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August 2006

## Country Classification of Armenia

## CURRENCY EQUIVALENTS

(as of 30 March 2006)

Currency Unit	–	dram (AMD)
AMD1.00	=	\$0.0022
\$1.00	=	AMD451.08

## ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
DMC	–	developing member country
GDP	–	gross domestic product
GNI	–	gross national income
GNP	–	gross national product
HIPC	–	heavily indebted poor country
IBRD	–	International Bank for Reconstruction and Development
IDA	–	International Development Association
IMF	–	International Monetary Fund
LDC	–	least-developed country
OCR	–	ordinary capital resources
TA	–	technical assistance
UN	–	United Nations

## NOTES

- (i) The fiscal year (FY) of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

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## I. INTRODUCTION

1. Armenia became a member of the Asian Development Bank (ADB) in September 2005. In accordance with ADB policy,<sup>1</sup> new member countries should normally be classified to determine their eligibility for the Asian Development Fund (ADF) and ordinary capital resources (OCR).<sup>2</sup> This paper discusses the economic and social conditions in Armenia and recommends that Armenia be classified as a Group B1 country in ADB.

## II. CLASSIFICATION POLICY

2. According to ADB's 1998 graduation policy, the eligibility of developing member countries (DMCs) to borrow from the ADF is based on two criteria: per capita gross national product (GNP), and debt repayment capacity. Regarding per capita GNP, the 1998 graduation policy adopted the World Bank's per capita GNP estimates based on the Atlas method and the International Development Association (IDA) operational cutoff for eligibility. In particular, the 1998 graduation policy applied the IDA eligibility per capita operational cutoff of \$925 in 1997 US dollars.<sup>3</sup> A multidimensional evaluation procedure, combining quantitative and qualitative assessments, was used for measuring the debt repayment capacity of DMCs.

3. Application of the two criteria is captured in a decision matrix in Table 1 below that yields the following system of four groups on DMCs' eligibility for borrowing from ADF and OCR:<sup>4</sup> (i) ADF only (Group A), (ii) ADF with limited amounts of OCR (Group B1), (iii) OCR with limited amounts of ADF (Group B2), and (iv) OCR only (Group C).

4. Under the graduation policy framework, cost-sharing limits for project financing by ADB change for the borrowing DMCs as follows: 80% for Group A, 75% for Group B1, 70% for Group B2, and 65% for Group C.<sup>5</sup> The government contribution to technical assistance (TA) should be at least 15% of the total TA costs for Group A, 20% for Groups B1 and B2, and 30% for Group C. Such contribution will be subject to the limit of total TA costs minus foreign exchange costs and costs of domestic consultants. The new policy on cost-sharing as set out in the Board approved paper "Cost sharing and eligibility of expenditures for ADB financing: A new approach" (R129-05) became effective in March 2006. While such policy, which supersedes the cost sharing limits under the graduation policy framework, has become effective, certain financial parameters still need to be established in order to determine the new country cost sharing ceiling applicable to Armenia. Until a decision on such new ceiling has been taken in accordance with the new policy framework, the cost-sharing ceiling applicable to Armenia under the graduation policy framework will constitute the country cost sharing ceiling under the new policy framework.

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<sup>1</sup> ADB. 1998. *A Graduation Policy for the Bank's DMC's*. Manila.

<sup>2</sup> On 25 August 2005, the Board approved the paper "Cost sharing and eligibility of expenditures for ADB financing: A new approach" (R129-05). Cost-sharing under this new policy framework supersedes the existing policy on cost-sharing limits. On 6 February 2006, the Board approved the paper "Revising the Procurement Guidelines" (R11-06). The existing policy on domestic preference is superseded by the revisions to domestic preference scheme under the new policy framework that becomes effective on 1 April 2006.

<sup>3</sup> Per capita income by the World Bank Atlas methodology is IDA's basic indicator or proxy for poverty. The operational cutoff stood at per capita gross national income (GNI, formerly GNP) of \$965 in 2004 US dollars.

<sup>4</sup> This excludes DMCs that have graduated from regular ADB assistance.

<sup>5</sup> ADB. 2002. *Review of Cost-Sharing Limits for Project Financing as an Element of ADB's 1998 Graduation Policy*. Manila.

**Table 1: Decision Matrix of Classification**

Debt Repayment Capacity	Per Capita GNP Cutoff			
	Below Per Capita GNP Cutoff		Above Per Capita GNP Cutoff	
	LDC <sup>a</sup>	Other	LDC <sup>a</sup>	Other
Weak	ADF only (Group A)	ADF only (Group A)	ADF only (Group A)	ADF with limited OCR (Group B1)
Limited	ADF with limited OCR (Group B1)	ADF with limited OCR (Group B1)	ADF with limited OCR (Group B1)	OCR with limited ADF (Group B2)
Adequate	OCR with limited ADF (Group B2)	OCR with limited ADF (Group B2)	OCR with limited ADF (Group B2)	OCR only (Group C)

ADF = Asian Development Fund, GNP = gross national product, LDC = least-developed country, OCR = ordinary capital resources.

<sup>a</sup> To be classified as an LDC on the basis of the United Nations' classification of low-income and less-developed countries, a country must fall below thresholds established for income, economic diversification, and social development.

Source: Asian Development Bank. 1998. *A Graduation Policy for the Bank's Developing Member Countries*. Manila.

### III. ECONOMIC CONSIDERATIONS OF ARMENIA

5. Armenia is a landlocked country in the Lesser Caucasus Mountains, neighboring Azerbaijan, Georgia, Iran, and Turkey. It has a land area of 29,800 square kilometers. The population is about 3.2 million. Its natural resources include small deposits of gold, copper, molybdenum, zinc, and alumina.

6. Armenia is a relatively small economy. The gross domestic product (GDP) in 2004 was about \$3.4 billion. Armenia faces disadvantages in terms of transport and trade compared with many of its neighbors.

7. The IMF has noted that Armenia's economy continues to perform well. Prudent fiscal and monetary policies, strong external inflows, and ongoing structural reforms have contributed to double-digit growth, low inflation, and declining poverty in 2005. The outlook is for continued growth in 2006, underpinned by buoyant investment and remittance inflows.<sup>6</sup>

8. In the World Bank, Armenia is classified as an "IDA only" country. Eligibility for IDA assistance is primarily based on relative poverty, defined as gross national income (GNI) per person below an established threshold, and lack of creditworthiness to borrow on market terms (underline added).

<sup>6</sup> IMF. 2005. *First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility*. Available: [www.imf.org](http://www.imf.org)

9. The IMF also noted that the energy sector poses the largest threat to Armenia's long-term fiscal sustainability. It warned that failure to plan in advance and save some of its wealth to pay for significant costs for decommissioning the Metzamor nuclear power plant expected around year 2016 could endanger the country's fiscal and debt sustainability.<sup>7</sup> Armenia is heavily dependent on imported energy and has limited access to international fuel markets because of its geographical location. It has no oil reserves or refineries, no natural gas reserves and no coal mines.<sup>8</sup> A long-term gas contract with Russia has recently been concluded, which will result in a significant increase in gas prices (from the previous \$54 per 1,000 m<sup>3</sup> to \$110 per 1,000 m<sup>3</sup>).<sup>9</sup>

10. The 1998 graduation policy reviewed country classifications based on 1997 per capita GNP and assessment of debt repayment capacity based generally on a specific set of data sources covering 1989–1996. For consistency, this section examines Armenia's status in terms of 2004 per capita GNP, and debt repayment capacity up to 2004,<sup>10</sup> using generally the same data sources and same methodology as for the 1998 graduation policy paper. The most recent available data from other specific sources have also been used.

#### A. Per Capita Gross National Product

11. By United Nations (UN) standards, Armenia does not belong to the group of least-developed countries (LDC).

12. As per *Asian Development Outlook 2006*, real GDP grew at 10.1% in 2004, lower than the 14.0% in 2003. Real GDP growth is expected to be 13.9% for 2005. Annual inflation (consumer price index based) was at 4.7% in 2003 and 7.0% in 2004, respectively. It is expected to be 0.6% in 2005. The average annual population growth rate for 2001–2004 was almost nil. It is projected that real GDP growth in 2006 and 2007 are at 7.5% and 6.0%, respectively; and that annual inflation in 2006 and 2007 are at 3.0% and 3.0%, respectively.<sup>11</sup>

**Table 2: Some Economic Indicators of Armenia**

Item	1999	2000	2001	2002	2003	2004
GDP Growth (% , in constant prices)	3.3	5.9	9.6	13.2	14.0	10.1
Consumer Price Index (annual percent change, average of period)	0.6	(0.8)	3.1	1.1	4.7	7.0
GNP (\$ billion, nominal prices) <sup>a</sup>	1.9	2.0	2.2	2.4	2.9	3.4
Per capita GNP (\$, nominal prices) <sup>a</sup>	490	520	560	790	950	1,070

GDP = gross domestic product, GNP = gross national product.

<sup>a</sup> World Bank estimates, using the Atlas method.

Sources: ADB. 2006. *Asian Development Outlook 2006*. Manila.

World Bank. 2004. *World Development Indicators Online*. Available: [devdata.worldbank.org](http://devdata.worldbank.org)

World Bank. 2000–2005. *Operational Policies, OP3.10, Annex D*. Available: [www1.worldbank.org](http://www1.worldbank.org)

<sup>7</sup> IMF. 2005. *Growth and Poverty Reduction in Armenia: Achievements and Challenges*. Enrique Gelbard, et al. Washington, DC.

<sup>8</sup> ADB. 2006. *Armenia: Country Economic Report and Interim Operational Strategy (2006-2009)*. Manila.

<sup>9</sup> International Herald Tribune. 7 April 2006. Available: [www.iht.com](http://www.iht.com)

<sup>10</sup> Currently, a complete set of data is available from the same data sources only up to 2004.

<sup>11</sup> ADB. 2006. *Asian Development Outlook 2006*. Manila.

13. Per capita GNP was estimated at \$1,070 in 2004 US dollars, which was higher than the IDA operational cutoff of \$965 in 2004 US dollars.<sup>12</sup> Per capita GNP in dollar terms (nominal prices) using the Atlas method has steadily increased from 1999 to 2004 (Table 2). It is expected that Armenia's per capita GNP will most likely stay above IDA's operational cutoff in the medium-term, in view of the projections on real GDP growth and inflation in 2006-2007.

## B. Debt Repayment Capacity

### 1. Quantitative Variables

14. **Debt Sustainability Ratio.**<sup>13</sup> The 3-year moving averages of debt sustainability ratios from 1997 to 2004 were all negative, ranging from -4.8% to -26.4%.

15. **Gross Domestic Savings Rate.** The gross domestic savings rate was 9.6% in 2004. The average of gross domestic savings rates for 1997–2004 was -4.1%.

16. **Private Capital Inflows.** The share of private capital inflows in total capital inflows, as an indicator of debt repayment capacity, increased to 70.8% in 2004 from 34.4% in 2003. The average value of the share of private inflows in total capital inflows for 1997–2004 was 39.5%. Foreign direct investment increased significantly in 2004 and 2005.<sup>14</sup>

17. **Size of the Economy.** The size of the Armenia's economy as measured by GNP, Atlas method, increased from \$1.9 billion in 1999 (in 1997 prices) to \$3.4 billion in 2004 (in 2004 prices), as shown in Table 2. In terms of 2004 GNP (footnote 15), Armenia's economy is smaller than those of Kazakhstan (\$33.8 billion), Uzbekistan (\$11.9 billion), Azerbaijan (\$7.8 billion), Turkmenistan (\$6.6 billion), and Georgia (\$4.7 billion), but larger than the economies of the Kyrgyz Republic (\$2.1 billion) and Tajikistan (\$1.8 billion).

### 2. Qualitative Variables

18. **Classification as Heavily Indebted Poor Country.** Armenia is not classified as a heavily indebted poor country (HIPC). In the context of IDA grant eligibility consideration, Debt Sustainability Analysis (DSA) of Armenia, undertaken jointly by the IMF and the World Bank, showed that Armenia is considered to be at a low risk of debt distress.<sup>15</sup>

19. **Vulnerability to Fluctuation in Export Growth.** Armenia's exports of goods and services increased steadily from 1998 to 2004, with average growth rate around 17% (footnote 15). Base metals and precious stones accounted for 60.0% of total exports in 2002, 64.3% in 2003, 60.4% in 2004, and 68.6% in 2005.<sup>16</sup> Armenia is considered to be "highly vulnerable" to fluctuation in export growth.

<sup>12</sup> The World Bank. July 2005. *Operational Policies, OP3.10, Annex D*. Available: [www1.worldbank.org](http://www1.worldbank.org)

<sup>13</sup> The debt sustainability ratio as defined in the graduation policy paper links the key elements bearing on a country's external debt sustainability: non-interest current account balance, the inflow of foreign direct investment, the stock of external debt, and the differential between the growth rate and the real interest rate.

<sup>14</sup> The World Bank. 2005. *World Development Indicators Online*. Available: [devdata.worldbank.org](http://devdata.worldbank.org)

<sup>15</sup> The World Bank. November 2004. *Debt Sustainability and Financing Terms in IDA14: Further Considerations on Issues and Options*. Available: [www.worldbank.org](http://www.worldbank.org)

<sup>16</sup> ADB. 2006. *Key Indicators of Developing Asian and Pacific Countries: Armenia (Draft)*. Manila

20. **Main External Financing Source.** Private financing, including foreign direct investment and portfolio investment, accounted for about 70.8% of Armenia's total external financing in 2004, and 78.6% in 2005 (footnote 15). Armenia's main external source of financing is private financing, as it accounted for more than two-thirds of the country's external financing in 2004–2005.

21. **Rating for Sovereign Borrowing.** Armenia is not rated by Fitch, Moody's, or Standard and Poor's. Armenia is classified as "not rated."

22. **Degree of IDA Access.** The World Bank classifies Armenia as an IDA only borrower. Armenia is currently eligible to borrow IDA concessional resources. The World Bank stated that "towards the end of the Country Assistance Strategy period (FY05 – 08), there could be a first loan from the International Bank for Reconstruction and Development (IBRD) if Armenia's creditworthiness improves significantly (underline added)" (footnote 7).

23. Taking into account of the preceding considerations, including the quantitative and qualitative variables (paras. 14-22), Armenia's debt repayment capacity is considered to be "weak".

### C. Joint Application of the Two Criteria

24. The 1998 graduation policy paper stated that the decision matrix (Table 1) provides the foundation for classifying and graduating DMCs. Thus, Armenia is classified as Group B1 (ADF with limited amounts of OCR). On balance, the proposal for a B1 classification is premised on the following: (i) Armenia's economic performance is improving; (ii) but it is also an economy that faces disadvantages in terms of transport and trade; (iii) the price of imported gas has increased significantly recently, and the energy sector poses considerable risk to Armenia's long-term fiscal and debt sustainability; and (iv) the World Bank has deemed that Armenia lacks creditworthiness to borrow on market terms; and its creditworthiness has not been officially assessed by the major credit rating agencies.

## IV. RECOMMENDATION

25. It is recommended that the Board of Directors approve the classification of Armenia as a Group B1 country for the purpose of access to ordinary capital resources and eligibility for resources from the Asian Development Fund.