



Concept Paper

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Proposed Programmatic Approach and Policy- Based Loan for Subprogram 1 Armenia: Fiscal Sustainability and Financial Markets Development Program

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 16 June 2022)

| | | |
|---------------|---|------------|
| Currency unit | – | dram (AMD) |
| AMD1.00 | = | \$0.0023 |
| \$1.00 | = | AMD429.65 |

ABBREVIATIONS

| | | |
|----------|---|-----------------------------------|
| ADB | – | Asian Development Bank |
| AFD | – | Agence Française de Développement |
| COVID-19 | – | coronavirus disease |
| GDP | – | gross domestic product |
| IMF | – | International Monetary Fund |
| MOF | – | Ministry of Finance |
| PPEF | – | Post-Program Engagement Framework |
| PPP | – | public–private partnership |
| TA | – | technical assistance |

GLOSSARY

| | | |
|--|---|--|
| Bond switch | – | Two parties agree to respectively switch ownership of two different bonds at an agreed price difference (i.e., for a 5-year–10-year bond switch, party A would buy a 5-year bond from party B who would simultaneously be contractually bound to buy a 10-year bond from party A at agreed prices). Debt managers use switches to build up benchmark issues and reduce the liquidity impact of benchmark bonds nearing maturity. |
| Benchmark issue | – | A bond that provides a standard against which the performance of other bonds can be measured. Government bonds are used as benchmark bonds. Benchmark issues are typically used as the basis of yield curves. |
| Financial dollarization (domestic liability dollarization) | – | Percentage of foreign currency loans in total loans or percentage of foreign currency deposits in total deposits. Excessive financial dollarization hinders the ability of domestic policy makers to deploy policy instruments which can help mitigate the impacts of external shocks. |
| Global Market Repurchase Agreement (GMRA) | – | GMRA is a model legal agreement designed for parties transacting repurchase agreements and is published by the International Capital Market Association (ICMA), which is the body representing the cross-border bond and repurchase agreement markets in Europe. Adoption of the GMRA in Armenia will enable increased operational efficiency of the market as a whole and harmonize market practice. Its standardization will also allow repurchase agreement transactions to be comparable and represented by legal interest rate indexes, a crucial element for monetary policy and a precondition for the introduction of variable-rate instruments. |

- Hedging instruments – Hedging instrument is a general term that refers to all the financial instruments used by investors aiming to offset the potential changes in the fair value or cash flows of their hedged items. Hedging instruments are also crucial for financial arbitrage, i.e., the simultaneous purchase and sale of an asset to profit from an imbalance in the price or to exploit price differences of identical or similar financial instruments on different markets or in different forms, a crucial precondition of efficiency in financial markets.
- IFRS 16 – The objective of IFRS 16 is to report information that (i) faithfully represents lease transactions and (ii) provides a basis for users of financial statements to assess the amount, timing and uncertainty of cash flows arising from leases.
- Interest rate risk – Interest rate risk is the danger that the value of a bond or other fixed-income investment will suffer as the result of a change in interest rates.
- Market making – Market making is typically required of primary dealers to offer both a buy price and a sell price for the same security.
- Medium-Term Debt Strategy – The Medium-Term Debt Management Strategy is a plan that the government intends to implement over the medium-term to achieve a composition of the debt portfolio that captures its preferences with regard to the cost-risk trade-off.
- Money market – Market where financial instruments such as Treasury bills, corporate notes, and repurchase agreements are used by financial institutions to fund their short-term liquidity requirements or invest their short-term cash surpluses. Developing money markets helps provide banks with more certainty over the size of the deposit pool they can rely on to fund their long-term loans to project their liquidity needs and lend or borrow cash from the markets to balance their books (key aspects of maturity transformation—explained in more detail below).
- Money market infrastructure – Financial market infrastructure refers to critically important institutions responsible for providing clearing, settlement and recording of monetary and other financial transactions. A payment system is a set of instruments, procedures, and rules for the transfer of funds between or among participants.
- Armenia Stock Exchange (AMX) – AMX is the only stock exchange in Armenia, operating for almost 17 years. It provides the market with a fully automated trading system.
- Price discovery – Price discovery refers to the act of determining the proper price of a security, commodity, or good or service by studying market supply and demand and other factors associated with transactions.
- Primary dealing – Primary dealers bid for government contracts competitively and purchase the majority of Treasury bills, bonds, and notes at auction. Primary government securities dealers sell the Treasury securities that they buy from the central bank to their clients, creating the initial market.
- Refinancing risk – Refinancing risk, in banking and finance, is the possibility that a borrower cannot refinance by borrowing to repay existing

- debt. Refinancing risk increases during rising interest rates, as the borrower may not have sufficient income to afford the higher interest rate on a new loan.
- Regular Treasury bill program
A program that provides a constant supply of benchmark Treasury bills issued by auction on a regular basis (weekly and/or fortnightly) across a range of key maturities (one or more of 90, 180, 270, 365 days), and is generally self-funding as the same principal value is issued in each auction.
 - Repurchase agreement (“repo”)
A form of short-term borrowing for dealers in government securities. The dealer sells the government securities to investors, usually on an overnight basis, with an agreement to repurchase them at a set term for a set purchase price which includes interest. For the party selling the security (and agreeing to repurchase it in the future), it is a repo; for the party on the other end of the transaction (buying the security and agreeing to sell in the future), it is a reverse repo agreement.
 - Maturity transformation
A key function of banking, i.e., the maturity mismatch needed to facilitate long-term investment projects while serving agents’ liquidity needs is a key driver of the net interest margin in banking.

NOTE

In this report, "\$" refers to United States dollars.

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PROGRAM AT A GLANCE

| | | | |
|--|---|--|------------------------------|
| 1. Basic Data | | Project Number: 55103-001 | |
| Project Name | Fiscal Sustainability and Financial Markets Development Program (Subprogram 1) | Department/Division | CWRD/CWPF |
| Country Borrower | Armenia, Republic of Armenia | Executing Agency | Ministry of Finance (MOF) |
| Country Economic Indicators | https://www.adb.org/Documents/LinkedDocs/?id=55103-001-CEI | | |
| Portfolio at a Glance | https://www.adb.org/Documents/LinkedDocs/?id=55103-001-PortAtaGlance | | |
| 2. Sector | Subsector(s) | ADB Financing (\$ million) | |
| ✓ Finance | Money and capital markets | | 50.000 |
| Public sector management | Public expenditure and fiscal management | | 50.000 |
| | | Total | 100.000 |
| 3. Operational Priorities | | Climate Change Information | |
| ✓ OP3: Tackling climate change, building climate and disaster resilience, and enhancing environmental sustainability | | GHG reductions (tons per annum) | 0 |
| ✓ OP6: Strengthening governance and institutional capacity | | Climate Change impact on the Project | Low |
| | | ADB Financing | |
| | | Adaptation (\$ million) | 8.740 |
| | | Mitigation (\$ million) | 6.240 |
| | | Cofinancing | |
| | | Adaptation (\$ million) | 0.000 |
| | | Mitigation (\$ million) | 0.000 |
| Sustainable Development Goals | | Gender Equity and Mainstreaming | |
| SDG 5.a | | Some gender elements (SGE) | ✓ |
| SDG 9.1 | | | |
| SDG 12.1, 12.2, 12.6 | | | |
| SDG 13.a | | | |
| SDG 17.1, 17.17, 17.3, 17.4, 17.5 | | | |
| | | Poverty Targeting | |
| | | General Intervention on Poverty | ✓ |
| 4. Risk Categorization: | Complex | | |
| 5. Safeguard Categorization | Environment: C | Involuntary Resettlement: C | Indigenous Peoples: C |
| 6. Financing | | | |
| Modality and Sources | | Amount (\$ million) | |
| ADB | | 100.000 | |
| Sovereign Programmatic Approach Policy-Based Lending (Regular Loan): Ordinary capital resources | | 100.000 | |
| Cofinancing | | 100.000 | |
| Agence Francaise de Developpement - Programmatic Approach Policy-Based Lending (Loan) (Not ADB Administered) | | 100.000 | |
| Counterpart | | 0.000 | |
| None | | 0.000 | |
| Total | | 200.000 | |
| Currency of ADB Financing: US Dollar | | | |

I. THE PROPOSAL

1. The proposed Fiscal Sustainability and Financial Markets Development Program builds on previous Asian Development Bank (ADB) reform engagement in Armenia and, on the basis of its Post-Program Engagement Framework (PPEF), aims to help the government further strengthen its fiscal management policies and practices, improve money markets and government securities market infrastructure, and promote capital markets.¹ The proposed programmatic assistance is aligned with the program of the Government of Armenia, 2021–2026;² with ADB's country partnership strategy for Armenia, 2019–2023; and with ADB's Strategy 2030, which prioritizes developing the financial sector and capital markets to support private sector development and enhance financial stability.³ The proposed program is included in ADB's forthcoming indicative country programs and monitoring report for Armenia, 2023–2025.

2. Designed as a two-subprogram proposal with parallel budget support and technical assistance (TA) from the Agence Française de Développement (AFD),⁴ the proposed programmatic approach enables the capturing of reform efforts supported by ADB TA into subprogram 1 (footnote 23); and allows for charting into subprogram 2 ambitious indicative reform targets until early 2024 with enough flexibility to cope with current uncertainties about the ultimate and specific legal and institutional formats that will be needed. Alignment with the same three reform pillars of past programs⁵ (i) recognizes the benefits of continuity in medium-term interconnected reforms, and (ii) allows a gradual transition into new and deeper reform activities within its fiscal management area, as requested by the government.⁶ The program is well-coordinated with policy reform work from the World Bank and International Monetary Fund (IMF).

II. PROGRAM AND RATIONALE

A. Background and Development Constraints

3. **Macroeconomic management performance.** The twin shocks of the coronavirus disease (COVID-19) pandemic and the military conflict caused gross domestic product (GDP) to fall by 7.4% in 2020, interrupting the sustained growth momentum and the crucial processes of fiscal consolidation that Armenia initiated in 2017.⁷ That fiscal track record enabled expansionary

¹ The Armenia Second Public Efficiency and Financial Markets Program was completed and approved in November 2019. Its PPEF—originally to be implemented from late 2019 until September 2021—guided most ADB technical assistance (TA) efforts to reform activities in Armenia until now. The coronavirus disease (COVID-19) pandemic, war, and political instabilities in 2020–2021 imposed important delays that have now been mostly overcome. ADB. [Armenia Second Public Efficiency and Financial Markets Program](#).

² [Government of Armenia. 2021. Programme of the Government of the Republic of Armenia, 2021–2026](#).

³ Mainly operational priority 6 on strengthening governance and institutional capacity. The proposed program supports two of the country partnership strategy's three strategic pillars. Under the first pillar (priority infrastructure investments), the program will help strengthen the integration of public–private partnership (PPP) development with the frameworks for public investment and fiscal risk management and ensure that private participation in infrastructure is fiscally responsible and well-managed. Under pillar 2 (targeted financial services delivery improvements), the program supports the development of financial and capital markets. ADB. 2019. [Country Partnership Strategy: Armenia, 2019–2023—Fostering Inclusive, Diversified, and Transformative Growth](#). Manila; and Government of Armenia. 2021. [Programme of the Government of the Republic of Armenia, 2021–2026](#). Yerevan.

⁴ AFD missions started to coordinate with ADB mission teams since early 2021 after the first formal request to ADB in November 2020. ADB and AFD initiated discussions towards joint programmatic assistance in October 2021, with joint consultations in Yerevan, Armenia, duly reflected in joint aides-mémoires.

⁵ Also see: ADB. [Armenia Public Efficiency and Financial Markets Program \(Subprogram 1\)](#); and ADB. [Armenia Public Efficiency and Financial Markets \(Subprogram 2\)](#).

⁶ Subprogram 2 will also help bring to fruition key reform processes initiated in subprogram 1 (footnote 21).

⁷ The fiscal deficit reached 1% of GDP in 2019, down from 5.5% in 2016. Government spending reached 24.8% of GDP in 2019, down from 28.6% in 2016. Public debt reached 49.9% of GDP in 2019, down from 53.7% in 2017.

fiscal policy in 2020 to counter multiple shocks to the economy.⁸ A credible inflation targeting framework allowed the Central Bank of Armenia (CBA) to keep its policy rate at accommodative levels for most of 2020 until exchange rate pressures in the fourth quarter justified significant hikes in interest rates since. With the lagged effects of the 2020 fiscal response (and a neutral stance in 2021), and despite two waves of COVID-19 and the heightened political uncertainties that resulted in snap elections in June 2021, the economy grew by 5.7% in 2021, mainly driven by activity in services and strong remittances from abroad.⁹ The moderate debt level,¹⁰ debt sustainability, and macroeconomic management credibility that Armenia attained in recent years was a crucial enabler of the efficacy of these policy responses.¹¹

4. **Drive for reforms: staying on track.** Despite challenges to reform implementation in 2020 and 2021 (e.g., lack of TA field work, COVID-19 response emergencies, political and high turnover of senior staff at key line ministries), reform directions in Armenia did not change:

- (i) The 2020 recession brought about record-high gross financing needs for the government to address within the same medium-term debt strategy orientation that had been followed and communicated to markets since 2017 and supported by ADB programs. Crucially, Armenia coped with this challenge by aggressively expanding its (potentially viewed as more expensive) issuance of market development-friendly benchmark securities in local currency, through the regular auction program.¹² Despite the difficulties that this faced in the fourth quarter of 2020, this key debt management strategy continued into 2021, helping Armenia to continue reducing its public debt vulnerabilities to currency risk¹³ and promote the liquidity in its financial markets, sending a strong signal to markets and encouragingly confirming expectations—reflected in ADB’s previous policy-based lending in 2019—that Armenia was acquiring a new public debt management confidence that should be supported. These actions also justified the public debt management option taken in 2019 for ADB to “stand ready to explore further policy-based lending on the basis of the reform engagement with the different implementing agencies under the PPEF,” should the fiscal needs arise.¹⁴

⁸ The government implemented a stimulus package equivalent to 3.5% of GDP, with subsidies for small and medium-sized enterprises’ employees, direct support to vulnerable households, and state-guaranteed loans to selected firms.

⁹ In cyclically-adjusted terms. Following stimulus implemented in 2020, the government narrowed the budget deficit from the equivalent of 5.4% of GDP in 2020 to 4.4% in 2021. Economic growth, revenue collection above target, and prudent spending helped reduce public debt from the equivalent of 67.4% of GDP in 2020 to 63.4% in 2021.

¹⁰ Assuming no budget revision to address the impact of external shocks, the 2022 budget projects a deficit equal to 3.1% of GDP. With a gradual shift in spending away from current expenditure, capital outlays are planned to reach 4.4% of projected 2022 GDP, about 1 percentage point above their share in 2021. In line with the government’s debt reduction program for 2021–2026, government debt is expected to decline gradually to 53.8% by 2026.

¹¹ The [IMF recently commented](#), “Armenia’s economy continued to recover in 2021 and early 2022, largely thanks to the authorities’ economic management efforts. They persevered with strong policy implementation and remained proactive to adjust policies appropriately to unforeseen developments. More generally, over the three-year program, the authorities advanced important structural and institutional reforms, including on improving tax compliance, refining the budget process, strengthening the inflation targeting framework and supporting financial sector stability, as well as implementing reforms to strengthen governance, foster transparency, and combat corruption. A flexible exchange rate is more entrenched within the country’s policy framework. The authorities (...) ambitious medium-term reform program (...) if successfully implemented, could lead to stronger and more inclusive growth.”

¹² The percentage of net domestic securities issuance in total debt issued was 26% in 2018 but reached 85% in 2020.

¹³ External public debt declined 45.7% of GDP at the end of 2021. Domestic public debt increased to 17.7% of GDP in 2021, in line with government strategy to gradually increase the domestic debt share.

¹⁴ On the lower financing needs projections of the time (footnote 1), para. 28 explicitly stated: “These expectations may be considered optimistic, but they reveal a new level of revenue mobilization and public debt management confidence that must be supported. One of the objectives of ADB’s current assistance to Armenia is to support Ministry of Finance (MOF) in moving towards a much higher reliance on market-based domestic borrowing. Successful implementation of these fiscal strategies in 2020–2021 will depend not only on the effective implementation of key reforms under the program but also on continuous fiscal revenue performance.”

- (ii) The government's fiscal strategy envisages consolidation over the medium-term and a gradual increase in the share of capital expenditure to support economic growth while still reducing public debt to less than 60% of GDP (Armenia's fiscal rule). This fiscal strategy is only growth-friendly if the government can: (a) improve the efficiency and impact of public expenditure (recurrent and capital), strengthen control over state-owned enterprises (SOEs), public-private partnerships (PPPs), and of fiscal risks to minimize disruptions to fiscal consolidation; and (b) enable banks and firms' access to more local currency finance through the improvement of interbank markets infrastructure, by deepening the government securities market, and fostering capital markets.¹⁵ Recent results are thus far encouraging.¹⁶

5. **Structure of the Armenian economy.** Armenia is a small open economy with about 3 million people and \$10,000 per capita annual income (in power-purchase parity). As a result of the deindustrialization process that accompanied the credit and construction-led boom of the early 2000s, the country is now highly import dependent with little integration in international capital markets. Inflows of remittances help finance large trade deficits.¹⁷ International trade is still challenging as (i) Armenia is landlocked, (ii) there are significant constraints for transportation, (iii) for geopolitical reasons, borders with neighboring Azerbaijan and Türkiye are closed, and (iv) transport infrastructure is past its life cycle, further hindering trade within the country and with its trading partners. The government that took office in 2018 initiated a set of major reforms with the medium-term aim of moving Armenia into an export-led economy model in which the sectors producing traded goods would play a key role, recognizing the consensus that the traded sector must become the engine of growth. This places crucial concern on real exchange rate competitiveness, public capital investments to raise private sector productivity and competitiveness, and on sustainable and affordable access to external finance.

6. **Binding constraints.** Achieving the government's development priority to develop a more knowledge-based, export-oriented economy will remain dependent on (i) whether fiscal management can be strengthened (not least to ensure urgently needed efficiency-promoting upgrades in public infrastructure and public spending with higher growth and social impacts), and (ii) whether financial markets can be developed to lower the costs (and raise the tenor) of local currency external finance to the private sector. But local financial markets remain nascent, limiting Armenia's private and banking sectors,¹⁸ constraining fiscal management and monetary policy, and threatening financial stability.¹⁹ Root problems to be addressed are:²⁰

- (i) **Fiscal management.** Gaps still hold back fiscal credibility in Armenia, pose risks to fiscal consolidation, and lower the efficiency and economic impact of public expenditure. All this is factored into country risk. To ensure fiscal sustainability and reduce risk premiums, public liability management functions must become more effective and credible in meeting their core objectives, especially at controlling

¹⁵ The turnover ratio in government securities increased from 7% in 2018 to 34% in 2021.

¹⁶ The term premium between policy rate and average lending rates in local currency (over 1 year) decreased from 625 basis points in December 2018 to 439 basis points by the end of April 2022.

¹⁷ Armenia ran trade deficits of close to 20% of GDP over 2010–2019. Remittances helped fund these trade deficits (average of 12% of GDP). However, after the implosion in construction and international sanctions of Russian Federation during 2015–2019, the trade deficit shrank to about 13% of GDP and the current account deficit to about 3% of GDP.

¹⁸ Constraints to the financial system's endogenous capacity to generate medium-term lending must be eliminated. Pricing benchmarks for financial contracts in local currency are currently nonexistent for medium-term tenors and are very steep at the short-term tenors available. With risk premiums considered, maximum tenors on offer by commercial banks in local currency are now below 24 months and on average at rates of about 15%–16%.

¹⁹ Foreign currency lending remains common practice in the banking sector, benefiting from commercial wholesale medium-term facilities made available from abroad. The economy remains dollarized, vulnerable to external shocks.

²⁰ Sector Assessment (Summary): Fiscal Management and Financial Sector (see linked documents in Appendix 2).

fiscal risks (e.g., of PPPs and SOEs). It is also crucial that public expenditure and investment decisions embedded in medium-term budget planning reflect national priorities and strategies, and that economic and social impact becomes the guiding principle for public expenditure approvals. Completing an effective legal and regulatory framework for private participation in infrastructure is a priority, not least in view of Armenia's past experience with PPPs. This is the only way to ensure efficiency-enhancing and fiscally-sustainable infrastructure development.

- (ii) **Government securities and money markets.** Several factors hold back efficiency and liquidity in Armenia's government securities and money markets, including the still small scale of market development-friendly securities outstanding; weak cash/liquidity management and forecasting between the Ministry of Finance (MOF) and the CBA, and the money markets volatility these difficulties create; and the need to fully implement legal and regulatory changes to increase liquidity in secured interbank markets, improve price discovery, and develop the standardized safe instruments for interbank trading that are missing. Formalized processes of consultation with markets on market development strategic options are nascent, and public debt management implementation must become sustainably in line with announced strategic orientation.
- (iii) **Capital markets.** Gaps in legal frameworks and corporate transparency, and deficiencies in key legal and tax frameworks for financial instruments (and vehicles) and for protection of investors stand in the way of corporate equity and debt markets development in Armenia. Market design efforts must also improve international financial integration of Armenia's financial and capital markets.

7. **Development partner coordination.** ADB is developing the program in partnership with the AFD, as ADB's parallel financing partner. The objectives of the program have been regularly discussed with the IMF and the World Bank, and efforts have been coordinated to leverage positions in areas where operational coordination has been required, especially with the IMF on fiscal management reforms (e.g., fiscal risk management, PIM and PPP reforms).

B. Policy Reform, ADB's Value Addition, and Sustainability

8. **Proposed reforms.** On the basis of the PPEF reform plan approved in 2019 and ADB's continued TA, the proposed program is structured along three pillars: (i) strengthening fiscal management, public debt and fiscal risk management policies and practices, and infrastructure investment and services delivery; (ii) improving government securities market and money market infrastructure; and (iii) broadening the base of financial instruments and investors and enhancing corporate transparency.²¹ In specifically addressing the gaps identified in para. 6, the proposed reforms will also support the government program, 2021–2026 (footnote 2),²² and builds on recent and ongoing ADB TA for the implementation of the Strategy and the Action Plan for Public Finance Management Reforms, 2019–2023 and Capital Markets Development Program.

9. **ADB's value addition and sustainability.** ADB has accumulated experience in supporting governments in deepening financial markets and strengthening fiscal management

²¹ Both subprograms have the same three policy areas and, in a sequenced manner, include actions to implement each of the complementing reform needs (para. 6) that are needed to achieve the outcome indicators (Appendix 1).

²² The section on financial policy (which calls for working with ADB and the IMF, among others) discusses tax policy efficiency reforms (e.g., eliminating bad tax benefit practices), fiscal sustainability, debt management reforms towards reducing the debt burden and reducing its foreign currency share (by continuously expanding the regular treasury/bonds issuance program), together with further developing capital markets, and fixing problems in capital program execution. The section on state expenses prioritizes reforms to medium-term budget planning and implementation, as well as better public investment integration with the PPP option and linkages to strategic planning.

functions. Its experience in Armenia in these areas since 2017 allowed it to help the government progress on the general policy direction with specific reform efforts in the required sequence, despite the country's several recent political transitions. Country specific TA, staff consultancy resources, and several regional TA windows at ADB have contributed to the effectiveness of this policy dialogue.²³ ADB's institutional memory of these specific reform challenges makes its assistance increasingly more efficient in supporting the government chart its multi-year efforts to develop the different underpinnings of financial markets and to strengthen the key public functions that can best promote and benefit from it.²⁴ This has ensured traction in policy dialogue during the difficulties of 2020–2021 and helped sustain agreements towards the 2023–2024 reform targets.

C. Expected Outcome of the Reform

10. The outcome is deepened financial markets in Armenia and strengthened fiscal management and sustainability. Reforms will help build fiscal credibility (and lower country risk premiums) and raise the economic impact of public investment and policies. Reforms will also help lower liquidity risk premiums in money and government securities markets and help the financial system lower the term premium in pricing local currency loans to the private sector.

D. Development Financing Needs and Budget Support

11. In November 2020, the MOF sent a formal request for budget support assistance in 2021, but the fiscal outlook benefited from a strong economic recovery and snap elections made it unfeasible. In November 2021, the MOF sent a formal request for a policy-based loan to support the government's ongoing reforms under the PPEF and to finance the 2022–2024 budget financing needs.²⁵ Regional conflict and geopolitical developments since late February 2022 left the Armenian economic outlook under serious uncertainty. Armenia's economic exposure to Russian Federation is significant (about one-third of its trade, half of its remittances, and 40% of its foreign direct investment), and its banking system depends on significant counterparty linkages to Russian banks. On the other hand, immediate attraction of new residents with service export activities has been a positive development. Growth projections for 2022–2024 are now significantly uncertain. In April 2022, the government requested ADB and the AFD to consider a loan amount up to \$100 million-equivalent from each in 2022, and for \$60 million-equivalent from each in either 2023 or 2024. These requests have been confirmed on the basis of updated projections of the Medium-Term Expenditure Framework for the government's gross financing needs in 2022–2024, estimated at \$2.9 billion. ADB and AFD have agreed that it is important to remain flexible in view of all the fiscal uncertainty.

E. Implementation Arrangements

12. The MOF will be the executing agency (as in prior programs). The CBA and the Ministry of Economy will be implementing agencies. The Ministry of Environment is an implementing partner because of some climate change actions. The proposed implementation period is

²³ ADB. [Armenia: Supporting Diagnostic Assessment of Public Financial Management](#); ADB. [Armenia: Preparing the Second Public Efficiency and Financial Markets Program](#); ADB. [Supporting the Enabling Environment for Public Financial Management Reforms](#); ADB. Armenia: Tax Policy Review (TA DRMTF/DC 0020); ADB. [Strengthening Fiscal Governance and Sustainability in Public–Private Partnerships](#); ADB. [Improving Infrastructure and State-Owned Enterprise Governance for Sustainable Investment and Debt Management](#); and ADB. [Strengthening Financial Management in Asia and the Pacific, Phase 2](#).

²⁴ These multi-year reform plans have been organizing frameworks for continued coordination between development partners and for adequately addressing sequencing challenges; a programmatic approach is best suited to this. ADB. 2021. [Completion Report: Public Efficiency and Financial Markets Program \(Subprograms 1 and 2\)](#). Manila.

²⁵ Initial estimates of total gross borrowing requirement determined original requests for \$200 million in total from ADB, AFD, and the World Bank, because policymakers were mostly interested in sustaining Armenia's reform engagement.

November 2019–August 2022 for subprogram 1 and September 2022–March 2024 for subprogram 2.

III. DUE DILIGENCE REQUIRED

13. Due diligence in several areas will be carried out during program preparation:
- (i) **Economy and finance.** ADB will undertake an assessment of the program’s financial and economic benefits of the proposed policy reforms.
 - (ii) **Governance.** ADB will agree on public financial management, procurement, and anticorruption issues and related capacity development with the government.
 - (iii) **Poverty and social issues.** No negative impact of the program on poverty, social, or gender challenges has been identified. The program is expected to produce indirect medium- and long-term poverty reduction effects. The program will also include *some gender elements* in specific policy actions (e.g., introduce and mainstream gender-sensitive budgeting).
 - (iv) **Safeguards.** The program is expected to be category C for environment, involuntary resettlement, and indigenous peoples, but will integrate climate change action in several reform areas to support mitigation and adaptation objectives.

IV. PROCESSING PLAN

A. Risk Categorization

14. The proposed program is categorized *complex* because the aggregate loan amount is over the \$50 million threshold.

B. Resource Requirements

15. The program team comprises ADB sector staff in public sector and fiscal management, financial sector and capital markets, and climate change, for an estimated total of 8 person-months. Additional TA resources for capacity development will be considered during processing.

C. Processing Schedule

Proposed Processing Schedule

| Milestones | Expected Completion Date |
|---------------------------|----------------------------|
| Reconnaissance missions | October 2021–February 2022 |
| Consultation mission | May 2022 |
| Concept paper approval | August 2022 |
| Fact finding mission | August 2022 |
| Management review meeting | August 2022 |
| Loan negotiations | September 2022 |
| Board consideration | October 2022 |
| Loan signing | October 2022 |

Source: Asian Development Bank.

V. KEY ISSUES

16. Specific reform objectives face technical and political economy challenges that pose risks. ADB and AFD are deploying TA to mitigate implementation risks.

PRELIMINARY POLICY DESIGN AND MONITORING FRAMEWORK

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| Country's Overarching Development Objectives Infrastructure Development (Pillar 3 of the Government's Programme), 2021–2026 ^a Institutional Development (Pillar 6 of the Government's Programme), 2021–2026 | | |
| Outcome Deepened financial markets in Armenia and strengthened fiscal management and sustainability. | Risks and Critical Assumptions R: Geopolitical tensions or regional conflicts can trigger fiscal shocks or exchange rate pressures that affect local currency and fiscal outlook | |
| Indicative Policy Actions: Subprogram 1 November 2019 to August 2022 | Indicative Policy Actions: Subprogram 2 September 2022 to March 2024 | Outcome Indicators |
| <i>Reform Area 1: Strengthening</i> fiscal management, public debt and fiscal risk management policies and practices, and infrastructure investment and services delivery | | |
| 1.1. To start linking medium-term fiscal planning and budget allocation decisions to national strategic and sectoral planning directions (and its explicit high-level economic and social objectives/targets), the government will (i) enhance the budget process and analysis requirements (to raise the overall design quality and effectiveness of recurrent public expenditure), (ii) approve a concept to establish the results-focused template for national strategies and high-level KPIs, (iii) enforce alignment between program budgeting and national strategic priorities (through the MOF issuance of mandatory new guidelines for MTEF preparation and the 2023 state budget), and (iv) pilot in two key ministries and evaluate gender-sensitive budgeting. 1.2. To enable linkages between annual and medium-term budget and expenditure planning to climate target and results, the government will approve, by government decree, a national climate adaptation plan identifying key principles to guide integration of climate adaptation into all policy and programming, including a principle on climate-aligned financial decision-making and management. | 2.1 To link medium-term fiscal planning and budget allocation decisions to national strategic and sectoral planning directions (and its explicit high-level economic and social objectives/targets), the government will (i) approve the decree and establishes/operationalizes the institutional set-up for national strategic planning of medium-term resource allocation; (ii) undertake further reforms to improve MTEF reliability for medium-term fiscal planning and accuracy against ultimate annual budget allocations; (iii) through MOF, approve the SDG budget tagging framework for full rollout in 2024 (to e.g. enable climate change mitigation and adaptation tagging); and (iv) through MOF, mainstream gender-sensitive budgeting across all ministries for FY2024. 2.2 To enable linkages between annual and medium-term budget planning to climate target and results, the government will: (i) approve a financing strategy and investment plan for their nationally determined contribution (NDC) to facilitate the broad engagement of relevant inter-ministerial stakeholders towards the coordinated mobilization and targeting of global sources of climate change finance into public and private efforts of climate change adaptation and mitigation, develops a Financing Framework for Climate Adaptation; (ii) modify its National Strategy for Disaster Risk Reduction to bring it in line with the Sendai framework for DRR, and ensure coherence between the Paris Accord and the Sendai Framework objectives; (iii) introduce comprehensive technical guidelines for mainstreaming climate | Performance indicator that is most directly attributable to reform area 1: 1.a By FY2025, 100% of new project investment allocations entering MTEF have been cleared by Investment Committee meetings in line with PIM legislation (2020 baseline: 0%). Data source: MOF reports. Performance indicators that are equally attributable to all reform areas (i.e., the overall program): By 2025: a. Percentage of annual net domestic securities issuance in total public debt issued increased |

| Indicative Policy Actions: Subprogram 1 November 2019 to August 2022 | Indicative Policy Actions: Subprogram 2 September 2022 to March 2024 | Outcome Indicators |
|---|---|---|
| <p>1.3. To raise the economic and social impact of public investments decisions and the fiscal sustainability of their implementation, a high-level, fully-fledged public investment management framework will be established and operationalized by government to include, inter alia, (a) disaster and climate change risk adaptation and mitigation objectives embedded in the key identification and prioritization criteria, (b) a full integration with the PPP operational framework, and (c) full integration with medium-term fiscal planning and the state budget process.</p> <p>1.4. To establish a complete of full-fledged risk vetting and monitoring framework for PPPs towards full integration with MTEF and fiscal rule, and to complete the operational framework for PPPs, government will approve: (i) a 'PPP Contingent Liabilities' Government Decree (with methodologies and tools for identification, assessment and calculation of risks and reporting in state budget documentation, as well as requirements for benchmarking against PPP "fiscal affordability" ceilings); (ii) more detailed methodological guidelines and tools—in consistency with the new PPP CLs Govt Decree; and (iii) Government decrees to establish PPP "fiscal affordability" ceiling mechanisms for both contingent liabilities and direct liabilities.</p> | <p>change mitigation and adaptation, and disaster risk reduction into public investment (leading agency: MOE); and (iv) introduce budget programs for disaster risk reduction and for climate change adaptation and mitigation (leading agencies: MOE and MOF), and develop detailed action plans for climate change mitigation in at least three sectors.</p> <p>2.3. To ensure fiscal sustainability and transparency and reduce possible biases towards off-budget solutions, the Government will standardize (reporting and accounting) the treatment to all fiscal liabilities by linking up the full-fledged risk vetting and monitoring framework for PPPs with the MTEF and the fiscal rule through government approval of new legal proposals to align PPP and budgetary system laws with the Public Debt Law and explicitly link up the (stock) PPP "fiscal affordability" ceiling to the debt ceiling of the fiscal rule.</p> <p>2.4. To improve financial transparency, strengthen centralized fiscal monitoring and oversight of, and establish corporate governance and operational performance in SOEs, the: (i) Government—through MOF—will upgrade the compliance monitoring functions for SOEs' publication of audited financial statements (e.g. a new separate corporate web portal/ registry becomes functional); and (ii) Government will amend the decree that sets oversights functions on SOEs to rationalize the current institutional set-up between State Property Management Committee and MOF's dual roles (fiscal risk management, dividend collection), streamline MOF's access to financial information; and align performance appraisal to efficiency gains.</p> <p>2.5. To establish a transparent governing framework for PPP renegotiations (for both new PPPs and pre-PPP law PPPs) and amendments to other long-term contracts, Parliament will approve the necessary legal amendments (to e.g., the PPP Law and the Law on Budget Process).</p> | <p>to 85% (2020-21 baseline average: 50%). Data source: MOF reports.</p> <p>b. Term premium between policy rate and average lending rate in local currency (over 1 year) decreased to 300 basis points (end-2020 baseline: 485 basis points). Data source: CBA reports.</p> |

| Indicative Policy Actions: Subprogram 1 November 2019 to August 2022 | Indicative Policy Actions: Subprogram 2 September 2022 to March 2024 | Outcome Indicators |
|---|---|---|
| | 2.6. To establish the legal anchoring for MOF's FRM responsibilities and functions, Parliament will approve legal amendment proposals to inter alia introduce the Fiscal Risks Management Council as well as Staffing Certification Requirements. | |
| <i>Reform Area 2: Improving government securities market and money markets infrastructure</i> | | |
| <p>1.5. To establish truly-secured interbank markets in Armenia and significantly improve price discovery and liquidity in money markets, the following reform processes are implemented:</p> <p>(i) Amendments to the civil code will be approved by Parliament to resolve, inter alia, re-characterization risks in repo transactions (and other issues that are key for the ICMA - certified GMRA Legal Opinion).</p> <p>(ii) CBA will approve the necessary amendments to its regulations to ensure GMRA applicability in Armenia to all counterparties.</p> <p>(iii) CBA will obtain ICMA-certified GRMA Legal Opinion (duly published in ICMA's website to establish financial markets recognition of GMRA applicability in Armenia to all counterparties).</p> | <p>2.7 To smooth the debt redemption profile further and decrease refinancing risk, the government (through MOF) will continue all necessary issuance practices and buybacks/exchanges and ensures that bond switch auctions become fully operational on the AMX platform.</p> <p>2.8 To promote GMRA adoption, the CBA will implement an array of market-moving and regulatory initiatives to promote the transition in the financial sector towards the GMRA, and fully implements a formal decision to use GMRA in its open-market operations.</p> <p>2.9 To promote the relevance of money markets to the financial system, the CBA will approve legal and regulatory solutions to enable interbank interest rate benchmarking (overnight), and will establish and fully operationalize the new money markets trading platform.</p> | <p>Performance indicators that are most directly attributable to reform area 2:</p> <p>By 2025: 2.a Turnover ratio (trading liquidity at both AMX and OTC) in government bonds increased to 50% (2020 baseline: 25%). Data source: AMX and MOF reports.</p> <p>2.b Demand Placement Index for government bonds reaches 3 (2020 baseline: 1.7) Data source: MOF reports.</p> |
| <i>Reform Area 3: Broadening the base of financial instruments and investors, and enhancing corporate transparency</i> | | |
| <p>1.6. To promote new financial instruments and investors, the following reform processes are implemented:</p> <p>(i) Parliament will approve legal amendments to the law on 'Currency regulation and Currency Control' to encourage corporate debt issuances and enable flexibility in the currency-denomination of repo contracts' settlement.</p> | <p>2.10 To promote the development of private equity and venture capital industries, government will submit legal amendment proposals to Parliament and (through MOE) approve the necessary secondary legislation to lift constraints and expand market development possibilities. Also, to ensure stability in tax treatment, government will establish its long-term position regarding the total burden and incidence of taxation on capital markets (in income tax and profit tax for dividends and interest).</p> <p>2.11 Parliament will approve amendments to the Law on Joint Stock Companies to give government the authority to set corporate</p> | <p>Performance indicator that is most directly attributable to reform area 3:</p> <p>By end-2025, 3.a Corporate securities trading turnover at the stock exchange</p> |

| Indicative Policy Actions: Subprogram 1 November 2019 to August 2022 | Indicative Policy Actions: Subprogram 2 September 2022 to March 2024 | Outcome Indicators |
|---|---|--|
| <p>(ii) CBA will amend its regulations to introduce clearer rules for market making in corporate bonds in line with international best practices.</p> <p>(iii) CBA will implement a new regulatory framework to (a) address regulatory gaps and eliminate uncertainties with derivative instruments, and (b) promote participation of foreign institutional investors in the local debt markets.</p> <p>(iv) Parliament will approve amendments to the Law on the Joint Stock Companies to enable the issuance of common shares of various classes, etc.</p> <p>1.7. To continue establishing a more effective insolvency regime and stronger protection of creditor's rights, Parliament will approve amendments to the Bankruptcy Law to provide additional and effective mechanisms for maximum satisfaction of creditors' claims.</p> | <p>governance requirements, and government will approve a new corporate governance code (setting, inter alia, a minimum 30% of women in management boards);</p> <p>2.12 To promote international integration of Armenia's capital markets, e.g., MOF and CBA will operationalize solutions to establish nonresidents' easier (and direct) access to the government securities market in Armenia (on-shore or offshore).</p> <p>2.13 To promote project finance, Parliament will approve amendment proposals to the Law on Joint Stock Companies (and approval of adjacent regulations) to e.g. (i) clarify the separation between ordinary and preferred shares, and (ii) align the rules governing negative equity balance with the insolvency legislation.</p> <p>2.14 To pre-empt financial stability risks and ensure market integrity and sustainability in the potential proliferation of green finance instruments, the CBA will (i) adopt and initiate the implementation of a Roadmap for Sustainable Finance in Armenia with time-bound actions and milestones; (ii) publish a study on the introduction of integrated corporate reporting standards on Environment, Social and Governance to its supervisees; and (iii) issues a new framework to certify banks' green finance internal tagging and classification frameworks (to address risks of green washing).</p> | <p>(including AMX outright trading and 'Addressed Deals'), in % of GDP, reached 3% (2020 baseline: 0.44%). Data source: AMX annual reporting and direct queries.</p> |
| <p>Budget Support ADB: \$100 million for Subprogram 1, and \$60 million for Subprogram 2 AFD: \$100 million for Subprogram 1, and \$60 million for Subprogram 2</p> | | |

ADB = Asian Development Bank, AFD = Agence Française de Développement, AMX = Armenia Stock Exchange, CBA = Central Bank of Armenia, CL = contingent liabilities, DRR = Disaster Risk Reduction, FRM = fiscal risk management, FY = fiscal year, GMRA = Global Master Repurchase Agreement, KPI = key performance indicator, ICMA = International Capital Market Association, MOE = Ministry of Economy, MOF = Ministry of Finance, MTEF = Medium-Term Expenditure Framework, NDC = Nationally Determined Contribution, OTC = over-the-counter, PIM = Public Investment Management, PPP = public-private partnership, R = risk, SDG = Sustainable Development Goal, SOE = state-owned enterprise.

^a [Government of Armenia. 2021. Programme of the Government of the Republic of Armenia, 2021–2026](#). Annex to Decision of the Government of the Republic of Armenia 1363-N of 18 August.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/LinkedDocs/?id=55103-001-ConceptPaper>

1. Initial Poverty and Social Analysis
2. Sector Assessment (Summary): Fiscal Management and Financial Sector