

INITIAL PROJECT INFORMATION DOCUMENT 29723
REPUBLIC OF ARMENIA

Project Name: Poverty Reduction Support Credit (PRSC)

Region: Europe and Central Asia

Sector: Adjustment Operation

Project ID: P078673

Borrower: Republic of Armenia

Implementing Agency: Ministry of Finance

Date this PID prepared: July 20, 2004

Projected Board Date: November 2004

1. Background. The Armenian government implemented a successful stabilization and structural reform program following the hyperinflation, fiscal crisis and severe economic contraction immediately after independence in 1991-93 – a period that also saw a major earthquake and conflict with Azerbaijan over a territorial dispute. Trade and prices were liberalized, the legal framework for a market economy was established, most small and medium-sized enterprises were privatized, and the government's intervention in the economy was considerably reduced. Macroeconomic stability was maintained, inflation was low, structural reforms were carried out successfully and economic recovery began. Despite being a landlocked country with few natural resources, success in economic reforms contributed to an average growth of 5.5 percent per year during 1994-2000. Nevertheless, rapid growth did not reduce poverty and unemployment because of insufficient progress in improving the business environment and weaknesses in the rule of law, and fair competition. . From early 2001, the government shifted emphasis to improving business environment and promoting exports, thereby creating conditions for an acceleration of growth in recent years. Economic growth accelerated during 2001-2003, with GDP growth rising from 6 per cent in 2000 to 9.6 percent in 2001, to 12.9 per cent in 2002, and 13.9 per cent in 2003. Economic growth was driven for the first time by a high rate of export expansion, which doubled in 2001-2003, with contribution from construction and trade sectors. While the diaspora and other donors financed much of the construction through grants, investment in tradable goods and exports contributed increasingly to growth in recent years. Inflation was confined to 2.9 per cent and 2.0 per cent in 2001 and 2002, respectively, but rising to 8.6 per cent in December 2003, largely because of cost-push factors.

2. The economy continued its strong performance during 2004 and is expected to remain strong in the medium-term with growth of 7 percent in 2004 and about 6 percent per year during 2005-08.

3. **Project Scope and Objectives.** The proposed PRSC is the first in a set of three annual PRSCs that is rooted in the medium term Poverty Reduction Strategy Paper (PRSP) of the authorities. The proposed credit is based on policy and institutional actions taken by the authorities as well as actions agreed for the following PRSCs that are formulated as triggers for the release of the succeeding credits.

4. The main areas of focus for the operation are: (i) developing *private markets* to underpin high rates of sustainable growth; (ii) advancing reforms in core *public fiduciary services*; (iii) continuing reform in key *social policies* – education, health and social protection; and (iv) promoting the revival of the *rural economy*. The three year program will contain supporting measures in all of these areas, with the thrust of the reform effort being concentrated on the development of private markets in the first year and on social sector policies and the rural economy in the latter years.

5. The proposed PRSC will build on the PRSP themes and will be closely linked to the FY05-08 Country Assistance Strategy (CAS) which focuses on three main objectives: (i) promoting private sector led growth; (ii) making growth more pre-poor; and (iii) reducing non-income poverty. The FY05-08 CAS envisions the proposed PRSC as the key elements of supporting PRSP implementation. The PRSC preparation is also closely coordinated with the IMF Poverty Reduction and Growth Facility (PRGF).

6. **Environmental Aspects.** In accordance with the Association's operational Directive on Environmental Assessment (OD 4.01, Annex E), the operation is proposed to be placed in Category "C" and does not require an environmental assessment.

7. **Benefits.** The main benefits of the proposed credit are to help sustain economic growth and poverty reduction by providing foreign exchange to support balance of payments and non-inflationary budgetary financing. The proposed credit will also support implementation of the PRSP objectives to improve business environment, advance social sector reforms, and strengthen the rural economy.

8. **Potential Risks.** The proposed credit is subject to several risks. First, government capacity to implement reforms and willingness to support over a three-year period will be necessary. Second, as the reform agenda begins to enter into difficult terrain, reform fatigue could set in. The wide participation through which the PRSP was formulated and the continuing involvement of civic organs in its implementation offer some protection against reform fatigue; nevertheless, the authorities are planning to step up dialogue, explanation and dissemination, especially in rural areas. A third risk relates to exogenous economic shocks reflecting reduction in worker remittances, export earnings, diaspora support or a substantial energy price or supply shock. Shocks could stem from natural disasters or renewed warfare. Clearly, each will have to be addressed in its own way, possibly necessitating a change in the content of future PRSPs and the use of other Bank instruments as envisaged in the CAS.

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Note: This information is provided for an evolving project. Certain components may not necessarily be included in the final project, while the scope and cost of other components may be adjusted.