

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

**STRATEGY FOR ARMENIA**

As approved by the Board of Directors on 7 February 2006

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## EXECUTIVE SUMMARY

Armenia is committed to the principles of multiparty democracy, pluralism and market economics in accordance with the conditions outlined in Article 1 of the Agreement Establishing the Bank, although application of these principles in the previous Strategy period has been somewhat uneven. Since elections were last held in 2003, politics was dominated by the powerful executive branch and the pro-presidential majority in the parliament. Some progress has been made in democratising the electoral code, reforming legislation on the mass media and freedom of information, and strengthening public governance. Constitutional reforms that would enable reinforcement of checks and balances in the political system have been endorsed in a national referendum. However, the political will to implement these commitments remains uncertain. Progress toward a resolution of the longstanding dispute over Nagorno-Karabakh has been slow, which leaves Armenia partially isolated in the region, impeding the country's economic development and largely excluding it from regional projects and initiatives.

Armenia's macroeconomic performance has been favourable in recent years. Real economic growth averaged 12.4 per cent over the last three years, mainly driven by the construction and services sectors. Consumer spending has increased significantly, supported by higher incomes and growing remittances. Tight monetary policy has been maintained, keeping annual inflation at single-digit levels since 1997. Fiscal performance also improved with increased tax revenues and better management of targeted expenditures. The current account deficit has narrowed to 4.6 per cent of GDP in 2004, in part due to growing remittances. The external debt situation has continued to improve, and most of the outstanding liabilities are on concessional terms. However, as advised by the IMF, careful management of the sovereign debt capacity should remain a priority for the government and the authorities will continue to refrain from incurring non-concessional borrowings.

Poverty reduction remains a top priority for the country. Although the government has made good progress in implementing its Poverty Reduction Strategy Programme (PRSP) and the overall poverty ratios have been falling, poverty remains a critical issue, particularly in rural areas and among socially vulnerable groups.

Armenia made rapid progress in a number of structural reform areas, including price and trade liberalisation as well as privatisation. The country joined the World Trade Organisation (WTO) in 2003 and maintains a floating exchange rate regime with full currency convertibility. The privatisation process in Armenia is nearing completion, but post-privatisation restructuring and improvement of corporate governance, *inter alia* through raising accounting standards and protecting minority shareholders, remain top priorities. While the government has made some progress in the reform of the financial sector, it is still relatively underdeveloped. Bank intermediation is low by CIS standards, and the role of the capital market is marginal. FDI increased in 2004-05, partially spurred by the renewed interest by the Armenian Diaspora in setting up businesses, but other FDI remains relatively low, deterred by the small size of the domestic market, the population's low purchasing power and the country's partial isolation in the region.

Against this background, Armenia's main transition challenges are: (i) to improve the business environment *inter alia* by reducing corruption and arbitrariness, and emphasising the

rule of law; (ii) to continue strengthening the financial sector by raising the level of financial intermediation through institutional development and increased competition, developing mechanisms for revitalising the securities markets, and introducing regulatory prerequisites for development of non-banking intermediaries and of the primary mortgage market; (iii) to accelerate post-privatisation restructuring and to improve transparency and corporate governance in the enterprise sector; (iv) to promote commercialisation of public infrastructure and utilities, with an emphasis on transparency and governance, (v) to establish competition in the market, and (vi) to improve tax and customs administration and ensure debt sustainability

As of 30 September 2005, the EBRD had a modest current portfolio of EUR39.3 million, spread among 24 projects, of which the majority (60 per cent) was in the private sector. During the previous Strategy period, there has been a steady growth in the EBRD's activities; the Bank committed EUR10.4 million in new business for 9 private projects, and provided EUR340 thousand in technical assistance funds.

While cognizant of the challenges of the local business environment, the Bank is committed to supporting the transition process in Armenia, and will continue to deepen and expand the scope of its activities in the country. Armenia's participation in the Early Transition Countries Initiative (ETCI) is core to the Bank's strategy in Armenia and some concrete results are starting to show. The Bank will target primarily the development of the local private sector, i.e. small and medium-sized enterprises (MSEs and SMEs) and the banking sector.

The main operational objectives will be:

- **Enterprise Sector** - The EBRD will continue to focus on expanding SME and micro-enterprise financing, primarily through credit lines to local partner banks, but also directly through the Bank's Direct Lending Facility (DLF) and Direct Investment Facility (DIF), as well as through co-financing and risk sharing with local banks under the Bank's Medium-Sized Co-financing Facility (MCFF). The Bank will seek to expand microfinance lending through cooperation with non-bank microfinance intermediaries, as they become regulated by the Central Bank. Continuing emphasis will be provided to expanding the Bank's TAM/BAS advisory services.
- **Financial Sector** - The Bank will continue to promote strengthening of financial intermediation in Armenia through provision of debt and equity financing to Armenian financial institutions. The Bank will increase its support for the local banks' SME lending and trade financing activities and will aim to broaden the scope of its collaboration with Armenian banks through co-financing and risk-sharing under MCFF, as well as through support of new products, such as mortgages. To reinforce the local banks' capacity for meeting the private sector's growing financing needs and accelerate transition, the Bank will pursue equity and quasi-equity participation in Armenia's best banks. To that end, the Bank will expand the scale and the scope of the Armenian Multibank Framework Facility (MBFF) to include equity and subordinated debt, as well as mortgages, which should enhance the Bank's ability to promptly react to the client banks' needs. The Bank will also seek to enhance its involvement with the Armenian financial sector through provision of debt and equity financing to insurance, leasing and regulated micro credit companies.
- **Infrastructure** - The EBRD will support creditworthy renewable energy and energy efficiency projects, and will consider non-sovereign/commercial financing of private

operators in the transport sector, as well as of operators and concessionaires of public utilities and transport infrastructure companies. In exceptional cases, the EBRD would pursue sovereign backed projects, but only with a significant component of grant co-financing.

The Bank will continue to ensure that all EBRD operations in Armenia are subject to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans. The Bank will co-operate with other IFIs specifically in the context of the implementation of the PRSP and through co-financing, complimentary projects and policy dialogue. The Bank will seek to mobilize increased donor grant financing from the Early Transition Countries Fund, but also from other multilateral and bilateral donors, to support the preparation, implementation and grant co-financing of selected investment projects.

## LIST OF ABBREVIATIONS

ADB	Asian Development Bank
ADM	Armenian Dram (national currency of Armenia)
AIPRG	Armenian International Policy Research Group
ATC	Assessment of Transition Challenges
BAS	Business Advisory Service
CBA	Central Bank of Armenia
CIS	Commonwealth of Independent States
DFID	Department for International Development
DIF	Direct Investment Facility
DLF	Direct Lending Facility
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECHO	European Commission for Development and Humanitarian Aid
ENP	European Neighbourhood Policy
ETCI	Early Transition Countries Initiative
EU	European Union
EUR	Euro
FDI	Foreign Direct Investment
FI	Financial Institutions
GDP	Gross Domestic Product
HIV/AIDS	Human Immunodeficiency Virus/ Acquired Immune Deficiency Syndrome
IAS	International Accounting Standards
IDA	International Development Association
IFC	International Finance Corporation
IFI	International Financial Institution
ILO	International Labour Organisation
IMF	International Monetary Fund
INOGATE	Interstate Oil and Gas Transport to Europe
IOM	International Organisation for Migration
JBIC	Japan Bank for International Co-operation
KfW	Kreditanstalt für Wiederaufbau
LTT	Legal Transition Team
MBFF	Multi-Bank Framework Facility
MCA	Millennium Challenge Account
MCFF	Medium-Sized Co-Financing Facility
MNPP	Metzamor Nuclear Power Plant
MFI	Micro Finance Institution
MSE	Micro and Small Enterprises
NEAP	National Environment Action Plan
NGO	Non-Governmental Organisation
ODA	Official Development Assistance
OSCE	Organisation for Security and Cooperation in Europe
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
PCF	Prototype Carbon Fund
RAO UES	United Energy Systems (Russian power and energy company)
RO	Resident Office
SEEC	South Eastern Europe and Caucasus
SME	Small and Medium Enterprise
TACIS	Technical Assistance for Commonwealth of Independent States

TAM	Turn Around Management
TC	Technical Cooperation
TFP	Trade Facilitation Programme
TRACECA	Transport Corridor of Europe-Caucasus-Asia
UNDP	United Nations Development Programme
USD	US Dollar
USAID	United States Agency for International Development
VAT	Value-Added Tax
WB	World Bank
WHO	World Health Organisation
WTO	World Trade Organisation

## COUNTRY STRATEGY

### 1 THE BANK'S PORTFOLIO

#### 1.1 OVERVIEW OF BANK ACTIVITIES TO DATE

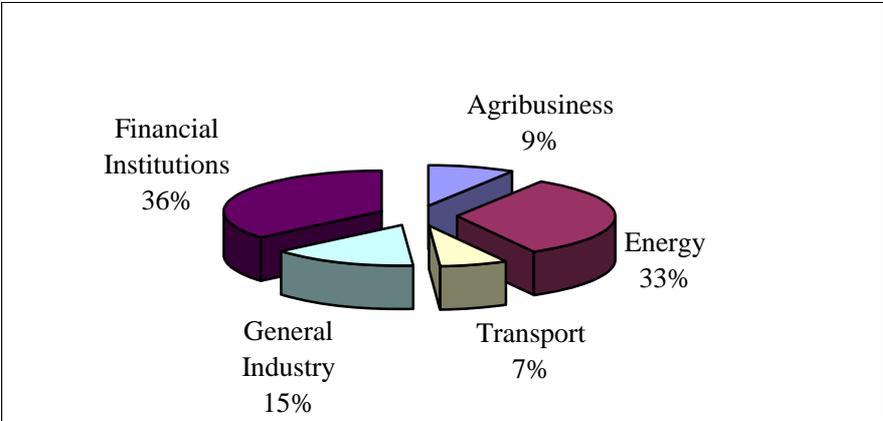
Although, in terms of volume, the portfolio remains dominated (58 per cent) by the three relatively large facilities (two of them sovereign) signed between 1993 and 2000 (Hrasdan Unit 5, Zvartnots Air Cargo, and Yerevan Brandy Company), much of the activity in the subsequent years can be attributed to an increase in the number of smaller transactions, many of them undertaken under ETCI and approved frameworks, largely targeting SMEs and MSEs. As of 30 September 2005, the portfolio of 24 transactions stood at EUR39.3 million, of which the majority (60 per cent) was in the private sector, and 40 per cent in the public sector, thus reversing the trend of the prior years. The three larger loans are all repaying, thus offsetting new additions to the portfolio, which are derived from significantly smaller facilities. Current undrawn ratio is 15 per cent.

**Table 1: Commitments and Portfolio as of 30 September 2005  
(EUR million)**

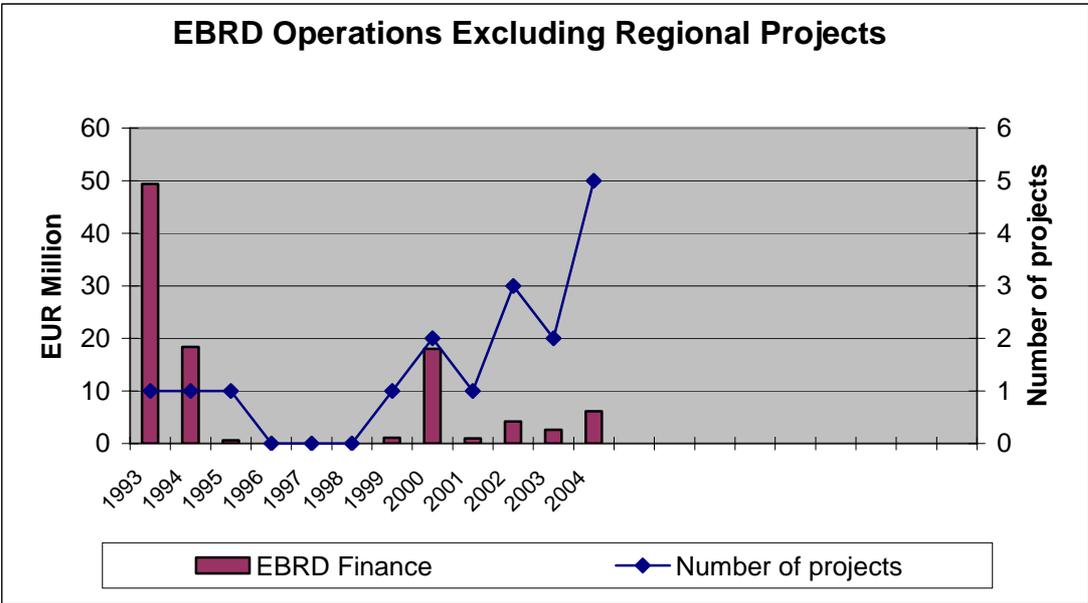
Sector Name	Commitments					Net Portfolio			
	No. of projects	Total Project Cost	EBRD Funding	% of total EBRD	Disbursed	Portfolio	% of Portfolio	Undrawn commitment	Operating assets
<b>Financial Institutions</b>	<b>16</b>	<b>16.7</b>	<b>16.7</b>	<b>16%</b>	<b>11.9</b>	<b>13.9</b>	<b>36%</b>	<b>4.0</b>	<b>9.8</b>
<b>Infrastructure</b>	<b>3</b>	<b>97.4</b>	<b>66.8</b>	<b>62%</b>	<b>66.1</b>	<b>15.8</b>	<b>40%</b>	<b>0.7</b>	<b>15.1</b>
<i>Energy</i>	<i>2</i>	<i>75.5</i>	<i>49.0</i>	<i>46%</i>	<i>48.3</i>	<i>13.2</i>	<i>33%</i>	<i>0.7</i>	<i>12.5</i>
<i>Transport</i>	<i>1</i>	<i>21.9</i>	<i>17.8</i>	<i>16%</i>	<i>17.8</i>	<i>2.6</i>	<i>7%</i>	<i>0.0</i>	<i>2.6</i>
<b>Enterprise support</b>	<b>5</b>	<b>55.0</b>	<b>24.0</b>	<b>22%</b>	<b>19.4</b>	<b>9.6</b>	<b>24%</b>	<b>3.3</b>	<b>6.2</b>
<i>Agribusiness</i>	<i>2</i>	<i>44.1</i>	<i>17.2</i>	<i>16%</i>	<i>17.2</i>	<i>3.7</i>	<i>9%</i>	<i>0.0</i>	<i>3.7</i>
<i>General Industry</i>	<i>3</i>	<i>10.9</i>	<i>6.8</i>	<i>6%</i>	<i>2.2</i>	<i>5.9</i>	<i>15%</i>	<i>3.3</i>	<i>2.5</i>
<b>Country Total</b>	<b>24</b>	<b>169.1</b>	<b>107.5</b>	<b>100%</b>	<b>97.4</b>	<b>39.3</b>	<b>100%</b>	<b>8.0</b>	<b>31.1</b>

Net portfolio distribution by sector was as follows:

**Figure 1: Armenia: Portfolio Distribution by Sector**



The portfolio remains somewhat skewed by the relatively large outstanding balances under the two public sector loans signed in the 1990's. The level of private sector activity in the previous strategy period increased sharply however, with five new transactions in 2004 (see the chart below).



This positive trend in the number of signed projects continued into the first nine months of 2005, during which the Bank signed nine new projects (average size EUR 1.1 million), which also indicates acceleration of the positive momentum in the Bank's activities in Armenia. While the improving Armenian economy has fuelled demand for financing, the sharp increase in the Bank's business in Armenia in 2004-2005, including the relatively robust pipeline, is also attributed to the impact of the ETC initiative.

## 1.2 PORTFOLIO PIPELINE

The 2005 portfolio pipeline is significantly more diversified across sectors than the existing portfolio and reflects additional business opportunities afforded by the ETC Initiative as well as Armenia's fast growing economy. In addition to the increased activities in the financial sector, agribusiness, natural resources, general industries energy and infrastructure, are represented.

## 1.3 IMPLEMENTATION OF THE 2003 COUNTRY STRATEGY

Implementation of the previous Country Strategy (end 2003 to date) benefited from the ETC Initiative, particularly in the later period (2005), as the new ETCI products (DIF, DLF, MCFF) enabled the Bank to start financing Armenia's private sector directly, as well as to broaden its co-operation with the Armenian financial sector, as follows:

- **Enterprise Sector** – as envisaged in the Strategy, new EBRD commitments largely flowed to the enterprise sector through local banks, which served as the Bank's primary conduit of funds to SMEs. Funds were provided primarily under the Armenia Multi-Bank Framework Facility (MBFF) for subsequent on-lending to SMEs. The performance of the partner banks was excellent, with only a small percentage of non-performing loans. Two enterprises were financed directly through DIF and DLF. The Bank's BAS and TAM programmes provided advice to 7 projects for TAM, and 43 projects for BAS, including 15 in the regions, spanning a wide spectrum of industries.
- **Financial Sector** –During the strategy period, four banks were provided with credit lines under the MBFF, and three more banks received support under the Regional Trade Finance Programme (TFP). The Bank acquired a 25 per cent equity stake in Armeconombank, Armenia's fifth largest commercial bank, in 2004. Contrary to expectations, the increased minimum capital requirements have not so far triggered a wave of mergers and acquisitions in the banking sector, while the pre-requisite institutional framework for mortgage lending is still evolving. Risk-sharing opportunities in the sector have been identified and an MCFF facility has been signed with ACBA, with Armeconombank in process.
- **Power and Energy** – the Bank has continued to develop its approaches to financing renewable energy projects in Armenia. One such project, a EUR1.5 million DLF financing of an independent mini-hydro, was approved in 2005.

**In the Infrastructure Sector** there were no new transactions in either transport or MEI during the Strategy period. Sovereign guarantees for infrastructure projects remained unavailable. The Bank has pursued selected opportunities in non-sovereign, commercial financing of public utilities including possible participation in the financing of a new passenger terminal at Zvartnots International Airport. The EBRD has also been in preliminary talks with the City of Yerevan regarding a possible urban transport project.

## **1.4 PORTFOLIO PERFORMANCE**

The current EBRD portfolio in Armenia has a weighted project risk rating of 6.30 compared with 5.48 for the Bank as a whole. With the notable exception of the two sovereign infrastructure loans (Zvartnots Air Cargo Terminal, and Hrasdan Unit 5), which experienced difficulties, the portfolio performed satisfactorily. The levels of operation of the Zvartnots Air Cargo Terminal remains well below capacity, but the new private operator of Zvartnots has de-facto assumed servicing and repayment of the loan, and will work to improve the terminal's utilisation. Hrasdan Unit 5 remains uncompleted and a sale to RAO UES of Russia or to an Iranian utility is under consideration by the Government.

## **1.5 PORTFOLIO RATIO**

Investments in the private sector now represent 60 per cent of the Bank's portfolio in Armenia. The share of public sector projects is likely to decline further from the current 40 per cent, as the sovereign-guaranteed Hrasdan Unit 5 and Air Cargo Terminal projects continue to repay.

## **1.6 TRANSITION IMPACT OF BANK'S ACTIVITY AND LESSONS LEARNED**

### *Transition*

The Bank's transition impact during the past Strategy period was higher than in the past, partially owing to the increasing concentration on SMEs, which are the "engine" of Armenia's economy. The EBRD's financial sector operations have contributed to the development of the local banks' institutional and core competencies while SMEs have received access to medium-term funds essential to growing business. The Bank's equity investment in Armeconombank enhanced that bank's ability to deliver services to Armenian companies and consumers under strengthened corporate governance.

Outside the financial sector, the Bank's equity investment in SHEN Concern has improved that company's corporate governance, while strengthening its competitive position, including through greater attention to marketing and financial management. The recently approved loan to Bazenk, a mini-hydro power station, is a first such facility to an independent renewable energy company.

Throughout the past Strategy period the Bank maintained a policy dialogue with the Government aimed at improving the business environment in Armenia for the private sector, including addressing such issues as expedition of VAT refunds, as well as strengthening corporate governance, particularly in the financial sector. The Bank co-ordinated its policy dialogue with other IFIs, as appropriate.

### *Lessons Learned*

Although no projects signed during the past Strategy period underwent ex-post PED reviews, the following general lessons from the past Strategy period can be drawn:

- **Carefully targeted approach.** It is important to recognize that, even though the Bank's pipeline of projects in Armenia now spans a variety of industries, the small country is not able to offer immediate opportunities in every sector in which the Bank operates. Concentration on those industry sectors where results can be achieved in the near- and medium-term will be most effective, while a long-term view, expressed through persistent policy dialogue, will be required with respect to others.
- **Reliance on strong local partners.** Immediate prospects for large-scale FDI inflows are modest, thus affording the Bank limited opportunities to work with blue-chip strategic investors. Ability to identify strong local partners, as well as to work with international entrepreneurs, and close co-operation with local banks have been crucial to the Bank's core activities in Armenia.
- **Careful selection of local and international partners.** The Bank's increasing involvement in the Armenian private sector, particularly SMEs, exposes it to universal risks associated with lending to privately held companies and entrepreneurs, some of which are more difficult to mitigate in Armenia. Careful attention will therefore be continued to be paid to integrity issues, management capacity, personality and management succession within larger enterprises.
- **Keeping it simple.** While careful adherence to principles of prudent lending is crucial in the risky Armenian market; overly-complicated structures are likely to confuse clients, delay signings, and may result in clients' losing interest, while not always affording additional protection to the Bank.

## 2 OPERATIONAL ENVIRONMENT

### 2.1 GENERAL REFORM ENVIRONMENT

#### 2.1.1 Political Developments

The conduct of the presidential election of 2003, in which the incumbent Robert Kocharian was returned to power for a second and final term, was severely criticised by the Organisation for Security and Cooperation in Europe (OSCE). The election caused tensions between the authorities and the opposition and between the state and society that have persisted over the past two and a half years. Political opposition parties have maintained their protests over the conduct and outcome of the election, including through large scale public demonstrations in Yerevan from March to June 2004. One demonstration in April turned violent as armoured police units used force to break up a vigil near the presidential administration building. Dozens of people were injured and up to 250 protesters taken into custody, according to opposition activists. Four opposition parliamentary deputies were detained but later set free. The Council of Europe and the OSCE criticised the authorities for their indiscriminate use of force and intimidation against the opposition, the media, and human rights campaigners.

Since the April 2004 incident the political situation has improved, though the opposition has maintained a boycott of the parliament and continues to press for the president's resignation.

The authorities continue to govern without the participation of opposition deputies, although this has deprived the political process of much-needed debate and vitality. Moreover, the protracted conflict between the authorities and the opposition has kept alive the issue of the legitimacy of the 2003 election results, which undermines public trust and support for political leaders and institutions.

The government has made some steps in the direction of political reform and reform of public institutions, and has articulated a programme of reform for 2005 that includes further legal and regulatory reform as well as strengthening corporate governance. The difficulties in building consensus among the pro-presidential parties that make up the coalition government and the parliamentary majority have been the main obstacle to a more rapid progress in reform. The political will to implement reforms effectively has also been lacking in some areas.

For a more detailed political assessment, see Annex 2.

### **2.1.2 Legal Reform**

Armenia has recently stepped up its efforts at legal reform, but it continues to face considerable challenges in entrenching the legal rules, institutions and culture upon which its successful transition to a market-oriented economy will depend. More importantly, implementation continues to lag behind the pace of legal reform, thus hindering the impact of such new legislation.

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

More importantly, an analysis of key commercial laws that directly contribute to creating a favourable investment climate in Armenia, such as corporate governance legislation, shows that even relatively good laws suffer from being poorly implemented. Surveys conducted by the EBRD confirm that commercial laws suffer as a result of not being sufficiently accessible to the public or from having inadequate administrative and judicial support. This implementation gap both undermines the utility of the specific laws in issue and diminishes the confidence that both Armenians and foreign investors and traders have in the legal system as a whole, in particular in its ability to uphold contractual rights.

Having said this, some progress was made in the last couple of years with respect to legal and regulatory reform in Armenia, particularly in the financial sector. The joint stock company law was amended in 2004 to, inter alia, curb insider dealing, asset stripping and generally strengthen the rights of small shareholders. A new law on audit was approved in April 2004, the law on bankruptcy was amended in April 2004, the law on insurance was amended in June 2004, the law on the securities market was revised in October 2004, an anti-money laundering law was adopted in January 2005, and a deposit insurance scheme became operational in July 2005. The minimum capital requirements for commercial banks were also raised, in effort to further bolster consolidation in the sector. There has also been a continued effort to simplify

the tax system and the administration of VAT returns to exporters has been streamlined and improved. Armenia joined the WTO and the recently-established Competition Authority is acting with increased dynamism and effectiveness.

For a more detailed assessment of Legal Reform, see Annex 5.

### **2.1.3 Social and Labour Issues**

Armenia has an ethnically homogeneous population of 3.1 million, which has been declining at an annual rate of 0.4 per cent<sup>1</sup>, mainly due to emigration, which has partially depleted the country's stock of human capital. The total decrease in population since 1990 is estimated at 21 per cent, with most of the decline traced to an outflow of migrants of a working age.

Recent (2002) data in the Poverty Reduction Strategy Paper indicate that the incidence of poverty fell from 55 per cent in 1998 to 51 percent in 2002 (it is estimated to have further declined to 43 per cent in 2005), while extreme poverty has declined from 27 to 21 percent. However, nearly all the improvement was among the urban poor, and rural poverty (affecting 36 per cent of the population) has remained high. Armenia is only likely to meet one Millennium Development Goal target, that for maternal mortality, and is unlikely to reach the targets for school enrolment, child mortality, and HIV/AIDS and tuberculosis incidence<sup>2</sup>.

Income inequality has declined to an estimated Gini coefficient of 0.52 in 2001, and National Statistical Agency for Armenia estimates that it has declined to 0.387 in 2004-2005, but Armenia continues to have the highest income inequality among European and Central Asian countries<sup>3</sup>.

Although Armenian law provides men and women with equal status, including equal pay for equal work, gender discrimination is a continuing problem in the public and private sector. A recent survey in Yerevan reported that, overall, women earned only 40 percent of what men earned<sup>4</sup>.

Armenia is an ILO member country, but has not ratified all of the core conventions, including those on child labour or forced labour. Under the law, the minimum age of employment is 16. In some cases however, with the permission of the child's parents and a labour union, children may work from age 14 in non-dangerous situations. The law has been unevenly enforced by local community councils, unemployment offices and the courts. Children under the age of 18 are prohibited from working overtime or in harmful and dangerous conditions, at night, and on holidays. There are legal and constitutional provisions prohibiting forced labour and there are no major reports of forced labour, apart from some trafficking for prostitution.

The law prohibits trafficking in persons, and offences committed for "mercenary purposes" are crimes according to a law that took effect in August 2003. Nonetheless, trafficking in persons from, through, and to the country remained a problem. The authorities have reported

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<sup>1</sup> World Bank : Armenia Country Assistance Evaluation, June 15, 2004. Report No. 29335.

<sup>2</sup> The Millennium Development Goals in Europe and Central Asia, ECA Region, The World Bank, September 2003, p. 7.

<sup>3</sup> World Bank PRSP, October 2003

<sup>4</sup> U.S. Department of State. Country Reports on Human Rights Practices – 2004, Armenia

that the country is a source and transit point for women trafficked primarily for sexual exploitation abroad. There are reports that the country is also a destination point for trafficked women from other parts of the CIS.

## **2.2 PROGRESS IN TRANSITION AND THE ECONOMY'S RESPONSE**

### **2.2.1 Macroeconomic conditions for Bank operations**

The economy has performed remarkably well since the last strategy. The real growth rate during the last three years averaged 12.4 per cent, and the country has now reached the level of GDP achieved in 1989. Recent growth was driven mainly by an improved performance in the construction and services sectors, while increased consumer spending was supported by higher incomes and growing remittances. Foreign direct investment, which increased significantly in recent years, also contributed to productivity increases. The agriculture sector recovered in 2004, recording 14.5 per cent real growth and has continued to grow during 2005 (10.2 per cent growth during the first nine months). However, the once-booming diamonds processing sector declined, mainly due to the disruptions of low-cost raw diamonds supply from Russia since 2004 and has not yet fully recovered. Real GDP grew by 12.2 per cent in the first ten months of 2005, suggesting that growth this year has largely maintained the momentum of previous years.

Over the last two years, the environment surrounding monetary policy has been difficult, partly due to volatile food and oil prices, continued private transfer flows, and real term currency appreciation. Under the circumstances, the Central Bank of Armenia (CBA) has maintained a prudent monetary policy focusing on price stability. The year-on-year inflation rate dropped from 8.6 per cent at end-2003 to deflation of 0.5 per cent by September 2005. The CBA has also made efforts to broaden its policy tools such as the issuance of its own domestic bonds. The CBA recently announced that it will fully switch to inflation targeting during 2006-07 with an expected core target of up to 3 per cent.

Fiscal policy continued to be sound. Expenditures have been managed tightly, with limited increases in social sector expenditures and wages. In 2005, tax revenues increased substantially. Tax receipts were increased by 21 per cent for VAT, 28 per cent for personal income-taxes, and 40 per cent for customs duties during January-May compared to the same period last year. A new one per cent tax on turnover, introduced since 2004 in the effort to combat the shadow economy and tax evasion, also contributed to increased tax revenue. The authorities started publishing the names of the 300 largest corporate taxpayers in an attempt to increase tax transparency. Reflecting these changes, the fiscal deficit declined to 1.7 per cent of GDP in 2004 and a marginal fiscal surplus was recorded till August in 2005. The tax to GDP ratio remains low at about 15 per cent however, partly because growing industries, such as foreign financed construction and foreign investments, are untaxed. Moreover, the tax and customs administration remains erratic, with particular concerns over lack of tax audit, poor use of information technology, lack of information sharing among the authorities, absence of self-declaration procedures and corruption. The government, with donor assistance has now targeted technical and institutional improvements in tax and customs administration.

Over the past two years, the dram has appreciated significantly, largely due to higher levels of remittances and increased confidence in the national currency. Despite continuous

appreciation, exports continued to grow rapidly (except diamonds exports). Imports also grew by 11.8 per cent (excluding raw diamonds) during 2004, due mainly to the increased spending on foreign consumer goods and on materials and machines for construction projects. The trade deficit remains large (13 per cent of GDP in 2004), but continues to be offset by substantial remittance flows. As a result, the current account deficit remains moderate at 4.6 per cent of GDP. According to the CBA, private transfers, including transfers through informal channels, rose by over 50 per cent during 2004 reaching USD 740 million (mainly from Russia).<sup>5</sup>

The total amount of Armenia's external debts currently stands at around USD 1.2 billion or 26 per cent of 2005 GDP, which is lower than that of other ETC countries, with the possible exception of Azerbaijan. The debt is concessional, with debt servicing accounting only for 9 per cent of fiscal expenditures, which the IMF has assessed as a sustainable level. However, debt levels remain relatively high in terms of fiscal revenues (over 150 per cent of fiscal revenues) and for this reason, strict discipline in assuming new indebtedness remains essential. The authorities continue to refrain from incurring any new non-concessional debt, although there is a possibility non-concessional sovereign lending could restart during the lifetime of the strategy.

## 2.2.2 Progress in Transition and transition challenges

Armenia has made relatively good progress in liberalisation and structural reforms compared with other transition countries in the CIS. This is reflected in the transition indicators compiled by the Bank and published in its annual Transition Report (see Table 2-1). Progress has been greatest in the areas of privatisation and market liberalisation. In other dimensions, the transition achievements in the financial institutions and some infrastructure sectors do not yet match the EBRD average indicators, but are still above the CIS averages.

**Table 2.1 Transition Indicators of the CIS countries, 2005**

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

Note: The index ranges from 1, indicating little or no progress, to 4+ pointing to standards similar to advanced economies. See Transition Report 2005 for the detailed definitions.

<sup>5</sup> The Balance of Payments statistics (USD 269 million during 2004) only reflect remitted funds through the banking system and do not reflect cash carried by migrant workers and money transferred by other informal methods. The CBA also anticipates a further increase in remittance flows in 2005, estimating more than USD 1 billion (about 21 per cent of GDP).

According to the Assessment of Transition Challenges (ATC) prepared by the Bank, (see Annex 3)<sup>6</sup>, transition gaps (i.e., gaps between transition goals and current situation) in Armenia are greater in sectors such as general industry, non-bank financial institutions, property and tourism, telecommunications, transport and municipal services. On the other hand, transition gaps are less significant in sectors such as agribusiness, natural resources, and power.

### ***Liberalisation, Markets and Trade***

Armenia has made good progress in trade and foreign exchange liberalisation. There are limited formal trade restrictions and no export quotas. The country maintains a floating exchange rate regime, with limited Central Bank interventions and with full currency convertibility. Armenia's trade regime is one of the most open in the CIS and Armenia joined the WTO in February 2003. Both exports and imports have been growing substantially, particularly with non-CIS countries which account for over 70 per cent of total trade. The benefits of a liberal trade regime are partly offset by Armenia's location (land-locked nature and remote from key markets), high transaction costs arising from an insufficient transport infrastructure, and shortcomings in customs procedures. Informal trade barriers seem to remain significant and continue to pose a key challenge. Domestic prices were fully liberalised at an early stage while utility prices are regulated by the regulatory agencies or ministries. The effectiveness of the competition authority has shown some signs of improvement although institutional capacity needs to be developed further.

### ***Private Sector Development***

Privatisation progressed relatively rapidly in Armenia. Since 1994 the government has privatised around 7,300 small enterprises and 2,000 medium and large enterprises. To complete the privatisation process, the government is now preparing a new law on the sale of state property for 2005–07. The law envisages 120 remaining state enterprises (including in such spheres as culture and entertainment) to be privatised by 2007. Most utility enterprises, including telecom, power distribution and generation, and the main airport, are in private hands, although many of these privatisations have been controversial. In 2004, the government completed the privatisation of the Zangezur copper-molybdenum plant, the second largest privatisation in Armenian history. The government also liquidated a number of medium and large-scale enterprises which were financially non-viable. The private sector share in GDP increased to approximately 75 per cent in 2004, among the highest in the CIS region. However, the privatisation process has not always led to deep restructuring or improvements in corporate governance, as many assets were sold to (regional) investors without relevant experience, or insiders.

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<sup>6</sup> The analyses map specific transition challenges under the transition indicator headings (i) Structure and extent of markets (e.g., extent of competition); (ii) Market institutions and policies (e.g., regulatory framework); and (iii) Market-based skills, conduct and innovation (e.g., improvements in corporate governance).

## ***Business Environment***

Over the past year there have been some improvements in the business environment. For example, the tax system was simplified and the administration of VAT returns to exporters was improved. A Business Council with the participation of local and foreign companies is acting to solve problems between the business community and the authorities and to more generally improve the business environment. The government has also begun to implement its anti-corruption strategy to tackle bribery and corruption, although much more work remains to be done in this area. Partly thanks to these developments, foreign direct investment (FDI) increased to USD 217 million in 2004. A large proportion of investments have been made in sectors such as metallurgy, food industry, telecommunications, energy, aviation, tourism and IT. Key investors are from Russia, Greece, Argentina, France, Germany and the United States.

**Table 2.2 Selected indicators for doing business in Armenia**

	<b>Armenia</b>	<b>Georgia</b>	<b>Azerbaijan</b>
Time to start a business (Days)	25	21	115
Cost to start a business (% of income per capita)	6.1	13.7	12.5
Rigidity of employment (index; 0=least rigid, 100=most rigid)	49	43	38
Time to register property (Days)	6	9	61
Disclosure Index (7=most disclosed)	3 (2005)	4	0
Time to enforce a contract (Days)	185	375	267
Cost to enforce a contract (% of debt value)	17.8	31.7	19.8
Time to go through insolvency (years)	1.9	3.3	2.7

Source: Doing Business in 2006, World Bank.

According to the 2005 World Bank Doing Business survey (see Table 2.2), the indicators for entry regulation, employment regulation, registering property and bankruptcy are above the regional average, while the indicators for legal rights, corporate governance, and to some extent enforcing contracts lag behind regional and advanced economy benchmarks.

According to the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS), 52 per cent of Armenian enterprises view access to finance as a moderate or major obstacle to the operation and growth of their business. Firms also complain about the lack of transparency in the regulatory system, cumbersome administrative procedures, tax administration and poor quality of infrastructure services. Corruption remains serious problem. The Transparency International Corruption Perceptions Index for 2005 shows a slight decline in Armenia's rating, from 3.1 in 2004 to 2.9 in 2005 (on a scale of 1-10, where 10 is least corrupt).

## ***Financial Sector***

The capital base in the banking sector has increased significantly in recent years. This has been promoted by raising the minimum capital requirements to USD 2 million from July 2003 and to USD 5 million in July 2005 (all banks are now in compliance).<sup>7</sup> Currently 21 banks remain in operation and all are under private control. Until recently, foreign participation was limited to two banks, of which one (HSBC Armenia) accounted for 16 per cent of total banking assets. However, in early 2005 the Central Bank of Armenia (CBA) awarded another licence to a new foreign bank, ARM SwissBank. Also in 2005, there have been two bank

<sup>7</sup> About USD 11 million is required for new entry.

acquisitions by foreign investors. Cascade Capital Holding (USA) has bought Emporiki Bank, while Turan Alem Bank (Kazakhstan), together with other Kazakh investors, acquired BTAInvestbank. Currently foreign ownership accounts for almost half of total banking capital. A deposit insurance scheme became operational from July 2005 providing 100 per cent guarantees on deposits up to 1.5 million Drams (approximately USD 3,000). An anti-money laundering law was also adopted in December 2004. Through these measures, the CBA aims to improve public confidence in the banking sector. Although bank assets grew from 18.1 per cent of GDP in 2003 to 22 per cent in 2005 (with improving asset quality, liquidity, and profitability), financial intermediation remains low by CIS standards. Non-performing loans account for approximately 2.1 per cent of total loans.

Bank deposits are not growing significantly in terms of GDP (from 12.0 per cent in 2003 to 12.4 per cent in 2005) and the ratio of domestic credit to GDP remains one of the lowest in the region (7.4 per cent in 2005). Interest rates spreads remain high<sup>8</sup> and loan maturities are relatively short. One reason for the lack of financial deepening is lack of competition among commercial banks.<sup>9</sup> Domestic banks are reliant on niche markets and government bonds in asset investments and corporate governance in the banking sector appears to be weak. The IMF has an objective of improving corporate governance of commercial banks under the current PRGF including through improving the effectiveness of the shareholders' general meetings, governance of the board of directors, separation of ownership and management and enhanced information disclosure on bank ownership.

The capital market is underdeveloped. Although 191 companies are listed in the Armenian stock exchange (Armex), market capitalisation is only USD 18 million (0.5 per cent of GDP), and trading volume remains marginal.<sup>10</sup> There is some trading in short-term government securities.<sup>11</sup> These securities are sold directly to dealers at regular auctions organized by the CBA, and the secondary market remains relatively inactive.

### *Infrastructure*

Following a series of privatisations and other forms of private sector participation, most utilities are now managed by the private sector. For example, the telecom company, Armentel, was privatised in 1997, and Armenian International Airports was awarded a 30-year private concession to operate Zvartnots Airport in 2002. A management contract to operate the Yerevan Water and Sewerage Company was awarded in 2000, following an open international tender. This improved operational efficiency and collection rates substantially leading to a significant reduction on government subsidies. The privatisation/restructuring of the Armenian railways has proceeded unevenly and slower than expected (a World Bank study is in progress, with recommendations expected in 2006). In accordance with private sector participation, tariffs have risen to cost recovery levels and collection rates improved

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<sup>8</sup> In mid-2005, spreads between deposit and lending rates were 12.6 per cent for domestic currency and 14.4 per cent for foreign currencies. These spreads have largely remained unchanged since 2001.

<sup>9</sup> One example is that commercial banks never advertise their interest rates in public.

<sup>10</sup> By comparison, the market capitalisation to GDP ratio is 134 per cent for the United Kingdom and 130 per cent for the United States. In the transition economies, the highest is Estonia (51 per cent).

<sup>11</sup> It accounts for approximately 3 per cent of GDP, but the government securities market is thin and lacks liquidity.

significantly. Regulatory bodies were also established for these sectors of natural monopolies.<sup>12</sup>

Some of the privatisation transactions, however, have been controversial with respect to such criteria as fairness and transparency. For example, the telecom privatisation was awarded to OTE, a Greek telecommunications company, with a long period of exclusivity rights (15 years for fixed line and five years for mobile telecommunications and data transmission services). In response to the business community's persistent complaints about the quality of telecommunications network, the government partly liberalised the mobile market, by issuing a second licence to K-telecom, an affiliate of Karabakh Telecoms in 2005.

The electricity distribution networks were also privatised in 2003 to Midland Resources, which was initially believed to be an investor without relevant experiences. The company started operations with satisfactory results but recently sold the networks to Interenergo, an affiliate of Russia's RAO UES. The transaction lacked transparency at the outset, and the acquisition process was initially questioned by the international community, notably the World Bank. Moreover this transaction is likely to create additional challenges for the regulator, as RAO UES already owns the Hrazdan thermal power plant and also manages the financial flows of the Medzamor nuclear power plant.

### 2.2.3 Transition Challenges

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

- ***Improving the business environment***  
Some improvements have been observed in recent years, but the business community continues to complain about obstacles to doing business. Further improvements are particularly needed in the areas of increasing transparency of rules and regulations, improving the legal and regulatory framework and governance, and reducing administrative barriers and corruption. Access to finance is important.
- ***Deepening financial intermediation***  
Financial intermediation needs further deepening, enabling enhanced access to finance for domestic enterprises, particularly medium to long-term funding for entrepreneurs and for micro and small enterprises. Increased competition and improvements in corporate governance in the banking sector are a necessary condition to achieve this. Further requirements include a strengthened judiciary and enhanced financial transparency from borrowers.
- ***Promoting commercialisation of public infrastructure and utilities***  
Continued efforts are needed to commercialise/restructure remaining state enterprises as well as privatised utility enterprises. The levels of tariffs require adjustment to enable cost recovery while collection rates remain relatively low. For the services

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<sup>12</sup> The Public Services Regulatory Commission (PRSC) was initially established as an energy regulator in 1997, but then the responsibilities were enhanced to telecoms and water sectors.

already privatised (i.e. power distribution and telecoms), operational efficiency and quality of service need to be improved.

➤ ***Accelerating post-privatisation restructuring and improving transparency and corporate governance in the enterprise sector***

Despite rapid progress in privatisation, many of the privatised enterprises have faced operational and financial difficulties during post privatisation periods. Many of these enterprises still require significant restructuring. For the remaining state-owned companies, the authorities expect to finalise the privatisation programme by 2007 in accordance with new legislation.

➤ ***Establishing competition in the market***

A key remaining task for the authorities is to increase competition in the market, by making entry into the market easier for enterprises and through strengthening the effectiveness of the anti-monopoly agency.

➤ ***Improving tax and customs administration and ensuring debt sustainability***

In support of sustainable public finances, tax and customs systems require substantial strengthening. Major areas of concerns are (i) governance in the public sector, (ii) poor information technologies and information sharing among authorities to improve the effectiveness of tax and customs collection, and (iii) discriminatory activities of tax and customs collection agencies including corruption.

## **2.3 ACCESS TO CAPITAL**

Armenia still has substantial investment needs both in the public and private sectors. Public sector investment finance remains essentially dependent on official financing from bilateral donors, IFIs and from Diaspora sources. Annually, Armenia received USD 200-300 million or around 7 per cent of GDP in ODA in recent years. The United States is the largest bilateral donor, followed by Germany and Japan. In 2004, Armenia was included in the countries eligible to the US Millennium Challenge Account (MCA) and the authorities are expecting approximately USD 175 million during 2006-09, primarily for the development of the rural infrastructure and irrigation. Moreover, the Lincy Foundation, a US based foundation which donated USD 170 million during 2001-03, has recently committed to provide another grant for USD 60 million for renovation of schools and transport infrastructure.

Armenia maintains good relationships with all IFIs. The programmes of the IMF and the World Bank progress relatively smoothly. The country also joined the Asian Development Bank in September 2005. The borrowings are limited to concessional loans. The government does not have access to international capital markets as Armenia remains unrated by internationally recognised credit agencies. Nevertheless, the government has the ability to issue domestic government bills, which have attracted domestic investors (mostly commercial banks).

In the private sector, access to finance is generally limited. Armenian private firms have not yet issued any international equities or bonds. Loans from major international banks are also limited. Thus, most of the private financing comes through foreign direct investment or through connected lending. Foreign direct investment has been increasing significantly in

recent years with the major foreign investors coming from Russia, Greece, Argentina, France, Germany and the United States. Domestically, private sector access to medium and long-term finance is limited. Domestic credit to the private sector remains low at 7 per cent of GDP (2004). Commercial banks continue to lend on terms falling well short of what is required to sustain the growth of the private sector (typically one year), although interest rates have declined to approximately 16 per cent p.a. Access to bank financing for most SMEs and MSEs, particularly in the regions, remains limited. Involvement of Diaspora foundations has been a mixed blessing. While some foundations have become involved in establishing banking and non-banking credit institutions aimed at developing Armenia's financial market on a commercial footing, others have opted for de-facto subsidising the private sector by providing credit at rates well below the market, thus distorting the market and undermining local banks.

### **3 STRATEGIC ORIENTATIONS**

#### **3.1 BANK'S PRIORITIES FOR THE STRATEGY PERIOD**

In line with its mandate, the Bank will continue over the new Strategy period to target primarily the development of the private sector, particularly SME's, in support of GDP growth and job creation, and hence, poverty reduction. The Bank's continuous support of the private sector is fully consistent with PRSP, which lists sustaining high economic growth, with particular attention paid to small and medium-sized enterprises, as the first of its five key policy objectives.

Opportunities for the Bank's new investments will largely depend on the investment climate. To that end, in addition to project-related policy dialogue, the Bank will maintain a policy dialogue aimed at development of an overall enabling climate for private investment. The Bank will continue to co-operate with other IFIs in this regard.

Given Armenia's debt position, as well as the Government of Armenia's views regarding the Bank's role in the country, the Bank will not actively pursue sovereign-supported infrastructure projects in Armenia. Should, however, opportunities for sovereign lending arise during the new Strategy period, heeding the lessons learned from the past large sovereign projects in Armenia, the Bank will selectively pursue bankable projects of sustainable scale and with viable underlying economics and technical solutions, thus minimizing the likelihood of resorting to the sovereign guarantee.

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

#### **3.2 SECTORAL CHALLENGES AND BANK OBJECTIVES**

##### **3.2.1 The Enterprise Sector**

Core to the Bank's activities in the enterprise sector will be expanding the depth and breadth of its collaboration with local partner banks, with a focus on SME and microfinance. Where justified, credit lines to partner banks for subsequent on-lending to SMEs will be increased, with sub-lending limits raised, while the scope of co-operation with the banks will be broadened through inclusion of risk-sharing and co-financing through the Bank's Medium-Sized Co-financing Facility (MCFF). Beyond the non-recourse component of MCFF, direct debt financing of the Armenian private enterprises will be accomplished through the Bank's Direct Lending Facility (DLF). The Bank will aim to intensify provision of equity capital through the Bank's Direct Investment Facility (DIF). The Bank will seek to expand microfinance lending through cooperation with non-bank microfinance intermediaries, as they become regulated by the Central Bank.

Additional emphasis will be made on expanding the Bank's TAM/BAS advisory services, as well as on strengthening their links with Banking Teams and the RO.

The following sectors offer likely potential for private sector investments:

*Agribusiness* – The Bank will support this sector, which is of particular importance to the Armenian economy. The Bank will seek bankable opportunities in packaging, bottling, beverages, frozen and dried fruit, dairy, and baked goods, as well as in food retailing.

*Textile and apparel* – Armenian textile and apparel manufacturers appear reasonably well-positioned to take advantage of the growing demand in Russia and the CIS, as well as in the niche markets in the west, which will require investment in product line upgrades, packaging, marketing and distribution. The Bank will seek to support the sector through financing equipment and working capital needs.

*Metals* – The sector has exhibited steady growth, and is one of the primary exporting sectors of the Armenian economy. The Bank will seek to expand its co-operation with existing clients, as well as to establish new relationships with creditworthy companies of good integrity.

*Construction* – The sector has demonstrated strong and consistent growth. The Bank will seek additional opportunities with creditworthy producers of construction materials.

*High-technologies* – Armenia has some potential for developing a credible high-technology industry, partially leveraging off the research and development capacity inherited from the USSR. The Bank will support selected projects with proven technology and strong sponsors.

### **3.2.2 Financial Sector**

Supporting the financial sector is the core priority for the Bank in Armenia, and the Bank will, on a number of levels, promote strengthening of financial intermediation in the country. This will include provision of debt and, selectively, equity financing to the country's best bank and non-bank financial intermediaries, accompanied by Technical Assistance, as well as advancement of the policy dialogue with the government and the Central Bank, with the focus on corporate governance, promotion of competition, attraction of new entrants (including foreign banks), and consolidation. Other areas for co-operation with the Central Bank may include assisting the latter in its efforts to obtain a credit rating for Armenia (e.g., through syndicating credits with international commercial banks, to the extent possible).

The Bank will strengthen and broaden its support of the local banks' SME lending and trade financing activities, and will broaden the scope of its collaboration with the banks through co-financing and risk-sharing under MCFF, which was launched in Armenia at the end of the previous Strategy period, and stands to evolve into one of the principal vehicles for private sector financing in Armenia. With this in mind, the Bank will work to include more Armenian banks in the MCFF programme.

The Bank anticipates that the institutional framework for mortgages will be largely in place during the new Strategy period, allowing the Bank to put in place lending facilities for mortgages. To that end, the Bank will continue to co-operate with other IFIs and donors to

support on-going development of the institutional infrastructure and regulatory framework for home-financing through *inter alia* policy dialogue with the government, and provision of legal assistance where deemed additional.

The Bank will pursue opportunities for equity participation in Armenia's best financial institutions, which will strengthen the target banks' capital base at a time when minimum capital requirements in Armenia are being raised, the market appears ripe for consolidation, and the clients' financing needs are growing, owing to the country's improving economy. While reinforcing the local banks' competitive edge and ability to take advantage of the opportunities offered by the evolving market, equity participation will also put the Bank in a stronger position to accelerate transition, including through improved corporate governance

With the opportunities for co-operation with local banks increasing, the Bank will aim to enhance its own ability to efficiently deliver its many products to the clients. To that end, the Bank will broaden the scope and significantly increase the size of the Armenian Multibank Framework Facility to include equity and subordinated debt, as well as mortgages, in addition to SME financing.

The Bank will also seek to expand its involvement with the financial sector through inclusion of such non-bank intermediaries as insurance, non-bank credit, leasing, and regulated micro credit companies, via provision of equity and debt financing, as well as through possible co-financing.

The Bank will advance its policy dialogue with the Central Bank, and will support the Central Bank in its efforts to improve corporate governance and organisational structure in the banking sector through possible assistance in developing relevant legislation, as well as by using its influence with local banks, particularly those in which the Bank has an equity stake. Where possible, the Bank will work to facilitate the dialogue between Central Bank and the banking community through knowledge exchange, including sharing experience from the Bank's other countries of operation.

### **3.2.3 Infrastructure**

#### ***Power and Energy***

Armenia's power distribution company has been acquired by Russia's RAO UES via a sale of its corporate owner, Midland Resources, to a subsidiary of RAO. Hrasdan's Unit 5 likewise may be transferred to RAO as part of debt redemption between Armenia and Russia (official decision is expected by the end of 2005). The remaining two large generating companies (one hydro and one thermal) are in the state's hands, and one of them is a likely candidate for financing from JBIC.

While the Bank remains poised to react to opportunities for privatization-related financing of larger generating companies as they arise, the main operational focus will be aimed at pro-actively pursuing renewable energy projects. To that end, the Bank will continue advancing the Armenian Renewable Energy Programme project, undertaken in conjunction with Cascade Credit, an offshoot of the US-based Cafesjian Family Foundation, while pursuing larger stand-alone independent renewable energy projects, such as wind and hydro. Bankable industrial energy efficiency projects will be likewise pursued in this context. However it is

important to note that such projects will likely require significant Technical Assistance resources in support of their development and implementation.

### ***Transport***

The Bank will not actively pursue any projects in this sector requiring sovereign support, but will consider providing commercial financing to private operators of state-owned infrastructure (e.g., Zvartnots International Airport), subject to satisfaction with the concession award process. The Bank will continue to monitor the progress of the railway system restructuring, with a view toward potential co-operation with the resulting railway company on a commercial basis to support rolling stock refurbishment and replenishment.

### ***Municipal and Environmental Infrastructure***

In view of the continuing unavailability of sovereign guarantees and the paucity of creditworthy municipalities in Armenia, the Bank will seek to identify bankable opportunities with private operators, such as creditworthy privately-owned urban transport companies, which are likely to be quite small. The Bank will closely monitor the situation with Yerevan's municipal budget, with a view to developing an urban transport project once the city is granted authority over its budget. The Bank will also assess the feasibility of developing non-sovereign municipal services projects in the water (drinking and waste-water), as well as in solid waste disposal, sectors with selected creditworthy Armenian municipalities and individual boroughs of Yerevan, some of which have independent budgets. To that end, identifying potentially creditworthy municipal counterparties in Armenia will be the main initial strategic priority.

### ***Telecommunications***

The Bank's activities in this sector have been hampered by the continuing lack of progress toward creating a competitive environment. As Armentel's de-facto monopoly in the sector continues largely unabated. Liberalization of the market, including implementation of a competitive framework for mobile telephony, is thus a key prerequisite for the Bank's involvement in the sector.

## **3.2.4 Natural Resources**

This sector could give rise to significant investment possibilities if the privatisation or sale of important non-ferrous metals mines is conducted in a fair and transparent manner and attracts credible strategic investors.

## **3.3 ENVIRONMENT**

The Bank will continue to ensure that its environmental requirements are followed by existing projects. The Bank will apply its Environmental Policy and Procedures, conducting environmental due diligence on environment, health and safety issues as appropriate to all new projects in Armenia. Given that Armenia still has insufficient environmental

management and enforcement capacity, the country stands to benefit from external technical assistance. To that end, the Bank will aim to provide further support to the strengthening of the environmental risk management capacities of local banks (e.g., by organising an in-country environmental due diligence training workshop for partner banks with funding from the Early Transition Countries Initiative (ETCI). One of the Bank's projects in Armenia with a strong environmental component is the Armenia Copper Programme's smelter in Alaverdi. The Environmental Action Plan for the project will address high priority environmental issues, such as dust emission and effluent discharge control. The Bank will also continue to assist Armenia in diversifying its energy sources by supporting bankable renewable energy projects, such as wind and hydro, through the Armenian Renewable Energy Programme project, which will also address the country's Greenhouse Gas reduction objective.

#### **4 OTHER IFIS AND BILATERAL DONORS**

The Bank will continue to co-operate with IFIs and bilateral donors through co-financing, complimentary projects and the close co-ordination of policy dialogue. Close cooperation will be maintained both through the monthly donor co-ordination meetings attended by the Bank's Resident Office in Yerevan, as well as regular contacts at working level on a bilateral or multilateral basis. The Bank will seek to mobilize increased donor grant co-financing of selected investment projects.

The Bank will work closely with the World Bank in coordinating its activities. Consultations will be maintained and policy dialogue coordinated with the IMF. Cooperation with the EC will be continued in the field of business advisory services, and in policy dialogue in conjunction with the European Neighbourhood Policy (ENP). The Bank remains ready to co-operate with the EC and donors on the implementation of the EC proposal for establishment of a fund for decommissioning nuclear power stations. The Bank will work closely with the USAID in the SME sector development. Close co-operation with KfW in the financial sector on development of the regulatory framework, particularly for mortgages, will continue. The Bank will co-operate with the Black Sea Trade Development Bank in the area of private sector development and is ready to co-operate with the Asian Development Bank, once it commences operations in Armenia. Cooperation with other donors, as well as with private Diaspora foundations, will be conducted on a case by case basis, as needs and compatibility of approach are identified.

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

##### **4.1 INTERNATIONAL MONETARY FUND (IMF)**

Armenia became a member of the IMF in 1992. Since then, the IMF has provided four programs to support macro stabilization and structural reforms in Armenia, including the Poverty Reduction and Growth Facility (PRGF). Armenia's relationship with the IMF is generally good. Following successful resolution of the IMF's discussion with the government on reform of the tax system, a new USD34 million program under PRGF was approved by the IMF Board in June 2005.

## **4.2 THE WORLD BANK**

The World Bank (WB) is the largest multilateral donor in Armenia (natural resource management and poverty reduction, foreign investment and export promotion, information technologies, infrastructure, education, health, social sector, agricultural reform, municipal development, transport, and judicial reform). Armenia joined the WB in 1992 and the International Development Association (IDA) in 1993. The IDA lending has helped finance infrastructure rehabilitation, including support for earthquake reconstruction, irrigation, power, road maintenance, and municipal water. The IDA credits supporting the social safety net and improving access to services have included operations in health, education, and a social investment fund aimed at improving basic social and economic infrastructure. The WB's commitments in Armenia to-date have totalled USD896 million divided among 40 projects. Armenia has been a member of the International Finance Corporation (IFC) since 1995. The IFC made a first investment in 2000, providing USD3.6 million in equity finance to Hotel Armenia. The IFC is also providing donor-funded technical assistance to improve the investment environment by promoting modern corporate governance practices, including legislative amendments. The IFC recently completed two investments, helping to establish the Armenia SME Fund, a private equity fund to channel investments from the Armenian Diaspora into equity investments in local companies and a private leasing company.

## **4.3 THE EUROPEAN UNION (EU)**

Co-operation between the EU and Armenia has focused on development of political institutions, the rule of law and human rights, regional stability, economic and social reforms, including gradual participation of Armenia in the EU market. In 1991-2003, the EU provided Armenia with EUR331.9 million in assistance (not counting member states' bilateral programmes), primarily through TACIS, Food Security Programme, and ECHO. In 2004-2006 the EU assistance to Armenia is estimated at EUR55 million. Co-operation between the EU and Armenia should further increase with the inclusion of Armenia in the European Neighbourhood Programme (ENP).

Armenia has benefited from regional programmes such as TRACECA and INOGATE. The current framework for EC assistance is the Country Strategy Paper (CSP) 2002-2006 which is based on the objectives of the Partnership and Co-operation Agreement signed in 1996 and on the Poverty Reduction Strategy Paper recently agreed by the Armenian government. The budgetary support of around EUR10 million per annum provided by the EC Food Security Programme is contributing to the implementation of key structural reforms in the agricultural and social sectors and to improved delivery of certain government programmes in line with PRSP orientations. Within the framework of the CSP, the TACIS Indicative Programme 2004-2006 has been adopted by the European Commission in September 2003. The main pillars of the programme are (i) support for institutional, legal and administrative reform (including legal advice, assistance to customs and statistics, energy policy reform, local government decentralisation/reform and regional development and civil society) and (ii) measures to address the social consequences of transition (focusing on poverty alleviation via agricultural and social protection policies, education and vocational and technical training). The EC's indicative budget for Armenia for 2004-2006 is EUR20 million. The EU and Armenia are expanding their discussions on the closure of the Medzamor Nuclear Power

Plant (MNPP). In this regard, the EU is ready to support Armenia in finding alternative power supplies and is consulting with other donors with the aim of creating a fund to help finance such replacement capacities. The EC has maintained, however, that EU's EUR 100 million proposed contribution to the fund is conditional on Armenia's agreeing an early closure date for Medzamor.

#### **4.4 THE BLACK SEA TRADE DEVELOPMENT BANK (BSTDB)**

The BSTDB commenced operations in Armenia in February 2003 by launching an SME financial program jointly with Izmirlyan Foundation (a Swiss-Armenian investment and charity organization). The programme provides SMEs with up to 5 year term loans, in the amount of up to USD500, 000 to finance capital expenditures and working capital. Portfolio at the end of 2004 remained low. In June 2005, Armenia hosted the BSTDB's Annual Shareholders Meeting, in which it was decided to expand the Bank's activities in Armenia. The main priorities of the BSTDB in Armenia for the forthcoming years remain SME financing with emphasis on transport, food processing, manufacturing.

#### **4.5 THE ASIAN DEVELOPMENT BANK (ADB)**

Armenia became a member of ADB in 2005, but the institution has not yet commenced operations in Armenia.

#### **4.6 MAIN BILATERAL PROGRAMMES**

##### *United States*

The United States, acting primarily through the USAID, is the largest bilateral donor to Armenia, having contributed well over USD1 billion of aid in 1991-2003, in addition to humanitarian aid. The USAID has historically provided in excess of USD50 million p.a. to Armenia, and its programme for Armenia for 2004-2005, estimated at USD100 million, covers seven strategic objectives, which concentrate on support of SMEs, campaigning for public investment, improving public governance and transparency. Ongoing programs include economic restructuring, energy sector reform, healthcare, democracy and government, and agricultural support, including through the Farmer-to-Farmer Programme.

In 2004, Armenia was selected as one of the 16 countries eligible to apply for the US Government's Millennium Challenge Account (MCA). Armenia has since applied to the Millennium Challenge Corporation for USD175 million in assistance to support development of rural infrastructure (roads and irrigation).

##### *Germany*

Germany is the second largest donor to Armenia. The main directions for assistance provided by Germany to Armenia are the projects implemented by the German Enterprise for Technical Cooperation (known by its German initials GTZ), and KfW, which first opened its office in Armenia in 1998. GTZ's main focus is on technical co-operation, including in local development, promotion of rule of law, and promotion of SME activities. GTZ's ongoing projects in Armenia total EUR14.3 million. KfW has provided assistance to SMEs through

local banks via the German-Armenian Fund (EUR19 million). Other ongoing projects total EUR38 million, and include rehabilitation of water and wastewater in selected regions (EUR14.5 million), rehabilitation of power transmission (EUR8.9 million), and a credit guarantee fund (EUR6.8 million).

### ***United Kingdom***

The main implementing agency for direct UK Government assistance to Armenia is the Department for International Development (DFID). DFID's direct assistance programme consists largely of activities in public sector reform and supporting social initiatives. DFID's currently ongoing projects in Armenia have a combined budget of GBP11 million.

### ***Japan***

Japan began its bilateral assistance (ODA) to Armenia in 1991. Over USD30 million has been disbursed at the end of 2003. The priority areas of Japanese assistance are (i) consolidating the basic economic structure, (ii) the energy sector, (iii) transport infrastructure, (iv) improvement of the irrigation and water supply systems, and (v) the social sector (health and medical care, education, and mitigating hardships faced by the unemployed and the low-income population).

Implementation of a JPY 5.4 billion loan for an electricity transmission and distribution network project began in 2001. A loan of JPY15.92 billion was made in 2005 to finance the Yerevan Combined Cycle Co-Generation Power Plant project.

### ***The Netherlands***

The Netherlands is prominent among the non-resident countries with bilateral programmes in Armenia. Following the constituency relationship between the Netherlands and Armenia in the World Bank and the IMF, the priorities of bilateral assistance mainly focus on strengthening public sector reform and good (economic) governance. In 2005 the Dutch Government has co-financed the PRSP programmes of the Worldbank for a total amount of EUR 4.7 million. Additional funds were allocated to DFID (silent partnership in support of the Medium Term Expenditure Framework), UNDP, IOM and international NGOs. The Netherlands Platform for Financial Sector Development (NFX, Cooperation of the Dutch Government and Private Financial Sector) is involved in providing policy advice to the Armenia banking, insurance and pension sector. The NFX has established contacts with CBA and AIPRG.

## **ANNEXES**

- 1 Signed Bank Operations
- 2 Political Assessment
- 3 Assessment of Transition Challenges (ATC)
- 4 Environmental Issues
- 5 Legal Transition
- 6 Selected Economic Indicators
- 7 Technical Cooperation Projects
- 8 Map of Armenia

## ANNEX 1: SIGNED BANK OPERATIONS

(as of 30 September 2005, €million)

### by Sector

Sector Name	COMMITMENTS					NET PORTFOLIO			
	No. of projects	Total Project Cost	EBRD Funding	% of total EBRD	Disbursed	Portfolio	% of Portfolio	Undrawn commitment	Operating assets
<b>Financial Institutions</b>	<b>16</b>	<b>16.7</b>	<b>16.7</b>	<b>16%</b>	<b>11.9</b>	<b>13.9</b>	<b>36%</b>	<b>4.0</b>	<b>9.8</b>
<b>Infrastructure</b>	<b>3</b>	<b>97.4</b>	<b>66.8</b>	<b>62%</b>	<b>66.1</b>	<b>15.8</b>	<b>40%</b>	<b>0.7</b>	<b>15.1</b>
<i>Energy</i>	2	75.5	49.0	46%	48.3	13.2	33%	0.7	12.5
<i>Transport</i>	1	21.9	17.8	16%	17.8	2.6	7%	0.0	2.6
<b>Enterprise support</b>	<b>5</b>	<b>55.0</b>	<b>24.0</b>	<b>22%</b>	<b>19.4</b>	<b>9.6</b>	<b>24%</b>	<b>3.3</b>	<b>6.2</b>
<i>Agribusiness</i>	2	44.1	17.2	16%	17.2	3.7	9%	0.0	3.7
<i>General Industry</i>	3	10.9	6.8	6%	2.2	5.9	15%	3.3	2.5
<b>Country Total</b>	<b>24</b>	<b>169.1</b>	<b>107.5</b>	<b>100%</b>	<b>97.4</b>	<b>39.3</b>	<b>100%</b>	<b>8.0</b>	<b>31.1</b>

### by Portfolio Class and Investment Type

	COMMITMENTS					NET PORTFOLIO			
	No. of projects	Total Project Cost	EBRD Funding	% of total EBRD	Disbursed	Portfolio	% of Portfolio	Undrawn commitment	Operating assets
Private	21	70.2	41.2	38%	31.1	24.6	62%	8.0	16.4
Public	3	98.9	66.3	62%	66.3	14.7	38%	0.0	14.7
<b>Country Total</b>	<b>24</b>	<b>169.1</b>	<b>107.5</b>	<b>100%</b>	<b>97.4</b>	<b>39.3</b>	<b>100%</b>	<b>8.0</b>	<b>31.1</b>
Non-Sovereign	21	70.2	41.2	38%	31.1	24.2	62%	8.0	16.4
Sovereign	3	98.9	66.3	62%	66.3	15.1	38%	0.0	14.7
<b>Country Total</b>	<b>24</b>	<b>169.1</b>	<b>107.5</b>	<b>100%</b>	<b>97.4</b>	<b>39.3</b>	<b>100%</b>	<b>8.0</b>	<b>31.1</b>
Debt	14	160.7	100.9	94%	94.1	34.5	88%	5.4	28.9
Equity	4	4.2	4.2	4%	3.3	2.4	6%	0.2	2.2
Guarantee	5	1.4	1.4	1%	0	1.4	4%	1.4	0.0
Debt and Equity	1	2.8	1.0	1%	0	1.0	2%	1.0	0.0
<b>Country Total</b>	<b>24</b>	<b>169.1</b>	<b>107.5</b>	<b>100%</b>	<b>97.4</b>	<b>39.3</b>	<b>100%</b>	<b>8.0</b>	<b>31.1</b>

## SIGNED BANK OPERATIONS (Cont'd)

(as of 30 September 2005, €million)

Operation Name	COMMITMENTS						NET PORTFOLIO			Public/ Private	Year of signing
	Total Project Cost	Debt	Equity	Guarantees	Total EBRD Funding	Disbursed	Portfolio	Undrawn commitments	Operating Assets		
<b>Financial Institutions</b>											
Armenia Multi Bank FW – Anelik Bank	0.8	0.8			0.8	0.8	0.6	0.0	0.6	Private	2002
Armenia Multi Bank FW – Armeconombank	0.8	0.8			0.8	0.8	0.0	0.0	0.0	Private	2000
CBG Armenia (sub project of CBG FW) (equity)	1.1		1.1		1.1	1.1	0.0	0.0	0.0	Private	1999
Regional TFP: Armeconombank	1.0			1.0	1.0	0.0	1.0	1.0	0.0	Private	2002
Regional TFP: Armimpexbank	0.0			0.0	0.0	0.0	0.0	0.0	0.0	Private	2001
Armenia Multi Bank FW – ACBA	2.5	2.5			2.5	2.5	2.5	0.0	2.5	Private	2003
Regional TFP: Anelik Bank	0.3			0.3	0.3	0.0	0.3	0.3	0.0	Private	2003
Regional TFP: ACBA	0.1			0.1	0.1	0.0	0.1	0.1	0.0	Private	2004
Armenia Multi Bank FW – Anelik Bank	2.1	2.1			2.1	2.1	2.1	0.0	2.1	Private	2004
Armeconombank Equity	1.4		1.4		1.4	0.9	0.9	0.0	0.9	Private	2004
Regional TFP: Ineco Bank	0.0			0.0	0.0	0.0	0.0	0.0	0.0	Private	2005
Armenia Multi Bank FW – ACBA	2.5	2.5			2.5	2.5	2.5	0.0	2.5	Private	2005
Armenia Multi Bank FW – Ineco Bank	0.8	0.8			0.8	0.4	0.8	0.4	0.4	Private	2005
MCFF- ACBA Full Recourse	1.2	1.2			1.2	0.0	1.2	1.2	0.0	Private	2005
DIF: Cascade Insurance and Reinsurance	0.4		0.4		0.4	0.0	0.2	0.2	0.0	Private	2005
Armenia Multi Bank FW Armeconombank	1.7	1.7			1.7	0.8	1.7	0.8	0.8	Private	2005
<b>SUB TOTAL</b>	<b>16.7</b>	<b>12.4</b>	<b>2.9</b>	<b>1.4</b>	<b>16.7</b>	<b>11.9</b>	<b>13.9</b>	<b>4.0</b>	<b>9.8</b>		
<b>Infrastructure</b>											
<i>Energy</i>											
DLF: Bazenc CJSC	1.1	1.1			1.1	0.4	1.1	0.7	0.4	Private	2005
Hrasdan No. 5, Republic of Armenia	74.4	47.9			47.9	47.9	12.1	0.0	12.1	Public	1993
<i>Transport</i>											
Yerevan (Zvartnots) Air Cargo Terminal	21.9	17.8			17.8	17.8	2.6	0.0	2.6	Public	1994
<b>SUB TOTAL</b>	<b>97.4</b>	<b>66.8</b>			<b>66.8</b>	<b>66.1</b>	<b>15.8</b>	<b>0.7</b>	<b>15.1</b>		
<b>Enterprise support</b>											
<i>Agribusiness</i>											
Wholesale Market Project	2.6	0.6			0.6	0.6	0.0	0.0	0.0	Public	1995
Yerevan Brandy Company	41.5	16.6			16.6	16.6	3.7	0.0	3.7	Private	2000
<i>General Industry</i>											
Armenian Copper Programme	6.8	4.5			4.5	0.9	3.6	2.3	1.2	Private	2002
DIF: Shen Concern CJSC	1.3		1.3		1.3	1.3	1.3	0.0	1.3	Private	2004
DIF: Liqvor CJSC	2.8	0.6	0.4		1.0	0.0	1.0	1.0	0.0	Private	2005
<b>SUB TOTAL</b>	<b>55.0</b>	<b>22.3</b>	<b>1.7</b>		<b>24.0</b>	<b>19.4</b>	<b>9.6</b>	<b>3.3</b>	<b>6.2</b>		
<b>Country Total</b>	<b>169.1</b>	<b>101.5</b>	<b>4.6</b>	<b>1.4</b>	<b>107.5</b>	<b>97.4</b>	<b>39.3</b>	<b>8.0</b>	<b>31.1</b>		
<b>Total projects</b>					<b>24</b>		<b>19</b>		<b>13</b>		

## ANNEX 2: POLITICAL ASSESSMENT

### **Compliance with Article 1**

Armenia is committed to the principles of multiparty democracy, pluralism and market economics in accordance with the conditions outlined in Article 1 of the Agreement Establishing the Bank, although application of these principles in the previous Strategy period has been somewhat uneven. Since elections were last held in 2003, politics was dominated by the powerful executive branch and the pro-presidential majority in the parliament. Some progress has been made in democratising the electoral code, reforming legislation on the mass media and freedom of information, and strengthening public governance. Constitutional reforms that would enable reinforcement of checks and balances in the political system have been endorsed in a national referendum. However, the political will to implement these commitments remains uncertain.

### **Political Accountability**

Political leaders in Armenia are held accountable through the Constitutional provisions for a separation of powers and regular, contested elections. However, the Constitution has provided for extraordinary executive power and in practice checks and balances in the political system have been weak. In addition, electoral practices have fallen short of international standards.

For the past several years the President's administration and the Government have sought to reform the Constitution and shift powers from the executive to the legislative branch, in accordance with the commitments undertaken at the time of accession to the Council of Europe in 2001. A referendum on reform failed in 2003 due to low turnout, and the President's administration and leading parties in the National Assembly have been debating a new reform draft ever since. A revised Constitutional reform package was approved by the parliament in September 2005, against the strenuous objections of the leading political opposition parties, which boycotted the vote. The reforms include measures to enhance the powers of the parliament and strengthen the independence of the judiciary. The amendments have been endorsed by experts from the Council of Europe's Venice Commission, who concluded that passage would contribute significantly to the country's democratisation and bring it into line with European standards of protection of human rights and the rule of law.

A second referendum was held on 27 November. According to the Central Election Commission (CEC), turnout was around 65 per cent (well above the one-third threshold needed to validate the results) and support for the proposals was overwhelming, with more than 93 per cent voting in favour. The political opposition, independent Armenian NGOs and a small observation delegation from the Parliamentary Assembly of the Council of Europe sharply criticised the conduct of the voting. Observers found both the turnout figures and the level of public support for the reforms to be non-credible, especially considering the current state of political detachment of the electorate. Some made accusations of widespread ballot-box stuffing, tampering with voter lists at some polling stations and other abuses.

Positive changes to the Electoral Code, advocated by the Council of Europe for the past several years, were also signed into law in 2005. The amendments change the system for electing legislators, increasing the number of parliamentary mandates distributed by proportional representation and reducing by the same amount the number of seats distributed through majoritarian voting in single mandate districts. This builds on similar changes introduced in 2002 and could have the effect of strengthening incentives for political party development. The amendments to the Electoral Code also seek to insulate the Central Election Commission from political interference by the executive: the new Code reduces the number of CEC members appointed directly by the President from three to one. This satisfies the recommendations of the Venice Commission, which worked closely with the authorities on the amendments, but it remains to be seen whether the bodies that will now appoint those two CEC members – a pro-presidential parliamentary group and the Court of Appeals – will themselves act independently of the President’s wishes.

The Venice Commission experts who reviewed the Electoral Code amendments commended the authorities for taking positive steps to address the “lack of confidence in the objectivity, impartiality and transparency of electoral administration” in Armenia. Despite the good intentions evident in the reforms, however, the Commission warned, “good faith implementation of the Code remains crucial for the conduct of genuinely democratic elections”. The first test of the authorities’ political will to carry out democratic elections came with the local elections during September and October 2005. This was largely successful, according to observers from the Council of Europe’s Congress of Local and Regional Authorities. The head of the Congress delegation concluded, “the local elections were generally in keeping with the Council of Europe’s electoral standards. The electoral process was generally satisfactory”. The main criticism of the election was its lack of democratic vitality: the leading opposition parties reportedly showed little interest in the local races, and the media engaged in un-balanced or lacklustre coverage of the elections.

Civil society is growing in size and professionalism, and the range of areas addressed through civic initiatives has widened. Political activism by civil society groups has been increasing steadily over the past two years, helped in part by a Law on Freedom of Information adopted in September 2003. Although enforcement of the Law is uneven, it has improved public access to official information regarding the activities of government bodies and public service providers. Civil society groups are becoming more involved in democracy building and economic development programmes. Importantly, the Government’s engagement with civil society groups is reported to have increased. Independent non-governmental organisations (NGOs) are involved in such activities as monitoring the Government’s implementation of the recently adopted anti-corruption programme, its progress in reforming the health and education sectors, its efforts on penal reform, and its reform of customs administration. NGOs also work increasingly with parliamentary bodies and international agencies in a wide range of advocacy and monitoring activities.

However, some NGO representatives complain that the Government is interested only in window dressing not real engagement with civil society groups. Consultations and commissions are established, but the policies do not change materially. Certain sensitive topics are considered off limits, particularly since the recent spell of “coloured revolutions” in the CIS countries, which have induced extra caution among the authorities. The participation of civil society organisations in the demonstrations of spring 2004, which were forcefully

suppressed by the police, has made them seem a source of potential instability rather than partners in policy development.

### **The Rule of Law**

The Constitution provides for an independent judiciary and the presumption of innocence; however, these were not always observed in practice. The judiciary continues to suffer occasionally from political interference and a lack of professionalism, while opposition activists have been detained arbitrarily.

According to a 2004 study by the American Bar Association's Central European and Eurasian Law Initiative's (ABA/CEELI), the courts have limited powers of judicial review and the advice they provide is not binding on political bodies. For example, the Constitutional Court's recommendation to hold a referendum of confidence one year following the disputed 2003 Presidential election was disregarded by the authorities, which triggered public protests. The Prosecutor General similarly disregarded advice from the Court calling for a criminal investigation into allegations of ballot-box stuffing and related election day irregularities.

International human rights groups and foreign embassies have viewed arrests of opposition activists as politically motivated and independent observers have noted several violations of legal due process in those cases. According to Armenia's Human Rights Ombudsman, during demonstrations in spring 2004 approximately 35 people were detained for up to 15 days under a Soviet-era law that allows administrative detention. Opposition groups and international human rights monitors alleged that the judiciary fulfilled the role of a "pocket court" for the police.

ABA/CEELI's 2004 report on judicial reform indicates a serious problem with the professionalism of Armenian judges. Although salaries have been raised significantly and are now generally paid on time, they are still quite low, making it difficult to attract and keep honest, committed judges on the bench. Bribery is considered quite common and the practice of "telephone justice", in which government officials seek to influence or dictate a court's ruling, is believed to persist. In 2004 the Council of Court Chairmen adopted an anti-corruption plan for the judicial system but thus far none of the components have been implemented.

Corruption in Armenia remains a serious problem. According to the latest report by Transparency International, Armenia's Corruption Perceptions Index rating slipped from 3.1 in 2004 to 2.9 in 2005 (on a scale of 1-10 where 10 is least corrupt). Although it is now the highest ranked country in the CIS (together with Moldova), Armenia's low score puts it below the threshold identified by Transparency International indicating rampant corruption. Results from the EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS) for 2005 also indicate difficulties in bringing down levels of bribery and other forms of administrative corruption. Firms on average see corruption as a larger obstacle to doing business and pay more in bribes to public officials to get things done than they did in 2002. Firms that bid for government contracts report that kickbacks to public officials were higher as a percentage of contract value than in 2002.

The Government's anti-corruption programme, adopted in 2003, took some time to establish priorities and implementing arrangements. In June 2004 the Council for Combating

Corruption was created, headed by the Prime Minister, which has a coordinating committee that has responsibility for overseeing implementation of the Government's strategy. Several NGOs are represented on the committee. Over the past year there has been progress on legislation relating to several of the Government's anti-corruption priorities, although enforcement is still a source of concern among monitors. In 2004 Armenia joined the Council of Europe's Group of States against Corruption (GRECO) and since 2003 has been cooperating with the OECD in its Istanbul Anti-Corruption Action Plan for transition countries.

## **Civil and Human Rights**

Armenia's Constitution guarantees basic democratic rights and freedoms; however implementation of these guarantees has been inconsistent. According to the most recent US State Department Report on Human Rights Practices in Armenia, serious problems remain in the protection of human rights.

Concerns centre on the events of spring 2004, when thousands of demonstrators gathered in the streets in Yerevan to protest the Government's unwillingness to hold a referendum of confidence in the 2002 Presidential election results. According to reliable reports, police used excessive force to break up a rally on 12 and 13 April and arrested more than 100 people. The Parliamentary Assembly of the Council of Europe (PACE) issued a resolution at the time calling on the Government to end its crackdown on the opposition and release all prisoners held on political grounds. This did not have the intended effect. On 20 May, police detained approximately 25 opposition activists prior to a planned demonstration, raising further questions about the security forces use of arbitrary arrest for political purposes. Violent attacks on human rights activists and opposition figures have also been on the rise in recent years.

A recently adopted Law on Demonstrations has been criticised by the OSCE. The law restricts the ability of civic groups to organise spontaneous peaceful demonstrations – it limits locations where demonstrations can be held without a permit, including in front of all government offices. It also grants the police the right to forcibly break up illegal rallies and demonstrations. Some aspects of the law violate the letter and spirit of the European Convention on Human Rights, which Armenia ratified in 2002. Experts from the OSCE continue to work with the Government to reach agreement on ways to improve the law and bring it into compliance with European standards for freedom of assembly.

The Constitution specifically guarantees press freedom and the legal framework for mass media is generally consistent with those guarantees. Amendments to the Law on Mass Media, adopted in December 2003, rescinded the need for journalists to disclose their sources of information and funding, which had been a point of contention with domestic and international rights groups. Armenia has a rather large and diverse private media sector, though in broadcast media the state-run Armenian Public Television is considered by far the most influential. Private media organisations have also been criticised for their bias in favour of narrow business interests and/or the authorities. Also, in the past two years there have been several incidents of attacks on independent journalists and the use of intimidation to encourage self-censorship by private media groups. Libel is still considered a criminal offence in Armenia, potentially hindering investigative journalism. Although the criminal code was amended in 2004, repealing the provision that punished libel with up to three years

imprisonment, the courts have been known to impose large fines in libel cases that financially strapped private media outlets cannot afford to pay.

## **External Relations**

Armenia has strengthened ties with the West through a combination of bilateral and multilateral agreements while also maintaining its strategic alliance with Russia. As a member of the European Union's Neighbourhood Policy, the authorities are working with officials in Brussels on an EU-Armenia Action Plan which would facilitate further political and economic integration with Europe. At the same time, Armenia has very close economic relations with Russia, particularly in the energy sphere, and cooperates on mutual defence and security needs in the Caucasus region. Unlike other countries in the region, Armenia has shown no interest in joining NATO, though it is a signatory to the Partnership for Peace initiative.

Within the South Caucasus Armenia remains geopolitically isolated due to the unresolved dispute with Azerbaijan over Nagorno-Karabakh, the Armenian enclave inside Azeri territory. Prospects for a settlement have improved following several high level contacts in the past year, as international negotiations, conducted within the framework of the OSCE Minsk Group, resumed in 2004. The foreign ministers of Armenia and Azerbaijan met on several occasions, and the two presidents met on the sidelines of the CIS Summit meeting in August 2005 (there are plans for additional high-level meetings in 2006) but the domestic obstacles to a settlement in both countries remain high.

A resolution is not expected soon, the more so as parliamentary elections are scheduled in Azerbaijan for November. That means that relations between Armenia and Turkey, Azerbaijan's natural ally in the region, will remain severely strained and the border between the two countries will remain officially closed. Nevertheless there is increasing movement of people and goods between the two countries (by air and via Georgia). Relations with Georgia, Armenia's main gateway to the outside world, are friendly. Occasionally, however, relations have been strained by issues affecting ethnic Armenians in Georgia. Economic co-operation with Iran continues to progress. Around 20 per cent of Armenia's land trade now passes through Iran, and the two countries have co-operated on a number of energy projects, including natural gas and hydroelectric power.

### ANNEX 3: ASSESSMENT OF TRANSITION CHALLENGES

<b>ARMENIA</b>	<b>Structure</b>	<b>Institutions</b>	<b>Conduct</b>	<b>Comments</b>
<b>Agribusiness</b>	<i>Medium</i>	<i>Medium</i>	<i>Medium</i>	Comprehensive land reform implemented and property registration system developing, but not yet led to a significantly increased use of land as collateral. Delays in privatising agro-processors and service companies. Beside Agricultural Cooperative Bank and MFIs, little lending to agriculture.
<b>Banking</b>	<i>Medium</i>	<i>Medium</i>	<i>Large</i>	The central bank has continued to strengthen banking regulation and encouraged consolidation in the sector, though enforcement has remained erratic. But poor transparency of bank ownership and related lending and uncertainty over enforceability of claims over collaterals hold back further expansion of the sector.
<b>Energy Efficiency</b>	<i>Large</i>	<i>Medium</i>	<i>Large</i>	Autonomous energy regulator has been established and tariffs have been increased and rebalanced. A feed-in tariff has been introduced to stimulate renewable energy. The energy services market is yet to develop.
<b>General Industry</b>	<i>Medium</i>	<i>Large</i>	<i>Large</i>	Complex legal and regulatory framework, weak enforcement of law and corruption. Although arguably better than in other CIS countries, cumbersome administrative processes continue to be major issues hampering business development. Improvements to corporate governance and standards of business conduct.
<b>MEI</b>	<i>Medium</i>	<i>Large</i>	<i>Large</i>	Control of municipal services rests with the municipalities and a private concession operates the water services in Yerevan with some progress in corporate governance over the past few years. Private sector participation is common in public transport. However, water tariffs and collection rates are still low and many municipal utilities in secondary cities are in need of substantial reforms.
<b>MSMEs</b>	<i>Small</i>	<i>Large</i>	<i>Large</i>	Starting a business is relatively easy. No credit registry or private credit bureau exists. Bankruptcy legislation is in place. There is very little lending from commercial banks to the enterprise sector apart from the EBRD credit line started in 2002.
<b>Natural Resources</b>	<i>Small</i>	<i>Small</i>	<i>Small</i>	Armenia has a limited natural resources sector, focusing mainly on copper. The EBRD has worked with the Armenian Copper Programme to support restructuring. Although the project has made significant improvements in environmental performance and management, more remains to be done.
<b>Non Bank Financial Institutions</b>	<i>Large</i>	<i>Large</i>	<i>Large</i>	Basic legislation and regulation on securities markets are in place but financial independence of the regulator needs further strengthening. Insurance legislation and regulation do not meet IAIS standards. The size of capital markets and insurance sector remains very small. There are no restrictions on foreign entry. In the leasing sector, while the legal environment is adequate, there is only one leasing company.
<b>Power</b>	<i>Small</i>	<i>Medium</i>	<i>Medium</i>	The sector has been unbundled and extensive private sector participation is present. An independent regulator has been established, but there are still regulatory challenges, particularly regarding tariff increases to fully reflect costs. Significant progress has been made in raising tariff collections.
<b>Private Equity Funds</b>	<i>Large</i>	<i>Medium</i>	<i>Large</i>	Despite some recent improvements in corporate governance, reporting standards and creditors' right protection, the country has not yet developed a local class of private equity managers or investors willing to invest in private equity funds operating in the country.
<b>Property + Tourism</b>	<i>Large</i>	<i>Large</i>	<i>Large</i>	Full tradability of land except foreigners. Some state interference in the sector. Property market is at early stages of development, including introducing new products and financing methods. Standards of business conduct need substantial improvements.

<b>Telecoms</b>	<i>Large</i>	<i>Large</i>	<i>Large</i>	Sector lacks an independent regulator and ministry yet to tackle the implementation of necessary reforms. The dominant operator has been privatised. A long term exclusivity both on fixed line and mobile was initially granted, which hindered the development of competition. A second mobile license has only recently awarded. Corporate governance is poor, particularly in terms of respect of minority shareholders.
<b>Transport</b>	<i>Large</i>	<i>Large</i>	<i>Large</i>	In railways, operating and policy setting functions have been separated. Core railway businesses partly unbundled. However, in practice, the company is funded and controlled by the state. In roads, there have been restructuring efforts made during the early 1990s and road sector financing has also improved.

## ANNEX 4: ENVIRONMENTAL ISSUES

### *Environmental conditions*

The National Environmental Action Plan (NEAP) approved by the Armenian Government in 1998 addressed key environmental problems of the country including degradation of water, soil and forestry, threat to biodiversity and environmental health issues. Significant portions of the land area suffer from erosion, landslide and desertification. Extensive illegal logging has resulted in less than 10 per cent of the territory now being afforested. Difficult economic conditions in rural areas have induced abusive natural resource use in the country (Country Profile for Johannesburg Summit, 2002). Like other early transition countries, environmental issue and poverty are closely interlinked in Armenia as the on-going natural resource degradation is a contributing factor to poor productivity in the agricultural sector, and the poor are disproportionately exposed to the impacts of the resource degradation. Lake Sevan, which covers 5-10 per cent of Armenia's surface (depending on how it is measured) and is an important source of fish and electricity, in addition to being the home of Armenia's only national park, is receding as a result of its use for irrigation and hydroelectricity..

In the industrial and energy sectors, Armenia also faces serious environmental challenges. Although the economic setback in the 1990s is likely to have reduced the overall pollution loads in the industrial sector, the country's industries continue to discharge wastewater without treatment either into the municipal sewage or directly into the rivers or reservoirs. The EU expresses concern over the safety of Metsamor nuclear power plant due to flaws in the plant's Soviet-designed reactors and the region's seismic activity and is pressuring Armenia to shut the plant. The power plant, with two reactors, was once shut down in March 1989 by the Soviet Union because of safety fears following the devastating earthquake that struck Armenia in December 1988. However, faced with a deepening energy crisis due to the country's lack of fossil fuels and the economic blockade imposed by Azerbaijan and Turkey, in November 5, 1995, Armenia decided to resume operation at the 440 megawatts second unit which now supplies approximately 40 per cent of the country's electricity. Risks associated with the nuclear power are exacerbated by the fact that nuclear waste must be stored on site because of the Turkish–Azerbaijan blockage, and fuel must be flown in from Russia over Georgian airspace. While the EU had originally provided millions of euros in aid for safety upgrades, the grouping of European states froze a 100 million-euro energy grant in June 2004, citing the government's continuing reluctance to close the plant.

In order to address overall environmental issues, the Armenian Government has increased the share of environmental expenditure in the GDP from 0.05 per cent in 1998 to 0.09 per cent in 2003 (it is still much smaller compared with figures of new EU member countries, such as 0.8 per cent for Poland and 0.5 per cent for Hungary in 2002). The State of the Environmental and Natural Resources Report (2002) acknowledges that although various legal acts regulating the environmental sector had been adopted, many of them have become outdated, as a consequence of rapid changes in the legal and economic realities in the country, and contradictions and deficiencies have emerged. Therefore, the report suggests that there is an urgent need to improve the legislative foundation for the environmental sector, with specific focus on standards and regulations for efficient use of natural resources.

### *International institutions' activities*

Among other institutions, the World Bank has been implementing, *inter alia*, projects assisting the Government in improving management of soil, water, forest, biodiversity and resources, alleviating rural poverty in mountainous areas, as well as projects in the municipal waste and waste water sectors. UNDP/GEF has been implementing a programme to reduce Greenhouse Gas emissions through improving energy efficiency of municipal heat and hot water supply in Armenia. The World Wild Fund (WWF) has been working on Ecological Conservation Plan for the Caucasus eco-region which comprises of (i) a biological and socio-economic assessment of the eco-region; (ii) priority biomes, focal species, a biodiversity vision of the eco-region, and (iii) overall conservation plan for the eco-region.

## ANNEX 5: LEGAL TRANSITION

### ASSESSMENT OF ARMENIA'S COMMERCIAL LAWS

The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws “on the books” (also referred to as “extensiveness”) and the actual implementation of laws (also referred to as “effectiveness”). All available results of these assessments can be found at [www.ebrd.com/law](http://www.ebrd.com/law). This annex presents a summary of the results for Armenia, accompanied by critical comments of the Bank’s legal experts who have conducted the assessments.

#### Capital Markets

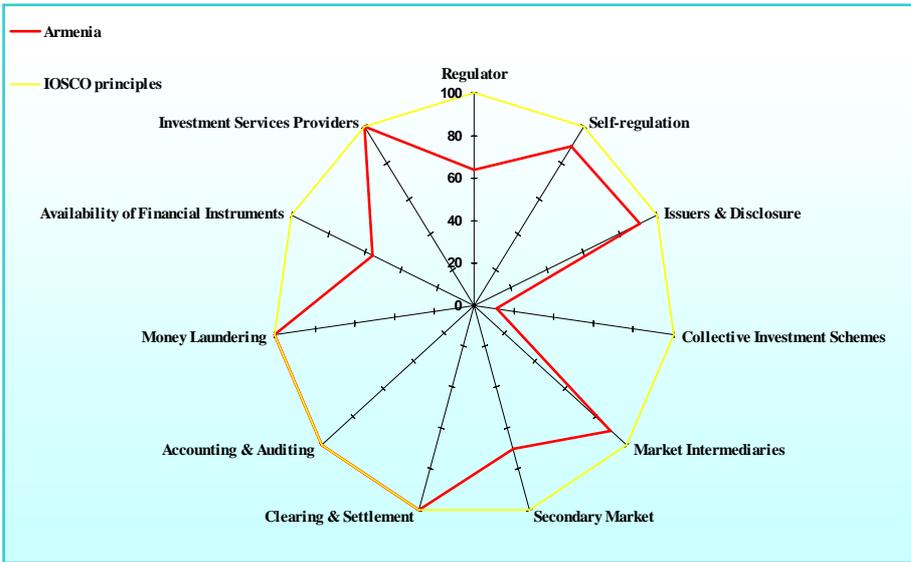
The primary legislation governing the securities market is the Securities Market Regulation Law, which entered into force on 1 August 2000 (the “SMRL”) as amended, most recently in October 2004. The SMRL regulates the issuance, registration and public trading of securities, the reporting, disclosure and tender offers procedures, rules governing the activities of professional participants in the securities market and finally regulations on self-regulatory organisations (including the central depository and the stock exchanges) and on the Securities Commission.

The securities market regulator is the Securities Commission of the Republic of Armenia (the “SCA”), which was established in August 2000 on the basis of the SMRL. The Securities Commission is in charge of the protection of investors and development of a fair and transparent market. It has regulatory and enforcement powers in specific issues defined by law. The Commission is composed of five members appointed by the President of the Republic for a term of five years. In April 2005, the Armenian Securities Commission was admitted as a member of the IOSCO (the International Organisation of Securities Commission).

The Armenia Stock Exchange (“Armex”) was formally registered under the SMRL by the SCA as a self-regulated organisation in February 2001.

In its 2004 Securities Market Legislation Assessment, the EBRD benchmarked the Armenian securities markets legislation against the “Objectives and Principles of Securities Regulation” published by IOSCO. The results demonstrated that the national legislation is in “medium compliance” with international standards. As shown in the chart below, the major flaws were evidenced in the “Regulator”, “Collective Investment Schemes”, “Secondary Market” and “Availability of Financial Instruments” sections. A recent update of the assessment reported no substantial changes in the legal framework and confirms the “medium compliance” rating.

**Quality of securities market legislation –Armenia (2004)**



*Note:* The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO’s *Objectives and Principles for Securities Regulations*. The fuller the ‘web’, the closer the relevant securities market legislation of the country approximates these principles.

*Source:* EBRD Securities Market Legislation Assessment 2004

When considering the legislation concerning the “Regulator” independence, tasks and responsibilities, the assessment revealed that the SCA is financed only by the State budget and therefore cannot be considered fully independent. The division of tasks and responsibilities between the Central Bank and the SCA is not clearly defined by law and there are no written arrangements in place for sharing of information between the two bodies. Finally, the law does not specifically provide the SCA with the authority to share information with foreign regulators. Turning the analysis to the “Collective Investment Schemes” section, Armenia does not yet have a law to legitimise the establishment of collective investment vehicles nor does it have such vehicles in operation. Despite the existence of the Government Decree on Investment Funds, there have been no activities in this field within the last 10 years. Currently, a new version of Investment Company Law is being designed. When considering the “Secondary Market” section, the assessment revealed that there are no financial integrity, capacity or performance criteria that must be met by persons with direct access to the exchange and the SCA has no procedure in place to assess the continuing compliance of the exchange with the initial authorisation requirements. Finally in the section “Availability of Financial Instruments”, there are no regulations concerning the private placement of financial instruments.

In conclusion, a great deal more work remains to be done to finalise the overall legal and policy framework, to develop and strengthen the supporting institutions needed for the growth of capital markets, and to create an environment to encourage market activities.

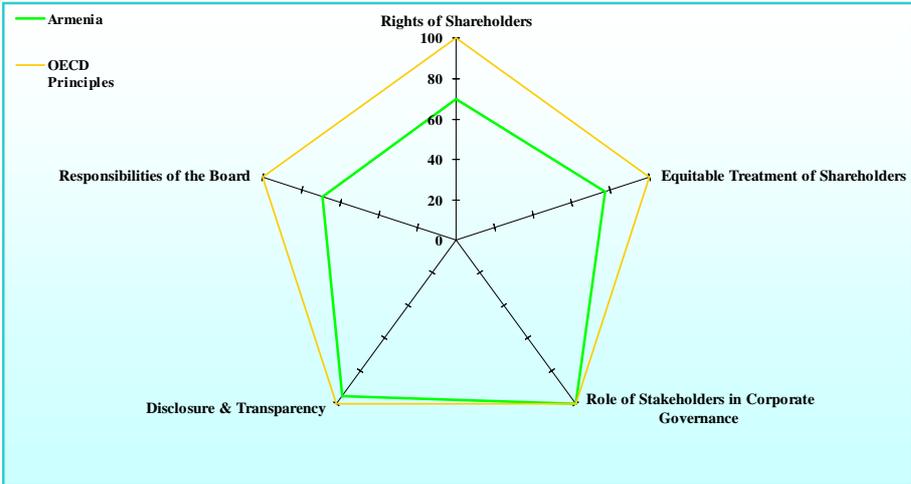
**Company Law and Corporate Governance**

The principal law dealing with corporate governance is the Law on Joint-Stock Companies (the “JSCL”), which was enacted in December 2001 and last amended in June 2004.

According to the JSCL, a joint-stock company (“JSC”) may be of closed or open type. A JSC is deemed open if a shareholder has the right to transfer its shares without the consent of other shareholders. The law gives the shareholders the right to bring an action to set aside a general

shareholders meeting resolution in cases that breach the rules relating to the holding of such a meeting. The board is legally required to act in the best interests of the company and its shareholders. Members of the board and of the supervisory board bear personal liability for breach of the law while they are in office. Shareholders have the rights to file a derivative suit against the board. Tasks and responsibilities of the board include functions overseeing major capital expenditures, monitoring and managing potential conflict of interests of management, board members and shareholders and misuse of corporate assets. The law is silent on the board’s responsibilities ensuring the integrity of the company’s accounting and financial reporting and that appropriate systems of control are in place.

**Quality of corporate governance legislation – Armenia (2004)**



*Note:* The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the ‘web’, the more closely the corporate governance laws of the country approximate these principles

*Source:* EBRD Corporate Governance Sector Assessment, 2004 assessment

In its 2004 Corporate Governance Sector Assessment, the EBRD benchmarked Armenian corporate governance legislation (i.e., “law on the books”, as opposed to how the relevant legislation is being implemented) against the “Principles of Corporate Governance” published by the OECD. The results demonstrated that the national legislation is in “high compliance” with international standards. This good rating is the result of international technical assistance provided by IFC. However, while “on the books” the legislation is generally sound, its effectiveness is reported to be a major problem.

In 2005, the EBRD conducted a survey testing the effectiveness of corporate governance (how the law works in practice). A case study dealing with related-party transactions was designed. The case study investigated the position of a minority shareholder seeking to access corporate information in order to understand if a related-party transaction was indeed entered into by the company and on how it was possible to obtain compensation if damage was suffered. Effectiveness of legislation was then measured according to four principal variables: institutional environment, enforceability, complexity and speed. The survey revealed serious deficiencies in all variables. Actions available to minority shareholders are complex and partly unclear. Case law offering guidance to legal provisions is very hard to find. The time needed to conclude the proceedings is usually limited to one year, but it is very easy for the defendant to delay the procedure and enforceability of judgements is a problematic issue. The reliability of corporate reporting is low and the independence of statutory auditors questionable. The competence of courts and prosecutors in corporate cases is limited and corruption is reported as a major problem. Arbitration proceedings are generally available, but the lack of enforcement precedents in corporate cases renders the whole procedure unpredictable.

As a result, the Government of Armenia should now give priority to the enhancement of enforcement powers by courts and relevant regulatory agencies.

## **Concessions**

Armenia does not have a specialist single-act concession Law applicable to infrastructure, municipal utilities and public services. General laws do not refer to or regulate concessions apart from a general reference in the Law on Foreign Investments providing that concessions are one of the forms of foreign investment. On a general policy framework level, there has been an indirect reference to improving the legal environment and promoting Public Private Partnership in the Poverty Reduction Strategy Paper.

Two sector-specific laws regulate concessions, in the mining and water sectors. The Law on Concession of Subsurface for Purposes of Mineral Prospecting and Mining (the “Mining Law”), dated April 2003, is a fairly detailed piece of legislation which regulates mineral rights, provision of licenses and contracts in the industry and which is expected to facilitate investment into the sector.

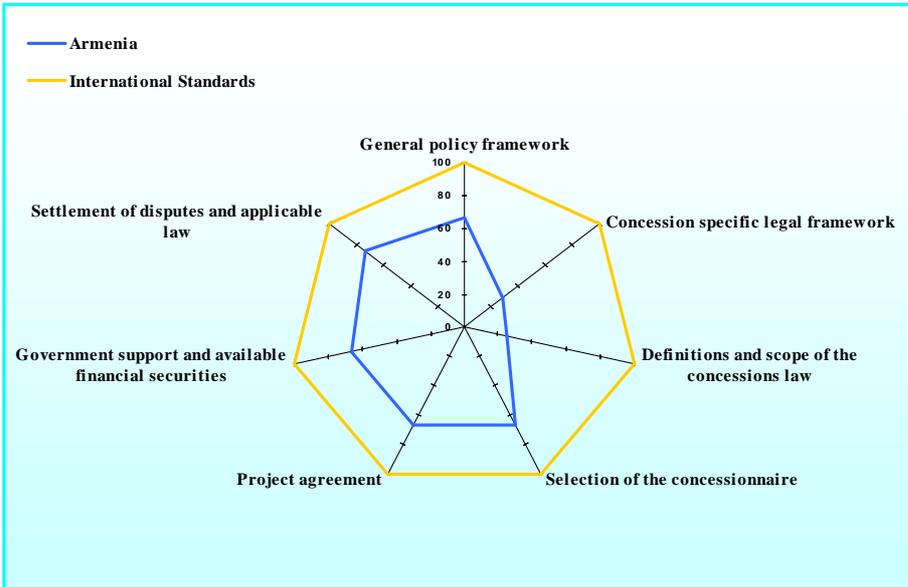
Pursuant to the Mining Law, a concession agency is to be created within the Ministry of Trade and Economic Development. The agency is expected to be dealing with the granting of mining rights and supervision of their use, as well as generally representing the Government. By way of implementing the requirements of the Mining Law, the Government has also approved model template agreements.

In addition to mining sector, legislation exists that govern water industry contracts, including the use of assets and their pledging as collateral for leasing and concession contracts. However, such laws do not contain clear definitions and need to be improved regarding the selection procedures (even though the general rule is that concessions are granted based on a tender/auction). In the water sector, the use of a model concession agreement is optional.

Government support and financial security interests are defined in the general legislation (Civil Code, Law on Budgetary System). No clear reference is made to international arbitration, although international arbitration has been allowed in privatisation contracts.

Thus, despite certain positive elements, the general legal framework for PPP needs to be further upgraded.

**Quality of concession legislation –Armenia (2005)**



*Note:* the extremity of each axis represents an ideal score in line with international standards such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure projects. The fuller the ‘web’, the more closely concessions laws of the country approximate these standards.

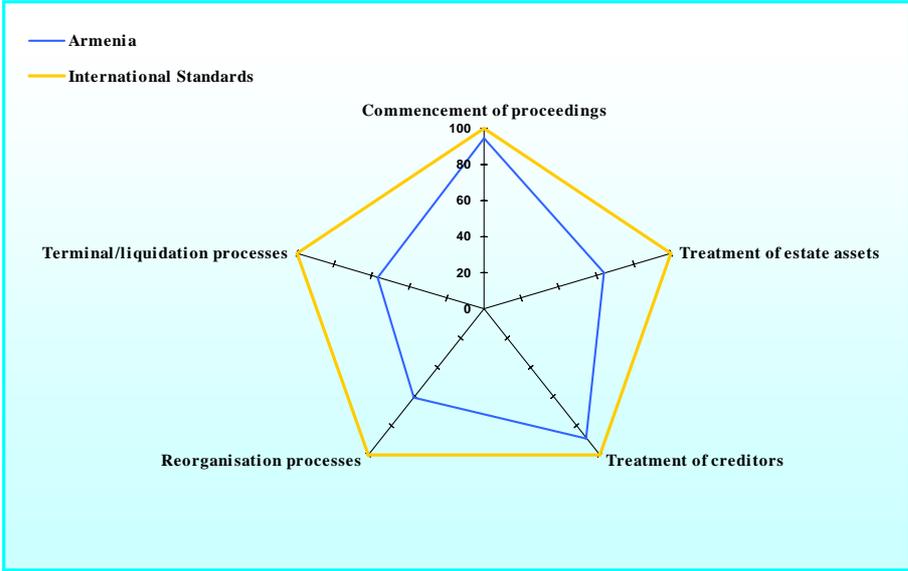
*Source:* EBRD Concessions Sector Assessment 2005

The EBRD’s recent Assessment of Concessions Laws undertaken to evaluate applicable regimes throughout the EBRD’s 27 countries of operations (the laws on the books only rather than how they work in practice), revealed that Armenian laws “partly conform” with internationally accepted principles of concession law. Ideally, therefore, comprehensive concessions legislation should be developed. As can be seen from the above graph, the lack of a special legislation coupled with imprecise definitions and the limited scope of rules governing concessions makes these issues in most need of reform.

**Insolvency**

Bankruptcy and insolvency are governed by the Law of Insolvency 2004 of Armenia (as amended) (the “Insolvency Law”). This law scored “medium compliance” when compared with international standards in the EBRD’s 2003-04 Sector Assessment Survey. The graph below displays the data collected in this project and shows level of compliance of the Insolvency Law with international standards in five core areas:

**Compliance of Armenian Insolvency Law with International Standards  
Quality of insolvency legislation –Armenia (2004)**



*Note:* The extremity of each axis represents an ideal score, i.e., corresponding to the international standards such as the World Bank’s Principles and guidelines for Effective Insolvency and Creditor Rights Systems, the UNCITRAL Working Group on “Legislative Guidelines for Insolvency Law”, and others. The fuller the ‘web’, the more closely insolvency laws of the country approximate these standards.

*Source:* EBRD Insolvency Sector Assessment Project, 2003/4

As the above graph also indicates, there is much room for improvement in the Insolvency Law. Specifically, the provisions requiring the delivery of assets of the debtor by third parties to the insolvency administrator are unclear and somewhat vague. There are virtually no sanctions against recalcitrant debtors or officers of debtor corporations for breaching the law and, consistent with many laws in the region, there are no provisions to deal with cross-border insolvency.

Although the insolvency law does contain some positive elements there is some doubt as to whether any positive attributes in this law can be properly implemented. The EBRD 2004 Legal Indicator Survey on Insolvency which examined the ‘effectiveness’ (or how the law works in practice) of insolvency regimes in both creditor-initiated insolvencies and debtor-initiated insolvencies revealed that the practical application of the insolvency law by debtors is likely to run into serious barriers to access and undue formality. Armenia is somewhat unique in the region in that it has an insolvency regime that is more easily accessed by creditors than by debtors. To some extent, this is indicative of a regime that overwhelmingly favours creditor enforcement rather than reorganisation. A rather more balanced approach would be preferable.

The survey results militate against the insolvency regime functioning properly to restructure businesses that are fundamentally viable. Significant reform in this area, both in the legislation and the institutions that implement the legislation, is needed to help create a legal regime that tries to limit the disruption that insolvencies cause by promoting the rescue of fundamentally healthy companies.

**Secured Transactions**

The Civil Code, which entered into force in 1999, governs secured transactions over movable and immovable property. Articles 226-272 provide for a security right over movable property

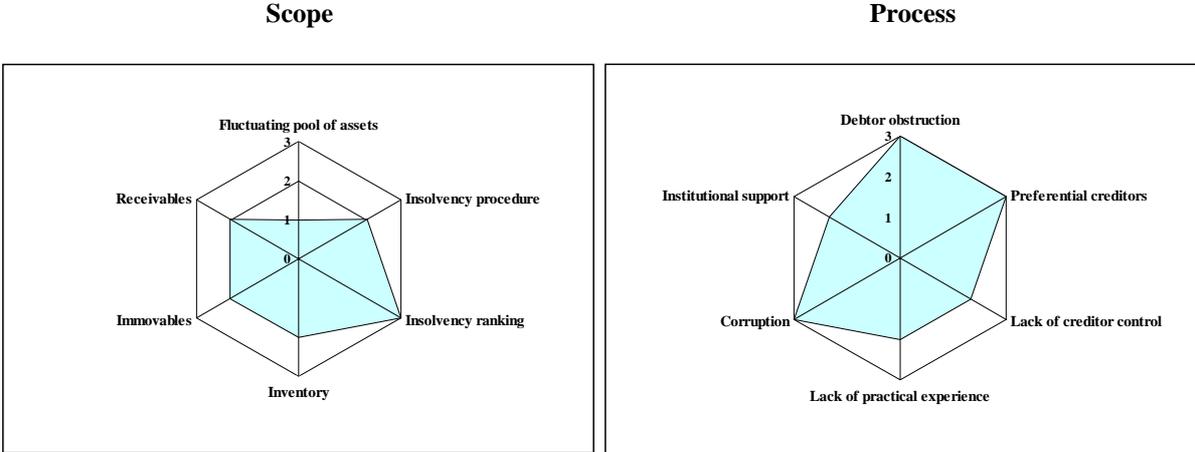
without the requirement to transfer the collateral to the creditor. These security rights can be registered if the parties wish so (and in practice, this is recommended).

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

A major problem that creditors face when taking security is the lack of reliable publicity. Since only charges on specific types of assets must be registered (especially over means of transport and shares), parties are free to choose whether or not to register the charges, lenders cannot ascertain whether or not the borrower has previously charged his property. This is of serious concern since priority would **not** depend on registration but on the date of the charge agreement. A limited registration process is available for security over auto vehicles (at the State Auto Inspection but it is not mandatory and its effectiveness is uncertain) and over shares (in the Shareholders Registry of the Company).

Enforcement is also highly hazardous: in 2003 the EBRD prepared a survey in all of its countries of operations, assessing the efficiency of enforcement of charges. Results for Armenia were among the worst in the region – a creditor is likely to face a very uncertain and lengthy process, fraught with difficulties. Although parties could in theory agree on the mode of enforcement such as a direct sale of the collateral, evidence shows that this is very unlikely to be implemented. Discussions with the Ministry of Justice revealed that, unfortunately, there are no current plans to address these deficiencies.

**Obstacles to charge enforcement process – Armenia (2003)**



*Note:* The fuller the web, the more serious the problems are in each of the respective categories. “Process” factors measure the impact of specific incidences on the enforcement proceedings. “Scope” factors relate to the ability of the system to deal with specific situations or items.

*Source: EBRD Legal Indicator Survey 2003*

A more positive note must be sounded with regard to mortgages. In July 2005, a feasibility study prepared on the behalf of the German development bank KfW for the “Development of a Sustainable Market for Housing Finance in Armenia” concluded that the legal framework for the primary mortgage market was reasonably strong, particularly as compared to other transition countries in the region, to support a robust primary market. A set of recommendations aimed at strengthening enforcement were put forward.

## **Telecommunications**

The telecommunications sector is currently regulated by the Ministry of Post and Telecommunications and governed by the Telecommunications Law of 1998. The 1998 law gives responsibility for overall regulation of telecom services to the Ministry of Post and Telecommunications. It is understood that the Armenian parliament recently adopted a new Electronic Communications Law during their session in August 2005. This new law (not scheduled to have effect before January 2006) will replace the 1998 law, providing procedures for tariff regulation, interconnection and the administration of scarce resources. While in common with the 1998 law, the new law also envisages a sector specific regulator for the sector, the Ministry remains both policymaker and regulatory for the present.

ArmenTel, the country’s national telecom provider, is currently majority owned by OTE of Greece. As part of their purchase of their ArmenTel shareholding in 1998, OTE was granted a 15-year monopoly in the provision of almost all telecom services in Armenia, including public switched telephony services and mobile telephony, until 2013. Many considered this exclusivity excessive and it was declared unconstitutional by the Armenian Constitutional Court in 1999, with the effect of the ruling being reserved until 2004. While, ArmenTel’s fixed line related exclusivity appears to remain intact the Government nonetheless, amid international pressure (including from the EBRD), reduced ArmenTel’s monopoly over mobile telephony to five years, expiring in 2003.

Following the expiry of the ArmenTel mobile exclusivity, competition arrived in the mobile sector in the form of VivaCell, a second licensed GSM operator. VivaCell launched in July 2005, and although vigorous price competition should be expected between mobile competitors, it will be sometime before the impact of the new competitor on the market will be fully felt.

As part of their purchase of ArmenTel shareholding, OTE made commitments for ArmenTel to invest significant amounts in network upgrade and expansion. Differing views as to whether this commitment has been honoured by OTE, together with the reduction in the period of mobile exclusivity, has resulted in a long-running dispute between the Government and ArmenTel/OTE significantly impacting upon sector development. With a fixed penetration rate at 16.9 per cent and a mobile penetration rate at 5.7 per cent (at end 2004) the dispute could be seen as continuing to retard sector development and growth prospects.

Going forward, while competition in the mobile sector will likely add a welcome boost to sector development, practical resolution of remaining issues between the Government and ArmenTel/OTE can be seen as an essential pre-cursor to meaningful sector growth and

development. Early full liberalisation of the marketplace is a critical for such growth and development. It is unfortunate that the new Electronic Communications Law does not appear to provide for such liberalisation. Accordingly, the government should treat the liberalisation goal as a sector priority and make and publish concrete plans to move towards full sector liberalisation as soon as possible. A similarly pressing issue is the absence of separation of the sector regulatory and policymaking function. The absence of such a body has likely impacted upon sector growth prospects and investor confidence. Such a body would provide the appropriate institution machinery to practically implement sector reform. While both the 1998 law and its 2005 replacement provide for a sector specific regulator, the Government has yet to take any meaningful steps towards making an independent sector regulator a reality.

## ANNEX 6: SELECTED ECONOMIC INDICATORS

	1999	2000	2001	2002	2003	2004 <i>Estimate</i>	2005 <i>Projection</i>
<b>Output and expenditure</b>							
<i>(Percentage change in real terms)</i>							
GDP	3.3	5.9	9.6	13.2	13.9	10.1	11.0
Private consumption	1.4	8.3	7.5	9.0	6.9	10.2	na
Public consumption	1.3	2.8	4.3	2.2	14.1	16.1	na
Gross fixed capital formation	0.6	16.2	5.3	33.1	33.7	12.4	na
Exports of goods and services	6.5	16.6	20.8	26.3	23.2	3.7	na
Imports of goods and services	-8.1	5.1	1.2	9.0	31.0	3.0	na
Industrial gross output	5.2	6.5	3.8	14.4	15.3	2.1	na
Agricultural gross output	1.3	-2.4	11.6	4.5	4.0	14.5	na
<b>Employment</b>							
<i>(Percentage change)</i>							
Labour force (end-year)	-0.9	-1.0	-2.5	-12.2	-0.6	-0.5	na
Employment (end-year)	-2.9	-1.6	-1.0	-12.5	0.5	-0.1	na
<i>(In per cent of labour force)</i>							
Unemployment (annual average) <sup>1</sup>	11.2	11.7	10.4	10.8	10.1	9.4	na
<b>Prices and wages</b>							
<i>(Percentage change)</i>							
Consumer prices (annual average)	0.7	-0.8	3.2	1.2	4.7	6.9	0.7
Consumer prices (end-year)	2.1	0.4	3.0	2.0	8.6	1.9	0.2
Producer prices (annual average)	2.3	0.8	-0.4	2.5	5.9	21.7	na
Producer prices (end-year)	3.8	0.4	-3.6	0.9	21.1	25.3	na
Gross average monthly earnings in economy (annual average)	21.8	15.0	10.7	12.2	21.7	22.8	na
<b>Government sector<sup>2</sup></b>							
<i>(In per cent of GDP)</i>							
General government balance	-7.2	-6.4	-3.8	-0.4	-1.1	-1.7	-2.4
General government expenditure	30.1	25.9	20.9	19.3	18.9	17.3	na
General government debt	44.4	44.0	41.5	45.4	40.5	30.6	na
<b>Monetary sector</b>							
<i>(Percentage change)</i>							
Broad money (M2, end-year)	13.6	39.7	4.3	34.0	10.4	22.3	na
Domestic credit (end-year)	3.7	12.3	-9.8	-8.1	-9.6	18.6	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	11.0	14.7	13.4	15.6	14.4	15.1	na
<b>Interest and exchange rates</b>							
<i>(In per cent per annum, end-year)</i>							
Refinancing rate	43.0	25.0	15.0	13.5	7.0	3.8	na
Money market rate <sup>3</sup>	23.7	18.6	19.4	12.3	7.5	3.1	na
Deposit rate <sup>4</sup>	27.4	18.1	14.9	9.5	6.9	4.4	na
Lending rate <sup>4</sup>	34.5	28.6	27.7	23.4	20.8	18.2	na
<i>(Drams per US dollar)</i>							
Exchange rate (end-year)	523.8	552.2	561.8	584.9	566.0	486.3	na
Exchange rate (annual average)	535.1	539.5	555.1	573.4	578.8	533.5	na
<b>External sector</b>							
<i>(In millions of US dollars)</i>							
Current account	-307	-277	-211	-149	-191	-162	-178
Trade balance	-474	-463	-431	-369	-434	-458	-554
Merchandise exports	247	310	342	514	696	738	904
Merchandise imports	721	773	773	883	1,130	1,196	1,458
Foreign direct investment, net	122	104	70	111	121	217	255
Gross reserves, excluding gold (end-year)	305	314	329	430	502	547	na
External debt stock	870	860	906	1,026	1,098	1,183	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	4.0	3.9	4.0	4.7	4.3	4.3	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	14.3	10.7	9.7	10.1	11.4	7.2	na
<b>Memorandum items</b>							
<i>(Denominations as indicated)</i>							
Population (end-year, million)	3.1	3.3	3.2	3.2	3.2	3.2	na
GDP (in billions of drams)	987	1,031	1,176	1,362	1,623	1,893	2,168
GDP per capita (in US dollar)	590	582	659	740	873	1,104	na
Share of industry in GDP (in per cent)	21.2	21.9	20.5	18.9	19.9	19.7	na
Share of agriculture in GDP (in per cent)	30.8	27.0	24.9	23.4	21.3	22.5	na
Current account/GDP (in per cent)	-16.6	-14.5	-10.0	-6.3	-6.8	-4.6	-3.7
External debt - reserves (in US\$ million)	565	546	577	596	596	636	na
External debt/GDP (in per cent)	47.1	45.0	42.8	43.2	39.1	33.3	na
External debt/exports of goods and services (in per cent)	227.1	192.4	171.3	147.0	121.6	120.1	na

<sup>1</sup> Registered unemployed. Unofficial estimates indicate substantially higher unemployment.

<sup>2</sup> Central government account only.

<sup>3</sup> Average of one to three-month Treasury bills.

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

## ANNEX 7: TECHNICAL CO-OPERATION PROJECTS

Commitment Number	TC OPID	Commitment Name	Fund Short Code	Euro Committed	Euro Disbursed	Fund Approved Date	Commit. Stage Name	Operation Leader	Sector	Team Name
<b>ARMENIA</b>										
AUS-1997-05-02	3675	Repair of the Pushkin tunnel	AUS	46,230	46,230	15/05/97	Closed	O'Grady L.	Construction	BG/Op. Teams/Transport
CA3F-2002-09-08	29733	Armenian Copper Programme - Environmental Audit	CA3F	24,425	24,425	19/09/02	Closed	Muent H.	Manufacturing	BG/Op. Teams/SEEC Headquarters
EC-1993-08-32	1560	Hrasdan Unit V Power Plant - financial systems and planning	ECT	198,723	198,723	20/08/93	Closed	Herbelot O.	Energy	BG/Op. Teams/Power and Energy
EC-1993-08-33	1560	Hrasdan Unit V Power Plant - power sector facilities planning	ECT	444,319	444,319	20/08/93	Closed	Herbelot O.	Energy	BG/Op. Teams/Power and Energy
EC-1993-08-34	1560	Hrasdan Unit V Power Plant - fuel supply contracting	ECT	45,185	45,185	20/08/93	Closed	Herbelot O.	Energy	BG/Op. Teams/Power and Energy
ECAR-2002-08-01F	29368	TAM Programme in Armenia	ECAR	411,035	411,035	30/08/02	Closed	McPhee J.	Manufacturing	PE/ESE/TurnAround Management Group
ECAR-2002-10-03F	29367	BAS Programme in Armenia	ECAR	925,459	925,459	07/10/02	Closed	McPhee J.	Manufacturing	PE/ESE/TurnAround Management Group
ECT99-99-09-10	6123	Telecommunications regulatory development programme	ECT	131,744	131,744	02/09/99	Closed	Moffatt P.	Telecommunications	GC/General Counsel/Legal Transition
EIPF02-2005-05-01	34755	Armeconombank (AEB) - Institution building	EIPF	495,650	34,999	06/05/05	Disbursing	Babayan A.	Finance, Business	RO/Yerevan (Armenia)
ETCF-2005-08-25	35484	Armenia Microlending Programme (AMP)	ETCF	300,626	0	28/08/05	Committed	Taylor M.	Finance, Business	BG/Op. Teams/Group for Small Business
FIN-1996-06-04	3450	Preparation of highway maintenance and rehabilitation programme	FIN	49,955	49,955	06/06/96	Closed	O'Grady L.	Construction	BG/Op. Teams/Transport
FRB-1994-07-04	1593	Private Investment Finance Corporation	FRB	149,348	149,348	20/07/94	Closed	Kjellstrom S.	Finance, Business	BG/Op. Teams/Financial InstitutionsA
FRB-1995-09-07	2736	Private investment finance company of Armenia - identification of sponsor	FRB	10,983	10,983	22/08/95	Closed	Kjellstrom S.	Community/Social Services	BG/Op. Teams/Russia and Central Asia Front Office

GER-1996-11-07	3967	Hrasdan 5 Technical Assessment	GER	102,033	102,033	19/11/96	Closed	Copley B.	Energy	BG/Op. Teams/Bulgaria/Alba./FYR of Maced./Slov./Armen./Georgia
GER-1997-04-06	4220	Hrasdan V power project tendering assistance	GER	177,761	177,761	01/04/97	Closed	Copley B.	Energy	BG/Op. Teams/Power and Energy
HOL-1993-11-19	1393	Yerevan (Zvartnots) air cargo terminal appraisal	HOL	18,995	18,995	01/11/93	Closed	Damaskos A.	Transport, Storage	BG/Op. Teams/Transport
HOL-1994-07-13	1727	Electricity auction sales	HOL	13,712	13,712	15/07/94	Closed	Herbelot O.	Energy	BG/Op. Teams/Power and Energy
HOL-1996-03-05	3029	Wholesale market project management unit - short-term assistance	HOL	25,811	25,811	18/03/96	Closed	Mettetal G.	Manufacturing	BG/Op. Teams/Agribusiness
HOL-2005-06-05	4526	FAO Framework Agreement - Tamara Fruit	HOL	27,599	0	13/06/05	Committed	Lapinskas D.	Manufacturing	BG/Op. Teams/Agribusiness
IRL-2004-03-01	32288	Armenia: Trade Finance Advisory Services	IRL	70,500	45,295	31/03/04	Disbursing	Poldaas U.	Finance, Business	BG/Op. Teams/Financial InstitutionsA
JAP-1994-09-31	1456	Food distribution and marketing (Phase II and III)	JAP	181,435	181,435	01/09/94	Closed	Mettetal G.	Manufacturing	BG/Op. Teams/Agribusiness
JAP-1996-08-21	3029	Wholesale market - project management unit	JAP	331,973	331,973	01/08/96	Closed	Mettetal G.	Manufacturing	BG/Op. Teams/Agribusiness
JAP-1998-08-26	5051	SME Line of Credit (Central Bank of Armenia)	JAP	735,190	735,190	20/08/98	Closed	Murphy J.	Finance, Business	BG/Op. Teams/Financial InstitutionsA
JAP-2001-05-08	19062	Armenia Institution Building Programme	JAP	498,260	498,260	01/05/01	Closed	Taylor M.	Finance, Business	BG/Op. Teams/Financial InstitutionsA
NLT-2003-09-03	5397	DIF - Maralik Legal Due Diligence	NLT	7,560	7,560	30/09/03	Closed	Muent H.	Finance, Business	BG/Op. Teams/Private Equity
SWE-1993-11-12	957	Yerevan (Zvartnots) air cargo terminal appraisal	SWE	19,958	19,958	01/11/93	Closed	Damaskos A.	Transport, Storage	BG/Op. Teams/Transport
SWEF-2002-07-04	4526	Assessment of Armenian Wood Sector	SWE2	16,224	15,086	31/07/02	Disbursing	Gourdin C.	Manufacturing	BG/Op. Teams/Agribusiness
SWI-1997-03-02	4219	Hrasdan V conservation measures implementation assistance	SWI	83,412	83,412	05/03/97	Closed	Copley B.	Energy	BG/Op. Teams/Bulgaria/Alba./FYR of Maced./Slov./Armen./Georgia
SWI-1998-07-02	5424	Hrasdan unit 5 Privatisation Project	SWI	115,895	115,895	07/07/98	Closed	Peter E.	Energy	BG/Op. Teams/Power and Energy

SWI-2003-11-13	5397	Shen Concern Technical Due Diligence Part B	SWI	15,466	15,466	12/11/03	Closed	Barkhudaryan A.	Finance, Business	BG/Op. Teams/Private Equity
SWI-2004-08-11	5397	Shen Concern Legal Due Diligence	SWI	13,000	13,000	12/08/04	Closed	Muurisepp U.	Finance, Business	RO/Yerevan (Armenia)
SWI-2004-08-12	5397	Shen Concern Follow-up Technical Due Diligence	SWI	3,750	3,750	12/08/04	Closed	Muurisepp U.	Finance, Business	RO/Yerevan (Armenia)
SWI-2004-08-13	5397	Shen Concern Environmental Due Diligence	SWI	6,000	6,000	26/08/04	Closed	Muurisepp U.	Finance, Business	RO/Yerevan (Armenia)
TAI-1994-05-02	1456	Food distribution and marketing - Phase I	TAI	11,352	11,352	01/05/94	Closed	Elling M.	Manufacturing	BG/Op. Teams/Agribusiness
TCS-2002-07-02	4526	FAO Framework Agreement	TCS	5,599	5,599	30/07/02	Closed	Gourdin C.	Manufacturing	BG/Op. Teams/Agribusiness
TCS-2003-11-07	5397	Shen Concern Technical Due Diligence Part A	TCS	13,745	13,745	10/11/03	Closed	Barkhudaryan A.	Finance, Business	BG/Op. Teams/Private Equity
UKB-1997-01-05	4169	Wholesale market project	UKB	28,873	28,873	01/01/97	Closed	Mettetal G.	Manufacturing	BG/Op. Teams/Agribusiness
UKB-1997-02-08	4142	Armenia, SME line of Credit	UKB	51,687	51,687	12/02/97	Closed	Okolie-Bourbac T.	Finance, Business	BG/Op. Teams/Financial InstitutionsA
UKD-1999-10-21F	8411	Armenia Power Distribution Privatisation Legal Due Diligence	UKD	146,737	146,737	13/09/99	Closed	Parshad N.	Energy	BG/Op. Teams/Power and Energy
UKD-2003-03-02	5397	Maralik Financial Due Diligence	UKD	3,900	3,900	17/03/03	Closed	Muent H.	Finance, Business	BG/Op. Teams/SEEC Headquarters
UKD-2005-08-06	35620	Research study on BDS providers capacity building in Gegharkunik and Tavush Marzs of Armenia	UKD	30,000	11,882	31/08/05	Disbursing	McPhee J.	Manufacturing	BG/Op. Teams/TAM/BAS Programme
<b>Country Total Euro Amount:</b>				<b>5,990,108</b>	<b>5,156,771</b>					
<b>Report Total Euro Amount:</b>				<b>5,990,108</b>	<b>5,156,771</b>					
<b>No of Commitments:</b>						<b>41</b>				

ANNEX 8: MAP OF ARMENIA

