company, and over the next three years the Government and the company traded charges over whether these goals had been met. In addition, the Government sued OTE over back taxes it claimed were owed. In the meantime, although OTE has increased collections and the number of pay phones available, the country has continued to endure high tariffs for telephone connections and internet access, as well as poor quality connections.

- Although there is little the Bank could have done differently, this very visible episode sullied the reputation of the privatization program. A further, and significant, question is the lack of significant work to establish a telecom regulatory framework.[33] During SAC II, the Bank should have been more proactive in the strengthening the telecomm regulatory regime. (SAC IV includes provision for the development of a telecom regulatory regime)

- <u>Premature Second Tranche Release</u>: In December 1997, the second (and final) tranche of SAC II was approved. The government was eager to receive the US$20 million payment, and Bank management was keen to release the funds. However, evidence of the achievement of some key tranche conditions was weak.[34] For the key condition of the rate of energy collections from end-users, the Bank was satisfied with evidence based on a shorter time period than was specified in the Loan Agreement. After disbursement, collections fell back to earlier levels. Also, for the privatization or liquidation of designated strategic enterprises, partial measures of compliance were accepted as confirmation of fulfillment, but many of them were not carried out until much later.

- <u>Poorly Designed Health Reforms</u>: At the Bank's urging the Government adopted a health financing strategy intended to provide a basic package of services fully funded by the state. A State Health Agency was created and charged with purchasing health care services from public and private providers. Although theoretically sound, the strategy was not well suited to Armenia with its extremely limited budget. Upon implementation, the plan also encountered considerable resistance from doctors, and the departure of a reform-minded Minister of Health further reduced support. This component produced negligible benefits.

6.6 *Sustainability.* Sustainability of the benefits achieved under SAC II is *likely*. The sustainability of achievements in the area of tax and trade policy is increased by the

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[33] Experience clearly shows the desirability of establishing a sound regulatory framework before divesting an infrastructure firm which may have natural monopoly elements. See World Bank, OED, "IDA Review of Private Sector Development," op. cit, p. 16.
[34] The ICR acknowledges that the second tranche release was "premature."

government's interest in sustaining its revenue flow, and by Armenia's prospective membership in the WTO. Sustainability of energy sector reforms is bolstered by the tangible improvement in the supply of energy to households, a critical and highly visible quality of life issue, and to the enterprise sector. Social Sector reforms are widely seen as having better targeted scarce resources, and some changes are embodied in law (e.g., the Pension Law). As noted earlier, policy makers and citizens appreciate the stronger and more stable financial sector, even while they have seen turbulence in this area in other FSU countries. And many individuals involved in the education area—particularly local officials and citizens—have enthusiastically embraced the reforms, which have received wide support in the society. For some other reforms, for example privatization of medium and large enterprises, the change in ownership is almost certainly irreversible, as the new owners comprise a strong lobby against reversal. And in regard to the financial restructuring of irrigation and drinking water companies, the budgetary improvements and the reduction in the fiscal drain should provide strong incentives to maintain, or even extend, the reforms.[35]

6.7 *Bank Performance.* Bank performance is assessed as *unsatisfactory*, compared to Satisfactory in the OED ES and the ICR. The SAC II project design was deficient: the objectives were of modest relevance, the health financing reforms were poorly designed, and as noted, in some cases the conditions did not match the project objectives.

6.8 But, in addition to the design issues, SAC II also had two shortcomings during implementation: the premature release of the second tranche—acknowledged in the ICR—which could well have demonstrated to the Armenians a lack of seriousness about requiring adherence to its conditions; and—in the context of difficulties with the telecom privatization—the failure to address a telecom regulatory framework. While during supervision, Bank efforts to assure compliance with most conditionalities were successful, on balance, the above deficiencies lead to a rating of unsatisfactory.

6.9 *Borrower Performance.* Borrower Performance is assessed as *satisfactory*, the same as the OED ES and the ICR. Most major project commitments were met, more often in formal terms than in spirit. While there was sometimes backtracking, in most cases progress resumed when the next important landmark approached (e.g., supervision mission, tranche release). While the Government was not positive about addressing some key obstacles to development such as a second generation of reforms, for the most part they had not yet committed themselves to such an agenda (that commitment was made, in part, in SAC IV). And, as described above, progress was achieved in a number of sectors: energy, social protection, financial, irrigation, and drinking water.

6.10 *Institutional Development Impact.* SAC II is assessed as having *modest* IDI. The project had modest relevance to Armenia's economic development challenges. SAC II achieved important contributions: improved payment discipline in the energy sector; increased energy payments by drinking water and irrigation companies; restructuring of three large banks; establishment of a single targeted poverty benefit; and education system reforms that provided a foundation for enhanced efficiency. However, less important contributions were made by the

[35] And as in the case of all five of the credits that are the subject of this PPAR, Armenia's strong and continuing relationship with the Bank and the Fund make sustainability more likely.

privatization large numbers of medium and large enterprises, and progress in strategic privatization was very slow. As noted above, the deficient manner in which the AmenTel privatization was handled sullied the reputation of the privatization program, and the failure to establish a telecom regulatory framework constituted an important lost IDI opportunity.

7. Third Structural Adjustment Credit (SAC III)

7.1 *Objectives. The objectives were identical to those of SAC II*: (a) improve financial discipline in the private and public sectors; (b) accelerate the growth and development of the private sector; (c) ensure the social sustainability of reforms, so as to preserve Armenia's stock of highly-skilled human capital. SAC III endeavored to achieve these objectives through the following components:

- Strengthening public sector management and improving financial discipline
  - Improve budgetary management through adoption of a medium-term-expenditure-framework, or MTEF
  - Implement an energy sector financial rehabilitation program, carry out tariff and regulatory reforms, and maintain energy payment discipline
  - Reform the district heat system
  - For the irrigation system, implement a financial rehabilitation plan, carry out tariff reforms, improve institutional capacity, and maintain payment discipline

- Accelerating the growth and development of the private sector
  - Maintain momentum of banking sector reform
  - Maintain momentum of the privatization program
  - Liquidate state-owned enterprises that have failed three attempts at privatization
  - Privatize power sector enterprises
  - Strengthen enterprise accounting and financial information systems

- Ensure the social sustainability of reforms
  - Initiate pension system reform
  - Increase share of public spending on education and health
  - Advance restructuring of the education and health systems

7.2 *Relevance.* SAC III became effective (December, 1998) when Bank management and staff were well aware that completion of first generation reforms alone would not automatically lead to private sector-led growth. The additional obstacles to private sector-led growth identified above (para. 2.3) were recognized. However, despite this realization, and the findings of analytical work, these obstacles were for the most part not addressed, in part because of government reluctance.[36] While the SAC III objectives were important and beneficial for the country, the failure to address many key barriers to the country's development leads to a rating of *modest relevance.*

[36] The SAC III ICR states (Section 6.2): "Improving the investment and business climate, an area that should have been addressed earlier by the Government under SAC III, is a central feature of SAC IV-supported reforms."

7.3 *Implementation Experience.* SAC III was effective within a month of Board approval, and the Government met all conditions agreed for release of the 1st tranche of US$15 million. Specified reforms were implemented smoothly, and the second tranche of US$25 million was disbursed in September 1999. Credit implementation was negatively affected by the Russian financial crisis. In the first half of 1999, remittances from Armenians living in Russia declined, and real Armenian GDP growth slowed to 4.9 percent. The exchange rate depreciated by 7 percent in January 1999, and interest rates on T-bills reached 60 percent.[37] There were two increments to project funding that occurred after effectiveness. To safeguard against the effects of the Russian financial crisis, the Bank increased the credit amount by US$15 million equivalent, and in December 2000 the Government of the Netherlands co-financed the project by providing a grant of US$3.8 million to mitigate the effects of a severe drought. It should also be noted that project implementation was hindered by the tragic assassination of many top leaders in October 1999, which introduced considerable economic and political turbulence.

7.4 However, as the third (and planned final) tranche approached, it was evident that there would be obstacles to achieving the condition of privatizing the electricity distribution companies.[38] The process suffered a setback when Parliament rescinded its commitment to privatize these companies, but in July 2000, under strong Government pressure, Parliament passed a new law specifically covering privatization of the four electricity distribution companies.

7.5 Since Bank management believed that many of the obstacles preventing privatization were outside the Government's control, and since good progress had been made on the other conditions for tranche release, in January 2000, the third tranche was restructured into two: a third tranche of US$20 million and a new fourth tranche of US$5 million. The new fourth tranche had four conditions carried over from tranche three, and all of these were met except for the sale of the companies. In September 2000, the Bank denied a request from the Government that a waiver be granted for the fourth tranche, and this action caused substantial budgetary and political repercussions in Armenia.

7.6 The Government took extraordinary care and conducted the tender process transparently. In summary, because the Bank believed that the Government was acting in good faith in this process, and did not wish to penalize government for taking extra care, a waiver was eventually granted for the fourth tranche, which was disbursed in December 2000. In the end, despite considerable interest, no bids were received, and the privatization of the companies was made the condition for a floating tranche of the SAC IV project. (Annex B provides more detail)

7.7 *Outcome.* Outcome is assessed as *moderately satisfactory*, compared to satisfactory in the ICR and moderately satisfactory in the OED ES. While SAC III had only modest relevance and did not succeed in selling the electricity distribution companies, most of the other relevant credit objectives were achieved, and will produce substantial development benefits:

[37] In December, 2000, the weighted average rate for T-bills was 23.5 percent. IMF, "Recent Economic Developments and Selected Issues," May 2001, op. cit.

[38] It was widely believed that these companies provided large opportunities for rent-taking, and so their privatization was strongly opposed by some factions.

7.8 *Main achievements.* The country's macroeconomic performance was very good, and satisfied all credit conditions (Annex H). The basis for improved budgetary management was laid, as the Medium Term Expenditure Framework (MTEF) was developed and presented to the Government. Officials interviewed believe that the framework, when implemented, will improve the effectiveness of the budgetary process, and will link it more explicitly to macroeconomic performance. However, to realize the benefits of the MTEF, the Government must make additional efforts to train officials and make MTEF part of its regular procedures. The Energy Sector Financial Rehabilitation Plan (FRP) was an extension of the Bank's ongoing and successful work to strengthen the sector (Annex E). SAC III achievements in reference to the FRP included attaining an overall collection rate of 85 percent, as required (90 percent in the budgetary sector); a 12.5 percent increase in the energy tariff; energy firms restructured their domestic debts, and audits in accordance with IAS standards were conducted—although with a delay; and budgetary arrears to the energy sector were cleared. Energy sector losses and theft were also reduced significantly. In the area of district heating, as required the Government introduced a strategy to rationalize the sector, including cost-cutting measures, revised tariffs, and improved collection mechanisms. Subsidies to district heating were substantially cut. In the irrigation sector, reforms were highly successful. Companies required 100 percent cash payment for irrigation water, avoiding barter; a collection rate of 60 percent was eventually reached, but later than envisioned in the credit.[39] The (irrigation) Financial Rehabilitation Plan introduced differentiated tariffs for higher and lower cost areas, and substantially increased tariffs (more than 40 percent for one season). In conjunction with the Irrigation Rehabilitation Project, SAC III facilitated the formation of Water User Consumer Cooperatives, a highly-innovative action that introduced the concept of participatory management of water resources infrastructure.

7.9 In the banking sector, the project succeeded in achieving its goals—the restructuring of two large state-owned banks, and the privatization of one of them—leaving only one extant state-owned bank (with 2.5 percent of total assets).[40] Action was also taken to prepare the remaining state-owned bank for privatization, further advancing the already extensive reforms in this sector (Annex F). SAC III partially met its goals in the area of privatization and liquidation: a decree was issued requiring liquidation of firms that had failed 3 attempts at privatization, 28 small enterprises were liquidated, and liquidation proceedings were initiated for others. The credit goal was to privatize 200 medium and large firms per year for 1999 and 2000, which was partially met: around 200 firms were privatized in those years. For the high-profile privatization of the electricity distribution companies, discussed in paragraphs 7.4 to 7.6, SAC III laid the legal and procedural foundation by requiring: audits of 1998 and 1999 financial statements by internationally-qualified auditors, and a detailed, time-bound privatization plan. These actions were taken as envisioned. Enterprise accounting and financial information systems were strengthened when the Government contracted with an accounting firm to transition four state enterprises to IAS-consistent accounting systems (Armenian Airlines, two water companies, and the Irrigation Enterprise)—although this action was taken later than envisioned.[41] New charts of account were adopted, a new Accounting Manual distributed, and

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[39] This rate was less than the 65 percent rate specified in SAC III, but the lower rate was agreed upon as a result of the severe drought (1999-2000).
[40] IMF, "Recent Economic Developments and Selected Issues," May 2001, op. cit. p. 21.
[41] The conversion to IAS standards was assisted by USAID technical assistance.

training was provided. Accounts for 1999 were converted to the new system, and 2000 accounts were prepared only in the new format.

7.10 SAC III successfully initiated the envisioned reforms in the areas of social assistance and pension reform. In the areas of social protection and education reform, Armenia is one of the leaders among FSU republics. A Law on Social Benefits was enacted, and significant social protection reforms were introduced: pension reform, raising of the retirement age, procedures to enhance pension collections, improved pension distribution procedures, and introduction of means-tested poverty benefits. Education reforms were introduced that decentralized school financing and administration for ten percent of the nation's schools (as a first phase; see Annex G). Reforms were initiated that led an increasing number of schools to receive funding on a per capita basis, rather than per class as had previously been the norm. Schools were also increasingly empowered to manage their own resources, making their management and governance more transparent. Budget management was devolved to the school level, and revised norms were developed for all parameters of the educational process. Reforms supported by SAC II were highly synergistic with the efforts of the Education Project, and made Armenia a leader among CIS nations. Health sector reforms were implemented as envisioned; the Government developed a hospital rationalization plan to close unneeded beds. A goal was adopted of reducing the bed count by 25 percent over five years, and a first step was taken by converting 31 small rural hospitals into ambulatory centers (a reduction of 500 beds). The budget allocations to both the health and education sectors specified in the credit (10.5 percent and 11 percent respectively) were met, although as discussed below, in the case of health actual spending fell short of the budgeted amount.

7.11 *Shortcomings.* The privatization of energy distribution companies failed to meet expectations, as described earlier. Also, while the Government met the credit conditions with regard to budgetary allocations to the health and education sectors, only 62 percent of the 1999 health budget share was actually spent.[42] (In education, over 90 percent of the budget allocation was actually spent.

7.12 *Sustainability.* The PPAR judges that sustainability of the benefits achieved under SAC III is *likely*, the same as the ICR and the OED ES. Sustainability of reforms in public sector management and improved financial discipline is bolstered by the strong commitment and support they enjoy from the government, and the evident potential for efficiency improvements. Sustainability of energy sector reforms is bolstered by the tangible improvement in the supply of energy to the population, for which it is a critical and highly visible quality of life issue, and to the enterprise sector, for which it is a key operational and efficiency issue. Social sector reforms are widely acknowledged as having better targeted scarce resources, and some changes are embodied in law. As noted earlier, policy makers and citizens appreciate the stronger and more stable financial sector, even while they have seen turbulence in this area in other FSU countries. And many individuals involved in the education area—particularly local officials and citizens—have enthusiastically embraced the reforms, which have received wide support in the society. For some other reforms, for example privatization of medium and large enterprises, the

[42] While budget allocations are an imperfect measure to use as a condition in adjustment lending, in this case it is considered that their inclusion helped raise the visibility of maintaining program spending in these areas, with the result being that sectoral spending was higher than it would otherwise have been.

change in ownership is almost certainly irreversible, as the new owners would have little interest in the state confiscating their share. And in regard to the financial restructuring of irrigation and drinking water companies, the budgetary improvements and the reduction in the fiscal drain should provide strong incentives to maintain, or even extend, the reforms.[43]

7.13 *Bank Performance.* Bank performance is assessed as *satisfactory*. SAC III is assessed as having modest relevance. Since it became effective 15 months after SAC II, the fact that it did not effectively address many of the country's development problems is probably less acceptable than preceding adjustment operations. And, as in the case of SAC II, there is also a partial mismatch between the stated objectives and the conditionality observed for SAC III, especially in addressing the country's needs to remove barriers to private sector growth.

7.14 The failed effort to privatize the electricity distribution companies is difficult to assess. In the wake of the unsatisfactory privatization of ArmenTel, the Bank and the Government proceeded cautiously, taking care that each step be as credible and transparent as possible. On the one hand, the tendering effort was unsuccessful. But on the other hand, the Government expended tremendous political capital in persuading the Parliament to rescind its prohibition of the sale. And for nearly a year the Bank declined to release the (restructured) fourth tranche despite repeated requests from the Borrower.[44] On balance, it is judged that the Bank, in its advice to the Borrower on this transaction, acted appropriately.

7.15 *Borrower Performance.* Borrower Performance is assessed as *satisfactory*. As described earlier, sufficient support was provided to achieve most major relevant objectives. Despite substantial political opposition to reforms, important progress was made in a number of sectors. The Government did not, however, agree to tackle important obstacles to private sector development (until SAC IV).

7.16 The Government expended a great deal of effort and political capital on the ultimately unsuccessful effort to privatize the electricity distribution companies. Part of the delay, and ultimate deferral, of the privatization of these companies was the fault of the Government. However, in due course Government determined that it would conduct the privatization in the most credible and transparent manner possible, and most of the delay involved procuring suitable legal and financial advisors. Despite having pre-qualified a number of well known international energy firms active in FSU countries, no bids were ultimately received. On balance, it is considered that Government conducted this process in a satisfactory manner.

7.17 *Institutional Development Impact.* SAC III is assessed as having achieved *substantial* IDI, compared with moderate in the OED ES and substantial in the ICR. Important contributions to IDI were made in the energy, education, financial, and irrigation sectors. However, mass privatization achieved less than anticipated, and even though the privatization of strategic enterprises began to gather momentum during SAC III, numerous obstacles were encountered (Annex C) and failure to sell the electricity distribution companies also hindered IDI. On balance, however, IDI is assessed as substantial.

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[43] As in the case of all five of the credits that are the subject of this PPAR, Armenia's strong and continuing relationship with the Bank and the Fund make sustainability more likely.

[44] The Bank's decision not to release the tranche had substantial political and economic ramifications in Armenia.

8. Key Lessons Learned

8.1 **When adjustment projects are synergistic with sectoral investment projects, effectiveness can be enhanced:** During the course of the 3 SAC projects, investment projects linked to the adjustment program were undertaken in the education, irrigation, and power sectors, and considerable synergy with the adjustment credits was achieved. The financial inducement of the SACs provided an incentive for the Ministry of Finance to become an advocate for sectoral reforms, and cooperation between ministries was enhanced. However, the Enterprise Development Project was not designed as complementary to the SACs, and thus did not achieve synergy.

8.2 **For an adjustment program focused on private sector-led growth, key constraints to private sector development must be confronted:** While considerable emphasis was placed on privatization and financial sector development, insufficient weight was accorded to critical complimentary aspects of private sector development, including: a business environment conducive to private enterprise and the entry of new firms; effective enterprise restructuring and governance; building adequate government capacity to support a market economy; and effective procedures for bankruptcy and liquidation.

8.3 **As a reform program advances, progress may become more difficult:** First generation reforms, such as trade and price liberalization and the promotion of open markets, did not for the most part pose a major challenge to vested interests. However, further progress involved fundamental changes in political, judicial, and social institutions, and in many cases challenged powerful interests. Bank staff found that overcoming these important opposing constituencies was much more difficult than earlier reforms, and more difficult than they expected.

8.4 **It is unrealistic to assume that if "the fundamentals are in place," an automatic supply response will take place:** A key assumption of the Bank's reform program was that, if the fundamentals (i.e., first generation reforms) were in place, a supply response (i.e., broad-based growth stimulated by the private sector) would be forthcoming. The Bank vastly overestimated the ability of Armenian workers, entrepreneurs, and institutions to overcome the legacy of decades of Communism and the power of indigenous vested interests. Also underestimated was the cost of the breakup of the Soviet Union to Armenia's productive assets.

8.5 **Legal reform should take adequate account of enforcement capacity:** Important progress was achieved by the passage of new legislation, and an impressive framework was put into place. However, the adjustment program placed insufficient emphasis on strengthening the judiciary and the actual role the legal system could play in furthering an improved business climate.

8.6 **Continuity and dedication of the country team are key to program effectiveness:** During the six years covered by this PPAR, there was substantial continuity of the task team: two Country Directors, three country economists, no more than two TMs for any of the adjustment operations. In addition, project supervision and coordination of the country team with sectoral specialists was very successful. This contributed significantly to Bank effectiveness.

8.7 **Turnover among policy officials hindered reform progress**: During the six years covered by this PPAR, there were seven Prime Ministers and four Ministers of Finance. There was also substantial turnover among other officials concerned with implementing the reform program. For an official contemplating a brief tenure, it is more difficult to appreciate the benefits of reform, and so this turnover made reform progress considerably more difficult.

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Annex A

Individuals Interviewed

Present and former GOA officials

Gagik Arzoumanian
Deputy Minister of Finance

Vardan Movsesyan
Chairman, Energy Commission

Shiraz Kirakosyan
Commissioner, Energy Commission

Vahram Nercissiantz
Chief Economic Advisor to the President
former World Bank Resident
Representative

Ashot Mnatsakanyan
First Deputy Minister of Energy

Areg Galstyan
Deputy Minister of Energy

Nerses Yeritsyan
Central Bank of Armenia

Hrant Bagratyan
former Prime Minister

Armen Yeghizarian
former Minister of Economy, and
Chairman, Parliamentary Commission
on Finance and Economy

Levon Barkhudarian
former Minister of Finance

Vahram Avanesian
former Deputy Minister of Finance

Rouzanna Tarverdian
former Director, ACMC

World Bank Staff

Judy O'Connor
Country Director

Basil Kavalsky
former Country Director

Owaise Sadaat
World Bank Resident Representative

Wafik Grais
Division Chief

Hafez Ghanem
Division Chief

Jonathan Walters
former Country Economist and Task
Manager, IBL, SAC I, SAC II, SATAC

Martin Slough
Task Manager, Enterprise Development
Project

Irina Kichigina
Country Counsel and Task Manager of
Legal Support Project

Cyril Muller
Task Manager, IBL, SAC II

Ana Revenga
former Country Economist and Task Manager, Rehabilitation and SAC I

Lev Freinkman
Country Economist and Task Manager, SATAC and SAC III

Onno Ruhl
former Country Officer

Chris Hall
Task Manager, IBL

Helen Sutch
former Country Economist

Salman Zaheer
Financial and Energy Analyst

Melinda Roth Alexandrowicz
Private Sector Development Specialist

Country Officer
Peter Nicholas

Cheryl Martin
Country Officer

Jacqueline Coolidge (FIAS)
Specialist on Foreign Direct Investment

Aleksandra Posarac
Social Sector Specialist

Anush Bezhanyan
Social Sector Specialist

Karen Grigorian,
Resident Mission Yerevan

Gohar Gyulumyan
Resident Mission Yerevan

David Shahzadeyan
Resident Mission Yerevan

Sussana Hayrapetyan
Resident Mission Yerevan

USAID

Barry Primm
Director, Office of Economic Restructuring and Energy, USAID Yerevan

Tom Delaney
Director, Program Office
USAID Yerevan

Michael Wyzan
Economic Advisor
USAID Yerevan

Michael L. Boyd
Senior Energy Policy Advisor
USAID Yerevan

Other

Balas Horvath
IMF

Susan Adams
IMF

Gerald Oberndorfer
Coordinator, U.S. Assistance to [illegible]
Caucasus

Annex B

BASIC DATA SHEET

ARMENIA – REHABILITATION CREDIT (CREDIT 2683-AM)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	69.0	69.0	100
Credit amount	60.0	60.0	100
C0-financing	9.0	9.0	
Date physical components completed	06/96		

Cumulative Estimated and Actual Disbursements

	FY95	*FY96*
Appraisal estimate (US$M)	50.0	60
Actual (US$M)	63.38	64.3
Actual as % of Estimate	127.0	107

Project Dates

	Original	*Actual*
Identification	10/94	10/94
Appraisal	1/95	1/95
Negotiations	1/95	1/95
Board Presentation	2/95	2/95
Signing	3/95	3/95
Effectiveness	3/95	3/95
Project Completion	6/96	6/96
Credit Closing	6/96	6/96

Staff Inputs (staff weeks)

Stage of Project Cycle	*Planned*		*Revised*		*Actual*	
	Weeks	*US$*	*Weeks*	*US$*	*Weeks*	*US$*
Preparation to Appraisal	10.0	41.6	30.6	103.7	30.8	139.7
Appraisal	0.0	0.0	0.6	.0.7	0.6	0.9
Negotiations through Board Approval	0.0	0.0	10.5	23.6	10.5	23.7
Supervision	20.0	90.1	18.6	148.8	20.9	135.2
Completion	10.0	30.6	4.4	9.0	4.4	9.0
Total	40	162.3	64.7	285.8	67.2	308.5

Mission Data

Stage of project cycle	Date (mm/yr.)	No. of persons	Duration of mission (# of days)	Specialized staff skills represented[1]	Performance rating[2]	
					Implement. Status	Develop. objectives
Preparation	06/94	3	15	CE		
Preparation	11/94	7	16	CE, ERS, FSS, HRS, PSDS, TE		
Negotiations	01/95	8	-	CC, CE, CO, DO, ERS,HRS, LC, PSDS		
Board Approval	03/95	-	-	-		
Signing	03/95	-	-	-		
Effective	03/95	-	-	-		
Supervision 1	05/95	1	13	CE	1	1
Supervision 2	07/95	6	12	CE, CO, EE, ERS, PSRS, TE	2	2
Completion	06/96	-	-			

[1]-Specialized staff skills
CC = Cofinancing Coordinator
CE = Country Economist
CO = Country Officer
DO = Disbursement Officer
EE = Energy Economist
ERS = Enterprise Resources Specialist
FSS = Financial Sector Specialist
HRS = Human Resources Specialist
LC = Legal Counsel
PSDS = Private Sector Dev. Specialist
PSRS = Public Service Reform Specialist
TE = Trade Economist

[2]-Performance ratings
1.= Highly Satisfactory
2.= Satisfactory

[3]-Types of problems
F = Financial
M = Managerial
T = Technical

Other Project Data

Borrower/Executing Agency: Government of Armenia

Related Bank Credits

Credit title	*Purpose*	*Year of approval*	*Closing date*
Preceding operations			
1. Institution Building Loan	Technical Assistance	FY93	11/30/99
2. Earthquake Reconstruction Credit	Specific Investment	FY94	6/30/99
3. Power Maintenance Credit	Specific Investment	FY95	6/30/99
4. Irrigation Rehabilitation Credit	Specific Investment	FY95	5/31/01
Following Operations			
1. Highway Project Credit	Specific Investment	FY96	12/31/99
2. Social Investment Fund Credit	Specific Investment	FY96	12/23/00
3. Structural Adjustment Credit	Balance of Payments Assistance	FY96	12/31/99
4. Structural Adjustment Technical Assistance Credit	Balance of Payments Assistance	FY96	6/30/00

BASIC DATA SHEET

ARMENIA – STRUCTURAL ADJUSTMENT CREDIT I (C2824-AM)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	60	60	100
Credit amount	60	60	100
Completion	7/97		

Cumulative Estimated and Actual Disbursements

	FY96	*FY97*
Appraisal estimate (US$M)	30	60
Actual (US$M)	30	60
Actual as % of Estimate	100	100
Date of final disbursement		12/10/96

Project Dates

	Original	*Actual*
Preparation		9/95
Appraisal		10-11/95
Negotiations		1/96
Letter of Development/Sector Policy		1/96
Board Presentation		2/29/96
Signing		3/4/96
Effectiveness	3/8/96	3/22/96
First Tranche Release	3/31/96	3/22/96
Second Tranche Release	9/30/97	12/10/96
Project Completion		6/30/97
Credit Closing	12/31/97	12/31/97

Staff Inputs (staff weeks)

Stage of Project Cycle	*Planned*		*Revised*		*Actual*	
	Weeks	*US$*	*Weeks*	*US$*	*Weeks*	*US$*
Preparation to Appraisal	0	0	45.9	109.7	45.9	110.0
Appraisal	0	0	6.2	15.3	6.2	15.3
Negotiations through Board Approval	0	0	5.0	12.9	5.0	12.8
Supervision	24.0	51.1	42.8	105.2	39.6	98.7
Completion	6.0	8.8	3.0	3.0	1.5	2.8
Total	30.0	59.9	102.9	246.1	98.2	239.6

Mission Data

Stage of project cycle	Date (mm/yr.)	No. of persons	Duration of mission (# of days)	Specialized staff skills represented[1]	Performance rating[2]	
					Implement Status	Develop. objectives
Through Appraisal	11/95	7	11	A, CE, CO, E, F, PS, S		
Appraisal through Board Approval	01/96	6	12	CE, CO, E, F, PS, S		
Supervision	04/96	6	12	DC, CE, CO, E, F, S	S	S
	08/96	8	15	CE, CO, E, F, PS, S	S	S
	11/96	6	13	DC, CE, CO, F, PS, S	S	S
Completion	07/97	-	-		S	HS

1 – Key to Specialized staff skills:
A = Agriculture Specialist
CD = Country Director
CE = Country Economist
CO = Country Officer
DC = Division Chief
E = Energy Specialist
F = Financial Sector Specialist
PS = Private Sector Develop. Specialist
S = Social Sector Specialist

2 – Key to Performance Ratings:
HS = Highly Satisfactory
S = Satisfactory

Other Project Data

Borrower/Executing Agency: Government of Armenia

Related Bank Credits

Credit title	Purpose	Year of approval	Closing date
Preceding operations			
1. Rehabilitation Credit	Economic stabilization and reform	FY95	06/30/96
Following Operations			
1. Structural Adj. TA Credit I	Technical support for GOA reform program and SAC I	FY96	6/30/00
2. Structural Adj. TA Credit II	Technical support for SAC II and III	FY98	6/30/02
3. Structural Adj. Credit III	Macro stability and private sector led growth	FY99	6/30/01

BASIC DATA SHEET

ARMENIA –STRUCTURAL ADJUSTMENT TECHNICAL ASSISTANCE CREDIT (CREDIT 2825-AM)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	4.1	1.6	39
Credit amount	3.8	3.8	100
Domestic contribution	0.3	0.1	-
Project completion	9/30/99	6/30/99	

Cumulative Estimated and Actual Disbursements

	FY96	*FY97*	*FY98*	*FY99*
Appraisal estimate (US$M)	0.40	2.80	3.80	3.80
Actual (US$M)	1.00	1.10	1.97	2.14
Actual cumulative as % of Credit	250	39	52	56
Date of final disbursement	1/8/01			

Project Dates

Steps in Project Cycle	*Original*	*Actual*
Preparation		9-10/95
Appraisal		11-12/95
Negotiations		1/19-22/96
Board Presentation		2/29/96
Signing		3/4/96
Effectiveness	3/8/96	3/22/96
Project Completion	9/30/97	6/30/99
Credit Closing	12/31/97	6/30/00

Staff Inputs (staff weeks)

Stage of Project Cycle	*Planned*		*Revised*		*Actual*	
	Weeks	*US$*	*Weeks*	*US$*	*Weeks*	*US$*
Negotiations through Board Approval			18	4.8	1.8	4.8
Supervision	28.8	61.1	33.5	75.1	31.2	62.6
Completion			2.	4.8	1.5	2.7
Total	28.8	61.1	53.5	84.7	34.5	70.1

Mission Data

Stage of project cycle	Date (mm/yr.)	No. of persons	Duration of mission (# of days)	Specialized staff skills represented*	Performance rating		Types of problems
					Implement. Status	Develop. objectives	
Preparation through Board approval	9/95	3	8	E, PROC	NA	NA	
	11/95	3	8	E, PROC			
Supervision	7/96	3	9	E, LEG, HR	S	S	
	8/96	4	7	E, PSD, F	S	S	
	12/96	3	5	E	S	S	Change in government
	6/97						
	3/98	4	6	SOC, F, E	S	S	
	6/98	2	6	E, F	S	S	
	1/99	2	7	E	S	S	
Completion		2	8	E,PROC	S	S	

E = Economist
F = Financial Analyst
HR = Human Resources
LEG = Legal
PROC = Procurement Specialist
PSD = Private Sector Development
SOC = Social Scientist

Other Project Data

Borrower/Executing Agency: Government of Armenia

Related Bank Credits

Credit title	Purpose	Year of approval	Status
Preceding operations			
1. NONE			
Following Operations			
1. Rehabilitation Credit	Economic Stabilization and reform	FY95	Closed
2. Structural Adj. Credit I	Economic Stabilization and growth resumption	FY96	Closed
3. Struct. Adj. Credit II	Consolidate macro stability and lay foundation for sustained medium term growth	FY98	Closed
4. Structural Adj. TA Credit II	Technical support for SAC II and III	FY98	Closed

BASIC DATA SHEET

ARMENIA – STRUCTURAL ADJUSTMENT CREDIT II (CREDIT 2980-AM)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	60	60	100
Credit amount	60	60	100
Completion	12/98		

Cumulative Estimated and Actual Disbursements

	FY98	*FY99*
Appraisal estimate (US$M)	40	60
Actual (US$M)	60	60
Actual as % of Estimate	150	100
Date of final disbursement		12/29/97

Project Dates

	Original	*Actual*
Preparation		11/96, 3/97
Appraisal		5/97
Negotiations		7/97
Letter of Development/Sector Policy		6/97
Board Presentation	8/26/97	8/26/97
Signing	9/22/97	9/22/97
Effectiveness	3/8/96	3/22/96
First Tranche Release	9/30/97	9/22/97
Second Tranche Release	12/31/98	12/29/97
Project Completion	3/31/99	3/31/99
Credit Closing	6/30/99	6/30/99

Staff Inputs (staff weeks)

Stage of Project Cycle	*Planned*		*Revised*		*Actual*	
	Weeks	*US$*	*Weeks*	*US$*	*Weeks*	*US$*
Preparation to Appraisal	40.0	93.6	46.1	109.2	46.6	112.0
Appraisal	0	0	3.9	9.8	4.0	9.9
Negotiations through Board Approval	5.6	15.5	5.6	15.5	6.3	17.5
Supervision	37.5	65.3	43.4	89.1	34.5	78.0
Completion	0	0	6.0	5.0	1.5	2.7
Total	83.1	174.4	105.0	228.6	92.9	220.1

Mission Data

Stage of project cycle	Date (mm/yr.)	No. of persons	Duration of mission (# of days)	Specialized staff skills represented[1]	Performance rating[2]	
					Implement. Status	Develop. objectives
Through Appraisal	11/96	7	12	A, CE,CO,E, F, PS, S		
	03/97	6	14	CE, CO, E, F, PS, S		
Appraisal through Board approval	06/97	5	10	CE, CO, E, F, PS, S		
Supervision	09/97	6	11	CE, CO, E, F, PS, S	S	S
	11/97	11	15	CE, CO, E, F, MS, PS, S	S	S
	03/98	5	7	CE, CO, S	S	S
Completion	12/98	-	-		S	S

1 – Key to Specialized staff skill:
A = Agriculture Specialist
CD = Country Director
CE = Country Economist
CO = Country Officer
DC = Division Chief
E = Energy Specialist
F = Financial Sector Specialist
MS = Municipal Specialist
PS = Private Sector Develop. Specialist
S = Social Sectors Specialist

2 – Key to Performance Ratings:
HS = Highly Satisfactory
S = Satisfactory

Other Project Data

Borrower/Executing Agency: Government of Armenia

Related Bank Credits

Credit title	Purpose	Year of approval	Closing date
Preceding operations			
1. Rehabilitation Credit	Economic stabilization and reform	FY95	6/30/96
Following Operations			
1. Structural Adj. TA Credit II	Technical support for SAC II and III	FY96	6/30/00
2. Structural Adj. Credit III	Macro stability and private sector led growth	FY99	6/30/01

BASIC DATA SHEET

ARMENIA – STRUCTURAL ADJUSTMENT CREDIT III (CREDIT 3153-AM)

Key Project Data *(amounts in US$ million)*

	Appraisal estimate	*Actual or current estimate*	*Actual as % of appraisal estimate*
Total project costs	65.0	65.0	100
Credit amount	65.0	65.0	100
Co-financing			

Project Dates

	Actual
Identification	
Preparation	
Appraisal	
Negotiations	
Board Presentation (Approval)	12/22/98
Signing (Agreement)	12/23/98
Effectiveness	12/28/98
Project Completion	
Credit Closing	6/30/01

Staff Inputs (staff weeks)

Stage of Project Cycle	Actual	
	Weeks	*US$*
Identification/Preparation	12	68,121
Appraisal/Negotiation	20	102,181
Supervision	67	412,398
Completion(ICR)	3	10,000
	102	592,700

Mission Data

Stage of project cycle	Date (mm/yr)	No. of persons	Specialized staff skills represented	Performance rating	
				Implement Status	Develop. objectives
Identification/Preparation	07/98	2	TM, E	S	S
	09/98	2	TM, E	S	S
Appraisal/Negotiation	10/98	2	TM, E	S	S
	11/98	2	TM, E	S	S
Supervision (PSR Date)	04/99	2	TM, E	S	S
	07/99	1	TM	S	S
	10/99	3	TM, E, E	S	S
	01/00	3	TM, E, E	S	S
	04/00	3	TM, E, E	S	S
	10/00	2	TM, E	S	S
	01/01	2	TM, E	S	S
ICR	06/01	1	TM	S	S

TM = Task Manager, E = Economist

Other Project Data

Borrower/Executing Agency: Government of Armenia

Related Bank Credits

Credit title	Purpose	Year of approval	Status	Closing date
Preceding operations				
1. SAC I	Economic Stabilization and growth resumption	1996	Closed	12/31/99
2. SAC II	Consolidate macro stability and lay foundation for sustained medium term growth	1998	Closed	12/31/98
Following Operations				
1. SAC IV	Support the Government's efforts to facilitate private sector development and job creation	2001		3/31/02

Annex C

The Effort to Privatize the Electricity Distribution Companies

1. A SAC III condition was that the bid evaluation for privatization of the Yerevan electricity distribution company would have been completed, and the majority of shares of the other 3 companies offered for purchase by strategic investors. The process suffered a major setback in April 2000, when Parliament rescinded its commitment, under an earlier Privatization Law, to privatize these companies. It took until July 2000, for Parliament, under strong Government pressure, to pass a new law specifically covering privatization of the four electricity distribution companies.

2. In this process, the Government and the Bank wished to avoid an experience similar to the unsatisfactory 1997 telecom privatization, and so took care to put a first-rate financial and legal framework in place. However, achieving satisfactory arrangements for top quality legal advice proved to be a lengthy process. For nearly a year the Bank declined to release the (restructured) fourth tranche despite repeated requests from the Borrower, a wise posture.[45]

3. However, when satisfactory draft tender documents had been sent to pre-qualified bidders, management asked the Board for a waiver of the condition, in large measure because Government had expended considerable political capital in persuading Parliament to permit privatization of these firms, and to avoid penalizing government for taking extraordinary due diligence with this transaction. The Government was told that Board presentation and tranche release of SAC IV could go ahead only if there was satisfactory progress in the above mentioned timetable, and specifically only if the authorities have brought the distribution companies to the point of sale and announced the winners among responsive bids. Since the next adjustment credit would be about $50 million, it was not thought that the release of the $5 million fourth tranche would undermine the fiscal incentives for continuing with the privatization process.

4. Therefore, based upon the Government's compliance with three of the conditions of disbursement, and in view of the factors outlined above, the decision was made to request the Board to waive the required privatization of four power distribution companies as a condition of the fourth tranche release, which was agreed, and on December 21, 2000, the fourth and final tranche of SAC III (US$5 million) was transferred to the Borrower.

5. In April 2001, the Government concluded the international tender for privatization of the electricity distribution companies without having received any bids. This happened largely because the pre-qualified bidders had been intensively engaged in bidding for power sector assets in other countries in the region, but also due to perceptions among bidders of political obstacles to the privatization. The Government has re-confirmed its intention to privatize the companies later in 2001 and will set up a new

[45] The Bank's decision not to disburse the fourth tranche during this period had significant economic and political consequences in Yerevan.

steering committee, led by the Prime Minister, to lead preparation of the new tender. The Government agreed to fully incorporate lessons from the earlier tender that would include making adjustments to the legal framework and ensuring that the corporate, financial and asset ownership issues are resolved before the next round of tendering is conducted. The completion of the sale of the companies through a transparent and competitive process is a condition of disbursement for the floating tranche of SAC IV.

Annex D

Privatization

Overview

1. Privatization had been expected to lead to significant gains in the short- to medium-term, but institutional weakness, among other factors, limited the gains. Although the mass privatization program for medium and large enterprises was "successful" in that the credit conditions were largely satisfied—although usually later than expected—and the firms were no longer publicly-owned, the *economic benefits expected from this process for the most part did not materialize.* This was because in many cases insiders—workers and mangers—became the dominant owners, and had little incentive or ability to restructure firms and improve their efficiency. Under the mass privatization program, insider-dominated privatization left enterprises with little access to investment capital, and no new management skills. Actual restructuring has been slow. Widespread appropriation of assets by managers and other well-placed individuals reduced public confidence that privatization would yield substantial and widespread economic benefits.[46] And the conduct of the "Strategic Privatization Program," described below, had a negative impact on public perception of privatization. Finally, as noted in "Lessons Learned" (para. 8.2) privatization is only a part of what is needed to stimulate private sector-led growth, and must be complemented by other measures to stimulate private sector development.

2. It should be noted that privatization, as pursued by the Armenia program of adjustment lending, conformed to the "best practice" of that period. *Ex post* reviews, as cited in footnote 46, have clarified that implementation of complementary measures—e.g., stronger enterprise governance and legal protection for minority shareholders and other investors —would probably have increased the gains derived from privatization, as would a better legal and regulatory framework and accounting practices.

Small Enterprise Privatization

3. The program to privatize small enterprises, which began in 1991-92, at Government initiative, was largely successful. By the end of the period under review, over 90 percent of small companies had been privatized. Small privatization slowed in 1992 due to the conflict with Azerbaijan over NK, but then picked up again in 1994.

Privatization of small enterprises

Credit	*Key Objectives: Small Privatization*	*Realization*
Rehabilitation	3,000 (end 1995)	3,000 (early 1996)
SAC I	2,000	2,000
SAC II	4,700	4,700
SAC III	24 bakeries and mills in the program privatized; 28 not sold were liquidated	achieved

[46] See OED, "IDA Review of Private Sector Development," March 2001; "Transition After a Decade," ECA, November 2000; and "Between State and Market: Mass Privatization in Transition Economies," World Bank, September, 1997

With the advent of the Rehabilitation Credit in 1995, a goal was set for 3,000 small enterprises to have been privatized by end-1995, a level that was actually reached in 1996, shortly after the credit closed. Rapid sales continued under SAC I, with 2,000 additional small enterprises privatized, meeting the credit conditions. SAC II stipulated the privatization of 4,700 additional small enterprises, which was achieved, with the result that by 1998 over 85 percent of all small enterprises in the country were successfully privatized, and by 2001 more than 90 percent.

Medium and Large Privatization

4. The privatization of medium and large enterprises was more difficult than that of smaller firms. The approach used—voucher privatization carried out by auction—was developed by the GoA, with the Bank providing assistance (via SATAC I) by assisting with the preparation of enterprises for privatization. At the start of the process, there were approximately 2,000 medium and large firms in the country. The Rehabilitation Credit set a goal of privatizing 900 of these by the end of 1995, a level that was nearly reached, but somewhat later than expected, as 850 firms were privatized by end-1996 (the credit closed on June 30, 1996).

Privatization of medium and large enterprises

Credit	*Key Objectives: Medium-large privatization*	*Realization*	*Comment*
Rehabilitation	900 (end 1995)	850 (end 1996)	Condition considered met
SAC I	Satisfactory implementation of the Government's 1996 privatization program—around 1200 additional companies	Around 500 (40 %) privatized in 1996	Government had set too ambitious a goal; Credit tranches released
SAC II	Satisfactory completion of the 1996-97 privatization program by the end of 1997—around 500-600 firms to be sold in 6 months	250	Condition "met in substance"
SAC III	Privatization of 200 firms per year in 1999 and 2000	Approximately 100 in 1998, and 200 in 1999-2000 (both years)	Condition considered met; by program end, 78% of the country's 2,000 large/medium enterprises had been sold

5. SAC I conditions called for the implementation of stricter procedures for the sale of companies that were not sold on their second or third attempts, and other measures streamlining the privatization program, which were implemented. As a 2nd tranche condition, the credit also called for "satisfactory implementation of the Government's 1996 privatization program." The Government privatized around 500 additional medium and large-sized enterprises during 1996—a substantial achievement, but only around 40 percent of those in the 1996 program—however the Bank considered that the 2nd tranche condition had been met. In retrospect, Government had set too ambitious a goal, and then did as good a job as could reasonably have been expected in selling the companies. So at

the end of 1996, a total of around 850 medium and large-sized enterprises had been sold, around 43 percent of all such firms.

6. SAC II also contained an overly-ambitious target for privatization of medium and large-sized enterprises—around 500 to 600 firms to be sold in the second half of 1997. The Government did achieve the sale of an additional 250 enterprises during that period, and SAC II was considered to have "met this condition in substance." This meant that by the end of 1997, 1,100—approximately 55 percent—of the country's medium and large-sized enterprises had been sold. In addition, under SAC II amendments were made to the Privatization Law to introduce time limits within which unsold enterprises were required to be reorganized or liquidated.

7. SAC III required that an additional 200 enterprises be sold per year in 1999 and 2000. In reality, in addition to the 100 firms that had been sold in 1998, approximately 200 additional were sold in 1999-2000 (both years), however, the SAC III condition was considered to have been met. In all, by the end of SAC III in June, 2001, 1,504 medium and large enterprises had been sold, approximately 78 percent of the total. The remaining firms had either failed to sell and were awaiting liquidation—some for a prolonged period—or the GoA had decided to retain ownership.

Privatization of "Strategic Enterprises"

8. Sale or liquidation of around 11 specific "strategic" enterprises was part of the conditionality of SAC II and SAC III. These were firms that were either very large, large lossmakers, or expected to be particularly attractive to foreign investors. The experiences were not positive; the process started in 1996 and progressed slowly, with many obstacles encountered. Until the end of 1997, none had been privatized. Three were sold in 1997 and 1998 (see below). By the end of 2000, however, 8 of the firms had been privatized, one liquidated, with the rest still state-owned. Although the obstacles encountered derived from a variety of sources, the process did not succeed in earning the anticipated amount of foreign exchange for the country, and it diminished the country's reputation among foreign investors.

Privatization of "strategic" enterprises

Credit	*Key Objectives: "Strategic" enterprise privatization*	*Realization*	*Comment*
Rehabilitation	None		
SAC I	Eleven large enterprises placed in restructuring program, expected to have undergone final offer for sale, or liquidation initiated	Not achieved	Privatization/liquidation occurred later; fiscal drag continued
SAC II	Eleven large enterprises placed in restructuring program; initiate liquidation for any firms not privatized	"Condition met in substance;" sales considered to be "well-advanced"	Achievement came later: one firm was sold in 1997, 2 in 1998; privatization /liquidation of others occurred later
SAC III	None		

Government of Armenia International Privatization Tenders

9. In mid-1997, the Government of Armenia (GOA) announced international tenders for 14 state-owned enterprises, with Merrill Lynch as broker (ML tenders).[47] This arrangement was sponsored by the World Bank. The GOA and World Bank objectives were:

a) attracting foreign direct investment into the country
b) securing renovation of the infrastructure and fixed assets
c) ensuring that the sales were conducted in a transparent manner based on market principles
d) improving services and operations of the companies to be privatized

10. Under this program, the monopoly telephone company ArmenTel was bought by Greece's Hellenic Telecommunications Organization (OTE) in December, 1997. This sale was actually the second stage of ArmenTel's privatization. The first stage had occurred several years earlier, when 49 percent of the company was sold to a foreign company Transworld which had veto rights over sale of the remaining share. (The Bank was not involved in this first phase) Transworld's veto rights made it more likely that a subsequent sale would be highly monopolistic, since this would increase Transworld's return on investment. Given the earlier arrangement, it would have been extremely difficult for the Bank to have taken any measures that would have avoided a monopoly arrangement in any subsequent sale.

11. After agreement from Transworld had been obtained, the 1997 sale of 90 percent of ArmenTel to OTE for US$142 million was the first major cash sale in the international cash tender program. In structuring this sale, the Government and its Bank-sponsored investment advisor attempted to maximize the selling price, and granted OTE a 15-year monopoly on all major services not an ideal approach to stimulating sectoral development. OTE had made substantial promises regarding planned investment in the company, and over the next three years the Government and the company traded charges over whether these goals had been met. In additional, the Government eventually sued OTE over back taxes it claimed were owed. In the meantime, although OTE has increased collections and the number of pay phones available, the country has continued to endure high tariffs for telephone connections and internet access, as well as poor quality connections.

12. This sale was followed by the Pernod Ricard acquisition in 1998 of the Yerevan Brandy factory. Pernod pledged to invest US$5 million in the development of vineyards during the next three years. However, in the aftermath of the acquisition, disputes arose with GOA concerning tax and brand ownership issues (see box below). While most issues have evidently been settled as of this writing, the process did not improve Armenia's reputation as a good destination for investment.

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[47] These 14 companies included most of the 11 large firms that had been the subject of conditionality for SAC II, plus several additional firms.

13. Also in 1998, the Hotel Armenia, a prime real estate property in downtown Yerevan was bought by a group of US Diaspora Armenian investors and put under a management contract with Marriott. The post-acquisition period was complicated by a class action suit brought by the downsized employees, and the hotel has still not been refurbished. While valuable time has been lost and competition has emerged, it should be noted that the difficulties and delays were not related to Government but to the investor's inability to raise additional funding.[48]

Risks in Purchasing Armenian Enterprises

Pernod-Richard of France purchased the Yerevan Cognac Factory, one of the country's best-known and attractive companies, for US$20 million in 1998. However, despite assurances to Pernod that the firm's brand names were included in the purchase, the Armenian Ministry of Agriculture continued to produce cognac at 3 factories it owned in Russia using the same or similar brand names. A long and costly conflict over the brand names finally resulted in the Ministry's sale of the 3 factories to a Russian concern. However, this Russian company subsequently began to sell cognac with a similar label and bottle design in Russia, Pernod's principal target market.

Pernod responded to the Ministry's action by cutting its 2000 purchase of Armenian grapes by 41 percent and then suing the new Russian company.

Source: "Armenia: Pernod-Richard Struggling to Prevent Illegal Use of Brand Names," Inzhenernaya Gazeta, November 28, 2000.

14. With regard to the overall strategic privatization program, it should be noted that several remaining companies have not yet been sold, and many current and former officials, as well as analytic work,[49] have noted that some large companies are still, in 2001, receiving direct or indirect subsidies from the government

Negative consequences of the sales

15. All three concluded deals had a certain negative impact on public perception of privatization. Many people regard these sales as being done at an unfair price and not beneficial either for the enterprises sold or for the nation. It is widely believed that the sales process was corrupt, non-transparent and resulted in no or little improvement in employment, services and production volumes and quality.

16. The privatized companies had long disputes with the GOA on pledged investment, tax regime and franchise issues, which disputes led to a deterioration of the investment attractiveness of Armenia. The business community feels that ArmenTel's high tariffs and its monopoly are a serious impediment for business development. Many also believe that the GOA public information campaign in support of these privatizations could have been stronger.

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[48] Information from Armenia Resident Mission Staff

[49] World Bank, "Armenia Targeted Financial Sector Review," (June 2000).

17. The negative fallout from these deals continues to hamper privatization and foreign direct investment in the country. In particular, the privatization of the energy distribution companies was affected, resulting in suspension of the privatization tender by the National Assembly in April, 2000.

Annex E

Legal and Judicial Reform

1. Since the Bank began work in Armenia, it has recognized that a well-functioning legal system was important for the development of the private sector, and all five projects reviewed in this assessment included legal reform components:

- "Early attention needs to be paid to the development of....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." (1993 CEM)
- The 1995 limited CAS recognized the importance of an adequate legal environment for private sector growth, and envisioned promulgation of laws and regulations on enterprises.
- The Rehabilitation Credit and the three SACs all had conditions regarding adoption of new laws
- SATAC I (1996-2000) was intended to provide technical assistance in liquidation and bankruptcy training, and was also intended to establish a Judicial Training Plan and Concept of Legal and Judicial Reform[50]
- The 1997 CAS stated that an improved legal framework was among the "major achievements" of Armenian reforms. *Inter alia*, the CAS cited progress regarding laws on real property, companies, and bankruptcy.

2. Laws supporting privatization and the functioning of the Central Bank had been passed in 1992, and by 1995, Armenia had just begun to implement a legal framework suitable for a market economy. From 1995 to 2001, in many cases stimulated by or assisted by the credits assessed in this PPAR, significant additional progress was made in the development of new laws to support a market economy:

- Law on Collateral (1995); Rehabilitation Credit condition
- Banking Law, Bank Insolvency Law (1996)
- Pension Law (1996); SAC I Board condition
- Company Law (1997); SAC I condition
- New Privatization Law (1997)
- Revised Bankruptcy Law (1997); SAC I condition
- Energy Law (1997); SAC II condition
- Law on Registration of Real Property (1997); SAC II condition
- Accountancy Law (1998)
- Telecomm Law (1998)
- New Civil and Procedural Code (1999)
- Securities Market Law (2000); SAC III condition

[50] Unfortunately, TA in these areas was dropped from the project. A March, 1997, mission reported that there was no Government consensus on whether a judicial sector assessment should be conducted.

3. All of the laws and regulations stipulated in the four adjustment credits assessed in this PPAR were enacted as envisioned. However, despite the great improvement in the legal framework during this time, however, insufficient attention was paid to enforcement, or to strengthening the judiciary and the actual role the legal system could play in furthering a healthy business climate. In this regard, the legal reform program fell short of providing an adequate basis for the functioning of a market economy.

4. For example, several surveys and studies found that respect for the judicial system is critically low, very few businesses or individuals use it to settle disputes, and bankruptcies and liquidations have been negligible.[51] Inconsistencies between laws,[52] delays in issuance of implementing regulations, and lack of a public repository listing all applicable decisions and regulations combine to create considerable uncertainty. This uncertainty exists among all stakeholders, including administrative authorities, the business community, and members of the legal profession.[53]

5. The 2000 EBRD assessment of "Legal Transition Indicators"[54] rates Armenia a 3 and 4- respectively (on a five-point scale, with 5 being the highest) on overall progress and extensiveness of commercial law, but just a 2 with regard to effectiveness, with that rating defined as: "Commercial laws are generally unclear and sometimes contradictory. There are few, if any, meaningful procedures in place in order to make commercial laws operational and enforceable."

6. Among the reasons for the ineffective functioning of the judicial system are:

- Inconsistent government support for effective legal and judicial reform
  - Under SATAC I, the contractor charged with providing technical assistance for liquidation stated that their work was delayed by two years (1997 and 1998) because of the government's unwillingness to designate candidate firms for liquidation.
  - Bankruptcy training planned under SATAC I was canceled
- The public view of the performance of the courts, prosecutor's office, Internal Affairs, and tax inspections as unreliable and untrustworthy[55]
- The image of judges and other justice employees as lacking honesty
- Laws are viewed as not equally enforced for all social groups
- The judicial system is seen as not affordable for the majority of people
- Most people do not turn to the court system, even in emergencies

The legal framework governing the financial sector is considered to require improvement, especially with regard to CBA enforcement powers:[56]

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[51] Interviews, and USAID, "Investigation of Factors Inhibiting FDI in Armenia," August, 1999
[52] Although they create uncertainty, inconsistencies are less than in many other CIS countries.
[53] FIAS report, 2000.
[54] EBRD, "Transition Report 2000."
[55] "Analysis of Public Awareness on Judicial Reforms," World Bank, December 1999-January 2000

> "…the ability of the CBA to enforce its decisions is frequently undermined by the courts. Judges can and do overturn legal technical findings of CBA staff."

7. And the objectives of the Judicial Reform Project, approved in September, 2000, suggest a substantial unfinished agenda. The project is intended to "assist in the development of an independent, accessible, and efficient judiciary….which is essential to governance, rule of law, and investment climate."[57]

8. So, despite the acknowledgement throughout the decade that an effective legal system was key to the functioning of the private sector, little progress toward this end seems to have been made. While the legal framework has been greatly improved, so far this seems to have provided few benefits for private business.

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[56] IMF, "Armenia Financial System Stability Assessment," March, 2001, p. 5.

[57] Significant judicial reforms were achieved as part of the preparation of the Judicial Reform Project and the dialogue leading up to it. This was in part a result of the "ownership" shown by the Ministry of Justice, but was achieved mainly outside the framework of the 5 projects that are the subject of this PPAR.

Annex F

Energy Sector Reform

1. Improvement in the energy sector is one of the most valuable outcomes of the Armenian reform program; it has provided benefits both to consumers and to industry

in the form of more reliable energy. While considerable progress still needs to be made, Armenia's achievements in this area compare quite favorably to those of other CIS countries.

2. All the adjustment operations considered in this PPAR included measures to increase budgetary discipline of public sector agencies, i.e., to encourage them to pay for the energy they consume. The program also included conditions that the Government gradually raise the price of energy, restructure the sector, privatize the electricity distribution companies, and require energy firms to use international accounting standards. <u>All but three of the energy sector objectives of the four adjustment credits were met</u> (see table below): the exceptions were (1) operations and maintenance costs were not covered by end-1995 as required by the Rehabilitation Credit; (2) the SAC II condition that energy collections average 75 percent for a 3-month period, which was deemed by the Bank to have been "met in substance" in December, 1997, was not met and in reality was only reached in 1998. The resultant premature release of the SAC II 2nd tranche is discussed in paragraph 9.8; (3) sale of the electricity distribution companies did not take place as required by SAC III; this is discussed above in Annex B.

3. In 1994, the energy situation was dire: electricity was provided to many areas only 4 hours a day; the frequency of the electricity supplied varied, which sometimes damaged electrical equipment; and supplies were interrupted by periodic explosions on the natural gas pipelines from Russia and Turkmenistan. Theft of electricity was estimated to be as high as 30 percent. From 1994 to end-1995, collection of electricity payments increased from 62 to 70 percent for the budgetary sector, and from 10 to 33 percent for households. (This was during the Rehabilitation Credit, which did not set quantitative targets for these variables) By 2001, theft had been reduced to around 10-12 percent and collections were 85-90 percent, despite a very large increase in tariffs. Supply interruptions had virtually ceased.[58]

4. The price of electricity, traditionally very low in the Soviet Union, was gradually raised under the reform program—which required political courage. From an average rate of 0.2 US cents/kwh in 1993, the price was doubled in early 1994, and then reached 1.4 US cents/kwh in December, 1994. It was gradually raised to 4.1 cents in September, 1997, 4.6 cents in January, 1999, and 4.9 cents currently.[59] While this is sufficient to

[58] *Some part of the improvement in electricity supply can be attributed to the re-start in 1995 of the country's only nuclear power plant, at Medzamor, which supplies 1/3 of the country's electricity.*
[59] Data from interviews with sector specialists. This can be compared with a current price of 1 cent/kwh in neighboring Georgia.

cover operations and maintenance costs—but not capital expenditures or debt service—it represents substantial progress in convincing industry, government, and individuals that energy is something that must be paid for.

5. The energy sector was also restructured under the program. Regional electricity distribution companies were legally separated from generation and transmission companies, in preparation for privatization, although as described earlier, they are not yet private. And a competent Energy Regulatory Commission was established, relatively independent from other sector agencies, which sets prices and grants licenses.

6. Key energy goals of the credits which were achieved (except as noted) are shown in the table below:

Energy Reform: Objectives of 4 adjustment credits and realization

Credit	*Key Objectives*	*Realization*	*Comment*
Rehabilitation	Improve energy collections; electricity tariffs to cover O&M costs	Budgetary sector collections rose from 62 percent to 70 percent; household collections rose from 10 percent to 33 percent; O&M costs not covered	
SAC I	Improve collections to 75%; restructure sector; electricity tariffs to cover O&M costs; Energy Law to be adopted	All objectives met	Electricity prices raised 25%; collection rate declined after tranche release
SAC II	Improve collections to 75% by 12/97; complete and implement financial rehabilitation plan; establish energy regulatory agency; adopt privatization strategy for power enterprises; eliminate 50% exemptions for privileged groups	All objectives met, except evidence of compliance with 75% collection requirement was insufficient; this objective not met	Collection rate declined after 2nd tranche release
SAC III	Improve collections to 87%; increase tariffs 12.5%; clear all energy arrears from budgetary agencies; electricity distribution companies to be: licensed by ERC; audited in accordance with IAS standards; and privatized	Collection rate reached 88%; arrears were cleared; tariffs were increased; companies were licensed by ERC; audits were completed (with a delay); distribution companies not privatized (Annex B)	Theft of electricity declined to 10 percent

7. It is important to note that, in spite of the progress that has been made in the energy sector, there is still the need for more advancement. The shortcoming in the privatization of the distribution companies has been discussed. While 88 percent of households pay their electricity bill, and the Government does not provide explicit subsidies to the energy sector, fiscal support is provided to some entities to enable them

to pay for electricity, with the largest being the drinking water and irrigation firms. Considering these implicit subsidies, the energy sector still comprises a quasi-fiscal deficit of 3.9 percent of GDP—by far the largest part of a total "ex ante net adjusted financing gap" of 5 percent (2000).[60]

[60] IMF, "Recent Economic Developments and Selected Issues," May 2001, p. 35.

Annex G

Financial Sector Reform

1. Following independence in 1991, the number of banks in Armenia rose dramatically, reaching as many as 80 in 1994. Many were weak and thinly capitalized. However, in conjunction with the IMF and the Bank, the Government introduced an effective system of financial regulation, with significant strengthening of bank regulation, which resulted in the closing of many weaker banks. Adoption of the Basle convention's capital adequacy requirements stimulated a gradual recapitalization of surviving banks, while a loan provisioning program helped reduce bad loans in bank portfolios. The rapid restructuring of the sector also hastened bank privatization, which has essentially been completed. Foreign bank ownership was permitted starting in 1995, and there are presently 5 branches of foreign-owned banks.[61] By 1998, there were 38 banks, and the current number is 31. All banks are presently privately-owned, except one, which the Government plans to sell in the near future. At present, foreign capital comprises around 40 percent of total capital, and the ten largest banks account for more than 70 percent of total assets and 75 percent of loans.

Adjustment operations and their major financial sector objectives

Credit	*Key Objectives*	*Realization*	*Comment*
Rehabilitation*	Guidelines developed for exposure, shareholder lending, forex; bank portfolios re viewed; increase minimum statutory capital (US$100,000)	All objectives achieved	
SAC I	Adopt law on bank insolvency; audit all banks; restructuring program developed for Savings Bank; new loan classification system developed; specialized bank resolution unit developed in CBA; IAS-compatible system designed; debt work-out unit established in one bank	All objectives achieved	Ratio of non-performing loans declined: see table below
SAC II	Initiate bankruptcy for any bank failing to achieve CBA targets; adopt and initiate implementation of privatization strategy for Savings Bank, and restructuring plan for Ardshinbank; move all banks to IAS basis; adopt laws on securities and Capital Markets Regulatory Authority (CMRA); operationalize CMRA	Most objectives were achieved: new accounting standards implemented; CMRA was operationalized; however, Savings Bank was not privatized—the Government intends to do so soon.	Banks at risk of failing to achieve CBA targets rapidly improved their performance.
SAC III	Privatize Ardshinbank; complete audit of 1998 financial statements for all banks; raise general capital adequacy ratio to 12% and minimum core capital adequacy ratio to 8%	All objectives achieved	Ratio of non-performing loans continued to fall

*Prior to effectiveness, actions taken for IMF STF included elimination of interest rate minima, charges by the authorities for cash withdrawals, and an increase in bank reserve requirements.

[61] IMF, "Recent Economic Developments and Selected Issues," May 2001, p. 20.

2. Privatization of state-owned banks was the subject of conditions of the four adjustment credits (see below), and technical assistance was provided under the SATAC I, as well as by the IMF. In particular, SATAC I provided assistance in strengthening bank supervision. The legal and institutional reforms of Armenia's financial system are among the most advanced in the CIS;[62] many aspects of the regulatory framework were encompassed in the reform program supported by the five credits that are the subject of this PPAR. One of the most positive contributions was made by SAC II in requiring that banks adhere to IAS standards (1998).

3. Regulatory reforms in the securities markets have lagged behind the banking sector, but have nonetheless been extensive. There is an active, though narrow, market for T-bills, with rates that are quite high considering the low level of inflation. For example, in 1999, T-bill rates ranged from 45 to 64 percent, depending on maturity (30 days to 364 days). There is an active, though thinly traded stock market, and an effective Securities and Exchange Commission.[63]

4. Several IMF assessments have found the current status of the Armenian financial sector to be healthy.[64] The efforts to recapitalize banks, especially through the gradual increases in the minimum capital requirement, helped increase the capital adequacy ratio (see data below). While Armenia's commercial banks were characterized by large volumes of non-performing loans prior to 1996, significant progress was made in improving the quality of loan portfolios in 1996-97, and consequently the level of non-performing loans fell to around 6 percent in December, 2000.

Armenia: Banking system indicators

Variable	*1997*	*1998*	*1999*	*2000*	
	March	*March*	*March*	*March*	*December*
Total capital to risk-weighted assets ratio	29.4	33.6	29.6	29.0	25.0
Total non-performing loan to total loan ratio	24.7	12.1	14.2	5.6	6.2

5. However, despite the financial sector's impressive progress, it has contributed little to Armenia's growth. This is because, firstly, the current size and scale of the informal sector—estimated by some to comprise 60 percent of the economy—discourages saving that could flow into the formal system, and limits the number of bankable investment propositions available for bank financing; as a consequence, the formal banking system plays a very small role in the intermediation of savings. Although the depth of Armenia's financial system is increasing, it remains very low and below that

[62] Oxford Analytica, "Armenia: Financial Sector," July 24, 2000; World Bank, "Armenia Targeted Financial Sector Review," June 2000.
[63] Interest rates declined substantially in 2000.
[64] IMF, "Republic of Armenia: Recent Economic Developments and Selected Issues," May, 2001; "Financial System Stability Assessment," March 2001.

of nearly all other CIS countries. For example, the ratio of bank deposits to GDP doubled from 3 percent in 1996 to six percent in 1999, still a very low level.[65] Secondly, most small and medium-sized companies have very limited access to resources from the formal sector, mainly because they lack sufficient collateral.

6. Financial sector structural reforms encompassed within the five projects that are the subject of this PPAR include:

- Enhanced guidelines for exposure limits (1995); Rehabilitation credit
- Bank portfolios reviewed (1995); Rehabilitation credit
- Minimum statutory capital increased (1995); Rehabilitation credit
- New law on bank insolvency adopted (1996); SAC I
- CBA established a specialized bank resolution unit; SAC I
- Bankruptcy proceedings initiated for any bank failing to achieve targets set by CBA unit; SAC II
- The Government adopted and implemented a strategy to privatize or restructure specified banks; SAC II
- The Government adopted a decree stating that enterprises with more than 50 shareholders must register all shareholders with the National Share Registry; SAC II
- Bank financial reporting moved to an IAS basis; SAC II
- Establishment of Capital Markets Regulatory Authority; SAC II
- Savings Bank audited and restructured; SAC III
- One bank privatized, two privatized banks restructured; SAC III
- Central Depository for securities was established; SAC III
- Securities Market Law (2000); SAC III

[65] World Bank, "Armenia Targeted Financial Sector Review" (June 2000), p. 6.

Annex H

Education Sector Reform

1. In the areas of education reform, Armenia is a leader among FSU republics. The Ministry of Education's Finance and Management Working Group started addressing efficiency issues in 1996 in the process of developing an overall strategy for reforming financial management of general education. This process was facilitated by the development of planning tools—including a computerized database on education facilities and a nationwide school map—that were developed as conditions of SAC I (and supported as part of the preparation of the Education Project). Another SAC I condition was that a new strategy be developed for financing of school books. In conjunction with the Education Project, SAC I supported development of an innovative (for the CIS) policy that entailed a revolving fund, essentially a rental scheme, which has proved very successful in financing school books. The textbook fund also established a mechanism for targeted subsidization of textbooks for poor families.

2. The policy document developed by the Ministry Working Group, Strategy for Reform of General Education in Armenia (MoES 1997), endorsed by the government, included the proposal in principle to increase efficiency though rationalization of staffing and buildings, as well as devolving budget management to the school level. The next stage of work led to the Ministry's Rationalization Plan (MoES, 1998) proposing revised norms for teacher wage rates, class size, pupil teacher ratio (proposed to be increased from 10 to 15), full time teaching hours, and non-staff inputs. Each of the marzes (administrative regions in Armenia) was required in 1998 to compile detailed school level data and prepare a plan for consolidation of classes and schools in region to enable schools to meet the new staffing norms. Most of the marzes complied with instruction at least in part. This was a useful preliminary exercise concerning the scope and options for consolidation; however, for political and other reasons it was not followed through.[66] While direct financing of much of this work was provided by the Education Project, the policy changes and facilitation of broader support within Government was motivated by SAC II conditions.

3. The SAC credits and the Education Project were synergistic in achieving reform. Close country team coordination in the use of both instruments helped to coordinate and support the interests of the two key ministries concerned, Education and Finance. It also helped sustain momentum in policy development and implementation despite frequent changes in key officials. SAC policy conditionalities supported necessary legal and regulatory changes, as well as crucial increases in the education budget needed to sustain the system, finance the reforms, and encourage public support. The Education Project supported the Ministry of Education's analytical work on policy development and related public information activities, as well as helping to build administrative capacity at the

[66] This exercise at the marz level is currently being repeated, and a more integrated approach to rationalization is being considered, through piloting in selected regions, the criteria and decision-making processes, and putting adequate incentives in place.

central and school levels. The reform strategy was outlined and agreed in broad principle before effectiveness of the investment project but has evolved significantly through piloting and through consultation with different stakeholder groups. It took at least five years of work for the reform rationale to become quite widely understood within the country. Although the momentum is now strong, a great deal more work and resources are still needed to implement fully and consolidate the new arrangements. This will be supported through a follow-on education project.

4. As part of the reform of the budgetary process and the introduction of program budgeting, the Ministry of Finance presented a draft in December 1999 of its first Medium Term Expenditure Framework (MTEF), covering the years 2000-2002. (Initiation and implementation of the MTEF were SAC III conditions). The MTEF required that priorities be established, and proposed significant changes in the level and pattern of expenditure on general education. It assumed a substantial increase in the share of the national budget allocated to the sector, nationwide extension of capitation in 2001, and increases similar to those proposed by the MoES plan in the pupil/teacher ratio, the pupil/non-teaching staff ratio, and teachers' wage.

5. Since 1994, Armenia's education budget effort has been low by international standards in terms of share of the total budget (although budgetary allocations conformed to SAC III requirements of 11 percent for 1999). The share of the budget allocated to education in Armenia—around 10-11 percent—is somewhat below the average for OECD countries (12.6 percent), and far below that of the middle income countries which share with Armenia a low rate of overall public expenditure in GDP. Chile, Korea, Mexico and Jordan, for example, have overall levels of public expenditure in GDP closer to Armenia's, around 20 percent, and they allocate respectively 15 percent, 18 percent, 23 percent and 21 percent of their budgets to education.[67]

6. SAC II and SAC III also supported a change in the structure of the national education budget, raising the share of total spending that went to general education. This is shown in the table below. Other categories which declined as a percent of the total were kindergartens—responsibility for which was transferred to local governments—and out-of-school institutions.

Funding for "General schools" as a Share of Total School Spending

	1995	*1996*	*1997*	*1998*	*1999*	*2000*
General schools	43.7	39.4	52.3	63.2	70.5	68.9
Kindergartens	16.2	19.3	13.1	0.1	0	0
Out-of-school institutions*	10.9	11.3	3.5	2.6	2.0	2.0

*Supplemental programs in the arts, music, sports, etc.

[67] "Armenia: Restructuring to Sustain Universal General Education," World Bank Technical Note, 2001. Note: Armenia's actual spending on education was at least 90 percent of budgetary allocations in each year.

Annex I

Macroeconomic Stabilization

1. Macroeconomic stabilization was a goal of each of the adjustment operations considered in this PPAR. As discussed above, Armenia's macroeconomic performance has been very good. In nearly every case, performance met or exceeded the targets established in the four adjustment credits (shown in table below). The only exception was during SAC II, where the actual current account deficit for 1997 was 26.1 percent of GDP, against an intended target of 24 percent.

Macroeconomic stabilization: Objectives of 4 Adjustment Credits and Realization

Credit	*Macroeconomic goals*	*Realization*	*Comment*
Rehabilitation	Create stable macroeconomic environment; budget deficit 12% of GDP or less	1995 budget deficit was 9.0%; monthly inflation fell from 46% in 1994Q1 to 1% by 1995Q4	SBA approved by the Fund 6/95
SAC I	Create and sustain stable macroeconomic environment; inflation 19% or less; fiscal deficit 7.6% of GDP or less	Inflation was 18.8% in 1996 and 13.8% in 1997; fiscal deficit was 8.6% in 1996 and 5.7% in 1997	3-year ESAF approved by the Fund 2/96
SAC II	Consolidate a stable macroeconomic environment; maintain agreed macroeconomic track with IMF ESAF; annual inflation 10% or less 1997-99; fiscal deficit 6.7% of GDP in 1997; 1997 current account deficit (excluding grants) 24% or less of GDP	Inflation was 13.8% in 1997, 8.6% in 1998, and 0.6% in 1999. The fiscal deficit in 1997 was 5.7% of GDP. The 1997 current account deficit was 26.1% of GDP.	ESAF performance maintained. Current account deficit for 1997 exceeded Bank target.
SAC III	Maintain satisfactory macroeconomic framework		3-year PGRF approved 5/01

2. It may also be useful to examine macroeconomic performance from the point of view of the following "checklist":[68]

	1995	*1996*	*1997*	*1998*	*1999*	*2000*
Exchange rate regime	The authorities maintain an independent floating exchange rate; the exchange rate is market determined, with interventions aimed at moderating the rate of change and preventing undue fluctuations, rather than at establishing a specific level.					
Exchange rate, Dram/US$	406.5	414	490.6	504.5	535	539
Current account, % of GDP		-26.6	-26.1	-26.7	-17.3	-16.1
Public sector debt, % of GDP	32.9	32.6	39.0	41.4	46.3	45.0
Concessional as a % of total debt	23.1	38.8	40.5	44.2	67.3	73.7
Budget deficit, % of GDP	-9.0	-8.6	-5.7	-4.7	-5.5	-4.0
Total budget support from donors, % of GDP	8.7	7.3	7.5	4.6	7.3	10.5

Sources: 2001 CAS, Annex 7; Data from Armenia Country Department; IMF, Recent Economic Developments and Selected Issues, May 2001; Armenia: Growth Challenges and Government Policies, World Bank, 2001.

3. From the data in the table above, in addition to that presented in Table 1.1, it can be seen that the exchange rate, after losing around one third of its value since 1995, has been relatively stable the last three years. As shown in the table below, Armenia compares quite favorably with other low-income CIS countries in terms of fiscal discipline.

Primary Fiscal Balance, Armenia and Four other Low-Income CIS Countries

Country	*Primary fiscal balance, average 1995-99, percent of GDP*
Armenia	-3.6
Georgia	-4.8
Kyrgyz Republic	-10.0
Moldova	-2.9
Tajikistan	-4.9

Source: Appendix Table 1, IMF and World Bank, "Poverty Reduction, Growth and Debt Sustainability in Low-Income CIS Countries," February, 2002.

4. The table below shows that, as assessed by a variety of measures, Armenia also compares favorably to other low-income CIS countries in terms of the sustainability of its debt burden.

[68] See "Evaluating Adjustment Lending: Some Suggestions," S. Ramachandran, August 2001.

Debt Sustainability, Armenia and Four other Low-Income CIS Countries

In percent	*Armenia*	*Georgia*	*Kyrgyz Republic*	*Moldova*	*Tajikistan*
NPV of debt/exports	135	128	201	139	133
NPV of debt/CGR	177	356	586	380	432
Total debt service/exports, 2000	11	10	23	15	10
Total debt service/CGR, 2000	16	36	26	42	35

Source: IMF and World Bank, "Poverty Reduction, Growth and Debt Sustainability in Low-Income CIS Countries," February 2002. CGR is Central Government Revenue.

Attachment

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May 13, 2002

Dear Mr. Lamdany,

Re: Armenia-Rehabilitation Credit (C2683); Structural Adjustment Credit I (C2824); Structural Adjustment Technical Assistance Credit I (C2825); Structural Adjustment Credit II (C2980); Structural Adjustment Credit III (C3153); Draft Project Performance Assessment Report

Thank you for sending me a copy of the draft Project Performance Assessment Report, dated March 26, 2002, for my comments. I have reviewed the Report and I wish to comment on a few key issues concerning the evaluations.

Clearly the World Bank Group has made an important and valuable contribution to the economic transition of the newly independent Armenia, for which we are very grateful. I concur with the performance rating of the PPAR that the early policy based operations, i.e. the Economic Rehabilitation and SAC I operations were much more successful, in both design and implementation, than the later operations, i.e. SAC II and SAC III. I also concur with the PPAR's performance rating of the SATAC I.

With the assistance of the Economic Rehabilitation and SAC I operations, Armenia succeeded to open the economy, privatize it, and bring about impressive export-driven growth. The economy has been growing steadily since 1994 around 5.5% annually, and this last year the growth rate was 9.6%. External trade has been diversified toward increasing trade with Europe, the Middle East and the United States, and exports are now growing around 31%. According to the 2002 Index of Economic Freedom, produced by the Wall Street Journal and the Heritage Foundation, Armenia's economy ranks as the most open among the countries of the CIS and on a par with France. With the assistance of the Breton Woods institutions the economy has been stabilized, as the annual inflation rate since 1998 has been around low single digits (less than 1% in 2000 and 2.9% in 2001), and the national currency, Dram, has been the most stable currency in the region for several years.

On the other hand, there have been imbalances in the pattern of economic growth and distribution because poverty (around 55%), unemployment (around 26%) and income inequality remain disturbingly high. The Gini coefficient is the highest in Armenia amongst the transition economies. The income based Gini coefficient was 0.27 prior to transition and it is currently running at around 0.61, while the average for all transition economies, the Gini coefficient is 0.34. Consequently, there has been much suffering and a massive exodus of Armenians. The human capital, our principal resource, has been shrinking, as we have not been investing adequately in social infrastructure. In recent years total budgetary expenditures for social sector has made up around 6.2% of GDP, of which education has represented only 2.6% and health 1%. These levels of investment in social infrastructure are not sufficient and seriously endanger the sustainability of our economic growth. Inadequate investment in social infrastructure has resulted from inadequate resource mobilization, as tax collections have been low around 14.5% of GDP. Serious financial hemorrhages in public utilities, and abuses of public resources, have also severely constrained resource availability.

The adverse trends summarized above were known to the designers of SAC II and SAC III and some policy measures were woven in the policy matrix of these operations to address some of these concerns. However, after a critical review of the SAC II and SAC III experience, I conclude that there was no effective dialogue and strategic focus on the social sector issues. Moreover, it appears there was no sufficient internal consensus on the policy packages supported by these two operations, and thus adequate Government ownership of these packages was not quite in place. This may partly explain the Government's rather limited success in implementation of SAC II and SAC III operations.

My suggestion for improving policy dialogue and enhancing government ownership of the reform agenda would be for the Bank to leave drafting of strategy and policy documents to the Armenians, and instead furnish the literature on international experience and request the authorities to prepare their analyses, strategies and policies internally on a collaborative basis (in Armenian). The authorities must participate intellectually in design of the strategies and policies, and their implementation targets, and not just process policy packages furnished by donor organizations. The Armenian authorities can produce credible strategies and policies when they work as a team and the Bank could encourage such teamwork. Once the substantive work has been done in Armenian, debated and consensus forged internally, it can be translated into English for external dialogue. This would enhance the policy dialogue and help to improve performance at both ends.

Again, as I indicated at the beginning of this letter, we greatly value and appreciate the World Bank Group's assistance during this difficult period of economic transition. I hope this feedback would help to improve future policy-based operations and enhance our collaboration for economic development of Armenia.

Best regards.

Sincerely,

Vahram Nercissiantz
World Bank Group Governor for Armenia

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IMAGING

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