

PART 2.

THE ECONOMIC SITUATION, DEVELOPMENTS, PROGRAMME OBJECTIVES, BENCHMARKS AND REQUIRED ACTIONS

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Executive Summary

In the period following the signing of the Partnership and Cooperation Agreement (PCA) with the EU, the Armenian economy continued to grow at fast rates as cooperation with EU Member-States increasingly expanded. The European Neighbourhood Policy (ENP) has opened new horizons for cooperation. In August 2003, the Government of Armenia approved the Poverty Reduction Strategy Programme (PRSP) and proceeded with the implementation thereof. Economic analyses undertaken within the auspices of this programme warrant a positive assessment of the implementation course of the PRSP and allow declaring its course to be congruent with the PCA National Programme objectives.

Within the framework of the National Programme, the Government of Armenia will seek to achieve the following priority objectives:

- In view of Armenia's economic growth rates in 2003-2005, which manifestly exceeded the projected rates as provided by PRSP, as well as the anticipated inflow of additional resources within the framework of the Millennium Challenges Account (MCA), the Asian Development Bank and the Lincy Foundation, which were higher than projected growth in agriculture and construction sectors, the Government of Armenia assesses the economic growth driven by the 2003-2005 PRSP framework as the minimum projected level of economic development and envisages higher rates of real economic growth¹ (given a 3% inflation rate as projected by the PRSP).
- The Government of Armenia will mobilize all available resources (leverage through macroeconomic and fiscal policy, marketing, industrial and other policies) to promote further development of trade and economic relations with the EU in the framework of the PCA and the ENP in an effort to accelerate the course of development. The Government of Armenia plans to boost the EU's share in Armenia's foreign trade turnover to 40% in 2008 as compared with 35.7% in 2004. Obtaining a status of a country with functioning market economy is an important landmark in the framework of cooperation with the EU. The Government launched this process in 2005. In 2006-2008, the Government will also actively seek to forge the required prerequisites for signing a free trade agreement with the EU.

The economic policy measures of the Government of Armenia in 2006-2008 will be aimed at noticeably reducing the gap between Armenia and the new EU Member or Accession States in regard to a number of indicators describing the administrative, business and investment climate.² In this respect, the key priorities of Armenia's economic policy 2006-2008 will be:

- to improve efficiency in the state governance system;
- to take anti-monopoly measures and elimination of barriers to market entry;
- to promote exports of Armenian products and services;
- to maintain and to pool human and physical potential;
- to promote the development of securities market, banking system and non-banking financial institutions.

¹ The Government will elaborate on the country's macroeconomic issues in greater detail in the framework of amending and reviewing the PRSP document at the end of this year.

² The above-mentioned indicators were selected using a mathematical model developed specifically for this purpose. The model was applied to determine the significance of the mentioned indicators for the accession talks between the EU and these countries.

2.1. Introduction

The Government of Armenia has extensively used the experience and methodology of the EU's new Member and Accession States in the process of drafting its National Programme (NP) for the implementation of the Partnership and Cooperation Agreement (PCA) between Armenia and the European Union.

The recent wave of the European Union's (EU) enlargement significantly changed the political and economic geography of the EU borders. As a result, the EU has set a goal to expand economic and political cooperation with neighbouring countries within the European Neighbourhood Policy (ENP) based on commonly shared values. On 14 June 2004, based on the recommendation of the European Commission, the EU Council of Ministers included Armenia, together with the other two South Caucasus countries, in the ENP, thus opening new horizons for Armenian-European economic cooperation and '... offering prospects for closer relations with the EU, including a significant level of economic integration and growing political cooperation'.³

The methodology used in the programme to assess the country's economy and economic policy draws on the Copenhagen criteria that measure the political and economic progress of EU Accession States. The forecasts of the indicators for the Armenian economy and economic development are based on the planned socio-economic and institutional indicators as provided by the Poverty Reduction Strategy Paper approved by the Government Decree No. 994 adopted on 8 August 2003.

The main objective of this Programme is to ensure sufficient progress towards achieving the Copenhagen economic criteria in an effort to cut to a minimum the gap between Armenia and the new EU Member and Accession States. The scoring levels of indicators assigned to these countries in the year when they embarked on EU accession negotiations (1999-2001) are established as a baseline for comparison.

2.2. Armenia's Socio-Economic Development Trends in 1999-2005⁴

Armenia's GDP amounted to about 3.91 billion Euros in 2005, with the population totalling 3,217.6 thousand. Due to opting for a liberal course of reforms from the outset of gaining its independence, today Armenia may be described as one of the most dynamically growing economies among transition economies. At present, the Armenian economy is ranked as the most liberal among the CIS countries. The macroeconomic stability was established in 1996 and has been maintained ever since.⁵

Consistent implementation of reforms and the stable internal political situation have enabled Armenia to make significant progress in making a transition to market economy, specifically in developing the private sector, liberalising prices and foreign economic relations.

³ European Neighbourhood Policy: Armenia (IP/05/237), Brussels, 2 March 2005

⁴ Starting from 1999 when the PCA entered into force.

⁵ EBRD "Transition Report 2005"

Table 1. Key Macroeconomic Trends

Armenia	1999	2000	2001	2002	2003	2004	2005	Average
Real GDP Growth Rate (%)	3.3	5.9	9.6	13.2	14.0	10.1	13.9	9.92
Inflation,								
Yearly average (%)	0.6	-0.8	3.1	1.1	4.7	7.0	0.6	2.30
End of Period (%)	2.0	0.4	2.9	2.0	8.6	2.0	-0.2	2.49
Unemployment								
National definition (%)	11.2	11.7	10.4	10.8	10.1	9.4	8.1	10.27
LFS definition (%)	38.4	35.3	31.2	31.6 (M8)	...	34.12
Consolidated Budget Balance (% of GDP)	-5.4	-4.8	-4.2	-2.5	-1.3	-1.5	-1.82	-3.07
Current Account Balance								
% of GDP	-16.6	-14.6	-9.5	-6.2	-6.8	-4.5	-4.19	-8.91
mIn €	-287.3	-301.1	-221.0	-156.6	-168.7	-130.2	-163.9	-204.1
Total Foreign Debt								
In relation to exports, %	219.4	192.2	169.9	126.4	122.8	119.8	83	147.6
mIn €	786.8	929.2	1010.9	933.9	982.7	950.6	882.2	925.2
Inflowing FDI, Balance of Payments								
% of GDP	5.9	4.8	3.1	4.4	3.8	5.9	5.55	4.8
mIn €	101.7	99.2	73.5	110.7	96.4	170.0	217.1	124.1

Source: Armenian NSS/Armenian Trends statistical appendix and additional calculations.

In the period following 1999, when the PCA Agreement signed between Armenia and the EU entered into force, the Armenian economy has demonstrated high economic growth rates. In 2001, the annual GDP growth totalled 9.6%, and starting from 2002 it has crossed the threshold of 10%. In 2005 Armenia boasts an economic growth rate of 13.9%, i.e. a two-digit economic growth rate has been maintained also during 2005. The services sector had a significant input in ensuring the cited GDP growth with its contribution of 3.7 percentage points, construction contributed 5.4 percentage points, and agriculture's contribution amounted to 2.5 percentage points.

The consolidated budget deficit relative to GDP dropped from 5.4% in 1999 to 1.82% in 2005. In this period, the current account deficit also diminished from 16.6% to 4.19%.

In this timeframe, Armenia succeeded in expanding the scope of its economic relations with the EU. In 2005, Armenia's foreign trade turnover with the EU amounted to 34.8% of the total foreign trade turnover.

As a result of the large-scale privatisation initiated in 1995, most of the state-owned property has already been privatized. The current privatization programme was adopted in 2001. The concomitant gradual cutback of barriers to accessing the market has dramatically improved the business and investment environment and contributed to the growth of the private sector's share.

In the past several years, a significant progress has been made in ensuring improved quality of the business environment. According to the most recent report of the World Bank's "Doing Business -2006" series, as of 2004, Armenia ranked 46-th among 155 countries according to the comprehensive index assessing the ease of doing business, thus steering ahead of all CIS countries and positioning itself on the 6th horizontal among transition economies (after the Baltic States, Slovakia, and the Czech Republic). The cited index is calculated as the ranking on the simple average of country percentile rankings on each of the following indices:

- Market accessibility (starting-a-new-business) index: ranks 41st or 6th among transition economies (after Romania, Russia, Kazakhstan, Serbia and Lithuania);
- Ease of obtaining licences (dealing with licenses) index: ranks 55th on the complete list, first among the CIS countries and the 6th among all transition economies (after Estonia, Lithuania, Latvia and Slovenia)
- Hiring and firing index: ranks 78th or 11th among transition economies;
- Index for registering property: ranks 9th and 3rd among transition economies (after Lithuania and Slovakia);
- Index for getting credit⁶: ranks 78th or 19th among transition economies and 5th among CIS countries;
- Index for protecting investors: Armenia did not qualify for this ranking due to the fact that by and large no securities market exists in the economy;
- Index for paying taxes⁷: ranked 147th among 154 countries, from CIS countries, Armenia's ranking compared favourably only with those of Belarus and Ukraine;
- Index for trading across borders: ranked 82nd on the general list and 15th among transition economies, falling behind all new EU Member and Accession States, as well as Belarus, Russia, Ukraine and Moldova;
- Index for enforcing contracts: ranked 36th on the general list, 6th among transition economies, and was recognised to be in the lead among CIS countries;
- Index for closing a business: ranked 39th on the general list, 4th among transition economies and the first among CIS countries.

The cited rankings directly outline the existing major obstacles impeding the development of the economic system and point to the priorities of future (third generation) micro-level economic reforms which essentially correspond to the priorities for improved business environment spelled out in the PRSP, specifically reduction and simplification of the list of and procedures entailed by licenses, clearly defined and simplified relations among the employer, the employee and the state, simplified formalities for imports, significantly reduced administrative burden for customs formalities, strict enforcement of the customs legislation and more clearly defined procedures for reimbursement of VAT to exporters.

As the indicators cited above show, the main barriers to Armenia's economic development and improved efficiency of state governance remain the weak institutional capacity of the tax collection system and the insufficient role of the financial system in financing the economy.

Underdevelopment of the securities market, insurance and non-banking financial institutions remain as weak points of the financial system. Judging from the presence of similar challenges in other transition economies, it may be concluded that addressing this set of issues will require a relatively longer period of time. The Government of Armenia will also focus its attention on promoting the development of this sector of the economy in the future.

The high economic growth rates in the recent years were the first steps that brought Armenia closer to the European living standards, however the gap between the indicators for per capita GDP still remains formidable. Based on the purchasing power parity in 2004, Armenia's per capita GDP merely constitutes 16%⁸ of the average figure for the EU Member States.

⁶ The index for the ease of getting credit explores the role of creditor rights and credit information registries in expanding access to credit.

⁷ This indicator represents a sum and records the number of taxes paid or withheld, the associated administrative burden, as well as the ratio of collected taxes and gross profit.

⁸ WB data and additional calculations

Table 2. 2004-2005 Macroeconomic Indicators

Indicator	2004	2005
Population (thousand people)	3,214	3,217.6
Per Capita GDP		
PPP, USD	4,221	5,767*
As compared with the EU average, %	16.0	21.8**
Agriculture's share ^a		
In total added value, %	22.7	18.8
In employment, %	46.9 ^b	...
Equity gross cumulative share in GDP structure, %	24.7	28.3
Total external debt to GDP, %	33.3	22.6
Share of exports in GDP, %	27.7	27.2
Cumulative FDI, %		
mIn €	810.2	1023.7
Per capita €	252.1	318.1
Unemployment ^c (to labour, %)	9.6	8.1

* Based on 2004 WB data, see: World Bank Report 2006, Table 1, 2005

** In regard to EU 2004 average

^a Includes agriculture, hunting, forestry and fishing.

^b As of August.

^c The cited indicator is based on the Armenian national definition.

Source: Armenian NSS/Statistical Appendix of the *Armenian Trends*, "World Development Indicators" Database (WB) and follow-up calculations.

2.2.1. The Socio-Economic Reforms by Individual Sectors

Economic Growth

Armenia has undergone a significant economic progress in 1994-2005 due to a consistent average annual economic growth rate of 8.2%, which qualified for the highest indicator among all transition economies. In 2001-2005 the economic growth rate has considerably grown and the annual average rate amounted to 12.1%. In 2005 Armenia has exceeded the 1990 indicator by 20.3% (as compared with 1994 – 2.43 times). Armenia's GDP in 2005 amounted to 113.7% of the corresponding indicator for 1989. In 2005, 18.8% of the GDP was generated in the agricultural sector, 18.7% in the industrial sector and 21.6% in the construction sector. The nominal per capita GDP amounted to 1,214.0 Euros in 2005.

Macroeconomic Stability

Armenia has been enjoying macroeconomic stability since 1996 when it successfully suppressed the inflation dynamics stemming from the introduction of the national currency in 1993. The average annual CPI growth rate since 1996 has come to 6.2%. This indicator has averaged 2.6% ever since the PCA entered into force (1999-2004). Based on the average quarterly indicators for the period from July 1999 to June 2005 inclusive, the exchange rate has averaged 569.5 AMD per Euro⁹.

Reform of the Fiscal Sector

In 1999-2006, the consolidated budget deficit has demonstrated a steady downward trend due to improved tax collection and proper budgetary expenditure planning. However, the tax revenues growth rates have been lagging behind economic growth rates in this period. In 1999, budget revenues made up 15.6% of the GDP, following which they dropped below the threshold of 15% by 2005 and down to 13.6% in 2005. A considerable gap is still present between actual

⁹ Additional calculations based on the Armenian NSS data.

and potential tax revenues. As of 2005, 60.9% of tax revenues came from indirect taxes and only 24% accrued from income and profit tax. The share of taxes levied on property did not exceed the threshold of 3% in 1999-2004, totalling 2.8% in 2004. The Government of Armenia views the improved level of revenues as an important dual application tool ensuring high economic growth rates and improved efficiency and effectiveness of the social policy pursued.

Monetary System

By introducing the Armenian national currency (the Armenian dram, AMD), the Central Bank of Armenia adopted a floating exchange rate policy. Ever since the PCA entered into force, no deviations from the established policy have taken place. In 1993-2003, both the nominal and actual effective AMD exchange rates have demonstrated a gradual depreciation trend. Like in a number of other countries, the national currency embarked on an appreciation dynamic, which is largely conditioned by external factors.

Labour Market and the Social Situation

Extensive emigration since the 1990s brought about changes in the structure of the labour market and diminished human resources. According to the NSS of Armenia, the country's labour force (economically active population) totalled 1,203.3 thousand people in 2005. As of 2005, the official unemployment rate makes up 8.1%. The unemployment rates are relatively high in Shirak, Syunik, and Lori marzes (as of 2005, 17.5%, 17.7% and 17.2% respectively¹⁰). At present, the small business and agriculture sectors account for about 70% of the employed labour¹¹. Based on the LFS definition, the unemployment level is much higher: as of August 2004, it was estimated to be as high as 31.6%.

Due to consistently high economic growth rates, the real growth of the average monthly salary in 2005 was 2.2 times more than the same indicator of 1999. The average salary in Armenia in 2005 was 52,000 AMD (or 91.2 EUR).

The economic upheaval also facilitated some progress in combating poverty. While in 1998-1999 the population below the poverty line was estimated to be 56%, in 2003 it dropped down to 42.9%, and in 2004 it diminished to 38%¹². Progress has also been made in terms of income distribution. The Gini coefficient by income, which, as of 2001, was equal to 0.528 in Armenia, dropped down to 0.387¹³ in 2004.

Development of small and medium enterprises is projected to be the key factor driving stabilisation of employment and further growth.

Education and Science

The country's population is reasonably well-educated. As of 2002, the literacy rate was 99.4%¹⁴. The education system has preschool, elementary, basic, secondary, higher professional and post-graduate levels, whereas the basic level is compulsory. Public education is free in Armenia. The share of children attending elementary school in the corresponding age group constituted 90% in 2004 and the corresponding indicator for the secondary school was 87.4%¹⁵. The state and community budget expenditures in the education sector in 2000-2003 dropped from 2.9% to 2.2% of the GDP, amounting to 2.6%¹⁶ in 2004. At the Bergen Summit of Education Ministers held in May 2005, Armenia joined the "Bologna Process" launched by the 1999 Bologna Declaration in an effort to fully integrate with the European system of higher education.

¹⁰ "Food Security and Poverty January-March 2005", NSS.

¹¹ Commission staff working paper annex to "European Neighbourhood Policy" Country Report for Armenia.

¹² RoA Ministry of Finance and Economy, Activity Report 2004. The preliminary estimate has been cited for 2004.

¹³ "Socio-economic situation of Armenia in January-September 2005" NSS, Armenia. According to the new methodology of the World Bank, which was applied based on 2004 sample studies, the poverty level in Armenia was 34.6% in 2004. See Armenia's Social Situation and Poverty, Yerevan, 2006

¹⁴ "Socio-economic situation of Armenia in January-September 2005", NSS, Armenia.

¹⁵ Food Security and Poverty January-March 2005, NSS, Armenia.

¹⁶ Food Security and Poverty January-March 2005, NSS, Armenia.

Public expenditures on research are estimated to be 0.9% of GDP¹⁷ and are projected to grow in tandem with the implementation of comprehensive reforms in the higher professional education and science sectors in 2006-2008.

Healthcare

Institutions providing public healthcare services are funded by the state. The present state of the insurance system does not allow providing healthcare insurance services to the population. There is a surplus of doctors in the healthcare system and the demand for medical services provided by hospitals is not met. In 2003, the average annual occupancy per hospital bed was 169 days¹⁸. Within the framework of the PRSP healthcare reform, the Government of Armenia plans to improve the quality and healthcare services and their accessibility for the public. The share of state and community budget expenditures in the healthcare sector in 2004 was 1.3% of GDP¹⁹.

2.2.2. Course of Structural Reforms

Liberalization of Economy

Armenia has attained significant achievements due to liberalising its economy, as a result of which, according to the 2004-2005 Economic Freedom Index²⁰, Armenia is in the lead among the CIS countries and has come in fourth among all transition economies.

The currency market is currently regulated by the Law of the Republic of Armenia “On Currency Regulation and Oversight” adopted in October 2004. Armenia has been employing a free-floating exchange rate regime²¹ since the introduction of its national currency in 1993. No limitations are applied on current account transactions, transactions involving movement of capital, transport, delivery and importing of currency, as well as opening foreign currency bank accounts in Armenia and in foreign non-resident banks. According to the EBRD foreign trade and currency liberalisation index, Armenia has scored the highest possible number of points, i.e. 4.3²² (this figure is comparable with the scores of developed countries).

Basically no price limitations and oversight measures have been applied since 1995. Several domestic prices are an exception, i.e. prices in irrigation, electricity, hot water, gas, heating, urban transport using electric power, sewerage, garbage removal and internal telephone service sectors. These prices are still subject to regulation, as state enterprises are the exclusive or dominant providers. In the case of telephone services, the private supplier who had exclusive right to provide these services until 2005 commands a dominant position²³. All prices regulated by the state are periodically reviewed. Armenia does not apply a price policy differentiated according to consumer category. According to the EBRD *Transition Report 2004*, the share of regulated prices in the consumer price index (CPI) constituted 8% in Armenia in 2004, and Armenia scored 4.3²⁴ on the EBRD price liberalisation index, which proves that Armenia has undergone a comprehensive price liberalisation without resorting to price-control measures, with the exception of housing, transport and natural monopolies sectors.

Privatisation

Five privatisation programmes adopted by the National Assembly have been implemented since 1995. These privatisation schemes encompassed most of the industrial, agricultural and transport sectors, as well as all ‘small’ and unfinished construction units. The fifth regular scheme for the privatisation of state property was adopted by the National Assembly in 2001,

¹⁷ Commission staff working paper annex to “European Neighbourhood Policy” Country Report for Armenia.

¹⁸ Food Security and Poverty January-March 2005, NSS, Armenia.

¹⁹ Food Security and Poverty January-March 2005, NSS, Armenia.

²⁰ *Economic Freedom Index 2006*, Heritage Foundation 2006.

²¹ According to the IMF classification, Armenia has a “free-floating” exchange rate regime.

²² EBRD Transition Report 2005.

²³ The second operator of mobile telephone network has launched its operation starting from 1 July 2005, thus putting an end to the monopoly in the mobile telephone sector.

²⁴ EBRD Transition Report 2005.

which included all enterprises left out of the preceding schemes. Based on 2005 results, 1976 medium and large state enterprises, and 7295 small businesses have been privatised. Only a small fraction of infrastructure enterprises are still controlled by the state or municipal authorities. With assistance from the World Bank, the Government is trying to pursue the privatisation of the remaining state enterprises through a specifically designed restructuring programme. In 2004, the share of GDP generated in the private sector amounted to 75%²⁵.

Finance Sector

Since the early 90s, the Government has stopped directly interfering with the activities of the finance sector and is instead relying on indirect measures of regulation. After the Savings Bank's privatisation in 2001, Armenia's banking system has become 100% privately-owned. As of September 2005, the banking system comprises 21 banks with 238 branches. The total capital amounts to 85.9 billion AMD (3.85% of GDP). Launching a deposit guarantee system in July 2005 was an important step towards spurring the development of the banking system. There are no limitations for foreign investors in the Armenian banking system, a national regime is applied²⁶.

From 2006 the administration and regulation of the entire financial system will be centralised under the Central Bank of Armenia, which will have a significant influence on the development of the sector. This step will allow establishing an integrated supervision system for the financial sector - initially within the Central Bank, and later on as an independent administrative body.

Despite the presence of the necessary regulatory and institutional framework, Armenia's banking sector is still very small in scale as compared with almost all transition economies and lags behind the other two South Caucasus countries, where the banking systems are also very small. The insurance market is still in an initial stage of development and it is also 100% privately owned. Based on 2004 data, Armenia had 26 insurance companies in operation, of which only 21 were engaged in statutory activities. The consolidated authorized capital stock of the licensed companies amounted to a mere 2.5 billion AMD (0.11% of GDP), and the number of ongoing contracts was 29,499²⁷. Revenues from insurance payments have grown 3.6 times in this period, the insurance reserves have increased by 2.75 times, and compensations have grown by 8.64 times²⁸. These trends are indicative of a growing vibrancy of the market. On 11 June 2004 the National Assembly adopted the new Law of the Republic of Armenia "On Insurance". The Government Decree No. 1345-N "On the Minimum Amount of Authorised Capital Stock of Insurance Companies" was adopted on 30 September 2004. In an effort to further develop the insurance system, the Government of Armenia is cooperating with the World Bank within the framework of an insurance regulation and supervision technical assistance programme (Financial Sector Reform and Strengthening Initiative, FIRST).

The securities market is regulated by the Law of the Republic of Armenia "On the Regulation of the Securities Market" adopted in July 2000. The institutional set-up of the securities market includes the Central Bank of the Republic of Armenia, the Central Depositor (self-regulatory organisation established by market participants as stipulated by the law "On the Regulation of the Securities Market"), the Stock Exchange of Armenia (self-regulatory organisation established by market participants as stipulated by the law "On the Regulation of the Securities Market"), professional participants of the securities market. Despite the fact that the institutional framework for the securities market is fully in place, the volume of securities transactions is insignificant: based on 2004 data, 194 companies²⁹ were listed with the Stock Exchange, and

²⁵ EBRD Transition Report 2004. According to RoA NSS calculations, the share of the private sector in GDP amounted to 84.1% in 2003.

²⁶ With the exception of investors registered in off-shore zones and other territories, which are included in the list of the Central Bank of Armenia. These investors must obtain an approval from the Central Bank of Armenia irrespective of the amount of the authorised capital stock.

²⁷ Armenia's Financial Statistics (1999-2003), Armenian NSS.

²⁸ Armenia's Financial Statistics (1999-2003), Armenian NSS.

²⁹ Armenia's Financial Statistics (1999-2003), Armenian NSS.

the level of capitalization of the Armenian securities market was in the range of about 0.5%³⁰ of the GDP in 2004, whereas the same indicator for the EU in 2004 was respectively 67.7%³¹.

The Government is aware of the need for speeding up the development of the financial sector, including the banking system, to be able to meet the increasing demand for domestic financing of the economic growth in the medium and long run, given the relative volumes of external funding that are currently diminishing and are expected to diminish. To this end, jointly with the Central Bank of Armenia, a comprehensive programme will be implemented in 2006-2008 to promote faster development of the banking sector, insurance (including mandatory insurance), mortgage and consumer lending and other sectors of the financial market.

Infrastructures

Development of the transport infrastructures is a particularly important factor for the development of the Armenian economy in view of existing transport limitations. Land routes connecting Armenia to the world include two roads going through Iran and Georgia, as well as the railway via Georgia. As a result of the closedown of railway routes connecting Armenia to Russia, Iran, Turkey, and Azerbaijan due to regional conflicts and the poor conditions of the existing transport infrastructures in operation, especially the Armenian railway, the transportation costs of communication with the external world are prohibitively high.

Armenia is participating in the TRACECA (TRANsport Corridor Europe-Caucasus-Asia) initiative in an effort to develop its transport infrastructures.

In 1998, the state railway operator - "Armenian Railway", was restructured into three specialised separate companies, as a result of which railway shipping became profitable in 2001-2002. However, the three companies merged again in late 2002. At present, both the railway and the rolling stock are in need of modernisation.

The aviation infrastructure comprises three airports ("Zvartnots" and "Erebuni" in Yerevan, "Shirak" in Gyumri). In view of the pressing need for renovation and refurbishment, "Zvartnots" was transferred to the *Corporación América* Company under a concession management scheme.

The energy sector is characterized with a number of challenges: poor condition of infrastructures, high rate of inefficiency and losses, lack of investments and great dependency from a single source (Russia), whence all of the nuclear fuel, gas and a significant share of oil products are imported. Gas is imported through the only gas pipeline going through Georgia. In 2004, an agreement was signed between Armenia and Iran to build a new gas pipeline by 2007. Thirty-four percent of the energy is generated by Unit 2 of the Metsamor NNP. In EU's assessment, funding of measures to bring the NNP in line with the established international standards is not economically expedient. The electricity distribution grid has been privatised and now belongs to Midland Resources Holding Ltd. registered in the United Kingdom, but the ownership of high-voltage grid has remained with the state. ArmRusgazprom CJSC manages importation, transportation and distribution of natural gas: 45% of the company's shares belong to the state, 45% of the shares belong to the Russian Gazprom CJSC and 10% of the shares belong to Itera International Ltd. There are plans for developing sources of renewable and alternative energy. Even though the main emphasis is on the hydroelectric power stations, there are prospects for production of energy using aeolian power (wind), geothermic and other alternative sources.

Since the privatisation of the "Armenia Telephone Company" (ArmenTel) in 1997 and granting exclusive rights for a term of 15 years, the development of the telephone sector has not been up to a desirable pace. The second operator made entry into the mobile telephone market only on 1 July 2005, as a result of which mobile line tariffs significantly dropped. The quality of land and

³⁰ EBRD Transition Report 2004.

³¹ Eurostat and additional calculations.

especially mobile line service still calls for improvement. Poor quality of communication services provided by ArmenTel hinders the development of the Internet in Armenia. In comparison with the telephone sector, the telecommunications system is more developed. At present, one state-owned and numerous private television and radio companies are in operation in Armenia.

2.2.3. External Economic Relations

External Debt

As a result of a consistent liberal foreign economic policy, Armenia became a full member of the WTO in the beginning of 2003. No restrictions are applied on foreign trade, movement of capital and financial flows. Throughout the period of 1999-2005, the total external debt has demonstrated a downward trend in relation with export volumes, dropping from 219.4% to 83%. As of the end of 2005, the public debt (both internal and external) accounted to 24.9% of GDP, out of which the internal debt totalled 2.3% and the external debt constituted 22.6%, which (the external debt) corresponds to the requirements set by the EMU³² Maastricht criteria (not more than 60% of GDP). The current indicators for the public debt/GDP ratio are more favourable than the PRSP projections (the ratio as projected by the PRSP for 2004 is 43%, while the actual indicator for 2004 corresponds to the projected level for 2008). The same trend has also been observed in 2005. In view of the higher-than-projected GDP growth rates, which are likely to be maintained in the upcoming several years, the debt will also be significantly reduced in the medium term.

In 1999-2005, a downward trend in the EU and EBRD shares in the structure of Armenia's external debt continued. As of 2005, the shares of the EU and the EBRD in the external debt structure amounted to respectively 0% and 1.3% as compared with 2.75% and 4.46% in 1999. In the future, this indicator will grow due to the funding of new programmes by the EU within the framework of the ENP, as well as the expected launch of activities by the European Investment Bank (EIB) in Armenia.

Current Account Balance

Throughout the period of 1999-2004, the current account deficit has been on the descendant. During 1999-2005, it dropped from 16.6% to 4.19% of GDP. The same trend can be traced in the foreign trade balance dynamic, which sloped down from 29% of GDP in 1999 to 16.8% in 2005. The export of precious and semi-precious stones, metals and metal wares, non precious metals and products made thereof, extracted raw materials, finished food and textiles prevails in the export structure of Armenia, accounting for 91.0% of the total export volume in 2005. During the period of 1999-2005, particularly fast growth rates have been observed for the export volumes of precious and semi-precious stones, metals and products made thereof (22.4%), equipment and tools (20.1%), finished food production (34.7%), extracted raw materials (12.4%), non-precious metals and products made thereof (52.6%), products made of stone, gypsum, cement (38.3%), textiles (18.0%), paper and paper products (24.5%), means of transportation (25.2%), as well as products made of rubber and plastic (-0.5%)³³. However, notwithstanding the fact that exported commodities list of Armenia has somewhat been extended in recent years, it remains very limited and its concentration coefficient³⁴ has stayed very high, which makes Armenia's exports very sensitive to external influences. In this respect, the expansion of the list of exported commodities and reduced concentration coefficient continue to be among the key priorities of the country's economic policy.

Capital Account and FDI

The highest inflow of FDI was registered in 1998 at 206.5 million EUR, which was connected with incoming investments as a result of ArmenTel's privatisation. The inflowing net FDI

³² European Monetary Union

³³ The respective annual average growth rates are cited in parentheses.

³⁴ In 1994-2004, the concentration coefficient of Armenia's exports (calculated based on a cross-section of two-digit commodity categories list of foreign economic operations) has essentially remained the same over the period of 1999-2004, amounting to 0.303 in 2004 as compared with 0.302 in 1999.

amounted to 196.3 million EUR in that year, following which it averaged at 124.1 million EUR over the period of 1999-2005, i.e. about 4.9% of GDP. In 1999-2005, the inflowing net cumulative FDI in Armenia amounted to 868.9 million EUR. In 2005, the inflowing net FDI reached the highest level for the period of 2000-2005 at 217.1 million EUR or 5.55% of the GDP. Due to the underdevelopment of the securities market, problems hampering consolidation of the corporate governance establishment and unresolved issues relating to the protection of shareholders' rights, the volumes of both inflowing and outflowing foreign portfolio investments (FPI) are extremely limited, and the balance, as a rule, is in the negative. In 1999-2005, the net outflow of FPI from Armenia amounted to 27.8 million EUR.

Economic Cooperation with the European Union

The share of CIS countries in Armenia's foreign trade turnover structure, while following a downward slope since the independence, amounted to 18.4% in 2005. Owing to liberal foreign economic policy, new trade and economic ties were established with other countries.

Starting from 1995, the EU's share in Armenia's foreign trade turnover has been steadily growing from 11.9% in 1994 to 34.8% in 2005. The data for 2005 indicate that the EU's share in Armenia's import and export volumes was respectively 46.6% and 28.5%. In 1999-2005, the shares of the USA, Iran and Turkey in the export and import volumes have shrunk and those of Israel, Switzerland and China have grown. The recorded trends are indicative of the fact that Armenia's economic ties are gradually leaning towards the EU. The EU Generalised System of Preferences (GSP) plays a significant role among factors conducive to the entry of Armenian products into the EU market and, under this regime the share of exports has been gradually increasing since 2001. Armenia's inclusion into the ENP opens significant prospects for further development of the economic cooperation between Armenia and the EU. If Armenia is granted the status of "a functioning market economy" within the framework of the EU's antidumping legislation, even more favourable conditions will be in place to facilitate the further integration of the Armenian economy with the EU. Within the framework of the National Programme, the Armenian Government has set a goal to forge the necessary economic preconditions during 2006-2008 with view of signing a free trade agreement with the EU.

2.3. Projections on Economic Indicators Used in the Programme

The medium- and long-term projections used in the Programme are drawn on the basis of the projections of the PRSP approved by the Government in August 2003, the State Medium-Term Expenditure Framework (SMTEF) for 2005-2007, as well as the first Progress Report on the Implementation of the PRSP (2004). In January 2004, the Government also approved a list of measures for 2004-2006 to ensure the implementation of the PRSP, thus defining the mechanism for submitting information on a quarterly basis by governmental entities to report on the course of implementing the measures.

The economic results for 2003-2005 surpassed the PRSP projections on several indicators. Specifically, the economy grew at almost twice the pace projected by the PRSP framework. As a result, more progress was made in reducing the poverty level than it was projected. In view of the results recorded in 2003-2005 and provided that further developments are in line with PRSP projections, Armenia will be able to reach the poverty reduction targets set for 2012 already in 2008.

Besides material and human poverty indicators, the PRSP projections set benchmarks for a number of other socio-economic development indicators. The PRSP projections on these indicators are cited in Table 3.

Table 3. Projected individual indicators for structural reforms and socio-economic development within the framework of PRSP*

Indices	PRSP Projections			Actual	Adjusted Projections	
	Y2004	Y2008	Y2015	Y2004	Y2008	Y2015
Private sector's share in GDP (%) ³⁵	73.0	76.2	80.0	75.0	78.3	82.2
Trade and foreign exchange currency liberalisation index (1-4.3 points)	4.3	4.3	4.3	4.3	4.3	4.3
Anti-monopoly policy index (1-4.3 points)	2.2	2.3	3.0	2.0	2.3	3.0
Banking reform (1-4.3 points)	2.6	3.0	4.0	2.5	3.0	4.0
Reform of non-banking financial institutions index (1-4.3 points)	2.1	3.0	3.7	2.0	3.0	3.7
Infrastructures reform index (1-4.3 points)	2.4	3.0	3.7	2.5	3.0	3.7
Per capita GDP, USD	904.2**	1142.0	1629	1259.8 (2005)	1826.6	2683
Inflation rate (CPI, %)	3.0	3.0	3.0	0.6 (2005)	3.0	3.0
State budget balance/ GDP (%)	-2.6	-2.0	-1.6	0.17	-2.0	-1.6
Gross accumulation/ GDP (%)	20.6	21.9	24.3	23.9	25.4	28.2
State budget expenditures/ GDP (%)	20.4	20.8	21.4	17.3	20.0	21.4
Exports/ GDP (%)	30.7	31.9	34.6	27.7	31.9	34.6
Industry (including construction)/ GDP (%)	40.2	43.2	47.2	34.5 (2005)	43.2	47.2
Total external debt/ GDP (%)	43.0	33.6	29.3	22.6 (2005)	17.7	15.5

Source: PRSP, EBRD Transition Report 2004, World Development Indicators Database (WB) and additional calculations.

* Some of the qualitative indicators cited in the table (based on a 1-4.33 scoring system) draw upon the methodology used in the EBRD annual transition reports.

**The GDP per capita figures for 2004 are presented in USD and are based on the supposition of invariable number of population (which was used in the PRSP projections and corresponds to the official data on population for 2003-2004). The adjusted figures for GDP per capita were derived from the shifted growth rates of PRSP projections starting from 2006: PRSP projections have been used as 2006 growth rate projections, projections for 2004 were used for 2007 and the same principle has been applied for the succeeding years.

Implementation of the PRSP has not proceeded at the projected rates in all aspects, specifically in 2004-2005, the growth rate of export volumes relative to GDP has been relatively slow, and thus the export volume/GDP ratio has diminished. This is partly due to a continuous appreciation of the Armenian national currency against USD and EUR in 2004-2005. However, the Government of Armenia plans to promote gradual growth of the relative export volumes and reduce imports by 2015, in accordance with the PRSP scenario. In the period of 2002-2004, the state budget expenditure/GDP ratio has also deviated from the set target. Reforms in infrastructures, anti-monopoly policy and finance sector proceeded at a slower pace than anticipated. Rectifying the situation in these areas and bringing development up to speed with the course envisaged by the PRSP are among the key priorities of Armenia's economic policy.

³⁵ According to EBRD methodology

2.4. Assessment of the Situation within the Framework of the Copenhagen Criteria

The methodology underlying this section of the NP draws upon the Copenhagen economic criteria. Armenia's inclusion into the ENP³⁶ lends more validity to the choice of this approach, as the Copenhagen political and economic criteria for EU membership formulated in 1993 reflect the common values that form the basis for relations between the EU and neighbouring countries within the framework of the ENP.

The Copenhagen economic criteria are used to assess the gap between the Armenian and European economies based on the present state of affairs and the future state of affairs as envisaged by the PRSP.

2.4.1. Existence of a Functioning Market Economy

According to the Copenhagen economic criteria, existence of a functioning market economy entails liberalised pricing system and foreign trade, a functioning and properly enforced legal system, specifically aimed at ensuring effective protection of property rights. Macroeconomic stability and extensive public consensus on economic policy are indispensable and required factors that facilitate the operation of a market economy. A developed financial sector and absence of significant barriers to market entry and exit are factors indicative of the efficiency of a given market.

The Government of Armenia has set a goal to maintain the high economic growth rates in the period of 2006-2015 at the levels stipulated by the PSRP as a minimum. The data for 2003-2005 show that the accelerated growth rates in the construction sector also give an impetus to the other sectors of the economy, which refutes the hypothesis that this growth is a short-term trend. The financial assistance of the order of 236 million USD from the Millennium Challenges Fund for 2006-2010 as approved by the Government of Armenia, the new 60 million USD project of the Lincy Foundation, as well as the membership to the Asian Development Bank from 2005 shall serve as an additional impetus for further economic development. Based on the current PRSP implementation results and provided that the future course of economic growth is apace with the rates envisaged by the PRSP, the per capita GDP will amount to 2,683 USD in 2015 as compared with the projected 1,629 USD³⁷.

The downward trend demonstrated by the current account deficit since 1999 will continue. It dropped from 287.3 million EUR in 1999 to 163.9 million EUR in 2005. In 1999-2005, the foreign trade deficit shrunk by almost fourfold as compared with the GDP, plunging down to 8.2 % as compared to 30.8%. The PRSP provides for continuous growth of the relative export volumes and reduction of import volumes by 2015, as a result of which this indicator will drop down to 5%. The export volumes in 2015 will amount to 31.2% of the GDP as compared to 19.5% of 2005.

Measures will be taken to improve the employment rates. The Government of Armenia seeks to address this challenge both through sustained economic growth at high rates, and the development of small and medium enterprises, as well as promotion of self-employment.

Annual inflation rates will be kept at a 3% level. Despite possible fluctuations around this level, in 1999-2005 the CPI annual growth rate based both on the average prices for the period and end-of-the period prices did not reach a two-digit level, amounting to -0.2% and 0.6% respectively in 2005. It is projected that the CBA will in the future succeed in ensuring the target inflation rate level under the new inflation strategy adopted as of January 2006.

³⁶ Commission Communication of 12 May 2004, 'European Neighbourhood Policy: Strategy Paper' Com(2004)373 final; European Parliament Report on the Wider Europe, A5-0378/2003, at para 8; resolution of the European Parliament of 26 February 2004 on 'EU Policy towards the South Caucasus'.

³⁷ In comparable 2004 prices.

Measures will be taken to ensure continuous reduction of interest rates. In the period of 1999-2005, reduction of interest rates on bank loans was relatively more significant in the case of loans provided in the national currency. As of September 2005, interest rates on loans provided in national and foreign currency for a term of over one year were respectively 18.3% and 17.6%. In contrast with the gradual downward tendency in interest rates, the profitability of T-bills went into a sharp decline in the period of 2000-2005, dropping from 24.9% to 7.9%, which is brought about by the country's economic development and reduced country risk. Development of the newly-introduced deposit guarantee system will contribute to the increased financial flow in banking system, among the population and organizations, hence boosting the absolute and relative volumes of lending through banks.

The downward trend of the consolidated budget deficit will be maintained. In 1999-2005, the budget deficit declined from 5.4% to 1.82%. However, the tax system is still characterised by high transaction costs and is in need of improved efficiency. Through improved efficiency of tax collection, the Government of Armenia plans to build more efficient political and economic institutions.

The liberal approach adopted for the regulation of the economy will be maintained. Armenia's level of economic liberalisation is comparable to that of the industrial developed countries.

Favourable conditions will be ensured for further development of the private sector. Reforms aimed at the creation of a private sector in the economy were implemented with much efficiency in Armenia. In 2004, 75% of Armenia's GDP was generated in the private sector. According to the PRSP projections, the Government of Armenia envisages that about 80% of Armenia's GDP will be produced in the private sector.

The privatisation process will be essentially completed. Privatisation processes are presently in their final stage. Tasks warranting attention in this area include post-privatisation oversight and management of state property use. Depending on the category of state property, various set of priorities apply. Even though some issues of social nature have not been fully addressed, in the Armenian Government's assessment the privatisation has served its main purpose of developing diversified ownership relations.

Continued reforms in the banking sector: The Central Bank of Armenia strives to promote concentration in the banking system. At present, there are about 21 banks operating in the system. The deposit guarantee system, which entered into force in July 2005, already promotes the increased confidence of the population towards the system, the anti-monopoly policy of the sector, further reduction of the spread between deposit and loan interest rates and interest rates in general, as a result of which long-term financing through banks will become more accessible for businesses. Within the framework of the PRSP, the Government of Armenia plans to bring bank supervision and regulation norms significantly closer to the new Basel standards and to have an efficient banking system, which will be characterised by real competition among market participants (4 points on the EBRD scale for assessing reforms in transition economies).

Continued and reinforced fight against monopolies: Further reform in this sector greatly depends on the successful course of the anti-monopoly policy and reforms launched to meet two key political criteria underlying the rule of law. In 2004, Armenia scored 2 points³⁸ on the EBRD's antimonopoly policy index, which in terms of reforms is equivalent to adoption of antimonopoly legislation, establishment of antimonopoly bodies, removal of a number of restrictions on the formation of new market participants, applying certain compulsory measures against monopolistic companies. According to PRSP projections, Armenia will reach a 3 point level in 2015 due to the anticipated removal of the key restrictions on the formation of new market participants and breakdown of particular monopolies. Based on the results for 2004, Armenia is lagging behind the benchmarks set by the PRSP framework.

³⁸ EBRD Transition Report 2004.

Modernized legislation and improved enforcement: Armenia's score for 2004 on the rule of law index puts the country at 49% of the average score of the EU countries. Judicial Reform Project launched jointly with the World Bank is a key initiative among projects aimed at reforming the system. Reform of the system is crucial to ensuring proper protection of property rights.

Promotion of the development of the securities market and the non-banking financial institutions, which are currently underdeveloped as compared with the banking system. Development of the sector will take time. At present, the reforms have fallen behind the course charted by the PRSP, which included large-scale issuance of private company shares, protection of interests of minority shareholders to a certain degree, improved market liquidity and progress towards approximation of the legal regulation of the system with the international standards.

2.4.2. Potential to Cope with Market Competition and Capacity for Efficient Economic Cooperation within the Framework of the ENP

Compliance with these criteria entails existence of a functioning market economy and a stable macroeconomic system, which enable economic entities to make decisions under conditions of least uncertainty. Availability of human and physical capital and existence of developed infrastructures are additional requirements. Even though accessibility of external funding for companies is also regarded as an important factor for measuring the competitiveness of the market within the framework of cooperation with the EU, the most important issue in this respect is the actual level of integration with the EU and the structure of trade.

Since its independence, Armenia has transformed into a market economy through establishing the key market institutions and private sector of the economy. Macroeconomic stability was established two years after the introduction of the national currency (in 1995). The economic policy was geared towards developing a liberal market economy. By its macroeconomic and price stability, public debt and fiscal deficit level, Armenia may be compared with EU accession countries, as well as Russia, which was granted a market economy status (MES) by the European Commission in November 2002 and which has a permanent surplus on its balance of payments, and Kazakhstan, which was granted an MES in March 2002 by the US Department of Commerce. On a number of indicators, Armenia meets the Maastricht Convergence Criteria, specifically the public debt to GDP ratio, stability of national currency exchange rate and state budget balance.

Promotion of the development of human and physical capital, a key factor in ensuring capacity to cope with competitive pressure and market forces in the framework of expanding cooperation with the EU. The Armenian nation is highly educated and has a propensity for continuously expanding the scope of knowledge and learning. State expenditures in the education and science sector are projected by the PRSP to reach 4.3% of GDP in 2015.

Reform of the labour market driven by economic growth: Some of the labour market problems stem from absence of direct linkages between the demand for specific specialists in the economy and the number of specialists prepared and trained by educational institutions. Training of professionals in response to the demand for specialists, together with the generation of new employment opportunities mainly due to the development of small and medium enterprises within the framework of the implementation of the PRSP and creation of additional opportunities for self-employment and entrepreneurship will enable Armenia to make a step-by-step transition from the state of economic growth "without expansion of employment opportunities" to economic growth fostering employment opportunities.

The share of private sector is already ahead of the PRSP projections. In 2004, the share of the private sector in the GDP was 75% as compared with the projected 73%. In 2015, this figure will go up to 80-82%. The private sector now boasts efficiently operating enterprises in the energy,

industrial, transport, telecommunications, education, healthcare, trade and services and other sectors of the economy. A middle class of property owners is gradually being formed. However, the lion's share of products exported to the EU belongs to the re-exports of precious stones and extracting industry. Increased share of output by the processing industry and advanced technologies should be among the key targets aimed at ensuring efficient cooperation within the framework of the ENP. To this end, measures are planned to be undertaken to ensure improved quality control and marketing of products.

Expanded scope of economic relations with the EU. Armenia's foreign trade with the EU has demonstrated a steady upward trend since gaining its independence. As a result, today the EU is the key economic partner of Armenia. The signing of the PCA and Armenia's inclusion into the ENP have opened new prospects for Armenia's further economic integration with the EU.

Continued stability of the national currency: In 2000-2003, the real effective national currency exchange rate has been on a gradual downward slope, which continued until the first quarter of 2004. However starting from the second quarter of 2004 the Armenian dram demonstrated a steady appreciation trend. There is a worldwide trend of appreciation of national currencies against the US dollar, which is conditioned by the monetary policy pursued by the United States, and in the near future it may not become a threat for the liberal exchange rate policy.

2.5. Comparison of the Armenian Economic System with the Indicators of Selected Transition Economies and Assessment of Progress Projected by the PRSP

The purpose of this section of the Programme is to assess how far Armenia's economy is from the EU in meeting the Copenhagen criteria with the purpose of ensuring efficient cooperation within the framework of the PCA and the ENP and expanding the scope of integration with the EU. The indicators of EU-25³⁹, EU-8⁴⁰ and 3 accession countries (Bulgaria, Romania and Croatia), as well as Romania's⁴¹ corresponding separate indicators for 1999, 2003 and 2004⁴² have been used as a basis for comparison. The key purpose of the economic part of the Programme is to assess for the upcoming 3 years Armenia's relative situation in relation to various groups of EU Member and Accession States in the medium-term (2008) and long-term perspective (2015) using the medium- and long-term dynamics of relevant development indicators as outlined by the PRSP and other documents, and thus to identify the sectors of the economy and economic policy warranting expedited development to come as close to the EU level as possible.

The Programme does not purport to define the long-term targets for these areas and to spell out the required measures to reach these targets. These issues should be addressed at the first review session of the PRSP which is scheduled to be held in late 2006.

2.5.1. Comparative Analysis

The results of the comparative analysis are presented along the following axes:

- Comparison of Armenia's indicators for 2006-2008 and 2015 with the corresponding indicators of the EU-25 in 1999;

³⁹ Present membership of the EU.

⁴⁰ New EU Member States (with the exception of Malta and Cyprus)

⁴¹ Romania has been chosen as an additional benchmark for comparison of the corresponding cluster analysis results (Appendix 2), as the closest country to Armenia (in terms of the least cumulative gap of the selected comparative indicators)

⁴² The choice of 1999 is explained by the fact that most of these countries started their EU accession talks in that year.

- Comparison of Armenia's indicators for 2006-2008 and 2015 with the corresponding indicators of the EU-8, three accession countries and Romania in 1999 and succeeding years;
- Defining the respective range for the EU-8 and accession countries for 1999 or the succeeding years (maximum and minimum value of the given indicator) and comparison of Armenia's indicators within a given range (whether an indicator falls within or outside of the given range).

2.5.2. Analysis of Quantitative Indicators of Economic Development

Table 4 lists the results of the comparison of per capita GDP, a key economic development indicator. Armenia's economic development course draws on the PRSP projections, which have been shifted into the future for 3 years: the economic growth rate for 2005 was 13.9%, a 7% growth rate is projected for 2006, 6% growth for 2007-2011, 5.5% for 2012, and 5% for 2013 and 2014.

As we may glean from the table, in this setting, Armenia will surpass the minimum level as of 1999 of the Accession States in 2014. Should the Armenian economy grow at a faster rate than projected by the PRSP, which in view of the actual growth rates for 2004-2005 and anticipated significant increase in the volume of external financial investments in the upcoming years (within the framework of the Millennium Challenges, Asian Development Bank, etc.) is more realistic than the quite conservative PRSP projections, the 1999 lowest level of accession countries will be within Armenia's reach already by 2012⁴³.

Table 4. Results of comparison of per capita GDP indicators (% of the corresponding figure in 1999)

	EU-25	EU-8	Accession Countries	Romania	Range of Comparison	Assessment
Armenia 2005	5.78	23.03	51.8	63.84	(9.06 - 61.7)*	No
Armenia 2008	6.99	27.82	62.56	77.1	(9.06 - 61.7)	No
Armenia 2015	10.26	40.85	91.86	113.2	(9.06 - 61.7)	Yes

Source: NSS, Eurostat, PRSP.

* The lowest (Bulgaria) and highest (Slovenia) values over the average per capita GDP of the EU-8 and 3 accession countries in 1999 have been chosen as end-points for the range of comparison.

Table 5 provides the comparison of the current trade volumes of Armenia with the EU, as well as the comparison of trade with EU-8, accession countries and Romania.

Table 5. Comparison with the trade volumes of EU-15 (% of the total volume of commodity trade)

	Armenia 2005	EU-8 1999	Accession Countries 1999	Romania 1999
Trade with EU-15 %	34.8	65.82	63.40	62.86
Range of Comparison	(47.8 -69.8)	(47.8 -69.8)	(47.8 -69.8)	(47.8 -69.8)
Assessment	No	No	No	No

Source: NSS, Eurostat, World Development Indicators

⁴³ In case of 9.98% (the average for 1999-2005) average annual economic growth rate in 2006-2014 as compared with the 5.8% projected by the PRSP.

The figures for the share of trade with the EU are one of the key indicators for the economic integration with the EU. Even though the share of Armenia's trade with the EU and hence the level of economic integration with the EU is one of the highest among CIS countries, it considerably falls short of the corresponding indicators of the new Member States and accession countries at the moment of starting the accession negotiations. Therefore the Government of Armenia has set a goal to work towards reaching the range of comparison within the course of the upcoming 10 years⁴⁴. In this regard, promotion of progressive growth of trade with the EU is one of the key priorities of this Programme. More extensive use of the EU Generalised System of Preferences (GSP)⁴⁵ through dissemination of relevant information, simplification of export formalities, as well as approximation of the legislative and institutional framework ensuring the compliance with the EU legislation on Free Movement of Goods are the key measures to be undertaken in this area. (See Part 3, Chapter 1 of this Programme for details).

2.5.2.1. Analysis of Financial Stability⁴⁶

Table 6 lists the results of the analysis.

Table 6. Comparison of financial stability indicators as of 2004-2005 (According to the Maastricht Treaty EMU membership criteria)

	Inflation (CPI), %	Bank Interest Rates %	Consolidated Budget Deficit (Surplus) (% GDP)	Public Debt (% GDP)
Czech Republic	1.8	4.7	-5	37.9
Estonia	2	-	0.3	4.8
Latvia	4.9	5	-2	14.7
Lithuania	-0.2	4.7	-2.6	21.4
Hungary	6.5	8.1	-5.5	59.9
Poland	2.5	6.9	-5.6	47.2
Slovenia	4.1	5.2	-2.3	30.8
Slovakia	8.4	5.1	-3.9	44.5
EU-8 average	3.75	5.67	-4.89	43.96
Comparison range	(-0.2 - 8.4)	(4.7-8.1)	(-5.6 - 0.3)	(4.8 - 59.9)
EMU threshold values	2.4	6.4	-3	60
Armenia	0.6 (2005)	17.29 (December 2005)	-1.76	35.7
Compliance				
EU-8 average	Yes	No	Yes	Yes
EMU threshold values	Yes	No	Yes	Yes
Comparison range	Yes	No	Yes	Yes

Source: NSS, Convergence Report 2005. European Central Bank 2004

As we may see from the table, Armenia's main divergence from the EMU requirements is due to the financing of the economy with insufficient involvement of the banking sector, its relatively small scale, as well the current high risk level of the Armenian economy. In view of the growing capacities of the financial sector to ensure economic development, the Government and the Central Bank will launch comprehensive measures in 2006-2008 to promote progressive growth and institutional reforms in the financial sector, including the banking system, with the purpose of reaching the current EMU threshold values of bank interest rates by 2015.

⁴⁴ The lowest threshold of the comparison range is the foreign trade volumes of Latvia with the EU as of 1999.

⁴⁵ Only 63% of the Armenian product exports currently subject to GSP benefit from this system.

⁴⁶ In this section of the Programme, the EU Central Bank data for the EU-8 countries in 2004 serve as a basis for comparison, all of which are candidates for participation in the EMU. See Convergence Report 2005. European Central Bank 2004.

As for inflation, developments in the period of 1999-2005 allow us to conclude that the inflation rate in 2005-2008 will correspond to the PRSP projections and the EMU requirements (both set the maximum annual inflation rate at 3% level). Developments in recent years show that in the future Armenia will be able to maintain its financial stability in accordance with the EMU requirements without much difficulty.

2.5.2.2. Comparative Analysis of Budget Revenues and Economy Financing (as of 2003)

Table 7. Comparison of the indicators for the budgetary sector and economy financing as of 2003

	State Budget Revenues % GDP	State Budget Expenditure % GDP	Domestic Credit % GDP	Interest Rate Spread, %	Securities Market % GDP	FDI % GDP	ODA* % GDP
Armenia	17.70	16.40	8.7 (2005)	14.00	1.00	4.30	8.50
EU-8 average	32.32	36.56	32.55	2.80	18.59	2.35	0.64
Accession countries average	31.73	33.42	24.82	9.00	12.69	4.91	0.88
Romania	26.7	28.4	9.5	n/a	9.8	3.2	1.1
Comparison range	(26.3 - 43.4)	(28.4 -46.4)	(9.5 -43)	(-1.4 - 10.1)	(8.5 -41.7)	(1 - 9.8)	(0.2 - 2.1)
Compliance	No	No	No	No	No	Yes	Yes

Source: World Development Indicators -2005, World Bank 2005

* ODA, Official Development Assistance (development loans and grants from international organisations and foreign governments)

It may be gleaned from the table that one of Armenia's current problems which may not be fully addressed in the medium-term perspective is the relatively low level of state revenues and hence the significantly lower level of state involvement in the economy as compared with the new EU Member States and accession countries. A number of factors account for this, specifically, the relatively low efficiency of tax administration, large scale of shadow economy (according to the recent World Bank estimates, the scale of shadow economy in Armenia was as high as 46% of the GDP, which is significantly higher than that in the new EU Member States and accession countries): According to the PRSP projections, the level of tax revenues is to grow by approximately 0.2 percentage points annually (in relation to GDP), and the level of the total state revenues is projected to amount to 18.5% of GDP in 2008 and 19.9% of GDP in 2015. Even if Armenia reaches these indicators, the scale of the state participation will significantly lag behind the present indicators of the New Member States and accession countries.

Thus, increased state capacities which are directly linked to the volume of collected taxes are one of Armenia's main long-term priorities.

As for the mechanisms of financing the economy, Armenia considerably differs from the EU-8 and accession countries. Thus, in 2003 official development assistance and FDI volume made up 12.8% of GDP or over half of gross accumulation (24.3% GDP 2003). Taking into consideration the large volume of unofficial transfers received by Armenia and by various estimates amounting to 8-12% of the GDP in 2001-2004, we may conclude that the fast economic growth that Armenia has been undergoing is largely financed by external sources.

As Table 7 shows, the situation is different in the EU-8 and accession countries, where the volumes of external financing (FDI and ODA) of economy in 2003 totalled a maximum of 10.8% of GDP (or 34.8% of gross accumulation, Estonia), and a minimum of 1.4% (or 5.6% of the gross accumulation, Slovenia). Thus, Armenia's dependency on external financing is much higher than that in the EU-8 and accession states. The situation is bound to stay the same in the medium term perspective due to the anticipated volumes of external funding.

From the viewpoint of ensuring sustainable economic growth, however, the progressive development of the financial sector is an imperative and is one of the country's key long-term priorities.

Specifically, in order to reach the 2003 average indicator of EU accession countries for economy financing in 2015, the volume of bank lending during 2006-2015 must grow at an annual rate of 18% or thrice the GDP growth rate projected by the PRSP for 2005-2008. If this growth rate is maintained, in 2015 the volume of domestic credit will amount to 25.6% of the GDP, surpassing Romania's 2003 level, however still considerably short of the 2003 level of all remaining New Member States and accession countries.

As for the development of the securities market, in view of the developments for the past decade, it is not realistic to expect Armenia to be able to bridge the gap in the medium-term as well as throughout the term of the first PRSP.

To spur demonstrable development of the financial sector and to considerably expand the role of financial intermediation in economic development, the Government of Armenia, jointly with the Central Bank of Armenia, will develop and adopt a programme for long-term development of the financial sector in 2006 in an effort to ensure progressive development in all sectors listed above, as well as several other sectors.

2.5.3. Analysis of the Qualitative Indicators of Economic Development

Indicators analysed in this section of the Programme are used to assess the gap between Armenia, EU-8 and 3 accession countries in regard to the development of the private sector, status of structural reforms and state governance.

The projections of the indicators for the development of the economy's private sector and structural reforms draw on the PRSP projections and are based on the methodology used by the EBRD to assess transition economies: the source for governance indicators and their dynamics was the World Bank Governance Indicators Database⁴⁷, and the corruption index values were taken from Transparency International's Annual Report 2005⁴⁸.

Table 8. Comparative analysis of indicators of economic development and governance as of 2004

	Private sector, GDP %	Price and trade liberalisation	Promotion of competition	Banking reforms	Non-banking financial institutions	Infrastructure reform	Governance efficiency	State regulation	Rule of law index	Corruption index
Armenia 2004	75.00	4.33	2.00	2.50	2.00	2.50	-0.34	0.05	-0.58	3.10
Armenia 2008	78.30	4.33	2.30	3.00	3.00	3.00	-0.15	0.24	-0.30	3.50
Armenia 2015	82.20	4.33	3.00	4.00	3.75	3.75	0.03	0.60	-0.15	4.60
EU-8 average	76.34	4.31	2.91	3.66	3.19	3.22	0.72	1.08	0.68	4.64
Accession countries average	68.26	4.28	2.58	3.58	2.33	3.17	0.03	0.24	-0.02	3.50
Romania	70.00	4.33	2.50	3.00	2.00	3.50	-0.15	-0.06	-0.18	2.90
Range of comparison	(60 -80)	(4.165 -4.33)	(2.5 -3)	(3 -4)	(2 -3.75)	(2.75 -3.75)	(-0.15 -1.02)	(-0.06 -1.61)	(-0.18 -0.93)	(2.9 - 6)
Compliance										
2004	Yes	Yes	No	No	Yes	No	No	Yes	No	Yes
2008	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	No	Yes
2015	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

⁴⁷ A. Kaufman, A. Craay & M. Mastruzzi "Governance Matters IV: Governance indicators for 1996-2004", The World Bank, 2005.

⁴⁸ Transparency International: Global Corruption Perception Report -2005

Note: The highest score for the indicators 2 through 5 is 4.33 points, which corresponds to the standards applied in developed countries. The lowest score is 1, which is equivalent to absence of reforms. The projections for these indicators for 2008 and 2015 correspond with the PRSP projections.

Indicators 6 through 9 reflect both the political (rule of law index) and economic (governance efficiency and state regulation) of Copenhagen criteria. The indicators are measured in the range of -2.5 – 2.5, where higher scores reflect a higher level of governance efficiency or democracy. As of 2004, Armenia's score for governance efficiency placed it on the 127th horizontal among 214 countries, Armenia came in 93rd among 203 countries on the state regulation index, and 132nd on a list of 207 countries on the rule of law index.

The highest score on the corruption index is 10, which corresponds to the status of a "highly clean" or corruption-free state and the lowest score is 0, i.e. highly corrupt state. As of 2004, Armenia was on the 82nd horizontal from among the evaluated 146 countries.

As we may see from the table, by 3 indicators out of 6 describing economic reforms for 2004, Armenia falls within the comparison range. According to the PRSP projections, by 2008 Armenia will be not be able to meet the minimum level of indicators for EU-8 and accession countries for 2004 only on the improvement of competition index: it will reach the EU-8 average for 2004 in 2015.

As for the corruption index, progress in recent years (3.1 points in 2004 as compared with 2.1 points in 1998) enabled Armenia to meet the compliance threshold since 2003 (Armenia's 2003 score was 3.0 points as compared with Romania's 2.8 points), however corruption level in Armenia still remains considerably higher than that of all New Member States and accession countries, except for Romania⁴⁹. In this respect, the Government has set a goal to significantly reduce the corruption level in the period of 2006-2015 through carrying out the measures spelled out in the Anti-Corruption Programme adopted in 2004 and in doing so, the Government has used the average level of the EU accession countries, as well as Poland's and Croatia's 2004 level, as a target indicator for 2008 and as a stepping stone for reaching the EU-8 2004 average corruption level by 2015.

As for the 7th, 8th and 9th indicators listed in Table 8, Armenia appears in a more favourable light in terms of the state regulation indicator, steering ahead of Romania⁵⁰, however just as in the case of the corruption index, Armenia significantly lags behind all remaining New Member States and accession countries. To address the challenge, the Government will develop and start implementing a comprehensive programme aimed at improving the efficiency of state governance in 2006. For the component focusing on state regulation, 0.24 will be set as the target value for the corresponding indicator for 2008 (average level of the accession countries for 2004), and 0.6 will be set as the target indicator value for 2015 (Bulgaria's 2004 level).

In the Government's assessment, the present situation in terms of the efficiency of state governance and especially rule of law is not adequate. Armenia's score for state governance for 2004 places Armenia behind not only all New Member States and accession countries, but also Russia. As for the rule of law index, despite the fact that Armenia's score for 2004 was the highest among CIS countries, in relative terms, it lags behind almost all other indicators discussed in this Programme, except for the finance and budgetary sector indicators.

The mentioned comprehensive long-term programme aimed at improving state governance efficiency will also focus on the rule of law and efficiency of state governance. In view of the long-term nature of the accumulated problems to be addressed, the target benchmarks are more modest in this case. Specifically, for governance efficiency, a target has been set to reach Romania's 2004 level by 2008 and catch up with the average level of accession countries for 2004 by 2015. In terms of its performance on the rule of law index, where the gap between Armenia and the EU-8 and accession countries is much larger, a two-fold increase of the value of the indicator is projected to be achieved by 2008 and only in 2015 Armenia will be able to surpass Romania's level for 2004⁵¹.

⁴⁹ From among countries with the highest corruption scores in 2004, Romania was followed by Poland and Croatia at 3.5 points with Slovenia being at the opposite far end at 6 points.

⁵⁰ The figure for state regulation has significantly grown in the period of 1996-2004 (from -0.74 to 0.05)

⁵¹ In contrast with other indicators, some relapse has been registered in terms of this particular indicator: in 1996 it was assessed to be -0.46, in 1998 it rose to -0.35 and in 2002 it fell down to -0.52.

2.6. Conclusion

The overall picture of the gap between Armenia and the new EU Member States and accession countries is provided in Table 9.

Table 9. Dynamics of the comparability of the basic indicators of Armenia, and EU-8 and EU accession countries in 2004-2015 (according to the projections of the PRSP and this Programme)

Indicator	Within the Comparison Range		
	2004	2008	2015
Per capita GDP in comparable prices in 2004	No	No	Yes
Inflation (CPI), %	Yes (2005)	Yes	Yes
Bank interest rates %	No	No	Yes
Consolidated budget deficit (surplus) (% GDP)	Yes	Yes	Yes
Public debt (% GDP)	Yes	Yes	Yes
State budget revenues % GDP	No	No	No
State budget expenditures % GDP	No	No	No
Interest rate spread, %	No	No	Yes
Domestic Credit % GDP	No	Yes	Yes
Securities market % GDP	No	No	No
FDI % GDP	Yes	Yes	Yes
ODA % GDP	Yes	Yes	Yes
Private sector, % GDP	Yes	Yes	Yes
Price and trade liberalisation index	Yes	Yes	Yes
Promotion of competition index	No	No	Yes
Banking reform index	No	Yes	Yes
Non-banking financial institutions index	Yes	Yes	Yes
Infrastructure Reform Index	No	Yes	Yes
Governance efficiency index	No	Yes	Yes
State regulation index	Yes	Yes	Yes
Rule of law index	No	No	Yes
Corruption index	Yes	Yes	Yes

The table clearly shows that upon successful implementation of the National Programme and the PRSP, the gap between Armenia and New Member States and accession countries will considerably shrink.

On the 20 indicators used for long-term projections within the framework of the PRSP and this Programme, 12 indicators for 2004 fell short of meeting the EU requirements for financial stability or fell below the various comparison ranges noted above. By 2008, the number of these indicators is projected to reduce to 6, and down to 2 by 2015, thus sharply boosting the level of EU-Armenia integration. To reach the above-mentioned results, continued economic growth, realization of the PRSP projections, approximation of the legal framework with the EU legislation as described in Part 3 of this Programme and effective enforcement of the respective legislative acts are of vital importance.

Overall, the Armenian Government considers the PRSP scenario congruent with the requirements of the National Programme for implementation of the EU-Armenia PCA and sees sufficient prerequisites for efficient economic cooperation between Armenia and the European Union.

To be able to reach the target indices for future development of the financial system and state governance systems as presented in Table 9 within the set timeframes, the Government will develop and start implementing 2 comprehensive long-term programmes in 2006: financial

sector development programme (jointly with the Central Bank of Armenia) and improved state governance programme.

As for the levels of state budget revenues and expenditures, as well as the scale of the securities market, their projected values will not be able to place Armenia within the comparison range in the period of 2006-2015. In this respect, realization of the PRSP projections will be the primary priority.

Appendix: Clustering

Cluster	Country
1	Slovenia
2	Czech Republic Estonia Hungary Poland Slovakia
3	Bulgaria Latvia Lithuania
4	Romania Armenia

Note: Two-step clustering method has been used (based on BIC criteria)

The following indicators have been used for grouping:

1. Private sector's share in GDP (%)
2. Foreign trade and currency liberalisation index (1-4.3 points)
3. Anti-monopoly policy index (1-4.3 points)
4. Domestic lending through banks (% EU average indicator)
5. Non-banking financial institutions reform index (1-4.3 points)
6. Infrastructure reform index (1-4.3 points)
7. Per-capita GDP, PCA (% corresponding EU indicator)
8. Average annual inflation rate (% EU average indicator)
9. Ratio of value-added generated in industry and agriculture (% EU average indicator)
10. External debt (% GDP)
11. Consolidated budget balance (% GDP)
12. Population (% EU population)
13. Average distance of capital from the EU capital cities (km)
14. Rule of law index (% EU average indicator)
15. Corruption oversight index (% EU average indicator)
16. Governance efficiency (% EU average indicator)
17. Number of refugees by place of origin