SECTOR ASSESSMENT (SUMMARY): FINANCIAL SECTOR AND PUBLIC SECTOR MANAGEMENT

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. Despite gradual progress in recent years, financial markets in Armenia are still highly dollarized.[1] Risky foreign currency lending remains common practice irrespective of whether the parties recognize the key risks. The systemic consequence is that the economy remains dollarized and vulnerable to external shocks. The promotion of financial deepening in local currency is of the highest priority. Shallow local currency financial markets with limited instruments available for investors contribute to high dependence on external and foreign-currency denominated finance for both the public and private sectors. This hinders private sector development in terms of access to affordable, sustainable long-term credit.[2] It also affects the public sector, whose weak fiscal risk management and macroeconomic and financial stability policies are exposed become vulnerable to risks associated with a high level of exposure to foreign currency denominated debt.[3] The core development problem the Public Efficiency and Financial Markets Program aims to address affects a number of sectors and administrative agencies.

2. **Ineffective public debt management and fiscal risk management.** Armenia has significantly reformed its public financial management function since independence, but structural challenges remain. The main issues are (i) an ineffective public debt management strategy based on strategic underpinnings; (ii) adequate and broad-scope fiscal risk management practices that can play a role in vetting new initiatives, make use of new methodologies for analysis, and exercise risk management and mitigation responsibilities; and (iii) the lack of a strong legal/regulatory base for the selection and implementation of fiscally responsible and development-relevant public–private partnerships (PPPs). Armenia still has weak fiscal risk management capacity, making it unable to foresee and mitigate fiscal risks arising from public sector enterprises and PPPs. In addition, cash and public debt management capacity within the Ministry of Finance (MOF) remains weak. As Armenia moves to middle-income country status, it needs to rely increasingly on mobilizing debt from its domestic market. A transition from external, predominantly concessional funding to government securities denominated in local currency is required to mitigate exchange and refinancing risk exposures, which are reflected in borrowing premiums. To move away from excessive reliance on external debt, the MOF needs to strengthen its public debt management function, particularly operational risk management and transparency, and effective communication regarding medium-term policy objectives. To continue attracting private expertise and capital for public investment in a fiscally responsible way, the MOF needs to begin adopting strict criteria in its adoption of PPP projects. A PPP pipeline will introduce contingent liabilities with fiscal significance, with a clear vetting mechanism in place and established methodologies to assess fiscal risk and management.[4]

3. **Weak government securities issuance and management practices, and incomplete infrastructure for money markets.** To overcome excessive dependence on debt denominated

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[1] About 60% of the Armenian financial sector is dollarized—one of the highest rates in the region.

[2] Dependence on external financing exposes banks to higher foreign currency and refinancing risks, increasing premiums.

[3] Financial dollarization limits the ability of fiscal and monetary policies to mitigate the impact of external shocks.

[4] Depending on how PPP contracts are structured, they can have direct liabilities, contingent liabilities, or implicit service delivery risks to government. These need to be well identified and managed.

in foreign currency, Armenia will have to rely increasingly on mobilizing its own debt resources. To do so, it will have to develop the public debt securities market further. The lack of developed money markets exposes financial sector stakeholders in Armenia to liquidity risks and hinders the emergence of a sovereign yield curve in local currency—a key public debt securities market cornerstone crucial for the efficient pricing and liquidity of all dram-denominated financial instruments in the finance sector. The prevalence of incomplete infrastructure for money markets and the limited issuance of government securities leads to an increase in exposure to foreign currency and refinancing risk by the public sector and corporate borrowers. The nascent government debt securities market also constrains interbank money markets. The incomplete implementation of the Global Master Repurchase Agreement (GMRA) leads to a perception of high counterparty risk for interbank transactions. Secured interbank trading is also limited, which manifests itself in the oversubscription of T-bill auctions and "hold to maturity" behavior of buyers.

4. Strengthening government securities issuance and management, and developing infrastructure for money markets, are also key steps toward financial market development in Armenia. The structuring of public debt issuance is of enormous importance in (i) making the government securities market more liquid over time, thereby providing better investment opportunities to financial institutions, pensions, and other investment funds as well as retail investors; and (ii) establishing reliable pricing benchmarks for private debt and equity markets to take off.

5. The MOF's domestic debt portfolio will need to increase. The MOF issues long-term bonds, medium-term notes, and T-bills based on a published issuance calendar. It has to establish benchmark maturities in all securities using regular issuances and bond switch operations to manage large maturities and rollover risk. Developing the primary dealer system will promote predictability and investor confidence and is likely to underpin future demand growth for government securities. Reforms to the existing internet-based facility for domestic retail investors to invest in retail government securities could also help open access and lower transaction costs for retail investors, opening scope for retail funding of government debt to increase above its current low level.

6. **Lack of instruments, corporate transparency, and low investor confidence in corporate governance.** The corporate debt and equity markets are underdeveloped. Corporate transparency and legislative frameworks are needed to incentivize the development of new instruments and investment vehicles. This should lead to more active capital (corporate) markets. In addition to lack of public debt benchmarks that could serve as a basis for pricing private debt, only a few institutional investors invest in the domestic capital market. This limits the effectiveness of channeling savings toward productive investments in the economy. Borrowers and investors need stronger legal protection to venture into private equity. A general lack of trust in corporate governance and transparency, as well as the accuracy of companies' accounts and audit practices, also inhibits investors. Lastly, despite some progress, significant challenges remain for foreign investors to access dram-denominated assets as there is no forward foreign exchange market to hedge currency risk, and a low-risk liquid instrument to hold dram funds.

2. Government's Sector Strategy

7. The government's 2019–2023 Program is centered around four key pillars: (i) anchoring fiscal policy on the fiscal rule to maintain debt sustainability, and creating space for priority (social and capital) spending; (ii) strengthening the monetary policy framework and maintaining a flexible exchange rate system; (iii) safeguarding the financial system and improving access to finance; and (v) implementing a strong package of structural reforms, with renewed emphasis on

inclusiveness and governance. This plan is complemented by the government's strategy for debt management. Drawing on the 2018 financial sector assessment program, the Central Bank of Armenia aims to (i) safeguard financial stability by improving the risk-based supervision framework; (ii) strengthen macroprudential measures in light of high levels of dollarization; (iii) enhance banks' foreign currency liquidity buffers; and (iv) develop capital markets to mobilize a growing supply of long-term domestic capital to fund economic developments and channel it to the economy. The Second Public Efficiency and Financial Markets Program was designed to support the new government in three key policy reform areas: (i) strengthening public debt and fiscal risk management, (ii) deepening the government securities market and improving the infrastructure for money markets, and (iii) broadening the base of instruments and investors and enhancing corporate transparency. These three reform areas are explained in more detail below.

3. ADB Sector Experience and Assistance Program

8. The Asian Development Bank (ADB) has a strong record of providing technical support and guidance to the government to deepen domestic financial markets while strengthening public management functions that can help mitigate risks to the public sector. ADB's experience in Armenia in this area allowed it to take an active role during negotiations with the government over the program design—the general policy direction as well as specific policy actions—during a time of political transition. ADB's institutional memory of the challenges and lessons learned during the first program proved to be useful in assisting the government to adopt a strategy aimed at developing financial markets and strengthening the key public functions that can best accommodate the deepening. ADB also played an important role in providing technical and guidance notes, which were instrumental in influencing the policy direction of the government in this area.

Problem Tree