

SECTOR ASSESSMENT (SUMMARY): FINANCE AND PUBLIC SECTOR MANAGEMENT

1. Sector Performance, Problems, and Opportunities

1. **Introduction.** Financial markets in local currency are not developed in Armenia. This is both a cause and a consequence of high financial dollarization in Armenia and is a constraint to private sector development in terms of access to affordable and longer term credit.¹ This also poses significant challenges to public debt and fiscal risk management and to macroeconomic and financial stability policies.² The core development problem that the Public Efficiency and Financial Market Development Program aims to address is rooted in three different but interconnected fundamental constraints as presented in the Problem Tree at the end of this document.

2. **Sector Challenges.** The sector challenges are analyzed along three dimensions:

- (i) public debt and fiscal risk management issues, and why it needs to become more credible, transparent and effective;
- (ii) gaps that impede the development of Armenia's government securities and money markets; and
- (iii) the lack of instruments and corporate governance practices that constrain the broadening of the investor base in Armenia's corporate debt markets.

3. While reforms in each of these areas are important, simultaneously addressing the challenges enumerated above provide mutually-reinforcing benefits: (i) significantly increasing the Ministry of Finance's (MOF) debt management capability, (ii) increasing money market liquidity, (iii) enhancing the role of government securities for developing local currency bond markets, and (iv) broadening the investor base in debt markets and increasing confidence in MOF's debt program.³

a. Ineffective Public Debt and Fiscal Risk Management

4. Armenia's public financial management ranks high in terms of budget credibility, comprehensiveness and transparency, policy-based budgeting and execution, and revenue administration. However, its management of fiscal risks related to public sector enterprises and PPPs, cash management, and forecasting ability is weak. In addition, ineffective tax collection, weak controls of government current expenditures, poor quality and timeliness of financial statements and audits, poor legislative scrutiny of external audits, and weak transparency of inter-government fiscal relations undermine public sector management.⁴

5. As Armenia moves to middle-income country status, it will need to increasingly rely on mobilizing debt from its domestic market. A transition from external, predominantly concessional funding, to local currency-denominated government securities, is required. A prudent public debt-

¹ The Armenian financial sector is characterized by high dollarization at around 60%—one of the highest in the region.

² Financial dollarization of banks' assets and liabilities exposes banks to foreign exchange and refinancing risks. With limited financial deepening in the dram, both fiscal and monetary policies have little maneuvering space to tackle external macroeconomic shocks or to ensure financial stability. Consequently, the role of the exchange rate in macroeconomic and financial stability remains a core concern during external shocks.

³ The benefits—along with financial quantification and the overall medium-term economic impact on the economy—are presented in the Economic and Financial Analysis, accessible from the list of linked documents in Appendix 2 of the Report and Recommendation of the President to the Board of Directors.

⁴ Republic of Armenia. 2014. *Public Expenditure and Financial Accountability (PEFA) Assessment*. Yerevan.

management policy is thus needed to ensure that the government's financing needs are met at a low cost and at a manageable foreign-exchange risk exposure. In addition, government debt management needs to be strengthened in the areas of operational risk management and transparency regarding medium-term objectives. As the government aims to attract private expertise and capital for the provision of public services and infrastructure, a robust policy framework for fiscally-sustainable PPPs needs to be established. A PPP pipeline will introduce contingent liabilities with fiscal significance, but for which there is still no vetting mechanism nor any established methodologies for risk assessment and management.⁵ Current PPP-related risks in Armenia are not well identified or managed. As the PPP development and decision-making process is fragmented across ministries, this exposes them to the risk of entering into new contracts without an accurate assessment of value-for-money, affordability, or fiscal risk.

b. Weak Government Securities Issuance and Management Practices, and Incomplete Infrastructure for Money Markets.

6. 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 (dram), a key public debt securities market cornerstone crucial for the efficient pricing and liquidity of all AMD financial instruments in the financial sector. The nascent stage of the government securities market also impedes the development of the money markets.

7. **Under-developed money markets.** Unsecured interbank transactions are minimal as banks perceive counterparty risk as high. Also, secured interbank trading is limited, reflecting a lack of effective "collateralized" instruments, and the currently shallow and volatile secondary market in Treasury-bills (T-bill). Over-subscribed T-bill auctions and "hold-to-maturity" behavior of buyers reflects such shortage.⁶

8. While the MOF needs to review its T-bill program in the context of its public debt strategy in order to ascertain the volumes that could also support money-market development, promoting less credit intensive products such as standardized tri-party repurchase agreements (also known as repos) and other derivatives will be an important step towards the development of money-markets.⁷ The few interbank repo transactions so far carried out in Armenia are based on non-standardized contracts that involve high transaction costs. The absence of settlement finality, netting, and of standard repo documentation has also reduced the "secured" nature of these interbank contracts. Ongoing efforts to establish the legal and regulatory framework for improving secured interbank trading and financial derivatives via a Global Master Repurchase Agreement for repos constitute important reform steps. In addition, addressing key IT and institutional gaps in interbank repo settlement and collateral management can be of major significance in this regard. The expected boost to secured interbank trading that can result from these reforms could spillover further to the government securities market and help promote yield curve development.

9. **Illiquid government securities market.** The past dependence of the public sector on foreign-currency denominated debt in Armenia makes it very vulnerable to exchange rate movements.⁸ In the future, Armenia will have to increasingly rely on mobilizing debt resources from its own, albeit still-nascent, domestic public debt securities market. This is also a key step

⁵ Depending on how PPP contracts are structured, they can have direct liabilities (e.g., fixed payments), contingent liabilities (e.g., payments if a risk occurs), and implicit service delivery risks to the government.

⁶ There is strong demand in all MOF securities primary auctions and oversubscribed by 2-4 times.

⁷ T-bills are issued in regular sufficient fixed volumes to provide investors with a regular supply of short-term T-bills to meet their demand for a short-term, low risk liquid instrument, and to support secondary market trading.

⁸ Government foreign debt is around 80% of total borrowing (the maximum under the medium-term debt strategy).

towards financial markets development in Armenia. Specifically, the structuring of public debt issuance is of enormous importance in (i) actually making the government securities market more liquid over time, thereby providing better investment opportunities to financial institutions, pension and other investment funds, and retail investors; and (ii) establishing reliable pricing benchmarks for private debt and equity markets to take off. Since 2013, MOF has diversified its foreign currency borrowing portfolio to include Eurobond issues which make up around 23% of the foreign debt. Domestic debt as a percent of total debt has increased from 15% in 2014 to 20% in 2015, and plateaued at this level. Secondary market trading is low, affecting the price-discovery and further lowering investors' appetite. MOF's domestic debt portfolio will need to increase along with reforms to promote increases in trading liquidity and bid-ask quoting reliability. The opportunity to reduce MOF's foreign currency risk through future expansion of the domestic funding program needs to be considered in Armenia's debt strategy.

10. Currently, the MOF issues long term bonds, medium term notes, and T-bills based on a published issuance calendar. MOF has to establish benchmark maturities in all securities (including T-bills) using regular issuances and bond switch operations to manage large maturities and rollover risk. Further reforms are needed to improve debt management and increase debt program transparency. Ongoing reform efforts to introduce a new, performance-based, primary dealers' system with market-making responsibilities can be a crucial step forward. This will promote predictability and investor confidence and is likely to underpin future demand growth for government securities. Reforms have also been implemented to establish an internet-based facility for domestic retail investors to invest in retail government securities. This technology opens access and lowers the transaction costs for retail investors and provides scope for retail funding of government debt to increase above the current level of 0.4% of the total domestic debt.

c. Lack of instruments, corporate transparency, and low investor confidence in corporate governance.

11. The corporate debt market is under developed. In addition to lack of public debt benchmarks that would serve as a basis for pricing private debt,⁹ there are only a few institutional investors in Armenia, such as pension funds and insurance companies, investing in the domestic capital market. As a result, savings are not effectively channeled from the public to the capital market through institutional investors into the economy and into productive investments. Also, there is a lack of protection in law for borrowers and investors as the legal framework is incomplete for new types of securities that could encourage private equity development. A lack of trust in corporate governance and in transparency and accuracy of companies' accounts and audit practices also inhibits investors. The government has undertaken to draft legislation to address these gaps by introducing new security types, improving consumer and investor protection, and strengthening corporate transparency and financial market practices. Lastly, foreign investors are reluctant to invest in dram assets as there is no forward foreign exchange market to hedge currency risk, and a low-risk liquid instrument (T-bill) to hold dram funds. Foreign investor holdings comprise only 0.2% of government securities. Parliament is approving the necessary law and amendments that will allow the Central Bank of Armenia to develop the foreign exchange forwards market.

⁹ A key prerequisite for the development of the capital markets is a deep transparent yield curve for government securities that sets the risk-free rate in the economy for longer maturities which serves as a benchmark for pricing private debt.

2. Government Sector Strategy

12. Armenia's long-term development vision is articulated in the Armenia Development Strategy, 2025, which prioritizes modernizing of public administration and governance. Activities proposed in the strategy are geared towards improving public sector efficiency, growing public revenues and improving their targeted use, improving access to quality services, reducing corruption via transparency of budget decision-making, and increasing civil society participation.¹⁰ The strategy also envisages developing money and capital markets, and increasing the private sector access to affordable credit and equity financing that can support sustainable growth.¹¹ The Central Bank of Armenia and the Ministry of Finance are initiating broad legal, regulatory, and institutional reforms, which are supported by international donors via technical assistance including by the European Union for debt management, and by the European Bank for Reconstruction and Development, the World Bank, and the International Monetary Fund in capital market reforms. Good coordination is crucial to managing this complex, multi-year reform agenda. The keys to success are the proper sequencing of activities and close interagency coordination under the ambit of the proposed capital market strategy.

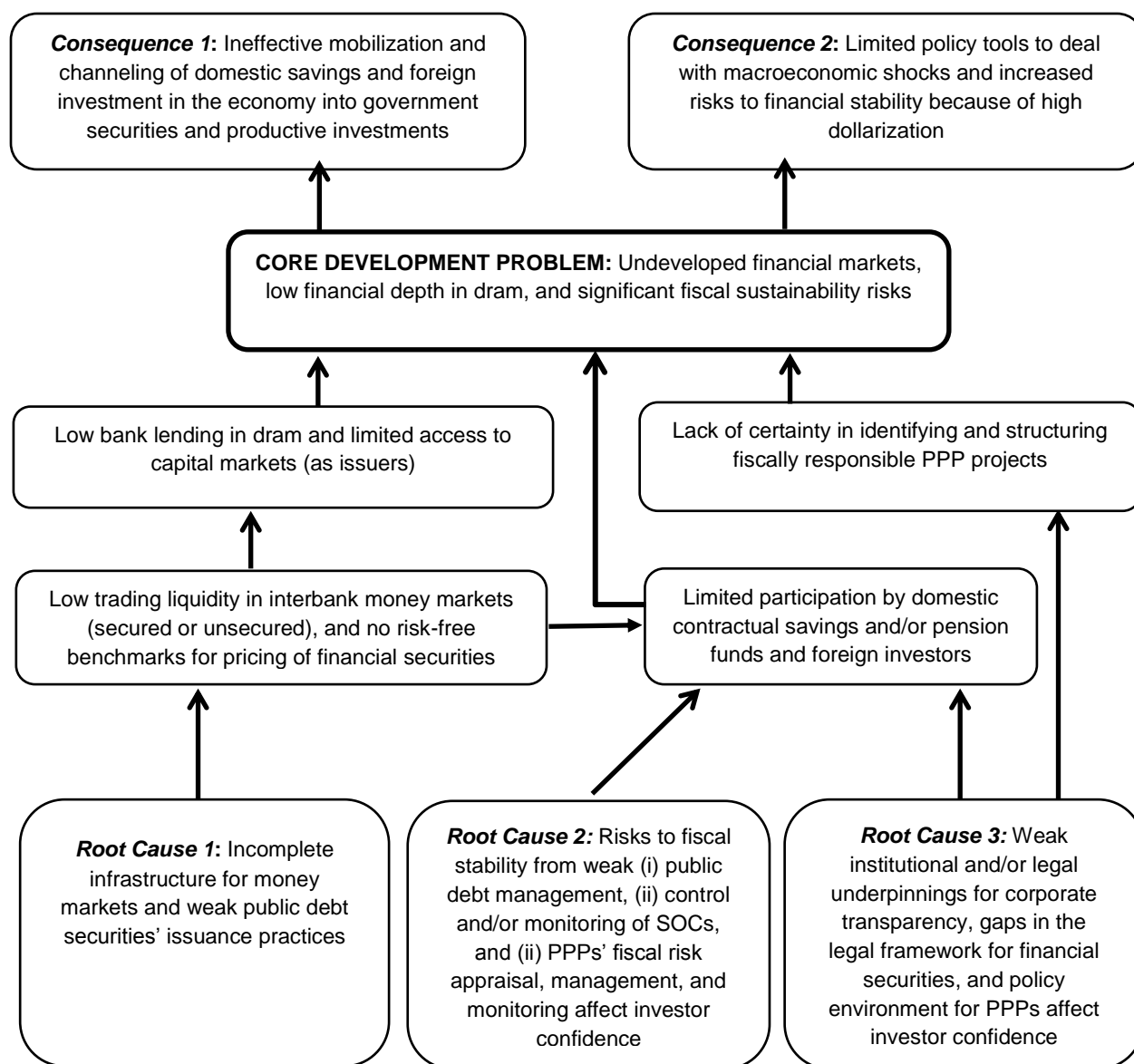
3. ADB Sector Experience and Assistance Program

13. In the finance sector, ADB has provided sovereign and non-sovereign support to Armenia. In 2012, the \$40 million sovereign Women's Entrepreneurship Support Sector Development Program included policy actions to strengthen a government loan guarantee scheme for micro and small- to medium-sized enterprises and a financial intermediation loan to eligible financial institutions to support women's micro and small- to medium-sized enterprises. ADB's non-sovereign support included small- to medium-size finance through senior loans to financial institutions (ACBA Credit Agricole, Ardshinvest Bank, Ameriabank, and Inecobank in 2011) and FINCA Microfinance Bank (in 2016) for a total of \$71 million. ADB has supported public sector management reforms in water supply and road transport since 2012, and in the energy sector in 2016 via two Infrastructure Sustainability Support Programs, which focused on institutional reform, identifying funding requirements for road transport and water services, building the capability of the road transport and water sector line ministries, and introducing legal reforms in the power sector to enable market trading including the export of power.

¹⁰ Government of Armenia. 2014. *Armenia Development Strategy for 2014–2025*. Yerevan.

¹¹ Central Bank of Armenia. 2014. *Strategy of the Central Bank of Armenia, 2015-2017*. Yerevan.

PROBLEM TREE



PPP = public-private partnership, SOC = state-owned corporations.
Source: Asian Development Bank