



BLACK SEA TRADE AND DEVELOPMENT BANK

ARMENIA

Country Strategy

2011-2014

THESSALONIKI
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Table 1: Basic Macroeconomic Indicators at a Glance for ARMENIA

Key Long Term Foreign Currency Sovereign Risk Rating at 28 February, 2011:

Moody's: Ba2 | S&P: Not Rated | Fitch: BB-

		2007	2008	2009	2010	Proj. 2011	Proj. 2012
1	Population (Million)	3.2	3.2	3.2	3.3	3.3	3.3
2	Avg Exch. Rate (Dram/ US\$)	342.1	306.0	363.3	373.7	373.7	373.7
3	Inflation (CPI Avg.)	4.4%	9.0%	3.4%	8.2%	8.7%	4.9%
4	Average monthly wages (US\$)	217.0	286.0	264.0	291.3	302.9	313.3
5	GDP (Dram billion)	3,149.3	3,568.2	3,102.8	3,462.0	3,790.6	4,093.9
6	GDP US\$ million	9,206.3	11,662.0	8,541.1	9,265.0	10,145.0	10956.0
7	GDP per capita (US\$)	2,853.3	3,606.1	2,686.0	2,847.0	3,108.0	3,343.0
8	Real GDP growth, %	13.7%	6.9%	-14.2%	2.1%	4.6%	4.1%
9	Official Unemployment (end of period) %	7.1%	6.3%	7.0%	7.0%		
10	Industrial Production Growth, %	2.8%	2.1%	-7.9%	10.0%	4.4%	7.6%
11	Agricultural Production Growth %	10.4%	3.3%	-0.1%	-15.7%	9.8%	3.5%
12	Domestic Credit Growth %	93.4%	59.1%	-1.0%	42.1%	21.3%	9.2%
13	Domestic Credit/ GDP	13.1%	18.3%	20.9%	26.6%	29.5%	29.8%
14	Foreign Direct Investment - \$US million	698.8	925.2	725.0	569.0	683.0	785.0
15	FDI/ GDP	7.6%	8.0%	8.5%	6.1%	6.7%	7.2%
16	Consolidated Budget Balance/ GDP, %	-1.5%	-0.7%	-7.7%	-5.1%	-3.9%	-2.8%
17	Total External Debt- US\$ million	2,909.2	3,370.6	3,544.5	4,206.2	5,726.2	6,742.2
18	Total External Debt/ GDP	31.6%	28.9%	41.5%	45.4%	50.8%	51.6%
19	Public External Debt/GDP	15.7%	13.5%	34.7%	35.6%	37.1%	35.5%
20	Private External Debt/ GDP	15.9%	15.4%	6.8%	9.8%	18.0%	23.0%
21	Exports- \$US million (Goods)	1152.3	1057.2	710.2	1011.4	1171.2	1370.0
22	Imports- \$US million (Goods)	3267.8	4426.1	3321.1	3782.9	4013.6	4294.0
23	Trade Balance \$US mn (Goods)	-2115.5	-3368.9	-2610.9	-2771.5	-2842.4	-2924.0
24	Trade Balance/ GDP	-23.0%	-28.9%	-30.6%	-29.9%	-28.0%	-26.7%
25	Current Account Balance \$US mn	-589.6	-1382.9	-1369.5	-1300.0	-1108.0	-1131.0
26	Current Acct. Bal./ GDP	-6.4%	-11.9%	-16.0%	-14.0%	-10.9%	-10.3%
27	Forex Reserves (end period- exc gold) US\$ m	1,659.1	1,406.8	2,003.4	1,859.0	1,693.0	1,506.0

Sources: Central Bank of Armenia, National Statistical Service of the Republic of Armenia, IFS –IMF February 2011, IMF Republic of Armenia: 2010 Article IV Consultation, First Review Under the Extended Financing Facility and Extended Credit Facility, and Request for Modification of Performance Criteria, Report No. 10/350 December 2010, EIU Country Report- Armenia November 2010.

I. Recent Economic Developments and Outlook

a. Real Sector

After suffering a precipitous economic decline in the aftermath of the break-up of the USSR between 1991-1993, Armenia enjoyed a 15 year period of high and positive GDP growth between 1994-2008. Over this 15 year period, real annual growth averaged 8.9%, a figure which accelerates to 11.9% for the eight year period from 2001-2008. Armenia's growth began from a low base, and initially represented recovery from the economic collapse of the early 1990s, but it proved enduring and broad-based across the entire economy. Fueled by emigrant remittances, diaspora capital, official assistance (international financial institutions- 'IFIs'- and donors), as well as foreign direct investment (FDI), the economy grew on the strength of rapid expansion of construction- which peaked in 2008 at 25.3% of GDP- and services sectors such as telecommunications, transport, and retail trade. The industrial and agricultural sectors also grew during this period, but more moderately and in the case of the latter with greater year to year fluctuations due to external and weather based factors.

The global financial crisis in September 2008 and subsequent economic downturn brought a sudden halt to the period of growth in Armenia. Since the country's financial sector is small and insulated from international capital markets, Armenia's banks suffered little damage in the first instance from the panic and freezing of global markets. However, the ensuing economic downturn proved quite severe, as Armenian GDP contracted by -14.2% in real terms in 2009, after posting growth of 13.7% in 2007 and 6.9% in 2008. This 'turnaround' of -21.1% between 2008 and 2009 was the largest single year negative swing in all of Eastern Europe, which as a whole suffered a GDP contraction of around 6%. Even though the financial sector had low exposure to the global crisis, a sharp decline in exports, remittances and other external inflows, resulted in a crisis of confidence and in sharp declines in private demand and investment. As a result, construction declined by approximately -42%. Significantly, the downturn exposed Armenia's high degree of dependence on external inflows, especially remittances which are equivalent to 15-20% of GDP but tend to be volatile, since they in turn depend on economic activity in the source country. The downturn also underscored a key vulnerability of Armenia's growth strategy and the underlying competitiveness of the economy, as these proved highly dependent on non-tradable goods such as construction and services, and commodity exports such as metals which often experience volatile price fluctuations.

The government responded rapidly with (i) a significant increase in spending in order to limit some of the worst effects of the downturn and to make up for a portion of the decline in private consumption and investment, and (ii) a return to a flexible exchange rate regime in order to restore external balance more rapidly. Fortunately, the crisis proved short-lived, aided by an upturn in commodity prices in late 2009 and 2010, as well as the recovery of the Russian economy, which is the principal source country for Armenian remittances. Industry grew by nearly 10%, while services also recovered and grew approximately 6%. However, agriculture, which still accounts for approximately 17% of GDP, suffered a decline of nearly -16% as a result of poor weather, and as a result overall GDP growth for 2010 was an estimated 2.1%.

Despite the 2008-2009 downturn, the sustained 15 year period of growth resulted in significant improvements in living standards. GDP per capita increased nine-fold between 1994 and 2008, the year at which it peaked at over US\$ 3600. Due to the downturn, it has receded somewhat and for 2010 is estimated at around US\$ 2900. This figure hides regional disparities, as urban areas, especially Yerevan, tend to be wealthier than rural areas.

After years of steady decline, unemployment rose during the crisis as mines closed and construction activity slowed down, even though the official rate shows stabilization at around 7%.

The incidence of poverty declined rapidly during the previous decade, from 56% in 1999 to 25% in 2007, while extreme poverty fell even more sharply, from 23% in 1999 to less than 4% in 2007. Much of the reduction occurred in rural areas and poverty has become shallower and less severe. As a result of the crisis, there was a reversal and the incidence of poverty increased, with projections suggesting that the increase could be on the order of five percent¹.

Despite the crisis, Armenia remains on track to achieve key Millennium Development Goals (MDGs) by 2015, which are more ambitious than global targets. In addition to the large declines in poverty rates, Armenia has achieved significant progress in infant mortality and maternal mortality, enrollment is virtually universal in primary schools, reforms to upgrade education quality are on track, as is improved access to water supply. Armenia lags further behind targets in areas such as promoting gender equality, combating communicable diseases, improving access to sanitation facilities and ensuring environmental sustainability, although the goals remain within reach.

b. Public Sector and Fiscal Policy

The linchpin of Armenia's stable macroeconomic environment which permitted rapid economic growth in the years through 2008 was improving fiscal performance relying primarily on expenditure constraint. The Government held expenditures steady at around 20-22% of GDP and the fiscal deficit in the years prior to the crisis was consistently below 2% of GDP. Interestingly, the Government experienced difficulties in improving tax revenues, which at around 14-17% throughout the period are low by international standards; external grants and official assistance for capital investments bridged most of the remaining gap.

In response to the onset of the economic downturn, the Government undertook a fiscal stimulus in order to counteract the output contraction. The budget deficit swelled from -0.7% of GDP in 2008 to -7.7% of GDP in 2009, as the Government sought to sustain demand and ensure the provision of essential services. Government expenditures increased from 22.7% of GDP in 2008 to 29.9% of GDP in 2009, while tax revenues declined from 17.4% to 16.8% of GDP, which denotes a significant drop due to the sharp contraction of GDP. The expenditure increase was focused on activities that protect or create jobs (such as public investment works) and towards social programs/ safety nets. Significantly, it deferred non-priority recurring expenditures and avoided permanent tax reductions, meaning that reversing the stimulus would be easier. To finance the stimulus, Armenia agreed to a Standby Arrangement with the IMF in the amount of \$540 million in March 2009.

With the economic recovery taking hold in 2010, the Government's emphasis shifted to fiscal consolidation in order to reduce the deficit and to address a sharp rise in public debt levels. Spending cuts resulted in a decline of public expenditure to an estimated 27.2% of GDP, led by a cut of 9.2% in capital projects. Tax collection also showed improvement, rising by approximately 14%. As a result, the Government's budget deficit for 2010 declined to -5.1% of GDP. Reform efforts have also been intensified in order to broaden the tax base and to crack down on tax evasion and informal sector activity.

¹ World Bank, Country Partnership Strategy for the Republic of Armenia for the Period of FY09 – FY12.

c. Monetary and Financial Sector

Inflation in Armenia has been stable and low for well over a decade. It has consistently been in single digits and more often than not in the low single digits. In 2007-2008, the final years of the boom period, it accelerated to annual rate of 4.4% and then 9.0% as the economy showed signs of overheating, while global food and energy prices also spiked in 2008. However, with the onset of the economic downturn, inflation quickly receded to 3.4% in 2009. It picked up again in 2010, as a result of a combination of domestic and external supply shocks, especially with respect to food prices which rose sharply due to a poor harvest. For the full year, it reached an estimated 8.2%. The moderate inflation is mainly the result of the commitment of the Central Bank of Armenia (CBA) to follow a tight monetary policy. The CBA has kept interest rates as high as necessary in order to keep inflation expectations low. It responded to the economic slowdown by cutting the refinancing rate by a cumulative 275 basis points in order to stimulate economic activity. As the economy recovered, it returned to monetary tightening, raising the rate by 225 basis points in 2010 and a further 50 basis points in February 2011, due to rising inflationary pressures.

In line with IMF recommendations, the CBA is in the process of moving to an inflation targeting monetary policy framework. For 2011, the CBA has a 4.0% (plus or minus 1.5%) inflation target. However, the low development of domestic capital markets and the high degree of dollarization limit the effectiveness of such a policy in terms of transmitting necessary signals to affect prices, and thus the CBA has also needed to take other measures directly such as targeting growth levels in the domestic money supply, an effort which it has managed despite the challenges posed by large and fluctuating inflows of external financial support and remittances.

Between 2004 and 2008 the Dram appreciated by over 40% against the dollar, on the strength of growing capital inflows, rising demand for the Dram and credible and relatively tight monetary policy. Even though the Dram officially floats in a flexible exchange rate regime, the CBA has also used the exchange rate in order to manage monetary policy. Authorities from time to time intervene to influence the exchange rate in order to counter inflationary pressures. Furthermore, they supported the Dram heavily after the outbreak of the 2008 financial crisis, resisting depreciation pressures in order to support the domestic banking sector against sudden devaluation (giving banks time to adjust). The policy resulted in net losses in international reserves of approximately US\$ 500 million and was eventually abandoned with a return to a flexible exchange rate regime in March 2009, which in turn resulted in a depreciation of around 20% against the dollar. The Dram stabilized, however, since then and declined an additional three percent over the course of 2010.

After several years of declining dollarization- by end 2007, dollarization in bank deposits as a share of total deposits had fallen to 35.7%- one important, and negative, consequence of the global financial and domestic economic crisis was a loss of confidence in the Dram and a return to greater use of the dollar. By end 2009, dollarization in deposits had rocketed to 68.5% and it peaked at around 73% in early 2010, before receding slightly over the remainder of the year. This has had an adverse impact on (i) lending in Dram, since the high dollarization of deposits has led banks to seek to minimize their risks and to balance their foreign currency positions, and (ii) the transmission mechanism of monetary policy, since rate setting by the CBA for Drams ends up having less of an impact. Authorities are committed to promoting dedollarization, and recognize it depends upon maintaining a track record of macroeconomic stability

Banking Sector & Capital Markets

Armenia has a two tier banking system, with the Central Bank of Armenia (CBA) acting as the central regulator of banking activity and ensuring the stable functioning of the banking system.

Departments within the CBA also supervise other financial institutions, such as credit organizations and currency exchange offices. At the end of 2010, there were 21 banks active in Armenia, all of which are privately owned. All 21 had some degree of foreign equity participation, and 14 were majority foreign owned (12 with more than 95% of their capital owned by foreigners). There were also 32 credit organizations (10 majority foreign owned), and 11 insurance companies (six majority foreign owned) active.

Armenia has the smallest banking sector in the BSEC region, as measured by the level of credit to GDP. Armenian banks were also relatively insulated from the global market. Therefore, they suffered little damage as a result of the 2008 global financial crisis, and in any event were small enough that the impact on the economy was also limited. During the high growth era, non-performing loans (NPLs) stood at approximately 2-2.5% of gross loans. At the peak of the crisis in early 2009, NPLs rose briefly to over 10% of gross loans, but have subsequently declined and at end 2010 stood under 5%. Losses were easily absorbed because capital and liquidity ratios of Armenian banks are extremely high (the aggregate capital adequacy ratio is around 30%), while leverage ratios are low. The deposit base expanded during the crisis and has continued doing so during 2010, albeit primarily in foreign exchange (dollar), not dram deposits.

Nurturing the domestic financial system and increasing levels of financial intermediation has long been a priority of the government, in order to boost investment on a sustainable basis and to reduce reliance on more volatile sources of financing such as external official assistance or remittances. To this end, the CBA has created a solid regulatory framework under its unified supervisory regime for the financial sector, and enforces the Basel principles. The government has also undertaken a number of related reforms to improve the business environment in order to boost financial activity. In recent years, this includes measures to strengthen creditor rights, improve civil procedures for debt recovery, simplify certification procedures for property sales and registration of secured credit, and establish a facility for registering pledges of movable property in the central cadastre registry.

The Armenian Stock Exchange (ASE) was established in 2000 in order to help develop capital markets in Armenia and provide an option to Armenian companies seeking to mobilize financial resources. To date, it has not played a significant role in helping firms access financing. Even though it lists numerous firms, market capitalization and trading volumes remain low and are primarily concentrated in treasury bills. The ASE was purchased in 2007 by the Nordic exchange operator OMX Group, which in turn merged in March 2008 with the US NASDAQ exchange. Along with ASE, the purchase included the Central Depository of Armenia, and in January 2009, they were renamed NASDAQ OMX Armenia. The CBA is the regulatory authority for the stock exchange and securities market, and instruments traded include stocks, corporate bonds, government and CBA bonds, currency, and repurchase agreements (Repos) on corporate securities.

d. External Sector

Debt

Following independence, Armenia accepted Russia's 'Zero Option' offer, renouncing its share of Soviet external assets in favor of Russia, and in return inheriting no Soviet era debt. From this zero base, Armenian debt reached 49% of GDP at the end of 1999, a result of borrowing at high interest rates and enterprise arrears on energy imports which were consolidated into inter-governmental debt. This necessitated a restructuring of Government debt and shifting to

concessional borrowing from the IMF and the World Bank's IDA facility. In combination with macroeconomic stability and high growth, Armenia succeeded in reducing its public debt levels to approximately 18.1% and 16.4% of GDP in 2007 and 2008, almost all of which represents external borrowing from official sources, the majority of it concessional.

However, the fiscal stimulus in response to the 2009 downturn forced the Government to undertake extensive foreign borrowing, chiefly via the US\$ 540 million non-concessional SBA with the IMF. The SBA was partially drawn down, but then cancelled in June 2010 and replaced by a joint three-year Extended Fund Facility (EFF) and Extended Credit Facility (ECF) amounting to a total of approximately US\$ 395 million, which was concessional relative to the SBA. Public debt ballooned in 2009 to 39.5% of GDP and rose further in 2010 to 40.7% of GDP, and on current trend is expected to peak at 41.3% of GDP in 2012, before beginning to come down again. Even though around 95% of the debt is owed externally, most of it is concessional in nature and owed to the IMF and international financial institutions or other official sources. Consequently, debt servicing is modest in relation to external earnings and fiscal revenues, although Armenia will face a 'bunching' of debt service obligations that rise to more than 8% of projected export receipts in 2013.

In contrast to other Eastern European countries, Armenia avoided downgrades to its sovereign credit ratings during the 2008 financial crisis, although in August 2009 it did receive a one notch downgrade from Fitch to BB-, due to the slowdown in the economy and the increase in public debt levels. However, the situation has stabilized and Moody's left Armenia's ratings untouched throughout the crisis at Ba2, a rating which was re-affirmed, with stable outlook, in February 2011.

Trade and the Current Account

After slumping by around 26.5% in 2009 relative to 2008, Armenia's international trade rose 18.9% in 2010. Export growth was particularly impressive at 42.4%, as external demand for Armenia's main exports recovered after dropping sharply the previous year. The value of the largest export item, base metals and metal products, rose by 43.8% while exports of mineral products, the second largest item, increased by an even more impressive 89.9% on the strength of both greater volume exported and higher global prices. Other key export items showed considerable growth as well: precious stones and metals increased by 27.6% in 2010, led by the diamond processing industry, and prepared foodstuffs rose 31.7%. Imports also grew, more moderately but from a much larger base to begin with. Import growth reached 13.9% and was led by mineral products (including energy), machinery and equipment, base metals and transport equipment. The European Union collectively is Armenia's largest trade partner, accounting for approximately 32% of total trade turnover.

Import levels typically are three to four times higher than export levels, resulting in structural trade deficits above 20% of GDP. One key reason for the deficit is that Armenia is resource poor, especially in energy, and thus needs to import a substantial portion of its energy needs. A second key reason involves the significant role of remittances in the Armenian economy. A substantial portion of the Armenian working age population lives outside the country and supports family members back home via remittances. Typically, remittances total between 15-20% of GDP, and have become as a key form of poverty alleviation for Armenian families over the years, and most of the transferred money is used for consumption, including imported goods, thus increasing the trade deficit.

Despite ongoing geopolitical conflicts which limit the ability of Armenia to develop closer trade ties with some of its immediate neighbors, Armenia's trade volume with other BSEC countries has grown more rapidly than its trade with the rest of the world. By 2009 (the latest year for which comprehensive country by country figures are available), Armenia's trade turnover with the rest of

the BSEC region had grown by 380% relative to 2000, whereas Armenia's trade turnover with the rest of the world over the same period had grown by 240%. The higher trade growth was observed both in exports (239% growth to BSEC countries vs. 136% growth overall) and imports (416% growth from BSEC countries vs. 275% growth overall). As a result, the share of BSEC trade as a proportion of total Armenian international trade grew from 28.9% in 2000 to 40.7% in 2009, and the drop in trade in the crisis year of 2009 relative to the last boom year of 2008 (when trade peaked) was smaller with the other BSEC countries than the overall decline.

In terms of export destinations, preliminary data for 2010² shows that Russia was the largest market for Armenian products absorbing approximately 15.9% of total exports, followed closely by Bulgaria which accounted for approximately 15.5% of exports. Other BSEC export destinations of note for Armenia are Georgia and Ukraine. Russia is the largest origin of imports, accounting for 22.1% of the total for 2010, primarily for energy and energy related products as well as for other raw materials. Ukraine at 6.1%, and Turkey at 5.6% are respectively the third and fourth largest sources of imports from the BSEC Region, with Bulgaria, Romania, Georgia and Greece also import originating markets of note, albeit on a smaller scale.

Armenia's current account deficit peaked at -16.0% of GDP in 2009 before improving in 2010 to -14.0%. It is less than half the size of the trade deficit but is still sizeable. During the boom years the current account deficit had improved substantially, to less than -2% of GDP between 2004-2006. However, as the real exchange rate appreciated and the economy showed some signs of overheating in 2007-2008, followed by the sharp contraction in 2009 with collapsing export demand (and declining remittances), the current account deteriorated. It has been financed mainly through donor assistance and foreign direct investment.

Foreign Direct Investment

Even during the 2009 downturn and its aftermath, Armenia suffered a much lower decline in foreign direct investment (FDI) than other countries in eastern Europe. After peaking in 2008 at US\$ 935 million, or 8.0% of GDP, FDI declined by 22.5% in 2009 to US\$ 725 million- a figure which represented an increase as a share of GDP to 8.5% due to the large decline of GDP and the devaluation of the Dram. FDI declined by 21.5% in 2010 to US\$ 569 million, or 6.1% of GDP. These figures come against a relatively low GDP base, but they do underscore the success of Armenia in recent years in attracting significant levels of FDI in sectors such as mining, energy, and real estate.

This in no small part is due to the fact that Armenia's business environment has improved in recent years, as also captured in the World Bank's annual *Doing Business* reports in which Armenia has achieved substantial progress between 2006 and 2010 as a reforming country. For 2010, it is ranked 48th out of the 183 total countries surveyed. In the nine categories covered by the survey, Armenia is a top ten performer in the area of registering property (5th overall). It is also in the top quartile in the area of starting a business (22nd). It is in the second quartile in most categories, including obtaining credit (46th), closing a business (54th), enforcing contracts (63rd), dealing with construction permits (78th), and trading across borders (82nd). It is just below in the area of protecting investors (93rd), while it ranks in the fourth quartile in the area of difficulty and cost of paying taxes (159th).

Another indicator of country risk and business environment in which Armenia is rated is *Euromoney* magazine's country risk score which has risen (improved) substantially over the years,

² EIU Armenia Country Report, February 2010

coming in 49.0 (out of a perfect score of 100) in September 2010, which ranks slightly below the average for the BSEC region of 52.6 and below the EU average of 75.0.

e. Forecast for 2011-12

For 2011, real annual GDP growth in Armenia is projected to rise to 4.6% as a result of the ongoing recovery in industrial production, increasing global commodity prices for metals, and a recovery in the agricultural and construction sectors which are expected to rebound after their recent downturns. Stronger than expected growth in Russia, an important source of remittances and FDI as well as Armenia's main trading partner, may well lead to even higher rates of growth. For 2012, projections are similarly for real GDP growth on the order of 4.1%, with growth in years further out likely to be in the 4-5% range. While these rates fall short of the double digit figures enjoyed during much of the previous decade, they represent a solid recovery from the sharp contraction of 2009, and should prove sustainable and more immune to overheating. The latter is significant since, as a result of the 2009 economic downturn, the Government not only seeks to achieve growth, but also to ensure stability and to reduce Armenia's vulnerability in the future to shocks and to mitigate their adverse effects. The projected growth will permit resumption of the lengthy and ongoing process of convergence to the higher living standards of western Europe, which the Government seeks to achieve, even if it is at a slower pace than during the boom periods of the previous decade.

Fiscal consolidation will remain a priority in order to ensure macroeconomic stability, and it should continue within the framework of the SBA with the IMF, with the deficit expected to fall further to -4.3% of GDP in 2011 and -3.3% of 2012, towards the long term target of a fiscal deficit of -2.0% of GDP. Inflation will be vulnerable to changes in global prices, but is expected to decrease to around 6% annually. The current account deficit is expected to linger in the around -10% of GDP.

In October 2008, the Government approved a *Sustainable Development Program (SDP)*, which contains three key objectives for the period 2009-2021: (i) reducing poverty, including the elimination of extreme poverty, (ii) ensuring human development, and (iii) deepening economic growth and accelerating development of lagging regions. Although it is under revision in light of the subsequent economic downturn, its key directions remain the same even though specific targets were revised. Economic policy priorities of the SDP include:

- a targeted territorial policy to mitigate the 'territorial development disproportions';
- undertaking of "second" generation reforms to ensure the modernization of Armenia and convergence to the standards of more developed countries
- policies aimed at ensuring free economic competition and monopoly limitation
- policies aimed at increasing the country's competitiveness
- export promotion and increase of the country's involvement in the global economic system, including intensification of EU integration process within the ENP
- intensive adaptation of the country's economic institutions and legislation to EU requirements and standards;
- establishment and development of new and knowledge based economy's key elements and institutions.

II. Overview of Current BSTDB Portfolio

As of 31 December, 2010, the active BSTDB portfolio in Armenia amounted to 10 operations approved by the Board of Directors (BoD), involving an investment of € 52.7 million (US\$ 69.9m). All 10 operations were signed for € 52.7 million (US\$ 69.9m) and the outstanding disbursements were at € 39.5 million (US\$ 52.3m). Armenia ranks ninth as a destination for operations by BSTDB, in terms of BoD approved operations, with 4.6% of the total portfolio, ninth in terms of signed operations, with 5.2% of the total portfolio, and sixth in amounts outstanding, with 5.9% of the total portfolio.

The Bank has made concerted efforts to identify suitable operations for financing in Armenia, and it has been one of the main beneficiaries of the increased emphasis placed on finding operations in small shareholder countries. Relative to the Bank's active portfolio at the end of 2006, Board approvals increased by 103%, signings by 137%, and amounts outstanding by 92%.

Table 2: Active BSTDB Portfolio in Armenia as at end December 2010

All Figures in Euros Million	BoD Approval Date	Approved Amount	Signed Amount	Amount Outstanding
Rusal	30-Jul-05	17.4	17.4	13.3
ACBA- Credit Agricole Bank SME	23-Jul-10	2.3	2.3	2.3
Beer of Yerevan*	15-Apr-06	2.1	2.1	0.7
Inecobank	16-Apr-10	2.3	2.3	2.3
Euroterm*	27-Apr-07	3.0	3.0	1.9
ACBA- Credit Agricole Bank SME	27-Jul-07	7.5	7.5	4.2
SAS Group	1-Dec-07	5.7	5.7	5.2
Armeconombank	1-Dec-07	3.8	3.8	2.1
Natfood	4-Apr-08/ 23-Jul-	6.4	6.4	5.3
Next Store Chain	23-Jul-10	2.3	2.3	2.3
Total		52.7	52.7	39.5

III. Review of Country Strategy 2007-2010

The current evaluation was performed by the Bank's Evaluation Office as per the respective Evaluation Policy. It reveals the performance of the Bank's 2007-2010 Country Strategy for Armenia. Its goal is to provide accountability to the Board of Directors and Board of Governors as well as facilitate the decision-making by the Bank's Management and Boards on the eventual update of the country strategies.

The evaluation of the respective country strategy compares the stated targets with actual results as of end of 2010, and provides a country-oriented analytical picture. A mid-term evaluation of the Country Strategy was conducted in early 2009 and reported to the Board of Directors and Board of Governors in June 2009, as part of the Annual Evaluation Overview, issued by the Evaluation Office.

Performance of Armenia Country Strategy 2007-2010

The 2007-2010 Country Strategy was approved by the Board of Directors in early 2007, reflecting an in-depth independent evaluation of the implementation of the BSTDB's earlier

strategies, conducted by the Evaluation Office in late 2006. It was aligned with the objectives of the Bank's Business Plan 2007-2010 and was therefore evaluated in that context.

Overall, the implementation of the Country Strategy was consistent with the Business Plan implementation. The performance of the strategy is rated as Satisfactory, as the targets were implemented at about 100%, including the intended sector coverage. For a more comprehensive overview, see Annex I.

IV. BSTDB Operational Priorities for 2011 - 2014

The Bank's role and priorities are defined (i) in accordance with the priorities and targets laid out in its *Medium-term Strategy and Business Plan 2011-2014* and (ii) country needs and objectives, as well as (iii) available resources, strategies and policies of BSTDB. In this respect, BSTDB will seek viable opportunities and will continue closely monitoring the developments in the Armenian economy in order to stand prepared to support bankable projects. In addition the Bank shall seek co-financing opportunities with IFIs, public sector institutions and private partners.

BSTDB will focus in the next four years on providing support for the implementation of the Government program and priorities, while responding to market demand. The Bank will consider undertaking activities and providing services as may advance its purpose, paying special attention to activities promoting export of goods and services, and development of infrastructure, including energy efficiency. In addition, through selected intermediaries, the Bank would attempt to expand its financing programs in favor of SMEs.

Based on the 2011- 2014 BSTDB Business Plan, the Bank would expect on average to approve one new operation per annum during this period, for approximately € 10-15 million per year. Over the four year period, this implies around four approved operations for approximately € 51 million. With the Bank determined to raise the level of commitments (signed operations) to approved operations to over 85%, the Bank expects signings for 2011-2014 to be on the order of four operations for € 44 million (a range of € 9-13 million per annum).

These indicative targets are based on the Base Case Scenario of the MTSBP, and given appropriate circumstances and sufficient operational opportunities the Bank would make efforts to exceed this level. In case of higher regional economic growth rates, increased demand for Bank funding, and an improved situation in financial markets, a phased increase in the average number and size of operations would allow the Bank to move towards achieving the targets envisaged under the High Case Scenario. Moreover, at the Mid-Term Review, depending upon performance and prospects, the above targets may be revised upwards³.

In line with the Bank's strategy to increase operational activity in smaller shareholder countries, the Bank will insist that all operations meet criteria of sound banking principles on the one hand, and financial viability/ economic sustainability on the other hand. Within these parameters, the Bank will explore the possibility of taking on additional risk- or risks- in order to facilitate the undertaking of additional operations. The greater 'reward' that justifies the acceptance of more risk is that the Bank would participate in a larger number and volume of operations in smaller countries,

³ Under no circumstances would targets be revised downwards unless the lower case scenario of the 2011-2014 BSTDB Business Plan were to be followed.

and thus better fulfill its mandate to promote economic development, especially where needs are greatest.

Areas for BSTDB Financing

Financial Sector

The financial sector will be a priority area for Bank activities for a number of reasons. The level of financial intermediation in Armenia remains low, despite reforms and improvements in the legal and regulatory framework of the sector.

The Bank will seek to increase the number of financial intermediaries with which it works, and also to expand its range of products (and increase lending amounts and tenors) with the ones performing satisfactorily. In addition, the Bank will help banks to support promising small and medium enterprises (SMEs) making available longer term financing to fast growing SMEs.

As SME development is a core priority for the Government, in the short-term the Bank will focus on financing to eligible intermediaries with developed branch networks with emphasis on SME financing. BSTDB will also seek other ways to support SMEs, and will be open to other forms of cooperation with intermediaries, including involvement in investment funds or innovative special purpose structures.

The Bank will focus on participation in equity funds which would in turn invest in the equity of local SME companies which otherwise would not be able to access BSTDB financing.

In the forecast period the Bank anticipates increase in the exposure to the financial sector in Armenia by about Euro 25 million. Financial viability remains an essential precondition, but the Bank will also seek to mobilize technical assistance resources to facilitate innovation, creative structuring, and help to upgrade managing practices and governance.

Manufacturing and Enterprise Sector

Given the size of the Armenian economy and its domestic market, the majority of private sector manufacturing enterprises are small and medium businesses with limited debt carrying capacity. Structuring small size financings in the range from Euro three to five million in accordance with BSTDB requirements is too expensive and time consuming for the local companies and, unless priced at market rates, such operations are not cost-effective for the Bank. The local commercial banking sector is much better positioned to service the needs of local SMEs. Besides, given the limited staff of the Ban, it lacks resources relevant for developing direct lending activities in this sector. Thus, during the next four years the Bank's portfolio related to financing of SMEs will gradually decline as the existing outstanding loans are amortized. The most feasible approach in maintaining its presence in the SME sector of Armenia could be extending additional financing to existing clients of BSTDB, i.e. SMEs, which are already in compliance with requirements of the Bank and have a credit history with BSTDB.

The real estate development sector of Armenia is the most frequent source of large-scale projects. High risks associated with financing of the real estate sector necessitate a careful screening and selection of projects eligible for BSTDB financing. The major criteria of a bankable real estate development transaction are (i) the availability of a financially strong sponsor(s) committed to support the project and bring it to successful completion, and (ii) reasonableness of the scale of the investment, which corresponds to realistic estimates of the market demand. The Bank will undertake steps directed at identifying bankable transactions in the real estate development sector of Armenia applying the aforementioned general criteria.

Another area with potential large-scale investment opportunities is the minerals and mining sector of Armenia. The Bank will investigate opportunities for its potential involvement in this sector during the period covered by the Strategy.

BSTDB transport and manufacturing strategy in terms of banking instruments:

- Project Finance limited recourse transactions;
- Continuing emphasis on financing in the form of equity and quasi-equity instruments;
- Co-financing with other international financial institutions, Russian and foreign commercial banks;

Areas of particular focus in the transport and manufacturing strategy:

- Minerals and mining, manufacturing of fast moving consumer products, food processing industry;
- Real estate development, including development and operation of wholesale and retail trade distribution networks, warehouse facilities and logistics centers, office space, tourism, recreation and catering facilities.

Energy and Infrastructure (E&I)

Given existing E&I development needs, so long as projects are ‘bankable’, the Bank will be keen to offer support. This applies to all key infrastructure sectors, including energy (especially renewable) and electricity, transport infrastructure, telecommunications, and municipal infrastructure. The existence of an appropriate competitive environment and regulatory framework will be an important consideration in ascertaining ‘bankability’ alongside development impact.

BSTDB will be willing to explore whether the Armenian Government will be able to provide sovereign guarantees for E&I projects. Should a sovereign guarantee be necessary and possible, it would only be sought for an extremely high priority activity in which the guarantee would also serve as a signaling mechanism of the Government’s commitment to/ ownership of the operation in order to facilitate greater resource mobilization and broader participation.

In the case of consideration of financing at the privatization stage of any E&I objects, the presence of a strategic investor would be a key factor for the Bank, and the Bank’s assistance would likely come in the form of post-privatization financing to upgrade facilities and restructure. Other involvement in infrastructure operations will need to be via creative arrangements such as public-private partnerships.

The Bank will continue to ensure that all BSTDB E&I operations in Armenia meet sound banking principles and comply with the Bank’s Environmental Rules and Procedures and incorporate, where appropriate, Environmental and Social Action Plans

The Bank will also maintain its contacts with complementary international financial institutions (IFIs) and organizations such as EBRD, IFC, KfW, DEG, OeEB, etc. to seek ways to coordinate activities and share experiences.

BSTDB Energy and Infrastructure strategy in terms of banking instruments:

- Project Finance limited recourse transactions;
- Corporate recourse financing transactions;
- Exploration of financing in the form of Equity;

- Co-financing of transactions with other international financial institutions, and commercial banks;
- Participation in syndicated facilities for E&I deals in Armenia

Areas of particular focus in Energy and Infrastructure:

- Energy (including renewable),
- Electricity,
- Transport infrastructure
- Telecommunications,
- Municipal infrastructure

ANNEX I: Post Evaluation of 2007-2010 Country Strategy Armenia (approved 04.02.2007)				
2007- 2010 TARGETS			RESULTS (end of 2010)	
General	Sectors	Target operations: Number approved/ number signed; USD approved/ USD signed (million)	Actual operations: Number approved/ number signed; USD approved/ USD signed (million)	Evaluation Summary
<p>Finding 'bankable' operations;</p> <p>Private sector development, and improved corporate governance</p>	<p>Financial sector Trade finance credit lines; Increase the number of financial intermediaries and expand the range of products, lending amounts and tenors with satisfactorily performing intermediaries; longer term financing to fast growing SMEs Manufacturing and Enterprise Sector Finance agri-industry (such as processed foodstuffs), light industry (such as textiles), metals, engineering, precious and semi-precious stone processing, real estate development construction, information technology, tourism, mining, extraction. Infrastructure and Regional Cooperation Energy, transport, telecommunications, and municipal infrastructure Focus on regional cooperation, knowledge generation, introduction of new products or activities involving state of the art methodologies, and/or enhance the prospects for resource mobilization in the economy.</p>	<p>10/9 46/40</p>	<p>9/8 44/44</p>	<p>1. Volume: on target</p> <p>Approved number: 90% Approved volume: 96% Disbursed number: 89% Disbursed volume: 110%</p> <p>2. Sector coverage:</p> <p>Incombank (Trade Finance) ACBA I (SME) ACBA II (SME) SAS Group (Retail) Armeconombank (SME) Natfood (Retail) Euroterm (Manufacturing-Private) Next Store Chain (Retail)</p> <p>3. <i>Performance</i>: Satisfactory. Targets achieved, including sector coverage.</p>