

ensuring medium-term debt sustainability. The program allows for additional spending should more donor financing become available to smooth the withdrawal of fiscal stimulus.

“An accommodative monetary policy stance remains appropriate given low inflation. The move to a more flexible exchange rate has served Armenia well, helping the economy avoid significant overvaluation and increasing the effectiveness of monetary policy. However, given the remaining weaknesses in the monetary transmission mechanism, targeted measures now being implemented to stimulate credit are crucial.

“The short-term outlook remains challenging. As external conditions improve, growth is expected to resume gradually in 2010, although risks remain, including a slower recovery of the global economy. Continued reforms, particularly in the areas of tax policy and tax reform administration, the financial sector, and the business environment will be necessary to boost the medium-term growth potential of the economy,” Mr. Kato said

**Statement by Age Bakker, Executive Director,
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Since the conclusion of the first review, GDP growth projections for Armenia for 2009 have deteriorated substantially. However, the deterioration in economic activity mainly reflects the sharp contraction in the construction sector, while the contraction of other sectors in the economy has remained more limited. Looking ahead, the authorities expect to see the start of a slow recovery in the coming months, and GDP to grow by slightly above 1 percent in 2010, as projected by staff during the first review of the program.

Implementing the agreed policies in response to the sharp external shock has led to strong program performance. All quantitative PCs and indicative targets for end-June were met and all PCs and indicative targets for end-September for which data are available have been met. The authorities' and staff's calculations show that the end-September fiscal balance PC may have been missed by a very small margin, although the final data on the fiscal deficit will only be available in early November. Structural benchmarks for end-June and end-September were implemented.

Going forward, recovery in Armenia depends crucially on improvement in the external economic environment, as two of the fairly important sources of income for Armenia's economy – exports and remittances - are highly dependent on global recovery. Regarding domestic policies, we believe that the slight fiscal tightening planned for 2010, alongside accommodative monetary policy and a flexible exchange rate regime adopted as part of the program, will support economic recovery and ensure the achievement of the government's economic and social objectives under the SBA.

Fiscal Policy

In response to the sharp downturn, the government has implemented a counter-cyclical fiscal policy that has gone beyond automatic stabilizers. Despite the collapse in nominal terms of tax revenues, nominal spending has increased compared to last year. As a result, the authorities expect the fiscal deficit in 2009 to widen substantially up to 7½ percent of GDP, which is about 1 percentage point higher than projected during the first review.

In 2009, tax revenues are projected to be around 16 percent of GDP. As a share of GDP, this level is slightly higher than projected by staff in June, and reflects both the authorities' efforts to increase the tax revenues, and historically low tax proceeds from the construction sector (pulling down the denominator more than the numerator).

Going forward, the authorities recognize that the rapid accumulation of public debt over the last year requires a gradual unwinding of their expansionary fiscal stance as soon as the first

signs of economic recovery become visible. Accordingly, the authorities' aim is to lower the deficit in 2010 to less than 6 percent of GDP, which hinges on increasing tax revenues (in nominal terms and as percentage of GDP) and on restraining capital expenditures. At the same time, the authorities will examine their debt management strategy to lengthen maturities in the period ahead.

Tax Administration Reforms

Tax administration reform is underway, yet a lot still has to be done. The Fund's TA has been very helpful in this regard, but further progress is needed, and thus efforts to increase the tax base and tax revenues must persist. In particular, the authorities intend to strengthen the use of risk-based audits in VAT refunds, which they aim to implement towards the end of March, 2010. Continued technical assistance in this area will be crucial.

The Armenian authorities expect that all large taxpayers will electronically file their returns by the end of this year. E-filing is motivated by allowing the taxpayers to file their returns electronically 10 days later than when filing returns by mail. VAT payers are expected to start paying taxes electronically at the beginning of next year, and other tax payers are expected to e-file their returns by 2011.

Monetary Policy, Exchange Rate, and the Financial Sector

Monetary policy continues to be underpinned by an inflation-targeting framework. As aggregate demand deteriorated and inflation and inflation expectations were low, this allowed monetary policy to focus on supporting real activity by easing credit conditions. The key policy interest rate has been lowered since March by 275 basis points reaching the low level of 5 percent. But, like in many other economies, the traditional monetary policy tools to bolster aggregate demand and economic activity did not function well. Banks have been reluctant to supply credit and private enterprises have been hesitant in increasing their demand for credit. Currency mismatches, due to the high level of dollarization, also played a role in hindering credit growth. In response, the authorities have introduced various programs to support bank lending to SMEs and provided government credit and guarantees to systemically important enterprises. The authorities expect bank credit to start rising, as the economy begins its recovery in the following months. The slowdown of credit to the private sector and of external financing of the fiscal deficit resulted in excess liquidity in the banking sector. This excess liquidity risks being channeled to the foreign exchange market and putting pressure on prices.

The authorities remain committed to their internal guidelines on foreign exchange intervention, limiting intervention to smoothing excessive exchange rate volatility and rebuilding reserves. The move to a flexible exchange rate regime as part of the program has served the economy well. Market perceptions that the CBA will defend an implicit exchange rate level or range have vanished as the dram has depreciated further since mid-September, with the exchange rate now stabilizing at about 385 AMD per USD, limiting inflation