Report and Recommendation of the President to the Board of Directors

Project Number: 51060-003
October 2018

Proposed Policy-Based Loan for Subprogram 2 Armenia: Public Efficiency and Financial Markets Program

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Asian Development Bank
CURRENCY EQUIVALENTS
(as of 24 September 2018)

Currency unit – dram (AMD)
AMD1.00 = $0.0021
$1.00 = AMD484.89

ABBREVIATIONS

ADB – Asian Development Bank
CBA – Central Bank of Armenia
GDP – gross domestic product
GMRA – Global Master Repurchase Agreement
IMF – International Monetary Fund
MOF – Ministry of Finance
MTDS – Medium-Term Debt Strategy
PDMD – Public Debt Management Department
PA – policy action
PEFMP – Public Efficiency and Financial Markets Program
PFM – public financial management
PPEF – post-program engagement framework
PPP – public–private partnership
TA – technical assistance

NOTE

In this report, “$” refers to United States dollars.

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### PROGRAM AT A GLANCE

**1. Basic Data**

<table>
<thead>
<tr>
<th>Project Number</th>
<th>Project Name</th>
<th>Department/Division</th>
<th>Executing Agency</th>
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<tr>
<td>51060-003</td>
<td>Public Efficiency and Financial Markets Program (Subprogram 2)</td>
<td>CWRD/CWPF</td>
<td>Ministry of Finance (MOF)</td>
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<tr>
<td>Country</td>
<td>Borrower</td>
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<tr>
<td>Armenia</td>
<td>Armenia</td>
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**2. Sector**

<table>
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<tr>
<th>Subsector(s)</th>
<th>ADB Financing ($ million)</th>
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<tbody>
<tr>
<td>Finance sector development</td>
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<tr>
<td>Money and capital markets</td>
<td>10.00</td>
</tr>
<tr>
<td>Public expenditure and fiscal management</td>
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</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>50.00</strong></td>
</tr>
</tbody>
</table>

**3. Strategic Agenda**

| Inclusive economic growth (IEG)          | Pillar 1: Economic opportunities, including jobs, created and expanded |

**Climate Change Information**

| Climate Change impact on the Project     | Low |

**4. Drivers of Change**

| Governance and capacity development (GCD) | Institutional development |
| Partnerships (PAR)                       | Implementation            |
| Private sector development (PSD)         | International finance institutions (IFI) |
|                                        | Public sector goods and services essential for private sector development |

**Gender Equity and Mainstreaming**

| No gender elements (NGE) |

**5. Poverty and SDG Targeting**

<table>
<thead>
<tr>
<th>Geographic Targeting</th>
<th>Household Targeting</th>
<th>SDG Targeting</th>
<th>SDG Goals</th>
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<tbody>
<tr>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>SDG8</td>
</tr>
</tbody>
</table>

**Location Impact**

| Nation-wide | High |

**6. Risk Categorization:**

| Low |

**7. Safeguard Categorization**

| Environment: C | Involuntary Resettlement: C | Indigenous Peoples: C |

**8. Financing**

<table>
<thead>
<tr>
<th>Modality and Sources</th>
<th>Amount ($ million)</th>
</tr>
</thead>
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<tr>
<td>ADB</td>
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<td>Sovereign Programmatic Approach Policy-Based Lending (Regular Loan):</td>
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<td>Ordinary capital resources</td>
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<td>Cofinancing</td>
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<tr>
<td><strong>Total</strong></td>
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I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan to Armenia for subprogram 2 of the Public Efficiency and Financial Markets Program (PEFMP).

2. The proposed program is the second of two subprograms of the current programmatic assistance of the Asian Development Bank (ADB) in Armenia. The program helps (i) strengthen public debt and fiscal risk management, in support of the authorities’ fiscal consolidation efforts and attempts to reduce financial risks in the economy; (ii) improve money market liquidity and financial market transparency, by deepening the government securities market and improving the infrastructure for money markets; and (iii) foster the development of corporate debt and equity markets by enhancing corporate transparency and developing legislative frameworks for new instruments and investment vehicles. Subprogram 1 ($40 million) was approved in October 2017. Subprogram 2 is for $50 million.

II. PROGRAM AND RATIONALE

A. Background and Development Constraints

3. Macroeconomic context. Real gross domestic product (GDP) expanded by more than 7% in 2017, in sharp contrast to 0.2% growth in 2016, mostly driven by mining-related and other manufacturing activities. Construction returned to growth following years of contraction, and remittance flows from Armenians working in the Russian Federation supported the growth spurt in wholesale and retail trade and other services. The growth in remittances will likely slow down in 2018; and a pickup in inflation will hit real wages, likely affecting demand for services. The expansion of exports of 2017 is also unlikely to be sustained, given the weaker forecast growth for copper prices in 2018. This might constrain mining investments. In 2018, real GDP growth is expected to decelerate to about 3%–4%, more in line with Armenia’s potential output growth.

4. Potential output growth in Armenia is partly limited by low levels of investment, which declined from about 40% of GDP before the financial crisis (much of it fueled by the pre-2009 capital-inflow and credit-induced construction boom) to less than 18% in 2017. This contraction in investment as a share of GDP is expected to end now, and pro-growth policies by the government could help revive it, especially if business environment challenges and geopolitical risks are addressed. However, a strong rebound is unlikely because of high costs of local currency finance and constraints to the banking system’s maturity transformation capacity. As a result of

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3 ADB provided transaction technical assistance for Support to Public Efficiency and Financial Markets Program.
4 Industrial output volumes were up by 12.6%, mostly because of increases in global prices of copper, the country’s largest export. Brandy, wine, tobacco, and textile industries also contributed to raising the exports by 25.8% to a record high of $2.2 billion.
5 The surprisingly high 2017 real GDP growth figure exceeded the estimates of most observers’ forecasts of 3.0%–3.5% and was mostly determined by an unanticipated fourth-quarter hike in economic activity. The unexpected recovery in remittances from the Russian Federation supported 5.5% growth in retail trade turnover, and a 14.4% surge in other services.
6 Maturity transformation is a key function of banking. The maturity mismatch that is needed to facilitate long-term investment projects, while serving agents’ liquidity needs, is a key driver of the net interest margin in banking. The term refers to the difference in the residual contractual maturity between assets and liabilities.
the root constraints highlighted below, pricing benchmarks for financial contracts in local currency are currently nonexistent for most tenors or are very steep when available, and the economy remains dollarized and vulnerable to external shocks.\(^7\)

5. **Core development problem.** While financial institutions in Armenia have improved their role over the years (predominantly banking), financial markets remain nascent. This limits Armenia's private sector development; and affects public finance, fiscal management, and macroeconomic and financial stability. This is rooted in three constraints:

   (i) **Fundamental gaps in public debt and fiscal risk management scope.** To ensure fiscal stability and sustainability, these functions need to become more credible, transparent, and effective. Before the PEFMP: (a) public debt management lacked effectiveness and strategic underpinnings; (b) fiscal risk management was inadequate and significantly incomplete in scope, played no role in the vetting of new initiatives, lacked basic methodologies of analysis, and exercised no risk management or mitigation responsibilities; and (c) private sector provision of public infrastructure services lacked legal/regulatory bases and was done in nontransparent and potentially fiscally adverse ways.

   (ii) **Key institutional and financial infrastructure gaps that hold back efficiency and liquidity in Armenia’s government securities and money markets.** Before the PEFMP debt securities issuance practices and communication were inadequate, at least in terms of the development of financial market benchmarks (price discovery) and the need to gradually reduce liquidity premiums in government debt securities. Lack of market-making frameworks also impeded price discovery.

   (iii) **Problems in key legal frameworks for new instruments and the protection of investors, and deep deficiencies in corporate transparency.** Before the PEFMP, gaps in legal frameworks for new financial instruments and asset classes hindered investor interest and feasibility in the issuance of new financial instruments. Lack of corporate information practices also constrains the broadening of investor/issuer bases in Armenia’s debt and equity markets.

6. **New government’s continuity in financial reforms.** It is crucial to support the new Government of Armenia's efforts in promoting reforms that can produce mutually reinforcing effects along the areas of intervention of the PEFMP. Financial reform processes are medium-term in nature, and the political transition that took place in March–May 2018 has not affected country ownership for the PEFMP. The constitutional transition to a parliamentary system in April 2018 did bring policy dialogue and technical assistance (TA) temporarily to a halt from late March. Even though a new cabinet was formed in the third week of April, political circumstances led to a new government step-down and a new cabinet solution only emerged in mid-May 2018. An ADB mission presented the PEFMP to the new government team at the end of May, and received formal support for its objectives and reforms, and for the policy dialogue that had been interrupted. Policy dialogue resumed swiftly under a formal request for support for both subprogram 2 reforms and for those included in the post-program engagement framework (PPEF). New elections, expected to take place in the near future, are likely to consolidate Parliamentarian support for the government solution and reform agenda.

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\(^7\) At the current Central Bank of Armenia (CBA) policy rate of 6%, risk-free rates for highly liquid instruments with a 5-year tenor are about 8.5% (and above 10% for a 10-year tenor). Maximum tenors offered by banks in Armenia in local currency are now below 24 months on average, at rates of about 13%.
B. Policy Reform and ADB’s Value Addition

7. Reform outputs area 1: Public debt and fiscal risk management policies strengthened. To ultimately enhance fiscal discipline, transparency, and credibility, this output aims to strengthen the legal framework and improve the analytical capacity of the Public Debt Management Department (PDMD) to mitigate system risks; introduce more clarity and transparency in PDMD’s internal procedures, operations, and debt issuance decisions; and bring transparency to the government’s debt management objectives over the medium term. Under subprogram 2, the Ministry of Finance (MOF) continued efforts to significantly improve (i) its fiscal policy framework to ensure fiscal sustainability, credibility, and transparency; and (ii) its institutional and regulatory capacity to manage key fiscal risks. These efforts are crucial to ensure fiscal stability and the confidence of financial markets going forward, and are key complements to the new fiscal rule approved in December 2017 (with International Monetary Fund [IMF] TA support).8 A key pillar of the overall effort is one of strengthening MOF control and understanding of the wide array of operations and activities that produce fiscal risks.

8. Under this output, the role of the PDMD has been expanded to include, e.g., the analysis and vetting of requests for guarantees. It now centralizes the analysis and reporting of all forms of explicit liabilities within the Medium-Term Debt Strategy (MTDS) process and through periodic public bulletins. Parliament approved new legislative amendments (to the Laws on International Treaties) to strengthen the role of the MOF in vetting all external borrowing. For example, the minister of finance is now the only government official charged with signing loan agreements, regardless of modalities, and is the final decision maker on all external borrowing proposals. To implement this new framework, the MOF developed and approved a manual to guide the analysis, negotiation, and contracting of external borrowing. Following the new reporting requirement, the MOF published its annual assessment on Armenia’s Debt Sustainability in May 2018. This upgrade in public transparency is a crucial complement to the new fiscal rule, itself a key new pillar in Armenia’s fiscal governance, and will help ensure market confidence in fiscal policy.9

9. The MOF also approved a formal operational risk management framework that includes business continuity planning and implementation routines. To adequately address credit risks and risks related to fiscal contingent liabilities associated with budgetary lending and guarantees, the MOF also established a framework to vet, monitor, and evaluate these operations. In coordination with the IMF, risk-vetting and monitoring procedures were adopted to close the wide gaps that had been identified and prioritized in the fiscal risk management road map.10 This policy area also addressed a fundamental institutional handicap related to (i) the lack of information flow routines for any integration of fiscal risk management and (ii) the absence of a full-fledged fiscal risks assessment department within the MOF. The MOF has adjusted its institutional framework to significantly facilitate the integration of risk monitoring and management functions, and information flows. To elevate the relevance of this new institutional function, it formed a Fiscal Risks Assessment Department in full integration with statistical functions.

10. In close coordination with several development partners (but mostly with the IMF), this output helped enhance the fiscal risk management capacity of Armenia in public–private

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8 The introduction of the new fiscal rule required amendments to the Budget System Law and the Public Debt Law, but this was not included in subprogram 2 as a policy action.

9 Fiscal transparency is favorable to emerging economies’ borrowing costs and help increase foreign investor’s demand for their sovereign debt, i.e. beyond issues of availability of information on debt servicing capabilities.

10 A separate set of procedures to vet, analyze, manage, and report risks that are associated with public–private partnerships (PPPs) was developed and will also be approved. These methodologies complement the general fiscal risk assessment models developed by the IMF.
partnerships (PPPs) and ensure that the proposed new legal and institutional ecosystem for PPPs only promotes development-relevant and fiscally responsible PPPs. This work has been developed by the Ministry of Economic Development and Investments (MEDI), in wide consultation with different line ministries and in line with the PPP Policy Statement approved earlier. The range of risks involved in contracting and implementing a PPP pipeline merited a thorough process of interministerial dialogue (and capacity development) to build consensus about key policy trade-offs. To a large extent, this effort had to be undertaken a second time from June 2018 onward, albeit very successfully. The PPP law proposal approved by the cabinet and submitted to Parliament in August 2018 meets crucial requirements in that regard.

11. Reform outputs area 2: Government’s securities market and money-market infrastructure improved. To develop financial markets in dram and finance public sector needs more sustainably, this output aims to increase trading volumes and liquidity in government securities. This will help enable a gradual reduction in foreign currency risk exposures by public and corporate borrowers and lenders in Armenia. These reforms are key prerequisites for the development of reliable risk-free benchmarks for the pricing of all other local currency financial contracts in Armenia. This is a precondition for financial deepening in local currency in Armenia and sustaining de-dollarization efforts. Under subprogram 2, the MOF and the Central Bank of Armenia (CBA) continued to improve the underpinnings of the government securities market and money markets—crucial cornerstones for the development of capital and financial markets. A time-bound road map for the medium-term development of capital and financial markets in Armenia was developed and approved through a memorandum of understanding between the MOF and the CBA. This memorandum recognizes the crucial interdependence of actions between the MOF and the CBA in this regard, and it includes the three pillars of policy action that are most relevant at this stage: (i) money-markets and systemic liquidity management, (ii) public debt securities market development, and (iii) corporate debt and equity securities development.

12. Access to public debt issuance for retail investors was established under subprogram 1, enhanced by mobile technology. This was implemented under subprogram 2, and the subject of a new public reporting requirement. A more effective primary dealers’ system was approved in subprogram 1, with market-making responsibilities to promote price discovery and liquidity in the government securities market. This was implemented under subprogram 2, reviewed and subject of a public report to the market on possible and planned improvements, with an explicit request for feedback. A Regular Treasury Bill Program (RTBP), approved under sub program 1, was implemented under subprogram 2 and reviewed against whether volumes and maturities were consistent with the feedback from the market and aligned with monetary and public debt management policies (and the need to develop money markets). The MOF also upgraded and published its treasury securities annual borrowing plan, with a clear policy on bond buyback and switch operations to ensure financial markets’ understanding of the MOF’s debt management operations. These reforms add predictability to the MOF’s debt issuance and management for investors. Working with NASDAQ OMX and the CBA, the MOF developed its requirements for bond switch auctions and regulations for enabling NASDAQ’s operationalization of the new system to facilitate MOF consolidation of outstanding issues.

13. Subprogram 2 aimed at ensuring that the MTDS (2019-2021) is effective in communicating the recognized need to (i) reduce exposure to currency risks and (ii) develop a local currency sovereign debt market. It was fundamental that the MTDS fully reflected the operational implications of these priorities in the debt issuance program going forward, including an explicit

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announcement of options and possible plans to address the Eurobond-related redemption challenge of 2020. The approval of the new MTDS introduced this public debt management dialogue to market participants, and now also articulates the critical risk trade-offs going forward. Together with the first publication of the public debt sustainability assessment report, these improvements are crucial breakthroughs in public debt management transparency in Armenia. A working group has also strengthened the much-needed analytical cooperation between the CBA and PDMD. A joint internal paper (on potential exchange rate impacts of accelerated local-currency debt issuance and mitigation options) was produced as a result.

14. To develop Armenian integration with international financial markets and mainstream the use of the Global Master Repurchase Agreement (GMRA) across money markets in Armenia, the CBA became a member of the International Capital Market Association (ICMA) and approved the introduction of the GMRA in 2018. Approved was also the implementation of a plan to, inter alia: (i) mainstream the use of GMRA by upgrading CBA’s own systems in all of its open-market operations and standing facilities from 2018 onwards; (ii) undertake a regulatory review to remove regulatory biases against GMRA adoption and publicly inform supervisees of the gradual removal of such regulatory biases. This market communication approach will enable a nondisruptive transition in market participants’ information technology and liquidity management systems. ADB TA efforts in this reform area complement the assistance of the European Bank for Reconstruction and Development.

15. Under subprogram 1, a steering committee was formed to implement a Tri-party Repo Project. Under subprogram 2 and with ADB TA support, this brought the MOF, the CBA, and the Central Depository of Armenia (and NASDAQ OMX) together to study system and institutional options, and their financial feasibility. A request for proposals was sent to potential international vendors, selection was finalized, and a financial feasibility analysis was presented to the steering committee. A full economic cost–benefit analysis was undertaken to assess short-listed systems. A survey was also launched to market participants to reassess the potential for this investment’s cost recovery and its drivers. A final decision at the second steering committee meeting reflected a consensus that this investment is premature and determined options for when (i) increases in banks’ liquidity management activity and (ii) improvements in the CBA’s systemic liquidity management can produce a higher economic feasibility for it. The MOF also reviewed the source and analysis of its cash flows to identify ways to improve its forecast projections. It reflected and approved these in a roadmap to (i) develop a new cash management framework using Treasury bills, buybacks, and switches; and (ii) better coordinated with CBA’s own liquidity management. This will remove one of the constraints to the CBA’s systemic liquidity management functions.

16. Reform outputs area 3: Base of instruments and investors broadened, and corporate transparency enhanced. To ultimately increase resource mobilization for private investments, this output aims to strengthen the legal and regulatory framework for new instruments and corporate transparency in Armenia. This aims to encourage more active investors and issuers to participate in Armenia’s capital markets. In a sign of strong economic policy commitment to the broad financial reform agenda, the new government confirmed the implementation of the mandatory capitalization system for pension contributions and investments, and actually increased the fiscal-sharing element of it to avoid informality in labor contracts. The new government is also preparing significant amendments to Armenia’s insolvency

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12 ICMA membership enables legal opinions on GMRA enforceability in Armenia to be published by ICMA, and will facilitate cross-border repo transactions between Armenian companies and ICMA members.

13 The funded pension system introduced in 2014 allowed involving internationally reputed pension fund managers into the financial markets of Armenia. As the result of funded contributions, the mandatory pension funds include assets of more than AMD105 billion as of end 2017.
framework. Cabinet is deciding on legal proposals to improve bankruptcy processes and protect creditors’ rights, e.g., by establishing specialized courts for insolvency procedures, ensuring alignment in court treatment of insolvency cases with civil cases, and ensuring the participation of the Ministry of Justice and the judge of an insolvency case (not just the insolvency officer) in the Supervisory Body.

17. Parliament approved a new Law on Residential Mortgage Lending, together with Amendments to the Covered Mortgage Bonds Law. With the latter, the regulation of covered bond issuance was brought in line with best practices. One of the major features introduced by the reform is the regulation of centralized covered bond issuance. There was a great uncertainty in cases of insolvency of the participant issuer, as the relations between the central issuer and the participant issuer could not be regulated simply by a contract. The reformed law addresses this issue and makes sure centralized issuance of covered bonds is safe, the assets in the pool are ring-fenced against insolvency, and all the procedures are certain. The reforms also updated the list of eligible assets for the pool, making the law a stronger basis for financial activities. Banks in Armenia have been trying to structure these investment vehicles and adding new asset classes, and this strengthening of legal frameworks is now expected to catapult these efforts forward. To clarify the nature and attributes of new investment instruments and special purpose vehicles (enabling synthetic securitization and the issuance of securities before a loan-book purchase), and to strengthen the legal basis for securitization, Parliament approved the proposed amendments to the Law on Asset Securitization and Asset-Backed Securities.

18. As illustrated above, there has been no slowdown in financial reform efforts by the Government in Armenia in 2018. By August 2018, the cabinet had approved proposals to introduce modern elements of corporate law in Armenia, such as (i) the concept of a shareholder’s agreement (e.g., as an amendment to the Joint Stock Companies Law); and (ii) the protection of minority investors’ rights (as amendments to the Joint Stock Company Law, the Law on Limited Liability Companies, and the Law on Securities Market). To establish stronger corporate transparency practices in Armenia and promote more availability of reliable financial information on domestic companies, the cabinet also approved a number of reforms that are expected to attract more investors and channel more savings through financial markets to companies that need capital to grow and generate jobs. Under subprogram 2, a package of audit reforms was proposed to Parliament that included the establishment of a public oversight board. These reforms, when adopted in Parliament (and supported by the PPEF), will pave the way to a systemic shift in the financial information and transparency industry in Armenia.

19. Lessons. As with subprogram 1, subprogram 2 incorporates important lessons from policy dialogue experience in finance sector and public sector reform programs in other countries, as well as from earlier ADB policy-based lending engagement in Armenia. International lessons for the successful development of local currency financial markets, public management, fiscal risk management, etc., were incorporated across all reform efforts to varying degrees, but the policy dialogue often emphasized the need to address and target more context-specific solutions that only TA and reform analysis could uncover. This was done in full use of the advantages of ADB’s programmatic assistance (relative to other modalities). In this sense, the experience of subprogram 2 has also confirmed the advantages of the programmatic modality to the nature of

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14 The law clearly defines the assets that can be used as substitutes, and introduces a cap on the percentage of such assets in the pool.

15 For example, prior to these amendments, the special purpose vehicles had the legal status of foundations (not of investment funds), which hindered securitization efforts. Amendments also now enable synthetic securitizations (and not only via true-sale). Other crucial constraints (e.g. lack of clarity on reserve requirements for the parties’ accounts receivables) were also removed, and securitization is now a viable option in Armenia.
this multi-period, multi-speed reform agenda in Armenia. Setting realistic policy actions is also critical to ensure that the reform program can be carried out effectively and implementing agencies’ technical staffs remain fully connected to the process. Policy reforms must be accompanied by significant government ownership, but this often requires a more pragmatic and sequenced approach from development partners (often emphasizing issues of form on how to approach reform challenges). As often observed in other “post-transition” contexts, catalyzing the levels of inter-agency institutional collaboration that are crucial in financial markets development is a challenge in Armenia (at working levels). Promoting analytical cooperation between agencies often requires setting formal requirements for it, to support policy dialogue continuity and frame the progress that is needed in more effective ways.

20. **Reform Implementation Challenges and Adjustments to Subprogram 2.** Subprogram 2 reforms and policy dialogue progressed broadly as expected in terms of indicative targets set in October 2017 at subprogram 1 approval. In some areas, the effectiveness of the policy dialogue resulted in more concrete reform achievements and new reform efforts (policy actions 1, 7, 15, and 23). Some key legal reforms also progressed faster than originally expected (policy actions 3 and 22). The timing of policy action 25 was also corrected, to be in line with policy action 24. Adjustments were required in policy actions 11 and 17–19 to achieve the underlying policy objectives more effectively and reflect concrete reform realities. A supplementary linked document discusses these reform adjustments in detail. All Subprogram 2 policy actions have been achieved before late-September 2018. All Subprogram 1 policy actions have been sustained without any rollback of the reform measures.

21. **Post-program engagement framework.** The policy dialogue process under subprogram 2 was successful in clarifying that several follow-up reform steps will be crucial and could benefit from further ADB support. The ADB team and the authorities agreed on a PPEF through which both can lock-in a working-level commitment to jointly prepare the next phase of associated reforms, i.e., reforms that are a natural sequence or necessary for subprogram 2 reforms to come to full fruition in terms of impact. The PPEF contains a non-exhaustive list of initial activities, including the development of an integrated fiscal risk management framework in close coordination with capacity development and the new institutional setup for this function, PPP pipeline development (within the new legal and regulatory framework), further development of market-making and primary dealer frameworks (and other efforts to enhance price discovery and turnover liquidity), reviewing tax challenges to securities’ trading and issuance, implementing regulatory efforts to encourage corporate debt issuance, developing the capacity of the new governing framework for accounting and auditing in Armenia, etc.

22. **Coordination with other development partners.** As indicated in specific references above, Subprogram 2 helped coordinate the benefits of different sources of TA for fiscal and finance sector reforms in Armenia. Different aspects in the scope of the program have been closely coordinated with the IMF and the EBRD. Close collaboration with IMF teams on PPP reforms and on the fiscal risk management upgrading dialogue was instrumental to the related – achievements under Subprogram 2 and are expected to continue during the PPEF. Collaboration with the EBRD on money-markets development is also expected to strengthen. Some reforms benefited from earlier TA by the European Union delegation in Armenia and by the World Bank. This has ensured that the proposed program reforms complement related (past and present) TA

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16 Reform Implementation Challenges and Adjustments to Subprogram 2 (accessible from the list of linked documents in Appendix 2).
17 Post-Program Engagement Framework (accessible from the list of linked documents in Appendix 2).
initiatives by other development partners, and that each partner’s work is always considered, integrated, and often actually incorporated for the first time are form-consequent policy dialogue.\textsuperscript{18}

C. Impacts of the Reform

23. To illustrate the potential financial and economic impacts of the reforms presented in Section II.B, a full discussion is presented in a supplementary document.\textsuperscript{19} Subprogram 2 reforms (i) bring to fruition a number of key legal and institutional game-changers for financial markets in Armenia, thus sustaining the benefits of complementary reform processes implemented in subprogram 1; and (ii) put in motion new reform processes that, for example, the proposed PPEF will help consolidate. The development of the financial markets is crucial for Armenia and can:

(i) support government funding possibilities in the domestic market, thereby reducing its currently very high foreign currency exposure and vulnerability to external shocks;

(ii) support the traction of monetary policy levers, and provide suitable instruments for the authorities to deal with macroeconomic shocks and risks to financial stability from high dollarization;

(iii) develop local capital markets, on the back of the development of an effective government securities market, to enable banks’ maturity transformation, and companies’ and households’ access to local currency borrowing; and

(iv) improve the efficiency of capital allocation and intermediation between investors and borrowers, through adequate disclosure and legal frameworks to protect investors and borrowers.

24. The proposed reforms under the PEFMP—to address each of the three root constraints presented in para 5 above, are important in their own specific context. The Program Economic and Financial Impact Assessment illustrates these potential financial benefits through estimates of the specific, partial benefits that proposed reforms can produce in each area.\textsuperscript{20} This due diligence and analysis indicates that this reform program, complemented by crucial contemporaneous and future reform processes, can indeed contribute to stronger and more sustained economic growth, and less episodes of macroeconomic and financial instability.

D. Development Financing Needs and Budget Support

25. Armenia experienced an economic growth spurt in 2017. As a result, the budget deficit in 2017 decreased to 4.8% of GDP from 5.5% in 2016. External public debt increased to 42.5% of GDP from 41.1% in 2016, while domestic debt rose to 11.1% from 10.9% in 2016. To reduce debt-related vulnerabilities, the government envisages significant fiscal consolidation in 2018-2019. With public debt exceeding the legal limit of 50% of GDP, Armenia’s fiscal rule requires a reduction in the budget deficit to 2.7% in 2018. Over the medium term, the budget deficit is expected to narrow further to 2% of GDP in both 2019 and 2020. The government has requested a regular loan of $50 million from ADB’s ordinary capital resources to underpin subprogram 2. The loan will have a 15-year term, including a grace period of 3 years, straight line method, an

\textsuperscript{18} Development Coordination (accessible from the list of linked documents in Appendix 2).

\textsuperscript{19} Program Economic and Financial Impact Analysis (accessible from the list of linked documents in Appendix 2).

\textsuperscript{20} This analysis takes into account the program of reforms under subprogram 1, subprogram 2, and commitments made under the PPEF. International reform and empirical experience have shown that, taken together, the reform processes in the program could be very meaningful. However, a meaningful quantification of the combined impact on the economy from these different and partial processes is extremely difficult to make. Instead, the linked document attempts at highlighting the several channels of medium-term potential economic impact that recent cross-country empirical literature has emphasized.
annual interest rate determined in accordance with ADB’s London interbank offered rate (LIBOR)-
based lending facility, a commitment charge of 0.15% per year, and such other terms and
conditions set forth in the draft loan agreement. The average maturity is 9.25 years, and there is
no maturity premium payable to ADB. The loan amount reflects the government’s financing needs,
considering its development expenditure over 2018–2020 (Table 1). The financing gap is
expected to be $146.12 million or 1.99% of GDP in 2018, to be financed partly through
subprogram 2. The closing date of the loan is 31 December 2018.

Table 1: Armenia State Budget Financing Gap for 2018–2020 (Projected)

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount 2018 ($ million)</th>
<th>Amount 2019 ($ million)</th>
<th>Amount 2020 ($ million)</th>
<th>GDP 2018 (%)</th>
<th>GDP 2019 (%)</th>
<th>GDP 2020 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Revenues and grants</td>
<td>2,801.93</td>
<td>3,083.67</td>
<td>3,402.89</td>
<td>23.4</td>
<td>23.5</td>
<td>23.6</td>
</tr>
<tr>
<td>2. Expenditure</td>
<td>3,126.76</td>
<td>3,398.70</td>
<td>3,706.10</td>
<td>26.1</td>
<td>25.9</td>
<td>25.7</td>
</tr>
<tr>
<td>3. Overall fiscal balance (1–2)</td>
<td>(324.83)</td>
<td>(315.03)</td>
<td>(303.21)</td>
<td>(2.70)</td>
<td>(2.40)</td>
<td>(2.10)</td>
</tr>
<tr>
<td>4. Debt repaymenta</td>
<td>667.41</td>
<td>701.92</td>
<td>1,372.50</td>
<td>2.36</td>
<td>2.31</td>
<td>9.51</td>
</tr>
<tr>
<td>5. Financing needs (excluding domestic debt repayment)</td>
<td>625.97</td>
<td>656.41</td>
<td>1,275.54</td>
<td>2.02</td>
<td>1.89</td>
<td>8.83</td>
</tr>
<tr>
<td>6. Financing</td>
<td>479.86</td>
<td>470.54</td>
<td>346.95</td>
<td>4.01</td>
<td>3.59</td>
<td>2.41</td>
</tr>
<tr>
<td>7. Financing gap (5–6)</td>
<td>146.12</td>
<td>185.87</td>
<td>928.58</td>
<td>1.99</td>
<td>1.69</td>
<td>6.43</td>
</tr>
</tbody>
</table>

() = negative, GDP = gross domestic product.

Notes:
1. GDP is $11,976.9 million for 2018; $13,126.9 million for 2019; and $14,437.8 million for 2020.
2. The exchange rate used was $1 = AMD483.06.

a Includes external debt repayment of $301.20 million and domestic debt repayment of $366.21 million in 2018;
   external debt repayment of $341.37 million and domestic debt repayment of $370.55 million in 2019; and external
debt repayment of $972.34 million and domestic debt repayment of $400.16 million in 2020.


E. Implementation Arrangements

26. The MOF is the executing agency. The CBA, the MOF and the MEDI are the implementing
agencies for their respective reforms (Appendix 4). The MOF was the executing agency in prior
program loans, including subprogram 1. The MOF, the MEDI and the CBA had a well-established
record of implementing reform programs with ADB, the World Bank, and the IMF, and
Subprogram 2 benefited from that. The implementation period for subprogram 2 is from November
2017 to December 2018. The proceeds of subprogram 2 will be disbursed in accordance with
ADB’s Loan Disbursement Handbook (2017, as amended from time to time).

III. DUE DILIGENCE

27. Governance. Armenia’s public financial management (PFM) has steadily improved over
time in budget credibility, comprehensiveness and transparency, policy-based budgeting and
execution, and revenue administration. However, the management of fiscal risks related to public
sector enterprises and PPPs, cash management, and forecasting ability is weak. The MOF
continues to have a consistent lead role in PFM reform efforts, including the new Tax Code
implemented in January 2018. The government’s Anticorruption Council is responsible for setting
anticorruption policies, leading investigations, and imposing remedies.

28. Poverty and social. Subprogram 2 is expected to contribute indirectly (over the medium
term) to poverty reduction through improved finance sector stability, stronger resilience to external
shocks, and more sustained economic and employment growth. In line with ADB’s Safeguard
Policy Statement (2009), the program is classified category C for impacts on the environment,
involuntary resettlement, and indigenous peoples. Major risks and mitigating measures are summarized in table 2 and described in detail in the risk assessment and risk management plan.\textsuperscript{21}

\begin{table}[h]
\centering
\begin{tabular}{|l|l|}
\hline
\textbf{Risks} & \textbf{Mitigation Measures} \\
\hline
The country is still vulnerable to external shocks, which may directly affect financial stability and spur increases in dollarization. Rating: Substantial & The mitigation of external risks remains a priority of the Government of Armenia. Resilience will be strengthened by implementing reforms such as those in subprogram 2, and by increasing the depth of the government’s domestic debt and reducing foreign exchange borrowing. \\
\hline
Fiscal instability and foreign currency debt servicing concerns can affect the stability of the domestic debt issuance program. Rating: Substantial & The government continues to reduce the fiscal deficit. A new tax code introduced in late 2016 is broadening the tax base and increasing revenues. This can reduce risks of fiscal instability. The new government has stepped up plans to strengthen the issuance of more dram debt to reduce foreign currency risk exposures earlier than otherwise. Reforms under the program are expected to strengthen public debt management. \\
\hline
\end{tabular}
\end{table}

Source: Asian Development Bank

29. ADB’s Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government.

IV. ASSURANCES

30. The Government and the MOF have assured ADB that implementation of the program shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan agreement.

V. RECOMMENDATION

31. I am satisfied that the proposed policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of $50,000,000 to Armenia for subprogram 2 of the Public Efficiency and Financial Markets Program, from ADB’s ordinary capital resources, in regular terms, with interest to be determined in accordance with ADB’s London interbank offered rate (LIBOR)-based lending facility; for a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan agreement presented to the Board.

Takehiko Nakao
President

9 October 2018

\textsuperscript{21} Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).
## DESIGN AND MONITORING FRAMEWORK

### Country's Overarching Development Objective
Fiscal sustainability and resilience in the finance sector increased by 2020

### Results Chain
<table>
<thead>
<tr>
<th>Effect of the Reform</th>
<th>Performance Indicators with Targets and Baselines</th>
<th>Data Sources and Reporting Mechanisms</th>
<th>Risks</th>
</tr>
</thead>
</table>
| Depth of financial markets increased | By 2020:  
  a. Percentage of net domestic securities issuance in total public debt issued increased to 42% (2016 baseline: 22%)  
  b. Turnover ratio in government bonds increased by 100% (2016 baseline: 4.17%) |  
  a. MOF annual public debt reports and medium-term debt strategy updates  
  b. CBA statistical reports | External shocks trigger financial instability and new dollarization sprees. |

### Reform Output Areas
1. Public debt and fiscal risk management policies strengthened

#### Key Policy Actions
1.1 MOF issuing procedures for (i) issuing Eurobonds, (ii) contracting external loans, and (iii) enacting payments for domestic and external debts by December 2017 (subprogram 1; 2016 baseline: none)

1.2 Government approved framework to (i) identify, vet, and prepare PPPs (based on risk profiling, fiscal affordability, and financial viability); (ii) govern unsolicited proposals; and (iii) monitor the operational performance of each PPP based on guidelines developed by December 2018 (subprogram 2; 2017 baseline: 0)

1.1 MOF decrees  
1.2 Ministry of Economic Development and Investments decrees

### Reform Output Areas
2. Government's securities market and money-market infrastructure improved

#### Key Policy Actions
2.1 Number of government securities auctions held by Public Debt Management Department increased to 10 per year by December 2017 (subprogram 1; 2016 baseline: 8 auctions per year)

2.2 Legal amendments for secured interbank lending based on standardized repos approved by

2.1 MOF decree  
2.2 Revised law on government website
<table>
<thead>
<tr>
<th>Results Chain</th>
<th>Performance Indicators with Targets and Baselines</th>
<th>Data Sources and Reporting Mechanisms</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.3 CBA becomes a member of ICMA, and approved the introduction for 2018 in Armenia (subprogram 2; 2017 baseline: not a member)</td>
<td>Parliament by December 2017 (subprogram 1; 2016 baseline: not approved)</td>
<td>2.3 ICMA website</td>
<td>The new government and Parliament do not prioritize these reforms.</td>
</tr>
<tr>
<td>3. Base of instruments and investors broadened, and corporate transparency enhanced</td>
<td>3.1. Law for Residential Mortgage Lending and amendments to the Covered Bonds Law submitted to the government for its consideration by December 2017 (subprogram 1; 2016 baseline: none)</td>
<td>3.1. CBA decree</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3.2. Legislative reforms proposals, which make it mandatory for large firms to be externally audited, submitted to Parliament by December 2018 (subprogram 2; 2017 baseline: none)</td>
<td>3.2. Government decree</td>
<td></td>
</tr>
</tbody>
</table>

**Budget Support**

Asian Development Bank: $50,000,000 (regular ordinary capital resources loan)


# LIST OF LINKED DOCUMENTS

http://www.adb.org/Documents/RRPs/?id=51060-003-3

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<td>Contribution to the ADB Results Framework</td>
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<td>Development Coordination</td>
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<td>5</td>
<td>Country Economic Indicators</td>
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<tr>
<td>6</td>
<td>International Monetary Fund Assessment Letter</td>
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<tr>
<td>7</td>
<td>Summary Poverty Reduction and Social Strategy</td>
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<td>8</td>
<td>Risk Assessment and Risk Management Plan</td>
</tr>
<tr>
<td>9</td>
<td>List of Ineligible Items</td>
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</tbody>
</table>

## Supplementary Documents

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<th>Description</th>
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<td>11</td>
<td>Post-Program Engagement Framework</td>
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<td>12</td>
<td>Reform Implementation Challenges and Adjustments to Subprogram 2</td>
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</table>
DEVELOPMENT POLICY LETTER

MINISTRY OF FINANCE OF THE
REPUBLIC OF ARMENIA
MINISTER
MINISTERSTVO FINANSOV
REPUBLICI ARMEYIA
MINISTR

To: Mr. Takehiko Nakao
President of Asian Development Bank
Manila, Philippines

Subject: Public Efficiency and Financial Markets Program – Subprogram 2

Dear President Nakao,

On behalf of the Government of the Republic of Armenia (RA) we would like to express our appreciation for the support of the Asian Development Bank (ADB) towards our reform efforts and development agenda.

This communication serves to outline Armenia’s recent economic developments and highlights our continuing commitment to reforms for reducing macro-financial vulnerabilities and raising our economic growth prospects. The Public Efficiency and Financial Markets Reform Program (PEFMRP) represents an important reform effort to further strengthen fiscal sustainability and deepen financial markets, through improvements in the areas of public debt and fiscal risk management, and efforts to develop financial and capital markets.

A. Armenia’s Economic Performance and Overall Reform Outlook

Since its independence, Armenia has made significant strides in enhancing macroeconomic stability. Growth has been satisfactory with inflation under control and the fiscal situation broadly well managed. Policy and structural government reforms helped keeping macroeconomic sustainability and the outlook for recovery is optimistic. Positive growth trends picked up in 2017 recording the highest growth in the latest decade. Improvements were due to favourable developments in domestic and external environment. However, our reality is not without risks and challenges: high-dollarization, high-fiscal exposure to currency risks, high public and banking dependence on foreign currency-denominated finance and public debt constraints to public investment. Other structural challenges include an important degree of vulnerability to external shocks, due to our economy’s decreasing but still significant dependency on remittances, as well as commodity prices, and limited export diversification. Poverty and high unemployment are also pressing issues.
The new Government of RA led by Prime Minister Nikol Pashinyan has stepped up its fight against corruption by ensuring an effective enforcement of laws and giving institutions the resources they need to tackle it, and remains fully committed to promoting competition and reinforcing macroeconomic stability through fiscal consolidation (in line with the new fiscal policy rule).

B. Development Strategy and Current Reform Agenda

In 2014, we approved a new Armenia Development Strategy 2025 to guide our efforts to ensure sustainable growth. The main goal of the Armenia Development Strategy is to create more high-productivity jobs through reforms including: (i) improving the business environment; (ii) deepening the financial sector and (iii) modernizing public administration and governance, including efficiency and transparency in decision-making.

Aligned with the Armenia Development Strategy, PEFMP is an important program of the Government of RA with strong ownership underpinning the policy dialogue and the technical assistance efforts that implementing agencies and the ADB team have been pursuing to devise reform solutions. It will over time: (i) strengthen Armenia’s public debt management; (ii) enhance fiscal transparency regarding fiscal risks in general, and in private participation in addressing public investment needs in particular; (iii) improve the efficiency of the government securities market, so that Armenia can rely on domestic borrowing to finance government activities and investment; (iv) increase the depth of financial markets in Armenia—prioritizing the development on money (interbank) markets and systemic liquidity management—to help fiscal sustainability; and (v) strengthen resilience in the country’s financial system and the private sector’s access to local finance, and enhance corporate transparency to improve the investment climate and increase private investment in the economy.

The Ministry of Finance and Central Bank of Armenia continue the reforms designed to deepen the government securities market and money markets including: an approved time-bound roadmap for the development of capital and financial markets covering money-markets, public debt securities and corporate debt and equity markets; continues efforts to promote the Global Master Repo Agreement (GMRA) in order to have a better access to the international financial markets.

C. Public Efficiency and Financial Markets Program (PEFMP)

C.1. Debt and Fiscal Risk Management

The government has been reforming its public financial management (PFM) system. With the introduction of the PFM Strategy in 2010, management of government spending has been decentralized under a new programme-based budgeting framework which aims to underpin the implementation of more efficient public service delivery towards the end goal of a more effective, accountable, and transparent expenditure system. Though this will be a significant achievement, the public expenditure and financial accountability assessment identified weaknesses in fiscal discipline, allocation of resources, and cost-effective service delivery.
In addressing these areas, the Government is committed to fiscal consolidation to meet the new fiscal policy rule and rein in public debt. We have through PEFMP strengthened public debt and fiscal risk management policies to ensure fiscal discipline and transparency. Under Subprogram 2, the Ministry of Finance (MOF) has continued efforts to strengthen its institutional and regulatory capacity to manage key outstanding and emerging fiscal risks in a comprehensive fashion. With a new fiscal rule approved in December 2017 (which benefited from TA support from the International Monetary Fund) PEFMP has supported: (i) the expanded role of PDMD including analysis and vetting of requests for issuance of Government guarantees; (ii) centralize the analysis and reporting of all Government guarantees through the MTDS; and (iii) publication of information on Government guarantees in periodic statistical bulletins regarding Government debt. To compliment these reforms, legislative amendments were approved by Parliament assigning MOF as the government ministry in charge of signing of all loan agreements, regardless of modality alongside approval of a manual to guide the analysis and negotiations of external borrowing.

An ADB TA has further supported these reforms through a new Medium-Term Debt Strategy (2019-2021) providing an effective platform to reduce exposure to currency-risks and develop the local currency sovereign debt market. Importantly, the MTDS has contributed to the dialogue on the Government debt management strategy to inform the crucial trade-offs required for the RA going forward.

These reforms have been supported by the implementation of the fiscal risk management roadmap committed under Subprogram 1, including the approval of an integrated risk management framework. The fiscal framework is also undergoing improvements. The authorities are taking steps to optimize planning of investment projects funded by international donor organizations. Prioritization of these projects is being carried out to ensure that loan absorption dynamics are consistent with the deficit and Government debt reduction targets. The authorities initiated a revision of the fiscal rule to take into account implementation characteristics of donor-financed projects, mitigate the pro-cyclical bias and allow for more flexibility in periods of external shocks. This has been complemented by ADB as well as other IFIs by enhancing the risk management capacity for Public Private Partnerships supported both through a proposed legal framework and institutional ecosystem.

In a sign of strong economic policy commitment to the financial reform agenda, the Government also confirmed in June 2018 the implementation of the new mandatory capitalization system for pension contributions and investments within the parameters of fiscal sustainability.

C.2. Financial and Capital Markets

We recognize that well-functioning financial and capital markets are essential for economic growth and job creation. We recognize that macroeconomic and financial risks associated with high-dollarization, high-fiscal exposure to currency risks, high public and banking dependence (foreign currency-denominated), finance and public debt constraints to public investment. Through implementing reforms supported under PEFMP supported by the ADB we seek to reinforce macroeconomic stability and uncover new sources of stable and shared growth anchored in a well-integrated and competitive economy.
Under Subprogram 1, the RA advanced the policy dialogue related to the need to gradually reduce foreign currency risk exposure in public debt issuance by focusing on domestic debt issuance in the medium-term public debt strategy. Specifically, (i) establishment of instruments for a more market-friendly public debt issuance program alongside the implementation of institutional and technological infrastructure; (ii) consolidation of debt issuances and increased frequency of debt auctions through the Regular Treasury Bill Program (RTBP) and; (iii) legal framework for secured interbank transactions by the passage of a number of key legal amendments.

Under Subprogram 2 and with ADB support, MOF and Central Bank of Armenia (CBA) continued deepening the reforms underpinning government securities market and money markets including: (i) an approved time-bound roadmap for the development of capital and financial markets covering money-markets, public debt securities and corporate debt and equity securities; and (ii) continues efforts to promote the GMRA.

C.3. Enhanced Corporate Transparency

To encourage more active investors and issuers to participate in Armenia’s capital markets, the Government of RA has continued to strengthen the legal and regulatory framework, alongside moving towards institutionalizing audit reforms for corporate transparency. Legal instruments have been approved including the Residential Mortgage Lending Law alongside Amendments to the Covered Bond Law and Law on Asset Securitization and Asset-Backed Securities. Amendments to the insolvency framework and legal proposals to improve bankruptcy processes and protect the right of creditors are being deliberated.

To establish stronger cooperate transparency practices in Armenia, a public oversight board with regulatory and oversight functions will be established under a myriad of audit reforms proposed to Parliament. As these will be supported under the post-program engagement framework, these reforms when adopted will enhance the standardized sharing and disclosure of financial information and transparency in Armenia.

D. Post-Program Engagement Framework

We have been working closely with ADB to implement these reform priorities. We recognize these objectives require continuity and multi-year sequence of reform efforts going forward. We therefore have committed to the post-program engagement framework for PEFMP with the ADB that will provide an opportunity to lock-in a reform effort to jointly achieve the “next phase” of associated reform targets (i.e. reforms that are either a natural sequence or actually necessary for PEFMP reforms to come to full fruition in terms of impact on the ground).

Specifically, across all three reform areas:

Reform Area 1 - Adoption of an integrated fiscal risk management framework, in formal coordination with line ministries, complemented by deepening the capacity of PDMD.

Reform Area 2 - Deepen CBAs liquidity management and MOFs cash management and treasury capacity; enhancement to market-making and primary dealer frameworks and
trading reporting frameworks to enhance price-discovery and turnover liquidity; modernizing financial market infrastructure in terms of automated trading support platforms and implementation of tri-party collateral management system; and full implementation by CEA of the GMRA roadmap.

Reform Area 3: Completion of systematic review of tax impediments and assessment of options to increase transparency in the public procurement system and incentivize external auditing by introducing mandatory audits for all public procurement bidders and implementation. Developing the capacity of corresponding bodies prescribed by the new legislation on accounting and audit, and regulatory work to implement the new accounting and auditing legal framework will complement this.

E. Our Request to ADB

We remain committed to the implementation of our broad and ambitious structural reform agenda and are confident that the reform initiatives supported under this program constitute important prerequisites for long-term sustainable and inclusive growth.

The program will help us:

(i) strengthen public debt and financial risks in the economy;
(ii) increase money market liquidity and financial market transparency, by deepening the government securities market and improving the money market infrastructure; and
(iii) foster the development of a vibrant private sector by enhancing corporate transparency and developing and strengthening legislative and regulatory framework.

We requested ADB provide a loan from its Ordinary Capital Resources in the amount of $90 million equivalent. Of this amount, we would request $50 million equivalent be disbursed upon effectiveness of the Loan Agreement and after completion of the Subprogram 2 Policy actions.

We would like to thank ADB for working closely with the RA Government of Armenia in developing this program and look forward to continuing the fruitful cooperation.

Sincerely Yours,

[Signature]

Atom Janjughazyan
# POLICY MATRIX

<table>
<thead>
<tr>
<th>Specific Policy Objectives</th>
<th>Policy Actions Subprogram 1 (by October 2017)</th>
<th>Policy Actions Subprogram 2 Proposed (by August 2018)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reform Outputs Area 1: Public debt and fiscal risk management policies strengthened</td>
<td>1. MOF strengthens the PDMD by: (i) introducing procedures on (a) issuance of Eurobonds; (b) payment procedures for the external and domestic debt, and (c) mapping links between PDMD's databases, the analytical tools used, and the reporting requirements; (ii) engaging PDMD front office in the end to end external borrowing process and negotiations.</td>
<td>1. MOF: (i) expands PDMD’s role in loan contracting and guarantee issuance processes within MOF (and implements needed changes); (ii) centralizes analysis and reporting of existing government debt within PDMD to ensure a holistic and consistent approach within the context of the MTDS.</td>
</tr>
<tr>
<td></td>
<td>2. Government approves revisions to the regulatory framework for government securities to allow reopening of T-bill issuance and improve the settlement system.</td>
<td>2. MOF approves a manual for contracting and negotiating external loans (which includes a framework for evaluating the cost-effectiveness of alternative forms of external borrowing and guarantees, i.e. the cost-at-risk analysis, and to check consistency with the MTDS process).</td>
</tr>
<tr>
<td></td>
<td>3. MOF issues a decree that a Debt Sustainability Analysis will be undertaken each year and be published annually.</td>
<td>3. Parliament approves legislative amendments to strengthen the role of MOF in the external lending process.</td>
</tr>
<tr>
<td></td>
<td>4. MOF issues a Decree approving an action plan to: (i) enhance PDMD's risk management capacity by considering the staff, systems and financial resources that would be required to identify and quantify risks associated with public debt management; and (ii) provide monitoring and regular reporting on PDMD risks.</td>
<td>4. MOF publishes the 2017 annual Debt Sustainability Analysis on its website.</td>
</tr>
<tr>
<td></td>
<td>5. MOF increases security and backup of all debt records to prevent unauthorized changes to debt records by appointing a systems administrator for DMFAS and approving rules and procedures for: (i) access to DMFAS system; (ii) monitoring</td>
<td>5. MOF adopts a formal Operational Risk Management framework for PDMD which includes a risk matrix that (i) identifies risks and the impact of those risks on outputs and assesses financial loss and the budget impact, and (ii) provide monitoring and regular reporting on PDMD risks.</td>
</tr>
<tr>
<td></td>
<td>6. MOF approves a Business Continuity Plan which includes establishing a secure offsite premise, and backup of records on the debt management and financial analysis system and spreadsheets with a capacity building plan.</td>
<td>6. MOF approves a Business Continuity Plan which includes establishing a secure offsite premise, and backup of records on the debt management and financial analysis system and spreadsheets with a capacity building plan.</td>
</tr>
<tr>
<td>Specific Policy Objectives</td>
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</tr>
<tr>
<td>----------------------------</td>
<td>-----------------------------------------------</td>
<td>-----------------------------------------------------</td>
</tr>
<tr>
<td></td>
<td>system security; and (iii) regular backup arrangements.</td>
<td>7. MOF approves and publishes a framework for vetting, monitoring and evaluating budgetary lending operations and guarantees. (7[b]) Establishment of a Fiscal Risks Assessment Department in MOF to elevate the institutional standing of the function and promote integration of fiscal risks analysis and data/information flows across MOF.</td>
</tr>
<tr>
<td>Strengthening the monitoring and management of fiscal risks</td>
<td>6. MOF submits to ADB a roadmap for the division of fiscal risk management responsibilities to cover—budgetary lending, concessions, PPPs including contingent liabilities, guarantees and other; as well as the different functions of risk management (e.g. vetting, risk monitoring and reporting) to be implemented during subprogram 2.</td>
<td>8. To improve transparency on fiscal risks, MOF publishes a summary of budgetary lending operations under the recently approved budgetary lending framework in the 2019-2021 MTEF.</td>
</tr>
<tr>
<td>Establishing a fiscally-responsible, development relevant PPP ecosystem</td>
<td>7. Government approves a PPP policy (paper) that defines the policy approaches to legislative, regulatory and institutional frameworks to: (i) govern the identification, vetting, and preparation of PPPs based on risk profiling, fiscal affordability, and financial viability; (ii) govern unsolicited proposals; (iii) monitor the performance of each PPP.</td>
<td>9. Government submits to the Parliament the draft PPP law for approval, based on the PPP Policy (paper).a</td>
</tr>
<tr>
<td></td>
<td>8. The PPP Policy or a subsequent government decision to determine the resources that are required for the functions based on PPP policy (irrespective of where it will be located) to be adequately operated under the prospective framework.</td>
<td>10. Standard methodologies, including guidelines and/or manuals to cover (i) the identification, vetting, and preparation of PPPs based on risk profiling, fiscal affordability, and financial viability; and (ii) monitoring performance of each PPP; This includes implementing value for money tests in the vetting process; and (iv) sector specific public sector comparator benchmarks are introduced.</td>
</tr>
<tr>
<td></td>
<td>9. Ministry of Economy and Investment publish, in its website, standard information about all past PPPs including concessions transactions.</td>
<td></td>
</tr>
<tr>
<td>Specific Policy Objectives</td>
<td>Policy Actions Subprogram 1 (by October 2017)</td>
<td>Policy Actions Subprogram 2 Proposed (by August 2018)</td>
</tr>
<tr>
<td>---------------------------</td>
<td>---------------------------------------------</td>
<td>--------------------------------------------------</td>
</tr>
<tr>
<td>Improving the public’s access to government retail debt</td>
<td>11. MOF establishes an electronic sales system for retail debt via the internet in line with international good practices.</td>
<td>12. Monthly reporting of retail debt issuance and redemption is implemented and available on the MOF website.</td>
</tr>
<tr>
<td>Expanding the domestic debt program and options to reduce foreign currency risk exposure in public debt</td>
<td>12. PDMD establish a Working Group with terms of reference to: (i) investigate the costs and benefits of accelerating the transition from external debt issuance to domestic debt issuance; (ii) identify a framework for this analysis to be undertaken regularly within the MTDS framework; and (iii) investigate how the transition to domestic debt may be structured to minimize foreign exchange volatility.</td>
<td>13. Working Group develops the process about: (i) how the analysis should be undertaken within the MTDS framework; (ii) how the findings will be reported and published in the MTDS. PDMD, in consultation with CBA, produces an internal paper on the potential exchange rate impact and mitigation strategy when external debt is repaid and funded domestically.</td>
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<td>Improving price-discovery and yield benchmarks in the government securities market</td>
<td>13. MOF approves a revised framework for primary dealers (PDs) that includes; (i) market making responsibilities with a maximum ceiling on bid-ask spreads; (ii) evaluation criteria orientated around an appointment process that reflects a PD’s contribution to developing the government secondary market and (iii) recognition of the need to rotate PDs with other market participants.</td>
<td>14. MOF implements the new governing framework for PDs.</td>
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<td>Improving liquidity in the Money Market</td>
<td>14. MOF: (i) increase the bond issuance ceiling to AMD200 billion; and (ii) consult investors on increasing the domestic bond auctions from 8 times a year to monthly to provide more price discovery around the yield curve and increased access to the supply of bonds and distribute the interest rate risk evenly over 12 months.</td>
<td>15. MOF implements the RTBP, reviews its implementation (e.g. whether maturities and volumes have been consistent with the feedback</td>
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<td>15. MOF supports further development of the short-term money market by (i) initiating amendments in the regulations to organize reopening for T-bills to</td>
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**Reform Outputs Area 2: Government’s securities market and money-market infrastructure improved.**
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<td>Consolidate the issuance to enhance liquidity: and (ii) develop and start a Regular Treasury Bill Program (RTBP). (Under a RTBP 91, 182, 273 and 365 bills are issued in regular fixed volumes which provide investors with a certain supply of short term T-Bills in sufficient volumes to meet demand for a short-term low risk liquid instrument and support the secondary market.)</td>
<td>from the market and aligned to monetary and debt management policies and the need to develop a liquid money market), and communicates the conclusions to market participants.</td>
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<td>Enhancing market transparency and predictability in public debt management</td>
<td>16. MOF publishes: (i) the Treasury Securities annual borrowing plan and updates on its website; and (ii) a clear policy on its bond buyback and switch operation to add predictability to its debt management for investors.</td>
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<td>Enhancing money market infrastructure and secured transactions</td>
<td>16. Parliament approves a new legal framework and necessary amendments to existing laws to enable the use of derivatives (ISDA agreement) and secured interbank lending based on standardized repos (using the GMRA; triparty repos).</td>
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<td>17. CBA becomes a member of the International Capital Markets Association, and approves GMRA introduction for 2018 in Armenia with the following key steps:</td>
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<td>(i) CBA shall review its repo and reverse repo system and perform an analysis to determine whether there are any obstacles to using GMRA (Gap analysis) for its repo transactions, as well as any obstacles for banks. The gap analysis shall be completed by the end of August. In case no serious obstacles are determined, CBA commits to use GMRA for its local repo transactions. (CBA shall have a reasonable time period for adapting its system to GMRA);</td>
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<td>(ii) CBA undertakes to assess the current regulatory treatment for the contracts in use in interbank repo transactions in Armenia (both in terms of capital charge, and liquidity treatment) and determines if they contain any issues for GMRA implementation in the interbank repo market (e.g. unjustified equal treatment of GMRA and repo agreements currently used by banks).</td>
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<td>CBA communicates to all supervisees, before end-August 2018, a plan to remove any found bias against the adoption of GMRA; and (iii) CBA communicates to market participants the GMRA training plan and topics that will facilitate GMRA adoption.</td>
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<td>17. CBA: (i) implement regulations and IT framework for unified repository of derivatives (repos) and (ii) facilitate establishment of Clearstream Link for issuance of local currency bonds.</td>
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<td>18. CBA and Central Depository of Armenia coordinate to implement the Repo project management plan (developed under subprogram 1 to e.g. assess the possible institutional design and required resources for a new IT system solution for triparty repos with NASDAQ OMX), to assess if a cost effective and affordable option can be found to operationalize triparty repos (in order to enhance money market liquidity).</td>
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<td>Improving Cash/ Liquidity management and forecasting, in support of CBA’s systemic liquidity management and public debt management.</td>
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<td>18. NASDAQ OMX is requested by MOF to offer bond switch auctions within 2018, to facilitate consolidation of outstanding issues based on the CBA and MOF agreement and MOF issued terms of reference.</td>
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<td>19. MOF transfer auctions to the new NASDAQ OMX platform for primary auctions of government securities.</td>
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<td>Reform Outputs Area 3: Base of instruments and investors broadened, and corporate transparency enhanced</td>
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<td>20. MOF; (i) reviews the source and analysis of government cash flows to improve the accuracy of its forecast projections; and (ii) develops a cash management framework using T-bills, buybacks, switches and other instruments which is coordinated with the CBA’s liquidity management function.</td>
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<td>Developing the legal framework for new types of securities to broaden the investor base</td>
<td>20. To strengthen the legal basis of the mortgage bonds market, the CBA submits to Government: (i) a new law for Residential Mortgage Lending, to strengthen consumer protection, and (ii)</td>
<td>21. Parliament approves: (i) a new law for Residential Mortgage Lending (consumer protection); and (ii) amendments to the Covered (Mortgage) Bonds Law.</td>
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<td>amendments to the Covered Bonds Law to enable multi issuer facilities.</td>
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<td>22. To strengthen the legal basis for asset securitization and asset-backed securities, Parliament approves a set of proposed amendments to the Securitization Law to clarify the fund nature of special purpose vehicles, enable synthetic securitization, and enable the issuance of securities before a loan-book purchase.</td>
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<td>Developing legal framework for private equity to increase the volume of resource mobilization</td>
<td>21. CBA makes regulatory changes to enable private equity and other investment fund vehicles to have their subscribed capital denominated in USD.</td>
<td>23. Cabinet approves legislative proposals to introduce modern elements of corporate law, such as (i) the concept of shareholder’s agreement (as an amendment to the JSC Law); and (ii) protection of minority investors’ rights (as amendments to the JSC Law, the Law on Limited Liability Companies, and Law on Securities Market)</td>
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<td>Strengthening corporate transparency requirements and the financial information practices, to encourage the participation of institutional investors in private debt and equity markets</td>
<td>22. MOF submits to the Government a private sector accounting and External Audit Development Strategy Concept that establishes actions to progressively mainstream external audit requirements in the Armenian private sector.</td>
<td>24. Cabinet approves amendment proposals to the Laws on Accounting and Audit, and a new proposed Law on Regulation and Public Oversight of Audit and Accounting to delegate some regulatory functions to a POB and the prospective Chamber of Accountants and Auditors of Armenia.</td>
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<td>23. MOF submits to the Government legislation regulating private sector accounting and setting requirements for companies that are subject to statutory audit based on the amount of annual turnover, the amount of assets and the average number of employees.</td>
<td>25. Cabinet approves legislation proposals including mandatory audits and establishment of the POB by MOF and initiates public outreach discussions on (i) delegation of oversight role on audit to the POB and (ii) mandatory audits and drafts sub legislations and relevant regulations to implement the new accounting and auditing legal framework.</td>
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<td>24. MOF submits to the Government amendments to the law on accounting and the law on auditing and introduce a new Law on the Regulation and Public Oversight of Audit and Accounting to enhance the quality of corporate financial reporting factoring in the recommendations of the Private Sector</td>
<td>26. MOF implements a statement of objections to ensure that all relevant regulations for the implementation of the new accounting and auditing legal framework are developed in accordance with the respective law and the MOU.</td>
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<td>Accounting and External Audit Development Strategy Concept.</td>
<td>25. MOF signs a MOU with the Association of Accountants and Auditors of Armenia (AAAA) on the way forward for a new division of responsibilities in the regulation of Audit in line with international good practices.</td>
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a The current legal proposal has been the result of intense policy dialogue, which ADB TA supported closely, and also reflects policy choices that ADB has explicitly endorsed (as documented from time to time) as being in line with the objectives of the PEFMP and its policy matrix. This has now included the policy preference, expressed by the authorities, to rule out ‘Unsolicited Proposals’, as the most effective way of governing the implicit challenges and addressing its risks.

b By eliminating, in the draft PPP Law, the possibility of unsolicited proposals and procurement with sole bidders, there is no need for guidelines/manuals.