authorities have requested the cancellation of the SBA and a new three-year Extended Fund Facility and Extended Credit Facility arrangement.
"The new program reflects a strong commitment to a sustainable fiscal position, in light of rising public debt and the weak external position. The authorities aim to reduce the deficit by around 5 percentage points of GDP by the end of the program, while ensuring that social spending is protected. The authorities have also drawn up a broad tax administration reform program to support the fiscal adjustment and raise Armenia's tax-to-GDP ratio in the medium term.

"Exchange rate flexibility will remain a cornerstone of the program, complementing the authorities' objective to target inflation. The monetary stance will remain neutral, as inflation, while currently above the target, is expected to recede.

"The financial sector is sound and well-capitalized. The authorities are strengthening their crisis preparedness frameworks.

"Wide-ranging structural reforms remain essential to achieving sustained growth and reducing poverty. Key elements in this regard include fighting corruption, stepping up public investment, simplifying the tax regime, regulations, reporting requirements, and increasing competition. The authorities also intend to improve the efficiency and targeting of social spending to reverse the increase in poverty levels."

ANNEX

Recent Economic Developments

Economic activity appears to be recovering, underpinned by a strong policy response. After a deep contraction in 2009, the economy now appears to be returning to broad-based growth. Public finances are steadily improving, credit to the private sector is rising, and banks' profitability and asset quality are recovering. Anti-crisis policies supported under the SBA—notably the return to a floating exchange rate regime, an accommodative monetary stance, and countercyclical fiscal policies to help cushion the output loss—were instrumental in maintaining economic and financial stability and mitigating the impact of the crisis on the poor.

Program Summary

The authorities' program reflects a strong commitment to a sustainable fiscal position. The authorities intend to scale back the deficit by 3 percent of GDP in 2010. Thereafter, the overall deficit would be reduced by about 1 percent of GDP annually over 2011–13. This approach relies in part on steady improvements in revenue collection, primarily through tax administration gains. It will also entail limiting the growth of nominal expenditure, reflecting in part lower volumes of donor-financed spending, including in 2010. Nonetheless, the fiscal targets will allow Armenia to boost spending on needed expenditure on investment in physical and human capital.

The medium-term plans rely on a strong tax administration reform program. The authorities underscored the importance of far-reaching reforms with meaningful effects on tax collection. The key principles of the reform effort are to improve the integrity of the tax system, achieve important efficiency gains, and ultimately cast the tax net as widely as possible. Modernizing the tax administration will be a core element of this strategy. In addition, strengthening taxpayers rights and curtailing the discretionary authority of the tax agency (the State Revenue Committee—SRC) will lower the cost for businesses to join the formal sector and reduce corruption among tax officials, thereby increasing taxpayers' incentives to comply with tax obligations and thus boosting collections.

The Central Bank of Armenia (CBA) will continue efforts to revitalize its monetary framework. With dollarization lingering at high levels, the interest rate channel has weakened. However, the CBA remains committed to inflation targeting and its chosen operational instrument, the policy rate. Exchange rate flexibility will remain critical to the monetary framework, and to help assure external sustainability. To reinforce the transmission mechanism, the CBA has launched several dedollarization measures, including through changes in the currency structure of reserve requirements, financial market development, and prudential regulations. Consistent with its inflation targeting framework, monetary policy should be geared toward a neutral stance in the short term.

A sound financial system is a cornerstone of the program. With increased dollarization and greater exchange rate flexibility, prudential regulations on foreign currency exposures are being strengthened. Comprehensive crisis preparedness and contingency planning continue to be improved with technical assistance from the Fund. In addition, the low level of financial intermediation requires further efforts to enhance financial deepening, encourage banking sector competition and improve functioning of financial markets. As credit growth picks up, continued attention should be paid to unhedged borrowers with loans in foreign exchange and cash flows in local currency.