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

**STRATEGY FOR ARMENIA**

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## EXECUTIVE SUMMARY

Armenia is committed to and applying the principles of multiparty democracy, pluralism and market economics, in accordance with Article 1 of the Agreement Establishing the Bank, although the application of these principles remains uneven.

The current Government, formed in 2014, has announced an ambitious reform programme, which includes among its key priorities fighting corruption and the shadow economy, promoting economic competition and improving the investment climate.

In January 2015 Armenia joined the Eurasian Economic Union (EEU), which aims to increase trade and investment with Russia, Kazakhstan and Belarus. At the same time, Armenia and the EU are in the process of deepening their cooperation, which has been enhanced by Armenia's participation in the Eastern Partnership programme. In addition to deficiencies in Armenia's investment climate, its economic development remains constrained by geo-political and security challenges, including the blockade of Armenia by two neighbours – Azerbaijan and Turkey. A volatile regional geo-political context and the unresolved Nagorno-Karabakh conflict are negatively impacting regional stability. Armenia and Azerbaijan continue to engage with the OSCE Minsk Group mediators to try to find a sustainable political solution.

After growing by 7.2 per cent in 2012, Armenia's economic growth slowed to 3.3 per cent in 2013 and 3.5 per cent in 2014. In 2015, GDP growth is projected to moderate to 2.3 per cent in the context of the broader regional downturn to which Armenia is exposed via trade, remittances and investment flows. A contraction in investment and weak household consumption – partly as a result of declining remittances – held back growth in 2014. After two years of relative exchange rate stability, the Armenian dram depreciated by 14 per cent against the US dollar at the end of 2014, influenced by weaker regional currencies; its international reserves also declined from US \$2.11 billion in January 2014 to US \$1.26 billion in February 2015, before rebounding to US \$1.63 billion in September 2015. The weakening currency may in turn reveal vulnerabilities in the banking sector, given the high level of dollarisation. Closer integration within the EEU can bring both benefits and uncertainties.

Against this backdrop, strengthening the competitiveness of the domestic private sector and levelling the playing field will be pivotal to Armenia's ability to engender a more broad-based economy, reduce vulnerability to external factors, and achieve sustainable growth. Increased access to finance, particularly for MSMEs, further improvements to the business environment, developing modern management capacity in corporates, and strengthening the value chain are all necessary. Capital markets development, especially in the context of pension reform, is another important element that could provide a much needed enhancement to the traditional bank lending that dominates the financial sector, and which has exhausted breathing space for many corporate borrowers. Finally, much more remains to be done to improve and commercialise public services and infrastructure, both for the direct benefit of citizens and to improve the competitiveness of business.

In this context, the Bank will pursue the following strategic orientations in the new Strategy period:

**Enhancing private sector competitiveness by strengthening capacity, increasing corporate transparency and improving the business environment:** For Armenia's small,

open economy, a significant improvement in competitiveness is the key to attracting investment. The Bank will target assistance for improvements to the regulatory and administrative environment, encourage more sustainable and resource efficient growth across sectors, and strengthen its assistance to MSMEs that strive to be more transparent and competitive through a combination of finance and advisory services. While financing of the best of the Armenian private sector through SBI instruments will remain an integral part of the support provided by the Bank, reaching out to SMEs across industries via partner banks will continue to deliver the most transition impact overall. Enhancing access to finance through SME loans therefore will continue to be a cornerstone of the Bank's strategy.

**Developing capital markets and promoting local currency financing:** While Armenia currently has access to international capital markets, the development of local capital markets and local currency finance is critical for the country's sustainable development. There is a need for new instruments across firm capital structure, along with modern behaviour among corporates in their approach to shareholder value. As the authorities roll out mandatory pension reforms, which will likely increase savings and create local demand for bonds and equity, the majority of pension fund investments will be channelled in local currency. Once in place, success will largely depend on the emergence of a healthy supply of capital market issues on the local market, and enough different investors to create market liquidity, alongside the emergence of a more robust money market and hedging instruments. The Bank will address these challenges in Armenia as a focus country for its local currency and capital markets work.

**Developing sustainable and commercialised public utilities:** Armenia's available fiscal space cannot fully accommodate the country's crucial energy, transport and municipal infrastructure needs in the absence of high growth rates. This highlights the importance of commercialisation and increased private participation in public service provision, while a significant grant element for all sovereign and sovereign guaranteed project financing will be needed during the medium term for debt sustainability. To achieve efficient prioritisation, the Government of Armenia will need to develop projects within national sector strategies that are consistent with its financing constraints. The Bank is well positioned to contribute to these strategies in cooperation with other donors, and assist in upgrading and expanding public service provision through policy advisory and capacity building assistance aimed at sustainable commercialisation combined with lending for energy and energy efficiency, transport and municipal service projects which are environmentally sound, improve competitiveness, and lead to cost recovery.

## 1 OVERVIEW OF THE BANK'S ACTIVITIES

### 1.1 The Bank's current portfolio

Private sector portfolio ratio: 91.5 per cent, as of 31 October 2015

Sector	Portfolio				
	Number of projects	Portfolio	% of Portfolio	Operating Assets	% of Operating Assets
<i>Amount in EUR million</i>					
<b>Energy</b>	<b>5</b>	<b>51</b>	<b>17%</b>	<b>51</b>	<b>22%</b>
Power and Energy	3	39	13%	39	17%
Natural Resources	2	13	4%	13	6%
<b>Financial Institutions</b>	<b>33</b>	<b>143</b>	<b>49%</b>	<b>106</b>	<b>46%</b>
Depository Credit (banks)	26	131	45%	96	42%
Non-depository Credit (non-bank)	7	12	4%	10	4%
<b>ICA</b>	<b>9</b>	<b>30</b>	<b>10%</b>	<b>29</b>	<b>13%</b>
Agribusiness	3	14	5%	14	6%
Equity Funds	1	2	1%	1	1%
Manufacturing & Services	4	12	4%	12	5%
Property & Tourism	1	2	1%	2	1%
<b>Infrastructure</b>	<b>9</b>	<b>70</b>	<b>24%</b>	<b>44</b>	<b>19%</b>
MEI	7	32	11%	16	7%
Transport	2	38	13%	28	12%
<b>TOTAL</b>	<b>56</b>	<b>295</b>	<b>100%</b>	<b>231</b>	<b>100%</b>

Source: EBRD Business Performance Navigator

### 1.2 Implementation of the previous strategic directions

Over the previous country strategy period, the Bank's main priorities in Armenia have been to: (i) develop the financial sector and improve access to finance; (ii) improve municipal and urban transport infrastructure; (iii) develop agribusiness and high value-added, export-oriented industrial companies; and (iv) improve the regulatory and institutional framework for sustainable energy and mining. In addition, the Bank has engaged in policy dialogue focused on improving the business climate. In spite of a challenging operational environment, the Bank signed 44 projects totalling €257.2 million in volume, bringing its cumulative investment to €876.7 million across 137 projects, combined with significant policy dialogue, technical assistance and capacity building engagements in each of these areas.

#### (i) *Develop the financial sector and improve access to finance*

The Bank has enhanced access to finance, particularly for MSMEs, through an array of dedicated credit lines to commercial banks and micro-credit organizations, direct debt, mezzanine and equity investments, as well as complementary technical assistance, with a special focus on local currency. Armenia is also one of the countries where the Bank's Local Currency and Capital Markets Development (LC2) Initiative has delivered its best and most visible results, setting the stage for further development of local capital markets. Notable achievements over the strategy period include:

- Signing 26 deals channelling €155.8 million to Armenian commercial banks and micro financing institutions for on-lending primarily to MSMEs, of which

approximately €80 million has been disbursed in local currency, helping reduce vulnerability to exchange rate risk. These credit lines have contributed to over 300,000 MSME loans, totalling €868 million, committed by EBRD partner banks during the strategy period.

- Developing both demand for and supply of energy efficiency investments through credit lines issued under the Caucasian Energy Efficiency Programme (CEEP), and extending its scope beyond corporates to include retail lending. Since 2013, four Armenian banks have joined the programme, signing a total of €27.5 million in loans for on-lending to industrial and residential EE sub-projects. As of January 2015, approximately US \$13.6 million (including 8 sub-loans to corporates in the amount of US \$8.53 million and 3,608 residential and retail sub-projects) had been disbursed, with an expected CO<sub>2</sub> emissions reduction of 29 kilotons per year.
- Building on prior efforts to develop the local institutional and regulatory framework, in 2014 the Bank issued its first bond in Armenian dram, with the proceeds on-lent to MSMEs through dram credit lines in the local banking system. As of March 2015, the Bank had issued 12.75 billion dram of local currency bonds, including a 6.75 billion dram US dollar-settled Eurobond, as well as three smaller dram issues over the local exchange.
- Finally, in April 2011 the Bank concluded a Memorandum of Understanding with the Government to provide technical assistance in a number of areas related to local currency and capital markets development. Consistent progress has been made throughout the strategy period, including enhancement of the CBA's inflation targeting capacity to better anchor monetary policy, partial implementation of a mandatory private pension pillar, and a number of measures designed to reduce dollarisation.

(ii) *Improve municipal and urban transport infrastructure*

The Bank has continued to contribute to improvements in municipal and urban transport infrastructure. Over the strategy period, the Bank has provided nearly €20 million in sovereign loans in order to achieve the following:

- Within the framework of a second €5 million sovereign loan signed in 2012, support a further rehabilitation programme for the Yerevan Metro, including a number of measures to improve environmental impact, energy efficiency and commercialization, such as elimination of water ingress into the system through energy efficient pumps, development of a modern management information system and signing of a public service contract between the company and the city.
- Construct a new bridge at Bagratashen, to improve transit at the main border crossing between Armenia and Georgia, as part of the EU's Integrated Border Management regional initiative.
- Construct the first EU compliant solid waste landfill in Armenia. The loan was complemented by capital grant financing of €3.5 million provided by the European Union Neighbourhood Facility and represents the first project under the National Solid Household Waste Strategy of Armenia.

(iii) *Develop agribusiness and high value-added, export-oriented industrial companies*

The Bank has also supported agribusiness and high value-added corporates through direct investment (debt, equity, mezzanine), typically combined with significant hands-on capacity building assistance, helping smaller clients grow their businesses by providing crucial financial and technical support to implement capex intensive business plans. While exit from equity investments has at times been challenging, good progress has been made recently toward facilitating pure equity exits to small strategic investors, confirming the transition impact of these engagements and laying the groundwork for future private equity deals in Armenia. The Bank has:

- Signed 6 deals totalling €9.8 million in support of agribusiness, as well as delivered credit lines and technical assistance to two partner banks for on-lending to micro and small agribusinesses.
- Through the Small Business Support (SBS) program, delivered technical assistance and consulting services to over 1,100 Business Advisory Services (BAS) projects and 50 Enterprise Growth Program (EGP) projects since 2003, helping high quality companies (including a significant number of rural businesses) improve their financial reporting, management capacity and marketing. Within this effort, during the last three years, EGP has provided international expertise to 13 dynamic corporates, which has been particularly effective in helping them design and execute business development strategies. Over the life of the program, nearly 30 per cent of SBS clients secured financing within one year, 57 per cent hired additional employees, and over 91 per cent increased turnover.
- Supported, together with other international financial institutions, the creation of the Caucasus Growth Fund in 2012 – the first dedicated fund to provide debt and equity to SMEs in the Caucasus region. Two promising equity investments have already been made in Armenia. Additionally, through the SBS program, the Bank conducted an extensive training-for-trainers course on investor relations and firm-level preparation for private equity.

(iv) *Improve the regulatory and institutional framework for sustainable energy and mining*

In sustainable energy and mining (in addition to energy efficiency credit lines), the Bank has signed 3 deals (including 2 equity investments) totalling €27.4 million. Notably, the Bank has:

- Provided a €19 million loan to International Energy Corporation (IEC) for the rehabilitation of seven small hydropower plants of the Sevan-Hrazdan Cascade, a project which also helped bring IEC's technical standards in line with best international practice.
- Signed three equity deals totalling €7.3 million with the Toronto-listed mining company, Lydian International. In addition to these investments, the Bank has engaged in a multi-faceted dialogue with an eye to developing a more comprehensive understanding of international standards, requirements and best practices in the global mining industry in Armenia. Lydian's Amulsar mine project in Armenia was permitted in late 2014; if successful, this project could serve as an important benchmark for the sector, and a positive signal to international investors.

(v) *Policy dialogue focused on improving the business climate*

Finally, the Bank has coupled these investments with sustained policy dialogue across numerous areas:

- The EBRD-supported Investment Council (IC) has played a positive role in improving the business environment, helping achieve significant regulatory improvements, including a turnover tax regime for small business and approval of a comprehensive risk-based inspection reform. The EBRD has provided material support to the IC Secretariat, thereby helping to provide a platform for dialogue, analysis, problem solving, and decision-making between the private sector and the Government on ways to improve the regulatory framework affecting private sector economic activity.
- In e-Procurement the Bank has assisted the Government by helping prepare the comprehensive legal and regulatory changes needed to make the system EU compliant. E-tendering was launched on January 1 2014, and other modules are in active states of preparation.
- Finally, the Bank also prepared detailed recommendations in support of an EU compliant telecommunications regulatory framework, although to date implementation by the Government has been limited to number portability.

### 1.3 Key lessons

Notwithstanding these achievements, the Bank's record in Armenia remains mixed, a function of a challenging internal and external operating environment and slow progress against transition, with medium to large gaps remaining across most sectors. Moreover, as the Bank's experience over the prior strategy period demonstrates, a sector-specific approach, such as a specific focus on agriculture and agro-processing, can be challenging to execute in small economies like Armenia, where the population of potential targets that meet EBRD investment requirements is limited.

Accordingly the Bank will need to be more strategic in its approach to supporting the increased competitiveness of the private sector, working with promising companies and projects across sectors, and integrating well-targeted technical assistance, capacity building and policy dialogue to deliver beneficial outcomes.

Key takeaways from the prior period include the following: (1) targeted credit lines, while successful, have seen slow to take-up; (2) local currency lending is in strong demand but supply remains constrained; (3) there are good examples of direct investment in SMEs but replication remains elusive and the universe of bankable clients very limited; (4) monopoly positions continue to hamper Government efforts to improve the business climate; and (5) infrastructure projects have been successful but will require enhanced donor coordination and an improved country strategic framework.

**Slow take-up of targeted credit lines.** As noted, a key aspect of the Bank's efforts to broaden access to finance for SMEs has been through targeted credit lines. However take-up, particularly for energy efficiency, has been slow. While significant education efforts have been deployed, to date the grant component has been the driver of client interest. Going forward, the Bank will need to more effectively demonstrate the costs savings of completed projects to encourage increased activity, although achieving strong organic demand for these products in the absence of a grant component may take time. This experience with energy efficiency credit lines will also in part guide the Bank's approach to those for Women in



Business (WiB) during the new strategy period. Although the Bank recently started providing advisory services to the female business leaders who will ultimately be the prime candidates for these credit lines, at the moment few female owned or managed businesses are in a position to benefit from direct EBRD engagement beyond advisory. Development of these WiB credit lines accordingly will take time.

**Local currency lending remains constrained.** There is a strong demand for SME credit lines in local currency. Unfortunately, TCX's saturation with Armenian dram has left its hedging terms relatively unattractive, and even once in place, hedges that roll over during market stress, such as during the first quarter of 2015 when exchange rate volatility was particularly high, effectively pass the exchange rate risk back to the client in the form of extraordinarily high interest rates. Short of the Bank taking local currency risk in debt as it does in equity, the Bank will have to focus more on issuing local currency bonds, which in Armenia is now a successful and ongoing process, and on developing money market instruments to encourage market hedging facilities to develop outside of TCX, especially in the local market. The Bank's technical support to the CBA to develop a local currency friendly monetary framework has helped create macroeconomic conditions for this task.

**Good examples of direct investments in SMEs exist, but scaling-up remains problematic.** The Bank has also had a number of success stories in direct (debt and equity) financing of SMEs that seek to grow through improved management, corporate governance, financial control systems and strategic capital investments. A prime example is Liqvor, an Armenian manufacturer of pharmaceutical eye drops and plasma, which is 45 per cent owned by the EBRD. The company recently became the first in Armenia to receive a Good Manufacturing Practice (GMP) certification. In preparation to certify Liqvor, the Ministry of Health has scaled up its capacity to provide similar certifications to other companies, which will help them and Liqvor obtain GMP in export target countries.

Significant hands-on advisory assistance and financial support from the Bank has been key to these successes, but scaling up across the economy remains a big challenge. While BAS has been highly effective in preparing potential clients for EBRD direct financing, and the resulting impact from direct investment is high, it is also a significant drain on the Bank's limited resources. Moreover, while successful exit from the Bank's small equity investments is possible, it can be highly challenging. A related difficulty has been finding clients that meet the streamlined MCFF requirements. The Bank needs both to be selective in its business development for direct financing to achieve demonstration effects and continue to work through intermediaries (such as banks and funds) to reach the broader SME population.

**The Bank continues to face challenges in finding bankable clients** at a time when traditional bank lending to the private sector remains constrained. Clients that meet the EBRD's requirements in terms of beneficial ownership and transparency tend to be highly leveraged, have little or no additional collateral, and are therefore financially repressed despite strategic plans and capital needs to further develop their businesses. Further, the CBA's risk metrics concerning collateral for traditional bank lending practically preclude bank loans to otherwise healthy rural businesses. This suggests an increased focus on credit enhancements, such as guarantees, trade finance, factoring, leasing, private equity and development of capital markets, as well as working with partner banks through MCFF wherever possible to be able to complete smaller size transactions in a cost effective manner.

**Monopoly concentration remains a major roadblock to an improved investment climate**, and represents perhaps the largest binding constraint to a diversified and robust private sector in Armenia. While progress continues in e-Governance and in eliminating administrative barriers to doing business, the Government has not yet exhibited the political capacity to reign in dominant and strongly connected groups. A non-level playing field in tax and customs is perhaps the worst offending area, and apart from select issues being addressed through the EBRD-supported Investment Council, such as inspections reform, broad tax and customs reform are not an area where the EBRD is best placed to lead. As a result, the Bank will need to continue to coordinate with other IFIs and donor agencies, while employing a bottom-up approach to policy dialogue and technical assistance in areas where the authorities are committed to achieving results, such as on recent improvements to the tax treatment of factoring. Typically these efforts would be focused around EBRD projects, such as the ongoing advisory assistance in connection with the privatisation of Hay Post. The Bank stands ready to step up its support should the reform environment improve.

In the meantime the Bank can continue to make a difference through its support of the IC Secretariat. Key policy changes coming out of that forum include a well-designed turnover tax for small business, a phased approach to formalising the status of IT specialists while bringing additional revenue to the Government, inspections reform, and select changes in regulations in support of small businesses such as a reduction of patents for real estate agents. The Bank should continue this fruitful engagement, and perhaps increase its technical and financial support for consulting services to support the Secretariat as it takes on new and increasingly difficult regulatory challenges.

**Infrastructure projects have been successful but will require enhanced donor coordination and an improved country strategic framework.** Finally, in the area of infrastructure and public service provision, projects that have been implemented by EBRD have tended to run smoothly and are providing good results. However, enhanced IFI/donor coordination and planning in concert with the Government in the context of fiscal space constraints – which are rapidly becoming binding – will be imperative. While Armenia is no longer an IDA country, the Government continues to seek a high level of concessional financing from donors for all sovereign supported project financing. This is now even more challenging as it will be more difficult for Armenia to secure EU-NIF funds.

Unfortunately, the traditional donor approach has been to identify attractive projects from the donor's perspective, obtain grant financing for feasibility studies, and then work with the Government and the Ministry of Finance to obtain a request to proceed with a healthy capex grant component. The Government almost never rejects a project before a feasibility study is completed. While many good projects are ultimately selected for sovereign support, there tends to be an absence of a national vision by sector, and some projects appear to have low economic feasibility, thus effectively using up precious fiscal space, a particular concern as the dram devalues against the US dollar, which is the currency of the lion's share of public debt.

In this context, donors/IFIs will need to coordinate more effectively and work with the Armenian authorities to define financeable strategies in each public utility and infrastructure sub-sector, as well as across sectors, so that donor financed projects can be aligned around those strategies. Like other IFIs in Armenia, the EBRD is currently preparing several public service infrastructure projects, with many at advanced stages of pre-signing feasibility,

without a clear Government strategy to secure the necessary funding, and against a backdrop where public borrowing may soon be limited by debt sustainability considerations.

Nonetheless, some progress is being made. For example, with strong assistance from the EU, the Bank was able to move forward the Kotayk Solid Waste project in 2014 after a three-year hiatus, allowing the Government to develop a National Solid Waste Strategy in the interim with the assistance of the ADB, while building consensus among participating mayors for service-boosting reforms and a gradual increase in tariffs to full cost recovery. Likewise, since 2013, a UN-supported Donor Infrastructure Working Group has met regularly and is making progress to better align projects in a coordinated manner around achievable strategies. The Government has utilised the group on road projects, for example on the design of the M6 project connecting Vanadzor with the Bagratashan border crossing to Georgia, and in mid-2014 initiated a donor-coordination roundtable series on energy, which is helping clarify certain important aspects for planning energy investments. Continued engagement through these mechanisms will be important to forging a unified approach with the Government and other IFIs to public sector and utility investment priorities.

## **2 OPERATIONAL ENVIRONMENT**

### **2.1 Political context**

Armenia is in the process of changing its political system from a semi-presidential to a parliamentary republic. Following parliament's approval, the package of Constitutional amendments will be voted on in a national referendum on 6 December 2015. The amendments introduce a greater clarity in the division of powers between different branches of government by limiting the powers of the President, strengthening the Government's executive role and enhancing parliament's capacity to provide legislative oversight over the executive. The amendments also enhance the independence of the judiciary. However, the Constitutional reforms, which were initiated by the President in 2014 could heighten political debate. Some opposition parties have joined the Constitutional reforms initiative, with others continuing to express reservations.<sup>1</sup>

The current President Serzh Sargsyan is serving his second five-year term in office, which ends in 2018. President Sargsyan heads the Republican Party of Armenia (RPA), which won a strong majority in the 2012 general elections and now controls 69 seats in the 131-seat Parliament, which also allowed the RPA to form a single party government. The new government, which was formed in 2014, has announced an ambitious reform programme, which includes fighting corruption and the shadow economy, promoting economic competition and improving the investment climate among its key priorities. Armenia established an Anti-Corruption Council headed by the Prime Minister, which also includes representatives of the civil society and some parliamentary opposition parties. The government also established a new Ministry for International Economic Integration and Reforms.

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<sup>1</sup> The Venice Commission of the Council of Europe has reviewed the constitutional reform concept document and concluded that the aims and the overall approach of the Constitutional reform deserve strong support. However it also noted that the change in favour of a parliamentary system of government will have to be debated extensively in the country and that constitutional reform can be carried out only on the basis of broad consensus within the society.

Given that the ruling party enjoys a strong majority in the parliament and the opposition remains weak and divided, the Government does not face significant opposition to approving its reform programme. However, the Government has faced several major public protests – in particular relating to pension reform and an increase in electricity tariffs – which have imposed certain political constraints over policies.

The approaching election cycle could pose opportunities and challenges to the pace of implementation of the Government's reform commitment. Armenia's next parliamentary elections are due to be held in 2017, and Presidential elections in 2018. The parliamentary elections are acquiring greater importance in light of Armenia's transition to a parliamentary system of government. Presidential elections are important because the current President is not permitted to stand again, given the two-term Constitutional limit. Armenia has transferred presidential powers through elections twice. While elections in 2008 were marked by protests and violent clashes, Parliamentary elections conducted in 2012, and the Presidential election in 2013, were peaceful.

Armenia faces a number of additional challenges, which could place political stability at risk. The first relates to growing geo-political tensions between the EU and Russia. Armenia joined the Eurasian Economic Union (EEU) in January 2015. This decision was underpinned by its close economic and security relationship with Russia. At the same time, the Armenian authorities have expressed a strong interest in deepening cooperation with the EU in both economic and political spheres in a manner that would be compatible with Armenia's commitments under the EEU. In October 2015, Armenia and the EU launched talks on a new treaty with the aim of deepening cooperation, enhanced by Armenia's participation in the Eastern Partnership programme of the European Union.

Economic development remains constrained by geo-political and security challenges, including the blockade of Armenia by two neighbours – Azerbaijan and Turkey. Stability is impacted by the volatile regional geo-political context and unresolved Nagorno-Karabakh conflict. Armenia and Azerbaijan continue to engage with the OSCE Minsk Group mediators to try to find a sustainable political solution.

## **2.2 Macroeconomic context**

The post-crisis recovery has slowed. Armenia experienced an investment-led slowdown in the aftermath of the 2008-09 global crisis, with the investment share of GDP gradually falling from around 40 per cent in 2008 to 20 per cent in 2014. Average economic growth during 2010-2014 was close to 4 per cent. The construction sector (including real estate), which was the major driver of growth in the 2000s, has continued to contract.

In 2013-2015, the economy has sustained moderate positive growth despite external economic challenges. After growing by 7.2 per cent in 2012, the economy decelerated to around 3.5 per cent growth in 2013-2014, and is expected to grow by 2.3 per cent in 2015. In addition to the contraction in investment activity, including due to delays in implementing infrastructure projects, weak household consumption – partly as a result of a downturn in remittances representing approximately 18 per cent of GDP in 2014 – was another drag on growth. Remittances declined by 28 per cent year-on-year in the first eight months of 2015, including remittances from Russia, which were down by approximately 40 per cent for the same period. Weak economic performance has contributed to elevated levels of

unemployment (17.6 per cent) and poverty, as measured by the share of the population living below the poverty line (32 per cent).

External imbalances linger. Accumulation of current account deficits has led to a negative net international investment position of approximately 70 per cent of GDP. The current account deficit remained at 7.3 percent in 2014, partly due to a weaker Russian economy. After two years of relative stability, the dram depreciated by around 14 per cent against the US dollar at the end of 2014, prompted, among other things, by the depreciation of the Russian rouble. Due to the pass-through effect, inflation accelerated to 5.8 per cent year-on-year in March 2015, but subsided to 3.6 per cent year-on-year in August 2015.

From January 2014 to September 2015, the Central Bank of Armenia's international reserves decreased by 23 per cent, from 5 months of imports to around 3.9 months. In March 2014, the government agreed a new 38-month, US \$128 million Extended Fund Facility (EFF) with the IMF, to provide a buffer in times of market volatility and support investor sentiment. Armenia's fiscal position has been relatively sustainable, with the public deficit at around 1.9 per cent of GDP in 2014. Stock of the public and publicly guaranteed debt was close to 44 per cent of GDP in 2014 and almost 85 per cent of this stock was f/x denominated, making debt sustainability vulnerable to exchange rate movement (although this vulnerability is mitigated by the prevalingly long term structure of Armenia's public debt portfolio). In September 2013, the Government tapped the Eurobond market with a debut US \$700 million issue with a 7-year maturity. A second issue of US \$500 million with a 10-year maturity followed in March 2015, with part of the proceeds (approximately US \$200 million) used to buy back a portion of the debut issue.

**Currency weakening may reveal vulnerabilities in the banking sector.** Armenia's banking sector is highly dollarised, with its share of f/x loans and deposits in September 2015 at 66 and 70 per cent, respectively. Banks were mostly sound before the devaluation, and withstood the dram depreciation relatively well. Further downward pressures on the currency could lead to capital shortfalls, a rise in NPLs, increased dollarisation and potentially deposit outflows. The CBA tightened monetary policy during December 2014-August 2015 by hiking interest rates and raising reserve requirements on foreign currency liabilities of banks. In January 2015, the Central Bank of Armenia increased minimum capital requirements for banks from AMD 5 billion to 30 billion (approximately US \$10 million to US \$60 million) by 2017 to increase buffers and efficiency. Discussions of new funding and acquisitions are under way.

**The short-term outlook depends on a combination of domestic and external factors.**

Armenia remains highly exposed to the regional economic slowdown via trade, remittances, investment flows and investor confidence links. In November 2015, the EBRD forecasted growth of 2.3 per cent in 2015. Lower oil prices could partially offset the negative external developments as Armenia is a net importer of hydrocarbons. Continued positive contributions from the agriculture, mining and hospitality sectors, which were engines of growth in the first half of 2015, would support the growth trajectory in 2015 and 2016. Closer integration within the Eurasian Economic Union will bring both benefits and uncertainties, which may come from economic developments in Russia.

**Risks to the outlook stem from the following:** (1) the high dollarisation of balance sheets in the public, financial and real sectors; (2) a narrow economic and export base, amid a relatively high and geographically concentrated dependence on migrant remittances as a source of foreign exchange inflow to the country, which leaves the economy vulnerable to external shocks; (3) regional geopolitical tensions; and (4) a large current account deficit and relatively large stock of public and publicly guaranteed debt.

**The medium- to long-term outlook is uncertain.** The World Bank estimates that Armenia needs investment of close to 30 per cent of GDP to sustain growth rates of 6-7 per cent per year.<sup>2</sup> Deeper integration in the global economy and further efforts to promote openness, diversification and inbound investments are crucial for Armenia's long-term development, given the country's small domestic market, scarce resources, landlocked status and geopolitical constraints. Armenia needs to pursue policies that will improve the investment climate and public sector governance and reduce monopoly power. It also needs to improve cross-border and in-country interconnectivity and develop other forms of infrastructure, bearing in mind increased debt affordability constraints and its relatively limited fiscal space.

### 2.3 Structural reform context

**Armenia made progress in structural reforms over the past years.** Armenia's average transition indicator score is comparable to that of the EU candidate countries of south-eastern Europe, reflecting progress over the years in privatisation and price liberalisation. Armenia ranks 35th out of 189 countries in the World Bank's 2016 Doing Business index. The government increased transparency of public services by introducing e-based systems, including e-government and e-signature, and made significant progress on e-procurement. The government initiated preparation of a new tax code to reduce tax privileges and high tax compliance costs and to redesign the tax system to foster growth. In October 2015, the draft tax code was discussed at the cabinet and it is expected to be presented for public discussion, with submission to the parliament in 2016. The new compulsory funded pension pillar has been substantially revised and will remain voluntary for the private sector until 2017. At the end of 2013, the "open skies" policy was announced in an attempt to liberalize the civil aviation market, leading to lower airfares and a 30 percent increase in passenger traffic in the first half of 2014. Some 15 bilateral aviation agreements, including the Common Aviation Area Agreement with the EU, are being negotiated and can attract European low-cost carriers, boosting the hospitality industry and tourism revenues. The first dram bonds were issued by the IFC and EBRD in December 2013 and January 2014, respectively, which aim to develop the local capital market, with the EBRD issuing additional tranches in 2015.

Armenia's policies under its EFF with the IMF remained on track in 2014, with all performance criteria and most indicative targets met as of the March 2015 IMF Country Report.<sup>3</sup> According to the IMF, competition and regulatory reforms advanced at a slower pace, causing delays in meeting structural benchmarks, mainly due to the change in government in mid-2014 rather than a change in policy direction. Structural benchmarks for the first half of 2015 were focused among other things on tax administration, public finance management, financial sector development, and central bank operations. Performance under the EFF in 2015 has faced challenges, as the impact from the recession in Russia has taken a toll.<sup>4</sup> Among these challenges are currency depreciation influenced by weaker regional currencies, lower remittances and exports; a high current account deficit; and dollarisation. The IMF emphasises that Armenia is capable of weathering these challenges and fostering medium-term growth, and assigns significant priority to stepped-up fiscal and structural reforms.<sup>5</sup>

<sup>2</sup> IMF Country Report No. 15/65, March 2015.

<sup>3</sup> IMF Country Report No. 15/65, March 2015.

<sup>4</sup> IMF program note on Armenia, April 6, 2015.

<sup>5</sup> IMF program note on Armenia, April 6, 2015.

**Armenia joined the Eurasian Economic Union from January 2015.** In October 2014 Armenia's President signed the accession treaty to the EEU with the Presidents of Russia, Kazakhstan and Belarus at the CIS summit in Minsk, and it came into force in January 2015. Armenia was allowed to temporarily exempt around 800 types of imported goods from the much higher customs duties set by the EEU; these goods represent the lion's share of Armenia's imports. On balance, membership is likely to lead to Armenia implementing more protectionist trade policies pursued by the EEU as Armenia is expected to move to the EEU's tariffs by 2022. In the short-to-medium-term, Armenia is likely to benefit from lower import energy prices, higher customs revenues (Armenia will receive approximately one per cent of the amount of customs duties derived from imports of goods into the territory of the EEU) and possibly increased investments from Russia. Longer-term implications on the structure of the economy and of trade, on commitments under the WTO, on foreign investments, and on the reforms momentum, remain unclear.

**Structural reforms progressed although challenges remain.** Links between business and political interests are strong and may affect anti-corruption efforts. Armenia's membership in the Eurasian Economic Union and less intensive institutional relations with the EU will require a heightened perseverance by Armenia to implement reforms and improve the business climate. Armenia and the EU have expressed commitment to finding a new legal basis for enhanced cooperation.

## 2.4 Access to finance

Access to finance remains constrained: the banking sector lacks some important funding tools (e.g., a functioning interbank market, better developed capital markets infrastructure) and is not effectively supplemented by non-banks, nor supported by institutional investors. Funding is highly dollarised, effectively pushing foreign exchange risk to borrowers. At the same time, a number of IFIs and bilateral institutions are active in the country and play an important role in providing finance, many with a high proportion of concessional funding.

### *Private sources of capital*

The primary source of financing for enterprises and households is the banking sector, with additional resources channelled through non-banking channels such as microfinance and leasing.

The Armenian financial sector is heavily dominated by banks, which account for about 90 per cent of financial sector assets. The banking sector itself is relatively fragmented and dominated by foreign-owned banks, which account for over 50 per cent of total sector assets. Comprising some 21 banks, the sector could benefit from consolidation.

While financial intermediation has increased in recent years, with domestic credit to the private sector as a share of GDP growing from 28 per cent in 2010 to 52 per cent by end-2014, it remains slightly lower than the average in Europe and Central Asia. Credit expansion has been supported by banking sector growth, which recovered well after the financial crisis, partly due to the government's anti-crisis funding to local banks. Total sector assets grew by 18 per cent in 2012 and 22.9 per cent in 2013, although the sector experienced a sharp slowdown in 2014 as a result of a more challenging external environment linked to economic challenges in Russia and Ukraine.

Nonbank sources of financing, such as microfinance, leasing, and private equity are limited and underdeveloped, contributing only about 9 per cent of financial sector assets. The microfinance sector is nonetheless active, with FINCA and other MFIs with networks in the rural areas. Leasing penetration is low, at 0.8 per cent of GDP. While home ownership rates are high, mortgage penetration remains low, at 3.24 per cent of GDP. Despite significant opportunities afforded by prospective and attractive local entrepreneurs, as well as by the limits of traditional bank lending, a local private equity sector is yet to develop and to date Armenia has not attracted significant interest from international private equity funds.

Capital markets could in principle supplement these resources, and the authorities are working towards developing those in Armenia. At present, Armenia's capital markets are at a somewhat early stage, despite relatively advanced infrastructure on account of the NASDAQ-OMX investment in the local stock exchange. There is no money market trading intermediating risk between banks, and hedging instruments are rare. The absence of a legal framework for repurchase agreements prevents banks from transacting secured interbank loans. The high cost of issuing local currency bonds has led banks to manage their balance sheets through longer term liabilities such as term deposits, of which there is limited supply and can be withdrawn by depositors with only loss of accrued interest. Dollarisation remains high, which further bifurcates liquidity and complicates balance sheet management. A securitisation law, including covered bonds and securitisation of mortgages, is in place but not yet tested.

The corporate bond market remains small with only a few issues outstanding, although interest in developing the market is growing. A lack of transparency among corporates has limited interest in both bonds and equity as financing options. Currently only seven companies have equity listed in Armenia.

The institutional investor base is virtually non-existent but expected to grow with recent pension reform. Steps to improve clearing procedures and connections to international clearing infrastructure could facilitate foreign investors' participation in the Armenian market. However it may require an additional critical mass of issues (debt and/or equity) to encourage international investors to devote the time and effort to understand the local market and set up clearing and custody arrangements.

As noted above, under the LC2 MoU signed in 2011 between the EBRD, the Government, and the CBA, an inflation targeting technical assistance programme was launched in 2012 in coordination with the IMF. Through this program, the CBA has taken significant steps to make the exchange rate more flexible, enhance its monetary policy toolkit and focus on sustainably lowering inflation. In 2014, Armenia partially introduced a mandatory component of the funded pension system that will provide steady demand for local currency assets. In addition, as noted, two successful Eurobond issuances have established Armenia's credit rating in the international market, helping raise international investors' appetite and possible future issuances by Armenian private sector entities. Nonetheless, many challenges remain, including high dollarisation and the underdeveloped corporate bond market. The Bank plans to revise the MoU in 2015 to refresh the goals, both in recognition of progress to date and to focus on current priorities as jointly agreed with the Ministry of Finance and CBA.

#### *Multilateral and bilateral development bank finance*

A number of multilateral development banks (MDBs) and bilateral financial institutions are active in Armenia, with varying investment levels and priorities.



As noted, a three-year, US \$128 million EFF was approved by the Executive Board of the IMF in March 2014. On December 22, 2014, the Executive Board completed the first review, enabling the release of approximately US \$17 million, bringing total disbursements under the arrangement to roughly US \$34 million.

To date, the World Bank has cumulatively committed US \$1.62 billion for 55 projects in Armenia, with the portfolio currently focused on the energy sector, financial and private sector development and urban development. In late 2014, the World Bank approved a US \$75 million Second Development Policy Operation Project (DPO) for Armenia to strengthen the business environment, improve access to credit, improve efficiency and transparency of the civil service, expand social protection, and improve fiscal space and the management of public infrastructure and environmental resources. The timing of the next DPO remains unclear due in particular in delays in approving a new tax code. The World Bank is also supporting the Government's strategy on the diversification of exports and tradable industries, on the design of its investment policy, on the improvement of the legal framework for FDI, as well as on advancing business inspection reforms through the new Trade Promotion and Quality Infrastructure Project and the IFC's new Armenia Investment Climate Reform Project. In 2014, Armenia graduated from an IBRD/IDA blend to full IBRD.

IFC's priorities in Armenia include supporting the development of small and medium enterprises, promoting energy efficiency to increase the competitiveness of local companies and mitigate climate change, strengthening Armenia's capital markets, and supporting the real sector. As of the end of June 2014, IFC has invested more than US \$320 million in 52 projects across a variety of sectors and mobilized US \$23 million from other lenders. IFC Advisory Services provide advice through projects focused on regulatory simplification, food safety practices, sustainable energy finance, the financial sector, and corporate governance.

Current USAID projects aim to improve Armenia's business environment and support the development of small and medium-sized enterprises (Enterprise Development and Market Competitiveness); create innovative start-ups and new products in the IT sector (The Innovation Through Technology partnership); assist the State Revenue Committee and the Ministry of Finance to improve tax policies and tax administration procedures (Tax Reform Project); and enhance the efficiency and technical capacity of Armenian financial institutions to finance enterprises in rural and urban areas as well as promote Armenia's pension reform (Finance for Economic Development).

EU technical and financial cooperation is in line with Armenia's declared intention to deepen its economic and political relationship with the European Union in a manner consistent with its commitments within the EEU. The overall objective is to support Armenian national priorities in line with EU standards and best practices. Total EU assistance to Armenia has amounted to over €500 million since 1992. As part of the European Neighbourhood Policy, Armenia benefits from the European Neighbourhood & Partnership Instrument (ENPI). EU bilateral assistance for 2014-2020 is expected to be approximately €250-350 million, of which €140-170 million is planned for the 2014-2017 period. Since Armenia's decision not to sign the Association Agreement/DCFTA, EU resources are being channelled toward three priority areas: judicial reform, public administration reform and private sector development.

In order to promote the Armenian economy, KfW Development Bank used funds provided by the Federal Ministry of Economic Cooperation and Development to set up the German-

Armenian Fund (GAF) in 1999, which is administered by the CBA. The GAF provides Armenian financial institutions with local currency funding for investment loans. The GAF's target groups are SMEs and agricultural businesses and it supports investments in renewable energies (small hydropower plants). In 2014 KfW provided a €50 million loan and a grant worth €2 million to Armenia for a water supply project. In 2015, KfW plans to launch a new programme for financing energy-efficient investments made by SMEs. In March 2015 KfW signed an €85.2 million sovereign loan to finance the construction of an electricity transmission line and a high voltage direct current station to develop a link between Armenia and Georgia, deepening regional integration and providing both countries with better access to European electricity markets. The project is also supported by a €10 million loan from EIB, a €10 million EU-NIF grant and Armenia's (€1.5 million) own resources.

The Asian Development Bank (ADB) has worked with the Government since 2005. As of October 2014, ADB cumulative sovereign lending amounted to almost US \$840 million, aiming to help Armenia integrate its economy regionally and rebalance it toward more resilient, inclusive, and environmentally sustainable growth. The ADB's business plan also takes into account Armenia's graduation from concessional financing under the Asian Development Fund in 2017. The ADB will support three priority sectors: transport, water and other urban infrastructure, and energy. In addition, the ADB will support reforms that build public sector capacity and efficiently allocate public finances to ensure infrastructure sustainability through planning, governance, and adequate funding for operations and maintenance, as well as improve the enabling environment for women entrepreneurs through enhanced policy coordination.

The European Investment Bank (EIB) supports the EU Neighbourhood Policy in the Eastern Partner Countries by financing projects of significant EU interest. In December 2014 the EIB signed a €50 million sovereign loan to finance SME projects in Armenia in the agro-processing, rural and tourism sectors. The EIB also provided two sovereign loans totalling €30.7 million at the end of 2014 to improve the quality and reliability of water supply services and upgrade wastewater treatment in Armenia. Finally, the EIB has supported the implementation of Armenia's Transport Sector Development Strategy 2020 and the North-South Transport Corridor Investment Program, with an estimated project cost of around US \$120 million.

## **2.5 Business environment and legal context**

### *Business environment*

Despite significant progress in the past, the business environment in Armenia remains uneven. According to the World Bank's 2016 Doing Business index, Armenia ranked 35<sup>th</sup> out of 189 countries. While Armenia scores well in areas such as opening a business (5<sup>th</sup>), registering property (14<sup>th</sup>), and enforcing contracts (28<sup>th</sup>), the country lags in terms of dealing with construction permits (62<sup>nd</sup>), resolving insolvency (71<sup>st</sup>), and obtaining electricity (99<sup>th</sup>). According to the 2012-2013 Business Environment and Enterprise Performance Survey (BEEPS), top obstacles faced by Armenian firms include access to finance, tax administration and political instability. Young firms complained heavily about customs and trade regulations. Although the Global Competitiveness Report 2014-2015 ranks Armenia well overall, it also identifies corruption as the biggest barrier to doing business, followed by access to finance, and tax regulation. Armenia is currently implementing the second stage of the Regulatory Guillotine Program, aimed at reducing administrative costs and the regulatory burden on businesses. According to a growth diagnostics assessment in the 2013-2014

National Competitiveness Report of Armenia,<sup>6</sup> the high level of monopoly power and an uneven competitive environment are among the most important constraints to Armenia's economic development.

#### *Legal context*

The Armenian authorities continue to make efforts to upgrade commercial, tax and financial legislation in order to improve the business environment. Starting a new business has been made easier. However, significant gaps in the legal and regulatory framework remain. In addition, as is often the case in early transition countries, implementation of the law by courts and officials is uneven and affected by corruption. A lack of capacity and funding and the absence of digitalisation in some areas also constitute impediments to an effective application of laws and regulations. It remains to be seen how Armenia's accession to the Eurasian Economic Union will impact on the path to convergence with EU norms that has been a reform driver in the past.

The law of secured transactions is relatively well developed and allows the taking of security on a variety of assets. A legislation package improving the law of secured transactions was adopted by the Parliament in December 2014 and signed by the President on 30 December 2014. The new legal framework aims at introducing a unified movable collateral registry in electronic form. Registration would be the main form of perfection of secured rights and would determine the priority of collateral. The new law should come into force on 1 October 2015. Whereas financial leasing contracts are regulated, albeit with scope for incremental improvements, there is a lack of dedicated rules for factoring.

The 2010 Corporate Governance Code, which was prepared with EBRD support, has not yet found wide usership; implementation of its recommendations has been mixed.

Following on the Law of Electronic Communication adopted in 2005, some progress has been made, for instance on mobile number portability. However, gaps in the legal framework and in the resources and capacity of the regulator still remain. Convergence to proven EU norms is necessary to attract investment. The divide between urban and rural areas in network connection is still significant.

Capital markets legislation remains underdeveloped. Although certain improvements to the legal framework were made in connection with the EBRD and IFC's dram bond issuance, much remains to be done to establish a robust legal infrastructure for capital markets and derivatives transactions.

In the energy sector, the Government recognises the need to enhance energy efficiency. An improvement of the existing legal and regulatory framework is a pre-condition to a successful energy efficiency program. The EBRD is currently discussing the scope of technical assistance which could be made available to the Armenian authorities to revisit the applicable rules for the residential sub-sector.

PPPs and concessions are not subject to a dedicated single legal act. Relevant provisions are scattered across various sector specific laws and regulations. The absence of a clear legal and regulatory framework is an obstacle to structuring and funding projects, although notable

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<sup>6</sup> National Competitiveness Report of Armenia 2013-2014.

achievements have been made implementing PPP arrangements, particularly with respect to water companies, Zvartnots International Airport and Hay Post.

Armenia has established a good standard of public procurement legislation with the Law on Procurement enacted in 2010. Such law would benefit from an update in accordance with the updated GPA standards.

See Annex 4 for a more detailed assessment of the legal environment.

## **2.6 Social context**

Armenia is a low middle income country with a population of 3 million people. It is still a largely rural economy and suffers from high unemployment and significant inclusion gaps, notably for the young and female workers. Significant regional disparities persist. The poverty rate has increased in recent years as a result of economic stress. In response, the Government has sought to increase spending in order to create jobs, and reform pensions to boost savings in order to support the aging population.

Similar to other countries in the region, the services and agriculture sectors constitute the largest employers, accounting for 44 percent and 39 percent of total employment, respectively. Unemployment rates are high at 16 percent and half of unemployed persons have been jobless for more than a year. Labour force participation is low, particularly for women (56 percent compared to 73 percent for men). In addition, existing jobs are often characterised by low productivity, with a quarter of jobs paying less than two thirds of the median wage, resulting in substantial numbers of working poor. Reported poverty was 32 percent in 2013. Nonetheless, new surveys presented by the World Economic Forum show labour market improvements since 2012, particularly in relation to the introduction of more flexible hiring, firing and wage setting policies, which should ease entry into the labour market for job seekers.

Youth unemployment is particularly high (30.2 percent in 2013) and tends to be highest among young women and youth with tertiary education, especially in urban centres where the labour market has difficulty absorbing new graduates. Just over 27.4 percent of young people are not in education, employment or training (NEETs). Young women are more likely to be inactive and out of school in order to tend to family responsibilities. Even though Armenian workers are generally well educated, with one worker in three having completed tertiary education and one in four at last secondary technical education, the quality of educational outcomes are below the EU average. In addition, the structure of Armenia's education system results in the majority of young people (close to 90 percent) not receiving work experience during their education. This creates a more challenging and lengthy transition process into the labour market and contributes to high levels of graduate unemployment, currently at over 21 percent. However, in comparison with other countries in the region, Armenian entrepreneurs attain a higher level of education; many have postgraduate degrees, and are involved in a higher level of innovation activities.

There is not much data on key sectors for women's entrepreneurship but women's businesses are thought to be clustered in lower-value activities, such as subsistence trade. A gender gap exists in access to finance and there are fewer females than males in the top management and ownership of enterprises, as evidenced by the 2012-13 BEEPS. Furthermore, gender disparities exist in relation to women's access to tailored financial programmes and business

products (such as debit and credit card use, as well as formal accounts used for business purposes). The OECD's 2014 Social Institutions and Gender Index (SIGI), which scores countries by level of gender discrimination in their social institutions utilising information on laws, attitudes and practices, indicates a relatively high level of gender discrimination in Armenia's social institutions.

In 2013, slightly more than one-third of the population in Armenia (36.7 per cent) lived in rural areas. Regional disparities are substantial, particularly in relation to the availability of (productive) employment opportunities in rural areas, access to health and municipal services and the quality of locally available education. These disparities were compounded by the financial crisis of 2009, which resulted in the poverty rate increasing from 27.6 per cent in 2008 to 35 per cent in 2011. The government has sought to decrease unemployment benefits and instead create more job opportunities, particularly through public works in rural areas, which will help close the large regional labour market gaps in the country. In addition, spending is being increased on social programs, education and healthcare. In particular, the government introduced a multi-pillar pension system and mandatory savings element in 2014, which is expected to increase the personal savings rate and support Armenia's aging population.

## **2.7 Energy efficiency and climate change context**

With substantial potential for development of renewable energy, a strong reliance on imports and the prospect of a significant supply-demand gap once its nuclear power plant is retired, Armenia needs to invest more in energy efficiency and further enhance the investment framework.

Armenia's energy intensity is 40 per cent greater than that of the EU.<sup>7</sup> The country has no proven oil or natural gas reserves and imports most of its fossil fuel resources from Russia and Iran. Net imports of energy accounted for almost 70 per cent of the country's primary energy needs with the need for transport and heating fuels being entirely met from imports.

Overall, energy demand in Armenia has steadily increased in recent years, growing by 10 per cent in 2011 and another 9 per cent in 2012. The primary energy domestically produced is currently electricity generated by a nuclear power plant (around 30 per cent), two thermoelectric power plants (around 42 per cent) and numerous large (23 per cent) and small (6 per cent) hydroelectric power plants.<sup>8</sup> Given growth in demand and the need to retire aging generation plants, Armenia will potentially face a major supply-demand gap once its sole nuclear power plant is retired (expected in 2026).

Lowering the energy intensity of the economy is therefore a key solution in addressing the competitiveness of local production, the high exposure to import prices, the rising electricity generation gap, and the limited energy affordability of the population. More specifically, the residential sector in Armenia is one of the largest energy end-users of the country; 37 per cent of its final electricity and heat consumption was in the residential sector in 2012 (IEA). This figure is higher than most other transition countries, calling for urgent measures in order to reduce the energy demand in the urban housing sector. The majority of the housing stock

<sup>7</sup> Toe per GDP in USD 2005 PPP (Source: IEA, 2011 data).

<sup>8</sup> Public Services Regulatory Commission of the Republic of Armenia – 2012.

comprises badly insulated and poorly constructed multi-story apartment buildings that generally provide a low level of energy savings and comfort. Energy efficient housing stock will be an important area for potential Bank investment to reduce energy use and associated GHG emissions.

There is a substantial potential for renewable energy development in Armenia in wind, solar, hydro and geothermal resources.<sup>9</sup> However, in terms of financing such projects, directly or through local banks, there is still a lack of awareness of what types of investments can be done and the sustainable technologies available, and often local banks are relatively unfamiliar with types of sustainable energy investments. Additionally, in order to enable private sector investments, feed in tariffs need to be adjusted to adequate levels.

With regard to water resources, Armenia is vulnerable to existing climatic conditions and to future climate change. According to the Second National Communication to the UNFCCC, Armenia already experiences significant temporal and spatial variability in precipitation and surface runoff, which is expected to become more severe with reduced surface runoff under most climate change projections. Technical and institutional measures are therefore needed in order to promote the efficient use of water resources. Investments and reforms to support water efficiency are especially needed in agribusiness, mining, and the industrial and municipal sectors. As Armenia's hydropower operations are also vulnerable to climatic conditions, measures to build resilience will need to be incorporated into the construction and rehabilitation of hydropower facilities.<sup>10</sup>

### **3 STRATEGIC ORIENTATIONS**

#### **3.1 Strategic Directions**

Strengthening the competitiveness of the domestic private sector and levelling the playing field is pivotal to Armenia's ability to engender a more broad-based economy, reduce vulnerability to external factors, and achieve sustainable growth. To that end, increased access to finance, particularly for MSMEs, further improvements to the business environment, developing modern management capacity in corporates, and strengthening the value chain are all necessary. Capital markets development, especially in the context of pension reform, is another important element that could provide a much needed enhancement to the traditional bank lending that dominates the financial sector, and which has exhausted breathing space for many corporate borrowers. Finally, much more remains to be done to improve and commercialise public services and infrastructure, both for the direct benefit of citizens and to improve the competitiveness of business.

In view of the identified sector and country-based transition gaps, the Bank's strategic orientations in the new strategy period therefore concentrate on enhancing private sector competitiveness, developing capital markets, and supporting commercialised public utilities with improved service delivery.

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<sup>9</sup> Scaling Up Renewable Energy Program (SREP), Investment Plan for Armenia, April 2014.

<sup>10</sup> <http://unfccc.int/resource/docs/natc/armnc2e.pdf>.

***Enhancing private sector competitiveness by strengthening capacity, increasing corporate transparency and improving the business environment:*** For Armenia's small, open economy, a significant improvement in competitiveness is the key to attracting investment. Lack of competition, particularly barriers to entry for private businesses, is a serious impediment holding back innovation and entrepreneurship, and is exacerbated by red tape, administrative barriers, low corporate transparency and limited access to finance, all of which tend to favor larger domestic incumbents and deter new entrants, including FDI. The Bank will target assistance for improvements to the regulatory and administrative environment, encourage more sustainable and resource efficient growth across sectors, and strengthen its assistance to MSMEs that strive to be more transparent and competitive through a combination of finance and advisory services. While financing of the best of the Armenian private sector through SBI instruments will remain an integral part of the support provided by the Bank, reaching out to SMEs across industries via partner banks (by way of dedicated credit lines such as CEEP) will continue to deliver the most transition impact overall. Enhancing access to finance through SME loans therefore will continue to be a cornerstone of the Bank's strategy.

***Developing capital markets and promoting local currency financing:*** While Armenia has access to international capital markets, the development of local capital markets and local currency finance is critical for the country's sustainable development. There is a need for new instruments across firm capital structure, along with modern behaviour among corporates in their approach to shareholder value. As the authorities roll out mandatory pension reforms, which will likely increase savings and create local demand for bonds and equity, the majority of pension fund investments will be channelled in local currency. Once in place, success will largely depend on the emergence of a healthy supply of capital market issues on the local market, and enough different investors to create market liquidity, alongside the emergence of a more robust money market and hedging instruments. While the size of the Armenian market presents special challenges, and the transition required will take significant effort over years, the Bank will address these challenges in Armenia as a focus country for its local currency and capital markets work.

***Developing sustainable and commercialised public utilities:*** Armenia's available fiscal space cannot fully accommodate the country's crucial energy, transport and municipal infrastructure needs in the absence of high growth rates. This highlights the importance of commercialisation and increased private participation in public service provision, while a significant grant element will also be needed for sovereign and sovereign guaranteed projects during the medium term for debt sustainability. To achieve efficient prioritisation, the Government of Armenia will need to develop projects within national sector strategies that are consistent with its financing constraints. The Bank is well positioned to contribute to these strategies in cooperation with other donors, and assist in upgrading and expanding public service provision through policy advisory and capacity building assistance aimed at sustainable commercialisation combined with lending (including sovereign-supported lending, as may be necessary) for energy and energy efficiency, transport, and municipal service projects which are environmentally sound, improve competitiveness, and lead to cost recovery.

### **3.2 Key challenges and Bank activities**

***Theme 1: Enhancing private sector competitiveness by strengthening capacity, increasing corporate transparency and improving the business environment***

## Transition challenges

- Surveys show that businesses continue to face major problems related to tax and customs administration, corruption and the shadow economy. The lack of a level playing field is a major challenge, and sector monopolisation remains high. Competition is limited because of barriers to entry, ownership concentration, market dominance, and vertical and horizontal integration.
- The competitiveness of Armenian products is also hampered by obsolete infrastructure and undeveloped logistics networks, which lead to high transport and logistics expenses.
- Key challenges include: (1) improving competition policy by liberalizing the ‘doing business’ environment and through sound regulatory action; (2) enhancing transparency and fairness in tax and customs procedures; and (3) further developing transport infrastructure and logistics to reduce costs and increase competitiveness of Armenian products.
- Banks are generally sound and well-capitalised, but the challenging macroeconomic environment calls for close monitoring, particularly given the heavy dollarisation. Weaker economic activity and currency depreciation have reduced profitability. A further slowdown is likely to increase non-performing loans and currency depreciation will affect banks’ capitalisation ratios. Even if these do not trigger recapitalisation or restructuring, banks will probably respond by tightening lending standards and reducing the amount of private sector credit flowing to the real economy. This will worsen access to finance by enterprises, including in the SME segment.
- Non-bank financial services in Armenia are at an early stage of development. The insurance sector remains small and composed only of property and casualty. MSME lending accounts for only about 25 per cent of domestic credit to the private sector notwithstanding the significant contribution of the SME sector to GDP. MSMEs face higher interest rates, shorter tenors (typically under one year), and higher collateral requirements. In addition, banks and other financial institutions direct only slightly over 20 per cent of their SME loan portfolio to SMEs located outside Yerevan, while the proportion of SMEs located outside Yerevan is well over 50 per cent.
- Key challenges include: (1) diversifying financial products, including SME lending instruments such as leasing and equity capital; (2) further developing insurance industry product range and skills, and bringing insurance regulation into compliance with international standards; (3) developing leasing markets and structured finance products; and (4) supporting and facilitating banking sector consolidation.
- Women face particular obstacles to establishing and running enterprises including access to credit, skills and networks. Improving women’s participation in the labour force will be crucial to developing a more competitive private sector.
- There is also a substantial skill mismatch between the output of the education system and the requirements of employers. This creates real challenges for companies to recruit and retain qualified staff and results in high levels of (particularly graduate) youth unemployment and NEET rates, particularly in rural areas.
- In agriculture, issues include the prevalence of small and inefficient subsistence farming in the primary agricultural sector and limited availability of finance, which contributes to low technology and yields. Supporting formalisation of agricultural enterprises would help increase access to finance.



- The mining sector lacks modern refining capacity apart from some cases (e.g., diamonds, aluminium), and most of Armenia's metals are exported as concentrates (i.e. low value added commodities). Exploration is also insufficient due to high capital expenditures and inadequate access to finance. While some progress is being made, a legacy of environmental degradation from mining remains, and socially and environmentally irresponsible practices continue. A key challenge will be to increase the transparency of revenue flows from extractive activities and develop mining beneficiation and refining facilities to broaden the supply chain.

### Operational Response

- Should the financial sector outlook deteriorate as a result of an economic slowdown and currency devaluation, the Bank will seek opportunities to help alleviate the growth of NPLs, particularly through dedicated technical assistance to partner banks, and will also explore the possibility of participating in viable recapitalisations of individual institutions.
- While the much needed bank consolidation has been long overdue, there is good reason for optimism within the country strategy period and in light of the CBA's recent decision to substantially increase minimum capital requirements by January 2017. The Bank's role here is particularly relevant at times of heightened financial stress, where EBRD will be prepared to support mergers and acquisition through strategic capital participation in support of stronger, more efficient bank leaders – which in turn will boost access to finance for corporate borrowers.
- Through the financial sector as a conduit, the Bank will work to ease access to finance for MSMEs through targeted credit lines. These will include credit lines for energy efficiency, and women-led businesses—subject to the development of bankable pipelines of women business borrowers. The Bank will also continue financing micro-credit organizations, particularly those who provide financial access to rural businesses excluded from the traditional banking sector.
  - With respect to energy efficiency, the Bank will continue to support investments through CEEP, and will look to boost energy efficiency in existing building stock. The Bank will also continue to promote effective resource utilisation and sustainable technologies through the Finance and Technology Transfer Centre for Climate Change (FINTECC) and similar initiatives.
  - The Bank is also launching a Women in Business (WiB) programme, which will bring together critical elements to support women's access to finance, including by providing dedicated financing (including a first loss guarantee for women-led MSMEs), technical assistance to help partner banks adjust their business models and delivery mechanisms, and advisory services for women entrepreneurs.
- The Bank will continue to support sound local corporates willing to demonstrate a commitment to improving corporate governance and transparency through advice using Small Business Support, while providing long-term investment and working capital financing, including in manufacturing, logistics and processing, with a heightened focus on innovation and the knowledge economy. All these areas will be addressed primarily under the Direct Lending, Direct Investment and Medium Sized Co-Financing facilities. In particular the Bank will seek bankable opportunities to invest in agro-enterprises throughout the supply chain, while providing technical assistance in key areas.
- The Bank will continue to support select mining projects that can serve as benchmarks for the industry in terms of standards, transparency and social-

environmental responsibility, with the aim of developing a critical mass of projects that could sustain a domestic refining industry, as well as attracting investment to expand exploration.

#### Policy dialogue and capacity building technical assistance

- The Bank will continue to support the Investment Council as a platform for policy dialogue between the Government and the private sector. As IC capacity increases and more challenging issues are addressed, the Bank will step up its technical and financial support for the Secretariat, including in-depth technical assistance in areas such as implementation of risk-based inspection reform, and harmonisation of EEU, EU and Armenian regulatory matters affecting small businesses and exporters. The Bank will also facilitate heightened coordination across the donor community, particularly with respect to tax/customs policy and administration.
- The EBRD will provide technical assistance and capacity building to improve the functioning of financial arbitration, and stands ready to assist where its advisory can enhance the business environment, such as improvements in the legal/regulatory frameworks for leasing and factoring, and remaining shortfalls in the framework for collateral recovery and liquidation.
- The Bank will coordinate with other donors to promote responsible mining and best practices through policy dialogue, including with NGOs, mining companies and the authorities. The Bank stands ready to assist Armenia in joining the Extractive Industries Transparency Initiative (EITI), which could further help attract additional investment into the mining sector.

**Results Framework for Theme 1: Enhancing private sector competitiveness by strengthening capacity, increasing transparency and improving the business environment**

	CHALLENGES	OBJECTIVES	ACTIVITIES	TRACKING INDICATORS
1.1	Competitiveness is hampered by limited capacity, lack of competition, difficult business environment and red tape	<b>Strengthen competitiveness through increased efficiency, productivity and competition, as well as advice on business practices and standards</b>	<ul style="list-style-type: none"> <li>▪ Direct and indirect (via partner banks) financing to sound local corporates and agribusiness, backed by TC on core competencies, skills transfer, corporate governance and transparency</li> <li>▪ SBS support for improving management practices and productivity, including through the Women in Business programme</li> <li>▪ Direct and intermediated financing (CEEP, FINTECC) to promote energy/resource efficiency and sustainable technologies across sectors</li> <li>▪ Financial support and strategic guidance to the Investment Council</li> </ul>	<ul style="list-style-type: none"> <li>▪ SBS/TIMS indicators on number of client firms that reported growth, increased productivity and qualitative account of improved corporate governance and business standards (<i>Baseline – established at project's approval</i>)</li> <li>▪ Total number/volume of loans for energy efficiency projects extended by the Bank and PFIs (under CEEP and FINTECC) and volume of energy savings achieved based on EBRD methodology in toe/yr (<i>Baseline – established at project's approval</i>)</li> <li>▪ Evidence of successful enactment and/or implementation of IC-sponsored reforms related to improving the business environment (<i>Baseline – N/A</i>)</li> </ul>
1.2	Businesses constrained by limited access to finance	<b>Strengthen the financial sector through deepened financial intermediation and development of non-banking alternatives to bank financing</b>	<ul style="list-style-type: none"> <li>▪ Financing of micro-credit organisations, particularly those providing financial access to rural businesses</li> <li>▪ Promote access to finance through a range of innovative bank instruments and credit lines</li> <li>▪ Policy dialogue and technical assistance on regulatory improvements, including on the functioning of financial arbitration, as well as collateral, leasing and factoring</li> </ul>	<ul style="list-style-type: none"> <li>▪ Total number/volume of loans extended by client banks and PFIs to MSMEs, including, as applicable, to rural businesses and women (<i>Baseline – established at project's approval</i>)</li> <li>▪ Evidence of improved regulatory environment, including for the non-banking sector (<i>Baseline – N/A</i>)</li> </ul>
<b>Context indicator:</b> $\Delta$ in MSME ATC score ( <i>Baseline (2014) – 2+ (Medium)</i> )				

## ***Theme 2: Developing capital markets and promoting local currency financing***

### Transition challenges

- As noted, dollarisation in the banking sector is persistently high. Dollarisation is driven by the liability side of bank balance sheets that, in the absence of forward and foreign exchange (FX) swap markets, cannot detach the denomination of lending from deposits which are their main source of funding.
- Around 25 per cent of deposits in the banking sector come from non-residents, predominantly in foreign currency. FX deposit rates are at around 7-8 per cent per annum for maturities of 6 months and longer. After two years of relative stability, the dram depreciated by 14 per cent against the US dollar at the end of 2014.
- Sources of private equity are nearly non-existent for Armenian companies. Companies rely mostly on banking loans for funding, with a limited range of financial instruments available to enterprises.
- MSMEs operating in investment-intensive sectors are particularly affected by the absence of long-term financing, especially in local currency. Key challenges include: (1) increasing the share of local currency lending in total lending, including to SMEs; (2) supporting the emergence of derivative instruments to hedge rates and currency risks; and (3) diversifying banking products, including local currency deposits.
- While the Armenian capital market has a relatively sound infrastructure and regulatory and legal framework for corporate debt and equity issuance, trading is limited. Activity is concentrated in the overnight interbank market and government bonds. One of the biggest impediments to further developing capital markets is the lack of institutional investors; others include the cost of issuance and corporate transparency. Key challenges include: (1) broadening the listed market with additional corporate issues, especially bonds; (2) attracting investor interest and liquidity by improving settlement arrangements; (3) lengthening the maturity of interbank market activity; (4) supporting development of bank to bank interbank activity, as opposed to the current fully-collateralised system-wide bid-offer for interbank lending through NASDAQ; (5) developing money market benchmarks and FX swaps; and (6) exploring regional alliances to enhance local market liquidity.

### Operational Response

- The Bank will continue to focus on affordable local currency lending through dram credit lines to banks, issuance of EBRD dram bonds on the local exchange and international markets, expansion of settlement arrangements and coordination with market hedge participants, both internationally and locally, with the aim of establishing domestic hedge facilities and higher participation of local wealth among long dram risk takers.
- By launching the Medium Term Bond Framework facility, and in parallel with implementation of the planned mandatory pension reform by 1 January, 2017, the Bank will aim to provide term finance to banks for participation in local bond issues over the exchange, along with supportive technical assistance to issuers, investors, and potentially domestic ratings agencies. Where possible, the Bank will look to participate in local mergers and acquisitions, international syndicates and bonds, while encouraging select privatisations which are executed transparently and

according to good practice – where possible via public markets to further stimulate capital market activity.

- The Bank will aim to help address a significant gap in private equity as a source of long-term capital, both through the Direct Investment Facility for select targets, and by encouraging private equity fund activity, potentially by enhanced participation in local equity funds, and through debt co-investment.

#### Policy dialogue and capacity building technical assistance

- Through policy dialogue with the CBA, and outreach with investors, traders and market infrastructure providers (such as Clearstream and Frontclear), the Bank will seek to support a more robust money market, the emergence of domestic hedge instruments, and more international investment into Armenian debt instruments.
- Through technical assistance the Bank will seek to support an improved legal, regulatory and judicial environment for private equity activity, such as helping to establish a legal basis for appropriately structured shareholder agreements.
- Through technical assistance and ongoing dialogue, the Bank will seek to educate potential issuers on derivatives, money markets, and the benefits of market issuance (both bonds and stocks) as well as clarify the issuance process. Included in this effort will be technical assistance through SBS and the Medium Term Bond Framework on the implementation of high quality investor outreach, including firm level institution of processes and behaviours which can attract the participation of financial risk takers in firm capital structure.

## Results Framework for Theme 2: Developing capital markets and promoting local currency financing

	CHALLENGES	OBJECTIVES	ACTIVITIES	TRACKING INDICATORS
2.1	Corporates, particularly MSMEs, lack access to local currency financing	<b>Increase availability of local currency financing</b>	<ul style="list-style-type: none"> <li>▪ Stimulate local currency lending through dram credit lines, bond issuances, derivative products and expanded settlement arrangements</li> <li>▪ Finance local bond issues by launching the Medium Term Bond Framework facility</li> </ul>	<ul style="list-style-type: none"> <li>▪ Total number/volume of local currency loans extended by client banks (<i>Baseline – established at project's approval</i>)</li> <li>▪ Introduction of innovative financial products by the Bank (qualitative account on financial market range and replication) (<i>Baseline – N/A</i>)</li> </ul>
2.2	Capital markets activity is limited, particularly institutional investment	<b>Further strengthen and help develop Armenia's capital markets by broadening activity and attracting investment</b>	<ul style="list-style-type: none"> <li>▪ Participate in international syndicates, bonds and key privatisations to stimulate capital markets activity</li> <li>▪ Facilitate private equity as a source of long term capital, including through DIF and local funds</li> <li>▪ Technical assistance and related SBS support to potential issuers on corporate governance, management and transparency</li> </ul>	<ul style="list-style-type: none"> <li>▪ Evidence of improvement in capital markets (debt and equity) (e.g., new issuances, increased volumes) and, as appropriate, attributed to the Bank (<i>Baseline – N/A</i>)</li> <li>▪ Volume of private equity with EBRD participation (including qualitative account of replication) (<i>Baseline – established at project's approval</i>)</li> </ul>
<b>Context indicator:</b> $\Delta$ in Capital Markets ATC (Market Structure) score ( <i>Baseline (2014): Large</i> ); equity and bond market trading volumes				

### *Theme 3: Developing sustainable and commercialised public utilities*

#### Transition challenges

- Armenia's power sector is legally unbundled and the private sector is present, but there is no effective competition as the system continues to rely on a centralised buyer model for wholesale energy. Electricity prices and tariffs are regulated by a semi-independent regulator, which needs to be strengthened to deal with political pressures. The development of a decentralised competitive wholesale system would increase the transparency of price signals and stimulate private investment. In the short-term, prospects for development of an open and competitive wholesale market are limited due to insufficient support for market reforms, lack of physical interconnection with neighbouring markets, the dominant position of large players and a single buyer market model. Network losses remain relatively high at around 13 per cent. Key challenges include: (1) improving market price signals through competitive systems in the medium term, (2) increasing private sector participation in the power sector, and (3) improving tariff methodology which would include introduction of cost reflective tariffs for end consumers.
- Domestic energy generation is relatively concentrated, and dependence on imported gas and oil from Russia is high. Diversification into renewable energy sources could be an option. The most promising are small hydro, wind, solar, geothermal and biomass. Key challenges include: (1) strengthening the technical and institutional capacity for preparing and deploying energy efficiency and renewable energy projects, (2) increasing awareness on best practices, and (3) achieving tariff and off-take arrangements which can attract additional private sector participation.
- In the water sector, utilities have been decentralised and partly regionalised. The two key companies are managed by foreign strategic operators. Major capital investments continue to be supported by donors and IFI loans, and tariff levels remain generally low. Bill collection is still an issue and manipulation of meters is a recurrent problem. There is a government plan to centralise operations, establish one large water company and unify tariffs. However this could potentially lead to cross-subsidisation among regions. The key challenge will be to increase the sustainability of the utility by (1) strengthening private sector participation, and (2) achieving cost recovery in all segments.
- In urban transport, municipally owned metropolitan and trolleybus companies experience financial, technical and operational challenges. Road infrastructure and service levels are in poor condition due to years of underinvestment. The institutional capacity to implement and monitor private sector participation and competition is weak. Key challenges include: (1) decentralisation of core regulatory aspects, including responsibility for tariff setting and service provision, (2) strengthening the institutional and legal capacity for municipalities to regulate and monitor public and private transport service provision; (3) reforming publicly owned urban transport operators to improve quality of service without compromising sustainability; and (4) improving integration and ticketing.

#### Operational Response

- The Bank will focus on physical modernisation of the high voltage transmission network to improve operational reliability, efficiency and enhanced supply capacity as well as a high-voltage interconnection to enable cross-border power trade, while

helping improve regulatory policy, primarily in coordination with the development banks and donors. The Bank will also stand ready to invest in power generation projects alongside the private sector.

- The Bank will seek to invest in energy efficiency measures such as “smart” street lighting and sustainable urban transport solutions, accompanied by transparent regulatory structures. To the degree that tariffs sustain bankable projects, the Bank will also stand ready to invest in renewable energy projects alongside private sector participants, potentially with the support of SREP grants to defray capex costs.
- The Bank will continue to invest toward commercially feasible solid waste projects along the lines of the Government’s National Solid Waste Strategy, and in particular will focus on bringing solid waste processing to cost recovery and environmental sustainability.
- The Bank will support further investments in water and wastewater infrastructure, providing support to sustainable private sector participation in light of the Government’s plans to combine two ongoing concessions into a national operator concession.

#### Policy dialogue and capacity building technical assistance

- The Government has shown a willingness to lead a more coordinated energy policy through a multi-donor working group. The Bank will use this opportunity to participate in heightened dialogue on key issues, particularly with respect to putting in place the necessary steps for financial feasibility of projects, including through improvements in regulatory and tariff policy where the Bank stands ready to supplement World Bank policy advice in this area.
- The Bank will also look for opportunities in conjunction with its public utility and infrastructure investments to promote privatisation, facilitate investor/concessionaire relations, develop cost-reflective tariff policies, and promote social and environmental sustainability, tailored to address Armenia’s fiscal constraints by crowding in the private sector. Examples include advisory services in support of private sector participation in the national post-bank, “Hay Post”, and toward potentially combining the current two private operator concessions for public water supply management into one.



### Results Framework for Theme 3: Developing sustainable and commercialised public utilities

	CHALLENGES	OBJECTIVES	ACTIVITIES	TRACKING INDICATORS
3.1	Armenia's municipal infrastructure is poor, and its public utilities inefficiently operated. Regulatory framework and approach to tariff setting constrain sustainability of operators	<b>Strengthen sustainability, operating practices, and governance of public utilities through improved management, a conducive institutional and regulatory framework and private sector participation</b>	<ul style="list-style-type: none"> <li>Investments in sustainable projects in water/wastewater, power and/or solid waste, where possible in cooperation with other IFIs, donors and/or the private sector</li> <li>Promote privatisation, commercialisation, sustainability and tariff reform through policy dialogue and technical assistance</li> </ul>	<ul style="list-style-type: none"> <li>Evidence of improvements in efficiency and infrastructure service delivery, including financial and operational performance of municipal operators reported through TIMS/TCRF (<i>Baseline – established at project's approval</i>)</li> <li>Introduction of improved tariff methodology in municipal services in line with cost-recovery principles as a result of the Bank's policy dialogue and technical assistance (<i>Baseline – N/A</i>)</li> </ul>
3.2	Armenia lacks the institutional and technical capacity to develop energy/resource efficiency and renewable energy projects	<b>Strengthen the institutional framework and improving incentives for sustainable energy policy and use</b>	<ul style="list-style-type: none"> <li>Direct investments in energy/resource efficiency measures and/or financially sound renewable energy projects, with private sector participation and backed by policy dialogue</li> <li>Support financially sound renewable energy projects with private sector participation</li> </ul>	<ul style="list-style-type: none"> <li>Volume of energy savings achieved through Bank investments based on EBRD methodology in toe/year (<i>Baseline – 0</i>)</li> <li>Change in capacity of renewable energy installed with Bank support (in MW and MWth) (<i>Baseline – 0</i>)</li> </ul>
<b>Context indicator:</b> $\Delta$ in MEI and Power ATC scores ( <i>Baseline (2014) – Water &amp; Wastewater: 3- (Medium); Urban Transport: 2+ (Medium); Roads: 3- (Medium); Power: 3+ (Small)</i> )				

### 3.3 Potential Risks to Country Strategy implementation

The EBRD's ability to deliver on its strategy in Armenia will be influenced by a number of factors outside the Bank's control. Where feasible, the Bank will work to address and mitigate these risks through proactive and sustained engagement with its clients, IFI partners and the Government.

Macroeconomic risks to the strategy are significant. Armenia is a small, open economy, with a narrow economic and exports base, and substantially dependent on Russia. Armenia runs a wide current account deficit, has accumulated a large stock of foreign debt, and its banking sector is heavily dollarised. Armenia is thus exposed to external shocks which through exchange rate and confidence links may have a material and lasting knock-on impact on the economy and affect implementation of the strategy.

The crisis in Ukraine, sanctions on Russia, and their related economic impacts are affecting Armenia through the exchange rate, regional trade, the threat of reduced (especially Russian) investment, and lower remittances. Some of the most immediate knock-on threats to the strategy are:

- Further exchange rate devaluation against the US dollar (the currency of denomination of the major part of Armenia's public debt) will push the ratio of the public and publicly guaranteed debt to GDP further above 50 per cent, i.e. close to what can be viewed as the 'debt intolerance threshold,' given the weak economic structure and governance standard and high dollarisation. Pursuant to Armenian law, this would limit the fiscal deficit to 3.0 per cent of GDP (calculated as a 3-year moving average, with the limit kicking in in the year after the threshold was exceeded). Should the debt ratio reach 60 per cent, Armenia would not be able to undertake further international borrowing without a change to its own legislation.<sup>11</sup> The law and the fiscal rule, however, could be changed by simple majority voting in the parliament. With or without the legal debt limit, debt sustainability and fiscal space represent significant concerns and will limit the type and volume of new sovereign financed and/or guaranteed projects. Among other things, this could result in a stop to any new EBRD infrastructure and public service provision projects that require sovereign support.
- While banks have managed immediate balance sheet risks from currency moves and remain well capitalised, the predominance of US dollar lending creates credit risks. There is a significant near-term risk of a rise in non-performing loans across the banking sector, which could lead to a slowdown of the EBRD's financial sector credit lines in the absence of sufficient bank capital. The bank consolidation effort can help address this risk over time, however, and the EBRD is well placed to participate in select consolidators.

Uneven progress by the Armenian authorities on their reform agenda represents a risk to strategy implementation, and the impact of reforms will in any case not be immediate.

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<sup>11</sup> Article 63 of the Treaty establishing the Eurasian Economic Union contains quantitative targets for the annual consolidated public sector deficit (not to exceed 3 per cent of GDP) and public debt (not to exceed 50 per cent of GDP), although whether they are binding on EEU members is unclear.

Political factors additionally may complicate policy advances. For example, mandatory pension reform was originally designated to start on January 1, 2014. Due to significant pushback by pension contributors and opposition parties, the mandatory portion of the reform has been delayed until 2017. On one hand this provides more time to help create instruments for pension fund managers to purchase locally, but on the other hand should the reform not move as planned, crucial long term dram assets will not be forthcoming in terms of demand for local instruments. Continued progress on tax and customs reform, risk based inspections, and improvements of the legal and judicial system for private sector investments are among the most important additional components needed for the success of the strategy.

On the Constitutional reform plans, the ruling party is proposing a major overhaul of both the judicial and political systems, including a transition from the current semi-presidential to a parliamentary system. The 2018 presidential transition (from the current president to a new one) could also heighten political polarisation.

While EEU accession may bring benefits, the Armenian economy could become even more closely tied to Russia, and the absence of an Association Agreement with the EU could mean the loss of a long-term reform anchor and convergence to EU standards. Currently the Armenian Government and the EU are discussing a new framework for cooperation which would be consistent with Armenia's commitments under the EEU. The Bank's strategy robustly supports Armenia's integration objectives, but implementation will be affected by the pace and quality by which Armenia is able to implement its trajectory.

Temporary uncertainties with regard to the new regulatory frameworks and mechanisms under the EEU remain a drag on investment activity, as companies participating in international trade face new risks such as new customs policies and implementation.

Lack of capex grant co-financing facilities, in the context of the authorities' minimum concession requirement for all IFI-financed public and public guaranteed debt, in particular with respect to Armenia's reduced access to the EU NIF window, will continue to limit the type, number and volume of public service infrastructure projects. Currently most EBRD financed infrastructure projects require a 10-50 per cent capex grant component, depending on the project and the share the EBRD is contributing. Efforts to broaden to sub-sovereign risk and crowd in the private sector are only partial solutions, and are unlikely to work without some level of sovereign support.

Finally, main *force majeure* risks include a severely deepened financial crisis, heightened tensions between Armenia and Azerbaijan, an accident at Metsamor nuclear facility, and the ever present risk of a major earthquake. While tail risks, should any of these negative events occur, it would surely put strategy implementation at risk.

### **3.4 Environmental and Social Implications of Bank Proposed Activities**

One of Armenia's most pressing environmental and social challenges is the limited availability of and access to municipal services, including clean water and adequate facilities for the management and disposal of solid and liquid waste. The prevalence of poor air quality also has significant impacts on the environment and the health of the population, an issue partly linked to the limited availability of appropriate solid waste disposal.

Lake Sevan has significant cultural and historical attachment for Armenians and the condition of the lake continues to be a highly emotive subject and focus of numerous CSO statements. Diminishing water quality and quantity in Lake Sevan is often cited as the primary environmental and cultural heritage concern of the Armenian people. Habitat and associated biodiversity loss is also a prominent concern of CSOs and the general public.

Historically, the voices of environmental activists have not been influential and public information and consultation in project development on environmental and social issues has been lacking. This has led to significant frustration and distrust at times between CSOs and the authorities. While some improvements have been made, there remains a strong environmental and social movement in Armenia, focusing on both current and legacy issues.

The Bank's 2014 Environmental and Social Policy will appropriately address these specific challenges and the wider remit of environmental and social sustainability and governance.

Investment in municipal infrastructure has the potential to realise significant environmental and social benefits and to address a range of sustainability challenges facing Armenia. EBRD projects in the municipal sector will be required to meet EU environmental standards, although this commitment may be challenging, particularly for projects where borrowing capacity may be limited. The limited borrowing capacity and small size of many projects can also be a challenge in sectors such as mining, where environmental and social risks, and associated public concerns are often high, and the costs of environmental and social commitments agreed with the Bank significant.

In January 2015, the European Union and Armenia confirmed their joint commitment to enhance and deepen their cooperation through the European Neighbourhood Policy and the Eastern Partnership, where engagement with civil society is a key element, underpinned with initiatives like the Civil Society Forum, the Neighbourhood Civil Society Facility, and dedicated funding at regional and country level.

In 2014 Armenia passed a revised Environmental Impact Assessment (EIA) Law that reflects requirements of the EU EIA Directive, including public participation and stakeholder engagement. Although this is a major step forward in regulating environmental issues in Armenia, the EU has noted that the areas of social reform and human rights are still in need of improvement. The Bank will encourage such developments through dialogue with other IFIs, and work with its clients to ensure meaningful and extensive stakeholder engagement in the design and implementation of investments. The degree of poverty, especially outside of Yerevan, will mean that special attention will be made to ensure accessibility of services for the most vulnerable and poor.

### **3.5 EBRD co-operation with MDBs**

A large number of IFIs and donors are active in Armenia. In addition to policy dialogue and coordination of technical cooperation related to projects, there have been encouraging examples of donors speaking with one voice to encourage implementation of reform, particularly related to improvement of the business environment, such as on "Open Skies". The Bank will continue the following:

- Cooperating with other IFIs in the context of regular donor coordination meetings, where the EBRD plays a leading role in capital markets development, private sector

development, improved planning of sovereign guaranteed infrastructure, and commercialisation of public services.

- Working with the IFC on inspection reforms, SME development and regulatory reforms, as well as with the EU, USAID, IMF, KfW and other donors on overall improvement of the business environment. In particular, the Bank will continue its efforts to link the work of the EBRD-funded Investment Council with expertise and recommendations emanating from the USAID Tax Project and WB/IFC attention to improved customs administration.
- Cooperating with the IMF, the WB/IFC and USAID to support local currency financing, improved bank and non-bank financial regulation and development of capital markets.
- Working with the EIB, ADB, WB and KfW on water sector reform (led by KfW), solid waste (led by the ADB), urban transport (led by the ADB), and energy sector policy and projects (led by the WB).
- Engaging with the Government, in tandem with other donors, on the outcome of ADB's planned multi-modal transport economic feasibility study for Armenia, which would contribute both to better transport outcomes and prioritised decision-making in the context of limited fiscal space. The EBRD in particular will look to team up with the EIB on priority roads projects.
- Expanding the cooperation with EIB and EU Neighbourhood Investment Facility (NIF) in financing municipal, transport and energy infrastructure projects. In energy in particular, further NIF support has been linked to an effort by the Ministry of Energy and Natural Resources to coordinate policy and projects across the donor community, while the ADB and EBRD are teaming up to implement improvements to the high power transit and distribution system, potentially with NIF support.
- Working with participating E5P institutions in Armenia, including the EIB, KfW, NEFCO and the EU, in coordination of the Ministry of Energy and Natural Resources, to prioritise and implement energy efficiency and environment enhancing projects, where possible in cooperation with the private sector.

## ANNEX 1 – POLITICAL ASSESSMENT

Armenia is committed to and applying the principles of multiparty democracy, pluralism and market economics, in accordance with Article 1 of the Agreement Establishing the Bank, although the application of these principles remains uneven.

Over the last strategy period Armenia has made progress in strengthening its democratic institutions by conducting generally free pluralist elections, by initiating reforms of public administration, local governance and the judiciary and by reaffirming the government's commitment to fighting corruption. In all these endeavours the Armenian authorities have cooperated with the Council of Europe, the OSCE and the European Union.

Democratic checks and balances exist but could be strengthened further. Citizens' participation in the political process is generally low, partly due to public distrust in the integrity of political institutions, the election process and the judiciary. Laws and regulations are often developed in line with best practices, but inconsistently implemented. Possible further escalation of the Nagorno-Karabakh conflict poses a challenge for Armenia's economic development.

### **Free Elections and Representative Government**

In 2012-2014 Armenia significantly improved its record in conducting free and competitive elections compared with the previous election cycle. The Republican Party of Armenia has increased its dominance over the political system after its candidates won a parliamentary majority and the Presidency. The President has initiated a comprehensive Constitutional reform aimed at strengthening democratic checks and balances through transition to a parliamentary system of governance. The Constitutional amendments were approved by the Parliament in October 2015 and will be voted on in the national referendum on December 6. Several opposition parties expressed reservations about the Constitutional reform. The Venice Commission of the Council of Europe has reviewed the concept document and concluded that the aims and the overall approach of the Constitutional reform deserve strong support. However it also noted that the political change in favour of a parliamentary system of government will have to be debated extensively in the country and that constitutional reform can be carried out only on the basis of broad consensus within the society.<sup>12</sup>

#### **1. Free, fair and competitive elections**

The Constitution of Armenia guarantees citizens the right to change their government through periodic, free and competitive elections based on universal suffrage. During the last country strategy period Armenia held parliamentary elections in May 2012 and presidential elections in February 2013. Elections were held on the basis of the new electoral code which was adopted in May 2011. According to international observers, it provides a generally sound framework for the conduct of democratic elections<sup>13</sup> and includes a number of improvements in line with recommendations by the Venice Commission and Office of Democratic Institutions and Human Rights of the OSCE (OSCE/ODIHR).

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<sup>12</sup> European Commission for Democracy through Law (Venice Commission) Opinion on the draft concept paper on the Constitutional reforms of the Republic of Armenia p.12.

<sup>13</sup> OSCE/ODIHR (2012) Armenian parliamentary elections observation, Final Report p.1.

Both elections were observed by international observer missions comprising the OSCE/ODIHR, the Parliamentary Assembly of the Council of Europe (PACE), the European Parliament (EP) and the Parliamentary Assembly of the OSCE (OSCE-PA). In both cases international observers noted progress in the conduct of the elections compared with the previous poll which took place in 2008. The 2012 and 2013 elections were deemed peaceful and pluralist; registration of candidates was inclusive; the election campaign environment was generally open, allowing candidates to campaign freely; freedoms of assembly and expression were respected; and media coverage was balanced. However, observers also noted the use of administrative resources and attempts to limit voters' freedom of choice by the ruling coalition which created an un-level playing field and ran counter to OSCE commitments.<sup>14</sup> After the presidential elections, which were won by incumbent President Serzh Sargsyan, his main election opponent refused to recognise the results and called for a re-run of elections. Unlike in 2008, the authorities responded to public protests with restraint, respecting the right of peaceful assembly.

## **2. Separation of powers and effective checks and balances**

The Constitution of Armenia provides for the separation of powers between the executive and the legislative branches of government. The modalities of this system are being modified by the new Constitutional amendments which limit Presidential powers, strengthen the government's executive power and enhance parliament's capacity for legislative oversight. The President is the Head of State and is elected by direct vote for a five year term. The President's tenure is limited to two consecutive terms in office. The Prime Minister is the head of the Government and is responsible for domestic policies. The Prime Minister is appointed by the President subject to confirmation by a parliamentary majority or the highest plurality of members of parliament (MPs). The Parliament consists of 131 MPs who are elected for a five year term under a mixed proportional and majoritarian system.

The Constitution was adopted in 1995 and was subsequently amended. The most recent amendments were approved by the parliament in October 2015 and will be voted on in the national referendum on December 6. Under the pre-existing system while checks and balances were written into the Constitution, in practice the President held the most powerful political role in the country and effective institutional checks on the president's prerogatives were not sufficiently strong. The Constitution did not provide sufficient powers to the National Assembly to fully implement its legislative and supervisory role and does not guarantee the parliamentary minority a meaningful voice within the legislative process.<sup>15</sup>

## **3. Effective power to govern of elected officials**

Armenian elected officials enjoy full power and authority to govern. None of Armenia's powerful political actors (oligarchs, military or the church) possess a veto power over political decision-making. The parliament's capacity to effectively exercise its powers is limited. As a result, the principal role in the law making process is played by the Government, leaving the National Assembly with little effective power to change the Government's legal proposals."<sup>16</sup>

<sup>14</sup> OSCE/ODIHR (2013) Final report on Presidential elections Armenia, p.1.

<sup>15</sup> Concept Paper on the Constitutional reforms of the Republic of Armenia, Venice Commission document CDL-REF (2014)033, pp.13-14.

<sup>16</sup> OSCE/ODIHR (2014) Assessment of the Legislative Process in the republic of Armenia, p. 8.

## **Civil Society, Media and Participation**

Armenia has a diverse and active civil society with informal grassroots groups playing an increasingly prominent role in mobilising urban middle class civic activism. Armenia's media operates without censorship, with authorities tolerating critical reporting. Freedom of the Internet is respected. At the same time, public trust in the political process remains low, resulting in a low rate of political participation. The political climate is polarised and characterised by a lack of genuine dialogue between the opposition and the ruling party.

### **4. Scale and independence of civil society**

Armenia has a well-developed and active civil society. According to the Ministry of Justice, around 4000 public organisations, 800 foundations and 300 legal entity unions were registered in Armenia by 2014; however only 15 to 20 per cent are active. Many informal civic groups and movements have emerged in recent years, showing strong determination and the ability to protect citizen's rights. Armenian civil society organisations (CSOs), including those engaged in political activity, operate mostly free from pressure and intimidation by the authorities. However, some cases of harassment by police and individuals occurred in 2013 and 2014. These cases were the subject of internal investigations within the police and in some cases led to disciplinary penalties and prosecution.

In recent years the Government has taken steps to enhance opportunities for further development of civil society in Armenia by approving in 2014 the Concept on CSO Institutional and Legislative Improvement which focuses on improving the legal environment for CSOs, reducing limitations on CSOs' entrepreneurial activity, creating an online registration system and providing more flexibility in their governance structure. Armenian CSOs are now actively engaged in the process of discussing amendments to the NGO law drafted by the Ministry of Justice, with a view to ensure greater independence and flexibility. CSOs' financial viability has not improved and foreign donors remain the primary source of funding for most registered NGOs. However, state funding for CSOs increased to around 7 billion dram (US \$18 million) per annum in 2012 and 2013. Business representatives in Armenia report difficulties in donating funds for charitable purposes because of complex bureaucratic procedures related to taxation and reporting. However, partnerships between businesses and CSOs have improved particularly in the area of healthcare, education and social policies.

### **5. Independence and pluralism of media operating without censorship**

Armenia has a diverse media landscape with seven national and 25 regional TV companies as well as over 52 cable channels. The press is equally well developed with 72 newspapers in circulation in 2013, including ten daily and 28 regional newspapers. However, in practice the independence and pluralism of the media remain constrained. The Law on Television and Radio does not ensure the independence and accountability of the media regulator (the National Commission for Television and Radio). There are no provisions in the law providing for civil society engagement in the selection and appointment of Commission members, and insufficient transparency of tenders prevents fair competition over broadcasting licences. There is a widespread perception in Armenia that television, the main source of information, is largely controlled by the state and thus attempts to provide a neutral perspective on key political issues. The current legislation does not guarantee transparency of media ownership.



Increased use of digital technology in recent years has led to improvements in content diversity and pluralism, although internet penetration remains low, particularly in rural areas. The impact of internet media on the public and political processes is growing.<sup>17</sup> The international observer missions fielded at the 2012 parliamentary elections and 2013 presidential elections commended Armenian media for meeting their obligation to ensure non-discriminatory conditions and unbiased news coverage of contestants during the official campaign.<sup>18</sup>

## **6. Multiple channels of civic and political participation**

A number of channels for political participation are available to the Armenian people, but their actual participation remains low, partly due to persistently high mistrust in the political process and state institutions. The OSCE/ODIHR assessment of the legislative process in Armenia characterised public participation in the law making process as “growing but ineffective.”<sup>19</sup> Throughout the legislative process there is a lack of adequate and sufficient stakeholder consultation starting from the pre-legislative stage.<sup>20</sup> CSOs are now more actively cooperating with each other to achieve results.

CSOs and informal social movements are playing a key role in mobilising other forms of political participation. In 2012-2014 CSOs’ advocacy capacity improved, with CSO networks being more successful in providing input into public policies. CSO partnerships with state structures are now more institutionalised (public council, joint working groups) enabling CSO participation in decision-making and promoting legislative changes. At the same time, informal movements actively organised protests in 2013, with a campaign to stop the rise of public transport fares in Yerevan being one of the most prominent examples. The observer citizen coalition played a key role in monitoring national and municipal elections with over 27,000 observers from 54 NGOs accredited by the Central Election Commission.

## **7. Freedom to form political parties and existence of organised opposition**

Armenia’s political parties are well established and cover the entire political spectrum, but the two largest parliamentary parties represent the political centre. Some parties were established after Armenia became independent, and others were formed around a particular personality and therefore are more vulnerable to upheavals if their leader’s fortunes change. The ruling Republican Party of Armenia, led by President Sargsyan, continues to dominate the political system in Armenia. The Republican Party holds the Presidency, the Prime Minister’s office and a parliamentary majority in the National Assembly. In the 2012 parliamentary elections, the main opposition party – the Armenian National Congress (ANC) – succeeded in entering parliament. At the same time, neither the ANC nor the second largest party in Armenia “Prosperous Armenia” ran candidates in the 2013 presidential elections, thus weakening their standing with voters who were left with a limited choice.

The political climate remains polarised and characterised by mutual mistrust and lack of genuine dialogue between the opposition and ruling party. The role of opposition parties in the parliament remains limited. The OSCE/ODIHR assessment of the legislative process

<sup>17</sup> The number of Facebook users in Armenia increased from 193,000 in 2012 to 362,000 in 2013.

<sup>18</sup> OSCE/ODIHR (2012) Report on Parliamentary elections 6 May 2012, p.2.

<sup>19</sup> OSCE/ODIHR (2014) Assessment of the Legislative Process in the republic of Armenia, p.9.

<sup>20</sup> OSCE/ODIHR (2014) Assessment of the Legislative Process in the republic of Armenia, p.6.

noted that “the most important challenge to the law-making process is the fundamental lack of agreement between Government and opposition over basic common understanding of the ways in which laws should be made.”<sup>21</sup> Draft laws are often prepared by the Government and then easily passed by its majority in the National Assembly without proper consultation with the opposition. This leads to a perception of opposition parties of being side-lined and unable to have any real impact on the legislative process. According to GRECO, Armenia has undertaken significant reforms to address concerns about the transparency of political funding including enhancing transparency and disclosure regarding election campaign financing and enhancing supervision through the newly established permanent “Oversight and Audit Service”. However, the efficiency of this supervision needs to be improved in practice.<sup>22</sup>

### **Rule of Law and Access to Justice**

Deficiencies in the rule of law have been consistently identified by international organisations as the key challenge for Armenia’s transition to a functioning democracy. The Council of Europe, the EU and the OSCE have all supported Armenia’s justice sector reform for a number of years. Some progress has been achieved through the refinement of legislation and training of judges. Armenia is currently implementing the third phase of judicial reforms on the basis of the Strategic Programme for Legal and Judicial reforms for 2012-2016. The 2015 Constitutional amendments strengthen the independence of the judiciary in line with recommendations of the Venice Commission of the Council of Europe.<sup>23</sup> However, Armenia still does not fully meet the objectives of guaranteeing the independence of the judiciary, combating corruption in the judiciary and more broadly in the public sector and ensuring proper implementation of laws.

### **8. Supremacy of the law**

In recent years, the Armenian authorities have reviewed much of their core legislation to bring it in line with international standards and to eliminate inconsistencies. A new Criminal Code and Criminal Procedure Code were developed, the former being geared towards better incorporation of the principle of proportionality of sanctions and providing for alternatives to imprisonment. The Code of Administrative Offenses is also being amended. While the quality of laws improved, their consistent implementation has remained a challenge. The OSCE/ODIHR assessment of the legislative process in Armenia notes that the problem of insufficient implementation of laws appears to be wide-spread.<sup>24</sup> This can be attributed to the following factors. Firstly, the quality of legislation is often poor because the system tends to be overloaded (more than 150 laws a year) and under-resourced, leading to the high frequency of amendments of legislation. Secondly, independent judicial review of the validity of legislation is lacking, resulting in passage of secondary legislation that is in conflict with the laws they are meant to implement. Thirdly, there is still very low public confidence in courts as an independent body guaranteeing implementation of laws.

<sup>21</sup> OSCE/ODIHR (2014) Assessment of the Legislative Process in the republic of Armenia, pp.7-8.

<sup>22</sup> GRECO (2012) Compliance report on Armenia “Transparency of Party Funding”.

<sup>23</sup> Venice Commission of the Council of Europe, Second preliminary opinion on the draft amendments in particular chapters 8,9,11 to 16 of the Constitutions of the Republic of Armenia , 11 September 2015 [http://www.venice.coe.int/webforms/documents/default.aspx?pdffile=CDL-PI\(2015\)019-e](http://www.venice.coe.int/webforms/documents/default.aspx?pdffile=CDL-PI(2015)019-e).

<sup>24</sup> OSCE/ODIHR (2014) Assessment of the Legislative process in the Republic of Armenia.

## **9. Independence of the judiciary**

The 1995 Constitution established a three-tier judicial system in Armenia comprising the courts of first instance, the courts of appeal and the Court of Cassation.<sup>25</sup> The same structure is preserved under the postposed Constitutional amendments, which strengthened the independence of the judiciary in line with recommendations of the Venice Commission of the Council of Europe.<sup>26</sup> The nine-member Constitutional Court is responsible for the administration of constitutional justice, including disputes relating to referenda and elections and deciding whether to suspend or prohibit the activities of a political party. Individuals and the Human Rights Ombudsman have the right to file human rights related applications with the Constitutional Court. The Council of Justice (COJ) is the body tasked with selection of judges and court chairs, as well as promotion and discipline of judges.<sup>27</sup>

The Armenian Constitution and legislation provide for the independence of judges. Institutional guarantees for ensuring independence of judges were enhanced by the 2015 Constitutional Amendments. However, the CoE Commissioner for Human Rights expressed concern over persistent reports regarding the lack of independence of the judiciary in practice, both from external actors, such as executive power holders at central and local levels (including law enforcement agencies), as well as from internal judicial actors – notably higher-instance judges.<sup>28</sup> In 2013, the Armenian Ombudsman issued a special report on the right to a fair trial, which refers to numerous instances of pressure exerted on individual judges by the Court of Cassation. A joint opinion by the Venice Commission and the Council of Europe Directorate of Human Rights issued in March 2014 refers to persistent reports of improper and extraordinary interference by judges of higher level courts with those of lower courts.<sup>29</sup>

## **10. Government and citizens equally subject to the law**

Government and citizens are equally subject to the law, although there were very few cases of officials being prosecuted for corruption and other offenses. Corruption is also believed to be prevalent within the police. The Government included police reform among its priorities leading to a reported increase in public trust in police forces. Further steps to improve police practices were integrated into the National Human Rights Action Plan. However, little practical progress was made in introducing independent complaints and an oversight mechanism over the police, which would be required to bring police fully under civilian control. Five civil society organisations were included in the composition of the disciplinary committee of the RA Police in 2015 pursuant to the Government's December 2012 decree on defining the composition and working procedures of the disciplinary committee of the Police.

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<sup>25</sup> Armenia has sixteen first instance courts of general jurisdiction – seven in Yerevan and nine in the regions – and an Administrative Court. There are three Courts of Appeal (Civil, Criminal and Administrative), and the court of highest instance – Court of Cassation.

<sup>26</sup> Venice Commission of the Council of Europe, Second preliminary opinion on the draft amendments in particular chapters 8,9,11 to 16 of the Constitutions of the Republic of Armenia , 11 September 2015 [http://www.venice.coe.int/webforms/documents/default.aspx?pdffile=CDL-PI\(2015\)019-e](http://www.venice.coe.int/webforms/documents/default.aspx?pdffile=CDL-PI(2015)019-e).

<sup>27</sup> The Minister of Justice is also involved in disciplinary proceedings against judges, which is inconsistent with judicial independence. Coe (2014): Report by the Commissioner for Human Rights following his visit to Armenia, p.11, footnote 18.

<sup>28</sup> CoE (2014): Report by the Commissioner for Human Rights following his visit to Armenia, p.9.

<sup>29</sup> Joint Opinion of the Venice Commission and the Directorate of Human Rights of the Council of Europe on the draft law amending the Judicial Code of Armenia (2014), paragraph 13.

## **11. Effective policies and institutions to prevent corruption**

Armenia has put in place the necessary legal and administrative mechanism to fight corruption; however this still represents a significant challenge for Armenia's political and economic transition. Armenia ranked 94<sup>th</sup> out of 175 countries assessed in Transparency International's Corruption Perceptions Index in 2014. According to a survey conducted by Transparency International for the Global Corruption Barometer in 2013, 69 per cent of respondents in Armenia considered the judicial system corrupt or extremely corrupt, and 18 percent indicated that they had themselves bribed court officials at least once. Improper influence upon judges through bribes and gifts, although prohibited by law, has been extensively reported, including by the special report by the Ombudsman issued in 2013.<sup>30</sup> It describes mechanisms of corruption and reveals that corruption affects all judicial instances.

In 2014 the Government approved a concept paper for the fight against corruption which focuses efforts in four areas: education, state revenues, police and healthcare. It led to the development of a draft strategy and an action plan, and provided for the participation of civil society. In addition, the Armenian Government took some practical steps to limit opportunities for corruption. It introduced e-government for many services and continued developing a 'regulatory guillotine'. Procedures for verifying asset declarations for high ranking officials have been brought in line with European best practices. An Ethics Commission for High Ranking Officials was established but its mandate and procedures need strengthening to enhance efficiency and credibility. Finally, GRECO noted progress in addressing financial irregularities related to political funding.

### **Civil and Political Rights**

In 2013, the Armenian Chairmanship of the Council of Europe Committee of Ministers declared strengthening of European standards on human rights among its top priorities. This provided impetus for improving Armenia's own human rights policies. In 2014 the Armenian authorities adopted a National Human Rights Action Plan for 2014-2016 on the basis of the National Strategy for Human Rights Protection adopted in 2012. The Action Plan is a comprehensive document providing for the implementation of specific measures within defined timelines. The international community welcomed this step, but urged the Armenian government to take stronger steps in a number of fields, including combating discrimination and effectively investigating torture and ill-treatment.<sup>31</sup> The 2015 Constitutional reforms have strengthened and expanded guarantees for the protection of Armenian citizens' fundamental rights and freedoms.

## **12. Freedom of speech, information, religion, conscience, movement, association, and assembly and private property**

The Constitution of Armenia provides citizens with all fundamental rights and freedoms recognised by the European Convention for Human Rights, however some of these rights are not upheld consistently in practice. Therefore the 2015 Constitutional amendment include the

<sup>30</sup> Ombudsman's Human Rights report (2013).

<sup>31</sup> Joint statement on the launch of the human rights Action plan (see CoE (2014): Report by the Commissioner for Human Rights following his visit to Armenia, p.6)

improvement of constitutional mechanisms for guaranteeing fundamental rights and freedoms among its top reform priorities.<sup>32</sup>

The Government generally respects the principles of freedom of association, freedom of assembly and freedom of expression. NGO registration was simplified and the number of assemblies not authorised by the authorities decreased in 2014. Criticism of public officials in the media and internet is tolerated in general and there are no restrictions on the use of the internet. The law requires all draft laws and government decisions, which are part of the Annual Action Plan by the Government, to be publicized. The Government generally respects the right to freedom of information. Armenia continues to face some challenges in guaranteeing religious freedom. This can be partially explained by the dominant position of the Armenian Apostolic Church which unites over 95 per cent of all believers in the country. However, the CoE Commission for Human Rights has recently commended the Armenian authorities for effectively addressing the long-standing issue of the right to conscientious objection, allowing followers of some religions to conduct other forms of public service and to avoid prosecution.

### **13. Political inclusiveness for women, ethnic and other minorities**

The Constitution provides for equality among its citizens. However a more detailed anti-discrimination law has not been adopted so far, despite the good work of the Ombudsman's office that has been drafting such legislation since 2012 in consultation with international organisations and civil society organisations. Women remain underrepresented in the political process and senior political positions in Armenia. There are only 14 women among 131 MPs and only two female ministers in the Government out of 18. There are no women governors or city mayors. The CoE Commissioner for Human Rights concluded during his 2014 visit that further substantial efforts are required to ensure the equal status of women in society and to combat discrimination and bias on the grounds of sex. Some steps have been taken by the Government with the adoption of gender-related policies and the 2013 Law on Equal Rights and Equal Opportunities for men and women. However, more work is needed to implement them in practice and thus increase women's participation in public and political life. The Government also adopted a Strategic Action Plan on Gender Policy for 2011-2015. In regard to political representation and decision-making, the plan aims to achieve 30 per cent of women in decision-making positions, to make civil servants more gender sensitive through training and to enhance women's leadership skills. Ethnic minorities are not adequately represented in the democratic process. Contemporary Armenian society is largely ethnically homogeneous with over 98 per cent of the population defining themselves as Armenians. Ethnic minorities, who constitute the remaining two per cent, have limited political representation, with the largest minority – the Yezidis – having no representative in the National Assembly.

### **14. Freedom from harassment, intimidation and torture**

According to a report by the CoE Commissioner for Human Rights, persistent reports of torture and ill-treatment by the police and other law enforcement agencies and the related problem of impunity are a major concern.<sup>33</sup> The Commissioner urged the Armenian

<sup>32</sup> Venice Commission (2014), Opinion on the draft concept paper on the Constitutional reforms of the republic of Armenia, p. 4.

<sup>33</sup> Council of Europe; Commissioner for Human Rights Report following his visit to Armenia (2014), p.4.

authorities to amend the definition of torture in the Criminal Code in compliance with international standards with a view to ensure proper qualification and punishment of acts of torture, as well as to enhance in law and in practice safeguards against torture and ill-treatment. At present, the national Human Rights Action Plan does not address compliance with the UN Convention Against Torture. Over the past strategy period there was only limited progress in investigating the deaths that occurred during protests in the aftermath of the 2008 presidential elections. This creates a perception of impunity and contributes to political polarisation and public mistrust in the political process. In recent years human rights activists and journalists occasionally faced intimidation, harassment, threats and abuse. In some cases these events were not fully and transparently investigated.<sup>34</sup>

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<sup>34</sup> European Commission (2014) Implementation of the European Neighbourhood Policy in Armenia, Progress in 2013 and recommendations for action, p.6; CoE (2014): Report by the Commissioner for Human Rights following his visit to Armenia.

## ANNEX 2 – SELECTED ECONOMIC INDICATORS

Armenia	2008	2009	2010	2011	2012	2013	2014
<b>Output and expenditure</b>							
	<i>(Percentage change in real terms)</i>						
GDP	6.9	-14.1	2.2	4.7	7.2	3.3	3.5
Private consumption	5.4	-4.5	3.8	2.4	9.1	0.9	0.5
Public consumption	-1.9	-1.2	3.9	1.9	-1.4	7.6	6.4
Gross fixed capital formation	11.9	-25.4	-2.9	-11.7	-1.9	-7.0	-2.4
Exports of goods and services	-13.1	-10.4	26.5	14.7	8.4	8.6	6.4
Imports of goods and services	7.3	-19.2	12.8	-1.4	-2.8	-2.1	-1.0
Industrial gross output	1.7	-7.6	9.7	13.9	8.8	6.9	2.7
<b>Labour Market<sup>1</sup></b>							
	<i>(Percentage change)</i>						
Gross average monthly earnings in economy (annual average)	17.8	9.9	6.9	5.3	4.7	4.1	8.2
Real LCU wage growth	8.0	6.2	-1.2	-2.2	2.0	-1.6	5.1
	<i>(In per cent of labour force)</i>						
Unemployment rate (annual average)	16.4	18.7	19.0	18.4	17.3	16.2	17.6
<b>Prices</b>							
	<i>(Percentage change)</i>						
Consumer prices (annual average)	8.9	3.4	8.2	7.7	2.6	5.8	3.0
Consumer prices (end-year)	5.2	6.5	9.5	4.7	3.2	5.6	4.6
<b>Fiscal Indicators</b>							
	<i>(In per cent of GDP)</i>						
General government balance	-0.7	-7.6	-5.0	-2.8	-1.4	-1.6	-1.9
General government revenues	22.0	22.0	22.6	23.3	22.2	23.5	23.6
General government expenditure	22.7	29.6	27.6	26.1	23.6	25.1	25.5
General government debt	16.4	40.4	39.9	42.2	44.1	40.9	43.6
<b>Monetary and financial sectors</b>							
	<i>(Percentage change)</i>						
Broad money (M2X, end-year)	2.4	15.1	11.8	23.7	19.5	14.8	8.3
Credit to the private sector (end-year)	50.1	18.2	26.8	33.9	25.5	11.4	21.2
	<i>(in per cent of total loans)</i>						
Non-performing loans ratio	4.3	4.9	3.0	3.4	3.7	4.0	6.2
<b>Interest and exchange rates</b>							
	<i>(In per cent per annum, end-year)</i>						
Local currency deposit rate*	7.7	8.1	8.8	10.3	10.1	10.4	12.5
Foreign currency deposit rate	6.6	6.2	5.3	6.1	6.5	5.5	5.3
Local currency lending rate	16.5	18.8	18.9	17.7	16.0	15.0	16.2
Foreign currency lending rate	13.8	13.2	12.3	12.2	10.9	10.5	9.8
Money market rate / Discount rate/ Policy rate	7.25	5.00	7.25	8.00	8.00	7.75	8.50
	<i>(Drams per US dollar)</i>						
Exchange rate (end-year)	307	378	363	386	404	406	475
Exchange rate (annual average)	306	363	374	373	402	410	416
<b>External sector</b>							
	<i>(in per cent of GDP)</i>						
Current account	-15.0	-16.5	-13.6	-10.4	-10.0	-7.6	-7.3
Trade balance	-24.1	-24.2	-22.3	-20.8	-19.9	-18.8	-17.7
Merchandise exports	9.5	8.9	12.9	14.1	14.3	14.7	14.6
Merchandise imports	-33.6	-33.1	-35.2	-34.9	-34.2	-33.5	-32.2
Foreign direct investment	7.9	8.2	5.6	4.3	4.5	3.2	3.3
Gross reserves, excluding gold (end-year)	12.0	23.2	20.1	19.1	16.9	20.2	12.8
External debt stock	29.7	58.2	68.1	73.1	72.3	78.5	73.3
Public external debt	13.5	35.9	37.1	36.6	36.6	36.4	33.8
Private external debt	16.2	22.3	31.0	36.6	35.7	42.1	39.6
	<i>(In months of imports of goods and services)</i>						
Gross reserves, excluding gold (end-year)	3.3	6.1	4.9	4.7	4.2	5.0	3.3
<b>Memorandum items</b>							
	<i>(Denominations as indicated)</i>						
Population (end-year, million)	3,087	3,066	3,045	3,028	3,024	3,022	3,014
GDP (in billions of Drams)	3,568	3,142	3,460	3,778	4,266	4,556	4,843
GDP per capita (in US dollars)	3,606	2,666	2,844	3,363	3,512	3,680	3,864
Share of industry in GDP (in per cent)	20.7	21.3	23.8	26.4	26.3	27.3	26.7
Share of agriculture in GDP (in per cent)	17.6	17.6	18.4	21.0	19.7	20.2	20.5
FDI (In million of US dollars)	925	710	521	437	481	353	388
External debt - reserves (in US\$ million)	2,055	3,033	4,441	5,485	5,874	6,479	7,047
External debt/exports of goods and services (in per cent)	178.1	323.0	285.3	270.5	263.0	276.6	257.2
Broad money (M2, end-year in per cent of GDP)	19.8	25.9	26.3	29.8	31.6	33.9	34.6

<sup>1</sup> Figures do not include emigrant workers abroad.

\* Figures for deposit and loan rates include average deposit rates (15 days up to 1 year)

## ANNEX 3 – ASSESSMENT OF TRANSITION CHALLENGES

Market Str:	Market Inst:	Key Challenges:
<b>CORPORATES</b>		
<b>Agribusiness</b>		
<i>Medium</i>	<i>Medium</i>	<ul style="list-style-type: none"> <li>▪ supporting formalisation of agricultural enterprises to increase access to finance;</li> <li>▪ developing transport infrastructure and logistics to reduce costs and increase competitiveness of Armenian products.</li> </ul>
<b>Manufacturing and Services</b>		
<i>Medium</i>	<i>Small</i>	<ul style="list-style-type: none"> <li>▪ building on recent administrative reforms and boosting their effectiveness on the ground and undertaking further deregulation;</li> <li>▪ further improving competition policy by strengthening the powers of the regulatory authority; and</li> <li>▪ enhancing transparency and fairness in customs procedures.</li> </ul>
<b>Real estate</b>		
<i>Large</i>	<i>Medium</i>	<ul style="list-style-type: none"> <li>▪ increasing the penetration of innovative construction technologies and improving building standards, including energy efficiency, sustainability and safety; and</li> <li>▪ increasing supply of modern commercial property (outside the residential segment).</li> </ul>
<b>ICT</b>		
<i>Medium</i>	<i>Medium</i>	<ul style="list-style-type: none"> <li>▪ continuing to develop the telecommunications infrastructure (broadband internet);</li> <li>▪ further developing the regulatory framework (implementing competitive safeguards); and</li> <li>▪ strengthening the independence of the regulator.</li> </ul>
<b>ENERGY</b>		
<b>Natural Resources</b>		
<i>Medium</i>	<i>Medium</i>	<ul style="list-style-type: none"> <li>▪ completing the unbundling of transmission and distribution businesses and ensuring transparent and non-discriminatory third party access to the natural gas transmission network;</li> <li>▪ strengthening the independence of the energy regulator (PSRC);</li> <li>▪ increasing the transparency of revenue flows from extractive activities; and</li> <li>▪ developing mining beneficiation and refining facilities in order to increase the breath of the mining supply chain.</li> </ul>
<b>Sustainable Energy</b>		
<i>Medium</i>	<i>Medium</i>	<ul style="list-style-type: none"> <li>▪ strengthening the institutional capacity for deploying energy efficiency and renewable energy projects;</li> <li>▪ developing technical capacity in the preparation of energy efficiency and renewable energy projects; and</li> <li>▪ increasing awareness on best practices for energy efficiency.</li> </ul>



<b>Power</b>		
<i>Medium</i>	<i>Medium</i>	<ul style="list-style-type: none"> <li>▪ improving price signals through continued improvements in tariff methodology;</li> <li>▪ reducing state dominance; and</li> <li>▪ improving tariff methodology and introduce cost reflective tariffs for end consumers.</li> </ul>
<b>INFRASTRUCTURE</b>		
<b>Water and wastewater</b>		
<i>Medium</i>	<i>Medium</i>	<ul style="list-style-type: none"> <li>▪ strengthening institutions to push through reforms;</li> <li>▪ tariff reform to achieve cost recovery;</li> <li>▪ improving operational (focused on reduction of commercial and technical losses) and financial sustainability; and</li> <li>▪ improving contractual arrangements.</li> </ul>
<b>Urban Transport</b>		
<i>Large</i>	<i>Medium</i>	<ul style="list-style-type: none"> <li>▪ decentralising some core regulatory aspects, including responsibility of tariff setting and service provision organisation;</li> <li>▪ strengthening institutional and legal capacity of municipalities to regulate and monitor public transport service provision;</li> <li>▪ reforming publicly owned urban transport operators to improve the quality of service without compromising sustainability; and</li> <li>▪ improving integration and ticketing.</li> </ul>
<b>Roads</b>		
<i>Medium</i>	<i>Medium</i>	<ul style="list-style-type: none"> <li>▪ developing a national transport strategy which considers intermodal integration;</li> <li>▪ continued capacity building for the road management authority;</li> <li>▪ developing performance based road maintenance contracts and/or small-scale PPP projects; and</li> <li>▪ road user charge reform.</li> </ul>
<b>Railways</b>		
<i>Medium</i>	<i>Large</i>	<ul style="list-style-type: none"> <li>▪ full institutional separation;</li> <li>▪ furthering financial sustainability in passenger and infrastructure businesses; and</li> <li>▪ introducing competition in railway businesses.</li> </ul>
<b>FINANCIAL INSTITUTIONS</b>		
<b>Banking</b>		
<i>Large</i>	<i>Medium</i>	<ul style="list-style-type: none"> <li>▪ improving loans/deposits ratio;</li> <li>▪ increasing share of local currency lending in total lending; and</li> <li>▪ diversifying products</li> </ul>
<b>Insurance and other financial services</b>		
<i>Large</i>	<i>Large</i>	<ul style="list-style-type: none"> <li>▪ further developing insurance industry product range and skills;</li> <li>▪ bringing insurance regulation into compliance with international standards;</li> </ul>

		<ul style="list-style-type: none"> <li>▪ developing leasing markets and structured finance products; and</li> <li>▪ developing the regulatory basis for private pension funds.</li> </ul>
<b>Micro, Small and Medium-sized enterprises</b>		
<i>Medium</i>	<i>Medium</i>	<ul style="list-style-type: none"> <li>▪ expanding local currency bank finance to SMEs;</li> <li>▪ developing alternative financial instruments for SMEs such as leasing and equity capital;</li> <li>▪ improving the institutional environment to support lending to SMEs such as enforcement of creditor rights.</li> </ul>
<b>Private equity</b>		
<i>Large</i>	<i>Large</i>	<ul style="list-style-type: none"> <li>▪ improving business environment to be more attractive for inward private equity investment by regional funds and the eventual establishment of sustainable locally based private equity funds.</li> </ul>
<b>Capital markets</b>		
<i>Large</i>	<i>Medium</i>	<ul style="list-style-type: none"> <li>▪ broadening the listed market with additional corporate issues, especially bonds;</li> <li>▪ attracting investor interest and liquidity by improving settlement arrangements;</li> <li>▪ lengthening the maturity of interbank market activity;</li> <li>▪ developing money market benchmarks and FX swaps; and</li> <li>▪ exploring regional alliances to enhance local market liquidity.</li> </ul>

ECONOMIC INCLUSION<sup>35</sup> GAP RATINGS

ECONOMIC INCLUSION		
Inclusion gap dimension	Inclusion gap	Key challenges
<b>Regions</b>		
Labour Market	Large	<ul style="list-style-type: none"> <li>▪ Improving access to local jobs and formal employment opportunities in Armenia's underserved regions (particularly in the two regions, Kotayk and Shirak, with the highest unemployment and poverty rates).</li> <li>▪ Supporting commercially viable investments which would help build competitive advantages in less developed regions and promoting local employment and skills transfer for youth, especially young women.</li> <li>▪ Improving access to entrepreneurial finance in rural underserved areas, and supporting people employed in subsistence activities, particularly agriculture and services.</li> </ul>
Access to Services	Medium	<ul style="list-style-type: none"> <li>▪ Increasing access to infrastructure and services that substantially enhance the economic opportunities of the local population, specifically in relation to improved health, access to employment, training or entrepreneurial activities.</li> </ul>
Education	Medium	<ul style="list-style-type: none"> <li>▪ Improving access to and quality of education in less developed areas, specifically for underemployed emigrants and women.</li> </ul>
Institutions	Medium	<ul style="list-style-type: none"> <li>▪ Supporting projects in metropolitan municipalities in underserved regions, by introducing better governance methods and more efficient operating practices.</li> </ul>

<sup>35</sup> The EBRD Economic Inclusion gaps rate institutions, markets and education systems across all of the EBRD's countries of operation in terms of their capacity to extend economic opportunity to individuals regardless of their gender, age or place of birth. These gaps measure *differences* in opportunities – between 15 to 24-year-olds and older workers, and between women and men – rather than opportunity *levels*. Gaps are reported in this Country Strategy where there exists an Inclusion Gap above Small. These gaps are consistent with the EBRD 2014 Inclusion Gap update.

<b>Youth</b>		
Opportunities for Youth	Large	<ul style="list-style-type: none"> <li>▪ Addressing the skills mismatch by aligning more closely labour market demand and educational outcomes, specifically to support progression into jobs for unemployed graduates.</li> <li>▪ Improving the engagement of the private sector in setting national skills standards and related training provision through improved partnerships between employers and education providers.</li> <li>▪ Supporting reforms aimed at increasing relevance and quality of VET to ensure a competitive and qualified workforce. Strengthen involvement of social partners in the dialogue on VET priorities and their implementation.</li> </ul>
Quality of Education	Medium	<ul style="list-style-type: none"> <li>▪ Improving the educational system through training programmes for teachers and school directors. Educational attainment is high but the quality low (as measured by PISA test scores).</li> </ul>
<b>Gender</b>		
Labour Practices	Large	<ul style="list-style-type: none"> <li>▪ Incentivising clients to improve equal opportunities practices, including equal pay practices and non-discrimination practices and female leadership programmes.</li> </ul>
Employment and firm ownership	Large	<ul style="list-style-type: none"> <li>▪ Improving client HR policies with regards to increasing female employment, training opportunities and progress routes into management opportunities.</li> <li>▪ Improving access to business training and financial literacy for female entrepreneurs.</li> </ul>
Access to Finance	Medium	<ul style="list-style-type: none"> <li>▪ Incentivising and building the capacity of Banks to develop credit lines aimed at female entrepreneurs, combining access to finance, training and business advisory services.</li> </ul>
Legal Regulations	Medium	<ul style="list-style-type: none"> <li>▪ Increasing legal and judicial protection to address violence against women.</li> <li>▪ Increasing policy dialogue on gender equality.</li> </ul>
Health Services	Medium	<ul style="list-style-type: none"> <li>▪ Improving access to and quality of health care for women (particularly to improve maternal mortality and contraceptive prevalence).</li> </ul>

## ANNEX 4 – LEGAL TRANSITION

### Introduction

This annex offers critical analysis on selected legal topics relevant to the Bank’s investment strategy in Armenia during the forthcoming period. It is based on the assessments of commercial laws conducted by the EBRD Legal Transition Programme.<sup>36</sup> For ease of reference, the analysis is presented along the main strategic orientations defined in this country strategy, in particular the actions proposed under ‘Policy dialogue and TC’.

#### 1. Enhancing private sector competitiveness

##### *Pledge of moveable property, leasing and factoring*

The Civil Code provides for different types of pledges that can be established without taking the collateralised asset into possession (e.g. a pledge of rights, monetary assets, goods in commerce, etc.). Furthermore, the Code also provides for a possibility to take collateral over a fluctuating pool of assets; however this option is limited only to the goods in commerce (stock of goods, raw material, supplies, etc.). This restriction effectively excludes the possibility to use account receivables as an asset for pledging. Usage of a fluctuating pool of assets is further limited by the obligation to keep the value of the pledged assets constant thus exclusive of assets that change value on everyday basis (equipment, inventory, etc.). It is not possible to use a general description of the pledged asset, which unnecessarily increases the risk of mistakes appearing in the pledge documentation. Such mistakes can result in the registration being rejected and/or the pledge nullified. It is not mandatory to register the pledge except when a specific statute prescribes so for certain type of asset. However, registration is advisable due to the priority achieved by registration over unregistered and unsecured creditors.

The Law on Register of Pledges over Movables governs the registration of security over movables. Registry functions are carried out by the State Committee of Real Property Cadastre, which is the body originally entrusted with the real estate property cadastre. The registration system suffers from deficiencies and structural reform is needed. The registration procedure requires the filing of the full security agreement and the law sets exhaustive lists of additional documents needed for registration as well as of reasons for rejecting it. The application for registration can be made only to the sub-division of the cadastre situated in Yerevan (“Kentron” subdivision). This centralisation can increase costs for parties situated elsewhere. While the register maintains the unified database for pledged movable property, it is not an electronic one and the information is accessible only upon submission of a written inquiry.

A legislation package improving the law of secured transactions was adopted by the Parliament in December 2014 and signed by the President on 30 December 2014. The new legal framework aims at introducing a unified movable collateral registry in electronic form. Registration would be the main form of perfection of secured rights and would determine the priority of collateral. The legislation was developed with assistance from USAID, among others. The new law should come into force on 1 October 2015. The objectives of the new law are to address some of the shortfalls of the existing laws described above.

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<sup>36</sup> See [www.ebrd.com/law](http://www.ebrd.com/law).

Articles 677-684 of the Civil Code regulate financial leasing contracts. The Code provides a simple but solid legislative background for undertaking leasing activities. It defines financial leasing relationships, regulates the transfer of ownership and passing of risk in relation to the leased assets, and the liability of the seller of the leased asset. However, the law would benefit from regulating a lessee/lessor relationship in a bit more detail, especially events of default and rights and duties of the parties in those circumstances. This would help to increase legal certainty and provide parties with a clear understanding of their obligations and duties. Financial leasing contracts relating to real estate have to be notarised and registered, while ones relating to movable properties do not have a set form.

There is no special legislation for factoring apart from general “assignment of claim by contract” provisions of the Civil Code, which provide the basis for assigning account receivables. As a result there is no definition of factoring services or types of factoring transactions which can help increase legal certainty of factoring transactions and hence reduce costs and risks of re-characterisation of transactions. Factoring, in particular international factoring is currently a developing industry in Armenia.

#### *Electronic Communications/Telecoms*

The main legal basis for electronic communications regulation in Armenia is the Law on Electronic Communications, adopted in 2005. This law sets out the functions of the Ministry of Transport and Communications and the regulator, the Public Service Regulatory Commission (PSRC), which itself is a multi-sector regulator established by the Law on Public Services Regulation.

There is a substantial digital divide between the main cities and rural areas of the country in terms of effective accessibility of new generation networks and services. The Government previously set out a strategy to create an all-inclusive information society, accelerated by state assistance in a high-speed broadband access network reaching the more remote regions. However, a decision on implementation has yet to be made and, for the moment, the state remains reliant on private investors, with a danger that they will continue to duplicate infrastructure (they appear to have largely resisted infrastructure sharing so far), keeping the overall cost of services relatively high in Armenia. Regardless of the investment strategy chosen, however, large-scale network construction is required to bring modern high-speed services to rural areas. Essential to the attraction of new investment or acceleration of planned investment in network and service rollout will be the adoption and full implementation of policy and regulatory frameworks to better reflect proven EU norms and practices. Key to adoption and implementation of new policies and procedures will be sector institutional resources and capacity, in particular that of the PSRC. Accordingly, to ensure effective achievement of government objectives for the sector, the authorities should accelerate adoption of proven EU norms and practices, and ensure that the PSRC is afforded sufficient, predictable, consistent and protected budgetary resources to effectively implement policy decisions.

## 2. Developing capital markets and promoting local currency financing

### *Capital markets*

Capital market activities in Armenia are scarce. Although the legal rules and a relatively developed market infrastructure are in place, only a handful of share and bond issuances are listed and admitted to trading on the stock exchange. Some local companies prefer listing their shares abroad. For example, Lydian International, a mining company in which the Bank maintains an equity stake, is listed in Toronto.

A lack of sufficient legislative incentives for institutional investors and distrust of the Government's ability to enforce statutory provisions may be contributing to the current scarcity of listings. Virtually all components of the capital markets sector require improvement. Beyond traditional banking services, access to finance and non-banking financial services is limited.

In 2014, the EBRD and the IFC each issued dram denominated bonds in the local market. Immediately prior to that, the Bank had assisted the Armenian government with the amendments required to facilitate such issuance, with some spill-over benefits for the legal framework in general. However, the law may benefit from further changes, such as the introduction of bondholder meetings and representatives (or similar concepts).

Armenian law allows derivatives transactions. However, netting legislation is not in place. There are no derivative instruments trading on the exchange and, based on reports from local contributors, OTC transactions are uncommon. The current Law "On Investment Funds" was adopted in 2010. However, private equity activities in Armenia remain limited.

### *Corporate Governance*

Armenia ranks among the weakest countries in the EBRD region from a corporate governance perspective. The most recent EBRD assessment (2014) looking at corporate governance legislation and practices of companies highlighted a relatively weak framework. For example, Armenian law does not require the presence of independent directors on the board, although it provides for involving "independent board members" in transactions with potential conflicts of interest. Both the law and the Corporate Governance Code (the CG Code) issued in 2010 provide for different definitions of independence. However, the law fails to provide an inclusive definition of independence. In practice, few companies have disclosed having independent members on their boards according to the criteria recommended by the CG Code. Further, the law does not require companies to establish board committees. Only the CG code recommends listed companies establish an audit committee comprised of non-executive directors, where the chairman and a majority of members are independent. In practice, only two out of the ten largest listed companies appear to have established audit committees (and the committees' composition was not disclosed). When looking at shareholder rights an obvious deficiency is that shareholders do not enjoy pre-emptive rights in cases of a public offer of new shares.

### 3. Developing sustainable and commercialised public utilities

#### *Energy efficiency*

There is a large potential for improving energy efficiency in Armenia. While the country's energy intensity has been decreasing during the past decade, the primary energy consumption has grown over the last 20 years. A more efficient use of energy resources and alternative sources of energy as well as increased energy independence are key government priorities in the sector, as stated in the Energy Law. The Law on Energy Savings and Renewable Energy addresses the need for improving energy efficiency and broadly outlines some implementation mechanisms. The National Energy Efficiency Action Plan was developed with international assistance and approved in 2010.

In 2013, Armenia joined the Eastern Europe Energy Efficiency and Environment Partnership (E5P), aimed at increasing the support for energy efficiency and reducing harmful emissions. Armenia has observer status at the Energy Community.

The Ministry of Energy and Natural Resources (MENR) is the main policy making and regulatory body, while other ministries also take the lead when energy efficiency measures relate to sectors of their competence (e.g. Ministry of Urban Development covers the buildings sector). Activities promoted by the Renewable Resources and Energy Efficiency (R2E2) Fund include energy audit training, carrying out energy efficiency assessments in dwellings and other buildings, and supporting energy efficiency refurbishments in residential buildings. The main obstacles for promoting and investing in energy efficiency include a lack of funding, absence of adequate information on energy consumption, deficient legal and regulatory framework, and low awareness of the benefits of deployment of energy efficiency measures.

The residential sub-sector is one of the largest energy end-users in Armenia. The majority of housing stock comprises badly insulated and poorly constructed multi-storey apartment buildings that generally provide a low level of energy savings and comfort. In 2012-2013, the EBRD carried out a "Study on Improving Energy Efficiency in Residential Buildings", reviewing the policy, legal, regulatory and institutional framework supporting energy efficiency in buildings and in particular the residential sub-sector, and identifying the need for bringing the existing legal and regulatory framework in line with international practices as a precondition for energy efficiency financing. Lack of institutional capacity is another obstacle for improving energy efficiency.

The Government recognises the need to enhance energy efficiency in a number of sectors, in particular buildings and industry. The Government and the EBRD are currently discussing the scope of technical assistance aimed at revising Armenia's legal and regulatory framework on energy efficiency in the building sector, introducing energy efficiency labelling for energy consuming products, and creating more incentives for private investments in newly constructed and existing residential and commercial buildings.

#### *Public-private partnerships (PPPs)*

Armenia remains one of the only few EBRD countries of operations where there has been no clear PPP policy or legal/regulatory and institutional framework. However, in comparison with the legal framework, PPP practices seem more advanced, with quite a few projects in place. General laws like the Civil Code do not refer to or regulate concessions or PPPs apart



from the general reference in the Law on Foreign Investments providing for concessions as one of the forms of foreign investments. Two sector specific laws regulate concessions, the mining and water sectors. In addition, there is also a reference to concessions in the Law on Railway Transport.

There has been no policy document adopted by the Armenian authorities to promote PPPs. However, an implied general policy framework for improving the legal environment and promoting private sector participation in public works and services has been identified in the Poverty Reduction Strategy.

Even though concessions are referred to in the above sector specific laws, these texts do not contain any clear modern definition of concessions and are fairly basic with regard to the selection rules that presume a general principle of a competitive procedure. No clear reference is made to international arbitration for concession arrangements while the use of international arbitration is provided in privatisation contracts.

Some positive features of PPP-related legislation can be noted in the water sector law: for example the optional use of a template concession agreement (rather than being binding, which would be too rigid and go against best practice). Also beneficial are provisions relating to government support to, and financial securities in favour of, PPP projects that are included in the general legislation such as the Civil Code and Law on Budgetary System.

## ANNEX 5 – GENDER PROFILE

### *Gender Inequality and Human Development*

According to the UNDP 2013 Human Development Index (HDI),<sup>37</sup> Armenia has a high human development level, ranking 87<sup>th</sup> out of 187 countries, which is around the regional average for Eastern Europe and the Caucasus. The HDI is comprised of three dimensions: health, education and decent standard of living. The country ranks better in terms of the UNDP Gender Inequality Index (GII), at 60<sup>th</sup> globally. The GII is a composite measure, which captures the loss of achievement within a country due to gender inequality (GII is based on reproductive health, empowerment and economic activity).

### *Labour force participation and Gender pay gap*

Women in Armenia have lower rates of labour force participation than men (55.9 per cent versus 72.8 per cent). These figures are broadly in line with the average figures for Central & South-Eastern Europe (non-EU) and the CIS (50.3 per cent versus 70.7 per cent). There are high levels of horizontal segregation, underpinned by societal norms regarding suitable jobs for women. For example, as the table below shows, roughly two-thirds of women work in agriculture and public administration, which are among the lowest paid sectors of the economy. Horizontal segregation is also perpetuated by the fact that women are over-represented in tertiary education courses, which do not lead to better paid sectors. There is a significant gender pay gap: on average, women's monthly earnings are only 65 per cent of men's.

Employment by sector	Employees	
	% women	% men
Agriculture	44.6	28.7
Public administration, education, health	26.4	15
Trade, repair, accommodation and food	11.4	11.8
Industry	6.2	16
Other services	5.3	4.0
Financial, real estate, professional, administrative	3.4	4.1
Transport, storage and communications	2.2	9.9
Construction	0.4	10.5
Total	100	100

**Sources:** Armenian Statistical Service, 2013

Women entering the labour market are constrained by the narrow range of occupations and sectors of employment, which are considered acceptable or desirable for women to work in, either because of cultural perceptions or the need to balance work with family responsibilities. Women bear primary responsibility for childcare and housework. Childcare services are thought to be unavailable or too expensive. Following the dismantling of the centralised state system, many services closed after the Government's decision to transfer

<sup>37</sup> According to the HDI, countries fall into four broad human development categories: Very High Human Development, High Human Development, Medium Human Development and Low Human Development.

them to the authority of local communities, many of which were unable to maintain them due to small budgets.

*Entrepreneurship, access to finance*

According to the 2012-13 BEEPS, about 13.6 per cent of the 360 surveyed firms in Armenia had a female top manager (below the Eastern Europe and Central Asia average of 18.7 per cent). Official statistics indicate that as low as 11 per cent of MSMEs are registered to women. There is not much data on key sectors of women's entrepreneurship but women's businesses are thought to be smaller and clustered in lower-value activities, such as subsistence trade, services and agriculture.

## ANNEX 6 – EBRD AND THE DONOR COMMUNITY

Donor funded technical cooperation (TC) assignments in Armenia have allowed the Bank to undertake early diagnostic work, including feasibility studies and preparation of investment opportunities, build capacities of prospective clients, in particular project implementation support in the infrastructure sector, and share transition experience from policy makers and private sector stakeholders from EBRD Countries of Operations.

Significant donor funds were provided to support non-TC projects in the form of investment grants that supported transport and solid waste management assignments within the municipal and environmental infrastructure sector (MEI). In addition, Armenia has benefited from TC assignments that have contributed to the growth of local private SMEs through a range of advisory and investment programmes, including the Business Advisory Services, the Enterprise Growth Programme and the Investment Councils.

For the past two years, there has been increased donor support in key Sustainable Energy Initiative (SEI) projects for street lighting and improving energy efficiency in residential buildings. The focus of donor grants is expected to remain in MEI and SEI projects. Additionally, donor funds are expected to support policy dialogue and legal transition with a view to helping the Government advance its reform agenda and building judicial capacity.

To sustain these needs, the EBRD will rely on a number of donor funds administered by the Bank or managed externally, in addition to resources made available by its shareholders:

- **Early Transition Countries Multi-Donor Fund (ETC Fund)** with contributions from 14 bilateral donors has financed projects in 10 countries for the last 10 years with Armenia being one of the recipients of these grants. The ETC Fund will continue to provide TC grants across a range of sectors, focusing mainly on first-tier priorities such as improving access to and delivery of affordable basic services in MEI and strengthening the financial sector.
- **The Eastern Europe Energy Efficiency and Environment Partnership (E5P Fund)** has close to €20 million in pledged support from the EU, Czech Republic, Denmark, Estonia, Germany, Latvia, Lithuania, Norway, Poland, Sweden and the USA. With pledged support of €1 million, Armenia is both a contributor to and beneficiary of the fund's resources. E5P provides grants which are pooled with IFI loans to support municipal sector investments that promote energy savings and other environmental benefits. Approximately €160 million in projects suitable for E5P co-financing have been identified, with project implementation expected to begin in 2016.
- **Bilateral donors:** grants will be sought from donors through their bilateral accounts administered by the EBRD, who have expressed interest in supporting activities in Armenia across all sectors and activities. Historically, Austria, Sweden and China Taipei have been particularly active donors in Armenia.
- **The EU Neighbourhood Investment Facility (NIF)** has been an important source of funding for TC and non-TC grants for Armenia. The EC has recently indicated its intent to support private sector development in Armenia, which may include a €15 million NIF contribution to the EBRD, although funding may be sourced from the

Armenia Annual Action Plan 2014 (SBS and improving access to equity finance). Overall availability of funds in the NIF East remains low for 2015, with Armenia not a high priority for the NIF at the moment. This will be monitored closely.

- **EU National Programme for Armenia** could be explored as to whether it is able to provide funds. Contact between the RO and the EU Delegation is already good, and must be maintained. It is a pre-requisite for any EU funding.
- **EBRD Shareholder Special Fund (SSF)** endowed by the Bank's net income. The SSF is a complementary facility to donor resources and will provide TC and non-TC support in priority transition areas where there is a shortage or lack of donor support.