

**DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT**

STRATEGY FOR ARMENIA

As approved by the Board of Directors on 25 November 2003

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ABBREVIATIONS

Armex	Armenia Stock Exchange
BAS	Business Advisory Service
BEEPS	Business Environment and Enterprise Performance Survey
CBA	Central Bank of Armenia
CIS	Commonwealth of Independent States
CPI	Corruption Perception Index
DFID	Department for International Development
DIF	Direct Investment Facility
EC	European Commission
EOM	Election Observation Mission
EU	European Union
EURATOM	European Atomic Energy Community
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
IFI	International Financial Institution
ILO	International Labour Organisation
INOGATE	International Oil and Gas to Europe
JSC	Joint Stock Company
JSCL	Joint Stock Company Law
NEAP	National Environment Action Programme
NPP	Nuclear Power Plant
ODIHR	Office of Democratic Institutions and Human Rights
OECD	Organisation for Economic Co-operation and Development
OSCE	Organisation for Security and Co-operation in Europe
PPP	Purchasing Power Parity
PRSP	Poverty Reduction Strategy Paper
SAC	Structural Adjustment Credit
SOE	State-Owned Enterprise
SME	Small- and Medium-sized Enterprise
TAM	TurnAround Management
TC	Technical Co-operation
TFP	Trade Facilitation Programme
TI	Transparency International
TPP	Thermal Power Plant
TRACECA	Transport Corridor Europe-Caucasus-Asia
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
WBG	World Bank Group
WTO	World Trade Organisation

I. EXECUTIVE SUMMARY

Armenia is committed to the principles of multiparty democracy, pluralism and market economics in accordance with the conditions outlined in Article 1 of the Agreement Establishing the Bank, although application of these principles in the previous Strategy period has been uneven. While economic performance has been generally good, and Armenia has made encouraging progress on liberalisation and selected structural reforms compared with other economies of the region, questions regarding the conduct of presidential and parliamentary elections in 2003, media freedom and rule of law are a source of concern. Since independence, Armenia had built a strong record of progress on democratic reform which led to their accession to the Council of Europe in 2001. The newly-elected authorities have an opportunity to return to that political course, which would restore public trust and underpin the policy steps needed to address the country's remaining transition challenges. On the dispute over Nagorno-Karabakh, the authorities demonstrated their commitment to negotiations but a final resolution has proven elusive. Until this matter is resolved, Armenia's partial isolation in the region will continue to impede the country's economic development and stall the creation of important regional initiatives in the Transcaucasus.

On the economic front, macroeconomic performance has improved markedly in recent years. Average economic growth over the last two years was 11.2 per cent, which was mainly driven by the construction and manufacturing sectors. Inflation has remained low, while the authorities have managed to substantially reduce the fiscal deficit. The current account deficit also declined significantly in 2002. Armenia formally joined the WTO in February 2003.

The external debt situation has improved as a result of an agreement for a debt-for-equity swap with Russia. However, due to low fiscal revenues and anticipated new borrowings, the authorities should continue to manage carefully sovereign debt capacity and prioritise public investments. The government is currently advised under the IMF programme not to incur non-concessional sovereign borrowings.

Armenia is a low income country (per capita income in 2002 was US\$ 789). With strong economic performance in recent years, however, the share of the population in poverty has declined to 48 per cent in 2001, down from 55 per cent in 1998/1999. To further reduce poverty levels the government has approved a Poverty Reduction Strategy (PRSP). Armenia maintains relatively good relations with both the IMF and the World Bank. The IMF's Poverty Reduction and Growth Facility is largely on track, while the World Bank also approved a new Structural Adjustment Loan (SAC-5) in April 2003.

Despite the strong macroeconomic performance and recent progress on sectoral reforms, transition challenges remain in further advancing structural reforms and improving the business environment. While most of the privatisation has been completed, post-privatisation restructuring has lagged behind. In the financial sector, while banking sector reform is progressing, the sector is still underdeveloped and financial intermediation is limited. Despite some improvements, the business

environment remains complex. Other constraints affecting private sector development and FDI include the small size of the Armenian market, and the country's partial isolation from neighbouring markets.

Under these circumstances, Armenia's main transition challenges are to: (i) improve the business environment, which continues to suffer from weaknesses in the legal system and widespread corruption; (ii) improve efficiency and credibility of the financial sector through consolidation and institutional capacity-building; (iii) promote commercialisation of public infrastructure by establishing market-based institutions with appropriate governance structures; (iv) finalise privatisation and accelerate post-privatisation restructuring; and (v) ensure debt sustainability.

As of end-September 2003, the Bank had a current portfolio of € 51.4 million covering 8 projects in the power, transport, general industry and financial sectors. Out of these, 6 projects are in the private sector, representing 44 per cent of the total portfolio. During the previous Strategy period, EBRD committed € 4.2 million in new business for 3 projects in the private sector and around € 720,000 in new TC.

The Bank is committed to supporting the transition process in Armenia, and notwithstanding the challenges of the local business environment, will endeavour to deepen and broaden its activities in the country. The Bank's activities over the coming Strategy period will focus primarily on support targeting the development of the private sector, including through an intensified policy dialogue with the authorities on measures to improve the business environment. In view of Armenia's limited sovereign borrowing capacity, the Bank does not anticipate pursuing any new infrastructure projects on a sovereign-guaranteed basis, unless these involve adequate grant co-financing.

The main operational objectives will be:

- **Enterprise Sector** - The Bank will focus on further expanding its SME and micro-enterprise financing. Funding will mainly be provided through credit lines to local partner banks and direct equity investments through the Bank's Direct Investment Facility (DIF). Co-financing through risk sharing with local partner banks will also be introduced. The recently initiated TurnAround Management (TAM) programme, and the recently established Business Advisory Service (BAS) will be expanded. The Bank is ready to provide legal transition assistance in areas such as secured transactions, bankruptcy legislation and regulatory reform in the telecommunications sector.
- **Financial Sector** - EBRD will aim to extend further support to existing and additional banks under its Armenia Multi-Bank Framework Facility, and to expand its Trade Facilitation Programme (TFP) with a view to further strengthen financial intermediation. In an effort to address capital adequacy limitations, the Bank will seek suitable equity investment opportunities in local banks. Assistance may be considered for possible mergers and acquisitions in an effort to support the sector's consolidation. Financing for the growing mortgage market will be pursued through suitable funding instruments and possibilities for engagement with the emerging non-banking financial institutions will be considered.

- **Portfolio monitoring and implementation support** - Given the issues affecting some of the Bank's public sector projects (e.g. Hrasdan TPP Unit #5 and the Zvartnots Air Cargo Terminal), particular emphasis will be given to continued proactive project monitoring, also with a view to facilitating constructive solutions to their further development.
- **Infrastructure & State-Owned Public Utilities** - Operations involving suitable state- or municipality-owned utilities and infrastructure companies would be considered mainly on a non-sovereign basis, if accompanied by appropriate regulatory and institutional reform.

The Bank will continue to ensure that all EBRD operations in Armenia are subject to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans. The Bank will co-operate with other IFIs specifically in the context of the implementation of the PRSP and through co-financing, complementary projects and co-ordination of policy dialogue. The Bank will seek to mobilise increased donor grant financing to support the preparation, implementation and grant co-financing of selected investment projects. The Bank is currently reviewing its instruments to better target the needs of early transition countries and the conclusions of the review will also be applied to Bank operations in Armenia.

II. COUNTRY STRATEGY

1. THE BANK'S PORTFOLIO

1.1. Overview of Bank Activities to Date

As of 30 September 2003, the Bank had signed 10 investment projects covering energy, transport, agribusiness, general industry and banking, for a total commitment of € 92.7 million. Of these, 3 projects were in the public sector totalling € 68.4 million (74 per cent) and 7 in the private sector (representing 6 clients), totalling € 24.3 million (26 per cent). Cumulative disbursements were € 89.6 million. The total amount of TC funds provided to date is € 5.1 million. Net portfolio stood at € 51.4 million, of which 97 per cent is disbursed.

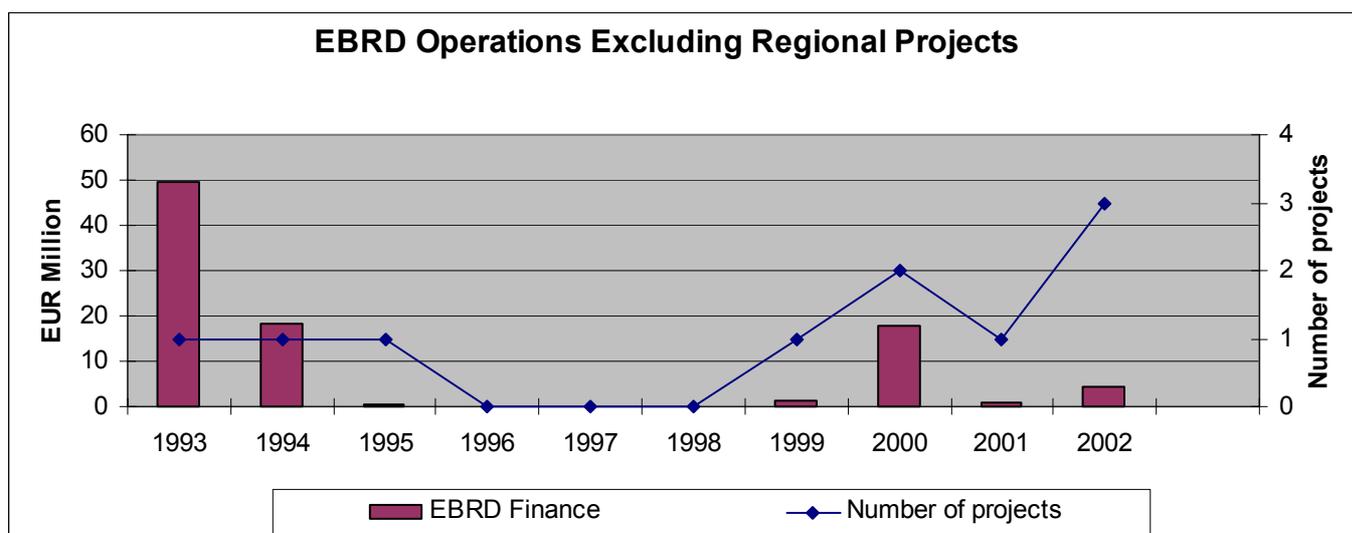
Table 1: Commitments and Portfolio at 30 September 2003
(€ million)

Sector Name	Commitments					Net Portfolio			
	No. of projects	Total Project Cost	EBRD Funding	% of total EBRD	Disbursed	Portfolio	% of Portfolio	Undrawn commitment	Operating assets
Financial Institutions	5	4.6	4.6	5%	2.9	2.9	5%	0.2	2.7
Infrastructure	2	99.6	67.8	73%	67.8	28.8	56%	0.0	28.8
<i>Energy</i>	<i>1</i>	<i>76.9</i>	<i>49.4</i>	<i>53%</i>	<i>49.4</i>	<i>22.5</i>	<i>44%</i>	<i>0.0</i>	<i>22.5</i>
<i>Transport</i>	<i>1</i>	<i>22.7</i>	<i>18.4</i>	<i>20%</i>	<i>18.4</i>	<i>6.3</i>	<i>12%</i>	<i>0.0</i>	<i>6.3</i>
Enterprise support	3	49.3	20.3	22%	18.9	19.7	38%	1.4	18.3
<i>Agribusiness</i>	<i>2</i>	<i>45.6</i>	<i>17.7</i>	<i>19%</i>	<i>17.7</i>	<i>17.1</i>	<i>33%</i>	<i>0.0</i>	<i>17.1</i>
<i>General Industry</i>	<i>1</i>	<i>3.7</i>	<i>2.6</i>	<i>3%</i>	<i>1.2</i>	<i>2.6</i>	<i>5%</i>	<i>1.4</i>	<i>1.2</i>
Country Total	10	153.5	92.7	100%	89.6	51.4	100%	1.6	49.8

¹Details of net portfolio are provided in Annex 5

Net portfolio distribution by sector was as follows: financial institutions 5 per cent infrastructure 56 per cent, and enterprise support (agribusiness sector and general industry) 38 per cent. Of the 8 on-going projects, one is an equity participation, 6 are funded through debt instruments and 1 is a trade guarantee. Equity investments represent 2 per cent of the Bank's net portfolio.

The chart which follows shows the number of projects signed in each year since 1993 and corresponding commitments. In 1993-1994, commitments included two larger sovereign-backed infrastructure projects – Hrasdan TPP Unit #5 and the Zvartnots Air Cargo Terminal. A wholesale market project was signed in 1995. No new commitments followed until 1999. Seven projects have been signed since then, all except the Yerevan Brandy Company being smaller projects reflecting the move away from sovereign-backed infrastructure projects, an underdeveloped financial sector, the complex business environment, and the lack of an equity culture.



During the last Strategy period, new EBRD commitments have concentrated on general industry and the financial sector. Three operations were signed in 2002 for a total amount of € 4.2 million, including one new SME credit line with a leading local bank, a TFP transaction and a loan to a local copper producer.

1.2. Implementation of the Previous Country Strategy

Implementation of the previous Country Strategy (end 2001 to date) was as follows:

- New Business:** new business was modest in terms of commitment volume, but with an important demonstration and transition impact in the core priorities of the Strategy (i.e. support of small- and medium-sized enterprises and the banking sector). After 2001, during which one operation was signed, EBRD undertook two commitments in the financial sector and one in the general industry sector. One credit line for € 0.9 million was signed with Anelik Bank, a trade guarantee for the amount of € 0.7 million with Armeconombank, and a loan for € 2.6 million with the Armenian Copper Programme, a local private sector company.
- Enterprise Sector/SMEs:** efforts to support foreign investors in entering the Armenian market have so far not yielded material results, reflecting generally low FDI and lack of bankable strategic investors in the country. However the Bank has managed to provide financial support to a local private investor in the copper refining sector for working capital replenishment and to address immediate environmental requirements. Progress with implementation of the Bank's Direct Investment Facility (DIF) has been slow, substantiating a largely undeveloped equity culture.
- Infrastructure:** restructuring of the Electricity Distribution Companies was undertaken in 2002 and a long-term management contract put in place. However, a somewhat controversial process eventually led to the Bank's decision to abstain from direct financial support and the cancellation of the approved privatisation participation project. Discussions concerning reducing

Armentel's monopolistic position continued but without resolution; consequently, there was no opportunity for EBRD involvement. Contacts have continued with the state-owned railway company probing for possible non-sovereign public sector operations.

- **Financial sector:** further support to the sector was extended, albeit at a slower than anticipated rate. Initial utilisation of funds under the Bank's Multibank Framework Financing and Trade Facilitation Programme was slow, but gradually improved over time, reflecting a mutual learning curve process. Efforts to provide direct equity financing in the sector have not succeeded so far, highlighting the already-mentioned equity culture constraints; this situation is, however, slowly changing, not least through increased knowledge facilitated by the technical assistance provided by the Bank. The abundance of concessional funding (mainly via Diaspora sources) and the specifics of the local banking sector have prompted the Bank to reconsider its earlier plans to establish a specialised micro-finance bank, and decide to channel micro-enterprise credit via local commercial banks.
- **Portfolio Management:** considerable efforts have focused on addressing the issues arising in relation to the Hrasdan Unit #5 and Zvartnots Air Cargo Terminal, both sovereign-guaranteed operations, with the aim of identifying economically viable solutions and possible FDI involvement. Prospects of long-term viable solutions, however, still remain to be demonstrated.
- **Project Pipeline Development:** The factors which have constrained project pipeline development during the last strategy period include the small size of eligible projects, the challenging local business environment, limited interest by suitable foreign strategic investors, an underdeveloped equity culture, the country's relative isolation from some of its neighbours coupled with the modest local market, low banking sector penetration which has limited EBRD's outreach ability, the availability of funding on soft terms particularly from Diaspora sources, and the fact that sovereign guarantees are restricted to projects funded on a concessional basis.

Notwithstanding these constraints, the pipeline currently includes seven projects: two general industry DIF equity investment projects, a local investment under a regional agribusiness facility, an extension of the Multibank Facility to a new local bank, an equity investment in another bank, as well as the further expansion of the Bank's TFP to two new clients. While relatively small, these projects require almost the same level of Bank effort to develop and monitor as would larger operations.

1.3. Transition Impact of the Bank's Portfolio and Lessons Learned

1.3.1. Portfolio Performance

The current EBRD portfolio in Armenia has a weighted project risk rating of 5.86 compared with a Bank average of 5.91 for SEEC countries and 5.58 for the Bank as a whole.

The two projects supported by sovereign guarantees continue to experience difficulties. Cost overruns during the construction of the Bank-financed Unit #5 of the Hrasdan Thermal Power Plant resulted in the eventual suspension of the project. New investments of about US\$ 40 million will be required to complete the construction. Discussions with the authorities on possible solutions continue. The performance of the Bank-financed cargo terminal at Yerevan Zvartnots Airport remains unsatisfactory, due to the extremely low level of air cargo serviced at the airport. The recent agreement to transfer the airport and the facilities to a private operator is expected to improve operations and increase air traffic volumes. The Bank maintains contacts both with the concessionaire and the authorities and is prepared to support additional proposals which would facilitate a turnaround.

1.3.2. Transition Impact of Bank's Activity

The transition impact of the Bank's projects has been mixed, improving substantially over the last few years. The initial projects signed over the years 1993-1995 (Hrasdan TPP Unit #5, Zvartnots Airport Cargo Terminal, and Wholesale Market) did not yield the desired transition impacts.

In terms of support for the development of the private enterprise and banking sectors, however, the Bank has had significant transition impact. Both the Yerevan Brandy Company and the Armenian Copper Programme have proceeded successfully, introducing a benchmark for corporate performance. The Yerevan Brandy Company project provided a commercial loan to one of the largest private companies in the country with a foreign strategic investor. The company established a solid base, exporting good quality brandy and its backward linkages in the agriculture sector are substantial. The Armenian Copper Programme supports an export-oriented Armenian corporate in a remote area and promotes restructuring of the company. The project also has good demonstration effects in terms of environmental, management and corporate governance standards. The project will assist Armenian Copper Programme in stabilising production levels through the provision of working capital, thereby improving the efficiency of the production process. Enhanced profitability will enable the company to introduce environmental improvements. The Environmental Action Plan for the project will allow addressing high priority environmental issues, such as dust emission and effluent discharge control.

Similarly, the Bank's financial sector operations (two TFPs, two lines of credit and one equity participation) have had an overall positive transition impact both in terms of institutional development in the sector and support for SMEs. The TAM programme and the recently launched BAS programme, both so far EC funded, are making an essential contribution in terms of direct advisory services to local enterprises.

1.3.3. Lessons Learned

During the past Strategy period, three Armenian projects were the subject of ex-post PED reviews: an power and energy sector project, a transport infrastructure project and an agribusiness sector project. The first two were signed in the Bank's early years, i.e. 1993 and 1994 respectively, and the latter in year 2000.

The key lessons identified from these evaluations and from the Bank's overall experience in Armenia are:

Larger power and infrastructure projects are under severe risk if addressed on the basis of an emergency approach, aimed to deal quickly with acute problems faced by the countries in these sectors (including in the case of Armenia in an attempt to forestall restart of unsafe nuclear generation), and ultimately will not achieve their main objectives. Despite the urgency, a staged approach or more time and resources devoted to preparatory studies are preferable. Large contingencies in consultant studies warn of unacceptable project risks. Geopolitical considerations need also to be appropriately reflected in risk assessments. Against this background it should be recognised that the state of flux experienced in 1992/1993 in the local economy is unlikely to be repeated and considerable experience in the sector has been acquired since then. PED also acknowledges that such risks and their mitigation are nowadays generally reflected by the Bank in its analysis of projects. In order to achieve the transition impact of complex infrastructure projects, strong project implementation units, project supervision by the implementing agencies and early pro-active monitoring by the Bank are also required. These must involve adequate industry experience at all stages.

Quality at entry. The Bank needs to exercise scrutiny and critical judgement towards market forecasts, provided by external consultants in order to counterbalance widely observed appraisal optimism. Plausibility checks, eventually carried out by, or with the help of, a second consultant should not be excluded as an option, particularly in economies heavily influenced by exceptional circumstances. Project risk assessment requires as input factor a thorough and realistic analysis of the political environment. In a situation of high uncertainty, the worst case scenario should not be excluded as an option in the financial sensitivity analysis.

Role of strategic investors in turnaround projects. In countries difficult to operate in, as in the Caucasus, with considerable constraints in the legal environment, well spread corruption, and where interference by the authorities in the economic sector can be high, EBRD's involvement in turnaround private sector projects requires the support of financially strong, experienced and powerful strategic investors to implement the projects in their various aspects.

Built-in flexibility. A reasonable degree of flexibility both in terms of financing instruments, as well as maturity and size (as has recently been introduced in EBRD banking sector projects) built in at an early stage, facilitates addressing clients' needs adequately in a rapidly changing financial and real sector environment. (Banking sector projects).

1.4. Portfolio Ratio

At the end of September 2003, 26 per cent of total EBRD cumulative commitments were in the private sector and 44 per cent of net portfolio, reflecting the significant weight in the Bank's operations of the two sovereign-backed infrastructure projects signed in 1993 and 1994, as well as the typically substantially smaller size of private sector projects. In terms of number of transactions in the Bank's portfolio, three have been in the state sector and seven in the private sector. Although during the next

Strategy period the Bank will focus primarily on private sector projects or projects involving private sector participation, it is unlikely that the private/state sector ratio of 60:40 can be met within that period.

2. OPERATIONAL ENVIRONMENT

2.1. The General Reform Environment

2.1.1. Political Developments

The re-election of President Kocharian in March 2003 and the success of pro-presidential parties in the Parliamentary elections in May 2003 ensure continuity in the country's market-oriented reform course. A coalition government has been put in place which has representatives from the leading Republican Party and two junior partners, the Dashnaktsutyun and the Orinats Yerkir parties. The Prime Minister from the previous government, Andranik Margaryan, and nine other ministers have kept their posts in the new government. The leader of the Orinats Yerkir party, Artur Bagdasaryan, was elected to the post of Speaker of the Armenian Parliament. Both the government and the Parliamentary majority have a pro-reform agenda, which was confirmed in June 2003 with the adoption of the government's Action Plan for 2003-2007. However, effective implementation of newly adopted laws remains a key challenge, and restoring trust and confidence to the country's political institutions after recent flawed elections is essential. (For more detail on political developments, see Annex 1).

2.1.2. Social Conditions and Labour Issues

Armenia is one of the low-income countries among the Bank's countries of operations with a per capita GDP of US\$ 789 at current exchange rates and US\$ 3,088 at PPP exchange rates¹. The official unemployment rate is 9.4 per cent in 2002, but hidden unemployment is believed to be much higher². According to the World Bank Integrated Living Conditions Survey (ILCS), the share of the population in poverty is 48.3 per cent (2001), down from 54.8 per cent in 1998/1999³. The share of those in extreme poverty (food poverty, consumption under 7,979 drams [US\$ 14.40] per month in 2001) is estimated at 20.0 per cent, down from 26.8 per cent in 1998/1999. The rate of poverty is higher in urban areas, due to higher rates of unemployment. In Armenia, a large portion of household income comes from non-productive sources (estimated at 45 per cent of incomes), such as remittances, pension benefits and humanitarian aid. Dependence on such income sources is not likely to be sustainable in the long run.

Due to widespread poverty and limited employment opportunities for educated and highly skilled workers, Armenia continues to experience a "brain drain" through the emigration of young, well-trained Armenians (mostly to the US, Russia and other CIS

¹ Armenia is classified as "IDA only" by the World Bank.

² ILO estimates around 25 per cent of the labour force are unemployed. World Bank ILCS suggests the unemployment rate in 2001 is 30.7% (39% in the urban area).

³ The population living below the national poverty line (measured in terms of nutrition and ability to meet basic needs). 11,221drams (US\$ 20.2) per month in 2001.

countries). This represents a serious problem for the country's future development.⁴

Poverty reduction is a clear priority for the government. The scarcity of public funds makes it difficult to resolve this problem through government spending, and there are limitations on investment and growth potential stemming from the country's small size, and the economic blockade erected by some of its neighbours. To increase real incomes and living standards and to target better government assistance to the poor, the government adopted a Poverty Reduction Strategy Paper (PRSP) in August 2003. This strategy forms the basis for future official donor assistance and outlines key policy priorities over the medium term. The strategy aims to reduce the share of the population in poverty to 35 per cent by 2007. Private sector development will be key to ensuring sustainable poverty reduction.

2.1.3. Regional issues

Armenia is a small, land-locked country. Because of its small size, international trade is crucial for the country but the key corridors through Azerbaijan and Turkey remain closed due to the conflict over Nagorno-Karabakh. Trade flows are distorted by border closures and high transport costs via alternative routes through Georgia or Iran. The nearest port is the Port of Poti in Georgia, which serves as a gateway for Armenian imports and exports (apart from high-value added products), but the route is severely affected by bribery, theft, poor road and railway quality, and high transport costs. Transport costs through Iran are lower but some of the main trade partners impose trade embargoes on Iran. In addition, there are practical difficulties including those on transport capacity and customs clearance.

A 2003 World Bank report indicated that Armenian truckers from Yerevan to Russia or other CIS countries must pay US\$ 1,800-2,000 in security services or bribery payments to border guards, traffic police and criminal gangs. These payments can often exceed the transport costs themselves. Moreover, railway tariffs set by the Georgian railways used to discriminate between local enterprises and foreign companies, although the issue was resolved in 2002 through the introduction of uniform tariffs. For these reasons, most Armenian products, particularly time-sensitive, low value-added and bulky exports (such as agricultural products), are not competitive in world markets.

2.1.4. Legal Environment

While in recent years Armenia has introduced notable reforms to its legal environment, the country continues to face considerable challenges in entrenching the legal rules, institutions and culture upon which its successful transition to a market-oriented economy will depend.

Although commercial law has improved, both the quality of selected individual commercial laws in Armenia and the manner of their implementation fall well below what is generally acceptable internationally. This assessment holds true for all key laws whose purpose is to foster investment, whether foreign or domestic, direct or indirect, although the degree of required reform does vary across these dimensions. For

⁴ It is estimated that around 700,000 Armenians have emigrated over the last 12 years. Emigrants are both the rich and the poor, not many from the middle classes.

example, pledge laws are adequate in many respects but still need upgrading in order to better foster direct investment. The current state of Armenian law regulating capital markets and concessions effectively operates to discourage indirect investment.

An analysis of key commercial laws that directly contribute to creating a favourable investment climate in Armenia, such as corporate governance legislation, shows that even relatively good laws suffer from being poorly implemented. Annual surveys, conducted by the EBRD since 1995, of the perceptions of lawyers who advise on or are otherwise familiar with the law of Armenia confirm this assessment, i.e., that commercial laws suffer as a result of not being sufficiently accessible to the public or having inadequate administrative and judicial support.

This implementation gap both undermines the utility of the specific laws in issue and diminishes the confidence that both Armenians and foreign investors and traders have in the legal system as a whole, in particular in its ability to uphold contract rights. Indeed, the seemingly systemic nature of the gap and the persistently low effectiveness of Armenian commercial laws are symptomatic of the larger problem that lies at the centre of the legal system, namely that the rule of law has not yet become fully entrenched in Armenia. The challenge facing Armenia in 2003 and beyond is to upgrade its commercial laws to standards that are generally acceptable internationally and, even more important, to make those laws fully effective, particularly through a strengthening of the court system, the tackling of corruption, and the adoption of appropriate measures to strengthen the rule of law.

2.1.5. Environmental Issues

The National Environmental Action Plan (NEAP) for Armenia approved in 1998 identified the following problems and priorities for action: air, land and water pollution, the overexploitation of natural resources and threatened ecosystems (including the overuse of water, land and forestry and depletion of biodiversity) as well as environmental health problems and hazards. It is expected that the Action Plan will be implemented gradually through a range of actions which collectively and cumulatively will promote environmental awareness and sustainability. The NEAP acknowledges however that environmental issues are generally not considered a top priority in Armenia. There is little social and local awareness of the need for environmental protection, and efforts to preserve the natural resource base are limited. In Armenia, environmental issues divide society (and scientists) sharply into those who fear “environmental time bombs” and those who view resumption of pollution-prone industrial operations as the only means of improving the country’s economy.

Key environmental concerns in Armenia include land contamination from toxic chemicals, deforestation, desertification, water pollution (Hrasdan and Aras rivers), preventing the draining of Lake Sevan, and the controversial Medzamor Nuclear Power Plant (NPP) operation in a seismically-active zone.

The general requirements of the Principles of Legislation on Nature Protection are reflected in the specialised laws. The most recent basic environmental laws include Law on Environmental Protection and Natural Resources Use (28 December 1998), the Law on Flora (22 December 1999) and the Law on Fauna (03 May 2000). Laws on

hazardous chemicals and waste management are under preparation, as well as draft legislation on Lake Sevan is under consideration in the Parliament.

2.2. Progress in Transition and the Economy's Response

2.2.1. Macroeconomic conditions for Bank operations

In recent years, the Armenian economy has performed well. The average growth rate in the last two years (2001-2002) was 11.2 per cent. This growth was mainly driven by the improved performance in the industrial (mainly diamond cutting and polishing, metals, woods, rubber, tobacco, and information technology) and construction sectors. Exports of processed diamonds have increased significantly and construction has benefited from funding from the Lincy Foundation, an American Diaspora fund, which donated US\$ 185 million over 3 years (2-3 per cent of GDP annually). Growth in 2003 remains robust at 15.2 per cent in the first nine months, but is uneven among the key sectors as industrial production grew by 20.5 per cent, but agricultural production increased by only 0.5 per cent. Future growth is vulnerable to demand for diamonds on international markets and availability of external funds. The availability of further funds from the Lincy Foundation is possible but has not yet been confirmed.

Armenia continues to benefit from a cautious monetary policy, which has brought low inflation and a relatively stable exchange rate. The Armenian dram is allowed to float freely with few Central Bank interventions. The authorities are aiming at a gradual depreciation of the dram, to maintain international competitiveness of Armenian products. Inflation in 2003 is expected to be slightly higher than recent years, mainly because of increases in utility tariffs, public sector wages, and food prices.

Fiscal policy has strengthened with the fiscal deficit declining from 3.8 per cent in 2001 to 0.6 per cent in 2002. This reflects lower-than-expected expenditures and improved tax and customs administration. Energy sector performance also strengthened as the deficit in the sector declined from 2.5 per cent of GDP in 2001 to 0.4 per cent in 2002 with improved collection rates from 81 to 90 per cent. However tax revenues remain low (15 per cent of GDP) and tax administration must be improved further. There are still a substantial number of items exempted from VAT and tax collection is hindered by weak accounting standards and corruption.

Both exports and imports have been increasing. Armenia formally joined the WTO in February 2003. However, international trade remains constrained by a weak transport infrastructure, insufficient communication links and poor customs administration. Moreover, neighbouring countries are unlikely to fully open their borders without progress in settling the Nagorno-Karabakh conflict. Armenia's main exposure to the global economy is through the diamond trade (around 40 per cent of exports) and remittances from the Diaspora. The current account deficit has declined substantially but remains high at 6.6 per cent of GDP in 2002 (from the peak of 21.3 per cent in 1998). Financing the deficit remains dependent on Diaspora inflows and official financing (particularly from the IMF and the World Bank).

Recent debt restructuring agreements with Russia (US\$ 94 million of debt written off in exchange for the equity of 5 state-owned energy enterprises) and Turkmenistan (US\$ 11

million) have significantly reduced the debt burden. Armenia's external debt amounted to around US\$ 1 billion or 43 per cent of GDP (most debt is on concessional terms), which is less onerous than that of some other CIS-7 countries. But the debt levels remain relatively high, particularly in terms of fiscal revenues (over 200 per cent of fiscal revenues). Strict discipline in assuming new indebtedness is essential. For this reason, the authorities agreed with the IMF not to incur any new non-concessional debt.

2.2.2. Transition success and transition challenges

Armenia has made good progress in liberalisation and structural reforms compared with other transition economies in the region. This is reflected in the transition indicators compiled by the Bank and published in its annual Transition Report. Progress has been greater in the areas of enterprise reforms and market liberalisation. In other dimensions, the transition achievements in the financial institutions and some infrastructure sectors do not yet match the EBRD average indicators, but are still above the CIS average. Nevertheless, Armenia still faces several important transition challenges in the future.

Transition Indicators of the CIS countries, 2003

Countries	Small-scale privatisation	Price liberalisation	Trade & foreign exchange system	Large-scale privatisation	Governance & enterprise restructuring	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions	Infrastructure reform
Armenia	4-	4+	4+	3+	2+	2	2+	2	2+
Azerbaijan	4-	4	4-	2	2+	2	2+	2-	2-
Belarus	2+	3-	2+	1	1	2	2-	2	1+
Georgia	4	4+	4+	3+	2	2	2+	2-	2+
Kazakhstan	4	4	3+	3	2	2	3	2+	2+
Kyrgyz Republic	4	4+	4+	3	2	2	2+	2	1+
Moldova	3+	4-	4+	3	2-	2	2+	2	2
Russia	4	4	3+	3+	2+	2+	2	3-	2+
Tajikistan	4-	4-	3+	2+	2-	2-	2-	1	1+
Turkmenistan	2	3-	1	1	1	1	1	1	1
Ukraine	4	4	3	3	2	2+	2+	2	2
Uzbekistan	3	3-	2-	3-	2-	2-	2-	2	2-
EBRD Average	4-	4	4-	3	2+	2	3-	2+	2+

The index ranges from 1, indicating little or no progress, to 4+ pointing to standards similar to advanced economies.
Source: EBRD Transition Report 2003.

Liberalisation, Markets and Trade

Armenia has made good progress in terms of liberalisation. Most of the prices are fully liberalised, while utility prices have increased substantially. The trade regime of Armenia is one of the most open in the CIS. After 10 years of negotiation, Armenia formally joined the WTO in February 2003. WTO membership should promote trade expansion, especially with the EU and the United States. Trade data for 2002 and 2003 shows significant increase in international trade, particularly with non-CIS countries. However, the benefits of a liberal trade regime are partly offset by high transaction costs arising from an insufficient transport infrastructure, shortcomings in customs procedures and the trade blockade imposed by some of its neighbours. These factors continue to constrain regional trade in the Caucasus.

Privatisation and Enterprise Restructuring

By July 2003, the government had privatised 7,178 small-scale and 1,789 medium and large-scale enterprises. The government also liquidated a number of medium and large-scale enterprises. As a result, almost all important state enterprises have been privatised. Accordingly, the private sector share in GDP has increased to approximately 70 per cent in 2002. In recent years the privatisation process has slowed down, mainly because remaining assets are less attractive and strategic investors are limited. The current privatisation programme covers nearly all remaining state-owned enterprises and sets out a plan for finalising privatisation by 2003, but due to a difficult business environment it has taken longer than originally expected. The authorities now intend to complete the privatisation process by end-2004. In 2002, Armenia's power distribution company was sold to British Midland Resources (an off-shore metal company with Ukrainian owners) after two unsuccessful attempts. The government also entered into a 30-year concession agreement with an Argentinean investor for the operation of the Yerevan international airport in 2002. In 2003, in an encouraging move by the government, the loss-making state-owned airline carrier was swiftly liquidated and its assets sold to two private operators. With little interest shown from Western strategic sponsors, however, most firms have been sold to insiders, investors from the CIS or entrepreneurs connected to the Diaspora.

Business Environment

Armenia has made progress in improving the business environment, though more remains to be done. Several surveys on the investment climate and recent trends in export growth suggest that the situation has improved in recent years. A number of relevant laws and regulations have been enacted and modified, although a more consistent track record of effective implementation is needed before firm conclusions can be reached. A Business Council was established to promote improvements in the business environment with the participation of local and foreign companies. Land title registration has also been established and land titles are now tradable in the secondary market. Customs administration has improved, according to the IMF, bringing the country's practices into line with WTO requirements. According to the business environment and enterprise performance survey (BEEPS) conducted by the EBRD and the World Bank in 1999 and 2002, the business environment in Armenia has improved over the past three years. The most significant change came in the level of the 'bribe tax' – the percentage of annual revenues firms say they pay in bribes to public officials to resolve administrative matters. Armenia had a very high level of administrative corruption in 1999, with firms reporting that they paid 3.75 per cent of annual revenues on average; by 2002, firms reported paying 1 per cent of annual revenues on average.

Despite these improvements, however, the business environment continues to be hampered by a lack of transparency in the regulatory system (particularly the uneven application of the rule of law), cumbersome administrative procedures (e.g., complicated and frequent procedures), uneven tax administration (e.g., VAT on exports, particularly lengthy and detailed tax investigations, advance tax payments), lax accounting standards, inadequate infrastructure, and difficulties in accessing finance. SME development, in particular, is hindered by these problems. A case in point is the tax legislation. An area of particular concern was until very recently the VAT legislation, which disadvantaged exporters due to much longer reimbursement periods compared to companies selling domestically. New legislation which was recently introduced addresses this issue, but it remains to be seen how effectively it will be implemented.

An anti-corruption programme, facilitated by World Bank funding and developed in close coordination with international donors, was adopted by the government in November 2003 after two years of study and negotiation.

Financial Sector

The Central Bank of Armenia (CBA) continues to strengthen banking regulation and encourage consolidation with the aim of building up public confidence in the sector. All banks are now under private control. Consolidation has been encouraged by raising the minimum capital requirements to the Armenian dram equivalent of US\$ 2 million from July 2003 and it will reach US\$ 5 million by 2005. The US\$ 5 million level already applies to new banks. There are still some 20 banks remaining in operation. In 2002 and the first half of 2003, six out of eight banks under CBA administration were closed either through liquidation or converting to a credit union. In 2003, the CBA established a deposit insurance scheme (to become operational in 2005) and a Money Laundering Commission. Moreover, the rights of creditors with respect to collateral have been strengthened by an amendment to the civil law. Most recent indicators for the banking sector are encouraging: growing assets and capital, improving asset quality, high liquidity, and profitability. Growth in the construction as well as trade and services sectors has increased demand by SMEs for debt financing and encouraged more bank lending. However, commercial banks are not fully performing their financial intermediation function and lending to the enterprise sector remains limited.⁵ Bankers associate with the lack of bankable projects primarily with the lack of collateral assets, weak business plans and a lack of transparency in business practices.⁶ The banking system remains small and undercapitalised, with assets equivalent to about 15 per cent of GDP. Domestic credit to GDP ratio is currently about 10 per cent, much lower than the CIS average of 22.6 per cent.

The capital market is in the early stage of development. There is a stock exchange (Armenian stock exchange), operated as a self regulated organization and a securities commission was established as an independent regulator. There are 171 listed companies on the stock exchange, but trading volume remains marginal. Market capitalisation is US\$ 25 million (1 per cent of GDP) as of mid-2003. The most frequently traded securities are short-term government treasury bills and middle-term treasury coupon bills. These securities are traded directly among dealers at regular auctions organized by the Central Bank of Armenia.

Infrastructure

In the last few years there have been significant achievements. In the power sector, the distribution network was privatised in 2002 and the Hrasdan thermal power plant (with the exception of the EBRD-financed and still uncompleted Unit #5) was transferred to the Russian RAO UES as part of a debt-equity swap in 2003. The government also made a concession agreement with the Argentinean company Corporation America for the operation of the Yerevan Zvartnots international airport in 2002 (30-year concession) with an investment commitment of US\$ 59 million over 8 years by the

⁵ A World Bank report indicates that the largest bank in the country (HSBC Bank Armenia) lends only 5 per cent of its liabilities to private business, compared with 60-70 per cent in other countries in the region.

⁶ Most large enterprises keep two books for tax evasion purposes. The minimum collateral level for real estate is 150-200 per cent of the value of the loan.

concessionaire. Moreover, the government commenced reforms in the water system by clearing previous arrears, improving collection rates and ensuring financial sustainability for future operations.

The annual deficit in the energy sector declined from 2.5 per cent of GDP in 2001 to 0.4 per cent in 2002, reflecting the introduction of energy efficiency measures, improved tariff collection rates (from 81 to 90 per cent) and higher tariff levels. The price of electricity is already high in comparison with other CIS countries and it is set to rise further from 25 dram/kwh (US 4.2 cents/kwh⁷) to 30 dram/kwh (US 4.9 cents/kwh⁸) in 2004. Efficiency is likely to improve further, following the privatisation of the distribution and the hydropower (Sevan-Hrasdan cascade) companies. Future relations between the power generators and the distribution company are likely to be increasingly on a direct contract basis and Armenergo, a state-owned intermediate payment clearance company, is likely to be progressively phased out of the system⁸. The dispatching centre has already been separated from Armenergo and operates as an independent unit. Technical and other losses in the sector, however, remain at around 26 per cent of total electricity generated.

The Russian RAO UES has now taken over financial management of the Medzamor Nuclear Power Plant and will be in charge of cash collection to pay for new nuclear fuel supplied from Russia (although old arrears for nuclear fuel remain a state liability). Future prospects for the plant and closure date are unclear.

However, post-privatisation performance has not always been satisfactory. The business community complains about the quality of telecommunications network, especially Internet and mobile services. The government is currently trying to liberalise these markets, removing its monopoly from Armentel, which was privatised to OTE, the Greek state-controlled telecommunications company.

Although significant achievements were made in aviation, the transport sector (especially railways and roads) is relatively underdeveloped and there are considerable investment needs. Recent restructuring and liquidation of the state-owned and loss-making Armenian Airlines has increased competition in the sector through the establishment of two local privately owned air carriers (Armenian International Airways and Aviaservice). The state-owned railroad company's freight operations turned profitable in 2002. Given the limited sovereign capacity, the government, together with the private sector, should continue to enhance commercialisation and private sector participation to ensure financial sustainability in the sector.

2.2.3. Transition Challenges

The following five areas emerge as the key transition challenges for Armenia over the strategy period:

⁷ Using average exchange rates in 2002 and 2003

⁸ Armenergo's accumulated liabilities to fuel suppliers and commercial banks are to be first restructured before it is liquidated. The government is planning to gradually repay/ restructure these and liquidate the company in one to two years.

➤ ***Improving the business environment***

Improvements have been observed in recent years, but the business community continues to complain about obstacles to doing business. Further improvements are needed along all business environment dimensions including streamlining the government's role (e.g. reduction in government inspections, eliminating uneven tax treatment, ensuring improvements in VAT refund procedures for exporters and curtailing excessive tax investigations), addressing weaknesses in the legal and regulatory framework, strengthening the integrity of the courts, and reducing corruption.

➤ ***Deepening financial intermediation***

Further development of the financial sector is needed to improve access to finance for the real economy, in particular long-term funding and financing for entrepreneurs and SMEs. Financial sector consolidation and increased capitalisation should continue to be encouraged. To improve collateral quality, property rights of borrowers and the creditors' rights with regard to collateralised assets must be strengthened.

➤ ***Promoting commercialisation of public infrastructure***

Continued efforts are needed to commercialise/privatise infrastructure enterprises while strengthening/establishing suitable regulatory institutions. The success of ongoing restructuring in the energy sector and recently started commercialisation efforts in the transport sector represent important steps. These should be supported across sectors by further tariff adjustments and improvements in collection rates to ensure commercial viability.

➤ ***Completing privatisation and accelerating post-privatisation restructuring***

Privatisation should be finalised without further delays. Privatisation of remaining large SOEs, particularly in the mining sector, will be a major challenge. Many of the already privatised enterprises have faced difficulties operationally and financially. It is therefore important to ensure post-privatisation restructuring and investments are carried out to improve productivity, quality of products/services, and governance. To this end FDI should be further encouraged with a view to attracting quality strategic investors. For unviable businesses, the enforcement of the bankruptcy procedure needs to be streamlined.

➤ ***Ensuring debt sustainability***

To ensure macroeconomic stability and debt sustainability, the government needs to continue its tight monetary policy, exercise fiscal prudence, and maintain access to finance from the World Bank and the IMF. Prioritisation of public investments, their economic and financial viability, as well as improved tax collection, will be key in this respect.

2.3. Access to Capital and Investment Requirements

Armenia still has substantial investment needs both in the public and in the private sectors. However, access to capital remains limited, except for foreign remittances. For

public sector finance, Armenia remains dependent on financing from bilateral donors, IFIs, and Diaspora funds. Some US\$ 200 million of ODA are granted to the country annually. The United States is the largest bilateral donor, followed by Germany, the EU and Japan. IFI lending is likely to continue, but is subject to further progress in structural reforms and the implementation capacity of the authorities. The domestic public debt market has been developing, although it still represents a minor share of public financing. The government successfully issued 5-year government bonds starting in December 2002 on three occasions.

Armenia has not been rated by internationally recognised credit agencies and the Armenian government and private companies have not been able to access international capital markets by issuing international bonds and/or equity. Most of the private financing comes through FDI. In recent years, net annual FDI has fluctuated around the US\$ 100 million mark. To date there has been a mix of successful investments (e.g., Pernod-Ricard Yerevan Brandy Company, HSBC, Marriott-Hotel Armenia) and a number of projects which encountered difficulties (e.g. Armentel, Nairit Chemical Rubber).

Domestically, private sector access to medium and long-term finance is limited. Domestic credit has declined from 13 per cent of GDP in 2000 to 9.8 per cent in 2002. The banking sector remains underdeveloped and the level of financial intermediation is low. Interest rates have come down significantly over the last two years, but remain high at over 20 per cent and tenors are typically less than one year. Access to bank lending is especially difficult for micro and small/medium sized enterprises, given collateral issues and high interest rates. The domestic capital market is still at the early stage of development. Trading is largely concentrated in treasury bills and short-term government bonds. Market capitalisation is less than 1 per cent of GDP.

3. STRATEGIC ORIENTATIONS

In line with its mandate and experience to date, the Bank will, over the new Strategy period, target primarily the development of the private sector. The Bank's support for the PRSP's implementation will be mainly from the perspective of private sector development and private sector participation in EBRD projects, in recognition of the fact that private sector development is a prerequisite to sustainable progress in poverty reduction. Given Armenia's current external debt position, the Bank does not anticipate pursuing any new infrastructure projects on a sovereign-guaranteed basis, unless these are accompanied by sufficient grant co-financing.

Opportunities for new Bank investments and the quality of the portfolio will depend on the investment climate. The Bank will collaborate with the other IFIs on an intensified policy dialogue with the authorities on measures to improve the business environment, including through legal transition work.

This Strategy does not apply to the disputed territory of Nagorno Karabakh.

3.1. Bank's Priorities for the Strategy Period

The main operational objectives for the Bank will be:

- **Enterprise Sector** – The Bank will focus on further expanding its SME and micro-enterprise financing. Funding will mainly be provided through credit lines to local partner banks and direct equity investments through the Bank’s Direct Investment Facility (DIF). Co-financing and risk sharing with local partner banks will also be introduced. The TurnAround Management (TAM) programme, and the recently established Business Advisory Service (BAS) will be expanded. The Bank will explore the possibility of providing legal transition assistance.
- **Financial Sector** - EBRD will aim to extend further support to existing and additional banks under its Armenia Multi-Bank Framework Facility, and to expand its Trade Facilitation Programme (TFP) with a view to further strengthen financial intermediation. In an effort to address capital adequacy limitations, the Bank will seek suitable equity investment opportunities in local banks. Assistance may be considered for possible mergers and acquisitions in an effort to support the sector’s consolidation. Financing for the growing mortgage market will be pursued through suitable funding instruments and possibilities for engagement with the emerging non-banking financial institutions will be considered.
- **Portfolio monitoring and implementation support** -- given the issues affecting some of the Bank’s public sector projects (e.g. Hrasdan TPP Unit 5 and the Zvartnots Air Cargo Terminal), particular emphasis will be given to proactive project monitoring, also with a view to facilitate constructive solutions to their further development.
- **Infrastructure & State-Owned Public Utilities** – In view of the constraints on the availability of sovereign guarantees for non-concessional financing, operations involving suitable state-owned utilities and infrastructure companies would be considered mainly on a non-sovereign basis, if accompanied by appropriate regulatory and institutional reform.

The Bank will continue to ensure that all EBRD operations in Armenia are subject to the Bank’s Environmental Procedures and incorporate requirements, where appropriate, for Environmental Action Plans in order to address issues identified during due diligence, in line with the Bank’s mandate to actively support environmentally sound and sustainable development through its investment projects.

Armenia has recently made good progress on selected structural reforms. The Bank hopes to leverage on this and further progress by the country in the future, to expand its activities in Armenia.

The Bank has an important requirement for technical assistance and concessional resources to help meet the challenges and opportunities in Armenia. Technical cooperation operations are essential in early transition countries such as Armenia because the Bank has to do much more itself to identify, prepare and implement projects, as well as in terms of meeting institution building needs and to support policy dialogue. Unconventional funding in terms of investment grant cofinancing and other funding schemes is needed for risk sharing, concessionality and affordability. The amounts made available can significantly influence the rate at which EBRD can develop

and implement its activities and find fresh impact. So too will predictability and consistency in funding such needs. The Bank is currently reviewing its instruments to better target the needs of early transition countries and the conclusion of the review will also be applied to Bank operations in Armenia. It will cooperate closely with other international and bilateral institutions in fields such as energy sector development.

It needs to be recognised that on average projects will tend to remain smaller in size even though every effort will be made to identify larger projects. However, the small size of projects will not be a limiting factor for Bank operations, in line with the increased emphasis given by the Bank to activities in early transition countries, and in particular to the number of projects implemented and their transition/demonstration impact.

3.2. Sectoral Challenges and Bank Objectives

3.2.1. Enterprise Sector

The Bank will work to directly or indirectly support private sector enterprises, and in particular to further expand its funding of SMEs and microenterprises, given the importance of this enterprise segment to long-term sustainable development in Armenia.

Opportunities are expected to arise particularly in sub-sectors such as agribusiness, tourism, construction materials, textiles, and information technology, since these are likely to be the main growth industries⁹ The Bank will ensure that appropriate attention is given to the agribusiness sector through its credit lines with the local partner banks, and if necessary will be prepared to provide sector-specific technical co-operation. The mining sector could give rise to significant investment possibilities, if the planned privatisation of some important non-ferrous metals mines is conducted in a fair and transparent manner and attracts credible strategic investors.

The Bank will work with both local enterprises and joint-ventures involving foreign strategic partners, thereby promoting transfer of professional know-how, skills, and much needed FDI. Specific attention will be given to corporate governance and transparency.

More specifically, the Bank will focus on:

- Working with local banks and other financial intermediaries to provide further support for SMEs and microenterprises through credit lines and introduction of

⁹ E.g., TAM projects to date include a furniture company, and two agribusiness enterprises. There are further TAM projects in brewing and IT proposed and awaiting agreements, and projects in textiles, metal furniture, and yarns that are screened and awaiting funding. BAS has now undertaken 13 projects, and the current sign-up rate is 5-6 projects per month. The next BAS project in the tourism sector aims at defining, developing and registering a tourism association around the Lake Sevan area, owned, managed and financed by the tourism industry. The aim is to follow this up with a second BAS project delivered to the association, comprising a market study and promotional strategy for the development and exploitation of the tourism opportunities in the region.

new financing instruments (e.g. leasing). Microfinance in particular will be expanded through enhanced cooperation with micro-business oriented local partner banks.

- Equity investments in local SMEs through the Direct Investment Facility (DIF). It will co-operate closely with local partner banks (as well as TAM) to identify prospective investee companies.
- Co-financing with local financial intermediaries, including through risk-sharing schemes, of medium-sized private enterprise clients to overcome longer-term funding constraints and the local banks' single borrower exposure limits.
- Expanding support for trade transactions, through the Trade Facilitation Programme (TFP).
- Providing direct financing to local private enterprises and joint-ventures with strategic foreign investors, including as part of privatisation and post-privatisation investment projects. This would include participation in the privatisation of infrastructure enterprises and supporting other forms of private sector participation (e.g. concessions). The Bank's contribution could include, subject to adequate commitment by the authorities, technical assistance to the authorities in support of these types of transactions.
- Expanding the Bank's advisory services to the enterprise sector through the recently initiated Turnaround Management Programme (TAM) and the newly established Business Advisory Service (BAS).

In an effort to help improve the business environment, and in close co-ordination with other IFIs and donors, the Bank will explore possibilities for legal transition projects (e.g. secured transactions legislation and creation of registry, improvements to bankruptcy legislation, regulatory reform in the telecommunications sector).

3.2.2. Financial Sector

The Bank will continue to provide financial support to the best local banks in the form of senior debt, and selectively equity, with a view to strengthening the banking sector and financial intermediation. The Bank will seek to play an active role in the development of non-bank financial activities, such as leasing and mortgage financing, provided market conditions allow. The Bank's operational objectives would include:

- Expansion of existing and provision of new lines of credit to local banks under the Armenian Multibank Framework Facility, aimed at SME and microenterprise support.
- Addressing longer-term lending requirements of selected clients of the partner banks via the recently approved risk-sharing facility for early transition countries to promote the funding of medium-sized private enterprises, and to enhance the services provided by the local banks to this segment of the market.
- Equity participation in selected performing local banks and support for the consolidation of the banking sector (i.e., for mergers and acquisitions).

- Enhancing the implementation of the Trade Facilitation Programme by encouraging more active utilisation of existing lines and through inclusion of new participants.
- Identifying new projects in leasing, mortgage finance, and other financial products, subject to the availability of reliable and committed sponsors, supported where appropriate by technical assistance to set up proper legal and regulatory frameworks and for institutional support.
- The Bank will continue its on-going dialogue with local financial institutions on developments in the business environment and the financial sector, to support its dialogue with the government and the Central Bank of Armenia.

3.2.3. Infrastructure & State-Owned Public Utilities

Power and Energy

The Bank signed a sovereign-guaranteed transaction in Armenia for Hrasdan TPP Unit #5 in 1993. However, the work was never completed on this project as cost overruns significantly exceeded funds available. The station remains uncompleted while the state continues to repay the loan. The rest of the Hrasdan complex has recently been sold to Russia (RAO UES) in a debt-for-assets swap, with RAO UES retaining an option on Unit #5. The Bank continues to try to identify grant funds for continued conservation work at this Unit to ensure that it can be completed at a future date should funding become available.

The Bank also agreed in 2001 to invest equity alongside a strategic investor (acceptable to the Bank) for the privatisation of the power distribution companies. However, the eventual successful bidder (Midland Resources) was not considered acceptable to the Bank (as at the time it had no power distribution experience), leading to the cancellation of this project. However, it appears that Midland Resources is currently managing the distribution business reasonably well and is now benefiting from technical assistance from USAID. The World Bank is monitoring the performance of the company closely.

In terms of future activities in the sector, the Bank will therefore:

- Monitor closely developments regarding the debt-for-equity swap on the Hrasdan TPP, which could potentially affect the Unit # 5 project, as well as plans for the phase-out of the Medzamor NPP.
- Work closely with other international institutions and bilateral donors to establish an appropriate mechanism to support the development of renewable energy sources. Armenia has substantial mini-hydro and wind potential, mainly in private hands, and the Bank is developing a debt fund concept to provide long term financing for such smaller size projects. The Bank is also assisting the Regulator in the development and introduction of appropriate tariff methodology to encourage investment in renewables.
- Monitor the performance of the recently privatised Armenian power distribution network with a view to considering participating in the financing of potential investments. The new owner is demonstrating capability to manage the network efficiently and is determining investment needs for the next five years.

- Consider the direct financing of larger independent power generation projects (including those based on alternative energy sources), if these prove bankable and competitive. There are some larger proposed renewables projects such as a wind farm, which the Bank may consider financing provided the tariffs are economic and affordable.
- Through advice based on its experience with similar instruments, co-operate with the EC and other donors on the implementation of the EC Medzamor Decommissioning Fund initiative.

Transport

The Bank may consider providing financing for the investment needs of the railway system with the main focus likely to be both refurbishment and new rolling stock. The Bank's investment would be linked to further commercialisation of railway activities, institutional strengthening, and the further facilitation of international trade.

Prior to independence, Armenia Railways operated a network of 796 km of main track running from Yerevan to Turkey, Iran, Azerbaijan and Georgia. As a result of the conflict only the line from Yerevan to Tbilisi totalling 350 km is open, providing a link to the TRACECA corridor. The railway serves as a lifeline for the importation of bulk goods such as petroleum products and wheat shipped through the Black Sea. The needs of the railway system are considerable for both track renewal and rolling stock and these will increase as borders are opened and links re-established. The former Armenia Railway Corporation has been separated into three operating companies (infrastructure, rolling stock and operations) and for the first time in 2002 freight was profitable.

Telecommunications

The Bank's potential involvement will aim at supporting competition in the sector. The continuation of fixed line exclusivity for Armentel, allied to the ongoing dispute between government and OTE with respect to the latter's shareholding in Armentel, impact negatively upon sector growth and development prospects. Revision of the exclusivity arrangements and a resolution of the dispute are essential prerequisites to effectively addressing the latter. The parties need to endeavour to come to an agreement that will resolve outstanding issues and facilitate early fixed-line competition as soon as possible. The government should also implement a competitive framework for mobile telephony without delay.

In addition, the absence of an independent regulatory body, and consequential lack of appropriate separation of regulatory and policy making functions, continue to negatively impact growth prospects for the telecommunications market. The existence of such a body would do much to enhance investor confidence and provide the appropriate institution spur for sector reform. While the government has promised the establishment of such a regulator on a number of occasions, concrete steps in this direction have yet to become apparent.

As a first step, therefore, should the government get adequate legal authority to liberalise mobile and internet services, and suitable strategic investors be willing to invest, the Bank would be prepared to consider participating in the funding of new

ventures. If the commitment by the authorities can be demonstrated to introduce appropriate regulatory frameworks into the sector (previous technical assistance provided by the Bank was terminated in 2001 as the environment was not conducive to making progress), the Bank would be prepared to consider further technical assistance for regulatory reform.

4. OTHER IFIs AND BILATERAL DONORS

The Bank will continue to co-operate with other IFIs and bilateral donors through co-financing, complementary projects and the close co-ordination of policy dialogue. Close cooperation will be maintained both through the monthly donor coordination meetings attended by the Bank's Resident Office in Yerevan, as well as contacts at working level on a bilateral or multilateral basis as required. The Bank will seek to mobilise increased donor grant financing to support the preparation, implementation and grant co-financing of selected investment projects, as well as policy dialogue on measures to improve the investment climate, including through legal transition work.

The Bank will work closely with the World Bank in coordinating its activities in the energy sector and in the development and implementation of the IBRD's conditionality matrices associated with future Fast disbursing operations to follow upon the approval of the PRSP, particularly from the perspective of private sector development. Consultations will be maintained with the IMF under its PRGF and follow-on programmes. Cooperation with the EC will be continued in a number of spheres, including in terms of strategy development for the South Caucasus, under TRACECA, and in the field of business advisory services. Through advice based on its experience with similar instruments, the Bank stands ready to cooperate with the EC and donors on the implementation of the EC proposed Medzamor Decommissioning Fund initiative. The Bank will work closely with USAID in SME promotion and private sector development, taxation and power sector regulation. Close cooperation with KfW in the financial sector, which has already yielded results, will continue, and be further expanded in the energy sector. Cooperation with other donors will be conducted on an ad hoc basis as needs are identified. In particular, the renewable energy resources fund project will require substantial grant investment cofinancing.

The programmes of the other IFIs and main bilateral donors are as follows:

4.1. International Monetary Fund (IMF)

Armenia became a member of the IMF in May 1992. The IMF has supported macro stabilisation and structural reforms in Armenia with four programmes: a systemic transformation facility (February 1994), a one-year stand-by-arrangement (June 1995) and the three-year Enhanced Structural Adjustment Facility (February 1996), and the current Poverty Reduction and Growth Facility (PRGF), which totals SDR 234.9 million. In May 2001, the IMF approved the PRGF worth SDR 69 million (US\$ 95 million). Despite some delays, Armenia's relationship with the IMF is generally good. The disbursement of the fourth tranche was delayed due to on-going discussions with the authorities on the tax system. The Executive Board discussion is tentatively scheduled for 24 November 2003 and the next review of the programme is expected by end April 2004.

4.2. World Bank Group

The World Bank is active in Armenia mainly through the International Development Association (IDA), its concessional lending arm.¹⁰ As of January 2003, the World Bank group approved 29 IDA credits, one IBRD loan and three IFC investments, with a total of US\$ 704 million (of which US\$ 511.2 has been disbursed). 19 projects are under implementation while 12 projects have been completed. The areas of activities include infrastructure rehabilitation (including support for earthquake reconstruction, irrigation, power, road maintenance, and municipal water), social sector (health, education, and a social investment fund), agriculture, energy, financial sector and the business environment. In recent years the focus has perceptibly shifted to address poverty alleviation. Four structural adjustment credits (SACs) have been completed by the end of 2002, totalling US\$ 235 million. Currently SAC V (US\$ 40 million) is under implementation aiming to develop the private sector, promote public administration, and make progress in social sector reforms. US\$ 20 million has already been disbursed upon approval and the second tranche is scheduled in late 2003. The World Bank is currently preparing six projects in the urban heating, water, health, education and legal sectors, totalling US\$ 65 million. A new Country Assistance Strategy (CAS) for the financial years 2004 to 2006 is due in March 2004.

Armenia has been a member of the International Finance Corporation (IFC) since 1995. IFC made a first investment in 2000, providing US\$ 3.6 million in equity finance to Hotel Armenia. IFC is also providing donor-funded technical assistance to improve the investment environment by promoting modern corporate governance practices, including legislative amendments. IFC recently completed two investments, helping to establish the Armenia SME Fund (a private equity fund to channel investments from the Armenian Diaspora into equity investments in local companies and a private leasing company).

4.3 The European Union

Over the period 1991-2002, Armenia has received grant assistance of over € 330 million from the European Community. About two thirds of this amount has been devoted to humanitarian assistance, food aid and food security, a quarter has been channelled through TACIS, and over € 20 million has been allocated for nuclear safety. In addition, the EC has provided € 86 million in loans. Moreover, Armenia has benefited from regional programmes such as TRACECA and INOGATE. If EU member states contributions are included, total EU assistance is well in excess of € 500 million. The current framework for EC assistance is the Country Strategy Paper (CSP) 2002-2006 which is based on the objectives of the Partnership and Co-operation Agreement signed in 1996 and on the Poverty Reduction Strategy Paper recently agreed by the Armenian government. The budgetary support of around € 10 million per annum provided by the EC Food Security Programme is contributing to the implementation of key structural reforms in the agricultural and social sectors and to improved delivery of certain government programmes in line with PRSP orientations. Within the framework of the CSP, the TACIS Indicative Programme 2004-2006 has been adopted by the European Commission in September 2003. The main pillars of the programme are (i) support for institutional, legal and administrative reform (including legal advice, assistance to customs and statistics, energy policy reform, local government decentralisation/reform

¹⁰ IDA eligibility for fiscal year 2004 is \$865 (2002 GNI per capita).

and regional development and civil society) and (ii) measures to address the social consequences of transition (focusing on poverty alleviation via agricultural and social protection policies, education and vocational and technical training). Its indicative budget for 2004-2006 is € 20 million. The EU and Armenia are continuing their discussions on the closure of the Medzamor Nuclear Power Plant (MNPP). The EU is ready to support Armenia in finding alternative power supplies and in this regard is consulting with other donors with the aim of creating a fund to help finance such replacement capacities. The EC is ready to contribute up to € 100 million to such a fund as soon as agreement is found on a closure date for the MNPP. The EC is currently funding the EBRD's TAM and BAS activities in Armenia.

4.4. Main Bilateral Programmes

United States

USAID have one of the most extensive bilateral programmes in Armenia totalling some € 1.3 billion over the period 1991 - 2002. The US has also traditionally been a source of substantial humanitarian aid. The USAID Armenia Programme 1999-2003 centres around six focal areas: (i) private sector development (including *inter alia*, technical assistance on commercial law, taxation, customs reform in light of Armenia's recent WTO membership, privatisation and support for SMEs); (ii) energy sector; (iii) democracy; (iv) social transition; (v) water management and (vi) special initiatives. In financial years 1997 to 2003, USAID assistance to Armenia ranged between US\$ 50 million and US\$ 70 million a year, with the emphasis shifting gradually from private sector development and the energy sector support more to the social spheres of co-operation.

Germany

Germany and Armenia cooperate both technically and financially and for the period 1993-2002, this cooperation amounted to € 118.19 million. Germany's bilateral programme has had a strong focus on SMEs. GtZ, through the Pro-SME initiative, has provided technical assistance at the macro level (e.g. legal reform and assistance to the government), medium level (support for SME promotional organisations, including training), and the micro level (direct support for SMEs). KfW, in the meantime, has provided SME finance through the German Armenian Fund to the National Bank of Armenia, which currently stands at € 12.3 million. An additional € 4.5 million are being committed in 2003. The programme is supported through a € 0.5 million TC component. Two guarantee programmes have recently been also committed for € 3.8 million each to support refinancing in favour of local commercial banks by their German counterpart banks. Assistance for the establishment of a deposit insurance scheme of up to € 4 million (€ 3.5 million loan and € 0.5 million grant) is contemplated.

United Kingdom

The main counterpart for co-operation with Armenia is the Department for International Development (DFID). During the period 1993 – 1997 the annual assistance extended averaged € 10 million. DFID's direct assistance amounted to € 3.1 million in 1998-2001 and was set to increase to € 3.7 million by 2003. DFID's work concentrates on helping Armenia address problems of poverty through support to the PRSP process. In this context DFID supports the Armenian government's Public Sector Reform Programme

(in co-operation with the EU and the World Bank) and its Medium Term Expenditure Framework. DFID has also been the major donor supporting the 2001 census. DFID planned to allocate about € 12 million over the five-year period 2002-2007 for social and economic development as well as regional administration reform programmes in selected regions of the country.

Japan

Japan began its bilateral assistance (ODA) to Armenia in 1991. A total of US\$ 27.7 million has been disbursed at the end of 2001, consisting mainly of US\$ 21.6 million of grants and US\$ 5 million of technical assistance.

Implementation of a JPY 5,400 million loan for an electricity transmission and distribution network project began in 2001. The largest grant aid project to date is a JPY 518 million donation, committed in 1999, to upgrade medical equipment at the Armenian Republic Medical Centre.

The priority areas of Japanese assistance are (i) consolidating the basic economic structure, (ii) the energy sector, (iii) transport infrastructure, (iv) improvement of the irrigation and water supply systems, and (v) the social sector (health and medical care, education, and mitigating hardships faced by the unemployed and the low-income population)

POLITICAL ASSESSMENT

Compliance with Article 1

Armenia is committed to the principles of multiparty democracy, pluralism and market economics in accordance with the conditions outlined in Article 1 of the Agreement Establishing the Bank; however application of these principles in the previous Strategy period has been uneven. In particular, questions regarding the conduct of presidential and parliamentary elections in 2003, media freedom and rule of law are a source of concern. Since independence, Armenia had built a strong record of progress on democratic reform which led to their accession to the Council of Europe in 2001. The newly-elected authorities have an opportunity to return to that political course, which would restore public trust and underpin the policy steps needed to address the country's remaining transition challenges.

Political Accountability

Political leaders in Armenia are held accountable through the constitutional provisions for a separation of powers and regular, contested elections. However, in practice checks and balances in the political system could be further strengthened and electoral practices fall short of international standards.

The President of Armenia continues to hold extraordinary executive authority, which limits the ability of other institutions of governance to set the political agenda, contribute to policy debates and check abuse of power. The President forms the Cabinet and can dissolve the legislature, and also retains the right to appoint regional governors and the mayor of Yerevan. In accordance with a revision to the electoral law adopted in 2002, the President received direct authority to appoint one-third of members of national and sub-national election commissions, enhancing his influence over the electoral process. Constitutional reform that would redistribute political power between the President and the Parliament was actively debated in the past two years, but a referendum on the matter in May 2003 (drafted by the Presidential administration) failed due to low turnout on election day.

Efforts to strengthen the political party system took a step forward with two reforms adopted in mid-2002. Toughened regulations for political party registration, requiring that parties have at least 200 members and branches in at least one-third of Armenia's regions, should help to reduce the number of frivolous parties contending for votes in national and local elections. The revised Law on Elections also increased the number of seats to be filled in the 131-seat Parliament by party lists from 56 to 75. This should provide a further incentive for political party development, as well as enhancing the professionalism and policy making functions of parliamentary factions.

The conduct of recent Presidential and Parliamentary elections represents a departure from the positive trends noted in previous elections. The two rounds of the Presidential election on 19 February and 5 March 2003 were heavily criticised by the OSCE/ODIHR Election Observation Mission (EOM), which concluded that the "presidential election in

the Republic of Armenia fell short of international standards for democratic elections.” The Final Report specifically noted “serious irregularities” in the key areas of voting, counting and tabulation, including “widespread ballot box stuffing.” The conduct of the election was also condemned by the political opposition, which organised large-scale public protests after the first round that were broken up by the police following the arrest of over one hundred people.

The OSCE/ODIHR observation mission criticised the authorities for contributing to a campaign atmosphere of intimidation, widespread use of public resources for the campaign of the incumbent, and biased reporting by State-owned television stations. The EOM report made reference to several shortcomings in the legal framework and election administration, but concluded that, on balance “the failure of the 2003 presidential election to meet international standards lay not in technical or procedural lapses, but in a lack of sufficient political determination by the authorities to ensure a fair and honest process.”

The Parliamentary election in May 2003 marked an improvement over Presidential voting, according to the OSCE/ODIHR and Council of Europe, but in the end “failed to meet international standards in several key areas.” This included falsification of results, intimidation of observers, and violations of the secrecy of the ballot during military voting. The observation team also noted that low turnout in the Parliamentary election of 53 per cent of registered voters should be seen as “a clear indication of the lack of voter confidence in the electoral process and political institutions in the country.”

The lack of public confidence in political institutions is also reflected in declining civic activism. The laws regulating the activities and registration of civil society organisations create an adequate framework for development of this sector, although they are described by many organisations as cumbersome. At end-2002, approximately 2,800 NGOs were officially registered in Armenia, about one third of which had been registered in the previous year. However, the majority of these organisations, which cover a wide range of activities, are in fact not operating in practice. Those that do function are able to exercise only a modest influence on the policy making process. One exception where civil society groups have been active is in election monitoring. Around thirty organisations were accredited by the Central Election Commission as official domestic observers for both the Presidential and Parliamentary elections in 2003, the largest of which – an NGO called “Its Your Choice” – deployed observers at nearly 700 polling stations on election day.

Rule of Law

Rule of law is at the top of the political agenda in Armenia, and a number of reforms intended to meet Council of Europe membership standards and facilitate investment have been introduced in recent years (see Section 3.1 and Annex 3 on legal developments). However, the independence of the judiciary and the General Prosecutor’s office, and integrity of the courts are still questioned by a large part of the population and by international donor organisations. Constitutional reforms to strengthen the independence of the judiciary have been put on hold following the failure of the referendum in May 2003 and donors have curtailed their judicial and court reform programmes due to lack of progress in these areas.

The public's attention to rule of law problems is high, as shown in recent surveys conducted by Transparency International (TI). In a 2002 "Country Corruption Assessment" conducted by TI Armenia, institutions where corruption was perceived to be highest were the General Prosecutor's office and the courts. Out of 1,000 households surveyed, more than 750 said they found the courts to be very corrupt or extremely corrupt. The public's concern is reflected in the fact that two leading parliamentary factions go by the name "Rule of Law" party and "Justice Bloc".

According to the TI Corruption Perceptions Index (CPI) for 2003, Armenia ranks 78th out of 133 countries with a CPI score of 3.0 out of 10 (where 10 is the best possible score). This places it right in the middle among transition countries and second from the top among CIS countries. However, the score on its own reflects a still serious corruption problem which the authorities have yet to tackle effectively. The government has been working with the international donor community on a national anti-corruption strategy for over two years, and a programme was adopted in November 2003. A financial disclosure law for public officials came into force in 2002, promising to increase transparency and cut down on conflict of interest. However, in practice the law has been poorly enforced. On a more optimistic note, levels of bribery by businesses as reported in the 2002 Business Environment and Enterprise Performance survey have come down, and recent reforms in tax and customs administration, civil service and de-regulation may have contributed to this positive trend.

Civil and Human Rights

Armenia's constitution guarantees basic democratic rights and freedoms, which are generally upheld in practice. Armenia was admitted into the Council of Europe in 2001, and in April 2002 Armenia ratified the European Convention on Human Rights. However, several problems in the legal framework, enforcement of national laws and international conventions have been noted by the international community. For example, national law prevents abuse of child labour and the law is respected in practice, but Armenia has not ratified the International Labour Organisation Convention 182 on the worst forms of child labour. A second problem is in the area of human trafficking, which is not specifically prohibited by law. The International Organisation for Migration reports that approximately 700 women and girls are trafficked abroad each year, mainly to act as prostitutes. Reports of corruption among police officers, border guards and customs officials only exacerbates the problem. Following pressure from the international community and national NGOs the Government is now focussed on the problem of trafficking more intently.

A significant problem area in the previous Strategy period was freedom of expression. While many independent media organisations continue to function, Armenia has come under heavy criticism by the OSCE, Council of Europe and various international media and human rights NGOs for its recent treatment of press organisations and journalists. This includes the use of criminal libel laws to stifle media criticism of government policies, a controversial media bill that will force media organisations to reveal their sources of funding, the closure of a major independent television station, and several cases of violence against journalists. The Law on TV and Radio grants the President the power to appoint nine members of the commission that grants licenses, which has resulted in some independent stations which have been critical of the government – such

as A1+ and Noyan Tappan – losing their licence. As a result of these developments, in 2003 Freedom House downgraded Armenian media from ‘Partly Free’ to ‘Not Free’.

External Relations

The unresolved conflict with Azerbaijan over Nagorno-Karabakh still constitutes the main challenge in Armenia’s foreign relations, resulting in the country’s continued partial isolation in the region. The OSCE Minsk process has actively sought to bring the two sides to a resolution, but the elections in 2003 in both countries have created domestic political obstacles to progress. With the election cycle over, attention will now turn to reinforcing domestic political stability in each country and, hopefully, energising the negotiation process.

The newly elected authorities are committed to retaining a balanced foreign policy, which seeks to promote friendly relations with the major powers with interest in the region – the US, EU, Russia and Iran. Armenia’s strategic alliance with Russia was further strengthened in the past year with the finalisation of a debt-for-equity deal that transferred 100 per cent ownership in five Armenian companies to Russia in exchange for a cancellation of Armenia’s \$94 million debt. Russia and Armenia are co-signatories in a mutual defence pact, and Russia maintains military bases in Armenia. Relations with Turkey, meanwhile, remain strained due to the unresolved conflict over Nagorno-Karabakh and differing interpretation of the events of 1915. Nevertheless, there have been talks in the past year of opening the border which would be a major boon to Armenia’s trade.

ENVIRONMENTAL ISSUES

1. Key Environmental Issues

- Land contamination from toxic chemicals: in 1996, 200 test samples were analyzed with the purpose of revealing chemical contamination. In one of the samples an excess of pesticides and in the other two - excess of heavy metals were detected. The results of the analysis of 17 test samples were beyond the normal or acceptable bacteriological limit, the other 20 test samples showed excess of helmit contents. The analysis carried out in Yerevan showed a widespread heavy metal contamination and extreme pollution.
- Deforestation: the forest resources of Armenia were mostly damaged starting from 1930s when industrialization and collectivization processes began and has been particularly exacerbated by the energy crisis of the 1990s when citizens scavenged for firewood. Forest degradation continued in last years, particularly in mostly forested areas close to the border with conflict zone.
- Desertification: the problem of desertification and the organization of measures to combat it are extremely urgent in Armenia, which is located in an arid area. One half of the territory of the country is subject to mudslides, which aggravate the processes of desertification. The processes of defluction and landslides are also pervasive. The anthropogenic impact on the landscape causes intensified soil erosion and salinisation. While Armenia's land amount is limited, a solid outflow from rivers outside its frontiers removes more than 4 million tons of fine soil and solutes. As a result of all this, every year thousands of hectares of arable land become unusable and forest and grazing areas are reduced.
- Pollution of Hrasdan (Razdan) and Aras Rivers: all industries discharge their wastewater either into the municipal sewage or directly into the rivers or reservoirs. Within the recent 9 years the industrial capacity has declined by 80-90 per cent thus eliminating any undesirable impact on the environment. The risk of water contamination also applies to all the legal and illegal solid waste landfills and deposits, where obviously a lot of hazardous waste has been stored. The consequences of contaminating rivers and lakes in the past have not been studied yet.
- Preventing the draining of Lake Sevan: as a result of its use for irrigation and the diversion of water to hydroelectric plants to compensate for the electric power lost through the inactivity of the nuclear plant at Medzamor. Since 1933 the outflow from the lake has been artificially increased. The water has been used for irrigation and electricity. Decreasing water-levels have affected both the ecosystem of the lake, its physical conditions (temperature, transparency) and biological conditions from phytoplankton to the fish community. It is however anticipated that an additional inflow of water from another aquifer to the south east of Sevan will shortly be on line.

- Controversial Medzamor Nuclear Power Plant (NPP): located in a seismically-active zone; the power plant, with two reactors and a combined capacity of 815 MW, was shut down in March 1989 by the Soviet Union because of safety fears following the devastating earthquake that struck Armenia in December 1988. However, faced with a deepening energy crisis due to the country's lack of fossil fuels and the economic blockade imposed by Azerbaijan and Turkey, on November 5, 1995, Armenia decided to resume operation at the 440-MW second unit. The plant, which was built in 1980 with a design life of 30 years, now supplies between 40 per cent and 45 per cent of the country's electricity. The EC, however, considers Medzamor to be a safety risk due to flaws in the plant's Soviet-designed reactors and the region's seismic activity, and is encouraging Armenia to shut the plant. The Armenian government has indicated its readiness to decommission the plant, provided the country has sufficient alternative energy sources by that time.

2. Activities of the World Bank and UNDP in the Sector

UNDP:

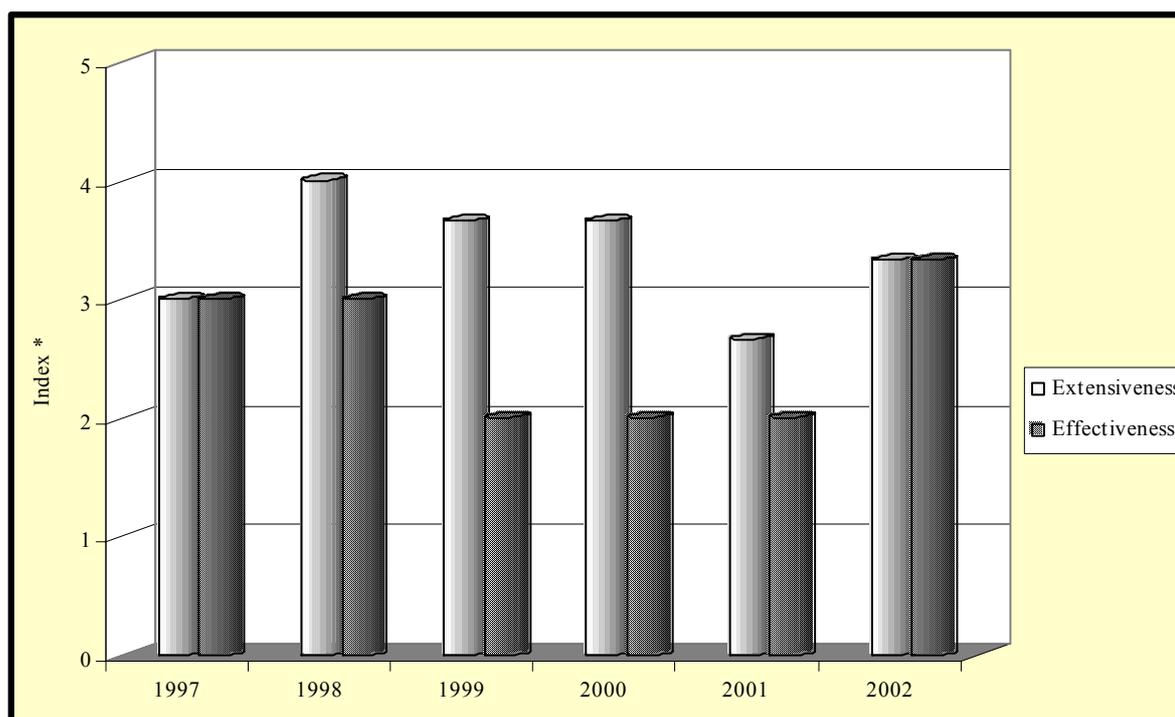
- Implementing the UN Convention on Struggling against Desertification - this project was launched in June 2003. The aim is to restore selected land areas subjected to desertification.
- The Environmental Rehabilitation Component of the Integrated Support to Sustainable Human Development project - aims at building the capacities of the regional forestry institutions and communities to carry out reforestation in the Lori Region.
- The Sewage Treatment and Water Supply project - planned to improve legislation and the regulatory framework for the protection of water resources and to undertake a feasibility study on sewage water treatment.

World Bank:

- Natural Resources Management and Poverty Reduction project - the objective of this project is to improve management of the natural resources base to enhance sustainable economic growth of poor rural communities in priority watersheds. The project will (a) develop and implement participatory micro-watershed management plans in selected local communities; (b) support implementation of on-site technical packages that would promote conservation of biodiversity and natural resources while generating also economic benefits to local communities; and (c) strengthen the capacity of local institutions responsible for natural resources management.
- Municipal Development project - this project aims at providing short-term emergency improvements in the drinking water supply system in Yerevan, improving the efficiency, management, operation and delivery of water and water services for the Yerevan area, and laying the basis for the sustainable involvement of the private sector in the management of these services.

LEGAL TRANSITION

Assessment over Time

Extensiveness and Effectiveness of Armenia's Commercial Law¹¹

Source: OGC Legal Indicator Surveys; 1997 – 2002

*Note: Indicators along the y axis range from 1 (little progress) to 5 (substantial progress)

While the quality of Armenia's commercial laws has been perceived as relatively stable over the last 6 years, these laws still fall short of standards that are generally acceptable internationally. Those legal rules are neither as clear and accessible nor as adequately implemented administratively and judicially as would be the case in more developed countries. Despite the apparent progress recorded in the perception of local practitioners in 2002, the systemic nature of the gap between extensiveness and effectiveness of

¹¹ The EBRD conducts a Legal Indicator Survey each year to measure the progress in legal reform in Central and Eastern Europe, the Baltic States and the Commonwealth of Independent States, as viewed by local lawyers and academics. The results of such survey are based on responses to the questionnaire sent out to lawyers practising in any given country. The survey represented their perception of the country's legal system and, in particular, the degree to which key commercial and financial laws have reached internationally acceptable standards (extensiveness) and to which extent these laws are implemented and enforced (effectiveness). The survey is based purely on local lawyers' perception of their own country legislation and does not represent EBRD's own view on these legal systems. In addition, it must be noted that each respondent is asked to answer the questionnaire for his/her country only, and not on a comparative basis.

commercial laws suggests that more attention and resources need to be directed towards building effective institutions.

Based on the OGC's 2002 Legal Indicator Survey, which measured the perception of lawyers familiar with Armenia, the commercial laws of the country can be characterised as "barely adequate" for supporting investment and other commercial activity.

LEGAL SECTOR ASSESSMENT

Bankruptcy

Bankruptcy in Armenia is governed by the Law on the Bankruptcy and Financial Reorganisation of Legal Entities, Enterprises Lacking Legal Entity Status, and Entrepreneurs (the "LB"), adopted on 3 December 1996. Although the LB contains a large number of provisions desirable in a modern bankruptcy and reorganisation law, it is still defective on some particular points and its effective implementation in practice should be improved.

Overall, the LB provides for liquidation and distribution of net proceeds to creditors or, alternatively, rehabilitation of a debtor through a court approved reorganisation plan. The LB accords first priority to the claims of secured creditors, which conforms to prudent commercial practice. However, it makes no mention of costs to preserve and sell secured assets. Provisions that clearly provide authority to recover reasonable costs of sales and limit other incidental costs are needed.

At present, no protection is provided for unsecured creditors who did not vote in favour of a rehabilitation plan. Moreover, administrator compensation being extremely low, it is generally insufficient to attract the appropriate calibre of professionals with the level of skill and resources necessary to conduct professionally run liquidations. There is an incentive on the part of bankruptcy administrators to slow down the proceedings in order to keep their income stream. Consequently, bankruptcy cases can linger on indefinitely.

Capital Markets

The primary legislation governing the securities market in Armenia is the Law on Securities Market Regulation enacted in 2000 (the "SMRL"). The SMRL was drafted with technical assistance provided by USAID. The SMRL deals with the issuance, registration and public trading of securities. The SMRL also contains rules governing the activities of professional participants in the securities market, self-regulatory organisations (including Central Depository) and stock exchanges. More importantly, under the SMRL, the Securities Commission of the Republic of Armenia (the "SCA") was established in August 2000 as the principal regulator for the securities market. The SCA has five Commissioners appointed by the President of Armenia for a term of five years. The National Assembly has the power to approve the annual programme, budget and subsequently the annual report of the SCA each year. The Armenia Stock Exchange ("Armex") was formally registered under the SMRL by the SCA as a self-regulated organisation in February 2001. Armex is a membership-owned self-regulated organisation based on the principle of "one member – one vote".

The insurance sector is regulated by the Law on Insurance adopted in November 1996. The principal regulator for the insurance industry is the Ministry of Finance and Economy. There are no restrictions on reinsurance or on foreign insurance companies establishing a business in Armenia. A draft Law on Non-State Pension Funds is currently being considered by the government.

Company Law and Corporate Governance

The current Law on Joint-Stock Companies (the “JSCL”) was promulgated in 2001. According to the JSCL, a joint-stock company (“JSC”) may be of closed or open type. A JSC is deemed open if its shareholder has the right to transfer its shares without the consent of other shareholders in the company. In a closed JSC, the number of shareholders cannot exceed 49. A JSC is subject to state registration according to the Law on State Registration of Legal Entities and a company is deemed created from the time of its state registration. Every company is required to maintain a shareholder registry. According to Article 47 of the JSCL, shareholders have a general right of first refusal on new shares commensurately with their existing shareholding in the company for a period stipulated by the company charter, except in special cases provided for by the same article.

According to the 2002 results of the EBRD’s Corporate Governance Sector Assessment Project, Armenia is a country where the current corporate governance related laws (i.e., “law on the books”, as opposed to how the relevant legislation is being implemented) when compared to the OECD *Principles of Corporate Governance* were assessed as relatively sound, which compares favourably with other countries in the region where the Bank operates. This result comes as no surprise since the IFC assisted the country with a comprehensive Corporate Governance Project from 1999 to 2001. This project played an important role in introducing the concept of corporate governance in Armenia by working not only with the public sector but also with the private sector in advocating good corporate governance standards. However, despite having good law on the books, Armenia still has a long way to go before it can claim victory in fostering good corporate governance practices. Many companies in the country have not registered their shareholders properly or have not transferred their shareholder registration to the required central registrar (i.e., the Central Depository of Armenia); many companies have never held a general meeting of shareholders; and problems of insider trading and asset stripping by major shareholders are rampant. Therefore, two major areas of reform which merit the attention and action of the government of Armenia are the raising of shareholders’ awareness on their rights in general and the enhancement of enforcement powers of relevant regulatory agencies (e.g., the Securities Commission of the Republic of Armenia).

Concessions

Armenia does not have a comprehensive concessions framework law applicable to infrastructure, municipal utilities and public services. However, over the last two-year period, Armenia has passed a few acts, notably the law on concessions in the mining industry. The law on concession of subsurface for purposes of mineral prospecting and mining (the “LCSP”) was signed at the end of 2002 and enacted 1 April 2003. It is a fairly detailed piece of legislation which regulates mineral rights, provision of licences

and contracts in the industry, and which is expected to facilitate investment into the sector.

According to recent reports, pursuant to the LCSP, a concession agency will be created within the Ministry of Trade and Economic Development. The agency is expected to be dealing with the granting of mining rights and supervising the use of those, and generally represent the government. By way of implementing the requirements of the LCSP, the government has also approved model templates of agreements.

In addition to the mining sector, on a sub-law level, regulations exist that govern water industry contracts, including the use of assets and their pledging as collateral for leasing and concession contracts.

Some general rules for private sector investors' involvement in the public sector may be found in the civil code and the law on foreign investments.

Secured Transactions

On 1 January 1999, the new civil code of the republic of Armenia entered into force. Articles 226-272 deal with the law on charges over movable and immovable assets. The 1995 law on pledge was repealed. There are currently two main types of security rights over movable assets under Armenian law: possessory charges where the collateral is transferred to the lender, and non-possessory charges. Non-possessory charges can be registered if the parties wish so (in practice, this is recommended).

The scope of assets that can be offered as collateral remains limited since the Civil Code does not allow for general description of collateral or the charging of a fluctuating pool of assets, except in the case of charges over commodities in circulation (e.g., stocks of goods, raw materials, supplies, semi-fabricates, etc). Even so, the total value of those commodities must remain constant and the borrower must keep records of all changes in the composition or the natural form of the assets, including their processing. Should the borrower fail to do so, the lender would have the right to place signs over the goods to prevent their further use. Therefore, inventories and other types of property, which may also be subject to constant change (such as equipment) may not practically be used to secure a debt. Moreover, assets like accounts receivables are also excluded.

A major problem that creditors face when taking security in Armenia is the lack of reliable publicity. Since only charges on specific types of assets must be registered (especially over means of transport and shares), parties are free to choose whether or not to register the charges, and lenders cannot ascertain whether the borrower has or not previously charged his property. A limited registration process is available for security over vehicles (at the State Auto Inspection but it is not mandatory and its effectiveness is uncertain) and over shares (in the shareholders registry of the company).

The 2003 EBRD Legal Indicator Survey which assessed the efficiency of enforcement of charges in EBRD countries of operations showed that the enforcement is highly uncertain and fraught with difficulties. Although parties could in theory agree on the mode of enforcement such as a direct sale of the collateral, evidence shows that this is very unlikely to be implemented.

Telecommunications

The telecommunications sector is currently regulated by the Ministry of Post and Telecommunications and is governed by the Telecommunications Law of 1998 (the “LT”). The LT, which granted the Ministry of Post and Telecommunications responsibility for overall regulation of telecom services, also provided a new legislative and regulatory framework for the sector. The LT further provided for the establishment of an independent telecommunications regulator; however such a body has yet to be established.

Armentel, the country’s national telecommunications provider, is currently 90 per cent owned by OTE of Greece. In March 1998, OTE of Greece paid US\$142.5m for their stake in Armentel and, as part of that purchase, Armentel was granted a 15-year monopoly in the provision of almost all telecommunications services in Armenia, including public switched telephony services and mobile telephony, until 2013. This monopoly was, however, declared unconstitutional by the Armenian Constitutional Court in 1999 and, amid international pressure (including from the EBRD), Armentel’s monopoly over mobile telephony was subsequently reduced. While the mobile telephony monopoly was reduced from 15 years to five years (i.e. until 2003) the Armenian government (the “government”) appears to have so far failed to license competing mobile operators, or done anything to initiate appropriate change within the fixed-line market.

Upon purchase of their share in Armentel, OTE made commitments for Armentel to invest more than US\$265m into the Public Switched Telephone Network within five years, starting in 1999. The government has been disputing OTE’s claims at fulfilment of this obligation, resulting in a long running dispute between the parties. This dispute and, *inter alia*, slow movement on issues related to the rebalancing of tariffs has resulted in sour relations between the government and OTE. The dispute continues to retard sector development and growth prospects and its resolution can be seen as an essential pre-cursor to meaningful sector growth and development. The parties should endeavour to come to an agreement in this regard as soon as possible.

An equally pressing issue remains the lack of separation of the regulatory and policymaking function within the telecommunications sector in Armenia. While there has been a separation of operational and regulatory functions within the sector, the establishment of an independent regulatory body to take over the regulatory functions from the Ministry of Posts and Telecommunications is still eagerly awaited. The absence of such a body continues to negatively impact upon the growth prospects for Armenia’s telecommunications market. The existence of such a body would do much to enhance investor confidence in Armenia and provide the appropriate institution machinery to effect badly needed sector reform. While the government has promised the establishment of such a regulator on a number of occasions, concrete steps in this direction have yet to become apparent.

ANNEX 4

SELECTED ECONOMIC INDICATORS

	1995	1996	1997	1998	1999	2000	2001	2002	2003
								Estimate	Projection
Output and expenditure									
	<i>(Percentage change in real terms)</i>								
GDP	6.9	5.9	3.3	7.3	3.3	6.0	9.6	12.9	12.0
Private consumption	9.0	3.8	7.3	5.3	1.4	5.9	15.2	5.8	na
Public consumption	0.2	-2.4	-2.3	-2.2	1.3	-0.3	3.3	-3.2	na
Gross fixed capital formation	-17.3	10.3	2.1	12.0	0.6	8.7	24.8	19.9	na
Exports of goods and services	-7.8	-9.7	28.9	8.9	6.5	16.6	20.8	25.0	na
Imports of good and services	-10.3	-5.5	24.4	5.0	-8.1	5.1	1.2	9.4	na
Industrial gross output	1.5	1.4	0.9	-2.5	5.2	6.4	3.8	14.2	na
Agricultural gross output	4.7	1.8	-5.9	13.1	1.3	-2.3	11.6	4.4	na
Employment									
	<i>(Percentage change)</i>								
Labour force (annual average)	-0.8	0.1	-2.8	-4.0	-0.9	-1.0	-2.5	0.3	na
Employment (annual average)	-0.8	-2.8	-4.4	-2.5	-2.9	-1.6	-1.0	1.4	na
	<i>(In per cent of labour force)</i>								
Unemployment (annual average) 1/	6.7	9.3	10.8	9.4	11.2	10.6	9.8	9.5	na
Prices and wages									
	<i>(Percentage change)</i>								
Consumer prices (annual average)	175.8	18.7	14.0	8.7	0.7	-0.8	3.2	1.2	4.2
Consumer prices (end-year)	32.2	5.8	21.8	-1.3	2.1	0.4	3.0	2.0	4.4
Producer prices (annual average)	275.4	22.4	19.0	13.4	2.3	0.8	-0.4	2.5	na
Producer prices (end-year)	38.3	9.6	12.4	8.2	3.8	0.4	-4.3	0.9	na
Gross average monthly earnings in economy (annual average)	243.6	45.7	37.8	31.0	19.2	22.5	5.4	8.1	na
Government sector 2/									
	<i>(In per cent of GDP)</i>								
General government balance (commitment basis)	-9.0	-8.5	-5.8	-4.9	-7.4	-6.3	-3.8	-0.6	-2.0
General government expenditure	28.9	26.1	25.5	25.6	30.1	25.9	20.8	19.5	na
Monetary sector									
	<i>(Percentage change)</i>								
Broad money (M2, end-year)	na	na	8.7	23.3	-2.2	36.3	10.8	15.4	na
Domestic credit (end-year)	68.0	27.8	6.3	60.8	7.7	22.2	-3.9	2.9	na
	<i>(In per cent of GDP)</i>								
Dram broad money (M2, end-year)	na	6.5	5.8	6.0	5.7	7.4	7.2	7.2	na
Interest and exchange rates									
	<i>(In per cent per annum, end-year)</i>								
Refinancing rate	52.0	60.0	54.0	39.0	43.0	25.0	15.0	13.5	na
Money market rate 3/	na	48.6	36.4	27.8	23.7	18.6	19.4	12.3	na
Deposit rate 4/	63.2	32.2	26.1	24.9	27.4	18.1	14.9	9.5	na
Lending rate 4/	111.9	66.4	54.2	48.1	34.5	28.6	27.7	23.4	na
	<i>(Drams per US dollar)</i>								
Exchange rate (end-year)	402.0	435.1	495.0	522.0	523.8	552.2	561.8	584.6	na
Exchange rate (annual average)	405.9	414.0	490.8	504.9	535.1	539.5	555.1	573.4	na
External sector									
	<i>(in millions of US dollars)</i>								
Current account	-218	-291	-295	-403	-307	-278	-201	-176	-163
Trade balance	-403	-469	-559	-577	-474	-464	-420	-380	-362
Merchandise exports	271	290	234	229	247	310	353	516	583
Merchandise imports	674	760	793	806	721	773	773	896	945
Foreign direct investment, net	25	18	52	221	122	104	70	110	135
Gross reserves (end-year), excluding gold	100	171	243	298	305	314	329	439	na
External debt stock	387	533	679	787	855	862	905	1,025	na
	<i>(In months of imports of goods and services)</i>								
Gross reserves (end-year), excluding gold	1.5	2.1	2.9	3.9	3.8	3.8	3.6	4.5	na
	<i>(In per cent of exports of goods and services)</i>								
Debt service	20.9	20.3	14.2	19.0	14.3	10.7	9.7	10.2	na
Memorandum items									
	<i>(Denominations as indicated)</i>								
Population (end-year, millions) 5/	3.1	3.2	3.1	3.1	3.1	3.1	3.1	3.0	na
GDP (in bn of drams)	522.3	661.2	804.3	955.4	987.4	1,033.3	1,177.2	1,357.0	na
GDP per capita (in US dollars)	408.9	507.0	522.2	605.1	589.8	615.4	679.8	788.9	na
Share of industry in GDP (in per cent)	24.2	23.8	23.9	21.6	21.5	22.0	20.2	20.5	na
Share of agriculture in GDP (in per cent)	40.7	33.0	30.4	30.8	25.4	22.5	25.5	23.1	na
Current account/GDP (in per cent)	-17.0	-18.2	-18.0	-21.3	-16.6	-15.0	-10.0	-6.6	na
External Debt - Reserves, in US\$ millions	287.4	362.3	435.5	489.0	550.0	548.0	576.2	586.0	na
External Debt/GDP (in per cent)	30.1	33.4	41.4	41.6	46.3	45.0	42.7	43.3	na
External Debt/Exports of goods and services (in per cent)	129.2	144.9	205.5	218.6	223.2	192.9	167.8	146.4	na

Note: Data for 1992-2000 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, and the World Bank.

Data for 2002-2003 reflect EBRD evaluations, partly based on information from these sources.

1/ Registered unemployment. Unofficial estimates indicate substantially higher unemployment.

2/ Consolidated accounts of the Republican government and the local authorities.

3/ Average of 1-3 month T-bills.

4/ Weighted average rate for maturities of 15 days to less than one year.

5/ Official figures. Estimates before the 2001 census are known not to reflect fully net emigration.

ANNEX 5

TECHNICAL COOPERATION PROJECTS

Commitment Number	Commitment Name	€ Committed	€ Disbursed	Commitment Stage	Sector
AUS-1997-05-02	Repair of the Pushkin tunnel	46,230	46,230	Closed	Construction
CA3F-2002-09-08	Armenian Copper Programme - Environmental Audit	24,425	24,425	Closed	Manufacturing
EC-1993-08-32	Hrasdan Unit V Power Plant - financial systems and planning	198,723	198,723	Closed	Energy
EC-1993-08-33	Hrasdan Unit V Power Plant - power sector facilities planning	444,319	444,319	Closed	Energy
EC-1993-08-34	Hrasdan Unit V Power Plant - fuel supply contracting	45,185	45,185	Closed	Energy
ECAR-2002-08-01F	TAM Programme in Armenia	427,500	91,810	Committed	Manufacturing
ECAR-2002-10-03F	BAS Programme in Armenia	972,500	157,538	Disbursing	Manufacturing
ECT99-99-09-10	Telecommunications regulatory development programme	131,744	131,744	Closed	Telecommunications
FIN-1996-06-04	Preparation of highway maintenance and rehabilitation programme	49,955	49,955	Closed	Construction
FRB-1994-07-04	Private Investment Finance Corporation	149,348	149,348	Closed	Finance, Business
FRB-1995-09-07	Private investment finance company of Armenia - identification of sponsor	10,983	10,983	Closed	Community/Social Services
GER-1996-11-07	Hrasdan 5 Technical Assessment	102,033	102,033	Closed	Energy
GER-1997-04-06	Hrasdan V power project tendering assistance	177,761	177,761	Closed	Energy
HOL-1993-11-19	Yerevan (Zvartnots) air cargo terminal appraisal	18,995	18,995	Closed	Transport, Storage
HOL-1994-07-13	Electricity auction sales	13,712	13,712	Closed	Energy
HOL-1996-03-05	Wholesale market project management unit - short-term assistance	25,811	25,811	Closed	Manufacturing
JAP-1994-09-31	Food distribution and marketing (Phase II and III)	181,435	181,435	Closed	Manufacturing
JAP-1996-08-21	Wholesale market - project management unit	331,973	331,973	Closed	Manufacturing
JAP-1998-08-26	SME Line of Credit (Central Bank of Armenia)	735,190	735,190	Closed	Finance, Business
JAP-2001-05-08	Armenia Institution Building Programme	500,000	417,855	Disbursing	Finance, Business

TECHNICAL COOPERATION PROJECTS (cont'd)

Commitment Number	Commitment Name	€ Committed	€ Disbursed	Commitment Stage	Sector
NLT-2003-09-03	DIF - Maralik Legal Due Diligence	16,560	0	Committed	Finance, Business
SWE-1993-11-12	Yerevan (Zvartnots) air cargo terminal appraisal	19,958	19,958	Closed	Transport, Storage
SWEF-2002-07-04	Assessment of Armenian Wood Sector	17,080	0	Committed	Manufacturing
SWI-1997-03-02	Hrasdan V conservation measures implementation assistance	83,412	83,412	Closed	Energy
SWI-1998-07-02	Hrasdan unit 5 Privatisation Project	115,895	115,895	Closed	Energy
TAI-1994-05-02	Food distribution and marketing - Phase I	11,352	11,352	Closed	Manufacturing
TCS-2002-07-02	FAO Framework Agreement	8,925	0	Committed	Manufacturing
UKB-1997-01-05	Wholesale market project	28,873	28,873	Closed	Manufacturing
UKB-1997-02-08	Armenia, SME line of Credit	51,687	51,687	Closed	Finance, Business
UKD-1999-10-21F	Armenia Power Distribution Privatisation Legal Due Diligence	146,737	146,737	Closed	Energy
UKD-2003-03-02	Maralik Financial Due Diligence	4,700	3,863	Committed	Finance, Business
	Total Amount:	5,093,000	3,816,802		
	Number of Commitments:	31			